Rice University's Baker Institute

INTERNATIONAL ECONOMICS

THE EURO CRISIS MINEFIELD

MAPPING THE WAY OUT

March 2014

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Foreword

Rice University's Baker Institute for Public Policy celebrated its 20th anniversary in 2013, and as part of the series of events highlighting its programs and research, the International Economics Program held a conference on Oct. 14, 2013, on the economic policy challenges in Europe. "The Eurocrisis Minefield: Mapping the Way Out" convened senior policymakers, academics and practitioners in Houston for a public discussion of this globally relevant issue. The conference proceedings can be found on the Baker Institute's website at www.bakerinstitute.org/events/eurocrisis.

As part of the conference, the speakers wrote short policy papers detailing the issues facing the eurozone, identifying potential flashpoints and suggesting policy measures to alleviate sources of economic stress. The International Financing Review published most of these papers at the time of the conference, though a few were published elsewhere or not at all. This volume collects these papers — supplemented by material from the conference proceedings — into a single document to provide a written record of the excellent policy advice produced by the conference participants.

The Baker Institute's International Economics Program studies many key issues in global economic policy, as well as domestic macroeconomic and developmental policy in foreign countries. Between debt concerns in Europe threatening another global financial crisis and the ascendancy of emerging economies, best typified by China becoming the world's second-largest economy, the shape and dynamics of the global economy and its governance are undergoing significant shifts. Baker Institute researchers study the role of financial imbalances in recent and potential crises, with the intent of proposing alternative mechanisms for correcting these imbalances and reducing the tight financial coupling of global markets that leads to contagion and systemic risk.

Acknowledgment

The organizers of the conference would like to thank the Will Clayton Foundation for their generous support of the Baker Institute's International Economics Program and this conference in particular.

Executive Summary and Policy Recommendations

by Russell A. Green

Overview

The contributors to this volume, in their chapters or in the conference proceedings, identified a number of serious challenges facing Europe. Some are widely discussed, but others do not receive the attention they merit. What follows is a condensed list of the primary concerns.

Government Debt

Government debt levels in peripheral Europe (generally thought of as Greece, Ireland, Italy, Portugal and Spain) are not only high, but also unsustainable. At the conference, none of the participants indicated hope that Greece, Ireland or Portugal will attain the combination of real economic growth and inflation necessary to service these debts.

Corporate Debt

Europe's companies are dangerously leveraged, and debt levels are also highest in the periphery countries' economies. Financing conditions are much tighter in the periphery, especially for the small and medium enterprise (SME) segment that relies exclusively on bank loans. High borrowing costs exacerbate the debt distress and provide stiff headwinds to economic growth.

Weak Banking Sector

An unhealthy share of European bank capital is tied up in unrecognized losses on bad assets. This prevents the capital from being repurposed for more productive uses, harming banks and legitimate potential borrowers. However, recognizing these losses may destabilize banks in the absence of a credible source of recapitalization. Neither banks nor the governments of periphery countries can mobilize the resources to recapitalize on their own.

Structural Impediments to Growth

A number of structural components in periphery economies impede economic growth. Labor markets are excessively protected from new entry, whether potential workers are residents of the same country or come from other EU members. Too much of the economy is dominated by state-owned firms. The public administration that has been charged with reducing red tape lacks the capacity or incentive to implement changes.

Low Inflation
Inflation would help periphery countries recover from their debt burden and regain competitiveness. Monetary policy — especially Mario Draghi, president of the European Central Bank (ECB), promising to do "whatever it takes" to maintain the euro — has proven effective at holding off financial market concerns for the time being. A higher inflation target, on the other hand, remains off the table. Avoidance of upward pressure on prices was an explicit goal in designing its measures to address financial markets. As effective as they were, the ECB's actions merely represent a postponement of the pressure to address unsustainable debt. True solutions lie elsewhere.

Design Flaws in the Currency Zone
The crisis has revealed major concerns that economic theory had always suggested in the fundamental structure of the eurozone. Similar to the historical experience of countries that followed the gold standard, eurozone members linked their monetary policy through their locked exchange rates (1-to-1 for euro members). This facilitated cross-border capital flows that generated imbalances, but effectively eliminated monetary policy as a tool for targeting particularly weak economies.

Like the interwar gold standard period in Europe, crisis-stricken countries have struggled to respond with limited domestic fiscal resources. In theory, workers can relocate to healthier parts of the eurozone, helping to rebalance their economies. In practice, Europeans move much less than Americans. The ECB cannot be as successful as the U.S. Federal Reserve because its single monetary tool must be applied to a much wider range of economic needs.

Weak Institutions
While most individual members of the eurozone have well-developed institutions for developing robust policy responses to economic challenges, the eurozone as a whole does not. Few of its institutions have been in existence for even a quarter century, and many are being created on the fly in response to the crisis. This relatively untested machinery must negotiate with its fully sovereign individual members, making compromises all the more impressive when they occur.

Policy Inertia
In the first chapter, Robert Zoellick, former president of the World Bank, notes the urgency with which most American observers view the eurocrisis. To Americans, the eurocrisis highlights the inadequacies of the design of eurozone institutions and indicates the clear need for strong policy response. This interpretation does not correspond with the measured pace of action in European capitals.

The difference between American and European interpretations plays out in this volume in the contrast between the confidence of the European contributor, Andrea Montanino of the International Monetary Fund, and the alarm of the American contributors. Europeans count on a combination of their deep pockets and political commitment to

European integration to see them through any imperfection in the eurozone design or any hiccups in the recovery process. The American contributors indicate that this complacency has slowed or weakened the measures taken to address the crisis, which may result in a much longer recovery.

Political Fragmentation
The final — and perhaps most troublesome — challenge is to hold back the upsurge in anti-integration sentiment while working to address the other challenges. Time is not on Europe's side, because opposition to integration and difficult reforms are experiencing a frightening upsurge across the continent. The past structural reforms that helped the U.K. and Germany build much stronger economies took nearly a decade to show their full benefits. It does not appear that political support in peripheral Europe for this type of reform will last that long. Similarly difficult and unpopular economic transitions in Europe during the Great Depression caused major political shifts and facilitated the rise of extremism.

Policy Recommendations

This volume provides a number of clear-eyed suggestions for European policymakers, and a few for U.S. policymakers as well.

Fiscal Policy

1. **A fiscal union is the missing piece of the eurozone arrangement that economists have been suggesting for decades.** Burden-sharing mechanisms — like the role the federal government plays among states in the U.S. — could help small groups of countries recover when their economies lag. Centralized approval of budgets would prevent economies from developing dangerous imbalances.
2. **Beyond the forward-looking theoretical fiscal union, Europe needs a practical debt reduction plan in the near term.** Countries in crisis need a collective, comprehensive approach to debt write-offs, ignoring the short-term harm to financial markets.
3. **A big, upfront austerity program to make major debt reduction progress is the only proven way to regain growth.** Growth would be a more ideal solution to the periphery's government debt problems, but high-enough growth is hopeless given their institutions and demography. As with Argentina in the 1890s or any number of other countries at the mercy of external creditors, swallowing the bitter pill leads to a faster return to health. Big austerity programs should be packaged with privatization and other structural reforms. Ireland managed to do it in the 1980s through great political skill and luck.
4. **Countries across Europe — not just in the periphery — need to rationalize their bloated welfare states.** Adverse demographics and low-growth trajectories make entitlement reform necessary to avoid repeat episodes of the current crisis.

5. **Germany needs to stimulate its internal demand and help reduce its current account surplus.** This would help generate growth and inflation in peripheral economies and allow the euro to weaken. This advice for Germany dates back at least to the 1960s, so any expectations that this point will be heeded should be low.

Corporate Deleveraging

6. **Corporate deleveraging will allow redeployment of capital to better uses and return to growth.** This point requires action from the private sector, where heavily indebted firms must endeavor to sell assets, reduce operating expenses and capital expenditure, and reduce debt. Periphery governments should support this process by allowing greater consolidation in the corporate sector. Consolidation will force the closure of "zombie companies" that have poor prospects but too much debt for creditors to allow them to fail.
7. **As long as the periphery has higher interest rates, firms from countries with lower interest rates can drive restructuring, but governments must take a friendly approach to cross-border acquisition.** Acquisitions by firms outside the EU would require explicit changes in policy, but would improve their competitiveness in the long run.

Banking Revitalization

8. **Banks must write down their bad debts.** If they keep rolling it over, capital is being deployed merely to preserve a façade of health. New lending requires them to recognize losses, raise new capital and begin making new loans to viable, promising companies. Spain especially needs to fix its bank balance sheets.
9. **Stress tests can move banks in the direction of recognizing losses, so they can recapitalize and return to active lending.** The ECB must be very careful to thread the needle between tests that are too harsh — which would damage confidence in the banking system by indicating too large a hole in their balance sheets — and tests that are too lax — which would not provide enough pressure for banks to clean up their balance sheets.
10. **A deposit guarantee scheme would equalize the banking environment, helping reduce the disparity in borrowing rates in the periphery.** Governments could initially back the scheme with a line of credit from the EU, because in the near term banks don't have enough capital to fund a scheme from their own resources. But questions may remain about whether a line of credit would satisfy markets. The Federal Deposit Insurance Corporation (FDIC) breached its line of credit from the U.S. Treasury on a couple of occasions. Hence a deposit guarantee scheme provides the greatest degree of depositor and market reassurance if designed to have a "full faith and credit" backing from a sovereign entity, as the FDIC does in practice.
11. **A banking union provides the necessary sovereign backing for EU banks by providing joint backing of each bank, regardless of the strength of their home jurisdiction's finances.** By removing the requirement that governments rescue

failing banks solely from their own resources, a banking union could also break the vicious cycle of downgrades that occurs between sovereigns and their banks in a widespread banking crisis.

Structural Reform

12. **Greater labor market flexibility will help countries adjust to shocks within the eurozone.** Wages will then adjust more rapidly, so countries do not get stuck in uncompetitive quagmires. This needs to include removing protections for professional classes. Labor mobility compensates for the inability to adjust monetary policy at the country level in response to shocks. The European labor markets should look more like the U.S., which shares a common currency with much less difficulty.
13. **Much of Europe — again, not just the periphery — needs to improve the business climate.** A concerted effort must be made to cut red tape to allow business to operate. Italy stands out as a country particularly in need of a business-friendly regulatory overhaul.
14. **The eurozone requires thorough policy reviews to remove barriers to cross-border competition within the currency area.** France stands out here as needing to reconsider its overall approach to inward foreign direct investment (FDI).
15. **Public administration must be reformed in the periphery**. This is an essential piece to improving the business climate. It is also critical to implementing the terms of the bailout packages, which often require complex restructuring of government activities.

Monetary Policy

16. **The ECB must defend against deflation, which makes the debt burden grow relative to incomes.** In fact, setting a higher overall inflation target might help peripheral countries get back to positive inflation. The inflation differential with core countries would remain, so competitiveness in the periphery would continue to improve. Germany in particular needs to accept a higher inflation rate to give the ECB political space to act more aggressively.
17. **Monetary stimulus is also needed as a counterbalance against fiscal austerity to preserve growth**.

Managing Political Support

18. **Europe's leadership must carefully manage the timetable for implementing reforms.** Structural reforms take time to take effect and can even undermine growth in the short run. Immediate needs exist now for economic growth and safety nets to underpin basic necessities.
19. **Maintenance of political stability and cohesion will require skilled political work.** Loss of political support can severely disrupt reform efforts. Leaders need to capitalize on the broad support for the overall Europe Project to finesse public acceptance of greater economic integration measures.

Upcoming European Parliament elections will be a key gauge of the difficulty of the political challenges.

20. **Core European countries may need to permit additional financing to flow to the periphery in the near term to bring some of the benefits forward.** If the crisis-stricken countries can sustain their reform efforts, the payoff will be substantial. Support from countries with healthier economies can provide a degree of consumption smoothing that bolsters public patience with the reform process. Moral hazard must be keenly managed, however, since the economic suffering motivates the difficult reforms.
21. **U.S. support is necessary to bolster forward momentum and decisive action, and to diminish reliance on a muddle-through strategy.** The U.S. can play an important role in building the case for a more robust European economic policy framework and a clear-eyed approach to bad bank debts in particular.

Trade Reform

22. **The Trans-Atlantic Trade and Investment Partnership (TTIP) can give the economy a near-term boost by improving cross-Atlantic trade.** This benefits the U.S. economy equally, and helps foster a political relationship between the two regions that some believed was losing relevance.

Greece Rescue

23. **Some discussion at the conference favored removing Greece from the eurozone to prevent an intractable problem country from creating more problems in the future.** Leaving the eurozone would give Greece the ability to both devalue its (new) currency and take much more aggressive action in writing down its debts. The only remaining private sector holders of Greek debt are holdouts from the previous deal, so knock-on impacts on the European banking sector should be minimal. The preponderance of the impact of more aggressive debt write-downs would fall on official creditors, which may create high incentives for the rest of the eurozone to resist a Greek departure.
24. **Others felt that there is absolute political commitment across Europe to do whatever it takes to keep all members in the eurozone.** Greece only represents 2-3 percent of European GDP, so mustering the resources to address Greek needs will not unduly burden European resources. In this case, Europe will need to mobilize resources to cover Greek support after the IMF programs phase out, because IMF programs are not designed for such long-term sustainability challenges.

Understanding the Eurozone

Remarks delivered at "Eurocrisis Minefield: Mapping the Way Out," a conference held at Rice University's Baker Institute on Oct. 14, 2014

by Robert B. Zoellick

I appreciate this invitation to join you for this conference on the eurozone. As most of you probably know, I had the great fortune — and privilege — of working for Secretary Baker from 1985 through 1992, and then briefly again in late 2000, although his portrayal in the movie "Recount" was much, much better than mine!

I learned a tremendous amount from Secretary Baker, and indeed, the experience continues to offer me insights on issues, institutions and politics today. I also appreciate the opportunities he gave me and never want to miss the occasion to thank him for that.

Secretary Baker was a rarity as a leader and executive: He didn't seem to care where people were from or their background or even, to a degree, their ages. He just wanted to see what one could produce, get done, and whether you could work as a member of a highly effective team. We always had our eye on results.

He was a master, first, of achievement within the operation of the shared and separated powers of our Constitution, and then in the wider international arena.

Perhaps I'm highlighting these attributes today because it seems that Washington — both the executive and Congress — seems to have lost that touch. And, unfortunately, those limitations constrain the role and leadership that only America can still provide in the wider world.

Furthermore, the perspectives offered by Secretary Baker's career shed light on the topic you've asked me to address today: the challenges for the eurozone. Many Americans who analyze the euro drama are scrutinizing events purely through an economic lens. That is, of course, a valuable perspective.

But to truly understand today's challenges in the eurozone, one needs to appreciate the arts of political economy. Those are skills that Secretary Baker mastered with shrewdness and judgment.

Therefore, before focusing on the eurozone issues of 2013, I'd like briefly to review the politics and economics that led to the creation of the eurozone. This is the window through which European policymakers view today's problems.

Creation of the Eurozone

The founding fathers of modern Europe were trying to escape a past of conflict and disastrous wars on the continent. They foresaw a sequence of integration: starting with a customs union and common polices for industry and agriculture, leading to a Single Market, then an Economic and Monetary Union, and finally a Political Union.

A key weakness, it turned out, was that the EU created a monetary union, but not much of an economic one. The European idea has been to set the machinery of integration in motion and then, at the right moment, expect that the results will trigger political unification.

For those of you who have studied earlier European history, one can see the parallel with the unification of Germany in the 19th century: moving from a customs union to an internal market, then monetary, and eventually political union. For the Euroromantics, these ideas revived old dreams of Kantian culture, the poets and even the universal Catholic Church in Europe — before my ancestors and other signed up for that divisive Reformation!

The roots of today's eurozone can actually be traced all the way back to 1970, with the Werner Report. One key idea in that report was that deep European economic integration wasn't compatible with flexible exchange rates.

The U.S. dollar figured in this assessment, because while the dollar generally depreciated (it lost value) vis-a-vis the deutsche mark, the dollar tended to appreciate vis-a-vis weaker European currencies. In effect, the dollar was a wedge between European currencies, and the gyrations of European exchange rates — sometimes triggered by movement of the dollar — complicated trade within Europe.

The Werner Report stated that if Europe could eliminate its internal currency exchange rates, it would be easier for businesses and people to compare prices, trade and invest within Europe —and that the competition this created across a bigger European market would improve the member states' global efficiency. This report led to extensive conceptual debates about what might be the optimal European currency area.

There were early efforts to move toward coordinated currencies, such as the "Snake" in 1972 and the European Monetary System (the EMS) in 1979. The Europeans also advanced the broader economic integration process through institutional changes, such as the Single Market Act of 1985, which targeted the creation of an integrated internal market by 1992. Europeans introduced Qualified Majority Voting in some policy areas to make it easier to achieve decisions. The French and Germans exchanged ideas about next steps, leading to the release of a "Blueprint" in 1989 by European Commission president Jacques Delors.

Of course, these events were unfolding just as the Cold War was coming to an end in Europe, highlighted by the unification of Germany in 1990, a process in which President George H.W. Bush and Secretary Baker played leading and skillful roles. The end of the Cold War — the uniting of a Europe "whole and free," as President Bush celebrated it — lent momentum to the creation of the European Union through the Maastricht Treaty of 1992.

At the time, I recall thinking that monetary union was the price Chancellor Helmut Kohl and Germany paid for French support for German unification. But I've subsequently concluded that my suspicion was overstated: The record makes pretty clear that Germany, France and others had been long committed to the Economic and Monetary Union (EMU) project — guided by that "integrationist" logic. French President Mitterrand no doubt recognized, however, that Germany's unification made EMU ever more of an imperative.

Yet the Maastricht Treaty only endorsed part of Delors' blueprint. And this piecemeal result planted a dangerous seed of today's problem: The Union ended up much more monetary than economic.

More specifically, the introduction of the euro made it easier for weaker economies to carry heavier debt loads. Italy, for example, had debt that amounted to about 120 percent of GDP, and suddenly its interest rates fell from 10 percent to 5 percent: How would those savings be used? Spain and Portugal gained similar windfalls. Greece, moving from the rule of colonels to a revived democracy, was admitted to the eurozone as a gesture to buttress the country's political modernization.

As long as good times continued, the EU member states tacitly agreed not to look too closely into the debts, spending, banking systems and competitiveness of one another's economies — because no one wanted the scrutiny directed at them. The financial crisis of 2008 then sparked a series of events that uncovered the eurozone's weaknesses.

The point of this history is to emphasize that Europeans view the European crisis as a crisis of integration — not just a monetary or economic problem related to having a common currency. The integrationists' perspective explains some of the trans-Atlantic disconnect in debating the dangers to the eurozone.

The Political Economy of Europe's Response

When Americans point to market risks triggered by anxieties about sovereign debt — or debate the need for stimulus policies — the Europeans respond with plans for fiscal, budgetary, banking and political union. When Americans worry about a "Lehman moment" and an illiquidity shock that could lead to financial panic, Europeans are thinking about how a break in the eurozone could unwind the achievements of the internal market — or even the EU Customs Union. When Americans point to problems to solve, or at least manage, in real time, Europeans turn to a discussion of architecture and legal arrangements.

So, how does this political economy background affect the challenges of the eurozone today?

As a practical matter, the EU has had to deal with three interconnected problems:

1. Sovereign debts;
2. Banking systems, which are related to the sovereign debt because many banks are big holders of government bonds, so if the value of those bonds falls, banks will take a hit to their capital; and
3. Some countries face a challenge of competitiveness.

While handling these issues, European political leaders have had to struggle with the integrationist challenge: How can they design — and build support for — a more deeply integrated eurozone within the EU?

Because of the political and historical perspective I've shared with you, I've had a different view than many Americans: I've suspected that because of the personal and political commitment of European leaders, the most likely course is that Europeans will "muddle through." But I certainly recognize that there can be a disconnect between markets and the Europeans' integrationist logic.

In the summer of 2012, as interest rates spiked for Spain and Italy, I was concerned that the eurozone was reaching a crisis point. I stressed this danger at my last G-20 meeting as head of the World Bank, to the discomfort of some European leaders.

Not long thereafter, Mario Draghi, the very skilled head of the ECB, made a strong statement about "doing what it takes" to protect the eurozone, and he backed up his words with new programs. Chancellor Merkel of Germany supported Draghi even though Germany's Bundesbank was more skeptical. And eurozone markets settled down.

Yet Mr. Draghi had just bought time. Neither his words nor monetary policies alone can solve the fundamental economic problems. By the way, that's true in the U.S., too. As Draghi himself has said, the greatest risk for the eurozone now is complacency. Even if European political leaders are committed to the eurozone, they can miscalculate — or fail to keep up with events.

Three actions are necessary. First, Germany is half right: Europe needs fiscal and structural reforms. The old welfare state just isn't affordable given demographics and world competition. Labor markets need to be more flexible, so workers and businesses can adjust more readily to changed circumstances. Too much red tape and too many licenses and restrictions strangle entrepreneurs.

Second, however, there is a "duration mismatch" between the time reforms take to produce benefits and the timing of debt rollovers. Italy and Spain are the big debt tests for the eurozone; the others can be managed if Germany and others work do so.

Third, European banks still have to rebuild capital and confidence, in part to prepare for hard-to-predict shocks. The greater the progress on forging European-wide deposit insurance and banking union, the more protection there will be from possible breakdowns in individual countries. Earlier this year, Chancellor Merkel told a group of us that while she had been ready for Greece to leave the eurozone, she concluded that the eurozone's financial and banking system wasn't prepared for the shock.

While Europeans recognize these three challenges, reforms are always hard to implement, especially with little or no growth. So the biggest challenge for the eurozone now is the politics of reforms. Can Greece maintain political support for the necessary actions for years to come — or at some point will a populist leader of the left or right tell the rest of the eurozone that Greece's big debts are Europe's problem, not Greece's? Will Italy and Spain keep up structural reforms?

The good news is that Spain has been reducing employment costs and regaining competiveness, but unemployment remains very high, output is still far below potential, and asset prices are very depressed — the country has a long way to go.

The not-so-good news is that Italy is stuck: Debt levels are high and rising, unemployment remains about 12 percent, and political battles have stalled further reforms.

Keep a watchful eye on France. France is at the heart of the European project: Will it be part of the solution or add to the problem? The government has not shown readiness or will to address France's loss of competitiveness and increase in debt. France is approaching the point where debt service costs will rise faster than incomes, squeezing consumption and lowering growth.

Finally, can the German government maintain political support? It is striking that in the recent German election the two major Volkspartei — the broad-based, popular parties — stood for continued, but disciplined, support for the eurozone. And they gained votes.

Here's one reason why: This is Germany's 68th year of peace. That's the longest period without war since at least the Peace of Westphalia in 1648.

But the public mood in Germany — not the opinion leaders, but the average Bürger — is becoming more wary of "having its pocket picked." I suspect that the German public will continue to back its government's eurozone efforts — as long as the other countries are seen as following through on their responsibilities for reform. If other governments slip, so will the German public.

I'll share a wonderful insight provided to me by Mario Monti, the reformer who headed Italy's government all-too-briefly: Keep in mind, Monti told me, that in Germany, economics is a branch of moral philosophy. So economic policy in Germany is not a question of Keynes or Friedman or debates about sources of demand, but a matter of hard work, discipline, rectitude and paying one's bills.

Potential Flashpoints

Looking ahead, we can identity events that might trigger trouble — or actions — in the eurozone.

In 2014, Portugal will need another financing package. This problem can be handled, but if European officials seek "contributions" — in other words, debt relief — from bondholders, the risk could expand to other euro markets.

Greece's debt remains too heavy, and Greece's private creditors have already taken a big discount, so when Greece's program is reviewed, the Europeans and the IMF will need to decide whether official creditors will assume losses — or whether they bide time by lending more and building up more unsustainable debt.

And then in 2014, the ECB, as the new, overall regulator of EU banks, is supposed to conduct another round of stress tests. The earlier tests, conducted by national authorities, were not seen as serious, in large part because the sovereign debts held by the banks were accounted at full value. If the ECB discounts sovereign debts for purpose of the stress test, some banks are likely to have capital holes to fill. If the ECB finesses the values, markets will question the banks' staying power.

So the eurozone drama has not run its course.

Relevance to the U.S.

In closing, one might ask why these tribulations matter here in the United States.

A few months ago, I came across an interesting report that showed that short-term correlations of global markets to the eurocrisis, across most asset classes, had remained very high during 2012. Indeed, about 30 percent of the market action in 2012 had been driven by anxieties about the euro. More fundamentally, the EU remains a big part of the world economy, buying lots of U.S. goods, with many EU companies investing in the U.S., and many U.S. multinationals engaged in Europe.

At the strategic level, one of America's greatest foreign policy achievements in the 20th century was contributing to the creation of an integrated — and unified — democratic Europe as the United States' closest ally and natural partner. This was the idea behind the Marshall Plan.

Might that trans-Atlantic partnership be at risk — either through a dramatic breakdown, or more probably through a slow erosion of Europe's economic vitality, defense capabilities and public will to assume obligations outside a troubled EU?

A couple of years ago, I asked a very senior administration official whether the U.S. had ideas to support our European ally and partner, given the strategic history and interests. I didn't get much of an answer.

Today, we do have an initiative, pushed principally by Chancellor Merkel of Germany: the Trans-Atlantic Trade and Investment Partnership, or TTIP, a comprehensive FTA between the United States and the EU. I think Chancellor Merkel's strong interest in TTIP is driven both by her belief that trade liberalization can help achieve structural competiveness reforms in Europe, and by her interest in a stronger economic foundation for 21st-century trans-Atlantic ties.

The tariff barriers with the EU are relatively low, so TTIP's real challenge will be to remove other limits on trade, investment and doing business — whether standards, regulations or special procedures. We also have some serious differences in agriculture, which is important to political support in the Congress. These are not easy topics.

It is encouraging that the president has announced his commitment to TTIP. Given that Republicans tend to be strong supporters of trade, this negotiation could offer a rare bipartisan opportunity to get something big done. I can't quite tell whether the administration will translate its rhetoric on TTIP — and the TPP trade negotiations in the Asia-Pacific — into the willpower to close and pass deals in Congress. But I know we have a national interest in encouraging and supporting the administration if it acts.

That approach would certainly accord with Secretary Baker's experience in government — an approach that I hope the Baker Institute here at Rice can continue to foster: having a keen eye for the national interest; recognizing the connections between economics and security; sensing when to seize the initiative; understanding how to negotiate with a perspective on policy and politics; and always pushing for results, for getting things done.

That's a pretty good formula for America.

The Honorable Robert B. Zoellick is a senior fellow at the Belfer Center for Science and International Affairs at Harvard University's Kennedy School of Government and a distinguished visiting fellow at the Peterson Institute for International Economics. Zoellick was the president of the World Bank Group from 2007 to 2012. He served in President George W. Bush's cabinet as U.S. trade representative from 2001 to 2005 and as deputy secretary of state from 2005 to 2006. From 1985 to 1993, Zoellick worked at the Treasury and State Departments in various capacities, as well as briefly in the White House as deputy chief of staff. In 2006 and 2007, he served as international vice chairman of Goldman Sachs Group. Zoellick holds a bachelor's degree from Swarthmore College, a master's in public policy from Harvard's Kennedy School of Government and a J.D. from Harvard Law School.

Eurozone Institutional Framework, Crisis Causes and Policy Options

by Andrea Montanino, Davide Assalve and Marco Senatore

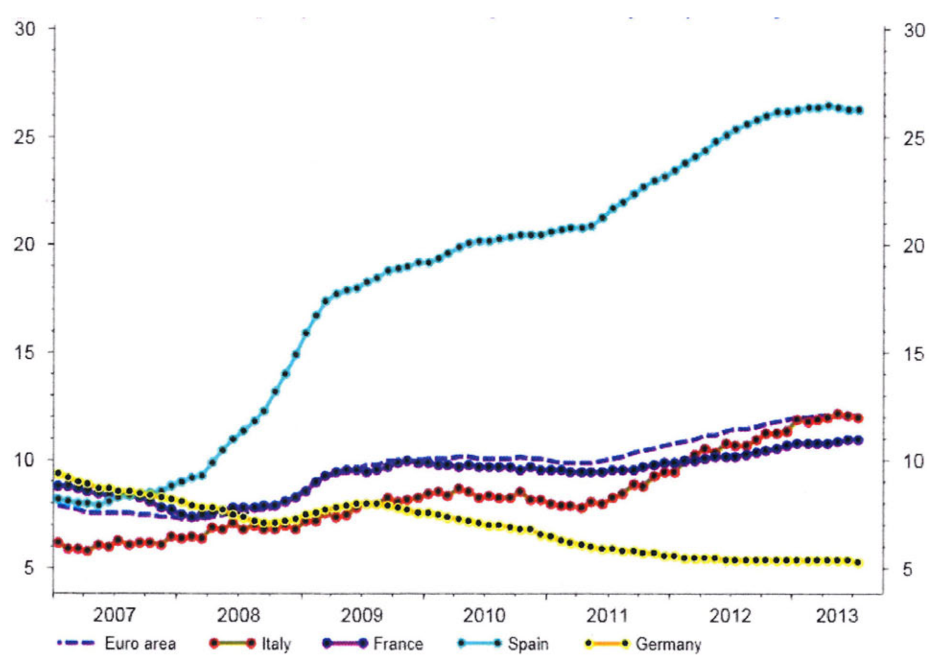
Over the last five years, a self-fuelling vicious cycle linked weak growth, difficulties in the banking sector and the high level of public debt. Yet the eurozone retains many economic strengths, facilitating a multifaceted response from its robust institutional framework. The eurozone stands resolved to go the distance, no matter the length, to see itself through the crisis.

Why the Eurozone Is Lacking Growth

The lack of confidence following the subprime crisis and the Lehman Brothers failure generated a sharp recession in Europe. Despite the soundness of the eurozone banking system, non-performing loans grew, resulting in higher perceived bank risk.

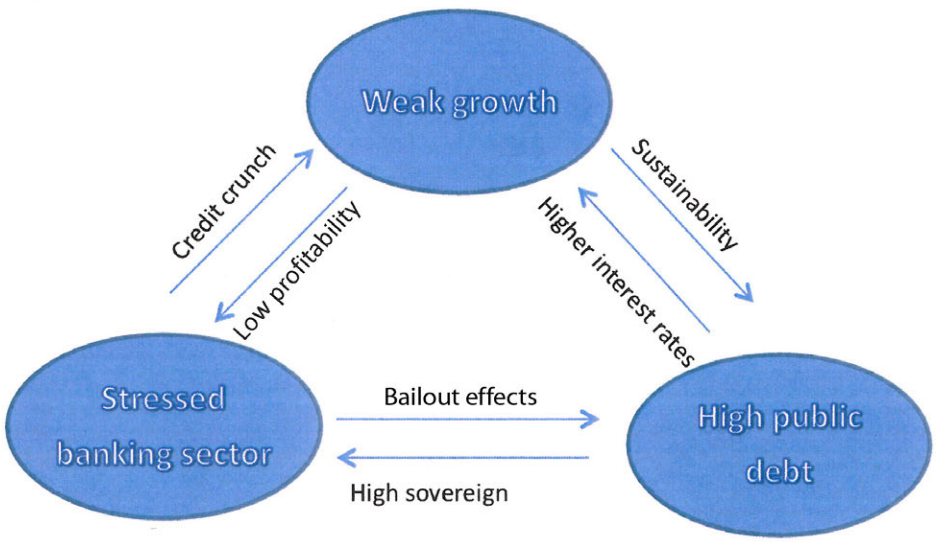
The real economy downturn undermined the profitability of the financial sector, mainly focused on traditional lending activity to the nonfinancial sector. The ensuing credit restriction particularly impacted small and medium enterprises, causing a significant rise in unemployment. (See Figure 3.1.)

Figure 3.1 — Unemployment Rates (seasonally adjusted)



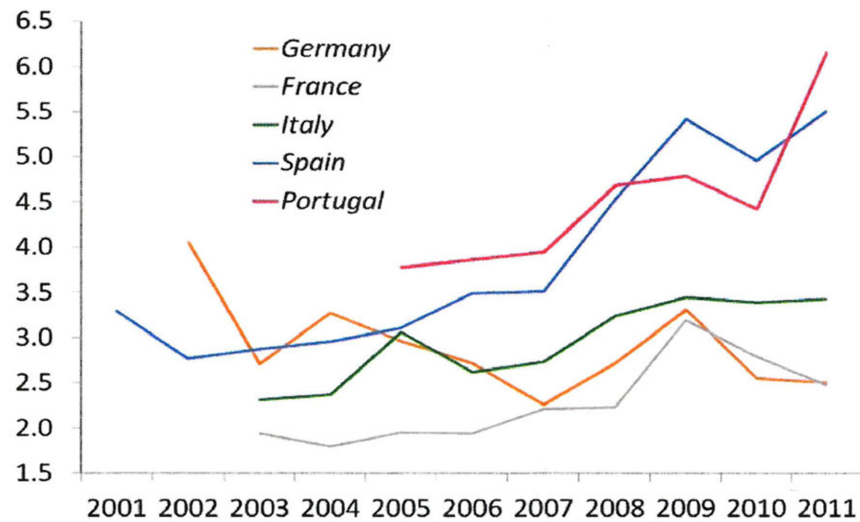
Therefore, Europe entered a vicious cycle where the poor growth performance affected the banking system through corporate sector weaknesses. (See Figure 3.2.) The lower confidence in Europe's ability to recovery pushed sovereign debt rates up, in particular in countries where the level of public debt was already high, exacerbating banking stress.

Figure 3.2 — Vicious Cycle of the Eurozone Crisis



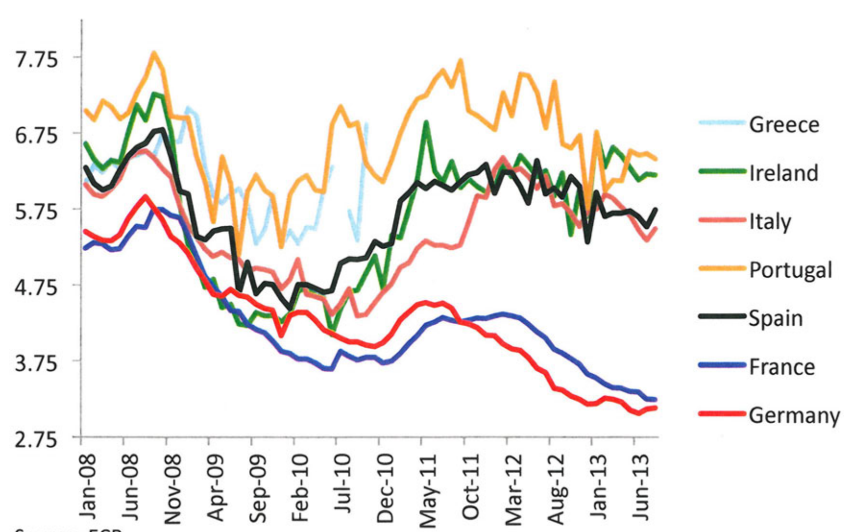
Causes of weakness in growth are to be found not only in stressed banks' balance sheets, but also in low credit demand, heightened uncertainty about eurozone prospects and policies, long-standing structural weaknesses in labor and product markets, financial market fragmentation, and intra-euro imbalances. As for low demand, the European corporate sector was already highly indebted well before the "Great Recession" kicked in (see Figure 3.3), and such a structural condition of European firms limited the demand for credit, particularly medium- to long-term credit. However, uncertainty over the future clearly contributes to limiting investment, with many firms facing the risk of being pushed out of the market.

Figure 3.3 — Corporate Sector Leverage Ratios (debt-to-EBITDA)



The Great Recession also intervened in a context where markets were not always efficient, making the recovery more difficult at this juncture despite painful structural reforms undertaken to promote recovery. Because of financial market fragmentation, which impairs the transmission of monetary policy, the divergence between policy rates and lending rates is still visible. Indeed, the spread in lending rates across Europe is excessively high, and does not appear to be justified by the different economic fundamentals of firms or national economies. (See Figure 3.4.)

Figure 3.4 — SME Borrowing Costs (rates on loans under €1m)



Source: ECB

Elements of Strength and Main Policy Responses

Against this backdrop, it is essential to recall at least four elements of strength that can be found in the eurozone. First of all, the level of household and, in general, private debt is relatively low, while net wealth is high (Italy is a clear example). This helped in managing those economies where public debt or corporate debt was high. Secondly, central banks in the eurozone have long experience in supervision activities, and European institutions were well equipped to intervene promptly in the most acute cases.

Third, while the role of emerging economies in the international economy became much stronger, major European economies (such as Germany and Italy) maintained a strong position as world leaders in manufacturing, sustaining growth through exports. Fourth, a strong pro-Europe sentiment helped in supporting initiatives across countries.

Given such elements of strength, it was possible to undertake effective initiatives via fiscal policy, monetary policy, and structural and institutional reforms aimed at responding to the crisis. (See Table 3.1.)

Table 3.1 — European Policy Response

Fiscal Policy	Monetary Policy	Structural and Institutional Reforms
Financial assistance to the banking sector	Rate cuts	Basel III
Fiscal consolidation	ECB asset expansion	Temporary and permanent assistance mechanisms (e.g., ESM)
	Unconventional (LTRO and OMT)	Fiscal compact
		Banking union

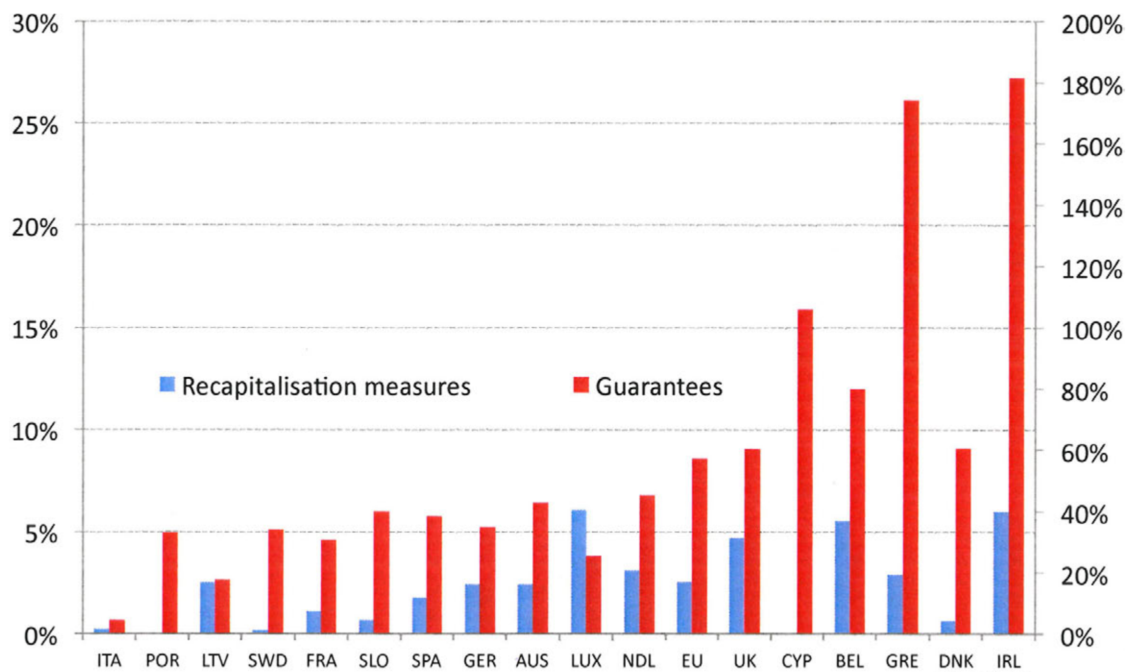
Fiscal policy interventions mainly consisted of fiscal consolidation (Table 3.2) and financing assistance to stressed countries and banking institutions (Figure 3.5).

Table 3.2 — Fiscal Consolidation

	Overall Balance (percent GDP)		Primary Balance (percent GDP)		Structural Balance (percent potential GDP)	
	2010	**2013**	2010	**2013**	2010	**2013**
GER	−4.1	**−0.4**	−2.0	**1.5**	−2.2	**−0.5**
IT	−4.3	**−3.2**	0.0	**2.0**	−3.6	**0.6**
FR	−7.1	**−4.0**	−4.8	**−2.0**	−5.7	**−2.0**
ES	−9.7	**−6.7**	−8.3	**−3.7**	−8.1	**−3.1**
GR	−10.8	**−4.1**	−4.9	**0.0**	−12.3	**0.6**

Source: IMF, World Economic Outlook Database, October 2013

Figure 3.5 — State Aid to Financial Institutions (percent of GDP)

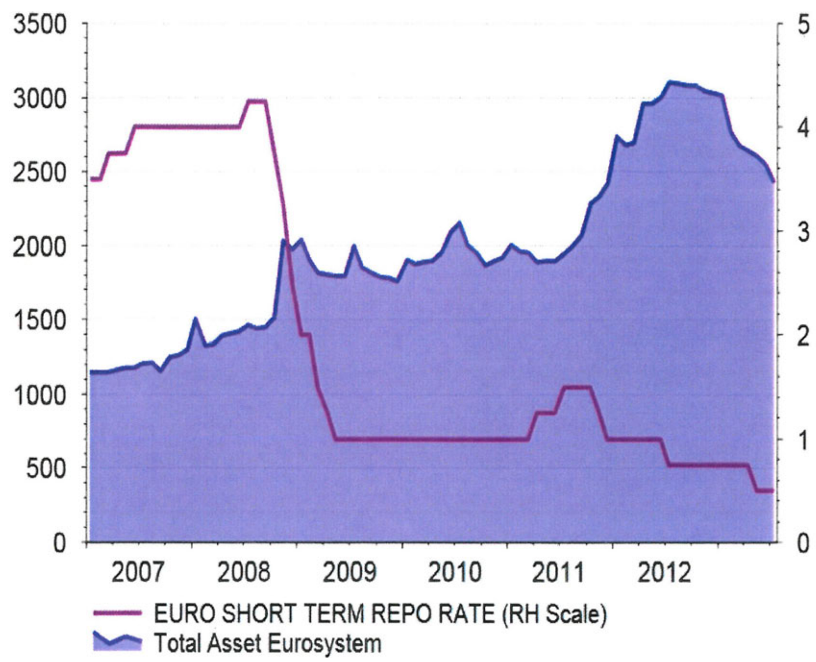


Source: Eurostat

EU partners provided financial assistance in the eurozone to Greece, Ireland, Spain, Portugal and Cyprus. Recapitalization of the banking sector was relevant in countries such as Belgium, the Netherlands, Germany and all program countries. In December 2013 the IMF program for Ireland expired, signaling a decrease in risk regarding perceived credit outstanding to this country.

Interventions by the ECB were both conventional (rate cuts) and unconventional (Long-Term Refinancing Operations, Outright Monetary Transactions). Long-Term Refinancing Operations aimed at providing liquidity to the banks, and Outright Monetary Transactions — i.e., purchases in secondary markets of bonds issued by eurozone member states — addressed the impairments to the transmission mechanism of monetary policy. (See Figure 3.6.) Such tools contributed significantly to restoring confidence even if they were not fully sufficient to eliminate financial fragmentation.

Figure 3.6 — ECB Intervention (€, millions)



European partners established instruments such as the ESM (European Stability Mechanism), aimed at providing financial assistance to stressed countries, and the Single Supervisory Mechanism (SSM), the first element of a banking union. While the supervisory model of the SSM has largely been developed, the ECB will undertake a comprehensive assessment of the credit institutions, through an asset quality review and a stress test, which will be performed in close cooperation with the EBA (European Banking Authority). With the Fiscal Compact, they strengthened fiscal discipline and increased coordination.

Policy Recommendations

According to the IMF's view, the following mutually reinforcing initiatives remain essential in the eurozone to ensure stronger and durable growth:

1. Repairing bank balance sheets, in order to restore confidence and revive credit growth. A forthcoming comprehensive, forward-looking assessment of banks' asset quality by the ECB will quantify any capital shortfall.

2. Making further progress on the banking union, as an essential element to prevent ring-fencing, sever bank-sovereign links and reverse fragmentation.
3. Providing sufficient near-term support to growth, with possible additional unconventional monetary support and a paced fiscal adjustment to avoid an excessive drag on growth.
4. Making progress in structural reforms, removing barriers to protected professions, promoting cross-border competition, and raising productivity and incomes.

Overall, despite the severe recession, the euro and the EU institutions proved to be a solid anchor for those countries with more difficulties. The road to stable and sustainable growth is still long, but Europe is ready to tread. Indeed, the latest available data suggest that at the current juncture the eurozone is going from recession to recovery, as growth is projected to reach 1 percent in 2014 and 1.4 percent in 2015. At the same time, the recovery will not be homogeneous, as the pickup is likely to be weaker in stressed economies.

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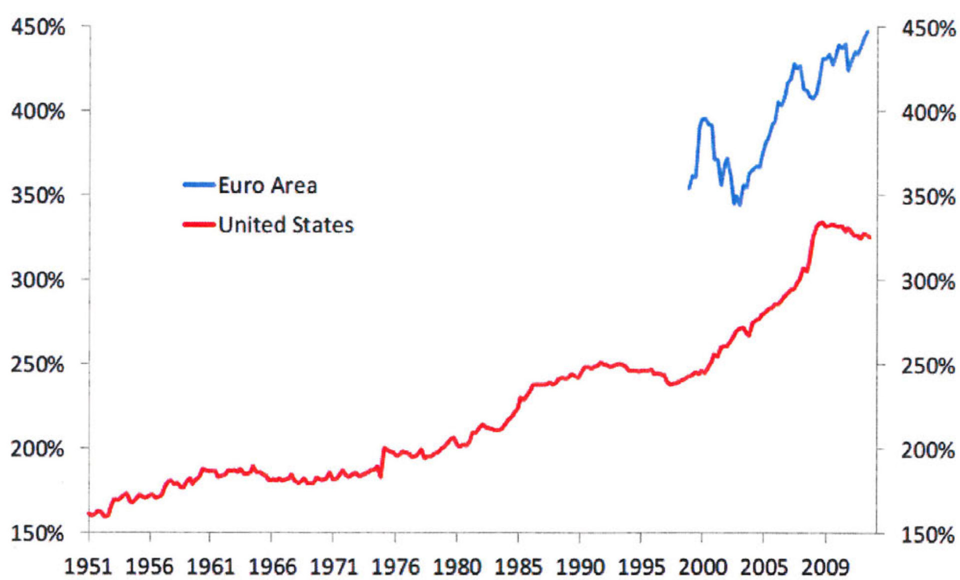
Euriabetes

by Marvin Barth

After two years of acute infection, the European Monetary Union (EMU) appears to be reviving and is hopeful of being discharged from the hospital. But in the background lurks a slow, chronic killer. Like diabetes, Europe's debt problems linger as a long-term ailment that is no less dangerous than the intense sovereign debt runs of the last two years. Recent signs of improvement and associated optimism are welcome, but cannot lessen the vigilance needed to treat the longer-term chronic problems.

Europe has two interwoven infirmities: too much debt and the continuing lack of a credible resolution mechanism. These two problems are linked by both economics and politics. The former will continue to noticeably slow growth, depressing incomes, for the foreseeable future. Slower growth, in turn, will fuel political instability that will make more difficult the fulfillment of a credible resolution mechanism. Without action on the latter, the likelihood of an eventual return to acute infection is high.

Figure 4.1 — Total Nonfinancial Debt/GDP

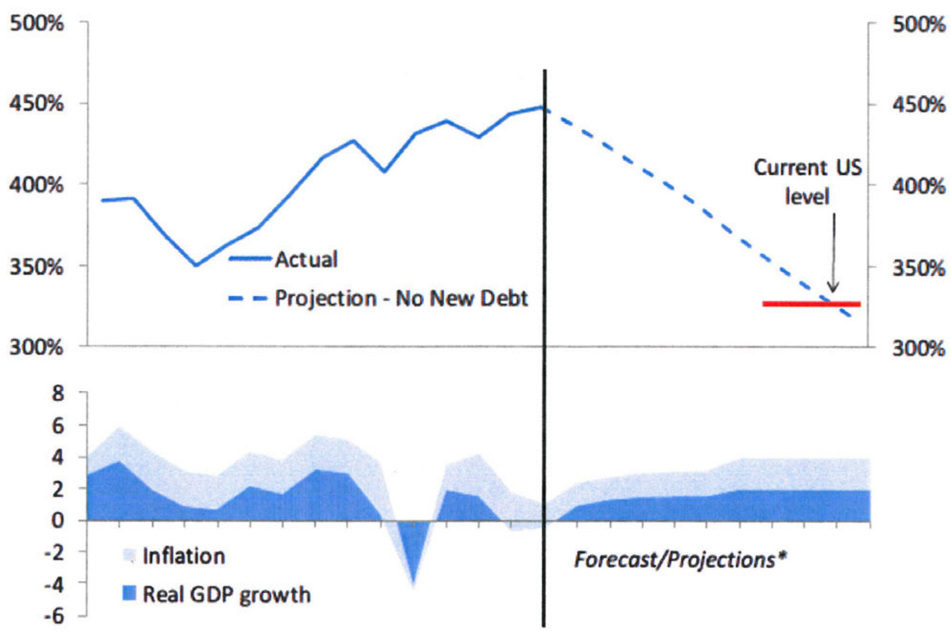


*Caveat: there are some domestic netting issues here, but this also excludes net financial sector liabilities to foreigners.
Source: Thompson Reuters

Europe's debt problem is foreboding. The collective nonfinancial debt of EMU members is 448 percent of GDP. (See Figure 4.1.) Whether public or private, all these debts are ultimately claims on the future income of EMU residents. Assuming — conservatively — that the weighted average interest rate on this debt is 2.5 percent, the annual cost of servicing this burden would be roughly 11 percent of EMU GDP. (There are some internal netting issues here, but this back-of-the-envelope analysis also neglects foreign claims on the financial sector that would add to EMU's total debt burden.) As this is significantly greater than Europe's nominal growth capacity, Europe's debt load will remain a long-term drag on EMU residents' incomes for years to come.

As an illustration, assume that the euro-area economy grows at the roughly 3 percent nominal rate the IMF forecasts through 2018 and grows at 2 percent with 2 percent inflation in the ensuing five years. Further, assume that EMU debt stays constant in nominal terms over the decade to 2023. EMU's debt to GDP would fall to just 320 percent, only just below the current U.S. level of 326 percent, and leaving the eurozone still vulnerable to crisis. To facilitate this modest deleveraging, disposable income of euro area residents would grow by little more than 1 percent per year.

Figure 4.2 — Euro Area Nonfinancial Debt/GDP



And considering the recent experience of the United States, this may be overly optimistic. In the five years since the U.S. economy bottomed in June 2009, U.S. nonfinancial debt to GDP declined just 9 percentage points from a peak of 335 percent. This was achieved largely through debt write-downs and below-trend — but still faster than projected European — annual economic growth averaging 2.2 percent real and 3.8 percent nominal. Even this overstates the experience of most Americans. Real median family incomes declined 1.2 percent per year over the period.

As a result, without an aggressive plan to deleverage, Europe's debt will remain a lingering drag on its residents' income growth for years to come and will leave no room for error. And for reasons of political economy, errors indeed are likely. Stagnant growth is already taking a toll on European political stability, and that is likely to worsen the longer it endures. If median European family incomes evolve like those in the United States, this likely will push the median voter away from the current political elite that is wholly wedded to the euro and increased political union. The Median Voter Theorem suggests this will invite mounting challenges to the existing political order from parties courting the median voter. This is already apparent in the electoral strength of new anti-euro parties like Golden Dawn in Greece, the Five Star Movement in Italy and most recently the Alternative for Germany.

But political cohesion is exactly what is needed to solve Europe's second malady: the continued lack of a resolution mechanism for intra-union fiscal and banking claims. Despite the delay afforded by the European Central Bank's (ECB) aggressive actions to support periphery debt and banks, in the long run EMU has only two sustainable paths: integration through a fiscal union or dissolution. Without a mechanism to "socialize" debts across sovereign borders, EMU is not long-term stable. At a minimum, a banking union, with a credible resolution authority and backed by the full faith and credit of all EMU members, is needed to sever the link between troubled sovereigns and banks.

Aggressive use of such resolution authority can accelerate debt consolidation and economic growth. By writing down bad debts of banks and consolidating nonfinancial debt in the process, Europe's debt burden will be reduced; "zombie" companies will no longer suck capital from more viable firms that can raise economic growth; and a perceived increase in economic solvency should lead to reduced credit spreads, lowering interest burdens.

However, despite "agreeing" to a banking union with supervisory and resolution authority vested in the ECB, Europe's political leaders appear to be backtracking. Germany and its northern EU allies — who expect to be the guarantors of the system — have walked back prior commitments to common fiscal support and to the ECB's resolution authority. Furthermore, the Cyprus crisis earlier this year set two haunting precedents. First, it made clear that Germany will not contribute another "pfennig" to bailouts and will instead insist on "bail-ins." While this could be constructive under other circumstances, without a credible resolution mechanism, this is likely to encourage capital flight at the first sign of trouble in a periphery country. Second, Cyprus' initial flirtation with bailing-in depositors is unlikely to be forgotten if a periphery bank runs into future trouble.

European policymakers may come to rue their backtracking and delay. The "cold" or chronic crisis can turn "hot" or acute in an instant. Europe's continuing debt problems and lack of resolution mechanism ensure that potential.

Curing the European disease is a multistep process. The first two steps are obvious. First, European policymakers need to follow through on their commitment to full banking union, and the sooner the better. Second, the ECB will need to use its resolution authority to decisively clean the banking sector, restore system confidence, deleverage through write-downs, and improve the allocation of capital to viable firms.

But the third step is less obvious and more controversial. Looking at the long game, it is clear that Europe's current "Keynesian" pseudo-austerity can only succeed with an unlikely sequence of near-perfect luck. Rather, a radical course of spending-based fiscal deleveraging is needed. Extensive research by Alberto Alesina, Silvia Ardagna and Francesco Giavazzi suggests that highly leveraged economies that pursue aggressive spending restraint simultaneously deleverage and return to trend growth more rapidly than economies that "ease" into the process. Unfortunately, their research also reveals that few countries take this path willingly; external creditors usually enforce it.

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The Goldilocks ECB and Muddling Through

by Megan Greene

Slow and Sluggish 2014

As the eurozone finally emerged from recession this year and Ireland even managed to exit its bailout program without any official sector help, many analysts and investors triumphantly declared the financial and economic crisis in Europe over. The days of wild sovereign bond market fluctuations and regular emergency EU summits to put out the latest fires in the common currency area seem to be behind us, but that just means the crisis has shifted from critical to chronic. Policymakers who will do just barely enough in the face of financial, economic, political and social headwinds in 2014 will ensure that the eurozone will muddle through yet another year with low growth and economic pain.

Stress Tests Must Be Just Right

The single most important exercise in Europe in 2014 will without a doubt be the joint Asset Quality Review (AQR) and stress test run by the European Central Bank. Before assuming its role as the supervisor of Europe's biggest and systemically important banks, the ECB wants to first gauge how healthy those banks' balance sheets are. With the help of national supervisors and external consultants (as well as the European Banking Authority, EBA), it will therefore collect and process reams of data from Europe's biggest banks and insist that they are sufficiently well-capitalized not only now but to survive an adverse scenario in the future as well.

The ECB will have to play Goldilocks with the AQR and stress test and get it just right. If it is too stringent with its requirements, sizeable capital holes in some European banks will emerge. There is no fund to fill in such holes, and consequently investors will have to pay to fill them via bail-ins or the national governments will have to pay via bailouts. More importantly, the extremely fragile economic recovery the eurozone experienced in 2013 will be choked off as investors accept big losses or taxpayers buckle under the burden of bailouts.

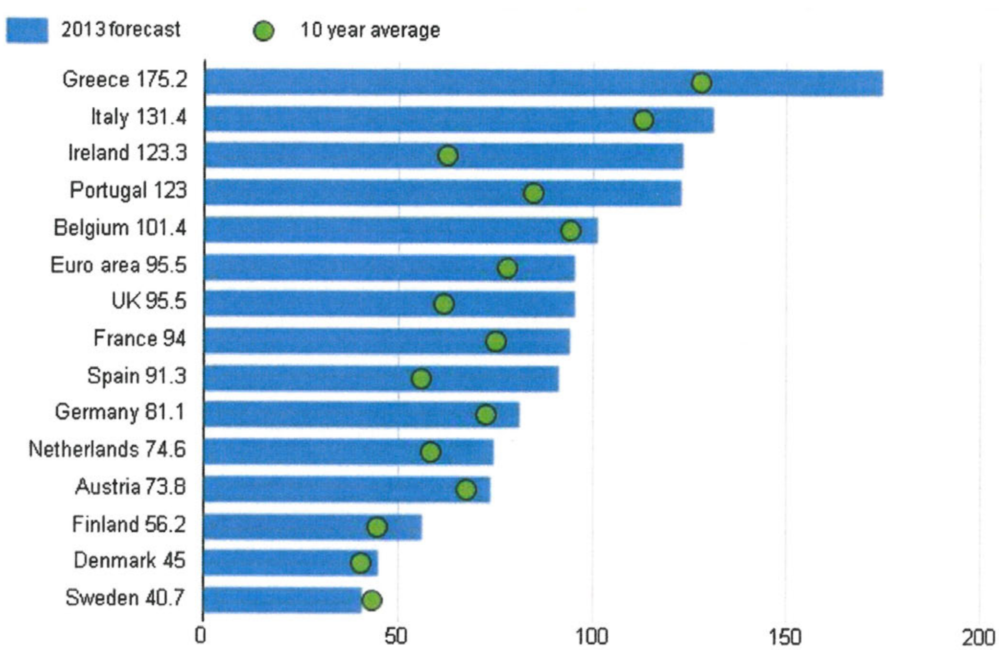
If the ECB is too loose with its requirements, however, the asset quality review and stress tests could severely damage the central bank's credibility — just as was the case with the EBA in the previous two European bank stress tests. Furthermore, banks will not be forced to write down or sell off their nonperforming loans (NPLs). With NPLs sitting on their balance sheets, banks will not lend, and the economic recovery in Europe will continue to be creditless and therefore weak. Financial fragmentation will persist in the eurozone, with small- and medium-sized enterprises continuing to face much higher borrowing costs in the periphery than in the core. The ECB is under significant pressure by national central banks to be lenient in the stress tests. If it cannot gauge them just right, it will probably err on the side of being too lax.

Disinflation Poses a Threat

The difficulty of getting the AQR and stress test just right will probably mean sluggish economic growth across Europe at best. Add to this disinflation in the eurozone, and the public debt burden in the weaker countries will grow even more unsustainable. In November 2013, inflation decelerated to 0.9 percent for the eurozone on average. This masked huge differences between the periphery and the core, however. In Greece, consumer prices fell by 2.9 percent compared with a year earlier. In Spain and Ireland, prices only rose by 0.3 percent. Arguably, this is exactly what policymakers were trying to achieve with wage and pension cuts and labor and product market liberalization; stuck in a common currency and unable to undergo a currency devaluation, these weaker countries have tried to engineer an internal devaluation.

As inflation decelerates and in some countries deflation kicks in, the peripheral countries in the eurozone will face higher borrowing real interest rates and will have more difficulty servicing their debt. This is a particular problem in countries such as Greece, Italy, Ireland and Portugal, which already have staggering debt-to-GDP ratios above 120 percent of GDP. (See Figure 5.1.)

Figure 5.1 — European Debt-to-GDP Ratios (gross government debt, percent of GDP)



Source: Thomson Reuters Datastream, European Commission.

The ECB is concerned about disinflation in Europe, and will be prompted to step in and act in 2014. In addition to further interest rate cuts, the ECB will probably offer additional liquidity operations and could introduce extraordinary measures such as negative deposit rates and possibly quantitative easing.

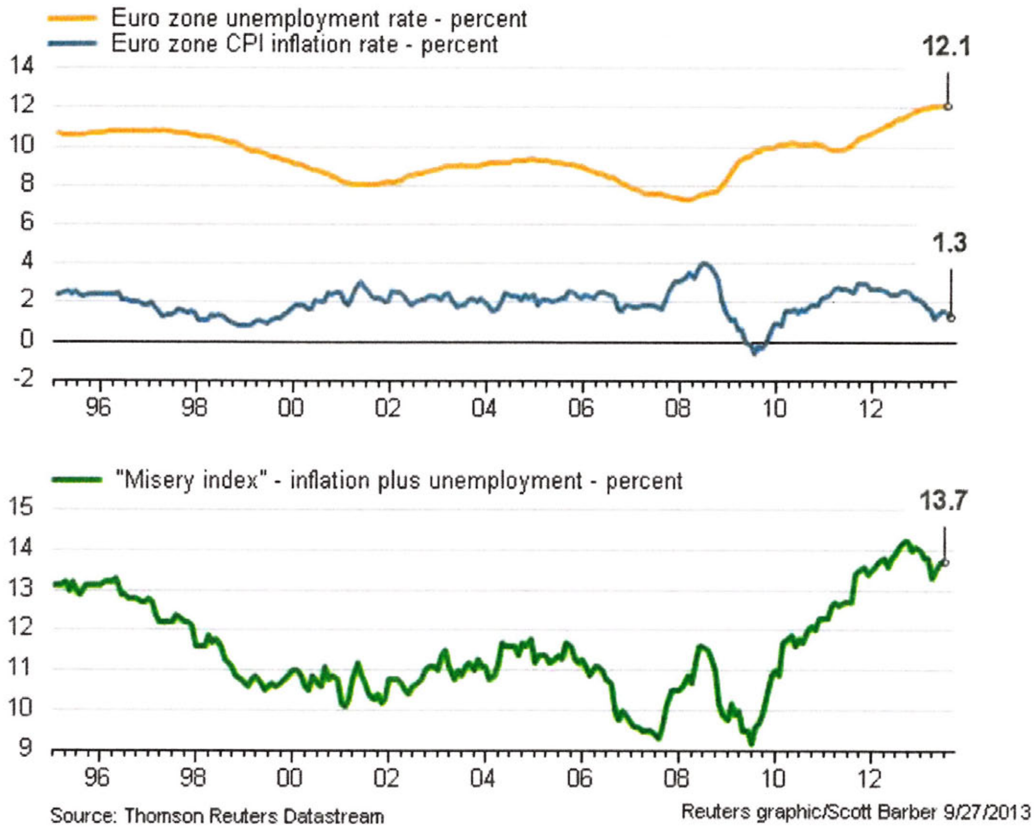
European Parliament Elections Could Crystallize Unrest

The ECB will continue to be the main player in terms of policy in the eurozone in 2014, but there are significant national political and social risks in the region that could cause investors to panic. These may crystallize around the European Parliament elections in May 2014, in which far right- and left-wing populist parties are expected to do very well. According to recent opinion polls, the Greek far-left opposition party Syriza would come in first if national elections were held today, and the extreme right party Golden Dawn would come in third despite a number of its members of parliament being arrested over the summer. In France, the far-right National Front has recently topped opinion polls as well. Italy's Five Star Movement has lost momentum since the last national parliamentary elections, but the anti-austerity "pitchfork movement" has gained some steam and is a concern to senior government members there.

Populist parties will continue to gain support across the eurozone as long as unemployment remains stubbornly high. Unemployment averaged 12.1 percent in the eurozone in October 2013, with particularly high rates in Greece (27.3 percent in August 2013) and Spain (26.7 percent). (See Figure 5.2.) Youth unemployment was even higher at 24.4 percent for the eurozone (54.8 percent in Greece in September 2013 and 57.4 percent in Spain in October 2013). Unemployment has shown signs of stabilizing and even slowly falling in some countries such as Ireland, but they have a long way to go. It is difficult to see significant job creation any time soon in the absence of robust economic growth in Europe.

Europe looks set to plod along in 2014 with lackluster growth, which is a slight improvement on 2013. But hold off on breaking out the champagne. With sluggish growth, disinflation, and simmering social and political pressures, governments will find it more difficult to stabilize their debt just as austerity and reform fatigue hits an all-time high. This cannot last. While the day of reckoning and debt restructurings will probably not come in 2014, it is still on the horizon for Europe.

Figure 5.2 — Eurozone Unemployment and Inflation



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One-Size-Fits-All Monetary Policy

by Mark A. Wynne

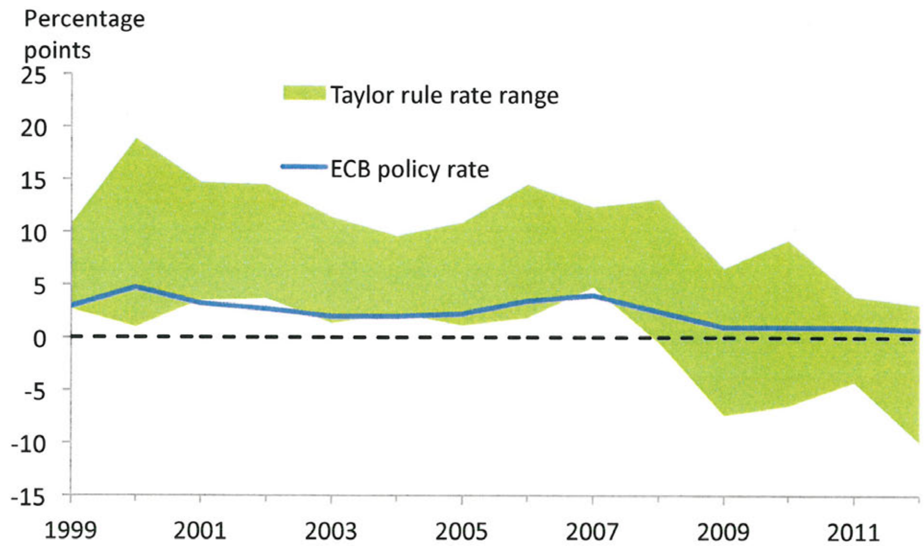
The eruption of the eurozone sovereign debt crises some years ago was seen by many as vindication of skeptics who said that a monetary union between such a disparate group of countries was doomed to fail because the group did not constitute what economists call an optimum currency area. Thus, it was argued, the one-size-fits-all monetary policy that goes with participation in a monetary union would create strains that would ultimately prove unsustainable.

In the eyes of the skeptics, each country would be better off setting its own interest rates at levels appropriate for local economic conditions. Such a contention raises the question: How far apart were the interest rates the European Central Bank set for the eurozone as a whole from those that would have been more appropriate for individual member states given their local economic conditions?

To answer such a question, we need to know what interest rate the various national central banks that make up the euro system would have set had they retained control over monetary policy. While we can never know for sure, given the counterfactual nature of the exercise, we can get some clues from one widely used rule that has been prescribed as a guide for making monetary policy. The so-called Taylor rule says that the appropriate policy rate depends on a country's economic output relative to its potential (the "output gap") and the deviation of inflation from the central bank's inflation goal (assumed to be 2 percent a year). The Taylor rule prescribes higher interest rates when inflation is above target and output is above trend — and lower interest rates when output is below trend and inflation is below target.

In research with my colleague Janet Koech we used the Taylor rule to calculate policy rates for each of the 11 original members of European Economic and Monetary Union, plus Greece (which joined the EMU in 2001), based on country-specific output gaps and inflation rates. We found that the Taylor rule prescribed much higher interest rates for some countries than were set by the ECB, and much lower rates for others. (See Figure 6.1.) In fact, the range of prescribed rates averaged 10.6 percentage points from 1999 to 2011. We also found that the level of interest rates set by the ECB tended to be toward the lower end of the range prescribed by country-specific economic conditions.

Figure 6.1 — Eurozone Taylor Rule Rate Range

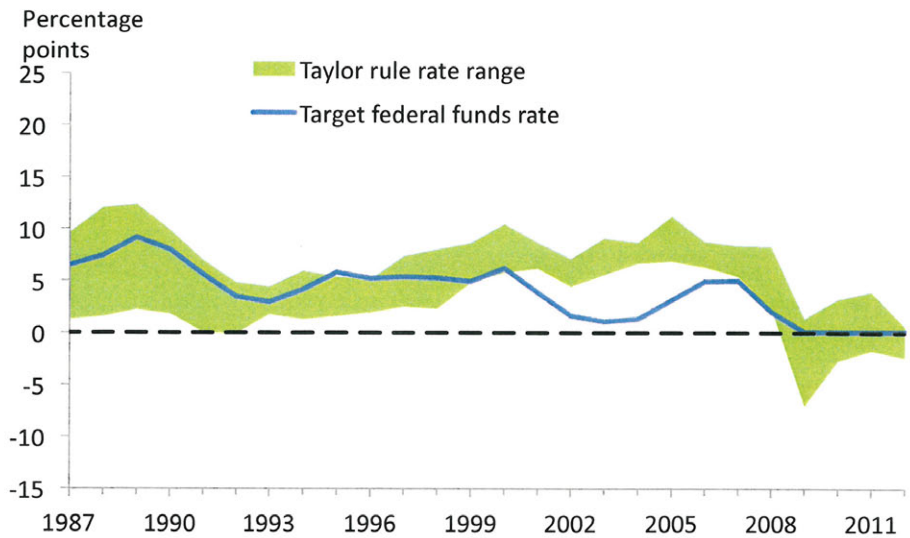


The currency union's weaknesses were exposed in the aftermath of the global financial crisis, when the gap between ECB and prescribed country-specific Taylor rates widened. Economic conditions in several peripheral euro-area countries deteriorated significantly following the financial turmoil of late 2008. In Ireland and Spain, housing market bubbles burst, pressuring those countries' banking systems. In Greece, a sovereign debt crisis erupted as past excesses came to light. At the same time, economies in the core euro region rebounded from the global financial crisis, creating large economic disparities within the region and making it harder for one policy to address the economic needs of all countries. In 2011, the Taylor rule policy rate prescriptions ranged from -7.3 percent (obviously infeasible, given the zero lower bound on nominal interest rates) to 3.8 percent.

The range of prescribed interest rates seems rather large and suggests that there may be something to the story that the one-size-fits-all monetary policy contributed to the crisis. But to get a better sense of whether the interest rate range is large, we then went on to ask what would happen if each state in the United States also had control over its own monetary policy. That is, what if instead of living with the interest rate set by the Federal Open Market Committee, Texas got to pick the interest rate most appropriate for its economic conditions, California picked the interest rate most appropriate for its conditions, and so on for all 50 states

We found that the Taylor rule prescribes a narrower range of interest rates across the U.S. states than across the countries in the eurozone. (See Figure 6.2.) The average range of prescribed rates for the sample period is about half that indicated for the eurozone — 5.2 percentage points versus 10.6 percentage points. Interestingly, according to our estimates, the actual level of the federal funds rate was not appropriate for any of the major regions in the U.S. in 1995 and 1996. The deviation was even greater from 2001 to 2006. Similarly, the ECB rate for the eurozone was outside the range prescribed by country-specific conditions in the eurozone in 2002, 2004 and 2007.

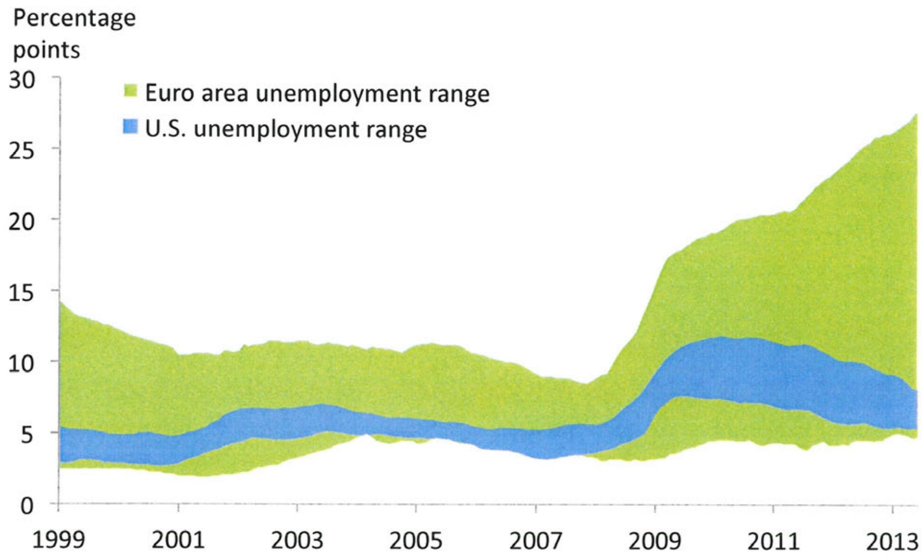
Figure 6.2 — U.S. BEA Regions Taylor Rule Rate Range



It is not surprising that the range of prescribed interest rates tailored to local (state) conditions is greater within the eurozone than within the U.S., suggesting that a one-size-fits-all monetary policy does not work well for the euro region. The U.S. is a lot closer to being a genuine single market than the eurozone, the argument goes, and goods, services and factors of production are quickly reallocated across the U.S. in response to variations in local conditions. A booming Texas will attract workers from a slumping Michigan, for example, damping wage and price pressures in Texas while putting a floor under wage and price declines in Michigan.

Within the eurozone, cultural, language and structural barriers impede labor movements, creating huge disparities caused by diverging economies. The difference became especially pronounced during the 2008-2009 global financial crisis and the sovereign debt crises. In August 2013, unemployment rates in the eurozone varied from 4.9 percent in Austria to 27.9 percent in Greece. In the United States for that same month, unemployment ranged from a low of 3.0 percent in North Dakota to a high of 9.5 percent in Nevada. The average divergence of unemployment rates in the eurozone is about three times the average size of the U.S. regions' unemployment rate gap. (See Figure 6.3.) The smaller divergence in the U.S. is due to its relatively larger factor mobility — in particular, the freer movement of labor.

Figure 6.3 — Variation in Unemployment Rates



There are signs that labor mobility within the eurozone has increased over the years, moving it closer to satisfying the conditions of being an optimal currency area. There are fewer obstacles to mobility than was the case in the past, and governments are less inclined to bail out failing industries or regions. Yet the scale of the movement remains small relative to the magnitude of the problems confronting the crisis countries. And ironically, increased labor mobility is the last thing some of the hardest hit countries need now, as it will have the effect of increasing the future tax burden on those who do not move.

Mark Wynne, Ph.D., is vice president, associate director of research, and director of the Globalization and Monetary Policy Institute at the Federal Reserve Bank of Dallas. In the latter role, he is responsible for developing and leading the bank's research program on globalization and understanding its implications for U.S. monetary policy. Since joining the Federal Reserve Bank of Dallas in 1989, he has had a variety of responsibilities, including briefing the bank's president on national and international economic conditions prior to meetings of the Federal Open Market Committee, providing updates on key economic issues to the board of directors, and conducting research on the effects of fiscal policy, business cycles, inflation measurement and monetary unions. Wynne also spent time at the European Monetary Institute and European Central Bank (ECB) during the formative years of the European Economic and Monetary Union (EMU), where he worked on issues related to the strategy of monetary policy under EMU. He has also been an occasional consultant to the ECB and International Monetary Fund. Wynne has taught at both the undergraduate and graduate level at University College Dublin, the University of Rochester and Southern Methodist University, and he has also served as a faculty member for the American Bankers Association Stonier Graduate School of Banking. His research has appeared in many leading peer-reviewed academic journals and Federal Reserve publications. He earned his bachelor's and master's degrees from University College Dublin, and also holds a master's and doctorate in economics from the University of Rochester.

Looming Corporate Sector Debt in Peripheral Europe

By George P. Tsetsekos

Corporate sector finances in Europe have not gotten the same attention as sovereign or bank balance sheets have as the eurocrisis has evolved. Yet addressing debt levels among eurozone corporates represents another hurdle the eurozone must cross before returning to economic health. The hurdles are disproportionately higher in peripheral Europe, making their recovery challenges even greater.

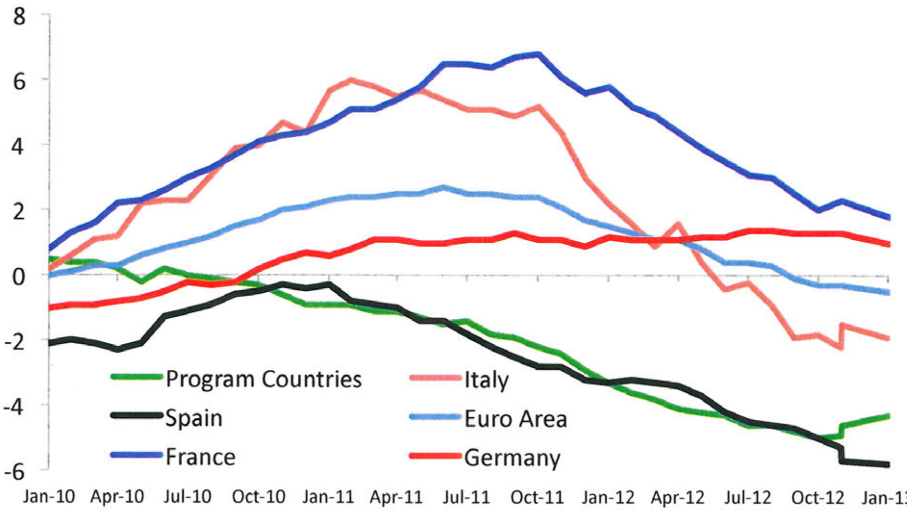
Global and eurozone financial and market conditions have improved in the last six months through policy commitments, renewed monetary stimulus and continuous ECB liquidity support. Future improvements in the eurozone will require both balance sheet repairs in the financial sector and smooth reduction of private and corporate debt overhangs. Overall, a sustainable recovery will depend on credit conditions and the prospects of fast — but not disruptive — deleveraging of the corporate sector.

Besides the divide between core and periphery countries, recognizing the divide between large firms and small and medium enterprises (SMEs) is equally important for understanding the problem of corporate debt in Europe. Periphery countries face steeper challenges along both lines.

Large firms in the eurozone area have access to global financial markets or global intermediaries. In contrast, SMEs depend heavily on traditional bank financing, a sector that has been has been strongly impacted by the crisis. Small firms create more than 85 percent of the net new jobs in the eurozone, but since the beginning of the crisis, small firms have lost jobs faster than large firms. This is an acute problem in peripheral countries where low domestic demand and the continued emigration of well-educated people has worsened recovery prospects in national economies.

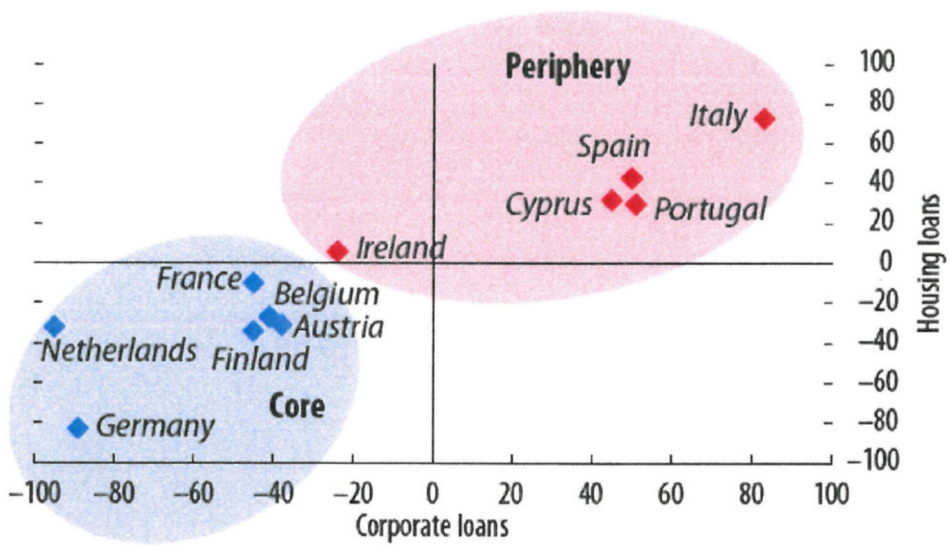
The supply of credit by banks and financial institutions has declined in the past three years, with bank lending in the nonfinancial sector declining at 4-6 percent per year (excluding Germany). Naturally, credit supply is tighter and interest rates for corporate loans are higher in the periphery, reflecting increased costs of funding for banks confronted with nonperforming loans (NPLs). (See Figure 7.1 and Figure 7.2, taken from the IMF's April 2013 Global Financial Stability Report.)

Figure 7.1 — Bank Lending to the Corporate Sector 2010–2013 (in percent, year-over-year)



Note: Program countries are Greece, Ireland, and Portugal. Chart adjusted for securitizations.
Source: Haver Analytics, IMF staff estimates

Figure 7.2 — Changes in Interest Rates for New Bank Loans, Dec. 2010–Jan. 2013 (basis points)



Sources: Haver Analytics and IMF staff estimates

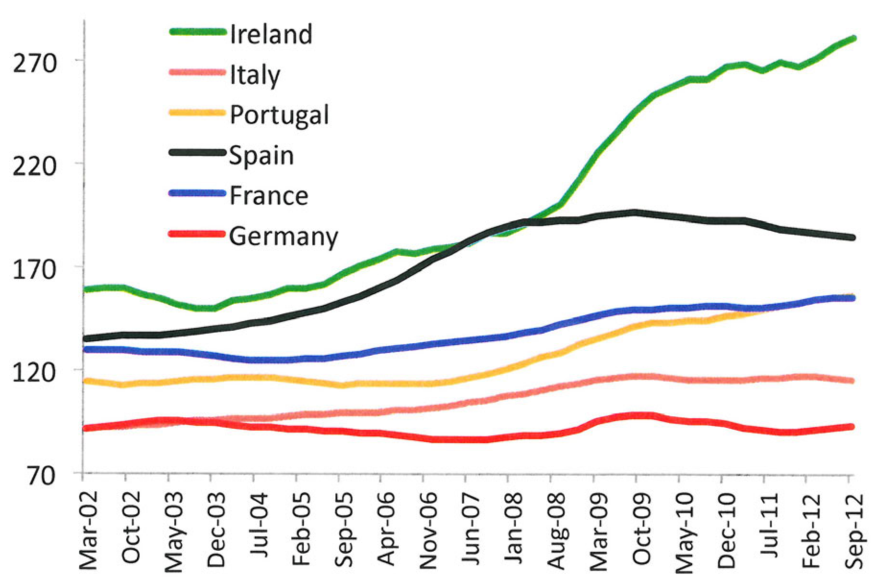
The higher costs of funding and restricted supply of credit hinder the recovery, especially for the periphery's SMEs. SMEs in peripheral countries are even more important than in the average EU country in terms of employment and value added to national economies (see Table 7.1).

Table 7.1 — The Contribution of SMEs in Different Regions of Europe

	Share of Employment	Share of Value Added
Core Area	64%	59%
Periphery	74%	73%

In addition, excessive corporate leverage — a result of past borrowing to accommodate growth — and reduced economic activity pose challenges for the corporate sector. Corporate debt levels now have doubled since 2003 and are higher in the periphery than in the core economies. Corporate debt as a share of GDP has reached excessive levels, and again this is especially true in periphery countries. (See Figure 7.3, again taken from the IMF's April 2013 Global Financial Stability Report.)

Figure 7.3 — Corporate Debt (percent of GDP, four-quarter moving average)



In the current economic environment, two parameters influence the health of the corporate sector in the eurozone. First, corporate debt sustainability, that is, the capacity of firms to generate free cash flow to keep debt at the same levels despite declines in revenues and at the same time maintain capacity to make appropriate investment decisions. Second, the ability to service debt, as reflected in the interest coverage ratio, or how many times interest payments are covered by corporate earnings.

Only 8 percent of the companies in core eurozone countries are considered at risk (interest coverage ratios less than 1). In contrast, more than 40 percent of the companies in periphery eurozone countries are at risk of default. In addition, more than 20 percent of the firms in periphery eurozone countries experience high leverage and low interest coverage ratio; approximately 40 percent of the firms maintain high leverage and negative cash flow. Certainly, these statistics present a negative picture for employment prospects and economic recovery.

Debt sustainability scenarios point to the need for corporate deleveraging in the eurozone to avoid bankruptcies. This needs to come from three mechanisms: sale of assets to higher-value users, cuts in operating and capital expenditures, and drastic debt reductions. Studies show that during the coming three years, on average, the corporate sector in eurozone countries should reduce capital expenditures by 10 percent and debt levels by 8 percent.

While the EU is an open, free market with mobility of capital and products, companies in the periphery now face higher financing expenses than equivalent core country-based firms as a result of country-specific debt premiums. Large credit spreads between core and periphery countries have therefore created asymmetries in financing structures for corporations operating within the eurozone. Working capital is more expensive due to limited bank lending. As a result, companies in the periphery that cannot access directly international capital markets have limited ability to reduce funding costs.

Differential financing opportunities place SMEs in periphery countries at an even larger disadvantage compared to core-based firms and thus harm their competitiveness. Already a large number of SMEs are exhibiting signs of financial distress.

In the short term, consolidation of the corporate sector in periphery countries may create local subsidiaries of large core country-based companies, which will have the ability to finance periphery country subsidiaries with inexpensive funds from core country financial institutions. This consolidation may generate conditions for economic concentration in several industries, market power and lack of competitiveness within the union. If non-eurozone companies participate in the consolidation process, the inefficiencies in the market place will shrink as assets and processes will be transferred to higher-value users.

The sovereign debt crisis in the eurozone has created pressures in the banking sector, followed by an evolving and escalating crisis in the corporate sector for periphery country firms. Efforts to contain the crisis have yielded to bank recapitalizations in periphery countries and structural reforms. However, uncertainty remains ahead as corporate debt sustainability and high leverage are still unresolved issues for periphery country firms.

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The European Crisis in the Context of Historical Trilemmas

By Michael Bordo and Harold James

The dramatic economic and social turmoil Europe experienced between the two world wars appears quite distant from the current crisis in Europe at first blush. But the linkages stand out alarmingly with some understanding of how the gold standard contributed to interwar turbulence, and how the eurozone resembles the interwar gold standard in a number of important ways.

The European financial crisis has often produced comparisons with the historical problems of the pre-World War I "classical" gold standard. Many of the key political figures who drove forward European monetary integration admired the discipline and certainty of the gold standard. Both Valéry Giscard d'Estaing and Helmut Schmidt shared this view. But recently, the comparison is more usually a negative or hostile one. The intent is to demonstrate the unrealizability or absurdity of the constraints that rigid monetary systems impose (Krugman 2013), or the problems of an asymmetric adjustment process (Eichengreen and Temin 2010).

The parallels between the two regimes are substantial. In their strong commitment to a rigid exchange rate system and openness to cross-border capital flows, they share many advantages and policy constraints. And while the interwar years highlight most vividly the limitations and risks of these exchange rate arrangements, the same can be found during the classical period.

Many of the benefits of the gold standard seen in the 19th century were also found in the euro: ease of a common monetary standard, better access to capital markets and reduction of borrowing costs. But the gold standard carried one important distinction in its contingent rule. In the event of an emergency such as a war, the gold peg could be temporarily suspended, but with an expectation of an eventual return to convertibility at the original peg. The contingent rule gave a safety valve for fiscal policy in dealing with exceptional circumstances (Bordo and Kydland 1995).

There were also substantial risks. Large-scale emerging market borrowers ran a substantial risk of entering into an unstable dynamic with a destabilizing fiscal policy that might threaten the maintenance of the rules of the game. The gold standard experience is filled with sudden stops of capital inflows in which advanced country creditors — either hit by domestic shocks or fearful of events in the borrowing countries — turn off the lending spigot (Bordo 2006).

Tsarist Russia provides a telling example. When countries credibly adopted the gold standard, they often experienced surges of capital inflows. These were almost always mediated through the financial system. The strong and effective State Bank in Russia was widely regarded as a reinsurance mechanism that would bail out problematical private debtors: It was often referred to as "the Red Cross of the bourse." This allowed greater volumes of borrowing to continue for longer and with greater sustainability. Russia had large inflows, and a sudden stop in the early 20th century, but no suspension of convertibility.

However, when corrections were needed, popular political discontent eventually limited the possibility of adjustment policy. The Tsarist empire was an effective and capacious borrower; it never seemed to violate the gold standard rule in peacetime, but it was brought down by massive social discontent that was in large part driven by the widespread perception that its policy had been sold out to foreigners. A major part of Lenin's analysis, for instance, was devoted to the demonstration that Russia had become a quasi-colony as a result of the large-scale capital imports — facilitated by its careful peacetime adherence to the rules of the gold standard — and that the foreign creditors in effect controlled Russia's foreign policy.

Some of these problems originate with the international macroeconomic trilemma that a country can only achieve two of the following three policies: fixed exchange rates, capital flows and autonomous monetary policy. But to tell the full story the standard trilemma must be supplemented with three more. That is, fixed exchange rates and free capital flows are also inconsistent with financial stability, national policy independence and democratization.

The trilemmas:

1. The macroeconomic classic: fixed exchange rates, capital flows, autonomous monetary policy
2. The financial sector: fixed exchange rates, capital flows, financial stability
3. The international relations setting: fixed exchange rates, capital flows, national policy independence
4. The political economy: fixed exchange rates, capital flows, democratization

The Interwar Period

All four of these trilemmas became impossible after World War I and played out to well-known results.

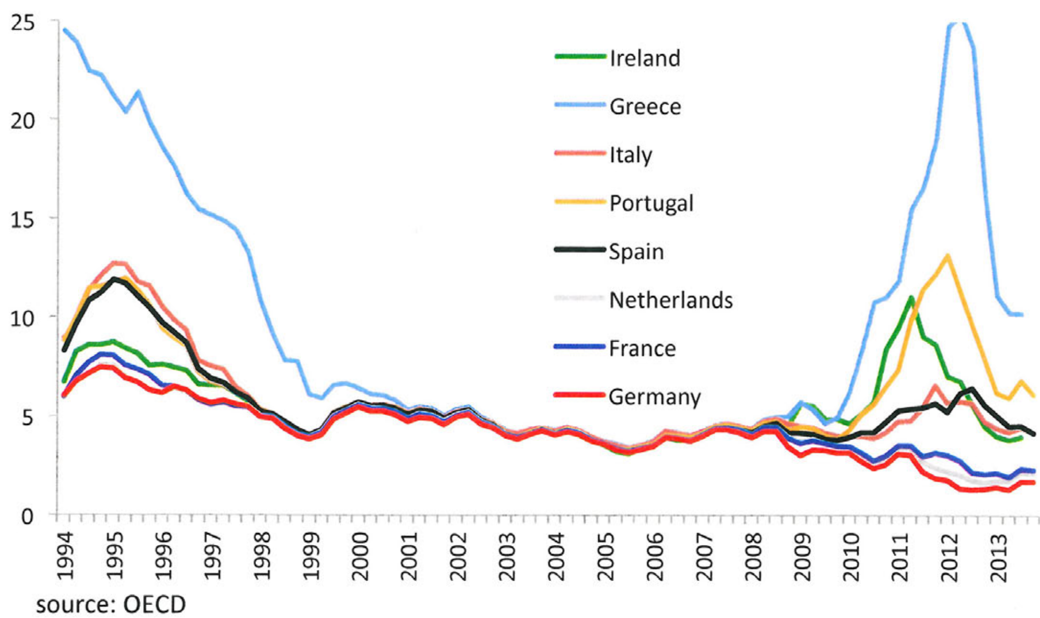
1. The asymmetric pressure of adjustment on debtor countries in the gold exchange standard of the 1920s and sterilization of gold inflows by the surplus countries (U.S. and France) put deflationary pressure on the deficit countries (U.K., Central Europe and Latin America) when capital flows dried up in the 1930s (Eichengreen 1992).

2. In the financial sector, high inflation in the 1920s destroyed the capital base of many financial institutions in the defeated countries of Central Europe, making them vulnerable to sudden stops. Correspondent banking networks between these countries and neutral countries exposed them to contagion.
3. In order to enhance their credibility with lenders (e.g., the U.S.) debtor countries took on international commitments, but the borrowing ultimately only increased the exposure to sudden stops.
4. Taking on international commitments became a focus for domestic political disorder when the Great Contraction after 1929 required adjustment by deflation.

The EMU Story

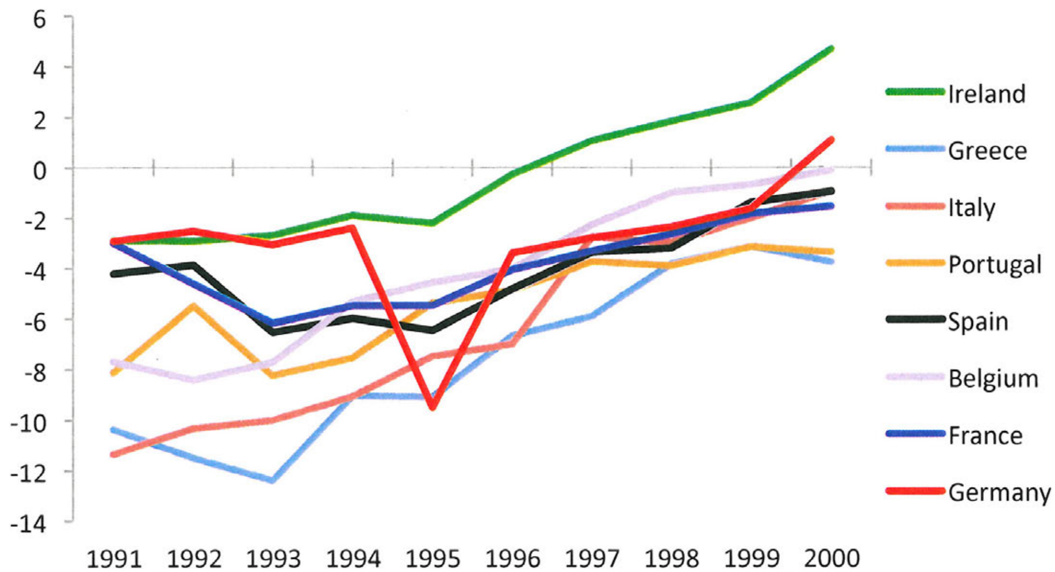
The move in Europe to monetary union for weaker countries was a credibility-enhancing mechanism that would lower borrowing costs. (See Figure 8.2.)

Figure 8.2 — 10-year Government Bond Yields



For countries that had strong creditor positions, the attractions of monetary union lay in the depoliticizing of the adjustment process (James 2012). EMU worked quite well as a disciplining mechanism before it entered into effect (see Figure 8.3), but much less well afterwards.

Figure 8.3 — Overall Fiscal Balance (percent of GDP)

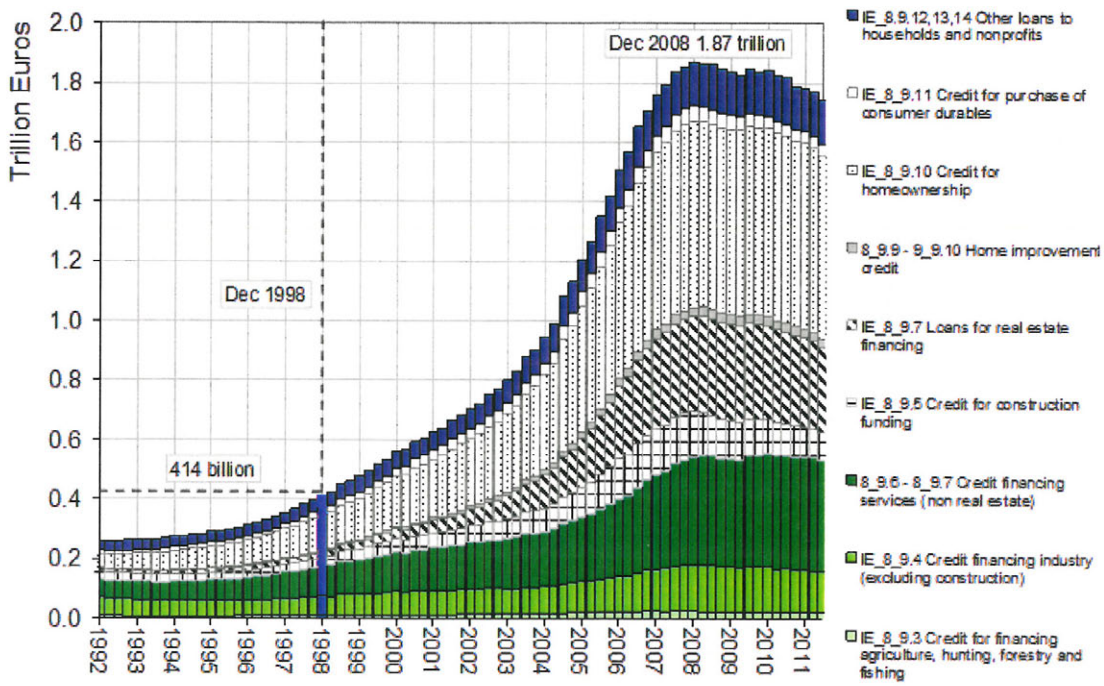


The trilemmas became an increasing constraint in the years after EMU:

1. No adequate provision on a European basis existed for banking supervision and regulation, which like fiscal policy was left to rather diverse national authorities. An explosion of banking activity occurred simultaneously with the transition to monetary union and may well have been stimulated by the new single money (Shin 2012). (For instance, see Figure 8.4.) A "banking glut" led to a new challenge to monetary policymaking.
2. The bank expansion could go on longer because of implicit government backstop. It was reversed when government debt management no longer looked credible: in the Greek case after the elections of October 2009.
3. The implicit national government backstop was really only credible because of the international commitment to the European integration project. It was that commitment that led markets to believe that — in spite of the no bailout provisions of the Maastricht Treaty — there were almost no limits to the amount to which debt levels could accumulate both in the private and the public sector. When governments turned round, in particular after the Deauville meeting of Chancellor Merkel and President Sarkozy in October 2010, and demanded a haircut for Greek creditors (or Private Sector Involvement), the yields immediately diverged. (See Figure 8.2.) Deauville undid the framework of solidarity that the EU treaties seemed to have created.
4. When the democratic/popular backlash occurs, it takes the form of rejection of international/cross-border political commitments. Voters are surprisingly discerning. Opinion poll data shows a major increase in hostility to the EU in peripheral countries, but with no corresponding unpopularity of the common

currency. Hostility to the EU is also evident in parliamentary elections results in Greece and Italy.

Figure 8.4 — Spain: Total Bank Credit to Domestic Borrowers



The trilemmas bind economic policy more painfully in the recent context because of the absence of an escape clause. In the absence of an option to devalue national currencies, there is a need for greater debt reduction, but that raises a politically awkward question of the distribution of losses between the private and the public sector.

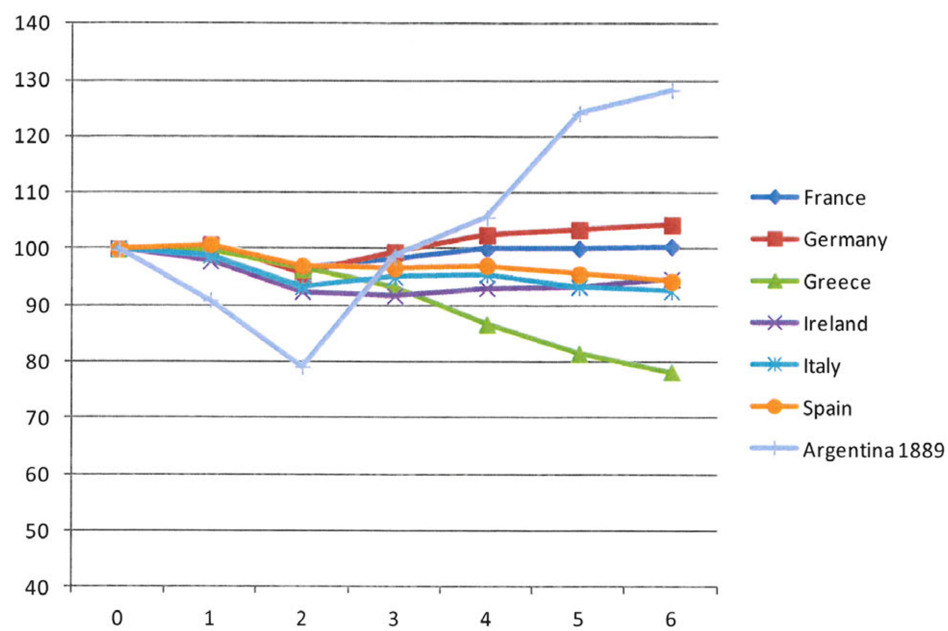
The result is reminiscent of the interwar political debate about whether private (mostly American) creditors or official (mostly European) reparations creditors should have priority in the payment of German debts. What made the interwar slump so intractable was that it was not just a financial issue, but also a crisis of democracy, of social stability and of the international political system. In the interwar period, increased social tension as a consequence of increased unemployment and of widespread bankruptcy related to rigid gold standard adherence made normal democratic politics impossible. Domestic political pressure also became a source of heightened international tension.

That is true in today's Europe. Democracy has become a central target of complaints by the European elite. Luxembourg prime minister and former eurozone chair Jean-Claude Juncker stated that it wasn't that European leaders didn't know what the right policies were, but that they didn't know how to be re-elected after they had implemented them. The 2013 Cyprus crisis and its resolution exposed two new dimensions to the clashes over

Europe's debt and bank crisis. The discussion of a levy on bank deposits, and whether small customers should be exempted, puts class conflict at center stage.

Supranational commitments, however, do not change the problems posed by the adjustment requirement. A design that intentionally excluded a contingent clause made the system at first apparently more robust, but aggravated the eventual adjustment issue. That is why the initial crisis may not have been so acute as some of the gold standard sudden stops, but the recovery or bounce-back is painfully slow and protracted (see Figure 8.5).

Figure 8.5 — Real GDP After Financial Crisis



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European Debt Problems Still Matter for the U.S.

By Russell A. Green

The ominous fretting by economists about debt turmoil has subsided recently — on both sides of the Atlantic. That's good news, right?

Not really. Just as the political compromise in Washington only postponed the hard decisions America faces, the European Central Bank (ECB) has engineered a temporary calm in the financial storm that had engulfed the eurozone.

Don't be lulled into imagining that the problems have been solved. Europe's leaders must take meaningful measures before the cycle turns again. It is important that they succeed, for their sake and ours.

ECB president Mario Draghi sticking his finger into the dike of European debt sustainability has made the current dearth of alarming euro-debt crisis headlines recently possible. Draghi's promise last year to do "whatever it takes" to keep the euro together bought time for politicians to act.

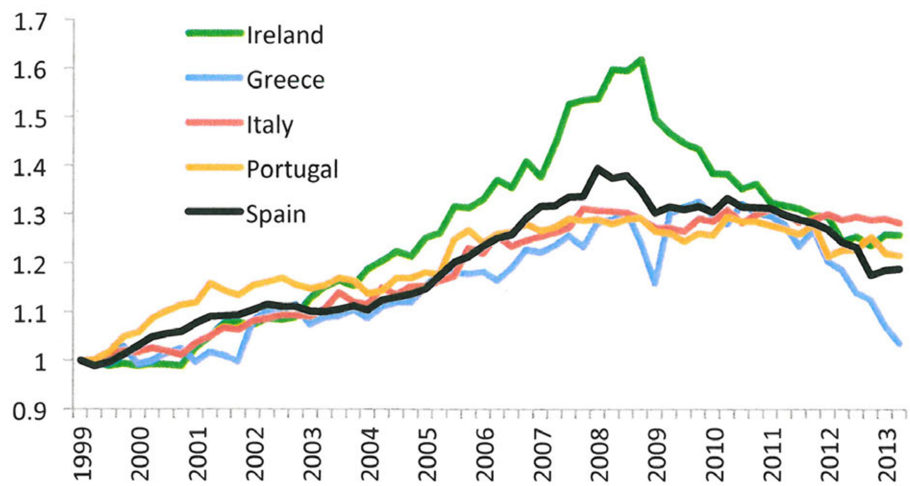
A sense of normalcy returned, allowing some progress in addressing Europe's underlying weakness. Ireland, Greece and Spain have made surprising gains in competitiveness, for instance (see Figure 9.1, where a high number means low competitiveness), and the Greek and Italian governments have gained control of their fiscal deficits (see Table 3.2).

Major Concerns Remain

Yet the magnitude of the remaining challenges is frightening. Despite making wrenching sacrifices, debt may still be unsustainable in peripheral Europe. (See Figure 5.1.) France's government debt is heading in the wrong direction, having risen by 11 percent of GDP since 2010. Weak banks constitute a dangerous liability to already-weak state coffers. And the mishandling of the Cyprus bailout offers the wrong lessons for depositors: Get ready to run.

The greatest risk is that Europe may never fully cure itself. European leaders lack the sense of urgency to make tough decisions. Instead they've delivered insufficient bailouts and baby steps elsewhere. Proposals currently being debated to address the banking crisis look likely to result in the next set of half-measures.

Figure 9.1 — Harmonized Competitiveness Indicators (relative to Germany, based on unit labor costs indices for the total economy)



source: ECB

Weak Europe Impacts the U.S.

This fumbling policy response is bad for the United States, too. Both sides rely on our deep trade relationship and substantial trans-Atlantic investments. Complex financial links remain, despite efforts by American banks to insulate themselves. Plus, fragile consumer and business confidence at home could collapse with another scare. Even if the eurozone avoids crisis but stagnates for a decade or two as the Japanese have, the growth void will drag on economies worldwide.

Just as bad, an economically weak Europe translates to a politically weak Europe, with repercussions in foreign policy. Take the rise in euro-skepticism — a movement opposed to greater integration — that will gain ground if the crisis drags on. Greater divisions and isolationism will impair Europe's projection of power.

Europe's outsized place on the world stage was arguably due for downsizing even before the crisis, as dynamic emerging powers demand a greater role in global governance. These countries naturally target different priorities, but their priorities rarely provide the same consonance that America enjoys with Europe.

Ever since Houston native Will Clayton crafted the Marshall Plan, broad European-American ties have produced an effective alliance in numerous global endeavors. A wilting Europe would be difficult to replace as a strong, like-minded partner on new foreign policy initiatives.

The joint action that helped remove Gadhafi from Libya provides a good example of effective sharing of the responsibility of global stewardship. Can Washington rely on its European allies to play a similar future role if they are hobbled by anemic budgets and limited popular support? Europe's weakness undermines our own effectiveness.

European Policymakers Need a Push from the U.S.

Europe's crisis has imposed the greatest hardships on Europeans themselves. But these challenges extend to the U.S. as well. Europe's leaders are moving too gingerly amid such high stakes.

America acted more forcefully in its own financial crisis to much greater success. Although America's debt problems still linger, it is time to toss aside the usual warnings to the residents of glass houses. We must urge Europe to step up reform and repair its economic and political vitality. The finger in the dike, as in the children's story, was never intended to be a lasting solution.

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