The Euro Area and Greece after the Crisis

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After a long period of non-inflationary growth, in 2008 the world economy entered its most severe crisis since the Great Depression of the 1930s. The initial responses of policy have shown that we have learned important lessons from the mistakes that were made in the 1930s. Central banks have provided liquidity to avert a credit crunch, governments have bailed out major financial institutions, protectionism has been held at bay and international policy coordination has included the emerging economies for the first time.

We now stand at a critical juncture. After the deep recession of 2009, there are signs of recovery both in the United States and in Europe. However, the recovery appears to be weak and fragile, and there are many question marks concerning the appropriate policy responses that would help sustain the recovery. Two of the most critical questions concern the fiscal imbalances that have emerged and the need to eventually contain the liquidity that has been injected into the world economy.

In this presentation I will address some of the issues that arise for macroeconomic policy, focusing mainly on the Euro area and the Greek economy, which have, sadly, become the main focus of attention.

I start though with the global outlook.

The Financial Crisis and the Global Recession

The financial crisis that we are experiencing started in the US economy - at the heart of the global financial system. Following the collapse of Lehman Brothers on September the 15th 2008, the global financial system entered a phase of severe deleveraging, malfunctioning credit markets, unprecedented write-downs in asset valuations, generalised risk aversion, and threats to the stability of the banking sector. The crisis has rapidly spread to the real economy in the US and the rest of the world. The financial crisis is affecting trade and investment, consumption, jobs and living standards everywhere. It may not be the first financial crisis of the new global economy, but it certainly has developed into the most severe and widespread crisis that the world has experienced since the great depression. This crisis bears no

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comparison to previous incidents of financial and stock market turmoil that we have experienced since 1987.

This crisis has provided a severe test not only for financial institutions but also for global economic governance and even for many other national and regional political, social and economic institutions and policies; no region or country has remained immune; no institution or policy rule has escaped a re-examination; both the developed and the developing world continue to re-assess their policies and institutions.

The crisis has, indeed, unveiled serious weaknesses in the functioning of our global financial and economic system. Serious regulatory and policy mistakes that have persisted for many years have contributed to the severity of the problem. Economic risks had been seriously underestimated in the pricing of financial assets and asset bubbles had persisted for too long, supported by an abundance of liquidity. Macroeconomic imbalances had developed in the global economy without any serious attempt to address them through coordinated action. The emerging economies had not been integrated adequately to the system of global economic governance. These weaknesses were apparent in minor crises that have taken place in the past. What makes today's crisis unique is that it has affected the core of the US economy and the global financial system, with huge repercussions everywhere. It is not about the sovereign debt of an emerging economy, like previous episodes, but about the core of the global economy.

Obviously, no country or region can respond to the crisis in isolation. What is needed is a coordinated policy response. Without coordination, even the best national policies are likely to prove "beggar thy neighbour" policies and thus ineffective. Global problems require coordinated global solutions. The solutions do not lie in a "fortress US" policy, or a "fortress Europe" policy, or, even worse, in a "fortress Germany" policy. The solutions must be sought in the context of an open world trading and financial system, without even a hint of a return to protectionism. Monetary policies and central bank responses must continue to be coordinated at a global level. Coordination of financial regulation must be strengthened. Fiscal policy coordination is also a necessary prerequisite. No country in isolation can spend its way out of trouble. If we were to use fiscal policies to strengthen the recovery, this has to be coordinated at a global level, and it will need to engage not only the US, Europe and Japan, but also the emerging economies of China, Russia, India and Brazil.

The Crisis and the Euro Area

Despite some initial shortcomings, Europe has responded to the crisis in a coordinated and relatively effective manner.

The European Central Bank has been extremely active in providing liquidity since the summer of 2007, although for a number of months the thrust of monetary policy was addressed to containing inflationary expectations. In coordination with the Federal Reserve, it responded adequately to both the first and the second manifestation of the financial crisis.

It is true that policy makers in Europe initially failed to anticipate the full impact of the crisis on the European economy. The initial assessment at the beginning of 2008 was that the European economy would escape the worst. This assessment has been fully revised since the summer of 2008. The Euro area economy slowed down to 0,6% in 2008, from a growth rate of almost 3% in 2006 and 2007, and entered a severe recession in 2009. Euro area GDP fell by 4% in 2009. The European Commission is expecting low growth (0,7%) in 2010 and a further pickup of growth to 1,5% in 2011. The unemployment rate has increased significantly. From 7,4% of the Euro area labour force in 2007, it rose to 9,5% in 2009 and is expected to continue rising through to 2011, when it is expected to reach 10,9%. Inflation has fallen to almost zero in 2009, from 2,9% in 2008, and is expected to slowly pick up during the recovery.

These developments are not too dissimilar to what is happening in the USA or the UK. The US experienced a smaller recession in 2009 as GDP contracted by 2,5%, and the recovery is expected to be stronger. On the other hand, the rise of unemployment in the US has been sharper than in the Euro area, or even the UK, which has experienced a deeper recession than both the US and the Euro area.

These developments are highlighted in Figures 1, 2 and 3.

In addition, the crisis has led to a severe worsening of public finances due to the operation of automatic stabilizers, the cost of bailing out the financial sector and discretionary fiscal measures. The average fiscal deficit in the Euro area rose from just 0,6% of GDP in 2007 to 6,4% of GDP in 2009 and is expected to rise to 6,9% in 2010. This is much smaller than the fiscal deficit of the US which rose to 11,3% of GDP in 2009 and is expected to top 13% of GDP in 2010. The average Euro area fiscal deficit is also smaller than the UK deficit which exceeded 12% of GDP in 2009 and is expected to touch 13% of GDP in 2010. Public debt is rising significantly as a result. In the Euro area it is rising from 66,4% of GDP in 2007 to 88,8% in 2011. In the US general government debt is rising from 61,2% of GDP in 2007 to 87,8% in 2011. In the UK it is almost doubling as a percent of GDP, from 44,2% in 2007 to 88,2% in 2011.

Figures 4 and 5 contain the relevant comparative fiscal developments.

It is these fiscal developments, and the associated question of what will happen when central banks start withdrawing the liquidity that they have provided during the crisis, which generate most of the questions about the sustainability of the global recovery.

The question I would like to address in the remainder of this presentation is whether and in what direction the Euro area institutions can adequately coordinate the required fiscal and monetary policy responses. Many seem to think that this will be a severe test for the Euro area, and will test it to the limit.

Can the Euro Area Coordinate its Policy Responses?

Events since the worsening of the crisis in the last quarter of 2008 have indeed confirmed that Europe can take a leading role in promoting an adequate global response to the crisis. In a period when the US was primarily preoccupied with the presidential elections, Europe has coordinated its own response to the financial crisis and taken initiatives for a coordinated global response.

Discussions in Europe have also addressed the problem of how to coordinate fiscal policy and apply the Stability and Growth Pact.

The Stability and Growth Pact requires all economies in the Euro Area and the European Union to maintain fiscal deficits below 3% of GDP at all times, to strive to achieve fiscal balance in the medium term and to ensure that public debt is no more than 60% of GDP, or tending towards this objective.

The Pact envisages corrective action for those economies that do not meet these fiscal objectives. The Pact was revised in 2005, after a number of economies failed to correct their excessive deficits promptly. The revised Pact is more flexible regarding the time available for the correction of excessive deficits, but more demanding regarding the attainment of fiscal balance. Those economies that have not attained fiscal balance are required in so called "good times" to reduce their deficits by at least 0,5% of GDP per annum.

In late 2008, it was decided to apply the pact flexibly in the circumstances. Economies that were considered to have fiscal room for manoeuvre could use it to try and counter the slowdown or contraction in aggregate demand, either through the operation of automatic stabilisers, or through limited discretionary measures. Those that did not were asked to take care not to exceed the 3% limit. In case that a country exceeds the 3% limit, the deviation should be small and in any case temporary. The flexibility envisaged in the revised pact would be utilised, and attainment of medium term fiscal balance was implicitly postponed for better times, i.e after the crisis.

The rules of the Pact are well defined. The problem is that almost all of the economies of the Euro area in 2009 exceeded the 3% threshold. Most have exceeded it by a large margin and few have room for manoeuvre. The contraction proved much more severe in 2009 than originally envisaged, and fiscal deficits overshot the admittedly optimistic predictions that were made in the autumn of 2008.

Thus, although there is flexibility in theory, in practice this flexibility is of limited practical importance in a severe contraction, like the one we have been experiencing. Even economies that had fiscal surpluses in 2007, saw their fiscal deficits soar and exceed the 3% threshold. Fiscal policy appears to be a heavily constrained instrument for countering the contractionary forces that have been unleashed by the financial crisis.

In addition, small peripheral economies like Greece, Portugal and Ireland, and larger economies like Spain, have been experiencing more serious fiscal problems and a widening of their government bond yields relative to the German benchmark. These economies, which were among the main beneficiaries of the creation of the euro, had until 2007 growth rates that were higher than average. However, they had also seen their current account deficits rise considerably. This was partly the result of autonomous capital inflows, but also due to a gradual deterioration of their international competitiveness.

The Greek Economy and the Crisis

I turn now to the case of Greece, which is probably the most difficult one. Since the elections of 2009, the Greek economy is at the center of international attention.

The focus has been on its fiscal situation, which worsened since the crisis, not unlike in many other economies in the euro area and the rest of the world. In addition, after many years of significant economic growth, in 2009 the Greek economy entered a recession, the end of which is not yet visible.

If one were to look at the fundamentals of the Greek economy, one would note that they have improved significantly in the last twenty years, during preparations for entry into the euro area, but especially since Greece’s entry.

Public finances and international competitiveness however have remained a problem throughout the period. There were short periods of improvement in government deficits, and longer periods of relapse, especially during election years.

The international financial crisis hit the Greek economy at its Achilles heel: The high public debt, which was accumulated mainly in the 1980s. Since the 1980s, public debt had stabilized at about 100% of GDP for about 20 years. Greece had no problem financing this debt until 2008. However, in the circumstances of the international financial crisis, the refinancing of the debt became a problem. The problem became much more serious after the elections of October 2009, when Greece found itself in the centre of a wave of criticism by the international press, international organizations, rating agencies and the European Commission. Despite the fact that the fiscal situation in 2009 worsened in almost all economies in the world, in many cases much more than in Greece, Greece found itself in the centre of the crisis. The financial crisis became for Greece a debt crisis.

This happened for three reasons. The first, and foremost, is the high level at which Greece had stabilized its public debt since the early 1990s: 100% of GDP. The second was the sudden announcement of the dramatic deterioration of the deficit in 2009 by the new government in October 2009. This took the markets by surprise, as the previous administration insisted that it would achieve a much lower deficit. The third reason is related to the delay of the new administration to tackle the fiscal situation, and the shortcomings of the program that was announced.

These three reasons created the circumstances for a sustained speculative attack on Greek bonds, which has led to the severe confidence crisis that exists today.

Under these circumstances, the Greek government has no other option than to accelerate the implementation of structural reforms, which, under different circumstances, could be implemented more gradually.

Greece now has no other option but to follow a particularly drastic program of fiscal adjustment and structural reforms. Ideally, it should aim for fiscal consolidation and an improvement in competitiveness that would help the recovery.

Greece should aim to reduce fiscal deficits below the average of the Euro area in three years at the latest. It should further aim to stabilize public debt as a percent of GDP by 2011 at the latest, and to drastically reduce it relative to GDP in the next decade. Only a fully credible fiscal problem will convince markets, rating agencies and Greece's EU partners.

In the meantime, Greece should make use of the European Support Mechanism that has been agreed, in order to have some breathing space until the program starts bearing fruit. With concrete evidence of substantial fiscal improvement, it will be very difficult for Greece to return to the markets. The credibility problems that have arisen in the last few weeks will need time and effort to be addressed.

Greece will succeed, if the rest of the Euro area has a successful and coordinated response.

The Appropriate Response for the Euro Area

What is the appropriate policy response for the Euro area in these circumstances?

First of all, there is very limited scope for fiscal policy to play an active role in sustaining the recovery. Fiscal consolidation must proceed as the recovery takes hold, but for the core Euro area economies this must be done extremely cautiously as a premature fiscal consolidation effort may stifle the recovery of the region as a whole.

Second, the peripheral economies that have the biggest fiscal problems must proceed with their fiscal consolidation efforts immediately. This will enhance their credibility vis-à-vis the markets and will lead to a reduction in their spreads. The reduction in their spreads will in turn strengthen both their fiscal consolidation efforts and the recovery of their economies.

Third, the ECB must continue to provide adequate liquidity. In the circumstances that have emerged after the crisis, many borrowers will be unable to borrow if the financial system does not have access to liquidity, irrespective of the level of interest rates.

Fourth, the Euro area needs contingency plans to assure financial markets that default is not a possibility for any of the Euro area economies. Unlike every other economy in the world, euro area economies cannot rely on the ECB to act as a lender of last resort. In the circumstances that have emerged in global financial markets since the crisis, some of the fiscally weaker euro area economies have seen interest rates rise significantly. This jeopardizes their fiscal adjustment efforts. A contingency mechanism is under discussion as we speak. However, disagreements have arisen among member states and the Commission, and it is only recently that one feels that an effective mechanism will be put in place.

Fifth, other options to boost the European economy must be accelerated despite their shortcomings. For example, structural reforms to increase productivity, such as those envisaged under the Lisbon agenda would imply long lags, even if they were to be promptly implemented. However, it is important to persist with the Lisbon agenda, as this would prepare the European economy to take better advantage of an eventual global recovery.

Finally, it is also extremely important to allow the European social model to function. The existence of provisions and institutions that can soften the impact of the crisis on the more vulnerable sections of our societies, is an important advantage of the European social model. Within the available budgetary limits, the European social model should be allowed to work. It is in periods of crisis such as the one that we are experiencing that its importance becomes more apparent.

The European Commission, the Euro group, the Ecofin Council and the

European Council have proven in the past that they can coordinate such ambitious efforts. I am confident that they can do it again.

Finally, it is also extremely important to strive in order to revive the Doha round on trade and development, so as to strengthen the momentum for an open global trading system and avoid protectionism. The protectionist spiral of the 1930s was a major contributing factor to the Great Depression.

Conclusions

To conclude, we seem to have drawn the right lessons from the mistakes made in the monetary field during the Great Depression. Monetary policy has responded adequately to the crisis and important initiatives are currently under way to restore appropriate regulation, liquidity and confidence in financial markets. Europe, to the surprise of many has shown remarkable leadership.

Because of high levels of public deficits and debts the room for using fiscal policy is limited. Despite that, and despite a poor track record on previous occasions, we must not abandon the effort for better coordination of fiscal policy at both the European and the global level.

At the same time, we should not lose sight of the medium term. Structural reforms that would increase productivity and protect the environment must continue. We must undertake new initiatives to further liberalise international trade and integrate emerging economies to the global economy. We must continue to pursue the Millenium Development Goals. Finally, long overdue reforms in global economic governance must be brought forward to integrate Russia, China, India and Brasil.

An economic crisis is not only a threat but also an opportunity. If we continue with the pro-active and coordinated approach that we have adopted in the last eighteen months, we can strengthen the recovery and end up with a stronger global economy and a stronger global financial system.

Figure 1
Growth Before and After the Crisis

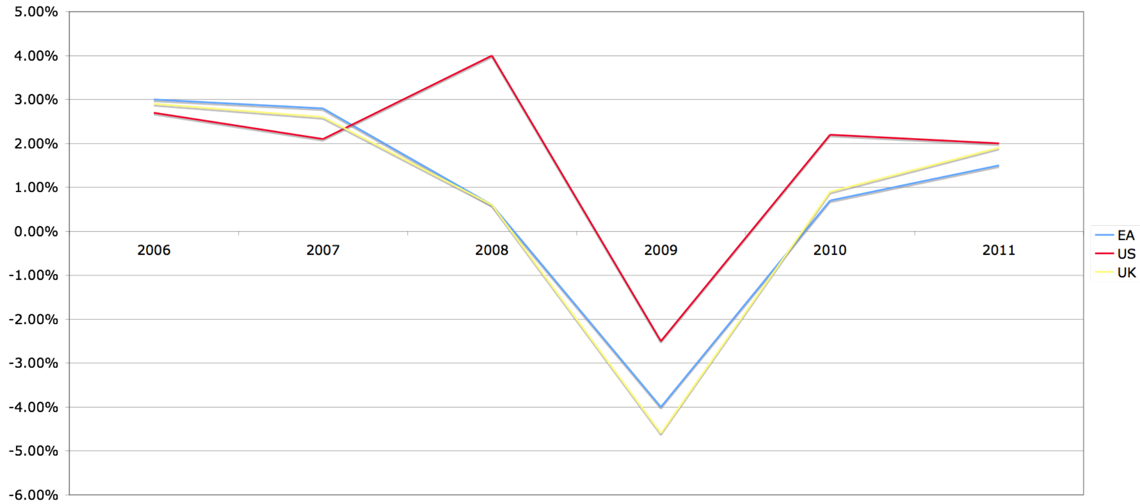

Figure 2
Unemployment Before and After the Crisis

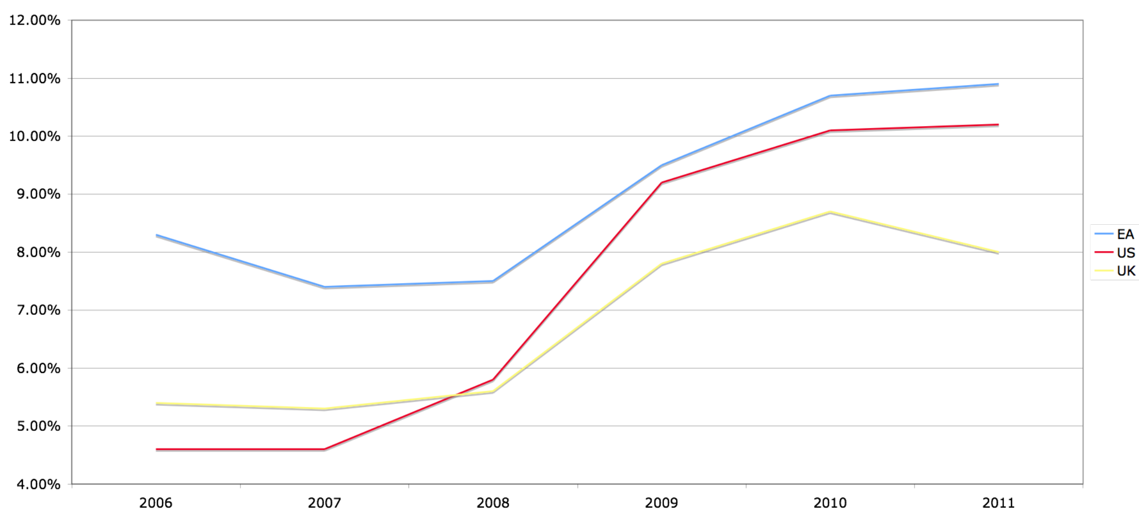

Figure 3
Inflation Before and After the Crisis

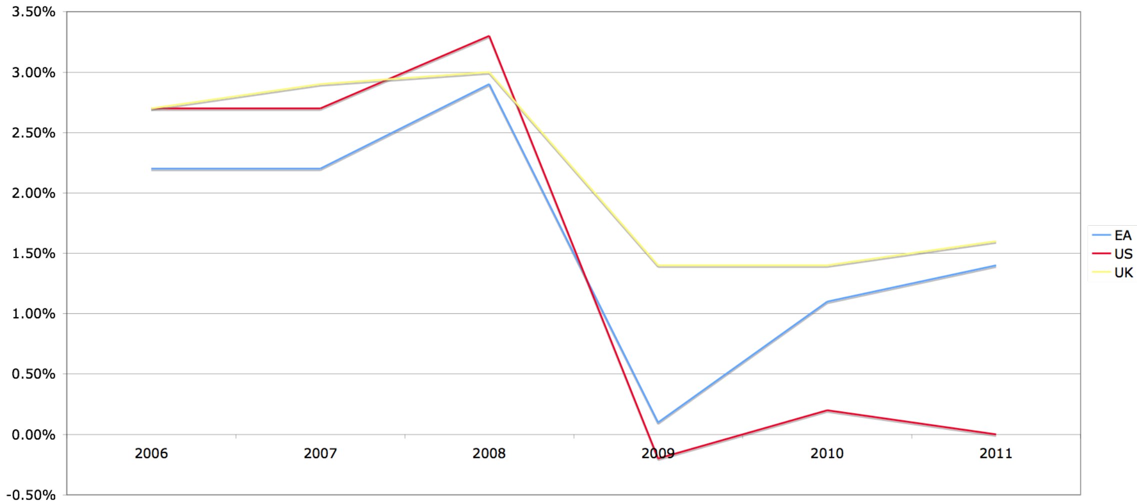

Figure 4
General Government Balance Before and After the Crisis

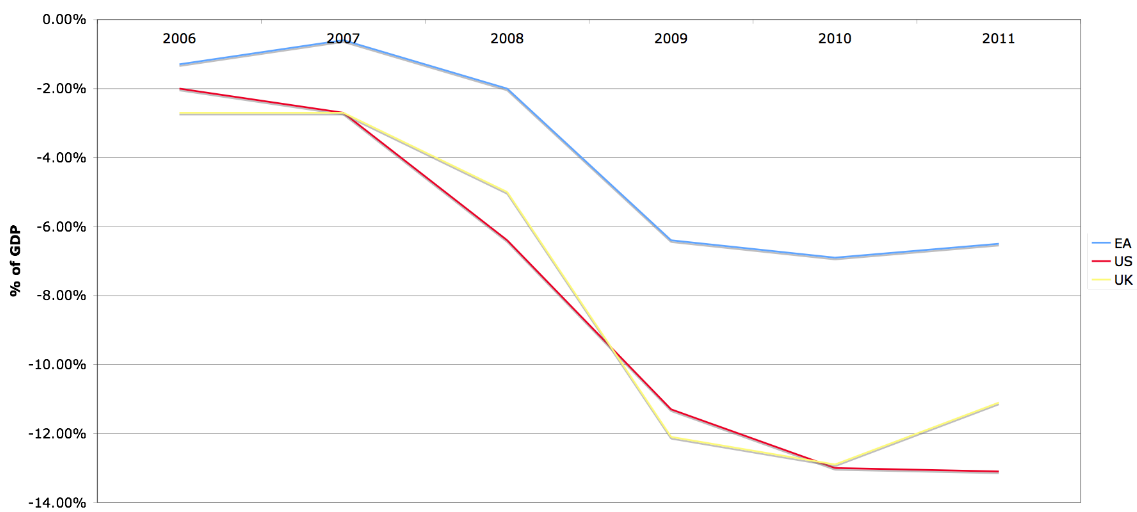

Figure 5
Government Debt Before and After the Crisis