EUROPE AT THE CROSSROADS: A UNION OF AUSTERITY OR GROWTH CONVERGENCE?

SESSION 6:
AUSTERITY AND GROWTH: AN IMPOSSIBLE ALLIANCE?

FINANCIAL FRAGILITY AND THE SINGLE CURRENCY

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Guiding Principle

"It is obvious that no country can go on for ever covering by new lending a chronic surplus on current account without eventually forcing a default from the other parties."

"The Balance of Payments of the United States"

J. M. Keynes, Economic Journal, Vol. 56, No. 222 (Jun., 1946), pp. 172-187

EMU and the Single European Act 1986

- To Rejuvenate Political Impetus to stalled Integration process
  - Trade integration and growth had slowed
  - 1988 Cecchini Report: Europe 1992 The Overall Challenge
    - Estimated Impact at 5% of Community GDP
  - Supply Side Policies: No need for (inflationary) monetary stimulus or deficit spending
    - Would reduce prices by 6%, improve fiscal balance by 2.2% of GDP and improve external balance by 1% of GDP

Cecchini Was Wide of the Mark

- Average EU growth rates continued to decline from 3.2 percent in 1970s, to 2.25 percent in the 1980s, and below 2 percent in the1990s.
- Introduction of the single market did coincide with

a decline in inflation rates from over 10 percent in the 1970s and ‘80s to below 2 percent in the 1990s.

- But this decline also occurred in non-EEC countries

Made Monetary Integration more pressing

- To insure success of the "Single Internal Market" the EU accelerated **Monetary Integration**
  - Bremen/Brussels 1978 European Monetary System (EMS)
  - Article 20 SEA Economic and Monetary Union (EMU)
  - Maastricht: A Common Currency for the Common Market: Euro Timetable, Entry conditions and ECB
- **But Political Unification lagged far behind**
- Is the Gap Coming Back to Haunt resolution to the European Union Sovereign Debt Crisis?

And created MAASTRICHT's Variable Velocity

"Historical experience shows that national territories and monetary territories coincide. … the relevant legislation as a rule defined monetary sovereignty in relation to a national territory. … In contrast to the normal rule, the Maastricht Treat implies a clear discrepancy between the intentionally rather modest political integration and monetary integration."

Otmar Issing "Europe: Political Union Through Common Money"

Political integration limits monetary union?

- For Germany, YES
- "After a certain point, economic integration cannot realistically be expected to advance further without the prospect of further progress in the field of politics. The transfer of an elementary sovereign right such as monetary policy to a European Central Bank is likely to mark that point."
- Hans Tietmeyer, 1995

Why political union is important

- In a single currency system, absent devaluation, negative external shocks will have to be met with increased (downward) flexibility in wages and conditions in labour markets
- Political unification designed to harmonise social safety nets (at highest common denominator) goes against required labour market adjustments. Social safety nets have to be redesigned
- Monetary union may reduce a government's incentive to implement prudent fiscal policy since there is no exchange rate risk and the impact on interest rates is absorbed by common interest rate policies.
- Resulting national differences in unemployment and commitment to fiscal prudence will produce political pressure for compensation from the wealthier or less indebted to the poorer or more indebted areas and undermine political solidarity as well as support for common ECB monetary policy.
- It may even undermine the ability of the ECB to establish the price stability that is the prerequisite for the EURO to be established as a credible alternative to national currencies.

What was Germany’s policy?

- Germany adapts to Single Currency
  - Reduce fiscal deficit caused by E. German unification
  - Reduction in Social Welfare System
  - Increased flexibility in labour markets
  - wage increases below productivity
- The failure of the rest of the EU to follow these policies has produced precisely the kind of political pressure that German experts had foreseen in 1996
- And now Germany calls for the rest of the EU to adopt deep political integration to preserve the EURO

In the Absence of Political Integration control on Government budgets became even more important

- Single Currency and Article 104 (Lisbon 123) on ECB lending to governments
- Means governments cannot fund themselves and borrowing will depend on private market conditions
  - Governments need to run fiscal surplus to fund
  - Governments need to run fiscal surplus to keep AAA credit rating that allows borrowing
  - (Except BIS gave it to them irrespective of debt)

The Rational for the SGPact and Six Pack Conditions

- Problem is to avoid the moral hazard created by the gap between monetary and political unification
- While the Conditions for entry are strict, and failure to meet them produces the ultimate sanction, exclusion from the Euro
- After entry, there are few sanctions to failure to maintain the entry conditions.
- Thus, you need incontrovertible pre-entry proof and hard post entry sanctions that debt and deficit conditions will be met.
- And this again requires strong political unification.

Under the Euro: No “Sovereign” Debt

- Euro = Fixed exchange rate system
- Government Debt similar to Private Debt
- Repayment of Private Debt: Profits (Wages) or Borrowing or Asset Sales
- Repayment of Sovereign Debt: Taxes or Borrowing (Roll Over) or Asset Sales
- Just as different private borrowers have different credit risk, “Sovereigns” have different credit risk

Fiscal Balance and Financial Instability

- The concern to insure ironclad conditions on fiscal balance is thus understandable.
- But are these fiscal conditions required for monetary stability conducive to financial stability?
- Minsky provides a way to analyse Financial Fragility in terms of
- Hedge
- Speculative
- Ponzi financing

Minsky Financial Stability: Hedge financing

- Hedge Financing for the Sovereign
- Requires Tax yields greater than expenditure by a cushion of safety
  - (T>>G).
- But, this requires Private Sector to
  - Increase tax payments
  - Reduce Consumption, Increase saving

Minsky Financial Stability: Hedge financing

- The ability of the private sector to
  - increase tax payments
  - repay debt
- Requires private sector to spend less than it earns
  - Households: Y-C >> 0
  - Firms: Net Profits > 0
- For Combined Private sector: S> I

Government hedge requires Private sector Debt

- Government Hedge T-G>0 or T>G
- Private Sector Hedge Y-C>0 or S- I >0
- But we know that for a closed system:
- Macro Economic Balance 0 = (S-I) + (T-G)
- For the Article 104 conditions to hold
- S<I
- And the Private Sector becomes increasingly indebted

Minsky Financial Profiles?

- Private Sector:
- 1) Hedge:
  - a) S>I
- 2) Speculative: some more debt
- 3) Ponzi: S<I more debt, sell assets

- Sovereign:
- 1)Hedge:
  - T>G
- 2) Speculative: some more debt
- 3) Ponzi: G>T more debt, asset sales

Macro Economic Balance $0 = (S-I) + (T-G)$

Is There a Way out of the Problem?

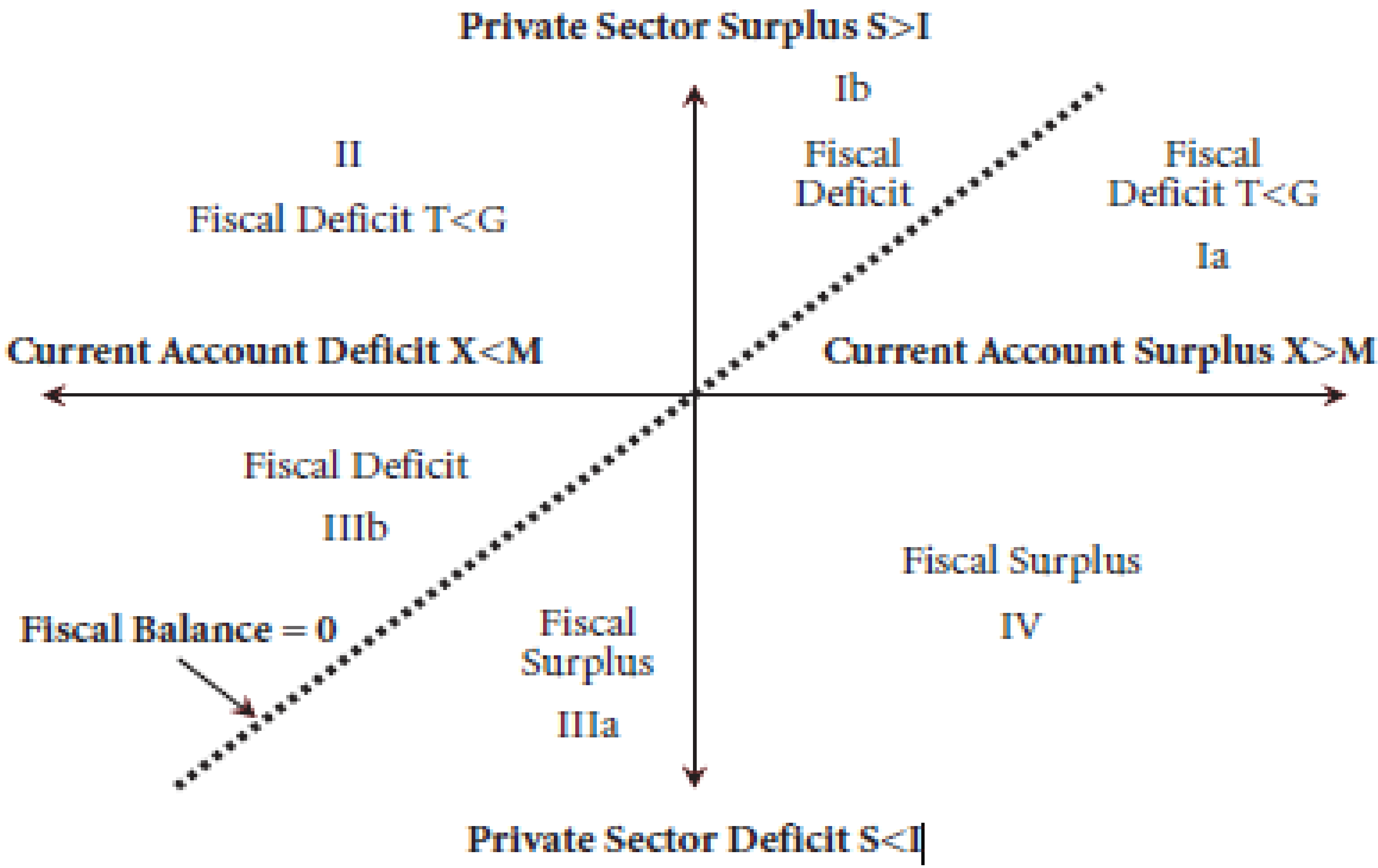
- Add the External Sector:
- $0 = (S-I) + (T-G) - (X-M)$
- We can have $S>I$ and $T>G$ IFF $X>M$
- Article 104 can only be met if the EU has an external surplus sufficiently large to offset the savings of the government and the private sector
- The EURO can only survive with an external surplus

Shift Financial Fragility to the External Sector

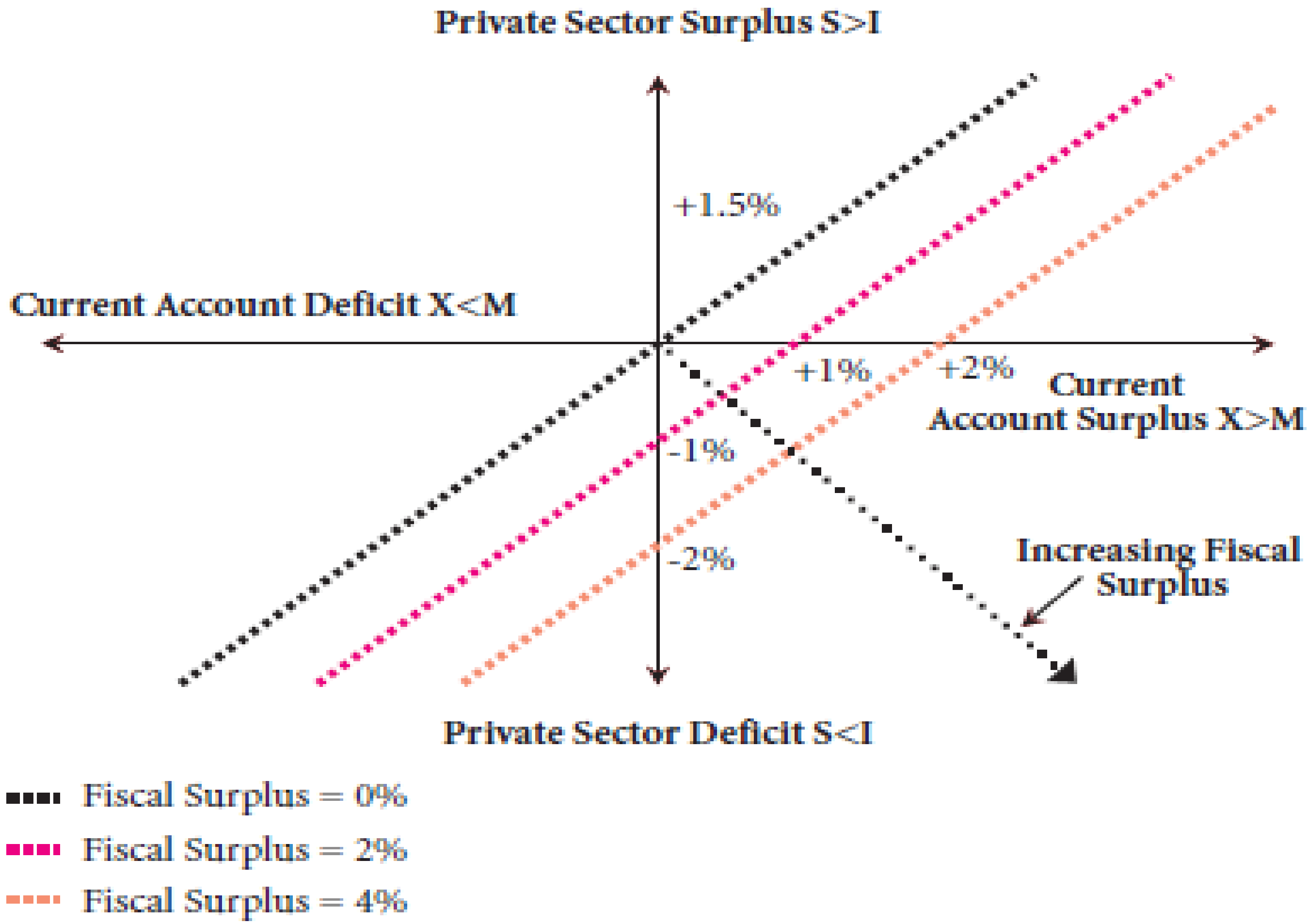
- 1Sovereign (104) Hedge
  - T-G>0
- 2 Private Sector Hedge
  - S-I < 0
- 3 Private & Govt Hedge
  - S-I > 0 &T-G > 0
  - Lending to Foreigners

- Private Sector:
  - S-I < 0 (more debt)
- 104 Fiscal Violation
  - T-G < 0 (more debt)
- External Ponzi:
  - X-M > 0
  - X-M = (S-I) + (T-G)
  - Foreigner's Borrowing

Parenteau Diagram of Financial Balances



Financial Balance: Government



Monetary Convergence, Real Divergence and Slow Growth

- "External" surplus is crucial determinant of ability of private and government sectors to repay debt.
- External account is mirror image of the net balance of the private and government sector of the country's trading partners
- Domestic adjustment to repay debt can only occur with the cooperation of the creditor trading partners.
- In the case of Greece, the most important "external" sector is the rest of the EU.
- Greece has little ability to increase exports rapidly due to real divergence due to differential impact of capital flows
    - **EXCEPTION: Export labour (Emigrant Remittances)!**
- THE SOLUTION CANNOT BE IN GREECE ALONE
- It must involve the Surplus Countries
- Or the existence of a large external debtor country

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But is this solution Financially Stable?

- In the 1940s the US considered a policy of supporting domestic demand by a permanent current account surplus
- Evsey Domar showed that a stable share of export surplus to GDP was feasible and stable on one condition:
- The rate of increase of the outstanding foreign lending was greater or equal to the interest rate charged on the loans.
- But this is the definition of a PONZI scheme!
- And the reduction in efficiency wages/or currency depreciation to keep the surplus will dampen domestic demand producing STAGNATION or STAGFLATION.
- The survival of the EURO seems to require with the permanent maintenance of a Ponzi scheme or Stagflation.

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