The Euro

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The Euro-crisis

- The fact that Europe is no longer in decline is *not* a sign that the austerity policies worked or that the euro-crisis is over
- Some countries are still in **depression**
- Europe has faced a lost half-decade
- The prospects are for a lost decade
- But unless there are marked changes—it could be a lost quarter century

Outline of talk

- Description of where Europe is today
- Explaining Europe's problems
  - The Euro
    - There needs to be fundamental reforms in the structure of the euro
  - European policies
  - Neo-liberal ideology which has influenced both
  - There are alternatives
    - Alternative policies
    - Need to rewrite the rules

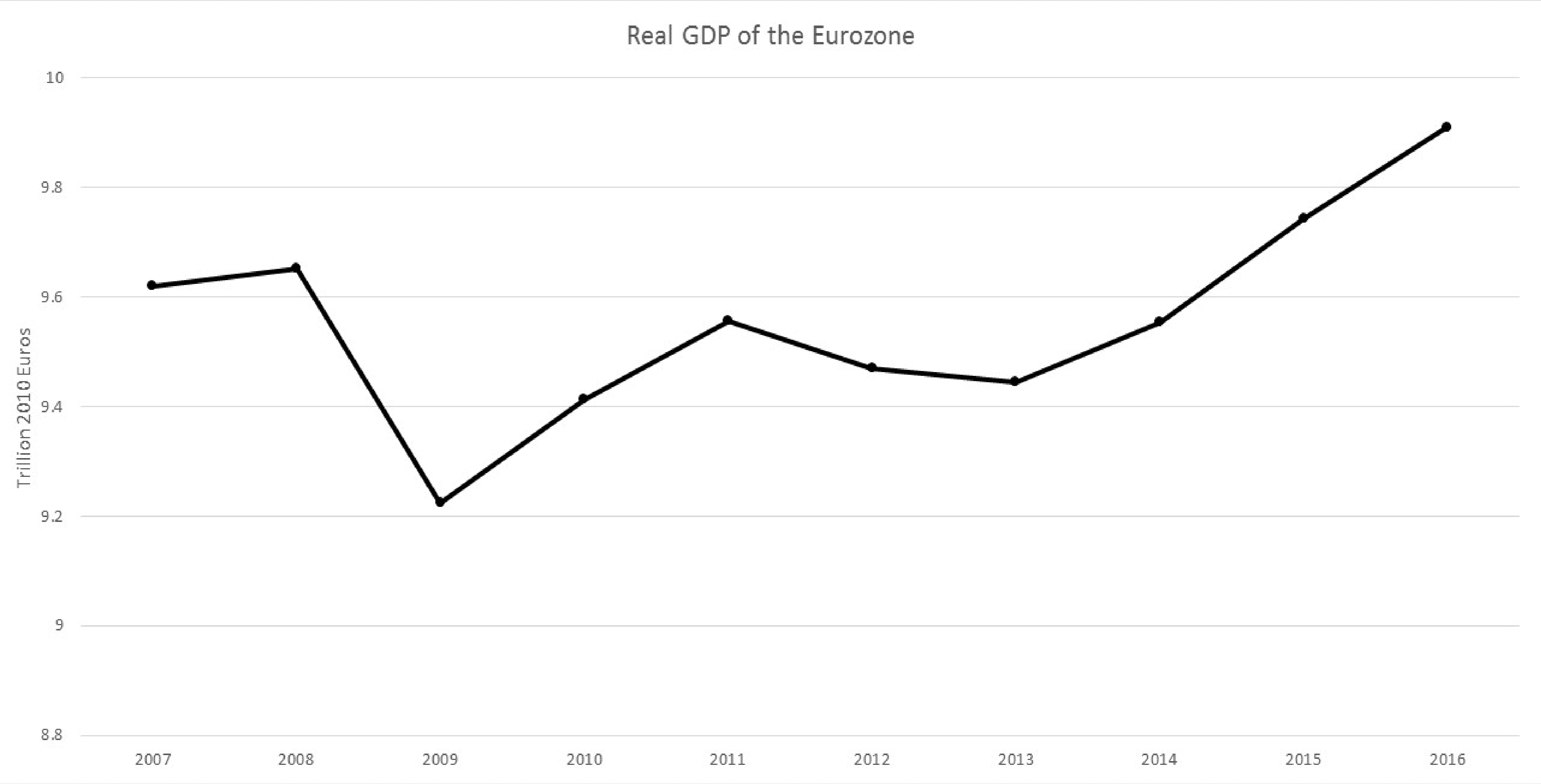
I. Europe: Hope and Disappointment

- Hope: Would lead to more prosperity
  - Did just the opposite
- Hope: Would lead to more solidarity
  - Did just the opposite

Born at a particular moment of history

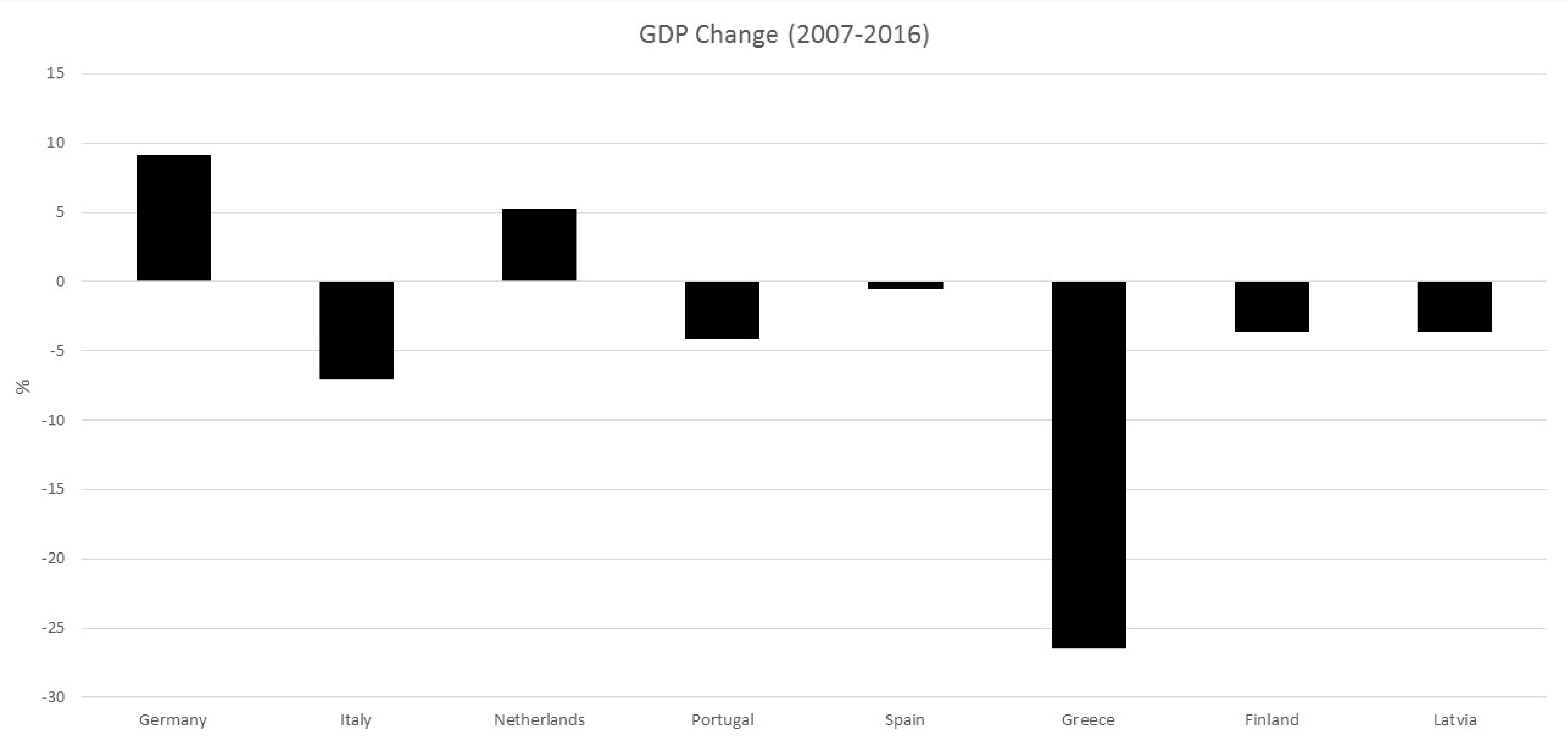
- After fall of iron curtain
  - Wrong interpretation of event
    - Thought it was a result of triumph of capitalism
    - Really a result of deficiency in Communism
- After Latin American crisis, before East Asian crisis
  - East Asian crisis would have taught important lesson: even countries with low inflation and fiscal prudence could have major crises
- Before 2001 and 2008 recessions
  - Showed that financial deregulation could lead to instability, inequality, and massive abuses, not growth
- Big question: would the rules, structure of the Eurozone have been different had it been founded at a different moment in history?
  - The Euro was flawed at birth, with rules that are hard and slow to change
  - With significant consequences

Real GDP is just recovering to earlier levels

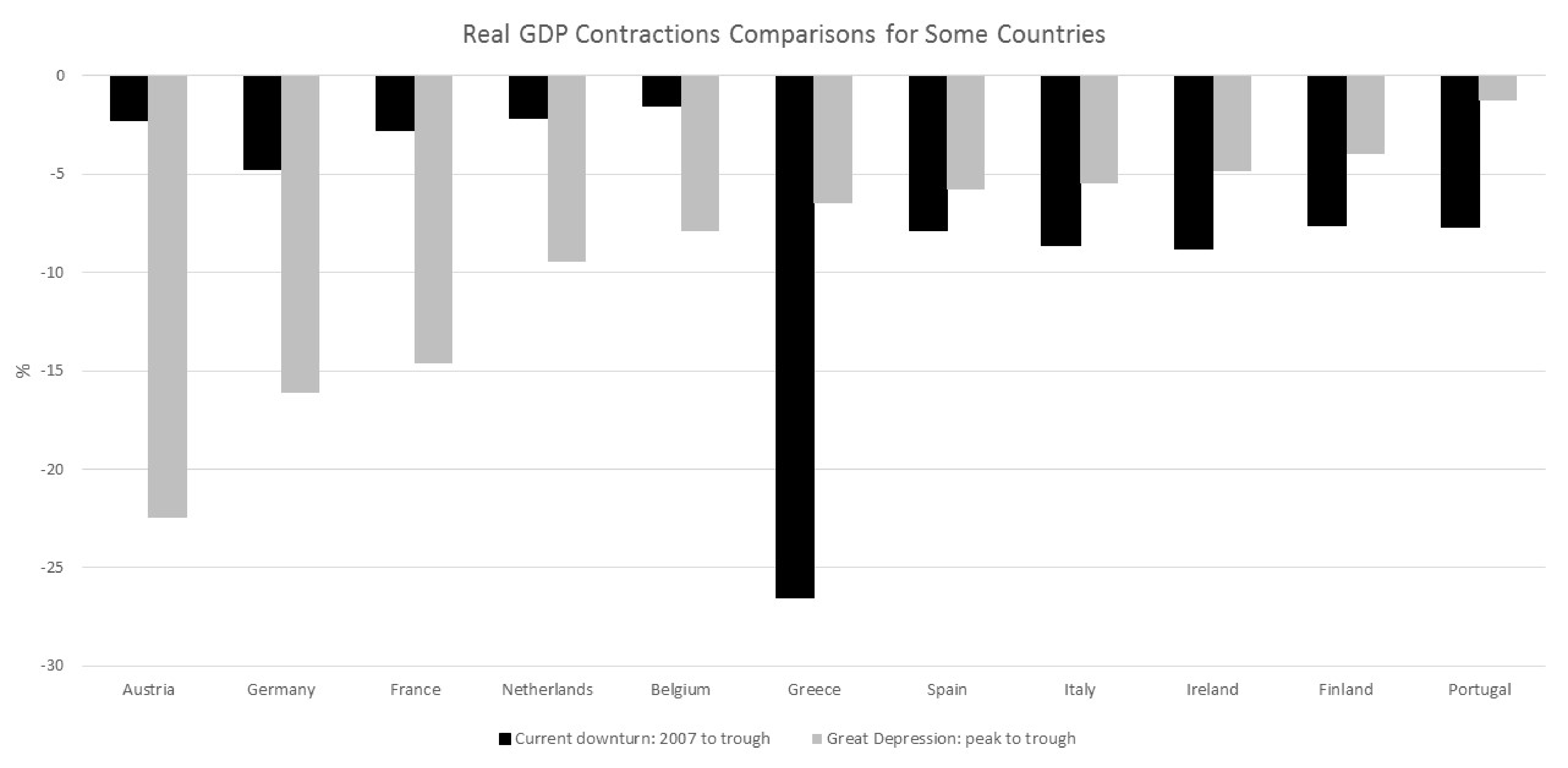


Source: IMF World Economic Outlook Database, April 2017

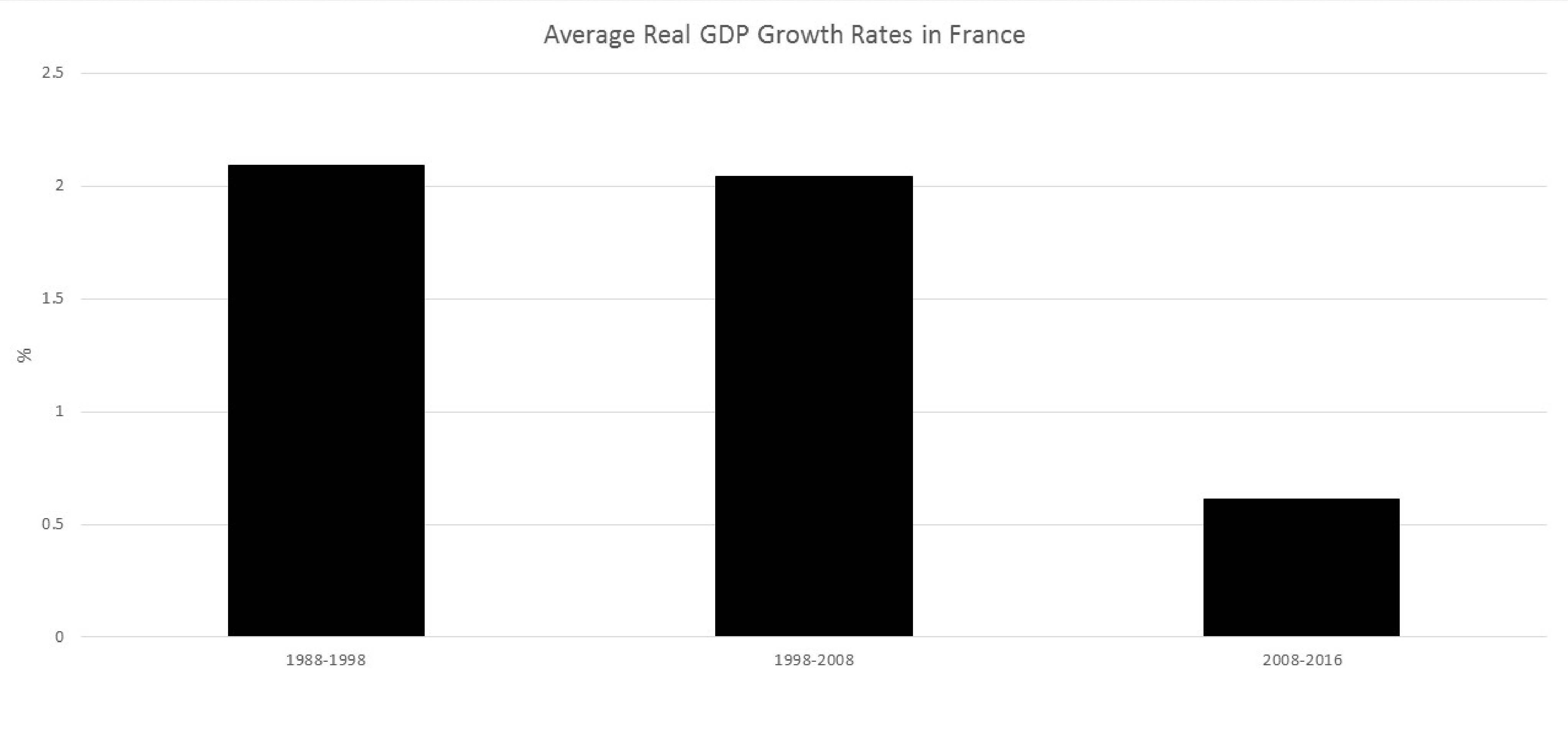
Many countries have lower GDP than before crisis



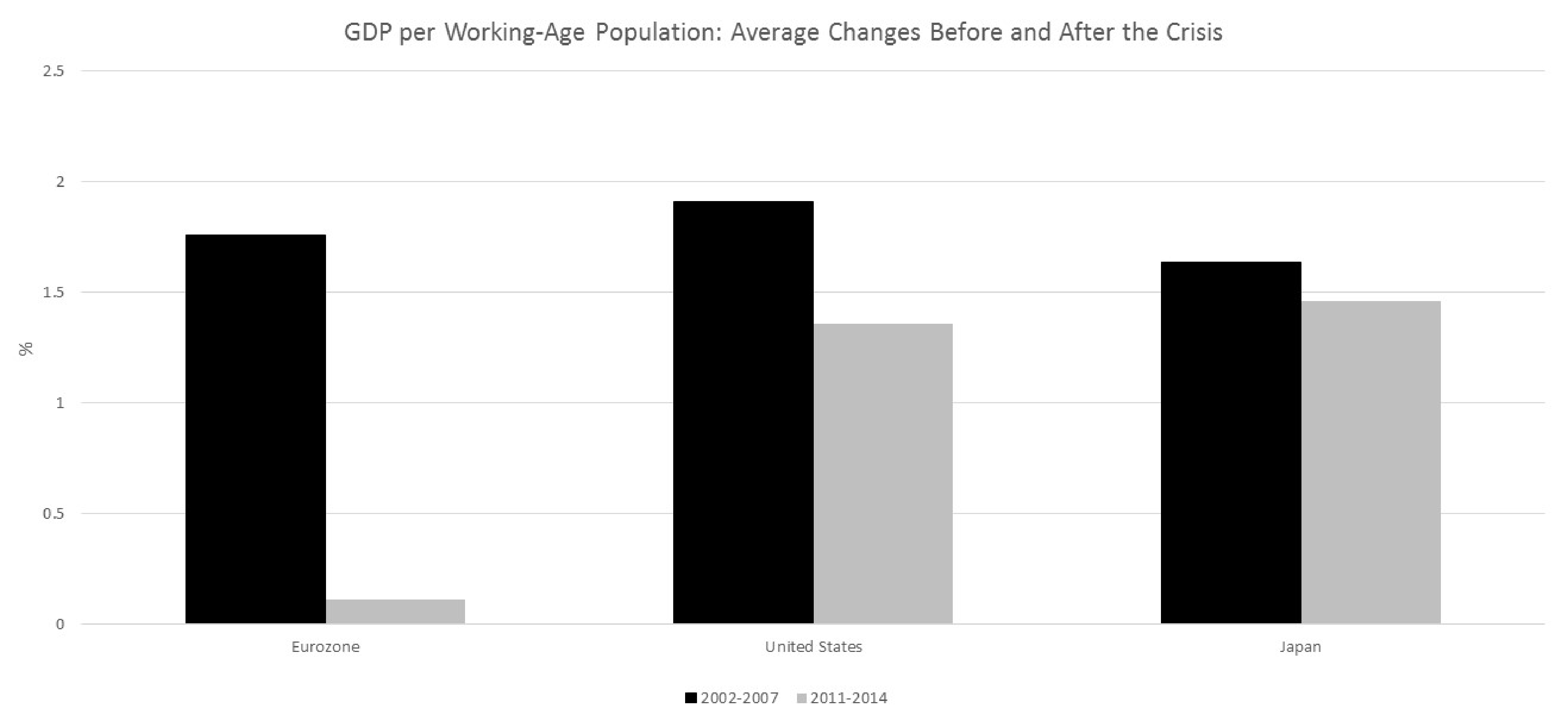
For some countries downturn was worse than Great Depression



France was performing well before the crisis



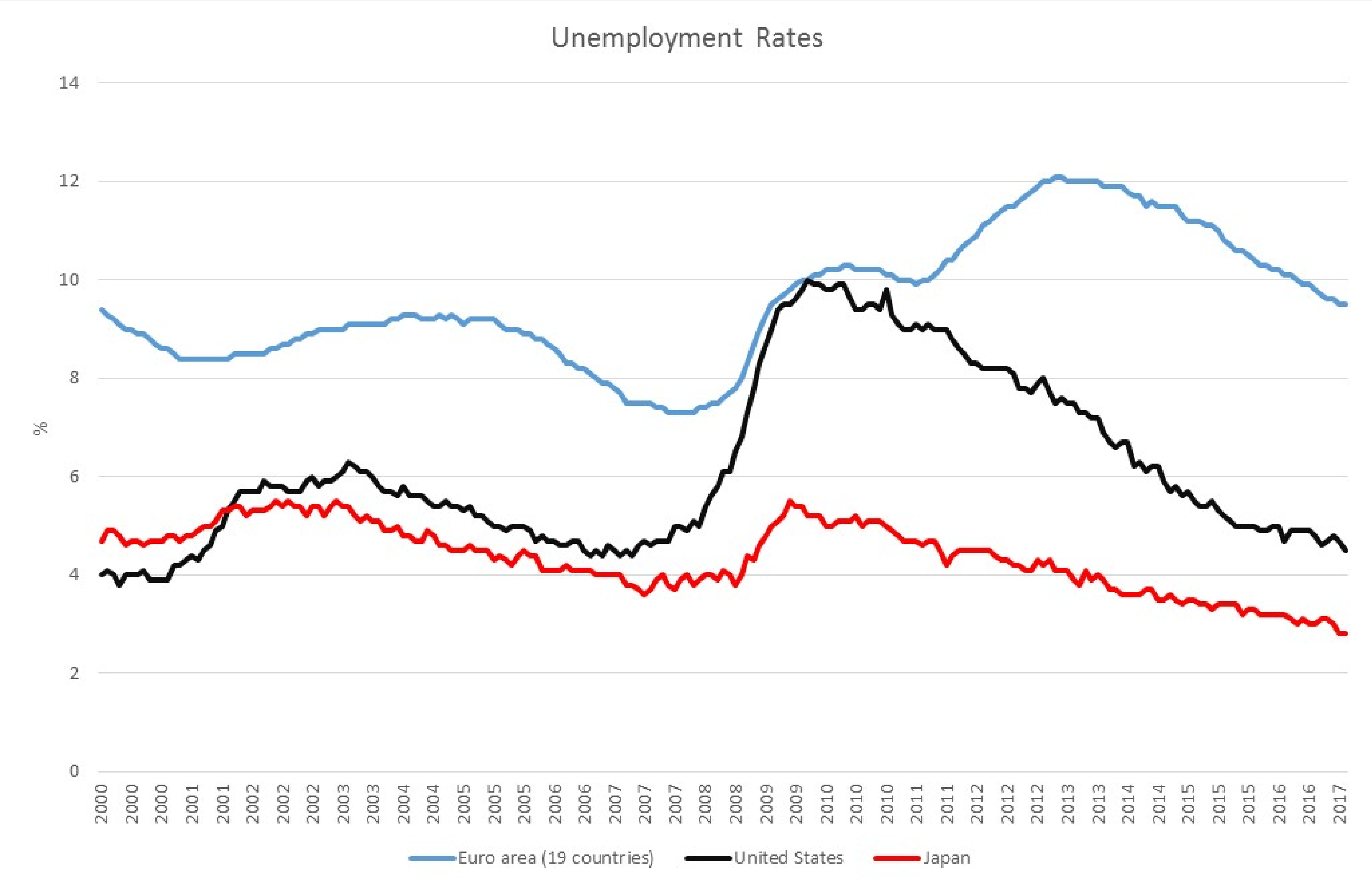
Growth in output per member of working-age population is lower than before the crisis for Europe



Sources: IMF and World Bank

High unemployment

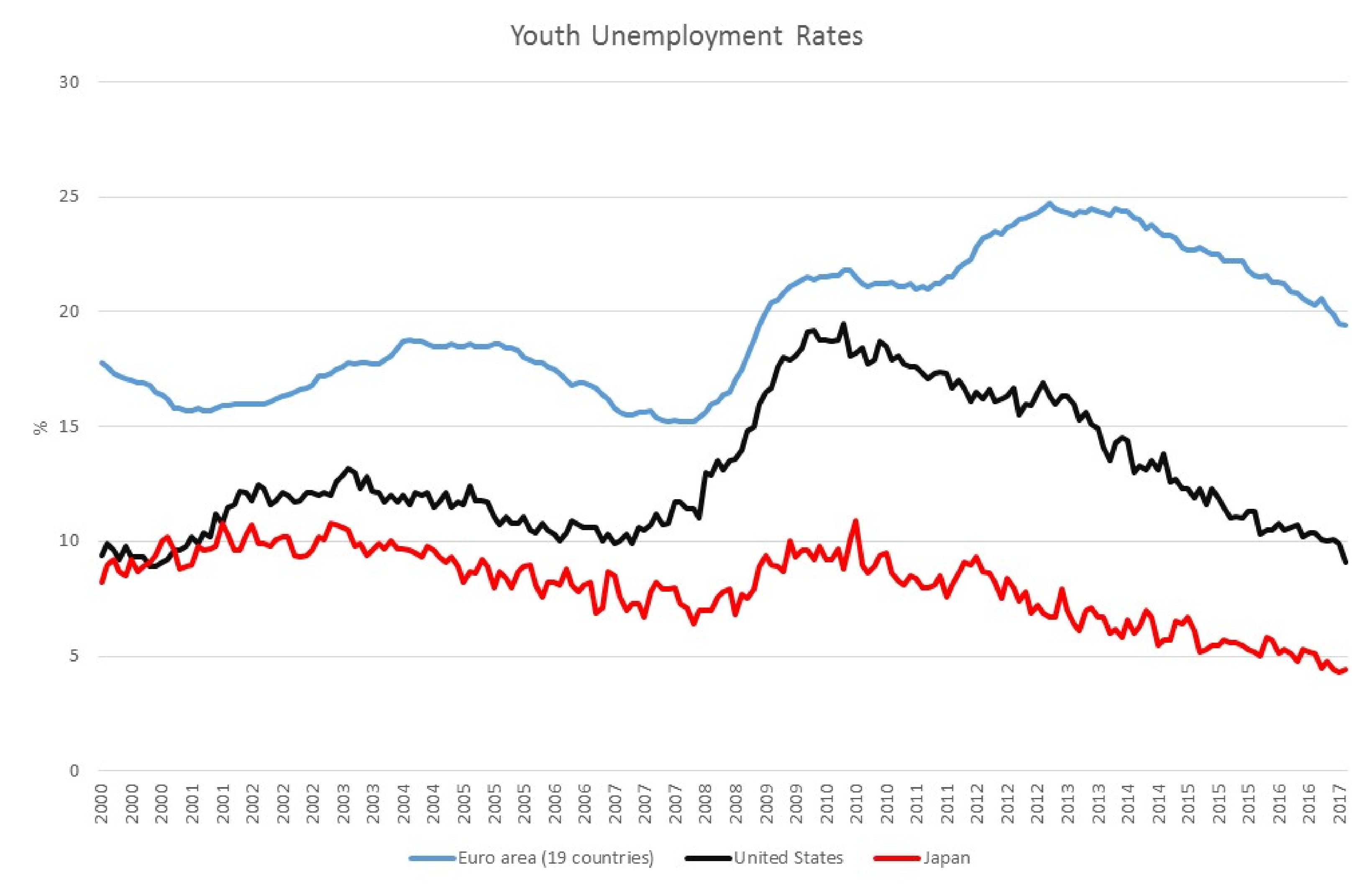
Unemployment rates, seasonally adjusted, January 2000 – March 2017



Source: Eurostat

And even higher youth unemployment

Youth Unemployment rates, seasonally adjusted, January 2000 – March 2017



Source: Eurostat

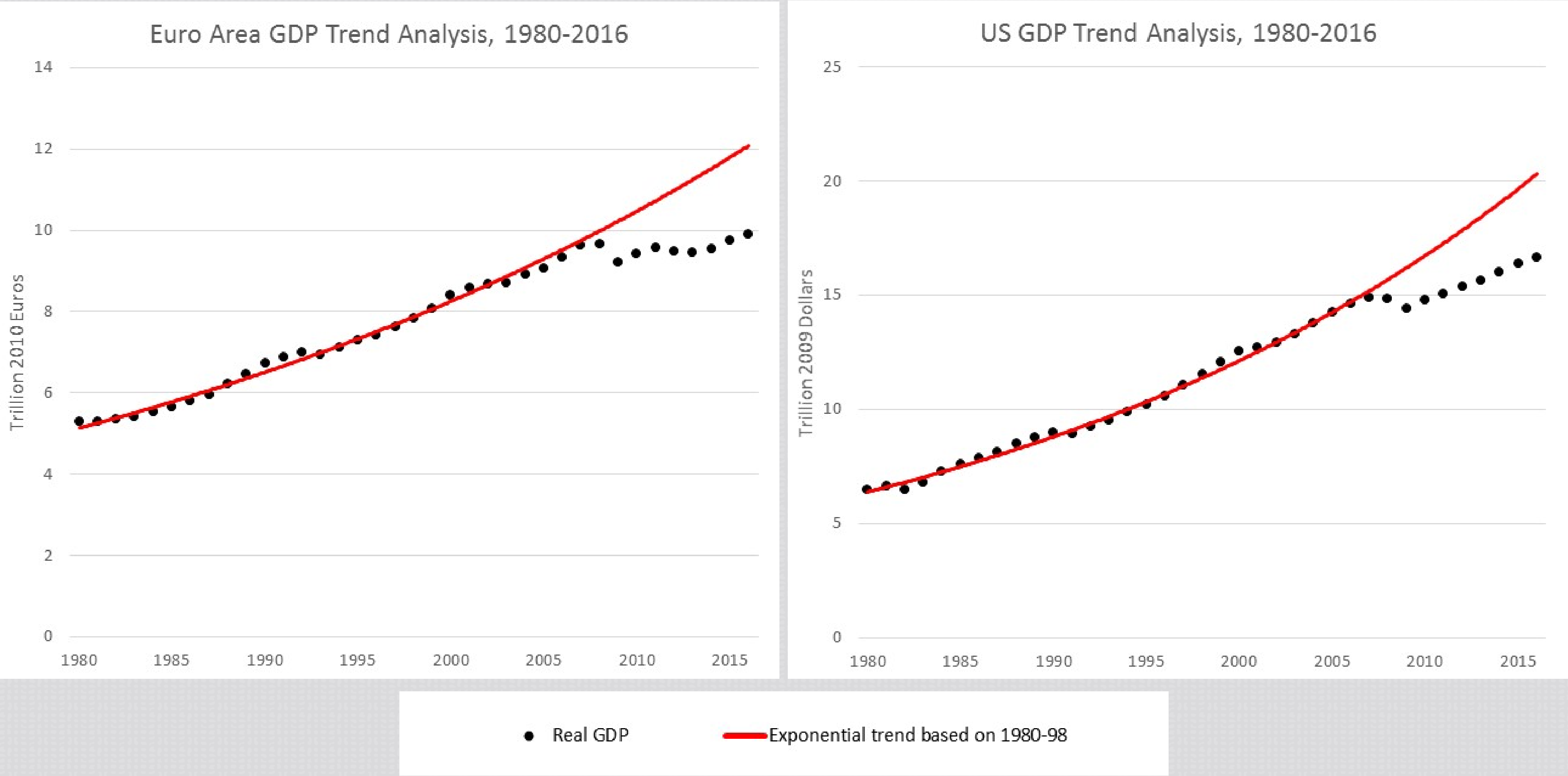
In any other context, even best-performing countries' growth would be seen as dismal

- Germany's economy grew at an average annual rate of just 0.8 percent from 2007 to 2015 adjusted for inflation
- As bad as Japan in its great malaise from 2001-2010
- For the eurozone, GDP per working-age person has increased by just 0.6 percent during 2007–2015, while for non-eurozone European countries, there has been a 3.9 percent increase.
- By 2011, US growth in GDP per working-age population had largely returned to precrisis levels, the eurozone area's number was markedly below—in fact, well below not only that of the United States but of the world and high-income countries.

Especially poor performance

- Once one looks at what is happening to large fractions of the population—who are seeing a decline in their real income
- Once one realizes that its strength is based on surpluses—surpluses that are creating a global problem
  - Worse than China’s
  - If everyone tries to run surpluses, the paradox of thrift kicks in—global insufficiency of aggregate demand

Euro area has performed much more poorly than the US—even though the crisis originated in US



Problems of the euro were widely anticipated

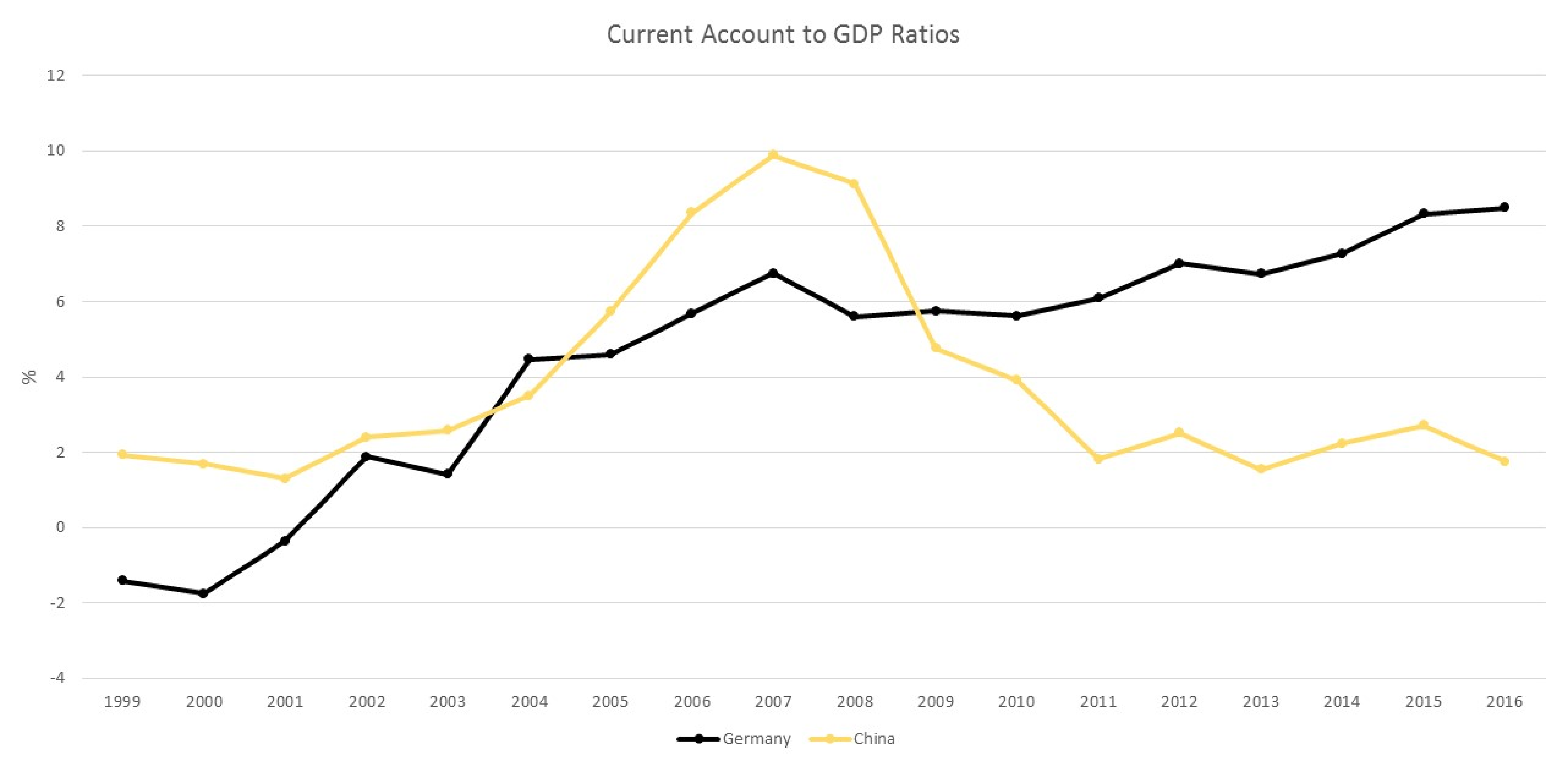
- Europe was not an optimal currency area
  - But even Mundell's analysis was based on simplistic model—gave an excessively optimistic view of success
  - Ignored banks, placed based debt, role of institutions
- Problems would arise when the region was confronted by asymmetric shocks
  - Had taken away two of the critical adjustment mechanisms
  - And hadn't put anything in its place
- The euro was a political project
  - But the politics were not strong enough to do it right

But few anticipated how bad the euro would be for Europe

- Even taking account of the boost that the euro gave to some countries in its first years, output today is far below trend

- Gap is increasing

Current account imbalances



GDP “gap” US vs. Europe

- Even though the 2008 crisis originated in the US, gap is as big, and on trend to be worse.
- Euro (and the policy responses to the euro crisis) are a key reason
- Lowering of future potential growth as a result of persistent unemployment means long term costs are mounting
  - Critical hysteresis effects

The euro helped create the euro crisis

- Earlier “successes” were actually part of the problem
- Markets foolishly thought that eliminating currency risk was equivalent to eliminating country risk
  - Excessive expansion (e.g. real estate boom in Spain) led to overvalued *real* exchange rate
  - Correction slow and costly

II. There are fundamental flaws in the structure of the euro

Not just a matter of poor policy

- Implication: just change policymakers and policies
- Policies were badly flawed
- But not even the best of policymakers could have made euro work, without breaking/changing rules
- Euro was flawed at birth

Understanding failures

- Took away two adjustment mechanisms:
  - Interest and Exchange Rates
- Didn’t put anything in its place
- Instead tied hands further
  - Fiscal constraints
- ECB mandate to focus on inflation

Key misconceptions as the time of the founding of the euro

Convergence criteria

- Thought that low deficits/debts would ensure convergence and prevent crises
  - But Spain and Ireland had fiscal surpluses and low debt GDP ratio before crisis
  - Debt and deficits didn’t cause their crisis
  - Crisis caused their debt and deficit

Europe had actually created a divergent system, not a convergent one

- Successful countries would grow richer, poorer countries poorer
- Built into the structure
- Reinforced by the policies

Creating a dynamically unstable and inefficient system

- Free mobility of labor—workers could move to escape debt burdens, implying allocation of labor was not efficient
  - Inherent problem with free mobility and place based debt
- Free mobility of capital and goods—but without tax harmonization--implying allocation of capital was not efficient (tax competition)
  - And problem of growing inequality could not be effectively addressed
- Failed to realize that backing any country's banks is its government
- Fundamental flaw of single market principle in absence of a banking union (and especially common deposit insurance)
  - Money flows from poor countries to rich countries (gravity-defying)

Financial contraction exacerbating effects of austerity

- As money flows out of banking systems in affected countries, private spending contracts
  - Marked decline in SME lending
- Deepening downturn
- Vicious circle

Further bases of divergence

- Restrictions on industrial policies made it difficult for laggards to catch up
- Single monetary policy meant firms and governments in weak countries had to pay higher interest rates
- Absence of central (EU) spending meant that weaker countries could invest less in education, technology and infrastructure

Resulting in ever widening gaps

Creating conditions for crisis

- Absence of adjustment mechanisms for real exchange rates
  - Put burden of adjustment on deficit countries
- Build-up of foreign debts, exposing country to “sudden stop”

While markets are not self-correcting, Euro made matters worse by impeding adjustment

- Euro introduces, within Europe, a kind of rigidity analogous to the gold standard—makes adjustments more difficult
  - Europe hurt by America’s “beggar-thy-neighbor” policies, as quantitative easing works to lower exchange rate, and ECB doesn’t fully respond

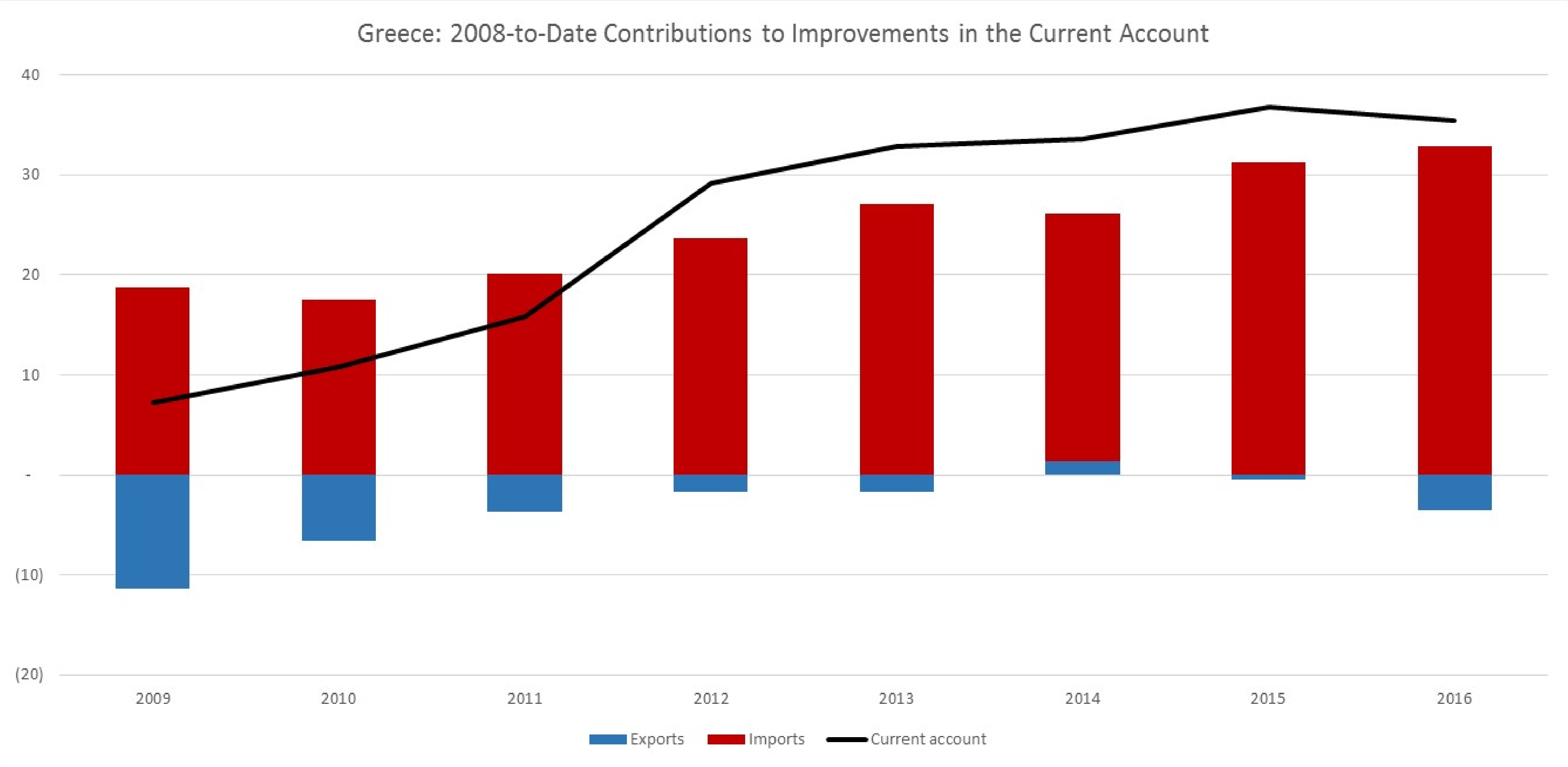
“Internal devaluation” is no substitute

- Deflation hard to coordinate
- And causes hardship, with unindexed debt contracts—borrowers can’t pay back what is owed
  - Leading to financial stress and instability
  - Leading to increased leverage
- If internal devaluation was an easy substitute, gold standard would not have imposed any constraint on adjustment
  - And Argentina would have fared better under its peg
- Two key intellectual failures
  - Failure to take into account consequences of unindexed contracts (especially debt)
    - Large distributive consequences—with adverse effects of aggregate demand, bankruptcies, financial stability
  - Failure to distinguish between traded and non-traded goods
    - Even if there were positive responses in traded sector, adverse effects in non-traded sector overwhelm effects
    - Leading to weaker financial sector
    - Even having adverse effects on exports (increased cost of capital)

There has been a high cost to correcting current account imbalance through internal devaluation

- Had hoped that internal devaluation and structural reforms would lead to increased exports
- In fact, most of the “correction” of current account balances has been through contraction of imports—as a result of killing of economy
- Increased Eurozone global imbalances not sustainable from global perspective

Current accounts improvements



Borrowing in a foreign currency

- US will never have a Greek style crisis
  - Can print the money that it owes
- The Euro brought emerging market style crises to Europe

Other adverse aspects of structure: the ECB

- *Inflation*
  - Monetary policy—single minded focus on inflation
    - As opposed to broader US mandate
  - Not only too narrow in mandates, too narrow in instruments
  - Ideology: keeping inflation low was necessary and essentially sufficient for maintaining growth and stability
    - Ironic: Fed founded not to fight inflation but to enhance financial stability
    - Underestimated significant of market failures
    - Ideology also wanted to keep ECB constrained in its use of tools
  - *Underlying problem: governance, lack of democratic accountability*
    - Ideology made a virtue of this

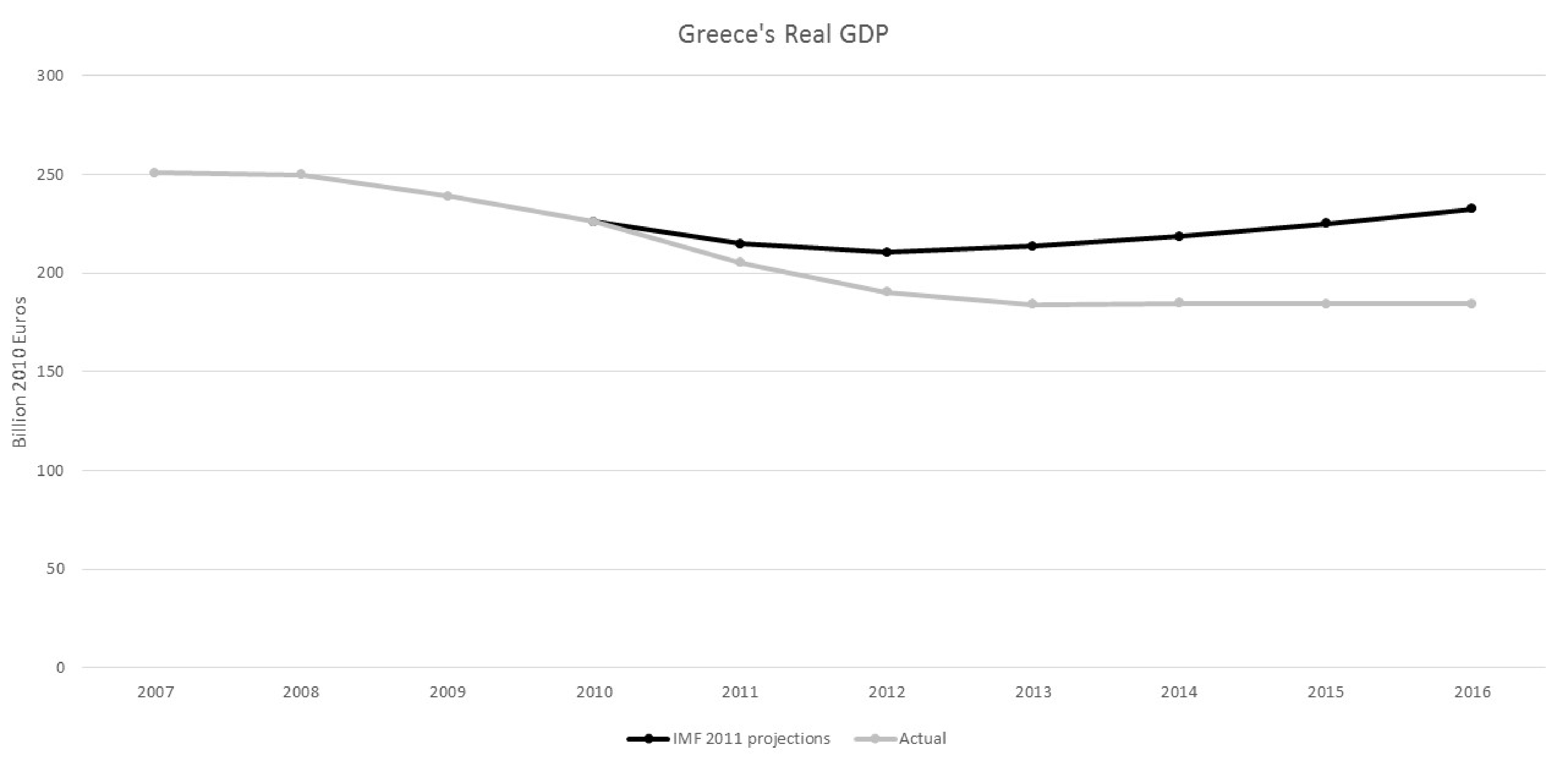
III. The flawed policy response

- Problems of *flawed structure* exacerbated by *flawed policies*
  - Not a surprise: both reflected similar economic misunderstandings (e.g. what is required for a currency union to work)
- Austerity
  - Talked about growth, but didn't do anything about it
- Emphasis on structural reform *within countries*
  - Some of which exacerbated current problem of insufficiency of aggregate demand
  - Real problem was the structure of the eurozone itself

Policies led to divergence rather than convergence

- The macro-policies forced on the periphery countries by the troika led to further *divergence*
  - *Strong countries grew markedly relative to weak countries*
  - predictable and predicted
  - expansionary contractions was a silly idea
- The economic performances were *repeatedly* less than the EU and the ECB anticipated
  - with disappointing growth and improvement in fiscal positions
  - EU and ECB had not fully taken on board what was happening in the financial sector
    - standard models used by central banks in the run-up to the 2008 crisis had demonstrated their inadequacies

Troika’s remarkably poor models



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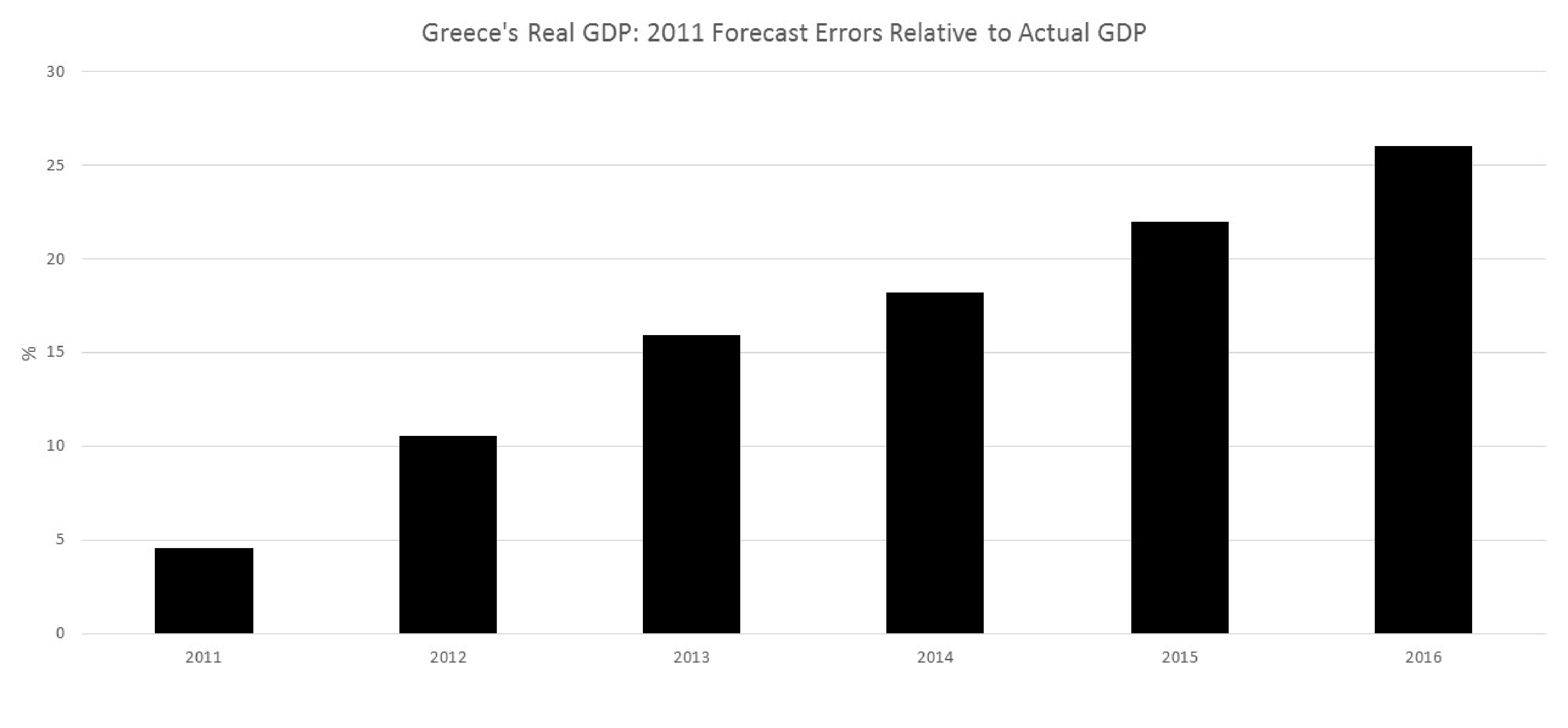


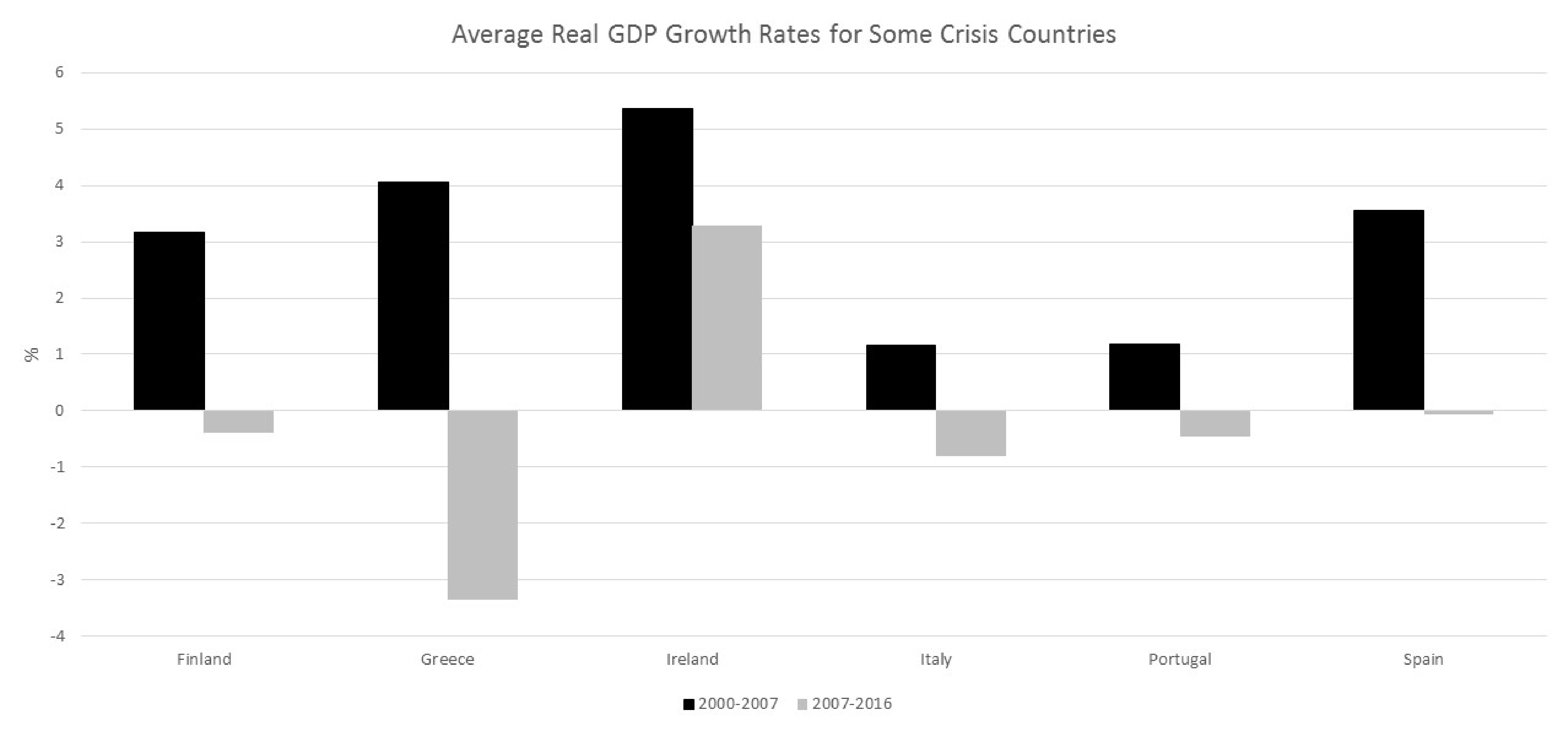
Austerity

- Enhanced budget discipline would not prevent next crisis
  - And would not help Europe get over this crisis
    - Made matters worse
- Austerity has essentially never worked
- Wrong diagnosis of the problem led to wrong prescription
- But without help from the rest of Europe, crisis countries have little choice but to accept what is demanded of them—austerity
  - And without a change in the eurozone structure/policy, expansion could lead to larger and unsustainable current account deficits

Structural Reforms *within countries* have not worked—and are often counterproductive

- Many Programs have heavy emphasis on structural reforms
- Structural problems on which they have focused didn't create crisis
  - Many of crisis and near crisis countries were performing well before 2008
    - With the same structure that they have today
    - From 1995 to 2007 Greece and Spain grew faster than the eurozone average (3.9% and 3.8% vs. average of 2.6%)
- And resolving alleged structural problems won't resolve crisis
  - But structural reforms take time
- Many supply side measures are of nth order importance
    - Size of loaf of bread, definition of fresh milk (Greek program)

Poorly performing countries today had performed well before 2007: no change in structure



Many “structural reforms” are counter-productive

- Structural reforms are mostly are supply side measures
  - Problem today is lack of demand
- Some so-called structural reforms may weaken economy by weakening demand and increasing current account deficit
  - Labor market flexibility (code word for lowering wages), weakening unions will lead to lower demand
    - US—allegedly most flexible labor market—has not performed well
  - Increasing consensus that growth in inequality is bad for economic performance
    - Leads to weaker demand
    - In fact, increasing inequality in US played major role in leading to crisis
      - Fed tried to offset by creating a bubble, through low interest rates and lax regulation

Needed: Reform in the structure of the Eurozone itself

- Many supply side measures are focused on non-traded sector
  - Depending on nature of reform and demand elasticities, could worsen current account deficits and lower aggregate demand and output

- Real structural transformation is needed—e.g. in many countries, from manufacturing to service sector
  - But this is not what Troika focused upon

→ **WHAT IS REALLY NEEDED IS A CHANGE IN THE STRUCTURE OF THE EUROZONE ITSELF**

IV. Two key neo-liberal ideas that contributed to the **crises**

- Failure of regulatory oversight based on belief that markets were self-regulating, efficient, and stable
  - Theory and history had shown otherwise
  - Often responses to a disturbance are not self-correcting
  - Major disturbances to economy are endogenous, created by the market itself

Other flaws in economic reasoning

- Key externality is danger of some country borrowing excessively
  - Providing explanation for constraints on deficits and debt

In reality, other key externalities

- Competitive real devaluation—some countries are better able to force workers to accept lower wages
- Surpluses—one country's surpluses become other countries' deficits
  - If Eurozone as a whole is in balance, if Germany has surplus, others must have deficits
  - Germany's failure to have strong wage and demand policies imposes high costs on others
- Single market
  - Banks regulated in any country could operate in any other
    - Implying inadequately regulated financial institutions could bring problems across borders
    - Especially important as financial markets become more interlinked
- More broadly: distorted banking/financial system—implicit guarantee of some governments worth more than others (greater capacity for bailouts), distorting flow of funds
- Tax competition—effects evidenced in Apple case

V. What is to be done?

Reforms *in the structure of the eurozone* need to be at core

- ***A common fiscal framework***
  - more than and fundamentally different from an austerity pact
    - or a strengthened version of the growth and stability pact
- ***Mutualization of debt***
  - Could be done in a variety of ways (**Eurobonds**)
  - Would lead to lower interest rates
  - Providing more fiscal space for countries to have expansionary fiscal polices

A common financial system (banking union)

- With system wide **deposit insurance**
- With system wide regulation
- Common resolution
  - Otherwise, money will flow out of banks of crisis countries to strong countries, exacerbating downturn
- But recognizing that even with a common interest rate, there can and should be differentiated macro-prudential regulations (Greenwald-Stiglitz, 2003)

Further structural reforms

- *Tax harmonization*
  - restricting the race to the bottom in capital taxation
  - Reducing the distortions caused by tax competition among countries
- *Industrial policies*
  - not just allow, but encourage, industrial policies
  - enabling those behind to catch up
  - to prevent further divergences within the countries of Europe
- *Tax and other measures to discourage surpluses*
  - When some country has a surplus, some other country must have a deficit
  - Surpluses also contribute to weak aggregate demand

Further structural reforms

- Change in the *mandate of the European Central Banking*
  - from its single minded focus on inflation
  - to a broader mandate
    - Including growth, employment, and financial stability
  - Important to encourage growth
    - Especially important in global context where other countries pursuing broader objectives
    - Preventing exchange rate appreciation
  - Broader instruments
  - Improved governance

Policy reforms

- ***From austerity to growth***
  - Role of EIB, other special funds (solidarity fund for stabilization)
  - Mutualization of debt will provide resources
- *Adjustment of real exchange rates*
  - Two ways—Germany increases its prices, rest of Europe lowers theirs
    - Through wage and income policies and aggregate demand
  - Large asymmetries of costs of adjustment
- *Towards debt restructuring*
  - May be necessary for some countries
  - Should be deep
  - Should be done quickly

Structural and policy reforms need to be viewed as a package

- A move away from austerity needs to be *financed*
- Growth needs to be sustained and sustainable
  - *Without a buildup of current account deficits*
- *And there is a need for urgency*

Concluding comments

- Current strategy has been very costly
  - Large waste of resources
    - Especially human resources
  - Of an order of magnitude greater than associated with the mistakes made before the crisis
  - Lowering future potential growth

The crisis in Europe is manmade

- It was not caused by a natural disaster
- It was caused by the decisions of Europe and its leaders
  - What they did
  - What they didn’t do
- They created conditions which enabled it to occur
- They responded in ways that made it worse

The high price of the euro

- *Undermining democracy*
- *Undermining the European project*
- The euro crisis, like so many other crises, is more attributable to market excesses than to government profligacy
  - Crises are perhaps an inherent feature of capitalism
  - they do not have to be as frequent, as deep, and as costly as they have been

The euro was a collective project of Europe

- And will require *collective* action by Europe to fix
  - The notion that Europe is “ not a transfer union” undermines solidarity and impedes the ability to find a collective solution
- Europe faces a choice
  - Reform the structure of the eurozone, and adopt pro-growth prices
    - Restoring shared prosperity
    - Allowing Europe to live up to their potential.
  - Muddling through, doing the minimum set of reforms that prevent the collapse of the euro
    - But do not allow for a true recovery, at least not any time soon
    - Imposing enormous costs on eurozone
    - Including lowering potential growth
  - Some form of break-up of euro
- The first course is preferable
  - It can be done
- There is a real urgency to making the reforms
  - Large costs to delay
    - Including undermining future potential growth

- Hope: changes will bring an end to the crisis *without too much more damage*
    - The original hope of the euro can be restored.
- But it won't happen on its own.
    - It won't happen if the leaders of Europe continue to blame the victims, the countries that are suffering from recession and depression.
- It will only happen if they recognize the fundamental flaws, *both* in the institutional arrangements and the policy frameworks, and make the requisite reforms
    - Not the reforms that are being discussed by the Troika, which will only reinforce failed structure and policies—more and deeper austerity, with worse automatic destabilizers
- What is needed is the structural and policy reforms discussed here
    - And most immediately, an end to austerity and a restoration of policies ensuring *shared* prosperity