The Moscow Times
30 YEARS
INDEPENDENT NEWS FROM RUSSIA

EU Stuck in Vicious Circle of Perpetual Crisis

By Yannos Papantoniou

April 06, 2013



The Cyprus bailout deal is a watershed in the unfolding euro-zone crisis because responsibility for resolving banks' problems has been shifted from taxpayers to private investors and depositors. But imposing major losses on Cypriot banks' depositors violates the deposit-insurance guarantee that forms part of the proposed European banking union, while the imposition of capital controls further erodes the monetary union's foundations. So, is Europe chasing its tail?

Germany and the other countries of the euro-zone core are signaling that debt mutualization within the monetary union is out of the question, and that bailouts of countries or financial institutions will be balanced by "bail-ins" of their creditors. Increased uncertainty concerning the safety of deposits will push up interest rates and deepen Europe's recession and may also trigger capital outflows from the euro zone's weaker peripheral economies to the core.

The implications of this shift may be far-reaching. The German model for resolving the debt

crisis and returning to internal or external balance relies on fiscal consolidation and structural reforms for the deficit countries. But, if all countries simultaneously attempt to improve their fiscal or external balances by cutting spending and raising taxes, all will fail, because each country's austerity implies less demand for other countries' output, in turn perpetuating both domestic and external imbalances. "Bailing in" creditors will exacerbate these trends.

An EU strategy
that deepens
recession and
weakens
confidence
won't solve
the debt crisis.

Moreover, a deep and prolonged recession implies vanishing support for reforms, as governments fail to convince citizens that current sacrifice will ensure a better future. Privatization, market liberalization, the opening of closed professions, and government downsizing involve conflicts with powerful vested interests, such as businesses in protected industries, public-sector unions, or influential lobbies. Resolving such conflicts requires social alliances, which are invariably undermined by discontent, civil disorder, and political instability.

The gaps in the strategy are clear. First, the euro-zone authorities misread the real causes of the debt crisis, which stemmed mainly from a growing competitiveness gap between the core and periphery countries. The resulting private-sector imbalances culminated in banking problems that were eventually transferred to sovereigns. Greece's fiscal profligacy was the exception rather than the rule.

Indeed, in contrast to the U.S., euro-zone authorities were slow to consolidate the banking system after the global financial crisis erupted in 2008, and failed to sever the ties between sovereigns' and banks' balance sheets. Nor did they push strongly for structural reforms. Instead, they emphasized harsh austerity, which was to be pursued everywhere.

Second, the effects of austerity were exacerbated by the choice to pursue nominal, rather than structural, fiscal-deficit targets. Countries with a stronger fiscal position — that is, smaller structural deficits — should be encouraged to adopt more expansionary policies in order to contribute to lifting overall demand. Moreover, the European Investment Bank's lending capacity could be increased substantially, and the European Union structural funds mobilized, to finance investment projects in the peripheral economies.

Third, the European Central Bank's announcement last August of its "outright monetary transactions" program — through which it guarantees euro-zone members' sovereign debt, subject to policy conditionality — has contributed significantly to subduing financial turbulence in the euro zone. But the outright monetary transactions scheme has not been reinforced by a reduction in key interest rates, which would boost inflation in core countries with external surpluses and thus help to close the competitiveness gap with the periphery. Crucially, monetary-policy measures do not address the underlying problem of lack

of demand.

Last but not least, the euro-zone authorities misread the confidence factor. In theory, simultaneous fiscal consolidation and supply-side reform facilitates economic recovery, because it increases confidence among consumers and investors, thereby inducing higher spending and production. But this does not necessarily work in an imperfectly functioning monetary union, such as the euro zone, where the continual appearance of systemic flaws erodes confidence; in such circumstances, the result may be hoarding and capital outflows, rather than increased spending.

The longer that European authorities postpone the introduction of eurobonds, an effective banking and fiscal union, and lender-of-last-resort status for the European Central Bank, the longer the crisis will last. By effectively defaulting on a deposit-insurance guarantee through its actions in Cyprus, the euro zone backtracked on the planned banking union.

Pursuing a strategy that simultaneously deepens recession and weakens confidence will not resolve the debt crisis. As funding problems recur in the recession-hit economies, governments may resist "bailing in" and the associated losses. Civil unrest and political destabilization could erupt into financial and social crises that ultimately threaten the monetary union's survival.

In short, the "solution" to the Cyprus crisis is no solution at all for the euro zone. Unless the authorities embrace a growth strategy — and do so quickly — the euro zone's prospects will become increasingly bleak.

Yannos Papantoniou, a former economy and finance minister of Greece, is president of the Athens-based Center for Progressive Policy Research. © Project Syndicate

The views expressed in opinion pieces do not necessarily reflect the position of The Moscow Times.

Original url:
https://www.themoscowtimes.com/2013/04/06/eu-stuck-in-vicious-circle-of-perpetual-crisis-a23006