

THE EUROZONE IN CRISIS: EVOLVE OR FAIL? THIS IS THE QUESTION

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The words 'crisis', 'criterion', 'critic' and 'critical' are derived from the Greek word 'κρίσις' which means 'judge', 'decide' or 'choose'. Although the term has been passed on to the English-speaking world, the full meaning of the word has not. To us it means a combination of surprise, uncertainty and threat to our established order. There are two connotations to the term crisis, a positive which means time to take the *right* decisions to resolve a problem and a negative which means 'oh my God, we are in trouble'. We use the word only in the second sense of the term, the Ancient Greeks used it for both.

The debt crisis gripping the eurozone, i.e. the 17 countries that share the common currency, needs to be viewed from a broader historical, geopolitical, economic and psychological context, not only from a narrower banking and financial one. It must also be considered from a dynamic standpoint as opposed to a static one. If the European policy leaders are to make the right decisions and avert a looming catastrophe they need to understand and accept the actual causes of the problem, define their goals, delineate and weigh the options and take action.

Why is the eurozone experiencing a sovereign debt crisis? There are a number of reasons why.

A common currency without a common treasury

There were serious design flaws built into the European Monetary Union (EMU) from its inception. First, a common currency, along with a common central bank and common monetary and exchange rate policy were created without establishing a countervailing common tax policy, fiscal policy and common treasury with system of intergovernmental transfers and euro-wide debt management. This should not come as a surprise to anyone as it has been known to economists and policy makers from the inception of the euro project. Eurosceptics, especially those residing in the British Isles who refused to join the project have been reminding us all along and today feel vindicated by the outcome. In theory, for a common currency to work you need an 'optimal currency area', i.e. a region of countries that are at a comparable level of economic development, allow free mobility of capital and labour and share similar social structure and institutions such as flexible labour markets: this means the whole of the periphery including Spain and Italy should never have been admitted into the union, let alone Greece and Portugal.

Why were all these countries admitted? The superficial answer is politics. The real reason was to advance the larger and fundamentally more significant goal of European integration and political unification following the re-unification of the two Germanys in 1990.

The bottom line is that the Eurozone is ill equipped to compensate for intra-union balance of payments imbalances through fiscal transfers or equalization payments the way any other federal state like the United States and Canada is able to.

A central bank that is independent with limited powers to create money

To convince Germans to exchange their cherished and strong German mark for the new euro and transfer authority from the trusted Bundesbank to the European Central Bank (ECB) the Europhiles were compelled to accept as a compromise a central bank that was a clone of the Bundesbank, located in the same city and socio-cultural environment, i.e. Frankfurt, Germany, completely independent of its member state governments, and with no explicit mandate to create money as a non-sovereign supranational institution.

On the surface, this sounds fairly normal, but the institution of central banking was not created to deal with normal times. Central banks have evolved historically from the need to respond to financial panics and sovereign debt crises. This is how the Bank of England became Britain's central bank, in response to the South Sea Bubble. The Federal Reserve was created in 1913 in response to the 1907 Bankers' Panic. Most central banks in the world, including the Bank of Canada were founded during the 1930s in response to the Great Depression.

While the US Federal Reserve and the Bank of England reacted to the 2008 global financial crisis by injecting respectively \$4.0 and \$0.6 trillion in liquidity (amounting to 28% of GDP in each country) to prevent their financial systems from crashing, the ECB has been the most restrained having injected less than \$1.0 trillion or 6% of the euro area GDP.¹ During the 2008 global financial crisis and during its follow-up global economic recession of 2009-10, the Federal Reserve has responded with two rounds of quantitative easing (i.e. printing money) with a highly accommodating monetary policy and focus on fighting deflation and stimulating economic growth.

Across the Atlantic its European counterpart, the ECB has adopted a considerably less accommodating monetary stance. Had it not been for the debt crisis gripping the eurozone's periphery since early 2010 the euro would be trading much higher today. The bottom line is that had the ECB possessed a freer mandate to create money and inject liquidity into the European financial

¹ Alessandri, P. & Haldane, A.G. (2009), **Banking on the State**, Bank of England

system the way the Fed does, the stresses may not have been so visible or acute as they have presently become.

A Monetary mindset biased against inflation and in favour of a strong currency

The United States and Germany have undergone different historical experiences that have shaped the psyche of their electorate, academic and banking communities and their leaders, and that predispose them to different assessments of the same situation and toward different responses to the same crisis.

In the 1930s the USA suffered a deflationary economic depression mainly caused by the unwillingness of the US Federal Reserve to take bold and decisive action to defend the banking system and create enough money to prevent a financial meltdown and economic catastrophe. The lesson learned is, if you have to take a risk between inflation and deflation, it is better to risk inflation than it is to risk deflation. It is much easier to control inflation with fiscal and monetary policy tools than it is to control deflation. You can raise interest rates as high as you need, to reduce inflation –as Paul Volcker did in the early 1980s- but you can only reduce interest rates down to zero to fight deflation –as Japan has painfully found out in the 1990s. Thus the response of the Fed and US policy authorities has been biased toward expansion, even at the risk of creating inflation.

German experience, on the other hand has been the opposite. In the 1920s, German authorities under the pressure of the huge reparations imposed on them at the Paris 1919 Versailles Treaty, were unable to pay their debts and were forced to print money, so much so that it resulted in the famous German hyperinflation, one of the worse recorded in history which wiped out all peoples' savings and reduced the once proud middle class, to paupers. Consequently, the Germans have learned to associate depression with inflation, and they fear inflation much more than they do deflation. As a result of this conditioning, when they issued the new German mark after the war they made sure that their central bank would safeguard price stability before any other policy objective.

The problem is that this psychological conditioning has been passed on to the ECB and the entire block of countries sharing the euro and is imposing unnecessary restraint on every member country, whether they need it or not. No wonder the euro has appreciated by roughly 50% against the US dollar in a period of a little over ten years. That is an annual compound rate of currency appreciation of roughly 5% when compared against the world's leading reserve currency! Clearly, as long as the US creates money in response to the aftermath of the global financial crisis and economic downturn while Europe doesn't, the US dollar will continue to fall against the euro and the euro continue to rise against the dollar, the pound and a host of other currencies including most

importantly the Chinese yuan and other Asia-block currencies which are loosely pegged to the US dollar.

The French have always had a fixation with trade surpluses and viewed the accumulation of gold as a sign of economic prowess. Due to the difficulties encountered in containing inflation and a stable franc since the collapse of the Bretton Woods system of fixed exchange rates in the 1970s, they have become a willing partner with Germany in the pursuit of a strong currency since the creation of the euro. Thus they have not objected too much to the German obsession with price stability and low inflation. But what is 'stable' about a currency if its external value keeps rising every year? No wonder that the countries of the European periphery with larger self-employed, family and small business sectors and smaller export orientation have found it difficult to compete with the more regimented work forces and the large export-oriented corporate sector of the European core.

A single interest rate with uneven economic conditions

When the euro was introduced short and long-term interest rates were drastically reduced in the periphery of the eurozone to near German levels (e.g. in Portugal they fell from 17% to 3%). The removal few years earlier in restrictions to international capital flows meant that these countries could borrow at lower rates than they were used to. In the meantime, large banks were looking for ways to increase their lending with higher spreads to private and especially sovereign borrowers in the periphery. Monetary conditions turned from highly restrictive to highly expansionary in short order and fuelled a housing boom from Ireland to Greece and all the way up to the Baltics.

Making things worse however was that in the first five years of the monetary union (2000-2005) the core countries of the eurozone (Germany, France and the Netherlands) were struggling with slow growth. To help them the ECB set monetary policy at a looser setting which was not appropriate for the periphery. A recent study² by the Federal Reserve Bank of San Francisco showed that since the launch of the common currency, the policy rate of the ECB was significantly lower than the rate recommended by the Taylor rule for the euro periphery, while being broadly in line for the euro core. Conversely, since the global recession of 2008-09, it has been the opposite, more restrictive than the rate recommended by this rule.

Loose monetary conditions in the periphery not only stimulated economic growth in these countries but fuelled a housing bubble (Ireland & Spain) and excessive public sector borrowing (Greece & Portugal) that, when the financial crisis of 2008 and global recession of 2009 hit, it precipitated the current debt crisis.

² Fernanda Nechio (2011) "Monetary Policy When One Size Does Not Fit All", Economic Letter, Federal Reserve Bank of San Francisco (FRBSF), June 13, 2011

A single exchange rate with uneven competitiveness within the zone

Sharing the same currency implies a common exchange rate for each member country. But when productivity levels and competitiveness vary within the common currency area, then the countries with the lower competitiveness lose market share to the countries with higher competitiveness and this results in growing current account deficits for one group and current account surpluses for the other. To maintain these imbalances capital needs to be transferred in the form of loans and foreign direct investment to the less productive ones, thus increasing their international indebtedness.

What happened since the creation of the eurozone is that despite a rise in productivity levels in the periphery, wages rose even further in most cases thus reducing their competitiveness. Making matters worse, the core countries led by Germany managed to hold down wage increases below productivity growth which further enhanced their competitiveness. As a consequence, current account deficits ballooned for the periphery since the introduction of the euro and increased their external indebtedness to unsustainable levels thus also contributing to the current crisis.

Had the periphery members paid more attention to competitiveness and enacted structural measures to boost their productivity they would have lessened the pressures and helped their situation, but unfortunately neither the periphery paid adequate attention nor did the leadership in Brussels and the ECB.

The allure of the single currency created the illusion of safety

Sharing a common currency has advanced the economic welfare of euro area countries by eliminating the transaction costs (approximately 2-3% of cross border sales) of converting money from one country's currency to that of another plus storage costs; it eliminated currency risk on intra-euro area trade and reduced currency risk in international trade by creating a larger and more stable currency. Since the euro was launched in 1999, it has gained credibility and has become the second most important reserve asset after the US dollar with roughly 33% of central bank reserves stored in euros, compared to 62% in US dollars.

Possessing a currency with reserve holding status bestows a nation or a common currency area with a tremendous advantage called 'seigniorage'. It means being able to buy products and resources from other countries without effectively paying for them! This is made possible because the seller chooses to hold your currency as a store of value instead of using it as a means of exchange in which case they will demand that you ship them the equivalent in products and resources. This is how the U.S. has managed to finance its super power status in the world during the post-war era.

The pitfall is that the advantage of eliminating currency risk was so alluring that players overlooked the sovereign risk entailed in cross-country lending. Interest rate differentials between German bunds and member area country bonds quickly narrowed to the point that spreads on Greek and Portuguese government bonds shrank to only 25-40 basis points above those of German bunds. From a distance, it appeared that euro debt obligations were similar to US ones, that euro area risk had replaced individual country sovereign risk.

Elimination of currency risk does not imply elimination of credit risk

While the euro area countries decided to share their currencies, they were not ready to do the same with their debts. Why not? If these countries are willing to share a common trade area, have a common customs and agricultural policy, allow free mobility of people and resources and share the same currency, why not complete the circle by sharing their debts as well, establish a common supranational treasury and coordinate fiscal policies in member states? The reason was that in the late 1990s, following the high cost to West Germans of paying for re-unification with East Germany, the West German people were reluctant to trade in their hard earned Deutsche marks for euros, let alone what they felt would be the prospect of assuming other nations' liabilities. Agreement on sharing a common currency was as far as they could go at the time. To have asked for more would have jeopardized the creation of the euro and the common currency project. When Jaques Delors, the last of the great Europeanists was asked "how do you expect a common currency to survive without a common treasury and shared debt obligations" he purportedly answered that, "if it comes to that, it will force the EU to complete the next round of integration"!

I do not think that anyone at the time expected that this moment would arrive so soon, but it has. When international investors purchased euro area sovereign debt obligations, their perception was that each sovereign debt issuer was jointly and severally liable for the other member's debt, just as, in the case with US treasuries and notes issued by the US Treasury. Never mind what the small print said, "if it walks like a duck, quacks like a duck, looks like a duck, it must be a duck".

Now, the euro periphery debt crisis begs the question, if a country like Greece defaults on its obligations, whose default is it? Is it the individual country that has defaulted on its debt? Or is it the whole system, the EMU that has defaulted on its obligation to stand by its members? If a euro-denominated debt of one member state is not the same as the euro-denominated debt of another member state, then what sort of 'union' is it? When they want to sell you bonds, they are a union; when you want to sell them back, they are not. Here lies the problem.

The crisis was precipitated because markets and credit rating agencies reminded everyone else that no, even though member states share the same

currency they do not share the fiscal obligation to pay each other's debt. When it comes to credit and sovereign risk, each country stands alone.

When the euro area political leaders were asked to confirm whether, this was true, or not, and where they stood on the issue they paused, twitched, mumbled and grumbled. In the meantime, the ECB accepted Greek government bonds on par on the same basis as other member states as if Greece was solvent, and the EU talked of "solidarity" amongst union members and promised that a solution will be found. Meanwhile, area country politicians refused to accept the obvious, that if they are going to stay a union they have to back each other's obligations, and hid behind public opinion polls reflecting the views of their common folk who think that hard working members should not have to pay for less prodigal ones.

True enough, Greek or Portuguese debt is not backed by other members of the union, so there was surprise, uncertainty and fear of loss and the markets have rightly panicked and in the process refuse to buy more debt of countries with uncertain repayment prospects. But as time unfolds and analysts are examining each member country's financial and economic position and asking more questions the crisis is intensifying and spreading to other members. After Greece, Ireland and Portugal, who is next? Spain? Italy? Belgium? Or, all of the above? Well, who is left? France? May be yes, may be not; Germany and the Netherlands for sure. If they are the only ones left in the euro then their currency will appreciate so much, so fast, that will send their exports into a tailspin and bring a deflationary contraction that will raise their debt burdens and drive them to the brink of insolvency themselves.

What does Europe do now?

Now that global financial markets and central banks have bought into the idea of the euro as a world reserve currency with the potential to complement or even replace the US dollar if need be, what do euro-area leaders do? Say "I am sorry"? You should have been careful and read the fine print? We are not capable or strong enough to serve as a world currency? The fact of the matter is that a common currency is meaningless without a common treasury and without a common euro-area debt obligation jointly backed by all member eurozone governments. Given the admittedly huge benefits that have accompanied the introduction of the euro, the reduced transaction costs to trade, the increased market efficiency, the lower interest rates, the reduced currency risk, the benefits of seigniorage and now that the euro is on its way to joining the US dollar as the world's two leading reserve currencies, do you just walk out and let it all fall apart?

What is being forgotten in the debate taking place in this crisis is that the eurozone does not only have responsibilities towards its members, but has a responsibility towards the world monetary system as well.

As I will argue in the next paper a solution to the crisis does exist, has existed and is already in the drawer, provided the political leadership of Euroland is willing, bold and visionary enough to adopt it. The solution is the mutualisation of euro country sovereign debts and their gradual conversion to euro-zone bonds, a new security issued jointly by all eurozone governments to replace national government bonds along with the creation of a supranational eurozone treasury and debt management agency, finance ministry and coordinated fiscal policy. The decisive moment in the history of European integration has arrived that could transform the crisis into an opportunity.

Evolve or Perish

The situation presently in place in the eurozone, namely the productivity gap between the core industrial countries and the periphery –Ireland, the Mediterranean zone and Southeast Europe and the Baltics will persist. It will not magically go away as the Germans are hoping, nor is it necessary to take place because each country and region has its own comparative advantages and disadvantages. If the periphery bridges the productivity gap then Germany will cease being a surplus country and will lose its competitive edge. To insist on austerity measures in the periphery will only reduce the wealth of the core and lead to lower collective income and living standards for the whole of the eurozone! If the Greeks become German, then the Germans will become Greek. What Germany needs to do is accept its leadership within the zone and act as a leader.

When the United States was faced with the same dilemma in the 1950s and 1960s between a highly productive America and an unproductive and war-ravaged Europe and Japan what did it do? Ask these countries to work harder, impose austerity and demand that they become more competitive overnight? No, they didn't. What they did instead is print all the US dollars needed to provide them with the liquidity required to reconstruct and expand their economies, thus fuelling the post-war boom and economic 'miracles' of Germany and Japan. Besides, in the then Bretton Woods regime of fixed exchange rates, doing so would have led to currency depreciation in Europe and Japan, currency appreciation in the US dollar and the Bretton Woods system –similar to the eurozone EMU- would have fallen apart barely 15 years after its creation in 1944. By accepting its leadership in the post-war period and acting as a leader, the United States enabled the whole world economy outside the Iron Curtain to expand and prosper. Incidentally, failure on the part of the United States to do the same, following the end of the First World War in the 1920s is one of the major factors that contributed to the economic catastrophe of that period, the Great Depression and its aftermath the Second World War.

The stakes are indeed very high today. Germany which heads the EMU - like the United States that headed the gold exchange standard in the post-war

period- is being called to accept and show its leadership in the eurozone –which includes the periphery on top of the core- and the wider global economy.

Japan was given a similar opportunity in the 1980s to become the leader in Asia and failed to take advantage of it because of its ethnic parochialism, xenophobia and insistence on recording trade surpluses. Instead, Japan slipped into a deflationary depression in the 1990s from which it has yet to emerge and has ceded leadership in the region to China which last year surpassed it, as the world's number two economic power.

Failure to act on the part of Germany will lead to similar results. It will not only rob it of the opportunity to emerge as the leader of the European block of nations, prosper and become the global leader it has always wanted to be, but it risks destroying all the progress that has been made to date toward European integration, sinking the continent into a regional depression, destabilizing the global economy and returning Europe to ethnic divisions, discord, desperation and ultimately even war itself.

Instead of being small minded and picking on small members like Greece, Portugal and Ireland that together barely account for 6.0% of euro area GDP, and inappropriately criticizing them for their “poor work ethic”, Germany needs to embrace its new found status as an economic super power and show leadership in the euro area and the world. Europe and indeed the world do not need another bean-counting accountant and comptroller on the top, we need a new CEO, one that will provide economic and political leadership to the region and the world.

In this most defining moment in history, will Germany choose to do so? Will it embrace its responsibility and lead the charge toward European integration or will it abdicate from its position of leadership and watch everything fall apart in its face? This is the question.

Your comments to this paper are greatly appreciated

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