Single currency bloc plays ‘beggar-my-neighbour’

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Might the **eurozone** break up? Until recently I would have answered: absolutely no. This is not because I thought the currency union a wise idea. I thought it a risky idea, made more so by the decision to accept member countries so different from those of the zone’s northern core. But the commitment to make it work seemed fundamental to the policies of Europe’s principal powers. Is that still true? I do not know.

So what has gone wrong? What is happening now? What happens next? What does it mean for both the eurozone and the world economy?

On the first question, the European orthodoxy is that the crisis is, at root, fiscal. Marco Annunziata of UniCredit summarises it in a recent note: “In hindsight, it seems obvious that the flaw in the eurozone’s institutional setup is both extremely serious and extremely simple: first, a currency union cannot work without sufficient fiscal convergence or integration; second, the eurozone has been unable to create incentives for fiscal discipline.” Mr Annunziata’s chart shows that this view is wrong. Just consider the frequency of breaches of the rules requiring fiscal deficits of less than 3 per cent of gross domestic product. **Greece** is a bad boy. But Italy, France and Germany had far more breaches than Ireland and Spain. Yet it is the latter that are now in huge fiscal difficulties.

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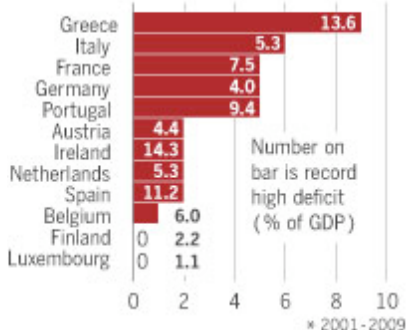
The fiscal rules failed to pick up the risks. This is no surprise. Asset price bubbles and associated financial excesses drove the Irish and Spanish economies. The collapse of the bubble economies then left fiscal ruins behind it.

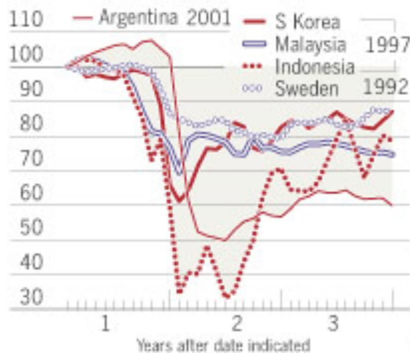
It was the bubbles, stupid: in retrospect, the creation of the eurozone allowed a once-in-a-generation party. Some countries had vast asset price bubbles; many had soaring relative wages. Meanwhile, Germany and the Netherlands generated huge current account surpluses. The union encouraged a flood of capital to the surging economies, on favourable terms. When private spending imploded, fiscal deficits exploded.

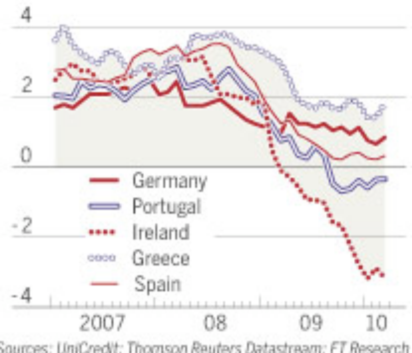
Where are we now? The eurozone politicians’ response to the crisis has been predictable: blame speculators; provide financing of shaky sovereign debtors (thereby rescuing creditors); rule out debt restructuring; and insist that fiscal discipline be **tightened** in countries with large deficits. The European Central Bank has also invested €16bn in riskier eurozone government bonds – a small sum by the standards of recent interventions, but a powerful signal. The euro has fallen, though it remains high by historical standards (see chart). At best, the eurozone has bought a bit of time for adjustment.

What happens next? Greece is likely to restructure its debt at some point, as John Dizard has **argued** in the FT. That would not be the worst outcome. Once a country is in the “junk bond” category, no reputation is left. In such circumstances, the benefit of a lower debt burden for creditworthiness is likely to offset the cost of a default. The logical moment is when the primary fiscal deficit (that before interest) is eliminated,

supposedly in 2012.







Yet there will be no return to fiscal stability in peripheral countries without a return to growth. For countries with large current account deficits, much of this growth will have to come from net exports. The alternative to higher net exports – a resurgence of private spending and huge ongoing capital inflows – is unlikely and undesirable.

The question is whether peripheral countries, which have lost so much competitiveness since entry into the eurozone, can generate a large structural – not just a cyclical – improvement in net exports. Historically, countries that have suffered debt crises have almost always been helped by a collapse of the exchange rate (see chart). Peripheral eurozone members do the bulk of their trade with one another. So the modest decline in the external value of the euro is little help. Inside the currency union, the way out is through falling prices (more precisely, falling costs). Ireland is on the way; others are far behind (see chart). But this is a drawn-out process and, not least, also raises the real value of debt. Proponents of structural reform ignore these facts.

What does this all mean?

First, markets are right to doubt fiscal resolve. **Debt restructuring** is quite likely, at least for Greece. But such restructuring cannot remedy the lack of competitiveness.

Second, the eurozone has bought itself time. Among the things it must do with that time is make its financial system credibly solvent and so able to stand a round of private and public debt restructuring.

Third, when analysing the woes of the eurozone, people persistently fail to recognise the private sector's instability. It has saved too much in some places and spent, lent and borrowed too much in others. This has been a hugely destabilising force, inevitably exacerbated by the "one-size-fits-all" monetary policy.

Fourth, while the peripheral countries wriggle, the fisherman is determined to keep them on the hook. Thus the fundamental proposition in all discussions of eurozone reform and policy is that fiscal policy must be disciplined. Indeed, Mr Annunziata argues that "fiscal limits should be hard-coded into each country's legislation in the form of automatic, binding and unchangeable rules". Such rules do apply in US states.

But the US has a federal budget, as well. The eurozone has not. The world's second-largest economy is on the way to adopting the pre-Keynesian fiscal orthodoxy.

Fifth, tension is bound to remain between a **Germany** determined to impose such fiscal constraints and countries that deny the primacy of such discipline (notably, France) or may prove incapable of sticking to it. Given the big adjustments ahead, it is no longer evident that the eurozone will manage these tensions. German patience could be stretched beyond breaking point.

Finally, the eurozone is moving towards **fiscal tightening**, with the offset, at least for the moment, of a weaker exchange rate. Americans will see this as a "beggar my neighbour" policy, unlikely to help global rebalancing. How much it will detract from world recovery is unclear. But it will not help.

Despite today's gloom and doom, the eurozone will probably survive. But the view that everything would now be fine had fiscal rules been followed is wrong. The private sector's irresponsibility was the biggest failing. Now, the emphasis is again on fiscal tightening. If this is to work, there must also be growth. Will the austerity itself deliver the growth, as some hope? I doubt it. The hair shirt alone will wear badly.

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