The Euro's *Endless* Horror

Or end to the horror.

BY DESMOND LACHMAN

According to an old German saying, an end with horror is better than a horror without an end. Judging by the eurozone's disappointing economic performance over the past twenty years, this saying might provide a useful way to frame the fundamental policy choice facing European economic policymakers in a post-coronavirus world.

Will European economic policymakers perpetuate the horror of the eurozone's poor long-run economic performance by allowing the European Central Bank to keep the euro afloat by further substantially expanding its already bloated balance sheet? Or, in the interest of enhancing the eurozone's long-term economic performance, will they allow the euro to unravel despite the immediate economic horror that the euro's unraveling would surely entail?

THE EURO'S DISAPPOINTING PERFORMANCE

It would be a gross understatement to say that since its 1999 launch, the euro has failed to deliver on its promise. Far from promoting European economic prosperity and narrowing the economic gap between the eurozone's southern and northern member countries, over the past twenty years the eurozone's overall economic growth rate has been mediocre at best while the economic gap between its core and peripheral countries has only widened. Far from putting the periphery's public finances and banking systems in better order, the eurozone periphery's public debt-to-GDP levels remained uncomfortably high and its banks remained weak.

The euro has also failed to deliver on its promise of promoting a European political union. Instead, we have seen growing mutual

Desmond Lachman is a Resident Fellow at the American Enterprise Institute. He was formerly a Deputy Director in the International Monetary Fund's Policy Development and Review Department, and the Chief Emerging Market Economic Strategist at Salomon Smith Barney.

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Fax: 202-861-0790
www.international-economy.com
editor@international-economy.com

We have seen growing mutual resentment between the eurozone's north and south.

resentment between the eurozone's north and south as well as strong resistance in the north to any idea of a European fiscal or banking union. We have also seen disturbing political fragmentation, rising nationalism, and declining support for Europe across much of the eurozone area.

THE EURO STRAITJACKET

At the heart of the eurozone's disappointing economic performance to date is the original policy mistake of tying in a monetary union a strong economic performer like Germany and weak productivity performers like Italy and Greece. It also did not help matters that following the 2008–2009 Great Economic Recession, Germany insisted on imposing fiscal austerity on the eurozone's economic periphery at a time of considerable economic weakness.

The disparate productivity performance between Germany and the eurozone's economic periphery resulted in a progressive loss in the periphery's international competitiveness. Stuck in a euro straitjacket, the periphery could no longer correct lost international competitiveness with currency depreciation. Similarly, the periphery could no longer use the exchange rate to boost exports as a cushion to the blow to aggregate demand that kept resulting from Germany's obsession of imposing budget austerity on the periphery in the midst of an economic recession.

THE COVID-19 SHOCK

The economic fallout expected from the coronavirus pandemic is now bound to exacerbate the eurozone's existing internal economic and political tensions. Not only has the pandemic dealt a major economic blow to the overall eurozone economy. It has been particularly cruel to the eurozone's service and tourist-dependent Club Med member countries. According to the International Monetary Fund, whereas the German economy is forecast to contract by close to 8 percent in 2020, the Italian and Spanish economies are both forecast to decline by almost 13 percent.

In a cruel twist of fate, it would seem that the eurozone countries whose economies are least suited to withstand the pandemic's severe economic body blow are precisely the ones that have been hardest hit by the pandemic. Greece, Italy, and Portugal all entered the pandemic with uncomfortably high public debt-to-GDP ratios, which are now going to be propelled very much higher by a collapse in economic output and in tax revenues. Similarly, they all had banking systems that were yet to fully recover from the 2008–2009 Great Recession and will now be hit hard by another tidal wave of non-performing loans.

THE ITALIAN CHALLENGE

The very troubling economic outlook for Italy, an economy some ten times the size of that of Greece and the eurozone's third-largest economy, is illustrative of the ECB's daunting challenge to hold the euro together. As a result of the pandemic, it would seem to be clear that Italy's public finances are no longer sustainable, while its banking system looks well on its way to a major crisis.

According to the IMF, Italy's public debt-to-GDP ratio is set to skyrocket from 135 percent before the pandemic

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Outdoing Draghi?

Since the start of the coronavirus pandemic, markets have become increasingly reluctant to buy Italian government bonds as doubts have grown about the sustainability of that country's public finances and the solvency of its banks. In 2012, the last time that markets were doubtful about Italy's economic outlook, then-ECB President Mario Draghi managed to calm the waters by famously pledging to have the ECB do whatever it took to save the euro.

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—D. Lachman

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to 160 percent by year-end at the same time that its budget deficit is set to balloon to more than 10 percent of GDP. Meanwhile, Italy's banks, whose balance sheets are already overloaded with Italian government bonds, are now being subjected to an economic scenario that is considerably more severe than that of the worst-case scenario under their earlier stress tests.

ECB TO THE RESCUE

Since the start of the coronavirus pandemic, markets have become increasingly reluctant to buy Italian government bonds as doubts have grown about the sustainability of that country's public finances and the solvency of its banks. In 2012, the last time that markets were doubtful about Italy's economic outlook, then-ECB President Mario Draghi managed to calm the waters by famously pledging to have the ECB do whatever it took to save the euro.

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Judging by the size of the Italian government's prospective gross borrowing needs and by the size of its banking system, it would seem that the ECB might need to provide Italy with a massive amount of financing to keep it afloat. Currently, the Italian government has an annual gross financing need of some €650 billion while its banking system has a balance sheet of close to €4 trillion. On that basis, it is not difficult to imagine that the ECB might need to provide Italy with at least €2 trillion over the next two years. This seems to be especially the case considering that it took around €300 billion of Troika financial support to keep afloat Greece, whose economy is one-tenth the size of that of Italy.

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THE GERMAN CHALLENGE

A principal challenge to the ECB's prospective efforts to keep Italy afloat is more than likely to come from the German Constitutional Court and from the German political system. This would seem to be especially the case considering the very large size of the bailout that Italy might need to keep it afloat. It would also seem to be the case considering the likely strong Italian political resistance to any notion of conditions being attached to any ECB or European bailout.

In May 2020, the German Constitutional Court raised serious questions about whether the ECB's earlier quantitative easing program had taken it beyond its legal authority. It did so at a time that the ECB justified its actions as purely monetary policy on the grounds that it was strictly adhering to the principal of buying member countries' government bonds in direct proportion to their contribution to the ECB's capital.

More recently, the ECB has been flagrantly deviating from its capital key in buying member country government bonds. In particular, it has in effect been buying Italian government bonds in the secondary market in an amount equivalent to that country's gross government borrowing needs. This makes it difficult to see how the German Constitutional Court is not going to rule at some stage that the ECB is in violation of Article 123 of the Lisbon Treaty. That article explicitly prohibits the ECB from engaging in the monetary financing of a member country's government deficit.

In the past, when confronted with an existential crisis to the euro, the Europeans have been adept at finding a way to waive rules that had earlier seemed to be ironclad. One must hope that they again find a way to do so in the current Italian context. The last thing that a coronavirus-weakened European economy now needs is the horror of Italy crashing out of the euro. Unfortunately, however, one cannot rule out the possibility that at some stage the German legal and political system might tire of bailing out the likes of Italy. Instead, they might come around to the view that an end with horror is after all preferable to a horror without an end. ◆