Five minutes with Philippe Legrain: “The Eurozone has become a glorified debtors’ prison”

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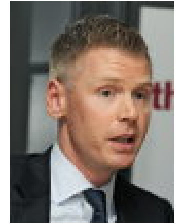
With no lasting solution yet found for dealing with Greek debt, and economies in the Eurozone continuing to suffer from weak growth, how can Europe finally solve the problems brought on by the financial crisis? In an interview with EUROPP’s editor Stuart Brown, **Philippe Legrain** *discusses the policy failures at the root of the crisis, the need to stimulate demand in Eurozone economies, and why the German focus on cutting wages to improve competitiveness is simply exacerbating existing problems.*



Have the right lessons been learned from the crisis in the Eurozone?

The short answer is No. Catastrophic mistakes by Eurozone policymakers – primarily Angela Merkel’s government in Berlin, the European Central Bank in Frankfurt and the European Commission in Brussels – have transformed a financial crisis into a much deeper economic and political one.

More than seven years into the crisis, the Eurozone is doing much worse than the United States, worse than Japan during its lost decade in the 1990s, and worse even than Europe in the 1930s. The economy, which is still 2 per cent smaller than in early 2008, is stagnating. The least-bad performer, Germany, has grown by less than Britain over that period and less than half as much as Sweden, Switzerland and the US.

The worst, Greece, has shrunk by more than a quarter and is faring worse than Germany did during the Great Depression. Many people’s living standards have slumped and unemployment is painfully high: 11.4 per cent overall, much higher in Southern Europe, scarily so among young people. A lost generation is in the making. In a nutshell, the Eurozone is sinking into a deflationary debt trap, with tragic social consequences and unpredictable political ones.

Unsurprisingly, voters are fed up of years of seemingly unending misery. Social tensions within countries are multiplying, as are political frictions between them. Understandable anger at the injustice of bailouts for rich bankers and budget cuts for poor schoolchildren overlaps with a despicable scapegoating of outsiders, notably immigrants. Old stereotypes have been revived and new grievances created. Northern Europeans slander southerners as lazy good-for-nothings, while Greeks label Germans Nazis. Nasty nationalism is on the march again and support for the European Union has never been lower.

Most Europeans now associate the EU with austerity, recession and German domination, with undemocratic constraints on what they can do, rather than how we can all achieve more together. And they’re angry and resentful at incompetent and sometimes corrupt establishment politicians and EU technocrats who seem incapable of resolving the crisis and have imposed misery on ordinary voters (but not on themselves). In the absence of mainstream alternatives, voters are turning to radical and extremist ones: the radical left in Greece and Spain (and separatists in Catalonia), the far-right in France and Italy, Sinn Fein in Ireland.

While Italy’s reformist prime minister Matteo Renzi remains popular for now, all three main opposition parties – the far-right Northern League, the anti-establishment Five Star Movement and Silvio Berlusconi’s Forza Italia – are now anti-euro. Resentment of southern Europe is also boosting the anti-euro, far-right in the Netherlands, Finland and Germany. So politics may yet achieve what quiescent markets are no longer doing: with luck, force desirable policy change, but potentially break up the euro. That’s the big picture.

Despite the prolonged nature of the crisis, there is still little agreement between politicians and economists on the root cause of the Eurozone's problems. How would you define the current situation?

The Eurozone is stuck in a balance-sheet recession, with broken banks, a huge overhang of private-sector debt and a big shortfall of demand. Households, companies and banks are all trying to repair their balance sheets at once, while governments – instead of accommodating the private sector's desire to save more by borrowing more themselves, or accelerating the balance-sheet repair by restructuring debts – are compounding the problem by trying to borrow less too.

So the economy is stagnating, private-sector debts have barely fallen, and public debts have soared all the same. A simplified way of putting it is this. Households aren't spending because their wages are stagnant and they are trying to pay down their debts. Since consumers aren't spending, companies don't want to invest. And governments are cutting back too. So domestic demand is depressed.

And since Eurozone economies mostly export to each other, each country's depressed domestic demand limits demand for others' exports. So the Eurozone is relying entirely on demand from the rest of the world in order to grow, but the Eurozone is too big and growth elsewhere too weak for that to generate a recovery strong enough to bring down debts and unemployment.

The Eurozone also has severe, longstanding supply-side problems: a lack of innovation and enterprise, cartelised product markets, ossified labour markets, rigged and subsidised land markets, a bloated and often inefficient public sector. Over the past decade, productivity growth averaged only 0.9 per cent a year, half that in the United States. On top of that, the Eurozone has dismal demography: its working-age population has been declining since 2011.

But even if we assume the Eurozone's trend rate of growth is as little as 1 per cent a year, it should still have grown by 6.5 per cent over the past six and a half years. Instead it has shrunk by 2 per cent. Clearly, then, the Eurozone's biggest problem is deficient demand. So while supply-side reforms to boost productivity are vital for future growth, they are not a substitute for policies to boost demand now – indeed they cannot succeed unless accompanied by measures to fix the banking system and boost investment.

What were the key policy failures that brought us to this point?

The official narrative that has taken hold in Germany and EU circles blames the crisis entirely on others, not least profligate and reckless southern Europeans. It argues that since others, not Germany, are responsible for the crisis, they must pay the price for it. Germany does not need to change, others do. As well as paying back their debts in full, they must emulate what Germany did a decade ago: consolidate public finances and bear down on wages to restore competitiveness. That way they can be as successful as Germany supposedly is.

There's just one problem with this narrative: it is entirely false. The true story is as follows. In the years up to 2007, there was a huge credit boom across the Western financial system, from the United States to Iceland. It involved a massive expansion of cross-border lending by dysfunctional and dangerously undercapitalised banks, abetted by the complacency – and sometimes the complicity – of central bankers, regulators, supervisors and politicians. And Eurozone banks were at the heart of it.

As well as gambling on American subprime mortgages, German and French banks lent too much, badly to Spanish and Irish homebuyers and property developers, Portuguese consumers and the Greek government, both directly and together with local banks. When the bubbles burst and banks began to fail, governments decided to bail them out, protecting banks' creditors. Banks' initial losses were often related to American subprime mortgages, over which European governments had no control. But when it became clear in early 2010 that Greece could not pay its debts, Merkel – together with a French trio of Jean-Claude Trichet at the ECB, Dominique Strauss-Kahn at the IMF and President Nicolas Sarkozy – took a different approach.

To avoid losses for French and German banks, they decided to pretend that Greece was merely going through temporary funding difficulties. And under the pretence that the financial stability of the Eurozone as a whole was at risk, they decided to breach the legal basis on which the Eurozone was formed – the "no-bailout rule" – and lend to the Greek government so that it could repay those foreign banks and investors. Further loans from EU governments to Ireland, Portugal and Spain followed, primarily to bail out local banks that would otherwise have defaulted on their borrowing from German and French banks and other financial investors.

As a result of these bailouts, the bad lending of private banks has become obligations between governments. And a crisis that could have united Europe in a collective effort to curb the banks that got us into this mess has instead divided it, pitting creditor countries – principally Germany – against debtor ones, with EU institutions becoming instruments for creditors to impose their will on debtors. The Eurozone has become, in effect, a glorified debtors' prison.

It is tragic – but hardly surprising – that as a result Germany and EU institutions are now resented so much in debtor countries. It is also understandable that northern European taxpayers are angry at this. But instead of resenting southern Europeans, they should direct their anger at the banks that their loans, in effect, bailed out and at the policymakers who made it happen. And the upshot is that European taxpayers now have an incentive to resist the debt relief that Greece needs to recover. They would also lose out if the €64 billion bank debt unjustly imposed on Irish taxpayers were written down.

By putting the narrow interests of the banks ahead of those of ordinary citizens, Merkel and other Eurozone policymakers have set Europeans against each other. While governments bailed out the banks, first directly and then indirectly through the EU loans to southern European governments, they didn't force them to clean up their balance sheets. As a result, the Eurozone now has state-sponsored zombie banks that use the cheap liquidity provided by the ECB to roll over their bad loans to zombie borrowers while denying credit to new ones.

And the flipside of failing to force banks to clean up their balance sheets is that households and companies still have huge, and often unpayable, debts. Until 2010, governments were at least supporting the private sector's desire to save more by borrowing more themselves. But after Greece's public-debt problems came to a head, policymakers wrongly decided that the Eurozone as a whole faced a fiscal crisis and embarked on premature, excessive, collective austerity.

Yet Greece was the exception, not the rule. High government borrowing was not the cause of the Eurozone's problems, but rather a consequence of the collapse of private spending after the bubbles burst, banks went bust and private debts suddenly loomed larger. And since households and companies didn't want to spend, banks didn't want to lend, and foreign demand wasn't big enough to fill the gap, austerity caused such deep recessions that, perversely, public debt soared.

Worse, policymakers' successive mistakes sparked panic, to which they responded by demanding ever greater austerity until finally, the ECB – after long insisting that it was legally unable to act – intervened in the summer of 2012. Now that the panic that policymakers created has abated and austerity has been eased off, economies have stabilised. But they are not recovering, because the underlying causes of their weakness – the broken banks, the private-sector debt overhang and the shortfall of demand – have still not been tackled.

You've said that there is a false narrative which draws a parallel between Germany's situation a decade ago and the Eurozone's current problems. How damaging has this narrative been for the EU's policy response?

Clearly, the Eurozone's current plight is very different to Germany's at the turn of the century. Back then, Germany was not suffering a banking crisis. It didn't have huge private debts that households and companies were trying to reduce. And it was surrounded by booming economies to which it could easily export more. So when Merkel repeats the mantra that Germany's earlier experience shows that fiscal consolidation can be compatible with growth in the Eurozone now, she is comparing apples and oranges.

Yet at Germany's behest the Eurozone is now locked into a stifling and undemocratic fiscal straightjacket: much more restrictive EU rules as well as the fiscal compact. These are unnecessary, because the EU's original Stability and Growth Pact did not fail, except in not spotting the Greek government lying about its finances. The crisis was caused by failures in the Eurozone's financial, not fiscal, governance. But because Merkel agreed to breach the no-bailout rule, German taxpayers suddenly feared they were liable for everyone else's debts. So she demanded much greater control over other countries' budgets – and the European Commission was delighted to grab new powers. This is economically dangerous because countries that share a currency need greater fiscal flexibility, not less.

It's also politically poisonous because when voters in a country throw out their government, as they have done at almost every election since the crisis, EU finance commissioner Olli Rehn and now his successor Jyrki Katainen pop up on television to insist that the new government sticks to the old one's failed policies. That remote, unelected and scarcely accountable officials in Brussels should deny voters legitimate democratic choices about tax and spending decisions alienates people from the EU. And if voting for mainstream politicians doesn't lead to change, it's no surprise they turn to the extremes.

To make matters worse, Germany is trying to reshape the Eurozone economy in its dysfunctional image. Its mercantilist strategy of suppressing wages to subsidise exports is beggaring Germans as well as their neighbours. Don't believe the hype about Germany's success: its GDP growth ranks 15th among the 19 Eurozone economies since the euro's launch. Once dismissed as the sick man of Europe, it responded not by becoming more dynamic, but by cutting costs.

Hobbled by a decade of underinvestment, its arthritic economy struggles to adapt: productivity growth averaged only 0.9 per cent a year over the past decade, less even than Portugal's. And the brunt of this stagnation has been borne by German workers, who now earn less after inflation than 15 years ago, even though their productivity is 17.8 per cent higher. German policymakers claim that holding down wages is a good thing because it boosts the country's competitiveness.

But countries are not companies. While it may make sense for an individual business owner to try to keep wage costs to a minimum, for society as a whole, wages are not a cost to be minimised. Provided they are justified by productivity, wages ought to be as high as possible. And since compressing wages suppresses domestic demand, Germany can only grow by exporting – and now that the rest of the Eurozone is stagnating and China is slowing, Germany is stagnating too.

German policymakers pride themselves on the country's vast current-account surplus as an emblem of its superior competitiveness. But if Germany is so successful, why don't businesses want to invest there? Its surpluses are in fact symptomatic of a sick economy – and that harms the rest of the Eurozone too. During the bubble years, Germany spread instability through its banks' bad lending of its surplus savings. Now, it is exporting deflation through its wage stagnation, depressed domestic demand and opposition to debt restructuring.

Foisting the German model on the rest of the Eurozone is disastrous. Slashing incomes depresses domestic spending and makes debts even harder to bear. For struggling southern European economies whose traditional exports have been undercut by Chinese competition, the solution is not to try to produce the same old products at much lower wages, but rather to invest in moving up the value chain and produce new and better products for higher wages.

Above all, with global demand weak, the Eurozone as a whole cannot rely on exports to grow out of its debts. The Eurozone urgently needs to change course. Yet policymakers' mistakes have created new obstacles to resolving the crisis. Northern taxpayers now have a vested interest in blocking the debt relief that the south needs to recover. The debt overhang is leading to deflation, whose tackling requires exceptional policies that offend Germans' monetary taboos. The new fiscal straightjacket prevents governments from boosting demand. The antagonism between north and south, broader resentment of a quasi-hegemonic Germany, institutional fatigue and corrosion of support for the EU precludes desirable further integration.

And because today's chronic misery seems less pressing than the acute financial panic that has abated for now, and Germany isn't suffering enough to feel that it needs to change course, there is a complacency among policymakers, who are often detached from those who suffer the consequences of their bad decisions and unaccountable to them. Thus Germany repeats like a mantra that all that is needed is fiscal consolidation and structural reforms.

France and Italy want to borrow a bit more in exchange for a bit more reform. The new president of the European Commission, Jean-Claude Juncker, has announced a €315 billion EU investment programme, but so far, this involves no new public money. The ECB continues to pump liquidity into Eurozone banks, when their real problem is not a lack of cash but the bad debts on their balance sheets. And markets pin their hopes on the launch of quantitative easing this month, which has helped drive down the euro but is unlikely to prove big and bold enough to offset the huge deflationary pressures in the Eurozone.

What is required to finally solve the crisis?

To solve the crisis decisively and fairly, the Eurozone ought to do what I advised President Barroso when I first met him back in 2010: restructure zombie banks; write down unbearable debts, both private and public; and support spending in ways that push the economy towards healthier patterns of growth, not least by increasing investment and lifting barriers to competition and enterprise, with Germany and other surplus countries playing their part by boosting domestic demand.

To work better in future, the Eurozone also needs institutional reform. Instead of a Eurozone caged by Germany's narrow interests as a creditor, Europe needs a monetary union that works for all of its citizens. A genuine, comprehensive and robustly independent banking union, with a workable mechanism for bailing in the creditors of failed banks. The ECB's role as a lender of last resort to solvent governments enshrined to avoid future panic. The no-bailout rule restored and with it much greater fiscal flexibility for democratically elected governments, constrained by markets' willingness to lend and ultimately by the possibility of default.

And ideally, once it becomes politically feasible, we should create a Eurozone treasury accountable to both European and national legislators, with limited tax-raising and borrowing powers. Ultimately, the freer, fairer and richer Eurozone that would emerge is in Germany's enlightened self-interest, too.

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About the interviewee

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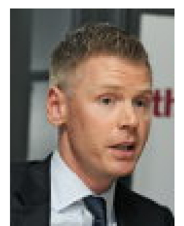

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