

# Exiting the Euro Crisis

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## I. Introduction

What do economics and history have to tell us about the ways euro zone countries are likely to resolve their problems of fiscal unsustainability and banking system insolvency? In answering that question, I recognize that I am among the most pessimistic observers at this conference about the likely future of the euro and its membership. My relative pessimism reflects three personal attributes.

### **Arithmetic Trumps Legalism**

First, I am an economist, which means that I place more stock in arithmetic than in the legalities of what countries supposedly are or are not permitted to do; legislation or politicians' pronouncements about the impossibility of a departure from the euro zone count for little if arithmetic requires it. I will argue that in the case of at least one country – Greece – the fiscal arithmetic strongly favors not only a sovereign debt restructuring but also a departure from the euro zone, and there may be others for whom this same outcome will soon become a necessity as well.

### **Real Exchange Rate Theory and Political Economy**

Second, I am an American. Since before the establishment of the euro, American economists have had a distinctly more pessimistic view of the euro experiment than have their European colleagues. Two years ago, Lars Jonung and Eoin Drea published a detailed and quite humorous review of the difference in opinion about the euro between American and European economists. Its title characterized what it (then) regarded as the excessive pessimism of the Americans: “The Euro: It Can’t Happen, It’s a Bad Idea, It Won’t Last. U.S. Economists on the EMU, 1989-2002.”<sup>1</sup> In fact, my own 1999 paper predicting the eventual collapse of the euro was included in that review. The implicit theory behind the Jonung and Drea paper was that American economists (perhaps out of jealousy or nationalism) did not want to believe that the euro would work. In light of recent events, an alternative theory may have greater weight: Europeans were in denial. After all, wishful thinking (the result of a need to resolve “cognitive dissonance”) is a fairly pervasive aspect of human nature.

In 1999, and subsequently, I predicted that roughly a decade after its creation, either some members of the euro zone would be forced to leave, or the currency would depreciate dramatically as a means of keeping those countries in the euro zone.<sup>2</sup> In particular, I predicted that southern European countries would become fiscally unsustainable, and that losses of European banks would create significant bank insolvencies, which would put further fiscal pressure on governments through the costs of bank bailouts.

No, I am not a modern-day Nostredamus. I was not alone in those prognostications, and the economists that predicted the outcome that Europe is now suffering did not rely on any supernatural access to insights. The consequences of the euro’s launch were predictable for the simple reason that the euro zone was not an “optimal cur-

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1 European Economy Economic Papers, No. 395, Economic and Financial Affairs, Directorate General, European Commission, December 2009.

2 Charles W. Calomiris, “The Impending Collapse of the European Monetary Union,” *Cato Journal*, Winter 1999, pp. 445-52; “The Painful Arithmetic of Greek Debt Default,” March 18, 2010, *Economics21.org*; “The Euro Is Dead,” *Foreign Policy*, January 6, 2011.

rency area.” Its demise was a likely result of the deadly combination of fundamental economic inconsistencies among its members and the predictably myopic political palliatives that would be applied by individual members to ease the pain caused by those fundamental inconsistencies. Here is the train of thought that I thought was pretty obvious in 1999.

Southern Europe (especially Greece, Portugal, and Southern Italy) has low long-term productivity growth, particularly in tradable goods. This relative productivity growth gap was likely to persist as the result of a combination of pre-existing trade patterns, human capital differences, rigid labor laws in the South, and low labor mobility in Europe. As we learned from the experience of the East Asian fixed exchange rate collapses of 1997, and from the Harrod-Balassa-Samuelson theory of real exchange rate determination (as embodied in many macroeconomic models, including the rational expectations models of real exchange rates pioneered by Rudiger Dornbusch in the 1970s), if two countries with persistent productivity growth differences in their tradable goods sectors adopt a common currency, eventually the slow-productivity growth country will experience recessionary pressure, and eventually, it will either have to suffer continuing price deflation or devalue its currency.

As Alwyn Young pointed out, East Asian countries’ relative productivity decline began several years prior to the crisis of 1997, and as Campbell Harvey and Andrew Roper point out, the financial leveraging of East Asia was a direct response to the lost profitability of manufacturers, who were able to obtain explicitly or implicitly subsidized access to credit to fill the gap between their income and their expenditures. The result, however, was growing leverage and increasingly unsustainable private sector and bank finances.<sup>3</sup>

Of course, in the short run, countries do not have to accept the dismal choice between slow growth and devaluation. Instead, they can apply fiscal stimulus, or facilitate (through easy bank credit) the

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<sup>3</sup> Alwyn Young, “The Tyranny of Numbers: Confronting the Statistical Realities of the East Asian Growth Experience,” *Quarterly Journal of Economics*, 110 (3), pp. 641-80; Andrew H. Roper and Campbell R. Harvey, “The Asian Bet,” Social Science Research Network, March 18, 1999.

growth of the non-tradables sector (also known as housing). Even worse, that temptation to compensate with fiscal stimulus and easy credit will be greater if the establishment of the currency union itself lowers the interest rates on sovereign debt or bank debt that the low-tradables-productivity-growth countries face. That was an important contributor to the fiscal binge of Greece, which ran fiscal deficits in excess of 5% of GDP in its boom years of 2004-2006. It should not be a surprise that Greece, Portugal, Italy, Spain and Ireland all underwent (albeit in different degrees) significant fiscal spending and bank lending booms, and that some of them saw remarkable rates of appreciation in housing markets. This is precisely what one would expect from the long-run implications of real exchange rate theory and the short-run implications of political economy theory.

**“Why, Sometimes I’ve Believed as Many as Six Impossible Things Before Breakfast.”<sup>4</sup>**

Third, I am an historian, and so I know that erstwhile impossible things – from a legalistic perspective – happen regularly in financial and monetary history. For example, consider the U.S. departure from the gold standard at the beginning of 1862, which began a seventeen-year period of U.S. experience known as the period of suspension under the “greenback” standard. Prior to the creation of legal tender notes by the federal government and the suspension of gold convertibility in 1862, the U.S. government had never issued legal tender notes, nor was there any credible basis for the view that the government had the Constitutional authority to do so.

The government had issued some treasury bills during the War of 1812, for a brief time, and had made them receivable for payments of taxes, but it promptly withdrew those notes after the War ended, and never declared them a legal tender for private debts. That experience comported well with the consensus that had emerged from the founders’ Constitutional debates over the monetary powers of the U.S. government during the Constitutional convention. Under the Constitution, the federal government was not given the right to declare anything but gold and silver a legal tender, but neither was it strictly forbidden from doing so (in contrast, the individual

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<sup>4</sup> Lewis Carroll, *Through the Looking Glass*.

states were forbidden). Delegates avoided the strict prohibition on the argument that it might be expedient as a temporary war measure to permit the federal government to issue paper legal tender, but there was also a consensus against allowing a permanent role for government-supplied legal tender.

Very few people would have argued, say, in 1860, that the federal government was likely to assert the right to create legal tender paper money as a permanent component of the money supply, or to substitute it for gold and silver as the definition of the dollar. But then the Civil War happened. Within a few months of the outbreak of the War – which was initially regarded as an event likely to cost the North little, and to last for only a few months – it became clear that the War would, in fact, cost much more, and take much longer, than anyone had guessed. In the fall of 1861, the initial debt offerings by the government had not gone well, and the government enlisted the banks of New York, Boston, and Philadelphia to subscribe to the debt as a syndicate. Within a few weeks of stuffing the banks full of new government debt, however, the Secretary of the Treasury, Salmon Chase, released a report estimating substantial increases in war expenditures, and proposing not to increase taxes to help finance the war. The result was a collapse of the value of government debt, which prompted a suspension of convertibility by the banking system (whose assets had consequently suffered major losses).

The legal tender law of 1862 was, effectively, a bank bailout. By creating a new, depreciated numeraire (the greenback), and by allowing dollar claims (including deposits) to be denominated in this depreciated version of the dollar, rather than in gold or silver, the government offset the negative shock to bank assets from government bond depreciation with a similar negative shock to the value of deposits. Later the legal basis for legal tender notes was challenged, but since it had been employed during wartime as an expedient to ensure the survival of the government and the banks, and since it would have been very difficult to unwind the sequence of payments that had been made on a depreciated currency basis over several years, its Constitutionality was upheld. To ensure that it was upheld, President Grant added two Justices to the Supreme Court (another outcome

that many would have dismissed as far-fetched in 1860). The force majeure of fiscal necessity can be a source of great legal innovation.

Nor was this U.S. experience exceptional. In 1933, the U.S. government prohibited the enforcement of gold clauses in private debt contracts. It did so to assist debtors to survive the double blow of a weak economy and a depreciated dollar (which increased the burden of paying gold-denominated debt). In a five-to-four Supreme Court decision, that action was upheld in 1935. That Supreme Court decision was widely regarded as permitting the government to orchestrate illegal takings from creditors and was decried as such in an apocalyptic minority dissent.

As recently as 2002, the Argentine Republic put aside its Constitutionally mandated adherence to a dollar-linked currency board when it left the dollar standard and redenominated dollar-denominated and dollar-indexed contracts into the newly depreciated peso. The precipitating event that led the Argentine government to recognize the need to resolve its longstanding fiscal crisis – which had been going on for over two years – was the run on Argentine banks that occurred in December 2001, which precipitated a suspension of convertibility of deposits.

## **II. The Divergent Realities of the Euro Zone**

I will not repeat here in detail my prior analyses published elsewhere of the currently unsustainable paths of Greece, Portugal, Ireland, Italy, and (depending on its bank bailout policies) Spain, but I would emphasize that these countries are not all facing the same problems, and that their strategies for dealing with their problems should differ, as should the strategies of the EU for agreeing loss-sharing arrangements to address those problems.

There are three distinct problems related to euro zone membership that confront this group of countries: (1) over-indebtedness, (2) high deficits in combination with over-indebtedness, and (3) non-competitiveness. These problems are distinct and pose different challenges for policy, and the relative weights to attach to these three

problems differ across the euro zone countries that are currently under the greatest pressure.

First, debt sustainability refers to an excessive amount of debt relative to GDP, which must be addressed through some form of default and restructuring.

Second, high deficits add another dimension to that problem. A country that defaults on its debt will find it difficult to fund its continuing deficits through new issues of sovereign debt into the market. Thus, a high-deficit country that is also in need of restructuring either must leave the euro zone to print money to finance its continuing deficits, or obtain public-sector support for deficit borrowing “in arrears” in the wake of its default (presumably with the hope of quickly ending its deficits, so that public sector support does not result in a second debt default).

Third, countries with over-valued exchange rates (which resulted from their slow productivity growth in tradable goods and their rigid labor markets) face the difficult choice between a protracted period of recession as their wages and prices decline to restore competitiveness, or departing from the euro zone, depreciating their currency, re-denominating their wages, prices, and bank deposits in the newly depreciated currency, and immediately beginning their recovery. Under either of those scenarios, long-term reforms of labor markets and other policies to address competitiveness are desirable, but those long-term reforms will not resolve the short-term problem; in the short term, over-valuation implies a clear tradeoff between continuing recession and devaluation.

In my view, all three of the fundamental problems listed above are severe for Greece. It is a matter of simple arithmetic that Greece’s debt is not sustainable. Greece’s deficits are also large, and it would be challenging for it to succeed in credibly promising to shrink those deficits to obtain sufficient short-term financing in arrears to avoid leaving the euro zone as it restructures its debts. Even if financing in arrears were possible, the costs of continuing over-valuation would deepen Greece’s recession because of over-valuation. It is hard to see

how – absent a massive transfer (not a loan) to Greece of roughly two hundred billion euros – Greece can avoid both debt default and exiting the euro zone. Portugal's situation is not as dire, but similar logic applies to its case. A restructuring and an exit from the euro would seem to make sense as a means of resolving all three problems.

Countries that leave the euro could and should re-join it in a matter of a few years, after undertaking significant reforms to their fiscal affairs, labor markets, and pension systems. It makes no sense to prohibit them from re-joining, and that prospect could be a useful source of encouragement for reforms.

Ireland and Spain are in a somewhat different position than Greece and Portugal. If they can avoid domestic government assumption of their local banks' debts held abroad (e.g., by German, UK, Belgian, and Danish banks), then they are not clearly in unsustainable fiscal positions (although Ireland's absorption of bank debt already has placed it at substantial risk in that regard). And there is a more realistic possibility of improvement in Spain's and Ireland's competitiveness positions and economic performance, if they can avoid the debt sustainability trap that would result from absorbing their banks' debt problems. If instead they absorb their failed banks' debts, they will make their sovereign debt problems much worse, and probably unsustainable. Although the right policy choice is clear, Ireland and Spain have come under enormous pressure from European counterparts (and from domestic political friends of insolvent cajas in the case of Spain) to absorb those debts. They must find the political will to say no.

Italy's situation is also unique. Its debt sustainability problem could be solved with quick, significant, but not crippling, cuts in fiscal expenditures, combined with significant reforms in tax collection and corruption. But Italy is deeply broken politically. There seems to be little prospect for timely and necessary policy changes to be implemented.

### **III. What Should Happen vs. What Will Happen**

The best path forward for the euro zone would be to encourage the policy adjustments for Greece, Portugal, Ireland, Spain, and Italy discussed above, and to agree loss-sharing arrangements to absorb in an orderly way the losses that would result to German, UK, French, Belgian, Danish, and other countries' banks from sovereign defaults and failed Irish and Spanish banks' and cajas' defaults.

If history is a guide, however, this is not the way the euro crisis will be resolved. Governments likely will prefer to try to postpone taking unpopular measures, and thus will not resolve the problems at hand. The most likely outcome will be a chaotic sequence of ad hoc and poorly coordinated emergency measures, taken in response to bank runs that will begin in Greece or somewhere else as depositors become increasingly wary of continuing euro convertibility of their deposits. The time to act is now, as the possibility of undertaking an orderly and sensible resolution of the crisis is slipping away.