Unraveling the Euro Crisis

by Edwin M. Truman, Peterson Institute for International Economics

Prepared remarks before the National Economists Club
January 26, 2012

I chose my title, Unraveling the Euro Crisis, with the thought that the question on everyone's mind is whether the euro will unravel. To answer that question one must identify where Europe was before the crisis in order to help unravel the strands of the crisis.

In my remarks, I will do just that. I will talk, first, about how Europe got to where it was before the outbreak of the euro crisis. I will then offer my views on the causes of the euro crisis, critique European crisis management, and conclude with some observations on where Europe might be going.

In summary, I have four points:

First, the European integration project has always combined political and economic motives. Sometimes those elements have worked at cross purposes, including over the past several years.

Second, the cause of the euro crisis is not primarily profligate fiscal policies by the countries principally affected. The causes are many and varied. This is why the crisis is existential for the European project as a whole.

Third, European crisis management has been abysmal. The failures are rooted in European wealth, history, and institutional shortcomings.

Fourth, the euro most likely will survive along with the European integration project, but the Europe faces a daunting agenda in order to achieve success.

How Europe Got Where It Is

The European integration project is facing an existential crisis. Some argue that the project has faced crises before and always has emerged stronger. That view is broadly correct; there have been some steps backward over the past 60 years. While we should learn from history, history normally does not repeat itself. The probability that the European project will completely unravel is low but non-zero—I'd put it at about 5 percent. The issue is how Europe will evolve after the crisis.

From the start, the European integration project involved a mix of economic and political motives. The Treaty of Paris in 1951, which established the European Coal and Steel

Community (ECSC) for 50 years, was based on a proposal the year before by the French foreign minister Robert Schuman. The Community bound together six countries that had been enemies during the Second World War—Belgium, France, Italy, Luxembourg, the Netherlands, and West Germany—in a region that had been prone to wars for five centuries. Schuman proposed an agreement governing the coordinated production of coal and steel (an economic concept) and the associated sharing of sovereignty that would make it more difficult for these six countries to fight future wars (a political concept).

This pattern of combining economic objectives with political goals continued in successive European treaties, including the Treaty of Rome, which established the European Economic Community in 1957, and the Maastricht Treaty in 1992, which established the framework for Economic and Monetary Union (EMU) among 11 countries. The number of member countries subsequently expanded to the current 27 countries.

To understand the European project and where it is today, it is important to remember that EMU stands for Economic and Monetary Union not European Monetary Union. Nevertheless, the backers of the European project long favored the inclusion of a monetary plank. The first complete examination of such a plank was in the *Werner Report* of 1970 prepared by a group chaired by Pierre Werner, who was the prime minister of Luxembourg, on the eve of the collapse of the Bretton Woods system of exchange rates.

The Maastricht Treaty on EMU was, in turn, preceded by the *Delors Report* in 1989, which provided a three-stage blueprint for the full establishment of EMU in 1999. The Maastricht Treaty was signed in February 1992 but did not come into force until November 1993.

The intervening period saw two crises in the exchange rate mechanism (ERM) of the then-existing European Monetary System (EMS), which came into existence in 1978–79 in the wake of the breakdown of the Bretton Woods system. Thus, many outside observers were skeptical and surprised when, through an application of raw political will, 11 of the then-16 members of the European Union were accepted into the euro area at the start and the European Central Bank (ECB) opened for business on January 1, 1999.

In March of 1997, I participated in an International Monetary Fund (IMF) conference on the euro and the international monetary system. At that conference I said:

The third stage of economic and monetary union in Europe would create a system with "an essentially stateless currency… [T]here is some unfinished business in terms of short-term arrangements and the longer-run evolution of Europe… The concern is that because Europe will be living in a halfway house where economic decision making is shared in an uncertain manner, the smooth functioning of the international monetary system could be adversely affected…. [Outside of Europe] we have some reason to be concerned about the effects of [a] creaky decision making process in Europe that is likely to prevail on some internal and external issues that will be important for the continued stability and prosperity of the global economy." Fifteen years later, little has changed.

My concerns in 1997 about the halfway house of the EMU arrangements were mild relative to those of some observers at the time.

What we have seen in Europe is an asymmetric shock that was largely internal in its propagation. Europe contributed to and participated in the global credit boom. The boom benefited exporters in Germany, consumers in Greece, and homebuyers in Ireland and Spain. The boom facilitated the buildup of global imbalances, but also imbalances within the euro area. In the subsequent global bust, the process of deleveraging has affected both borrowers and lenders, including within the euro area.

In sum, the euro area halfway house has not served its members well. It preserves internal nominal exchange rate stability, but internal and external deficits and debts expanded, imbalances grew, leverage increased, and asset bubbles emerged and burst.

Causes of the Euro Crisis

The standard European narrative is that the euro crisis has been caused by fiscal profligacy on the part of the governments that are now experiencing difficulties in borrowing in euros. This is a false, or at best incomplete, narrative. Look at the data.

In 2007, before the outbreak of the global financial crisis, the gross general government debt of Greece was 105 percent of GDP, essentially the same level as Italy's. The figures for Germany and France were 65 and 64 percent respectively, about the same as the figure for Portugal (68 percent), but above the 60 percent target that was embedded in the Maastricht criteria for joining the euro area. The figures for Spain and Ireland in 2007 were 36 and 24 percent respectively.[1]

Moreover, in 1998 the politicians broke the weak rules that were in the Maastricht Treaty when they decided on a large membership of the euro area. They included Italy and Belgium, and subsequently Greece, with debt ratios substantially above 60 percent of GDP. In 2003, Germany and France contested the Stability and Growth Pact, which was designed to continue the application of the Maastricht criteria, and, consequently, the application of the pact was watered down. All this fed a view within Europe that politics would always paper over economic problems. In effect, politics and economics were already in conflict at the birth of the euro. Politics trumped economics then. Over the past three years we have seen the reverse to the consternation of many European policymakers who regularly rail at financial markets.

However, each of the members of the euro area facing actual or potential financial problems has a different story to tell about how it got to where it is today.

The stories start with different macroeconomic positions prior to the outbreak of the global financial crisis in 2007. Some countries had experienced economic booms. The economies of Spain, Greece, and Ireland grew by 3.4 to 5.1 percent annually between 2002 and 2007.[2]

However, EMU did not produce economic booms in Portugal and Italy. Those countries experienced average annual growth rates of only 1 percent from 2002 to 2007, less than the 1.8 percent in France and the 1.4 percent in Germany.

Moreover, Germany's slow growth was due largely to an expanding current account surplus, which increased from 2 percent of GDP in 2003 to 7.5 percent in 2007. Over that period, the expansion of German net exports contributed three quarters of overall German growth. Meanwhile, the current account deficits of Spain, Portugal, and Greece reached between 10 and 14 percent of GDP by 2007.

The major portion of the overall surpluses and deficits of the members of the euro area were within the area itself, but until 2010 no one paid any attention to those internal imbalances because the euro area as a whole had a current account surplus or a small deficit. The deficits of the individual countries were smoothly financed within the euro area just as surpluses and deficits are smoothly financed within the United States.

Aside from differential growth rates, one contributing factor to the overall and intra-euro-area external deficits was differences in rates of inflation. With a fixed nominal exchange rate within the euro area and a common external nominal exchange rate, different rates of inflation drive real effective exchange rates (REER). According to Bank for International Settlements (BIS) calculations, between December 1998 (just before the euro was launched) and December 2011, the real effective exchange rate for Germany, depreciated by 11.5 percent while that of Greece appreciated by 7 percent and those of Ireland and Spain appreciated by almost 9 percent. Portugal's appreciation was only 3 percent and Italy's REER actually declined by about 2 percent.

After the global financial crisis hit, the stories of the individual countries involved the uncoordinated approach to addressing financial institutions that were under stress. In the absence of common financial supervisory and regulatory policies and institutions, some countries like Ireland were more active in rescuing institutions than others.

Uncoordinated fiscal responses to the global financial crisis were a factor as well. The general government cyclically adjusted fiscal position is a measure of fiscal activism.[3]

Between 2007 and the year of maximum change in this indicator, fiscal activism was 9.5 percentage points of GDP in Spain, 8 percentage points in Greece, 4.5 percentage points in Ireland, 5 percentage points in Portugal, and only 1 percentage point in 2009 in Italy. (But Spain, Ireland, and Portugal in 2007 had relatively low levels of government debt.)

In contrast, in Germany there was no change in fiscal activism in 2008 or 2009 and only a 1.4 percentage-point impetus in 2010. The maximum swing in France was 2.2 percentage points.

The appropriate conclusion is that the establishment of the euro area with its single currency was not enough to produce the necessary convergence to support economic and monetary union; the birth of the euro facilitated the emergence of numerous intra–euro area imbalances that involved more than fiscal policies.

In addition, the political elite failed to explain to the general public in Germany, and in similarly situated countries such as Finland and the Netherlands, that there would be short-term economic benefits from EMU in the form of a weaker currency and stronger net exports, but there might be a delayed price to pay if some of the recipient euro area countries subsequently could not meet their financial obligations. The political elites in those countries like Greece, Italy, and Spain that are now having problems meeting their financial obligations, in turn, failed to explain to their citizens that the benefits of economic convergence might turn out to be short-lived with wrenching economic, financial, and political ramifications.

All good things have to come to an end.

In summary, the primary cause of the euro area crisis is not profligate fiscal policies by the countries principally affected. The causes are many and varied. They differ across the affected countries. But one thing is clear: The euro area economic and political structure was ill-equipped to monitor the boom or to cope with the bust.

The Failure of Crisis Management in Europe

Today Europe is divided into three parts: the Europe of the euro, the Europe of the European Union but not of the euro, and the Europe not of the European Union. These divisions in Europe, as well as within the euro area, have not helped to bring about the type of rapid decision making that is necessary in a crisis.

As is well known, the euro crisis began in late 2009 in Greece and spread to Ireland and Portugal. It now threatens Italy and Spain as well as the entire euro area economy and, consequently, the pace of economic growth of the rest of the world. European Union and euro area leaders and institutions have failed for more than two years to contain the euro crisis.

The best measure of their overall failure is the steady rise in the price of credit default swaps on the sovereign debt of every member of the euro area over the past two years, including the sovereign debt of Germany. The best measure of the failure to address the contagion produced by the crisis is the persistent widening of spreads on the debt of an ever-broader list of euro area sovereigns relative to Germany.

We are in the third year of the euro area crisis. The experience of the past 20 years is that the extreme phase of financial crises lasts no longer than six months. We may finally have reached a turning point. We won't know for several more months, but a tremendous amount of unnecessary damage already has been done.

No one should be surprised that non-European leaders and observers are frustrated by the inability of European politicians to deal with their crisis. The revised forecasts released on Tuesday, January 24, 2012 by the IMF marked down global growth in 2012 by 1.2 percentage points compared with the IMF's *World Economic Outlook* forecast in April 2011.

The deterioration can be largely attributed to mismanagement of the euro crisis. The projected loss in global output in 2012 amounts to about $925 billion in purchasing power parity terms. A bit more than one quarter of that total ($260 billion) has been self-inflicted by the euro area on the euro area; its 2012 growth has been marked down to a decline of 0.5 percent from 1.8 percent 10 months ago. However, the remaining 75 percent of the hit ($665 billion) is projected to be absorbed by the rest of the world as a result of growth that is now projected to be a percentage point lower, including US growth.

Why has it taken so long for European leaders to come to grips with their crisis? The answer comes in three parts: European wealth, history, and institutional failures.

The first part is simple. Europe on the whole is wealthy. The adverse impacts of economic crises can be more easily absorbed in wealthier societies than in societies that are less well off. Consequently, there is less political urgency to deal with the euro crisis than in the crises that have affected Mexico, Asia, and Russia over the past 20 years, or even the global financial crisis itself.

The history part is more complicated. In the mid-1970s, a number of European countries experienced economic crises. (They were called balance-of-payments crises in those days.) The crises in the United Kingdom and Italy were most prominent. Those countries were forced to turn to the IMF for assistance. It was a politically painful experience, and the associated IMF stigma was pronounced. It has been no surprise that, for the next three decades, when European countries faced economic difficulties, their authorities turned to Brussels for help rather than to Washington.

Since the late 1970s, members of the European Union have used EU mechanisms to address their economic and financial problems because those mechanisms were light on policy conditions. The resulting economic and financial programs tilted the balance between adjustment and financing too far toward financing with insufficient policy adjustment.

During the past three decades, policymakers in Washington were generally content that EU countries were not borrowing from the IMF because the IMF could then concentrate its limited resources elsewhere. However, in retrospect US policymakers should have promoted European adjustment assertively, including through the IMF. (As a former Federal Reserve official, I hold myself partly to blame for this failure.) The pattern of limited adjustment in Europe became part of the problem and contributed to the present crisis in Europe. European officials now apparently grudgingly recognize that the credibility of IMF policy conditionality is greater than that of their own conditionality.

The European view of the IMF began to change in November 2008, when Iceland—a non-EU European country—embarked on an IMF-supported economic reform program with some aid form the rest of Europe. Subsequently, after considerable internal debate in Europe, European leaders decided that they needed IMF financial and policy assistance in supporting economic reform programs in Hungary, Latvia, Poland, and Romania. These countries are members of the European Union but not of the euro area.

In retrospect, the euro area versus non–euro area distinction diverted the Europeans from acting promptly in Greece as well. Because of their pride, the political elites in the countries using the euro as their currency actively resisted the involvement of the IMF. Opposition initially was led by the European Central Bank, which has had an uncomfortable relationship with the Fund from the start of EMU. As has been amply documented, Europeans felt that the IMF surveillance had little to offer to policymakers in Europe. Because the Europeans largely controlled the rules of engagement with the IMF, IMF management and staff went along until it was too late.

Turning to institutions, the Europeans had no crisis-management institutions for the euro area. The notion that the European Central Bank should play more than an advisory role was initially rejected. The European Financial Stability Facility (EFSF) had to be conjured up from scratch. The process took months—from January to early May 2010. Moreover, the EFSF has failed to accomplish its assigned task which was to contain the crisis to Greece. The crisis spread to Ireland, then Portugal, and now realistically encompasses the entire euro area.

The urgent task in Europe over the past three years has been crisis management, but European leaders have allowed themselves to become distracted by crisis prevention–the effort to prevent future crises. The two activities do not mix well. Talk about facilitating private sector involvement in the future via the insertion of collective action clauses in European sovereign debt instruments put markets on notice that any euro area country could unilaterally reschedule all of its debt issued under domestic law.

In addition, as I have detailed, the underlying causes of the sovereign debt crises were not agreed upon. Fiscal failings were excessively emphasized. Continued weaknesses in financial sectors across Europe were largely ignored. Instead, the debates were framed in terms of the moral hazard associated with so-called bailouts. Attention was focused on making an example out of Greece to frighten the leaders other countries, Italy in particular, into shaping up. The European Community suddenly had problems acting communal.

Citizens of the euro area and in the rest of the world were promised repeatedly a comprehensive response by euro area leaders, but the responses have proved to be less than comprehensive in their effectiveness. The crisis spread from country to country and from market to market.

The leaders promised to do what was necessary to save the euro, but failed to do what it took to end the crisis. Instead of mobilizing overwhelming financial and policy force to support Greece and to prevent contagion from Greece, the debates focused either on future arrangements or on minor additions to crisis management tools.

To be fair, a lot has been done, as was argued on January 26, 2012 by German Chancellor Merkel in Davos, Switzerland. But it has not been enough to stop the bleeding.

European leaders eventually swallowed their pride about the role of the IMF. New mechanisms have been created, including the EFSF and prospectively the European Support Mechanism (ESM).

The ECB has embarked on programs that were unimaginable three years ago. The securities markets program (SMP) of direct purchases of sovereign bonds in the secondary market was, and is, controversial. The more recent massive longer-term refinancing operations (LTRO) in many respects should be more controversial. The ECB is saying it can save insolvent banks but cannot save insolvent countries; by doing the former, it may indirectly accomplish the latter. But that is subterfuge.

A lot has been done, but few responsible policy officials, or knowledgeable observers outside of the euro area, think that Europe has done enough to help itself. That is the reason why there is resistance to the recently announced effort to augment the IMF's financial resources. That resistance will continue until the authorities at the center of the euro area crisis do more to help themselves. What is needed now is not a firewall. The conflagration has spread too far. What is needed is a safety net for all of the euro area, largely made in Europe.

The apologists for European leaders say "We should understand better the politics and the institutional constraints within the euro area. The politics is about applying maximum pressure to force maximum compliance by reluctant politicians in the countries in actual or potential crisis. The institutional constraints prevent the authorities from saying what they will do. We should watch what the authorities do, not what the authorities say they will or will not do."

In my view, this is a cynical and dangerous line of argumentation.

First, the maximum-pressure scenario is based on the false premise that the entire blame for the crisis lies with the countries in crisis and none with their partners or with the original construction of the EMU halfway house.

Second, at some point, the pressure may become too intense for political systems in the countries in crisis and support for the European project will collapse.

Third, even if, in the end, the authorities know they will try to do what is necessary to save the situation from spiraling entirely out of control, when they eventually act it may be too late in terms of the scale of the additional economic and financial damage to Europe and the world economy.

Finally and most important for the European integration project, leaders of democracies should talk straight to their citizens. To do otherwise undermines trust and confidence in the leaders and in the European project. In my view, one of the glaring weaknesses of EMU is that it was a construction, and an imperfect construction at that, by the political elites in Europe. The EMU phase of the project lacked sufficient support and understanding by most of those most affected by the changes and constraints entailed. This flaw could be fatal to the entire European integration project.

The Future of the European Project

The European integration project is facing an existential crisis. What can we expect to happen?

Will the euro survive this crisis?

I assign a 95 percent probability to this outcome. The euro area countries were insufficiently unprepared for the demands of a single currency and the associated institutions were flimsy or absent. However, I do not anticipate a complete unwinding of the euro and a general reversion to national currencies.

If this were to happen, it would threaten many other aspects of the European project including the free movement of goods and capital and the nearly free movement of people. The political and the economic underpinnings of the European project would be wiped away. Few responsible people want that now. Unfortunately, if the probability of a total collapse of the euro raises much above 5 percent, defensive actions of market participants might precipitate that result.

Will every current member of the euro area retain the euro?

I assign an 80 percent probability to this outcome. Objectively, it may have been a mistake for some countries to have joined the euro. In fact, many of them had no choice under the terms of the Maastricht treaty. The costs of exiting are high. But given the economic and financial wringers that some countries are going through partly, but only partly, because of the mistakes of their leaders, it would be foolish to exclude the possibility that political events in one or more countries could force a newly elected leader to lurch to embrace exiting from the euro.

What are the chances that as a consequence of the euro area crisis and its mishandling by the European authorities Europe will experience a decade of economic stagnation?[4]

I think the probability is 60 percent. If the Europeans follow through on their tough fiscal compact, essentially every member of the euro area will be required to tighten its fiscal position and maintain a sizeable primary fiscal surplus until its sovereign debt is comfortably below 60 percent of GDP. But they will have little help in achieving this from the denominator because of slow growth.

On the other hand, if the Europeans do not follow through on their current commitments and abandon them within the next year or two, the resulting economic and financial chaos will probably also condemn these countries to a decade of economic stagnation. Given where the euro area countries are and how they got there, they are damned if they do and damned if they don't.

What is the probability that the leaders of the euro area have done enough to end the crisis?

I put the probability at 40 percent. While it may not prove necessary to put in place precautionary IMF programs for Italy and or Spain, that need cannot be excluded. For this to happen, the Europeans would have to augment their own support mechanisms, the EFSF and the ESM, in order to be in a position to pay their probable two-thirds share of a program of several hundred billion dollars per year for each of those countries; a conservative estimate is $1 trillion for both countries combined over three years. The problem is that if Italy needs an IMF program, Spain will require one too, and vice versa. That is what contagion is all about.

What is the probability that the crisis is essentially over?

I put that probability at 20 percent. It is possible that the corner has been turned and market participants will relax skepticism and pressure. In these crises, one does not know that a crisis is past its nadir until at least three months later. On the other hand, the wild cards are multiple: the Greek debt restructuring, the potential need for Ireland and or Portugal to follow suit, one or more major bank failure, the politics of Greece, Italy, and France.

What does Europe have to do in order to move the European project forward decisively?

The agenda contains five elements:

First, the fiscal challenges facing the crisis countries have to be dealt with decisively through a combination of unavoidable fiscal retrenchment and possibly debt relief. This process should not be drawn out indefinitely or political support for the European project will be fatally eroded.

Second, the European integration project needs to incorporate true fiscal union. The proposed fiscal compact is insufficient because it is all sticks and no carrots.

The fiscal union should create a central authority that can issue debt, eurobonds if you like, and also can impose or raise taxes on all members of the union to backstop its fiscal operations. Joint and several guarantees will be insufficient.

The fiscal union also should have the capacity to conduct counter-cyclical fiscal policy if the member states are to be constrained from doing so other than through the use of automatic stabilizers.

Third, the project needs an integrated banking and financial structure in which the supervision, regulation, support, and rescue operations for financial institutions and their depositors are centralized substantively and financially. A few small steps in this direction have been taken in the wake of the global financial crisis, but subsequent events have proved them to be inadequate. As long as the national authorities are responsible for implementation of common policies, including financial assistance, nationally chartered and supervised financial institutions will have the potential to cripple a government and damage the union.

Fourth, the European democratic deficit must be addressed. The citizens of Europe must be convinced that they have a stake in the project. The project can no longer be the exclusive plaything of the intellectual and political elites. For example, member governments must understand that it is counter productive to go through contortions to avoid referendums or other forms of broad political endorsement of the European project.

Fifth, decisions have to be made about membership in the Europe. Transitions are one thing, but permanent opt outs and constructive ambiguity are inconsistent with further progress. Further progress is necessary if the project is not going to unwind.

In the end, I side with those who think that the Europeans will use this painful crisis to move the European integration project forward. I worry that the pace will be too slow for the good of Europe and for the world as a whole. Thus, I agree with both pairs of my colleagues at the Peterson Institute for International Economics: Fred Bergsten and Jacob Kirkegaard, who emphasize the first part of my conclusion, and Peter Boone and Simon Johnson, who emphasize the risks of the current trajectory.[5]

Time is running out and European leaders need to understand that they have exhausted a great deal of good will in many countries around the world by their dithering.

Notes

1. These data and those that follow are drawn from the IMF's *Fiscal Monitor* reports and database.

2. These data and those below are drawn from the IMF's *World Economic Outlook* and database.

3. The data below are drawn from the IMF's *Fiscal Monitor*.

4. I define stagnation as growth averaging less than 1 percent per year.

5. See C. Fred Bergsten and Jacob Funk Kirkegaard, *The Coming Resolution of the European Crisis*, Peterson Institute for International Economics Policy Brief 12-1, and Peter Boone and Simon Johnson, *The European Crisis Deepens*, Peterson Institute for International Economics Policy Brief 12-4.