

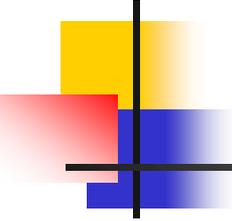
The eurozone crisis

Richard Portes

London Business School and CEPR

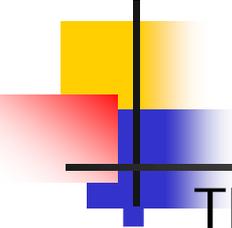
RIETI, Tokyo, 8 October 2013

*Revised version of presentations 18 April 2013 at Trinity College
Dublin, 14 May 2013 at Swiss National Bank - IMF conference,
Zurich, and 3 June 2013 at Trento Festival of Economics*



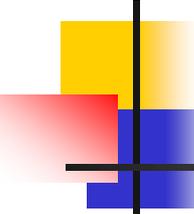
Out of the woods?

- 'US hedge funds turn bullish over Eurozone assets...US smart money is seeking opportunity in the belief that disaster has been averted.' (*FT* 14.05.13)
- 'Smart'? – the performance of hedge funds over the past decade has been below trackers, even before their much higher fees (*Economist* 22.12.12)...
- So now is the time to be *really* worried



It's pretty bad now...

- The unemployment rate across the euro zone was 12.0% in August, 0.2% below the highest rate recorded since records began in 1995
- The number of unemployed was 19.2 million, of whom 3.5 million were under 25 years old
- There are deep divisions within the 17-member euro zone: unemployment was just 4.9% in Austria and 5.2% in Germany, based on common European data standards. It was more than 25% in Spain and Greece.
- Higher taxes and reduced state spending in southern Europe have exacerbated already deep recessions, pushing joblessness sharply higher.
- The youth unemployment rate in Spain and Greece is around 60% and more than 40% in Italy.

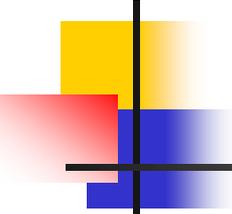


...but could get worse fast: major threats

- *Austerity fatigue* – a country might try to escape from its Troika programme or just exit from monetary union – then bank runs elsewhere, capital controls, disintegration
- *Bailout fatigue* – Germany exits (Finland?)
- Draghi's *Outright Monetary Transactions (OMT)* programme loses market credibility or is constrained by German Constitutional Court – then vicious spiral: spreads jump, fiscal burden of debt rises, so do bank funding costs, deeper contraction, spreads up further, debts unsustainable (see Giavazzi *et al.*, 2013)

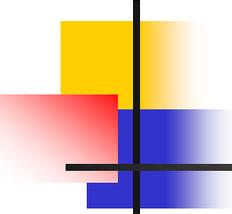
To see where to go, must correctly interpret how we got here

- EMU a success, confounding skeptics, *until global financial crisis* – though we knew long ago that it needed unified financial supervision and LOLR
- In crisis, banks and their creditors got bailouts, tax revenues down, deficits up, austerity policies, recession, further fiscal deterioration
- Basic problem was *not* intra-zone disparities in competitiveness, *nor* fiscal profligacy (except Greece), but rather the *capital flows* unleashed by monetary union and financial deregulation
- Now exit once again a threat (Cyprus), we have financial disintegration, financial intermediation doesn't work
- Macro: austerity and recession, can't grow out of debt, *'internal devaluation' is contractionary and unnecessary because competitiveness is not central*
- Cyprus affair casts serious doubt on decision-makers, and explicit capital controls are a major step towards collapse of EMU (though some had already been imposed by national supervisors)



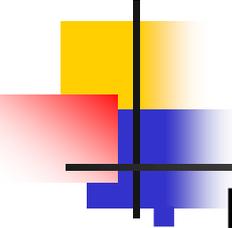
Elements of a solution

- Credible OMT conditional (only) on *independent* DSA (not Troika)
- Serious triage of banks, resolution of the weak, full recognition of NPLs and proper provisioning, burden on creditors not taxpayers insofar as possible
- Banking union: common supervision (not just for 'large' banks), common resolution mechanism – common deposit insurance can wait
- Financial re-integration, initiative to reopen flow of credit to SMEs
- More sovereign debt restructuring
- Euro zone running structural primary surplus, Bund yield is 1.80%, 5-yr inflation expectations 1.5%, 10-yr 2.0% →
- Switch to growth-oriented monetary and fiscal policies – expansion where there is fiscal space, infrastructure investment at EU level (EIB)
- *Not* austerity and lengthy internal devaluation ('a decade of stagnation'), *nor* fiscal union



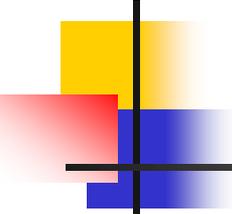
Causes – not violation of OCA criteria, nor fiscal excesses (except Greece), nor periphery's loss of competitiveness

- **Greece:** fiscal profligacy and duplicity, deep structural weaknesses, political polarisation, capital inflow
- **Ireland:** housing boom, capital inflow to (through) banks, crony capitalism (bankers and construction), then government guarantee of bank debts
- **Spain:** housing boom, capital inflow to construction, *cajas*/politics
- **Portugal:** product and labour market rigidities, poor education, uncompetitive production structure, capital inflow (financing current account deficit) wasn't used to modernise
- **Cyprus:** Banks bet on Greek debt, couldn't take haircuts



Capital flows were key

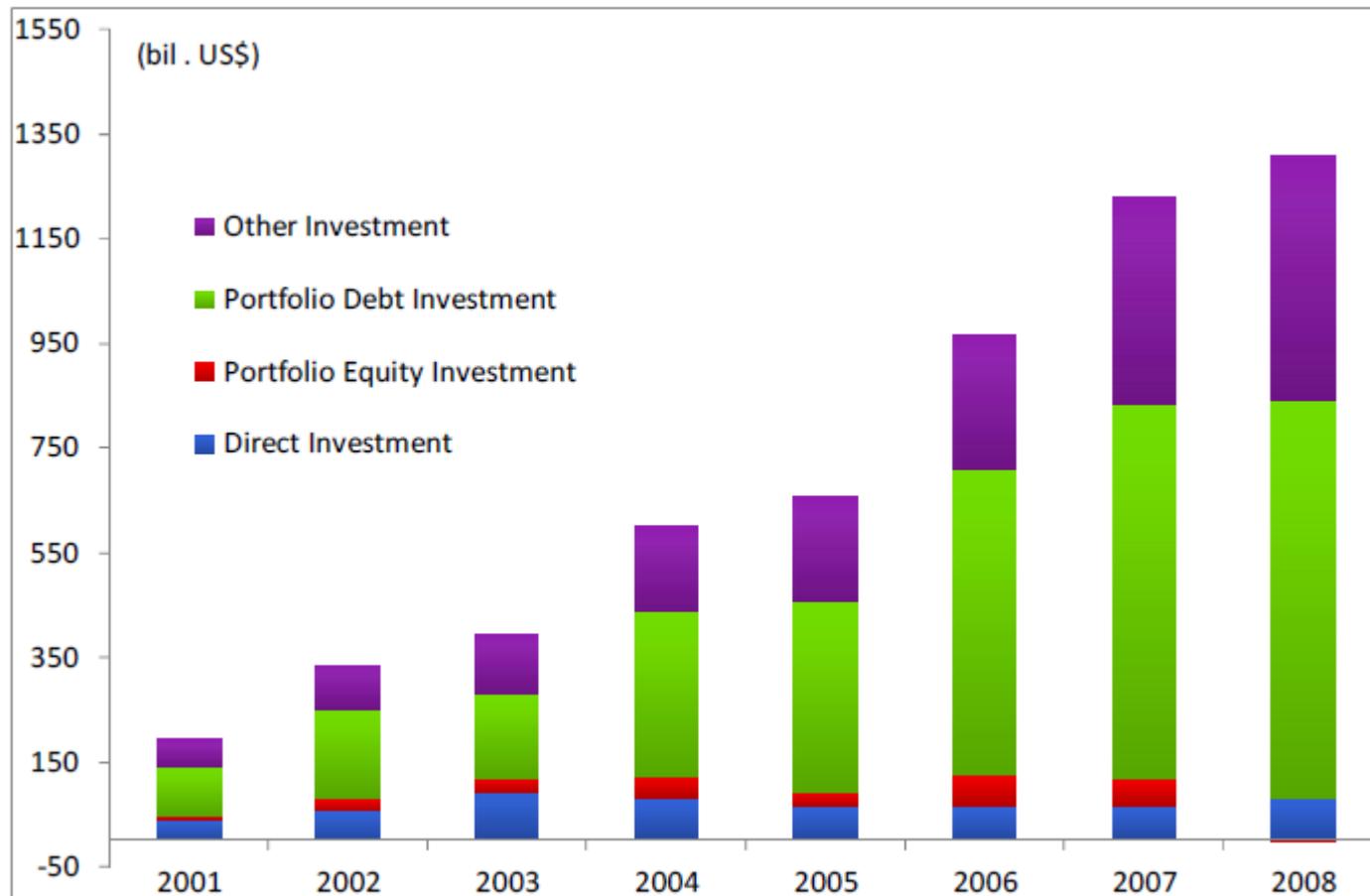
- From 2002, cross-border bank lending grew explosively. Euro eliminated currency mismatch on banks' balance sheets, so banks drew deposits from surplus countries in rapid expansion, while permissive bank-capital rules removed regulatory constraints (Shin 2011)
- So periphery experienced capital inflow 'bonanza' (mainly from Germany and France) pushing interest rates down and feeding excessive credit growth, with corresponding CA deficits and some accompanying real exchange rate appreciation
- Borrowing was private sector, not governments
- 'Walters critique' of monetary policy was right (Wyplosz 2013), and fiscal policy not used to offset it and combat overheating, nor 'macroprudential' measures



The problem today

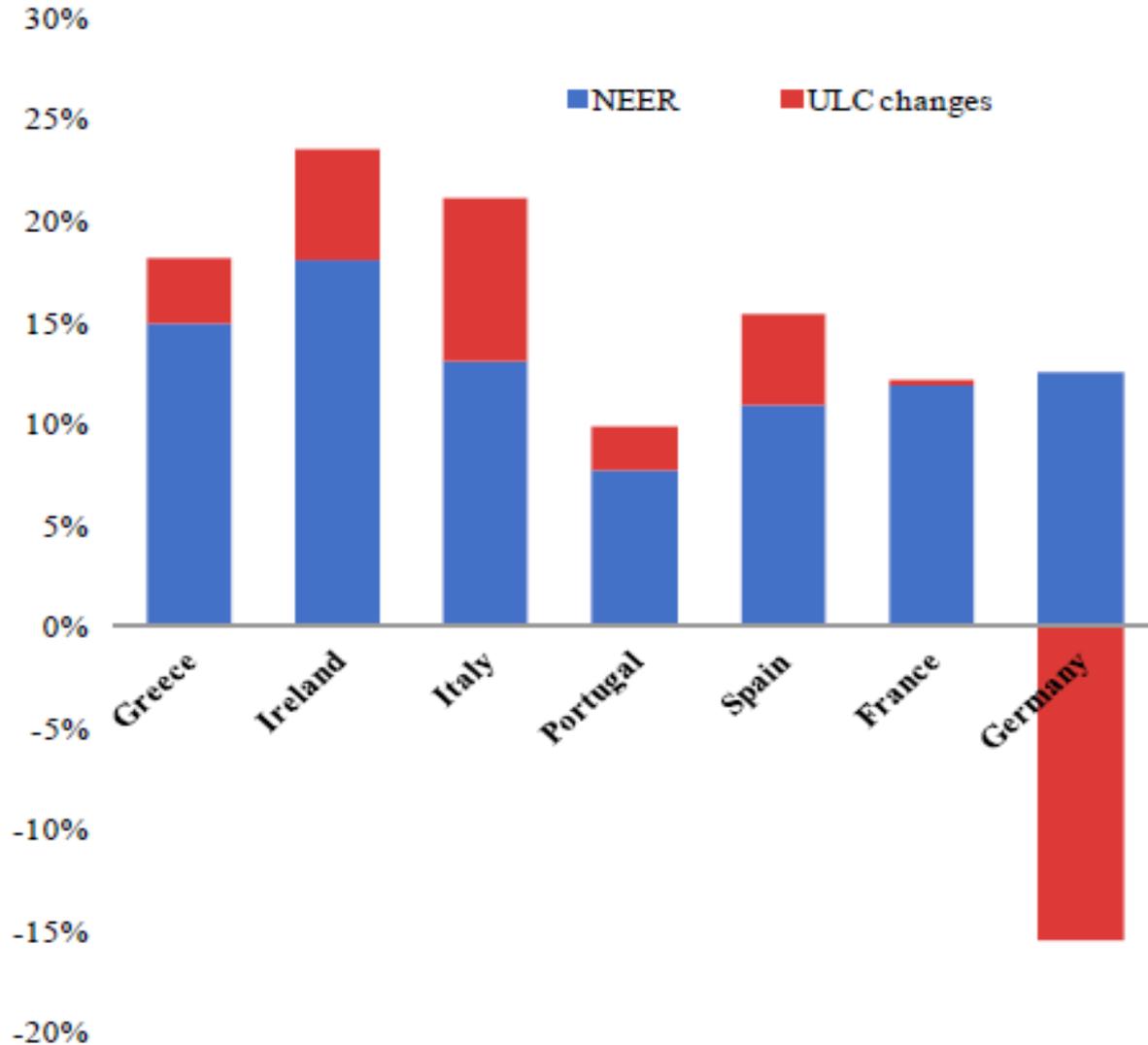
- The problem then and now is *not primarily 'competitiveness'* as measured, for example, by unit labour costs (Gros 2012, Wyplosz 2013)
- Indeed, export market shares did not deteriorate significantly for these countries in the 2000s, while since beginning of 2010, Spanish and Portuguese exports growing at over 10% annually
- Rather, we see mainly *fiscal consequences of crisis in bank-based financial systems*, where burden of balance-sheet deterioration is shifted from creditors to taxpayers of debtor countries
- We are told the necessary adjustment of the crisis countries (except Ireland) has been avoided by 'printing money' – this is the story of ELA and the TARGET2 balances (Sinn 2013) – if tempted to believe that, read Whelan (2013)

Huge capital flows from Germany and France to periphery were bank and portfolio debt, not FDI



Most of the real appreciation was due to nominal appreciation of the euro

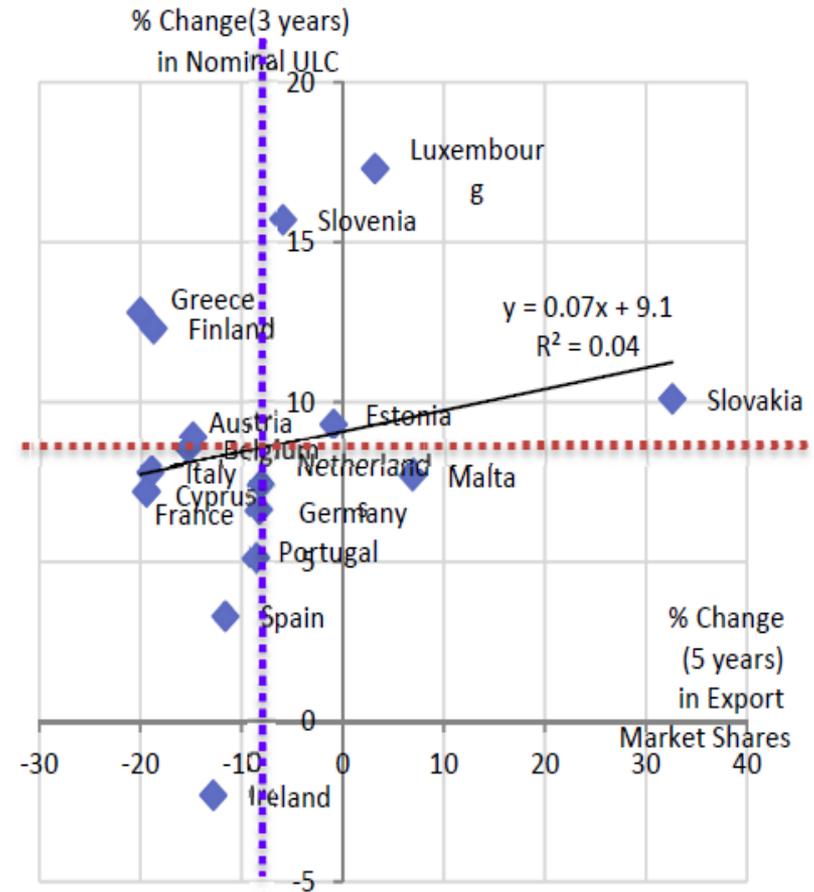
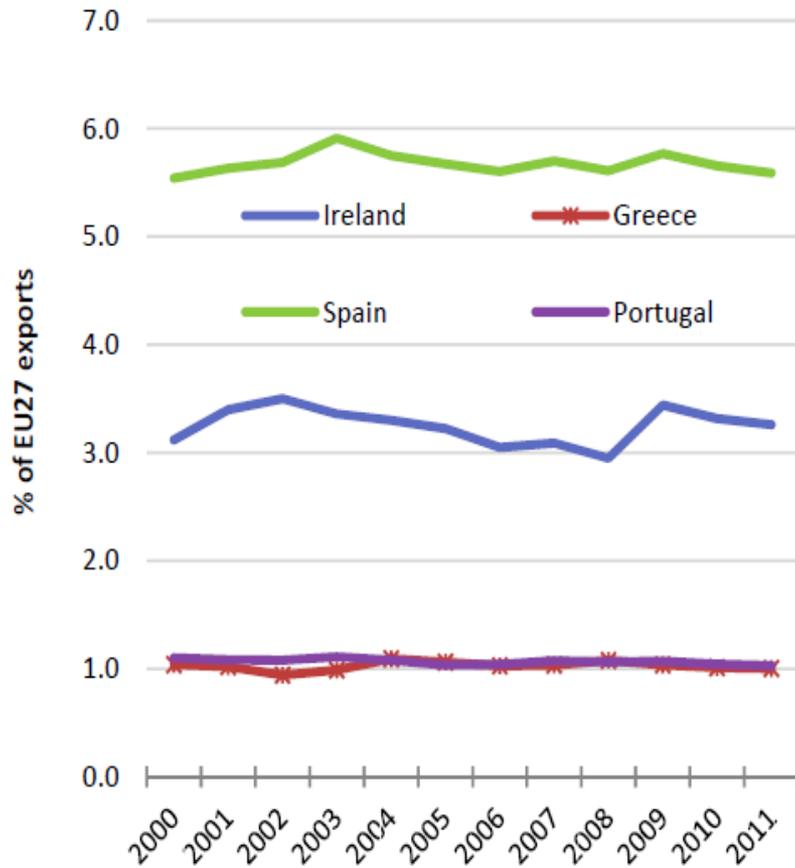
ULC-based REER

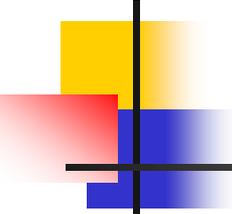


Source: Chen *et al.*, 'External imbalances in the euro zone', *Economic Policy* 2013

Market shares of 'problem countries' were in fact stable, no relation between ULC and market shares

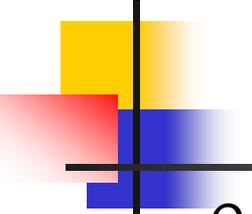
Figure 5. Exports of goods and services and competitiveness vs. market share (MIP 2011)





So a different story: boom in non-tradeables due to capital inflows, with some loss of competitiveness due mainly to euro appreciation

- Borrowing didn't go into investment in tradeables sector with productivity improvements – rather, into non-tradeables, especially construction
- Prices rose there, resources flowed there
- Capital flows weren't accommodating CA deficits
- If CA deficits due to lack of competitiveness, would have had low growth (low external demand) – but in fact, growth rapid, deficits due to low savings ('Dornbusch test', as applied by Wyplosz 2013)
- Most relevant relative price is not terms of trade, nor even ULC-based real effective exchange rate (REER), but rather *ratio of traded to non-traded goods prices*

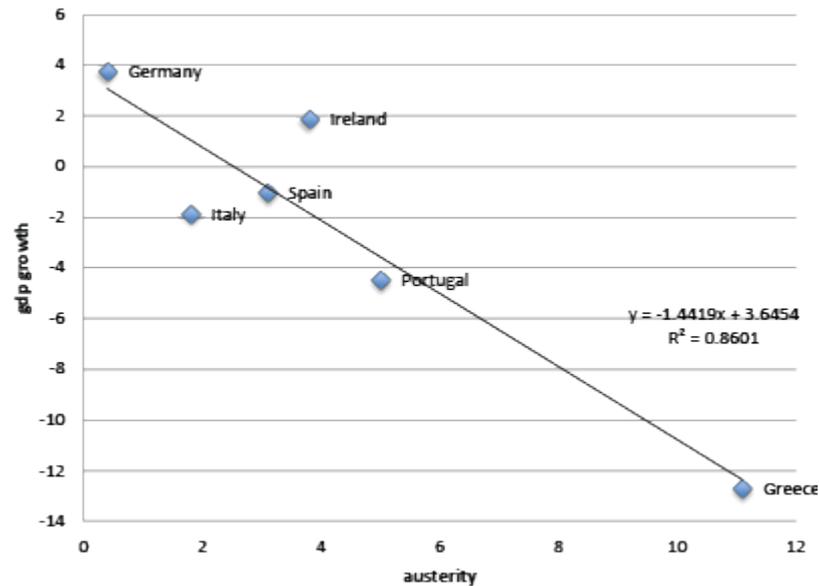
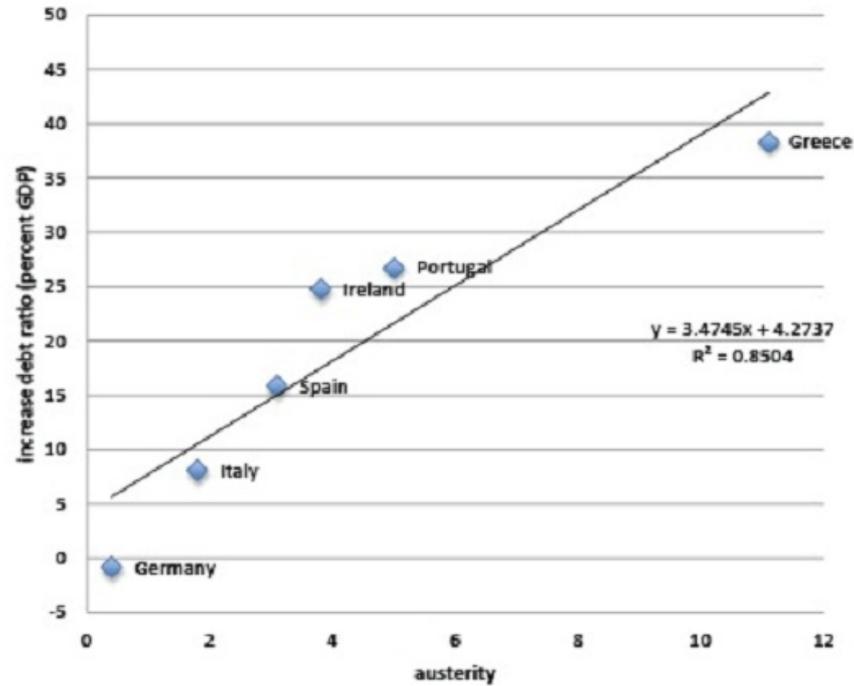


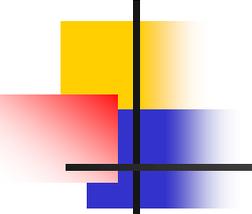
And it's also the politics, stupid! – or the stupid politicians (well, maybe too clever...)

- Creditor countries have been bailing out their own banks that made foolish loans to these countries by transferring fiscal costs to debtor country taxpayers, meanwhile taking the moral high ground – hypocrisy!
- We are told continuous pressure on crisis countries is necessary in order that 'everyone should do his homework'
- But asymmetric: all burden on debtors, while Germany (for example) blocks serious supervision of incompetent German banks and any burden-sharing that includes German creditors
- And those who should know better (EC, ECB, IMF) are in denial ('no euro country can default', 'programmes are on track', discussion of multipliers is 'unhelpful', ...)

Austerity isn't working

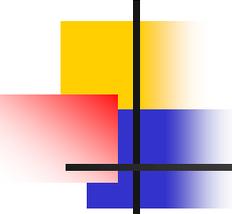
Source: DeGrauwe and Ji (2013a)





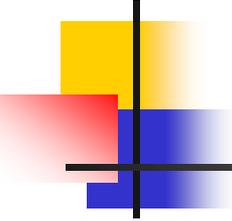
Austerity makes it all more difficult

- So we have interconnected sovereign debt and banking crises with debt trap exacerbated by austerity
- ECB can buy time, but long-run debt sustainability requires growth
- *Austerity is not the solution* – rather, part of the problem: asymmetric adjustment with austerity bias → €-zone primary surplus in recession!
- Deleveraging public and private sector simultaneously (excess of savings over investment in both) is not feasible without current account surplus $[CA = (S_p - I_p) + (T - G)]$
- So surplus countries must raise domestic demand and intra-eurozone imports, thus permitting deficit countries to raise CA
- *And euro should depreciate – need further monetary ease*



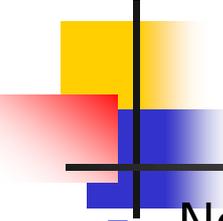
Must avoid bank runs: no exits, debt relief

- Any country's exit, with the inevitable loss to depositors, would provoke bank runs elsewhere that could be stopped only with capital controls – and that is the end of monetary union
- But 'no exit' for Greece will require a major aid programme to cut its debt burden to a sustainable level, permit growth, and give political impetus for profound institutional change
- More broadly, there will have to be debt restructuring (debt relief) in several of the countries at risk (see Paris and Wyplosz 2013 for an 'ambitious' proposal – but there are more 'conventional' alternatives)



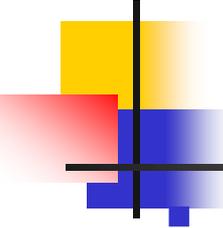
Fiscal

- Recall that US didn't have a serious fiscal union until long after it had a single currency – *limited measures should suffice*
- ESM should underwrite recapitalisation of banks, taking equity participation, without burden on sovereign
- Going forward, ESM should take (limited) fiscal risk for euro zone, so need 'banking union' with central supervision
- Fiscal integration: credible simple fiscal rules
- Not a fiscal union, but eventually some variety of euro bond



Recapitulating: elements of a solution

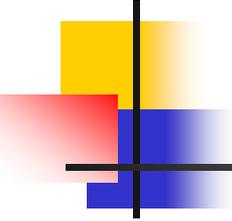
- No exit
- Credible OMT conditional (only) on *independent* DSA (not Troika)
- Serious triage of banks, resolution of the weak, full recognition of NPLs and proper provisioning, burden on shareholders and creditors, not depositors or taxpayers, except where that's not enough and ESM must participate
- Banking union: common supervision for *all* banks, common resolution mechanism – common deposit insurance can wait
- Financial re-integration, initiative to reopen flow of credit to SMEs
- More sovereign debt restructuring – lighten the debt burdens
- Growth-oriented monetary and fiscal policies – true QE, infrastructure investment at EU level (EIB)
- *Not* austerity and lengthy internal devaluation ('a decade of stagnation'), *nor* fiscal union



Germany is key...

...but is captive of myths: debtor country profligacy, misinterpretation of 1920s and early '30s, the 'transfer union', unique demerits of Cyprus bank 'business model', laziness of southerners, their uncompetitiveness, now 'evidence' that they are 'much richer than Germans' (but see De Grauwe and Ji 2013b), ...

- German public aren't told that their lenders should share burden of bad loans, that their banks have been badly managed and badly supervised
- France, Italy, Spain all overwhelmed by internal problems – *only Germany can save the euro* – Soros (2012) says perhaps only by leaving it
- Germany needs a serious public discussion of euro and EU...

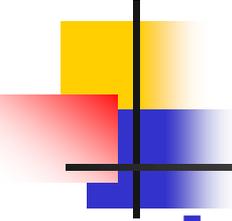


...but that is not happening

'The debate in Germany is very irrational at the moment. They think that they are going for the best strategy and that Europe has opted for the worst strategy. German people think they already pay a lot and they don't want to pay more instead of seeing that working together could be a progress. But I'm afraid that being pro-European is not a vote-winner in Germany.'

Karl Aiginger, Director of the Austrian Institute for Economic Research (WIFO), 16 May 2013, at

<http://www.euractiv.com/priorities/karl-aiginger-austerity-compleme-interview-519651>



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