



THE IMF AND THE EUROZONE: SOME OBSERVATIONS

Andrew Tyrie MP

26 April 2012

It is commonly held that currency unions require large transfer payments from high productivity to low productivity areas.

But this is not necessarily so.

A currency union will be robust if at least one of two other conditions are met. *Either* competitiveness can be maintained by domestic price adjustment – internal devaluation or revaluation– *or* countries which cannot cope need to be able to leave, or be ejected.

So the three conditions are indefinite transfer payments, domestic price adjustment or a means of getting out.

Any one of these three conditions will suffice.

The Eurozone will remain in difficulties because it satisfies none of them.

Twenty years ago I wrote a number of papers making these points.

If I made them in front of vigorous euro enthusiasts, particular senior people in the European Commission, I found that these points were ignored.

On occasion I was described as a wrecker of the whole euro project.

As it happens, I also argued that participation could bring some modest economic benefits, particularly from its effects on the allocation of investment.

I did not oppose British participation in the euro on principle but favoured staying out because I was concerned among other things that:



ANDREW TYRIE MP – THE IMF AND THE EUROZONE: SOME OBSERVATIONS

- '[the zone's] monetary credentials could be diluted, perhaps by influences from Europe's southern tier';
- 'it might turn out that [the euro was] being created in a fleeting benign moment in the business cycle (enabling the Maastricht criteria to be more or less met) and that huge further tough adjustments await participants';
- the euro might be used to 'justify an unwarranted increase in powers over fiscal policy'.

All the above are quotations from one of these papers.

It was clear from the start that the countries of the Eurozone would be subject to the discipline of the bond markets and therefore, notwithstanding the criticism I took for raising the issue, I thought that it would be better to address the possibility of exit rather than go into denial about it.

This is not an easy moment to contemplate a Euro exit, but it must be done.

The stakes are too high not to do so.

Instability in the Eurozone threatens the prosperity of the UK, the region and possibly the globe.

Lest any of you think I am exaggerating, it was the Bank of England that described the Eurozone as 'a very significant catastrophe risk' in evidence to the Treasury Committee.

A recent Deloitte Survey of UK CFOs suggests that the private sector agrees.

The crisis is multidimensional, involving the risk of multiple commercial bank defaults, the risk of sovereign default, contagion to other sovereigns and some risk of the ECB's insolvency.



ANDREW TYRIE MP – THE IMF AND THE EUROZONE: SOME OBSERVATIONS

Among the other problems, the need to solve the payments imbalances within the euro area and the need for structural and supply side reform are the trickiest.

All of the above can be illustrated by looking at the problems of an individual country.

Take Greece.

The Eurogroup's latest rescue package, agreed in March, does not provide a permanent solution.

Nor does the firewall created by the ECB's three-year liquidity provision, massive though it is, provide a permanent solution to the contagion risk of a Greek default to other countries and institutions.

The Greek package will tide things over for a while, assuming that Greece can meet its terms.

But even if Greece can meet the terms, Greece needs growth, not just to pay its debts (even after the haircut) but also to maintain political stability.

Most analysts do not think that that Greece can return to growth at current exchange rates and current policies.

For example, a recent publication by Goldman Sachs suggests that Greece and Portugal require relative price adjustment of around 30 percent to achieve external balance.

In other words, they need to reduce their production costs by that amount relative to other Eurozone countries, to get into balance.

Furthermore, for Greek membership to be sustainable in the long run, further falls in their production costs from that level will be required of them in the years ahead, unless productivity growth slows in the North.



ANDREW TYRIE MP – THE IMF AND THE EUROZONE: SOME OBSERVATIONS

In passing, it is worth pointing out that, in the same study, Germany is required to undergo an upward relative price adjustment of perhaps about 25 per cent.

The Germans are anxious to ensure that their adjustment is achieved through reductions in other countries' costs, and not by inflation in Germany.

But if this is not achieved Germany must, in the long run, be at some risk from inflation.

Gloom about the durability of the Greek package is not confined to commentators, economic scribblers and backbench MPs like me.

An unpublished compliance report by the EU has concluded that Greece will have to impose a further fiscal squeeze next year amounting to 5.5 percent of GDP.

It says that there are 'large fiscal gaps' in the budget plans.

In other words, the path to sustainability lacks credibility.

Another unpublished report which has found its way on to the web some weeks ago is marked strictly confidential.

Entitled 'Preliminary debt sustainability analysis', it looks suspiciously like an IMF report.

In classic IMF speak it reads like a catalogue of reasons why Greece may suffer even deeper recession, remain accident prone and fail to achieve the necessary growth.

So, the radical structural reform programme demanded of Greece by the euro group, worthy in intention, may well be insufficient to restore Greece's competitiveness.

It may simply generate political crisis.

A huge risk on the political side must be a weakening of the commitment of the Greek authorities to deliver wage cuts and supply side liberalisation.



ANDREW TYRIE MP – THE IMF AND THE EUROZONE: SOME OBSERVATIONS

And they have elections on May 6th.

The IMF (if that is what it is) also makes this point.

So the radical structural reform programme being imposed on Greece – a programme to force domestic price adjustment – looks full of risk.

In which case, if the Eurogroup really want to keep Greece in the Eurozone, they will have to accept one of the other conditions with which I began these remarks: large transfer payments, not as loans, but grants.

These will need to become a prominent feature of the Eurozone.

In fact, some large transfers have already taken place, in addition to the highly publicised bail-outs of Greece, Ireland and Portugal.

Commercial banks in the countries perceived as weak, not only Greece, Ireland and Portugal, but also Spain, Italy and Belgium, have been unable to borrow in commercial markets and have become increasingly dependent on financing from the ECB.

Banks in the stronger countries have placed their surplus liquidity in the ECB.

Such recycling amounted to over 600 billion Euros at the end of last year.

Germany is the main creditor and the German public is understandably concerned to ensure that it will get repaid.

There is certainly, as yet, no sign of any commitment to continue such payments indefinitely.

Given the fragility of the Greeks' commitment to deliver the difficult reforms, and given that we have not yet seen a commitment from the Eurozone's northern tier to enduring large budgetary transfers, it must be logical to examine the third condition – Euro exit.



ANDREW TYRIE MP – THE IMF AND THE EUROZONE: SOME OBSERVATIONS

We should take advantage of the breathing space afforded by the latest bailout to develop a contingency plan for Greece to leave the euro zone.

I first hope that this work is going on behind the scenes.

Disorderly exit could indeed be catastrophic.

To paraphrase Wilde, and in a generous mood, to be caught out by the collapse of Lehman might be construed as a misfortune.

Not to be prepared for a Greek exit would be carelessness.

Of course, were the authorities to advertise the issue, it would increase the likelihood of its happening.

That's why the work should have been done at the Eurozone's inception, in more benign economic circumstances.

Those who argue that Greece should remain a member point out that the contagion risk to other southern areas could cause a catastrophe.

That is why the robustness of the firewall is hugely important.

The fundamental issue troubling the market is not the liquidity of government securities markets but the solvency of government finances.

The European Central Bank can't solve that problem, and shouldn't try.

A convincing firewall requires both the willingness and ability of governments of Eurozone countries to commit taxpayers' money to mutual support in sufficient quantities.

First, though, governments need to sort out what sort of Eurozone they are prepared to defend in this way. This they have failed to do so far.



ANDREW TYRIE MP – THE IMF AND THE EUROZONE: SOME OBSERVATIONS

I am not confident that they will succeed.

If the euro area were a single polity with a single government, it could solve its own problem – its debt and deficit levels, in aggregate are lower than those of the UK or the US.

It is capable.

But is it willing?

The Eurozone is not a single polity.

Its central authorities owe their existence to the mantra of 'ever closer union among the peoples of Europe'.

The mantra owes more to ideology than economics.

It is deployed to oppose any repatriation of powers or functions, regardless of the circumstances.

A broad coalition of politicians, of left and right, Europhile and Eurosceptic have queued up to challenge this mantra, from Ralf Darhesdorf to Norman Tebbit.

It rendered historic service by contributing to European stability for more than half a century.

But it has been pushed to its limit, or beyond, in the creation of a broad monetary union.

Put crudely, the citizens of Germany may be unwilling indefinitely to maintain the citizens of Greece in the style to which they have become accustomed.

The citizens of Greece are certainly resisting the painful adjustments which the Germans wish to impose on them in an effort to reduce the size of the cheque.



ANDREW TYRIE MP – THE IMF AND THE EUROZONE: SOME OBSERVATIONS

Ideology got us into this mess.

It must not be allowed to stop us getting out of it.

Only the IMF has the necessary detachment and economic credibility to help sort out this crisis.

Until now their resources have been inadequate to handle a full-scale Eurozone bail-out. The cost of this could be vast. At last week's Spring Conference, the world's leading industrial nations agreed to increase the IMF's resources, to \$400 billion enough to bail out Spain – if that were needed.

I hope that this is enough.

Certainly, it is a step in the right direction.

I note, though, that the OECD's Secretary General recently argued for a bail-out fund of at least €1 trillion and for the 'mother of all firewalls' to be created.

The IMF is not perfect; it is possible that this crisis is beyond even that body.

But it is a great deal better than nothing.

The IMF now needs to show the toughness in negotiations with which it has made its reputation.

These will be testing times for Christine Lagarde.

She must see off Eurozone special pleading.

If she failed to do so, the extra resources would be wasted.



ANDREW TYRIE MP – THE IMF AND THE EUROZONE: SOME OBSERVATIONS

Of course, the IMF can be no more than an advisor. It can't in the end issue instructions to sovereign nations. But it can dispense, or withhold, money in ways calculated to force a better outcome.

Its immediate objective should be to set out the three options available to the euro area, their costs and consequences.

It should evaluate the consequences of maintaining the euro area with its current 17 members.

The costs will include an enduring commitment to make permanent transfers of income to Greece and probably other countries too.

It needs to say how large these are likely to be.

It needs to spell out the dangers of relying on Greece, and possibly others, making the necessary deep structural reforms.

It should also evaluate the consequences of letting Greece depart and continuing with 16 members.

The costs of that would include the costs of a firewall to protect for example Portugal, Spain and Italy.

More radically, it should also evaluate the consequences of a smaller euro area.

The IMF must not allow ideological baggage to get in the way of the process of decision-making.

At the moment the IMF is treating the ECB and the Commission as a partner in discussions.

This should end.



ANDREW TYRIE MP – THE IMF AND THE EUROZONE: SOME OBSERVATIONS

Both European bodies have an existential conflict of interest.

The ECB in particular also has a financial conflict, arising from its holdings of government debt and its enormous exposures to the national central banks of the deficit countries in the euro area.

These European bodies will be part of the solution.

But they are also part of the problem.

The IMF should of course, hold discussions with them.

But their advice should be given to the governments of the member countries, which alone have the legitimacy to make the necessary decisions.

That is also what the IMF's own articles require of them.

So the IMF's job would not be to decide among the policy choices but to evaluate them, present them to the euro area governments, and put pressure on those governments to make a sustainable choice.

Its influence could be decisive.

It can put up money to help support the firewall that would be needed as part of any sustainable plan, or withhold the money until it concludes that a sustainable plan has been developed.

This is what, on a smaller scale, the IMF has been doing around the world for decades.

Its judgement on the sustainability of any plan would carry enormous weight in financial markets.

That fact considerably strengthens the IMF's hand.



ANDREW TYRIE MP – THE IMF AND THE EUROZONE: SOME OBSERVATIONS

The IMF's major non-European members should also speak up.

More than three quarters of the voting power in the IMF belongs to these non euro-area countries.

They should instruct the IMF to take a detached view.

They may need to watch like hawks to fend off special pleading.

Never has the IMF's well established un-sentimentality been more needed.

Some have argued that the IMF should keep out of it, that those not part of the Eurozone shouldn't do any more to help it, even in their capacity as members of the IMF.

This brings together those that believe we would be better off if the Eurozone collapsed completely, those who argue that extra IMF help will only reduce the likelihood of the Eurozone ever helping itself; and those such as the US, particularly Congress who rarely support increases for the IMF, whatever their justification.

These points have some force but so do three simple points which, taken together, look persuasive to me.

First, there is a non negligible risk out there of a serious regional and a possibly global economic fire.

The Eurozone crisis has the capacity to engulf us all.

Second, we can't rely on the Eurozone to do the hard work for us.

Their decision making structure is flawed, as I have described.

The Eurozone is sustained, at the moment, by sticking plaster bailouts, the three year ECB handout – at the expense of the Northern tier countries who ultimately underwrite the ECB's balance sheet – and, possibly a sense in the markets that the German



ANDREW TYRIE MP – THE IMF AND THE EUROZONE: SOME OBSERVATIONS

population may be more reconciled to the possibility of large fiscal transfers to prop the system up.

The third reason for backing the IMF is the simplest. They are the only global fire brigade we have.

That is why it was right to increase their resources.

I am not predicting disaster: The resilience of global growth may well enable the Eurozone to muddle through. But it must be right to be paying the insurance premium now.

Gloom comes cheap but there are some grounds for optimism.

By far the most important is that, despite a little fraying at the edges, the fabric of the global trading system is not succumbing to protection.

In contrast to the 1930s, globalisation, so far, seems to be surviving this crisis.

Absolute levels of income and wealth are much higher than the 1930s and the rise of political extremism in the countries in the Eurozone, although a matter of concern, are not comparable to these years.

I have alluded to what I consider to be mistaken policy making in the Eurozone but there is a lot they have got right.

Policy makers have now bought themselves some time to solve the Eurozone mess. They must use it.