

The eurozone: tale of a bad marriage
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Tale of a bad marriage

“The effort to bind states together may lead, instead, to a huge increase in frictions among them. If so, the event would meet the classical definition of tragedy: hubris (arrogance); ate (folly); nemesis (destruction).”

Martin Wolf, FT, December 1991.

Tale of a bad marriage



Tale of a bad marriage

- Why the euro is a bad marriage
- Why the happy honeymoon was a tragedy
- Why the risks were misunderstood
- Why it is hard to save the marriage

1. Why the euro is a bad marriage

- A number of very different countries rushed into a monetary marriage with inadequate forethought.
- The hope was that either there would be no crisis or that a more effective union could be agreed, once a crisis happened.
- But one should be careful what one wishes for!
- Remember: Nobody likes people who mess with *their* money.

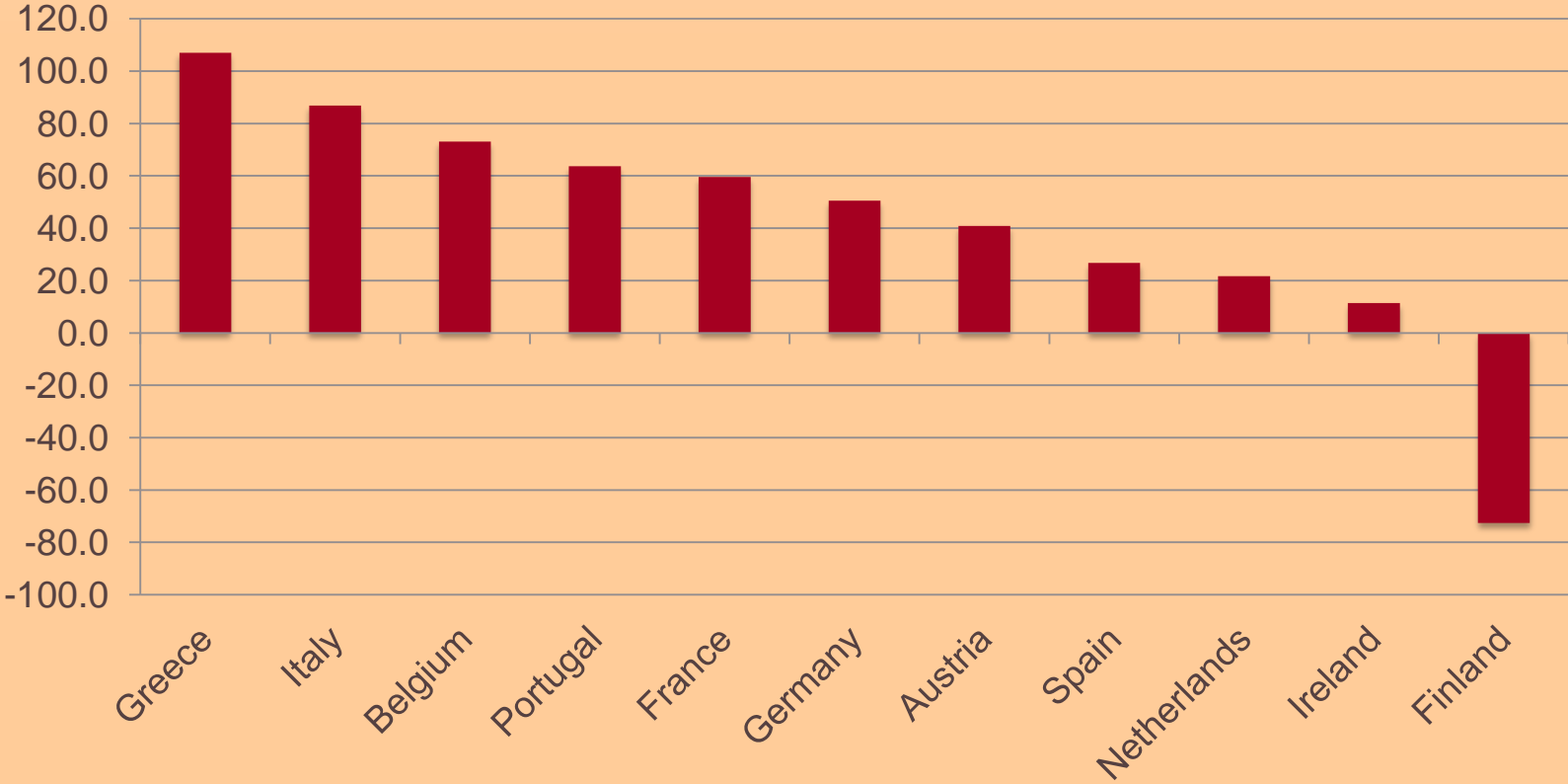
2. Why the happy honeymoon was a tragedy

- In the first decade, members had a honeymoon:
 - Countries with historically low credibility and high interest rates enjoyed low interest rates, surging capital inflows and booming economies.
 - Countries with an historic attachment to export surpluses got improved competitiveness and apparently good investment opportunities for their surplus funds;
 - But precisely what made everything seem so good was laying the ground for an acute crisis.
- After 2008, cross-border private financial flows suffered a series of “sudden stops”.

2. Why the happy honeymoon was a tragedy

NOT THE ROAD TO THE EUROZONE CRISES

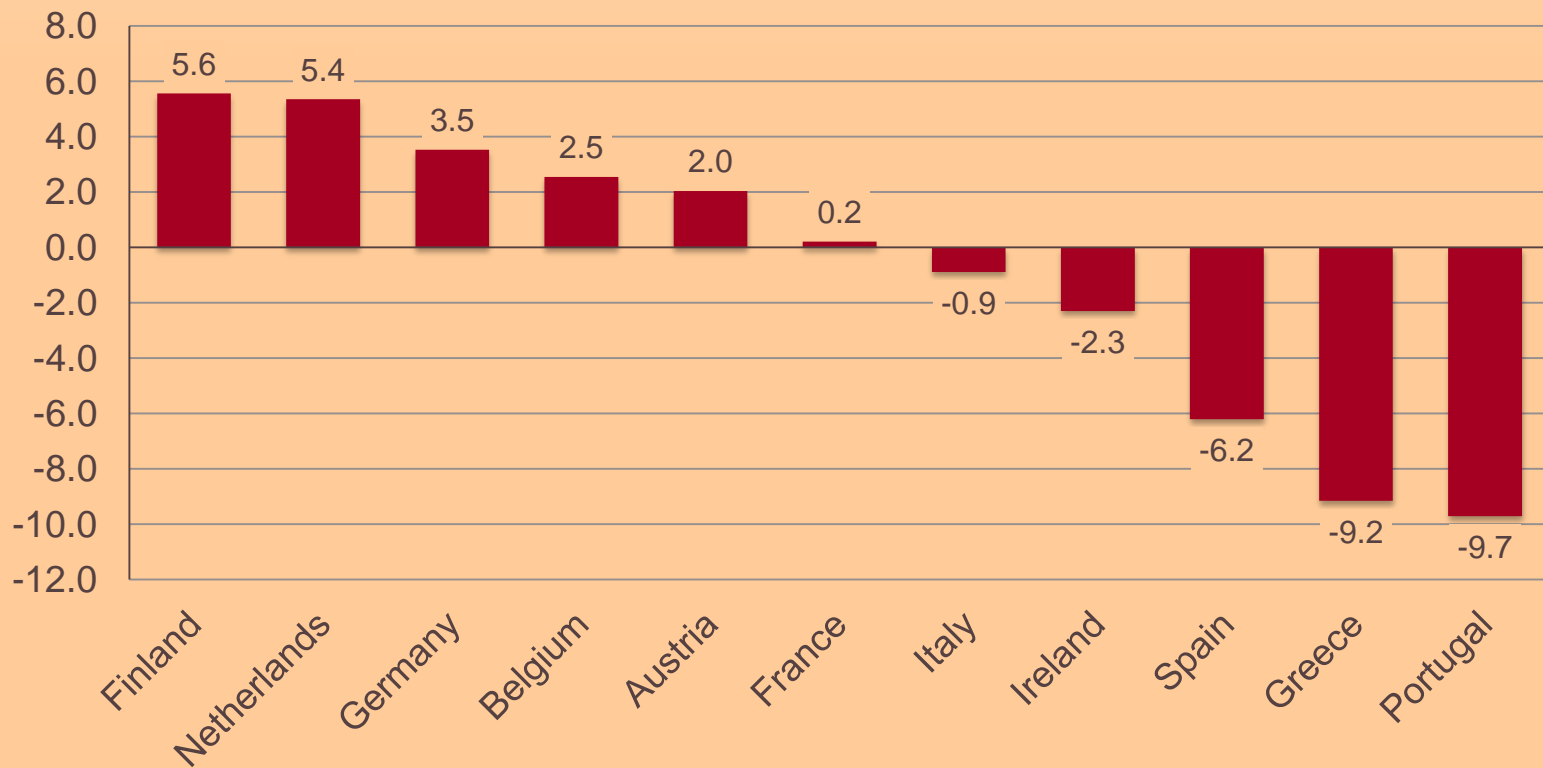
GOVERNMENT NET DEBT OVER GDP (per cent)



2. Why the happy honeymoon was a tragedy

THE ROAD TO THE EUROZONE CRISES

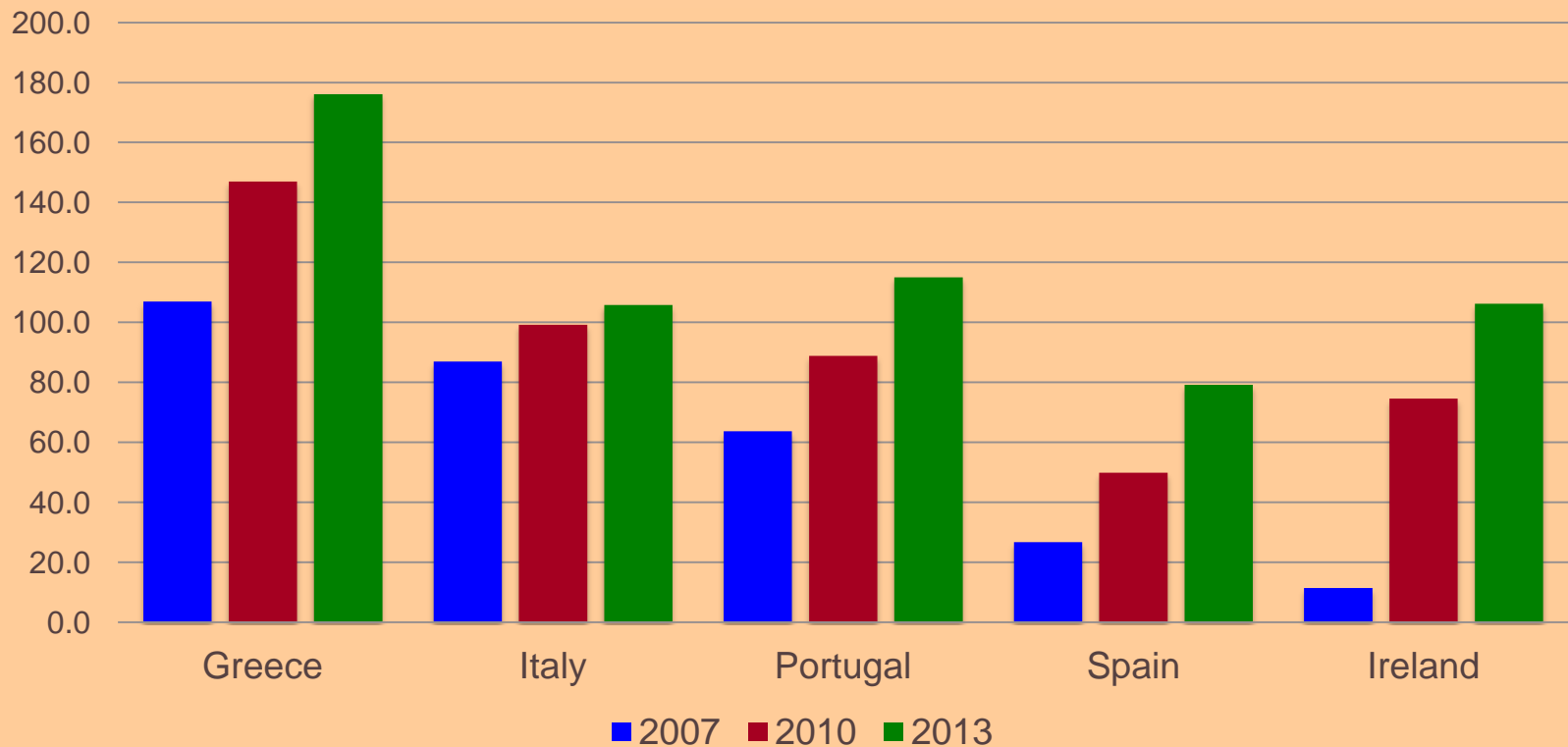
AVERAGE CURRENT ACCOUNT BALANCES 2000-08



2. Why the happy honeymoon was a tragedy

CRISIS-HIT COUNTRIES SUFFER

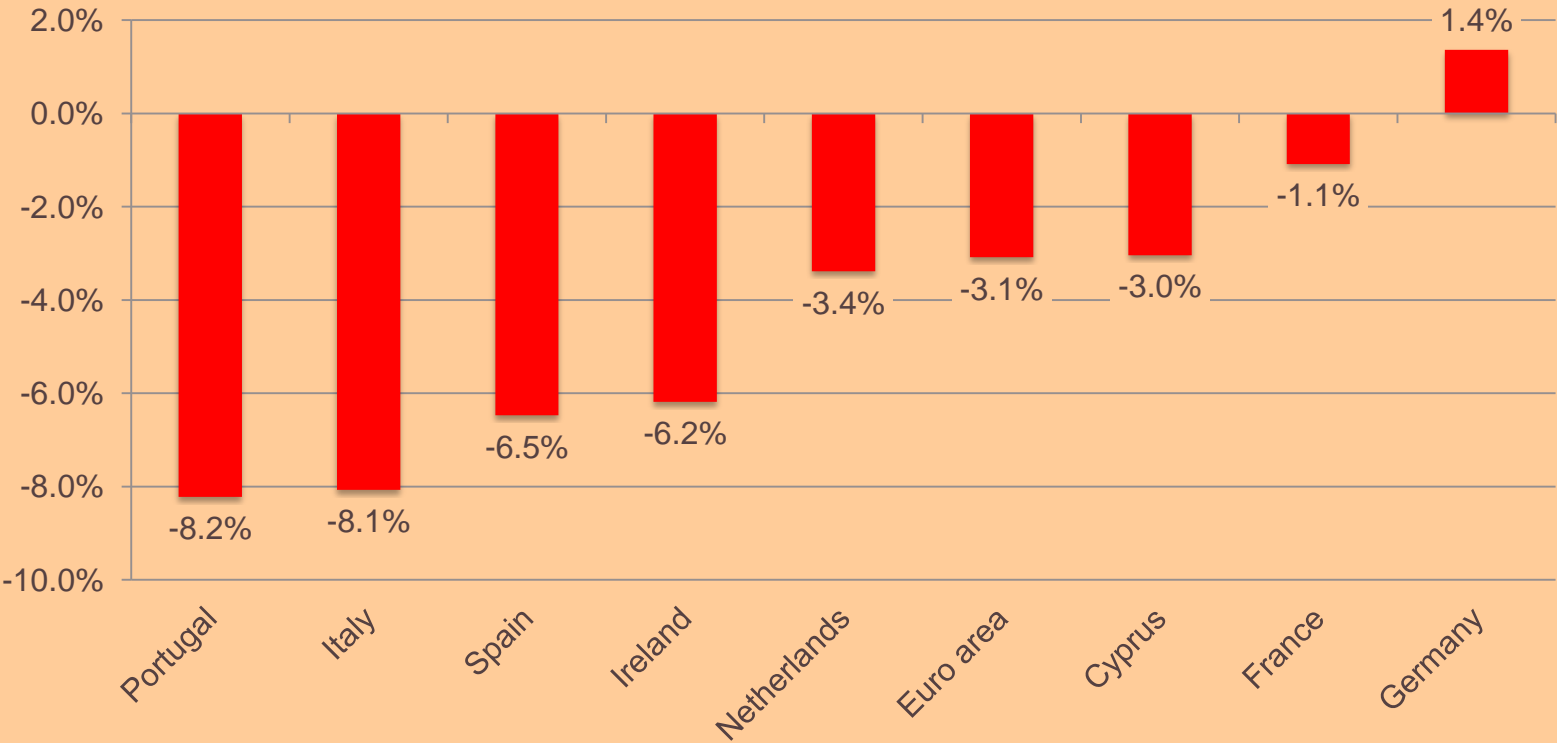
NET GOVERNMENT DEBT OVER GDP (per cent)



2. Why the happy honeymoon was a tragedy

DEPTH OF THE RECESSIONS

CHANGE IN GDP FIRST QUARTER 2008 TO FOURTH QUARTER 2012



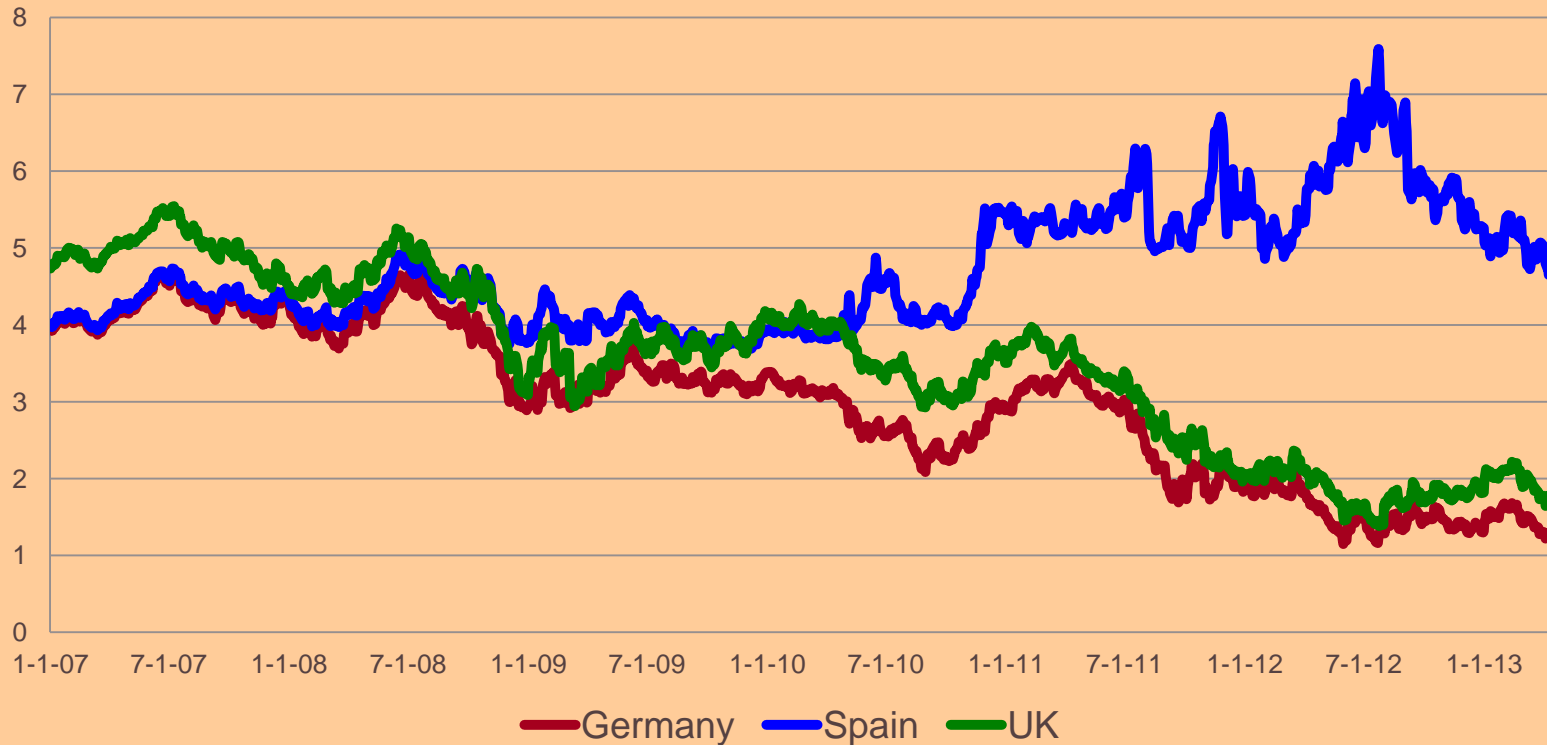
3. Why the risks were misunderstood

- Countries embedded inside a currency union are *more* vulnerable to balance of payments *cum* financial crises than those with floating exchange rates and their own central banks.
- Spain and UK have similar fiscal situations, but very different interest rates on public debt.
- This reveals liquidity (multiple equilibrium), credit, deflation and break-up risks.
- The currency union has replaced brief currency crises with long-running solvency crises.

3. Why the risks were misunderstood

WHO'S THE MORE INDEBTED?

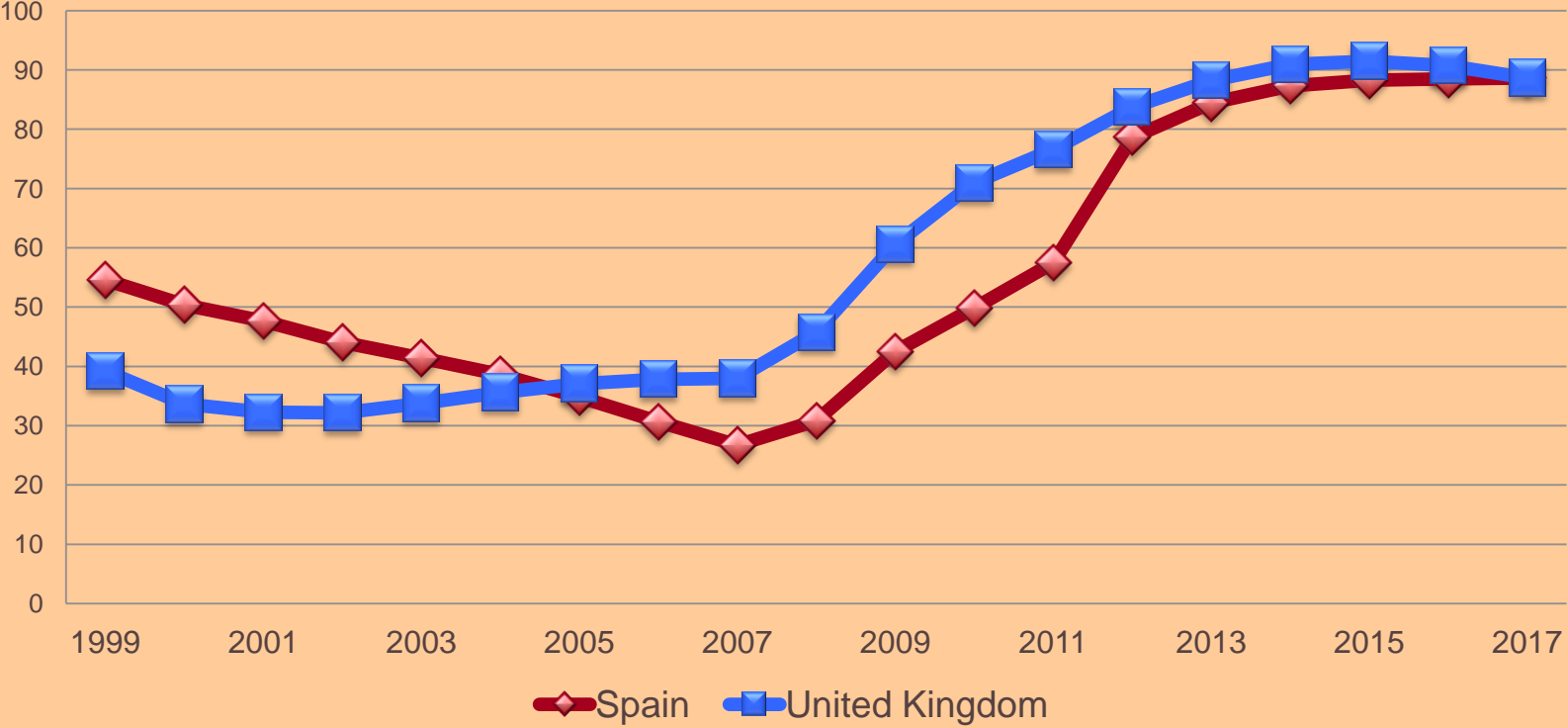
10-YEAR GOVERNMENT BOND YIELDS



3. Why the risks were misunderstood

WHO'S THE MORE INDEBTED?

NET PUBLIC DEBT
(as per cent of GDP)



4. Why it is hard to save the marriage

- How is the eurozone going to resolve its crisis?
- I see three scenarios - divorce, bad marriage or good marriage:
 - Bad marriage is painful.
 - Divorce is known to be very costly, for everybody.
 - So the aim is to struggle through to a good marriage, *in which everybody thinks they are better off in than they would have been if they had never joined*
- This will take a lot of reform, both economic and political. It will also take at least a decade.

4. Why it is hard to save the marriage

- Here are the challenges to be met:
 1. *Debt write-offs*: to clear up the legacy costs of the poorly structured and managed currency union, Mark I.
 2. *Financing*: to prevent financial, fiscal and economic collapses.
 3. *Adjustment. structural reforms and divergent inflation* across the eurozone, with higher inflation and stronger final demand in core countries. To make this work the macroeconomic policies of solvent countries must be more flexible than they are now.
 4. *Reforms: these are needed to prevent a recurrence of the crisis* – banking union, fiscal union and political union.

4. Why it is hard to save the marriage

- Divorce remains a possibility. But would be very hard to manage.
- A good marriage is unlikely for many years.
- Continued participation in a bad marriage is the most likely outcome.