



Economic Outlook for Europe

Session 4: Global Financial Impacts: Europe & Latin America

27th Annual Hyman P. Minsky Conference on the State of the U.S. and World Economies: Financial Stability in a World of Rising Rates and the Repeal of Dodd-Frank (Annandale-on-Hudson, 17-18 April 2018)

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Message and outline of talk

- **Message:** Tailwinds that supported recovery may turn into headwinds just when ECB support is waning and constructive solutions for Europe's dysfunctional currency union remain hard to come by
- **Outline:** ECB, EZ reform & Brexit key homemade forces shaping future
 - Some background to Europe's currency union
 - Crisis and crisis responses: the euro disaster
 - Complacency about recovery despite vast imbalances and rising disparities
 - External vulnerabilities and ECB's challenges re: QE exit & 'normalization'
 - In the long run we are all dead, in the short run we are cheerfully up dancing to the € gamble song ...

Europe's currency union: the good, the bad, ...

- Old longing for regionally stable exchange rates: to foster trade and integration, and prevent 'beggar-thy-neighbor' devaluations
- EMS had evolved into Buba/deutschmark regional hegemony
- German unification made restoring regional balance more urgent
- Hope that common currency would solve all these issues, and more
- Alas, Germany's strong bargaining position meant euro regime had to be "made in Germany":
 - Independent central bank with price stability (only!) mandate
 - Fiscal discipline, discipline, and more (über-)discipline

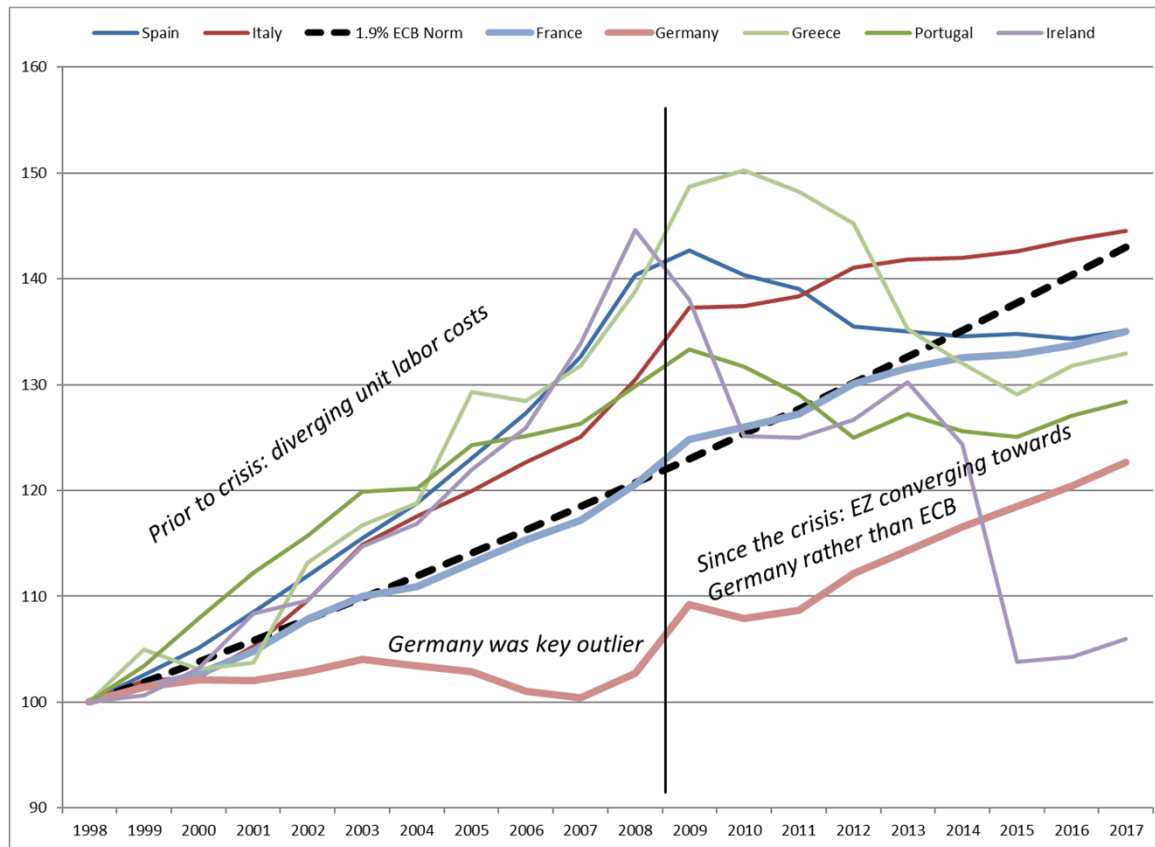


... and the ugly

- German belief system has it that price stability & balanced budgets *cause* growth – which had been the (West) German DM-experience!
- German model rested on **lower** inflation under fixed exchange rates
 - As price stability bolsters competitiveness and fires up net exports
- Model works *if and as long as others behave differently*
- Germany failed to grasp that exporting German model to Europe was not a good idea: German export engine sputtered in 1990s
- Germany's fateful response: *wage repression & austerity*
- And so Germany turned itself into: *'sick man of the euro'*



Spreading the German disease



J Bibow 27th Minsky Conference April 2018

- Euro was meant to end 'beggar-thy-neighbor'
- After getting EZ to sign up to German 2% norm, Germany set out to underbid its EZ partners
- Asymmetric shock!
- Growing divergences & imbalances: *fragility*
- Was not to end well ...

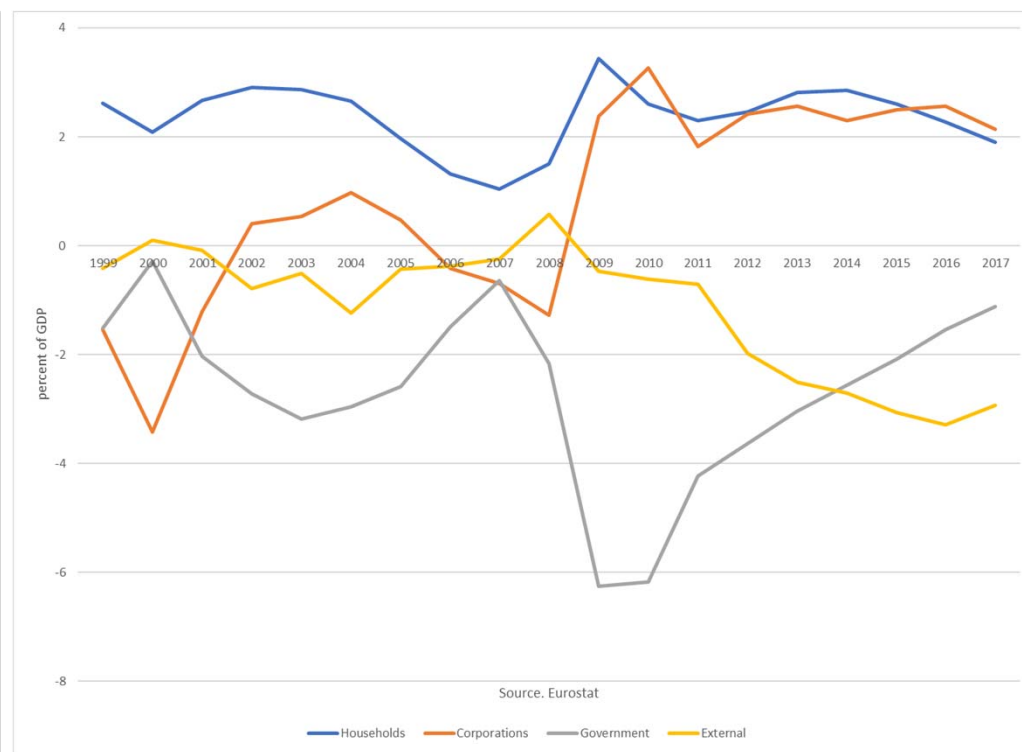
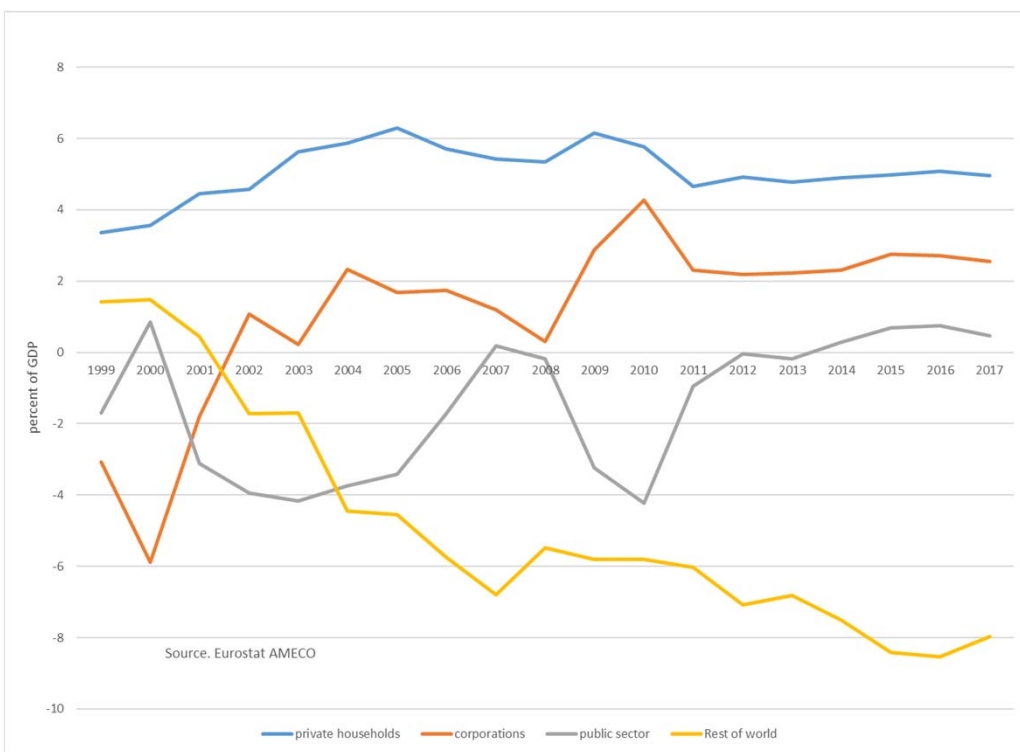
Crisis & responses: the euro disaster



- As Lehman triggered implosion of home-grown imbalances, euro regime was found lacking proper defenses
- Germany forced its all-time favorite medicine on euro partners: wage repression ('internal devaluation') & austerity
- So eurozone became union of the sick
- Among the sick, über-competitive Germany appears super-strong
- Contrary to euro hopes & aims, Germany more hegemonic than ever
- And in Germany's 'parallel universe' the country has done everything right while others just need to become more German. *Really?*

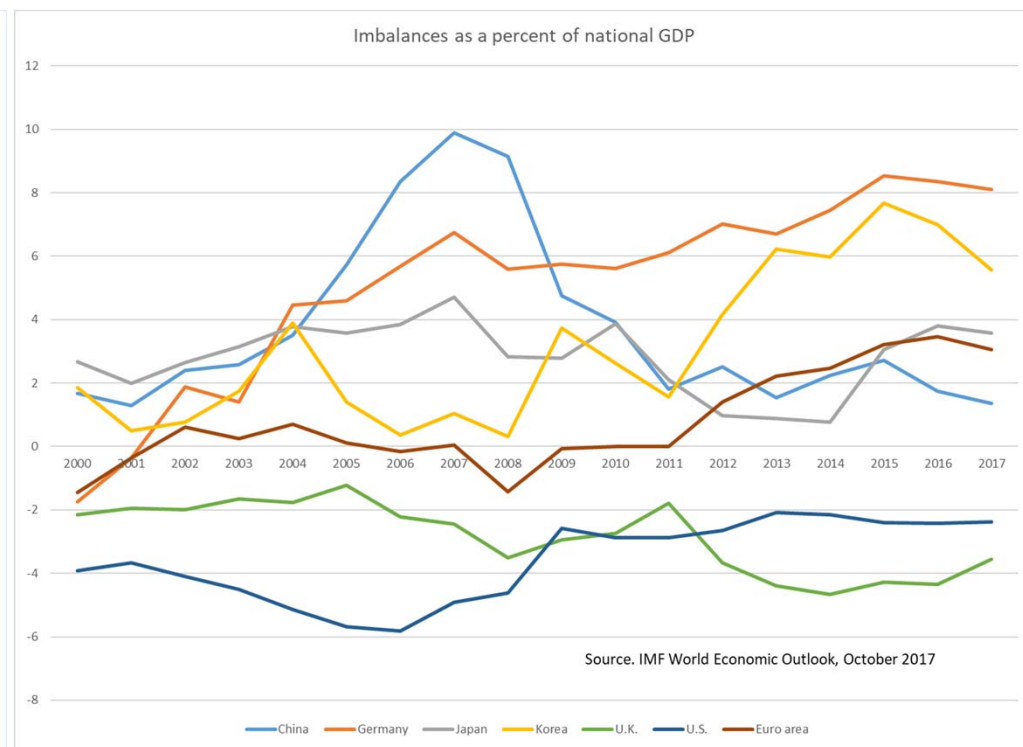
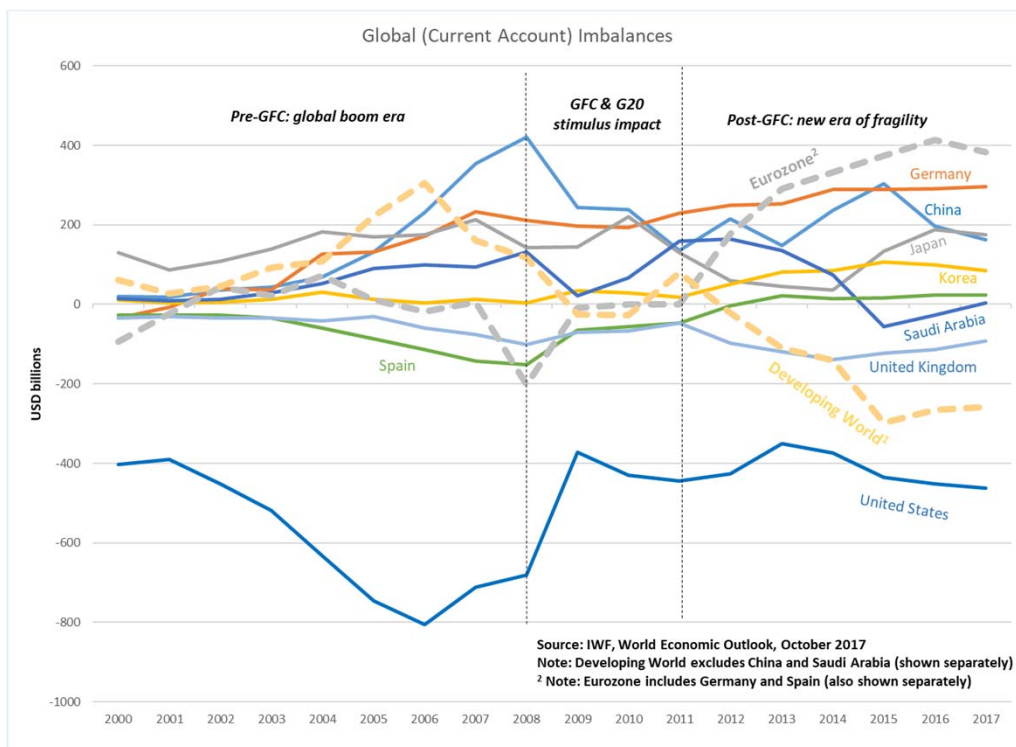
Actually, EZ has turned German

Sectoral financial balances



- France is almost alone in still running CA deficit

Germany & EZ on top of world('s imbalances)



- So much for G20 'Framework for strong, sustainable and balanced growth'

Complacency about recovery despite vast imbalances and rising disparities



- Recovery owes to:
 - ECB finally turning more active in summer 2014 (negative interest rate, QE)
 - Commission turning more lenient (pausing austerity)
 - With weak euro magnifying role of net exports: CA surplus soared
- Yet, fragile recovery with vast internal disparities!
- As debt legacies and internal imbalances unresolved
- And asymmetric rebalancing featuring ‘internal devaluations’ goes on
 - German wage trend causes ECB’s target misses & conveniently weak euro
- Unsurprisingly, social hardship feeds social discontent, rise of nationalism & political instabilities, and anti-EU sentiments



Regime reform vital, but deadlocked



- Euro regime is officially ‘incomplete’; actually: utterly dysfunctional, fragile & unsustainable
- Post-crisis reforms either made things worse (fiscal compact), placebo (MIP), or incomplete & overrated (banking & capital markets union)
- ESM/EMF & OMT remain part of austerity dogma
- Various ‘safe bond’ proposals not the real thing either
- ❖ No solution other than proper **fiscal union**: deficit spending organized at center based on common bond & tax (see my: ‘**Euro Treasury plan**’)
- ❖ **Stop wage repression/underbidding** (see my: ‘Germany’s euro trilemma’)
 - Germany ‘cannot have it all —perpetual export surpluses, a no transfer / no bailout monetary union, and a “clean,” independent central bank.’

ECB's challenges in QE exit & 'normalization' – internal and external vulnerabilities



- The plan
 - QE purchases seem set to end in 2018q4
 - Policy rate lift-off mid2019, followed by very slow & gradual rate rise path
- Internal challenges & risks
 - All of the above plus: ECB leadership change, rising austerity pressures etc.
- External challenges & risks
 - Huge EZ CA surplus, very trade & exchange rate dependent: highly vulnerable!
 - Plenty of risks in global economy, but U.S. (& U.S.\$!) by far no. 1 risk
 - U.S. fiscal and monetary policies in conflict
 - U.S. fiscal and trade policies & global leadership role in conflict
 - With U.S. financial deregulation & Brexit ... 'race to the bottom', augmenting fragilities ...



Smile & dance while music is still playing ...



- EZ's 'muddling through' to continue without real reforms for as long as no whiff hits € house of cards and 'recovery' continues
- U.S. and rest of world unlikely to further sponsor EZ's huge CA surplus
- U.S. rather likely to let off 'whiff' of some kind in next 1-3 years ...
- Will EZ authorities be capable of € regime reform under acute stress?
- Politically situation got so much more complicated as partners keep drifting apart (and even Merkel's 'GroKo' has only small margin left)
- ... 'smile & dance' and hope for the best, however unlikely ...



Thank you!



Some Levy papers

- 'How Germany's Anti-Keynesianism Has Brought Europe to Its Knees' (WP 886), Mar 2017
- 'From Antigrowth Bias to Quantitative Easing' (WP 868), Jun 2016
- 'The Euro's Savior?' (WP 845), Sep 2015
- 'The Euro Treasury Plan' (Public Policy Brief 135), Aug 2014
- 'Lost at Sea' (WP 780), Nov 2013
- 'Germany and the Euroland Crisis' (WP 767), Jun 2013
- 'On the Franco-German Euro Contradiction and Ultimate Euro Battleground' (WP 762), Apr 2013
- 'The Euro Debt Crisis and Germany's Euro Trilemma' (WP 721), May 2012
- 'How the Maastricht Regime Fosters Divergence As Well As Fragility' (WP 460), Jul 2006
- 'Is Europe Doomed to Stagnation?' (WP 379), May 2003
- 'Making EMU Work' (WP 326), Mar 2001