# The IMF and the Eurozone

Some observations

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Andrew Tyrie MP
May 2012

# FOREWORD

**Dr Robin Niblett**

**Director, Chatham House**

This could not be a more timely paper.

Andrew Tyrie warned in both 1991 and 1997 that the structural flaws at the heart of the design of the Euro in the Maastricht Treaty might remain hidden during a “benign moment in the business cycle” in Europe. In 2008, some 17 years later, the collapse of the US sub-prime mortgage market and of Lehman Brothers and the ensuing global financial crisis have laid bare the vulnerabilities of the Eurozone. Governments in Dublin, Brussels and Madrid were forced to step forward to bail out domestic banks which had undertaken their own risky loans during the ten years of historically low Euro area interest rates that followed the formal introduction of the single currency in 1999. Those same low interest rates had lulled governments in Athens, Lisbon, Rome and many other Eurozone capitals into ignoring the need to undertake structural reforms to improve their economic competitiveness within a single currency union. Instead, they ran large trade deficits with their more competitive

North European Eurozone partners, while maintaining large and expensive public sectors that meant debt levels expanded at the same time.

Now, sovereign debt levels across a host of Euro members have surged to levels where markets no longer believe that the debts can be serviced, given the low prospects of growth in these countries caused by the repeated deferral of structural reform at a time when the rise of emerging markets make such adjustments imperative. Interest rate spreads, which had remained in lock step for the first eight years of the single currency, have diverged rapidly and painfully, making the debt levels potentially unsustainable.

Andrew Tyrie lays out starkly in this paper the options currently confronting Eurozone leaders who, as he argues, should have prepared better for the risks inherent in creating a European currency union, but who chose to focus instead on its near-term political and economic benefits.

The first option is to carry out "domestic price adjustments". But these should have been undertaken at the outset of monetary union rather than now, as they were in Germany. Driving forward structural reforms at a time of crisis poses two problems. On the one hand, the positive effects of these reforms take time to bear fruit, potentially too long for the markets. On the other, implementing structural adjustments at the same time as cutting government spending risks creating a vicious cycle of austerity, particularly as all members of the Eurozone are suffering from low, or no, growth. The private sector may not able to compensate fast enough for the loss of public income, not least when banks are limiting their lending and companies are wary of taking on debt. Predictably, government deficits in the Eurozone are not dropping as fast as hoped, as tax revenue is depressed and unemployment benefits and other support payments increase.

The only good news is that there are some signs of price adjustment in Germany – wage demands and awards as well as domestic consumption have all started to rise in 2012. And Spanish and Italian exports to Germany grew strongly last year. German politicians have also talked publicly of the need for some reflation in Germany. But can the relative competitiveness of economies within the Eurozone adjust fast enough?

The second option, as Andrew Tyrie notes, is to transfer funds from the creditor to the deficit countries. It is certainly the case that the Eurozone cannot afford to continue to run 17 separate national financial and banking systems in a single currency area. A Eurozone-wide deposit insurance scheme, a more flexible rescue fund and the creation of Eurobonds are all being mooted today. It has been clear throughout the crisis, however, that German politicians have left it dangerously late to explain to their electorate the extent to which Germany's economic success over the past six to seven years has been a result not only of their own skill and hard work and the structural adjustments they undertook in the early 2000s, but also because of the profligacy of their Eurozone neighbours which, together, constitute by far their biggest export market. As the European summit on 23 May 2012 revealed, Angela Merkel still looks to structural adjustment in Greece first and transfers or reflation a distant second.

This brings us to the third option that Andrew discusses in this paper – exit from the Euro. The risk that Greece may not survive in the Euro has increased markedly since the start of the year and, above all, since the inconclusive Greek parliamentary elections in May. However, the impact of a Greek exit is highly unpredictable. Could the Greek government manage the drastic effects on their economy, citizens and politics? And could the rest of the Eurozone really impose an effective firewall to prevent a contagion of financial instability into other vulnerable Euro countries? Andrew is right to point out that the risks of miscalculation are high, and the likely effects of such an outcome not only on the Eurozone, but on the entire EU, including the UK, and, ultimately, on the global economy would be very negative.

This brings us to the second dimension of this paper: the role of the IMF. Here, the paper offers a bold proposal: the IMF should no longer serve as an 'enabler' of Eurozone fiscal and political mismanagement. Instead, it should return to its role as a detached and dispassionate adviser and, if necessary, as a key financial supporter of its European members.

There is no doubting the political commitment of Eurozone members to their monetary union. In fact, there is a strong likelihood that this crisis will lead to a deepening of the fiscal union among Eurozone members. But, as Andrew Tyrie reminds us, this does not mean that the Eurozone is a single polity. As a result, EU leaders and institutions have proven incapable not only of gauging their own vulnerabilities, but also of getting ahead of the curve in terms of agreeing upon a coherent set of policy steps and institutional initiatives. Given the effects of their inability to do so on the global economy as a whole, engaging the IMF to play a far more active and traditional role in helping manage the Euro-crisis could be a critical part of the near-term solution.

**May 2012**

# 1. INTRODUCTION

It is commonly held that currency unions require large transfer payments from high productivity to low productivity areas.

But this is not necessarily so.

A currency union will be robust if at least one of two other conditions are met. *Either* competiveness can be maintained by domestic price adjustment – internal devaluation or revaluation – *or* countries which cannot cope need to be able to leave, or be ejected.

So the three conditions are:

- indefinite transfer payments,
- domestic price adjustment
- or a means of getting out.

Any one of these three conditions will suffice.

The Eurozone will remain in difficulties because it satisfies none of them.

In 1991, and again in 1997, I wrote papers making these points.

If I made them in front of vigorous Euro enthusiasts, particular senior people in the European Commission, these points were ignored.

On occasion I was described as a wrecker of the whole Euro project.

As it happens, I also argued that participation could bring some modest economic benefits, particularly from its effects on the allocation of investment.

I did not oppose British participation in the Euro on principle but favoured staying out because I was concerned among other things that:[1]

- "[the zone's] monetary credentials could be diluted, perhaps by influences from Europe's southern tier";
- "it might turn out that [the Euro was] being created in a fleeting benign moment in the business cycle (enabling the Maastricht criteria to be more or less met) and that huge further tough adjustments await participants";
- the Euro might be used to "justify an unwarranted increase in powers over fiscal policy".

It was clear from the start that the countries of the Eurozone would be subject to the discipline of the bond markets and therefore, notwithstanding the criticism I took for raising the

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[1] *Sense on EMU*, European Policy Forum, 1997. See also *A Cautionary Tale of EMU*, CPS, 1991.

issue, I thought that it would be better to address the possibility of exit rather than go into denial about it.

This is not an easy moment to contemplate a Euro exit, but it must be done. The stakes are too high not to do so.

Instability in the Eurozone threatens the prosperity of the UK, the region and possibly the globe.

This is no exaggeration: it was the Bank of England that described the Eurozone as ‘a very significant catastrophe risk’ in evidence to the Treasury Committee.

The crisis is multi-dimensional, involving the risk of multiple commercial bank defaults, the risk of sovereign default, contagion to other sovereigns and some risk of the ECB’s insolvency.

Among the other problems, the need to solve the payments imbalances within the Euro area and the need for structural and supply side reform are the trickiest.

## 2. THE GREEK PROBLEM

All of the above can be illustrated by looking at the problems of an individual country.

Take Greece.

The Eurogroup's latest rescue package, agreed in March, does not provide a permanent solution.

Nor does the firewall created by the ECB's three-year liquidity provision, massive though it is, provide a permanent solution to the contagion risk of a Greek default to other countries and institutions.

The Greek package will tide things over for a while, assuming that Greece can meet its terms.

But even if Greece can meet the terms, Greece needs growth, not just to pay its debts (even after the haircut) but also to maintain political stability.

Most analysts do not think that that Greece can return to growth at current exchange rates and current policies.

For example, a recent publication by Goldman Sachs suggests that Greece requires a relative price adjustment of around 30 per cent, and Portugal 35 per cent to achieve external sustainability.[2]

In other words, they need to reduce their production costs by that amount relative to other Eurozone countries, to get into balance.

Furthermore, for Greek membership to be sustainable in the long run, further falls in their production costs from that level will be required of them in the years ahead, unless productivity growth slows in the North.

In passing, it is worth pointing out that, in the same study, Germany is required to undergo an upward relative price adjustment of perhaps about 25 per cent.

The Germans are anxious to ensure that their adjustment is achieved through reductions in other countries' costs, and not by inflation in Germany.

Germany must, in the long run, be at some risk from inflation; they are likely to have to accept some inflation as a price of Euro-area stability.

Gloom about the durability of the Greek package is not confined to commentators, economic scribblers and backbench MPs like me.

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2 Goldman Sachs, *Achieving fiscal and external balance*, 15 and 22 March, 2012.

An unpublished compliance report found its way on to the web some weeks ago, marked strictly confidential. It concluded that Greece will have to impose a further fiscal squeeze next year amounting to 5.5 per cent of GDP.

It says that there are 'large fiscal gaps' in the budget plans.

In other words, the path to sustainability lacks credibility.

Entitled 'Preliminary debt sustainability analysis', it looks suspiciously like an IMF report.[3]

In classic IMF speak it reads like a catalogue of reasons why Greece may suffer even deeper recession, remain accident prone and fail to achieve the necessary growth.

So, the radical structural reform programme demanded of Greece by the Euro group, worthy in intention, may well be insufficient to restore Greece's competitiveness.

It may simply generate political crisis.

A huge risk on the political side must be a weakening of the commitment of the Greek authorities, particularly given the result of the 6 May elections, to deliver wage cuts and supply side liberalisation.

The 'IMF paper' (if that is what it is) also makes this point.

All in all, the radical structural reform programme being imposed on Greece – a programme to force domestic price adjustment – looks full of risk.

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3 *Greece: Preliminary Debt Sustainability Analysis*, 15 February, 2012 available at http://av.r.ftdata.co.uk/files/2012/02/Greece-DSA.pdf

In which case, if the Eurogroup really want to keep Greece in the Eurozone, they will have to accept one of the other conditions with which I began these remarks: large transfer payments, not as loans, but grants.

These grants will need to become a permanent feature of the Eurozone.

In fact, some large transfers have already taken place, in addition to the highly publicised bail-outs of Greece, Ireland and Portugal.

Commercial banks in the countries perceived as weak, not only Greece, Ireland and Portugal, but also Spain, Italy and Belgium, have been unable to borrow in commercial markets and have become increasingly dependent on financing from the ECB.

Banks in the stronger countries have placed their surplus liquidity in the ECB.

Such recycling amounted to over €600 billion at the end of last year.

There is, as yet, no sign of any commitment to continue such payments indefinitely.

Germany is the main creditor and the German public is understandably concerned to ensure that it will get repaid.

Given the fragility of the Greeks' commitment to deliver the difficult reforms, and given that we have not yet seen a commitment from the Eurozone's northern tier to enduring large budgetary transfers, it must be logical to examine the third condition – Euro exit.

We should therefore take advantage of the breathing space afforded by the latest bailout to develop a contingency plan for Greece to leave the Eurozone.

I first hope that this work is going on behind the scenes.

Disorderly exit could indeed be catastrophic.

To paraphrase Wilde, and in a generous mood, to be caught out by the collapse of Lehman might be construed as a misfortune.

Not to be prepared for a Greek exit would be carelessness.

Of course, were the authorities to advertise the issue, it would increase the likelihood of its happening.

That is why the work should have been done at the Eurozone's inception, in more benign economic circumstances.

Those who argue that Greece should remain a member point out that the contagion risk to other southern areas could itself cause a catastrophe.

That is why the robustness of the firewall is hugely important.

The fundamental issue troubling the market is not the liquidity of government securities markets but the solvency of government finances.

The European Central Bank can't solve that problem, and shouldn't try.

A convincing firewall requires both the willingness and ability of governments of Eurozone countries to commit taxpayers' money to mutual support in sufficient quantities. The commitment may need to be indefinite.

First, though, governments need to sort out what sort of Eurozone they are prepared to defend in this way. This they have failed to do, so far.

I am not confident that they will succeed.

If the Euro area were a single polity with a single government, it could solve its own problem – its debt and deficit levels, in aggregate are lower than those of the UK or the US.

It is capable.

But is it willing?

## 3. THE IMF TO THE RESCUE?

The Eurozone is not a single polity.

Its central authorities owe their existence to the mantra of ‘ever closer union among the peoples of Europe’.

The mantra owes more to ideology than economics.

It is deployed to oppose any repatriation of powers or functions, regardless of the circumstances.

It fuels enthusiasm for withdrawal from the EU.

A broad coalition of politicians, of left and right, Europhile and Eurosceptic have queued up to challenge this mantra, from Ralf Dahrendorf to Norman Tebbit.

It rendered historic service by contributing to European stability for more than half a century.

But it has been pushed to its limit, or beyond, in the creation of a broad monetary union.

Put crudely, the citizens of Germany may be unwilling indefinitely to maintain the citizens of Greece in the style to which they have become accustomed.

The citizens of Greece are certainly resisting the painful adjustments which the Germans wish to impose on them in an effort to reduce the size of the cheque.

Ideology got us into this mess.

It must not be allowed to stop us getting out of it.

Only the IMF has the necessary detachment and economic credibility to help sort out this crisis.

Until now their resources have been inadequate to handle a full-scale Eurozone bail-out. The cost of this could be vast. At the Spring Conference held on 20 April, the world's leading industrial nations agreed to increase the IMF's resources, to over $400 billion, enough to bail out Spain – if that were needed.

I hope that this is enough.

Certainly, it is a step in the right direction.

I note, though, that the OECD's Secretary General recently argued for a bail-out fund of at least €1 trillion and for the 'mother of all firewalls' to be created. He may be right.

The IMF is not perfect; it is possible that this crisis is beyond even that body. But it is a great deal better than nothing.

The IMF now needs to show the toughness in negotiations with which it has made its reputation.

These will be testing times for Christine Lagarde – her credibility, as well as that of the IMF, is on the line.

She must see off Eurozone special pleading.

If she failed to do so, the extra resources could be wasted.

Of course, the IMF can be no more than an advisor. It can't in the end issue instructions to sovereign nations. But it can dispense, or withhold, money in ways calculated to force a better outcome.

Its immediate objective should be to set out the three options available to the Euro area, their costs and consequences.

It should evaluate the consequences of maintaining the Euro area with its current 17 members.

The costs will include an enduring commitment to make permanent transfers of income to Greece and probably other countries too.

It needs to say how large these are likely to be.

It needs to spell out the dangers of relying on Greece, and possibly others, making the necessary deep structural reforms.

It should also evaluate the consequences of letting Greece depart and continuing with 16 members. The costs of that would include the costs of a firewall to protect, for example, Portugal, Spain and Italy. It may conclude that one or more of these cannot reasonably be protected.

The Spanish banking system is in deep trouble. Much, probably most, of it needs a bailout.

In 2008 a broadly analogous crisis of financial institutions in Anglo-Saxon economies was addressed by a mixture of recapitalisation and nationalisation. Private sector debt became sovereign debt; the debt to GDP ratios of the UK and US rose sharply.

Spain's financial system now needs similar treatment, but the markets doubt the capacity of the Spanish Government to service the debt. Among other things, they doubt whether the Spanish tax system can raise the necessary revenue while the government simultaneously engages in the deep structural reforms needed to improve productivity and secure internal devaluation. Without those enduring reforms, another Eurozone crisis would emerge in time, even after a bailout.

In which case, either the Eurozone as a whole must underwrite much or all of the debt (whether through Eurobonds or some other tool), and also provide enduring transfers to lower productivity areas (a transfer union), or one or more countries will have to leave the Eurozone and default. Either way, IMF support is likely to be needed.

It is essential that the IMF evaluate the costs and benefits of a smaller Euro area, not least because the ideologically hidebound European institutions appear incapable doing this work.

It is not just dispassionate assessment which is obstructed by ideological baggage. It is the decision-making process itself.

At the moment the IMF is treating the ECB and the Commission as partners in discussions.

This should end.

Both European bodies have an existential conflict of interest. The ECB in particular also has a financial conflict, arising from its holdings of government debt and its enormous exposures to the national central banks of the deficit countries in the Euro area.

These European bodies will be part of the solution. But they are also part of the problem.

The IMF should of course, hold discussions with them.

But their advice should be given to the governments of the member countries, which alone have the legitimacy to make the necessary decisions.

That is also what the IMF's own articles require of them.

In sum, the IMF's job would not be to decide among the policy choices but to evaluate them, present them to the Euro area governments, and put pressure on those governments to make a sustainable choice.

Its influence could be decisive.

It can put up money to help support the firewall that would be needed as part of any sustainable plan, or withhold the money until it concludes that a sustainable plan has been developed.

This is what, on a smaller scale, the IMF has been doing around the world for decades.

Its judgement on the sustainability of any plan would carry enormous weight in financial markets.

That fact considerably strengthens the IMF's hand.

The IMF's major non-European members should also speak up.

More than three quarters of the voting power in the IMF belongs to these non Euro-area countries.

They should instruct the IMF to take a detached view.

They may need to watch like hawks to fend off special pleading.

Never has the IMF's well established un-sentimentality been more needed.

Some have argued that the IMF should keep out of it, that those not part of the Eurozone shouldn't do any more to help it, even in their capacity as members of the IMF.

This brings together those that believe we would be better off if the Eurozone collapsed completely, those who argue that extra IMF help will only reduce the likelihood of the Eurozone ever helping itself and those such as the US, particularly Congress who rarely support increases for the IMF, whatever their justification.

These points have some force but so do three simple points which, taken together, look persuasive to me.

First, there is a non-negligible risk of a serious regional and a possibly global economic fire.

The Eurozone crisis has the capacity to engulf us all. In that sense, we are all in this together.

Second, non-Eurozone countries should not rely on the Eurozone to do the hard work for us.

Their decision making structure is flawed, as I have described.

The Eurozone is sustained, at the moment, by sticking plaster bail-outs, the three year ECB hand-out – at the expense of the banks of Northern tier countries who underwrite the ECB's balance sheet – and, possibly a sense in the markets that the German population may now be more reconciled to the possibility of large fiscal transfers to prop the system up than they were two years ago.

The third reason for backing the IMF is the simplest. They are the only global fire brigade we have.

That is why it was right to increase their resources.

I am not predicting disaster: the resilience of global growth may help the Eurozone in muddling through. But it must be right to be paying the insurance premium now.

What began as a financial crisis in the Eurozone is now developing into a crisis of the real economies of most of Europe. The depth and duration of the crisis are difficult to assess, not least because reliable estimates of the strength of balance sheets of a number of large European banks have been hard to come by. The uncertainty about the long-run future of the Eurozone is therefore reinforced by uncertainty about the credit-worthiness of the banking system.

The sooner it is addressed, the better.

## 4. SOME GROUNDS FOR OPTIMISM

Gloom comes cheap but there are some grounds for optimism.

By far the most important is that, despite a little fraying at the edges, the fabric of the global trading system is not succumbing to protection.

In contrast to the 1930s, globalisation, so far, seems to be surviving this crisis.

Absolute levels of income and wealth are much higher than the 1930s and the rise of political extremism in the countries in the Eurozone, although a matter of concern, are not so far remotely comparable to those years.

I have alluded to what I consider to be mistaken policy making in the Eurozone but there is a lot they have got right.

Policy makers have now bought themselves some time to solve the Eurozone mess. They must use it.

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There are three possible outcomes to the Eurozone crisis: deep-seated reform to restore competitiveness to countries such as Greece; permanent transfers payments from higher productivity countries to lower productivity countries; or the exit of struggling countries.

Andrew Tyrie shows that the first two of these are increasingly unlikely: we should therefore develop a contingency plan for Greece (and maybe other countries) to leave the Eurozone.

Today there is a non-negligible risk of a serious regional and a possibly global economic fire. And the IMF – and not the ECB nor the Commission – is the only global fire brigade we have. Only the IMF has the necessary detachment and economic credibility to help sort out this crisis. It is time for the IMF to evaluate the options, present them to the Euro area governments, and put pressure on those governments to make a sustainable choice. Its influence could be decisive.

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