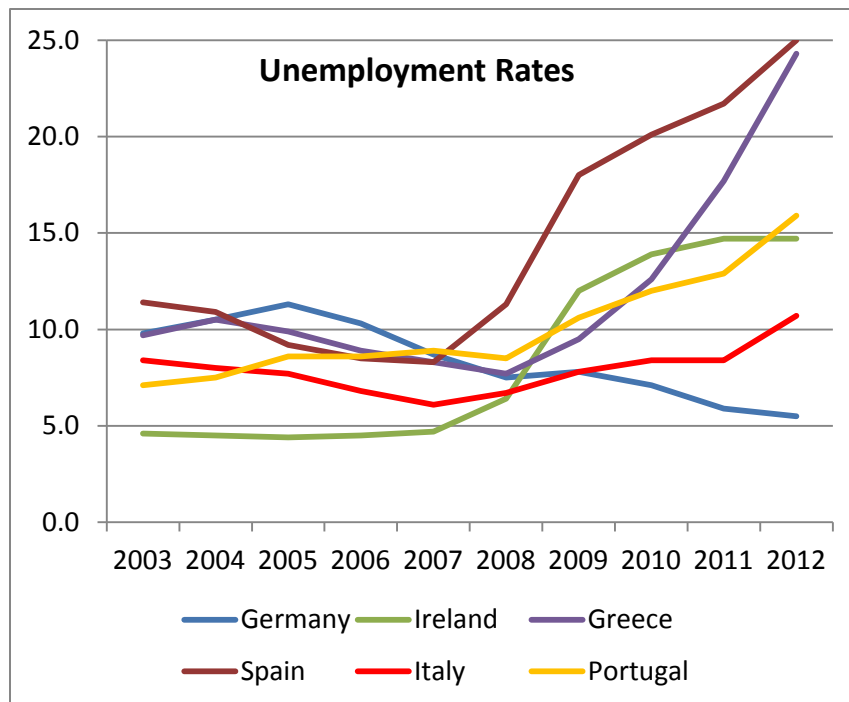


Exiting the Eurozone Crisis

By Prof. Harald Uhlig, Department of Economics, University of Chicago

May 1st, 2013

Perhaps, we will be lucky. Since the announcement of ECB president Draghi to “do whatever it takes”, yields on sovereign bonds in Europe have declined. The Cyprus crisis has been contained, for now. Italy has a new government. Perhaps, things gradually quiet down. Perhaps growth returns as it usually does at the end of recessions: not by government interventions, but by renewed entrepreneurial innovation and market activities, as consumers, workers and firms seek to return to their normal lives and competitive spirits, as the wait-and-see paralysis regarding the macroeconomic risks recedes, as reasonable bargains get struck to resolve remaining logjams. Perhaps wages in Europe get adjusted to bring them back in line with pressures arising from recent divergences in competitiveness. Perhaps sustainable fiscal policies will be designed and implemented. Perhaps the financial sector returns back to health and deposits flow back to the southern part of the Eurozone. Perhaps. It is valuable to think through the policy options for this “benign scenario”, to think about the tradeoffs between short-term fiscal stimulus and long-run consolidation, to think about supportive structural policies such as labor market reforms, financial sector regulations and reforms of welfare state arrangements.



But perhaps, we will not be so lucky. Unemployment rates have hit record highs: almost two thirds of those under 25 in Greece and Spain are unemployed. Slovenia’s debt has been downgraded to “junk” status by Moody’s. Perhaps, doubts about the sustainability of Italian and Portuguese fiscal policy re-emerge, in the absence of convincing long-term plans. Perhaps, the crisis in the Spanish banking system deepens once again, as the

value of real estate continues to decline. Perhaps the Cyprus resolution breaks down, as the tie-in of large deposits and large loans there makes the substantial haircuts on large deposits impossible without similar write-downs of large loans. Perhaps, fears are triggered once again in the European financial system. Perhaps yields rise again to dangerous levels. Perhaps, the ECB is forced to show its true color

on the Draghi announcement, and either starts buying massive amounts of sovereign debts or stands by as member countries exit the Eurozone: perhaps we will get both. Perhaps the Euro skeptics in Germany gain enough momentum in the parliamentary elections in September or the constitutional court in Germany rules the Eurozone unconstitutional, to trigger a German retrenchment or even exit from the Eurozone. Or perhaps the sovereign debt crisis reaches France and Germany too, eliminating their stabilizing influence. Then what?

We need to find credible policies that allow us to avoid disaster scenarios, and we need to have credible policies in place, in case they were to happen nonetheless. This perspective of policy as insurance against disasters is far more important than the perspective of finding just the right policies in the benign scenario of the usual end-of-recession re-stabilization of the European economies. We must avoid forgetting the former, when thinking about the latter. Governments must spell out their plans in case the crisis deepens once again, whenever they argue for their favorite benign-scenario policy choices. We cannot afford to pretend that things are simply gradually returning to normal, and that it is enough to “muddle through”. Without assurance that policy makers understand and are prepared for the return of the storm, the Eurozone crisis forces might be unleashed once again: the consequences could be disastrous. The Eurozone economies currently operate in the shadow of the fear what will happen then: for optimism and growth to return even in the benign scenario, it is paramount that policy makers have a plan and have the resolve to implement it, should things fall apart. I am pessimistic that we are doing well on that front. Let me therefore draw on some guiding principles.

European integration and the creation of the Eurozone is a political project. Emerging from centuries of warfare and the horrors of two world wars, the postwar political leaders wisely decided that more integration is the only reasonable way forward. We have come far. Germans now consider French, Italians and Greeks their friends, and I hope the converse is true too. This is a remarkable achievement. My biggest fear is that, as a result of the Eurozone crisis, we turn this process back irrevocably, that prejudice and nationalism reemerges, that the countries in Europe will once again see each other as enemies. We must not allow that to happen. The Eurozone countries are not just nation states with interests, they are and they must be friends. A friend in need must be able to count on the better-off friend to help, but will not ask for more than is truly needed or cheat in order to accomplish that.

We are beyond this point in Europe. As a banking union is discussed, what, truly, is the magnitude of the legacy problems in Spanish banks? As bailout programs and Eurobonds are discussed to solve short-term imbalances, what, truly, are the hard choices made to achieve fiscal sustainability in the medium run in the member countries? In the periods of relative calm, have the nations in difficulty done everything within their means to get their house in order, or have they chosen to discard the one technocratic leader even attempting to get these hard choices made, in a recent election? How do the chosen actions compare to what a nation would have done in the face of some large-scale natural catastrophe, and without friends to help them? How reasonable is it to blame Germany for austerity, if Germany is the only friend remaining that is willing to lend at all?

This is where the discussion must start. It is the responsibility of Eurozone member states to outline and implement sustainable fiscal and structural policies, which return them to a healthy state, and

eventually enable them to help others, that do not rely on long-term handouts or overly large bailouts, and then seek short-term help in the context of that long-term strategy. Help yourself and help shall be given. I will try to outline what that implies. These choices will be painful: not because some sort of punishment needs to be imposed for excesses of the past (what a silly idea that would be!), but because a specific plan must be found to live within the means available in the future. Let me take on the catastrophic scenarios first, before then returning to the (hopefully more likely) benign scenario.

What are the options, should the crisis return?

The first: Germany plus the few remaining healthy Eurozone members pay, per turning all national debt into Eurobonds. Thomas J. Sargent, in his Nobel lecture at Stockholm, December 2011, advocated this approach, drawing a parallel to the history of the United States. Eurobonds ultimately need firm fiscal backing. This requires creating a United States of Europe, and introducing fiscal policies and taxation procedures set at the European, not the national level. Let me call for a high-level commission to provide a blue print for going that route. But I do not see any political momentum going in that direction: on the contrary. But without that, Eurobonds are a non-starter.

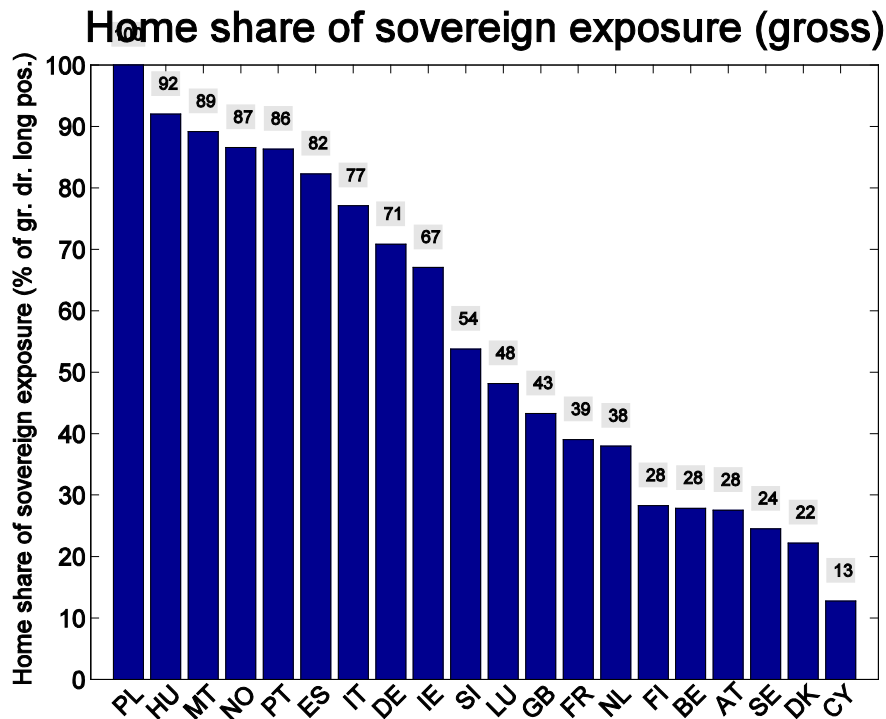
The second: the ECB follows through with Draghi's announcement and backs up weak sovereigns, per accepting questionable collateral and outright purchases of sovereign debt at a guaranteed price. The ECB has already taken on substantial risks and may do more. The most benign view of this policy is that it serves as coordination on a "good equilibrium" in a situation where sovereign debt markets are prone to panics and run. The least benign view is that it is the introduction of Eurobonds and joint fiscal policy through the backdoor, circumventing the fiscal prerogative of parliaments. It may not take much for the German constitutional court to declare the German Eurozone membership unconstitutional as a result. If losses occur, they will either need to be financed per recapitalizing the ECB, presumably by the wealthier countries, or by printing money and thus substantial inflation. Either route puts the ECB and thus the Euro in deep trouble.

A third option is a northern exit from the current Eurozone, perhaps creating a "new" or "Northern" Euro (the "Neuro") or re-introducing the Deutsche Mark, leaving the Euro to the South. This is not as bad as it seems. No default in the South, as the southern countries can now print as many Euros as they wish to keep at least their nominal repayment promises. Exchange rates would realign competitiveness. The flight to the safe-haven Neuro would make things tricky for exporters in the North for a while, and it will make imports expensive in the South. It will be the end of a dream, it will be quite a mess, but things will be fine after a while. Politically, though, it would be a disaster. Europe has been trying to grow together for 60 years. Such a Eurozone breakup would be a massive step backwards. Sympathy for an Eurozone breakup is growing, though, for example in the form of a newly-formed Euro-sceptic "Alternative for Deutschland" party in Germany.

The fourth option: have Greece or Cyprus or Portugal or Spain or Italy exit, and introduce their own currency. Indeed, remarkably many prominent economists are now leaning in that direction. But what would be the consequences? The Eurozone is close by. High-level workers and workers with strong unions would immediately seek to have their contracts be indexed to the Euro. The same may be true

for rents and prices for tradeables. The depreciation might be considerable. It will then be politically very hard to pay pensions in the local depreciated currency, without compensating for the depreciation, diminishing the contribution to rebalancing fiscal budgets. The majority of workers will see the real value of their wages decline dramatically: certainly, considerably more dramatically than anything on the table during the current “austerity” debates. Banks and governments would go bankrupt, as their revenues are in the depreciated currency, but their liabilities possibly are not. Lawsuits would stifle economic activity for years to come, sorting out the currency in which previously written contracts ought to be settled. Import prices would rise. It is hard to see that there is much to gain for these countries to do that --- so, why should they? There is no treaty provision to force them either. In sum, while it may look superficially attractive, this is unattractive for economic as well as political reasons for those countries that would have to take that step. For the record, this is not a consensus view.

Option five is my favorite: stick to what used to be best practice, stick to the treaties and original intentions. Each country solves its problems: no mutual bailouts, no bailouts from the ECB, genuine emergency measures only. If a country is bankrupt, it defaults on its bonds (even if owned by the ECB). If banks are insolvent, close them or resolve them: wipe out the share holders, hit the bond holders and large depositors, safe-guard small depositors. Now is the time to get prepared.



A sovereign default in the Eurozone at current will endanger its own banks, as the majority of the sovereign debt held by banks is domestic. This conundrum is at the very heart of the Eurozone crisis. According to the EBA bank stress test data of 2011, 77 percent of sovereign debt held by Italian banks is Italian debt, 82 percent of sovereign debt held by Spanish banks is Spanish debt, and 86 percent of sovereign debt

held by Portuguese banks is Portuguese debt. A sovereign default then triggers the need to bail out small depositors, thus not only adding further to the sovereign debt burden, but deepening the resulting crisis by endangering the financial system. But this does not have to be so: indeed, it should not be so. If Portuguese banks held Dutch debt instead, if Italian banks held French debt and if Spanish banks held German debt, the financial system would remain intact, as their sovereigns declare bankruptcy. This is an important step to take to safeguard the Euro, to safeguard the financial system and to safeguard

small depositors. It can be accomplished now by having regulators in southern countries put gentle pressure on their banks to dramatically reduce and even eliminate their exposure to own-country debt. Regulators, of course, seem to have largely been doing the opposite. In an effort to hold down yields and finding buyers during troubled times, they have relied and perhaps even pressured their domestic banks to help, effectively shifting the burden of costly default premia onto depositors and the ECB. This has to stop immediately. Yields are currently low enough, and financial markets work sufficiently well to accomplish it. Together with some overdue bank closures, interbank lending will revive, when no longer dragged down by zombie banks and multi-step counterparty risks, described in recent work by Caballero-Simsek as “complexity risk”. It is an important step to take in order to regain confidence on financial markets and thus to stimulate optimism and growth in private enterprise and households.

Preparing for option 5 and, hopefully avoiding it altogether, means finding growth-enhancing and fiscal-imbalance-correcting policies which will be suitable for the benign scenario as well. Unfortunately, some form of Orwellian newspeak has tainted the debate. “Growth enhancing” policies seem to be equated with deficit-financed fiscal spending, called “fiscal stimulus” with yet another Orwellian twist. “Fiscal-imbalance-correcting policies” are relabeled as “fiscal austerity”, and then branded as unhelpful in finding a path out of the current dilemma.

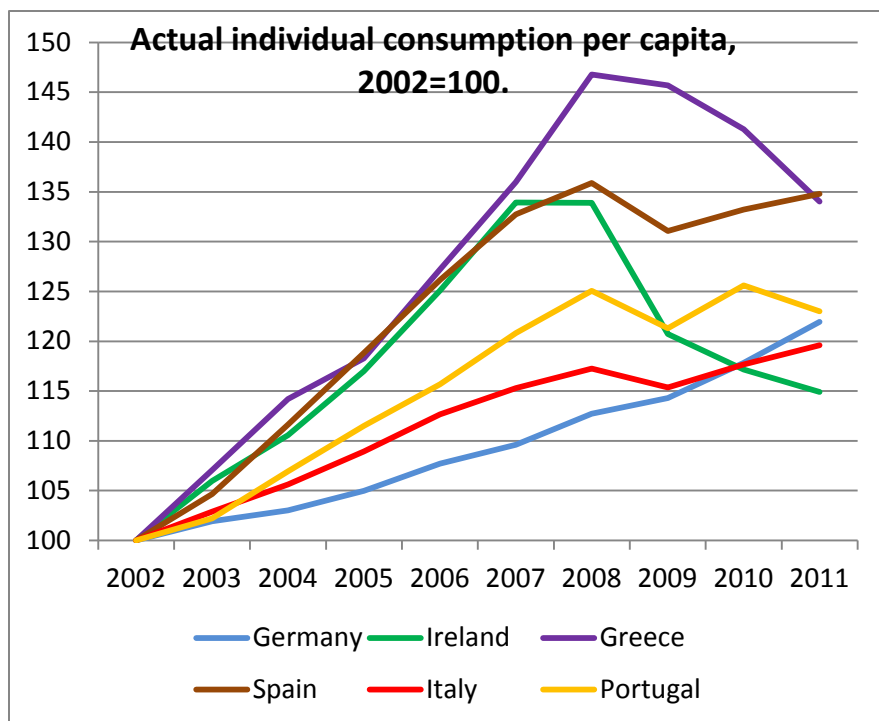
So, let me first and for the record state, that Keynesian-flavored deficit-financed fiscal spending will not be a productive route to take for the southern states of the Eurozone. There is a body of recent research regarding “fiscal stimulus”, by, say, Eggertson, Christiano and Eichenbaum, Perotti, Ramey, Cwik, Cogan, Taylor and Wieland, Drautzburg and myself, teams at policy institutions, and many others. The essential insights are that “fiscal stimulus” is generally not advisable, but can help in principle, if the central bank has run out of room to maneuver and interest rates are stuck at or near zero, as seems currently to be the case in the Eurozone, the US and Japan, provided, the stimulus is immediate and short-lived. Empirically and quantitatively, “fiscal stimulus” does not seem to do that much, though, resulting instead in higher debt and distortionary taxes down the road. It is hard to view the last decade in Japan as encouraging on that matter, for example. Furthermore, research by Farhi and Werning has shown that “fiscal stimulus” for a country in a monetary union will do far less than what it do in, say, the United States.

The argument in favor of fiscal stimulus furthermore often rests on the ability of the government to borrow cheaply and then to spend, when their own households do not choose to do so. But the governments of southern Europe find themselves in the opposite situation: they can only borrow due to implicit guarantees from their friends in the North and bailout perspectives by the ECB. This is hardly a good time to think about deficit-spending.

Does additional fiscal spending increase GDP, perhaps by more than one-for-one? There is a mechanical way in which this can be accomplished: pay people for “services” to the government, regardless how useful these services actually are. One must not go to the extreme, but one could: tax everyone 100 Euro per month to then pay everyone 100 Euro per month as part-time government employee (on top of any other jobs they may hold) for providing the “government service” of, say, sleeping a few hours per day. National statistics account for the “value” created by these services by adding up how much

the government pays for it. In this little example, GDP is increased by 1200 Euro per person per year! Clearly, though, nothing has improved in the lives of ordinary citizens.

The same argument also holds in reverse, and there it is of considerably more importance for the current debate: cut government employment and GDP falls, for exactly the same mechanical reasons. What should really matter, though, is whether essential services are cut or whether these are services that citizens would pay little for, if they had to. For that reason, it is considerably more informative to examine the data on private consumption rather than GDP to assess how well or how badly the countries in the south of Europe are doing. Indeed, as Eurostat nicely argues on their website, http://epp.eurostat.ec.europa.eu/statistics_explained/index.php/GDP_per_capita_consumption_per_capita_and_price_level_indices, it is best to look at the data on actual individual consumption (AIC), as it “consists of goods and services actually consumed by individuals, irrespective of whether these goods and services are purchased and paid for by households, by government, or by non-profit institutions”, thereby making them comparable cross-country and cross-institutional changes.



Based on the available Eurostat data and calculating the cumulative percent increase from 2002 to 2011 of actual individual consumption per capita, when measured in Euro, one finds Spain and Greece doing rather well at around 34 percent, whereas the numbers for Ireland, Germany, Italy and Portugal are between 15 and 23 percent. One can see the decline in Greece from its former peak, a 47 percent increase over 2002 until 2008, and in Ireland from its former peak in 2007 of a 34 percent

increase over 2002: that decline is obviously painful, but should perhaps be seen in the larger context of the entire decade. Notice, that the numbers in Italy, Spain and Portugal have remained rather stable from 2008 to 2011. The numbers move, when adjusted for purchasing power parities: now Germany does better and Greece worse, for example, but overall, one still would be hard-pressed to see a substantial decline in actual individual consumption per capita over this period. Perhaps, the private sector has been more resilient than has been given credit.

Growth of private consumption requires the resurgence of private enterprise, supported by labor market reforms, by solidifying the financial system and supportive and sustainable fiscal plans. To get there, eliminate the barriers of entry for new or foreign enterprises in all sectors. Welcome takeovers

by Chinese and other owners. In the countries with high unemployment, cut wages. If unemployment is very high, pass a law to do so: for workers, this is still better than an exit from the Eurozone. If this means taking on powerful unions and protective industry groups, then bring them on board in this state of national emergency. Germany was considered the sick man of Europe a decade ago, with its bloated welfare state and fossilized labor market. The reform of the labor market has cost the Schröder government the election in 2005 and has split the Social Democratic Party. It has been painful. But it has led Germany back to a vibrant labor market and a strong economy, whose resources are so urgently needed now in these troubled times in Europe. If Germany can reform, so can Italy, Spain and Portugal and reap similar gains in similar time.

Engineer a fiscal devaluation by increasing the value-added tax and reducing social security contributions: there are a number of academic papers by Correia, Farhi, Nicolini and Teles, that show how to do them, and ongoing debates are currently clarifying key points. Solidify public finances. If a government cannot afford to pay the pensions, cut them further and increase pension entry ages further. If a country has difficulty borrowing, but the government sector is larger than the median in the Eurozone, shrink it. Enforce existing tax laws. Replace distortionary taxes by less distortionary taxes. For example, rather tax immovable objects such as property than labor. The new Italian government must reconsider these policies rather than reject them outright.

On the European level, some temporary increase of inflation to, say, four percent for the next five years, and with commitment to return to below two percent after that, can help ease wage negotiations, provided workers in less competitive countries exercise wage restraint. The ECB has been tasked with ensuring price stability, but these are unusual times: some inflation is the lesser evil, compared to the break-up of the Eurozone. Additionally, the ECB needs to unwind its emergency measures, return to its role as guardian of monetary policy and leave the responsibility of fiscal policies to those elected to deal with it.

Politicians should not hope for or promise magic solutions: they do not exist. As a southern politician, do not promise that your friends in the North will pay ad infinitum: they won't. Do not create the illusion that sovereign debt problems can be solved by printing money and by ECB bailouts. Clearly spell out and commit to a medium-term strategy, clearly spell out the policies should the crisis deepen, in order to ask for short-term help, where absolutely necessary. There will be pain: not because one wishes to impose it, but rather because the life style many have gotten used to turned out not to be affordable. But if we get the cleanup done now, if the right policies are put in place and if we are prepared for the worst, growth will resume and the future will be bright in Europe once again.