The Unfolding Euro Implosion: Can The ‘Modest Proposal’ Save Europe?

Joerg Bibow, Skidmore College & Levy Economics Institute

At the workshop “Crisis in the Eurozone” of the EU Center of Excellence, LBJ School of Public Affairs, University of Texas, Austin, November 3-4, 2011

Outline

- Malfunctioning of euro regime perfectly foreseeable
  - Regime design based on flawed (German) presuppositions
- As manifested in tendencies toward stagnation & divergence across Euroland since Maastricht
  - Of implanted policy biases and out-of-sync national policies
- Immediate causes behind Euroland crisis & policy responses
  - Implosion of homegrown imbalances, amplified by ever higher doses of wrong medication – as misdiagnosis continues
- Can the ‘modest proposal’ save Europe?

Malfunctioning no surprise: Key flaws

- (1) Nobody minding the €land store
  - No deliberate (domestic) demand management
    - No lender of last resort
    - No fiscal backstop
  - Actually worse, as ECB afflicted by anti-growth bias
    - Macro policy mix made worse by SGP's asymmetric discipline

- (2) No proper coordination of national policies
  - Result: National policies source of asymmetric shocks
    - Wage/unit-labor cost trends as quasi-exchange rates
  - Maastricht regime actually amplifies divergence
    - Again, ECB & SGP as ugly twins behind destabilization

Flawed (German) presuppositions

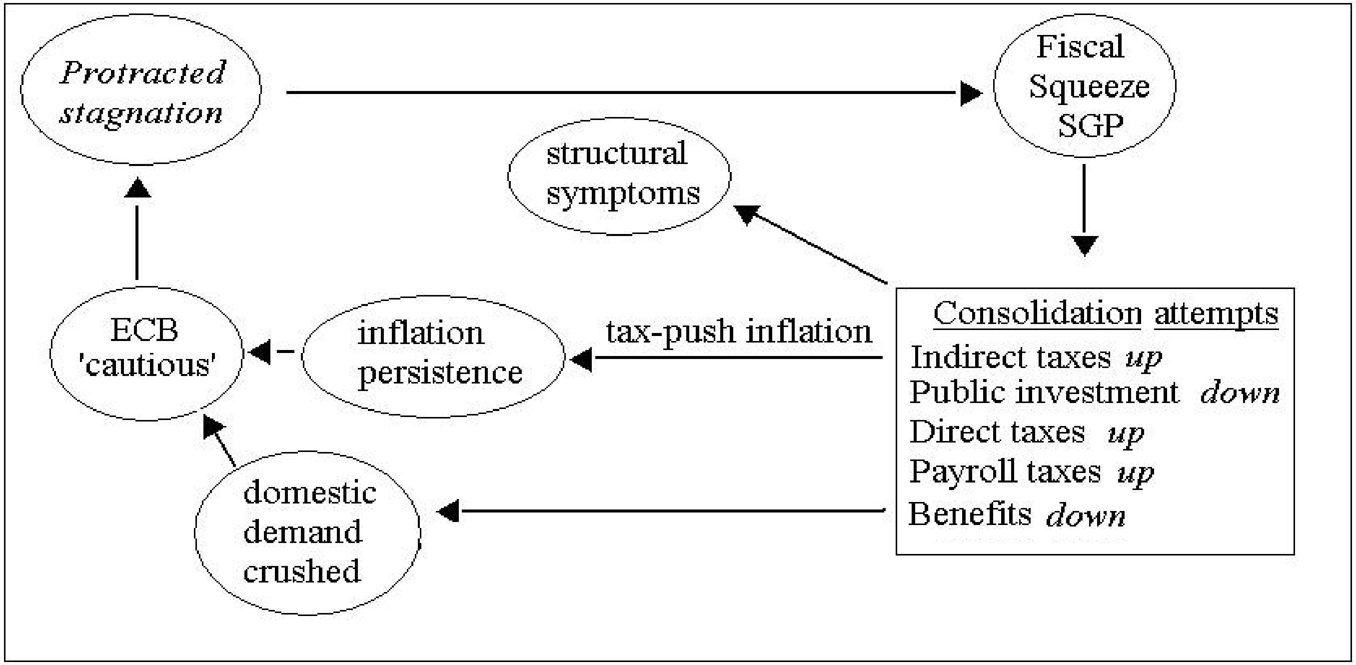
- German/Buba economic dogma ('stability culture')
  - Price stability *causes* economic growth
  - Fiscal austerity key to price stability (& hence growth)

- In practice, German model (undercover) mercantilism
  - Not price stability, but lower inflation than trade partners' (i.e. *relative* price stability) caused growth under fixed ER
  - As freeloading on exports allowed 'expansionary austerity', at least *as long as partners behaved differently* (1980s)

- Maastricht Treaty on EU exported German model to €land
  - Clearly unsuitable for 'large country', but 'small-country' mindset prevails until today (shielding flawed institutions & policies)
    - Supposed guarantors of stability, ECB & SGP, have caused instability … and today they accelerate the € implosion …

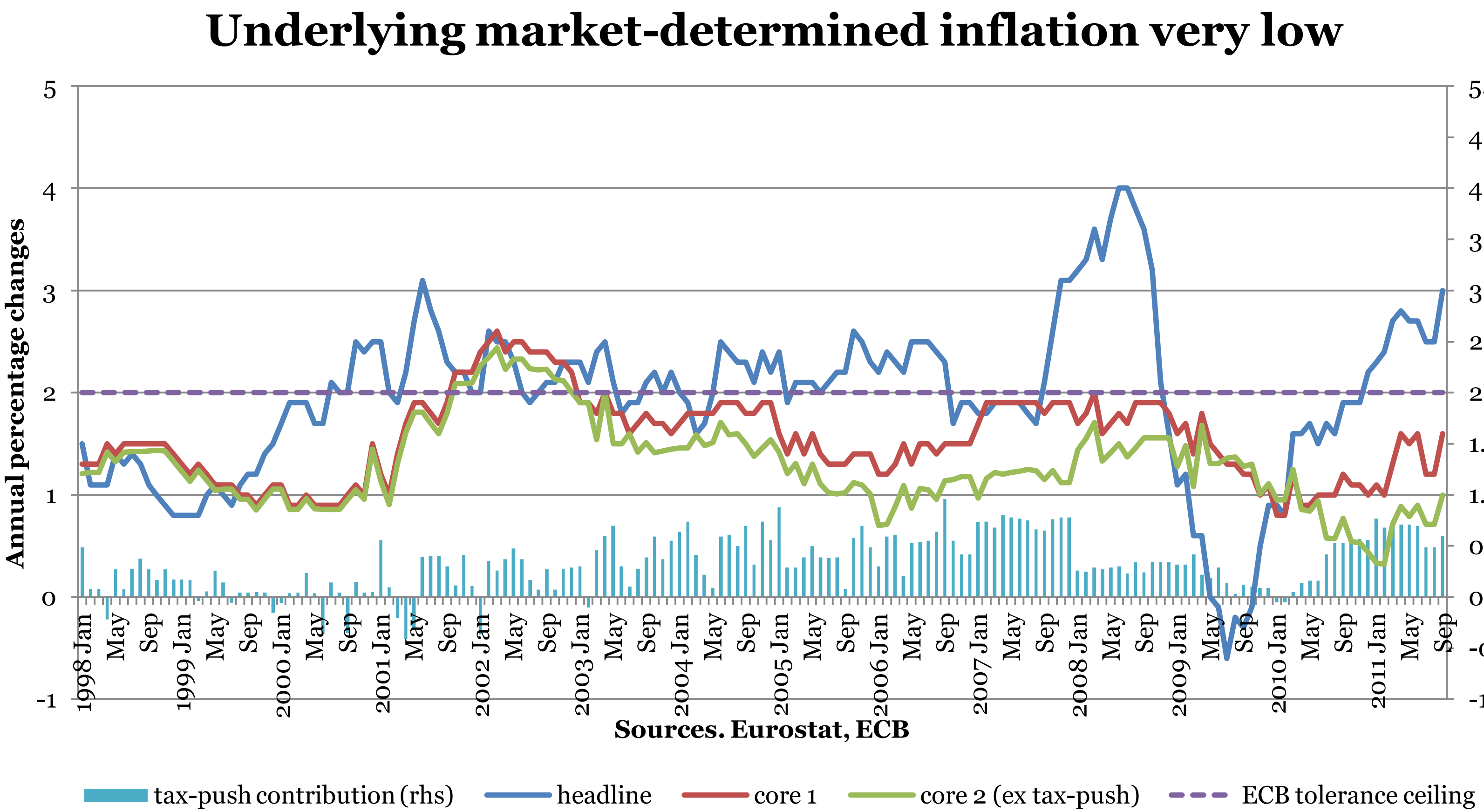
Re flaw (1): Counterproductive macro policy-mix – by design

Box 2. Stuck in a "stability oriented" vicious circle

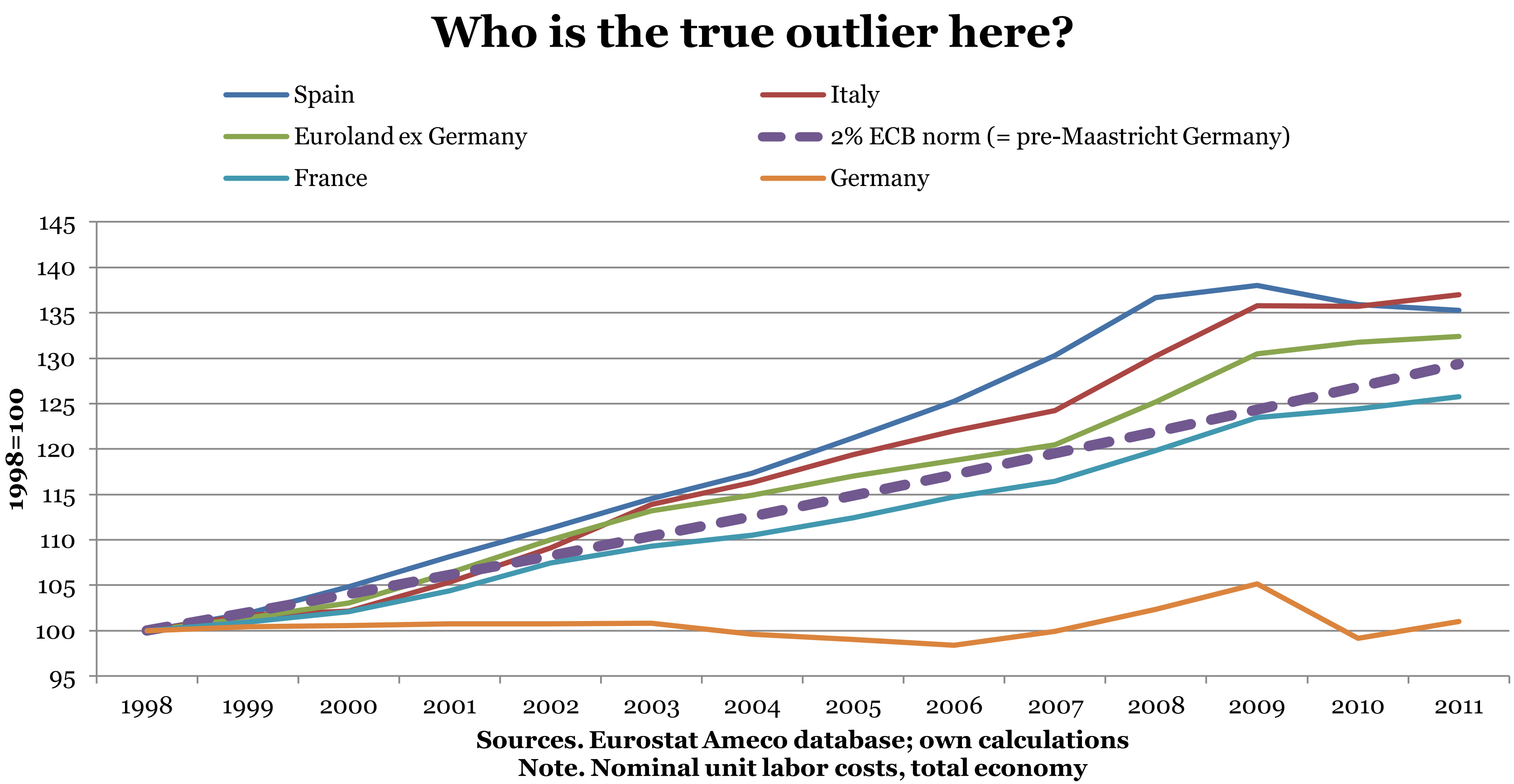


Describes protracted stagnation period 2001-05, and again today!

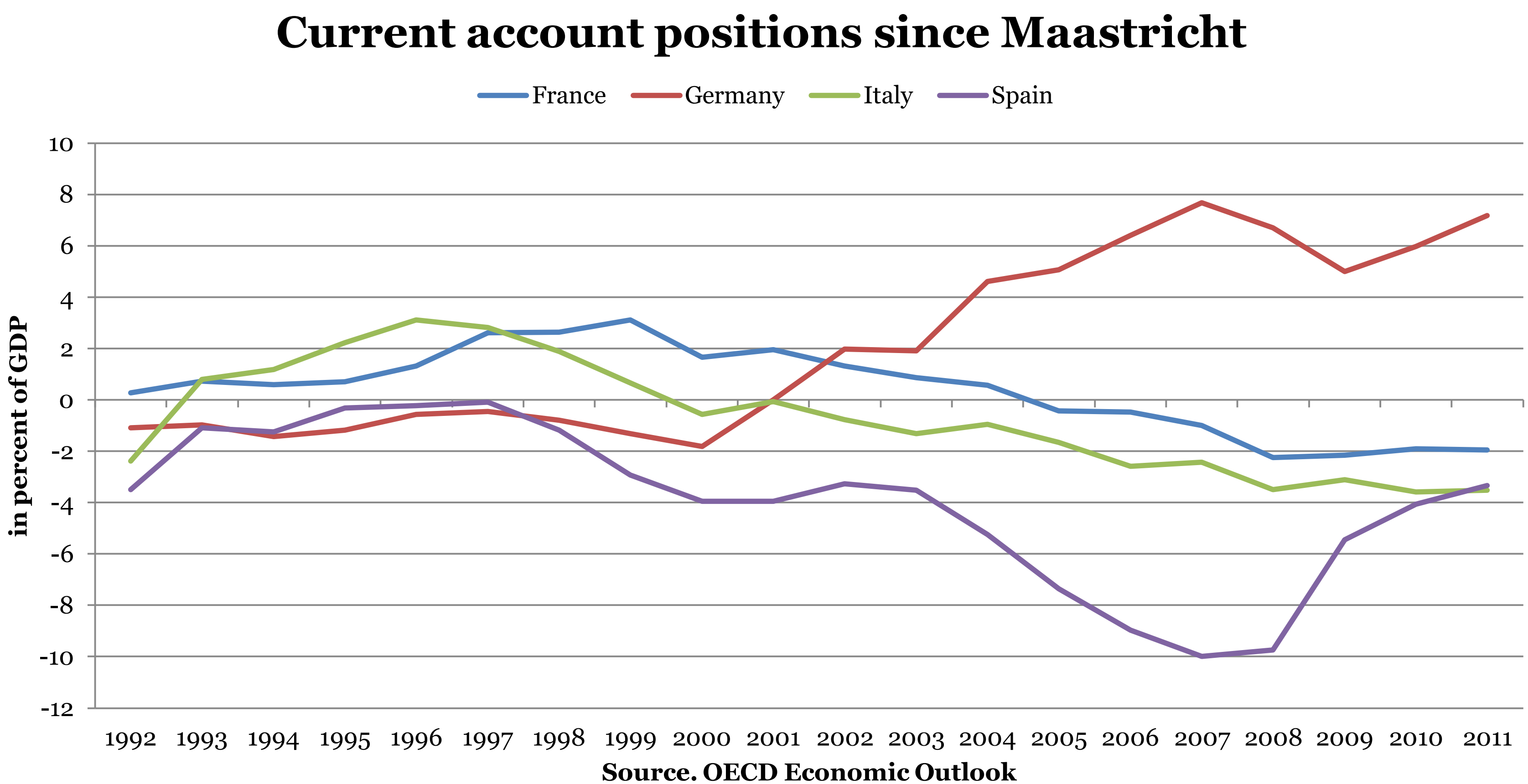
Stagnation and 'tax-push inflation'



Re flaw (2): Counterproductive wage trends – for failure to coordinate

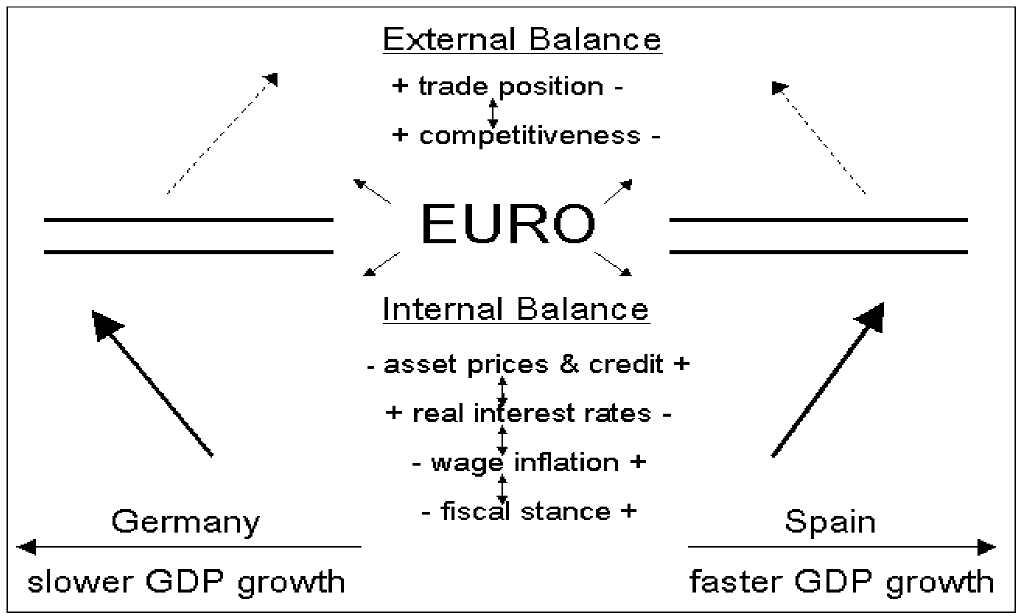


As competitiveness positions run out of kilter, CA imbalances build up



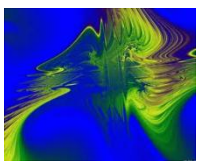
While Maastricht regime actually amplifies divergence

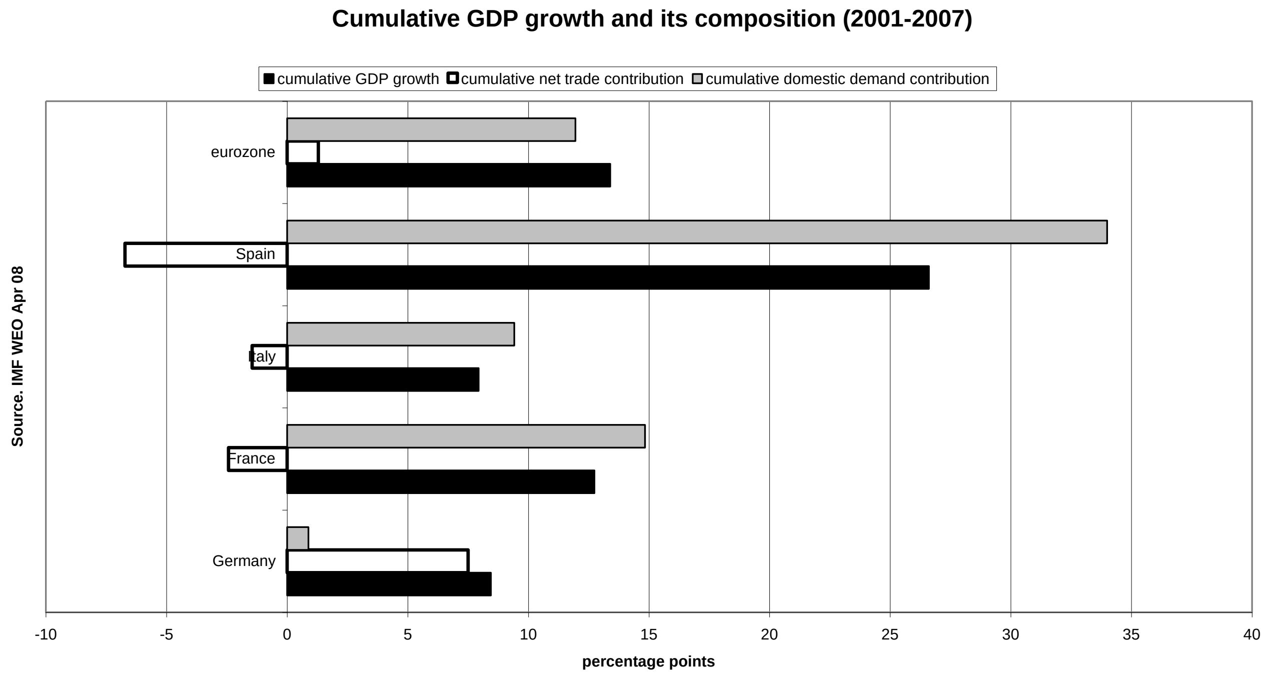
Partners drifting apart until…



- *Mindless German wage restraint and fiscal austerity produce financial conditions that are far too easy for periphery*

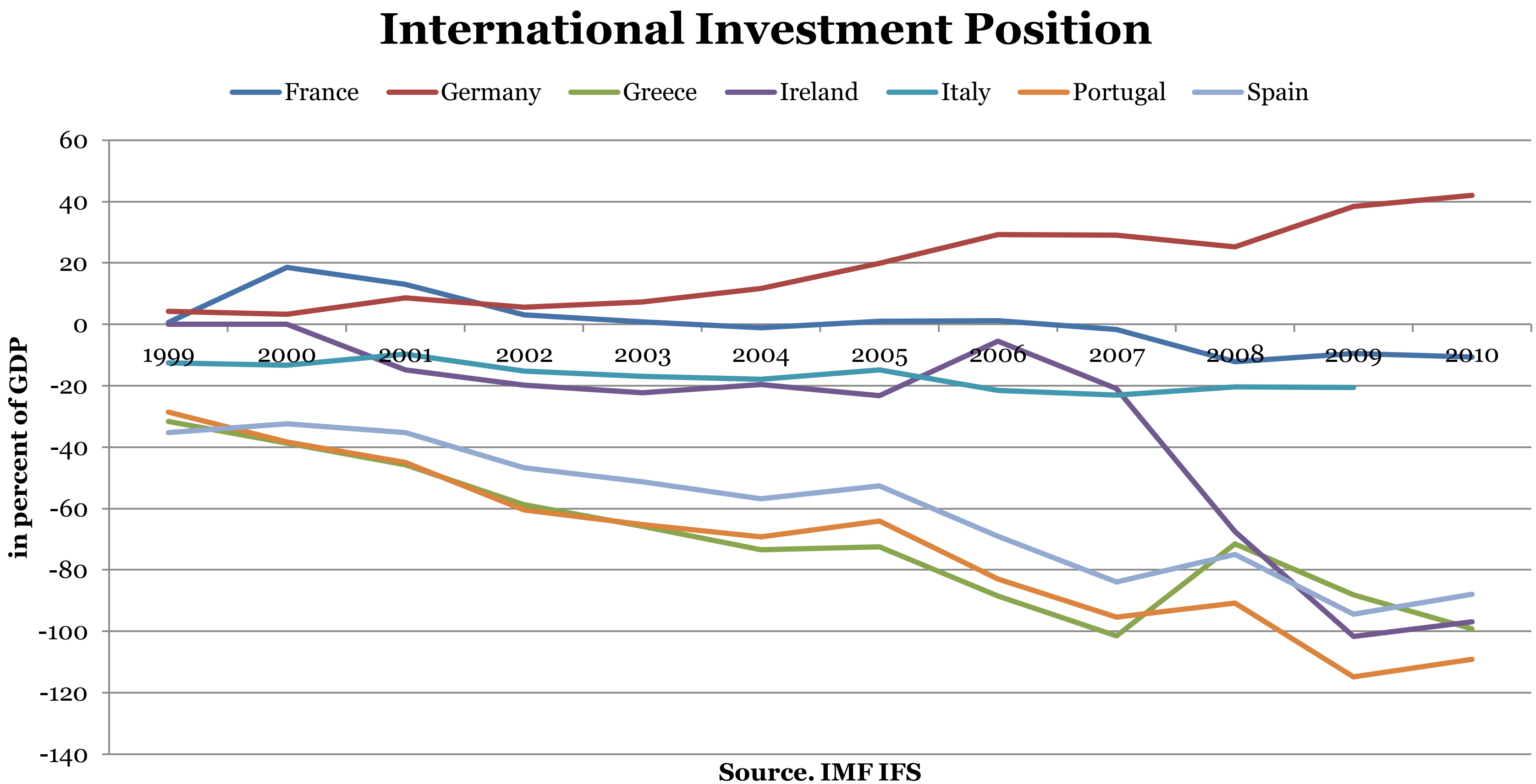
Unbalanced growth





- Peculiar world export champion notoriously grows on one cylinder only
- As old Buba model does not quite work anymore

Ultimately resulting in build-up of balance sheet stress



Causes behind Euroland crisis?

- Lehman & global trade collapse merely trigger
  - U.S. exposures of European banks, who had co-sponsored U.S. boom, meant they were at center of global crisis from start ($ gap)

- Covert fragility in place at home too as European banks were also at center of purely homegrown intra-€land imbalances
  - Private lending was financial counterpart to trade imbalances
  - As flows change stocks fragile balance sheets had built up over time
    - Largely PRIVATE balance sheets; Greece was exception!!!!!

- While real transfers (trade) long past, debt legacies remain
  - Crisis is about turning bad loans into fiscal transfers
  - Fiscal transfers to whom though? And how?
    - To debtor countries or creditor country banks?

Policy response: Germanic overdose

- Trade imbalances have to end abruptly with freeze of private financing unless replaced by public financing
  - Enter "rescue packages", i.e. EFSF/ESM & €system (Target2) *loans*
    - Asking the impossible: continued trade surpluses, no transfers or bail-outs, while appearance of loan soundness be upheld
- Austerity impacts growth & financing conditions adversely
  - Debtor country debt dynamics worsen, acute debt deflation risk!
- Without offsetting stimulus in creditor countries €land domestic demand gets suffocated
  - Hence debt dynamics worsen area-wide, and without solving intra-area imbalances
  - Alas, freeloading on global growth (NX) fails too

The ‘modest proposal’

- German medicine counterproductive; EFSF/ESM, ECB/SMP, ECB “liquidity ocean”, … fiscal transfers = *not even needed*

Instead:

- “Tranche transfer” of (up to 60% of) national debt to ECB/SPV, issuing “eurobonds” = the stock issue
  - To secure improved financing conditions (like USTs)
- Plus: Eurobond issuance by ECB/EIB to finance new public investment (European Economic Recovery Program) = the flow issue
  - To secure growth and other EU goals
- EIF to provide equity (venture) finance to SME
  - To compensate for credit crunch
- EFSF/ESM to recapitalize banks (preferred shares)
  - To make shareholders rather than taxpayers pay (Euro TARP)

Can the ‘modest proposal’ work?

- Appropriate focus on establishing favorable debt dynamics to assure solvency of debtors and €land as a whole!!!
  - But vital underlying issue of intra-area imbalances as caused by divergent competitiveness trends ignored (or attributed to disparities; Cohesion & Structural Funds)

- Comparison with U.S. and USTs relevant, and aggregate €land debt situation no worse than in U.S., also highlighting that euro crisis caused by flawed EMU institutions & policies,
  - but comparable global status of eurobonds may not be secured without Euro Treasury backing (as “no bailout” remains)

- Proposal seems to assume that €land needs foreign savers to finance investment & recovery – when it doesn’t
  - Envisions € as $ rival, with €land running current account deficit

Proposal not quite so modest …

- Tranche transfer perhaps seen as accounting gimmick as nations rather than union remain liable (“no bailout” clause upheld)
  - Eurobonds are not quite USTs!
    - At least as long as ECB/SPV not backed by Euro Treasury
  - Implicit fiscal transfer through common eurobond rating
    - Or fiscal transfers arise ex post as ECB losses shared through NCBs

- For SGP deficit limit (=flow) not to constrain members, public investment (financed by ECB/EIB €bonds) has to be large
  - At least 2% GDP in good times, more in bad time

- So rest assured that ECB “monetization” of eurobonds will be seen as hyper-inflation risk in Germany (haunted by MEFO ghosts …)

But not nearly immodest enough!

- In my view, € monetary union not viable without *some* fiscal union & euro Treasury
- Beyond redistribution (structural & cohesion funds; fiscal union = transfer union), scope of fiscal union (as mutual insurance) may be limited as long as:
  - Intra-area imbalances are avoided
  - And (related) cross-border financial crises & bailouts are avoided

- The irony is that imbalances & crises provoked by German beggar-thy-neighbor wage deflation have greatly increased the needed scope for fiscal – as transfer! – union
  - Of course Germany may run trade surpluses for ever if goods were handed out as gifts (i.e. no debts, no regrets)
  - But debts will turn into fiscal transfers at some point
    - As transfers to partners, or banks, or via ECB recapitalization …

A happy ending for the euro?

- Germany is actually pushing for fiscal union today, Germanic-style "fiscal union" though
  - Export of Germany's "debt brake" (anchored in constitution)
    - Supposed to discipline the deficit "sinners"
- *Misdiagnosis*!!! Would only reinforce anti-growth bias in regime!

- As to true problem of intra-area imbalances, Germany wants all partners to become more competitive/more German (unaware of what that would imply???)
  - In effect, Germany dreams of perpetual trade surpluses without transfers to bankrupted deficit countries (or cheap perpetual lending as in China-U.S. case).
    - Another German fairytale dream turning into a European nightmare …
      - 'Good-bye' Europeanized Germany, 'hello' Germanized Europe …

- Another irony is that the holy land of CB independence is thereby pushing €land towards transfers effected through the Eurosystem
  - As German constitutional court rulings would not seem to constrain fiscal transfers through ECB recapitalization
    - Germany CAN bail-out (make transfers to) German banks & iconic Bundesbank

JB's Homepage http://www.skidmore.edu/~jbibow/
JB @ Levy Economics Institute http://www.levy.org/vauth.aspx?auth=20

My research on EMU in Europe includes:

Bibow, J. (2001) "Making EMU work: some lessons from the 1990s", *International Review of Applied Economics*, 15 (3), 233-259.

- ... (2003) ""Is Europe doomed to stagnation? An analysis of the current crisis and recommendations for reforming macroeconomic policymaking in Euroland", Levy Economics Institute, Working Paper No. 379.
- ... (2004) "Assessing the ECB's performance since the global slowdown", *Levy Economics Institute*, Working Paper, no. 409.
- ... (2005) "Germany in crisis – The unification challenge, macroeconomic policy shocks and traditions, and EMU", *International Review of Applied Economics*, 19(1), 29-50.
- ... (2006) "Europe's quest for monetary stability: central banking gone astray", *International Journal of Political Economy*, 35(1), 24-43.
- ... (2006) "The euro area drifting apart - Does reform of labor markets deliver competitive stability or competitive divergence?", in Structural Reforms and Macro-Economic Policy, ETUC, 76-86.
- ... (2006) "Inflation persistence and tax-push inflation in Germany and the euro area: A Symptom of macroeconomic policy mismanagement?", IMK Study, 1/2006.
- ... (2006) "Bad for Euroland, worse for Germany – The ECB's record", in *Germany's Economic Performance: From Unification to Euroisation* (ed. J. Hölscher) London, Palgrave, 42-65.
- ... (2007) "How the Maastricht regime fosters divergence as well as instability", in P. Arestis et al. (eds) Aspects of Modern Monetary and Macroeconomic Policies, Palgrave.
- ... (2007) "The ECB – How much of a success story, really?", *European Integration in Crisis* (eds. E. Hein, J. Priewe, & A. Truger), Marburg, Metropolis, 301-29.
- ... (2007) "Global imbalances, Bretton Woods II, and Euroland's role in all this, in J. Bibow and A. Terzi (eds) Euroland and the World Economy – Global Player or Global Drag?, Palgrave.
- ... (2007) Euroland and the World Economy - Global Player or Global Drag?, Palgrave. (with Andrea Terzi).
- ... (2009) "On the origin and rise of central bank independence in West Germany", *European Journal of the History of Economic Thought* 16(1): 155-90.
- ... *(2009) Keynes on Monetary Policy, Finance and Uncertainty: Liquidity Preference Theory and the Global Financial Crisis*, Routledge.
- ... (2009) "Will Germany really stop undermining European integration?" , Eurointelligence, October 2.
- ... (2009) "The euro and its guardian of stability: the fiction and reality of the 10th anniversary blast", Levy Economics Institute, Working Paper no. 583. Forthcoming in L.-P. Rochone (ed.) Monetary Policy and Crisis, Edward Elgar.
- ... (2010) "Germany is unfit for the euro", Eurointelligence, 21 April.
- ... (2010) "Suffocating Europe", Eurointelligence, 25 June 2010.
- ... (2011) "Europäische Geldpolitik: Fehlkonzipiert, irregeleitet und lernresistent", WSI Mitteilungen, no. 6/2011, 278-85.