Euro area policy options to solve the debt crisis

Christian Dreger, DIW Berlin

Euro area outlook

- Modest growth in core euro area states, ongoing recession in some smaller countries
  - Export performance does not compensate due to decline in global markets
  - Low US growth, restrictive policies in emerging markets to combat inflation (China)
- Fiscal consolidation depresses short run growth perspectives, debt crisis intensifies
  - Negative spillovers to core countries (Italy, Spain)
  - Low confidence limits expansion of domestic demand
- While GDP raised by 0.2 in Q3, fall is likely in Q4

Recession probably ahead

- Policymakers have pushed uncertainty
  - Increased stock market volatility
  - Securities in bank balances worthless when debt is restructured
  - Distrust in interbank market, risk of credit crunch
- Firms and households have option to wait
  - Firms do not invest if they are uncertain about demand
  - Consumers spend less on durable products
- Double dip recession would be difficult to combat
  - Interest rates at zero lower bound
  - New fiscal stimulus difficult if crisis remains unsolved

Debt crisis in the euro area

- Global financial crisis turned into a crisis of sovereign debt
  - Lower tax revenues and fiscal expansionary measures
- Investors demand high risk premia for holding debt from deficit countries
  - Country specific performance becomes important
  - Reversal of interest rate convergence
- Stability and Growth pact not entirely reliable
  - Routinely weakened by EU Council before the crisis
  - Recent reforms promise long run solutions, but did not prove to work

Fiscal consolidation

- Consolidation to keep debt under control over medium horizons
  - Debt to GDP ratio wil increase to 120 percent (2020)
- Population ageing implies higher financial burden on social security systems
  - PAYG pension systems and healthcare
- Long run growth prospects supported when public finances are on sustainable path
  - Increased reliability of plans of households and firms
- Consolidation accompanied by structural reforms to improve competitiveness

Fiscal consolidation (II)

- Consolidation has to include the revenue and the expenditure side
  - Higher indirect taxes might keep the incentives to work
  - Privatisation of firms to improve competitiveness
- Consolidation can lead to lower growth in short run
  - Might actually worsen debt problems
  - Structural reforms have positive effects in the long run
  - Tax increases and spending cuts caused recession in the peripheral countries
  - Fiscal consolidation in healthy countries lowers short run growth perspectives

Improve policy mix

- Short run stimulus injections to peripheral states
  - Special economic zones to attract investors
  - Loans at reduced interest rates by public development banks to spur investment
  - Regional EU funding should be mobilized by lowering requirements for co-payment
  - External support to identify growth enhancing projects
- Ensure sufficient liquidity and financial stability
  - Interest rates fixed at low levels over some period
  - Continuation of unconventional monetary policy
  - Liquidity growth affects inflation only in the long run

Institutional reform

- Governments issue bonds in a currency that is not under their control, no guarantee for repayment
  - Central bank acts as lender of last resort in case of stand alone countries
  - Lower confidence can raise interest rates to levels high enough to make any country insolvent
- Lender of last resort can limit the risk for investors
  - Can buy unlimited amounts of government bonds when a solvent country comes under attack
  - Downward spiral of eroding confidence and higher interest rates will be abolished
  - Lender might act if interest rates reach high levels

Institutional reform (II)

- ECB acts as lender of last resort
  - ECB has already purchased Italian and Spanish bonds, most important creditor for Greek debt
  - Decision processes more efficient compared to other institutions (EFSF/ESM)
- Generates moral hazard problem
  - Deficit countries bailed out by the monetary union
  - Might even lead to a faster accumulation of debt
- Improved incentives for fiscal consolidation
  - Reliable fiscal framework based on rules (debt brake)
  - Fiscal coordination to reduce moral hazard effects