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MISDIAGNOSIS, ILL-MEDICATION, & MISGUIDED REFORMS: IS THE EURO RESCUABLE?

MESSAGE & STRUCTURE OF PRESENTATION

- Euro doomed if current policies upheld

- STRUCTURE

1. Governance by myth
2. Maastricht EMU deeply flawed from start
3. Conditions for crisis resolution
4. Is the euro rescuable?

Denying reality is euro authorities' favorite sport

1. GOVERNANCE BY MYTH

MISDIAGNOSIS: INNOCENT BYSTANDER

- "Today, in light of the evidence gathered so far in the euro area, I am more confident in saying: 'One size does fit all!'" (Issing 2005, May).
- Euroland "has not made any real contribution to the build-up of [global] current account imbalances" (Issing 2005, Oct).
- "this crisis originated in the United States and is mainly hitting the United States … [In Europe and Germany, such a package would be] neither sensible nor necessary" (Steinbrück 2008, Sep, *post-Lehman*)
- "(EMU) and the euro are a major success. For its member countries, EMU has anchored macroeconomic stability … And for the world, the euro is a major new pillar in the international monetary system and a pole of stability for the global economy" (Almunia 2008).

Myth #1: external shock hit 'pole of stability'

MISDIAGNOSIS: SOVEREIGN DEBT CRISIS

- Euro authorities were not only oblivious of:
  - Severe intra-area imbalances & bubbles
  - Huge banking exposures to U.S. subprime risks

- With onset of Greek crisis they also concluded that all euro problems due to fiscal profligacy
  - "The main origin of crisis lies in the lack of fiscal discipline on the part of most Member States" (Noyer 2012).

Myth #2: fiscal profligacy & sovereign debt crisis

ILL-MEDICATION: AUSTERITY OVERDOSE

- Having (mis-)diagnosed the crisis as a "sovereign debt crisis", knee-jerk reaction was to push for austerity no matter what

- For risks of excessive or premature austerity nonexistent as fiscal consolidation expansionary
  - "Overall, the confidence generated and the financial benefits of fiscal consolidation far outweigh the negative effects on effective demand in the short run" (Noyer 2012).

Myth #3: Fiscal consolidation expansionary

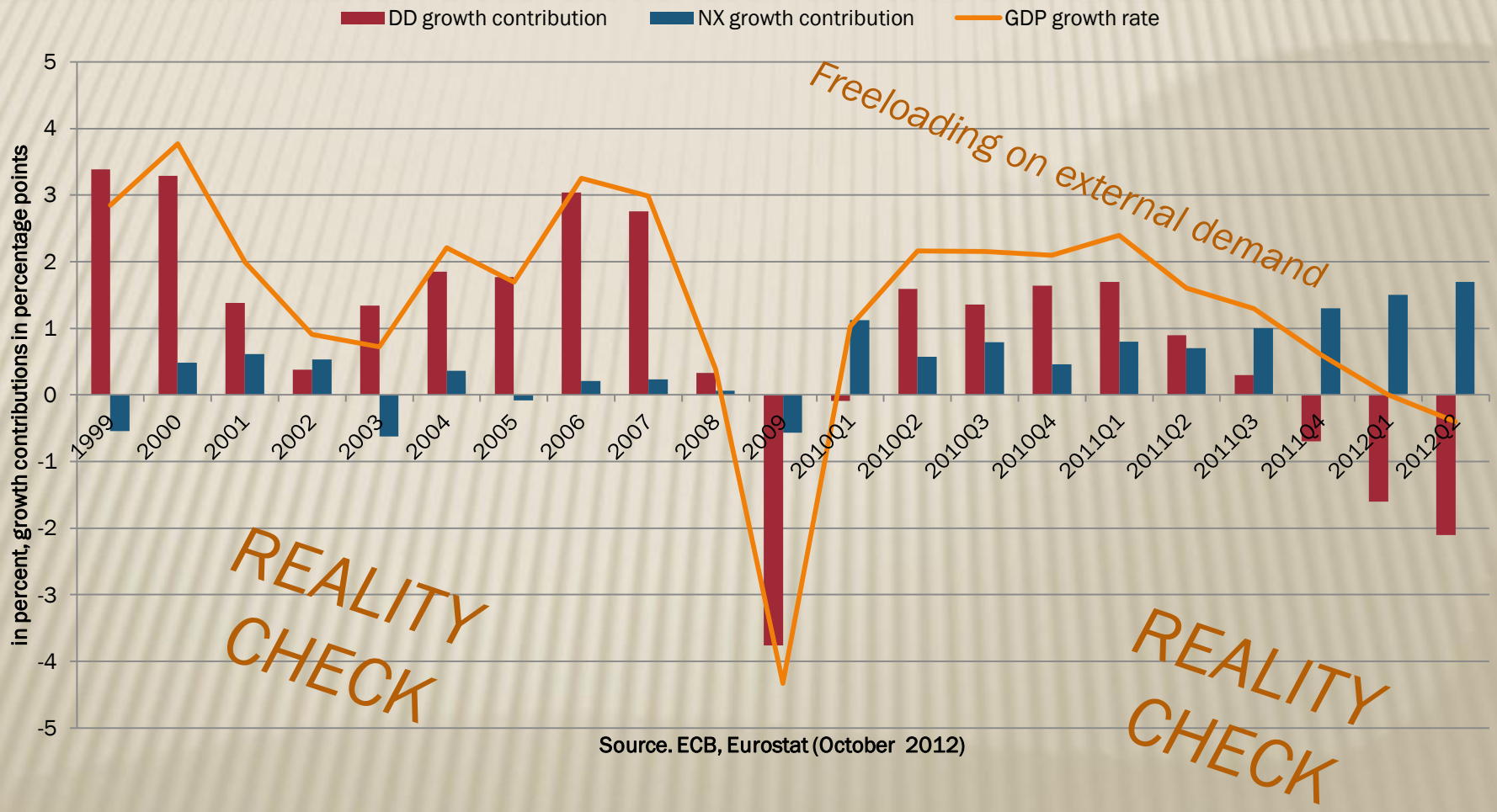
MISGUIDED REFORMS: AUSTERITY FOREVER

- Stability-oriented reforms "strengthened" SGP
- And to further "strengthen" the "strengthened SGP" we now also have the: "Fiscal Compact"
  - Merkel: 'great leap', 'masterpiece'

- Can you name three German virtues?
  - Discipline, discipline, and, yes, discipline

Alas, more of the same ensures € BREAKUP

€LAND'S 'EXPANSIONARY FISCAL CONTRACTION' SUCKING THE AIR OUT OF GLOBAL RECOVERY



G-20 not amused!

Balanced budgets and price stability are not nearly good enough

2. MAASTRICHT EMU DEEPLY FLAWED FROM THE START

KEY FLAWS OF MAASTRICHT EMU REGIME

1) No one is 'minding the store', in particular:
   - No demand management in good times (asymmetry!)
     - On top, no LOLR foreseen in bad times

2) No proper policy coordination to ensure convergence and cohesion of union, in particular:
   - Nothing keeping competitiveness positions balanced
     - No mechanism to rebalance union should imbalances arise

- Instead, obsession with two numbers: 2% and 3%

Market integration without policy integration

FLAW #1 RESULTS IN:

- Weak domestic demand growth & export reliance
- Historically, *relative* price stability and fiscal discipline under fixed exchange rates caused growth in Germany by firing export engine – *precisely because and as long as others behaved differently*
- Exporting the German model to (i.e. Germanizing) Europe undermines its working

FLAW #2 RESULTS IN:

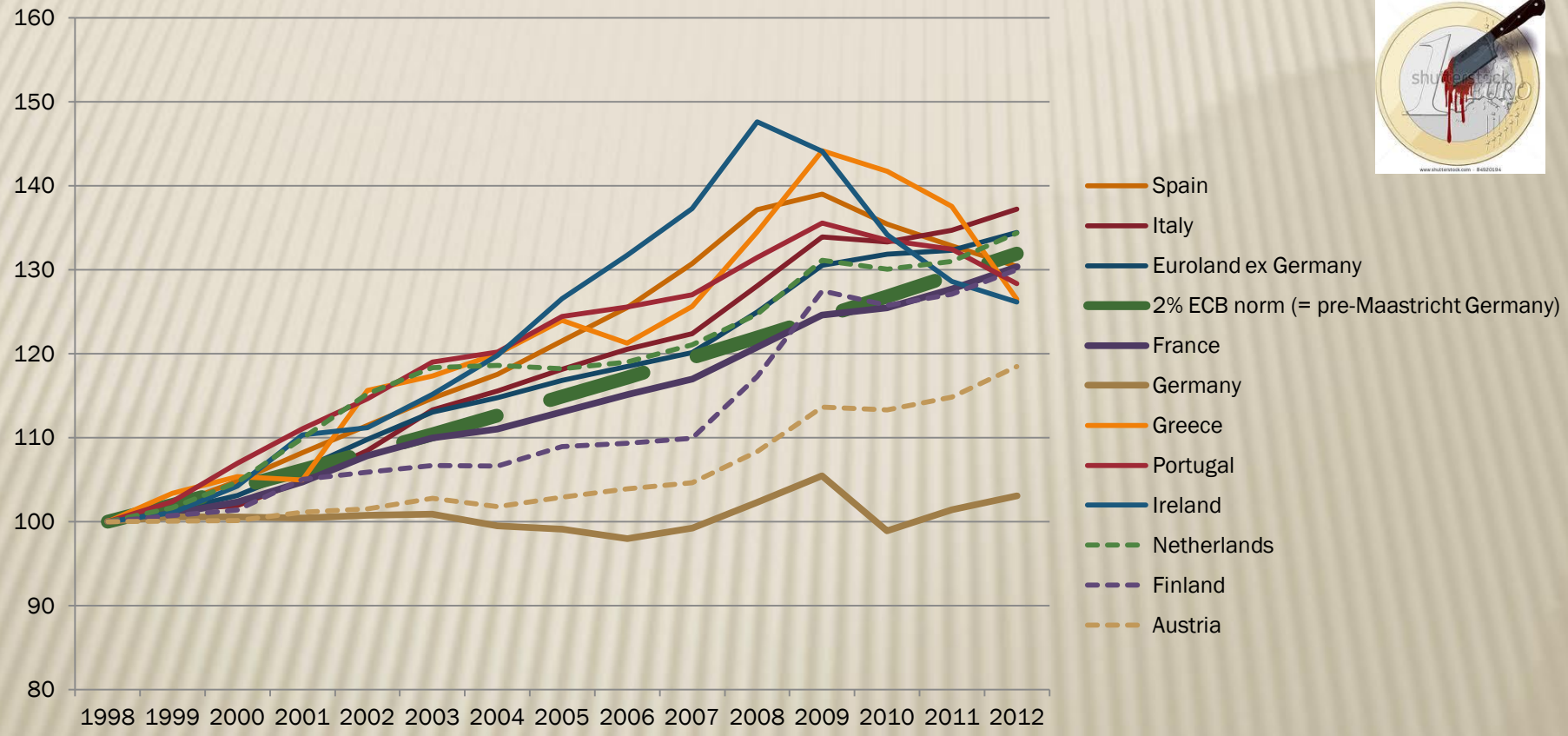
- Intra-area divergences and imbalances
- Historically, preventing "beggar-thy-neighbor" exchange rate devaluations motivated European monetary cooperation – forever banned by € (as coronation of 50-year process)
- Ironically, risk of wage devaluations ignored
  - "Golden rule of monetary union"

GOLDEN RULE OF MONETARY UNION

- MU = commitment to common inflation rate
  - Hence national unit-labor cost (ULC) trends must be aligned with common inflation norm (ECB: 2%)
    - Unless rebalancing of competitiveness positions necessary
  - As divergences are *cumulative*, they lastingly distort competitiveness positions, causing current account imbalances
    - And *persistent* CA imbalances involve debt buildups

Myth #X: Germany had to 'restore' its competitiveness

GERMANY RENEGES ON GOLDEN RULE



Sources. Eurostat Ameco database; own calculations
Note. Nominal unit labor costs, total economy

Officially, everybody 'lost competitiveness' but Germany

WITH NASTY CONSEQUENCES

- As Germany turns "über-competitive"
  - Internally, Euroland seriously unbalanced
  - Externally, euro exchange rate too weak for Germany, too strong for rest
  - = *asymmetric shock!!!*

- One-size-does-NOT-fit-all ECB policy
  - Too tight for Germany … domestic demand flat
  - Too loose for periphery … 'hello' bubbles …

INTRA-AREA IMBALANCES BUILD UP

- Germany's current account balance surges: 7.5% of GDP
- Spain's current account deficit soars: -10%

- Germany's net international investment position (NIIP) climbs to 40% of GDP
- Spain's NIIP sinks to -100%

- Once again, it only worked for Germany, if it did, *because and as long as others behaved differently*
  - Yet Germany truly shot an own goal in exporting the German model to Europe – to then underbid its partners

AND INTRA-AREA IMBALANCES BLOW UP

- For bankrupting the countries that buy your export surpluses not a smart idea, especially if you are also their lender

- Resulting in: Germany's "euro trilemma"! Germany can't have all three:
  - Perpetual export surpluses, a no transfer/no bailout monetary union, & 'clean,' independent central bank
- As soon as private capital flows stop (or reverse), something has to give

CRISIS MANAGEMENT: ECB LIQUIDITY

- Choice: Bailing out German banks or supporting partners facing so-called "sovereign debt crises"?
- As private capital flows return home, replacement by official sector needed
  - Bilateral & EFSF loans to governments
  - ECB LOLR liquidity to banks (LTROs etc); 'hello' TARGET2
  - ECB LOLR (indirectly) to governments (SMP, OMTs)
- Essentially, allow banks to pull out, while mutualizing bad debts and turning ECB into giant "bad bank"
  - Ultimately, Buba TARGET2 balance German fiscal exposure

When you find yourself in a hole, stop digging

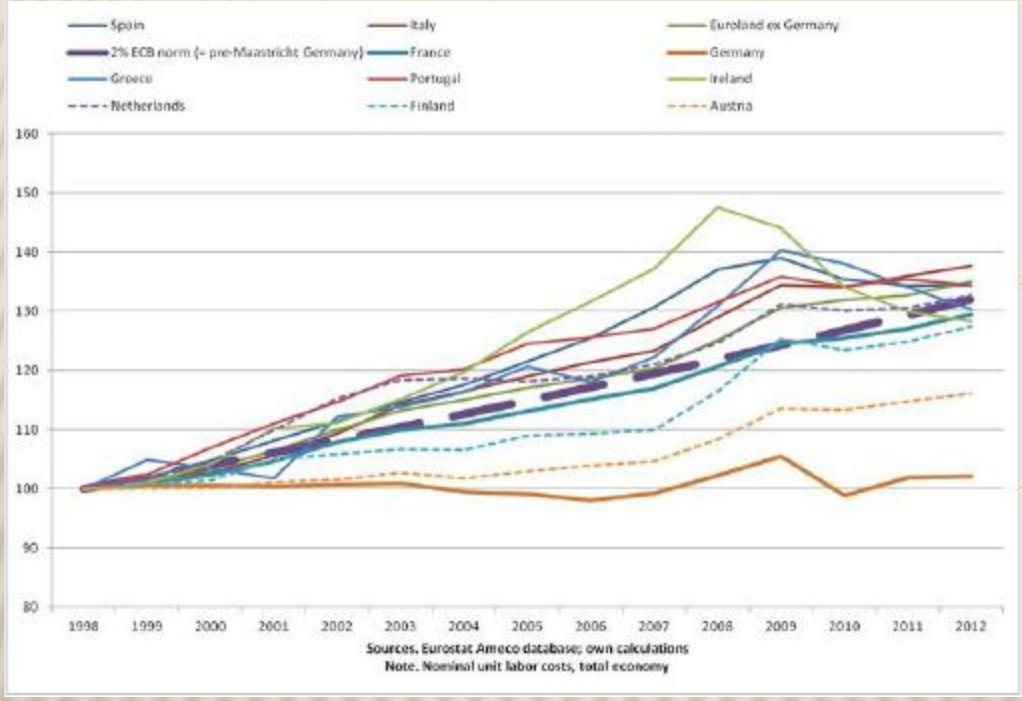
3. CONDITIONS FOR CRISIS RESOLUTION

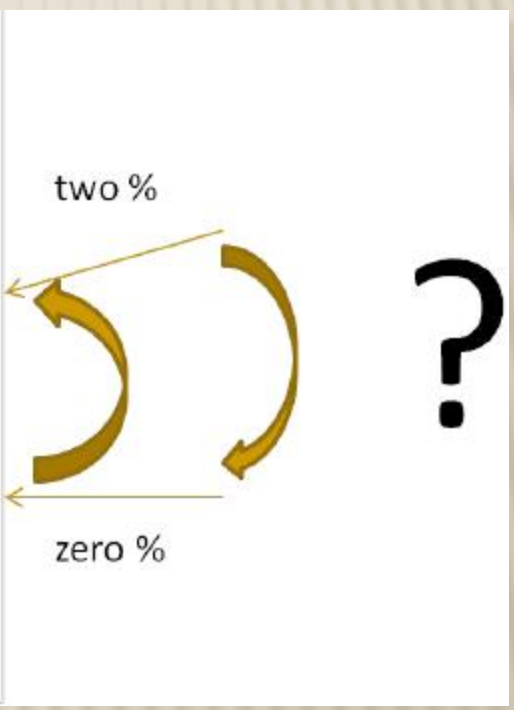
PROPER CRISIS RESOLUTION

- Has three parts to it and one precondition
  1) Rebalancing the currency union
     - Restoring intra-area equilibrium (transition; flows)
  2) Fair deal on debt legacies
     - Balance-sheet cleanup (past; stocks)
  3) Fixing (Maastricht) EMU regime
     - Establish *viable* EMU regime (future)

- *Precondition*: robust GDP growth

1) ASYMMETRIC ADJUSTMENT = DEBT DEFLATION





- Convergence to Germany's historical 2% norm not good enough!
- Even France forced into debt deflation!

2) … MAGNIFIES NEED FOR DEBT RELIEF

- "The more the debtors pay, the more they owe" (I. Fisher 1933).
- Ongoing IMF-Euro authorities' spat over OSI
  - Greece only the foretaste
  - More in pipeline (Portugal, Ireland, Spain …)
- EMU partners share *mutual responsibility* for setting up a rotten EMU regime and failing to make it work
  - Perversely, markets rewarding Germany (= unsafe haven)
  - German strategy to hold out until regime reforms agreed both costly for Germany itself as well as hopeless …

3) … AS "MORE-OF-THE-SAME" STYLE REFORMS MEAN PERPETUAL AUSTERITY

- SGP/Fiscal Compact imply public debt ratio converging to zero (or even debt paid off). Can only work if:
  - Either private sector seizes to be net saver
  - Or ROW tolerates perpetual, large CA surplus of Euroland
    - Repeating Germany's feat inside union for union as a whole externally
- Macroeconomic Imbalance Procedure
  - Placebo. Primary aim was acquittal of Germany, turning key blunder into virtue (to justify more structural reform)
- Structural reform NOT a growth strategy though
  - As distributional impact further undermines domestic demand

IN NUTSHELL, FROM BAD TO WORSE

- Asymmetric rebalancing by lethal mix of mindless austerity and structural reform equals debt deflation
- While still taboo, need for debt relief rising by the day
- While regime reforms guarantee eventual € breakup
- Suffocating growth by area-wide austerity means breakup will come sooner rather than later
  - First Greece …
  - then … Spain … France … Germany

Tinkering will no longer do, high time for a proper fix

4. IS THE EURO RESCUABLE?

HOW MUCH TIME UNTIL MARKETS CALL LIQUIDITY BLUFF???

- Even on optimistic assumptions about U.S. fiscal cliff, 2013 will be very difficult for euro
- Half-measures will no longer do
  - Schuldentilgungsfonds, safe bonds etc
- Get serious! Not Ireland, Latvia or Monocasiono, but *U.S. the only relevant model for EMU!* Needs:
  - Central fiscal backing of euro (Euro Treasury)
  - Backing of euro labor market ("golden rule" plus Euro unemployment scheme)

EURO TREASURY

- Euro Treasury with power to raise its own euro taxes
- Euro budget balance calibrated so as to see Euro Treasury debt ratio converge to 60%
  - *New spending (mainly investment) from center* (= offset for national austerity); *otherwise Fiscal Compact will not work!!!*
  - Also provides: Anti-cyclical offset for symmetric shocks
  - Intra-area offset for asymmetric shocks
  - Fiscal backing for "banking union"
  - Fiscal backing for euro unemployment scheme

Necessary for Euro survival! Just "put your money where your mouth is."

- How about ECB?
  - Intelligent & open-minded central bankers needed

EURO LABOR MARKET

- Ensure compliance with “golden rule” (ulc trends)
- Create area-wide unemployment scheme
  - Common scheme replaces national schemes
  - Uniform rules, contribution & benefit rates (% income)
  - Calibrated for balanced budget when full employment
  - Hence in deficit in case of area-wide recession
- Acting as automatic stabilizer for both symmetric shocks (underwritten by Euro Treasury) and asymmetric shocks (mutual insurance). Underpins convergence & cohesion!

CONTINUED FREELOADING NOT AN OPTION

- Euroland is reneging on G-20 commitment to global rebalancing ("Framework for Strong, Sustainable, and Balanced Growth"; Pittsburgh)
- Abusing the IMF

- Undermining global recovery
  - Risking "currency wars"
  - Risking "trade wars" too

THANK YOU!

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Background

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