

Today's Top Economic Historian: The Path to European Stability

By Dan Richards
June 15, 2010

Niall Ferguson is arguably today's leading economic historian. A member of both Harvard's Faculty of Arts and Sciences and the Harvard Business School faculty, he is also a Senior Research Fellow at Oxford University and a senior fellow of Stanford University's Hoover Institution, and he has been named one of the world's 100 most influential people by Time Magazine.



*Ferguson has authored numerous books on war and on economic history, the most recent being *The Ascent of Money*, which was turned into a television series that won the 2009 International Emmy for Best Documentary. He also writes extensively for periodicals and newspapers in the UK and the US, and he is a contributing editor to the Financial Times.*

Dan Richards interviewed Ferguson on May 25 in Boston at the CFA Institute Annual Conference. Below is part one of a two-part series, in which Ferguson discusses the current troubles and future outlook of Europe. Part two will appear next week.

A video of this interview appears [here](#).

I want to talk about your outlook for the Eurozone in light of recent turbulence. Clearly there is some real tension between northern and southern Europe. What do you see happening in the period ahead in terms of the Eurozone as an entity?

You are asking the right person this question, because 10 years ago Larry Kotlikoff and I wrote a piece for the magazine *Foreign Affairs* called *The Degeneration of EMU*, in which we said that if you create a single currency without any fiscal coordination mechanism – in other words if you have monetary union, but no federal fiscal system – it will fall apart.

We said that would happen in about 10 years.

Right on cue the Eurozone has fallen apart for just the reasons that we envisioned: a huge divergence in fiscal balance has essentially destroyed what was called “the stability and growth pact,” which was supposed to regulate how much governments could borrow.



Everyone's deficit is wildly over the 3% of GDP threshold. In the case of the Greeks, they are over it by more than 10 percentage points of GDP.

So that didn't work. The question is now what?

Europe has a very difficult choice. Choice one is to go the next step and have a federal fiscal system like the United States has. That means that there can be transfers through regular taxation and expenditure between rich flourishing states and the poor backward states.

That would entail giving up more control. Right now members of the Eurozone have already given up control over their currency. So what you are suggesting is you now have to give up control over the other great lever, which is spending and taxation.

Exactly, and this is the more important of these two things – sovereignty is more than anything else about taxation and expenditure.

Decisions about taxation and expenditure have been firmly in the grip of national parliaments and executives throughout the postwar period.

Anybody who knows any history knows that when you give that up, and you create some central authority that has the final say on taxation, then that central authority will grow. That has been the case in every federal system ever created.

So the likelihood that Europeans and particularly Germans will vote in a massive new treaty that creates a United States of Europe is a 0% probability. It's not going to happen.

So the question then is whether the status quo is sustainable – where you have a monetary union, but not fiscal union, and those kinds of pressures that we've seen in Southern Europe?

It's sustainable, but only under certain very important conditions.

Many people talk in a rather alarmist way about countries leaving the euro. Some people say Greece should leave and other people say that the Germans will leave.

This is probably wrong, because the costs of exit are prohibitively high, and it was designed to be that way.

If Greece were to leave, they could restore and then devalue the drachma, and that would be business as usual for Greece. It's the way Greece has been run for many, many years.



The problem is that would destroy a very important sector of the Greek economy, including their banks, which would have a huge mismatch between their assets suddenly being in drachmas and their liabilities being considerably more in euros.

There is no real incentive for a weak country to exit. It would get killed by the financial markets the moment that it stepped out into the market with its old currency and its old credit rating.

So a weak country can't leave. How about a strong country like Germany?

Why would the Germans do that? What would they gain?

Let's think this through.

They would stop being asked to subsidize the Greeks, and that might be kind of gratifying, but if we restored the deutschmark it would soar relative to the weakened rump euro.

Although Germans whine a lot about this current crisis, the one thing that they are not really whining about is the weakened euro, which is a boon for German exporters.

The German export machine is getting a huge shot in the arm for what is a really steep devaluation of the euro relative to other currencies, and, by the way, that is likely to continue. Back in the early days of the euro, it went below parity with the dollar. I think it is going back there now, and that is great from a German point of view. So why would they want to lose that?

I don't see anybody leaving the euro. The costs outweigh the benefits quite decisively.

The critical thing is that the European Central Bank (ECB) has to become the accommodative engine of devaluation and reflation. That means Jean-Claude Trichet, the President of the ECB, really has to continue rolling over.

He's already rolled over once – that really was the key event when he agreed to have the ECB directly buy government bonds, including Greek government bonds. I think he's going to roll a little further in the weeks ahead. Essentially, he is going to print money.

That's really the only way you keep the European Monetary Union together, by having a weak currency as the offering.



A couple years ago, before the 2008 crisis, it seemed clear that several countries were on track to join the Eurozone – Eastern Europe, Turkey perhaps. Do you see the Eurozone expanding going forward?

Estonia is joining, and so bizarrely in the midst of this crisis a new member is on the way to being in the club.

If the Eurozone is a weak currency zone there's no reason why not. The only danger to this scenario is that the Germans insist that everybody puts on a hair shirt and adopts a balanced budget amendment the way the Germans have. If you embark on that kind of a strategy where the Eurozone is conditional on fiscal austerity, then I think it could fall apart.

A real fiscal austerity as opposed to the Goldman Sachs-aided shell game that allegedly – and, I think, fairly clearly – the Greeks went through some years ago.

Right. There was a huge amount of cooking the books that went on to get Greece into the Monetary Union, but the Greeks were by no means alone in this regard.

The real fiscal austerity that the Germans have in mind goes beyond the old stability and growth pact. Now they're talking about a balanced budget amendment that effectively precludes member states running deficits at any time. It's crazy to start talking about stuff like that in the midst of a European recession. But it's a measure of how the psychology has changed in Berlin.

Previously, the Germans, in the age of Helmut Kohl and before, were content to be the people who underwrote European debt and who signed the checks. That's changed. That may be the biggest source of instability in the Eurozone – not Athens, but Berlin.

You are suggesting that there may be new members joining the Eurozone.

In the past, when countries like Ireland and Portugal came on board, they received very, very substantial subsidies for an extended number of years in that transition period. That's been one of the big incentives. Do you see that continuing?

Yes and no.

The subsidies were more associated with European Union membership than with single currency membership. There are still some attractive benefits to being inside the club, but they are way less attractive than they were in the glory days when the Irish got on the gravy train.



There isn't really a slush fund or a gravy train anymore in Europe. It used to run from Berlin, or in those days Bonn, to the periphery and to new member states. It essentially took money from German taxpayers and distributed it to farmers and the Irish.

Everyone felt tremendously happy about this. The Germans didn't mind, because they still felt connected to European integration as a project, as part of their kind of war-guilt assuaging program.

We have moved on so far from there, particularly since German reunification in 1989.

The psychology of Helmut Kohl, a German from southwest Germany from Rheinland-Pfalz is very different from the psychology of Angela Merkel, who was born and brought up in the German Democratic Republic in East Germany.

I don't think Merkel really gets it about European integration. That's part of the problem here, in that instinctively she just doesn't think it's proper for dentists in Athens to fiddle their tax returns and get money indirectly from German taxpayers.

As I've said, the biggest threat to the stability of the European Union now comes from Germany, because without a German banker, without Germany underwriting the process of integration with real money, then the incentives for everybody else to behave are much less strong.

Turning to Great Britain, we have just seen in the last couple of weeks a change in government there.

Does that make you optimistic or pessimistic relative to where we would've been previously?

Less pessimistic.

The United Kingdom faces a huge fiscal challenge in the years ahead. It would've been a disaster if the discredited figure of Gordon Brown had stayed a minute longer in Downing Street.

So I'm less pessimistic, but it's going to be hard for a Liberal-Conservative coalition to do the tough things that need to be done.

The Liberals don't exactly have a record of making tough decisions in government, because they haven't been in government for as long as anyone can remember. They don't really have the kind of party discipline that one would normally associate with a spending, cutting, and maybe even tax-raising government.



George Osborne is the new Chancellor of the Exchequer.

He has the toughest job in Britain, if not in Europe, right now. One's got to hope that he is supported by not only Conservative members of Parliament (MPs) but also Liberal MPs as he puts through what are going to be some extremely stringent budget measures.

Last summer Osborne, in the run-up to the election, tabled some fairly tough proposals, which was unusual for an opposition party to come out front and suggest that some tough decisions were going to have to be made.

Despite that the Tories got elected. Does that make you a little more optimistic?

Only a tiny bit, because if you remember when George momentarily spoke the unvarnished truth, the Tory polling took a tumble. He was quickly told to shut up and turn it down.

All the parties campaigned just as you would expect, with the notion that there would have to be cuts, but they wouldn't really be that huge. In fact, the kind of cuts that are probably necessary are an order of magnitude bigger than anybody dared to say during the election campaign for fear of terrifying the public.

For George Osborne, it was uncomfortable to have to campaign in that way, because he's actually a straight-talker, and yet the stakes were very high.

It was extremely important that Labor lose the election even if the Conservatives couldn't get a clear majority.

I never thought they were going to get a clear majority; you can see that there is now a structural anti-conservative majority in the UK, not really surprising since the Labor Party spent 13 years creating jobs in the public sector, increasing benefits, and essentially buying a whole class of people who are dependent on government.

The Conservatives did pretty to get to this point, to have staked out the center ground sufficiently for a coalition with the Liberals to be viable.

So I give George really high marks. This was a very tough assignment. Those who say they should have won a clear majority are dreaming. That was never in the cards.



As that tough medicine you talk about comes into play, what kind of response do you anticipate from the public in Great Britain? Do you see the same kind of response – not quite riots, but perhaps demonstrations in the streets – that we've seen in Greece?

The public sector unions who have to take some of the pain here, and in fact have to take quite a big part of the pain, are fairly reliable when it comes to turning out in the streets with neatly printed placards and chanting anti-government slogans. So we can expect demonstrations, but I don't think it's likely that these will turn into the violent demonstrations.

Trade unions are much weaker today than they were when Margaret Thatcher became Prime Minister.

She had to take on the miners' union, which was then led by the firebrand Arthur Scargill, and there was blood in the streets in the early 1980s in Britain.

I don't think it's going to be that kind of a conflict, but I suspect the biggest battles that George Osborne will have to fight will be with Liberal MPs within the coalition, who will find themselves for the first time having to deal with power and responsibility, rather than political posturing. That's going to be the issue.

Blood in the streets of Britain is a relatively low probability scenario. When I said there will be blood, in an interview with Toronto's *Globe and Mail* some while back, early in the financial crisis, it was the emerging markets that I had in mind, not countries like Britain and Canada, which after all have a very longstanding tradition of resolving conflicts through the democratic process.

How do you see the fiscal situation and the debt situation in Great Britain playing out?

The situation right now is horrible.

If you look at the Bank for International Settlements' projections of the debt-to-GDP ratio going forward over the next 30 years, Britain is actually worse than Greece.

It ends up with an unbelievable debt-to-GDP ratio of around 500% by 2040 if there's no change to policy. A lot of attention recently has focused on Greece for obvious reasons, because bond investors panicked about Greek fiscal policy. But British fiscal policy is actually more of a mess.

The IMF did some calculations about how much a country would have to tighten fiscally in terms of both tax increases and spending cuts to stabilize its debt-to-GDP



ratio. Britain came number two after Japan, with a whopping 12% to 13% of GDP tightening necessary to stabilize its debt-to-GDP ratio.

Britain has a huge problem on its hands. It's actually the worst fiscal situation that Britain has been in since the end of World War II, which of course was a time when Britain's debt had exploded for pretty good reasons – if you're going to run up a debt-to-GDP ratio of 250%, do it beating Hitler.

They've run up this kind of huge debt mountain with a dysfunctional welfare state and whopping bank bailouts. I worry hugely about how Britain navigates its way back to fiscal stability. It's in an environment of great global uncertainty, and likely low growth in neighboring continental Europe.

The problem for David Cameron, the Prime Minister, and for George Osborne, the Chancellor of the Exchequer, is that they have a fiscal mountain to climb, but they are doing it with a team of climbers some of whom I don't think they can really rely on, because they are from another political party.

Next week: Niall Ferguson on China, Japan and the United States

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