Europe's Financial Woes[*]

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In a previous conference I attended, mixed with speakers from Asia and Europe, I was struck by the fact that the Asian speakers, in general, seemed to be deeply concerned by the current international monetary system. In contrast, the Europeans who spoke generally thought that the current international monetary system was livable and found it difficult to think of serious improvements that could be made. Of course, this may have been a result of the intentional choice of speakers by the conference organizers. But in any case, I was one of two Americans who spoke at the conference, and my view lies somewhere between the Asians and Europeans. My own view is that the international monetary system—although we do not have a 'system' and I prefer this word over 'regime'—was not deeply implicated in the financial crisis. On the other hand, we have not reviewed it seriously for 35 years, and I think regular reviews, done every 10 or 15 years, should be undertaken of all institutions. Thus, I actually welcome the disgruntlement about the current system not because I think it was a serious cause of the financial crisis, but because I think it is time to review it anyway. However, I am not here to speak about the international monetary system but instead to focus on Europe and its financial woes.

The European financial crisis dates from November 2009 and was an unpleasant surprise to many people. The fall of 2008 and early 2009 was a terrible time for the economy but by the second half of 2009 it looked like so-called green shoots were sprouting. They were not very strong, but nonetheless there were signs of economic recovery. Then came this major setback in Europe.

Fortuitously, I was in Athens in January of 2010 and I learned of the Greek problem just as it was getting underway. At that time I stated that there was a natural solution to this because the international community has a lot of experience with this type of situation. First, the nation goes to the IMF to arrange a large loan. Greece could have done exactly this in exchange for serious fiscal reform. After all, it was clear that these reforms were badly needed.

For reasons that are still not entirely clear to me the Europeans did not take that route. In fact, Mr. Juncker, Finance Minister of Luxembourg—in his role as Chairman of the Committee of Finance Ministers—said, "This is a European problem and the Europeans can solve it." When I heard this my heart sank because the last time I heard that phrase was in 1991 when Yugoslavia dissolved. My response on both occasions was one of disbelief. The Europeans are not set up to solve these problems, and sure enough the Yugoslav problem was not solved by the Europeans. Rather the situation deteriorated and finally NATO, involving the Americans and Canadians, had to take military action.

From my outside perspective, the Europeans dithered for three and a half months and

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unnecessarily converted a Greek crisis into a European crisis, which it had become by May 2010. I am not sure that if the straightforward route had been followed that it would not have become a European crisis because, as we know, Ireland has had some problems intrinsic to Ireland. The same was true for Portugal, Spain, and Italy. However, these nations were greatly aggravated by the turmoil in financial markets created by the mishandling, as I see it, of the Greek crisis. At the end of the day, Greece did go to the IMF with European approval, but 4 months later than it should have. In financial markets 4 months is an eternity, and a lot of turbulence can be generated in that time.

As expected, the Europeans augmented the IMF package with European support funds. A very substantial package was put together—80 billion euros—for a country of roughly 10 million people. Basically, this was designed to buy Greece a three-year grace period to get its fiscal affairs in order and keep financial markets off its back. In the secondary market Greek bonds continued to be priced freely so the financial market reaction could always be monitored, but under the program Greece was not obliged to go to the financial markets to borrow. Of course, the world in recession was not a good environment in which to have a crisis. Greek export earnings, particularly from tourism, were down because of this recession, but the recession did not create the Greek crisis. It was largely self-created. In response, Greece is undertaking a series of absolutely remarkable changes in both its expenditures and taxes.

Two years ago, if you had asked if Greece could have undertaken some of these changes, the answer would have been an unambiguous no. These changes, at that time, were politically impossible. Of course, there are sometimes slippages between actions taken by the government and impact on the economy, and that is especially relevant in the Greek case with respect to taxes. The tax rates have been raised and loopholes have been closed, but these changes have not yet shown up as revenues because Greece has a horrible reputation for tax evasion. So the jury is still out on the effects of the actions taken by the Greek government, but that does not diminish the fact that these measures have been extraordinary.

While Greece was not a charter member of the euro it was the first post-charter member, joining in 2002. Greece has not had its own currency since, and this is a very important background fact. Typically, when the IMF goes into a country that country has its own currency, one of the important steps is to devalue the currency along with making reductions on the fiscal side. The fiscal squeeze results in a negative impact on aggregate demand, while the devaluation of the currency, with a lag of some months, works in the opposite direction. Resources are drawn from the non-tradable sector into the tradable sector. That particular option is not open to Greece unless it leaves the euro. There has been a certain amount of speculation that Greece will do exactly this, but I do not think it will happen. The Greeks will live with austerity as it is politically and economically important to remain in the euro area.

Joining the euro instigated, in an indirect sense, the Greek crisis because the interest that had to be paid on government bonds quickly converged to the interest rate of German bonds. Germany is the biggest, and by reputation fiscally soundest, of the European nations. Between 2002—when Greece joined the Euro—and the summer of 2007, the premium the Greeks had to pay over 10 year German bonds was 26 basis points—almost nothing. So Greece could borrow in worldwide financial markets at very low rates by historical Greek standards, and the interest burden on public debt fell quite dramatically. However, instead of

using that benefit in a constructive way the Greeks abused it by running deficits even during good years and building up their public debt. As we now know, this was a worldwide problem—the under pricing of risk in the middle of the decade. Today Greece pays about 900 basis points above the 10 year German bond. My own judgment is that world financial markets during this crisis, and as a result of the crisis, moved from very substantial under pricing of risk to now tremendous risk aversion and overpricing of risk.

As I said, the European handling of the Greek crisis converted it into a European crisis. After putting together the Greek package, financial markets remained in turmoil, effecting not only Greece but Ireland, Spain, Portugal, Italy, and even Belgium. These are all countries with relatively high debt-to-GDP ratios. Within a week the Europeans had to put together a much larger package should other nations run into trouble. The headline number was 500 billion euros—750 billion if you count the IMF pledge. To use a term from the military, this was a shock and awe approach. Well, it will not surprise anyone to learn that financial journalists did their homework and realized that the 500 billion euro package was not actually 500 billion euros. There were a number of caveats and hedges. Spain was one of the big contributors but was also likely to have to draw on the fund. That does not really make any sense. Removing those kinds of contributions the package was still large, but not as large as the headline numbers.

In the fall of 2010 Ireland drew on this new package. There is a tendency to lump Ireland and Greece together. They are both in some financial difficulty, and bond markets are certainly treating them that way. Spreads have not risen to Greek heights, but they have risen several hundred basis points. However, looking at each country individually reveals significant differences. Ireland, in sharp contrast to Greece, was a booming economy—like the United States, Britain, and Spain. Ireland actually pursued a fiscal policy which appeared to be restrained, but given the very strong boom in Ireland it could have been even more restrained. The debt-to-GDP ratio was much lower than in Greece, but the banks were in serious trouble. The banks had made a lot of development loans for construction and during the financial crisis the government hastily guaranteed all of the liabilities of the Irish banks. At the time it was seen as a mistake that distinctions were not made, and it has proven to be a mistake. Irish public debt has moved from modest levels—20% or 30% of GDP—to much higher levels because the Irish banking system was essentially taken over by the government.

Like Greece, Ireland also took a series of fiscal austerity measures. These were dramatic in detail, but that is less surprising in the case of Ireland because it has a much more flexible economy and is much more flexible politically. Nevertheless, severe fiscal measures were not enough to avoid the need for Ireland to go to the IMF.

Next in line is Portugal, where the prime minister insists that Portugal can handle its own problems. Portugal's situation is somewhere between those of Greece and Ireland. Its debt-to-GDP ratio was lower than in Greece but much higher than Ireland. It did not experience the economic boom that Ireland had, growth was rather sluggish, and the budget situation was not great. Again, this was not as bad as Greece, but not as good as Ireland. Currently, the markets vary in their assessment of that. Portugal does pay a premium for borrowing in the market. It is not as big as the Greek premium, but still several hundred basis points above the German bond. I do not know whether Portugal will need assistance or not but this may be one of those cases where national pride gets in the way of good economic sense.

Portugal is going to go through an IMF-like fiscal austerity on its own and will not get any credit for it. The measures will not be as draconian as the Greeks, but they have taken a number of measures. The difference is that Portugal has to worry monthly about financial market reactions. If I were advising the Portuguese I would advise that they take the loan from the IMF to give themselves some breathing space.

It should be said that Europeans have not been generous on interest rates. They have charged around 5%, which is far below what the Greeks would have to pay in the market, but much above what European borrowing costs are—which are under 3%. The Europeans are charging a penalty rate for use of this package. That actually became an issue during the Irish election. It may not have been a defining issue, but it likely played a role in the former Irish government being unseated. The new Irish prime minister stated that he would lower this borrowing rate, but he lost that battle. Germany and France wanted Ireland to raise corporate tax rates in exchange for a concession on interest rates, and Ireland refused to do this. As a small open economy, Ireland argued, they benefit from attracting foreign investment and they do not want to jeopardize that. Greece actually got a concession of 1% in the same meeting.

The really big country that is seen to be in jeopardy is Spain. It had a huge boom, even bigger than in the United States. A lot of money from Northern Europe flooded into the country to buy vacation and retirement homes, and that bust during the crisis was a big letdown for the Spanish economy. In normal times, the Spanish debt-to-GDP ratio was not especially high and the budget was relatively well-managed. But, like Ireland, Spain found itself with a lot of really bad bank loans. Unlike Ireland and Britain, Spain did not have problems with the major banks. Spain has a lot of savings banks that made a lot of building and mortgage loans which went bad. So the Spanish government is now wrestling with the problem of what to do with these institutions. That is an ongoing process. Unlike Ireland, Spain has not taken over all of the bank liabilities. However, it is an issue of concern because no one is quite sure how it will turn out. Many of these banks are non-transparent, non-public institutions often with complicated ownership structures. So first, a lot of factors have to be considered to determine the risks. Then the Spanish need to figure out what to do about it. This is all ongoing at the moment, and the markets are uncomfortable with this situation. Thus, the premium on public debt has risen significantly, but remains below Greece, Ireland, and Portugal.

Italy and Belgium are also on the radar for problems in the future. Italy has a high debt-to-GDP ratio, and so far Belgium has largely escaped notice, but that is changing. Both countries have serious political problems. Belgium does not have a functioning government, and Italy has a government that *The Economist* thinks is not functioning. So there is still a lot of queasiness about Southern Europe. Every now and again questions are raised about Britain, but Britain still has its own currency and that is helpful. In the meantime, European senior officials have been stewing.

The ECB was founded, wrongfully in my view, with the prime objective of price stability. The charter does not mention financial stability. I believe the prime function of the central bank is to preserve financial stability and be a lender of last resort. Yet, this is not even mentioned in the Maastricht Treaty. Fortunately the ECB is in the hands of seasoned central bankers, including Jean-Claude Trichet. They recognize a crisis when they see one and they have acted astutely. In August of 2007, the ECB flooded the market with liquidity temporarily

in the face of the first credit freezes. This was very sensible but falls outside of the charter of the ECB. I worry that in the long-term, in another two generations, there will be leaders who will have grown up in the Maastricht environment and not have the experience of people like Trichet. That is a possible long-run problem but the recent experience is good experience for the future leaders of the system.

Unlike the Federal Reserve, which in normal time runs monetary policy by buying and selling U.S. securities, the modus operandi of the ECB is different when it comes to the financing of government debt. The ECB engages in its open market operations through repurchase agreements, but the eligible paper for these repurchase agreements is actually decided by the national central banks. So the Bank of Spain determines which Spanish paper is eligible for repurchase by the ECB. Obviously, that was a problem when the market essentially froze up on Greek debt. Again, sensibly in my view—but against all the philosophical principles of the ECB—the ECB began to intervene in government debt. Most of their repurchase agreements are private loans, but the ECB now holds a substantial amount of government debt. It has also been supporting the secondary markets. These operations are special only in the sense that the eligible paper that they have built up has been public debt. Then came a rating's downgrade of Greek debt to make it what would have been ineligible for rediscounting under the ECB rules. In response, the ECB changed the rules and now allow themselves to do repurchase agreements in debt that is, at least by the ratings agencies, below the standards which have traditionally been used. The ECB has come under heavy criticism for this, but I am much more tolerant. I believe that good central banking involves the exercise of discretion guided by the circumstances of the moment rather than hard and fast rules.

However, ECB actions have created a practical problem because it is now a substantial holder of "doubtful" debt. That makes the ECB an interested party in the outcome in a way that it would not otherwise be, particularly on the question of debt restructuring. Should the ECB holdings be considered? If it is excluded, what would be the grounds to do so? There is some talk about a Greek default and some insist that there is no way for the Greek government to avoid this. Yet others are outspoken on why Greek default is highly undesirable and should not take place. I consider default a very harsh word—restructuring is much gentler. There is a lot of experience around the world with restructuring debt. It has been done very badly in some cases, with Argentina being the prime example. In some cases, it has been done so smoothly that most people do not even know it took place. I am not entirely sure whether or not the Greek debt will need to be restructured. It is an empirical question, but I must say that the numbers do not look good.

The IMF program had Greek debt stabilizing at 140% of GDP by 2014. That is very high for a nation paying 5% on its public debt. That is 7% of GDP in debt servicing alone. However, there are complicated definitional questions about what constitutes public debt and what does not, especially when considering state-owned enterprises. Including these, public debt jumps to 150% by 2014.

On restructuring, I do not think that decision should be made right now—they should at least wait until August of 2011. Greece has made a lot of policy changes and the impact of those policies needs to first be seen. The European recovery between now and the 3rd quarter of this year should also be taken into account. By going to the IMF, Greece bought three years to

deal with this problem, but it should not wait the entire three years to decide on restructuring. If restructuring does need to take place it is not the end of the world, but it needs to be done as smoothly as possible. Should the ECB be included in any restructuring? I think it obviously should be, but that is something for the Europeans to determine by themselves.

On my last trip to Europe to attend several conferences, I was struck by the tremendous pessimism of the Europeans. I found myself, as someone from across the Atlantic, being the cheerleader for the euro. I do not believe that the Euro Area will fall apart. I also do not believe that Greece will leave the euro. Restructuring its debt is a piece of cake compared to leaving the euro. Will Germany leave the euro? This is a political issue the Germans have to face. In my opinion, they will certainly not. These are worse than worst case scenarios, imagined when people are feeling the most pessimistic.

Greece, Portugal, and Ireland are left with a serious problem. These countries are uncompetitive within Europe and internationally. While that depends on the exchange rate, this is a classic gold standard kind of case where international competitiveness has to be assured through macroeconomic adjustment and not through changing the exchange rate. That particular route has been ruled out by being a member of the euro. So Greece is going to have a rough decade. Public sentiment in Germany is correct which is that the Greeks have been profligate over the last decade. However, just because they were profligate does not mean that they should not be helped. If it has to be done, it has to be done properly.

While all of this is going on the Europeans have been stewing at the European level. An ad hoc arrangement was created for Greece, and markets signaled very quickly that it was not sufficient. A much larger package was then put together which is due to expire in 2013. So Europeans have been wrestling with what, if anything, will succeed the European Financial Stability Facility (EFSF). On this, there have been major disagreements between northern and southern Europe.

What governance arrangements should be insisted on as a condition for having access to the package? This has to do essentially with Brussels' review of the fiscal policies of the states. There is a general feeling that they need much closer fiscal coordination. I think the degree of coordination of national fiscal policies is highly problematic from a philosophical point of view as the absolute heart of democratic government is taxes and budgets. The more Brussels gets involved in framing budgets and taxes the more problematic it becomes.

So what is Europe going to look like in the long run? There was a time when Europeans talked openly about the objective of a creating a United States of Europe, by very rough analogy—a federal solution with a lot of devolution of authority to the member states but nonetheless within a federal framework. It was never open and shut, but open discussion of that has now disappeared.

Questions & Answers

Q First, if the problem countries in Southern Europe had been able to implement

monetary policy would the current problems have been avoided? Second, having witnessed all of the trouble in Europe after forming the Euro Area, is Turkey still interested in joining the euro?

A On the first question, I think the answer is 'no' simply because European monetary policy has been very easy throughout this period. Independent monetary policy would have done very little beyond what has already been done. That may not continue to be true as there is talk that the ECB will raise interest rates in the near future. I think the big loss in this episode was the freedom to change the exchange rate. In the case of Greece, it had just lost all fiscal discipline. If it had an independent central bank, the central bank would be telling the government that it has to get control of the budget. However, under any circumstance it would be economically easier if Greece had an exchange rate it could devalue.

I am not an expert on Turkey, but the current government is trying to make Turkey more accepting of open adherence to Islam without becoming an Islamic state. When Turkey applied for membership in the EU the Europeans put down a number of conditions for this to happen. Most of these were sensible. The Turkish government undertook a series of legislative actions—including some constitutional changes—designed to facilitate membership. Turkey thinks that the EU has not fully appreciated these changes, and I detect a certain disillusionment among the European-oriented Turks. The Middle East is now in turmoil and Turkey could play a potentially very important role there. The foreign minister is an academic by training and he wants to be friends with all of his neighbors, including Syria and Iran. So at least outwardly, Turkey seems to be turning its attention away from Europe and more towards the Middle East. Some people are interpreting this as Turkey backing away from Europe. I do not know enough about the internal politics of Turkey to have insight on that, but in external Turkish behavior there is more attention being paid to non-European affairs.

Q How do you evaluate the EU's attitude towards Special Drawing Rights (SDR) as a substitute for, or supplement to, the U.S. dollar as a key currency? Second, do you have any thoughts on increasing the role of the yuan in the international financial system?

A Europe is a very diverse continent and on any given issues there will be many views, not a single view. That being said, most people have given the SDR no thought whatsoever. Historically, the German government has been the most hostile toward SDR, with that hostility growing mostly out of the view that SDR would be inflationary. However, any such scenario is extremely improbable. The most probable scenarios assume that the Fed, the ECB, the Bank of Japan, and other major central banks all keep their eye on domestic inflation and under these scenarios SDR are not inflationary. While I do favor giving the SDR a more prominent role I do not see this issue as being at the top of the agenda when looking at the international monetary system.

On the role of the RMB, there are several issues. First, is the internationalization of the currency. China has begun to do that, but they are proceeding very cautiously. China seems to have ambitions which go beyond the current role of the RMB, but my reaction is simple: until the RMB is fully convertible it will not be a key currency. Achieving this is intimately linked

to reform of their domestic financial system which, in turn, is linked to relations within the Communist party. This is not an easy issue to address. There is also a more technical issue with respect to SDR. SDR is now defined in terms of four currencies: the dollar, the euro, the yen, and the pound. Some in China have suggested that the RMB should be added. I am opposed to that so long as the RMB is not convertible. My opposition is predicated on wanting to keep open the option that SDR could become much more important than it is and even be used by the private sector. To keep that option open only convertible currencies should be in that basket due to arbitrage opportunities that would arise. Another question is what would be gained by adding the RMB? In my opinion, nothing would be gained. The RMB is linked to the dollar and its inclusion would not bring the benefit of diversity. Instead, SDR would become more reliant on the dollar.

Q You briefly mentioned long-term status of the euro as a currency. Can it remain the common currency in Europe? Individual countries are taking a hit to their competitiveness and I am unsure how long this can last.

A There has always been a worry that adopting the euro would take away important policy instruments. Europeans decided to adopt the euro on economic grounds neglected by the economics profession—namely efficiency gains. In their modeling, economists assume cost-free markets. But anyone who lives in the real world knows that markets are not cost free. According to economic models there should be no financial industry. So I think the economics profession has understated efficiency gains.

To make an unofficial forecast my guess is that the euro will stay together. The political support is incredibly strong and there have been serious gains. Europeans have become fierce advocates of competition within Europe. Greece will have an uncomfortable decade, but the euro will survive and even thrive. Members who are part of the eurozone but non-members of the euro will increasingly use the euro. So my expectation is that the share of euros in international reserves will rise.

Looking at long-term trends, Europe is in serious demographic decline, as is Japan, Korea, and China. Europe's share of the world economy is going to decline, and it will gradually become less important. In that respect, there is a marked difference between Europe and Japan on one hand and the United States on the other. The United States is not in demographic decline. Yes, the birthrate has fallen over the last few decades but has not dropped below the net reproduction rate, which is 2.1 births per woman. Thus, the U.S. population is stable. On top of that, there are over 1 million immigrants coming to the United States every year. My own view is that the immigrant population is a tremendous source of vitality for the American economy.

Q Why did European countries face such difficulties in such a short period of time? Was this due to the Global Financial Crisis or the common currency? It seems like the phenomenon of contagion.

A I think the crisis, and especially the recession now, is an aggravating circumstance for everyone. To have your own domestic turmoil while there is international turmoil exacerbates

the problem. As I have suggested, there are important differences among the nations having trouble. In the case of Greece, there was great opportunity after joining the euro. Greece misused that opportunity, and it is not alone. In the previous decade, Argentina had the same problem. It was not disciplined fiscally, but paradoxically its interest rates were lowered due to successful monetary reform. Instead of taking advantage of the lower rates to assert serious fiscal discipline it ignored fiscal problems.

Q What are the medium-term and long-term prospects for the UK to join the Euro zone?

A My long-run forecast is that Britain will join the Euro area. The current Tory government is much more hostile to joining the Euro area than the previous government. The developments of the last year will give valid reasons not to join the Euro area. However, I still think that in the long-term Britain will join. It will not be an easy decision, but I think that decision will be made. When the Euro was created there was a lot of concern that there would be a strong negative impact on London as a financial center. So far, that has not come to pass. The main international markets in Europe are still in London, and that pressure to join the euro has diminished.