A ‘north-south’ divide behind euro debt crisis

GREG ELLIS

THE challenges of managing a common currency such as the euro in a region made up of countries with varying financial markets cannot be understated, according to SMART Infrastructure Facility’s Professor Henry Ergas.

Prof Ergas said among the challenges facing the European Central Bank (ECB) when it developed euro monetary settings was that what made sense for one city, such as Frankfurt, might not make as much sense to another, such as Athens.

That was because inflation was significantly higher in countries on the periphery than in the euro’s core countries. So when ECB policy made real interest rates in the periphery zero or less, that low rate reduced the cost of debt and made new borrowing in those countries attractive. And the response by each country was dependent on its fiscal development.

For example, when Spain, with its highly sophisticated banking system, was faced with zero real interest rates, the banks expanded their loans to households and businesses which unleashed a property boom causing Spanish prices to double.

That resulted in a building spree that consumed 60 per cent of all the cement in Europe.

Prof Ergas said in contrast, financial markets were far less developed in countries such as Greece and Portugal so voters elected governments committed to borrowing on their behalf and expanding the public sector.

“The counterpart to this borrowing in the periphery was substantial net lending from the core,” he said. “Northern Europe, especially Germany, was still in the midst of fiscal consolidation until 2007 and that resulted in low inflation and declining unit labour costs. So while prices in Spain rose by 8 per cent more than in the eurozone as a whole, in Germany they rose by 6 per cent less.

“Given low inflation, real interest rates in northern Europe remained relatively high, encouraging households to save. Along with reduced budget deficits this meant that northern Europe spent less than it earned while southern Europe did the opposite.”

That resulted in sharp changes in competitiveness within Europe. Declining labour costs made goods from northern Europe more competitive than those from southern countries where producer costs were increasing.

Prof Ergas said the changes in competitiveness that followed the introduction of the euro had two naturally related manifestations. The first was large current account imbalances within the eurozone as the countries on the periphery, such as Portugal, Greece and Spain, increased their input and subsequent trade deficits.

Meanwhile, countries such as Germany enjoyed increased surpluses and exports.

The deficits in the south were largely financed by loans from northern European banks to commercial borrowers and governments in the south, he said.

That meant countries on the periphery committed to servicing large loans in a currency they did not control were vulnerable to collapse.

Prof Ergas said the euro problem lay in the nexus between competitiveness, solvency and liquidity and that was the fundamental feature the eurozone crisis had brought to public attention.

“So it looked like a country was going to default on debt then obviously the financial viability of its local banks became questionable. However, with fiscal constraints already binding, it was not apparent how national government could afford to recapitalise its local banks. So its own solvency was further degraded as was that of the banking system.”

Contrasts: Imbalances between the euro’s core and periphery are the basis of the crisis, says Prof Henry Ergas. Picture: GREG ELLIS