After the Eurozone Crisis – Prospects for Europe and Beyond

A CIC Seminar Report
Hosted by Foreign Affairs and International Trade Canada
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AFTER THE EUROZONE CRISIS:
PROSPECTS FOR EUROPE AND BEYOND

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SEMINAR REPORT
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EXECUTIVE SUMMARY

The objective of this seminar was to provide Canadian policy makers and analysts with a more sophisticated understanding of the impact of the Eurozone crisis and possible scenarios for the future. The key messages participants heard (on which there was not always necessarily full consensus) were:

- The Eurozone (EZ) crisis is a traditional balance of payments crisis enabled by flawed institutional architecture and fed by policy responses that neglected its systemic nature. Fiscal imbalances are a symptom of deeper financial and external imbalances within the common currency. This means the crisis cannot simply be resolved by adjustment in affected countries in the periphery. Imbalances need to be addressed by both core and periphery economies.

- Europe is pro-actively dealing with its problems and taking steps to address the institutional challenges that have made it difficult to resolve the crisis, but this will take some time. While one speaker provocatively said that "Europeans will eventually find the right solution after trying out all the others", a number of participants were more optimistic about timelines and saw some hope in recent and current efforts toward a fuller economic and banking union.

- Fiscal adjustment in some periphery economies might be self-defeating. The pace at which economies are contracting and at which political opposition is rising – and sometimes giving rise to extremist ideology - is very worrisome. If this dynamic further undermines the political viability of much needed structural reforms, it could have a compounding negative effect on economic stability. As such, fiscal consolidation programs, despite having had impressive results on paper, might make things worse rather than better if forced to take place at an extremely rapid pace and not coupled with broader rebalancing within the entire Euro Area.

- Implications for Canada include the validation of our systemic approach to financial regulation; but some participants noted the need to avoid complacency and be sure we are ready for the next crisis, not the last one. Canada’s messaging to Europe in the G20 and beyond was praised as being appropriate in encouraging Europe to take effective steps to deal with its challenges, while noting that the continent is sufficiently rich to be able to find the required resources internally. There was also a call for Canada to carefully assess how Europe's economy is likely to be transformed -- both in periphery and core economies -- as a result of the crisis to ensure we adapt our trade and investment promotion efforts accordingly.

KEY POLICY RECOMMENDATIONS PERTAINING TO MACROECONOMIC AND FINANCIAL MANAGEMENT IN EUROPE:

(Once again, there was not necessarily full consensus around any of these recommendations)

- Additional reform is needed, including continued structural reforms (labour, product, and service markets) in both core and periphery economies; better macroeconomic policy coordination across the Euro area; and revamped EU financial sector oversight through the creation of a single supervisor, a single resolution mechanism and authority, and shared deposit insurance. The latter reforms are needed to restore the efficacy of monetary policy transmission mechanisms in the Euro Area periphery and mitigate the risk of capital flight.

- Once fiscal discipline is restored, some form ex ante or ex post risk sharing among Eurozone governments should not be ruled out. While liquidity support to national governments, either through the European Stability Mechanism (ESM) or the European Central Bank’s (ECB) Outright Monetary Transactions (OMT) program, is important, if government insolvency is instead the underlying malaise then additional sovereign debt restructuring (involving both official and private creditors) may be needed.

- Euro Area financial institutions remain significantly undercapitalized. While direct government support may be required at present to improve bank balance sheets, European leaders need to swiftly implement a common resolution framework capable of insuring that private sector ‘bail-ins’ and not public sector ‘bail-outs’ are relied on in the future to bolster financial stability.
BACKGROUND

The Eurozone Crisis was never supposed to happen. When the idea of European monetary union gained momentum in the late 1980s, the aim was to deepen the continent’s common market and further integrate Europe on the basis of fiscal discipline and policy coordination. Instead, the crisis has raised questions about the viability of the European project itself. The origins of this crisis are multifaceted, as are its social, economic, and political impacts. On February 6, 2013, the Canadian International Council (CIC) Ottawa Foreign Policy Initiative hosted its tenth seminar in partnership with the Department of Foreign Affairs and International Trade Canada (DFAIT) to better understand the Eurozone crisis and its implications for Europe and the world. The half-day session at DFAIT headquarters convened a select group of panellists and participants from Europe and North America for a not-for-attribution discussion.

INSTITUTIONAL INNOVATION

While the Euro remains a pillar of European political solidarity and economic integration, the Euro Crisis has exposed the internal contradictions and fault lines within its architecture – and serves as a reminder that the efficacy of intergovernmental and supranational governance requires legitimacy and acceptance by member states. As such, the long-term sustainability of both the Euro and the European Union (EU) demands greater institutional deepening and governance reform. Participants opined that the Treaty of Maastricht - the 1992 agreement creating the European Union and the basis for the single currency – has proven an inadequate framework for addressing the current crisis. It remains a poorly designed treaty that was the product of a geopolitical response to the reunification of Germany. It lacks binding force and has proven more adept at generating ‘peer protection’ rather than ‘peer pressure’. It has hindered a systematic response to a systemic crisis.

Optimistically, one panellist noted the “astonishing amount” of policy innovation that has occurred in response to the crisis - well beyond what was thought possible before the crisis. However, many also stressed that the crisis continues to demonstrate that Europe needs stronger macroeconomic policy coordination and deeper integration of financial supervision to complement its common monetary policy. A prominent European politician once observed that Europe is like a bicycle – you stop pedaling and you fall off. The solution lies in more Europe, not less. As such, periods of relative calm in financial markets must not lull European policy makers into complacency. They must keep pedalling.

In the drive towards greater European governance integration, several institutional problems will need to be addressed. First and foremost, there needs to be robust follow-through on past commitments. For example, as one participant noted,

“A prominent European politician once observed that Europe is like a bicycle – you stop pedaling and you fall off.”

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it remains to be seen how effective the new series of reforms (the ‘six pack’, ‘two-pack’, and Fiscal Compact reforms1) will be in disciplining national fiscal frameworks considering the constant target slippage witnessed during the crisis. More broadly, it was argued that new institutional arrangements must strike the delicate balance between the flexibility needed to address crises, and the discipline required to ensure the long-term viability of the European project. As discussants stressed, crises will happen, and institutions need to be built to manage these inevitabilities. In this regard, the European Central Bank’s new Overt Monetary Transactions (OMT) program and the launch of the European Stability Mechanism (ESM) last summer are important achievements. As a panellist noted, the OMT serves to complete the integration of monetary policy by removing the perceived risk of government illiquidity (a function that central banks traditionally perform), while the establishment of the ESM comes close to creating a genuine ‘European Monetary Fund’ capable of financing the adjustment of imbalances. The importance of the former cannot be over-stated. Countries which possess their own central bank and borrow in their own currency are less likely to experience the type of crisis currently facing European policy makers.

A wider theme of the seminar was the challenges inherent in the nature of policy coordination and the design of optimal policy frameworks. For example, a form of dynamic inconsistency is present in the tension between the longer term structural and governance reforms (e.g. labour market reform and increased fiscal policy coordination) that are needed to make the Eurozone a viable common currency zone; and the short-term imperative of restarting growth. These two goals can often push against one-another - without the latter taking shape there exists little political capital and social licence to undertake the former. Germany’s experience with labour market reforms in the early 2000s demonstrates that it often takes years for structural reforms to bear fruit. Additionally, as one panellist noted, a delicate balance must be struck between: (1) providing (positive and negative) incentives for member states to undertake the necessary fiscal and structural reforms and (2) ensuring that there is enough flexibility in the adjustment programs to take into account deviations from expectations in a member state’s economy and polity.

To overcome these challenges, greater trust must be (re)built between national capitals. As some participants argued, on the current trajectory, EZ leaders are risking a permanent schism between periphery and core nations – which could in time, undermine the entire European project.

1 See list of terms in the Annex.
INTERNAL AND EXTERNAL IMBALANCES

The dynamics of the Eurozone (EZ) Crisis bear witness to the immense difficulties in managing international monetary and economic relations in an era of high capital mobility and arguably unprecedented interconnectedness between national economies. The operation of a common currency demands an even higher level of macroeconomic policy coordination than that required at the global level. The Growth and Stability Pact, adopted in 1997 as a complement to the Maastricht Treaty, was designed to address this issue by preventing the development of unsustainable fiscal imbalances. However, its institutional mechanisms proved incapable of enforcing commitments – among small and large economies alike. As one participant noted, in the case of Greece, the governance frameworks in place even proved incapable of enforcing common statistical standards. However, while certain EZ countries can be accused of fiscal profligacy, many of the countries now at the heart of crisis, at the most, can only be criticised for not running larger fiscal surpluses during the boom years of the mid-2000s. If this is the benchmark for fiscal discipline then almost all OECD countries are guilty of this policy mistake, to varying degrees (see Figure 1).

Moving beyond fiscal issues, a more potent lens for understanding the crisis...

**Figure 2: External Imbalances lay at the heart of the crisis...**

![Graph showing current account (% of GDP) from 2000 to 2012 for various countries including Austria, France, Germany, Greece, Ireland, Italy, Netherlands, Portugal, Latvia, Spain. Denotes a country currently under an IMF, EC, and/or Troika Adjustment Programme. Latvia is not a member of the EZ, but it is on the ERM II (i.e. pegged to the Euro).](source: IMF WEO Database (October 2012))

However, as one discussant highlighted, despite near balanced budgets (or even surpluses), most of these countries were in fact running significant structural fiscal deficits. As such, more fiscal space should have been built - which would have allowed for stronger and ultimately affordable fiscal stimulus. Hence, as one participant noted, it would be incorrect to argue that the strict fiscal rules recently adopted in the Eurozone do not allow for traditional counter-cyclical macroeconomic policy.

Moving beyond fiscal issues, a more potent lens for understanding the crisis,

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2 A structural fiscal deficit is a statistic used to reflect the underlying position of fiscal policy. It is measured by taking the fiscal deficit and dividing it by an estimate of potential GDP, rather than current GDP. As such it smooth’s the measurement of deficits through the business cycle.
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many participants concurred, is through balance of payments and credit growth dynamics (See Figures 2 and 3 respectively; and Appendix I). It has long been known that a fundamental problem in most international monetary systems is that the burden of adjustment falls overwhelmingly on the deficit country; for if a surplus country is unwilling to off-set the aggregate demand loss of the deficit country, it suffers no discomfort in the short-term. As such, an efficient and symmetric adjustment mechanism between surplus and deficit countries is lacking, leading to a chronic deficiency in aggregate demand. Economists use the term ‘deflationary bias’ to refer to this phenomenon.

As discussants alluded to, this dynamic is currently on powerful display in the Eurozone. That the common currency’s governance structures focused solely on fiscal imbalances as opposed to private sector, financial, and external imbalances explains how such large imbalances were ignored during the boom years. For example, private sector credit growth (largely the result of massive intra-EZ capital flows) during the mid-2000s routinely exceeded 15 percent of GDP in Greece, Latvia, Estonia, Spain, and Ireland. These large capital inflows in turn spawned higher inflation rates, eroding competitiveness and engendering significant current account deficits. Given the small size and high degree of openness of many deficit nations currently in crisis, the adjustment needed is staggering. Under a fixed currency regime the only mechanism for such rebalancing is changes in relative price and productivity levels (i.e. ‘internal devaluation’). The former necessitates a long period of painful disinflation or outright deflation while the later requires politically sensitive reforms to labour, service, and product markets. The end result is the current economic and socio-political crisis.

While there was a difference of opinion on the matter, some participants struck a somewhat upbeat note by highlighting that Greece - one of the hardest hit economies of the Eurozone - appears to be through the worst of the fiscal and external adjustment process. For example, the country has

3 To the EU’s credit, a new ‘Macroeconomic Imbalance Procedure’ has been put in place to track key economic stocks and flows. This surveillance procedure establishes thresholds, which once reached trigger additional investigation and consultation with the member in question. If imbalances reach a ‘severe’ level, corrective action will be required though a rigorously enforceable action plan under the ‘Excessive Imbalance Procedure’. For more information, see: http://ec.europa.eu/economy_finance/economic_governance/macroeconomic_imbalance_procedure/index_en.htm

4 To put the size of Eurozone imbalances in perspective, on the eve of the global financial crisis the US was running a current account deficit of around 6 percent of GDP. However, this number was sufficiently large to trigger a multilateral effort by the IMF to address the growing size of global imbalances.

5 Because the ECB has a Eurozone-wide inflation target, which it was broadly able to achieve during the 2000’s, it was unable to respond to these large divergences in price levels between member states.
managed to move from a structural fiscal deficit of almost 19 percent of GDP to a projected deficit of 1.1 percent this year. On the external front, Greece has managed to move from a current account deficit of almost 15 percent in 2009 to a projected 2.9 percent this year (IMF, 2012). These are impressive statistics. However, what remains to be seen is 1) how much of a drag hysteresis effects will be on output growth; 2) whether the country’s remaining debt burden is manageable without additional restructuring; and 3) to what extent the improvement in the current account is cyclical versus structural. On the latter issue, one participant noted that most of the competiveness lost by Greece during the 2000s will have been clawed back by the end of this year. Unfortunately the same cannot be said for all of the periphery economies.

With the crisis being at its heart a traditional balance of payment and financial crisis, some participants argued that the under-consumption (and in some cases under-investment) in the EZ core should not be over-looked as a significant contributing factor. In short, core countries’ policy mixes – which arguably inadvertently fostered high national savings, low investment levels, and thus large current account surpluses – when combined with financial frictions and other market failures enabled the emergence of concomitant financial and external imbalances in the periphery; as these countries’ national balance sheets came under severe stress (See Figure 2). The divergence of unit labour costs across the EZ is but one symptom of this internal monetary dysfunction. This process was all the more enabled by a sanguine attitude on the part of periphery governments towards rising private (and in some cases public) debt levels. As one panellist noted, eventually private imbalances became socialized, as governments were forced to use fiscal policy to rescue their major financial institutions and attempt to offset the deleveraging of households and corporations.

As such, either the current account positions between the core and periphery must be significantly

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6 To varying degrees these three issues apply to all periphery countries in the Eurozone
7 However, it should be noted that the measurement of relative unit-labor costs (ULCs) are subject to serious methodological pitfalls.
8 It should be noted that intra-EZ imbalances only explain part of the divergence of core and periphery current account positions. As the region is highly open to international trade and finance, external factors (such as asymmetric terms-of-trade shocks) also played an important role.
narrowed (or even reversed) or the periphery must find a way to erode the value of its external debt (e.g. through default or restructuring)\(^9\). Alluding to the latter issue, one discussant opined that despite the importance of the ESM, it remains solely a governance mechanism designed to support government liquidity. However, if government insolvency is the underlying malaise (as it has become in Greece) then further private and/or official sector debt restructuring may be needed\(^10\).

As a few discusants opined, the immense difficulty in rebalancing the Eurozone is a reflection of the unsustainability of pre-crisis growth dynamics; with periphery and core countries contributing to, and indeed even embracing, the growing imbalances. The result is the current misshapen structure of Eurozone economies: with the core characterized by very large export sectors and the periphery by equally large service and non-tradable sectors.

More broadly, some participants, argued that it is time for core countries to reciprocate for the painful reforms and fiscal consolidation accepted by the periphery. To aid the process of rebalancing, core countries may need to commit to reflate through a variety of policy measures and broad-based wage growth. Efforts to increase consumption, promote investment (which in many core countries lags the OECD average) and reform service sectors could also increase potential GDP — which would benefit both core countries and their periphery trading partners. On the monetary front there is also a need for core countries to accept in the short term higher inflation: comparable to that which prevailed in EZ periphery during the 2000 to 2008 period. Targeted Eurozone-wide infrastructure investment, funded through a joint special purpose vehicle, was another possible option discussed by participants. Once fiscal discipline is restored, the possibility of ex ante and/or ex-post risk sharing through the mutualisation of some public debt should not be ruled out.

Also, because target slippage has become a serious problem and continues to undermine market confidence, one panellist argued that periphery countries should be given greater room to breathe by extending, in a highly credible manner, the current timelines for fiscal consolidation. Without this change, adjustment fatigue may set in. As another panellist noted, with a large proportion of EZ countries attempting to push up their national savings rate and a majority of national private sectors (in both the EZ core and periphery) only mid-stream in the process of deleveraging, the austerity packages currently being implemented in the periphery could easily become self-defeating. If this dynamic further undermines the political viability of much needed structural reforms, it could have a compounding negative effect on economic stability. The free-fall in Greek GDP, and accompanying heightened social tensions, is a potent example of this potential reality. In both core and periphery countries the political feasibility of implementing the necessary policy packages remain highly uncertain, however.

On financial imbalances, discussants remained concerned that leaders have yet to admit the extent to which large-scale bank recapitalization is needed — and not simply in the EZ periphery (See Figure 4). In short, ‘zombie banks’ cannot be expected to extend new net credit. Some smaller countries (e.g. Ireland) were forced early on to apply for international assistance in order to restructure their largest institutions. However, unlike their American\(^11\) and British counterparts, the

\(^9\) This could occur through many different channels. Internal devaluation and changes in relative productivity, as mentioned above, are two such means for this to occur.

\(^10\) Note that the ECB holds billions of dollars of periphery debt on its balance sheet. Under existing rules, any capital losses by the institution through official sector involvement (OSI) in debt restructuring become liabilities of EZ governments.

\(^11\) For example, there is no European-wide program comparable in scale or scope to the US’ Trouble Asset Relief Program (TARP).
The vast majority of Eurozone member states are only now beginning to comprehensively address the impaired balance sheets of their financial institutions. Banks in periphery countries continue to barely tread water under the weight of the credit growth which occurred between 2000 and 2008. The situation is exacerbated by the fact that the ‘safe assets’ held by these institutions are the debt securities of their own distressed sovereigns. These dynamics have led to a self-reinforcing ‘doom-loop’ between banks and sovereigns which continue to impair the transmission mechanisms – or in the words of ECB President Mario Draghi the “one-ness” - of the ECB’s monetary policy.

As a result, despite two rounds of unconventional monetary policy (i.e. the Long Term Refinancing Operation [LTRO] programs), interest rates approaching the zero lower bound, and the announcement of the ECB’s new OMT programme, periphery countries continue to operate in a tight monetary policy environment – all while money market rates continue to flirt with negative territory in the EZ core. With fiscal policy creating a drag on economic expansion, the need for offsetting accommodative monetary conditions is essential – as many participants noted. To alleviate this constraint to adjustment, EU leaders – it was argued - need to commit to finally revamp EU financial sector oversight through the creation and swift implementation of a single supervisor, single resolution mechanism and authority, and shared deposit insurance. The latter is required to stop the continued slow motion bank run that is seeing capital flow out of the periphery and into the core. Recent events (2013) in Cyprus underscore this point vividly. Monetary union must be supported and complemented by banking union. Only once the perceived ‘convertibility risk’ is removed, will the effectiveness of monetary policy in the periphery be restored.

Discussants also argued that any comprehensive resolution framework must include mandatory minimums on specific forms of subordinate debt for financial institutions’ capital structures. This would help ensure private sector ‘bail-ins’ and not public sector ‘bail-outs’ are used in the future to support distressed institutions. Such subordinated debt would be structured to convert into equity once certain contingencies were reached (with the objective of forestalling chaotic liquidations and thereby helping support asset values); and be supported by resolution funds raised from a levy on financial institutions. The higher market yield on such forms of subordinated debt would also help internalize the risk which certain financial activities pose to the broader economy and in doing so hopefully incentive lower levels of leverage. EU leaders have taken important initial steps towards achieving these reforms, as recent events in Cyprus suggest. However the slow pace of implementation and general confusion over what approaches to bank resolution will be taken in the future continues to undermine market confidence.

**SOCIAL AND POLITICAL INSTABILITY**

While the Euro crisis is first an economic crisis, it has had important social and political consequences. Much of the focus has been on the austerity measures imposed on Greece and other bailed-out countries as a condition for large financing packages. The political and social upheaval caused by this rapid contraction - particularly the shedding of public and private sector jobs – is significant. Younger workers are facing unemployment rates of nearly 50%. Additionally, as one panellist noted, between 2/3rds and 3/4th of those surveyed in periphery countries have felt "personally affected by the crisis." In Portugal, nearly 90% perceive an imbalanced economic system (GMF, 2012). This has led to the rise of several "anti-establishment" parties in Europe on both the political right and left. There remains a high degree of political alienation, which goes to the legitimacy of the EU itself.

There are some reasons for optimism, however. As one panellist reflected, in national elections in Europe, despite the presence of extreme parties, centrist views have largely carried the day, though the recent results of the March 2013 Italian elections and events in Cyprus remind how fragile the political and social consensus remains. While much of the media focus has been on the unacceptably high levels of youth unemployment in the Eurozone periphery, numbers are
actually comparable to other developed countries. Figures of 50% youth employment are misleading - a better statistic is the number of "idle youth" as measured by the OECD’s 'not in employment, education or training' (NEET) statistic for those aged 15-24. As one panellist stressed, on this measurement in Q1 2011 the United States (14.8%) actually had a higher rate of youth unemployment than the EZ average (~13.2%). Two of the hardest hit countries – Spain and Ireland – had slightly higher ratios at 17.6% (OECD, 2012b). Although conditions have continued to deteriorate in many countries, these statistics highlight that this is not a European Union specific problem; but rather, as in much of the developed world, it is the legacy of the stressed private balance sheets wrought by the boom years preceding the global financial crisis.

There remain no clear solutions. However, as one panellist argued, "After the firefighters, you need the architects." The goal is ultimately to have more Europe, but this does not necessitate building a United States of Europe. The EU will never be a classic federation, nor does it need to become one in order to resolve its current problems. Instead it will remain a unique hybrid somewhere between a federal state and a free trade area. However, these realities do not remove the necessity of further democratic reforms to match the institutional deepening currently underway in Brussels. Citizens will only submit to a supra-national authority if they view such institutions as legitimate. Failure to admit and address this fact will only plant the seeds of future crises.

**IMPLICATIONS FOR CANADA**

- **Messaging within the G20 and beyond**: Canada’s economic and financial strength and co-chairmanship of the Working Group on the G20 Framework for Strong, Sustainable and Balanced Growth make it a particularly influential and credible member of the G20. Its actions and messaging on Europe can therefore play a role in encouraging the EU to adopt policies that will help resolve the crisis. Most participants were of the view that Canada’s messaging was adequate and that there is a need to continue to apply pressure on Eurozone leaders. The Canadian position has been clear from the beginning of the crisis: Europe is a wealthy continent and has the financial resources, if deployed properly, to manage the crisis by itself. The IMF has an important role to play – particularly in designing adjustment programs and facilitating agreement between stakeholders - but the rules governing the scale of resources it is allowed to provide to members must be observed. Allowing exceptions for European members risks undermining the legitimacy of the institution in the eyes of many of the Fund’s major stakeholders, of which numerous were forced to accept painful adjustment programs in the past.

- **Possible changing bilateral trade and investment patterns**: Canada’s direct exposure to the crisis, while not insignificant, is not large, according to one discussant, who said that Canada will be impacted to the same extent the global economy is impacted by the crisis; no more, no less. However, it is important to note that Canada faces indirect financial and trade risks through the exposure of its major trading partners (e.g. China and the US) to Europe. Through these channels the ongoing crisis continues to dampen external demand for Canadian products and impact investment opportunities. However, the resiliency of the Euro’s value on foreign exchange markets – while certainly exacerbating the restructuring of EZ periphery economies – has also allowed Canadian goods and services to remain competitive. Indeed, a number of participants expressed surprise at how resilient the Euro has been given the intensity of the crisis. The
dramatic restructuring of some national economies (including the shifting relative weights of tradable and non-tradable sectors) in the Eurozone, could potentially transform the structure of Canada’s traditional commercial relations with individual EZ economies. It is important to note that not only periphery economies will change as a result of the crisis. Core economies will also likely be impacted by bank deleveraging and recapitalization and gradual Europe-wide rebalancing as a result of falling unit labour costs in periphery economies, and possibly higher inflation and dampened demand for exports in core economies. This will have implications for the future evolution of Canada’s trade and investment relations with all European economies.

**Opportunities and lessons for Canada’s financial sector:** In the aftermath of the global financial crisis Canadian banks made significant inroads into the US market. Given the lending constraints faced by much of Europe’s financial services sector, a similar opportunity might now be available in Europe. While the Canadian financial system fared well during the global financial crises, one panellist stressed that the Eurozone crisis serves as an important reminder that Canadian authorities responsible for micro and macro-prudential regulation must avoid complacency.

Canada’s approach to systemic financial stability management has proven effective; however, given the concentration in its financial services industry and universal nature of its institutions, the ‘too-big-to-fail’ issue is just as relevant in the Canadian context as in other jurisdictions. The message of many participants was clear: Canada cannot rest on its laurels when it comes to financial stability management.

**Lessons for the economic management of the federation:** Some participants noted possible parallels between provincial-federal economic relations in Canada and ongoing dynamics in the Eurozone. Discussants also reflected on what lessons Canada’s history with ‘monetary union’ and sovereign debt guarantees might hold for the Euro area; with some arguing that Canada’s monetary union has been made workable through the existence of a strong federal fiscal authority, a central bank capable of lending fully in last resort, an effective collaborative approach to banking supervision, common deposit insurance, and concerted efforts to promote factor mobility. There might well be lessons that Europe could learn from Canada’s experience and vice-versa, but the discussion during the seminar was fairly preliminary given the huge difference in institutional arrangements on both sides of the Atlantic. There were no firm recommendations from participants but certainly an interest in further investigation of how best practices and lessons learned could be shared between the EU, its member states, and Canada’s federal and provincial governments.

**Canada-Europe as global partners:** While recognizing Europe’s weight and critical importance on the world stage, some participants wondered if the crisis could make it a less influential actor and partner in foreign affairs and defence matters. One panellist even said that the EU ‘doesn’t have a functioning foreign policy’ at present. However, most participants were of the view that when Europe is able to ‘put its house in order’ it will likely emerge on a far more stable footing than before the crisis and that a more politically unified Europe, bound together by the shared experience of its current crisis, will remain an indispensable ally for Canada and the US in shaping the future of global norms and rules.

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12 Under the rules which govern monetary policy in the Eurozone, the ECB can only lend in last resort to financial institutions on the highest quality of collateral. Lending on lower quality collateral – under the Emergence Liquidity Assistance (ELA) plan – to illiquid institutions is the responsibility of national central banks, subject to approval by the Governing Council of the ECB. Any potential losses incurred under ELA lending are a contingent liability of the respective national government – as events in Ireland and Cyprus underscore. This remains one of the distinctive differences between monetary union in the EZ and traditional monetary unions like Canada.
CONCLUSION

The European narrative has been one of greater continental interdependence within a globalizing context, under the common umbrella of exporting economic and political liberalism, the rule of law, and democracy. Reflecting on this legacy, participants agreed that despite current challenges, Europe remains one of Canada's most crucial economic and political partners. However, there was also a recognition that the current crisis is sometimes leading to the perception of a very different Europe, especially for some of its youth. As many young people now view Europe as moving back on its core integration narrative, they increasingly blame the EU for current bleak youth employment prospects rather than find inspiration in the old integration narrative as was the case for the "Erasmus" generation. This is leading many of them to want to emigrate out of Europe altogether (including to places like Canada) rather than simply move within the EU. There was strong unity among seminar participants in the belief that Europe will be able to overcome its challenges and emerge stronger; but there were also equally strong and urgent calls for leadership, vision and commitment to the ideals that have served Europe so well during the last half century and which were so appropriately recognized when it was awarded the Nobel Peace Prize in 2012. This is a very timely reminder of the need to focus on what unites Europe in challenging times.

ACKNOWLEDGEMENTS

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ABOUT THE AUTHORS

Kevin English is a recent graduate of the M.A. in Global Governance program at the Balsillie School of International Affairs (BSIA) and a former junior fellow at the Centre for International Governance Innovation (CIGI) in Waterloo, Canada. His academic and policy research focuses on international monetary system reform, global imbalances and the G20 summit process. He currently works as a policy analyst at Foreign Affairs and International Trade Canada (DFAIT).

John Burnett is a Legal Officer in the DFAIT Legal Bureau and member of the Canadian International Council (CIC). He has degrees from the University of Toronto, McGill University, and Columbia University School of International and Public Affairs (SIPA), including concentration on public international law, supra-national institutions, and global collective action.

WORKS CITED


AFTER THE EURO CRISIS – PROSPECTS FOR EUROPE AND BEYOND

Wednesday, February 6, 2012
Lester B. Pearson Building,
125 Sussex Drive, Ottawa

Chatham House Rule

8:30  Arrival & coffee

9:00  Introduction

Dan Costello, Director General Policy Planning Bureau, DFAIT
Robert Hage, former Ambassador to Hungary & Slovenia and Deputy Head of Mission to the European Union

9:10  Causes & Management of the Euro Crisis; Impact on European Integration

Chair: Paul Jenkins, former Senior Deputy Governor, Bank of Canada; Distinguished Fellow, Centre for International Governance Innovation

Manfred Zöllmer, Member of the German Parliament Finance Committee
George Pagoulatos Professor of European Politics & Economy, Athens University; Senior Advisor to Prime Minister Papademos 2011-12 (by video conference)
Constanze Stelzenmueller, Senior Transatlantic Fellow, German Marshal Fund

9:55  Discussion

10:30 Break

10:45  Repositioning: Impact of the Euro Crisis on Canada, the United States and the Global Economic and Political Order

Chair: Patrick Leblond, University of Ottawa

Malcolm Knight, advisor to Deutsche Bank and Swiss Re Ltd., New York; visiting professor, LSE; CEO Bank for International Settlements, 2003-08; Senior Deputy Governor, Bank of Canada, 1999-2003
Jacob Kirkegaard, Senior Fellow, Peterson Institute, Washington; Senior Associate, Rhodium Group, New York; previously with Danish Ministry of Defence

11:30 Discussion

12:15 Conclusion

Alan Bowman, Director, Policy Research Division, DFAIT
Craig Hunter, Co-Chair, CIC Ottawa Foreign Policy Initiative
CHAIR AND PANELIST BIOGRAPHIES

Paul Jenkins is Distinguished Fellow at the Centre for International Governance Innovation. His current research focuses on international policy coordination and financial stability. In 2011, he co-authored the special report, *Preventing Crises and Promoting Economic Growth*, with Paola Subacchi, Chatham House’s director of international economics research. Paul received his M.Sc. in economics from the London School of Economics and Political Science in England and his B.A. in economics from the University of Western Ontario in London, Canada. From 2003 to 2010, Paul served as senior deputy governor of the Bank of Canada. In addition to his position at CIGI, Paul is a member of the board of governors of the University of Western Ontario; senior distinguished fellow in the Faculty of Public Affairs, Carleton University; and a senior fellow, C. D. Howe Institute.

Jacob Funk Kirkegaard, has been a senior fellow at the Peterson Institute since 2002. He is also a senior associate at the Rhodium Group, a New York-based research firm. Before joining the Institute, he worked with the Danish Ministry of Defense, the United Nations in Iraq, and in the private financial sector. He is a graduate of the Danish Army’s Special School of Intelligence and Linguistics with the rank of first lieutenant; the University of Aarhus in Aarhus, Denmark; and Columbia University in New York. He is coeditor of *Transatlantic Economic Challenges in an Era of Growing Multipolarity* (2012) and author of *The Accelerating Decline in America’s High-Skilled Workforce: Implications for Immigration Policy* (2007) and coauthor of *US Pension Reform: Lessons from Other Countries* (2009) and *Transforming the European Economy* (2004). His current research focuses on European economies and reform, pension systems and accounting rules, demographics, offshoring, high-skilled immigration, and the impact of information technology.

Malcolm Knight was Vice Chairman of Deutsche Bank Global Group and currently serves as an Advisor. Concurrently, Dr. Knight is Visiting Professor in Finance at the London School of Economics and Political Science and a member of the board of directors of Swiss Re Group AG. Dr. Knight served as General Manager and Chief Executive Officer of the Bank for International Settlements during 2003-2008. From 1999 to 2003 he was Senior Deputy Governor of the Bank of Canada. From 1975 to 1999 Dr. Knight was with the International Monetary Fund, where he held senior positions in both research and operations. From 1971 to 1975 he taught at the University of Toronto and the London School of Economics and Political Science. Dr. Knight holds an Honour BA in Political Science and economics from the University of Toronto, and MSc (Econ) and PhD degrees in economics from the London School of Economics and Political Science. He has published widely in the fields of macroeconomics, international finance and banking.

Patrick Leblond is an Associate Professor at the University of Ottawa. His expertise concerns questions relating to global economic governance and international and comparative political economy, more specifically those that deal with international finance, international economic integration as well as business-government relations. His regional expertise focuses on Europe and North America. Before joining the University of Ottawa in 2008, Patrick was assistant professor of international business at HEC Montréal and director of the Réseau économie internationale (REI) at the Centre d’études et de recherches internationales de l’Université de Montréal (CERIUM). He was also visiting scholar at the Institute for Research on Public Policy (IRPP). Before embarking on his academic career, Patrick worked in accounting and auditing for Ernst & Young (he holds the title of Chartered Accountant) as well as in corporate finance and strategy consulting for Arthur Andersen & Co. and SECOR Consulting.

George Pagoulatos is Professor of European Politics and Economy at the Department of International & European Economic Studies, Athens University of Economics & Business and Visiting Professor at the College of Europe in Bruges. In 2011-12 he was Senior Advisor to the Prime Minister and Director of Strategic Planning, Office of the
Prime Minister Lucas Papademos. He holds a Law degree from the University of Athens, M.Sc. and D.Phil. in Politics from the University of Oxford, where he was a Rhodes Scholar. His research and publications focus on the EU and Southern European political economy, European integration, economic governance, the political economy of banking and finance, politics of reform. He is a member of the High Council of the European University Institute in Florence, and has served in the past as member of the Greek government’s Council of Economic Advisors. He has lectured at several universities including Oxford, LSE, Harvard, Yale, New York University, and Princeton, where he was a postdoctoral fellow (1998–99). His book *Greece’s New Political Economy: State, Finance and Growth from Postwar to EMU* received the Academy of Athens award for best book in economics.

**Constanze Stelzenmüller** has been a Senior Transatlantic Fellow with the German Marshall Fund of the United States in Berlin since 2009. Before, she served as the director of the Berlin office from 2005 to 2009. From 1994 until 2005, Constanze Stelzenmüller was an editor in the political section of the Hamburg weekly DIE ZEIT. From 1998 onwards, she was defense and international security editor; previously, she covered human rights issues, humanitarian crises in Africa and the Balkans, as well as international criminal tribunals. Stelzenmüller holds a doctorate in law from the University of Bonn (1992), a Master in Public Administration from the Kennedy School of Government at Harvard University (1988), and a first state examination in law from the University of Bonn (1985). From 1988–1989, she was a Visiting Researcher at Harvard Law School. She was a GMF Campus Fellow at Grinnell College in Iowa, a Woodrow Wilson Center Public Policy Scholar in Washington, DC, and a member of the Remarque Forum (a conference series of the Remarque Institute at New York University). Constanze Stelzenmüller’s dissertation (“Direkte Demokratie in den Vereinigten Staaten von Amerika”) was published in 1994 by Nomos. Essays and articles by her have appeared as GMF publications, as well as in *Foreign Affairs*, *Internationale Politik*, the *Financial Times*, the *International Herald Tribune* and *Süddeutsche Zeitung*. She is a regular guest in American and European TV and radio shows, e.g. in Presseclub (ARD), National Public Radio and the BBC. Stelzenmüller chairs the academic advisory board of the German Foundation on Peace Research (DSF). She is chairwoman of the German section of Women in International Security, WIIS.de. She is a member of the advisory board of the Protestant Academy of Berlin-Brandenburg, and a governor of the Ditchley Foundation.

**Manfred Zöllmer** has been a member of the German Bundestag for the Social Democratic Party (SPD) since 2002. He currently serves on the Finance Committee and is a deputy member on the Committee on Economic Cooperation and Development. Mr. Zöllmer is also a member of the SPD parliamentary committees on Finance and on Global Economy. He serves on the Administrative Council of the Federal Financial Supervisory Authority. Prior to his federal political career, Manfred Zöllmer was a teacher at an adult high school and a member of the city council of Wuppertal (1989 – 2002).
## ANNEX: LIST OF FREQUENTLY USED TERMS

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<th>Term</th>
<th>Description</th>
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<tr>
<td><strong>The Eurozone</strong></td>
<td>A monetary union covering 17 of 27 European member countries. Monetary policy for these 17 countries is set by the European Central Bank in Frankfurt, German. Members of the Eurozone include: Austria, Belgium, Cyprus, Estonia, Finland, France, German, Greece, Ireland, Italy, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia, and Spain. A further 5 small European countries also use the Euro, but have no role in its governance.</td>
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<td><strong>Economic Adjustment Programme</strong></td>
<td>The official name given to the ‘bailouts’ and reform packages provided to struggling Eurozone members. Financing has been provided by a series of investment vehicles operated by the EU/Eurozone (in tandem with financing from the IMF) since the beginning of the Eurozone crisis. These include: the European Financial Stability Mechanism (EFSM), the European Financial Stability Facility (EFSF), and the newly-created (and permanent) European Stability Mechanism (ESM). To date five Eurozone Members have received (or are in process of negotiating) financing from one of these three investment vehicles. These countries are: Greece, Ireland, Portugal, Spain, and Cyprus. Latvia, a member of the European Exchange Rate Mechanism II (ERM II) and hence pegged to the Euro (and which recently voted to formally adopt the currency), also requested a joint IMF-EU programme following the Global Financial Crisis.</td>
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<td><strong>Eurobonds</strong></td>
<td>A form of risk-sharing in which the Eurozone (EZ) countries would individually or collectively issue debt instruments explicitly backed by the full-weight and trust of the entire currency bloc. Because such securities would result in one interest rate for the entire Eurozone, it has been argued that their utilization would result in an indirect transfer of wealth from core countries (with strong credit ratings) to periphery countries (with weaker credit ratings). However, it can also be argued that the current ‘artificially’ high interest rates in the periphery, paired with the ‘artificially’ low interest rates in the core have led to a transfer of wealth from the periphery to the core.</td>
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<td><strong>European Stability Mechanism (ESM)</strong></td>
<td>An investment vehicle designed to provide liquidity support to Eurozone members experiencing severe budgetary, financial sector, or balance of payments problems. Loans from this fund are usually attached to a reform or conditionality programme designed jointly by the European Commission, the ECB, and the IMF (collectively known as the Troika). To date, the ESM can only lend directly to governments and cannot directly recapitalize financial institutions. This has become an important issue of contention between members. Combined with funds already issued by its predecessor institutions (the EFSF and EFSM), the ESM has resources totally 700 BN Euros.</td>
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<td><strong>Internal Devaluation</strong></td>
<td>A form of real exchange rate depreciation in which the adjustment occurs through changes in relative price levels between countries rather than through the nominal (or market) exchange rate. This often requires the deficit country (i.e. the country undertaking the devaluation) to undergo deflation or disinflation. The result is usually a sustained period of economic contraction or stagnation relative to if adjustment occurred through traditional nominal exchange rate devaluation. In theory, if the surplus country is willing to inflate (through domestic economic expansion) while the deficit country is deflating, the burden of adjustment can be shared. The absence of such a symmetric adjustment mechanism has become a matter of heated debate within the Eurozone.</td>
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<td><strong>Fiscal Union</strong></td>
<td>The integration of the spending and taxation policies of ‘sub-national’ units under the auspices of a single ‘supra-national’ or national institution. In the case of the EU and/or Eurozone this would most likely occur by transferring a certain degree of control over fiscal policy to the EU Commission or another EU institution. Fiscal unions are often designed to allow direct or indirect transfer payments from wealthier regions to poorer ones (e.g. Canada). In the case of EZ this could occur through the issuance of Eurobonds by national governments or built-in progressivity of a common fiscal budget.</td>
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<td><strong>Banking Union</strong></td>
<td>The integration of financial supervision, regulatory, and resolution powers under a single or set of national or supra-national governance institution. Banking unions usually are characterized by a large degree of risk-sharing in the form of common deposit insurance and shared exposure to any bank recapitalization programs. Banking Unions are often argued to be the natural complement to a monetary union.</td>
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<td><strong>Troika</strong></td>
<td>A term used to describe the joint undertakings of the European Commission, the European Central Bank, and the International Monetary Fund. During the EZ crisis the three institutions have taken joint ownership over providing financial assistance to weaker EZ members and crafting the conditionality programmes attached to these resources.</td>
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<td><strong>Outright Monetary Transactions (OMT)</strong></td>
<td>A new monetary program established by the European Central Bank under the leadership of Mario Draghi. The stated aim of the OMT program is to re-establish the ‘oneness’ of monetary policy within the common currency. In other words, the program is designed to remove the component of the risk premium attached to periphery bond yields that is owed to the doubts of market actors over the future survival of the Eurozone. Once activated, the ECB will intervene in the open market to hold down the yields on the government securities of the requesting country. The program has yet to be utilized, and any future use will be contingent on the requesting country agreeing to a comprehensive reform package with the EU Commission (and potentially the IMF).</td>
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**Balance of Payments (BoP)**

The terms refers to the statistical system through which economic transactions occurring during specific time periods between an economy and the rest of the world can be summarised in a systematic way (official IMF definition). The BoP is devised as a national balance sheet comprised of two offsetting columns: one encompassing transactions on the current account (trade in goods and services, and net international investment income) and a second encompassing transaction on the capital account (trade in financial and real assets). A country that is said to be experiencing BoP difficulties is one that is struggling to successfully fund a current account deficit through access to international capital.

**European Fiscal Compact (or Fiscal Stability Treaty)**

An intergovernmental treaty currently signed by 25 of the 27 EU member countries and all of Eurozone members. It is designed to be a more rigid version of the previous Stability and Growth Pact. Its overarching goal is insure appropriate fiscal discipline of EU members. Once fully in effect, the treaty will require countries to maintain fiscal deficits below 3% of GDP, gross government debt below 60% of GDP, and structural fiscal deficits below 0.5-1.0% of GDP. The regulations contained within the treaty are enforceable by the European Court of Justice through the imposition of penalties – up to a maximum of 0.1% of GDP. All future ‘bailouts’ through the ESM will be contingent on the applying country’s ratification and implementation of the treaty.

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**ABOUT THE SPONSORS**

The objective of the CIC Ottawa Foreign Policy Initiative is to engage government decision makers in a dialogue on important foreign policy issues with outside experts from Ottawa and beyond. A volunteer organisation, we do this mainly through private seminars, public seminars and periodic conferences. The initiative is supported by a grant from the International Development Research Centre and the guidance of an advisory council chaired by Mel Cappe.

The Friedrich-Ebert-Stiftung is a non-profit German political foundation committed to the advancement of public policy issues in the spirit of the basic values of social democracy through education, research, and international cooperation. The foundation, headquartered in Bonn and Berlin, was founded in 1925 and is named after Friedrich Ebert, Germany’s first democratically elected president.
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