



Policy Note

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SIX LESSONS FROM THE EURO CRISIS

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Every crisis reveals unexpected consequences of economic policies. The current euro crisis should be no exception. As European Union (EU) governments search for a solution, there are already a number of lessons to be learned.

1. Currency zones don't solve the problem of payments imbalances.

The problems that are now being faced by the eurozone are not new; we have been here before. Remember the global imbalances and currency turbulence that produced the 1985 Plaza Accord, and then the meeting at the Louvre, and, finally, the freefall collapse of the dollar? At that time, many economists proposed that the exchange rate instability produced by global payments imbalances could be resolved by dividing the world into independent, unified currency zones dominated by the dollar, deutsche mark (DM), and yen. However, the introduction of the euro to create an ersatz DM zone does not seem to have produced the stability that the proponents of such a system had envisaged, even within the eurozone. Indeed, the attempts to manage the dollar-DM-yen exchange rates in the Plaza and Louvre Agreements eventually generated an equity and real estate bubble in Japan whose collapse ushered in decades of stagnation and eliminated any possibility for the creation of a yen zone in Asia. As is now recognized, even within the DM zone, the imbalances that had plagued the European Economic Community (EEC) were not eliminated; instead, they were exacerbated by the introduction of the single currency.

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2. The “structuralists” got it wrong.

Recall the debates between the “economists” and the “structuralists” on the appropriate means of transforming the EEC into a unified “single market” economic zone. The structuralists argued that it was important to create common structures, and that the member economies would eventually conform to them. This was a justification for the introduction of the Common Agricultural Policy, which created de facto fixed rates to distribute EU agricultural support. The same argument was used in justification of the introduction of a common currency despite wide disparity in economic performance in the EU.

The “economists,” on the other hand, argued that common structures could only emerge from an extended endogenous process of economic convergence; the introduction of the common currency was to be the crowning achievement of full European integration into single markets for goods and capital. It is impossible to know if this would ever have been achieved. Although it seems clear that the expectations of the structuralists have been disappointed, some continue to argue that if the proposals for stronger EU institutions were implemented—such as a common EU bond or fiscal authority, or an EU banking regulatory system—they would prove the worth of this strategy. But see lesson six below.

3. There is no French-German compromise on policy convergence.

The old Exchange Rate Mechanism (ERM) was designed to remedy the difficulties caused by the speculative capital flows produced by the persistent policy, growth, and inflation performance differences between the major European countries; in particular, Italy, France, and Germany. The flows were usually in one direction: into the DM, causing real appreciation, currency disruption, difficulty in the Bundesbank’s management of domestic monetary policy, and more restrictive policies in France and Italy than were merited by domestic demand conditions. The final structure of the ERM was a compromise between two objectives. France in particular sought to soften the constraining impact that low inflation in Germany and real DM appreciation had on domestic activity in France and the other economies linked to the DM. Germany, on the other hand, sought to use the mechanism to encourage convergence to German monetary and fiscal policies, and to German preferences for low inflation over high growth and employment levels.

This conflict was to have been resolved by the introduction of a common, reference currency unit, the European Currency Unit, with relative large fluctuation bands against national currencies. However, in the end, the German position prevailed and the ERM was constructed as a bilateral exchange rate grid, substantially reducing the hoped-for margins for policy flexibility. Here, the “economists” scored a clear advantage. Despite the calls for greater policy coordination, it is clear that France is not an equal partner in the discussions of appropriate common policies.

4. Competition reduces inflation but does not produce growth and convergence.

Recall the 1986 Single European Act to create a more integrated single market and Economic and Monetary Union (EMU) to be introduced in 1992. This was basically an attempt to respond to the disappointing growth rates and slow pace of convergence in the Common Market by means of supply side policies to create a fully integrated internal market for trade in goods and services. The 1988 Cecchini Report claimed that EEC income could be increased by at least 5 percent as a result of these structural changes to open borders and increase competition within the Community. This clearly did not happen, as average EU growth rates continued to decline from 3.2 percent during the dismal 1970s, to 2.25 percent in the 1980s, and below 2 percent in the 1990s. However, the single market did manage to coincide with a decline in inflation rates from over 10 percent in the 1970s and ‘80s to below 2 percent in the 1990s. Since this decline in inflation also occurred in non-EEC countries, it is not clear if this was due to the increased competition or the continued restraint on demand required by the operation of the ERM.

5. A common currency does not eliminate the need for internal adjustments.

The introduction of monetary union, in the form of a common currency, was the required, logical complement of the single market to ensure that exchange rate changes did not distort relative changes in productivity and country competitiveness in the internal market. However, policy and performance divergences have continued to exist, and German policy to reduce efficiency wages as part of its adjustment to the debts built up by German reunification, in the presence of higher rates of productivity, have re-created the same problems of divergent

competitiveness as those caused by the pre-ERM exchange rate misalignments. Beggar-thy-neighbor wage policy replaced beggar-thy-neighbor exchange rate adjustments.

Without the expedient of exchange rate adjustments, other member-states were faced with the prospect of either forcing reductions in their domestic wage levels and domestic purchasing power or using fiscal policies to offset the losses of sales to domestic producers and keep growth and employment expanding despite the continuing losses in relative productivity and competitiveness.

In addition, a common interest rate, which for many countries was too low for domestic conditions, exacerbated these problems and led to financing of governments with rising deficits by banks from countries with falling deficits. The result was growing differences in government debt, growth, and tax yields, which were a major cause of the sovereign debt crisis that is threatening the survival of the euro. This is, of course, just the mirror image of the position of the economists noted in lesson two.

6. The solution to the problem facing the eurozone is not increased political integration via more sovereign EU economic and political institutions.

With each increase in interest rate spreads on a highly indebted member country, an EU summit has announced another step toward increased EU integration via another sovereign EU political or economic institution. The positive influence on the markets lasts for a shorter and shorter time frame—and is now down to about two days!—producing another crisis and the need for another summit. Eventually, EU leaders should realize that these very laudable long-term steps to reinforce the single market are not a solution to the difficulties currently facing the eurozone.

Among the proposals to resolve the current crisis are the creation of a common fiscal policy institution, such as a supra-national treasury and the issue of a common debt instrument, or a security issued by the European Commission or representing an instrument collateralized by the existing debt of member states. Others proposals involve an EU regulatory agency or system of deposit guarantees.

It is curious that none of these proposals are concerned with meeting the short-term problem, which is the inability of some member-states to roll over outstanding debts. These proposals seem to suggest that more EU integration—European

monetary and political union—would solve the problem of the creditworthiness of the highly indebted member-states. As a result, the perceived problem is the lack of political integration to accompany monetary integration.

But this is not the problem. As should have been obvious at the time of the creation of the European Central Bank (ECB) as the sole issuer of the common EU currency, what had been the zero-risk sovereign debt of members of the eurozone was no longer fully “sovereign” in the sense of the aphorism attributed to Walter Wriston, head of Citibank during the Latin American debt crisis, and Delfim Netto, former Brazilian minister of finance: “Sovereigns do not default.” By this they simply meant that sovereigns will always be able to refinance their debt by issuing new debt.

With the advent of the euro and euro-denominated government debt, this was no longer true. Since governments could no longer issue the currency in which their debt was denominated, nor could they be permitted to borrow it from the ECB, their ability to repay the debt, or even to meet the debt service, was determined by their ability to generate fiscal surpluses in euros. The current crisis is not really a crisis of the euro, it is a crisis of the member-states’ ability to meet the minimum conditions for refinancing or retiring debt through fiscal policy.

In simple terms, since the government cannot create euros but merely generate them by taxing the private sector, it must run a surplus sufficient to cover debt service and amortization if its guarantee to meet debt service is to be credible. The surplus must be higher if it is to pay down debt to reach the debt limits stipulated by the Stability and Growth Pact (SGP). In Hyman Minsky’s terms, member-states should be engaged in “hedge” finance, which means producing a fiscal surplus well in excess of debt service. If it cannot do this, it must issue additional debt to the private sector, since it cannot borrow from the ECB. In this case, the government would be engaging in what Minsky called “Ponzi” finance: it would be borrowing to meet debt service.

The concern of the ECB to introduce ironclad conditions on fiscal deficits is thus understandable. If it is to respect the prohibition on lending directly to governments and allow governments to refinance, which is the bottom-line condition for the survival of the eurozone, precise limits on government borrowing and deficits are absolutely necessary. However, such a policy contains a paradox for countries that have debt above the SGP limits. A rising fiscal surplus can only be achieved through

a combination of higher growth and taxation. The answer to the eurozone problem is thus to be found in higher growth.

But governments cannot produce this growth through deficit spending; it must come from either domestic or foreign demand. Lowering government expenditures or raising taxes to generate the required fiscal surplus will only reduce domestic demand. This leaves external demand as the only solution. But without the ability to improve external competitiveness through exchange rate adjustment, internal depreciation through wage reductions or productivity increases in advance of wage increases will be required. However, this is also a policy that reduces domestic demand, offsetting the benefits of higher foreign demand. And here is the paradox: all the policies proposed to increase growth of incomes and generate fiscal surpluses ultimately have a negative impact on income growth. Keynes called it the paradox of saving; here, it is the paradox of euro survival.

And this is why the proposal for more intensive EU unification cannot solve the problem. It can only be solved if some member-state is willing to run a fiscal deficit that allows the indebted countries to run a surplus. But this would simply shift the burden of the debt from one country to another. Germans have rightly objected to their having to take on the debt burdens of the Mediterranean countries, for this would simply turn Germany into a higher-credit-risk country. Indeed, this might even create problems for Germany in terms of refinancing its debt, which is also substantial. Thus the paradox: the survival of the euro and the refinancing of government debt require a fiscal surplus across the system, and a foreign surplus is only possible if the unified EU treasury can itself run a fiscal deficit.

Of course, the problem could be resolved if the ECB were able to act as the lender of last resort to allow governments to achieve an acceptable rate of growth, since the sustainability of the ECB's debt is independent of its net income. The current ECB policy of requiring more EU political action on fiscal policy is thus just the opposite of what is required. The ECB should be asking for the European Commission to run a fiscal deficit financed by the issue of a global European security. The solution to the problems of the euro does not lie in increased political integration; the solution is to allow the new fiscal agent or the Commission to run a fiscal deficit that would generate a surplus in the highly indebted countries sufficient to allow them to service and retire debt that the market will not refinance.