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The legacy of the Eurozone crisis and how to overcome it ☆

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ABSTRACT

I argue first that the Eurozone crisis has left a legacy of unsustainable government debt levels. These will continue to exert a deflationary dynamics in the Eurozone. Second, I argue that the institutional innovations since the start of the debt crisis fall short of what is needed to solve the design failures of the Eurozone. In addition, they are not sustainable, mainly because they have led to a situation where bureaucratic institutions have been vested with more responsibilities without a concomitant increase in the democratic legitimacy of these institutions.

1. Introduction

After years of turbulence in the Eurozone that at some point led to existential fears about the survival of the monetary union, peace and tranquility seem to have returned in 2016. In official circles the view prevails that the Eurocrisis is over and that the return of tranquility is the result of the institutional changes that have been introduced since the start of the sovereign debt crisis in 2010. Prominent among these institutional changes is the setup of tighter discipline in fiscal policies, the monitoring of macroeconomic imbalances and the banking union.

In this paper I dispute this view. I will first analyze the legacy of the sovereign debt crisis, arguing that this crisis has led to unsustainable debt levels that will continue to haunt the Eurozone. Second, I will argue that the ill-designed of fiscal policies is at the core of the continuing low growth performance of the Eurozone. Third, I will argue that although there has been some progress towards institutional reform, this falls short of what is needed to deal with the design failures of the Eurozone.

2. New governance of Eurozone: creditor nations rule supreme

There can be little doubt that the ECB saved the Eurozone, at least for the time being when in 2012 it announced its OMT program. The latter is a commitment to provide unlimited amounts of liquidity in the sovereign bond markets of the Eurozone in times of crisis. The ECB's announcement, however, did not prevent the Eurozone from developing into a governance in which the creditor countries dictate the budgetary and macroeconomic policies for the Eurozone as a whole.

The Southern European countries (including Ireland) are the countries that have accumulated current account deficits in the past, while the Northern Eurozone countries[1] have built up current account surpluses. As a result, the Southern countries have become the debtors and the Northern countries the creditors in the system (see Fig. 1).[2] This has forced the Southern countries

☆ I am grateful for the comments of an anonymous referee that added value to this paper.
[1] We define Northern Eurozone countries to be Austria, Belgium, Finland, Germany, and the Netherlands.
[2] The numbers in Fig. 1 show the total cumulative current accounts. Ideally one would also like to know the intra-Eurozone current account positions and the net debt and creditor positions within the Euro area. We did not include these data as they are difficult to find in a consistent manner over a period of more than 20 years (as in Fig. 1).

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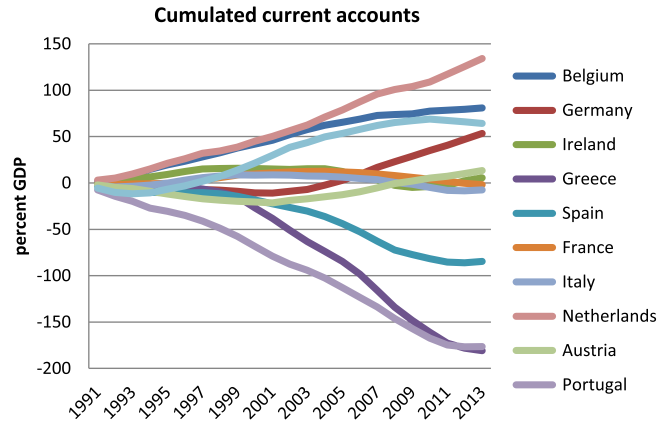

Fig. 1. Cumulated current accounts.
Source: European Commission, Ameco.

hit by sudden liquidity stops to beg the Northern ones for financial support. The latter have reluctantly done so but only after imposing tough austerity programs pushing these countries into quick and deep spending cuts and intense recessions.

Put differently, the creditor nations imposed their interests on the whole system. Their interest is that the loans they have extended recklessly to the South in the past should be repaid in full. Austerity is the mechanism to achieve this objective.

What is surprising is that the European Commission accepted to become the agent of the creditor nations in the Eurozone, pushing austerity as the instrument to safeguard the interest of these nations. The Commission could have decided otherwise and become the agent of the debtor nations protecting these from the insistence of reckless creditors to be repaid in full. This has been the response of many governments after the banking crisis. In many countries legislation has been introduced to protect consumers and house-owners from the banks' insistence on full repayment. The view in many countries has been that, as the banks (the creditors) are equally responsible for the financial crises, they should face a significant part in the cost of adjustment, mainly by accepting losses on their loan portfolios.

Another view could have prevailed and guided the conduct of macroeconomic policies in the Eurozone. This is the view that the responsibilities for the current account imbalances are shared between the creditor and debtor nations. The debtor nations took on too much debt and are responsible for that. The creditor nations extended too much credit and are thus equally responsible for the imbalances. For every foolish debtor there must be a foolish creditor. This symmetric view, however, has not prevailed in the relations between the creditor and debtor nations of the Eurozone. The former have been viewed as having followed virtuous policies and the latter as having followed foolish ones. As a result, the debtor nations have been forced to bear the full brunt of the adjustment.

This has led to an asymmetric process where most of the adjustment has been done by the debtor nations. The latter countries have been forced to reduce wages and prices relative to the creditor countries (an “internal devaluation”) without compensating wage and price increases in the creditor countries (“internal revaluations”). This has been achieved by intense austerity programs in the South, while in the North no compensating stimulus was imposed.

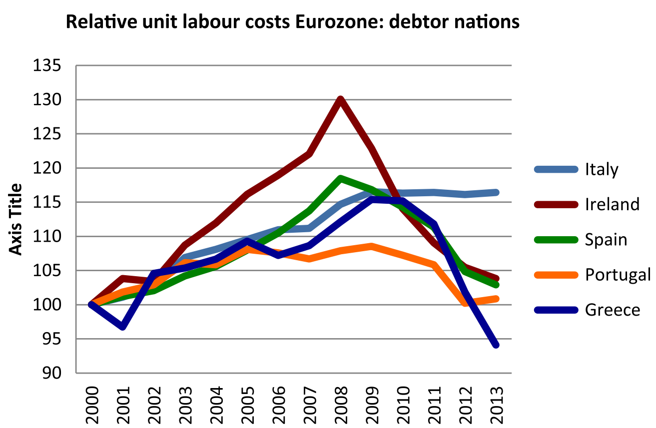

Fig. 2. Relative unit labour costs Eurozone: debtor nations.
Source: European Commission, Ameco.

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