

# Can the euro be saved?

## *An analysis of the future of the currency union*

Joseph E. Stiglitz

Rome

May, 2014

# The Euro-crisis

- The fact that Europe is no longer in decline is *not* a sign that the austerity policies worked or that the euro-crisis is over
- Some countries are still in **depression**
- Europe has had a lost half-decade
- The prospects are for a lost decade
- But unless there are marked changes, it could be a lost quarter century

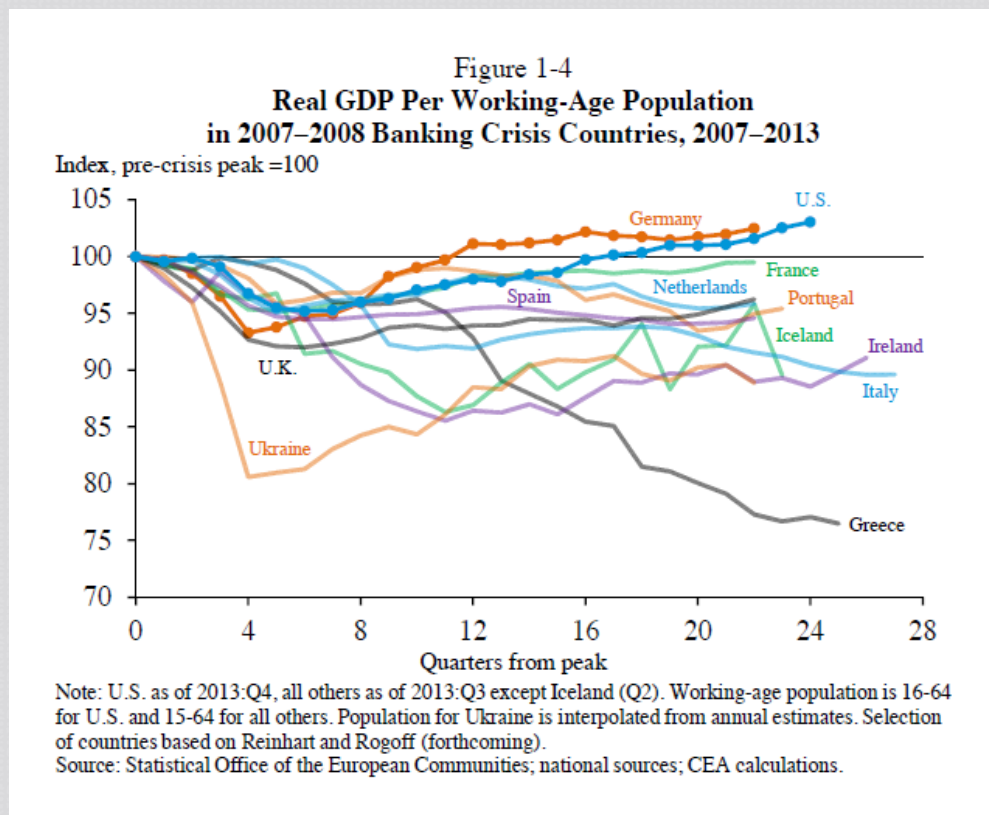
# Per capita income is lower than before the crisis

## GDP per capita, constant 2013 US\$

	GDP per capita, 2007 or peak	GDP per capita, 2012
France	41,727	40,841
Germany	43,501*	44,706
Greece	27,950	22,160
Italy	37,292	33,846
Spain	32,368	30,120
United Kingdom	47,745	45,148
United States	52,049	51,366

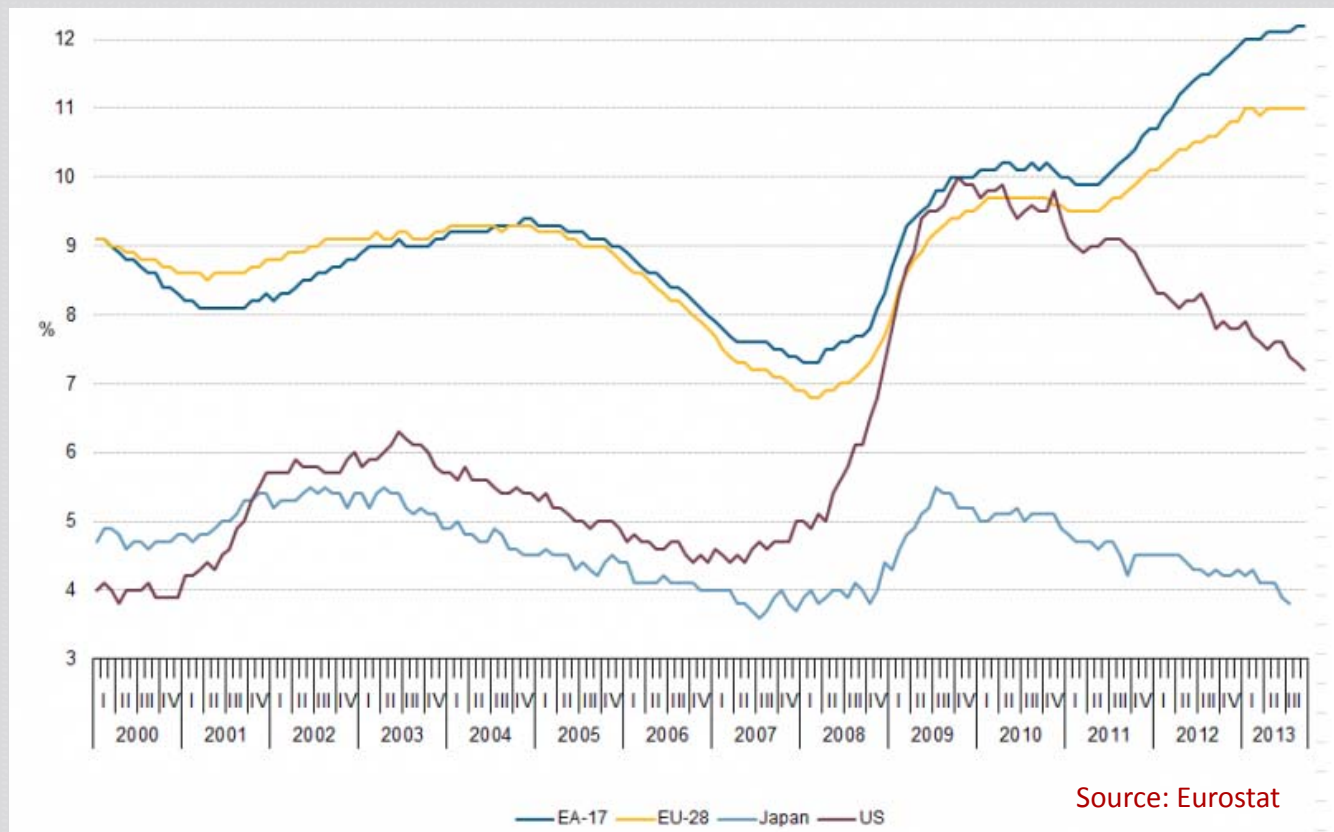
\*Germany data is for 2008, its pre-crisis peak year  
Source: World Bank

# Output per member of the working-age population is lower than before the crisis

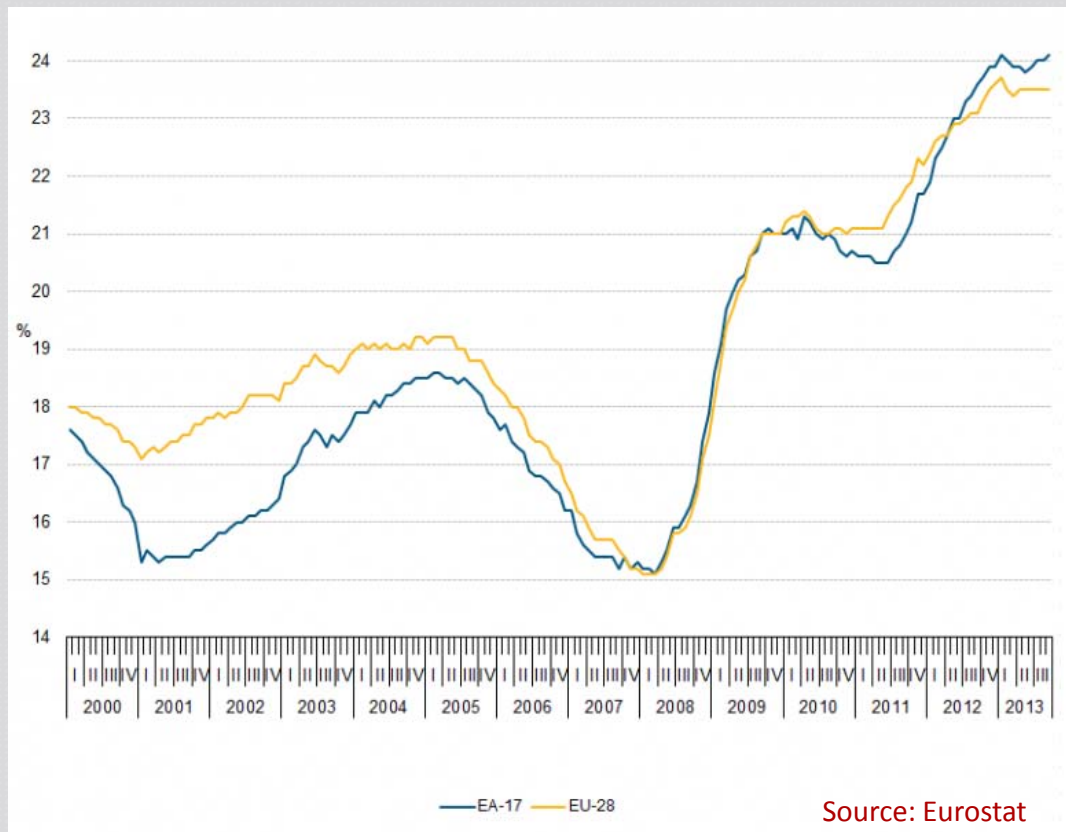


Source: Economic  
Report of the President  
2014

# High unemployment



# And even higher youth unemployment



# In any other context, even best-performing countries' growth would be seen as dismal

- Germany grew at an average annual rate of just .63 percent over the past 5 years
- As bad as Japan in its great malaise—which grew .79 percent from 2001-2010, and just .67 percent if 2011 is included
- Especially bad once account is taken of the rate of growth of its work force
  - Japan's working-age population (ages 15 to 64) shrank 5.5 percent from 2001 to 2010, while the German working-age population shrank 3.6 percent, and the number of Americans of that age increased by 9.2 percent
  - Thus, between 2001 and 2010, Japan's GDP per working-age population grew 14.2 percent, Germany's grew 12.6 percent, and America's grew just 6.4 percent

# Germany's lack of stellar performance

Especially poor

- Once one looks at what is happening to large fractions of the population who are seeing a decline in real income
- Once one realizes that its strength is based on surpluses—surpluses that are creating a global problem
  - Worse than China's
  - If everyone tries to run surpluses, the paradox of thrift kicks in—global insufficiency of aggregate demand



# Problems of the euro were widely anticipated

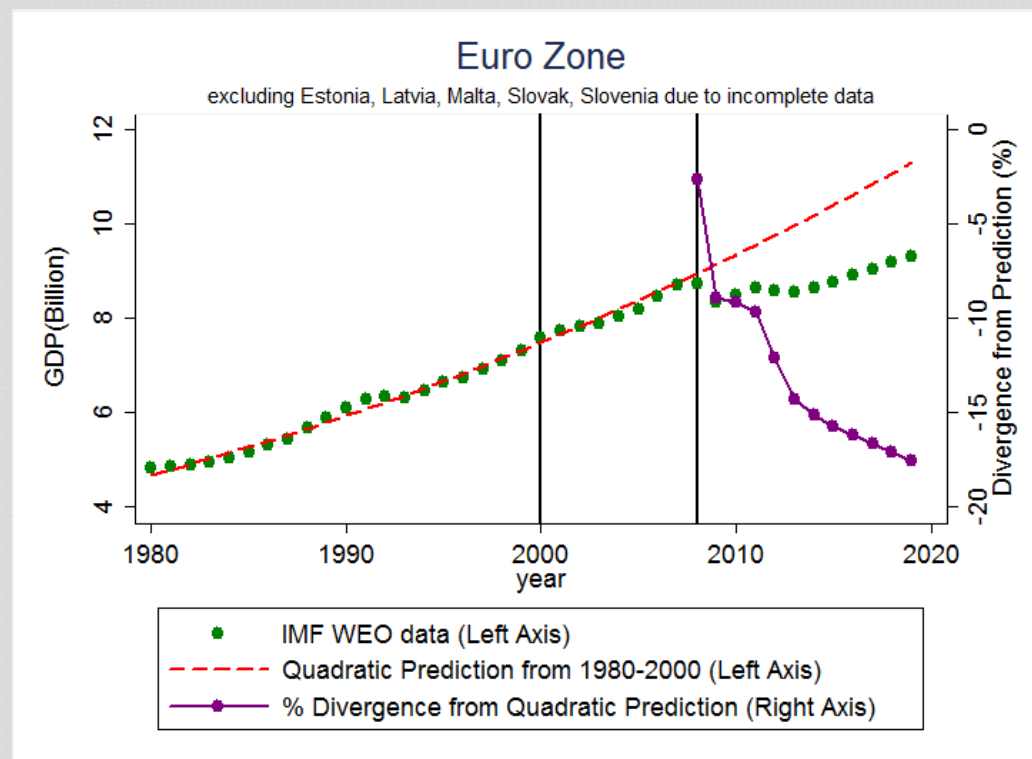
- Europe was not an optimal currency area
- Problems would arise when the region was confronted by asymmetric shocks
- Two of the critical adjustment mechanisms were taken away
- But nothing was put in their place
- The euro was a political project
- But the politics were not strong enough to do it right

# But few anticipated how bad the euro would be for Europe

- Even taking into account the boost that the euro gave to some countries in its first years, output today is far below where Europe would have been had pre-crisis trends continued
- Gap between where the economy would have been if pre-crisis trend had continued and where it is now (“GDP gap”) is increasing

# Europe has paid a high price for the euro

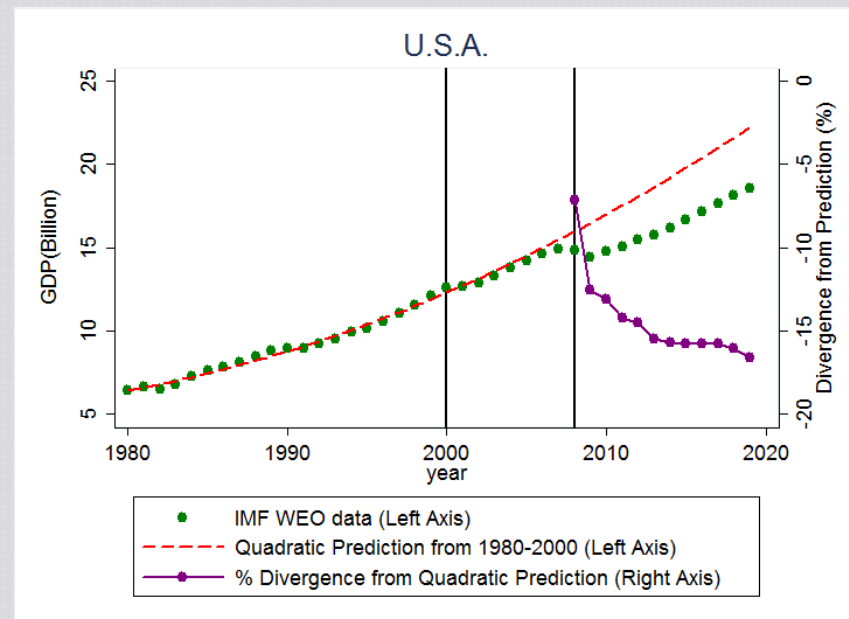
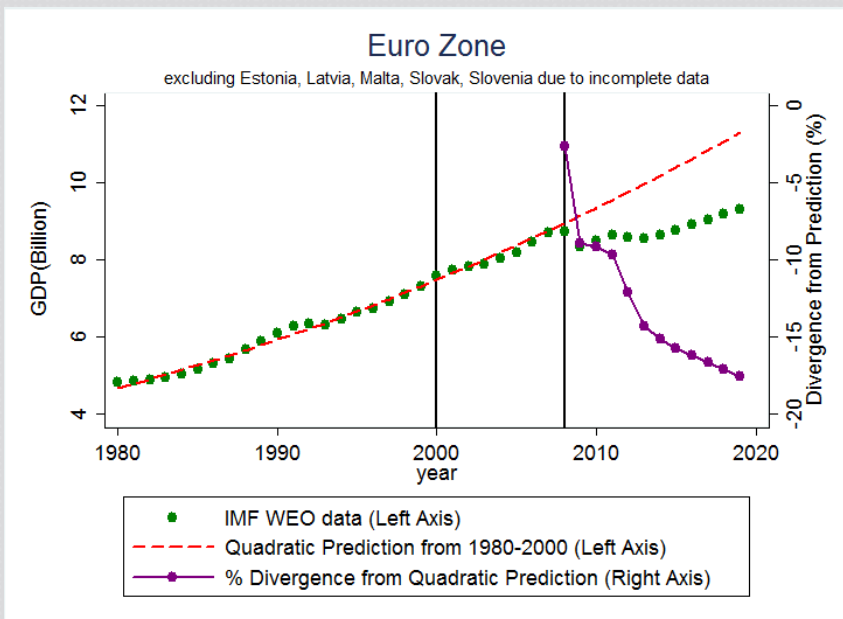
**GDP growth since 1980 and poor performance since crisis**



# GDP “gap” US vs. Europe

- Even though the 2008 crisis originated in the US, the gap is as big, and on trend to be worse
- Euro (and the policy responses to the euro-crisis) are a key reason
- Lowering of future potential growth as a result of persistent unemployment means long-term costs are mounting
  - Critical hysteresis effects

# GDP “gap” US vs. Europe



- The euro had a negligible effect on GDP growth before the crisis, but Europe's performance after the crisis was worse than America's
- Earlier “successes” were actually part of the problem
- Markets foolishly thought that eliminating currency risk was equivalent to eliminating country risk

# Main message of this talk

- There are fundamental flaws in the structure of the euro
- Europe faces a choice.
- Reform the structure of the eurozone, and adopt pro-growth policies
  - Restoring shared prosperity
  - Allowing Europe to live up to its potential
- Muddling through, doing the minimum set of reforms that prevent the collapse of the euro
  - But do not allow for a true recovery, at least not any time soon
  - Imposing enormous costs on eurozone
  - Including lowering potential growth
- The former course is preferable
- And there is a real urgency to making the reforms
  - Large costs to delay
    - Including undermining future potential growth

# I. Understanding failures

- In part, a failure of politics
- But also, in part, a failure of economics
  - Reliance on flawed neoliberal models
  - Same models that had proved so influential in the run-up to the crisis—and so misguided
- Hardwired structure/policy framework based on the flawed models/ideology into the design of the eurozone
  - Ideology reflected in multiple decisions
- Problems compounded by the failure to get certain critical details right
- Problems further compounded by policy failures after the crisis broke
  - Policies predicated on same flaws in modeling/ideology



## II. Key misconceptions at the time of the founding of the euro

### ***A. Convergence criteria***

- Thought that low deficits/debts would ensure convergence
  - But Spain and Ireland had surpluses and low debt-to-GDP ratio before crisis
  - Debt and deficits didn't cause their crises
  - Crisis caused their debt and deficit

# *Divergence rather than convergence*

- The macro-policies forced on the periphery countries by the troika led to *divergence*
  - Predictable and predicted
  - Expansionary contractions was a silly idea
- The economic performances were *repeatedly* poorer than the EU and the ECB anticipated
  - With disappointing growth and improvement in fiscal positions
  - EU and ECB had not fully taken on board what was happening in the financial sector
    - Standard models used by central banks in the run-up to the 2008 crisis had demonstrated their inadequacies

# Austerity

- Enhanced budget discipline will not prevent next crisis
  - And will not help Europe get over this crisis
    - Has made matters worse
- Austerity has essentially never worked
- Wrong diagnosis of the problem led to wrong prescription
  - Parallel to the flawed analysis of what was required to make Euro work
- But without help from the rest of Europe, crisis countries have little choice
- And without a change in the eurozone structure/policy, expansion could lead to larger and unsustainable current account deficits

## B. Other adverse aspects of structure of the eurozone

- *Industrial policy*
  - Europe proscribed policies that might have enabled true convergence
- *Inflation*
  - Monetary policy—single-minded focus on inflation
    - As opposed to broader US mandate
  - Ideology: keeping inflation low was necessary and essentially sufficient for maintaining growth and stability
    - Ironic: Fed founded not to fight inflation but to enhance financial stability
    - Central banks in EU, US underestimated the significance of market failures

# *Flaws in the structure of the ECB*

- Failure of regulatory oversight based on belief that markets self-regulating, efficient, and stable
  - Theory and history had shown otherwise
- Major disturbances to economy are endogenous, created by the market itself
  - And often responses to a disturbance are not self-correcting

## C. While markets are not self-correcting, euro made matters worse by impeding adjustment

- Took away two critical mechanisms for adjustment, exchange rates and interest rates, and didn't put anything in their place
- Euro introduces, within Europe, a kind of rigidity analogous to the gold standard—makes adjustments more difficult
  - Europe hurt by America's "beggar-thy-neighbor" policies, as quantitative easing works to lower exchange rate, and ECB doesn't fully respond

# “Internal devaluation” is no substitute

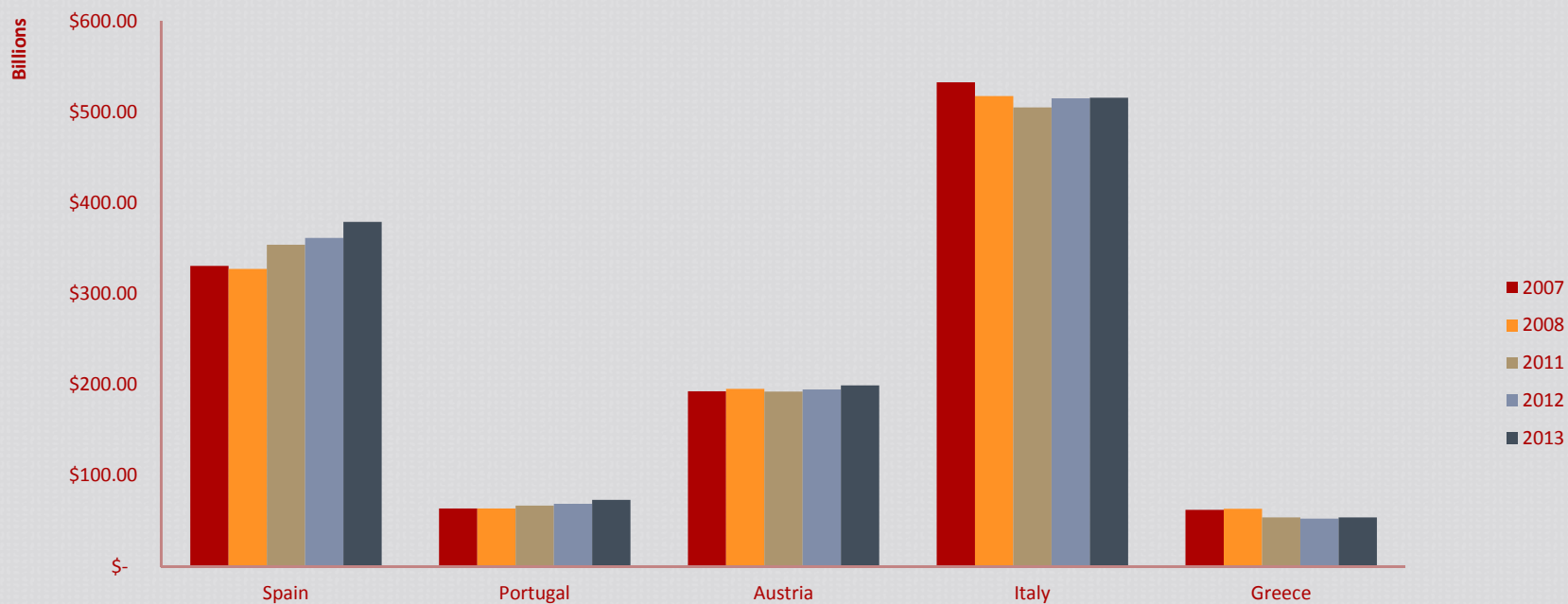
- Deflation hard to coordinate
- And causes hardship, with unindexed debt contracts—borrowers can’t pay back what is owed
  - Leading to financial stress and instability
- If internal devaluation was an easy substitute, gold standard would not have imposed any constraint on adjustment
  - And Argentina would have fared better under its peg

- Had hoped that internal devaluation and structural reforms would lead to increased exports
- In fact, most of the “correction” of current account balances has been through contraction of imports



# Poor performance of exports

## Exports of Goods and Services



Note: 2013 values estimated based on growth rate data from IMF WEO. Quantity values are expressed in constant 2005 USD, which is the baseline year in which the World Bank reports its data.

# III. Two problems that were not grasped

## *A. Borrowing in a foreign currency*

- US will never have a Greek-style crisis
  - Can print the money that it owes
- The euro brought emerging market-style crises to Europe

## *B. Creating a dynamically unstable and inefficient system*

- Free mobility of labor—workers could move to escape debt burdens, implying allocation of labor was not efficient
- Free mobility of capital and goods—but without tax harmonization, implying allocation of capital was not efficient (tax competition)
  - And problem of growing inequality could not be effectively addressed

# Single market

- Banks regulated in any one country could operate in any other
  - Implying that inadequately regulated financial institutions could bring problems across borders
  - Especially important as financial markets become more interlinked
- Implying distorted banking/financial system—implicit guarantee of some governments worth more than others (greater capacity for bailouts)

# Financial contraction exacerbating effects of austerity

- As money flows out of banking systems in affected countries, private spending contracts
  - Recall earlier data on decline in SME lending
- Deepening downturn

## IV. The flawed policy response

- Problems of *flawed structure* exacerbated by *flawed policies*
  - Not a surprise: both reflected similar economic misunderstandings (e.g. what is required for a currency union to work)
- Austerity
  - Talked about growth, but didn't do anything about it
- *Bootstrap operations: savings banks and sovereigns simultaneously*
- A “confidence” game?
  - Promise to do “whatever it takes”
  - So far, ECB hasn't had to deliver on its promise
  - What would happen if it had to?
- Emphasis on structural reform *within countries*
  - Some of which exacerbated current problem of insufficiency of aggregate demand
  - Real problem was the structure of the eurozone itself

# Structural reforms *within countries*

- Many programs have heavy emphasis on structural reforms *within the individual countries*
  - But structural reforms take time
  - And mostly are supply side measures
  - Problem today is lack of demand

# These structural problems didn't create crisis

- And resolving them won't resolve crisis
- Some so-called structural reforms may weaken economy by weakening demand
  - Labor market flexibility (code word for lowering wages)
  - US—allegedly most flexible labor market—has not performed well; much worse than Germany and other European countries with better systems of social protection
  - Increasing consensus that growth in inequality in US contributed to crisis
    - Led to weaker demand
    - Fed tried to offset by creating a bubble, through low interest rates and lax regulation
- Real structural transformation is needed—e.g. in many countries, from manufacturing to service sector

→ WHAT IS REALLY NEEDED IS A CHANGE IN THE STRUCTURE OF THE EUROZONE ITSELF



# V. What is to be done?

A. Structural reforms *in the structure of the eurozone* need to be at core

- *A common fiscal framework*
  - More than and fundamentally different from an austerity pact
  - Or a strengthened version of the growth and stability pact
- *Mutualization of debt*
  - Could be done in a variety of ways (Eurobonds)
  - Would lead to lower interest rates
  - Providing more fiscal space for countries to have expansionary fiscal policies

# *A common financial system (banking union)*

- With system wide deposit insurance
- With system wide regulation
- Common resolution
  - Otherwise, money will flow out of banks of crisis countries to strong countries, exacerbating downturn
- But recognizing that even with a common interest rate, there can and should be differentiated macro-prudential regulations (Greenwald-Stiglitz, 2003)

# *Further structural reforms*

- *Tax harmonization*
  - Restricting the race to the bottom in capital taxation
  - Reducing the distortions caused by tax competition among countries
- *Industrial policies*
  - Not just allow, but encourage, industrial policies
  - Enabling those behind to catch up
  - To prevent further divergences within the countries of Europe

# *Further structural reforms*

- Change in the *mandate of the European Central Bank*
  - From its single-minded focus on inflation
  - To a broader mandate
    - Including growth, employment, and financial stability
  - Important to encourage growth
    - Especially important in a global context where other countries pursue broader objectives
    - Preventing exchange rate appreciation

## B. Policy reforms

- *From austerity to growth*
  - Role of EIB, other special funds
  - Mutualization of debt will provide resources
- *Adjustment of real exchange rates*
  - Two ways—Germany increases its prices, rest of Europe lowers theirs
  - Large asymmetries of costs of adjustment
- *Towards debt restructuring*
  - May be necessary for some countries
  - Should be deep
  - Should be done quickly

# Structural and policy reforms need to be viewed as a package

- A move away from austerity needs to be *financed*
- Growth needs to be sustained and sustainable
  - *Without a buildup of current account deficits*
- *And there is a need for urgency*

# VI. Concluding comments

- Current strategy has been very costly
  - Large waste of resources
  - Especially human resources
  - Of an order of magnitude greater than associated with the mistakes made before the crisis
  - Lowering future potential growth

# The crisis in Europe is manmade

- It was not caused by a natural disaster
- It was caused by the decisions of Europe and its leaders
  - What they did
  - What they didn't do
- They created conditions which enabled it to occur
- They responded in ways that made it worse



# *The high price of the euro*

- *Undermining democracy*
- *Undermining the European project*
- The euro crisis, like so many other crises, is more attributable to market excesses than to government profligacy
  - Crises are perhaps an inherent feature of capitalism
  - they do not have to be as frequent, as deep, and as costly as they have been

# The euro was a collective project of Europe

- And will require *collective* action by Europe to fix
- The notion that Europe is “not a transfer union” undermines solidarity and impedes the ability to find a collective solution

- Hope: change in actions will bring an end to the crisis *without too much more damage*
- The original hope of the euro can be restored.
- But it won't happen on its own.
- It won't happen if the leaders of Europe continue to blame the victims, the countries that are suffering from recession and depression.
- It will only happen if they recognize the fundamental flaws, *both* in the institutional arrangements and the policy frameworks, and make the requisite reforms