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Greece and the Future of Europe

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Since the last speaker ended with a medical analogy, let me begin with one. A person has a rash on his arm that gets a little infected and goes to the doctor. What the patient needs is a dose of antibiotics, but the doctor misdiagnoses the problem as cancer and institutes a harsh regime of radiation and chemotherapy. The patient becomes very sick as a result and now there is question as to whether the patient will live or die. That is of course the situation with Greece; the overall situation was misdiagnosed and the austerity policies put forth to solve the problem were the wrong medicine and as a result they have destroyed the Greek economy. The real tragedy of current situation is that this is a crisis that did not have to happen. It is the result of policy mistakes by the creators of the eurozone two decades ago and the current poor implementation of macroeconomic policy by Brussels, Frankfurt, and especially Berlin.

It is my overall assessment that the Greek tragedy is largely the result of a failure by the creators of the eurozone, and current policy makers in the EU and ECB, to fully appreciate the gross inefficiency and ineffectiveness of relying on nominal wage cuts to address macroeconomic disequilibrium. This is all the more remarkable given the importance of this factor in the history of macroeconomic thought which is further supported by a large body of empirical analysis. Therefore in my remarks today I would like to use a simple graphical framework to describe the Greek situation that highlights the nominal wage since that is the critical variable.

Currently the nominal wage in Greece is too high to achieve external balance (basically a minimal current account deficit). Excessive capital inflows in

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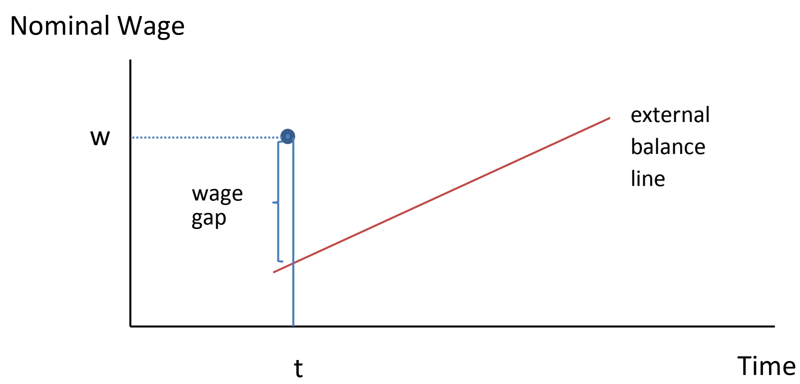
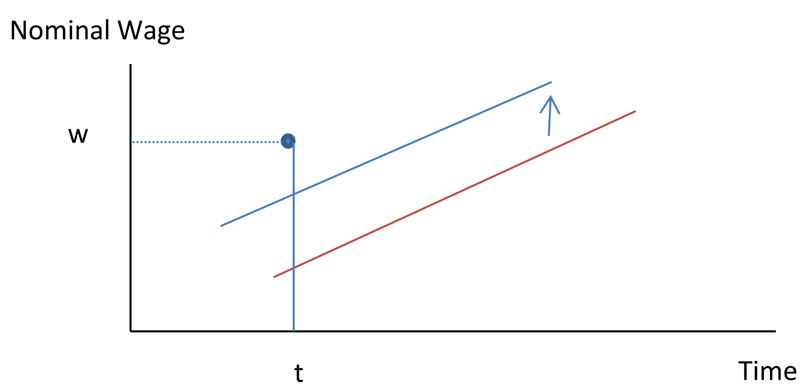
the decade prior to 2008 boosted the Greek wage to unsustainable levels and the Greek government had no tools with which to correct this situation. The global financial crisis and excessive Greek government debt brought this process to an end in 2009. This is shown in figure 1 where the nominal wage at time *t* is *w* and is higher than the wage consistent with external balance. The wage consistent with external balance varies overtime and is an upward sloping line since it increases over time due to inflation and productivity growth. This gap between the current wage and the external balance wage line is the essence of the current Greek problem.

Figure 1



Given this disequilibrium, what can be done? There are three possible ways to address this situation. The optimal policy would have been to implement some policy that would shift the external balance wage line upwards to restore equilibrium (figure 2). Increasing aggregate demand throughout the eurozone, especially in the surplus countries would have increased the demand for Greek products and services and shifted this line upwards. However, Germany refused to go along with what would have been the optimal policy not only for Greece but for the eurozone as a whole. Likewise a more aggressive monetary expansion, starting with the beginning of the global financial crisis and maintained since then would have also worked to increase demand and shift the external balance line upward. The ECB failed to do this. At two critical points over this period - in mid-2008 as the global financial crisis was unfolding and in mid-2011 as the PIIGS debt crisis was unfolding - the ECB raised interest rates when they clearly should have been lowering interest rates. The ECB also failed to implement anything similar to quantitative easing as was undertaken in the United States. A lower interest rate would have stimulated investment, reduced the costs of government borrowing and thus allowed more fiscal expansion, and would have lowered the exchange value of the euro thereby stimulating exports. The failure to stimulate aggregate demand not only has produced dismal growth and something close to disinflation in the eurozone, but has contributed significantly to the problems in Greece.

Figure 2



The institutional design of the eurozone also created a situation which meant that this upward shift in the external balance line would not occur. For example, choosing an inflation target of 2 per cent and ignoring unemployment in the ECB's mandate resulted in a central bank that has been unable to do what a central bank should do. More specifically, the ECB was unable to lower the real interest rate to the level needed for macroeconomic stability. Likewise the failure to have any significant automatic fiscal transfers in the eurozone created a serious deficiency for the smooth operation of a currency union, and some other similar adjustment mechanism should have been designed to compensate for this deficiency. Underlying both of these defects in the original design of the eurozone resulted from the incorrect belief of the creators of the eurozone that downward wage adjustments could easily compensate for these design defects.[2]

[2] The design faults of the eurozone and EU economic policy more generally were explained by this author to this conference in 2005. See, Robert Shelburne, Is Europe Sick? *Global Economy Journal*, Vol. 5 (3), 2005 which was presented at the International Trade and Finance Association conference, Istanbul, Turkey, May 2005.

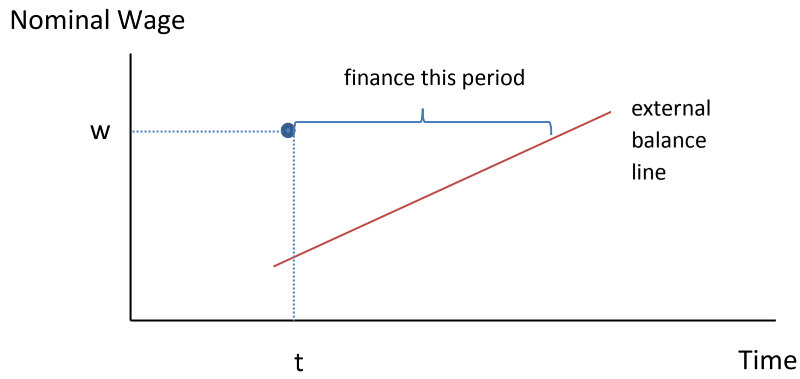
And perhaps most importantly, the austerity policies (tax increases and budget cuts) imposed on Greece by the troika have further pushed the external balance wage line down when what was needed were policies to push it up.

Thus there were a whole set of policies which could have lifted up the external balance wage line and this would have been the optimal policy response; but instead almost every policy actually implemented had the opposite effect. Most importantly, these policy errors were not made by the Greek government but by the elites in the European Union.

A second option for addressing the gap between the current wage and the external balance wage is to finance this gap over time until the external balance wage increases back up to the current wage (figure 3). In a properly designed currency union (such as the US) some of this financing happens automatically as additional net central government revenues go to the deficit region through the standard macroeconomic automatic stabilizers such as welfare and unemployment benefits. Of course, as already discussed this type of mechanism is not part of the eurozone design. Instead of recognizing that this was a defect that would need to be addressed in some alternative way, the creators of the eurozone chose to simply ignore the need for this based upon their misplaced faith in the effectiveness of wage adjustments.

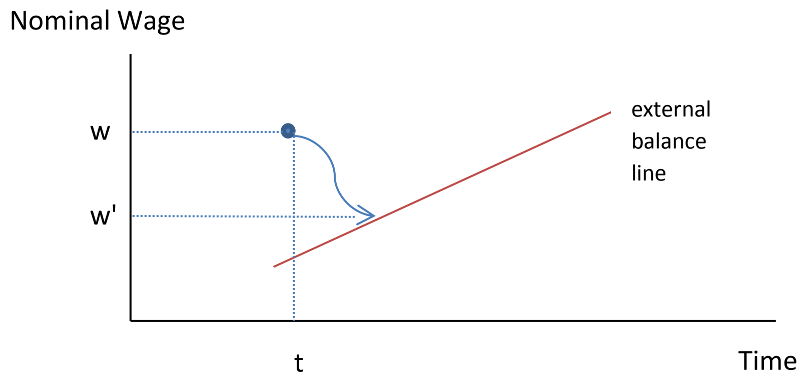
As this crisis has developed, the EU has created several half-hearted financing mechanisms but the conditions they have imposed on the borrowers have, as in the case of Greece, simply compounded the problem. The Greek government would probably have been able to finance this deficit itself if the ECB would have backed the government by providing lender-of-last-resort functions which almost every other advanced economy central bank provides. Without a central bank to act as lender of last resort, Greece became essentially a typical emerging economy which lacked the ability to finance a significant current account deficit.

Figure 3



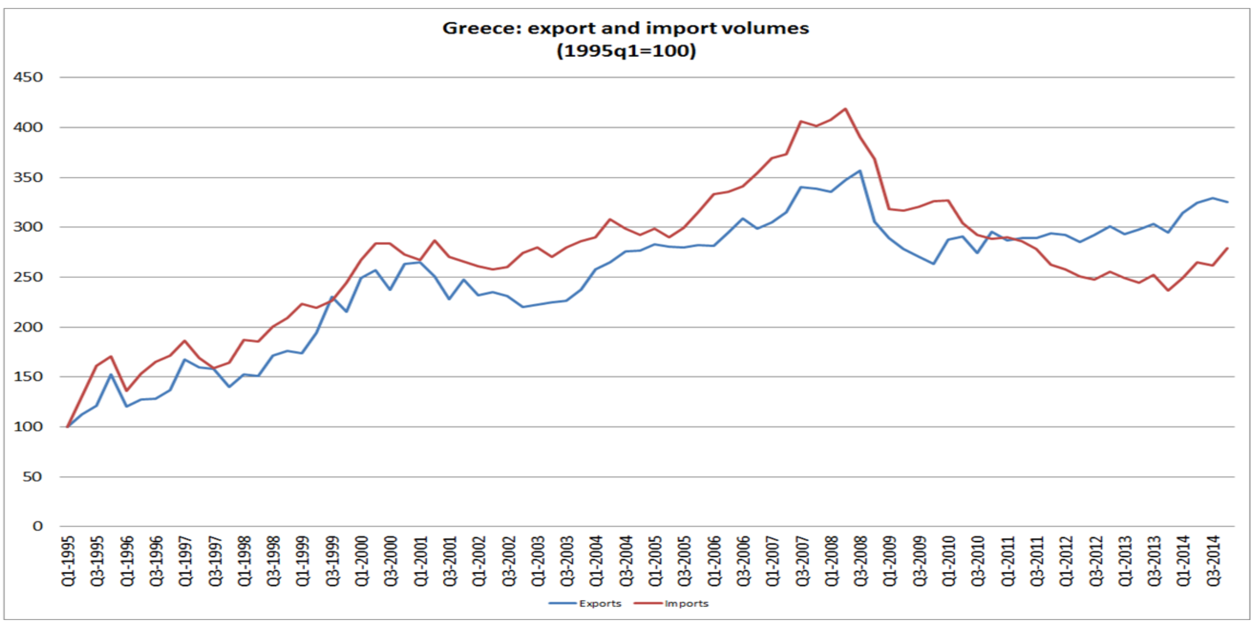
The third option for addressing a gap between the actual wage and the external balance wage is to lower the actual wage (figure 4). This was the option chosen by the EU and forced upon the Greek government. The only real mechanism that can produce a large decline in the nominal wage is to produce mass unemployment. Greek unemployment has now been over 25 per cent for several years and economy-wide nominal wages have declined by over 15 per cent with real wage declines closer to 25 per cent. Thus this option comes with a very high price in terms of social and economic costs. These are not simply possible theoretical costs but are costs that have been verified empirically time and time again historically. The gold standard was abandoned because the costs of nominal wage declines were viewed to be too great. A monetary system which requires nominal wage declines is an option that had been largely discredited. Given this sordid history it is almost unbelievable that European policy makers would choose it as its primary adjustment mechanism for macroeconomic disequilibrium.

Figure 4



Despite producing huge economic, political and social costs for the affected country (in this case Greece) if pushed excessively this option can essentially destroy an economy which makes repayment of its debt unlikely. Thus, although the amount of financing needed in the transition to the lower wage under option 3 is less than under option 2 (financing is needed for some period since the wage cannot be cut instantly), the debt created is more problematic. For example, current GDP in Greece is about 25 per cent lower than prior to the crisis and it will struggle this year to achieve a surplus of (and thus pay back to external creditors) one per cent of GDP; doing so means consumption is down to 74 per cent of its pre-crisis GDP. (It's down even more relative to pre-crisis consumption.) If instead policies had been implemented to keep Greek GDP close to its pre-crisis level, the economy could pay back 5 or even 10 per cent of GDP and consumption would still be significantly higher. Thus in destroying the Greek economy, the austerity policies and the macroeconomic mismanagement of the eurozone more generally have simultaneously destroyed the ability of the Greeks to pay back their external debt.[3]

Figure 5

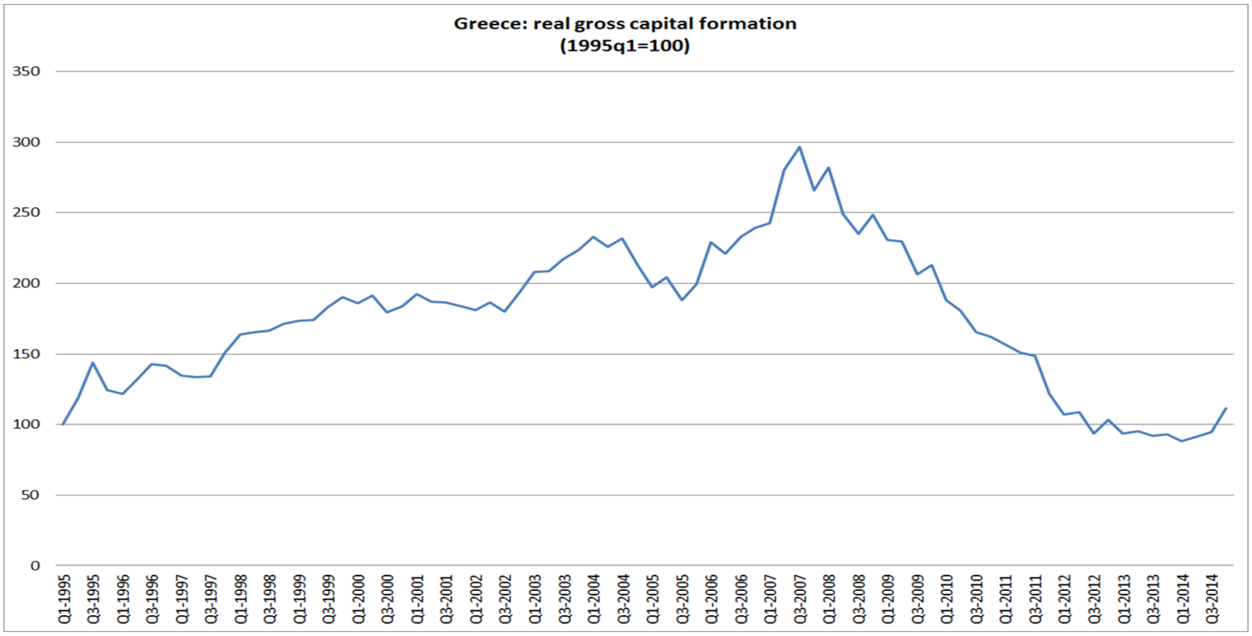


[3] One can ask, how is it possible that such an ill-informed and misguided view could come to dominate supposedly serious and important public officials? An analogy might be the belief among ex-US President George Bush's circle that climate change was not related to human activities. Macroeconomics is to Angela Merkel as climate change science is to George Bush; neither has a clue.

The policies imposed by the troika have failed. Obviously this is the case for the Greek people, but even by the EU's own self-centered objective of getting their funds back, this is the case. It is widely agreed that no matter what options are chosen in the coming months, much of the current debt will not be paid back on current terms. Very little has been achieved in terms of creating a large current account surplus, which is a precondition for any debt payback. As shown in figure 5, exports are below their pre-crisis level and the small surplus that has been created is a result of the fall in imports due to the depression in Greece. Any economic recovery in Greece will cause imports to rise and wipe out the surplus.

Given that it is widely recognized that many Greek products are not exportable, increasing investment in the sectors potentially able to export should be a priority, but that is not happening; in fact as shown in figure 6 the opposite has happened. Therefore under the current set of policies the only way Greece can pay back even a trivial amount of debt is to stay in a depression. It should be obvious that if you owe a lot to foreigners, the top priority should be to produce as much as possible so that you have the output to pay back your debt. The policies implemented however have had the opposite effect.

Figure 6



It is not clear if the Greek government will continue to play along. It's not unreasonable for creditors, before committing additional funds, to ask a borrower to implement policies that will ensure or enhance the probability of being paid back. However, due to their misplaced belief in the efficacy of wage deflation, the creditors have in the Greek case been imposing conditions that have actually made repayment more unlikely. This represents a clear policy failure by the elites of the European Union.

Since this is a session on the future of Europe let me make a few other more general quick observations. Because of its inadequate macroeconomic framework, the European Union will continue to experience relatively slow economic growth accompanied by high unemployment. Given the current high levels of unemployment, the EU may be able to experience a transitional bounce-back period of higher growth as it continues to recover from the Great Recession, but over the medium-to-longer run its prospects are not particularly good. One could be more optimistic if European leaders at least recognized their predicament, but they do not. With no effective macroeconomic framework, every macroeconomic problem is instead (incorrectly) viewed to be a "structural problem" and the solution to these structural problems is always a more flexible labor market. As a result there will be a continuing set of policies to weaken labor rights and welfare policies. The result will be a continuing increase in inequality. Thus the medium-term outlook for the European Union is slow growth, high unemployment and rising inequality.

The non-EU economies in southeastern Europe which on their own may collapse into failed states, have little option but to pursue EU membership despite its dismal prospects. Russia, despite its recognition that it needs economic diversification away from the energy sector, seems unable to bring this about. Thus the prospects for the Russian economy in the medium term are largely dependent on the price of energy. In conclusion, the medium-run prospects for the continent of Europe are not particularly bright.