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Euro Crisis or Debt Crisis?

By Marek Dabrowski

The public debt crisis is not limited to Greece or to the Euro area. In fact, several developed economies face rapidly growing debt-to-GDP ratios, which raise doubts about their long-term solvency. Thus, suggesting that the Eurozone is undergoing a currency crisis or is in danger of disintegration is not the right diagnosis (or at least premature). However, if prudent fiscal policies, fiscal discipline and far-reaching structural reforms are not undertaken soon, both the EU and EMU may face serious internal tensions and obstacles to future economic growth.

This is not a Euro crisis

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. True, the Euro lost a bit against the US dollar and other currencies, but this remained within a "normal" fluctuation range among major currencies over the last few years. There is equally no desire by any country to leave the Eurozone.

In this context the analogies to the demise of the Argentinean currency board in 2001-2002[1] are wrong. The direct cause of abandoning Argentina's currency board was related to insufficient foreign exchange reserves and the Central Bank's inability to defend Argentina's fixed exchange rate (peso to US dollar) against speculative attack. In fact, Argentina did not have a true currency board, which required 100% reserve backing.

The hypothetical exit of Greece (or any other country) from the Euro would require the reintroduction of its own national currency, while all outstanding private and public liabilities would remain denominated in Euros. Therefore, attempts to exit the Euro (which cannot happen technically overnight as an ordinary currency devaluation) would mean, in practice, an immediate default on both public and most private debt, caused by soaring debt-to-GDP ratios and total financial chaos. This would do nothing to repair Greece's debt woes or help any other European economy. In today's sophisticated and interdependent economies, devaluation is neither effective nor believed to be the universal medicine of choice.

…but a standard public debt crisis

Instead of speaking about the Euro crisis one should speak about the public debt crisis. Greece's current fiscal problems are a surprise to nobody as they have systematically accrued over the last 30 years (see Figure 1). Worse, the fiscal crisis is not limited to Greece. Several other countries, not only those within the Eurozone and the EU (see Table 1), have recorded a dramatic increase in their public debt-to-GDP ratios over the last two years. Due to years of fiscal indiscipline, scale of global recession (automatic fiscal stabilizers) and poor design of fiscal stimulus packages, the list of victims includes but is not limited to Japan, US, UK, Spain, Portugal, Ireland, Italy and Hungary.

The current public debt crisis is not a new phenomenon, and as we mentioned above, is not limited to Eurozone countries. The choice of monetary regime has a very limited impact on fiscal accounts. Economic history gives us several examples of public debt defaults both under the gold standard, and fiat currencies, as well as under fixed and floating exchange rate regimes.

Therefore, the debt crisis must be addressed by means of fiscal and structural reforms. Public expenditures must be reduced (including the most costly and wasteful spheres of social transfers), taxes must be more effectively collected and, in some cases, increased. All of these measures are not easy and involve high political costs.

What is promising is that the Greek crisis changed the intellectual perspective towards Europe's fiscal policy challenges. The previous calls for fiscal stimulus have largely disappeared giving way to discussions on fiscal

[1] See e.g. Dadush, U. & Stancil, B. (2010): *Greek Crisis: A Dire Warning From Argentina and Latvia*, Carnegie Endowment for International Peace, International Economic Bulletin, March 3, 2010 http://www.carnegieendowment.org/publications/index.cfm?fa=view&id=40275

adjustment (including such fundamental measures as increasing the retirement age) and strengthening fiscal discipline at both the EU and national levels. This can help overhaul Europe's public finances, which is necessary to avoid future macroeconomic turbulences and ensure economic growth.

Changes in fiscal surveillance rules

The EU's fiscal surveillance rules are based on provisions of the Treaty of the Functioning of the European Union (TFEU, Article 126 and Protocol No. 12) and the Stability and Growth Pact (SGP), i.e. secondary legislation. Unfortunately, both lack the effective sanction mechanisms with respect to those member states (especially large ones) that breach the rules. Worse, in 2005 the SGP was watered down under collective pressure by its major offenders.

After agreeing to a Greek rescue package, the European Commission presented a set of measures aimed at reinforcing the SGP. This included strengthening Eurostat's mandate to audit national statistics (in light of negative experiences with Greece's misreported fiscal data), speeding up the Excessive Deficit Procedure (EDP), particularly in respect to repeated SGP offenders, and tightening financial sanctions such as suspending Cohesion Fund transfers or more rigorous use of EU expenditure to ensure better compliance with SGP rules. The current focus of EDP on fiscal deficit criterion is to be amended, with a greater emphasis on the level and dynamic of public debt and long-term fiscal sustainability. The Commission also offers the idea of the "European Semester", which should provide a mechanism of early peer review (at the beginning of each calendar year) of the Stability and Convergence Programs as well as national draft budgets.

All of these proposals seem to go in the right direction, but they will hardly make a substantial difference in Treaty and SGP enforcement mechanisms. Instead, they will pose a greater threat for smaller and lower-income countries. The former have limited voting power in the Economic and Financial Affairs Council (ECOFIN), the latter are net recipients of EU budget transfers. Making sanctions truly serious and potentially painful for all countries abusing fiscal surveillance rules would require (i) ensuring their automatic (instead of discretionary) character; (ii) going beyond financial fines (which may be difficult to enforce in difficult economic times and when countries require extra financial support). Such additional sanctions could involve suspending voting rights in ECOFIN and perhaps in the Governing Council of the European Central Bank (in cases where Maastricht fiscal criteria are breached). However, this would require changes to the Maastricht Treaty, which do not seem realistic over the next few years.

National fiscal rules

As fiscal policy remains mostly the prerogative of individual EU member states, their national legislations can play a crucial role in tightening fiscal discipline and preventing a future public debt crisis. Several member states have certain fiscal rules written down into their constitutions and ordinary legislation. However, in some cases they have never been tested in practice (like a 60% public debt-to-GDP limit in Poland's Constitution). Some countries have set up special institutions in charge of monitoring long-term fiscal sustainability (like the Fiscal Policy Councils in Sweden and Hungary or the newly created Office for Budget Responsibility in the UK). One may expect that fears of future debt crises will push more countries towards strengthening their national fiscal rules and institutions, including internalizing the EU's fiscal rules. Germany's 2009 constitutional amendment, which limits opportunities to increase public debt both on a federal and state (land) level, is a good example to follow.

Financial markets can also play a positive role in increasing fiscal discipline on a national level. Almost non -existent spreads between yields on government bonds within the EMU and very low spreads in respect to other EU members seem to be gone for good. More generally, risk premia on government bonds will have to be reassessed almost everywhere, against the increasing danger of public debt crisis in many countries. At the moment, financial markets seem to increasingly over-react to default risk premia in peripheral EMU economies. However, in the long-term, a more balanced assessment has a chance to provide the right warning signals to policymakers.

A European rescue mechanism

It is no secret that the EU lacks the fiscal capacity to offer a crisis resolution mechanism on its own. This applies to both systemic banking and financial sector crises (as happened in the fall of 2008) and sovereign debt or balance of payment crises. Designing such a mechanism is not easy both for legal and conceptual reasons. The size of the EU budget does not exceed 1% of total Gross National Income (GNI) of EU member states. Its expenditures are strictly allocated to support major EU common polices such as the Cohesion Policy, Common Agriculture Policy, competitiveness, research, and development aid. The medium-term budget perspective requires a unanimous decision by all member states. In addition, Article 125 of TFEU prohibits any direct bailout of member states.

However, in light of a potential Greek default, these limitations and fears of creating moral hazard incentives have to be put against the dangers of an uncontrolled and highly devastating contagion effect. The latter could involve not only the simple domino effect, i.e. flight from government bonds in other EU/EMU member states such as Portugal, Spain and Italy but also the next round of the European banking crisis (due to banks' high exposure to public debt and the fragility of their balance sheets).

As a result, on May 9, 2010 ECOFIN agreed to establish the European Financial Stabilization Mechanism which consists of €60 billion of the EU's own resources and €440 billion of the Special Purpose Vehicle that is guaranteed on a pro rata basis by participating member states. More importantly, this mechanism is backed by IMF resources. Greece became the first beneficiary of this mechanism (closely coordinated with the standard IMF stand-by loan and its conditionality).

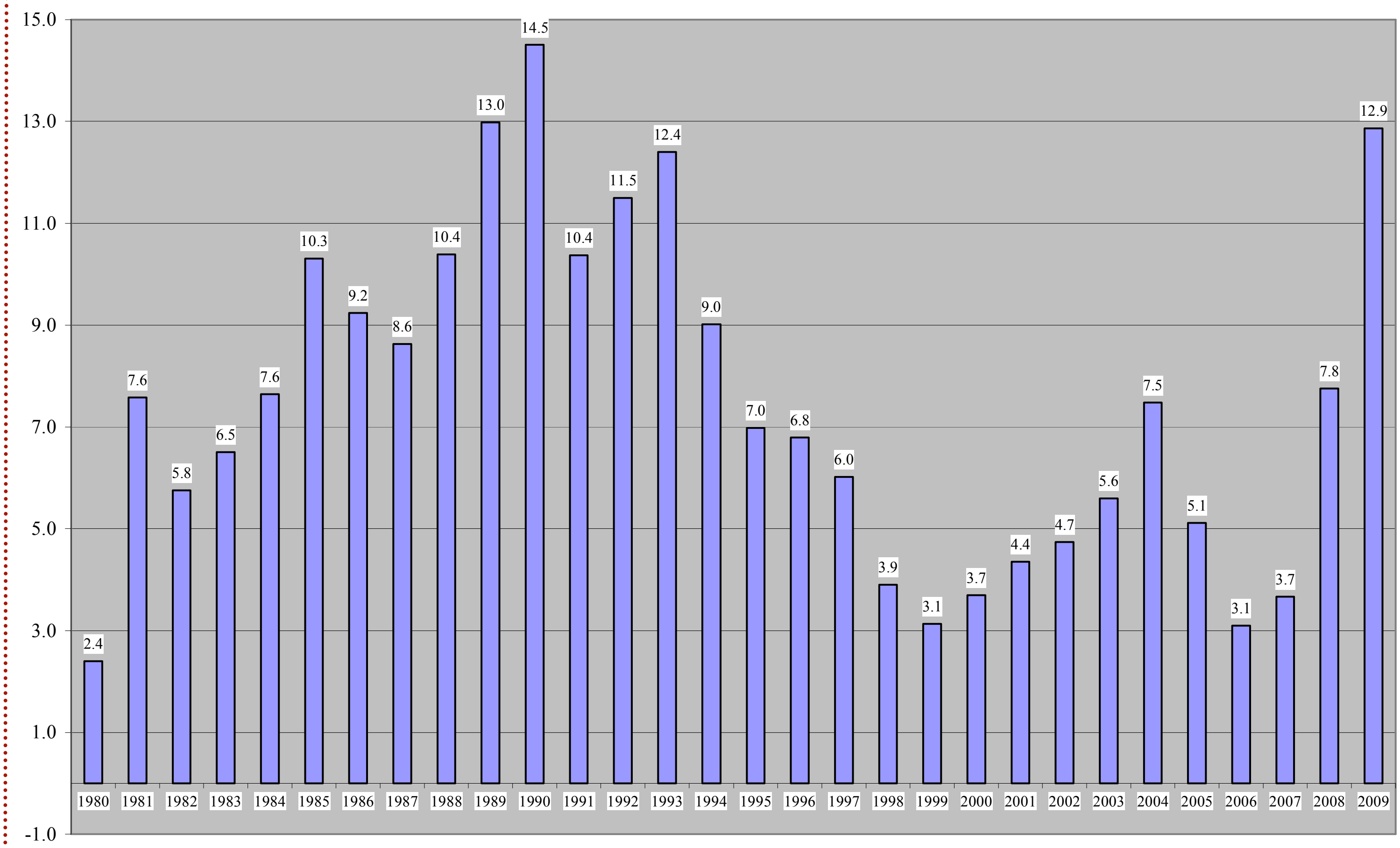
This is, however, only a temporary and emergency solution. In the long-term a permanent crisis resolution mechanism needs to be set up on the EU level, in addition to stronger fiscal surveillance rules. Greece's problems are only the tip, of a rapidly growing EU fiscal liability iceberg. Leaving the rescue operations solely to the IMF is not realistic because of its limited resources and limits to policy conditionality. It will not calm the financial markets in times of distress, as the recent Greek episode (and danger of spillover) clearly demonstrated.

One proposal, which tries to offer not only a rescue mechanism but also an orderly sovereign default mechanism, calls for the establishment of the European Monetary Fund. Another proposal suggests sharing responsibility for part of the public debt within the EMU, but this (like the blue bonds/red bonds mechanism) may raise the risk of moral hazard and requires further discussion.

ECB credibility at stake

Part of Greece's rescue package was provided by the ECB, via government bond market intervention under the so-

Figure 1: Greece's fiscal deficit (general government net borrowing) in % of GDP, 1980-2009



Source: IMF WEO Database, April 2010

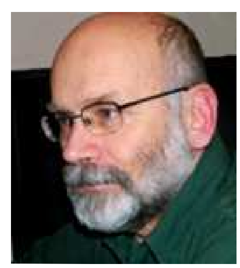
Table 1: Gross debt to GDP in EU, in %, 2004-2009

Region/ Country	2004	2005	2006	2007	2008	2009
EU-27	**62.2**	**62.7**	**61.4**	**58.8**	**61.6**	**73.6**
Euro area	**69.5**	**70.1**	**68.3**	**66.0**	**69.4**	**78.7**
Austria	64.8	63.9	62.2	59.5	62.6	66.5
Belgium	94.2	92.1	88.1	84.2	89.8	96.7
Bulgaria	37.9	29.2	22.7	18.2	14.1	14.8
Czech Republic	30.1	29.7	29.4	29.0	30.0	35.4
Cyprus	70.2	69.1	64.6	58.3	48.4	56.2
Denmark	44.5	37.1	32.1	27.4	34.2	41.6
Estonia	5.0	4.6	4.5	3.8	4.6	7.2
Germany	65.7	68.0	67.6	65.0	66.0	73.2
Greece	98.6	100.0	97.8	95.7	99.2	115.1
Hungary	59.1	61.8	65.6	65.9	72.9	78.3
Ireland	29.7	27.6	24.9	25.0	43.9	64.0
Finland	44.4	41.8	39.7	35.2	34.2	44.0
France	64.9	66.4	63.7	63.8	67.5	77.6
Italy	103.8	105.8	106.5	103.5	106.1	115.8
Latvia	14.9	12.4	10.7	9.0	19.5	36.1
Lithuania	19.4	18.4	18.0	16.9	15.6	29.3
Luxembourg	6.3	6.1	6.5	6.7	13.7	14.5
Malta	72.1	70.2	63.7	61.9	63.7	69.1
Netherlands	52.4	51.8	47.4	45.5	58.2	60.9
Poland	45.7	47.1	47.7	45.0	47.2	51.0
Portugal	58.3	63.6	64.7	63.6	66.3	76.8
Romania	18.7	15.8	12.4	12.6	13.3	23.7
Slovakia	41.5	34.2	30.5	29.3	27.7	35.7
Slovenia	27.2	27.0	26.7	23.4	22.6	35.9
Spain	46.2	43.0	39.6	36.2	39.7	53.2
Sweden	51.3	51.0	45.7	40.8	38.3	42.3
UK	40.6	42.2	43.5	44.7	52.0	68.1

Note: Blue fields indicate countries where the public debt to GDP ratio increased by 15 percentage points or more in the period of 2007-2009
Source: Eurostat, http://appsso.eurostat.ec.europa.eu/nui/show.do?dataset=gov_dd_edpt1&lang=en

called Security Market Program. Its official justification was to provide temporary liquidity relief to financial market segments suffering distress. In terms of money supply, the effects of this intervention have been sterilized by ECB term deposits, however, it compromised the reputation of this institution and raised financial market doubts about its actual policy priorities in the future. In fact, it may result in serious problems for macroeconomic and financial stability in Europe. In addition, long-term costs (in terms of lost credibility) may well exceed the short-term benefits coming from temporary bond market relief. This is the shortest path from public debt crisis (which has already happened) to an eventual Euro crisis.

__Dr. Marek Dabrowski__ is the President of CASE. Since the end of the 1980s, he has been involved in policy advising and policy research in Central and Eastern Europe, Central Asia, Africa and the Middle East, as well as in numerous international research projects on monetary and fiscal policies, currency crises, international financial architecture, EU and EMU enlargement, European integration, European Neighbourhood Policy and the political economy of transition.



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