



Perspectives by Ruth Lea

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The eurozone's rescue package: buying time and postponing the day of reckoning

Introduction

In the first week of May the eurozone came extremely close to breakdown, totally eclipsing the markets' interest in the British General Election. A reluctant German Chancellor, torn between a hostile domestic electorate and eurozone meltdown, finally agreed, firstly, to a €110bn bailout for Greece which effectively covers Greek credit needs for the next 3 years at rates of 5% or less and, secondly, a "shock and awe" stabilisation package amounting to €750bn for other weaker eurozone countries faced with funding problems. The €750bn consisted of a €440bn (up to) loan facility backed by the more creditworthy eurozone members operational for the next 3 years, €60bn of EU27 bonds and up to €250bn of support from the IMF.¹

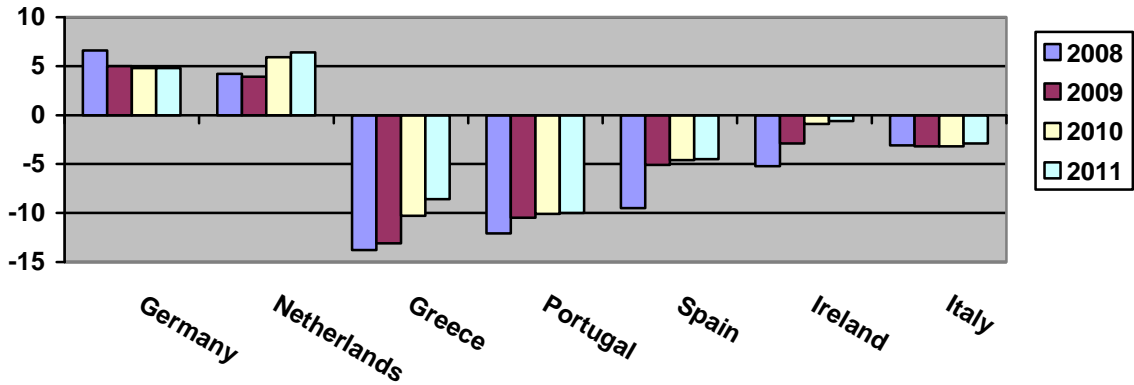
These moves have almost certainly bought the eurozone time. They are designed to protect weak links in the eurozone for the next 3 years so that the individual economies can be given the breathing space to try and shore up their public finances, clean up their banks and instigate economic reform packages to improve the competitiveness of their economies. The moves have reduced the probability of a collapse of the currency bloc within the next 3 years – though it would be unwise to discount further eurozone crises erupting during this period. But these packages, along with the policy responses on offer to date, will probably fail to address the problems of the economically fractured eurozone. And there remain serious questions over the longer-term sustainability of the eurozone in its current format, with its current membership.

During the 1990s the euro was planned and launched as part of the vision of a unified Europe – irrespective of the economic wisdom of trying to meld such disparate economies together. The vision has gone. The EU's politicians now have the face-saving task, given the political capital sunk into the project, of expensively bailing the system out. But at some point, surely, they will balk at the costs involved and actively push for a slimmer, more economically coherent currency union. The prospect of currencies leaving the eurozone was, until fairly recently, considered unthinkable. It is now being actively thought about. Indeed the question is no longer whether a country could leave the euro, but which one might want to (or be forced to), and how it could pick a way through a financial and legal minefield to the exit. The candidates discussed so far include Greece and Portugal (on the grounds of weakness) and Germany (on the grounds of strength).

The economically fractured eurozone

We have already discussed the divergent economies of the eurozone between the strong "core" surplus countries of Germany and the Netherlands on the one hand and the weak deficit peripheral countries, especially Greece and Portugal, on the other.² Updated forecasts from the European Commission make this painfully obvious (chart 1).

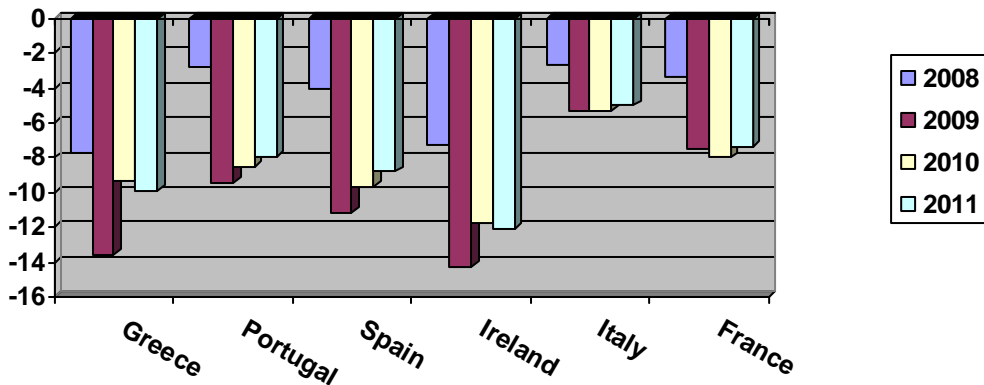
Chart 1 Selected EU countries: current Account balance, % of GDP



Source: The European Commission, *European Economic Forecast – Spring 2010*, 5 May 2010

The latest Commission forecasts also underline the truly parlous fiscal positions of the weak peripheral economics. Despite the austerity packages already announced government borrowing is forecast to remain high in Greece, Portugal, Spain and Ireland as the expected weak growth outlook bears down on revenues. This is shown in chart 2. But note that Italy's borrowing position is significantly better than France's. It can be argued that the French government is not being serious enough about cutting the budget deficit, expecting economic growth to pull them out trouble.

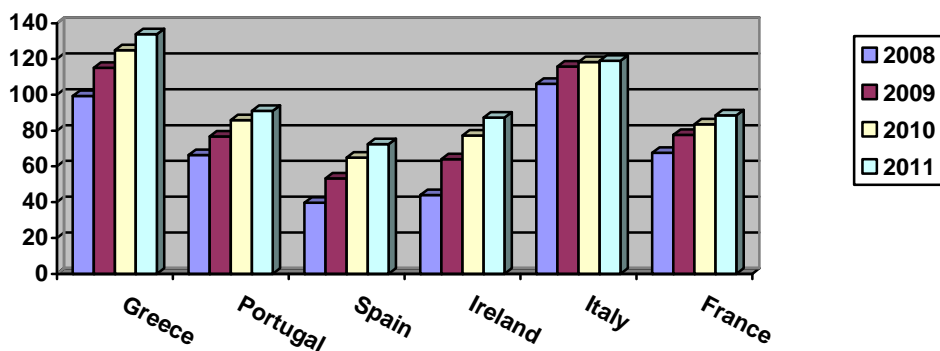
Chart 2 Net borrowing (-), general government, % of GDP



Source: The European Commission

Chart 3 shows the rapid build-up of total public sector debt. This is especially the case in Greece, which is arguably insolvent. In addition to their high public sector indebtedness, Spain and Portugal have substantial levels of private sector indebtedness.

Chart 3 General Government gross debt, % of GDP (EU forecasts)



Source: The European Commission

Austerity packages and the weaker economies

The Greek bailout and the “shock and awe” rescue package are both contingent on recipient countries imposing vigorous austerity packages. In addition the Commission has for some months been urging the high deficit countries to impose fiscal consolidation measures. Spain and Portugal have 2013 as their target for reaching the EU budget deficit guideline of 3% of GDP and Ireland and Greece have 2014. Ireland has already imposed cuts in public sector pay of up to 20%, with reductions in child and unemployment benefit.³ Spain has recently announced further budget cuts⁴ and Portugal took additional consolidation measures in April.⁵ Further substantial tightening measures are part of the EU-IMF bailout package for Greece. Tough austerity measures can only undermine further the feeble economic growth prospects for these countries.

Apart from the threat to social cohesion of high unemployment and falling living standards, it has to be questioned whether these countries are in any position to grow out of their debts, given the size of their deficits and debts. As we discussed in a previous Perspective, they have lost competitiveness compared with other eurozone countries over the past decade.⁶ And politically unpopular labour market reforms are very necessary in both Portugal and, especially, Spain. The situation is particularly parlous for Greece which, as already suggested, is arguably insolvent. Under these circumstances the eventual will of Greece and to a lesser extent Spain and Portugal to administer the required fiscal pain has to be questioned.

One age-old solution to high indebtedness is of course rampant inflation associated with a depreciating currency. But given the straightjacket of the eurozone and the tough anti-inflationary stance of the ECB, this is not an option. The question then has to be whether the growth prospects can be improved. There are two suggestions. The first is to impress on the countries the need to raise their competitiveness and in the case of Spain and Portugal grasp the need for labour and product market reforms. And the second is to address the imbalances, discussed above, between the strong surplus countries and the weak deficit countries. Germany’s position is crucial and Germany has been exhorted to stimulate domestic demand to raise growth within the eurozone – so far to no avail.

Where next for EU policy?

The Greek bailout package and the stabilisation package have been accompanied by vigorous debate about the future of the eurozone and its governance. Though it is generally agreed closer cooperation and greater fiscal control are required, there are major differences between France’s and Germany’s ambitions. For France, the crisis has proved the need for decisive steps in the direction of common eurozone economic governance – nothing less than a “gouvernement économique” with wide powers over taxation and monetary policy. The Germans, however, want a different sort of centralisation built on rules to impose fiscal discipline and punish the profligate – in other words achieve a “harmonisation of rigour”. And they resist the notion of a comprehensive “fiscal union” with even more transfers going from the rich north (principally Germany) to the poorer southern peripheral countries. Suggested ways of imposing sanctions include losing voting rights in the council of ministers for budgetary laxity or having funding lines withdrawn.

The Commission has recently released its own proposals for coordination of economic governance, the major ones being:⁷

- Improving the functioning of existing mechanisms under the Stability and Growth Pact (which has spectacularly failed to date).
- Addressing high public debt and safeguarding long-term fiscal sustainability.
- Better incentives and sanctions to comply with the rules of the Stability and Growth Pact.

And the newly convened special “economic taskforce”, which includes the ECB and the EU finance ministers, is working on a preliminary report ahead of the 17-18 June summit and will make its final recommendations in October.

The debates surrounding the economic governance of the EU27 in general and the EU16 in particular are already proving contentious. One proposal is that all EU countries, and not just the EU16 countries, should have their budget plans scrutinised by the Commission. The UK has already stated that this would be unacceptable. Another set of proposals relate to possible treaty changes – including Mrs Merkel’s suggestion that treaty law should be changed to expel countries that repeatedly violate fiscal rules from the eurozone. But whether or not these proposals are implemented, two conclusions can be safely drawn. The first is that there will be more centralisation of economic and fiscal policies in the wake of this crisis. And the second is that tighter fiscal rules,

though dominating the debate to date, will do little to help the weaker eurozone countries trapped in the eurozone with crippling indebtedness and poor growth prospects.

References

1. See the annex for a chronology of recent events of the eurozone crisis.
2. Ruth Lea, "The divergent eurozone: no easy solutions in sight", Arbuthnot Banking Group, 18 January 2010.
3. Ruth Lea, "Greece's possible bailout: a painful precedent", Arbuthnot Banking Group, 1 February 2010.
4. Economist, "Zapatero's cuts", 22 May 2010.
5. The European Commission, *European Economic Forecast – Spring 2010*, 5 May 2010.
6. Ruth Lea, "The divergent eurozone: no easy solutions in sight", Arbuthnot Banking Group, 18 January 2010.
7. European Commission, "Reinforcing economic policy coordination", 13 May 2010.

Annex: Recent chronology of the crisis - policy decisions

Date	Policy decisions
11 February 2010	Summit of the Council of the European Union: "Agreement to support Greece", but no rescue package to help Greece pay its debts. (Followed announcement of Greek target to reach EU budget deficit guideline of 3% of GDP by 2012.)
Late April 2010	Credit ratings agencies downgrade sovereign debt of Greece (to junk bond status), Portugal & Spain.
2 May 2010	<p>The IMF, the European Commission & the ECB agreed on a €110bn financing package for Greece. It comprised:</p> <ul style="list-style-type: none"> • A total of €80bn in bilateral loans from eurozone members (of which Germany the greatest provider). Implementation of the fiscal & economic reform programme will be monitored by the IMF. • A 3-year €30bn Stand-By Arrangement (SBA) from the IMF. <p>Target to reach EU budget deficit guideline of 3% of GDP extended to 2014. This bailout effectively covers Greek credit needs for the next 3 years at rates of 5% or less.</p>
3 May 2010	The ECB said it would indefinitely accept Greece's debt as collateral regardless of its credit rating.
5 May 2010	3 people were killed in Athens as protesters set fire to a bank during a general strike over planned austerity measures.
8 May 2010	The EU16 approved the Greek bailout. They also agreed to tighten EU budget rules, put in place more effective sanctions for breaking debt guidelines & monitor deficits & competitiveness.
9 May 2010	The CDU was defeated in the state of North Rhine-Westphalia, robbing Chancellor Merkel's centre-right coalition of its majority in the upper house of parliament (Bundesrat)
9 May 2010	<p>In response to the contagion spreading across the eurozone, thus undermining the stability of the euro, the EU's Council of Ministers & the ECB announced a "shock-and-awe" stabilisation (rescue) package for other weaker eurozone members: Spain, Portugal and possibly Ireland & Italy. The package included:</p> <ul style="list-style-type: none"> • Up to €440bn of loans raised by a facility (special purpose vehicle) backed by loan guarantees from the more creditworthy members of the EU16, Sweden & Poland (of which Germany the most significant) for any eurozone member facing "trouble". The facility is based on intergovernmental-agreement rather than on EU law. The plan is to retire the scheme after 3 years. Countries who use this facility will have to agree an adjustment programme with the IMF • €60bn of EU27 bonds that can be sold fairly quickly to help eurozone countries with severe public finance difficulties (the UK could contribute up to €15bn). This is an extension of a similar €50bn fund introduced for non-euro countries (Hungary, Latvia & Romania) with balance-of-payments problems. • An ECB programme to support securities markets (by buying eurozone sovereign debt, but sterilized to neutralize the impact on the money supply and rein a tight control over inflation) & reactivate temporary liquidity swap lines with, for example, the US Federal Reserve (in order to ease fears of a \$ shortage if/when investors switch to the "safe haven" \$ from € assets). <p>It was reported that the IMF could provide up to a further €250bn in the form of straight loans, though this is an undefined commitment rather than a specific pot of money. Markets initially reacted favourably. The package buys time, but arguably puts off the day of reckoning.</p>
12 May 2010	Spanish government announced further austerity measures: €15bn of spending cuts over 2 years. Approved on 20 May. Target to reach EU budget deficit guideline of 3% of GDP by 2013.
13 May 2010	Portuguese government announced further austerity measures. Target to reach EU budget deficit guideline of 3% of GDP by 2013.
18 May 2010	Greece received €14.5bn from Commission – in addition to €5.5bn already released by IMF
19 May 2010	Bafin, Germany's financial markets regulator, announced unilateral decision to ban naked short-selling of government shares & shares of some financial firms, & to ban the buying of sovereign credit-default swaps by investors who have not bought the underlying bonds. The markets reacted adversely, partly reflecting the view that this action demonstrated a damaging lack of a coordinated EU policy response to the euro-crisis. Moreover the ban was seen as rather futile as most of the relevant markets are in London & New York.

	Note: naked short-selling is selling shares that have not been borrowed first.
21 May 2010	German Parliament (both houses) approved rescue package for the euro & permitted the government to offer credit guarantees of up to €148bn.
21 May 2010	Special EU economic taskforce met: to produce preliminary report ahead of 17-18 June summit & final recommendations in October. Under French pressure, shifted away from measures that require treaty changes. 4 central priorities: greater budgetary discipline (German inspired); effective crisis management; stronger economic governance; means to reduce divergence in competitiveness in EU27.
21 May 2010	PM David Cameron rejected the idea of treaty changes to accommodate Chancellor Merkel's vision of stronger economic coordination in the EU (or an "economic government" in French parlance).

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