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Europe's crisis is all about the north-south split

Alan Greenspan

The A-List

The eurozone is confronted with a crisis of not just labour costs and prices – but culture. The burden is primarily on southern Europe, where sovereign bond credit spreads (relative to the German Bund) range from 370 basis points (Italy) to 1,960 basis points (Greece). The northern eurozone countries have tight spreads against Germany – a narrow 40 to 80 basis points for the Netherlands, Austria, Finland and France. There are thus two distinctly defined eurozone areas: in the north and in the south.

The ranking of credit risk spreads by size across the eurozone in 2010 was almost identical to the ranking of the level of unit labour costs (relative to that of Germany), suggesting that the higher labour costs and prices have rendered "euro-south" less competitive and so more subject to credit risk. The more competitively priced net exports of the northern eurozone participants, in effect, more than covered the rising level of net imports of the south. In short, between 1999 and the first quarter of 2011, there has been a continuous net transfer of goods and services shipped from the north to the south. Northern Europe in effect has been subsidising southern European consumption from the onset of the euro on January 1 1999. It is not a recent phenomenon.

I recall that in the early years of the eurozone there was a general notion in the markets that the Greeks were behaving like the Germans. But there is scant evidence that on embracing the euro southern members significantly altered their behaviour – behaviour that precipitated chronically depreciating exchange rates against the D-Mark. From 1990 through to the end of 1998, euro-south unit labour costs and prices rose faster than in the north. In the years following the onset of a single currency, that pace barely slowed. In fact, the underlying trend was stopped only by the financial crisis of 2008. Since then there have been signs of price level stabilisation in the north and the south.

The ability for the south to sustain its pre-euro financial excess after 1999 was facilitated by borrowings subsidised by the credit ratings of euro-north members. Before 1999, borrowing in the legacy currencies of the south was far more expensive than in the north. But, anticipating the euro, drachma-denominated 10-year sovereign bonds fell more than 450 basis points relative to German Bund rates in the three years leading up to Greece's adoption of the euro in 2001. Likewise, Portugal's escudo yields fell almost 375 basis points and Italy's lira yields fell by nearly 500 basis points in the three years preceding the formation of the eurozone on January 1 1999. Changes in pre-euro entry bond rates for France, Austria, the Netherlands, Finland and Belgium were negligible.

Subsidised borrowing may have accounted for much of the acceleration in the ratio of euro-south consumption relative to that of Germany. It rose between 1995 and 1998 at a 1.26 per cent annual rate. Presumably as a consequence of subsidised euro credit, that ratio accelerated to a 1.63 per cent annual rate of increase between 1998 and 2007.

In the early years of the eurozone the markets believed the Greeks were behaving like the Germans. They did not

Euro-north has historically been characterised by high saving rates and low inflation, the metrics of a culture that emphasises longer-term investments rather than immediate consumption. In contrast, negative saving rates – excess consumption – have been a common feature of Greece and Portugal since 2003.

There remains the question of whether most, or all, of the south would ever voluntarily adopt northern prudence. The future of the euro beyond a select group of northern countries with a similar culture will depend on the ability of all eurozone nations to follow suit.

Failing that, the eurozone will not have the ability to address the key concern of currency-pooling arrangements: that the value created by a pooling arrangement tends to be distributed disproportionately in favour of the financially less collegial and less prudent members of the pool. We observed this tendency as growth of the south relative to Germany accelerated following the creation of the euro. Thus, unless restrained, the less collegial members of the pool will try and often succeed in exploiting their advantage, as Greece so brazenly did recently.

If the euro is to remain a viable currency across the eurozone, members must behave in the responsible manner contemplated in the Maastricht treaty. But it is not clear that culture, so integral to a nation's personality, can be easily altered. As Kieran Kelly noted last week: ". . . if I lived in a country like this [Greece], I would find it hard to stir myself into a Germanic taxpaying life of capital accumulation and arduous labour. The surrounds just aren't conducive."

It seems inevitable that for the euro to prevail, something more formidable than the failed stability and growth pact is needed to constrain aberrant behaviour. It may be that nothing short of a politically united eurozone, or Europe, will, in the end, be seen as the only way to embrace the valued single currency.

The writer is former chairman of the US Federal Reserve

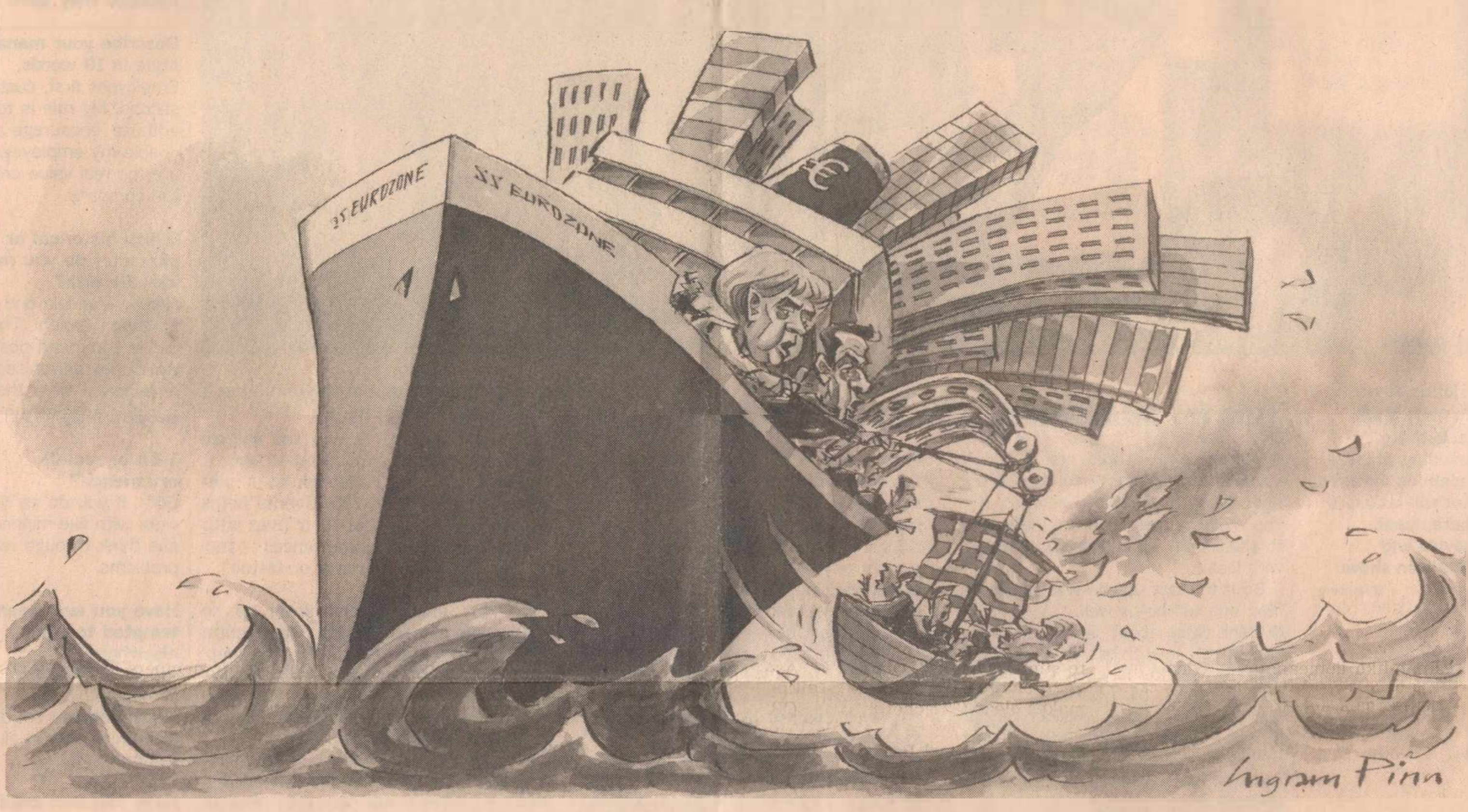
Save the euro – let Greece default

Philip Stephens

It is time to let Greece go. I do not propose stamping on the fingers of the Athens government as it clings to the edge of the euro cliff. But we have reached the point where hoping for the best invites calamity. Europe needs a plan to manage Greece's fall.

The eurozone has two sets of problems. The first revolves round the insolvency of Greece, the fragility of Portugal, Spain and Italy, and the accompanying strains on Europe's banks. The second is the dire fiscal and competitive weakness of economies beyond the core. Dealing with the first will not of itself settle the second. But it is a necessary start.

The pressing decision is about the timing and terms of Greek default. It is possible that the politicians still have a choice between orderly restructuring and a chaotic collapse that quickly engulfs everyone else. Possible, but not certain. The more governments argue about how to build firewalls around the other peripheral economies and about how to insulate the banking system, the more likely the flames will spread uncontrolled across the continent.



Greece should receive the next tranche of its current financial facility. The Athens government has been showing long-awaited resolve in cutting its deficit. It has begun to collect taxes. But longer term the numbers cannot be made to add up, and Greece's politics, as we saw from this week's general strike, are not getting any better. The eurozone has a matter of weeks – perhaps a couple of months – to come up with what policymakers euphemistically call a restructuring programme.

You can still find European policymakers who argue otherwise. They are mostly in Berlin. Angela Merkel says she will not be pushed around by the markets. Consider the turnround in Belgium's public finances during the 1990s, her officials add. Look at Ireland's remarkable progress in stabilising its position. Given space and political will, Greece could do likewise.

I do not think they really believe this. Given its debt, its budget and current account deficits and its woeful lack of competitiveness, Greece cannot escape the debt trap. Austerity piled on austerity will simply kill the patient.

Politicians live with the nightmare of the collapse of Lehman

Thus far the eurozone's unspoken strategy, in so far as there has been anything that merits the description, has been to delay the day of reckoning. Keep Greece afloat for a couple of years and the rest of the eurozone will be robust enough to withstand the shock of a default.

Let Athens off the hook now, German officials still warn, and Portugal and Spain will think they should be spared the worst. Then there is Italy, as politically dysfunctional as it is economically troubled. Dealing with Silvio Berlusconi is impossible at the best of times. This is not the moment to arm him with excuses for inaction.

Avoiding moral hazard is a good principle. But it can also be a dangerous one. The European Central Bank is jealous of its credibility and its mandate. Jean-Claude Trichet, the ECB president, said again this week that governments must take responsibility for the crisis rather than shuffle it off on to the ECB. In theory, he is probably right. But rules must sometimes be torn up. The ECB's credibility will not count for much if it becomes the euro's epitaph.

Plan A was predicated on the assumption that Greece could be safely quarantined. Economic growth, a recapitalised banking system and tangible improvements in the public finances of other peripheral states would return the eurozone to good health. Only then could Greece be allowed to default.

As things turned out, the dynamics could not have been more different. The failure to deal with Greece has weakened the rest of the eurozone, seen contagion spread as far as Italy and exposed the fragility of French and German banks.

The result is what you might call a reverse loop. The sovereign debt crisis was born of the banking crisis. It is now feeding a second banking crisis. This week's downgrading of Italy's credit rating and the troubles at the Franco-Belgian Dexia were only the latest instalments.

Managing a default will be neither easy nor risk-free. Politicians live with the nightmare of the collapse of Lehman Brothers. Rightly so. There cannot be a guarantee that the effect of a writedown of, say, 50 per cent or 60 per cent in Greece's debt can be neatly contained. What is certain, though, is that an uncontrolled default will wreak economic and financial havoc. Sometimes, as a certain British prime minister used to say of tough economic decisions, there is no alternative.

There is nothing mysterious about what needs to be done to mitigate the risks. It starts with a co-ordinated recapitalisation of the banks and a quadrupling to €2,000bn or so in the firepower of the European financial stability facility. It demands a willingness on the part of the ECB to accept that saving the euro is more important than sticking to its inflation remit.

The markets have to be persuaded of two things: the eurozone has the resources to deal with any eventuality; and, more importantly, governments will deploy those resources. Managing a Greek default should be presented as a measure of Europe's political will to do whatever it takes to sustain the single currency.

This leaves the question of whether Greece should remain in the euro. The answer is yes – for now. In Spain and Portugal, Europe has been seen as the path to modernity. Greece has not made the effort. Default would not absolve it of the need to overhaul its institutions and modernise its economy. If it does not, then sooner or later it will be forced out of the euro. But then that would be Greece's choice.

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Call off the misguided crusade against 'inequality'

Samuel Brittan

Before the credit crunch it used often to be said that the Right had won the economic argument and the Left had won the cultural one. But the Left had also appeared to win a third argument, a linguistic one. I refer to the use of the term "inequality" to signify differences in income and wealth. The implication is that equality should be the norm, deviations from which need to be explained.

The issue has become topical again. A number of rich businessmen, including the fund manager Warren Buffett, seem to feel guilty about their earnings and have called for higher taxes on people like themselves. Official statisticians turn out endless studies of movements in inequality. Britain's last Labour government left behind a monster Equalities Act, which on some interpretations may be mainly concerned with race and sex discrimination, but on other interpretations is much more intrusive. If I tell my social democrat friends that material equality is only to be found in the grave and not even there – Mozart was buried in a pauper's cemetery – the look of distaste that comes into their faces is painful to behold.

There has been a half-hearted riposte from the other side, concentrating on the UK's top 50 per cent marginal tax rate, which is said to be a futile but harmful exercise in gesture politics – which it is, but not necessarily the best place at which to begin a counterattack.

Let me, however, dispose of some *bad* arguments against seeking material equality. The first is that egalitarian legislation will lead to an emigration of scarce talent. To rely on it is to concede the moral high ground. It makes the non-egalitarian position depend on the division of the world by frontiers, and collapses in the face of any serious attempt to promote equality at an international scale. Another bad argument is that existing differences in income and wealth reflect merit. They do so very imperfectly, if at all. Who do you think wrote the following? "There is little a man can do to alter the fact that his special talents are exceedingly rare or very common. A good mind or a fine voice, a beautiful face or a skilful hand, a ready wit or an attractive personality are in large measure independent of a person's efforts . . . In all these instances the value which a person's services have for us, and for which he is recompensed, has little relation to anything we can call moral merit or 'deserts'". Karl Marx? Lenin? Ed Miliband? No. It was FA Hayek, the author of the anti-socialist *Road to Serfdom* and Margaret Thatcher's favourite economist.

The one valid argument against egalitarian policies rests on a denial that all wealth originally belongs to the state

The one valid argument against egalitarian policies rests on a denial that all income and wealth originally belong to the state. This was well put by the Harvard philosopher Robert Nozick: "We are not in the position of children who have been given some portions of pie. There is no central distribution. What each person gets, he gets from others who give it to him in exchange for something or as a gift. In a free society, diverse persons hold different resources and new holdings arise out of the voluntary exchanges and actions of persons."

In other words, there is no fixed sum to go around; individuals add to the pie by their activities. And it is by no means obvious that others should treat the results as part of a common good. Nozick went too far. The very content of property rights and the rules governing their transfer and protection are the result of collectively enforced rules and decisions which we are at liberty to change. But this is a qualification which gives the state the right to influence the distribution of income and not an assertion that all income belongs to it.

I can just hear someone saying that none of this logic-chopping gets away from the fact that there has over the past 30 years been an increased concentration of income and wealth at the top of most English-speaking countries, and a fall in at least the relative position of those at the bottom. It is not good enough to say that people like Mr Buffett are free to give away as much of their wealth as they please. It would be perfectly rational for Mr Buffett to say: "I will give away x on my own, but x plus y, if there is a mechanism for ensuring that other fat cats contribute proportionately."

The crucial question is "who gains?" The desire simply to humble the better-off reflects jealousy and envy. Most indices of inequality, whether the technical sounding Gini coefficient, or the "90:10 ratio" of the earnings of the top 10th compared with the bottom 10th, would show an apparent improvement from confiscatory taxation of the rich even if the resulting revenues were thrown into the sea. What has to be shown of any proposals to tax more heavily or otherwise bear down on the better-off is how the bottom 10th, or even the median citizen, would benefit. For years I have been reprinting an essay entitled "Redistribution: Yes. Equality: No." Maybe someone will now take notice.

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America's currency war against Beijing will backfire

Yao Yang

Charles Schumer is stirring up tensions between the US and China again. It is the fourth time the Democratic senator from New York has proposed legislation aimed at imposing high tariffs on "currency manipulators", a pseudonym for China. But this bill is unlikely to fare any better than the previous incarnations because it shoots America in the foot.

The US would not have a smaller trade deficit if the Chinese renminbi appreciated against the dollar. And a strengthened renminbi would not reduce Chinese exports to the US as much as many expect. In part, this is because Chinese exporters are able to absorb the costs of moderate appreciation. But another reason is that China's trade surplus has been entirely created by processing trade, where imported components are assembled at factories in the country. This is less sensitive to the appreciation of the currency than ordinary trade because companies can save on the imports, even while exports suffer.

However, that range of appreciation is still too small for Mr Schumer. He is probably looking for something in the range of 20 to 40 per cent. That would certainly slam Chinese exports but it would not mean that the US would necessarily start producing the things China exports today. In many cases it would simply be too expensive to produce certain goods in the US. Chinese assembly-line workers are earning one dollar an hour, less than one-10th of the rate their American peers enjoy.

In fact it would be very likely that any vacuum left by China would quickly be taken up by other exporter countries such as Mexico and Malaysia. Because these countries have higher wages than China, American consumers would end up paying higher prices, while the US's total trade deficit would remain more or less the same.

John Boehner, Republican speaker of the US House of Representatives, has already raised doubts over Mr Schumer's bill. The White House has also voiced concerns about the proposed bill's consistency with the international obligations of the US. The retaliatory tariffs proposed by the bill would not find support from the World Trade Organisation and, in fact, the US would be likely to face a serious legal challenge if China brought the case to the organisation. In the worst case scenario, though, Beijing could choose to reciprocate with higher tariffs on American exports to China. People on both sides would lose out in that scenario and neither government would gain.

Instead of pressing for the renminbi's appreciation, it would be much wiser for Mr Schumer to work to persuade both governments to enter a free trade agreement. Less than 3 per cent of China's $1,400bn imports last year were made up of consumer goods, primarily because China still imposes high tariffs on such imports. American consumer goods would then be more likely to enter the Chinese market as many US products are currently more expensive there than in the US.

From a purely American perspective, a trade deal could be better than currency revaluation. The recent mild appreciation of the renminbi may not continue because it is subject to volatile market movements. A trade deal would not add any burden to the US, while a revaluation may force American consumers to pay higher prices.

Beijing authorities would also love the idea – gaining more imports from the US would serve multiple purposes for China. Americans would complain less; China's blooming foreign reserves would grow more slowly and, for that matter, inflation would slow down. Added to that, ordinary Chinese would also be able to consume cheaper and better American goods.

But perhaps the most important element would be that a free trade agreement would represent a welcome acknowledgment from Washington that China is now a country of its own rank.

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The FT's A-List

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● Once again Congress is finding it more convenient to play the China currency card as the panacea for US economic woes, rather than deal with the difficult issues in Barack Obama's employment bill, writes **Yukon Huang** in his A-List column.

● With a leadership transition planned for 2012, Beijing could determine it beneficial to ratchet up tensions with the US in response to the currency bill, writes **Rodger Baker** in response to Yukon Huang