Levy Economics Institute of Bard College

Policy Note

2015 / 1

EUROPE AT THE CROSSROADS: FINANCIAL FRAGILITY AND THE SURVIVAL OF THE SINGLE CURRENCY[1]

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To outside observers, Germany's insistence that the new Greek government continue to impose austerity policies in the presence of rising unemployment and mounting debt levels appears to defy economic logic. However, an acquaintance with the historical evolution of the path to the creation of the common currency in the European Union (EU) sheds some light on the logic of the German government's strategy in dealing with the eurozone sovereign debt crisis and its negative response to Greece's request for an alternative economic policy.

Given the continuing divergence between progress in the monetary field and political integration in the euro area, the German interest in imposing austerity may be seen as representing an attempt to achieve, de facto, accelerated progress toward political union; progress that has long been regarded by Germany as a precondition for the success of monetary unification in the form of the common currency. Yet no matter how necessary these austerity policies may appear in the context of the slow and incomplete political integration in Europe, these policies are ultimately unsustainable. The survival and stability of the euro, in the absence of further progress in political unification, paradoxically require either sustained economic stagnation or the maintenance of what Hyman Minsky would have recognized as a Ponzi scheme. Neither of these alternatives is economically or politically sustainable.

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Two Roads to European Unification

There have always been two different approaches to European unification. These can be roughly divided into the "economists" and the "structuralists." For the latter, unification was a process of creating the appropriate institutions on the presumption that the comportment of the member-states would eventually adapt to the desired structure. An example of this strategy is the common agricultural policy, which incorporated an implicit fixed exchange rate structure that was supposed to eventually produce the kind of market exchange rate stability that would allow the introduction of the common currency. On the other hand, "economists" argued that the operation of market processes would produce real economic convergence, which would eventually create the conditions to allow the introduction of institutions such as a common currency as the "crowning" achievement of the European project.

But whatever the approach, it was always accepted that the end result would be something on the pattern of a United States of Europe, with a common currency similar to the dollar in the United States. The diversity that has prevailed in individual US states operating under a single currency seemed to support the structuralist view, while the existence of a strong federal government to offset regional diversity supported the economists' view that Europe should first move to more integrated political structures before the introduction of the single currency.

The October 1970 Werner Report had set out the problems involved with the introduction of a single currency in the European Economic Community (EEC), but these intentions were diverted by the breakdown of the Bretton Woods system after the failure of the Smithsonian Agreement to restore stable parities. The path to the single currency had been conceived in a fixed exchange rate world, and the Community stumbled along in its absence, attempting to preserve fixed rates through a series of "snakes" and "snakes in tunnels," until it became obvious that floating exchange rates would become the global standard. The impetus for the rapid creation of a single currency faded, as did the stability of the international financial system in the face of volatile energy prices, inflation, and stagnant economic growth in the 1970s and early 1980s.

The proposals for Economic and Monetary Union (EMU) and the Single European Act of 1986, which resurrected the idea of a single currency, were primarily conceived as measures to rejuvenate the political impetus to what had become a stalled integration process focused on trade. The rapid integration of trade flows through a common external tariff, which represented the first fruits of the Common Market, was slowed by the stagnation of the 1970s and early 1980s, and left little promise for further measures toward integration.

The 1988 Cecchini Report, "Europe 1992: The Overall Challenge," was meant to provide additional support for integration in the form of an open "single market." It estimated the impact of more complete market integration at an increase of 5 percent of Community GDP. The advantage of this proposal was that it relied on supply-side incentive measures to increase growth. There was no need for (inflationary) monetary stimulus or deficit spending. The report forecast that the full removal of cross-border trade impediments would reduce prices by 6 percent, improve fiscal balances by 2.2 percent of GDP, and improve the external balance by 1 percent of GDP—all at the stroke of an administrative pen reducing impediments to greater competition across EU countries.

However, the Cecchini forecast was wide of the mark: average EU growth rates continued to decline, from 3.2 percent in the 1970s, to 2.25 percent in the 1980s, to below 2 percent in the 1990s. While the introduction of the single market did coincide with a decline in inflation rates—from more than 10 percent in the 1970s and '80s to below 2 percent in the 1990s—critics pointed out that a similar decline also occurred in non-EEC countries that had not experienced increased market integration. More likely, the decline in inflation was due to restrictive demand policies and the associated disappointing growth outcome, along with declining energy prices.

The failure of the single market initiative to jumpstart the stalled integration process turned attention back to monetary integration—failure to move in this area being considered one of the impediments to the realization of the advantages of the operation of the single market. Thus, to ensure success of the "single internal market," the EU accelerated the push for monetary integration. In true European fashion, acceleration did not necessarily mean rapid movement, and occurred in a number of measured decision-making steps. First, the 1978 Bremen/Brussels declaration proposing the European Monetary System (EMS) was incorporated in Article 20 of the Single European Act as the basis of EMU. The Maastricht Treaty then provided for a "common currency for the common market" through a euro timetable, the specification of entry conditions for the common currency, and the institutional structure for the European Central Bank (ECB) as the bank of issue for the common currency.

While this movement to the single currency was not rapid, taking some 30 years from Werner to the introduction of the euro, the crucial point is that its acceleration in the Maastricht Treaty made monetary integration much more rapid than the movement toward the political unification that, in the view of the "economists," would normally have accompanied the creation of a single monetary unit. It is this "gap" between monetary and political union that has come back to haunt the resolution of the EU sovereign debt crisis, and has made Greece a crucial political pawn in the chess game being played out in the EU over the degree of political unification and centralization of powers. Put more simply, the debate between the economists and the structuralists is being resumed in the imposition of austerity as the solution to the sovereign debt problems in the EU.

Indeed, this "gap" was enshrined in the Maastricht Treaty's sanctioning of "variable velocity" as the mechanism for European integration. This point was made in the 1990s by Otmar Issing, then one of the most powerful members of the German Bundesbank's board and eventual chief economist of the ECB. He noted, in a review of the Maastricht process, that

> historical experience shows that national territories and monetary territories normally coincide. . . . the relevant legislation, as a rule, defines monetary sovereignty in relation to a national territory. . . . In contrast to the normal rule, the Maastricht Treaty implies a clear discrepancy between the intentionally rather modest political integration and monetary integration. (Issing 1996, 14–15)

Thus, at least for the Bundesbank, it was very clear that Maastricht had the integration process backward. Political integration set the limits on monetary union and the creation of a single currency. Hans Tietmeyer, president of the Bundesbank, put the matter this way:

> After a certain point, economic integration cannot realistically be expected to advance further without the prospect of further progress in the field of politics. The transfer of an elementary sovereign right such as monetary policy to a European Central Bank is likely to mark that point. (Quoted in Issing 1996, 16)

In other words, a governing board of the ECB composed of governors of the various EU-member central banks did not have sufficient authority to set monetary policy aims for the EU, failing corresponding political institutions.

Issing and other German economists made it very clear why they considered political union the prerequisite for monetary unification and the shift of monetary policy control from national governments. They argued that with the creation of a single currency system, devaluation would no longer be available as the policy response to negative external shocks or internal policy failures, as had been the case ever since the creation of Bretton Woods and had been employed in EMU. Under the common currency, the only available policy response would be internal adjustment of wages and prices, and in particular the increased (downward) flexibility in wages and contractual conditions in labor markets. Because harmonization of the existing national social safety nets within the EU was likely to converge to the most generous social and income support measures, the required increase in labor market flexibility and the downward wage adjustment process would be thwarted. The common currency would thus mean that existing welfare state social safety nets would have to be dismantled and the appropriate measures redesigned in the interest of providing fluid wage and price adjustment. Indeed, if German unification is recognized as an external shock, this is precisely the policy that was followed: reduction of social programs and reduction of wage growth below productivity gains.

Further, in this view of the operation of the EU without extensive political integration, monetary union was likely to reduce individual governments' incentives to implement prudent fiscal policy in general, or austerity policy in particular, in the face of external shocks. Under a single currency, there is no longer the risk of an exchange rate crisis and any lack of adjustment in fiscal measures will have little impact on domestic interest rates, since it would be partially absorbed by the single euro interest rate set by the ECB for the euro area as a whole. The operation of this effect was seen in the period after the introduction of the euro, when, despite widely divergent fiscal policies and debt and deficit performance, any private market adjustment to reflect sovereign risk differentials across countries was absent.

The result of these inherent national differences in unemployment and commitment to fiscal prudence would produce, in the German view, political pressure for compensation in the

form of transfers from the wealthier or less indebted to the poorer or more indebted areas and undermine political solidarity, as well as undermine support for a common ECB monetary policy. Indeed, it might even undermine the ability of the ECB to create the price stability that, for Germany, was the prerequisite for establishing the euro as a credible alternative to existing national currencies. Only a strong political center would be able to resist these pressures, and thus political convergence and integration were considered the obligatory initial steps to the establishment of a single currency.

These arguments in favor of prior political integration have been reflected in Germany's own policies under the single currency. As noted, in response to German unification and the increased transfer measures required from rich West Germany to poor East Germany (recall the Bundesbank resistance to the 1:1 OM-to-DM transition imposed by Helmut Kohl as a political measure), actions were taken to reduce the fiscal deficit, dismantle the German social welfare system (which had provided unemployment insurance and pensions to the East German workforce at West German levels), and increase flexibility in labor markets—including, in particular, formal agreements to keep wage increases below productivity gains, as production was outsourced to the former Soviet satellite countries at extremely low wages.

Indeed, it was in the absence of the desired level of political integration and control that Germany insisted on embedding measures limiting the size of government budgets in the various EU treaties pushing for monetary union. These measures have simply served as substitutes for failed real political integration. The major examples are the conditions of entry to the euro and the Maastricht Article 104 (TFEU Article 123) preclusion of ECB lending to governments. These conditions mean that governments cannot fund themselves through domestic liquidity creation, so that budgets will depend on fiscal surpluses or borrowing from private markets. But even to source private markets on a sustainable basis requires governments to run fiscal surpluses to meet debt service and maintain a triple-A credit rating (although the Basel risk-weighting rules implicitly provided triple-A ratings, irrespective of deficit and debt performance).

Thus, the rationale for the Stability and Growth Pact (SGP) and "six-pack" conditions is to impose fiscal sustainability under the single currency as a substitute for strong central control. The problem is to avoid the moral hazard cited above that is created by the gap between monetary and political unification. While the conditions for entry to the euro are strict, and failure to meet them produces the ultimate sanction—exclusion from entry to the euro—after entry, a country faces few binding sanctions if they fail to maintain the entry conditions. Countries cannot be expulsed, and the system of monetary penalties does not seem to be an appropriate incentive to adjustment—hence the need for incontrovertible pre-entry proof and hard post-entry sanctions that debt and deficit conditions will be met. But the latter requires strong political unification, something that is now the German objective in resolving the euro crisis.

As noted, the basis of the German approach is that the euro is equivalent to a fixed exchange rate system with no possibility for change of parity. But, in contrast to the original Bretton Woods system, there is no government that issues the reserve currency. This means that the sovereign debt of national governments is no different than the debts of the private sector. Repayment of private debt requires firms (households) to earn profits (wages), roll over the debt via additional borrowing, or sell assets, while repayment of sovereign debt requires taxes greater than expenditures, borrowing (rolling over), or asset sales. Just as different private borrowers have different credit risks, "sovereigns" have different credit risks, but the fact that they are incurred in a common currency issued by a single central bank led financial markets to completely overlook these risk differentials in the first 10 years of the euro's existence. The concern to ensure ironclad conditions on fiscal balance is thus understandable, for it is the only way to avoid government default and maintain the integrity of the euro. The failure of the rest of the EU to follow these policies has produced precisely the kind of political pressure that German experts had foreseen in 1996, with Germany called upon to bail out the indebted Greeks, Italians, Portuguese, and Spanish, and possibly the French workers who were successful in introducing a 35-hour workweek when German workers were facing restrictions on wage increases and reductions in social safety nets.

It should thus be no surprise that Germany now refuses to grant debt reduction and is calling upon Greece to implement similar policies and upon the rest of the EU to accept deeper political integration in order to preserve the euro and solve the sovereign debt crisis. It is a return to the policies that Germany has always advocated as necessary for the successful creation of the single currency. Greece thus becomes the poster child for the German argument about the need for its own policies and provides the picture postcard of the kind of policies that have to

be implemented. As long as Greece threatens to disobey and to leave the euro, Germany's position in favor of increased political integration and centralized control based on its own proposals for the euro's success grows stronger.

The Paradox of Euro Stability and National Government Instability

But while for Germany these are the necessary conditions for the stability and success of the euro, from a Minskyan point of view they are the source of the financial instability in the euro area. We can use Minsky's analysis of financial fragility—in terms of hedge, speculative, and Ponzi financing profiles—to see the paradox of the German position. For Germany, governments should always have hedge financing profiles (that is, generate fiscal surpluses sufficient to meet debt service), since they do not have access to financing from the ECB that would allow for speculative finance (i.e., occasionally rolling over to refinance), while the current conditions facing Greece and the other peripheral countries are those of Ponzi finance—they have to borrow in order to meet debt service. To this end, Germany has introduced balanced budget legislation and strengthened the SGP to pledge EU members to the same objectives through the "six-pack" and "two-pack" amendments. However, a policy of imposing hedge financing as a common EU policy contains a paradox, and a virtual impossibility theorem for countries that currently have debt and deficit ratios above the SGP limits, as this requires a rising fiscal surplus that can only be achieved through a combination of higher growth and taxation. Since governments cannot produce this growth through deficit spending, it must come from either domestic consumption and investment or foreign demand. But increased domestic expenditures cannot be generated by reducing government expenditures or raising taxes to generate the required fiscal surplus, since this only reduces domestic demand.

Further, these objectives have been made more difficult by the misdirection of investment, which has tended to reinforce real divergence across countries. This is seen in the differential impact of capital flows in the euro area. The northern tier economies have attracted foreign investment flows into "productive" sectors, increasing productivity relative to wages, while the southern tier economies have attracted investment in real estate and other non-productivity-increasing activities—all while wages have tended to grow at the EU average, thereby reducing their competitiveness. There is thus a positive relationship between foreign direct investment (FDI) and trade balances for the "North" and a negative relationship for the "South."

After 1999, a substantial rise in the net inflow of FDI in the euro area tended to reinforce this divergence. At the industry level there was a positive relationship between FDI in the manufacturing sector and the trade balance in the North, and a negative relationship between FDI in the nonmanufacturing sector and the trade balance in the South. When FDI inflows are channeled to the productive/tradable (unproductive/nontradable) sector, this leads to substantial improvement (deterioration) in productivity and competitiveness in the long run.

For Minsky, financial stability is similar to the requirements of the SGP: hedge financing for the government. This requires that tax yields are greater than expenditure by a cushion of safety $(T \gg G)$. But higher tax yields in the absence of higher growth require the private sector to increase tax payments, which can only be done by reducing consumption and increasing saving. Thus, the ability of the private sector to increase tax payments and repay debt requires the private sector to spend less than its income. Thus, if households net save $(Y\text{-}C \gg 0)$ and firms earn net profits > 0, this means that for the combined private sector, saving exceeds investment $(S>I)$. But this contradicts the condition for macroeconomic balance: government hedge finance requires a government surplus $(T\text{-}G \gg 0$ or $T \gg G)$, while private sector hedge finance requires a private sector surplus $(Y\text{-}C > 0$ or $S\text{-}I > 0)$. And we know that for a closed system to maintain output levels, macroeconomic balance requires $0 = (S\text{-}I) + (T\text{-}G)$. So for the Article 104 conditions to hold, $S<I$ and the private sector becomes increasingly indebted. In a closed system, the public and private sectors cannot both be engaged in hedge financing at the same time. Figure 1 shows the Minskyan financial profiles for the private and government sectors.

Is there a way out of this paradox? The answer is in the external sector: then macroeconomic balance requires $0 = (S\text{-}I) + (T\text{-}G) - (X\text{-}M)$ and it is possible for the private and public

Figure 1

Private Sector	**Sovereign**
• 1 Hedge: S>I	• 1 Hedge: T>G
But macroeconomic balance requires 0 = (S-I) + (T-G):	
so if T>G then S<I and:	so if S>I then T<G and:
• 2 Speculative: some more debt or:	• 2 Speculative: some more debt or:
• 3 Ponzi: S<I more debt, sell assets	• 3 Ponzi: G>T more debt, asset sales

sectors to be in surplus *(S>*I and *T>G)* if and only if there is a current account surplus *(X>M)*. This means that Article 104 conditions can only be met if the EU has an external surplus sufficiently large to offset the savings of the government and the private sector, and that the euro can only survive if the EU has an external surplus. But this means that the financial fragility, deficit spending, and increasing indebtedness are shifted to the external sector; in this case, to the United States, which is actively trying to reduce its role as global debtor of last resort. Figure 2 summarizes these arguments.

The same ideas can be presented graphically by means of Robert Parenteau's 45-degree line diagram (see Parenteau 2010) to give a picture of the problem facing the euro area and Greece (Figure 3). The vertical axis shows the financial position of the combined private sector, with a saving surplus represented by a positive sign (above the horizontal line) and a deficit position of increasing debt a negative sign (below the horizontal line). The horizontal axis shows a current account surplus as a positive sign (to the right of the vertical line) and a deficit as a negative sign (to the left of the vertical line). The 45-degree line thus shows the combination of private sector and external sector positions compatible with government fiscal balance.

At the origin, both the private sector and the foreign sector are in balance, so the government is also in balance. At any point along the 45-degree line, the fiscal balance is positive, yielding a hedge position for the government. However, the private sector can only net save and have a hedge profile along with the government in quadrant Ia, in which the external surplus exceeds the private sector surplus. In quadrant Ib, the current account is not sufficiently large to offset private saving and the government is in deficit.

An increase in the fiscal surplus, as would be required by countries that are in excess of the SGP limits, is illustrated in Figure 4 by the shifting of the 45-degree line downward to the right. It also shows the area in quadrant IV compatible with a fiscal surplus, on condition that the external surplus is sufficiently large to offset a private sector deficit. This is what is required for countries such as Italy and Greece, which have very large debt ratios that will have to be reduced.

Figures 5 and 6 show the same exercise, now from the point of view of the private sector, with the 45-degree line showing *S=I* for the private sector. Thus, the shift in the 45-degree line showing an increasing private sector surplus (Figure 5) would represent the repayment of debt by the private sector.

Given the collapse of the banking sector, it is unlikely that the private sector will be able to finance deficit spending such that its viable positions lie in quadrants Ia, IV, and IIIa. Again,

Figure 2

- 1 Sovereign (Article 104) Hedge
  T–G > 0 → Private Sector
  S–I < 0 (more debt)
- 2 Private Sector Hedge
  S–I < 0 → Article 104 Fiscal Violation
  T–G < 0 (more debt)
- 3 Private and Government Hedge
  S–I > 0 and T–G > 0
  Lending to Foreigners → External Ponzi
  X–M > 0
  X–M = (S–I) + (T–G)
  Borrowing by Foreigners

Figure 3 Financial Balances: Government Balance

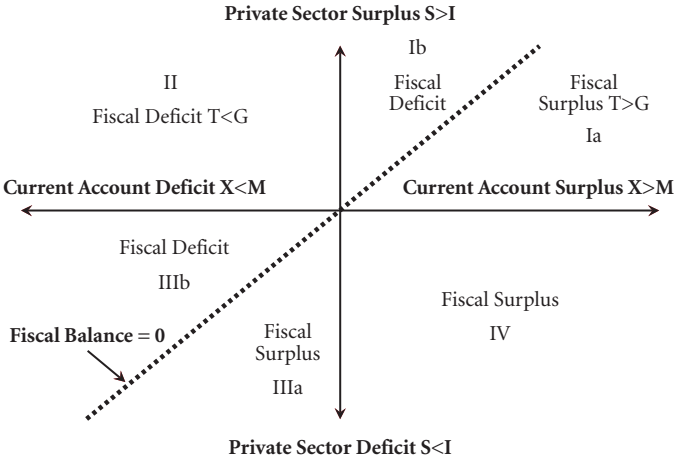


Figure 4 Financial Balances: Increase in Fiscal Surplus

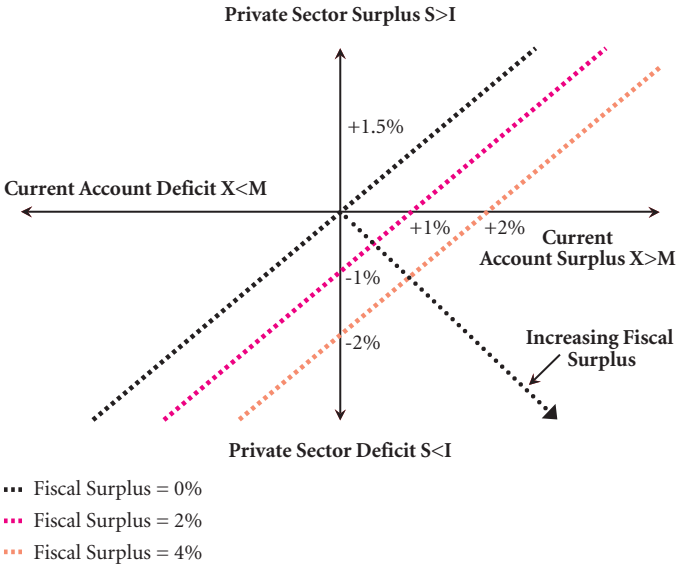


Figure 5 Financial Balances: Private Sector Balance

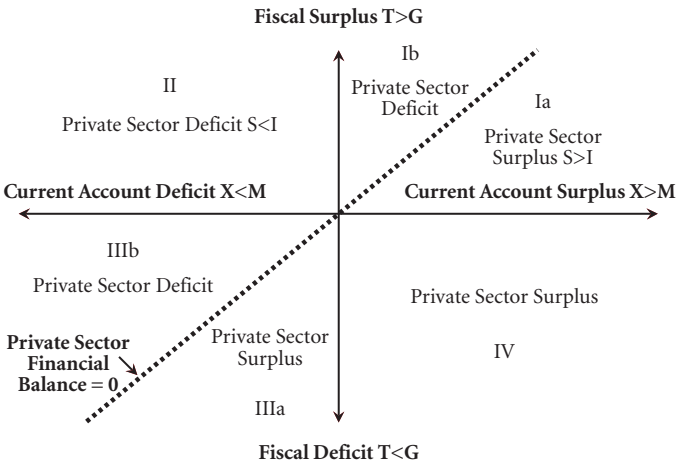
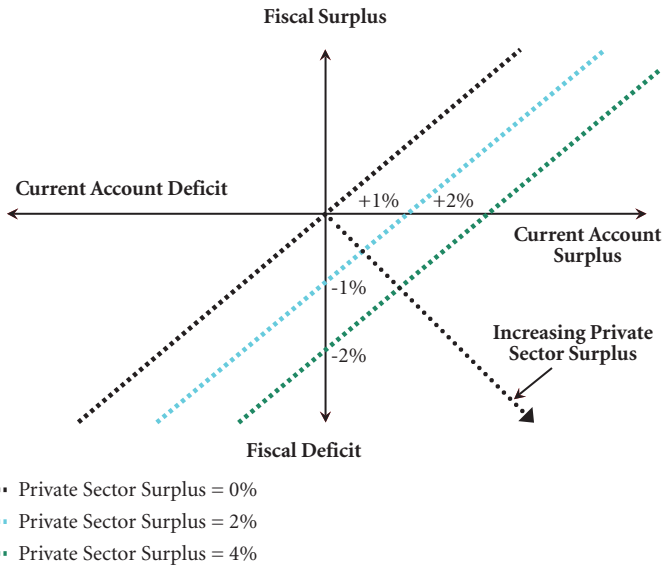


Figure 6 Financial Balances: Private Sector Delevers



if the government sector remains in a hedge financing mode, the only possible position is in quadrant Ia, with a current account surplus sufficient to offset the combined net saving of the government and the private sector. Of course, the crucial question is whether the external sector can be expanded by the amounts required to support equilibrium.

But is this solution financially stable? In the 1940s, the United States considered a policy of supporting domestic demand through a permanent current account surplus. Evsey Domar showed that a stable share of export surplus to GDP was feasible and stable on one condition: the rate of increase of the outstanding foreign lending was greater or equal to the interest rate charged on the loans. But this is the definition of a Ponzi scheme! And the reduction in efficiency wages and/or currency depreciation required to keep the surplus would dampen domestic demand, producing stagnation. The survival of the euro seems to require the permanent maintenance of a Ponzi scheme or stagflation.

This leaves external demand as the only solution to survival of the euro, given the German insistence on fiscal stability. But without the ability to improve external competitiveness through exchange rate adjustment, internal depreciation through wage reductions or productivity increases in advance of wage increases will be required. However, this is also a policy that reduces domestic demand, offsetting the benefits of higher foreign demand. And here is the paradox: all the policies proposed to increase growth of incomes and generate fiscal surpluses ultimately have a negative impact on income growth. Keynes called it the paradox of saving; here, it is the paradox of euro survival. Historically, deflations have produced financial crises just as easily as inflations. While Germany pleads for more political control and integration, the EU may disintegrate through political reaction to prolonged stagnation.

Note

1. This policy note is adapted from remarks presented at the Levy Institute conference "Europe at the Crossroads: A Union of Austerity or Growth Convergence?," Athens, Greece, November 22, 2014.

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