Suspicious Silence and Diffuse Light

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Given the current low level of noise about the future of the Euro and potential changes in the composition of the Eurozone one could conclude that the worst scenarios of the past turn out to be exactly – scenarios. Michel Barnier, Commissioner for Financial Services, even declared the beginning of the end of the Eurozone crises. Indeed, good news seems to pile up. The risk premiums for the southern economies of the Eurozone are getting smaller; in early November 2012 Greece managed to auction 4.06 bn Euro of one-month and three-months treasury bills for 3.95%, respectively 4.25%.

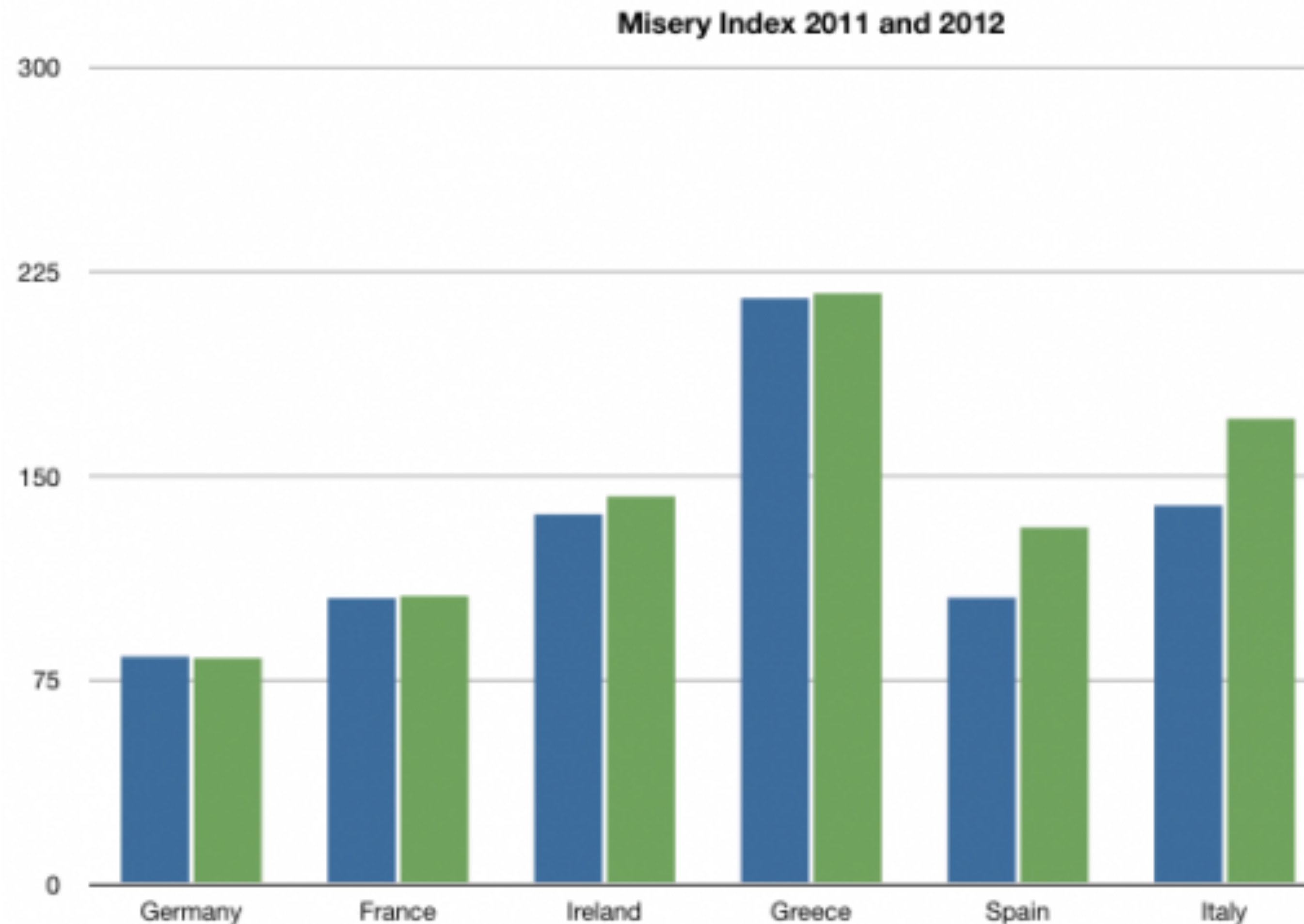
At least one hedge fund, Franklin Templeton, is actively betting big time on the recovery of Ireland by increasing its already significant Irish portfolio by one third to now Euro 8.4 bn – about 10% of overall Irish bonds. Also, the Greek government could announce a first primary budget surplus for the month of September. Spain and Portugal as well as Italy are getting political support from the Commission for their efforts to deal with the implementation of their austerity and reform programs. DG Economic and Financial Affairs states significant progress in correcting external imbalances and catching up in terms of competitiveness. All this good news seems to generate a change in sentiments that dwarfs the ongoing serious problems. Risk premiums are going down, and Christmas-like silence moves in.

For those interesting in listening, though, bad news is not really in short supply. The Eurozone is in the early stage of a recession that may turn into a phase of stagnation. The debt-prone economies of the southern core are continuing to experience shrinking GDP rates that are accompanied by dramatic increases of unemployment. No surprise then that, for example, the debt ratio of Greece is climbing to 175% this year, and will continue to climb. The public disagreement between IMF chief Lagarde and EcoFin head Juncker about the adequate debt ratio-time schedule for this economy shows a deepening rift between the European and the Global crisis managers. Hundreds of thousand protesters in the streets of European cities belong now to the overall picture of crises and austerity, an indication of political-social limits for the austerity medicine administered by Brussels and Washington. The planned banking union, briefly seen by some commentators as the ultimate medicine, is on the way to become a deeply compromised institution, not least due

to the insistence of member states like Germany and Britain to defend national interests. Moody's followed Standard & Poor's downgrading procedure of France, and adds additional pressure on the Socialist French government to change course and to move into the austerity camp.

Self-defeating Strategy

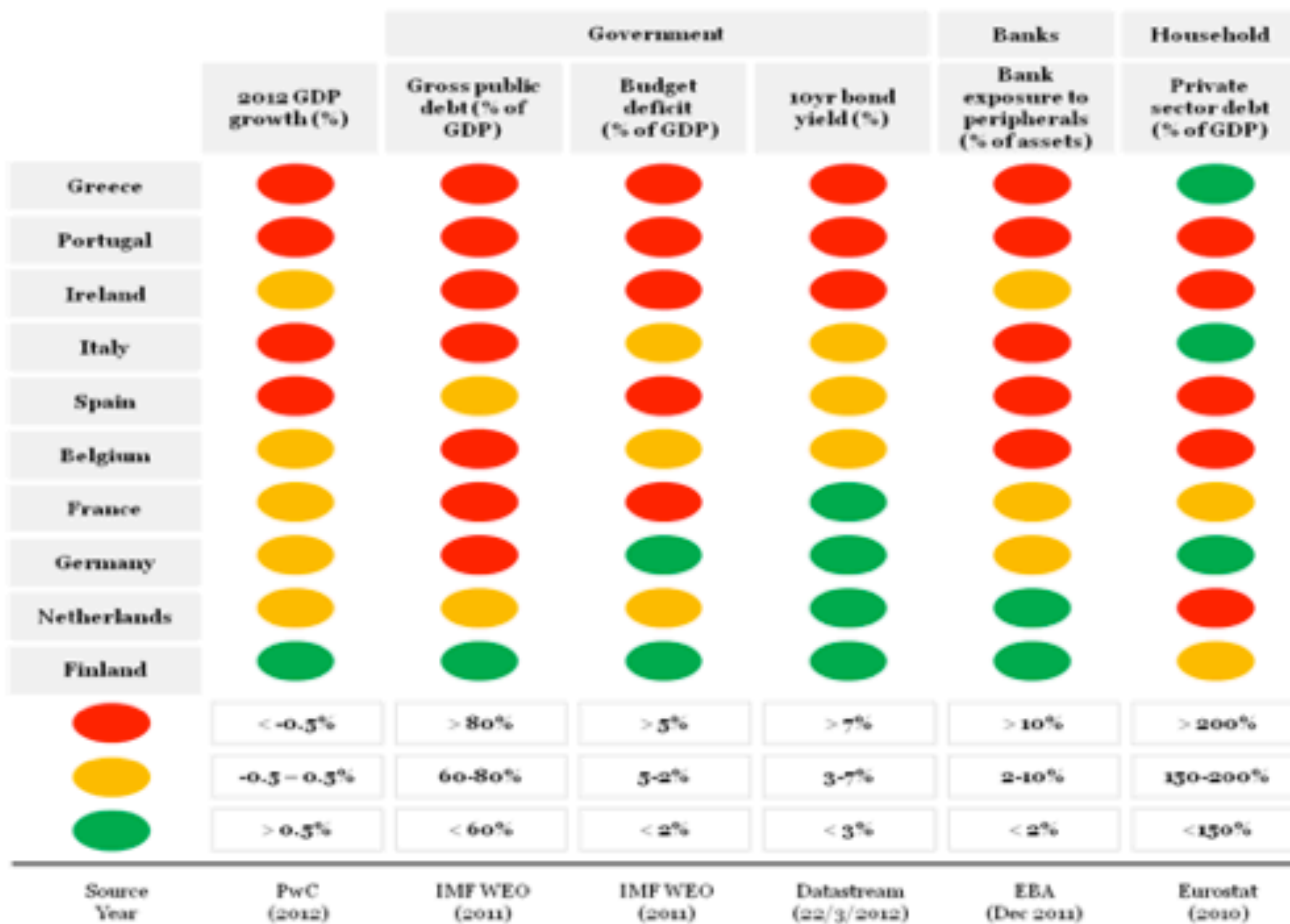
Reasons enough to reassess the situation. For a start, it may be helpful to take an overall look at the macroeconomic situation. For this purpose I calculated a modified version of a 'misery index' that includes the unemployment rate, inflation rate, public deficit ratio, public debt ratio and the current account. The first graph uses data for 2011 and the second graph includes data as recent as October 2012 plus forecast data until the end of 2012. The comparison is revealing. The austerity programs put in place and politically implemented in the southern periphery did not improve the macroeconomic situation. Rather, the situation has become worse, particularly in Spain and Portugal. Even the 'misery leader' Greece experienced a worsening of the situation. Those aggravations have been driven on the one hand by the rise of unemployment that added significant social costs to the public budgets but also reduced effective demand and thus contributed to the continuation of recessions. In macroeconomic terms, slow or negative growth increased the debt ratio despite reductions in public deficits ratios.



Data: Eurostat; SVR

It is now a well-documented insight that the fiscal multipliers in times of zero bound monetary policy and fiscal austerity are much stronger than previously envisaged (IMF 2012; Holland & Portes 2012). Fiscal austerity actually translates into much higher negative growth effects than the economic mainstream is assuming. In other words, the core of the current crisis management, austerity, is not only not delivering promised results but is a self-defeating strategy. The empirical findings are very much confirming the theoretical insight already provided by J.M. Keynes in chapter 23 of his 'General Theory' when he discussed what has become known as the 'paradox of thrift': If all sectors of a closed economy simultaneously deleverage, the result is a shrinking of the economic pie. Individual economies can overcome this paradox by achieving export surpluses, and this started to happen recently in Ireland where multinational corporations, that dominate the export sector, contributed heavily to the surplus. However, it is well known that not all economies can reach such a surplus at the same time.

The macroeconomic picture gets even darker if one increases the number of relevant indicators that signal tendencies of macroeconomic performance. The *heat map* for Eurozone economies may oversubscribe the fragility of the Eurozone due to the narrow definitions of degrees of vulnerability but still depicts an overall sound impression of the macroeconomic performance.



Source: PwC, Economic Views, Eurozone, March 2012

It is obvious that the inclusion of private sector debt makes the actual fragility and instability of the Eurozone even more visible, and this is true in particular for individual member economies. Take Ireland. Although unit labor costs decreased and its trade balance shows a surplus, the level of private sector debt as well as the pubic debt ratio signal that the story its far from a happy end. Non-financial corporate debt reached 205% of GDP in the second quarter of 2012, the highest ratio on record (Central Bank of Ireland 2012). This high private business sector debt ratio may misrepresent the actual ratio as it reflects partially the tax avoiding operations of multinational corporations in Ireland; however, even a downgrade calculation signals the necessity for further drastic deleveraging, and indicates that a fiscal policy that would solely focus on austerity will make the macroeconomic performance even worse.

The more the Troika and individual member states insist on the continuation of fiscal austerity, the higher the probability that the 'red-hot economies' will fall further into recession. Shrinking economic growth, in absolute or relative terms,

results in a further rise of public debt ratios, and thus in a potential rise of risk premiums that further increase 'country risks'. Internal devaluation is not restricted to fiscal austerity. Its core is wage pressure, and in this regard the strategy delivered what it promised. Relative unit wage costs in Greece, Spain, Portugal and Ireland decreased in the last two to three years, not so much due to increases in productivity but due to shrinking wages. According to Buti & Turrini (2012:4) notably Greece and Portugal need significant further reductions of unit labor costs. This implies ongoing output and income losses and a further worsening of the employment situation. In brief, the macroeconomic vicious circle has not been broken yet.

Spelling it out

Some time ago Greece passed the barrier of illiquidity and firmly settled in the zone of insolvency. The current policy path established by the Troika resulted in a cumulative real output loss of 22 % since 2008 as well as in a similar employment loss (Darvas 2012). Wages and overall household incomes experienced severe cuts, and will continue to do so. The result of this medicine in regards to public finances has been disastrous. The public debt ratio is up to about 175% in 2012 and will continue to rise to 190 % soon – and this is despite the exchange of Euro 199 bn of public bonds that resulted in a nominal debt reduction of 53%.

For quite some time the Greek government could not unlock the urgently needed next installment of its bailout program because the conditionalities of the program were not fulfilled. After some public quarrel the money will start flowing again. As a matter of fact, there was never a real danger that the tranches will not be provided because at this point Greece's creditors are not willing to let Greece go bankrupt. The reason is straightforward: Due to the closed access of Greece to private credit markets, Greece's is only getting money from the IMF and member states of the Eurozone, and none of them is willing to sacrifice large losses. Despite differences in detail they agree that the game has to go on. In concrete terms this means that the de-frozen installments will immediately flow back into the coffers of the creditors. So far, the contributors to the Greek bailout program made a small but still nice profit from the bailout funds.

In case of the ECB, for example, it has been calculated that the bank holds about Euro 56 bn of Greek bonds, most of them purchased at a discount. The ECB, like other creditors, is so far getting interest on the face value, and the negotiated lending rate is favorable for the creditors. Creditor economies benefit in their own ways from the Greek (and Spanish, Portuguese, or Italian) malaise: The ongoing capital flight from those economies put string downward pressure on creditor interest rates, and thus 'subsidize' the debt service of those economies. The counterpart of high risk premiums and shrinking growth is the 'good equilibrium' enjoyed by the creditor economies, in particular the combination of current account surpluses and low interest rates. Recently, the IMF argued in favor of a hefty debt cut for Greece. This proposal met with resistance on the side of the ECB, the Commission and a majority of the member states, if only for the reason that unlike the IMF whose credits to Greece enjoy super-seniority the credits by the other political actors would have to bear losses.

The political compromise for de-freezing the current tranche to Greece reflects the differences between the creditors. In order to decrease the expected public debt ratio in 2020 closer to the IMF target of 120% the Europeans were willing to make small sacrifices. The overall package is vague but includes lower interest rates on bail-out loans from the first bailout package by 100 basis points to then 50 basis points above the interbank rate; a doubling of the maturity period from 15 to 30 years for bilateral credits and assistance provided by the second bailout package; a deference of interest payments on the second package by ten years; the retransfer of ECB profits on Greek bonds that are owned by Eurozone governments; and a debt buyback program. Even in the best case, Greece's public debt ratio would only go down to 124% in 2020 – a far stretch away from the IMF demand. Reaching 120% already in 2020 would have asked Eurozone governments to accept large losses, and none of them is currently politically prepared to go down this route. In the case of Germany the center-right coalition mobilized (again) a large majority of the Bundestag but not without increasing complaints about the opaqueness of the deal. As a matter of fact, this new political deal comes for the first time with budget implications for Germany that are estimated as Euro 730 mio for 2013 and about Euro 600 mio in 2014 – consisting of forgone profits of the *Kreditanstalt für Wiederaufbau*. The reduction of interest rates for Greece will also have budget implications for those Eurozone governments who can only borrow far above the interbank rate, and thus suffer losses due to the subsidized loans to Greece.
It has been argued by Gros (2012) that the Greek situation is actually not as bad because the interest service of Greece of 5.5 % is only slightly higher than in the case of Italy and Ireland, and thus by far not as catastrophic as the debt ratio indicates. He makes the point that Greece does not need a debt cut as proposed by the IMF. Some more austerity, so the argument, and growth comes back. Such macroeconomic optimism is not justified. For one, financial crises in general have the empirically demonstrated outcome to permanently destroy the base for future growth due to the destruction of human capital, the downgrading of infrastructure, the destruction of entrepreneurial spirits and the overall increase of uncertainty (Furceri & Mourougane 2012). For two, Greece is the only member economy of the Eurozone with an interest rate service above 5%. This ratio will go down with the new deal but comes with further structural austerity and internal devaluation that contributes to the ongoing output loss. The leaked draft version of the Troika report from November 2012 showed the continued emphasis on austerity measures that ask for further cuts and the indefinite fixation of primary budget surpluses. The by far strongest exonerating cumulative effects are supposed to come from the envisaged (i) further reduction of the wage bill of the public sector, (ii) cuts in pensions and social benefits, and (iii) reductions in public health provisions. Changes in the tax system are supposed to make up another significant chunk of fiscal improvement. The estimated cumulative effects in relation to GDP for the next years speak for themselves.
Is there an end for Greece? Optimists like Gros make the argument that in economic terms the next decade or so will bring back substantial economic growth to Greece that will outpace the interest rate, and consequently lead to a improvement of the public debt situation. Pessimists may argue that the output losses since 2008

destroyed the actual potential of the Greek economy and any resurgence in growth would have to be based on a newly built production regime. Realists may argue that the political and social limits of the reform policies have been reached and that Greece may quickly move into a political vicious circle of social unrest, social devastation and economic pressure from outside.

What Next?

The tunnel at the end of the light is unavoidable. It seems to me that the current brief period of light will not help to successfully navigate the next tunnel. Guidance, leadership and a well-drafted map are missing. Instead, we have opposing suggestions, compromised plans, national interest-biased strategies, weak governance and divided electorates.

There is no scarcity of alternatives. Most of them are in favor of *symmetric responses* rather than the dominating policy of one-sided internal devaluation. The argument for wage increases above the Eurozone-average in current account surplus economies, particularly in Germany, features prominently. The empirical fact that growth rates of German unit wage costs were substantially below the rates of the vast majority of Eurozone economies does not justify such a proposal. German trade unions tried hard to exchange job security with nominal wage increases in order to avoid labor market pressures on wages. However, the fact that over a long period nominal wage increases in Germany did not make use of the distribution space, consisting of annual increases in labor productivity plus annual inflation rate, can be turned into a strict future policy rule that argues for a permanent productivity-oriented wage policy. Such a norm is no fantasy but only reminds of a long-standing practice during the Golden Age of capitalism. In 2011 German trade unions across all sectors were successfully returning to this norm, and this led to an increase in unit wage costs that contributed slightly to a narrowing of relative unit wage costs in the Eurozone. Symmetric wage policy that follows the productivity norm definitely is a constructive tool but far away from solving the underlying problems.

The proposal for a stronger symmetry in fiscal policy follows a similar logic (De Grauwe 2012). Rather than asking deficit economies for endless austerity programs creditor countries should stabilize their achieved debt ratio and not try to further decrease this ratio. Depending on the growth rate of GDP and the underlying interest rate such economies could even afford running public budget deficits. Implementing such a norm would help countering the deflationary effects from the various internal devaluation programs.

Political-institutional fixes have been introduced in manifold versions. This is true for all variants of Eurobonds, the establishing of a true fiscal union or the introduction of a banking union, the launch of a single supervisory financial mechanism. The most recent communication from the Commission on a 'blueprint for a deep and genuine economic and monetary union' (EC 2012) represents what the Commission hopes is a politically feasible design.

Most of those proposals can claim economic or even governance rationality. To translate rationality into politics and policies is a different task that still needs to be mastered. By then the train steadily moves through diffuse light towards the next tunnel.

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