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# A Final Word on the European Debt Crisis

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The European sovereign debt crisis has been covered numerous times in previous letters (notably January 2011 – Out of Africa: Perspectives on the European Debt Crisis, February 2010 – A Mediterranean Debacle and April 2010 – A Mediterranean Debacle Part 2) and even if I wish it could really be the last word on this topic I am afraid it is highly unlikely. In fact, during 2011 the crisis deepened and engulfed the global economic (and political) scene of recent times. It is just that I am really tired of reading incessantly in financial media about the latest plans to resurrect the fading concept of an economically-unified, yet divergent cultural (work ethic) and politically independent members of the Eurozone.

Today it seems obvious it was probably never really a feasible experiment to merge the productive Northern Europe with the laid-back Southern European countries. Moreover, in recent times we have seen how difficult it was for West Germany to fully integrate East Germany into the post cold war Germany, despite similar cultures, language, etcetera. What were the political leaders of the day thinking? Perhaps it is a classic case of political leadership and dogma ignoring economic realties, of which we in South Africa can also relate to very well. The lesson for us here in Africa is that any grand idea that an "Africa Union" will ever be economically viable in European Union style is for all practical purposes dead in the water.

Nouriel Roubini, the famous economist who accurately predicted the financial crisis of 2008 and the subsequent fallout, opined in of his latest *EconoMonitor* columns that it seems increasingly likely that the Eurozone in its current format will break up. He puts forward a number of possible solutions, none of which will lead to a pleasant outcome for any of the affected countries. But it is really about avoiding the worst possible scenario:

<u>Why we are here</u>

*For the last decade, the PIIGS (Portugal, Ireland, Italy, Greece, and Spain) were the eurozone's consumers of first and last resort, spending more than their income and running ever-larger current-account deficits. Meanwhile, the eurozone core (Germany, the Netherlands, Austria, and France) comprised the producers of first and last resort, spending below their incomes and running ever-larger current-account surpluses.*

*These external imbalances were also driven by the euro's strength since 2002, and by the divergence in real exchange rates and competitiveness within the eurozone. Unit labor costs fell in Germany and other parts of the core (as wage growth lagged that of productivity), leading to a real depreciation and rising current-account surpluses, while the reverse occurred in the PIIGS (and Cyprus), leading to real appreciation and widening current-account deficits. In Ireland and Spain, private savings collapsed, and a housing bubble fueled excessive consumption, while in Greece, Portugal, Cyprus, and Italy, it was excessive fiscal deficits that exacerbated external imbalances.*

*The resulting build-up of private and public debt in over-spending countries became unmanageable when housing bubbles burst (Ireland and Spain) and current-account deficits, fiscal gaps, or both became unsustainable throughout the eurozone's periphery. Moreover, the peripheral countries' large current-account deficits, fueled as they were by excessive consumption, were accompanied by economic stagnation and loss of competitiveness.*

## The reflation option

*Reflation is the best option for restoring growth and competitiveness on the eurozone's periphery while undertaking necessary austerity measures and structural reforms. This implies significant easing of monetary policy by the European Central Bank; provision of unlimited lender-of-last-resort support to illiquid but potentially solvent economies; a sharp depreciation of the euro, which would turn current-account deficits into surpluses; and fiscal stimulus in the core if the periphery is forced into austerity.*

*Unfortunately, Germany and the ECB oppose this option, owing to the prospect of a temporary dose of modestly higher inflation in the core relative to the periphery.*

## The deflation option

*The bitter medicine that Germany and the ECB want to impose on the periphery – the second option – is recessionary deflation: fiscal austerity, structural reforms to boost productivity growth and reduce unit labor costs, and real depreciation via price adjustment, as opposed to nominal exchange-rate adjustment.*

*The problems with this option are many. Fiscal austerity, while necessary, means a deeper recession in the short term. Even structural reform reduces output in the short run, because it requires firing workers, shutting down money-losing firms, and gradually reallocating labor and capital to emerging new industries. So, to prevent a spiral of ever-deepening recession, the periphery needs real depreciation to improve its external deficit. But even if prices and wages were to fall by 30% over the next few years (which would most likely be socially and politically unsustainable), the real value of debt would increase sharply, worsening the insolvency of governments and private debtors.*

*In short, the eurozone's periphery is now subject to the paradox of thrift: increasing savings too much, too fast leads to renewed recession and makes debts even more unsustainable. And that paradox is now affecting even the core.*

Default and exit

*If the peripheral countries remain mired in a deflationary trap of high debt, falling output, weak competitiveness, and structural external deficits, eventually they will be tempted by a third option: default and exit from the eurozone. This would enable them to revive economic growth and competitiveness through a depreciation of new national currencies.*

High-debt countries default, but not exiting

*Of course, such a disorderly eurozone break-up would be as severe a shock as the collapse of Lehman Brothers in 2008, if not worse. Avoiding it would compel the eurozone's core economies to embrace the fourth and final option: bribing the periphery to remain in a low-growth uncompetitive state. This would require accepting massive losses on public and private debt, as well as enormous transfer payments that boost the periphery's income while its output stagnates.*

*But such permanent fiscal transfers are politically impossible in the eurozone, where Germans are Germans and Greeks are Greeks. That also means that Germany and the ECB have less power than they seem to believe. Unless they abandon asymmetric adjustment (recessionary deflation), which concentrates all of the pain in the periphery, in favor of a more symmetrical approach (austerity and structural reforms on the periphery, combined with eurozone-wide reflation), the monetary union's slow-developing train wreck will accelerate as peripheral countries default and exit.*

Source:

Nouriel Roubini, 2011. "Rising Risk of Eurozone Breakup", EconoMonitor, November 11.

www.economonitor.com/nouriel/2011/11/11/rising-risk-of-eurozone-breakup/