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The Eurocrisis: Muddling Through, or On the Way to a More Perfect Euro Union?

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USC and the NBER

Abstract*

This paper looks at the short history of the Eurozone through the lens of an evolutionary approach to forming new institutions. The euro has operated as a currency without a state, under the dominance of Germany. This by itself may be good news, as long as Germany does not shirk its growing responsibility for the euro's future. This would require Germany to invest more in upgrading Eurozone institutions and balancing its dominance gains with the economic and political responsibilities that come with it.

Germany's resilience and dominant size within the EU may explain its "muddling-through" approach towards the Eurozone crisis: doing enough to prevent the unraveling of the Eurozone while resisting policies that may mitigate the depth of the crisis if they involve short-run costs to Germany. We review several manifestations of this muddling through process. The challenges associated with managing the growing fragility of the euro may induce a reluctant Germany to face an upcoming stark tradeoff: the vibrant growth of Germany, while running large current account surpluses under a pegged exchange rate with the other Eurozone countries, may come to an abrupt end if the Eurozone unravels. Greater mobility of labor and lower mobility of under-regulated capital may be the costly "second best" adjustment until the arrival of more mature institutions in the Eurozone. Germany's attitude toward the Eurozone resembles the attitude of the U.S. toward the Bretton Woods system in the 1960s—benign neglect of the growing tensions, which led to the ultimate demise of the Bretton Woods system. Chances are that unraveling the Eurozone would be much more costly than the end of the Bretton Woods regime. Recently, one detects green shoots that with proper stewardship may lead the emergence of a more resilient and successful union. One hopes that the Eurozone would use the muddling through process as stepping-stones towards a more perfect euro union, yet hope may not be enough to deliver it.

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The euro – a currency without a state

"After more than seven years, the euro is firmly established as the currency of over 300 million people. Its internal stability is evidenced by the fact that inflation has been steadily low from the very start, despite a sequence of negative price shocks (in particular a continuous surge in oil prices). As an international currency, the euro is second only to the US dollar."

"The EU has always been, and will remain, a unique undertaking for which there are no models that can easily be adopted. It is important to allow an evolutionary process, which is open to further steps of integration, yet safeguards what is already in place and working well, and which assigns competencies to nation states or even regions as appropriate. In fact, we have been in the midst of such a process for quite some time, and Monetary Union is and will remain one of its major success stories."

The opening and the closing of a speech by Otmar Issing, Member of the Executive Board of the ECB, Helsinki, 24 March 2006

The short history of the Eurozone has been remarkable and unprecedented: the euro project has moved from the planning board to a vibrant currency within less than ten years. Earlier concerns about the stability of the transition from national currencies to the euro as well as skepticism regarding the gains from forming the euro were deemed overblown by the mid-2000s. Issing's optimistic 2006 speech reflects well the buoyant assessment of the first decade of the euro—an unprecedented formation of a new currency without a state. Observers viewed the rapid acceptance of the euro as a viable currency and the deeper financial integration of the Eurozone and the EU countries as stepping stones toward a stable and prosperous Europe. The growing current account deficits of GIIPS (Greece, Ireland, Italy, Portugal, and Spain) were caused by borrowing at low sovereign spreads. Intriguingly, GIIPS bonds' interest rates dramatically converged during the 1990s to the German rate [see Figs. 1 and 2]. The IMF's World Economic Outlook (WEO; 2008) viewed emerging Europe's large current account deficits as a validation of the gains associated with "capital flowing downhill,"[1] possibly

[1] WEO (2008, October, page 228) noted "…emerging Europe's ability to borrow foreign capital for long periods suggests that the standard growth model, with capital flowing downhill, remains relevant." "In emerging Europe, the large current account deficits are related to a rapid liberalization of domestic financial markets and open capital accounts, which attracted large capital inflows and prompted a rapid rise of foreign bank ownership. The process of integration into the EU also enhanced foreign capital inflows by improving prospects for economic and policy stability."

dispelling concerns about the limited benefits of importing foreign savings as a means of financing domestic growth.[2] The celebratory assessment of the euro continued well into its tenth-year anniversary,[3] only to crash by the unfolding events of the Eurozone crisis. Fig. 3 shows the association between the current account and economic growth before and after 2009 in the Eurozone and Emerging Markets, illustrating the impact of the euro crisis on reversing the current account - economic growth patterns in the Eurozone.

This paper looks at the short history of the Eurozone through the lens of an evolutionary approach to forming new institutions. This lens provides a useful perspective on the formation of global exchange-rate regimes, currency unions, and the like.[4] It suggests that Issing's optimism on "*The euro as a currency without a state*," overstates the evidence. At best, the euro is *a currency without a state, under the dominance of Germany*. This statement by itself may be good news: Cohen (1994) identified two crucial political characteristics common to sustainable currency unions: first, the presence of a dominant state "willing and able to use its influence to keep a currency union functioning effectively," and second, the presence "of a broader constellation of related ties and commitments sufficient to make the loss of monetary autonomy, whatever the magnitude of prospective adjustment costs, seem basically acceptable to each partner." The growing dominance of Germany in the Eurozone suggests that it may meet Cohen's first characteristic. Yet, Germany would stabilize the Eurozone as long as it does not shirk its growing responsibility for the euro's future. This would require Germany to invest more

[2] Gourinchas and Jeanne (2006) found that the welfare gains in switching from financial autarky to full capital mobility equal a paltry 1% increase in domestic consumption for the typical emerging market. Aizenman, Pinto and Radziwill (2007) and Prasad, Rajan, and Subramanian (2007) noted that fast growing developing countries have tended to self-finance their investment, and run current account surpluses.

[3] See Weber (2008) and Jonung and Drea (2010).

[4] See Aizenman (2012) and for further discussion and references dealing with the evolutionary approach of forming currency unions and new institutions.

in upgrading Eurozone institutions and balancing its dominance gains with the economic and political responsibilities that come with it.

Ironically, there are curious parallels between the global role of the U.S. since the end of the Bretton Woods system and the role of Germany in the Eurozone. The presumption in the 1970s was that the demise of the Bretton Woods system would propagate a symmetric global-financial architecture, where major currencies would freely float against each other. Within two decades, it became clear that in the post-Bretton Woods system, the U.S. had kept its hegemony. The U.S. dollar has retained its position as the leading global currency, with the country enjoying the exorbitant privilege of running current and growing account deficits supported by an increasingly vibrant demand for U.S. government bonds by the foreign central banks, as well as by the private sector in foreign countries [as “safe haven asset”]. The global financial crisis, propagated globally from the U.S., induced a reluctant U.S. Treasury and Federal Reserve Board (FED) to adopt unprecedented steps aiming at stabilizing the global economy.

In the same vein, the presumption was that forming the euro as “a currency without a state” would provide a more symmetric structure to Europe and contain the fear of a German hegemony. This supposition seemed to work in “good times”—the first decade of the euro. The Eurozone crisis put an end to the euro honeymoon, bringing to the fore the key importance of Germany’s economic and political decisions in determining the Eurozone’s viability and future. The challenges associated with managing the growing fragility of the euro may induce a reluctant Germany to face an upcoming stark tradeoff: the vibrant growth of Germany, while running large current account surpluses under a pegged exchange rate with the other Eurozone countries, may come to an abrupt end if the Eurozone unravels.

Germany has not yet been exposed to the full costs of the macro straightjacket associated with the euro. The economic benefits of the Eurozone to Germany and GIIPS were initially frontloaded. Arguably, the improving growth and current account surpluses of Germany during the first decade of the euro were the outcome of earlier investing in structural reforms as well as the euro’s growing credibility at the time. Being a member of the Eurozone mitigated Germany’s real appreciation, in comparison with retaining the Deutsche Mark. For GIIPS, the availability of cheap borrowing at a time of growing optimism about the euro supported growing current account deficits; vibrant consumption and investment, which eventually contributed to unsustainable growth and real estate booms.

Similar to the experience of emerging markets that liberalized financial systems in the 1990s under a fixed exchange rate, the increasing costs of the resultant balance-sheet exposures were below the radar screens of markets and policy makers, until an abrupt stop, which was followed by capital flight crises [Calvo (1998)]. This may reflect a fundamental problem with the pricing of sovereign risk in which the private sector, as the "interest rate taker," overlooks the growing marginal impact of borrowing on sovereign risk [Aizenman (2004)]. This externality also holds under a flexible exchange rate, but has probably been magnified by the economic strength of the Eurozone core and by moral hazard—the presumption that the growing costs of unwinding the euro will induce bailouts down the road. Chances are that the elusive "Great Moderation" did not help by masking the growing tail risks in the OECD countries (Rajan (2005)). The countries joining the Eurozone experienced two decades of growing optimism associated with their deepening financial integration and convergence to low inflation before the Eurozone version of the "capital flight" crisis hit.

The Eurozone crisis forced GIIPS to confront the costs of their excessive borrowing prior to the crisis, as the crisis terminated the countries' easy access to funding their current accounts and addressing their growing fiscal deficits. In contrast, beyond the growing balance-sheet exposure of its financial system, Germany has not yet been fully exposed to the downside risk of higher unemployment and lower growth that has already hit most of the Eurozone countries [see Fig. 4]. The resilience of the German economy probably reflects the advantage of running a sizable current account surplus under a fixed exchange rate with its Eurozone counterparts; the relative efficiency of the German labor market; and the country's specialization in exporting advanced manufacturing products and highly demanded capital goods. Germany's resilience and dominant size within the EU may explain its "muddling-through" approach towards the Eurozone crisis. The muddling-through approach is akin to walking on a double-edged sword: *doing enough to prevent the unraveling of the Eurozone while resisting policies that may mitigate the depth of the crisis if they involve short-run costs to Germany.*

A manifestation of this approach is the revealed asymmetric bias of the European Central Bank's (ECB) inflation targeting. The short history of the ECB reveals a strong deflationary bias, which probably reflects the well-known German aversion to moderate inflation. A hint of this bias is provided in Issing's (2006) opening statement: "*Its internal stability is evidenced by the fact that inflation has been steadily low from the very start, despite a sequence of negative price* *shocks (in particular a continuous surge in oil prices).*" A symmetric inflation targeting would also require an aggressive expansionary-monetary policy in the presence of a sequence of deflationary prices shocks, such as a sequence of lower prices of commodities, and other deflationary developments that impact the Eurozone's consumer price index (CPI).

So far, we have not seen the willingness of the ECB to follow symmetric inflation targeting. Observers have noted that the ECB's revealed inflation targeting is closer to targeting Germany's inflation rather than targeting inflation of the entire Eurozone. While this may not be a surprise considering the bargaining clout of Germany, the resultant low Eurozone inflation—approaching 0.5% as we speak—puts further drag on the adjustment of GIIPS. The net outcome is the continuation of accelerated debt deflation, which pushes the Eurozone toward the Japanese style of lost decades [see iMFdirect (2014)]. The risk of lost decades for the Eurozone is much greater than the risks that faced Japan: low employment and growth in the Eurozone would increase the strength of the "Anti-euro" camp, leading to deeper social and political instability and threatening the survival of the Eurozone.[5]

Another manifestation of Germany's muddling-through approach is the prevalent view that its persistent current account surplus is a reflection of the country's efficiency and is irrelevant to the adjustment challenges facing the global economy, the Eurozone, and GIIPS.[6]

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[5] There are several key differences making lost decades much more destabilizing in the Eurozone than in Japan. Unlike the Eurozone, Japan is a mature currency and fiscal union of its 47 prefectures, a country with large net foreign asset position, and overall homogenous population and economic structure.

[6] The debate about the merits of current account imbalance is as old as the debate about the merits of financial integration. Supporters of current account surpluses tend to focus on competitiveness as the key driver of surpluses, viewing it as a virtue [see Schäuble's FT September 16, 2013 column]. Opponents of current account surpluses focus on the truism that current account surplus reflects the excess of saving over investment [see Wolf's FT September 16, 2013 column]. On balance, this debate is less relevant at times of strong global growth, but at times of global deflationary stance; the global adding up property, stating that sum of global current accounts is zero, matters. It implies that current accounts of large countries matters in the

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Approaching the fifth year of the Eurozone crisis, one detects green shoots that, with proper stewardship, may lead to the emergence of a more resilient and successful union. Recent output projections suggest that the worst may be over for GIIPS and recovery may be around the corner. Their primary fiscal deficits stopped have been drastically trimmed and are moving toward surpluses. GIIPS are also gaining access to borrowing at declining sovereign spreads. These developments may be the bonus of the "positive contagion" triggered by Draghi's policy stance. The challenges facing the ECB and Germany is to do what it takes to prevent a reversal of these gains. The tentative recovery of GIIPS may be threatened if and when global interest rates rise, or when the risk tolerance towards GIIPS debt deteriorates. The chance of pushing these countries' future to the wrong side of the debt Laffer curve would be mitigated by a greater willingness for debt concessions tied to deeper structural reforms. The mixed messages from Germany regarding its lackluster support of Draghi's policies, including the country's constitutional court "thunderbolt" ruling in February, is the "elephant in the room," raising serious questions about the durability of any green shoots.

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global distribution of employment and economic activities. The sheer size of Germany suggests that its current account surpluses have a non-trivial effect on the Eurozone and the global economy [see Fratzscher's November 18, 2013 FT column]. At times of global deflationary pressure, global employment is not a zero sum game -- higher investment and lower saving in surplus countries would help in mitigating global protectionist threats and underemployment pressures.

In the same vein, the Balkanization of the banking system induced by the Eurozone crisis is also a double-edged sword. Rapid financial integration in the Eurozone prior to setting efficient and prudent supervision helped contribute to over-borrowing by GIIPS. The challenge facing the Eurozone financial system remains that of finding a healthy balance between banking integration and prudent regulations. This challenge remains a work in progress in both the U.S. and the Eurozone, and the hope is that GIIPS greater access to renewed borrowing will not backfire down the road.[7] An underappreciated development has been the growing mobility of labor in the Eurozone and in the rest of the EU.[8] Although this mobility is mostly confined to younger workers and immigrants, it facilitates easier adjustment and increases the flexibility of labor markets. Greater mobility of labor and lower mobility of under-regulated capital may be the costly “second best” adjustment until the arrival of more mature institutions in the Eurozone.

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[7] The banking system of the US was ‘Balkanized’ during the three decades post WW II. While this system came with its costs, the US grew at a healthy rate during that period. The deregulation of the US banking system in the 1990s came with its short term benefits, and the longer run costs. Chances are that the growth challenges of countries are less the balkanization of their banking and financial systems, and more their structural distortions.

[8] Jauer et al. (2014) reported “there is tentative evidence that the migration response to the crisis has been considerable in Europe, in contrast to the United States where the crisis and subsequent sluggish recovery were not accompanied by greater interregional labour mobility in reaction to labour market shocks. Our estimates suggest that, if all measured population changes in Europe were due to migration for employment purposes – i.e. an upper-bound estimate – up to about a quarter of the asymmetric labour market shock would be absorbed by migration within a year. However, in the Eurozone the reaction mainly stems from migration of third-country nationals. Even within the group of Eurozone nationals, a significant part of the free mobility stems from immigrants from third countries who have taken on the nationality of their Eurozone host country.”

Looking forward, one hopes that the Eurozone will use the muddling-through process as a stepping-stone toward a more perfect euro union. The challenges facing the Eurozone are not unforeseen or unprecedented. The history of other unions provides examples where crises, with the proper leadership, created new institutions and upgraded existing ones in ways that increased their resilience.

European Commission President Romano Prodi stated in 1999, “I am sure the euro will oblige us to introduce a new set of economic policy instruments. It is politically impossible to propose that now. But some day there will be a crisis and new instruments will be created.” **Well, the crisis has arrived, the barbarians are at the gate, and it’s high time to follow Prodi’s dictum.**

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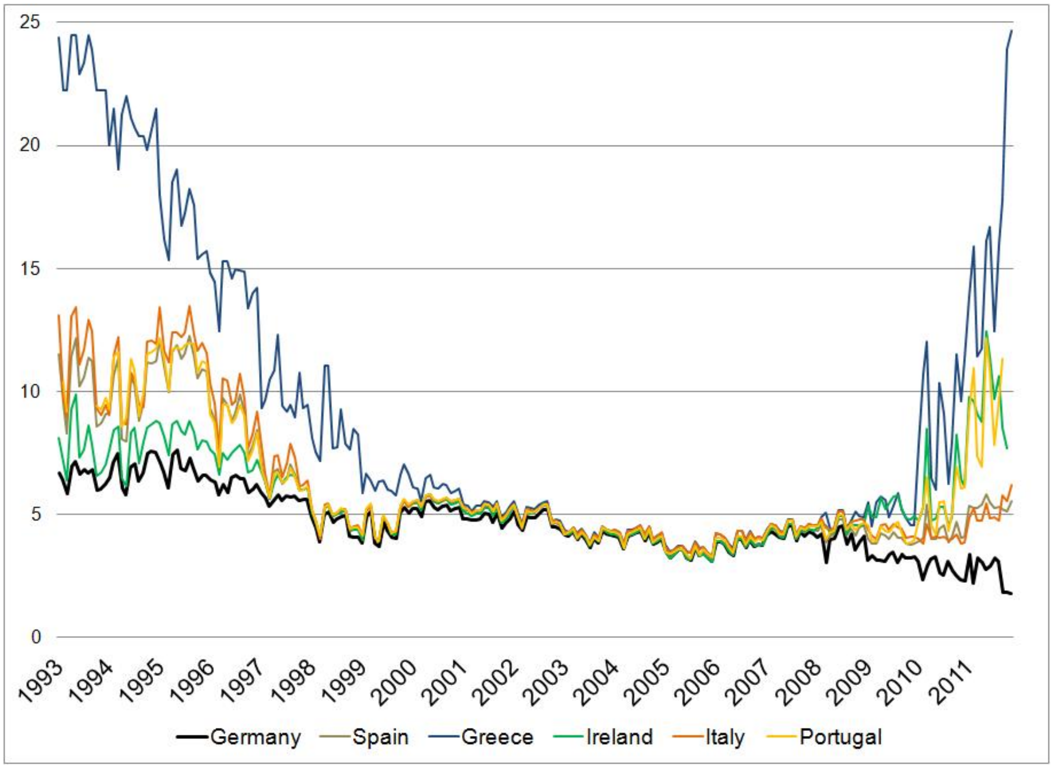


Figure 1

GIIPS and German Government Bond Rates [Source: European Central Bank, Bloomberg, http://iuwest.wordpress.com/]

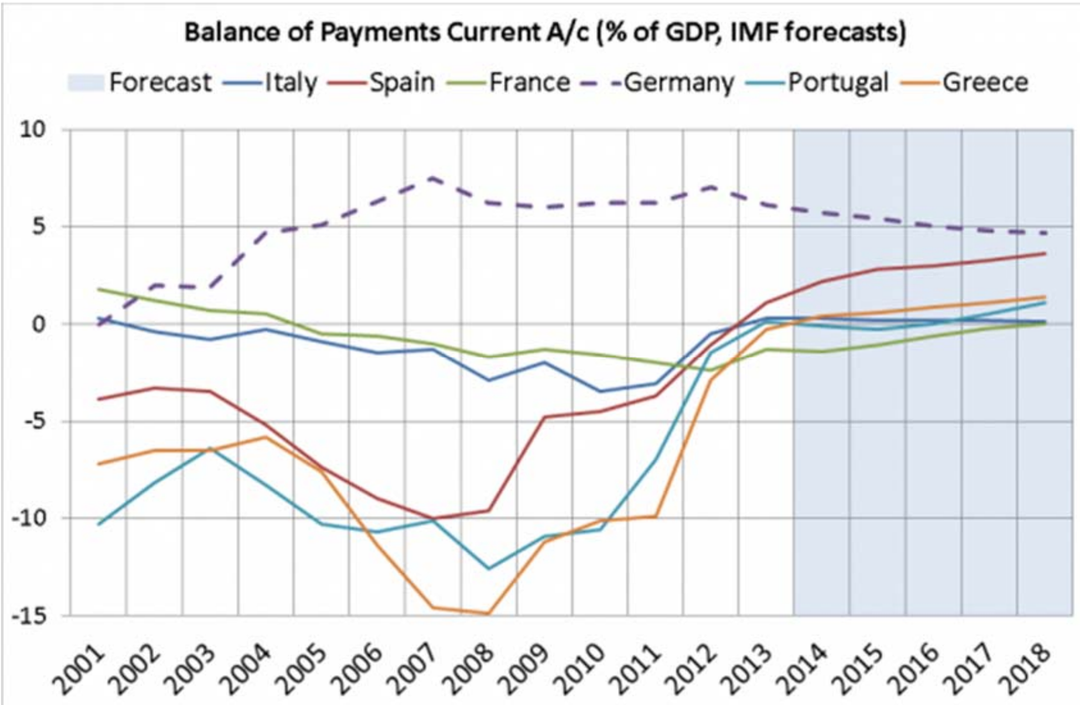
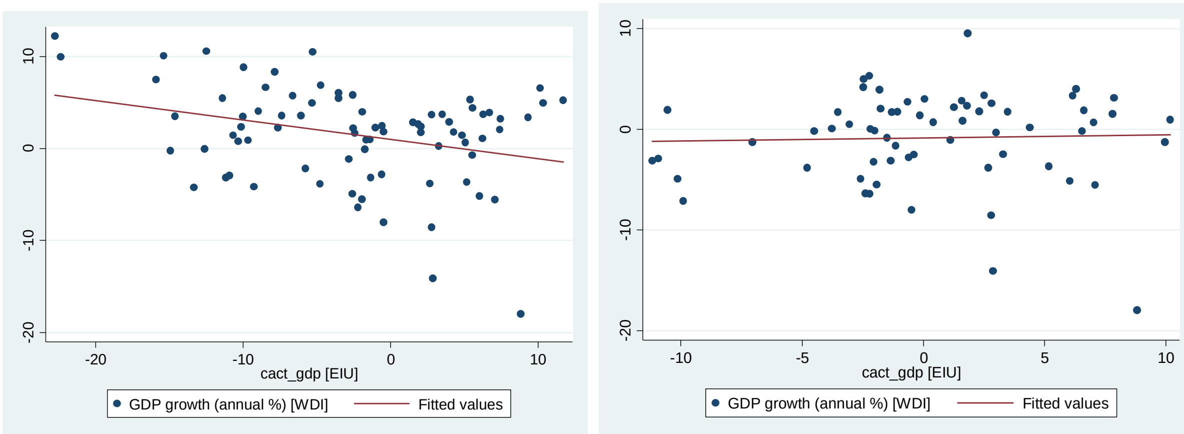


Figure 2

GIIPS and German current account/GDP [source: FT, Gavyn Davies]

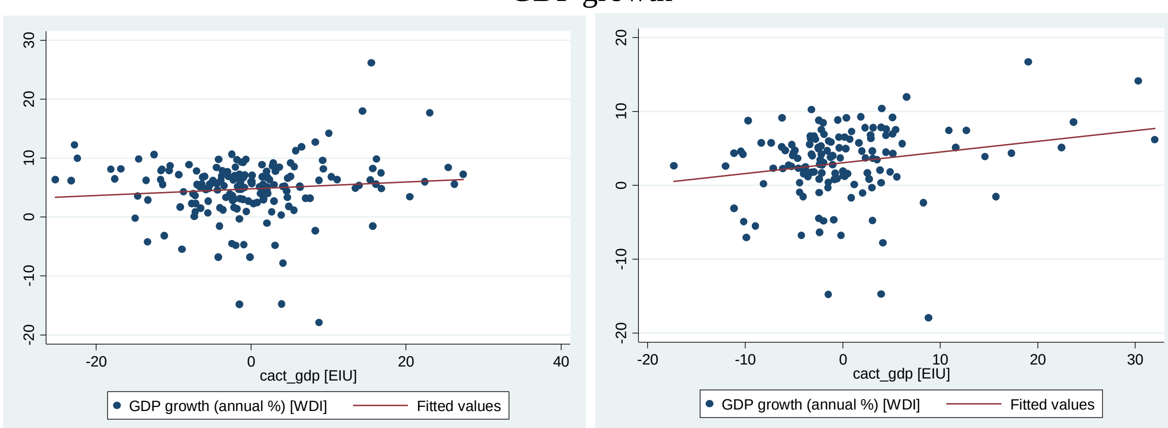
Figure 3a: Eurozone - the association between current account surplus/GDP and Real GDP growth, before and after 2009 [9]



2005-2009 Slope: -0.211, P-value: 0.005

2009-2013 Slope: 0.03, P-value: 0.8

Figure 3b: Emerging Markets - the association between current account surplus/GDP and Real GDP growth



2005-2009 Slope: 0.06, P-value: 0.18

2009-2013 Slope: 0.15, P-value: 0.01

[9] Source: Aizenman and Koo (2014), in progress. Data Sources WDI, IFS and EIU
Emerging Markets: Emerging markets categorized by Dow Jones (as of 2013) plus markets categorized by Prasad (2014, countries that meet the cut off of annual per capita income of $16,000 in 2012)
Argentina, Brazil, Bulgaria, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Jordan, Kazhkstan, Kenya, Latvia, Lithuania, Malaysia, Mexico, Morocco, Nigeria, Pakistan, Peru, Philippines, Poland, Quatar, Romania, Russia, Saudi Arabia, South Africa, South Korea, Taiwan, Thailand, Turkey, UAE, Ukraine

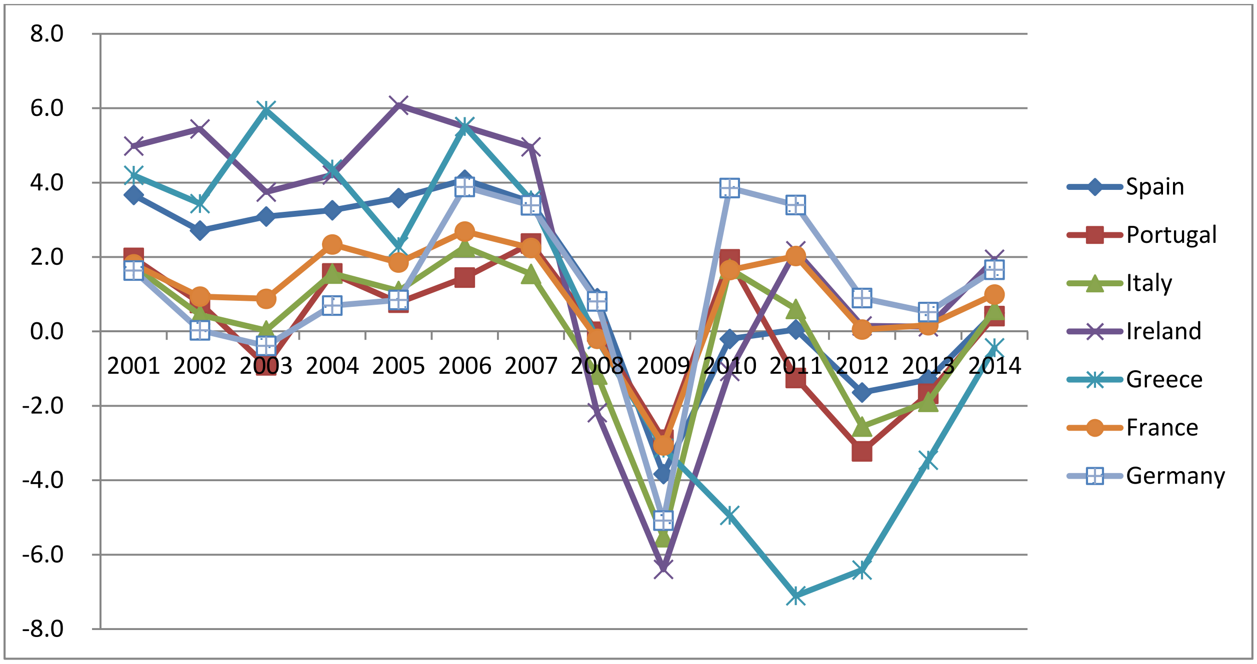


Figure 4: Real GDP, percentage change from previous year, 2001-2014
Germany, France, and the GIIPS [Source: OECD]