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IS THE EUROZONE NOW SAFE?

Berenberg Macro Flash

On 24 June, I contributed to an "Oxbridge-style" debate at my old alma matter, the London School of Economics. Below are my slightly edited and deliberately pointed remarks to advance the motion that "the Eurozone is now safe". Comments and rebuttals welcome.

In real life, nothing is perfect. Nothing is fully safe forever. However, by realistic standards, be it by the standards of its own past or the standards set by the US and the UK, the Eurozone is now reasonably safe. Relative to the repeated currency crises of the 1970s, 1980s and early 1990s, the euro stands for serious progress. Today, the risk that Italy or any other country may exit the euro is lower than then risk that the UK may break apart with Scotland and/or Northern Ireland leaving. Relative to the political chaos in Westminster and the persistent gridlock in US Congress, the institutions of the EU and the Eurozone are working reasonably well.

In the Eurozone, prices are stable and real wages are rising. Unemployment at 7.6% is close to the record low of 7.3% of early 2008 and well below the 10.5% average of 1998, the year before the euro started. Economic differences between the regions are similar to those within the US. The trajectory of public debt is much less alarming than in the US, the UK or Japan over the last twenty years. Before the start of the euro, UK public debt at 41.2% of GDP in 1998 was miles below what at it was in the Eurozone with 71.8%. Today, the UK is slightly more indebted than the Eurozone, with debt ratios of 86.8% and 85.1% in 2018, respectively. Roughly the same holds for the US where gross public debt now exceeds 107% of GDP. While GDP per capita is rising slightly faster in the US than in the Eurozone, the US advantage is financed by an unsustainable surge in public debt.

The Eurozone has been hardened by crisis. In its early years, the institutional architecture of the Eurozone had one major institutional gap: the lack of a designated lender of last resort. While the US Fed and the Band of England (BoE) started to buy huge amounts of government bonds in 2008/2009, it took the European Central Bank (ECB) much longer to do so. That was an expensive mistake. But contrary to widespread rumours in the US and the UK, the "euro crisis" was never about the euro going under. Berlin, Brussels and Frankfurt are and always were 100% determined to preserve the euro. Instead, the euro crisis was the search for who would back up a troubled country under which terms.

That gap in the euro's institutional architecture has been plugged by the European Stability Mechanism (ESM), de facto a giant common fiscal resource, and by the ECB, which has vowed to back up any ESM programme with its virtually unlimited resources if need be through the so-called "Outright Monetary Transactions (OMT) programme. Ever since ECB president Mario Draghi announced that the ECB would be the lender of last resort in his "whatever it takes" speech in London on 26 July 2012, the Eurozone has been safe.

Despite some serious initial mistakes such as too much emphasis on austerity in Greece in 2010 to 2012, the adjustment programmes in the Eurozone did work in the end. All five countries that once received help are now growing at a faster rate than the Eurozone average and the UK. At the moment, Trump's trade war and Brexit are weighing on Eurozone exports. But domestic demand remains firm, supported by some fiscal easing in Germany, France and Spain and by continuing gains in employment and real wages across almost the entire region.

Politics is messy everywhere, the rise of radical anti-establishment parties presents serious challenges across much of the developed world and beyond. In the Eurozone, however, peer pressure is helping to tame the radicals. In Greece, Syriza has turned itself from a motley bunch of radicals into a largely responsible standard centre-left party - more Chuka Umunna than Jeremy Corbyn. In Italy, the radicals remain very strong and noisy but have implemented only a small fraction of their expensive promises. In France, Marine Le Pen has dropped her demand for an EU or euro referendum after learning in her futile campaign against Emmanuel Macron in 2017 that even most of her potential voters would prefer their salaries and pensions to be paid in euros rather than a new funny money. Taken together, euro-sceptic radicals made only small gains at the European election on 23-26 May 2019 – and they did so only because they had abandoned earlier demands to leave the euro or the EU. In the US and the UK, we do not see any comparable mechanism that is taming the radicals, think Donald Trump or Boris Johnson.

The Eurozone still has institutional deficiencies. A joint fiscal capacity to buffer short-term asymmetric or cyclical shocks would be good, so would be completing banking and capital markets union. Progress on these issues is slow. However, with the ECB standing ready as the lender of last resort with virtually unlimited firepower, any country that needs help and is ready to respect the rules somewhat can and will be protected against any storm that it cannot weather on its own.

The fiscal debate

The lack of a common fiscal policy often gets overemphasised. We need to mind the difference between textbooks and practice. In theory, it would be great to have a common fiscal policy to dampen swings in the business cycle. In practice, however, it depends very much on how countries actually deploy their fiscal tools. The UK example is enlightening. In good economics times from 1997 to 2007, the UK had used its fiscal powers to wreck the budget under Gordon Brown. In worse economic times, the UK followed up with excessive expenditure cuts under George Osborne. The US granted itself a massive fiscal stimulus last year despite strong economic growth. Put differently, whereas both the US and the UK have full freedom to use their fiscal policy to smooth the cycle, they are often doing the opposite, running pro-cyclical rather than anti-cyclical policies while piling up mountains of public debt in the process. Admittedly, in the mega-crisis of 2008/2009, both the US and the UK did the right thing, using a fiscal stimulus to contain the immediate fall-out. But so did the Eurozone at the time.

Along similar lines, the argument that the Eurozone suffers from a lack of fiscal transfers between its regions, while containing a kernel of truth, often neglects two key facts: First, the huge support programmes for five peripheral countries during the euro crisis de facto amounted to significant fiscal support recipient countries. Greece, Ireland, Portugal, Spain and Cyprus were granted credits at very low interest rates at a time when they were de facto shut out of debt markets. Second, courtesy of membership of the Eurozone, even Italy led by its radical government can today borrow at rates close to those of the United States while Spain, led by a more responsible government, can fund itself significantly more cheaply than the UK. This has opened up significant fiscal space for these countries. Whether or not they always use the space wisely is a separate matter, of course. But that caveat holds for the US and the UK as well.

Occasionally, euro critics berate the region for an insufficient co-ordination between monetary and fiscal policy. Although ECB president Draghi is a regular guest at the "Eurogroup" meetings of Eurozone finance ministers and the European Union's finance commissioner takes part in each policy meeting of the ECB, the actual co-ordination falls short of textbook ideals. But once again, we have to compare the Eurozone to realistic benchmarks. Just think of the US, where Trump has reportedly threatened to demote the Fed chairman Jerome Powell whom he himself had installed in early 2018. Or consider the case of the UK, where Bank of England Governor Mark Carney draws heavy political fire from senior Tories for speaking the truth about hard Brexit risks. Relative to that, the interaction between monetary and fiscal policy in the Eurozone looks quite smooth.

Judging by results, not by textbook nirvanas, the imperfect fiscal policies in the Eurozone have probably been better than those in the US, the UK and Japan over the last twenty years. Relative to realistic benchmarks, the Eurozone now looks sufficiently safe indeed.

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