Cambridge University Press & Assessment
978-1-107-10489-1 — The Euro Experiment
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Excerpt
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1 A question of survival

In January 2009, ten years after the single currency had been founded, there seemed ample cause to celebrate in Brussels, the uncrowned capital of Europe, and Frankfurt, home of the European Central Bank (ECB). The euro was a club that other states wanted to join. Starting as a monetary union of eleven, it had expanded to sixteen, with Slovakia the latest to become a member. More important, the euro had withstood the gravest test of its first decade, the financial crisis that came to a climax in late 2008; despite its tender years, the ECB won plaudits for its prompt response when the crisis started in the summer of 2007, whereas the three-centuries-old Bank of England was rebuked for being slow off the mark. In troubled times, the single currency appeared to offer a security sorely needed by European countries that had shunned it, such as the UK whose banking system had come close to collapse. Jean-Claude Trichet, the ECB's president, described the euro as a 'shield', saying that in its first ten years it had 'proven its stability, its resistance to shocks and its resilience in the face of financial and economic turmoil'.[1]

The verdict of the European Commission when publishing a study in May 2008 that examined the decade since the first eleven members of the club had been selected was grandiloquent. Though the findings of the actual report were more nuanced, the Commission proclaimed the euro 'a resounding success'; the monetary union was 'an achievement of strategic importance' not just for the wider European Union but for the world at large in which Europe had become 'a pole of macroeconomic stability'.[2] A sense of complacency persisted among the euro-zone elite in 2009, even though bond markets signalled alarm early in the year about Greece and Italy. In December, the Commission published a study that surveyed the mostly sceptical views of American economists as the drive to create an economic and monetary union (EMU) gathered momentum in the 1990s.[3] Martin Feldstein, an economist at Harvard University and a former economic adviser to Ronald Reagan, had even speculated that the venture could spur renewed conflicts in Europe.[4] The told-you-so title of the paper was: 'The euro: it can't happen. It's a bad idea. It won't last. US economists on the EMU, 1989–2002.'

The sarcasm about American economists was mistimed. By then, the first rumblings of the euro crisis could already be felt when the recently elected Greek government revealed that its finances were far worse than previous figures had shown. The crisis, which broke out in earnest in early 2010 when Greece became unable to borrow in private markets, mutated over the following two years into an existential drama, as the markets laid siege to one country after another on the periphery of the euro area by refusing to lend at interest rates that were sustainable. Sovereign debt crises, a condition formerly confined to emerging-market economies, afflicted not just smaller euro-zone states such as Greece but large ones such as Italy. Ireland, Portugal and Cyprus followed Greece in requiring full rescues, and Spain needed a partial bail-out to secure its banks.

One crisis-fighting European summit followed another, while the ECB made increasingly bold moves to bolster the currency union's troubled banks through lavish provision of central bank funding, which indirectly propped up states as the banks bought sovereign bonds. It was to no avail – the crisis gathered in intensity. Greece became the first advanced economy in more than half a century to default on its debt. Under intense external pressure from the creditor nations in the euro area led by Germany, emergency technocratic governments took over in Italy as well as Greece in late 2011. When hedge funds and investors betting on a break-up renewed their attack on Italy and especially Spain in mid 2012, driving up bond yields again, and Greece teetered on the brink of exit, the single currency appeared close to falling apart, inflicting a crippling blow on not just the European but also the global economy.

The siege was lifted only when Mario Draghi, who had replaced Trichet less than a year before as head of the ECB, promised in impromptu remarks made in a London preparing to stage the Olympic Games to do 'whatever it takes' to save the euro. Crucially, Angela Merkel backed his stance even though Germany's top central banker vehemently opposed the ensuing 'outright monetary transactions' (OMT) policy announced by the ECB, which threw a lifeline to the sinking bond markets of beleaguered peripheral countries. In another vital step, the German chancellor decided around the same time not to expel Greece, rejecting a policy option that had been pressed by Wolfgang Schäuble, her finance minister, and agonised over for months in Berlin.

Draghi's 'whatever it takes' intervention marked a turning point. Bond yields among the peripheral countries began to fall as fears of a break-up ebbed (see Figure 1). Any remaining caution among investors was swept aside in the first half of 2014. A remarkable rally in peripheral-country debt drove down bond yields that had still been unsustainably high in countries such as Portugal just a few months earlier, in the autumn of 2013. Indeed, ten-year government debt yields in the euro area dropped to record lows, not just in the short lifetime of the euro but stretching back centuries, both in the core creditor countries, such as the Netherlands, and in the once troubled states on the periphery, such as Spain (though Greece was a notable exception). According to figures compiled by Deutsche Bank in September 2014, Spanish borrowing costs were at a two-century low, while French yields were their lowest in more than 250 years. Yields in the Netherlands, where data extended back the longest (preceding in fact the Dutch breakaway from the Habsburg empire of the Spanish king, Philip II) reached a five-century low.[5]

As financial markets capitulated, European officials declared victory. On a visit to Greece in January 2014, José Manuel Barroso, the Commission's president, could not disguise a triumphalist tone when he asserted that the euro's existential crisis was over.[6] He had made a similar claim a year earlier, which proved premature since it was followed by a tense bail-out of Cyprus in the spring of 2013.

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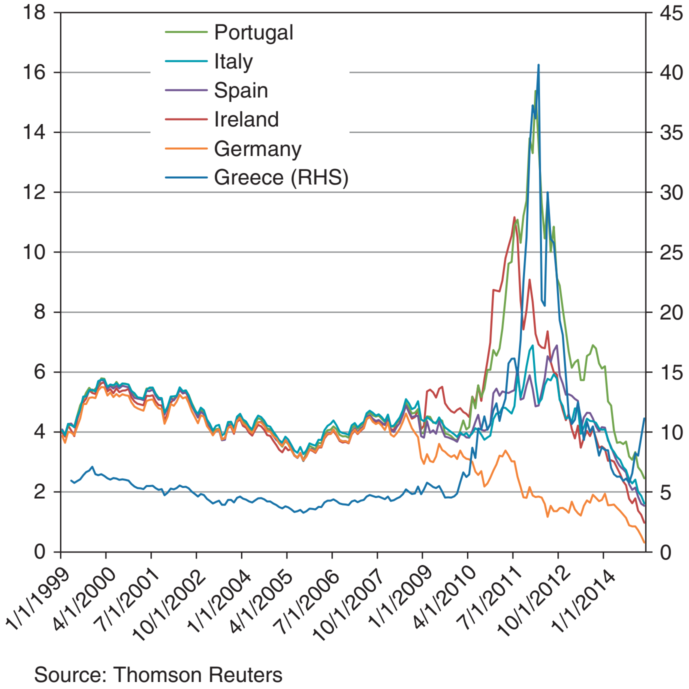

FIGURE 1 Ten-year government bond yields, 1999–2014

Indeed, European leaders had repeatedly misjudged the scale of the crisis and their capacity to contain it. When Greece was rescued in May 2010, they believed that their arsenal of hastily assembled bail-out money would frighten off traders contemplating attacks on other countries. Even after the crisis had leapt one national boundary after another on the periphery, false assurances continued. In March 2012, Nicolas Sarkozy, the French president, talked about turning a page on the crisis, and crowed that for once a European summit had not been dominated by it.[7] As well as swiftly losing office two months later, he was just as swiftly proved wrong about the crisis since it resumed with even greater virulence. For most of 2014, however, Barroso was broadly correct as far as the battle in the markets was concerned, though towards the end of the year there was a temporary reverse as investors became nervous again, fretting mainly (and correctly) about the prospect of another political upset in Greece.

Any sounding of the all-clear based on the behaviour of investors and traders at a time of extraordinary monetary ease across the world failed, however, to recognise the continuing fragility of the currency union. The euro area might have survived its ordeal by fire in the markets but, as became increasingly clear during 2014, it was enduring a new ordeal by ice as its economy suffered from the chill of a recovery that barely merited the name and a collapse in inflation. The combination of weak real growth and persistently ultra-low inflation – the latter dubbed 'lowflation' by Christine Lagarde, head of the International Monetary Fund (IMF), in the spring of 2014 – meant that nominal incomes were barely rising, making it far harder to cope with the overhang of debt, private as well as public, that weighed down the weaker economies.[8] The spectre of deflation hung over the euro area, a lethal condition since when prices fall the burden of debt, which is generally fixed in nominal amounts, rises in real terms. Meanwhile, in familiar fashion, euro-zone leaders were bickering about what to do in order to make their blighted currency club work better.

By late 2014, the renewed weakness of the euro area was a matter of grave concern not just within Europe but from a global perspective. Inflation across the euro area dropped to just 0.3 per cent in September, far below the ECB's objective of close to 2 per cent, while the recovery had virtually halted in the second quarter of 2014, only a year after it had begun. In October, the IMF forecast a 40 per cent probability that the euro area would lapse into recession between mid 2014 and mid 2015.[9] If that occurred, the euro area would follow Italy in suffering a 'triple dip' downturn, following the extended double-dip recession in 2011–13, which had followed the first and most severe one in 2008–9, induced by the financial crisis.

As a result of the euro zone's second recession and feeble recovery, output in the final quarter of 2014 was 2 per cent lower than at its peak in early 2008 (see Figure 2). By contrast, American GDP was

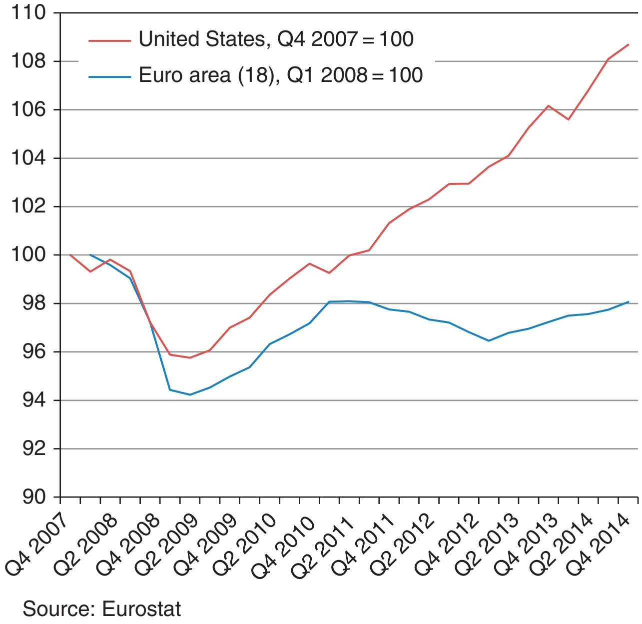

FIGURE 2 Euro area and American GDP, from pre-crisis peak in 2007–2008 to 2014

nearly 9 per cent above its pre-crisis high, which it had already surpassed during 2011. Whereas unemployment in the United States had fallen to 5.6 per cent of the labour force in December 2014 from a peak of 10 per cent five years earlier, in the euro area the jobless rate was 11.4 per cent, still close to its high of 12.1 per cent in the spring of 2013. Moreover, even that gauge of distress for the euro area as a whole disguised the fact that in some countries such as Greece and Spain it was far higher, at 26 per cent and 24 per cent, respectively. Youth unemployment rates appeared to be ruinously high at 23 per cent for the euro zone as a whole and approaching or even above 50 per cent in some countries, though these figures exaggerated the plight of young people since the denominator, fifteen to twenty-four-year-olds in the labour force, excluded large numbers who were in full-time education and were therefore not looking for work. Even so, the scale of joblessness as a share of the youth population as a whole was woefully high, at between 15 and 21 per cent in the worst affected countries in 2013.[10]

Manifestly, the euro-zone economy was floundering, as an unexpected slowdown in Germany in the middle of 2014 removed what had been the main source of economic resilience since the euro crisis erupted. Although some of the troubled countries on the periphery, such as Portugal and Spain, were belatedly reviving, France and Italy, whose economies were the second and third largest in the euro area, remained inert. Businesses might no longer be battening down the hatches as they had done in 2011–12 when uncertainty about the survival of the single currency was most intense, but they remained nervous about making new investments. High unemployment induced caution among households, constraining their spending. Above all, the burden of high debt when inflation was so low bore down on growth prospects. The euro area resembled a cancer patient following a punishing bout of chemotherapy; the treatment might have put the disease in the bond markets into remission, but it had left the patient enfeebled.

The renewed difficulties in the euro area in 2014 reflected the fact that the crisis was multifaceted. Indeed, a recurring pattern throughout was a failure on the part of euro-zone policymakers to grasp and to respond to the multidimensional nature of the crisis. Its origins in Greece led the crisis to be characterised at first mainly as one of sovereign debt, caused by earlier fiscal profligacy, which meant that the governments affected were unable to finance themselves in private markets. This prompted the solution of stringent fiscal austerity. But there were at least two other dimensions to the crisis. If Greece, the first country to require a rescue, succumbed because of its unsustainable public finances, Ireland, the next to need a bail-out, in late 2010, was brought low by its collapsing banks, both through the fiscal bill for saving them and the damage they inflicted on its highly leveraged economy. The rickety nature of many national banking systems was the second component of the euro crisis, as the preceding global financial crisis of 2007–8 turned out to have a longer fuse in many parts of the euro area. Compounding the misery was a third element: a macroeconomic crisis as countries on the periphery suffered sharp recessions and tried to close gaping current-account deficits that had opened up in the first decade of the single currency. Their woes reflected underlying economic weaknesses in labour and product markets that were hampering competitiveness.

The broader characterisation of the euro area's malaise as a three-fold crisis was widely accepted by 2012, following an influential paper in the spring of that year by Jay Shambaugh, an economist at Georgetown University, who emphasised the mutually reinforcing nature of the three interlocking crises.[11] Worries about the integrity of government debt undermined banks given their big holdings of sovereign bonds, while, conversely, concern about banking solvency undermined governments given the potential costs to national exchequers of rescuing toppling banks. The austerity imposed to tackle sovereign debt concerns weakened economies, which hurt banks and impaired their ability to support the economy. This in turn made it harder to fix the public finances. The German Council of Economic Experts adopted a similar approach in a study of the crisis published later that year.[12]

This was a more synoptic appraisal of the misfortunes assailing the euro area, but it still remained a partial account. For there were three other crises as well. The fourth was that troubled economies on the periphery were oppressed not only by unsustainable sovereign debt but also by excessive private debt. Measured in relation to GDP, the debt burdens of households and non-financial businesses were especially heavy in Cyprus, Ireland, Portugal and Spain. Though they were lighter in Italy, especially for its prudent households, the stricken state of its economy meant that on other gauges, such as corporate debt to equity ratios, Italian firms were in a bad way. Private debt was also worryingly high in some northern countries, particularly for households in the Netherlands, which largely accounted for the Dutch economy's bumpy ride during the crisis.

To varying degrees, other advanced countries like the US and the UK suffered from burgeoning public debt and high private indebtedness. They, too, had experienced severe economic imbalances in the run-up to the financial crisis, and their banking systems had come close to collapse. What made the difference was the fifth and most fundamental dimension to the euro crisis, a defective system of economic and fiscal governance in the currency union. The creators of the euro had brought into being a single money, but not a single government. Theirs would be a monetary union of nation states whose only concession to a broader federal principle was a weak set of budgetary rules that failed to discipline governments before the crisis. These arrangements, which included a limited conception of the ECB's role as a central bank and the national retention of banking supervision, were too flimsy to support the currency union when it came under stress.

The inadequate economic and fiscal governance left the fate of the single currency in the unsteady hands of national politicians. The uncertainty created by politics was the sixth crisis. Investors and traders posed two ever-more insistent questions. Were the creditor countries at the core of the euro area, above all Germany, willing to underpin a currency union whose shallow foundations were being so starkly exposed? Were the governments of debtor nations on the periphery prepared to play their part in dealing with the crisis by pushing through painful measures, and were their peoples prepared to accept them?

A gap opened up between the politics of the creditor countries and the politics of the debtor nations. In the former, governments needed to mobilise support both for the rescues and for more enduring reforms to strengthen the monetary union. Yet, as the crisis spread well beyond Greece, 'rescue fatigue' started to set in as many taxpayers not just in Germany but also in other northern nations like Finland increasingly resented the cost of bailing out what they regarded as wastrel economies. But if the politics in creditor countries soured, so too did the politics in the debtor states. What was initially represented as a relatively brief dose of unpleasant-tasting medicine turned into a much longer regimen, inflicting far harsher treatment on their citizens, especially through higher unemployment. The concomitant to the onset of 'rescue fatigue' in the creditor countries was that of 'austerity fatigue' in the debtor nations, especially among those in bail-out programmes overseen by the 'troika', officials representing the IMF, Commission and ECB. This caused increasing rancour, which fused especially in Greece with anti-German sentiment drawing upon the experience of the Nazi invasion and Axis occupation in the Second World War.

What made the gap particularly dangerous was that it created an environment for bluff and counter-bluff, especially in the original and most vexed rescue of all, that of Greece, as it required not just one bail-out in 2010 but a second one in 2012 followed by the third and most contentious one of all, in 2015, which was agreed upon in principle in mid July though several tricky hurdles had to be jumped for the new three-year provision of financial assistance in return for austerity and reforms to be signed and sealed. In the fraught elections of mid 2012, Alexis Tsipras, leader of the insurgent left-wing Syriza party, pledged to put an end to Greece's fiscal misery by reneging on the 'memorandum' – the Greek government's commitments under the rescue programme. This was a bluff on his part that the euro-zone creditor governments would flinch at punishing Greece by suspending the bail-out money for fear that the resulting 'Grexit' from the euro might precipitate a wider break-up of the monetary union. Countries joining the single currency were supposed to fix their exchange rates 'irrevocably'. An exit would irrevocably devalue that commitment.

Despite that danger, the German government for its part had a rather more compelling counter-bluff – making an example of Greece by forcing it out anyway, which made Tsipras's bluff all the more perilous. In the event, Syriza came second in the election to New Democracy headed by Antonis Samaras, who was able to form a coalition government that brought the country back from the edge.