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# "Saving the Euro: A Test for Globalisation"

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The sovereign debt crisis originating in the eurozone immediately after the eruption of the global financial crash represents a significant challenge not only for the European but also for the world economy. Overcoming it will contribute to creating the conditions for sustained global economic recovery and also provide a testing ground for our capabilities to control the dangers surrounding the globalisation process which is unfolding over the recent decades.

The integration of markets in products and finance, and less so in services, coupled with enormous technological progress in communications and transport diffused growth to regions and continents that, during the last centuries, had been left behind the dramatic rise in living standards witnessed in Europe, North America and Japan since the Industrial Revolution. The opening up of markets led to more efficient use of global resources allowing productivity to grow while billions of people transgressed poverty lines and joined the modern world.

The downside of this process is that national control over economic policy has been significantly diminished, even vanished for small economies, while intricate problems emerged for international economic governance. These problems were brought to the fore during the recent crisis at the global and eurozone level.

As markets integrate and systems converge, controlling imbalances in either the real economy or the financial sector becomes increasingly difficult since it requires much more advanced policy cooperation than allowed for in institutional set-ups corresponding to nation-centred economic models. The extent of the changes that are needed will become clearer as we review the origins of the present crisis.

At the global level the huge current account imbalances that have been built up over the last decades produced an unusual pattern of savings flows. Poor countries, chiefly China, have been financing rich ones, such as the United States. This pattern reflects the fact that emerging countries have had large current account surpluses, whereas developed economies have accumulated sizeable deficits. The imbalances led capital to flow 'the wrong way' from the developing to the advanced economies, destabilising the financial system and thus creating the conditions for the economic crisis.

The existence of a savings glut at the global level depressed world interest rates and stimulated a search for higher yields. Excessive liberalisation and inadequate

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supervision of the global financial system allowed banks to accept dubious lending projects, and invent and proliferate questionable derivatives thus spreading the crisis to the rest of the world. Excess savings of poorer countries indirectly financed a U.S. consumer boom and also supported consumption in other advanced countries.

In line with developments in the global economy, large external imbalances were allowed to emerge over the last decade within the eurozone. The competitive position of peripheral member countries, particularly Greece, Spain, Portugal, Ireland and Italy, deteriorated sharply as measured by unit labour costs vis-à-vis the core countries of the eurozone. Governments in the periphery ignored warnings and turned a blind eye to the accumulation of credit-fuelled bubbles and public or private debt while they failed to take anti-cyclical fiscal measures or promote structural reforms for improving competitiveness. Large peripheral external deficits were matched by surpluses in Germany and other core countries. The persistence of these imbalances has transferred excess savings to the periphery creating the conditions for extensive borrowing, helped by the low money rates attached to the euro—as compared to those that historically prevailed under national currency regimes—on the part of both the private and public sectors. In fiscally responsible countries like Spain, excess savings resources have been borrowed by the private sector and invested in what later became bubbles—housing assets. The burst of the bubbles created problems of insolvency to the banks—as people were unable to repay their loans—while the bubble-induced recession, coupled with the disruption produced by the financial crash and the associated collapse in exports, led to an explosion of budget deficits and full-blown fiscal crises.

In fiscally profligate countries like Greece, the chain of events was more straightforward. Excess savings resources had mainly been borrowed by the government, leading directly to a fiscal crisis. Debt growth undertook catastrophic proportions after the financial crash when the recession led to drastic cuts in private spending and the automatic capture of redundant savings resources by the government. An interesting, and critically important, part of the story is that much of the debt that was induced by the savings glut in core economies ended up, whether indirectly or directly, on government books of the peripheral economies. The weakness of the competitive position of these economies helped to transform the fiscal crises into debt crises threatening to lead to sovereign defaults and a potential break-up of the monetary union.

Greece was the first country to seek financial assistance and a bail-out programme was concluded in May 2010 with the so-called troika (the IMF, the EU Commission and the European Central Bank). This agreement set the tone for the overall approach of the eurozone and the IMF in tackling the debt crisis. It focused on exceptionally harsh austerity measures including cuts in public sector salaries and pensions and tax rises with a parallel push for structural reforms aimed at enhancing productivity and sustaining a process of economic recovery.

However, the balance proved to be wrong. Austerity measures were fully implemented while structural reforms, in particular privatisations, market liberalisation, opening up closed professions and downsizing the government sector, were either neglected or poorly monitored. In the absence of the devaluation weapon that is available in countries possessing national currencies, the result from such policies was a deep and prolonged recession, limited gains in competitiveness and overshooting of fiscal deficit targets owing to systematic recession-induced shortfall in tax revenues.

Greece's GDP has fallen by 16.8 percent in four years and is expected to decline by another 4.5 percent in 2013. Unemployment exceeded 25 percent of the labour force while it reached 51.5 percent for young people. The bail-out agreement had to be revised with packages of new loans and austerity measures which, however, have not proved to be more successful than the initial programme. The prospect of default has not been significantly reduced carrying the risk of an eventual forced exit from the euro area.

Ireland and Portugal have responded more effectively to the challenge of the bail-out process, but for Europe's south as a whole the outlook remains bleak, punctuated by recession, high unemployment and drop in living standards. This is starting to impact upon the entire eurozone. Recent IMF forecasts suggest that eurozone countries as a whole face stagnation this year and the next while Germany's leading economic institutes have halved German GDP forecast for 2013.

The implications of the eurozone crisis are reaching the rest of the world with the main emerging economies (China, India, Brazil) registering cuts in expected growth rates compared to recent performance.

Poor implementation of the adjustment programmes undoubtedly accounts for a substantial part of the blame concerning the persistence of crisis conditions. Pursuing structural reforms faces many obstacles. For instance, the Greek governments' 'revealed preference' over the last couple of years has been to spread misery horizontally through austerity than confronting the special interests which block reforms such as businesses in protected markets, public-sector trade unions and closed professions.

However, the fact that nowhere in the eurozone, with the possible exception of Ireland, success is in sight while, on the contrary, the crisis risks to spread to Spain and Italy, which are far more important size-wise than the sum of Greece, Portugal and Ireland, indicates that the programmes themselves suffer from fundamental flaws.

As already referred to, the main cause of the debt crisis has been the persistence of large imbalances within the eurozone—current account deficits in the periphery mirrored by surpluses in the core—owing mainly to differences in productivity and competitiveness. Excess savings have been transferred from the core to the periphery, creating conditions for extensive borrowing and accumulation of debt.

Debt growth exposed critical weaknesses in the eurozone's economic constitution: national debts are the responsibility of member countries, but the common currency is without a sovereign. Unlike most central banks, the European Central Bank (ECB) cannot act as a lender of last resort, which, in conjunction with the absence of common bonds (Eurobonds), induced large-scale speculation on intra-European national debts, expressed in widening spreads.

Resolving the crisis inevitably includes action on both fronts. The causes of the persistent imbalances should be addressed through a combined effort at fiscal consolidation and strengthened competitiveness by the over-indebted countries themselves, with structural reforms focusing on liberalising markets and encouraging wage flexibility.

At the same time the eurozone, as a system of economic governance, must be equipped with the instruments needed to restore stability and prevent the recurrence of crisis conditions. This agenda includes centralising European debt through Eurobonds, mobilizing sufficient rescue funds, allowing the ECB to buy, if conditions require it, unlimited quantities of sovereign bonds in the primary markets, creating a banking union with unified supervision, a mutualised system of bank recapitalisation and a collective bank-deposit insurance programme, and also unifying fiscal policy in order to manage demand across the euro area and, in particular, sustain economic activity in austerity-stricken countries. A European Marshall Plan for financing public investments in the over-indebted countries would substantially contribute to economic recovery.

Monetary unification should be extended to the fiscal and financial field so as to create an integrated economic union. The United States offers a model of such a functioning union. Europe, on account of the specificity of its historical trajectory, cannot emulate the U.S. model. However, in order to make the currency union work, it should take decisive steps in that direction.

It may, of course, be suggested that, as most of the problems within the eurozone stem from national mismanagement, the lessons that are currently being learned will render governments more disciplined in the future sparing thus the need for such decisive steps. However, markets need to be assured that if something goes wrong, there will be backstops in the shape of Eurobonds, ECB bond-buying, banking union, etc. Similar arrangements contain the potential damage that economic mismanagement in a state (e.g. California) could inflict on the U.S. economy. If such confidence-building foundations are missing, the next eurozone crisis may, again, spark an explosion of spreads out of proportion with the deterioration in fundamentals.

The unification agenda lacks consensus support. It touches upon sensitive issues including the allocation of fiscal resources within the monetary union as well as transposing sovereignty from national to European institutions. The issuance of Eurobonds would involve subsidising debt service costs for the benefit of the less credit-worthy countries, raising the specter of 'transfer economy', that is of dependency of poorer countries on rich countries' assistance, which is strongly opposed by Germany.

Permitting the ECB to buy sovereign bonds in the primary markets would lead to monetary financing of debt which would relieve the pressure from profligate governments while carrying risks for inflation. Fiscal union would include, besides Eurobonds, the creation of a European Finance Ministry as well as common taxation, implying loss of sovereignty. Such fears are reinforced by the prospect of extending fiscal and economic unification to the political sphere so that supranational institutions are endowed with sufficient democratic legitimacy. This could involve transforming the Commission into a real executive agency with a President elected by universal suffrage and reinforcing the powers of the European Parliament while diminishing those of the Council of Ministers, that is the national governments.

The difficulties in obtaining agreement on changes of this scale are reflected on the very slow pace of reforms in the direction of improving the system of economic governance of the eurozone. Eurobonds are not even placed on the negotiations table, the volume of rescue funds remains very low in relation to the size of aggregate European public debt, the ECB uses by-passes so as to intervene in the sovereign bond market, the prospects for banking union have not yet firmed up while fiscal policy coordination is inadequate and lacks institutional solidity.

'Too little, too late' and 'muddling through' are the attributes that are customarily attached to the initiatives taken at the eurozone level. This, in conjunction with the weakness of the efforts of several governments in the over-indebted countries, goes a long way to explain the inability of the eurozone to overcome the crisis and set the union on the course of economic recovery and steady growth.

It is notoriously difficult to make predictions in economics, particularly when so many political parameters are involved. I will limit myself in suggesting that 2013 may prove to be critical for the future of the euro area. If Greece, Spain and Italy manage their economies effectively with adequate financial and policy support from the eurozone authorities while the unification process is pursued, the union should survive and start to recover, albeit at a slow pace. In the contrary case, the risks of default will increase, with a partial break-up remaining a possibility over the medium term.

The eurozone crisis is, in effect, a globalisation crisis. As markets integrate and become more interdependent, the need for policy discipline and international cooperation increases. Saving the euro will provide evidence of the extent to which modern nations can impose self-discipline and subject policy tools to supranational coordination processes so as to ensure stability and maintain the necessary equilibria for steady growth.

The lessons from the eurozone crisis may be summarised as follows:

First, maintaining current account balance in a growth environment is a critical condition for financial stability. Excessive current account deficits lead to large inflows of capital which disturb borrowing conditions creating unsustainable levels of debt in both the private and public sectors. Moreover, in a free exchange rate system, they lead to devaluations of the currency and high inflation which undermines competitiveness.

Second, current account balance requires robust export performance, implying a continuous effort to improve competitiveness. Competitiveness rises in the longer term as a result of the increase of productivity through more efficient allocation of resources, investment in physical and human capital and technological change. Southern European countries have neglected supply-side reforms during the last decade and lost substantial amounts of competitiveness to the more advanced countries of the core of the eurozone.

Privatisation, opening up of markets in products and services, promoting entrepreneurship and a favourable investment environment, and spending in education and research are crucial for raising productivity levels. Competitive markets and wage flexibility impart dynamism to the growth process while an efficient and well-functioning state is essential for ensuring adequate regulation and supervision of markets, the support of entrepreneurial activity, the provision of high-quality social services and the promotion of public investment projects.

Third, preserving fiscal balance is, in itself, an important objective, independently of the current account balance, because of the need to avoid government overindebtedness. Excessive cost of public debt service becomes a burden on growth while it may also push up interest rates and discourage investment. Fiscal discipline assumes fair and efficient tax systems as well as effective public spending controls.

Fourth, international cooperation is needed so as to benefit from foreign private investment flows as well as the support of international economic agencies, such as the IMF and the World Bank, for managing economic and financial crises, facilitating technology transfers and implementing infrastructure projects.

If current and fiscal balances were maintained, competitiveness enhanced and policy coordination reinforced, the eurozone crisis may not have occurred. The same can be said for other financial or real-economy crises of the globalisation era. Of course, these lessons were valid in earlier eras as well. The difference today is that the margin of errors, or deviations from the desired path, has become much more limited. Market sanctions, as a result of integration and interdependence, are brought forward sooner and are harsher.

Greek governments' irresponsibility during the last decade was not uncommon in relation to earlier periods. The price, however, that the country paid, and continues to pay, for such behaviour is a multiple compared to past times.

We live in a new world. In an open, globalised economy the divide between winners and losers widens as competition intensifies. It has become more important, even critical for a nation's future, to be on the winners' side. Moreover, tensions tend to erupt into more severe crises than those occurring in a protected and restrictive regime. It is no coincidence that the recent global financial crash produced the greatest depression since the Second World War.

Success requires discipline, resilience and a spirit of cooperation so as to take advantage of international synergies. The longevity of the globalisation experiment will depend on whether nations or groups of nations display these qualities in sufficient degree so as to create conditions for steady progress in the international economy. Reinforcing economic policy coordination constitutes the core of the G20 agenda. A key task is to prevent the emergence of excessive current account imbalances among the major trading partners by supporting exchange rate realignments and appropriate adjustments in fiscal policies. A new global financial services rulebook comprising tougher regulation, strengthened supervision as well as cross-border resolution mechanisms, trade liberalisation, and higher volumes and efficiency of aid will also contribute decisively to raising the standards of international economic governance.

The challenge for political leaderships is to ensure that the present era of rising and more widely diffused prosperity endures so that the poorest sections of humanity eventually reach the stage of sharing the fruits of modern civilisation. There is, still, a long way to go in order to fulfil this goal, as shown by the persistence of enormous economic and social disparities both among and within countries.