

The causes of the debt crisis in Europe and the role of regional integration

by Carlo Panico¹

1. During 2010 the government debt of Greece, Spain, Portugal, Ireland and Italy have undergone speculative attacks, which have caused intensified financial distress, a sharp decrease in the rate of growth, higher unemployment, economic and social instability, changes in economic and social policies that are undesired by the majority of the population, dramatic social conflicts.

In July and August the interest rate on the 10-year government bonds of Greece, the most affected country, moved around 10.3%, a level considered unsustainable. Why did that happen? Could it be avoided? Are the authorities operating effectively to solve the problem and avoid further distress?

2. The factors that allow the launch of a speculative attack are always multiple. In the case here considered they can be found in some simultaneous events (e.g. the regional German elections of the 9th of May), in some previous faulty behaviors of the governments under attack, and in some defects of the institutional organization of the European Monetary Union (EMU). Those who believe that the operation of market forces (and of financial speculation) is always able to bring about efficiency tend to stress the role played by the faulty behaviors of the authorities. Those holding a different standpoint tend to blame the faults in the institutional organization that have prevented the authorities from operating effectively against the speculative attack.

3. For those having faith in the “market efficiency hypothesis”, the government of Greece and of the other countries under attack failed to take advantage of the positive trend of the world economy before the financial crisis. They allowed public finance to decay, productivity to stagnate and ‘wages to soar’ (*Economist*, 10-16 July 2010, p. 24).

The available data throw doubts on this view. During the 10 years preceding the financial crisis, Ireland, Greece and Spain enjoyed the highest growth rates in the Euro-

¹ Università di Napoli “Federico II”, Dipartimento di Economia, Via Mezzocannone 16, 80134 NAPOLI (Italia). Email: panico@unina.it

area. They performed far better than Germany and France. What's more, according to OECD data, from 1998 to 2007 labor compensation per hour in Greece grew less than productivity. It rose at an average annual rate of 1.39%, the same as in France and not much more than in Germany (1.26%), while productivity grew at an average annual rate of 2.21%, higher than that of the OECD countries (1.98%), of France (1.88%) and of Germany (1.47%). Finally, labor compensation per hour in Greece was in 2006 half that of Germany (52.7%).

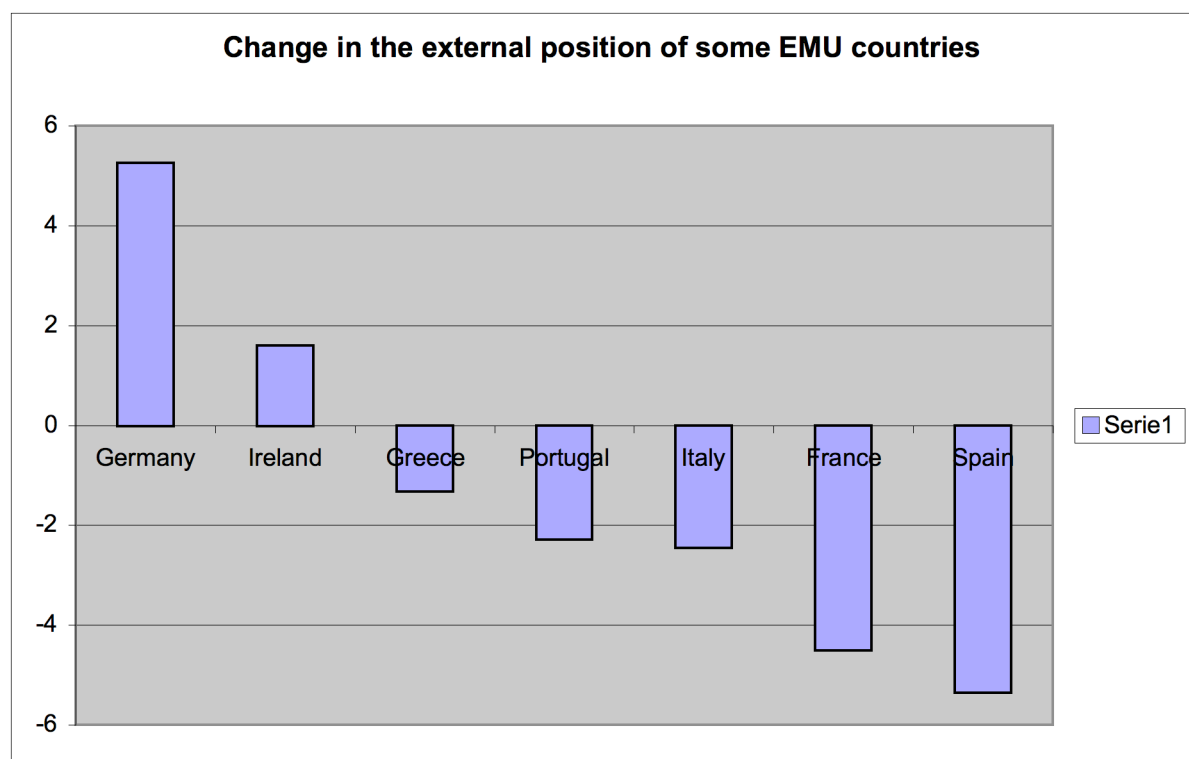
The OECD data also show a weakness in the external accounts of Greece, Spain and Portugal, which had in 2007 a worse position in the balance between export and import of goods and services than Italy, France, Ireland and Germany. During the period 1998-2007 the Greek deficit, measured as a ratio of GDP, rose from 6.93 to 9.40. The deficit of Spain rose from 0.81 to 7.58 and that of Portugal from 7.09 to 7.31. Italy and France moved from surplus (respectively 2.33 and 2.34) to deficit (1.23 and 2.73). Ireland and Germany instead increased their surpluses, the former from 11.22 to 15.90 and the latter from 1.04 to 7.93.

The data on labor compensation and productivity suggest that the weakness of the external accounts of these countries comes from the international specialization of their economy, rather than from the 'faulty management' of the labor market. The European Central Bank (ECB) confirms this view when it claims that in the first 10 years of the EMU the countries with an overweight in labor-intensive sectors lost positions in favor of emerging economies with a relative comparative advantage, whereas Member States specialized in the higher-price and higher-quality segments of mature industries and products even gained market shares (ECB, 2008, p. 92). This interpretation implies that the loss of competitiveness shown by some EMU economies requires structural industrial policies, rather than reductions in labor compensation, to be corrected.

What's more, an analytical comparison between the 1998 and the 2007 data on the external disequilibrium and the rate of growth shows that Spain, France, Italy and Portugal worsened their external positions more than Greece. An index² constructed for

² The index is constructed by first deriving, for each country, a linear function ($e = -g + b$, where e is the external deficit, g is the real rate of growth and b is a constant) to which the 1998 pair of values "deficit (surplus) in the balance between import and export of goods and services and rate of growth" belongs,

some EMU countries by taking into account both the deficit (surplus) in the balance between import and export of goods and services and the rate of growth of 1998 and 2007 shows that Germany and Ireland improved their external position, with the former showing through the value of the index (5.26) a stronger improvement than the latter (1.6). Spain shows the worse deterioration of its external accounts (-5.35), followed by France (-4.5), Italy (-2.45), Portugal (-2.28) and Greece (-1.32). One should consequently doubt that the ‘faulty management’ of the weakness in the external account is what can justify the launch of a speculative attack against the Greek government debt.



Finally, the data on public finance can provide an argument in favor of the ‘faulty management’ view. Greece respected the 3% rule of the Stability and Growth Pact (SGP) only in 2006. None the less, its ratio Government Debt – GDP moved from 100.3 of 1999 to 95.6 of 2007 owing to the rise in GDP, the ratio’s denominator. This

then by calculating the distance from this line of the 2007 pair “deficit (surplus) in the balance between import and export of goods and services and rate of growth”. The underlining idea of this index is that a country should increase its deficit (reduce it surplus) in the balance between import and export of goods and services when the rate of growth rises because of the increasing relation between GDP and import and of the constant relation between GDP and export. For a previous analytical use of this idea see Moreno Brid and Ross (2009).

reduction proves that the Greek authorities did not let their finance decay: they were neither the ant nor the cricket of Aesop's fable. Referred to Portugal and Italy, this allegation is even less founded; in the case of Ireland and Spain, it is foolish.

3. Those blaming the institutional organization of the EMU for the speculative attack can focus on three defects: the faults in the process of policy coordination, the absence of a super-national Agency dealing with the structural needs of the different countries, the absence of a Stabilization Fund defending the Euro-area from speculative attacks.

The faults in the process of policy coordination have been identified by the literature.³ The organization of monetary policy foresees the existence of the *European System of Central Banks* (ESCB), composed by the European Central Bank (ECB) plus the national central banks (NCB) of the 27 countries of the European Union (EU), and of the *Eurosystem*, composed by the ECB plus the central banks of the 16 countries that have adopted the euro. The Eurosystem, not the ESCB, takes the EMU monetary policy decisions, which are binding for the NCBs of the area. The rules of the Treaties make them effectively enforced, leaving no uncertainty on the behavior of the central banks.

The organization of fiscal policy foresees the existence of the *Council of the Economics and Finance Ministers* (ECOFIN), in which the European Commission, the ECB and the Ministers of the 27 countries of the EU participate, and of the *Eurogroup*, in which the European Commission, the ECB and the Ministers of the 16 countries of the Euro-area are represented. In the EU fiscal policy is decentralized; thus, within the EMU fiscal policy is decided by the national governments, while monetary policy decisions are taken at super-national level. The decentralization of fiscal policy generates the need of a process of coordination. The ECOFIN, not the Eurogroup, takes the formal resolutions regarding this process. The Eurogroup just works as a place where information on the state of the economies and on the conduct of policy are exchanged. Thus, unlike the Eurosystem, it has no authority over its members and no power to take binding decisions.

³ For a review of this literature, see Panico and Vázquez Suárez, 2008a; 2008 b.

The discrepancy between the powers of the Eurosystem and those of the Eurogroup is the main cause of inefficiency in the process of policy coordination. The lack of a binding and effectively enforced mechanism to coordinate national and super-national decisions generates uncertainty on the behavior of the actors, lack of confidence and a non-cooperative attitude among national governments and monetary authorities. The outcome is that fiscal and monetary policies work as “strategic substitutes”, rather than complements. They tend to compensate each other, generating poor results that negatively affect the growth performance of the area.

The lack of confidence among the different actors is also responsible for introduction of the Stability and Growth Pact (SGP) as the main tool of the process of coordination. The SGP is a rigid fiscal rule, which, like all rigid policy rules, has proved difficult to implement. It tends to generate pro-cyclical policies and is unable to take into account the cyclical and structural needs of the different economies. For its failures, it already underwent in 2005 a reform that worsened the situation. Several experts now believe that, as it occurred in monetary policy, the implementation of fiscal policy too must rely on the introduction of independent authorities, rather than on rigid policy rules.⁴ Consequently, they propose that the EMU must change the institutional design of its process of policy coordination in order to achieve better policy results and a more satisfactory growth performance.

During the financial crisis and the speculative attacks to the government debts the SGP has ceased to work, but the lack of confidence among the different actors is still producing dangerous pro-cyclical policies, delayed reactions, higher costs in the defense of the economies and a dramatic inability to help many of them to find a way out of the problems.

⁴ Wyplosz (2002) compares the organisation of monetary policy and that of fiscal policy in recent years and argues that ‘the crucial change that has rehabilitated monetary policy has been the move from rule design to institutional reform’ (Wyplosz, 2002, p. 5). In the Seventies the conduct of monetary policy was restricted by “rules” (e.g., that relative to the rate of growth of the money supply), which proved difficult to be implemented. In the subsequent years, the tendency has been to replace these “rules” with delegation to institutions endowed with independence and a clearly specified objective to achieve. Fiscal policy, Wyplosz (2002, p. 5) says, is following similar lines with some delay. It is currently dominated by “rules”, which are difficult to be implemented, and there are already discussions to replace the “rules” with delegation to newly created institutions. For a similar position, see Pisani-Ferry (2002) and Panico and Vázquez Suárez (2008a and 2008b).

The need to reform the institutional organization of policy coordination is more urgent than ever. The Eurogroup must be transformed into a Fiscal Agency able to identify, analytically and in accordance to the different needs of the economies, the appropriate mix between fiscal and monetary policy and to fix, period by period and for each one of the EMU countries separately, the deficit-GDP ratio that they must respect. In order to eliminate the uncertainty on the behavior of the different actors and the lack of confidence among them, the Eurogroup must be endowed with powers similar to those of the Eurosystem, by changing its role and introducing incentives (prizes and sanctions) able to make its decisions binding.⁵ Without these changes it is highly probable that the EMU will not be able to avoid new dramatic problems and further unnecessary suffering to its citizens.

4. The second fault in the institutional organization of the EMU is the absence of an independent super-national Development Agency able to identify the structural needs of the economies and to establish priorities among them. The Agency should be managed by the European Commission, should be endowed with funds made available by the national governments and should co-operate with the new Fiscal Agency (the reformed Eurogroup). It should strengthen the effectiveness of the system of incentives (and thus the enforcement of the Fiscal Agency's decisions), increase the flexibility of policy coordination, generate benefits for all the citizens of the area and improve their sense of participation in what can be felt as a positive experience.

In order to achieve these objectives, the Agency should not limit itself to transfer funds to the national governments. It should participate directly in all phases of implementation of the projects in order to improve transparency and to sanction the authorities showing inadequate or inefficient behaviors. In addition, it should fix the priorities in such a way as to privilege super-national projects and to care for the needs of the countries requiring more external support, also in relation to their financial situation.

The support of the weakest countries is in the interest of the whole area. The data point out that the economies that mostly need to improve the international competitiveness

⁵ For a more detailed description of how these changes should be introduced, see Panico and Vázquez Suarez, 2008b.

often have tight constraints on their public finance. These constraints make it difficult for them to implement the expensive industrial policies required to improve the international position without severely cutting other types of expenditure and risking to increase unemployment, social tensions and disappointment for the European institutions among the citizens. The outcome of these complex processes may be a higher government deficit, a lower rate of growth and, on account of the high degree of commercial and financial integration of the area, recessive effects on the other EMU economies.

Thus, provided that it can guarantee an efficient and transparent use of the funds, the Agency should have among its priorities the support of the weakest economies of the area.

5. The third fault in the institutional organization of the EMU is the absence of a “Monetary Stabilization Fund” that could be used to defend the Euro-area from speculative attacks. The Fund should be managed by the monetary authorities, guarantee timely reactions and be endowed with an amount of resources sufficiently large to discourage speculative attacks.

It should be funded through the issue of bonds. If necessary, the monetary authorities can ask the monetary financial institutions (MFI) participating in the European payment system TARGET to invest in bonds of the Fund a portion of the legal reserves, lying idle in their current accounts at the ECB. This investment would allow the MFIs to earn a return on their large legal reserves (in July 2010 amounted to more than 210 billion euros, more than 80% of the Greek government debt). This solution would make a vast amount of resources promptly available in normal time and in emergency situations.

The mere existence of a Monetary Stabilization Fund counting on large resources would reduce the probability of speculative attacks, in the same way as the role of lender of last resort of the central banks reduces the probability of bank runs. It would make it possible to achieve better results at a lower cost.

6. The analysis of the recent events allows one to confirm that the faults in the institutional organization of the EMU have favored the speculative attacks to the

government debt of some EMU countries. They have enhanced the formation of negative expectations on their solvability and the rise of the interest rate on their government debt.

Between October and November 2009, when the new elected government pointed out that the deficit for 2008 was larger than previously indicated, the interest rate on the Greek 10-year government debt moved from the average monthly value of 4.57 to 4.84. Owing to the lack of EMU policy reactions to the speculative attack, the rate of interest kept rising from December 2009 to February 2010, when it reached the average monthly level of 6.46. After a slight decrease in March, it jumped to 7.83 in April (average of that month), in the eve of the regional elections in Germany, which made it difficult for the government of that country to support a coordinated Euro-area reaction. The high probability of a delay in a coordinated reaction further enhanced the speculative attack and the interest rate kept rising until the week-end of the German elections (8th and 9th of May), to decline immediately afterwards. The average level for May was 7.74. According to Buiter (2010, p. 4), the interest rate on the Greek 10-year government debt rose up to nearly 10% before that week-end and diminished to 4.5% the next day.

During the same week-end the European governments and the ECB met and agreed on a package of extraordinary measures. The package foresaw a set of related interventions of the European Commission, of some EMU and EU Member States and of the IMF, aiming at providing the euro-countries with loans given by a Fund named “European Stabilization Mechanism”. The Fund can rely on a large amount of resources, 750 billion euros for a period of three years, of which only 60 billion euros are immediately available, in the sense they do not need any further process of approval. They represent supranational EU lending facilities administered by the European Commission and funded through the issue of EU bonds by the European Commission.⁶ Other 250 billion euros should come from IMF, after its Executive Board will approve the participation in the package. The last 440 billion euros will be administered by a Special Purpose

⁶ The issue of Eurobonds by the European Commission can represent an important step forward for the future improvement of the institutional organization of the EMU. On this topic see Panico and Vázquez Suárez (2008b).

Vehicle, which will be set up after the approval of the package by the countries participating in the European Stabilization Mechanism.⁷

The rules regulating the operation of the package were unfortunately negatively affected by the lack of confidence and cooperation among the actors of the agreement. They prescribe that its loans will be guaranteed, *severally and not jointly*, by the governments receiving them in proportion to their paid-in capital shares in the ECB. These conditions could not reassure the markets. They suggest that the package, rather than to give external support to the weakest economies under attack, is mainly designed to protect the credit institutions of the strongest economies, which are heavily exposed to Greece, from the risk of contagion of the financial distress. The governments under attack can only rely on their paid-in capital shares in the ECB and on their separate ability to guarantee the loans they receive. As a matter of fact, they are left alone and forced to bow to the pressures of financial speculators.

The uncertainty generated by the possible distress of the sovereign debt also led the ECB to announce on the 10th of May the launch of a “Security Market Program” to deal with the tensions of the markets. On the 14th of May the Governing Council took a resolution that allowed the Eurosystem to purchase government bonds in the secondary market, under the condition that these interventions would be sterilised and would not change the stance of monetary policy. On the 17th and the 24th of May the ECB proceeded to buy 16.5 billion euros and 10 billion euros of bonds, introducing a drastic change in the philosophy of its operation.

The measures decided in May have failed to reach their objectives. Since June the interest rate on the Greek 10-year government debt has been rising again. In July and August it overtook 10%, spreading the view that Greece is practically insolvent and that the strategy actually followed by the authorities just consists of delaying the Greek default and the consequent bailouts of the exposed financial institutions of the Euro-area, hoping that the delay and an improvement of the global economic situation could contribute to reducing the damage.

⁷ For an assessment of the Greek rescue package, see Buiter, 2010 and Silbert, 2010.

The lack of confidence and cooperation among the actors is the main responsible for this failure. It has delayed the policy reactions and has made them costly and ineffective. In our view the existence of a Monetary Stabilization Fund, like the one described in the previous section, would have led to timely reactions, decided in a transparent way by an independent monetary authority not constrained by the “games” of national politics. These reactions would have been less costly (in economic and social terms) and more effective.

7. The faults in the institutional organization of the EMU are the main responsible for the present problems. They generate a lack of confidence and cooperation among the authorities, which led to the slow growth performance before the financial crisis and favored the recent speculative attack against the government debt of some countries. The faults have contributed to delaying the policy reactions to the speculative attack, have made these reactions costly (in economic and social terms) and inefficient, and have made it difficult for many countries to find a way out of the problems.

Until the end of 2009 the EMU was considered a successful experience. During the financial crisis it has performed efficiently, according to standard criteria, leading the IMF to advise the Eastern European countries to look for its protection. Its working before the financial crisis has also been judged satisfactory, although it has been recognized that its institutional organization requires some reforms to make its growth performance more satisfactory. The speculative attacks to the government debts and the delays and weakness of the policy reactions underline the need to realize these reforms and to carry further the process of integration.

In the previous pages we have identified three defects in the institutional organization: the faults in the process of policy coordination, the absence of a super-national Agency dealing with the structural needs of the countries, the absence of a Stabilization Fund defending the area from speculative attacks. Like any experience of regional integration, to provide stability, growth and welfare for its citizens the EMU needs an institutional mechanism that can efficiently coordinate fiscal and monetary policy, a Development Agency than can improve the process of convergence among the economies by identifying their structural problems and contributing to their solution, and a Monetary Stabilization Fund that can defend its economies from speculative attacks.

Without the introduction of reforms on these three points, the EMU will not be able to come out of its problems. It will betray its citizens and the founders of the European process of regional integration, who choose to proceed by small steps towards an organization of the European institutions that could guarantee the stability and the growth potentials of the economies involved and the security and welfare of their citizens.

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Statistical Appendix

Table 1 – Average annual growth of real GDP in percentage – OECD data, 1998-2007.

Ireland	Greece	Spain	France	Portugal	Germany	Italy
6.78	4.08	3.81	2.35	2.03	1.61	1.45

Table 2 – Real GDP growth, annual growth in percentage – OECD data

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Germany	2.0	2.0	3.2	1.2	0	-0.2	1.2	0.8	3.0	2.5
Greece	3.4	3.4	4.5	4.2	3.4	5.6	4.9	2.9	4.5	4.0
Spain	4.5	4.7	5.0	3.6	2.7	3.1	3.3	3.6	3.9	3.7
Ireland	8.4	10.7	9.2	5.8	6.4	4.5	4.7	6.4	5.7	6.0
Portugal	4.9	3.8	3.9	2.0	0.8	0.8	1.5	0.9	1.4	1.9
Italy	1.4	1.5	3.7	1.8	0.5	0	1.5	0.8	1.8	1.5
France	3.5	3.3	3.9	1.9	1.0	1.1	2.5	1.9	2.2	2.2

Table 3 – Labor compensation per hour, total economy- Average annual percentage – OECD data, 1998-2007 - US dollars calculated using PPPs.

Korea	Greece	France	Mexico	Spain	Germany	Italy
1.41	1.39	1.39	1.39	1.30	1.26	1.23

Table 4 –Annual average rate of growth of labor productivity (GDP per hour worked) – OECD data, 1998-2007.

Ireland	Greece	OECD	France	Germany	Spain	Italy	Portugal
3.61	2.21	1.98	1.88	1.47	0.72	0.30	1.68

Table 5 – Export and Import balance of goods and services as a ratio of GDP

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Germany	1.04	0.55	-0.01	1.43	3.62	4.07	5.77	5.83	6.08	7.93
Greece	-6.93	-6.04	-5.28	-4.58	-5.10	-7.31	-6.88	-6.47	-7.89	-9.40
Spain	-0.81	-2.01	-2.34	-1.98	-1.90	-2.61	-4.47	-5.82	-6.76	-7.58
Ireland	11.22	13.57	11.75	12.31	17.73	19.05	19.77	17.51	13.39	15.90
Portugal	-7.09	-8.11	-7.79	-6.98	-5.80	-5.76	-7.05	-8.40	-8.12	-7.31
Italy	2.33	1.15	0.20	0.52	0.31	0.04	0.03	-1.07	-2.51	-1.23
France	2.34	1.97	0.74	0.82	1.06	0.66	-0.23	-1.34	-1.96	-2.73

Table 6 – Government deficit (+) and surplus (-) as a ratio of GDP – European Commission data, various years. Failures to respect the SGP's 3% rule in yellow.

	1995	1999	2000	2001	2002	2003	2004	2005	2006	2007
Germany	3.2	1.5	1.3	2.8	3.7	4.0	3.8	3.3	1.8	-0.2
Greece	9.1	3.1	3.7	4.5	4.8	5.6	7.5	5.2	2.9	3.7
Spain	6.5	1.4	1.0	0.6	0.5	0.2	0.3	-1.0	-2.0	-1.9
Ireland	2.1	-2.7	-4.8	-0.9	0.4	-0.4	-1.4	-1.7	-3.0	-0.3
Portugal	5.0	2.8	2.9	4.3	2.8	2.9	3.4	6.1	3.9	2.6
Italy	7.4	1.7	0.8	3.1	2.9	3.5	3.5	4.3	3.3	1.5
France	5.5	1.8	1.5	1.5	3.1	4.1	3.6	2.9	2.3	2.7

Table 7 – Government debt as ratio of GDP – European Commission, various years.

	1995	1999	2000	2001	2002	2003	2004	2005	2006	2007
Germany	55.6	60.9	59.7	58.8	60.3	63.8	65.6	68.0	67.6	65.0
Greece	97.0	100.3	101.8	102.9	101.5	97.3	98.6	100.1	97.1	95.6
Spain	62.7	61.5	59.2	55.5	52.5	48.7	46.2	43.0	39.6	36.1
Ireland	81.1	48.2	37.7	35.5	32.2	31.0	29.4	27.6	25.0	25.1
Portugal	61.0	51.4	50.4	52.9	55.5	56.9	58.3	63.6	64.7	63.6
Italy	121.5	113.7	109.2	108.8	105.7	104.4	103.8	105.8	106.5	103.5
France	55.5	58.8	57.3	56.9	58.8	62.9	64.9	66.4	63.7	63.8

Table 8 – Rate of interest on 10-year government debt of Greece – Eurosystem data, average monthly level from May 2009 to August 2010.

2009		2010	
May	5.22	January	6.02
June	5.33	February	6.46
July	4.89	March	6.24
August	4.52	April	7.83
September	4.56	May	7.97
October	4.57	June	9.01
November	4.84	July	10.34
December	5.49	August	10.28

Table 9 – Index comparing the deficit (surplus) in the balance between import and export in goods and services and the real rate of growth in 1998 and 2007. OECD data

Germany	5.26
Ireland	1.6
Greece	- 1.32
Portugal	- 2.28
Italy	- 2.45
France	- 4.50
Spain	- 5.35

Figures showing the evolution of the deficit (surplus) in the balance of import and export of goods and services and of the real rate of growth from 1998 to 2007 - OECD data

