

# ➤ Macroeconomic Policies That Will Help Southern Europe

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**L**ast year saw fundamental changes in the workings of the Eurozone. The most important change was the decision of the ECB, announced in July and enacted in September, to commit itself to unlimited purchases of Eurozone government bonds in the secondary market in times of crises. Surely, this constituted a regime change. Prior to this decision the Eurozone had been a fragile construction.

This fragility was the result of the fact that, when becoming members of the Eurozone, national governments lost their power to call in their own central bank in times of crises to pay out bondholders. Thus, bondholders could not be guaranteed that the cash would always be available to pay them out at maturity. This lack of guarantee could and did generate 'self-fulfilling' liquidity crises. The slightest doubts that a government may experience payment difficulties were sufficient to lead investors to massive sales of government bonds thereby precipitating a liquidity crisis.<sup>1</sup>

This paper argues that the decision of the ECB to commit itself to unlimited purchases of government bonds has eliminated the existential fears about the future of the Eurozone and has stabilised financial markets. Second, regarding the question of whether financial stabilisation will be sufficient to save the Euro, this paper argues that new risks have arisen from the continuing deep recessions in Southern Eurozone countries (Greece, Italy, Portugal and Spain). Finally, it suggests how the macroeconomic policies should be redesigned in the Eurozone so as to reduce these new risks.

## THE ECB AS THE LENDER OF LAST RESORT

The system needed a lender of last resort (LOLR). Last year, the ECB stepped in and committed itself to this role. Although the ECB prefers to call these operations 'Outright Monetary Transactions' (OMT), these are true lender of last resort operations. Whilst the ECB attached a number of conditions to the application of its OMT facility, in particular that countries should apply for it and commit themselves to further austerity programmes, the fact that it provided such a facility in which it committed itself to unlimited purchases of the bonds of troubled governments dramatically reduced the fragility of the system. It also took away the existential fear that gripped the Eurozone and that destabilised the system. Prior to the ECB's decision investors feared that the Eurozone might collapse. The new stand taken by the ECB reduced this existential fear that was destroying the Eurozone.

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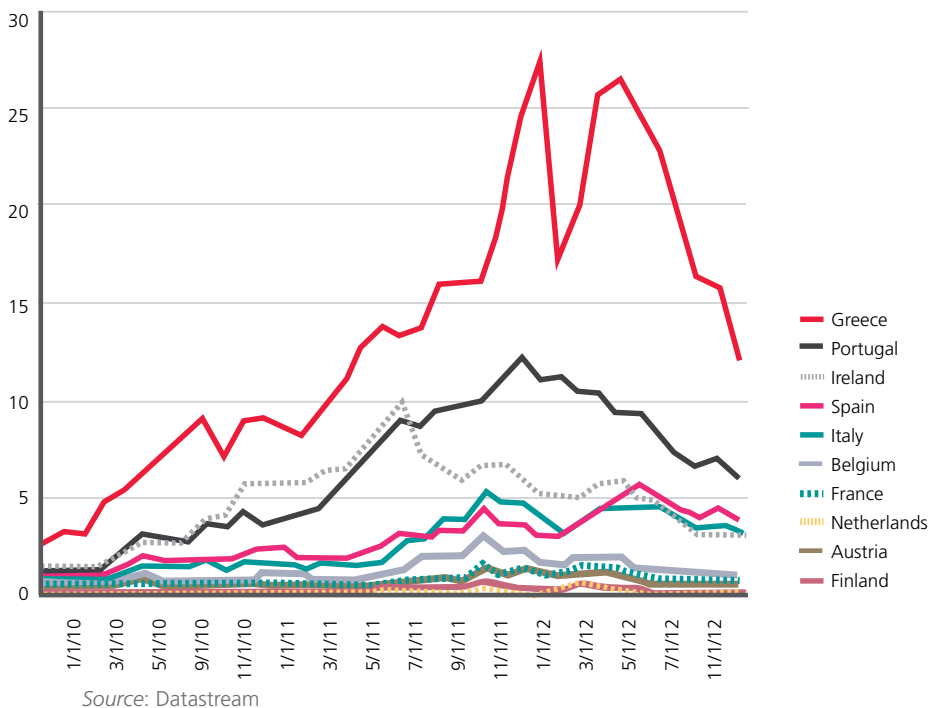
<sup>1</sup> P. De Grauwe, 'The Governance of a Fragile Eurozone,' CEPS Working Documents, Economic Policy, May 2011 <http://www.ceps.eu/book/governance-fragile-Eurozone>; P. De Grauwe, 'The European Central Bank: Lender of Last Resort in the Government Bond Markets?' CESifo Working Paper No. 3569, September 2011; P. De Grauwe, 'Towards a Less Punishing and More Forgiving Approach to the Eurozone Debt Crisis,' Centre for European Policy Studies, Commentary, 2011. <http://www.ceps.eu/book/less-punishing-more-forgiving-approach-debt-crisis-Eurozone>.

Figure 1 shows that the government bond market has pacified since July 2012. Thus the many critics, especially in the North of Europe, have been proven wrong. The ECB has made the right decision to become a lender of last resort, not only for banks but also for sovereigns, thereby re-establishing a stabilising force needed to protect the system from 'boom and bust' dynamics. This view was forcefully argued by a number of economists before the ECB decided to act.<sup>2</sup>

However, the credibility of the OMT-programme suffers because of continuing vehement criticism. This criticism culminated into the steps taken by the President of the Bundesbank calling on the German Constitutional Court to declare the OMT-programme illegal under German law. Such opposition explains why the ECB attached a number of conditions to its OMT-programme, conditions that are likely to reduce the effectiveness of that programme. First, the ECB will restrict its bond purchases to bonds with a maturity of three years or less. There is no good economic argument to impose such a restriction. In fact, it may even increase the fragility of the sovereigns. These will now have an incentive to issue bonds with shorter maturities than they would have done otherwise, making them more vulnerable to liquidity crises.

Second, the ECB has attached as a condition to the use of the OMT-programme that the countries concerned apply to the ESM (which may then subject these countries to additional austerity programmes). This creates the problem of pushing countries further into a recession as a condition to obtain relief from the ECB. It is difficult to understand the economic logic of such an approach, which appears to be the result of a moralistic approach to the problem, popular in the North of Europe, that wishes countries applying for support to be punished first for their sins.<sup>3</sup>

**Figure 1. Spreads 10-year government bond rates in Eurozone**



<sup>2</sup> P. De Grauwe, May 2011; P. De Grauwe, September 2011; C. Wyplosz, 'They Still Don't Get it,' *VoxEU*, October 2008, <http://www.voxeu.org/article/Eurozone-leaders-still-don-t-get-it>; M. Wolf, 'Be Bold Mario, Put out that Fire,' *Financial Times*, 25 October 2011.

<sup>3</sup> P. De Grauwe, May 2011; P. De Grauwe, September 2011.

## NEW RISKS FOR THE EUROZONE

From the previous analysis one can conclude that the ECB saved the Eurozone from imminent collapse during 2012. Does this mean that the Eurozone is saved? In the short and medium run, it does; in the long run, it does not. The greatest threat for the Eurozone today does not come from financial instability, but from the potential social and political instability resulting from the economic depression in which Southern European countries have been pushed into and that has led to increases in unemployment not seen since the Great Depression. In some Southern Eurozone countries the unemployment rate now stands far above 20 percent (in Greece, Spain and Portugal). The most dramatic development is the increase in youth unemployment that in Greece and Spain, which now stands above 50 percent and around 30-40 percent in Italy and Portugal. If not reversed soon, this situation may lead to social and political upheaval in societies that have become incapable of providing a future for their young citizens.

Thus, the most important development during 2012 is the change in the nature of the risks in the Eurozone. At the beginning of 2012, the risks were mainly financial, i.e. there was a risk that some governments may not find the cash to pay out the bondholders. The ECB solved that problem. At the start of 2013, the risk has become social and political. It is the risk that in some countries the continuing increase in unemployment and decline in real income leads desperate young people to start listening to politicians that promise them a better life outside the Eurozone.

There can be little doubt that part of the problem faced by Southern Eurozone countries relates to the poor functioning of their labour markets.<sup>4</sup> For example, in these countries strong employment protection laws make it difficult for the young to enter the labour market. As a result, youth unemployment has become a severe structural problem. Still, these structural problems cannot explain the dramatic decline in economic growth in these countries and the equally dramatic increase in unemployment. This state of affairs is the result of a deep failure of macroeconomic management in the Eurozone.

## FAILURES OF MACROECONOMIC MANAGEMENT IN THE EUROZONE

Financial markets have dictated macroeconomic policies in the Eurozone. The Southern European countries (as well as Ireland) have accumulated trade account deficits in the past, while the Northern Eurozone countries (Austria, Belgium, Finland, Germany, and the Netherlands) have built up trade account surpluses. As a result, these countries have become the debtors and the Northern countries the creditors in the system. This has forced the Southern countries to beg the Northern ones for financial support. The latter have reluctantly done so, but only after imposing tough austerity programmes pushing these countries into quick and deep spending cuts.

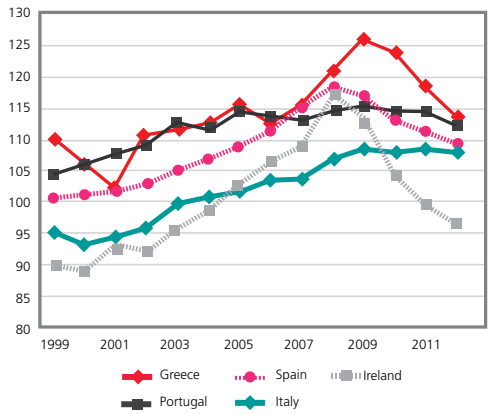
The recent explosion of government debt-to-GDP ratios makes spending cuts in the South inevitable, but these cuts were enforced too quickly and too drastically. More importantly, the Northern countries were not willing to offset the spending cuts in the South by increasing their own spending in order to stabilise growth in the Eurozone as a whole. The necessary austerity imposed on the Southern European countries could have been offset by demand stimulus in the Northern European countries. Instead, under the leadership of the European Commission, tight austerity was imposed on the debtor countries while the creditor countries continued to follow policies aimed at balancing the budget.

This has led to an asymmetric adjustment process where most of the adjustment has been done by the debtor nations. The latter countries have been forced to reduce wages and prices relative to the creditor countries (an 'internal devaluation') without compensating wage and price increases in the creditor countries ('internal revaluations').

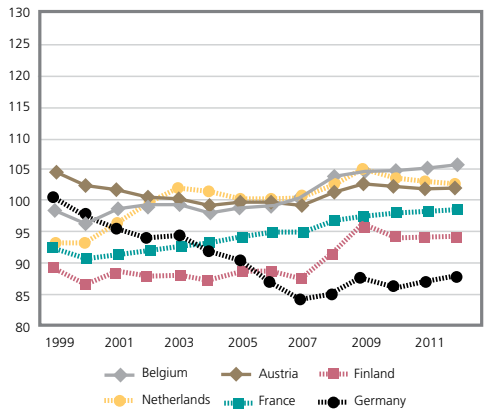
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4 T. Boeri and J. van Ours, *The Economics of Imperfect Labor Markets*, (Oxford Princeton University Press, 2008).

**Figure 2. Relative Unit Labour cost  
(average 1970-2010=100)**



**Figure 3. Relative Unit Labour cost  
(average 1970-2010=100)**



Source for Figures 2-4 : European Commission, AMECO

**Figure 4. Growth of GDP in Eurozone**

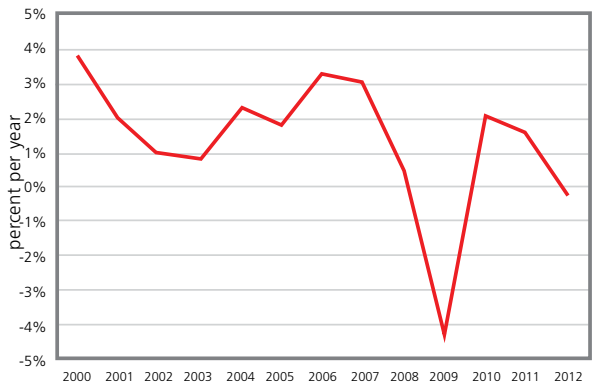


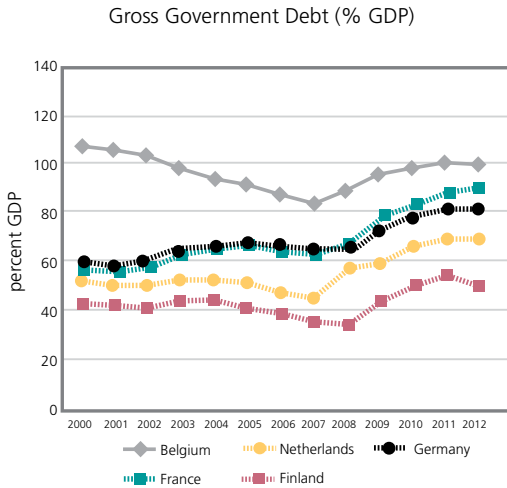
Figure 2 shows some evidence of the nature of this asymmetry. The figure shows the evolution of the relative unit labour costs of the debtor countries (using 1970-2010 period as the base period).<sup>5</sup> Two features stand out. First, from 1999 until 2008-2009, one observes the strong increase of these countries' relative unit labour costs. Second, since 2008-2009, dramatic turnarounds of the relative unit labour costs have occurred (internal devaluations) in Ireland, Spain, Greece and to a lesser extent in Portugal and Italy.

These internal devaluations have come at a great cost in terms of lost output and employment in the debtor countries. As these internal devaluations are not yet completed (except possibly in Ireland), more losses in output and employment are to be expected.

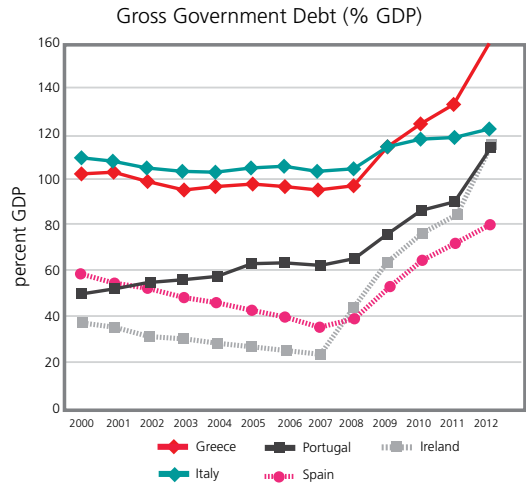
Is there evidence that such a process of internal revaluations is going on in the surplus countries? The answer is given in Figure 3, which presents the evolution of the relative unit labour costs in the creditor countries. One observes that these countries have had very little movement in these relative unit labour costs since 2008-2009.

<sup>5</sup> The Relative unit labour cost of a country is defined as the ratio of the unit labour costs of that country and the average unit labour costs in the rest of the Eurozone. An increase in this ratio indicates that the country in question has seen its unit labour costs increase faster than in the rest of the Eurozone, and vice versa.

**Figure 5. Gross Government debt ratios  
in creditor countries of the Eurozone**



**Figure 6. Gross Government debt ratios  
in debtor countries of the Eurozone**



Source for Figures 5 and 6 : European Commission, AMECO

Thus, one can conclude that the debtor countries in the periphery almost exclusively bear the burden of the adjustments to the imbalances in the Eurozone. This creates a deflationary bias that explains the Eurozone's double-dip recession since 2012 (as seen in Figure 4).

As argued earlier, the risk is real that citizens in Southern European countries, subjected to prolonged deep economic downturns that have increased unemployment to levels not seen since the 1930s, may revolt and reject a system that promised to be an economic heaven.

## TOWARD SYMMETRIC MACROECONOMIC POLICIES IN THE EUROZONE

How can macroeconomic management be organised in a way that will avoid a prolonged period of historically low growth that risks creating lost generations in the Southern member countries of the Eurozone?

The answer is that macroeconomic policies should be organised symmetrically. This symmetric approach should start from the different fiscal positions of the member countries of the Eurozone. Figures 5 and 6 show this difference. They present the government debt ratios of two groups of countries in the Eurozone, the debtor and the creditor countries. One observes from Figures 5 and 6 that while the debtor countries have failed to stabilise their government debt ratios (in fact they remain on an explosive path), the situation of the creditor countries is dramatically different. The latter countries have managed to stabilise these ratios. This opens a window of opportunity to introduce a rule that can contribute to more symmetry in the macroeconomic policies in the Eurozone.

Here is the proposed rule: the creditor countries that have stabilised their debt ratios should stop trying to balance their budgets now that the Eurozone is entering a new recession. Instead, they should stabilise their government debt ratios at the levels achieved in 2012. The implication of such this rule is that these countries can run small government budget deficits and at the same time keep their government debt levels constant. Germany in particular, which may achieve a balanced budget in 2013, could afford to have a budget deficit of close to 3 percent of GDP while keeping its debt to GDP ratio constant.<sup>6</sup> This would provide a significant stimulus for the Eurozone as a whole.

<sup>6</sup> I use the forecast of the nominal growth of GDP in Germany in 2013 (real growth plus inflation) made by the European Commission at the end of 2012. This forecast was 3.5 percent. This allows Germany to stabilise its debt to GDP ratio while running a budget deficit of 2.9 percent.

Such a stimulus would also make it easier to deal with the trade account imbalances between the North and the South of the Eurozone. The Northern countries could wind down the surpluses they have accumulated against the South by stimulating spending. This condition is necessary for the South to reduce its trade account deficits vis-à-vis the North.

Whether the symmetric rule proposed will be implemented very much depends on the German government and the European Commission. The latter should stand up against the 'dictatorship' of the creditor nations. As an alternative rule, the European Commission should convince the creditor countries that stabilising their government debt ratios is in theirs and the Eurozone's interests.

## CONCLUSION

The austerity programmes imposed on Southern European countries are unsustainable, not only economically – because they led to unsustainably high levels of unemployment and unbearable economic misery – but also politically, because they subvert the national interests of Southern European countries to the interests of foreign countries (that is, the creditor nations of the North of Europe). No political system can survive if it is seen as serving foreign rather than national interests.

The source of the crisis is by now well-known. Southern European countries took on too much debt in the past. But these countries could only do this because banks in the North of Europe, especially in Germany, eagerly lent massive amounts of money. For every foolish debtor in the South there was a foolish creditor in the North.<sup>7</sup>

When the crash came, the inevitable conflict between debtor and creditors arose. For many debtors the debt burden had become too high. The creditor nations, however, insisted on full repayment. As if following a war, the victorious creditor countries imposed their conditions. They benefited from the support of European policymakers, in particular the European Commission and the European Central Bank. Together they designed a strategy of austerity for the debtor countries that only aimed to restore surpluses on the current accounts of these countries so that they could start repaying their debts.

Creditor nations apparently had no alternatives. Yet, there was of course an alternative, and a very reasonable one: since both the debtor and the creditor nations were responsible for the crisis, they could share the cost of adjustment. This would have implied, as was argued here, that the creditor nations stimulate their economies so that Southern European countries could reduce their external debt with less austerity. Up to now the Northern European countries have refused this course of action, thereby putting the future of the Eurozone at risk. ■

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<sup>7</sup> M. Blyth, *Austerity: The History of a Dangerous Idea* (Oxford: Oxford University Press, 2013), 287.