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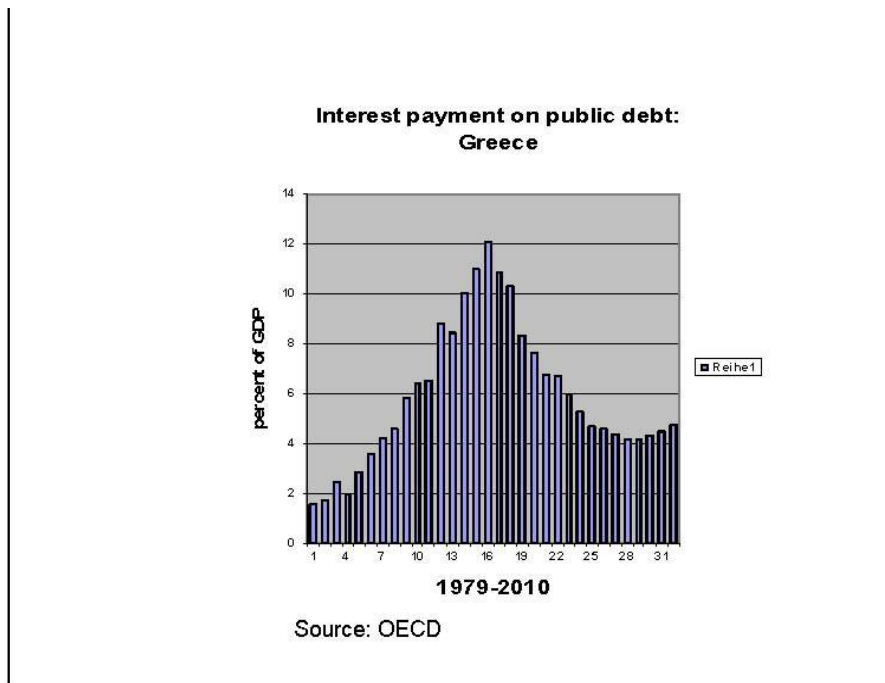
The Challenge of European Policy Coordination after the Economic Crisis

*'The funny thing is that ...
the expectations, even the prejudices of investors,
become economic fundamentals'
Paul Krugman, The Return of Depression Economics*

Today, in the third year after the US sub-prime crisis struck, we observe a huge increase in public debt, not only in the leading economies, the United States, the United Kingdom and also in Germany, but as well in peripheral, developing economies. In the European Union, Hungary and Romania were particularly hit by this new phenomenon of the crisis, requiring IMF-assistance, but also Greece, Spain and Portugal got into troubles (see appendix). There are different reasons for the excessive growth in public debt: government expenditure to rescue banks and stabilise the financial system; anti-crisis measures to tackle the real consequences of the crisis; built-in stabilisers; structural deficits. The result is a mixture of temporary effects and a long-lasting impact on the public debt, and these effects are difficult to disentangle. So, we should be careful in interpreting deficits: A deficit is excessive if it leads to non-sustainable public budgets.

Why the Greek deficit is different from the United States' deficit: both countries have double deficits, that is to say they borrow from abroad. The United States service their debt in their own currency, Greece has to pay for interest and redemption in euro. It takes advantage of the euro's credibility (see figure 1).

Figure 1



The markets have particularly perceived an excessive deficit for Greece and demand a risk premium on Greek bonds. At the same time, this has set the euro's credibility at stake. So, European policy coordination is challenged: Do the European partners, in particular the partners in the euro zone have to assist Greece if it cannot regain a sustainable budget on its own? Or should the euro zone member states protect themselves and urge Greece to exit the monetary union?

The Greek Tragedy

An economic analysis has to distinguish two different aspects of the problem: First, is the Greek deficit unsustainable? And what are the adequate measures of economic policy to regain sustainability? Second, which measures are required to regain the confidence of investors, not only to hold Greek bonds but also to invest in euro. It is this second aspect of the problem that urges the European partners and the EU to engage in measures of cooperation and coordination. This is an urgent task since investors' confidence may deteriorate in a self-fulfilling process quite independent of the Greek deficit problem.

Is the Greek deficit unsustainable? After the Greek government has abandoned its practice of creative accounting, it disclosed a budget deficit of more than 12 percent of GDP in 2009. The corresponding debt ratio, the total amount of debt in relation to GDP, was calculated above 110 percent. According to the criteria of the Stability and Growth Pact, these figures are clearly excessive. But is the Greek debt unsustainable? The actual size of the deficit is the result of the crisis. Greece had provided a rescue fund for banks, and the economy was hit severely and unemployment rose. Nonetheless, the Greek budget shows a structural deficit of considerable size. So, to calm down the EU Commission and the Council, prime minister Papandreou promised to reduce the budget deficit by four percentage points this year. By this binding commitment he gave up any flexibility to combat the consequences of the crisis in his country.

A short primer on fiscal policy should remind us of the criteria to evaluate the sustainability of a budget. The budget balance,

$$(1) \text{BB} = G - T + iD = \Delta D;$$

is composed of the primary deficit - that is government expenditure, G , minus tax revenue, T - and interest payments on the existing debt D . How to finance this balance? Excluding monetisation of the debt as well as the option of privatising public assets, a deficit has to be financed on the capital market by issuing bonds. So, each year's deficit increases the existing stock of the public debt. To receive a sustainable budget, the growth of debt must be restricted. Since each additional euro of debt creates interest payments, the critical question is if future budgets can bear the increase of interest payments. In particular, if additional interest payments would be financed by issuing new bonds, the growth of debt gained momentum (see, for instance, the exponential increase of interest payments on Greek public debt from 1979 to 1995, figure 1). We may take components of the growth of debt as the criteria to evaluate sustainability of the budget.

$$(2) \Delta D / D = (G - T + iD) / D = (G - T) / D + i = \alpha (Y / D) + i ;$$

$$\text{for } \alpha = (G - T) / Y;$$

The growth rate of debt has as components the primary deficit ratio α , that is the relation of the primary deficit to GDP or income, Y ; the debt ratio, D / Y ; and the rate of interest, i . Let us now compare the growth of debt to the growth of income. A useful comparison is to ask under what condition the growth of debt equals the growth of income. Taking r as the

growth rate of income, this condition is:

$$(3) \alpha (Y / D) + i = r;$$

or

$$(3a) \alpha = (r - i) (D / Y);$$

So, in a macroeconomic equilibrium, when the rate of interest equals the rate of income growth, the primary budget has to be balanced. We may also conclude that a primary surplus is necessary to compensate for a fall in the growth rate. Otherwise, the burden of debt would increase. The amount of the required surplus depends on the size of the debt ratio. A debt ratio above 100 percent, the case of Greece, works as a multiplier. Suppose, Greece's GDP will rise by 2 percent in nominal terms in 2010, which means stagnation in real terms, and the long-term interest rate on government bonds will be 6 percent on average. Taking the actual debt ratio of more than 110 percent as basis, the government would have to achieve a primary budget surplus of at least four and a half percent of GDP in order to avoid a further increase in the debt ratio. Although this is not impossible, it is very hard to achieve in a stagnant economy without applying new methods of creative accounting. And even if the Greek government is successful in consolidating its budget this will almost certainly have a contracting impact on the economy, aggravating the recession. What is actually required is for the government to withstand the demand of balancing its budget and to pursue a countercyclical policy. But this, as the simple arithmetics teaches us, would inevitably produce an increase of the debt ratio. In spring 2010, the financial markets have shown that they are not prepared to finance the required additional debt of Greece.

It should be clear, then, that the Greek government got stuck in a severe dilemma. Long-term sustainability requires a reduction of the budget deficit. So, the government has to reform its tax system, particularly by increasing the fiscal drag on higher incomes and, on the other hand, cut public expenditure. But even if it is successful in undertaking these measures which have already been enacted, the results will not immediately show up in the budget criteria. The reason is that the immediate income effect of its measures will reduce tax revenues. In addition, if the budget deficit cannot be brought down financial markets may further increase the risk premium on government bonds and thus aggravate the task of consolidation.

The problem is that financial markets' expectations (as well as the regulations of the Stability and Growth Pact) are fixed on criteria that are not under control of the government in the short run. Under these conditions, as the Greek experience has demonstrated, if the budget

is perceived of being unsustainable, an austerity programme of the government cannot turn investors' expectations.

The present debate

Several emergency measures to regain / secure credibility have been adopted. First, the ECB decided to prolong a crisis regulation that allowed banks to offer bonds as collateral to the central bank which have been rated as sub-prime by the agencies. This provides a bottom line for depreciation of Greek bonds. By June 2010, the ECB took an additional discount of 5 percent p.a. when taking Greek bonds as collateral. Second, after some political debate the European Council achieved a consensus to offer a credit-line to Greece if that should be required: In case Greece would not be able to finance its debt on the capital market, the European partners together with the IMF should provide credit on a bilateral basis and on the condition that subsidy elements should be excluded. This condition was clarified by Jean Claude Trichet in a press conference: Interest rates should not be below those rates at which lenders can refinance themselves. In a formal sense, this looks like a neutral pass-through, but in effect the lender will have to bear the credit risk. Within weeks, confronted with increasingly nervous financial markets, the Greek government had to ask for credit. The EU and the IMF jointly offered a €110 bn credit at 5 % p.a. Not all the lender countries could refinance their share at these conditions. So, Slovakia refused to approve the programme. As for Greece, the IMF calculates that implementation of the programme will raise the debt ratio to 150 percent of GDP by 2013.

This leads us to the second aspect of the problem, the lack of confidence in financial markets. Evidently, Greece needs some backing to discourage speculative attacks on Greek bonds, but, on the other hand, the promise of assistance given by the other member states must not weaken incentives for the Greek government to resolve the debt problem on its own. The base line for a solution is a default. Although Greece is member of the euro zone, it is a sovereign debtor. So, the government may well be tempted to achieve a default, renegotiate on its debt, accept a hair cut and start from scratch again. Its main interest is to have further access to financial markets. If Greece stood on its own, that would be a rational solution avoiding an accelerated debt growth and giving the opportunity to revive the economy. After all, insolvency procedures during South American and African debt crises have been designed according to this principle. The lenders would bear the cost of default and would have to depreciate Greek bonds in their portfolios. So, the cost of default would be laid mainly on banks and financial institutions, both inside and outside of Greece. So long as Greek private households have invested in Greek bonds the default would hit them like a tax on their assets

and that would have an indirect progressive effect.

But Greece is member of the euro zone. For that reason, Europe cannot stand aside since a Greek default might severely damage the euro's reputation. This, at least, has been the official saying. Accordingly, it would not even be helpful that the European Council would compensate the banks for their losses – which it might have done instead of direct assistance to Greece to avoid a default. To secure credibility of the euro, new rules of fiscal cooperation seem to be necessary.

Apart from those pragmatic steps, there were proposals, particularly launched from German politicians, to restructure the EMU architecture. Prominent among them was the idea to establish a European Monetary Fund and by this to sharpen the blunt weapons of the Stability and Growth Pact. This proposal touches a sensitive point since giving decision-taking power to such an institution would violate the Pact's *modus vivendi* to leave decisions on fiscal rules with the Council. However, the debate changed its direction when the European Council had met to an urgent weekend session of May 7-9 to conclude a European Stabilisation Mechanism for assistance of European governments under threat of insolvency. This enormous rescue package which amounts to €750 bn, about five times the ordinary EU budget, was born under heavy pressure of international financial markets and rating agencies that had put solvency of Portugal and Spain into question. The package was intended to be a temporary device to calm down markets and was enriched by some IMF-conditionality. Nonetheless, it became clear that eventually the union would lack the political power to stem such a burden which was an enlarged security net for banks and their investors. By overruling the Treaty's no-bailout clause twice the Council had set the substance of the Treaty at stake. Going on with that kind of solidarity would end up in a European transfer union between 'weak' and 'strong' members. The only option at this point was to sharpen the Treaty's instruments and improve credibility of the no-bailout clause. This was early recognised by Daniel Gros and Thomas Mayer in February 2010 (who updated their paper on 17 May), and it was underlined by a group of renown German economists by 18 June. On 21 June, the ECB joined in with a similar proposal recommended to the Rampoy Commission.

The idea is to introduce an orderly-insolvency procedure for European governments and so to avoid a situation like in case of Greece, when a default was considered as being a political taboo out of fear that it would dangerously hit financial markets. The real possibility of a sovereign default would have three basic effects. First, investor would have to realise that in case of insolvency they must take part of their investment risk. Second, fiscal responsibility would predominantly stay with national governments – a substantial element of the Treaty. Third, the clear and transparent assignment of risks would sharpen incentives of risk-taking

with borrowers as well as with lenders. There are different proposals of how to institutionalise a procedure of sovereign insolvency (see, for instance, Gros/Mayer, May 2010; Fuest et al., June 2010) but the basics are meanwhile common among economists. To become a credible threat, the Treaty's no-bailout rule has to be institutionalised by establishing a fund. In case of an upcoming sovereign default, the fund would buy 'junk bonds' at market prices in exchange for own bonds. So, investors would have to realise losses, although on a restricted scale, and contagion effects would be avoided. The fund's capital – which founds its credibility – would have to be collected by EU member states, presumably applying a scheme similar to IMF rules. In addition, it seems attractive to charge countries during a deficit procedure according to the Stability and Growth Pact (the original idea of Gros/Mayer) and so sharpen the Pact's incentives. But those incentives are not decisive. The real effect on expectations and behaviour should come from the fact that an orderly sovereign default was a real option..

There were other proposals to improve fiscal discipline in the EMU. So, introduction of an exit clause into the Treaty to get rid of unpleasant partners was discussed. Though an exit clause and an exclusion clause exist already in the Lisbon treaty, this option seems to be too general to exert strong incentives on fiscal discipline. The idea to instrumentalise these clauses was meanwhile rejected in the political debate. More recognition deserves the idea to institutionalise economic governance in the EMU and so to achieve fiscal discipline by closer policy coordination among EMU members and, at the same time, reduce macroeconomic imbalances within the union. This proposal has been particularly stressed by the French government that pursues the objective of a European economic government. The topic of policy coordination concerns again the monetary sphere of the economy – competition policy and structural policies are settled on the European level – and the relationship between the real economy and financial markets. It is nurtured by the critique that the EMU in its present form is not a viable policy regime.

This has to be clarified, taking a more general perspective. So, in what follows I would like to address some basic relationships between a monetary regime and policy coordination in order to analyse and evaluate those proposals.

The Trilemma of Monetary Integration

In a globalised world with free trade, market agents and, in their interest, governments are striving for stable exchange rates. To achieve this objective in an integrated monetary regime, there are but two options for the international financial architecture which basically exclude each other. You may have either free movement of capital – which is also in

the interest of market agents. Or you may have national autonomy in monetary policy – which is liked by governments to pursue national goals of economic policy.

Graph: The trilemma

Stable Exchange Rates

Autonomous Monetary Policy

Free Movement of Capital

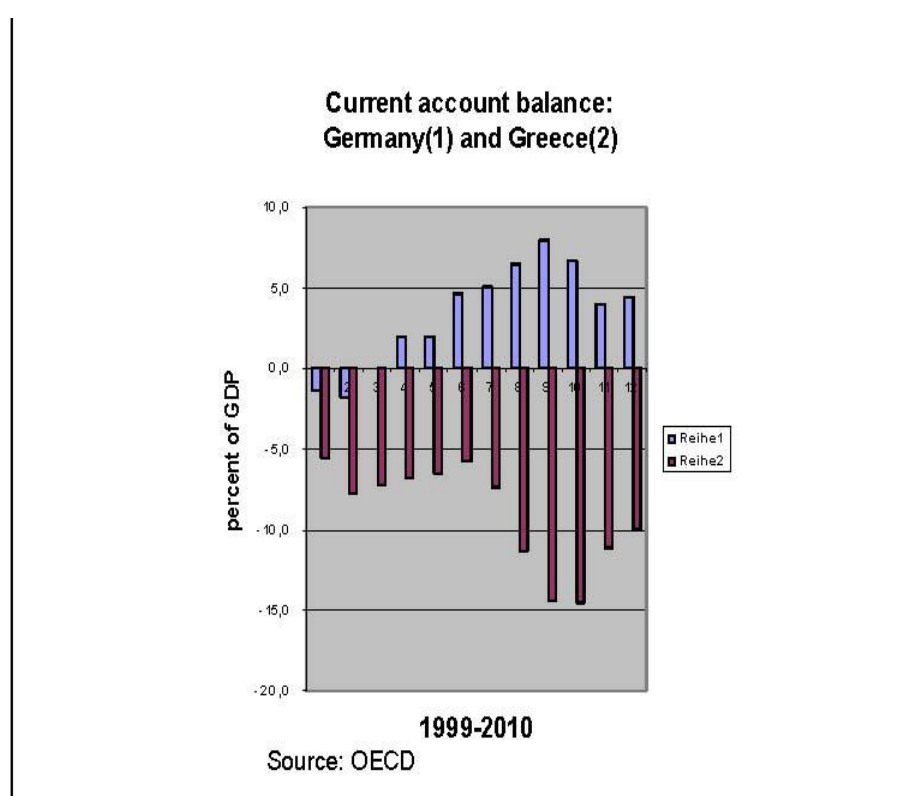
After World War II, the Bretton-Woods-Regime combined stable exchange rates and some autonomy in monetary policy. In that regime, external disequilibria showed up in current account imbalances which required policy adjustments, in case of a fundamental disequilibrium adjustment of the exchange rate. Policy coordination in that regime followed a simple rule which was to stabilise the exchange rate vis-à-vis the US dollar. There was some asymmetry in the system because surplus countries could stand an external disequilibrium – and, consequently, were not prepared to cooperate – whereas deficit countries could not. So, “autonomy” was with the surplus countries. It was due to the rise of international capital movements and a dollar “glut” that the system collapsed.

The following regime of flexible exchange rates was dubbed a “regime of no commitments” (Paul de Grauwe). Central banks were freed of the burden of defending exchange rates and the globalisation of capital markets surged. However, in this regime, that we know today, it turned out that flexible exchange rates did not easily stabilise. On the contrary, and unexpectedly, they were not only volatile in the short run but followed long-term trends that did not fit to the “fundamentals”, that is to say trade balances and productivity trends and inflation differences. The reason is that exchange rates are now determined by financial markets and it is the expectations – and even the prejudices (Paul Krugman) – of investors which have become fundamentals. So, we may dub the present regime as well a “regime of currency competition” (Hajo Riese).

Against this background of past and present experience, how should we assess the European Monetary Union? First of all, the predominant objective of stable exchange rates has been (re-)established by irrevocably fixing the rates within the union. At the same time,

since the EMU is a regime of low inflation, inflationary expectations have been stabilised on the low end. So, there is much less uncertainty for market agents and investors within the EMU than without it. On the other hand, there is a case for policy coordination since national governments still pursue their independent economic policies. As for fiscal policies, national sovereignty and responsibility is underlined by the no-bail-out rule, and also the Stability-and-Growth Pact does not really touch autonomy of the national governments because the final decisions are taken by the Council. As for national wage policies which have also macroeconomic effects since they determine real exchange rates within the EMU, there is still less coordination, mainly through the “Macroeconomic Dialogue”. So, without coordination, external imbalances may arise also within the EMU – not only as a consequence of market forces but as a consequence of divergent national policies. It is true, such imbalances do not imply immediate solvency problems – like in the Bretton-Woods regime – but they may endure. If they should be tackled for some reason, this again was a task for the Council. The Commission has only limited competence in the field of macroeconomic coordination. Let us have a closer look on the monetary imbalances within a monetary union like the EMU and analyse flows and stocks, respectively.

Figure 2



Flow analysis

Regarding flows, an external disequilibrium is expressed by the fact that real absorption (a) and real income (y) are not in balance. For a country performing a deficit in its current account, like Greece, the condition is

$$a > y;$$

that is to say, the sum of real investment and real consumption in Greece exceeds real income (the value of production). The monetary implication is that the excess of

Figure 3



absorption is externally financed (by capital imports). This market constellation is typical for a country in the stage of catching-up, when investment exceeds internal savings. The use of capital for investment should increase productivity and enable the country to repay the borrowed money. If, on the other hand, the excess of absorption indicates over-consumption (private or public), a return to an external equilibrium requires to reduce the level of real wages. In such a constellation, policy implications are different within the EMU. As an outsider, Greece would have been required to adjust the exchange rate. Devaluation of its currency would have increased competitiveness of Greece's internal production and, on the other hand, would have reduced real absorption by the rise of import prices. Within the EMU,

this remedy is excluded. If, for some reason, the external imbalance has to be closed, real adjustments are required, either real productivity growth and / or a reduction of real wages by reducing the wage level. So, Greece would have to steer an austerity course of economic policy in order to reduce its external deficit. But there is another condition which has to be fulfilled. Within the EMU, Greece can only be successful in reducing its deficit if its partner countries accept that their surplus is diminished accordingly. In view of the recent criticism of the German export surplus put on the agenda by the French government and the embarrassed response of German politicians to this critique, that option seems to be quite unrealistic. So, accumulation of Greek external deficits will go on, expressing the preferred market constellation within the EMU. Greece seems to be in a situation comparable to Germany's case after World War I, when German reparation payments were not in the economic interest of the receiver countries because a real transfer would have required for them to accept a deficit in their current accounts (Keynes, *The Transfer Problem*, 1929).

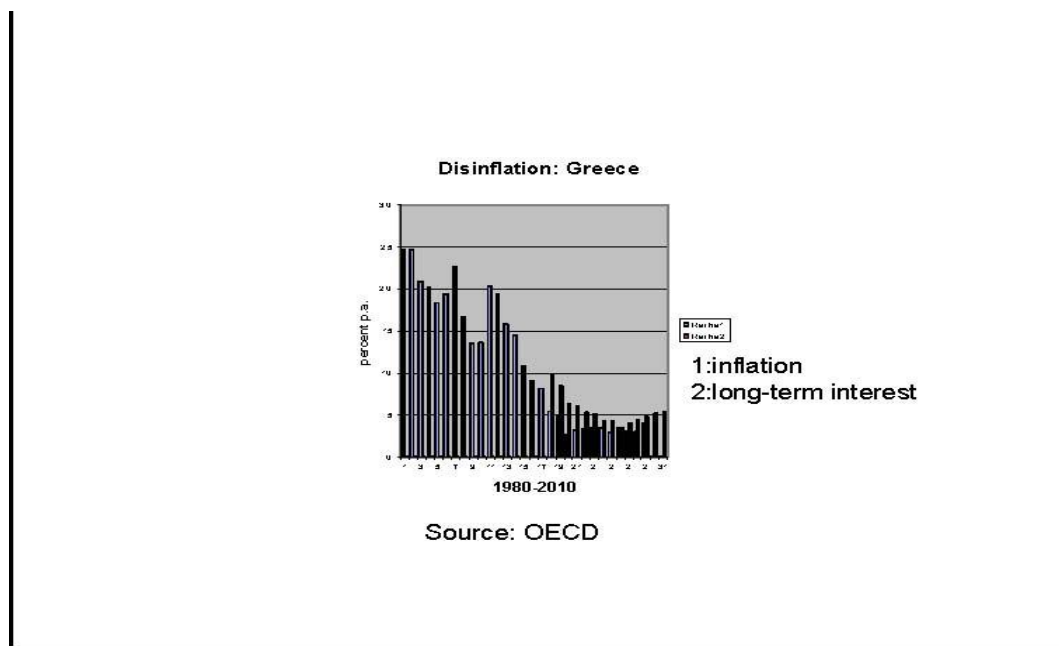
Stock analysis

The catch-up to higher income levels requires public as well as private capital investments. So, one would expect that a country like Greece has a high and growing public debt in relation to national income, corresponding to its external deficit. However, there are two reasons why the Greek public debt might be overvalued. First, Greece's high debt ratio is to a large extent the legacy of the past. Before entering the monetary union, Greece experienced waves of high inflation (jointly with devaluations of its currency). With high inflation, the nominal value of public debt does not correctly express its burden since inflationary expectations also blow up the expected value of the government's revenues. This comes true in a process of (unexpected) disinflation, when the inflation rate is cut but the interest burden on long-term public debt remains. By accessing the EMU, Greece was exposed to such a process of disinflation (figure 4). It is true, by restructuring its debt the Greek government by and by took advantage of the low EMU interest rates. Consequently, the current interest payments were reduced but still the nominal value of debt was too high: the reduction of inflation had increased the real burden of the debt. Since inflation is no more an option to reduce the burden of the debt, its devaluation seems necessary. Second, as I said, the Greek government is a sovereign debtor. The economic rationale for such a debtor is to service its debt so long as the net value of payments is positive (Niehans, 1986). That is to say, the net amount of borrowing should exceed the amount of interest payments. Writing δ for the growth rate of debt, $\Delta D / D$, the condition in any given period t is

$$(4) \quad c(t) = (\delta - i) D(t);$$

Actually, this condition is evidently violated for Greece. Again, what seems necessary is a depreciation of the nominal value of the debt in order to reduce the amount of interest payments in relation to net borrowing. It should be clear that this remedy is not due to some

Figure 4



warm-heartedness but is necessary to restore viable relations within the EMU. Moral hazard problems that might arise concern the future and have to be taken seriously. However, they seem to be more tractable than moral hazard problems induced by bail-out solutions. How much remains of those problems in the end, depends largely on the design of an orderly-insolvency procedure (see above).

Conclusion

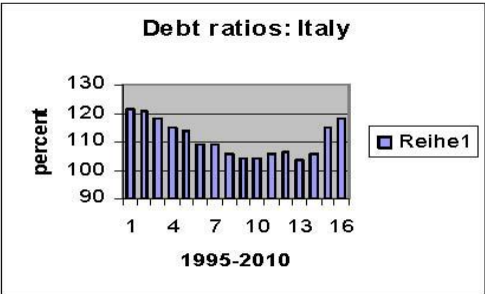
The EU constitution does not provide a comprehensive system of fiscal transfers. The EU structural funds and the Cohesion Fund are of minor importance as far as the macroeconomic equilibrium within the union is concerned. The EU may rather be described as a competitive system of fiscal federalism. Accordingly, the member states' governments are sovereign debtors. On these conditions, the credibility of the no-bail-out rule requires to consider default

as a real option. So, to depreciate Greece's public debt would have strengthened the rules of the system and not weakened them. On the other hand, flow imbalances within the EMU do not indicate solvency problems. Economic policy coordination should rather be concerned with attempts to shift real exchange rates within the EMU. In the case of Greece, a strategy to reduce its external deficit would require to deflate the national wage level (the substitute for an exchange rate adjustment which is no longer possible). Independent of the economic rationale of such a strategy, its success rests on the condition that the partner countries are prepared to accept its consequences. Otherwise, the EMU would end up in a deflationary process. So, like in the Bretton-Woods regime, there is a case for economic policy coordination within the EMU, even though the terms of coordination are different.

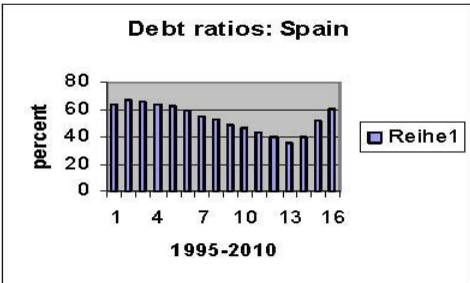
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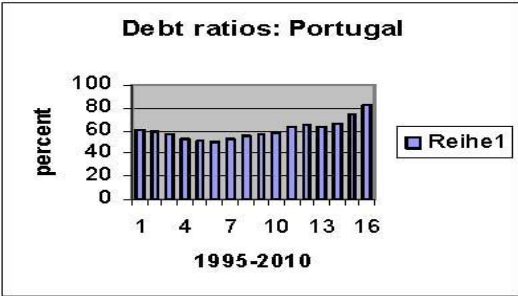
Appendix: Debt ratios



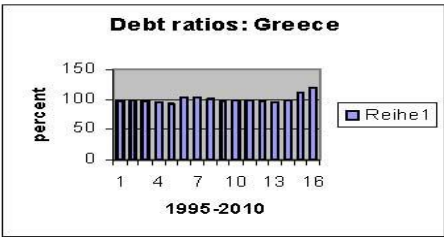
Source: OECD



Source: OECD



Source: OECD



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