# FISCAL POLICY IN THE EUROZONE AFTER THE CRISIS*

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## 1 Introduction

The world has just been through a catastrophic financial crisis. In late 2008 financial markets around the world seized up catastrophically. By early 2009 this had caused the most rapid downturn in global economic activity that has been seen since the Great Depression.

In response, policymakers gave an unprecedented show of cooperation, particularly at the G20 meeting in London in April 2009, something which led to a worldwide coordination of fiscal and monetary policies. As a result, the global financial crisis (GFC) did not lead to an all-out collapse, and recovery began. But a similar process of international cooperation will be needed if we are to sustain this global recovery, and if we are to address the global savings-investment imbalances which still threaten global stability.

In Europe, there has been a follow-on crisis. This peaked in May this year, and, as I write, is again causing great uncertainty. This Europe-centred follow-on crisis poses significant risks to the process of recovery and adjustment, for Europe, and for the world as a whole.

The present paper describes the reasons for the follow-on crisis in Europe, which are centrally to do with the conduct of fiscal policy. The current European crisis is leading to significant changes in financial and fiscal governance in Europe, which be discussed in this paper. I am deeply sceptical whether these changes have been adequate – although they might be. It is right that the concerns which I express should be discussed at a conference on fiscal policy, since the conduct of fiscal policy has not just been central to the cause of the follow-on crisis within Europe, but will be central to its resolution.[1]

## 2 The Policy Problem Globally and in Europe: Three Objectives not Two

### 2.1 The Advanced World

As is well known, two things are necessary for global adjustment.

- There must be a change in the *relative* levels of absorption, when comparing deficit countries and surplus countries.

[1] The macroeconomic analysis presented in this paper are set out in more in detail in Allsopp and Vines (2007, 2010) and in Adam and Vines (2009).

In thinking about the macroeconomics of the crisis I have been greatly helped by Blanchard, *et.al* (2010), Bean (2009), and Obstfeld and Rogoff (2009). For a helpful narrative guide to the crisis, see Garnaut and Llewellyn-Smith (2009). Krugman (2009) and Caballero (2010) are thought-provoking.

- To make this possible, there must be changes in the *relative* prices of goods coming from the deficit countries and the surplus countries.

But the world also needs to achieve a third objective

- The level of absorption must grow fast enough to ensure a satisfactory *absolute* level of global growth.

At present, much discussion of global policy focuses on the first two of these objectives. Such discussions fail to recognise that actions directed towards achieving these objectives might put the third objective at risk.

At the London summit in April 2009 the world's leaders promised not to repeat the fiscal mistakes of the 1930s. The global response to the Financial Crisis involved an unprecedented display of global monetary cooperation. In addition, attention was given to ensuring the solvency of the global financial system. Furthermore, fiscal authorities embarked, world-wide, on a range of schemes to recapitalise banking systems, and to put in place fiscal stimulus programmes. They also ensured that automatic stabilisers were allowed to operate as activity fell. As a result of these policies the public sector was obliged to go into deficit – by unprecedented amounts – in most countries. The consequence was very large increases in public debt.

But while fiscal expansion has been effective in aiding the initial stages of global recovery, fiscal authorities cannot spend beyond their means indefinitely. Financial markets, and policymakers, are now focused on this question, and are concentrating attention on reducing public deficits and debt. They have settled on a view that global rebalancing requires fiscal consolidation in the deficit countries, which are mainly Anglo-Saxon, but which also include the European countries known as the GIPS – an acronym which stands for Greece, Ireland, Portugal and Spain. As a result, temporary stimulus packages are unwinding, and fiscal consolidation is setting in. Nevertheless, unemployment in most advanced countries remains disastrously high. To solve this problem requires a sustained recovery, and an expansionary fiscal position might continue to be necessary for this. The question now is this: how quickly should the fiscal deficit be closed in these advanced countries, and elsewhere where fiscal consolidation is also taking place *(e.g.* France and Germany)? And will these attempts at fiscal consolidation, globally, put growth at risk? We have a clear vision of how they might do this, since this has happened in in the past - in the US in 1938, at the end of the Great Depression, and in Japan in the 1990s. Paul Krugman sets out a clear version of this concern, as it relates to the US, in the *New York Times* on 5 September, 2010. (See Krugman, 2010.)

This worry has been echoed by Nouriel Roubini. (See www.roubini.com)

The worry is that in the US – and elsewhere – the demand for labour will remain way below trend. This means that, even if there is not actually a double-dip recession, unemployment will remain exceptionally high for a very long period. This is now a massive social issue globally.[2]The recent election results in the US demonstrate that it has become a political issue as well. We can re-express Krugman's worries for the US as a concern that the level of output will not be anywhere near high enough to bring about anything close to full employment, for many years to come. This worry applies in many other countries. Furthermore, there are risks posed to even the modest rate of recovery which would lead to this outcome.

### 2.2 Europe

The policy problem within Europe is a microcosm of that faced by the world. In Europe as in the wider world, three objectives (not two) need to be pursued.

Two things are necessary for adjustment within Europe.

- There must be a change in the *relative* levels of absorption when comparing the deficit countries and the surplus countries: *i.e.* there must be cuts of absorption in Greece, Ireland, Portugal and Spain - the GIPS coupled with expansion of absorption in Germany.
- There need to be changes in the *relative* prices of goods coming from the deficit countries and the surplus countries: there needs to be below-average inflation in Greece, and elsewhere in the GIPS, for a long time, coupled with above-average inflation in Germany.

But Europe also needs to achieve a third objective.

- There needs to be a satisfactory *absolute level* of European growth

Most European policy discussion at present focuses on the first two of these objectives, without recognizing that actions directed towards achieving them might put the third at risk. Not only is adjustment of absorption in the GIPS extremely difficult. It appears likely that Germany will resist the second, 'coupled-with', part of the absorption-adjustment process described above. And the adjustment of relative prices within EMU - a common monetary system - is particularly difficult. Not only will deflation be difficult in the GIPS, but above-

[2] See the interview with Olivier Blanchard on September 9, reported in IMF (2010).

average inflation will – it seems likely - be resisted within Germany.

There are two key questions. Will Europe will be able to deal these macroeconomic disequilibria? And if it does not – will the world have the resilience to deal with the resulting difficulties in Europe?

### 2.3 Emerging Market Economies

The picture is complicated by the fact that emerging market growth is very rapid, particularly in East Asia, with China predicted to grow by 10.6 percent this year. So slow growth is not a feature of the outlook for the entire world. Nevertheless, there are key questions concerning the extent to which rapid East Asian growth continues to rely on undervalued real exchange rates and on a growth in net exports. Thus, in the emerging market countries too there are also three objectives.

Two things are necessary for adjustment within East Asia.

- There must be a continuation of rapid domestic demand growth, so that *relative* levels of absorption can adjust as compared with the deficit countries
- There needs to be changes in the *relative* prices of goods coming from these countries, either through currency appreciation or through domestic inflation.

But East Asia also needs to achieve a third objective

- The level of absorption must grow fast enough to ensure that East Asia makes a satisfactory contribution , so that there is a sufficient *absolute* level of global growth.

At present, most discussion of the East Asian role in the world economy focuses on the first two of these objectives, without recognising that the size of the actions which need to be directed towards achieving them might depend on the role which East Asia is to play in achieving the third. However, I will not discuss this important set of emerging-market issues in the present paper, except in passing.

## 3 The Macroeconomic Adjustment Problem *within* Europe

The global financial crisis was transmitted from the US to Europe both through trade connections and through financial links. This process of transmission is discussed in

Obstfeld and Rogoff (2009), in Krugman (2008) and in various issues of the IMF's *World Economic Outlook.*

The GFC imposed itself upon a European economy which was already suffering from internal adjustment difficulties. It is the task of the present section of this paper to describe these difficulties. For this I will draw heavily on Allsopp and Vines (2006, 2010)

Whilst some member states of the EU have fully enjoyed the benefits of belonging to a currency union, notably by experiencing high growth rates, there have been large divergences in growth rates. Although the German economy is now growing rapidly, Germany experienced a prolonged period of slow growth and low inflation from 2000 onwards. By contrast the GIPS experienced a prolonged period of high growth and more rapid inflation.

What factors lay behind such inter-EMU divergences? The divergences partly reflect the process of economic catching up underway in the GIPS. From1990 until three years ago, all Greece, Ireland and Spain all achieved particularly rapid real growth, and very rapidly rising living standards.[3] But there was more at work than this.

The conventional *microeconomic* view is that the differences between countries relate to long-standing issues about progress in enhancing the flexibility of markets. This has led to the conventional suggestion that to improve performance the emphasis should be on supply-side flexibility — and on the 'Lisbon agenda' about productivity within Europe. An influential Report – *EMU after 5 Years* – published in 2004 took this line (European Commission, 2004). One should not dispute the importance of this supply-side explanation.

Nevertheless, there is another possibility. This is that interactions between competitiveness, prices and fiscal positions within EMU have been causing inter-country divergences to cumulate, over-and-above what has just been said about catch-up or about supply-side flexibility.

Within EMU, the adjustment process which brings national conditions back in line with the Eurozone average works as follows. There is a single centralised monetary policy. This means that a recession in one nation, caused, say, by competitiveness in that nation being less than in the rest of the union, will not lead to an EMU-wide response in monetary policy,

[3] On the other hand, Portugal experienced a stalling of living standards, for reasons which I will not discuss here.

either if the country is small, or if there is a corresponding, offsetting, boom elsewhere. But it will lead to a reduction in inflation in that nation, and to a corresponding gain in competitiveness there, and this will moderate the recession. Similarly, the reverse will occur if there is a boom in one nation, caused, say, by a gain in competitiveness there; inflation will rise there and so the competitiveness of that nation will worsen, damping the boom. The former kind of adjustment is what has been happening in Germany throughout the present decade, and the latter has been happening in the GIPS.

The conventional *macroeconomic* view is that this equilibrating process will work satisfactorily, so as to ensure inter-country adjustment within EMU. This conventional view is discussed in detail in European Commission (2006). It has long been believed that such an adjustment process will be difficult within a monetary union. The speed of the process will necessarily depend on the degree of price flexibility, since within a monetary union competitiveness cannot be rapidly adjusted by exchange rate change. If this price flexibility is low then the adjustment process will be prolonged. Hence the conventional beliefs, described above, about the need to promote supply-side flexibility.

But the follow-up crisis in Europe has made it widely apparent that there is a new and different adjustment difficulty, to do with the *dynamics* of the adjustment process. This dynamic adjustment problem is as follows. The ECB sets a single nominal interest rate for all Euro zone countries. In countries experiencing a loss of competitiveness and so a recession, prices need to fall. But we know that the price level will not jump down immediately because inflation is ‘persistent’, i.e. the price level will only begin to fall *gradually*. [4] The opposite is true in countries experiencing a boom. This means that in uncompetitive countries with a recession the real interest rate (the single common nominal rate minus domestic inflation) will begin to rise, and vice-versa in competitive countries experiencing a boom. But as the real interest rate gradually rises in countries with a recession, expenditure will gradually fall (at least amongst credit constrained consumers, but probably amongst investors, too). As a result there will be further downward pressures on domestic economic activity. This means

[4] This statement assumes some persistence in the inflation process, rather than prices following the kind of inflation process described by Calvo (1995). We have known since Fuhrer and Moore (1995) that there is such persistence. How much there is depends on the degree of forward-lookingness of price-setters. The European Persistence Network has studied this problem over the past 5 years. It is apparent that price and wage-setting within EMU countries has been sufficiently gradual – and un-forward-looking – for the issue being discussed here to be important.

that the rate of inflation will fall, the real interest rate will rise further, and expenditure will fall further. Output may continue to fall, even although the country is becoming more competitive. The opposite is true in the countries with a boom.

As a result, while aggregate inflation in the Euro zone may be on target, inflation rates across individual countries may not converge; the resulting real interest rate differences may diverge, and outputs may diverge cumulatively. This may happen even although the relative competitive position of countries changes in a direction which would promote convergence, as in the conventional view described above.

This difficulty has long been understood informally in the UK. It is known as the Walters Critique, after Sir Alan Walters, who as a result of concerns of this kind, advised Margaret Thatcher to keep the UK out of the Exchange Rate Mechanism of the European Monetary System (EMS). His advice was subsequently overturned by John Major, who, disastrously, took Britain into the EMS. But knowledge of this critique was part of the reason that the UK refused to join EMU in 2003. (See Westaway, 2003)

Allsopp and Vines (2007, 2010) discuss this dynamic adjustment difficulty in detail. In the latter paper they use a microfounded new Keynesian model for this purpose. They suggest that there is a possibility of very long-lasting divergence. In fact, something like this appears to have happened in EMU over its first 9 years, from 1999, when EMU was formed, to 2008, the year just before the onset of the GFC. Figures 1 and 2, taken from Allsopp and Vines (2010) show the behaviour of the real exchange rates within Europe, and the real (long-term) interest rates in Germany and Spain. Most people agree that Germany entered EMU at an uncompetitive exchange rate, and that the opposite was probably true for the GIPS. Figure 1 shows that a period of adjustment of real exchange rates was still underway nine years after it began. Figure 2 shows how real interest rates diverged for Germany and Spain over a period of nearly ten years, since inflation rates diverged, in turn because demand pressures differed, as a result of differing initial levels of competitiveness. The same was true for the other GIPS countries as well.

Allsopp and Vines (2010) show that, even if this adjustment process is eventually stable, competitiveness is likely to overshoot in this adjustment process. Using the central calibration of their model, they show that an uncompetitive economy, such as Germany at the beginning of the decade, may suffer too much deflation, so that the price level overshoots too far in the downward direction.

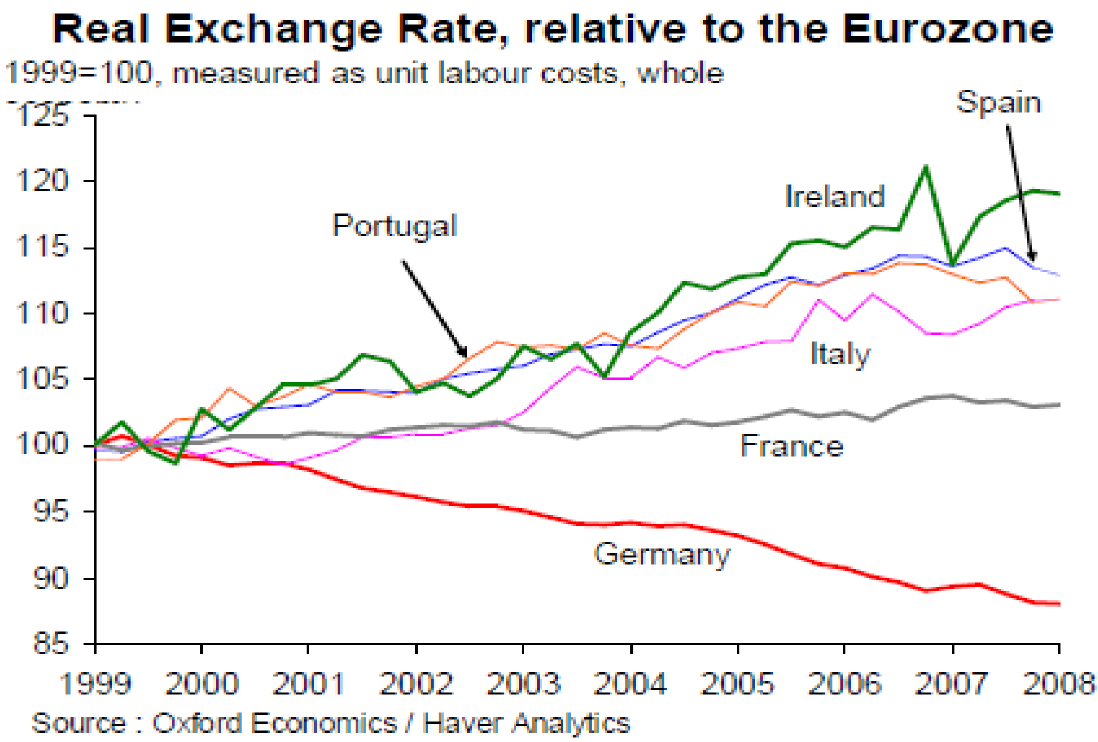


Figure 1: Real Exchange Rate

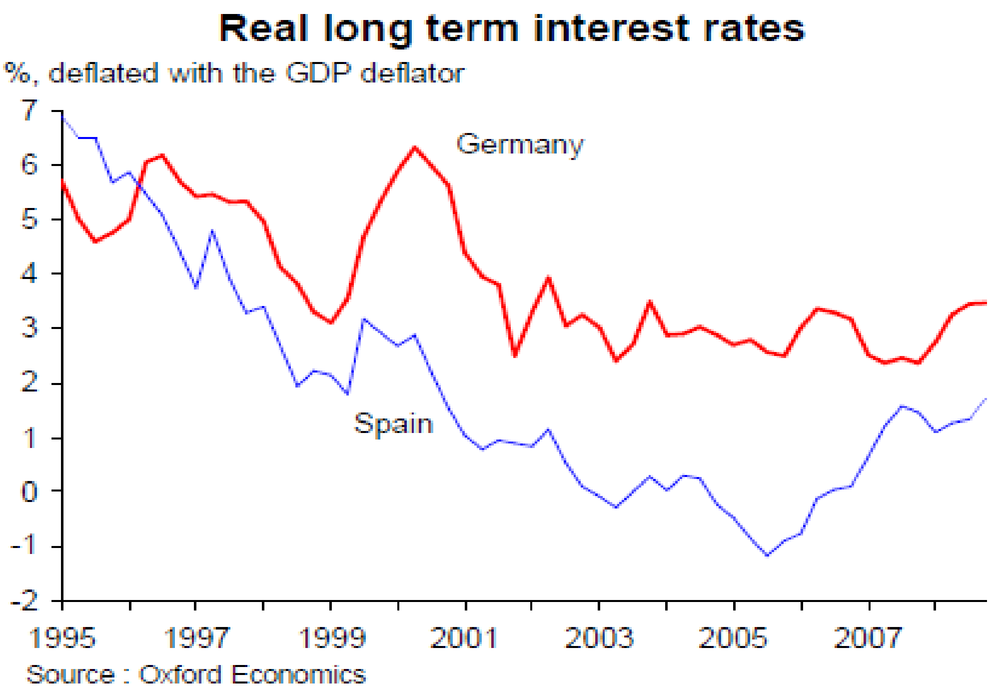


Figure 3: Real long term rate of interest

The reason for this is as follows. With inflation persistence, when the price level in the initially uncompetitive economy (Germany) has fallen enough to have adjusted to the appropriate level relative to the initially-too-competitive economies (the GIPS), inflation in the first economy (Germany) will still be below that in the other economies (the GIPS), and so prices will still be falling there. This means that the price *level* in the first economy (Germany) will go on falling below the relative position that is necessary.

This is what appears to have happened in the case of Germany. The adjustment picture shown in Figure 1 is one in which the German competitive position became gradually more competitive until about 2004, when it was about right. But the relative prices level kept on falling until 2008, to the point where Germany had become much too competitive.

Allsopp and Vines (2010) go one stage further than this. They show that fiscal policy could help to rectify this adjustment process, by offsetting the way in which real-interest-rate effects push in the wrong direction, as described above. They show that fiscal policy could help to avoid a process of cumulative divergence, and that fiscal policy could help to dampen any overshooting of competitiveness. In addition, they show that a tight control over debt, as required by the Stability and Growth Pact (SGP), would prevent fiscal policy having either of these ameliorating effects. Furthermore, they show that it would make the overshoot worse, since it would – in the case of an uncompetitive economy with a low level of output and a low level of tax receipts – require an increase in taxes, pulling the economy down further.

Allsopp and Vines were thus critical of the SGP, arguing that the SGP does not provide a framework which will facilitate inter-European adjustment. They said this even whilst acknowledging that the SGP might provide a valuable framework for managing the *aggregate* fiscal stability of the Euro zone as a whole.

It seems that Allsopp and Vines (2010) foresaw some of the difficulties that EMU countries are now facing. Their paper was presented at a meeting in Brussels in late 2007, and published informally as a working paper in 2008. It was published formally in a European Commission volume in 2010. This volume celebrated the tenth anniversary of EMU, and contained a large number of papers explaining how well macroeconomic policy had operated in EMU. It was finally published in February, 2010, three months before the EMU crisis erupted. The paper by Allsopp and Vines was the only one in the volume to suggest that there were difficulties ahead for EMU of the kind just described.[5]

However, Allsopp and Vines (2010) miss one extremely important macroeconomic feature, which means that their paper tells only half of the story of the difficulties in the EMU crisis. As discussed above, their paper suggests that a crisis might come as a result of an overshooting of competitiveness. What it does not do is explore the problems of sovereign risk which have come to haunt the un-competitive countries in Europe, i.e. the GIPS. What happened in the latter part of this decade was that one country, Germany, gradually increased its competitiveness vis-a-vis the others – the GIPS- and that, as a result, output in those other countries fell. Of course output also fell in these countries because of the global financial crisis, which affected everyone, and not just because these countries were uncompetitive within Europe. The GFC has made these countries more vulnerable to sovereign difficulties. But the internal-to-Europe process discussed here has also been important.

As a result of the fall in output in these countries, tax revenues fell, worsening the budgetary position of their fiscal authorities. In Greece the budgetary position was also in difficulty because of fiscal profligacy, and this was also true, to a lesser extent, for Portugal. But it was not true for Spain or Ireland. The fall in tax revenues in these countries led to a point at which fears about the sustainability of the fiscal position began to be important.

The fear about solvency led to a rise in the risk premium on the debt of those countries, a premium which peaked in May, 2010. This premium has again, this month, risen to unsustainably high levels.

This risk premium increases the real interest rate in the uncompetitive countries, making demand fall further, and making tax revenues in those countries fall even further. This has made the adjustment of intra-European competitiveness, discussed above, an even more difficult process then the one discussed above. It is this additional difficulty which provoked the crisis.

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[5] These difficulties were raised in European Commission (2006), a document which thoughtfully explored them in a more detailed, more carefully-calibrated, model than that presented in Allsopp and Vines (2010). The conclusion of that paper was that the adjustment process was likely to be satisfactory. But, in retrospect, the calibration in that paper may have been too optimistic.

# 4 Europe in 2010: A Financial Crisis in the GIPS

## 4.1 Introduction

The Asian financial crises of 1997-98 happened in emerging-market economies. Little did we think that the next sovereign debt crisis would be in an advanced country, or even in Europe. We have all watched Greece over the past nine months. But what has happened is not just a Greek problem but a consequence of the wider European macroeconomic disequilibrium discussed above.

Within EMU, all of Greece, Ireland, Portugal and Spain (the GIPS) are in difficulty, with very large collapses in activity, large public deficits, an uncompetitive position and current-account deficits. At the time of writing this paper only Greece had so far experienced an out-and-out crisis. But as the paper was presented a crisis enveloped Ireland too. And the risk premium on public sector debt for Portugal and Spain suggests that the threat of crisis looms there too. At the same time, as noted above, Germany has become extremely competitive. It also has only slowly-growing domestic expenditures, and is growing as fast as it is only because of export-led growth.

As noted in Section 2, the way forward in Europe requires two things

- First, there need to be cuts of absorption in the GIPS, to be brought about by a tighter fiscal policy, coupled with expansion of absorption in Germany, requiring a looser fiscal policy there.
- Second, there needs to be below-average inflation in Greece, and elsewhere in the GIPS, for a long time, combined with above-average inflation in Germany.

But, in addition,

- The overall level of absorption needs to be high enough to ensure that there is a satisfactory recovery process for Europe as a whole.

In what follows we will discuss the way in which these objectives are – or are not - being brought about.

### 4.2 The Current Strategy for the GIPS: Liquidity Injection followed by Austerity

In May there was a rescue of Greece by the IMF and the European Union. This means that Greece will not need to borrow again from private financial markets for three years - Greece has been given an interval of time during which it can put its house in order, and adopt the austerity which is necessary to achieve this. This rescue was achieved by the creation of a new Special Purpose Vehicle, the new European Financial Stability Facility (EFSF). This facility was used for the rescue of Ireland, at the time that this paper was presented.

The adjustment required in Greece, Ireland and the other GIPS is very large. Severe cuts to public expenditure programs, to entitlement payments and to pensions, coupled with increases in a wide range of taxes are a central part of the rescue package. Even if such austerity is accepted, in the case of Greece it is projected that it will take some time even to get the primary deficit back to zero, let alone to start repaying debt. As a result of this, at the end of the three-year breathing space provided by the rescue, the ratio of Greece's debt to gross domestic product will still be rising. Starting from 125 percent now, it will eventually reach a level of to 140-150 percent in five years' time, before beginning to decline. Servicing this debt on an on-going basis, and eventually repaying it, will be a very, very large task.

We learned from the Asia crisis that a rescue of this kind is *not* a bailout for the citizens of the country. Twelve years ago, what were huge loans from the IMF, approaching $100 billion, meant that Korea, Thailand and Indonesia could repay Wall St in 1997-98 when, all of a sudden, capital fled from Asia. But these loans were not gifts – they did not involve the obligations of the citizens of the crisis countries being written down. Indeed, the IMF does not possess any kind of sovereign-debt-reconstruction mechanism through which debts can be written down. This is despite valiant attempts by Anne Krueger to establish one early this century. (See Krueger, 2002, and House, Vines and Corden, 2008.) Those attempts were blocked by the US Treasury and by US financial markets. As a result, instead of debts being written down, what happened was that the IMF loans enabled the countries' other creditors to be repaid by the countries' governments. The countries then collected the money from their own taxpayers, and used this money to repay the IMF. IMF loans simply made it possible to repay Wall St bankers immediately, whilst collecting the money from taxpayers gradually: as a consequence the IMF simply acted as a debt collector for Wall St.

The same is true for the current joint IMF-European rescue plan for Greece. This is *not* a bailout for the citizens of Greece. Instead the IMF and the European Union have together acted as a debt collector for the German and French banks which lent large sums of money to Greece. Such action does not encourage moral hazard on the part of the countries involved. The same is true about what has happened in Ireland.

We also learned from the Asia crisis that an IMF rescue *is* a bailout for the banks and other financial institutions that lend to a country. The rescue of Greece in May protected German and French banks from the consequences of their lending to Greece. And the Irish rescue in November did something similar to European banks holding Irish assets. Such a set-up does indeed lead to moral hazard on the part of lenders.[6]

An alternative to such a rescue is default and debt write-downs.

However, we learned from Asia that default and debt write-downs, may not be a good idea after a financial crisis. It is true that dealing with a debt overhang poisons recovery, since the need to repay very large loans leads to tax increases and cuts in government services which delay the return to growth. But when recovery comes, foreign direct investment will assist, bringing new technology and access to foreign markets, and helping exports to grow rapidly again. It may be good to avoid default to make this investment possible. Messy legal fights about debt write-downs make it much more difficult to get investment going again, and so are likely to seriously impede any recovery process. East Asia recovered rapidly without debt write-downs. The current rescues of Greece, and of Ireland, make sense when viewed in this light.

### 4.3 The Greek Rescue – more needs to be done

The official hope is that in the next few years European banks who lent to Greece will get their money back. This is meant to happen, not just over the next three years, during which any roll-over of debt will be taken over by the EU and the IMF, but further out beyond that time frame. The hope is that, beyond that time frame, the private sector will resume lending so that the IMF, and European taxpayers, will be able to withdraw and their support will be able to be repaid. The hope is that, eventually, private sector creditors will end up holding

[6] At present lenders to Greece, and to Ireland, are being doubly rewarded. Debts have not been written down. In addition, the high risk premium attached to Greek debt, and to Irish debt, means that – so far – holders of this debt have been well-remunerated for holding it.

Greek debt, and charging reasonable interest rates on this debt, which, as a result of Greek resolve, will be fully paid.

In my view, this will not work and Greek debt will need to be written down in some way. Markets appear to agree with me – current risk premia suggest that there is a high probability of a large restructuring of Greek debt (see Vines, 2010).[7]

***The Need for an Adjustment of Competitiveness***

It is important to take a second lesson from the Asian crisis; a crucial lesson about competitiveness. That crisis showed that the way for a country to recover from a financial crisis is to devalue its currency – to a very large extent– and then to go for export-led growth. This was the case for all of Thailand, Korea, Malaysia and Indonesia. What looked like tragedy in the late 1990s now looks like a remarkable set of recoveries. But these recoveries have *not* been led by a recovery of domestic demand. They have been led by selling into world markets, at low costs and prices, output made available for sale abroad, as a result of domestic austerity. The strategy was one of austerity, accompanied by export-led growth. That growth was enabled by a high degree of competitiveness, which was achieved by currency devaluation.

To do something similar, Greece needs to become more competitive, and to achieve export-led growth, selling more both within Europe, and externally to Europe. The difficulty for Greece is that such an export-led recovery strategy is not available. EMU countries cannot devalue their currencies. Even if there is a willingness to accept extreme austerity in Greece, there is not – as things now stand - the possibility of accompanying this with a more competitive position, and thus with a growing export sector. The obvious way of making this possible is blocked by an inability to devalue the Greek currency. As a result, the only way in which this might happen is if there is an unprecedentedly large downward adjustment of nominal wages and prices in Greece.

For Ireland this problem is made doubly difficult by the fact that the UK constitutes a disproportionately large component of the Irish export market. The very large depreciation of

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[7] A risk premium of ten hundred basis points – the roughly-relevant number – implies that markets think that in each of the next three years Greek debt roughly a 30% probability of being written down by 30%.

the UK pound, at a time when Irish competitiveness is hampered by Irish membership of the Euro makes the recovery task in Ireland an even more challenging one.

Since devaluation is not possible, fiscal cuts in Greece – and Ireland – are likely not to make way for export-led growth, but are instead likely to drag down economic activity. In the case of Greece, Standard and Poors, the ratings agency, has estimated that the Greek economy will return to its 2009 level of nominal GDP at a much slower rate than that assumed in the calculations mentioned above – S and P suggest that Greece will not return to the 2009 level of GDP until 2017. With low activity, tax revenue may remain even lower than that assumed in the discussion above – which means that the adjustment of the public deficit position may be more difficult, and may take longer, than the story described above. Fiscal correction requires growth, which this strategy is unlikely to deliver.

It is apparent from the above that some decisive move is necessary to restore Greek competitiveness. The period from 2005 to 2008 saw a very rapid reduction in Greece's competitiveness. Greece now needs the equivalent of a very large currency depreciation. The numbers are big. I have not done the sums formally. But competitiveness in Greece may need to increase by 20 to 30 percent if Greece is to be able to do what Asia did in the 1990s. It does not appear likely that it will be possible to achieve a large enough reduction in wages, costs and prices, without some sort of central administrative intervention in the process.

The mechanics of such a wage cut will be difficult to achieve. By the mid-summer we had already seen a reduction in salaries in the public sector of something like 15 percent, and this was beginning to be followed in the private sector in a sporadic way. But, even if it were fully followed, this would not be enough. Some suggest that there is at least twice as much to do, in both the public and the private sectors.

Such a general wage cut will need to be accompanied by some legal surveillance which ensures that prices fall in the same way. It is difficult – impossible – to impose price control as a continuing system. But some oversight of a one-off cut in prices might be possible. There will be difficulties. Some activities are very import intensive and the costs of imports will not fall at all. Some activities – services - are very labour intensive. The costs of those activities will fall a great deal – and prices of those goods and services will also need to fall by a large amount. In addition, there will need to be a write down of domestic debts – as wages and prices fall. This will be very difficult to achieve.

Notice too that a wage cut of – say 30 per cent - would not lead to a reduction of real wages of anything like such a large number. In Greece imports are around 30 percent of GDP, and exports are about 20 percent. This means that imports are about a quarter of total final expenditure. A cut in nominal wages of – say – 30 percent would mean that – if prices followed wage-costs downwards – the CPI would fall by three quarters of this amount. Real wages would only need to fall by seven or eight percent – a manageable number. But there is a coordination problem. Nobody wants to be the one person who cuts their wages by 30 percent. That is why policy intervention may be necessary.

***The Need for a Debt Restructuring***

The Greek political system may thus end up finding that it cannot raise sufficient taxes to cover the required debt service, and debt repayments, especially if the outcome is worse than expected, because output growth does not recover, due to the country's uncompetitive position. Severe cuts may begin to look like pointless ones. These are cuts of a size which it is extremely difficult to believe that a democratically elected government will be able to deliver.

At a time of crisis, it is always necessary to ask whether adjustments of the kind proposed can be delivered by the government of the country in crisis, without that country defaulting on its debt. Keynes argued in *the Economic Consequences of the Peace* (Keynes, 1919) that the adjustment required of Germany by the Versailles Treaty after the First World War, including the payment of reparations, could never be made. (See Harrod, 1952, page 317 in the paperback 1972 edition. See also Moggridge, 1976.) The reasons which Keynes advanced are of some relevance in thinking about whether Greece will be able to pay the transfer demanded of it in the settlement made in May at the time of the Greek rescue[8]. A similar judgment needed to be made of Britain's position after the Second World War (See Vines, 2003, and Skidelsky, 2000). And similar judgments were also required in the case of the countries involved in the Asia crisis a decade ago, and have been needed in the case of many other countries in situations of financial crisis, over a number of years.

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[8] This adjustment would, in Keynes view, have required 'a heroic effort of self-control, by hard-work and living of an austerity unknown in any industrial society, and in a spirit of meek and mild compliance and honourable fulfilment of a treaty signed'. This was something which, Keynes thought, was unlikely to happen. He was right.

It is it seems highly likely that, in the Greek case, the policies of austerity may come to be resisted politically, and that the necessary retrenchment polices may be unable survive. The political will to soldier on may evaporate, and be replaced by a rise in anti-European, and anti-German, sentiment.

This suggests that recovery in Greece will require a very large restructuring of Greece′s public debt. And that means that the rescue package, negotiated in May, will *not* fix Greece's debt problems on its own. Some time in the next few years, before the Greek government can successfully return to international markets, there will need to be some kind of haircut of existing debt. It is true that it might be best to delay this restructuring until the primary deficit has been reduced to the point where the debt level is no longer rising, or is only rising slowly, so that new debt is not issued in parallel with existing debt which has been written down.[9] But delay, or no, such a restructuring does seem likely. Markets seem to believe this, which is why the high risk-premia on Greek debt have returned, after the fading away of the euphoria which was initially associated with the rescue in May.

My belief is that there is, within the framework of the new European Financial Stability Facility (EFSF), the capacity to manage such a debt reconstruction for Greece, as and when this proves necessary. What was invented in May, during the rescue, was very remarkable indeed. With the new EFSF, an open-ended structure was created, in which the managers of the EFSF can act with remarkable discretion. They can do this to engineer fiscal transfers, and can act with politically delegated authority The existence of the open-ended structure means that dealing with crises will not need to be delayed – as was the case with Greece – by Angela Merkel and by the needs of German politics.  This is extraordinary, given where Europe was just six months ago.  But it may not be enough. The EFSF has so far been used to provide *liquidity* at a time of crisis. The next task may well be to use this framework to resolve *solvency* issues.

The use of the EFSF in this way will be politically as well as an economically challenging. This is because the burden of restructuring will fall on French and German banking  - since French and German banks own a large amount of longer- term Greek debt - as well as on the European fiscal authorities and the IMF, which took over much of Greece’s short- term debt

[9] An alternative might be to issue new debt which is senior to the old debt, but this might also not be a satisfactory outcome.

at the time of the Greek rescue. The politics of supporting the European Banking Systems, and of allocating the fiscal losses, will be very tricky. But – on an optimistic interpretation - the framework necessary to do this is now in place

***A Shared Political Solution: Competitiveness Adjustment and Debt Renegotiation***

How to bring this about? The politically courageous thing to do may be to seek a very large overall wage cut in Greece, coordinated across the whole economy, and to do this alongside a debt restructuring. This way, it will be possible to present the wage reductions to the Greek population as part of a burden-sharing approach.

In my view, it is essential that this happen as fast as possible. A slow and gradual reduction of wages would bring about the worst possible outcome. With falling costs and prices, but no fall in interest rates to match, very few people could be persuaded to invest. This is the basis of the Walters critique of monetary union, which I described above. Countries in an uncompetitive position, experiencing deflation, undergo a period in which there is a higher level of real interest rates, as wages and prices come down. The slower this happens, the longer this problem remains, with the difficulty which it causes for expenditure. In 2010, post May, Greece is living out a particularly serious version of the problem described in Section 3 of this paper.

Export-led growth, and a process of investment to make this possible, are what Greece needs. An environment of gradual deflation means that the recovery in exports will be slow, and that the investment needed to sustain this will not be forthcoming. That is not a satisfactory adjustment strategy. At present, markets are just waiting for all this to happen. That is why risk premia on Greek debt are so high. And such high risk premia make the adjustment path all the more difficult for the Greek economy, making investment by the private sector in the transition process all the more difficult to bring about. This is an even worse outcome than the one envisaged by Walters, when he framed the Walters critique.

The solution to this is a political task – and it requires skilful political leadership. Since a wage cut needs to be done fast and decisively, and since debt restructuring and cuts in wages should be done at the same time for the reasons discussed above, this all points towards the need for speed, even in the approach to debt. Since wage cuts are a domestic action, but the resolution of the debt problem has significant international aspects, this Greek policymaking needs to be undertaken with support at the European level, and with support from the IMF internationally. To obtain this support will be demanding. But it seems to be necessary.

### 4.4 The Risk of Contagion

Since last May, the European crisis has spread from Greece to Ireland. The countries next in the line are Spain and Portugal. International investors have come to fear that the difficulties in Spain and Portugal are like those in Greece and Ireland. And they are right to be afraid, even although, in Spain, as in Ireland, the problem has not been fiscal in origin. Until recently the fiscal position in Spain was sound. Spain has, instead, the remnants of a collapsed housing boom, nearly twenty percent unemployment, an uncompetitive economy, and a banking sector in difficulty as a result of a housing crisis. As a result of this, Spain has ended up with economic collapse, and a headlong fall in tax revenues leading to an unsustainably large public sector deficit. But the origins of this problem are not, as in Greece, fiscal irresponsibility. Something similar is true of Ireland, as explained by Regling and Watson (2010). See also the recent piece in the *Financial Times* called "Ireland: the long hangover" (Gardner and Brown, 2010), and the even more recent piece by Kelly (2010).

A strategy of austerity alone, like that for Greece outlined above, may not work in Spain either, for reasons like those explained above. Spain has a much larger economy than Greece, and therefore difficulties there will be even more significant. Portugal is smaller, but has suffered from a lack of competitiveness and a fiscal problem since well before the financial crisis. The spread of the crisis to Ireland, and the rising risk premia for Spain and Portugal, suggest that the Greek problem has already become systemic. These countries may also need a debt write-down.

This contagion risk will need to be managed. The EFSF *may* come to be very important in managing this trans-border process

## 5 Europe in 2010: difficulties posed by the German Position

### 5.1 Competitiveness

The crisis has revealed a different, slow-acting difficulty, beyond that due to competitiveness in the GIPS. This is the problem which we first mentioned in Section 2 above.

For all of the ten years since EMU was formed, Germany has determinedly cut its cost and wage levels. Within a common currency area other countries have been unable to escape the effects of such a ‘race to the bottom’ on costs and prices. The more competitive Germany, which has resulted from this, has taken demand away from other countries within EMU - not just from Greece, Ireland, Portugal and Spain, but also others such as Italy. It is beginning to be realised that membership of a monetary union is going to require significant changes in wage fixing, and in price fixing, so as to make the competitive positions of these other countries compatible with their sharing a common currency with Germany.

There is beginning to be talk of building an intra-European ‘competitiveness strategy’. This would be a response to the difficulty, described in Section 3, about the level of competitiveness adjusting slowly, and possibly overshooting its desired level. This response recognizes that there may need to be policy intervention to ensure a satisfactory outcome. I have already discussed the need for such a policy intervention in the case of Greece in the previous section.

### 5.2 Absorption

But this is not all. German policymakers have insisted that German domestic demand be held down to make room for the foreign demand which is attracted by its increasingly competitive position. Given a restrained level of private demand within Germany, this strategy has not required particularly contractionary fiscal policy. But the effect has been to ensure that a recovery of demand in Germany needs to be sustained by a significant German current-account surplus.

The requirement that the deficit countries – the GIPSs - cut their absorption is understandable – although as I discuss in the previous section it will be difficult in a monetary union in which relative prices cannot be adjusted at the same time through an exchange rate depreciation. But if this cut in the GIPS is not matched by an increase in demand in Germany then the region will suffer from a shortage of demand.

That, in turn, means that, taken-as a-whole, European recovery is only possible through export-led growth. This requires a world in which demand is growing rapidly. Absent such a world and export-led growth in Europe will only be obtainable by a depreciation of the Euro. This is the kind of policy which has recently been practiced by China. It is a danger to the whole world. We live in a world in which, for reasons similar to those in Europe, there is a need for the US dollar to depreciate. This is also a world in which China, and thus the rest of East Asia, are not prepared to countenance a large currency appreciation. If we are not careful, German policy help to will condemn the world to a currency war.

This is not systemically responsible behaviour. There is a serious conceptual issue here. Thatcherite 'fiscal responsibility' is possible in a small open economy, and export-led growth is possible for such a small open economy. But a larger significant country, such as Germany, which is a hegemonic leader of a group of countries, has wider macroeconomic responsibilities. These are responsibilities to other countries within the monetary union, and because that union is large, responsibilities to the rest of the world. Germany seems unwilling to accept the kind of hegemonic responsibilities which its position in Europe now requires of it.

German insistence on its right to make policies in its own interest, whilst disregarding the interests of other countries within EMU, has culminated in a constitutional provision, enacted last year, which will, within a few years, prevent Germany from running any significant budget deficits at all. Such a constitutional enactment appears to be entirely improper. It should not be possible for one member of a monetary union to change the rules of that union, unilaterally, and it should especially not be possible for this to be done by constitutional means. The effect of this provision will be that, if German private sector expenditure remains cautious, the problem which we describe above will become a permanent one, written in stone.

## 6 New Rules for Fiscal Policy in Europe

Everyone now believes that the Stability and Growth Pact (SGP) needs to be replaced as a framework for macroeconomic policy in Europe. The above analysis shows why the rules of the Stability and Growth Pact are unhelpful. Allsopp and Vines (2010) make this analysis more precise. They show that if the fiscal authorities tightly target fiscal sustainability (aiming, say, for a particular deficit or debt ratio as in the SGP), this will make for a larger overshooting of competitiveness, may cause the economy to cycle, and may even make macroeconomic stability difficult to achieve.

What sort of framework should replace the SGP? Clearly such a framework will need to involve some discretion, so that it can respond to unexpected kinds of shocks. The most extreme version of such an unexpected shock is the crisis which we have been living through. Following rules as rigid as those of the SGP is a bad idea in the face of such shocks, whatever the details of those rules. Nevertheless it is desirable to have a rule-bound framework of some kind. In this section, which follows Allsopp and Vines (2010), I explore what these rules might be. I first review the difficulties associated with the Stability and Growth Pact.

If a country were to follow the SGP when adjusting to a downturn in competitiveness, the fiscal authorities would be unable to allow the in-built stabilisers to operate — i.e. they would need to cut government spending. Further, this would stop them from intervening so as to prevent Walters Critique problems form emerging. As a recession emerged, inflation fell and the government deficit increased, government expenditure would need to fall, or taxes would need to rise, causing further falls in inflation. The fall in inflation would, quite possibly, be undesirably rapid, possibly making stability difficult to achieve, as suggested by the Walters critique. Even if that did not happen, the level of competitiveness would be likely to overshoot.

It thus appears that there is interference between the fiscal arrangements of the SGP and the need to adjust real exchange rates and competitiveness between countries within EMU. It appears that the constraints of the SGP — particularly if they apply asymmetrically to countries facing competitiveness difficulties — do interfere with the macroeconomic responses which are desirable in such countries. The general prescription is that there should be a greater delegation of fiscal freedom to those countries which are suffering from such sustained negative shocks to competitiveness.

Importantly, however, such policies must not lead to the postponement of necessary adjustments of the relative real exchange rate. The additional fiscal freedom should be used in such a way as to be consistent with that long-run outcome. The analysis here does not suggest that there be fiscal expansion to prevent adjustment in these countries. Instead Allsopp and Vines suggest that fiscal policy might even be used to speed adjustment - fiscal expenditures could be cut initially in countries suffering from a low level of competitiveness. But fiscal policy would subsequently become expansionary to prevent adjustment going too far. Their overall conclusion is that such additional policy freedom is likely to improve the trade-offs in the country concerned, resulting in better adjustment to competitiveness shocks, and that it will do this without causing additional inflation.

It appears that, for a good outcome, the choice for fiscal policy might need to involve

(i) only very gradual feedback from the level of debt to the fiscal position,
(ii) active fiscal policy feedback which becomes more stimulatory if inflation becomes low, to prevent unstable developments in the price level, and to prevent the price level overshooting, and
(iii) active feedback to fiscal policy from the future equilibrium value of the real exchange rate, being cut if the economy is uncompetitive but becoming more expansionary as the real exchange rate depreciates towards its equilibrium level, in order to help prevent the real exchange rate overshooting.

Thus I am suggesting that the fiscal authorities target the longer-term fiscal position in such a way that they steer the real exchange rate towards the appropriate position. Alternatively, I suggest they might target (i.e. introduce feedback from) an appropriate future real exchange rate, where that competitive target is chosen so as to lead to a competitive position which would be consistent with full employment.

This course of action – rather than using fiscal policy to target national debt - seems desirable because the debt ratio *per se* does not normally, of itself, have much weight in the authorities' objective function. The fiscal position needs to be sustainable, as we have seen, but otherwise debt should be allowed to act as a shock absorber, by allowing the automatic stabilisers to operate, as has been discussed above. This point is discussed in detail in Kirsanova et al. (2005) and Kirsanova et al. (2007).

The appropriate real exchange rate would be that which ensured that, after any worsening of the external competitiveness position which was expected to be sustained, competitiveness was again returned to a position at which demand for domestic resources was restored. At this point, the level of capacity utilisation would have returned to a normal position, and tax revenues would have been restored, rather than being low because output was below capacity. At that position ,the sustainability of the budgetary position would be assured.

The contrast between such a conduct of fiscal policy, and one directed to the control of deficit and debt, is as follows. Initially, once it became clear that the position was one of worsened external competitiveness, fiscal policy would be tightened, with the aim of putting downward pressure on wage and price settlements, so as to help speed the adjustment of the real exchange rate, which – in a monetary union – must be brought about by means of Phillips-curve pressure. But as the adjustment happened, fiscal policy would become looser again, to ensure that downward pressure on wages and prices did not continue to be exercised even after competitiveness had improved sufficiently relative to other countries within EMU. There is an obvious contrast here with how fiscal policy has been conducted in Germany recently.

What we are suggesting for fiscal policy involves a regime of ‘constrained discretion’. The longer-term objective for fiscal policy, or the ‘constraint’, would remain that of ‘sustainability’. This would be an objective, just like that in the SGP, specified in accordance with a framework of ‘sustainability pacts’. (See Coeure and Pisani-Ferri, 2005).
The difference of our approach from that in the SGP lies in the way in which ‘discretion’ would operate. The policy action which we suggest, in response to indications of ‘unsustainability’, would be different from what is now meant to happen within the SGP. At present, within the SGP, the required response to such a problem is a programme of budgetary cuts, even if the problem is caused by a loss of competitiveness, as in the thought experiment that we have been carrying out in this analysis. What we are suggesting instead would be a policy directed towards achieving changes in the real exchange rate over time, towards a long-run target.

That target would be one which was consistent with the sustainability objective. The required move of the economy towards this position would be assisted by fiscal restraint. But that restraint would be devised so as to help avoid cycles, as has been explained.

There is an additional reason that such a policy might be desirable, beyond that shown in our modelling simulations discussed above. That modelling work assumed that those who were setting prices in a forward-looking way would know by how much competitiveness would need to be improved when bringing down the inflation rate so as to improve competitiveness. In reality it may be difficult for the private sector to determine the degree of adjustment of competitiveness that is required. If fiscal policy were to target the level of competitiveness in the way discussed here, that might make it easier for the private sector to form the appropriate expectations.

The policy framework which we are outlining is not a simple one. But adjustment of the real exchange rate in a way consistent with fiscal sustainability in the longer term, is not a simple problem within a monetary union. It is clear that the computation of the appropriate real exchange rate would require significant modelling work. In the same way in which inflation targeting does not operate by the mechanical operation of a Taylor rule, this kind of fiscal policy would need to operate in a non-mechanical way. Such policy might be managed by a national fiscal policy committees in the way advocated by Charles Wyplosz (Wyplosz, 2005), Jean Pisani-Ferri, and Simon Wren-Lewis.

## 7 The Emergence of a new form of European Macroeconomic Governance

What has happened in the past year has presented a great political challenge to Europe as a whole, not just to Greece. What is needed is much more than a set of new fiscal policy rules, of the kind discussed in the previous section, however well they are formulated. What is needed is a new governance framework. As argued by Walter Munchau in the *Financial Times* on 3 May, 2010, many now believe that EMU will break up, unless there is very much greater political and fiscal integration within Europe, within such a framework .

### 7.1 Macroeconomic Surveillance over Deficit Countries

The behaviour of Greece revealed deep weakness in the EMU policy-making system. This system permitted the kind of fiscal irresponsibility in Greece which drove it to the edge of a financial precipice. There should have been intervention from Brussels to prevent what was happening. There were the rules of the SGP to ensure this. But in fact the SGP turned out to be completely unhelpful. It has been suggested to me in private discussions that those in DG EcFin in Brussels knew very well about Greece, but were unable to act. This seems to have been because both Germany and France had already breached the SGP, so compromising the ability of Brussels to exert discipline.

I have learned much about what was wrong with the SGP from my experience in bringing up my three sons and two stepsons. I found that being a father was to be subject to constant challenge, a process in which I was in constant retreat. But I learned to draw lines, to defend what I knew that I could defend. I knew that without this wisdom I would always end up being overwhelmed. The SGP drew its lines-to-be-defended in unwise places, and was overwhelmed.

The un-wisdom of the SGP must be replaced by a new approach to fiscal policy, both new rules of the kind described in the previous section, and a much greater degree of properly-exercised discretion in the implementation of these rules. In future, the Euro system will need to require that countries in difficulty accept a much greater degree of intervention by the European Commission in the conduct of their economic policy. Those who live in federal countries, like the US, Australia, and Canada, recognise the inevitability of such ‘federal intervention’.

The political obstacles in the face of achieving this within Europe look very large. But the position is now an unsustainable one. There is only a way forward, or a way back. European macroeconomic governance cannot remain where it is. In some ways the situation is analogous to that which obtained in the early 1990s, when the European Monetary System broke down. At that time there was only a way forward to European monetary union, or back to floating exchange rates. What is now needed is a way forward to a greater integration of European competitiveness policy *and* fiscal policy, even although both of these will be highly political acts. It is not obvious that there is any way back.

A new policy system will need to be able to do three things. The rules for fiscal policy described in the previous section, when sensibly implemented, would allow all of these things. First, such a framework will need to enable fiscal authorities to respond *expansively* when there is a general crisis. Such a policy response happened during the GFC. It was brought about both by means of fiscal discretion and through allowing the automatic stabilizes to operate, both things which were against the rules of the SGP. But, second, the redesigned system will also need to ensure long term overall Europe-wide sustainability, and so avoid a fiscal policy which, in the aggregate, crowds out productive private capital in Europe, and so crowds out the ability to deal with long-term burdens, such as health and ageing. And, third, the redesigned system will also need to assist with the relative adjustment of competitiveness within Europe, and so avoid a fiscal policy which accentuates inflationary differences between different members of EMU, and causes the real exchange rate to overshoot. Those redesigning the policy system will need to understand the vital trade-offs between short-term expansionary needs, longer-term solvency requirements, and relative intra-European adjustments. The rules articulated above would make this possible.

This kind of system will require a degree of trust in the authorities to act appropriately, something which cannot possibly be achieved by means of simple arbitrary rules, as was hoped by the designers of the SGP. And it will almost certainly require delegation of the authority to act in a trusted manner to national fiscal councils.

The conceptual difficulties are large. And implementation of the new approach must be both comprehensive and flexible. It must be able to discipline behaviour like that practiced in Greece, which helped to tip the Greeks into crisis. But it must also be able to guard against difficulties like those in Spain, in which fiscal indiscipline was not the cause, and for which mere fiscal discipline is not a remedy.

### 7.2 Macroeconomic Surveillance over Surplus countries

The crisis has revealed another deep weakness in the EU policy-making system. As noted above, for all of the ten years since EMU was formed, Germany has become progressively more competitive. As a result, Germany has taken demand away from other countries within EMU - including not just Greece Portugal and Spain, but also others such as Italy. The construction of a European 'competitiveness strategy' designed to prevent this, of the kind described above, is a big institution-building task. This will need to be managed as a Europe-wide political task.

Germany's unilateral approach in the face of this gain in competitiveness has also played itself out in a harmful way. It has led to a growing German surplus within Europe. It has also been accompanied by an insistence that the less competitive, deficit countries, beginning with Greece, cut their spending – for reasons discussed above. The result is that demand, which has been taken away from other countries by Germany, has not been replaced. The German competitive drive is leading, through this route, to a too low-level demand within Europe.

A Europe of this kind, deprived of demand, will face two alternatives. The first of these is that it is that is unable to grow to its full potential. The second is that, to restore growth, the Euro will need to be depreciated, in order to stimulate growth through exports. But doing this will deprive other countries in the world of demand for their exports.

If Germany is to remain the hegemonic leader within the Eurozone, it must step up to the responsibilities which are required of it. The private virtues of good housekeeping are admirable in a small open economy. They are not what is required if a country is to be a regional and global leader

I have been asked, quite rightly, whether I exaggerate. The fiscal position of Germany – it has been said to me – is still broadly expansionary. Surely this is enough? We need to understand that the fiscal needs, for Europe as a whole and for individual countries, depend on what is happening in the private sector. The expansiveness of fiscal policy may not be enough, and a country which aspires to be a responsible world leader must realise this. We are living in a world in which the personal sector balance sheets are still very damaged by the fall in world asset prices, and so the personal sector is saving. The corporate sector is, because of uncertainty, unwilling to invest. And the financial sector, which is still de-leveraging, has stressed balance sheets, and is –as a result - still not lending enough. In such circumstances the public sector may – still – need to be a spender of last resort. I would not want to deny that fiscal responsibility is essential in the longer term. But there is a timing problem here of the first order.  Fiscal probity may thus not be enough. Indeed, until the world recovery is secure, it may be dangerous. This is a matter =which requires analysis, rather than an acceptance of simple rules.

Thus the European Union Project not only faces a deep political challenge with regard to the need for surveillance of countries in the South. It also faces a challenge concerning surveillance over Germany. That country must be wise enough to lead Europe in a way which does not damage Europe – or the world.

### 7.3 A European Macroeconomic Policy System

The above discussion explains why many economists advocate fiscal responsibility councils in each of the EU countries. These fiscal authorities would be independent from day-to-day politics, analogous to central banks that have been made independent, in order to guard against related credibility problems. There would also need to be guidance, by DGEcFin or some other Europe-wide body, towards some understanding both of how fiscal polices should operate, relative to each other, and of what the European fiscal stance should be. This Europe-wide macropolicy system would need to ensure fiscal discipline of countries in the South, to ensure that the problems which have struck the GIPS do not recur there. There would also need to be discipline over the policies adopted by Germany.

My hope is that the design of such a Euro-wide policy system will become a workshop, and a model, for the design  of a workable international macropolicy system for the world as a whole – a system which will exert surveillance and influence over national economic policies at a global level.

### 7.4 A European Crisis Management System

We have described above the kind of crisis resolution process which is needed for deficit countries, and how it is being constructed within Europe. My belief is that there is, within the framework of Europe's new EFSF, the capacity to manage such a debt reconstruction, not just for Greece but for the other GIPS countries, as and when it is proved necessary. The new European Macroeconomic governance system will need to have such a process, as well as the surveillance system described above.

The use of the EFSF in this broader way will be politically as well as an economically challenging. This is because – just as in the case of Greece - the burden of restructuring will fall on French and German banking , since French and German banks own a large amount of longer- term Spanish housing debt. The politics of allocating the fiscal burdens of supporting the European banking system losses will be tricky, just as in Greece.  But – on an optimistic interpretation -  the framework necessary to do this is now in place.

My hope is that Europe's EFSF will develop the capacity to manage sovereign debt reconstruction in the way just described.  If it does, this might even become the basis for a global sovereign debt reconstruction mechanism, of the kind for which Anne Krueger pressed whilst at the IMF. As noted above, this mechanism was blocked by Wall Street and by the US Treasury. Europe may have learned how to bypass Wall Street, and may have begun the process of building a Sovereign Debt Reconstruction mechanism at the global level.

## 8 Conclusion: Some Political- Economy Implications

This paper has raised two sets of issues concerning fiscal policy – one to do with the role of fiscal policy in macroeconomic management, and the other to do with the role of fiscal policy in crisis management.

The discussion of the role of fiscal policy in macroeconomic management has raised four important issues.

(a) The way in which fiscal policy is policed in the Eurozone needs to pay much more attention to the competitive position of a country, and much less attention to the level of public debt. Of course fiscal policy needs to ensure that the level of public debt is sustainable. But helping to ensure that the competitiveness of the country is adequate is an important part of ensuring that the creation of public debt will not turn out to be unsustainable, since it has to respond to the political problems of the country being uncompetitive.

(b) The above analysis has shown how important the level of competitiveness is for the macroeconomic outcomes for countries within EMU. It shows that consideration of relative levels of competitiveness needs to be an important part of the policy process.

Competitiveness outcomes will need to interact with fiscal policy decisions. At present there is a fundamental policy rift between Germany and other countries about whether, because of its competitive position, Germany has an excessive current account surplus and this rift is leading to a core disagreement about Germany's fiscal position. It appears to me that, because of its competitive position, the fiscal stance in Germany needs to be weaker than Germany admits.

(c) Fiscal policy will need to be implemented in a more flexible manner. The above two outcomes cannot be achieved in a rigid, rule-based manner. The days of a formulaic fiscal policy like that in the SGP are now gone.

(d) Perhaps the most important point is that public debt problems in one country (Germany) cannot be resolved without the policy mix in Germany, and in the rest of the union, being one that facilitates adjustment in the GIPS – given their competitiveness position and their external demand trends. This is a million miles from the way people still think in Berlin, where there is an ambition to get back to a set of fiscal-policy rules that put a limit on public debt.

One small, but perhaps important, way of moving towards a resolution of this disagreement about Germany's position might be through targeted liberalisation measures in Germany. Germany is going to remain in current account surplus for the medium term under all fiscal-policy scenarios, but that surplus can be reduced somewhat more rapidly, and it can be associated with higher levels of gross imports from Eurozone partners, if market liberalisation leads to an expansion of spending in Germany. Such a reduction in the German surplus would happen without any explicit move towards fiscal loosening and would be helpful. It could be brought about without policymakers in the different countries within EMU needing to resolve their disagreement about fiscal policy.

The discussion of the role of fiscal policy in the crisis-rescue experience of Europe has raised two additional, important, issues in relation to fiscal policy, beyond those to do with macroeconomic management. In doing this it has shown just how politically interdependent the countries within EMU have become, now that they share one currency.

(i) Precisely because of the weakness of the fiscal-policy institutions, the nature of the crisis management process within Europe has been unsatisfactory. It has delivered results only in the face of a market crisis. And - importantly - it has left huge scar tissue. Specifically, the policing of much of the adjustment required by the GIPS is being carried out by the ECB. This institution appears to be internally divided, is mistrustful of the

Commission, and is itself viewed with widespread suspicion in Germany. Nevertheless, adjustment in Greece, Spain and Ireland appears at present to be forced on those countries not by the IMF. or by the European Commission – which has been almost entirely powerless – but by the ECB. The ECB is able to exert pressure on countries because it is the ECB which is preserving the market for the debt of these countries, and buying the debt of these countries in its own version of 'quantitative easing. A policy system which relies on the ECB to impose conditionality in this way is both constitutionally irregular and politically unsustainable. The development of a centralised fiscal policy system now seems to be a core policy need in the EU, not only to improve macroeconomic adjustments in the way described above, but also to manage the post-crisis, cross-border imposition of conditionality.

(ii) There are big issues of political commitment enmeshed with the crisis-resolution-by-fiscal-means which has become necessary in Europe. Earlier this year, Germany was faced with a historic choice: to bail out Greece – and to signal that it might also bail out some other countries - or to bail out of the Eurozone instead. In the end, the latter course of action appeared too costly, in terms of the financial and economic chaos which it would cause.

What Germany did was insist on IMF intervention – and on a process in which it exerted a blocking majority. It also brought intergovernmentalism to the centre of the stage, at the expense of the European Commission, something which is understandable, given how weak the Commission has been. But, conversely, the creation of the European Financial Stability Facility during the process of crisis resolution has seen the construction of a Europe-wide policy institution – one which may be able to withstand such a Germany-first orientation of policy within Germany.

Financial realpolitik might continue to force the changes that are needed in deficit countries in Europe. It might even ensure, within Germany, that there is continued domestic political support for the European project. As a result, monetary and economic integration in Europe really might be reformed, rather than dismantled. But it might not be.

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