Completing the Eurozone Rescue: What More Needs to be Done?

Edited by Richard Baldwin and Daniel Gros

Greek crisis Eurozone Sovereign debt haircuts Ireland European Monetary Fund IMF dollar ECB G20 PIIGS sovereign debt workouts debt-to-GDP Spain Naked short selling Italy fiscal deficits inflation credit rating agencies

A VoxEU.org Publication

CEPR

Completing the Eurozone Rescue: What More Needs to Be Done?

A VoxEU.org Publication

Centre for Economic Policy Research (CEPR)

Centre for Economic Policy Research
2nd Floor
53–56 Great Sutton Street
London EC1V 0DG
UK

Tel: +44 (0)20 7183 8801
Fax: +44 (0)20 7183 8820
Email: cepr@cepr.org
Website: www.cepr.org

ISBN: 978 1 907142 10 9

Completing the Eurozone Rescue: What More Needs to Be Done?

A VoxEU.org Publication

Edited by Richard Baldwin and Daniel Gros

Centre for Economic Policy Research (CEPR)

The Centre for Economic Policy Research is a network of over 700 Research Fellows and Affiliates, based primarily in European Universities. The Centre coordinates the research activities of its Fellows and Affiliates and communicates the results to the public and private sectors. CEPR is an entrepreneur, developing research initiatives with the producers, consumers and sponsors of research. Established in 1983, CEPR is a European economics research organization with uniquely wide-ranging scope and activities.

The Centre is pluralist and non-partisan, bringing economic research to bear on the analysis of medium- and long-run policy questions. CEPR research may include views on policy, but the Executive Committee of the Centre does not give prior review to its publications, and the Centre takes no institutional policy positions. The opinions expressed in this report are those of the authors and not those of the Centre for Economic Policy Research.

CEPR is a registered charity (No. 287287) and a company limited by guarantee and registered in England (No. 1727026).

Contents

Foreword

VoxEU was launched three years ago, in June 2007. VoxEU was lucky – and the world very unlucky – that the subprime crisis erupted only a few weeks later.

The crisis created a need for expert commentary, delivered quickly and in an accessible format. VoxEU has met that need with a steady flow of cogent and compelling columns – over 1600 of them over the past three years.

Some issues need closer and more sustained examination and debate, and VoxEU has responded to this need with its eBooks. Launched at the height of the financial crisis in October and November 2008, these collections of essays by leading economists have made important contributions to global thinking on pressing policy issues.

The Eurozone Crisis is certainly one of these issues. Richard Baldwin and Daniel Gros put it very well in their editorial introduction: "The Eurozone 'ship' is holed below the waterline. The ECB actions are keeping it afloat for now.... What European leaders need to do very soon is to find a way to fix the hole. The risk now is that politicians become complacent."

This eBook aims to dispel this complacency and to offer ways of fixing the hole. The thirteen chapters analyze the full range of issues confronting Eurozone policymakers: monetary policy, fiscal policy, banking and financial market regulation, competitiveness and structural reform. The Editors, in their introduction, suggest how to prioritise and sequence these reforms.

The eBook is addressed primarily to policymakers in the EU member states and it is timed to coincide with the European Council's meeting today. As the Editors note, "Most of these measures have to be executed at the national level. The EU can only provide a framework and coordination."

Addressing the Eurozone crisis is a matter of urgency. We are grateful to the eBook's Editors, Richard Baldwin, Daniel Gros and Luc Laeven, for bringing together such a distinguished group of authors with such speed and efficiency. In closing, it is also important to acknowledge the rapid and highly professional contribution made by "Team Vox" – notably Jonathan Dingel, Bob Denham, Samantha Reid, Anil Shamdasani, and Pierre-Louis Vezina. This eBook would not have been possible without their energy, enthusiasm and commitment. Luc Laeven was a co-editor, but his name did not appear on the launch edition as he could not get approval from the IMF in time. The views expressed in this eBook are those of the authors and do not necessarily represent those of the IMF.

Stephen Yeo
Chief Executive Officer, CEPR
London, 16 June 2010

This publication has received financial support from the European Commission's Seventh Framework Programme for Research, through the Collaborative Project 'Politics, Economics and Global Governance: The European Dimensions' (Contract no. 217559).

Introduction: The euro in crisis – What to do?

Richard Baldwin and **Daniel Gros**
Graduate Institute, Geneva and CEPR; CEPS, Brussels

Looking at Europe from afar, it must be difficult to understand the Eurozone crisis. How could a small nation's refinancing difficulties – Greece constitutes only 2% of the Eurozone's GDP – trigger a systemic crisis for the euro that brought global financial markets to the brink?

But it did happen. And the crisis is not over. This eBook gathers the views of a dozen world-renowned economists on a simple question: What more needs to be done? How should European leaders end this crisis and what should they do to prevent future crises?

Although the essays were largely uncoordinated – and the authors hark from diverse backgrounds – a remarkably coherent message emerges from this collection of essays.

Most importantly, the authors unanimously believe that the Eurozone rescue is not finished. More needs to be done.

As Charles Wyplosz puts it, the Eurozone is levitating on the hope that European leaders will find a way to end the crisis and take steps to avoid future ones. Unless more is done, however, this levitation magic will wear off and the Eurozone crisis will resume its destructive, unpredictable path.

If European leaders demonstrate that they are incapable of completing the job, or if they merely tinker with existing rules and institutions, the magic could wear off at an alarming pace. Crises start and stop according to market expectations – expectations that can change at the speed of fear. As Angel Ubide puts it: "European leaders must now make a clear-cut decision; either they move on and complete the Economic and Monetary Union that is needed to underpin the euro, or they accept the risk that the Eurozone will fail in its current form."

This introduction is structured in three parts. The first discusses the Eurozone's "policy framework" broadly defined – how it was designed to work in theory and how it worked in practice up to 2007. The second part describes the causes of the crisis by relating the sequence of events since August 2007 and how they produced the predicament Europe is in today. The final part describes our views on what more needs to be done, drawing largely but not exclusively on the essays in this eBook.

The Eurozone's policy framework

The Eurozone's design was subject to intense study and debate ranging back to the 1970 Werner Report. What emerged made sense on paper. Understand-

Table 1. Eurozone policy framework: How it should have worked

Policy	Policymakers	Goal and rationale
Monetary	EU: ECB National: none	Price stability
Fiscal	EU: Eurogroup + no bailout clause + no ECB national bond purchase National: Member governments with coordination via SGP and Eurogroup	Allow room for national macro stabilisation, but avoid spillovers (e.g. drive up borrowing cost, or default possibility)
Banking & financial market regulation	EU: EU directives and coordinating bodies (EBA) National: Supervision: member governments with loose coordination (colleges)	Maintain stability of banking system and financial markets to avoid crises
Competitiveness	EU: none National: Differs across member countries: markets, social dialogues, and wage norms	If banks and financial markets are stable, current account imbalances are not an issue
Structural reform	EU: Lisbon Strategy, now EU 2020 National: National action plans	Boost flexibility to improve the fit of the one-size-fits-all monetary policy

Source: Authors' compilation; SGP denotes Stability and Growth Pact.

ing how it was supposed to work is essential to answering the critical questions:

- Why did it go wrong?
- How can it be fixed?

Table 1 helps organise the discussion of what Jean Pisani-Ferry calls the "completeness" of the euro's policy framework.

Monetary policy was assigned to the ECB, which was made politically independent and instructed to maintain price stability. Fiscal policy was a different matter.

Analysts warned that a monetary union without a fiscal union would be problematic, pointing to two main concerns. Governments might be tempted to run up unsustainable debts and push the ECB to inflate them away, or to run up high levels of debts that would create negative spillovers for others, potentially to the point of what Thomas Mayer calls "bailout blackmail".

Despite these concerns, fiscal policy was left to national governments but subjected to three safeguards:

- The primary defence was the Stability and Growth Pact – intended to keep deficits below 3% of GDP in normal times and debt levels below, or at least heading towards, 60% of GDP.
- The secondary defence was the ECB's independence – protection against political pressures to inflate away debt; the ECB was also explicitly forbidden from financing members' deficits directly.[1]
- The "no bailout" clause was a third line of defence aimed at preventing "bailout blackmail".[2]

Coordination of national fiscal policies was facilitated by the European Commission and the Eurogroup (Eurozone Financial Ministers) which emerged as a forum for informal coordination and eventually acquired some institutional substance.

Banking and financial market regulations were also left to national governments, with only loose coordination. The lack of attention paid to banking and finance stemmed in part from the economic "received wisdom" of the time. When the euro policy framework was designed, economists assumed that financial markets would work well; contemporary economists were guided by macro models in which something like the 2008/09 Global Crisis could not happen (Buiter 2009, Leijonhufvud 2009).

Competitiveness policies and current account imbalances, like banking and finance, received scant attention from Eurozone architects. After all, if the fiscal and banking parts of the framework did their jobs, current account imbalances were nothing more than the net outcome of many lending/borrowing relationships – contracts between consenting adults, as it were. There are plenty of solid economic reasons for nations like Germany to invest in nations like Spain, so there seemed to be no reason to worry about such lending.

Structural reforms were the final pillar. It was widely recognised that a one-size-fits-all monetary policy would work better if labour and product markets were more flexible. Agreeing reforms at the EU level, however, was too difficult, so this was left to national governments, coordinated loosely by the Lisbon Strategy.

The practice, 2000–2007

Monetary policy was a great success at the level of Eurozone as a whole. Up to 2007, the ECB managed to keep both growth and inflation around 2%. Likewise fiscal policy, on aggregate, was a winner – the 3% target was violated only once by the Eurozone16 taken as a whole.

[1] The purchase of government bonds is not against the statutes of the ECB, but it cannot "finance a public deficit". In practice, this means it cannot buy on the primary government debt market (nor any other central bank of the Eurosystem) but it can buy it on the secondary market.

[2] The no bailout clause had loopholes; see Gros and Mayer (2010) on what exactly was forbidden.

A closer look, however, presents a very different picture. Most obvious is the Pact's failure (Table 2, first two columns).

- From 2000 to 2007, Greece violated the 3% rule in eight out of eight years.
- Others also flaunted it – Italy (five times), Portugal and Germany (four times), and France (three times).

Deficits and debt discipline, in short, was essentially absent. Greece's cumulative deficits in this period amounted to 40 percentage points of its GDP; Portugal was close behind at 29 points. Even the Eurozone core members had problems; the numbers for Germany and France were 18 and 22.

An important shortcoming in the policy framework can also be seen in the fact that Ireland and Spain – who subsequently found themselves in debt problems –were among the few to respect the Stability and Growth Pact (SGP) rules. Not only did they respect the letter of the law, they respected the spirit by running surpluses during the "good times" in preparation for deficits in bad times.

The one-size monetary policy plainly failed to fit all. The old deutschmark (DM) bloc (Germany, France, Austria, Netherlands, Belgium and Luxembourg) tended to experience lower than average growth and inflation, while the Eurozone periphery experienced the reverse (Table 2, columns 4 and 5). Booming economic performance in Greece, Ireland, and Spain was accompanied by prices that rose much more than average. The cumulative excess inflation was 10 percentage points for Ireland, and 8 points for Greece and Spain. Portugal saw slower growth but higher inflation.

The asymmetric development of economic output and competitiveness produced massive current account imbalances. While the Eurozone's overall trade account remained in balance, the GIPS (Greece, Ireland, Portugal and Spain) saw very large deficits offset by the old DM bloc's large surpluses.

This created a massive interconnectedness in the Eurozone; banks' balance sheets in the core nations became stuffed with GIPS debt. To misquote Keynes: If the GIPS owe German banks 1% of their GDP, the GIPS have a problem; if they owe 30% of their GDP, the banks (and Germany) have a problem.

With hindsight, national bank and financial market regulators also failed, although such failures occurred in the US and other OECD nations as well. Irish, French, Spanish, and Italian banks aggressively expanded lending (Figure 1).

- Ireland's total bank assets as a percent of GDP soared from 360% in 2001 to 705% in 2007;
- For France the numbers were 229% to 373%, for Italy 148% to 220%, and for Spain 177% to 280%.

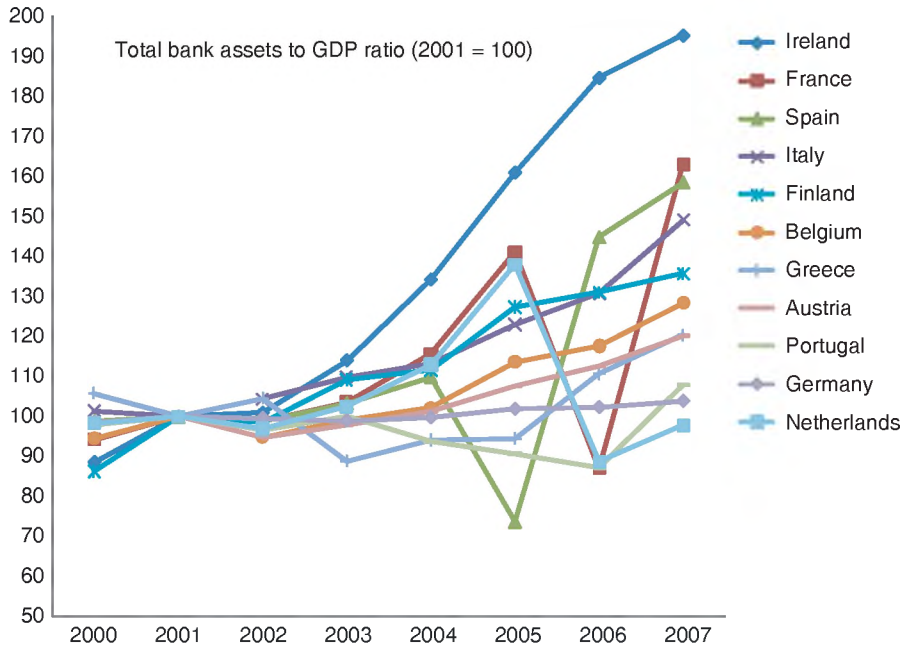
This created fragility and interconnectedness so massive that it became a macroeconomic problem when the global crisis hit in late 2008 (Table 2, column 7).

Table 2. Eurozone policy framework in practice, 2000–2007

		Percentage points of GDP		Percentage points			
	Number of 3% deficit violations	Cumulative deficit	Cumulative current account	Cumulative inflation above EZ16 rate	Cumulative growth above EZ average	CER Lisbon rank, 2007	Bank assets as percentage of GDP, 2007
Austria	1	11.8%	13%	−4.1%	0.014	3	332%
Belgium	0	2.7%	26%	−1.0%	0.002	13	419%
Finland	0	−32.4%	50%	−5.3%	10.5%	5	152%
France	3	21.7%	4%	−3.3%	−0.3%	9	373%
Germany	4	17.7%	26%	−4.2%	−5.3%	8	314%
Greece	8	40.0%	−67%	8.1%	16.6%	19	157%
Ireland	0	−11.9%	−15%	10.0%	31.0%	6	705%
Italy	5	22.9%	−10%	1.0%	−5.5%	23	220%
Luxembourg	0	−18.6%	83%	4.1%	21.2%	12	2443%
Netherlands	1	4.7%	45%	2.4%	0.2%	4	382%
Portugal	4	28.9%	−71%	6.3%	−5.6%	21	240%
Spain	0	−2.3%	−46%	7.6%	11.7%	16	280%

Source: Authors' compilation.

Figure 1. Growth in bank-asset-to-GDP ratios, EZ12, 2000–2007



Source: European Banking Federation and Eurostat.

The structural reform pillar of Eurozone governance also failed, as reform proceeded slowly throughout Europe and in a particularly uneven manner in the Eurozone. The Centre for European Reform publishes league tables ranking EU members according to overall performance judged by Lisbon Strategy criteria (Table 2, column 6).[3] While the Eurozone core nations tended to do rather well, the GIPS were among the worst, with Ireland being an important exception.

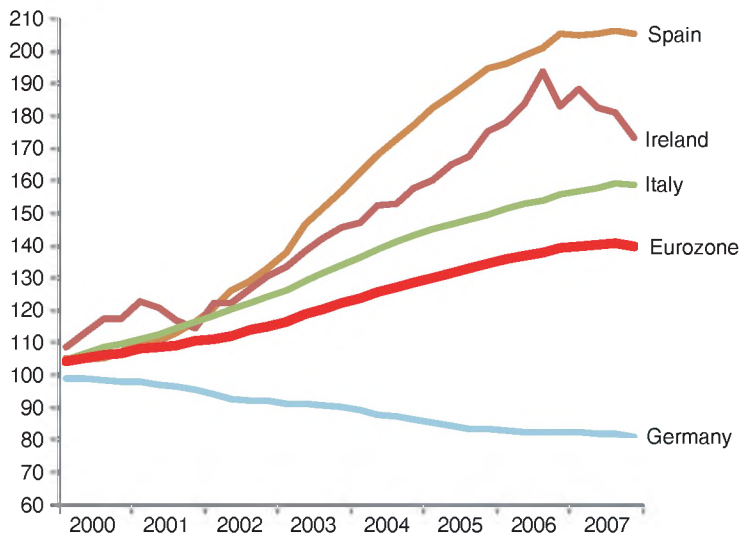
Walter's critique

Uneven inflation rates with a uniform policy interest rate can produce real interest rate differences that prompt divergent trends. Borrowers in Ireland and Spain, for example, faced negative real interest rates that encouraged borrowing-fuelled investment in assets such as housing. Germany's lower than average inflation, by contrast, produced relatively high real interest rates that had the opposite effect.

Symptoms of this so-called "Walter's critique" can be seen in the housing price booms (Figure 2). Hindsight would show that the Irish and Spanish housing prices were bubbles whose bursting played an important role in the ongoing Eurozone crisis. Avoiding such imbalances would have required GIPS

[3] "The Lisbon Scorecard" CER annual publication.

Figure 2. House price trends, EZ12, 2000–2007



Source: OECD online database.

policymakers to run fiscal policies that were more contractionary than the ones actually implemented.

Causes of the crisis

The Eurozone's policy framework was designed like the rigging of a racing sailboat. The interlocking system of stays and braces could hold against the strongest winds as long as all parts of the system held fast. Failure of one or two cables, however, would transfer overwhelming stress to other parts, potentially triggering a catastrophic collapse.

This is what happened in the 2010 Eurozone crisis and its run-up. In fact, many of the "cables" in the Eurozone's policy-framework proved deficient, but failure to coordinate fiscal policy – when teamed with a fragile and interconnected banking system – can be viewed as the first fault – the design flaw that eventually led to what engineers call "system failure".

Before turning to the sequence of events that lead up to the 2010 Eurozone crisis, we briefly review the basic dynamics of debt and banking crises, as these are essential to the story. The crisis is, in our view, a thorny tangle of incipient debt and banking crises.

The economic logic of debt and banking crises

Debt is sustainable when the debt burden – commonly measured by the debt-to-GDP ratio – is not rising forever.[4] The numerator, the debt stock, rises when

[4] Full consideration of sustainability is far more complex; see Wyplosz (2007).

the government runs a budget deficit or shoulders private sector debt (e.g. by nationalising a failing bank). The denominator rises when GDP grows. The debt stock can growth forever and still be sustainable, but only if debt grows in line with GDP.

Study of this algebraic identity leads markets to focus on two key variables – today's and expected future GDP growth rates, and today's and expected future government deficits – typically broken down into interest payments on the debt stock and other items (the so-called primary balance). A debt crisis happens when investors who previously judged a government to be a sound borrower change their minds and decide that it is time to head for the exit.

Here's how a vortex gets started. If the market perceives a higher default risk, it raises interest rates on the debt to compensate for the extra risk. Higher debt-service payments, however, worsen the budget deficit, and – if the government does nothing – this pushes the nation towards the edge of sustainability. If this precipice is already close to start with, the higher interest rates themselves can magnify default fears, thus yielding even higher interest rates and so on; the spiral inexorably drags the nation towards default.

Because expectations are so critical, there is never a clear-cut "event horizon" beyond which the nation gets sucked into a black hole. The location of the precipice changes at the speed of fear.

To counter the vortex, the government must slash non-interest spending programmes and/or raise tax rates. But even this may backfire. This type of fiscal contraction may slow growth thereby undermining sustainability. If it does, default risk and interest rates can rise, which then requires further cuts or higher taxes. But cutting and taxing cannot go on forever – eventually the people will revolt. In the end, the government may find default to be the least bad option.

If the vortex is allowed to go for long enough, there are only two ways to stop it; the nation partially defaults – usually by "rescheduling" its debt – or a buyer of last resort is found to hold the debt that private lenders are trying to unload (usually the IMF, a collection of the nation's debtors, or both, as in the May 2010 Greek bailout).

Banks can be subject to a similar vortex, with two critical differences that make systemic banking crises so pernicious. Banks borrow money short term to lend it out long term. What puts the "bank" in bankruptcy is the fact that the money the bank borrows is tied up in long-term projects, so the bank goes broke any time its short-term funders want their money back all at once. Banks' business model, in other words, requires them to operate in a state that would look like financial irresponsibility in most other lines of business. Things are made more precarious by leverage – for each euro of capital, the bank makes long-term loans of a dozen or more euros. This is highly profitable in good times (when short-term funds are abundant) and highly dangerous in bad times (when short-term funding suddenly dries up).

The key differences between government debt and bank debt vortexes concern magnitudes.

- While a typical Eurozone nation has a debt stock of about 70% of its GDP, its banks hold liabilities many times larger (Table 2, column 7). In 2007, German bank debt was over 300% of Germany's GDP; similar figures hold for French, Dutch, and Austrian banks. The corresponding figure for Belgium is over 400%, 700% for Ireland, and 289% for Spain. Luxembourg's ratio is 2,443%!

These eye-popping figures matter; they mean that a systemic banking crisis can bring down a whole nation – not just its banks. More worrying yet, banks can be both too large to fail and too large to be saved by their home nation alone (Gros and Micossi 2008) and may cause spillovers to other economies. Iceland's predicament is recent testimony to this fact.

- The need for new funding is radically more pressing for banks. A typical Eurozone government may have to seek fresh loans to cover, say, 10% of its outstanding debt *per year*, i.e. it rolls over 10% annually. A typical Eurozone bank has to seek fresh loans worth 10% or more of its total debt *on a daily basis*.

This daily need for billions of euros of fresh liquidity loans means that the vortex – once it gets going – can accelerate at a terrifying pace. Fear slows refunding, which raises default probabilities, which in turn feeds the fear. During the Lehman Brothers debacle, one bit of bad news – Lehman's default – brought the entire US credit market to a halt within hours; it spread to the rest of the world within days.

A similar thing started first week of May 2010 when global financial markets again began to freeze. This forced the hand of European policymakers during the second weekend in May.

The bank and government vortexes are often tightly linked. The bust in the Spanish real estate sector is a clear case in point. As long as real estate prices boomed, the Spanish budget was in surplus and Spanish public debt looked highly sustainable. But when boom turned to bust, a budget deficit of over 10% of GDP arose in the space of two years, and the Spanish banking system came under pressure. A similar pattern occurred in Ireland. This confirms the observation of Reinhart and Rogoff (2009) that when a credit bubble bursts, private debt becomes public debt. For the Eurozone this can be seen in Figure 3 which shows the quarterly growth of private and public debt since the start of EMU. Private and public debt move like two blades of scissors: when one is up, the other is down.

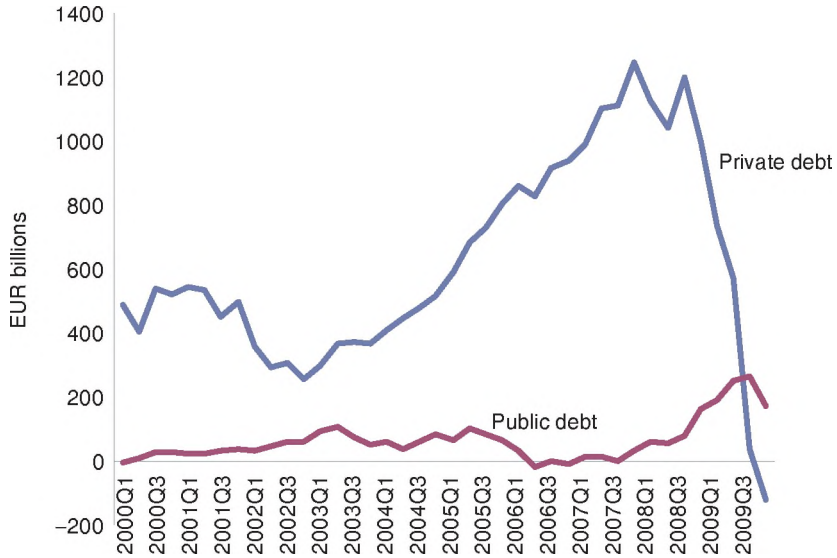
With this as background, we turn to the causes of the Eurozone crisis.

The Eurozone crisis story

What began in early 2010 as a standard fiscal crisis in Greece mutated quickly into a crisis of the entire Eurozone. Why?

The short answer is straightforward. Financial markets in Europe are so integrated that any large insolvency (be it a government or bank) threatens the system's stability. Since the failure of Lehman produced such catastrophic

Figure 3. Eurozone private and public debt



Source: ECB (moving average of first difference over four quarters).

consequences, it is no longer a question of who is too large to fail, but rather whether there is anybody small enough to be allowed to fail. The tale of how Europe got here is worth telling.

External factors: The Global Crisis

The Subprime Crisis, which blew-up in August 2007, became the Global Crisis in September 2008. This placed enormous strain on the Eurozone in two ways.

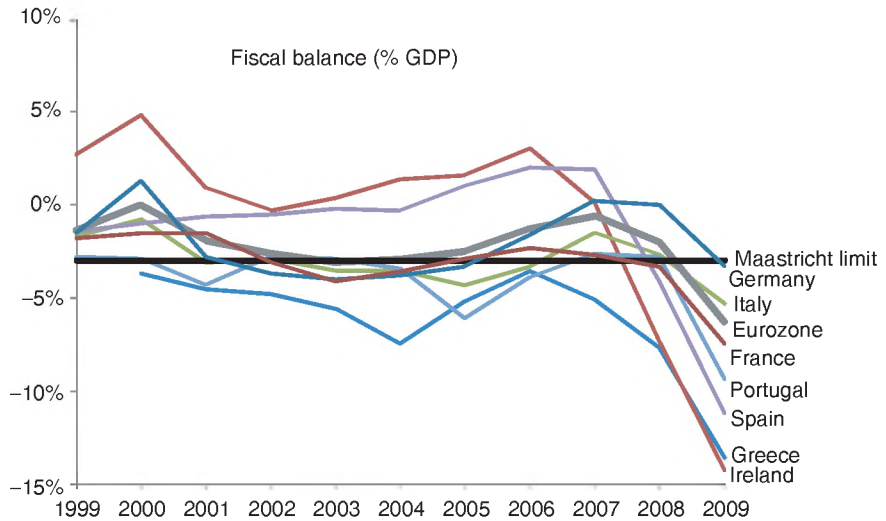
- The recession activated automatic stabilisers that worsened Eurozone deficit positions. Tax receipts fell while social spending soared (Figure 4).

On top of this, the recession convinced many Eurozone governments to go beyond automatic stabilisers – to counter the recession with expansionary fiscal policy. That, of course, meant wider gaps between government spending receipts, i.e. quicker public debt accumulation. The attendant collapse in asset prices and global trade put additional strains on tax revenues.[5] But that was not the end of the recession's damage.

The recession weakened sustainability through the debt ratio's denominator. Growth rates fell from an average of +3% in 2007 to −4% in 2009. For the GIPS, the swing was much larger. Ireland saw +6% turn into −7%; the figures for Greece, Spain, Portugal were also very large (as was Italy's). This by itself made Eurozone sovereign debt burdens look less sustainable, but this was especially true as the global crisis burst Eurozone housing bubbles – above all in Ireland and Spain. Markets began to reassess their views on these nations'

[5]See the VoxEU.org eBook on the trade collapse (Baldwin 2009) and Lane (2010) on fiscal aspects.

Figure 4. Deterioration of government deficits



Source: Eurostat. General government deficit (–) and surplus (+).

medium- and long-run growth prospects – maybe 3.5% Spanish growth was a chimera.

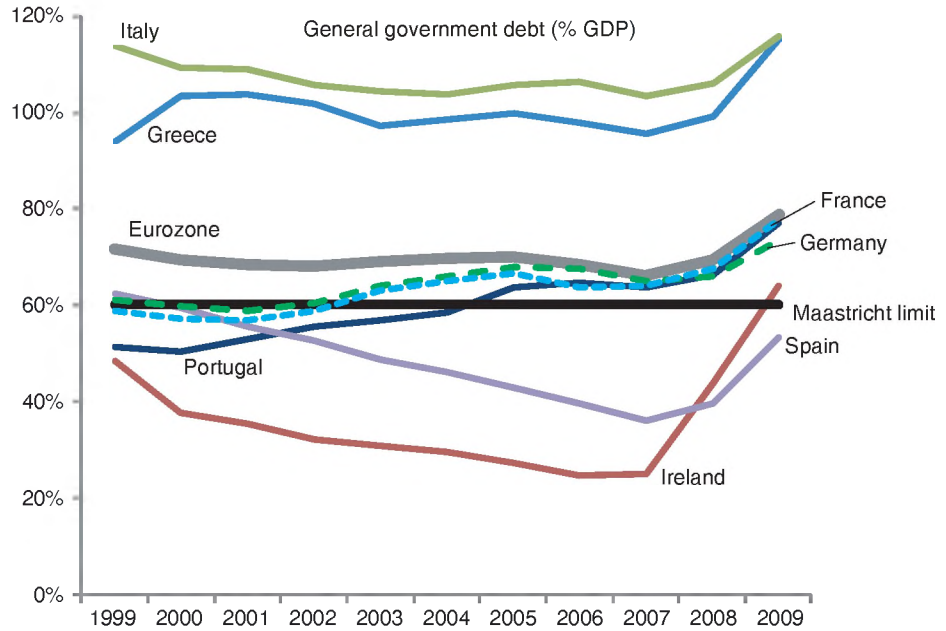
If the fiscal-discipline elements of the Eurozone's policy framework had worked better prior to the crisis, low national debt ratios would have provided the room to absorb this sort of additional pressure.

- Many Eurozone banks were both massively overleveraged and holding important quantities of toxic assets, having bought into overheated housing markets directly or through complex derivatives. At the same time, the credit markets' "sudden financial arrest" (Caballero 2009) in September 2008 wiped out the wholesale market that many Eurozone banks relied upon for funding. The ECB stepped in to replace this short-term liquidity funding. But EU governments failed to follow the US practice of stress-testing banks to see which were healthy and which needed additional capital. The European banking landscape was not cleaned up, so many Eurozone banks entered the "Greek crisis" in a fragile state.

The bank rescues that did take place directly worsened governments' debt ratios by turning private debt into public debt (especially in Ireland). The recession also worsened the banks' positions by hindering borrowers' ability to repay loans, and deleveraging by undercapitalised banks yielded a credit crunch that further deepened the recession.

If the policy framework's banking regulation elements had functioned well, Eurozone banks would have been in a position to absorb this sort of shock. For example, Canadian, Japanese, and Spanish banks were not deeply affected by the global crisis, thanks in part to domestic prudential regulation in the boom years.

Figure 5. Eurozone debt-to-GDP ratios, 1999–2007



Source: Eurostat. General government gross debt; Eurozone includes 16 members.

The lack of a coordinated banking policy deepened the problem. Some Eurozone governments ring-fenced the problem assets and cleaned up their banks, while others – especially France, Germany and Italy – did much less. As a result, banking fragility became concentrated in the largest economies.

The combination of wider budget gaps and newly shouldered debt from the banking sector played havoc with Eurozone debt ratios (Figure 5). The moderately positive developments that the GIPS had worked from 1999 to 2007 where completely reversed in 2008. By 2009, the debt ratios were deteriorating at an alarming pace (Figure 5).

By 2008, the Eurozone banking sector was not only fragile; it was also heavily interconnected due to a separate failure in the policy framework – the framework's competitiveness element. Below-average inflation in the Eurozone core and the opposite in the periphery fostered current account imbalances within the monetary union. For example, Greece's current account deficits from 2000 to 2007 added up to 67 percentage points of its GDP (Table 2).

As a simple matter of accounting, these imbalances meant that Eurozone core lenders lent more to the GIPS than the GIPS lenders lent to the core. For example, Germany's 25-point cumulative trade surplus meant that German investors – mainly German banks – were heavily exposed to public and private debt in the periphery nations, including Greece; in the decade up to 2009, exposure of euro core banks to the GIPS quintupled (Table 3). This extraor-

Table 3. Intra-Eurozone banking exposure, EZ core banks' holding of GIPS debt

	1999 4th quarter	2009 4th quarter	Percentage change 1999–2009
Portugal	26	110	320
Ireland	60	348	481
Italy	259	822	217
Greece	24	141	491
Spain	94	613	554
GIPS	204	1212	495
Total	463	2033	340

Note: EZ core is Germany, France, Austria, Belgium and Netherlands
Source: BIS Consolidated Banking Statistics, June 2010

dinary growth was also driven by a search for yield by banks everywhere triggered by extraordinarily low global interest rates.

The Global Crisis was a largely exogenous shock. Other causes of Eurozone crisis were home-grown.

Home-grown factors

As a consequence, the core Eurozone banks had become massively exposed to GIPS debt – both public and private. Note that the exposure to Italy alone – the nation with one of Europe's worst debt-to-GDP ratios – is almost as large as the exposure to all four GIPS combined – a fact that is worth keeping in mind as the crisis unfolds.

This interconnectedness is critical to understanding why Eurozone leaders could not afford to let Greece face its debt problems alone. A failure in Greece, especially if it triggered failures in Spain, threatened a systemic banking crisis in the Eurozone core nations, such as Germany and France. One can never know what history looks like in parallel universes, but the Greek crisis might well have remained a Greek problem if Eurozone core-nation banking sectors had not been so exposed to the GIPS.

Again the intersection of policy failures is important to highlight. If the financial and banking regulation elements of the framework had worked as they should have, the banks would have had adequate capital to absorb the loss from Greek debt problems. Instead, many are heading towards the brink of failure.

Asking for trouble

The Eurozone sailed into the storms of Spring 2010 with three of its mainstays broken.

Broken cable #1: The failure of deficit discipline meant that almost half the Eurozone nations, and all of the largest ones, entered the crisis period (2007–2010) with high debt ratios – many well above the Maastricht limit.

Greece and Italy had debt ratios that markets might think were perilously close to the unsustainability precipice.

Broken cable #2: The lack of competiveness policies (or sufficiently countercyclical national fiscal policy) fostered large current account imbalances. These current accounts were financed mainly by banks in the Eurozone core nations. As a result, any debt crisis in the periphery threatened a banking crisis in the core.

Broken cable #3: Eurozone banks, including those in the Eurozone core, were dangerously overleveraged due to regulatory failures before 2007, and half-hearted bank clean-ups in 2008 and 2009.

All that was needed was for the wind to blow from the wrong direction – a wind from the southeast, as history would have it.

The Greek trigger

George Papandreou won the October 2009 elections promising to spend more on social causes and clean up Greece. The first promise was ditched when he discovered that previous governments had been cooking the books; the 2009 budget deficit would be 12.7% – more than double the previously announced figure. The sustainability calculations investors used to justify the billions of euros of Greek debt on their books suddenly looked iffy.[6] Interest rates demanded on Greek debt started to soar. On 8 December 2009, one of the major credit rating agencies cut Greece's debt rating, triggering sales by many private investors; this pushed up yields.

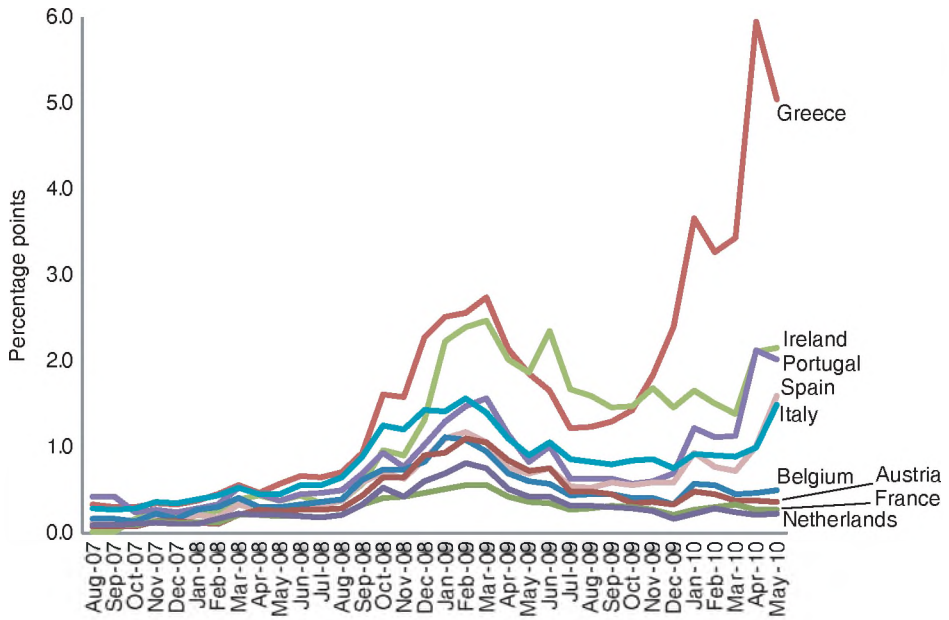
To stave off the vortex, Papandreou set out ambitious deficit-slashing plans. Credit rating agencies were not convinced and continued to downgrade Greek debt. Interest rates continued to rise. By early 2010, Greek spreads over the benchmark German bonds exceeded the peaks witnessed during global financial meltdown of 2009 (Figure 6). More stability programmes were announced. While the vortex slowed temporarily, social unrest led many to doubt the government's credibility. Interest rates soon resumed their climb (Figure 6).

Ominously, the crisis began to spread to Spain, Italy, Portugal and Ireland – at least as judged by movements in their interest rate spreads (Figure 6). This is one of the most dangerous aspects of crises. Self-fulfilling crises can happen (Obstfeld 1986, Eichengreen et al. 1996) – a vortex can start itself – and they can be contagious. Worse yet, as contagion depends on expectations, crises can spread at the speed of fear.

Matters came to a head over the first weekend in May. Greece had to refinance €54 billion in 2010, with €20 billion due at the end of May. To prevent Greece's €54-billion problem from becoming a systemic banking crisis, Eurozone leaders joined with the IMF to devise a Greek bailout worth €110 billion. This was supposed to stop the vortex long enough for Greece to get its

[6]From 2000 to 2008, the Greek budget deficit notified to the EU averaged 2.9% of GDP; the real number was 5.1% (Marzinotto, Pisani-Ferry, and Sapir 2010).

Figure 6. Ten-year sovereign bonds spreads (over Germany 10-year bond rates), August 2007–May 2010



Source: Bloomberg. Monthly data.

deficit under control. The programme included strict budget cutting rules to be supervised by the IMF.

This action proved to be too little, too late. Debt-crisis storm clouds continued to gather during the week after the Greek package was announced. Barry Eichengreen, writing on 7 May, put it in stark terms:

> It's not a pretty picture. The IMF botched its rescue. The ECB hesitates to erect the necessary ring-fence around Greece. Portuguese and Spanish policymakers underestimate the gravity of their position. German leaders are in denial. But although it may be too late for Greece, it is still not too late for Europe. That said, a solution will require everyone to wake up.
>
> (Eichengreen 2010)

And wake up they did. Over the second weekend of May, they announced a much larger but much vaguer programme to handle future debt crises. More important in terms of immediate effect was the fact that the ECB started buying GIPS debt – a move that stopped the Greek vortex instantly. If the ECB was willing to be the buyer of last resort, there was no pressure in the market to drive down government bond prices.

The ECB move, called the "securities market programme", started on 9 May. This is quite different to the quantitative easing implemented by the Fed and Bank of England. The ECB buys public debt only of fiscally "challenged"

countries. It promises to "sterilise" this operation, so it conducts liquidity-absorbing operations of the same magnitude. In effect, the ECB is buying risky assets issued by one government and, via its "sterilisation operations", selling its claims on banks, which is equivalent to selling other assets. The equivalent for the Fed would be to buy large amounts of Californian debt while reducing credit to New York banks – a move that might be viewed as an improper risk transfer and certainly as something that had nothing to do with monetary policy. The amounts bought to date have been limited, only €40 billion, i.e. only 2% of the balance sheet of the Eurosystem. Still this is about 10% of the public debt of the three countries whose bonds it is buying (Greece, Ireland and Portugal).

Wreckage of the Eurozone policy framework

The second May package was comprised of extraordinary measures for extraordinary times, but if the Eurozone were a schooner, it would mark the hour when the mainmast went overboard. Most elements of the Eurozone's policy framework were in tatters – only monetary policy setting could be said to be functioning correctly.

- Fiscal policy failed when SGP failure allowed Greece's debt to get to a point where the global recession would push it over the edge.
- Competitiveness policy failed to avoid the large imbalances that made the Eurozone core's banking systems hostage to GIPS public debt problems.
- Banking policy failed to provide capital cushions large enough to absorb a GIPS debt crisis without putting the core nations' banking systems at risk.

To stop the Greek vortex from creating other, even larger vortexes, the ECB used the "nuclear option" of buying outright GIPS debts. On this, Barry Eichengreen notes that: "The ECB, recent events remind us, is a lender and market-maker of last resort and not just the steward of a monetary rule."

While one can never be sure why central banks do anything, the ECB's actions indirectly helped GIPS finance their 2010 budget deficits. The ECB says it will sterilise these bond purchases, but that simply props up one asset price at the expense of another. Or, as Thomas Mayer writes: "By subsidising some government borrowers at the expense of others, the ECB has moved dangerously close to becoming a supranational fiscal agent."

At the heart of this triggering mechanism was the fiscal policy failure. As Charles Wyplosz says, "monetary union would not deliver price stability unless fiscal discipline was guaranteed. Perfectly aware of this original sin, the authors of the Maastricht Treaty introduced no less than three safeguards." Citing the SGP, the no-bailout clause, and the no ECB-financing-of-public-debt clause, he goes on to say: "Failure of the Pact led to a sequence of events that blew away the other two safeguards."

The fiscal policy failure, though necessary, was not sufficient. Had the Greek crisis occurred when Eurozone banks were strong and/or not very interconnected, the Greek sovereign debt crisis would not have threatened a Eurozone-wide banking crisis.

Lesson from the causes of the crisis

The baseline message from our account of the crisis consists of one word – interconnectedness. Debt and bank crises were interconnected, as were policy failures. No single element of the framework can be pointed to as "the" culprit.

The obvious implication is that fixing a single element would be a serious mistake. Jean Pisani-Ferry makes the point this way: "Limiting reform ambitions to tinkering with the Stability and Growth Pact would be widely regarded as indicative of a worrying inability to reform."

What more should be done?

Eurozone leaders embraced two bold moves in May – a Greek bailout worth €110 billion, and a Special Purpose Vehicle to fund future bailouts up to €750 billion counting the IMF's maximum contribution. This could refinance Irish, Portuguese, and Spanish public debt needs for a couple of years. And the ECB is helping with direct debt purchases. Isn't this enough?

In our view, doing nothing more is not an option. The crisis is not over. Eurozone bank systems – in both the core and periphery members – are in a parlous state. Greek public finances have not been stabilised. Massive shocks could come from any number of sources ranging from the Spanish banking sector to disturbing political developments in members facing severe fiscal austerity measures.

We already see ominous signs of fear and stress in the interbank market. Risk premia on some Eurozone government debt have resumed their upwards trend despite the two May packages. The underlying causes of the crisis have not been addressed. Confidence in the financial system has not been restored.

Doing nothing thus risks reigniting the vortex of increasing risk premia and declining confidence. The time for action is now, for, as Barry Eichengreen puts it, "financial crises feed on uncertainty. The longer uncertainty is allowed to linger, the greater the damage to confidence."

Systemic solutions for systemic problems

The systemic nature of policy failures and risks facing the Eurozone demands a systemic solution. "To avoid similar crises in the future, Europe will have to build out the institutions of its monetary union," writes Barry Eichengreen.[7] But the reforms must be based on a hard-headed evaluation of the possible. As Jean Pisani-Ferry writes: "A realistic reform agenda must ditch long-held

[7] Eichengreen is worth listening to; he foresaw the Eurozone crisis in a January 2009 Vox column (Eichengreen 2009).

federalist dreams" – such as a significant increase of the EU budget, significant horizontal transfers, or a much tighter coordination of national economic policies – and attempt at reconciling the need for serious reforms and the lack of political momentum.

As concerns the immediate term, the ECB has already done more than its share (and some would argue too much) by buying GIPS government debt. And governments have expressed a willingness to support member countries. But more is needed.

The Eurozone "ship" is holed below the waterline. The ECB actions are keeping it afloat for now, but this is accomplished by something akin to pumping out water. What European leaders need to do very soon is to find a way to fix the hole; ECB bond purchases are merely a palliative. The risk now is that politicians become complacent – confusing treatment of the symptoms for treatment of the disease. In fact, much reform is needed and soon.

Reform is needed in five areas (Table 1). This draws largely, but not exclusively, on the essays in the eBook.

Monetary policy

- The ECB should embed financial stability considerations into its policy mix while maintaining price stability as its core mandate. This will require close coordination between the Eurosystem central banks and regulatory authorities and the centralisation of macro-prudential responsibilities within the ECB.

- Leaders need to clarify the fact that the ECB is not a fiscal institution. What the ECB is doing is an emergency reaction to an emergency situation – not an expansion of its competencies. This will be critical to maintaining its hard-earned credibility – its independence in the area of price stability needs to be made absolutely clear. The purchase of government bonds is not a long-run solution. In fact, it creates balance-sheet risks for the ECB as well as complicating the conduct of monetary policy.

Fiscal policy

- The Special Purpose Vehicle (SPV) announced on 9 May 2010 to allow for Eurozone fiscal transfers is now operational (its legal home is in Luxembourg). The operational and legal framework of this "Super SPV" needs to be clarified, including limits on the amount of fiscal transfers permitted.

- The process of longer-term fiscal consolidations needs to be made credible. This should be accomplished primarily through the establishment of independent national fiscal boards. Charles Wyplosz's logic on this is impeccable: "fiscal discipline is and remains a deeply seated national prerogative of each national government and parliament. The inescapable implication is that the Stability Pact must be decentralised to where

authority lies.... Each country must be required to adopt national institutions that can guarantee fiscal discipline." Some form of heightened coordination at the Eurozone level may also be wise. The essays by Phil Lane and by Antonio Fatas and Ilian Mihov contain detailed suggestions on how such "independent fiscal councils" should operate, and the essay by Michael Burda and Stefan Gerlach offers some novel thinking on how to coordinate the new national institutions.

- Fiscal restraints, however, should not be straightjackets. Eurozone nations – especially those in the periphery – need fiscal policy to smooth out the booms and bust from real interest rate effects. Combining fiscal discretion with medium-term sustainability will be a key task for the new national fiscal institutions.
- The domain of the Stability and Growth Pact and the national fiscal councils should be broadened to include the monitoring of private debt developments.

Banking & financial market regulation

- Until Europe's banking mess is cleaned up, every shock has the potential to create a systemic crisis. A first step would be to improve transparency. Stress tests of Eurozone banks need to be released in order to reveal the potential losses that are now lurking in the darkness, causing banks to fear for each others' solvency. This would clear the road for bank recapitalisations where needed.
- There is broad consensus among economists that it is better to acknowledge losses early on and to recapitalise financial institutions that cannot bear them, with appropriate loss sharing by the private sector. Dealing with the weak bank-problem now will be cheaper than continuing with blanket guarantees. Sizeable funds from the bank rescue packages announced in 2008 are still available for these purposes, and if need be, more public sector funds should be made available; shareholders should share the pain and possibly creditors as well.
- Financial sector resolution frameworks need to be improved at a European level to deal with cross-border bank failures. This is particularly important given the growing integration of the European banking market and the size of banking systems relative to domestic economic activity.
- Many authors in this volume call for an explicit European Debt Resolution mechanism that would allow nations like Greece to restructure the debt into a more sustainably maturity profile; the essay by Avinash Persaud presents some clear thinking on this. Thomas Mayer argues that such a mechanism would put an end to what he calls bailout "blackmail".
- Better banking and financial market regulations should be a top priority for leaders worldwide, but there is no particular reason for Eurozone leaders to take up the matter independently of the mainly national and international initiatives.

Competitiveness

- The GIPS countries need to repair macroeconomic imbalances through a painful process of much-needed wage adjustments. To facilitate this process, labour market reforms are needed (if possible with a national pact), and plans for backwards price indexation of wages need to be abolished.
- Going forward, Eurozone nations should use counter-cyclical fiscal policy to dampen national wage and price developments that undermine their competitiveness.

Structural reform

- Structural reforms, especially in the services sector, should strengthen domestic demand in members with trade surpluses (especially in Germany) and promote export opportunities (especially for GIPS countries) to enhance growth. The essay by Alberto Alesina and Roberto Perotti makes a particularly strong case for structural reform. As they put it: "The constraint on European growth is not Germany's fiscal policy. It is the supply-side rigidities that riddle all European national economies – especially those of southern European countries."

Reform priorities

This is a very long list. Some prioritisation is needed. The following sequence of steps follows naturally from the nature of actions involved.

1. **Bank restructuring:** Stress-testing and repair of Eurozone banks is a high priority; the euro is crisis-prone due largely to the fragility of Eurozone banks. Some countries have already done such stress tests but results have not always been made public; others will need to update previous stress test results. Mobilising funds for recapitalisation purposes with the private sector being offered a chance to contribute funds will take some time. This process should not be further delayed and a clear timetable for bank restructuring needs to be communicated to the public.
2. **Framework for Eurozone fiscal transfers:** Clarification of the legal and operational framework for the use of the Luxembourg Special Purpose Vehicle for Eurozone fiscal transfers is also a priority, so that action can be taken quickly should events so require (e.g. a run on Spanish banks). However, any conditions on bailouts (and the threat to not bailout a member) become credible only once it has become clear from the stress testing and recapitalisation of banks that the European banking system could actually take the hit and survive.
3. **Competitiveness:** Wage adjustments require time. But it is important that all labour market participants understand what they have to expect over the next few years. The road ahead is going to be painful for nations where wages outstripped productivity growth in the euro's first ten years.

Table 4. Eurozone policy framework: What should be done now?

Policy	Needed now
Monetary	Add explicit emphasis on financial stability; clarify that ECB is not a fiscal institution
Fiscal	Clarify the framework for Eurozone fiscal transfers; make long term consolidation credible through independent national fiscal policy councils
Banking and financial market regulation	Stress test banks and recapitalise if needed; establish crisis resolution procedures
Competitiveness	Promote wage adjustment in the GIPS countries through labour market reforms; abolish backwards indexation
Structural reform	Accelerate structural reforms to strengthen domestic growth and promote export opportunities

Source: Authors' compilation

4. **Structural reforms:** Structural reforms are always hardest, but they might become somewhat easier under crisis conditions. Without structural reforms, the growth path ahead will be modest at best, even with successful fiscal consolidation.

5. **Other reforms:** Measures to ensure longer-term fiscal sustainability, like independent fiscal boards, while important, can be taken once crisis pressures abate. The same applies to establishing a framework that coordinates monetary policy and macroprudential regulation.

Most of these measures have to be executed at the national level. The EU can only provide a framework and coordination. This also applies to the one step that is widely regarded as unavoidable, but officially off-limits, namely a restructuring of Greek public debt.

Let's now put national differences aside and finish the job of restoring stability and prosperity in Europe. The European flotilla may have run aground, but it need not sink. This will require coordination, teamwork, and discipline. All hands on deck!

References

Baldwin, Richard (ed) (2009). *The Great Trade Collapse: Causes, Consequences and Prospects*, VoxEU.org eBook, 27 November.

Buiter, Willem (2009). "The unfortunate uselessness of most state of the art academic monetary economics", VoxEU.org, 6 March.

Caballero, Ricardo (2009). "Sudden financial arrest", VoxEU.org, 17 November.

Eichengreen, Barry (2009). "Was the euro a mistake?", VoxEU.org, 20 January.

Eichengreen, Barry (2010). "It is not too late for Europe", VoxEU.org, 7 May.

Eichengreen, Barry, Andrew Rose and Charles Wyplosz (1996). "Contagious Currency Crises: First Tests", *Scandinavian Journal of Economics* 98(4), December 1996, 463–484.

Gros, Daniel, and Stefano Micossi (2008). "The beginning of the end game", VoxEU.org, 20 September.

Lane, Philip R. (2010). "Some Lessons for Fiscal Policy from the Current Crisis," in preparation for the *Nordic Economic Policy Review*.

Leijonhufvud, Axel (2009). "Macroeconomics and the Crisis: A Personal Appraisal", CEPR Policy Insight 41, November.

Obstfeld, Maurice (1986). "Rational and Self-Fulfilling Balance of Payments Crises", *American Economic Review* 76(1), March 1986, 72–81.

Pisani-Ferry, Jean, Andre Sapir and Benedicta Marzinotto (2010). "Two crises, two responses". Bruegel Policy Brief 2010/01, March 2010.

Reinhart, Carmen, and Kenneth Rogoff (2009). *This Time Is Different: Eight Centuries of Financial Folly*, Princeton University Press.

Wyplosz, Charles (2007). "Debt Sustainability Assessment: The IMF Approach and Alternatives", HEI Working Paper 03/2007, Geneva.

About the authors

Richard Edward Baldwin is Professor of International Economics at the Graduate Institute, Geneva since 1991, Policy Director of CEPR since 2006, and Editor-in-Chief of Vox since he founded it in June 2007. He was Co-managing Editor of the journal *Economic Policy* from 2000 to 2005, and Programme Director of CEPR's International Trade programme from 1991 to 2001. Before that he was a Senior Staff Economist for the President's Council of Economic Advisors in the Bush Administration (1990–1991), on leave from Columbia University Business School where he was Associate Professor. He did his Ph.D. in economics at MIT with Paul Krugman. He was visiting professor at MIT in 2002/03 and has taught at universities in Italy, Germany and Norway. He has also worked as consultant for the numerous governments, the European Commission, OECD, World Bank, EFTA, and USAID. The author of numerous books and articles, his research interests include international trade, globalisation, regionalism, and European integration. He is a CEPR Research Fellow.

Daniel Gros is the Director of the Centre for European Policy Studies (CEPS) in Brussels. His current research concentrates on the impact of the euro on capital and labour markets, as well as on the international role of the euro, especially in Central and Eastern Europe. He also monitors the transition towards market economies and the process of enlargement of the EU towards the east (he advised the Commission and a number of governments on these issues). Since 2002, he has been a member of the Shadow Council organised by Handelsblatt; and since April 2005, he has been President of San Paolo

IMI Asset Management. He is editor of *Economie Internationale* and editor of *International Finance*. He has published widely in international academic and policy-oriented journals, and has authored numerous monographs and four books.

1. Drawing a line under Europe's crisis

Barry Eichengreen
University of California, Berkeley and CEPR

Financial crises feed on uncertainty. This essay warns that the longer the Eurozone crisis is allowed to linger, the greater will be the damage. But Europe can take concrete actions to bring it to an end. It should make bank stress tests public, provide more clarity on its special purpose vehicle, move forward with restructuring Greece's debt, and support growth through quantitative easing.

Financial crises feed on uncertainty. The longer uncertainty is allowed to linger, the greater the damage to confidence and the more difficult it becomes to repair. It is essential therefore that European policymakers move decisively to draw a line under the crisis.

This will be easier said than done. The Greek, Portuguese, and Spanish governments are struggling to build a consensus for fiscal consolidation. Ireland shows that doing so is possible. But street demonstrations across Southern Europe are a reminder that replicating its success will not be easy. Political consensus for fiscal consolidation is not built in a day.

And if fiscal consolidation is hard, structural reform is harder. Fiscal consolidation means belt-tightening, but pension and labour market reforms cut to the heart of national social and economic models. The reform of models will be an ongoing process stretching over years. Modest down payments will add a fillip to confidence, but they will not draw a line under the crisis.

More challenging still is the reform of EU institutions, since not just one but 27 national polities have to agree. To avoid similar crises in the future, Europe will have to build out the institutions of its monetary union. It will have to create a proper emergency financing mechanism – no more emergency meetings at 2 o'clock in the morning, and no more special purpose vehicles to finesse awkward statutory provisions. It will have to create institutions of fiscal coinsurance to provide temporary transfers to countries with strong policies but transitory budgetary problems.

The ECB, recent events remind us, is a lender and market-maker of last resort and not just the steward of a monetary rule. It will have to become more transparent. To protect its independence in what is a messy world, it will have to publish minutes and votes. This will mean significant changes in institutional practice. The ECB may not savour the prospect, but its legitimacy and credibility are at stake.

And Europe will need fiscal rules with teeth; it will need to move well beyond the Commission's modest proposals that governments describe their budget plans to their EU partners prior to submitting them to their national parliaments and that the provisions of the Stability and Growth Pact should come into play before the 3% threshold for deficits is reached. The Commis-

sion will have to be strengthened to where it has veto power over those pre-legislative submissions. Application of the Stability Pact's sanctions and fines will have to be outsourced to an independent European Fiscal Council.

Getting the agreement of 27 EU states on these reforms will not be easy. But the longer the delay in starting, the less confidence the euro will inspire.

What can Europe do *now* to draw a line under its crisis? Four things

- First, European regulators need to make public the detailed results of their bank stress tests and be ready to recapitalise those institutions whose positions are dangerously weak.

Uncertainty about which banks are holding how many Southern European bonds is allowing investor fear to take on a life of its own. Until investors are given the information they need to feel reassured about the condition of individual banks, the crisis will not pass.

- Second, policymakers need to provide more clarity on their €440 billion special purpose vehicle.

We need to know whether its bonds will be senior or junior to existing national debts. We need to know that the special purpose vehicle will be able to fund itself and provide assistance with the speed required by financial markets. The announcements of early May are not enough to reassure.

- Third, the untenable Greek situation needs to be resolved.

So long as European officials continue to assert, contrary to the facts, that Greece's debt will not have to be restructured, everything else they say will similarly be dismissed as wishful thinking. Policymakers need to bite the bullet now and move forward with restructuring Greece's debt if only to restore their own credibility.

- Finally, more needs to be done to support growth, besides simply allowing the euro to weaken, while other difficult adjustments are taking place.

Some of us were saying this as long ago as April this year (Eichengreen 2010). But just because the point is familiar doesn't make it less important. Drawing a line under the crisis requires Germany to support aggregate demand while its European partners undertake fiscal consolidation. Budget balance is an admirable goal for an ageing German society, but it is a goal for 2012, not 2010.

Further action by the ECB is also overdue

The argument for not cutting policy rates to zero has been that it is better to keep room to cut in reserve for a rainy day. Well, it's raining. And since

100 basis points are unlikely to make a big difference, it is time, long since time actually, for the ECB to get serious about quantitative easing. Without growth, the pain of adjustment and consolidation will quickly become unbearable. The only pain relievers on the horizon are Germany and the ECB.

Conclusion

This crisis has been allowed to fester for too long. Fortunately, there are concrete actions that Europe can take to bring it to an end.

References

Eichengreen, Barry (2010). Remarks at the Ninth Annual Munich Economic Summit.

About the author

Barry Eichengreen is the George C. Pardee and Helen N. Pardee Professor of Economics and Professor of Political Science at the University of California, Berkeley, where he has taught since 1987. He is a CEPR Research Fellow, and a fellow of the American Academy of Arts and Sciences, and the convener of the Bellagio Group of academics and economic officials. In 1997–1998, he was Senior Policy Advisor at the International Monetary Fund. He was awarded the Economic History Association's Jonathan R. T. Hughes Prize for Excellence in Teaching in 2002 and the University of California at Berkeley Social Science Division's Distinguished Teaching Award in 2004. He is also the recipient of a *doctor honoris causa* from the American University in Paris. His research interests are broad-ranging, and include exchange rates and capital flows, the gold standard and the Great Depression, European economics, Asian integration and development with a focus on exchange rates and financial markets, the impact of China on the international economic and financial system, and IMF policy, past, present and future.

2. How to embed the Eurozone in a political union

Paul De Grauwe
University of Leuven and CEPR

The Eurozone lacks the mechanisms needed to ensure convergence of members' competitive positions and to resolve crises. This essay argues that the survival of the Eurozone depends on its capacity to embed itself into a political union. The latter must imply some transfer of sovereignty in macroeconomic policies and the organisation of automatic solidarity between member states.

Two fault lines marred the Eurozone's foundation from its inception but were overlooked by most. The recent debt crisis has laid them bare for all to see.

- There is no mechanism to ensure convergence of members' competitive positions, and thus to prevent major trade imbalances.

This stems from the fact that economic policies (spending and taxation, social policies, wage policies, etc.) remain firmly in the hands of the member governments and members do not coordinate such policies.

- There is no mechanism to resolve crises caused by these imbalances and divergent competitive positions.

Consequently, Eurozone crisis management is ad hoc, time-consuming, and hindered by a lack of credibility.

Lack of political union: What are the essential missing elements?

These two fault lines are intricately related to the fact that the Eurozone is not embedded in a sufficiently strong political union. The Eurozone's future depends critically on its capacity to move forward into a political union. Failure to move forward towards a political union will almost certainly condemn the Eurozone to oblivion.

But a full political union seems unrealistic for the foreseeable future, as it would imply a significant transfer of spending and taxing powers to a central EU government and parliament. Today, the EU budget represents about 1% of EU GDP and proposals to boost that by even 0.1% consistently attract vetoes from several EU members. A budgetary union, in short, is out of reach.

Is there anything less than full budgetary union that can save the Eurozone? Put differently, what is the minimum ingredient of a political union that can keep the Eurozone alive in the long run?

The answer is dictated by the Eurozone's fault lines. The political union needed is one that can repair the two fault lines.

Redressing the imbalance fault line

The necessary elements of political union must be able to:

- Prevent the massive divergences in competitive positions and trade imbalances within the Eurozone.

Importantly, with the exception of Greece, the imbalances and divergences we see today had little to do with government profligacy. They appeared in the private sector. Unsustainable consumption and real estate booms financed by private debt emerged in a number of member countries, like Ireland and Spain. These led to strong price and wage increases, undermining the competitiveness of these countries and leading to large current account deficits.

It is both ironic and instructive that these countries scrupulously adhered to the Stability and Growth Pact. Enforcing the pact may be a necessary condition for preventing future crises, but it is far from sufficient.

The domain of the Stability and Growth Pact must be broadened – it must include the monitoring of private debt developments as well as public debts.

Additional pooling of economic policy sovereignty

The European Commission has recognised this point in its latest proposals on economic governance in the Eurozone. The issue, however, is how one can make these proposals bite. One thing is certain – there will have to be a transfer of sovereignty in economic policies.

This transfer of sovereignty should not only take place in the "deficit" countries that allowed private and/or public debt levels to explode. One should not forget that "surplus" countries helped finance this debt explosion. Any scheme aiming at identifying and monitoring imbalances will have to be symmetric. It would have to ensure that both deficit and surplus countries change their policies.

From the Eurozone's perspective, there are not good imbalances and bad imbalances – just imbalances. There are, consequently, no good and bad guys when it comes to international imbalances. Institutional reforms must recognise this.

Redressing the crisis-resolution lacuna: A second-best proposal

Full-fledged monetary unions – most of which are embedded in political unions – typically involve automatic transfers across regions. Regions experiencing economic good times transfer resources to regions in economic distress.

As argued earlier, such a budgetary union remains a remote possibility for the Eurozone. That's why a second best solution must be sought.

The recent decision to create a financial stability fund within the Eurozone goes in the right direction. It should allow the Eurozone to pool resources

and to act quickly in a crisis situation. It falls short of an automatic insurance mechanism, however, mainly because it is a network of bilateral loan agreements, making it possible for individual countries to pull out in the future.

Thus far, the design of the Eurozone has foregone any form of automatic insurance mechanism. The main reason was that – as with any insurance mechanism – the risk of moral hazard was viewed as too great. The specific risk here was that governments would create excessive debts and deficits in anticipation of insurance-fund bailouts. Avoiding this was the main reason why the Eurozone was created without an insurance mechanism.

While it is understandable that countries were not willing to automatically transfer resources to deficit countries, it is less clear why so many fell for the illusion that a monetary union could function smoothly without such an insurance mechanism.

The present crisis shows that even if countries never intended to provide assistance to others, events can force them to do so. The same juxtaposition of intentions and actions exists on the domestic front. Governments that never intended to bailout their banks found themselves doing exactly that when the banking crisis erupted. Thus, at some point, a monetary union forces its members to show solidarity, whether they like it or not. That's why setting up an explicit solidarity (insurance) mechanism is important.

The official doctrine in the Eurozone has been that an insurance mechanism is not necessary for a smooth functioning of the Eurozone. The Stability and Growth Pact would do the trick. The received wisdom was: "Just make sure that countries abide by the rules". If they do so, i.e. if they are always well behaved, there is no need for an automatic insurance mechanism funded by a centralised budget or European Monetary Fund. But this is like saying that if people follow the fire code regulations scrupulously, there is no need for a fire brigade. The truth is that there will always be some people who fail to follow the rules scrupulously, so a fire brigade will always be necessary.

Survival of the Eurozone

There can be little doubt that the survival of the Eurozone depends on its capacity to embed itself into a political union. The latter must imply some transfer of sovereignty in the conduct of macroeconomic policies other than monetary policies and the organisation of minimal forms of automatic solidarity between member states even when some of these have misbehaved.

About the author

Paul De Grauwe is Professor of International Economics at the University of Leuven, Belgium, having also been a visiting scholar at the IMF, the Board of Governors of the Federal Reserve, and the Bank of Japan. He is a member of the Group of Economic Policy Analysis, advising the EU Commission President Manuel Barroso, and was a member of the Belgian parliament from 1991 to

2003. His research interests are international monetary relations, monetary integration, foreign-exchange markets, and open-economy macroeconomics. His books include *The Economics of Monetary Union* (Oxford University Press), *International Money. Post-War Trends and Theories* (Oxford University Press), and *The Exchange Rate in a Behavioural Finance Framework* (Princeton University Press). He obtained his Ph.D. from the Johns Hopkins University in 1974 and *honoris causae* of the University of Sankt Gallen (Switzerland), of the University of Turku (Finland), and the University of Genoa. He is a CEPR Research Fellow.

3. The Eurozone's levitation

Charles Wyplosz
Graduate Institute, Geneva and CEPR

Some see the Eurozone crisis as a harbinger of a more perfect union, others as the euro's death knell. In contrast, this essay suggests the current situation is something in-between; the Eurozone is levitating on the hope that an exit strategy can soon be found. The key is to establish fiscal discipline in every Eurozone member. As a real European government is politically impossible, this must be based on national institutions that can guarantee fiscal discipline.

Recent events in Europe can be interpreted in the light of two diametrically opposed theories.

Eurozone crisis: Stepping stone to a more perfect union

As intended, the markets have been "shocked and awed" by a European Financial Stability Facility (EFSF) of 750 billion euros – that's 6% of EU GDP – and by the ECB scooping up public debts to the tune of 100 billion euros. But this is not the end of it.

Eurozone governments are scrambling to announce ambitious deficit-reducing packages, and Finance Ministers are meeting at least once a week to prepare further far-reaching measures including:

- A strengthening of the Stability and Growth Pact to enforce fiscal discipline (at long last);
- A statistics police that will deliver safe data from every corner of the Union; and
- A race between the Commission and Eurozone governments to establish a sort of pan-European government.

This is the silver lining theory of the Greek crisis. Greece's woes and the attendant contagion pointed out the cracks in the Eurozone's architecture. They also provide the urgency political leaders needed to take Europe one step up towards a more perfect union. Three cheers for their courage and determination!

There is, however, another storyline out there – one with an unhappy ending, namely the euro's demise.

Eurozone crisis: The euro's fatal flaws finally revealed

Proponents of the euro-is-doomed theory view the Eurozone crisis as validation of their analysis. We told you all along, they say, sovereign countries can-

not share a common currency. Highly favourable conditions hid the cracks for a while, but the Greek crisis widened them enough so that now they are plain for all to see. The euro was always a political project, not based on sound economic principles. It was just a matter of time before economic trouble would arise. Self-preserving political leaders now see that it is in their electoral interest to return to normality by re-establishing their old cherished currencies. The end of an interesting but doomed experiment, the euro is already falling. Three cheers for hard-nosed economists!

A third theory: The "levitation theory"

I am inclined to embrace another theory, which I call the levitation theory. The market run on European public debts was stopped by the ECB when it effectively put a floor under public debts. This gives Europe time to deal with the problem, but not unlimited time. The ECB can sterilise its operations but it must return to normalcy at some point. The EFSF has not yet proven that it can exist, much less that it can bail out a government without bailouts becoming the norm.

The Eurozone, according to this theory, is levitating – hanging in mid air – sustained by the hope that an exit strategy from this crisis will be designed in time. Unfortunately, the rescue operation has made the cracks wider and deeper than before the crisis; the solution is now all the more daunting.

What are these cracks, then? The creation of the euro was an extraordinary bold undertaking because member countries were to remain fully sovereign as far as budgetary matters are concerned. It was clear that the monetary union would not deliver price stability unless fiscal discipline was guaranteed. Perfectly aware of this original sin, the authors of the Maastricht Treaty introduced no less than three safeguards.

- First, the no-bailout clause established that national governments alone were in charge of their budget and that they alone would be sole responsible for any slippage. No European government or official institution was allowed to rescue another Eurozone member.

- Second, the ECB was barred from financing public debts.

- Third, the excessive deficit procedure led to the Stability and Growth Pact.

The Pact never worked and cannot work because it presupposes that a sovereign government can be told what to do with its budget. Failure of the Pact led to a sequence of events that blew away the other two safeguards. Not only must we now face the immediate consequences of the debt crisis, we must also find new ways to deal with the "original sin". The no-bailout clause has been sidelined, and the ECB's credibility has been undermined.

What is to be done?

Let me start with what should not be done, or at least not right away.

- Eurozone governments should not waste time trying to strengthen the Stability and Growth Pact. Strengthening means adding sanctions but sanctions cannot be really imposed on democratically elected governments.[1]
- A meaningful government of Europe will not emerge soon as EU citizens are not now willing to give up much sovereignty. The disastrous saga of the Constitutional Treaty and the painful ratification of the Lisbon Treaty show that, very sadly, this is not the time for bold European undertakings.

What then should be done? How can EU leaders arrange an exit strategy before the levitation trick grows old?

Fiscal discipline enforced by new national institutions

The solution is to go back to basics. We absolutely need to establish, once and for all, fiscal discipline in every Eurozone country. But fiscal discipline is and remains a deep-seated national prerogative of each national government and parliament. The inescapable implication is that the Stability Pact must be decentralised to where authority lies. Instead of dreaming up ways around sovereignty, it is much more productive to try and make sovereignty work for the common good. Each country must be required to adopt national institutions that can guarantee fiscal discipline.

In a democracy at least, fiscal profligacy is not a story of "politicians gone crazy". It is the rational outcome of the interplay between elections and pressure groups.[2] Fiscal profligacy occurs because politicians find it politically optimal given the constraints and pressures they face. It will continue as long as the same pressures and constraints are in place.

Restoring fiscal discipline therefore requires Europe to tackle this political failure head on by adopting institutions that bind the budgetary process. There are many possible approaches, as shown in Von Hagen and Harden (1995) and Wyplosz (2002). It well may be that – given history and local politics – different countries need to adopt different solutions. A good precedent is last year's decision by Germany to write into its Constitution the interdiction for the structural deficit to exceed 0.35% of GDP.

The first step forward

A good way to proceed is to invite – and please do so kindly because this is a national sovereignty issue – each member to submit its own proposed

[1] The point was made long ago in Eichengreen and Wyplosz (1997).

[2] See, for example, Alesina and Tabellini (1990) or Krogstrup and Wyplosz (2010).

solution, and have it vetted by the Commission or an *ad hoc* committee under the EU Presidency. Countries whose plans are not approved should lose the support of the EFSF and of the ECB until they come up with a better one. The same will apply to those countries who have not transcribed an approved plan into their national legal structure by a given deadline.

Even with all the plans in place, a delicate question will remain. It is sometimes felt that not all Eurozone members strictly abide by their own laws. There will be a need to empower the European Court of Justice to fill that gap in the event that a budget violates the country's own laws. It is for legal experts to tell us how this can be done.

Medium-run credibility without short-run overkill

Adopting water-tight legislation that guarantees budgetary discipline has an important additional advantage. With a recovery that is shaping up to be modest at best, the current wave of fiscal tightening is premature. It is understandable that governments feel that they have no choice; they must signal to markets that they are serious about fiscal discipline. But the price of this signal may be huge. The adoption of strong legislation, even if it implies progressively rebalancing, would be a much more powerful signal than a potentially unsustainable fiscal tightening, and it would allow the exit strategy from fiscal stimulus packages to be delayed for a bit longer.

References

Eichengreen, Barry, and Charles Wyplosz (1997). "The Stability Pact: Minor Nuisance, Major Diversion?", *Economic Policy* 26: 65–114.

Krogstrup, Signe, and Charles Wyplosz (2010). "A Common Pool Theory of Supranational Deficit Ceilings", *European Economic Review* 54(2): 273–281.

Von Hagen, Jürgen, and Ian Harden (1995). "Budget Processes and Commitment to Fiscal Discipline", *European Economic Review* 39(3): 771–779.

Wyplosz, Charles (2002). "The Stability and Growth Pact: Time to Rethink", Briefing Notes to the Committee for Monetary and Economic Affairs, European Parliament.

About the author

Charles Wyplosz is Professor of International Economics at the Graduate Institute, Geneva; where he is Director of the International Centre for Money and Banking Studies. His main research areas include financial crises, European monetary integration, fiscal policy, economic transition and current regional integration in various parts of the world. He was a founding Managing Editor of the review *Economic Policy*. Currently a member of the Group of Independent Economic Advisors to the President of the European Commission, and of the Panel of Experts of the European Parliament's Economic

and Monetary Affairs Committee, as well as a member of the "Bellagio Group", Charles Wyplosz is an occasional consultant to the European Commission, the IMF, the World Bank, the United Nations, the Asian Development Bank, and the Inter-American Development Bank. He has been a member of the "*Conseil d'Analyse Economique*" which reports to the Prime Minister of France, of the French Finance Minister's "*Commission des Comptes de la Nation*" and has advised the governments of the Russian Federation and of Cyprus. He holds degrees in Engineering and Statistics from Paris and a Ph.D. in Economics from Harvard University.

4. Eurozone governance: What went wrong and how to repair it

Jean Pisani-Ferry
BRUEGEL and Université Paris-Dauphine

The crisis has revealed deep flaws in the Eurozone's governance regime. This essay argues that EU leaders should address fundamental questions about the operational principles upon which the euro is based. Key choices for Eurozone leaders are the nature of the economic policy framework, the optimal degree of decentralisation, and the identification of reforms that will ensure the policy regime can deal with all eventualities.

The EU faces two challenges: managing the crisis while coordinating Eurozone adjustment, and reforming its governance to avoid future crises. The first is vital in the eyes of the markets but creation of the Van Rompuy Task Force has focused attention on the second.

Recent events have indeed shown that the Eurozone economic governance framework is incomplete (see for example Bofinger and Ried 2010). But to know how to repair the framework, we must first answer the question: "What went wrong?"[1]

What went wrong in the Eurozone?

The simplistic answer blames bad implementation of good rules. Poor implementation was surely part of the problem, so enforcement must be an important part of the solution. However lessons from recent events indicate that there are deeper problems (European Commission 2010a,b). Before turning to the remedies, however, consider the lessons learned.

The most basic lesson is:

- Top-down government by statistics does not work (especially, but not only, when they are wrong).

From 2000 to 2008 the Greek budget deficit reported to the EU averaged 2.9% of GDP. We now know the real number was 5.1% (Marzinotto et al. 2010). There are political and practical reasons behind this failure, but the problem runs deeper. The EU budget monitoring system is based on national-accounts data, not central government budget data, and it makes cyclical corrections. These two well-meaning practices imply that the EU budgetary surveillance system need not reflect fiscal facts on the ground.

[1] This essay is an abridged version of the full analysis in Pisani-Ferry (2010).

- Deterministic governance does not work in a stochastic world.

Since 2008, some countries moved from apparently sound fiscal positions to alarmingly weak situations in an astonishingly short period. Given uncertainties, a "value at risk" – or what might be called a "policy at risk" – approach is called for.

- Not all problems are fiscal.

The existing framework implicitly assumes that all stability threats arise from budgetary indiscipline. While this was the key to the Greek case, the Spanish and Irish cases are quite different. Recent history makes a strong case for a broader surveillance framework (Commission 2010a). Fiscal risks need to be prevented more effectively, and non-fiscal risks arising from credit booms, asset-price developments, or a sustained appreciation of the real exchange rate also need to be addressed.

- A commitment to no assistance is not credible.

Although the "no-assistance principle" is nowhere to be found in the Treaty, there was, until Greece, a widespread belief that a member would be allowed to default rather than be provided with assistance (as is the case for US states). Events show that Eurozone members are entitled to assistance as part of an IMF-led programme with strict conditions. But this does not entirely clarify the endgame. What happens if the bailout programme needs to be bailed out? What if a member benefiting from assistance remains unable to regain access to the market? The ECB's government bond purchase programme raises related problems. As long as such ambiguity persists, there will be room for speculation about the nature of the solution to insolvency cases.

- Policy coherence is lacking while ownership of the euro rules is shallow

The euro's success ultimately depends on its members' commitment to run policies that are consistent with participation in a monetary union. Such "ownership" has been lacking from the start of the euro. Any reform will therefore require greater ownership by members.

How to repair it: Three dimensions of Eurozone governance reform

Problems clearly run deeper than enforcement, so limiting reform ambitions to tinkering with the Stability and Growth Pact would be widely regarded as indicative of a worrying inability to reform. The Van Rompuy Task Force should therefore look beyond strengthening existing provisions.

The political situation, however, is not auspicious. Fundamental reforms will be difficult – few of the founding EU members show any appetite for further integration. The Monnet philosophy according to which "l'Europe se

fera dans les crises et elle sera la somme des solutions apportées à ces crises" applies partially at best.

A realistic reform agenda must ditch long-held federalist dreams – such as a significant increase of the EU budget, significant horizontal transfers, or a much tighter coordination of national economic policies – and attempt at reconciling the need for serious reforms and the lack of political momentum. Three dimensions of such reforms are worth highlighting.

Dimension 1: What policy framework?

Currently, price stability is assigned to the ECB and budgetary discipline to the Stability and Growth Pact. Other objectives were ill-defined in the Treaty and not operational in practice. There are three economic objectives for Eurozone governance besides price stability:

- Budgetary discipline,
- Financial stability, and
- The avoidance of macroeconomic imbalances.

This poses two key challenges to a new policy framework: task allocation in the reformed policy framework should be clearly defined, and three distinct objectives require at least three instruments. On the first, the much-discussed modifications of the Pact might be sufficient, but national supervisory instruments are also of limited effectiveness in a financially integrated context. This necessarily brings in another array of instruments that can be of a regulatory or a tax nature. On the last, guidelines for wage formation may also be considered part of the required competitiveness monitoring toolkit.

Dimension 2: How much centralisation?

Eurozone budgetary discipline was not a great success. Budgetary discipline might be more successful in a more decentralised system. What might emerge is a system that combines domestic institutional reforms and market forces to keep debts and deficits in check. Germany with its new budget rule could become a benchmark against which market judge a nation's the fiscal creditworthiness. As such, Germany might become the fiscal policy anchor as it became the monetary policy anchor in the European Monetary System.

A strategic choice for the EU is whether governance reforms should encourage decentralisation through providing an umbrella framework for national rules and institutions, through ensuring they are consistent with Eurozone objectives, and through somehow rewarding countries with better institutions. There are strong economic and political-economy arguments in favour of such an approach.

Dimension 3: Which reforms to ensure completeness of the policy regime?

The lessons listed above illustrate the importance of completeness the reformed policy framework – i.e. how the regime behaves in various states of nature and how ex ante incentives relate to ex post rules. Part of this is the meshing of ex ante surveillance and ex post crisis resolution. The sort of issue is particularly pressing for the European Financial Stability Facility recently established.

As regards debt crises, a full crisis-resolution regime – call it the European Debt Resolution Mechanism – needs to be defined including the principles and modalities of assistance, debt restructuring, and – possibly – exit. If exit is (sensibly) ruled out because of its potential spillover effects, then this only strengthens the case for defining the debt resolution regime as proposed by Germany (Federal Ministry of Finance 2010). Current reluctance to create expectations of an imminent default should not serve as an excuse for refusing to work out the whole set of principles upon which Eurozone reform needs to be based. Half measures now would only perpetuate the incomplete character of the system.

Conclusions

Europe's problems run deeper than an enforcement. The Stability and Growth Pact faces more serious difficulties than most European policymakers are willing to admit. Its "preventive arm" is debilitated by the combination of estimation uncertainties in the structural deficit concept, and an overly deterministic approach. Its "corrective arm" is debilitated by the speed at which the budget balance deteriorated in this crisis.

Discussions of Eurozone governance have been going on at least since the first negotiations on the creation of the euro. They have not been settled because of the ambiguities in the positions of the key participating countries, especially Germany and France, and the ambiguities in the compromises they had reached (Pisani-Ferry 2005). But something new has happened.

This crisis is an opportunity for clarification. In order not to waste it, the Van Rompuy Task Force and the European Council should resist the temptation to patch up divergences and limit ambitions to tinkering with the existing policy framework. Rather, they should take the opportunity to address fundamental questions about the operational principles upon which the euro is based.

Keynes once quipped, "When the facts change, I change my mind. What do you do, sir?" Let us hope that Eurozone leaders have the mental flexibility to answer this the right way. The future of the euro depends upon it.

References

European Commission (2010a). "Surveillance of Euro Area Competitiveness and Imbalances", May.

European Commission (2010b). "Reinforcing Economic Coordination", Communication COM, 250 final, May.

Pisani-Ferry, Jean (2010). "Euro Area Governance: What Went Wrong? How to Repair It?", Bruegel, 8 June.

Pisani-Ferry, Jean, Andre Sapir and Benedicta Marzinotto (2010). "Two Crises, Two Responses", Bruegel Policy Brief 2010/01, March.

Ried, Peter, and Stefan Ried (2010). "A New Framework for Fiscal Policy Consolidation in Europe", VoxEU.org, 20 May.

About the author

Jean Pisani-Ferry is director of BRUEGEL, a Brussels-based economic think tank, and Professor at the Université Paris-Dauphine. He is a member of the French Prime Minister's *Conseil d'Analyse Economique* and of the European Commission President's Group of Economic Policy Analysis (GEPA) to the European Commission's president. He was previously Director of CEPII, the main French research institute in international economics (1992–97), and Executive President of the French Prime Minister's Council of Economic Analysis (2001–02). His policy experience includes positions with the European Commission (1989–92) and working as the economic advisor to the French Minister of Finance (1997–2000).

5. The European bicycle must accelerate

Angel Ubide

Tudor Investment Corporation

The euro's history has been marked by half-steps, derogations, and political expediency. This essay argues that Eurozone leaders must complete the Economic and Monetary Union that is needed to underpin the euro if they are to avoid a serious risk that the Eurozone in its current form will fail. Europe must find the courage to address its structural shortcomings in order to boost potential growth. Fiscal adjustment alone is not the solution.

The history of the Eurozone has been a story of exceptions and half steps.

- Some of the initial Maastricht criteria were waived for some countries.
- Mountains of research – which made clear that a monetary union without a fiscal union was incomplete (Eichengreen and von Hagen 1996) – were ignored; the Stability and Growth Pact was a created as a second-best solution.[1]
- The Stability and Growth Pact was overruled by Germany and others when domestic political constraints were given precedence over the pact's requirements – this fatally undermined its credibility.
- The integration of Eurozone banking and capital markets was achieved without the prudential and supervisory infrastructure necessary to match this integration.

Whenever there was a strong political hurdle to overcome, the process stopped – regardless of how suboptimal was the stopping point. After all, "muddling through" was working, or so it seemed, as the global economic expansion was delivering growth regardless of the policies adopted.

The take-away message from this history is clear. European leaders wanted the euro but at the minimum political cost.

The challenge

The events of the last couple of years – and the serious implications for growth over the next decade – make one thing very plain. European leaders must now make a clear-cut decision; either they move on and complete the Economic and Monetary Union that is needed to underpin the euro, or they accept the risk that the Eurozone will fail in its current form.

[1] Also see Bayoumi and Masson (1995), Chari and Kehoe (2007), and Dixit and Lambertini (2003).

The European bicycle must accelerate now; it can't remain still. In simple terms, markets seem to have lost confidence in the soundness of the European policy framework. The lack of decisive action risks a permanent reversal of the integration of European capital markets.

Lessons from the euro's first decade

There are two important lessons from the first decade of the euro.

- The choice of structural policies across countries was key to the development of intra-European imbalances; and
- The Eurozone must move towards a system of common debt management.

It is useful to start the discussion about intra-European imbalances back in the early 1990s.

- From 1990 to 1995, Germany's real effective exchange rate appreciated sharply as a consequence of unification – by almost 30%.
- In reaction, Germany adopted a policy of competitive disinflation to correct this appreciation. And it worked.
- By 2008, its index of real effective exchange rate was back to where it was in 1990.

In other words, the first decade of the euro saw Germany correcting the "unification shock" via wage moderation. Rather than boosting competitiveness via much needed structural reforms in goods, services and banking markets, Germany opted for stringent wage moderation and some labour market reform.

- This German policy choice delivered very weak growth, averaging barely above 1% over 15 years – recall that during a large part of the decade Germany was dubbed "the sick man of Europe".
- As Germany accounts for such a large share of Eurozone GDP, this very weak growth greatly conditioned the monetary policy of the ECB, producing a monetary stance that was too loose for some members, producing rapid growth in the Eurozone periphery.

Why is this relevant? Because a system of common monetary policy that is heavily conditioned by an initial strong disinflationary effort – combined with a framework of national fiscal policies where the political economy of fiscal surpluses makes the achievement of the optimal fiscal stance rather difficult – is clearly suboptimal.

For example, Spain faced too loose a monetary policy; it probably should have been running fiscal surpluses of the order of 5–6% of GDP to offset the negative real interest rate its borrowers enjoyed. Yet pleas in Spain for improving public infrastructure were politically impossible to ignore when surpluses

were in the 1–2% range. The efforts to strengthen the macroprudential framework for banks with dynamic provisioning offset this asymmetry to some extent, but not fully.

By chance or by design, Spain's looser-than-optimal fiscal policy stance supported Germany's competitive disinflation efforts and helped deliver an optimal policy stance for the Eurozone as a whole.

Fast forward to today and one can see the mirror image of that situation. Spain and other Eurozone members must now engage in a disinflationary process of wage moderation and structural adjustment that – with monetary policy at the zero bound – would require a Germany policy stance that is looser than optimal for Germany. Germany should now be complementing an easy fiscal policy stance with a wide-ranging package of structural reforms that boost its domestic demand. It is critical for European policymakers to understand that the choice of structural policies matters as much, if not more, than the conduct of fiscal policy.

Imbalance debate echoed at the global level

This is the debate that the G20 is having at the global level – China, the US or Germany can choose from a menu of policies to stabilise their economies, and each choice implies a different outlook for global imbalances.

Germany is choosing to continue with wage moderation and fiscal discipline because, from a political standpoint, that is the easy path. There is a clear constituency supporting those actions in Germany. The real test of Germany's commitment to the Eurozone, however, is whether it is willing to take on the constituencies that oppose the reform of its inefficient goods, services, and banking markets. This is what Spain failed to do over the years.

Spanish labour markets were allowed to remain very rigid, and the savings banks were allowed to continue funding the housing market and the regional governments. But what cannot go on forever will not – Spain is being forced to tackle these problems in a crisis setting.

Unless Germany finds the courage to address its structural shortcomings in order to boost potential growth via domestic demand expansion, the Eurozone will remain at risk. Fiscal adjustment alone is not the solution. The Eurozone must move towards an effective system of review of structural policies, including sanctions, which boosts potential growth and reduces intra-European imbalances.

The experience of the last two years has also shown that in a world of low inflation fiscal policy may have to be used in a discretionary fashion. The Eurozone therefore needs a centralised fiscal policy mechanism to deal with tension between discretion and rules. With high debt levels and an adverse demographic outlook, debt intolerance has likely increased on a permanent basis. This is especially so for less liquid markets.

In this context, developing a European debt market would improve efficiency and lower the cost of debt issuance for all countries, Germany included. To restore credibility and avoid free riding, this would have to be combined

with an agreement to legislate, at the national level, balanced budgets over the cycle. This should be regulated by a very strong mechanism of independent, ex ante authorisation of national annual budgetary ceilings.

Countries would retain full control over the composition of taxes and spending but not over the levels of the deficits. In addition to completing the European fiscal policy framework, this would also create a liquid alternative to US Treasuries that would consolidate the euro as a reserve currency and contribute to the resolution of the global imbalances.

A crisis is something too valuable to waste. It is time for European leaders to move forward and complete the Eurozone's policy framework.

References

Bayoumi, Tamim, and Paul Masson (1995). "Fiscal flows in the United States and Canada: Lessons for monetary union in Europe" (1995). *European Economic Review*, Volume 39, Issue 2, 253–274.

Chari, V. V., and Patrick J. Kehoe (2007). "On the need for fiscal constraints in a monetary union", *Journal of Monetary Economics*, Volume 54, Issue 8, November 2007, 2399–2408.

Dixit, Avinash, and Luisa Lambertini (2003). "Symbiosis of monetary and fiscal policies in a monetary union", *Journal of International Economics*, Volume 60, Issue 2, August, 235–247.

Eichengreen, Barry, and Jürgen von Hagen (1996). "Federalism, fiscal restraints, and European monetary union", *American Economic Review*, 86, May, 134–138.

About the author

Angel Ubide is the Director of Global Economics at Tudor Investment Corporation, a leading global funds management company. He is an active member of several international economic policy organizations, including the Euro50 Group, the ECB's Shadow Governing Council, the Atlantic Council of the United States, the Reinventing Bretton Woods Foundation and the Centre for European Policy Studies. He writes a bi-weekly column on international economics for *El Pais*. Dr Ubide has written numerous papers on international macroeconomics, banking, and exchange rates, and his work has been published in major international journals and leading newspapers. Dr Ubide was formerly an economist at the International Monetary Fund and a management consultant with McKinsey and Co. He holds a Ph.D. in Economics from the European University Institute in Florence (Italy).

6. What more do European governments need to do to save the Eurozone in the medium run?

Thomas Mayer

Deutsche Bank

Two key building principle of the Eurozone were that the ECB should be insulated from political interference, and prevented from funding government deficits. This essay explains how the Eurozone crisis has threatened these principle and suggests ways to restore them.

Key building principles of the Eurozone were:

- Each country is responsible for its own government finances; and
- The ECB must not be instrumentalised for fiscal policy purposes.

These principles were based on lessons learned from previous monetary unions that failed when monetary policy became subservient to fiscal policy objectives (Bordo and Jonung 1999).[1]

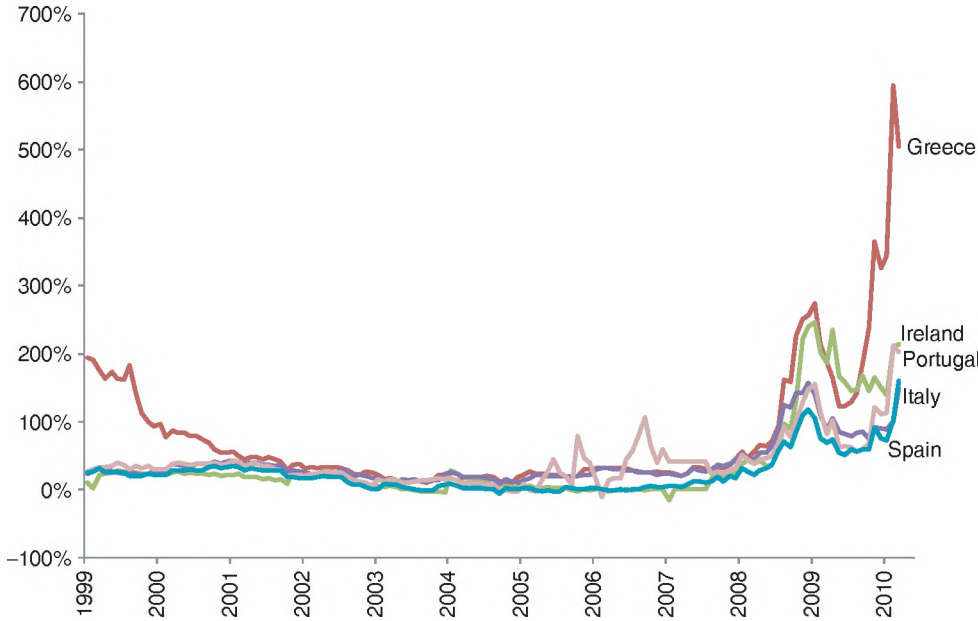
The Stability and Growth Pact was established to maintain the first principle. Government finances were to be closely monitored and fines were to be imposed when countries strayed from the path of fiscal virtue. Prevention and early correction of "excessive deficits" (defined as government deficit ratios in excess of 3%) were supposed to eliminate even the slightest possibility that a fiscal crisis in one country could affect the entire Eurozone.

To ensure the second principle, the ECB was made independent from political interference, and prevented from funding government deficits. By introducing a firewall between national fiscal policy and the ECB, the founders of the euro thought that monetary policy was safe from being used by governments in fiscal distress as a lender of last resort.

The Eurozone crisis has pulled the rug out from under both principles. Ensuring the long-run survival of the euro will require a speedy return to these two key principles. Failure to do so could induce some countries to look for alternatives. One can ask: Is a German withdrawal from the Eurozone beyond the realm of the plausible?

[1] For instance, the Latin and Scandinavian monetary unions of the late 19th century eventually failed because member countries took recourse to monetary financing of government spending in World War I.

Figure 6.1. Ten-year government yield spreads over Germany



Source: IMF/Bloomberg.
Ten-year sovereign bond spreads over 10-year German sovereign band. Monthly data.

The demise of the first principle

Due to actions taken by Germany and France in 2004, the Stability and Growth Pact came into the current crisis severely damaged. There had already been widespread breeches of the excessive deficit strictures and the procedures had been weakened. The pact's death knell came with Greece's revelations this year. Not only did the country run excessive deficits before and during its Eurozone membership, but it actually hid the true size of its violations.

After these revelations, nothing about the pact seemed solid and markets' dim view of Greek solvency spread doubts about the stability of the Eurozone. Markets have sold the euro against other key currencies and are selling government bonds in the euro periphery against German Bunds (see Figure 6.1).

In response to the Greek crisis, the European Commission presented proposals for a fundamental overhaul of the Stability and Growth Pact on 12 May 2010. Key elements in the proposal are:

- Improvement of the functioning of existing mechanisms under the pact;
- Greater focus on high public debt and long-term fiscal sustainability;
- Better incentives and sanctions to comply with the rules of the pact; and
- A framework for crisis management, including financial assistance to financially distressed countries under policy conditionality (European Commission 2010).

"Blackmail" possibilities must be eliminated

The Commission proposals are important and a useful improvement. The Commission's proposals, however, fail to address the crucial question in my view – what do we do when a country is unable or unwilling to follow the fiscal rules? What happens when a Eurozone member fails to bring its deficit and debt numbers in line or improve its external current account deficit?

If such countries pose a threat to Eurozone financial stability, they can blackmail their partners into open-ended transfers to cover both fiscal and external deficits. Or they can press the ECB to buy up and monetise their debts so as to avoid default. This is not a solution for long-run stability. In my view, the Eurozone's fiscal policy coordination apparatus must be completely overhauled to rule out such blackmail situations. What the Eurozone needs to rule out such situations is a facility that allows an orderly sovereign debt rescheduling/default as a last resort.

Earlier this year, Daniel Gros and I proposed the creation of a "European Monetary Fund" for this purpose (Gros and Mayer 2010). This fund would manage and finance assistance programmes of countries with excessive deficits (along the lines of the IMF-led Greek programme). It would also engineer a debt restructuring if unavoidable – sharing the resulting losses between private creditors and the Eurozone governments backing the fund.

I believe that speedy establishment of such a fund is essential. I also believe that it could be done without a Treaty modification by using the enhanced cooperation clause. This, of course, is essential since Treaty changes take years, while Europe needs a solution within weeks or months. The €80 billion stabilisation programme for Greece and the €500 billion stabilisation facility for the Eurozone could be merged into the fund.

The demise of the second principle

The political economy forces currently at play are far from novel. What we are seeing today is a situation much like that predicted by Bordo and Jonung (1999) more than a decade ago. Closer fiscal policy integration follows from monetary integration if the latter is to survive. But how can deeper fiscal integration be accomplished?

Full political union of Eurozone members is not on the agenda. Instead, we need structures that allow controlled fiscal support for countries in financial difficulties as well as orderly debt restructuring as a measure of last resort. The absence of the latter has forced the ECB to step in and to buy bonds of Eurozone governments with fiscal problems that have difficulties accessing the market. True, the ECB has emphasised that it will sterilise the liquidity effects of this intervention by offering term deposits to banks. Hence, their action should not be compared to the "quantitative easing" conducted, for example, by the Bank of England.

Indeed, assuming that sterilisation is successful, the ECB's action will come to resemble the "credit easing" undertaken during the financial crisis by the

US Fed. Yet, there is a major difference. The Fed eased credit costs of some US private sector borrowers at a possible cost for the US tax payer. The ECB lowers the borrowing costs of Eurozone governments in financial distress at the cost of raising costs for all borrowers in all other Eurozone countries. By subsidising some government borrowers at the expense of others, the ECB has moved dangerously close to becoming a supranational fiscal agent.

While France has always favoured a closer relationship between the central bank and the political authorities, this has been an anathema in Germany. Hence, the ECB's decision to support governments in financial difficulties is seriously undermining public support for the euro in Germany. A rift is growing between the two countries.

Blurring the distinction between monetary and fiscal policy and engaging in international income redistribution creates other risks as well. It poses a danger for the internal cohesion of the "Eurosystem" – euro-jargon for the complex set of relationships binding national central banks and the ECB. The ECB justified its actions as a way of calming dysfunctional markets. Other Eurozone national central banks may find good reasons why their government bond markets are also "dysfunctional". If other central banks are more sceptical, conflicts within the ECB's governing structure could multiply. We may already have seen the start of this. The Bundesbank President did not support the Governing Council decision to buy Greek bonds – and he voiced his disagreement publicly.

What if the ECB's Greek debt goes bad?

This ECB manoeuvre has opened the door to unprecedented political risks. If the ECB's bond holdings go bad, the ECB could require recapitalisation. The problem is that Germany, as the largest shareholder, would have to foot the biggest bill – and this would undoubtedly provoke another public backlash. Alternatively, if Eurozone members resisted recapitalisation, the bad debt would have to be monetised, thus eventually causing inflation. With these alternatives as the backdrop to the ECB's purchases of government debt, it seems absolutely clear that these interventions will be temporary, limited in size, and a singular event.

References

Bordo, Michael D., and Lars Jonung (1999). "The Future of EMU: What Does the History of Monetary Unions Tell Us?" NBER Working Paper 7365, September.

European Commission (2010). "Reinforcing Economic Policy Coordination", Brussels.

Gros, Daniel, and Thomas Mayer (2010). "Towards a Euro(pean) Monetary Fund", Policy Brief 202, Centre for European Policy Studies (CEPS), Brussels, February.

About the author

Thomas Mayer is Chief Economist of Deutsche Bank Group and Head of Deutsche Bank Research. From 2002 to 2009 he was Chief European Economist at Deutsche Bank in London and co-head of the Bank's Global Economics Group. Before Thomas Mayer joined Deutsche Bank in 2002, he worked for Goldman Sachs in Frankfurt and London (1991–2002), and for Salomon Brothers in London (1990–91). Before moving to the private sector, he held positions at the International Monetary Fund in Washington D.C. (1983–90) and at the Kiel Institute for the World Economy (1978–82). In 1982, he received a Ph.D. in economics from the University of Kiel and is a CFA Charterholder since 2002.

7. The narrative outside of Europe about Europe's fiscal crisis is wrong

Avinash D. Persaud
Intelligence Capital

Europe has run out of policy instruments to deal with booms and busts and to restrain unsustainable fiscal behaviour. This column suggests a national regulatory policy that could take the form of countercyclical charges, loan-to-value limits, tighter leverage ratios, transaction taxes, or other macroprudential tools. Also, countries should have automatic access to a fund to swap their debt for the debt of other Eurozone countries, but on condition of an effective 30% haircut.

It is commonly argued that because the market knows Eurozone members will bailout their recalcitrant fellow members, market interest rates provide little restraint on deficits, while credit spreads are small and driven by liquidity concerns, not credit.

In this environment, deficits grow to the point where bailouts are no longer credible. It is one of those elegant stories only spoiled by the facts. Paul De Grauwe has marshalled these facts well in his Vox column "Fighting the wrong enemy" (De Grauwe 2010). So what is the real enemy and how do we engage it?

Fiscal trends: US versus the Eurozone

Professor De Grauwe shows that the Eurozone has had a better fiscal trend than the US. Over the past 10 years, US public sector debt to GDP has risen by a third, while it has risen by only half that in the Eurozone.

At the root of the macroeconomic imbalances of the past decade was excessively loose US fiscal policy, not loose European fiscal policy. If the US had tightened monetary policy earlier, it would have improved its internal balance – a euphemism for a less overheated labour market – but it would have potentially worsened the external balance, assuming the higher interest rates would have also led to a stronger dollar that priced the US out of its remaining export markets.

Tighter US fiscal policy on the other hand would have slowed growth and thus eased market interest rates, which in turn would have weakened the dollar, so that both internal and external balance would have been reached. But it does appear likely that higher taxes in particular and tighter fiscal policy can get past the combined force of what the Washington locals call the "Republicants" and the "Demonoes".

Private versus public debt in the Eurozone

Professor De Grauwe goes on to argue that the real problem in the Eurozone was a rise in private debt, not public debt. Before the financial crisis, Ireland and Spain were the poster children for responsible fiscal policy. Ireland's debt-to-GDP ratio was halved to 23%, and Spain exhibited a reduction from 60% to 40% in the decade before the crisis. But fiscal conservatism by the public sector was matched by corporate and personal largesse. Once the crash arrived and the private sector had to be bailed out, private sins became public problems.

The need for a new policy instrument for private debt accumulation

Let us now depart from De Grauwe's little gem of a note. It may not be coincidental that public debt reduction was matched by private debt increases. A combination of lower deficits, credible monetary policy, and low interest rates may have crowded in private investment. Whatever the mechanism and however endogenous, my point is that the rise in private debt was not independent of policy.

We do have a "Tinbergen problem", i.e. we have run out of policy instruments to deal with a new policy goal. Regional monetary policy focused on Eurozone inflation cannot help crack a national boom. Nor can national fiscal policy be sufficiently finely calibrated to deal with private debt issues. The solution is national regulatory policy.

National regulation, which could take the form of countercyclical charges, loan-to-value limits, tighter leverage ratios, transaction taxes, or other macroprudential tools, would strengthen the integrity of Europe by providing an additional policy tool to manage macroeconomic developments that are more national than regional (Brunnermeier et al. 2009). Macroprudential regulation would have to be focused on activity within a jurisdiction and would be more easily carried out by the host country regulator. It would be made possible by making contracts unenforceable if they have not been subject to host country regulation.

National barriers to the movement of capital are not permissible within the single market, but that does not stop prudential bank regulation from having differentiated regulation. Spain was able to run a mild countercyclical provisioning mechanism. Elements of host country regulation already occur, and as long as activities are defined by where they take place and not by bank origin, this will be possible.

There are parallels between differences in national regulation and differences in national VAT rates among EU members. The mapping and mechanism of higher capital charges could be made consistent across countries to maximise transparency and promote one of the purposes of such tools, which is to direct lending to areas that are depressed from areas that are not.

If the Eurozone's private debts had risen more moderately, the Eurozone would not be in such a fiscal mess and the euro's credibility would not be so undermined. What the sharp rise in private debts in certain regions highlights is the difficulty of managing a large region with a single monetary policy, a single economic space, and inflexible and national fiscal policy.

Plainly we need an additional policy instrument – one that is sufficiently flexible to deal with boom–bust. It must also operate on a geographic basis that coincides with potential asset market bubbles, which are more often national than regional or Eurozone-wide.

My European friends may consider this to be un-European, but it is important that the euro is not lost through the excessive worship of common standards. In finance, homogeneity is a false god. Engineering and other disciplines teach us that the integration of diversity creates systemic strength. It is the basis for the robustness of the World Wide Web. Just one superhighway is vulnerable; it is not "fail-safe". Excessive homogeneity will make for a highly brittle system.

Further institutional developments needed

These measures could moderate a private boom, limiting the potential spillover effects on public debt. But Europe needs further institutional developments to deal with Eurozone members that are unsustainable fiscal positions – regardless of the reasons.

There are many good ideas for institutional development in the eBook. I cannot comment on them all, but I do not believe that a status-quo option is a wise course of action for such a highly interconnected region.

Equally, while I recognise that it was not as much of a problem as feared, the expectation of bailout does allow market discipline to act on fiscal deficits, creating incentives for fiscal largesse. If the solution sounds as if it should lie somewhere in between, then I think it does.

I propose a mechanism where countries can automatically access a fund to swap its debt for the debt of other Eurozone countries, but only on condition that there is an effective 30% haircut. This will address the moral hazard of bailouts – by making them painful – but at the same time "contain" them. For more detail of this proposal see my recent column "How to Save the Eurozone: A Greek Debt Swap" (Persaud 2010).

Conclusion

Part of the panic of crises is the fear that it is uncontained and all-conquering – that no one knows where the bottom of the well is. In this sense, creating a mechanism that puts a bottom on how bad a sovereign debt crisis can get could help prevent panic and contagion.

References

Brunnermeier, Markus K., Andrew Crockett, Charles A. Goodhart, Avinash Persaud, and Hyun Song Shin (2009). *The Fundamental Principles of Financial Regulation*, Geneva Report on the World Economy 11, CEPR and ICMB.

De Grauwe, Paul (2010). "Fighting the Wrong Enemy", VoxEU.org, 19 May.

Persaud, Avinash (2010). "How to Save the Eurozone: A Greek Debt Swap", VoxEU.org, 18 May.

About the author

Avinash D. Persaud's career spans finance, academia and public-policy in Europe and America. He is currently Chairman of Intelligence Capital, a financial consultancy. Previously, he was managing director, State Street Corporation; global head, currency and commodity research, J.P. Morgan and Director, fixed income research, UBS. His analytical innovations led him to be ranked in the top three of currency analysts in global investor surveys for over a decade. According to the *Financial Times*, his work on investors' shifting appetite for risk has entered the popular lexicon of analysts. Persaud was elected Member of Council at the Royal Economic Society and is Emeritus Professor, Gresham College. He is Visiting Fellow at the Centre for Financial Analysis and Policy at the Judge Institute, University of Cambridge and Governor, London School of Economics & Political Science. He is Co-Chair, OECD Emerging Markets Network and Deputy Chair, Overseas Development Institute.

8. Rethinking national fiscal policies in Europe

Philip R. Lane
Trinity College Dublin and CEPR

The global crisis has developed into a fiscal crisis within the Eurozone. This essay argues that fiscal policy during normal times must be sufficiently sustainable and counter-cyclical to enable aggressive fiscal intervention in the event of a major negative shock. It says that the solution is to set up independent fiscal councils in Eurozone member countries.

The Eurozone crisis has compelled several European governments to undertake sizeable fiscal corrections in the midst of a severe recession. These countries lacked the "fiscal space" to respond to the crisis, as Spilimbergo et al. (2008) would call it.

The lesson to be drawn is that fiscal policy during normal times must be sufficiently sustainable and counter-cyclical to enable aggressive fiscal intervention in the event of a major negative shock. A re-evaluation of the cyclical behaviour of fiscal policy is especially important for members of the Eurozone, since fiscal policy is the main tool available to deal with country-specific shocks.

One priority in re-designing the conduct of fiscal policy during "normal" times is to expand the scope of fiscal stabilisation policy. The traditional focus has been on GDP cycles, but fluctuations in asset markets and the sectoral composition of output are also relevant in determining the optimal stance for fiscal policy.

Cyclical tax receipts

Tax revenues are sensitive to the distribution of output across different sectors. For instance, the UK was heavily reliant on tax receipts from financial services' high profits and high incomes. In the Irish case, tax revenues during the 2002–2007 boom were highly reliant on transactions-based taxes in the property sector. Capital gains tax receipts were also high during a period of rapid property price appreciation.

More generally, high asset prices can amplify tax revenues through several channels.

- Capital gains and wealth taxes increase with asset prices.
- High asset prices also boost consumption, and thus VAT receipts, through positive wealth effects.
- Rising asset prices often fuel high turnovers in asset markets and thus boost revenue from transactions taxes.

Accordingly, the optimal fiscal balance is not just a function of the output gap. Fiscal policy should account for the transitory nature of tax revenues stemming from rapidly inflating asset prices or disproportionate growth of high-income sectors.

Under such conditions, a more cautious approach would be to run larger fiscal surpluses in view of the temporary nature of windfall revenues and the risk of "sudden stops" in activity level in such sectors.

The importance of private debt developments

A related point is that risks to the fiscal position may arise due to the accumulation of balance sheet risks in the private sector. A previously healthy public balance sheet may rapidly deteriorate due to rescue operations that transfer private assets and liabilities to the public sector. In some cases, the costs of such bailouts may feed directly into public debt holdings. In other cases, the main liabilities may remain "off balance sheet" as guarantees or insurance to private entities. Under either scenario, the impact on the public balance sheet may affect funding costs for the government and affect choices over public spending and taxation.

Ireland's government, for example, ran a solid surplus during the boom years, driving down its debt-to-GDP ratio from almost 50% in 1999 to 25% in 2007. This public rectitude, however, was paralleled by a private leveraging spree. When the banking system had to be rescued, Ireland's public-debt-to-GDP ratio soared.

Excessive external imbalances

Fiscal policy should also take into account the risks associated with excessive external imbalances. Monetary unions are subject to a perverse "real interest rate" mechanism, whereby the common nominal interest rate is translated into a national real interest rate using the national inflation rate. Ireland, for example, ran inflation that was consistently above the Eurozone average, so its real interest rate was consistently lower. In such cases, national fiscal policy could be used to offset this sort of unintentional monetary stimulation, or stimulation arising from underlying distortions in the economy such as a housing bubble. When fiscal policy fails to offset this, it is contributing to the emergence of external imbalances. Regardless of the source of an external imbalance, fiscal policy may have a role to play in the external adjustment process.

A broader use of fiscal stabilisation policy

For these reasons, the scope of fiscal stabilisation policy needs to be expanded to recognise that fiscal sustainability is sensitive to boom–bust cycles in asset

markets and balance-sheet fragility in the banking sector, other private sectors, and the external account.

The optimal fiscal surplus during good times should be determined by examining the sectoral composition of output in addition to the overall level. In addition, a nation's fiscal stance should take into account financial and external imbalances that may be accumulating in the economy. Flanking policies may also be required to deal with such events. Governments have to selectively deploy fiscal instruments (such as taxes on the size of bank balance sheets or transactions taxes in the housing sector) to reduce the exposure to the fiscal risks associated with banking sectors and asset markets.

Independent advice and analysis for non-political experts

This wider scope for fiscal stabilisation policy reinforces the importance of designing a fiscal policy process that benefits from the substantial input of fiscal, macroeconomic, and financial experts. It is very difficult for political systems to make robust judgements on the appropriate cyclical stance of fiscal policy without an explicit role for expert input. To this end, an independent fiscal council can help identify the stabilisation risks facing the economy, estimate the appropriate cyclical position for the annual budget, and estimate the optimal future path of fiscal balances that will ensure fiscal sustainability.

Rules and flexibility

The role of an independent fiscal council may be complemented by formal fiscal rules that specify the medium-term path for the structural fiscal balance. However, a structural balance fiscal rule should contain an escape clause by which discretionary fiscal interventions are permitted in the event of a sufficiently large macroeconomic shock.

Such an escape clause provides the flexibility to address major recessions or (in the other direction) overheating episodes, which may require extra fiscal measures beyond the automatic stabilisers that are part of the passive cyclical component of the budget. However, in order to ensure that the escape clause is only triggered in episodes of genuine severity, the triggering of the escape clause should be the responsibility of the independent fiscal council rather than the political system.

In addition, the independent fiscal council could contribute to the transparency of the fiscal process by acting as an independent monitor of the quality and availability of fiscal data. It could also promote a public debate on fiscal policy through engagement with parliamentary committees, media, and the organisation of policy workshops.

It is important to emphasise that the establishment of a fiscal framework does not constrain the fundamentally political nature of decisions over public spending and taxation. In particular, medium-term fiscal sustainability is consistent with a wide range of public spending levels – it just requires that

the trend component of public spending is matched by a corresponding level of trend revenue streams.

Accordingly, if the politically supported ratio of public spending to GDP shifted from one level to another, this can be accommodated by the specification of a transition plan that specifies how revenues will be adjusted to match the new desired level of government expenditure.

Independent but accountable

While independence of such fiscal policy councils is critical – for the same reasons that justify the independence of central banks – it is also vital that the fiscal councils be accountable. Accountability can be made effective by a two-track process.

- First, the members of the fiscal policy council should testify before the relevant parliamentary committees on a regular basis and explain clearly any errors in the projections made by the council.
- Second, the technical quality of the work produced by the fiscal council should be audited by regular reviews carried out by an international expert group.

Moreover, if each member country has an independent fiscal council, cooperation across these independent fiscal councils in developing best-practice analytical frameworks may be an effective mechanism to improve the quality of cross-country surveillance and mutual understanding of fiscal positions across the Eurozone.

Conclusion

The latest crisis has shown that fiscal policy is a vital element of any Eurozone members' policy mix. The crisis has also driven home the complexities of analysing fiscal sustainability in a world where revenue can be affected by asset booms and busts and transitional growth of high-income sectors. The solution to these problems is to set up fiscal councils in Eurozone member states. These should be independent and accountable. Cross-Eurozone cooperation by such national fiscal councils would be an effective mechanism for surveillance and the development of mutual trust.

References

Lane, Philip R. (2010a). "Some Lessons for Fiscal Policy from the Current Crisis," in preparation for the *Nordic Economic Policy Review*.

Lane, Philip R. (2010b). "External Imbalances and Fiscal Policy," *IIIS Discussion Paper No. 314*.

Spilimbergo, Antonio, Steven Symansky, Olivier Blanchard and Carlo Cottarelli (2008). "Fiscal Policy for the Crisis", IMF Staff Position Note No. 08/01.

About the author

Philip Lane is Professor of International Macroeconomics at Trinity College Dublin and Director of the Institute for International Integration Studies (IIIS), having previously been Assistant Professor at Columbia University. He is also a CEPR Research Fellow, and a regular visiting scholar and consultant at the International Monetary Fund, World Bank, and several central banks in Europe. His research interests include international macroeconomics, economic growth, European Monetary Union and Irish economic performance. He is a member of the Royal Irish Academy and the Euro50 Group, as well as on the editorial boards of the *Journal of the European Economic Association*, *Journal of Economic Perspectives*, *International Journal of Central Banking*, *Moneda y Credito* and *Open Economies Review*. He holds a Ph.D. in Economics from Harvard University.

9. A credible Stability and Growth Pact: Raising the bar for budgetary transparency

Michael C. Burda and **Stefan Gerlach**
Humboldt University of Berlin and CEPR;
Johann Wolfgang Goethe University of Frankfurt and CEPR

While the Stability and Growth Pact had good intentions, it failed because nothing happened when governments broke the rules. This essay proposes an enhanced Pact with increased fiscal transparency, an independent committee of fiscal experts, and a 1% tax on new debt above the 60% debt-to-GDP ratio. This would redistribute the costs of running Europe from the countries that have their house in order to those that don't.

In a few short weeks this spring, the Greek crisis transformed the environment for monetary policy in the Eurozone. To stabilise the markets, the ECB was forced to accept Greek public debt as collateral, ignoring its abysmal credit rating; it even went so far as to purchase this debt outright. How the world has changed. Just a year ago, the ECB was the rock of stability while the US Fed was propping up value of dodgy securitised debt, and bailing out troubled financial institutions.

This raises the question: What can be done to save the ECB and the euro?

The crisis teaches us three things

- Excessive fiscal deficits and large public debts pose serious risks to monetary and financial stability in the Eurozone and elsewhere.

It is now clear that a large contractionary shock can push heavily indebted governments to the brink of default even though debts appear manageable in good times (Reinhart and Rogoff 2009). To ensure that the euro remains a viable currency in this new environment, debts must be reduced, massively in some countries.

- While the Stability and Growth Pact had good intentions; it failed because nothing happened when governments broke the rules.

Yet once this rule was broken, another stability-oriented rule paradoxically created the potential for instability. A sovereign default by Greece, forced by the no-bailout rule, would have risked another Lehman-like wave of credit freeze-ups, instability in the European banking sector, and spillover to global financial markets. Simply put, the no-bailout rule stands in direct conflict with financial stability objectives and is therefore not credible.

- Precisely because the no-bailout rule is ineffectual, we need much stronger mechanisms to limit public sector debt in Europe.

While the Stability and Growth Pact was originally focused on deficits, recent events have shown that limiting government indebtedness is the key to achieving a credible and sustainable level of monetary stability in the Eurozone.

Redesigning the Stability and Growth Pact

To redesign the Stability and Growth Pact, we need to understand why it failed. The main reason was a lack of scrutiny of EU governments' budget plans and outcomes. The Pact blithely assumed that governments were in control of their revenue and spending at all times, and that they would set aside short-term political considerations in the interest of long-run fiscal stability. Violations, it was hoped, would be obvious to all and swiftly punished.

But in practice, budget outcomes depend on the business cycle. Recessions are inevitably associated with declining tax revenues and increasing expenditures on the unemployed. It can thus never be absolutely clear whether an observed "excessive deficit" is due to unexpectedly weak economic conditions or lax budget plans. This is particular true since there is plenty of scope for fraudulent bookkeeping and dubious financial transactions that can hide the real size of the deficits. This lack of clarity made it difficult to hold governments accountable, and created moral hazard problems.

Enforcement is further complicated by the "we all live in glass houses" syndrome. Governments with deficits just below 3% have little incentive to enforce the rules, since they may soon find themselves on the wrong side of the limits. Simple lines in the sand are just not credible – a fact that became crystal clear when the Schröder and Chirac governments simply ignored the Pact in 2004.

Institutional reforms

To save the euro, we need a new Stability and Growth Pact that significantly increases fiscal transparency. And there must be a party willing and able to take governments to task when they break the Pact. This would involve a higher level of EU involvement in national budgetary affairs, so many members may reject this. Yet objective evaluation of national budgets is the only way to restore credibility to the Pact.

- First, national budget plans and fiscal accounts must be audited annually by extra-national, non-political European experts.

This does not imply a loss of sovereignty since no government would be forced to accept the recommendations given. But such audits would significantly strengthen incentives for politicians to keep their fiscal house in order.

A thorough and public review of fiscal policy by outsiders would be embarrassing for misbehaving governments. And the outcome of the review would

be used for other purposes. For instance, the ECB could link the haircut it demands on collateral to such reviews and even decide not to accept debt of sinner governments. Agricultural support payments and other EU transfers could be made contingent on passing the reviews as well.

- Second, to implement this proposal, an independent committee of fiscal experts is necessary.

Such a "Fiscal Stability Board" would monitor fiscal developments in the Eurozone, vet governments' justifications of fiscal deficits, and assess – and publicly comment on – proposed consolidations. It must be small and manageable, composed of legal scholars, former senior central bankers, and academic economists from across the Eurozone. But it would also need to be taken seriously in the political sphere, so some ex-finance ministers must also be included.

- Third, to rein in government debt, the new Pact needs teeth. A tax or surcharge on public debt is one option.

Borrowing costs of Eurozone governments are currently artificially low because they do not reflect the bailout insurance implicit in Eurozone membership. We propose a 1% surcharge per year on *new* debt above the 60% debt-to-GDP ratio set by the Pact. A government that exceeds that limit by 50%, as Greece does today, would pay 0.5% of GDP per year. Such a surcharge debt does not infringe on sovereignty since countries could continue to borrow as they see fit.

We propose that tax should be imposed on new debt only. As an illustration, Greece's public is about 110% of GDP with an average maturity of 7.7 years. If debt of 14% of GDP is rolled over each year, it will take four years and three months before the 60% of GDP limit is reached and the surcharge applies. In the following year, it would issue 14% of GDP in new bonds and pay 0.14% of GDP in charges. Once all the debt has been rolled over, the full surcharge will apply.

- Who would get the revenue? We propose it be paid to the Commission, which would return the proceeds to Eurozone government in a pro rata rebate of their annual contribution.

Our proposal would thus simply redistribute the costs of running Europe from the countries that have their fiscal house in order to those that don't.

References

Reinhart, C., and K. Rogoff (2009). *This Time Is Different: Eight Centuries of Financial Folly*. Princeton University Press.

About the authors

Michael Burda is Professor of Economics at Humboldt University of Berlin. He previously taught at INSEAD, and Berkeley. His research centres on macroeconomics and the economics of labour markets. With Charles Wyplosz, he is the author of the textbook *Macroeconomics: A European Text* (Oxford University Press), which is now in second edition and translated into eight languages. He has published papers on the economic origins and impacts of labour market institutions, economic integration, employment and wages, and globalisation, as well as the transformation of Eastern and Central Europe and the former German Democratic Republic. In 1998 he received the Gossen Prize of the *Verein für Socialpolitik*. He received his BA, MA and Ph.D. (1987) at Harvard University.

Stefan Gerlach is Professor of Monetary Economics at the Institute for Monetary and Financial Stability at the Johann Wolfgang Goethe University in Frankfurt, a CEPR Research Fellow and a Fellow of the Center for Financial Studies in Frankfurt. Between 1992 and 2007, he served as a staff economist at the BIS. On leave from the BIS, in 2001–2004 he was Executive Director (Research), and as such directed the Economics Department, at the Hong Kong Monetary Authority and Director of the Hong Kong Institute for Monetary Research, for which he remains an External Advisor. He received an undergraduate degree from the University of Lund in Sweden in 1979 and a doctorate from the Graduate Institute of International Studies in Geneva in 1983, and has written in the areas of monetary theory and policy, and financial stability. Much of his current research focuses on the role of asset prices in monetary policy.

10. Fiscal policy at a crossroads: The need for constrained discretion

Antonio Fatás and **Ilian Mihov**
INSEAD and CEPR

The inability of governments to maintain fiscal discipline is not new. But this column argues that numerical budget rules are a far from optimal solution. They cannot be enforced and can produce highly procyclical policy during downturns. Instead, it proposes constraints on fiscal discretion imposed, monitored, and enforced by an independent fiscal policy council.

The Eurozone is at a difficult juncture when it comes to fiscal policy.

- Members' debts are at levels not seen since World War II.
- Default risk is on the rise for some of the Eurozone governments.
- Financial markets have pressured governments to adopt concrete plans for reducing debts and deficits levels in the short and medium term.

But the need for massive fiscal adjustment comes at the wrong time. The economic recovery is weak and many voices call for additional fiscal stimulus. The difficult task facing Eurozone finance ministers is to "strike the right balance" between the short-term demands of stabilising aggregate demand and the long-term need for sustainability.

A history of failed balancing acts

Recent decades have shown that governments are not good at striking the right balance between conflicting goals. When short-term economic needs and electoral interests converge, long-term sustainability issues are forgotten. After all, today's high debt levels are not only, or even mainly, due to the global crisis. With few exceptions, OECD governments increased their indebtedness ratio from 1980 to 2007. This is not limited to the Eurozone.

In this sense, Europe's recent problems are just a wakeup call. Governments have been sleepwalking their way into troublesome debt-to-GDP ratios. It is time for governments to address long-term sustainability issues that have been debated, and largely ignored, since the 1980s.

The temporary improvement in public finances during the 1990s, which in some cases led to overoptimistic scenarios of adjustment, was partly behind the relaxation of fiscal discipline in the years that followed.

This inability to keep debt under control has led to the need for frequent large adjustments (fiscal consolidations) with significant macroeconomic consequences. Today we seem to have gone one step further. Policymakers and observers debate whether in some cases fiscal consolidation is not feasible at all and the only remaining resolution mechanism is a sovereign debt crisis.

Fiscal indiscipline and external constraints

The inability of governments to maintain discipline in fiscal policy is not new. Scholars have been studying it for decades (Fatás and Mihov 2003 and 2006, Larch and Turrini 2008, and IMF 2009). There is abundant empirical evidence showing that constrained governments tend to deliver better fiscal policy. Explicit or implicit constraints on budgetary processes have been shown to produce better discipline – less volatility in terms of discretionary changes in fiscal policy. There is some evidence that this discipline creates a virtuous cycle, boosting GDP growth rate in a way that boosts sustainability. There is also evidence that the existence of constraints increases the likelihood of successful fiscal consolidation.

But what type of constraints works best?

We are today witnessing in some countries a call for strict numerical budget rules aimed at ensuring that future fiscal plans are sustainable. Germany is the leading example, having imposed a constitutional debt cap. By 2016 the government has to reduce the structural deficit to less than 0.35% of GDP. Impressive, certainly, but are strict numerical constraints the solution?

There is no doubt that such constraints provide an anchor, or backbone, that helps governments ensure sustainability. Recent experience in the Eurozone and several US states, however, shows that numerical rules are far from optimal. There are two problems.

- Either the rules are abandoned due to political demands (i.e. they cannot be enforced),
- Or they produce highly procyclical policy during downturns and further exacerbate the collapse of demand during recessions (as in the case of some US states).

Additionally, many numerical constraints on deficits tend to be completely ineffective in generating the necessary surpluses during good years. For example, most of the EU economies saw their budget balances hovering just slightly above the −3% limit during the expansionary years from 2004 to 2007.

The need for judgement

Our view is that effectiveness requires an element of independent judgement. Constraints on fiscal policy need to ensure discipline while allowing for the

flexibility (and feasibility) of the entire fiscal policy framework and over the entire business cycle. This is what we call *constrained discretion*. It differs from rules because it allows for discretionary decisions, but it provides the necessary checks and balances to ensure sensible policy in the long run.

The Eurozone's Stability and Growth Pact illustrates the limitations of numerical constraints. We have witnessed a tension between the need for simplicity (as expressed by the numerical limit on deficits) and the need to enforce a reasonable policy on an annual basis that leads to a sustainable outcome in the long run.

The problem is that numerical limits on deficits and debt are not sufficiently informative to discipline budgets on an annual basis. Judgment is still required to assess budget proposals. For example, are the macroeconomic forecasts accurate? Are the assumptions about tax revenues correct? Do current budget policies take into account the looming fiscal crisis due to demographic shifts? Government must answer these questions if they are to implement a simple rule.

Combining judgement and discipline: Independent fiscal policy councils

Academics have proposed several ways of bringing "judgment" to numerical rules. Most involve the creation of institutions – often called "independent fiscal policy councils" – to provide the judgment from outside of the realm of politics. Constraints on fiscal discretion imposed, monitored, and enforced by an independent body like a fiscal policy council will produce a superior outcome relative to the current situation.

Examples of these proposals can be found in Wyplosz (2008), von Hagen and Harden (1995) or Fatás, Siebert, Hughes-Hallet, Strauch and von Hagen (2003); some countries have already started moving in this direction (e.g. Chile and Sweden).

In the case of Sweden today, we can see how an independent body can allow for flexibility in times when there is a clear trade-off between sustainability and stabilisation. And if good fiscal behaviour is ensured in good times, the nation has more room for flexibility in bad times. It is too early to proclaim the Swedish example a success, but it is instructive to understand the behaviour of these institutions during crises. Here is a paragraph from the last report of the Fiscal Policy Council (2010):

> Swedish fiscal policy also faces a trade-off between long-term sustainability and short-term stabilisation. However, the situation in Sweden differs sharply from that in most other countries.... Sweden is also one of the few EU countries that is not subject to an *excessive deficit procedure.... Sweden has had substantial room for manoeuvre in using fiscal policy as a stabilisation policy instrument in the crisis.*

The time for reform is now

Is now the right time to push for the implementation of these proposals, or should Europe wait until the crisis is over? We believe that now is the time for two reasons.

- First, it seems that in good times there is never sufficient political will to implement the idea.
- Second, a good institutional framework ensuring fiscal policy sustainability would lessen pressures on governments to produce quick, large, and possibly suboptimal fiscal consolidations to calm the fear of default.

Europe should not waste the current crisis. The time for institutional reform is now.

References

Fatás, Antonio, and I. Mihov (2003). "The Case for Restricting Fiscal Policy Discretion", *Quarterly Journal of Economics*.

Fatás, Antonio, Jurgen von Hagen, Andrew Hughes Hallett, Rolf R. Strauch and Anne Sibert (2003). *Stability and Growth in Europe: Towards a Better Pact*. Monitoring European Integration 13. CEPR.

Fatás, Antonio, and I. Mihov (2006). "Restricting Fiscal Policy Discretion: the case of US States", *Journal of Public Economics*.

IMF (2009). *Fiscal Rules Anchoring Expectations for Sustainable Public Finances*. International Monetary Fund, Fiscal Affairs Department.

Larch, Martin, and Alessandro Turrini (2008). "Received Wisdom and Beyond: Lessons from Fiscal Consolidations in the EU", *European Economy*, Economic Papers No. 320.

von Hagen, Jürgen, and Ian Harden (1994). National Budget Processes and Fiscal Performance: European Economy. Reports and Studies 3: 315–418.

Wyplosz, Charles (2008). "Fiscal Policy Councils: Unlovable or Just Unloved", *Swedish Economic Policy Review* 15.

About the authors

Antonio Fatás is the Portuguese Council Chaired Professor of Economics at INSEAD, an international business school with campuses in Fontainebleau (France) and Singapore. He received a Masters and Ph.D. in Economics from Harvard University (Cambridge, MA, USA). He has also worked as an external consultant at the International Monetary Fund, the World Bank, the OECD and the European Commission. His research covers areas such as the macroeconomic effects of fiscal policy, the connections between business cycles and growth and the effects of institutions on macroeconomic policy and has been published in academic journals such as *Quarterly Journal of Economics*, *Journal of Monetary Economics*, *Journal of Economic Growth*, *Journal of Money, Banking and Credit*, and *Economic Policy*.

Ilian Mihov is a Professor of Economics and the Novartis Chaired Professor of Management and Environment at INSEAD. Since January 2010 he serves also as a Dean of Research. He holds a Ph.D. degree from Princeton University. His research is primarily in the fields of monetary and fiscal policies, economic growth and political economy. Ilian is also a research professor at the German Institute for Economic Research (DIW Berlin) and a research fellow at the Centre for Economic Policy Research (London, UK).

11. Fiscal consolidation as a policy strategy to exit the global crisis

Giancarlo Corsetti
European University Institute and CEPR

The Eurozone crisis is forcing fiscal retrenchments across Europe. The challenge is to reassure financial markets about debt sustainability without resorting to budget cuts and tax hikes that kill the recovery. This essay argues that quick corrections may be important signals of the government's determination on fiscal discipline, but they are not sufficient. True sustainability must be based on policies that have lasting effects; a gradual implementation of spending cuts is probably the best strategy.

The Greek crisis has so far been treated as a Eurozone problem. However, fiscal consolidation is now a global issue, and should be understood in the context of the policy reaction to the global crisis. This essay emphasises two dimensions of debt consolidation during early phases of the recovery from deep recessions.

- The output costs of spending cuts today might be substantial if the financial crisis continues, but
- The benefits from commitment to gradual implementation of deficit cutting measures in the future are important.

Asymmetric multipliers

As the world economy is still undergoing financial stress, the withdrawal of the fiscal stimulus (via a reversal of previous spending and tax measures) has an economic cost. There are reasons to believe that this cost is not low.

According to Reinhart and Rogoff (2008), an economy in the throes of a financial and banking crisis is especially sensitive to government spending. Unexpected changes in such stimulus have big affects on output, consumption, and investment – much more than the mechanical one-to-one boost. In my own research, I find the impact multipliers for government spending on goods and services are usually quite low in normal circumstances but they become high – as high as two for output and consumption – during financial and banking crises (Corsetti et al. 2010b). Policymakers should keep these asymmetries in mind. Macroeconomics works differently in crisis and non-crisis periods.

These results call for a countercyclical approach to fiscal policy. Buffers should be built up in good times so as to avoid forced contractions in bad times when the cost of a contraction is asymmetrically high. For the Eurozone

today, these results offer a warning about the macro costs of sharp cuts in government deficit. The crisis, after all, is not over yet.

How should fiscal consolidation proceed?

While fiscal consolidation is a common goal, the appropriate strategy to pursue it may not be the same across countries. In some cases, a sharp correction is obviously called for in response increasing risk premia paid on government debt. Failure to consolidate would not only raise the cost of borrowing for the government; it would also undermine macro stability with widespread economic costs. In this case, immediate cuts in spending and tax hikes may be useful in signalling the government commitment to consolidation.

Yet the extent and credibility of corrections will be mainly judged by their sustainability, and their budget effects, in the medium to the long run.

Given the size of the public debt, it is unlikely, if not unwise, to place the whole burden of the correction on higher taxes. On the contrary, experience shows that most successful debt consolidations depend on a government ability to cut, or at least contain, spending.

A gradual implementation of spending cuts has several desirable effects (see Corsetti et al. 2010a). While this research is still ongoing, it suggests that steady but gradual consolidation may be the strategy that has the lowest cost in terms lost output. Cutting too much today could be throw us back into a recession, but cutting too slowly may heighten panic in the markets for government debt.

Conclusions

As financial markets are still fragile in Europe and elsewhere, policymakers face a challenging task. Failure to reassure financial markets about debt sustainability would bring back the unstable market conditions seen this spring. This requires immediate action. However, the immediate action can be more than immediate budget cuts and tax hikes. The key to maintaining market confidence is a plan that puts government debt on a sustainable path. And debt sustainability does not depend mainly on quick corrections with limited effects in the near future – however, important such moves may be as signals of the government's determination on fiscal discipline. Sustainability requires policies with lasting effects on the budget, reducing the medium- to long-run budget risk.

References

Christiano, Lawrence, Martin Eichenbaum and Sergio Rebelo (2009). "When is the government spending multiplier large?" NBER Working Paper 15394.

Corsetti, Giancarlo, Keith Kuester, Andre Meier and Gernot Mueller (2010a). "Debt Consolidation and Fiscal Stabilization of Deep Recessions". *American Economic Review*, May.

Corsetti, Giancarlo, Andre Meier and Gernot Mueller (2010b). "What determines government spending multipliers?" Mimeo.

Reinhart, Carmen, and Kenneth Rogoff (2008). "Banking crises: An equal opportunity menace." NBER Working Paper 14587.

About the author

Giancarlo Corsetti is Pierre Werner Chair, joint professor at the Robert Schuman Centre for Advanced Studies and the Department of Economics at the European University Institute. His main field of interest is international economics. His main contributions to the literature include general equilibrium models of the international transmission mechanisms and optimal monetary policy in open economies, analyses of currency and financial crises and their international contagion, and models of international policy cooperation and international financial architecture. Corsetti is a Research Fellow of the Centre for Economic Policy Research in London, where he serves as Co-Director of the International Macroeconomic Programme. As Pierre Werner Chair at the EUI, he has promoted a visiting programme on issues related to the macroeconomics of monetary unions, open to researchers from both policy and academic institutions, and has been organising yearly international conferences at the Institute.

12. Germany spending is not the cure

Alberto Alesina and **Roberto Perotti**
Harvard University and CEPR;
Bocconi University and CEPR

Many analysts blame Germany's fiscal prudence for worsening the crisis. This essay argues that the monomaniacal focus on aggregate demand is based on slightly outdated and oversimplified Keynesianism. The real constraint on European growth is not Germany's fiscal policy. It is the supply side rigidities that plague all European nations – especially those at the heart of this crisis. The demand side matters, but is it foolish to think that German budget deficit of 5% instead of 3% of GDP would solve Europe's problems.

A widely held view in Europe goes more or less as follows. After the shock of reunification, Germany has sought to enhance competitiveness through a variety of means. The policy was remarkably successful, turning the "sick man of Europe" into a highly competitive economy. One implication, however, was an imbalance with the rest of Europe. Germany's current account surplus find its counterparts in, amongst other places, current account deficits in southern Europe, especially Spain, Portugal, and Greece.

This was not particularly worrisome – or at least not many complained – until the financial crisis. The recession and stimulus packages pushed up budget deficits and public debt throughout Europe but particularly in the Eurozone's most vulnerable part – southern Europe. As a result, virtually everybody now agrees that southern European countries (and Ireland) have no alternative but to take a healthy dose of fiscal austerity, whatever the cost.

This situation, however, implies that these countries are now hit by two negative demand shocks.

- The German deflationary stance, and
- Their own fiscal austerity.

As a consequence, according to the standard story, this puts a double onus on Germany. It should reduce its competitiveness advantage, and stimulate consumption as it is now the only positive source of demand in Europe.

In the very short run, both of these goals can and should be accomplished, according to the standard story, with expansionary fiscal policy being the only tool available to German policymakers – perhaps with some inflation.

The standard story is wrong

This view is widely held by a host of economists and commentators in Europe. It is also the semi-official view of the US government as spelled out in the

private letter sent by Treasury Secretary Geithner to his G20 colleagues at their last meeting.

We believe that both the diagnosis and the proposed cure are wrong. Of course, the world's current account is always balanced, so Germany's surpluses must appear somewhere else as deficits. But is it Germany's fault if it became more competitive? And is it reasonable to ask the Germans to carry the burden of a country like Spain that has based its economic development in the past 15 years on construction – the un-competitive sector *par excellence*? Or of a country like Greece with its retirement at age 53, fake budgets, etc.? Moreover, Germany's fiscal policy in recent years has not been a particularly restrictive. Its improvements in competitiveness have come from other sources – limited and timid labour market reforms, but still some reform.

The cure is also wrong, and impractical

At the normative level, if government debt is what markets fear right now, it is not clear at all that markets would welcome an increase in the supply of debt by the country they perceive as the last bastion of fiscal and monetary control. The biggest and most immediate fear today is market worries linked to excessive European debt. How an increase in German debt would ease such fear is not clear to us.

The immediate effect of an increase in supply of debt would be only indirectly and partially compensated by indirect effects on the growth of other countries, if at all. After all, a realistically sized German fiscal expansion could not rescue Europe from its slump and stimulate significantly growth. Asserting that it could requires one to believe in implausibly large government spending multipliers.

Both theory and some empirical evidence support the notion that the multiplier is small if not negative, although we admit that there is much uncertainty on this point. But the large Keynesian fiscal multipliers so popular in the 1960s are hard to defend today on either theoretical or empirical grounds. If this is true for domestic multipliers, cross-border multipliers are even smaller.

The cure is politically unrealistic

From a positive standpoint, the idea that Germany should carry Europe on its shoulders and internalise all the positive externalities it can provide (assuming they indeed exist) defies political reality. Asking a government do embrace the interests of a small, far-away country is a political dead end – especially at a time of financial crisis.

Arguments for undertaking this sort of altruism are often shrouded in the veil of "by doing this, Germany would enhance its long-run interest". Maybe, but it is far from clear that Germany's long-run interest involve a rescue of Greece or Spain. And even if this were the case, it would require a degree of far-sightedness that no elected government, German or otherwise, generally has.

Myopia is especially a problem in an emergency situation like the one Europe currently finds itself. In any case, accusations of shortsightedness made by southern European leaders against Germany are a bit too much!

The constraint on European growth is not Germany's fiscal policy. It is the supply side rigidities that riddle all European national economies – especially those of southern European countries. To obsess about the demand side is simply misplaced – a slightly outdated, and oversimplified Keynesianism. Perhaps supply side reforms are unfeasible, but that should not lead us to fool each other that a German budget deficit of 5% instead of 3% of GDP will take Europe out of its predicament.

About the authors

Alberto Alesina, born in Italy in 1957, is the Nathaniel Ropes Professor of Political Economy at Harvard University. He served as Chairman of the Department of Economics from 2003 to 2006. He obtained his Ph.D. from Harvard in 1986. He is also a member of the National Bureau of Economic Research (NBER), and the Centre for Economic Policy Research (CEPR). He is a member of the Econometric Society and of the American Academy of Arts and Sciences. He is a leader in the field of Political Economics and has published extensively in all major academic journals in economics. He has published five books and edited many more. His two most recent books are *The Future of Europe: Reform or Decline* published by MIT Press (2006) and *Fighting Poverty in the US and Europe: A World of Difference,* published by Oxford University Press. He has been a Co-editor of the *Quarterly Journal of Economics* for eight years and Associate Editor of many academic journals. He has published columns in many leading newspapers around the world and has visited several institutions including MIT, Tel Aviv University, University of Stockholm, The World Bank, and the IMF.

Roberto Perotti is Full Professor of Economics at Bocconi University, a Research associate at the National Bureau of Economic Research (NBER) and a CEPR Research Fellow. Previously he was a Contract Research Fellow at IGIER, Università Bocconi. He has taught at Columbia University and the European University Institute.

13. The long shadow of the fall of the wall

Daniel Gros
CEPS, Brussels

Many analysts of the Eurozone crisis take members' asymmetric competitiveness for granted and underplay the role of the global crisis. This essay argues that some of the trends which now are widely assumed to be the result of the euro are actually natural consequences of two unique events: German unification and the mid-decade global credit boom.

Economists call a happy monetary union an "optimum currency area". The Eurozone is clearly no longer a happy family, but as Tolstoy observed some time ago, unhappy families are unhappy in their own ways.

The Eurozone is not really suffering the kind of "asymmetric" shock that economists used to take as the biggest problem for a monetary union. The crisis of 2010 seems rather to be the result of a large global shock which affects different Eurozone member countries differently because some are not prepared for rough times.

This essay shows that some of the trends which now are widely assumed to be the result of EMU are in reality the natural consequence of the confluence of two unique events: German unification and the global credit boom of 2003–2007.

Keeping this perspective in mind is critical to avoiding the mistake of old generals. The new policy framework for the euro should not be designed to "win the last war"; it should not be designed assuming that the first decade represents the norm.

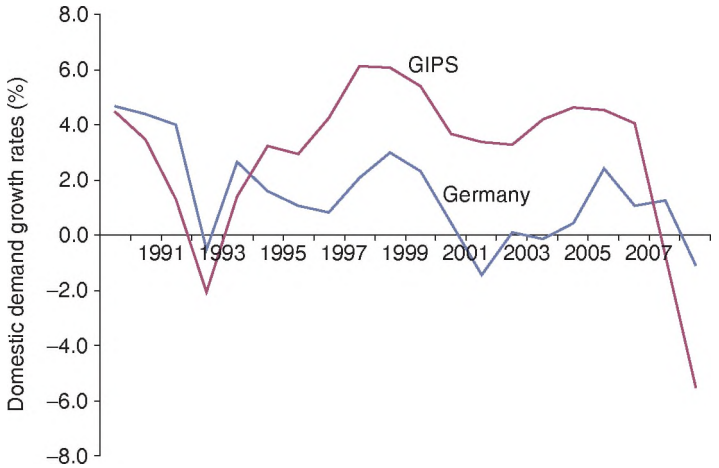
From German unification to boom in the European periphery

The sequence of events that led to the present crisis looks, in retrospect, quite simple if one goes back twenty years ago. Unification produced a domestic demand boom in Germany, but a recession in most of the rest of Europe.

When the unification boom ended in Germany in 1995, the tables turned and Germany became for a decade the weakest economy of Europe – "the sick man of Europe" (Figure 13.1) – while the others enjoyed export-led growth (1995–2000, Figure 13.2) and later a domestic demand boom fuelled by low interest rates and easy availability of credit (from about 2000 onwards). All the while, Germany's slow income and wage growth allowed it to regain competitiveness.

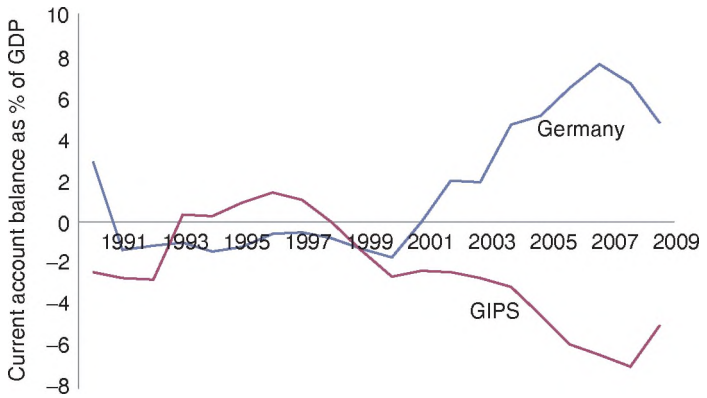
This background is important because today it is taken for granted that Germany has low relative unit labour costs and a huge current account surplus. However, this was not the case for much of the decade preceding monetary union.

Figure 13.1. GIPS and German growth, 1990–2009



Source: European Commission, AMECO (at constant prices excluding stocks).

Figure 13.2. Long-term current account swings



Source: WEO (IMF).

The great asymmetry in the European business cycle started in late 1989 with the fall of the wall. Within one year Germany was unified and a U-turn in economic policy arrived. While (West) Germany had achieved a balanced budget in 1988, the year preceding unification, the unified Germany was now burdened by the huge expenditure necessary to rebuild the dilapidated infrastructure and housing in the former GDR, leading in a couple of years to a fiscal deficit reaching 4% of GDP (not counting very large off budget expenditures). Moreover, East German wages were quickly brought close to the West German level, leading to a huge increase in new Länders' purchasing power, and an attendant consumption boom.

This extraordinary demand impulse led to inflationary pressures (despite a sizeable current account deficit). The Bundesbank reacted in a predictable manner – it increased interest rates. Other central banks in Europe could not follow suit because their countries had no unification boom and, in the case of Italy, had to keep interest rates low to keep a lid on the interest payments their treasuries had to make on their huge public debt.

The indirect consequence of the fall of wall was thus not only a boom in Germany, but also serious problems in the European Monetary System. Britain and Sweden quit, and the fluctuations bands were widened enormously. It also led to an overvaluation of the deutschmark which contributed to the weakness of the German economy between 1995 and 2005. Indeed when the euro arrived, most observers predicted that Germany would have a rough time ahead because it entered with excessively high relative labour costs.

Mirror image growth patterns

German growth was the mirror of that of most other Continental nations was for almost twenty years (Figure 13.1). Between 1990 and 1995 Germany had exceptionally strong domestic demand, but a weak export performance. Just the opposite of what most of the rest of Europe was experiencing. They suffered from high interest rates but got competitive exchange rates.

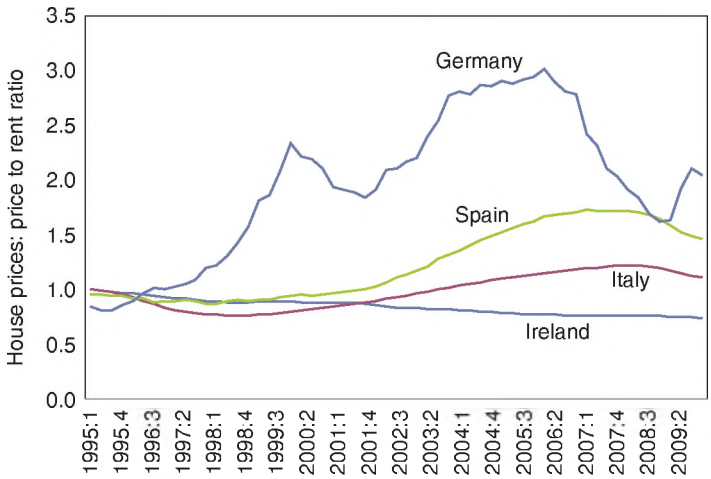
After 1995 the tables turned and the traditional pattern returned whereby domestic demand became weak (and remained persistently so for over a decade) in Germany, but domestic demand (both in terms of consumption and construction) took off in the rest of Europe, especially in those countries which enjoyed a sharp fall in interest rates as they prepared for the euro. These countries – often lumped together under the acronym PIGS, or more respectfully, GIPS (Greece, Ireland, Portugal, and Spain) – were regarded as the star performers of the Eurozone until 2007.

The impact of the low euro interest rates – sometimes negative real interest rates in the GIPS – was magnified by the new-century worldwide credit boom. Asset prices soared (especially of housing Figure 13.3) thus increasing greatly the availability of credit even to weaker borrowers (subprime housing in the US and Spain, and subprime governments in Europe). Without this global credit boom, the imbalances that developed after the euro's launch would likely have remained much smaller.

This asymmetric business cycle over the last twenty years can be seen for example in the current account of Germany relative to that of the Southern EU members. Figure 13.2 shows that for much of the 1990s Germany was running a deficit and the GIPS a (small) surplus. This changed only around the time the euro's creation. However, until about 2003/4 the resulting divergence was not much different from values seen just before unification. The German surplus and the Southern deficits reached unprecedented values only when the credit boom really started.

The importance of the credit boom in pushing house prices and thus domestic demand in a differentiated way can be seen by looking at the evolution of house prices. The chart below shows the ratio between house prices

Figure 13.3. Asset bubbles in the GIPS



Source: OECD. Note: Index divided by the average 1990–1999.

and rents, which in principle (like the price/earnings ratio for stock prices) should be stationary and thus presents a good indicator of potential bubbles. This ratio went down in Germany, but started to increase in Southern Europe already before EMU started, i.e. once the ERM crisis of 1995 had been overcome.

Concluding remarks

This short summary of the broad economic trends which conditioned the euro's debut suggest a simple question: "Given the starting position, was the euro destined to fail?" The answer seems to be "no".

The key disruptive element was the global financial crisis which ended the preceding global credit boom – none of which was the euro's fault. If this boom had ended with a whimper rather than a bang, the construction booms in Ireland and Spain might have unwound themselves slowly. Accompanied by a strengthening of domestic demand in Germany which leads gradually to higher wages in Germany as the German labour market nears full employment (recall that when full employment was reached in 1995 wages increased considerably), the world is likely to have looked very different.

The required adjustment in Ireland and Spain might thus have been much more gradual, without an accompanying systemic crisis.

The Greek case, however, is entirely different. Greek governments ran profligate fiscal policies for years, hiding the debt where possible. This was a story that was doomed to end badly with or without the global crisis. Overspending and data manipulation almost never ends well.

About the author

Daniel Gros is the Director of the Centre for European Policy Studies (CEPS) in Brussels. His current research concentrates on the impact of the euro on capital and labour markets, as well as on the international role of the euro, especially in Central and Eastern Europe. He also monitors the transition towards market economies and the process of enlargement of the EU towards the east (he advised the Commission and a number of governments on these issues). Since 2002, he has been a member of the Shadow Council organised by Handelsblatt; and since April 2005, he has been President of San Paolo IMI Asset Management. He is editor of *Economie Internationale* and editor of *International Finance*. He has published widely in international academic and policy-oriented journals, and has authored numerous monographs and four books.

The Eurozone's life-threatening crisis in May 2010 was halted when Eurozone leaders and the ECB to strong measures in May. But these were palliatives not a cure.

The crisis is not over, according to the dozen world-renowned economists whose views are contained in this eBook. The Eurozone rescue needs to be completed. More needs to be done.

The Eurozone 'ship' is holed below the waterline. The ECB actions are keeping it afloat for now, but this is accomplished by something akin to bailing the water as fast as it leaks in. European leaders must very soon find a way to fix the hole.

This eBook that gathers the thinking of a dozen world-class economists on what they need to do on banking-sector clean up, fiscal discipline, structural policies, and more.

Centre for Economic Policy Research

53-56 GREAT SUTTON STREET • LONDON EC1V 0DG • TEL: +44 (0)20 7183 8801 • FAX: +44 (0)20 7183 8820 • EMAIL: CEPR@CEPR.ORG

www.cepr.org