Economic Outlook for Europe
Session 4: Global Financial Impacts: Europe & Latin America


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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

- 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 ...

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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’

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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