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HIGHLIGHTS

ENDGAME FOR THE EURO? WITHOUT MAJOR RESTRUCTURING, THE EUROZONE IS DOOMED

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Introduction

From the way markets reacted, the €750 billion ($930 billion) rescue package that European leaders hurled at the continent's growing debt crisis might as well have been code-named Panacea. Stocks rose and even Greek bond yields tumbled. The reprieve did not last long, however, as markets realized that the bailout might allow financial institutions to unload some risky government debt, but it would not improve government finances going forward. The rescue plan cannot address the central problem, which is that countries with very different economies are yoked to the same currency.

The entire rescue plan rests on the assumption that given more time, the eurozone's problem children can get their fiscal houses in order—and that the European Union (EU) can somehow grow its way out of trouble. But Greece and some of the other major European debtors are seriously uncompetitive, in comparison with countries that are either more productive (e.g., Germany) or have lower production costs (e.g., Latvia).

Austerity is quite unlikely to work. All of the cost cutting associated with austerity measures, such as falling wages and lower pensions, will reduce consumption and retail sales, and hence government revenues. And as the bigger troubled economies like Spain and Italy also adopt aus-

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terity measures, the entire continent could find government revenues collapsing. Worse, exports to neighbors will be hurt by a reduction in demand. Finally, competitive deflation could compound the problem.

What's missing is a policy mechanism (think John Maynard Keynes's "bancor" proposal) that would even out trade imbalances by "refluxing," in a progrowth fashion, the current account surpluses of countries such as Germany, the Netherlands, and France to the deficit countries. The problem is that the trade-surplus nations in the eurozone are allowed to accumulate euros and avoid big government deficits, while trade-deficit nations like Greece must borrow euros, and tend to run large deficits in an effort to generate domestic demand—and thus are asked to adopt austerity.

What's needed is a way of redirecting demand to the trade-deficit nations—for example, by having surplus nations spend euros on direct investment. Such a mechanism could be set up very quickly under the aegis of the European Investment Bank. If successful, this would enable Greece and the other trade-deficit nations to become competitive enough to secure their future through higher exports.

How Did Greece Get into This Mess?

A large portion of Greece's government deficit is not discretionary but rather the result of automatic stabilizers. As the European economy began sliding into recession, tax revenues fell and social transfer payments rose, resulting in a larger gap between tax receipts and spending. Once the economy starts growing again, the deficit will shrink automatically, as tax revenues rise and social transfers fall.

If the government tries to shrink its deficit in the midst of a recession by cutting costs or raising taxes, the strategy is doomed to fail, since it will lower national income and further reduce tax receipts, making the budget deficit bigger. More important, lower income means lower effective demand, which will further exacerbate the already bad unemployment situation in Greece, causing more civil disturbances.

Some observers argue that this crisis exposes the profligacy of the Greek government and its citizens. In reality, Greece has one of the lowest per capita incomes in Europe, its social safety net is truly modest, and its welfare system administrative costs are lower than those of the German, French, and Irish bureaucracies. Even spending on pensions, which is the main target of the neoliberals, is lower than in other European countries. The evidence is not consistent with the picture presented in the media of an overly generous welfare state.

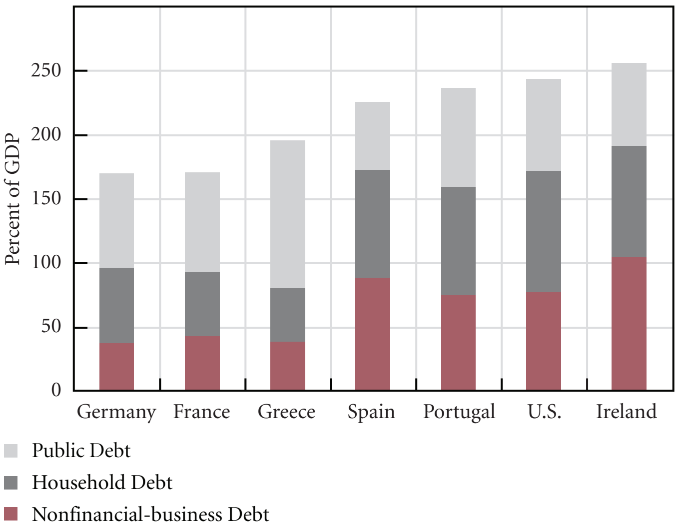
What most economists fail to understand is that changes in the government sector balance will have (opposite) consequences for the nongovernment sector balance. This is not a theory but a simple accounting identity based on double-entry bookkeeping. When the government sector goes into deficit, the shortfall equals the additional private sector saving (or reduction of private sector deficit), plus additional net imports. Greece has chronically run a current account deficit as well as a private sector deficit. During recessions, the private sector cuts spending and tries to increase savings, moving the government balance further into deficit territory as automatic stabilizers kick in. In the context of Greece's high current account deficit, its private sector has been running a deficit for the past decade (from minus 6 percent of GDP in 2000 to minus 7.5 percent in 2008). The household sector's net saving declined much more over the same period, from minus 7 percent of GDP to minus 11 percent.

The sectoral balances approach is a good tool for analyzing policy proposals. By adopting the euro, Greece abandoned the option of allowing its currency to depreciate as a means of improving its current account stance. Without this option, it is hard to imagine how Greece could boost its exports (and/or reduce its imports) to the point of achieving a balanced or surplus trade account—a swing of 10 percent of GDP. If the country is to lower its budget deficit to 3 percent of GDP to comply with the Stability and Growth Pact (SGP) limit, the private sector will need to run a deficit of minus 7 percent, provided there is no change in the current account balance.

Without a massive adjustment in its current account balance, Greece must replace its public deficits with private ones for the austerity plan to succeed—a necessarily rapid buildup of private debt that would be unsustainable. Germany's highly extolled disciplined fiscal policy has been able to accomplish precisely this (Figure 1). Indeed, the "profligate" Greeks have less private debt than their neighbors do—which could put them in a better position to withstand this crisis.

The problem is not that Greece has very high levels of debt and deficit because of a profligate government or lazy workers. Most developed countries, including the United States, the UK, and Japan, are in a similar situation. The issue is that the SGP requirements are arbitrary, and they are not rooted in any

Figure 1 **Eurozone and U.S. Outstanding-debt Levels, 2009 (in percent of GDP)**



Sources: Calculations by Flavia Krause-Jackson and Giovanni Salzano of Bloomberg, based on ECB and Eurostat data

sensible theoretical arguments or empirical evidence. Countries have different export profiles and private sector savings rates, and these will endogenously affect the public sector's balance. We want to show how the nondiscretionary nature of the deficit leaves government few options in terms of cutting a deficit during a recession.

Why Won't the Rescue Plan Save the Euro?

It's hard to see a positive European outcome from the rescue plan, given the perverse incentives in place. The bailout will make it harder to convince people in the problem debtor nations that failing to change will result in disaster. Since the real rescue is of the European banks that hold all this debt, we once again have a transfer of money from thrifty taxpayers to imprudent banks, making moral hazard more hazardous.

The largest component of the bailout is the European Financial Stability Facility (EFSF), which has access to €440 billion ($545 billion) to lend to struggling eurozone members. Ironically, as the number of nations receiving funds from the EFSF grows, the number backing that debt decreases—making it less likely that EFSF debt can retain the highest rating. What we have is mostly lower-rated governments guaranteeing EFSF-issued debt that *hopes* to get an AAA rating. At least on the surface, that arrangement seems fishy. It is possible that the guarantees will not be sufficient to allow the EFSF to issue the full €440 billion, precisely when the full amount is needed most.

Greece has already begun to implement its austerity program—which, of course, came with strings attached. Its budget deficit has been reduced by 40 percent thanks to big spending cuts, yet slower growth is causing revenues to come in below targets. And more spending cuts are on the horizon: the bailout terms require the deficit to be reduced by more than five percentage points, to 8.1 percent of GDP, by the end of the year. Social unrest has increased in response to the combined layoffs, pay cuts, tax and price increases, and proposed pension reforms.

A few irreducible facts are now distressingly clear. First, Greece has no hope of repaying its debts as they are now constituted (i.e., the three-year €110 billion bridge bailout plan will not restore Greece's fiscal situation). Greece has a primary deficit exceeding 6 percent of GDP and a budget deficit of at least another 4 percent due to financing the interest on its accumulated debt. And it faces a contraction in its GDP for at least the next three years. Do the math: Greece must contract its deficit by an amount equal to 10 percent of GDP in order to achieve a stable debt-to-GDP ratio—a feat that is basically impossible for any government to accomplish in a short time span.

Second, although Greece can default on most of its public debt, the ramifications of default would be huge. A third fact is that large quantities of Greek public debt are held by other eurozone members and massive amounts of Greek nonpublic sector debt are held by eurozone banks. In fact, total euro bank exposure to Portugal, Ireland, Italy, Greece, and Spain (PIIGS) far exceeds the funds committed through the bailout. Clearly, default by the PIIGS on government debt would spill over to the rest of the EU, and the effects would be even greater if private sector defaults rose.

So what is to be done? Basically, Greece needs more favorable credit terms—lower interest rates and a longer period in which to pay. The impact of such a plan would be significant, perhaps saving more than €140 billion over the next five-and-a-half years. The cash-flow improvement in servicing the country's debt, together with the ongoing rebalancing of its public finances, would raise its credit profile and make access to credit from private markets possible.

What's Wrong with Euroland?

It is important to recognize the difference between sovereign and nonsovereign currencies. A government with a nonsovereign currency, issuing debts either in foreign currency or in domestic currency pegged to foreign currency (or to precious metal), faces solvency risk. However, a government that spends by using its own floating and nonconvertible currency cannot be forced into debt. This is recognized by markets and even by credit raters. It is why a country like Japan can run government debt-to-GDP ratios that are more than twice as high as the "high debt" PIIGS, while enjoying extremely low interest rates on sovereign debt. A nation operating with its own currency can always spend by crediting bank accounts, and that includes spending on interest. Thus, there is no default risk (Nersisyan and Wray 2010).

Most commentators have rushed to embrace the argument that the Greek debt crisis presents a possible scenario for the United States, the UK, and Japan, and to use that argument against deficit spending in these countries despite unacceptable levels of unemployment. We believe this view is mistaken.

The problem with the eurozone is that each nation gave up its sovereign currency in favor of the euro. National central banks have to get euro reserves at the European Central Bank (ECB) for clearing purposes, and the ECB in turn is prohibited from buying the public debt of governments. This is similar to the situation of individual U.S. states, which, along with the euro nations, need to tax or borrow in order to spend.

By contrast, a sovereign nation does not borrow its own currency or need to issue bonds to "finance" its spending. Bond issues are voluntary, and nothing more than alternative accounts at the same central bank operated by the same government. It becomes irrelevant for matters of solvency and interest rates whether there are takers for government bonds or whether the bonds are owned by domestic citizens or foreigners.

There is a further consideration. Private debt *is debt*, but government debt is *financial wealth* for the private sector. And since there is no imperative to borrow, a sovereign government is never in a Ponzi position. The need to balance the budget over some time period or over the course of a business cycle is a myth—a superstition imposed to control (public) spending.

On the other hand, countries that give up their monetary sovereignty face financial constraints, and are forced to borrow from capital markets at market rates in order to finance their deficits. As the Greek experience shows, this monetary arrangement allows the markets and rating agencies (or other countries, in the case of Greece) to dictate domestic policy to a politically sovereign country.

Instead of using the government budget as a tool to create a system that is relatively stable and supports high employment, the Europeans have made low deficits the policy goal, without any regard for the consequences that has for the economy. Yet even without the SGP, government spending is constrained by market perceptions of risk. Indeed, except for Luxembourg and Finland, all of the other EU countries, including Germany, are in violation of the deficit limit rule, and all but six are already over the 60 percent debt limit.

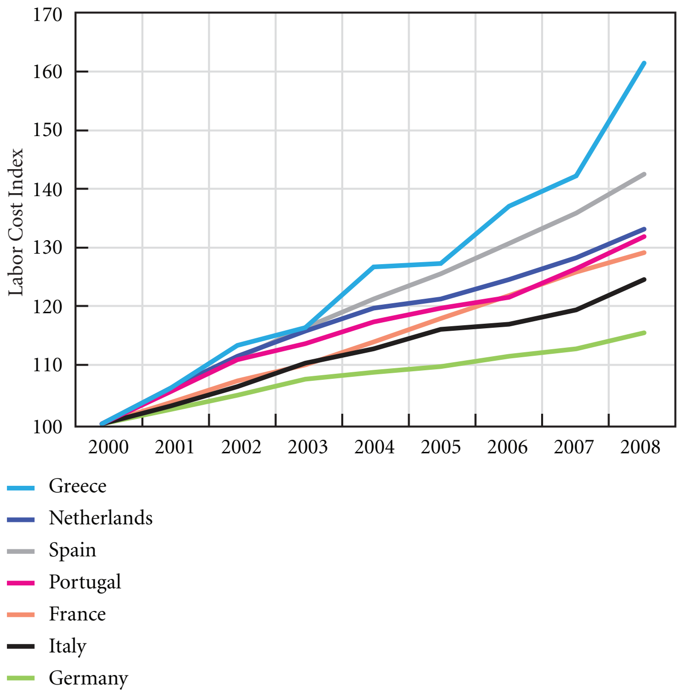
Germany's Contribution to the Problems of the PIIGS

It is doubly ironic that Germany chastises its neighbors for their "profligacy" but relies on their "living beyond their means" to produce a trade surplus that allows its government to run smaller budget deficits. Europe runs an approximately balanced current account with the rest of the world. Hence, within Euroland it is a zero-sum game: one nation's current account surplus is offset by a deficit run by a neighbor. And given triple constraints—an inability to devalue the euro, a global downturn, and a powerful neighbor committed to running its own trade surpluses—it seems quite unlikely that a nation like Greece could move toward a current account surplus.

An examination of labor costs shows that Germany has been pursuing a low-wage growth strategy (Figure 2), which is consistent with its export-led growth strategy. By contrast, Greece has not, with Greek wages growing about 50 percent more than those in Germany. It is clear that severe austerity measures will have to be imposed in order to reduce nominal wages and make Greece competitive with Germany.

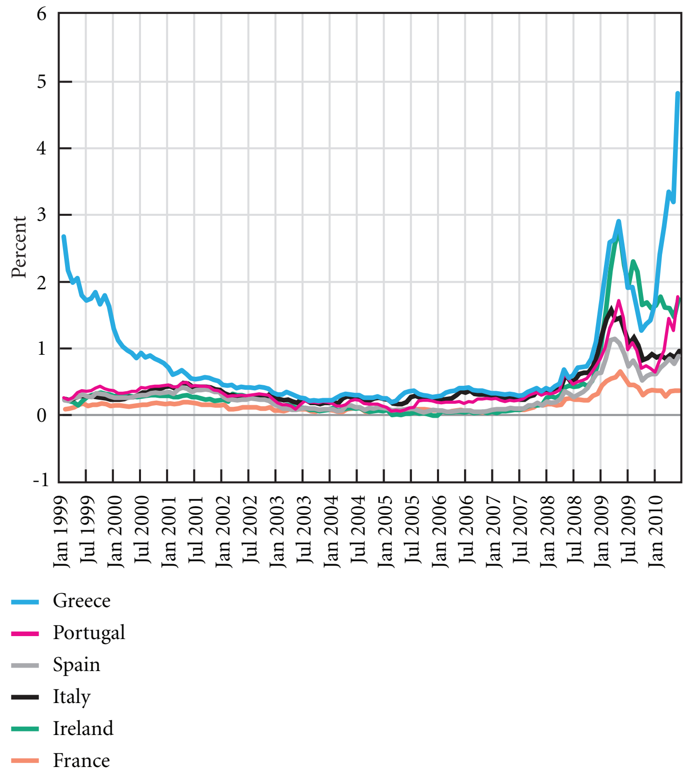
Not surprisingly, bond-yield spreads between the PIIGS and Germany have increased to all-time highs (Figure 3), creating a vicious cycle of higher debt and higher interest rates. The monetary arrangements of the eurozone have made countries hostage to markets and rating agencies alike. Downgrades of the PIIGS' ratings boost yields on government debt in a self-reinforcing death spiral.

Figure 2 **Labor Cost Index, Industry and Services, 2000 Q3 – 2008 Q2 (excluding public administration)**



Source: Eurostat

Figure 3 **Ten-year Government Bond-yield Spreads, January 1999 – April 2010 (German benchmark)**



Sources: Eurostat and authors' calculations

The problems in Euroland will, of course, affect other nations outside the region. Japanese banks had invested heavily in euro-denominated government debt, and at least two-thirds of lending to emerging markets originates in European banks. It is not out of the question that the crisis in Euroland will cause a "second dip" crisis around the globe.

Conclusion

The tragedy ushered in by the current crisis is only just beginning, and it spells the death of not just a currency but also a vision for a unified Europe. The essential problem is that the EU was founded as a political venture but quickly grew into a (promising) economic venture. The irony is that the lack of a true political union—which would have permitted a unified fiscal policy—is precisely what will kill the whole idea.

It is time to start thinking about a major reconstruction of the European project, along two possible paths. First, what would a post-euro world look like? There would have to be a coordinated dissolution, since each nation would face the threat of bank runs and severe inflation. The net result would be a more inefficient, fractured system, of the kind that inspired the euro in the first place. Income inequality between European countries would increase, if only because poorer nations could kiss their subsidies good-bye. The end of the euro would be a blow to European pride and to the *idea* of Europe as well. And it would bolster the preeminence of the dollar in global commerce and affairs, and perhaps leave China as the only plausible rival to American power.

The second path would be to achieve a more perfect union. Immediate relief could be provided by the ECB, if it were directed to create and distribute 1 trillion euros across all eurozone nations on a per capita basis. Each nation would have the discretion to use this emergency relief as it sees fit.

Over the longer term, a permanent fiscal arrangement would be necessary, through which the central authorities could distribute funds to member nations (e.g., 10 to 15 percent of the eurozone's annual GDP). Ideally, this would be overseen by the equivalent of a national treasury responsible to an elected body of representatives—in this case, the European Parliament. This would relieve pressures to adopt austerity measures, and limit the necessity of borrowing from financial markets in order to finance deficits.

Another possibility is the creation of "parallel" currencies by individual member states for domestic use (for a similar proposal, see Goodhart and Tsomocos 2010). These currencies would "float" against the euro, and hence would be sovereign by our definition. The member governments would not need to issue bonds but might choose to pay an overnight rate on reserves. They would create more currencies as spending increased and destroy currencies when tax payments were received. And they would continue to service euro debt with euros (requiring a portion of taxes to be paid in euros) but they would not issue new euro debt.

A related proposal by Marshall Auerback and Warren Mosler (2010) is that Greece issues and places new debt at low interest rates. The trick is to insert a provision stating that in the event of default, the bearer on demand can use those defaulted securities to pay Greek government taxes. This would not only allow Greece to fund itself at low interest rates, but it would also serve as an example for the rest of the eurozone, and thereby ease the funding pressures on the entire region.

In our view, both of these intermediate proposals suffer from moral hazard: they could lead the Greek government to pursue "business as usual," spending too much and generating inflation. And they do not resolve the fundamental problem with the euro: the absence of a supranational fiscal authority that can generate an alternative to the "beggar thy neighbor" export-led growth strategy that the current arrangement promotes.

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