A Conversation with Mark A. Wynne

Greece's Fiscal Woes Among Issues Hobbling Euro Zone Rebound

While the U.S. has emerged from the global economic downturn, the path for the euro zone has proven bumpier. Senior economist Mark A. Wynne, vice president and director of the Globalization and Monetary Policy Institute in the Research Department at the Federal Reserve Bank of Dallas, explores the reasons and outlook.

Q. Why has the euro zone's economic recovery from the global financial crisis lagged behind the U.S. recovery? Is the situation improving?

The euro area suffered two big shocks in recent years: first, the shock associated with the global financial crisis that was centered in the United States, and second, a euro-area-specific shock due to problems in a number of geographically peripheral countries (Cyprus, Portugal, Ireland, Greece and Spain).

Economic activity in the euro zone significantly contracted between first quarter 2008 and second quarter 2009. After the economy resumed growing, it stalled in early 2011 before it could attain its precrisis level of economic output. The second contraction lasted through early 2013. Although the euro zone economy has since been in recovery, the latest estimates show real gross domestic product (GDP) remains below first quarter 2008 levels.

Some of the hardest-hit countries are doing better—Ireland, Spain and Portugal, in particular. Italy has taken longer to turn around but seems to have done so this year. Of all the peripheral countries, Greece has experienced the biggest collapse. There were signs that it was beginning to come back, but recent developments seem to have snuffed out the fragile recovery.

Q. What contributed to the European sovereign debt crisis?

In 2011, different countries got into difficulty for different reasons. In Ireland and Spain, public finances were in very good shape in the run-up to the financial crisis, but both countries experienced enormous housing booms fueled by low interest rates that dwarfed the boom we experienced in the U.S. In the cases of the U.S., Ireland and Spain, loans linked to real estate development went bad, creating problems in the banking sector.

In Ireland, the government guaranteed the liabilities of the banking system and nationalized two of the largest banks in the country. This in turn put public finances on a dangerous trajectory and eventually necessitated a bailout from the European Union and the International Monetary Fund (IMF). A similar situation arose in Spain, although in that instance it was the Spanish banking system rather than the Spanish government that was bailed out.

In Greece, the problems stemmed from a pattern of public spending and taxation that was simply unsustainable. In 2009, Greece ran a government budget deficit equal to more than 15 percent of its GDP, which is more than five times the supposed maximum of 3 percent for euro zone members. The absence of a formal fiscal or banking union as concomitants to the monetary union launched in 1999 complicated dealing with these problems.

Q. Has Europe's malaise harmed the U.S. economy?

It probably contributed to the sluggish pace of recovery in the United States by reducing demand for U.S. exports. For all its problems, Europe remains one of the more important and wealthier economic regions in the world and, as such, is an important trading and investment partner of the United States. In addition to slow growth impacting demand, financial volatility in the euro area can lead to capital flows out of the area to "currency safe haven" countries such as Switzerland and the United States. This tends to increase the value of our currency, making it harder for our exporters to compete globally.

Q. Is there anything the U.S. can do to aid the euro zone recovery?

Not really. The Europeans need to figure out for themselves what form they want their monetary union to take. In its original conception, there was to be no banking or fiscal union and no bailouts. Potential members had to meet specific criteria to join, and once in, had to adhere to certain rules. For a variety of essentially political reasons, the rules were bent to admit some countries and then subsequently broken by others.

Q. Is recent improvement in Europe the result of quantitative easing by the European Central Bank (ECB) earlier this year or have there been structural changes?

I think quantitative easing—the purchase of bonds and addition of euros to the monetary supply—has helped. But perhaps more important was the promise in mid-2012 by ECB President Mario Draghi to "do whatever it takes" to preserve the single currency, and the subsequent announcement of the so-called Outright Monetary Transactions—a plan to buy sovereign debt of euro zone countries under specific circumstances—to back up that promise.

There have also been structural reforms. For example, in Spain it is now easier to register new companies. Similar steps have been taken in Portugal and Greece. But the payoff from structural reforms takes time. In the short run, such reforms may even temporarily depress economic activity as capital and labor are reallocated to more productive activities.

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Q. The euro area includes the richest nations in the world, yet the challenges seem unending. Could it be that adopting a common currency—the euro—was a bad idea?

I think it is fair to say that most North American economists (and a good number of European economists as well) felt that the idea of such a diverse group of countries sharing a common currency was doomed to fail at some point because the countries in question did not constitute what economists refer to as an "optimum currency area." This is an idea that is more than a half-century old and originated with Robert Mundell (who won a Nobel Prize for his work) asking the question: When is it a good idea (from an economic perspective) to stipulate the use of a currency within a geographic boundary that coincides with a political boundary?

In North America, an east-to-west border determines where U.S. and Canadian dollars are used. But one could just as easily imagine drawing a north-to-south line that would demarcate currency zones independent of the political boundary. Under what conditions might it make more sense for the eastern U.S. and eastern Canada to share a common currency, and for the western U.S. and western Canada to share another currency?

As economists began thinking about these issues, they highlighted a number of considerations key to a successful monetary union between a group of sovereign nations—things such as the degree of integration between the nations, mobility of labor and capital, the similarities and differences in the structure of their economies and the flexibility of wages and prices.

On the economic side, advocates of the single currency pointed to the fact that a single internal market within the U.S. functions a lot better because all 50 states use the dollar. One of the long-term economic goals of the European project was to create a common single market in Western Europe that would be as integrated and seamless as in the U.S. But there was always an important political dimension, an idea that by sharing a common currency, a shared European identity would emerge independent of national identities, thereby advancing the goal of "an ever-closer union" among the peoples of Europe.

The architects of the treaty that provides the legal and institutional basis for the euro were well aware of the concerns expressed by many economists, and to that end they specified a set of rules governing which countries could join the single currency and how those countries were to behave once they were in. Unfortunately, these rules were not rigorously enforced, and this contributed to the recent crisis. Skeptics also pointed to the absence of a fiscal union to accompany the monetary union as a key design flaw. The argument was that the U.S. monetary union works so well in part because of the insurance provided to individual states by the federal government.

For example, when Texas experienced the oil bust in the 1980s, the adjustment here was eased by the fact that we paid in less in taxes to the federal government as economic activity contracted, and we received more in the way of benefits. In addition, the burden of bailing out depositors in the many financial institutions that failed was shared among all 50 states rather than falling on just Texas. There is no comparable arrangement in Europe. Another factor that makes the U.S. monetary union work well is the high degree of labor mobility between individual U.S. states, facilitated in no small part by the fact that we all speak the same language. Legally, there are no barriers to labor mobility in Europe, but informal barriers due to differences in language and culture remain.

But what the crisis really revealed was that the absence of a banking union to accompany the monetary union was an even bigger design flaw and, surprisingly enough, not one that many of the skeptics seemed to have anticipated. For all the problems that the euro has experienced in recent years, it has nevertheless brought real benefits, and even in some of the hardest-hit crisis countries, support for the shared currency remains relatively high.

Q. What is the outlook for Greece?

The Great Depression was the most traumatic event in our nation's history. At the Depression's depth, the unemployment rate approached one-quarter of the U.S. labor force. Greece is experiencing a comparable economic trauma.

Earlier, I mentioned that the architects of the monetary union had established a set of rules for euro membership. One of these is a limit on government deficits of no more than 3 percent of GDP. Greece did not get to join the euro in 1999 when the project was launched because it failed to meet this condition and various other criteria for membership. But it was admitted in 2001. Just three years later, Greece's public accounts were revised to show deficits exceeding the 3 percent limit every year from 2000 to 2003. But the proximate cause of the crisis was the revelation in late 2009 following a general election that the deficit for that year would not be the 3.7 percent of GDP originally reported but instead would be closer to 12.5 percent of GDP—more than four times the euro-area treaty limit. Greece has been in a state of crisis since then.

Is there a scenario in which Greece leaves the euro? Yes. But it would do little to fix the deeper problems Greece is wrestling with and could prove to be destabilizing for the rest of the euro area and for the global economy.