European *End Game*

The striking similarity between today's eurozone situation and the end of Bretton Woods.

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The financial community claims nearly unanimously and somewhat vociferously that the eurozone is suffering from a confidence crisis that can only be solved by wielding a "big bazooka." If the rescue fund is large enough, goes the argument, markets will be assuaged, interest spreads will shrink, and the distressed countries will manage to refinance their public debt. But as popular as this view may be, it is far too optimistic.

Of course markets are jittery, and the risk of self-reinforcing runaway processes is real. However, markets have every reason to be nervous. There is not just the self-inflicted instability of mutually infecting speculators, but a fundamental distortion of prices for goods, labor, and capital that would need a currency realignment that is impossible within a currency union. Whoever offers his guarantee for the funds powering the big bazooka should know that such a guarantee will be drawn eventually, given that the debtor countries lack the competitiveness to be able to redeem their debt.

The distortion of prices stems from the bubbles that built up in the eurozone's periphery in the years before the crisis. The rapid interest convergence that took place from 1995 to 1997 in anticipation of the

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euro induced governments and private agents to overborrow and overspend, making their respective economies overheat. In Greece and Portugal, the borrowed funds went largely into the wages of government employees, and in Ireland and Spain largely into the wages of construction workers. As construction workers paid more taxes, and government employees bought more homes, they pulled each other along into the bubble. At the end of the day, whoever borrowed the cheap funds from abroad made little difference. From 1995 to the crisis year 2008, the GIIPS countries (Greece, Ireland, Italy, Portugal, and Spain) appreciated against their eurozone trading partners by 30 percent. By contrast, Germany depreciated against its eurozone trading partners by 22 percent, which translated, for instance, into Italy appreciating by 50 percent against Germany. Increasing wages, prices, and nominal incomes in the GIIPS undermined their export competitiveness and boosted imports, driving all countries into current account deficits: 2.2 percent of GDP in Italy, 3.5 percent in Ireland, 7.7 percent in Spain, 10.9 percent in Portugal, and 12.5 percent in Greece over the past five years.

These problems of the eurozone are similar to, but much more extreme than, those of the Bretton Woods system, the fixed exchange rate system that lasted until 1973.

The most recent estimates for 2011 show that the combined current account deficits of the GIIPS will be on the order of €127 billion, and their net foreign debt position will have risen to €1,620 billion. Italy's net foreign debt amounts to only 26 percent of GDP, but that of the rest to a staggering 95 percent (95 percent for Greece, 86 percent for Ireland, 105 percent for Portugal, and 95 percent for Spain). No less than 52 percent of the total net foreign debt of the GIIPS, or about €1,021 billion in absolute terms, lies in Spain, with €417 billion or 21 percent in Italy, and the rest shared among the other GIIPS countries. (Surprisingly, even France had a net foreign debt position of about €215 billion in 2010, the eurozone's third-largest in absolute terms. In relative terms, however, that amounts only to 11 percent of French GDP.)

A net foreign debt position on the order of 100 percent of GDP is extreme by any standards. Greece, Ireland, Portugal, and Spain will therefore have a hard time repaying their foreign debt, to put it mildly. There is every reason for the current holders of the respective government bonds to be frightened.

The only chance to repay the debt is to become competitive enough to earn a current account surplus. That, however, requires becoming cheaper. The terms of trade must deteriorate in order to stimulate exports and redirect import demand towards the purchase of domestic goods. That is easy if a country exits from the euro, but difficult if it stays in.

Nevertheless, the available data show that the extraordinary nature of the Irish crisis provoked a depreciation that brought about an improvement of the Irish current account balance. The Irish price level declined by 15 percent relative to its trading partners from the peak in the second quarter of 2007 to the second quarter of 2011. In 2010 and 2011, Ireland even clocked in a small current account surplus, the first in a decade.

By contrast, in the other crisis countries, net-of-VAT prices have hardly reacted to the crisis. These countries inflated as much as their eurozone competitors did, or even more. Portugal and Spain have depreciated by just 1 percent relative to their euro trading partners, and Italy even appreciated by 2 percent. Thus, except for Ireland, based on the hard statistical facts available, there is no sign whatsoever as yet that the euro countries are undergoing the necessary internal realignment to improve their competitiveness.

The question is why such realignments have not yet taken place. After all, the European interbank market broke down as early as August 2007, and it has been increasingly difficult for some of the crisis countries to rustle up the necessary funding to cover their deficits. Their financial difficulties should have resulted in sufficiently deep cuts in aggregate demand to exert the necessary downward pressure on wages and prices.

The answer is that the afflicted countries all had easy access to the money-printing press. Backed by the ECB Council's decisions to substantially lower the collateral requirements for refinancing credits, Greece and Portugal in the years 2008 to 2010 were able to cover more than 90 percent of their current account deficits by resorting to the printing press. Spain financed a quarter

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of its current account deficit this way. Had the money-printing presses been less easily available, the downward pressure on prices and wages would surely have been much stronger.

Ireland not only covered its current account deficit with money printing, but in addition and primarily a huge capital flight. From the summer of 2011 onwards, Italy too accommodated a brisk bout of capital flight with the printing press, about €80 billion in August and September alone. The Bank of Ireland and

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the Banca d'Italia lent fresh money to their commercial banks, which in turn bought government bonds and other assets from their clients, and the clients then went on a shopping spree, buying foreign assets to safeguard their wealth.

The money printed in the periphery flowed to the core countries, Germany in particular, and the resulting abundance of liquidity crowded out the normal provision of money via refinancing credit or induced banks to lend the surplus money back to their national central banks. This eventually brought the Bundesbank into a net debtor position with regard to the German commercial banking system. In exchange for the now inexistent claims against the banking system, the Bundesbank received so-called Target claims against the European Central Bank, by now about €500 billion, accounting for about 50 percent of Germany's net foreign wealth. In the years 2008–10, Germany was unable to acquire marketable assets in exchange for its current account surplus, as the case should normally be. Fully 96 percent of its current account surplus with the rest of the eurozone was compensated just with Target claims.

As my colleague Wilhelm Kohler has pointed out, these problems of the eurozone are similar to, but much more extreme than, those of the Bretton Woods system, the fixed exchange rate system that lasted until 1973. At the time, the U.S. Federal Reserve System had printed many more dollars than were needed for internal U.S. circulation. These dollars were used, for example, to buy cheap goods and assets in Europe, including German and French firms that had attracted the interest of American investors. By virtue of the fixed exchange rate regime, the dollars arriving in Europe had to be converted into national currencies by the Bundesbank and the Bank of France, and the converted "dollar-deutschmarks" and "dollar-francs" then crowded out the refinancing deutschmarks and francs that usually constituted the respective currency stocks. The dollars (or U.S. Treasury Bills to which they were converted) accumulating with the European national banks were the analogue of today's Target claims, and in both cases there were sizable public credit flows through the central bank systems. It was said that Europe financed the Vietnam war that way.

General De Gaulle did not like this public credit flow. In 1968, he asked the United States to convert the dollars that had piled up with the Banque de France into gold, and he sent a warship to protect the gold transport back home. This was the beginning of the end of the Bretton Woods system, as the United States was forced to end the gold convertibility of the dollar.

Today, the Bundesbank cannot call due its claims in a similar fashion. No warship and not even a public letter will be sent to the GIIPS countries or the European Central Bank. German politicians try to sweep the issue under the carpet rather than making a federal case out of it. After all, there are already too many fires that need to be put out. This should give the eurosystem a better survival chance than the Bretton Woods system.

Nevertheless, even Germany's tolerance cannot be stretched indefinitely. As two of its representatives in the ECB Council, Axel Weber and Jürgen Stark, resigned this year because of the ECB's government bond purchases, and as German President Christian Wulff has already accused the ECB of circumventing the Maastricht Treaty, the ice on which the euro skitters along has become very thin indeed. ◆