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CAN EUROLAND SURVIVE?

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Introduction

Governments worldwide have spent the last year or so trying to find the right mix of fiscal and monetary policies to deal with the worst global economic meltdown since the 1930s. Virtually all central banks have responded by cutting interest rate targets and intervening as lenders of last resort. In the United States, the Federal Reserve (Fed) has injected massive amounts of liquidity into the banking system and also eased global liquidity conditions through dollar swap-line arrangements. In addition, treasuries around the world have turned to fiscal "stimulus" packages like the $787 billion American Recovery and Reinvestment Act passed by the U.S. Congress in February 2009.

In this brief we show that Euroland—comprising the 16, out of a total of 27, European Union (EU) countries that use the euro—is in a particularly difficult situation. We continue to argue that at the level of individual member states the euro is not a sovereign currency, so it imposes serious constraints on the ability of states to mount a substantial fiscal stimulus (Bell [Kelton] 2003, Sardoni and Wray 2006). At the EU level, parliament spending amounts to only 1 percent of total GDP, an amount far too modest for the job at hand. By contrast, the U.S. Treasury spends the equivalent of 20 percent of GDP, which will climb sharply this year (to a proposed $2.94 trillion) and next ($3.55 trillion).

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The Global Crisis

Protests and riots broke out worldwide toward the end of 2008. Social unrest was perhaps most severe on the periphery of Euroland (e.g., Latvia, Lithuania, and Iceland), with the exception of violent demonstrations in Ireland in February 2009. Democracy has at best a shaky foothold in many of these countries, leading to fears that the widespread unrest could signal a turn toward authoritarianism.

The World Bank projects that over the next year 100 million more people will fall below the poverty line worldwide, and that 50 million might lose their jobs. Euroland is collapsing faster than the United States because its exports have dried up and its fiscal response has been weaker. Its three largest economies have seen the sharpest declines: Germany (-2.1 percent), France (-1.2 percent), and Italy (-1.8 percent) (Pfanner 2009). The European Commission (EC), which acts as executive of the EU, projects rising budget deficits across Euroland that will likely exceed current projections as economies collapse. Further, markets are punishing these countries, as exemplified by credit downgrades, rising prices for credit default swaps (CDSs), and widening interest rate spreads. Higher interest rates on government debt "crowd out" other government spending and reduce fiscal policy space. While Germany might have room for fiscal stimulus, it is unclear that the other euro nations do—making an accelerating slide toward depression, and the dissolution of the EU, a real possibility.

The Federal Reserve's Global Response

There have been two types of response to the global financial crisis. The first is a run to U.S. dollar assets; in particular, U.S. Treasuries. The second is that many international corporations have had to exchange foreign currencies and liquidate eurodollar assets to meet their dollar liabilities (e.g., to pay for oil imports with "petro dollars"). This in turn has pressured foreign central banks to secure dollars. In response, the Fed has expanded its lending facilities.

The primary way that the Fed lends to foreign central banks is via swap lines—a reciprocal arrangement whereby the Fed creates dollar liabilities and the foreign banks create liabilities in their own currencies. In terms of the European Central Bank (ECB), the Fed holds euro deposits and issues dollar deposits to the ECB, while the ECB holds dollar deposits and issues euro deposits to the Fed. The ECB is then able to lend dollars to its domestic banks, with the Fed acting as the global lender of last resort.

From the perspective of Euroland, dollar lending has helped to cushion exchange rate volatility and allowed individual banks to meet the demand for eurodollar withdrawals. However, it is not clear how the central banks will service and retire this debt. And it is questionable if there is sufficient political will for U.S. policymakers to continue to support foreign central banks as Treasury and Fed spending, lending, and guarantees explode.

Finally, the U.S. bailouts have been "passed through" to foreign financial institutions, including European banks (e.g., the funds used to bail out insurance giant AIG), leading to a public outcry in the United States. Since the bailout has been shrouded in secrecy, we can only surmise that other such funds have found their way to Euroland.

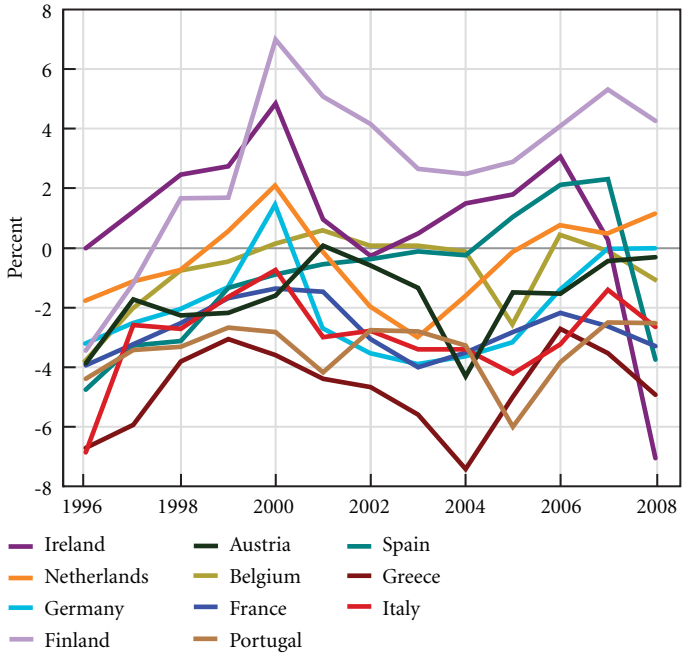
Fiscal Policy in a Sovereign Nation

A sovereign government spends by crediting bank accounts and taxes by debiting those accounts. A budget deficit means that credits exceed debits, which show up as net financial wealth in the nongovernment sector and as net reserve credits in the banking system. These credits normally generate excess reserves that are offered in the overnight market. The excess in aggregate pushes the overnight lending rate toward zero, downward pressure that is relieved through sales of government bonds by the central bank and treasury.

Bond sales are properly seen as part of monetary policy. The central bank sets its target rate according to its belief about how that rate will impact a range of economic variables within its policy objectives. Banks prefer interest-earning treasury debt over non-interest-earning excess reserves, so there is no problem selling treasury debt. Treasury debt can be eliminated entirely if the central bank pays interest on reserves (as in Canada and, more recently, in the United States) or if the central bank's overnight interest rate target is zero (as in Japan). In either case, the central bank is able to hit its target regardless of the size of the treasury's deficit, and there is no need for sales of sovereign debt.

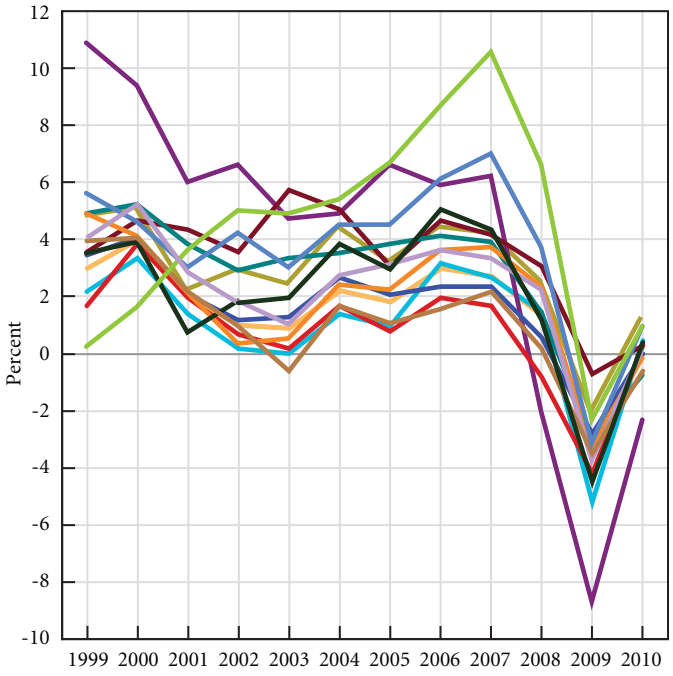
The notion of a "government budget constraint" only applies ex post for a sovereign nation with its own currency. At year-end, any increase in government spending will be matched by an increase in taxes, high-powered money (reserves and cash), and sovereign debt held. This does not mean that taxes or bonds actually "finance" government spending. A sovereign

Figure 1 General Government Balance as a Percent of GDP, 1996–2008



Source: ECB

Figure 2 Euroland's Real GDP Growth Rate, 1999–2010* (in percent)



* Forecast data for 2009 and 2010

** Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, and Spain

Source: Eurostat

government's spending can never be constrained by taxes or bond sales. Nor can one force a sovereign government to default on its domestic currency commitments, which can always be met by crediting bank accounts.

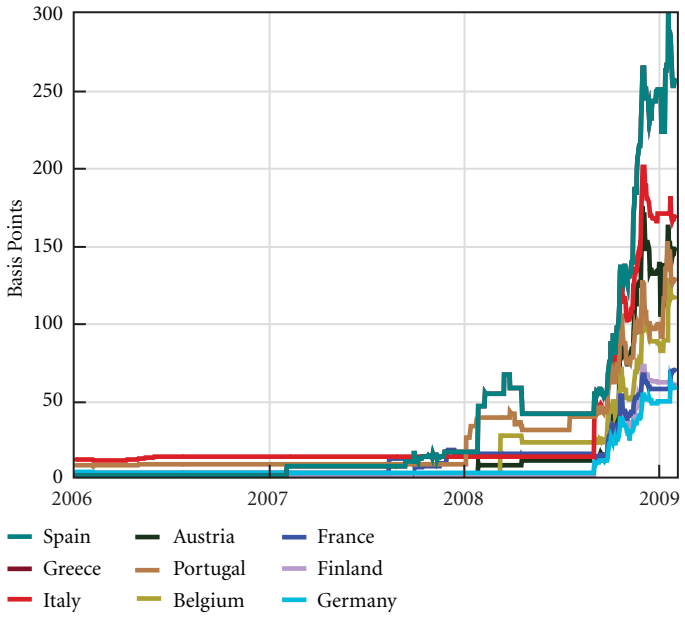
What About Euroland?

While monetary policy has not diverged much between the United States and Euroland, fiscal policy has differed between the two regions. Cyclical swings in government spending by the European Parliament are insignificant for such a "small government" budget (i.e., 1 percent of GDP), and they cannot stabilize the euro economy. Most government spending in Euroland is decentralized and large relative to national output, and member states routinely exceed the deficit limit of 3 percent specified in the Maastricht Treaty (Figure 1). The formation of the euro area has resulted in some fiscal constraints, since state debt ratios have converged (mostly downward) toward the Maastricht benchmark of 60 percent of GDP (a trend that will likely reverse as declining output and rising deficits force debt-to-GDP ratios higher). But: even though no euro nation has a "large" deficit or debt ratio relative to what is commonly observed in independent sovereign nations, a euro nation faces "market-imposed" constraints on borrowing because it is not a sovereign country.

It is probable that the fiscal restraints on the EU's nonsovereign member states have led to a greater reliance on foreign demand as the engine of economic growth. Individual states have tried to increase net exports as domestic demand declines, but since exchange rates with other EU members are fixed, their only alternative is to maintain or reduce wages and prices internally. This response reinforces fiscal austerity and slow growth.

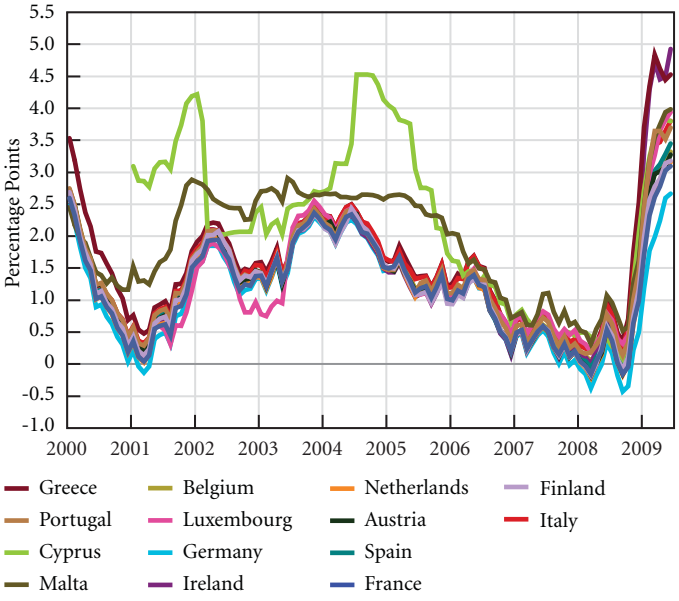
Euroland's unemployment rates have remained high and are trending upward. Moreover, GDP growth rates fell below 2 percent throughout Euroland in 2008 (Figure 2). Thus, the economic performance in Euroland has converged to one that is uniformly poor for all members—a situation consistent with nonsovereign nations' relying on export-led (mercantilist)

Figure 3 Euro Price of Credit Default Swaps for Five-year Euro State Government Debt, 2006–09 (in basis points)



Source: Bloomberg

Figure 4 Euribor Spreads* for 10-year Government Bonds, 2000–09 (in percentage points)



*Monthly average of one-week Euribor rate

Sources: ECB; euribor.org

policy: Euroland's annual growth rate rose above 3 percent only when the U.S. economy boomed in 2006–07.

Government debt issued by euro nations has been perceived by markets to be heterogeneous because national interest rates have actually diverged rather than converged since monetary union (Bell [Kelton] 2003). The markets must weigh the risk of default by individual member states as well as the probability of a bailout by the EU. The procedure for bailing out a member state, however, is unspecified. The ECB is practically prohibited from taking over the debts of member states, and, as discussed, there is no central fiscal authority that has anything like the responsibility of the U.S. Treasury.

This flawed fiscal arrangement poses the most important problem for sustaining European unification. If a nation's debt is downgraded, interest rates and government deficits will rise and threaten to set off a vicious cycle of recursive downgrading among member states. According to the EU governing treaty, members are not liable for the debts of other members, but they can purchase those debts. The question is whether a strong member such as Germany would be willing to buy the debt of a downgraded member such as Italy or, even less likely, that of a periphery nation.

Market Perceptions of the Riskiness of Government Debt

One measure of the market's perception of the risk of default is the credit default swap, which is essentially a speculative bet on the probability of default. Figure 3 shows the euro price of CDSs for five-year euro state government debt. As in the case of U.S. Treasuries, prices have risen sharply. Only Germany, France, and Finland enjoy CDS prices as low as those for U.S. government debt. While we believe markets are wrongly interpreting the possibility of U.S. government default (which is zero), the much larger increase in CDS prices for some euro nations is feeding a legitimate fear that these nations might default.

Figure 4 shows Euribor spreads for 10-year government bonds since 2000. Despite the fact that all member governments issue "identical" (euro-denominated) debt, the capital markets clearly perceive a difference between countries. Spreads vary across time and by member, and they have widened tremendously during the current economic downturn, indicating that liquidity and/or default risk are expected to rise. Further, spreads also increase when a nation's fiscal position deteriorates (presumably for the same reason).

Financing Euro Budget Deficits in a Hostile Environment

Euroland officially entered a recession when its GDP declined 0.2 percent in the third quarter of 2008 and governments adopted countercyclical "stimulus packages" to try to cope with the deteriorating economic situation (as in the United States). The EC estimates that the fiscal stimulus (including nondiscretionary spending) will amount to about 4 percent of GDP through 2010 and push Euroland's deficit-to-GDP ratio to an average of 4 percent. The expanded deficits, together with sizable "below the line" operations (such as the recapitalization of banks and loans to private enterprises), should push debt levels to about 73 percent of GDP in 2009 and 76 percent in 2010 (EC 2009).

All of this debt has to be purchased in private capital markets, which has intensified competition between sellers and forced some states to pay markedly higher rates in light of the states' perceived risk. Only five of the EU-16 member states are expected to avoid breaching the 3 percent budget-deficit rule during the next two years, but their fiscal positions will also "deteriorate," and markets are expressing an unprecedented preference for issues of the German treasury. (A string of national downgrades by the rating agencies caused markets to raise the premium on non-German issues.) Once markets begin to perceive a nation as a "weak" issuer, they can effectively shut down a nation's ability to stabilize conditions within its borders. This is the fundamental weakness of the euro zone that we have warned about since its inception.

Some groups (e.g., the European Council) argue that the Stability and Growth Pact limits "mark an essential condition for sustainable and noninflationary growth and a high level of employment" (Spiegel 1997, 1). Others suggest that member states should be free to pursue independent fiscal policy without arbitrary limits or penalties (Pasinetti 1997; Arestis and Sawyer 1998). A third group (Wray 1998; Mosler 1999; Bell [Kelton] 2003) believes that the Pact and the Excessive Deficit Procedure probably don't constrain government spending, so changing the arbitrary limits would do little to increase fiscal freedom. This argument is based on the (correct) notion that financial markets (by pricing risk) are likely to discipline member governments even *before* the Maastricht Treaty limits are reached.

Because member states can no longer create spendable deposits internally (i.e., "print" money), they must compete (fiscally) for euros by selling bonds to private investors (including private banks). To the extent that policymakers pursue objectives such as competing for benchmark status (e.g., Germany and France), they assign a less important role to goals such as stabilizing output and employment.

Conclusion

Following the switch to the euro, there was convergence to slower economic growth and higher unemployment, and, initially, to tighter fiscal stances. Markets continued to differentiate between issues on the basis of liquidity, and credit risk emerged as the primary cause of the *divergence* of bond-yield spreads—especially as the global financial crisis unfolded. And, since ratings agencies made it clear that they would take into account possible increases in fiscal deficits when assigning credit ratings to EU state governments, fiscal competition intensified. Until something is done so that these states can avert such financial constraints the prospect for stabilizing the euro zone appears grim.

The problem is that Euroland lacks a fiscal entity, such as the U.S. Treasury, that has the ability to provide a significant budgetary stimulus. Thus, the region must depend on a combination of automatic stabilizers and discretionary fiscal policies at the state level to stimulate an economic recovery.

The EC's optimistic projection of a growth recovery beginning in the second half of this year "depends crucially" on the passage of a sufficiently large fiscal stimulus package (5.5 percent or more) in the United States, which has already emerged as the lender of last resort to the ECB (EC 2009). Since the crisis cannot be addressed without ballooning budget deficits, the downgrading of EU-member debt is adding to the cost of borrowing, and reducing the likelihood that the crisis can be mitigated by a sufficiently large fiscal expansion.

The only way out of this mess is to use the sovereign power that exists in countries such as the United States, the UK, and China, and ramp up government spending. By contrast, the outlook for Euroland is bleak unless it forms a "more perfect union" by investing in the fiscal authority of the European Parliament. This action is easy enough in terms of economics, accounting, and budgeting, but it could be politically, culturally, and socially difficult. We suspect that EU expansion has made the prospects for changing the structure of the union virtually impossible. Hence, there remains the possibility of a trend toward dissolution rather than greater unification.

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