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The future of Europe's economy Disaster or deliverance?

Paul De Grauwe, George Magnus,
Thomas Mayer and Holger Schmieding

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The Centre for European Reform is a think-tank devoted to making the European Union work better and strengthening its role in the world. The CER is pro-European but not uncritical.

We regard European integration as largely beneficial but recognise that in many respects the Union does not work well. We also think that the EU should take on more responsibilities globally, on issues ranging from climate change to security. The CER aims to promote an open, outward-looking and effective European Union.

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The future of Europe's economy: Disaster or deliverance?

Edited by **Simon Tilford** and **Philip Whyte**

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Introduction

by **Simon Tilford**

The introduction of the euro was supposed to usher in a period of improved economic performance across Europe. By fixing exchange rates the single currency would make it impossible to engage in competitive devaluations, which in turn would open the way for more trade integration. This would increase competition and hence productivity growth, raising economic growth and living standards. This, in turn, would strengthen member-states' public finances, and with it the sustainability of welfare states or Europe's 'social-market' economies. The euro would challenge the dollar as an international reserve currency, and boost Europe's standing in the world. Politically, the euro would bring EU member-states together, fostering a closer sense of unity and common identity. For some, this would be the first step on the road to full political union.

Things have not turned out quite this way. Since the onset of the financial crisis in 2007-08, Europe has suffered an unprecedented loss of economic activity, big (in some cases dramatic) increases in public debt in most countries and a crisis of its currency union. The EU economy is still considerably smaller than in 2007, the debt positions of many economies continue to worsen, and the eurozone has at times appeared close to collapse. Productivity growth has stalled, and living standards are declining, in some cases precipitously. The gradual convergence of living standards with the US in the run-up to the introduction of the euro has now gone into reverse, and welfare states are under pressure like never before. Relations between member-states, moreover, are perhaps more strained than at any point since the birth of the EU, and Europe's standing in the world has declined sharply.

Against this backdrop, the Centre for European Reform thought it a good time to invite four leading European economists – Paul de Grauwe, George Magnus, Thomas Mayer and Holger Schmieding – to anticipate how the European economy will look in 2020. Perhaps predictably, there are sharp differences between them over the

outlook for the currency union and for the broader EU economy. Some are highly critical of the current strategy for dealing with the eurozone crisis – which relies strongly on fiscal austerity and structural reforms in the debtor countries, with little in the way of burden-sharing between debtors and creditors, or off-setting fiscal stimulus in the creditor countries. For others, this strategy is essentially the correct one. Any sharing of risk through a fiscal union or monetisation (write-off of debt) by the ECB would be economically damaging and politically destabilising.

“For Paul De Grauwe, the eurozone’s creditor countries carry a large share of the blame for the crisis.”

For Paul De Grauwe, the eurozone’s creditor countries – aided and abetted by the European Commission – carry a large share of the responsibility for the

crisis. Their success in making sure that the burden for reducing the imbalances in the eurozone has been borne almost exclusively by the debtor countries in the periphery has created a deflationary bias and slump across the south of the eurozone. The debtor countries will have to transfer huge sums to the north for years, if not decades. This will run up against the limits of political legitimacy, as Germany’s experience of reparations following the first World War illustrates. Under the current governance structure, stagnation (and ultimately default) across much of the south is all but inevitable. To avoid this unfavourable outcome, the eurozone needs symmetric budgetary policies (whereby austerity in the south is matched by budgetary stimulus in the north) and partial monetisation of government debt by the ECB. If the member-states fail to overcome these obstacles, the European economy of 2020 is likely to be little bigger than it is now, with lower growth potential (because of persistently weak investment) and ongoing sovereign solvency problems.

George Magnus argues that the crisis has exacerbated economic differences between Germany and other northern creditor countries on the one hand, and those countries bordering the Mediterranean on the other. The north-south divide is reflected in different visions of, and policy approaches to, deeper integration, that have undermined trust between member-states and cast an existential cloud over European institutions. If the southern eurozone countries knuckle down to existing economic orthodoxy, and years of painful adjustment and reform, they will effectively be trying to replicate Germany’s highly export-dependent economic

model which only works because other economies are structured differently. If it is to avoid fracture, the eurozone needs symmetric macroeconomic adjustment, an effective joint-liability banking union, and macroeconomic policies that lessen the likelihood of funding crises and default. However, if the eurozone does beat a path towards high levels of integration, it will supplant the EU as Europe's principal organising force, giving non-eurozone EU member-states reason to question the value of remaining part of the union.

Thomas Mayer agrees that the eurozone is on an unsustainable course, but his prescriptions are different. Looking back from 2020, he argues that many member-states were not fit for the nineteenth century-type gold standard that was the blueprint for the euro. They allowed their economies to run up big budget and trade deficits, and could not tolerate the sacrifices needed to put them back on a sound footing. Mayer argues that there will be an easing of austerity and debt monetisation by the ECB, but that

this will destroy the eurozone by driving up inflation in the central and northern member-states (CeN), creating a stand-off between them and the Mediterranean members

“Thomas Mayer argues that the eurozone will split into two currency blocs.”

of the currency union. Faced with the imminent collapse of the project, eurozone governments will agree to introduce a parallel currency for the CeN, to be overseen by a new central bank; the existing ECB will be freed to pursue a monetary policy suited to the perceived needs of the Mediterranean countries. The new currency will appreciate against the euro, boosting real incomes in the CeN economies by making their imports cheaper, while a combination of euro depreciation and expansionary macroeconomic policy would kick-start recovery in the Mediterranean ones. Over time the latter will adopt sounder fiscal policies and reform their economies in an attempt to combat inflation, and substantive convergence between the two groups of countries will begin. The two currencies would compete within a looser institutional structure that will not require an all-powerful centre and would not force the likes of the UK out of the EU.

For Holger Schmieding the problems besetting the eurozone are not principally down to the eurozone being institutionally incomplete. The absence of automatic transfers between the participating economies is in fact an advantage: those countries which need protection against market turmoil have to make their economies more dynamic and

hence less likely to require aid in the future. The eurozone, in other words, denies its members easy escape routes: they can no longer devalue or inflate their way out of trouble. Instead, they have to take the hard route of fundamental reforms. And this is what is happening: Europe is finally reforming. If this continues – and France is a big risk in this regard – and the UK resists the pull of isolationism, the EU will be stronger economy in 2020 than it was in 2010 or 2000. The eurozone will not turn itself into a genuine political or fiscal union with a big eurozone budget and largely harmonized tax and spending policies,

“The future of the European project will to a large extent depend on which of the four authors is right.”

and nor should it. Tougher fiscal rules and a banking union are the likely consequences of the euro crisis, not a political union or any similar grand scheme.

The future of the European project will to a large extent depend on which of the four authors has best predicted the future. If the eurozone economy as a whole, and those of its debtor states in particular, suffer prolonged stagnation (culminating in a series of funding crises), popular faith in European integration could be hit hard. Aside from casting doubt over the future of the single currency, the damage to the EU's single market, perhaps Europe's biggest economic asset, would be considerable, and relations between member-states severely undermined. Conversely, if the eurozone stages a sustained economic recovery, and the currency union's debtor countries are able to honour their debt burdens while engineering a bounce-back in living standards, the outlook for the euro (and the EU more generally) will be much brighter.

Chapter 1

The creditor nations rule in the eurozone

by Paul De Grauwe

The European Central Bank's (ECB) bond buying programme launched in September 2012 saved the eurozone from collapse. But it has not prevented the currency union's creditor countries from dictating the budgetary and macroeconomic policies for the eurozone as a whole. Their perceived interest is in having the loans they have recklessly extended to the debtor countries in the past repaid in full. Austerity is the mechanism to achieve this objective. Surprisingly, the European Commission has been advancing the interests of the currency union's creditor countries, to the detriment of the debtors.

The burden of the adjustment needed to reduce imbalances within the eurozone has been borne almost exclusively by the debtor countries in the periphery. This has been contractionary and explains why much of the eurozone economy has been trapped in recession since 2012. Under the current governance structure, stagnation (and ultimately default) across much of the south of the eurozone is all but inevitable.

To avoid this unfavourable outcome, the eurozone needs symmetric budgetary policies (whereby austerity in the south is matched by budgetary stimulus in the north) and partial monetisation (write-off) of government debt by the ECB. Although a combination of these two policies would be in both sides' interests, the political obstacles to the needed change of direction are formidable. If the member-states fail to overcome these obstacles, the European economy of 2020 is likely to be little bigger than it is now, with lower growth potential (because of persistently weak investment) and continuing sovereign solvency problems.

The ECB rides to the rescue

Last year saw fundamental changes to eurozone governance. The most important was the ECB's decision, announced in July, to commit itself to unlimited purchases of member-states' government bonds in times of crisis. Prior to this decision the eurozone had been a fragile construction. This fragility was the result of the fact that, in joining the eurozone, national governments lost their power to call on their own central bank in times of extreme financial stress to buy out the holders of government bonds. Thus bondholders could not be guaranteed that cash would always be available to buy them out at maturity. The slightest concern that a government might experience payment difficulties was sufficient to prompt massive sales of government bonds, thereby precipitating a liquidity crisis.

“Prior to the ECB's launch of its OMT, investors feared that the eurozone might collapse.”

What the system needed was a lender of last resort. Although the ECB prefers to call its operations 'Outright Monetary Transactions' (OMT), these are in fact lender of last resort operations. The central bank's promise to buy troubled governments' bonds in unlimited amounts dramatically reduced the financial fragility of the system. It also took away the fear of break-up that had destabilised the system. Prior to the ECB's decision investors had feared that the eurozone might collapse.

As a result, the government bond market has stabilised since July 2012 (see chart 1). The many critics, especially in the north of Europe, who argued that the ECB should not intervene in the secondary bond markets have been proven wrong. The ECB's decision to become a lender of last resort, not only for banks but also for sovereigns, now protects the system from collapse.

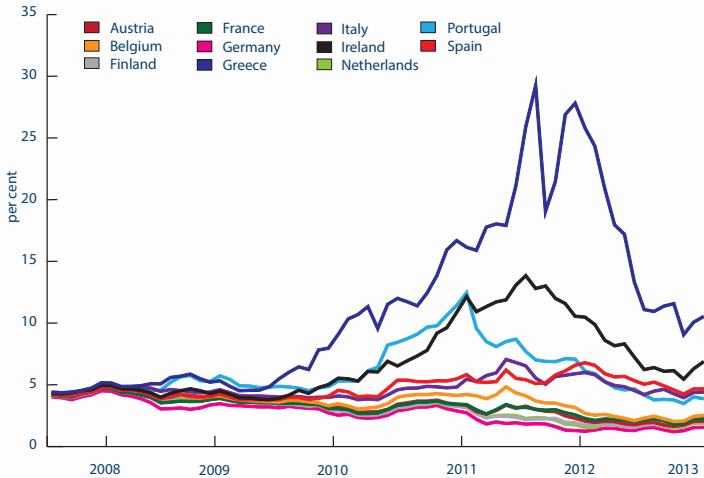


Chart 1:
Ten year
government
bond yields

Source:
Datastream

New governance of the eurozone: Creditor nations rule supreme

There can be little doubt that the ECB saved the eurozone, at least for the time being. However, this has not prevented the eurozone developing a governance system through which the creditor countries dictate the budgetary and macroeconomic policies for the eurozone as a whole.

In the run-up to the crisis, countries in the eurozone's periphery accumulated current account deficits, while many in northern Europe built up current account surpluses.¹ As a result, the peripheral countries became the debtors and the northern countries the creditors. This has forced the peripheral countries hit by sudden liquidity freezes to beg the northern ones for financial support. The latter have reluctantly provided it, but only after imposing tough austerity programmes requiring debtor countries to make deep spending cuts. Put differently, the creditor nations have imposed their interests on the whole system.

What is surprising is that the European Commission has assumed the role of agent of the creditor nations in the eurozone, pushing austerity as the instrument to safeguard the interest of the creditor nations. The Commission could have decided otherwise and become

1: Austria, Belgium, Finland, Germany and the Netherlands.

the agent of the debtor nations, protecting them from the insistence of reckless creditors to be repaid in full. After all, this has been the response of many governments after banking crises. Legislation has been introduced to protect consumers and home-owners from the banks' insistence on full repayment. The view in many countries has been that since banks are responsible for bad lending, they should share a significant part of the burden, mainly by accepting losses on their loan portfolios.

“The creditors are viewed as having pursued virtuous policies and the debtors foolish ones.”

This view has not prevailed in the relations between the creditor and debtor nations of the eurozone. The former are viewed as having followed virtuous policies and the latter as having pursued foolish

ones. This has led to a one-sided process where most of the burden has been shouldered by the debtor nations. They have been forced to reduce wages and prices relative to the creditor countries ('internal devaluation') without compensating wage and price increases in the creditor countries ('internal revaluation'). This has been achieved by intense austerity programmes in the south, while there has been no compensating stimulus in the north.

From 1999 to 2008, the relative unit labour costs of the debtor countries increased rapidly (see chart 2). But since 2008 there have been quite dramatic turnarounds in relative unit labour costs, reflecting internal devaluations in Ireland, Spain and Greece, and to a lesser extent in Portugal and Italy. However, there have been no offsetting internal revaluations in the surplus countries; as chart 3 shows, relative unit labour costs in these countries have barely moved.

The internal devaluations in the debtor countries have come at a great cost in terms of lost output and employment. As the process is not yet complete (except possibly in Ireland), more losses in output and employment are inevitable.

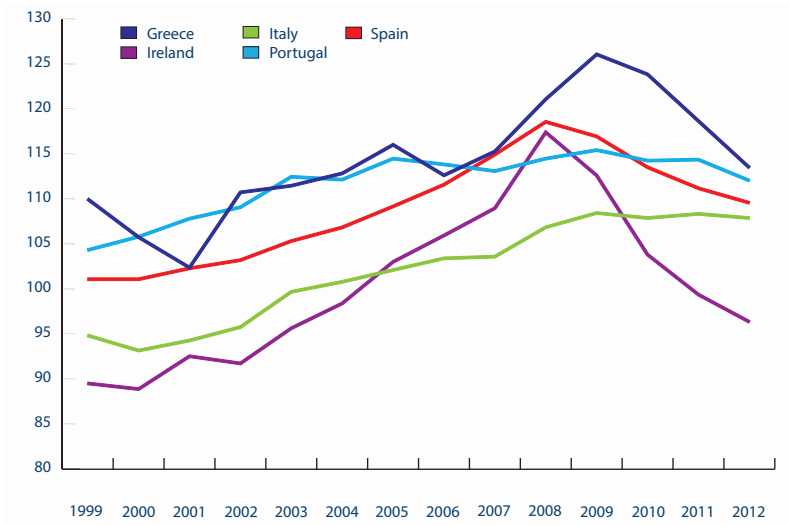


Chart 2:
Relative unit
labour costs
(average
1970-2010
= 100)

Source:
European
Commission,
Ameco

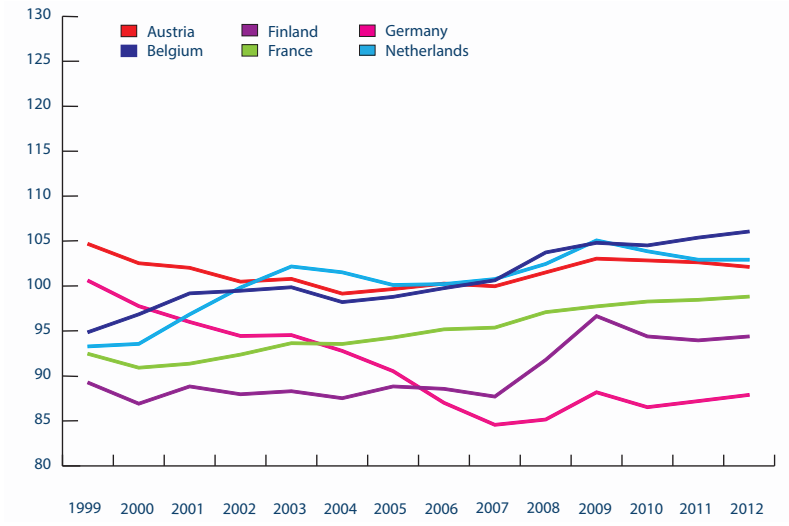


Chart 3:
Relative unit
wage costs
(average
1970-2010
= 100)

Source:
European
Commission,
Ameco

The legacy of creditor-dictated governance

The creditor-dictated governance that has arisen since the eruption of the sovereign debt crisis in the eurozone has failed and the damage will take a long time to repair. There is no evidence that these programmes have increased the capacity of debtor countries to service their debt.

As chart 4 illustrates, the austerity programmes that were set in motion after 2010 have not stopped the explosive growth of government debt to GDP ratios. Austerity programmes in fact have been responsible for rising debt. The debtor countries suffered 'balance sheet recession' in which households and businesses desperately tried to reduce their debt levels. When, at the insistence of the European Commission and the creditor nations, the debtor countries' governments were also forced to deleverage (cut spending and boost savings), deep recessions resulted. This, in turn, had the effect of dramatically raising their government debt ratios, mainly because the denominator (GDP) declined significantly.

“Austerity programmes have not stopped public debt from rising explosively.”

Due to their persistent current account deficits, the external debt of a number of southern members of the eurozone exploded, reaching 100 per cent or more of GDP (see chart 5). The counterparty to this

accumulation of external debt in the south was northern Europe: Belgium, Germany, Finland and the Netherlands became major creditors. Only in 2013 did the external debts of Greece, Portugal and Spain stop rising (as they have closed their current account deficits). This has occurred mainly because of deep domestic recessions that have significantly reduced imports.

An historical parallel highlights the risks of the eurozone's current approach to resolving the crisis. After World War I, the victorious nations imposed reparation payments on Germany. At that time, the British economist John Maynard Keynes argued that these reparation payments were too punitive and that Germany would be unable (or unwilling) to repay its debt. A nation can only repay its debt – that is, make a transfer of resources to the rest of the world – by running current account surpluses. Such a transfer of money creates great hardship for citizens of the debtor nation. At some point, citizens' willingness to finance these painful transfers to foreigners wears thin and leads to political upheaval. This is what happened to Germany.

The same transfer problem arises today. Southern eurozone countries are now forced to generate current account surpluses that will make it possible to transfer large amounts of money to northern creditor countries, in particular to Germany, one of the wealthiest countries in the eurozone.

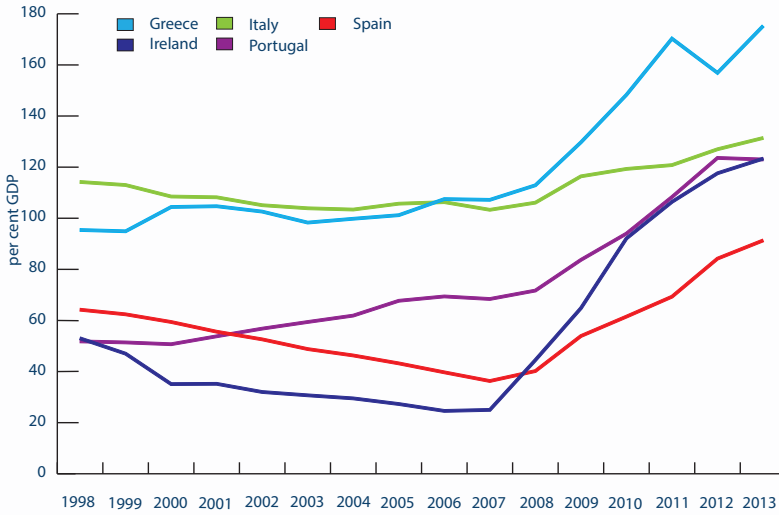


Chart 4:
Government debt to GDP ratio

Source:
European Commission, Ameco

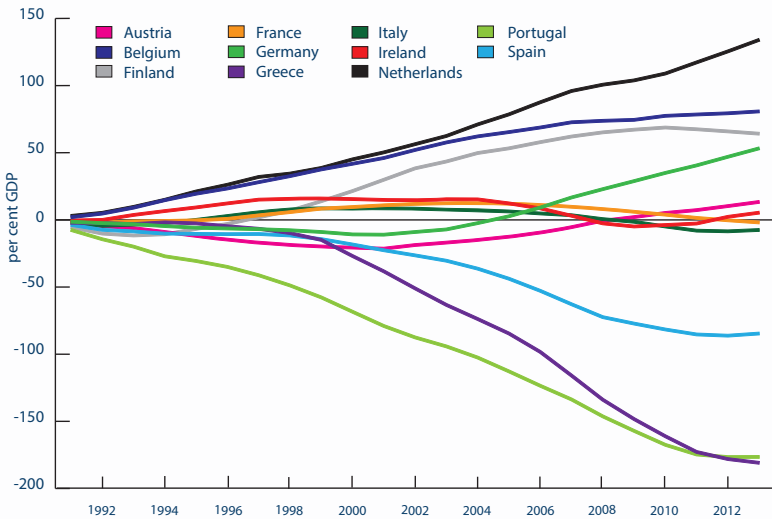


Chart 5:
Cumulated current account balances, 1990-2012

Source:
European Commission, Ameco

This strategy is unsustainable. For example, the three most heavily indebted countries – Greece, Portugal and Spain – will have to run current account surpluses of 3 per cent of GDP for between 10 and 30 years just to halve their external debts. And even then, Greek and Portuguese levels of external debt may still be unsustainable (see table 1).

Table 1:
Number of years needed to half external debt (with different current account surpluses)

Current account	Greece	Spain	Portugal
Surplus of 3 per cent	30	13	29
Surplus of 4 per cent	22	10	21
Level of external debt reached (per cent GDP)	90	43	88

Source:
Author's own
calculations

Such a prolonged period of transfer of resources to foreign nations will run up against a lack of political legitimacy, much as it did in Germany after World War I. No political system can survive if it is perceived to act in the interests of foreign nations rather than its own citizens.

Policy options

There are three possible options to deal with the problem of excessive debt in the southern eurozone countries.

(i) Symmetrical budgetary policies

As argued earlier, the eurozone's debtor nations have been forced to apply budgetary austerity, while the creditor nations have not been obliged to impart any offsetting budgetary stimulus. This has created a deflationary bias which has made it very difficult for the debtor nations to deleverage (reduce their debts) irrespective of how much austerity they impose. A symmetrical approach to fiscal adjustment is needed instead. Such an approach should start from the different fiscal positions of eurozone member-states.

“No political system can survive if it acts against the interests of its own citizens.”

While the debtor countries have been unable to stabilise their ratios of government debt to GDP (in fact, these are still on an explosive upward path), the situation of the creditor countries is dramatically

different (see chart 6). Not only are their debt levels significantly lower, but more importantly some of the creditor countries (Austria, Belgium and Germany) have managed to stabilise their debt to GDP ratios. This opens a window of opportunity to introduce a rule that would contribute to more symmetry in the macroeconomic policies of the eurozones' member-states.

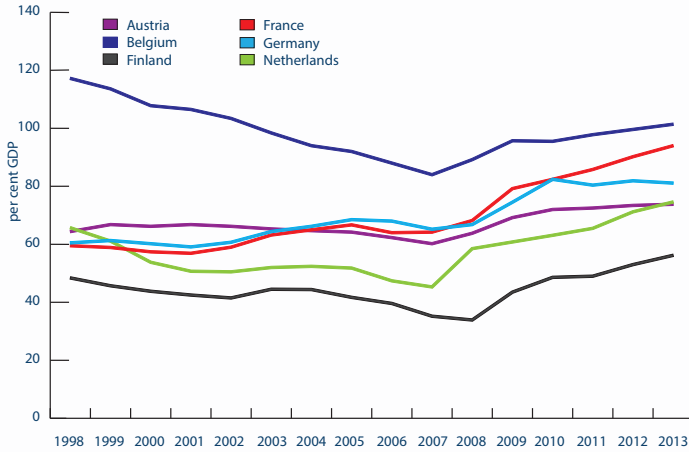


Chart 6:
Gross
government
debt to GDP

Source:
European
Commission,
Ameco

Those creditor countries that have stabilised their debt ratios should stop trying to balance their budgets now that the eurozone is caught in a protracted slump. These countries can run small budget deficits and yet keep their government debt levels constant. Germany, which is close to achieving a balanced budget in 2013, could run a budget deficit of close to 3 per cent of GDP while keeping its ratio of public debt to GDP constant. This would provide a significant stimulus for the eurozone as a whole and reduce current account imbalances between the north and the south of the eurozone noted above. A German stimulus would boost eurozone growth, allowing all other countries to achieve the same budget targets with less austerity. Put differently, a German stimulus would help the rest of the currency union to deleverage with less loss of output.

Whether the symmetrical rule proposed here will be implemented very much depends on the European Commission. It needs to stop acting as the agent of the creditor nations and instead take up its role as defender of the interests of the currency union as a whole.

(ii) Debt monetisation

The second option is a (partial) monetisation of debt. The ECB could buy a significant amount of the southern member-states' outstanding

government debts. For this to constitute debt relief the ECB would need to write off the bonds that it added to its balance sheet.

Two objections can be made to such an approach. The first has to do with the fiscal implications, the second with the inflation risks. At the point the ECB purchases the bonds and then writes them down there are no fiscal implications for the creditor countries. All that happens is that government debt disappears and that money base (that is, notes and coins in circulation and commercial bank deposits with the central bank) takes its place. The ECB would not receive interest and would not pay out interest to creditor countries. The only fiscal implication is that the debtor countries would save on interest payments because part of their debt would have been written off. Over time, however, there could still be fiscal implications for the creditor countries, depending

“Open market operations involving the purchase of government bonds create the potential for inflation.”

on whether the central bank's actions led to higher inflation and what other strategies it employed to reduce the money base once economic recovery took hold.

Every open market operation involving the purchase of government bonds by a central bank creates the potential for inflation because it increases the money base. But the extent to which this feeds through into the money supply (the amount of money in circulation in the economy as a whole), and hence to inflation, depends to a large extent on the economic and financial situation.

Before the financial crisis which began in 2007, the two monetary aggregates (money base and money supply) moved in unison in the eurozone, suggesting that the so-called money multiplier (the ratio of money supply to money base) was constant. Put differently, in this period a 1 per cent increase in the money base led to an increase of the money supply of approximately 1 per cent.

However, the evolution of money base and money supply has been quite different in the period after the onset of the crisis (see chart 7). Between October 2008 and May 2013 the eurozone's money base increased by more than 50 per cent, while the money supply increased by only 7 per cent. The result is that underlying inflation pressures have remained very weak (see chart 8). Indeed, the strong increase in the money base helped to reduce the deflationary forces in the economy, rather than being a source of inflation.

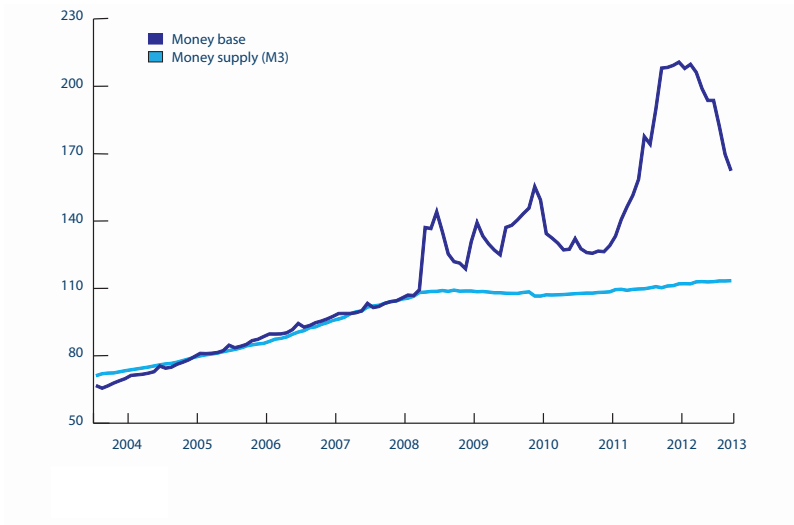


Chart 7:
Eurozone
money base
and money
supply
(December
2007 = 100)

Source:
European Central
Bank, Statistical
warehouse

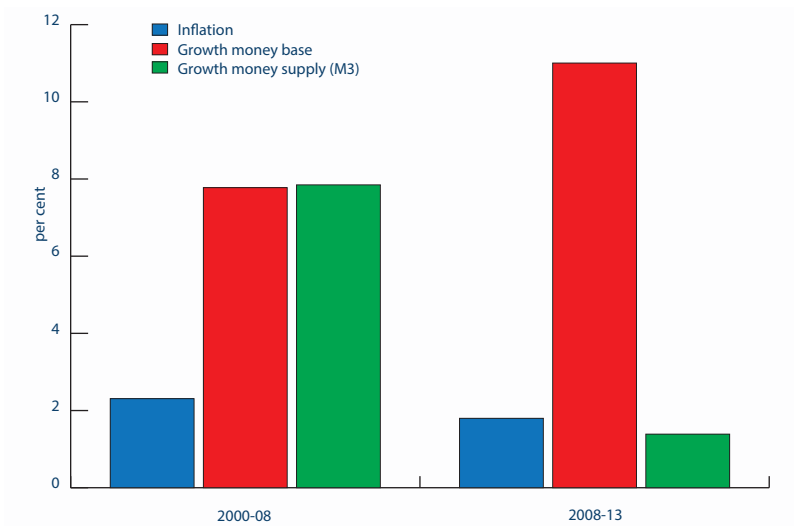


Chart 8:
Inflation and
growth in
money base
and money
supply
(average
annual per
cent growth
per year)

Source:
European Central
Bank, Statistical
warehouse

The reason that money supply has barely expanded despite a sizeable increase in the money base is that the money multiplier has dropped dramatically, perhaps to as low as zero. Banks, which accumulate reserves as a result of the liquidity injections by the ECB, are hoarding these reserves. Their degree of risk aversion is such that they do not use their cash reserves to expand bank credit. As a result, there may be

no limit to the amount of government bonds the ECB can buy without endangering price stability, as long as the crisis lasts.

But what will happen when the eurozone economy expands again? The large amounts of liquidity (money base) held by the banking sector (the direct result of debt monetisation) would in all likelihood be used by the latter to expand credit and the money supply. At that moment the inflation risk (and possible fiscal implications for creditor nations) would materialise.

“Ideally, the eurozone would combine symmetric budget policies with debt monetisation.”

The ECB would then have to choose between one of two options. First, it could do nothing and allow the supply of credit to expand strongly, driving up inflation. Under this scenario, the debt relief provided by

the ECB would be paid in the future by all eurozone citizens in the form of an inflation tax, but there would be no further fiscal implications.

This scenario is highly unlikely given the ECB's strong mandate to keep inflation low. The ECB is much more likely to follow policies aimed at reducing (or sterilising) the money base. The central bank could issue interest-bearing bonds and sell these in exchange for money held by banks. This would have fiscal implications; for example, the ECB would have to pay interest on these bonds. Alternatively, the ECB could raise the minimum reserve requirements of the banks, limiting their scope to expand credit. The latter option would be easier to implement than the issuance of interest-bearing bonds, and would probably be the ECB's preferred course of action.

Ideally, the eurozone would combine a symmetrical budgetary policy with debt monetisation by the ECB. Yet it remains highly unlikely that either of these two options (let alone their combination) will be chosen. The emotional resistance to such strategies remains very strong in the north of Europe. This then leaves only one solution – that the southern European countries default on their debts.

(iii) Debt default

In the absence of either symmetrical budgetary policies or debt monetisation, debt default by a number of southern member-states of the eurozone, in particular by Greece and Portugal, and possibly

others, has become almost inevitable. As argued in the previous sections, politicians in these countries will not accept their countries being forced to transfer resources for years, if not decades, to rich creditor nations in the north in an effort to reduce their debts.

The only question is: when will they default? Ideally, this should happen as soon as possible. There are two reasons for this. First, it is in the interests of the debtor nations to default in an orderly way today rather than delay the inevitable: this would free their economies from the damaging deflationary policies to which they are currently subjected. Second, it is also in the interests of the creditor nations to accept debt relief. The insistence of these nations that the debtors pay back their debts in full makes much bigger (and potentially disorderly) defaults more likely. It can be in the interest of creditors to relieve debtors of part of their debt in order to give the latter incentives to continue servicing a proportion of it.

Unfortunately, a large part of the north's claims on the south is now held by public institutions in the north. And in many northern countries, Manichean views of good and evil prevail, leading to an emotional desire that evil be punished. This attitude makes it difficult for politicians in these countries to choose the rational outcome that would make everyone better off.

Conclusion

A solution to the eurozone crisis requires burden-sharing between the currency union's creditor and debtor countries; so far nearly the entire burden of adjustment needed to address the imbalances between the member-states has fallen on the debtors. To prevent a political backlash in these countries, and the potentially calamitous defaults this would be likely to precipitate, the ECB needs to write off a proportion of the public debts of the southern members of the eurozone and Ireland. And the eurozone's overall macroeconomic stance needs to counter the weakness of demand across the currency union rather than reinforce that weakness. Without a combination of these two approaches, the outlook for the eurozone will remain bleak.

Chapter 2

Europe needs an alternative to stagnation and fragmentation

by **George Magnus**

In 2020, Europeans will have something to celebrate, and they will do so with fanfare across a swathe of European cities. But UEFA's grandiose ideas for the 60th Euro football championship in 2020 are a far cry from the dark shadows that have fallen over the EU economy. Long-standing weaknesses in Europe's demographics, competitiveness, productivity and financial architecture have been amplified by the euro crisis, driving the region's trend rate of economic growth to below 1 per cent per year.

The crisis has illuminated and exacerbated economic performance and structural differences between Germany and other northern creditor countries, and those countries bordering the Mediterranean. The north-south divide is reflected in different visions of, and policy approaches, to deeper integration that have undermined trust between member-states and cast an existential cloud over European institutions. If eurozone countries prove unable to make significant progress towards shared macroeconomic adjustment, an effective joint-liability banking union, and a workable strategy for sovereign debt sustainability and default risk, the currency union could fracture by 2020. If the eurozone beats a path towards high levels of integration, though, it will supplant the EU as Europe's principal organising force, giving non-eurozone EU member-states reason to question the value of staying part of the union. The British government has already promised UK voters a referendum on EU membership by 2017.

Internationally, Europe will do well simply to manage its relative decline in an orderly fashion. Its share of world economic output is set to fall as that of developing countries increases and its contribution to global economic growth will continue to slide. Even though China is embarking on an economic transition that will result in slower growth and instability, and a possibly renascent US still

faces a demanding budgetary adjustment, Europe will be likely to lag behind both in terms of economic dynamism and productivity growth. If Europe is to flourish, it must emphasise the importance of home-grown economic renewal, and avoid becoming over-reliant on exports to emerging markets, whose economic prospects are starting to look rather more pedestrian.

The challenge of economic renewal

Europe's economic track record since the launch of the euro in 1999 has not been impressive. In 2000, the Lisbon Strategy aimed to make the EU the most competitive and dynamic knowledge-based economy in the world by 2010, capable of delivering robust economic growth and high employment, while maintaining high levels of social cohesion. In spite of a relaunch in 2005, this strategy foundered under the weight

“If Europe is to flourish it must avoid becoming over-reliant on exports to emerging markets.”

of complex multiple goals, opaque responsibility and accountability, an ineffective central authority (the Commission), a lack of political engagement by EU member-states, and finally the financial crisis.

The launch of the Europe 2020 strategy three years ago set out a more modest goal of smart, green and inclusive growth. Its principal economic and social aims are to raise the employment rate of working age adults to 75 per cent, increase research and development (R&D) spending to 3 per cent of GDP, and strengthen the contribution to growth from human capital by raising education levels and improving skills. But Europe 2020 suffers from the same weaknesses as its predecessor and faces even bigger obstacles, because the euro crisis has diverted attention of policy makers from these issues.

The consequences of rapid population ageing are becoming increasingly apparent. As a result of low birth rates and rising life expectancy, old age dependency ratios are rising rapidly across Europe. The number of people aged over 65 is forecast to rise by 18 per cent to 93 million, pushing the old age dependency ratio up from 26 per cent to over 31 per cent by 2025. The working-age population of the EU is expected to fall by 1.5 per cent over the next decade, with much steeper declines than this in Germany, Italy and Spain.

These trends have been accentuated by the extreme weakness of business investment since the onset of the crisis, which has further hit productivity growth, and by a reversal of many of the gains in employment rates made in the run-up to the crisis. Spain's employment rate stood at 69 per cent in 2007 but had fallen to 59 per cent in 2012 (Greece's fell by a similar margin over this period). For the EU as a whole the trend has been less dramatic, with the employment rate falling from close to 70 per cent in 2007 to 68 per cent last year. All this casts doubt over the affordability of welfare states, and challenges European countries to redefine the entitlement rights and obligations of citizens versus the state in the most difficult of economic times.

The EU's 2020 strategy recognises the need to raise employment rates and productivity growth. But the prospects of this happening over the next few years are

“EU countries must redefine the rights and obligations of citizens in the most difficult economic times.”

unpromising for four reasons. First, it is widely acknowledged that the restoration of financial stability and a functional banking system is a key pre-condition for, if not a guarantor, of sustainable economic growth and improved labour market performance in Europe. This has not yet been achieved.

Second, raising employment rates will be hard against a backdrop of economic slump and demographic change that is generating more retirees than new entrants to the work force. In many countries, especially Mediterranean ones, there are also major structural weaknesses in the employment of women and older citizens, the two groups of workers that hold the key to raising the proportion of the population in work.

Third, although in some EU countries manufacturing productivity levels are high, overall productivity growth has been declining in Europe for some time, notably since the second half of the 2000s. In contrast to the US, Europe has not been able to boost productivity through the deployment of information and communications technologies (ICT). It has failed to improve productivity in service industries, or sparkle in innovation and technological change. European leaders believe that increasing spending on R&D is crucial to boosting the region's productivity. They want to increase the proportion of EU GDP devoted to R&D from the current level of below 2 per cent of GDP (where it has

been stuck for over a decade) to 3 per cent by 2020. However, against a backdrop of widespread fiscal cutbacks, private businesses, which account for three-fifths of Europe's modest R&D spending, will have to raise their share of the total considerably if the target is to be met. This seems improbable, and Europe (including Germany), will probably continue to lag the US in terms of innovation and private sector R&D, and may well lag both the US and China by 2020 in terms of total R&D spending.

“Europe (including Germany) will continue to lag behind the US in terms of innovation.”

Fourth, the goal of boosting R&D as well as productivity and investment rates is easy for the Commission to proclaim, but national governments have to address the underlying causes, which include their own

inadequate investment in human capital and a lack of investment in so-called non-physical capital by businesses. The latter comprises, for example, corporate intellectual property rights (such as patents, trademarks, designs and copyrights), worker training, business models and organisational structures, as well as goodwill and brand recognition. Apart from a few countries, notably Germany, Sweden, and the UK, Europe has fallen behind the US in 'intangible' investment, and in the business functions designed to extract commercial value from this increasingly important form of investment.

In 2010, around 30 per cent of the EU population lacked upper secondary education, and less than a quarter had graduated from university. This compares with 6 per cent and 40 per cent respectively in the US. It suggests that increasing European employment rates and boosting productivity may be much more a question of upgrading the education and skill base of the population than the current obsession with labour market and pension reforms.

Reforms of welfare and wage systems, and of the provision of public services, will most probably contribute to better economic performance in the long term. But for the time being, the reliance on this approach may do more harm than good as labour market reforms are depressing wages (and hence consumer demand). The economic surveillance and monitoring systems established by the Commission penalise countries for allowing real wage growth to outstrip productivity growth, but not for allowing wage growth to lag behind the rate of productivity growth. Elsewhere, cuts in pension entitlements and the privatisation of public

services are also weakening demand, and may have a marked negative impact on the consumption and savings habits of future retirees and the long-term unemployed.

Rebalancing and banking union

Tentative signs in the summer of 2013 that the eurozone recession may finally have come to an end mean neither that economic growth is sustainable, nor that sovereign debt and default risks have diminished.

Greece and Portugal still cannot meet their austerity targets, and require continuous financing. In Spain and Italy, debt-to-GDP ratios are still increasing and the primary budget surpluses needed to stabilise, let alone reduce, public debt are economically and politically daunting. Without robust growth in nominal GDP, debt burdens will continue to rise, maintaining Greece and Portugal as financial wards of the eurozone. There is a real risk of funding crises in Spain and Italy, especially since their banks already own substantial government debt holdings relative to their capital. (In these systemically important countries holdings of government debt amount to 1.37 and 1.76 times' bank capital, respectively). The consequences of a major financing crunch might require a shift by the ECB to open-ended and unconditional lending, and or to a major expansion of the European Stability Mechanism (ESM), but

neither is inevitable. Default risks are likely to hang over the European economy, and over the integrity of the eurozone.

“Funding crises and default risks are likely to hang over the integrity of the eurozone.”

Even though financial market turbulence has subsided, at least for now, most people acknowledge that Europe has to do two things. First, it must achieve stronger and more balanced macroeconomic adjustment policies to lift the economy out of a slump in aggregate domestic demand and business confidence. Second, it has to make rapid progress towards an adequately backstopped banking union which includes joint liability for banks. This would boost bank capital, act as an agent for bank restructuring, restore credit flows, and finally sever the ties between weak banks and weak sovereigns.

The rhetoric about growth versus austerity changed in Europe in 2013, with eurozone policy-makers starting to acknowledge the

contractionary impact of fiscal austerity. Progress was also made over the past year in launching a banking union, and establishing a Single Supervisory Mechanism (SSM). But in both areas, Europe still lacks political will and imagination. Fiscal policy remains strongly pro-cyclical while the banking union is at best embryonic. The SSM, in fact, is less important than a common resolution regime for banks or pan-eurozone deposit insurance.

“The eurozone crisis has put Germany, as Europe’s dominant creditor, centre-stage in Europe.”

Rightly or wrongly, the eurozone crisis has put Germany, as Europe’s dominant economy and creditor, centre-stage in Europe. Many people hope that after the German elections in September, a new

government coalition, most likely headed by Angela Merkel again, will steer the eurozone towards more expansionary macroeconomic policies and a fully-fledged banking union. But while there is every prospect of new initiatives, it seems very unlikely that Germany will change its economic DNA, or its political ‘shyness’ when it comes to leadership. It is difficult to imagine Germany abandoning its ‘*Ordnungspolitik*’ (rules-based governance) at home or in Europe for expansionary fiscal and monetary policies; or forsaking its belief in step-by-step, legalistic, and reciprocal agreements as the quid pro quo for relatively limited financial concessions and pooling of sovereignty. Germany emphasises the need for constitutionally-binding budgetary restraint, wage and pension suppression, and reforms of labour (and to a lesser extent) product markets. Its hesitancy to move beyond the establishment of the SSM is because it does not want to be bounced into a system of bank resolution and joint liability, which it does not like, and for which it sees no legal foundation as things stand.

Germany is not a model for the whole of Europe

The German government maintains that its economic success has allowed it to play the lead role in the development of a structural reform agenda for Europe, new fiscal governance procedures and instruments, and new financial rescue mechanisms. But the principal victims of the eurozone crisis (and France) have stigmatised Germany for its alleged obsession with fiscal prudence and constitutional legitimacy, and for a lack of urgency and compassion in accelerating economic and political integration. The differences between Germany

and France are important and sensitive: Berlin believes Paris must reform, but fears that the pressure on France to do so may be dulled by the implicit acknowledgment of German credit and political protection.

How these political differences are resolved will have a powerful bearing on the economic outlook to 2020. If southern eurozone countries knuckle down to existing economic orthodoxy, and years of painful adjustment and reform, they will effectively be trying to replicate Germany's economic model but without many of the advantages that Germany enjoys and exploits. The most likely outcome, then, would be continued economic stagnation, default risk and social and political stress. A Europe made up of many 'Germanys' would almost certainly fail.

Germany's mainly export-driven economic model reflects a structural excess of domestic savings over investment. It is impossible for all eurozone countries to run trade surpluses unless there is an unprecedented global boom. Curiously, the IMF thinks that all eurozone countries, except Finland, will be in external surplus by 2018. But there is not going to be a global boom, and so this outcome will only be possible if Europe persists with policies that depress domestic demand. This, in turn, will lead to rapid rise in debt burdens, opening the way for funding crises.

“Germany's agenda 2010 reforms, left the country with perhaps the largest low-wage sector in Europe.”

Moreover, it is often argued that Germany's economic success can be traced to reforms of the country's labour market, social security and public sector (the so-called Agenda 2010) unveiled in 2003. If they worked for Germany, the reasoning goes, they should work for everyone else. But these reforms were not regarded as ground-breaking at the time, and while they did restructure and liberalise the benefits system and some labour market practices, they were not the reason for Germany's celebrated competitiveness gains. The Agenda 2010 reforms hardly touched important issues such as collective bargaining, working time rules, and hiring and firing flexibility. They did not raise Germany's anaemic rate of productivity growth, and they have left Germany with perhaps the largest low wage sector in Europe. These reforms should certainly not be on Europe's 'to-do' list.

The secrets of Germany's economic success are rather to be found in a social organisation that encourages systemic wage restraint, an emphasis on specialised and high quality manufactures and capital

goods, and the strong exploitation of rising demand in China and other emerging markets, especially Central and Eastern Europe. This is a model that will not transfer easily or at all to much of the rest of Europe.

Rapid relative decline all but inevitable

Even if the eurozone finds a way to definitively break the link between banks and sovereigns, and eases back on fiscal austerity, Europe's shares of global GDP and of the growth in global GDP will decline in the face of the rising significance of China and other emerging markets and a reinvigorated US. The latter's economic growth is set to easily outpace that of Europe as a combination of strong productivity growth

and lower energy costs boosts competitiveness. Between now and 2020, Europe's share of global output growth may drop to around 15 per cent, or less than 10 per cent in the case of the eurozone.

“Europe's share of the global economy may drop to as little as 15 per cent.”

The successful completion of the proposed Trans-Atlantic Trade and Investment Partnership by the middle of the decade could help to mitigate European decline. Europe and the US would gain from lower regulatory and non-tariff barriers to trade, and the rate of economic growth in Europe could get a timely boost, with estimates of this ranging from 0.25 to 0.4 per cent per year.

Indeed, some commentators think trade is Europe's best hope. Since 1999, when the single currency was launched, the eurozone's share of goods and services exported to the rest of the world has already risen from 14 per cent to 22 per cent of GDP, as trade with China and other emerging markets has grown rapidly. Exports to Brazil, China, India, Russia and South Africa (BRICs) have risen by between 10 and 15 per cent per year since 2007, with China and Russia emerging as major markets.

But future benefits from trade may not be as large as assumed. Competitive conditions will get tougher as countries such as China continue to move up the value chain. And the benefits of greater trade integration have in any case accrued disproportionately to Germany and a few other northern European countries. In 2012, Germany accounted for 46 per cent of EU exports to China. There is an implicit

danger here that as trade diversification continues, it will further strengthen a German-centric supply chain, incorporating Central and Eastern Europe. In the long-term, if these countries increasingly trade with countries outside of the eurozone, it might call into question the value of monetary union itself.

In the meantime, though, even successful export models, such as Germany's, will have to pay attention to what appears to be a long-term slowdown in growth in China, as well as in other major emerging markets such as Brazil and India, and, closer to home, Russia and Turkey. These emerging nations have experienced a lengthy period of fast growth in exceptionally benign global circumstances that have run their course, and they have more or less exploited many of the economic benefits associated with rapid economic catching-up that are unique or unrepeatable. The biggest shift is going on in China, which may be only half way through a transition from annual growth rates of around 10 per cent to closer to 4-5 per cent.

Conclusion

It would be churlish to assert that the largest and one of the most sophisticated economies in the world, with high living standards, world-class companies, and a justified reputation for successful regional integration and rule-making is not capable of economic renewal and a reinvention of its prized social model. The consensus view that Europe will continue to muddle through, weakly, to 2020 may well prove correct. At the same time, it is also true that cumulative competitiveness, demographic and productivity shortcomings, and the consequences of the sovereign and banking crisis, have collided to produce the most significant threats to the European economy and the legitimacy of its institutions since the 1930s. There are no black swans lurking out there in the next few years, just political miscalculation, weakness, and inertia.

Chapter 3

The view from 2020: How the eurozone and the EU were finally stabilised

by **Thomas Mayer**

“Everything needs to change, so everything can stay the same”

Giuseppe Tomasi di Lampedusa

Ten years after the insolvency of the Greek state triggered the crisis of the euro and the EU, it is time to look back and review the events and policy decisions that led to the eventual resolution of the crisis. Finding the right answer to the problems which had accumulated during the single currency's first decade of existence was difficult and time consuming. For the first five years, from 2010 to 2015, the crisis deepened. The healing process could begin only when the crisis reached Germany in 2015. This eventually induced the German and French governments to abandon their piecemeal approaches to crisis management and to take radical steps for a comprehensive reform of the EU. They convinced their partners that the structures of the EU and EMU, designed in the 20th century, had to be made fit for the 21st century in order to preserve the European idea: a community of peoples united in freedom and democracy. Five years after this historical decision, we can conclude that the measures adopted have been successful. The eurozone and the EU now have a stable architecture, even if it is very different from that envisaged at the outset.

A false start

In the 1990s the single currency was designed essentially along the lines of the gold standard. An independent central bank was to pursue

price stability as its only goal, and governments were supposed to be fully responsible for their general economic and fiscal policies. Even in financial difficulties they were not supposed to receive financial help from the common central bank, other governments, or other EU institutions. This was, of course, a very demanding regime. Without recourse to the money printing press, governments would have to keep their fiscal houses in order. Only with sound public finances could they expect to have continuing access to capital markets and to be able to roll over their debt. Moreover, participating economies had to be flexible to adjust to country-specific shocks, and companies had to exercise strict controls over their costs to be able to compete

“EMU benefitted from the upswing of the global credit cycle induced by very easy monetary policies.”

in the common European and world markets. Exchange rate devaluations to correct for losses of competitiveness caused by a lack of cost control were supposed to be a thing of the past.

Of course, countries did not live up to the challenges posed by the Maastricht model of Economic and Monetary Union (EMU). Many made only half-hearted efforts to control their budget deficits, or failed to bring their public debt down to the ratios originally established as entry criteria. Some allowed labour costs and prices to surge and were complacent about the build-up of large current-account deficits. Although the first decade of EMU was widely regarded as a big success, with the benefit of hindsight it is obvious that it only worked because of the availability of cheap credit. It was cheap and plentiful credit that allowed governments to run big budget deficits and countries to fund very large current-account deficits. Thus, EMU benefited from the upswing of the global credit cycle induced by very easy monetary policies across the world. Moreover, EMU also benefited from the fact that the export of German excess savings was no longer constrained by exchange rate risk.

Before EMU, the demand for D-mark by foreign importers of German goods was larger than the ability of German financial institutions to supply the German currency. It fell to companies, investment funds, and wealthier private investors to take the exchange rate risk associated with the export of German savings. Banks and insurance companies, which had large domestic currency obligations, could not acquire sufficient assets denominated in foreign currency. As a result, there tended to be global excess demand for D-mark, which pushed the

exchange rate of the German currency up over time. Exchange rate appreciation improved the country's terms of trade and the wealth of the German consumer who could buy foreign goods and services, notably holidays abroad, more cheaply.

But EMU eliminated exchange rate risk for German foreign investments in the eurozone, allowing banks and insurance companies to participate in the intermediation of German savings abroad. As a result of increased capital outflows from Germany, attracted by higher interest rates on government, bank, and mortgage debt in other EMU countries, the underlying German current account surplus tripled from about two percent of GDP before EMU to roughly six percent of GDP in EMU. With other countries fully absorbing German excess savings, the eurozone ran a broadly balanced external current account.

This helped to shield the euro from the pressure for appreciation that had afflicted the D-mark for most of its existence. *“The eurozone’s honeymoon came to an end with the bursting of the global credit bubble.”*

A failed rescue

The eurozone's honeymoon came to an end when the bursting of the global credit bubble ended the era of cheap credit. To prevent the single currency from falling apart, the European authorities quickly replaced private credit by official credit – partly through official loans to distressed countries by newly created euro area institutions such as the European Stability Mechanism (ESM), but even more so through the Eurosystem of central banks. However, what was initially seen as temporary help for countries to return to the Maastricht requirements of sound public finances, economic flexibility and cost control soon turned into a seemingly permanent arrangement. Some countries were obviously not fit for the nineteenth century-type gold standard that had been the blueprint. Electorates used to the amenities of the modern welfare state tended to expect more benefits than they collectively were willing to fund through taxes. This made budget surpluses and the reduction of public debt impossible. The only way to fund the borrowing needs of governments was through the money printing press. As a result, the ECB was forced to provide financial backstops for both governments and banks, which had lent heavily to over-indebted governments. Over the course of 2013-14, the ECB bought securitised debt of companies in

southern European countries that neither risk-averse banks nor capital market participants were prepared to buy.

In 2012 Germany cajoled other eurozone member-states into concluding a web of international treaties that would limit their national sovereignty, with a view to restoring sound government finances and cost competitiveness. With these treaties concluded, the European Council of heads of state and government and the Eurogroup of finance ministers attempted to exert control over national governments in fiscal and economic affairs. A eurozone 'shadow state', constituted by inter-governmental treaties and pacts, and a

“A eurozone ‘shadow state’ seemed to have emerged in early 2013 to run EMU.”

'shadow government', made up of the European Council and the Eurogroup (with the 'Troika' of the IMF, ECB and European Commission as its task force), seemed to have emerged in early 2013 to run EMU.

However, this set-up was soon rejected at national level. First, the Italian electorate ejected Mario Monti, who was regarded as a representative of the euro shadow state, from office. Second, the Portuguese constitutional court challenged its authority by declaring wage cuts for civil servants and benefit cuts for pensioners – essential demands in the adjustment programme to engineer an 'internal devaluation' – as incompatible with the country's constitution. Finally, and most importantly, governments in the Latin European countries – notably France, Italy and Spain – began to rebel against the austerity policies 'imposed by Germany'. As a result, the authority of the eurozone shadow state rapidly eroded. Conditions for access to ESM funds were significantly weakened, and limited ESM funding was substantially augmented by funding from the ECB for governments, banks and companies. As interest rates and the exchange rate of the euro declined, and fiscal deficits increased again, the recession in the Latin European economies finally eased in the course of 2014. Governments in these countries felt encouraged to form a Mediterranean Council aimed at breaking German dominance in the eurozone and the EU.

The crisis comes to a head

In Germany, Chancellor Angela Merkel was re-elected in the autumn of 2013. However, since the new eurosceptic party Alternative für

Deutschland had drained votes from her previous coalition partner, the Free Democratic Party, she was forced to form a government with the social-democratic SPD. Together with the new vice-Chancellor, Frank-Walter Steinmeier, and her europhile finance minister, Wolfgang Schäuble, she initially backed the new course of less austerity and more monetary financing of private and public borrowing requirements. However, as the euro's exchange rate declined, an increase in German exports and employment was accompanied by a rise in German inflation. Moreover, in the course of 2014 a new Greek government headed by Alexis Tsipras, the leader of the Syriza Party, announced that it would not recognise the debt to the ESM incurred by previous governments.

Responding to the decision of the Greek government, Schäuble announced new tax increases and spending cuts to fund Germany's contribution to the repayment of Greek debt. Other governments decided not to follow the German example, opting instead to issue bonds of their own to fund Greek debt repayments. With rising inflation, increases in taxes and cuts in public spending taking their toll on the Germany government's popularity, Steinmeier publicly regretted the decision of the finance minister and expressed support for the decision by other eurozone governments to borrow to fund redemptions of the Greek public debt. He pointed out that the ECB would stand ready to buy any bonds the market would not absorb. But it was too late. Public sentiment in Germany turned decisively against the government and

the euro as growing numbers of German voters began to feel that EMU was developing into a heavy financial burden for the country.

“At the beginning of 2015 the European Union and the eurozone were deeply split.”

During the course of 2013-14, the Bundesbank president, Jens Weidmann, had continued to warn of the risk of turning the eurozone into a 'Latin Monetary Union' and of the euro becoming the "successor to the franc, lira, and peseta instead of the D-mark". With his popularity surging, Chancellor Merkel increased the frequency of her television appearances alongside him. At the same time, she began to criticise the ECB for giving too much weight to the views and needs of Latin European countries in its monetary policy decisions. To counter the influence of the Mediterranean Council on EU and EMU policies, she launched the Central and Northern European (CeN) Council, with Germany, the Netherlands, Austria, Finland, the Baltic States, Poland, the Czech Republic and Slovakia as founding members.

At the beginning of 2015, the EU and the eurozone were deeply split. The Mediterranean Council advocated more fiscal and monetary policy stimulus as the economies of club members stagnated, unemployment reached new highs and social unrest spread through the region. The Mediterranean countries also tried to protect their weak industries by erecting administrative barriers to imports from abroad and discouraging foreign takeovers of companies by demanding employment guarantees from new foreign owners. Against this, CeN-countries wanted to promote growth through further trade liberalisation and regarded expansionary macroeconomic policies as counter-productive. The UK, meanwhile, prepared for exit from the EU as polls suggested that the public would vote against continued membership in the forthcoming referendum. Against this background, France and Germany called for a crisis meeting of the European Council

in the summer of 2015 to avoid a disorderly break-up of the EU and the eurozone. Both governments vowed not to end the meeting before an agreement to stabilize the EU and EMU had been reached.

“The Mediterranean countries tried to protect their weak industries by erecting barriers to imports.”

A new beginning

The Council meeting started with a day of recriminations, with the Mediterranean countries and the CeN countries blaming each other for the sorry state of the union. Several Mediterranean countries castigated Germany for pushing them into counter-productive fiscal austerity and for resisting a more growth-oriented monetary policy by the ECB. In addition, they accused the Bundesbank of being a German instrument for establishing economic dominance over Europe. By contrast, the CeN countries accused the Mediterranean ones of trying to engineer wealth redistribution from creditor to debtor countries by imposing an inflationary monetary policy on them. The British prime minister declared that the situation was hopeless and that it was therefore best to dissolve the EU and agree on a free trade zone to take its place.

During the night, however, the French and German leaders presented a plan they had hammered out secretly before the meeting. The plan envisaged that all countries presently in the EU and EMU would remain members of the respective unions. However, countries could form unions within the unions. In EMU, the Mediterranean countries

would retain the euro both as cash and book money. The ECB would effectively become the central bank of this group, since they held a majority of votes on the ECB Council and this allowed them to set monetary policy according to their preferences. Moreover, a separate committee within the Eurogroup of finance ministers would emerge to co-ordinate fiscal policy for this group of countries alone.

For their part, the CeN countries already in EMU would keep the euro as cash but introduce a new parallel currency to the euro that would exist only in the form of book money (later named the CeN). A new common central bank would be established to manage the new currency, which would appreciate against the euro according to the evolution of cost and price differentials between the higher inflation Mediterranean countries and the lower inflation CeN countries. Prices for goods and services in the CeN countries would be quoted in both euros and the new parallel currency, allowing consumers to pay either in euro cash or by debit or credit card in the parallel currency. More generally, all private payments could be contractually agreed to be effected in either currency, but CeN governments would require all payments to and by them to be made in CeN only.

Thus, for private financial transactions both the euro and the CeN would be legal tender, while for payments to and from CeN governments this status

“Agreement was reached to introduce a parallel currency for the CeN countries.”

would be reserved for the CeN only. The central banks of the CeN countries would remain members of the Eurosystem of central banks, but they would not vote on the monetary policy decisions of the ECB. However, they would be voting members of the new CeN central bank and manage the CeN currency with a view to keeping inflation of the parallel currency low and to avoiding disruptive exchange rate movements of this currency against the euro. In practice, it was expected that the CeN central bank could achieve these objectives by managing a gradual appreciation of the CeN currency against the euro, in line with inflation differentials between the Mediterranean and CeN countries. To avoid a disruptively brutal appreciation of the CeN against the euro, CeN countries could manage capital flows into their currency by taxing speculative investments. Although now members of different but (thanks to common cash money) overlapping monetary unions, France and Germany would continue to co-operate closely in the name of European unity.

In this emerging European constellation, the European Union would effectively become an organisational wrapper for the unions within the union, and would cease to exert direct influence over the economic policies of its member-states. EU countries outside EMU would be given the choice of joining pre-in groups for the euro or the CeN, or of retaining their respective national currencies and becoming members of the European Union Free Trade Area (EUFTA). All in and pre-in countries of either the euro or the CeN currency area would adopt the

euro as common cash. Thus, the EU would be transformed into two groups of concentric circles around the euro and the CeN currency and a third circle encompassing all EU members in the Free Trade Area.

“The EU ceased to exercise direct influence over the economic policies of member-states.”

A more stable system at last

After another day of heated discussions, all EU countries eventually agreed to the French-German proposal. The UK elected to become a member of the outer circle, the Free Trade Area, while the founding members of the Mediterranean and Central-Northern European Councils formed the nuclei of the Mediterranean and CeN currency areas, with most central and northern European countries not yet in EMU becoming pre-in countries for the CeN area. In the subsequent months and years, Switzerland, Norway and Turkey joined the UK in the EU Free Trade Area. In 2018, the Ukraine became a candidate country for the EUFTA and joined in 2020.

Initially, depreciation of the euro against the CeN and looser fiscal policies helped the Mediterranean countries to stabilise their economies. Growth in the CeN countries – as well as the countries aspiring to join this group, which managed their currencies against the CeN – was at first dampened by the effects of the appreciation of the CeN against the euro. However, growth in these countries soon resumed as they controlled their costs and increased economic flexibility. At the same time, the Mediterranean countries suffered from higher inflation, which threatened their longer-term economic outlook. As a result, they eventually opted for more conservative monetary and fiscal policies and took measures to reduce economic rigidities. Last but not least, the enlargement of the EUFTA exerted a positive influence on growth in the entire EU.

As we enter the new decade, it seems that all countries are again on a path towards greater convergence of inflation and interest rates. As a result, after some initial volatility, exchange rates among the different European national and supra-national currencies have become more stable – allowing the CeN countries to phase out their policies of capital account management. Most importantly, in contrast to the first decade of EMU, when nominal convergence came at the cost of real divergence, there are also signs of convergence of economic growth as all economies have become more flexible. In the event, we may conclude that a healthy degree of currency competition among countries and groups of countries in Europe achieved what economic policy co-ordination in the old EU and EMU could not deliver: better economic growth and more stable private and public finances.

Chapter 4

Reaping the rewards of reform

by **Holger Schmieding**

Crises are usually handmaidens of change. The worst mistake we can make in gauging the future, therefore, is to simply extrapolate from the present. If something is unsustainable, it will change. Transformed by the current euro crisis, the European economy in 2020 will look very different from what it is today and from the pre-crisis economy of, say, 2007.

Europe in 2020 will consume a smaller share of global output than it does today. But Europe in 2020 could still be a more dynamic place than it is today, with a reformed France and Spain outclassing an overly complacent Germany over time. The chances are that Europe will be one of the most pleasant places to live in the world, with an excitingly diverse culture, an advanced and sufficiently vibrant economy and a strong degree of social cohesion. Within that new Europe, a stronger eurozone with up to 30 members will be surrounded by two distinct circles of countries – those that are part of a looser European Union with a long list of *à la carte* opt-outs, and those like Turkey, Ukraine and Russia that will remain outside the European structures well beyond 2020.

Rising to the challenge

Europe has shown in the past that it can rise to serious economic challenges if it has to. Some thirty years ago, Margaret Thatcher slayed an inflation dragon and crushed the power of trade unions in Britain, turning the then 'sick man of Europe' into a modern service-led economy. Twenty years ago, Sweden and Denmark transformed soft socialism into a welfare system that works. Ten years ago, Germany cut social benefits and loosened labour market rules sufficiently to turn Europe's worst-performing economy into the continent's new growth engine. Two years ago, the three small Baltic countries emerged from a dramatic post-bubble crisis in better shape than they had been before.

In all these cases, the initial results of tough reforms were record unemployment, social unrest and howls of protests from many

economists. In all cases, history proved the hard-nosed reformers right – as it did in the even more traumatic transformation of post-communist Europe in the 1990s.

The lessons are simple. First, the mature and ageing economies of Europe can change. Second, in order to assess the future, we have to look through the eurozone's current travails.

Tough love: The nature of the euro crisis

Over the last three years, the countries of the eurozone have struck a grand bargain. The strong support the weak and the weak accept the tough conditions attached to such help. The weak need to make their fiscal positions sustainable by reining in their budget deficits and by raising their long-term growth potential through structural reforms.

“Germany let a crisis happen in order to force the weaker eurozone countries to mend their ways.”

The eurozone is very different from a nation-state. Markets usually see this as a drawback. But it can also be a major advantage. The European Central Bank (ECB) is the most independent central bank in the world. It faces 17 finance ministers. As a result, it can ignore all of them, with the possible exception of the German finance minister. The ECB knows that nobody can change its mandate, which is enshrined in an international treaty. Any change would have to be ratified by all 28 EU members, which renders that feat virtually impossible. As a result, the ECB can play hardball with most of its member countries like no national central bank could ever do with its national political masters.

The ECB has fully exploited its unique position. Since financial turmoil erupted in late 2008, the direct market interventions of the ECB have amounted to just under 3 per cent of eurozone GDP. In the US and the UK, central bank purchases of sovereign and mortgage bonds have reached 20 per cent and 25 per cent of GDP, respectively. To some extent, Germany and the ECB let a crisis happen in order to force the weaker eurozone economies to mend their ways for good.

In the eurozone, support from the strong to the weak takes the form of highly conditional credits. ‘Tough love’ is the rule of the game.² As a result, there is much less risk of moral hazard in the mutual support

2: Holger Schmieding, ‘Tough Love: The true nature of the euro crisis’, Berenberg, August 20th 2012.

systems between eurozone countries than there is in the usual transfer systems within nation states. In the eurozone, the donors can and do set the terms under which they grant support to the recipients. Put simply: Germany (as a donor) can be much tougher on Spain (as a recipient) than it ever could be on its own destitute regions such as Bremen and the Saar. Whereas Spaniards do not vote in the national election of the donor country (Germany), the citizens of Germany's problem regions vote in the elections to the German parliament.

According to the static criteria of an optimum currency area, the lack of major automatic and unconditional transfers between member countries counts against the eurozone. But on the more important dynamic criterion as to whether the institutional setting sets the right incentives, the absence of automatic transfers counts as an advantage:

those who need protection against market turmoil have to make their economies more dynamic and hence less likely to require aid in the future. *“The eurozone denies its members easy escape routes: they have to make fundamental reforms.”*

The eurozone, in other words, denies its members easy escape routes: they can no longer devalue or inflate their way out of trouble. Instead, they have to take the hard route of fundamental reforms. Inflation or devaluation do not solve long-term structural problems. These macroeconomic gimmicks merely postpone the day of reckoning. For countries with ossified labour markets, bloated bureaucracies, excessive entitlements and runaway government spending, only structural reforms can cure the malaise. The common currency forces its weaker members to choose between the chaos that would ensue from a euro exit and the painful reforms needed to improve their lot for good.

The big call for the economic future in Europe is whether this tough love approach will work. In my view, it probably will. In the OECD's league table for actual structural economic reforms, Greece takes the top spot of all OECD members for 2011 and 2012, followed by Ireland, Estonia, Portugal and Spain.³ All four countries that had received external assistance by the end-2012 cut-off date for the analysis are among the five top reformers.

Risks abound, of course. But at the time of writing in mid-2013, the data are starting to support my view that the eurozone periphery will emerge from its harsh adjustment recession in late 2013 or early 2014.

3: Organisation for Economic Co-operation and Development, 'Economic policy reforms 2013: Going for growth', 2013.

The chances are that the peripheral countries will be more balanced and more dynamic economies in the future than they were before the crisis. As a result, I expect the eurozone to be a stronger economy in 2020 than it was in 2000 or 2010, with a reformed periphery joining a Germany that will still be enjoying decent trend growth in its per capita GDP.

Europe's 'big four': The countries to watch

Italy has not yet asked for help from its eurozone neighbours. As a result, its reform efforts have been less thorough than elsewhere on the eurozone's geographical periphery – notwithstanding the fiscal tightening engineered in 2012 to make Italy's public finances sustainable. Italy's trend rate of growth will probably stay close to its rather dismal 1 per cent of previous decades. Italy will remain well below the potential which it could unlock if it were to reform its labour market, its judicial system and its bureaucracy much more thoroughly.

“France's chronic economic malaise is unlikely to deteriorate into an acute financial crisis.”

France is today the real 'sick man of Europe'. Its afflictions include bloated government spending, pervasive lack of competitiveness, rigid labour laws and a wasteful education system. For better

or worse, Paris enjoys a rare blessing. Financial markets know that, come what may, Germany will never abandon France. Bond markets remember that even the fearsome Bundesbank, which did nothing to prevent Britain's unceremonious exit from the European Exchange Rate Mechanism (ERM) in 1992, repeatedly intervened and even cut interest rates for the sake of the French franc in the various currency crises of the 1980s and early 1990s. As long as France does not renounce German friendship, France's chronic economic malaise is unlikely to deteriorate into an acute financial crisis.

But this French blessing is also a curse in disguise. Because the bond vigilantes are reluctant to round on France, Paris can get away with more economic nonsense than any other member of the eurozone. It will have to reform itself without being forced into such wrenching change by the bond market.

Fortunately, that is possible. Germany turned the corner decisively with its 'Agenda 2010' reforms, announced in 2003, without any financial

market pressure. Germany had breached the ‘stability and growth pact’ which it had imposed on the eurozone before giving up the D-mark in 1999. This shamed the political elite of stability-obsessed Germany into swallowing the bitter reform medicine.

In France, a different national trauma may play a similar role. The eurozone crisis has revealed that all key decisions in the currency union are taken by two players – the German government and the ECB. Paris plays barely any role in shaping the future of Europe. I expect the political elite to eventually draw the right conclusion from this state of affairs. The only way to regain some influence in Europe is to fix the French economy. The German experience has shown that, once they finally grasp the nettle, centre-left leaders can break the resistance of trade unions to such changes more easily than the centre-right can.

What cannot go on will not go on. The chances are, therefore, that France will follow Britain and Germany into some fundamental reforms in coming years. If

“France could easily be in a position to grow faster than Germany by the end of the decade.”

so, the result could be spectacular. Germany moved from record unemployment in early 2006 to a dearth of qualified labour within five years. France has a much higher birth-rate than Germany, with 2.0 rather than just 1.4 babies per woman. With a growing and more youthful population, France could easily be in a position to grow faster than Germany by the end of this decade and to become the biggest European economy in absolute terms by 2030 or 2035, in a neck-to-neck race with Britain.

Germany is currently at the peak of its economic prowess. As a result of its post-2003 reforms, it can now enjoy a golden decade of robust trend growth, low unemployment, a healthy fiscal position and stronger gains in consumption. Despite the ravages of the financial and eurozone crises, the number of people with a good job in Germany, earning enough to be subject to payroll taxes, has risen by more than 12 per cent since early 2006. That strength underpins a balanced budget. Germany is also attracting young and well-qualified immigrants to fill job vacancies.

Unfortunately, success breeds complacency. Germany has not implemented any serious supply-side reform for the last five years. Instead, Germany has started to make its economy a little less flexible

again, with the creeping introduction of a minimum wage and new restrictions on temporary work contracts. An ill-advised energy policy adds new burdens on businesses and consumers alike. I expect this process to continue and to gather pace. As a result, Germany will gradually lose its economic prowess. By 2020, Germany will still have a solid economy. But it will probably have slipped back from the top to the middle of the European league for trend growth per capita.

“By 2020, Britain can start to vie with France for the top spot in Europe.”

For the United Kingdom, the longer-term outlook is mostly positive. By 2020, Britain will probably have restored its public finances to structural balance.

Thanks to its microeconomic strengths (with one of the least regulated markets for goods, services and labour in Europe), the UK can hope eventually to bounce back from its inevitable period of harsh fiscal correction. By 2020, Britain can start to vie with France for the top spot in Europe, on track to relegate a demographically challenged Germany to second or third place in Europe by 2030 or 2035.

The new structure of Europe

The euro crisis and the British reaction to it have opened up sharp divisions within the European Union. The long-valid assumption that all significant European economies will eventually drift into a ever-closer integration, with some moving a little faster than others but all remaining on roughly the same track, has been shattered for good.

However, the political glue holding the eurozone together is very strong. European integration – backed up by the key role of the US in NATO – has delivered the longest period of peace and prosperity for major parts of Europe since the heyday of the Roman Empire. For vulnerable countries that once were part of the Soviet orbit, Europe remains a major draw. The pain which the countries on the eurozone's periphery are enduring today in order to stay in the single currency shows how strong the political glue still is. True, it is not unbreakable. But all those who last year confidently predicted the collapse of the eurozone before the end of 2012 failed to consider the strength of the political will to keep Europe whole even under extreme duress.

Although support for European integration has fallen across Europe in recent years, the glue that has held the region together should hold. So far, anti-European parties have made only modest headway in serious national elections despite the occasional upsets in elections such as those to the European Parliament (where inconsequential protest votes are sometimes cast). Once the positive results of the current reforms become visible, anti-European sentiment should recede again.

The current crisis has exposed a need for deeper integration to strengthen the euro against speculative attacks, but it has also eroded the will to accept such integration. My best guess is that Europe will draw the right conclusions from this integration fatigue. It will focus on integrating more deeply in those areas where it is absolutely needed for the eurozone, while granting EU members outside the eurozone more room to opt out. The eurozone will not turn itself into a genuine political or fiscal union with a big eurozone budget and largely harmonized tax and spending policies. But the new rules of the eurozone will make sure that countries do not run excessive budget deficits.

“Germany is using the euro crisis to enshrine stricter fiscal rules for the eurozone.”

All in all, Germany is using its current strength wisely. Having already seen to it that the ECB is, in practice, even more independent than the Bundesbank ever was, Germany is using the euro crisis to enshrine stricter fiscal rules for the eurozone and all those willing to join in. Even more so than these new rules, memories of harsh austerity will likely deter most euro members from returning to fiscal profligacy for a long time. None of them would ever want to call in the Troika again. Tougher fiscal rules and a banking union are the likely consequences of the euro crisis, not a political union or any similar grand scheme.

One consequence of integration fatigue is a growing reluctance of core Europe to welcome other countries into the club – be it into the EU or the eurozone. Smaller countries already more or less on track to join the European clubs will probably be allowed to sneak in. By 2020, quite a few countries in Central and Eastern Europe will probably have adopted the euro, including Poland, the Czech Republic and perhaps even Hungary. This eurozone could eventually include almost all successor republics to Yugoslavia, plus Albania, bringing the total membership up to almost 30 a few years after 2020.

Outside the eurozone, a disparate group of euro refuseniks – ranging from the UK to Switzerland and Sweden – will probably still share a single market with the euro members. But I expect this EU to be much more *à la carte* than the current EU. Britain in particular will probably secure some further opt-outs from current EU arrangements in exchange for treaty changes to allow the euro members to pursue their own integration as they desire.

The big outsiders

Currently, Russia, Ukraine and Turkey play only a marginal role in European affairs. I do not expect that to change much by 2020. Beset by integration fatigue, Europe will probably keep the bigger countries in its outer periphery at a distance.

With its youthful population, Turkey is turning itself into a major economic and political power. As the country grows up and its civil

society matures, Turkey's claim to be part of Europe can get stronger. But even if it still wants to get into the EU and is eventually allowed to do so, this will not happen before 2020.

“With its youthful population, Turkey is turning itself into a major economic and political power.”

Russia has a tough task ahead of it. It needs to wean itself off its dependence on raw material exports and turn itself into a modern industrialised economy instead. Its economic and political system is not suited to the grand role it would like to play on the world stage. Unless Russia decides to react to the Chinese challenge on its eastern border by turning itself into a much more European country (with a stable rule of law and full freedom for its civil society), Russia will probably remain what it is today: an important and sometimes troublesome neighbour with hardly any say in European affairs.

Ukraine, meanwhile, has the chance to reorient itself towards a more dynamic Europe and away from Russia. But whether it wants to use that chance is an open question. Even if it chooses to do so, EU membership is still a long way off. As with Turkey, however, it may draw closer to the EU's common market.

The risks

The risks to this positive outlook for Europe are large. Ironically, the two countries that give the most cause for worry are precisely those to whom demography has granted the best long-term potential: the United Kingdom and France.

Take the UK first. Weirdly, British observers who rightly praise the Thatcher reforms now heap scorn on those eurozone leaders who are trying to transforming their economies in the same way. The

“Britain turning its back on Europe and France sinking the euro are the key risks.”

eurozone crisis has strengthened the insular instincts of a Britain that seems to understand its European neighbours ever less well. I still expect British pragmatism to prevail, with a fading of the euro crisis helping to defuse tensions. But it will be a close call.

If Britain were to vote in a referendum in, say, 2017, to leave the EU, the step could be tantamount to political and economic suicide. The Thatcher reforms turned Greater London into the services centre for Europe. If Britain left the EU, it might have to accept all regulations of the single market without having a say in them (like Norway). Or it could lose free access to its major market. As London is in the wrong time zone to turn itself into a services centre for Asia, exit would deal a damaging blow. Without a vibrant Greater London, the source of transfers that prop up much of the rest of the country would dry up. Some two years after the UK had left the EU, Scotland could vote to rejoin the EU by leaving the UK. The end result could be little England mired in decline, isolated in the world and shut out of its major market.

In France, the reforms spurred by the current relative decline could sorely test the country's commitment to Europe. It is in the interest of France and its political elites to reform the economy and regain economic and political parity with Germany, while staying firmly wedded to its eastern neighbour in a close alliance. But if the French street were to rebel against reforms, and if such reforms were to be seen as having been imposed by 'Europe', the risk of a wounded and insecure France breaking its post-war marriage to Germany would no longer be negligible. This scenario is unlikely to happen. But if it did, the entire European edifice would be shattered, with unpredictable consequences.

In short, the possibility that Britain might turn its back on Europe or that France might sink the euro are the key risks we need to watch in Europe for the remainder of this decade.

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The future of Europe's economy

Disaster or deliverance?

**Paul De Grauwe, George Magnus, Thomas Mayer
and Holger Schmieding**

Edited by Simon Tilford and Philip Whyte

The CER invited four leading economists to predict what the European economy will look like in 2020. Their answers differ sharply. Paul De Grauwe fears for the future because the eurozone's creditor countries have succeeded in loading nearly all of the cost of eurozone adjustment onto the debtor nations. The creditors need to do more to stimulate demand in their economies and the debts of the eurozone's hard-hit members must be cut. For George Magnus, rapid population ageing, weak productivity and a divided eurozone have collided to produce the most significant threats to Europe's economy and the legitimacy of its political institutions since the 1930s. Thomas Mayer suspects that fiscal discipline in the eurozone will crumble and the ECB will monetise debt, leading to higher inflation in northern Europe. The result will be stand-off and the launch of a German-led parallel currency to compete with the euro. Holger Schmieding is more optimistic. He believes that by 2020 the countries that are today in difficulties will be reaping the rewards of structural reform and that the eurozone will be stable.