

The Eurozone: Difficult Choices Ahead for Germany

Response to Speech by Commissioner Moscovici

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1 Introduction: Difficult Choices

- Difficult choices facing policymakers, and Germany in particular.
- The Euro framework was like this.
 - Macroeconomic stabilisation
 - Disciplined wage and price setting
 - Stability and Growth Pact – fiscal discipline
 - Financial liberalisation – to promote growth and convergence
- Two things went badly wrong
 - Great divergence in relative unit labour costs – in some countries by 30 or 40 percent
 - Undisciplined overlending to GIIPS countries
- Suddenly crisis arrived in 2010
 - Uncompetitive GIIPS became vulnerable
 - Sovereign debt crises came to Europe
- Europe survived – there was even euphoria
- But now there are three difficult policy choices

2 **Difficult Choice I: a Need for Sovereign Debt Write-downs**

- The sovereign debt of the GFIIPS countries will need to be written down.
- Cast your mind back to the Latin American debt crisis, which struck in 1981.
 - In the late 1970s, US banks had overlent to Brazil, Argentina, Mexico.
 - Then Paul Volker raised interest rates to fight inflation in the US.
 - Bankruptcy of US banks
- Banks charged high margins and earned their way out of difficulty
 - Eventually debt written down
 - It took 8 years - Latin America's lost decade
- A similar writedown is inevitable in Europe, and necessary soon
 - Think of difficulty in 2010
 - Think how difficult it now is – in some ways more difficult
 - Who holds debt?; the role of the ESM

3 **Difficult Choice II: Adjustment of Relative Unit Labour Costs**

- How to adjust relative unit labour costs.
- Requires 5 percent difference in inflation rates for 6 years.
 - Imbalances procedure should focus on this need – it does not
- How is that to be achieved?
 - Only by more inflation in Germany
 - Consider the resistance over the past two years
 - Consider the problems this week
- QE is necessary
 - For QE to be effective - will require mutualisation of risk on public debt
 - How likely is that?
- ‘Whatever it takes now in doubt’ – even at the ECB

4 **Difficult Choice III: Need for Revision of the Stability and Growth Pact and the Imbalances Procedure**

- Stability and growth pact actually allowed excessive laxity in GIPPS countries during the Great Moderation, and forced the opposite on Germany
- Now it is imposing overall fiscal deflation in Europe
 - The effects are very large
- Imbalances procedure is adding to this asymmetry
- With such asymmetry the only way that demand growth can recover is externally
 - Required ECB to seek currency depreciation
 - Exchange rate warfare
 - this fiscal framework is not enabling good European or global citizenship
- This must change

5 Implication : an impossible trinity

- It seems that in all three of these cases the necessary move may be politically impossible in Germany.
 - That is why I have called my comments “ difficult choices”.
- Those of you will who are economists will know about an ‘impossible trinity’ in macroeconomics.
- We are watching the operation of another ‘impossible trinity’
 - monetary union,
 - coherent economic analysis
 - European (and German) political reality.
- Incoherent economic analysis in the end brings crisis: think 1931, 1971, 1997
- It may be that coherent economic analysis and European and German political reality implies that monetary union is not sustainable.

6 Conclusion

- Marginal choices and incommensurable choices
 - big choices, between very different alternatives, with far-reaching effects.
- In Europe we face such a incommensurable choices
- Commissioner, please do not choose an impossible trinity.
- And Jens Weidman, Angela Merkel and other German policymakers
.....please think as Europeans and not as Germans.....