Transcript

Has Europe Solved the Euro Crisis?

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Anatole Kaletsky

Thank you all very much for coming. I think the audience is sufficiently compact that we'll be able to engage, I hope, in a fair amount of give and take in the second half of this discussion. The question is one of these things that will always be with us but it's a particularly relevant one this week given, on the one hand, the European election that's just happened, and on the other hand, the extremely high expectations that there now are in the markets that the ECB is going to do something fairly decisive, perhaps even dramatic to reinforce, on the one hand, the stabilization in the financial markets, and on the other hand and much more importantly, the modest signs of improvement in the European economy, next Thursday when we have the next ECB meeting. So it's a very good moment to be discussing all this.

The way that we're going to structure today is that each of the three speakers will speak for seven or eight minutes, under ten minutes in any case – I will ensure that it's under ten minutes. Then we'll have a discussion, in which we are very eager that you should participate. Just to kick it off, let me take advantage of my position here – I certainly don't have ten minutes but maybe I'll give myself one or two minutes – to pose the questions that I think are really worth examining, although I'm not sure what the speakers are going to say.

First of all, obviously, is the euro crisis resolved or is it merely brought under control? Clearly, the situation is much better now than it was a year or certainly two or three years ago, but is this a resolution or merely a deferment of the crisis? Or to put it in the sort of medical analogy that is hard to avoid, is this just a remission or is it actually a cure?

The second question – and I suspect most of the people on the panel will believe that it's more of a remission than a permanent cure – is what might cause the next breakout. This brings us right up to date. Many people, myself included, believe that once the financially acute phase was resolved temporarily by Draghi and Merkel's famous promise to do 'whatever it takes' to save the euro, the next crisis might be, if you like, a metastasis from the financial markets into the political sphere. I felt, at least until last week, that the next big threat to the euro was going to be a political rather than a financially driven one, with the European elections perhaps being the next hurdle. It looks like, despite the very large vote for the populist parties, that political hurdle has again been overcome, at least to the extent that the euro is not seriously or existentially threatened by the outcome of the European elections.

If that's the case, and again maybe people on the panel will not agree with that, the final question that I'd like to hear an answer to is: what is the longer-term future, if we have a temporary financial stabilization, if we have a political stalemate for the next few years, both within European countries and between Germany on the one hand and the debtor countries on the other. How long can this stalemate or ceasefire continue? What might threaten it in the long run?

And the part that fascinates me particularly is the interaction – I think this is particularly relevant for a place like Chatham House – the relationship, which has become a very sort of binary or bipolar relationship in Europe, between Germany and a very small group of allies on the one hand (Austria; Finland, perhaps) and the whole of the rest of Europe. How do we foresee the future of a Europe which is so dominated by these central, what used to be called the axis powers? Is that a situation which is going to be sustainable, not just economically but politically and diplomatically?

I've now exhausted my two minutes and I'll turn it over to John, who is going to launch it off. John has just published a book on these very issues so we're going to give him a little bit longer, perhaps ten minutes, to lay out his argument.

John Peet

Thank you, Anatole. I will try to lay it out in as short a time as I can. I am indeed here partly to promote the book that I wrote jointly with my Brussels correspondent, Anton LaGuardia, which is for sale for anybody who's interested.

I would start with your first question, because when we launched this book in Brussels four weeks ago, two Commission officials came up to me and said: I don't know why you're writing about the euro crisis – it's over. We solved it. There is no euro crisis, so nobody will be interested in your book. Terribly sorry.

Of course, part of the reason for writing the book was just because it's a fantastic story. The story of how it developed since 2010 is a very interesting one. Part of the reason for it being interesting is that a great many mistakes were made between 2010 and 2014, and I will touch briefly on them. But part of the reason is indeed because we think the euro crisis is not over. It may be over in the financial markets for the time being, but it is certainly not over in the sense of the troubles of the European Union, the troubles of the eurozone, and I think the elections very much play into that. So that, in a sense, is my main message.

But let me just spend a couple of minutes talking about the way the crisis developed and what, in a sense, went wrong with it. There were many imbalances building up in the eurozone, long before 2009. One big part of what happened was there was far too much complacency both in financial markets and in governments about the situation that was prevailing. The loss of competitiveness of some countries was very apparent. The balance of payments imbalances were also very apparent. The asset bubbles that were building up in certain countries were very apparent. Nothing was being done about this until 2009.

The problem that I think then happened was – and in a way, the whole tragedy of the euro crisis can be summed up very simply: it is very sad that it began with Greece. If it had begun, as it might have done, with Ireland, I think we would be in a much better position today.

There are three reasons why it was very tragic that it began with Greece. The first reason was that it was apparent and is still apparent that one of the central problems for Greece was fiscal irresponsibility. Because the euro crisis began with Greece, fiscal irresponsibility then became the problem for the eurozone, particularly in the eyes of Germany. It followed from that that the cure for the euro crisis was fiscal austerity, and that's precisely what then happened. Because it had been applied to Greece, it then had to be applied to everybody else. Fiscal austerity became the order of the day.

As Anatole himself has written repeatedly on this, the trouble is that austerity wasn't the right answer and fiscal irresponsibility was not the main source of the eurozone's troubles. We saw that much more graphically when they spread to Ireland, Spain and others who had not been fiscally irresponsible. So that, I think, is the central reason why the handling of the euro crisis became so bad.

The second reason why it was sad that it began with Greece was that because it had begun with Greece, and we retail this a lot in the book, there were two whole years in which there was a long debate about whether Greece should be kept in or out of the euro. This debate happened, again, particularly in Berlin. Right the way up until the middle of 2012, there were still quite a lot of people in Berlin who thought the answer to the euro crisis was either for Greece to leave or indeed for Greece to be kicked out. The trouble with that is that only encouraged the markets to have doubts about whether the euro would survive, because obviously if Greece fell, then other people could fall – Cyprus could fall, possibly Portugal, possibly Ireland. It would have been much better to have said right from the beginning: we are not going to have a country leaving the euro. That would have been, again, the case had Ireland been the initial one.

The third reason why this was sad was because the focus on fiscal irresponsibility and on the question of whether Greece should stay meant that Europe's leaders took far too long to wake up to the problem that the banks were in. It took until late 2012 before they realized that they needed to fix the banks. One of the most graphic illustrations we have in our book, which has been repeated elsewhere, is the contrast between the United States and the eurozone. The United States and the eurozone followed a very similar path up to about 2010, and after 2010 the United States has done much better than the eurozone. My belief is that the main reason for that is because the United States' response to the global financial crisis was to sort out their banks. They didn't pay too much attention to their budget deficit; instead, they sorted out their banks. The eurozone did the opposite: they paid a great deal of attention to the fiscal deficit and did nothing about their banks. Result: where we are today.

So that's what I wanted to say about the mistakes that were made in the euro crisis. I'll move on to the second thing I wanted to talk about, which is what I'm calling the 'collateral damage' of the euro crisis. The euro crisis has had seriously bad effects on the way the European Union works, and the elections confirm that, in many respects. I'll just touch briefly on three.

The first is that it's enormously changed the balance of power within Europe in lots of different ways, which we can talk about when we come to questions. The one that I particularly want to focus on is the dominance of Germany, which has become a familiar theme. The Germans themselves are not very comfortable with this. Angela Merkel is not very comfortable with this. She sees that she has to be the leader of Europe and she also sees that there's nobody else who's anything like as good as leading Europe as she is.

But the imbalance is a serious problem. It's a serious problem partly because Germany continues to believe that it did nothing wrong during the years that the euro crisis built up, whereas actually Germany was a source of problems. If there is an imbalance, it's an imbalance on both sides: it is a deficit imbalance but it is also a surplus imbalance. If countries' banks are getting into trouble, they are often German banks as much as Greek banks. So Germany was part of the problem but they refuse to accept that.

But it is also troubling – and Anatole touched on this in his opening comments – because Europe doesn't really work very well if it is only led by one country. I think the whole history of the European project since the 1950s really demonstrates that it has to have particularly the two main countries playing a much bigger role together. What's happened as a result of the euro crisis is that the Franco-German motor, which I continue to believe is vital for the European Union, has essentially just stopped functioning completely. In Berlin, they see France as in many ways the biggest problem in Europe and not as part of the solution to Europe's difficulties. Clearly, the election results confirm once again the great weakness of the French president, both at home and abroad. We retail many times in the book how people always pay a great deal of attention when Angela Merkel has something to say and nobody in Brussels or Frankfurt pays any attention at all when Francois Hollande has something to say. That is a serious structural problem for the future of both the eurozone and the European Union.

The second problem of collateral damage that I wanted to mention – there are many others, but the second one I want to mention is the issue of 'ins and outs'. The issue of ins and outs has been around for a long time. In a sense, it's been around since the Maastricht treaty. But because it became apparent early on that part of the solution to the eurozone's difficulties was going to be more rules, more intrusiveness, more integration, the formation of a banking union, the fiscal compact, all the provisions of the economic semester, I think it's made the division between ins and outs much more pronounced. That clearly has big implications for this country, and I do think the euro crisis and the way it has been handled has increased the risk that Britain may eventually decide to leave the club altogether.

But this country is not the only one. There are currently ten. It is our view that there will probably be at least eight or nine for quite a long time who are not in the eurozone. The relationship between these two and the attempt to ensure that the outs are not disadvantaged by decisions taken by the ins is something that hasn't really been addressed sufficiently so far, and it clearly raises concerns for the single market, for consultation and so on, that we haven't really resolved.

Then the third thing about collateral damage which again relates to where we stand today is that I think it's hugely accentuated this popular concept of the democratic deficit in the European Union. What we have actually seen during the last few years is many countries in effect having policies imposed on them – substantial policies relating to taxation, labour market reform, pension reform and so on – imposed on them from outside. This has now been entrenched in the structure of the eurozone. The analogy that we use in the book is it is almost as if you go to the IMF because you've got into trouble, the IMF then tells you what to do – this is what happened to Latin America and East Asia – but when you're out of trouble, the IMF then goes back to Washington. In Brussels, now what's happened is the IMF has in effect moved in and is going to be there forever. It is a permanent occupation of your country by the IMF.

Our conclusion is that this is a structure that is not going to be tenable in the long run. That is why I very much share Anatole's opening comment that the next stage of the euro crisis – and we predicted this in the book – was going to be to move from a financial market crisis about whether you could sell sovereign debt, towards the much more difficult issue of: are the people of Europe going to accept this political situation in which their countries feel they have lost sovereignty to an unaccountable, unelected machinery in Brussels, Frankfurt and to some extent in Berlin, where the only person who really counts politically is Angela Merkel. I think the European election, and particularly the result in France, showed that it is highly questionable whether this is going to be a sustainable situation for much longer.

The problem that I think we are in now is we are in an economic situation where it looks to me as if, partly thanks to German intransigence, the eurozone is heading for a long period when it will resemble what happened to Japan in the 1990s. There will be ups and downs. Today actually looks a bit better than it did six months ago. But I don't think it is out of the woods and I think the chances of a Japan-type of semi-stagnation are very high. That was sustainable in Japan: it's a single country; it's a very cohesive society. They could live with that.

I do not believe the eurozone will be able to live with that, and I think what we are likely to see is some kind of political explosion – and I think Marine Le Pen is currently the best symbol of such a political explosion – in which people say: we're just not going to accept that. One way or another, we want to get back our own freedom to run our own affairs. We want to have more control of our own taxation and spending. We're not going to accept a system in which Brussels and Frankfurt are telling us what to do.

We don't really offer a clear solution to this problem, other than to identify it, but the tentative solution we suggest is that we should try to go back to what we should have done at the beginning, which is instead of bailing Greece out in full, we should have said: Greece's debt is unsustainable and Greece has to restructure (i.e., default). That would reinstate what we tried to have from the beginning, which is a sort of no-bailout rule – if a country gets into difficulty, then it has to restructure its debts rather than look for a bailout from the centre. The quid pro quo for that would be that countries would then be allowed to run their own affairs and if they get things wrong, the markets will punish them. It would be difficult to get back to that situation but I think that would be a more politically tenable situation than the one we're in today.

Anatole Kaletsky

Thank you very much, that's fantastic. Megan, you're about to go and work in the German Ministry of Finance, so your reflections on that or any other aspect of this problem will be very interesting.

Megan Greene

Sure, thanks. You'll be shocked to hear that Germany will have me after you hear what I have to say probably, but I'll start with the good news, just to counter some of John's pessimism.

The eurozone is out of recession. It grew in the last quarter of last year and the first quarter of this year. Purchasing managers' indices are all expanding, which shows that the manufacturing and services sectors are finally expanding. All confidence indicators are up across the eurozone. Unit labour costs are coming down for everyone except for France and Italy, which is an issue. Ireland, Portugal and Spain have all exited their bailouts without any help at all. So this is all really good news, and the reason for unprecedented complacency and euphoria in the eurozone at the moment.

But of course, I have bad news as well. The unit labour costs are coming down – as I mentioned, they're not coming down in some of the biggest countries. France, I agree with John, it is a huge worry. Their unit labour costs keep going on an upward march. Unit labour costs are a measurement of competitiveness so that's an issue. But they're coming down in some of the weaker countries in part because companies are just shedding employment, so unemployment has gone up to around 12 per cent in the eurozone. That number masks huge regional differences: unemployment is between 25 and 30 per cent in Spain and Greece. That figure, again, masks underlying issues: youth unemployment in Greece and Spain is between 55 and 60 per cent, which is pretty massive and I do think will feed into one of the biggest risks in Europe, which is social and eventually political as well.

Credit is still contracting in the eurozone, though it's contracting by a slightly smaller number every month. Public debt is actually going up everywhere except for in Germany, where public debt was never really a main issue, and in Greece, where they had a massive debt write-off. But actually, in the wake of that, it's going up again. Inflation is somewhere around 0.5 or 0.7 per cent in the eurozone, which of course just makes it harder for countries to actually stabilize their public debt levels. So that's an issue.

In looking at whether the crisis response has been successful in ending the crisis or not, it's first important to identify what the crisis response has been. I think the crisis response has really been driven out of two German cities rather than out of Brussels: Berlin and Frankfurt, mainly. In looking at the policies that have been driven out of Berlin, of course with a few other smaller countries siding with Germany, I would argue that actually the crisis response has been unsuccessful in every metric.

The crisis response coming out of Berlin has been that all the other countries in Europe need to make all of the adjustments so that their economies look a lot more like Germany's, with higher national saving and higher investments going externally. Everybody needs to export their way out of this crisis. So the weaker countries have done all the adjusting; the stronger countries haven't really done any adjusting at all. That's reflected in current account balance figures across Europe.

We could argue that, sure, Berlin avoided the eurozone exploding, or imploding I guess, and the euro has been saved with this policy response. I would argue actually the Berlin approach needed to be bailed out by the ECB, and I think the real test here is in the first half of 2012. Rajoy was elected in Spain, Monti was appointed in Italy; both leaders implemented a number of austerity measures and some structural reforms (not as many as they needed to, but some). Yet bond yields for both Spain and Italy continued to rise, particularly from March 2012, once the effect of the ECB's long-term refinancing operations wore off. By July, yields hit really critical and unsustainable levels. There was basically a market run on all the peripheral countries and the ECB had to step in and announce this OMT programme, a bond-buying programme. Draghi said he would do whatever it took, and that has certainly been a game-changer in the eurozone crisis.

But I would say that if we think that the strategy to ending this crisis was the Berlin approach, then I think it's been insufficient in ending this crisis unless you include in that strategy sort of quietly stepping aside while Draghi steps in and violates German monetary orthodoxy at the last minute if any other options run out. So I don't think that response has been sufficient really.

You could say maybe the goal was for Europe to emerge stronger from this crisis than it was going into it, and I think on this metric actually that policymakers have really failed as well. If everybody is trying to increase their national savings and export their way out of the crisis, it pushes aggregate demand really low and just ensures that there won't be any demand in the eurozone. That's been evidenced in high unemployment figures and low inflation figures and really grim growth figures. Debt is going up, as I mentioned, so sustainability isn't being improved. European companies have been at really depressed levels so a lot of them have shut down, a lot of them have shed good labour, and a lot of that labour is going abroad and may never come back.

From an institutional perspective, the fiscal pact is no stronger than the stability and growth pact really. The ESM, this bailout fund, has been set up but it's insufficient to make a huge difference, particularly if a big country gets into trouble. Banking union has been set up but I would argue it's more of a loose banking federation than a banking union and it doesn't actually break this doom-loop between sovereigns and banks as it promised to. There's the 'six-pack' and the 'two-pack' but they're really ineffective. They don't have any teeth, and proof of that is that Germany has actually run too big a current account surplus but they haven't been able to force Germany to do anything about that.

From an ideological standpoint, Europe is actually weaker now than it was going into the crisis. We just saw the results from the European Parliament elections. That's a big signal, but also Eurobarometer polls have been pretty grim in the eurozone as well. So I'd say that the crisis response hasn't been effective in ending the crisis.

The other piece of that is what has been done from Frankfurt, and that includes this OMT bond-buying programme, which has certainly made a big difference in the sovereign bond markets. It hasn't fed through to all the other markets, so it's helped but it hasn't ended the crisis. There's an asset quality review coming up and the SSM is being established. There's not time to go into it now but I think that will be a huge fudge.

So some of these measures have helped. Have they ended the crisis? Absolutely not. So what can we do now to end the crisis? I think in the first instance, the ECB needs to step in. It has a couple of options and it may well act in June. It could offer some more LTROs. It could cut deposit rates into negative territory. It could offer huge amounts of credit and quantitative easing. But it's not clear that any of these measures will actually be a silver bullet.

I agree with John that we need debt workouts across the eurozone – not just in Greece though. I think actually in all these weaker countries, public debt is unsustainable and will have to be written down. The sooner we do it, the better.

Finally, I think we need steps toward an actual banking union, but also a political and fiscal union as well. John highlighted that we risk looking at a kind of Japanese-style lost decade in Europe. I don't think it's a risk, I think it's probably the main scenario. I'll leave it there.

Anatole Kaletsky

It seems this is emerging as a consensus. The second opinion is also it's remission rather than cure. A third opinion from Stephen, which I suspect will support the others. Stephen is a senior fellow here but before that he worked in HM Treasury. Specifically, at the end you were in charge of international affairs. Do you have a solution for them?

Stephen Pickford

Yes, but whether it's sustainable, I don't know. I'm not going to disappoint you: I'm also going to be on the gloomy side of this debate. Indeed, if you jog back to the origins of the crisis, I think John's being a little kind to Europe. They spent a lot of time arguing it was a fiscal problem; actually, they spent a year before that arguing it wasn't a European problem at all, it was a US problem. So there's been a degree of ostrich behaviour through this crisis.

What the crisis tells me is that there are some really fundamental problems with the European construct – with the euro construct, to be more specific. When you think about it – and indeed John's book goes into this, so I'll happily plug that as well, John – the origins of the euro and the Maastricht treaty actually were a bit of a fudge. If you look back at the Delors Report, they recognized many of the problems which have subsequently come to pass. The problem is that the euro area is not a [indiscernible] currency area and therefore, if that is the case, then you need to have lots of other structures in place to compensate for that. In particular, you need structures that allow greater convergence, more flexibility, fiscal transfers between member states – something to ensure that what John and Megan recognized as a problem, that most of the pressure for adjustment is on the deficit countries, actually is more symmetric.

So you need lots of other things to make this construct work more effectively. I would argue that since the onset of the crisis, some things have been done – not nearly enough, and some of them have been the wrong focus. So the focus on fiscal discipline at the member-state level was probably necessary but is certainly not enough. It also is, again, an asymmetric discipline.

On the financial side, where the doom-loop between banks and sovereigns had to be broken, the banking union is probably not a bad way through this. The problem is that only half, or perhaps less than half, has actually been put in place so far. The supervisory mechanism, with the ECB taking the lead on the big European banks, is probably pretty much entrenched now. The problem is, the difficult one, which is the resolution mechanism, has not got past first base and is going to be very difficult, because it requires agreement on burden-sharing. Who's going to pick up the bill when a big European bank goes bust?

The third area where the structures don't really work is – Megan's referred to a deflationary bias in Europe. That's partly, we argue, because there are no real mechanisms to have coordination or a degree of cooperation between fiscal, monetary, structural policies. In a recent report that I wrote with a couple of colleagues from the Elcano Institute, and indeed papers that I've written with Paola Subacchi in the past, we argue that you need to have some form of coordination mechanism.

This all requires institutions. It probably requires, in the end, some sort of central treasury or fiscal authority, not least because the resolution mechanism is going to require to have some fiscal resources put in there. Also, you probably need to have some mechanism for fiscal transfers. You need to have some incentives to introduce structural reforms in member states: even in a more integrated Europe, most of that is going to happen at the member-state level. And you also need to have mechanisms to have this coordination of economic policy.

The ECB, I think, has genuinely played a helpful role, by and large. The single currency and the single monetary policy is a problem for the euro area, but within those constraints the ECB, in particular Mario Draghi with his 'whatever it takes' speech in 2012, basically stopped the rot.

If I can just briefly touch on your second question, Anatole, what is likely to cause the crisis: I don't know. The problem in Europe is that without a crisis, you don't get reform. So wishing for a crisis is a bit odd but nevertheless to get the reforms we think are necessary, you're probably going to have to have a crisis. One crisis may well be that the markets decide to test Draghi's promise to do whatever it takes. If the OMT mechanism is tested, it may be found wanting. As John says in his book, it's a bit like a nuclear option: it's much better not to be tested.