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Article

Policy responses to the Euro debt crisis: Can they overcome the imbalances that caused the crisis?

Intervention. European Journal of Economics and Economic Policies

Provided in Cooperation with:

Edward Elgar Publishing

Suggested Citation: Niechoj, Torsten; van Treeck, Till (2011) : Policy responses to the Euro debt crisis: Can they overcome the imbalances that caused the crisis?, Intervention. European Journal of Economics and Economic Policies, ISSN 2195-3376, Metropolis-Verlag, Marburg, Vol. 08, Iss. 2, pp. 245-266,
<https://doi.org/10.4337/ejeep.2011.02.02>

This Version is available at:

<https://hdl.handle.net/10419/277218>

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Selected Publications of Stephen Marglin

The Dismal Science. How Thinking Like An Economist Undermines Community, Cambridge: Harvard University Press 2008 • Individualism and Scarcity, in: Cullenberg, S./Pattanaik, P.K. (eds.), *Globalization, Culture, and the Limits of the Market: Essays in Economics and Philosophy*, New Delhi: Oxford University Press 2003 • Understanding Capitalism: Control vs Efficiency, in: Gustafsson, B. (ed.), *Power and Economic Institutions*, Aldershot: Edward Elgar 1991 • Profit Squeeze and Keynesian Theory, in: Marglin, S./Schor, J. (eds.), *The Golden Age of Capitalism: Reinterpreting the Postwar Experience*, Oxford: Clarendon Press 1990 (with A. Bhaduri) • *The Golden Age of Capitalism: Reinterpreting the Postwar Experience*, Oxford: Clarendon Press 1990 (edited with J. Schor) • *Growth, Distribution, and Prices*, Cambridge/London: Harvard University Press 1984 • *Value and Price in the Labor-Surplus Economy*, Oxford: Clarendon Press 1976 • *What Do Bosses Do?*, in: *Review of Radical Political Economics*, Part I: 1974; Part II: 1975.

Policy responses to the Euro debt crisis:**Can they overcome the imbalances that caused the crisis?**

*Torsten Niechoj**, *Till van Treeck**

Introduction

The recession of 2009 following the financial market crisis of 2008 was severe, especially in Europe. World GDP decreased by 0.6 per cent, the GDP of the USA by 2.6 per cent, and in the European Monetary Union (EMU) it declined by 4.1 per cent (IMK/OFCE/WIFO 2011). The export-oriented German economy had to face a relatively strong negative growth of 4.7 per cent of GDP. By mid-2010, however, it seemed that the disastrous effects of the financial market crisis were successfully countered by stabilisation measures in countries all around the world: rescue programmes for banks were established in most of the European countries; some countries like Ireland and Spain tried to compensate for the effects of busted housing bubbles; and fiscal stimuli were initiated to dampen the downturn of the economy, e.g. by the introduction of a scrapping premium for cars in Germany, France and other countries.

But for Europe, the crisis was not over. This transformation of private debt of banks, house owners and consumers into public debt raised the state's debt-to-GDP ratio for the euro area as a whole from 66.3 per cent in 2007 before the crisis to 85.3 per cent in 2010

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(see Table 1). While the downturn due to the financial market crisis was in abeyance, the financial markets lost trust in the capacity of some member states of the EMU to repay their debt and to pay their interest. First Greece, then Ireland and afterwards Portugal were confronted with rising mistrust, a downgrading of debt ratings and difficulties in accessing credit at reasonable interest rates. This is mirrored in the development of yields for government bonds on the secondary market. The premia of Greek, Irish and Portuguese bonds on German yields were enormous. Against the benchmark of German bonds, which were during 2010 mostly below three per cent, the spread for Greek papers was up to ten percentage points in 2010, Irish bonds seven and Portuguese five percentage points – and even increased further up to 16 (Greece), twelve (Ireland) and ten (Portugal) percentage points by mid-2011 (see Figure 1). These yields on the secondary market give an idea of the risk premia these countries would have had to pay, relative to German bonds, on the primary market for new government bonds.

Table 1: Debt-to-GDP ratio in the euro area and in selected member states

	Euro area (16)	Greece	Ireland	Portugal	Spain	Italy	Belgium	Germany	France
1999	71.7	94	48.5	49.6	62.3	113.7	113.7	60.9	58.9
2007	66.3	105.4	25	68.3	36.1	103.6	84.2	64.9	63.9
2008	70	110.7	44.4	71.6	39.8	106.3	89.6	66.3	67.7
2009	79.4	127.1	65.6	83	53.3	116.1	96.2	73.5	78.3
2010	85.3	142.8	96.2	93	60.1	119	96.8	83.2	81.7

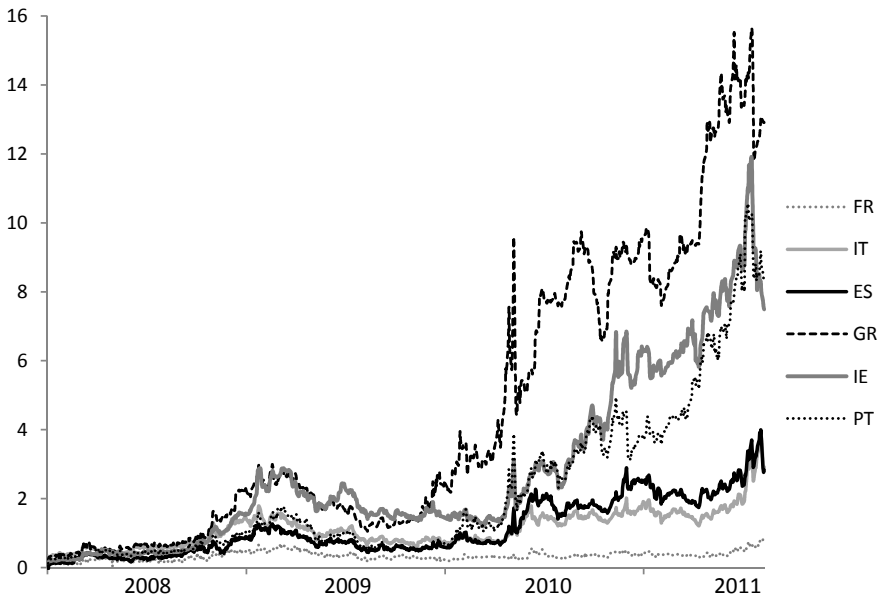
Source: Reuters EcoWin (Eurostat)

Interest rates of three per cent, as in the case of Germany, can be repaid relatively easily even with the lower growth rates that are common within the European Union in the last decade. This is obviously not the case for interest rates of 18 and more per cent. Therefore, the financial rescue packages from May 2010 onwards had to guarantee the solvency of Greece, Ireland and Portugal.

But the crisis was still not over but has been spreading ever further. Spain, Italy, and even France were suspected of solvency problems. At the summit on July 21st, for the first time the heads of states acknowledged the severity of the crisis and tried to comprise a package of measures that addressed several problems, including the necessity of reducing the Greek interest burden, preventing spill-over effects to other countries and a potential banking crisis in Greece (European Council 2011). The effects these announcements had on the bond markets are mildly encouraging, as bond spreads declined somewhat after the summit. On Friday, 22nd July, Greek spreads fell to 11.9 percentage points, Irish to 9.2 and Portuguese to 8.4. In our view, however, the measures concluded at the summit are still largely insufficient in view of the structural causes of the euro crisis. This crisis is more than a public debt crisis and can only be solved if the underlying causes, rooted in imbalances of the economies, are

properly and institutionally addressed, too. Therefore, in the remainder of this article, we briefly review the development of the crisis, show the causes and the structure of the crisis and outline the main ingredients of a policy response more appropriate to deal with the crisis.

Figure 1: Difference in yields on 10 year government benchmark bonds of selected countries against German bonds, in per cent, daily values



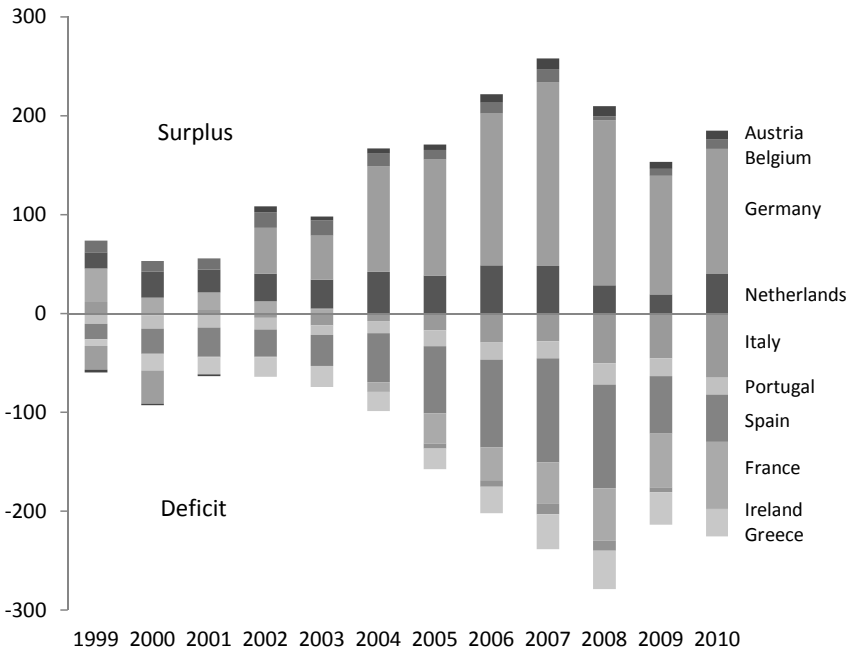
Sources: Reuters EcoWin (EcoWin Financial), own calculations

From crisis to crisis: Causes of the debt increase

Although public debt and deficits rose significantly in many countries after the financial market crisis, it would be a mistake to ascribe the European debt crisis to a loose spending behaviour of irresponsible politicians – for two reasons. Firstly, the increase in public debt was a direct response to the turmoil within the financial system and essential to dampen the negative economic consequences of the financial crisis. Public spending stepped in when private consumption and investment dropped. Without it the recession would have been more pronounced and longer lasting. Secondly, – and for the future prospects more important – the causes of the crisis are more profound, located elsewhere, and still virulent. Since the establishment of the EMU, current accounts have diverged and non-sustainable growth patterns emerged, which holds for both current account deficit as well as surplus countries (see Figure 2 on the next page). The monetary union created a new economic situation in

Europe, characterised by levelled interest rates and a common currency that eliminated the automatised mechanism of de- and appreciation. Broadly speaking, two growth patterns emerged that were both unsustainable. Some member states followed a growth path relying on domestic demand, another group of countries one of export-oriented growth.

Figure 2: Growing current account imbalances in the euro area, in bn. Euros



Source: Macrobond (AMECO)

Due to the fact that in a monetary union the central bank can only set one interest rate for all member states and that the mandate of the European Central Bank (ECB) is to keep the average rate of inflation below, but close to two per cent, monetary policy could and did not react even to large differences in national inflation rates. While the very low inflation in Germany exerted a strong negative effect on euro area-wide inflation (with Germany accounting for more than one quarter of euro area GDP), national inflation rates in countries like Greece, Ireland, Portugal, but also Spain, were far above the average. Hence, real interest rates were relatively low. This fall in interest rates fostered reasonable investment of firms and raised the growth rate, but it may also have contributed to excessive lending in some sectors of the economy. In any case, the very dynamic domestic demand was accompanied by a boom in construction and a rise in housing prices in Spain and Ireland as well as cheap consumer credits boosting private consumption. Domestic demand could expand but overheating and bubbles

emerged as well. Moreover, much of this expansion was financed by foreign credits. For the reasons discussed above, monetary policy did not react to the associated rise in inflation. Nor did it attempt to prevent the emergence of financial asset price bubbles and excessive lending practices, which is not part of the ECB's mandate and was not considered compatible with the economic policy framework in the EMU. Additionally, before the crisis, the ECB was explicitly in favour of financial market deregulation and summarised its position regarding the workings of the financial markets within the Eurosystem as follows:

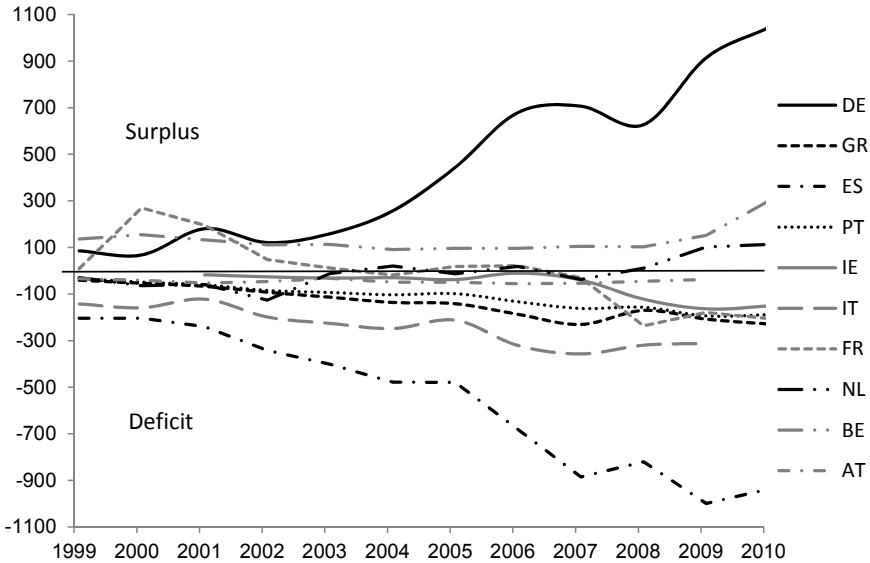
»In line with its position that the financial integration process should be market-led, the Eurosystem considers that the role of public policy in fostering financial integration should be limited. In particular, policy measures should not promote a specific level or type of cross-border activity, as only market participants themselves are in a position to develop the underlying business strategies, take the respective investment decisions and assume responsibility for the economic consequences.«
(ECB 2008: 101)

Apart from this apparent misjudgement of financial market efficiency, further country-specific problems developed over time that contributed to the troubles of the countries in question. It was not by accident that Greece was the first country in dire straits. On the one hand, the state massively undermined trust in its capacity to repay debt by issuing dubious statistics on public finances. On the other hand, the state seems to be chronically underfinanced. Tax revenues, tax bases and tax compliance are all meagre. As a consequence, the debt-to-GDP ratio was, at 106 per cent, already high before the financial market crisis in 2007. In Portugal, before the crisis the debt-to-GDP ratio of 63 per cent was nearly in line with what the Stability and Growth Pact (SGP) recommends as a limit to a sound debt level. But it rose fast afterwards, by roughly 20 percentage points since then. So there is justification in the case of Greece, and to a certain degree in the case of Portugal too, to hold the government and its fiscal policy responsible, at least from the perspective of the SGP. For Ireland and Spain, however, this criticism clearly does not hold. On the contrary, both countries' debt-to-GDP ratios were very low with 25 per cent for Ireland and 36 per cent in the case of Spain in 2007 – and far below the German level and the debt criterion of the SGP. The problems of Ireland and Spain are located elsewhere. In Ireland, besides the interest rate effect following the monetary union and the housing bubble that developed, the economy was able to achieve strong growth due to its high export surpluses but nevertheless it had to face deficits in the current account balance. The reason being the transfer of profits of Foreign Direct Investments (FDI), attracted by low taxes, to the investors' countries. Moreover, the financial services sector in Ireland is huge, which has not been an advantage as the financial market crisis developed. In Spain, foremost the inflated construction boom was responsible for a significant decrease of unemployment but the bust of the housing bubble contributed also massively to the recent surge in the unemployment rate to more than 20 per cent.

For different reasons, the growth pattern of the export-oriented member states is not sustainable either. To name only the countries with the highest and most durable current account surpluses in the euro area, Germany, the Netherlands, and Belgium appeared to

benefit absolutely from the current situation. Net exports and net international investment positions increased permanently due to the surplus in exports (see Figure 3). Despite relatively weak economic growth during the first years following the introduction of the euro, these countries now seem to be widely considered as centres of financial stability and as good examples to be followed by all others.

Figure 3: Net international investment position against foreign countries in bn. EUR



Source: EcoWin (BIS)

However, this situation is not as comfortable as it seems at first glance because it hinges on two assumptions: firstly, that there are enough countries with current account deficits that are willing to absorb the exported goods, and secondly, that the deficit countries will still be capable of repaying their debt in the future. Both assumptions can be questioned. International net importers such as the USA are now trying to reduce their current account deficits. Most emerging market countries like China are nowadays large net exporters¹ and are unlikely to strongly reverse their growth patterns in the near future. Greece, Ireland, Portugal and other European countries are reducing their public spending and have to face negative growth rates so that import demand will be sluggish. In such an environment, however, an export-oriented model is not a stable option. And it is not a rational strategy to invest large amounts of private savings abroad – say, in an attempt to prepare for demographic problems – either. If firms or countries become insolvent a country’s net international investment position

1 The paradoxical direction of net capital flows, which has also been called the »Lucas paradox«, is in stark contrast to what conventional theory would suggest.

is reduced by the default. This indicates that such financial investments may reduce to nothing more than a slip of papers.

The specific contribution of Germany to the crisis

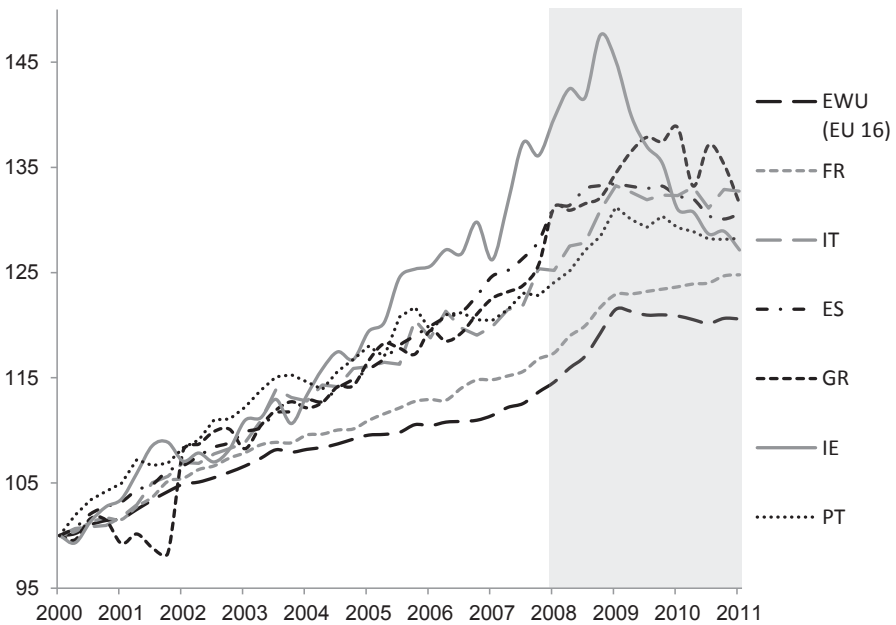
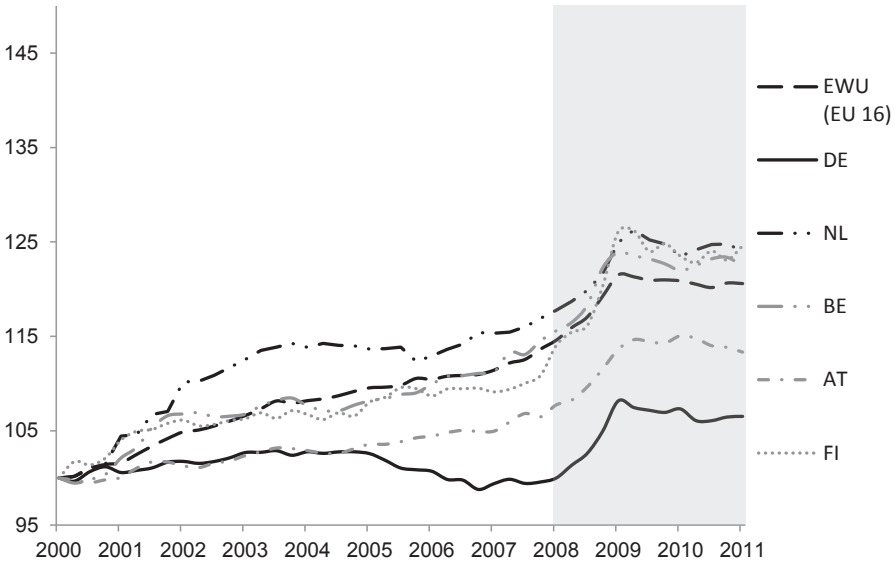
Germany, by far the biggest economy in the euro area, contributed to the current situation in a very specific manner. Over the past decade, domestic demand was extremely weak in Germany in a context of stagnating or declining real mass incomes and very restrictive fiscal policies. At the same time, export growth was fostered by an improvement in price competitiveness linked to very weak labour cost growth.

In Figure 4 and 5 the development of nominal unit labour costs – firstly, for the whole economy, then for industry only² – is depicted, starting in 2000 (=100).³ Changes in nominal unit labour costs relate changes in nominal wages to the growth of labour productivity, and hence are a good indicator of international competitiveness in a monetary union. Nearly all countries which are now in dire straits experienced a deterioration of price competitiveness as a by-product of above-average increases in nominal unit labour costs since the beginning of the union. The only exception is Ireland, when it comes to industry only. Here, nominal unit labour costs even declined over much of the 2000s, although other sectors saw very large increases in nominal unit labour costs. Germany's nominal unit labour cost growth was far below the average of the euro area both for the whole economy and industry during the whole period. As there are no nominal exchange rates within the currency union and to the extent that nominal unit labour costs are related to prices, Germany has improved its international price competitiveness vis-à-vis the other euro area countries. In Germany, unit labour costs are in the end of 2010 nearly the same as in the beginning of 2000. By contrast, in many other countries they rose by 25 per cent and more. Clearly, in so far as unit labour cost growth and price inflation are related, unit labour cost developments in both Germany and the peripheral countries are an indirect violation of the inflation target of the ECB. As a result, Germany has a permanent and increasing price advantage compared to the other countries which has fostered exports on the one hand, while implying relatively high real interest rates, which have dampened domestic demand, on the other. The fact that Ireland's price competitiveness in industry is far better than those of the southern countries indicates that the Irish problems are somewhat different and stem mainly from unsound developments in the financial sector.

2 It has to be noted, however, that neither nominal unit labour costs for the whole economy nor for industry are perfect indicators of the competitiveness of the export sector. While labour costs in the industrial sector are especially important for the competitiveness of tradable goods, export-oriented firms also depend on other sectors providing services and semi-finished goods. Moreover, price competitiveness is not determined by nominal unit labour costs alone.

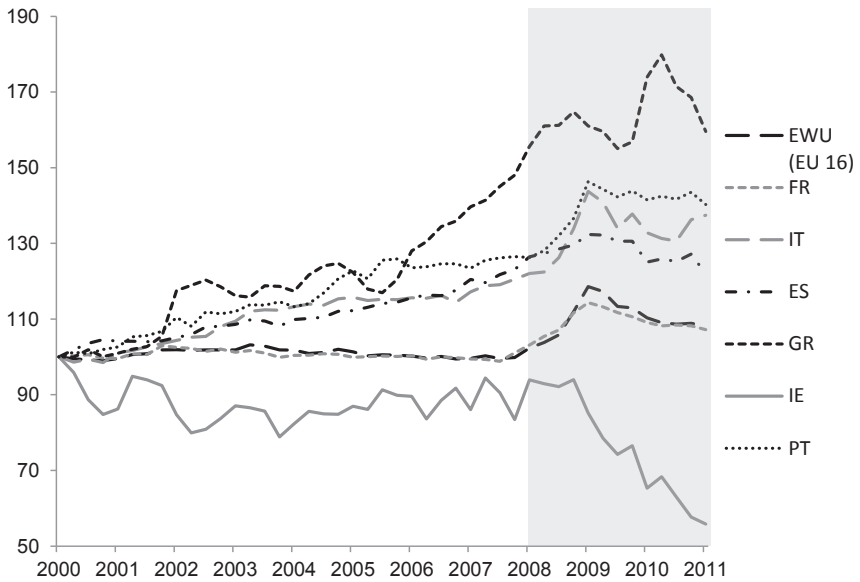
3 Due to lacking data for some member states it is not possible to calculate quarterly nominal unit labour costs since the beginning of the monetary union. A cross-check with yearly data and with the data for 1999, where available, indicates, however, that starting in 1999 instead of 2000 would not change the overall picture.

Figure 4: Nominal unit labour cost development in the euro area (16) and in selected member states for the whole economy, quarterly data, per person



Source: EcoWin (Eurostat), own calculations

Figure 5: Nominal unit labour cost development in the euro area (16) and in selected member states for industry, quarterly data, per hour

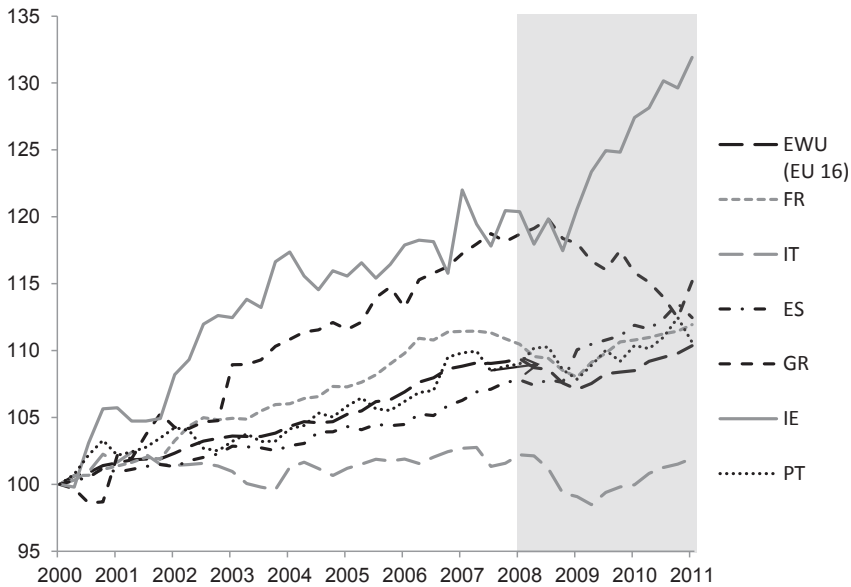
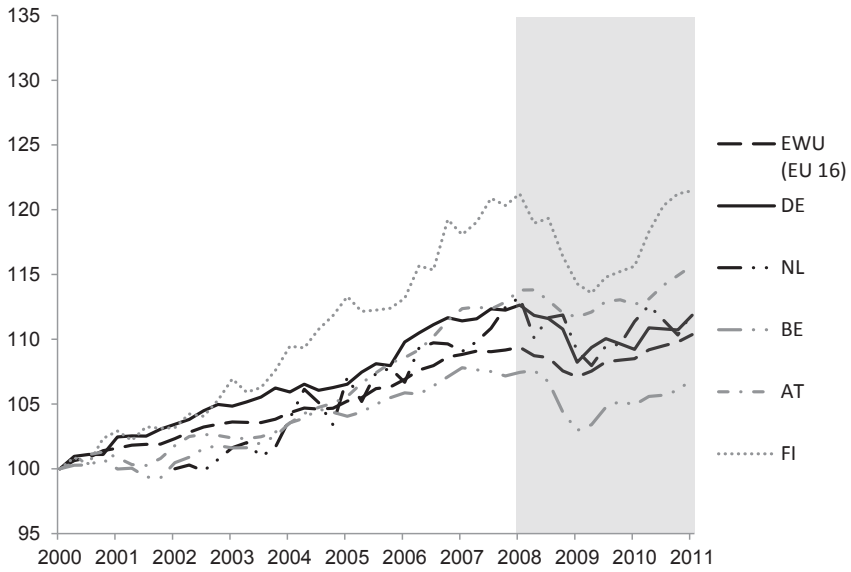


Source: EcoWin (Eurostat), own calculations

What the development of price competitiveness in terms of nominal unit labour costs does not reveal is whether the increase in price competitiveness stems from wage developments or from increases in productivity. Nominal unit labour costs include both. Thus, in Figure 6 labour productivity per hour is depicted: Germany's labour productivity growth has been only very slightly above the average of the euro area. Moreover, with the exception of Italy, the other countries' productivity growth is similar to that of Germany or in the case of Ireland (and, to a lesser extent, Greece) far higher. To conclude, despite its reputation as a high-productivity economy it is not a remarkable increase in productivity that has kept Germany's nominal unit labour costs low.

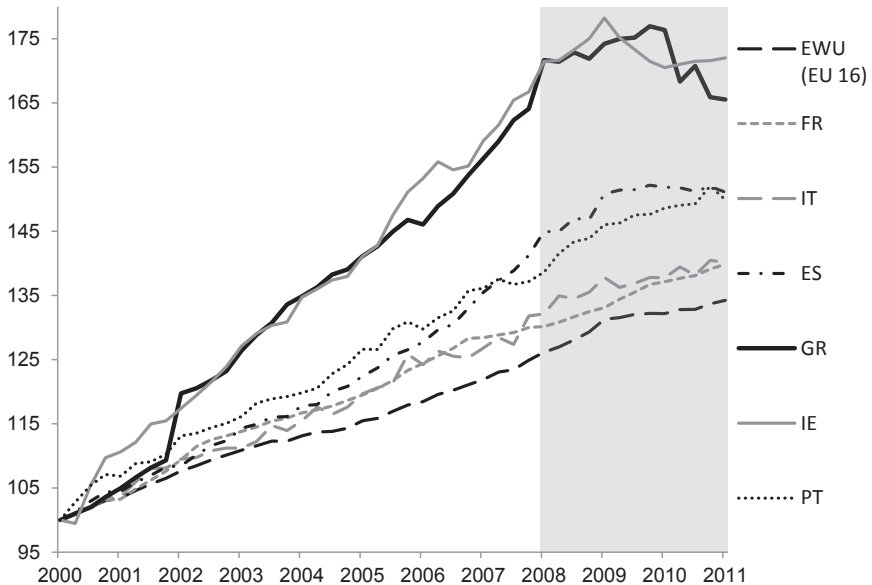
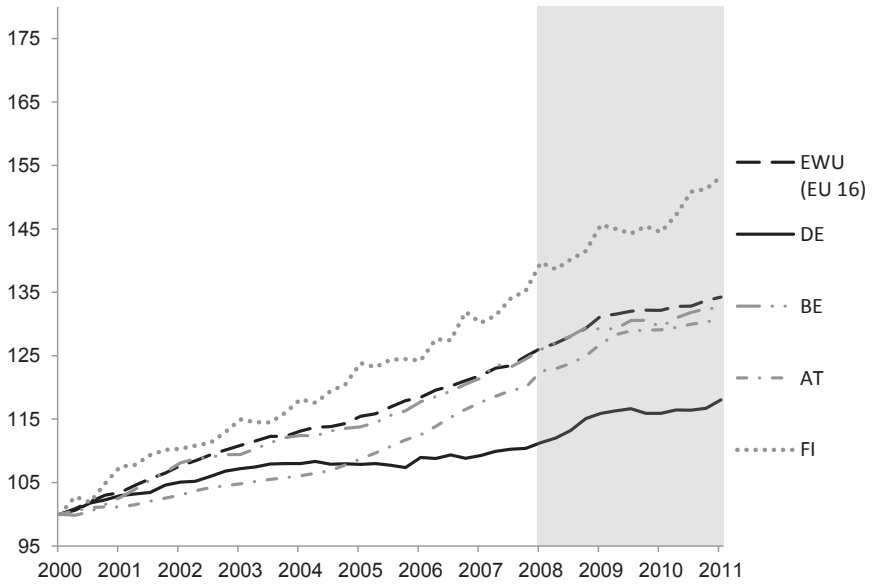
The development of the compensation of employees shows, see Figure 7, that in Germany low wage increases were causing the muted development of the nominal unit labour costs. At the same time, real wages were stagnating or even declining during much of the 2000s. During the last decade, the position of trade unions in wage negotiations was a very difficult one in face of firms leaving employers' organisations and laws laying the ground for an extended low-paid sector (Massa-Wirth 2007, Niechoj 2009, Herzog-Stein et al. 2010, Sturn/van Treeck 2010). Indeed, wage increases in Greece and Ireland were high but growth was high as well until 2008 (Figure 8). So in some cases, like Ireland, wage increases were a follow up-effect of a growing economy. By contrast, growth in Germany was amongst the lowest of all euro area member states between 1999 and 2007. Moreover, it is the only country where net exports have on average contributed more to overall growth than the private and the public sectors taken together. This means that wage restraint and export orientation have not paid off for Germany and especially its employees. The answers to this puzzle are straight forward (for more details, see Joebges et al. 2010): in a large economy, and Germany is a large one, domestic demand is normally more important for growth than exports. Year after year of depressed wage developments have muted private consumption and therefore domestic demand as well as profit expectations and investment within Germany. In addition, real total government expenditure shrank in Germany during 1999–2007, a development not observed in any other European country, and that contributed to the weakness of domestic demand in Germany (see Table 2). This could not be matched by growth in the export-oriented sectors.

Figure 6: Labour productivity per hour (BE, GR: per person), in real terms, quarterly data, 2000q1 = 100



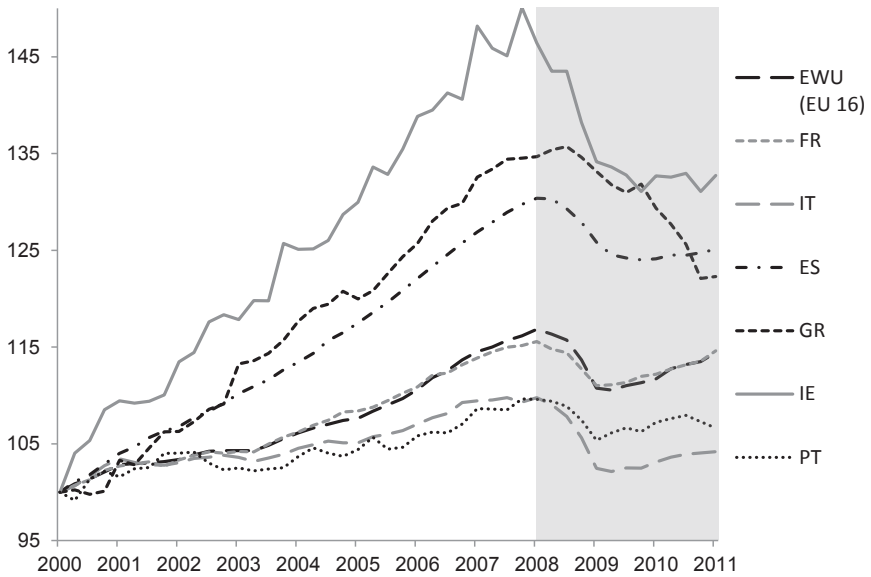
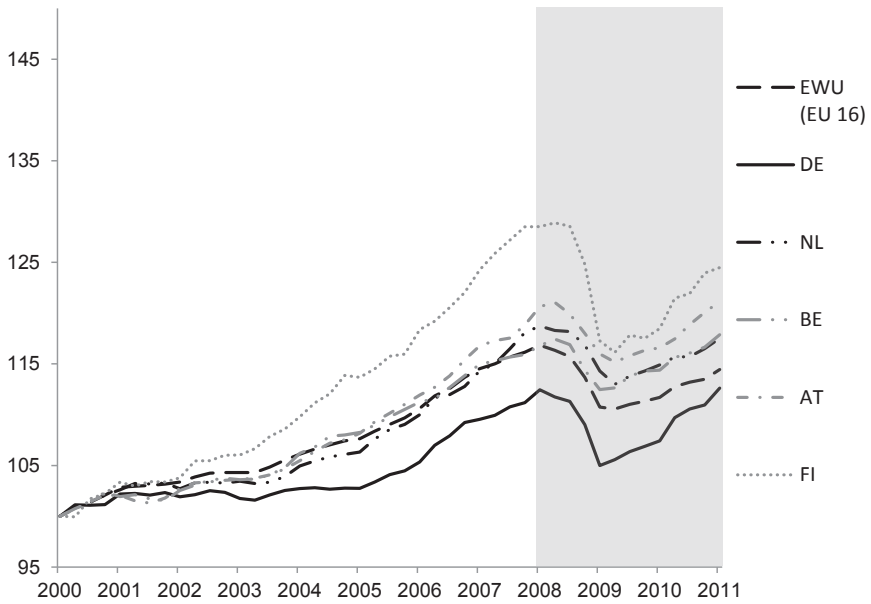
Source: EcoWin (Eurostat), own calculations

Figure 7: Compensation of employees per hour (BE, GR; per person; due to data restrictions without NL), nominal values, quarterly data, 2000Q1 = 100



Source: EcoWin (Eurostat), own calculations

Figure 8: Gross domestic product, in real terms, quarterly data, 2000q1 = 100



Source: EcoWin (Eurostat), own calculations

Table 2: Government expenditure in selected countries from 1999 to 2007, average annual growth rate in per cent

	nominal	real ¹		nominal	real ¹
EU-27	4,3	1,7	USA	6,1	3,3
EU-15	4,1	2,0	Hungary	10,2	3,2
EWU-16	3,7	1,6	Slovenia	8,8	3,2
EWU-12	3,7	1,6	Poland	7,2	3,2
Latvia	14,2	9,2	Malta	5,1	2,7
Romania	31,0	8,4	Portugal	5,6	2,6
Estonia	11,9	7,6	Netherlands	4,8	2,4
Ireland	11,0	7,4	France	4,0	2,2
Cyprus	8,9	6,2	Finland	3,6	2,0
Iceland	9,6	5,8	Sweden	3,5	1,9
Lithuania	7,4	5,5	Belgium	3,8	1,8
Bulgaria	11,5	5,0	Italy	3,6	1,3
Great Britain	6,6	5,0	Denmark	3,1	1,1
Luxembourg	7,4	4,5	Austria	2,8	1,0
Greece	7,7	4,3	Slovakia	6,5	0,1
Norway	5,9	4,0	Germany	1,3	-0,3
Szech Republic	6,4	4,0	Japan	-1,6	-1,3
Spain	7,2	3,9			

¹ Deflated with the (harmonised) consumer price index CPI.

Source: Horn et al. 2010

An assessment of the reforms and reform proposals

For a thorough assessment of the reform proposals and actual reforms it is necessary to keep these causes of the crisis and the specific German contribution in mind. Of course Greece's manipulation of statistics and its persistent failure to reform the tax system triggered the debt crisis. But the deeper cause is that two growth models have failed. The monetary union led to both overheating and bubbles in some countries as well as growing current account imbalances, which can be traced back to growth differentials and differences in price competitiveness (Dullien 2009, Laski/Podkaminer 2011). Here, Germany bears a large part of responsibility in light of the weak wage developments and weak domestic demand over the last decade. What amplified the situation was the financial market crisis, leading to a transformation of private into public debt. Therefore, the loss of trust on the markets may have speculative elements but it is grounded in fundamental factors. All policy responses

have to address the whole picture of these interlinked processes and cannot focus solely on the rise in public debt.

The European level did not counter the debt crisis once and for all, but it introduced a sequence of rescue packages and measures reacting to peaks in the mistrust of the markets. On 02 May 2010, a first package was agreed on for Greece. The volume was 110 bn. euros, of which 80 bn. were provided by the other member states of the Euro area and 30 bn. by the International Monetary Fund (IMF). Following this decision on helping Greece in May, a new institution was established, the European Financial Stability Facility (EFSF). The EFSF should provide a shield against further mistrust of the markets and was set up as a crisis resolution mechanism limited in time to 2013. This facility lends money from the market and gives it to the country that has lost access to the credit market. In return the country has to pay a mark-up on the interest rates paid by the fund and has to set up an economic adjustment programme. It became quite clear in short time that both, one rescue package for one country and an only temporary crisis mechanism, were not enough to stabilise the situation. In November 2010, a further rescue package was necessary for Ireland and in April 2011 the next debtor that requested financial assistance was Portugal. In both cases the newly established EFSF and the IMF contributed to the credits besides several other countries, funds by the debtors themselves and money from the European Commission's European Financial Stabilisation Mechanism (EFSM), a programme that was originally oriented on non-euro area member states in financial difficulties. The volumes were 85 bn. in the case of Ireland and 78 bn. for Portugal. Interest rates for all rescue packages are at fixed rates between 5 and 6 per cent for money from the EU, including EFSF, depending on the maturity of the bonds and the market rates the EU has to pay for the different tranches of their funding. The countries have to pay slightly more than three per cent for credits by the IMF but these are at variable interest rates that are depending on market fluctuations. Moreover, the IMF uses Special Drawing Rights, i.e. a weighted basket of several currencies, which raises the costs of the borrowers if they want to hedge against depreciations of the euro. If then the countries swap their variable interest payments for fixed rate loans denominated in euros the resulting interest rates of the IMF are more or less equal to the EU's rates. The EFSF's volume of potentially lendable credits was extended in March 2011, and a decision was taken to transform the EFSF into a permanent European Stabilisation Mechanism (ESM) from mid-2013 on – with a volume of 500 bn. euros, a slightly lower mark-up compared to the EFSF, collective action clauses for creditors, and solvency tests for debtors that might lead to a haircut before further money is given. Last but not least, institutional reforms were initialised, a reform of the Stability and Growth Pact (SGP) was initiated and a so-called Pact for the Euro (or Euro-Plus pact) was established.

Since the end of 2010, a reform of the SGP is in the making and will be finalised presumably in autumn 2011. What is known so far is that the focus on public debt will be reinforced by a new rule that states that the difference between a country's debt-to-GDP ratio and the 60 per cent limit has to be reduced by 5 per cent of this difference per year, which implies a reduction to the target debt level within 20 years, otherwise sanctions will be applied (Niechoj 2011). There is also a second procedure introduced besides the Excessive Deficit

Procedure: the Excessive Imbalances Procedure. It includes a scoreboard for macroeconomic imbalances, i.e. indicators for private and public debt, incomes, unemployment, asset price bubbles, investment, R&D and more. Against the background of this scoreboard, macroeconomic imbalances should be identified. Although current account surpluses are not excluded from indicating a macroeconomic imbalance, the main burden of adaptation will likely be on the side of the current account deficit countries. From the perspective of the Commission, imbalances can be reduced by structural reforms of product and labour markets. Sanctions can be applied if member states do not comply. The proposals do not explicitly state what procedure has priority, which implies that the Commission does not see any trade-off between the procedures. Debt and deficit criteria have to be observed, and this does not conflict with the structural reforms that may be recommended after an assessment based on the scoreboard. In other words, »structural reforms« are seen as a remedy always and everywhere, and coordinated fiscal policies (other than via the three per cent deficit and 60 per cent debt criteria) and employment-friendly monetary policies are not part of the toolbox.

The Pact for the Euro, a result of bilateral negotiations between the German Chancellor Merkel and France's president Sarkozy, takes this lead up. In order to raise price competitiveness in Europe, wage restraint is recommended in case labour cost growth lies above productivity growth. To foster this, wage indexation should be abolished and labour markets should be deregulated. Moreover, the public sector should play a leading role for wage restraint. This is accompanied by a commitment to introduce rules for public debt similar to the debt and deficit criteria of the SGP at national level. Contrary to the intentions of Merkel and Sarkozy, however, these guidelines are not strictly binding, sanctions are not introduced. Similar to other guidelines at European level, like the Integrated Guidelines, naming and shaming is the primary tool to achieve compliance.

Although the EU has reacted to the crisis, for a long time its response was neither timely nor sufficient. A thorough solution to the crisis in the beginning would have restricted the crisis to Greece – but the crisis spread further and further. Increasing the volume of the ESFS and the establishment of the ESM have their merits but these measures were not sufficient to stop the crisis. Moreover, interest rates were still too high and discussions on restructuring and exit from the euro area were on the agenda during the first half of 2011. Despite the obvious fact that the financial market crisis contributed massively to the current crisis and that macroeconomic imbalances did develop over the last decade, the European answer to this was and still is unsatisfactory. Financial market regulation ran dry and public debt is still the primary addressee of policy measures although the low public debt levels of Spain and Ireland before the financial market crisis make it very clear that it was not irresponsible politicians (in terms of compliance with the SGP) that caused the debt crisis. Indeed, the adoption of a second procedure as part of the SGP does acknowledge this to a certain degree. The scoreboard may be capable of identifying future bubbles and increases in private debt as well as imbalances within the euro area. The remedy is, however, for several reasons misleading. Firstly, price differentials are not the only factor, therefore the emphasis on structural reforms neglects other reasons for growth differences. Moreover, deregulation and more wage restraint are the wrong answer to the right question of what macroeconomic

degree of imbalances are bearable. If all countries follow the example of Germany, all countries would aim at current account surpluses. But surpluses for all countries are impossible. Each surplus has to be balanced by a deficit. Only if the euro area as a whole reached a surplus with the rest of the world such an export-driven model might work. But then, the problem of current account imbalances would become even bigger at the global level. However, it is likely that the monitoring of current account balances will be asymmetric, i.e. countries with current account surpluses that contributed to the crisis as in the case of Germany do not have to take corrective measures. All in all, this means that the scoreboard might identify the correct problems but the measures proposed cannot solve these problems. The suggested structural reforms will deteriorate the situation, they will not improve it: generalised wage restraint might bring the euro area near a deflation; austerity leads to contraction of private demand and depresses growth even further.

At the end of May 2011, the crisis developed further. Members of the Euro group and of the ECB met to discuss the Greek situation once more. Jean-Claude Juncker's dementi not to aim at a haircut and to prefer a reprofiling, i.e. an extension of bond maturities and a reduction of interest rates, fuelled the debate and made Greece No. 1 candidate for a haircut and an early bankruptcy. Although at first glance it seems highly desirable to reduce the Greek debt through a haircut, the disadvantages outweigh the advantages (Horn et al. 2011). Greece could reduce its debt burden significantly, and to include the private sector in the restructuring would relieve the public. Incalculable risks, however, exist. In the case of a massive default, banks in Greece will have to face a default, too, and might collapse, afterwards bond holders of the Greek state and of Greek banks have to write off their bonds. Some of them might go bankrupt, too. A chain reaction might lead to a new bank crisis in Europe and restricted credit access for firms. Moreover, the ECB is itself a holder of government bonds and would have to write off these bonds as well. Then, the states would have to take over private debt and to support the banks, including the ECB; once more, public debt would rise. More to the point, if Greece becomes insolvent, what about other countries in crisis, like Portugal and Ireland or even Spain and Italy? If markets lose trust in their solvency after a Greek crash the whole euro area is at danger. Spain and Italy are too big to be saved by rescue packages.

These questions were – to a certain degree – addressed by the summit on 21st July. The package of measures included an interest rate reduction for Greece, Ireland and Portugal that makes it easier for these countries to repay their debt and to remain solvent. It also included a voluntary and limited debt reduction by banks which will lead to a selective default of Greece which has not taken place at the time of writing. For science, this is a great opportunity to analyse the real experiment of a (limited) haircut within a monetary union. For Greece and the Euro area this might lead to spill-overs and financial disruptions although the heads of state have tried to contain these effects by – intentionally established – supportive measures for banks and – *nolens, volens* – by the limited volume of the private participation in the debt reduction. Nevertheless, this selective default is still not without risks, it might affect the perception of the solvency of other member states like Italy or Portugal.

A truly European way to overcome the crisis

As is becoming clear now, the establishment of the monetary union alone does not guarantee a prosperous growth development for all member states. On the contrary, it led to imbalances. These could arise because the impossibility of de- and appreciations due to the common currency was not kept in check by new and better institutional arrangements. Currently, the European Union prefers as a solution to lay the burden on the current account deficit countries only. However, a truly European solution, one that sees the union as an entity, not a destructive gathering of competitors, has to aim at a different institutional setting. Such a setting would have to acknowledge that in a union the members support each other, i.e. in particular that both deficit and surplus countries have to contribute to a stable monetary union.

Against this background, two conditions have to be fulfilled to relax the current unstable situation and to avoid a further aggravation of the problems of the monetary union. First, all member states that follow sound economic policies have to have access to credit at reasonable interest rates. Second, macroeconomic imbalances have to be reduced durably. Moreover, implementing policies along these lines from one source could be an advantage because it facilitates the combined achievement of these two conditions.

The best option to accomplish these tasks would be a higher degree of European integration and specific economic policies that are inspired by a Keynesian approach (Hein/Truger 2004). In such a scenario all member states of the euro area would have to transfer some of their fiscal competencies from the national to the European level, i.e. the European Parliament and the Commission as the executive body. The European level would set a fiscal framework for the countries that is more binding than the Stability and Growth pact but different in content. It would entail a certain degree of fiscal transfers and tax harmonisation and the authority to set limits to national expenditures as well as coordinated fiscal policies to react to adverse business cycle developments and current account imbalances within the euro area. But it would not determine the structure of the budget which is still the responsibility of the national parliaments. Although this could – and in our view: should – serve as a guideline for the future, it appears fairly unlikely to be implemented in the near future. Therefore, we sketch a second best option that is more realistic against the background of national interests in the euro area.

We propose a new agency, we might name it European Monetary Fund (EMF) in analogy to the International Monetary Fund and taking into account the specific European constellation, replacing the Stability and Growth Pact and the European Stability Mechanism (Horn et al. 2010, IMK/OFCE/WIFO 2011: 18–32).

An EMF would issue euro bonds on behalf of the euro area. The idea of euro bonds was recently discussed by Delpla and Weizsäcker (2010) and later on at the political level by Juncker and Tremonti (2010). Although both proposals were still bound to targets for public debt and therefore are not appropriate in a situation where excessive private debt and current account imbalances are the real problem, they nevertheless offered an essential element of a new institutional setting: a common bond that is guaranteed by all member

states together. Such euro bonds would immediately stop the endless discussion about the necessity of further rescue packages and debt restructuring. It would also offer an ordered way as to how member states can finance their debt, now and in the future. This might raise the interest rate for some countries like Germany in comparison to its level in 2010. Here, it is important to note, however, that this level was only so low due to the portfolio transfers of investors from bonds of Greece, Ireland, Portugal etc. to Germany and due to low interest rates of the ECB, which brought the price for German bonds down. Moreover, if interest rates for euro bonds are seen as too high, the ECB can intervene, similar to the Fed and not much different from what the ECB did as quantitative easing in 2010/11. So, the ECB could buy government bonds on the secondary market to reduce the long-term interest rate. If this instrument is used excessively it might lead to inflation. But with its focus on price stability and considering its behaviour in the past it seems highly unlikely that the ECB will allow inflation. Even without any support by the ECB, euro bonds will c.p. lead to lower interest rates on average. The new euro bonds market offers bonds that are due to its enormous volume more liquid than bonds of any of the member states, which is preferable from the point of view of an investor. This again makes the bond more attractive and lowers the interest rate.

Euro bonds are, however, not offered for free to the member states. Access to euro bonds should be bound to certain conditions. These conditions constitute a limit to credit access, therefore it is not possible for member states to extend their debt indefinitely at the expense of the other member states. Expenditure paths are key to this. In exchange for euro bonds a country has to accept a certain expenditure path that prescribes the future development of public expenditures (Hein/Truger 2006, for a similar concept cf. Bofinger/Ried 2010). Expenditures and not revenues are the right variable because they can be controlled more easily than revenues, which are more volatile. Expenditure paths allow to uphold a certain level of infrastructure and public services but it might be that the state is underfinanced, i.e. revenues are not sufficient for the required level of public expenditure. In such a case tax base has to be extended and/or rates have to be raised. If then a member state keeps its expenditure in line with the path, all deficits that arise are due to cyclical fluctuations and therefore are justified to stabilise the economy. Access to euro bonds is given. The path itself is, however, modelled in a way that over a longer period deficits take place only for two reasons: first, in recessions deficits stabilise the economy and they are levelled by revenues in boom phases; second, as far as deficits (and debt) are used for investment in public infrastructure which generates positive effects for future generations (Will 2011).

If macroeconomic imbalances persist, further conditions have to be fulfilled in exchange for access to euro bonds by the countries. The current account balance can act as the main indicator of whether a problem exists or not. A current account surplus or deficit of two or more per cent of GDP signals a potential problem (Horn et al. 2010). If so, further indicators – similar to the newly introduced scoreboard of the Excessive Imbalances Procedure – are taken into consideration in order to check if this imbalance is only temporary or otherwise economically justified, and therefore no action is required. If this broader assessment leads to the conclusion that the imbalances are destabilising, symmetric reactions of both deficit and

surplus countries will be enforced. Deficit countries have to increase their price competitiveness. Therefore, their wage developments should be below the inflation target of the ECB plus the national trend productivity growth but above a level that might lead to deflation. In surplus countries, wage increases should be somewhat higher than this guideline. Doing so, surplus countries would reduce their price competitiveness in favour of deficit countries. Without violating the inflation target of the ECB – all countries together would be in line with the target –, price competitiveness is levelled and current account imbalances are reduced by fostering exports in deficit countries and imports in surplus countries. Wages are, however, not directly controllable by the state, they are the outcome of independent negotiations between trade unions and employers. Thus, the state has to follow two other options if it will not be restricted to moral persuasion. On the one hand, the state can implement changes in labour market regulation, e.g. the introduction or modification of minimum wages can raise the level of wages and private consumption; organisational support for trade unions and employer organisations can take volatility out of the labour market by fostering collective agreements; the scope of existing agreements can also be extended by the state. On the other hand, fiscal policy as the genuine instrument of the state can be used which implies the adjustment of expenditure paths: deficit countries have to lower their expenditures or to increase taxes and extend the tax base. Surplus countries should inject fiscal stimuli in order to accentuate domestic demand and consequently imports, which makes it possible for deficit countries to export more. In case a surplus country is deviating from the two per cent current account target and is not undertaking corrective measures, it has to pay a penalty that is forwarded to the European budget where it can be used to foster growth in deficit countries.

For Greece such symmetric balancing policies would imply dampening wage increases, to raise the level of tax revenues and strengthen tax compliance, and to reach a primary budget surplus. This alone would have very negative social consequences because it reduces domestic demand and incomes. Therefore, other European countries have to accompany the Greek adaptation by growth impulses from outside Greece. Germany and other current account surplus countries should enact more expansionary fiscal policies in order to foster imports. For Germany and its constitutionally anchored debt brake, introduced in 2010, this translates into tax increases that are more or less neutral to economic activity combined with a higher public expenditure path.

Simulations with the Oxford model and other studies show that policies along these lines can work (IMK/OFCE/WIFO 2011, Dullien/Schwarzer 2010). In a simple model, Dullien and Schwarzer simulate the effects of such policies for the debt-to-GDP ratio. It is a combination of fiscal stimuli from fellow euro area members plus a catch-up process concerning price competitiveness that leads in these simulations to a considerable improvement in Greece and other countries subject to the insufficient access to the credit market. By using the far more complex Oxford world model, the three institutes IMK-WIFO-OFCE simulate for their recent common forecast, among other scenarios, 1) the effect of a reduction of short-term interest rates for firms and governments to 1.5 per cent and to three per cent for long-term interest rates, and 2) of an increase in price competitiveness of the European member states, except Germany which makes this increase possible by a real wage increase of two per cent

higher than in other countries. Both measures have significant positive effects on growth, employment and public finances in the euro area. Although these simulations are highly dependent on specific assumptions, and their implementation would be a heroic task, what they demonstrate is that such policies do have an impact, qualitatively and quantitatively.

Conclusions

To perceive the current crisis as a public debt crisis alone is a misperception. The very existence of the euro area is at stake and the current crisis is the result of macroeconomic imbalances that have been developing since the very start of the monetary union and that can be traced back to an insufficient institutional setting: a monetary union without sustainable national growth models and without an adequate fiscal framework supporting this union.

In our view, the best solution would imply to take European integration to a higher level, based on a more centralised economic and fiscal policy. This would require a transfer of institutional power to the supranational level. If this is deemed unrealistic, a second best solution could be established that introduces a new body, the European Monetary Fund, that issues euro bonds at low interest rates, bound to conditions for both surplus and deficit countries if they violate a current account target of, say, two per cent. Such a setting would reduce the debt burden of the state and guarantee its future solvency. Furthermore, it would also reduce macroeconomic imbalances and raise the level of growth in the euro area.

None of the options outlined above will be easy to implement. Above all, they require a new understanding of how a monetary union, and indeed the macroeconomy more generally, works.

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