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ECONOMIC AND MONETARY AFFAIRS

FISCAL AND COMPETITIVE TENSIONS WITHIN THE EURO AREA

NOTE

Abstract

This briefing starts by analysing the reasons why the individual members of the euro area (EA) cannot not yet be considered to jointly constitute an "optimal currency area", such as low labour market mobility, divergences in competitiveness, fiscal position and inflation, etc. Thereafter, the paper discusses the current short-comings of the Stability and Growth Pact (SGP) as an economic governance mechanism in light of the Greek crisis. Lastly, the paper discusses 4 possible policy options:

1. Letting Greece default;
2. IMF intervention or joint IMF EA intervention;
3. Creation of an "EMF"; and
4. Creation of a single issuer of Eurobonds.

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DISCLAIMER

After ten years of monetary integration, the recent large recession is proving to be the most important challenge to EMU and the Euro Area (EA) in its short history. All of the tensions that the EA is suffering now are not new, they were warned by many economists many years ago as shown by de la Dehesa and Krugman (1992):

First, the lack of a supranational or federal-like system and the need for fiscal federalism, shown by the MacDougall Report (1977) and Sachs and Sala i Martin (1992) or more recently by Padoa-Schioppa (2004). Second, that the EA was not an optimal currency area (OCA) shown by Mckinnon (1963) and Kenen (1969); that the size of the EU budget was too small, as shown by Krugman (1993), Eichengreen (1993) and Bayoumi and Eichengreen (1994) and that labour mobility was too low pointed by Sachs and Sala i Martin (1993). Third, that the Stability and Growth Pact (SPG) as a substitute for the lack of EU automatic stabilizers was showing many weaknesses and was too pro-cyclical (Wyplosz, 2002) and fourth, that the ECB no bail-out clause was going to create problems in asymmetric recessions (Masson and Taylor, 1993).

It is well known that the EA is not yet an optimal currency area according to the requirements set by Nobel Prize Robert Mundell (1961). His requirements included: high labour mobility and lack of physical and cultural barriers within the monetary union, high capital mobility and financial integration, high price and wage flexibility and above all, a large federal or union budget capable of making generous transfers to member states which suffer asymmetric or idiosyncratic shocks. United States was considered to be a benchmark fulfilling most, if not all, these requirements.

By contrast, in the EU and in the EA, labour mobility is very low, due to high language and cultural barriers among its member states, financial and banking integration is also low, prices and wages tend to be sticky and the EU budget is only 1.1 per cent of the EU GDP, versus 25 per cent in the US (de la Dehesa and Krugman, 1992). Labour mobility has increased with the recent wave of immigration from third countries but those who move freely within Schengen members states unfortunately are mainly irregular immigrants, given that legal immigrants have to work for 4 years in a member state to be able to move to another one.

Now, the EA faces two important challenges after suffering the hardest recession in its short history (as well as the EU in its long history) which is showing more than ever its suboptimal character:

On the one side, today most member states of the EA are being subject to an excessive deficit procedure (EDP) for being much above the 3 per cent of GDP and nearly all of them have a public debt to GDP ratio above 60 per cent set as maxima by the SGP. Those member states with the weaker tax revenue base and tax collection systems and with the higher relative government expenditure are suffering high and rising spreads in their debt issuance versus the German Bund which acts as the benchmark. Therefore, financial markets are now forced to apply to those member states the necessary discipline that the SGP procedures have not been able to impose before. The SPG started to lose credibility when some years ago Germany and France managed to interrupt the rules of the excessive deficit procedure and bought themselves some time (Verdun, 2010).

On the other side, relative competitiveness divergence among EA member states has reached a historical record. One the one side, member states with the higher relative inflation rates and collective bargaining systems based on inflation (instead of on productivity), have lost competitiveness. On the other side, large exporter member states have reduced their cost of labour by reducing social security contributions by employers and by raising VAT, that is, have been engaging in "beggar my neighbour" policies within the EA, that is, by making their exports cheaper and their imports more expensive within the EA.

Thus, member states which have lost competitiveness relative to the best to performers are now forced to make an internal real devaluation, by forcing their prices, margins and wages to grow below the EA average for some years and forcing their productivity to grow above the EA average for several years, in order to regain their previous levels of competitiveness, which is also very hard to implement from a political point of view. Both problems are interlinked, the larger the competitiveness loss the harder to achieve the fiscal requirement levels imposed by the SGP and vice-versa.

Therefore, as it is happening right now, if the SGP is not applied effectively enough to avoid reaching these asymmetrical public finance tensions within the EA, if competitiveness is not enhanced by some member states and if there is no central budget capable of helping those member states with serious fiscal problems in the hard process of reducing their budget deficits and debt levels, then the EA and the euro could be at stake, which could undermine 52 years of successful EU economic and monetary integration.

The present EA governance set-up to address these serious problems is the following: First, there is in the EU Treaty a no bail-out clause (article 103) which stipulates explicitly that neither the Community nor any member state is liable for or can assume the commitments of any other member state. Second, the EU Commission has neither the expertise nor the funds to help Greece and less so other member states which could also need them, as shown by Pisani-Ferry and Sapir (2010). Third, the ECB could help temporarily with liquidity provision but even if it did, which is very doubtful, it cannot impose any conditionality unless it decides to disqualify Greek public debt for its monetary policy operations, which is also very doubtful, and definitely, it cannot try to bail-out Greece because it is forbidden by the no bail-out clause of article 103 of the Treaty. Several members of the ECB Governing Council have confirmed, on February 2010, that the ECB will not help Greece because of the existence of the no bail-out clause. Nevertheless, as Schwartzer (2009) has shown, it is one thing to implement a bail-out and another very different thing to provide temporary financial assistance.

As the EA and EU member states keep opposing any increase of the EU budget, national treasuries are now the only ones capable to help Greece directly, under strong conditionality, and capable to later help other member states which could have solvency problems as well. But national taxpayers oppose such help because they say that they are now forced to paying for the profligate conduct of other member states which have been living beyond their means and eventually producing a serious problem of moral hazard for the rest of the EA. (For instance, 70 per cent of German voters were opposed to use taxpayer funds to bail-out countries in financial difficulties such as Ireland or Greece). Financial markets are aware of the inability of the EU and the EA to deal with and solve this situation and thus are requiring a larger risk premium from the debt issuance of the members states affected, which makes it for them even more difficult to achieve their fiscal consolidation programs required by the SGP.

Is there any way to improve the present situation? There are several options some can be executed in the short term and others in the medium to long term as shown by Schwartzer and Dullien (2010):

1) A non starter option is just to let Greece to default as some economists have proposed on the basis that there is a no bail-out clause in the Treaty and that a bail-out would increase even more the moral hazard already built in the construction of the EA as pointed by Feldstein (2010 and Issing, (2010)). But letting Greece default would put produce a large contagion effect on other member states and finally put the EA and the euro at serious risks and give a very bad reputation to European integration in general and to the EA in particular. Moreover, this option would not solve the competitiveness problem of Greece if it stays in the EA and if it leaves the depreciation of its currency will be huge, producing very serious social and political upheaval.

2) The easier and clearer option is to allow the IMF to perform its duties and help Greece or any other EA member state which may suffer solvency problems through a program with due conditionality. The IMF has the mandate, the knowledge, the experience and the resources to do it, even more so after the G20 decision in 2009 approving a large increase of resources and DEG issuance for the IMF to lend up to an additional 750 billion US dollars. As a matter of fact, the IMF has helped several EU member states like Poland and Hungary in 2009 and is now helping Latvia. This option has two sub-options. The first one is that Greece decides to call the IMF for help without agreeing it with the EA member states. This option would be a big mistake. The second one is that the IMF and the authorities of the EU and the EA decide that the IMF should also be involved in the rescue and conditionality of Greece working together and adding resources to the EA package.

Unfortunately, there seems to be some unwarranted rejection by the EA and the Eurogroup of any IMF involvement in Greece or any other EA member state, when previously the IMF was involved in helping both the UK and Italy in 1977, Spain in 1978, and Portugal in 1983 and now, the economic situation of some members states is similar to the one experienced three decades ago.

Nevertheless, the fact that the IMF experts have been allowed to get involved in checking Greece economic statistics and its real fiscal situation in order to evaluate the size of its necessary fiscal retrenchment maybe a good sign in terms of the probability of it getting involved eventually together with the EU and some member states of the EA in an IMF program. The IMF then could work together with those EA member states willing to participate and most probably with the European Investment Bank (EIB), in solving the problem posed by Greece which would be the most efficient way to do it and also it would add experience in case any other EA member state would later suffer from the same level of fiscal unbalance.

A joint rescue package by the EA and the IMF is much better option than an EA bilateral conditional package. On its own with such a problematic package, the EA runs the risk of failure given that it has not enough experience and independent resources to accomplish a successful outcome. Also, it would be very difficult for the Member States offering financial resources to convince their voters and taxpayers to do so unless they impose extremely hard conditions which they would demand Greece to accept. Therefore a joint effort EA-IMF would be the best available option in the short term, until the EU and EA finally decide to create a more sophisticated and reliable system of funding and conditionality for future cases that solves the moral hazard issue within the EA and improves the stringent application of the SGP.

3) Another option which should be part of this second stage for finding a definitive solution is that proposed by Gros and Mayer (2010) as a present alternative to the IMF or the joint EA-IMF option by calling for the immediate creation of an IMF by the EU, called Euro(pean) Monetary Fund (EMF). They think that the IMF can do very little if the country in question just does not live up to its promises, except withhold further funding and moreover, calling the IMF would destroy any prospect of a common EA representation in the IMF and in the international institutions in general and, as the IMF is dominated by the US it could be more lenient with some countries like Greece, because it hosts important US bases being a member of NATO and available evidence shows that no country with US bases has ever been let down (Hale, 2010). They propose as well the creation of an EU orderly resolution scheme to deal with sovereign default of any member state similar to the one being designed for large financial and complex institutions.

The EMF should be funded eventually by those EA countries which might constitute in the future a burden on the other member states given the existence of a principle of solidarity among them and the necessity for EA member countries to avoid creating difficulties on to other member states. Therefore they propose that, annually, 1 per cent of the stock of excess public debt above the 60 per cent of GDP (maximum limit established by the SPG) would be contributed to the EMF by every member state with debt in excess and the same annual 1 per cent of the excess public deficit (above the 3 per cent of GDP set by the SPG) should also be used to fund the EMF.

This system of punishing excessive debt and deficit member countries would give clear incentives for member states to keep their fiscal house in order at all times. Gros and Mayer provide also for an orderly sovereign bankruptcy procedure that minimises the disruption resulting from a default. According to them, both features would lower the moral hazard problem.

This option could be a solution to the present problems but it will be very long and difficult to implement. The main issues with this option are the following: To create an EMF will take a long of time and it would not solve the urgent problem of helping Greece unless they think that it should default. If the EMF imposes a tougher conditionality than the IMF then member states will call the IMF first. Its funding system is going to be difficult since most member states are under an excessive deficit procedure and almost all are exceeding the debt SPG ceilings. Finally, sovereign member states are not companies, they can also default but they never go bankrupt (because they are sovereign) so that they do not need an orderly bankruptcy procedure. Nevertheless, an adequately modified EMF could be part of a solution to these issues in the medium term.

4) Another option, which is complementary to the first, is to create a single issuer of eurobonds instead (or even besides) the present 16 issuers member states. This should have two important advantages for the sovereign bond investors, a higher liquidity and a higher risk diversification. One of the reasons why the German bund is the EU benchmark with the lowest spread is, besides having the lowest relative probability of default, to have the largest and most liquid market in the EU. The higher is the liquidity the lower is the spread, because investors pay a premium for being able to sell and buy every day in deep and liquid sovereign debt market.

By having a single euro bill and bond grouping the 16 present member states bonds, even Germany could benefit. The reason is that the size of the US Treasury bond market is around 6 trillion US dollars and the joint 16 EA bond market would reach around 4 trillion (European billion) euros, while the present German bund market size is only 1 trillion euros. By grouping the 16 issuers, liquidity would multiply and average spreads will go down without any apparent cost, it is a kind of "free lunch".

By grouping the 16 bond markets into one with the joint guaranty of the EA member states, investor risk diversification will increase notably given that default rates will be more widespread and thus average spreads will be lower and all member states could end up gaining, although those with a lower default probability would gain less than those with a higher one. But it would be difficult to find out the net gains of each and, in any case, the net transfers from the lower default probability member states will be much lower than the costs of them bailing out other member states as it is happening at this moment in time with Greece.

This option can be a substitute for the strong reluctance of most EU and EA member states to commit more resources to the EU budget (and maybe to the EMF) and, at the same time, will help the euro to become more used by financial markets, not only by central banks and get closer to the dollar as an international currency.

The main problem of the single EA eurobond is that it would weaken the financial markets discipline on to those member states that do not control enough the relative size of their deficits and debts, in terms of their GDP, through the cycle. But this problem could be solved by introducing stronger discipline and fines by SPG for those countries which get into excessive deficits and debts ratios over the cycle, which should be used to fund bail outs in case of asymmetric shocks or a potential EMF in the future. That would give more credibility to the eurobond in the markets and spreads could be even lower. Finally, the issuer of these eurobonds could be the EU Commission or the EIB or a special new EA institution.

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