Transcript

The Eurozone’s Fight for Survival

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Robin Niblett:

Good morning, ladies and gentlemen. I'm Robin Niblett, Director of Chatham House. This meeting was not planned heavily in advance. What we thought we wanted to do, watching all that's happening in the Euro area at the moment, and given the work that's been done at Chatham House from various different dimensions of this problem, it might be good to have a conversation and to invite our members to come along and participate in that, about what we think's happening.

The person I'll turn to first is Dr Paolo Subacchi, who is the Research Director for International Economics here at Chatham House. She's worked not only extensively on the EU and the EU economic questions, but also leads all of our work on the G20 and the G20 responses that are being developed – to the extent that they are being developed – to confront this problem.

I'll be turning then to Matthew Goodwin, to talk a bit about the domestic politics of this problem. I think part of what we're trying to do at Chatham House is make sure that we don't think about the Eurozone crisis in its isolation as a technical issue or purely political-economic issue. It's also a political challenge to the credibility of governments, with some interesting elections coming up in France next year, and pressure being put on political parties all across the Eurozone, from Italy, to Finland, to Germany. I think being able to give some insights into how leaders are coping with what is almost a popular, if not populist at times, revolt against their government, will be particularly interesting. This is an area that Matthew Goodwin, an associate fellow at Chatham House, and also a professor and senior lecturer in International Politics at Nottingham University, as well as author of a recent report we just put out at Chatham House on some of these topics, will be able to address.

Xenia Dormandy, who's a senior fellow here for the US and US foreign policy at Chatham house, has experience both in the US government and outside in academia in the United States. She looks very carefully at how the United States is coping with all the big changes taking place internationally. What she'll be able to tell us about how the US perceives this problem and the kind of challenges and answers it can bring will be especially interesting. We're going to kick off, in a second when he's drawn breath, with Ian Begg, who I introduced a second ago before he came here – Professorial Research Fellow at the European Institute at LSE. Ian, I'm hoping, as you may know, that you can set the scene for us about the crisis – where you think it's at, are we at some terminal moment, or are we at the next bump in the road which has a few more bumps to go, and what's your prognosis for the immediate
here now? After your analysis, I'm going to take it through each of my colleagues here across the panel. Thanks for being here.

**Ian Begg:**

Sorry for the delay in arrival. The only consolation in travelling at this time of the day was the wonderful vision of a Cabinet Minister standing in the train when I had a seat.

**Robin Niblett:**

That was in economy class?

**Ian Begg:**

Yes. I've been asked to contemplate what's at stake, what it will take, and what it will cost as my three briefs. So what's at stake? In a way it's very straightforward: economic stability. The lack of confidence around the markets threatens to lead to a new outbreak of recession. It could undermine all the recovery and echoes of 1930s with people saying that we're at the point of 1937, where there was a further dip into recession. There's also a severe threat of trust in the banking system. You can't fail to notice it over the last couple of days – that suddenly the banks are back in the picture, suddenly there's a freezing up of inter-bank lending. So in other words, we risk having Lehman Bros revisited. That's the spectrum.

So where does that lead us? One question it's going to raise is; is the integrity of the European single market at risk of being compromised? I know it's one of Robin's favourite things, so I thought I'd mention that one. More generally, where does it leave us with a post-war consensus on the European Union? There is, particularly for countries like the UK, and countries like Poland which are outside the Eurozone, a real challenge: to what extent do we go along with a deepening of the Euro area, which seems to be one direction of the response, or do we stand aside from it and say 'you do what you want, and we'll do something different'. It sounds beguiling at the moment, but where does it lead? That's where you start to see the prospect for the break-up of a European Union.

So what's been going on? I'll add the word 'diagnosis' to my trilogy of questions. What we've seen in the Euro area is an increasing dichotomy between, broadly speaking, north and south. The northern exporters – we've
got pretty phenomenal figures coming from Germany and, even more so, the Netherlands. I just checked the figures on the way here – the Netherlands is now expected to have a current account surplus and a balance of payments of the order of 8 percent of GDP this year. You must think, that's wonderful, aren't the Dutch great. But the flipside of that is that someone must have a deficit. The somebody else who has a deficit is southern Europe. That dichotomy between north and south needs to be looked at.

There's also a parallel diagnosis of leaders and laggards in economic reform. You might say the Dutch, Swedes, to some extent the Brits, have been in the lead in economic reform. Italy, above all, during the Berlusconi period, has been one of the great laggards in economic reform. That too doesn't bode well for the immediate future. We still don't know whether France and Germany fundamentally agree on the design of monetary union. Germany always wanted a system of rules; France, a system of *gouvernement economique*, in which there was a political counterpart to the power of the European Central Bank. So that too is part of it. Allied to all of this is some notion of how prepared are countries to comply with the rules that are in place – so that to some extent is my diagnosis.

But I would be cautious about this simplistic and often glib assertion that it's a core-periphery problem – countries in the core doing well, countries in the periphery doing badly. You don't get much more peripheral than Finland. If you look at the crises of the three countries which have had to be rescued over the last 18 months – in Greece it's a dysfunctional public sector above all that's the root of the problem. In Ireland, it's an old-fashioned banking crisis, so it emulates what Sweden and Finland had in the early 1990s, and reassuringly it looks like Ireland is on the way to recovery. Ireland has not suffered visibly from a competitiveness problem, the way the other countries in the south do, all of whom have lost ground against Germany and the Netherlands in terms of labour costs, which with the single currency is the best measure of competitiveness.

So let's go beyond these glib statements of core and periphery. Second, solutions: in no particular order, here are some of the things I think are required. One is a way for Greece to accept this. Greece is at risk of falling – it already has fallen – into a vicious circle of decline. It tightens the belt through austerity packages, growth goes down, so the debt gets bigger as a proportion of GDP so they have to tighten more, and there's no way out of that unless you get some external help. So it's very clear that Greece needs something, and that something is being cooked up in Washington as we speak - or might even be overnight, for all I know. So Greece is a particularly
egregious problem which has to be solved. Second, if Greece were to go in the direction of default – which looks likely – without getting into the details of what that default consists of, it does need some shoring up of the banking system so it can absorb the debt effectively, and also a firewall around Greece, to prevent the contagion spreading to other parts of the Euro area. The two things have to go together. The arithmetic of this is not that daunting. The scale of Greek debts, suppose it were to be halved, is about 1 percent of the EU’s GDP. That ought to be something the banking system can absorb and deal with, particularly when it’s spread amongst the large number of banks – and it’s more, these days, the European Central Bank than the other member states, which own the Greek debt, rather than the banking system as such.

Other solutions: one is much talked about. Fiscal union. Except nobody’s terribly clear what fiscal union means. I’ll offer three forms of fiscal union: the union of rules, which is what the Germans want. Fiscal transfers across borders, which I think is beyond the scope of the European Union. Transfers across borders were accepted in Germany after unification because Germans have solidarity with other Germans. But transfers in which German taxpayers paid directly for Greek public services is beyond the scope of EU political integration at the moment. So it’s the intermediate area of fiscal union which is the pivotal one, and that is what I call a financing union, in which other member states accept some of the liability to lend money to finance Greek governments, or Italian governments, or others.

The way that ideally comes about is through Euro bonds, a single Euro bond, in which there is both an opportunity for countries from the rest of the world to say OK, there’s a single instrument here, it would get rid of the fragmentation of particular markets in Europe, which is a key part of the story. The markets attacked Greece, then they attacked Ireland, then Portugal, then Spain, even France has come under the microscope recently. With all of that, you get fragmentation. With a single Euro bond, that wouldn’t have happened. So a fiscal union of financing is the way forward, I think. Beyond that, we need to find a way of getting economic growth and to end the procrastination and prevarication that’s gone on by political leaders.

I’ll sum up – I could elaborate on Euro bonds – but I thought since it’s one of these glib ways of saying things, here are five Cs for the future. Crisis resolution – get on with it. C2 – better communication from all levels, between political leaders to the markets, which has been pretty abysmal, and between political leaders and citizens are so on. C3 – better coherence in the policy approach. There isn’t coherence, because one country does one thing and
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another country does another. C4 is compliance – better compliance in roles, and better compliance in what’s agreed. Get on with it as well. And C5 is leadership – not a C – so I will change it to command and control!

Robin Niblett:

Thank you very much Ian. To try and do the whole Euro crisis and solutions in 7 minutes…

Ian Begg:

Sorry, I left out what will it cost! The ideal scenario is nothing. Crisis resolution of this sort takes some toxic assets, parks them for a while and eventually gets them back into the market. It worked in Sweden in the 1990s, and the net cost to everyone was virtually zero. This is in spite of the huge numbers we see: two trillion, three trillion and so on. But the real question is, what will it cost not to do something? That’s where I’ll conclude.

Robin Niblett:

There are a lot of points we’ll want to come back to, either questions from the audience or from us here on the panel. Ian, I think your comment about what’s driven this crisis, and as you said, there are glib answers about a north-south split and so on, but the deeper structural challenges are something we might want to come back to in Europe: demographic change, loss of competitiveness of some economies internationally, and whether this is something that’s a Euro problem, and not just a problem of southern Europe – perhaps of welfare systems that have become too expensive. We may want to come back to some of those issues later on. I think your comment about needing to have a firewall around Greece begs the question of whether you can have a firewall around Greece, if we are looking at a 50 percent cut of its overall debt. I know the European Council’s said this will be it, but can they definitely do that?

Then one of your solutions, the Euro-bond, of a financing union, obviously poses political problems right now in Germany, and your point about being quick and getting down to resolving things quickly, that may be difficult if one of your key solutions poses such difficult problems for Angela Merkel. Maybe these are ideas for others to pick on and come back to later on. Paola, how does this look? You may want to make a comment or two on Ian’s analysis of
the crisis situation Europe's in right now, and how does this fit also in the
global economy, and how you think the G20's reacting.

Paola Subacchi:
Right, well, how does it fit: it is a potentially global crisis, a multiple crisis, we
have different levels here, and different countries in different situations. It's a
potentially global crisis which requires a global solution. It's very urgent, and
we have short-term solutions which need to be implemented now, and also
long-term solutions which deal with governments, whether we need a fiscal
union, whether or not we need a Eurobond and so on. But a short-term needs
to be devised now. Also I would say that I do not believe one of the solutions
is a Greek default, and I'll try to explain this point.

So it's a multiple crisis, morphing into one. I'd like to really stress that there
are fundamental differences between Ireland, possibly Spain and Portugal,
and Italy and Greece. Italy and Greece have endemic public finance
problems, which predate the European Monetary Union. We can discuss
whether or not it was a mistake to admit this to countries, to the monetary
union, possibly it was a mistake – I believe it was a mistake – to have Greece,
but now Greece is part of it and we have to deal with that. These countries
have always had problems with public finances, and really they made it into
the European monetary union just about, but they were admitted with very
high levels of public debt. Both countries got into the European Monetary
Union with a level of debt which was around 100 percent of GDP. On the
basis that the trend was the downfall and in any case they needed critical
mass for the monetary union. Ireland, Portugal and Spain actually always had
better public finances, and for them the problem was excessive credit growth
due to inappropriate interest rates, because this country was part of the
monetary union. We can claim that for Ireland, Portugal and Spain – possibly,
although they are a bit more borderline – the crisis was a liquidity crisis,
whereas for Greece certainly it's a solvency crisis.

So how do we get out of here? It's a global crisis now, a potential global crisis
– we don't know what the spill over effects are of a badly-managed disorderly
default of Greece, because that could be one possible scenario. We don't
know, it could be another [inaudible]… another Lehman Brothers, it could be
even more devastating than Lehman Brothers because we'll have
implications on the financial and banking system and a real economy as well.
There is a lot of preoccupation with the so-called rising powers, certainly
China and India. I was recently in both countries and I was present at
meetings where policymakers were very concerned – the concern was not just because China had European assets and securities in their portfolio, but also because of the impact of the real economy.

The thing which worries me is that there is a cacophony of voices and solutions. Recently Christine Lagarde, rightly I think – I hope she has the right information, she didn’t disclose her sources – she said the problem isn’t now in the banking system and the capitalised banking system in Europe. But again we don’t have consistent and firm numbers here. Again just looking at some numbers, like we have – according to the European Banking Authority – the capital shortfall in the banking system in Europe is €2.5bn. According to independent estimates, it’s between €100-450 billion. And according to the IMF it’s €300bn. So which one is the right number? Also we can’t play with this. If we get it wrong, we get it wrong in an amazingly, spectacularly bad way. If it’s €2.5bn, that means we don’t even need to discuss this issue. If it’s €450bn, that’s above the total amount of money that the European Financial Stability Facility has in its pockets, so where do we start? We don’t know, so at the very least we need a very thorough and good analysis.

Which brings me back to this idea of a Greek default - which is playing with fire. This morning there is a letter in the Financial Times by a group of French and German economists as they define themselves, and it says in a very theoretical way, they’ve put forward some solutions. Then they say, this move might trigger contagion to other vulnerable Europe countries. At that point, my heart sank – what happens? It would not pose a big problem for Ireland and Portugal, we know that. But it could be a problem for Spain and Italy. We know that if Spain and Italy go under, it's the end of it. The point is, we cannot take the risk of going towards a Greek default without knowing exactly what we are heading to. We made a mistake with Lehman Brothers and we can't repeat it now because the consequences and the costs will be very high. So what is the solution? I think the solution goes through the European Financial Stability Facility, and first of all make this facility operation.

On Thursday we had the vote in Germany and this facility, this measure, has to be approved by the European Parliament. A movement on that would be a really good thing. But I also strongly believe that the G20 kind of solution, with what I would want to call a flexible credit line provided by surplus countries – and by this I mean China and other countries with a surplus and large reserves, could be helpful for Europe – could actually help to sort of bridge this time where the European financial stability facility is not operational yet, but we need funds now.
So a solution similar to the one the G20 devised and implemented at the time of the London summit in April 2009, it could go through a more better-funded IMF. There are various solutions and possible solutions, but this is something which I think would really send the right message, it would be a co-operative solution with all countries involved. It doesn't involve China or India or the Greeks buying bonds – European bonds – because I could see that could be a potentially not a very smart move, because these are potentially toxic assets. This kind of credit line would really help and most of all restores the kind of confidence we need now, because the problem is financial markets do not believe any of these solutions that have been put forward would work. They are so unclear, and because the decision making process in Europe is very complicated and very messy, because there are too many institutions and players involved.

We really need to have a G20 solution, co-operative solution, a financial facility available, and just one line of action – and please stop talking about the default of Greece.

**Robin Niblett:**

Right, again we're watching the news every day at the moment to see what they're going to do about Greece, so this is an important line to take. I think your point about the role of the IMF in this becomes interesting. Of course we have this slightly uneasy marriage right now between the European Commission, the ICB and the IMF. This kind of Troika that they're negotiating with the Greeks. Obviously the IMF has a larger role – the question we might want to talk about here is, does that become almost too difficult to manage? You've almost got two policemen focussing on one or two countries. I think those figures you gave on the estimate of what the shortfall is in the bank is just crazy, and quite enlightening in terms of the nature of why the markets are so uncertain.

Let's move off the economics, store up your thoughts for a second on those, but I just wanted to get five minutes of comments in just quickly – if I could ask Matt and Xenia to be quite succinct in their comments. Let's look at the politics for a moment, because part of the reason that governments are being so cautious and, as Paola said, in a way decisions have been taken so slowly, is that everyone's looking at democratic society and how they're going to get voting in again. More importantly, I think they're worried about what they're seeing, are they not Matt? Look at Finland – there's a real populist turn against some of the kind of steps that are being taken in governments in
Europe getting us into this crisis, and even how they're getting us out. What are your thoughts?

Matthew Goodwin:

Ian mentioned that linkage between citizens and leaders, and that's where I do most of my work. What's striking about the crisis is that even before it kicked off we had very high levels of public dissatisfaction in political institutions. Upwards of 75 percent of citizens across EU states distrusted political parties. Upwards of 60 percent distrusted their government, and upwards of 50 percent distrusted their national parliament, and this was before the financial crisis really kicked off. What we now know, in the study of elections and voting, is that what matters most when voters head into the ballot box aren't old ideological debates and conflicts, but simply competence. Which party will deliver the best outcome on the issue that matters the most to voters, and that issue since 2008 is the economy.

At the same time, I think what we've seen particularly over the last year, if not two years, are declining levels of public confidence in the ability of their politicians to deal with this particular crisis. There's an interesting facet in that particular trend that I just wanted to draw your attention to: if we look at Greece for example, according to a poll taken 2 days ago, only 16 percent had faith in the capacity of their government to deal with their crisis, but only 23 percent had faith in the opposition to deal with the crisis. That trend has been mirrored across different states. It's not simply that voters are doubting the competence of their incumbent governments, they're doubting the capacity of all political parties to deal with this crisis. That has potentially some, what I would say are interesting political implications, if not slightly worrying.

What we also know, particularly in northern Europe – less so in southern Europe – is that there are significant levels of dissatisfaction with the whole process of European integration, and in particular the institutions of the European Union. Particularly since the late 1990s onwards, we've seen rising support for parties that are specifically now targeting the bailouts as they would argue, evidence of a dysfunctional European Union. Those parties are gathering increasing support, and we've got important elections in France and Germany not too far away. I think many in the mainstream are looking at this trend as worrying, but at the same time I don't think they can do a lot about it. But it's that notion of competence, and voters aren't stupid. They can see the nigging over the US debate in Congress, and the nigging over the Greek
situation, and they can see some of the debates around the stability fund that you mentioned. Those are the trends domestically that we need to keep tabs on.

**Robin Niblett:**

Thanks. Those figures are fascinating on the Greeks there – it's kind of a plague on both houses which makes it very difficult then for governments to be able to take tough decisions, but at the same time they almost don't have the discipline of an opposition who could stand up and be an alternative to them, so we end up somewhat stuck as we are at the moment. Let's come back to some of those points about political parties, especially with questions to Matt in a minute.

Xenia let me bring you in for a second. The US is becoming increasingly vocal, as far as I've seen, about the crisis. I thought it was interesting to see Tim Geithner complaining about the Europeans needing to get their act together on deciding what to do about their budget deficits after I think them almost bringing the global financial crisis to a halt with trying to get authority to extend their own debt ceiling, but never mind. It certainly reflects the fact that America's worried. Just give us a feel of what you think's coming over from the US side.

**Xenia Dormandy:**

Let me just start by saying that America is very worried about what's going on in Europe, and Geithner's increasing willingness to talk about it is a sign of that. But you have to put it in context: America's also of course very worried about its own domestic situation – whether it's the Republican primary going on, whether it's the potential government shutdown, which if you read the papers this morning, we may have managed to avoid but that's still to be seen; or whether it's their own debt ceiling debate, which is continuing to go on until the end of November, and seeing whether America will be able to find the $1.2 trillion that it needs to find. That's the context in which America's looking at what's going on in Europe, essentially, and this isn't anything new perhaps. There are three reasons that America cares about what's going on in Europe.

The first of course is the globalisation of the economy – the collapse of the Euro would have huge impacts in the US financial systems itself. The first one is just the globalisation factor, and the second one is Europe as a market for
American goods. Europe counts for a fifth of global GDP, it counts for a quarter of global personal consumption, over 50 percent of corporate America's non-US revenue is from Europe, so as a market for American goods, given America's financial problems at the moment, it's extremely important. And the third part of it is just the protection of American banks that have investments and holdings here in Europe. Particularly exposed, and again, the story changed, in Ireland and in Spain, but it matters more broadly.

Paola mentioned about what can other nations and institutions do about this. Unfortunately, again, you have to put it in context. Given America's financial situation as the broader-fit window through which you look at this, there's actually not a lot that America can do today. America provides 25 percent of IMF funding, which is a significant amount, and that's the only source of funding that's going to be coming from the United States, but we also have to put a question mark at the end of that. Given America's financial situation, that is going to be harder and harder, politically, to continue. While it may be 25 percent now, there has to be a question in people's minds in 5 years from now, will it still be 25 percent? Will the American political system be able to withstand that?

In terms of what else the United States can do, it can continue to ensure dollar liquidity and ease of dollar access – this is the Fed that does that, and continues to do so – and really the only other instrument if you will that the United States has is what Tim Geithner, the Treasury Secretary is doing, which is kind of moral suasion. Both in terms of confidence building – and you have been hearing him talk a lot more about this fact that Europe does have the capacity to withstand this and get through this – so by building up this confidence that is so lacking. And also, perhaps, and here's a question mark, providing some political cover for Angela Merkel and others, that action does need to be taken, and there are outsiders talking about this.

What are the political implications? Beyond the economic question, essentially there are two. The first is that the sense by some Americans that there's been a debate going on in the United States whether Europe really is an entity with which as a whole America can work – and whether America needs to continue working with the member states. The reality today is, if you want to get something done, you work with the member states – you don't work with Europe. That reality is mixed with also the American desire, if you will, by most to actually reinforce Europe as an entity. You have this kind of dichotomy on one hand of wanting to reinforce Europe as an entity, and on the other hand realising that if you want to get something done, you have to work with the member states. The inability of Euro members to actually
resolve this, take action, sufficient action and quickly enough, reinforces the vices of those who say that Europe isn't an entity that is terribly effective, and we need to keep working with the member states.

So that's one implication, and the second implication is that the time spent discussing this when the leaders meet, or on the phone, is time not spent discussing some of the other issues – whether it's Palestinian independence, the Middle East peace process or Libya. So you have to recognise that for example, when President Obama was here back in May, this was top of the agenda. The other issues that perhaps should have been discussed didn't make it to that agenda, and that has significant implications more broadly.

So just to close, there isn't actually a lot that America can do, but America cares very deeply that this is resolved for all the reasons that have been mentioned. Geithner is walking a very, very fine line between trying to build that confidence and provide some political capital, but also not so much that he gets; 'What on earth are the Americans doing in this, this is none of your business, get out of here', which he got some of coming to the European finance meeting a week or so ago, and I'll perhaps just close with that.

Robin Niblett:

It sounds like, for what you were saying there, that this is the US leading from behind again. A second example of that. I think the interesting thing to come back to here is that it's difficult to lead when there is such a different approach between Germany in the lead and the UK in the Euro case, with its focus on austerity, and the US' heavy emphasis on easing and on stimulus and recovery. So in a way, there are two different philosophical approaches perhaps at play here, even though the US may get pulled more onto the austerity track as a result of the debt ceiling discussions.