"Understanding the Eurozone"
remarks by
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• I appreciate this invitation to join you for this conference on the Eurozone.

• As most of you probably know, I had the great fortune-and privilege-of working for Secretary Baker from 1985 through 1992- and then briefly again in late 2000, although his portrayal in the movie "Recount" was much, much better than mine.

• I learned a tremendous amount from Secretary Baker, and indeed, the experience continues to offer me insights on issues, institutions, and politics today.

• I also appreciate the opportunities he gave me, and never want to miss the occasion to thank him for that.

• Secretary Baker was a rarity as a leader and executive: He didn't seem to care where people were from, or their background, or even, to a degree, their ages. He just wanted to see what one could produce, get done, and whether you could work as a member of a highly effective team.

• We always had our eye on results.

• He was a master, first of achievement within the operation of the shared and separated powers of our Constitution, and then in the wider international arena.

• Perhaps I'm highlighting these attributes today because it seems that Washington-both the Executive and Congress- seems to have lost that touch.

• And, unfortunately, those limitations constrain the role- and leadership-that only America can still provide in the wider world.

• Furthermore, the perspectives offered by Secretary Baker's career shed light on the topic you've asked me to address today: the challenges for the Eurozone.

• Many Americans who analyze the Euro drama are scrutinizing events purely through an economic lens. That is, of course, a valuable perspective.

• But to truly understand today's challenges in the Eurozone, one needs to appreciate the arts of political economy. Those are skills that Secretary Baker mastered with shrewdness and judgment.

• Therefore, before focusing on the Eurozone issues of 2013, I'd like briefly to review the politics and economics that led to the creation of the Eurozone.

• This is the window through which European policy-makers view today's problems.

• The Founding Fathers of Modern Europe were trying to escape a past of conflict and disastrous wars on the continent.

• They foresaw a sequence of integration: starting with a customs union and common polices for industry and agriculture-leading to a Single Market-then an Economic and Monetary Union-and finally a Political Union.

• A key weakness, it turned out, was that the EU created a monetary union, but not much of an economic one.

• The European idea has been to set the machinery of integration in motion and then, at the right moment, expect that the results will trigger political unification.

• For those of you who have studied earlier European history, one can see the parallel with the unification of Germany in the 19th Century: moving from a customs union to an internal market, then monetary, and eventually political union.

• For the Euroromantics, these ideas revived old dreams of Kantian culture, the poets, and even the universal Catholic Church in Europe- before my ancestors and other signed up for that divisive Reformation!

• The roots of today's Eurozone can actually be traced all the way back to 1970, with the Werner Report.

• One key idea in that report was that deep European economic integration wasn't compatible with flexible exchange rates.

• The U.S. Dollar figured in this assessment, because while the Dollar generally depreciated-it lost value-vis-a-vis the Deutsche Mark, the Dollar tended to appreciate vis-a-vis weaker European currencies. In effect, the Dollar was a wedge between European currencies and the gyrations of European exchange rates-sometimes triggered by movement of the Dollar-complicated trade within Europe.

• The Werner Report stated that if Europe could eliminate its internal currency exchange rates, it would be easier for businesses and people to compare prices, trade, and invest within Europe-and that the competition this created across a bigger European market would improve the member states' global efficiency.

• This report led to extensive conceptual debates about what might be the optimal European currency area.

• There were early efforts to move toward coordinated currencies-such as the "Snake" in 1972 and the European Monetary System, the EMS, in 1979.

• The Europeans also advanced the broader economic integration process through institutional changes, such as the Single Market Act of 1985, which targeted the creation of an integrated internal market by 1992. Europeans introduced Qualified Majority Voting in some policy areas to make it easier to achieve decisions.

• The French and Germans exchanged ideas about next steps, leading to the release of a "Blueprint" in 1989 by European Commission President Jacques Delors.

• Of course, these events were unfolding just as the Cold War was coming to an end in Europe, highlighted by the unification of Germany in 1990, a process in which President George H.W. Bush and Secretary Baker played leading and skillful roles.

• The end of the Cold War-the uniting of a Europe "whole and free," as President Bush celebrated it-lent momentum to the creation of the European Union through the Maastricht Treaty of 1992.

• At the time, I recall thinking that Monetary Union was the price Chancellor Helmut Kohl and Germany paid for French support for German unification. But I've subsequently concluded that my suspicion was overstated: The record makes pretty clear that Germany, France, and others had been long committed to the Economic and Monetary union project-guided by that "integrationist" logic. French President Mitterrand no doubt recognized, however, that Germany's unification made EMU ever more of an imperative.

• Yet the Maastricht Treaty only endorsed part of Delors' blueprint. And this piecemeal result planted a dangerous seed of today's problem: the Union ended up much more monetary than economic.

• More specifically, the introduction of the Euro made it easier for weaker economies to carry heavier debt loads. Italy, for example, had debt that amounted to about 120% of GDP, and suddenly its interest rates fell from 10% to 5%: How would those savings be used? Spain and Portugal gained similar windfalls.

• Greece, moving from the rule of Colonels to a revived democracy, was admitted to the Eurozone as a gesture to buttress the country's political modernization.

• As long as good times continued, the EU member states tacitly agreed not to look too closely into the debts, spending, banking systems, and competitiveness of one another's economies-because no one wanted the scrutiny directed at them.

• The financial crisis of 2008 then sparked a series of events that uncovered the Eurozone's weaknesses.

• The point of this history is to emphasize that Europeans view the European crisis as a crisis of integration-not just a monetary or economic problem related to having a common currency.

• The integrationists' perspective explains some of the trans-Atlantic disconnect in debating the dangers to the Eurozone.

• When Americans point to market risks triggered by anxieties about sovereign debt-or debate the need for stimulus policies-the Europeans respond with plans for fiscal, budgetary, banking, and political union.

• When Americans worry about a "Lehman moment" and an illiquidity shock that could lead to financial panic, Europeans are thinking about how a break in the Eurozone could unwind the achievements of the internal market-or even the EU's Custom Union.

• When Americans point to problems to solve, or at least manage, in real time, Europeans tum to a discussion of architecture and legal arrangements.

• So how does this political economy background affect the challenges of the Eurozone today?

• As a practical matter, the EU has had to deal with 3 interconnected problems:

- Sovereign debts;
- Banking systems, which are related to the sovereign debt because many banks are big holders of government bonds, so if the value of those bonds falls, banks will take a hit to their capital;
- And, 3rd, some countries face a challenge of competitiveness.

• While handling these issues, European political leaders have had to struggle with the integrationist challenge: How can they design- and build support for-a more deeply integrated Eurozone within the EU?

• Because of the political and historical perspective I've shared with you, I've had a different view than many Americans: I've suspected that because of the personal and political commitment of European leaders, the most likely course is that Europeans will "muddle through."

• But I certainly recognize that there can be a disconnect between markets and the Europeans' integrationist logic.

• In the summer of 20 12, as interest rates spiked for Spain and Italy, I was concerned that the Eurozone was reaching a crisis point. I stressed this danger at my last G-20 meeting, as head of the World Bank, to the discomfort of some European leaders.

• Not long thereafter, Mario Draghi, the very skilled head of the ECB, made a strong statement about "doing what it takes" to protect the Eurozone, and he backed up his words with new

programs. Chancellor Merkel of Germany supported Draghi even though Germany's Bundesbank was more skeptical. And Eurozone markets settled down.

• Yet Mr. Draghi had just bought time. Neither his words nor monetary policies alone can solve the fundamental economic problems. By the way, that's true in the U.S., too.

• As Draghi himself has said, the greatest risk for the Eurozone now is complacency.

• Even if European political leaders are committed to the Eurozone, they can miscalculate-or fail to keep up with events.

• Three actions are necessary.

• 1st Germany is half right: Europe needs fiscal and structural reforms.

• The old welfare state just isn't affordable given demographics and world competition. Labor markets need to be more flexible, so workers and businesses can adjust more readily to changed circumstances. Too much red tape, and too many licenses and restrictions strangle entrepreneurs.

• 2nd, however, there is a "duration mismatch" between the time reform's take to produce benefits and the timing of debt rollovers.

• Italy and Spain are the big debt tests for the Eurozone; the others can be managed if Germany and others work do so.

• 3rd, European banks still have to rebuild capital and confidence, in part to prepare for hard-to-predict shocks.

• The greater the progress on forging European-wide deposit insurance and banking union, the more protection there will be from possible breakdowns in individual countries.

• Earlier this year, Chancellor Merkel told a group of us that while she had been ready for Greece to leave the Eurozone, she concluded that the Eurozone's financial and banking system wasn't prepared for the shock.

• While Europeans recognize these three challenges, reforms are always hard to implement, especially with little or no growth.

• So the biggest challenge for the Eurozone now is the politics of reforms.

• Can Greece maintain political support for the necessary actions for years to come-or at some point will a populist leader of the left or right tell the rest of the Eurozone that Greece's big debts are Europe's problem, not Greece's?

• Will Italy and Spain keep up structural reforms?

• The good news is that Spain has been reducing employment costs and regaining competiveness, but unemployment remains very high, output is still far below potential, and asset prices are very depressed-the country has a long way to go.

• The not-so-good news is that Italy is stuck: debt levels are high and rising, unemployment remains about 12%, and political battles have stalled further reforms.

• Keep a watchful eye on France. France is at the health of the European project: Will it be part of the solution or add to the problem? The government has not shown readiness or will to address France's loss of competitiveness and increase in debt. France is approaching the point where debt service costs will rise faster than incomes, squeezing consumption and lowering growth.

• Finally, can the German government maintain political support?

• It is striking that in the recent German election the two major Volkspartei the broad-based, popular parties-stood for continued, but disciplined, support for the Eurozone. And they gained votes.

• Here's one reason why: This is Germany's 68th year of peace. That's the longest period without war since at least the Peace of Westphalia in 1648.

• But the public mood in Germany-not the opinion leaders, but the average Bürger-is becoming more wary of "having its pocket picked".

• I suspect that the German public will continue to back its government's Eurozone efforts-as long as the other countries are seen as following through on their responsibilities for reform. If other governments slip, so will the German public.

• I'll share a wonderful insight provided to me by Mario Monti, the reformer who headed Italy's government all-too-briefly: Keep in mind, Monti told me, that in Germany, economics is a branch of moral philosophy. So economic policy in Germany is not a question of Keynes or Friedman, or debates about sources of demand, but a matter of hard work, discipline, rectitude, and paying ones bills....

• Looking ahead, we can identity events that might trigger trouble-or actions-in the Eurozone.

• In 2014, Portugal will need another financing package. This problem can be handled, but if European officials seek "contributions"-in other words, debt relief-from bond holders, the risk could expand to other Euro markets.

• Greece's debt remains too heavy, and Greece's private creditors have already taken a big discount, so when Greece's program is reviewed, the Europeans and the IMF will need to decide whether official creditors will assume losses- or whether they bide time by lending more and building up more unsustainable debt.

• And then in 2014, the ECB, as the new, overall regulator of EU banks, is supposed to conduct another round of stress tests. The earlier tests, conducted by national authorities, were not seen as serious, in large part because the sovereign debts held by the banks were accounted at full value. If the ECB discounts sovereign debts for purpose of the stress test, some banks are likely to have capital holes to fill. If the ECB finesses the values, markets will question the banks' staying power.

• So the Eurozone drama has not run its course.

• In closing, one might task why these tribulations matter here in the United States.

• A few months ago, I came across an interesting report that showed that short-term correlations of global markets to the Euro crisis, across most asset classes, had remained very high during 2012.

• Indeed, about 30% of the market action in 2012 had been driven by anxieties about the Euro.

• More fundamentally, the EU remains a big part of the world economy, buying lots of U.S. goods, with many EU companies investing in the U.S., and many U.S. multinationals engaged in Europe.

• At the strategic level, one of America's greatest foreign policy achievements in the 20th Century was contributing to the creation of an integrated-and unified- democratic Europe as the US's closest ally and natural partner. This was the idea behind the Marshall Plan.

• Might that trans-Atlantic partnership be at risk-either through a dramatic breakdown-or more probably through a slow erosion of Europe's economic vitality, defense capabilities, and public will to assume obligations outside a troubled EU?

• A couple of years ago, I asked a very senior Administration official whether the U.S. had ideas to support our European ally and partner, given the strategic history and interests. I didn't get much of an answer.

• Today, we do have an initiative, pushed principally by Chancellor Merkel of Germany: the Trans-Atlantic Trade and Investment PaJ1nership, or TTIP, a comprehensive FTA between the United States and the EU.

• I think Chancellor Merkel's strong interest in TTIP is driven both by her belief that trade liberalization can help achieve structural, competiveness reforms in Europe, and by her interest in a stronger economic foundation for 21st Century trans-Atlantic ties.

• The tariff barriers with the EU are relatively low, so TTIP's real challenge will be to remove other limits on trade, investment, and doing business whether standards, regulations, or special procedures. We also have some serious differences in agriculture, which is important to political support in the Congress. These are not easy topics.

• It is encouraging that the President has announced his commitment to TTIP. Given that Republicans tend to be strong supporters of trade, this negotiation could offer a rare bi-partisan opportunity to get something big done.

• I can 't quite tell whether the Administration will translate its rhetoric on TTIP-and the TPP trade negotiations in the Asia-Pacific-into the willpower to close and pass deals in Congress.

• But I know we have a national interest in encouraging and supporting the Administration if it acts.

• That approach would certainly accord with Secretary Baker's experience in government-an approach that I hope the Baker Institute here at Rice can continue to foster: Having a keen eye for the national interest; recognizing the connections between economics and security: sensing when to seize the initiative; understanding how to negotiate with a perspective on policy and politics; and always pushing for results, for getting things done.

• That's a pretty good formula for America.