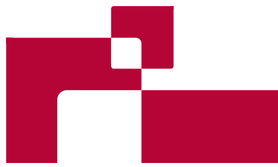

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TWO CRISES, TWO RESPONSES

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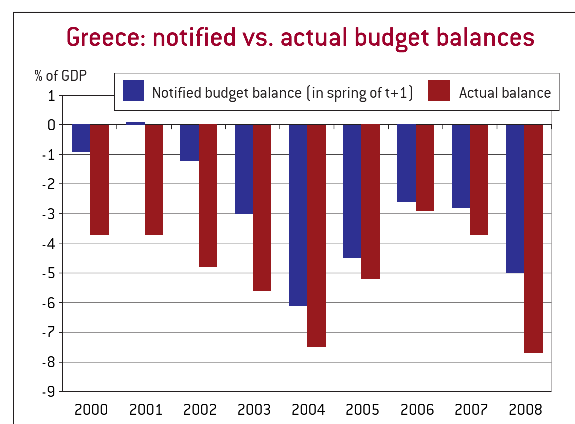
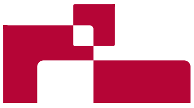
SUMMARY The Greek budgetary crisis has provoked a debate about crisis management and prevention in the euro area. Clarity is needed on the nature of the challenges and the extent to which the European Union is already equipped to address them. The Greek situation is 'mostly fiscal' and results from a failure to use fully the instruments at the EU's disposal. But another country under pressure, Spain, was fiscally virtuous until the crisis. Its problems are 'mostly about competitiveness' and originated in a domestic credit boom and the wage/price consequences. The EU has instruments to help address such problems and correct internal imbalances, but in the first decade of the euro it was too often assumed that threats to stability could come from budgetary indiscipline only.

POLICY CHALLENGE

The EU does not need new sanctions to prevent fiscal crises, but must more effectively enforce fiscal surveillance provisions, including granting to the European Commission independent auditing powers. To manage budgetary crises, the EU should be able to give medium-term financial assistance to euro-area countries, in cooperation with the International Monetary Fund. This would not violate the principle of no-coresponsibility for public debts.



To prevent competitiveness crises, the EU needs strengthened surveillance over real exchange rates, and must use existing coordination instruments. Governments should improve monitoring of their relative competitiveness over the cycle, learning from Belgium's and Finland's use of wage guidelines and buffers.



THE GREEK CRISIS has degenerated into a much-needed but chaotic debate about crisis management and crisis prevention in the euro area. Intellectual and policy confusion has been widely exposed, raising questions about the consensus that underpins the single currency.

To be fair, Greece is a special, rather pathological case: no other euro-area country exhibits a similar combination of budgetary misreporting and misbehaviour. Nevertheless, many other euro-area members are having to face major macroeconomic challenges. Spain, in particular, exemplifies another type of crisis that does not result from a lack of budgetary discipline, but originates from a domestic credit boom and its wage and price consequences.

Global capital markets were first to sound the alarm about the situation in several euro area countries: for several months, spreads on bond and credit default swap markets signalled diminishing investor confidence. Speculators have been blamed for triggering crises, but had the EU acted earlier, domestic imbalances would not have resulted in such tensions over external financing.

'The Greek crisis has exposed intellectual and policy confusion, raising questions about the consensus that underpins the single currency.'

The current situation is a severe test. It is not surprising that it comes now: a lesson from fixed exchange-rate regimes is that weaknesses take several years to emerge. What is worrying is that these weaknesses have become evident at a time when the world environment is exceptionally challenging.

The test concerns the euro area as a whole. Confidence in the euro is now affected by increasing doubts about the area's functioning and resilience in times of turmoil. How this test is tackled will have a decisive bearing on the future of the euro. If the right lessons are drawn, the euro will emerge stronger; if not, it will emerge weakened.

To meet the challenge, clarity about the various types of crisis is needed so that new principles for action can be established. The essential pillars governing Economic and Monetary Union (EMU) enshrined in the Treaty remain sound and solid. But practices and procedures for crisis prevention and crisis management must be reformed and reinforced.

This Policy Brief starts by highlighting the two types of problem that must be faced today, namely the results of budget policy and threats to competitiveness. We then turn to governance reforms, and set out what needs to be done to tackle the two types of problem.

1 TWO TYPES OF PROBLEM

The Greek crisis has led to a tendency to view the problems facing other euro-area countries as being variations of the Greek case, hence the infamous 'PIIGS' label (Portugal, Ireland, Italy, Greece and Spain). In reality, however, the vulnerabilities of these countries are of a different nature, as are the reasons why they got into trouble in the first place.

The Greek and Spanish cases illustrate this point well:

- The Greek problem is 'mostly fiscal'. Throughout the 2000s, the country has been running an irresponsible budgetary policy while attempting to hide it (Figure 1a). The problem it poses is therefore primarily one of enforcement of the existing provisions of the Treaty and the Stability and Growth Pact (SGP). This is not to deny that Greece has a competitiveness problem too. But its first-order problems are budgetary.

- The Spanish problem is 'mostly about competitiveness'. Since Spain joined the euro, its budgetary policy has been remarkably disciplined – with even a substantial surplus in 2005-2007 – and its budgetary reporting has been fairly accurate (Figure 1b). Spain's main problem relates to a private sector-induced construction boom and to poor economic performance in the rest of the economy, which economic policy has failed to correct. Competitiveness woes have resulted in fiscal strains, but the origin of the difficulties is not budgetary in nature.

Before the crisis, there was a strong belief in the EU that budgetary discipline was the 'mother of all policies'. Accordingly, budgetary surveillance was deemed sufficient to prevent instability. The

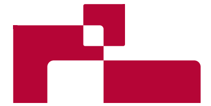
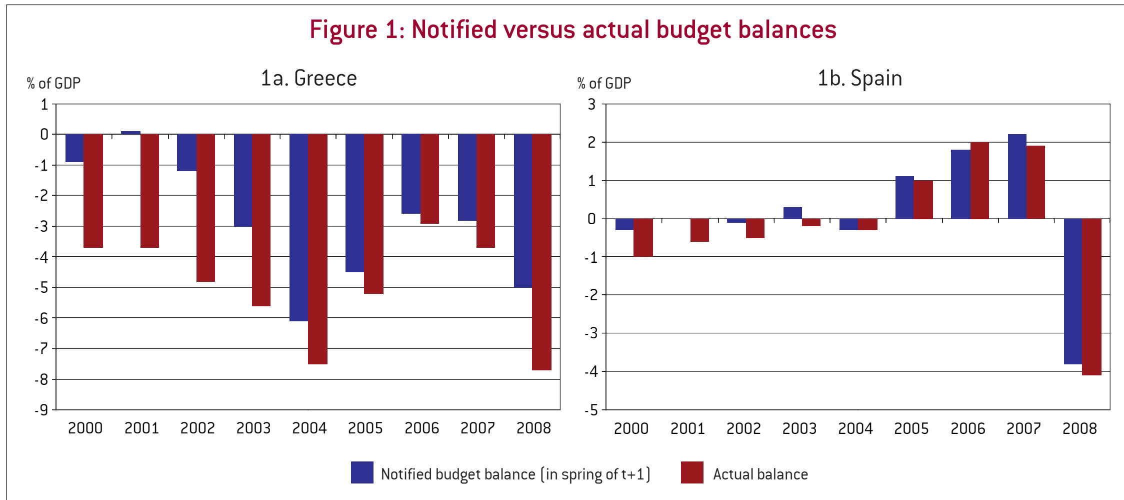


Figure 1: Notified versus actual budget balances



Source: Bruegel calculations based on European Commission, DG ECFIN. Notified deficits are the estimates released in spring of the following year.

implicit assumption was that the private sector is inherently stable. The dangers of such neglect started to become apparent at the beginning of the crisis, as emphasised in the European Commission report on the first ten years of the euro (European Commission, 2008). These dangers have since become obvious.

To illustrate the point, Table 1 shows Spain's competitiveness relative to the rest of the euro area. From 1998 to 2007, relative production costs increased significantly, particularly in the tradable goods sector, leading to a shrinking of manufacturing. This was a consequence of the country's real estate investment boom, which attracted a progressively bigger share of the labour force. However, there were also other factors behind poor international cost competitiveness, namely i) wage indexation to past high inflation, and ii) the automatic extension of wage increases agreed at industry level to all firms and regions, independently of local conditions. The final result was a significant current account deficit that peaked at 10 percent of GDP in 2007.

Imbalances of the kind described above do in fact arise independently of the fiscal policy stance. To show this, in Figure 2a (overleaf), we plot for the euro-area countries and the countries in a fixed exchange-rate regime the change in the current-account balance between 1999 and 2007, and the change in the actual budget balance relative to the average of each country's main trading partners (EU12). Figure 2b shows the same but for 2007 – the last year before the crisis. In both cases, there is no strong correlation between the two variables.

Table 1: Indicators of the competitiveness of the Spanish economy

	Relative labour costs *	Relative wage costs in manufacturing **	Manufacturing/total employment (%)	Construction/total employment (%)	Current account balance (% of GDP)
1998	100.0	100.0	18.6	9.8	-1.1
1999	100.7	97.4	18.4	10.4	-2.7
2000	102.2	100.0	18.1	11.1	-4.0
2001	102.9	100.9	17.8	11.6	-4.3
2002	103.3	101.6	17.6	11.7	-3.8
2003	104.0	104.9	17.1	11.8	-4.0
2004	105.7	107.6	16.7	12.1	-5.9
2005	107.9	111.9	16.1	12.5	-7.5
2006	110.5	115.6	15.5	12.8	-9.0
2007	113.0	118.3	14.9	13.1	-10.0

Source: Bruegel calculations based on AMECO and Price and Cost Competitiveness Databases. Note: * REER vs EU16 based on unit labour costs, total economy. Normalised as 1998=100; ** REER vs EU16 based on unit wage costs, manufacturing. Normalised as 1998=100

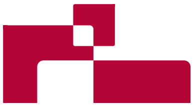
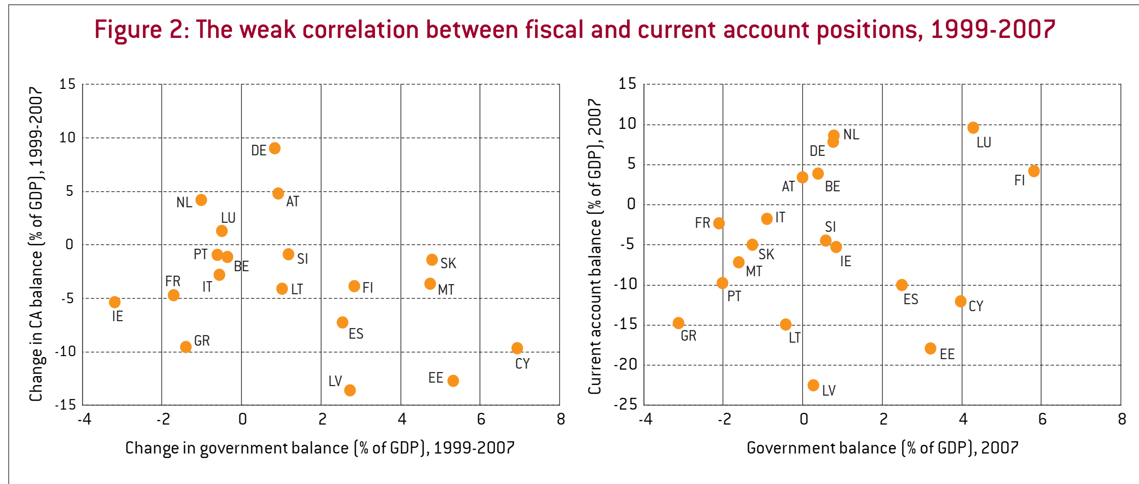


Figure 2: The weak correlation between fiscal and current account positions, 1999-2007



Source: Bruegel calculations based on AMECO. Note: change in government balance is with respect to EA12.

Lack of budgetary discipline has always – rightly – been considered a major potential threat to the stability of the euro. Competitiveness problems, however, can also pose a serious threat. In the euro area, a competitiveness shortfall in the traded sector can only be corrected by a long and painful adjustment. This would have serious employment and distributive consequences that might be hard to sustain politically, especially in large, not very open economies like Spain.

2 HOW TO DEAL WITH BUDGETARY CRISES

Fiscal indiscipline raises questions, first, about prevention, and, second, about crisis management.

A. Crisis prevention

It has been suggested (Schäuble, 2010) that in order to enforce budgetary discipline the EU needs to have the nuclear option of expelling a country from the euro area. It may indeed be useful to think the unthinkable, though the notion that large countries would expel small ones runs against the very idea of the EU project. Be that as it may, the problems in the Greek case were created simply by the lack of implementation of mundane policing provisions.

The prevention of budgetary problems is first and foremost a matter of enforcing existing provisions, namely the SGP, and the attendant EU rules on the quality of statistical data reported by governments[1]. The Greek case represents a failure on both fronts. No sanction was applied for violation of the SGP and the statistical rules[2].

So the agenda for the euro area is merely one of enforcing existing rules.

Recommendations

- **In-depth auditing.** The European Commission should be given proper auditing powers, as envisaged in its proposal of 15 February[3]. The proposal foresees 'in-depth methodological visits' to member states by Eurostat, going beyond the mere checking of compliance with statistical standards. Eurostat would also be granted access to all the information required for assessing the quality of statistical data. Such external oversight is particularly welcome in countries that lack an independent fiscal authority, such as Greece and Ireland[4].

- **Stress-testing of budgetary positions.** The fast deterioration of the budgetary situation in several countries has highlighted that apparently strong budgetary positions were in fact precarious because they were based on an unsustainable evolution of tax receipts. This calls for a less formulistic, smarter approach to budgetary discipline whereby budgetary positions would be tested against a range of possible economic scenarios.

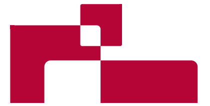
- **Providing incentives for budget reform.** While tightening fiscal surveillance, the EU should also provide incentives to improve the quality of national budgetary institutions. The Commission should differentiate its budgetary surveillance procedures depending on the quality

1. Council Regulation (EC) No 3605/93 of 22 November 1993; Council Regulation (EC) No 2103/2005 of 12 December 2005; Council Regulation (EC) No 479/2009 of 25 May 2009.

2. In 2004, the Commission opened an infringement procedure against Greece for misreporting deficit figures but the procedure was closed in 2007. See Commission (2010).

3. COM(2010)53.

4. European Commission, Fiscal Governance Database.



of domestic budgetary institutions, especially statistical institutes and fiscal oversight councils.

B. Crisis management

Crises happen even with the most elaborate crisis-prevention regime, raising the question of the quality and effectiveness of the crisis-management regime. The euro area's problem is that it does not have a defined crisis-management regime in place.

Had Greece been an EU country outside the euro area it would have by now turned to the International Monetary Fund for financial assistance, just as Hungary, Latvia and Romania did a few months ago. Like these countries, along with the conditional IMF loan, Greece would have probably received an EU conditional loan under the medium-term financial assistance (MTFA) facility.

Being a member of the euro area, Greece retains the option of obtaining financial assistance from the IMF. However it is not eligible for MTFA assistance because Article 143 of the Lisbon Treaty explicitly reserves such assistance to member states 'with a derogation', ie those outside the euro area. This clause has generally been interpreted as one element of the Treaty's prohibition on bailing-out euro-area countries with budgetary problems. Such an interpretation is plainly wrong.

Article 125 of the Treaty explicitly prohibits the EU and individual member states from being 'liable for or assum[ing] the commitments of… any (other) member state'. This *no-coresponsibility principle* was introduced into the EU Treaty at the time of Maastricht, and is an essential pillar of EMU. It is clear and sound, and should remain untouched. However, Article 143 is totally different. It is not about the EU or any member state *assuming the liabilities* of another member state, but about *granting a loan* to a member state. It has a different origin in the history of EMU to Article 125 (see Box 1), and should not be interpreted as a *no-assistance principle*, for two reasons:

- First, euro-area members remain members of the IMF and therefore have access to conditional assistance. It would be illogical for the EU to ban assistance to its members while allowing them to get assistance from the IMF.
- Second, the availability of assistance does not necessarily create moral hazard if it is subject to proper conditionality.

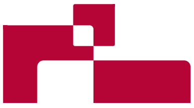
Lingering confusion between no-coresponsibility and no-assistance has been a damaging

BOX 1: THE ORIGINS OF ARTICLE 143

This article derives from Article 109h of the Maastricht Treaty (later renumbered Article 119), which itself derives from Article 108 of the 1957 Treaty of Rome. The only substantive difference between Article 108 and the later versions is the distinction between member states with a derogation (and therefore not participating in the third stage of EMU) and the others.

Why was this distinction introduced by Maastricht? Why were euro-area members made ineligible for mutual assistance? The short and full answer is simply that the assistance scheme was intended to address balance-of-payments problems, and that these problems were expected to disappear as a result of these countries forming a monetary union. The exclusion of euro-area members from mutual assistance is purely the consequence of what was considered to be self-evident at the time of Maastricht. It has nothing to do, as many assume today, with the no-coresponsibility principle.

The correctness of our interpretation has been confirmed by many persons who were involved in the Maastricht Treaty negotiations. It is also attested by several Community documents: the original machinery for MTFA in case of balance-of-payments difficulties was set up by a Council Decision of March 1971, which makes no reference to monetary union and, therefore, no distinction between the members and non-members of such a union. The MTFA facility was revised by a Council Regulation of June 1988 , three years before Maastricht was signed. The 1988 Regulation clearly specifies that 'the financing obligations on member states under the machinery for medium-term financial assistance [should] remain in force until the final stage of the European Monetary System', ie until the creation of monetary union. This echoes the view of the 1970 Werner Report that 'In such [a monetary] union, all that matters is the global balance of payments vis-à-vis the outside world.'



feature of the recent European discussion on crisis management[5]. This should be remedied by sticking to the no-coresponsibility principle while putting in place a clear and predictable conditional assistance regime.

The question then is who should be in charge of crisis management in the euro area? The IMF, the EU, or both together?

A purely IMF approach is not desirable because it would risk creating incompatibility between IMF and EU policy requirements. Whereas the IMF has full leeway when negotiating a programme with a country that is not part of a regional arrangement, EU members (and especially euro-area members) are part of a policy system that needs to be taken into account when designing a programme.

A purely EU solution would also have problems. First, it would amount to creating an entirely new legal and financial apparatus. IMF conditional assistance rests on specific agreements, procedures and instruments that do not exist in the EU. This is why the EU relies on joint programmes with the IMF for providing assistance to its non-euro members: it makes good sense for the European Commission to benefit from the IMF's extensive worldwide experience. The second problem is that EU loans under the balance-of-payments programme are financed exclusively by funds raised by the EU on capital markets. These EU bonds are, however, fully guaranteed by the EU budget. As long as the sums involved are relatively small, as in the case of Hungary, Latvia and Romania, the tiny size of the EU budget is not a severe constraint. The matter would be totally different if larger EU countries needed assistance.

These considerations call for establishing a framework for joint EU-IMF assistance to countries in the euro area. A solution of this sort could also serve as a model for IMF agreements with other regional groupings, not least the Asian Chiang Mai initiative, and could help make cooperation between the IMF and such groupings more effective and efficient.

Recommendations

- **Extending Article 143 to euro-area countries.** It would be desirable to modify Article 143 so that the EU conditional loan facility can be made available to euro-area members facing financing difficulties. Loans could still be granted, as has always been the case with MTFA loans[6], as part of a package of aid put together with the IMF, a possibility that Article 143 makes explicit.

- **Defining a framework for joint EU-IMF assistance to euro-area members.** This framework should outline the principles and procedures for cooperation, and, in particular, make clear that the conditions set by the IMF for assisting a euro-area country have to be consistent with euro-area rules.

3 HOW TO DEAL WITH COMPETITIVENESS CRISES

The EU is not short of policy-coordination instruments. Quite the contrary, there is a variety of rules and procedures, from the Treaty itself to the Broad Economic Policy Guidelines and the Open Method of Coordination. Article 121 is the basis for economic surveillance, both in a bilateral and a multilateral perspective. The Treaty does not foresee sanctions in this area but, as appropriate for policy coordination, softer instruments are available, such as Commission warnings and Council recommendations. The new Article 136 of the Lisbon Treaty calls for a strengthening of this coordination within the euro area. Last but not least, the Eurogroup was created to monitor economic developments and serve as a forum for coordination.

However, the EU track record in this area is poor. The Broad Economic Policy Guidelines are largely ignored by national policy makers, recommendations have been acted on only once since the introduction of the euro – and in an ineffective way[7]. There has been a failure, if not to diagnose, then at least to trigger appropriate responses to massive changes in relative competitiveness. And the Eurogroup has not taken advantage of its informality to address problems as they develop and trigger appropriate policy responses by national governments.

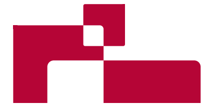
It is now of utmost importance that the EU develops an agreed analytical framework for assessing potential imbalances, setting goals and triggering action.

One approach would be to replicate for current account balances what already exists for budgetary balances[8]. There is, however, a fundamental difference between the two: whereas there is broad

5. See for example Issing (2010).

6. There have only been six instances of medium-term financial assistance to EU countries: Italy (1974), Greece (1991), Italy (1993), Hungary (2008), Latvia (2009) and Romania (2009).

7. In February 2001, the ECOFIN Council issued its first Article 99(4) (non-binding) recommendation against Ireland for running a fiscal policy that was inconsistent with the objective of macroeconomic stability. The Council's move spurred a heated debate, not least because, at the time, Ireland was actually running a fiscal surplus, and because its exports were thriving. The recommendation was essentially ignored by the Irish government.



agreement on desirable budgetary outcomes, it would be absurd to impose balanced or near-balanced current accounts. One motive for the euro was indeed to encourage flows of savings across borders. Furthermore, economic analysis does not provide numerical benchmarks for determining what is a 'good' current-account balance (Blanchard and Milesi-Ferretti, 2009). Thresholds can be used to trigger examination and assessment, not to determine policy action.

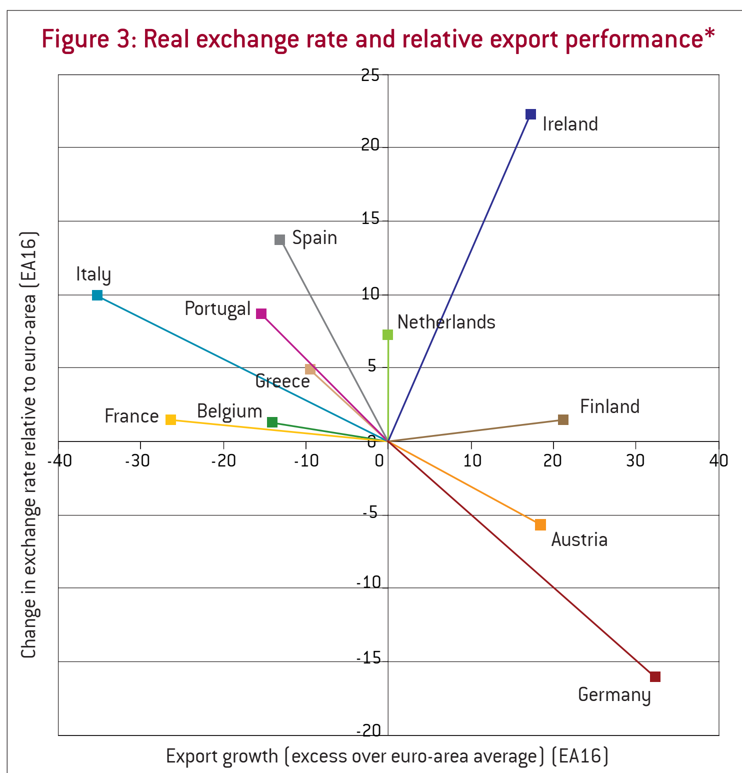
A more promising avenue is to monitor wage and price developments systematically – in effect to carry out surveillance of real exchange rates. The EU has a tradition in this respect, which was strangely discontinued with the introduction of the euro: in the Exchange Rate Mechanism, no country could realign (change its nominal exchange rate) without the consent of its partners precisely because of the effect on competitiveness (ie real exchange rates). But nowadays a country can unilaterally modify its real exchange rate, for example through a combination of VAT increases and cuts in social security contributions.

Evidently, the purpose of this surveillance should not be to prevent changes in the real exchange rate, when they are justified on grounds of relative economic performance. As Figure 3 shows, the performances of euro-area members in this respect vary.

Whether the focus is on current account balances or real exchange rates, the surveillance process must have a strong euro-area dimension because, barring changes for the area as a whole, a country's current account deficit (or competitiveness loss) is another country's surplus (or competitiveness gain). Therefore, analyses need to be done and recommendations made for all the players in the system. As recognised in the Eurogroup note of 15 March (Eurogroup, 2010), when adjustment is needed, it concerns both deficit and surplus countries.

At the national level, governments should monitor competitiveness and act when needed. Most lack an appropriate policy framework and instruments, but some do have them (Box 2, overleaf). These (mixed) experiences could provide inspiration for governments to put in place mechanisms adapted to the institutional features of national wage and price-setting.

Figure 3: Real exchange rate and relative export performance*



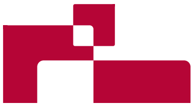
Source: Bruegel calculations based on DG ECFIN and Eurostat. * Cumulative change between 1999 and 2008. Real exchange rates are based on unit labour costs.

Recommendations

- **European competitiveness-monitoring framework.** The Commission should take responsibility for periodic reporting on real exchange rates in the euro area, and should propose a policy agenda for the discussion within the Eurogroup, whenever it is felt that economic developments 'risk jeopardising the proper functioning of EMU' (Art. 121).

- **A tentative alert procedure.** It may be appropriate to set up an alert procedure that calls for a specific Commission assessment whenever the changes in a country's current-account balance or real exchange rate over a period of several years exceed predefined thresholds. The assessment should take into account a range of country-

8. Dullien and Schwarzer (2009).



specific and euro area-wide factors. On the basis of the assessment, warnings could be issued by the Commission. If the Commission judges after one year that the response of the country or countries concerned has not been satisfactory, it should make a proposal to the Eurogroup to issue recommendations.

- **National competitiveness-monitoring frameworks.** EU surveillance cannot substitute national vigilance. Governments should put in place competitiveness-monitoring frameworks consisting of regular assessments and the definition of potential instruments for remedial action.

The authors are grateful to Juan Ignacio Aldasoro and Hélène Vuillermet for very effective research assistance.

BOX 2: WAGE GUIDELINES AND WAGE BUFFERS THE BELGIAN AND FINNISH EXAMPLES

In 1996, the Belgian Parliament approved a law to keep the evolution of wages in Belgium in line with that of wages in its main trading partners in order to preserve the country's competitiveness in EMU. Every two years, the Central Economic Council of Belgium publishes a report on the maximum margins for nominal wage increases on the basis of the expected evolution in Germany, France and the Netherlands. Social partners then decide on a (maximum) wage increase. The law makes provision for this norm to be made mandatory through a government decision. This has only happened once, in 1997-1998. Since then, the norm has been considered 'indicative'. Indeed probably because of its non-binding character, the measure has not always served the purpose for which it was designed. After 1998 Belgian wages repeatedly overshot those of trading partners. Moreover, in December 2008, the social partners could not agree on a guideline for 2009-2010.

In 1997, Finland introduced, in agreement with its social partners, an ingenious adjustment mechanism to balance out cyclical changes in EMU. The key idea is to act on the non-wage component of labour costs. During good times, employers and employees pay slightly higher than necessary social security contributions. The funds thus raised are used to pay social security costs when there is an adverse cyclical shock. The funds are meant to reduce the pressure to cut jobs and wages during recessions. While the buffer is unlikely to be enough during a long recession, it is useful for increasing the flexibility of labour costs over a normal cycle.

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