European economic policies: what can be done ?

Jacques Mazier, September 2011[1]

Imperfect compromise followed by a new crisis

Measures adopted at the european summit on 21 July 2011 bought time in respect of the severe crisis which had afflicted the eurozone since 2010. These measures represented significant progress on many points including participation of private creditors in the reduction of Greece's debt, increases and extensions of loans to Greece at lower rates, guarantees by member states enabling the ECB to make cautious purchases of Greek securities, expansion of the role of the European Financial Stability Facility, support for ECB purchases of debt of countries in difficulty in the secondary market, participation in recapitalisation of Greek banks (if required), possible preventitative support for other countries in difficulty, half-hearted recognition of the need to support economic growth.

The compromise included a strictly limited element of default on the Greek debt.

Observers were under no illusions about durability of the compromise. Agreement that participation of private creditors would not be applicable to other member countries made the initiative look thin and served to increase concern about the debt of other countries. The most crucial step from many people's point of view, mutualisation of european debt and the issue of eurobonds, was not agreed. This could have made a cheaper and more substantial contribution to aid countries in difficulty and would have reduced risks of contagion. Although such an initiative, combined with the establishment of a European Monetary Fund, would have been welcome in some quarters it was not forthcoming.

The eurobond proposal itself was subject to significant limitations. The scheme would only have covered part of the outstanding debt of each member country (up to 60% of GDP) leaving residual uncertainty about additional debt which would be subject to market pressures. There was no prospect of mutualisation for all european debt. At the same time, although partial, the eurobond proposal included a requirement for ex ante control over national budgets. This was a major political issue on which there was no agreement at the time. A similar problem arises in the case of an unrestricted commitment by the ECB to purchase debt of countries subject to excessive market pressure - the "atomic bomb" solution that could in principle have calmed the markets once and for all.

Proposals like the above ran into the opposition of Northern European countries led by Germany which are unwilling to finance countries in difficulty without recompense. Northern countries are not ready to pay any additional cost on their own debt even if this is clearly limited. They consider higher spreads on debt issued by different eurozone governments to be a necessary incentive for improved management.

The european crisis returned at the beginning of August after the downgrade of US debt and questions about the sustainability of global recovery. Spreads increased further and higher rates began to affect Italy. A stock market relapse affected european banks already exposed to risks of default in South Europe. The European Financial Stabilisation Facility was not yet operational and difficult negotiations were in progress with Finland and Austria. The situation was eventually settled by ECB intervention in the form of purchases of Spanish and Italian securities. But the Franco-German summit on 16th August revealed a state of paralysis with

[1] (translation by Francis Cripps)

discussion of stronger european supervision and above all a hardening of policies of restraint. Policy hardening may have been intended to contribute to reduction of public deficits but it worsened the climate of economic activity and made adjustment more difficult.

Restructuring of Greek and Portuguese debt now appeared inevitable. The issue was whether this would be achieved in an orderly or chaotic manner. In any case defaults would not eliminate structural imbalances within the eurozone given the extreme heterogeneity of its member countries. Therefore viability of the eurozone itself came into question.

Intra-european imbalances

The monetary union which was expected to generate stronger economic growth rested on a fundamentally flawed model. Without changes in exchange rate parity there was no adjustment mechanism to correct divergent performance of the economies of member countries which results from their considerable heterogeneity. No federal budget or guarantee system was put in place. The fact is that there was no political majority in favour of such policies.

The idea that closer financial integration would provide sufficient stabilisation mechanisms through internal capital transfers was promoted by the ECB and the Commission in the 2000s (Trichet 2007, European Commission 2007, Asdrubali and Kim 2004). Intra-zone credits and income on capital from the remainder of the European Union would play a sufficient stabilising role to compensate for lack of a federal budget. But the thesis of international risk sharing proved false. Benefits to stability from closer financial integration were minimal and in the face of financial crisis integration has magnified the problems (Duwicquet and Mazier 2010).

What remains in the eurozone is adjustment through relative price changes, in particular for weaker countries, reductions in prices and pay together with cuts in employment and budgetary austerity. Such mechanisms are at best only effective in reducing imbalances in the long run. They have unequal effects on different countries and result in low growth and increased unemployment. They are the less effective the more widely they are implemented in a group of interdependent countries, albeit somewhat more effective if the countries where they are implemented are very small. Austerity was the policy stance implemented in France in the second half of the 1980s under the banner of competitive disinflation. The outcome in France's case was mediocre. Inflation was reduced but the economy was mired in slow growth and mass unemployment. There was no long-term cure. France in 2010 exhibits the same structural problems of weak competitiveness as thirty years before. Reductions in prices and pay were also followed in Germany in the 1990s to deal with problems arising from German reunification. This is now the policy imposed on Greece and other countries of South Europe. The results are unsurprising: reduced output, cost-cutting and increased unemployment with at best a slow and difficult reduction in budget deficits as revenues diminish. Irrespective of weaknesses in the tax sysem, difficulties experienced by Greece in meeting its budget targets are hardly surprising.

The situation within the eurozone reflects one important fact. The zone as a whole has a more-or-less balanced current account with lower government deficits than other OECD countries. The euro, considered globally, is near its equilibrium parity. Devaluation of the euro might facilitate recovery in Europe but only at the expense of other world regions. It would be a unilateral policy without any objective rationale and one which would aggravate global imbalances. Yet internal imbalances within Europe are considerable. The euro is strongly over-valued from the perspective of countries in South Europe, including France, and under-valued for countries in North Europe, in particular Germany (Jeong, Mazier and Sadaoui 2010). The degree of misalignment within the eurozone may be debated but there can be no

doubt that in the theoretical event of a breakup, the German euro would appreciate substantially while Spanish, Portuguese and Greek euros would depreciate strongly. Estimates of the degree of misalignment are substantial: in 2010 the Spanish and Greek euros were overvalued by between 20 and 40%, the Portuguese euro by 20 to 30% and the French euro by 15% while the euro mark was undervalued by 20%.

Misalignments of competitiveness within the zone bloc economic growth and increase government deficits and current account deficits in the South. Growth in Northern Europe is maintained by exports to the rest of the eurozone, facilitating reduced deficits. German trade surpluses vis-a-vis Spain, France and Italy averaged 3% of GDP at the end of the 2000s. Such imbalances implied substantial transfers of income from the South to the North. One could estimate that a 10% overvaluation is equivalent to a transfer of between 3 and 5% of GDP, depending on the openness of the economy. Undervaluation like that experienced by countries in the North is the mirror image. In effect and allowing for multipliers Spain, Portugal and Greece are penalised by negative transfers equal to between 5 and 10% of GDP, France by a negative transfer of 8% while Germany benefits from an inward transfer equivalent to 10% of GDP.

Income transfers resulting from misalignment of costs are strangely ignored in political discussion. In principle they might be used to justify the introduction of budgetary transfers of the kind found in federal systems rather than financial transfers which have been adopted by the eurozone. Fiscal transfers provide a stabilising role in the case of a negative shock in any member country and help to compensate for cost differences between member countries. We shall return to this issue later but the point here is that a system of fiscal transfers is rejected by countries of North Europe for reasons that can readily be comprehended. At the same time these countries believe adjustment of the price level, although costly, is more effective than we have credited above.

Examples

The Baltic countries whether eurozone members as Estonia has been since January 2011 or having a euro-based currency board, are often put forward as examples of cost adjustment. Confronted by large current account deficits and lesser government deficits, the Baltic countries achieved substantial internal devaluation. Production fell by 10-20%, pay and prices were cut and high unemployment followed but current accounts were restored and budget deficits were reduced by spending cuts and reductions in the pay of government employees. In 2011 vigorous export-led growth resumed. Several specific characteristics of the Baltic countries explain the success of their adjustment, notably flexibility of their labour markets compared with 'old' countries of South Europe, the small size and high degree of openness of their economies (47% as compared with 26% for Portugal) and the relatively low weight of their internal markets which made cost adjustments more effective and less costly in their impact on demand. Their public debt, inherited from the period of transition, was already much reduced which considerably lowered the cost of debt adjustment. Similar if less substantial developments took place in Slovakia (67% degree of openness).

Internal adjustment is the model that european leaders seek to impose on countries in South Europe. But Greece, Portugal, Ireland and even more Spain are less open and have larger domestic markets. Having more complex economic and social structures these economies have less capacity to adapt. Their banking sectors are more fragile and their public debts heavier. The proliferation of austerity policies slows economic growth in the eurozone as a whole and limits the possibility of an export-led recovery, so much the more to the extent that Spain, Italy and France, are affected or threatened. The strategy of internal devaluation combined with budgetary austerity has a strongly negative impact in terms of growth and

employment and could only be effective in the long term, especially if put into effect in the larger countries.

Germany's own experience has to be considered along two axes. On the one hand reunification in the 1990s was a very costly process resulting in significant escalation of prices and costs which jeopardized German competitiveness, albeit reputed to be relatively less sensitive to costs. Between 1991 and 2001 the current account of Germany moved into deficit. In this period instead of achieving a surplus of 5% of GDP as in the 1980s West Germany transferred the equivalent of 5% of its GDP (nearly 40% of East Germany's GDP) to restructure the East German economy. The latter, already in a bad state before reunification, had seen its productive capacity collapse with an unrealistic one-to-one conversion rate for east marks to west marks, chosen against the advice of the Bundesbank for political reasons. Thus Germany put into effect massive transfers and other assistance to compensate for the overvalued exchange rate in the East. The results were mixed. Twenty years after reunification infrastructure in East Germany is on a par with the West but unemployment in the Eastern lander is higher and productivity remains lower than in the West.

On the other hand in the 1990s with the repercussions of reunification and up to the launch of the euro in 1999, the mark was overvalued which hindered the German economy as a whole, traditionally orientated to exports. It is in this context that a set of liberal reforms was initiated (l'Agenda 2010) in 2002 in Chancellor Schroeder's second term with the aim of restoring the German model. Reforms included a disguised devaluation with a 2 point increase in VAT financing a reduction in social contributions. The German labour market was made more flexible with stagnation of pay and an increase in the number of insecure jobs. Social protection was reduced. This dose of austerity blocked German growth and contributed to mediocre performance of the european economy throughout the decade. But costs of production reduced and competitiveness was restored. Together with restructuring and relocation of industries to Eastern Europe this allowed the German economy to recover its momentum. After having been badly affected by the global crisis in 2008-9 German industry profited from the subsequent recovery as a supplier of machines and equipment to emerging markets. Yet however enviable German performance may be this must be put in perspective. Germany has deficits vis-a-vis China, Brasil and Japan. It achieves most of its surplus in trade with South Europe, Spain, Italy, France and the US, taking full advantage of under-valuation of the German euro which is an outcome of the eurozone. All this doesn't stop adjustment of the German economy in the past decade being put forward as an example. From a state of over-valuation in the late 1990s the mark, converted to euro, became under-valued. Thus it is argued that the strategy of internal devaluation worked, even when applied to a large country whose reputation lies on non-cost factors. It should follow that Southern European countries in difficulty have only to follow the same path.

But this line of argument ignores several important points. The duration of the adjustment process for a large country is of the order of decades unless they are very open (this does not apply to Greece or Portugal even though they are small countries); the social cost is high in terms of reduced purchasing power, insecurity and unemployment; the policy is less effective and more costly if it is applied simultaneously in interdependent countries; growth is reduced in a cumulative manner and problems of public debt are exacerbated.

Europe at an impasse

The European system and more particularly the eurozone is at an impasse. The European public debt crisis is in fact the logical outcome of 25 years of liberal policies applied in an indiscriminate manner. Attacks of financial markets on countries in South Europe whose position is correctly judged to be unsustainable reflect this situation.

The strategy of european governments has two aspects. On the one hand austerity policies are required to bring about internal devaluations (meaning reductions in pay, employment and prices) and cuts in public deficits. On the other hand cautious implementation of new institutions and operating rules is undertaken in successive, circumscribed steps to provide strictly necessary funding to the countries in difficulty. Oversight of budgetary policies has been reinforced at the european level in a reform of the stability pact that introduces new indicators (in particular the current account deficit and public debt) and a new "first half" procedure for framing national budgets.

The way ahead is narrow and the process of institutional reform is incomplete. Everything conspires to limit growth, particularly in South Europe, making management of public debt problematic although it is precisely this which commands the most attention. If pursued to the end the current strategy will result in a new economic geography to the profit of North Europe and detriment of the South. The policies can only be understood from the perspective of the european elite, the governing class and technocracy, which is taking advantage of the crisis to proceed further in the implementation of liberal policies. The recommended policies include a reduction of social expenditures that has the effect of increasing inequality and obliging households to rely more on private insurance, a stricter budget framework that reduces the role of the state and state expenditures on education and research, the continuation or resumption of privatisation, rejection of fiscal harmonisation at the european level to protect income from financial wealth, high salaries and property in general which benefits from tax concessions and increased labour market flexibility. The new policies discount the case for stronger regulation of the financial sector whose liberalisation since the 1980s was at the heart of disequilibria over the past two decades.

In truth even the european elite has some doubts about the viability of the current strategy. Tensions increased after the US debt crisis in July 2011 exposed the risk of renewed recession in the US and industrial countries. Some expect that new steps in a federalist direction could be taken in Europe in response to the current relapse. Federalism could take various forms: mutualisation of european debt through eurobond issues up to a certain threshold; creation of a european ministry of finance to coordinate and plan national budgets as suggested by the ECB president; unrestricted purchases by the ECB of securities of countries in difficulty. Bankruptcy of countries in the South (Greece in first place) would not leave any other choice except default on government debt which should best be managed in an orderly manner before time runs out. The risk that the crisis may spread to large countries (Spain and in particular Italy since the summer of 2011) has become clear with rising interest rates and a relapse of economic activity. France whose mediocre fundamentals are reflected in franc euro over-valuation is not sheltered from similar pressure.

Proposed responses to this situation do not match up to the problems at hand. Eurobond issues may be helpful but only provide a partial solution that needs to be combined with other measures: adjustment policies may permanently obstruct growth; default in some countries may lead to banking crises in others. ECB purchases of securities of countries in difficulty could in principle provide a more global response but it is already late in the day as the bankruptcy of some countries is already too obvious. Moreover the Fed's experience of large-scale quantitative easing has demonstrated limited effectiveness. With economic growth failing to match expansion of the Fed's own balance sheet the latter looks increasingly unbalanced. If the ECB were to undertake unrestricted purchases of securities of countries in difficulty the only possible recompense would be increasingly strict control of budgets which raises several problems both in principle and in practice. The ECB can be brought in to deal with a sudden crisis (as was the case in August 2011 after the convulsion provoked by

downgrading of the US debt) but such intervention will not provide a long-term solution if growth fails to restart.

The underlying idea that financial initiatives (eurobonds, ECB purchases, sovereign default of the worst-affected countries) are sufficient to overcome the eurozone crisis in unconvincing. The present crisis arises from structual disequilibria linked to heterogeneity of member countries and permanently asymmetric patterns of development. It has proved difficult or impossible to combine countries as different as Greece, Portugal and Germany in the same currency area. This is well illustrated by the scale of imbalances in internal exchange which characterise the eurozone. Internal devaluations are costly, hard to achieve and limited in their effect as was demonstrated by the experience of France which followed such policies consistently from the mid 1980s with mixed effects except in the second half of the 1990s when France benefitted from German cost escalation.

Financial federalism is an insufficient response yet over the past decade the ECB and European Commission repeatedly proposed that deeper financial integration at the european level would provide sufficient mechanisms of adjustment (through flows of credit and international diversification of porfolios) to render fiscal federation unnecessary. But the facts were otherwise. Eurobond issues, mutualisation of public debt and unrestricted ECB purchases of securities of weaker countries are now proposed and some people add restructuring and partial cancellation of the debt of the most affected countries to the package. Although such measures are useful and even necessary at the present time they do not provide a long-term answer to problems arising from heterogeneity of the eurozone. The european system is in this sense fragile and this itself contributes to the frequency of speculative attacks.

Two short-term factors come into play with the renewed global crisis (even less growth and risks of higher rates to come). On the one hand bankruptcy of countries in South Europe is worsened. It will doubtless render inevitable the restructuring of Greek and Portuguese debt, difficult to manage because this may provoke a crisis of banks facing major losses and a new hiatus in the interbank market. On the other hand pressures will increase on larger countries such as Spain, Italy and France whose fundamentals are not good for a variety of reasons. When it comes to the larger countries rescue mechanisms implemented at the european level will not be sufficient. Although some voices, including that of the president of the Commission, have started to insist on an increases in resources of the European Financial Stability Facility, Germany has immediately reserved its position.

Strong political determination to mobilise and augment tools already implemented may be capable of containing the european pressure cooker. Nevertheless there are considerable obstacles to action: arguments about burden-sharing among countries each considering its own interest; social and political costs of austerity measures that make them unpopular; lack of a medium-term recovery perspective unless it comes from outside the eurozone (emerging markets ?).

In the short-to-medium term everything combines to cause a cumulative reduction of growth. Current imbalances, public debt and degradation of the ECB's balance sheet, may be difficult to correct. After a major financial crisis resumption of growth is far from being self-evident. The case of Japan since the early 1990s is well known. The crisis of the 1930s is equally instructive as it was only german rearmament from 1933 onwards and that of the US after 1938 that effectively restarted the system.

In this context a breakup of the eurozone cannot be excluded. Unsustainable institutions do not survive for ever as demonstrated by the Argentine currency board in 2001, the EMS in 1992-3 or devaluation of the pound in 1967 and of the dollar in 1971, to quote a few examples. Breakup of the eurozone would obviously have a huge political fallout unless

handled softly. Assuming that a small eurozone would survive around Germany, the main issue is whether France and Italy would be within or without. The cost of remaining would be high because the smaller euro would appreciate substantially.

Alternatives

Alternative policies are frequently discussed but do not make up a coherent, identifiable package. The way out has to be a growth strategy rather than increasing austerity. Regulation of financial markets is required to escape from the problems of the 1990s and the past decade. Objective difficulties facing coordination of economic policy and the idea of "european economic government" have to be recognized. Most important of all, an effective system must be established to deal with problems of countries in South Europe most affected by overvaluation and deep, long-standing imbalances.

A european growth strategy has to mobilise the potential for growth in countries that have undervalued currency and a small public debt, with Germany in first place. Corrective measures would include an immediate increase in pay to reduce undervaluation. Growth of the european economy must be restarted by investment programmes in areas such as education, research, infrastructure for sustainable development and revitalisation of the suburbs. A european system must be established to restore the capability for public intervention in cooperation with the private sector. Investment programmes could be financed partly by issues at the European level (eurobonds) and partly by credits refinanced by the ECB which it must be assumed will continue to evolve the institutional framework. Debt reductions will be achieved by surpluses resulting from economic recovery and tax increases reversing some of the concessions awarded since the 1990s to income from wealth and the most favoured social categories.

Coordination of economic policy and the concept of "european economic government" conflict with national interests and the fact that social and political activity in Europe is focussed at the national level. For more than 20 years dreams of coordination and "european economic government" have given rise to pious hopes and a number of ineffective academic studies. In practice institutional complexity makes coordination difficult and inefficient and it may be better to recognize this fact. "European economic government" could in principle be effective in limited areas such as budget surveillance as suggested by the president of the ECB but this is not the objective that we will discuss here. "European economic government" in the proper sense implies organised expansion and can only be implemented effectively through explicitly federal institutions.

The federal approach to finance has progressed with growing interest in eurobond issues and expansion of the European Financial Stability Facility as well as ECB intervention to purchase securities of countries in difficulty. But these innovations are insufficieint to deal with the imbalances confronting the eurozone.

The question of a federal budget cannot be put aside. Although there is no political majority in Europe for such a direction an objective justification for fiscal transfers between eurozone members may be found in the scale of imbalances in exchange within the zone that as we have seen imply large transfers from the South of Europe to the North (currently of the order of 10% of GDP of Spain, Portugal and Greece). Such transfers could arguably justify compensatory mechanisms of a federal nature similar to those between German lander. Admittedly the probability of agreement on any such scheme is low. Within Germany transfers between lander are criticized and the outcome of large transfers to the East following reunification is judged to be mixed.

A major expansion of the european budget could nevertheless be considered (up to 5% of GDP from the present 1%) based on new taxes such as taxes on financial trasactions or CO2

emissions and on taxes transferred to the european level on the grounds that they are better justified at this level and to minimize fiscal competition (examples are taxes on income from capital and corporate profits).

The limited size of the current european budget does not allow it to play a significant role with regard to stabilisation and redistribution in the event of uneven shocks. To deal with such shocks an Employment Stabilisation Facility might be established following schemes formerly developed by the Commission (Italianer and Pisani-Ferry 1992). In case of a rise in unemployment faster than the european average, the country affected would benefit from a transfer (automatic or negotiated) from the European budget.

At the social level minimum standards, differentiated by member state, could be fixed for minimum pay, social security and pensions with meaningful definitions and enforcement procedures giving effect to the standards - for example the relationship of pensions to average income per capita. In the framework of the European budget a sum equal to between 0.5% and 1% of Europe's GDP would be pledged to a European Social Fund that would finance social transfers to assist maintenance of minimum standards giving priority to the least advanced member countries.

Besides the above, the concept of large european investment programmes must be reestablished. National industrial policies relying on large projects and public markets have been brought into question by liberalisation, competition policy and technological change. But experience of implementing such projects remains and transposition to the european level could be considered in a number of domains. The first step would be to launch specific investment programmes such as the Gallileo satellite positioning system (restarted in 2002) or the troop transport project. These high-technology projects have had or will have positive impacts and will make a practical contribution to closer cooperation. Such specific projects could be followed by broader programmes with a more structural character such as schemes fields like rail transport, renewable energy and nanotechnology. To overcome obstacles encountered in the past european operators should be designated to take charge of individual projects with independent budgets.

There remains the question of countries in the South of the eurozone most affected by overvaluation and confronted with deep and long-standing imbalances even if their position is to some extent alleviated by a more favourable environment in Europe as a whole. Federal budget transfers are hardly credible in the current situation. To avoid being trapped permanently in the vicious circle in which they now find themselves, a more radical but less costly innovation would be provided by transformation of the euro into a common, convertible external currency with fixed but adjustable parities relative to inconvertible national euro currencies in member states. On this basis it would be possible to devalue Southern euros and revalue Northern euros, putting an end to trade-related transfers from South to North that occur today. Adjustment of intra-european parities would be decided in a concerted manner taking account of structural developments. Such a transformation of the eurozone may be compared with proposals to adapt Keynes's Clearing Union (Amato and Fantacci 2011). Intra-zone imbalances would be financed through the Clearing Union with symmetric treatment of surplus and deficit countries and the possibility of proceeding with parity adjustments in case of necessity.