Towards more symmetry of macroeconomic policies in the Eurozone

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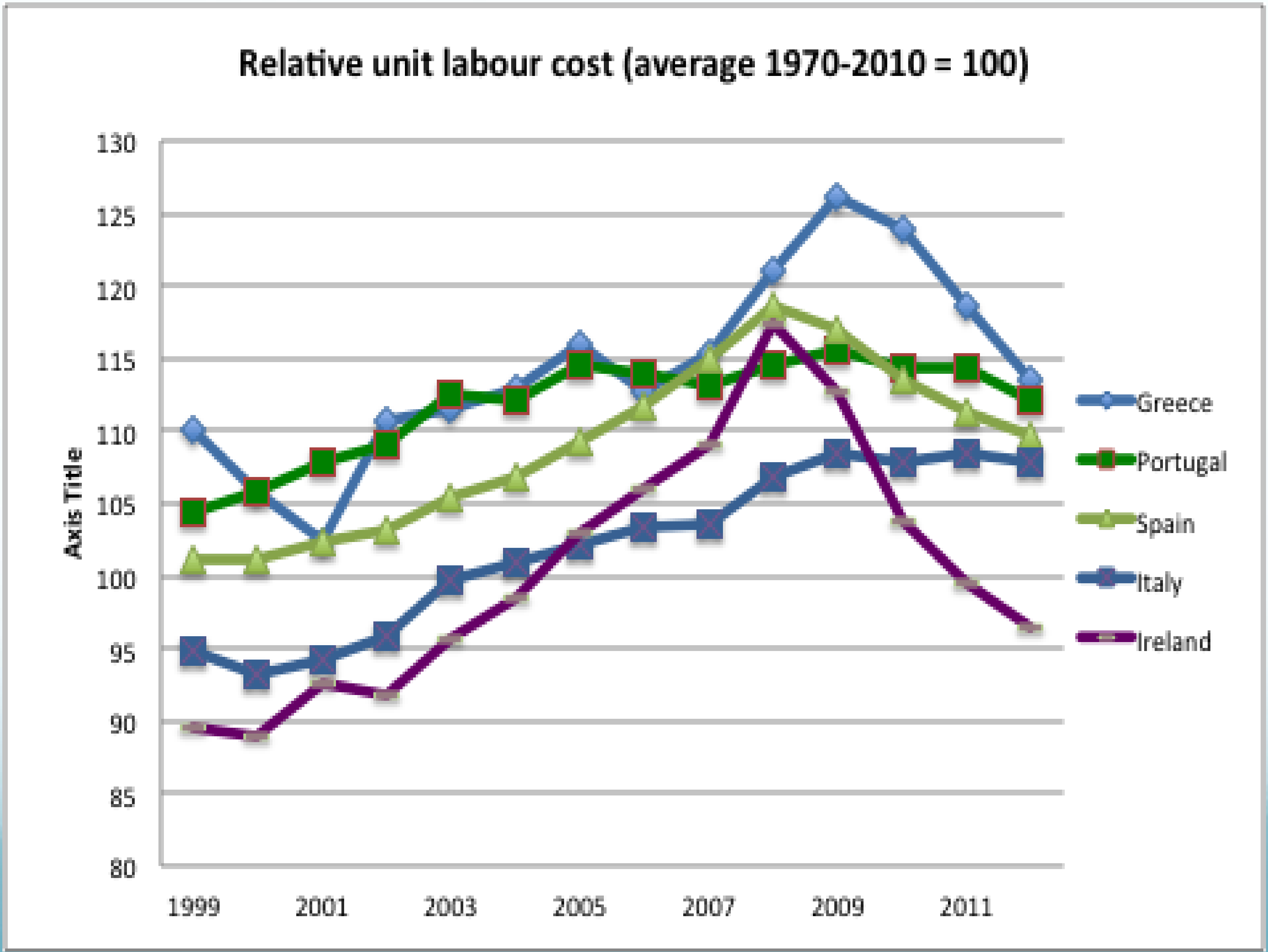
Introduction

- Markets have pushed some countries in bad equilibria (Spain, Portugal, Ireland) and others in good equilibria (Germany)
- Authorities should not accept this market outcome, which is the result of fear and panic.
- Unfortunately macroeconomic policies exclusively geared towards austerity in the South reinforce the split between countries in bad and in good equilibria

Asymmetry prevails

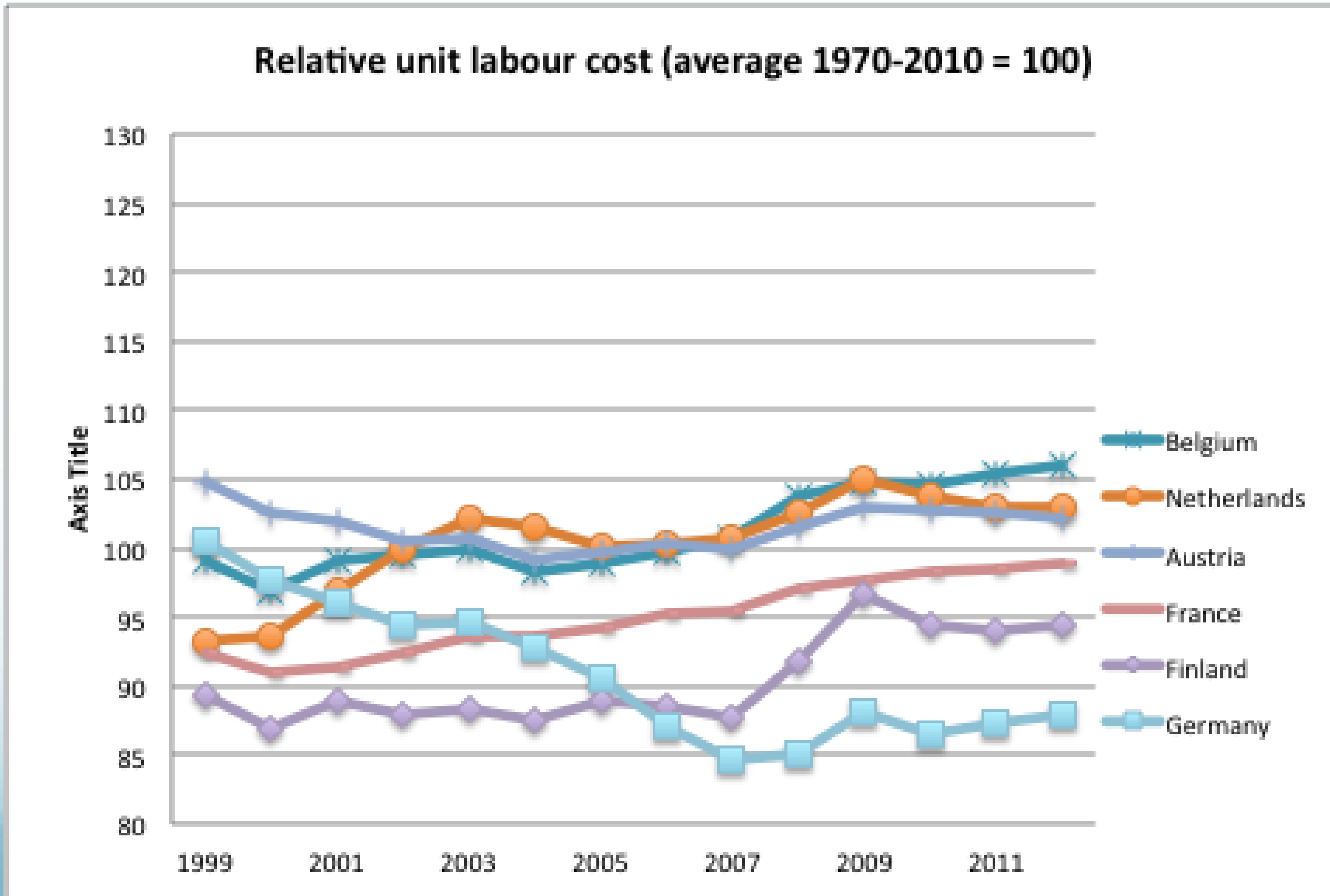


Internal devaluation in PIIGS countries
(since 2008-09)

	devaluation	% achieved since peak
Ireland	21,1	121%
Greece	12,6	48%
Spain	9,0	48%
Portugal	3,4	22%
Italy	0,6	7%

- These are significant internal devaluations (except in Italy)
- Contradicting the view of many analysts that these countries are unable to make adjustments
- These internal devaluations are very painful
- Have surplus countries been helpful?

What has been the contribution of the Core countries in the adjustment? zero



Interpretation

- Burden of adjustments to imbalances in the eurozone between surplus and deficit countries is borne almost exclusively by deficit countries in the periphery.
- The surplus countries do not seem to be willing to make life easier for the deficit countries and to take their part of responsibilities in correcting external imbalances.

Why this asymmetry?

- Asymmetry reminiscent of asymmetry in EMS: deficit country had to adjust because it hit the constraint that stock of international reserves is depleted
- Surplus countries did not have this liquidity constraint
- And called the shots

Liquidity constraints in the Eurozone

- This mechanism arises from inherent fragility of a monetary union in which national governments issue debt in a currency over which they exert no control.
- When the fiscal position of a country deteriorates, e.g. due to the deflationary effects of an internal devaluation, investors may be gripped by fear leading to a collective movement of distrust.
- The ensuing bond sales lead to a liquidity squeeze in the country concerned.
- This “sudden stop” in turn leads to a situation in which the government of the distressed country finds it impossible to fund its outstanding debt except at prohibitively high interest rates.

- Thus, in the absence of a lender of last resort, individual governments of a monetary union can be driven into default by financial market panics
- In order to avoid default, the crisis-hit government has to turn hat in hand to the creditor countries that like their fixed exchange rate predecessors impose tough conditions.
- The creditor countries reign supremely and impose their rule on the system.

There is some good news

- The recent decision of ECB to be lender of last resort in government bond markets (OMT) has the potential of reducing liquidity constraints and thus asymmetry in adjustment
- It is therefore incomprehensible that Spain is waiting to apply for obtaining liquidity relief and thereby to reduce asymmetry in adjustment.
- Spanish government prefers further suffering of its citizens rather than losing face

Towards symmetric macroeconomic policies

- Stimulus in the North, where spending is below production (current account surplus)
- Austerity in the South (but spread out over more years)
- This also allows to deal with current account imbalances
  - It takes two to tango
- This symmetric approach should start from the different fiscal positions of the member countries of the Eurozone

Figure 6: Gross Government debt ratios in creditor countries of the Eurozone

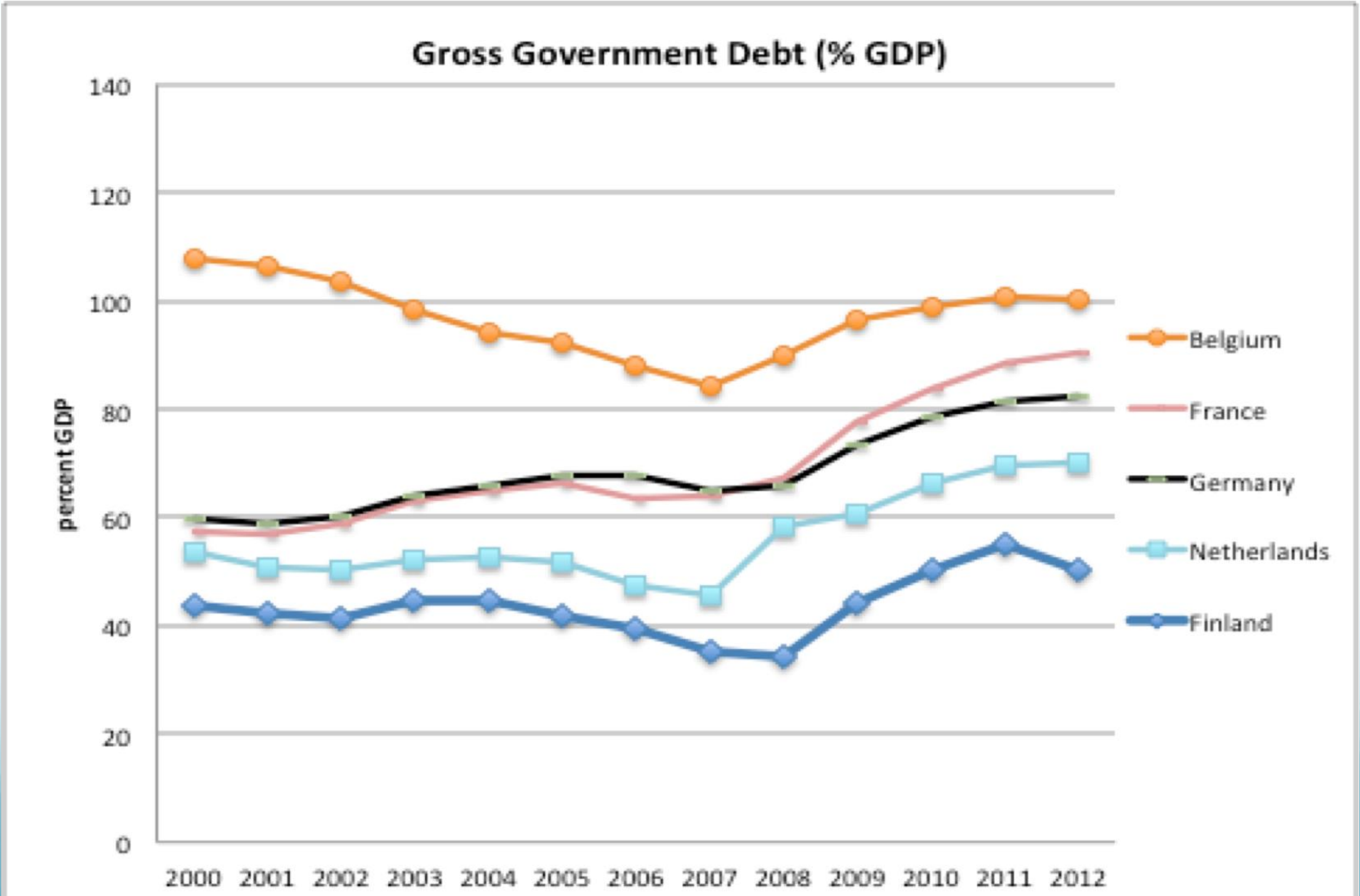
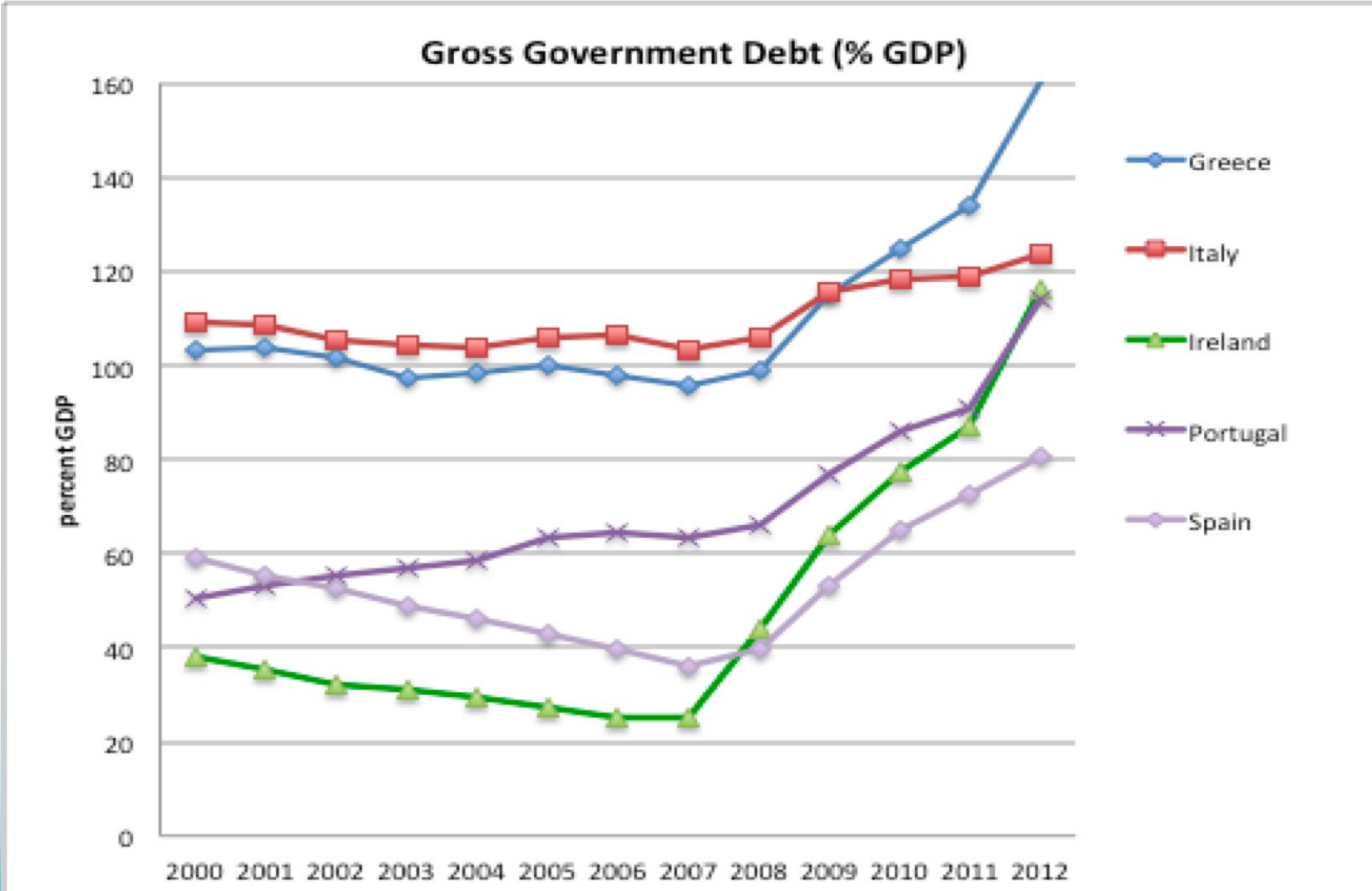


Figure 7: Gross Government debt ratios in debtor countries of the Eurozone



Source: European Commission, AMECO

- The debtor countries have not been able to stabilize their government debt ratios (in fact these are still on an explosive path),
- The situation of the creditor countries is dramatically different.
- Creditor countries have managed to stabilize these ratios.
- This opens a window of opportunity to introduce a rule that can contribute to more symmetry in the macroeconomic policies in the Eurozone.

Here is the proposed rule

- The creditor countries that have stabilized their debt ratios should stop trying to balance their budgets now that the Eurozone is entering a new recession.
- Instead they should stabilize their government debt ratios at the levels they have achieved in 2012.
- The implication of such a rule is that these countries can run small budget deficits and yet keep their government debt levels constant.

Table 1: Government budget deficits that will keep debt ratios constant in 2013

	Budget deficit	Debt ratio 2012	Nominal growth 2013
Belgium	3,5	100,5	3,5%
France	2,8	90,5	3,1%
Germany	2,9	82,2	3,5%
Netherlands	1,7	70,1	2,4%
Finland	1,9	50,5	3,8%

Source: European Commission, AMECO

- Whether such a rule will be implemented very much depends on the European Commission.
- The latter should invoke exceptional circumstances, i.e. the start of a recession that hits the whole Eurozone and threatens to undermine the stability of the Eurozone,
- European Commission should urge creditor countries to temporarily stop trying to balance their budgets.
- European Commission should convince creditor countries that it is in theirs and the Eurozone’s interests that they stabilize their government debt ratios instead.

Conclusion

- Eurozone is falling into new recession
- This recession is home-made
- And the result of an asymmetric macroeconomic adjustment process in the Eurozone that has introduced a deflationary bias.
- Asymmetry is potentially weakened by the fact that ECB can relieve liquidity constraint on countries that have been pushed into bad equilibrium.
- Inexplicably some (Spain) are hesitating to use OMT and prefer to suffer more

- European Commission should fundamentally change its conduct of macroeconomic policies
- It is the only institution that can take a system-wide perspective taking into account the negative spillover effects of austerity in one country on the other countries.
- Unfortunately the European Commission does not do this
- It continues to push each country towards balancing the budget when the Eurozone is pushed into a new recession.

- I have proposed new rule: creditor countries stabilize their government debt ratios, thereby allowing some budget deficit
- As compensation for the continuing austerity in the debtor countries.