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Origins and prospects of the Euro existential crisis

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Origins and prospects of the Euro existential crisis

Luigi Bonatti* and Andrea Fracasso#

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Abstract

The current large current account imbalances in the Euro zone reflect persistent diverging trends between the core and the peripheral countries, which were paradoxically reinforced by the very same introduction of the Euro. The reduction in the credit spreads and the increase in capital flows that followed the Euro adoption, permitted to most peripheral countries to fail to uniform their price and wage dynamics, as well as their fiscal policies, to the more disciplined countries. The global financial crisis and the Greek misreporting of budgetary data made the situation precipitate and expose the periphery's deep weakness. Despite some temporary financial assistance from the core countries and the ECB, the long term solution to the situation can only be a rebalancing and real convergence within the Euro zone. Because the core countries are unwilling to accept higher inflation and larger fiscal expenditures, and even less inclined to set up a transfers union, the burden of adjustment will bear on the peripheral countries which will most likely suffer very painful processes of internal devaluation. The long-term future of the Euro, thus, will depend on how the societies and political systems of the Euro periphery will react to the rebalancing process and the sacrifices that this will entail.

Key words: European imbalances; Macroeconomic divergence and adjustment; Germany; Political economy of structural change; Social market economy.

JEL codes: F41, F42, F43, F51

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1. Introduction

It may appear paradoxical that, in the aftermath of a crisis caused by the U.S. households' excessive accumulation of debt, the United States has been able to regain some modest but steady GDP growth and to bring the unemployment rate slightly below 8%, while the Euro zone is still struggling to put its debt crisis under control, with its southern periphery (Portugal, Greece, Italy and Spain) suffering a deep recession that is raising unemployment at record levels. How was possible that a financial crisis originated in the United States became a Euro-zone existential crisis? And what will be the most likely future developments of the European debt crisis?

In this short essay, we try to contribute to answer these questions without pretending to provide an exhaustive and complete explanation of a complex situation which involves different countries with specific characteristics and is conditioned by many factors. More modestly, we aim at highlighting a few points that have emerged as particularly relevant in the unfolding of the crisis or that may play an important role in its evolution in the future.

The essay is organized as follows. Section 2 provides a brief examination of some motivations that from the beginning were behind the Euro-core countries and the peripheral countries participation in the process of European monetary integration. Section 3 discusses some of the deep reasons of the current crisis. Section 4 focuses on the current situation of the Euro periphery. Section 5 seeks to look at the bailing out of the periphery from the viewpoint of the core countries and in particular of Germany. Section 6 concludes by arguing that the long-term future of the Euro will depend considerably on how the societies and political systems of the Euro periphery will react to the current deep depression and consequent impoverishment.

2. A (brief) historical excursus

One may argue that Germany's desire to limit the possibility of competitive devaluations on the part of its European trading partners through some monetary arrangement was already apparent in the last phase of the Bretton Woods system (see Notermans 2012). However, it was after its demise in the early 1970s that this willingness materialized in some European agreement ("currency snake"), and it was in the late 1970s that it led to the European Monetary System (EMS). At the end of the 1970s, indeed, the peripheral countries were in desperate need of an external constraint (a "nominal anchor") to discipline their social actors' wage- and price-setting behavior and to buy credibility, so as to lower the high inflation brought about by the lax monetary policy that accommodated the rapid increase of nominal wages, fiscal expenditures and oil prices of the previous decade. Thus, it is legitimate to say that the European monetary integration project was the result, from the true beginning, of these complementary demands: the core countries' desire to avoid uncontrolled competitive devaluations and the peripheral countries' need to have the Bundesbank's (and then the European Central Bank's) monetary policy as an external anchor (Giavazzi and Giovannini, 1989). One may also conclude in retrospect that overall the EMS was quite successful in helping the two blocs of countries to achieve in the 1980s their complementary objectives, since Germany could resume those significant trade surpluses that it had in the 1960s and early 1970s but not any longer at the end of the 1970s, while the peripheral countries participating in the EMS could disinflate their economies at a relatively low cost.

However, the relative success of the EMS in providing a credible exchange-rate commitment device for the European countries in the 1980s was (paradoxically) an important cause of the currency crisis of 1992-93, in which the Italian Lira (together with the British Pound) took center stage. We briefly discuss this episode because it should have represented an important experience from which to learn about the behavior of policy-makers, the reactions of financial markets and the design of any future European monetary arrangements to prevent the repetition of such patterns of events. The fact that the wrong conclusions were drawn from that experience became apparent to everybody—as we shall see—only with the outbreak of the current European debt crisis in the late 2000s.

As a matter of fact, indeed, the credibility of the exchange-rate commitment that the participation in the EMS guaranteed to the Lira was probably decisive for allowing the Italian governments of the 1980s to postpone a urgently needed fiscal consolidation, since thanks to this credibility the country could increasingly borrow from abroad at reasonable interest rates. This credibility was also a critical factor in the late 1980s and early 1990s for permitting to the Italian domestic demand to go on expanding—in spite of the gradual loss of competitiveness and increased trade account deficits—thanks to foreign capital inflows. Only at a late stage of this process of growing real imbalances and accumulation of both government and external debt, when interests rates were on the rise in Europe as a consequence of the German reunification and of the Bundesbank's restrictive reaction to the reunification plans of the German government, financial markets suddenly realized that the Italian economy was moving along an unsustainable trajectory and that a major devaluation of the Lira was inevitable, thus triggering the crisis of the Italian currency (and of the Italian public finance).

3. What went wrong?

It was widely believed that the establishment of a single currency for the countries previously participating in the EMS would have eliminated the main cause of the speculative attacks that led to the European currency crisis of 1992-93 (see Eichengreen and Wyplosz 1993). Indeed, the conviction was that the creation of the Euro would have suppressed any intra-European exchange-rate risk by ruling out forever any possibility of exchange-rate realignments within the monetary union. The lack of any legal provision for regulating the exit of a country from the monetary union reinforced this perception of irreversibility of the latter. Moreover, the tight fiscal rules of the Stability and Growth Pact, making operational the vague provisions on the Excessive Deficit procedure contained in the Maastricht Treaty, were supposed to keep in check governments' profligacy and prevent the fiscal irresponsibility that was crucial in precipitating the crisis of 1992-93. Finally, financial markets were deemed able to properly discriminate among both private and public borrowers according to their specific credit worthiness, thus pricing efficiently the risk inherent in the securities issued by different debtors.

The conventional wisdom described above concerning the solidity of the European currency construction was complemented by the widespread belief that—thanks to the Euro—real convergence would have occurred between core and periphery countries, namely that peripheral countries would have displayed German-like wage moderation and low inflation in order not to lose competitiveness vis-à-vis the core countries.[1] In other words, the optimistic conviction that the elimination of the nominal exchange rate as a means of adjustment within the Euro area would have forced the peripheral countries to uniform their price and wage dynamics to the more disciplined core countries was a key determinant of the investors' benign neglect attitude towards the persistent structural differences across members of the Euro zone.[2]

These expectations were self-defeating since it was precisely because of them that the elimination of (nominal) exchange risk, together with the ECB anti-inflationary credibility, allowed the periphery to borrow at interest rates much lower than those observed before the establishment of the Euro; this, in turn, created incentives to postpone painful fiscal consolidations (Italy, Greece) or to boost debt-financed households' consumption and housing investment (Spain) (see Lane and Milesi-Ferretti 2007). Since the late 1990s, the spreads between the yields on the long-term German government bonds and those on the peripheral countries' securities of the same maturity were practically reduced to zero (Figure 1). Hence, the possibility of easy access to credit at German interest-rate levels, which was the true bonanza for which the peripheral countries had struggled to be admitted to the Euro club, ended up feeding a process of real divergence between the Euro core and the periphery, with real unit labor costs increasing much faster in peripheral countries (Figures 2 and 3).

[1] The Delors Committee Report (European Commission 1990), that set the steps of the monetary integration process and established the main features of the prospective monetary union, was mainly motivated by the belief that the single currency was the best response of closely economically integrated countries to the risks brought about by the liberalization of capital flows within a multi-currency monetary system, such as the EMS, with not fully credible exchange rate pegs and independent national monetary policies. The Report was mainly concerned with the 'impossibile trinity' concept and deliberately ignored optimum currency area considerations (see, on this, Wyplosz 2006).

[2] In the debate on the Commission's plan, two main approaches emerged: the 'monetarist view', held by France, and the 'economists' view', embraced by Germany (see Wyplosz 2006). In a nutshell, the former was against discriminating among the candidate countries on the basis of demanding entry conditions: newly established European institutions in charge of the monetary integration and the very same integration process would have reset past expectations and habits. The economists camp, on the contrary, considered the participation in the monetary union as the very last stage of a long-term convergence process, along which the candidate countries adopt a stability culture and more similar socio-economic systems. Notably, the adoption of the Maastricht criteria to select the member of the union should not be read as a victory of the economists camp: the convergence criteria were exclusively on nominal convergence, their respect was monitored only over a very short period of time before the irrevocable fixing of the exchange rates, and their interpretation was, to say it euphemistically, liberal. Markets and policymakers acted as if convergence had been achieved, although it clearly—as timely argued by various economists, such as Lane (2006) and Wyplosz (2006)—had not.

Indeed, for a certain period of time, most of the countries with large external deficits were recording high rates of growth, good fiscal results, and declining unemployment rates. Housing bubbles, large private debts (see Figures 4 and 5), high bank-leverage and large current account deficits did signal the existence of some structural problems, but neither the local nor the European authorities felt like intervening at the risk of spoiling the favorable momentum.[3] On the contrary, in the 2000s the core countries implemented structural reforms and budgetary policies with a view to improving their international competitiveness. The European authorities could not actively intervene to ensure greater convergence, mainly because the European treaties focused on fiscal policy and neglected macroeconomic coordination and financial surveillance. Moreover, the Commission had been severely weakened in the early 2000s by its struggle against Germany and France over the adoption of excessive deficit procedures, notwithstanding the favorable judgment of the European Court of Justice in 2004.[4]

In the same years, the growing real imbalances between the Euro core and periphery were exacerbated by the emergence of new economic powers (e.g., after the accession of China to the WTO) and by the extension of the EU to Eastern Europe, which for Euro-core countries enterprises—more than for the enterprises of other countries—represented an opportunity for de-localizing some production processes in nearby low-cost countries, thereby boosting productivity and profitability. The emergence of new industrial powers in the world economy was a true asymmetric shock for the Euro zone: China was directing competing with the southern European producers specialized in labor-intensive industries (like textile), while it represented a new destination market for the German investment goods (see Chen et al., 2012; Mikkelsen and Ruiz, 2012).

[3] It should be noted that while Italy and Greece share some weaknesses common to the other peripheral countries, they are unique along certain dimensions. Italy's growth has always been very modest (when positive) given the absence of credit and housing booms, and fiscal policy has remained severe, although not enough to bring the debt over GDP ratio below 100%. Greece has been instead characterized by very generous budgetary policies, hid to the markets through what amounted to an accounting fraud by the Greek officials. This said, they also lost competitiveness and their external imbalances worsened progressively.

[4] Focusing on the progressive worsening of the Greek external position, Katsimi and Moutos 2010 argue that European authorities have been unable or unwilling to intervene. If Greek budgetary data were misreported, the ongoing large current account deficits were well visible and clearly dangerous.

4. Euro-periphery and some unpleasant facts

The absence of relevant financial market reactions in the face of growing intra-European imbalances came to an end with the worldwide crisis of the housing and banking sectors. Even if the contagion transmitted through the U.S. toxic assets hit primarily financial institutions located in central and northern Europe and no major southern European bank was significantly affected by the financial turmoil, the discovery that Greek governments had regularly misreported public finance data led international investors to pull their money out of the peripheral countries, thereby increasing the cost of debt financing (Figure 6) and exposing the structural weaknesses of these countries (see Lane 2012 and Shambaugh 2012).

From the moment in which the Euro zone became the epicenter of the global crisis, it has been apparent that the periphery is highly vulnerable because of its twin problems, that are closely intertwined: i) high government debt, because of high public deficits in the past (Italy and Greece) or because of the necessity to bail out banks that lent heavily to the private sector (Ireland, Spain), and ii) low long-run growth, because of lack of competitiveness (low productivity, high labor costs, diffuse inefficiencies, vested interests).

The therapy suggested to (or "dictated" by the Euro-core and by institutions like the European Commission and the International Monetary Fund) to the periphery for dealing with the debt problem has been fiscal austerity, in parallel with the strengthening of the economic and fiscal governance in the Euro zone (Buti and Carnot, 2012). However, this therapy has been indicated by some commentators, such as Paul Krugman (2012) and eventually by the IMF itself (IMF 2012), as a typical self-defeating strategy: the fiscal contraction exacerbates the recession hitting the peripheral economies and, in the presence of prolonged periods of negative GDP growth, the public debt may become unsustainable in spite of whatever expenditure cut and tax increase governments may implement. As a demonstration that this is the case, critics of fiscal austerity have pointed at the scepticism that financial markets have shown with respect to the possibility for the southern European countries to address successfully their debt problems by severe fiscal austerity measures. This scepticism, indeed, translated into very high spreads between core and periphery government bonds, thus raising the interest rates on periphery bonds and aggravating the debt-sustainability problem.

In the first half of the 2012, the risk that a sort of vicious circle of deeper recession and higher interest rates fed by self-fulfilling expectations could rapidly make unsustainable the debt of large economies like Italy and Spain convinced the reluctant core-country governments of the necessity of some interventions by the ECB (Eichengreen 2012). After the extraordinary injection of liquidity in the banking sector by means of two 3-year long refinancing operations (LTROs) between late 2011 and early 2012, in order to reduce the disruptive impact of this vicious circle and restore a smooth and regular functioning of the EMU-wide money markets, the ECB announced in September 2012 that—subject to certain conditions—it would act as lender of last resort, buying periphery's government bonds through a newly created Outright Monetary Transactions scheme (Drudi et al. 2012). This announcement has been sufficient to bring down the interest rates on Italian and Spanish bonds (and also to ignite harsh criticism in the core countries from the extreme defenders of the no-bail-out principle), thus gaining time for the process of structural adjustment that should allow the peripheral countries to regain their lost competitiveness.

Indeed, the important point here (that critics of fiscal austerity, e.g. Cesaratto and Stirati (2011), often overlook) is that the ECB may give relief in the short term, but for resuming long-run sustainable growth peripheral countries must become more competitive, so as to loose their external constraint and grow at a decent rate without piling up private and public debt. With regard to this, a first unpleasant fact is that, with no possibility of nominal exchange-rate devaluations within the Euro zone, a peripheral country can regain competitiveness relatively to the core and to extra-Euro countries only by means of an internal devaluation, i.e., by reducing nominal wages, prices of goods and services, land and housing prices and so on, with respect to its trading partners. It is straightforward that such a process would be less painful and have more chances of success if it could take place in a more favourable external environment of rapidly growing foreign demand; this is an environment, however, that can hardly materialize if too many countries at one time are committed to fiscal austerity and debt consolidation and/or want to pursue an export-led growth strategy. It is also often argued that the so-called structural reforms, if effective, could smooth and facilitate the adjustment process; in fact, the approval and the implementation of such reforms tend to meet strong internal resistance, and—even when successful—structural changes take time to produce sizable results. All in all, it seems that peripheral countries cannot avoid that the adjustment process will bring about reductions in the levels of consumption and private wealth, and in general in the standards of living of a large number of their citizens.

It is worth recalling that while the Euro core countries have eventually accepted to relax their pro-austerity stance and to provide temporary financial assistance to the banks and countries in trouble, neither a fiscal transfers mechanism nor a fully fledged banking union have been created. Most core countries, indeed, fear that such arrangements (typically, and ideally, present in any monetary union) might ultimately lead to the crystallization of the imbalances (and the vicious incentive spirals mentioned above) recently observed in the Euro zone. For this reason, it is very unlikely that, in the medium term, large internal transfers in the Euro zone will compensate the inevitable contraction in the domestic demand of the peripheral countries.

There is also a second fact, probably even more unpleasant than the first one, that regards the economic and social context characterizing most peripheral countries needing adjustment. These countries, in fact, tend to i) have institutions and regulations that polarize the labor market between a core of highly protected workers and a large number of outsiders, ii) be characterized by strong lobbies and administrative/legal barriers that limit competition in many service sectors, iii) exhibit a tradition of clientelistic politics and rent-seeking activities, and iv) suffer of remarkable distortions implied by extremely high tax evasion. In such countries, an internal devaluation process—even if accompanied by effective reforms—requires a long and painful recession (and high unemployment!) to be completed, as documented for instance by Darvas (2012). Apart from the social and political implications of a recession, a prolonged period of time with zero or negative growth cannot but exacerbate the debt sustainability problem. Notably, this is exactly what is going on in the Euro periphery.

5. Euro-core countries and the bailing out of the periphery

It seems apparent that the core countries have tacitly renounced to the no bail-out principle in the Treaty: they participated in the rescue of Greece, accepted the intervention of the ECB as provider of unlimited liquidity to periphery's banks and as buyer of periphery's government bonds, and approved an European entity that will be in charge of the recapitalization of the periphery's banks. Are the costs that the core countries are incurring in order to save the Euro worth to be borne? In particular, in the case of Germany, are these costs consistent with its ambition to play as a global economic and industrial player, i.e., to remain competitive vis-à-vis the emerging countries?

Indeed, some observers have argued that "Euro membership has encouraged Germany into a costly mercantilist strategy", by avoiding an excessive appreciation of its currency. As a matter of fact, it is claimed, this strategy has required the compression of real wages and consumption, and has soared external surpluses, leading German banks to lend to profligate foreigners (Wolf, 2012). It is indeed true that Germany has spent large political capital (think of the early 2000s Schröder's reforms) and made some sacrifices in order to improve its international competitiveness (Carlin 2012, Coricelli and Worgotter 2012), thus strengthening its vocation as a global player and continuing to pursue an export-led growth strategy (Germany is the only advanced country whose world export market shares remained stable after the emergence of new industrial powers like China, see Figure 7).

In this way, Germany has been able to preserve its peculiar socio-economic model, which has its core in the relatively stable and decently paid, medium-skilled jobs provided by the manufacturing industry, where vocational education and the ongoing cooperation between employers and organized labor give their best fruits in terms of productivity and social stability. Because of their limited size, neither the German market, nor even the EU market, could have guaranteed sufficient economies of scale to the German producers specialized in high-quality consumer durables and investment goods.

The alternative to this socio-economic model is essentially a consumer-oriented economy centred on the service sectors, with a few clusters of high-skilled, well-paid jobs and a mass of unskilled, insecure jobs. The German ruling elite seems to be aware that its country's exit from the Euro and the return to an "appreciating Deutschmark" would probably accelerate this "Americanization" of the society, which most Germans would prefer to avoid. This awareness explains the strong opposition of the German authorities to the IMF recommendations (IMF 2011, and Bornhorst and Ashoka Mody, 2012) that Germany rebalances its growth model toward domestic demand and the service sectors.

6. Conclusions

We conclude by briefly discussing whether the impoverishment under way in the Euro periphery is socially and politically compatible—in the medium and long run—with the survival of the Euro.

It is reasonable to state, indeed, that the southern European countries are among the losers of the globalization process of the last 20 years. In a way, they have appeared particularly vulnerable, being squeezed between other rich countries with more capacities for producing high value-added goods and services—especially those embodying high content of knowledge—on the one side, and those emerging countries that have so far specialized in cheap manufacturing and are now seeking to upgrade their production structure, on the other side. The comparative advantages that the peripheral countries currently enjoy, their role in the international division of labor, the quality of their institutions and social capital, have probably become inconsistent with the levels of consumption, private wealth, public entitlements and aspirations to which most people got used in these countries. Increasing private (and, in some cases, public) indebtedness has permitted for some years to conceal this inconsistency. Now, a brutal and rapid downward readjustment of the living standards of a large portion of the population toward the real possibilities of these countries is under way. This, not surprisingly, creates social unrest and political instability. Financial markets are aware of this and doubt that periphery's governments will have enough consensus to stick to the reform projects for the long period of time that would be necessary to reach sizeable results.

The doubts mentioned above are reinforced by the weak legitimacy of the political class managing this collective impoverishment (especially in Greece and Italy); moreover, the widespread perception that losses and sacrifices are unfairly distributed across the population makes this painful process even more problematic. In this context, it is easy for unscrupulous political entrepreneurs to propose populist ways out of the crisis and to use European institutions, or Euro-zone core countries like Germany, as scapegoats. Under this respect, to avoid that populist forces will prevail in the periphery it is very important that some significant improvement of the economic situation—signalling that the painful adjustment therapy does indeed deliver some results—will be visible relatively soon. In the meantime, the capacity of the political systems of the various southern European members of the Euro zone to contain those forces will be crucial. The long-term survival of the Euro depends to a considerable extent on this capacity.

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Figures.

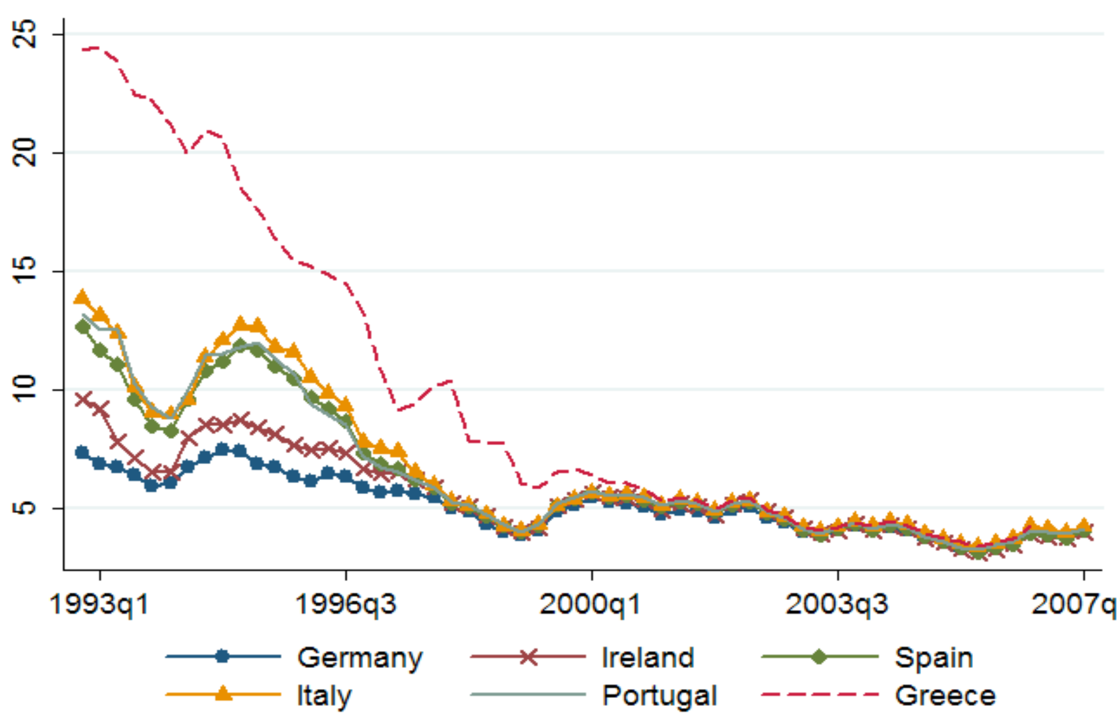

Figure 1. 10y government bonds yields (quarterly averages).
Source. Eurostat

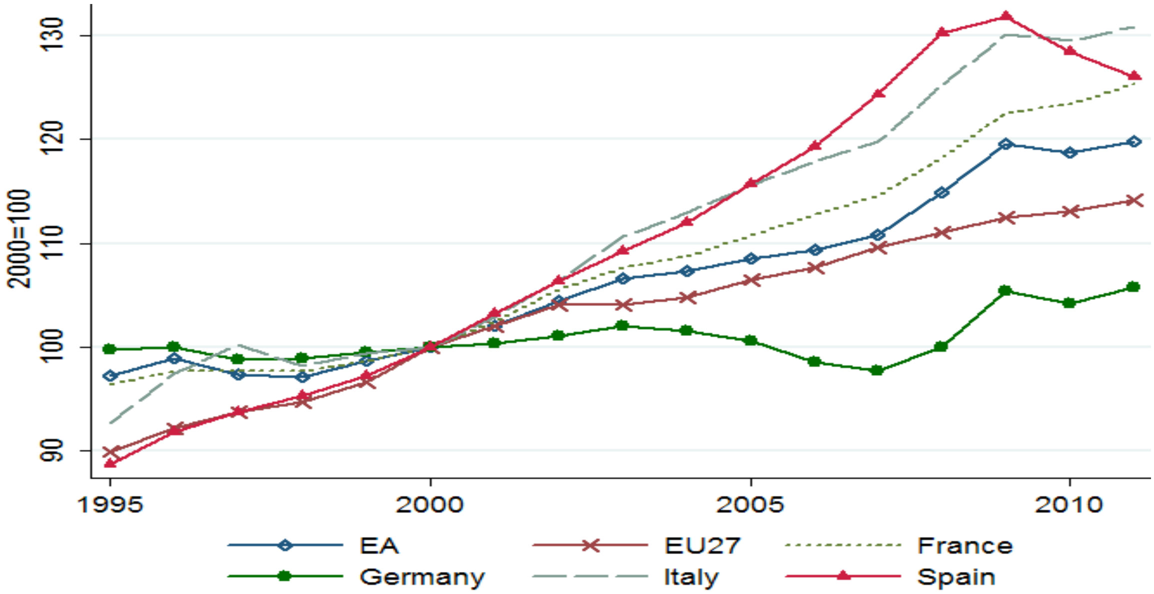

Figure 2. Nominal unit labor costs (2000=100)
Source: Eurostat

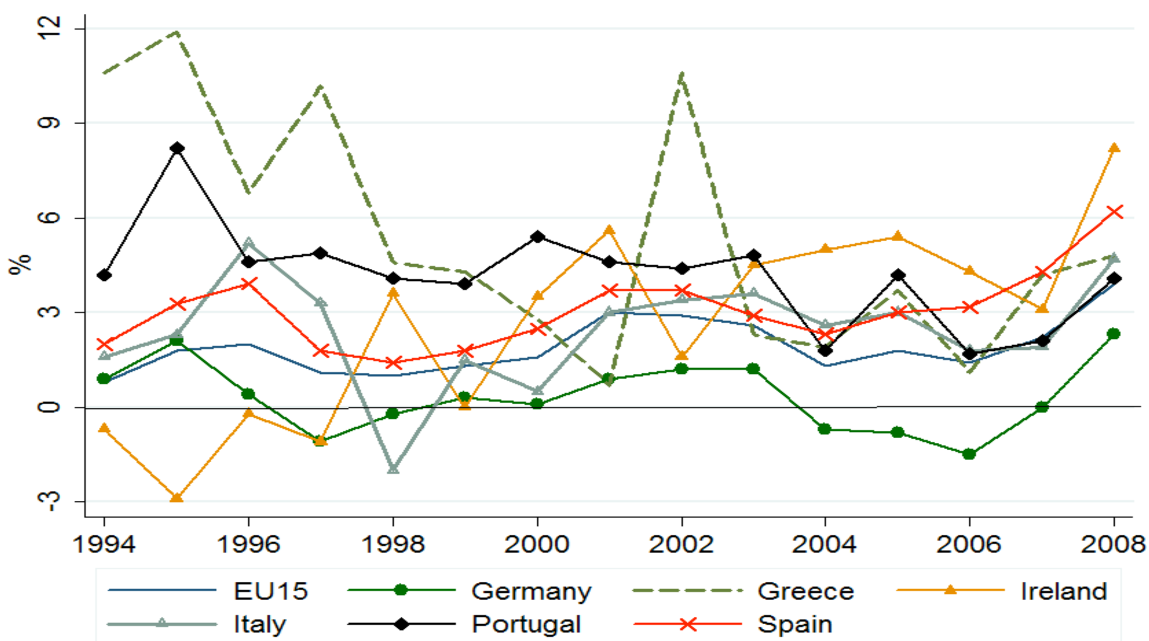

Figure 3. Annual growth rates of compensation for employee adjusted by changes in the TFP .
Source: OECD

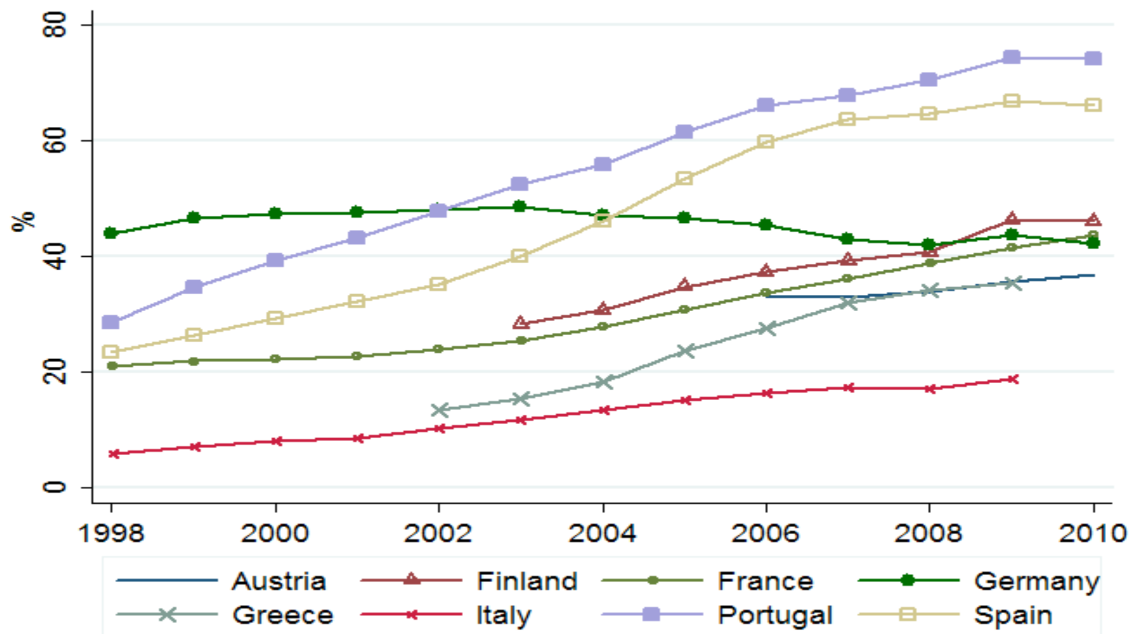

Figure 4. Household mortgages over gross national disposable income.
Source: OECD

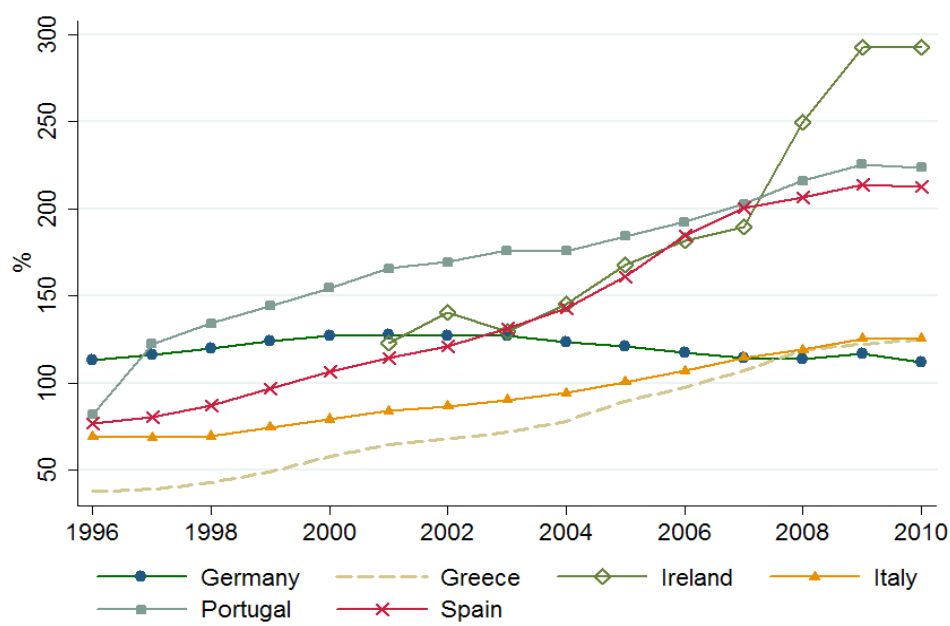

Figure 5. Private sector debt over GDP (consolidated, non financial sectors).
Source. Eurostat

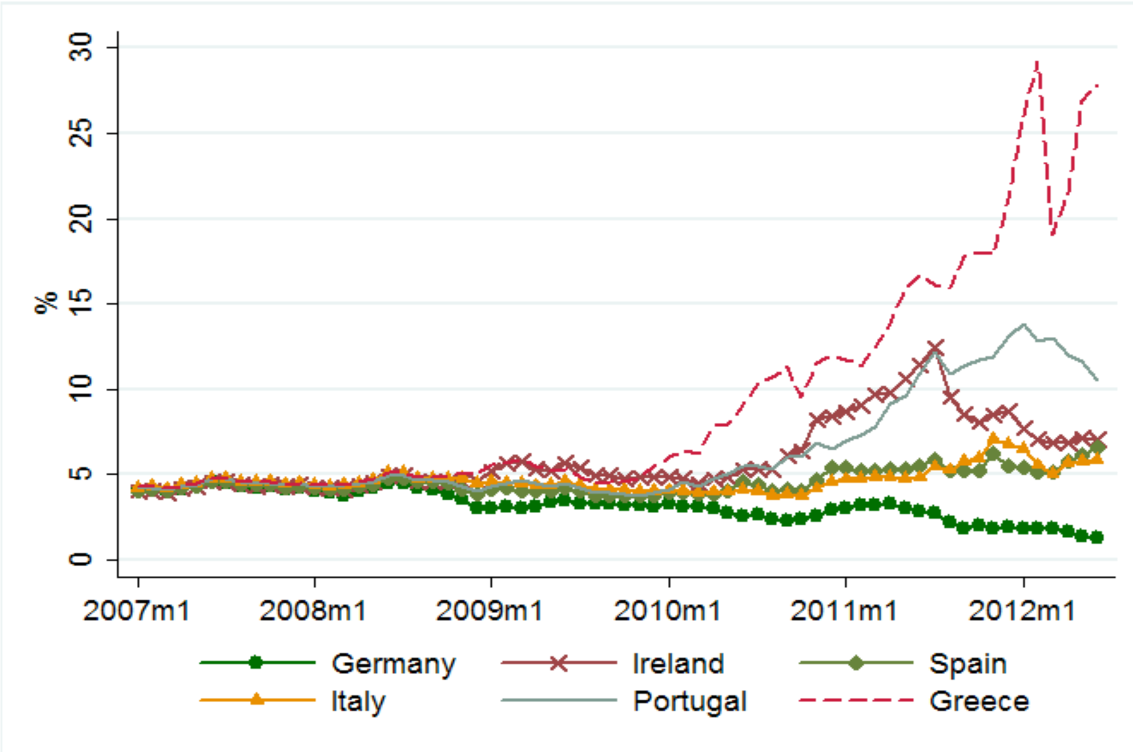

Figure 6. 10y government bonds yields (monthly averages)
Sources: ECB.

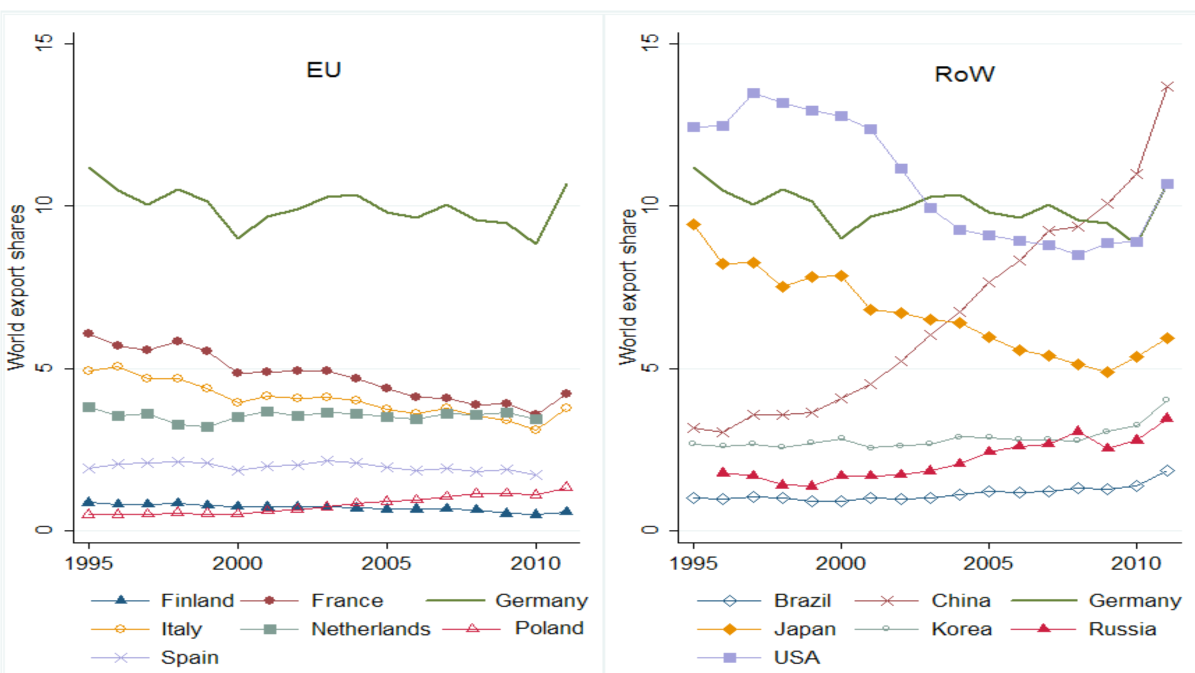

Figure 7. World merchandise market shares (export): selected countries.
Source: UN Comtrade