



Perspectives by Ruth Lea

Economic Adviser to Arbuthnot Banking Group



Eurozone pain will continue: a lesson from Black Wednesday

Introduction

On 16 September 2010 “Black Wednesday” came of age. Black Wednesday, 16 September 1992, was of course the day when the speculators forced the pound out of the EU’s Exchange Rate Mechanism (ERM). It was a blessed relief for the British economy which had been struggling to keep up with Germany’s high interest rates (in the wake of the post-unification inflationary boom) which were unnecessarily prolonging Britain’s recession. German rates, right for the German economy, were clearly inappropriate for Britain. The “one size fits all” concept quite simply did not fit all. The economies were different and required different policy responses. Once out of the ERM, Britain was free to cut interest rates, which it did, the pound depreciated and the economy recovered well.

Fast-forwarding 18 years the troubles of the euro and its “one size fits all” policies are only too painfully obvious. We have written on previous occasions about the mismatch of the eurozone economies.¹ Unfortunately, the latest evidence suggests that the economic divergencies are worsening. And the doubts about the long-term future sustainability of the eurozone in its present configuration continue to grow.

Last spring’s eurozone sovereign debt crisis, triggered by Greece’s parlous financial state, was almost existential. In early May the currency group all but ceased to function. The immediate crisis was resolved with the announcements of two massive rescue packages:

- The €110bn bespoke rescue package for Greece, agreed by the IMF, the European Commission and the ECB, was announced on 2 May.
- The European Financial Stability Facility (EFSF), now triple-A rated, was announced on 9 May. The EFSF is available, if required, to support the other weaker eurozone members: Spain, Portugal, Ireland and possibly Italy. The EFSF comprises up to €500bn of loans and bonds, supported by a further €250bn of IMF loans. It was also announced at the time that the ECB would be buying sovereign eurozone debt.²

These rescue packages calmed the markets and took the eurozone off the front pages. But, as we argued at the time, however enormous they are they merely act to buy time.³ They do not solve the underlying problems.

The eurozone: back in the news

The eurozone was back in the news last week with Ireland and Portugal again besieged by the markets. Their sovereign debt yields reached record-high spreads over German Bunds before receding. Ireland's banks, brought down by collapsing property prices, were centre stage as the Irish Government announced a bank bailout which could cost €50bn (equivalent to about one third of GDP). The costs of the bailout could push the deficit to GDP ratio to 32% in 2010, but this requires some careful interpretation. While the costs of the bailout are included in the 2010 numbers, they will be spread out over 10 years and the deficit will fall back next year.

Any suggestions that the Irish government may resort to the EFSF for help were robustly denied. Indeed it may well be that the Irish government does get through its problems without EFSF help - at this stage of developments it is quite impossible to say. But what is self-evident is that there a great deal of painful adjustment ahead in Ireland, as in the other weaker eurozone countries, as they cope with the economic and social effects of their increasingly onerous austerity packages.

Concerning austerity packages, there have been several key developments recently:

- Ireland announced last week that a new 4-year deficit reduction plan will be released in November, including the already agreed deficit target of 3% of GDP by 2014 (from 14.3% of GDP in 2009). The plan will probably include new spending cuts on top of the austerity measures already announced.
- Portugal announced a new round of austerity measures last week, including a 5% cut in the annual public sector wage bill and a 2% increase in VAT to 23%. The markets responded positively and government bond yields fell, though the unions dismissed the package as "unjust & humiliating" The Portuguese government hopes to reduce the budget deficit to 4.6% in 2011 from 9.4% in 2009 and an expected 7.3% this year. Moreover, the government is planning to bring down its public deficit to 3% of GDP by 2012, bringing it into line with EU rules on budgetary discipline a year earlier than agreed in March in an attempt to convince investors that it can avoid a Greek-style debt crisis. In March the government planned to get the deficit down to 2.8% of GDP by 2013.
- Spain continues with its stark deficit cutting programme, with the pledged deficit target of 3% of GDP by 2013 (from 11.2% in 2009). Despite this, last week Moody's became the third rating agency (after Fitch and Standard and Poor's) to downgrade its coveted triple-A credit rating.
- Greece meanwhile continues with its policies to cut its budget deficit to 8.1% of GDP this year (from 13.6% in 2009) and to 3% by 2012. But last week the country attracted criticism by rushing through legislation giving tax amnesties.
- Even France seems to have begun to fret about the safety of its ratings and announced a planned freeze on spending and higher taxes for 2011, intended to cut 1.7% of GDP off the deficit. This is arguably the toughest fiscal consolidation in France for 50 years. After an expected deficit of 7.7% of GDP for 2010, France is projecting 6% in 2011 and the deficit target of 3% of GDP by 2013.

Austerity fatigue?

As much as these austerity packages may be considered necessary to impose fiscal discipline on the eurozone's members, there are two major and interconnected concerns.

The first concern is that the austerity packages will hold back recovery and the slower growth will make it harder for countries to repair their public finances. Though there are hopes throughout the EU that there will be "export-led" recovery, this cannot be guaranteed and much will depend on private sector domestic demand picking up the public sector slack – but this cannot be guaranteed either.

It is sometimes argued that tighter fiscal policy does not undermine growth in the short-term, but a timely study from the IMF provides evidence that the "received wisdom" is broadly valid.⁴

The IMF concluded that fiscal consolidation does indeed typically lower growth in the short term. They concluded that, after two years, a budget deficit cut of 1% of GDP tends to lower output by about ½% and raise the unemployment rate by ⅓%. They added that interest rate cuts and a fall in the value of the currency usually softened the impact of fiscal consolidation on growth. However, ominously, this cushioning effect was lower when interest rates were already near zero (as they are), or when many countries consolidated at the same time (as they are). More encouragingly they found that, over the long term, debt reduction could raise output by bringing down real interest rates and allowing taxes to be reduced.

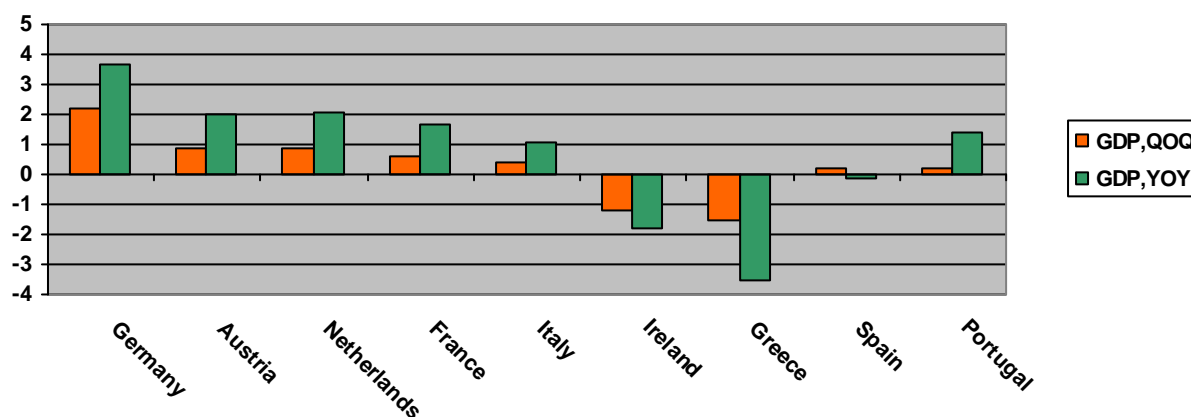
The second concern is socio-political and that is that “austerity fatigue” sets in. Last week there was the “European day of Action” (with the main action in Belgium, Greece, and Spain where there was general strike) against the austerity measures. France has experienced two strikes recently in protest at President Sarkozy’s plans to raise the retirement age from 60 to 62. If growth is severely curtailed by the austerity packages, then more industrial action has to be expected and more discomfort for Europe’s politicians.

The eurozone’s economies continue to diverge

Recent data confirm that the eurozone’s economies are diverging. The following charts show how different Germany’s current experience is from the weaker eurozone economies.

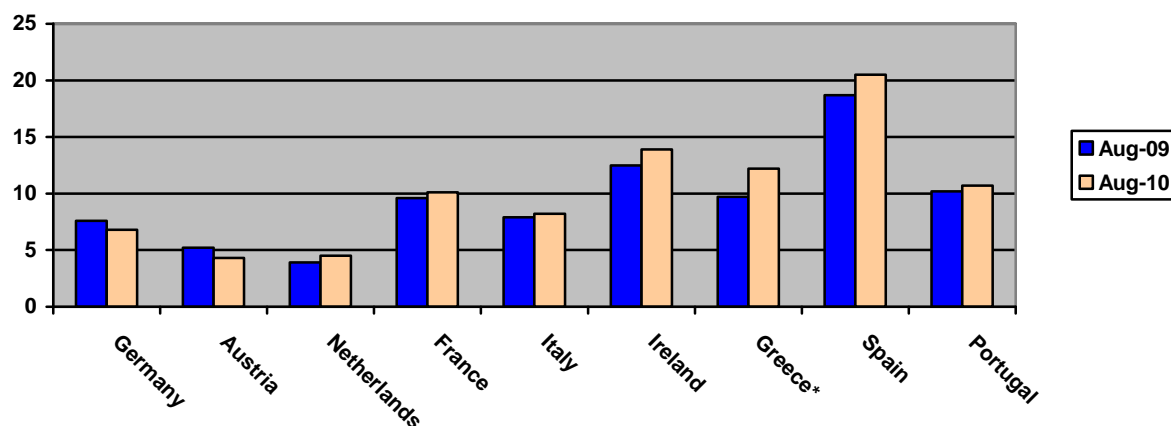
Chart 1 shows that German GDP rose by 2.2% in 2010Q2 to be 3.7% higher than a year earlier, whilst both Irish and Greek GDP fell. Chart 2 shows that the unemployment rate in Germany has fallen over the past 12 months, whilst it has risen, especially, in Ireland, Greece and Spain.

Chart 1 Eurozone, GDP data from 2010Q2, quarterly and annual changes (%)



Source: Eurostat, “Euro area and EU27 GDP up by 1.0%: 2010 second quarter”, 2 September 2010. Ireland’s data is from the Irish Central Statistics Office.

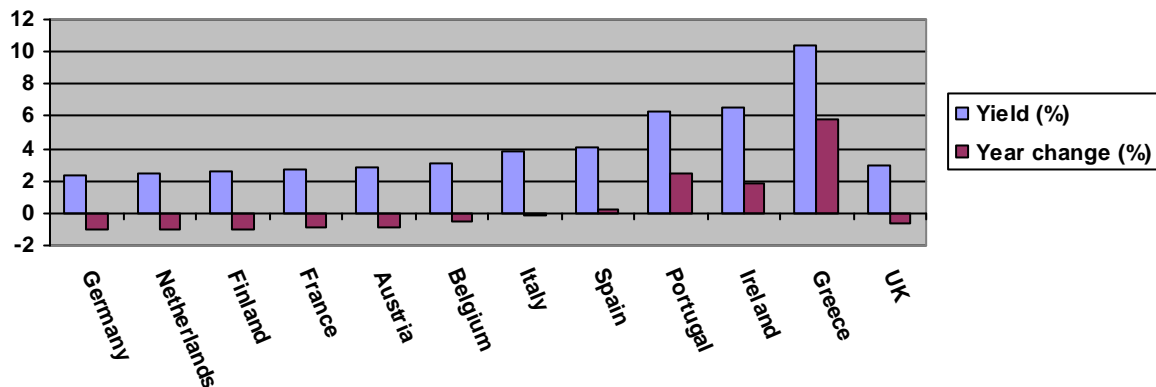
Chart 2 Unemployment rates (%): selected eurozone countries



Source: Eurostat, “Euro area unemployment rate stable at 10.1%”, 1 October 2010
Greece’s latest figure is for June 2010, not August 2010

Moreover the Commission's latest interim forecast, which is confined to the seven largest economies in the EU, confirms that whilst Germany is enjoying a strong recovery (3.4% growth expected in 2010), Spain's GDP will probably fall again this year (albeit by only 0.3%) reflecting the ongoing adjustment in the housing market and cuts in public spending.⁵ Arguably the countries that are imposing the toughest austerity packages are already lagging in the growth stakes. Moreover, they are also disadvantaged by higher borrowing costs as shown in chart 3. Their prospects look bleak. And the prospects for economic convergence look even bleaker.

Chart 3 10-year government bond yields (%), and year-on-year change



Source: *Financial Times*, 2 October 2010, data for 1 October 2010.

What is to be done?

As we discussed in a previous Perspective,⁶ the options are limited and/or painful for the weaker countries locked in the "one size fits all" eurozone:

- One option is for the weaker economies to significantly raise their price competitiveness, lost in the 2000s, relative to Germany. Years of deflation may deliver this, but at great cost.
- Alternatively Germany may be exhorted to stimulate domestic demand and act as a magnet for imports, thus stimulating other countries' export sectors and cutting its net trade surplus. There may be some mileage in this option, but past experience suggests there are limitations as to what can be achieved.

The alternative scenario of allowing Greece, Portugal, or Ireland (say) restructure their debt and/or easing up on the austerity packages has attractions but it is completely politically unacceptable to the Commission - and with reason. Alleviating these countries' difficulties would, firstly, create a dreadful precedent and, secondly, Spain and Italy would probably be targeted as the eurozone's next weak spots.

The "ultimate scenario" of countries leaving the eurozone is not, apparently, seriously being contemplated at present. Such is the political capital invested in the project and the damage that would be done to the EU if such a decision were to be made. So these economies do not have the escape route that Britain had 18 years ago. Whatever the ERM's shortcomings, at least it was easy to leave!

In the meantime the Commission is proposing ever more detailed and controlling measures not just to deal with excessive deficits under a toughened up Stability and Growth Pact (under "the excessive deficit procedure") but also to deal with the macroeconomic imbalances in such areas as competitiveness and trade imbalances.^{7,8}

In the latest Commission document,⁹ there is a proposal for an “Excessive Imbalance Procedure” (EIP) aimed at preventing and correcting macroeconomic imbalances. The EIP would be a “new element of the EU’s economic surveillance framework”, comprising a “regular assessment of the risks of imbalances based on a scoreboard composed of economic indicators”. The proposed EIP is arguably the Commission’s latest – and rather desperate – attempt to make compatible the incompatible economies of the eurozone and would mark a major step towards a Commission-controlled eurozone economy. It remains to be seen whether member states accept the proposals and, if they do, how the EIP would work in practice.

It should be noted that fines are suggested for eurozone miscreants:

- If members failed to correct their “excessive deficits”, the fine would be 0.2% of GDP.
- If members failed to correct their “excessive imbalances”, the yearly fine would be 0.1% of its GDP.

Thus the Commission and the members of the eurozone struggle to rectify a dysfunctional currency bloc with an arsenal of bailouts, fines and controls. But the eurozone will remain dysfunctional and the weaker economies will struggle.

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**Ruth Lea, Economic Adviser, Director,
Arbuthnot Banking Group,
ruthlea@arbuthnot.co.uk,
Tel: 07800 608 674**