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EURO: IMBALANCES AND ADJUSTMENT IN COMPARATIVE PERSPECTIVE

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Confusion in the debate on the euro

- **I.** Problems of the eurozone - confused with those which have been caused by the euro
- **II**. More general issues mixed up with those which are specific to the eurozone
- **III.** Problem of verbiage in the debate on the necessary solutions to the euro's problems
    - expressions as 'fiscal union' or 'political union'
- **IV.** Excessive generalizations in the discussions on the euro
    - …which mask a huge variation in the economic performance of the member countries, especially since 2008. (The same goes for the rest of the EU).

2. The variation in GDP growth in the EU; 2008-2013

EU member countries:

- eurozone, 2008 – 2014: between +7,2% (in Slovakia) to -24,1% (in Greece)

- non-euro EU members between +18,4% (in Poland) to -4,7% (in Britain)

Source: AMECO.

Table 2. Cumulated changes in GDP per capita

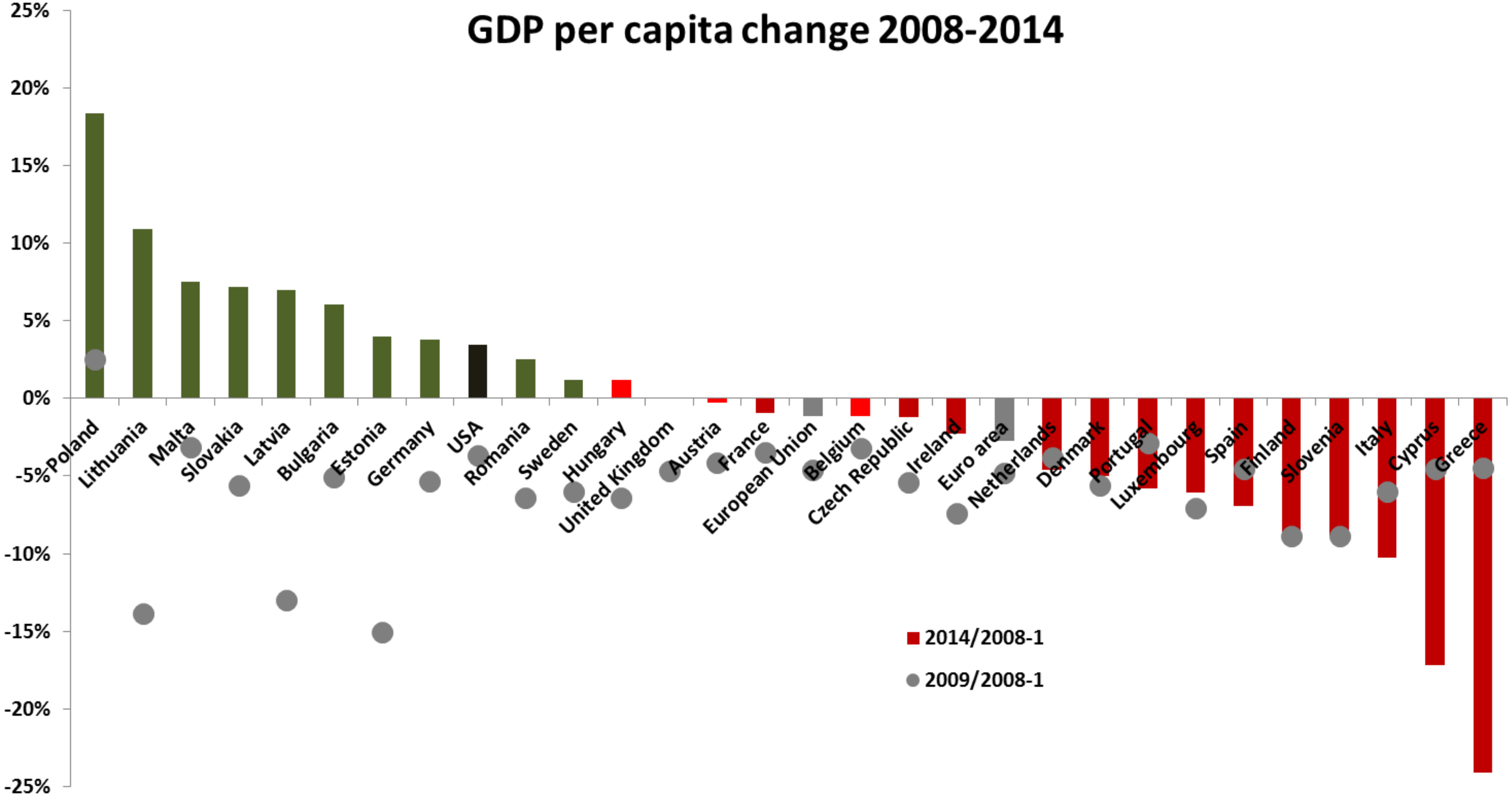
		2008-2015	2008-trough*	trough*-2015	Comments
Group I	Poland	21.9%	2.5%	18.9%	no recession
	Lithuania	13.9%	-13.9%	32.2%	
	Malta	13.8%	-3.1%	17.4%	
	Slovakia	11.1%	-6.3%	18.6%	
	Bulgaria	8.9%	-4.0%	13.4%	
	Latvia	8.0%	-15.0%	27.1%	
	Ireland	7.4%	-6.7%	15.1%	through-2010
	Romania	7.1%	-6.4%	14.4%	
	Estonia	6.3%	-14.3%	24.1%	
	Germany	4.9%	-5.2%	10.7%	
	United States	4.5%	-3.7%	8.4%	
Group II	Hungary	4.1%	-6.4%	11.3%	double deep recession
	Sweden	3.7%	-6.0%	10.3%	double deep recession
	Czech Republic	3.1%	-5.4%	9.0%	double deep recession
	UK	2.3%	-5.0%	7.7%	
	Belgium	0.0%	-3.2%	3.3%	double deep recession
	France	-0.3%	-3.5%	3.3%	double deep recession
	Austria	-0.6%	-3.9%	3.5%	double deep recession
	Luxembourg	-1.1%	-7.1%	6.4%	double deep recession
	Netherlands	-2.5%	-4.3%	1.9%	double deep recession
	Denmark	-3.5%	-5.6%	2.2%	double deep recession
	Portugal	-3.5%	-2.9%	-0.6%	double deep recession
	Spain	-5.3%	-9.8%	5.0%	
	Slovenia	-6.3%	-8.9%	2.9%	double deep recession
	Finland	-8.8%	-8.8%	0.0%	double deep recession
	Croatia	-9.0%	-8.5%	-0.5%	double deep recession
	Italy	-9.9%	-6.0%	-4.2%	double deep recession
	Cyprus	-17.1%	-18.0%	1.0%	
	Greece	-24.8%	-25.7%	1.2%	through-2013
	Korea 1997	22.1%	-6.4%	30.5%	peak1997, trough=1998
	Turkey 2000	17.1%	-7.0%	25.9%	peak=2000, trough=2001
	Sweden 1990	2.4%	-4.4%	7.1%	peak=1991, trough=1993
	Finland 1990	-5.3%	-11.4%	-5.3%	peak=1990, trough=1993
	Chile 1981	-11.7%	-18.7%	8.6%	peak=1981, trough=1993

***through -2009 if not indicated otherwise; recessions and through defined relative to GDP per capita; data for 2015 – preliminary**

Source: EC Winter forecast 2016

9. Recent European Experience: the euro area

Aggregate performance of the EU masks huge variation: 8 countries outperformed the US, while 19 underperformed.



Source: AMECO.

The variation in GDP growth in the eurozone; 2008-2014

countries which outperformed the US in terms of GDP per capita:

- Free floaters (Poland, Sweden)
- Countries with hard pegs, i.e. members of the euro (Germany and Malta)
- countries with euro-based currency boards (the BELL: Bulgaria, Estonia, Latvia, Lithuania)

The variation in GDP growth in the eurozone; 2008-2014

The worse performers:

- problem countries in the eurozone (the PIIGS: Italy, Ireland, Greece, Portugal, Spain, but also Cyprus and Slovenia)
- the free floaters: Britain and Hungary

Contrast between the growth performance of the BELL and the PIIGS as well as other problem countries in the eurozone

Problems in some euro-area countries

A) the financial booms, boom-bust episodes -> imbalances and declining price competitiveness of the affected economies

B) the accumulations of microeconomic distortions -> a break in economic growth

Problems in some euro-area countries

I. differences in the intensity, structure and the 'location' of the booms

II. two types of boom – bust episodes in the euro

- Fiscal to financial (Greece, What are the root causes of the tendency of modern political systems' to systematic overspending?)
- Financial to fiscal (Ireland and Spain, laws and regulations which contributed to the financial crises by encouraging an excessive risk taking by the private agents and by distorting the operations of the financial markets; the monetary policy of the leading central banks (US and credit boom))

Problems in some euro-area countries

III. Assumptions: the present monetary constitution crises; the present financial system

IV. Italy, Portugal and France: growth laggards during 2008 – 2013 but they did not suffer from the acute boom – bust episodes after the introduction of the euro

Has euro contributed to problems in the euro-area countries?

I. Problems can be linked to:

- features of the original design which have been implemented (e.g. modus operandi of ECB)
- the fact that some design features had remained on paper ?

Has euro contributed to problems in the euro-area countries?

II. An extreme suppression of the spreads in the euro-area

- the acute booms had occurred in these eurozone countries which had obtained the largest declines in their credit spreads (fiscal to financial vs. financial to fiscal)
- why credit spreads have been till recently so drastically suppressed across the eurozone countries?
  - market failure?
  - the modus operandi of the European Central Bank

Has euro contributed to problems in the euro-area countries?

III. How to reduce the risk of the serious boom – bust episodes in the eurozone?

- the causes of the extreme suppression of the nominal credit spreads across the eurozone
- the structural reforms, which are necessary to complete the Single Market.

IV. Was the propensity to generate boom – bust episodes especially strong in the eurozone, i.e. compared to other hard peg arrangements?

- Literature: the credit spreads in the eurozone were, indeed, extremely suppressed

Has euro contributed to problems in the euro-area countries?

V. Is there a link between the euro and (1) little progress on structural reforms, (2) accumulated anti-market distortions and (3) delayed the necessary institutional improvements (especially Greece, Portugal, Italy, France)?

- The pace of structural reforms - very disappointing
- The main reason for this state of affairs - the introduction of the euro has not removed all the easy ways of coping with the countries' economic problems.
- The option of nominal devaluation has been eliminated, but another easy way of tolerating distortions and delaying reforms was created: cheap credit and cheap capital inflows, especially to the future problems countries.

Policies and adjustment under the euro

I. The bail-out bias: especially dangerous in the case of ECB; delaying the adjustment? Compare BELL and PIIGS

II. reforms even can bring benefits only in the longer run

III. potential conflict between the availability and scale of official lending and crisis prevention

IV. easy availability of the official bail-outs may prolong the crisis

Policies and adjustment under the euro

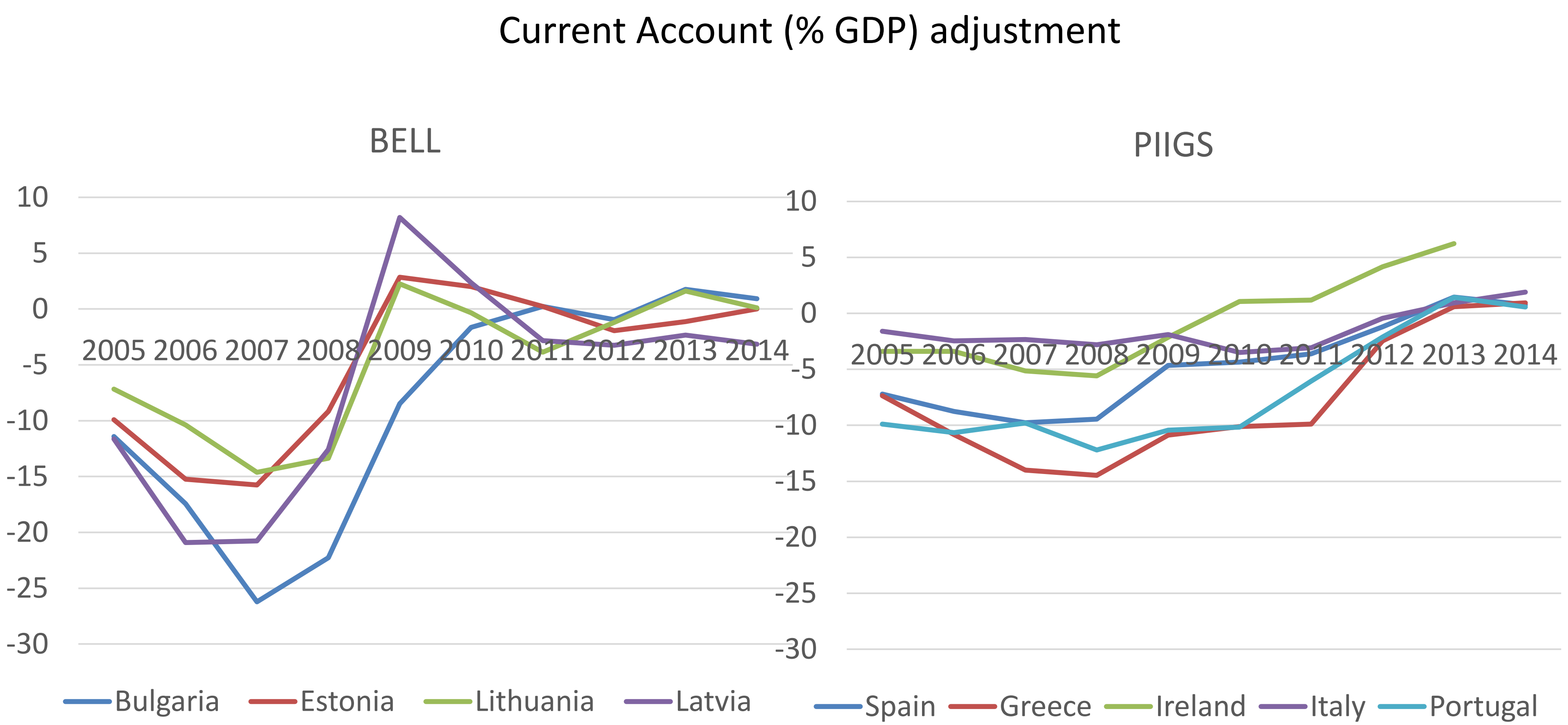
Adjustment 2007-2013

	CPI	unemployment	General government structural balance	CAD	ULC*
	pp	pp	pp	pp	%
Bulgaria	-6.2	5.4	-2.3	26.4	25%
Estonia	-3.1	3.7	0.0	15.3	2%
Latvia	-9.4	5.8	-0.3	21.3	-7%
Lithuania	-4.5	7.5	2.4	14.2	-7%
Portugal	-1.7	9.4	0.7	11.0	-10%
Italy	-0.4	6.4	3.2	1.3	1%
Ireland	-1.9	9.1	3.5	7.7	-18%
Greece	-3.7	18.7	11.4	13.6	-9%
Spain	-1.1	18.6	-3.8	11.4	-10%

**2007-2012, relative to Germany*

Source: IMF, EC

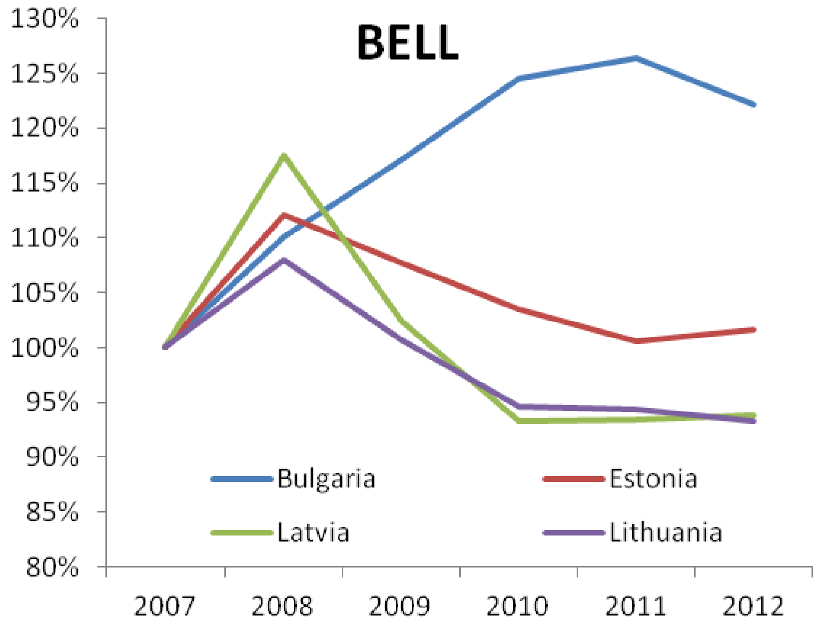
Policies and adjustment under the euro

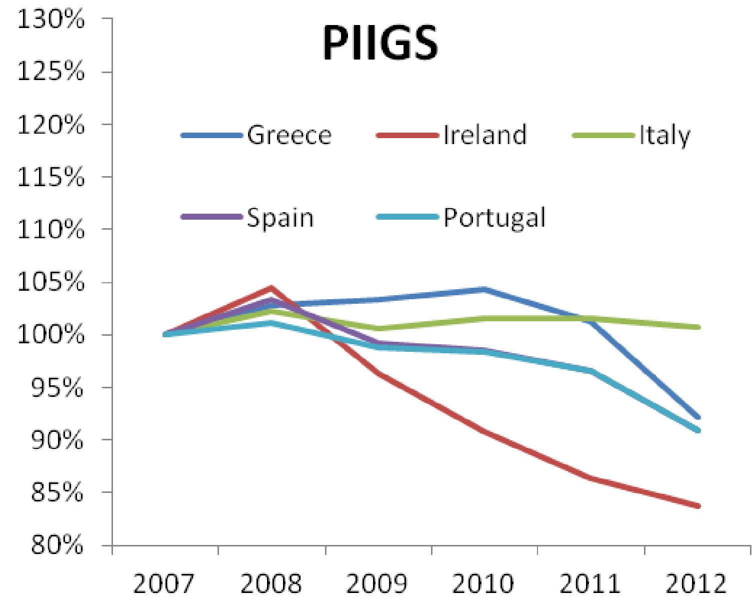


Source: IMF

Policies and adjustment under the euro

ULC relative to Germany, 2007=100%

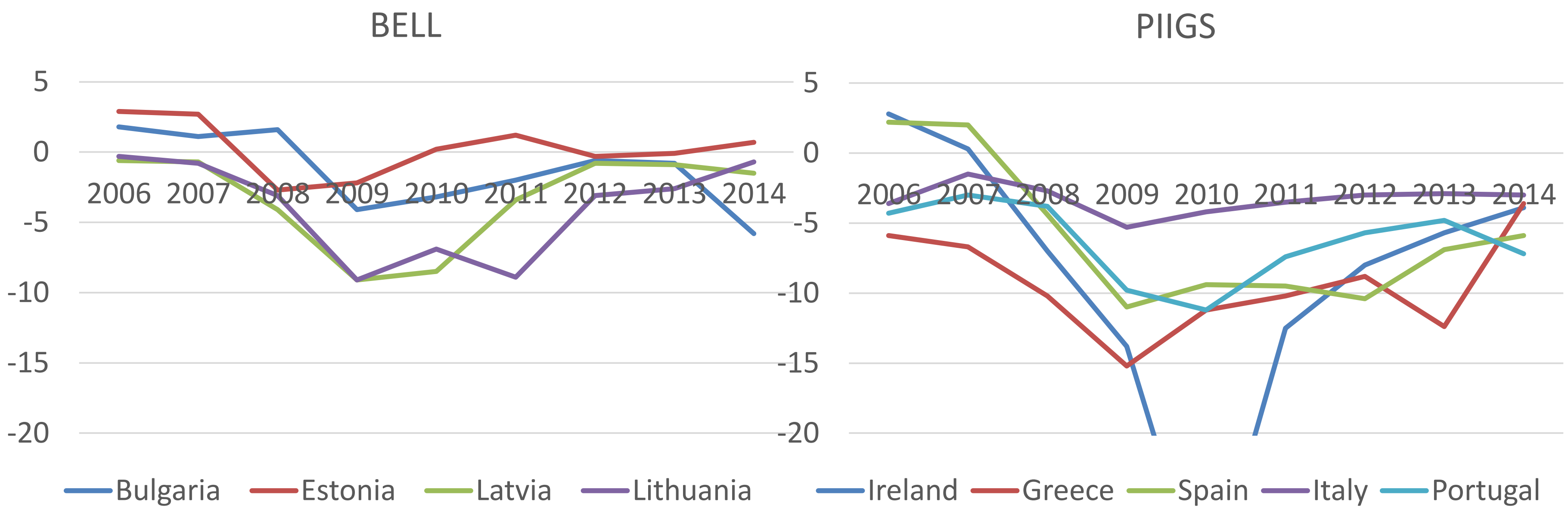




Source: IMF

Policies and adjustment under the euro

General government deficit/surplus (% of GDP)



**Ireland 2010 out of scale, with deficit reaching -30% GDP due to costs of banking sector bailout*
Source: EC

Policies and adjustment under the euro

bail-out mechanisms in the eurozone:

- the ESM;
- the policies of the ECB (UMP);
- the operation of the Target 2 payments system.

Policies and adjustment under the euro

- other elements of these policies: refinancing operations with respect to the Eurozone banks
- the expansion of the refinancing credit -> sudden stop and then partial reversal of the private capital flows to the PIIGS
- the expansion of the refinancing credit flowing to the PIIGS - radical relaxation of the refinancing standards by the ECB
- the flows of the official funds to the PIIGS had been filling in the gaps created by the declines in the flows of private capital, and delayed the reduction of the CA deficits in these countries
- the ECB' extraordinary refinancing operations have substantially delayed the reduction in previously inflated CA deficits in the PIIGS

4.3 Fiscal policy: case of Greece

IMF report from:	*Revenue side*	*Spending side*	*Structural reforms*
March 2011, Dec 2011	*- Greece has "**reached the limit of what can be achieved through increasing taxes**"*	*- "Through **socially difficult wage and pension cuts, tax increases, and deep spending cuts**, the government achieved the extraordinarily ambitious stabilization goals that it had set for itself for 2010"* *- While the overall fiscal target was met, this happened because the **government under executed the state budget in order to offset revenue shortfalls and overspending at local levels**. These in turn reflected weak tax administration and problems in controlling spending, leading to a build up of budgetary arrears."*	*- "**major reforms still need to be designed and implemented** to build a critical mass necessary to secure fiscal sustainability and economic recovery"* *- "The authorities have **implemented an ambitious upfront approach to liberalization of the regulated professions**" → but see quote from July 2013 below about delays in implementation* *- "The authorities **acknowledged that in some instances implementation of the reforms is lagging**. Delays have been evident in the set up of one-stop shops and fast track investment procedures, largely reflecting limited administrative capacity."*
March 2012, Dec 2012	*- „Greece achieved a cumulative improvement in the primary balance of 8¼ percentage points of GDP between 2009 and 2011, **on the back of VAT, income and property tax increases, and cuts in wages, pensions, and public mployment**."* → <u>the quote from March 2012, keep in mind the quote from Dec 2012 on the right.</u>	*- "The authorities and staff agreed that, beyond the crucial fight against tax evasion, **new measures should be largely targeted on the expenditure side. Greece already has tax rates that are comparable to other European countries**, and new burdens on the formal sector would pose an additional hurdle to the recovery."* *- "Still, **some important underlying expenditure policy reforms have lagged**, most notably efforts to make staff reductions more targeted (only 200 employees were placed in the labor reserve during 2012, well short of the end-2012 target of 15,000)."*	*- "as a result of **indirect tax hikes and deeply entrenched product and service market rigidities**, disinflation has been delayed and is expected to be less pronounced than in the case of Baltic comparators"* *- "**The structural transformation of Greece's economy continues to proceed at a slow pace (outside of the labor market)**, and this is making Greece's adjustment more costly"* *- "**Privatization targets have been missed** by a wide margin"* *- "**Institutional reforms continued to disappoint during 2012**, again complicating overall adjustment efforts. (…)Tax administration reform stalled. (…) Public financial management reform has also slowed down."*
Jan 2013, June 2013, July 2013	*- „The authorities' adjustment strategy focuses on reducing expenditures. The authorities recognized that they needed to refocus on spending cuts, **after relying heavily on tax rate increases during 2010–12.**"* *- „Following a major cut in public sector wages and pensions in 2010 , **measures in 2011 relied mostly on tax increases**."*	*- "The fiscal program is ambitious in its scale—the adjustment remains huge by international comparison for the fourth consecutive year— and in its focus on **difficult but overdue spending cuts**, and the strong implementation speaks to the Government's determination."*	*- "The high adjustment cost reflects in **important part the delayed, hesitant and piecemeal implementation of structural reforms**. (…) **reforms have fallen well short of the critical mass needed to transform the investment climate**."* *- Structural reforms are **progressing slowly (…)** The **privatization** program is behind schedule.(…) Progress in **liberalizing regulated professions** has been slower than targeted, particularly in issuing secondary legislation for a number of professions, reflecting resistance from vested interests."*
June 2014	*- Public budget balance: **– 3.5% percent of GDP** („target of **1.5 percent of GDP**")* *- „Steps are being taken to **tackle tax evasion, improve debt collection, and better process tax refunds**, among others"* *- „**Modernization of tax policy and the tax system is underway**, but the **authorities** must guard against pressures to roll **back progress**."*	*- „The authorities (...) recognized that cuts would inevitably **fall on pensions, wages, and social benefits**, where spending exploded after Greece's euro accession (...) To make this (…) the government decided on a two-pronged approach: (i) **carefully targeting the cuts to protect the most vulnerable**; and (ii) **matching the cuts with immediate efforts to reduce waste in government** operations and to **improve tax compliance**."* *- „To promote growth, the authorities are **reducing the labor tax wedge**, which is one of the highest in the OECD."*	*- „(…)Greece has lagged on **productivity-enhancing reforms.**"* *- „(…)emphasized product and service **market reforms**, where progress so far has been **slower,** to develop a critical mass of reforms for sustained growth"* *- „Performance on **privatization continues to fall short** of expectations."* *- „The authorities are taking further steps to **open up regulated professions**"*

Source: IMF Reports

Discussion of the problems and solutions put forward in the debate on the euro

One monetary policy cannot fit all

- Nominal devaluation is no panacea

Monetary union requires the fiscal (political) union

- Terms *fiscal union* and *political union* are not clear.
  - Political union as code words for some centralistic agreements in Eurozone that would ensure the fiscal discipline in member states.
    - Stability and Growth Pact and violation of non-bail out clause
  - Political union as code words for a federal state, with more emphasis on increased cross-country fiscal transfers and less focus on the fiscal discipline.
    - This solution is not necessary to solve the euro's problems. (It was not the lack of larger fiscal transfers which has caused the problems in the PIIGS.)

The model of federal state is also not politically feasible (e.g. political tensions caused by inter-regional fiscal transfers, discussion on the EU budget).

Concludnig remarks

- excessive suppression of the credit spreads across countries with different fundamentals, - the changes in the modus operandi of the ECB
- risk premium can better correspond to the risks
- increased fiscal discipline requires **stronger monitoring** from the fiscally conservative voters, and cannot be imposed from outside
- to reduce the risk of serious financial crises one has to **eliminate various perverse regulations** and **prevent the central banks from fuelling the booms**

What **model** for the euro area?

1. How to mitigate private credit booms in the euro area countries?

2. What is „fiscal” union? What is „political” union?
   Larger cross-country transfers or a non-bail out clause (US, Australia, Switzerland)?

3. Can top-down fiscal monitoring substitute for market monitoring and domestic monitoring