Special Report 2012/06

Why is the euro crisis not ending? *(part 2)*

In the first part of this series, we will show that fiscal indiscipline is not at the root of this crisis. This is why the current policy prescription (fiscal austerity) has not been the silver bullet most hoped for. In part 2, we propose a number of steps the European policymakers can take in order to end the crisis. All it takes is a little bit of imagination and a lot of willingness.

Where do we stand?

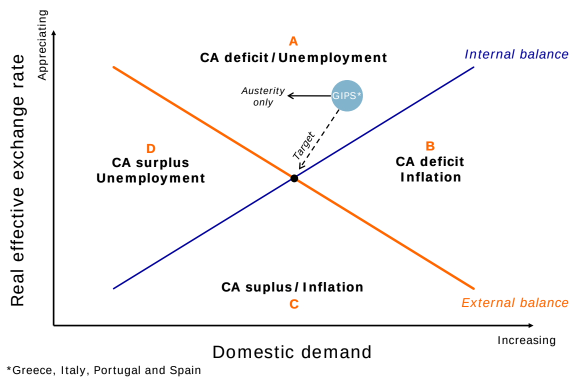
In part 1 (Rabo Special Report 12/05) we argued that macroeconomic imbalances, and not fiscal profligacy, lie at the heart of the eurozone crisis. We also revealed that simultaneous deleveraging by banks and sovereigns is not succeeding to put an end to the crisis amid weaker economic activity. Finally, we claimed that the policy measures taken by the European leaders and the ECB are not adequately addressing the periphery's economic woes. Even long-awaited structural reforms are not going to help much in the short-term. So how can the GIIPS get out of this predicament?

Understanding the crisis

A good way to illustrate the uncomfortable position the GIIPS find themselves is to consider a classic analysis of macro policy in an open economy: Trevor Swan's 1955 discussion of the difficulty of reconciling 'internal balance' (i.e. more or less full employment) with 'external balance' (i.e. an acceptable current account balance). The 'Swan diagram', as it is famously known in economic textbooks, analyses the economic effects of two kinds of policies: those that affect domestic demand and those that affect the relative costs of domestic goods and services.

Figure 1 depicts a standard Swan diagram. One curve represents conditions under which the country has 'internal balance'. The reason why it is upward-sloping is that any rise in the country's relative costs (i.e. an appreciation of its real effective exchange rate, REER) would tend to hurt the export sector, result in higher imports, and thus reduce employment. To prevent unemployment from rising, the policymakers would need to boost domestic demand. At any point below this internal balance curve, the economy will suffer from 'too much' demand for its goods and services, and will, therefore, experience inflationary pressures. At any point above, it will suffer from lack of domestic demand (i.e. rising unemployment). The other curve shows conditions under which the country has 'external balance'. It slopes downward because an increase in spending would, other things equal, result in a deterioration in the current account (CA) balance. To compensate for this, the REER would have to fall so that exports pick up. Conversely, a drop in the REER would, other things equal, result in a CA surplus if domestic demand is not raised. The two curves define four 'zones of economic discomfort': CA deficit + unemployment (zone A); CA deficit + inflation (zone B); CA surplus + inflation (zone C); CA surplus + unemployment (zone D).

Figure 1: The Swan diagram

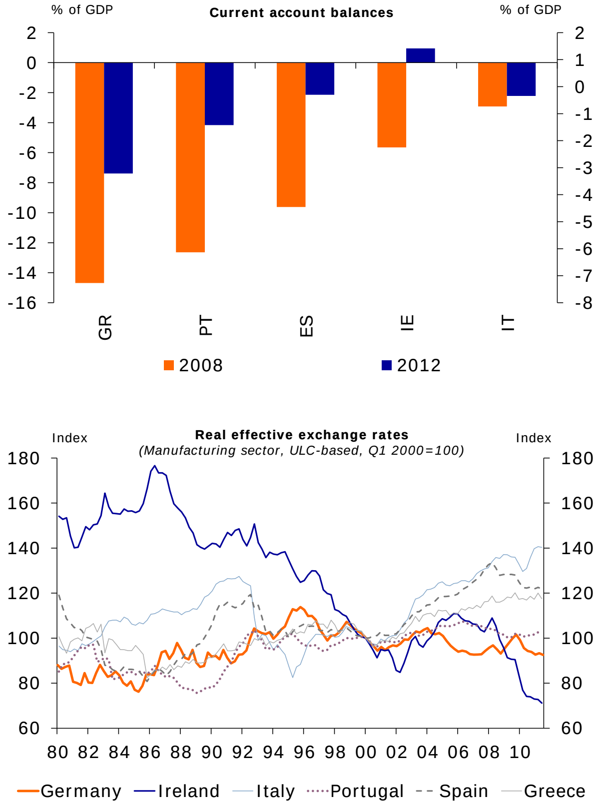


Source: Swan (1955), Rabobank

What the Swan diagram demonstrates is that there are some states wherein an economy will require changes in *both* domestic demand and the REER to achieve the desired combination of internal and external balance. So by understanding which zone an economy is situated, one gets a clue as to what kind of macro policy action is appropriate.

Clearly, the periphery is suffering high and rising unemployment, together with a worrying external deficit. Hence, we can deduce that the periphery countries are located in zone A[1]. Against this background, to reach the desired target they need not only austerity, which shrinks domestic demand and helps them reach external balance, but also a lower REER to attain internal balance.

Figure 2: Rebalancing underway

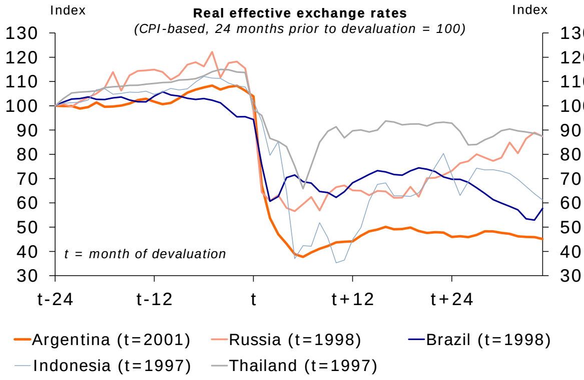


Source: IMF, Reuters EcoWin, Rabobank

As mentioned in part 1, the policy prescription has been austerity only. This has resulted in shrinking CA deficits (see figure 2, top panel) and in the case of Ireland even a CA surplus. But only the latter has truly regained competitiveness through a sharp drop in its REER (i.e. desirable external rebalancing). Figure 2 (bottom panel) shows that Ireland's external adjustment appears broadly complete due to the country's flexible labour market. The other countries have experienced the undesirable version of external rebalancing, namely domestic demand compression pushing down CA deficits. At the very extreme, the GIPS will achieve external balance through this policy path, but that will only come at the cost of even higher jobless rates (i.e. they will be further away from internal balance). It is important to realise that the resulting contraction of GDP will add to the problem of debt overhang in the periphery.

So what are the policy options facing Greece, Italy, Portugal and Spain (GIPS)? Similar to Ireland, they need to increase their growth based on exports (or shift consumption towards domestic goods and away from imports) through 'internal devaluation' —their prices/wages must fall relative to the average of their competitors (e.g. the 'core' European countries) given that they are in the euro straitjacket. For that matter, they cannot benefit from rapid external devaluations that other crisis-hit countries experienced in the past.

Figure 3: External devaluations in the past



Source: Reuters EcoWin, Rabobank

Nevertheless, a drop in the REERs through internal devaluation is of utmost importance since the GIPS need foreigners to do the spending for them while they are repairing their balance sheets. With large fiscal contraction and private sector deleveraging in store

[1] Prior to the crisis, the GIIPS were in Zone B given yawning current account deficits and rising inflation.

over the coming years, there is no possibility of growth coming from domestic demand in the foreseeable future. Indeed, with structural reforms incomplete and slow to work, prolonged recession is the main instrument to reach external balance but at the cost of moving away from internal balance.

The downhill battle in a monetary union

Indeed, regaining competitiveness within the eurozone is by no means easy since it means the GIPS would need to post inflation rates close to zero or even experience deflation for some time to come. Going through years of wage stagnation/contraction will be a herculean task in any society. Not to mention that a debt-deflation spiral will add to economic misery. So the trick is to restore competitiveness while avoiding deflation. But how?

One approach would be 'fiscal devaluation'. With a fixed money wage —more precisely, a fixed money wage *net* of employers' social contributions (e.g. payroll tax)— a reduction in the rate of those contributions reduces ULCs and thus lowers producer prices, including those of exported goods and services. The effects on the government budget can then be neutralised by a corresponding rise in the VAT rate[2], which bears on domestic consumption but not on exports, and so will increase the consumer price of imports. Foreign demand for exports increases and domestic demand for imports falls; consequently, the CA balance improves —as it would with a depreciation of the real exchange rate. Meanwhile, this policy will be revenue-neutral (i.e. the fiscal position does not deteriorate). Sadly, empirical evidence shows that fiscal devaluations have small positive effects on the CA balance. The IMF surveys a number of studies and concludes that the positive effect of fiscal devaluation on trade "*while not trivial, should not be overestimated*" (see *Rabo Special Report No. 11/15*).

A more effective approach would be for the core countries to boost their domestic demand by carrying out structural reforms (e.g. deregulating the services sector) and raising disposable incomes. The advantage of stronger domestic demand in the core is that the periphery countries will get a bit of breathing space while repairing their balance sheets. In a similar vein, core countries that still have some fiscal space should opt for a slower pace of fiscal adjustment to ensure domestic demand does not weaken unnecessarily strongly. To be sure, credible medium-term fiscal austerity plans are needed to retain market trust.

Fiscal risk sharing is beneficial

To further cushion the impact of fiscal adjustment in the GIIPS, euro members may decide to pool fiscal risks in the context of eurobonds, which provide for common sovereign borrowing with joint and several liability (for a discussion see Boonstra, 2011). As such, eurobonds can prevent sharp increases in borrowing costs due to country-specific or euro-wide shocks. This will give more fiscal leeway to the periphery and, therefore, allow budgetary consolidation measures to proceed in a manner consistent with supporting growth. Besides, by allowing banks to switch from country-specific to euro area sovereign risk, eurobonds would help reduce the close ties between banks and the risks of their own sovereigns.

The ECB must act boldly

We have argued that policies geared towards supporting growth in the periphery are indispensable for an orderly process of deleveraging and rebalancing. The ECB can also help by running sufficiently accommodative monetary policy, consistent with the recognition that deflationary dynamics in the periphery, once in train, are particularly difficult to reverse. This means even allowing eurozone inflation to rise to, say, 3-5%. With such a policy change, the

[2] In practice, the room for VAT changes may be limited because substantial differences in VAT rates between eurozone members would create opportunities for cross-border trade to exploit the possibilities of tax arbitrage.

GIPS regain competitiveness by simply posting moderate inflation rates for the coming years instead of going through outright deflation, which will challenge their solvency. Moreover, the ECB must stand ready to resort to more unconventional tools should the situation warrant it. If government bond yields rise to unsustainable levels, the ECB may even consider capping interest rates (this is known as the nuclear option). The alternative might be the end of the eurozone and, as a result, the closure of the ECB headquarters in Frankfurt.

Bailout funds need to recapitalise banks

Stronger economic growth in the GIIPS will go a long way to alleviate fears over the banks operating in these countries. But the risk of synchronised, large-scale, and aggressive shedding of bank assets in the periphery is still very high. To this end, public support may be necessary for banks that have difficulty attracting new capital from private sources. And to avoid having such support raise concerns about fiscal sustainability, resources from the eurozone bailout funds (EFSF/ESM) should be used to inject capital directly into such banks. This will put an end to the notion that 'banks are global in life, but national in death'.

It is important to note that using the firepower of the bailout funds to support the banking sector, as opposed to the too-big-to-save behemoths such as Italy and Spain, can end the destructive fiscal-financial nexus discussed in part 1 (Rabo Special Report 12/05). Mind you that the US government also used the *Troubled Asset Relief Programme* to inject capital directly into financial institutions, thereby shoring up their balance sheets. This was a key step in ending the US banking crisis.

To enhance transparency, regulators must carry out stress tests that are deemed credible by market participants (e.g. including sovereign default in the eurozone as a stress scenario). Once investors identify the weakest links in the banking sector and notice that they are recapitalised, funding costs for all European banks will improve. Needless to say that this will lead to an easing of credit conditions and further support the recovery in the GIIPS.

Bottom line: The European policymakers have been advocating simultaneous deleveraging by banks and sovereigns as a solution to the eurozone crisis. But we argue that the current policy prescription will not end the vicious sovereign-bank-growth feedback loop. In our view, policymakers can take a number of steps to address this problem:

- To boost growth, the periphery countries would need to improve their competitiveness. The European policymakers must assist by supporting domestic demand in the core countries.
- To lower sovereign risk, the EU leaders must consider pooling fiscal risks through eurobonds.
- To address banking sector concerns, the bailout funds must be utilised to recapitalise banks. Credible stress tests must be carried out to improve transparency.

These measures taken together can put an end to the eurozone crisis. All we need is a bit of imagination and a lot of willingness. Failure to act risks enormous long-term repercussions in the form of messy sovereign defaults. Even a complete break-up of the eurozone cannot be entirely excluded. We can only hope that the policymakers will do whatever it takes to avoid the great economic and political costs associated with default/exit.

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