The Eurozone Crisis Still Threatens Global Growth

Paolo Guerrieri *Professor of Economics, University of Rome Sapienza; Professor, College of Europe, Bruges*

The outlook for the global economy in 2012 is clear, but doesn't look very reassuring: recession and stagnation in Europe, anemic growth at best in the United States, and a sharp slowdown in China and in most of the emerging market economies. Under the present conditions and policies, there are very serious downside risks for the global recovery; the most serious of these being a new deterioration of the eurozone crisis.

In the eurozone, fiscal austerity measures applied on a large scale are determining recessionary effects on output in many Southern European economies and stagnation in the core euro area. Interest-rate spreads for Italy and Spain are widening again, while borrowing costs for Portugal and Greece remain high.

The European Central Bank's longer-term refinancing operation to provide nearly $1 trillion in cheap three-year funding to European banks has temporarily stabilized the eurozone and the global financial system, but has not addressed the underlying problems of the crisis in the peripheral countries: large and rising private and public debt as a share of GDP on the one hand, and a deepening recession and large macroeconomic imbalances on the other.

The major risk is that the eurozone is going to repeat the fundamental mistakes of the Great Depression. Under present conditions, more turmoil is likely and Europe will suffer along with the rest of the world.

Looking ahead, the primary goal of the G-20 and the international community should be to call for a rebalancing of some aspects of the current strategy in Europe to ensure that there is not an excess of near-term austerity. The recessionary effect caused by fiscal austerity may itself fuel market doubts about government solvency and thus worsen the fiscal position of the euro area's highly indebted countries, defeating the very purpose of the initial austerity measures. In light of these considerations, a common European commitment to growth is strongly needed. Furthermore, a push for balancing trade within the eurozone should also be made compatible to the new overall global equilibrium. In the past, the eurozone has largely balanced trade with the rest of the world, although countries like Germany ran large trade surpluses against the rest of the eurozone. The risk is that future adjustment could transform the eurozone as a whole from a region with balanced trade with the rest of the world to another trade surplus and export-led growth area like East Asia. That would make it even more difficult to stabilize and promote growth in the global economy as a whole.

The Conventional Narrative of the Eurozone Crisis

Since the start of the crisis, European leaders have misdiagnosed the problems and set the wrong policy course based on fiscal austerity. On the conventional (German) reading of the crisis is that it is not the product of the eurozone system itself, but of misbehavior of individual countries within the region in terms of fiscal laxity and irresponsibility. There is a banking crisis as well, but it is not seen as a central part of the problem in Europe. Therefore, under this reading of the crisis, the adjustment should be entirely one-sided and centered on the highly indebted countries. The resulting prescription was austerity and economic reforms. According to the current approach if the periphery can achieve this then the eurozone debt crisis will be resolved without new great institutional changes.

Fiscal austerity measures have been introduced and diffused everywhere in the eurozone from Greece's unique fiscal problems to countries such as Spain and Ireland which have banking and not fiscal crises. The belief is that these countries should restrain from excessive spending enough to restore credibility, bring down interest rates and restart economic growth. However, what is happening is that growth has suffered and recession has hit all peripheral countries. If most eurozone country governments are cutting spending at the same time, the contractionary effect on GDP is further magnified. The deficit countries must improve competitiveness and save more to pay down their debts, without offsetting a decline in saving and expansionary policy in the surplus countries like Germany. Slowdowns in one country will reduce demand for exports in others.

Fiscal austerity in individual European countries has resulted in excessively tight macroeconomic policy for the euro region as a whole. Together with Europe's inability to handle the problems in Greece, it contributed to weakening market confidence and creditworthiness in many countries, notably Spain and Italy. The decline in sovereign bond prices of highly indebted countries has exposed the banks' undercapitalization. The prospect that European governments will have to finance recapitalization has driven up risk premiums on government bonds. The sovereign debt crisis in the periphery is thus bound up with a banking crisis across the euro area as a whole. As a consequence, the banking crisis and sovereign debt crisis has been so far interacting with each other in a perverse direction.

Fiscal Austerity Alone Will Not Solve the Crisis

It is very clear that the fragility of the financial system, together with the sovereign debt crisis, represents the biggest threat to the long-term stability of the eurozone. It's also clear that fiscal austerity alone will not solve the crisis. EU countries, particularly those across Southern Europe, would be well-advised to take supply-side reforms more seriously than they have in the past. But there are obvious contractionary effects for the eurozone as a whole deriving from such an asymmetric approach. As previously noted, increases in saving and exporting in eurozone deficit countries have to be offset by equal increases in spending and importing in surplus ones. Peripheral Europe cannot possibly succeed in reducing its borrowing substantially unless surplus countries like Germany pursue policies that allow their surpluses to contract.

For the past two years, policymakers across Europe seem to contest this point and argue that fiscal consolidation by itself will boost growth. The main hypothesis is that confidence-inspiring measures will foster and not hamper recovery. However, these assertions have little empirical evidence to support them. As a careful study conducted by the International Monetary Fund concluded in 2010, "fiscal consolidations typically lower growth in the short term". In other words, their net effect on demand is contractionary, rather than expansionary. Furthermore if a eurozone deficit country were to reduce its trade and current account deficits without Germany playing any offsetting role, this would implicitly assume that the rest of the world would have to absorb a huge shift in the eurozone's external position, from broad balance to large surplus. Currently, there seems to be very little room to shift the euro area's imbalances to the rest of the world by transforming the region as a whole into another export-led growth area like East Asia. Such an action would also make it even more difficult to stabilize and promote growth in the world economy as a whole.

An Alternative Diagnosis and Therapy

In the light of what has been said, it is no wonder that Europe's economic prospects are so poor. Twelve European countries are in recession—meaning they have suffered at least two consecutive quarters of negative growth—including big countries like Spain and Italy. Eurozone unemployment has risen for a 10th consecutive month to reach a new record high of 17.1 million in February, with the pace of increase showing little sign of slowing due to austerity programs across the continent.

To avoid further recessionary trends in the eurozone and the potential for another major global crisis, it is crucial that European policymakers modify their policy strategy. First, they should recognize that fiscal austerity has become part of the crisis. We need an alternative therapy based on a better understanding of the causes of the crisis since the diagnosis and the corresponding therapy are strictly related.

Contrary to the official narrative of the underlying cause of the eurozone crisis, with the exception of Greece, the real cause of the crisis is not the fiscal irresponsibility of some EU member countries but rather the unsustainable accumulation of debt among private actors (households and banks) linked to the large and persistent imbalances in the euro area. Up until the time of the global financial crisis, the euro area as a whole remained relatively close to external balance. However, the current account balances and the competitive positions of individual EU member countries have widely diverged.

The launch of the euro did produce a key effect on creditor and debtor countries—a common monetary policy. Removing exchange rate risk with the introduction of the euro encouraged massive capital flows to and as a consequence large current account deficits in the Southern European nations—Greece, Italy, Portugal and Spain. Nordic countries run spectacular current account surpluses, notably Germany (6 percent of GDP in 2011). External divergence also took the form of steadily widening and different competitive positions of the two groups of countries.

For many years, however, very little attention was paid to these imbalances by national authorities and the European institutions. The assumption was that changes in competitiveness and current accounts are not necessarily bad in a monetary union. This assumption was accepted even more so because for many years large current account deficits were easily financed by net private capital flows of surplus countries in the euro area. In other words, the banks of the core countries (Germany and France) heavily financed the excess demand in the peripheral countries, thus promoting the accumulation of large macroeconomic imbalances within the eurozone.

The global financial crisis in 2008-09, however, has put an end to this easy financing and has revealed many weaknesses in the euro architecture. Private funding of imbalances dried up and the system of euro area central banks has had to replace the banking sector as a key source of funding of current account imbalances and private capital movements. This massive intervention was to a certain extent successful, but the cost was the dramatic increase of budget deficits and sovereign debts in deficit countries. In the years after the crisis, highly indebted European countries with large external deficits experienced the highest sovereign bond yield spreads. Current account imbalances were placed at the heart of eurozone crisis. As a result, the euro system has become exposed to the risk of sovereign and bank defaults. High public deficits and debts are much more an effect than a cause of the eurozone crisis.

A Mix of Austerity, Liquidity and Growth Policies Needed

The diagnosis sketched above shows us the complex and systemic nature of the eurozone crisis. Countries in the euro area are facing major structural problems and need prolonged technical assistance to implement the necessary adjustment policies over the next decade.

First, the excess of private and sovereign debts requires fiscal adjustment and consolidation measures in the highly indebted peripheral countries. In short, these countries need a significant dose of austerity to impose a new discipline in the conduct of national economic policies in order to correct past mistakes. To be effective, however, these adjustment policies need time and adequate financial resources in the hands of the European Central Bank and/or the European Stability Mechanism (ESM) to avert the risk of a liquidity crisis inherent in a currency area such as the eurozone. In addition, the solution to the crisis requires a dynamic growth environment in Europe, which will involve both national reforms and policy strategies implemented at the European level.

A more articulated approach to addressing the crisis in Europe should involve a composite mix of policies based on austerity, liquidity and growth measures. A specific role should be assigned to each of them since the various combined effects may generate very different outcomes in the painful adjustment process that is currently affecting euro-area countries.

The trouble today is that the eurozone has an austerity strategy but a very inadequate liquidity policy and no growth strategy at all. This biased composite mix has led to the current recession trend that makes austerity and national reforms self-defeating because in peripheral countries output continues to contract and debt ratios continue to rise to unsustainable levels. Moreover, the social and political backlash in these countries will eventually become overwhelming.

A radical rebalancing of the eurozone's strategy is thus needed by introducing effective adjustment mechanisms of both liquidity resources and enhanced growth capability. Only a more composite balanced mix of policies for austerity, liquidity and growth can offer a solution to the crisis in Europe. While the austerity strategy remains the responsibility of each individual member-state, a much more coordinated effort at the European level is needed for liquidity and growth. In this perspective, two key problems should be solved for the euro area as a whole: the banking sector's problems and the low growth-stagnation problems.

The Banking Sector's Problems: A Comprehensive EU-wide Plan

It is evident that no solution to the solvency/liquidity capability of peripheral European countries, and in particular Italy and Spain, could save them if the restructuring and/or recapitalization problem of many European banks is not addressed and solved. Thus one should focus on a comprehensive EU-wide plan to restructure and/or recapitalize and/or shrink troubled banks. Only until very recently, were we able to talk openly about the need to implement a plan to restructure and recapitalize banks and this should be part of a large, comprehensive strategy for the whole euro area.

The plan should be managed at a common European level and not on a national scale, as agreed to last year at October Euro Summit. We already made a mistake at the beginning of the global financial crisis in 2008 by requiring each country to save their banks with their own resources. This approach created rising public deficits in weaker European economies and the subsequent increases of the interest rate spreads. In turn, this led to a vicious circle: recapitalization undermined the creditworthiness of governments and then this fed back into the banks, which saw the values of their assets decline further. Instead, the reinforced European Stability Mechanism, or the European bailout fund, should support weak banks in eurozone countries with weak economies. Capital buffers can also be built up by enacting a moratorium on bonus and dividend payouts. A complementary fundamental pillar is new bank resolution legislation, making it possible for any bank, including large cross-border banks, to fail and thus not reimburse fully their creditors and equity holders—with the sole exception of insured (retail) depositors. Such a system would introduce strong incentives for bank managers and equity holders to limit risk taking and to create more stringent market discipline, which would also be extended to sovereign borrowers. Finally growth is a fundamental ingredient to reduce the fragility of the banking sector.

It is clear that in facing these problems the recent generous supply of liquidity made by the European Central Bank in favor of banks across Europe only offers extra time to implement the necessary reforms mentioned above but is hardly a solution to the existing problems.

A Growth Agenda Is Even More Pressing

As I have already pointed out, a protracted recession in Southern Europe would quickly again put the single currency in danger. The European Union's growth agenda has become even more pressing because growth is what is needed in order to counter the falling economies of the peripheral European countries. From this perspective, the EU should launch a new initiative to mobilize the array of available policy instruments to boost growth. Without a quick return to growth, the main problems of the eurozone will likely become even more unsustainable.

More than just a fiscal crisis, the situation in Europe is more a crisis of unsustainable private debt accumulation linked to large and persistent imbalances in the euro area. The huge challenge now is to make managing the crisis compatible with the adjustment of these external imbalances. Austerity measures and/or the indefinite financing of them are not the solution. The former will exacerbate recessionary trends in the eurozone while the latter will create economic and politically unsustainable tensions among countries.

An effective approach requires looking at both competitiveness (euro-area relative performance) and stronger growth (euro-area absolute performance) so to introduce: (1) structural reforms to strengthen key markets (products, service, housing) to increase investments and boost growth; (2) effective mechanisms to address long-term external imbalances, including in surplus countries since current account imbalances lead to asymmetric adjustment in monetary unions too.

In order to restart economic growth, there is a need for both traditional demand management policies and pure supply-side economics. Demand is crucial and this requires growth-orientated macroeconomic policies: the fiscal policies of EU member-states must be coordinated and trade balances narrowed symmetrically. Countries with imbalances will have to demonstrate how they intend to close them, with the onus being as much on those running trade surpluses as those with deficits.

The other challenge is how to implement simultaneously a sort of Schumpeterian supply-side policy. A classic example in this direction is a substantial increase in investments for the single market infrastructures (material and immaterial). It would bring great benefits by boosting demand in the short term and by raising the European Union's potential output in the long term.

Under present conditions, the market alone cannot produce a demand recovery rapidly enough by itself due to the current imbalances and divergent growth pattern in Europe. And it cannot produce structural adjustment until a demand recovery is well underway. Even as structural reforms are implemented, they only pay off in the long run but slow growth in the short to medium term tends to fuel austerity fatigue and political risk. This is even more so the case with the lack of aggregate demand at the global level given the deleveraging of households and governments and the glut of capacity due to the massive overcapacity in China and in other Asian countries. The need for balancing trade within the eurozone should be made compatible in order to achieve a new overall global equilibrium. In the past, the eurozone has largely balanced trade with the rest of the world, although countries like Germany have run large trade surpluses against the rest of Europe. One should avoid transforming the eurozone as a whole from a region with balanced trade with the rest of the world to another region of trade surpluses and export-led growth like East Asia. That would destabilize the world economy even more and hurt global growth.

Therefore, it is essential that eurozone countries put in place a comprehensive policy response geared at speeding up and improving intra-area regional adjustment mechanisms. The present zero-sum game approaches will be very risky for the stability of the euro area and the rest of the global economy as well. New policy priorities are thus required in the eurozone that put more emphasis on cooperative games in convergence and competitiveness.