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An agenda for Europe

The grand vision of Delors, Kohl and Mitterand has brought us the euro. Whether we are still as pleased with this vision today is debatable, as the introduction of the European currency feels more like a failed gamble. It was obvious from the very beginning that the design of the monetary union was incomplete. A monetary union that stands alone without also having a political and fiscal union to support it is like an orphan. Such a monetary union either expands into a political union or ultimately is destined to crumble. Many have warned that such further expansion would encounter resistance, and so it has. The way back, however, would be costly. In an economic sense, as the dismantling of the monetary union would cause the economy to come to a grinding halt for a couple of months and, following that period, provide lawyers with many years of work. And in a political sense, because it would be unimaginable for Brussels, as a market place for settling intra-European disputes after such a debacle, to be able to continue to function normally. This explains ECB president Draghi's political statement that he will do all that is needed to uphold the euro. From the way German Chancellor Merkel operates must be concluded that she feels the same.
Thus, everything is being done to save the euro. But what does that mean, really? For the Netherlands, this question has acquired an additional dimension following CBS on Nov. 30 of figures on the Dutch economy. Although the publication provides only a brief analysis that is likely to be adjusted somewhat, later on, it does show that short-term prospects for the Dutch economy are bleak.

United Kingdom versus Spain

The problems that may surround a monetary union have been aptly described in an analysis by Belgian economist Paul De Grauwe, who made a comparison between Spain and the United Kingdom. Objectively measured, two years ago the Spanish economy was in better condition than the UK economy, and yet the interest on the general government debt in Spain rose by much more than in the United Kingdom.

Why was this so? The answer is simple: the euro. Spain is connected to the rest of the Euro zone via a fixed exchange rate, while the UK's flexible exchange rate offers two benefits. One of which is the simple mechanism of being able to reduce national wage levels by devaluing the British Pound. This means that British companies are in a better position to compete on the world market. Spain would only be able to compete if it were to reduce its wages in euros – something that is close to impossible in actual practice. Another, much less well-known benefit for the United Kingdom is that, as its sovereign government debt is denominated the national currency, a devaluation of the British Pound also causes a reduction in the value of its debt in euros. Adjustment of the exchange rate, thus, also relieves the United Kingdom of part of its sovereign debt. Whenever countries find themselves in trouble with their general government debt, lowering the exchange rate works like some sort of insurance mechanism. However, with the changeover to the set exchange rates, this insurance mechanism has disappeared and an alternative must be sought.

Crisis in Florida

A comparison between the European Union and the United States clearly indicates the seriousness of the problem; for example, see the studies by Barry Eichengreen or by Goodhart and Lee.

When house prices in the US State of Florida dropped by more than 60%, the federal government functioned as a safety net – not because Washington took on Florida's government debt, but the federal government did cushion some of the impact indirectly. Florida receives various financial transfers from Washington; from old-age pensions to health insurance and welfare benefits – the costs of which are being covered by federal taxation. Although less growth means lower tax payments, it does not mean fewer financial transfers. These transfers, thus, function as an automatic stabiliser; in times of economic stress tax payments decline, while financial transfers increase. In addition, the federal government is also responsible for insuring the banks' balances in case of collapse. All in all, Washington carries between 30% and 40% of the costs of a local recession.

And what of the current European monetary union? Here, percentages are much lower, namely only a mere 1%. This also shows the core of the Euro zone's problem: having a 30% to 40% insurance between EU Member States would simply be unfeasible, but a 1% safety net really is too little for a monetary union to function properly. From this perspective, recent discussions about increasing the European budget from 1% to slightly more than 1% are only marginal.

Start with a banking union

How could such a mutual insurance between EU Member States take shape? The best start would be to create a banking union. In the current situation, a bank's fate has become inextricably linked to the financial health of the Member State involved. A bankrupt banking system would drag along its Member State, and vice versa. The results are devastating; as the current interest rate on the Italian general government debt is 4% higher than that of Austria, a hotelier in the Italian Alps, for example, is paying 4% more interest than his counterpart only 10 kilometres away in the Austrian Alps. This type of disadvantage is seriously hurting the Italian economy, forcing it into recession, thus causing a decline in government revenue, which, in turn, makes it even more difficult for Italy to meet its financial obligations. The only remedy would be a European market for government debts and a European supervisory body that operates independently of the financial interests of national governments (see also Goodhart and Lee). Such supervision could only function properly if Europe, in case of emergency, would have the actual means to solve a banking crisis. Therefore, any banking union would require some form of European taxation to cover the costs of a banking crisis. Such a banking union would be the first necessary step towards a properly functioning monetary union: a system of financial transfers between EU Member States, with which they could support each other in times of economic setbacks.

Incidentally, as many of the new European institutions that have to be build are inevitable for the smooth operation of the monetary union, those countries that are not part of the Euro zone – 10 of the 27 EU Member States – do not always see the need for these new institutions. Therefore, often, they slam on the breaks during discussions, with the United Kingdom as the most clamorous example. For them, things could stay the way they are. For members of the monetary union, however, time is of the essence. This makes life within the EU more difficult for Member States outside the Euro zone, which means that speculation about a possible UK exit is rife.

Regulation alone is insufficient

Over the past two years, Europe has undergone an enormous transformation. Authority power was transferred to Brussels, on a large scale, notably through pleas of the Dutch government. Member State budgets are required to meet a number of conditions. These conditions are being supervised by the European Commission in Brussels, which thereby has gained in power and influence, and from now on offenders will be penalised. These rules correspond to those of the US monetary union. Experience has taught US states to impose similar rules; they are not allowed to have debts or budget deficits. These rules are similar to those that Dutch municipalities and provinces must adhere to. Municipalities in the Netherlands, therefore, are not prone to bankruptcy, and should any of them suffer financial problems, there is the federal safety net. A monetary union demands a certain level of mutual solidarity, but by the same token requires stringent financial regulation to prevent misuse. Large general government debt is bad for economic growth. Therefore, it is important to maintain a well-balanced government budget. In the meantime, European Commissioner Olli Rehn has started procedures to ensure a balanced budget and European authority. However, in the short run, spending cuts are detrimental to economic growth, which means that implementing effective budgetary policies is like sailing between Scylla and Charybdis: if, in a bend in the road, you let go of the steering wheel you will loose control, but putting the brakes on will cause the same effect. The question, therefore, is what would be the right time to apply the brakes? A few weeks back, the International Monetary Fund (IMF) published an overview of recent research in this area. Spending cuts in times of increasing unemployment (see Auerbach and Gorodnichenko) and financial crisis (see Corsetti et.al.) at the time of an already low Central Bank interest rate have been shown to be very costly. In the current recession in Europe, the lights have turned red with regard to these issues. However, in the case of high general government debt spending cuts cannot be avoided. The CPB model takes differences in the timing of spending cuts only into account to a limited extent – which caused the IMF to state that the CPB Netherlands Bureau for Economic Policy Analysis probably had underestimated the cost of spending cuts in the current circumstances. Looking at these studies, this could very well be true. At the very least, it would explain why the Dutch growth lags behind that of Germany.

The deep recession that Europe currently is falling into, thus, presents Olli Rehn with a dilemma. Reputations take a long time to build and can be lost very quickly. To achieve credibility for the new regulations, Rehn therefore still has a long road to travel. At the same time, economic circumstances require conventional policies. If he were to take the initiative, his actions could make the difference, although each of the choices that he is faced with carry their own negative consequences.

Debt and penalties

Today, you would have to be crazy to invest in Greece. After all, investors run the risk of loosing the profits on their investments on government taxes imposed to pay national debts. And high debt is bad for economic growth for a reason – see Kummar and Woo. Recently, certain Irish economists paid a visit to the CPB Netherlands Bureau for Economic Policy Analysis. Ireland is the wunderkind among PIIGS countries; faced with an enormous sovereign debt due to a banking crisis, it continued to implement all reforms and spending cuts as agreed. As a result, the interest on the Irish sovereign debt is falling. The underlying facts, however, show that Ireland has hardly progressed at all. Its young talent has emigrated to better places, where taxes are not imposed in order to combat towering debts. And who could blame them? Unfortunately, each emigrant worsens the fate of those that stay behind. This vicious circle needs to be broken. Young people must once again have faith in the possibility of building a bright future for themselves in Ireland. And this can only happen if part of Ireland's debt would be erased.

Look at the tragedy of the European debt crisis: 12 countries have substantial financial claims on 5 other countries, some of which will never be repaid. This is annoying, unfair and unethical, and bringing it up has a reducing effect on EU's bargaining power against the Greeks. Although this is true, it is not enough to brush the matter aside. Remission would seem the only option. And the longer such remission is postponed, the more young Irish will leave their country and the longer investments in Greece and Spain will be put off. And the part of the debts that could in fact be paid off, thereby, reduces further and further. As Professor Carmen Reinhart said in her Tinbergen lecture at De Nederlandsche Bank, this pattern can be seen to repeat itself from debt crisis to debt crisis. Initially, claimants do not want to talk about remissions, but at a certain point the question arises of whether something would not be better than nothing. Almost inevitably, the answer is: all right, then give me something. And, if I am not mistaken, this time has come for Europe.

Other related CPB publications:
(in chronological order)

- On the sustainability of Greece's debt:
    - CPB policy brief The Netherlands and the European debt crisis; March 2011
    - Blog (in Dutch) about the dynamics of the debts of the problem countries in Europe; 30-01-2012
- CPB Book: Europe in Crisis (in Dutch); 14-11-2011
- CPB background document: Budget multipliers, overview of recent empirical studies (in Dutch); 12-12-2011
- Article 'European budgetary policy at this time of recession' by Jean Pisany Ferry and Coen Teulings in the Financial Times; 27-2-2012
- Column 'Fiscal consolidation and reforms: Substitutes, not complements' by Coen Teulings in VoxEU; 13-9-2012
- MEV 2013, about the lagging growth of the Dutch economy compared to that of Germany: Section 1.2 (p. 15) and text box on multipliers (p.42) (in Dutch); MEV 2013 Chapter 1 18-09-2012
- Presentation 'The European Semester: Road to Prosperity or Imperial Overstretch?', Europe House, The Hague; 21 -11- 2012