# The Eurozone Crisis and Global Monetary Reform: A Conversation

*Robert B. Zoellick and Sebastian Mallaby*

*Sebastian Mallaby:* We are here to talk to Bob Zoellick. I have been in Washington 16 years, Bob is the personification of the kind of silo busting polymathic energy which says, I am not just interested in international economics, I am not just interested in international relations, I am not just a U.S. government official, I am also going to do multilateral diplomacy. So Bob has been on all sides of those various divides. He has a voracious intellect, so it is always interesting to speak with him whether he is in office or out of office.

## The Eurozone Crisis

Let's start with Europe, since Europe is on everybody's minds. This is a monetary policy conference. I think there might be some monetary policy lessons that come out of this mess. Questions about what will and won't work as an optimal currency area might be one set of questions. But let me ask you, what do you see as the lessons coming out of the European crisis?

*Robert B. Zoellick:* Well first Sebastian, thank you for doing this, and I thank Cato for the invitation. When I was the trade representative from 2001 to 2005, I used to interact with Sebastian, but always appreciated Cato as one of the last free traders in Washington. So I

---

*Cato Journal*, Vol. 32, No. 2 (Spring/Summer 2012). 

Robert B. Zoellick is President of the World Bank Group, and Sebastian Mallaby is a Senior Fellow at the Council on Foreign Relations. This "conversation" took place at the Cato Institute's 29th Annual Monetary Conference, November 16, 2011, in Washington, D.C. These remarks have been edited for publication.

very much appreciate the support you always had on the trade agenda, as important now as ever, I would say.

On the European issue right now, I said in August, and I hold to this, I think we are in a danger zone. We have a combination of three issues: a banking issue, a sovereign debt issue, and a competitiveness issue related to the monetary union. And I think so far the European countries have tended to address these, sort of, a day late and a euro short. And, by and large, they have been trying to provide liquidity measures and some of the fundamental issues still have to be addressed.

I think one of the best ways to frame the agenda now is to relay a description of the eurozone problem that one of the German officials said to me after the meeting in late October. He highlighted five elements that have to move together to be able to help address this problem.

The first was that of building bank capital, obviously the case. But from a broader policy view, and this is something we are working on at the World Bank, one has to recognize that banks can improve their leverage ratio in one of two ways: either add capital or lower assets. And so one has to expect, and we are already seeing, for example, trade finance, which is very important and easy to run off. However, it is a short-term product, and it is also a very labor, and organizationally, intensive product—so it is not so easy to replicate. Banks in central and eastern Europe, in the Balkans, which are often linked with European banking systems, are vulnerable. And I think, just in general, you are going to see a broader deleveraging process.

Second is the forgiveness of the Greek debt. Time will tell whether that is a significant enough amount. And a lot of this obviously relates to the Greek policy actions. In a way, Greece is truly a peripheral issue at this point because Greek GDP is only about 2 percent of EU GDP, and there is a funding mechanism to keep rolling Greek debt over.

But the real issue then goes to the third element, which was that Europe was trying to create a European Financial Stability Facility (EFSF) of about $600 billion. This agency was to provide funding to roll over debt in Greece, Portugal, and Ireland, which has been doing better in any event. But the real core issue, and this is the core issue we have seen break over the past seven days, is to be able to assist Italy and Spain with the rollover. And the idea, in late

October, was that the European countries would multiply this in some fashion. One of the ideas was to use this money as, in a sense, a first-loss insurance provision. It might have worked, but it has kind of drifted.

And so you are really now in the fourth issue, namely, the actions that are going to be taken by the governments in Italy and Spain. This is, I think, also indicative of a larger change we have seen in Europe, which is that what markets started to do, at least in my view, in August, was start to move away from just making economic and financial calculations to making judgments about governance. In effect, what you saw with the Berlusconi government is even if they talked about various plans, there wasn't confidence that they would be followed through. The challenge now—what markets are really questioning—is whether the Monti government, or the Spanish government after the elections, will follow through. To give you a sense of validation of this, I just came back from London and Berlin. And in London, if you go back and you look at the British debt to GDP ratio, or budget deficit, numbers aren't so good. But because the government has quite firmly convinced people of the path, Britain's public debt actually has become a safe-haven investment. So what we are seeing right now is, in a sense, a bit of a slow motion run as people are uncertain about that sovereign debt, and obviously the banks that hold the debt, and all the liquidity aspects of this.

And the fifth piece, which would complement the monetary union, is what Chancellor Merkel at her party conference (the CDU Conference over the weekend) referred to as "political union"—or what might be called "fiscal union" on this side of the Atlantic.

These issues are similar to those faced by Alexander Hamilton. But, there is one other aspect that I want to underscore, because even at a monetary conference I think it is useful to come back to this. All these measures are about liquidity and buying time. Now I am not against buying time as a policy official, but it is a question of how you use the time. And ultimately, there have to be policies that create the foundations for growth. I am not talking about macroeconomic policies; I am talking about policies that create the right investment environment, the deregulatory environment, the structural growth environment, the innovation. And that is still a very open question here, whether Europe will get on this agenda.

I will make one last observation, just because it is coincidental. I have had a number of meetings with members of Congress over the past couple of days, including one this morning. And one other takeaway that I will just share with you was when I was at the Cannes G20 meeting. I have been to a lot of these summits, a lot of these meetings. I had a very uncomfortable feeling watching the eurozone members and the other EU members basically flail around with a group of emerging markets that are now part of the G20. Fifteen years ago these were countries subject to the IMF programs. And basically you could feel, in a courteous way, there was a feeling somewhat between pity and contempt for Europe being unable to deal with this crisis. And I will just say, while I am in a multilateral post, and as an American I will just say: I never want the United States to be in this position, because the implications of this—the implications of monetary affairs toward power and perceptions of power—are quite significant. And this is going to be another element of what comes out of this autumn's events.

## *The Role of Germany*

*Sebastian Mallaby:* Let me just drill down a bit on Germany because you know Germany very well. And, at the CDU Conference, they have just introduced the objective of redoing the European Treaty, to some extent, and they have set a deadline at the end of next year. Their vision seems to be that this is the biggest challenge since the Second World War and that they need to rise to the challenge. They hope to have a directly elected president for Europe.

It appears that there is a massive mismatch between the aggression of the vision for a unified Europe and the willingness to commit short-term resources to get anywhere. What is going on with that? I mean, would you expect them to be more willing to transfer resources in the short term to keep the show on the road if in the long term they want to be a united Europe?

*Robert B. Zoellick:* Well, be a little patient with me because I have been reflecting on this a lot. I have been in Germany twice in the past three or four weeks and I stay in touch with a number of German friends, in and outside the government. And I think Germany is going to be the critical question going forward on this.

One aspect is Germany has taken a series of positions that, at least in my view, individually are reasonable. But I am not sure they will add up with the vision that Germany has. Now let me be more specific. Unlike the Federal Reserve, the European Central Bank is not truly a lender of last resort. It is not set up that way. It is legally not supposed to perform that role. So while it can intervene, and did intervene with these bond markets, it is not willing to be there to buy Italy and Spain out of their problems. And the Germans as a country, and the Bundesbank in particular, feel this very strongly. And this is where it gets to the notion of a fiscal and monetary union. Part of this is the traditional German fear of inflation, but part of it is a sense that they don't want to avoid the fundamental reforms that these countries have to make.

A second approach would be to provide more liquidity through the EFSF. And here again Germany said, "We put in a big sum of money (a couple hundred billion dollars). That's enough."

A third approach that came up, for example at the G20 meeting, was whether you have another issuance of SDRs, and Europeans might put the SDRs in the EFSF. Here again, the Bundesbank said, "No." The question is: Could you leverage the EFSF more? And they said, "Well, that is also risky to credit." Each of these positions is, in my view, respectable and responsible. However, I think there is going to be a fundamental disconnect with the nature of the European Monetary Union. So, not to put too fine a point on it, but when I talk with many German colleagues and friends, at heart when you say, "How do you get through this?" it kind of becomes, "Well, other Europeans should become more like us." And so if Greeks and Italians and others in the southern Mediterranean are not willing to become Germans, you haven't solved the fundamental problem.

*Sebastian Mallaby:* So is breakup the only path?

*Robert B. Zoellick:* Well, this is what the core issue will come to. The second political point that I wanted to touch on is what I think Chancellor Merkel is doing, and personally I am very sympathetic to this. The German taxpayer is saying: "Why are we paying for all this?" The Greeks could privatize more, and they retire too early, and so on and so forth. But I think, sometimes the Americans may underestimate the German commitment to Europe as an institution. The whole postwar logic has been built into that; unification has been built into that. So what I think Merkel is doing, and frankly I urged her to do this a little earlier, is to start to say to the German public, "Look, we need to have a vision of where this is going. What is the picture? Where is the direction?" And I think that is what she is highlighting now is to build the overall public support. Now the tricky part though, will be that this is not just a question of saying, "Thou shall do this." This is going to require some careful economic diplomacy, not only with France but with the European Commission (just as Kohl used the European Commission for unification), and with other countries. And that will be the devil in the details of how this moves forward.

But to go to your question: I think (and this may come relatively soon) that you either have to create a more effective reform system, a more effective transfer union, and a more effective liquidity while you are doing the reform, or you have to face the consequences that to have a single currency with countries that are highly indebted, some of which are uncompetitive, won't work. It is understandable in Europe, and it's true in America and other places, that politicians prefer to muddle through. But I honestly believe that Europe is at a point where muddling through won't work. So I think the questions that you are asking are fundamentally questions that can only be answered by Europeans. They are obviously issues of political economy as much as finance. I think Merkel is trying to set the stage for that.

And, to go to your point about the disconnect of time periods: I think a vision of what they call "economic governance," or what we might call "political fiscal reform," could allow one to start to take some of these intermediate actions. But I think it is far from clear where they may go on these intermediate actions. And if I have one particular worry, another part of the German perspective is, for those of you who work in continental Europe, or Germany in particular, across the political spectrum there is this deep felt sense that markets should not dictate to the state. The state should be the primary force. And in the United States, or Britain, or other commonwealth countries, government officials may not like the market overwhelmingly, but there is a practical sense that this is what we have to do when the markets start on Monday. And I think there is a resistance to this in Germany.

What I am quite concerned about is you have seen the European process take a few steps and, kind of, move close to the edge, and then the abyss starts to come and they move a little closer. But at some point, at least my caution was that, this becomes a step function. And I don't know when that point comes, but that is the sort of issue that people in Europe are going to be watching in the coming weeks.

*Sebastian Mallaby:* The tragedy of the Continent may be that Germany says it believes in Europe, it wants to save Europe; it is the biggest challenge since the Second World War. At the same time, as you say, there is an insufficient appreciation in the practicality of markets—there could be a step change. They have a well-defined goal, but if they don't do things on the way they get knocked off course. But then there is also, I feel as though, they could do with a lecture from your research department. In the period that I studied the World Bank, which was under one of your predecessors from 1995 to 2000, one of the central intellectual findings was that we have overused the tool of conditionality. This was the argument for which Bill Easterly became well known when he left the World Bank, but it was basically the view of the institution that if you count the number of times that Pakistan signed on the bottom line and said they would shrink their budget deficit, and you see how many times they actually did it, well you know it is only a small fraction.

Now if that is the case, and there has been a lesson learned about overusing conditionality from the Bretton Woods institutions, what about from Germany? And Brussels? I mean you go tell the Greeks, "Oh you have got to do this and shrink this," and they can't. Essentially politics is politics.

*Robert B. Zoellick:* Well, there may be a lesson from the research department, but I will draw a lesson from diplomacy. In my experience, lecturing Germans probably isn't the most profitable form of advocacy. Your father served as ambassador to Germany, so you are probably on my side with this one. But you are focusing on the core issue. Italy, if given time to make the reforms, should be able to make it. Now the danger is, in simple terms, when it joined the eurozone it had a debt of about 120 percent of GDP. It was paying 6 percent interest, which went down to 3 percent, and is now back to 6–7 percent, but it still has debt of 120 percent. Italy will need to build a primary surplus. But one could make a believable case that if Italy could continue to roll over its debt, then it could pursue the reform program. And you now do have a political process in Italy, but we will have to see where it goes, where you have, at least, officials trying to do that.

The real challenge is just not technocrats versus politicians. The question is whether technocrats, policy people, can get the political support to make these difficult decisions, whether in Europe or the United States. And that is less an issue now in Greece because they can continue to roll over the debt, but it is an issue in Italy, and it will be an issue in Spain. I think there is now a warning signal for the new Spanish government that it will have to set the policy course. But is it possible? Yes. Look at what Britain has done. So it is possible.

If you are in Germany you are going to say, “I am going to push that as far as possible, and for good reason: I want to have the fundamental reforms made.” The question will be: If you start to get to a point where the liquidity starts to run out of the system and it starts to affect French financing and others, does the acrimony start to create a tension in the European system so you can’t operate it? And that is, I think, the picture, the challenge, we are going to see over the coming weeks. You know I am cheering for the parties to make the reform process, but you are certainly correct about wondering whether simply telling people to do the right thing is sufficient. That may not work as a policy. There are people in Germany who will cite the Marshall Plan, which is always much overused and incorrect historically. But their concept is: We actually, as Germans, are willing to invest and put money in to try to support this, but it goes back to the overall conditionality issue.

### *A Global Perspective*

There is also another point, namely, that we have talked about this in a European context, but my prime interest is seeing it in a global context. The concern that I started to have in August was that, up to August, the emerging markets, which had represented up to two-thirds of global growth over the past five years, were in a little bit of a—since we have a German theme going here—a little bit of a *schadenfreude*. In other words, they were saying, “Oh well, you guys are struggling,” but the main problem for them was overheating. What we saw with the events in August was equity markets, bond spreads, currencies, trade, all start to take a tumble. It came back a little bit with this October accord, but if we think about this as an international economic system, one has to be careful because if emerging markets have represented two-thirds of global growth, and the blows to confidence of consumers and business that you have seen in Europe and the United States spread to the developing world, then the overall environment for pulling out of any of this becomes a lot harder.

## Reforming the Global Monetary Order

*Sebastian Mallaby:* In some sense, what you have got going in Europe is a crisis of the reserve system where there were all these peripheral sovereign bonds that were viewed as safe assets because the Basel Accords said they were safe, and because the ECB had a repo system that basically treated Greek sovereign debt as safe, and so we were encouraged to think they were safe. Then all of a sudden, it's not safe. And all these reserve assets issued by all these governments turn out to be risk assets.

But let's relate that to the bigger picture, because you have written in the *Financial Times* that there is a problem with the global monetary system (Zoellick 2010). That the reserve assets, that a dollar-based system, is perhaps not the right one. And you have raised a question about it. Can you explain what you're getting at?

### *The Role of International Coordination*

*Robert B. Zoellick:* Since this is a broader policy and academic conference, I will go back a step. My thinking on this goes back to the 1980s when there was some interest in the G7 international economic coordination. I think the starting point then and now for me is a need to recognize that we still have a system of sovereign states. We are not going to have some international body dictate or coordinate this. But the question is, at the margin, I don't want to overstate this: Can we encourage the economies to cooperate enough to start to recognize what the externalities of their actions are—that is, their effects on others, on a global whole? It is intriguing because, by and large, much of the economics and policy profession, after the effort under Baker at the Treasury in the mid-1980s, is very dismissive of it.

What is quite intriguing is that much of the current G20 has returned to this. If you look at what has been given to the IMF and the role of the others, they are very similar in their set of ideas. So we are coming back to it. But, and this is a big but, the world economy has changed. So the huge shift in the role of emerging markets has to be accounted for in the system. So coming back to my own perspective, what I was trying to say is that I think, by and large, it is important for countries to try to have flexible exchange rates independent of central banks. And so for the G7, as developed economies that have more sophisticated financial systems, one should have a norm, not a rule but a norm, of saying that you will allow the exchange rates to adjust with an exception that if the G7 agree that there is a situation, as sometimes happened with Japan, that is out of sync, they would agree on some potential form of intervention.

Second, the idea was that over time you want to move the emerging markets into this system. You are trying to move them to flexible exchange rates independent of central banks. But one needs to recognize that there could be situations where the rapidity of capital flows means you should look at the best practices of what has and hasn't worked.

Third, I personally believe that the dollar will remain the principal reserve currency. But I can see that due to the discipline of the dollar and as a fact of economic reality, the world could move to a multiple reserve currency system. A lot of this depends on the future of what happens with the euro. And over time, if China moves to an open capital account, I think the yuan can play a role, and the yen and the pound at a certain point.

### *The Role of the IMF and Gold*

So how will countries, in a sense, manage that system? Not in formal coordination. And here, my view was that the IMF could have a role as, in a sense, a referee who could blow a whistle but it doesn't necessarily have a penalty it can impose. But at least it can try to prod the countries to recognize some of the risks of policy action. I then raised a lot of attention by considering gold, even though I did not suggest a gold standard. If you think about this, I am talking about flexible exchange rates. But from my experience over the past decades, what I have seen is, with all due respect to central bankers, central bankers never want to have anyone judge them. But what I was seeing in markets when I wrote the *Financial Times* article was that the price of gold was starting to reflect some lack of confidence in national policies and central bankers' policies. And so I was simply suggesting that gold should be used as an indicator, as an information tool.[1] I wasn't seeing it so much as a formal anchor, but as a way of being a check on the checkers, and used in the global monetary system.

[1]You can make this point about general commodities. I think there are other commodities sometimes that supply and demand factors are more influential, but you could also look at this as a basket of commodities with gold.

*Sebastian Mallaby:* If I am a central banker, I see that the gold price is going up. Do I have to change my monetary policy in response to that?

*Robert B. Zoellick:* Not necessarily. I don't think central bankers simply look at one variable and then turn the switch. I think they look at a series of variables, and it would start to indicate some things about the fact that, in practical terms, people are treating gold as a monetary store of value and they are saying, "I am not quite comfortable in the dollar and the euro, and I can't totally invest in the renminbi because it hasn't got an open capital account." That thinking should be factored into the calculation of central bank policies.

*Sebastian Mallaby:* But they probably do already. Central banks are already aware of what is going on in the markets. They see what's happening to the price of gold; they couldn't avoid seeing it.

*Robert B. Zoellick:* But whether it is factored in? I don't know. I think that there are some very intelligent people who have done work on this, but they become captives of their own past analysis. Obviously, there has been a lot of work done on the problems of the gold standard and the Great Depression and recoveries, and sometimes people overreact against the idea that gold could ever play a role. I am being very pragmatic. What I probably reflect is that I talk to people in the markets. I ask them what they have seen in markets. And sometimes, no offense to scholars, but scholars get so wedded to the beauty of the structure of their ideas, or their dissertation, or their book, that they ignore markets. My experience is that that is a mistake.

I also suggested a role for the SDR, but it is just a combination of currencies, so I don't see it playing a principal role.

## *The China Factor*

I believe the world would have a healthier monetary system if the Chinese moved toward an open capital account. And my experience with the Chinese in the WTO was that they accept, and sometimes appreciate, the role of international organizations if they are part of a rules-based system. And one might be able to encourage the forces in China to be more eager to move toward an open capital account, if you said the renminbi can have a role in an SDR—provided China pursues certain policies. So it is an incentive system. Now, could people legitimately criticize this and say, "Well look, that's not much of a structure, it's a little bit of a nudge here and there." I freely acknowledge that. But, until you change the nation-state system, I think that is what you have got. But the question is, at the margin: Can you move toward some greater sense of avoiding autarchy and recognizing that national policies will influence others? Because, at the end of the day, remember I started part of this as a trade person. The bottom line of what is the eurozone or others is that, you know, I am always worried about protectionism raising its head. And you see signs of that today too.

*Sebastian Mallaby:* The analogy with the WTO is very interesting. The WTO accession did drive a series of market-based reforms in China, and I can see that the SDR could act as a carrot to drive capital account reforms. There have been Chinese officials who have said they would like to have the renminbi included in an SDR as early as 2015. What do you see as a reasonable time frame?

*Robert B. Zoellick:* I don't set a date. I set it based on performance. In other words, I think one should have a reasonable sense of what sort of open capital account that you should have. There are clearly Chinese officials moving to internationalize the renminbi. You see this in the discussion of the role of Hong Kong. Frankly, I think China is actually looking to London as perhaps playing a role with the international renminbi market. But I will add one other element because, remember, for all the talk about macroeconomics, I actually think microeconomics is quite important. I think that the Chinese have come to recognize that the model of investment- and export-led growth, which has been very successful for 30 years, is not going to work in the balance of the international economy in the future. And so, we are trying to take their planning of what they would like to do for the next five-year plan, and go into detail of how they need to change pricing, financial institution policies, deposit policies, and move away from the structure of that system. And the good news is people in China—even though China has grown 10 percent a year for 30 years—could say, "Look, we are going to keep doing what we are doing." In some ways that is what Japan did. But, they realize, for example, if you take the Chinese growth rates out to 2030, it would be like adding 15 South Koreas to the international system. And I just don't think that the system is going to take that.

*Sebastian Mallaby:* In terms of export volume?

*Robert B. Zoellick:* Yes. And so, if anything, I would say that the fact that China is willing to consider some of these structural changes could be a bit of a salutary statement to the Europeans and the United States. Maybe we ought to be looking at some of the structural changes on the microeconomic side in our economy.

## Reference

Zoellick, R. B. (2010) "The G20 Must Look beyond Bretton Woods." *Financial Times* (7 November).