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Item 4: Interdependence: Coorinating stimulus for global growth

Endgame for the Eurozone?

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Professor Costas Lapavitsas,
School of Oriental and African Studies,
United Kingdom of Great Britain and Northern Ireland

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Costas Lapavitsas

SOAS/RMF

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Unusual nature of EMU

- Not merely a system of fixed exchange rates
- A formal alliance to create an international reserve currency – the main competitor to the US dollar.
- A formal alliance to create a domestic monetary standard – the national money of 17 sovereign states.

Inherent weakness

- International and domestic roles of the euro clash with each other.

- The changes needed to make them compatible are highly unlikely given the social, political and institutional conditions in Europe.

Domestic Euro - International Euro

- The domestic euro is managed by the ECB via interest rates and controls on credit provision
- The international euro is not directly managed. It is supposed to be non-existent within the EMU. No reserves required.
- In effect, international money has reappeared within the EMU

For the euro to work

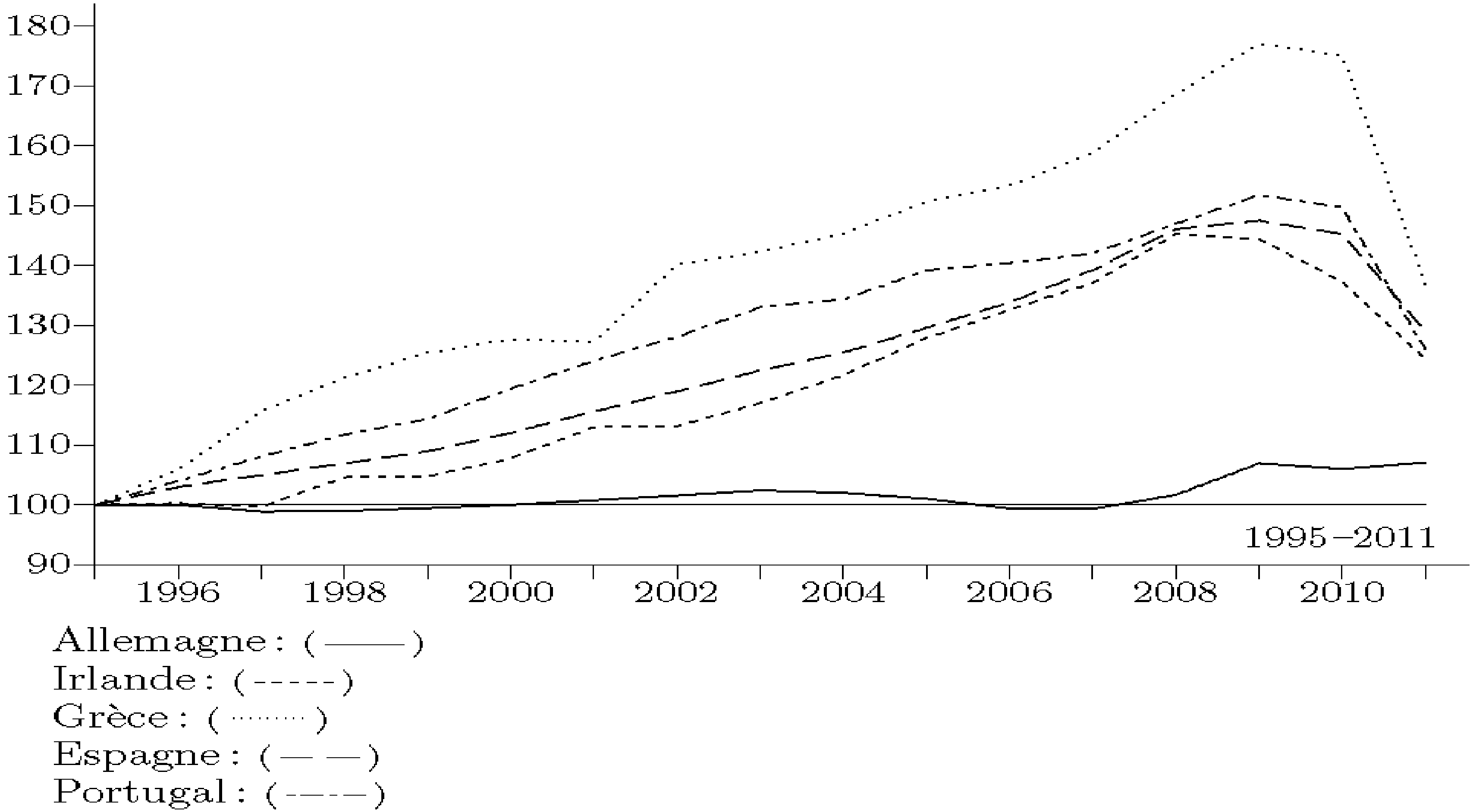
- The factors affecting its international functioning must be eliminated within the EMU – diverging inflation, imbalances in current accounts and capital flows.

- The factors affecting its domestic functioning must be handled by the ECB according to each country’s specificities.

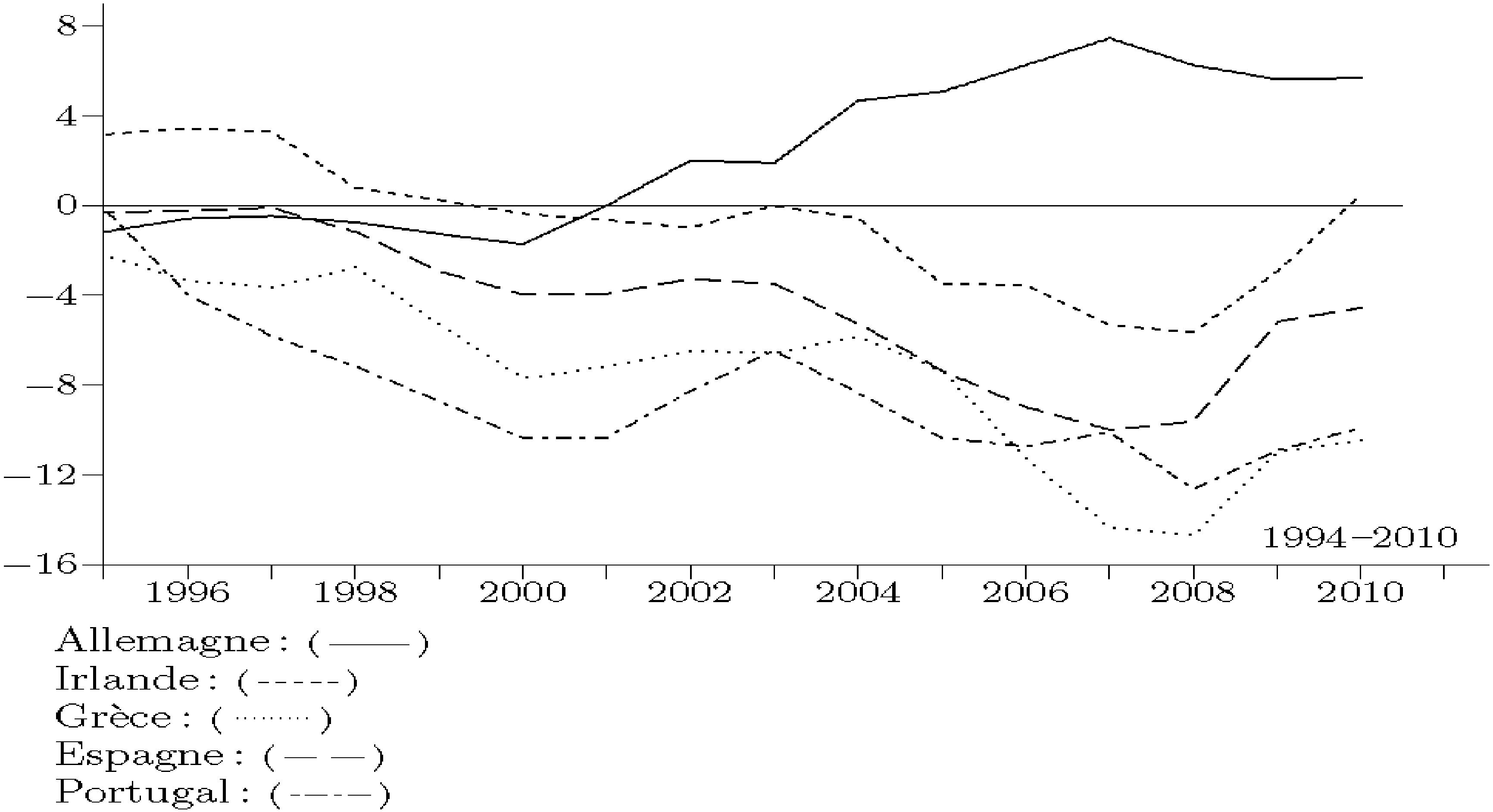
‘International’ functioning within EMU

- Systematic divergence in competitiveness/inflation
- Systematic imbalances in current accounts
- Sudden and violent shifts in capital flows

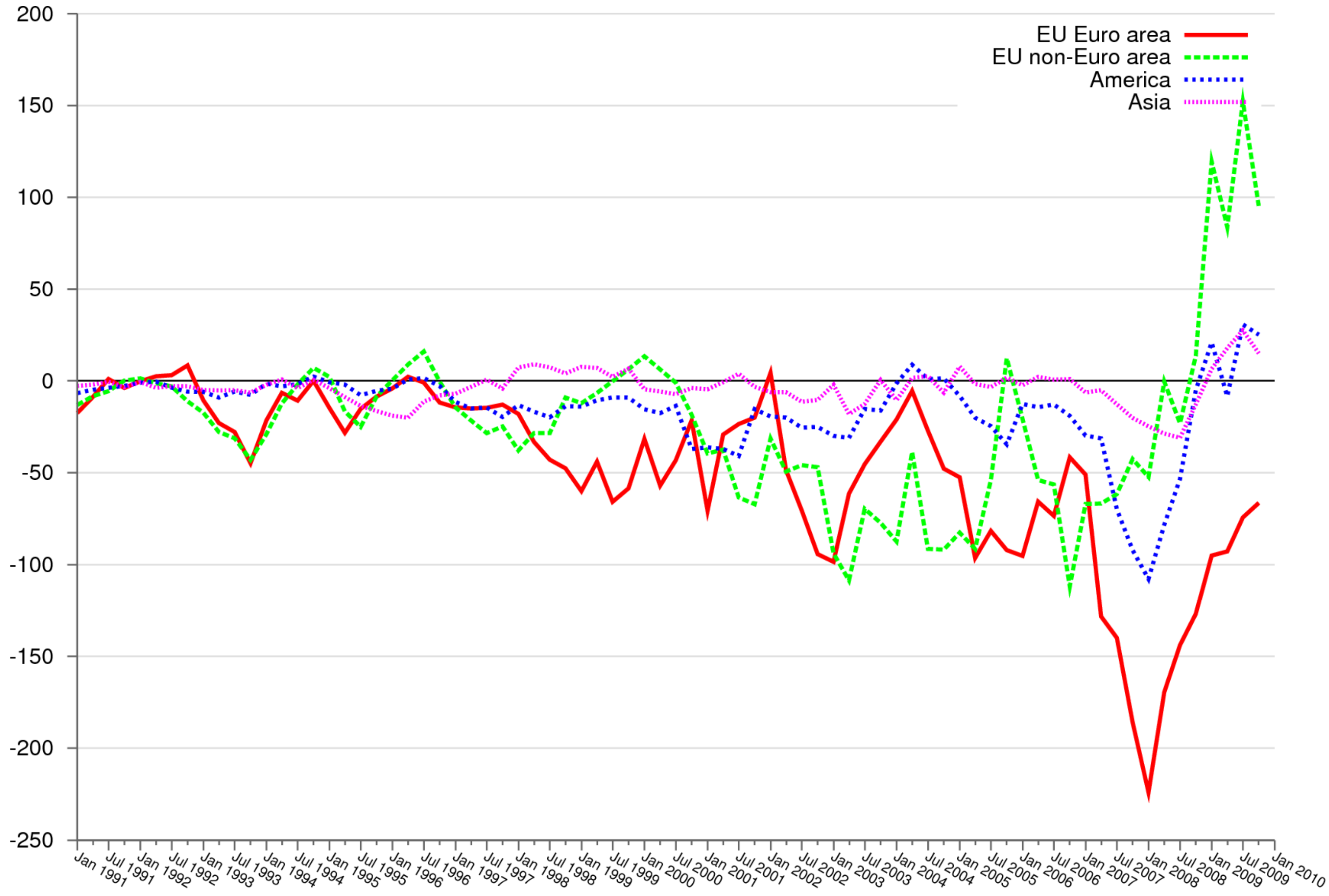
Unit labour costs/Inflation, core-periphery



Current account deficits, core-periphery



German ‘other’ capital flows by region



Outcome: Core vs periphery split

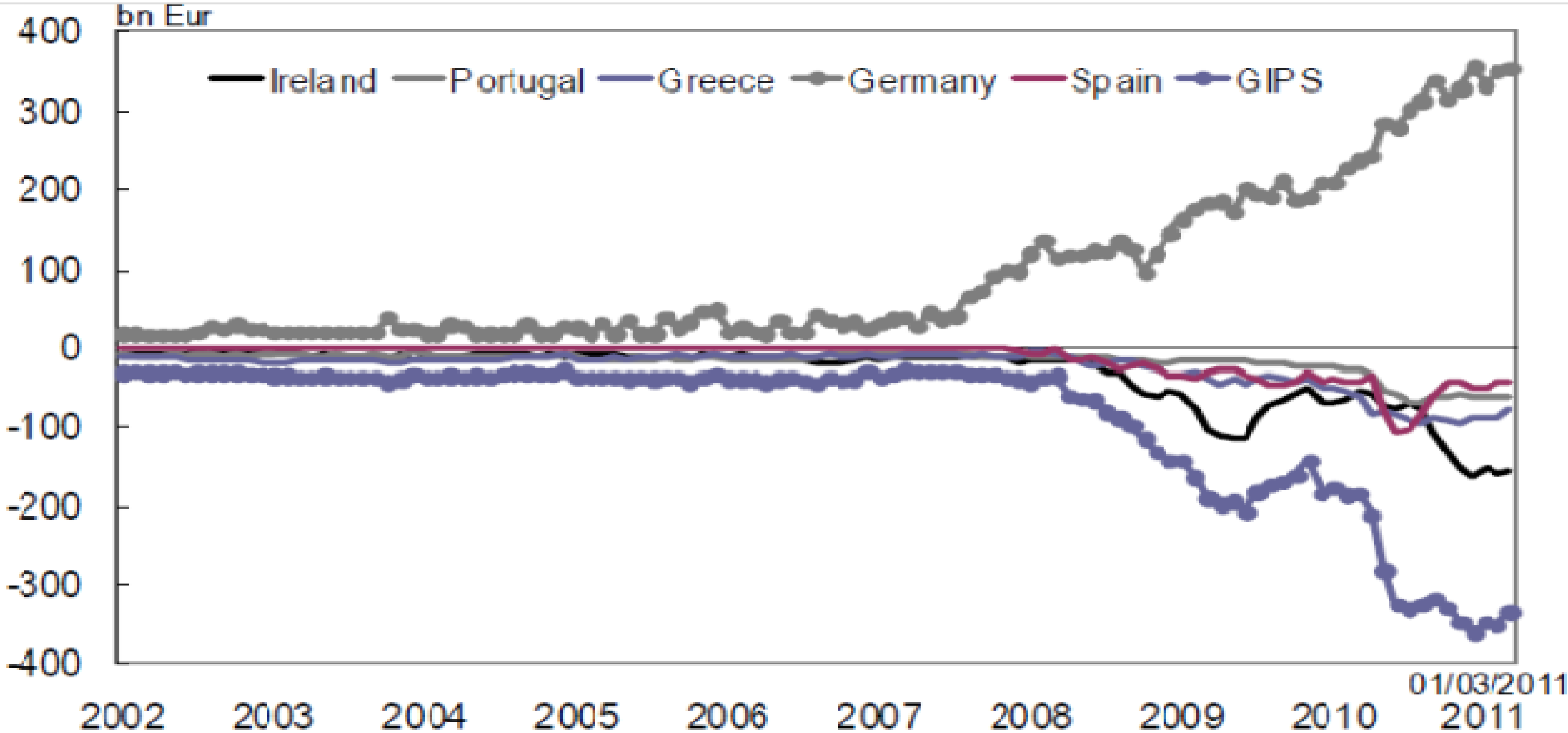
- Periphery has accumulated euro-denominated debt for ‘international’ and ‘domestic’ reasons. The debt is held publicly and privately.
- Peripheral debt appears entirely ‘domestic’, since it is denominated in euro, but much of it is in reality ‘international’.

EU policy toward the periphery

- Fix ‘international’ malfunctioning through austerity, privatisation, liberalisation.

- Replace private flows from abroad with official flows the ECB and EFSF as well as by ELA.

Target 2 flows

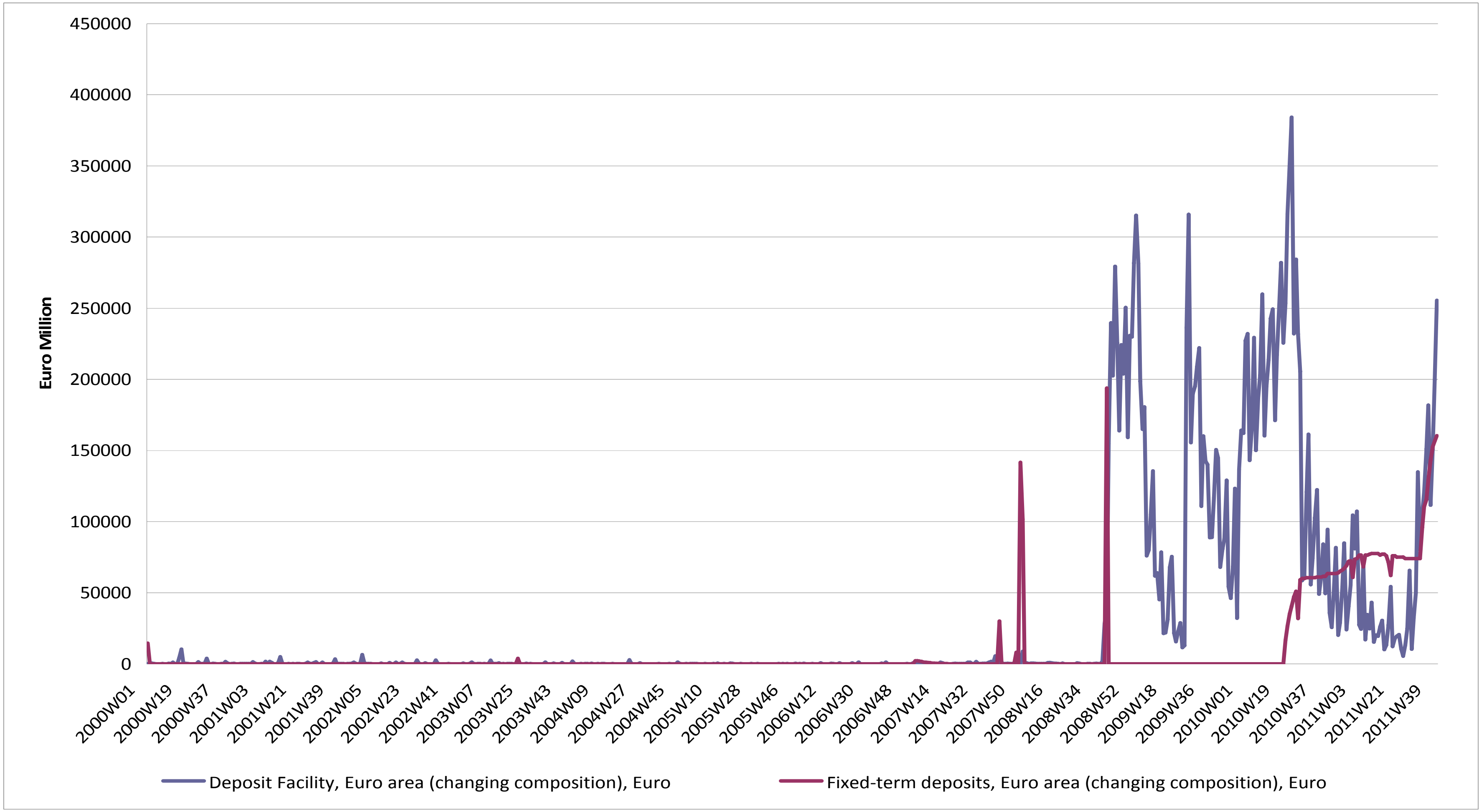


Notes: Germany: Other Assets of the Bundesbank. Spain: Banco de Espana: Liabilities: Other euro area countries: MFIs: of which: euro. Greece: Bank of Greece: Liabilities: Liabilities to Other MFIs: Other Euro Area Countries. Portugal: Central Bank Balance Sheet Liabilities: Non-Residents: Deposits & Related Instruments. Ireland: Central Bank Liabilities: Other Liabilities. GIPS is the sum of Greece, Portugal, Ireland, and Spain.
Source: Haver, Bundesbank, Central Bank of Ireland, Bank of Greece, Banco de Espana, Banco de Portugal, Citi Investment Research and Analysis

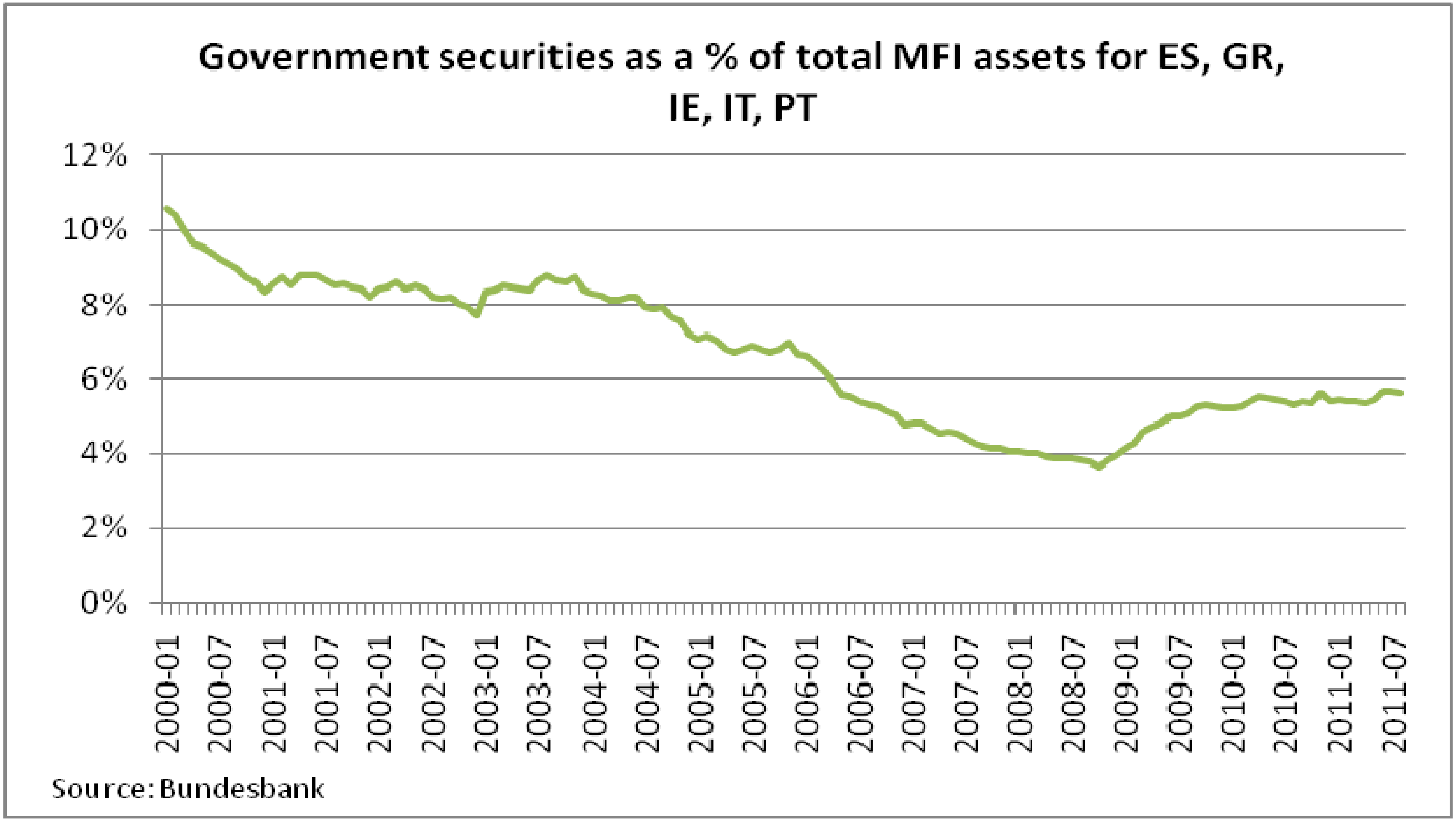
Results:

- ‘International’ functioning dominates ‘domestic’ functioning - crisis.
- Collapse in demand, huge social costs, debt position has worsened.
- Shortage of domestic private credit as banks hoard liquidity with ECB.
- Tightening of links between national banks and nation states.

Bank fixed-term deposits, Eurosystem



Peripheral bank holdings of public bonds



Could it be done otherwise?

- Marshall plan for the periphery to raise productivity
- Rebalancing the German economy
- Debt forgiveness
- Restructuring finance
- Income and wealth redistribution

- Little chance of this happening, hence a break-up is likely

Greece – a depression

- Huge reduction in labour costs
- Disappearance of liquidity
- Vast contraction of public spending
- Persistent debt – public and private
- Contraction of all sources of demand

Current outlook in Greece is unsustainable

- Output contraction, 2008-11: 14%, 2012: 7-9%, 2013: perhaps 5-7%
- Unemployment: Adult >24%, Youth > 55%
- Public debt: 2012 perhaps 160%, 2013 perhaps 170%
- A humanitarian crisis in urban centres

Outcomes?

- Greek default and exit from EMU in 2012-3 taking command over ‘domestic’ money and treating euro as ‘international’ money
- Economic, social and political instability for a long time
- First step in unravelling of EMU.