The euro and its discontents

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Amazon tells us what the euro zone needs
(Civilisation and its Discontents)...

What Other Items Do Customers Buy After Viewing This Item?

- A General Introduction to Psychoanalysis by Sigmund Freud
- Madame Bovary by Gustave Flaubert
- Three Contributions to the Theory of Sex by Sigmund Freud
- The Communist Manifesto by Karl Marx 4.0 out of 5 stars (93)
To see where to go, must correctly interpret how we got here

EMU a success, confounding skeptics, until global financial crisis – though we knew long ago that it needed unified financial supervision and LOLR

Then banks and their creditors got bailouts, tax revenues down, deficits up, austerity policies, recession, further fiscal deterioration

Basic problem was not violation of OCA criteria, nor intra-zone disparities in competitiveness, but rather the capital flows unleashed by monetary union and financial deregulation

Now exit once again a threat (Cyprus), we have financial disintegration, financial intermediation doesn’t work

Macro: austerity and recession, can’t grow out of debt, ‘internal devaluation’ is contractionary and unnecessary because competitiveness is not central

Cyprus affair casts serious doubt on decision-makers, and explicit capital controls are a major step towards collapse of EMU (though some had already been imposed by national supervisors)
Threats

- Bank runs
- Austerity fatigue
- Bailout fatigue
- OMT loss of market credibility
- Exit
Elements of a solution

- Credible OMT conditional (only) on *independent* DSA (not Troika) – though still not clear how it could be withdrawn once extended
- Serious triage of banks, resolution of the weak, full recognition of NPLs and proper provisioning, burden on creditors not taxpayers
- Banking union: common supervision (not just for ‘large’ banks), common resolution mechanism – common deposit insurance can wait
- Financial re-integration, initiative to reopen flow of credit to SMEs
- More sovereign debt restructuring
- Euro zone running structural primary surplus, Bund yield is 1.25%, 5-yr inflation expectations 1.5%, 10-yr 2.0% →
- Switch to growth-oriented monetary and fiscal policies – expansion where there is fiscal space, infrastructure investment at EU level (EIB)
- *Not* austerity and lengthy internal devaluation (‘a decade of stagnation’), *nor* fiscal union
Causes - not violation of OCA criteria, nor fiscal excesses (except Greece), nor periphery’s loss of competitiveness

- **Greece**: fiscal profligacy and duplicity, deep structural weaknesses, political polarisation, capital inflow
- **Ireland**: housing boom, capital inflow to (through) banks, crony capitalism (bankers and construction), then government guarantee of bank debts
- **Spain**: housing boom, capital inflow to construction, cajas/politics
- **Portugal**: product and labour market rigidities, poor education, uncompetitive production structure, capital inflow (financing current account deficit) wasn’t used to modernise
- **Cyprus**: Banks bet on Greek debt, couldn’t take haircuts
Capital flows were key

From 2002, cross-border bank lending grew explosively. Euro eliminated currency mismatch on banks’ balance sheets, so banks drew deposits from surplus countries in rapid expansion, while permissive bank-capital rules removed regulatory constraints (Shin 2011)

- So periphery experienced capital inflow ‘bonanza’ (mainly from Germany and France) pushing interest rates down and feeding excessive credit growth, with corresponding CA deficits and some accompanying real exchange rate appreciation

- Borrowing was private sector, not governments

- ‘Walters critique’ on monetary policy, and fiscal policy not used to offset it and combat overheating, nor ‘macroprudential’ measures
The problem then and now is not primarily ‘competitiveness’ as measured, for example, by unit labour costs.

Indeed, export market shares did not deteriorate significantly for these countries in the 200s, while since beginning of 2010, Spanish and Portuguese exports have been growing at over 10% annually.

Rather, we see mainly fiscal consequences of crisis in bank-based financial systems, where burden of balance-sheet deterioration is shifted from creditors to taxpayers of debtor countries.
Huge capital flows from Germany and France to periphery were bank and portfolio debt, not FDI
Most of the real appreciation was due to nominal appreciation of the euro

Market shares of ‘problem countries’ were in fact stable, no relation between ULC and market shares

Figure 5: Exports of goods and services and competitiveness vs. Market share (MIP 2011)

Source: D. Gros, 2012
So a different story: boom in non-tradeables due to capital inflows, with some loss of competitiveness due mainly to euro appreciation.

- Borrowing didn’t go into investment in tradeables sector with productivity improvements – rather, into non-tradeables, especially construction.
- Prices rose there, resources flowed there.
- Capital flows weren’t accommodating CA deficits.
- If CA deficits due to lack of competitiveness, would have had low growth (low external demand) – in fact, growth rapid, deficits due to low savings (‘Dornbusch test’, as applied by Wyplosz 2012).
- Most relevant relative price is not terms of trade, nor even ULC-based real effective exchange rate (REER), but rather ratio of traded to non-traded goods prices.
And it’s also the politics, stupid! - or the stupid politicians (well, maybe too clever...)

Creditor countries have been bailing out their own banks that made foolish loans to these countries by transferring fiscal costs to debtor country taxpayers, meanwhile taking the moral high ground – hypocrisy!

- We are told ‘everyone should do his homework’, but politicians assign all responsibility to debtors while Germany (for example) blocks serious supervision of incompetent German banks and any burden-sharing that includes German creditors

- And those who should know better (EC, ECB, IMF) are in denial (‘no euro country can default’, ‘programmes are on track’, discussion of multipliers is ‘unhelpful’, ...)
Austerity isn’t working

Source: P Krugman, 10 May 2012
Austerity makes it all more difficult

- So we have interconnected sovereign debt and banking crises with debt trap exacerbated by austerity
- ECB can buy time, but long-run debt sustainability requires growth
- Austerity is not the solution – rather, part of the problem: asymmetric adjustment with austerity bias $\rightarrow$ €-zone primary surplus in recession!
- Deleveraging public and private sector simultaneously (excess of savings over investment in both) is not feasible without current account surplus $[\text{CA} = (S_p - I_p) + (T - G)]$
- So surplus countries must raise domestic demand and intra-eurozone imports, thus permitting deficit countries to raise $\text{CA}$
- And euro should depreciate – need further monetary ease
Must avoid bank runs: no Greek exit

- Any country’s exit, with the inevitable loss to depositors, would provoke bank runs elsewhere that could be stopped only with capital controls – and that is the end of monetary union.

- But ‘no exit’ will require a major aid programme for Greece to cut its debt burden to a sustainable level, permit growth, and give political impetus for profound institutional change.
Fiscal

- Recall that US didn’t have a serious fiscal union until long after it had a single currency – limited measures should suffice
- Agree that ESM should recapitalise banks, taking equity participation, without burden on sovereign
- Going forward, ESM takes fiscal risk for euro zone (so need ‘banking union’ with central supervision)
- Fiscal integration: credible simple fiscal rules
- Not a fiscal union, but some variety of euro bond (e.g. Soros proposal)
Recapitulating: Elements of a solution

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- Financial re-integration, initiative to reopen flow of credit to SMEs
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Germany is key...

...but is captive of myths: debtor country profligacy, misinterpretation of experience of 1920s and early ‘30s, the ‘transfer union’, unique demerits of Cyprus bank ‘business model’, laziness of southerners, their uncompetitiveness, now ‘evidence’ that they are ‘much richer than Germans’, ...

- German public aren’t told that lenders should share burden of bad loans, that their banks have been badly managed and badly supervised
- Germany needs a serious public discussion of euro and EU
- France is helpless, Italy paralysed, Spain overwhelmed by its political problems – only Germany can save the euro – Soros says perhaps only by leaving it (with Finland), but this would be a deep blow to Europe and our common future