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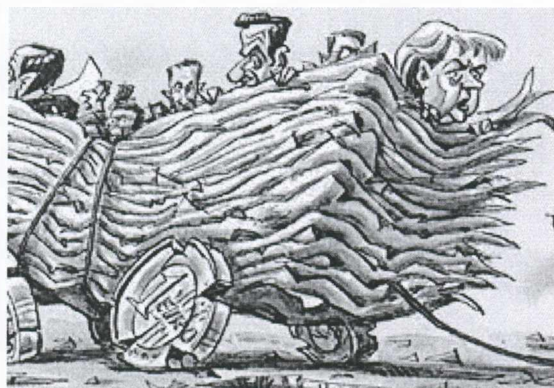
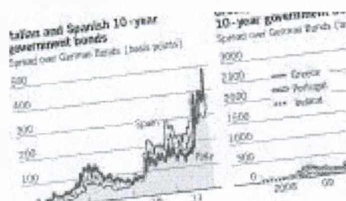
Thinking through the unthinkable

By Martin Wolf



Will the eurozone survive? The leaders of France and Germany have now raised this question, for the case of Greece. If policymakers had understood two decades ago what they know now, they would never have launched the single currency. Only fear of the consequences of a break-up is now keeping it together. The question is whether that will be enough. I suspect the answer is, no.

Efforts to bring the crisis under control have failed, so far. True, the eurozone's leadership has disposed of George Papandreou's disruptive desire for democratic legitimacy. But financial stress is entrenched in Italy and Spain (see chart). With a real interest rate of about 4.5 per cent and economic growth of 1.5 per cent (its average from 2000 to 2007, inclusive), Italy's primary fiscal surplus (before interest rates) needs to be close to 4 per cent of gross domestic product, indefinitely. But the debt ratio is too high. So the primary surplus has to be far bigger, the growth rate far higher, or the interest rate lower. Under Silvio Berlusconi, none of the necessary changes is going to happen. Would another leader fix things? I wonder.



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The fundamental difficulty throughout has been the failure to understand the nature of the crisis. Nouriel Roubini of New York University's Stern School of Business makes the relevant points in a recent paper.* He distinguishes, as I did in a column on October 4, between the stocks and the flows. The latter matter more. It is essential to restore external competitiveness and economic growth. As Thomas Mayer of Deutsche Bank notes, "below the surface of the euro area's public debt and banking crisis lies a balance-of-payments crisis caused by a misalignment of internal real exchange rates". The crisis will be over if and only if weaker countries regain competitiveness. At present, their structural external deficits are too large to be financed voluntarily.

Mr Roubini discusses four options for addressing these stock and flow challenges simultaneously: first, restoration of growth and competitiveness through aggressive monetary easing, a weaker euro and stimulatory policies in the core, while the periphery undertakes austerity and reform; second, a deflationary adjustment in the periphery alone, together with structural reforms, to force down nominal wages; third, permanent financing by the core of an uncompetitive periphery; and, fourth,

widespread debt restructuring and partial break-up of the eurozone. The first could achieve adjustment, without much default. The second would fail to achieve flow adjustment in time and so is likely to morph into the fourth. The third would avoid both stock and flow adjustment in the periphery, but threaten insolvency in the core. The fourth would simply be the end.

Alas, huge obstacles exist to all of these options. The first is the most likely to work economically, but is unacceptable to Germany. The second is politically acceptable to Germany (despite the bad effects on its economy), but would ultimately be unacceptable in the periphery. The third is politically unacceptable to Germany and is even likely to prove unacceptable in the periphery, too. The fourth is unacceptable to everybody, if only for now.

What is now happening is an unhappy mixture of the second and third options: one-sided austerity with grudging finance. Mr Mayer argues that it could morph into the first. His argument is that the lender-of-last-resort activity of the European System of Central Banks, in favour of banks unable to fund themselves in the market, is financing payments deficits. Central banks of the surplus countries are, as a result, accumulating large credit positions vis a vis the European Central Bank, while those of the deficit countries are accumulating counterpart liabilities (see chart). This is a transfer union. In the long run, suggests Mr Mayer, monetary financing of balance of payments deficits is going to prove inflationary and so turn into the first of Mr Roubini's options. I am not sure that the danger of inflation is real. But Germans certainly fear it is.

In the long term, the first and last of Mr Roubini's options seem most likely: either the entire eurozone adjusts, or it breaks up. Germany should accept the risks of the former path. I know that its nightmare is the hyperinflation of 1923. Yet the brutal austerity of 1930-32 finally brought Adolf Hitler to power.

The question is whether exit would be feasible without blowing up the world. Start with a decision that, for a severely uncompetitive country, such as Greece, exit would be co-operative. Greece would introduce a currency – the "new drachma". New contracts executed under Greek law and taxes and spending in Greece would be in this currency. Existing contracts would stay in euros. Banks would have legacy euro accounts and new drachma accounts. The exchange rate of the new currency against the euro would be set in the market. It would depreciate rapidly. But that is desperately needed.

The Greek government would abide by the terms of a reformulated external programme. It would continue to strive for fiscal balance, helped by what is likely to be a massive real depreciation. Its central bank would manage the new currency independently. The price level would jump in the new currency, but, given the excess capacity, hyperinflation could be avoided with some external support. Public and private default on euro liabilities would be sizeable. But if Greece were to experience prolonged domestic deflation, in order to regain external competitiveness, without the new currency, the real value of euro debt would also explode upwards. This would

merely accelerate the process. Meanwhile, Greece would lose its vote in the ECB. But the possibility of a return would remain.

Such a co-operative approach to reintroduction of a new currency would be the least costly. But it would surely generate contagion. If the eurozone has decided that it must avoid that threat, then it must go back to the first on the menu of options laid out by Mr Roubini. Potentially solvent countries would be financed and the eurozone would grow its way out of the crisis.

A eurozone built on one-sided deflationary adjustment will fail. That seems certain. If the leaders of the eurozone insist on that policy, they will have to accept the result.

**Four Options to Address the Eurozone's stock and flow imbalances*, unpublished, www.roubini.com/analysis/165338

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