A Conversation with Barry Eichengreen

Part of the 'Conversations with Re-Define' series

About Barry Eichengreen

Barry Eichengreen is the George C. Pardee and Helen N. Pardee Professor of Economics and Political Science at the University of California, Berkeley, and a former senior policy advisor at the International Monetary Fund. His most recent book is 'Exorbitant Privilege: The Rise and Fall of the Dollar and the Future of the International Monetary System'. He has done research and published widely on the history and current operation of the international monetary and financial system. He received his BA from UC Santa Cruz and his Ph.D. from Yale University in 1979.

Executive Summary

Barry Eichengreen and **Sony Kapoor** discuss the state of the European economy and whether we have seen the worst of Eurocrisis. Dr Eichengreen draws attention to the dangers of a decade of lost growth and the short-term horizons of the politicians and decision-makers. Both Dr Eichengreen and Sony Kapoor agree that a redistribution of resources from the core to the periphery is essential to the survival of the Eurozone, but that the political space necessary to accommodate such an action is small, and is shrinking rapidly. Dr Eichengreen argues that there is more turbulence and problems ahead of European countries due to the failures to tackle the underlying economic and fiscal problems that led to and perpetuated the Eurocrisis.

Sony: Nice to see you Barry, what would you say is the state of play in the Eurocrisis as you see it?

Barry: European officials and leaders were telling us at the beginning of the year that the crisis was over. I doubt that most people believed them, although the markets were surprisingly sanguine for a time. None of the underlying problems had or have been solved; even before the fiasco surrounding Cyprus it was clear that the crisis would to be back. There had been no real re-balancing within Europe, no progress on banking union, and no agreement on limited fiscal union. So, I do not think anything has been solved, which renders me more pessimistic with the passage of time.

My view has always been that there would be no Eurozone collapse. At the same time I see no signs of a miraculous resumption of growth. Ruling out these alternatives leaves only the option of a lost decade in Europe, as the member states stumble towards deeper integration. But increasingly I worry that the political system cannot support a lost decade.

Sony: The way we have described Cyprus is that it did not fundamentally change anything, but Cyprus is what you get if you account for the red lines that have been drawn. The situation is like that of a cartoon character that had already walked off the cliff and was walking on thin air. Cyprus ought to have woken markets up to the possibility that we are already off the cliff and about to plummet.

Barry: Let me add two things about Cyprus: First, it underscored the extent of banking problems in Europe, and how troubling it is that the members are making such slow progress towards a banking union. Second, Cyprus underscored the chaotic and incompetent way that decisions are being made in response to the crisis. They are being handed down to small countries on a case-by-case basis; there is no consistency.

Sony: And it does not inspire confidence to see this being played out in public.

Barry: This makes me think that Cyprus may be a turning point and not for the better.

Sony: That is true, but more in that it revealed the extent of political divisions and of banking problems, rather than actually causing them. If you did the math – that you wanted to keep Cypriot sovereign debt sustainable, that aid transfers to Cyprus were politically impossible and that Germans are (rightly) concerned about making whole losses already incurred in banking sectors in third countries – then depositor bail-in was the only answer. Of course, the manner in which it was done could not possibly have been more incompetent. Let's just say it does not inspire confidence.

Barry: In addition to that, one must to ask where the German government was when the decision was made to let Cyprus adopt the euro. It is not as if the nature of the Cypriot banking system and its offshore deposits is an entirely new development. Someone was looking the other way when the decision was taken to admit Cyprus to the euro zone, and that someone should now take responsibility.

Sony: When we were talking before, you mentioned the political and the social dimensions. To me that is the biggest worry. At a lecture I did at the European Commission a few years back and I used two PowerPoint slides – one was a big circle and one was a small circle. I said the big circle is the political space available and the small circle is the size of economic problems, which could then be tackled by changing strategy. I warned that the small circle would grow and the big circle (of

political space) would shrink. At some point they would cross over, and when they did, we were basically screwed.

Now, do you think that crossover has happened? Do we have so little political space now and economic problems of such a complex and large nature that it is impossible to see how (short of a miracle), we are able to reach decisions that are actually able to bring the crisis under control?

Barry: As I said before, I am growing more pessimistic. Until recently I would have ruled out all arguments about Eurozone collapse and about countries choosing to abandon the euro. Now I would no longer rule them out entirely. The patience of the public and the supply of responsible policy makers are both diminishing. The argument we have heard is that there will be no compromises until after the German election in September, but it is far from clear that there will be compromises even then. So, on the one hand, I find it hard to see a political way forward, while on the other I find it hard to see the endgame. This means that there is going to be more turbulence ahead – that is one thing we can be sure of.

Sony: On the political dimension, would you say it is fair to think of this primarily as a distributional issue? What you have seen, at an aggregate level, is that the Eurozone is relatively fine, and the issue has been primarily distributional – with the creditor and debtor countries at loggerheads. Now, as an instinctive response to the crisis (as we have seen in past politically turbulent times), as the level of insecurity goes up, everybody wants to cling to the resources they have, even within countries. I think that one of the most disturbing statements is one I have heard from German policymakers in the past six months: 'If even the Catalans do not want to pay for the rest of Spain, why the hell should we?'

This is a very dangerous sentiment. Within Germany, of course, there is Bavaria versus the rest. So there seems to be this particular development, where the insecurity is actually causing the distributional pockets to shrink even further, which makes the politics even harder.

Barry: Yes, there is a very prominent distributional logic at work, as you say. This has made all the more difficult to deal with in a slow growth, or even no growth, environment. When all boats are rising, reforms with the potential to create insecurities are easier to deal with. In contrast, a crisis environment causes time horizons to shorten. Germans forget that they benefited distributionaly from the period of relatively rapid growth – partly as a result of the euro keeping their exchange rate down.

Together with some colleagues, I have been studying the history of the inter-district settlement system of the Federal Reserve System, in an effort to understand how and why some U.S. regions compensated other U.S. regions that experienced balance of payments problems after WWI, in the Great Depression and after WWII. An important feature of U.S. experience, which enables one to adopt a longer term perspective, is that those problems have tended to be transitory. A region in balance of payments deficit in one period could be in surplus in another. If U.S. experience is any guide, European countries accumulating TARGET2 assets in one period will have TARGET2 liabilities in another. Member States would benefit from awareness of the fact. That kind of long-term thinking allowed the EU to come into existence, but there is not a lot of long-term thinking going on at the moment.

Sony: Just picking up on that point, that is a very deep insight about the shrinking horizons. Because of the context of domestic politics, one has to present things in the national interest.

The Germans, for example, have been using an implicit objective function of minimising German taxpayer losses (which may not be appropriate). However, even with this narrow objective, one gets very different policies depending on whether the time horizon is 6-months or 10 years. The best way to minimise Eurozone taxpayer losses over a 10-year horizon would mean completely different policies, which are actually consistent with the solutions to the crisis, in comparison to what is applicable in 6-months, which is self-defeating in the long-term, right?

Barry: Historically European countries have had politicians prepared to make that case to their publics. It is unfortunate that at the moment far-sighted, articulate European visionaries are in short supply.

Sony: Is this part of a general trend that you see across the world? Are political decision-making horizons, for several reasons - it could be the media - shrinking across the board in Western OECD economies? The US is no exception to this extreme short-termism. On the one hand, we blame financial markets, but political decision-making horizons are shrinking just as rapidly as those in the financial markets.

Barry: This certainly sounds familiar to an American! The US political system has not exactly done a good job in-terms of medium term planning and implementation. I do not have a convincing theory of why that is the case. It has something to do with media and it has something to do with campaign finance. It has something to do with gerrymandering as well; as a result of how political redistricting has tilted the balance in favour of incumbents, political competition does not have the healthy discipline effect that it once did.

Sony: What is the best thing that could happen within the Eurozone? What is the best-case scenario that you still keep rooted within political reality? What do you think is the best way out?

Barry: Economic growth is a powerful solvent. A little bit of growth would go a long way towards buying the time that the European system needs to undertake the institutional deepening and the structural reforms necessary to fix the flaws in the Eurozone. For the Eurozone could get nominal GDP growth of 5%, maybe 1%-2% real growth and 2%-3% inflation would be helpful under current heavily indebted circumstance. It would create a window of time during which the political classes could put their heads together.

But I do not see at the moment where the growth will come from. Maybe the European Central Bank (ECB) will change its stripes, but I would not count on it. Maybe Northern European countries will agree to use their fiscal space to stimulate demand. Again, I am not predicting this, but those are the kind of policy actions that would be needed to create that window of time and hold the project together.

Sony: Would you agree that the Eurozone's focus on immediate, front-loaded austerity fails to recognize the fallacy of composition and the pernicious impact it has not just on directly depressing aggregate demand, but also on increasing bank losses, and making credit conditions tight exactly where they need to be loose? Is this not, through impeding an effective transmission of monetary policy and killing off investments, not blocking the only hope we have - of growth in the medium term? The politics of the short-term undermining what would be appropriate for a longer time period?

Barry: The strategy in the past has been that the ECB and countries with strong budgets should not do too much to help their weak brethren, because they want to keep the pressure on for reform. But that pressure has now pushed the crisis countries to the breaking point. I think the way to promote reform is not to ratchet that pressure up again, but instead to relax it and get growth going. It is important that political support for mainstream, reasonable, reformist governments is not further undermined and so that populists, whose intentions would be less Europe-friendly, do not replace them.

Sony: Last question. On the political side, would you roughly agree that the next big headlines will probably be generated by social fabric-tearing or the politics becoming completely dysfunctional within a country? The problem is that at a European level the smallest coalition partner for the smallest of Eurozone countries has de facto veto power, so the path from small social changes emerging to big macroeconomic gridlock is actually much shorter than elsewhere.

Barry: I think our views are pretty similar, so your questions answer themselves. But let me say two things: first, yes, I think that the danger point has shifted from self-fulfilling financial crisis, which was the fear of 2012 (before Mr Draghi stepped up and said he would do what it takes to prevent self-fulfilling crises). But Mr Draghi's statements and actions cannot do anything to prevent politics from becoming the danger point.

My second observation would be as follows. Long ago, in my 1992 book 'Golden Fetters' I described the importance of the structure of electoral systems put in place after WWI for the kind of policies were implemented and for the coherence of economic policy. Proportional representation electoral systems with low thresholds for representation produced fragmented coalitions, weak governments and unstable policies. That is another aspect of post-war experience that is unfortunately coming back to haunt us.

Sony: Thank you so much for talking to Re-Define.

Barry: The pleasure is mine. I follow all your excellent work on the Eurocrisis.