The Eurozone: How to Grow out of the Crisis?

Peter Wolff *Head of World Economy and Development Financing, German Development Institute*

The G-20 Summit in Cannes last November was overshadowed by the eurozone crisis. Since then there have been several instances where drastic measures have been pushed through a cumbersome European negotiation process: (1) the European fiscal compact, introduced in order to create trust in the long-term fiscal stability of the eurozone; (2) the three-year longer-term refinancing operation (LTRO) of the European Central Bank, which is supposed to give a lifeline to the European banking system and thus indirectly to the governments of the crisis countries; (3) the second rescue operation for Greece which entails a debt write-down of around €100 billion; and (4) the decision to increase the financial firepower of the European Financial Stability Facility (ESFS) as well as the International Monetary Fund, the latter with financial support also from China and other emerging countries.

During the IMF and the World Bank spring meetings, the German government in tandem with the European Central Bank voiced confidence that with those measures enough had been done to stabilize the eurozone. Therefore, the eurozone would not stand in the way to global financial stability anymore. Other countries and regions would have to bring their house in order and reduce their public debt as was agreed to at the G-20 Toronto Summit in 2010: "advanced economies have committed to fiscal plans that will at least halve deficits by 2013…" However, only a few days after the spring meetings, the crisis of the eurozone was back with sovereign bond spreads in Spain and Italy again growing and financial markets jittering. It has become clear that the European fiscal compact and the financial firewalls are not sufficient to create trust in the longer-term solvency of the European crisis countries. Continued austerity leads to a continuing increase in the debt ratio and will neither create the economic nor political conditions for Southern Europe to regain the competitiveness that is required for the internal rebalancing of the eurozone. Against this background, it can be foreseen that the eurozone crisis will again be the main subject at the June G-20 Summit in Los Cabos.

Austerity versus Growth

In the run-up to the national elections in France and Greece, the public discourse on the eurozone crisis had already changed. It became clear that the austerity strategy of the German government was losing political backing, not only in the Southern European countries. Suddenly, everybody was talking of a growth strategy and even the German government got prepared to negotiate on specific measures for growth in the framework of the European Union, with the new French government as the driving force. This was actually a welcome development for the German government, which became increasingly isolated, to moderate its "bad cop" image in Europe. In the discussion about a European growth strategy, Germany could show its goodwill—"who could be against growth?"—and still insist on the principles of the European fiscal compact which had been signed by 25 member states only on March 2, 2012 and still needs to be ratified by national parliaments.

The interesting question will be whether the fiscal compact, calling for sanctions on those member states that fail to meet targets, will be compatible with growth measures that require higher spending or whether it will fail before it has even come into force on January 1, 2013. Growth measures without neglecting the fiscal targets can be made possible only with off-budget instruments, such as increasing the lending capacity of the European Investment Bank (EIB) or creating new instruments such as the "European project bonds", which would not be accounted for in the public budgets. But will this strategy—targeted investments in infrastructure projects which would take years to materialize—break the vicious circle of recession, increasing debt and loss of trust in the financial markets that had rendered the European rescue strategy ineffective after two years of crisis management? Most probably, it would be again too little, too late, and therefore not the appropriate strategy to generate growth in the short run.

Breaking the Vicious Circle

If a policy of breaking away from the fiscal compact is ruled out, there are basically two core elements of a renewed strategy that would have to be introduced: (1) a policy to delink the weak financial sectors from the public budgets and thus regain the trust of the financial markets in sovereign bonds and (2) a policy to restructure and reduce the public debt in the crisis countries, instead of relying on continuous liquidity measures such as the purchase of sovereign bonds by the ECB, which is a feasible but unsustainable solution to keep the Southern European countries afloat.

The first strategy—stabilizing the financial sector, particularly in Spain—is already under intense discussion, particularly since it has become clear that despite the efforts of the ECB a credit crunch is looming and banks will not be able to raise enough funds in the market for meeting the targets under the Basel III standards. Since the EFSF and its successor, the European Stability Mechanism (ESM), to be operational by July 2012, in their present legal form cannot be used to recapitalize European banks, another instrument will have to be created to fulfill this function or the rules have to be bent somewhat to make the use of the ESM for bank recapitalization possible. In the past, European governments as well as the banking industry have continuously resisted a European solution to the weakness of the banking system since the financial crisis. A U.S.-style solution such as the Troubled Asset Relief Program (TARP) of October 2008 was ruled out. Now it is clear that there is no alternative to a European instrument of bank recapitalization if the eurozone is to survive because the financial interdependence of weak sovereigns with weak banks has turned out to be the crucial bottleneck for regaining the trust of the financial markets and returning to market-based financing of the public sectors. This will entail additional financial contributions from member states through the ESM or another vehicle as well as changes in the European system of banking supervision and regulation. In addition, it will entail an intrusion into the sovereignty of countries whose banks will benefit from the fund. Both will require bold steps which will be resisted by those who prefer a continuation of the "easy credit" strategy with unlimited firewalls and the ECB purchasing of sovereign bonds—in other words, further debt monetization.

A strategy to restructure and reduce the public debt of European countries and break the cycle of spiraling debt in low-growth economies has been proposed by the German Council of Economic Experts in November 2011.[1] The proposed Debt Redemption Fund—modeled after a fund for the restructuring of U.S. government debt after the War of Independence—would entail a joint liability for all debt of eurozone countries surpassing 60 percent of their GDP and would require strict fiscal discipline as well as a medium-term consolidation and growth strategy for the participating countries. Due to the notion of joint liability in this proposal, it was ruled out immediately by the German government and met with fierce opposition by a large part of German economists. However, in contrast to the various proposals for a Eurobond, the joint liability would be valid only on past debt and it would thus recognize the construction failures of the eurozone, which are the responsibility of all eurozone countries. The mutualization of future debt, still anathema to Germany, is still a far way off because it will require legal and institutional changes ensuring strict surveillance of member states' fiscal policies even beyond the fiscal rules of the fiscal compact.

It appears that both pillars, a bank recapitalization fund and a temporary joint-liability fund for refinancing public debt, will be necessary to regain space for the private and public sectors in order to avoid a continuing downward adjustment, particularly in Southern Europe, without jeopardizing the fiscal compact. It will also be crucial to end the period of financial repression where banks focus on carry trades on the basis of near-zero interest rates with negative long-run effects on capital allocation. Banks would be in a position to resume lending to the private sector and the public sector would gain space through lower interest rates on its debt.

In an ideal world, both policies would have been part of a comprehensive rescue strategy for the euro two years ago when the ECB started purchasing sovereign bonds because there was no alternative to avoid a "sudden stop" in the refinancing of banks and governments. German economists in particular have always viewed the ECB's policy with skepticism. Axel Weber and Jürgen Stark resigned from their posts of members of the ECB Governing Council mainly for that reason. But they were not able to propose a feasible rescue strategy apart from a massive downward adjustment in the form of "internal devaluation" in the crisis countries which, without complementary measures, is putting enormous political pressure on those countries and may eventually lead to the break-up of the eurozone.

The Politics of Eurozone Reform

A quick solution of the eurozone crisis has been hampered by various factors, not least the German government's hesitation to accept any "grand solutions", such as outright purchases of government debt by the ECB or the issuance of "Eurobonds". It has to be taken into consideration, however, that it is mainly the German parliament as well as lobby groups and a large part of the economists, including the Bundesbank economists, which are responsible for the somewhat narrow and predominantly national perspective of the economic policy discussion in Germany, which did not allow the government to embark on a comprehensive crisis management strategy.

In the view of a mainstream member of parliament, who had to vote for the substantial capital contributions and guarantees to the ESFS and the ESM, the strategy of muddling through was the only feasible way of moving forward since the financial costs and risks for the taxpayer were perceived as too huge to be digested by a population that had suffered from two decades of reunification "solidarity taxes" and a tough reform program of the labor markets since 2005. A large part of the population had not seen any increase in real wages for many years and was just now seeing the first benefits of labor market reforms in terms of declining unemployment. A considerable part of the working population, particularly in the Eastern part, had to migrate and to completely change their lives in order to regain an economic livelihood in the past two decades. Against this background, it was not possible for the government to ask taxpayers for a higher degree of solidarity for Europe in the framework of a more comprehensive strategy.

Furthermore, there is a broad consensus in the population that government debt—which has been rising inexorably since the 1970s and is up to almost 80 percent of GDP in 2011, higher than in Spain—should be reduced. A national "debt break" meant to prevent any further increase in government debt from 2016 for the national government and from 2020 for the federal states met with a broad consensus in principle in parliament. The notion of intergenerational equity is taken seriously in view of the aging society and the shrinking population. A critical public discussion on the merits of economic growth and on new concepts of measuring well-being beyond GDP-growth contributes to a public sentiment that more growth, particularly growth that is based on credit, will not improve the quality of life.

This is reinforced by the predominant view among German economists that supply-side policies are more effective for growth than any demand stimulus. It is assumed that the liquidity injections by the ECB as well as the support through the ESFS and ESM constitute an incentive for bankers and policymakers in the crisis countries to postpone hard but inevitable decisions. It is argued that without the German rejection of "easy" solutions—such as the introduction of Eurobonds which would entail a mutual liability for new debt without control on the budgetary decisions in other countries—there would have been no radical policy changes like the ones that have taken place in Italy and Spain. However, as the crisis unfolds and political realities change, there will be the willingness to discuss new, more comprehensive steps and also contribute to common solutions as long as there is trust that all sides contribute and that there are no free riders.

Agenda for Growth: Toward a Cooperative Solution

At the G-20 Summit in Los Cabos, the European heads of state will present a European growth compact which will go alongside the fiscal compact. This will constitute yet another intermediate step but not the grand design which would include the two major elements mentioned above: a plan for bank recapitalization and a restructuring of public debt with a joint liability for the debt built up in the past. The political dynamics in Europe will just not allow the region's policymakers to arrive at the necessary conclusion in the short time that has passed since the French and Greek elections. These developments have changed the political realities in Europe. In this context, it will be important for the non-European G-20 members to understand the difficult political economy processes within and between European countries that make the crisis so difficult to manage. Anyone expecting quick fix solutions will be disappointed yet again. However, it can be expected that some breathing space can be won provided that the G-20 will endorse the European proposal in principle and thus reassure financial markets.

It will be essential, however, that the G-20 clearly endorses a stronger role for the IMF with regard to its role in Europe and globally. The Mutual Assessment Process—agreed to at the Pittsburgh Summit 2009 in order to provide the technical analysis needed to evaluate how G-20 members' policies fit together and whether collectively they can achieve the G-20's goals—has not yet become fully operational. The imminent global risks of the eurozone crisis should give the opportunity for the IMF to provide a clear and balanced view on the scope for collective action in Europe and beyond. A coordinated medium-term fiscal policy framework for the eurozone that addresses the weaknesses of the banking sector, provides a financial envelope for the Southern European countries, and is tied to the implementation of structural reforms would give the necessary signal to Europe to get its act together. The IMF has been a junior partner in the "Troika" which devised the adjustment program for Greece—a program which was intellectually flawed because it was based on far too optimistic assumptions on a resumption of growth in a situation of continuous public expenditure cuts. It is time for the IMF to resume its role as an independent multilateral institution with a global perspective. If this will be achieved, it will add to its credibility as much as the reform of its governance which is still to be completed in the years to come.

Endnotes

http://www.sachverstaendigenrat-wirtschaft.de/fileadmin/dateiablage/Sonstiges/chapter_three_2011.pdf