



PARADIGM LOST

THE EURO IN CRISIS

URI DADUSH
AND CONTRIBUTORS

CARNEGIE ENDOWMENT

FOR INTERNATIONAL PEACE

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WITH SERGEY ALEKSASHENKO, SHIMELSE ALI, VERA EIDELMAN,
MOISÉS NAÍM, BENNETT STANCIL, AND PAOLA SUBACCHI

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PREFACE AND ACKNOWLEDGMENTS

This report was prepared to explore the causes and consequences of the Euro crisis, the biggest risk to the global recovery at present. It incorporates work done by the International Economics Program of the Carnegie Endowment for International Peace, as well as contributions by a small number of external contributors—Sergey Aleksashenko, Moisés Naím, and Paola Subacchi.

Several articles in this collection appear in print for the first time. Others were prepared over the last three months, in the midst of the rapidly evolving Euro crisis. These pieces are marked with their original publication dates.

The effort was led by Uri Dadush, and drew intensively on the International Economics team, Shimelse Ali, Vera Eidelman, and Bennett Stancil. Carnegie's marketing, publications, and web teams—including Zeena Feldman, Eben Gilfenbaum, Jessica Jennings, Tim Martin, Ilonka Oszvald, Peter Reid, and Malachy Tuohy—provided close and invaluable assistance in the positioning, design, editing, and web distribution of the publication.

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INTRODUCTION

PARADIGM LOST: THE EURO IN CRISIS

URI DADUSH

The acute phase of the global financial crisis was short, lasting from the collapse of Lehman Brothers on September 15, 2008, to the day the Dow hit a trough on March 9, 2009. But, like a violent heart attack, the interruption of credit—the economy’s life blood—lasted long enough to permanently damage the industrial countries at the center of the crisis. The damage took three main forms, each of which poses a major risk to the stability of the global economy today: high and rising public debts, fragile banks, and a huge liquidity overhang that will need to be eventually withdrawn.

The Euro crisis, which strikes at the heart of the world’s largest trading block, contains only two of the three fateful elements—problematic sovereign debt in Greece and other vulnerable countries, and fragile European banks, which hold a large part of that debt. Monetary policy in the Euro area and in industrialized countries more generally, remains expansionary and, if anything, the crisis pushes back the time when tightening can occur safely. As a result of the problems in Europe, the world economy has become even more exposed to the three mega-vulnerabilities.

The Deeper Causes of the Euro Crisis

While ballooning public debt may be the clearest manifestation of the Euro crisis, its roots go much deeper—to the secular loss of competitiveness that has been associated with euro adoption in countries including Greece, Ireland, Italy, Portugal, and Spain (GIIPS).

The sequence of events that led to the secular loss of competitiveness is depressingly similar among the GIIPS countries:

- The adoption of the euro was accompanied by a large fall in interest rates and a surge in confidence as institutions and incomes expected to converge to those of Europe's northern core economies.
- Domestic demand surged, bidding up the price of non-tradables relative to tradables and of wages relative to productivity.
- Growth accelerated, driven by domestic services, construction, and an expanding government, while exports stagnated as a share of GDP, and imports and the current account deficit soared amid abundant foreign capital.
- The result was that indebtedness—public, private, or both—surged.

Meanwhile, following reunification, Germany was undergoing a historic transformation to become the world's largest exporter, and all of Europe's northern economies reaped the benefits of the expanded market and decreased competition offered by the GIIPS. But the growth model in the GIIPS was inherently flawed: eventually, the domestic demand bubble burst. Now, governments must shrink, and high costs preempt any efforts to resort to export markets for growth. Countries are stuck in a low growth equilibrium—and potential domestic battles over the limited resources will only accelerate the onset of crisis.

This basic story fits the Euro area periphery, but the details vary within each country. For example, Italy and Portugal saw growth peak very early on, while Greece, Ireland, and Spain enjoyed decade-long booms followed by busts during

the global crisis. The single monetary policy of the euro was too loose for the countries who enjoyed the biggest boom and accentuated their inflation and competitiveness loss, while it was too tight for larger economies like Germany, depressing domestic demand there and widening its unit labor cost advantage vis-à-vis the GIIPS.

Effects on Other Countries

A similar and even more virulent strain of the euro disease has already hit countries that are not part of the Euro area but that pegged their currencies to the euro many years ago, beginning with Latvia, Estonia, and Lithuania. Other recent EU joiners, such as Hungary and Romania, retain flexible exchange rates, but are constrained by large foreign currency debts in their ability to devalue. As a consequence, they too suffer from the euro disease.

The rest of the world will feel the effects of the Euro crisis via six important channels: first, the crisis will lower growth in Europe, a market toward which about a quarter of world exports are destined. Second, it will lead to further euro depreciation, sharply reducing profits from exports to Europe while also increasing competition from the continent. Third, by keeping policy rates low in Europe and potentially other industrialized countries as well, the crisis may encourage capital surges into emerging markets. Fourth, the crisis will add greatly to the volatility of financial markets and will lead to bouts of risk-aversion. Fifth, and potentially most important, the crisis could deal a mortal blow to many fragile financial institutions. Sixth, a failure to contain the crisis will raise the alarm on sovereign debt in other industrial countries and, inevitably, in any exposed emerging market.

Remedies

Policy in the Euro Area

The disastrous recessions in Argentina, which broke its convertibility law, devalued, and defaulted in 2001–2002, and Latvia, which chose instead to adjust through fiscal consolidation and wage cuts, show that there are no easy options for dealing with a large loss of competitiveness combined with high indebtedness denominated in a foreign currency. To be sure, the euro is no longer a foreign currency to Greece, but it would become so if Greece chooses to leave the Euro area to regain its competitiveness, which may one day prove to be Greece's best viable option for dealing with the crisis.

Unless the nine most affected countries (the GIIPS, Estonia, Latvia, Lithuania, and Bulgaria) are prepared to break from the euro, they must resort to a well-known cocktail of fiscal consolidation designed to stabilize their debt-to-GDP ratio, and structural reforms designed to boost productivity, competitiveness, and potential growth. Fiscal consolidation can by itself help reduce domestic demand and moderate wages, but relying on it alone—without structural reforms—to restore competitiveness could require as many years of painful austerity as have elapsed since the start of the euro boom.

Even in the best of circumstances—where the adjustment is politically feasible and financing is stable—reestablishing competitiveness, fiscal sustainability, and a more balanced growth model will take several years. As a rough guide, countries have to engineer a fiscal adjustment of 5 to 12 percent of GDP, and claw back a unit labor cost disadvantage of between 15 and 30 percent, though the precise figures vary by country. Bearing in mind that the imbalances have built up over a decade or longer, at least three or four years will be required to affect the necessary reforms and, during that period, domestic demand will decline or, at best, stagnate.

Even with the recent support packages for Greece and other vulnerable countries, these adjustments will be deflationary. Nominal GDP in the adjusting countries could decline, compounding the challenge of stabilizing the debt-

to-GDP ratio, unless the deflationary effect is offset by a combination of the following: a continued recovery of world trade; expansionary monetary policy; a lower euro; and expanding domestic demand in Europe's surplus countries, including Germany and the Netherlands, which are likely to benefit most from a lower euro. Since European countries trade predominantly with each other and the least competitive countries tend to be most oriented toward other European markets, most of the competitiveness and aggregate demand realignment needs to occur within Europe.

Response in the Rest of the World

Most importantly, this crisis shows countries outside the Euro area that they need to rely more on domestic demand and on the demand of emerging markets and be even more cautious when formulating macroeconomic policy. In addition, prospective euro joiners should take heed and delay entry until they have dealt with their lack of competitiveness. Based on the experience of the GIIPS, if and when they enter, they must discourage a flood of investment from going into non-tradable sectors and they must maintain large fiscal surpluses.

The Euro crisis experience has also reinforced the message that strictly pegged exchange rates, combined with open capital accounts and the ability to borrow abroad (as in the GIIPS and the Baltics), can be dangerous. Countries with flexible exchange rates or pegged exchange rates but tight capital controls have dealt with the dislocation caused by the Great Recession better.

Last but not least, the Euro crisis has exposed the limitations of regional mechanisms—even among countries with deep pockets—in dealing with financial crisis and underscored the vital role that a global lender of last resort, in the form of the IMF, can play. Not only can the institution bring more resources and broader expertise than would plausibly be available to a regional institution, but its distance from potentially divisive regional politics can represent a big asset.

PART I

CAUSES

The Making of a Crisis

1. Confidence in the prospects for growth and stability of the economies of Greece, Ireland, Italy, Portugal, and Spain (GIIPS) surged when the euro was introduced, causing their interest rates to decline to those of Europe's more stable members.
2. Improved confidence and lower interest rates drove up domestic demand in the GIIPS and investors and consumers were emboldened to increase spending and run up debts, often owed abroad as foreign capital flowed in.
3. Growth accelerated and the prices of domestic activities (i.e., those least exposed to international competition, such as housing) rose relative to the price of exportable or importable products, attracting investment into the less productive non-tradable sectors and away from exports and industries competing with imports.
4. Meanwhile, exports rose sharply as a share of GDP in Germany, the Netherlands, and other historically stable countries in the European core. Growing demand in the GIIPS enabled these core countries to increase exports. The adoption of a common currency whose value was based on broader European competitiveness trends that made it lower than the deutschmark or guilder might have been, made their exported goods more affordable.
5. The domestic demand boom in the GIIPS induced rapid wage growth that outpaced productivity, increasing unit labor costs and eroding external competitiveness further. This trend was reinforced by especially rigid labor markets in most of the GIIPS. The emergence of China, as well as currency depreciation and rapid labor productivity growth in the export sectors of the United States and Japan, added to the competitiveness problems of the GIIPS.
6. The single European monetary policy was too loose for the rapidly growing GIIPS (Spain, Greece, and Ireland) and too tight for Germany, whose domestic demand and wages grew very slowly compared to the European average. This reinforced the loss of competitiveness in the GIIPS.
7. Lower borrowing costs and the expansion of domestic demand boosted tax revenues in the GIIPS. Instead of recognizing this as temporary revenue and saving the windfall gains for when growth slowed, GIIPS governments significantly increased spending. Blatant fiscal mismanagement added to the problems in Greece.
8. The financial crisis in 2008 brought an abrupt end to the post-euro growth model in the GIIPS. As they plunged into recession and tax revenues collapsed, government spending was revealed to be unsustainable and their loss of competitiveness dimmed hopes of turning to foreign demand for recovery. The GIIPS are left with high public and private debts and weak long-term growth prospects, unless they make difficult adjustments to cut deficits and restore competitiveness.

EUROPE'S DEBT CRISIS: MORE THAN A FISCAL PROBLEM

URI DADUSH AND BENNETT STANCIL

Headlines label the Euro crisis as one caused by sovereign debt. Unfortunately, the problems in the most affected countries—Greece, Ireland, Italy, Portugal, and Spain (GIIPS) and other smaller economies pegged to the euro, such as Latvia—are much more severe than just fiscal profligacy.

At its heart, the crisis was created by a misallocation of resources among and within countries and a loss of competitiveness that resulted from—and was in many cases concealed by—the economic boom associated with the adoption of the euro a decade ago. Today's fiscal problems are in large part the consequence, rather than the cause, of these changes, a fact that policy makers must recognize in order to successfully resolve the crisis.

The Euro Boom

In February 1992, European leaders signed the Treaty on European Union (also known as the Maastricht Treaty), laying the foundation for monetary union and adoption of the euro. The agreement eventually bound the currencies and monetary policy of the signatories—which included all the GIIPS except Greece—to that of Germany, Europe's largest and most stable economy, and to those of other successful economies in northern Europe.

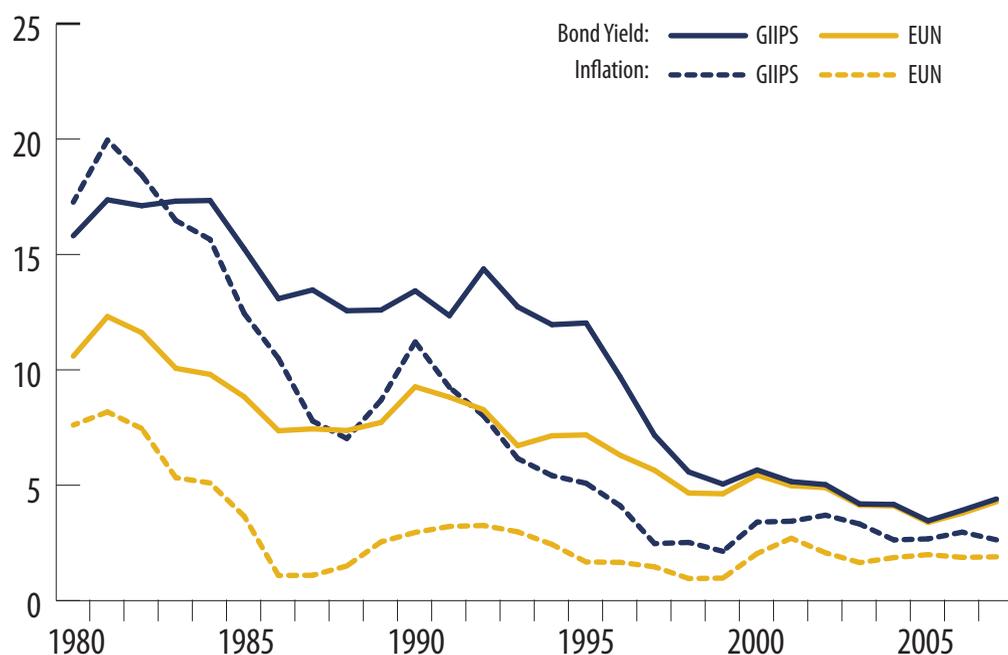
Expecting that the stability and wealth of Europe's northern members (EUN)—Austria, Belgium, France, Germany, and the Netherlands—would diffuse

throughout its periphery and that the EUN's stronger institutional and economic frameworks would prevail over those of the GIIPS, confidence in the GIIPS surged. After averaging inflation levels and public borrowing costs from 1980 to 1990 that are comparable to those of Ghana today, the GIIPS (excluding Greece¹) saw their inflation and interest rates converge with those of the EUN during the 1990s. Long-term government bond yield spreads of the GIIPS vis-à-vis the EUN, which indicate the perceived risk of lending to the GIIPS instead of the EUN, fell from 550 basis points in 1980–1990 to just 10 in 1999.

Annual Inflation Rates and Long-Term Government Bond Yields

Average aggregate rate, percent

Source: IMF



¹ The process of convergence to EUN fundamentals occurred slightly later in Greece, which did not win final approval to join the Euro area until 2000; bond yield spreads fell from 750 basis points in 1980–1990 to about 30 in 2001.

Widening External Imbalances

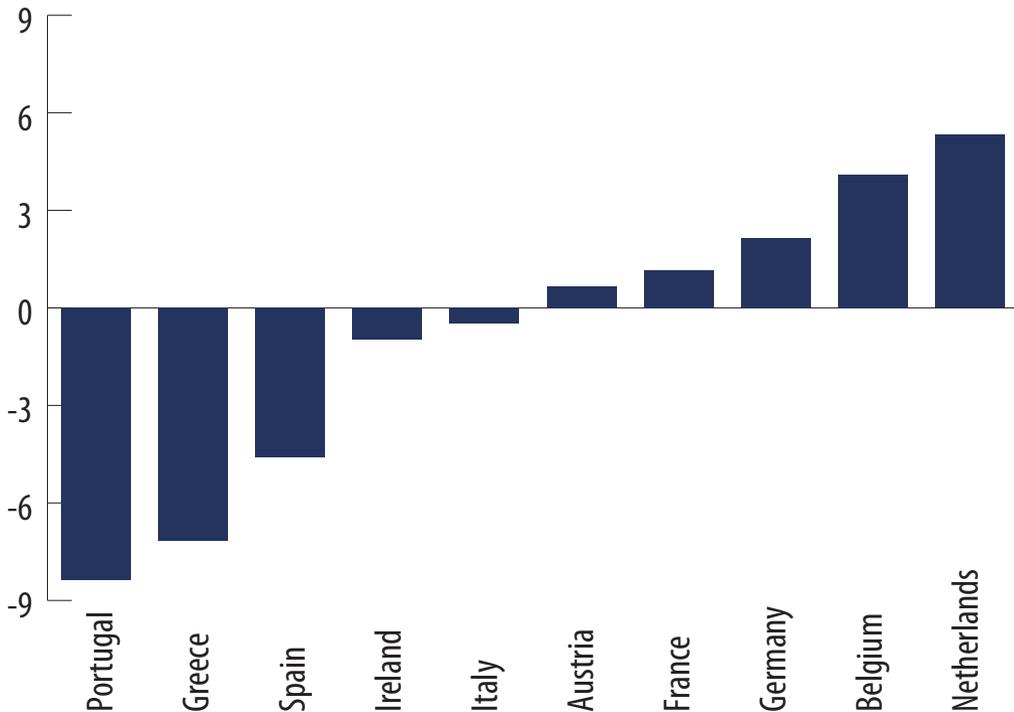
Low interest rates and improved confidence fueled a domestic demand surge partly financed by foreign lending. The GIIPS, especially Greece, Ireland, and Spain, saw an increase in domestic spending accompanied by deteriorating current account balances and rising private debt.

The demand surge drove up both prices and wages, particularly in service and non-tradable sectors, leading the price of non-tradables to rise relative to tradables and attracting even more investment in the former. From 1997 to 2007, the price of services in the GIIPS rose by an average annual rate of 1.5 percentage points more than that of goods, compared to a difference of 0.5 percentage points in the EUN. The GIIPS' economies realigned away from manufacturing and industrial sectors and toward services and housing construction: 4 percentage points of GDP

Current Account Balance

Percent of GDP, average, 1997–2007

Source: IMF



shifted from industry to financial services, real estate, and business from 1997 to 2007, compared to a shift of 2 percentage points in the EUN.

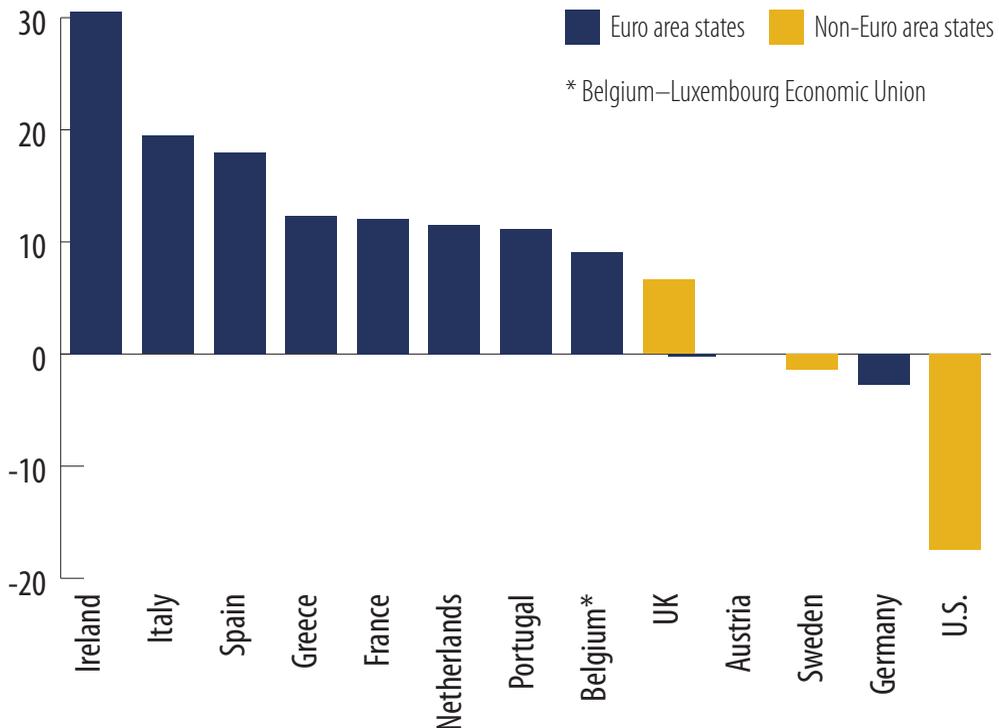
Over the same period, per capita employee compensation rose by an average annual rate of 5.9 percent in the GIIPS, considerably faster than the EUN's average of 3.2 percent. These increases were not matched by improvements in productivity, particularly in the GIIPS, where labor productivity per employee grew by 1.3 percent per year, compared to 1.2 percent annual growth in the EUN. As a result, unit labor costs rose by 32 percent in the GIIPS from 1997 to 2007, compared to a 12 percent increase in the EUN. Underpinning these trends was a remarkable transformation of the German economy following the country's unification, making it the world's largest exporter (see "Germany: Europe's Pride or Europe's Problem?" p. 17).

Change in Real Effective Exchange Rate

Based on nominal unit labor cost, relative to the EU and other major industrialized economies

Source: European Commission

Percent change, 2000–2007



The result was a dramatic decline in competitiveness in the GIIPS against other advanced countries. The loss was particularly severe relative to countries outside of the Euro area, which saw labor costs increase only moderately and whose labor costs in euros benefited from the euro's nearly 50 percent appreciation against the dollar from 2000 to 2007.

Nevertheless, the effects of this common loss of competitiveness and sector realignment varied across the GIIPS. Greece, which saw the most dramatic decline in interest and inflation rates, enjoyed sustained growth over many years on the back of strong capital inflows—net foreign assets fell from approximately -5 percent of GDP in 1995 to -100 percent in 2007. In Ireland and Spain, housing and construction bubbles further fueled strong GDP growth. From 1997 to 2007, housing prices rose at an average annual rate of 12.5 percent in Ireland and 8 percent in Spain, compared to 4.6 percent in the United States during its bubble. Over the same period, construction as a share of gross output rose from 9.8 percent to 13.8 percent in Spain and from 7.9 to 10.4 percent in Ireland. In the United States, the same figure only increased from 4.6 percent to 4.9 percent. Furthermore, in Greece, Ireland, and Spain, output growth encouraged private debt to build up; from 1997 to 2007, domestic credit increased by an average of 155 percent, compared to an average increase of only 27 percent in the EUN.

In Portugal and Italy, where export sectors were already suffering from declining productivity and labor market inflexibility, growth improved only briefly before reverting back to being the lowest in Europe. Nevertheless, these countries also saw private sector balance sheets weaken, with household savings rates dropping 4.7 percentage points in Portugal and 5.7 percentage points in Italy from 1997 to 2007.

The troubles in the GIIPS were exacerbated by the difficulties associated with having a single monetary policy in the Euro area. Without control over interest rates, Greece, Spain, and Ireland were limited in their ability to deal with the bubbles, while Italy and Portugal, both fighting slowing economic growth, would have benefited from looser monetary policy. A recent OECD study estimates, for example, that policy interest rates over 2001–2006 were approximately 50 basis points too high for Germany but between 300 and 400 basis points too

low for Spain, Greece, and Ireland. These divergences added to the widening competitiveness gaps by stimulating economic growth and wages in the latter countries.

Importantly, the GIIPS are not the only countries to which this narrative applies. Other EU members that have pegged their exchange rates to the euro—Estonia, Latvia, and Lithuania chief among them—experienced similar, if not more severe, crises (see “The Euro Crisis Is Bigger Than You Think” p. 93).

Expanding Government

In all of the GIIPS, lower borrowing costs and the expansion of domestic demand boosted tax revenues and tempted governments to expand spending as well.

Rather than recognize that the revenue increases from the boom were windfall gains that should be saved, the GIIPS accelerated government spending. From 1997 to 2007, public spending per person rose by an average of 76 percent and government’s contribution to GDP rose by 3.5 percentage points. In the EUN, average per capita spending increased by 34 percent and the government’s contribution to GDP stayed constant.

In Ireland and Spain, the temporary revenue surge more than compensated for these spending increases—both countries averaged government surpluses from 2000 to 2007, despite increases that were greater than those in nearly all other Euro area countries. Nevertheless, signs of budget weakness emerged. For example, Ireland’s structural deficit, a figure that ignores the cyclical changes in revenues and expenditures, worsened from 1 percent of GDP in 2000 to over 8 percent in 2007.

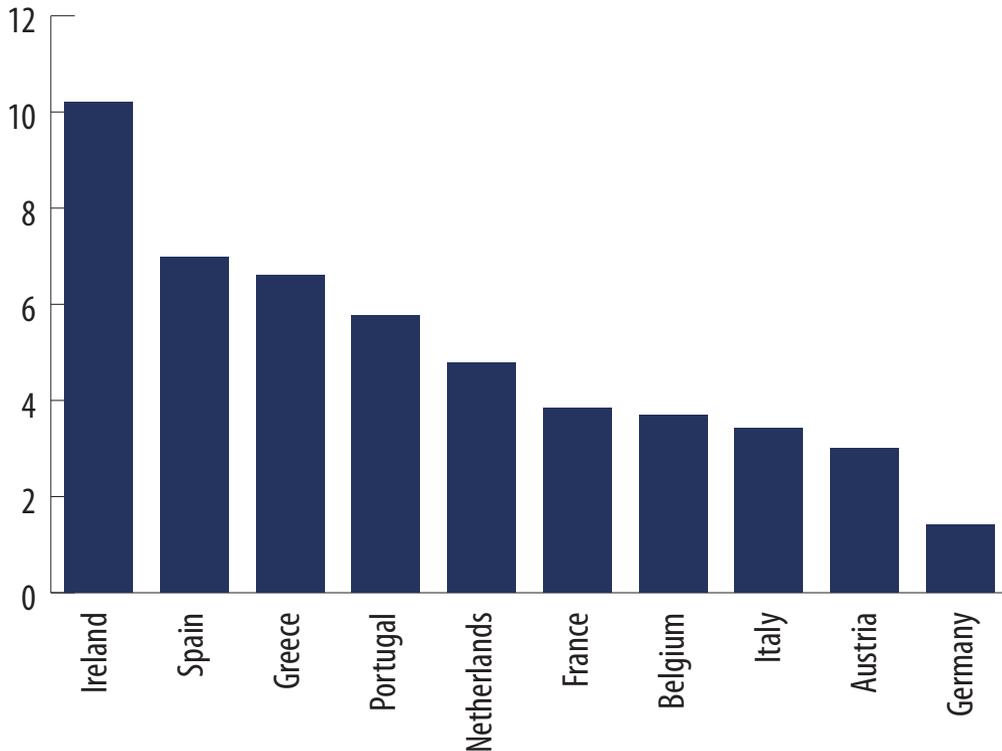
Other GIIPS showed more evidence of fiscal deterioration. As growth in Portugal and Italy slowed at the end of the 1990s, their deficits gradually increased, rising by approximately 1.3 percentage points of GDP by 2007. In Greece, blatant mismanagement added to the troubles—despite strong growth, Greek deficits averaged 5 percent of GDP from 2000 to 2007.

The global financial crisis fully exposed the flaws of the GIIPS’ post-euro growth model. Tax revenues collapsed as output growth slowed, revealing that

Annual Growth of Government Expenditure

Percent average, 1997–2007

Source: Eurostat



the expanded state sector was unaffordable. The housing bubbles in Ireland and Spain burst, putting additional strain on government budgets. Ireland was forced to rescue its hugely expanded financial sector at an estimated cost of 13.9 percent of GDP, greatly increasing its difficulties. As their domestic recessions deepened, the GIIPS' loss of competitiveness made resorting to export markets extremely challenging. Rising borrowing costs and ballooning public debt—up by an average of 20 percent of GDP from 2007 to 2009—further restricted public spending when it was needed most.

Though the GIIPS are currently suffering from overextended governments, the roots of their problem run much deeper and reflect a structural misallocation of resources that will require more complex and protracted reforms than just deficit reduction. These are discussed in the sections that follow.

GERMANY: EUROPE'S PRIDE OR EUROPE'S PROBLEM?

URI DADUSH AND VERA EIDELMAN

Greece, Ireland, Italy, Portugal, and Spain (GIIPS) have become increasingly uncompetitive since adopting the euro. But competitiveness is relative, raising an important question: how did Germany, Europe's largest and most competitive economy, fare under the euro? The answer begins with Germany's unification ten years prior, which was followed by massive investments designed to modernize the East's economy and integrate it with Germany's industrial heartland. Though this process remains incomplete even today, it has prompted far-reaching structural reforms and contributed to exceptional wage moderation following the immediate post-unification surge. Additionally, the introduction of the euro consolidated Germany's unit labor cost advantage vis-à-vis its Euro area partners. Exports surged and domestic demand growth fell behind that of the GIIPS, widening bilateral trade surpluses. Germany, now poised to derive the greatest gains from the euro's crisis-triggered decline, should boost its domestic demand to compensate for the deflationary measures taken by the GIIPS.

Post-Reunification Reforms

Immediately after reunification in late 1990, Germany experienced a significant loss of competitiveness. Unit labor costs (ULC), which measure increases in wages relative to productivity, rose significantly. Wages in the East rapidly began to converge to those in the West even as productivity in the former remained

substantially lower. As a result, unit labor costs grew by 17.6 percent from 1990 to 1995, compared with an average of 11.5 percent in the rest of what would become the Euro area.

Reunification also brought a demand boom that emphasized services over export sectors. As the West made transfers to the East in order to boost living standards, domestic demand expanded by nearly 7 percent of GDP from 1990 to 1992. This fueled services, which grew 7 percent on average each year from 1990 to 1995, compared to only 3 percent on average from 1996 to 2008. On the other hand, exports fell as a share of GDP from 1991 to 1993.

The economy's historic restructuring and the high unit labor costs in the East hindered the country's competitiveness, and drove unemployment up from 4.2 percent in 1991 to 8.2 percent by 1994. Export-oriented industries were particularly hard hit in terms of employment.

Germany responded to these challenges with structural reforms, including wage moderation and industry restructuring. Government spending on employee compensation fell by 1 percent of GDP from 1993 to 2000 and the private sector soon followed the public sector's lead. Rising unemployment, as well as the ability of corporations to turn to cheaper sources of labor in other countries, encouraged domestic labor to soften demands in collective bargaining. As a result, unit labor costs actually fell 3.4 percent in industry from 1995 to 2000 and stayed almost stagnant in services, rising only 1.8 percent over the same period.

As a result of these changes, Germany saw its export performance improve and rise in significance. From 1993 to 2000, the share of exports in its GDP rose by more than 10 percentage points, from 22 percent to 33 percent. Despite its exports losing 3.5 percent of world share from 1990 to 2000, Germany outperformed advanced economies as a whole, whose share fell by 6.3 percent, over that period.

Euro Adoption and the Export Boom

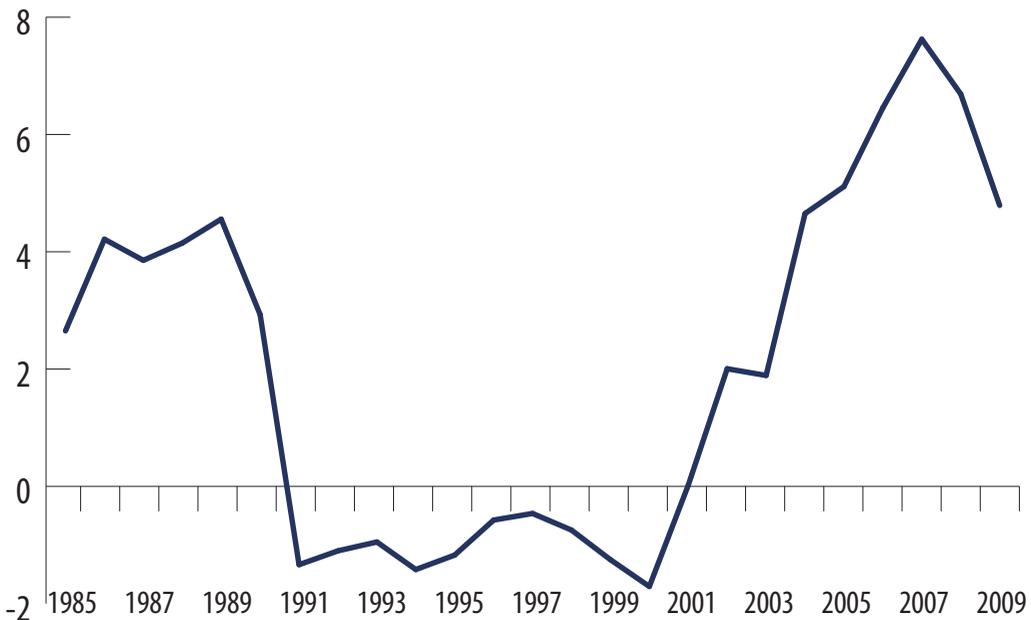
Germany's exports benefited further from the adoption of the euro, which eventually became cheaper than the deutschmark might have been, given that it reflects Europe's—and not only Germany's—competitiveness trends. For example, the European Commission estimated that the euro was about 10–12 percent undervalued for Germany in the first quarter of 2009. The euro also increased external demand, including from the GIIPS.

Since adopting the euro, Germany has seen its exports regain world share, rising 0.5 percentage points from 2000 to 2009—a remarkable performance compared with the 11.6 percent contraction in the share of advanced countries over that period. Over the same period, exports have gained an additional 14 percent of GDP share in Germany, bringing the total gain from 1993 to 2008 to a remarkable 25 percentage points. In a nutshell, while the GIIPS became more inward-focused and driven by domestic activities, Germany became the world's largest exporter.

Current Account Balance

Percent of GDP

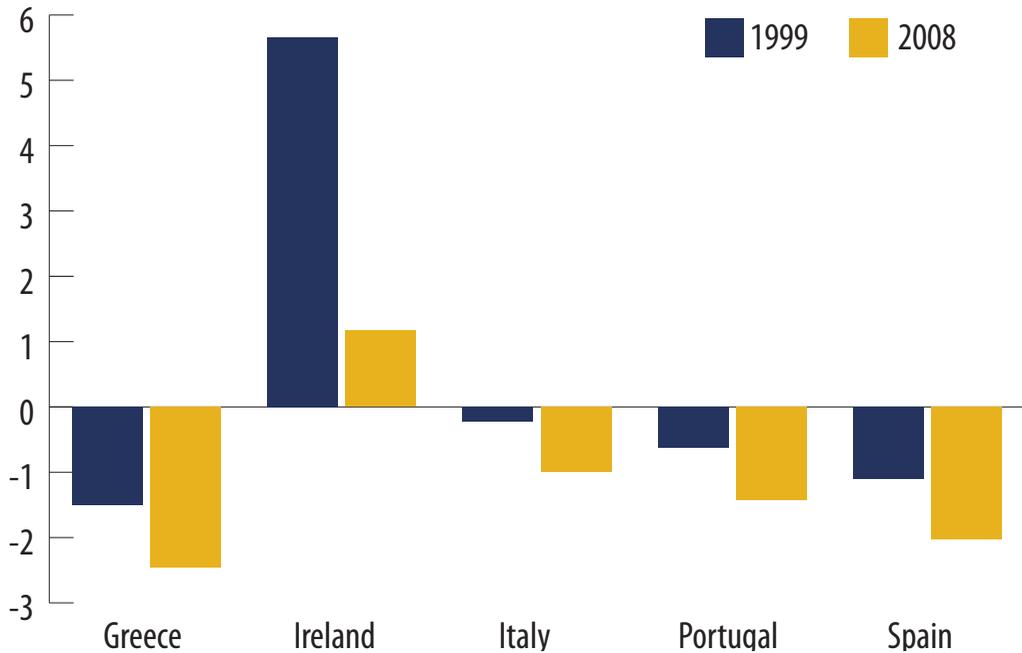
Source: IMF



Bilateral Trade Balances With Germany

Percent of GDP

Source: OECD



The percent of total German exports going to the Euro area as a whole has actually declined since the euro was introduced because the Euro area has grown more slowly than other regions. Germany's bilateral trade balance in goods with each of the GIIPS, however, has improved. For example, Greece's bilateral trade deficit with Germany widened from -1.5 percent of Greece's GDP in 1999 to -2.5 percent in 2008. Other core European countries, like the Netherlands, saw similar developments with the GIIPS, suggesting that all of the surplus countries benefited from increased demand in the weaker Euro area members.

Low Wage Growth and Sluggish Domestic Demand

Despite the benefits the euro brought Germany, its wage growth has remained moderate, keeping unit labor costs highly competitive relative to the rest of Europe. From 2000 to 2009, unit labor costs rose 7 percent in Germany, compared

to an average increase of 31 percent in the GIIPS over the same period. Again, Germany's ULC performance has been due more to limited wage increases than to relative productivity growth: compensation grew by 11 percent from 2000 to 2009 in Germany—15 percentage points below the Euro area average and 36 below the GIIPS average—while productivity grew 13 percent—only 2 percent above the Euro area average and substantially below the 25 percent growth exhibited in both Greece and Ireland.

However, while Germany's unit labor costs in euros have declined relative to the GIIPS and even other core European countries like Austria and the Netherlands, they did rise vis-à-vis major countries outside of the Euro area, including the United States, Japan, and China.

Slow GDP growth and even slower growth of domestic demand contributed to Germany's wage moderation following the adoption of the euro. From 2000 to 2008, Germany's average annual GDP growth, 1.4 percent, was half that of the GIIPS, which grew 3 percent on average each year. Over the same period, domestic demand's share of GDP contracted by 5.8 percentage points in Germany, while it gained an average of 0.6 percent in the GIIPS. A variety of factors account for this demand slump, from the Euro area's monetary policy—too tight for Germany, but too loose for several of the GIIPS—to high unemployment and low wage growth to high savings among an aging population.

Thus, while Germany's improved competitiveness did come on the back of tough domestic reforms—an experience the GIIPS can learn from—it also depended on demand from other countries, including those same GIIPS.

With the euro having depreciated by more than 20 percent against the dollar since late November and emerging markets booming, Germany is in a good position to both grow exports and expand its domestic demand. Increasing domestic demand would not only ease the painful adjustments of Germany's weak Euro area partners, whose exports are oriented predominantly inside Europe, but it would also shield Germany's own economy from excessive reliance on international markets. Unfortunately, German policy makers are unlikely to pursue this, given that it runs counter to the stated intention of bringing the deficit back in line with the Maastricht criteria by 2013.

PART II

**COUNTRY
NOTES**

WHY GREECE HAS TO RESTRUCTURE ITS DEBT

BENNETT STANCIL

Facing the dual challenge of massive and rising debt and a loss of competitiveness, Greece faces only bad options to dig itself out from the current crisis. Of these choices, an orderly debt restructuring as soon as creditors are better prepared to deal with the shock is the least bad alternative for Greece. Given that Greece's tax net is so small and its informal economy is presumed to be so large, however, it is conceivable, though unlikely, that an unsuspected tax windfall could materialize and alter this conclusion.

A Proliferation of Problems

Prior to the establishment of the euro, Greece was among the worst economic performers of eventual Euro area members. Annual inflation was one of the highest in the region; the Greek government paid the highest borrowing premium; and GDP growth was the slowest in Europe.

The adoption of the euro appeared to solve many of these deficiencies. Inflation fell from an average of 18 percent from 1980–1995 to just above 3 percent from 2000–2007. Over the same time periods, long-term government bond yield spreads vis-à-vis the German bund fell from 1100 basis points to less than 40.

As Greece stabilized, it quickly became an attractive destination for foreign capital. Greece's net foreign asset position, which measures the assets Greece

holds abroad minus Greek assets held by foreigners, plummeted, falling from approximately -5 percent of GDP in 1995 to around -100 percent of GDP in 2007. Awash with cheap capital, domestic demand surged and the current account balance deteriorated from -3.7 percent of GDP in 1997 to -14.4 percent in 2008.

Domestic demand growth drove up prices in Greece relative to that of the Euro area, increasing domestic labor costs and eroding Greek competitiveness. Since 1997, consumer prices have risen by 47 percent in Greece, compared to an increase of only 27 percent in the Euro area; since 2000, per capita employee compensation has grown by over 80 percent in Greece compared to an increase of 23 percent in the Euro area. The resulting loss of competitiveness has been substantial: the IMF estimates that Greece's real effective exchange rate is overvalued by 20–30 percent.

Competitiveness was hurt further by a shift away from manufacturing sectors in favor of the expansion of service and non-tradable sectors. Though not as large as the shift in other troubled European economies, manufacturing as a share of GDP fell by 2.5 percentage points from 1997 to 2007 from a low initial level, while construction's share grew by 2 percentage points. Over the same period, the price of services increased faster than that of goods by an average of 1.3 percentage points, compared to a difference of 0.6 percentage points in the Euro area, encouraging further misalignment toward services.

These imbalances were not without (temporary) benefits. After averaging annual GDP growth of 1.1 percent from 1980 through 1997—the slowest in eventual Euro area countries—Greece's economy expanded at an average rate of 4.1 percent over the next ten years, the fourth fastest rate in the Euro area. Per capita GDP rose from 39 percent of that of Germany in 1995 to 71 percent in 2008.

As tax revenues rose, the government rapidly expanded spending, especially in social transfers and public sector wages. From 1997 to 2008, Greece increased government spending per capita by 140 percent, compared to 40 percent in the Euro area. Over that period, social transfer spending rose from 13.9 percent of GDP to 18.9 percent, while the aggregate Euro area decreased such spending from 17.1 percent to 16.1 percent; Greek public sector per capita employee

compensation grew by 112 percent, compared to 38 percent in the Euro area.

Reflecting the economy's rapid growth, public sector deficits remained within what appeared to be reasonable bounds—averaging 5 percent of GDP from 2000 to 2007. The picture changed markedly with the financial crisis and when markets realized Greece's chronic failure to report accurate statistics. GDP expanded by only 2 percent in 2008 and contracted by 2 percent in 2009, pushing down tax revenues and driving up the restated deficit to 7.7 percent in 2008 and 13.6 in 2009.

With debt ballooning from 96 percent of GDP in 2007 to 115 percent in 2009—and the IMF projecting it to reach nearly 150 percent by 2012 even under the assumption of draconian fiscal measures—Greece's borrowing costs skyrocketed. Worries mounted that Greece would not be able to repay its loans and that the crisis would quickly infect other troubled European nations. EU and IMF leaders attempted to reassure markets with pledges of support to Greece; though initial efforts failed, later attempts, including a \$145 billion support package, appears to have stabilized the situation, as it effectively covers the government's borrowing requirement over at least the next two years.

Agreed Adjustment Measures

In order to receive the support package, Greece was required to agree to a number of adjustment measures that fall into three general categories:

- **Fiscal Policy:** Fiscal policy adjustments aim to begin reducing the debt-to-GDP ratio by 2013 and bring the government deficit below 3 percent of GDP by 2014. The total adjustment—11 percent of GDP—is composed of reductions in spending of 5.3 percent of GDP, tax increases of 4 percent, and structural reforms that are expected to add 1.8 percent of GDP. The measures are frontloaded with the largest adjustment planned for 2010.
- **Structural Reforms:** Reforms will be implemented to enhance government productivity and transparency, increase wage flexibility in the private sector, and improve the business climate and competition across Greece.

- **Financial Sector Policy:** Greek banks have been hurt by concerns over sovereign debt, of which they hold large amounts, and have lost access to international markets for wholesale funding. Support will be provided by the EU and IMF to ensure that banks are adequately capitalized.

Prospects

The EU–IMF support package is, first and foremost, a lending facility and addresses concerns over Greek liquidity. Any durable improvement in the Greek situation must come from fiscal adjustment. At 11 percent of GDP, however, the adjustment required of Greece is massive and represents more than annual government spending on military defense, health care, and education *combined*. These cuts are likely to accentuate the deep recession in the private sector and to result in wage and price deflation, which in turn will take a major toll on output growth and on tax revenues. Given Greece’s relatively closed economy, which funnels most government spending back into the domestic market, the multiplier effects of fiscal consolidation in Greece on output are expected to be especially large.

The IMF projects that Greece will need to maintain a primary balance of 6 percent of GDP and annual GDP growth of 2.7 percent to reduce its debt-to-GDP ratio to 120 percent by 2020, which is still 5 percentage points more than the current level. Of all Euro area countries, from 2000–2007, Belgium had the highest average primary balance at only 4.7 percent and a growth rate of just 2.2 percent annually. Given that Greece is a less competitive and less diversified economy than Belgium, the prospects for Greece to achieve annual growth of 2.7 percent against a background of such large-scale fiscal consolidation are at best dim.

Furthermore, if GDP growth stagnates, as is possible given Greece’s loss of competitiveness and the severity of the austerity measures undertaken, and if debt reaches 150 percent of GDP as projected, a primary balance of 6 percent of GDP will only reduce the debt level if interest rates remain below 4 percent. Given that ten-year Greek bond yields averaged 4.25 percent from 2002 to 2007—a

time when the Greek economy was growing, worries over sovereign default were minimal, and Greek bonds were not rated as “junk”—it is difficult to believe that Greece will not pay significantly more for any debt it issues after the EU–IMF package expires in 2012.

Under such conditions, debt restructuring is necessary, but may not be sufficient to place Greece back on a sustained growth path. Greece will need to rely increasingly on exports to restart growth, but this strategy faces significant obstacles—primarily Greece’s severe loss of competitiveness. Debt restructuring could actually intensify this loss by implicitly improving Greek wealth and increasing domestic demand. Furthermore, the external environment may not be especially propitious for Greece, which sends about two-thirds of its exports to the rest of the EU, where fiscal austerity programs are being widely adopted.

Restoring competitiveness will require wage reductions, deflation, and increases in productivity, but these measures take time—and will severely test Greece’s social fabric. If these efforts prove unworkable with a reasonable timeframe, abandoning the euro while remaining in the EU may prove to be Greece’s only other viable option.

Finally, there is one caveat to this assessment. Greece is known to have a large informal economy, large scale tax evasion, and wholly inadequate statistics. As Greece widens its tax net, a tax revenue windfall of unprecedented magnitude is possible, albeit unlikely. If this occurs, one should see the results over the next twelve months or so, when the political momentum behind the fiscal adjustment effort is greatest. By then, wise creditors will have prepared for the haircut to come.

A DIRE WARNING FROM LATVIA AND ARGENTINA

URI DADUSH AND BENNETT STANCIL

Greece has been profligate and fiscally irresponsible. Still, the contrasting experiences of Argentina and Latvia in dealing with excessive spending and currency overvaluation—problems that now plague Greece—hold a warning for Europe: leaving the Euro area and defaulting—while almost unthinkable now—could become the best of very bad options for Greece, though it would have disastrous implications for both the European Union (EU) and the world. The EU must support Greece with all available means to prevent this from happening.

Inflation has been higher in Greece than in its northern Euro area neighbors for years, and wage increases in excess of productivity have impaired Greece's ability to compete. As the table below shows, this problem is shared to different degrees by Ireland, Italy, Portugal, and Spain. Together, the affected countries represented 35 percent of the Euro area's GDP in 2009 and constitute an economy over 30 percent larger than that of Germany.

Common features of currency overvaluation include an inability to grow without creating excessive current account deficits, rising debt burdens, and a gradual loss of investor confidence. There are only two ways to address the problem. The first is to devalue. For countries in the Euro area, this would require the radical step of abandoning the euro and returning to a national currency, leading to default as debt burdens soar relative to incomes. The other course of action is austerity and structural adjustment—reducing government spending, cutting wages, and undertaking reforms that raise productivity.

This piece originally appeared in the March 3, 2010, edition of the International Economic Bulletin.

Devaluation: The Best of Bad Options?

Examination of two polar cases of resolving overvaluation—Argentina, which was forced to break out of its currency board in January 2002 and devalue, and Latvia, which had to resort to IMF help in December 2008, has decided to tough it out and maintain its peg to the euro—suggests that the output losses associated with the latter can be even higher than those associated with devaluation and default.

In the three years prior to the onset of each country's respective crisis, GDP in that country grew rapidly: 5.8 percent per year in Argentina and 10.9 percent per year in Latvia. Meanwhile, the real effective exchange rate appreciated by 12 percent in Argentina and by 24 percent in Latvia; the current account deficit exceeded 20 percent of GDP in Latvia in 2006 and 2007, and nearly 5 percent in Argentina in 1998—its highest level since before 1980.

As investors lost confidence and exports slowed, both countries eventually entered recession. Brazilian devaluation and the mild global recession in 2001 were precipitating factors in Argentina, while the onset of the global financial crisis triggered the Latvian crisis. In both countries, debts were denominated in foreign currency and debt burdens rose sharply in the years preceding crisis, though private debt dominated in Latvia, whereas both private and public debt were large in Argentina.

Argentina was forced to devalue and the peso declined by nearly 70 percent

against the dollar, while Latvia—despite its much larger external deficit—elected to maintain its peg and adjust with the help of massive support (43 percent of GDP) from the IMF and the EU.

Wages Rising Much Faster Than Productivity

Percent increase in unit labor cost in euros (Q1 2001 to Q3 2009)

Greece	33%
Italy	30%
Spain	28%
Ireland	27%
Germany	6%
United States	-27%

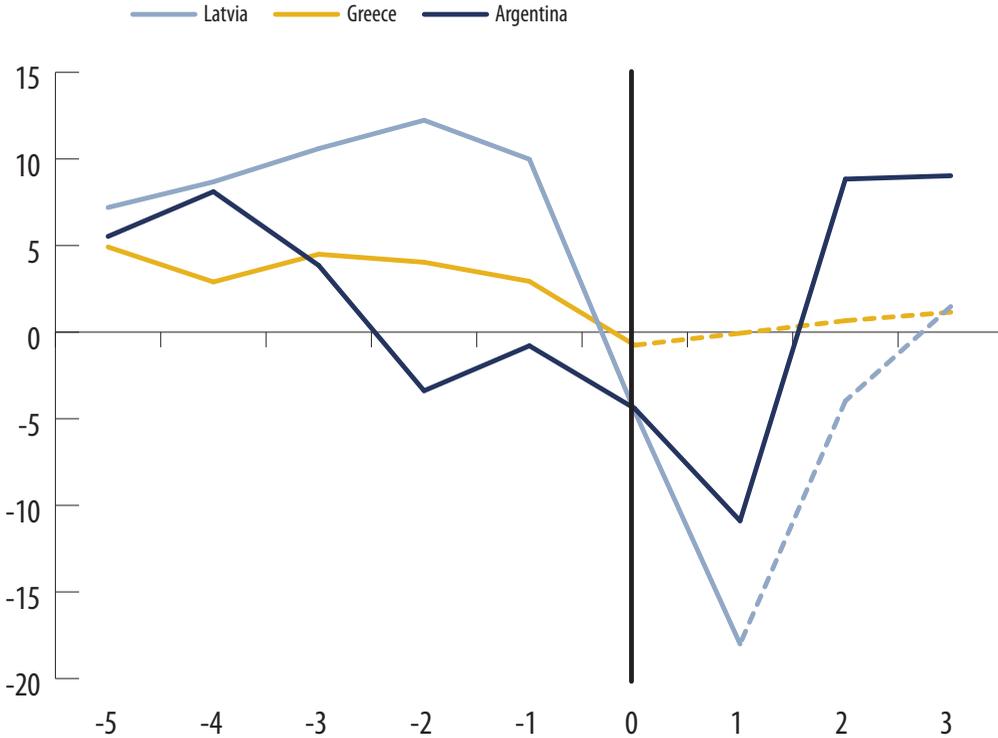
Sources: OECD, IMF

Output Losses Are Large, but Latvia Has Suffered the Most

Real GDP Growth

Source: IMF

Annual percent change, dashed lines represent projections



NOTE: The vertical line represents the decisive point in each crisis: Argentina's decision to devalue in January 2002, Latvia's acceptance of an IMF Stand-By Arrangement in December 2008, thus signaling Latvia's intent to maintain its exchange rate peg, and the current situation in Greece.

Though they adopted widely different courses, both countries saw a massive fall in output and employment. From peak to trough, GDP fell by 18.4 percent in Argentina and 21 percent in Latvia, and forecasters predict further declines in Latvia. Unemployment in both countries surpassed 20 percent.

In Argentina, the massive devaluation led to widespread disruption and outright default on 75 percent of its \$100 billion (today's prices) foreign debt. In the seven years following devaluation, the total cost of default to foreigners, including the direct cost of lost principal and interest and the indirect losses in equity values, has been estimated to be nearly twice as large as the initial value of

the debt in default. Thus, Argentina was able to make its creditors share the cost of the crisis. However, eight years later, Argentina has yet to recover the confidence of investors, its access to capital markets remains restricted, and its S&P rating is seventh worst among 123 countries.

Though Argentina paid a heavy price for devaluing and defaulting, its competitiveness was quickly restored and a rapid recovery—helped by favorable global conditions—ensued. Exports grew by 15 percent in 2003 and 17 percent in 2004, while GDP grew 8.8 percent in 2003 and 9.0 percent in 2004, regaining its pre-crisis peak within about ten quarters.

In contrast, though Latvia's current account balance has swung to surplus, this has come on the back of demand containment rather than export growth: since the end of 2007, imports have fallen 41 percent compared to a 14 percent decline in exports. Latvia remains mired in recession, with the IMF forecasting that GDP will contract by 4 percent in 2010, followed by anemic growth of 1.5 percent in 2011. In addition to its large outstanding private debt, it now has a large foreign public debt burden to repay to the IMF and the EU.

How Do Greece and Others Compare?

Greece's vulnerabilities have been building for years, and are in some respects as or more pronounced than those of Argentina and Latvia. From 2002 to 2007, domestic demand grew by an average of 4.2 percent, compared to growth of 1.8 percent in the Euro area. Foreign borrowing helped to finance this relatively rapid growth, and higher inflation in Greece resulted in a 17 percent appreciation of the real effective exchange rate over the past four years, less than various estimates for Argentina and Latvia. The current account deficit increased from 5.8 percent of GDP in 2004 to 14.4 percent in 2008, much larger than Argentina's increase but smaller than Latvia's. Greece's public debt has reached an estimated 112 percent of GDP, almost double Argentina's debt of 63 percent of GDP prior to devaluation, and about six times larger than Latvia's pre-crisis level.

It is unlikely that a deepening crisis in Greece will be confined to that country. In Spain, the current account deficit exceeded 10 percent of GDP in 2007, and the recession has already pushed unemployment above 20 percent. Though Italy's current account deficit—2.5 percent of GDP in 2009—remains moderate, this has come at the expense of growth underperforming its Euro area partners by an average of 1.2 percent over the last five years. With Italian government debt rising to 116 percent of GDP, a crisis in Greece and Spain could quickly become a crisis in Italy.

What is the Best Policy Response?

Four simple policy messages emerge from this comparison: first, regardless of how Greece adjusts to excess demand growth and overvaluation, the effect on incomes and employment will be large, and likely much larger than current forecasts suggest.

Second, abandonment of the euro and default, though an extraordinarily painful course, may eventually prove to be a less costly option for Greece if its adjustment does not succeed and help is not forthcoming. Devaluation and default would shift some of the burden onto foreign creditors, avoid further debt buildup in the bailout, and establish conditions for resumed growth much more rapidly than policies of austerity and adjustment.

Third, what may be a less costly course for Greece may be much worse for its Euro area partners. Devaluation and default would lead to further impairment of banks, unpredictable contagion effects on other countries, and a hit below the waterline on the euro project. There would also be global implications. Assuming the cost of default is proportionally just half of that of Argentina, devaluation in Greece and Spain—which hold an estimated \$370 billion and \$770 billion in debt respectively—would cost foreign investors 2 percent of global GDP; default in Italy alone would cost over twice this sum.

Fourth, it follows that it is in Europe's and the international community's vital interest to support Greece and facilitate its adjustment. This should involve not

only direct loans but also increased aid if necessary (as happens when social safety nets operate to support depressed regions in the United States). Additionally, expansionary fiscal policies in Germany and other countries that can afford it and more expansionary monetary policy in the Euro area over several years should be considered. Recourse to the IMF should remain a live option not only because of its resources and expertise, but also because it creates the sorely lacking political space for providing finance and administering tough conditions. Whatever course is adopted, a likely result of the crisis will be a lower euro, which would also work to facilitate adjustment in Greece and other vulnerable countries and create more space in Germany and other external surplus countries to help.

LESSONS FROM RUSSIA'S CRISIS

SERGEY ALEKSASHENKO

Reflecting on the depth of its crisis, several experts have counseled Greece to restructure its debt and leave the Euro area. In 1998, when I was deputy governor of the central bank and in charge of IMF relations, Russia successfully dealt with a severe fiscal crisis using those tools. Helped by rising oil prices, the country recovered quickly and eventually repaid its debts. Russia's situation in 1998 differs greatly from Greece's today, but the experience nevertheless offers three lessons for Greece and the Euro area more broadly: always beware of large macroeconomic imbalances, avoid piecemeal solutions because only comprehensive plans work, and know that the size of the external support package is central to the success of the recovery plan.

Origins of the Russian Crisis

Twelve years ago, in mid-1998, Russia found itself with a debt-to-GDP ratio of 57 percent and a fiscal deficit of around 5 percent of GDP. While neither imbalance is staggering, and both are only a fraction of what Greece exhibits today, the situation was severe. Since the beginning of reforms in 1992, Russia had failed to implement proper tax administration, and the government had been running fiscal deficits for years. A rapid fall in oil prices, which began in January 1998, compounded the already-poor fiscal situation. By the summer, oil prices had dropped to \$12 per barrel (equivalent to production costs), down from \$20 per

barrel twelve months earlier, sharply decreasing tax revenues from the oil and gas sector. Revenues gathered through July were enough to finance only about two-thirds of government spending for the year; borrowing was needed for the rest. The price shock also significantly weakened the current account.

Furthermore, much of the ruble-denominated debt—equivalent to approximately 18 percent of GDP (high inflation had reduced the value of previous debts)—was short-term. The high inflation, which had exceeded 20 percent from 1994 (when the government first offered bonds) through 1997, had prevented the Ministry of Finance from selling long-term bonds. As a result, the government was forced to repay about \$1 billion of principal each week from June through December—the equivalent of 1.3 percent of GDP each month (based on a pre-default exchange rate); this was clearly unsustainable. At about 1.8 percent of GDP, Greece's financing requirement each month is even higher.

In addition, having committed in November 1997 to continue managing its exchange rate within a band, Russia found itself bound to a nearly fixed exchange rate. Having adopted the euro, Greece today finds itself even more constrained in that regard.

The replacement of Prime Minister Chernomyrdin, who had been in office since 1992 and was expected to win the 2000 elections, with Sergey Kirienko, a relative unknown, in May further aggravated the crisis. Growing tensions between the parliament and the executive branch dragged out the approval process for the new prime minister, and the weak government structure further hurt market confidence and slowed negotiations with the IMF in June.

The Government and IMF Response

In mid-July, the IMF decided to provide \$20 billion in credit to Russia, with a first tranche of \$4.8 billion. This credit represented 6.7 percent of Russia's GDP,¹

¹ This percentage is calculated using the average exchange rate for the whole year. Based on the annualized GDP from the second quarter of 1998 and the exchange rate by the time the credit was approved, it represents less than 5 percent of GDP.

in contrast to today's 110 billion euro package for Greece, which represents 46 percent of Greece's GDP. Not surprisingly, the IMF package for Russia failed to appease markets and did little to slow the crisis.

On August 17, 1998, Russia declared that repayment of ruble-denominated debt would be frozen until the end of 1999 and began negotiating a restructuring of the short-term debt. It also banned repayment of external debts by residents until the end of 1998 and announced a widening of the exchange rate band. Ten days later, the band was abandoned altogether and the ruble was allowed to float; it quickly plummeted to one quarter of its previous level.

Even without access to financial markets, the government managed to eliminate the deficit by mid-1999—one year before oil prices began to recover. Though there were no haircuts and the debt was eventually repaid, maturity on much of it was extended, sharply reducing the debt servicing and refinancing needs for the period over which the adjustment took place. In addition, tax revenues rose as raw material exporters saw profits grow amid the ruble's massive devaluation. High annual inflation also increased revenues in nominal terms while the government followed a rigid spending policy and refused to index public wages and pensions.

This approach covered all of the country's weak points: the debt burden (both interest and repayment) was reduced and the exchange rate was allowed to float. Furthermore, at the beginning of September, the new government, headed by Yevgeny Primakov—Yeltsin's opponent at that time—gained the support of the parliament, thus enabling it to implement several austerity measures.

Though extremely painful for the economy and the population, these policies appear, in hindsight, to have been the right ones. Starting in November 1998, industrial production began to grow rapidly as sharp devaluation not only made exports much more profitable, but also benefited many industries selling goods in the domestic market. The automobile, food, and light industries, mechanical engineering, and metallurgy started to grow at annual rates above 10 percent.

Lessons for Greece and the Euro Area

1. Imbalances matter. While a favorable combination of factors can fool governments into thinking that monetary and fiscal policy can be loosened with little negative effect, practice shows that any long-term imbalance tends to result in a serious shock sooner or later. In 1998, a history of macroeconomic imbalances led to an overload of short-term debt in Russia. In 2010, Greece is experiencing the consequences of sharply escalated government debt, much of which is also short-term, increased unit labor costs, and consumption financed via external borrowing. Though this lesson comes too late for Greece, which has had to learn it the hard way, it is still of value to other exposed countries in the Euro area who are being too timid in tackling their deep-seated problems.

2. Only comprehensive solutions work and the country in crisis must do its job. The Russian experience shows that, when battling a crisis, policy makers must identify all of its origins and address each, never assuming that any one will resolve itself. Investors understand the problems just as well as government ministers do, and so are prepared to give policy makers some time—but they are not prepared to believe in miracles. In the case of Greece, the EU–IMF package buys time but does not solve the problem. Greek authorities now have a window during which they can modernize their economy and regain competitiveness—changes that must come from Greece itself and address the underlying structural problems as well as the fiscal and debt issues. Nevertheless, it is very hard to imagine how Greece can improve its competitiveness without control of its exchange rate. Wage reduction (if it occurs) is not likely to be enough, as Greece’s main competitors—Spain, Portugal, and Italy in the case of tourism, which accounts for one-third of Greek exports—have implemented similar measures.

3. The size of the rescue package matters. IMF assistance to Russia was unable to calm markets and give policy makers sufficient time to restore budget discipline.

As a result, Russia was only able to address its problems by rescheduling its debt and breaking out of the exchange rate band. This time, IMF assistance is several magnitudes larger, providing the countries in trouble with more opportunities and perhaps avoiding the most extreme outcomes. It should be clear, however, that a failure to restore Greece's competitiveness within a reasonable time span may force the country to abandon the euro and devalue; in that case, default will be inevitable, as devaluation will greatly increase the already staggering debt-to-GDP ratio. That means Greece will need not only debt rescheduling, but also significant debt forgiveness. In Russia's case, the much smaller size of the foreign-currency-denominated debt enabled the country to avoid debt forgiveness.

IRELAND: FROM BUBBLE TO BROKE

BENNETT STANCIL

Greece, Italy, Portugal, and Spain have all come under fire for a varied mix of labor inflexibility, high-spending, and lost competitiveness, yet Ireland's experience demonstrates that the Aegean flu can attack even apparently flexible, parsimonious, and competitive economies. Following a massive financial crisis, Ireland now faces the same double-edged sword wielded at the other GIIPS¹: lost competitiveness and an unsustainable government debt trajectory.

The Celtic Tiger

Well before the euro's introduction in the late 1990s, Ireland was prospering. From 1990 to 1995, GDP was growing significantly faster than in other GIIPS, and inflation and borrowing costs were not only below that of the other GIIPS, they were close to German levels.

Additionally, Ireland's governance and business climate indicators² were among the world's strongest. Labor markets were flexible and the education system was one of the best in Europe.

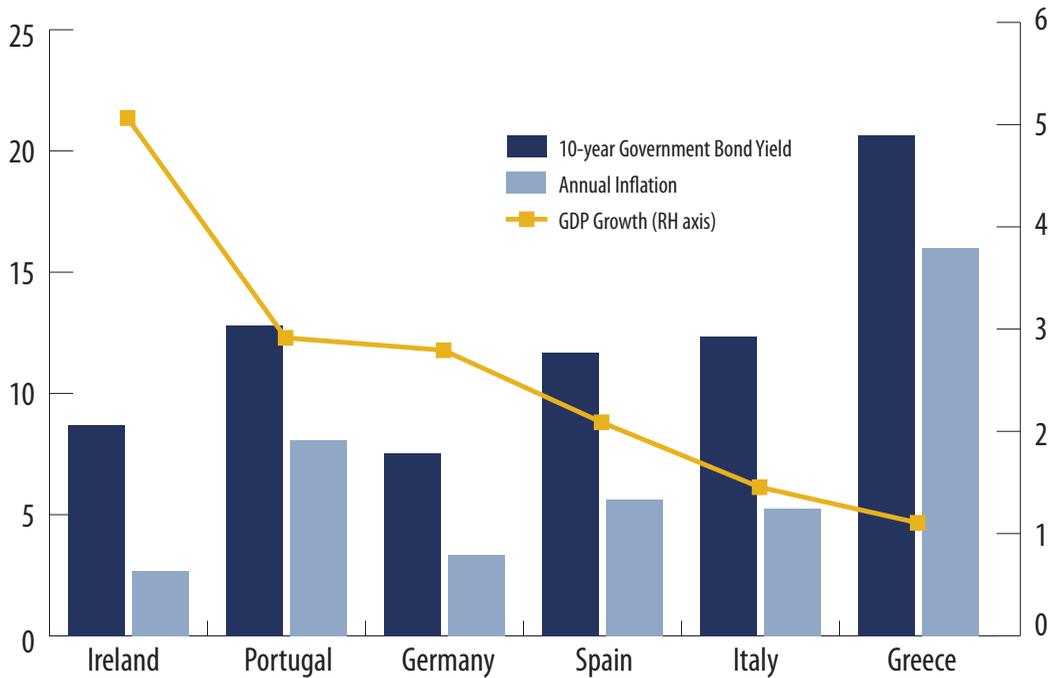
¹ Greece, Ireland, Italy, Portugal, and Spain.

² Though historic indicators are not available, in 2008, Ireland ranked 7th out of 183 countries in the World Bank's "Doing Business" survey.

Before the Euro

Average, 1990–1995

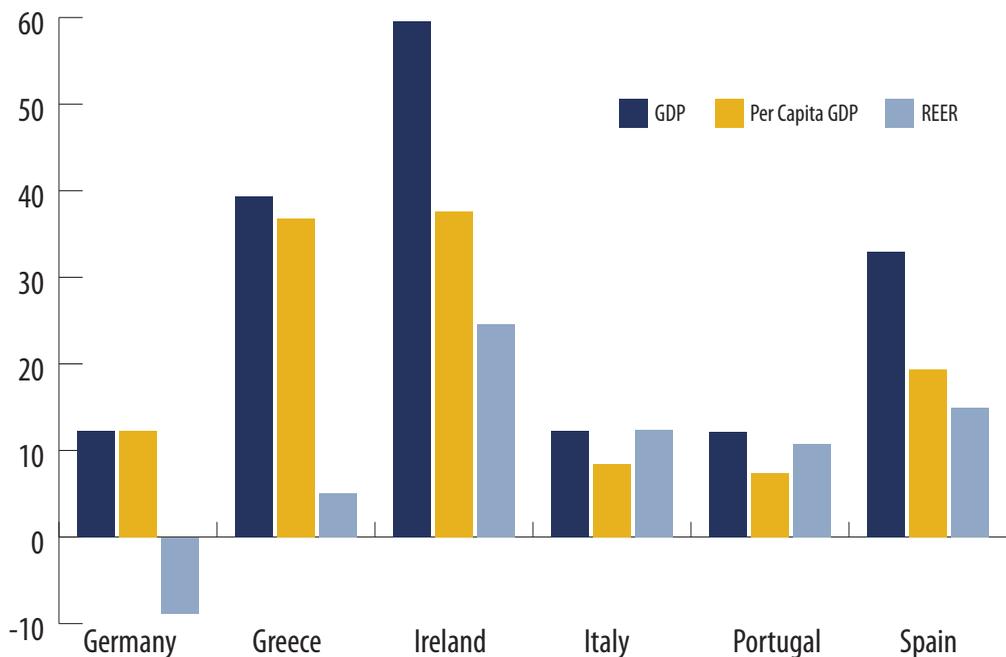
Source: IMF, Eurostat



Ireland's Big Boom

Total Percent Increase, 1999–2007

Sources: IMF, Eurostat



A Path to Crisis

Whereas in other GIIPS, the euro added confidence where there previously was none, in Ireland, the euro gave an unsustainable boost to an already booming economy.

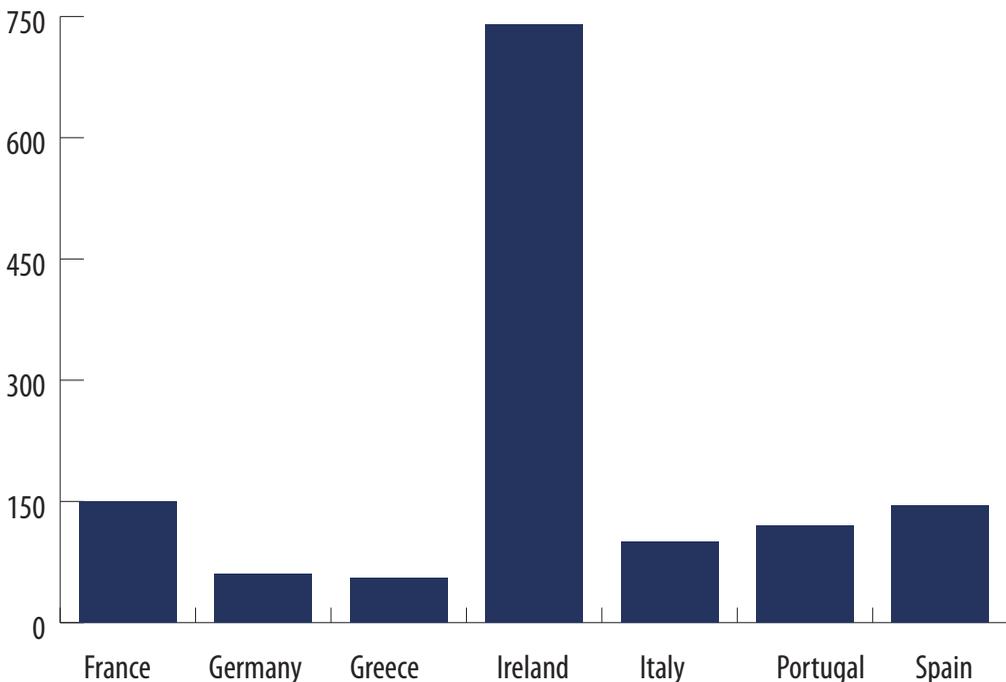
From 1995 to 2000, growth in Ireland accelerated to an average of 9.6 percent per year, and interest rates fell below German levels by 2005. Irish wages grew nearly five times faster than the Euro area average from 1997 to 2007, resulting in the real effective exchange rate (REER) increasing by 36 percent from 1999 to 2008, compared to an average increase of 13 percent in the other GIIPS.

This rapid growth and a European monetary policy that was far too loose for Ireland fueled the enormous overleveraging of the financial sector. The supply of credit exploded, surpassing 200 percent of GDP by 2008 after averaging around 40 percent from 1975 to 1994. In just ten years, financial and monetary

Increase in Banks' Balance Sheets

Percent of GDP, Jan. 1999–Jan. 2009

Source: European Commission



institutions expanded their balance sheets by approximately 750 percent of GDP, and by 2007, gross financial exposure had reached nearly 1,400 percent of GDP. In the other GIIPS, balance sheets expanded by “only” 100 percent of GDP and exposure averaged close to 200 percent.

An extraordinary housing bubble emerged. From 1997 to 2006, housing completions grew by 9.6 percent a year, and by IMF calculations, Irish house prices grew by 90 percent more than fundamentals predicted, compared to 28 percent in Spain and 20 percent in the United States.

As in other GIIPS, the economy shifted away from manufacturing and toward services and housing. Financial intermediation, real estate, and business sectors sapped 10 percent of GDP away from the industrial sector from 1999 to 2006. Residential investment grew from 5 percent of GDP in the mid-1990s to over 12 percent by 2007.

Throughout the course of this boom, the Irish government appeared to behave responsibly, running an average budget surplus of 1.6 percent of GDP from 1997 to 2007, helped by surging tax revenues. Over that period, the aggregate Euro area never once recorded a surplus, and Greece averaged a deficit of 4.8 percent.

Ireland's Massive Bust

In 2008, Ireland's bubble burst. Over the next two years, domestic demand fell by 16 percent, investment collapsed by over 40 percent, and housing prices plunged 30 percent. By the end of 2010, Irish output will likely have contracted by 14 percent since the beginning of the crisis.

The financial sector was hit even harder. Financial equities plummeted by more than 70 percent. In June 2009, bank losses through 2010 were estimated to be as high as 35 billion euros, or 20 percent of GDP; since that estimate, nationalized Anglo Irish Bank announced losses of 12.7 billion euros, the biggest loss in Irish history.

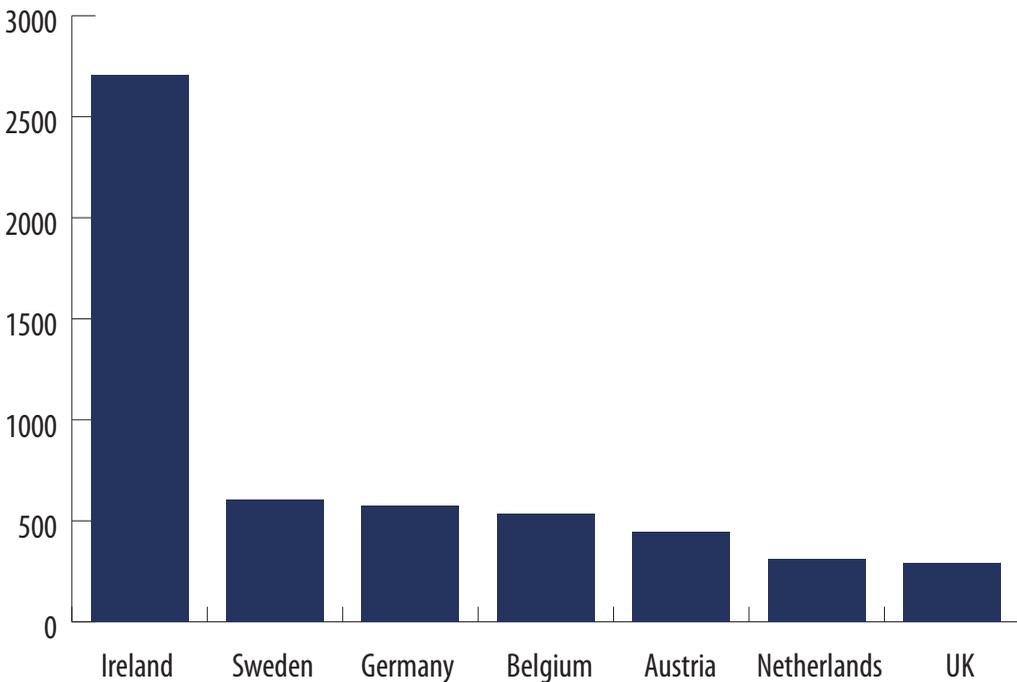
The government responded to the financial crisis with extraordinary measures, issuing capital injections and guarantees to depositors and creditors of major

banks and purchasing troubled assets. The total assets of the guaranteed banks are now valued at 440 billion euros, or 270 percent of Irish GDP and 2700 percent of Ireland's average yearly net debt issuance.

Sovereign Guaranteed Bank Debt

Percent of average yearly net debt issuance, 2003–2007

Source: IMF



These measures obviously took a heavy toll on government finances. At 13.9 percent of GDP, estimated financial sector stabilization costs through 2009 are the highest of any advanced country.

In addition, the loss of output and increase in unemployment—the largest rate increase of any advanced country—drove tax revenues down by 11.6 percent in 2009, exposing the prudent budget as a mirage: the IMF estimates that the structural balance (which ignores cyclical increases in revenues or expenditures) was in deficit, at -9 percent of GDP in 2007. Real government expenditures, despite staying steady relative to GDP, had been among the fastest growing in Europe.

This, coupled with public support of the financial sector, plunged the government balance into deficit; it reached -14.8 percent of GDP in 2009. Debt—even excluding the government guarantees of the financial sector—is expected to leap from 25 percent of GDP in 2007 to nearly 90 percent in 2011.

Finding the Way Back

To escape the trap now ensnaring the GIIPS, Ireland must follow a path similar to the others—restore competitiveness and return public finances to a sustainable trajectory.

Competitiveness is already returning. Since its peak in mid-2008, the REER has fallen by 10 percent and exports are adding to growth. The wage adjustment is already underway as well, as public sector wages were reduced by 5 to 15 percent in December 2009. This will help rebalance the economy away from services and the financial sector and—drawing on Ireland’s sound business climate and flexible labor market—toward exports.

Irish leaders have already taken bold steps—including expanding the tax base, increasing the minimum pension age, reducing social welfare benefits, and cutting public wages—to lower spending by 2.5 of GDP in 2010 and reduce the deficit below 3 percent of GDP in 2014. Achieving these goals will be difficult: as increasing unemployment and still-retreating domestic demand continues to cut into tax revenues, deficits are still expected to exceed 10 percent of GDP through 2011. Both steady, tenacious leadership in Ireland and the “ruthless truth telling” of the IMF—now a major player in resolving the European crisis—are critical in ensuring that these much-needed reforms persist, especially if public support wavers.

The financial sector still presents a difficult-to-evaluate risk to Ireland’s budget reform. If events in Ireland or Europe shake banks, the government will be forced to make good on its guarantees and debt could balloon even higher. To reduce this risk, flexibility is needed in how financial support programs respond to continuing trouble and, when appropriate, unwind these guarantees.

The case of Ireland underscores the fact that flexibility and dynamism do not make a country immune to the disease now afflicting southern Europe. A financial bust can overwhelm public budgets in a matter of months, even after many years of rapid growth and budget surpluses.

During the boom, the Irish state could have moderated the economic misalignment toward services and real estate through taxes: for example, a large VAT hike on services and home construction. This would have both reduced the tidal wave of capital that flooded real estate markets and the financial industry and cushioned the fiscal adjustment when the boom ended. As Ireland discovered, reducing spending during lean years is much more difficult than withholding expenditures during a boom.

IS ITALY THE NEXT GREECE?

URI DADUSH AND VERA EIDELMAN

The sovereign debt crisis in Greece is still in its infancy and its effect on other vulnerable countries, including Spain, Portugal, and Ireland, have been widely discussed. But how is Italy—whose economy and public debt are more than six times larger than Greece’s—faring?

Italy did a better job than Greece of managing its fiscal affairs during the crisis, but its debt as a percentage of GDP is still higher than that of Greece and, since adopting the euro, its competitiveness has deteriorated just as sharply. The combination of high debt, declining competitiveness, and anemic growth means that, even if contagion from Greece is controlled, the Italian economy will remain exceptionally vulnerable to adverse shocks in a highly uncertain post-crisis global environment.

To maintain its membership in the Euro area and avoid its own disastrous sovereign debt crisis, Italy should, as a first step, adopt a three-year program to raise its primary balance by at least 4 percent of GDP and engineer a real devaluation vis-à-vis Germany of at least 6 percent through wage cuts and far-reaching structural reforms. Compared to the programs enacted or planned in Greece, Ireland, and the Baltic countries whose crises have already erupted, these steps are modest and should be interpreted as preemptive.

However, action in Italy and other vulnerable countries will not be enough: the Euro area must ease the painful adjustment by maintaining expansionary policy

This piece originally appeared in the April 20, 2010, edition of the International Economic Bulletin.

and targeting a weaker euro. To ensure that the global recovery continues, the G20 also has a vital interest in accommodating the lower euro.

The Post-Euro Boom and the Crisis Bust

After Italy and Greece adopted the euro in 1999 and 2001, respectively, interest rates in both countries fell to near German levels (the lowest in the Euro area), fueling consumer spending and house prices, particularly in Greece. Though the two governments used the lower borrowing costs to increase spending, they were also able to reduce deficits and debt. In Italy, debt fell by 10 percent of GDP from 1999 to 2007. Greece cut its debt by a larger 12 percent of GDP over the same period. This was a step forward, though other highly indebted countries, such as Belgium, did much better.

Since the outbreak of the crisis, debt in Greece and Italy has surged, as in other countries. In 2008 and 2009, Greece ran public deficits twice the size of Italy's and added about twice as much debt as a share of GDP. But the fact remains that Italy's debt load today is similar to that of Greece.

Debt as Percent of GDP, Current and Projected

	2009	2011	2014
Japan	218.6	231.9	245.6
Italy	115.1	123.5	128.5
Greece	113.4	126.8	—
Belgium	97.9	104.9	—
United States	84.8	97.7	108.2
France	77.4	86.6	92.6
United Kingdom	72.9	89.3	98.3
Germany	72.5	87.8	89.3
Ireland	64.5	87.9	—
Spain	55.2	66.9	—

Sources: European Commission, IMF, OECD

With a public debt of 115 percent of GDP and interest rates near 4 percent, Italy must spend about 4.5 percent of GDP a year just on interest—the equivalent of its public education budget this year. Moreover, even if public revenues are able to cover all expenditures, interest costs will still lead Italy's debt to grow faster than its sluggish economy—which consensus expects to grow at an average annual rate of 3 percent in nominal terms over the next seven years. Therefore, the debt burden will grow larger each year unless the primary balance (the difference between public sector revenues and expenditures, excluding interest paid on the public debt) moves firmly into surplus. Since Italy's debt is of relatively short maturity, Italy is potentially more vulnerable than other countries to a change in market sentiment.

Better Fiscal Management

By moderating expenditures, partly via pension reform in the 1990s, and increasing revenue through temporary tax measures, Italy has avoided a starker debt explosion so far. More recently, its conservatively managed banks did not need a bail out, nor did Italy enact substantial fiscal stimulus.

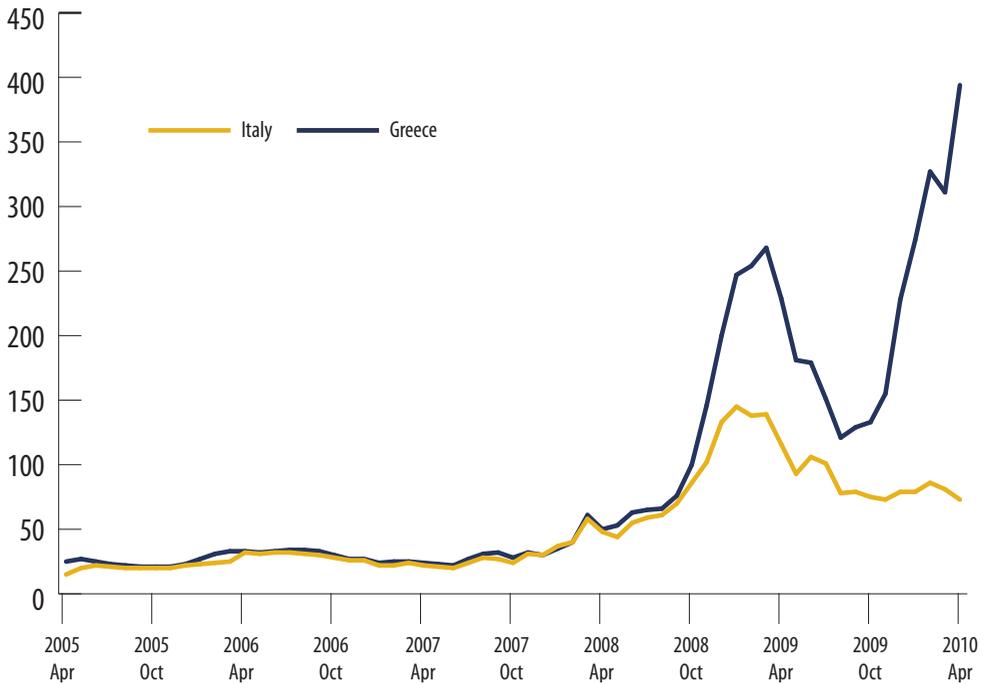
Crucially, Italy's lower fiscal deficits, together with higher private sector savings, establish an external balance that is also sounder than that of Greece. From 1993 to 1999, Italy's current account was in surplus, and the country has maintained a modest average current account deficit of 1.6 percent of GDP since 2000. Greece, where domestic demand grew much faster, saw average current account deficits of 9.1 percent from 2000 to 2009. Had growth in Italy led to a domestic demand surge similar to that in Greece, Italy's current account deficit might have been of similar magnitude. For similar reasons, and because it didn't attract as much foreign investment during the boom, Italy is also in a relatively healthy net foreign indebtedness position.

Markets have rewarded Italy for its better fiscal management. During the crisis, spreads on ten-year government bond yields rose much more in Greece than in Italy and the difference has grown even starker recently.

10-Year Government Bond Spread to German Bund

Source: Haver Analytics

Basis Points



Lost Competitiveness and Low Growth Potential

Nonetheless, Italy has lost as much competitiveness as Greece since joining the Euro area. Italy's unit cost of labor rose 32 percent from 2000 to 2009, comparable to Greece's 34 percent rise over the same period. To keep its unit labor costs level with those of Germany—where wages essentially kept pace with productivity—Italy should have kept its wages nearly flat in nominal terms over the last decade. Italy's competitiveness deteriorated even more against other large trading nations, including the United States, China, and Japan—all simultaneously large markets for and in competition with Italian exports.

Econometric studies conclude that falling total factor productivity is responsible for Italy's low growth problem. From 1996 to 2004, total factor

productivity in Italy declined at an average annual rate of almost 1 percent, while it grew by approximately 1 percent per year in Germany. Numerous structural issues have plagued Italy's economy for decades. These include labor market rigidities and dual labor markets, small average business size, defective and excessive regulations, inadequate public services, insufficient competition in backbone services (including energy, telecommunications, and transport), and profound governance issues in the South.

The consequences of Italy's lost competitiveness are massive: a recent European Commission study concludes that, from 1998 to 2008, exports of goods and services grew more slowly in Italy than in any other member country, Italy lost the most market share in its traditional geographic markets, and its market share fell by more than can be explained by cost considerations alone. Given Italy's specialization in low-skill goods, its inability to resort to currency devaluation is particularly challenging.

Hostage to Fortune

Italy's cycle of high debt and low growth has re-enforced itself for decades, but the uncertainty of the post-crisis world economy poses new risks. In the short term, continued failure by the Euro area to deal with the Greek crisis and contain its spread could easily lead interest premia to surge on both government and private borrowing, eventually stifling European demand. This would kill Italy's fragile recovery by forcing greater fiscal adjustment and further depressing exports.

On the other hand, sustained global growth would come with higher interest rates and could mean another large oil shock this year or next. This would hit Italy—a heavily oil-reliant country that imports 93 percent of its supply and is limited in its ability to increase exports in order to pay more—particularly hard.

The most pernicious risk is that Italy will continue to lose competitiveness against Germany and other trading partners as the wage and productivity differentials continue to widen. Unchecked, this process will eventually strangle the economy's ability to grow at all. Financial markets will react (or may anticipate the trend), forcing a Greek-sized surge in the cost of borrowing.

Policy Actions: A Three Year Plan

Italy should not wait for the heart attack before addressing its high blood pressure and excess weight.

- Over the next three years, it needs to increase its primary balance by 4 percent of GDP to ensure that its debt-to-GDP ratio begins to gradually decline again. By way of comparison, the primary balance improvement expected of Greece under its EU agreement is 10 percent of GDP over the same period.
- Italy must cut its unit labor costs and enact critical structural reforms in order to regain its lost competitiveness. A 6 percent claw back would regain only about a quarter of the competitiveness lost to Germany over the last ten years, but it would send an important signal to markets. This could be achieved immediately through a 6 percent across-the-board wage cut, beginning, as in other countries, with public sector workers. Alternately—and politically more likely—Italy could reduce wages more gradually, cutting them 1 percent per year over three years while also enacting structural reforms to raise productivity.
- Critical structural reforms would include removing rules that create a dual labor market and increasing the efficiency of backbone services, which affect the competitiveness of all firms in the economy.

Growth in the Euro area would also help the adjustment—not only in Italy, but also in Greece and other vulnerable countries.

- To ensure growth, Germany and other surplus countries should commit to stimulating domestic demand and relying less on exports to the Euro area.
- In addition, the European Central Bank (ECB) must maintain an expansionary monetary policy that errs on the side of growth for many years. Slightly higher rates of inflation are not likely to increase nominal interest rates immediately, and they will ease the necessary cuts in real wages.

- To help stimulate Europe's competitiveness during this crucial time, the ECB's explicit objective must be a weak euro, and the G20 must accept the lower euro if it hopes to avoid implosion of the Euro area. A sequence of sovereign debt crises in Europe would inevitably spill over onto some vulnerable emerging markets and could affect borrowing costs for governments in Japan and the United States, as well as hinder exports there and in China.

Europe's potential debt crises pose a large risk to a sustained global recovery; these policy changes are the premiums the world needs to pay to insure against another collapse.

PORTUGAL'S GROWTH CHALLENGE

SHIMELSE ALI

Unlike its most vulnerable Euro area counterparts, Portugal saw its boom that followed the adoption of the euro fade quickly. In the run up to the launch of the euro, its GDP had grown at an average annual rate of almost 4 percent—one of the highest rates in the Euro area and more than 1 percentage point above the Euro area average. However, the demand boom, which was triggered by a sharp decline in interest rates and fueled by expansionary fiscal policy, was not followed by a parallel increase in potential supply and, much like its boom, Portugal's rapid loss of competitiveness happened early relative to the other GIIPS. By 2001–2005, Portugal's growth rate had decelerated sharply to just one percent.

While Portugal is doing better than Greece in terms of controlling its budget deficit and public debt, its poor long-term growth prospects, drastic loss of competitiveness, and high public and private indebtedness all make the country highly vulnerable to the Aegean flu. Moreover, Portugal's reliance on Spain—itself vulnerable—as a market for 25 percent of its exports, adds to the contagion risk.

An Early End to the Euro Boom

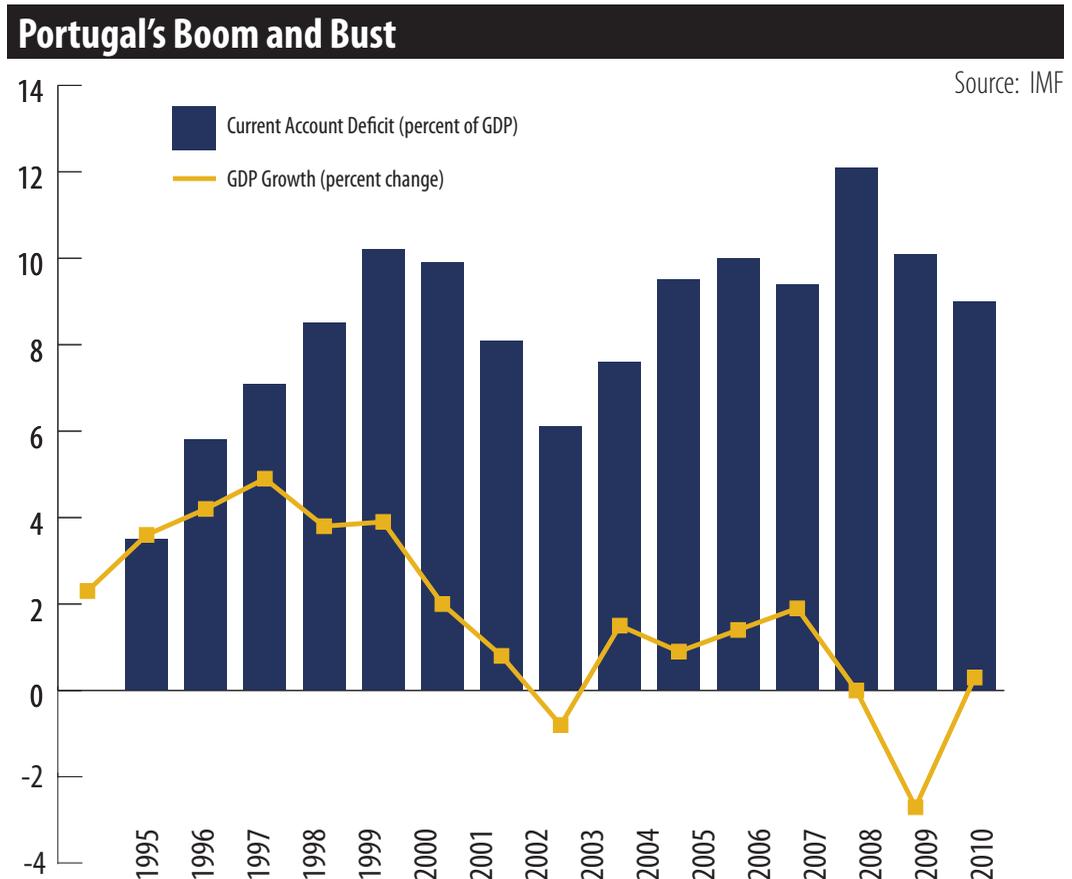
As in the other GIIPS, the euro's adoption led interest rates to fall sharply in Portugal—from an average of 12.3 percent in 1991–1995 to about 6 percent in 1996–2000—setting the stage for a consumption boom. Overly rosy expectations

This piece originally appeared in the May 13, 2010, edition of the International Economic Bulletin.

that Portugal's GDP per capita—less than 60 percent of Germany's from 1985 to 1995 in PPP terms, compared to 76 percent in Spain and 70 percent in Greece—would converge to Euro area levels likely further catalyzed the boom.

Between 1995 and 2000, private savings dropped by about 7 percentage points of GDP, while average gross fixed capital formation had accelerated. Household and non-financial sector debt more than doubled in percent of GDP terms between the mid-1990s and 2002. Reflecting external borrowing's role in financing consumption and investment, the current account deficit soared to 9.0 percent in 2000, up from near-zero in 1995.

Though tax revenues surged, fiscal policy was pro-cyclical, adding to the expansionary conditions. The primary balance deteriorated by about 3.5 percentage points of GDP between 1995 and 2001.



After formal adoption of the euro, monetary policy in the Euro area, while clearly too loose for Greece, Spain, and Ireland, who saw housing booms, was too tight for Portugal, where housing investment as a percentage of GDP had declined over time and inflation had dropped. As household spending stalled amid high levels of debt and prospects seemed to deteriorate—with little actual GDP per capita convergence—the investment and consumption boom came to an end. Household consumption grew by an average of 1.5 percent per year from 2001 to 2007, compared to 3–5 percent in Spain, Greece, and Ireland. GDP growth averaged just 0.8 percent between 2001 and 2008.

Though the Great Recession did not hit Portugal as hard as the other vulnerable economies, it did lead GDP to contract by 2.7 percent in 2009. GDP is projected to grow by 0.5 percent in 2010 and 0.7 percent in 2011, driven by external trade as domestic demand is set to essentially stagnate. The downturn is also having a significant impact on unemployment, which reached 10.7 percent last month, up three percentage points from two years ago—a relatively modest increase by the standards of Spain and Ireland. In addition, the crisis severely affected public finances, with the debt level reaching 86 percent, up from 66 percent two years ago.

What Explains the Stagnation?

Portugal's export structure at the launch of the euro was too weighted towards traditional slow-growing sectors where comparative advantage was shifting toward the emerging economies in Asia. The share of production in low-tech manufacturing sectors, for example, was 80 percent in 1995 and 73 percent in 2001. There is much evidence that Portugal's business climate was especially weak and labor markets inflexible.

These facts, together with the rapid deterioration of competitiveness clearly played a role in the early end of its Euro boom. Significant labor market tightening and rapid wage increases had characterized the boom, with wages per capita rising by about 6 percent annually from 1995 to 2002, twice as fast

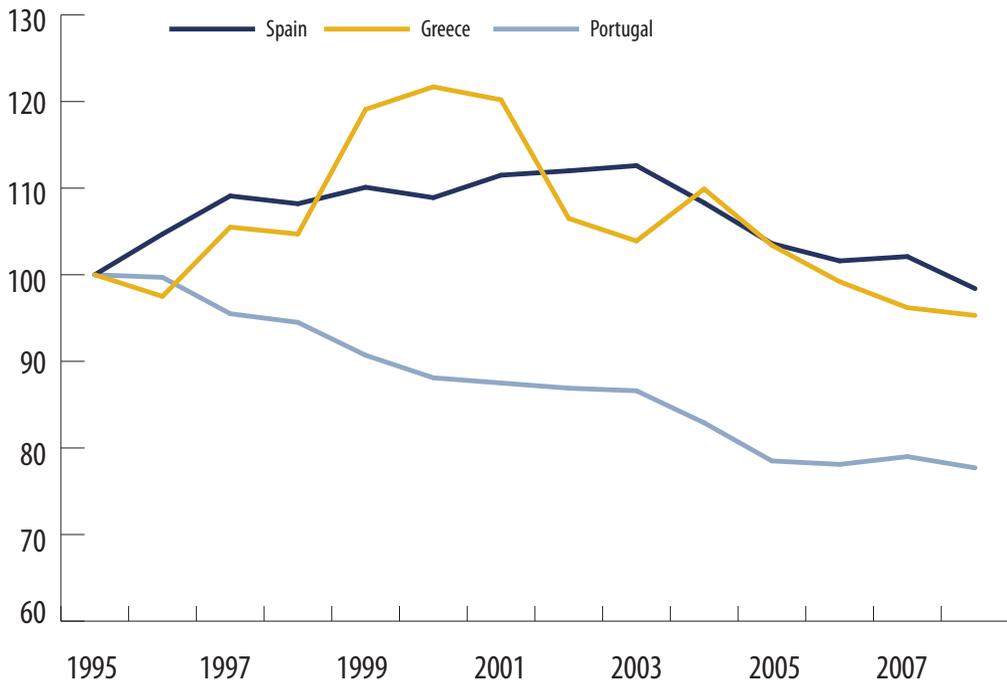
as the EU average. Moreover, while Portugal's wage bill increased by about two percentage points of GDP from 1995 to 2002, Spain's and Ireland's each fell by more than one percent. Portugal's government wage bill reached 15 percent of GDP in 2002, compared with an average of around 10 percent in the Euro area.

The consequence is an appreciation in the real effective exchange rate (REER) (based on unit labor cost)—about 12 percent from 1994 to 2000, while it remained more or less unchanged in Spain and Ireland. This appreciation, which favored domestic demand over exports and led to a build-up of macroeconomic imbalance, was reflected in the current account deficit's steady deterioration and the decrease in FDI inflows. FDI inflows fell below the Euro area's average in the second half of 1990s as the country became less attractive for investment. The country also saw a 10 percent loss in export market share from 1995 to 2000.

Evolution of Export Market Share*

1995=100

Source: OECD



* This shows whether the country's exports grow faster or slower than its market, i.e., if it is experiencing market share gains or losses.

At the same time, labor productivity slowed, with average annual growth falling from 3.1 percent in 1995–2000 to less than 1 percent in the beginning of this millennium. Labor productivity was also well below EU average—32 percent in agriculture, for example—in all sectors of the economy. The country's relatively low human capital formation and limited use of information technology partly explain this disappointing productivity performance. At 9 percent, Portugal's labor force participation in tertiary education is the lowest in the Euro area, compared to 18 to 22 percent in Spain, Ireland, and Greece. Similarly, Portugal's spending on R&D as a percentage of GDP is half of the average in the Euro area. Furthermore, its governance and business climate indicators are today among the lowest in the euro area.

Policy

Portugal could have taken the opportunity presented by the boom to move into higher value-added and faster growth sectors and toward a more outward-oriented production structure. Instead, its export structure was weighted too heavily toward traditional sectors. In addition, the government missed the opportunity to build a budgetary surplus—which would not only have balanced the budget, but would have also moderated the domestic demand boom and the excessive concentration in non-tradable activities. In hindsight, a tax structure weighted toward discouraging consumption and investments in non-tradables (e.g., housing) could also have been imposed.

Against the currently bleak outlook, the government has now devised a strategy to reduce its deficit from 9.4 percent in 2010 to below 3 percent of GDP by 2013. This would help stabilize the debt-to-GDP ratio at around 90 percent, compared to nearly 150 percent for Greece and 75 percent for Spain, according to their government plans.

The plan involves privatization, raising taxes on high earners and capital gains, and cutting civil servant wages and public investment spending. The recent announcement of tough austerity measures, including a 5 percent pay cut

for top government officials and a 1 percent increase in the value added tax, is encouraging. However, the growth assumptions underlying the deficit reduction projections are overly optimistic. They are based on stronger growth than has been observed historically and do not take the fiscal policy's potential deflationary effects adequately into account. In addition, Portugal's effort to increase taxes may face difficulties, as the country has one of the highest brain drain rates in Europe.

Furthermore, while this strategy may buy some time and should help dampen wage growth and reorient the economy toward exports, it is unlikely to address the country's low productivity and slow growth on its own. Policy needs to concentrate on boosting competitiveness, especially through increased flexibility in labor markets, and increased competition in relatively sheltered backbone services. In the longer term, improving the country's human capital base is of paramount importance to improve productivity and would also help Portugal regain attractiveness with foreign investors. In addition, Doing Business indicators where Portugal performs poorly—especially in starting a business, paying taxes, and getting credit—suggest that a systematic approach to correct deficiencies in its business climate is needed.

CAN SPAIN OVERCOME THE AEGEAN FLU?

URI DADUSH AND VERA EIDELMAN

The answer depends on how quickly and forcefully the government responds. The challenges confronting Spain stem from the same source as those in Greece: a huge misallocation of resources and loss of competitiveness that began with the adoption of the euro. Spain's non-tradable sectors—housing, government, and a broad array of market services—had grown far too big. Spain has a debt-to-GDP ratio that is half that of Greece and thus has more time and resources to fix its problems. However, its large deficits and the collapse of its post-euro growth model imply that its public debt could—if remedial measures are not taken—follow an exploding path.

Moreover, Spain has to effect a profound structural transformation and cannot look to a cyclical recovery to reignite growth and reduce its mass unemployment. It must instead unwind distortions that were built up over more than a decade, restore its competitiveness, and reallocate resources to manufacturing and other growing tradable sectors. With currency devaluation not an option, these reforms will only happen if unit labor costs, house prices, and the price of services decline relative to its European partners. A smaller government sector and other far-reaching reforms must kick-start this process, and do so soon.

The Euro and the Boom

The housing sector's boom and bust has undeniably defined Spain's crisis. At its peak, construction value-added reached 17 percent of GDP, compared to a peak of less than half that in the United States. In just ten years, Spain's housing prices more than doubled, and, at the peak in 2006, Spain started more homes than the UK, Germany, France, and Italy combined, a significant share of which were sold to foreigners.

The housing sector's boom was only one manifestation of a deeper structural misallocation, however. In the run-up to the euro, interest rates plummeted and confidence soared, leading domestic demand and inflation to rise more than 1.5 times faster than the Euro area average. A European monetary policy that was too loose for Spain reinforced these trends.

Amid this demand boom, the price of all non-tradable activities rose relative to that of tradables (whose price is set in world markets); investment and labor were pulled into these non-tradable sheltered sectors; and wages were bid up higher than in other Euro area members and in excess of productivity. Spain's manufacturing sector, already small at the start of the process, shrank its share of GDP by 4 percent. Amid this boom, Spain's tax receipts swelled temporarily,

generating more revenue than expected. As a result, the government was able to rapidly expand spending—by 7.5 percent of GDP from 2005 to 2009—while creating the impression of solid fiscal management and maintaining a public debt-to-GDP ratio

Manufacturing Value Added

Percent of GDP

	2007	Change Since 2000
Germany	24	+1
Ireland	22	-10
Italy	18	-3
Spain	15	-4
Portugal	14	-3
Greece	10	-1

Source: World Bank

that was among the lowest in the Euro area. Though Spain's government sector is smaller than that of some other large European countries, its rapid expansion contributed to Spain's weak productivity performance.

Lost Competitiveness

Even as Spain's economy boomed, growing almost 1 percent per year more on average than the Euro area from 1999 to 2007, its total factor productivity (TFP) fell behind. Between 2000 and 2008, TFP was essentially stagnant in Spain, compared to average annual growth of 0.9 percent in Germany and 1.4 percent in the United States. Spain's non-tradables—including post, telecommunications, and transport—fared particularly poorly.

Nonetheless, booming demand led wages to grow faster in Spain than in its partner countries. Since 2000, Spain's hourly labor costs have consistently outpaced those of the Euro area by more than 1 percent per year. Spain's labor market rigidities, including a dual labor market that protects permanent workers and their wages, accentuated the rise. Spain's unit labor costs (ULC), the average cost of labor per unit of output, have risen more than 30 percent since 2000, whereas Germany's nominal wages have grown roughly in line with productivity.

Relative to the United States and Japan, which both saw ULC in euros decline by more than 20 percent (partly due to euro appreciation), Spain has suffered an even greater competitiveness loss. Though comparable figures are not available for China, enormous labor productivity increases and modest currency changes almost certainly caused ULC in euros to decline there as well.

Over the last decade, Spain's exports have lost share in world markets but

Rapidly Expanding Expenditure

Increase in Government Expenditure's Share of GDP, 2005–2009

Germany	0.8
Ireland	14.5
Italy	3.7
Spain	7.5
Portugal	3.4
Greece	6.6

Source: Eurostat

have roughly matched the advance of other Euro area exporters. This perhaps seems adequate at first glance, but is wholly unsatisfactory in reality, given that Spain's productive capacity surged relative to that of its Euro area partners due to immigration and investment growth, and that its import demand expanded correspondingly.

In fact, exports as a share of GDP fell by 3 percentage points from 2000 to 2008 in Spain, compared to a rise of nearly 14 percentage points in Germany. While Germany grew its current account surplus, Spain's plunged into deep deficit. In this regard, Spain shared the experience of Greece, Ireland, and Portugal, which also became excessively dependent on domestic demand and non-tradables.

Spain's deteriorating national balance sheet reflected these trends. The country's net foreign liabilities reached nearly 80 percent of GDP in 2007, third largest in the Euro area, and loans to households and non-financial corporations grew to more than 200 percent of GDP—more than double their level in 1998.

The Crisis

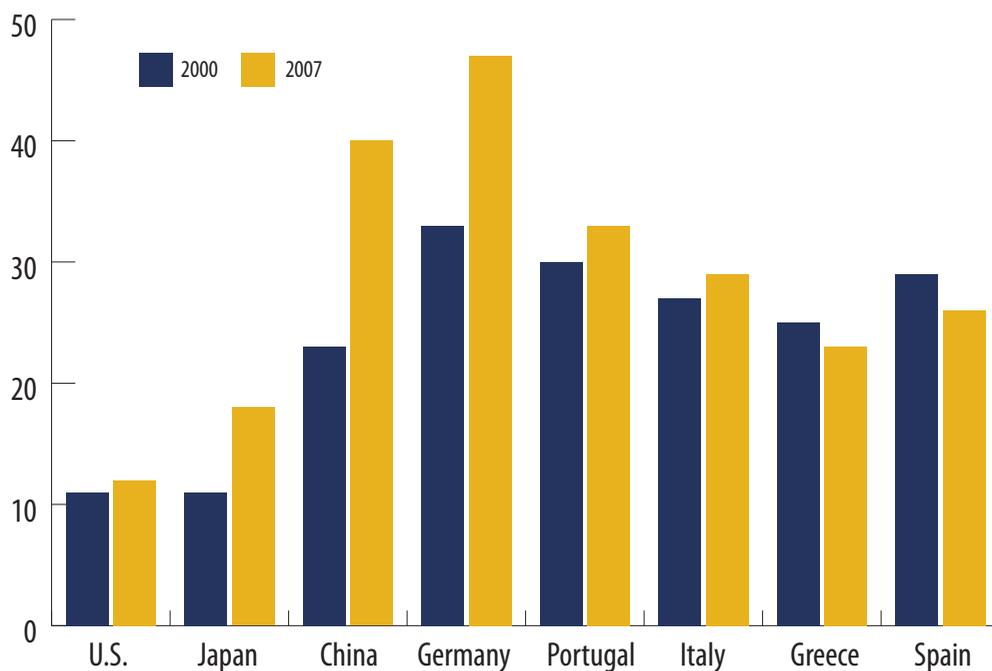
The Great Recession helped reduce the current account deficit and restore household savings rates, but it also crippled domestic demand and exposed the fragility of Spain's growth model. Though world GDP is now growing, Spain's economy is expected to contract an additional 0.4 percent this year. Spain's banking sector weathered the crisis relatively well, but according to the IMF, its savings banks may see a net drain on capital of 2 billion euros—nearly 30 percent of their reserves for repossessions—if, as expected, unemployment rises and housing prices fall further.

The massive rise in unemployment—which crossed the 20 percent threshold in April—should be interpreted as part of the unwinding of the structural misallocation, as it reflects not only the effects of global trade's collapse on manufacturing (which is now recovering) but also the collapse of demand for housing and non-tradable activities generally.

Exports of Goods and Services

Percent of GDP

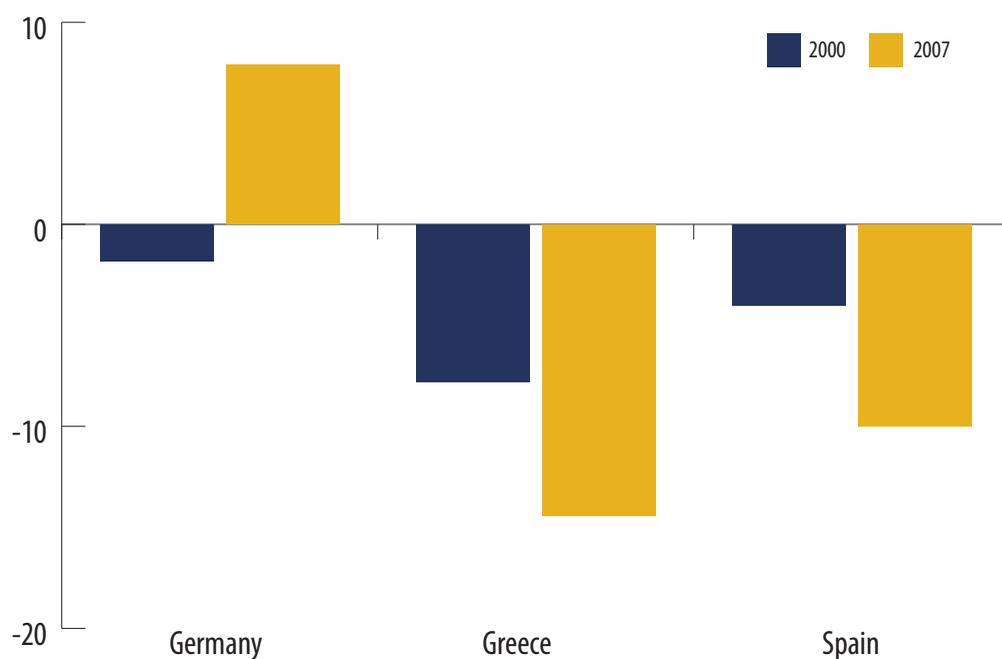
Source: World Bank



Current Account Balance

Percent of GDP

Source: IMF



The crisis also exposed the fragility of Spain's tax base and its unsustainable expenditure increases. In 2009, the fiscal deficit reached 11.4 percent of GDP, comparable to that of Greece and more than double that of Italy. Though the debt-to-GDP ratio remains among the lowest in the Euro area, it is rising more rapidly than in any other country.

What To Do

The collapse of domestic demand has already begun to reverse the imbalances begun by the long euro boom. But the adjustment will not reach the protected sectors—the government, labor markets dominated by “insiders,” savings banks dominated by regional politics, and so on—unless explicit reforms are undertaken. The protected sectors are so important that, if they do not adjust, they will prevent the wider economy from doing so. The faster prices and wages in the protected sectors adjust to the new situation, the smaller the decline in activity needs to be to redress Spain's imbalances.

The anti-flu medicine is familiar, but the pharmacist has yet to deliver it.

Start with government spending. Though Spain has put forth plans to cut its primary balance (the fiscal balance excluding interest payments) to below 3 percent by 2012, the government's ambitious austerity plan is not set to kick in until next year, which is too late to preempt contagion from Greece.

Reduce the unit cost of labor. Spain should aim to recover competitiveness against Germany at the rate it has lost it. Since Germany's unit labor costs are essentially flat in nominal terms (wages grow in line with productivity), Spain should target a six percent reduction in ULC over the next three years. How to achieve this? A freezing of, or modest reduction in government wages, will set a benchmark for wage-setting in the private sector. Rigidities that favor “insiders,” including large severance payments and indexations, need to be removed, and greater reliance must be placed instead on social safety nets.

Encourage reallocation across sectors. Acceleration of other structural reforms will help boost productivity and avoid extreme wage cuts. Broader measures to increase competition in backbone services such as transportation, finance, communications, and energy will help lower prices and encourage investment in growth sectors such as information technology and clean energy. Forcing a restructuring of savings banks that underpin the real estate market will set the stage for a faster liquidation of the vacant housing stock and a sharper fall in rents and housing prices.

Demand a coordinated effort across Europe. These measures, needed in Spain as well as in other vulnerable countries, will cause deflation unless they are accompanied by more expansionary policy in the rest of Europe. Germany and other surplus countries should commit to stimulating domestic consumption and investment. Meanwhile, the European Central Bank must maintain an expansionary monetary policy for many years, and should explicitly target a lower euro. The G20 should support this course to avoid an implosion of the Euro area, which would threaten the global recovery and could spread to other countries with high and rising public debts.

This plan could, if vigorously executed, and if the global recovery is sustained, lead Spanish exports to rise more rapidly (say, six to eight percent a year in real terms, in line with world trade projections), while domestic demand and imports decline or remain steady. Spain could then complete its structural transformation within three to four years and, with luck, not succumb to the Aegean flu.

PART III

REMEDIES

A THREE POINT PLAN TO SAVE THE EURO

URI DADUSH

The rescue package requested by Greece will, if endorsed, buy the Euro area six months, perhaps a year at most. By then, the Greek government will have exhausted the aid and be forced to ask for more or to borrow at astronomical rates. This assumes that, before then, Greece does not precipitate into an even deeper confidence crisis, causing a meltdown of its banks and tax base, and that the contagious fever affecting other countries is contained.

But even if it does restore a measure of confidence, the rescue package will not have addressed the fundamental causes of the Euro area crisis, of which Greece is only the harbinger. Fiscal problems and widening sovereign spreads are the crisis's most evident symptom but they are inextricably associated with a deeper malady, the slowdown in productivity and loss of competitiveness in Greece, Ireland, Italy, Portugal, and Spain. Since the euro's inception, these countries have to a massive degree lost competitiveness against Germany and, even more so, against the United States, China, and Japan.

The implication of this loss of competitiveness is a decline in their potential growth rate, and, consequently, of their ability to accumulate not only public but also private debt. This has been evident for at least five years in Italy and Portugal, but was concealed until recently by an unsustainable demand and housing boom in the other three countries. In all five countries, the effect of the Great Recession

was to lay bare the fragility of their post-euro growth model and to expose or underscore the unsustainable trends of their debts.

As experts and the public have known for a long time, dealing with these problems requires major structural as well as fiscal reforms. That is daunting enough. But the situation is now complicated by the conclusion reached by numerous analysts that Greece is insolvent and that its debts will sooner or later have to be restructured, and by the contagious decline of confidence in other countries.

The question, then, is how to use the six months gained by the Greek rescue package. Here is a plan that, while not guaranteed to work, would greatly increase the likelihood of the Euro area surviving in its current form.

First, task the International Monetary Fund to come up with a recovery plan that is far-reaching but also provides the time needed for the Greeks to execute it credibly. Just to stabilize its debt ratio at the current 150 percent of gross domestic product (GDP) would require Greece to make a huge fiscal adjustment, equivalent to at least 12 percent of GDP. That implies even larger declines in output. That is why an agreed rescheduling of Greek debts (extending the maturity of the outstanding debt while maintaining interest payments), and perhaps “haircuts” (creditors taking losses on the principal), appear inevitable.

Although Euro area leaders are refusing even to discuss a restructuring, the financial markets have already discounted very large losses on Greek debts. They will not lend to Greece at reasonable rates until there is clarity about how it will manage its way out of the mess. The alternative would be for the Euro area to cover Greece’s financing requirement over the next three years, some 60 billion euro each year.

Second, as part of a preemptive program to contain contagion from Greece, other vulnerable countries should accelerate measures to address their fiscal and competitiveness problems.

A good guideline for them should be to reduce the primary balance—the budget balance excluding interest payments—by enough to ensure that the debt-to-GDP ratio is firmly on a downward path within three years. In the case of

Spain, for example, this means reducing the primary balance by some 8 percent over three years, and in Italy by 4 percent. In both cases, that is more than is currently being contemplated.

The other, equally important reform relates to competitiveness and productivity. A good guideline is that countries should now aim to recover competitiveness vis-à-vis Germany at the rate they have lost it. Since unit labor costs in Germany are about flat in nominal terms (nominal wages rise almost in line with productivity), this means that unit labor costs in the vulnerable countries need to decline by 5–7 percent over three years. This calls either for modest wage cuts or—better—for structural reforms to boost productivity (or for both). The main structural reforms should relate to increasing flexibility and competition in the non-tradable sector, including a smaller and more efficient government, and reforms of the labor market. Some of these reforms would take time to bear fruit, but enacting them over the next year would help reassure markets that the tide was turning.

Third, Germany and the other surplus countries should support a three-year program to expand demand by about 1 percent of the Euro area's GDP in order to offset the deflationary impact of fiscal adjustments in the vulnerable countries.

Hopefully accompanied by a world trade recovery, the aim of such a program should be to keep the aggregate European growth rate in the 2 percent+ range, even at the risk of slightly higher inflation in surplus countries. Reforms favoring consumption and domestic investment in countries with budget surpluses, a continuation of a policy of low interest rates in the Euro area and an explicit favoring of a weaker euro would help boost growth. The G20 should support the program as a means of avoiding a string of sovereign-debt crises endangering the global recovery.

It is high time for the Euro area leaders to move from denial to action—not only in Greece, but, just as importantly, at home.

If all goes well, this episode may be remembered as the Euro area's adolescent crisis.

EUROPE BOUGHT TIME AND NOT MUCH ELSE

URI DADUSH AND MOISÉS NAÍM

Stock markets reacted euphorically Monday to the massive rescue package announced the night before to prop up crashing European economies. Passions cooled slightly on Tuesday as the market rally halted, but still, it seemed, all was as it should be: The package agreed upon in Brussels provides Europe's embattled economies with a much needed respite and may even save the European integration project from the disaster of several countries being forced to shed the euro. It is all good news—that is, if it works.

Unfortunately for Brussels, however, whether or not the package works is not a decision that will or can be decided there. The real decisions needed to deal with Europe's crisis will have to be taken in Portugal, Spain, and Italy. It won't be easy; belt-tightening and tough choices are needed. This is something last week's rioters in Athens seemed to understand all too well. Therefore, as the different countries attempt to reform their economies, expect street demonstrations in Lisbon, Madrid, and Rome.

Before raining on the parade, however, we should mention an upside to the Brussels package. The measures taken are important not just because of the unprecedented amount of money involved (the size of the financial package is larger than the economies of Finland and the Netherlands combined) but also because they mark the end of two dangerous ideas—and their promotion by European leaders.

This piece originally appeared in the May 11, 2010, edition of Foreign Policy.

First, the bailout requires Europe to admit that the eurozone setup is defective at its very foundation. The measures mark the end of the misguided hope that centralized monetary policy can co-exist with decentralized fiscal behavior. Since the single currency's inception, interest rates and the money supply for the whole of Europe have been decided by a single entity, the European Central Bank (ECB), while taxes and public expenditures remain under the control of each national government. The recent decisions explicitly recognize that a monetary union is as weak as its weakest link and, as such, requires strong fiscal coordination. Inevitably, this means that countries will have to cede some of the autonomy that they have thus far used to (mis)manage their fiscal affairs. On the other side, the ECB's decision to buy government bonds is also a landmark, eliminating the pretense that the central bank will not help governments in difficulty under any circumstance.

Second, the measures also mark the end of the pretense that the eurozone can and will take care of its problems without anyone else's help. For this emergency, help was marshaled not only from other EU countries that are not members of the Eurozone but also from the U.S. Federal Reserve and the International Monetary Fund (IMF). The IMF will carry an unprecedented financial burden in support of Europe's rescue, and its help never comes without stringent conditions: The IMF will play a central role in dictating how Europe has to behave in order to access the funds it needs.

Shedding these illusions is good news. But that's where the good news ends. For a start, 750 billion euros represents only about eighteen months of the financing requirements for Europe's most obviously vulnerable countries, which, contrary to pretense, also include Italy, whose debt burden and labor cost disadvantage is as high as that of Greece. The solution to their problems—a loss of competitiveness, inflated government payrolls, and rigid labor markets—obviously won't come with a new borrowing facility. These measures only buy time, and not very much time at that.

Indeed, the time available to bring these countries back from the brink is very limited. This is not about governments bailing out insolvent banks, as was the case with the financial rescues at the end of 2009; this is about unsound

governments trying to bail out other unsound governments. Greece, Portugal, Spain, and Italy, for example, are on the hook for more than 6 percent of their GDP in support of the agreed facilities, not counting any money that the European Central Bank might lose on the government bonds it has agreed to buy. That's money that these countries simply do not have. And with the average debt to GDP ratio of advanced G20 countries on pace to hit 120 percent by 2015, the financial ability of Germany, France, and others to backstop Europe's errant countries is also in doubt.

The real problem is that Europeans are not ready for the reforms they need, and politicians have not clearly explained the severity of the situation to their citizens. Europeans must realize that, unless Europe moves forward with the necessary and deeply unpopular reforms still required, the newly available money will do little to save them. Rather than postponing reforms again, leaders must use the time they just bought to build the political coalitions needed to implement the necessary changes.

What will that look like exactly? The medicine for these sick countries is well known. Spain, Portugal, and Italy must cut their budget deficits, freeze or reduce government wages, and reform labor markets in a quest to boost productivity and claw back some of their lost competitiveness vis-à-vis Germany. Meanwhile, Germany and other healthier economies must take more aggressive measures to boost domestic demand in order to keep Europe from spiraling into deflation.

And yes, under this scenario, European leaders must come clean soon on cases in which debts simply cannot be repaid (which is obviously the case in Greece) and insist that—instead of the European and Greek taxpayers carrying the entire burden—the private creditors also take a hit.

The way to gauge the economic measures decided by the European leaders on Sunday is not by watching the gyrations of the stock markets. The real mark of success will be the determination and speed with which Europe's individual economies pursue tough reforms at home. And, tragically, that is why street demonstrations in Lisbon, Madrid, or Rome would be a better indicator of the seriousness with which governments are pursuing the reforms.

EMERGING FROM THE EMERGENCY

PAOLA SUBACCHI

The eurozone's 720 billion euro emergency funding facility, which follows and complements the 110 billion euro rescue package approved for Greece, comes with some seemingly tough conditions attached. Nonetheless, issues of credibility and moral hazard remain, because, despite their repeated commitment to the Lisbon treaty's 'no bail-out' clause, European governments—and the International Monetary Fund (IMF)—eventually provided a safety net for countries at risk of default.

Does this affect the eurozone's credibility? Probably not. Financial markets never believed the 'no bail-out' clause. Nor was confidence boosted by the eurozone's clumsy attempts to avoid anything that looked remotely like a concession to lax fiscal policies. If, at the beginning of the Greek 'tragedy', the eurozone had come out with a credible plan and delivered a message of confidence with one voice, it would have proved more effective—and, in the long run, less costly—to reassure investors, tame volatility, and reduce uncertainty.

The stabilization scheme is good news, as it signals Europe's ability and willingness to coordinate a policy response and its desire to avert the currency union's collapse. But European governments may not have done enough to convince the markets. If investors become persuaded that fiscal consolidation is neither economically feasible nor politically manageable, they will further test Europe's willingness to support the euro. But the scheme is not large enough

to deal with contagion spreading in all countries at risk—especially if Italy is involved. It can buy some time to restore fiscal stability and promote growth, but credible action to prevent contagion is now imperative.

The implicit message of the stabilization scheme is that the onus for restoring confidence now falls on all countries with severe fiscal shortfalls as well as competitiveness problems. But leaving these countries—Portugal, Spain, Italy, and Ireland as well as Greece—to their own policy devices and domestic constraints is a recipe for disaster. The austerity measures these countries are now unveiling are too timid, too narrowly based, and too vulnerable to political pressures to persuade investors. More generally, this crisis has demonstrated how domestic failings can necessitate an emergency intervention by Europe. A European response is also needed when the emergency has passed.

In the case of those countries with the severest fiscal problems, European governments—not just the European Commission and the International Monetary Fund—should be able to discuss, propose, and oblige appropriate action to be taken—and even agree on appropriate sanctions. They should also monitor implementation of the plans.

As well as setting out concrete steps for fiscal consolidation (as current plans do), the plans should set out methods to improve competitiveness and increase productivity, trying to achieve the right balance between fiscal measures and growth-oriented policies, between fiscal coordination and structural reforms. The plans should be credible and there should be no room for complacency. Furthermore, with the public opinion in most vulnerable countries, at best, uncommitted to or, at worst, hostile to any austerity measure, reaching out and building support is critical. Fiscal measures and plans for reforms therefore have to be clearly communicated, while the burden of the adjustment process should be distributed in a transparent and fair way so that people in those countries do not feel unjustly hit.

Beyond these emergency measures, measures are needed to identify potential emergencies. We know that Greece was the tip of the iceberg, rather than an isolated case. Clearly, surveillance at an EU level was not strong enough to prevent

countries from building up unsustainable debt positions. As has been proposed, member states should have the right to review other member states' annual budgets. Such reviews would also act as a means of monitoring compliance with agreed objectives. And surveillance should not be confined to budgetary matters, but should be extended to the main economic indicators, such as GDP growth, productivity growth, and balance of payments.

Greece's problems have also demonstrated that there was a lack of due diligence when the country was admitted to the currency union. Greater thoroughness—as well as fuller scrutiny of its figures—would have revealed Greece's structural shortfalls.

Future bids for membership of the eurozone should be reviewed more rigorous. Estonia, whose application the European Commission was approved last week, may provide a test case. The release of timely, reliable and comparable series of macroeconomic indicators—Greece's statistics were not—should become part of the requirements for members-to-be. The criteria for membership should be changed: the Maastricht criteria assume 'one size fits all.' Cyclical as well as structural indicators should be considered.

A currency union requires accurate statistics, a full exchange of information, cooperation on policy and peer pressure. The survival of the single currency union depends on them.

BEWARE OF INFLATION FUNDAMENTALISM

URI DADUSH AND MOISÉS NAÍM

What happens in Greece will not stay in Greece. Even though the country accounts for only 0.5 percent of the world's economy, the crash of that profligate nation will have global consequences. The financial irradiation from Greece may be the biggest threat so far to the euro and, indeed, to the European project.

Too much spending, too little tax-collecting, and book-cooking are at the core of Greece's troubles. But this is not the entire story: Spain and Ireland are in trouble even though their public debt as a percentage of gross domestic product is much smaller than that of Germany. Italy, also in the financial markets' crosshairs, has high public debt but a lower deficit than the eurozone's average. Good fiscal management did not inoculate Spain against mass unemployment.

At the root of these countries' problems is the fact that their prices and wages have risen much faster than those of Germany and other eurozone members. This loss of competitiveness can no longer be compensated for by currency devaluation. Property bubbles in Ireland and Spain contributed to the troubles. Wage pressure and rigid labour laws across most of these countries did not help either.

Since abandoning the euro looks, at least for now, unthinkable, these countries risk years of wage and budget cuts with anaemic growth, high unemployment, and deflation.

This piece originally appeared in the March 5, 2010, edition of the Financial Times.

There are ways to mitigate the pain. For example, Germany and other countries could adopt more expansionary fiscal policies for a while. Or, more powerfully, the wider Euro area could adopt more expansionary monetary policies for several years. Today, this second option is anathema as the “inflation fundamentalists” will have none of it. This elite of central bankers, top economic officials, politicians, academics and journalists maintains the risks of allowing inflation to climb above 2 percent are unacceptable.

Their view is informed by the disastrous experience with hyperinflation in Germany in the 1930s and stagflation in industrial countries in the 1970s and 1980s. Undoubtedly, moderate inflation can creep up to become high inflation. But, like many good ideas that take on the mantle of a cult, inflation fundamentalism can hurt. There is little if any empirical evidence that moderate inflation that stays moderate hurts growth. In most countries, cutting actual wages is politically difficult if not altogether impossible. But, to regain competitiveness and balance the books, real wage adjustments are sometimes inevitable. A slightly higher level of inflation allows for this painful adjustment with a lower level of political conflict.

Ultra-low inflation, on the other hand, can easily become deflation in a recession. Falling prices encourage people to defer spending, which makes things worse and erodes tax payments, impairing a government’s ability to service debt, which, in turn, increases the debt’s size and costs.

The harms of inflation fundamentalism do not stop there. A single-minded focus on inflation makes it easy for policy makers to lose sight of the broader picture—asset prices, growth, and employment. Policy can become too tight or too loose—as in the run-up to the crisis in the United States when low inflation was seen as a comforting sign that things were in order.

Very low inflation also reduces the effectiveness of monetary policy when growth slows since interest rates cannot go below zero. In the current crisis, governments were forced to rely too much on fiscal stimulus, and central banks to buy securities directly, taking on more risk themselves, and distorting financial markets.

The crisis in the euro area underscores the need for a more open-minded discussion of the merits and costs of ultra-low inflation, and Olivier Blanchard, the IMF's chief economist, has just called for consideration of a more moderate (4 percent) inflation target. This took courage. Coming from what was once the temple of inflation fundamentalism, it is akin to the chief rabbi calling for reconsideration of kosher laws.

The reaction of members of the European Central Bank council to Mr. Blanchard's proposal? "Playing with fire," "extremely unhelpful," and even "a satanic error." The euro crisis and the dismissive reaction to a proposal from a respected source are sure signs that the time for serious scrutiny of inflation fundamentalism has come.

PART IV

**EFFECTS ON
THE REST OF
THE WORLD**

THE EURO CRISIS IS BIGGER THAN YOU THINK

URI DADUSH AND SHIMELSE ALI

The eight newest European Union (EU) members (Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, and Romania) are committed to eventually adopting the euro. But, all already suffer from the problems that dragged the GIIPS—Greece, Ireland, Italy, Portugal, and Spain—into crisis: lost competitiveness, widening external deficits, and deteriorating public finances. However, the “peggers”—Estonia, Latvia, Lithuania, and Bulgaria, who have fixed exchange rates—are in much worse shape than the “floaters”—the Czech Republic, Hungary, Poland, and Romania. The structural distortions, including external imbalances, in all of the newcomers suggest that none of them will be ready to join the euro soon, as joining would likely only accentuate the distortions. When, or if, they adopt the euro, they should apply valuable lessons from the GIIPS’ experience so as to avoid painful adjustments later on.

The Initial Boom Among the Newcomers

The process through which the EU newcomers lost competitiveness was largely similar to the one in the GIIPS: lower interest rates and their expectations of rapid convergence to Euro area members’ economic fundamentals led to a boom in domestic demand. Deepening financial integration and low barriers to incoming capital, as well as reduced perceptions of exchange rate risk, particularly among the peggers, helped attract capital inflows. This furthered the demand

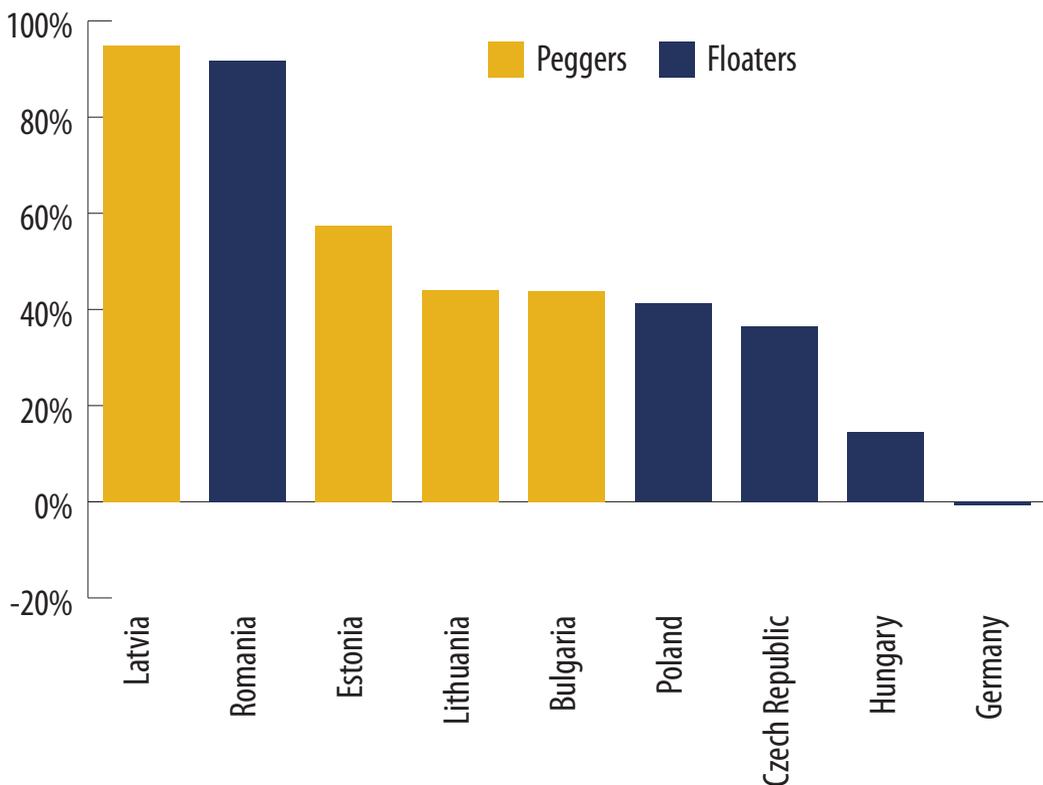
surge, which saw domestic demand grow by more than 10 percent annually in the three Baltic states (Estonia, Latvia, and Lithuania) and by nearly 9 percent annually in Bulgaria from 2002 to 2007. The price of non-tradables rose compared to tradables and labor markets tightened—inducing wage increases well in excess of productivity. The deterioration of competitiveness soon resulted in large macroeconomic imbalances. Economic activity was pushed above potential, and the output gap (the difference between actual GDP growth and potential GDP growth as a percentage of potential GDP) in the three Baltic states grew to be very large. The phenomenon was less pronounced among the floaters, but Romania and the Czech Republic also observed rapid output gap growth.

Real effective exchange rates, based on unit labor costs, appreciated significantly in most of the newcomers, particularly in Latvia and Romania. This

Change in Unit Labor Cost

In euros, 2004–2008

Sources: OECD, Eurostat



was reflected in the deterioration of their export performances, especially among the peggers. The external trade balance widened by 10 percent of GDP in Bulgaria and 14 percent of GDP in Latvia, from 2002 to 2007.

Peggers and Floaters

Both external and domestic imbalances have grown to be much more pronounced in the peggers. While a fixed exchange rate appeared advantageous during the pre-crisis boom when the peggers grew faster than the floaters, the downturn that followed has also been much greater in the former.

After joining the EU, the peggers saw wages grow at double-digit average annual rates from 2004 to 2008. The average rate reached about 25 percent a year in Latvia—more than ten times the Euro area average. Unaccompanied

by matching productivity increases, this led unit labor costs (in euros) to nearly double in Latvia and grow 45–60 percent in Estonia and Lithuania—significantly faster even than in the GIIPS. While unit labor cost increases were generally moderate among the floaters, Romania saw an increase of about 90 percent.

The sharp drop in capital inflows after mid-2008 to the Baltics, which experienced the largest surge in inflows before the crisis and relied on foreign banks to fund credit growth, resulted in a deeper downturn. In 2009, domestic demand fell by about 25 percent in the Baltics—almost eight times the decline in

Change in External Trade Balance

Percent of GDP, 2002–2007

Peggers

Bulgaria	-14
Latvia	-10
Lithuania	-7
Estonia	-4

Floaters

Romania	-6
Poland	0
Hungary	4
Czech Republic	7

Source: World Bank

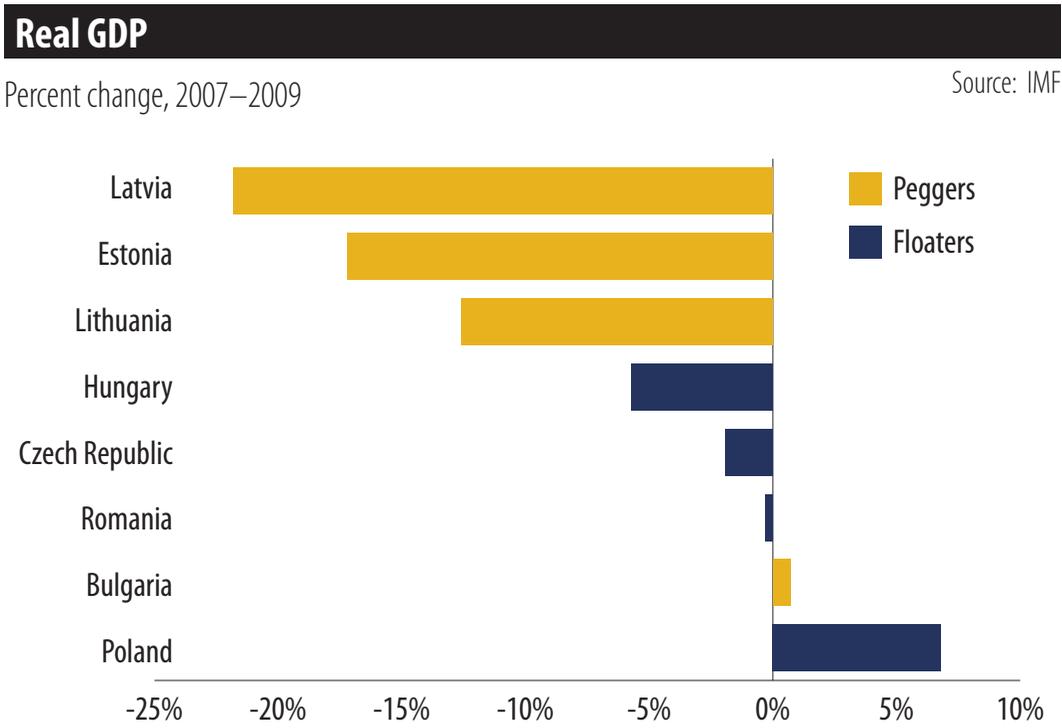
the Euro area—and by about 15 percent in Bulgaria. Unemployment, which had been declining amid the pre-crisis domestic demand boom, shot up in 2008 and 2009, with the increase ranging from around 9 percentage points in Estonia and Lithuania to double-digits in Latvia.

The floaters enjoyed a less pronounced boom, but, with a wider range of policy instruments at their disposal, they were also able to moderate their recessions. GDP contracted by 4–7 percent in Hungary, the Czech Republic, and Romania in 2009, still greater than the Euro area's average contraction of 4.1 percent but much less than the peggers' contraction. Currency depreciation and expansionary monetary policy helped. The currencies in Hungary, Romania, and the Czech Republic depreciated by 10 to 20 percent against the euro from the third quarter of 2008 to the second quarter of 2009, while Poland's zloty depreciated by more than 30 percent, giving the economy a needed export boost. Poland was the only EU country to register positive growth in 2009. However, given the severity of the liquidity crunch, several of the floaters were forced to rely on IMF support.

Ready to Join the Euro?

None of the newcomers appear ready to adopt the euro soon, even assuming that the Euro area countries were able to quickly restore stability and investor confidence in their economies. Despite the particular attention on fiscal criteria for joining the Euro area, however, and the painful austerity measures the newcomers undertook during the recession, the core problems in these non-euro economies are a loss of competitiveness and excessive allocation of resources toward non-tradable sectors, not fiscal mismanagement.

Estonia has a much better fiscal situation than the others and is expected to adopt the euro in January 2011. However, it had been running very large current account deficits—averaging about 12 percent of GDP between 2002 and 2008—and its gross external debt more than doubled, which raised concerns about its external sustainability. While the country managed to turn the current account deficit into surplus in 2009, it came at the expense of an increase of



about 10 percentage points in the unemployment rate. Among the floaters, where competitiveness is a less obvious problem, only the Czech Republic exhibited inflation and interest rates that satisfied the convergence criteria last year.

With gross debt less than the Euro area’s prescribed 60 percent of GDP, the newcomers, with the exception of Hungary, are currently in a much better debt position than the GIIPS. However, their debt is rising rapidly. For example, Latvia’s debt level in 2010 is projected to be about four times its 2000–2007 average and the debt level in Estonia and Lithuania is expected to double over the same period. Though the debt-to-GDP ratios are low, they can quickly become unsustainable if the competitiveness problems are not addressed. The governance indicators of the newcomers, with the exception of the Czech Republic and Estonia, rank below debt-burdened Greece and lag the other euro countries by a wide margin, suggesting that their capacity to carry large amounts of public debt without alarming the markets is limited.

While devaluation could, combined with other measures to restrain demand

and wages, help the peggers regain some lost competitiveness, their large foreign-currency-denominated debt deters them from straying from the euro. Loans denominated in foreign currency amount to nearly 90 percent of total lending in Latvia, 85 percent in Estonia, and 65 percent in Lithuania. Even among the floaters, the scope for exchange rate flexibility is limited by the degree of foreign-currency borrowing. Hungary and Romania, for example, have large euro-denominated debts to Austrian banks.

Lessons From the Crisis

One obvious lesson for the Euro area is that it must tighten its criteria for admission. In particular, the Maastricht fiscal deficit criterion of 3 percent of GDP, which has frequently been criticized as too rigid in a downturn, is also misleading for newcomers. Rather than target a small deficit, they should run large fiscal surpluses to offset the demand boom that typically accompanies euro adoption. Furthermore, much like the GIIPS, the EU newcomers have a long road of competitiveness-restoring reforms ahead, including wage cuts and fiscal austerity. At the same time, they can learn from the GIIPS experience. Three other important lessons have emerged for the newcomers:

- **First**, competitiveness needs to be closely monitored and, since currency devaluation is not an option under the euro, reforms must be made early on. For example, a tax structure that weighs more on construction and services could help moderate the demand for and supply of non-tradables.
- **Second**, special attention needs to be placed on wage-setting and labor market flexibility, as well as on how to bolster the tradable sector.
- **Third**, there is a strong case for moderating the inflow of foreign capital, especially debt-creating capital, during the early years of euro adoption via tighter bank regulations on borrowing abroad and general capital controls.

In conclusion, despite their commitment to join the euro, the newcomers need to assess their situation and apply these valuable lessons to avoid much painful adjustments in the future.

A THREAT TO THE U.S. ECONOMY

URI DADUSH

The United States has a vital interest in assuring that the crisis across the Atlantic is contained. The country is tightly linked to Europe via trade, investment, and financial markets, and the Euro crisis is already affecting the U.S. economy. If the crisis were to spread further across Europe, the sound conduct of U.S. monetary and fiscal policy could also come under threat. The United States has taken action to help ease the crisis, restarting the Federal Reserve's dollar-swap line in early May and supporting the IMF's participation in the European rescue plan. The United States should also accept a weaker euro for some time. In exchange, it can exercise moral suasion to encourage fiscal consolidation and structural adjustment in the vulnerable Euro area countries and more expansive policies in the surplus ones.

Effects on the United States

The trade and investment links between the United States and the European Union (EU) are significant. Europe consumes twenty percent of U.S. exports and holds more than 50 percent of U.S. overseas assets, while the United States holds close to 40 percent of Europe's foreign assets. Lower growth and higher volatility in Europe could therefore have serious consequences for the United States, hindering export growth and endangering assets. Europe has already shown itself to be the laggard in the global recovery—in the first quarter, European GDP was

up only 0.3 percent (y/y), compared to 2.5 percent in the United States and 11.9 percent in China—and the situation may well get worse before it gets better.

The crisis will likely lead the euro to depreciate further in the coming months. The euro has already fallen more than 20 percent against the dollar since late November—two months before Obama unveiled his goal of doubling exports in the next five years—and it may fall to parity. In sectors where U.S. and European exports overlap (e.g., aircraft, machinery, professional services), a lower euro will hinder the competitiveness of U.S. goods on the global market. The depreciation will also reduce the purchasing power of European tourists traveling to the United States and make European goods relatively cheaper in U.S. markets at a time when policy makers are hoping to avoid a return to high current account deficits. With imports likely to rise and exports likely to fall, the U.S. bilateral trade balance with Europe will likely deteriorate. By definition, the profitability of U.S. companies operating in Europe will be affected by the Euro crisis when profits and assets on the balance sheets are expressed in dollars. U.S. companies selling in Europe and sourcing in dollars will see even sharper profit declines, though U.S. companies selling into the dollar area and sourcing in Europe will benefit.

Despite the negative effects a weaker euro would have on U.S. job creation, the most important consequences of the Euro crisis in the United States will operate through financial and, more specifically, banking channels. Though the exposure of U.S. banks to the most vulnerable countries in Europe is limited to \$176 billion, or 5 percent of their total foreign exposure, their indirect linkages to these countries, which operate through all of the international banks, are much larger. Not surprisingly, European banks hold large amounts of their own countries' bonds and, according to a recent World Bank report, these holdings exceed reserves in some instances. A string of bank failures in Europe could well trigger another global credit crunch.

The crisis has already significantly increased stock market volatility; the VIX volatility index more than doubled in the last two months. The confidence that banks have in doing business with each other has also plummeted, with the TED spread, the difference between the three-month inter-bank lending rate and the

yield on Treasury bills, reaching a nine-month high of 35 basis points in May, up from 10.6 basis points in March.

Stopping the Spread

These worries come against a background where the crisis has been largely confined to Greece, a country that accounts for 2.6 percent of the Euro area's total GDP. One can only imagine what would happen if the crisis spread to Spain or Italy—countries 5 to 6 times larger. The trade, investment, and financial problems would clearly balloon, but a spreading Euro crisis would also hurt U.S. interests in three other fundamental ways:

1. Although a spreading Euro crisis could initially lead U.S. government debt to fall in price due to a safe haven effect, it will place the spotlight on the high and rapidly rising debt levels of the United States. This could force a large rise in the yield that investors demand to hold U.S. debt, aggravating the country's unstable debt dynamics. At the same time, the United States does enjoy obvious advantages compared to individual European countries, given that the dollar floats freely.
2. If the crisis were to spread, it would prolong the timeframe during which the European Central Bank maintains low policy rates, making the United States less likely to raise its own rates. This could aggravate the liquidity overhang with difficult-to-predict consequences as well as accentuate imbalances in the economy.
3. Were a spreading Euro crisis to trigger defaults and lead a number of European countries to leave the Euro area, it could undermine the viability of the wider European project, including the accession of several countries in the East. This could create a new frontier of geopolitical instability all around the European periphery and further the decline in confidence.

Thus, for the United States, the dangers involved in a spreading Euro crisis clearly outweigh the costs of supporting the European adjustment by accepting a lower euro, expanding the resources available to the IMF, and expanding the Fed's currency swap operations. In return, the United States can add its weight to the push for necessary adjustments within Europe.

THE EURO CRISIS AND THE DEVELOPING COUNTRIES

URI DADUSH

The Euro crisis threatens the economic stability of much more than the Euro area alone. A weakened Europe implies slower export growth in developing countries as well as increased financial volatility. The Euro crisis may also be only the first episode in which post-financial-crisis vulnerabilities converge to such devastating effect, implying that similar dangers for developing countries could emerge from sovereign debt crises in other regions or another global credit crunch. Policy makers in emerging markets can take a variety of steps, outlined below, to limit the potential consequences right now. In addition, the crisis underscores the importance of the IMF as a lender of the last resort.

Impact of the Crisis on Developing Countries

Exports: The Euro crisis is likely to deduct at least 1 percent of growth, and potentially much more, from Europe—a market that consumes more than 27 percent of developing countries' exports. In addition, the euro has already devalued more than 20 percent against the dollar since November 2009 and the two could reach parity before the crisis is over. A lower euro will sharply reduce the profitability of exporting to the European market and will also increase competition from Europe in sectors ranging from agriculture to garments and low-end automobiles.

Tourism and Remittances: A lower euro will reduce the purchasing power of European tourists traveling to developing countries, and the value of remittances originating from Europe.

Domestic Competition: At the same time, a lower euro may provide opportunities for consumers and firms to import from Europe at a lower cost.

Capital Flows: The Euro crisis will force the European Central Bank to maintain a very low policy interest rate for the foreseeable future. Similarly low rates in Japan and the United States, combined with low growth in Europe, may lead even more capital to flow to the fastest-growing emerging markets. This will lead to inflation and currency appreciation pressures, as well as increase the risk of asset bubbles and, eventually, of sudden capital stops in emerging markets.

Market Volatility: The Euro crisis will add greatly to the volatility of financial markets and will lead to sharp bouts of risk-aversion. The VIX index, which measures the cost of hedging against the volatility of stocks, has more than doubled in the last two months. This, in turn, has increased the level and volatility of spreads on emerging market bonds—which have risen by more than 130 basis points since April—and will make currencies more volatile across the globe.

Credit Availability: The Euro crisis may constrain trade and other bank credit available to developing countries as it raises questions about the viability of European banks—especially those based in vulnerable countries whose assets likely include large amounts of their own government's bonds. But all international banks will be viewed as having either direct or indirect (through other banks) exposure to the vulnerable countries. The confidence that banks have in lending to each other has already fallen; the TED spread (the difference between the three-month inter-bank lending rate and the yield on three-month Treasury bills) reached a nine-month high of 35 basis points in May, up from this year's low of 10.6 basis points in March.

Contagious Crises: A failure to contain the crisis in Greece and its spread to Spain or other vulnerable countries will raise the alarm on sovereign debt in other industrial countries—for example, Japan, whose debt-to-GDP ratio is projected to be nearly twice that of Greece in 2015—and inevitably in any exposed emerging market. If more countries are hit, the pressures on trade, global credit, and capital flows to emerging markets will only increase.

Policy Implications

Though there are no one-size-fits-all prescriptions for developing countries given their very different starting points, some general policy conclusions emerge:

- Developing countries will need to rely less on exports to the industrial countries and more on their own domestic demand and South-South trade.
- In some cases, greater caution may be called for in reversing stimulus policies. In other cases, even greater prudence may be called for in containing fiscal deficits and moderating the accumulation of public debt.
- Given the sharp rise in exchange rate uncertainty, matching the currencies of foreign liabilities with those of export proceeds and reserve holdings will become even more important.
- The Euro crisis also calls for great caution in the way surging capital inflow is managed. In some countries, regulations to moderate the inflow of portfolio capital and to instead encourage the more stable form of foreign direct investment may be warranted.
- Countries with large external surpluses and that receive large capital inflows may allow their currencies to appreciate, as this may help both stimulate domestic demand and moderate inflationary pressures.

- Close monitoring and tight regulation of the operation of foreign banks and of their links with domestic banks may be prudent in the current circumstances.

Two other important policy lessons flow from the Euro crisis experience to date: one is a reinforcement of the message that strictly pegged exchange rates together with open capital accounts and the ability to borrow abroad in foreign currencies are often a dangerous combination. Just as a tight peg to the U.S. dollar led to significant GDP contraction in Argentina (18.4 percent from 1998 to 2002), countries that are not part of the Euro area but had pegged their currencies to the euro many years ago have seen their GDP decline sharply. GDP in Latvia, Estonia, and Lithuania, for instance, will have contracted by 24.8 percent, 16.5 percent, and 14.1 percent, respectively, from 2007 levels by the end of 2010. Countries with flexible exchange rates, such as Poland or Brazil, and those with pegged exchange rates but tight capital controls appear to have dealt with the dislocation caused by the crisis more successfully.

Last but not least, the crisis has exposed the limitations of regional mechanisms in dealing with financial crisis—even among countries with deep pockets—and underscored instead the vital role that a global lender of last resort, in the form of the IMF, can play. Not only can the institution bring more resources and broader expertise than would plausibly be available to a regional institution, but its distance from potentially divisive regional politics can also be a big asset.

IS A SOVEREIGN DEBT CRISIS LOOMING?

URI DADUSH AND BENNETT STANCIL

As the dust settles from the great financial crisis, skyrocketing government debt in advanced countries presents a new risk and is prompting calls for stimulus withdrawal. However, falling output, not stimulus spending, is by far the main cause of wider fiscal deficits. Accordingly, sustaining growth—not withdrawing stimulus—should remain most countries' top priority if they are to break the debt spiral. Crucially, markets must remain confident in the major economies' capacity to handle their fiscal affairs, hence the need for persuasive long-term fiscal consolidation plans.

Though markets are nervous about holding the sovereign debt of the smaller Euro area members, these countries' problems should prove manageable—assuming the European economy continues to recover and neighbors help. Among the major economies, Japan offers the greatest source for worry in the medium term.

Mounting Public Debt

Debt levels increased sharply during the crisis. Moody's estimates that sovereign debt jumped from 62 percent of world GDP in 2007 to 85 percent in 2009. Over the same period, the average fiscal deficit in the G20 rose from 1 percent of GDP to 7.9 percent. These trends were much more pronounced in advanced countries due to sharper output declines, a more severe banking crisis, and highly developed social safety nets. Since 2007, debt in seven out of the nine advanced G20 countries

This piece originally appeared in the February 2, 2010, edition of the International Economic Bulletin.

increased by more than 10 percent of GDP. By contrast, debt-to-GDP ratios declined or are little changed in eight of the ten emerging economies in the G20.

Discretionary fiscal stimulus measures and bank rescues played a much smaller role in the increase in debt than did falling tax receipts and the automatic increase of government spending. Stimulus measures cost G20 countries an estimated 0.5 percent of GDP in 2008 and 2 percent of GDP in 2009. As of August 2009, the average capital injection into banks in advanced G20 economies amounted to 3.4 percent of GDP, but much of this is expected to be recovered. The cost of the bank rescue to U.S. taxpayers is now estimated at less than 1 percent of GDP.

The bigger story is the effect of the recession on tax receipts and the automatic increase of spending on unemployment and other safety nets. Total expenditures in the United States grew from a historical average of 20.7 percent of GDP to 24.7 percent in 2009, while tax receipts are expected to fall to 14.8 percent of GDP in 2009 from an average of 18.1 percent. EU tax revenue is predicted to decline to 29.2 percent of GDP, down from 30.9 percent in 2008. Reflecting GDP decline, U.S. tax revenues fell by a remarkable 17 percent over the last year, while EU revenue likely declined by 8 percent.

With only a modest economic recovery predicted in advanced countries in 2010, government debt will continue to rise as a share of GDP. The rate of increase will slow, however, as tax revenues improve and governments derive returns from large capital infusions into banks. According to a recent IMF staff paper, public debt in advanced G20 economies will rise from 78 percent of GDP in 2007 to 118 percent in 2014. Faster growth would help slow the rise in debt but would not break it, underscoring the need for increased taxes and reduced discretionary spending.

The Effects of Rising Debt and the Importance of Governance

By raising the supply of sovereign bonds, debt can push bond prices down and yields (which, by definition, move inversely to price) higher, raising the cost of

borrowing throughout the economy and hurting housing and other interest-rate sensitive sectors already badly hit by the crisis. Higher public debt can also raise expectations of tax increases and inflation, undermining business and consumer confidence.

Additionally, rising yields and debt levels can reinforce one another. Studies show that debt's marginal impact on yields increases as debt levels rise. The White House estimates that U.S. interest payments will nearly triple from 2009 to 2019, rising from 1.2 percent of GDP to 3.4 percent, a result of rising debt and yields.

Debt levels, however, are not the sole determinant of yields. Monetary policy, perceived currency risk, inflation expectations, and risk appetite—which vanished during the financial crisis—also play important roles. As the recovery strengthens and investors turn from government bonds to riskier assets, the yield on government securities will rise. The latest consensus forecasts predict a 20 to 70 basis point increase in the yield of ten-year government bonds in major advanced economies in 2010.

But perhaps the most important factor in determining government bond yields—and thus, the impact of higher debt—is investor confidence in the country's governance, including, for example, the integrity and quality of its administration, the independence of its central bank, and its political cohesion. Common sense and academic research suggests that countries with poor governance borrow at a substantial premium.

History shows that confidence in governance critically affects how investors react to debt increases. Following World War II, debt reached over 120 percent of GDP in the United States and 250 percent of GDP in the UK. However, governance indicators in these two countries are among the highest in the G20, giving investors confidence that these debts would be managed—which they were—allowing for gradual adjustment to occur over many years without triggering a crisis. For at least a decade, Japan—which also has high governance scores—has run the largest peacetime debt of any major country with, until recently (see below), little visible effect on its bond yields.

On the other hand, at the end of 2001, Argentina—whose average governance

scores across six categories were below the world's 55th percentile in 2000—defaulted with debts at the much lower level of 63 percent of GDP. Turkey—whose same average was below the 45th percentile—suffered a massive public

Debt Levels, Bond Yields, and Governance Indicators

Country	Government Debt (% of GDP)		10-Year Government Bond Yield		Governance Indicator ^a
	2007	2009	2007 Q4	2009 Q4	Percentile Rank (0–100)
Advanced G20	78.2	98.9	—	—	—
United States	61.9	84.8	4.26	3.40	91.9
Japan	187.7	218.6	1.55	1.40	89.5
European Union	66.0	78.2	—	—	—
Germany	63.4	78.7	4.19	3.22	93.3
France	63.8	76.7	4.33	3.56	90.0
United Kingdom	44.1	68.7	4.79	3.67	92.3
Italy	103.5	115.8	4.53	4.08	62.2
Spain	36.1	52.0	4.33	3.78	85.2
Greece	95.6	111.5	4.51	4.57	73.2
Ireland	25.1	61.3	4.42	4.69	94.3
Portugal	63.6	74.9	4.45	3.83	83.7
Developing G20	37.4	38.9	—	—	—
China	20.2	20.2	7.83	5.94	45.0
Russia	7.4	7.2	6.68	9.59	19.6
Brazil	66.8	68.5	12.53	13.65	46.4
India	80.5	84.7	7.25	7.18	56.5

^a Average of World Bank Governance Indicators. 0 indicates lowest score; 100 indicates highest score.

Sources: World Bank, OECD, IMF Staff Report, European Commission

debt crisis at the beginning of 2001, though public debt had only been 57.4 percent of GDP in 2000.

The Market Response: Stable, But With a Few Exceptions

Despite surging debt levels and questions raised by credit agencies, indicators suggest that investors are far from losing confidence in major economies. The

10-Year Government Bond Yields			
	2007 Q4	2008 Q4	2009 Q4
United States			
Real Yield	1.93	2.59	1.38
Nominal Yield	4.27	3.23	3.46
Inflation Expectation	2.34	0.64	2.08
United Kingdom			
Real Yield	1.58	2.26	0.76
Nominal Yield	4.74	4.20	3.85
Inflation Expectation	3.16	1.94	3.09
Germany^a			
Real Yield	1.98	2.21	0.95
Nominal Yield	4.25	3.50	3.22
Inflation Expectation	2.27	1.29	2.27
Japan			
Real Yield	1.04	0.41	3.55
Nominal Yield	1.57	1.43	1.32
Inflation Expectation	0.53	1.02	-2.23

^a Due to data availability limitations, German yields are for bonds with 5–15 year maturities.

Sources: U.S. Treasury, Bank of England, European Central Bank, Bloomberg

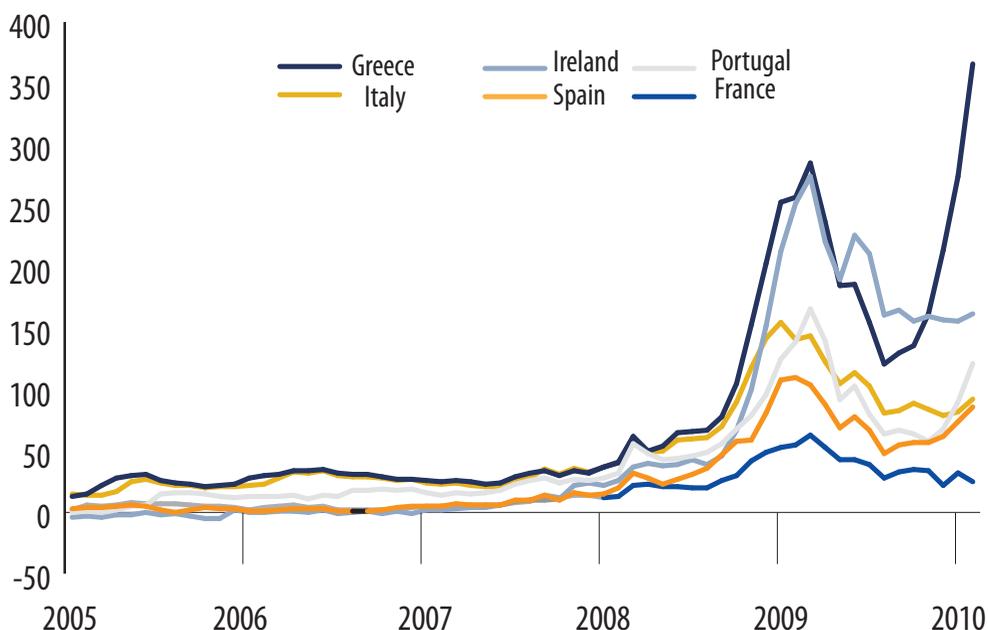
nominal and real yields required to hold government debt have declined, as have inflation expectations (calculated as the difference in yield between inflation-indexed and non-indexed 10 year bonds).

Japan, where the IMF expects government debt to exceed 245 percent of GDP by 2014, presents the greatest worry in the medium term. Though the yen remains strong, credit rating agencies are threatening downgrades. Markets are showing signs of concerns: real yields have risen well above pre-crisis levels on the back of negative inflation expectations. Deflation and sluggish growth imply a rising debt-to-GDP ratio even assuming a zero primary balance (the budget balance excluding interest payments) and low nominal yields. The cost of credit default swaps on Japan (the cost of insuring \$10 million in sovereign bonds against default) is over \$80,000 per year, nearly 19 times as great as it was three years ago. (By comparison, the cost of insuring similar U.S. and German debt is close to \$35,000.) A remarkable 94 percent of Japanese debt is still held domestically.

10-Year Government Bond Spreads to German Bund

Basis Points

Sources: IMF, Bloomberg



Market nervousness may also reflect concerns about the fiscal impact of Japan's rapidly aging population, projected to shrink by 2.6 percent over the next decade.

Confidence in the sovereign debt of several small Euro area economies is more obviously wavering. With credit default swaps on Greek debt costing close to \$400,000 and bond spreads compared to the German bund rising to nearly 4 percent in recent days, markets are becoming increasingly nervous. Though well below that of Greece, the cost of credit default swaps for Ireland, Portugal, Spain, and Italy have all been inching up since November. Greece's 2009 deficit is projected to be at least 12.5 percent of GDP and its debt-to-GDP ratio is expected to reach an EU-high of 125 percent in 2010. The European Commission's recent questioning of the reliability of Greece's government accounts and debt statistics only confirms the market's low confidence in Greek governance, reflected in its governance indicators.

As many commentators have underlined, the most vulnerable Euro area members must adjust to the crisis without the option of devaluing their currency or exercising an independent monetary policy. These countries benefit from the relative stability of the euro, however, and would likely have to pay even higher yields if they were not a member. Nevertheless, they will face more painful and protracted adjustments in wages and government spending. Despite high unemployment, Greece passed a budget for 2010 that aims to reduce the deficit from 12.7 percent of GDP to 9.1 percent and Ireland has proposed a \$5.8 billion budget cut in 2010—or 7.8 percent of its expenditures in 2009.

A combination of European recovery, sustained fiscal consolidation, and support from neighbors when needed, can be expected to see these countries through. To put the Greek problem in perspective, loans required to fund half of its 2010 projected fiscal deficit would amount to about 0.1 percent of the GDP of its Euro area partners. Bearing in mind the inevitable contagion effects from Greek default onto the major European economies, and the currency instability as the euro comes under attack, providing support would only make sense.

Policy Focus Should Remain on Stimulus, But . . .

Given that strong economic growth is the best long-term debt reduction strategy and that the global recovery is still dependent on government support, policy makers, particularly those in the advanced economies worst-hit by the crisis, must maintain stimulus efforts in the short term.

Market confidence that debts will be managed in the large countries is reassuring for now. Nevertheless, this cannot induce complacency; investor sentiments can change quickly, especially if smaller, more exposed economies run into trouble. Any high-public-debt economy is a more exposed one, and effective plans to restrain spending and/or increase taxes as soon as a robust recovery is established must be made. In addition, monetary policy should respond quickly to signs of inflationary pressure.

PART V

**POLICY
RECOMMENDATIONS**

SUMMARY OF POLICY RECOMMENDATIONS

This summary of policy recommendations should be read in conjunction with the preceding articles.

Greece, Ireland, Italy, Portugal, and Spain

- Implement fiscal consolidation to stabilize the debt-to-GDP ratio within three years.
- Structural reforms designed to rebalance the economy toward the tradable sectors and increase competitiveness are essential. To facilitate this, reduce unit labor costs by at least 6 percent over three years—either immediately with a 6 percent across-the-board wage cut, or more gradually—and institute structural reforms to raise productivity. Begin with public sector wages.
- Explain the severity of the situation to citizens in order to build the public will necessary for these adjustments. Distribute the adjustments in a transparent and fair way to ensure that specific groups do not feel unjustly hit, and that the most vulnerable are protected.

Greece

- Seriously consider restructuring the debt, allowing time for creditors to prepare to facilitate progress on an agreed solution.
- Prepare for a severe contraction in employment and income—likely larger than forecasts predict—regardless of how the crisis is resolved.

- Rely increasingly on exports and undertake measures, including encouraging wage reduction in the private as well as the public sector, to restore competitiveness, in spite of political challenges.
- If progress on restoring competitiveness is not achieved within a reasonable time frame, consider leaving the Euro area—this will imply restructuring the debt.

Ireland

- Maintain reforms to lower the deficit, including expanding the tax base, increasing the minimum pension age, reducing social welfare benefits, and cutting public wages.
- Promote further rebalancing of the economy away from services and the financial sector toward exports.
- Encourage flexible management of financial sector support programs as they respond to continuing trouble. When appropriate, unwind the guarantees.

Italy

- Reduce the primary deficit by 4 percent of GDP over three years.
- Attack rigidities that create a dual labor market.
- Increase the efficiency of backbone services.

Portugal

- Increase flexibility in labor markets.
- Increase competition in relatively sheltered backbone services.
- Improve the human capital base. This will improve productivity and help the country regain attractiveness with foreign investors.

- Implement a systematic approach to correct deficiencies in the business climate, especially in starting a business, paying taxes, and getting credit.

Spain

- Reduce the primary deficit by 8 percent of GDP within three years.
- Increase competition and decrease barriers to entry to help lower the price of non-tradables.
- Lower the severance costs that employers must pay to terminated employees that create labor market inflexibility.

Euro Area

- Maintain an expansionary monetary policy that errs on the side of growth for an extended period.
- Explicitly promote a weak euro.
- Require countries to cede some fiscal autonomy. Give member states the right to review other members' annual budgets and main economic indicators, such as GDP growth, productivity growth, and the balance of payments.
- Allow European governments—not just the European Commission and the IMF—to discuss, propose, and monitor action taken by the GIIPS, as well as agree on appropriate sanctions.
- Tighten the criteria for admission to the Euro area. Require newcomers to run large fiscal surpluses to offset the demand boom that typically accompanies euro adoption. Do not require one size to fit all, however; consider cyclical as well as structural indicators.
- Implement requirements that existing members and members-to-be release timely, reliable, and comparable data on macroeconomic indicators.

Germany and Other Surplus Countries

- Expand domestic demand by about 1 percent of the Euro area's GDP over three years in order to offset the deflationary impact of fiscal adjustments in the GIIPS.
- Accept slightly higher inflation to keep the aggregate European rate in the 2 percent range.

Prospective Euro Area Members

- Do not rush to join the Euro area before addressing competitiveness problems at home and making sure that inflation and interest rate convergence is almost total before accession.
- Increase taxes on non-tradables (e.g., housing) relative to tradables.
- Save the windfall revenues likely to come during the euro boom to cushion fiscal adjustment once growth slows.
- Use the boom as an opportunity to move into higher value-added and faster-growth sectors, and toward a more outward-oriented production structure.

The Rest of the World

- Rely more on domestic demand.
- Look to the global lender of last resort, in the form of the IMF, when significant resources, broader expertise, and distance from regional politics are needed.
- If support packages are needed, ensure that they are of sufficient size to reassure markets.

Developed Countries

- Maintain stimulus efforts in the short term. Strong economic growth is the best long term debt reduction strategy and the global recovery is still dependent on government support.
- Restrain spending and/or increase taxes as soon as a robust recovery is established.

United States

- Accept a lower euro.
- Expand the resources available to the IMF.
- Expand the Fed's currency swap operations.
- Use moral suasion to push for necessary adjustments within Europe.

Developing Countries

- Rely less on exports to the industrial countries and more on South-South trade.
- Match the currencies of foreign liabilities with those of export proceeds and reserve holdings.
- Moderate the inflow of portfolio capital and encourage the more stable form of foreign direct investment instead.
- Allow the currency to appreciate if the external surplus is large and capital inflows are significant.
- Closely monitor and tightly regulate the operation of foreign banks and their links with domestic banks.
- Either allow the exchange rate to float, or institute tight capital controls if the exchange rate is pegged.

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