

The eurozone's next decade will be tough

By Martin Wolf

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What would have happened during the financial crisis if the euro had not existed? The short answer is that there would have been currency crises among its members. The currencies of Greece, Ireland, Italy, Portugal and Spain would surely have fallen sharply against the old D-Mark. That is the outcome the creators of the eurozone wished to avoid. They have been successful. But, if the exchange rate cannot adjust, something else must instead. That "something else" is the economies of peripheral eurozone member countries. They are locked into competitive disinflation against Germany, the world's foremost exporter of very high-quality manufactures. I wish them luck.

The eurozone matters. Its economy is almost as big as that of the US. It is three times bigger than those of Japan or China. So far, it has passed its initial test. Nevertheless, the peak to trough decline of the US economy was only 3.8 per cent (second quarter 2008 to second quarter 2009), while the eurozone's was 5.1 per cent (first quarter 2008 to second quarter 2009).

More important than the eurozone's overall performance is what is going on inside the zone. The starting point must be with the pattern of current account deficits and surpluses. In 2006, the zone was in rough balance. Inside it, however, were Germany, with a huge surplus of \$190bn (6.5 per cent of gross domestic product) and the Netherlands, with a surplus of \$64bn (9.4 per cent of GDP). At the opposite end of the spectrum were the capital importers, of which Spain was the most important, with a huge deficit of \$111bn (9 per cent of GDP).

Many have argued that, within a currency union, current account deficits do not matter any more than between Yorkshire and Lancashire. They are wrong. Deficit countries are net sellers of claims to the rest of the world. What happens if people in the rest of the world sell these claims or withdraw their loans? The answer is a recession. But within a country, people can move relatively easily to another region. That is usually far harder across borders. There is another, bigger, difference: the Spanish government cannot respond to the complaints of the **Spanish unemployed** by arguing that things are not so bad elsewhere in the eurozone. It must offer a national solution. The question is what.

Before the crisis, peripheral countries had an excess of demand over supply, while countries in the core were in the opposite position. Since fiscal positions were similar, patterns of private demand had to diverge: in 2006, the private sectors of Greece, Ireland, Portugal and Spain were spending far more than income, while the private sectors of Germany and the Netherlands were spending far less (see charts.)

Then came the crash. Inevitably, it hit the most extended private sectors hardest. Between 2006 and 2009, the private sectors of Ireland, Spain and Greece shifted their balances between income and spending by 16 per cent, 15 per cent and 10 per cent of GDP, respectively. The offset was also quite predictable: it was a huge deterioration in the fiscal position. This underlines a point that economists seem amazingly reluctant to take on board: the fiscal position is unsustainable if the financing of the private sector is unsustainable. In these countries, the latter was just that, with dire consequences, as the crisis made evident.

In its first decade of existence, the imbalances inside the eurozone (and associated bubbles) finished up by doing massive damage to the credit of the private sectors of the booming economies. But now it is damaging the credit of their public sectors. While risk spreads have fallen in financial markets, those on sovereign debt in the eurozone are an important exception. Spreads over German 10-year bunds have soared from what used to be negligible levels: in the case of Greece, spreads recently reached 274 basis points.

The late Charles Kindleberger of MIT argued that an open economy required a hegemon. One of its roles is to be spender and borrower of last resort in a crisis. The hegemon, then, is the country with the best credit. In the eurozone, it is Germany. But Germany is a lender, not a borrower, and is sure to remain so. This being so, weaker borrowers must fulfil the role, with dire results for their credit ratings.

Where does that leave peripheral countries today? In structural recession, is the answer. At some point, they have to slash fiscal deficits. Without monetary or exchange rate offsets, that seems sure to worsen the recession already caused by the collapse in their bubble-fuelled private spending. Worse, in the boom years, these countries lost competitiveness within the eurozone. That was also inherent in the system. The interest rates set by the European Central Bank,

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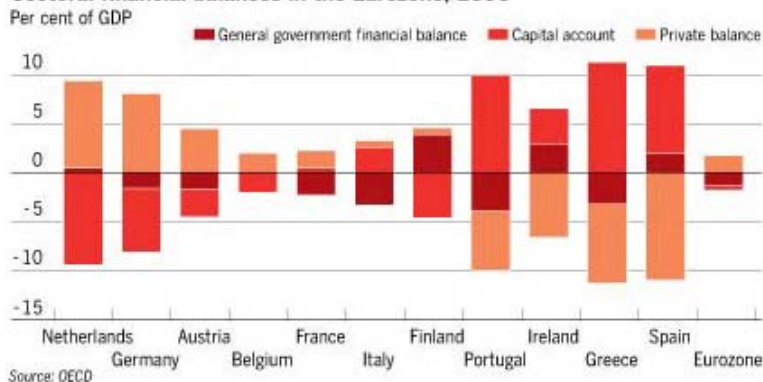
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aimed at balancing supply and demand in the zone, were too low for bubble-fuelled countries. With inflation in sectors producing non-tradeables relatively high, real interest rates were also relatively low in these countries. A loss of external competitiveness and strong domestic demand expanded external deficits. These generated the demand needed by core countries with excess capacity. To add insult to injury, since the core country is highly competitive globally and the eurozone has a robust external position and a sound currency, the euro itself has soared in value.

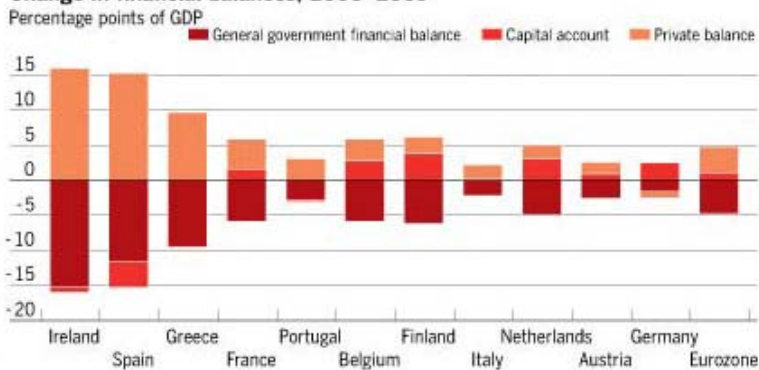
This leaves peripheral countries in a trap: they cannot readily generate an external surplus; they cannot easily restart private sector borrowing; and they cannot easily sustain present fiscal deficits. Mass emigration would be a possibility, but surely not a recommendation. Mass immigration of wealthy foreigners, to live in now-cheap properties, would be far better. Yet, at worst, a lengthy slump might be needed to grind out a reduction in nominal prices and wages. Ireland seems to have accepted such a future. Spain and Greece have not. Moreover, the affected country would also suffer debt deflation: with falling nominal prices and wages, the real burden of debt denominated in euros will rise. A wave of defaults – private and even public – threaten.

The crisis in the eurozone's periphery is not an accident: it is inherent in the system. The weaker members have to find an escape from the trap they are in. They will receive little help: the zone has no willing spender of last resort; and the **euro itself is also very strong**. But they must succeed. When the eurozone was created, a huge literature emerged on whether it was an optimal currency union. We know now it was not. We are about to find out whether this matters.

Sectoral financial balances in the Eurozone, 2006



Change in financial balances, 2006-2009



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