The Euroland Crisis and Germany's Euro Trilemma

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Aim & Structure of Presentation

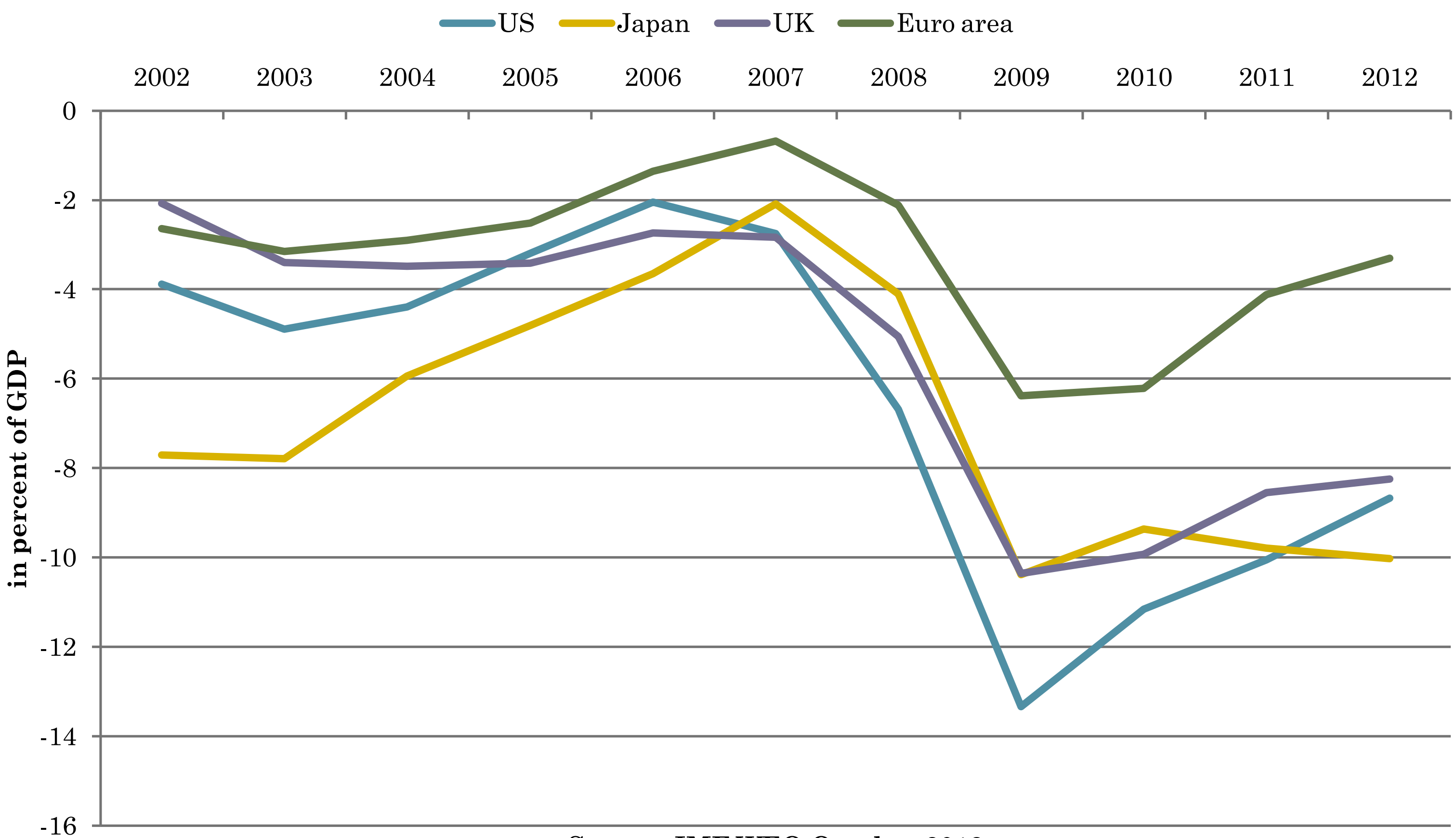
- AIM: Investigate causes behind Euroland crisis, particularly Germany's role, and crisis resolution

- STRUCTURE

1. Euroland in global perspective
2. Inside Euroland
3. What caused divergences & buildup of intra-area imbalances?
4. Germany's 'euro trilemma'
5. Crisis management & crisis resolution
6. Concluding observations

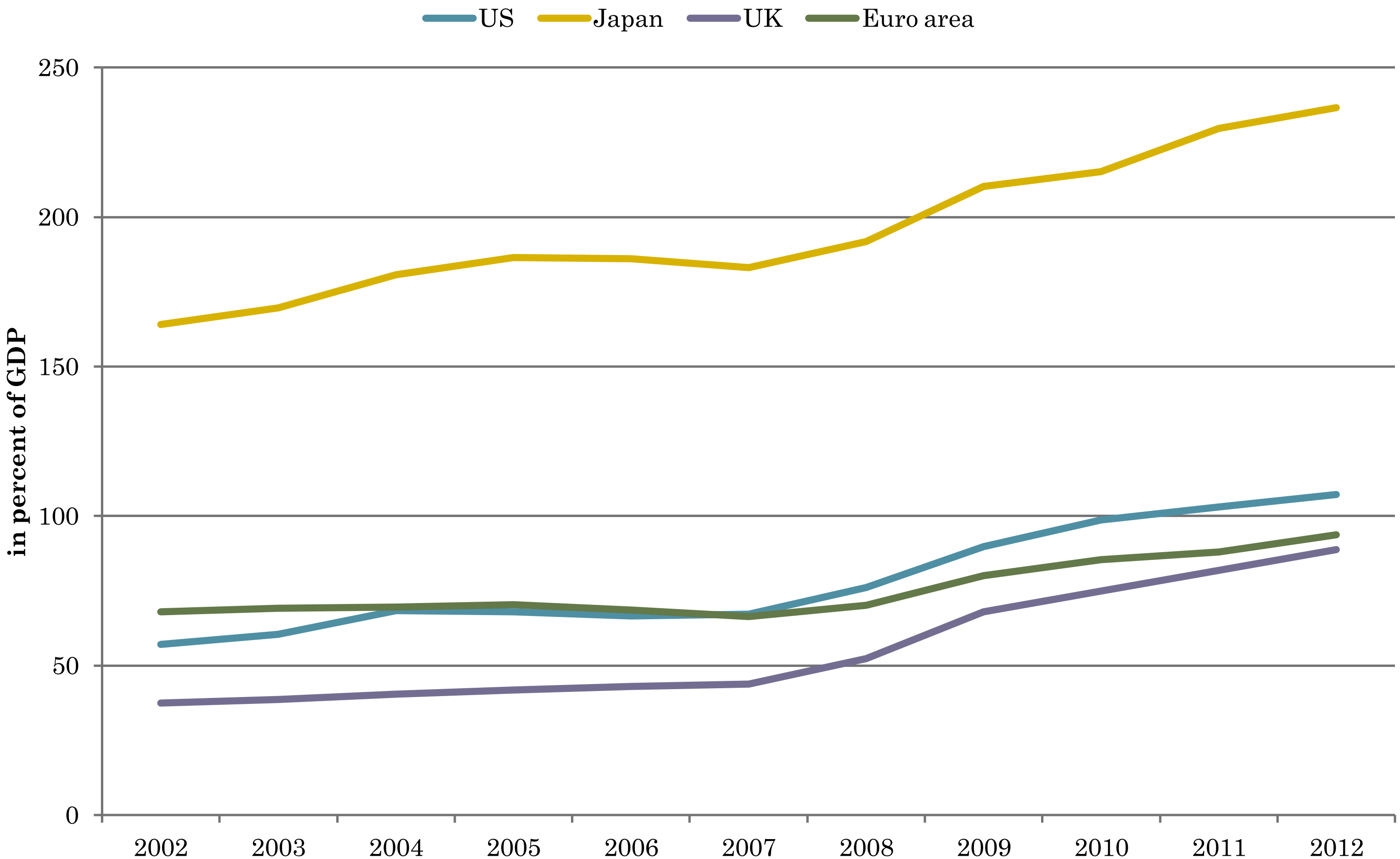
1. Euroland in global perspective

General government net lending/net borrowing



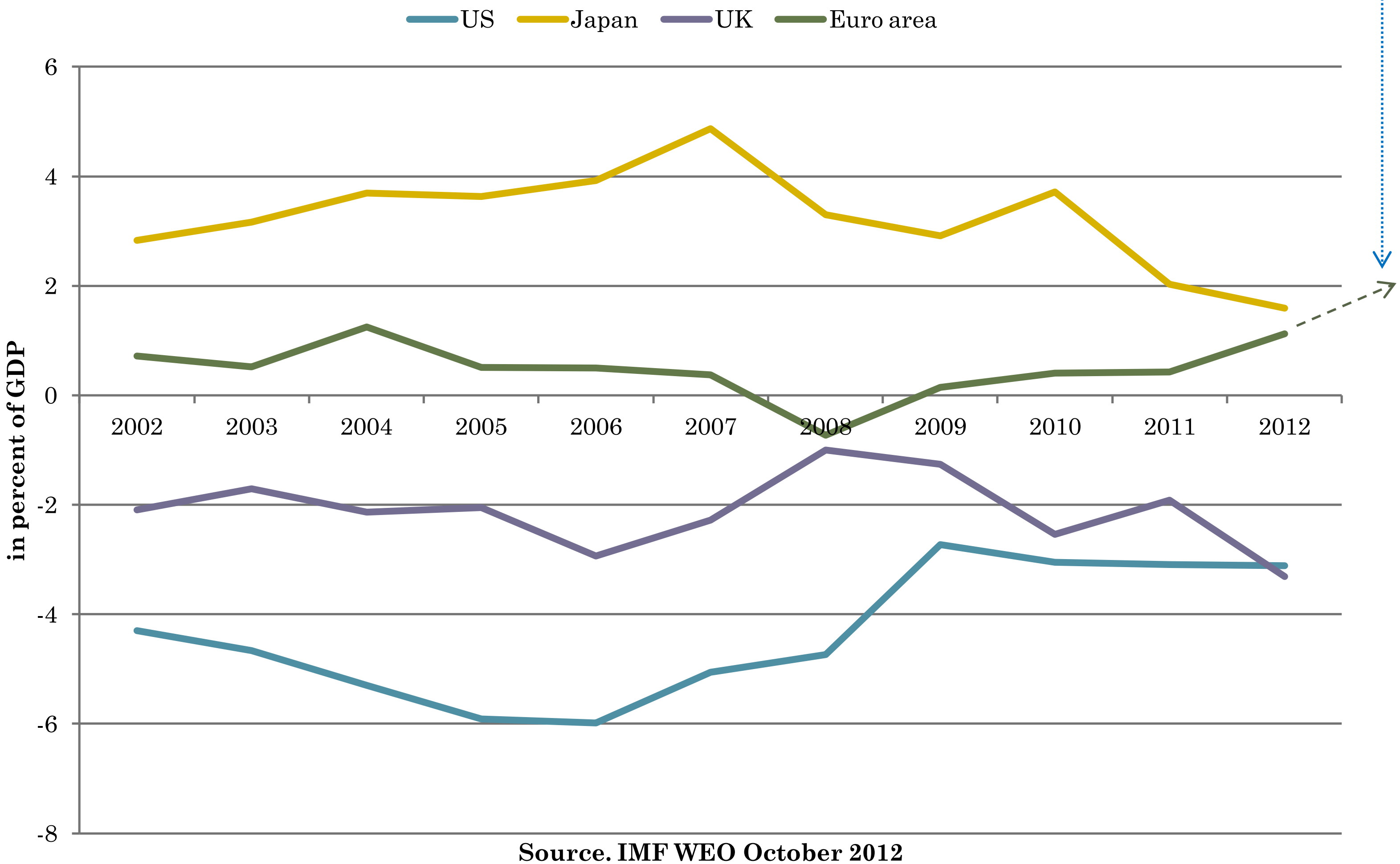
Source. IMF WEO October 2012

Public debt



Source. IMF WEO October 2012

CURRENT ACCOUNT POSITION



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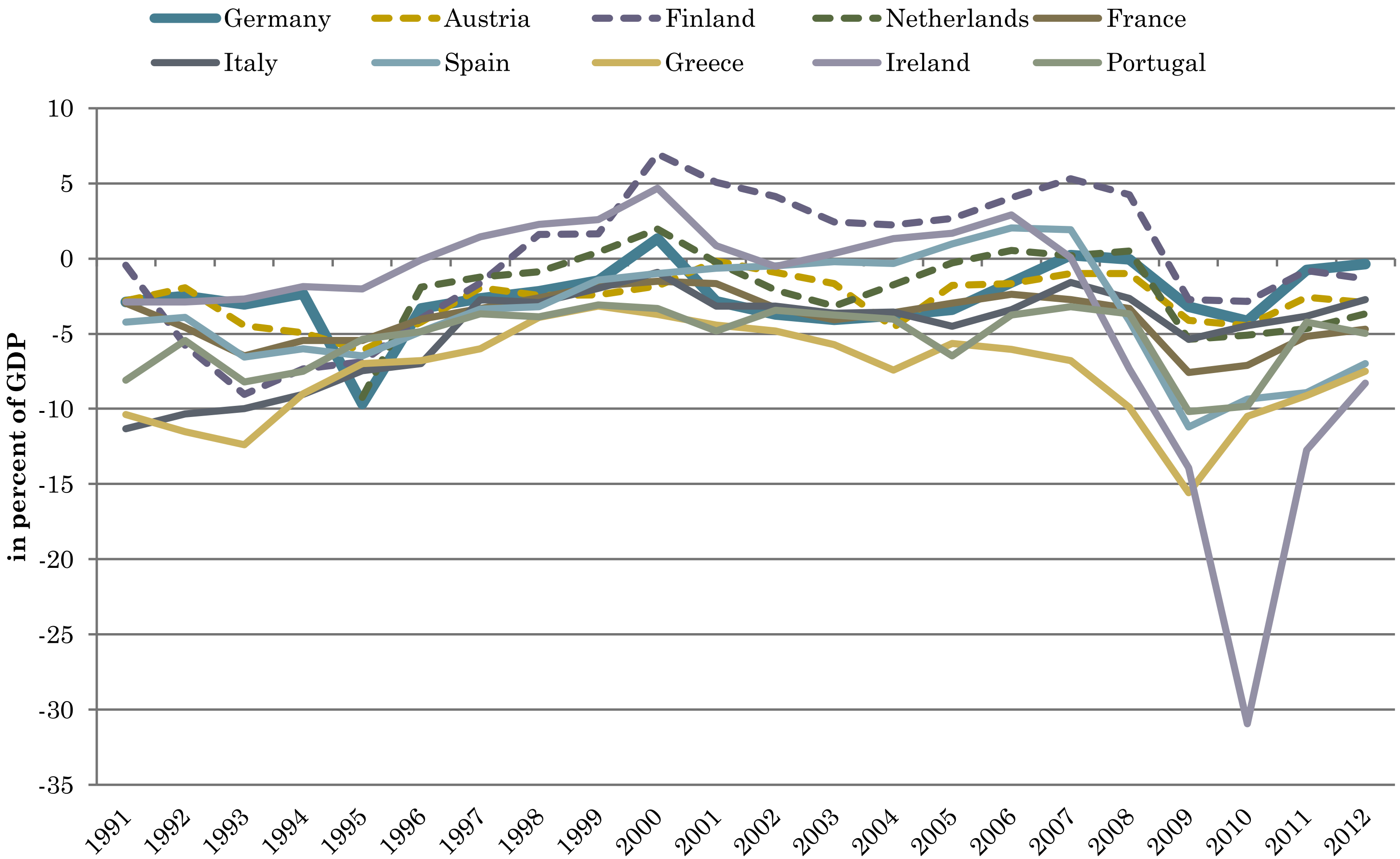
Assessment

- Based on public finances and external balance Euroland is not in particularly bad shape compared to peers
- Suggests problems are internal/intra-regional
- Suggests failings of Maastricht EMU regime

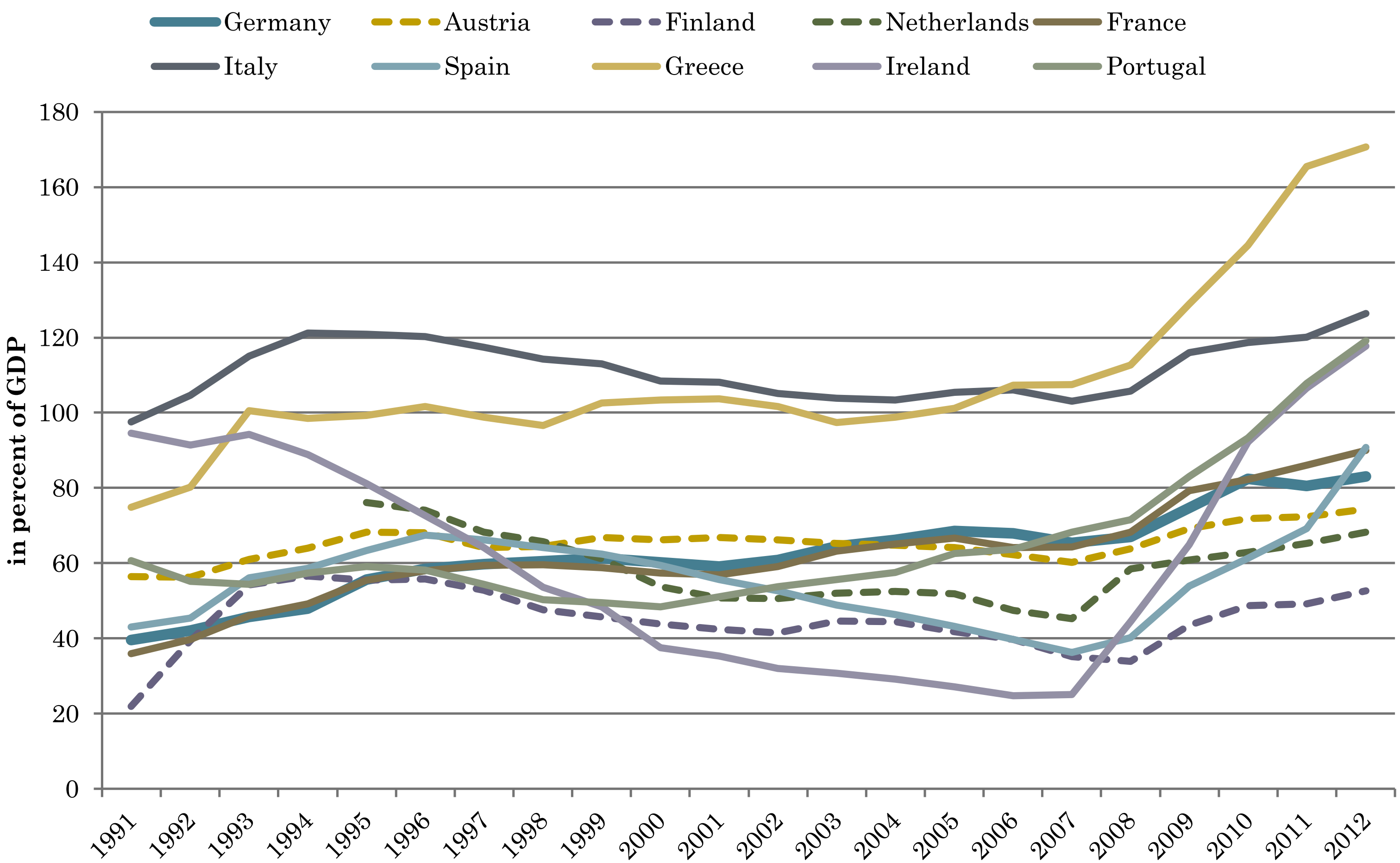
- Also, rather than €land being held back by rest of world, it poses a serious threat to ROW

2. Inside Euroland: government balances



Source. IMF (WEO October 2012)

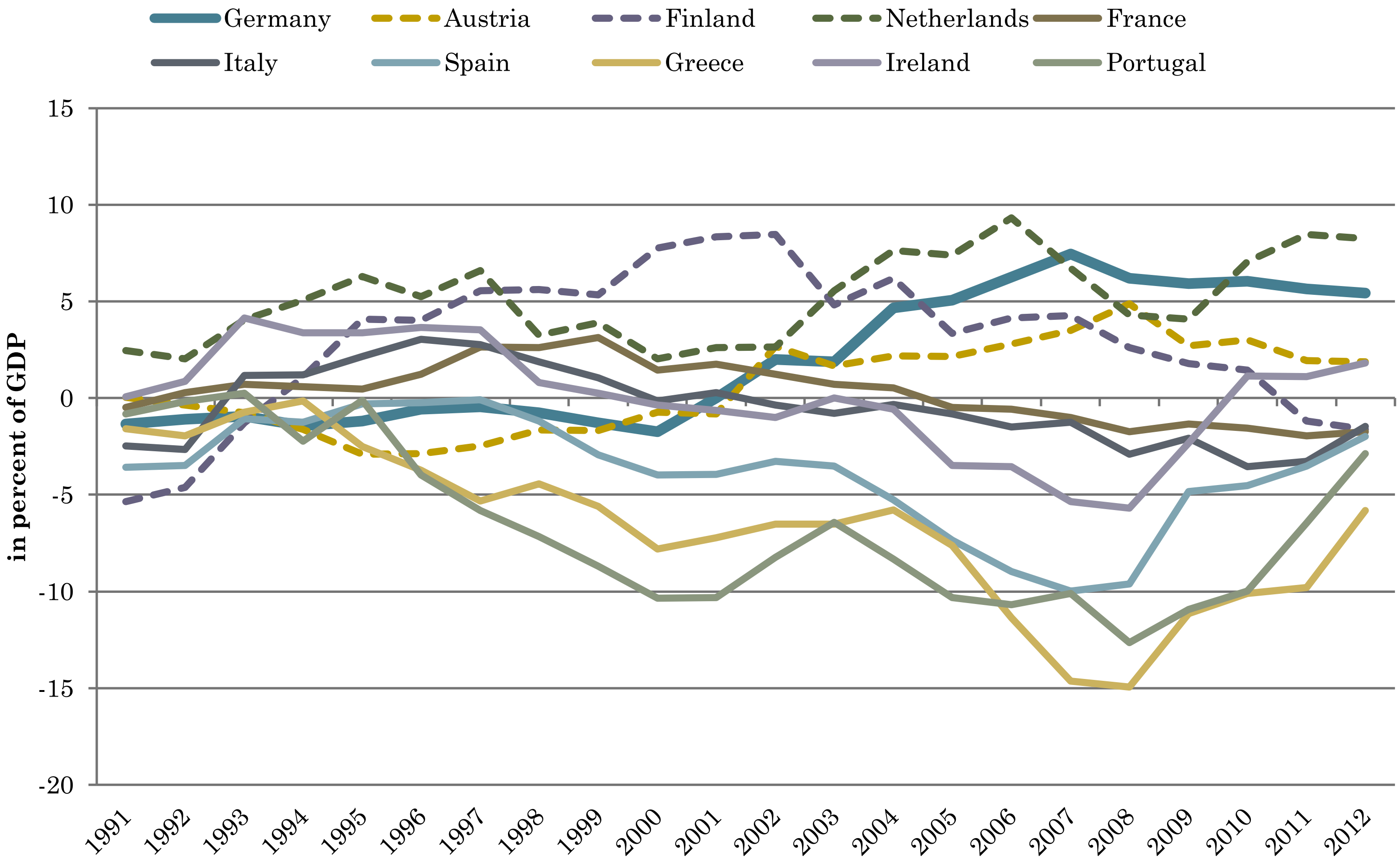
PUBLIC DEBT



Source. IMF (WEO October 2012)

Germany's CA balance shifted by 8% GDP!

CURRENT ACCOUNT POSITIONS



Source. IMF (WEO October 2012)

Assessment

- Crisis countries (GIIPS) both externally and fiscally challenged (Ireland and Spain only since crisis!)
- Creditor countries fiscally in better shape too
- No surprise here:
  - Private sector + public sector + external sector = 0
    - All intra-Euroland imbalances, as union externally balanced!
  - While Germany's balanced budget owes to foreign over-spending, Spain's pre-crisis budget surplus cum external deficit owed to private sector over-spending
  - As flows change stocks, GIPS ran up huge external debts; Italy & France less so; while Germany's net IIP surged
  - Conspicuously, German & French debt ratios rose in tandem; up from 40% to 80+% since '91 (= austerity start!)
- *Signals massive failure of Maastricht EMU regime!*

3. Causes of intra-area divergences & buildup of imbalances?

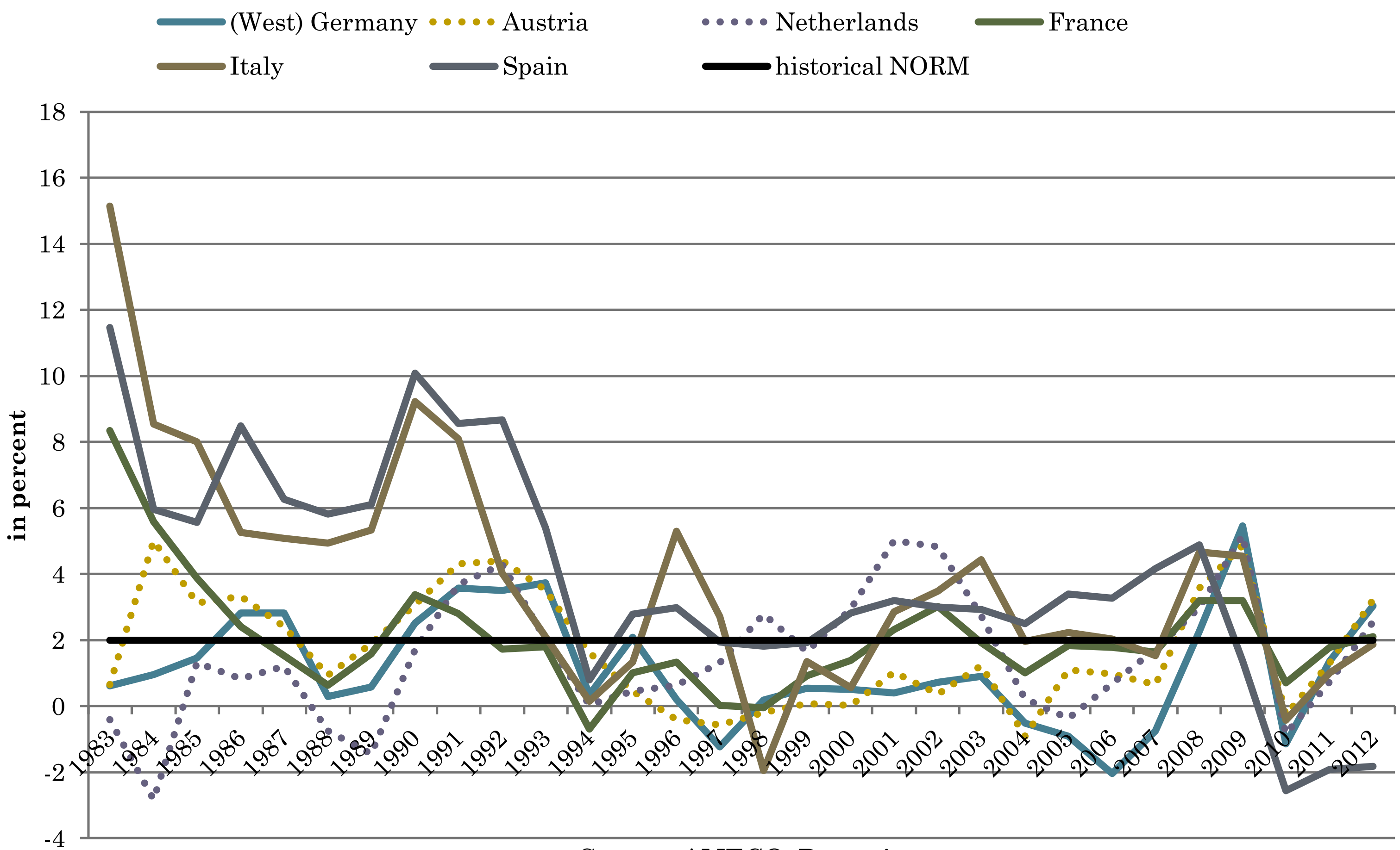
Key features/flaws of Maastricht regime

- No one is ‘minding the store’, in particular:
  - No demand management in good times (asymmetry!)
    - On top, no LOLR foreseen in bad times
- *Hence: weak growth and export reliance*

- No proper policy coordination to assure convergence and cohesion of union, in particular:
  - Nothing keeping competitiveness positions balanced
- *Hence: divergences and imbalances*

- Instead, obsession with two numbers: 2% and 3%

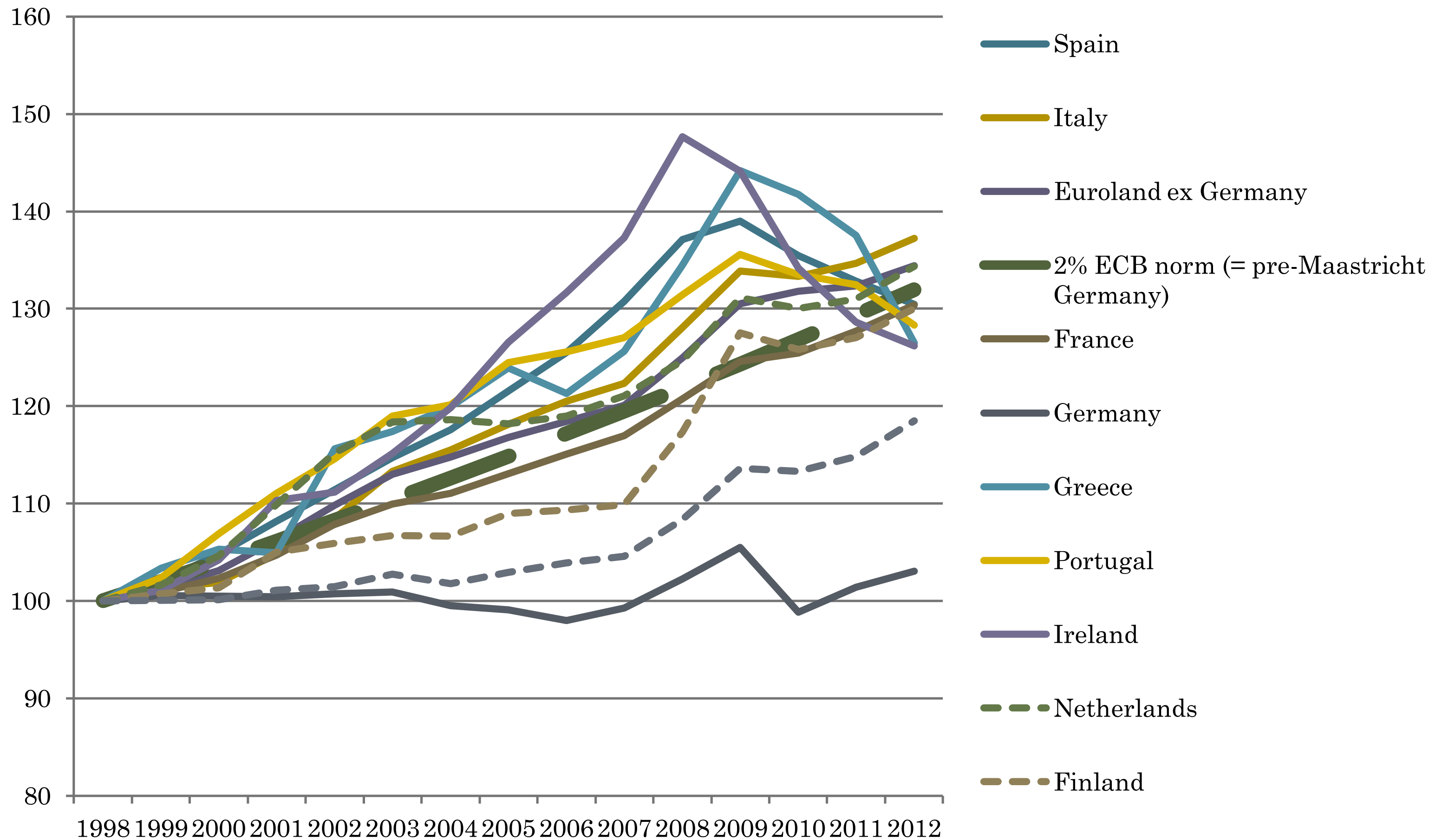
Europe Converges to Germany's historical stability norm by mid '90s



Source. AMECO, Destatis
Note. Nominal unit labor costs, total economy

BUT GERMANY ITSELF DIVERGES

Officially, everybody 'lost competitiveness' but Germany



Sources. Eurostat Ameco database; own calculations
Note. Nominal unit labor costs, total economy

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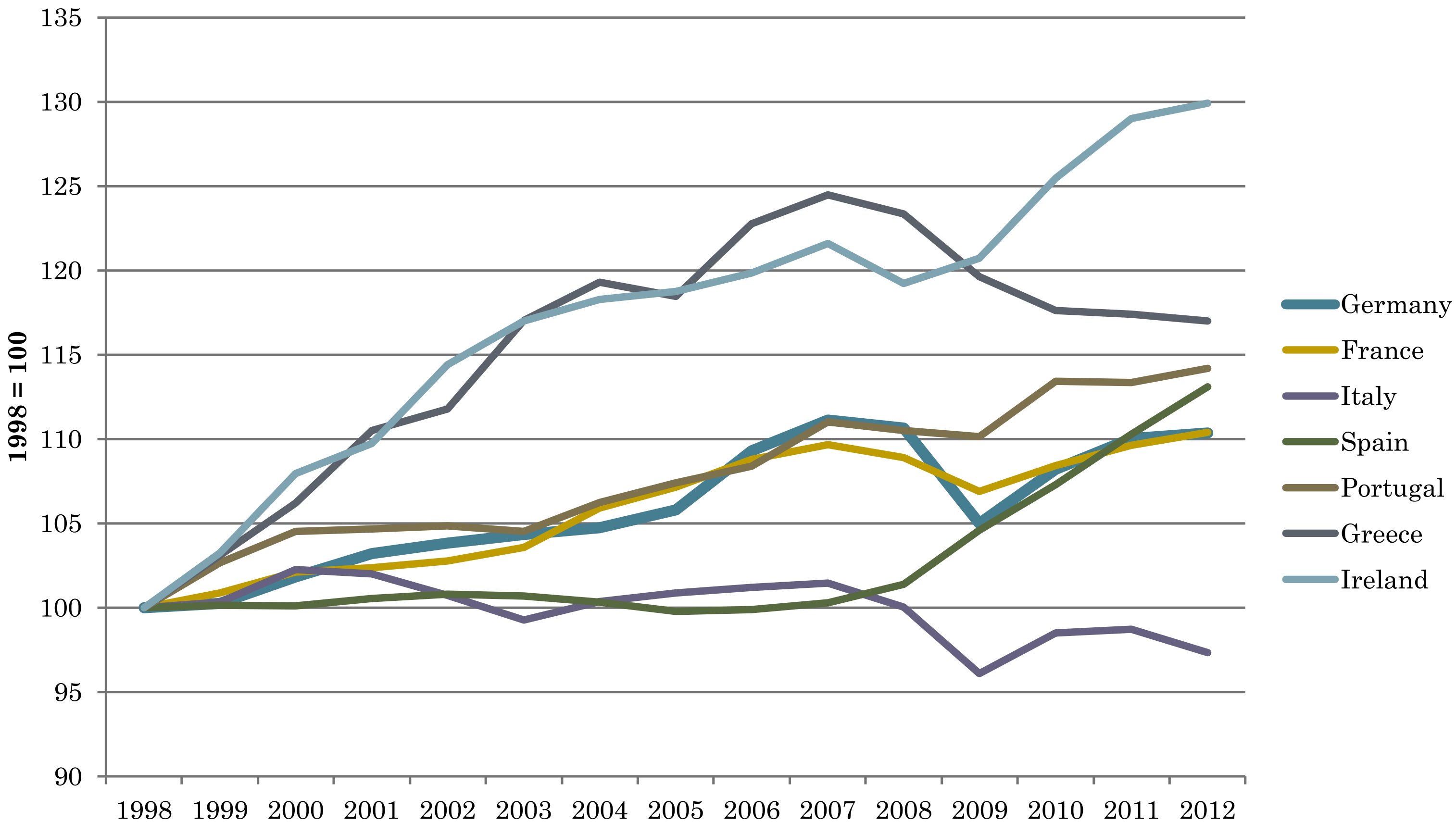
PRODUCTIVITY?

Not the source of Germany's super-competitiveness

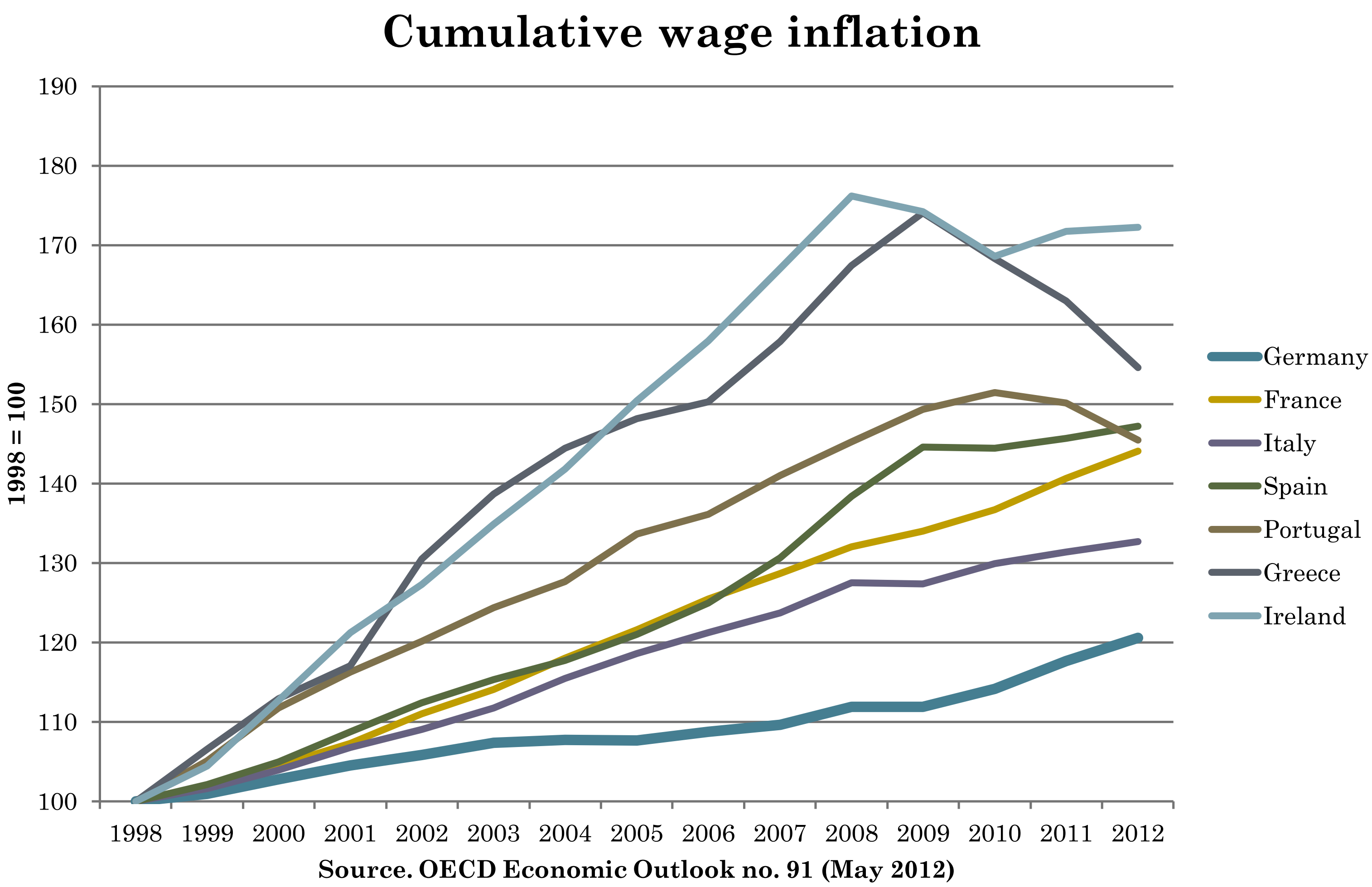
Cumulative productivity growth



Source. OECD Economic Outlook no. 91 (May 2012)

It's Wages, stupid!

Irony: Euro was meant to ban 'beggar-thy-neighbor' ER devaluations forever; so Germany did it through wages, reneging on 'golden rule'



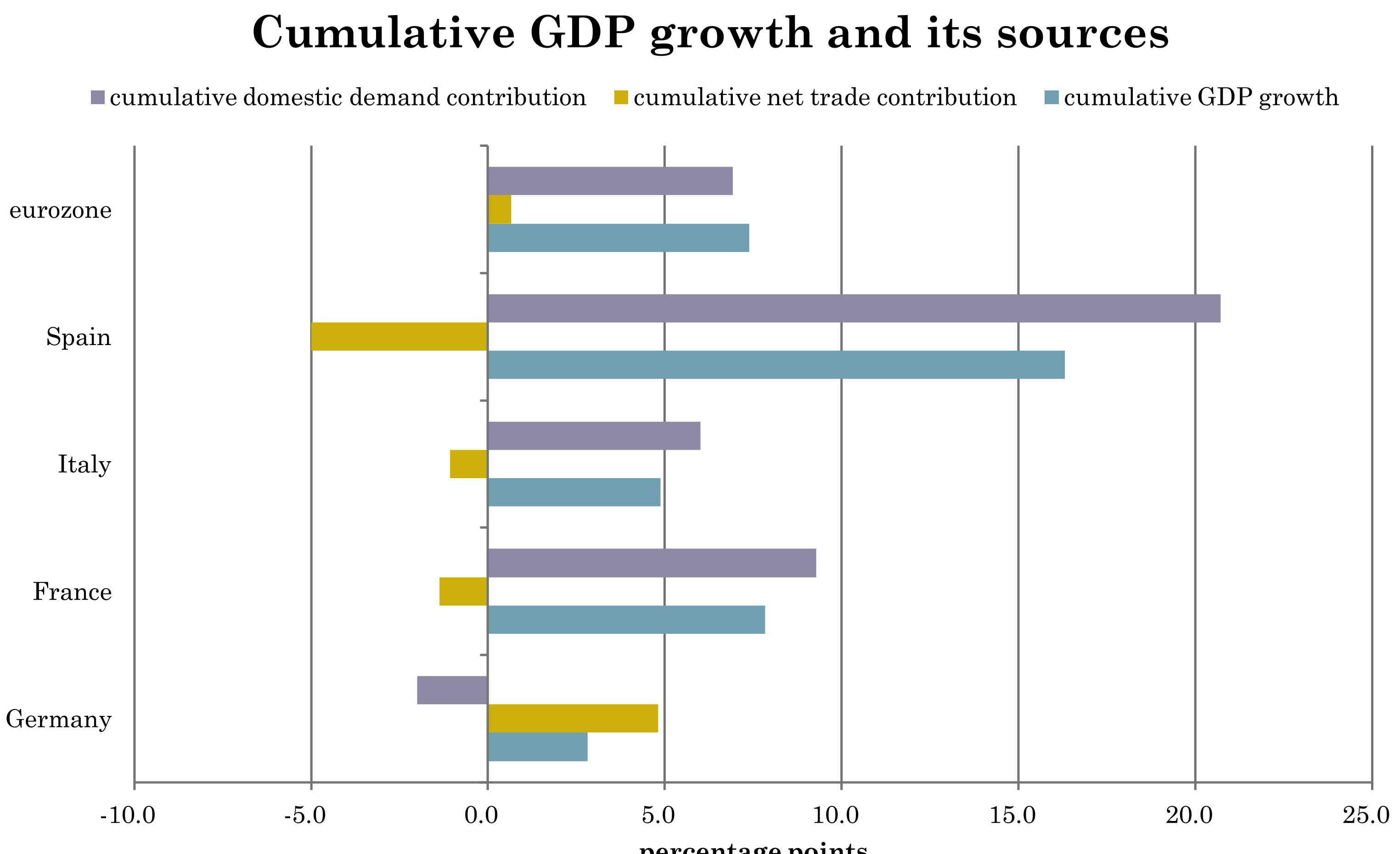
Golden rule and German myths

- The 'Golden Rule' of monetary union:
  - National unit-labor cost (ULC) trends must be aligned with common inflation norm for common currency (ECB: 2%)
  - As divergences are *cumulative*, they lastingly distort competitiveness positions, causing current account imbalances
    - And *persistent* CA imbalances involve debt buildups

- Myth no. 1: 'burden of unification'
- Myth no. 2: had to 'restore' its competitiveness

- #1 German tradition of macro policy blunders
- #2 If 'restoring competitiveness' means ending up with an 7.5% current account surplus, good luck with rebalancing Euroland! And world economy too!

‘Sick man of the euro’: Germany 2001-5
The art of Flying on one engine



Source. OECD Economic Outlook no. 91 (May 2012)

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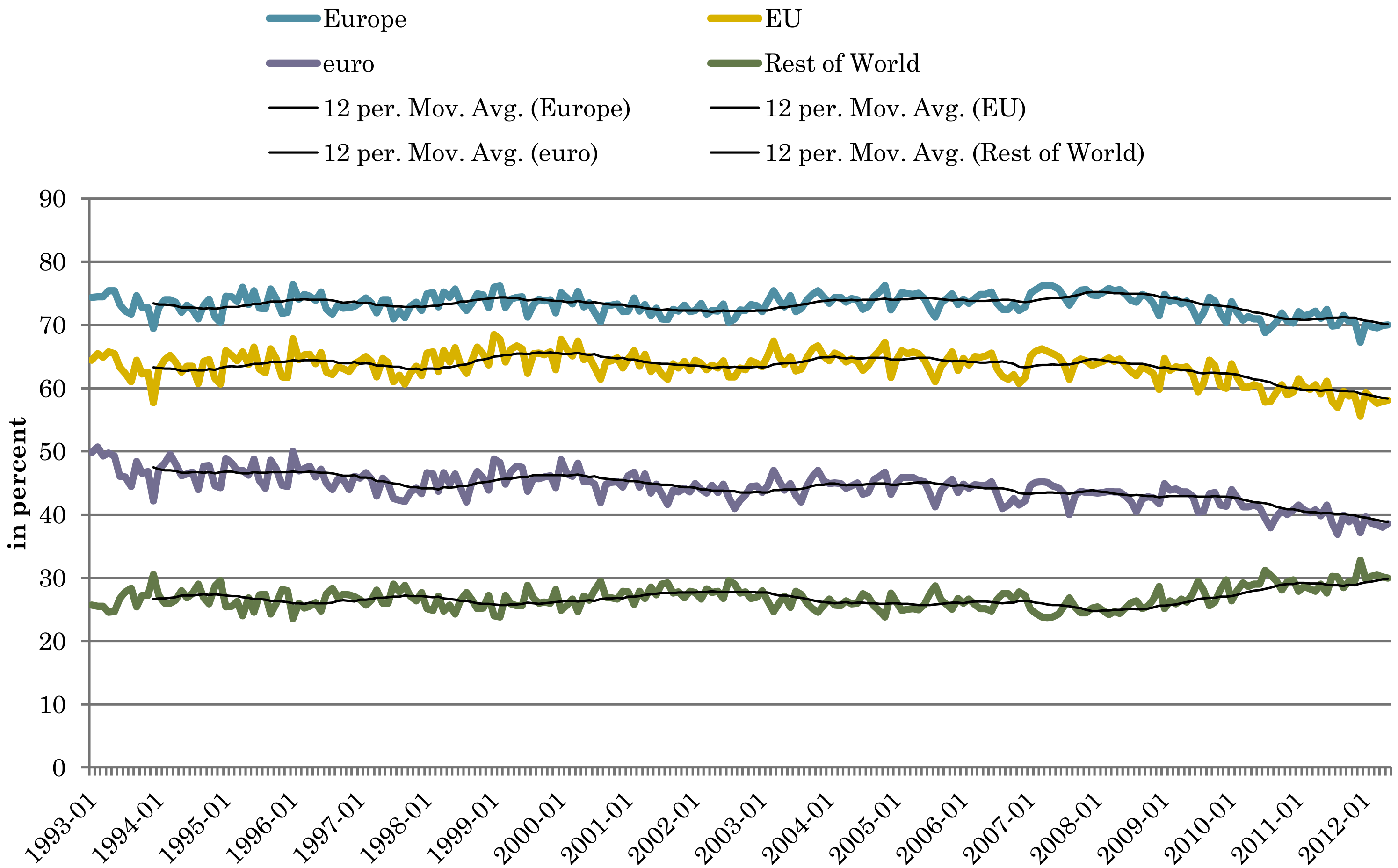
Maastricht regime amplifies rather than contains divergences

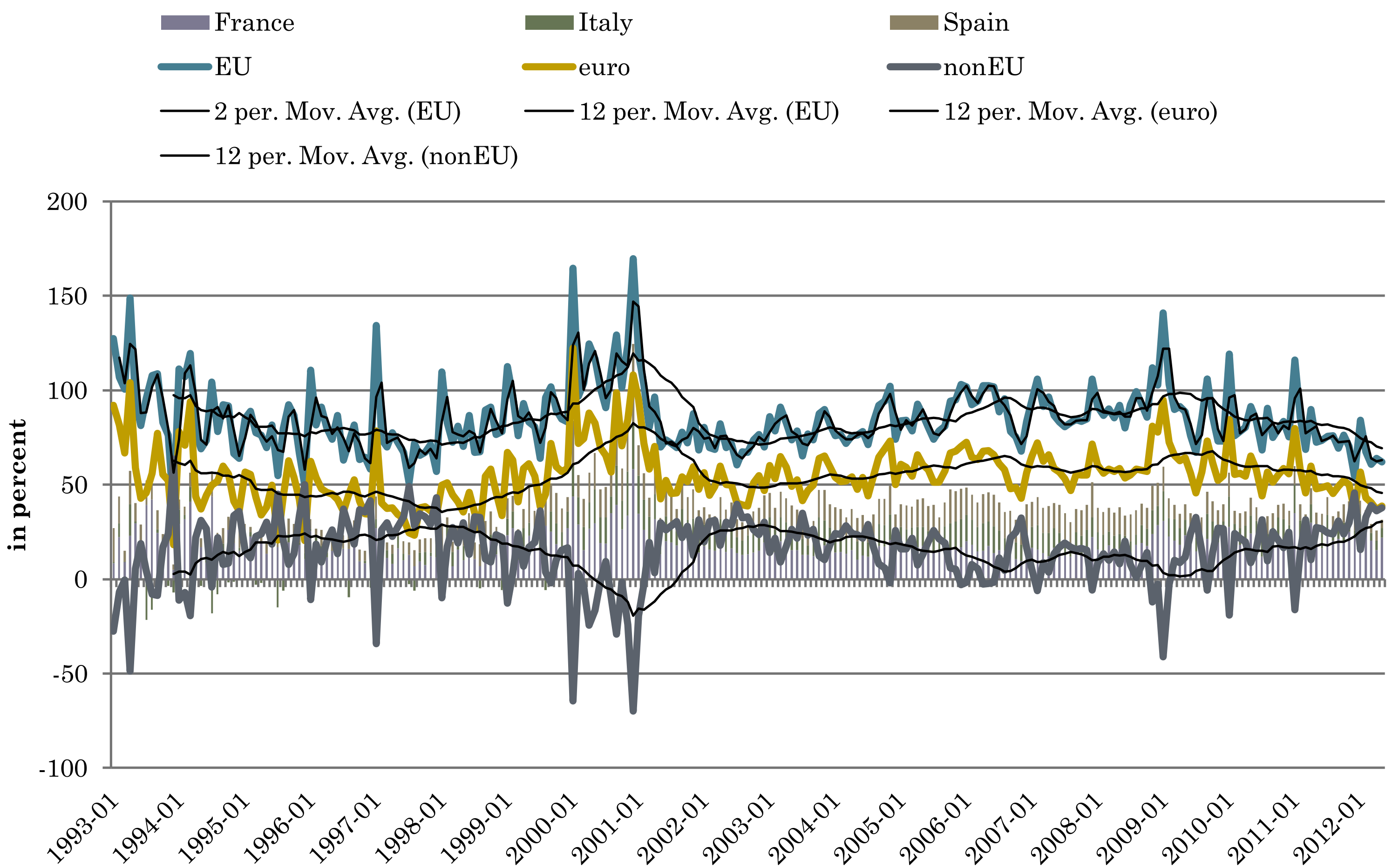
- As Germany suffocates domestic demand through wage repression and mindless austerity, German macro conditions become relatively tighter
  - Financial conditions, credit, property prices …
  - More SGP prompted austerity … vicious circle …
- Also undermines common monetary policy, as ECB stance becomes too easy for periphery
  - Financial conditions, credit, property prices …
  - Fiscal ease as public finances seemingly healthy
- Feedback loops sustain divergences, smoothly financed by liberalized & integrated markets (equally wise as their dozing supervisors); fragilities build up

German export destinations (% shares)



Source. Deutsche Bundebank

Geography of German merchandise trade surpluses (% shares)

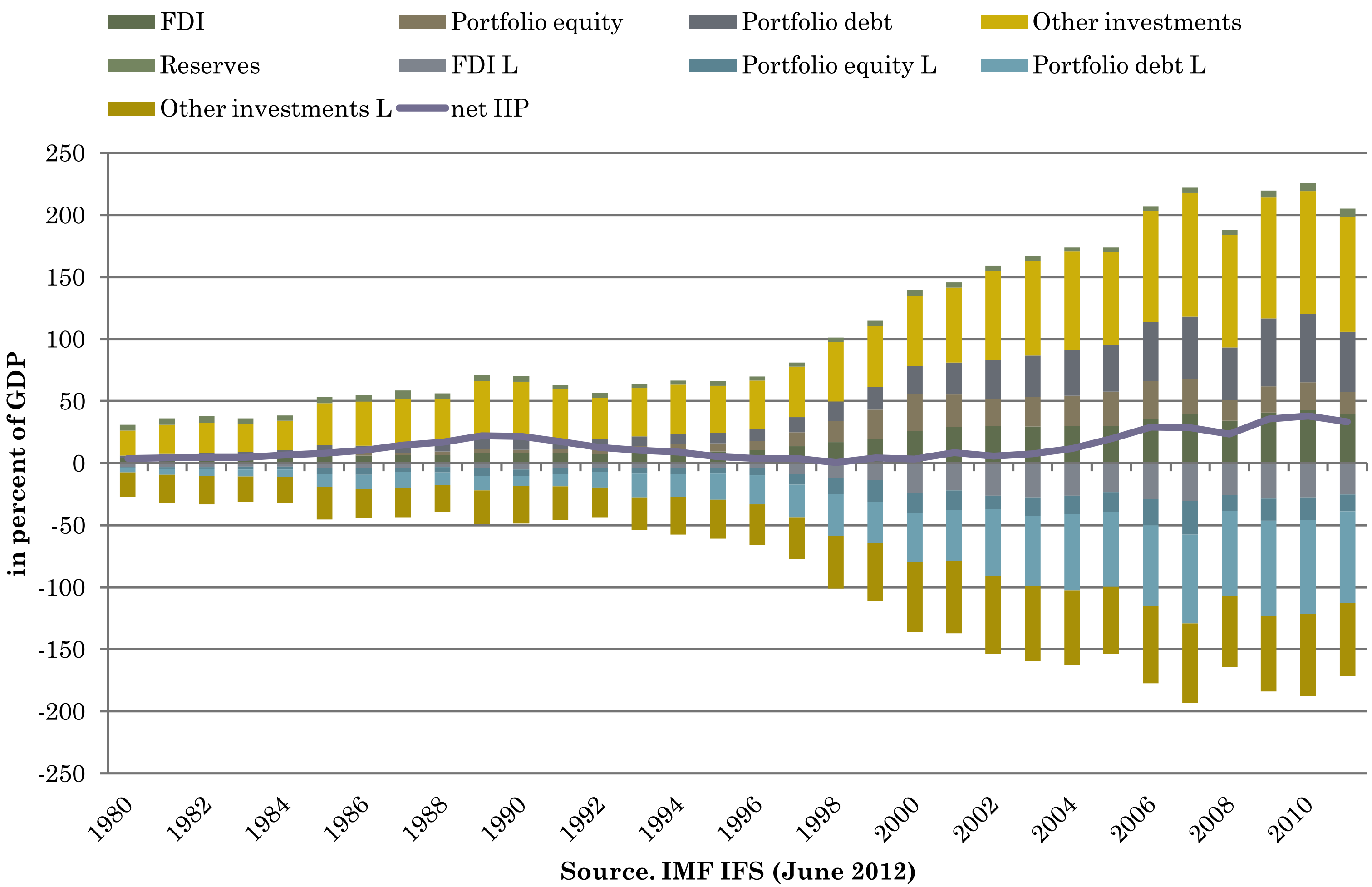


Source. Deutsche Bundesbank

4. Germany's euro trilemma

- Germany can't have all three:
  - Perpetual export surpluses, a no transfer / no bailout monetary union, & 'clean,' independent central bank
- Maastricht regime prohibits
  - CB financing of budget deficits ('monetization')
  - Fiscal transfers or 'bailouts' of partners
  - BUT NOT: beggar-thy-neighbor wage policies
- Alas, bankrupting the countries that buy your export surpluses not a smart idea, especially if you are also their lender

Germany's IIP
Net foreign assets peaked at 40%



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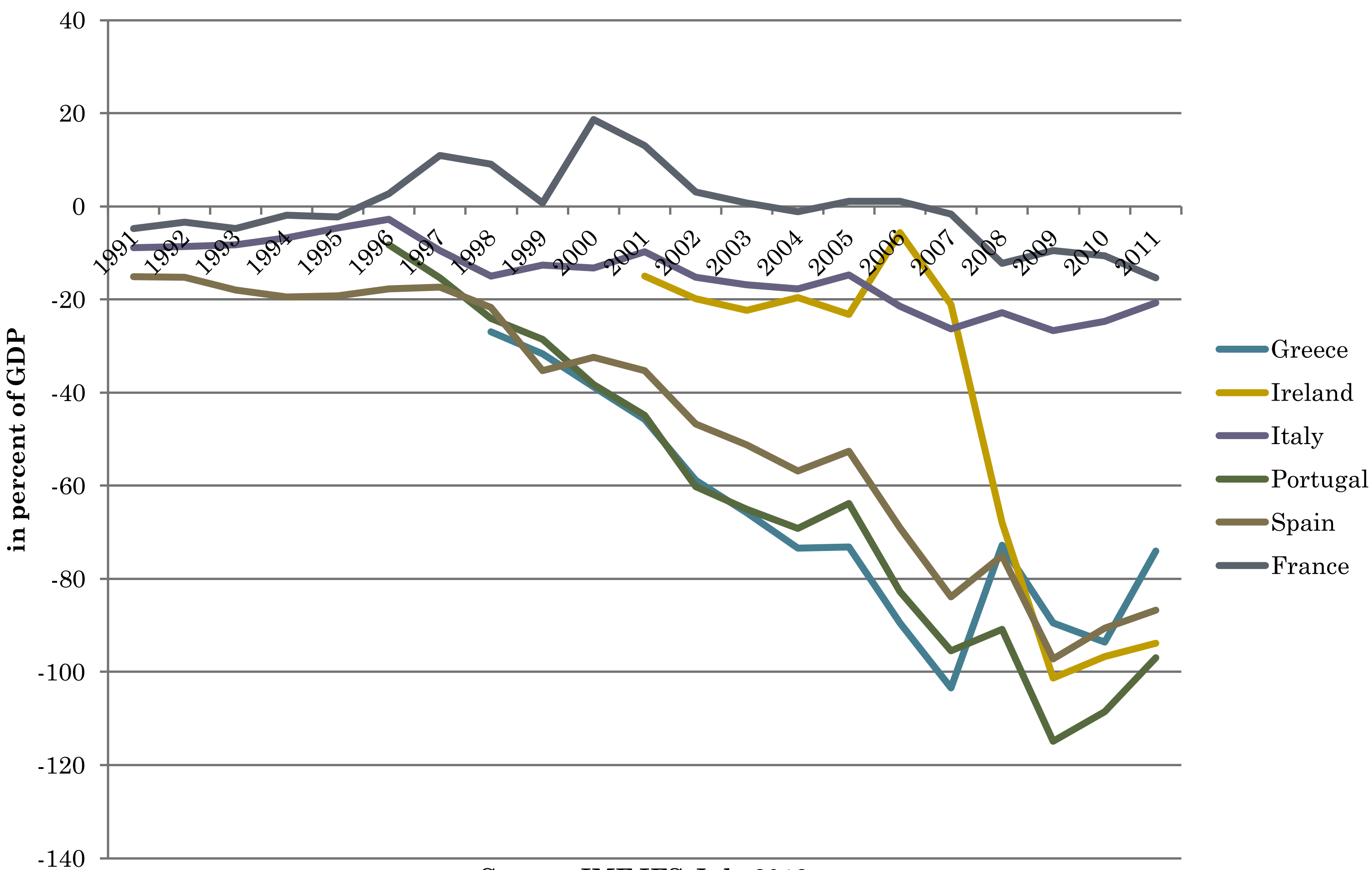
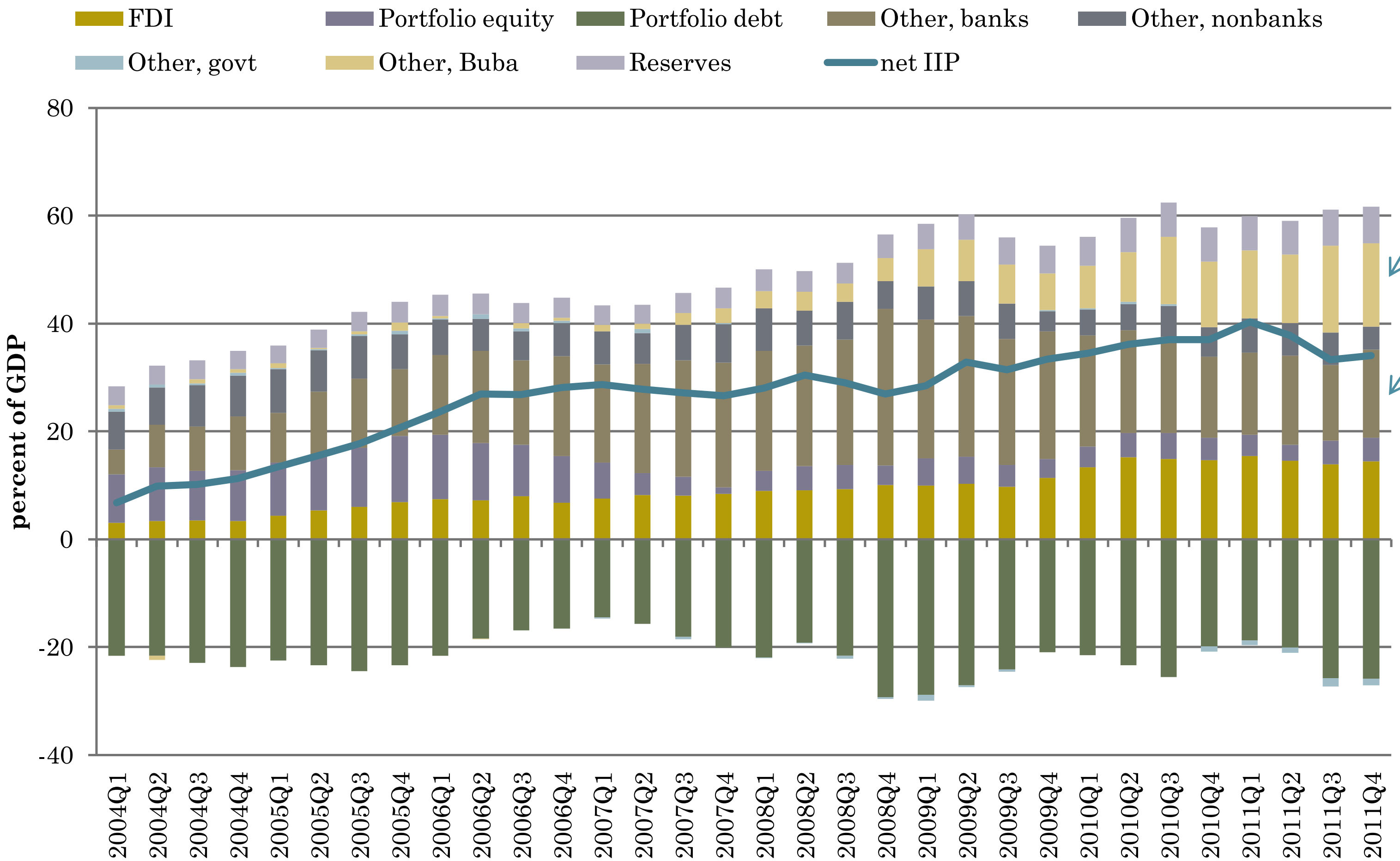
NIIPs of GIIPS (plus France)



Source. IMF IFS July 2012

IIP COMPOSITION

As German banks decline roll-over, ECB steps in as LOLR; 'hello' TARGET2 imbalances



Source. IMF IFS (June 2012)

A rather vulnerable 'safe haven'

- Initially: German banks! (50% of foreign A & L)
  - 'decreasing home bias seems to have been offset by an increased euro-area bias'; 'Germany is .. more financially integrated in € area than .. in a real economic sense' (Buba)
  - Damage partly parked in state-backed bad banks
  - Plus: Other financial institutions (portfolio flows)

- Then increasingly taken over by official sector:
  - Bilateral loans (Greece bailout no. 1 etc)
  - EFSM/EFSF
  - ECB bond holdings (SMP)
  - Intra-Eurosystem (TARGET2)

- Mainly, latter are not really new exposures, but just allow banks to pull out, while mutualizing bad debts and turning ECB into giant 'bad bank'

5. Crisis Management

- Fiscal policy:
  - brief ‘Keynes moment’ followed by mindless austerity
- Fiscal support to financial sectors
  - Guarantees, recapitalizations, deposit insurance etc.
- ECB monetary policy:
  - foolish hikes, delayed easing
- ECB as LOLR to banking systems:
  - Promptly starting August 9, 2007, as euro banks exposed to U.S. subprime mess and ‘dollar gap’
  - Various, culminating in LTROs
- ECB as LOLR to governments(indirectly):
  - Securities Markets Program (SMP)
  - Outright Monetary Transactions (OMTs)

From Crisis Management to Crisis Resolution?

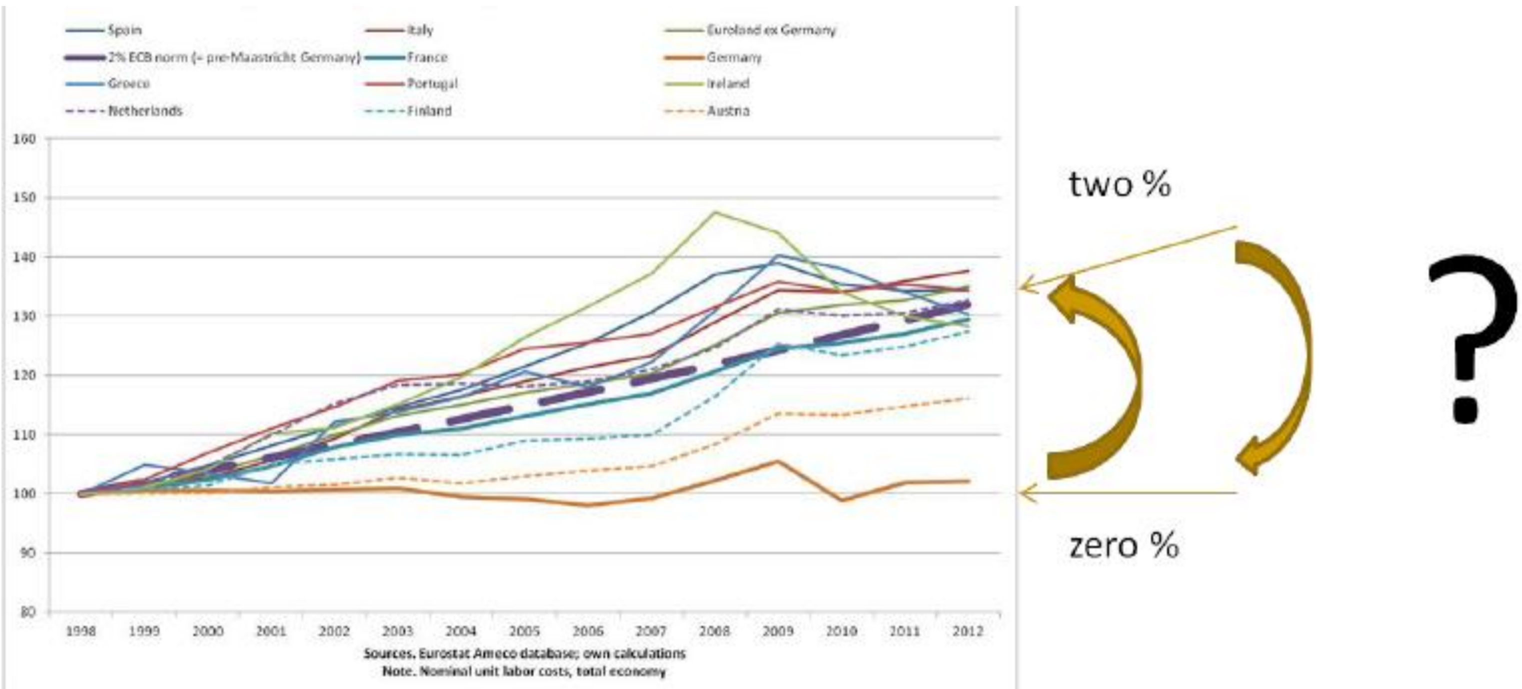
- Crisis resolution - and sustaining EMU - has three parts to it, and one precondition
  1) Rebalancing the currency union
     - Restoring intra-area equilibrium (transition; flows)
  2) Fair deal on debt legacies
     - Balance-sheet cleanup (past; stocks)
  3) Fixing (Maastricht) EMU regime
     - Establish *viable* EMU regime (future; flows & stocks)
- *Precondition*: robust GDP growth

- Alas, Euroland is failing dismally in every regard!
  - Perversely, markets even rewarding Germany
  - Hence, ever more of the same German medicine & economic 'wisdom' – that are killing the patient

From Bad to Worse

- Area-wide austerity suffocates growth
  - Sucking the air out of global recovery, too
- Asymmetric rebalancing forced upon debtors
  - Pushed into debt deflation by lethal mix of mindless austerity and structural reform
- Debt restructuring/forgiveness still taboo
  - Debtors drowning in legacy debts
- Regime reform features 'more of the same'
  - Fiscal Compact and SGP on steroids
  - Macroeconomic Imbalance Procedure (MIP)
    - Asymmetric, as anything in (German) Maastricht think!
  - Banking union? Fiscal union?
    - Talks concern future crises, not resolving the current one!
      - Even Single Supervisory Mechanism (SSM) proving difficult

Symmetric adjustment or debt deflation?



- Convergence to Germany's historical norm not good enough!
- Even France forced into debt deflation

ULTIMATE OBSTACLES ARE INTELLECTUAL

- German economic wisdom 
  - Price stability and balanced budget *cause* growth
    - Well, only if others are kind enough to stimulate your exports sufficiently; assuming incomplete offset by currency appreciation
  - Germany scored own goal by exporting Buba 'success model' to Europe – only to then underbid its partners
- Small-country mindset afflicts euro leaders
  - Key motivation behind EU/euro was to join forces and be stronger globally as a union
  - Yet, euro policymakers continue to 'think small'
- And now? Covering up key blunders as virtues
  - Follow German export model! The very problem!

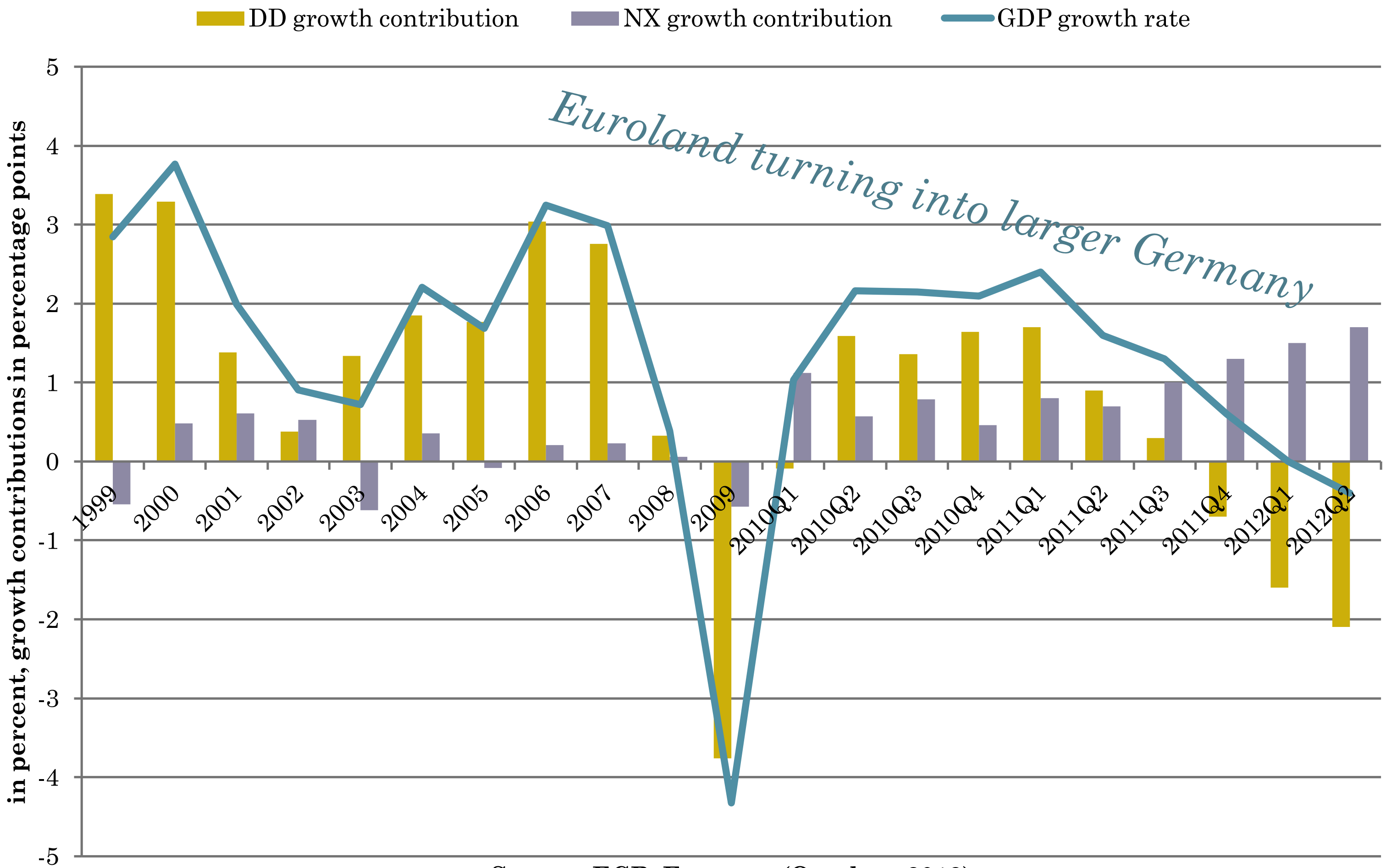
That sinking sound

Here goes the 'island of stability' dream

- 1st Act: Greece
  - GDP: 20% below pre-crisis; unemployment: 25%
  - Budget deficit: -15.6% (2009) to -9.4% (2011)
  - Fiscal retrenchment: >10%
- 2nd Act: Spain
  - GDP: 5% below pre-crisis; unemployment 25%
  - Budget deficit: -11.2% (2009) to -9.4% (2011)
  - Fiscal retrenchment ongoing: >5%
- 3rd Act: France
  - GDP: at pre-crisis level; unemployment 10.6%
  - Budget deficit: -7.5% (2009) to -5.2% (2011)
  - Fiscal retrenchment coming …
- Final Act: Germany
  - GDP: up 2.5%; unemployment 5.5%
  - Budget deficit: -4.1% (2010) to -0.8% (2011)
  - Imported Swiss 'debt brake' will assure area-wide 'expansionary' fiscal contraction

‘Expansionary fiscal contractions’ myth
Already undermining global recovery

FREELOADING ON EXTERNAL DEMAND



Source. ECB, Eurostat (October 2012)

6. Concluding observations: Misdiagnosis, ill-medication, & misguided reforms

- Maastricht EMU regime deeply flawed
- Germany reneged on 'golden rule' of MU
- Germany not facing up to its 'euro trilemma'
- Instead, more wreckage through mindless austerity and structural reforms
  - Debt deflation, rising inequalities, destabilizing economies & nations …
- Regime reforms do not address flaws; more myths
- Consequences for Europe? European integration?
- Consequences for global recovery? Global cooperation?

BACKGROUND TO 'THE EUROLAND CRISIS AND GERMANY'S EURO TRILEMMA'

- Levy Working Paper no. 721, May 2012, http://www.levyinstitute.org/pubs/wp_721.pdf

- International Review of Applied Economics, online version, October 2012, http://www.tandfonline.com/doi/abs/10.1080/02692171.2012.721757

- See JB's homepage http://www.skidmore.edu/~jbibow/research.htm