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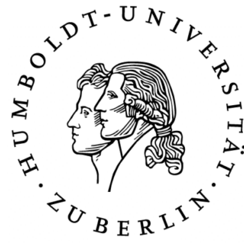

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EUROPE IN CRISIS

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- ES GILT DAS GESPROCHENE WORT -

Das Forum Constitutionis Europae ist eine gemeinsame Veranstaltung des Walter Hallstein-Instituts und der Robert Bosch Stiftung.

I believe that misconceptions play a large role in shaping history, and the euro crisis is a case in point.

Let me start my analysis with the previous crisis, the bankruptcy of Lehman Brothers. In the week following September 15, 2008, global financial markets actually broke down and by the end of the week they had to be put on artificial life support. The life support consisted of substituting sovereign credit—backed by the financial resources of the state—for the credit of financial institutions that had ceased to be acceptable to counterparties.

As Mervyn King of the Bank of England explained, the authorities had to do in the short term the exact opposite of what was needed in the long term: they had to pump in a lot of credit, to replace the credit that had disappeared, and thereby reinforce the excess credit and leverage that had caused the crisis in the first place. Only in the longer term, when the crisis had subsided, could they drain the credit and reestablish macroeconomic balance.

This required a delicate two-phase maneuver—just as when a car is skidding, first you have to turn it in the direction of the skid and only when you have regained control can you correct course. The first phase of the maneuver was successfully accomplished—a collapse has been averted. But the underlying causes have not been removed and they surfaced again when the financial markets started questioning the creditworthiness of sovereign debt. That is when the euro took center stage because of a structural weakness in its constitution. But we are dealing with a worldwide phenomenon, so the current situation is a direct consequence of the crash of 2008. The second phase of the maneuver—getting the economy on a new, better course—is running into difficulties.

The situation is eerily reminiscent of the 1930s. Doubts about sovereign credit are forcing reductions in budget deficits at a time when the banking system and the economy may not be strong enough to do without fiscal and monetary stimulus. Keynes taught us that budget deficits are essential for countercyclical policies in times of deflation, yet governments everywhere feel compelled to reduce them under pressure from the financial markets. Coming at a time when the Chinese authorities have also put on the brakes, this is liable to push the global economy into a slowdown or possibly a double dip. Europe, which weathered the first phase of the financial crisis relatively well, is now in the forefront of causing the downward pressure because of the problems connected with the common currency.

The euro was an incomplete currency to start with. In 1992, the Maastricht Treaty established a monetary union without a political union. The euro boasts a common central bank but it lacks a common treasury. It is exactly that sovereign backing that financial markets are now questioning and that is missing from the design. That is why the euro has become the focal point of the current crisis.

Member countries share a common currency, but when it comes to sovereign credit they are on their own. This fact was obscured until recently by the willingness of the European Central Bank (ECB) to accept the sovereign debt of all member countries on equal terms at its discount window. This allowed the member countries to borrow at practically the same interest rate as Germany, and the banks were happy to earn a few extra pennies on supposedly risk-free assets by loading up their balance sheets with the government debt of the weaker countries. These positions now endanger the creditworthiness of the European banking system. For instance, European banks hold nearly a trillion euros of Spanish debt, of which half is held by German and French banks. It can be seen that the European sovereign debt crisis is intricately interconnected with a European bank crisis.

How did this connection arise?

The introduction of the euro in 1999 brought about a radical narrowing of interest rate differentials. This in turn generated real estate bubbles in countries like Spain, Greece, and Ireland. Instead of the convergence prescribed by the Maastricht Treaty, these countries grew faster and developed trade deficits within the eurozone, while Germany reigned in its labor costs, became more competitive, and developed a chronic trade surplus. To make matters worse, some of these countries, most notably Greece, ran budget deficits that exceeded the limits set by the Maastricht Treaty. But the discount facility of the European Central Bank allowed them to continue borrowing at practically the same rates as Germany, relieving them of any pressure to correct their excesses.

The first clear reminder that the euro does not have a common treasury came after the bankruptcy of Lehman. The finance ministers of the European Union promised that no other financial institution of systemic importance would be allowed to default. But Germany opposed a joint Europe-wide guarantee; each country had to take care of its own banks.

At first, the financial markets were so impressed by the promise of the EU finance ministers that they hardly noticed the difference. Capital fled from the countries that were not in a position to offer similar guarantees, but the differences in interest rates on government debt within the eurozone remained minimal. That was when the countries of Eastern Europe, notably Hungary and the Baltic States, got into difficulties and had to be rescued.

It is only this year that financial markets started to worry about the accumulation of sovereign debt within the eurozone. Greece became the center of attention when the newly elected government revealed that the previous government had lied and the deficit for 2009 was much larger than indicated.

Interest rate differentials started to widen but the European authorities were slow to react because the member countries held radically different views. Germany, which had been traumatized by two episodes of runaway inflation, was allergic to any buildup of inflationary pressures; France and other countries were more willing to show their solidarity. Since Germany was heading for elections, it was unwilling to act, but nothing could be done without Germany. So the Greek crisis festered and spread. When the authorities finally got their act together they had to offer a much larger rescue package than would have been necessary if they had acted earlier.

In the meantime, the crisis spread to the other deficit countries, and in order to reassure the markets the authorities felt obliged to put together a €750 billion European Financial Stabilization Fund, with €500 billion from the member states and €250 billion from the IMF.

But the markets are not reassured because the term sheet of the Fund, i.e., the conditions under which it operates, was dictated by Germany. The Fund is guaranteed not jointly but only severally, so that the weaker countries will in fact be guaranteeing a portion of their own debt. The Fund will be raised by selling bonds to the market and charging a fee on top. It is difficult to see how these bonds will merit an AAA-rating.

Even more troubling is the fact that Germany is not only insisting on strict fiscal discipline for weaker countries but is also reducing its own fiscal deficit. When all countries are reducing deficits at a time of high unemployment they set in motion a downward deflationary spiral. Reductions in employment, tax receipts, and exports reinforce each other, ensuring that the

targets will not be met and further reductions will be required. And even if budgetary targets were met, it is difficult to see how the weaker countries could regain their competitiveness and start growing again because, in the absence of exchange rate depreciation, the adjustment process would require reductions in wages and prices, producing deflation.

To some extent a continued decline in the value of the euro may mitigate the deflation. But as long as there is no growth, the relative weight of the debt will continue to grow. This is true not only for the national debt but also for the commercial loans held by banks. This will make the banks even more reluctant to lend, compounding the downward pressures.

The euro is a patently flawed construct, which its architects knew at the time of its creation. They expected its defects to be corrected, if and when they became acute, by the same process that brought the European Union into existence.

The European Union was built by a process of piecemeal social engineering: indeed it is probably the most successful feat of social engineering in history. The architects recognized that perfection is unattainable. They set limited objectives and firm deadlines. They mobilized the political will for a small step forward, knowing full well that when it was accomplished its inadequacy would become apparent and require further steps. That is how the six-nation Coal and Steel Community was gradually developed into the European Union, step by step.

Germany used to be at the heart of the process. German statesmen used to assert that Germany has no independent foreign policy, only a European policy. After the fall of the Berlin Wall, Germany's leaders realized that unification was possible only in the context of a united Europe and they were willing to make considerable sacrifices to secure European acceptance. When it came to bargaining they were willing to contribute a little more to the pot and take a little less than the others, thereby facilitating agreement. But those days are over. Germany doesn't feel so rich anymore and doesn't want to continue serving as the deep pocket for the rest of Europe. This change in attitudes is understandable but it did bring the process of integration to a screeching halt.

Germany now wants to treat the Maastricht Treaty as the scripture that has to be obeyed without any modifications. This is not understandable, because it is in conflict with the incremental method by which the European Union was built. Something has gone fundamentally wrong in Germany's attitude toward the European Union.

Let me first analyze the defects of the euro and then examine Germany's attitude. The biggest deficiency in the euro, the absence of a common fiscal policy, is well known. But there is another defect that has received less recognition: a false belief in the stability of financial markets. As I have tried to explain in my writings, the crash of 2008 conclusively demonstrated that financial markets do not necessarily tend toward equilibrium; they are just as likely to produce bubbles. I don't want to repeat my arguments here because you can find them in my lectures, which have recently been published.[1]

All I need to do is remind you that the introduction of the euro created its own bubble in the countries whose borrowing costs were greatly reduced. Greece abused the privilege by cheating, but Spain didn't. Spain followed sound macroeconomic policies, maintained its sovereign debt level below the European average, and exercised exemplary supervision over its banking system. Yet it enjoyed a tremendous real estate boom that has turned into a bust resulting in 20 percent unemployment. Now it has to rescue the savings banks, called *cajas*, and the municipalities. And the entire European banking system is weighed down by bad

debts and needs to be recapitalized. The design of the euro did not take this possibility into account.

Another structural flaw in the euro is that it guards only against the danger of inflation and ignores the possibility of deflation. In this respect the task assigned to the European Central Bank is asymmetric. This is due to Germany's fear of inflation. When Germany agreed to substitute the euro for the Deutschmark it insisted on strong safeguards to maintain the value of the currency. The Maastricht Treaty contained a clause that expressly prohibited bailouts and that ban has been reaffirmed by the German constitutional court. It is this clause that has made the current situation so difficult to deal with.

And this brings me to the gravest defect in the euro's design: it does not allow for error. It expects member states to abide by the Maastricht criteria—which state that the budget deficit must not exceed 3 percent and total government debt 60 percent of GDP—without establishing an adequate enforcement mechanism. And now that several countries are far away from the Maastricht criteria, there is neither an adjustment mechanism nor an exit mechanism. Now these countries are expected to return to the Maastricht criteria even if such a move sets in motion a deflationary spiral. This is in direct conflict with the lessons learned from the Great Depression of the 1930s, and is liable to push Europe into a period of prolonged stagnation or worse. That will, in turn, generate discontent and social unrest. It is difficult to predict how the anger and frustration will express itself.

The wide range of possibilities will weigh heavily on the financial markets. They will have to discount the prospects of deflation and inflation, default and disintegration. Financial markets dislike uncertainty. Meanwhile, xenophobic and nationalistic extremism are already on the rise in countries such as Belgium, the Netherlands, and Italy. In a worst-case scenario, such political trends could undermine democracy and paralyze or even destroy the European Union.

If that were to happen, Germany would have to bear a major share of the responsibility because as the strongest and most creditworthy country it calls the shots. By insisting on pro-cyclical policies, Germany is endangering the European Union. I realize that this is a grave accusation but I am afraid it is justified.

To be sure, Germany cannot be blamed for wanting a strong currency and a balanced budget. But it can be blamed for imposing its predilection on other countries that have different needs and preferences—like Procrustes, who forced other people to lie in his bed and stretched them or cut off their legs to make them fit. The Procrustes bed being inflicted on the eurozone is called deflation.

Unfortunately Germany does not realize what it is doing. It has no desire to impose its will on Europe; all it wants to do is to maintain its competitiveness and avoid becoming the deep pocket for the rest of Europe. But as the strongest and most creditworthy country, it is in the driver's seat. As a result Germany objectively determines the financial and macroeconomic policies of the eurozone without being subjectively aware of it. When all the member countries try to be like Germany they are bound to send the eurozone into a deflationary spiral. That is the effect of the policies pursued by Germany and—since Germany is in the driver's seat—these are the policies imposed on the eurozone.

The German public does not understand why it should be blamed for the troubles of the eurozone. After all, it is the most successful economy in Europe, fully capable of competing

in world markets. The troubles of the eurozone feel like a burden weighing Germany down. It is difficult to see what would change this perception because the troubles of the eurozone are depressing the euro and, being the most competitive of the countries in the eurozone, Germany benefits the most. As a result Germany is likely to feel the least pain of all the member states.

The error in the German attitude can best be brought home by engaging in a thought experiment. The most ardent instigators of that attitude would prefer that Germany leave the euro rather than modify its position. Let us consider where that would lead.

The Deutschmark would go through the roof and the euro would fall through the floor. This would indeed help the adjustment process of the other countries but Germany would find out how painful it can be to have an overvalued currency. Its trade balance would turn negative and there would be widespread unemployment. German banks would suffer severe exchange rate losses and require large injections of public funds. But the government would find it politically more acceptable to rescue German banks than Greece or Spain. And there would be other compensations: pensioners could retire to Spain and live like kings, helping Spanish real estate to recover.

Let me emphasize that this scenario is totally hypothetical because it is extremely unlikely that Germany would be allowed to leave the euro and to do so in a friendly manner. Germany's exit would be destabilizing financially, economically, and above all politically. The collapse of the single market would be difficult to avoid. The purpose of this thought experiment is to convince Germany to change its ways without going through the actual experience that its current policies hold in store.

What would be the right policy for Germany to pursue? It cannot be expected to underwrite other countries' deficits indefinitely. So some tightening of fiscal policies is inevitable. But some way has to be found to allow the countries in crisis to grow their way out of their difficulties. The countries concerned have to do most of the heavy lifting by introducing structural reforms but they do need some outside help to allow them to stimulate their economies. By cutting its budget deficit and resisting a rise in wages to compensate for the decline in the purchasing power of the euro, Germany is actually making it more difficult for the other countries to regain competitiveness.

So what should Germany do? It needs to recognize three guiding principles.

First, the current crisis is more a banking crisis than a fiscal one. The continental European banking system was never properly cleansed after the crash of 2008. Bad assets have not been marked-to-market—i.e., valued according to current market price— but are being held to maturity. When markets started to doubt the creditworthiness of sovereign debt, it was really the solvency of the banking system that was brought into question because the banks were loaded with the bonds of the weaker countries and these are now selling below par—the price at which they were issued. The banks have difficulties in obtaining short-term financing. The interbank market—i.e., for borrowing and lending between banks—and the commercial paper market have dried up and banks have turned to the ECB both for short-term financing and for depositing their excess cash. They are in no position to buy government bonds. That is the main reason why risk premiums on government bonds have widened, setting up a vicious circle.

The crisis has now forced the authorities to disclose the results of their stress tests of banks, which assess the extent to which their resources are sufficient to meet their obligations. We cannot judge how serious the situation is until the results are published, presumably before the end of July. It is clear however that the banks are greatly overleveraged and need to be recapitalized on a compulsory basis. That ought to be the first task of the European Financial Stabilization Fund, and it will go a long way to clear the air. It may be seen, for instance, that Spain does not have a fiscal crisis at all. Recent market moves point in that direction. Germany's role may also be seen in a very different light if, in recapitalizing its - *Landesbanken*, it becomes a bigger user of the stabilization fund than contributor to it.

Second, a tightening of fiscal policy must be offset by a loosening of monetary policy. Specifically, the ECB could buy Spanish treasury bills, an action that would significantly reduce the punitive interest rates, set by the German-inspired European Financial Stabilization Fund, that Spain now must pay on its bonds. This would allow Spain to meet its budget reduction targets with less pain. But that is not possible without a change of heart by Germany.

Third, this is the time to put idle resources to work by investing in education and infrastructure. For instance, Europe needs a better gas pipeline system, and the connection between Spain and France is one of the bottlenecks. The European Investment Bank ought to be able to find other investment opportunities as well, such as expanding broadband coverage or creating a smart electricity grid.

It is impossible to be more concrete at the moment but there are grounds for optimism. When the solvency situation of the banks has been clarified and they have been properly recapitalized, it should be possible to devise a growth strategy for Europe. And when the European economy has regained its balance the time will be ripe to correct the structural deficiencies of the euro. Make no mistake about it: the fact that the Maastricht criteria were so flagrantly violated shows that the euro does have deficiencies that need to be corrected.

As I said at the beginning, what is needed is a delicate, two-phase maneuver, similar to the one the authorities undertook after the failure of Lehman Brothers. First help Europe to grow its way out of its difficulties and then revise and strengthen the structure of the euro. This cannot be done without German leadership. I hope Germany will once again live up to the responsibilities. After all, it has done so in the past.

Germany went into the G-20 meeting in Toronto on June 26–27 largely isolated. Before the meeting, President Obama publicly pleaded with Angela Merkel to change her policies. At the meeting the tables were turned. Canada's Stephen Harper as the host and David Cameron, the newly elected Conservative prime minister of the UK, lined up behind Merkel, leaving Obama isolated. Supporting Merkel's approach, the G-20 endorsed a halving of budget deficits by 2013 as the target. This has extended the threat of a deflationary spiral to the global economy, making the experience of the 1930s even more relevant than it was when I gave much of the preceding text as a speech at Humboldt University.

The political leaders claim to take their cue from the financial markets but they are misreading the signals. Sovereign risk premiums have widened in Europe because of the situation of the banks; but yields on the government bonds of the US, Japan, and Germany are at or near all-time lows, yield curves are flattening, and commodity prices are declining—all foreshadowing deflation. Equity markets have also come under pressure but that is because of the lack of clear leadership. The range of uncertainties is unusually wide: markets need to

discount inflation, default, and disintegration, all at the same time. No wonder that equity prices are falling.

The world's leaders urgently need to learn that they have to lead markets and not seek to follow them. Of course, they also need to get their policies right and forge a consensus—a difficult trifecta. Right now the G-20 nations are converging around the wrong policy.