

How to save the euro

By Simon Tilford

★ The gap between the rhetoric of an integrated Europe and the reality of national interests and politics usually does little damage other than to undermine the EU's credibility. But this gap is proving lethal for the euro. A monetary union requires a very high degree of political and economic integration. Without it, a shared currency will do more harm than good. That is the stark reality now confronting the eurozone.

★ Poor economic growth prospects, rather than fiscal ill-discipline, lie at the heart of the eurozone's problems. Without a sustained economic recovery, public finances in a number of member-states will remain in crisis. Reforms to the way the currency union is run must, therefore, centre on removing obstacles to growth. This requires a concerted drive to deepen the EU's single market, improve policy co-ordination, recapitalise the banks and ensure a closer fiscal union. In short, reforms must tighten economic and political integration.

★ Unfortunately, current efforts to reform the eurozone are set to fall dramatically short of what is required to secure the future of the single currency. Eurozone governance will comprise little more than a beefed-up system for ensuring budgetary discipline. Trade imbalances within the currency union are to be treated as a matter for the deficit countries alone; surplus countries will not be obliged to strengthen domestic demand. And there will be no push to accelerate market integration or move to fiscal union.

★ Unless there is a rethink, the eurozone risks permanent crisis, with chronically weak economic growth across the region as a whole, and politically destabilising deflation in the struggling member-states. This would create strains between the north and south of the eurozone and between France and Germany, in the process damaging the chances of progress in other areas of EU business.

Introduction

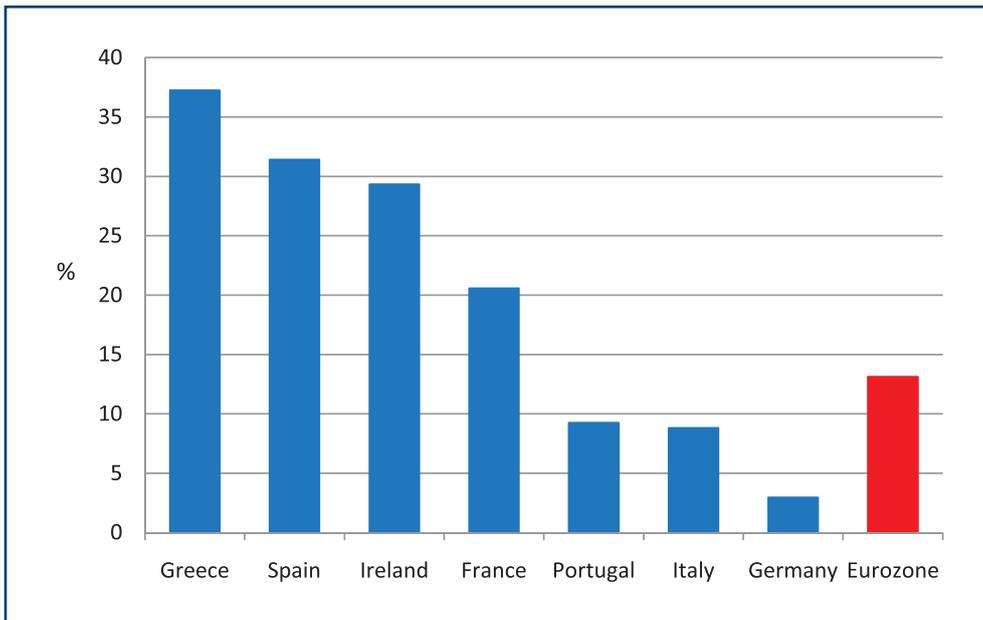
A successful monetary union requires a very high degree of political and economic integration. Without it, the sharing of a currency will do more harm than good, which is the stark reality now confronting the eurozone. Insufficient market integration and inadequate policy co-ordination are the underlying reasons for the collapse of market confidence in the public finances of a number of member-states. Eurozone governments need to do two things if they are to dispel doubts about the long-term survival of the euro. They have to embrace the 'liberal' economic reforms that many have spent the last decade decrying,

and accept much greater limits on their policy autonomy.

This paper starts by briefly analysing the origins of the crisis. This is necessary in order to demonstrate the short-comings of the EU's policy response. It then outlines what needs to be done and how this could come about. The paper concludes that the political will to do what is necessary is lacking, not least because many eurozone politicians still do not acknowledge the implications of their predecessors' creation.

The origins of the crisis

The eurozone is nowhere near integrated enough,

Chart 1: Growth in domestic demand, 1999-2009 (per cent)

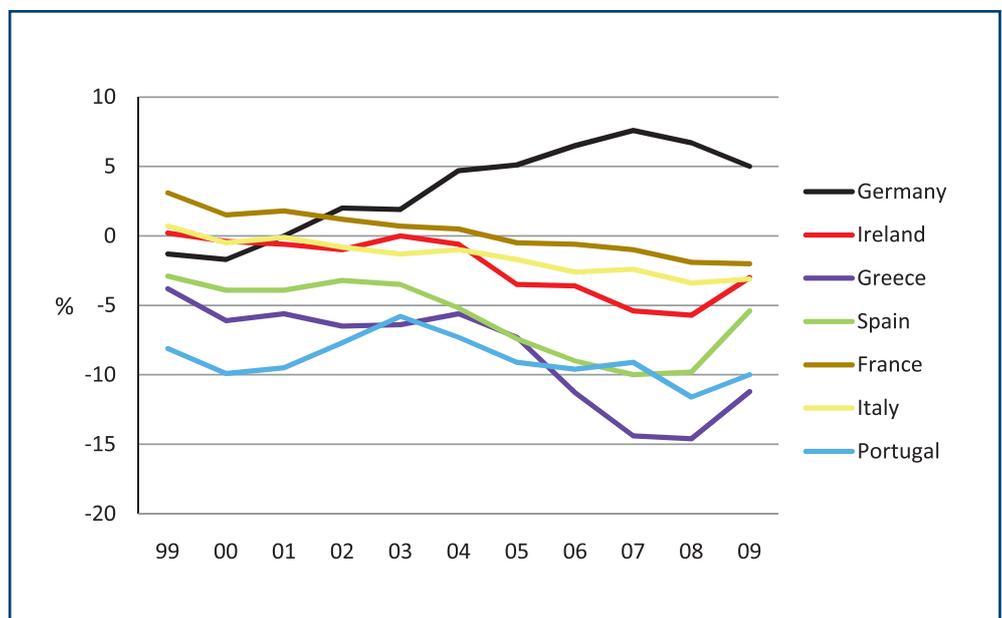
Source: European Central Bank; Economist Intelligence Unit

either economically or politically, to be an optimal currency area (OCA) – that is, a region in which the benefits of sharing a currency outweigh the disadvantages. It is worth remembering why economies launching a single currency need to be highly integrated with one another and to have flexible labour markets. A high degree of integration lowers the risks associated with a one-size-fits-all monetary policy. If economies are highly integrated, capital, goods and people will move freely between them, reducing the risk of excessively strong growth (and inflation) in some members-states and stagnation (and deflation) in others. Currency devaluation is no longer an option so real wages have to fall if an economy loses competitiveness. This requires labour markets to be flexible. There has to be a high degree of policy co-ordination, as the policies of one economy have a significant impact on others. Countries cannot pursue policies which can only succeed at other member-states' expense. Finally, no currency union has survived long without a federal budget to transfer funds between its constituent parts. Policy

co-ordination and a central budget inevitably require a high degree of political integration.

The eurozone does not meet any of these criteria. When the currency was introduced in 1999, the economies were too heterogeneous and insufficiently integrated with one another to cope with a single interest rate. Rates were too high for Germany's economy, throwing a further obstacle in the way of stronger domestic demand in that

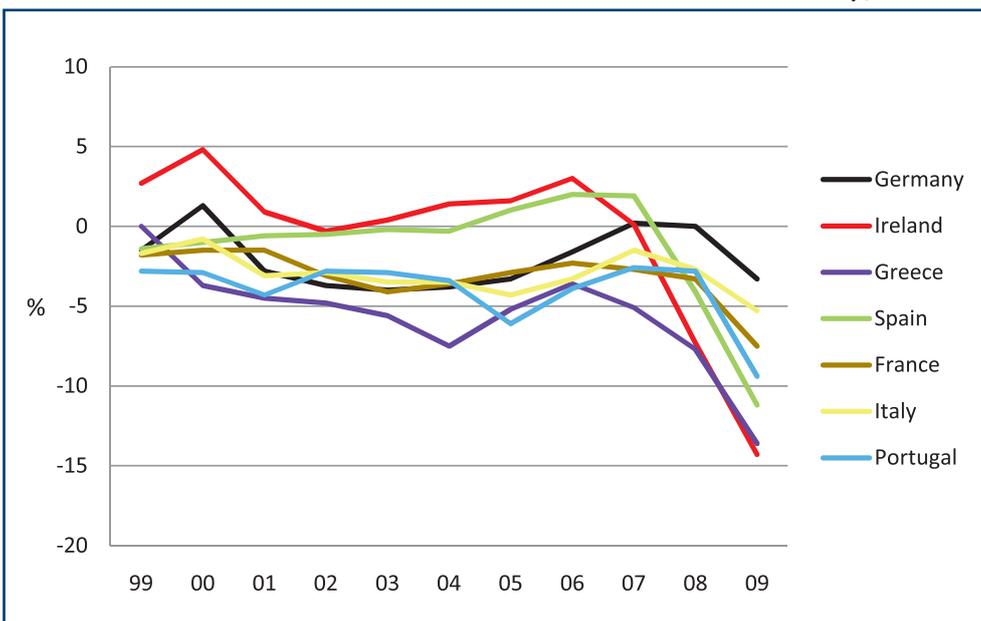
country. German wages stagnated, employment growth stalled and households became very cautious, saving more of their income. Together, these developments depressed consumption and investment. By contrast, interest rates were too low for the faster growing, higher-inflation member-states such as Spain and Ireland. Negative real interest rates encouraged excessive borrowing and hence consumption and investment. Booming economies such as Spain sucked in imports, leading to very large trade deficits. German exports to these economies boomed, partially offsetting Germany's extremely weak domestic demand (see charts 1 and 2).

Chart 2: Current account balances (per cent, GDP)

Source: Economist Intelligence Unit

The booming countries of the currency bloc could not raise interest rates in order to lower demand for credit. They were also slow to employ less orthodox methods to rein in loan growth, such as direct controls on the amount of credit banks could extend. Some – Ireland and Spain, for example – did the right thing and tightened fiscal policy in an attempt to offset the impact of excessively low interest rates. Both countries were running budget surpluses in 2006-2007, before the onset of the crisis. By contrast, Greece was slow to tighten fiscal policy (see chart 3).

Chart 3: Budget balances (per cent, GDP)



Source: Eurostat

Investors from northern eurozone economies with surplus savings, in particular Germany and the Netherlands, were happy to funnel investment into the fast-growing ones, and continued to do so even when the trade deficits of the latter had reached unprecedented levels. Their confidence was underpinned by two factors: there is no exchange rate risk within the eurozone and both governments and businesses in these economies benefited from strong credit ratings. It appeared to be a win-win situation.

Indeed, the aggregate picture for the eurozone gave little cause for concern – inflation was stable, economic growth steady and the bloc's trade position with the rest of the world balanced. But the structure of eurozone growth in the years running up to the crisis was unsustainable. Economic expansion was not driven by rapid productivity growth, in either the northern core of the currency union or among the southern

member-states. Rather, it relied on excessive consumption and unproductive investment in some countries and increasing dependence on exports in others. Imbalances between members became ever more entrenched, as booms in the South pushed up inflation and wages, undermining the international competitiveness of firms based in these countries (see charts 4 and 5). Private sector debt in the boom countries mushroomed.

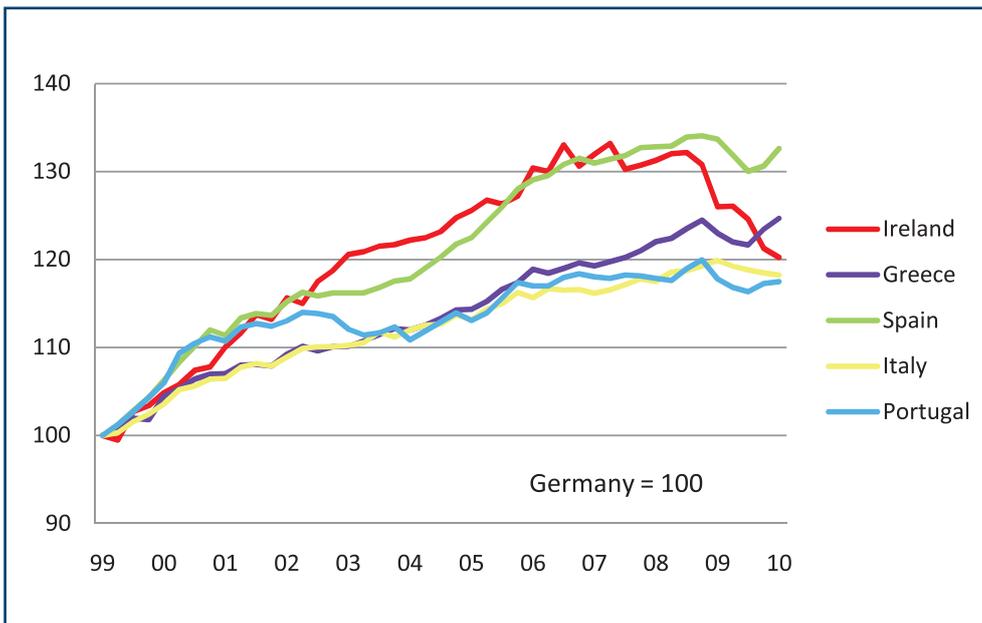
The structural differences between a low-inflation, slow growing core and a higher inflation periphery were supposed to narrow following the introduction of the single currency.

In reality, these differences grew. The credit driven boom lessened pressure on the southern Europeans to address underlying structural problems in their economies, such as inflexible labour markets and protected service sectors. At the same time, Germany could ignore the structural factors that depress its domestic demand, relying instead on exports for economic growth.

When the financial crisis began in the summer of 2007, economic growth in the boom countries collapsed as the supply of credit dried up, and their budget deficits ballooned. Investors, who had hitherto been relaxed about the rise in these countries' debts, started to question whether their economies would grow fast enough to be able to service their debts. In this context, the decline in the price competitiveness of their goods and services within the currency bloc (which had until then received little attention) suddenly started to unsettle the markets. Bond spreads – the difference between the interest rate the German government pays to borrow money and that demanded of other eurozone governments – started to rise, slowly at first, but then rapidly as investors effectively stopped lending to Greece, the worst hit economy. Creditors, most of whom had previously treated the debts of each eurozone economy equally, suddenly decided that default was possible, and demanded corresponding risk premia (see chart 6 on page 5).

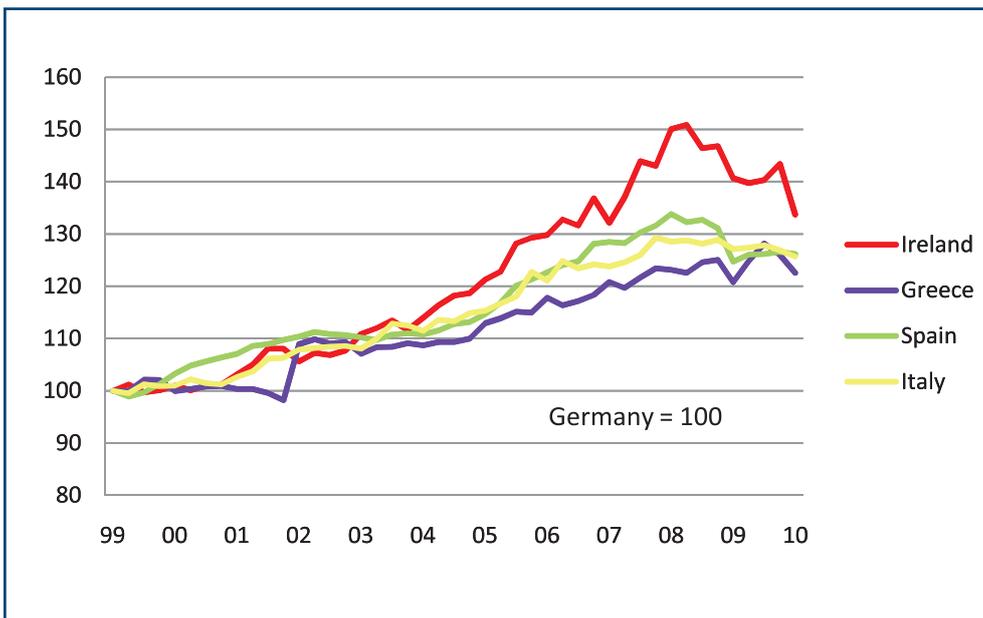
Divergences in competitiveness since 1999*

Chart 4: Competitiveness indices based on GDP deflators**
(A higher number represents a loss of competitiveness)



Source: European Central Bank

Chart 5: Competitiveness indices based on unit wage costs***
(A higher number represents a loss of competitiveness)



Source: European Central Bank

* The ECB's competitiveness indicators take into account both intra and extra-eurozone trade. The indicators are calculated vis-à-vis 21 leading trade partners and the other eurozone economies.

**The GDP deflator is the broadest measure of inflation in an economy.

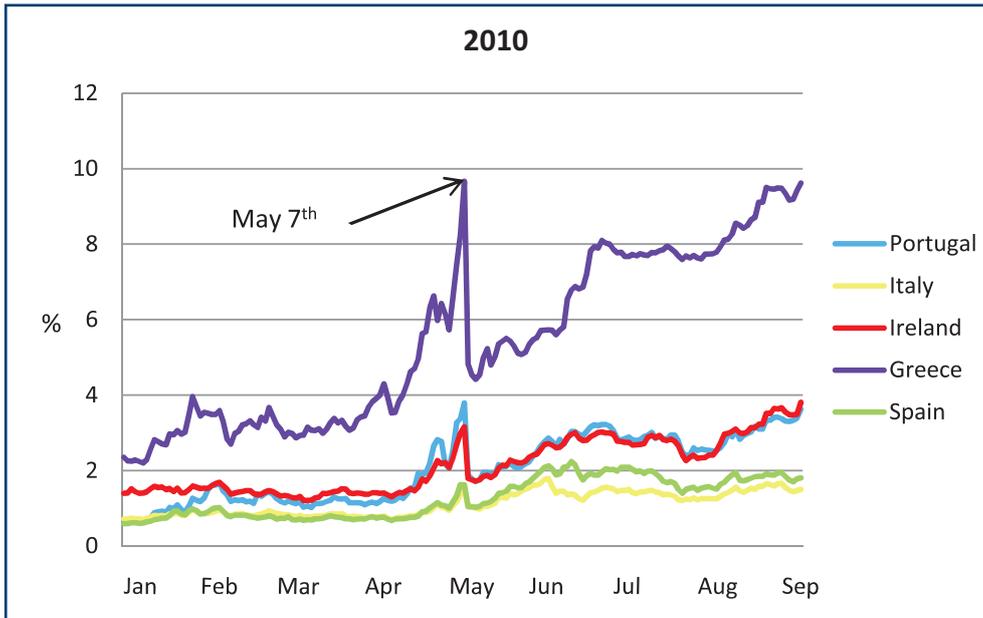
*** Portugal N/A.

Once it became clear that verbal expressions of support for Greece would not be enough to restore investor confidence, the EU launched a series of attempts to address the problem. At the beginning of May 2010, the EU together with the International Monetary Fund (IMF) announced a

€110 billion rescue package for Greece. This did little to reassure investors, who by this point had started to shun other struggling member-states' assets. Contagion was spreading. After a week in which the European banking sector flirted with collapse, the EU held crisis meetings over the weekend of May 8th-9th. The EU (in conjunction with the IMF) announced the creation of a €690 billion European Financial Stability Facility (EFSF) to guarantee loans to struggling member-states. EU governments will underwrite €440 billion worth of bonds and the IMF a further €250 billion. Struggling eurozone countries were set to get access to the EFSF from September 2010, with the plan being to wind down the fund after three years. The Commission also made a further €60 billion available to eurozone countries struggling to pay back loans.

Despite their huge scale, these rescue measures provided only a temporary respite from market volatility. In early September 2010, bond yield spreads within the eurozone as well as the cost of ensuring the debts of hard-hit eurozone economies against the risk of a default, were at (or close to) their all-time highs (see chart 6). This was unsurprising. The rescue measures are designed to address a liquidity crisis – that is, a temporary loss of access to the capital markets. But the underlying problem in the eurozone is one of solvency: without robust economic

Chart 6: Eurozone bond yields (*The spread – or difference – over the the yield on ten-year German government bonds*)



Source: Bloomberg

growth, the debts of a number of eurozone economies will be unsustainable.

Fears over the economic outlook for the struggling eurozone economies have been exacerbated by an unco-ordinated rush by governments to tighten fiscal policy at a time when the economic recovery remains weak. While there is no doubting the scale of the fiscal challenge, the eurozone economy will struggle to cope with the effects of a generalised budgetary tightening. Some economies – Greece, Ireland, Portugal and Spain, for example – have little choice but to cut now. However, those governments that can borrow cheaply, and whose economies are running big trade surpluses with the rest of the currency bloc, should delay tightening fiscal policy until their domestic economies are growing sustainably. The German government believes it is leading by example in aiming to cut the country's budget deficit to just 0.35 per cent of GDP by 2016. But fiscal tightening by Germany is likely to hit the country's domestic demand, throwing a further obstacle in the way of the necessary rebalancing of the eurozone economy.

Economic growth is the key

Poor economic growth prospects, not budget deficits, lie at the heart of the eurozone crisis. With the exception of Greece – whose debts are already unmanageable (see section on Debt

restructuring, pages 12-13) – it is not so much the existing debt levels that are unnerving investors, but countries' so-called 'contingent liabilities'. These largely take the form of bad debt held by banks: as the banks are guaranteed by their governments, much of this private debt will ultimately end up on governments' books if borrowers in these countries are unable to service it. Investors fear that with economic growth set to remain very

weak there will be a steady rise in bad debt in the private sector. For example, Spain faces years of economic stagnation as it attempts to rebuild its competitiveness within the eurozone, through wage cuts, while pursuing fiscal austerity in a drive to strengthen its public finances.

The resulting fears for the solvency of banks have led to partial paralysis of the eurozone interbank market, forcing banks in the struggling economies to rely on the European Central Bank (ECB) for funds. Over the two years to the middle of 2010, banks in Greece, Portugal, Ireland and Spain borrowed €225 billion in emergency loans from the ECB. Since these local banks buy government debt in their respective markets, the ECB effectively helped to finance public deficits. However, this liquidity programme – the largest ever conducted by a central bank – came to an end in June 2010. (The banks can still borrow unlimited funds from the ECB, but on shorter maturities and less attractive terms.) The ECB has also stepped in directly to purchase government bonds of the struggling member-states – it bought around €70 billion of sovereign debt between April and July 2010 – but is keen to avoid expanding the programme.

The ECB justified its refusal to step-up these bond purchases on the grounds that governments will have access to funds under the EFSF from September 2010. But the problem of weak banks remains unresolved. Mounting concern over the solvency of the eurozone's banking sector forced

the EU to conduct stress tests of the region's banks in July 2010. The aim was to demonstrate that banks have sufficient capital to cope with a prolonged period of weak growth, as well as a decline in the value of their holdings of struggling eurozone economies' government debt. Ninety-one European banks comprising around two-thirds of the European banking sector were tested and the results published on July 23rd. Just seven banks failed the test: five Spanish ones, and one each from Greece and Germany. This process, however, has not allayed investors' fears about the soundness of Europe's banking sector. The banks were tested for the impact of two years of economic stagnation across the eurozone on their balance sheets, but they were not, for example, tested to see whether they have sufficient capital to cope with a sovereign default by a eurozone member (see section on the Banks, page 12).

Shooting the messenger

Investors' concerns about the sustainability of the eurozone are well-grounded. But this has not stopped eurozone policy-makers, including Jean-Claude Trichet, the president of the European Central Bank (ECB), and José Manuel Barroso, the president of the Commission, criticising the financial markets for exaggerating the eurozone's problems. Politicians and officials have directed particular ire at the ratings agencies, and their allegedly 'Anglo-Saxon' bias. The ECB's chief economist, Jürgen Stark, has gone as far as to insinuate that the ratings agencies should concentrate their attention on countries with 'real' problems, such as the UK and the US. The European Commission wants to step up regulation of the ratings agencies and is even exploring the feasibility of establishing a European ratings agency. There may well be a case for subjecting the agencies to tighter supervision. But there is an obvious reason why they have not downgraded the US and UK, and why the British and US governments can borrow at much lower rates of interest than their Spanish counterpart – despite having similar levels of public debt. The medium-term outlook for the US and UK economies is considerably better than for the Spanish one.

The eurozone can only avoid permanent crisis by convincing investors that growth will be strong enough for the hard-hit members of the currency

union to service their debts. As things stand, it is hard to see how they can grow their way out of trouble. They need a big external stimulus to offset budget cuts and falls in real wages at home: their exports need to grow faster than their imports, for a lengthy period. Since they have no national currencies to devalue, they will have to depend on stronger demand in the eurozone and elsewhere, and on their companies becoming more price-competitive. Both requirements look elusive.

First, Greece, Italy, Portugal and Spain all conduct nearly three-fifths of their trade with other members of the eurozone. But the German economy – the largest in the currency union – remains as dependent on exports as ever. Germany will be the fastest growing member of the eurozone in 2010, but this will very largely be down to exports; domestic demand remains very sluggish. Over the first half of 2010, Germany's surplus on trade in goods and services with the rest of the eurozone was equivalent to around 3 per cent of German GDP, out of a total surplus of over 5 per cent. Germany remains what it has been for most of the past decade: an economy that is structurally reliant on foreign demand for its growth. Furthermore, domestic demand is likely to falter over the quarters ahead. The government's fiscal stimulus is being withdrawn and manufacturers have now largely rebuilt their stocks, so the impetus provided by the inventory cycle over the first half of 2010 will weaken sharply. As a result, Germany is unlikely to make much of a contribution to growth elsewhere in the EU, or to reducing imbalances within the eurozone.

Second, the deficit countries have to make sure that their costs rise by less than those of the Germans. Falling unemployment means that German wages (taking account of inflation) have risen slightly in 2010, but unit wage costs (output per hour worked) have fallen sharply as industrial production has rebounded. German consumer prices are on course to rise by just 1 per cent in 2010, below the eurozone average of around 1.5 per cent. This leaves other member-states having to make sizeable reductions in their wages and consumer prices if they are to undercut the Germans by a meaningful margin. Ireland is managing to deflate relative to Germany – Irish wages and consumer prices have

fallen very sharply in 2009 and 2010. But the impact on the Irish economy has been devastating: Irish GDP (at market prices) contracted by around 20 per cent between the third quarter of 1997 and the end of 2009. Recession, combined with huge fiscal deficits, has led to an unprecedented rise in the ratio of Irish public debt to GDP. At the end of 2007, Irish public debt was equivalent to around 25 per cent of GDP. According to the European Commission it will reach around 90 per cent in 2011 and is all but certain to top 100 per cent in 2012. Economies such as Spain and Greece that entered the crisis with higher levels of debt than Ireland could not sustain a debt accumulation of this order. Moreover, if every economy in the eurozone succeeded in reducing their unit wage costs more rapidly than the Germans manage to reduce theirs, it would simply lead to a eurozone slump and almost inevitably deflation (see section on Policy co-ordination, pages 9-11).

Why did this happen?

Few observers believed the eurozone was an OCA in 1999, but optimists thought it stood a fair chance of becoming one in time. Why has the euro not led to the kind of integration which would have reduced heterogeneity and the risks of sharing a single interest rate? And why does the currency union lack any meaningful system of governance or a federal budget?

Trade between members of the eurozone has grown slightly quicker than trade with EU countries outside the single currency – as have foreign direct investment flows. The euro has also served as a catalyst for financial market integration, spurring cross-border consolidation among banks and the emergence of a large, euro-denominated market in corporate bonds. But these market-led changes do not go far enough.

In many respects the eurozone economy is still more like a patchwork quilt of 16 national markets than a properly integrated market. For example, there is little trade in services between the members, despite the fact that services account for a large (around 70 per cent) and rising proportion of economic activity. Enforcement of single market rules is also patchy and bureaucratic obstacles to doing business across borders remain formidable. The fast growing digital economy is segmented along

national grounds because of differing tax and consumer protection rules and the lack of a single retail banking system. There are numerous obstacles to cross-border acquisitions, and labour mobility between member-states of the EU is limited.

Nor has the euro galvanised countries into adopting the reforms needed to make their economies more flexible. True, EU countries signed up in 2000 to the Lisbon Agenda, a programme designed to improve the supply-side performance of their economies. But most countries' progress has been pedestrian at best. Improvements in education have helped make Europeans more employable, but onerous labour market laws in many countries continue to favour privileged 'insiders' (those with full-time, salaried jobs) at the expense of 'outsiders' (the unemployed and part-time or temporary workers). Eurozone members have not been more assiduous than non-members in reforming their labour markets. The EU's most flexible labour markets are largely to be found outside the eurozone, the most rigid inside.

Incomplete market integration and inflexible labour markets would perhaps have been manageable if there had been a workable system of eurozone economic policy co-ordination in place, including a strategy to deal with internal imbalances. But there was scant recognition by participating governments or EU officials that the policies of one member-state could have a major impact on others. For example, there were no mechanisms to compel countries with excessively strong domestic demand to take steps to rein it in. Similarly, there was nothing done to force countries with structurally weak domestic demand to do anything to stimulate it. Indeed, the significance of mounting trade imbalances between member-states was routinely downplayed. In the run-up to the crisis, eurozone policy-makers liked to argue that trade imbalances between euro economies were no more of a problem than those that exist between states of the US. Of course, such a contention was always specious: the US is a sovereign state, with a federal budget, which transfers huge sums of money between the states. The eurozone comprises 16 largely sovereign countries, with little pooling of fiscal powers. There was nothing resembling a fiscal union, and next to no acknowledgement that one would be required.

Eurozone governance largely consisted of the Stability and Growth Pact (SGP). This required participating economies to run budget deficits of no more than 3 per cent of GDP, to maintain balanced budgets over the medium-term and to reduce public debt levels to 60 per cent of GDP. However, the SGP has done nothing to ensure balanced economic growth across the region. Such a limited system of governance reflected the belief – particularly strongly held in Germany – that the biggest threat to the stability of the euro was fiscal ill-discipline. Fiscal discipline would prevent inflation from rising and ensure that the euro was a strong replacement for the Deutschmark.

There is no doubt that sound public finances are important, but they are only one of many prerequisites for the success of the currency union, and the SGP was in any case a very poor gauge of fiscal sustainability. Even assuming that it had been enforced more rigorously, the SGP would have done nothing to prevent the current crisis: neither Spain nor Ireland – two of the hardest-hit eurozone economies – breached the fiscal rules until the onset of the financial crisis. The weakening of these countries' public finances since 2008 cannot, therefore, be blamed on government irresponsibility before the crisis.

Why was the institutional basis for the eurozone so weak? After all, there were plenty of warnings that a currency union would require a high degree of political integration, and many considered it risky to push ahead with the euro as long as this looked unfeasible. Member-state governments either believed that the euro could flourish without greater policy co-ordination or assumed that the necessary political integration would come with time. For many governments, national status was the primary driver of their determination to join: they wanted a seat at the top table. Very few of the current member-states undertook national debates about the advantages and disadvantages of joining the single currency. They certainly did not acknowledge that membership effectively committed them to pursuing a liberal economic agenda of more competition and flexible labour markets, or accepting much greater political integration.

In short, many eurozone members seem to have viewed the single currency as a shield from the

outside world, rather than a corset imposing disciplines of its own. This was a big mistake. If European politicians were as hostile to economic liberalisation as their rhetoric suggests, and opposed to the pooling of greater sovereignty, they should not have established a shared currency. Anglo-Saxon commentators are often guilty of under-estimating the depth of member-states' political commitment to the euro. By the same token, European politicians have routinely under-estimated the economic implications of their creation.

The necessary reforms

European policy-makers need to convince investors that eurozone economies' debt burdens are sustainable. To do so, they will have to remove obstacles to economic growth. First, the eurozone governments must embrace market-led reforms aimed at deepening integration and increasing the flexibility of their labour markets. Second, they need to accept that the eurozone requires a comprehensive system of governance. There must be policy co-ordination aimed at preventing imbalances arising and for addressing them when they do. Third, eurozone countries have to take aggressive steps to strengthen their banking sectors. Weakened banks threaten to hold back the needed recovery in investment. Fourth, the eurozone needs to bite the bullet and push ahead with restructuring Greece's debts. The pretence that the country's debts are sustainable threatens to undermine the credibility of the euro. Finally, a fiscal union is almost certainly necessary. Unfortunately, on all five points the EU's response falls short of what is required.

I. Market reforms

Much closer economic integration between the members is essential. This would increase competition and with it productivity and economic growth. It would also lessen the risk of a one-size-fits-all monetary policy. To this end, the eurozone should launch an aggressive campaign to break down barriers to integration, especially in the areas of services. The remaining obstacles to the flow of capital such as barriers to cross-border takeovers also need to go. Increased labour mobility within the eurozone may be difficult to bring about due to language barriers, but that does not mean that eurozone governments should not try.

Unfortunately, there is little, if any, support among eurozone countries for accelerated integration. And without support from the member-states, there is little the European Commission can do. Eurozone governments led a successful campaign to water down the Commission's 2005 services directive, which aimed to break down barriers to the trade in

¹ *European Commission, 'Directive 2006/123/EC on services in the internal market', December 2006.*

services across the EU.¹ Indeed, it is clear that many countries are suffering from 'integration fatigue'. They evince little

enthusiasm for extending the single market to new areas; and some openly flout the letter or spirit of its rules. Worryingly, as a recent report by Mario Monti notes, political commitment to the single

² *Mario Monti, 'A new strategy for the single market', report to the president of the European Commission, May 2010.*

market seems to be lowest among eurozone members.² Bluntly, there is less support for economic union within the monetary union than outside.

The EU's new programme to boost the performance of the European economy – known as 'EU 2020' – is no more likely to deepen market integration than its predecessor, the Lisbon Agenda. The programme diagnoses Europe's problem well enough. It includes a welcome emphasis on the internal market, in particular the service sector, and calls for greater policy co-ordination between member-states. But the European Commission has no way of forcing the patient to take the medicine. There is no reason to believe that EU 2020 will act as a catalyst for governments to embrace the

³ *European Commission, 'Europe 2020: a strategy for smart, sustainable and inclusive growth', March 2010.*

structural reforms needed to strengthen the euro. There is, for example, little prospect of a renewed drive to free-up trade in services.³

Another daunting obstacle to greater economic integration within the eurozone is the scale of the trade imbalances themselves. If the member-states running big external deficits cannot rebalance their economies, they are likely to oppose moves to deepen the single market, such as freeing-up trade in services. They may (understandably) fear that further integration will exacerbate their external deficits by making it easier for domestic consumers and businesses to buy goods and services abroad. They could even start questioning existing elements of the single market.

The outlook for labour market reform seems little better. The EU 2020 programme includes useful targets for employment rates and skills levels, but they are largely aspirational. And, in any case, the big problem in terms of the stability of the eurozone is the lack of real wage flexibility. Greece and Spain are taking some steps to liberalise their labour markets in an attempt to bolster investor confidence in their economies. But much more is needed. These reforms need to be replicated across the eurozone, and not be confined to the countries which are currently struggling. Governments need to explain to their electorates why the current systems of labour market regulation are incompatible with membership of the euro.

II. Policy co-ordination

Market integration and greater labour market flexibility are needed to boost economic growth, but so is policy co-ordination. Symmetrical adjustment (stronger domestic demand in eurozone's surplus economies and weaker domestic demand in the deficit ones) is an indispensable element of any strategy to address obstacles to economic growth in the eurozone. Imbalances cannot simply be ignored – particularly in the absence of a fiscal union to transfer funds to depressed areas. They are partly the result of the fact that eurozone interest rates were too low for the fast-growing economies and too high for the slow-growing ones. But they are also the product of the lack of any meaningful policy co-ordination within the currency bloc.

The way eurozone economies are run has profound implications for other member-states of the currency union. The euro will not flourish if member-states are permitted to pursue policies which can only work at other member-states' expense. Policies need to be consistent with economic growth across the eurozone. This goes for a country's wage-setting policies and other policies that affect domestic demand as much as its management of public finances. A meaningful system of eurozone governance would devote as much time to German labour market policies and other obstacles to stronger domestic demand in that country, as to the monitoring of Spain's public finances.

In May 2010, the European Commission proposed a broad reform of the way the

eurozone is run, combining stricter monitoring of public finances with stronger policy co-ordination aimed at addressing the eurozone's imbalances.⁴ Crucially, it argued that these could not be addressed by the deficit countries alone, and that surplus economies would also have to make adjustments. The Commission also proposed that the forum for tighter policy co-ordination should be the Euro Group of eurozone finance ministers, not the wider EU. The French government backed the Commission's line, calling for the establishment of a Eurozone Secretariat to monitor the policies and performance of each eurozone economy; the country's finance minister, Christine Lagarde, had previously called upon the German government to do more to stimulate Germany's domestic economy. France has long argued that institutional integration and policy co-ordination rather than greater market integration is the key to ensuring the success of the euro, a position that is largely shared by Italy.

However, a group of countries – led by Germany – objected to the Commission's proposals, which were heavily watered-down as a result. The German government strongly rejected the argument that its own policies were part of the problem. It called for tougher penalties for fiscal miscreants, including suspension of their voting rights in the European Council, and even their expulsion from the euro. Germany also opposed the Commission's drive to make the Euro Group the focus of any new governance mechanisms, on the grounds that this would entrench divisions within the EU between eurozone members and the rest. This is no doubt true, but a more important reason for the German government's preference for EU-wide mechanisms is almost certainly the fact that it will make it harder to agree on closer policy co-ordination. For example, non-euro member-states such as Britain would strongly oppose such a move.

The Commission's second set of proposals – published in early July – are much narrower in scope than the original ones. All EU countries would have to submit their annual budget plans to the Commission, which would assess their compatibility with long-term fiscal sustainability.⁵ The European Council

⁴ *European Commission, 'Reinforcing economic policy co-ordination', May 2010.*

⁵ *European Commission, 'A toolbox for stronger economic governance in Europe', June 2010.*

would then consider the Commission's assessment and issue recommendations. If a eurozone country fails to follow these recommendations, it could face penalties, such as the suspension of aid under the EU's Common Agricultural Policy, as well as structural funds. The Commission would monitor imbalances within the eurozone, with countries at risk of running excessive levels of private sector indebtedness and current account deficits being placed in a so-called 'excessive imbalances position'. The Commission would then issue policy recommendations to the country in question, which would have to submit regular reports to the Ecofin Council (which comprises the finance ministers of the 27 EU member-states) and the Euro Group. Countries with excess savings and large current account surpluses would not be deemed to be suffering from structural imbalances and would not be required to take corrective policy action.

The European Council's proposals for reform of eurozone governance promise to be equally one-sided. Council President Herman Van Rompuy's taskforce charged with looking into eurozone governance is due to formally announce its recommendations in mid-September 2010. It is set to call for action to address divergences in competitiveness, rather than the imbalances themselves. The benchmark will be the country that has seen its price competitiveness improve most. Again, no action will be taken where improved price competitiveness reflects wage policies which would be unsustainable if pursued by the eurozone as a whole. The taskforce is expected to recommend that the burden of adjustment be placed squarely on the 'uncompetitive' countries. For its part, the ECB has put forward detailed proposals for reforming the way the eurozone is run, but these are similarly asymmetric.⁶

⁶ *European Central Bank, 'Reinforcing economic governance in the euro area', June 2010.*

The Commission's original proposals would have given the eurozone the kind of governance mechanisms it needs. The final compromise – which is likely to comprise a mixture of the Commission's and the European Council's proposals – risks perpetuating the crisis. Of course, budgetary rules have to form part of any balanced system of eurozone governance.

Greece's behaviour has been egregious and the incontinence of its government has played a key part in the country's difficulties. Public finances are weak across the eurozone and need to be strengthened over the medium term. In short, crafting a more credible framework for fiscal policy must form part of the policy response to the crisis. But the idea that the eurozone's problems are reducible to budgetary indiscipline alone is very dangerous. The SGP did nothing to prevent the current crisis, so will do nothing to rescue the eurozone from it. Budgetary austerity will not solve Spain's underlying economic problems, which are high levels of private sector debt and a dramatic loss of trade competitiveness.

All three sets of proposed reforms – the latest ones from the Commission as well as those from the ECB and the Council – ignore the issue of demand. As such, they threaten to impart a strongly deflationary bias to policy in the eurozone. In the absence of stronger foreign demand, the deficit countries can only rebalance their economies by reducing real incomes and hence demand for imports. This implies at the very best stagnation in these countries. At the same time a German economy where domestic demand remains chronically weak will remain a drag on the eurozone economy rather than a driver of economic growth. Nor will the eurozone as a whole be able to rely on demand from the rest of the world to bail it out. German exports to economies outside the currency union are growing strongly. But it is not possible for every member of the eurozone to rely on exports to countries outside the currency bloc, unless the eurozone runs an ever larger trade surplus with the rest of the world. Euro policy-makers who think Germany is the model need to explain who the eurozone is supposed to run these surpluses with and what the implications would be for financial stability and the faltering global economy. The upshot is that the eurozone economy will suffer from an acute lack of demand, heightening the risk of deflation, with all the attendant problems that falling prices pose for highly-indebted economies.

The EU commissioner for economic and monetary affairs, Olli Rehn, says: "Nobody is

wanting to weaken any country's export performance."⁷ But it is impossible for the trade deficits of one group of economies to decline without an offsetting reduction in the surpluses of the other group.

Moreover, trade surpluses tell us little about economic dynamism. Germany has world class companies producing first-rate products. But productivity growth in recent years has not been spectacular and output per head is now below the eurozone average. The only reason German unit labour costs have fallen is that real wages have stagnated. Growth in German wages has lagged productivity growth for the past 10 years. Wage costs (as a proportion of GDP) fell steadily between 1999 (when the euro was introduced) and 2008.⁸ This is not healthy 'system competition' between members of the currency union, but a 'competitive devaluation' in all but name.

For example, if wages rise in line with productivity growth in every member-state bar one (where wages lag productivity), the latter will become more price 'competitive' relative to the rest. But it is a zero-sum game: Germany has been able to rely on wage restraint because others have not.

If the euro is to survive as a pan-European currency, the members have to accept that they need to pool much more of their sovereignty. Close policy co-ordination should include stiff penalties for fiscal ill-discipline, but surplus countries have to accept scrutiny of their own policies too. Surplus countries must face comparable obligations to deficit ones. Because of their asymmetric bias, the proposed governance reforms threaten to exacerbate the underlying problems in the eurozone. The forum for closer policy co-ordination has to be the eurozone itself, not the EU. It is the sharing of a common currency which makes such co-ordination essential among the eurozone economies; policy co-ordination is merely something desirable for the rest. This will inevitably cement the divisions within the EU and risks marginalising the likes of Britain, Sweden and Denmark. But that was inevitable once these countries opted to stay out of the euro.

⁷ James Kanter, 'European Commission proposes penalties for budget offenders', *New York Times*, June 30th, 2010.

⁸ OECD, 'Economic survey of Germany 2010', March 2010.

III. Banks

Many eurozone governments are assuming that economic growth will gradually solve the problems of a weakened banking sector, but the banks themselves are an obstacle to such economic expansion. Bank lending to households and non-financial businesses is still falling across the eurozone, suggesting that the economic recovery will remain anaemic at best. The ECB claims that weak credit growth in the eurozone reflects a lack of demand for credit. This is no doubt partially true. But it also reflects the travails of the region's banks. According to the IMF, eurozone banks will have to refinance €1.4 trillion of debt over the course of 2010 and 2011, massively more than their US equivalents will have to do and proportionally more than in the UK. The Bank for International Settlements (BIS) calculates that lending by eurozone banks (excluding domestic ones) to Spain, Portugal, Italy, Ireland and Greece totalled €3.2 billion at the end of 2009. At the same time, many eurozone banks are poorly capitalised. The levels differ from member-state to member-state, but data from the BIS shows that eurozone banks' levels of tier one and tier two capital is lower in the eurozone than in the US, UK or Japan.⁹

⁹ Tier one comprises equity capital and retained earnings and tier two secondary bank capital.

As a result of their relatively low levels of capitalisation and their exposure to potentially bad debt, many eurozone banks are likely to struggle to raise sufficient funds, at least at competitive rates. If they have to renew at high interest rates, it will be even harder for them to grow their way out of trouble. If they do not refinance they will have to sell assets or cut back lending, which will hold back the recovery. The stress tests of EU banks carried out in July 2010 were not tough enough to dispel fears over the ability of the sector to cope with a renewed financial crisis. The worst case scenario tested was one in which the value of Greek debt on banks' trading books falls by 23 per cent. But at the time the tests were carried out, Greek debt was trading at a 25 per cent discount. The Committee of European Banking Supervisors (CEBS) – which carried out the tests – did not assess the impact on the bank of a default on sovereign debt by a eurozone economy. The CEBS recommended that the seven banks which failed the tests seek a combined total of €3.5

billion in additional capital. Following the 2009 stress test of US banks – which have much higher levels of capital than the eurozone average – the US regulators urged the affected institutions to raise around €60 billion in new capital.

The CEBS's assumption that there will be no sovereign defaults within the eurozone is unduly optimistic (see section on Debt restructuring below). Stress tests should have included tougher scenarios and then been backed by recapitalisation of the affected banks. A useful test would have been a Greek debt default in which investors only receive half their money back and one in which they sustain losses of 20 per cent on their holding of Spanish, Portuguese and Irish debt.

If private investors are unwilling to provide the capital at a cost which enables the banks to maintain lending levels, then governments will need to provide the necessary capital injections. The alternative – allowing bank lending to stagnate – will inevitably cost governments much more because it will put paid to any chance of a sustained economic recovery, and lead to a rise in private sector bad debt. Where governments are unable to finance bank recapitalisation themselves, they should raise the funds from the EFSF. Fiscally stronger member-states that need to inject capital into banks will find it cheaper to raise the funds themselves.

IV. Debt restructuring

Eurozone governments and the European Commission are determined to prevent a restructuring of Greece's debt, believing that this would set an unfavourable precedent and increase the risk of contagion to other struggling eurozone economies. However, the assumption that Greece can service its debt burden is unhelpful. It almost certainly cannot – the debts are simply too high and the country's economic growth prospects too weak. Postponing the inevitable default/restructuring simply ensures that when the time comes, the default will be bigger than would otherwise have been the case and the impact on the eurozone's banking sector and confidence in the euro correspondingly greater. The current strategy involves piling more debt on top of an already unsustainable level of debt, and will not work.

Under the terms of its EU/IMF bail-out, Greece must cut its budget deficit by around 10 percentage points of GDP over four years, from almost 14 per cent of GDP in 2009 to less than 3 per cent in 2014. The country cannot bring about a fiscal adjustment of this size, at least not in that timeframe and not at the interest rates investors are prepared to lend to the country. Those who believe it is possible point to the fiscal consolidations made by Ireland, Sweden and Canada in the 1990s. However, these countries managed this over much lengthier periods of time and against a backdrop of falling currencies and strong external demand. Greece must do it without the benefit of a weaker currency and at a time when interest rates will be rising, not falling, and when external demand is likely to be weak. However, Greece might be able to service its debts if interest rates were lower. This is what would happen under a managed restructuring of its debt. The Greeks would be given more time to pay the debt back and investors would receive a lower rate of interest.

The current state of affairs is the worst of all worlds. The EU/IMF programme for Greece means that a lucky minority of private investors will continue to get their money back. But when the eventual restructuring comes, private investors as a whole will incur a much bigger loss. In a forced restructuring (or default), as opposed to a pre-emptive negotiated restructuring, public investors like the EU and the IMF will take precedence over private ones. It would make more sense to use some of the money from the bail-out fund to compensate lenders for the losses they would incur in the restructuring of the debt now than continuing to throw much larger sums of money at Greece without preventing a default/restructuring later. This money should be held back and used to fight more winnable battles, such as ensuring that there is sufficient money to support Spain if and when it requires it.

V. Fiscal union

The eurozone will always be an imperfect currency union, even assuming the participating countries get serious about deepening political and economic integration. As such, it is hard to see how it can survive in the long-term without pan-eurozone transfers to depressed regions.

Although the US is much closer to meeting the criteria for a successful currency union than the eurozone, regions of the US still suffer stagnation and are kept afloat through transfers from the federal government. But a eurozone fiscal union could only work if substantial progress was made on addressing the macroeconomic imbalances. Only by doing so could the transfers be kept to a manageable level. If imbalances of the current order persist within the eurozone, the currency union could unravel. No fiscal union could ever paper over cracks this big, let alone one that would inevitably be based on fragile political foundations.

Article 136 of the Lisbon treaty gives the European Council the power to adopt more 'powers of co-ordination', and as such a eurozone fiscal union could be forged without a treaty change. The obstacle is the lack of political will. Fiscal supra-nationalism is anathema to many participating countries, not least Germany, which fears that such a union would leave it having to transfer large sums of money to other members of the currency bloc on a continuing basis. But if the surplus member-states fail to provide the demand needed to pull the Southern Europeans out of a vicious cycle of slow growth, countries like Germany will end up paying one way or another. The German government can underwrite huge loans to the struggling member-states through the EFSF. But, as argued above, this does not solve the underlying problem. Moreover, the EFSF will not be dismantled after three years, as the German authorities argue. The alternative to continuing to transfer funds under the EFSF – forcing countries that cannot consolidate their debts out of the eurozone – is politically unrealistic, despite Germany's sabre-rattling. Some kind of fiscal union almost certainly offers Germany the least costly way forward – politically and economically. It is within the country's discretion to ensure that transfers are kept to a minimum by rebalancing its own economy.

Where does this leave the eurozone?

There is no doubting the member-states' political commitment to EMU. But the markets will speculate against the euro until the underlying obstacles to economic growth are addressed. The ratings agencies will continue to downgrade the debt of eurozone economies, citing poor growth

prospects. The new governance arrangements threaten to undermine relations between the participating economies because they are asymmetric and ignore many of the underlying reasons for the problems. Against this backdrop, economic stagnation across a swath of the eurozone and an ongoing series of fiscal crises and bail-outs look highly likely. Eventually, this risks leading to a rupture, as either the surplus countries tire of loaning money to struggling member-states which will be unable to pay it back, or the recipient countries balk at the political humiliation of trying to comply with impossible terms. An unravelling of the eurozone would not be a cathartic experience, either for the countries quitting the currency union or for the remaining members.

Even assuming that the departing economies defaulted before they left the currency union, they would have to deal with collapsed banking sectors, very high borrowing costs and steep inflation as their reintroduced currencies fell in value against the core euro. The core would – in all likelihood – comprise Germany, the Benelux, Austria, Finland and possibly France (see below). These would not be the modest devaluations of the pre-euro period, which facilitated adjustment between member-states of the euro, but seismic adjustments. The Dutch bank ING has calculated that a newly introduced Greek Drachma would fall by 80 per cent against a reintroduced Deutschmark (a similar fall could be expected against a core euro). The currencies of Spain, Portugal and Ireland would fall by 50 per cent. Economic dislocation would not be confined to the devaluing countries. The core eurozone would suffer slump and deflation, as exports contracted and the price of imports fell sharply.

Deflation would put these economies banking sectors under huge pressure and they would incur large losses on external assets, as the euro value of these investments fell steeply.¹⁰

¹⁰ Mark Cliffe, 'EMU break-up: Quantifying the unthinkable', ING Financial Markets Research report, July 2010.

In such a situation, the chances of deeper political and economic integration between the member-states would be poor. The fall-out for the single market and the EU more generally would be damaging. The impact on relations between member-states, especially to the

crucially important Franco-German relationship, would be far-reaching. France might form part of the core euro. Politically the country would move heaven and earth to achieve this. But investors would take some convincing. This is not a negative reflection on France, whose economic performance has been superior to Germany's since the launch of the euro. But unlike the other potential members of the 'core area' France already has a sizeable current account deficit (partly as a result of extremely weak domestic demand in its biggest export market, Germany), and relatively weak public finances (see charts 2 and 3, pages 2-3). These imbalances would almost certainly grow rapidly within a core eurozone.

The other members of a core euro would focus single-mindedly on rebuilding their trade competitiveness (and hence external surpluses) through reductions in labour costs. Over time, they would probably succeed, albeit at the cost of domestic demand. But France would not be willing (or able) to reduce costs as quickly. Unlike in economies such as Germany and the Netherlands, economic growth in France is largely driven by domestic demand, and persistent wage restraint would depress French consumption and investment. As a result, French firms' exports would suffer as their costs rose relative to companies based in other 'core' eurozone economies and domestic demand stagnated or fell across the rest of the core euro. French exporters would also struggle to compete with businesses based in former eurozone economies with newly devalued currencies. France's trade deficit would widen, hitting economic growth and casting doubt over the sustainability of its public finances.

The EU would no doubt survive, with all countries remaining in the EU (officially, eurozone members cannot leave the euro without leaving the EU). But the loss of influence in the world would be enormous, ending any hope of the EU punching its weight on the global stage. Such a scenario can be prevented, but only if France and Germany overcome their differences and agree to lead a powerful new integration drive. Of the two, Germany is the key player. The future of the euro largely rests on its shoulders. Greater integration is in Germany's interests; it should not fear policy co-ordination,

including co-ordination aimed at addressing imbalances. It cannot rely indefinitely on exports to drive economic growth: in the absence of a sustained recovery in domestic demand the German economy will soon falter. However important a market China becomes for German firms, it will not compensate for stagnation in Europe and the impact that would have on German industry and its banks. Moreover, accumulating foreign assets is risky and inefficient, as these assets are exposed to default and/or exchange rate risk. The rate of return on these savings would be much higher if they were invested at home. But firms will not want to step up investment in Germany unless consumption in that market recovers.

Germany has huge leverage over other eurozone economies at present. It should use it to put the currency union on a sustainable footing. In return for accepting closer policy co-ordination aimed at correcting imbalances, and an element of fiscal supra-nationalism, Germany could demand a dramatic deepening of the single market, labour market reforms across the eurozone, and tough rules to enforce fiscal discipline. This would put the German government in an impregnable position to resist pressure to dilute the eurozone's inflation-fighting credentials. Such pressure will build if the eurozone economy stagnates and the ECB refuses to loosen monetary policy by embracing unorthodox measures such as quantitative easing (the practice of a central bank injecting funds directly into an economy through the purchase of assets such as government bonds). France would have little choice but to overcome its reservations about greater market integration and go along with this German quid pro quo. The alternative – a crisis-riven eurozone in which Germany call the shots – would mark humiliation for the French, whose support for the single currency has always been about preventing German ascendancy.

Unfortunately, France and Germany are unlikely to strike such a grand bargain. The big problem is Germany's increasingly ambivalent attitude to the EU. Take the single market. Although Germany is the biggest winner from the single market, it is far from being a cheer-leader for it, and strongly opposed to the opening up of its service sector to greater competition. It is

similarly hard to imagine any German government championing flexible labour markets. The country's elite and media have also been quick to present the country as the victim of the euro crisis – fuelling a sense of injustice on the part of the population as a whole. German public opinion certainly constrains the German authorities' room for manoeuvre. Years of wage restraint and cuts in public services mean that the average German is understandably sceptical of calls for Germany to do whatever it takes to save the euro. German politicians do not appear to be in the mood to explain why it is in Germany's interests to do so.

Conclusion

The eurozone crisis can be traced back to the gap between the rhetoric of an integrated Europe and the reality of national interests and politics. Much of the time, this gap causes little harm other than to undermine the EU's credibility in the world. However, that gap is proving lethal for the euro. A shared currency cannot rest on a group of national markets that are insufficiently flexible and imperfectly integrated with each other. If eurozone governments cannot treat the movement of goods, services, capital and people across their boundaries in the same way that they treat them within their boundaries, then the question must be: what are they sharing a single currency for? Similarly, it is untenable to persist with the pretence that the eurozone can prosper without a comprehensive system of eurozone governance.

The task is daunting. Aside from containing a sovereign debt crisis in their ranks, eurozone countries must push through microeconomic reforms that many have spent the past decade avoiding or openly attacking. The participating countries also need to acknowledge that a successful currency union will require a much greater degree of political integration. The problem is that most leaders were not candid about this when they signed up to the single currency. Political elites need to start explaining why further integration is essential. The status quo is no longer an option.

The signs are not encouraging. There is scant acknowledgement that market integration must form part of any strategy to save the euro. Stronger eurozone governance seems likely to

comprise little more than a beefed-up system for ensuring budgetary discipline. There is no doubt that the eurozone (and the EU as a whole) faces daunting fiscal challenges: deficits must be cut. But tougher budget rules will achieve little in the absence of aggressive steps to remove the obstacles to economic growth. This requires concerted moves to integrate the economies, a system of governance that acknowledges that the way economies are run has major implications for others, the recapitalisation of some banks and greater fiscal union. Any response that neglects these elements will make matters worse.

Unless there is a rethink, the eurozone risks permanent crisis, with chronically weak economic growth across the region as a whole, and politically destabilising debt-deflation in the

struggling member-states. This would lead to a deep breach in relations between the north of the eurozone and the south and almost inevitably between France and Germany, in the process putting paid to any likelihood of meaningful progress being made in other areas. Fixing the euro is so difficult because it involves convincing people that markets and closer integration can work. It also requires eurozone economies to show solidarity with one another. Maybe it will take an even bigger crisis before eurozone governments get serious about saving the single currency.

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