The Wolfson Question

A Reflective Essay by Edward Hugh

"*If member states leave the Economic and Monetary Union, what is the best way for the economic process to be managed to provide the soundest foundation for the future growth and prosperity of the current membership?"*

The Euro should not exist, but it does. I am certainly not the first, and surely will not be the last observer to notice this otherwise trivial historical detail. According to Lombard Research Chief Economist Charles Dumas, the Euro is a form of "suicide pact" (City Wire, 2012), but the Hellerian Catch 22 twist which makes this pact so, so special is that the threat of ending the Euro could easily -via contagion and balance sheet effects - transform it from being simply a local European piece of collective insanity into a thoroughly global one. That is to say, we do have a choice, we can either all be hung out to dry separately, or we can be hung out together, and at one and the same time. Unfortunately, at this stage of the game there are no neat and easy solutions left, which is not the same as saying there is nothing to be done.

To anticipate the conclusions reached at the end of this essay, no sane person would willingly leave the Euro System as it is currently set up on an individual, go it alone, basis, whether the agent in question be one of those supposedly problematic pupils, or one of the theoretically sound teachers who has simply become tired of the energy drain associated with having to discipline so many irremediably naughty children. For a variety of reasons neither one nor the other will chose to move-on being of sound mind. Which leaves with the other option, "whom the gods would destroy they first make made", meaning in this sense that the big risk of the current policy strategy of Europe's political leaders and the IMF is that the essentially politically destabilise a number of EU countries – whether on the periphery or in the core – leading to extreme solutions and policy decisions with which rational agents would normally not wish to be associated.

Preamble: Why No One Will Leave Voluntarily

The principal issue impeding exit is not the one of the presence of sunk costs, but rather existence of non-linear credit and currency impacts - in either one or the other direction – impacts which could not be envisaged in the pre-Euro era during which most of the critics of the common currency cut their theoretical teeth.

The only conceivable way a deliberate decision to leave could actually be taken would be as a result of one or more of the respective agents being actually driven "insane" by the constant painful efforts involved in trying to retain the pin in that grenade they are holding as they are driven to ever more desperate efforts in a vain attempt to try to stop it going off in their face. Could, for example, Hungary's leader Viktor Orban be about to offer us an early prototype for the kind of road map which some of the participants might need to follow in order to reach the point whereby they actively decide to leave? In Hungary's case, of course, the departure would be from the EU, not the Euro, but the point is effectively the same, since the farewell party would most certainly acrimonious, where the possibility of regulating the exit would be limited, and where the end product would almost certainly be the creation of a pariah state.

For the inevitably defaulting participants, given the total determination not to have official sector restructuring, leaving the Euro would more or less automatically mean a sharp break with both the EU and the IMF and in all probability the United States. If we take Greece as an example, and assuming the currently proposed PSI debt swap goes forward, the country would almost certainly see the jurisdiction of its debt shifted from national to international law, making converting sovereign debt instruments into New Drachma (or whatever) impossible, and given the likely creation of an escrow account to pay the private sector creditors, the only meaningful possibilities for default would be against the official sector – the ECB, the IMF and the EU member states – and clearly such a development would not be well received, among other reasons due to the precedents which could be created for other struggling countries who might wish to follow the same path.

So the list of probable allies for an exiting country – Venezuela, Bolivia, and North Korea come to mind, or nearer home Serbia, Belarus and Ukraine – would not be entirely alluring. The difficulty is that after the ending of the cold war, the world is rather short of role models for developed economies who want to pursue unorthodox policies, especially if they are engaged in a disorderly default causing considerable discomfort for most of their “first world” peers..

On the other hand, those with more stable, internationally competitive economies would not readily wish to surrender this condition, and since, as will be argued below, they have clearly benefited significantly from membership of the currency union they will be unlikely to offer themselves as candidates for departure. In a post Euro world they would face the likelihood of trying to export their way forward while labouring under the constraint of a substantially over-valued currency.

Many key features of the Euro Area debt crisis have changed since the summer of 2011, and even since the announcement of the Wolfson Prize and formulation of the question. The most important change is that the German administration has now completely thrown the towel in about the possibility of Germany leaving to go back to the Deutsche Mark.

In fact the principal characteristic of the current conjuncture in the ongoing European Sovereign Debt Crisis is that agent behaviour is now primarily being driven by fear: fear of leaving, fear of being forced outside, and fear of the whole thing blowing up in the faces of all concerned.

One possible road for those arguing the Euro Area could downsize without too many problems to go down could be to take the view that this fear is exaggerated, currency unions have broken up in the past, countries have defaulted (even in groups) and life has moved on. The present essay will not take that view. Many things have changed about the economic and financial world since the last important currency union broke up, and no modern developed country has so far defaulted. The past has lessons to offer us, but the future will have even more. Only one thing is certain here: the future and the past are not symmetrical.

It will be argued here that the two most important changes which have taken place since the last currency union break-up, or even the last major sovereign default is the degree of financial globalisation, and the advent of the elderly population phenomenon in the developed countries. Unfortunately, this implies that many of the arguments previously advanced to explain why the Euro couldn't work as its creators intended which were perfectly valid before the experiment was set in motion are now to some extent out of date. It is the insistence on reiteration of such arguments that explains the apparent irritation of many policymakers, and their almost total inability to listen. Simply put, they do not find these arguments convincing.

Meanwhile the situation on the struggling periphery is hardly an enviable one. The economies there are condemned to either steep recession or depression, and the degree of lost competitiveness means that a decade or more may pass before daylight is seen. This will prove very painful for the respective populations, but to date it should be noted that there is no real sign of any kind of substantial popular revolt. Given Europe's evolving demographics the political process now manifestly favours the over 50s – who effectively have a de facto majority in the electoral system, given the apathy of the young (who find identification with the current generation of politicians difficult) and their relatively smaller cohort size. Thus, condemned to substantial periods of unemployment (or underemployment in relation to their skill level), many vote with their feet by emigrating, thus reinforcing the domination of the "old age" vote, and making it even more difficult for their respective economies to recover sustainable growth paths. Pensioners, it will be noted, are rarely to be found burning down the centres of cities.

So it does seem, with the benefit of hindsight, that Marty Feldstein (Feldstein 1998, 2005) was the most perceptive of all the early critics of the project, in that he foresaw that the Achilles heel of the common currency might well be the political collateral damage it would generate. Could it be that one day we will once more see the military back in politics and crazed dictators all along Europe's southern fringe? If we do locating those responsible for presiding over such a deterioration will not be hard, they will be in their offices in Brussels, Washington, Paris and Berlin. Fortunately we are still in time to avert this disastrous outcome since such a development does not look to be just around the next corner, but on the other hand continuing procrastination would be ill advised, since it may well be lurking round the one after.

As indicated above, the societies on Europe's periphery have changed from those of the 1960s in a very important way – their median age is now a lot higher. The specific political weight of the over 50s and their preoccupations about health and pensions has a much higher electoral and media profile. So there is an inbuilt policy bias to ensure that pensions are maintained as much as possible, while far less importance people is given to the problem of youth unemployment beyond making indignant speeches and promising to address the issue.

In one sense the outcome we are seeing does indirectly address one of the deficiencies the early critics (see Mundell 1961) mentioned – the lack of factor mobility – since young qualified workers are been drawing from the periphery to the core in ever growing numbers. However the position is far from being win-win, since the resulting brain drift only exacerbates the existing imbalances, and it is clear that without a common treasury the one way flow only makes periphery debt even less sustainable.

The general impression that has been generated is that Germany's leadership will now make almost any concession in order not to have to look for the door, and the others, starting with the highly intelligent Mario Monti, are beginning to sense this. Even Spain's Mariano Rajoy has caught on to this, and seen he can negotiate a relaxed deficit target for 2011, despite the fact that the country missed last year's target by a large margin. It is clear that there is nothing like a majority in the EU for putting a budget supremo in charge of Greece (although this may eventually come, why not, when everything which was previously considered impossible has now come to pass), let alone for forcing Greece out of the Euro Area to make an example of the country. This is the sort of outcome one-track Eurosceptics in London dream about over a gin and tonic. The Latin mentality doesn't think like that, and it should never be forgotten that even France is half Latin. The European Union is an association of states, and Germany needs a majority behind its proposals to enforce them, with German weakness now evident this majority may become harder and harder to obtain.

On the other hand, the impact of recent policy changes at the central bank should not be underestimated. In particular, the latest decision to implement two 3 year Long Term Repo Operations has been very important, and is a short term game changer. Distressed sovereigns can, for the time being fund themselves, even if the commercial banks are only really inclined to bid at the short end, and may well be exaggerating the extent of relief provided by buying short term bonds in an attempt to store liquidity to meet their own future wholesale financing needs.

Basically, the liquidity provided, in conjunction with the all important flexibilisation of the collateral rules, has enabled banks to make provision for their wholesale funding needs right through from now to 2015, at which time there will doubtless be another round of LTROs, and who knows, they could even have a longer term than a mere three years. The days when banks saw it as a stigma to have recourse to ECB liquidity, and when journalists entertained themselves making fun of packaged used car loans being offered as collateral in Ireland by the Australian bank Macquarie are now long gone, as are the times when anyone really imagined that any sovereign bond from a country losing the minimum rating qualification of at least a single A from one agency would not be available for use as collateral at the central bank.

And this liquidity policy knocks yet another of the old chestnut endgames straight out of the window too, since it makes deposit flight within the Euro Area as a whole a much smaller problem. German and other core country deposits can be recycled - via wholesale finance provided at the ECB - as a substitute for the missing peripheral ones. Naturally this measure does not unblock the credit crunch problem, but it does reduce immediate systemic pressure.

So, if the Euro system is inherently unstable, and unsustainable, from which no one wants to exit since fear of the unknown always trumps hatred of the known, how does it all finally unwind?

The implicit market assumption that Portugal will follow Greece into default comes as no surprise. If Greece is to be given an ongoing debt pardoning programme then surely in Portugal is going to want one too. And then there will be Ireland, and so on.

But what about Greece itself? Logic suggests that they will sign on for the second bailout. However doubts remain, not only due to the complexity of the deal involved – getting so many parties to sign up to so many things – or even resistance to the proposed austerity measures. There also concerns that Greece's leaders may come to the conclusion it is not in the best interests to proceed.

Such concerns may be based on a combination of three factors: a) a recognition that even a reduction of debt to GDP to 120% by 2020 may well not be sustainable; b) a recognition that after the formal bailout is awarded there will still be ongoing programme reviews, and the country will struggle to comply with the conditions; and c) the fact that the implementation of the Private Sector Involvement debt swap will probably mean changing the jurisdiction under which Greek debt is denominated from mainly Greek law in the majority to international law in the totality.

This latter point is undoubtedly the most important, although being able to grasp its full implications implies an understanding of the first two. Essentially, if the unsustainability of the Greek debt path and the inability to comply with conditionality are accepted, then a further default will be inevitable, but such a default will undoubtedly be a very, very hard one, and most likely an uncontrolled one. In the first place if the country were to leave the Euro after the debt swap, then the new Greek bonds could not be converted to New Drachma (or equivalent) by a weekend session of the Greek parliament, and the country would have to default on bonds denominated in Euros, which would presented them with all kinds of problems.

Secondly, given the terms of the debt swap, and the condition of an escrow fund to protect the interests of private bondholders, then the only liabilities on which the country could still default would be those commitments it has with the official sector, which means defaulting on the IMF, the ECB, the EU and Germany. These would not be especially nice people for the country to default on, since if Greek reaches such a point the country would almost surely be made an example of, which means effectively establishing a pariah state. The EU certainly wouldn't be sending in the social workers and psychologists to help them cope with this massive tragedy, which also implies that investors generally would be inclined to steer clear.

Realising this, and having taken the decision not to default now, short of seeking allies among other rogue states (the North Korea path) the country's leaders have probably taken the decision to stay in as long as they can. But then it is worth remembering the old Greek saying that "whom the gods would destroy, they first make mad", by which I mean we could well see extreme factors at play in Greek politics - the extreme right, the extreme left, and the military - before they then all went rolling off the cliff together.

All this would have important geopolitical implications, since surely the EU could not let Greece become a nice place, since then Portugal would immediately say "I want one of those", and so on and so forth along the daisy chain.

In the meantime private capital will be steadily forced out of periphery sovereigns like Spain and Italy, and the ECB will ultimately have to provide. But we have already crossed the Rubicon on this, and there is no real turning back. Ongoing debt restructuring will continue, as none of the really troubled economies can either grow or sustain their existing debt. And if the private sector either can't, or won't accept the degree of involvement being asked of it, then the ECB will be taken out of the official sector, and somehow or other find a way to swallow the losses. At least for the time being.

On the other hand, if adequate measures are not taken to hold the monetary union together the Euro will not survive, since as the situation deteriorates international investors will steadily sell off Euro denominated assets, and the quantities will eventually become large enough for it to be difficult for the ECB to constantly make up the difference, while the region is subjected to uncontainable capital flight – this time out of the currency itself, and not simply from periphery to core.

So it is with regret that I have been forced to reach the conclusion that there is no best way to manage and guarantee an exit process that will offer growth and prosperity for the current membership, quite simply because the leaving (which may well be en-bloc) will not be a managed process. There is a path available by dividing the structure in two, along the lines which will be outlined below, but it would require will and determination and the current political leadership of the European Union has already demonstrated that it is simply not up to the task. The best advice that can be offered to those not directly involved would thus be to prepare for the disorderly eventuality.

Doubts From The Start

The Euro has always been a highly controversial project, dividing economists much more than it has ever brought them together. In part this is doubtless because it is, at heart, as US economist Marty Feldstein has consistently argued (Feldstein 1998, 2005), a political project, and even though macroeconomic objections to the currency project as planned have accompanied the monetary union across the course of its brief history, such viewpoints have largely been ignored by those responsible for its implementation. Indeed, as Barry Eichengreen (Eichengreen, 2007) noted, the possibility the euro area would breakup was already being mooted even before the single currency was born (Garber, 1998 and Scott 1998).

For a time, however, all this early debate and controversy drifted into the background, possibly due to the effect of having so many crisp new banknotes in people's hands. Despite a poor start in terms of its dollar parity, the currency soon became widely adopted and accepted (including in the vaults of the planet's key central banks), and rapidly came to form part of the natural and familiar furnishing of the global financial architecture. So much so, that economists steadily moved from asking themselves when the experiment was going to go bust, to wondering how long it would be before the Euro would replace the Dollar as the global reserve currency (Chinn and Frankel, 2005). Five years into the project, the current Chairman of the US Federal Reserve simply remained non committal (Bernanke, 2005), the currency was a "great experiment", he wrote, leaving the reader to interpret for him or herself the meaning of the term "great" in this context
.
However, the whole sustainability issue resurfaced again, and with a bang, following the onset of the global economic crisis. Behind the tranquil and reassuring picture of stable price outlooks and rigorous fiscal containment, the world discovered that during the first decade of its existence the monetary union had enabled huge inter-country imbalances to accumulate, while several of what had previously been regarded as risk free, solvent sovereign were found to have been unwittingly allowed to let their debt to stray onto what had all the appearance of an entirely unsustainable path. Naturally an enormous furore broke out, both in the financial markets and in the popular press.

Unfortunately, it seems that ten years of experience have served for little in this case, since the common currency's defenders and detractors have lined up quite predictably on one side or the other of the debating line as if nothing significant had happened in between, and little was to be learnt from the whole experience.

The issue stirs up a good deal of emotion on both sides and opinions voiced on might sometimes seem to the unconvinced almost extreme. According to a recent study by Stephen Deo and his collegues at UBS (Deo et al, 2011), for example, the Euro – as it is currently structured – simply should not exist. Many would find it hard to disagree, but the problem is that it does, and just like the legendary Hotel California the UBS authors refer to, it was intentionally set up in such a way that once you get inside there is no evident way you can leave. You can check-in, but you can't check-out.

Others, myself included, have been put in mind of the cult film Stanley Kubrick directed in the 1960s, “Dr Strangelove”. In a key scene the US President, on being informed of the existence of a device (termed the Doomsday Machine) which shares some notably similar characteristics with the current monetary union, is stupefied. “But how is it possible,” he asks those gathered around him, “for something with these characteristics to be created, something which will be triggered automatically, and at the same time is impossible to untrigger?” To which the Peter Sellers/Dr Strangleove character replies “Mr. President, it is not only possible, it is essential. That is the whole idea of this machine, you know”.

Disintegration of the Euro, we are understandably told, would provoke a global financial disaster. But leaving the structure of the common currency as it is now will surely destine many parts of the developed world to a decade (or more, who really knows) of depression, as an entire planet tries hard to find a way to deleverage itself. The worst role in this unfortunate mise-en-scene has undoubtedly been reserved for those who find themselves trapped in one of the unfortunate economies on the Euro periphery, since they are destined to suffer constant economic asphyxiation weighted down as they are by unsupportable and unsustainable private and public debt dynamics even as their lack of competitiveness rules out meaningful economic growth. Condemned as they as to their Sisyphean task, it seems unlikely they are even able to summon the sort of smile which Albert Camus optimistically attributed to the now long forgotten Greek hero.

Problems with the common Currency

Optimal Currency Area

As noted above, many macroeconomists in the US and elsewhere were visibly concerned about the viability of the Euro right from the outset. Objections normally focused on perceived weaknesses in the monetary policy determination process and in the lack of factor (or labour market) mobility, the presence of which was one of the key conditions set out by Robert Mundell in his initial essay advancing the optimal currency area idea (Mundell, 1961) . In addition, the absence of any common fiscal coordination mechanism beyond the basic policy rules laid down by Maastricht clearly presented a problem, since again the pioneers of “currency area” thinking had recognised this as one of the obvious requisites (Kenen, 1969).

In recent years work on the idea of optimal currency areas has been influenced by the framework of Real Business Cycle theory within which asymmetric shocks constitute the principal impediment to the smooth functioning of the real economy (**REFERENCE**). The critical issue, naturally, is the extent to which the various economies making up any given area are vulnerable to such shocks.

The five criteria most frequently cited criteria (or **conditions**) (**REFERENCE**) for the successful operation of a currency union are:

- **Labour mobility across the entire area covered**. Beyond the absence of simple impediments to movement (visas, residence requirements and work permits, etc.), lack of an open labour market at country level or the presence of cultural barriers to free movement (such as the use of different languages) and the existence of deficient institutional arrangements (lack of simple reciprocal pension and health rights, or equivalence of qualifications) are obstacles which have often been cited in the Euro Area context.
- **The degree of economic openness.** This goes significantly beyond mere capital mobility and financial market integration. In particular wage and price flexibility across the currency area as a whole is essential, in order that simple market forces of supply and demand may work to distribute capital and economic activity to where they may be most effectively operationalised. The evident deficiencies within the Euro Area in this regard are currently being addressed through the structural reform process in the periphery countries.
- A high degree of trade interconnectedness. This is evidently a condition which is readily satisfied in the Euro Area case, although the recent crisis has shown that the downside is that if there is a slowdown in domestic demand across the entire region then just this interconnectedness may become a major impediment to swift recovery from a deep economic recession.
- A risk sharing and rebalancing framework such as an automatic fiscal transfer mechanism to redistribute resources to countries/regions which have been adversely affected by the factor mobility and economic openness processes. The absence of this kind of mechanism is the major institutional weakness of the Euro Area, and the deficiency becomes particularly pronounced in the face of imbalances which have been generated by an environment in which the third condition is satisfied while the first and second are not.
- Harmonised business cycles. When one country experiences a boom or recession, economies in other member countries should be similarly affected. This is in part related to the trade interconnectedness condition but is also a necessary requirement for the successful application of a common monetary policy. In the Euro Area case this condition is not and has not been satisfied. During the first decade the Irish and Spanish economies barely noticed the 2000/01 recession, while the Portuguese and Italian ones hardly escaped from it. The German economy had several years of very slow growth during the initial phase, and now shows above par growth at precisely the moment that the previously best performing economies are stuck in a lengthy recession.

There is another important assumption which lies behind the non vulnerability to asymmetric shocks argument, namely that the various component parts of the area are in some meaningful sense converging towards a common goal. Naturally, it would be virtually impossible to argue that the multiplicity of economies which made up the Euro Area were converging, since self-evidently they are diverging, and even though data limitations supplied at the Euro Area level have meant we have not always been able to see what was going on inside the black box, it is now clear they have been doing so throughout the Euro era.

This is not the place to address the rather deeper theoretical question concerning whether all the constituents are ultimately heading towards one common prototype in finite time, and that what we are currently witnessing are transitional dynamics, what is obvious is that simple application of some “forcing control” procedure at this point is as likely to send the constituents farther apart as it is to draw them together.

One Size Fits All Monetary Policy

One of the key issues which critics of monetary union have continually raised right from the start is the extent to which a single monetary policy is able to cater for the diverse needs of such a wide variety of palpably different economies. Thus even though the ECB’s target interest rate might seem to be in line with the key policy objective of maintaining price stability for the euro area as a whole, sizeable economic differences between periphery and core countries all too often mean (and have meant) that at national level the policy applied was thoroughly inappropriate. Critics of the way the Euro has worked have often focused on the fact that many economies on the periphery may have received excessively loose monetary policy during the years between 2002 and 2008, and then excessively restrictive conditions after the ECB started to raise interest rates again in April 2010.

One way of thinking about this problem to apply a simple Taylor rule procedure to ECB policy and see what result is obtained. The Taylor rule is a broad policy yardstick that generates monetary authority interest rate recommendations according to the respective forward paths of inflation and economic activity (Taylor, 1993). According to one popular version of this rule, central bank policy interest rates should respond to deviations of inflation from its target and unemployment from its perceived natural rate (Rudebusch, 2010).

Evidently, the ECB Statute makes no mention of the unemployment rate, but still, a counter factual thought experiment can be helpful, just to see what has been going on. San Francisco Federal Reserve Economist Fernanda Nechio did just this, and applied a simple Taylor rule procedure to determine what the interest rate policy recommendations would have been. Unsurprisingly she found that taking the euro area as a whole, the Taylor rule fit has been tolerably good since 2005, as indeed it has been for the United States.

But applying the rule separately to the euro area's core and periphery, Nechio discovered something much more interesting. She found the ECB policy rate post April 2010 was well above the Taylor rule derived rate for the periphery, but below it for the core. In addition she also found that this divergence between the ECB target rate and the Taylor rule derived one was not a new phenomenon, although the sign attached to the divergence had reversed. From the inception of the euro to the 2008 financial crisis, the actual ECB policy rate was below the rate predicted by the Taylor rule for the peripheral countries and more in line with Taylor rule recommendations for the core euro-area countries. Naturally this finding comes as no surprise for those critical of the role ECB monetary policy played in creating the distortions to the economies on the periphery which have now become only too evident.

Naturally, the euro area's problem of a "one-size-fits-all" monetary policy is not unique. In the United States, economic conditions have frequently differed dramatically across regions. And as many of those who have defended the history of ECB policy have argued, the Federal Reserve does not set different monetary policies for different parts of the United States. Nevertheless, tensions over the impact of monetary policy in a union of many separate countries are likely to be far greater than they are in a single country, for the simple reason that there are fiscal transfer mechanisms in place in the latter case which do not exist in the former. The United States can rely on its relatively high labour mobility (supported by jointly funded health and pension systems) and on automatic stabiliser fiscal policy to counterbalance growing economic weakness, offering support and policy options that are not available to the euro area's heavily indebted peripheral countries.

In fact, as we will see later, it could also be argued that in just the same way that neither core nor periphery receive appropriate interest rates from the ECB, the value of the Euro fails to approach "fair value" in either case, since at one end the currency value is inappropriately low (the core) while at the other it is inappropriately high (the periphery). Surely I am not the first to note that had the currency area not been created the core countries could easily have been confronted with "currency manipulation" objections of the kind which are constantly presented to China.

Mechanisms For Controlling Fiscal Spending, The Stability And Growth Pact.

One of the problems identified as a key issue from the outset of EMU by all parties was the issue of how to prevent "free riders" taking advantage of the low interest rate environment being provided to finance excessive fiscal spending on the cheap.

This concern was one of the principal reasons the ECB statute stipulated the maintenance of price stability as the bank's one and only objective while an outright prohibition was placed on the acquisition of member state sovereign bonds in primary markets. Monetisation of member state debt was to be avoided at all costs. Ironically, it has been the limitations of just this framework which has offered the greatest obstacle to the central bank in attempting to identify means to help the various constituent economies recover from the present crisis.

The Stability and Growth Pact (SGP) was established as one of the pillars of EMU, precisely in order to try and avoid cases of fiscal “indiscipline”. One author even went so far as to compare the importance of the pact with the founding of the Bretton Woods system.” (Artis, 2002: 115).

In fact, the Pact became the subject of heated controversy right from its inception. It was extensively criticised by both academics and policymakers. In particular the governing council of the ECB were most audible in expressing public reservations about how the Pact operated, and the bank’s later insistence on structural reforms to some significant extent has its origin in its earlier frustration with the inability of Europe’s political leaders to make the Pact work.

The debate gained added momentum (and bitterness) post 2002 after the inability of the Euro Area’s two largest member states (France and Germany) to reign in their deficits following the termination of the “internet recession” called into question its effectiveness. The Pact was subsequently revised, but to little avail, as events following the Global Financial Crisis were to make more than amply evident.

The basic idea behind the Pact has once more emerged following the emergence of the idea that what the Euro Area needs is a new Fiscal Treaty (on which more below), where objectives are laid out in binding law, and punitive sanctions available for those who fail to comply.

But in many ways this move can be seen as a regression, since arguably what the common currency lacks is a common fiscal treasury, one which most certainly places strict spending limits on the participating states, but which also provides automatic stabilising transfers to help correct developing imbalances, and offers an institutional welfare framework to underpin increasing levels of factor mobility between countries.

However all this fudges the main issue, which is that over and above any specific series of rules, what the various constituent parts of the Euro Area lack above all else is mutual trust. Thus Christian Reiermann writing on the idea of fiscal union in Der Spiegel told his readers: “The euro zone looks set to evolve into a transfer union as it struggles to overcome the debt crisis. There are a number of options for the institutionalized shift of resources from richer to poorer member states -- and Germany would end up as the biggest net contributor in every scenario” (Reiermann, 2011).

Or as Citibank’s Chief Economist Willem Buiter so delicately put it, attempts to transform the current bailout mechanisms into a transfer union are doomed to failure since “the core euro area donors would walk out and the periphery financial beneficiaries would refuse the required surrender of national sovereignty" (Buiter, 2011).

But would they, since as we will see below, they certainly might not like the situation they would be faced with if they did?

Perhaps Paul Krugman has come closest to putting his finger on the core of the whole problem in the following paragraph: "America, we know, has a currency union that works, and we know why it works: because it coincides with a nation — a nation with a big central government, a common language and a shared culture. Europe has none of these things, which from the beginning made the prospects of a single currency dubious" (Krugman, 2011).

Mechanisms For Correcting A Crisis Once One Develops

One of the greatest difficulties which has confronted those debating both the desirability and the efficacy of the currency union has been the fact that the two sides of the argument have often been talking about entirely different things. One of the clearest examples of this has been the insistence of representatives of the EU Commission and the ECB on using Euro Area data, while many of the critics were willing to grant that the numbers looked fine on aggregate, it was what was happening at the individual country level that worried them. It seems the kind of research that was obvious to researchers trained in the US tradition like Fernanda Nechio or Nathan Sheets and Robert Sockin (see below) either did not occur to or was considered taboo by economists employed at the heart of the monetary union.

This dis-aggregating response only served to frustrate central bank representatives even further, leading them to point time and time again to the way across the United States state level differences are if anything greater than they are in the Euro Area, a point which the critics freely granted, but this they argued was beside the point since the United States was a single nation, with a universally accepted cultural identity, a single language and a central treasury able to redistribute resources between richer and poorer States (see Krugman 2011). Defenders of the single currency promptly pointed to the European Structural funds, to which the critics responded by comparing the levels of GDP committed to such transfers (under 2% of GDP in the EU case). And so the debate went (and continues to go), on and on. It seems the two parties are condemned to misunderstand each other until the day what can only go on for as long as it can can go on no longer.

One of the problems with only studying aggregate Euro Area data is that some of the traditional "flashing red light" warning indicators (like for example international reserves at the central bank, or levels of household credit and indebtedness, or current account balances) are no longer placed on the table for policy consideration. With the benefit of hindsight it is apparent that there was something deeply preoccupying about the sizable current account deficits being run in Southern Europe, but at the time the consensus was rather that since the Euro Area as a whole was more or less in balance, the situation was not especially preoccupying (Milesi-Ferretti & Lane, 2007, Lane and Milesi-Ferretti, 2007). Far more importance was attributed to the dangers inherent in the ongoing US current account deficit (Setser & Roubini, 2005), yet ironically to date it has been the (virtually un-noticed) Euro Area ones which have brought the global economy near the point of breakdown.

Referring to the prevailing voices among European policymakers during the build up to the crisis former IMF Chief Economist Simon Johnson testified as follows: “I vividly recall discussions with euro-zone authorities in 2007 — when I was chief economist at the I.M.F. — in which they argued that current-account imbalances within the euro zone had no meaning and were not the business of the I.M.F. Their argument was that the I.M.F. was not concerned with payment imbalances between the various American states (all, of course, using the dollar), and it should likewise back away from discussing the fact that some euro-zone countries, like Germany and the Netherlands, had large surpluses in their current accounts while Greece, Spain and others had big deficits” (Johnson, 2011).

Naturally, when it comes to the G20 and the German external imbalance, the European position does not seem to have changed that much with time. There is no question that the German currency has been systematically undervalued in a similar way to the Chinese one.

The backdrop to these current account balance problems is, of course, the issue of international capital flows. Labour mobility there might not have been, but capital mobility there certainly was, with large surpluses in core countries like Germany and Holland effectively financing substantial deficits in Greece, Spain and Portugal. As far back as 1998 the impact of creating apparently “risk free” sovereigns started to become evident in the bond spreads, the expansion of the interbank market, and the development of a Euro Area wide markets for securitised debt instruments.

As one insider working in this latter field at the time put it to me, “demand for these securities effectively exploded overnight, with a trickle of clients demanding such assets one day, and a queue right round the block the next”. Heading the list of those offering securitised debt at that point were the Italian state and two Spanish banks (Santander and Bancaja), anyone with an ounce of common sense to spare should rather than lauding the huge advance in deepening the Euro bond markets being scratching their head and wondering where all this was going to lead. Two synchronised movements (risk and securitisation) moving in opposite directions on the way up, and then back again on the way down as the positions unwound following the outbreak of the global financial crisis.

Perhaps one of the first people to think seriously about the problem of how monetary and fiscal policy would work in an economy in which capital flowed freely in and out in response to differences in interest rates was Robert Mundell, back in the 1960s. In an epoch in which many consider that “carry is king” this late development may seem strange, but that is how things were in the world of international economics at the time.

Now interestingly for our present concerns Mundell came to the conclusion that everything depended on what that country did about its exchange rate. If, for example, a country insisted on maintaining the value of its currency in terms of other nations' monies constant, monetary policy would become entirely impotent. Only by letting the exchange rate float would monetary policy regain its effectiveness. This lead him later to broaden this initial insight by proposing what has become widely known as the concept of the "impossible trinity" - free capital movement, a managed exchange rate, and an effective monetary policy (Mundell, 1968). The trinity is impossible because a country can pick two (and only two) of the three. A country can fix its exchange rate without emasculating its central bank, but only by maintaining controls on capital flows; or it can leave capital movement free but retain monetary autonomy, but only by letting the exchange rate fluctuate; or it can choose to leave capital free and stabilize the currency, but only by abandoning its ability to control the movement of interest rates to fight inflation or recession.

Krugman later coined the expression eternal triangle to describe essentially the same phenomenon, referring in so doing to the catechism first suggested by the Bellagio Group (see Krugman, 1999). As he puts it:

“In the world according to Bellagio, the problem of choosing an international monetary regime could be summarized as the effort to achieve Adjustment, Confidence, and Liquidity. Exactly what these terms mean is somewhat in the eye of the beholder; but my version goes as follows. Adjustment means the ability to pursue macroeconomic stabilization policies - to fight the business cycle. Confidence means the ability to protect exchange rates from destabilizing speculation, including currency crises. Liquidity basically means short-term capital mobility, both to finance trade and to allow temporary trade imbalances”.

Interestingly, if we think of the current Euro crisis in terms of the Bellagio conditions, the Euro Area now has liquidity (thanks to the ECB), confidence has been returning (slightly) since the dark days of November 2011, but Europe’s leaders are still unable to pursue meaningful policies directed towards adjustment (ie macro growth-promoting policies for the periphery). Au contraire, despite all the talk about creating jobs and attracting investment their uncompetitive economies remain condemned to eternal austerity. This is what comes, evidently from simply ignoring macroeconomic constraints which are evident to a broad cross section of economists working in the field.

Monetary Policy And Exchange Rates In A Globalised Economy

As has been argued above, having a single size monetary policy that did not make allowance for the specificities of individual country needs played a large part in blowing credit bubbles and facilitating competitiveness loss on Europe's periphery. But having noted this, it is important to realise that simply having countries return to the status quo ante may not have the effect which many al too readily assume. The reason for this is the presence of what the Danish economist Carsten Valgreen has called the Global Financial Accelerator (Valgreen, 2007).

The thought involved is the following: real economic decision makers are increasingly isolated from local monetary conditions and more exposed to global monetary conditions and credit extension willingness (or, if you prefer, global risk sentiment). As Valgreen says:

"Take an arbitrary example: A Polish household wants to buy a second home in France. To do this they contact their local bank (which happens to be the subsidiary of a Swedish based banking corporation) in order to obtain mortgage finance. They then chose to borrow the money in Swiss Francs and Yen. This action is likely to have a large impact on the future income streams and net asset value of this Polish household, and – hence – its future behaviour in the real economy. However, as long as free capital flows are maintained the Polish central bank has limited influence on the transaction. None of it is in Polish Zloty. And the credit decision of the private banking corporation extending the credit is taken based on a credit model maintained in Stockholm in Sweden. What will matter for the family is the future currency and rate moves in Swiss Francs and Yen. And the price developments for second homes in France. And perhaps also the future credit attitude of a Swedish based credit institution"

The point of Valgreen's example is to show just how powerless national monetary policy can actually become in small open economies in a world of fluid cross border financial flows. He goes on to illustrate his point by referring (in mid 2007, before the global financial crisis broke out) to two countries which were later to gain a certain notoriety. As he points out, neither the Icelandic nor the Latvian central bank would have been able, using simple recourse to conventional monetary policy tools to control the rate of credit extension in their countries, despite the fact that one country had floating exchange rates while the other had a currency peg.

The Icelandic central bank could control the interest rate on Icelandic kronur. But that did not matter much for households, non-financial companies or banks borrowing funds in foreign currency. Neither does it seem to matter too much today that the official currency of Croatia is the Kuna, since the country has one of the most Euro-ised economies outside the actual Euro Area.

As Valgreen argues in the Icelandic case, as long as the banks have a high credit rating and are perceived as sound by the international markets, credit flows easily to them in a liquid global environment. “Perversely”, he noted, “it even seems as if a stronger currency stimulates the Icelandic economy in the short run, as consumer spending reacts to increasing external buying power and as exports are concentrated in price insensitive commodity sectors.

Perhaps Valgreen was the first to note this “perverse” rising currency stimulating credit growth (the financial accelerator) phenomenon, although it was later to gain much more attention as Ben Bernanke’s various attempts at quantitative easing put the pedal to the metal on credit demand, not in the United States, but in countries as far apart as Thailand, India and Brazil. Policy reactions then were relatively swift. As Dani Rodrik proudly heralded:

“In the world of economics and finance, revolutions occur rarely and are often detected only in hindsight. But what happened on February 19 can safely be called the end of an era in global finance. On that day, the International Monetary Fund published a policy note that reversed its long-held position on capital controls. Taxes and other restrictions on capital inflows, the IMF’s economists wrote, can be helpful, and they constitute a “legitimate part” of policymakers’ toolkit”. (Rodrik, 2010).

Naturally, in this case the IMF were prepared to contemplate the use of capital controls to make it more difficult for money **to enter** (not leave) a country, for the simple reason that raising interest rates to slow an overheating economy was having the perverse consequence of attracting even more money, pushing up the currency in the process, and giving nascent manufacturing industries a hefty dose of the Dutch disease.

Thus the world of international macro economics has changed mightily over the last decade, and things are far from being what they used to be. Which should give us all some serious food for thought when it comes to arguing in favour of a simple return to the status quo ante in the case of the Euro Area countries.

Another pioneer in raising the issue of national monetary policy in a globalised world in a systematic way was Richard Fisher of the Dallas Federal Reserve. As Fisher was arguing back in 2005:

“Globalization is an ecosystem in which economic potential is no longer defined or contained by political and geographic boundaries. Economic activity knows no bounds in a globalized economy. A globalized world is one where goods, services, financial capital, machinery, money, workers and ideas migrate to wherever they are most valued and can work together most efficiently, flexibly and securely”.

Now, as Fisher asks, "Where exactly does monetary policy come into play in this world?" Well let's see:

“The language of Fedspeak is full of sacrosanct terms such as “output gap” and “capacity constraints” and “the natural rate of unemployment,” known by its successor acronym, “NAIRU,” the non-accelerating inflation rate of unemployment. Central bankers want GDP to run at no more than its theoretical limit, for exceeding that limit for long might stoke the fires of inflation. They do not wish to strain the economy’s capacity to produce. One key capacity factor is the labor pool. There is a shibboleth known as the Phillips curve, which posits that beyond a certain point too much employment ignites demand for greater pay, with eventual inflationary consequences for the entire economy”.

"Until only recently, the econometric calculations of the various capacity constraints and gaps of the U.S. economy were based on assumptions of a world that exists no more".

A world that exists no more. And one that individual countries cannot go back to. The issue being presented is not that individual domestic economies are not subject to price and wage increases following surges in domestic demand, but that they are not subject to these to anything like the degree they used to be, since behind the domestic supply of raw materials, labour and capital, there now lies a much broader and much deeper factor supply market and unless allowance for the degree of this change is made in traditional econometric models, then prior notions of "capacity" are likely to lead policymakers well wide of the mark when it comes to estimating the impact of monetary policy changes.

The very idea of capacity itself has become much more elusive and elastic, and it is this very elasticity - ie the capacity for local economies to draw on large pools of underutilized labour, and even over long distances, and to avail themselves of the increased (and normally cheaper) supplies of capital which are available through global financial markets (and of course in the Eurozone context the European capital markets themselves) - which means they are able to respond to rapid increases in demand without the normal wage and prices pressures coming immediately and visibly into play to anything like the extent that they once did.

To take but one simple example, between 2000 and 2008 the Spanish population increased by six million people (from 40m to 46m). Of this increase virtually none was the product of natural factors. Six million people came to live in Spain, some to enjoy the sun and the benefits of a new home, but the vast majority were economic migrants, nearly 5 million of them, the majority coming looking for work, work which was available due to Spain’s unsustainable property boom, a boom which was made possible by an excessively lax evaluation of the situation by the various credit rating agencies, and the availability of ultra cheap funding in the new European capital markets.

The lesson here is that we live in a non linear world, were capital flows, warped exchange rates or rapid movements of labour can create dynamics which look very attractive in the short term, but prove to be totally unsustainable over a longer one.

Germany The Reluctant Partner?

Another red herring that is often introduced into the Euro debate is the idea that Germany has always been a reluctant party to the common currency, and will eventually seek to leave, along possibly with a number of other “core” countries like the Netherlands and Finland. For example Lombard’s Chief Economist Alexander Dumas, who says that ‘what you’re actually dealing with here... is a German population which has had a rotten deal – and that’s why they’re all so angry’ (Dumas, 2011).

Now this view is interesting since it highlights two popular misconceptions. The first of these is that Germany has been a long suffering victim of the spendthrift policy of its Euro Area partners, and the second is that German household consumption is so weak due to a domestic policy of wage compression.

Now if we take the former argument, in fact the German economy made a substantial transition at the end of the 1990s from being a partially consumer-credit-driven economy with a small current account deficit to being an export driven economy running a large current account surplus.

In a couple of recent and highly stimulating essays two Citi economists, Nathan Sheets and Robert Sockin (see Sheets and Sockin 2012a and 2012b) argue that German trade performance since the introduction of the euro has been significantly boosted by having a currency which was valued significantly below the valuation it would have been subjected to had the country still been using the Deutsche Mark. As a result of this systematic undervaluation Germany’s external surpluses widened significantly, led by rapid export growth.

Sheets and Sockin use a simple econometric procedure to estimate that that European monetary union, coupled with the country’s extraordinary wage restraint, has resulted in a real effective exchange rate for Germany that is currently 15 to 20 percent lower than the one which would have prevailed if Germany had had its own floating currency. And naturally the weaker real exchange rate has provided a significant windfall for Germany’s export sector.

They thus find that the lower German real exchange rate has lifted the country’s nominal trade surplus by roughly 4 percent of GDP (or €100 billion) annually and the real trade surplus by about 3 percent of GDP annually. In addition, since the outbreak of the Greek crisis, Euro weakness has meant that German exports have been in an almost uniquely privileged position to benefit from strengthening global demand in the emerging market economies.

The comparison with Japan is significant in this case, since as of December 2011, Japanese exports were still running at 8% **below** their pre-crisis high point, while German exports were about 7% **above** their pre-crisis high. Since the global financial crisis German exports to China have risen most strongly, while Japanese exports to China have virtually stagnated. What could be the explanation for this strange phenomenon, since evidently Japan has efficiently produced technologically-advanced products to sell? Well, the relative values of the two currencies the countries use might offer us some part of the explanation. From the start of 2007 to mid 2008, the Japanese yen was trading in the range of 0.06 – 0.065 to the Euro. At the start of 2012 it was trading at all time record levels of just over 0.1 to the Euro – that is the yen rose versus the Euro by over 60% in just three and a half years. What German policy makers might with good reason worry is that should their country go back to the Deutsche Mark a similar fate might well await them.

Naturally in June 2008 Japan's currency was significantly under-valued, due to its habitual use as the "carry" funding currency of preference, while Germany's currency is currently significantly under-valued (due to the impact of the sovereign debt crisis). In July 2008 Japan's currency valuation spiked dramatically – rising by around 30% in 3 months – as the global financial crisis took its toll and the carry trade unwound. Since that time Japan's currency has risen steadily (as has, for example the Swiss Franc) due to the country's safe haven status. Naturally such a state of affairs only serves to exacerbate the country's long running deflation problem.

Taking everything into account, surely it would not be unreasonable to suggest that a Euro unwind would lead any new German currency to surge dramatically in the aftermath just as the Japanese one did in 2008, and then continue its upward path for safe haven reasons. The key point is that in the age of the global financial accelerator currency movements have a strong non-linear component (Valgreen, 2007).

Mentioning Japan brings us to the second basic misunderstanding about Germany's long transition, that it was simply a question of wage compression. In order to understand why there is something more than a common or garden variety of deflation behind the German competitiveness correction it is worth reflecting on what the term "export dependency" means.

Ageing Populations And Export Dependency

Essentially mature economies become dependent on export expansion for growth either if they are in the aftermath of a credit driven consumer boom (and hence deleveraging, weakening domestic demand) or their population median age rises above a certain point (yet to be adequately calibrated) meaning that the demand for consumer credit no longer expands as the balance between savers and borrowers shifts across cohorts and across the life cycle. Hence Germany's wage adjustment is not something exceptional, or even reversible, but forms part of a natural process to reinforce competitiveness in the export sector of a society with a large elderly population and hence generate GDP growth.

At the start of this century, when wages were relatively higher in Germany consumption was already lacklustre, but GDP growth was also mediocre, and unemployment was high. Contrary to what Alexander Dumas seems to assume, since the wage-cost adjustment consumer demand has improved moderately, GDP growth has revived and unemployment has fallen significantly. It is hard to argue that this has been a “bad deal for the Germans”.

Since the international value of the Euro has served to keep trade for the Euro Area as a whole near balance, the counterpart to Germany’s rising surplus has obviously been mounting deficits in the peripheral countries, where the growth of wages has significantly outpaced that of productivity. This has put these economies in an unsustainable position, and it is this imbalance within the Euro Area itself which must now be remedied by finding some way to enable the peripheral economies to follow the same path as the German one. Since the degree of distortion is much greater than in the German case, and the level of indebtedness much higher, then it is hard to see how the transition can be achieved without substantial deflation and ongoing debt restructuring.

Why Deposit Flight Is A Thing Of The Past

Another of the popular ideas about how Euro Area disintegration might come about is via the flight of deposits from the struggling periphery to the stronger core. This is a phenomenon which has to some extent occurred, but recent developments at the ECB suggest the issue is nothing like as relevant or as much of a headache as it was.

The Euro Area situation has, to date, been a hybrid one, since as long as each country was solely and exclusively responsible for its own debt, and the ECB was either prohibited from monetising it or disclaiming responsibility for openly and permanently supplying liquidity to national commercial banks there was no clear redistribution mechanism via the central bank. Now things have changed considerably, with the arrival of the Securities Market Programme, the 3 year Long Term Repo Operations which banks are encouraged to use, and the new collateral rules which are specifically designed for a limited number of countries (Buiter, 2012). Arguably an element of shared risk is being assumed, and most importantly given the level of economic literacy of the voting population it is largely being assumed by stealth.

Essentially the LTROs have three objectives: a) to help the Euro Area’s weaker sovereigns finance their debt; b) to help the commercial banks on the periphery meet their wholesale financing needs; and c) to help move credit in the gridlocked economies on the periphery. The operations seem to be working as far as the first two objectives go, at least for the time being. Banks are buying up government debt, and certainly at the short end of the maturity range, in order to earn some money from “carry” to improve their profit and loss numbers, and ultimately help them recapitalise. At the same time they are preparing and packaging collateral to get financing to cover their future refinancing needs, and many of them seem now to have been able to do this right the way though to 2015. At which point, and assuming the Euro and the ECB are still with us, there will almost certainly be another round of LTROs. Arguably the ECB is now going beyond the initial role of supplying liquidity to banks and offering them more permanent forms of financing which is much more akin to capital. The ultimate development in this unusual and unprecedented process would only need to be the conversion of the ECB liabilities into equity for the circle to have been completely squared.

It is in connection with the third objective – that of moving credit in the troubled economies - that the ECB operations are failing (and arguably will continue to fail) in reaching their objective. Basically the problem here is that most of the economies on the Euro Area periphery are currently significantly over-leveraged. That is to say the proportion of their **TOTAL** debt (public and private) to GDP is too high relative to their future capacity to pay, and this problem really lies behind why there was a global financial crisis in the first place (in most developed economies including in the US).It is important to understand that from this point of view it doesn't matter whether the debt is public or private, especially since fiscal austerity combined with ample liquidity for the commercial banks will do little to help deleverage the private sector, in fact this combination will only serve to make the problem worse.

The issue is that if you have too high a debt ratio (that is, if you are overleveraged) you can reduce it either by growing GDP (nominal GDP) or by reducing the debt. That is why, for example, Paul Krugman tries to ridicule those who say you can't reduce debt by contracting more debt. It isn't that simple. If you run a company, and you have a good product, then getting some working capital from the bank to let you produce, and even a subsidy from the government to get you started, then maybe by going to work you will be able to pay back more of what you owe. And as with the single company, so with the whole economy on aggregate.

But, here comes the rub: the countries on the periphery can't get the growth they need until after they have deleveraged, since getting more credit will only make them even more leveraged and since they have a competitiveness issue they can't expand their export sectors as fast as they need to to get traction. So they are stuck, and this – and not the credibility of some ratings agency or other – is what the whole Euro Area debt crisis is all about.

Once these economies have deleveraged and banks recapitalised to cover the losses, which means the banks will have less credit on their balance sheets, then, of course, the banks can leverage again and offer new credit. This kind of deleveraging is long, painful and arduous, since it also produces deflation (economies contract along with credit) but with time (let's say a decade) competitiveness is eventually restored. The other alternative is for the banks to write off bad loans more quickly, but this means accepting greater losses, and with these will come more government intervention in the financial sector, and hence eventually more public debt. So Euro Area commercial banks and governments are reluctant to bite the bullet and go for this solution, since it balloons the deficit (see Ireland), and prefer the slow process.

It is not that no new loans are possible, but that new loans can only be issued after old ones are paid or written off, and after the balance sheet has been reduced to deleverage to a certain extent. Which means the quantity of new loans is not sufficient to produce growth or (in Spain's case) stop unemployment rising. And as banks remain reluctant to write down assets, and the ECB gives them the liquidity and accepts the kind of commercial credit claims as collateral in a way which helps them not do this, then the normal adjustment process doesn't take place, and Schumpeterian style creative destruction is postponed for another day.

The central issue in all this really is that the ECB, which was once a highly constrained institution, has now, whether by accident or design, been converted into the principle instrument through which policy is implemented. There is a simple reason for this: voters don't really understand how central banking works.

Thus, there is a still a lot of juice left in the ECB lemon, and it will all be squeezed. The latest example has been during the Greek bailout negotiations. Understandably private sector investors have a red line beyond which they are reluctant to go on a voluntary haircut. Politicians don't want to be seen to be giving Greece yet more money, so in steps the central bank. That the ECB be taken out of the "official sector" and take a loss (or is that lose some of its profit) on its Greek "investments" has been the latest suggestion to come on the table from the IMF. This has the advantage that it is yet another bank that is being seen to take losses, and not the taxpaying public. But at the end of the day the ECB is also using "carry" to help its bottom line, and if needs were to must, it could always increase the corridor between what it pays on deposits and what it charges on loans. It could even go so far at some point as to pay negative interest on all those core deposits, which would have the double impact of penalising the German saver for not spending more, and improving the ECB's interest margin.

While the growth issue has no short term fix for the common currency's administrators, the debt restructuring one has, at least for the time being. So will the next client – Portugal perhaps – please step inside.

Ageing Populations An Additional Headache?

Ours is an age of rapidly ageing societies. What is so modern about our current situation is not the ageing itself, but its velocity, and its global extension. West

European societies have been ageing steadily – in terms of their median population age - ever since the coming of the industrial revolution, but now, following a sharp fall in birth rates and a sustained rise in life expectancy, we are ageing far more quickly than any previous generation could have contemplated. Median ages in several countries are now around the 45 mark, and by 2030 the first pioneers will be breaking the 50 year barrier,

The economic and social implications of this are going to be profound, and, as the credit rating agency Standard & Poor's noted in a recent report on the topic (Standard and Poor's, 2010), seemingly irreversible. Indeed, no other single force is likely to shape the future of national economic health, public finances, and policymaking in the coming decade as the unprecedented rate at which developed country populations are ageing. Yet, strangely, the issue receives only a fraction of the attention that has been devoted to global climate change, even though, arguably, ageing is a problem our s ocial and political systems are, in principle, much better equipped to deal with.

And if the problem has received little attention on the global level, its significance for the Euro sovereign debt problem has been even less appreciated, at least outside the ratings agencies.

The problem, however, is potentially, massive. According U.N. data, the proportion of the world's population aged over 65 is set to more than double by 2050, rising to 16.2% from 7.6% currently. By the middle of the century, about 1 billion over 65s will join the ranks of those currently classed as being of non-working age. The cost of supporting and caring for all these people will inevitably profoundly affect economic growth prospects and dominate public finance policy debates worldwide for many years to come.

As far as we are able to understand the issue at this point, population ageing will have major economic impacts which can loosely be categorised under four main headings:

i) ageing will affect the size of the working age population, and with this the level of trend economic growth in one country after another

ii) ageing will affect patterns of national saving and borrowing, and with these the directions and magnitudes of global capital flows

iii) through the saving and borrowing path the process can influence values of key assets like housing and equities

iv) through changes in the dependency ratio, ageing will influence pressure on global sovereign debt, producing significant changes in ranking as between developed and emerging economies.

While demographic changes taking place in the developing countries mean that global growth is currently running at historically unprecedented levels, there can be little doubt that trend growth in some of the older developed economies has been progressively slowing.

The long term growth rate in Italy is now not far above zero, and in Germany and Japan it is only just sustaining the 1% level. This phenomenon will become increasingly important as the number of those in the key 35-54 age group falls relative to those aged over 65 in one country after another.

On the global scale the ratio is expected to fall from the current level of 3.25 to 1 to a mere 1.58 in 2050. But the really worrying numbers come from the countries who will have more people aged over 65 than between 35-54 by the time we reach 2050. Those in this category are Japan (who fall from a 1.19 ratio to 0.58 over the period), South Korea (a dramatic fall from 3.05 to 0.65), Italy (1.28 to 0.69), Germany (1.19 to 0.69), Spain (1.80 to 0.70), France (1.61 to 0.87) and Canada (2.12 to 0.92).

So without significant extensions in working life over the next few years, there will be more retirees than those in their economic prime across large swathes of the Western World as we approach 2050. But even with the increase in working life the productive capacity of the workforce is sure to be affected its the average age rises.

And historical data reveal a relatively good longer-term correlation between risk-asset prices and the proportions of those who are in the 35-54 year age group when compared to those in the child and elderly dependent groups. In principal this age group constitute the main income producers for an economy and their ability to drive activity and invest in assets may well be influenced by the level of economically inactive population they have to support either personally or through taxation.

With high and rising rates of economic dependency the burden on the economically active population may become such that consumption is negatively affected while the pool of available money to invest becomes significantly reduced. This implicit ‘productivity ratio’ may well give us one of the best measures available of the likely capacity of the net accumulators of assets in an economy to influence asset prices as the population ages.

In this sense Japan already offers us a clear warning as to what may await the rest of the developed world as a significant part of their population hits the old age dependency stage. In terms of the 'life cycle hypothesis' Japan becomes a fascinating test case for what may happen in many countries in the years to come. While it may be statistically difficult to establish whether the bursting of the Nikkei bubble at the end of 1989 and the bursting of the dot.com bubble in 2000 had a common root in changing demographics, it is clear that financial markets have become more prone to bubbles as the pool of potential savers has grown.

Current Account Transition?

If you accept that having a growing population (especially those in their working age) has been a key component of growth in many countries throughout what we have come to call the modern growth era, then it does seem those parts of Europe where labour forces look set to stagnate have a much higher risk of an eventual Japan style outcome than the US does.

And nowhere could this situation be clearer than in Spain. The Spanish economy sustained several years of what was clearly above par growth by increasing labour inputs dramatically, while productivity growth remained between low and nonexistent. In the Spanish case the labour force growth came not from natural population growth, but from labour migration from other parts of the globe, while the demand which supported the growth was also not organic, but fuelled by the very cheap and ample liquidity which had become available with the creation of the Euro-wide capital markets.

In order to see how this problem may have arisen, and what may now happen to domestic saving in Spain, a comparison between the recent history of the Spanish and German economies can prove illuminating, especially since, as I will argue below, there are strong structural homologues to be observed in the evolution of the two economies, with a time delay of about a decade between the process in one country and that in the other.

The first, rather surprising, discovery which an examination of the recent historical data for Germany reveals is that it simply is not true that the Germans are a group of "non consumers", and inveterate savers. Back in the 1990s German private consumption enjoyed a substantial boom, a boom which ground itself to a halt around the year 2000. It is only since 2000 that German private consumption growth has been lacklustre, and seemingly incapable of driving GDP growth. And when we come to Spain, it is immediately evident that Spanish household consumption growth enjoyed a similar expansionary cycle between 1999 and 2007, demonstrating the same kind of "blossoming" (if on a rather larger scale) that German consumption had experienced in the mid 1990s.

More than the phenomenon of the consumption boom in and of itself, what is really important is what it was that was driving it. Unsurprisingly perhaps, what we find when we come to examine the data is that same old "usual suspect" – a very rapid increases in private sector credit. And examined carefully the figures belie the idea that Germans have always been a nation of meticulous savers. The Spanish history of mortgage growth tells a very similar (but even more exaggerated) story to the German one. And, as can be seen, it wasn't only households who were doing the borrowing, corporate entities were rapidly increasing their leveraging too. Interestingly, after years of being almost dormant, corporate borrowing seems to have had a brief renaissance in Germany on the back of the current crisis.

But one more time, when it comes to corporate borrowing the only aspect in which the situation in Spain distinguishes itself is in the magnitude of the phenomenon. Spanish corporate indebtedness has become a much, much bigger issue than German corporate indebtedness ever was. Indeed, while total private sector debt in Germany around the turn of the century was not that different from Spanish private debt today, German GDP at the time was (in relative terms) around twice as large as Spanish GDP is today. And moving forward, if we come to look at the long tail on the stagnation in German year-on-year borrowing, this is the point where we should be able to discern something of the future which awaits Spain and especially in an environment where the financial markets have little willingness to finance yet more indebtedness. Interannual lending in Spain simply isn't going to climb back up again towards its previous levels, and we should expect it to trawl around the zero percent mark in the years to come, as Spain's private sector steadily, and somewhat painfully, deleverages itself.

But there is another aspect of the situation which should attract our attention here, and that is the close association between ongoing lending booms and current account balances. Germany was no exception to the general rule here, since all through the duration of its consumption boom the country ran small current account deficits. Deficits which then became surpluses in the wake of the huge structural adjustment the country passed through during the transition from being a consumer-driven to being an export-driven economy.

And this is the path that the Spanish economy will now surely have to follow, even if we should again not miss point that there is a very significant difference in scale between the two cases. In comparison with the process Germany was submitted to between 1999 and 2005 Spain's adjustment will need to be quite literally enormous. As some economists have observed the transition which awaits the Spanish economy is one without precedents, and is certainly right off the map as far as recent historical experience is concerned.

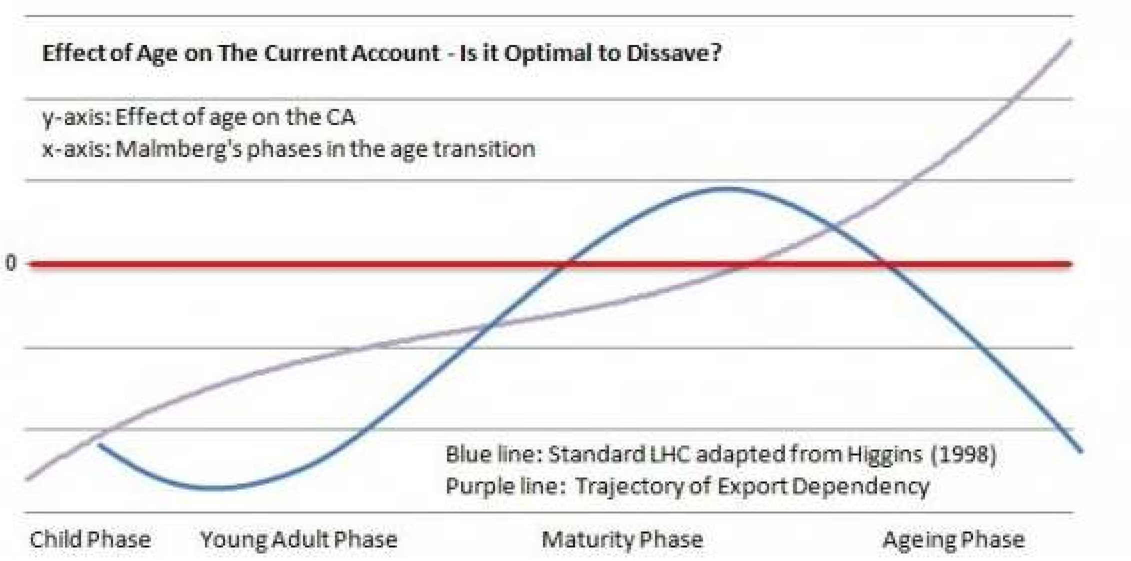
So what is going on here? Certainly the close similarity is too striking to be merely coincidental. The economic literature is replete with examples of countries who experienced financial crises, and then dug themselves out of the hole they found themselves in by increasing their exports (Reinhardt & Rogoff). The reason for this is obvious. Once the private sector in a country gets itself into crisis precipitating excessive debt, there are only two realistic possibilities: restructure the debt, or pay it down. There isn't a third possibility of getting into even more debt (via for example government fiscal deficit spending), since as we can see at the present time, such attempts have a relatively short life, and the markets rapidly lose patience with this kind of attempt to flee into the future. So given that the restructuring option isn't an especially attractive one either, most countries ultimately solve their problem, by exporting their way out of difficulty, in order to then restart the credit cycle.

But the conjecture advanced here goes beyond this, since what is being postulated is not the idea of economies which are temporarily export driven, but of ones which become completely export dependent.

The argument than now follows is more of a hypothesis than anything else, but if we look seriously at all the above argumentation above about how demographic processes affect patterns of national saving and borrowing, and if we accept that ageing is (whatever the drivers of fertility declines may be), as a matter of fact, an irreversible process, and if we pay careful attention to the recent historical experience of countries as they age, then it does seem not unreasonable to postulate that there is a transition which occurs, and that this transition has at its centre a steady transformation of the current account balance.

As we have seen, it economies transit from being consumption driven to export driven, and it would appear that the process is not merely random, a question of options or “growth models”. There is not a choice here, since there are deep underlying structural dynamics at work, and these dynamics seems to be intimately associated with the dynamics of the demographic transition. As I am trying to argue in the German case, the shift doesn't seem to be a cultural one, or a pure question of public policy. And the hypothesis is empirically testable, in the sense that if Spain does follow Germany down the exactly the same road then this will count as additional corroboration for the thesis.

But what could be really be driving this transition? Well, as the young Danish economist Claus Vistesen and I have suggested on a number of occasions, the close association of the export dependent phenomenon with population ageing and the demographic transition which lies behind it may well provide us with the key. Using Franco Modigliani's life cycle saving and borrowing idea (**reference**), and the Swedish demographer Bo Malmberg's one of population "ages" (child, young adult, middle aged and elderly, **reference**), Claus Vistesen has prepared the following chart which attempts to illustrate the process which might be at work.



The current account balance is here associated with dependence, or lack of it, on exports. Very young societies, such as those which are to be found in the African Sahel, or Uganda, or Pakistan, or Bolivia, have very low saving rates due to the high preponderance of those under the working age, and as a result are dependent on current account deficits and imports to maintain a minimum standard of living for all. If markets were completely rational in this context, they would be prepared to finance these deficits conditional on policies to reduce fertility and raise female empowerment, which are sure ways to reduce the level of child dependence, in the same way they are prepared to finance elderly but highly indebted European societies conditional on policies to raise labour force participation rates and extend the working life via reform of the pension systems.

At the other extreme, elderly societies become increasingly dependent on exports to avoid falling into dis-saving, and negative current account balances, since the once the current account balance deteriorates into negative territory it is unclear how the situation can ever correct itself, given the absence of homeostatic processes.

Of course, all of the above remains for the time being at the level of hypothesis. What is beyond doubt is that Spain's boom bust cycle followed Germany's by a decade, while their demographic profile also reveals a ten year lag between one country and the other. In terms of median population ages Spain is roughly at the same point today as Germany was at the turn of the century. And when we come to the percentage of the 25 to 40 age group in the total population, we can see that this peaked in Germany at the end of the 1990s, while it is peaking in Spain at the present time.

One of the clear macroeconomic conclusions that flows from this little excursus, is that if the hypothesis is valid, the Euro Area will steadily generate a current account surplus in the years to come (time permitting), enabling the region to self finance itself in much the same way that Japan is able to finance for the time being. It also follows that a recovery in Euro Area domestic demand to become a driver of growth is most unlikely, indeed if it did there would be something fundamentally wrong with the above advanced hypothesis.

Perhaps this excursus into the economics of ageing populations and export dependence will seem to some out of place in an essay which was expected to be largely about how a legal divorce from the currency union might be negotiated by a dissenting member, or how assets and liabilities could be redenominated in such a situation, but arguably many of those who are most vociferous in the present debate are operating either on the basis of old theories which are now rather questionable or on the basis of inadequate information concerning what the problem actually is. Europe's debt problem, and here I am intentionally including Euro and non-Euro states, is far more serious than is normally understood, and unless we get to the roots of the problems we will not find solutions. In the meantime we should perhaps note that Standard and Poor's recently warned they would start downgrading all developed sovereigns (over and above downgrades already in the pipeline) simply on the grounds of the health costs associated with ageing populations (Standard and Poor's, 2012).

Solutions

Split The Euro In Two?

Evidently the Euro Area is now at the crossroads, and important decisions need to be taken. Preserving the Eurozone — as it is now — might be workable if it were possible to transform the Eurozone into a full fiscal union where budgetary policy was coordinated across nations by a central treasury in the way major programmes are between states in the US. But such an arrangement is currently a political impossibility, as Europe’s core economies would inevitably reject what would be seen as a permanent transfer union between high-growth regions and their poorer neighbours.

However the present debate about creating Eurobonds is resolved, these alone will not solve the problem at this point, and, as many observers have noted, may even make matters worse by further weakening the sovereign credit ratings in the core. In the longer run such bonds could form part of a more general solution, but the moral hazard dimension they entail means that in the absence of a fix for the immediate competitiveness problems on the periphery they only risk making the common currency project even more politically unstable.

So, with fiscal union effectively off the table, there are basically three possibilities. The first is for the Euro Area to stay more or less where it is, applying an ever stronger fiscal tourniquet, maintaining and expanding the bond purchasing programme of the ECB, and having a steady stream of LTROs to keep the river of liquidity flowing. The various stability funds can and are being increased, but still, we have that awkward nagging question, where is the growth which will be needed to make all this sustainable in the longer term going to come from?.

A second possibility would, naturally, be to disband the currency union entirely, leaving everyone to go back to their own national currency. This would be a disastrous outcome for all concerned, and for the global financial system. It would even, as I have tried to argue, be a pretty disastrous outcome for Germany, who could easily loose all that hard won international competitiveness at one foul swoop.

Coordinating the unwinding of cross country counter liabilities would be a nightmare given the level of interlocking in the corporate and sovereign bond markets, and the sudden disappearance of one of the major global currencies of reference would cause havoc in financial markets. The dollar would most likely be pushed to unsustainably high levels in the rush for safety, and it is only necessary to look at what is already happening to gold, the Swiss Franc and the Japanese Yen to catch a glimpse of what would be in store.

Evidently this kind of violent unwinding would never be undertaken voluntarily, but that does not mean that it is an eventuality which might not take place, if solutions are not found and the force of market pressure continues and even augments.

There is a third alternative, even if it is one that at first sight appears no more appetising than either of the other two: **the Eurozone could be split in two**, creating two different euro currencies. Naturally the composition of the groups would be a matter of negotiation, since some countries do not easily belong in either one group or the other. The broad outline is, however, clear enough. Germany would form the heart of one group, along with Finland, Holland and Austria, while the Southern periphery would form the nucleus of the other.

Naturally the technical challenge would be enormous, but it would not be insurmountable. The great advantage of such a move would be that two of the major burdens under which the monetary union is labouring – the lack of price competitiveness on the periphery and the lack of cultural consensus between the participants – would be resolved at a stroke.

No one knows the values at which the two new currencies would initially operate, but for the purpose of a thought experiment let's assume a Euro1 at around U.S. $1.80 (the euro/USD is currently around US$ 1.40), and a Euro2, at around $1. Obviously, in the short term the winners of this operation would be the members of Euro2, who would get the devaluation their economies have been yearning for. Why would this be? At a time when the countries concerned are loaded down with debt and domestic demand is correspondingly weak, export growth is the only way for their economies to move forward, and the changed currency valuation would allow cheaper labour and production costs, giving their economies an enormous push in the export direction.

And it would encourage growth in other ways. Take Spain as an example. The country has at the present time a large pool of surplus property, on many estimates of around 1 million unsold new housing units. Many have criticised the banking sector for not dropping prices sharply to enable the market to clear, but the banks are understandably reluctant to do this due to the impact this would have on their balance sheets, and due to the knock-on effect on their existing mortgage books. The beauty of this solution is that no further drop in price would be needed, since for external buyers the real price of all this housing would suddenly become much cheaper.

The case of tourism would be somewhat similar, since not only would more tourists come to Spain, they would come for longer and they would spend more. The shopping bags would certainly not be empty on the plane home.

Spain's troubled savings bank sector has been desperately looking for foreign investors to help them recapitalise, but while many have shown interest virtually none have participated to date. After the devaluation all this would change since they would be able to buy shareholdings at attractive prices, and without having to worry about a sudden drop in prices and hence loss of capital.

Spain's 4.5 million unemployed would gradually start to go back to work, new investment could steadily be attracted for other productive projects in manufacturing industry, no one would doubt the solvency of the Spanish state, and the private sector would be in a better position to start paying back its debts as the economy grew.

Now obviously, as we all know, in economics as in life there are no free lunches, so there must be a catch here somewhere, and of course there is. In fact there are two big "catches". In the first place those countries who joined together to form Euro1 would be making a big sacrifice, since many of them also depend on exports for their livelihood, and their manufacturers would suddenly and sharply find themselves at a disadvantage. In particular Germany would suffer.

However, assuming that all could agree at some point that the current arrangements are unworkable (which seems unlikely at the present point), and that going back to individual national currencies would be a disaster, then the German sense of responsibility and the country's commitment to the European project might well make the acceptance of some sort of sacrifice (and especially if it were a sacrifice which offered longer term solutions) bearable. Fortunately, recent German historical experience provides us with two concepts which might just help everyone see their way through this. The first of these is the Treuhandanstalt, the Privatisation institution (and bad bank) which was created to handle East German assets between1990-1994. The second is Lastenausgleich, or burden sharing, which refers to the mechanism used to share the unequal outcome of WW II between Germans who found themselves living in the West: between those who had come from the East and lost everything and those who were from the West and had retained something.

The Treuhandanstalt experience is useful in helping us to think about how to handle the common set of assets/liabilities acquired during the initial Euro stage. Think about Spain's banks and their property assets. These would now be sold in Euro2, but many of the liabilities which correspond to them are in fact liabilities with institutions who will find themselves in Euro1. Marking them to market immediately, and in Euro2, would produce sizeable losses in the Euro1 financial sector. Some of these losses are inevitable and to some extent correspond to the kind of restructuring haircuts which are now being contemplated. But in the initial period (and for reasons which will become clearer below) it would be advisable not to mark them to market, but to hold them for a specified time in a common institution of the Treuhandanstalt kind.

As I say, some losses are now inevitable, and this is where the second concept from recent historical experience – Lastenausgleich, or burden sharing – becomes important. Despite protests to the contrary from Lorenzo Bini Smaghi (See, for example, Bini Smaghi, 2011) the Euro experience to date has not been a success for any of the participants once you add-in the potential losses which are now looming. At the same time the common currency has been a shared experience, in which all have taken part, so it is not unreasonable to assume that all should share when it comes to the downside. The problem with the measures adopted to date is that they are perceived on both sides of the fence as unfair. Those who are funding the bailouts feel that they are being asked to pay for the “excesses” of the recipients, while those who receive feel that what they are getting is not help, but loans which make it easier for the financial sector in the donor countries to avoid declaring losses. This “communicational impasse” is one of the major reasons the current approach won’t work.

What is needed at this point is an appeal to the European spirit of the Euro1 countries, in a way which helps them to see that some costs are unavoidable, but that any agreed costs will be shared, and above all that the game-changing solution is workable and offers some sort of constructive positive future for all Europeans. Put in other words, what we need is a mechanism which contains both realism and idealism in just sufficient proportions.

The advantage that the split Euro option has over all the other proposals on the table at the present time is that it would address the growth issue head on. The countries on Europe’s periphery could return to growth, and once the economies involved start growing rather than shrinking the proportion of the liabilities incurred during the earlier period which they will be able to pay rises significantly. It is much more difficult to collect debts from an unemployed household than it is from one which is gainfully employed.

Another attractive feature of this proposal is that no “in principle” decisions would need to be taken about the long term structure of the European financial system. The ECB could be retained as a kind of holding entity and clearing house for the outstanding financial mismatch, and the current national central banks could be grouped into two separate sub-entities. This would leave open the possibility of reconvergence at a later date should conditions obtain which would make the move viable. The first stab at creating a currency union has failed, but this doesn’t mean that any possibility of creating one in the future should be abandoned. Hard and costly lessons have been learned, and what is now needed is a full and open discussion of the reasons for failure, precisely to avoid similar mistakes being made in the future.

Having the move co-ordinated by pan-European institutions has another advantage, and that is to do with the degree of conditionality the process must involve. Devaluing their currency would, as I have suggested, give a great short term boost to growth in countries along the periphery, but this short term boost would only be converted into a long term sustainable improvement in trend growth if a lot of other things were done too. It is very easy to laud the great advance Argentina made on breaking the dollar-peg, but look where Argentina is today. This “short sharp shock” treatment only has a lasting impact (as it did in Scandinavia in the 1990s) if measures to improve institutional quality (reformed labour and product markets, productivity and innovation drives) are implemented and maintained. Here again partnership is needed, since while giving back to the periphery “ownership” over its own reform programmes would be another significant advantage of the arrangement, the reform process would need to remain under the auspices of a common European project, one which could lay the basis for a consensually grounded lasting political union, a union which would be the essential precondition for any future attempts to move back towards greater monetary integration.

But What We Get Is Another Attempt At A "Silly" Stability Pact

However, none of the above is likely to happen.Time and again Europe's political leaders have been tested and found wanting. It would be nice to be able to believe that this was only because the election cycle and the Euro crisis run on differing time scales, that every non-solution would be tried before eventually the right thing would be done. But this now seems unlikely, and it is hard not to come to the conclusion that Europe's leaders understand so little of what the problems really are that the only way they might press the right button would be in error. Worse, in order not to draw attention to their failings they have effectively walled themselves in from listening to all rival opinions. Effectively Europe's leaders – and with them the citizens they represent - are caught in a kind of Pavlovian trap – they need one sharp electric shock (fear of the abyss) to send them running in one direction, and then another (fear of a transfer union) to send them back in the exact opposite one. At this point in time there are no easy choices left, although there are still better ones and worse ones.

The latest attempt to put forward a legally enforceable version of the stability pact unfortunately belongs to the latter group. As Wolfgang Munchau (Munchau, 2011) so aptly put it:

"Contrary to what is being reported, Ms Merkel is not proposing a fiscal union. She is proposing an austerity club, a stability pact on steroids. The goal is to enforce life-long austerity, with balanced budget rules enshrined in every national constitution. She also proposes automatic sanctions with a judicially administered regime of compliance".

Or as Tony Barber, in another piece of FT commentary (Barber, 2011) said:

"Nothing better illustrates Europe's grimly legalistic approach to the crisis than its apparent belief that new treaties, laws and regulations – rather than hard cash – will make everything all right. Ms Merkel and Nicolas Sarkozy, France's president, are making it their mission this year that all 17 eurozone countries should insert a commitment to balanced budgets into their constitutions, or adopt equivalent binding rules"

The cornerstone of the new fiscal agreement is going to be a "permanent and binding" structural deficit limit coupled with a timetable for reducing the excess debt (that is the fraction above the Maastricht 60% of GDP limit). The exact level of permitted deficit has become something of a moveable feast (0.35%, 0.4%, finally it seems 0.5%) but much more important will be how the idea of "structural deficit" will be interpreted since there seems to be no pre-agreed methodology. In principle the structural deficit of a country is the number derived by applying a formula which averages out the deficit registered over the course of the economic cycle. In principle this way of measuring things allows for fluctuations caused by recessions yet Spain's much publicised new constitutional amendment permits exemptions to balanced budgets in the event of "natural disasters, economic recession or extraordinary emergency situations" that inflict serious damage on the nation. All that is needed is for an absolute majority of legislators to give the green light.

By defining "economic recession" as an event that justifies deficit spending beyond that allowed in a normal economic cycle, Spain's amendment is even less watertight than its earlier German role model and can give an inkling of how other eurozone governments may craft their own version of the law, which need not, according to the latest draft version of the new treaty, be enshrined in constitutional law. In fact, the reality was that exactly the same moment that leaders of both Spain's main parties were reaching an "unprecedented" agreement to change the country's constitution in this direction, the government party was permitting a fiscal deficit to be generated which was more than 2% above target, while the main opposition party (which now forms the government) was largely responsible for the overshoot due to excess spending by the regional governments it controlled.

The silence about any sanctions from the EU institutions for this grave failure to comply has been more than deafening.

More important even than this deficit restriction, however, is the so called debt brake (or Schuldenbremse as it is known in German) principle, which implies countries must steadily reduce their debt to 60% of GDP over a specified time period. If, as may be anticipated, growth and inflation in the Euro Area is going to be low, then effectively this means countries will not be running deficits at all, but rather surpluses, depending on how much over 60% they will be when the present crisis comes to an end, given that from 2013 countries reduce the part of the debt which is over 60% of GDP by 1/20 per annum. This clause alone could send those Euro Area countries who have large sovereign debt piles, debt-impaired domestic demand, and internationally non-competitive economies (like Italy) to years of continuing depression.

At the end of the day one thing is clear, and this has not been emphasised enough, this is the end of Keynesian demand management as a policy tool as it has been practised in Europe since the end of WWII. That is to say, while it may be one thing to argue that simply creating more debt through fiscal policy is not the most appropriate way to solve a crisis which has itself been caused by excessive indebtedness, it is going a bridge further to suggest that substantial counter-cyclical fiscal policy should not be practised, ever. Germany's leaders have, it seems, crossed that bridge.

On a normal Keynesian view, the proposed balanced budget amendment could choke-off economic recoveries from substantial recessions – some would even argue Germany's commitment to this principle at this point is an example of this. Evidently, having a structural component in the target allows deficits to rise slightly when output falls below trend with the additional deficit being offset by surpluses during upswings. But, as the German economist Peter Bofinger argues, this “assumes textbook-like economic cycles,” and garden variety recessions (The Economist, 2011). In the real world, as we are seeing, cycles and crises vary considerably in their depth and duration. An externally induced (asymmetric shock) recession followed by a weak recovery can excessively reduce short term growth and employment, while the balanced budget restriction would restrict the deficit spending needed to stimulate demand in the interim.

Given the magnitude of these issues, it is surprising how little debate the proposal is generating within the Euro Area, and of course it is hard not to be struck by how quickly people who obviously would not have understood what was really involved were to arrive in Brussels and offer to sign on the dotted line without too much attention to the small print.

In fact, in her insistence on the Schuldenbremse Angela Merkel is marking out a very long term agenda for the Euro Area. She is prioritising sustainability and stability in the longer run over short term growth. This is very consistent with the modern German view of things and completely in harmony with the ecological strain of thought in the contemporary German world view. It is not hard - especially given the weight of the ageing population problem - to have a good deal of respect for this kind of argument (even while disagreeing over implementation), and especially for the fact that someone in Europe is trying to think in the longer term. But it is hard not to reach the conclusion that many of the people and countries voting for the new agreement were only thinking about their financing needs in the short term, and were not fully cognisant of the fact that they were voting for a new beginning, a new type of Europe, where living standards may be lower, but the debt dynamics will be more stable.

Europe’s leaders now find themselves in that most uncomfortable of positions which is to be found between a rock and a hard place. Staying where they are leaves them in a kind of permanent electric shock zone where their constant feeling of failure only serves to further deteriorate their own sense of personal and political worth. Advancing also seems painful, but more than the intensity of the shock it is the sensation of fear and angst which dominate. Still there is no alternative but to advance, since you cannot stay where you are. Simply applying administrative measures to force stability onto a financial system which resists with all its might will only result in increasingly destabilizing behaviour (read “speculation”) by the agents within the system. Administrative fiat simply represses and pushes forward instability (read ”kicks the can down the road”), leading the system itself to become ever more inefficient. In any malfunctioning financial system, as the late Hyman Minsky famously said, “stability is itself destabilizing”.

Perhaps it is appropriate to close this essay with a quote from from one of the Euros most persistent defenders, ECB Board member Lorenzo Bini Smaghi: “as J.K. Galbraith observed: “*Politics consists in choosing between the disastrous and the unpalatable*”. To see disaster looming before choosing the unpalatable is a dangerous strategy”.

I wish I could believe Europe's leaders will prove able to see the disaster coming while there is still time to choose the unpalatable, but with every passing day this belief gets harder to summon.

Edward Hugh 31 January 2012, revised 20 February 2012.

Postscript

This essay has intentionally not entered into the areas which perhaps the judges awarding this prize value most highly, the legal question of how to exit, and the question of what to do with the redenomination of assets. My decision not to enter into this has been deliberate, since in the first place I do not think achieving political agreement on exit would be as difficult as is being claimed (and certainly not if the country was Greece), and in the second place, as I argue in the essay, much of this is likely (in my opinion) to prove irrelevant, since countries like Greece are unlikely to want to leave, given all that that act would imply.

In addition there is a perfectly good summary of the legal aspects of the situation available in the work of Eric Dor (Leaving The Euro A Users Guide). As Dor says:

"For a country wanting to abandon the euro the only legal way possible following the European treaty regulations would be to leave the whole of EU using article 50 of the treaty and then try to rejoin but asking for special dispensation with regards to the monetary union. Another legal way would be to negotiate an amendment to the treaty with other member countries. All these options require long negotiations and ratification by all member states. Some people therefore think that, because of urgency, only a unanimous agreement by the European Council leading to the issue of a European regulation, could be sufficient despite the legal uncertainty that this could entail. Some articles from the Vienna Convention on the Law of Treaties could also be used when a country wants to leave the euro zone without leaving the UE, as long as it is accepted that international public law applies to the European treaty, which is however a much debated issue."

Basically, I think any country wanting to leave the Euro would only have to inform the other partners in the currency of its intention to do so, if need be in a disorderly fashion, to have some formula or other whisked onto the table (like the above mentioned unanimous agreement by the European Council), since in this day and age there is nothing political leaders like less than having to contemplate the possibility of a disorderly something or other, especially if that four letter word "default" is also mentioned.

For many of the ideas about how the Euro Area could be divided in two I am deeply indebted to my friend and colleague Detlef Gürtler, in whose home in

Marbella many of the ideas herein expressed were germinated during 4 hectic days in August. (Detlef is author of the recent book Entschuldigung! Ich Bin Deutsch (Sorry, I'm German, Mermann Verlag GmbH, Hamburg).

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