



EURO CRISIS OR FISCAL CRISIS: LOOKING FOR THE RIGHT DIAGNOSIS AND THERAPY

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The perspective of new global crisis?

The world economy and, in particular, Europe, seems to enter the new phase of serious macroeconomic and financial turbulences which, most likely, will result in an output slowdown. It remains to be seen whether this slowdown¹ will evolve towards a second ‘dip’ similar to that of the second half of 2008 and first half of 2009. Very much depends on the right diagnosis of the current troubles and right therapy.

Unfortunately, the public discussion on both causes of the crisis and potential remedies are sometimes misleading and overdramatize policy choices which does not help in taking right decisions. It is driven by short-term interests of financial market participants who want to minimize their potential losses and look for another generous bailout at the expense of taxpayers, media hunt for breaking news, and politicians wanting to remain on the top of events and be heard by the media.

In addition, most governments are reluctant to adopt sufficient long-term corrective measures, which may involve high political costs in the short run. As the crisis is currently centered on the euro area and European Union the reforms shall also involve some changes in the EU/EMU institutional design, including, additional transfer of political power from a national to Union’s level. This makes things even more complicated as the issue of national sovereignty remains sensitive in several EU member states. On top of this, there is no intellectual consensus on both crisis origins (a common currency project vs. unsustain-

able fiscal policies) and optimal design of fiscal and macroeconomic management within the single currency area.

Many analysts and commentators speak about the euro crisis but this is not a right diagnosis, at least not yet. A currency crisis can be defined as a sudden decline in confidence in a given currency, leading to a speculative attack against it and resulting in its substantial depreciation. Nothing like this has happened with the euro so far. Instead we observe a sovereign debt crisis in a number of eurozone countries and beyond. However, it may happen that wrong diagnosis and therapy may undermine, at some point, the credibility of the euro as the currency. We will return to this question later in this paper.

Fiscal crisis in advanced economies

In 2010 and 2011 the attention of public opinion and analysts concentrated on the fiscal problems of the so-called eurozone periphery – Greece, Ireland and Portugal, more recently on Italy and Spain. However, as can be seen from Table 1, dramatic increase in public debt to GDP ratio was recorded in most EU member states and other major developed economies.

In 2010, according to the IMF WEO statistics, the gross public debt of 12 out of 17 members of the Economic and Monetary Union (all but Estonia, Finland, Luxembourg, Slovakia and Slovenia) exceeded a ‘Maastricht’ limit of 60 percent GDP, and the same situation concerned 2 non-EMU members of the EU (Hungary and Britain). The threshold of 80 percent was exceeded by 8 EU member states: Belgium, France, Germany, Greece, Hungary, Ireland, Italy, and Portugal. Looking at these numbers, the popular perception that eurozone is divided between the fiscally prudent ‘North’ and imprudent ‘South’ looks questionable. Actually, the debt-to-GDP level of Germany and France is not much lower than that of Portugal and much higher compared to Spain. As a result of fiscal deterioration in the largest member states the entire EU debt reached a level close to 80 percent of its GDP

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¹ This contribution has been completed in the first week of December 2011 and reflects author’s perception and understanding of macroeconomic situation at this particular point of time.

Table 1
General government gross debt-to-GDP ratio in EU
and other developed countries, 2007–2012

Country	2007	2008	2009	2010	2011	2012
World	62.1	65.2	75.6	79.3	79.6	80.0
EU	59.5	63.9	74.3	79.8	82.3	83.7
EMU members						
Eurozone	66.4	70.1	79.7	85.8	88.6	90.0
Austria	60.7	63.8	69.6	72.2	72.3	73.9
Belgium	84.2	89.6	96.2	96.7	94.6	94.3
Cyprus	58.3	48.3	58.0	60.8	64.0	66.4
Estonia	3.7	4.6	7.2	6.6	6.0	5.6
Finland	35.2	33.9	43.3	48.4	50.2	50.3
France	64.2	68.2	79.0	82.3	86.8	89.4
Germany	65.0	66.4	74.1	84.0	82.6	81.9
Greece	105.4	110.7	127.1	142.8	165.6	189.1
Ireland	24.9	44.4	65.2	94.9	109.3	115.4
Italy	103.6	106.3	116.1	119.0	121.1	121.4
Luxembourg	6.7	13.6	14.6	18.4	19.7	21.5
Malta	61.8	61.3	67.3	67.1	66.3	66.1
Netherlands	45.3	58.2	60.8	63.7	65.5	66.5
Portugal	68.3	71.6	83.0	92.9	106.0	111.8
Slovakia	29.6	27.8	35.4	41.8	44.9	46.9
Slovenia	23.4	22.5	35.5	37.3	43.6	47.2
Spain	36.1	39.8	53.3	60.1	67.4	70.2
Non-EMU EU members						
Bulgaria	18.6	15.5	15.6	17.4	17.8	20.5
Czech Republic	29.0	30.0	35.4	38.5	41.1	43.2
Denmark	34.1	42.2	41.8	43.7	44.3	45.8
Hungary	66.1	72.3	78.4	80.2	76.1	75.5
Latvia	7.8	17.1	32.8	39.9	39.6	40.5
Lithuania	16.9	15.6	29.6	38.7	42.8	44.6
Poland	45.0	47.1	50.9	55.0	56.0	56.4
Romania	12.7	13.6	23.9	31.7	34.4	34.4
Sweden	40.2	38.8	42.8	39.7	36.0	32.6
UK	43.9	52.0	68.3	75.5	80.8	84.8
Other developed countries						
Canada	66.5	71.1	83.3	84.0	84.1	84.2
Japan	187.7	195.0	216.3	220.0	233.1	238.4
US	62.3	71.6	85.2	94.4	100.0	105.0

Note: blue fields indicate IMF estimates/forecasts.

Source: International Monetary Fund, World Economic Outlook Database, September 2011.

and the eurozone – above 85 percent. Outside the EU situation looks even worse with the US gross public debt approaching quickly the level of 100 percent of GDP and Japan's – well above the level of 200 percent.

The debt dynamics have been even more worrying: during the crisis period (2007–2010) the global gross public debt to GDP ratio (including developing countries which perform much better) increased by 17.2 percentage points of GDP. The EU recorded an increase by 20.3 percentage points and the eurozone – by 19.4 percentage points.

The short-term perspective does not look rosy either. According to the IMF forecast of September 2011 in all highly indebted countries except Belgium, Germany and Hungary the situation is going to deteriorate further in 2011–2012 and one must remember that this forecast has been built on relatively optimistic growth assumptions which, most probably, will have to be revised down.

Summing up, as seen in December 2011 the current macroeconomic and financial turmoil has been caused by a widespread fiscal crisis which affected most of the developed world and the largest economies such as Japan, United States, Italy, France, Germany, Canada and Britain. Contrary to popular perception this is not the phenomenon limited to the eurozone periphery and to the eurozone itself. The only factor which is specific to the EMU concerns uncertainty of the debt resolution mechanism, i.e. how the burden of debt restructuring will be eventually shared between the country affected by the debt crisis and their single currency partners and which part of this burden will have to be absorbed by private creditors.

However, the above uncertainty has not resulted from the Treaty itself. The Article 125 of the Treaty of the Functioning of the

European Union is quite clear in this respect: it prohibits any direct bailout of member states. Rather it has been the effect of an *ad hoc* policy of providing the EU member states in trouble with partial rescue packages (very often against the no-bailing-out principle), conducted under the pressure of financial markets to avoid their panic and broader contagion effect.

Why financial markets became so nervous?

The recent change in attitude of financial markets to sovereign debt solvency of many developed countries

results mostly from the rapidly changing global macroeconomic and financial environment. In the pre-crisis period of relatively high economic growth and abundance of cheap finance originating from the surplus savings in Asia and in oil-producing countries lending to governments look relatively safe and attractive. Most countries recorded either gradual decrease or at least stabilization of their debt-to-GDP levels.

The rapid deterioration of the global public debt to GDP level and perspective of slower GDP growth in a medium term means that financing becomes relatively more expensive and difficult to obtain. There is an increasing global competition for scarce financial resources both between private and public sectors (the former being crowded out by the latter) and within the public sector itself. Countries with uncertain macroeconomic and fiscal perspectives are losing to those with a more solid credit reputation. However even those who were considered by financial markets as safe havens not so long time ago have now a good reasons to fear about their credit ratings and debt sustainability perspective. With low growth or no growth in the next few years their debt-to-GDP level will continue to grow rapidly putting their debt solvency perspective under question. As a result, the perception of the 'safe' debt level (or the threshold of debt intolerance – see Reinhart and Rogoff 2009) is changing rapidly leading to massive sovereign rating downgrades and capital outflows from public debt market of individual countries.

This has also an impact on the debt sustainability perspective within the EU and eurozone. In the pre-crisis environment investors might expect that in case of isolated debt service problems, faced by countries with the highest debt-to-GDP ratios like Greece, other EU/EMU members will have enough fiscal room to provide them a rescue package (even if such expectations went against the Article 125 of the TFEU). Now when most of EU countries, including France, Germany and Britain face serious fiscal challenges themselves and there are more candidates for actual or potential rescue this kind of assumption is not justified anymore.

The additional constraints come from continuous financial deleverage in many countries (as result of bursting bubbles in 2007–2008) and from the regulatory reform in the banking sector (especially increasing capital adequacy ratios and liquidity requirements) which make lending more scarce and expen-

sive, other things being equal. If the idea of new banking or financial transactions tax materializes it will add to lending costs even more and will further slow economic growth.

Causes of the sovereign debt crisis

Which factors led to such unprecedented deterioration of fiscal accounts in most of developed countries? The recession of 2008–2009, high costs of financial sector rescue and resulting high budget deficits played, of course, an important role. However, the negative fiscal trends in all major economies started earlier – either at the beginning of 2000s (the United States and most of the EU) or in 1990s (Japan). In case of the United States these were the costs of the war on terror and generous tax incentives aimed to overcome consequences of the dotcom recession in 2001. In case of Japan this was the effect of long stagnation in 1990s, subsequent unsuccessful attempts to reactivate the economy through aggressive fiscal stimulus and costs of banks restructuring after the 1990 financial crisis. Finally, in the EU this was a combination of the slowdown (similar to that of the United States) and relaxation of fiscal discipline in early 2000s.

During the boom years of 2003–2007 policymakers were overoptimistic about the long-term potential growth of their economies and largely forgot about adverse fiscal consequences of forthcoming population aging. They were also misled by the unexpectedly high revenue elasticity of this particular business cycle. In the boom years budget revenue in several countries grew much faster than nominal GDP, a trend which was then abruptly reversed when the 2008–2009 recession started. The nature of these windfall revenues requires a more in-depth analysis.

In the wake of 2007–2009 crisis the costs of financial sector rescue have been largely underestimated and potential of a countercyclical fiscal policy – overestimated. These are the important lessons for the future.

In the globalized economy any fiscal stimulus has tendency to 'leak' outside a given economy.² The cross-border coordination of fiscal stimuli, even within the EU, proves problematic for many reasons (see Dabrowski 2010). In addition, in the environment of

² Unless it is accompanied by protectionist measures. Fortunately, the incidence of protectionist measures during the 2008–2009 recession was limited, especially within the EU.

excessive private and public indebtedness economic agents prefer to increase their net saving rather than spend more. As a result, the potential spending multipliers have been smaller than experienced in the previous business cycles.

More generally, the recent business cycle experience gives a good food for thought about limited practical usefulness of such traditional concepts as the potential output and cyclically adjusted fiscal balance (difficult to be estimated *ex ante* when the business cycle is irregular), internationally agreed definitions of public debt (which do not include unfunded liabilities of the public pension and healthcare systems, and contingent liabilities in the financial sector) or even such popular measure as the debt-to-GDP ratio which tell very little about country's long-term fiscal sustainability, especially in good times.

If one analyzes the political economy dimension of the discretionary fiscal policy, its asymmetrical potential becomes very clear. It is politically easy to provide fiscal stimulus but it is much more difficult to withdraw it. The US experience with tax incentives of the Bush era or the 2008–2009 stimulus package, both intended to be only temporary, are very telling here.

The on-going financial sector reform must aim, among many other things, at diminishing future contingent fiscal liabilities. One of the key issues here is addressing a 'too big to fail' problem, i.e. decreasing the market share and political bargaining power of the so-called systemically important financial institutions (SIFI). The reform should also decrease procyclicality of financial sector regulations.

The remedies which will not work

When the 2008–2009 recession started, many analysts and policymakers, especially those who preferred active countercyclical fiscal policies (actually there was no fiscal room for such policies as we discussed in the previous section), believed in gradual growing out of the debt when the economic situation improves. However, in spite of relatively fast recovery since the mid 2009 it did not happen. And this is not a realistic perspective in the foreseeable future. In the second half of 2011 most of developed economies, and Western Europe in particular, entered the period of a new slowdown, perhaps leading to a new recession in 2012.

Even if the current slowdown/recession will be short-living, the economic growth will not come back to the pace of 1990s or mid-2000s. First, as mentioned before, financial deleveraging and financial sector reform will negatively influence growth potential for quite a long time. Second, there are no new substantial growth impulses similar to those which happened in 1990s (peace dividend after the end of 'Cold' war, economic opening of China, India and the former communist countries, global trade liberalization, ICT revolution). Third, both monetary and fiscal policies which stimulated growth in the mid-2000s will have to be more restrictive now.

Another strategy, i.e., inflating out debt may work only to a limited extent (until financial markets start to charge an inflation-related risk premium) and in those countries which do not have substantial debt denominated in foreign currency.³ However, the negative side effects of such a policy – higher inflationary expectations, building up inflationary inertia, price/wage indexation practices and lower central bank credibility – may be serious, long lasting and devastating for both growth perspective and financial stability.

In case of the eurozone it may involve the additional risk of undermining cross-country political consensus around a common currency. Countries less burdened with a public debt and more committed to price stability may consider paying an inflationary price for inflating out others' debts as economically and politically unacceptable. And they may decide to leave the monetary union even if it involves undermining their export competitiveness (because the new currency of the leaving country will probably appreciate *vis-a-vis* the euro).

The opposite case when the country experiencing debt crisis (like Greece) would like to leave and reintroduce its own (weaker) national currency seems highly unlikely because all its outstanding private and public liabilities would remain denominated in euros. Therefore, exiting the euro would mean an immediate default on both public and most private debt, caused by soaring debt-to-GDP ratios. In today's sophisticated and interdependent economies, devaluation is not so obvious medicine as one would have believed thirty years ago in case of developing countries. Furthermore, such an exit could not happen technically

³ Depreciation of domestic currency which may result from a pro-inflationary policy will increase the debt service burden in both nominal and real terms.

overnight and the very first steps in this direction would already trigger total financial chaos and loss of market confidence not only in an exiting country.

This should be remembered by those who use a threat of kicking out trouble countries from the eurozone as the pressure instrument to discipline them. Such a rhetoric may have unintended and devastating consequences in the form of, for example, panic withdrawal of banking deposits, capital flight, etc.

ECB as the 'lender of last resort' to governments

The high costs of leaving the common currency area for any single member country makes the EMU project more sustainable than its critics and forecasters of its quick demise would like to see. Nevertheless, there are limits of this sustainability. As discussed above, failure of the European Central Bank (ECB) to keep inflation low and euro stable can bring us closer to these limits. This should be taken into consideration by those who advise the ECB to declare unlimited and unconditional purchase of debt instruments issued by the eurozone governments in case of market distress (see e.g. Bofinger and Soros 2011).

The idea that the ECB may serve as the 'lender of last resort' (LOLR) to governments is deeply flawed and based on doubtful theoretical foundations. Central banks can play such a role in respect to commercial banks supplying them with temporary liquidity to avoid depositors panic.⁴ In practice, it is often difficult to distinguish bank's illiquidity from its insolvency (see Goodhart 1987). This is even more true in case of a sovereign debt where market perception of government's solvency is conditional on various *ex ante* assumptions hardly verifiable and subject of multiple equilibria.

Thus calling the ECB to play the role of LOLR on the sovereign debt market means no less than asking this institution to monetize government debt and print money without limits.⁵ This may be the shortest path from the debt crisis Europe is facing now to the gen-

uine euro crisis and collapse of the common currency project.

As for the other forms of bailout, wide-scale ECB's interventions can bring yields on treasury bonds down and improve financial markets' mood for a while. However, apart from their inflationary consequences and undermining ECB's credibility they will create wrong incentives for private investors and encourage moral hazard. The investors who did not hesitate to accept higher risk in exchange for higher yields would receive risk insurance for free.

The solutions which may work

Since the previously discussed remedies are either unrealistic (growing out of debt) or counterproductive (inflationary scenario and ECB involvement) one should consider two other options: fiscal adjustment backed by microeconomic and institutional reforms and debt restructuring. Both are politically and socially painful and both involve substantial negative side effects. However, only these two options offer durable solutions.

Fiscal adjustment, by its nature, addresses the core roots of debt crisis, i.e. allows improving primary fiscal balance and decrease debt service costs. If concentrated on spending reduction rather than on rising taxes and backed by well-designed microeconomic and institutional reforms (for example, rationalizing welfare programs and increasing elasticity of labour market) they may increase a country's growth potential in a medium-to-long run. However, the short-term output and employment costs (and therefore additional negative fiscal shock) are hardly avoidable.

Furthermore, as other developed economies must do the same, one may expect slower global growth in a short term. No substantial demand support can be expected from emerging markets because most of them will have to struggle with their macroeconomic overheating.

In some cases like Greece the debt burden is so high that fiscal consolidation although necessary is not sufficient to return the country's solvency. This is why debt restructuring must be also considered as the part of adjustment package. Obviously, this is a costly solution for lenders and involves other negative side-effects. For example, it may trigger a cross-border contagion on sovereign debt market and in the entire

⁴ This is the consequence of fractional reserve banking system with less than 100-percent reserve requirement and with its imminent mismatch between long-term assets and short-term liabilities.

⁵ The frequent references to quantitative easing (QE) operations conducted by the US Federal Reserve Board, Bank of Japan or Bank of England are incorrect for at least two reasons. First, the above banks purchase government bonds on secondary market (apart from other kinds of financial assets) within the quantitative limits set from the point of view of monetary policy goals. These purchases are neither unlimited nor unconditional. Second, the ECB has also conducted QE operations increasing its monetary base when it has considered necessary from the monetary policy point of view.

financial sector. However, it is sometimes unavoidable. The sooner it is done in an orderly fashion (i.e., through negotiations of all interested parties) the eventual cost of debt restructuring will be smaller. Excluding this option up front, as some governments try to do, is neither realistic nor creating right incentives for both creditors and borrowers. And negotiated debt restructuring or even unilaterally declared ('messy') sovereign default of any eurozone country does not mean breaking up the common currency area. Economic history gives us several examples of sovereign defaults under the gold standard (see Reinhart and Rogoff 2009) or in individual US states (see Gros 2010) which caused neither monetary nor political disintegration.

What kind of fiscal union?

Part of the discussion concerns the reform of EU institutions to increase Union's capacity to deal with the current crisis and minimize danger of its repetition in future. In this context many speak about the necessity to complement the EMU with the fiscal union. However, less clear is what such a fiscal union means in practice.

Definitely, the EMU needs more fiscal discipline on the national level⁶ to minimize the risk of free riding under the umbrella of common currency which has been one of the principal causes of the current crisis. However, fiscal trouble of non-eurozone EU members will also have negative repercussions for both the Union and outside world. Hence, fiscal stability and prudence should be considered as an important European public good and apply equally to all EU members regardless whether they are part of the eurozone or not.

In this context the effort to strengthen fiscal surveillance rules in the Treaty and Stability and Growth Pact and reinforce their both 'preventive' and 'corrective' arms (including automatic and meaningful sanctions) are going in the right direction. The same can be said about attempts to push member states towards enhancing their national fiscal rules and institutions either through constitutional changes or equivalent legislation.

Another step towards strengthening EU fiscal federalism involves building a permanent debt resolution

mechanism on the EU level the European Stability Mechanism (ESM) which will replace the European Financial Stability Facility (EFSF), the temporary mechanism established in May 2010. The ESM is to start its operations in mid-2012.

Ideally, the permanent resolution mechanism should correctly balance punishment for past irresponsible behavior (including the orderly sovereign default/restructuring mechanism), incentives to correct past mistakes and elements of financial aid to smooth the painful adjustment process. It should also relieve the European Central Bank from its current engagement in assisting countries in trouble. It remains to be seen whether the ESM will meet these expectations.

Regretfully, not all proposals go towards strengthening fiscal discipline and eliminating moral hazard and free riding. This refers to the idea of Eurobonds,⁷ which are to be jointly issued/guaranteed by the EMU members. They can lead to weakening fiscal discipline on national level and creating adverse incentives rather than serving fiscal consolidation and avoiding moral hazard. The practice of fiscal federalism in many countries gives an evidence of negative consequences of sharing responsibility for the debt of subnational governments with federal/national authorities.

Some other 'federalist' ideas are interesting but do not necessarily address the challenge created by the sovereign debt crisis. The proposal of harmonizing tax bases and (more controversially) tax rates across the EU should be discussed in the context of functioning of the Single European Market rather than crisis prevention and resolution. The same relates to the proposal that in future the EU budget should be higher than the current 1 percent of Union's GDP. Perhaps it does, but this depends on which additional policy tasks and responsibilities could be transferred from the national to the EU level and whether such a transfer would offer bigger efficiency in their implementation.

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⁶ First time this idea was presented publicly soon after launching the Euro in Giovannini *et al.* (2000) report. Recently the European Commission (2011) analyzed in its Green Paper three potential options of the so-called Stability Bonds.

⁶ The EU runs a balanced budget so the problem of fiscal discipline on the Union level does not exist.

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