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CHALLENGES FOR THE EURO AREA AND IMPLICATIONS FOR LATVIA

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Highlights

- This Policy Contribution reviews the major challenges faced by the euro area, and discusses recent initiatives and the way forward. Some implications are drawn out for Latvia's euro accession, which is likely to be beneficial on balance.
- The euro area faces three major challenges: (1) high private and public debt in some of its parts together with a requirement for competitiveness adjustment that in some countries has barely started; (2) weak growth outlook; (3) continued banking-sector fragility that, with sovereign stress, feeds a negative feedback loop. The euro area has agreed many significant measures to overcome these problems, including the European Stability Mechanism and the fiscal compact. The 21 February agreement on Greece removes a major source of financial instability even though it is likely that further debt reductions will be needed. Significant concerns remain, the most important of which are the slow real economic adjustment and the largely unaddressed banking-sovereign fragility. The fiscal compact raises the issue of appropriate fiscal stabilisation tools at the euro-area level.
- Countries that will soon join the euro should actively shape the debate about the further development of the overall set-up. For Latvia, joining the euro makes sense because Latvia has kept its exchange rate fixed and has undergone internal adjustment. In its euro-area accession negotiations, Latvia should ensure that it does not participate in any of the currently ongoing financial assistance programmes.

This Policy Contribution reproduces evidence given by Guntram B. Wolff to the Latvian parliament's European affairs committee, 22 February 2012. Guntram B. Wolff (guntram.wolff@bruegel.org) is Deputy Director of Bruegel.

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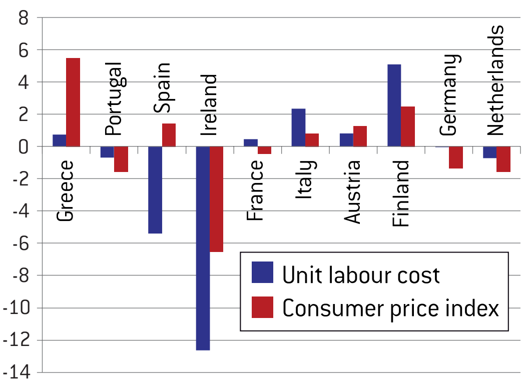
GUNTRAM B. WOLFF, MARCH 2012

EUROPEAN LEADERS ASSEMBLED for many summits during 2011 to decide on the fate of the euro area. In 2012, we should expect a large number of further summits. The euro area still faces severe challenges. The ongoing crisis clearly exposes the failure of the Maastricht architecture for Economic and Monetary Union (EMU). Central to this failure is the lack of any fiscal capacity for the euro area, and the lack of a right to intervene in national policymaking that a central authority would normally need. The EMU architecture must be strengthened by taking steps towards a fiscal union that involves both a political authority (a euro-area 'finance minister') and fiscal resources to prevent, manage and resolve crises. On balance, Latvia's accession to the euro makes sense.

The euro area faces three major challenges.

First, it is confronted with very high private and public debt levels in some of its parts, and a formidable adjustment challenge. The debt is not only held domestically. In Spain, Portugal and Greece, debt owed to creditors outside of the country is above 80 percent of GDP (see Ahearne and Wolff, 2012). Repaying external debt while at the same time being obliged to reduce prices to become competitive and export more to repay for the external debt is extremely difficult. In fact, historical lessons show that even the external interest burden can become difficult to shoulder[1]. Figure 1 summarises the difficulty of internal devaluation in the euro area.

Figure 1: Changes in real effective exchange rate* (%), 2007-11



Source: Eurostat. * Real effective exchange rate relative to 16 euro-area trading partners.

1. John Maynard Keynes wrote extensively at a different time and in a different context about the problem of external debt payments, but his lessons remain valid today.

Broadly speaking, since the onset of the crisis, price adjustment has been modest or absent in most euro-area countries. Greece continued to lose price competitiveness, as did Italy, even though in the last 6-12 months some adjustment is evident. Germany's relative position has not changed, and its competitiveness remains unchanged. Spain and in particular Ireland have become more competitive. Similarly, current-account divergence has reduced since the beginning of the crisis, but significant differences in deficits and surpluses remain, with Greece still running a current account deficit of 10 percent and Germany continuing to have a 5 percent surplus.

Real macroeconomic adjustment in EMU is proving very difficult. For the Latvian Saeima, this is not a surprising message of course. Zsolt Darvas of Bruegel has argued in a paper comparing Latvia with Ireland and Iceland that insisting on an internal devaluation in Latvia has had significant social consequences. It is also clear, however, that a devaluation would have implied significant costs in terms of external assets and liabilities. Moreover, a devaluation could have implied a loss of credibility in the policy framework and may have delayed some reforms that Latvia was now required to undertake quickly. In the euro area, internal devaluation is happening much more slowly because financial support is provided by the European Central Bank and from other sources. This sustains domestic demand and reduces price adjustment needs. In fact, one of the striking features of the Greek economy is that, despite all the fiscal austerity, Greece is still running a current account deficit of 10 percent.

Second, economic growth in the euro area as a whole and in particular in the so-called periphery is very weak. Growth forecasts have been revised downwards. None of the four big euro-area economies, ie France, Germany, Italy and Spain, is projected to grow more than 1 percent in 2012, according to European Commission forecasts.

Third, European Banking Authority stress tests have not restored trust in the euro-area banking system. More worryingly, the euro-area banking system lacks a credible fiscal lender of last resort. National finance ministries in the periphery cannot credibly prevent deposit runs or withdrawals of funds from banks located in their country by themselves, as they are too small and may lack access to markets to borrow at good rates. We have seen the build-up of such negative feed-back loops from an increasingly fragile sovereign to an increasingly fragile banking system. Purely national strategies will fail to stop this banking fragility.

During 2011, euro-area leaders took a number of significant steps to overcome these problems. At the summit of 8-9 December 2011, leaders agreed on tougher and more biting fiscal rules, which are to be mostly implemented at national level. This will help to increase fiscal discipline and thereby help to prevent from happening again problems of the kind currently seen in Greece. Such measures will also to some extent be helpful in increasing investors' trust in a country's political ability to repay debt. For example, the Spanish debt break enshrined in the Spanish constitution is a strong signal and may contribute to the comparatively low Spanish interest rates in relation to Italy's.

In exchange for more commitments to fiscal discipline, significant money has been put on the table. This includes €150 billion for the International Monetary Fund decided at the December 2011 summit, on top of €500 billion for the European Financial Stability Facility/European Stability Mechanism (EFSF/ESM) decided earlier. Even without leveraging, up to €700 billion could be available to help countries with liquidity problems. In addition, leaders re-affirmed their promise that Greece would remain a unique case and no other country would impose losses on investors. For the time being, private-sector involvement thus appears to be ruled out.

The new ESM treaty requires the introduction of collective action clauses (CAC) with an aggregation clause. These CACs are introduced for government securities of all euro-area countries. The ESM treaty foresees that financial assistance is granted to ESM members that require such assistance. The treaty stipulates that: *"In accordance with IMF practice, in exceptional cases an adequate and proportionate form of private sector involvement shall be considered in cases where stability support is provided accompanied by conditionality in the form of a macro-economic adjustment programme."* The key reference is here to IMF practices. IMF practices foresee that financial assistance is only granted in case the IMF assesses a country to be solvent. It is clear, however, that a solvency assessment always rests on a fair degree of judgement and assumptions regarding the development of interest rates, growth and inflation. Ultimately, there may still be cases of significant private sector involvement in case the economic situation of a country is so bad that full debt-repayment of official loans appears unlikely. The advantage of collective action clauses is that the restructuring will be made much easier. The new system applying to newly issued debt will thus allow for restructuring of debt according to defined CAC.

The 21 February deal on Greece[2] is positive news for the euro area. It removes to a great extent a major uncertainty for international investors, because a disorderly default scenario or even a Greek exit from the euro is off the table for now. Any future debt restructuring will have to come from the public sector. Official sector involvement (OSI) will be politically difficult but it will not be a problem for the stability of the financial system.

'The 21 February deal on Greece is positive news for the euro area. It removes to a great extent a major uncertainty for international investors, because a disorderly default scenario or even a Greek exit from the euro is off the table for now. But Greece still lacks a growth outlook.'

2. Eurogroup and Economic and Finance Ministers Council, Brussels, 20-21 February 2012.

However, details matter and some details still need to be clarified. In particular, the private-sector involvement (PSI) was agreed by those around the table on 21 February. There is still a debate on retroactive application of collective action clauses to Greek government securities and how this will play out. This should be watched. Debt sustainability is also not yet guaranteed and further discussions can be expected in case of negative shocks with more OSI.

More worryingly, Greece still lacks an encouraging growth outlook. While the deal has avoided a catastrophic scenario, the highest priority now needs to be to offer opportunities for growth. Ultimately, this growth will have to come from exports. To get exports growing, an increase in competitiveness and an internal devaluation are necessary. The better the policy measures implemented for that purpose, the easier real economic adjustment and the better the political dynamics will be. The decision to give priority to debt repayments via an escrow account is understandable. It is a binding constraint on political choices in Greece right now. It is, however, a risky strategy from a political point of view. This may be accepted for now while Greece has little room for manoeuvre. The political view might change in the future. The Greek government might want to renegotiate the deal. The escrow account will likely be a focal point of political and public resistance against foreign involvement in the country, and the question of its democratic legitimacy will arise.

But major challenges for the euro area remain, in particular in relation to the real economic adjustment, the growth agenda and the right institutional set-up for dealing with the fragility of the EMU banking sector. Stepping up the euro-area's institutional framework also means that a serious debate will have to take place about the democratic foundations of the new framework.

While markets have calmed recently, significant risks remain. So what is missing and why is the current solution unsatisfactory?

First, a euro-area growth strategy is missing but is urgently needed. Without significantly higher economic growth in southern Europe, debt dynamics in combination with price adjustment needs will jeopardise sustainability. At the regional and national levels, reforms need to focus on improving supply-side conditions for business, including better administration, governance and rule of law, and significantly better education and innovation systems. The key reform needed is improvement of the conditions for exports. An economy with an external debt overhang needs to export to generate growth and to adjust. Price and wage adjustments are necessary in that regard.

At the euro-area level, the macroeconomic policy mix needs to be appropriate. Monetary policy alone may prove insufficient to boost demand in the face of a severe downturn. Therefore, a euro-area-level mechanism to boost demand may become necessary. After all, it should be recalled that federal states such as the USA have strong anticyclical fiscal policies at the federal level, while at a state level, balanced budget rules render public budgets pro-cyclical. In the euro area, the new fiscal rules – if successful – will reduce anti-cyclical fiscal policy action, which is currently anyway limited because of market pressure[3]. Currently, the euro area is not equipped with appropriate tools for this. It is advisable to think about putting in place a robust euro-area mechanism for a euro-area investment project, eg financed through project bonds.

Second, the integrated euro-area banking system needs an integrated and powerful banking supervision and resolution authority backed by sufficient means to prevent bank runs. The current system centred on national supervisors and national fiscal resources is clearly fragile. A true euro-area deposit insurance corporation (EDIC), ultimately backed by the euro-area taxpayer, might become necessary and would increase stability. This EDIC would have the power to supervise, control and resolve all systemically important banks in the euro area. It would also need to correct the currently highly pro-cyclical bias induced by the strategy to increase banks' capital ratios.

Third, a solution to deal with debt overhang is needed. Ultimately, if debts are too large to be repaid from purely national resources, financial assistance will be needed and a framework for orderly restructuring needs to be in place. The

3. Henning and Kessler (2012) make this point in the context of their account of the development of the US federation over the last 200 years. Bruegel fellows have repeatedly made this point in the euro-area context.

current structure around the ESM may prove insufficient in terms of size, decision-making mechanism and set-up for dealing with a crisis in one of the larger euro-area countries. It may therefore become necessary, to pool all euro-area public debt. To issue such common debt, a common treasury with tax-raising powers appears necessary[4].

The most efficient way to address these three points is to create a truly federal structure with a finance minister at euro-area level who has the authority to raise taxes[5]. This raise the question of EU versus euro-area. A number of guiding principles should be kept in mind.

1 Member states that will soon join the euro should certainly be playing a part in the negotiations about the set-up of the new governance framework. It is welcome that the fiscal compact has been signed by many countries outside the euro area.
2 It appears reasonable that decisions on financial assistance to a euro-area member are mostly a matter for countries of the euro area – in particular as long as the assistance is paid from euro-area fiscal resources[6].
3 A robust new framework for banking supervision and resolution will require steps towards deep integration. Economic and political logic suggests that this will mostly happen at euro-area level. However, the strong degree of financial integration with non-euro area members will require a high level of information sharing, as is already done within the European Systemic Risk Board and the European Banking Authority.

Finally, some remarks can be made about Latvia's euro-area accession. Putting aside the geopolitical and historic reasons for Latvia to join, on balance, Latvia should join the euro. The following points should be considered in this regard:

- After Latvia's decision to keep the exchange rate fixed and after largely achieving adjustment, euro-area accession would bring benefits.
- Having a fixed exchange-rate implies that monetary policy independence is largely gone. Thus it is preferable to join the euro and be part of the monetary policy decision-making process.
- Joining the euro would have beneficial effects for the banking system because access to ECB liquidity will be granted. Membership would also imply significantly lower interest rates than the current interest rate of 3.5 percent, compared to the ECB rate of 1 percent. Of course, it will be crucial that Latvia avoids after accession the mistakes of previous euro accession countries, and does not use the overly low interest rate to start a consumption boom based on cheap borrowing. The new EU excessive imbalances procedure should mean such developments are closely monitored.
- It is clear that the euro-area club is very different from the club as it was in 2007. The political logic dictates that Latvia will join the European Stability Mechanism, and thus make a contribution, estimated to amount to about €200 million to be paid over five years. This will of course be a burden to the Latvian budget. However, it is clear that the euro area is only attractive if it is stable and every member of the club needs to contribute to this stability. Moreover, the ESM provides insurance that will also benefit Latvia in case of need.
- The newly signed fiscal compact reduces national fiscal sovereignty somewhat, but needs to be signed as a condition of access to the ESM. However, fiscal prudence appears to be advisable in Latvia in any case, and will also have to be stuck to if Latvia stays out of the euro and keeps its exchange rate fixed.
- In the negotiations on the ESM, Latvia should make the clear request not to be burdened with any existing liabilities resulting from financial assistance programmes decided before its adoption of the euro . This means in particular, that any past financial assistance that had been given to Greece and that will in the future be given to Greece via the ESM based on a decision taken now should not concern Latvia.

'A solution to deal with debt overhang is needed. The current structure around the ESM may prove insufficient. It may become necessary to pool all euro-area public debt. To issue such common debt, a common treasury with tax-raising powers appears necessary.'

4. Currently, the interest cost of all euro-area debt is 3.7 percent of euro-area GDP. The euro-area finance ministry would thus need tax-raising power equivalent to at least 4 percent of euro-area GDP to credibly take on all debt. National taxes could be reduced by a similar amount so that the overall tax burden for the average euro-area citizen would not change.

5. For a detailed exposition of such as set up see Marzinotto *et al* (2011).

6. The assistance given via the EFSM is, of course, backed by the EU budget and therefore concerns all member states.

Latvia should only be held liable for those decisions in which it participates.

- One may argue that given the current uncertainties surrounding the euro it might be advisable to wait and see how the situation develops before joining. I see some value in this argument. However, it is also clear that members of the club have more scope to shape the way the club develops than EU countries that have not joined the euro. Moreover, given the fact that the exchange rate is fixed to the euro, any major perturbation of the euro area would in any case have significant implications for Latvia. Finally, by the time of Latvian accession to the euro, the contours of the euro area's governance should be already well defined.
- Latvia should not only be fit to join the euro but should also be able to live with the competitive pressure inside the currency union to be able to prosper. Some further reforms may still be needed to achieve this goal. Certainly one lesson from the current crisis is that the more real convergence is achieved before joining the euro, the less likely problems are to arise later.

Let me add a final point on accession: the most difficult target for Latvia to meet appears to be the inflation criterion, which should, according to the treaty, be the average inflation rate of the three countries with the lowest rate in the EU plus 1.5 percent. This criterion does not make sense in current circumstances. Several euro-area countries will have very low inflation rates in the next few years in order to achieve internal devaluation. They should not be considered as a benchmark. Instead, euro-area inflation should be taken as the appropriate reference value. Darvas (2009) has made this point previously. One option, if a treaty change is ruled out, would be to allow some flexibility in this rule by omitting outliers from the sample.

In summary: the euro area has taken significant steps to overcome its crisis. The six-pack, fiscal compact and ESM are important steps that go in the right direction. The fiscal compact, however, raises the issue of appropriate fiscal stabilisation tools at the euro-area level.

The 21 February deal on Greece is an important practical milestone because it has removed a major uncertainty. While it is clear that Greece's problems are not solved, they are much less of a concern for financial stability now. Further Greek debt restructuring will eventually become necessary but this will concern the public loans to Greece and is therefore more of a political than a financial-stability problem.

However, major challenges remain. There is still a significant risk of a confidence crisis involving one of the larger euro-area economies. It is unlikely that this could be dealt with within the current framework. Banking sector fragility persists and remains a major concern. The ECB's current Long Term Refinancing Operation (LTRO) policy provides much needed liquidity but cannot address solvency concerns. Finally, real economic adjustment is happening far too slowly.

Ultimately, in the author's view, the euro area will need to create a euro-area finance ministry with tax-raising powers and significant authority in the budget, structural and banking fields. History shows that monetary unions require this. All countries outside the euro area that might soon become part of it should actively participate in the debate about such a new set-up. On balance, I would make the case for Latvia's euro-area accession even though it comes with a price.

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