The Euro-zone: what are the problems and what are the solutions? *

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The Plan

1. Europe, 2000-2011: the boom, the crisis, the recovery (?)
2. Developments preceeding the present situation in the Euro-zone
3. Crisis managment versus crisis prevention
4. Two kinds of problems in the Euro-zone
5. The inherent problems of the Euro-zone: The common interpretations
6. Adjustment without nominal devaluation: PIIGS versus BELL (Bulgaria, Estonia, Latvia, Lithuania)
7. The necessary reforms

1. Europe 2000-2011: the boom, the crisis, the recovery (?)

Table 1. Public spending /GDP

	Austria	Belgium	Finland	France	Germany	Greece	Ireland	Italy	Luxembourg 1995	Netherlands 1995	Portugal	Spain	Denmark 1995	Sweden	Switzerland	UK
1993	57,0	55,0	65,0	55,0	48,0	43,6	43,2	56,3	39,7	56,4	43,3	46,6	59,6	67,9	37,1	43,0
2000	52,2	49,1	48,3	51,7	45,4	46,6	30,3	46,2	37,6	44,1	39,3	39,1	54,0	52,8	35,2	36,6
2007	49,0	48,4	47,2	52,6	43,6	46,6	35,7	47,9	36,2	44,9	44,3	39,2	50,8	49,0	34,6	40,3
2008	49,3	50,1	49,1	53,3	43,9	49,6	41,7	48,8	36,9	45,8	44,6	41,3	51,8	49,6	32,6	42,7
2009	53,0	54,0	55,6	56,7	48,0	52,8	47,8	51,8	42,2	50,6	49,8	45,8	58,3	53,1	34,4	47,1
2010	52,9	52,9	55,1	56,6	47,0	49,5	66,0	50,5	41,2	50,2	50,6	45,0	57,9	51,0	34,2	46,8

	Bulgaria 2001	Czech R. 1995	Estonia 1995	Hungary 1995	Latvia 1998	Lithuania	Poland 1994	Romania	Slovak R. 1997	Slovenia 1995	Russia 1998	Ukraine 1997
1993	n/a	54,5	39,2	47,6	39,5	n/a	47,7	n/a	48,9	40,3	42,5	42,2
2000	37,3	41,8	35,0	48,1	36,7	36,2	41,1	35,0	52,1	41,5	32,8	36,7
2007	34,9	42,5	35,4	50,0	35,6	35,0	42,2	35,4	34,3	40,3	33,1	43,8
2008	35,2	42,9	41,5	48,8	42,9	37,5	43,2	37,0	35,0	41,4	34,3	47,4
2009	36,2	45,9	47,6	50,5	44,0	44,1	44,5	38,7	41,5	46,4	41,4	48,6
2010	36,7	45,2	45,5	48,9	44,0	41,7	45,7	39,4	41,0	46,4	38,5	48,5

Source: IMF WEO IX 2011

Table 2. Fiscal deficit (surplus)/GDP

	Austria	Belgium	Finland	France	Germany	Greece	Ireland	Italy	Luxembourg 1995	Netherlands 1995	Portugal	Spain	Denmark 1995	Sweden	Switzerland	UK
1993	-4,5	-7,5	-9,1	-6,4	-3,0	-12,4	-2,7	-10,0	2,4	-9,2	-6,1	-6,6	-3,2	-11,2	-3,6	-7,8
2000	-1,9	0,0	6,8	-1,5	1,3	-3,7	4,7	-0,9	6,0	2,0	-1,1	-1,0	1,8	3,6	2,4	1,3
2007	-1,0	-0,3	5,2	-2,8	0,3	-6,7	0,1	-1,5	3,7	0,3	-3,2	1,9	4,8	3,6	1,4	-2,7
2008	-1,0	-1,3	4,1	-3,3	0,1	-9,8	-7,3	-2,7	3,0	0,4	-3,5	-4,1	3,4	2,2	1,9	-4,9
2009	-4,1	-5,9	-2,8	-7,6	-3,1	-15,5	-14,2	-5,3	-0,9	-5,5	-10,1	-11,1	-2,8	-0,9	0,5	-10,3
2010	-4,6	-4,1	-2,8	-7,1	-3,3	-10,4	-32,0	-4,5	-1,7	-5,3	-9,1	-9,2	-2,9	-0,3	0,4	-10,2

	Bulgaria	Czech R. 1995	Estonia 1995	Hungary 1995	Latvia 1998	Lithuania	Poland 1995	Romania	Slovak R. 1997	Slovenia 1995	Russia 1998	Ukraine 1997
1993	n/a	-13,4	-1,2	-5,0	-0,7	n/a	-4,4	n/a	-6,3	0,0	-8,0	-5,6
2000	n/a	-3,7	-0,9	-4,2	-2,5	-4,0	-3,0	-4,0	-12,3	-1,2	3,3	-3,3
2007	3,3	-0,7	2,9	-5,0	0,6	-1,0	-1,9	-3,1	-1,8	0,3	6,8	-2,0
2008	2,9	-2,7	-2,3	-3,6	-7,5	-3,3	-3,7	-4,8	-2,1	-0,3	4,9	-3,2
2009	-0,9	-5,8	-2,1	-4,5	-7,8	-9,2	-7,3	-7,3	-8,0	-5,6	-6,3	-6,3
2010	-3,9	-4,7	0,2	-4,3	-7,8	-7,1	-7,9	-6,5	-7,9	-5,3	-3,5	-5,7

Source: IMF WEO IX 2011

Table 3. Public debt /GDP

	Austria	Belgium	Finland	France	Germany	Greece	Ireland	Italy	Luxembourg 1996	Netherlands 1995	Portugal	Spain	Denmark 1998	Sweden	Switzerland	UK
1993	61	133	54	46	46	101	94	116	7	76	54	56	72	70	50	38
2000	66	108	44	57	60	103	37	109	6	54	48	59	60	54	61	41
2007	61	84	35	64	65	105	25	104	7	45	68	36	34	40	57	44
2008	64	90	34	68	66	111	44	106	14	58	72	40	42	39	55	52
2009	70	96	43	79	74	127	65	116	15	61	83	53	42	43	55	68
2010	72	97	48	82	84	143	95	119	18	64	93	60	44	40	55	76

	Bulgaria	Czech R. 1995	Estonia 1995	Hungary 1997	Latvia 1999	Lithuania	Poland 1995	Romania	Slovak R. 1998	Slovenia 1995	Russia 1999	Ukraine 1997
1993	n/a	15	9	61	12	n/a	49	n/a	34	17	99	30
2000	n/a	19	5	55	12	24	37	n/a	50	27	60	45
2007	19	29	4	66	8	17	45	13	30	23	9	12
2008	15	30	5	72	17	16	47	14	28	23	8	21
2009	16	35	7	78	33	30	51	24	35	35	11	35
2010	17	39	7	80	40	39	55	32	42	37	12	40

Source: IMF WEO IX 2011

Table 4. Domestic credit to the private sector /GDP

	Austria	Belgium	Finland	France	Germany	Greece	Ireland	Italy	Luxembourg 1994	Netherlands	Portugal	Spain	Denmark	Sweden	Switzerland	UK
1993	92	76	81	91	97	28	43	61	83	85	56	76	35	112	159	108
2000	103	78	53	85	119	47	105	76	102	134	127	98	135	42	158	129
2007	116	91	82	106	105	92	199	101	185	188	162	188	203	121	174	187
2008	120	94	86	109	108	96	220	105	183	193	174	203	218	128	165	211
2009	127	98	94	111	112	93	236	111	184	215	187	211	232	140	175	214
2010	123	95	95	114	107	115	218	123	180	198	191	212	225	140	176	204

	Bulgaria	Czech R.	Estonia	Hungary	Latvia	Lithuania	Poland	Romania 1996	Slovak R.	Slovenia	Russia	Ukraine
1993	66	73	13	28	18	17	21	11	56	22	12	1
2000	12	49	36	31	19	13	27	7	51	36	14	11
2007	63	48	94	62	89	60	39	35	42 na		39	58
2008	72	53	97	69	90	63	50	46	45 na		42	74
2009	76	55	108	71	109	72	53	47 na		93	46	73
2010	75	56	100	72	104	66	55	46 na		93	45	62

Source: WB WDI online

Table 5. Current account deficit (surplus)/GDP

	Austria	Belgium	Finland	France	Germany	Greece	Ireland	Italy	Luxembourg 1995	Netherlands	Portugal	Spain	Denmark	Sweden	Switzerland	UK
1993	-0,8	5,1	-1,3	0,7	-0,9	-0,7	4,0	1,2	11,9	4,1	0,2	-1,1	2,7	-1,3	7,7	-1,9
2000	-0,7	4,0	7,8	1,5	-1,7	-7,7	-0,4	-0,5	13,2	1,9	-10,4	-4,0	1,4	4,2	12,0	-2,6
2007	3,5	1,6	4,3	-1,0	7,5	-14,4	-5,3	-2,4	10,1	6,7	-10,1	-10,0	1,4	9,2	8,9	-2,6
2008	4,9	-1,8	2,8	-1,7	6,3	-14,7	-5,7	-2,9	5,3	4,4	-12,6	-9,6	2,4	8,7	2,3	-1,6
2009	3,1	0,0	2,3	-1,5	5,6	-11,0	-2,9	-2,1	6,9	4,9	-10,9	-5,2	3,8	7,0	11,4	-1,7
2010	2,7	1,0	3,1	-1,7	5,7	-10,5	0,5	-3,3	7,8	7,1	-9,9	-4,6	5,1	6,3	15,8	-3,2

	Bulgaria	Czech R. 1995	Estonia	Hungary	Latvia	Lithuania 1995	Poland	Romania	Slovak R.	Slovenia	Russia	Ukraine
1993	-24,1	-2,5	1,2	-10,8	11,9	-9,1	-1,3	-4,5	-4,9	1,7	1	-3
2000	-5,5	-4,7	-5,4	-8,5	-4,9	-5,9	-6,0	-3,0	-3,5	-3,1	18	5
2007	-30,2	-3,3	-17,2	-6,9	-22,3	-14,6	-6,2	-13,4	-5,3	-4,8	6	-4
2008	-23,2	-0,6	-9,7	-7,4	-13,1	-13,4	-6,6	-11,6	-6,6	-6,7	6	-7
2009	-8,9	-3,3	4,5	0,4	8,6	4,5	-4,0	-4,2	-3,2	-1,3	4	-1
2010	-1,0	-3,7	3,6	2,1	3,6	1,8	-4,5	-4,3	-3,5	-0,8	5	-2

Source: IMF WEO IX 2011

Figure 1. Unit Labor Costs in Manufacturing

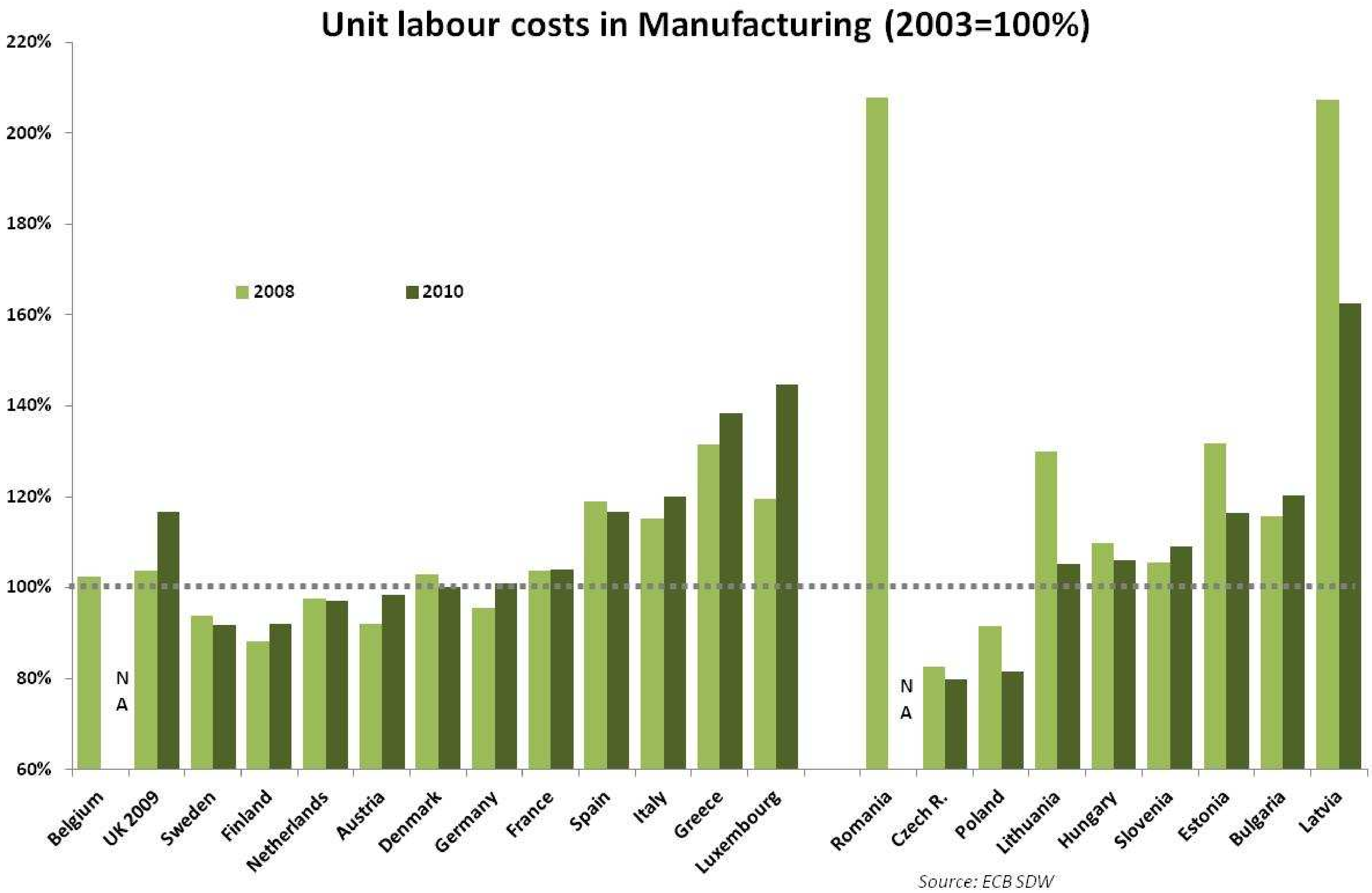


Figure 2. GDP growth in Europe 2008-2009 and 2010-2011

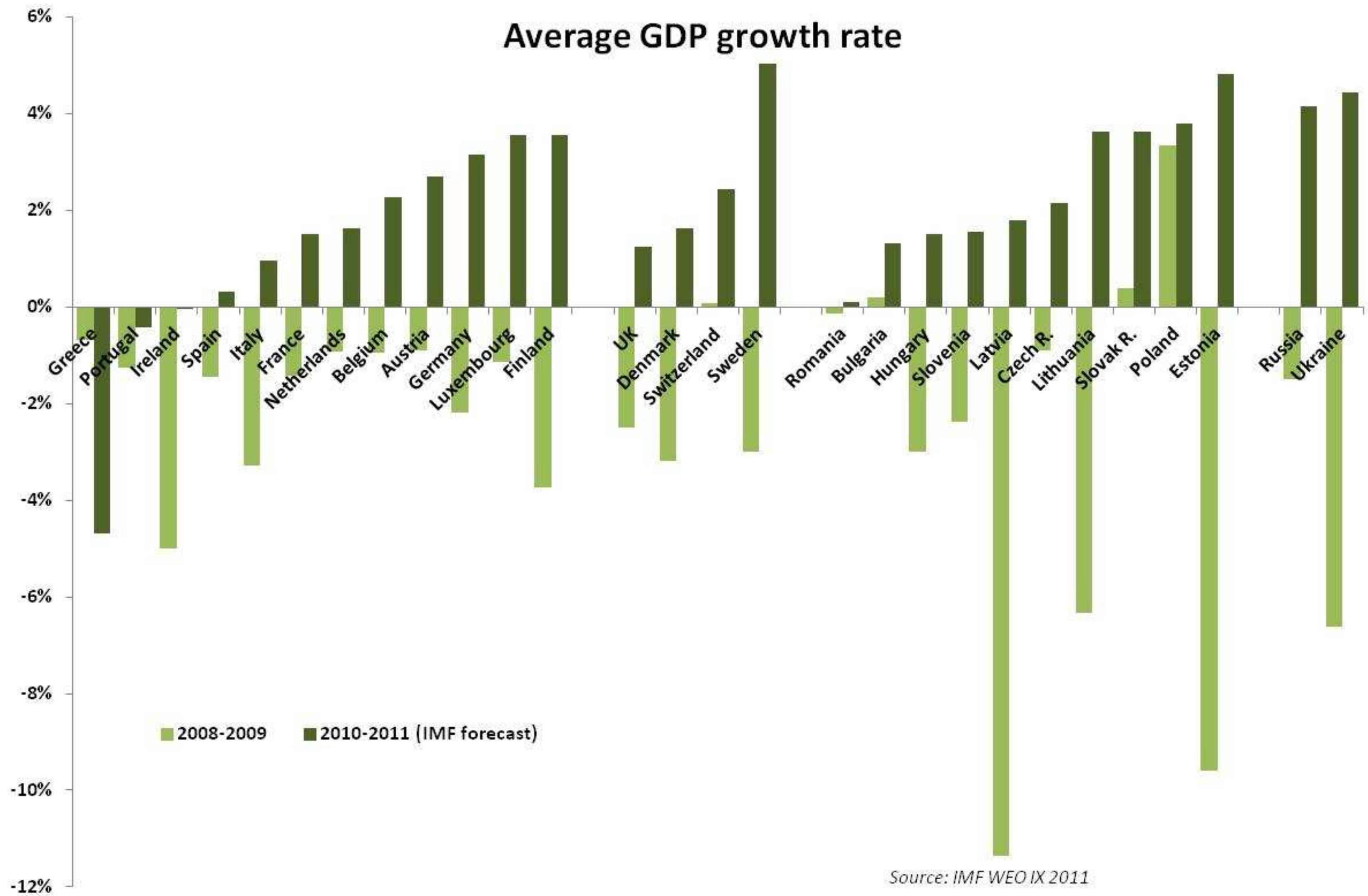


Figure 3. Unemployment in Europe 2008-2009 and 2010-2011

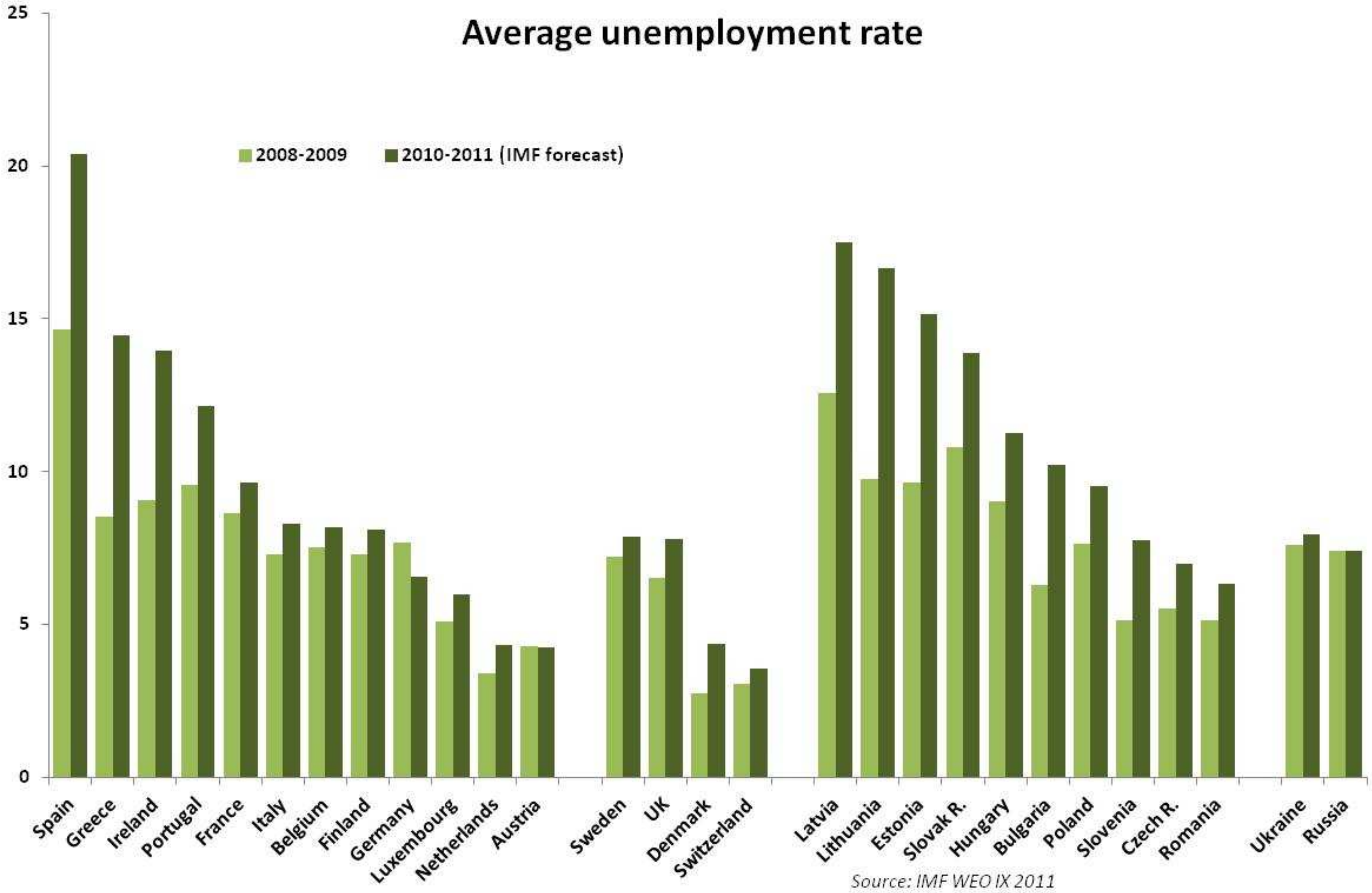


Figure 4. Inflation in Europe 2008-2009 and 2010-2011

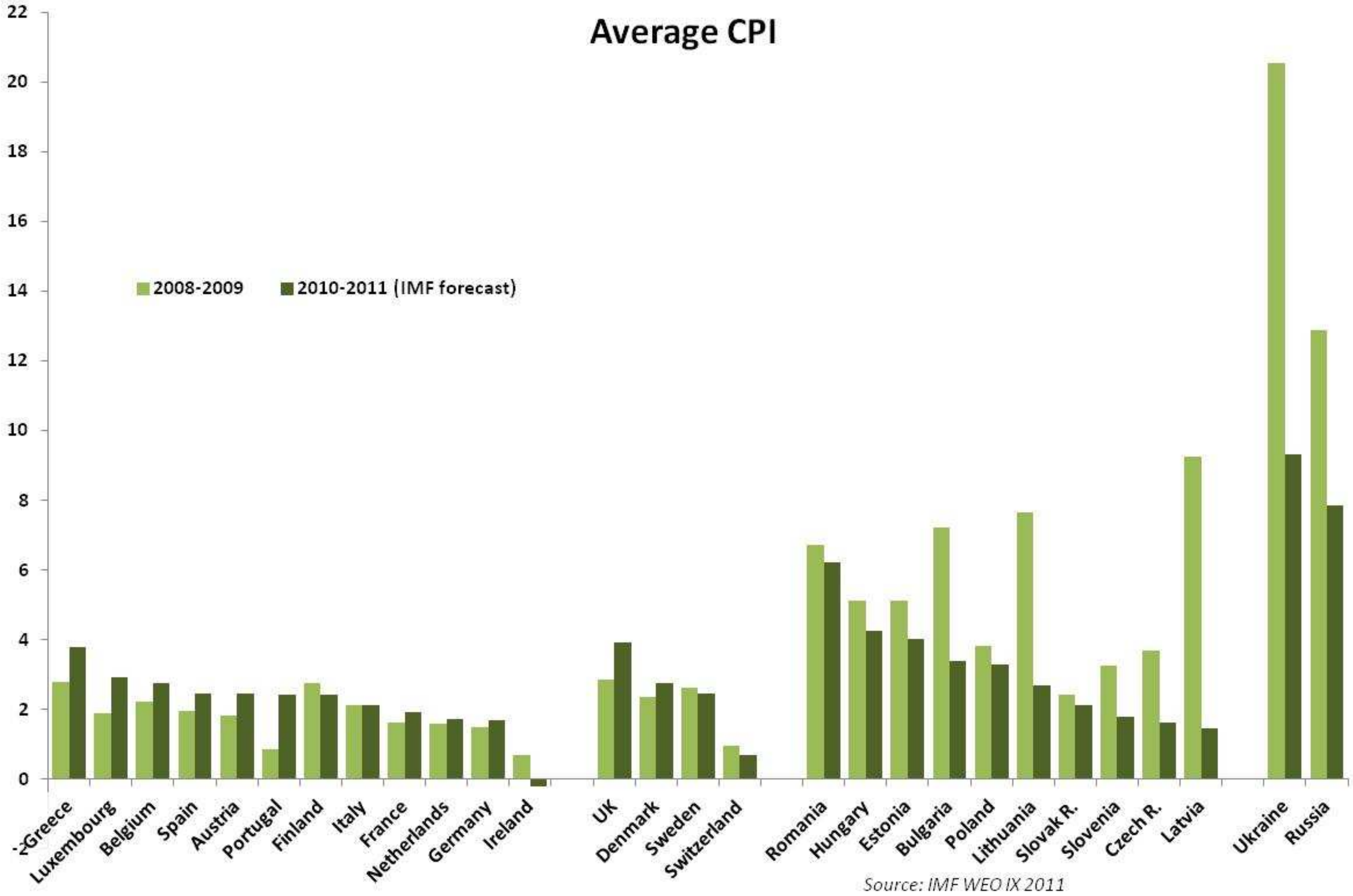
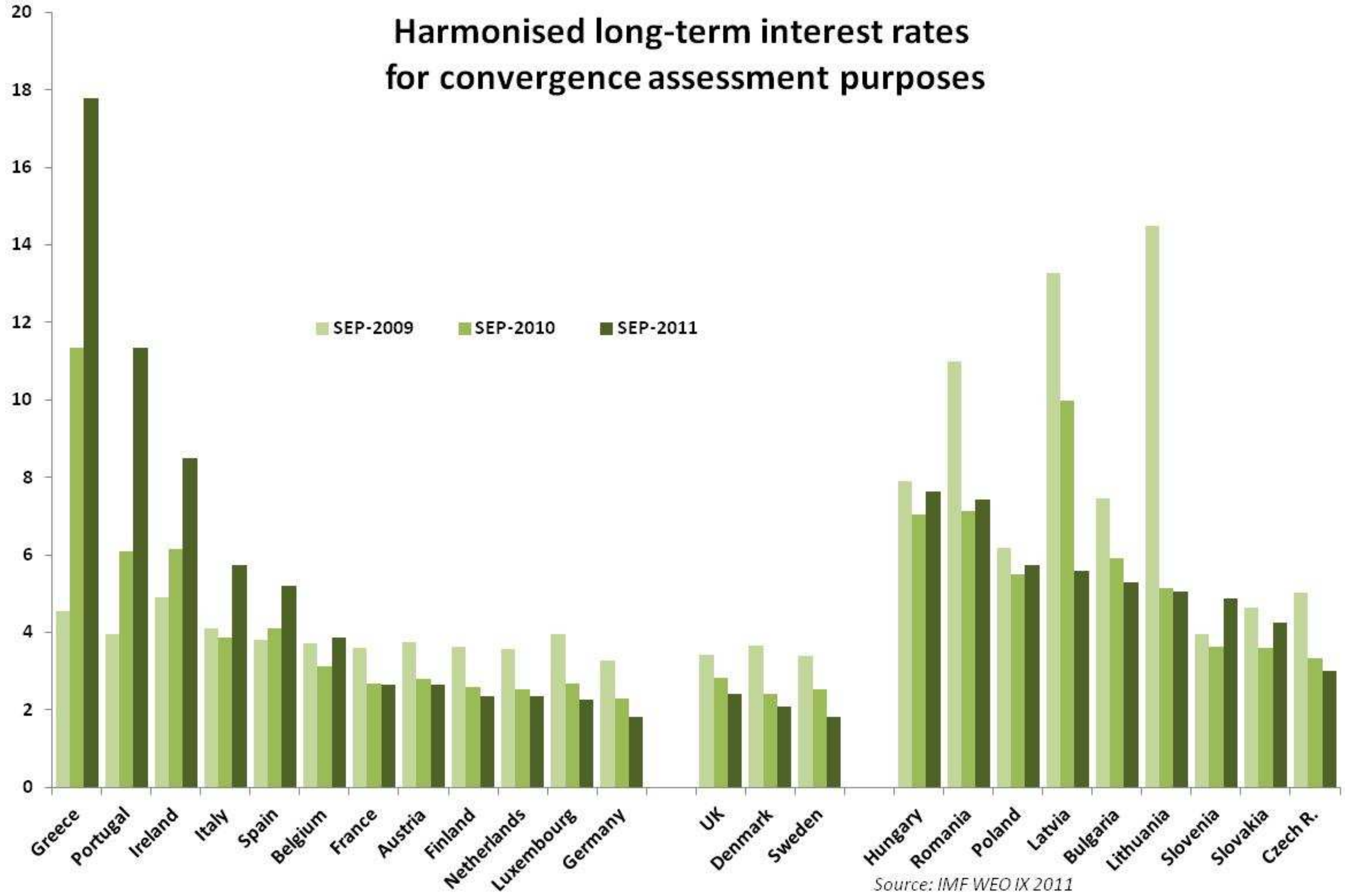


Figure 5. Harmonized long-term interest rates, Sept. 2009, 2010 and 2011



2. **Developments preceeding the present situation in the Euro-zone**

- The creation of the Euro-zone, 1999, „the original sin”: the admission of countries which violated the agreed fiscal criteria;
- Stability and Growth Pact – first violated, then modified;
- ECB’s liquidity operations did not distinguish the credit risks of various countries (Greece = Germany);
- Late 2009: the beginning of the Greece crisis (budget deficit more than 2 times larger than previously reported); long discussions in the EU about what to do;
- 9 May 2010: the start of enlarged rescue operations (creation of EFSF, ECB starts to buy the sovereign bonds and increases its liquidity operations);
- Later in 2010 Ireland and Portugal followed;
- 2011- modifications of the granted rescue packages, governments adopt the ESM (a permanent rescue mechanism), debates how to strenghten the fiscal discipline and the competitiveness in the Euro-zone;
- European Summit 26-27 October 2011- main proposals: Eur 106 bn more capital in the European banks, further reduction of the Greek public debt owned by the banks (50% haircut), extending the fire power of the EFSF to over Eur 1 trillion, seed money for the new bailout funds in the hope of attracting capital from China,

3. Crisis management versus crisis prevention

1. Two types of crisis management:
   1.1. The crisis lending
   1.2. The adjustment: the steps which reduce uncertainty in the financial markets: compare BELL and PIIGS
2. Crisis prevention: reforms which reduce the risk of fiscal and private credit booms, strenghten economic growth, increase the flexibility of markets (see later)

Comments:

- The focus in the Euro-zone so far is on 1.1, while
- 1.1. can reduce politicians' incentives to do 1.2 and 2. (which largely overlap) – the moral hazard problem;
- The ultimate solution resides in 1.2 and 2; no crisis lending is sufficient for Italy.

4. Two kinds of problems in the Euro-zone

1. Problems <u>not related</u> to the essence of the Euro-zone (i.e. one currency for a group of countries), e.g. low capital/assets ratio in the large European banks, especially the French ones, rigid labor markets in many Euro-zone countries, etc.
2. Problems <u>related</u> to the essence of the Euro-zone: what are these problems?

One should not confuse these two groups of problems.

5. The inherent problems of the Euro-zone: The common interpretations

1. One monetary policy cannot fit all (temporal problem, i.e. that of assymetric shocks versus the structural problem of lastingly excessively low interests rates in the poorest member of the Euro-zone), impossibility of nominal devaluations;
2. A currency union without a "political union";

Are these interpretations convincing?

Ad.1. PIIGS versus BELL, the issue of macroprudential regulation;

Ad. 2. What is „currency union”? What is „the political union”?

6. Adjustment without nominal devaluation: PIIGS versus BLLE

Figure 6. GDP growth: PIIGS vs. BLLE (Bulgaria, Lithuania, Latvia, Estonia)

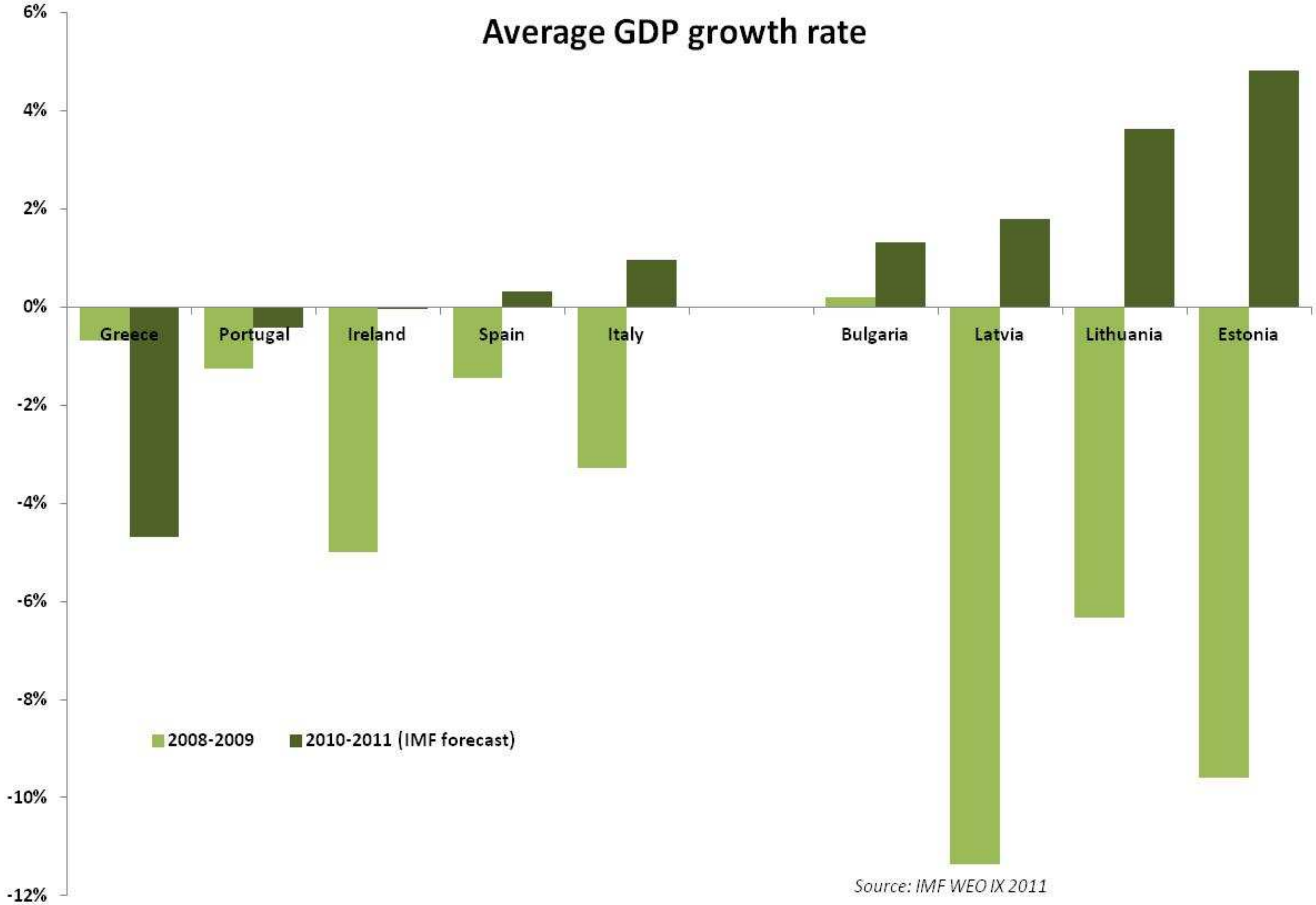
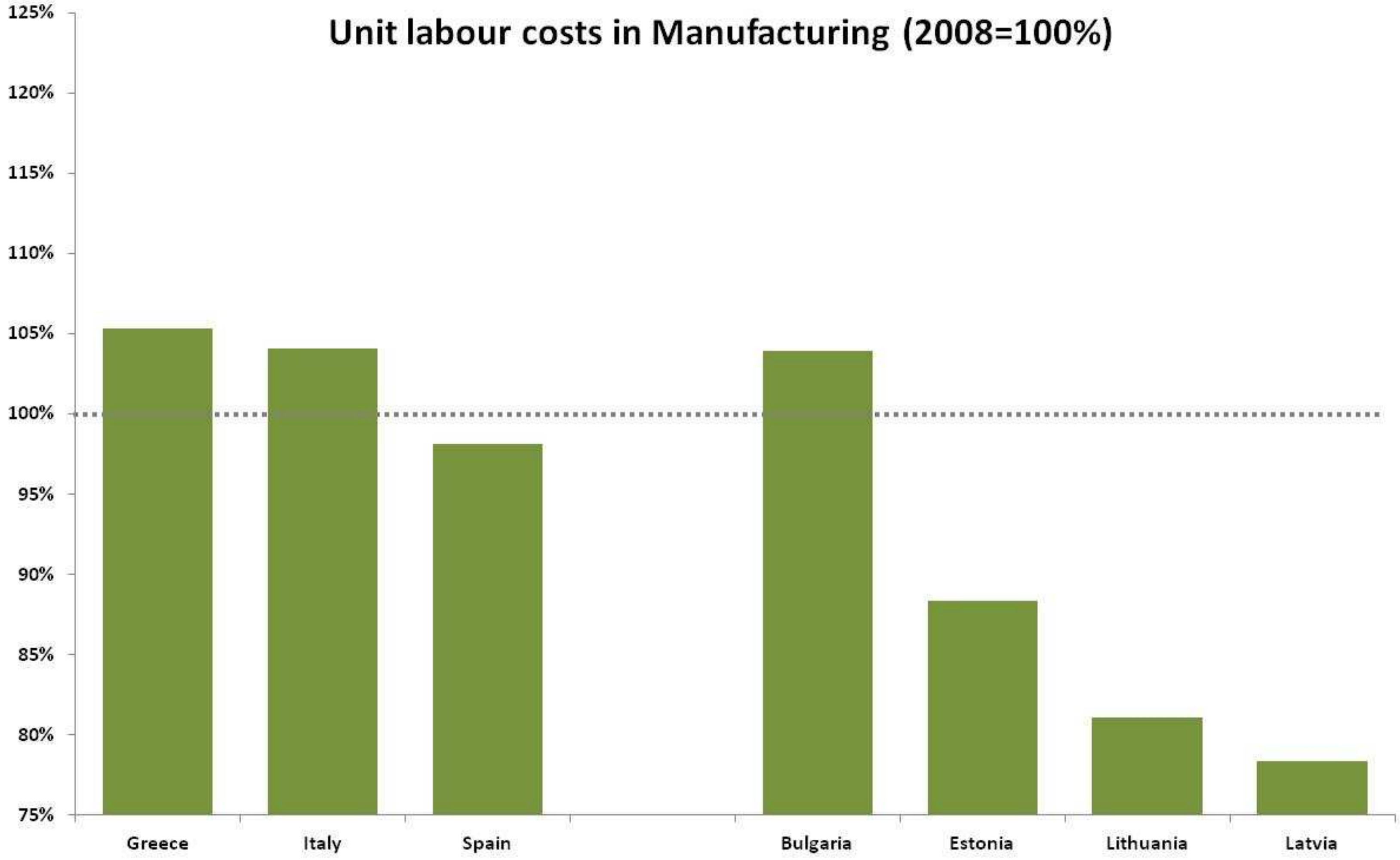


Figure 7. ULC in Manufacturing: Greece, Italy and Spain* vs. BLLE



Source: ECB SDW

Figure 8. Public debt: PIIGS vs. BLLE

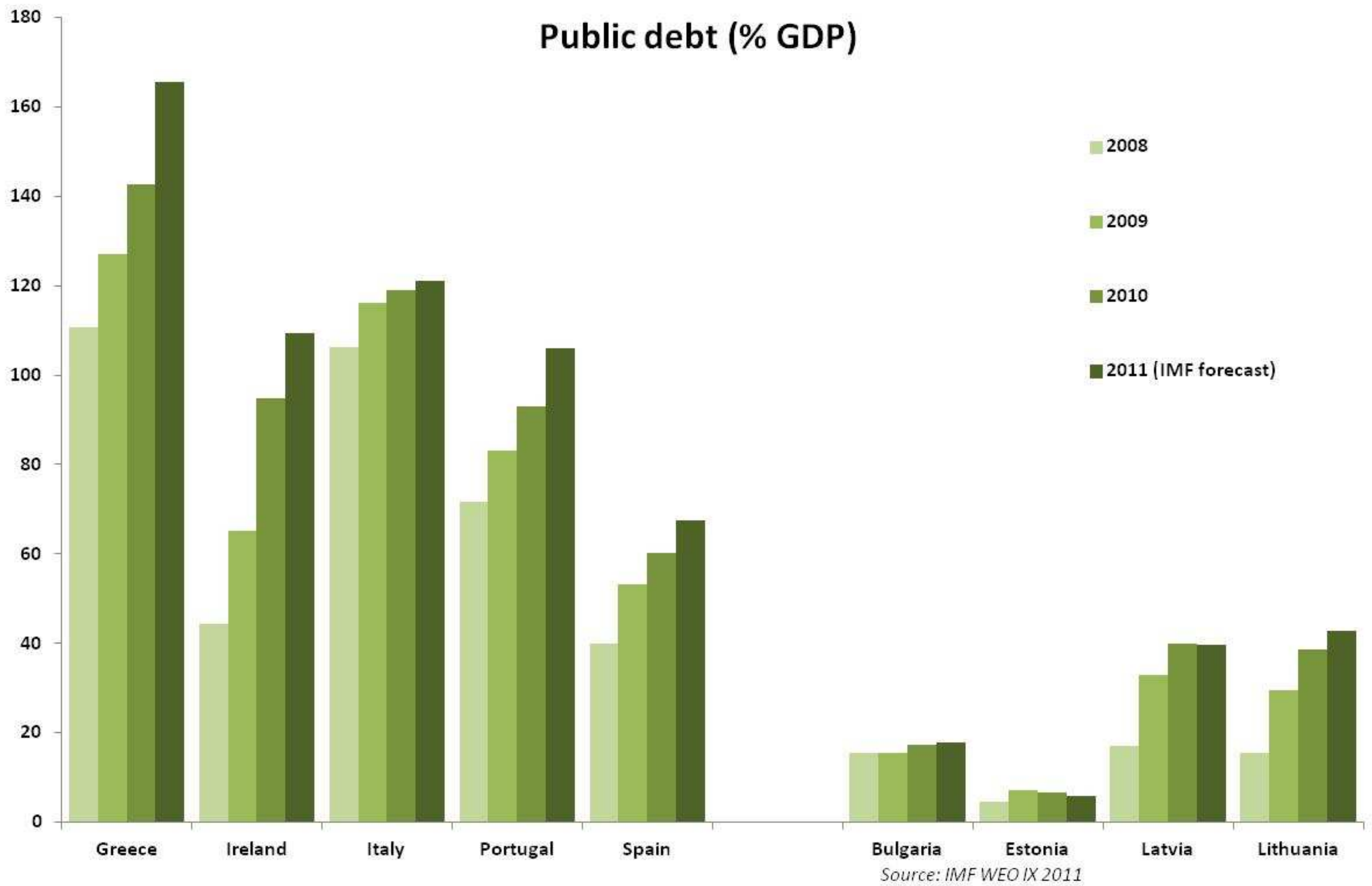


Figure 9. Fiscal deficit: PIIGS vs. BLLE

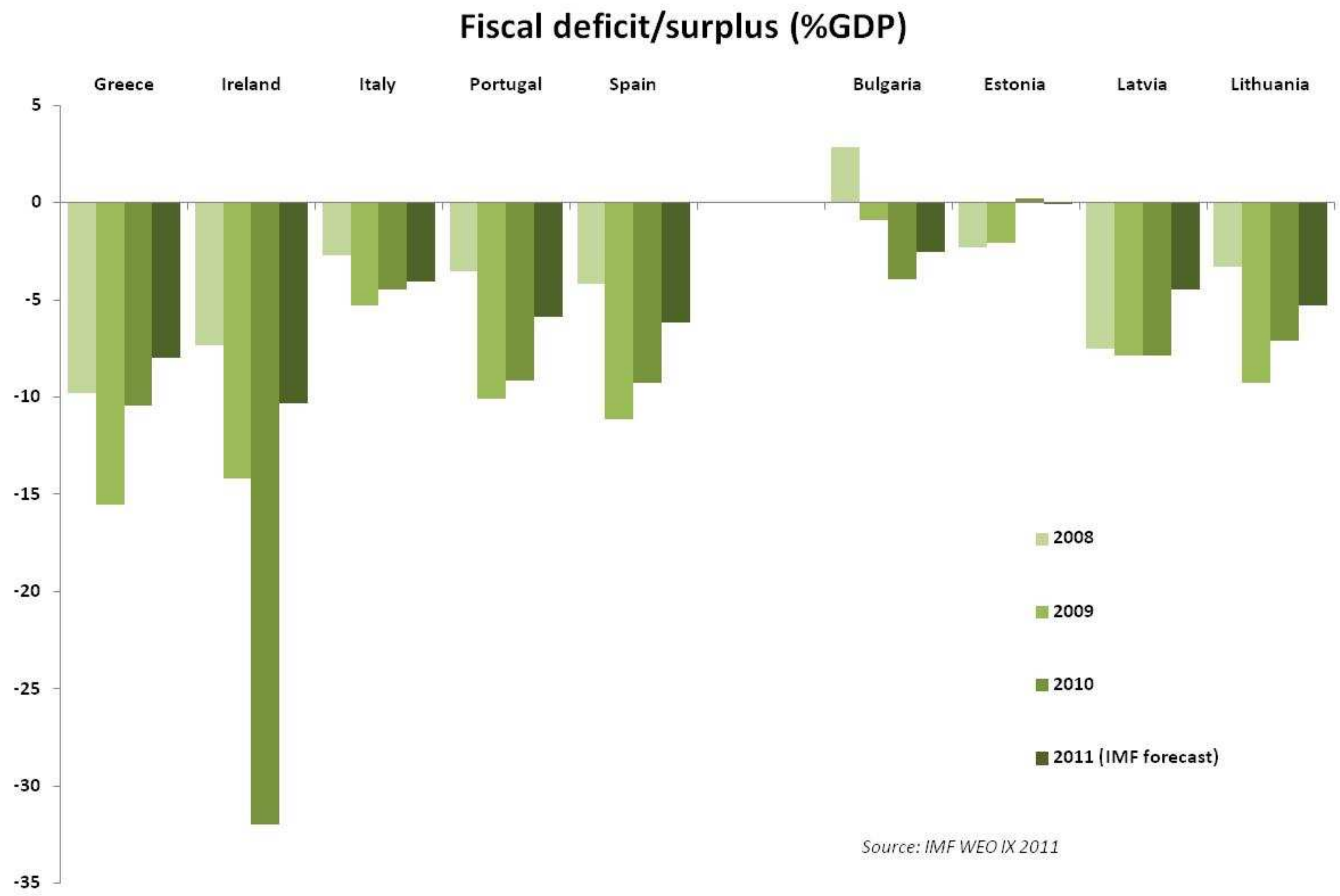


Figure 10. Public spending: PIIGS vs. BLLE

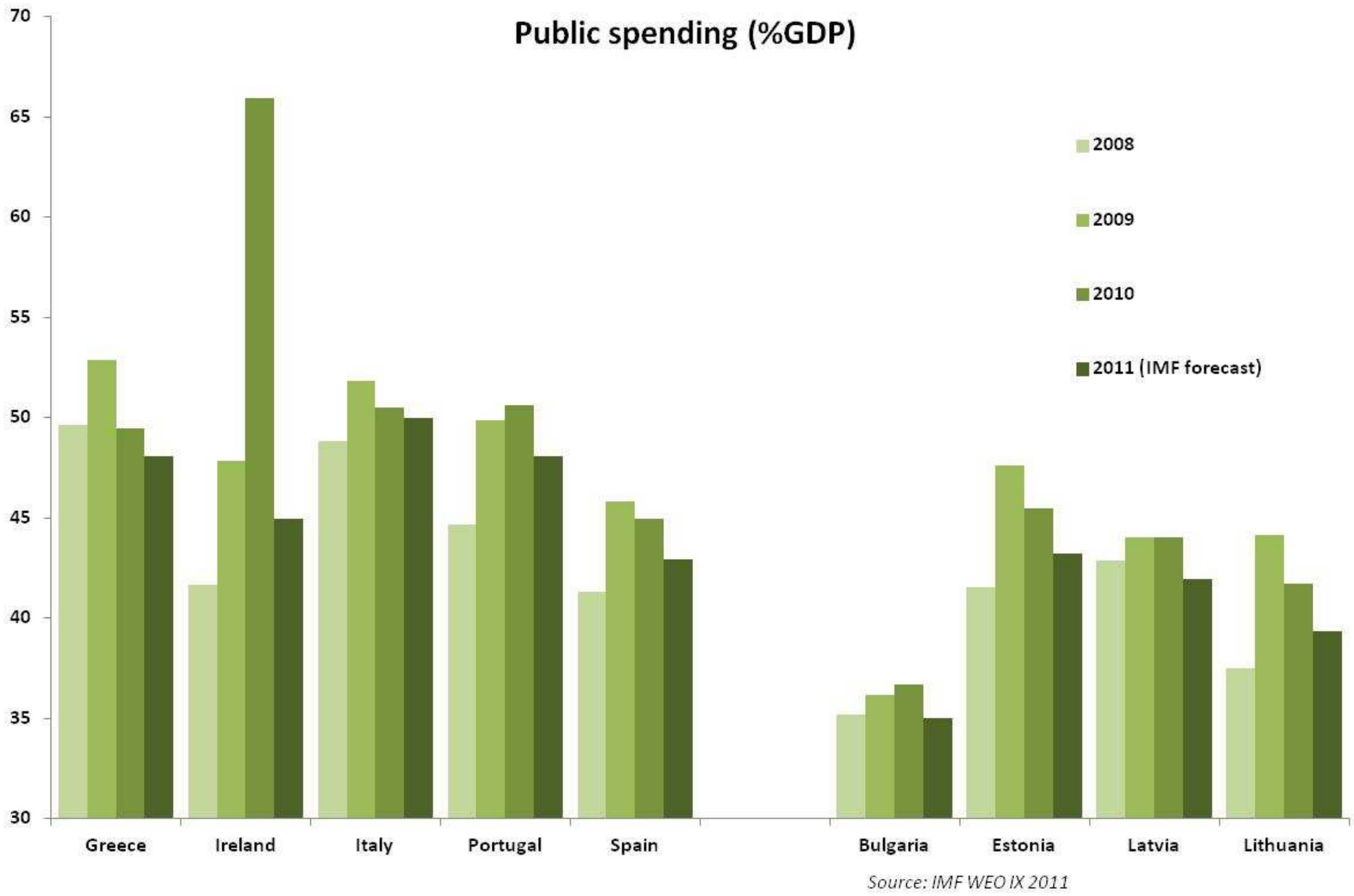
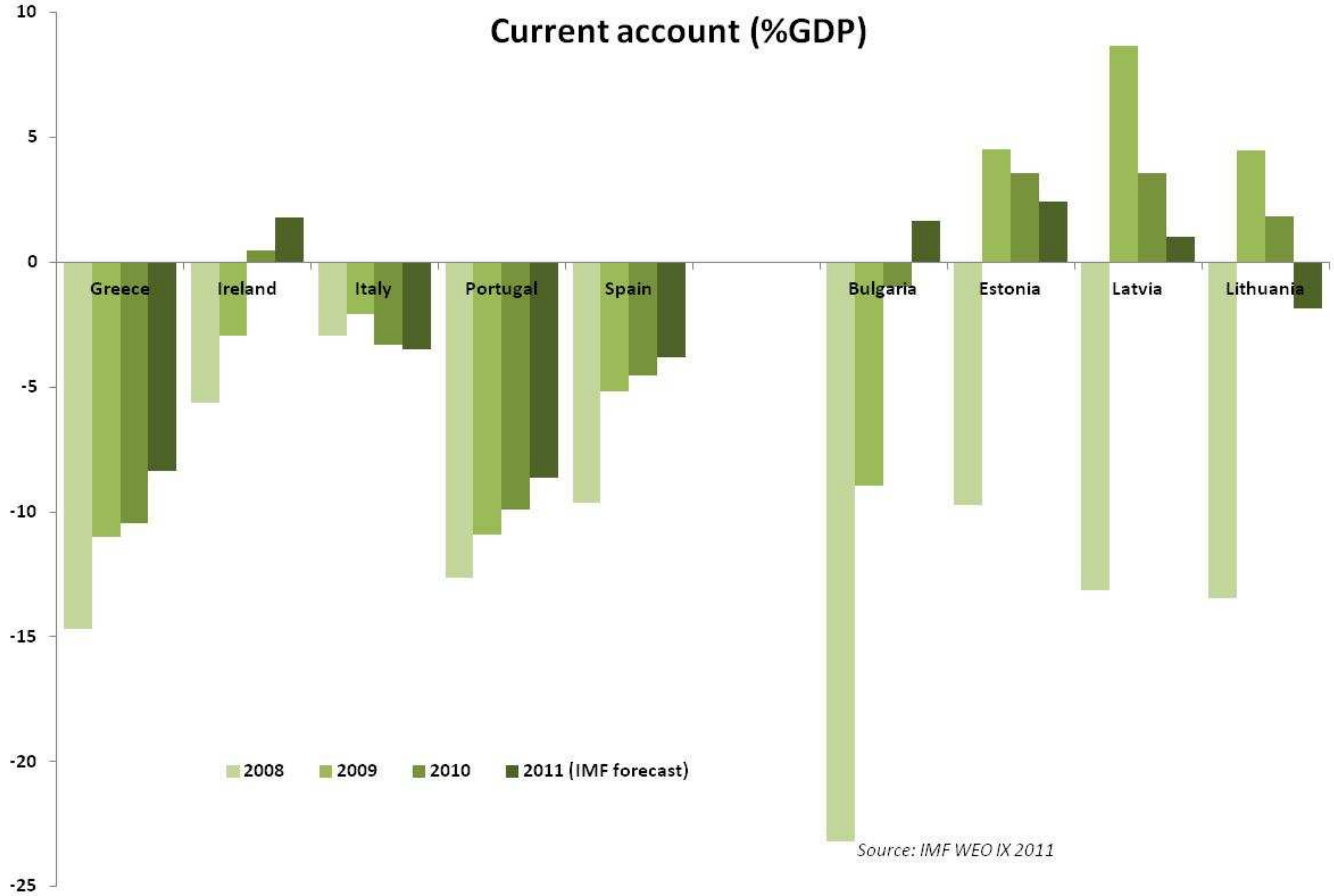


Figure 11. Current account: PIIGS vs. BLLE



7. The necessary reforms

Instead of looking at the *wrong* model: that of a single state, the EU institutions and countries should focus on what are the conditions for proper functioning of a *right* model, i.e., a gold standard–type of a monetary union, a union of countries with a single currency but without any larger common budget to compensate for asymmetric shocks. While doing that one must consider, of course, some later developments that are or should be present to strengthen these conditions.

One may group these conditions into three categories:

1. *The mechanisms to prevent the procyclical policies and large fiscal shocks*. These mechanisms should operate both at the level of the European Union (and at the eurozone) and at the level of the respective countries.
2. *Structural reforms that would strengthen their long-run growth*. They are not only necessary for the continued improvement of the standard of living of the populations but also to help them to grow out of the increased public debt.
3. *Structural reforms to facilitate the adjustment of the economy to various shocks.*

In the first category the following measures appear to be most important:

- ***The accounting rules***, which define the budgetary deficits and the public debt, must be made credible and transparent. The rules should consider not only the explicit debt but the implicit debt, too (e.g., the pension liabilities).
- ***The monitoring* of the budget deficits** and of the public debt must be strengthened. The monitoring should also focus on the development of the asset bubbles that, when burst, may produce deep recessions and the resulting sharp increases in the budgetary deficits.
- ***The Stability and Growth Pact*** should be enforced, which implies the use of available sanctions that should be strengthened.
- ***The monetary policy of the ECB*** should pay more attention to the developments of asset bubbles, which, when burst, can produce huge fiscal shocks. It should be more conservative than the policy that is only guided by the inflation measured only by the consumer price index.
- The eurozone countries (and other countries, too) need an additional instrument: ***macroprudential regulations,*** which aim at reducing the excessive growth of credit. While the need for such regulation is nowadays widely recognized, much technical work remains to be done.
- The initiatives at the EU and/or eurozone level cannot substitute for the strengthening of **the preventive mechanisms in the respective countries**, which is ultimately the responsibility of the domestic politicians and the public at large. However, the disciplining measures at the EU level are desirable or perhaps even necessary to spur the growth of the preventive mechanisms in their respective countries.

The second category:

- At the EU level, probably the most important mechanism for longer-term growth of *all* the member states is ***the single market****.* The vigorous effort to complete the single market should be relaunched.
- The EU institutions and countries should reconsider measures that **risk imposing additional burdens** on the economies and/or hamper the flexibility of markets (the European climate and social policies)
- ***The fiscal reforms*** in the respective EU countries are not only fundamentally important for the short run, i.e., to deal with the increased budgetary deficits and the public debts, but from the longer run, too. Persistent deficits and a large public debt are detrimental to the longer-term growth, because sooner or later they crowd out private investment and introduce harmful uncertainty, which worsens the investment climate. *The mode* of fiscal consolidation also affects the forces of growth: As all EU members have an already large tax burden, further tax increases would weaken those forces. The focus of fiscal reform should thus be put on measures that reduce the growth of spending commitments, which—given the aging of the EU societies—must include the pension reforms that raise the age of retirement.

The third category:

Rigid (or dual) labor markets and—more generally— rigid prices and regulatory constraints on the supply response of the economy deepen its recessionary reaction to various shocks and contribute the growth of unemployment. Therefore, the liberalizing reforms should be a priority wherever needed, and should be the other focus of the reinvigorated Lisbon Agenda.