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## A sustainable Euro area with exit options

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POLICY PAPER SERIES

IZA Policy Paper No. 120

**A Sustainable Euro Area with Exit Options**

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DECEMBER 2016

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# A Sustainable Euro Area with Exit Options

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## ABSTRACT

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### **A Sustainable Euro Area with Exit Options\***

All explorations of the future of the Euro show serious risks for its survival in the present form. The road map of the Five EU Presidents presented in 2015 is far from sufficient to reduce the risks of the Euro zone falling apart by Brexit type developments or new economic shocks. The EU Presidents rely too much on high international economic growth smoothing the convergence in labor productivity between EU member states, while the more likely low growth scenario shows a serious risk of the Euro-area falling apart in a chaotic way, through further divergence in labor productivity, through new Banking crises or through the popular vote in response to fiscal and labor market reform. The Presidents argue for strengthening the Banking union with an independent watchdog, with a single resolution mechanism for Bank defaults and for a European credit deposit insurance system. The support for these proposals is overwhelming. They also argue for more transfer of sovereignty on financial policy and for debt mutualisation (sharing of the risks of country debt among all EU countries). This is unlikely to happen, while at the same time the urgency for dealing with the drag imposed by the high debt levels of many EU countries on economic growth is high. We propose that the EU negotiates a New Deal between the highly indebted Euro countries and the other Euro countries. In this deal the trust is built that the richer countries agree on debt mutualization against the assurance of an automatic exit from the Euro area at non-compliance with the agreed (and simplified) rules.

**JEL Classification:** E02, E24, E32, E44, E62, F15, F21, F36, F44, F45, N24

**Keywords:** euro, EMU, debt crisis, stability, fiscal, productivity, financing, banking

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## 1. The Euro as a Decisive Step

The sustainability of the Euro has been the subject of ample consideration (for example: Baldwin and Giavazzi, 2015, 2016, Stiglitz, 2016 or Flassbeck and Lapavitsas, 2015). The one thing which emerges from all explorations is that there are serious dangers for its survival in the present form. The policies proposed by the Five EU presidents (EC, 2015)<sup>2</sup> provide important elements for a road map for sustainability, in particular for a “Banking Union”. However there is also broad agreement that more needs to be done to ensure the survival of the Euro as we know it in 2016 and that the required changes cannot occur without treaty changes (Baldwin and Giavazzi, 2016).

The present paper attempts to put these analyses into perspective, discussing the ins and outs of the proposals, concluding that the best guarantee for a survival of the Euro is a New Deal with debt-mutualization and automatic exit, while strengthening the “Banking union” possibly also for non-Euro EU countries. Automatic exit in case of non-compliance with the rules is the one side of the bargain, the agreement of the richer EU countries on debt-mutualization is the other side.

The Maastricht Treaty signed in February 1992 laid the basis for the EMU (European Monetary Union). The response was overwhelmingly favorable. The EMU would complement an EU as a means to create a better and fairer life for all citizens, to prepare the EU for future global challenges and to enable each of its members to prosper. The Euro would be introduced for those EU countries willing to engage in an ever closer union. The political leaders thought of this as an economic policy serving the political goals of peace and prosperity in Europe. The Euro would be helpful to if not the savior of continued peace and prosperity in Europe. It would also be a vehicle for convergence between the richer and the poorer parts of the EU.

The Delors report (1989) had provided the stepping stone for the Euro as the currency of the EMU. The EMU would cement the relations of the EU Member States while at the same time making their joint positions against the outside world much stronger. The EMU would become a dominant international player and an important party for international organizations. It would be a reserve currency. Countries have to hold foreign exchange reserves for the eventuality of shocks. The pooling of reserves at the level of the European Central Bank meant that fewer reserves would be needed in the Euro-area compared to the pre-EMU state. Benefits of the EMU would also stem from reducing transaction costs and eliminating exchange-rate uncertainty within the Euro-area.

The far-reaching Maastricht treaty decision had a specific political context of the French desire to move forward on an ever closer Europe in combination with the German reunification in 1990. The German reunification needed the consent of France and the UK. French President Mitterrand gave his approval in exchange for German Kanzler’s Kohl agreement with the introduction of the EMU. The UK Prime Minister Major also agreed with the reunification but precisely on the basis of the opposite condition on the EMU: that the UK would be able to opt-out from the EMU.

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<sup>2</sup> The five Presidents were: Jean-Claude Juncker, President of the European Commission; Donald Tusk, President of the Euro Summit; Jeroen Dijsselbloem, President of the Eurogroup; Mario Draghi, President of the European Central Bank; and Martin Schulz, President of the European Parliament. This report builds on the report ‘Towards a Genuine Economic and Monetary Union’ (the so-called ‘Four Presidents’ Report’), on the Commission’s ‘Blueprint for a Deep and Genuine EMU’ of 2012, which remain essential references for completing EMU as well as on the Analytical Note ‘Preparing for Next Steps on Better Economic Governance in the Euro Area’ of 12 February 2015.

The Euro was defended first and foremost on political grounds: to contribute to a Europe which could stand tall in the forces of globalization and protect in that way the European way of life and the cherished European values and culture. It was also meant to bring convergence in economic growth between the North and the South. There was a minor sales pitch towards the broader public in that the transaction costs of buying and selling currencies would disappear realizing an additional growth rate of .4 % per year for the Euro-area.

The Maastricht treaty could build on the success of the European Monetary System (EMS). The EMS had been able to reduce the short-term volatility of exchange rates between European Community currencies, thanks to a mixture of converging inflation rates and interest rate management which targeted the exchange rate.

The EMU would be enshrined in the Stability and Growth Pact (SGP). The SGP was the pledge of members of the European Union (under the Maastricht Treaty) to limit their deficit spending to a maximum of 3% of GDP and debt levels to 60% of GDP (unless serious shocks would prevent countries from doing so). The responsibility for maintaining the rules of the stability pact were left to the individual member states. The SGP criteria were only concerned with the public sector. Private debt was ignored. At the time no-one believed that private debt might end up on the Government slate as happened repeatedly in the crisis (and still might be happening in 2016 if the Italian Government would need to save private banks). This was not just the payments for the deposit insurance but for the full amount of savings and the investments made by the owners (the share and bond holders). The SGP framework assumed that real exchange rate misalignments within the Euro area, and current-account imbalances, would be considered as symptoms of the underlying fiscal imbalances, assuming that convergence in productivity and economic growth would occur anyway. In other word the assumption was that the EMU just had to safeguard the "fisc" (by imposing maximum levels on Government deficits and debt).

The founding countries of the Eurozone were Germany and France, with other EC countries agreeing to the compromise. The compromise was between the in the philosophical differences of Germany, a federal state with strong regional governments and France, with a more centralized system of government. Germany saw the Maastricht Treaty, the framework for the Euro, as a set of rules, necessary for decentralization. France saw the framework as flexible, to be overseen by a European Government, to be developed in the near future.

The EMU would pertain to all EU countries which satisfied the "convergence criteria". Countries could opt-out by referendum, as happened in Denmark. In 2000 11 out of the then 14 European Union countries changed their currency to the Euro. At the time of the beginning of the crisis 19 member states were part of the EMU.

The EMU did not satisfy the criteria for an "optimal currency area": similar inflation rates, similar business cycles, financial market integration, labor and capital mobility, the degree of economic openness and fiscal and political integration (as first defined by Mundell, 1961). But the EU politicians at that time thought that the Euro would spur the development towards an optimal currency area, with the SGP framework as guiding principle. Many economists were critical of the introduction of the incomplete framework of the Euro with national independence for the fisc (e.g. Friedman (1997)). Countries gave their national currencies up at entry in the EMU. They could no longer dispose of devaluation as a means for correcting a relative decline in competitive position, with the notion that

shocks would be absorbed by fast adjustment in economic structures (read: deregulation) and through national fiscal policy (read: budget cuts and higher taxes). There was little awareness that such a process of “internal devaluation” might have extra-ordinary political costs. More over the notion was widespread that serious relative price adjustment would never have to occur.

Lastly there was the trust in the automatic stabilizers of the individual member states. The impact of a drop in world trade on the economy of a country depends on the state of the economy and on the feathers in the pillow of automatic stabilizers. Automatic stabilizers provide a cushion against the shock in the form of extra Government spending for unemployment benefits, so that consumption does not drop as fast as the loss of earnings due to the loss in trade. Ups and downs in trade (business cycles) have been of all times.

At the time of the introduction of the Euro there were already concerns about the banking system. They did not have anything to do with the introduction of Euro, but were the result of the globalization of finance (Eichengreen and Bokyong, 2016) in the 1990s and thereafter. There were questions whether National Central Banks were well enough equipped to deal with the increasing complexity of what were called “financial vehicles” while at the same time it could not be ruled out that private rating agencies were not acting in concordance with their clients, in contrast to their image of independence.

The early years of the Euro (2000-2008) were like bliss. The concerns expressed at the introduction of the Euro of too little control did not find support in economic development (section 2). World trade growth was high and created a sense of happiness and success of the Euro, even though under the surface the vulnerabilities of the Euro to the coming shock increased substantially. Part of these vulnerabilities was visible in the widespread neglect of the rules of the SGP without the application of sanctions. The sounds of the alarm bells of fiscal irresponsibility, of divergence in competitiveness, of housing and asset booms were smothered by economic growth and decreasing unemployment.

The crisis hit the EU and the Euro in two successive stages: the imported crisis from the default of the Lehman Brothers Bank in the US, followed by the admission of the Greek Government that the actual data on the Greek Government’s budget deficit (12.5% of GDP) were twice as high as the numbers provided by the previous Greek Government.

In section 3 we describe how the crisis affected countries. Like other crises before this economic crisis turned into a banking crisis, in a vicious loop between the financial side and the real side of the European economies. The inadequacy of the supervision of the banking system was aggravating the crisis seriously.

The response and repair period after 2008 is characterized by too little too late, mostly because of the absence of a single authority on the Euro level to act quickly. In section 4 we present the main lines of this response in the form of the rescue of Greece from a default, the repair in the banking system, the introduction of new instruments like the European Financial Stability Facility and the European Stability Mechanisms. Also the European Semester was introduced to help countries to safeguard the rules. It is remarkable how little of the available knowledge on “crisis management” (derived from earlier crisis like the East Asia crisis of 1997-1998) was used. Banks were rescued on the costs of taxpayers.



Section 5 looks into the future (the next 15 years) of the Euro. This future is set in the context of low economic growth as predicted by Gordon (2015) and Summers (2014). We juxtapose the answers to Euro-area challenges to those of the Five Presidents' report of the EU (EC, 2015). This Report' says : "Europe's Economic and Monetary Union (EMU) today is like a house that was built over decades but only partially finished. ... we will need to take further steps to complete EMU" (European Commission 2015). It proposes the completion, in the long run, of three unions to match the Monetary Union: Economic Union (including Banking Union and Capital Market Union), Fiscal Union, and Political Union. While the Five Presidents' report was an important step in getting the debate going, it seems to be unrealistically ambitious in the long run – essentially pushing all the way to something like a United States of Europe. At the same time, it is insufficiently ambitious in the short run – shying away from the needed reforms that would bring about more convergence by –amongst others dealing with the debt-overhang in many of the Southern countries. This would require a treaty change (as also Baldwin and Giavazzi, 2016 suggest). Half-measures and muddling through will not do the job. They are likely to lead to a chaotic falling apart of the Euro at the time of a new crisis (for example, if the support for Italian banks might exhaust the willingness of Germany to contribute). Also Stiglitz (2016", p. 239) is clear on the point that the Euro is unsustainable. It is –in his view- either more Europe (more economic and political integration, for which little appetite exists) or less (a dissolution of the Eurozone in its present form), while others see alternatives (like Baldwin and Giavazzi, 2016).

We suggest that three steps are to be taken for ensuring the sustainability of the Euro:

- The introduction of controlled exit, either by popular vote or automatically in case of the breach of the rules for coordination. This is argued as a means to ensure the coordination of the economic and fiscal policies needed for convergence, when countries refuse to transfer authority, so that there is no "sovereign", no common authority at the EU level who is responsible for that coordination. The present solution for the lack of a European Sovereign is the "semester" (in which countries submit their budgets for approval by the European Commission). This "semester" approach has highly sophisticated to the point of complexity which very few still are able to comprehend. At the same time it only leads to the kind of popular dissent which might bring countries at the end to leave the Euro in an uncontrolled fashion. It is still the country which has to do the dirty job of policy reform (like: more flexibility on the labor market, budget cuts and tax increases), laying the blame on "Europe". We propose as an alternative to create an automatic "controlled" exit options in order to ensure adherence to agreed rules setting the framework for policy coordination. Exit would replace the present system of sanctions for non-adherence to agreed rules. It is up to the country to decide: being part of the Euro (and satisfying the rules) or not.

- The "debt-overhang" of highly indebted countries needs to be taken care of. This requires a New Deal in which on the one hand countries with a debt overhang find that part of their debt is "mutualized" in exchange for an agreement on automatic exit of countries from the Euro.

- The Banking Union needs completion. The common banking supervision for the Euro-area needs to be strengthened further. Perhaps the banking system needs a further overhaul, with a separation between the "savings banks" with a public function and commercial banks. For commercial banks it is clear that both the benefits and the costs of the risks are for the shareholders and the savers: they cannot be transferred to the Government or to an insurance fund in case of a default. These could be the steps to be taken in the "Banking Union" as part of the EU.

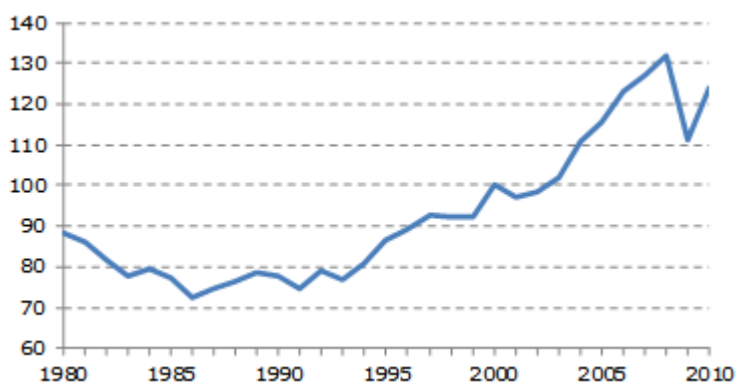
The Banking Union as proposed and already partially implemented can move forward fast and might involve all EU countries. It is amazing that the banking reform has taken so long. Popular support would have been overwhelming.

## 2. Eu(ro)phoria 2000-2008

### 2.1 Bliss and divergence

The early years of the introduction of the Euro were happy years. Economic growth was relative high and unemployment decreased pretty much all over the Euro area. This was not only a Euro-success, but also the result of world trade growth. World trade growth as shown in Figure 1 recuperated in the early 1990s and kept swinging upwards until it reached its highest point in 2008.

Figure 1 World Trade Growth



Source: World Trade Organization

The Euro was supportive in translating the relatively high growth rates of world markets to the Euro-area countries and to the EU as a whole.

The Euro Area was characterized from its inception by big capital flows from the EMU core nations like Germany, France, and the Netherlands to the periphery: Ireland, Portugal, Spain and Greece. The total flow from core to periphery between 2000 and 2008 was in order of magnitude of no less than half a trillion Euro (Baldwin and Giavazzi, 2015, p 33). Private Banks in the core countries assumed that Euro-area debt was safe and without a risk of default. Also financial parties external to the EU made the same assumption. They took it for granted that all Euro-area members would vouch for each other. Therefore, private Banks and other investors were willing to hold debt at low interest rates even though some countries had quite high debt levels (e.g. Greece, Italy). At the same time, the low interest rate discouraged countries like Greece from tackling their debt levels. Investors also lend to private parties or private Banks in the periphery at low interest rates, unleashing a building boom in countries like Ireland and Spain.

At the time of the introduction of the Euro Germany had just had its “Harz reform” package turning the “sick man of Europe” into a healthy highly competitive economy with a substantial trade surplus. The reforms had been a painful process, but they paid off. Like Germany also other Northern European economies had experienced a moderate increase in wages in the years, with labor

productivity increasing at a higher rate than wages, leading to a gain in competitiveness. They as well had had their share of painful economic reforms, but enjoyed with Germany the corresponding improvements in competitiveness.

In contrast, Southern Europe had experienced substantial increases in wages in the decade preceding the crisis. These wage increases were not backed up by a similar increase in labor productivity. Their economies had thus lost competitiveness and had seen deterioration in their external balance: more imports than exports, with exports falling and imports increasing.

It was a vicious cycle with the core constantly increasing competitiveness, increasing trade surpluses and exporting the money earned to the periphery. The cycle was vicious because the capital flows from the core to the periphery fueled to a substantial extent the increasing divergence in unit labor costs. The flows funded a housing bubble with real values far exceeding the borrowed money or Government services and Government staff without creating assets (Flassbeck and Lapavitsas, 2015). Growth in the periphery relied mainly on strong consumption, investment in the housing sector financed by debt and expansion of the Government sector (including transfer payments).

The Euro framework, the SGP –meant to ensure convergence- did little to nothing to break this cycle. More-over the SGP started to show serious breaches when Germany and France in 2000 broke the rules. They set “particularly detrimental precedents”( Feld et al., 2015) as they “negotiated” themselves away from sanctions as included in the SGP rules. Subsequently there were 34 breaches of the 3% threshold for the general government deficit between 1999 and 2007 (Feld et al., 2015). This continues into 2016, when Portugal and Spain were allowed to surpass the 3% GDP budget deficit without sanctions.

## **2.2 Private Banks pre-crisis**

The successes and failures of the Euro are strongly related to the finance sector of the Euro-societies: the Banks. Banks are about saving and lending. You, the individual customer, want to have your money put in a safe place hopefully with a return (interest). The Bank uses your money to lend it to an enterprise for a slightly higher interest rate (to cover its costs and the risks of lending) or to you for a mortgage. Gradually this Banking function became more extended to provide liquidity (money) to those who need it (for credit card purchases or firm investment or firm liquidity), backed by the deposits of the Banks’ customers. Banks are licensed and overseen by the National Banks of countries. There are also many other forms of financing enterprises or credit, like for example, stocks and bonds.

Licensed Banks are allowed to create money. They can lend out far more than they have in terms of savings of individuals, with the Central Bank of the country “creating” that money.

Pre-crisis EU Banks transformed fundamentally in the 1990s and in the years before the crisis, in line with the “globalization” of finance. Banks sold and bought to each other and to clients highly esoteric “financial products”, like securitized investment (packages which were supposed to be low risk, because the risks inside the package compensated one another), or derivatives and options (bets on the rise or fall of a currency, a stock, or the interest rate etc.) and even second derivatives. Risk assessment became more difficult with these complicated financial products. The short-term

orientation of shareholders of Banks was increasing, advancing procedures to put short-run gains above the long-run.

These new times were not just felt in the EU. Everywhere the globalization of finance had its impact. The increasingly fluid and complex nature of the Banking industry – via speed of change, interconnectedness and the presence of large and complex institutions generally bad at valuing risks made it difficult for regulators to see the risks that were being built up: “the institutional structure (including regulation) has not kept up with the enhanced marketability, ‘changeability’ and hence complexity of the industry” (Boot, 2011).

The international environment also made it hard to impossible for individual Banks (and their regulators) not to join in the risk taking. Stock-listed Banks whose profitability would lag those of its competitors faced the danger of a take-over. The Bank rat-race was in full swing with headlines of daring Bank take-overs.

(National) Central Banks discuss the trends in international finance at the forum of the “Bank of International Settlements” (located in Basel) and agree to common guidelines (not compulsory). The first guideline “Basel I” (1988) contained guidelines for the solvability of Banks (and the required capital). Basel II was a refinement taking into account the globalization of finance. The guidelines of Basel II took effect in 2007. They provided for higher capital requirements for Banks.

The EU had already taken steps to integrate its financial markets through two measures:

- The Second Banking Directive of 1989 creating the Single Banking License.
- The Financial Services Action Plan of to create a single market for financial services.

Both measures had a tremendous impact on intra EU capital flows and provided the basis for the imbalances sketched above.

In this pre-crisis period Banks strongly increased their scale and scope. EU Banks learned from the US about high salaries and bonuses. Scale became a goal (even though the extensive literature on scale and scope economies in Banking provides little evidence for the economic rationale behind this, Boot, 2011). Some even argue that Banks have effectively been chasing a too big to fail premium (the fact that big and interconnected Banks are seen as safer and hence can borrow against lower costs, Benink and Benston, 2005)

The European Banking system was known to be frail, long before the crisis erupted. Some financial experts warned in 2005: “If the Bank regulatory structure in developed countries, particularly those in the EU as well as the US were not changed, considerable private and social costs could be incurred” (Benink and Benston, 2005). Words that came back to haunt the Euro-area during the crisis.

## **2.3 Conclusion**

What would have happened if the Euro would not have been introduced? It is likely that economic growth in that period would have been less, but it is equally likely that the periphery might have done more in generating policies for increasing labor productivity. Under the “old” EMS some of the core countries, like Belgium, Germany, and the Netherlands might have had to re-valuate their currencies to the benefit of their citizens. Capital flows from North to South would have been

smaller. The indebtedness of Southern European countries would have been less. The Spanish and perhaps the Irish building boom would have been averted. It is likely that the impact of the crisis would have been less severe as countries would have come into the crisis in a better way. On the positive side: the introduction of the Euro increased the awareness of the need for better Banking regulation and control in a period of the globalization of finance.

### 3. The Euro and the Financial Crisis 2008-2014

#### 3.1 A tale of two shocks

Since 1929 Europe had not experienced a serious economic crisis. So Europe was led to believe that in “our” world economic crises are eradicated like the pest had been eradicated in the 20<sup>th</sup> century, even though while world-wide crises continued to erupt with great regularity. For example, in 1999 East Asia suffered from a major crisis. This crisis wiped out some 10 % of GDP in several countries in one year. But Europe did not see this any more as a serious possibility in its borders.

Economic crises have been recorded since 1637 when “Tulpomania” hit the Netherlands. Every crisis is different but the general characteristics are the same: too much borrowing to buy overvalued goods or unproductive investments. These goods were tulip bulbs in the case of Tulpomania. Their market price rose in a bubble to that of a canal house in the centre of Amsterdam. Banks happily lend out money to buy bulbs only to notice that they were broke once the crisis broke out and tulip bulbs were without value. This is also a recurrent element of crises: an economic crisis always goes together with a Banking crisis.

The East Asia crisis went in a similar way: too much public and private debt. The East Asia crisis brought out an element foreign to the Tulpomania crisis: it was debt for money borrowed from abroad. Too much debt, that is to say, in relation to the productive investment financed through the borrowing. East Asian countries came into a crisis when their currencies devalued so that they would have to pay more in return for the loans they had taken in foreign currencies. Banks were unable to recoup the loans from their clients and went broke, setting in motion a downward spiral of being more restrictive in lending, followed by less investment, followed by less economic activity, followed by more Bank failures etc.

The EU story is equally simple and straightforward. It is also uncontested (Baldwin and Giavazzi, 2015). The foreclosure of Lehman Brothers brought about a shock in the Euro-area. “Lehman Brothers” stands for the start of a sharp recession. Lehman Brothers brought about the fall in world trade of Figure 1 in 2008. This meant that exports dropped substantially in most countries, which meant fewer earnings and job losses, which meant less spending in countries, leading to further job losses and less spending: a spiral downward. In that spiral Banks get in trouble because some of their investments turn sour and cannot be recouped. In response they become far more selective in choosing new loans, so that investment drops, adding to the decrease in earnings and consumption while aggravating unemployment.

The foreclosure of Lehman Brothers was just a single even, relatively small on the scale of finance world- wide. Nevertheless, it brought the entire US credit market to a halt within hours, spreading to the rest of the world within days. The foreclosure of Lehman Brothers was due to overextended

lending for mortgages (“subprime lending”) in the US while hiding these huge risks in “securities”. By the way: these securities were approved by the rating agencies as rock-solid<sup>3</sup>.

The downward spiral also hit the EU with a closely integrated financial market with the US. It then turned out that in many Euro countries private Banks had taken disproportional risks, without the National Banks (supposedly safeguarding the system) intervening. These risks were of two different types:

- The new “financial products”, like securitized mortgages or derivatives, which turned out to be heavily overvalued. These were more or less “US”-induced causes of the crisis.
- The real estate market in particular in Ireland and in Spain, a local component of overvaluation of assets. These were to a large extent financed by Banks from other EU countries.

The crisis struck Southern economies in a vulnerable state, with relatively low competitiveness, high indebtedness and substantial trade deficits. But also in the core Euro-area the combination of overvalued housing prices and credit market restrictions which Banks had imposed on themselves at the beginning of the crisis had a serious impact on the economy as well as on the Banking sector.

Then a second shock hit the Euro-area (and solely the Euro-area). This one was home-grown: Greece, contrary to the first Lehman Brothers shock, imported from the US. The Greek Government announced that previous Governments had lied about the real budget deficit and the real amount of debt. The rules of the SGP had been grossly violated. This was aggravated as some EU member states had turned to “securitizing” future government revenues to reduce on paper their debts and/or deficits, thus masking their real debts and/or deficits.

Financial markets feared for a risk of a sovereign default in combination with defaults of many of the private Banks. Since many of these loans had been financed by private Banks of other Euro countries, such a default might trigger off a spiral of defaults all over the EU.

The crisis subsequently spread to Ireland and Portugal, while raising concerns about Cyprus, Italy, and Spain essentially in a domino effect with Banks getting in trouble because of “bad loans” (which had looked so good at the time when they were made). Banks went bust loading their burdens onto Governments.

The pre-crisis debt boom was a major explanation for the depth of the crisis (Baldwin and Giavazzi, 2015, p. 61).

Table 1 shows how much the EU and the Euro area were affected by the crisis in economic growth.

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<sup>3</sup> The story is best told by the movie “The Big Short” (2015).

Table 1

**Real GDP growth 2007- 2014**

	2007	2008	2009	2010	2011	2012	2013	2014*
<b>EU</b>	3.3%	-16.4%	8.2%	11.4%	11.9%	10.6%	3.3%	3.1%
<b>Euro area</b>	3.0%	0.4%	-4.4%	2.0%	1.6%	-0.7%	-0.5%	1.2%

Source: [IMF World Economic Outlook, April 2014](#)

The crisis had significant adverse economic effects and labor market effects, with unemployment rates in Greece and Spain reaching 27%. It was blamed for subdued economic growth, not only for the Euro-area, but for the entire European Union. As such, it can be argued to have had a major political impact on the ruling governments in 10 out of 19 euro-area countries, contributing to power shifts in Greece, Ireland, France, Italy, Portugal, Spain, Slovenia, Slovakia, Belgium and the Netherlands, as well as outside of the euro-area, in the United Kingdom. It is unlikely that a Brexit would have occurred in the absence of this crisis.

Most states in Europe had to bail out several of their most affected Banks with recapitalization loans or by a take-over. First –in 2009- a group of 10 central and eastern European Banks had to be rescued. The bail-out sums sharply increased Government debt and deteriorated debt-to-GDP ratios. Second, in the first few weeks of 2010, there was renewed anxiety about excessive national debt, with lenders demanding ever-higher interest rates from several peripheral countries with higher debt levels, deficits, and current account deficits. This in turn made it difficult for four out of eighteen euro-area governments to finance further budget deficits and repay or refinance existing government debt, particularly when economic growth rates were low, and when a high percentage of debt was in the hands of foreign creditors, as in the case of Greece and Portugal.

Money flocked out of crisis countries in the periphery to the core. The core –considered as a safe haven- benefitted as it could attract money for very low interest rates. Switzerland and Denmark equally benefitted but were also harmed as they had to re-valuate their currency.

Housing prices fell, leading to Bank losses but also to many individuals who saw their house “under water” (the mortgage exceeding the house value). Citizens were faced with increased taxes and reduced benefits in order to keep Government lending within the agreed SGP criteria.

The states that were most adversely affected by the crisis faced a strong rise in interest rate spreads for government bonds as a result of investor concerns about their future debt sustainability.

### **3.2 Banks in the crisis**

When Basel II had been introduced in 2005 Banks had mobbed against these too strict rules for the ratio between lending and deposits (the capitalization). Now Banks and Governments started to worry about their vitality. One source of worry was the exposure to the US Credit Market, with

subprime mortgages and “funny” financial “products. Very few Banks understood what they were about. Yet they brought in substantial bonuses for Bankers who bought and sold them, while shareholders applauded the profits these products brought in. After the subprime losses in the US in 2007 and 2008 materialized, also EU Banks turned out to be heavily exposed.

The other source was local exposure to loans which might have gone sour, in particular loans for buildings in Ireland and Spain. But also the prices paid for assets before 2007 turned out to be substantially overvalued with between 21% for the US in the period 1997-2007 (Basu, Inklaar and Wang, 2011) and 24-40% for the Euro-area between 2003-2008 (Colangelo and Inklaar, 2010). Banks were hurt when these assets (purchased with their credit) had to be sold for a much lower price than the value of the credit.

The third worry was about the loans Banks had given to Governments (to their own Government and to other Governments). With the low economic tide also other loans to southern governments (Greece and Portugal) turned toxic.

Banks had brought assets (loans) increasingly off balance through securitization so that the National Banks only learned about the real extent of their exposure when the Banks were close to collapse. Banks crashed or were saved by Governments.

Banks failed because of unregulated “greed”: they went for the most profitable even if this might be more risky. For example: buying Greek Government bonds yielded slightly more than buying German Government bonds. Regulation fed this trend by valuing Greek government bonds as safe as any other OECD country, like Germany. When the risk materialized it was the public at large, and to a lesser extent the Banks shareholders that paid the costs. In that sense from a point of view of maximizing income individual Bankers have done the rational thing to take excessive risks.

The Banking crisis shook Government finance seriously. Bail out costs of Banks as a percentage of 2010 GDP ranged from a top of 30 in Ireland to a lowest of 2.9 in Spain, with an average of 6.5 for the countries which had to bail out Banks like the Netherlands (14.4), Germany (10.8), the UK (7.1), the US (5.2), Greece (5.1) and Belgium (4.3).

### **3.3 Conclusions**

The major reason for the Euro-area crisis was simply a substantial flaw in the design of the Euro, with a misalignment of liability and control (Feld et al., 2015).” If the control and liability had been supranational – as it is in US’s monetary union – the imbalances could surely have been handled without provoking a continent-wide economic crisis. It is much more likely that at least the public debt run up would have been not allowed to go so far in Greece. Likewise, if control and liability had been effectively unified at the national level, nations would have had to deal with their own debt problems, perhaps with the help of the IMF. This might also have prevented or reduced some of the pre-crisis buildups as happens among US states (most of whom have balanced budget clauses in their state constitutions)”.

Moreover: “when the Euro-area was started, a fundamental stabilizing force that existed at the level of the member-states was taken away from these countries. This is the lender of last resort function of the central Bank” (De Grauwe, 2015). As a result, “Euro-area governments could no longer guarantee that the cash would always be available to roll over the government debt.”



Or in summary: flaws in the institutional setting of the Euro (Baldwin and Giavazzi, 2015, p. 49):

- Policies failures that allowed the imbalances to get so large;
- Lack of institutions to absorb shocks at the Euro-area level.

The Southern European economies were already less competitive than the North due to higher per unit costs but could only “internally” devalue to restore competitiveness, by lowering wage costs. This caused lower growth and lower tax revenues in these countries, giving rise to further budget cuts tax raises, with the corresponding social and political conflicts.

Fears of sovereign defaults boosted bond yields, making it much more expensive to pay interest on debt. It became a second vicious spiral with higher debt leading to higher interest rate costs making it more difficult for heavily indebted countries to repay the debts.

The early critique on the Euro (“it does not satisfy the conditions of an Optimal Currency Area”) have less played a role in the crisis than thought, even though the stabilizing mechanism of labor mobility hardly worked (unemployed from countries with high unemployment moving to countries with low unemployment) (Svrtinov, 2015).

## 4 Response and repair

### 4.1 Never waste a good crisis?

Crises are often periods of drama but also of opportunity. Never waste a good crisis is about using the opportunities for change offered by a crisis. Of the opportunities offered by the Euro-crisis only the Banking Union seems to have come to fruition.

The response to the crisis on the Euro-area level was too little too late. The crisis was mismanaged. The major source of mismanagement was –in the absence of a sovereign or an institution that could take responsibility- the need for “committee decision” making on the measures to be taken. These decisions took too long and were fraught with short term self-interests of the participants in the decision making process (the Euro-member countries). They became decisions of the lowest common denominator (Jones et al., 2016).

A second source of mismanagement was the seeming absence of learning from other crisis, in particular from the South East Asia crisis, despite the involvement of the IMF with substantial experience in fighting the South East Asia crisis: see for example Cho (2000) or Blustein (2001). In fighting the EU crisis many of the same mistakes were made as in Korea in 1999, in particular by “too little, too late policies”. The IMF involvement in Korea had shown the importance of robustness in the response. The only robust response came from the ECB President when he said that he would do everything in the books to save the Euro. Yet, this lack of robustness is to a large extent explained by the “committee decision making” agreeing on the lowest common denominator (as mentioned above).

There is considerable debate on a third element: the role of wage restraint and the lack of substantial public investment programs in the core Euro-area, in particular in Germany. Flassbeck and Lapavitsas (2015) blame part of the rising divergence between the North and the South on German wage cost

restraint, contributing to over-exporting: the core Euro-area was living beneath its means in the pre-crisis period. Storm (2016) and Wyplosz (2013) disagree pointing out that it was the appreciation of the Euro (relative to currencies of non-Euro countries) which had by far a bigger negative impact on Euro-area competitiveness than increases (or decreases) in unit labor costs. "The crisis was driven by excessive domestic demand, not by exogenous losses in competitiveness and current account deficits".

At the same time in an alternative scenario for the period 2008-2014 Eichengreen and Wyplosz (2016) argue that the crisis would have been much quicker and easier resolved if Germany had invested on a large scale in public works programs even when this might have increased its budget deficit substantially. This is in line with proposals in 2012 and 2013 from the "Deutsches Institut fuer Wirtschaftsforschung" (German Institute for Economic Research) which pleaded for an 85 billion Euro investment in infrastructure in Germany. It is also in line with the Juncker plan advanced during the European Parliamentary Elections in 2014. This plan hoped to bring about an additional investment of 300 billion Euros in the EU. It was adopted by the Commission, but the implementation seems to be difficult, because it lacked orientation and was supposed to be used as a leverage for private money (where the private-sector gusto for investment in public infrastructure exists only for profitable projects).

The Euro-area had to respond during the crisis when several Euro-area member states (Cyprus, Greece, Ireland, Portugal and Spain, the CGIPS group) were unable to repay or refinance ("roll over") their government debt or to bail out over-indebted Banks under their national supervision without the assistance of third parties like other Euro-area countries, the European Central Bank (ECB), or the International Monetary Fund (IMF).

When in non-Euro countries it becomes difficult to 'roll over debt' on reasonable interest rates (issue new debt when old debts are paid off) the Central Bank of that country intervenes to buy government bonds. This can reassure markets, prevent liquidity shortages, keep bond rates low and can help to avoid panic. But, the ECB made it very clear to markets in the beginning of the crisis (spurred by the core EU countries) that it would not do this. Thus it became evident to the financial world that countries in the euro-area had no lender of last resort, so that a liquidity crisis actually might lead to a default<sup>4</sup>.

Banks of non-CGIPS group Euro-countries owned a significant amount of sovereign debt in other Euro-area countries, including CGIPS countries, for example: German Banks in French Banks and French Banks in government debt in Greece. A default of Greece would then this would have made large segments of the Euro Banking system insolvent. Bank-bankruptcies would in turn have threatened the solvency of sovereigns.

There were two reasons why "financial markets" sold Greek and Italian bonds: high structural debt, but also because of (very) poor prospects for growth, while Euro countries could not buy their own

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<sup>4</sup> For example, UK debt has risen faster than many Euro-area economies, yet there has been no rise in UK bonds yields. One reason investors are willing to hold UK bonds is that they know the Bank of England will intervene and buy bonds if necessary.

bonds through their Central Banks. Financial markets feared for a sovereign default especially of Greece which in turn would have its impact on the Banks in other countries threatening the solvability of these countries as well. This forced the Euro countries to work together with the IMF to develop a rescue package.

Four euro-area states had then to be rescued by sovereign bailout programs, which were provided jointly by the International Monetary Fund and the European Commission, with additional support at the technical level from the ECB. Together these three international organizations representing the bailout creditors became nicknamed "the Troika".

The response to the Euro crisis in the form of this rescue operation was first and foremost slow, as it had to be negotiated between so many partners (in contrast to the response in the member states where government decided). After much debate the European Financial Stability Facility (EFSF) and European Stability Mechanism (ESM) were introduced. The ECB also contributed to solve the crisis by lowering interest rates and providing cheap loans of more than one trillion euro in order to maintain money flows between European Banks. In 2012 the ECB calmed financial markets by announcing free unlimited support for all euro-area countries involved in a sovereign state bailout/precautionary program from EFSF/ESM, through yield-lowering Outright Monetary Transactions (OMT). This is widely seen as a powerful tool for ending the "debt vortexes" (the spiral downward of rising interest premiums making debt to GDP ratio's look questionable, lowered credit ratings and rising premiums) (Baldwin and Giavazzi, 2016). At the same time it is viewed as a stop gap measure that needs to be complemented with more direct measures that reduce the likelihood and cost of any future cycles where a Euro country's liquidity problem get transformed into a solvency problem.

Return to economic growth and improved structural deficits enabled Ireland and Portugal to exit their bailout programs in July 2014. Greece and Cyprus both managed to partly regain market access in 2014. Their bailout program was scheduled to end in March 2016, but this is now deferred to October 2018. Spain was never officially involved in a bailout program. Its rescue package from the ESM was earmarked for Bank recapitalization and did not include financial support for the government itself.

In mid-2012, due to successful fiscal consolidation and implementation of structural reforms in the countries being most at risk and various policy measures taken by EU leaders and the ECB financial stability in the euro-area had improved significantly and interest rates had steadily fallen. This had also greatly diminished contagion risk for other euro-area countries. As of October 2012 only 3 out of 17 euro-area countries, namely Greece, Portugal, and Cyprus still battled with long-term interest rates above 6%. By early January 2013, successful sovereign debt auctions across the euro-area but most importantly in Ireland, Spain, and Portugal, showed investors believing the ECB-backstop worked. In November 2013 ECB lowered its Bank rate to only 0.25% to aid recovery in the euro-area. As of May 2014 only two countries (Greece and Cyprus) still need help from third parties.

Despite all actions of the ECB, the Euro-countries and the IMF, economic growth in the Euro-area and in the EU has been lower than in the US over the period 2008-2015. In part this is the result of the way the Euro-area came into the crisis with substantial imbalances. But for another part is the construct of the Euro-area itself with too little economic coordination and perhaps an inadequate economic model relying too much on markets and too little on public coordination (see: Ritzen and Zimmermann, 2014).

During the period 2005-2014 accumulated economic growth was negative in Italy (-4.4%) and Greece (-18.6%). It was above 20% in the Baltic States, many Central and Eastern European Member States (Bulgaria, Czech Republic, Poland, Rumania and Slovakia) and the City-States Luxemburg and Malta, with an average for the EU as a whole of 9.3%.

All of the countries who had to seek refuge under the umbrella of emergency funding (Cyprus, Greece, Ireland, Portugal and Spain) showed positive economic growth rates as of 2013. Onwards from 2013 Ireland is leading the pack with the highest growth rate of all EU member states. However, the economic problems of the South of Europe are far from resolved with still relatively bleak prospects for economic growth (Gros and Alcidi, 2013) and substantial debt.

Exit was and still is discussed in the period of repair in the context of Greece (“Grexit”) (Pisany-Ferry, 2012 and Sinn, 2015). Grexit accompanied by debt relief, humanitarian aid for the purchase of essential imports and an option for eventual return to the euro is considered by many a better option. “Greece could reintroduce the drachma as the only legal tender. All existing prices, wages, contracts and balance sheets, including internal and external debt, could be converted one-to-one into drachmas, which would immediately decline in value. The devaluation would induce Greeks to buy domestic rather than imported products. Tourism would get a boost, and capital flight would be reversed. Rich Greeks would return with their money, buy real estate and renovate it, fueling a construction boom. As the trade deficit gradually turned into a surplus, creditors would get some of their money back. Greece would have the option to return to the Euro-zone, at a new exchange rate, after carrying out institutional reforms — such as public recording of land purchases, functioning tax collection, accurate statistical reporting — and meeting the normal conditions for Euro-zone membership. It could take five or 10 years” (Sinn, 2015).

A Grexit along these lines sounds as too good to be true. For a proper perspective one has to recognize the other side of the medal: what would happen with the existing debt and how is the transition to be handled? If the existing debt remains in Euro’s than Greece would be worse off than before: it will have to repay more in Drachmes, than it would have to repay in Euro’s. If -as a more reasonable alternative - Greece’s debt would also translate from Euro’s into Drachmes then this would mean a serious reduction in debt (the size of which is determined by the ensuing devaluation). More-over exits from a currency union or defaults of Governments on their debt are often accompanied by hyper-inflation (see further: section 5.3), as had been the case in Argentina in 2001<sup>5</sup>. Presumably the Troika did not go for a Grexit because it feared that such a reduction in the size of Greece’s debt would endanger the position of the French and Italian Banks holding large portions of Greece’s debt, and the position of the German Banks, holding large portfolios in French and Italian Banks. A Grexit might have caused an uncontrolled domino-effect if it had been pushed for in 2009/2010. Lastly, the concern for a paralysis of financial markets in case of a Grexit in 2009/2010 is real, if one looks at the panic caused by Lehman Brothers.

Exit was more broadly discussed around 2012 with suggestions of a new line dividing the Euro-area into a “Neuro” (North) and a “Seuro”-area (South). Some initial calculations showed that the impact

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<sup>5</sup> The 2014 default of Argentina was in this respect different as it was brought about by a court case of one party demanding money from the Argentinian Government, not from a wholesale inability to pay off on debt.

of such a policy would have serious costs due to the uncertainty generated and the reactions of financial markets.

In the repair period the EC negotiated with the Member States to frame the SGP into a "Semester Approach" (the macro-economic imbalance procedure), while recommending the set-up of national "Competitiveness Authorities". These "Authorities" should be independent and assess both actual competitiveness (compared to other Euro-countries) as well as policies to increase competitiveness. The MIP was created at the height of the crisis. It is part of the European Semester: the annual cycle of reporting and surveillance of EU and national policies. In this "Semester" approach the EC provides "Country Specific Recommendations" of a general nature (for example: too rigid a labor market). These are very much like the IMF country surveillance recommendations. Their impact is positive on development, but limited, as there is no mechanism to enforce their implementation. The way they are framed is seen by many outside observers as too rigid and too complex.

The SGP was substantially stiffened with rather massive amounts of national sovereignty being shifted to European control. There were five new provisions and one directive (the "Six Pack"), and surveillance and coordination were enhanced (the "Two Pack"). Fiscal rules were anchored at the national level via the Fiscal Compact (Baldwin and Giavazzi, 2016). While useful, observers see the system as unworkable. Jean Pisani-Ferry (2016) writes: "The piling up of fiscal, economic, and financial surveillance procedures has made the system of policy rules undecipherable even for insiders. For this reason there is little ownership of it among national policymakers, and even less among national parliamentarians...".

#### **4.2 Banking: response and repair**

Early in the crisis Basel III was agreed upon. This was once more a voluntary framework aimed at increasing Bank-liquidity and decreasing Bank leverage (the ratio between loans given out and savings received plus the capital for running the Bank). These measures were to be introduced in 2010-2011. This time Banks in the Euro-area followed meekly the advice (in contrast to Basel II). Of course, this reduced the private Banks potential to provide credit.

The "Banking Union" was introduced with severe conditions imposed on private Banks and requiring countries to let the bond- and shareholders and the individual savers carry the brunt of a default of a Bank (bailing in), effective in 2015. In this way the lethal Bank-Government debt loop (called the "doom" loop) is closed. In this loop the tax payer will foot the bill for a Bank-insolvency, so that Bank-insolvencies will not increase Government debt.

The "Banking Union" introduced stress tests and the requirement of a "living will". The stress tests are to show the viability of the Bank if economic growth in the country would take a downturn over a set period of time (say 3 years). The "living will" requirement is to formulate confidentially the process of winding up the Bank in case of a default, without burdening the public coffers.

These tests have successfully brought out the weaknesses in Banks. The 2016 round of tests (the fourth round) showed for example that the oldest European Bank (the Monte dei Paschi di Siena) would not survive serious economic stress in Italy.

Repair of the Euro finance sector is still in the process of implementation with the measures of the Five Presidents Report (EC, 2015). This report admits frankly: "In a Monetary Union, the financial

system must be truly single or else the impulses from monetary policy decisions (e.g. changes in policy interest rates) will not be transmitted uniformly across its Member States. This is what happened during the crisis, which in turn aggravated economic divergence" (p. 11).

The ECB made true to its word to "do everything possible to save the Euro". Even though it was not allowed to extend Euro bonds as a way to borrow money, it ensured lower interest rates for heavily indebted countries by buying up their bonds on a massive scale.

The ECB followed the US in "quantitative easing" (the large scale printing of Euros) as a means to drive up inflation (dangerously hovering around the deflation point). However, this put further strain on the system, characterized by a tremendous divergence in labor productivity. It's like a cart pulled by horses with different strengths. It slows down the cart below the best performer, while the slow horses become more and more exhausted and in danger of collapse.

Lastly the interest policy of ECB ensured low interest rates to the point that "money became almost for free" (close to zero interest rates). The ECB Board became increasingly and openly split on the monetary policies with some of the core countries openly opposing the quantitative easing, as their economies suffered substantially in pensions and savings, while driving up prices of assets (real estate) and shares to a potential bubble. To be sure: the low interest rate policy of the ECB is not some whim from a politicized Central Bank leadership. Also the Central Banks in other parts of the world (in particular the US) used low (short term) interest rates to spur investment. Some even come to the conclusion that even long run interest rates are likely to be low, because of the ageing of the population which creates strong incentives to save for pensions (Von Weizsäcker, 2015). This is part of the reasons for "secular stagnation" with low economic growth as a consequence (see section 5.2).

At the end of the repair period (2013/2014) there was still substantial "debt overhang": a size of debt in a country which is too large to permit reasonable economic growth (as interest payments take away more than the extra revenues of the countries for growth). The SGP stated a percentage of government debt to GDP as 60 as a safe maximum. Many others now speak of 90% debt to GDP as the start of "government debt overhanging the future of the country" (Corsetti et al., 2015). No less than 8 out of the 19 Euro countries are still "overhung" by debt as of 2015 (in order of increasing debt: France with 97%, Ireland, Cyprus, Belgium, Spain, Portugal, Italy, and Greece with 195%).

## 5 A sustainable future 2017-2030

### 5.1 Introduction

There is a serious risk for the Euro-area to fall apart in a chaotic way in the years to come. The Euro-area would be in great danger if a new economic crisis would emerge. New crises cannot be excluded with the present levels of debts of countries and the size of "bad debt" in private Banks in some of the countries with high public debt. But even without a crisis countries might be driven out of the Euro by political resistance against EU membership.

Low levels of economic growth in the next 10 years in an explosive mix with more inequality might stimulate political resistance against the EU. The divergence between the North and the South, in terms of incomes and competitiveness is a further threat to the sustainability of the Euro.

There is broad agreement among economists on the fact that the Euro –as it is organized at present– is not sustainable (see for example: Baldwin and Giavazzi, 2016 or Stiglitz, 2016). But there is also the other side, advanced by Mitchell (2014), Sinn (2015) and Stiglitz (2016): the Euro area could be so much better organized. It should allow for exits. Essential in this reasoning is that the Euro area becomes again an area of convergence in productivity and economic growth while the present straightjacket of the Euro has worked just the other way around.

Convergence in economic growth appears to be necessary for a currency union to work across nations. This might be different within nations where different regions with diverging productivity and growth rates may co-exist (for example in Germany, between the less competitive North and East and the more competitive South), because there is the linking power of the nation. The EU cannot as yet provide such a linking power.

The Euro has not served its purpose as was intended: to contribute to convergence. Borio et al. (2015) document that the divergence in labor productivity in 2015 is greater than it was at the start of the Euro (in 2000). They attribute this to the credit boom of the early Euro years (the North “investing” their trade surpluses in the South). Credit booms are shown to reallocate labor from more to less productive activities. We depart from the notion that the Euro either should be restructured to ensure convergence or in going to fail.

Much then depends on the economic growth perspectives of the Euro-area as a whole and the individual countries in the Euro-area. The growth perspectives are discussed in sub section 5.2. For the developed world as a whole low growth is likely. The Euro-area is no exception. But there are substantial differences in growth between the North and the South: the divergence of the past 5-10 years is likely to continue unabated at least for the next 5-10 years adding strain to the Euro.

The sustainability of the Euro is discussed here from the vantage points first of the leadership of the EU as captured in the Five Presidents Report (subsection 5.2). Many of these proposals are broadly supported and help the Euro to become more sustainable, but they rely too much on trust in the support for “more Europe”, in the form of a fiscal union. This plan A appears to be unrealistic for the fore-seeable time. Therefore we look here into a plan B.

Broadly supported is definitely the further development of the Banking Union (as discussed in subsection 5.4). Inherent in the Banking Union is the break-up of the ‘doom loop’ between Banks and their sovereigns. This Banking Union needs further steps before it can be considered as “completed”, in particular by ensuring a Europe wide insurance guarantee system.

There is practically unanimity among economists that it would be urgent to dealing with “the debt overhang” that is bringing countries with excessive sovereign debt back into a position where they can realistically grow economically and be able to repay their debts. The Five Presidents report assumes a general sharing of the debt –accumulated in the past in particular in the South. There is no gusto for such a proposal. The “debt overhang” needs to be resolved in other ways, as discussed in subsection 5.5. All of these proposals require “solidarity” from the North. This can only be expected in our view in a “New Deal” in which the North can count on the willingness of the South to re-engage in a convergence course in productivity and economic growth.

The possibility of an exit from the Euro is discussed in subsection 5.6. This is linked to the notion advanced by some economic thinkers of “letting the Euro-area breath” (Sinn, 2016), by allowing an orderly exit of countries. Exit is to be related to a “New Deal” on debt reduction or debt-mutualization.

Such a “New Deal” with a reduction of the debt-overhang for highly indebted countries, with voluntary or forced exit from the Euro area in case of a breach of the rules could save the Euro-area from chaos. The New Deal should include elements on “hope for the future” for those who have reverted to populism and nationalism as an answer to financial uncertainty (Ritzen et al., 2016). It is essentially a deal between three groups of countries with different stakes:

- The lowly indebted but relatively poor Central and Eastern European countries. They are on a convergence path in labor productivity with the West.
- The highly indebted relatively poorer Southern European countries with a divergence in labor productivity with the Western core group.
- The countries often called the “core” (Germany, the Netherlands and some other countries) that have substantial balance of payment surpluses while Government debt and financing deficits are close to the “Maastricht” criteria.

The only way such a deal can come about is by the recognition of a joint interest. This joint interest is clearly available in the position of the Euro as a reserve currency and in the power the EU and the Euro-area have in international negotiations. It would be a way for Europe of maintaining its system of values and democracy in a fast globalizing world.

## 5.2 Secular growth?

The economic growth prospects for the years to come are important for this analysis: high growth rates with low unemployment would be beneficial to make the changes towards a more sustainable Euro. However, high growth rates across the EU are unlikely. Gordon (2015) has extensively argued that economic growth of the past 100 years is not likely to be continued in the near future in the US or in OECD countries in general. Also Summers (2014) supports the notion of “secular growth”: low growth as a result a hesitation to invest, leading to lower demand for goods and services. The Euro-area might in many respects already be an example of “secular growth”.

Von Weiszaecker (2015) argues that secular stagnation is the consequence of a relatively recent characteristic of the world economy: the end of capital scarcity, leading to a negative ‘natural’ rate of interest (i.e. the rate of interest which would prevail if there were no Government debt). This in turn has a lot to do with the ageing of the population: younger people have to save more in an ageing society to guarantee their old age pensions. This depresses the interest rate, unless the demand for savings (investment) would substantially increase. That is not the case when technical progress makes investments with the same productivity cheaper. This phenomenon was first described by Alvin Hansen in 1938.

Sinn (2014) however sees the low interest rates as “self-inflicted malaise.” The crisis was in his view a bursting of a bubble in asset prices: a “creative destruction”, preceding a new phase of rapid expansion. However –in his view- monetary policy preempted the creative destruction that could have formed the basis for a new upswing in growth. “Asset holders talked central Bankers into believing that Schumpeter’s economic cycle could be overcome by large-scale bond purchases



financed via the printing press, and by corresponding interest-rate reductions. To be sure, these measures stopped the fall in asset prices halfway and thus saved much wealth. But they also prevented sufficient numbers of young entrepreneurs and investors from risking a new start". Also this might be part of the story, it ignores the fact that apparently also other parts of the developed world (North America) choose for the same self-inflictions

He believes that "the only way out of the trap is a hefty dose of creative destruction, which in Europe would have to be accompanied by debt relief and exits from the euro-zone, with subsequent currency devaluations. The shock would be painful for the incumbent wealth owners, but, after a rapid decline in the dollar values of asset prices, including land and real estate, new businesses and investment projects would soon have room to grow, and new jobs would be created. The natural return on investment would again be high, meaning that the economy could expand once again at normal interest rates. The sooner this purge is allowed to take place, the milder it will be, and the sooner Europeans and others will be able to breathe easy again".

At the same time the little growth we experience is combined with mechanization and robotization (Brynjolfsson and McAfee, 2014) inducing less demand for semi-skilled or low-skilled workers that hold jobs in routine work, while the demand for high skilled workers continues to rise. The supply surplus of less well skilled workers translates in stagnant wages, while the wages of high skilled labor continue to rise. The political impact of such a rise in inequality in a low growth setting is substantial as Ritzen et al. (2016) show for euro-skepticism. This seriously limits the room for maneuver of Governments within the present economic model.

The Euro can only be sustained if there is convergence in labor productivity across the EU countries. This is not likely to happen without considerable effort: projections (like those of Gros and Cianza, 2013) give a different perspective for developments between the North and the South. "They show that Eastern European countries (e.g. Poland) are in economic catch-up phase with the rest of Europe. In the years prior to the crisis, they were a desirable location for industrial activity due to lower wages than in Western Europe. These countries had initially low levels of public debt. Even if their wages rose sharply, they remained highly competitive due to the very low initial levels of labor costs. The economic catching-up of these countries takes the form of a sustained labor productivity growth rate." "Eastern European countries originally had lower levels of GDP per head, but higher rates of GDP per capita growth. In contrast, the countries of southern Europe, ...are in a situation of divergence with the rest of Europe. Starting off from a situation of lower GDP per capita than the EU27 average in 2010, they also experience GDP per head growth rates that are lower than the EU27 average."

### 5.3 Vision Five Presidents Report

The vision of the "Five Presidents of the EU" (2015) for the EU (and the Euro) to develop is profound:

"Progress must happen on four fronts: first, towards **a genuine Economic Union that ensures each economy has the structural features to prosper within the Monetary Union**. Second, towards a **Financial Union** that guarantees the integrity of our currency across the Monetary Union and increases risk-sharing with the private sector. This means completing the Banking Union and accelerating the Capital Markets Union. **Third, towards a Fiscal Union** that delivers both fiscal sustainability and fiscal stabilisation. And finally, towards **a Political Union** that provides the

foundation for all of the above through genuine democratic accountability, legitimacy and institutional strengthening” (p. 4).

In many respects this echo’s the spirit of the Maastricht Treaty and the Delors report (1989) that preceded this Treaty. The Five Presidents want to go for one speed, for one “menu” and not for an “EU a la carte”, as the continuation of their report states:

“All four Unions depend on each other. Therefore, they must develop in parallel and all **euro area**<sup>6</sup> Member States must participate in all Unions. In each case, progress will have to follow a sequence of short- and longer-term steps, but it is vital to establish and agree the full sequence today. The measures in the short term will only increase confidence now if they are the start of a larger process, a bridge towards a complete and genuine EMU. After many years of crisis, governments and institutions must demonstrate to citizens and markets that the euro area will do more than just survive. They need to see that it will thrive. This longer-term vision needs the measures in the short term to be ambitious. They need to stabilise the European house now and prepare the ground for a complete architecture in the medium term”.

Although this was written before the UK voters decided to leave the EU it still doesn’t sound as very closely related to the feelings among citizens and Governments (even though Governments were consulted before the Five Presidents Report was published). In particular the following sentences appear to be rather utopian for the near future:

“This will inevitably involve sharing more sovereignty over time. In spite of the undeniable importance of economic and fiscal rules and respect for them, the world’s second largest economy cannot be managed through rule-based cooperation alone. For the euro area to gradually evolve towards a genuine Economic and Monetary Union, it will need to shift from a system of rules and guidelines for national economic policy-making to a system of further sovereignty sharing within common institutions, most of which already exist and can progressively fulfil this task”.

The Five EU Presidents offer one single solution for the sustainability of the Euro: more power to the EU to repair the basic “Maastricht” flaw of the divergence between liability and control (see section 3.3 on the causes of the crisis), including a European budget, with European taxes and European debt rather than country debt. In this Five EU Presidents vision there is no plan B for the present situation in which virtually no EU country is willing to engage in more transfer of sovereignty to “Brussels”.

It is our attempt here to contribute to the thinking on a plan B which departs from strengthening the existing structure, in which some States are Euro-members and others are outside of the Euro. Euro membership should be attractive and to be sought for, rather than to be considered a liability and a curse. Countries like Denmark and Sweden should be tempted to join.

Plan B should have solutions for the banking system and for the debt overhang to be discussed in the following two subsections, without resorting to more transfer of sovereignty. This is found in the

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<sup>6</sup> The bold is the author’s.

“breathing space” in a New Deal with debt mutualization but including automatic exits in case of breaching the terms of the deal.

## **5.4 The Banking Union moving forward**

### *5.4.1 Supervision, resolution and deposit insurance*

The Five Presidents proposals for the Banking union are brilliant and should be pursued under any broad vision of the future of the EU. The kind of transfer of sovereignty towards the EU for the Banking union is broadly supported by citizens who are fed up with a financial system which is mostly to the benefit of new elites while the risks which have turned sour are pushed onto the shoulders of those citizens. The Banking Union takes a big step towards reducing systemic risk in the Euro-area. Before the crisis, Banks were a national responsibility. Yet during the crisis, it became clear that responsibility for stabilizing the Euro-Banking system was a burden that could only be shouldered at the EU-level. The Banking union is also needed to cut the “doom loop” where Governments had to bail out banks only to notice that their own debt levels became unmanageable.

The Five Presidents (EC, 2015) envision a "truly single system" with single Bank supervision, single Bank resolution and single deposit insurance. The "Single Supervisory Mechanism" is in the process of construction. The single supervision is a clear answer to lack of centralized Banking supervision, together with the absence of clear responsibilities in crisis management (Begg et al., 1998). The crisis has shown that internationalization of financial sector has to be accompanied by internationalization of regulation and oversight. This awareness grew leading to the notion of a single supervisor as early as 2012. An effective EU/euro supervisor for the pan-European Banks requires:

- Be able to act in a matter of hours” (Wyplosz, 2015).
- Real (time) data sharing on the Banks (beyond the mandate to ask for data).
- Burden sharing, what is needed is an ex-ante legally enforceable agreement on the distribution of costs.
- Crisis resolution, the European supervisor needs a European government to take the final decisions on how to wind up defaulting Banks.

The "Single Resolution Mechanism" has been agreed but not fully implemented. This fund provides for the money of Bank defaults and is to be privately funded. The single resolution mechanism is an answer to problems of the past: the Euro area needs to have a lender of last resort.

The "European Deposit Insurance Scheme" (EDIS) should be ready by July 2017. Common deposit insurance is a form of "automatic stabilizers" when economic shocks hit countries in different magnitudes ("asymmetric shocks"): an EU deposit insurance would reduce the excessive exposure of a single euro country due to the home-country principle for cross-border Banks that is in place now (Allen et al., 2011, Veron, 2011). This Scheme is to be funded by private Banks

These three approaches complement the EMS: the European Monetary Stability Mechanism, set up to recapitalize Banks in trouble (respecting the bail-in guidelines). The EC is well aware that these measures may not be sufficient. In particular the capital requirements of Banks are subject to the

guidelines of the National Banks, thus creating a slanted playing field<sup>7</sup>. Capital requirements should also be imposed Euro-zone-wide. The ESM is designed to help share risk among Euro- members by providing financial assistance to crisis-stricken countries in the Euro-area. It is widely supported, even though there are questions. One question is whether it is insufficient to deal with large systemic crisis. A second is that the decisions have to be taken by unanimity with prior approval by national Parliaments, which makes its availability uncertain and too open-ended to instill confidence (Baldwin and Giavazzi, 2016).

As a by the way: it is important to recognize that the EU could decide also to open up the Banking union to non-euro countries. Part of the rationale of the Banking union is the common currency. Another part is a hedge against the impact of globalization on finance. Scale in risk assessment and supervision is helpful, and could also be extended to non-Euro EU countries<sup>8</sup>.

While the Banking union is needed, a more fundamental review of the finance sector in the Euro area would be appropriate. The financial sector has inadequately assessed the risks and has exhibited a short-term orientation and the interests of society and individual Bankers have increasingly diverged. The risk assessment is dealt with in the proposals of the EC (2015) by means of the "European systematic risk board" and by means of procedures avoiding bail-outs as bail outs are essentially the burdening of the public for bad risks, while the good risks are captures privately. Bail outs contribute to "moral hazard". They also create the dangerous loop from Bank problems to Government problems in case of Bank failures. Fiscally undisciplined governments and their lenders must know with 100% certainty that they will not be bailed out (Wyplosz, 2015).

#### *5.4.2 Finance beyond the Banking Union*

Van Tilburg (2014) sees the need for more structural reform ahead:

"The trend in the financial sector towards ever-increasing size, complexity and risk has to be reversed. Finance must become manageable again, this means:

- More transparent, so that regulators, market participants as well as the public at large are better able to see where risks are building up and what is the right price for financial products and services.
- More sober, so that there will be less incentives to focus on short term gains at the expense of long term costs. A more sober and long term oriented remuneration policy is one important aspect in this, but so are realistic profit expectations.
- Less interconnected and complex, so that market discipline can play a bigger role and the need of state aid is reduced.

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<sup>7</sup> In many Euro-countries private Banks hold debt of their own sovereign equivalent to more than 200% of their capital. Rises in the risk premia of the sovereign's debt during a crisis always lowers the market value of government bonds on the Banks' balance sheets. A substantial rise in the risk premium can thus wipe out a Bank's capital (Baldwin and Giavazzi, 2016).

<sup>8</sup> The Five Presidents seem to go in the same direction, apparently assuming that plan A is not going to work in the near future: "The process towards a deeper EMU is nonetheless open to all EU Members" (EC, 2015, p.10).

- More diverse. Group-think and tunnel vision has been a severe problem. This should give rise to more diversity within financial institutions, of valuing dissent voices and organizing internal and external debate. The Banks' leadership (CEOs and Supervisory Councils) are almost entirely drawn from the financial community in contrast to the broad societal role of finance”.

The bigger the Bank, the bigger the chance the Bank will be “systematically” important and hence needs public guarantees: “The formation of cross-border Banks will also tend to increase the complexity, the interconnectedness and the size of institutions. Cross-border Banks are hence more likely to be systemically relevant Banks. Their failure may thus impose significantly higher costs on economies than the failure of a purely domestic Bank. In addition, international diversification tends to make previously domestic Banks more similar. This can increase the likelihood of systemic crises – even if diversification has the potential to reduce isolated Bank failures” (Allen et al., 2012).

However, small is no panacea. Small Banks have failed as well as was shown during the crisis (for example, S&L in the US and Landes Banken Germany). Large cross-border Banks can make the financial system more resilient by providing diversification. In that sense further integration of Europe's Banking system could make Europe and the Euro-area more resilient against major aggregate economic downturns in the future. The key is to let regulation and supervision follow the internationalization that Banks have already accomplished, as would happen with the new supervisory authority.

More is needed in terms of making Banks more resilient than what has been achieved through Basel III. Raising capital- and liquidity requirements (especially for large Banks and in good times), introducing a leverage ratio and better risk weighing of assets are all important steps. However, looking at the losses that Banks made in the last crisis, capital requirements should be made higher, possibly through the use of bail-in debt (debt that can be transformed into equity when needed) as is done in the UK and Switzerland.

The implicit guarantee of the government to systemically important Banks has become all too explicit during the recent financial crisis when many Banks were saved by their governments. With an even smaller number of big Banks around now than before the crisis, this moral hazard problem now is probably higher than ever. This is especially an EU-problem, on a first list of ‘systemically important financial institutions’ (SIFI) 29 have been identified, amongst which 17 European firms, 8 US firms and just 4 Asian.

Shareholders of Banks suffer from an excessive short term focus of shareholders. Public policies could address these. Several proposals have been made to correct this, like a Governance including non-financial sector representatives, giving extra voting rights and/or dividend (or tax breaks) to long term shareholders or punishing frequent stock trading through a transaction tax, like the UK stamp duty).

There are substantial new developments in providing credit (Egan, 2016): “new players and ideas will emerge; many from the start-up community but mostly from adjacent industries... the rise of the Networked Bank, the rise of the platform, the rise of the user and ultimately, the accelerated demise of the traditional notion of Banks and Banking”. ICT makes it easy to fulfill the role of providing

liquidity by other means, by crowd funding, by angel and venture investments funds. Peer to peer lending like prosper.com and lendingclub.com. However, the official Banks will retain the function of “money creation”: lending in excess of depositions. The fast developments in the traditional role of Banking (the provision of liquidity) still make it necessary to reflect on the Government control of Banks that “create” money.

Yet, they but need to be extended by measures to split up Banks in a “public” part with guarantees and a “private part” which carries more risks from which shareholders and savers benefit of –in case of a default- suffer. There is no reason why they should not be implemented with the greatest possible speed. Political support will be broad from the right to the left. Only selected groups might want to keep control of public part of private Banks, as this serves their personal interests.

#### *5.4.3 The ECB*

In principle the role of the ECB is well-defined. However, during the crisis, the ECB was seriously hampered by disagreements in the Board (the Euro system’s Governing Council composed out of the Presidents of the National Central Banks of the Euro countries), leading to long delays in dealing with the crisis. These disagreements were sometimes of an economical-philosophical nature, but mostly the result of conflicting interests of the Euro-area member states, represented in the board. The disagreements became public in the period around 2015/2016 undermining the trust in the ECB.

The structure of decision making in the ECB has gone through major steps. Initially the ECB Board with President Duisenberg at the helm had to agree in unanimity in order to reach a decision. Subsequently this became under President Trichet decisions by consensus (leaving the opportunity for some dissent). The present structure is one of majority decision making in which each Euro country counts for one vote independent of the size of the country.

Majority decision making is risky when there is a strong difference in interests between the countries with low and with high labor productivity growth and the corresponding trade deficits and surpluses. Many of the peripheral countries with low productivity growth would want the monetary policies to be stimulating for the economy, while the core countries want them to be neutral. The peripheral countries form a majority and have given a leeway for the ECB to go for expansionary policies, by a program starting in March 2015 to buy up from private Banks Government bonds, business bonds and securitized mortgage loans for 80 billion Euro per month as a form of “quantitative easing”. Private Banks would have more money to lend out to businesses and individuals for investments. This would encourage investors to buy more equipment and thus contribute to the economy. It would reduce the interest rate for investors as I would the overall interest rate and contribute to inflation –which was aimed to be on the level of 2% a year in the Euro-area<sup>9</sup>.

This conflict of interest has played out in 2015/2016 around quantitative easing and the low interest rates. For the core countries (especially Germany and the Netherlands) with strong economies these low interest rates play out negative in society (for pensions, savings) while contributing to asset price

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<sup>9</sup> This goal was set before the substantial reduction in energy prices. Part of the low inflation in the period 2014-2016 was the result of the decrease in oil and energy prices.

bubbles. For the periphery these ECB policies bring cheap interest payments on Government debt, but as such also an incentive to procrastinate on reducing debt.

A first question arose whether indeed the quantitative easing had worked. Analysts say that 90% of the extra money stayed within the financial sector and was not transmitted to the real economy through investments. They point out that on the one hand the price of new capital (machines) has decreased (as a result of the substantial increase in the power of computer chips) while on the other the taste for investment has decreased. The latter is apparently not to be swayed by low interest rates. The core countries would want to stop with quantitative easing.

The ECB Governing Board must act in independence without accountability to the Governments of the countries for the ECB to fulfill its role<sup>10</sup>. Formally this is case. But informally National Bank President will act for the benefit of their National Central Banks and thus for their country.

The divergence in productivity growth and trade between the North and the South thus puts a serious bomb under the cohesion of the ECB Board.

### **5.5 Dealing with the debt overhang**

There is broad agreement that the much needed convergence in the Euro-area can only be achieved by dealing with the debt-overhang (e.g. Bertola et al., 2014 or Corsetti et al., 2005). Brunnermeier, James, and Landau (2016) argue similarly pleading for a Euro-wide insurance mechanism built on a form of Eurobonds designed to please both France –with its Keynesian logic- and Germany with its strong adherence to zero debt budgeting. The economists writing on the future of the Euro in Baldwin and Giavazzi (2016) all agree on the need for “debt-mutualization” in one form or another.

Debt levels are far beyond sustainable levels for several periphery countries. High debt levels are likely to act as a further drag on already low growth, as servicing debt requires the transfer of resources from debtors to creditors. Slower growth, however, will exacerbate the debt overhang problem. Debt rescheduling is therefore imperative as a no-regret scenario in the face of the likely prospect of low international economic growth.

Many different proposals have been launched to reduce the debt overhang, e.g. Van Tilburg (2014) or Corsetti et al. (2016). The general characteristic of a solution is to create a “Stability” Fund which is fed by all Euro countries. This Fund effectively buys up the debt of countries, so that debt service (the payment of interest is reduced. “Hence, countries swap national debts which are subject to default risk for a “nominally” safe asset issued by the stability fund. The fund would be guaranteed by the ECB”. At the end any deal with the debt overhang requires some form of redistribution from less to more indebted countries. Eurobonds is another form of mutualization of debt.

But why would creditors agree with debt rescheduling, debt reduction or debt mutualization? Why would Euro-area countries who are net creditors agree to a Fund to help heavily indebted countries?

The Five Presidents seem to understand that the future of the Euro is bleak when they write: “It raises the question whether they [the euro-area countries] will move towards integration primarily by sharing risks or whether they will put emphasis on better adherence to discipline”. Apparently

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<sup>10</sup> Stiglitz (2016, p. 157) pleads –in contrast- to a more political accountability of Central Bank Presidents.

they do not believe in a bridge between the two. Plan B is based on a realignment of risk-sharing and adherence to the rules. The latter statement is somewhat puzzling. Risk sharing was not in the original Euro-area design, but de facto has taken place by the interdependencies between the banks of the EU countries, with insufficient oversight of the Central Banks. Also the ECB policies de facto are a form of risk sharing.

The willingness to share risks depends on the presence of “moral hazard”. If countries are not sure about other countries to following the agreed common rules for fiscal responsibility, then they are less willing to share risks. Moral hazard is a situation in which one party gets involved in a risky event knowing that it is protected against the risk and the other party will at least incur the cost. It arises when both the parties have incomplete information about each other. The European private banks used to be in that position. They took risks and profited to the benefit of the shareholders and the bankers themselves through the bonuses. Or they took risks and lost, with the bill deposited at the tax payer: bail out.

In the past there used to be great both political profit and some economic short-run profit to be gained from NOT following the rules (and even from forging the data). A second best was to reluctantly following the rules and lamenting that the resulting policies –often dealing with more flexibility on the labor market, cuts in welfare and more in general public budget cutting- are the fault of a neo-liberal “Europe” imposing austerity. This was a lose-lose game. It was self-destructive. The post-crisis period is one of renewing the vow of discipline (but hardly supported by the population). This lack luster renewal is at peril of being renege upon against a history of no effective penalties. We suggest that whomever (as a country government) puts himself or herself out of the pack by renege on discipline is indeed left out of the pack until further order and is supposed to leave the Euro area. This might be a basis of the renewed confidence and trust needed to reschedule debt.

There might be a willingness to reschedule debt if countries would promise to the necessary to achieve competitiveness, so that creditors can see a better chance for the return of the remaining debt. These reforms are of the type of fiscal austerity and downward wage flexibility. “Weak domestic demand moderates price and wage inflation, supporting the real devaluation path that is needed to restore the competitiveness lost during the boom years. That path can be followed in less costly manner and at a faster pace if wages adjust flexibly” (Bertola et al., 2014). These are exactly the reforms so heavily opposed by large segments of the population and leading to a rise of the populists’ parties. They are also the reforms of the semester approach of the EU. Also Van Tilburg (2014) point in the direction of a “tit for tat”: “reduction of the debt overhang in exchange for permanent changes in institutions”. In this context often debt/equity swaps are proposed. These are transactions in which the debts of a country are exchanged for something of value, equity, with the notion that this value is created in the Fund.

“The stakes are high: when economic shocks and political crises coincide, the risk of disintegration rises to alarming levels. Coordinated actions are needed, but these are difficult to implement because of the political climate. In short, we may be contemplating the end of Europe as we know it”, as Corsetti et al. 2016) put it. “In the absence of a credible and effective debt restructuring regime, official lenders to countries with excessive debt tend to procrastinate and provide additional lending, despite serious solvency concerns. In addition, private-sector investors know that they will



be paid, at least in part, by taxpayers. In response, countries in financial distress tend to borrow excessively from other member states and the private sector". At the same time: the heavily indebted countries are between a rock and a hard place as the appetite for even more stringent "institutional reform" than already is implemented.

At present the ECB ensures low spreads on the debt of heavily indebted countries by the combination of low interest rates, quantitative easing and the buy-up of Government bonds of heavily indebted countries. Debt restructuring would still be needed once interest rates would increase.

Perhaps Greece is a special case. The debt of Greece is far beyond what normally (in IMF terminology) is considered as serviceable and repayable. Greece should long ago have received a debt rescheduling or a further write off of debt, in combination with an exit from the Euro (while remaining within the EU).

But the bottom-line is for plan B: bring debt mutualization (in whatever form) and trust in adherence to rules into one package: a New Deal.

### **5.7 A New Deal with exit as an option**

"Until Europe is turned into a federal state — as it should become, at some point — it will not have a currency like the dollar. Until then, what is needed is a "breathing" currency union, with orderly entry and exit options, coupled with an insolvency rule for member states. This would be a better compromise between the goals of avoiding speculative attacks and excessive debt accumulation than the current promise of eternal membership" (Sinn, 2015). It was the case of Greece which raised the debate on exit, strongly supported by famous economists, like Nobel Prize winner Stiglitz.

This is the spirit of our aim for a plan B, for the period of an "interregnum" between a period of a fast expansion of the EU (2000-2010) and a new time when countries are ready to go for a full Federal Europe (hopefully after a couple of years in which new trust is built up). Let's call it a period of consolidation.

During the crisis in the years 2010-2012 there was also discussion in states with good credit ratings on exiting the Euro-area (Art, 2016). The exit-possibility raised several questions. Could a member state leave the Euro-area and stay a member of the European Union? Could such an exit be managed without catastrophic disruptions to the state's economy? Would the exit of one country—Greece, most likely, but potentially even a country such as the Netherlands—lead to a series of exits and the rapid unraveling of the common currency? Facing such uncertainty, firms invested millions in contingency planning for a reinstatement of national currencies, and think tanks sponsored contests for the best idea on managing a euro breakup. The wisdom of the crowds, or at least the wisdom of Intrade<sup>11</sup>, set the odds of a state exiting the Euro-area within a year at 50 percent for much of 2012 (Art, 2016).

Exit of a country from a currency union like the Euro has often been depicted as an uncontrollable process bringing the country in a negative spiral. An exit from the Euro of for example Greece would lead immediately to a substantial devaluation of the newly introduced currency (the new Drachme).

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<sup>11</sup> An Irish sports-betting site.

That is an intended result to avoid devaluation through the lowering of salaries and social security payments, needed to bring about competitiveness. Devaluation is then a good alternative to the austerity course which has been followed in practice.

But the unintended effects could well –if not properly controlled- overshadow the intended ones. Devaluation will bring a surge in inflation with it as prices (in Drachmes) of imported goods rise. This might lead to an inflation spiral if workers demand higher wages, if social security payments are adjusted upwards for inflation, in an uncontrolled exit. At the same time the rich with assets (houses, machines and land) will get richer relative to others as their assets will appreciate with the devaluation of the currency. This is a first step of a controlled exit: an agreement by the country that the devaluation implies the acceptance of a decrease in real income measured in “Purchasing Power Parity”. In the Euro context it would be logical to make this step together with a renegotiation of debt.

The country's debt will be increased as a percentage of GDP measured in Drachmes, because of the devaluation, as the debt is in Euro's. Renegotiation on the debt seems to be the only way to convince Governments to take the exit –route for devaluation instead of the austerity route. Of course, such a negotiation is not necessary if exit would be an automatic system in case of a breach of agreed principles. At the same time a new questions arises: how to get agreement on this new system of automatic exits from countries that might see this as a possible future. We propose that this be part of the New Deal in which the debt overhang of the South is dealt with in combination with the acceptance of automatic exit.

A second unintended side effect of devaluation is the outflow of capital. When devaluation is in the air people will try to move into a foreign currency and move that money out of the country, or alternatively when Greece would leave the Euro, people will have a Bank run and put their Euro's in a hopefully safe place at home. After devaluation people will try to move as much as possible capital held in foreign currencies out of the country. Greece has shown the combination of the Bank run and the move of capital to the outside world. The answer was that capital controls. They were imposed and can deal effectively with capital outflows, even though they have a price in terms of restricting the functioning of the economy.

Exit from the Euro is mostly referred to as exit of countries which might want to devalue. The divergence in competitiveness with the Euro area might also give rise to voluntary exit of Northern countries with substantial trade surpluses. They might gain from exit through revaluations with the reverse effect as above.

This reverts back to a system with exit. There ought to be an automatic exit for countries which do not follow the rules. This is fairer than the present system which might in the longer run force at the countries which follow the rules.

Exit is the necessary complement of a New Deal. Any serious effort to reduce the debt overhang of heavily indebted countries requires a substantial contribution from the core Euro countries. The political support would be minimal unless this could be viewed as a long run benefit to all (also the core countries). Such support could be more substantial if –instead of the present system of sanctions (which has not been effective) a system of automatic exit could be envisaged. In such a system countries which fail to adhere to the rules effectively leave the Euro. Such a system could also

include a voluntary exit. Countries that believe to be better off outside the Euro than inside –also on the long run- should leave the Euro-area.

Exit always will be associated with uncertainty and unrest on financial markets. Such is the price to be paid for a monetary system without a sovereign, as the Euro is and will remain. Orderly procedures can help to mitigate this. Mitchell (2015, p. 400-410) discusses some of the points relevant for an orderly exits, like secrecy so as not to give rise to anticipation effects and capital controls.

## 6. Conclusions

The Euro has provided for relatively high economic growth in the pre-crisis period 2000-2008. Unemployment could be reduced to unprecedented low levels. But the Euro also contributed to the depth of the crisis as high growth was accompanied by substantial divergence in competitiveness between the North and the South of Europe and to sizeable capital flows from the North to the South that were not backed by investments or properly valued assets.

The Euro framework was the Stability and Growth Pact. This turned out to fail as an instrument to ensure fiscal stability as countries could violate the rules without sanctions, even though the Maastricht Treaty –introducing the Euro- had made such sanctions close to compulsory. The safeguard of the SGP also was not developed to recognize another risk for stability: the debt of private Banks.

If anything the introduction of the Euro was helpful to recognize that the regulation and control of the private Banks had to be modernized in view of the globalization of finance. This created new interdependencies in risks and a greater complexity of financial products, making it more difficult to assess risks. Unfortunately the private Banks – with sometimes more and sometimes less support of their Central Banks had done little to increase their capital relative to their balance sheet, as the Basel II guideline recommended. Also private Banks started to merge across boundaries to form international Banks with a substantial size.

The crisis was first US induced, but secondly part homegrown. “Lehman Brothers” stands for the start of a worldwide recession. The default of this Bank led to a credit crunch, starting the downward spiral of the crisis, with the housing price bubble and other asset price bubbles bursting. This exposed many Bank loans to be “bad loans”, bringing Banks both in the US as in Europe on the brink of default. Banks had to be rescued with public money, increasing already high government debt in many countries. The home-grown part of the crisis was the announcement that Greece was de facto Bankrupt. It was not only unable to pay interest on its debt and to receive new loans to roll over its debt, but also needed substantial amounts of money to fund its deficit.

Greece’s debt was held mostly by private Banks in other Euro countries. These Banks were now in trouble. The shares in these troubled Banks in turn were in part held by other Banks in other Euro countries. A Greek default was considered to be a domino threatening to cause a chain reaction, with defaults of private Banks in other EU countries holding Greek debt and subsequently pushing government money into private Banks in order to save them. The Euro-group decided to rescue

Greece with fresh loans heaped upon an already overweighed debt burden. They kept the bad loans to Greece on the balance sheets of Banks waiting to deal with them at some time in the future. The new loans were sold to the citizens of other Euro countries as rock solid, even though it must have been clear that they would not be paid back any time soon. These were the costs of buying time to write off the bad loans to Greece.

Also Cyprus, Ireland, Portugal and Spain got in trouble as the interest rates they would have to pay for new loans (to roll over debt and to finance their Government deficit) were exorbitant. Two new funds were established: the European Financial Stability Facility (EFSF) and European Stability Mechanism (ESM). Together with the IMF these funds provided the money needed for a bail-out in a strict program supervised by a Troika of the ECB, the EC and the IMF. Spain profited from these funds to rescue some of its Banks, but was not part of the Troika supervision.

Crisis management was seriously hampered by the communal decision-making without something close to Euro “sovereign” authority. This underlines the early hesitations on the political agreement on the Euro with the Euro-fathers Mitterrand and Kohl, best captured by Friedman (1997):

*“Political unity can pave the way for monetary union. Monetary union imposed under unfavorable conditions, will prove a barrier to the achievement of political union.”*

The crisis was more or less over in 2013-2014 and economic growth resumed in most countries. However, 8 out of the 19 Euro countries in 2015 are confronted with a “debt overhang”: too high a public debt to be able to repay and to pay interest on. Moreover, the debt overhang puts a serious drag on economic growth, making more difficult to repay the debt. “Debt overhang” is often put at a level of debt of more than 90% of GDP.

What complicates the situation is the huge size of private Banks’ bad loans. A new domino ripple would go through the Euro-area if these were written off.

There are no signs of convergence in productivity between on the one hand the North and East and on the other the South. There has been lower productivity growth in the South, compared to the East and North. Convergence in productivity and competitiveness is essential for maintaining unity in the Euro-area. Convergence in Southern countries can –within the Euro- only be achieved by “internal devaluation”, implying cuts in government expenditures, in social assistance, in pensions and in wages, while labor markets become less rigid.

There is a strong will on the part of Southern governments to reach convergence as is evidenced by policies adopted in for example France and Italy. The political backlash however is substantial and supports those political movements that want countries to get out of the Euro.

The “Semester Approach” advanced in 2012 by the European Commission has been a helpful instrument for convergence in labor productivity and in moving towards the criteria of the Stability and Growth Pact, but it also has become extremely complex and in-transparent.

Economic growth has been the lubricating oil for economic reform. The near future is likely to be one with limited economic growth worldwide. This makes the needed economic reforms harder. It is insufficiently realized that the success of reforms in the absence of substantial world economic growth depends also on the distributive effects of reforms. If large parts of the population feel that

they are worse off with the reform, they will object, even though on the longer run they would be better off. The “neo-liberal” model underlying the economic reforms may then not be suited and needs to be complemented with EU wide regulations, for example on the involvement of workers in managing firms, but also on maximum salaries for wage earners throughout the economy and possible even in trade agreements.

The Five Presidents of the EU (EC, 2015) have designed a course for the Euro. Wyplosz (2015) puts it very starkly: “The Presidents report is an unimaginative catalogue of pious statements that call for ‘more Europe’, without any analytical justification. Of course, a fiscal union or a political union, for whatever these vague terms may mean, would be wonderful and might even deal with some of the problems – if they were well done. Everyone knows, however, that no further transfers of sovereignty are now possible”.

This does injustice to the excellent proposals for a Banking Union, some of which have already been implemented. The “Banking Union” (the cooperation between Euro-countries in financial institutions) will have an independent central watchdog, a “single resolution mechanism” in case of defaults of Banks and a European deposit insurance scheme.

We advocate in addition for the separation of the public Bank functions from that of the commercial Banks, such that the risks of the commercial Banks can fully be carried by the shareholders and those who choose to save at their accounts. The public Banks fulfill simple functions of saving and credit, safeguarded from adventures in complicated financial products. They are extra carefully overseen and run at arms-length from the government, but as a quasi EU government institution.

The urgent need for some form of “debt-mutualization” is met with distrust by the countries with low debt to GDP ratios. How can they trust the countries which need the release from the debt-overhang? They may fear that debt mutualization is used as a new start for a spending spree. We argue for a New Deal: to place debt mutualization in the framework not of highly detailed supervision, but in an automatic exit from the Euro area in case of a breach in the rules.

That might be a way in re-creating the trust within the Euro area between countries and re-establish the autonomy of Governments for their own actions, while avoiding new moral hazards.

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