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The Eurozone rebalancing challenge

Lessons from the past and dilemmas for the future

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Introduction

In March 2011, the European governments decided to create a permanent European Stability Mechanism (ESM). In December 2011, the European Central Bank (ECB) decided to lower its refinancing rate to 1% and to offer two new longer-term Refinancing Operations (LTROs).[1] In March 2012, a haircut was imposed on private holders of Greek debt. These decisions have led many policy-makers and analysts to conclude that the Eurozone is finally on the right track towards solving its debt problems.

The experience of the last few months, however, does not support this conclusion. Rather, a series of facts has shown that these measures do not suffice to solve the Eurozone's problems and act, at the most, as deferring mechanisms. They appear to fight the symptoms but do not cure the disease or, more appropriately, they buy time until the fundamental issues are addressed. The fundamental problems that the Eurozone faces are dealing with unsustainable levels of debt, significant deterioration in the competitiveness of some member countries, and that the unification process of the European Union has almost remained stagnant since the inception of the single currency.

Against this background, this paper shows that the architecture of the Eurozone, established at the end of the 1990s, was bound to lead the whole project into trouble and, today, saving the euro is a difficult task with significant policy dilemmas. I have structured the paper as follows. The first section provides a brief overview of how the architecture of the Eurozone has contributed to fiscal unruliness by creating a framework of perverse incentives. Section 2 discusses the present situation in the countries of the Eurozone and the dilemmas that policy-makers face, while Section 3 provides an analysis of the alternative ways of saving the euro and the cost entailed. Section 4 develops policy recommendations.

The architecture of the Eurozone

If one wants to understand the causes of the present crisis in the EU, she has to study the dynamics and the context in which the single currency has been introduced. At the end of the 1990s, there was an evident

[1] In response to the LTROs offerings, European banks borrowed 489 billion euros in December 2011 and 530 billion euros in February 2012.

tendency to include as many countries as possible in the monetary union. The decreasing competitiveness of the European Union (see Papadimitriou 2008) and the fear that the prosperity in Europe was at risk contributed to the perception that it was necessary to complete the internal market through a single currency and to provide the European Union with the characteristics of a continental economy. In this context, the Maastricht Treaty's criteria started being interpreted with greater flexibility. More emphasis was given to the tendency of the countries to fulfil the fiscal criteria, and, explicitly or implicitly, countries were allowed to use techniques of creative accounting in order to meet the criteria. 'Innovative' one-off transactions—such as securitization, financial derivatives, and one-off- payments by state related entities—that allowed spending without increasing the recorded deficit, are examples of creative accounting techniques.[2]

On the other hand, the monetary unification established in 1999 was regarded by the member countries as a big step towards unification, and no country was actually prepared to accept other restrictions on its autonomy. Fiscal policy remained in the hands of the national governments and the Eurozone became a monetary union without fiscal backups. Consequently, almost all the pressure of adjustment has fallen on the labour markets.

The big troubles[3] that could ensue from the establishment of a monetary union of members, with divergent ethics and capabilities in the management of public finances and with uneven economic strength, led to the establishment of the Stability and Growth Pact (SGP).[4] The SGP (of 1997 and its reform in 2005) imposed the well-known deficit and public debt targets for the Eurozone. The SGP consisted of a commitment to a balanced or surplus general government budget in the medium-term, a binding 3% limit for the deficit-to-GDP ratio, and a non-binding 60% limit for the debt-to-GDP ratio.

Today, after more than a decade of research, a consensus exists that the quantitative targets of the SGP have proved ineffective in restraining the Eurozone member states from running excessive deficits. The SGP became dysfunctional very early, when it became evident that the Council would not impose sanctions and political considerations would prevail. Even from the first years of its implementation, the governments, including those of Germany and France, had started pushing for a reform of the SGP that would allow more 'flexibility'. Quite ironically, Germany, the country that had pushed for tighter fiscal rules in the EMU in the mid-1990s, was the second EMU country to violate the fiscal rules.

[2] The possibility that the candidate countries could follow such policies had been pointed out at an early stage by various economists such as Buiter, Corsetti, and Roubini (1993) and Easterly (1999).

[3] Several economists (Dafflon and Rossi 1998, Easterly 1999) had predicted the troubles that lay ahead in the absence of coordination in national fiscal and budgetary policies.

[4] Substantial parts in the following paragraphs of this section are based on the previous work of the author, in Papadimitriou (2011) and Papadimitriou and Hadziyiannakis (2012).

Economic theory teaches that a monetary union by itself induces fiscal laxity. According to the Mundell-Fleming model, an expansionary fiscal policy can be effective in increasing output under fixed exchange rates. For many governments, the introduction of the euro was a chance for more active fiscal policies in the context of relaxed fiscal constraints. The ability to borrow with low interest rates, the disappearance of a closed economy crowding out the effects of expansionary fiscal policies, and the removal of the threat of open economy exchange rate crises, created wrong incentives. For some countries, participation in the EMU brought the opportunity of a free ride on the collective creditworthiness of the euro, leading to borrowing at rates that would have been unimaginable with their national currencies. Perverse incentives were also created under the guise of meeting the SGP fiscal deficit target. As we shall see in the following paragraphs, many governments fell into the trap of overlooking the long-term effects while focusing on the short-term benefits.

In the period prior to 1999, when the EMU membership was still not secure, voters in almost all member countries rewarded efforts of fiscal discipline, as the latter would increase the chance of getting into the monetary union. Governments had an incentive to undertake discretionary fiscal contractions even in election years. Once the EMU membership was obtained, the old pattern of political budget cycles re-emerged in many countries. Koen and Noord (2005) and von Hagen and Wolff (2004) provided evidence that one-off measures and creative accounting techniques had been used more frequently since the inception of the EMU.

The SGP also produced disincentives in carrying out productive public investments, by treating all expenditures in the same way.[5] In this context, governments often postponed or even cancelled public investment spending, that is, expenditures with the most multiplicative impact on the factors of production and productivity, thus undermining the prospects of future growth rates (Blanchard and Giavazzi 2004, Coeure and Pisani-Ferry 2005, Heller 2005).

In addition, there have been disposals of public assets with the sole aim of showing a lower budget deficit and lowering public debt. Many of these sales were controversial because, on the one hand, the disposal price of the public assets was often low, and on the other, because most public asset sales were likely to have a negative impact on the net worth of the government concerned (Dafflon and Rossi 1998, Koen and Noord 2005). Milesi-Ferretti and Moriyama (2004) empirically investigated the dynamics of the EU governments' net worth and they found that many became 'poorer' after the establishment of the SGP. They compared changes in the financial and non-financial assets with changes in financial liabilities and corrected for valuation effects. The research showed a sharp contrast between the periods 1992–1997 and 1997–2002. In the first period, increases in liabilities were matched by changes in assets and the net worth

[5] The budget deficit criterion did not distinguish between current and capital expenditure.

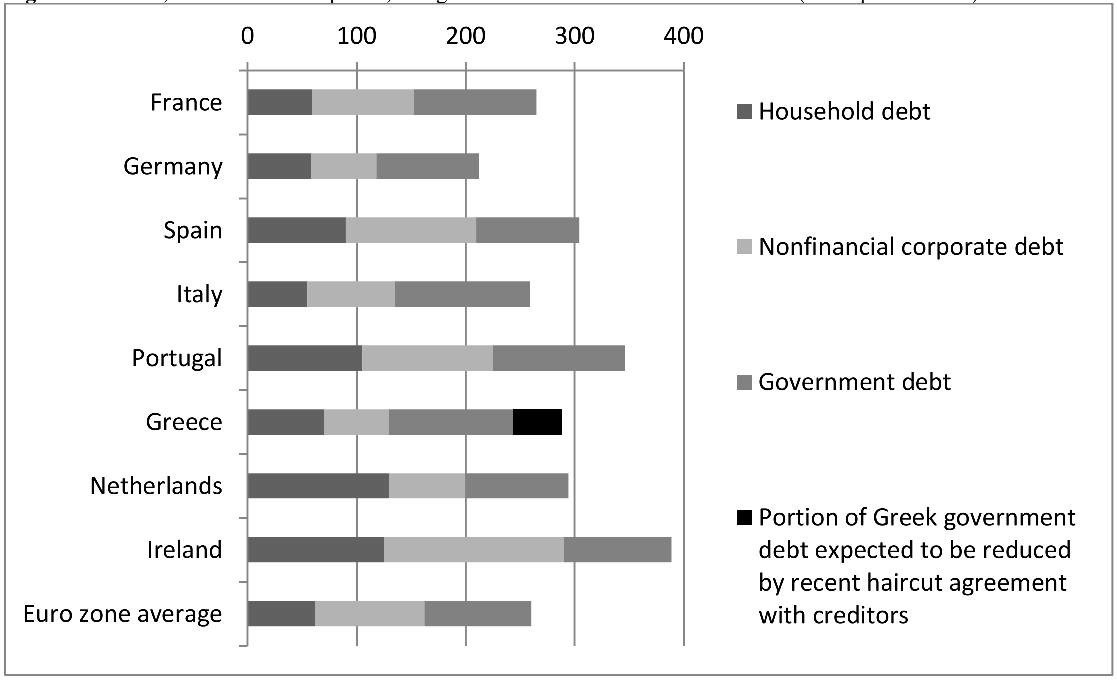
of governments was relatively stable. This was not the case in the second period. The EU governments were worse off in 2002 than they were in 1997. The situation is probably even worse today.

One can easily attribute the above practices to the incentive structure created by the SGP. Many governments ignored sustainability and opted for current consumption and immediate political gains. Short-term considerations overrode long-term perspectives. By emphasizing on partial criteria such as deficit and debt, the Pact reinforced the governments' myopia (Coeure and Pisani-Ferry 2005) and added to the difficulty of structural reforms, at least for those that implied short-term budgetary cost.

The fundamentals and the policy dilemmas

Over the last decade, intra-Eurozone imbalances have grown. Southern Europe has massively lost competitiveness and built-up large current account deficits vis-à-vis its northern counterpart, where industrial activity has gradually concentrated. Public debt has grown to unprecedented levels in almost all Eurozone countries. Private debt—initially very low in the southern Europe compared to the north—has grown impressively, showing that hard times are expected in the process of private deleveraging.

Fig. 1 Household, non-financial corporate, and government debt in Eurozone countries (third quarter 2011)



Source: Eurostat

In Figure 1, the levels of household, non-financial corporate, and government debt are depicted. From the data, it is clear that a large public debt, especially in the southern European countries, coincides with private over-indebtedness. For most countries, the government debt-to-GDP ratio exceeds the 60% level, which according to Maastricht Treaty represented the upper limit of sustainability. As far as the private debt is concerned, the data from Figures 2 and 3 show that both non-financial corporate debt and household debt have increased substantially between 1999 and 2009/10.

Fig. 2 Debt-to-GDP ratio of the non-financial sector (1999–2010)

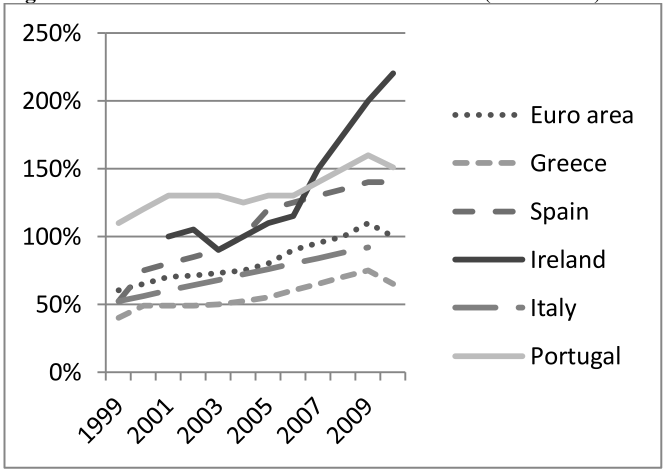
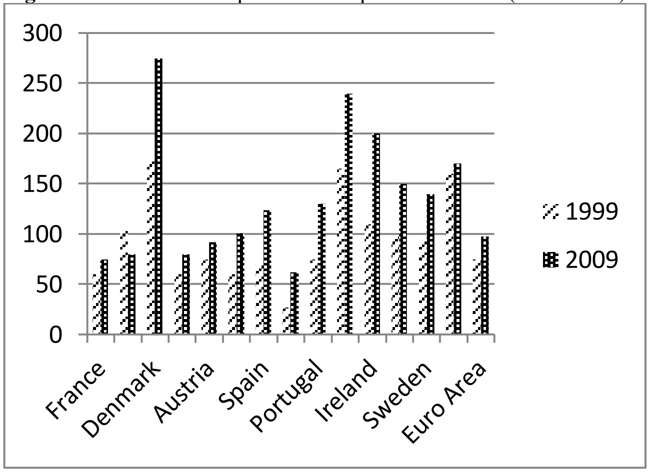


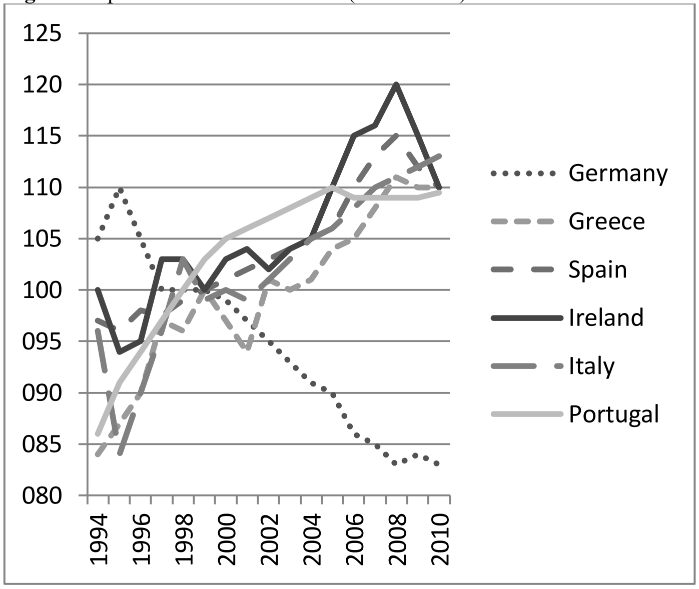
Fig. 3 Household debt as percent of disposable income (1999–2009)



Source: Eurostat

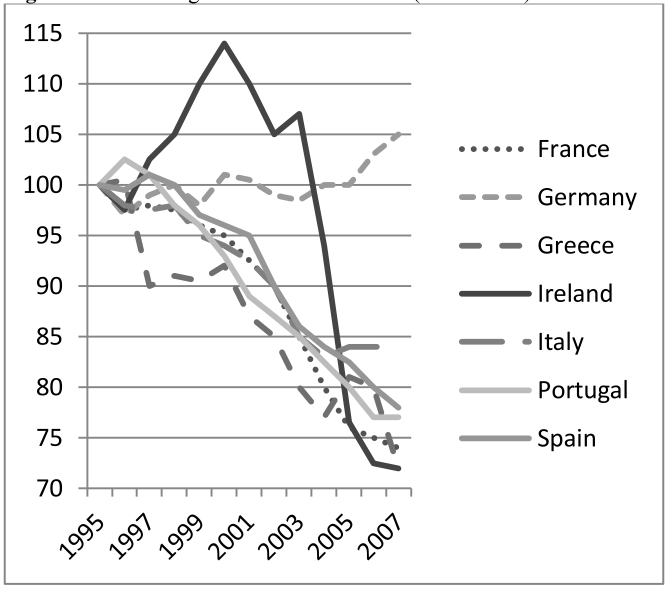
At the same time, many Eurozone countries, and especially the southern ones, faced deterioration in competitiveness. Figure 4 shows that there has been a continuous divergence in relative unit labour costs for these economies since 1999. The loss in competitiveness has proceeded along with a significant decline in the share of the manufacturing sector in the total value added. The data in Figure 5 show that the value added share of manufacturing has fallen by 25 percent, highlighting a tendency of de-industrialization in the euro area 'periphery'.

Fig. 4 Competitiveness: ULC indices (1995 = 100)



Source: EUROSTAT

Fig. 5 Manufacturing Share of Value Added (1995 = 100)



Source: OECD

The rise in the debt and the loss of competitiveness in most Eurozone countries can be attributed to, among others, the economic and financial environment that prevailed after the introduction of the euro. The latter coincided with the global credit boom. Furthermore, the convergence of interest rates, because of the introduction of the new currency, and the disappearance of the risk spreads, resulted in a surge in cross-border lending to both private and public sectors. This convergence also resulted in a reduction in the pressure for fiscal consolidation, especially in the high-debt countries, and finally in the emergence of huge payments imbalances and divergences in competitiveness. The debt and competitiveness problems have been further aggravated by the financial crisis in 2008, when a ‘sudden stop’ in lending led to a collapse in private borrowing and spending and to a wave of fiscal crises.

The present situation in the Eurozone creates various policy dilemmas. First, the reduction of the vast debt burden is a difficult task, which, in the case that may occur, takes a lot of time and requires unpopular measures. Second, it is difficult to cope with a debt burden when interest rates on public and private debt are rising, and incomes are falling, due to recession. Increases in taxation, cuts in spending and reduction in consumption, which are usually associated with the implementation of fiscal consolidation programmes, normally result in even lower growth rates and higher unemployment, which, in turn, frustrate the efforts of both the private and public sector to reduce their debt (Eggertsson and Krugman 2010). Third, the simultaneous effort to restore competitiveness and to repay debt, especially foreign debt, is a difficult task. As Ahearne and Wolff (2012) argue, a decrease in the external debt of countries with sovereign debt problems requires current account surpluses and real exchange rate depreciation, through cuts in prices and wages to boost net exports. However, it usually takes time for improvements in competitiveness to lead to faster export and income growth. Empirical evidence shows that a decline in export prices relative to import prices may, in the short-run, reduce net exports and produce an effect similar to the J curve, which may worsen the trade balance.[6] Under these circumstances, in heavily indebted countries, the required depreciation of the real exchange rate may push up the debt relative to net exports and income in the short term, making debt repayment more difficult.

Table 1 Gross exports as percentage of the GDP

	2007	2011
Ireland	80.5	110
Portugal	32.2	34.6
Italy	29	29.1
Spain	26.9	28.4
Greece	22.7	24

Source: Eurostat

Another factor that hinders the possibilities of these economies to adjust through growth in exports is the size of the export base in each country. The export sector's contribution to the GDP is quite small in the southern countries (Table 1) indicating that any increase in exports will have less effect on overall economic activity. The unique exception in the case of the over-indebted countries is Ireland, whose exports exceed its GDP.

According to economic theory, the best way to reduce debt-to-GDP ratios is by accelerating growth rates. However, countries have rarely achieved this in the past, and are less likely to do so now. Growth prospects for the developed economies in general and for the Eurozone countries in particular are limited in a world in which growth is gradually shifting to developing countries. Even with substantial structural reforms, the IMF (2010) estimates only a 0.5% additional growth potential for the Eurozone. Growth will also be hampered by the fact that the European societies are aging,[7] and by the existence of the debt itself, because it reduces the ability and willingness for additional spending and investment.

[6] Backus, Kehoe, and Kydland (1994) note that the negative effects of such deterioration in the terms of trade usually reverse themselves after 2–8 quarters, giving rise to a J-shaped pattern.

[7] By 2020, the workforce in Western Europe is expected to shrink by 2.4%.

The rebalancing challenge

The previous section has described the fundamental problems of the Eurozone. The most important problem is, however, that the Eurozone entered this crisis without having an effective way to sustain its banking systems, finance countries in trouble, and secure the adjustments by the creditor and debtor economies. On the contrary, as Martin Wolf (2012) argues, we 'see improvisation instead: the eurozone's aircraft is being redesigned while crashing'.

There is also disagreement on the causes of the crisis and the policies that have to be followed in order to restore symmetry. The dominant German view is that the crisis reflects fiscal indiscipline. Others insist that the core problem is excessive lending, divergent competitiveness, and external imbalances. The European Central Bank (2012) seems to support that southern European countries can become more competitive while Germany can remain unaffected. On the other hand, Paul de Grauwe (2012), drawing on unit labour cost comparisons, found that the adjustment is predominantly achieved by the countries of southern Europe and in contrast, in northern European countries, only a moderate deterioration is observed in relative unit labour costs.

Until recently, the issue of adjustment in the southern European economies was treated as a one-sided process. For most north European countries, budgetary adjustment in southern Europe was regarded as a process that could deliver both fiscal sustainability and a return to competitiveness, without affecting the north heavily. Policy-makers seemed to have realized only very recently that 'debt repayments' and the 'restoration of competitiveness' are relative concepts and economic conditions in the north affect the adjustment process in the south. The haircut imposed on private holders of Greek debt in March 2012, the wage agreement in the German metal industry in May 2012 (Wiesmann 2012), and some recent declarations by the German Finance Minister Wolfgang Schäuble (Bryant 2012) and by Bundesbank chief economist Jens Ulbrich (Atkins 2012), are some indications of a new policy direction. However, we are still far from reaching a policy consensus; that is, we are still do not have an accurate perception of the implications of a two-sided approach to rebalancing.

This disagreement, vis-à-vis the causes and the policies of rebalancing, has far reaching repercussions. The adjustment cannot be imposed outright. As Martin Wolf (2012) argues, given the exit option, the adjustment policies have to be negotiated. 'In such a negotiation, creditor nations must understand their role in the crisis. If they wish to preserve their surpluses, they must finance their borrowers. If they wish to be repaid, they must move towards deficit. The two sides—finance and trade—have to be brought into alignment'.

A substantial debt restructuring is a prerequisite for enabling Eurozone countries to return to stable growth. This policy has, however, to be accompanied by a comprehensive plan to restore competitiveness, at least in the periphery countries. An overall rebalancing is vital for the future of the euro. If it does not take place, the existence of the European currency will be ultimately undermined. The principal economic force that now keeps the system together is fear of a break-up. As the OECD (2011) described, a break-up of the Eurozone in the short run will lead to ‘massive wealth destruction, bankruptcies … and a deep depression in both the existing and remaining euro area countries as well as in the world economy’ (p. 6).

However, one cannot rule out the possibility of a breaking up of the euro. Exits from currency unions are not a rare occurrence in history (see Nitsch 2003) and, in particular, in the second half of the twentieth century. The difference with the Eurozone stems from the size of the currency union and the consequences for the world economy.

Any plan to rebalance will be a very expensive exercise. Without a restructuring of debt and implementation of fundamental reforms, the social and political tensions, and the risk of disorderly exits of countries from the euro zone, increase. The creditor countries have to accept that they will lose money. The existing debt is too large to pay back. Under the present circumstances, creditor countries have the option to choose how they will lose their money, that is, through defaults and economic chaos or though a more organized restructuring and a perception of joint responsibility and solidarity. It goes without saying that such a plan has to include measures for lowering the unit labour cost and introducing more flexibility in labour markets. This effort should also be combined with higher inflation in order to facilitate wage adjustments and to help in real debt reduction. In this context, north European countries have to accept real wage increases and subsequently an increase in total consumption.

Concluding Remarks

Any plan for saving the euro must be implemented as soon as possible because a protracted adjustment process is not politically sustainable. Today, the debate has to be focused on learning the lessons of the past and designing realistic plans for the future. However, it is important to understand that, policies and the reforms, similar to those described in the previous section, need a fundamental revision of the EU. Status quo choices will not save the euro and closer fiscal co-ordination, by itself, will not solve the problem. There is need for greater political unification.

In the EU, power still rests with the member states. In the case of the euro, power is concentrated in the hands of Germany, the largest creditor country. This makes the Eurozone function politically like a multi-country arrangement. However, while the Eurozone is not a country, it is much more than a currency union and cannot survive without political legitimacy. Europe’s leaders cannot carry out large transfers across countries indefinitely, without a coherent European political framework.

Cutting national sovereignty out of the picture could have many unforeseen consequences and would be a difficult task. However, the interest of the most important member countries to save the euro is huge. The big idea of an integrated Europe, the huge investment of the elite in that project, and the enormous cost that a breaking up of the euro entails are the principal political forces that will eventually save the euro and enhance political unification.

Unless the fundamental structure of the Eurozone changes and a politically unified Europe leads to fiscal transfers and joint liabilities, this crisis will not end. Under the present circumstances, however, the 'most likely outcome, though far from a certainty, is compromise between Germanic ideas and a messy European reality. The support for countries in difficulty will grow. German inflation will rise and its external surpluses fall. Adjustment will occur' (Wolff 2012).

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