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The European Sovereign Debt Crisis

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Roundtable on the European Sovereign Debt Crisis[1]
Comments by

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The eurozone is in a crisis: real GDP is lower now than five years ago, unemployment is at 10.9 per cent and rising; in Greece and Spain it could reach 25 per cent by year's end and youth unemployment is close to 50 per cent. Several governments are insolvent; the financial system is impaired and more bailouts are imminent. European inter-regional private sector financial intermediation has ceased. A double-dip recession is underway and any recovery in 2013 and 2014 is likely to be quite weak. Long-term growth is being stymied by falling investment in education and infrastructure. The social situation has already deteriorated significantly and will only get worse. In Greece suicides, homicides and theft have almost doubled, and heroin use, HIV infections and prostitution are up sharply. There is a serious possibility that some countries will be forced out of the eurozone which could lead to bank runs throughout southern Europe.

The similarities between Europe today and in the 1920s and 1930s are striking. Most historians have concluded that the catastrophe of the 1930s was the result of numerous policy failures. In the future, historians in evaluating the current crisis will conclude the same. This is a crisis caused by policy failures of historic proportions both at the national and European level --policy failures both in the institutional design of the eurozone and in the current implementation of macroeconomic policy.

Let me highlight some of the similarities to the 1930s. 1) You have a financial crisis that created a once in a generation economic downturn with historically high levels of unemployment. 2) There is a dysfunctional monetary system that policy makers are reluctant to abandon or reform. Today it's the eurozone, then it was the gold standard. 3) Constrained by the institutional design of this monetary system, the effective implementation of macroeconomic policy is difficult. Then as now there is little flexibility regarding monetary and exchange rate policies. 4) Governments failed to enact the necessary fiscal stimulus because of unsubstantiated doubts about the effectiveness of fiscal policy and misplaced concerns about debt levels. 5) Harsh "reparations" are imposed on a problem country and they destroy the economy. Then it was Germany, now it's the periphery of Europe. 6) In both cases the repayment of "reparations" is made extremely difficult by complications of the transfer

[1] Other participants in the roundtable included Pompeo Della Posta (University of Pisa, Italy), Mordechai Kreinin (Michigan State University, USA), Radu Vranceanu (ESSEC Business School and THEMA, France), and Michael G. Plummer (Johns Hopkins SAIS-Bologna, Italy and the East-West Center, USA). The views are those of the author and not necessarily those of the UNECE or its member states.

problem. 7) Beggar-thy-neighbor depreciations pushed unemployment and adjustment problems on to others. Germany has in fact been implementing such a stealth depreciation over the last decade as its unit labor costs failed to rise at the ECB target inflation rate. 8) And finally and most importantly, countries made policy to maximize their own particular advantage instead of implementing a regional solution, and just as in a prisoner's dilemma, the result is that everyone has been made worse off.

There are many underlying causes of the crisis that can be analyzed at many different levels. But the most immediate cause is as Nobel Laureate (and Italian) Franco Modigliani said undiplomatically many years ago, "Europeans simply do not understand macroeconomics." I believe this is due to the fact that Europe is made up of small countries where historically fiscal policy was not effective due to large leakages, and monetary policy could not be used because of the economic trilemma. Thus Europeans students learned and policy makers believed that there were no macroeconomic stabilization tools and every problem was structural. When they created the euro, instead of realizing they were creating a large country like the US where macroeconomic policies are effective, they instead kept their small country mindset in designing the euro's macroeconomic framework. The Stability and Growth Pact emasculated fiscal policy and the European Central Bank was told to ignore growth and unemployment and concentrate only on inflation. Thus this failure to understand macroeconomics led to the establishment of institutions that were not suited for the economic challenges that Europe would face. This was understood by many, years before the crisis.[2] My own paper presented at this conference in 2005 and later published in our journal the Global Economy Journal,[3] spelled out that the eurozone was designed for smooth sailing on a sunny day and when a storm came, it would flounder.

There are many design defects in the eurozone but the two most important are: 1) there is no lender of last resort. This has essentially turned eurozone members into emerging markets that must issue debt in a foreign currency and thus has made them susceptible to currency/sovereign debt crises. And 2) there is no adjustment mechanism for current account imbalances. They have neither fiscal transfers nor significant labor mobility as in the US and must rely on recession and wage deflation. This adjustment mechanism did not work under the gold standard and it does not work today.[4] To address the crisis you need to address these two problems.[5]

If the ECB is not going to be the lender of last resort, then an alternative needs to be designed. The approach has been to set up assistance funds (the European Financial Stability Facility and the European Stability Mechanism) to back the sovereigns. However with limited funds they will

[2] Even current IMF chief economist Olivier Blanchard in 2003 many years before the crisis said "Economies which try to aim for very low inflation (0 to 2 per cent) and put sharp constraints on fiscal policy are playing with fire." (Remarks at a conference in honor of James Tobin, New School, November 2002.)
[3] Robert C. Shelburne, Is Europe Sick? *Global Economy Journal*, Vol. 5 (3), 2005.
[4] It used to be thought that this adjustment mechanism was just slow and costly, but more recently theories such as the paradox of toil and the paradox of flexibility suggest that in a liquidity trap it does not work at all.
[5] A third problem which is becoming increasingly important by the day is the need for a European-wide (as opposed to separate national) regulatory system for the financial industry, including deposit insurance.

be constantly tested and may not work. Eurobonds are another proposal to provide increased backing for sovereign debt.

The current adjustment process makes no sense. If you have a country with significant debts to be repaid, it needs to be producing as much as possible; it makes no sense to implement policies that put 25 per cent of the labor force out of work, thus severely limiting what is available to be used for debt repayment. Adjustment will require: 1) more fiscal transfers to ease the debt burdens, 2) more pressure on the surplus German economy to inflate, 3) and more economic growth throughout Europe. Faster growth will require more unconventional monetary policies in addition to the ECB's long-term refinancing program which is essentially quantitative easing, and a regionally coordinated fiscal expansion. The UN using its Global Policy Model has modeled the effects of such a program in its recent World Economic Situation and Prospects.[6] Such a program not only achieves higher growth and lower unemployment but also has better debt dynamics in the medium and longer run.

Finally let me say that although I have concentrated on the eurozone, the austerity implemented in the United Kingdom represents an even greater policy failure since it was undertaken without any pressure from capital markets and there were no institutional constraints.

Europe must change course fast to a more growth oriented focus if the eurozone is to be saved.

[6] These simulations take a somewhat more global perspective.