Europe's Ugly Future

Muddling Through Austerity

Andrew Moravcsik

And the Weak Suffer What They Must? BY YANIS VAROUFAKIS. Nation Books, 2016, 368 pp.

Welcome to the Poisoned Chalice: The Destruction of Greece and the Future of Europe BY JAMES K. GALBRAITH. Yale University Press, 2016, 232 pp.

The Euro: How a Common Currency Threatens the Future of Europe BY JOSEPH STIGLITZ. Norton, 2016, 448 pp.

Some foreign policy decisions hang like albatrosses around the necks of the states that made them. For the United States, the war in Iraq offers the prime example of a costly and seemingly irreversible blunder. For Europe, it is the adoption of the euro. Fifteen years ago, when the EU established its single currency, European leaders promised higher growth due to greater efficiency and sounder macroeconomic policies, greater equality between rich and poor countries within a freer capital market, enhanced domestic political legitimacy due to better policies, and a triumphant capstone for EU federalism. Yet for nearly a decade, Europe has experienced just the opposite.

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Even in good times, economic growth under the euro was unexceptional, but with the global financial crisis, the situation grew dire. Since 2008, inflation-adjusted GDP in the eurozone has stagnated, compared with an expansion of more than eight percent in European countries that remain outside. Greece's economy is more than 25 percent smaller than it was in 2008. Italy's is almost ten percent smaller, and its financial system may be the next to melt down. The loss of European output totals about six trillion euros—a massive figure, reflected in the shattered lives of unemployed youth, bankrupt business owners, and vulnerable citizens unable to maintain their standards of living. Although losses from short recessions are often offset by higher-than-average growth thereafter, that process does not typically occur after prolonged depressions such as the current one. In this situation, a lost decade may well become a lost generation.

Nor has the euro reduced inequality among European countries. Since 2007, the German economy has grown by almost seven percent, whereas the economies of Belgium, France, and the Netherlands have remained stagnant, and those of Finland, Greece, Ireland, Italy, and Portugal have all contracted more than they did during the Great Depression. Inequality has also increased within countries—to a stunning degree in the worst-performing ones, such as Greece, but even in Germany, too.

The prolonged depression has helped fuel the rise of right-wing nationalists and Euroskeptics. In Austria, Finland, France, Germany, Greece, the Netherlands, and elsewhere, radical right-wing parties now enjoy more success at the polls than at any time since the 1930s. In Italy and Spain, left-wing antiestablishment parties, such as the Five Star Movement and Podemos, have prospered. Trust in EU institutions, traditionally higher than the popularity of national political institutions (even in the congenitally Euroskeptical United Kingdom), has fallen through the floor. Anti-European radicalism is spreading. A catastrophic collapse of the whole monetary system may yet lie ahead.

Most observers now attribute these troubles to the euro. Yet more than eight years after the financial crisis began, the EU has done little to fundamentally reform its single-currency arrangement. Three new books, all by Keynesian economists, are among the first to argue that more radical change is necessary and that the euro system must be replaced. Yanis Varoufakis, who served as Greece's finance minister during the first half of 2015, and his erstwhile economic adviser, James Galbraith, base their critiques of the system on their firsthand experience guiding the country most ravaged by it. Joseph Stiglitz, a Nobel Prize–winning economist and former chair of the U.S. Council of Economic Advisers, lays out the euro's failures and flaws and advances original proposals to repair it. All three would prefer that the system be reformed. Yet all three reluctantly conclude that since that option is off the table, the best remaining choice may be to scrap the system altogether.

DECLINE AND FALL

How did Europe fall into this trap of low growth, high inequality, and political discontent? Galbraith offers the most succinct explanation of why the system has benefited Germany at the expense of weaker economies:

> Without a currency that could appreciate against those of her trading partners, German productivity increased and its technical excellence produced a declining real cost of exports, while in its European trading partners, deprived of currencies that could depreciate, stable purchasing power and easy credit produced a corresponding increase in demand for German goods. Meanwhile, Germany held down its internal wage levels while other countries allowed wages and unit labor costs to rise. The flow of goods from Germany . . . was matched by a flow of credit, either directly to state purchasers of arms and infrastructure, as in Greece, or indirectly via private financing of residential and commercial construction booms, as in Spain and Ireland. In all cases the unbalanced flow of goods matched the accumulation of debts; the Greek instance was merely the most extreme. The Greek story is properly a European story in which, as in all European stories, Germany takes the leading role.

In short, Germany depresses the value of its currency to promote exports, just as China is often accused of doing—yet in this case, the euro makes Berlin's policy seem more legitimate and deflects the blame. Varoufakis, Galbraith, and Stiglitz differ on the details, but they all blame the euro system and, especially, Germany.

Such a failure of international monetary design is hardly unique to today's Europe. Stiglitz shows that international systems of pegged currencies, of which Europe's single currency represents only an extreme example, "have long been associated with recessions and depressions." In the 1920s, many countries returned to the gold standard, which culminated in the Great Depression. In the early 1970s, the Bretton Woods system of pegged currencies once again slowed economic growth in a deficit country—in this case, the United States. To restart growth, President Richard Nixon decided to destroy the system unilaterally. And in 1991, Argentina hoped to curb inflation by pegging its peso to the U.S. dollar, which triggered a severe economic crisis from which the country has still not entirely recovered.

The reason currency pegs often depress economic growth lies in the essential nature of monetary arrangements. Currency pegs force a common policy on countries, and almost all economists agree that this works properly only when the macroeconomic performance of the participating countries converges. If countries have similar levels of wage and price inflation, public and private deficits, exposure to external shocks, and competitiveness, it is relatively easy to find a common policy response to a shared threat that suits all and shares the pain and relief more or less equally. In the real world, however, countries have diverse market positions and domestic institutions, which means that macroeconomic convergence is hard to come by.

That's a problem, because a currency peg prevents the governments of countries that run trade deficits and incur debt from pursuing healthy economic policies to correct the problem. When a country faces a recession, a negative external shock, or eroding competitiveness, its government would normally loosen domestic monetary policy (thereby lowering interest rates and stimulating investment), let its currency depreciate (thereby boosting exports, reducing imports, and transferring income to the sector of the economy that produces competitive goods), and increase government spending (thereby stimulating consumption and investment). But if a country belongs to a single-currency zone, the first two options are by definition unavailable. And in the eurozone, the third option is difficult thanks to the EU's stringent fiscal requirements.

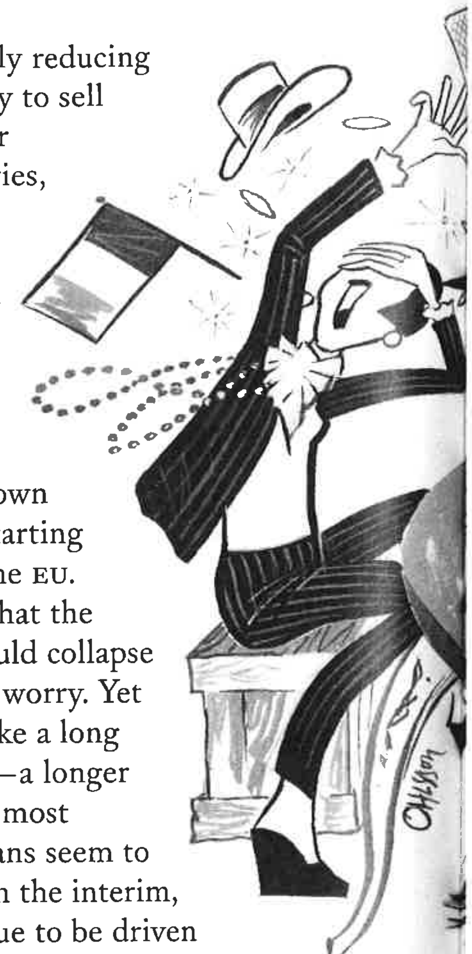
Deficit countries are thus left with only one way to restore their competitiveness: "internal devaluation," the politically correct term for austerity. The country must reduce wages, government spending, consumer demand, corporate investment, imports, and, ultimately, growth itself. Stiglitz concedes that austerity may eventually work, but he argues that even if it does, the cost is too high. Better to allow countries to declare bankruptcy and start over, just as individuals and firms can do in a domestic economy. Varoufakis and Galbraith dismiss austerity as flatly self-defeating, because low growth simply ends up increasing the debt-to-GDP ratio. In such cases, including Greece in recent years, permanent austerity becomes the only way to maintain international equilibrium.

In the acknowledgments to his book, Varoufakis promises a forthcoming tell-all about his negotiations with the EU and the International Monetary Fund, but he and Galbraith say enough to make it clear that the self-interested way in which France and Germany handled Greek debt only served to exacerbate the crisis. At the time, the IMF was led by Dominique Strauss-Kahn, and the European Central Bank by Jean-Claude Trichet—both nationals of France, the country whose banks were most exposed in Greece. German banks also faced large potential losses. As Galbraith tells it, the French and German governments, loath to accept responsibility for the misjudgments of their own private investors or the design flaws of the monetary union, and seeking to avoid the unpleasant task of asking their parliaments to bail out domestic banks directly, formed a "creditors' cartel" that foisted the costs on taxpayers across the EU, as well as on the IMF.

As Varoufakis and Galbraith detail from the inside, the punitive combination of debt, depression, and inequality has rendered Greece and other debtor countries all but ungovernable. Centrist governments have lost political legitimacy, as has the EU. Citizens grasp at increasingly radical new parties and lack the faith in Europe required to enact needed reforms.

Germany has emerged almost unscathed—at least so far. Berlin has preserved the existing euro system, which advantages it as an international creditor, an exporter of high-quality goods, and a country that suppresses wage increases. It has enjoyed lower interest rates and higher growth than the rest of Europe, which has depressed the real cost of its exports, resulting in a trade surplus larger in absolute terms than China's.

Yet the costs of a flawed monetary system may eventually boomerang and depress growth even in Germany. Austerity is slowly reducing Germany's ability to sell its goods to other European countries, which buy more than half its exports. German citizens, stuck bailing out foreign governments and, indirectly, their own banks, are also starting to lose faith in the EU. The possibility that the entire system could collapse spreads fear and worry. Yet such concerns take a long time to develop—a longer time frame than most German politicians seem to be thinking in. In the interim, decisions continue to be driven by capital markets, European rules, and dictates from Paris and Berlin.



REFORMING THE SYSTEM

So what should Europe do? Stiglitz offers the most thorough evaluation of the possible options. There are three. The first entails reforming the fundamental structure of the euro system so that it generates growth and distributes the benefits fairly. Stiglitz details how the EU and the European Central Bank might rewrite tax laws, loosen monetary policy, and change corporate governance rules in order to boost wage growth, consumer spending, and investment. Such policies could push the euro exchange rate downward, enhancing the entire region's competitiveness in relation to non-European countries.

tax on them. The German government, meanwhile, could unilaterally engineer a rise in domestic wages (by, say, strengthening unions' bargaining rights) and increase deficit spending. Over time, such moves might help deficit countries stimulate growth and restore the competitiveness of their exports, both vis-à-vis Germany (by increasing German demand and raising the relative price of German goods) and vis-à-vis the rest of the world (by further lowering the real exchange rate of the euro).

Yet since the basic problem is the divergence of national economies, sound common policies are insufficient. National policies must be made to converge. The crisis has already placed pressure on deficit countries to adjust through internal devaluation, but to eliminate macroeconomic imbalances within the EU, any such program would also have to force the German economy into line. To do so, the EU could discourage trade surpluses by imposing a

Another set of structural policies would encourage large fiscal transfers and migration in order to offset the inequities that the euro has induced. In essence, this would replicate the movements of capital and people that make single currencies viable within individual countries. In the United States, for example, federal spending on unemployment insurance, welfare, infrastructure, and industry bailouts, along with progressive taxes, adds up to sizable fiscal transfers from richer and more economically vibrant regions to poorer ones. The EU might establish a similar system of fiscal transfers from creditor countries such as Germany to deficit countries such as Greece and Italy. Varoufakis, for example, favors massive European investment and antipoverty programs.

An even more important factor that makes the dollar work in the United States is internal migration. When sectors in some regions decline—such as farming in the Midwest or manufacturing in the rust belt—people move to places with more jobs. In Europe, Stiglitz proposes, Germany and other surplus countries could do more to accept and encourage continuous migration flows from deficit countries. Germany might even benefit from such policies, since its growth has also slowed recently, in large part due to its dependence on exports to other European countries suffering under austerity.

In theory, deep structural reforms represent the optimal choice—so much so that the phrase "monetary union requires fiscal union" has become a cliché among European federalists. Yet such reforms have little chance of being adopted. Germans are unlikely to renounce the export-led growth that has stemmed from their 60-year tradition of high savings, low inflation, and modest labor contracts. They are even less likely to accept massive fiscal transfers to other countries. The net contribution of Germany to the EU totals just over 0.6 percent of GDP. To match the transfer levels from rich to poor states within the United States—hardly a generous welfare state by European standards—that net contribution would have to be at least 40 times as high. Moreover, German technocrats protest, with some justification, that fiscal transfers simply encourage irresponsible behavior by debtors—so-called moral hazard. Even if the German government were inclined to support such policies, its own electorate and business elites would surely block them.

Just as unlikely is a major uptick in migration from Europe's south to its north. To be sure, a few percent of the Greek labor force has already fled, mostly to countries outside the eurozone. Yet for migration to have a major macroeconomic effect, many more millions of Greeks, Italians, Portuguese, and Spanish would have to move to Germany. Cities the size of Phoenix would have to pop up in northern Europe—an unthinkable prospect in the current political climate. Despite the EU principle of free movement, many informal barriers to mobility still protect special interests. Political opposition to immigration is already strong in Austria, Denmark, Germany, and the Netherlands, and these countries would not tolerate many millions of additional foreigners. Even if the north were more welcoming, most southern Europeans have little desire to leave home.

MUDDLING THROUGH

If major structural reform is unrealistic, then the only way left to save the euro is to turn to a second policy option: muddling through. In this scenario, member states would strengthen the EU's ability to manage the crisis. Governments have already taken initial steps in this direction.

In 2012, the EU created the European Stability Mechanism, an institution responsible for bailing out member states. The European Central Bank has engaged in monetary easing. And by putting in place greater central oversight and regulation, the EU has finally taken the early steps toward a real banking union.

Yet as Stiglitz rightly insists, such changes are insufficient to make the EU's single-currency system work properly. The burden of the current system on deficit countries must also be eliminated—a change that requires far more serious reform. Eventually, Europe would have to restructure its debt, perhaps by swapping existing debt with GDP-indexed bonds, which reward investors if a given country's economy grows, or by issuing so-called eurobonds, which would make all European governments responsible for the debts national governments incur. At the same time, the EU could more stringently regulate and guarantee the solvency of national banks, thereby decoupling them from national governments.

Yet Germany and other creditor governments are naturally hesitant to accept financial responsibility for debtor countries. With some justification, they view guarantees for banks and the mutualization of debt as ways of sneaking major structural reform and European fiscal union in through the back door, resulting in greater costs for Germany. Such reforms would also require the EU to massively expand its oversight over national financial systems, so as to avoid the possibility that irresponsible behavior and moral hazard would create costs for others. No country likes this idea, because in every member state—Germany no less than Greece or Italy—the government is loath to accept any external controls that might call into question quiet political deals it has made with specific banks.

THE END OF THE EURO

If neither of the two options to save the single currency and restart growth is viable, this leaves only a third option: abolishing the euro. Almost all European politicians, and majorities in every member state, reject this course. Most contend that it not only would prove unimaginably expensive in the short term but also would spark another economic crisis and deal a fatal blow to European integration.

Yet various governments have already come closer to abandoning the euro than many people realize. Galbraith recalls the Greek government preparing to withdraw from the eurozone ("Grexit") both in 2011 and in 2015. Italian Prime Minister Silvio Berlusconi seriously contemplated withdrawal in 2011, as did the Spanish government at various times. Although Stiglitz would prefer that the euro be reformed, he admits that "there is more than a small probability that it will not be done" and therefore argues for breaking up the system.

A unique virtue of Stiglitz's book is that he takes this option seriously, advancing original proposals for a "friendly separation." Such options range from Grexit to his preferred alternative of breaking the eurozone into several subgroups, each with its own currency. Stiglitz makes the controversial argument that eliminating the euro as currently constituted, if implemented properly, would be feasible without speculators gaming the system or triggering catastrophic bank runs—and that the move may be the only viable way to save Europe. Varoufakis and Galbraith would likely sympathize with his proposal and clearly regret that Greece lacked the political courage to forsake the system earlier, when it could have done so more easily.

Yet even the radical step of breaking up the eurozone, Stiglitz makes clear, would probably help deficit countries only if Germany agreed to increase domestic spending, rein in speculation, and reduce deficits. Recall that European governments originally embraced a single currency in part to limit the self-interested use of German monetary power. Abolishing the euro might slightly improve the options for deficit countries, but absent deeper structural reforms, it would not eliminate the underlying problem.

The truth is, politicians want to be reelected, and no European leader will risk his or her future by pursuing a policy that is costly in the short term but possibly beneficial in the long term. The result of muddling through by politicians with short time horizons can thus only be more of the same: austerity and slow growth, punctuated by intermittent economic and political crises.

FROM HERE TO AUSTERITY

These three books advance compelling critiques of the current euro system and creative suggestions for alternative policies. And yet ironically, they make for depressing reading, because in the end, they suggest that there is no easy way out of Europe's predicament, given the current political constraints. In the long run, muddling through may be the worst outcome, and yet it is the most likely.

In response to such a bleak prognosis, many European federalists, particularly on the left, contend that Europe's real problem is its "democratic deficit." If only EU institutions or national governments were more representative, they argue, then they would enjoy sufficient legitimacy to solve these problems. The EU needs more transparency in Brussels, more robust direct elections to the European Parliament, a grand continent-wide debate, and political union, the argument runs, so that the resulting European superstate would be empowered to impose massive fiscal transfers and macroeconomic constraints on surplus countries. Alternatively, if more radical alternatives could be fully debated in national elections, then member states might muster the power to pull out of the eurozone or renegotiate their terms in it.

These three books show how far from reality such schemes for democratizing Europe really are. Despite their creativity in suggesting alternatives, these authors concede that in the end, everything comes down to choices made by self-interested sovereign states. Governments have little incentive to make charitable and risky concessions, even in a united Europe with economic prosperity on the line. Politicians simply lack the strength and courage to make a genuine break with the status quo, either toward federalism or toward monetary sovereignty. As Varoufakis writes, "All talk of gradual moves toward political union and toward 'more Europe' are not first steps toward a European democratic federation but, rather, and ominously, a leap into an iron cage that prolongs the crisis and wrecks any prospect of a genuine federal European democracy."

Thus, one is forced to conclude that short of a catastrophic economic crisis, Europe can do little more than continue to muddle through in a self-induced state of austerity, thereby undermining its future prospects and global standing.