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Research Report

Where now for the euro area crisis? Interim assessment and a model for a stable euro area

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Report

At a glance

The euro area crisis is not yet over. Austerity policies in the crisis countries have had a disastrous effect on economic growth and are placing increasing strain on the euro area as a whole. The primary cause of the crisis – the long-term consistent failure of individual Member States to meet inflation targets – is still not widely acknowledged, and remedies focus instead solely and narrowly on reducing government debt. And while there is progress in tackling foreign trade imbalances, it is not based on growth.

A fundamental shift of direction in economic policy is, therefore, essential and should include:

- Immediate extension of the time-frame for austerity measures
- Rapid instigation of a debt redemption fund
- A reformed Fiscal Pact aimed at avoiding foreign trade imbalances
- In the longer term, a European Monetary Fund that monitors trends in Member States' current accounts

Where now for the euro area crisis?

Interim assessment and a model for a stable euro area

Gustav Horn, Fabian Lindner, Silke Tober and Andrew Watt

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1. Getting to grips with the euro area crisis

The most current interpretation of the euro area crisis identifies the cause as inadequate budgetary discipline on the part of Member States. In this interpretation, profligate expenditure and soaring budget deficits are the factors underlying the most recent dramatic turn in the crisis – the growing burden of debt in the crisis countries, which has prompted the financial markets to lose confidence in their solvency, with the consequences that are now evident. The critics point particularly to budget discipline in the countries identified as priority cases before the crisis but do not spare Germany and France; when, in 2003, these two countries faced deficits in excess of the 3 % of GDP threshold set out in the Maastricht Treaty, they simply ignored the Stability and Growth Pact, say the critics, a lapse that then fatally weakened the discipline the Pact was designed to exert.

Contribution of bank bail-outs to the rise in government debt as % of GDP

	Ireland		Greece		Spain		Portugal	
	Overall rise in debt	Proportion not increasing the deficit	Overall rise in debt	Proportion not increasing the deficit	Overall rise in debt	Proportion not increasing the deficit	Overall rise in debt	Proportion not increasing the deficit
2008	0.1	0.1	0.0	0.0	0.9	0.9	0.2	0.2
2009	3.8	1.4	1.6	1.8	1.0	1.0	0.6	0.6
2010	20.5	0.3	0.0	0.4	0.6	0.7	2.7	1.5
2011	5.5	2.3	0.3	0.6	-0.2	-0.1	0.6	0.1

Source: Eurostat; IMK calculations.



This view is widespread, underpinning in particular the first Annual Growth Survey of the European Commission published in 2011, a document intended to coordinate Member States' economic policy and present an over-arching EU strategy for tackling the euro area crisis¹. The interpretation is wrong, however, because it does not actually tally with the facts and because it is only even partially plausible for just one euro area country – Greece. The budget deficits and the rapid growth in levels of government debt ratios are, in general, patently the consequence of the crisis, not its cause.

In 2007, government deficits across the euro area were low (an average of -0.7 %) and actually below the euro area average in all the crisis countries except Greece. Indeed, Spain had been running a surplus since 2005, as had Ireland continuously since 2003. However, the crisis on the financial markets sent government budgets deep into the red under the impact of automatic stabilisers, economic policy measures and, in particular, the stabilisation of the finance sector in 2009 (Table 1). The crises caused debt ratios in the euro area as a whole and in all its Member States to rise by stages (see Figs. 3 and 7, section 2). It is striking that two of the countries hit by the crisis – Spain and Ireland – still had very low government debt ratios in 2007 (36 % and 25 % of GDP respectively, as against a euro area average of 66 %) but that the euro area crisis then hit them too. The key factor was, however, the very high level of *private* sector debt. It is, therefore, misleading to speak of a general government debt crisis as triggering the euro area crisis.

This narrow view, focusing solely on government debt, thus takes us in entirely the wrong direction if we are seeking the causes of the euro area crisis. The real causes lie deeper and are quite different. Many commentators stress the role of capital flows within the monetary union (INET 2012, Sinn 2010), an approach that has much to commend it. Before monetary union, the current crisis countries had higher rates of inflation than the countries of the former deutschmark block, their currencies were more vulnerable to devaluation, and their rates of interest, both nominal and real, had been pushed up by risk premia. When they adopted the single currency and were subject to the same monetary policy as the other euro area Member States, both real and projected inflation fell in those Member States, and with the risk of devaluation removed, the risk premia on interest also disappeared, so both nominal and real interest rates fell markedly, stimulating economic growth. Yield expectations rose accordingly, particularly in the property and financial markets, and this boosted the flow of speculative capital, particularly in the countries where the crisis originated, because low levels of economic growth and low rates of inflation had previously precluded such growth there. The result was a growing speculative bubble.

So far, this argument is sound, but many commentators then suffer a logical short-circuit, interpreting these trends as the crisis itself. That judgement is premature. While such an approach correctly views the euro area as a contained system with mutually reinforcing trends in the countries exporting and importing capital, rising levels of capital import and export are entirely normal in a developing economic area with a single currency and do not necessarily trigger a crisis. Standard theory dictates, in fact, that these higher

¹ "The most urgent task for the EU is to restore confidence by preventing a vicious cycle of unsustainable debt, disruption of financial markets and low economic growth. Public expenditure must be put on a sustainable track as a pre-requisite for future growth." (EU Commission 2011)

levels actually boost real convergence, leading to a different dynamic equilibrium, with higher rates of investment and productivity both in the “catch-up” countries and in those with more developed economies. Part of this additional productivity potential is then transferred to the capital-exporting countries in the form of interest, dividends and so on. To interpret flows of capital as a crisis is, therefore, to beg the question why the convergence that should have materialised has actually failed to do so. The commentators fail to raise or answer this question.

There are, however, some even more fundamental problems with the capital flow approach, at least as expounded by commentators such as Hans-Werner Sinn (Sinn 2010). First, it erroneously establishes a causal relationship from the definitional equation that a current account surplus like Germany’s must be equivalent to its capital account deficit – and, conversely, that a current account deficit like Spain’s must be equal to its capital account surplus. The capital account dominates the current account, so flows of capital are seen as the cause of current account imbalances. Second, it interprets a capital account deficit as a flight of capital from countries with a current account surplus – that is, to simplify slightly, countries that export more than they import. And third – a key conceptual error – it assumes an *ex ante* limited volume of savings and investment in the euro area that is determined by the will of the entire population to save and then, as it were, “distributed” among the individual Member States. In this construct, a “capital export” from Germany comes at the expense of domestic investment: savings capital from Germany finances investment and employment in countries with a deficit – or, as (Sinn 2010: 7) sees it, Germany is weakened because its savings capital is in flight.

This view is problematic for a number of reasons. In Hans-Werner Sinn’s interpretation, capital flows have the effect of weakening precisely countries that have a current account surplus and are well equipped to survive the crisis whereas the current crisis countries have for many years benefited from a kind of blood transfusion. Here, the commentators’ critique is not systematic (see, *inter alia*, Horn/Lindner 2011, Flassbeck/Spiecker 2012). This interpretation is based on a misconception of savings. In contrast to the views of these authors, savings are not a given but are the result of growth in the economy. To simplify, savings are not a sealed body of water but a sea into and out of which water flows, affecting the level as it does so. In such a construct, an outflow of capital does not necessarily cause the water level to sink provided capital also flows in, for example where general

economic demand is boosted, triggering greater economic activity, perhaps as the result of new export markets opening up. In such cases, Germany is not weakened; it thrives.

1.1 The neglected inflation target

If we avoid this logical short-circuit, though, capital flows lead us to the real cause of the crisis. That cause is not, however, the capital flows themselves but the reaction to economic growth they help bring about in the current crisis countries: specifically, the reaction of pay and prices. In the euphoria surrounding higher economic growth, companies had more leeway to put up prices. As a result, nominal wages also grew strongly, in particular where (as in Spain, for example) indexation mechanisms were in force and where there was marked growth in employment. The result was that an inflationary process – a wage/price spiral – became established in these countries that was incompatible with the ECB’s goal of price stability. At the same time, there was a symmetrical reaction in the countries with lower rates of growth: here, inflation was below target. Since these two trends tended on average to balance each other out across the euro area, there appeared to be no problem from an aggregated monetary policy perspective.

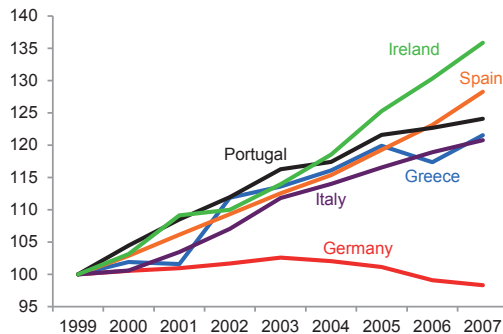
That was not, however, the case, because broadly parallel increases in national inflation rates are essential if countries are to grow in step in a monetary union. Short-term fluctuations around the average rate cause no problems, but monetary union will ultimately break down when a country’s inflation rate differs consistently and substantially, year after year, in either direction from the euro area average. The reason is that without an adjustment to their exchange rates – something that is no longer open to individual countries within monetary union – and without compensatory transfers, there will be substantial current account imbalances. Those countries with excessively high inflation rates become less and less competitive; their foreign trade balance goes into deficit, and they build up foreign debt. Countries with lower rates of inflation, meanwhile, become more and more competitive, and their foreign trade balance becomes increasingly positive as they accumulate foreign assets. There is, therefore, also a broad balance of indebtedness and assets between these countries: countries with surpluses increasingly become creditors to those with deficits. And this is exactly what happened in the euro area.

Fig. 1 shows the close correlation between growth in unit labour costs and the current account

FIGURE 1

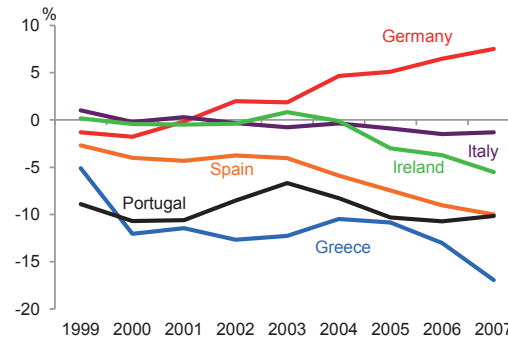
Competitiveness and current account balances

Nominal unit labour costs,
1999=100



Source: AMECO.

Current account deficit/surplus,
% of GDP



IMK

deficit of the crisis countries and of Germany. It would be wrong to read this correlation simply as a causal one, with wage policy influencing the current account balance: the interaction between these two indicators is more complex (Watt 2012). Differing rates of development in demand and growth fuelled both unit labour costs *and* current account deficits. When these imbalances proved unsustainable, internal and external sources of finance ran out, and the deficit countries saw themselves confronting an “emergency stop” the crisis hit.

Fundamentally, the euro area crisis is a crisis of current account imbalances and relative competitiveness and this needs to be clearly differentiated from a crisis of current account deficits and poor competitiveness in the crisis states or, indeed, the euro area as a whole. These imbalances and distortions of competition are, ultimately, an expression of the inadequate architecture of monetary union. Its designers did not build in the effective and symmetrical coordination of fiscal and pay policy that would have been required to counterbalance the strong positive and negative feedback mechanisms produced by differing rates of real interest in the Member States signed up to the single currency. As the advocates of the capital flow approach stress, having a single notional rate of interest set by the ECB when inflation rates varied so much had the effect of boosting the economies that were already growing and whose prices and pay were rising more rapidly while at the same time stifling the economies where growth and inflation were already low (Allsopp/Watt 2003). The causes of the current account imbalance were the differing pace of increase in demand and the accompanying – and

growing divergences between – growth in nominal wages and prices.

This trend could have been halted only if the Member States’ fiscal policy had taken a strong anti-cyclical approach both in countries with surpluses and in those with deficits, and if the nation states had implemented a nominal growth in pay and prices in line with the ECB’s inflation target more energetically and symmetrically. Relying on international trade as an adjustment mechanism, as the architects of the single currency did, made insufficient impact for many years, only all of a sudden to hit, one-sidedly, the deficit countries with full force. Unimpeded policy-induced capital flows allowed this process to continue up to the moment of crisis.

1.2 Pay or productivity: where was the mistake?

One of the key indicators determining inflation – though by no means the only one – is unit labour costs, which reflect the relationship between pay growth and productivity. Analysis of the factors determining this indicator helps answer the question of whether inflationary trends are the result of insufficient innovativeness within an economy or of differing rates of growth in nominal wages. Observers frequently favour the former interpretation (Hoekstra/Schuknecht/Zemanek 2012, *inter alia*).

There are, without doubt, serious structural deficiencies in the political economy of the crisis countries, such as the crass inefficiency of Greece’s taxation system or the marked segmentation of labour markets in countries like Spain and Italy. Nevertheless, such arguments do not of themselves explain the crisis, as both a major

theoretical argument and empirical evidence show.

In theory, both productivity levels and growth in productivity are of little importance for membership of a monetary union. If the above-mentioned structural weaknesses in the crisis countries push productivity below Germany's level or if they impede a rapid catch-up, this will have an impact on real standards of living in those countries relative to Germany: they will be lower or will rise less rapidly. However, these weaknesses do not a priori rule out membership of a monetary union nor do they of themselves trigger a crisis.

Fig. 2 shows the trends in employment and hourly labour productivity in the crisis countries and Germany in the years leading up to the crisis. The figures are difficult to reconcile with an explanation for the crisis that relies on structural "rigidities" in the later countries to be affected by the crisis. Spain was undergoing a substantial employment boom, despite segmentation of its labour markets. Ireland, too, had seen employment levels rise by around one third in just eight years. In Italy and Greece, meanwhile, employment grew by around 12 % in the years between the launch of monetary union and the crisis. By contrast, employment growth in Germany was largely stagnant. Trends in labour productivity do not fit easily into such an interpretative framework, either. Productivity growth in Germany was around the euro area average, good but not outstanding, while it was markedly higher in the much maligned Greek economy (albeit from a much lower starting point) and in Ireland (from a relatively high starting point). Growth in productivity in Portugal more or less kept step with that in Germany, whereas in Italy and Spain it was genuinely weak.

Real or supposed long-term "structural" weaknesses in national economies are, therefore, an inadequately convincing explanation for the generally rapid economic "catch-up" and subsequent abrupt decline in the countries now hit by the crisis.

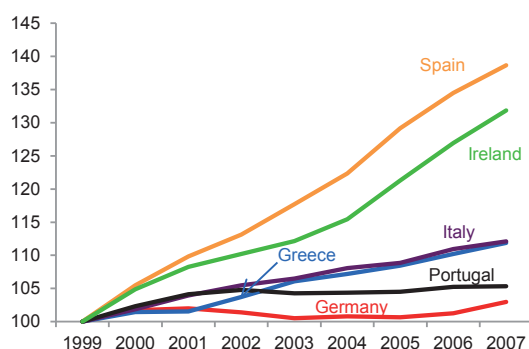
The varying levels of price competitiveness within the euro area were indeed a key factor in the crisis. Nevertheless, focussing solely on the southern European Member States is both short-sighted and misleading. Competitiveness is a relative concept. If trade is balanced overall across a monetary union – and, empirically, this is effectively the case for the euro area – then import surpluses recorded by "uncompetitive" countries are exactly reflected by the export surpluses of the "highly competitive" countries.

Competitive positions as measured, for example, against unit labour costs diverged during the first decade of this century (Fig. 1). However, the production figures illustrated in Fig. 2 show that the apparent inability of the current crisis countries to increase productivity in line with the other euro area countries (and particularly Germany) is only part of the explanation. The main factor driving the divergence in unit labour costs was, in fact, differing rates of growth in nominal gross wages. That makes a key difference. A business that increases its market share by manufacturing better products or adopting more efficient production methods represents a net gain to an economy, even if its success puts less productive businesses under pressure: total earnings and standards of living are both higher. However, if a business puts its competitors under pressure solely because it pays its workers less, then this is, at best, a zero-sum game for the economy as a whole: one company grows at the

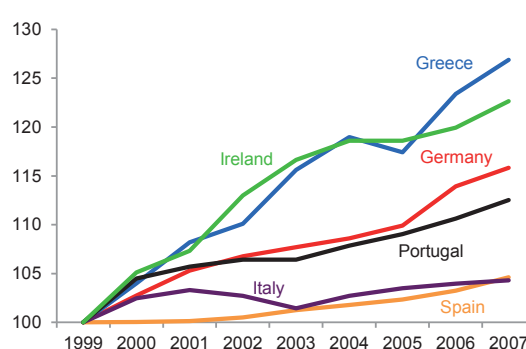
FIGURE 2

Employment and productivity before the crisis

Numbers in employment based on domestic concept, 1999 = 100



GDP per working hour at 2005 costs, 1999 = 100



Source: AMECO; IMK calculations.



expense of the others, while incomes are static at best. This pattern is, however, exactly what typifies competition between the euro area Member States.

It is true that, given the framework represented by the relevant national productivity trends, nominal pay and prices have risen more rapidly in the deficit countries than on average across the euro area. However, it is also the case that in the surplus countries, they rose markedly more slowly than the average.

1.3 From current account imbalances to a liquidity crisis

The trigger for the deepening crisis in the euro area was the international financial crisis prompted by the collapse of Lehman Brothers in 2008. In late 2008 and 2009, this crisis produced a direct and wholly negative impact on output and employment. However, by the spring of 2010, monetary union was already on the road to recovery: in the first six months of that year, growth in the euro area as a whole was strong, at 0.5 % quarter on quarter to March and 1 % quarter on quarter to June. Just one country, Greece, had negative growth.

The key factors in the unravelling of the crisis were the shockwaves the financial crisis triggered across the banking sector, particularly in countries such as Ireland and Spain, where the property market was booming, fuelled by pre-crisis lending that led to massive debt write-offs when the property bubble eventually burst. Without a common European bank bail-out fund, the Member States affected were left to take individual responsibility for tackling the insolvency of their banking system or using public funds to recapitalise it, thereby putting their own solvency at risk. Losses on their balance-sheets prompted the banks to restrict further lending, hampering growth and placing a further burden on public finances. The falling output and growing unemployment that followed also put a strain on public finances through the effect of automatic stabilisers, the need for economic stimulus packages and direct support for national finance sectors. Banks hold a particularly high percentage of their assets in bonds issued by the country in which they are established. Any decline in prices of, not to mention defaults on, government bonds therefore affects the banks directly and threatens their solvency, just as, conversely, the looming insolvency of the banks threatens governments. The entangled nature of a crisis of the real economy, of public finances and of banking, then, laid bare the deep-rooted institutional weaknesses in the economic governance of the euro area as a whole and in its model for growth. The euro area crisis therefore

erupted at the point of intersection of two distinct crises: the crisis in the financial markets; and the crisis in the institutional arrangements within the euro area.

The most significant structural deficiency of monetary union is that the common monetary policy has not been combined with economic policy instruments at national level to even out divergences.

Binding policy coordination was restricted to the area of budgetary policy, where deficit targets were set. However, the aim here was not to promote balanced real growth across the euro area but to implement arbitrary fiscal limits in the belief that poor budgetary discipline was the major threat to a functioning monetary union. The aim of fiscal policy rules was primarily to prevent governments falling into “moral hazard” – that is, forcing other Member States to take liability for unsustainable growth in their own government debt. This concept, and the scepticism about state intervention that underpinned it, were therefore to prove central to attempts to resolve the crisis and, ultimately, to their failure. In the case of the Stability and Growth Pact (SGP), the countries with high levels of both real and, in particular, nominal growth before the crisis did not, however, find it particularly difficult to keep their deficits below the 3 % cap imposed by the Maastricht Treaty or, at least, to stabilise their debt ratio. And debt ratios were indeed successfully stabilised, albeit at a high level, even in Greece; Spain and Ireland, in fact, ran budget surpluses for several years before the crisis.

In retrospect, these countries should have had a (more) restrictive fiscal policy, although they were under no obligation to do so under European coordination mechanisms. Quite the reverse: their apparently solid public finances attracted consistent praise from the institutions of the European Union, which saw no cause for adjustments to be made despite the current account deficits these countries were running². At the same time, those economies that were growing sluggishly, again both in real and, especially, in nominal terms, were for many years prevented by the one-sided approach of the SGP from providing fiscal stimulus to their economies. These countries included Germany and France. In Germany in particular, there was, therefore, a mercantilist approach to economic policy: growth in wages and prices was kept firmly under

² When it assessed Spain's fiscal policy in 2007, the Council of the European Union concluded: “[T]he medium term budgetary position is sound and the budgetary strategy provides a good example of fiscal policies conducted in compliance with the Stability and Growth Pact. Maintaining a strong budgetary position, thus avoiding an expansionary fiscal stance, is important in the light of large and rising external imbalances and the existing inflation differential with the euro area.” (Council of the European Union 2007, para.12).”

control to bring down the real rate of exchange and to simulate demand and employment, in particular by boosting foreign trade. This policy was indeed “successful” in terms of its own instrumental goals, but for many years, the impact even on Germany was negative because it actually prevented domestic demand from expanding. Above all: a policy of this kind inevitably ends up pushing a monetary union into a competitiveness and balance of payments crisis (Horn et al. 2010, Horn et al. 2005, Joebges et al. 2010, Niechoj et al. 2011).

For some time, the combination set out above of mutually reinforcing crises in banking, government finance and balance of payments has taken the form of a general crisis of liquidity. Economic entities running a deficit (which can include countries, federal states, government budgets and individual financial and manufacturing companies) – in other words, those who before or during the crisis were spending more than their current earnings – are finding it difficult to gain reliable access at acceptable rates to the credit they need. Their attempts to balance their books stifle economic activity because there is insufficient compensation by economic policy and by economic entities running a surplus. In a monetary union with a broadly balanced current account, total expenditure must necessarily equal total income. Any “deleveraging” of economic actors running a deficit – that is, any attempt to bring their expenditure back down below their income – is a highly risky economic strategy unless those who have been living within their means start to increase their own expenditure. This process initially impacts on the crisis countries themselves but in the long term, the entire European economy – including countries, such as Germany, that run a surplus – are pulled down into the mess.

2. Austerity hampers growth

One of the main conditions for states to receive financial aid from the European Financial Stability Facility (EFSF) is the implementation of harsh austerity policies aimed largely at reducing government debt. However, recent studies by the International Monetary Fund (IMF) indicate that such a policy severely hampers growth and has hardly any significant impact on levels of debt. (IMF 2010, see also Hein and Truger, 2006; 2008). Furthermore, in the past, austerity has always increased unemployment, in particular long-term unemployment, while wage-earners lose significantly more than recipients of income from profits and gains of business (IMF 2010; Guajardo, Leigh et al. 2011; Battini, Callegari et al. 2012). Little evidence has

been found of the much-quoted positive impact of austerity policies, for example in terms of greater confidence amongst private investors and businesses (IMF 2003).

According to the IMF, the negative impact of austerity policy on economic performance has been more marked the deeper in recession an economy already was (Battini, Callegari et al. 2012). In periods of weak economic performance, strenuous efforts to consolidate budgets have even had the effect of increasing the debt-to-GDP ratio that they were supposed to reduce (Cherif and Hasanov 2012; IMF 2012a, p. 15). Austerity policies have a particularly negative impact on economic performance when a country has no possibility to devalue its currency in order to compensate (at least partially) for any drop in domestic demand by increasing demand from abroad.

The negative impact on economic performance is further intensified if all the country’s trading partners are simultaneously trying to consolidate their budgets, thereby reducing demand for each other’s exports. It was for this reason that some observers warned early on against a co-ordinated European austerity policy (Theodoropoulou/Watt 2011, IMK/OFCF /WIFO 2012).

All these exacerbating factors are playing an important role in the current austerity policies pursued by those countries worst affected by the euro crisis – Greece, Spain, Ireland and Portugal. We shall examine the impact of austerity policy on growth, unemployment and debt reduction in greater detail.

Greece, Portugal and Ireland have all received emergency loans from other EU states, the EU, the EFSF and the IMF. One of the conditions for the loans was an agreement to implement consolidation programmes under the supervision of a so-called “troika” of representatives of the EU, the IMF and the ECB. The Irish government submitted its consolidation plans back in the spring of 2009, Portugal in the spring of 2010 and Greece in May 2010. Spain also decided on a programme of consolidation in spring 2010 (IMF 2012a). Italy, which became a focus of concern in the financial markets from mid-2011 onwards, only began to consolidate its state budget towards the end of 2011, which means it is too early to assess the impact of the Italian policy. Italy will not therefore be included in our considerations – although a significant drop of 2.4 % in GDP is forecast for 2012 (OECD 2012).

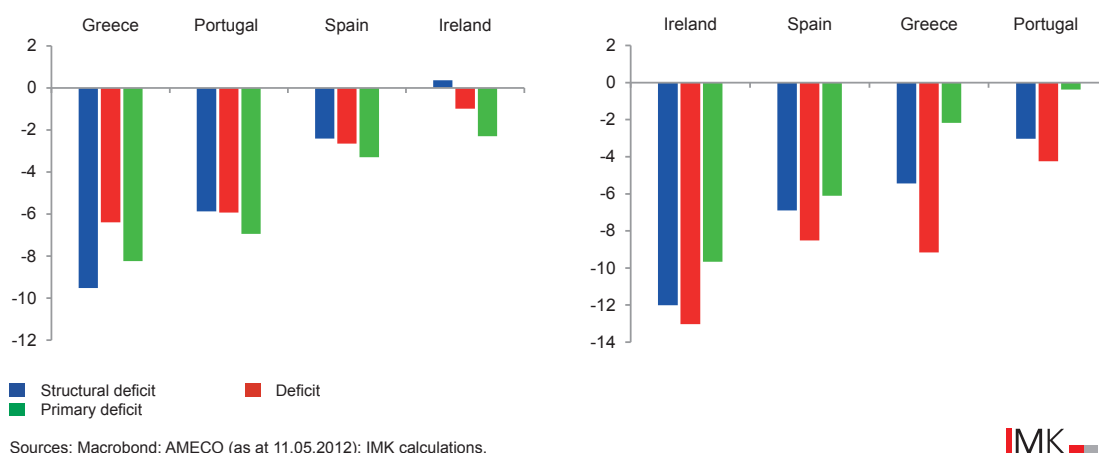
All the consolidation programmes aim to reduce government debt compared with the year 2009, and for this reason this has been chosen as the base year for comparing austerity policies in the countries affected by the crisis (see also OECD, 2011). As

FIGURE 3

Trend in government deficit in the countries hit by the Euro crisis

Growth in deficit in percentage points, 2009-2011

Deficit as % of GDP in 2011



annual data are only available up to the end of 2011, trends between 2009 and 2011 are examined.

During this period, all the countries have succeeded in reducing their debt-to-GDP ratio (deficit as a percentage of GDP). Fig. 3 shows the total, primary and structural deficits. The total deficit is the difference between total government spending and revenue. The primary deficit is the difference between government revenues and spending without interest payments. This is a good way to present consolidation without the cost of servicing debt and is the key figure that indicates the way government debt is developing.

If one looks at the actual total and primary deficits, however, it becomes difficult to reach conclusions about the fiscal policies of a government on this basis, as deficits are strongly cyclical: during the low point in the economic cycle, expenditure rises, for example as a result of higher unemployment benefit payments, while revenue from taxation and other levies automatically declines.

Because of this problem the so-called structural deficit is calculated in order to remove the cyclical element. In principle, it is possible to calculate how a government varies its expenditure and income on a discretionary basis. However, data on structural deficits have to be interpreted with care, as they depend on more or less speculative assumptions³.

³ To calculate the structural deficit, a cyclical component, plus financial transactions, is removed from the total deficit. The process is as follows: a production function approach is used to calculate production potential (D'Auria, Denis et al. 2010). The production gap (a measure of cyclical over- or under-utilisation of capacity) is the difference between production potential and actual GDP. The cyclical component is defined as a product of budgetary sensitivity (European Commission 2005) and the production gap. The cyclical component thus calculated is then subtracted from the total deficit. In addition, financial transactions (e.g. borrowing and other sectors) are removed from the calculation. The

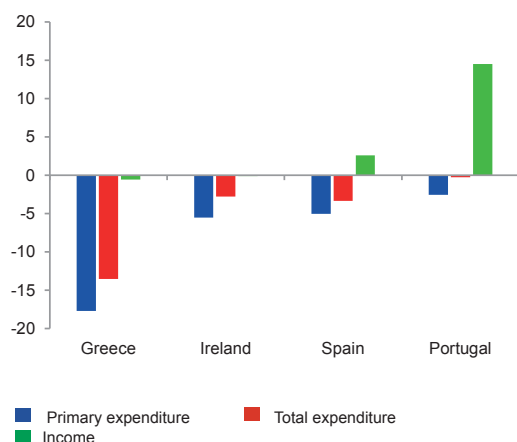
Of all the countries under scrutiny, Greece has reduced its debt-to-GDP ratio most radically: by 9.5 percentage points between 2009 and 2011 (primary debt-to-GDP ratio: -8.3 percentage points; total debt-to-GDP ratio: -6.4 percentage points). Amongst the countries worst affected by the crisis, only Portugal has achieved a comparable reduction, cutting its structural deficit as a percentage of GDP by 5.9 percentage points (primary debt-to-GDP ratio: -6.9 percentage points; total debt-to-GDP ratio: -5.9 percentage points). Spain and Ireland have so far made much less effort to consolidate their budgets, reducing their structural deficits by 2.4 and 0.4 percentage points respectively. In 2011, Ireland had the highest deficit of all the crisis countries (12 % structural deficit, 9.7 % primary deficit and 13 % total deficit). Spain had the second highest structural debt-to-GDP ratio at 6.9 % (Fig. 3).

But it is not just the extent but also the method of consolidation – via spending cuts or increases in revenue – that differ from country to country. Spending cuts usually have a more restrictive impact than increases in taxes or other levies, because they directly drain spending power out of the economy (Bouthevillain/Caruana et al. 2009; OECD 2009; IMF 2012a, P. 33-39). In the crisis countries, a variety of different approaches have been taken, and as a result the impact on economic growth has also varied considerably (Figs. 4 and 5).

remaining sum makes up the structural deficit. However, production potential is as difficult to observe as structural deficit. Calculation of these is strongly influenced by GDP development and depends partly on arbitrary assumptions (Horn/Tober 2007; Trüger-Will 2011a). The IMF also takes a critical view of the method of calculating structural deficits. Thus IMF researchers in the majority of the studies quoted above have selected alternative methods of identifying an active austerity policy (Ball, Leigh et al. 2011).

FIGURE 4

Percentage change in income and expenditure, 2009 - 2011



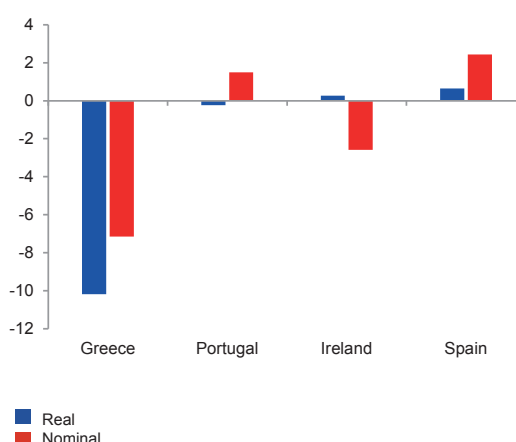
Sources: Macrobond; AMECO (as at 11.05.2012); IMK calculations.



The Greek government has above all drastically cut its nominal expenditure; nominal primary expenditure has been reduced by 17.7 % but nominal total expenditure by only 13.5 % because of increased interest payments (Fig. 4). This has put an extra burden on the Greek economy, which had been suffering from weak levels of growth since 2008. Between 2009 and 2011, real GDP in Greece dropped by 10.2 %, and a further significant drop is forecast for 2012. In particular, public investment fell by half between 2009 and 2011. Public consumption also declined particularly dramatically compared with other countries – almost 16 % (Table 2).

Cuts in social spending and tax increases have also had a heavy impact on private industry in Greece. Private consumption has dropped by 10.5 % and private

Percentage change in real and nominal GDP, 2009 - 2011



Sources: Macrobond; AMECO (as at 1.05.2012); IMK calculations.



investment by almost a third. Only Ireland has seen private investment decline more steeply – by almost 40 %. The fall in domestic demand in Greece has led to a decline in real imports of 14.8 %.

By contrast with Greece, the Portuguese government did not throttle back spending particularly drastically until 2011 (-2.6 %), but was able to increase revenues by 14.5 % (Fig. 4). Partly because of this, GDP declined by just 0.2 % between 2009 and 2011. Public consumption and public investments have fallen in Portugal, but by far not as dramatically as in Greece (Table 2). In Ireland and Spain, whose governments introduced far less drastic consolidation measures, GDP actually slightly increased between 2009 and 2011 (Fig. 5).

As a result of stagnation and recession, unemployment has increased in the crisis countries (Fig. 6). It had already been driven up by the

TABLE 2

Percentage change in components of real GDP, 2009-2011

	Greece	Portugal	Ireland	Spain
Exports	3.9	16.8	10.7	23.7
Imports	-14.8	-0.4	2.0	8.7
Household expenditure	-10.5	-1.9	-3.6	0.6
Public expenditure	-15.6	-3.0	-6.7	-2.0
Private investment ¹	-28.6	-14.8	-39.4	-4.7
Public investment ¹	-53.3	-16.6	-14.6	-39.1

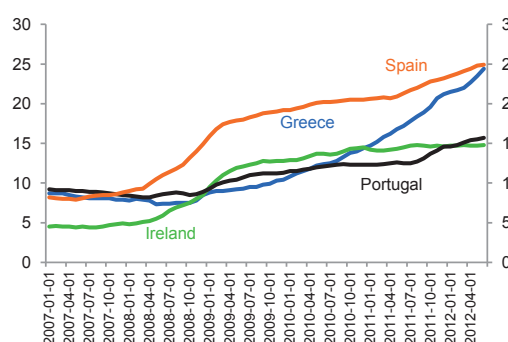
¹AMECO publishes only unadjusted public and household investment figures. The deflation applied here to both values is therefore achieved by applying the deflator to total investment.

Source: Macrobond (AMECO, as at 11.05.2012); IMK calculations.



FIGURE 6

Unemployment rate in %



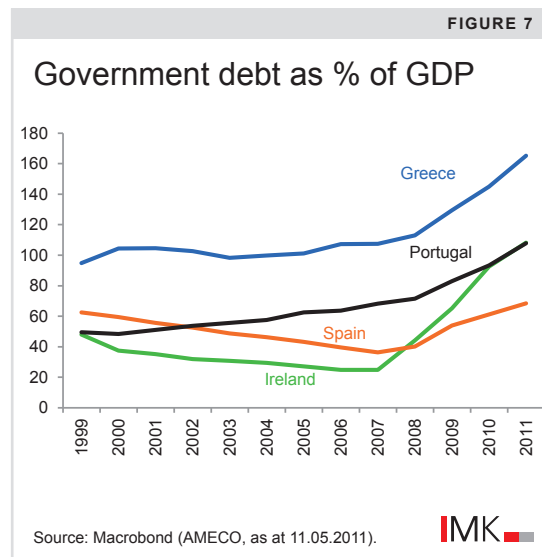
Source: Macrobond (Eurostat).



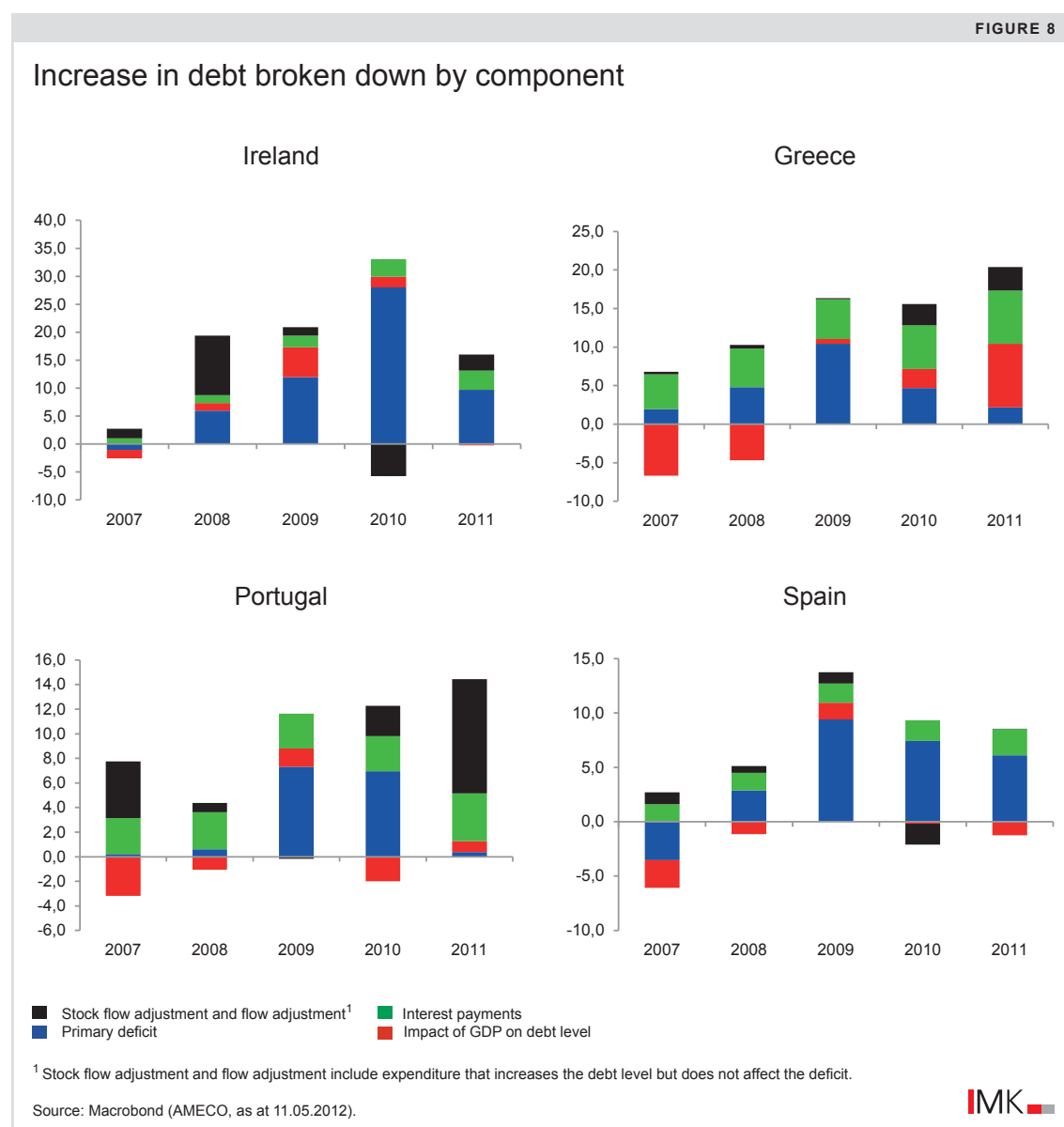
international financial crisis in 2008 – particularly in Ireland because of the collapse of the property market. But with the onset of austerity policies from 2010 onwards there was a sharp upturn in unemployment in all the crisis countries. In Ireland, though, with its relatively weak consolidation, there was only a marginal increase. In August 2012, unemployment was at 15 % in Ireland, 15.9 % in Portugal, 25.1 % in Spain; in Greece it was 25.1 % in July of the same year. This resulted in lower taxation revenue and increased social expenditure, thereby making the task of consolidating public budgets even more difficult.

An excessively harsh austerity policy not only reduces growth and increases unemployment but can also delay the desired medium-term reduction of the debt-to-GDP ratio. Fig. 7 shows this sharply increasing in all countries since 2008.

This was not just caused by the deficits (consisting of primary deficit and interest payments) but



also by the development of nominal GDP (Fig. 8). A decline in nominal GDP automatically results in an increase in the debt-to-GDP ratio, which it deno-



minutes. In Greece in 2011, falling GDP as a result of the deep recession was directly responsible for almost half of the increase in debt-to-GDP ratio. This effectively cancelled out the government's success in reducing its primary deficit that year. In Ireland in 2010 and in Portugal in 2011, the drop in nominal GDP also increased the debt-to-GDP ratio, albeit not to the same extent as in Greece.

All in all, the crisis countries – especially Greece – may have been able to reduce their deficits between 2009 and 2011, but doing so produced a severe recession in Greece and economic stagnation in the other countries. In the case of Greece, one can see just how counter-productive a consolidation policy focused mainly on spending cuts can be, because the reduction in nominal GDP actually increases the debt-to-GDP ratio. In the case of Portugal, consolidation on the income side also considerably reduced the deficit, but had much less negative impact on growth. Thus the experiences of the four crisis countries match the results of the quoted IMF studies.

2.1 Unit labour costs and current account balances adjust accordingly

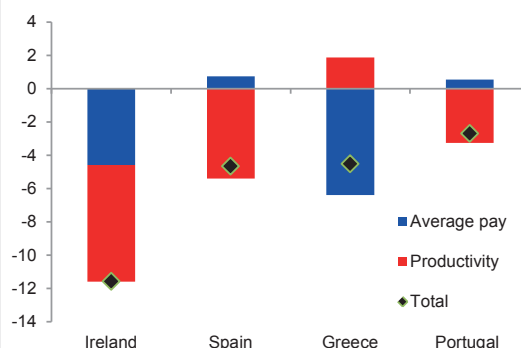
The economic downturn triggered by austerity policies has contributed to a large drop in unit labour costs in all countries. Unit labour costs are an important factor for the price competitiveness of any economy. Prior to the crisis they had increased in the crisis countries in relation to the average in the euro area (Fig. 1). The biggest decline between 2009 and 2007 took place in Ireland – 11.6 %. In Spain they fell by 4.5 % and in Portugal by 2.7 %.

The change in unit labour costs can be divided into changes in gross wages and productivity. Fig. 9 shows that the influence of these two elements varied greatly from one country to the other. Only in Ireland and Greece did average wages drop nominally – in Ireland by 4.6 % and in Greece by as much as 6.4 %.

With the exception of Greece, productivity trends in all countries were positive and thus contributed towards a drop in unit labour costs. The increase in productivity was particularly strong in Ireland and Spain, probably because dismissals of many employees in the construction industry, with its relatively low productivity, following the collapse of the real estate bubble resulted in an increase in average productivity levels. There are now fewer employees working, but they are working in sectors with higher average productivity (for Ireland, see O'Brian 2011).

Unit labour costs are, however, only one factor influencing price competitiveness. The development of prices themselves also has to be taken into ac-

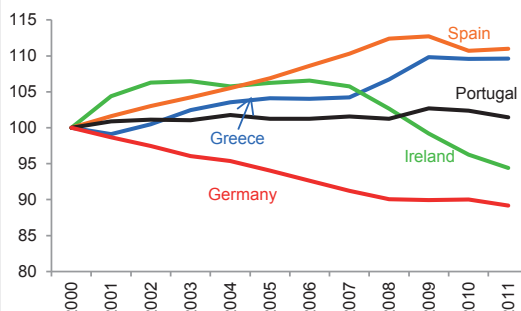
FIGURE 9
Percentage change in unit labour costs broken down by component, 2009 - 2011



Source: Macrobond (AMECO, as at 11.05.2012); IMK calculations.

IMK

FIGURE 10
Growth in the GDP deflator excluding taxation compared with the Eurozone



Source: Macrobond (AMECO, as at 11.05.2012); IMK calculations.

IMK

count. If one looks, for example at the development of the GDP price deflator without changes in direct taxation⁴ in the crisis countries and compares this with the figures for euro area as a whole⁵, one can see a smaller relative improvement in price competitiveness compared with unit labour costs (Fig. 10; for a breakdown of the GDP deflator see ECB 2005).

The reason can be found in the rising income from profits and capital (gross operating surplus) (Table 3). In all countries, profits rose between

⁴ Changes in indirect taxation (after subtracting subsidies) are not taken into account, as they are not of relevance for price competitiveness. The only impact they have is on domestic demand, for example in the form of excise duty. As exporters can write them off, they are not relevant for exports. As indirect taxation impacts domestic consumption, it tends to have a negative effect on imports.

⁵ The GDP deflator for the euro area includes indirect taxation. AMECO does not break down the rate of increase of the GDP deflator into unit labour costs, indirect taxation and profits.

Growth in GDP deflator excluding taxation and its components

		2008	2009	2010	2011
Greece	Unit wage costs	3.8	3.9	-1	-1.6
	Indirect taxation	0.3	-1	1.2	0.3
	Gross operating surplus	0.7	-0.1	1.5	3
	GDP deflator excluding taxation	4.4	3.8	0.5	1.3
Ireland	Unit wage costs	3.8	-1.3	-3.9	-2.2
	Indirect taxation	-1.3	-1.5	-0.2	0.2
	Gross operating surplus	-4.8	-1.2	1.6	1.5
	GDP deflator excluding taxation	-1	-2.5	-2.3	-0.7
Portugal	Unit wage costs	2	1.8	-0.9	-0.4
	Indirect taxation	-0.1	-1.4	0.6	0.3
	Gross operating surplus	-0.3	0.5	1.3	0.8
	GDP deflator excluding taxation	1.7	2.3	0.4	0.4
Spain	Unit wage costs	2.7	0.8	-1.5	-1.1
	Indirect taxation	-1.6	-1.1	1.5	-0.2
	Gross operating surplus	1.3	0.4	0.4	2.6
	GDP deflator excluding taxation	4	1.2	-1.1	1.6

Source: Macrobond (AMECO, as at 11.05.2012); IMK calculations.



2000 and 2011 despite economic stagnation or even recession. This offset the positive effect of reduced unit labour costs on price competitiveness – in some cases quite dramatically. It could be an indication that the market power of companies in these countries is very strong. But what is striking is that there is no shift of national income towards profits in countries not subjected to an austerity program. On the contrary – in recent years, the ratio of wages to GDP (without the influence of indirect taxation) has increased in countries like Germany and also France. The developments in the euro area thus confirm the strong distributional effect of austerity policies identified by the IMF.

The increase in price competitiveness and reduction in domestic demand enabled all the crisis countries to improve their trade balance for goods and services and therefore their current account balance⁶ (Fig. 11). Between 2009 and 2011, exports rose more strongly than imports in all the countries concerned – with particularly sharp increases in Portugal (16.8 %) and Spain (23.7 %). In addition, imports fell in Greece and Portugal – by as much as 14.8 % in Greece, but by a mere 0.4 % in Portugal (Table 2). Despite the improvements in their trade balance for goods and services, Greece, Portugal and Spain continued to record deficits in 2011. In

the case of Greece the figure was 7.5 % of GDP, in Portugal 3.9 % and in Spain a mere 0.6 %.

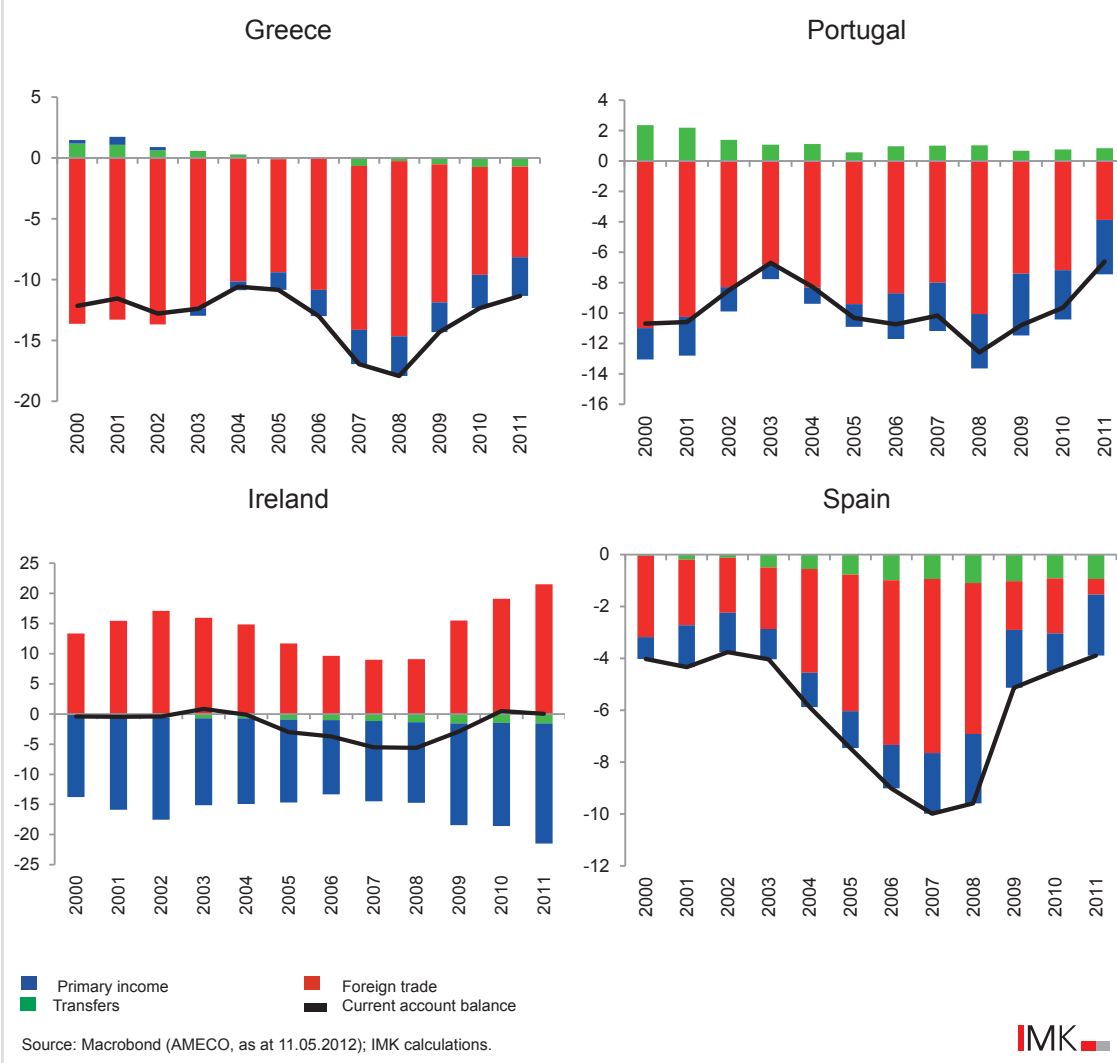
In these countries, reduction of the trade balance deficit also reduced the current account deficit by about the same amount, though the latter still remains higher. The reason for this is the balance of primary income, which is dominated by the investment income balance. As a result of their high levels of net foreign debt, these countries continue to pay more interest and dividends abroad than they themselves receive from abroad. The high current account deficits mean that Greece, Spain and Portugal continue to depend on foreign financing, thereby increasing their foreign debt.

Ireland, too, has been able to significantly improve its trade balance for goods and services – by 12 % since 2008. But in contrast to the other crisis countries, Ireland has consistently had a balance of trade surplus for goods and services since the introduction of the euro. In 2011 this amounted to 21.5 %. At the same time, however, the current account balance has only improved by 5.7 percentage points. This is because investment income balance has dramatically deteriorated. In 2011, Ireland showed an overall slight increase of 0.1 % in its current account balance.

Thus all the crisis countries have been able to cut their current account deficits, thereby reducing their dependence on foreign financing. Up to 2011, exports increased in all countries, while in Greece

⁶ The trade balance is one element in the current account balance. Other elements include earnings and investment and transfer income balance.

Current account balance, by component



and Portugal, imports also dropped. All countries have also experienced a reduction in unit labour costs.

2.2 Greek debt restructuring exacerbates euro crisis

In Greece in particular, the austerity policy has driven up the debt-to-GDP ratio to such an extent that it is regarded as unsustainable. For that reason, the European heads of state and government decided, on July 21, 2011, that if the Greek government were to receive further loans, it would have to restructure its debts (Council of the European Union, 2011). This sent a shockwave through the financial markets and considerably exacerbated the crisis. Thereafter, the banks were extremely reluctant to offer interbank loans and the flight of capital out of the crisis states accelerated sharply. Various observers, including Horn et al. (2011) and the ECB (2011),

had already warned of this. Massive intervention by the ECB was required in order to rescue the euro area banking and financial system from collapse.

The interbank market plays a central role in ensuring the functioning of the payment system and bank lending. Normally, banks use it to lend each other central bank money⁷ that they need in order to cover the cash requirements of the population at large, meet their obligations regarding minimum reserves, and operate the payment system. Prior to the euro crisis, the banks in today's crisis countries were able to use the banks in the rest of the euro area to refinance via the interbank market.

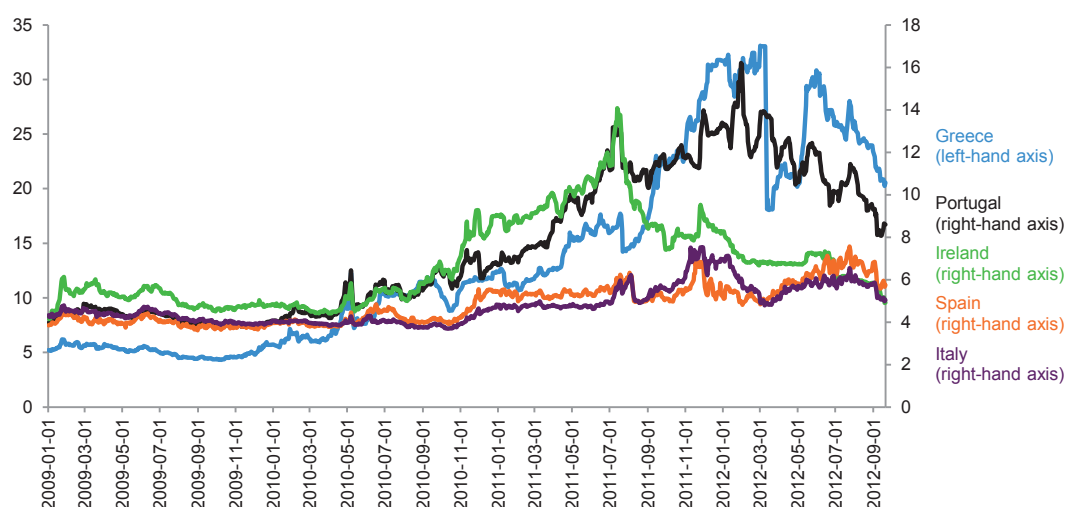
However, the announcement and implementation of the Greek debt restructuring increased the danger that the banks would have to write off

⁷ Only the central bank can create central bank money, which consists of deposits by commercial banks with the central bank, as well as notes and coins.

FIGURE 12

Yields on ten-year bonds in selected Eurozone countries

Current cost values in %



Source: Macrobond.

IMK

more of their outstanding debts, thereby bringing them closer to insolvency. But this could also mean cancelling debts from the interbank market, which would then threaten the solvency of other creditors. The danger of insolvency does not just affect holders of Greek bonds and their creditors. The announcement of the Greek debt restructuring has been interpreted as a basic decision that the debts of every state in the euro area – and therefore also the claims of creditors – can be reduced by a so-called “haircut”. Banks in the crisis states and their creditors in other countries of the euro area can no longer be certain that other states will not also carry out restructuring of their debts because of the crisis of the euro.

This has severely shaken confidence in government bonds – on which modern finance systems have to depend, not least for regulatory reasons (IMF 2012b). Since May 2011, the prices of Italian and Spanish bonds, which had not been the focus of the financial markets prior to announcement of the debt restructuring, have fallen, and their yields and refinancing interest rates have risen accordingly (Fig. 12).

The situation in the crisis countries is exacerbated by the fact that the banks hold above-average quantities of bonds issued by their own governments (Merler/Pisani-Ferry 2012), and loans to the private sector are increasingly not being serviced as a result of the recession triggered by austerity policies. The proportion of non-performing loans, including private sector ones, has risen sharply in

all crisis countries since 2008 (Table 4). The banks may have been able to increase their equity to some extent since 2008 – not least with government support – but the risk of insolvency has increased enormously for all banks in the crisis states as a result of the deteriorating economic situation and the possibility of restructuring of government debt.

The extent to which announcement of the Greek debt restructuring has undermined the confidence of the banks can be seen from the increase in holdings of deposits in the central banks of the euro system, the increase in the spread between the EURIBOR and EONIA swap, and target balances (Figs. 13 and 14). If banks are making increased use of deposit accounts with the central banks of the euro system,

TABLE 4

Banking sector indicators

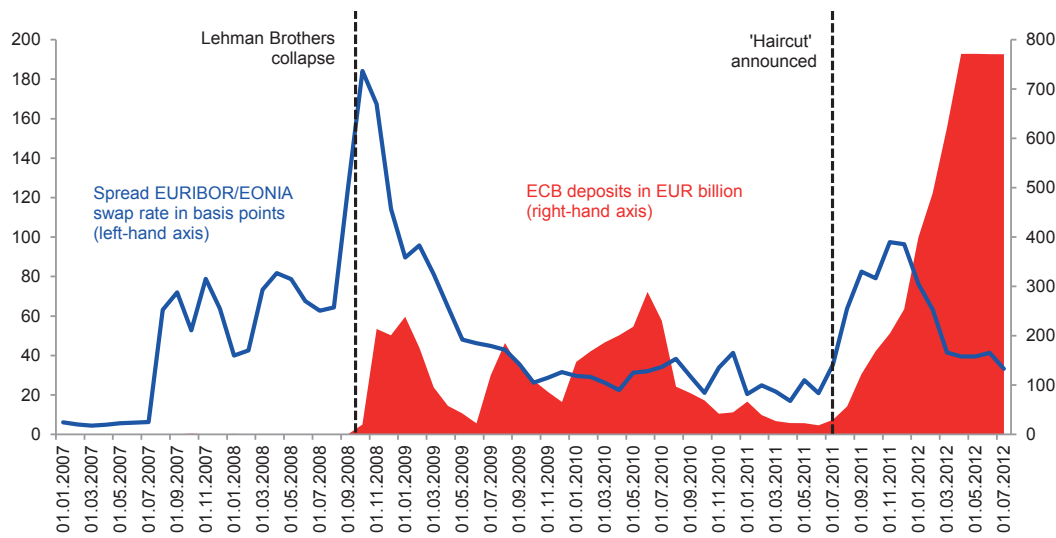
	Non-performing loans as % of all loans		Net assets as % of assets	
	2008	2011	2008	2011
Ireland	2.6	14.7	3.7	6.4
Greece	5	14.7	7.3	5.0
Portugal	3.6	6.9	5.8	6.1
Spain	2.8	5.3	6.1	6.1
Italy	6.3	11	4.1	5.4

Source: Macrobond (IMF Financial Soundness Indicators).

IMK

FIGURE 13

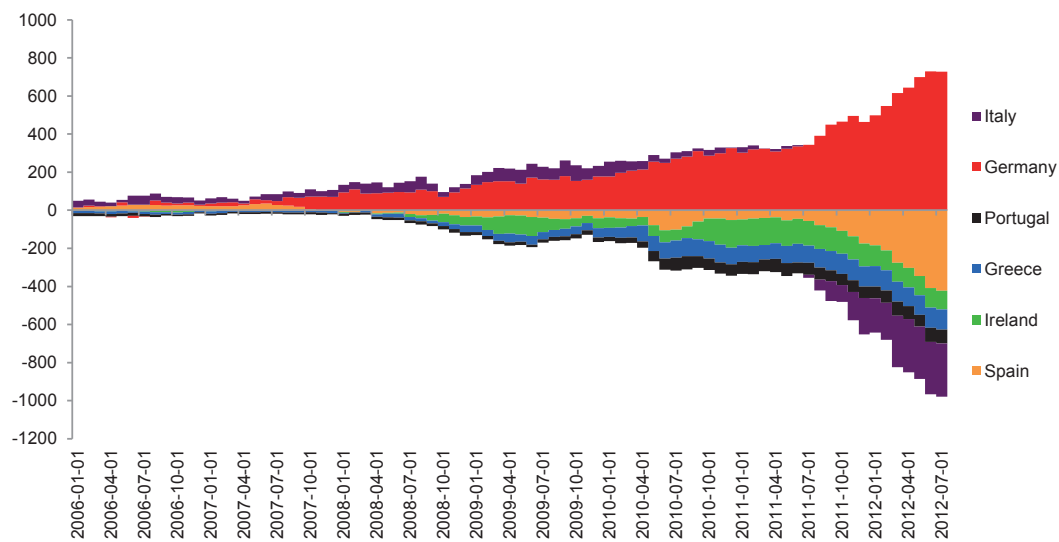
Indicators of stress on the inter-bank market



Source: Macrobond (ECB, EURIBOR FBE).

FIGURE 14

Target balances in EUR billion



Source: Macrobond.

this means they are no longer lending their surplus liquidity to other banks but, rather, preferring to put it in the relative safety of the central bank, despite the lower interest rates on offer. Such deposits, which were very scarce prior to 2008, thus become a good indicator of the uncertainty of the banks and

their massively increased preference for liquidity.

The spread between the EURIBOR and the EONIA swap is also a good indicator of stress on the interbank market and can be interpreted as a proxy for the concerns of the banks that the central bank money they have lent to other banks may not be

returned (ECB 2008, pp. 93-4)⁸. Like deposits with the central banks of the euro system, the spread has also increased markedly since the end of July 2011.

The development of these deposits and the spread indicate that the announcement of the Greek debt restructuring was a sort of “Lehmann moment” for the euro area: in September 2008, the US investment bank Lehman Brothers had filed for bankruptcy and this had shaken the confidence of banks in each other and exacerbated the financial crisis.

The increase in target balances illustrates the specific characteristic of the euro area crisis, namely the degree of mistrust between the banks in the crisis countries and the banks in the rest of the euro area (Fig. 14). Target balances are created when payments between banks in different countries are not balanced by private interbank loans. They are therefore a good indicator of the flight of capital from the crisis countries (Garber 2010). Following the debt restructuring decision in July 2011, target balances increased sharply.

Up to that point, Italian banks had received more central bank money than they themselves had lent out. Thereafter, their target surplus became a deficit (Tober 2011). Spain had already had a slight deficit prior to July, but thereafter it also increased sharply. One can see clearly from target balances that the announcement of the Greek debt restructuring massively affected the banks in Spain and Italy.

Against this background it would seem that – setting aside the monetary policy of the ECB – there is a need for a fundamental review of economic policy. Fiscal policy is increasingly proving to be too restrictive and – as the past has shown – the recurring debate (IMK/OFCE/WIFO 2012) about further debt restructuring, in particular for Greece, is counterproductive.

3. A systematic response to short-term economic policy challenges

3.1 Preserving or splitting the euro area

The situation in the euro area is not yet stable, despite a wide range of interventions. Interest rates are still too high for stability, because the markets have

clearly not yet regained their confidence in the euro area’s survival. There is also continued concern about further “haircuts” and the austerity policy is not sustainable for the crisis countries, worsening their recession and driving up unemployment. Four scenarios can be identified for the euro area’s future development. In the first scenario, the most severely affected country – Greece – leaves the euro area and re-establishes a national currency. In the second scenario, the euro area fragments into two or more groups, either because Greece’s exit triggers a further bout of “contagion” or because a number of countries opt to break up the union. In the third scenario, Member States continue to do the absolute minimum in economic terms to preserve the euro area, which then enters a long period of stagnation or recession. The fourth scenario is one in which a new strategy of doing more than the minimum is adopted, the euro area economy recovers, and macro-economic imbalances are reduced.

A Greek exit is currently being mooted in various quarters, not only because of the impact it would have on the stability of the euro area but also because of the benefits it is assumed to bring Greece itself. Having its own currency brings a country the indisputable advantage of being able to use exchange rate policy as an additional macro-economic tool. The required real devaluation need not come through unit labour costs and prices but rather through a nominal devaluation of the new national currency. However, this advantage would probably be outweighed by a number of disadvantages. Levels of confidence in the new currency and in the country’s political stability would be very low, because the currency would be starting off with elevated levels of foreign and government debt, resulting in high risk premia on the interest rates demanded for both private sector and government securities and a more drastic devaluation than would be necessary in strictly foreign trade terms. A substantial devaluation favours exports and brings down imports but would probably then make it impossible to service Greece’s debt. At the same time, there would be a greater risk of a dramatic wage/price spiral, since a major devaluation would dramatically drive up the cost of imports and substantially cut real incomes. The high risk premia that investors on the financial markets would then demand for purchasing Greek bonds would stifle economic activity. And while, unlike the impact on Greece itself, the direct costs for the rest of the euro area would be kept low by the country’s relatively small size and foreign debt, this assumption is based on the unrealistic hypothesis that the effect on the euro area would not spread beyond Greece.

⁸ The EURIBOR rate is the rate offered for unsecured loans on the interbank market. It contains a risk element in case of default, a further element to cover possible short-term interest rate changes and also a mark-up to cover the liquidity risk. The EONIA swap rate is the rate the banks are prepared to pay in order to receive the average EONIA during the period of the swap contract. As the EONIA is only a rate for overnight lending, the default risks are much less than in the case of longer term loans on which the EURIBOR rate is based. The spread between the EURIBOR and the EONIA swap for a particular period is therefore a good measure of the risks incurred by the banks on the interbank market.

The second scenario therefore assumes that larger economies, such as Spain and Italy, would also exit the euro area, either because they felt they had no real option in the wake of a further massive loss of confidence triggered by Greece's departure or because they believed their economic prospects were better in an independent currency area. The devaluation of the new currency would massively drive up the burden of real debt, so any exit is inconceivable without a national "hair-cut". This would affect not only the existing crisis loans from the EFSF and the EFSM (currently worth around EUR 165 billion with an additional promise of EUR 350 billion) but also the obligations of the national central banks of the exit countries to the European Central Bank under the Target2 accounting system, which in July 2012 amounted to just under EUR 900 billion⁹. And the countries remaining in the euro area and their banks, pension funds and private investors would also have holdings of government and private sector stocks from the exit countries. Government debt would, however, increase drastically under such circumstances, because euro area banks would need to be recapitalised. At the same time, the rise in value of the euro against the new currencies adopted by the exit countries would weaken those countries' exports. Weak exports, declining assets and the likely prospect of tighter fiscal consolidation in the euro area would then pave the way for a long period of recession.

In the third scenario, the simmering crisis continues to be tackled with a minimal strategy, an approach that is equally problematic because of the high risk premia and excessive austerity that it involves. There would be a permanent risk that this third scenario would turn into the second scenario. It is not inherently stable because of a lack of confidence and excessive consolidation measures. It is possible, however, that it could go on for years given continued but limited bail-outs by governments and the central banks, albeit with negative impact on direct economic growth potential output and risk levels.

In the fourth and final scenario, tackling the imbalances in foreign trade within the euro area and fiscal consolidation would be linked with a strategy for growth, although this would represent a departure from the present policy. It is set out in more detail below.

3.2 The ECB as the lender of last resort

Changing course is much harder after two and a half years of steadily worsening crisis than when

the crisis first started, when it could still have been nipped in the bud. Substantial costs have already accrued in the form of lost production, foregone investment, and high unemployment. However, even now, it is still possible to stabilise the economic position of the euro area, to steer it on to a course of balanced growth and rising employment, and to counter the threat of massive costs for the taxpayer.

The key factor in tackling a crisis of liquidity is regaining investors' confidence. A vital part of any strategy for tackling the euro area crisis must be to remove risk from the government bond market through a declaration by the ECB that it is willing to make unrestricted interventions on this market to achieve this goal. This would not only reduce the burden of interest on the Member States and boost the yield on private investments but also strengthen the banking system in the crisis countries. The drastically reduced cost of government bonds from the crisis countries – the counterweight to a substantial rise in yields – is a key cause of the problems that those countries' banks face in terms of liquidity and solvency.

3.3 Guarantees and conditionality

The ECB can, however, remove the instability on the government bond market only with the continued backing of governments and their commitment to preserving the euro area in its current composition and to acting together to enable all Member States to service their debt. Creation of a modified debt redemption fund, implying both guarantees but also – in contrast to the proposal put forward by Germany's Council of Economic Experts (Sachverständigenrat 2011) – sustainable repayment conditions, could form the basis for such backing.

The fear expressed within the current crisis strategy – that relaxing the pressure through guarantees and lower risk premia would provide crisis countries' governments with false incentives and actually increase macro-economic instability in the euro area – is misguided for a number of reasons.

Acceptance of guarantees is, firstly, not a *carte blanche* to run up unrestricted debt but is linked to conditions, as set out in more detail below. Secondly, the supposed disciplinary strength of the financial markets is a myth, as became evident during the 2007-2009 international financial crisis, if not before: actors on the financial markets lack adequate information, do not always act rationally and have something of a herd instinct, which prompts them to react too late and exaggeratedly. It is the institutions of the euro area that will, in

⁹ Cyprus, Greece, Italy, Portugal and Spain.

future, have to continue to discipline governments to pursue an economic policy that secures the macro-economic stability of the euro area.

The current crisis strategy, by contrast, has substantial potential for moral hazard for two reasons. The existing minimalist strategy and the high economic cost it entails represent moral hazard to the extent that governments may judge leaving the euro area, combined with a “haircut”, as a more sustainable approach. And where foreign trade surpluses are seen as a success, countries like Germany that continue to rely on high current account surpluses, thus jeopardising the macro-economic stability of the euro area, can also be seen as engaging in a sort of moral hazard.

Conditionality is currently linked solely to government debt. In this context, what is more important than the size of the maximum debt ratio is how that is to be achieved in terms of fiscal policy. In particular, it must be ensured that abiding by a fiscal rule does act pro-cyclically. For this reason, too, the conditions linked to debt reduction should not also be linked to the Fiscal Pact, in contrast to the recommendations of the ESM Treaty and the debt repayment pact proposed by the Council of Economic Experts (Sachverständigenrat 2011). Rather, a proportion of revenue from a form of taxation that reacts to economic trends – such as income tax – should be used to reduce debt. Because it is difficult to determine the structural deficit precisely enough, and because of the associated risk of a pro-cyclical policy, there should be an expenditure pathway rather than a deficit rule. The negative impact on demand of austerity measures could be partially offset by investment projects funded from Europe. The package of measures adopted by the European Council in June 2012 is fundamentally on the right track but is markedly inadequate in quantitative terms and inadequately focused on the urgent needs of the crisis countries.

As we argue in detail above, the major underlying cause of the current crisis is not high levels of government debt but imbalances in Member States’ current accounts. For this reason, conditions must also be linked to the current account balance. This means that fiscal policy would have to be more restrictive in deficit countries if their foreign trade position did not improve. Countries with high levels of current account surplus, by contrast, would have to boost domestic demand, by means of fiscal policy among other measures. If there were no improvement, a penalty would be payable – for example, 20 % of the surplus above the 3 % limit, to be paid into EU structural funds. By contrast with existing provisions, this would link sanctions

to the reduction of government debt and imbalances in foreign trade. These factors would be tackled symmetrically and no longer be linked solely to the allocation of assistance, and Member States would have to commit to complying with the rules in the interests of stable development within the euro area.

3.4 Differentiated fiscal policy

Consolidation of public debt and the reduction of foreign trade imbalances therefore require a differentiated fiscal policy. However, all Member States would be subject to the principles that austerity measures should be implemented over a longer timeframe, not least as the euro area is already in recession. The high negative multiplier effect of cutting expenditure during a crisis means that a policy of intensifying austerity when deficit reduction targets are missed leads nowhere.

All euro area countries should also temporarily increase taxation on top incomes and on unearned income so as to reduce additional debt built up during the global financial crisis. This makes sense from both an economic perspective and the perspective of redistribution of wealth and would avoid the need substantially to reduce public investment, which would reduce output potential.

Additionally, however, there is also a need for a country-specific approach both to reducing the severity of austerity programmes and to designing fiscal policy instruments. Countries with current account surpluses, such as Germany, should be required to adopt a more expansive fiscal policy and stimulate domestic growth by boosting domestic demand. Germany’s unemployment rate has traditionally been low, yet the potential for mobilising skilled labour and other workers may be so great that its private sector can grow at rates substantially above the average of the previous decade for a number of years to come. That would not only benefit Germany’s employment levels and pay growth but also stabilise the euro area as a whole and promote exports from the crisis countries. If the growth differential in the euro area were to be reversed in this way, it would be possible to tackle the imbalances without damage to the ECB’s inflation target.

3.5 Cornerstones of a short-term solution

The preceding sections have demonstrated that overcoming the crisis relies primarily and essentially on rebuilding confidence. Tackling the current euro area crisis therefore requires four key measures:

- 1. The willingness of the ECB to intervene unrestrictedly
- 2. A commitment by governments to work to-

gether to tackle this crisis

- 3. Conditionality to reduce government debt and current account imbalances
- 4. A differentiated fiscal policy consistent with these conditions

The first step has already been taken. On September 6, 2012, the ECB announced that it was willing, if necessary, to purchase unlimited amounts of government bonds from the crisis countries to support bond prices and to restore returns to a sustainable level. In the absence of a further-reaching guarantee from the euro area countries, it was logical to link the purchases to an aid programme from the EFSF or the ESM. The effectiveness of this instrument depends largely on further decisions by euro area governments, including for example setting up some kind of debt repayment pact.

The second step to build confidence is a credible commitment by governments to tackle the crisis together without the need for further “haircuts”. There needs to be prior agreement that a “haircut” of the sort imposed on Greece in the spring of 2012 will not be repeated elsewhere. Some kind of debt redemption fund would be a practical way of implementing this goal in institutional terms: if the euro area countries jointly guarantee debt beyond a threshold of 60 % of GDP, they are effectively ruling out a “haircut”. This contrasts with the practice currently envisaged whereby crisis countries whose government bonds are to form part of the ECB purchase programme have first to apply for ESM funds. This, however, explicitly signals acceptance of the possibility of a “haircut”, though it no basis for building confidence in the security of government bonds, not least as the ESM’s financial resources, which are strictly limited, would not in any case be adequate to refinance the bonds of a number of larger euro area countries. It is, therefore, doubtful whether the solution adopted will actually substantially reduce yields.

Far-reaching guarantees or assistance require conditions for a number of reasons. The third step would be to put this in place. The conditions would need not only to tackle the risk of moral hazard but also to promote future solvency. They would, therefore, need to be linked to the reduction of both government debt and current account imbalances, but particularly the latter as they are indicators of the early stages of balance of payments problems – that is, excessive foreign indebtedness of private sector actors or of the state or the corollary, an excessive increase in foreign claims.

Since the euro area has a single monetary policy, the conditionality of the fourth step would have to be geared primarily to national fiscal policy. In

countries with an excessive level of government debt and a current account deficit, it is clear which direction fiscal policy must take: it needs to be restrictive because of the need to pay down the deficit, and it must be more restrictive to the extent that there is no supporting pay policy that could be harnessed to improve international competitiveness. In the countries that have to reduce government debt levels simultaneously with current account surpluses, it is more difficult to design conditions. Reducing the deficit and/or government debt must primarily be achieved through measures that have as little impact as possible on domestic demand, because conditionality in relation to balance of payments requires a boost to domestic demand. In these cases, therefore, fiscal policy must be expansive.

Such a macro-economically consistent and growth-promoting crisis strategy is broadly compatible with existing institutional and statutory arrangements within the euro area. What hinders the timeframe for implementing austerity measures and regional differentiation from being extended is, however, not merely the Fiscal Pact but also the existing long-standing arrangements under the Stability and Growth Pact and the Six-Pack, which came into force in December 2011. While the Fiscal Pact includes transitional periods, the rules of the Six-Pack – which are almost as stringent – take immediate effect. An international financial crisis followed by a crisis of confidence in the euro area that triggers a recession and jeopardises the integrity of the euro area is such a rare occurrence that it should be possible in such a case to activate the emergency clause.

The Six-Pack already includes provision for detailed macro-economic monitoring, which also provides for targets for fiscal consolidation and restrictions on current account imbalances that also relate to balance of payments deficits. The primary need is to adjust them so that they are symmetrically defined.

4. Cornerstones of a stable monetary union of sovereign states

4.1 Principles of a long-term solution

4.1.1 The importance of the inflation target

A monetary union represents an agreement to pursue a common inflation target. Even where – as is the case with the euro area – this is not spelled out in statutory terms, it has an economic logic that is unavoidable in any common currency area: without a common inflation target, there would be repeated

internal balance of payments crises across the euro area of the kind that are at the root of the current crisis. We have already shown that this common inflation target was in the past ignored or missed – sometimes spectacularly – by many Member States, with consequences that are now only too evident. The future institutional shape of European economic and monetary union must, therefore, be aimed primarily at serving this logic, so restrictions or adaptation mechanisms are needed for the post-crisis period that will ensure that major divergences in inflationary trends cannot again threaten the existence of the euro area.

It is also important to note that any redesign of the euro area need to be set against the backdrop of increasingly deregulated financial markets in which uncertainties can trigger violent reactions that then spiral down into a lack of confidence. We believe this argues for a rapid and thorough regulation of financial markets. However, such a step does not look likely, given the resistance from financial market players who, despite extensive efforts to reduce it, clearly still have substantial influence on European policy. Consideration must, therefore, always be given to possible reactions on the financial markets to any fundamental change in the euro area. Banking union plays only a subordinate part in this argument: while it is desirable that the major banks, at least, are regulated in the same way across the euro area and subject to the same responsibilities, institutional reforms in the bodies setting economic policy are, in fact, more important.

4.1.2 A centralised or decentralised monetary union?

A first, and much-discussed, question that arises in this context is whether monetary union is necessarily posited on greater “Europeanisation” in the sense of a centralisation of decision-making powers. That is, indeed, an option for achieving the goal of a stable monetary union. If similar and automatic transfer mechanisms were established, differences in inflation would become largely irrelevant, as they now are within a nation state. It is conceivable that, as in the USA, the European level could be given powers in the area of taxation and expenditure along side the member states.

The first prerequisite for such a step is, admittedly, that individual euro area Member States would have explicitly to refrain from demanding more fiscal sovereignty. This could be achieved through a referendum or a decision by the national parliament. The second requirement is that monetary union would need to be made more democratic at European level (Bofinger et al. 2012): sovereignty

over European taxation powers must lie with the European Parliament. The question remains open whether there is a political will to implement such a major process that would fundamentally change relations within Europe, but in any case, such changes would take a long time and any progress towards them would be very long-term. It is, however, important for the stability of the euro area that a long-term solution to the crisis is identified already in the short term, so that market expectations are stabilised and economic and political confidence is built. There is, therefore, a risk that any such process would be too lengthy and, in the short term at least, freighted with too many uncertainties.

To that extent, it is advisable to envisage a more decentralised solution, at least in the medium term. However, this solution should be so designed that, in the long term, it does not exclude more centralised arrangements, should those be deemed politically desirable. From an economic perspective, a monetary union in which sovereignty essentially remains with the individual Member States is theoretically possible. Without automatic transfer mechanisms, however, it is essential to ensure that each Member State is actually meeting the inflation target. The Open Method of Coordination, which has so far been most commonly used, is almost certainly inadequate for this purpose, not least as it imposes additional uncertainty because its outcomes are by definition unpredictable.

There is, therefore, a need for more concrete coordination between national fiscal policy and European monetary policy. Under a decentralised system, responsibility for meeting inflation targets ultimately lies with national governments. Statutory regulation would form part of a fundamentally revamped Fiscal Pact; the current Pact is inadequate, focusing as it does solely on austerity targets. Austerity across the board will trigger a deep recession in the euro area and merely reinforce existing economic disparities (IMK/OFCE/WIFO 2012). Against this backdrop, it is also important not even to threaten, let alone implement, a strategy of adverse sanctions that would affect the euro area as a whole more severely than any individual government to whom they were addressed. Exiting, or being excluded from, the euro area is, therefore, not an option: sanctions must be reliable but not counter-productive for the euro area as a whole.

4.1.3 Economic policy in a decentralised monetary union

There needs to be a clear hierarchy and sequencing of policy areas. Central, and ultimately of key importance, is fiscal policy and, hence, gover-

nance within a Member State. Policy must be so designed that the inflation target in each Member State is met in the medium term and current account imbalances are not allowed to build up. However, there is also economic policy responsibility upstream in the form of pay policy. The rate of wage growth is a key factor in fuelling inflation, and excessive pay increases create a risk that the inflation target will be exceeded, while sluggish pay growth will drive down inflation, possibly below the target. Both are equally harmful. Pay policy can, therefore, both help and hinder national fiscal policy. However, this responsibility exists only in an economic policy sense, and not under the Treaties, and therefore has no statutory force; this reflects institutional factors that cannot, or should not, be changed.

The conditions for a macro-economically oriented pay policy vary from one euro area Member State to another (Schulten 2006, Watt 2012: 110ff.). The pre-requisite is that there is a minimum level of coordination or centralisation in pay-setting. Where pay-setting is largely decentralised, it is inappropriate to speak of a pay policy as such. However, despite a trend towards erosion of collective bargaining, a relatively high proportion of employees in euro area countries are still covered by collective agreements, even where trade union membership is low. This is the result of a wide range of institutional mechanisms, including provisions for collective agreements to be declared “generally binding” on all workers in a particular sector, or legislation requiring contractors to abide by sector-level rates of pay. In some countries, such as France, the statutory minimum wage plays a key part in underpinning pay settlements, while Belgium has an explicit requirement for pay increases to be linked to indicators of national competitiveness. In such cases, the rate of increase in national average nominal pay is not merely the endogenous outcome of the country’s labour market situation but is also open, within specified limits, to direct influence through national policy rather than merely to indirect influence through fiscal policy.

However, European policy must ultimately respect the collective bargaining autonomy of the two sides of industry in a particular country or, where appropriate, the outcomes of pay-setting mechanisms at national level, as was demonstrated clearly by the vehement rejection of the Euro-Plus Pact, launched by France and Germany late in 2010. Automatic pay cuts resulting from European Treaties would be a crass breach of this principle, and in political terms, there would be a substantial risk of abuse at employees’ expense, because such provi-

sions would substantially weaken their bargaining position. This could have a knock-on effect on the economy, with employees no longer benefitting proportionally from improved productivity within the euro area in future, producing a fundamental weakness in Europe’s domestic demand and a brake on growth as a result. Therefore, while pay policy at national level forms part of general economic policy, it must be autonomous. It would, accordingly, be reasonable to strengthen the existing but weak forms of European pay coordination politically and institutionally (Glassner/Watt 2010); these include autonomous coordination by European trade unions and the loosely institutionalised but tripartite Macro-Economic Dialogue (Koll 2011).

There is, however, a risk not only of wage inflation but also of profit inflation. The analysis in section 2 shows that this was, for many of the crisis countries, the key factor underlying high inflation rates. The favourable economic environment was used to drive up prices in exactly those countries where pay increases were determined partly by indexation mechanisms, pointing either to inadequate competition or a speculative bubble. Depending on the cause, this should be tackled by means of tighter competition rules or a determined policy against the formation of bubbles.

Where trends in wages and profits are incompatible with overall economic targets and, when combined with other influences, threaten to hamper compliance with the inflation target, there is a case for appropriate action under national fiscal policy. If pay settlements are too low to preserve the inflation target, the policy must be more expansive; where settlements are too high, the policy must be restrictive.

However, a further contribution towards preserving European stability could also come from a nationally differentiated form of monetary policy. The euro area crisis was, as argued above, also fed by substantial capital flows between Member States but particularly from Germany to Spain, Ireland and Portugal, encouraged by apparently favourable returns, particularly on property and financial investments. Of themselves, such flows do not produce current account difficulties, but where there is a general expectation of high returns on investment, this can fuel distortions that ultimately produce a current account crisis when exacerbated by excessive and mutually-reinforcing pay and prices. Such trends produce not only a generalised euphoria but also a marked rise in lending. A differentiated monetary policy may be an approach to the growth in lending. For example, by using the tool of differentiated minimum reserve

requirements, it can specifically promote or restrict lending in individual euro area countries, enabling it to take the heat out of excessive demand that could ultimately trigger excessive rates of inflation.

The chronological sequence of these policy areas is also important. Both pay policy and competition policy are upstream of fiscal policy: a problem with meeting an inflation target arises only when pay or profits rise, which in turn requires a fiscal policy response. Monetary policy is different: it can act only where, for example, there is evidence of excessive lending, and this may come relatively late on. Ultimately, higher lending within an economy does not, per se, signal a danger to price stability, but it can herald or accompany a boom in an economy that has previously enjoyed price stability.

This policy mix of stability-oriented fiscal policy and supporting monetary and wage policy sets out a course that a still largely decentralised monetary union can follow. Within such a framework it would not be necessary to relocate any substantial powers to an emerging European central state nor to put in place cumbersome and expensive transfer mechanisms to offset current account imbalances.

4.2 Several routes to the same goal

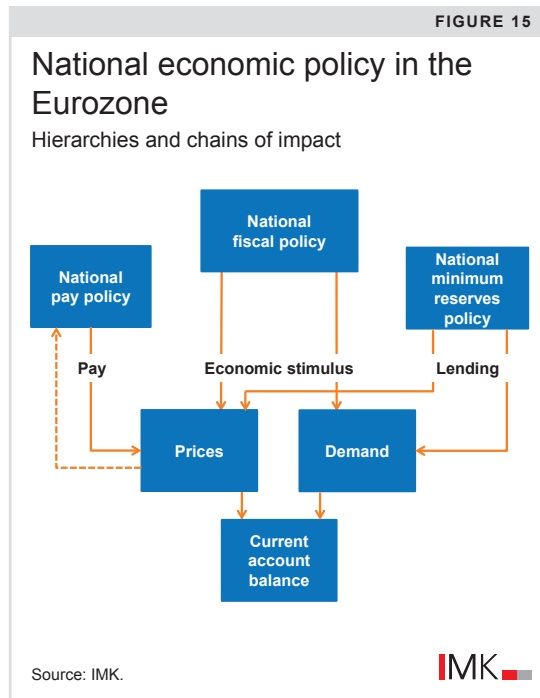
4.2.1 Fiscal policy in the service of a stable euro area

Within a monetary union of sovereign nation states, fiscal policy is responsible for avoiding macro-economic imbalances nationally on the basis of democratic legitimacy. Of key importance in this respect are preventive measures to stop such imbalances arising in the first place.

If, in the long term, there is evidence of inflation rates above the ECB target, a restrictive course of action will be needed. Where inflation is too high, growth and employment are generally strong, at least initially. A fiscal “brake” on economic growth is, therefore, usually feasible at this stage, both economically and socially. The advantage of such a policy is that it puts growth and employment on a more stable footing, because weaker growth trends will also generally calm down rapidly-rising prices.

The reverse is also true. If prices are rising by less than the inflation target, a country’s fiscal policy must become more expansive, because when inflation rates are low, economic growth is also generally low, and such a strategy will boost it.

It is for national governments to decide how they can make their fiscal policy more restrictive or more expansive. Minor deviations from the inflation target can be tackled simply by the automatic stabilisers. For example, when inflation is high,



progressive rates of taxation will increase the tax-take disproportionately. However, the additional revenue should not be fed back into the economy through reductions in other forms of taxation or higher expenditure but should be used to reduce government debt. When inflation is low, on the other hand, the tax-take is also relatively low, but similarly, this should not be offset simply by increasing other forms of taxation or by cutting expenditures. The more progressively a tax system is designed, the more efficiently it will be able to fulfil its role as a stabiliser.

Discretionary fiscal policy action is needed only in cases where the inflation rate misses the target over a lengthy period or by a substantial margin. Experience shows that changes to taxation will achieve the desired result more rapidly; changes to expenditure are more effective, but take longer (Truger/Will 2011b, IMF 2010). It is the role of national governments to decide the appropriate route for their country, and they should be constrained only regarding the end, not the means.

4.2.2 Supporting policy areas

The stronger other policy areas are within a stable euro area, the less has to be tackled through fiscal policy. A pay policy can take pressure off an economy if it achieves wage settlements that produce medium-term pay growth across the economy in line with the growth in productivity plus the inflation target. Where they are lower than this, there is a risk that prices will not rise by enough, bringing the threat of trade imbalances. Then, either wage policy acts on its own initiative to correct the imbalance or

other economic policy measures become necessary. The former solution is difficult, because employers will always be opposed to demands for higher pay. Employees therefore need labour market support in such cases to secure higher pay increases, for example by introducing or increasing minimum wage levels. And if that is not successful and low pay growth turns into low prices rises, fiscal policy has to step in. By contrast, where pay settlements are too high as measured by the stability target set out above, symmetrical reactions will be needed.

The supporting national monetary policy should focus on national lending levels, because these are the best early indicators that speculative bubbles may be forming. By contrast, very low levels of lending may well lead to excessively low price rises, requiring prompt counter-action from the national central bank. One way it can do this is through an appropriate minimum reserve policy, requiring commercial banks to make minimum reserve deposits that can be increased when lending reaches excessive levels or decreased when lending is sluggish. In this way, a central bank can make access to its reserves – and, hence, to lending – cheaper or more expensive in the Member State concerned. If those seeking credit seek to meet their needs under more favourable conditions in other euro area Member States, the total level of credit will rise in those other countries; if the demand for credit exceeds what is generally sustainable in economic terms, the minimum reserve deposits would have to be increased there as well. If lending ultimately became excessive across the euro area, the ECB would in any case be forced to react in monetary policy terms.

4.2.3 Institutional reform of the euro area

Independently of whether the euro area takes a centralised or decentralised approach to economic policy, some fundamental institutional changes are unavoidable. Below, we set out solely those that would be required in a decentralised economic policy – those that, as it were, represent the minimum needed for economic policy coordination.

The Macroeconomic Policy Institute (IMK) has long advocated creating a European Monetary Fund, or EMF (Horn et al. 2010b), whose role would be to monitor divergences in national rates of inflation and current account balances. It would be able to identify distortions and notify these to the Member State(s) concerned. An EMF could also make proposals for an appropriate policy reaction, but should not have the powers to impose these on Member States, so they would preserve their national sovereignty. Such a procedure

would, moreover, permit a wide range of possible actions, which may be appropriate given different national situations. Moreover, a range of policy strategies would mean learning more about successful and less successful approaches. The key aim would always be to serve the goal of preserving price stability and avoiding current account imbalances.

Such an approach often raises the issue of possible sanctions if targets were not met. An EMF would first have to assess whether excessive current account deficits were the result of a lack of economic discipline on the part of a Member State or were attributable to other factors. Sanctions would be appropriate only where a Member State had exercised insufficient economic discipline and, as we argue in the preceding section, should be at a threshold low enough not to jeopardise the survival of the euro area but should also be automatic, so that Member States know they will kick in if economic trends run out of control. They should also be designed in such a way that they are actually unattractive to governments of all complexions. Ideally, Treaty provisions would define a priori rules for a category of taxation that could be increased or decreased depending on whether the Member State in question was running an excessive deficit or an excessive surplus on its current account. Revenue from higher taxation would accrue to the EMF, while the relevant government(s) would have to accept any loss of tax revenue. Income tax would be the obvious choice of tax in such a case. In the case of spending, cuts could be made in areas of consumptive spending, while spending on public investment could be expanded if necessary.

The question remains how an EMF could be integrated into the network of EU institutions. From that perspective, the ESM could be seen as a kind of embryonic EMF but would need appropriate capacity and expertise and would have to take on the role of monitoring the Commission's macro-economic targets. It is also possible to envisage an EMF forming part of the European Commission itself, which currently already has the role of monitoring the Six-Pack. In such a case, however, the European Parliament would have to have greater oversight of the Commission than it currently does.

5. Redesigning the euro area

Despite some minor successes, the economic policy strategies of the past have fundamentally failed. The only area for optimism is the intervention announced by the ECB to step in and buy government bonds. One particular failed strategy has been the

procedure to consolidate national budgets through sometimes drastic spending cuts. This policy reflects relatively outdated macro-economic thinking (IMF 2012) and imposes an unacceptable economic burden on large sections of the population in the form of pay cuts and high unemployment; these factors will ultimately doom the strategy to failure because it actually erodes the basis on which the state derives its income by strangling the revenue from taxation that it needs if it is to reverse the deficit. The drastic economic impact of such a strategy would also trigger a wave of uncertainty on the financial markets, which would make it increasingly difficult for governments to refinance their debt or, at least, prevent the Member States concerned from returning to the capital markets. Countries would be prevented from standing on their own two feet and condemned to reliance on bail-outs.

A change of strategy is, therefore, a matter of urgency, focusing on reducing the constraints currently in place and extending the period over which austerity measures take effect. At the same time, sanctions must be viable across the monetary union and cannot be allowed to be ultimately self-destructive. The introduction of less swingeing but credible sanctions is, therefore, essential. At the same time, steps must be taken to restructure the euro area in institutional terms to ensure that the underlying problem of divergent national rates of inflation that impair price stability and, therefore, cause current account imbalances is tackled symmetrically. To achieve this, it seems sensible to create an EMF with responsibility for prevention and proposals, aid packages, and monitoring compliance with targets. There is scope for many different ways of reaching the goal in different countries. This would, however, be a way of stabilising the euro area sustainably without, at least in the medium term, jeopardising national sovereignty. It would also represent a way out of the vicious cycle of bail-out after bail-out and the drastic economic consequences that is having for wide swathes of the population of Europe.

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