

## Martin Wolf on the Eurozone and Beyond

By Robert Huebscher

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*Martin Wolf is widely considered to be one of the world's most influential writers on economics. Since joining the Financial Times in 1987, where he is chief economics commentator, he has received numerous awards for excellence in financial journalism. His most recent publications are [Why Globalization Works](#) (Yale University Press, 2004) and [Fixing Global Finance](#) (Johns Hopkins University Press, 2008 and Yale University Press, 2009).*

*I spoke with Martin at his office in London on January 12.*

**The consensus seems to be that ultimately the European Central Bank (ECB) will have to print money to shore up the banks. That will run the risk of inflation. Do you foresee that as part of the inevitable end game for how things will play out in Europe?**

I would say it's a possible part of the end game. It's wrong to think that this is a crisis that can be managed by financing a loan, which is what we are talking about. But maybe one way of thinking about this is that there is an adjustment problem in the Eurozone, which is an underlying real adjustment problem. It derives from the fact that there was a long period when people in the core countries with surplus savings were willing to invest and lend to the peripheral, weaker countries.

After the financial crisis in 2008, that stopped.

You ended up with a structural balance-of-payment problem within the Eurozone. That meant that neither the private sectors nor the public sectors in those countries were able to borrow abroad. But something had to finance their large external deficit. In practice, the governments and predominantly the ECB financed that.

Financing of this kind essentially transfers of resources through the monetary side or the fiscal side of the policy machine, and that is what allowed us to avoid a collapse in the banking sectors and the economies of these peripheral countries. But in the long run they need to restore competitiveness, and they need to reverse their current-account deficits. Or, alternatively, they need to generate new assets that people want to buy. There is a very big real adjustment problem.

The ECB can't solve that problem except to the extent that its monetary policy ends up generating higher inflation in the core than in the periphery – which it might do – but that



will take a very long time to work through, given where we are now with inflation that is very low.

### **Will the Eurozone go into recession?**

The core is going into recession, or at least it is weakening. Differential inflation is very low. The ECB has to act as the dominant financier of these deficits, which it has been. In financing the banks, it's financing these balance-of-payments deficits.

It is very important to understand that there is a macroeconomic side of what the ECB is doing; it is not just financing the banks.

The ECB can't allow the banking sector to collapse. Therefore it is committed essentially to funding the banks, predominantly through lender-of-last-resort operations, but also through its so-called long-term refinancing operation (LTRO). I expect that to continue to the extent necessary. The balance sheet of the ECB will therefore expand a great deal. At the moment, this is having absolutely no inflationary effect at all because the credit growth in the Eurozone is very, very low – incredibly low. The banks are accumulating reserves. But in the long run the ECB needs to create inflation. That is not a bad thing.

If you are optimistic about the outcome, it is because the ECB will act in this way.

### **In his most recent letter, at the end of the third quarter, Jeremy Grantham wrote that he had no particular insights into the Eurozone crisis, but that it was a terrifying situation. Is he right to be terrified?**

I think he's right. The problem is that we are now in the following situation: We have some very, very large divergences in competitiveness in the Eurozone. We have some enormously over-leveraged banking institutions, which are exposed to some very, very doubtful debt, both private and public. We have an absence of effective adjustment mechanisms, as I've already discussed, profound weaknesses in political coordination, and a lack of political leadership.

Therefore there is the possibility of a break-up.

It's very difficult to imagine a break-up process which would not lead to a chain of both sovereign and private bankruptcies across the Eurozone. The Eurozone has far and away the biggest banking sector in the world. It's much bigger than the American banking sector, which few people realize, because Europe is a very bank-dependent economy.

In a break up, we could have a wave of bank failures, as well as defaults by sovereigns that have no choice other than printing their own new money which could mean genuine hyperinflation in some countries.



The risks here are very broad and very big. Furthermore, if the Eurozone were to break up – I'm not predicting that – it would almost certainly affect the European Union itself. It might affect the ability to stay in the single market. It could lead to protectionism, in other words. That could radiate across the world.

There are very, very big risks involved in a break-up event.

### **What would be the most disruptive effect of a country – Greece for example – leaving the Eurozone?**

Greece itself is a pretty small country. Nobody expects Greece to pay its debt anyway, so that is all in the market. In and of itself, the disappearance of Greece from the single currency would not be in any way a traumatic event. In all truth, if Rhode Island were to leave the United States, the United States would go on.

But if Rhode Island were to leave, people might say, "What next?" Greece is a very, very small country, but people would say, "If Greece leaves, what would that mean?" Nobody is absolutely sure, but it probably would mean that the debts of the Greeks that had been contracted inside Greece would be re-denominated in a new drachma. Their value would collapse perhaps 50% to 70% depending on what happens to the exchange rate. The banks would almost certainly implode and have to be taken over all by the state. It would immediately be a huge crisis in Greece. Of course, those Greeks who still had money in Greece would be the less-savvy people, who would lose enormous value in real terms. Those companies who borrowed outside Greece would be bankrupt because of the balance sheet effects.

In other countries – Italy, Spain, perhaps even France – people would ask if their money is safe in the banks. Should they keep their euros in the banks, or should they move them to Germany or Switzerland or to the Netherlands? The likelihood is there would be an accelerated flight, not just of wholesale funding, but even of deposits. There would certainly be a flight from the government debt of those countries, probably further collapses in prices, and possibly difficulty rolling over the debt of these countries.

This would create a general financial crisis across the Eurozone.

### **How could the ECB deal with that?**

If the ECB were willing to recycle all the money that came out of the weaker countries, for example what was then deposited in German banks, they could certainly transfer it all back, but that would imply taking an ever-increasing risk on the balance sheet of the ECB. That might be politically very difficult. The Germans on the ECB's board might say we are exposing ourselves too much to these very large risks.



The major consequence of a Greek departure would be to generate a pan-Eurozone financial crisis, because the banks are so important. They are very big global players that would certainly affect other economies, including the US, through the financial channel predominantly. There would also be trade effects, but the loss of confidence in the financial channel would be the most important.

You could argue that the chance that Greece will leave is increasing the market. You can also argue that it is increasingly clear that the ECB will act to support the system, so in the event of a crisis, it might not be quite as severe as I have described. But this is the danger, that suddenly you realize that what had previously been unthinkable is now thinkable, and it might include the breakup of the Eurozone.

**While on the subject of Greece, much has been made of the austerity that is being imposed on them. It is fair to characterize those measures as “austerity”?**

Greece started with a huge fiscal deficit, and they still have a huge fiscal deficit. They started with a huge current-account deficit, and they still have a huge current-account deficit. So somebody is still giving them lots of money, and none of that is being financed in the market. So there is a huge external support operation.

As a result, the Greeks are enjoying a much higher standard of living as a nation than they would otherwise. In that sense, it may be worse than they thought it would be before the crisis, but it is a hell of a lot better than it would be without all the support.

At the same time, the Greek economy is progressively shrinking. A lot of the burden is being imposed not on the Greek public sector, but on the ordinary Greek citizens who are not getting what they used to expect and are being required to pay more tax. There is a certain amount of pain being felt in Greece, and a very important aspect – which you must be familiar with from the American experience – is that this pain is very far from equally borne.

There are extremely wealthy people in Greece who have certainly taken all their money out, and they are not suffering at all. Most of them don't pay much tax. Many of the upper-middle-classes don't really pay tax. In the extreme case, famously so, there are public servants who continue to enjoy relatively privileged positions, and then there are ordinary people who are genuinely squeezed.

There are real losers here because the economy is shrinking dramatically, because some public spending programs have been dramatically cut. Many of those programs are for the weakest and the most vulnerable.

It is fair to say that Greece is being more than adequately cushioned, in some sense, against the worst of the crisis. But, in a very unequal and unfair way, there are lots of losers.



**The attention now seems to be focused on Italy, which has a large debt burden that it needs to rollover in 2012, particularly in the next several months. Is it appropriate to be focusing that much attention on Italy? Is that now the most imminent threat?**

It is absolutely appropriate to look at Italy.

It is incomparably the most important threat. Italy has either the third- or fourth-largest public debt in the world. Italy depends on its relationship with Germany. But it is very large, and therefore a major crisis in Italy – either a default or an exit – would be a very big event for the future of Europe.

Italy's situation is very interesting because it is quite complicated and a bit different than that of other countries. It has a very large debt stock relative to its GDP, almost all of which was inherited from the early 1990s. The debt hasn't increased very much. Italy actually has been running quite small deficits, much smaller than the US or the UK for example, and also smaller than France.

The big problem with Italy is that it lost competitiveness significantly in the last decade, which means that it has a pretty significant structural account deficit – not enormous but quite significant. Above all, its economy hasn't grown. The economy structurally stopped growing. It's not just cyclical; it's not just because of the crisis.

People looking at a country like this say to themselves, "Okay, you've got this debt stock of 120% of GDP or so, you've got a competitiveness problem and you've got a growth problem. How are you going to manage this debt in the long run?"

To manage the debt, you have to act on both the numerator and denominator. The numerator is the deficit and the denominator is the growth of the economy; the fraction represents the underlying growth of debt-to-GDP. If the denominator is not growing at all, to regain competitiveness Italy needs very, very low – perhaps zero – inflation. But the economy is hardly growing, and that means zero growth of nominal GDP. If you've got a deficit of even 3% or 4% year, the debt will keep on rising, so that is the nightmare. Of course, interest rates have gone up to 6% or 7%. That makes the deficit worse in future.

That starts looking explosive.

Even though it had a reasonably contained deficit, because of very low growth, competitiveness problems, and high interest rates, what people fear is that Italy is going to move into a very bad equilibrium and will ultimately be driven to default. It is a very important country and at the moment it looks very, very dicey.



## **What is the best alternative for Italy?**

To move back to a better equilibrium, it has to reform its economy so that it can generate growth again. This is quite difficult to do, because this is a country with shrinking population and a shrinking labor force, but they can increase labor force participation, which is now very low.

But they've got to get growth again, and that means they've got to get competitive again, and they have to squeeze their fiscal deficit all at the same time. That means taking on a lot of powerful interests by a government. Though it is led effectively by Mario Monti, the old parties are still in Parliament and they are opposed to some of what he's doing, for instance on taxation.

It is very realistic to look at Italy very closely and ask yourself, "Is it sustainable?"

Spain has a much bigger fiscal deficit – 8% of GDP, we've just discovered -- and a bigger external deficit that has to be funded, but its debt ratio is much lower, even lower than Germany's. They have some time. But there are similar questions. Can it get to competitiveness so it can get growth again? Its pre-crisis growth was essentially unsustainable housing-construction-driven growth, a bit of what happened in the US and the UK.

Together, Italy and Spain have a gross debt stock of about 2.5 trillion euros. These are very, very important countries in the global debt markets. At the moment, the markets are not convinced their longer-term structural problems are soluble.

## **Is the prescription that you just gave for Italy, in terms of restoring competitiveness and fiscal reform and so forth, pretty much the prescription across the peripheral countries?**

Indeed it is. The difficulty is that it's very difficult to do quickly. It involves a lot of painful changes. There is a lot of political resistance. It is almost impossible to do if the whole Eurozone economy isn't itself growing. These countries need to improve their net export position. That means they need buoyant markets. They were helped by a weak euro, which is beginning to happen. But the core story is these are countries that are finding it very difficult to make the adjustment without expansion in the Eurozone as a whole. Unfortunately it looks like the Eurozone is going into recession.

It is not quite clear what is going to happen to Germany. But in that situation they really have enormous problems in managing their debt positions. That comes back to the beginning of our discussion: The ECB can manage this in the short run, but there is a very large medium- to long-term adjustment problem, which, if it is going to work, will take a decade or so.



The question is if they will have that time.

**Stepping back, how is the current crisis over the euro part of a larger problem with global trade? Is the US now locked into the position that Britain was in the 1920s, when it was running trade deficits to the rest of the world? Is the US trapped in a deflationary slow-growth economy, because of its status as the reserve currency?**

The Eurozone crisis is related to what has happened to the US, but perhaps not quite in the way that you suggest.

It is related in that there were a set of circumstances in the 10 to 15 years leading up to the crisis in which credit conditions – the willingness to take on risk in financial markets by financial institutions and therefore ultimately by people – were extremely easy and favorable across the developed world. I might even say across the world, but particularly across the developed world – less so in the emerging countries, partly because of the consequences of their own previous crises.

Now an interesting question is why that happened. There are two very big elements to that story. I have argued that one, which is partly linked to the dollar as a reserve currency, was the emergence of the emerging and developing countries as very large capital exporters. This was a very unexpected situation, in that they were net capital exporters, supplying capital to the world from the Asian financial crisis onwards. China was a big part of that.

The second part of that was the form that those capital accumulations took, mainly the desire for safe assets, particularly US Treasuries, which created extremely easy conditions for the supply of those reserve assets.

There was very low inflation in the world for a whole set of reasons. You had this huge aggregate net supply of capital – the so-called savings surplus, which is a correct description of part of what was happening – that created conditions in which central banks, particularly the Fed but also the ECB, could pursue extremely relaxed monetary policy, particularly in the early 2000s.

The two together – low real interest rates from the savings surplus and low nominal short rates because of central bank policy – created the conditions for this huge credit boom, which was not just unique to the US. You saw it in the UK, Spain and Ireland. It buoyed up also the exporting countries – Germany, the Netherlands, Japan and China of course. So that's the story of how we got here. I wrote a book about that aspect of the story.

The fact that people were very happy to buy US assets as reserves was obviously a part of that story. It would've been an interestingly different and complicated story if that hadn't happened. I've argued that, with the rest of the world wanting to buy US assets, which pushed up the real exchange rate of the dollar and weakened the external competitiveness



of the US, it was inevitable that Fed policy would generate demand predominantly in the non-tradable sector. It did that, in construction and all the rest of it, and that created the conditions for the financial boom.

Now, if we look to the future, we don't want to do this again, right? So logically, that means that these extraordinary global imbalances which are part of the story need to reverse. It's fairly easy if you look at the US, and also the weaker countries in Europe, to say that in order to balance their economies again, they need a large improvement in net exports to eliminate deficits and move into surplus. That will allow higher savings in the private sector and reduce their fiscal deficits. Instead of having a situation in which the higher savings of the private sector in the US are completely offset by the reduced savings of the public sector, you actually would accumulate assets. But the developing world is resisting.

Now it's very important to get this story correct. I don't believe – and this is crucial – that the dollar as a reserve asset in this story emerges simply from the choices all these countries make. Those choices were made for very good reason and there is no alternative to those choices and I will come to that in a moment.

**But the surplus countries are really in the driver's seat here. The surplus countries are creating the trade imbalances.**

Yes, it's predominantly the emerging countries. It's the Chinas and so forth. Those countries want to accumulate claims on the rest of the world, and the claim they want is the safe asset, and the safe asset by agreement is US government liabilities.

The US doesn't have much capacity to deal with this as long as those surplus countries target their exchange rate and are willing to buy these reserve assets, which they clearly are. The reserve position is a byproduct of people's desire to hold assets that are considered to be perfectly liquid and safe, which are US liabilities. That is going to continue for some time, but not forever. There will be a point at which that changes, but I don't expect that to be the next 10 years.

If it is going to change, it will change – this is really crucial – for one of two reasons. Either there is some competitor currency. It doesn't look like the euro at the moment, so it would have to be the renminbi.

**But no one wants to be the reserve currency. It's a curse, right?**

Yes, exactly. It's a curse and benefit. It allows higher standards of living, but it a curse. There needs to be a competitor. The other alternative of course is that they decide – and that I think is possible – that they've got enough reserves. Reserves have increased in the world as a whole from \$1.6 trillion equivalent immediately after the Asian financial crisis to \$10 trillion today. So you have to ask yourself how much is enough? These are very low-yielding assets; in real terms they are negative for most the holders. So it is possible that,



even if they don't switch to another reserve currency, that holders of US assets will say to themselves, "We've got enough of this stuff. It doesn't make any sense."

The demand coming from the US consumer is no longer something you can rely on. Basically, consumption growth is going to be weak from the US. We certainly can't rely on the Eurozone consumer, so actually we are going to have to accept the elimination of our surpluses. We'll have to invest our money abroad. The reserves will stabilize again, as they did for a very long time. The US dollar has been the reserve asset since the 1930s. But it was only in the 2000s that we had this explosive increase in the foreign currency reserve positions. But it's not a permanent consequence.

So it is possible that the dilemma will disappear even if there is no alternative simply because people will say, "That's enough US Treasuries, thank you." But at the moment, when we are in a position of such panic in the world and people are so nervous, there is a very strong demand by everybody for what is regarded as the least unsafe liquid asset. There has been a run into US Treasuries, not away from them, because of the panic.

But if you are an optimist in the medium to long term, as I am, you say confidence will return. Ultimately we will get through this. People will start wanting riskier assets. They won't want to accumulate more safe US Treasuries, because they really yield very little, and if long-term rates start rising US Treasuries are going to be a terrible investment.

If you look at US Treasuries now, you have to say the downside looks more persuasive than the upside.

### **Could the special drawing right (SDR) emerge as a viable reserve currency?**

We will never agree on the SDR. There is no mechanism because it's not the currency of a state. It doesn't have the guarantee of a state. It's even worse than the euro. In the end, US liabilities are backed by the US economy and the US taxpayer, and people know that is a real entity that will survive. People think that in the end the US fiscal problems will be resolved. Ultimately they are optimistic that the US will solve its problems. That gives some real backing to those assets, which doesn't exist in the case of the SDR. It's just a political fiction.

If this is going to be resolved, it won't be by some great big "let's have a new world currency" movement. It won't be resolved by the replacement of the dollar by the renminbi. It will simply be resolved by normal economic processes, in which people say that they own enough dollar assets. We've got to where we don't want to continue to rely on the US consumer because the US consumer is not going to come back. That will become more and more obvious. The adjustment will slowly and painfully occur over the next decade.



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