March 2010

What's happening in the euro area ?

Jean Pisani-Ferry

The euro area is in the spotlight. Amid speculation about a Greek default, expectations of a European bail-out and even conjecture about a euro break-up, overseas investors have shunned the European currency, letting it depreciate from 1.50 dollars in early December to 1.35 in recent days. Long-time eurosceptics seem vindicated. Meanwhile, Greece goes for severe budgetary consolidation and markets, in characteristic contagion mood, wonder which European country will be next.

It is astonishing that this is the same euro that was hailed a great success on the occasion of its tenth birthday last year and whose dollar exchange rate appreciated by almost 100 percent between 2001 and 2008.

To understand what is happening, it is important to distinguish between Greece and other countries in difficulty such as Spain. The Greek crisis is a trauma because, as in a classic tragedy (where the heroes know exactly what awaits them, make every effort to prevent it, but in the end let it happen), it was a story foretold. German doomsayers at the time of the creation of monetary union predicted that at some point a Southern European country on the verge of bankruptcy would appeal to German taxpayers' generosity. In order to alleviate their fears, all sorts of safeguards were enshrined in the EU treaty at the time: only countries with a strong fiscal record would be admitted; they would have to abide by strict rules designed to prevent a build-up of public debt; and in the event of a crisis EU financial assistance was explicitly ruled out, whereas it exists for countries outside the euro. But Greece cheated to join the euro, eschewed surveillance and bent the rules until the newly elected government admitted that it was facing an acute fiscal crisis.

Europeans are now facing a difficult choice and have been agonising over it for several weeks. Either they stick to the rules and refuse to assist Greece, but then Greece will most likely turn to the IMF for money and get angry against the EU – potentially disturbing the functioning of the European institutions, while other problem countries may suffer from contagion effects. Or Europe finds a way to help Greece, at a cost for the credibility of the very rules that were supposed to elicit budgetary responsibility.

Neither of the alternatives is appealing, but by the same token neither is lethal for the euro area. Greece in both cases has to embark upon severe budgetary consolidation. And there will in both cases be a need for system repair after the crisis, as indicated by recent declarations about a possible European assistance mechanism or a European Monetary Fund. This is after all part of a normal learning process. It was in any case unimaginable that the euro would never be confronted with a crisis of this sort.

The Spanish crisis is of a different type. Spain has always played by the rules and as recently as in 2007 recorded a budgetary surplus of 2 percent of GDP. But participation in the euro from 1999 resulted in a drop in interest rates and fuelled a private sector-led boom that lasted for almost a decade: until 2007 consumption grew much faster than income, residential investment jumped from less than 5 percent of GDP to almost 10 percent, and the current account moved from balance into a deficit of nearly 10 percent of GDP. Wages and prices rose fast, thereby lowering real interest rates and perpetuating the boom.

Productivity in manufacturing barely grew and unit labour costs increased by about 30 percent between 1998 and 2007 while they stagnated in Germany. The result is that Spain has become a massively uncompetitive investment location, that its growth model is wrecked and that the only way for it to recover is to embark upon a painful and protracted restoration of its competitiveness through wage cuts and productivity hikes. Meanwhile, the collapse of tax receipts has resulted in a major fiscal crisis.

The fates of Greece and Spain in the short run may not differ much, as adjustment is the order of the day in both cases, but the causes of the problems are not the same and the crisis portends significantly different lessons. To prevent a repetition of the Greek crisis, budgetary scrutiny has first and foremost to be made credible. This requires stronger investigative powers for the EU and a consensus to use them. But the lesson from Spain is a more disturbing one. Two opposite channels are at work in a monetary union: a real interest-rate channel which tends to amplify divergence across countries and a competitiveness channel that helps to narrow them. The first one results from the domestic-demand effect of higher inflation: as the nominal interest rate is the same throughout the area, inflation results in a lower real interest rate and therefore in higher domestic demand, which in turn pushes inflation further up. The second one arises from the pressure of international trade and investment: higher inflation results in higher costs, output losses and a rise in unemployment, which in turn helps contain costs and inflation. What the Spanish crisis demonstrates is that for several years in a row the first channel, increasing imbalance, can trump the second. By the time domestic demand finally abates, the proportion of the traded and the non-traded goods sectors in the economy may have been altered dramatically.

So the big question for the euro area is what is to be done in the short run for Spain and in the long run to avoid similar crises. The answer to the first question is: facilitate adjustment by not letting inflation slip below target, so that some of Spain's return to competitiveness takes place through wage restraint rather than outright wage cuts. This implies a lengthy period of supportive monetary policy. The answer to the second question is: strengthen the competitiveness channel through making more goods and services tradable across borders, and complement it through much closer mutual surveillance of national economic policies. The EU has started to move in this direction, but tough challenges remain. Especially, it remains to be seen who tomorrow will have the courage to remove the punchbowl when the real-estate party gets going. The Spanish government could have done it but did not. To expect that peer pressure will prevent similar failures tomorrow is a non-trivial call.

When in the 1990s they embarked on a monetary union, Europeans were proud of an experiment which no other region of the world had tried in modern times. They knew it would not be a straightforward journey. Now is the time for them to draw the consequences – even if these consequences go beyond what they initially expected.

Jean Pisani-Ferry is director of Bruegel, the Brussels-based economic think tank