The Wolfson Prize

'If member states leave the Economic and Monetary Union, what is the best way for the economic process to be managed to provide the soundest foundation for the future growth and prosperity of the current membership ?'

1. The present economic and financial structure of the Eurozone (EZ) is not sustainable. The operation of the Euro since its launch has led to economic and financial paralysis in the Eurozone.

2. The features of the problem

a) The operation of the Euro since its launch in January, 1999, has led to persistent and growing economic and financial imbalances between two member groups of the EMU, the competitive northern bloc (NB) centred round Germany and the Netherlands, and the southern bloc (SB), consisting of Italy, Spain, Portugal and Greece, with Ireland as an additional member. France is for the moment in neither group.

The causes of these imbalances, which have now reached crisis levels, are:

i) growing current account deficits for the economically weaker members of the EMU (Greece, Portugal, Spain, Italy and Ireland), and, correspondingly,

ii) growing current account surpluses for the economically stronger members (chiefly Germany, the Netherlands).

b) The single currency structure has enabled the deficit countries to finance their growing deficits without difficulty by borrowing from banks and other financial agents in, chiefly, the surplus economies because these agents interpreted the single currency structure as a solid framework eliminating or reducing to irrelevance the financial and credit risk of the borrowers.

This misjudgment was encouraged by certain structural features of the EMU, adopted in 1997. These were:

i) the Stability & Growth pact, a commitment on the part of EMU members to limit annual budget deficits to 3% or less of their GDP and to limit the maximum level of their sovereign debt to 60% of GDP,

ii) the creation of a central bank for the EMU, the European Central Bank, established in 1998, based in Frankfurt and given in its articles the primary objective of maintaining price stability. The bank was also prohibited from financing the debts of its member countries, with the intent of avoiding weaker members using the ECB to finance their deficits.

These operating factors, and particularly the ease of borrowing from surplus countries, led to the build-up of the present very large debts of the deficit EZ members.

c) The sums now outstanding are very large, in most cases approaching or exceeding 100% of the GDP of the debtor countries (multiple data source). As a matter of simple arithmetic, if a country (or any borrower) pays more on its debt than its growth or earnings rate, it will in due course be unable to pay its debts and will default or need to restructure them. This is the present position of the following Eurozone members: Greece, Portugal, Ireland, Italy and Belgium, with France looking likely to join the group soon and Spain in due course.

3. The fundamental cause of the growth of the imbalances

The fundamental cause of the growth of the current account imbalances has been the increasing divergence in productivity between the competitive 'Northern Bloc' countries (NB) and the Southern Bloc (SB) since the launch of the Euro. (For a succinct and thorough analysis of the reasons for the growth of the imbalances see a recent Working Paper (No. 702, The Euro Imbalances and Financial Deregulation: a Post-Keynesian Interpretation of European Debt Crisis) of the Levy Economics Institute (http://www.levyinstitute.org).)

The view that the major reason for the growth of the imbalances has been lax economic and financial management on the part of the deficit countries, held firmly by Germany, the dominant EZ economy and looked to as the potential saviour of the Euro, is simply inaccurate.

4. Necessary conditions of a sustainable solution to the problem

A sustainable solution to the problem must enable the deficit/SB countries to return to durable economic growth. This is a necessary condition of any valid and viable solution - socially, politically and financially. Without this no solution has a realistic chance of working or of being successfully implemented. Enabling a return to durable growth on the part of all the present EZ membership is, therefore, a necessary condition of any realistic, valid proposal for the management of the departure of any EZ member.

5. Current proposed solutions to the problem

a) Fiscal Union

A fiscal union between the EZ members, as presently proposed in the draft Fiscal Pact, will not solve the problem. Even if it were achievable politically (and leaving aside the fact that it would constitute the complete suppression of democracy and democratic accountability in the continent which can fairly claim to be the birthplace of democracy), it would be no more than an evasive pretence: that the present members of the EZ, jointly, are financially and economically strong enough to meet by fiscal transfers all the needs of the countries in economic difficulties.

The essential feature of a viable fiscal union must be to provide a structure for the transfer of tax surpluses from one or more economically strong members to members with large fiscal deficits. At present the only country in any position to make significant transfers to the many countries in deficit is Germany. Germany's finances are much too inadequate to fund the transfer payments which will be necessary; the German economy is simply too small, even if we ignore the clear statements from Angela Merkel that such transfers are out of the question.

Aggravating this difficulty is the fact that the EZ is entering what may be a serious recession. Growth forecasts for all the major economies in the EZ (Germany, France, Italy, Spain) have been steadily reduced and the EZ as a whole is now predicted to record negative growth for 2012.

EZ unemployment is not only at unprecedented levels but is increasing (e.g. France, where present unemployment is at the highest level since start of the Fifth Republic and Spain, where unemployment has now reached 23%). This will further reduce any potential fiscal surpluses available to fund transfers. The worsening recession also discredits the idea that, with taxing powers exercisable over all EZ members, a central EZ tax authority will be able to extract tax easily from EZ citizens.

The proposed terms of the Fiscal Pact, as far as they are known, include procedures for punishing backsliders which are similar to the penalties of the Stability & Growth Pact accepted by EZ members at the launch of the Euro. These were misconceived and unworkable and were regularly ignored, not least by Germany and France.

It should not be forgotten that as recently as 1999 the entire Santer European Commission was obliged to resign en masse amid allegations of endemic corruption. Historically, less than 10% of the expenditure of the European Commission has been approved by the Commission's own Court of Auditors as having been properly spent. Empowering a group of unelected bureaucrats in Brussels to impose taxes on the 450 million citizens of the EZ and enforce their decisions in the courts should be utterly out of the question.

Fiscal Union therefore is not a solution.

b) European Financial Stability Facility/ European Stability Mechanism

The EFSF/ESM proposal is also a non-starter as a solution to the problem.

i) the proposed capital resources of the EFSF and ESM, even if increased to Euros 1 trillion, are much too small to fund the outstanding debts of the EZ deficit members and establish a solid base for growth and prosperity. A recent paper by the Peterson Institute (Policy Brief no PB12-4: The European Crisis Deepens, by Peter Boone and Simon Johnson, available at http://www.iie.com/publications) estimates the probable funds needed simply to backstop the present debt of Italy, Spain, Ireland, Greece and Portugal at between Euros 2.3 and 4.3 trillion depending on the severity of the crisis. (This paper also confirms the analysis that a divergence in productivity/labour costs was the key reason for the growth in imbalances.)

ii) even supposing such sums could be raised, simply funding the present debts of the Club Med countries would be no more than a temporary sticking plaster and would not constitute a durable solution to the problem. The hope that underwriting the existing debt of the CM would give them time to put their finances in order and modernize and restructure their economies is no more than pious wishful thinking, particularly if these countries are struggling with the effects of severe austerity programmes. Such transformations would take decades to implement even with domestic political support.

iii) the joint structures of the EFSF and ESM entail the pro rata liability of each EZ member. There is therefore an inherent circularity of liability as Italy, for example, is required to finance or guarantee its large proportion of the capital and debt of the EFSF and ESM in order that these entities in turn can bail out Italy. It is the potential risk implicit in this structure which has led to rising market doubts about the financial consequences for Germany as the largest EZ member. Credit Default Swap rates for Germany have now exceeded for several months those for the UK.

c) a joint Eurobond

This proposed solution fails for the same reasons as the Fiscal Pact.

It would not be remotely large enough, would not attract investors except at less than AAA rates and suffers from the same structural circularity as the EFSF/ESM. The assumption behind this proposal seems to be that a joint financial obligation of all the EZ members will deserve a higher credit rating than the members separately. Since many of the members now have junk bond credit status this is delusional.

d) the ECB

i) the proposal that the ECB act as a traditional, central bank lender-of-last-resort to the member countries of the EZ, standing ready to acquire any obligations of these members as required by market conditions also fails as a solution to the problem.

Financing the debts of the debtor EZ members will not generate growth and would be no more than another financial sticking plaster. Even supposing the present ECB constitutional ban on financing sovereigns could be overcome and the German Constitutional Court (and public) be persuaded, the implementation of a lender-of-last-resort obligation would see the balance sheet of the ECB explode with, in the absence of growth, no realistic possibility of reduction. The problem of circularity would also arise again.

ii) the LTRO: introduction of the 3-year LTRO by the ECB has successfully reduced, though not eliminated, the funding problems of the EZ banking systems. The EZ interbank system had effectively shut down, as even the largest banks refused to risk lending to each other even overnight. So far approximately Euro 490 billion has been taken up by EZ banks and a further amount will be offered in February.

Banks are using this funding to help meet repayments due on their outstanding debts; they are not using it to increase lending. Furthermore, as an additional constraint on lending and growth, EZ banks are required to meet the Basel III capital adequacy levels by June 30th of this year and are as a result aggressively shrinking their balance sheets by selling assets. The economic consequence is a severe and growing credit squeeze on European industry and a further intensification of recession.

The LTRO is, therefore, simply another financial sticking-plaster; it is not, as some wish to believe, a solution to the fundamental EZ problem and, above all, not a basis for growth.

e) Austerity

So far the main thrust of the proposals made by Germany, now emerging as the acknowledged dominant power in the EZ, is for Greece and the other deficit countries to put their houses in order by bringing their finances into balance, slashing public expenditure, raising taxes, and implementing severe programs of economic restructuring and liberalization.

Austerity is not a viable answer to the EZ members' problems of uncompetitiveness and their need to restructure and modernize their industrial capabilities:

- first, austerity policies of the severity being required by Germany (and also, at least so far, the IMF) will have, and are already having in Greece and Spain, the predictable immediate consequences of further reducing growth and thus worsening, not improving, a country's fiscal position,

- secondly, the financial problem is immediate and, even in the best circumstances, the successful transformation of a country's industrial methods and structure is a process of many years, if not decades (a recent paper by Confindustria, the Italian industry group, and the Bank of Italy has estimated that liberalization of the Italian economy could add 11% to Italian GDP but that it would take more than 30 years to realize),

- thirdly, several of the deficit economies (for reasons of small size or lack of resources (Greece, Portugal), antiquated industrial structures (Italy, Spain)) are unlikely, even given time, to succeed in transforming themselves into vigorous, competitive economies in a world where globalization, the spread of technology and the rise of the super-competitive developing economies like China, Brazil and India are changing the rules of the global economy. Austerity will add to the negative impact of the current, severe, global debt-deleveraging process, slowing global growth (see the IMF latest forecasts) and the secular long-wave shift of economic growth from the present developed economies (the G3) to the other members of the G20.

The implementation of austerity measures has already had a predictably negative impact on the economics of those countries who have implemented them. Spain has just reported a probable fiscal deficit of 8% for the year, 2% worse than predicted earlier; the Greek economy contracted by nearly 6% last year and is expected to lose another 2-3% in 2012, significantly more than expected only in October last year. Austerity is therefore having the diametrically opposite effect to that desired; the public finances of countries which are imposing austerity packages are getting much worse, not better, and the possibility of their repaying their debts much weaker than before

The extremely pernicious social effects of this approach are already evident. Greece risks becoming a failed state. Capital has been fleeing the country (25% of the monetary base has fled in the last two years), strikes are frequent, shops are no longer open, small businesses are failing, public services are non-existent (after salaries were slashed) and social unrest and misery widespread. Similar tendencies are gathering pace in Portugal, Spain and Italy.

The political consequence of the imposition of severe austerity measures has seen elected governments replaced by unelected 'technocratic' regimes in Greece and Italy. Elections are imminent in France and approaching in Germany, Spain, and Italy. The possibility of a comprehensive revolt by electorates against the harsh consequences of austerity measures and against the Euro itself is very high.

Thus;

a) all the present proposed solutions fail to provide a durable foundation for the future growth and prosperity of the present members of the EZ,

But,

b) doing nothing and persisting in the policy of kicking-the-can-down-the-road in the hope that something will turn up is not a realistic or responsible option.

The consequences of doing nothing are already painful and will rapidly become very unpleasant. Failure on the part of the EU authorities to address the problem has led to the creation of zombie EZ economies, sliding into recession, and a zombie EZ financial system with the EZ banking system frozen, no longer operating normally and surviving on the life-support of the ECB LTRO 3-year financing.

A disorderly default by Greece would lead rapidly to the extension of the crisis to Portugal, Spain and in due course Italy. The interest rate for 10-year Portuguese paper has already risen above 15% p.a. and in spite of the ECB 3-year financing, Italy and Spain (and France) are still borrowing at rates which will in due course lead to default.

The alternative, of Germany and the NB undertaking to finance the SB without limit as to time or amount, is utterly unrealistic.

6. A sustainable solution

A valid solution to the problem posed in the Prize question, therefore, must enable the SB countries to return to durable growth.

Without growth the economic and financial condition of the EZ and its members, already critical, will continue to deteriorate.

This will not be possible while they share the same currency as the NB.

The operation of the Euro over the last 10 years has demonstrated that the deficit countries will not achieve durable growth while they remain members of the EZ and share the same currency as Germany and the NB. To continue to do so will simply aggravate their present desperate economic and financial situation. This would be true even if their present debts were reduced to, say, 50% of GDP. The present crisis would in due course arise again after much pain and misery.

7. A separate currency

There are two major possibilities:

a) the SB countries leave the euro and recreate their former separate currencies, leaving the Euro to Germany and the NB.

b) Germany and the NB leave the Euro and recreate a new Deutsch Mark for Germany and the NB (the Netherlands, Belgium and possibly France and Finland), leaving the Euro to the SB.

Of the two possibilities (b) is much the better solution.

Both solutions would achieve the benefits of devaluation. In the case of either (a) or (b) the SB countries would be enabled to return to growth through the fall in their industrial cost structures as their currencies, either individually, or as a jointly held Euro, fell in value in the foreign exchange markets. The enormous advantage of a currency devaluation is that it is immediate and pervasive in its effect. From an economic viewpoint this would give these economies room for maneuver and time to introduce the necessary reforms to their finances and industrial structures.

It is also likely that they would see immediate inward direct investment to take advantage of their new low cost structures.

Advantages of solution (b):

While both devaluation solutions would enable a return to growth, option (b) has the following major additional advantages:

i) it would avoid the very disorderly and costly need to recreate piecemeal the former currencies; the latter move would be seen as the effective collapse of the Euro,

ii) the beneficial economic effects of a devaluation are likely to be very much less in the case where the SB countries readopted their former currencies (option (a)),

iii) it would preserve a major part of the structure of the Euro as a continuing currency,

iv) there would, *pace* the lawyers, be no prima facie breach of contracts denominated in Euros,

v) it would be much less disorderly, financially, socially and politically than (a). Simply continuing to use the Euro will be overwhelmingly less socially disorderly than re-introducing the drachma, peseta, escudo and lira,

vi) importantly, it would enable the less competitive members of the EZ (the SB) to make common cause in negotiations with the other members (see below the proposal for the role of the ECB),

vii) it would thereby enable the important survival and continuation of the 'European Project' (see below).

Financial consequences

There is no durable and realistic solution which does not have negative financial consequences

The consequences for financial contracts (assets/liabilities, contractual liabilities, investments of all kinds etc.) and for national and bank balance sheets would be severe in the case of either (a) or (b). However, resolution of the resulting conflicts and problems would be much more easily achieved in the context of two surviving currencies (the Euro and the new DM) than if all the former currencies were recreated.

The treatment of contracts, assets and liabilities is certain to be the subject of widespread legal action whether the SB leave the Euro or the NB do so. Such limited legal comment as has been made public so far (e.g. Clifford Chance, 'When a derivatives counterparty leaves the Euro', FT.com Alphaville blog of 23/1/12) is, understandably, inconclusive. In the conditions which are likely to prevail, EZ governments will need to collaborate to impose the most workable solutions on debtors and creditors. A dual currency structure, with the surviving Euro and the new DM rather than a reversion to multiple national currencies, would make this process very much easier.

It does not appear fruitful, therefore, to speculate on detailed specific recommendations for the treatment of assets/liabilities or contracts nor on the mechanics of transition other than to emphasize the advantages of potential coordination which would be afforded by the dual currency structure recommended in this proposal.

The major negative f/x effect of the currency restructuring recommended in this proposal would be a rise in the value of the new DM. This revaluation would certainly have unpleasant economic consequences for Germany and the other NB economies. Nonetheless these economies will be better able to adapt to a strengthening currency than the weaker members of the EZ have been to the strong Euro. In effect Germany would face a situation similar to its absorption of East Germany, which it digested over a decade at a cost of Euros 2-3 trillion.

8. The ECB

An additional structural recommendation supporting recommended solution (b) is that the ECB remain the central bank of the surviving Euro and that the Bundesbank resume its former central bank role for the new Deutsch Mark.

There would be a major benefit from a continuing role for the ECB and the recreation of the role of the BUBA. This is that this structure would, crucially, provide a formal institutional forum for policy coordination and collaboration between the two blocs. Specifically, this would help avoid or reduce the disruptive consequences of the new structure and encourage the adoption of policies conducive to the growth and prosperity of the whole EZ.

9. The 'European Project'

Although the major focus of the Prize question is the present economic and financial problems of the EZ, it is of enormous importance to preserve as far as possible a European voice in international affairs. Europe is the birthplace of many fundamental values which its members share (personal freedom, democracy, the rule of law, property rights), and the home of many great nations who can realistically claim that over the centuries and in spite of travails they have together created humanistic civilization. It would be a tragedy if this voice fell silent, particularly in a world undergoing a new wave of change. This is the real European Project in which all its citizens can share and this is why a collaborative solution to the problems of the Eurozone is of the utmost importance.

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