The Eurozone crisis: time for a reset

1. Summary

- The crisis in the Eurozone (EZ) has reached a dangerously unstable condition, politically, socially, financially and economically.

- Without a return to growth in the peripheral economies a disorderly outcome is becoming probable as the debtor countries approach the 100% debt-to-GDP default horizon. They will not return to growth while they share a currency with Germany.

- It is time for a reset.

- The best and least disorderly solution would be for Germany, whose dominant economic competence is at the root of the economic and financial imbalances which are tearing the EZ apart, to quit the Euro, effect a managed re-adoption of the D Mark and commit itself to close collaboration with the other EZ members and the European Central Bank (ECB) to manage the exchange rate structure of the EZ in the interests of the EZ as a whole.

2. The problem: the major economic statistics tell the disastrous story

Intra-zone financial imbalances

These have not improved. The announcement of Outright Monetary Transactions (OMT) by the ECB has reduced and to an extent reversed the volume of funds fleeing the peripheral economies for the core and has reduced somewhat the precautionary balances the banking systems of the peripheral economies are keeping with the ECB.

However, no significant reduction has been made in the Target 2 imbalances which, for Italy and Spain, remain at crisis levels. Furthermore, 10-year bond rates for France and the peripheral economies remain at levels which, taken together with the size of their sovereign debts at above or approaching 100% of GDP, will soon lead to default.

EZ sovereign debt

The table below shows recent figures for the debts, fiscal deficits and growth of France, Italy and Spain:

	France	Italy	Spain
Debt as % of GDP:	90	123	84
10-year bond rate % p.a.:	2.1	4.6	4.9
Fiscal deficit as % of GDP, 2012:	-4.5	-2.8	-7.0
Growth rates % p.a., 2012:	0.0 (falling)	-2.4 (falling)	-1.6 (falling).

Without a strong and durable (and unprecedented) turn-round, France and Spain will therefore reach the 100% debt/GDP default event-horizon within 3 years. Italy passed it some years ago but has hitherto survived thanks to complacent EZ 'convergence' thinking and the fact that much of its debt is held domestically.

Economic growth and growth divergences

Economic growth in the peripheral economies, so far from improving, is getting weaker. The Greek economy is entering depression and Spain and Italy, together with France are in steadily worsening recessions, with unemployment, already at depression levels, moving still higher.

The operation of the banking money multiplier in generating growth by supplying finance to the real economy has gone sharply into reverse, with a severe tightening of borrowing conditions in all the peripheral economies, particularly for the small and medium-sized enterprises which are the major source of new employment.

Austerity

The continued insistence by Germany on austerity for the peripheral economies is having the malign results which were very clearly foreseeable and foreseen at the inception of the Euro: a sharper and sharper deceleration in economic activity. This has revealed the complacent expectations that these countries could work their way out of their economic difficulties as the unrealistic and irresponsible delusions they have always been. Besides an ever-increasing cost in human misery, the prevailing austerity programs are generating ever-larger fiscal deficits, further propelling these countries towards the event-horizon of debt default.

3. Competitiveness

Intra-Eurozone

Since the inception of the Euro, as the data demonstrate, there has been an accelerating divergence in competitiveness between Germany and the peripheral countries, who have seen their labour costs rise by 25-30% or more versus Germany. These divergences are persisting; since the onset of the Euro crisis, now more than 5 years ago, there has been no significant and durable improvement in the competitiveness of any of the peripheral economies. (The recent improvement in Spain has been achieved at the cost of a brutal and worsening recession; it is not a basis for durable recovery.)

More importantly, the chances of these countries successfully modernizing their industrial structures and turning into vigorous mini-Germanys are no better now than at the start of the crisis. The likely mechanics and probable timing of the kind of transformational restructuring which would be necessary in the peripheral economies make it utterly unrealistic to place any confidence in this as a policy for restoring internal balance within the Eurozone.

Even this assumes that the consequences of determined and thorough restructuring do not get disorderly, politically and socially. Besides the recent rise of extremist and separatist parties in Greece and Spain and the reappearance of the discredited Silvio Berlusconi in Italy, recurrent and increasingly violent protests indicate that a durable solution to the crisis must be found by the end of this year at the latest; time is not on the side of the European policy-makers.

Furthermore, even if adopted, the initial effect of any worthwhile restructuring would almost certainly be an additional increase in unemployment and consequent further deterioration in the public finances. It is therefore unrealistic and irresponsible to place faith in this as a durable solution.

External competitiveness

Adding to the obstacles to a recovery in growth in the Eurozone is the continuing long-wave secular shift in competitiveness and growth away from the developed economies towards the developing economies. This shift has all the hallmarks of being a present-day iteration of the fundamental shift in the tectonics of the global economy which took place in the 1870s when the USA first entered the global market place as the new low-cost producer of agricultural and manufactured goods. The effect on Europe, at the time the dominant industrial power, was devastating.

This time around the economic authorities in the developed economies have tried to meet the competitive threat by massive monetary stimulus measures. These moves have chiefly been adopted as a response to the financial crisis of 2008 and the massive accumulation of public and private debt in the developed economies but the persistent lack of any significant recovery after stimulus measures in the $ trillions suggests that the underlying problem is not liquidity but fundamental global uncompetitiveness.

In this respect, while the historically resilient US economy looks better placed to hold its own and in due course adapt and recover, Europe and Japan are failing. With even Germany now slowing, developments at the global level are thus putting additional pressure on Europe's economies and preventing a return to growth.

4. Policy responses

For the last two decades, since the Maastricht Treaty was signed in 1992, the European Commission (EC) has pursued, with steadily increasing political determination, economic policies for the EU aimed at the suppression of free competition between the EU members. The overriding thrust of the sorcerer's apprentice flood of directives and regulations issued by the EC has been to impose, in the name of 'solidarity', an inert uniformity on European economies.

The result has been to discourage competition, except at a lowest-common-denominator level, to institute an inflexible and unadaptable standardization on Europe's economies and to deter growth. The consequence, now visible across the EZ, is growing economic stagnation, a stagnation which is now degenerating steadily into economic recession. Public defence of these policies has increasingly relied on appeals to the importance of 'solidarity" and, more recently, to the 'need for more integration' within the EU and the desirability of the member states surrendering their political authority to the European Commission.

From time to time over the last two decades the European elite have paid lip service to economic reality (and also to democratic accountability). In 2000 they met at Lisbon and undertook to make the EU 'the most competitive and dynamic knowledge-based economy in the world, capable of sustaining economic growth with more and better jobs and greater social cohesion'.

The laughably deficient results, more than 12 years later, are deeply worrying. Growth in Europe, even in Germany, has now turned negative. (The recent speech by David Cameron, the UK Prime Minister, which has been roundly criticized by the EU elite as unacceptable special pleading, voiced real, realistic and justified concerns at the misguided thrust of EU economic policy.)

5. The political context

Germany continues to reiterate its desire that the Euro must survive; 'if the Euro fails, Europe fails' (Angela Merkel). This wish is undoubtedly sincere; Germany does not wish to precipitate the demise of the euro and to be seen, once again, as causing trouble in Europe. Germany has been the major beneficiary of the Euro, with a Euro exchange rate which has been, since its inception, substantially lower than the D Mark would have been.

A fiscal union would rapidly become a transfer union, with Germany looked to as the provider of funds to the deficit countries. Germany is nothing like large enough to play this role, even assuming it was prepared to do so, and calls for Germany to accept it are misguided; thus far it has opposed even a central banking authority. Also, a transfer union would not solve the basic economic problem of unbalanced growth and would not therefore constitute a durable solution to the crisis.

It is undeniable that since its inception the euro has played an important role in encouraging growth in Europe. Although the great unwinding of the panoply of post-war tariff barriers in Europe, propelled by the European Economic Community (EEC), did most of the initial heavy lifting, the ease of commercial exchanges enabled by the adoption of the euro has been an significant element in Europe's more recent growth. Other things being equal, a pan-European currency is economically desirable.

6. Impasse

The present position is therefore as follows:

- economic growth in the EZ is negative and falling, particularly in Greece, Portugal, Spain, Italy and France,
- divergences in competitiveness between Germany and the peripheral economies (and the resulting financial imbalances) are not improving,
- the sovereign debts of many EZ members, including France, Italy and Spain, now approach or exceed the 100%-of-GDP event-horizon, presaging default, as their present 10-year bond yields remain substantially higher than their rates of growth,
- France, Italy and Spain, the second, third and fourth economies in the EZ, are running substantial fiscal deficits and will not return even to fiscal balance while their economies shrink,
- in spite of its negative impact, Germany continues to insist on austerity as the only sound solution to the economic and financial imbalances,
- austerity is now causing severe social and political unrest in the EZ with Greece, Spain and Italy likely soon to be joined in political turmoil by France, as cutbacks take effect,
- all the evidence from economies, financial markets and societies since the start of the crisis has confirmed that the Euro is not simply unworkable in its present structure but disastrously malign,
- the various proposals for remedying the structural failings of the Eurozone as a currency union (fiscal union, a pan-Europe bond, a central banking authority) would have no impact on the fundamental economic problem and are irrelevant,
- the Eurozone elite have decided to ignore reality and maintain the delusional fantasy that time, money and exhortation will solve the problem. It is becoming clear that they are

quite ready to sacrifice the populations of Europe to maintaining the present structure of the Euro,
- the ECB commitment to unlimited buying of EZ sovereign bonds in case of need (OMT) has avoided the short-term collapse of the Euro but is conditional on a surrender of sovereignty by applicants and, even if exercized, would do nothing more than buy time,
- the necessary precondition of a durable solution to the crisis, socially, politically, financially and economically, is that the peripheral economies and France be enabled to return to sustainable growth,
- the overwhelming evidence is that this will not happen while they share the same currency as Germany.

7. A solution to the crisis

The present situation cannot be sustained. It is time to consider what realistic steps might be taken to resolve it.

The necessary conditions of a durable and workable solution to the crisis seem to be:

- that it enable the peripheral countries to return to durable growth and thereby restore their societies to normal life,

- that it provide much more time for these countries to modernize their economies, as compared with the 'cold turkey' austerity imposed by the present strait-jacket of the Euro,

- that it provide time for the banking systems of the Eurozone to work back to both acceptable capital strength (including the substantial writing-off of bad private and sovereign debts) and the ability and will to resume lending.

These conditions will not be achieved unless Germany accepts, in the fundamental long-term interests of the EU and all its members and the desirable survival of the political values Europe represents, that it should enable a fundamental rebalancing of commercial and financial flows within the EZ by re-adopting the D Mark on a managed basis agreed with the other EZ members.

This would enable the peripheral EZ economies (together, perhaps, with France) to devalue significantly and return to positive growth. It would thereby constitute the necessary first step towards a durable solution to the crisis.

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