The Euro and the Financial Crisis

Erik Jones

The global financial crisis is the first major challenge for the euro as a multinational currency. Many wonder whether it will also be the last. Although early indications suggest that the eurozone countries are weathering the storm, this has not stopped prominent economists such as Martin Feldstein from cautioning that 'the current financial crisis may provide a severe test of the euro's ability to survive'.[1]

This is not the first time that Feldstein has issued such a warning. He published an even stronger statement in the pages of *Foreign Affairs* shortly before the euro was formed. Then he speculated that conflicts between participating countries, or between those inside and outside the euro, could even escalate to war.[2] Few took the prospect seriously, either during the launch of the single currency or in the years that followed. As the current crisis continues to deepen and popular protests begin to mount, however, many fear Feldstein's nightmare scenarios are no longer so absurd.[3] War is not on the cards, but a deep and divisive conflict over the functioning of the single currency cannot be ruled out. Such a conflict would not only set European countries against one another, but could also undermine the solidarity of the European Union as a whole.

In an effort to determine whether the survival of the eurozone is threatened, commentators have naturally turned to the economic data. What they find is troubling. Real unit labour costs relative to major trading partners

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(a rough measure of national competitiveness) are moving against some of the poorer southern countries of the eurozone, Italy in particular. The same is also true for some countries outside the eurozone, such as the United Kingdom. The difference is that these countries at least retain the ability to restore national competitiveness by devaluing their national currencies.

A further problem is that the poorer and more highly indebted countries of the eurozone are witnessing an increase in the relative cost of long-term sovereign borrowing. The difference in the yields on ten-year benchmark government bonds between Greece and Germany, for example, has increased by a multiple greater than five. Again, borrowing costs are rising for some countries outside the eurozone as well, but they have control over their own monetary policy and so – at least in extremis – are able to print their own money and inflate away the difference. Countries that have adopted the euro do not have this pressure-release value. Hence the threat is not so much that countries will leave the eurozone but that they may default. The only hope defaulters can have for salvation lies in the possibility that the richer countries such as Germany will find the economic resources and political will to bail them out.[4]

The closer one looks at the problem, the worse it becomes, particularly if the economic data are to be believed. Nevertheless, there is good reason to believe that the situation is much better than most commentators are willing to admit. The trick is to dissect the economic analysis, much of which not only exaggerates the significance of recent trends but also underestimates or ignores the costs and benefits of the most likely alternatives.

The simple conclusion is that Europe's economic and monetary union is not only much stronger than many fear, it is also much better than the system of fixed but adjustable exchange rates that it replaced. Far from engendering conflicts, the single currency has diffused them. Along the way, it has also insulated politicians from being forced to make inevitably unpopular and difficult choices. Thus, the eurozone is more likely to get larger than it is to get smaller.

Competitiveness lost and found

The Italian case clearly illustrates the cost of giving up the exchange rate as a policy instrument. Even before the global financial crisis, economists noticed that Italian real unit labour costs were losing ground relative to near competitors, Germany in particular. These same economists pointed out that the old Italian policy response would have been to devalue the lira against the German mark. This devaluation would have lowered the relative cost of Italian exports abroad even as the real cost of Italian labour domestically continued to rise. Italian consumers and non-traded industries would have suffered from the rising cost of imports but Italian manufacturing profits would have stabilised or increased. Now that Italy is trapped within the single currency, however, Italian manufacturing can expect to receive no such reprieve. This means that Italy either has to leave the eurozone and bring back the lira at a lower value, or witness the demise of its manufacturing industry as it goes through the long and painful process of bringing its real unit labour costs back into line. If these are the alternatives, it is small wonder that some have already started questioning whether the eurozone will crack.[5]

The data are striking. The European Commission publishes a series that reflects the real unit labour costs for the total economy in national currency relative to the 15 pre-2004-enlargement member states of the European Union. If relative labour costs are set to equal 100 in the year 2000, which is how they are published on the European Commission's website, then by 2008 Germany was at 94.2 while Italy was at 106.9. Britain, by contrast, remained relatively unchanged at 99.7. The interpretation of this data seems straightforward. Within the single currency, Germany has gained in competitive terms and Italy has lost. Outside the euro, British competitiveness is much the same.

The German economy was struggling in 2000

The problem with this easy interpretation is that it depends on the base year for the index: 2000 = 100. There is a seductive logic to the arbitrary choice made by the Commission. Not only is the year 2000 a round number and a millennial date change, it is close to the start of the single currency. Choosing it implies that national performance that year was somehow normal and therefore that it is an appropriate basis for comparison. Yet there is good reason to believe that it was not. The German economy was struggling in 2000 and the situation

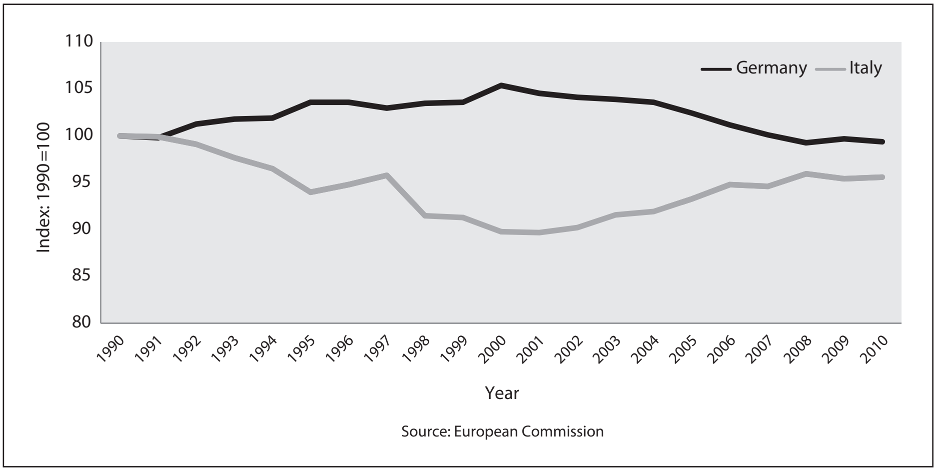

Figure 1. Competitiveness in Germany and Italy

would get worse before it got better. Meanwhile, the Italian economy was just emerging from reforms made to join the single currency in the first place, measures that included both a healthy dose of fiscal austerity and strong efforts to bring relative unit labour costs under control. The importance of these conditions can be seen if we shift the baseline for the index back by a decade (1990 = 100). This has the added advantage of revealing the implications of the German unification shock. The evolution of German and Italian labour costs using this new index can be seen in Figure 1, which also includes the European Commission's estimates for 2009 and 2010.

Figure 1 clearly shows the impact of the German unification shock on German labour-cost competitiveness. It also reveals the scale of the effort made by Italy to prepare for entry into the European single currency after 1996. Both of these effects reached their peak intensity in the year 2000, which was anything but a normal year for either country – it was also when the difference between the two was at its greatest. Both economies have since begun to move back toward the centre. In terms of relative labour-cost competitiveness, however, Italy is still ahead of Germany. The European Commission's latest projections suggest that this positive difference in Italy's favour is likely to remain in effect for at least the next two years. While this does not mean that the Italian economy is necessarily stronger than Germany's, it is hard to see why Italy would leave the eurozone.

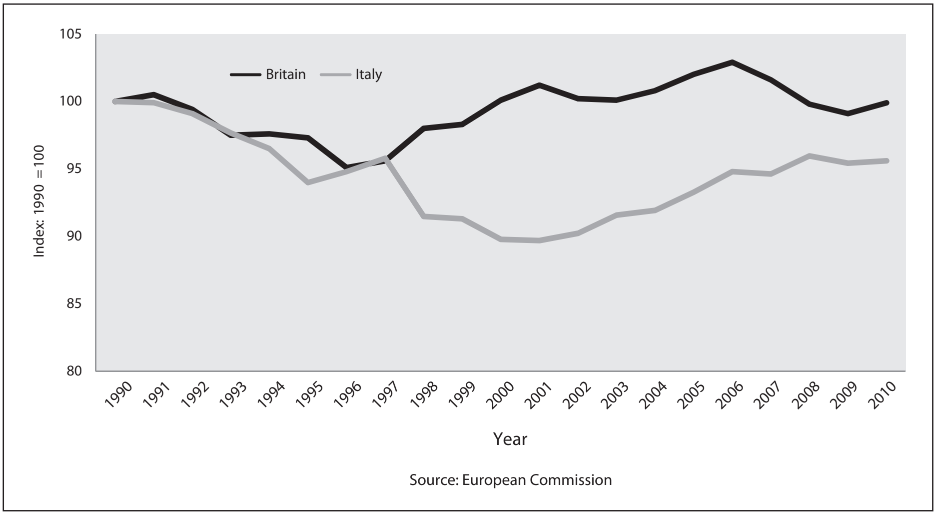

Figure 2. Competitiveness in Britain and Italy

In any case, the more telling comparison is not between two countries within the eurozone, but between a country that is in and another that is out. This is where the British case becomes interesting. If we look at the data series based in the year 2000, it is possible to claim that the United Kingdom did better for not having joined because its relative competitive position remains unchanged. If we base the data in 1990, however, the picture looks very different. Where Italy made great efforts to join the single currency, Britain did not. UK labour-cost competitiveness in manufacturing suffered as a result. This can be seen in Figure 2, which repeats the data for Italy but replaces Germany with Great Britain. The striking feature is how much British relative real unit labour costs deteriorate after 1997, only recovering after 2006.

How do we know which story gives the more accurate description of changes in relative economic competitiveness? Again, the point to emphasise is that these stories emerge from an analysis of an index that is itself dependent on the choice of base year. If we are going to choose between different versions of the same index, we should do so with reference to a different line of data.

In this case, it is useful to look at the data for manufacturing employment. Because manufacturing is exposed to international competition,

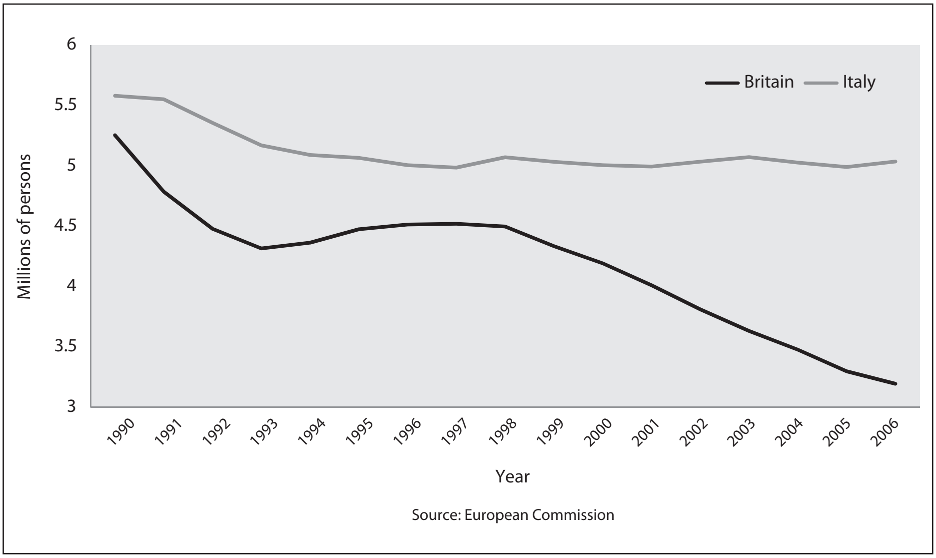

Figure 3. Manufacturing employment

manufacturing employment should go up or down depending on the relative level of international competitiveness (among other factors). If the story based on 2000 as a normal year is accurate, then all things being equal Italy should do worse than the United Kingdom in terms of holding on to manufacturing jobs. If the story based in 1990 is more accurate, then the trends in manufacturing employment should go the other way around. These data are presented in Figure 3. What they reveal is the secular decline in British manufacturing employment from 1997 to 2006 (the latest year for which figures are available from the European Commission). By contrast, Italian manufacturing employment remains roughly constant. The argument here is not that British manufacturing employment declined because of the deterioration in relative real unit labour costs, although that loss in competitiveness surely did not help. Rather, the data suggest that the relative merits of staying outside the euro rather than joining are not obvious on the competitiveness front. If the British experience is representative, Italy is better off staying inside.

Relative unit labour costs tell only part of the story. A fuller account would have to take into consideration both the cost of capital and the cost of doing business. Once again, it is hard to make the case for abandoning the euro. One of the major benefits of joining the eurozone is that it has offered members both greater liquidity and a lower cost of capital. For highly indebted countries such as Italy, Greece or Belgium, this meant that they could borrow larger amounts at longer maturities and lower prices in 'domestic' currency. During the months leading up to the start of the single currency, interest rates on long-term sovereign-debt obligations across the eurozone converged to within one-half of one percent. As refinancing recycled increasing volumes of public debt into longer maturities with lower yields, public finances in highly indebted countries benefitted to the tune of several percent of domestic GDP in foregone debt-servicing requirements. Corporate borrowers also benefitted as bond holders adapted expectations to a lower-risk, lower-inflation environment. Finally, manufacturers across the eurozone no longer have to deal as frequently with multiple currencies. The savings that this foregone cost of changing currencies implies may not be great, but are not negligible either.

Bond holders adapted expectations to a lower-risk environment

Show me the money

The worry is that at least some of the principal benefits of joining the eurozone are coming undone. Where Greek debt used to trade at yields within one-half of a percentage point of Germany's, they now yield an additional 2.5% or more. This widening of the yield differential during the current financial crisis implies a significant increase in the relative cost of Greek government debt-financing at a time when fiscal accounts are already being stretched by automatic stabilisers in the form of lower taxes (on lower incomes) and higher benefits payouts because of higher unemployment. Worse still, Greece, like many highly indebted countries, still has much to do in preparation for the costs of an ageing population and the burden on government finances that this will entail. If the Greeks are highly indebted now, this is nothing to what they face in the future. As the relative cost of debt financing rises, or so the argument runs, the risk that the Greek government will default on its commitments begins to creep up as well. On

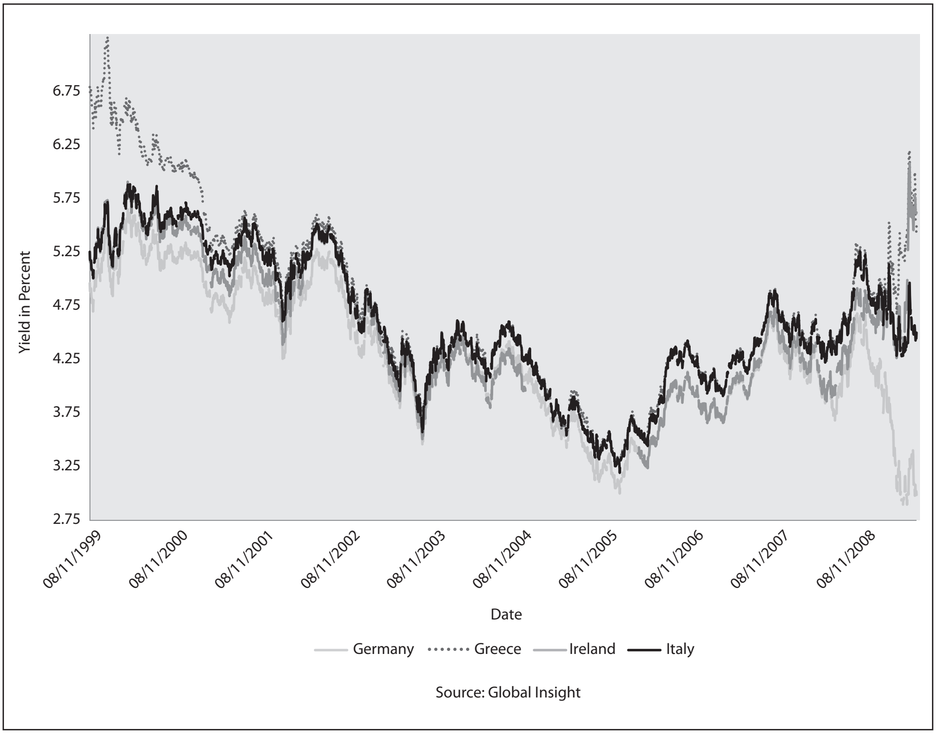

Figure 4. Long-term bond yields in the eurozone

14 January 2009, Standard & Poor's downgraded the Greek government's creditworthiness from A to A⁻ for long-term borrowing and A-1 to A-2 for short-term.[6]

The Greek government's default risk is increasing, but the point to note is that it would surely be higher outside the single currency than it is now. Although the yield differential with Germany has increased, this is largely due to the fact that while Greek sovereign-debt yields have been relatively stable, German sovereign-debt yields have gone down. As a result, Greece is still paying a lower interest rate on its long-term debt than it was just before it joined the single currency in 2000. The relative cost has increased but the absolute cost has not. This can be seen in Figure 4, which shows the yield on 10-year sovereign-debt obligations for four countries in the eurozone: Germany, Greece, Ireland and Italy. Germany is the benchmark; the other three are subject to varying degrees of concern about their creditworthiness.

Toward the middle of February 2009, the situation began to look more worrying. Both Ireland and Greece witnessed a sudden spike in their long-term yield rates, taking them to record highs since they entered the eurozone. Nevertheless, it is still worth noting that neither country has experienced a general run on its government securities, and what went up has started to come back down. Much of this new-found confidence in the market is due to suggestions made by German Finance Minister Peer Steinbrück that no eurozone member would be allowed to default.[7] Regardless, the threat of default is a long way off.

In real terms – that is, when relative inflation rates are taken into account – the long-run interest rates in Greece and Germany are much closer than the nominal yield spreads would suggest. According to data from Eurostat, prices rose by 2.4% more per annum on average in Greece than in Germany for 2008 (similar data for Ireland are still unavailable). If we subtract this inflation differential from the yield differential, the real rate of interest paid by the Greek government is not that much higher than that paid by Germany. This 'real' equivalence is not important to the large institutional investors that trade in sovereign bonds because most such institutions have Europe-wide interests and so perceive only a single real interest rate for the eurozone as a whole. This explains why the yield differentials were so tight across the eurozone before the current crisis. What has changed is the sudden increase in demand for safe-haven investments. Even including the most recent spike, German bond yields have gone down at least as much as Greek yields have gone up.

The threat of default is a long way off

The real interest-rate differential is important to national governments, however. National tax receipts tend to move in line with the national rate of price inflation and so the relatively higher rate of Greek inflation means that the Greek government's ability to manage its debt is not yet much affected by the increase in yields relative to Germany. Of course, the difference in inflation rates is diminishing under the weight of the current crisis and Greece still has to prepare for its ageing population. Nevertheless, the situation could be much worse.

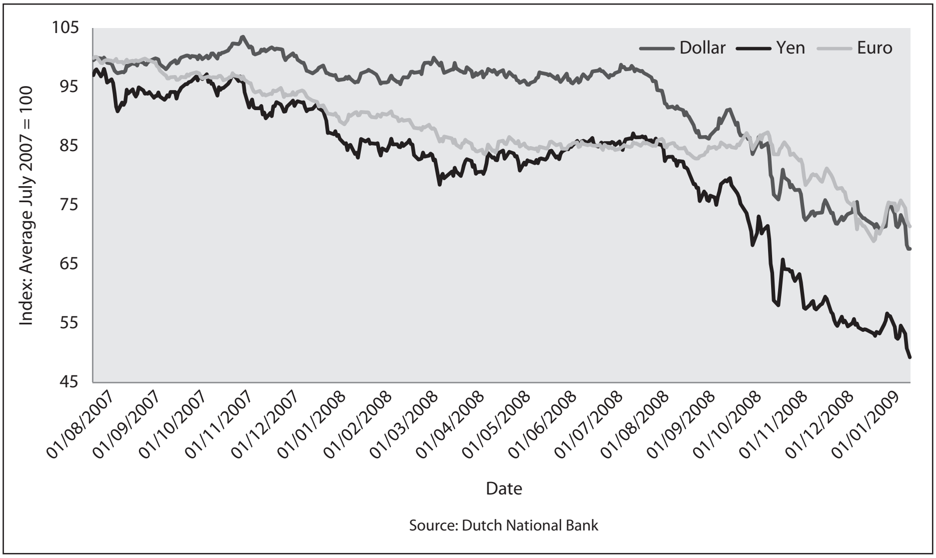

Figure 5. Exchange rates against the pound

Indeed, if Greece were outside the eurozone it probably would be. At the moment, Greek sovereign bonds benefit from the liquidity of deep eurozone markets. Were Greek bonds traded in drachmas rather than euros, much of that liquidity would evaporate. The same is true for Italy, Ireland, Spain and Portugal. The rule would apply to banks in those countries as well, with the implication that any run on the national currency would effectively become a run on the banks, and any run on the banks could trigger a run on the currency. Hence Greece would not only face a higher cost of borrowing, but it would also have to deal with the cost of exchange-rate volatility.

The British case shows just how quickly and erratically exchange rates can move. Since the start of the global financial crisis in August 2007, the United Kingdom has experienced an unprecedented increase in the volatility of exchange rates relative to the pound. As a result, not only has the pound lost value relative to other major world currencies, but its position in the triangular relationship between foreign currencies has gyrated as well. The effects can be seen in Figure 5. In turn, this increase in exchange-rate volatility has greatly complicated the process of manufacturing for export, because so much of what Britain exports to foreign markets is first imported from abroad.

Sophie's choice

Most governments in Europe are envious of the liquidity that is available in the eurozone and cannot tolerate the high degree of exchange-rate volatility that has been experienced by countries outside the zone, such as Great Britain. Hence their alternative to participation in the euro is to open their capital markets and peg their exchange rates. Denmark is a good example, but the same thing loosely applies to Norway, Sweden and Iceland, not to mention many of the countries of Central and Eastern Europe.

There is nothing new in this formula. It is roughly the same as what the eurozone countries did within the European Monetary System before they formed the single currency. The difference is that the eurozone countries have made an important structural choice. In exchange for capital-market liberalisation and irrevocably fixed exchange rates, they have agreed to maintain a common monetary policy. Those countries outside the eurozone have left themselves a bit more discretion. They can choose to maintain open capital markets and fixed exchange rates at the cost of an autonomous monetary policy, or not to fix the exchange rate and seek greater monetary policy autonomy instead, or to close their capital markets altogether.

What the countries outside the eurozone cannot choose is when they will have to exercise their discretion and at what cost. The obvious example is Iceland, which had to close its capital markets when a run on the currency threatened to bring down the country's entire economy. The timing of that decision was not in the hands of Iceland's politicians. Instead, it was determined by the weight of market forces that were driving the Icelandic krona into the ground. Now, as the Icelandic authorities look to reopen their capital markets to the outside world, they must also consider whether they would have more autonomy within the eurozone than without.

The Danish example sits at the other extreme. The exchange rate between the Danish krone and the euro fluctuates in a very tight band around 7.45 krone to the euro. Danish monetary authorities maintain this tight link by anticipating the policy decisions made at the European Central Bank (ECB). By October 2008, however, this strategy began to break down, confronting Danish monetary authorities with a choice. They could either cut interest rates and see the krone devalue against the euro, or raise them even as the ECB was cutting its own. In the end, the Danish authorities opted to fix the exchange rate by raising their discount rate to 4.5% on 8 October even as the ECB prepared to cut the rate on its main refinancing operations to 3.75% a week later. The gap between Danish and ECB policy rates widened further in early December. Only by mid January 2009 did the difference in policy rates begin to come back down.

The Swedish case shows a middle alternative. Throughout much of the financial crisis Sweden has sought to stabilise the fluctuation of its krona against the euro within a wider band than Denmark. To do so meant raising the Swedish central bank's policy rate by 50 basis points above that in the eurozone. As Denmark began to raise its rates in October, Sweden decided to follow the ECB down. This meant giving up some control over the value of the krona, which has continued to depreciate against the euro as Swedish interest rates have fallen.

None of these Nordic countries can be happy with its situation

None of these three Nordic countries can be happy with its situation. Each is rumored to be re-evaluating its official position with respect to participation in the eurozone. In contrast to the rumours circulating about Italy and Greece, these reports are plausible. Although reasonable people might disagree, it is possible to see how the Nordic countries could benefit from membership. It is much harder to make a realistic case that the existing member states could benefit from getting out.

Still in the woods

The euro as a multinational currency is not as vulnerable as it may first appear. Indeed, it provides a bulwark against the forces currently wreaking havoc in the global economy. It has eliminated exchange-rate volatility between participating countries, insulated them from having to make unpopular choices, lowered the relative cost of borrowing for the highly indebted, and created an incentive for countries like Italy to gain control over their relative unit labour costs along the way. This has not prevented Europe from staggering under the weight of the global financial crisis, but it has blunted at least some of the blow. Despite its advantages, however, the euro and the eurozone suffer from two obvious problems.

The first is that macroeconomic-policy coordination has not gotten any easier just because many European countries now use the same currency. This is evident as Europe struggles to come up with an effective macroeconomic stimulus package. (It was also evident when Europe struggled to engineer a lasting consolidation on fiscal accounts.) Like it or not, European fiscal politics has a very parochial focus, and even when there appears to be a Europe-wide pattern of coordination, chances are the 'pattern' is more coincidence than anything else.[8] This is not fatal for the single currency, nor is it a reason to believe that macroeconomic coordination would be better without one. All it means is that when called upon for a coordinated response to the global financial crisis, the countries of the eurozone are going to find it just as difficult to make concessions as anyone else.

The second problem is that the euro does not encompass the whole of the European Union, so whatever advantages it offers are, from an EU-wide perspective, at best only partial. Of course, one could argue that those countries that chose to remain outside the eurozone – either deliberately or through inaction – have only themselves to blame. Perhaps there is merit in this position for the United Kingdom, Denmark or Sweden: these countries not only understood the risks but also have the resources to withstand the consequences. The countries of Central and Eastern Europe are a different matter. Whether they chose to delay entry (Czech Republic, Hungary, Poland) or strove to enter and failed (the Baltic States, particularly Lithuania), these countries are even more ill-equipped to be outside the eurozone in such a turbulent global environment than they are to enter. The problem is not just that they cannot bear the costs of market volatility, but that they cannot contain them within their borders either. From inside the eurozone looking out, refusing to allow the Central and East European countries a firm commitment to enter into the single currency is unwise if not exactly unfair.[9]

The problem of macroeconomic-policy coordination within the eurozone is unlikely to be solved. Fiscal politics is politics after all, and all politics is local. The problem of the euro hold-outs is more easily handled. The eurozone will survive the current crisis. The question is how soon and how quickly it will start getting larger.

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