

Chapter One

European Macroeconomic Policy

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The fact that the European Union is not only an international political organization but also a monetary union poses a unique challenge to addressing the financial crisis, the subsequent recession, and planning a recovery. Every eurozone country shares a common currency, and so their monetary policies are all the same, as set by the European Central Bank (ECB). The ECB responded quickly to the crisis working with the U.S. Federal Reserve and the Bank of England to orchestrate a coordinated interest rate cut in October 2008. On the fiscal side, each country can set its own policy and nearly every EU country engaged in stimulus, although the discretionary fiscal packages of the EU were significantly smaller than the U.S. stimulus, due in part to the larger automatic stabilizers built into European economies. While both the monetary and fiscal responses were necessary to stem the crisis, the accumulation of debt as a result of declines in tax revenues and the increase in spending has made the road to recovery less clear. Most EU countries increased their debt burdens during the crisis, and now most members are struggling to balance the two goals of promoting growth and paying off debt. Due to the European debt crisis, many have questioned the split system and have suggested that either a European fiscal union is needed to complement the monetary union, or that the common currency itself should be dissolved. It has become apparent that although unified monetary policy during the crash eased the shock to Europe, the status quo is untenable in times of economic stress

The traditional theory of recovery in an economy with weak demand says that countries in a recession should lower taxes and/or increase government spending as a way to increase growth. Only after a recovery is underway should governments curb fiscal and monetary stimulus to keep the economy from overheating. A competing theory,

known as the “expansionary fiscal contraction hypothesis,” proposes that when high debt burdens put government solvency into question, fiscal consolidation can increase confidence in the economy and consequently increase investment and growth. In the last year, many European countries have begun to engage in fiscal consolidation in the hopes that restoring confidence will simultaneously decrease their debt burdens and increase growth more than any direct offsetting impact on demand of higher taxes or spending cuts.

Even though the ECB acted quickly to offset the crisis, the existence of a common currency necessitates a one-size-fits-all monetary policy for the eurozone, despite the substantial variations among member countries in their levels of economic slack. And of course their exchange rates are fixed, despite major differences in their competitiveness within and outside the EU. The lack of competitiveness of some of the countries is of added importance if they have issued large amounts of sovereign debt that is held outside the country. The only ways to service foreign debt are either to keep borrowing or to increase net exports and transfer real resources overseas. In the wake of the crisis, it is difficult or impossible for the weaker countries to keep borrowing from private markets. And unfortunately, most of the countries trying to service debt are also the least competitive in the EU. This uneven burden has stressed the single currency system and prompted many to question whether the system can survive, or should. The combination of fiscal contraction and monetary restraints has set the stage for an uneven, slow, and for some, uncertain and painful road to recovery.

This chapter will (1) detail the EU countries’ discretionary and automatic fiscal response to the crisis as well as the accompanying monetary policy; (2) present the standard view and the expansionary fiscal contraction hypothesis debate; and (3) discuss the difficulties some EU countries will have repaying the debt they accumulated before and during the crisis due to their uncompetitive labor unit costs.

The Macroeconomic Response to the Crisis

The difference between the European and U.S. responses to the crisis and global recession did not lie in the remedies used, but in what

proportion they were prescribed. Both the EU and the U.S. used a combination of monetary policy and discretionary and automatic fiscal policy. The ECB and the Federal Reserve took both conventional and extraordinary action in the face of the crisis in order to increase the availability of credit. They also cut interest rates to ease the increasing pressure on the banking and financial systems. While European and U.S. monetary policy were similar, the fiscal policies used diverged significantly, largely due to structural differences between EU countries and the U.S. EU countries have more countercyclical policies built into their budgetary structures than the U.S. does, meaning that the EU did not have to rely as heavily on stimulus packages during the recession. EU countries relied on automatic and discretionary fiscal policy in nearly equal proportion, while the U.S. was forced to pass a much larger temporary stimulus package.¹ In sum, a combination of swift monetary and fiscal policy helped EU countries to avoid an even worse downturn than the one that actually has occurred.

The ECB's response to the financial crisis began as early as August 9, 2007, when growing uncertainty and a lack of confidence pervaded interbank markets and caused a gridlock in the payment system.² In response, the ECB lent a total of €95 billion³ to banks to aid in refinancing. The ECB used other extraordinary credit support policies to address financial turmoil, including: extending the maximum maturity on refinancing from three months to one year, expanding the list of acceptable collateral assets, providing liquidity in U.S. dollars, and making direct purchases in the covered bond market.⁴ But after the collapse of Lehman Brothers on September 15, 2008, it became clear that the financial crisis would drag the real economy into a recession. On October 8, 2008, in an unprecedented move, the ECB reduced eurozone interest rates by 50 basis points in concert with the Bank of England, the Bank of Canada, the Swiss National Bank, the Sveriges

¹ The decline in state and local spending partly offset the federal stimulus package, however.

² ECB, "The ECB's Response to the Financial Crisis," *Monthly Bulletin*, October 2010.

³ Ibid.

⁴ ECB, "The ECB's Monetary Policy Stance During the Financial Crisis," *Monthly Bulletin*, January 2010.

Riksbank, and the Federal Reserve. All told, the crisis forced the ECB to cut interest rates by 325 basis points to 1.00% between October 2008 and May 2009.⁵ The ECB's swift and extraordinary actions helped to lessen the blow of the financial crisis and the downturn of the real economy, but were not enough to fully address the severity of the crash.

In a crisis, both automatic stabilizers and discretionary policies are intended to cushion a negative shock to the economy. Automatic stabilizers are a facet of a country's budgetary structure, as opposed to discretionary stimulus policies, which are temporary measures enacted during recessionary periods and intended to expire once normal economic activity resumes. EU countries have larger social safety nets, stricter labor laws, and more progressive tax systems than the U.S., which all help to mitigate the effects of a recession. Unemployment benefits are a traditional example of automatic stabilizers since benefit claims necessarily increase during periods of high unemployment and depressed economic times. EU unemployment benefits are generous; in addition, most EU countries have stringent labor laws that restrict firing. Both structural policies help to stabilize gross income, and therefore consumption. In Germany, for example, severance notice periods are lengthy, firing employees is expensive, and access to government subsidies is strictly controlled, all of which incentivize scaling back worker hours instead of firing. To counteract the income effects of decreased work hours, Germany has implemented what is known as a "working time corridors" policy. Working corridors allow employers to create overtime accounts for every employee, so companies can pay the standard wage for overtime into the employee accounts and pay them out during times of financial stress. German companies are therefore able to save up labor costs during periods of high output and spend them when they want to decrease worker hours. This policy allows companies to either delay or avoid layoffs in recessions, easing the burden on both the private sector and government expenditures.⁶ These types of countercyclical policies benefit from their institutional-ity; there is no need for political consensus or action during periods of

⁵ ECB, "The ECB's Response to the Financial Crisis," *Monthly Bulletin*, October 2010.

⁶ Michael Burda and Jennifer Hunt, "What Explains the German Labor Market Miracle in the Great Recession?" BPEA, Fall 2010.

economic stress and no implementation lag, unlike discretionary policy that must be passed, organized, and implemented during a crisis.

Using microsimulation techniques, Dolls et al.⁷ were able to estimate that automatic stabilizers in the eurozone are able to absorb 49% of a 5% decline in household income and a 5% unemployment shock, whereas the U.S. is only able to absorb 34%. This disparity in automatic stabilization effects has significant implications for the amount of discretionary fiscal policy necessary in the EU versus the U.S. during downturns. The Organization for Economic Cooperation and Development's (OECD) Economic Outlook Interim Report from March 2009 estimated the unweighted average of OECD countries' discretionary stimulus packages at 2.5% of GDP between 2008–2010, with the U.S. stimulus of 5.5% of GDP being the largest. Figure 1 shows that European countries in the OECD benefited from larger positive automatic stabilization effects and implemented smaller stimulus packages than the U.S. did. In addition, the ECB estimated that eurozone fiscal stimulus amounted to 4.9% of GDP in 2008–2009, with 2.4% attributed to automatic stabilizers.⁸

Nevertheless, not all countries were able to implement stimulus measures—some relied solely on automatic stabilizers. Italy, Greece, and Ireland all suffered from budgetary constraints and did not implement fiscal stimuli; Ireland actually passed contractionary measures.

During the crisis and accompanying recession, European countries have benefited from swift monetary policy and automatic stabilizers, supported by some discretionary fiscal stimulus.

The Expansionary Fiscal Contraction Hypothesis

Once the crisis free-fall stopped and the recovery was underway, ballooning deficits became a cause for concern. Ireland saw the largest increase in debt as a percentage of GDP, a 61 percentage point jump

⁷ M. Dolls, C. Fuest, and A. Peichl (2010b), "Automatic Stabilizers and Economic Crisis: US vs. Europe", *NBER Working Paper 16275*, August 2010.

⁸ Afonso, Antonio et al., "Euro Area Fiscal Policies: Response to the Economic Crisis", Euro Area Fiscal Policies and the Crisis, ECB Occasional Paper Series No 109, April 2010.

Figure 1A. Automatic and Discretionary Fiscal Impulse in Response to the Crisis

Impacts on fiscal deficits accumulated over the period 2008–2010 as a percentage of 2008 GDP.

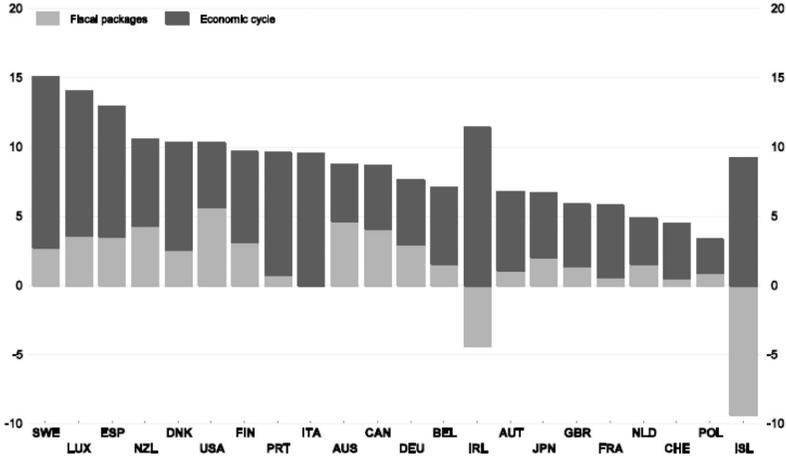
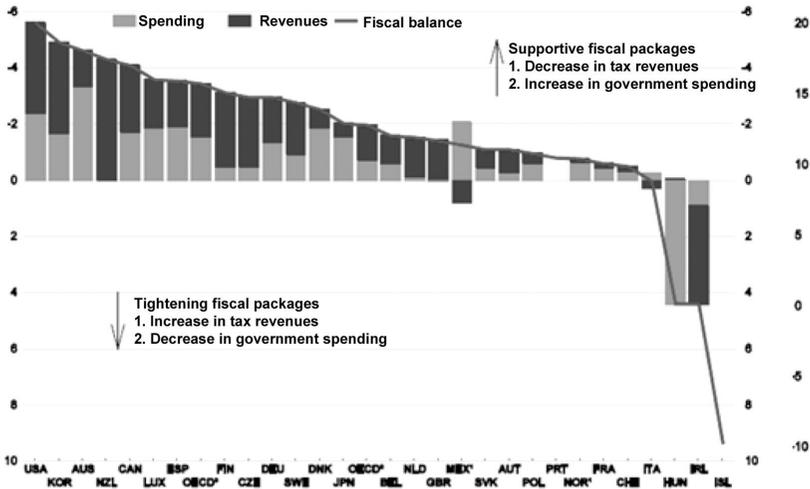


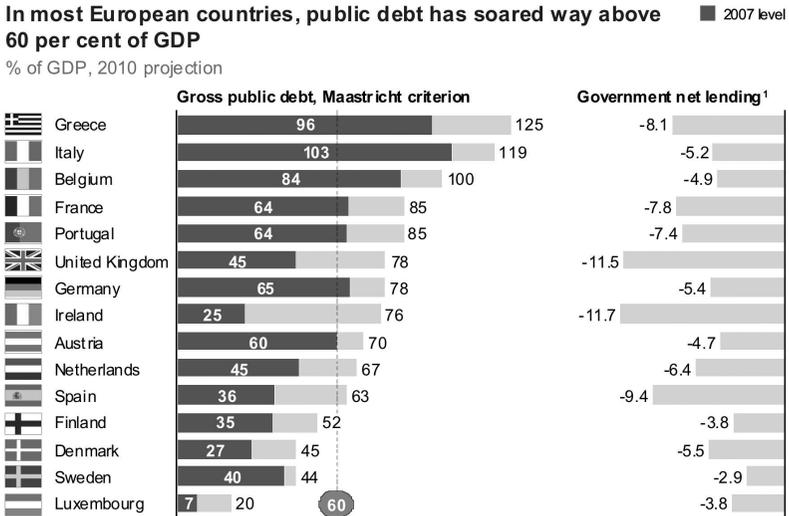
Figure 1B. Size and Composition of Fiscal Packages

Cumulative impact of fiscal packages over the period 2008–2010 on fiscal balances as a percentage of GDP



Notes: Only 2008–2009 data available for Mexico and Norway. Simple average of above countries except Greece, Iceland, Mexico, Norway, Portugal, and Turkey. Weighted average of above countries except Greece, Iceland, Mexico, Norway, Portugal, and Turkey.

Source: OECD Economic Outlook, Interim Report, March 2009.

Figure 2. Gross Public Debt and Government Lending

¹Differs from the Maastricht definition in that it does not include streams of payments and receipts from swap agreements and forward rate agreements.

Source: OECD Economic Outlook Database 2010.

from 25% to 76%, although Greece and Italy had the largest absolute levels of debt of 125% and 119% respectively.⁹ Although these are three stand-out cases, they are by no means isolated; most European countries' public debt has soared way above 60% of GDP.

While the debt was necessary to enact stimulus measures, once the recession was deemed to have ended, governments were forced to confront the challenge of balancing growth and debt reduction simultaneously. This dilemma led to an international and academic debate over traditional Keynesian theory and the expansionary fiscal contraction hypothesis. Ultimately, a majority of EU countries chose to implement policies in line with the expansionary–contraction hypothesis.

It is easy to see why the expansionary–contraction hypothesis appeals to the EU. It asserts that a country can solve two problems—slow growth and high debt—with one policy: fiscal contraction. On

⁹ OECD Economic Outlook, *Interim Report*, March 2009.

the other hand, Keynesian theory argues that fiscal stimulus increases aggregate demand, and requires that governments run large deficits until the economy returns to normal conditions. In contrast, the expansionary–contraction hypothesis relies on the private sector, rather than the government, to kick-start the economy. The hypothesis states that during times of fiscal crisis when government solvency is in question, decreasing the debt burden will ease fears and uncertainty in the private sector, which will increase confidence and consequently investment. Therefore, consolidation policies are meant to decrease the debt directly, while their effect on the private sector is intended to boost growth.

Initially, the United States took a more Keynesian approach to recovery. President Barack Obama even wrote a letter warning against a premature withdrawal from stimulus at the June 2010 G20 meeting in Canada. Obama's letter was met with a negative response from many Europeans, including the then-President of the ECB Jean-Claude Trichet who said,

As regards the economy, the idea that austerity measures could trigger stagnation is incorrect. I firmly believe that in the current circumstances, confidence-inspiring policies will foster and not hamper economic recovery, because confidence is the key factor today.¹⁰

But in 2011, a series of budget fights, debate over raising the debt ceiling, and congressional gridlock have made it all but impossible to maintain current economic stimulus (i.e. unemployment benefits and the payroll tax cut) and greatly increased the likelihood of drastic spending cuts. Most European nations have followed Trichet's prescription for growth and have or plan to implement fiscal consolidation. In 2009, Ireland was one of the first countries to start consolidating with deficit reductions equivalent to 5% of GDP, and in 2010 added 2.6% in consolidation measures. By 2010, Greece had followed suit with a consolidation of 7.8% of GDP, along with Portugal at 2.3%, Spain at 2.7%, and the UK at 0.6% in 2010–2011. In 2011,

¹⁰ Hughes, Krista, "ECB's Trichet: austerity plans don't risk stagnation," *Reuters*, June 2010. <http://in.reuters.com/article/2010/06/24/idINIndia-49598120100624>.

France, Germany, Greece, Ireland, Italy, Portugal, Spain, and the UK will all be consolidating in an attempt to comply with the Stability and Growth Program by 2014, which mandates that all EU countries maintain a budget deficit of no more than 3% of GDP.¹¹ Greece passed an austerity package in June 2011 and Italy took similar action in September with legislation that would cut their deficit by \$70 billion over three years. Although countries that violate the Program are subject to pressure from other EU countries, and theoretically face sanctions if they refuse to comply, historically, the penalty of breaching the agreement has not been applied universally. Ironically, Germany was the main advocate of the rule, but in 2003 when both France and Germany were running large deficits, neither complied with the EU Commission's recommendations nor ceded to its threats, which were ultimately abandoned. In contrast, in 2002 Portugal was forced to reign in its budget under the threat of sanctions.

Alberto Alesina is one of the most prominent supporters of the expansionary–contraction hypothesis and has made several regression analyses of the effects of fiscal contraction. Alesina and Ardagna (1998) found that

*...regardless of the initial level of debt, a large fiscal adjustment that is expenditure based and is accompanied by wage moderation and devaluation is expansionary. However, no large tax-based fiscal adjustment can be expansionary even if it is accompanied by a devaluation.*¹²

The same study found two cases of fiscal consolidation in Ireland and Australia to be “unambiguously expansionary.” The authors also noted that exchange rate devaluations helped to sustain growth, which could make fiscal consolidation in the EU monetary union more contractionary and wage moderation mechanisms even more important.

The International Monetary Fund (IMF) did a study on the expansionary–contraction hypothesis in October 2010. It found flaws in Alesina's case selection and got very different results using an alterna-

¹¹ OECD, *Restoring Public Finances*, 2011.

¹² Alesina, Alberto et al, “Tales of Fiscal Adjustment,” *Economic Policy*, Vol. 13, No. 27 (October 1998), pp. 487-545, here p. 516.

tive selection method. Alesina (1998) used swings in the cyclically adjusted primary budget balance (CAPB) to identify periods of fiscal consolidation. The IMF noted two major biases present in this selection method: (1) measurement errors in the CAPB are likely correlated with economic developments, that is, they are more likely to include asset price booms during times of economic expansion and exclude asset price busts, and (2) the CAPB tends to omit cases of consolidation that are followed by adverse shocks and addressed with discretionary stimulus, since there is little to no rise in the CAPB. In sum, the CAPB approach

*...tends to select periods associated with favorable outcomes but during which no austerity measures were taken. It also tends to omit cases of fiscal austerity associated with unfavorable outcomes.*¹³

In contrast to the Alesina studies, the IMF attempted to identify cases using policy *actions* “motivated by deficit reduction” instead of budget *outcomes* that show successful budget deficit reductions not necessarily related to austerity measures. The IMF used a selection method similar to the “narrative approach” proposed by Romer and Romer.¹⁴

The study found that there are five major macroeconomic effects of fiscal consolidation. (1) Consolidation has a contractionary effect on output and raises the unemployment rate. (2) Interest rate reductions usually support output during consolidation. (3) Currency depreciation typically diminishes the contractionary effect by spurring net exports. Since not all countries can depreciate their currencies and increase their net exports at the same time, the contractionary effect of fiscal policy will be more painful when multiple countries attempt consolidation at once. (4) Consolidation that relies on spending cuts has a smaller contractionary effect than tax increases. (5) Consolidation is less contractionary in countries that face the risk of sovereign default. Overall, the study found that a consolidation equivalent to 1%

¹³ IMF, “World Economic Outlook: Recovery, Risk, and Rebalancing” October 2010, p. 96.

¹⁴ Christina D. Romer and David H. Romer, “The Macroeconomic Effects of Tax Changes: Estimates Based on a New Measure of Fiscal Shocks,” *American Economic Review*, June 2010.

of GDP results in a 0.5% real reduction in GDP and a 0.3% increase in the unemployment rate after two years. As the economic recovery weakens in Europe, countries could face an increase in their debt-to-GDP ratios despite deficit reducing policies. They may end up slowing the denominator of the ratio (GDP) more than the numerator (debt). In fact, Germany's 2012 GDP growth forecast has been downgraded from 2% to 0.8%, a dramatic fall from the 2.9% growth that Germany saw in 2011.¹⁵ This forecast downgrade is especially troubling since Germany is one of Europe's strongest economies and faces a smaller debt burden than most. Europe's debt crisis and anemic growth are not just weighing down the weakest economies, but threaten to bring down the entire Union.

Both studies agree that devaluation and lowering interest rates are helpful in either supporting expansionary–contraction or cushioning the contractionary effects of consolidation. In terms of intra-European trade, however, eurozone countries will not benefit from devaluation. Multiple EU countries are implementing fiscal consolidation packages at the same time, which will make export-led growth even more difficult. While the ECB lowered rates quickly, it has not dropped them as much as the Federal Reserve has; it, in fact, raised rates in April 2011¹⁶ and again in July 2011.¹⁷ If the IMF study is correct, however, the fact that most countries are implementing spending-based consolidations,¹⁸ makes the consolidation less contractionary.

On balance, we agree with the IMF study's findings that confirm the longstanding view that raising taxes and cutting spending will reduce demand and worsen a recession. Herbert Hoover's economics did not work in the Great Depression and things have not changed since.

¹⁵ *Bloomberg Business Week* "German Institutes Cut 2012 Forecast, See No Recession" <http://www.businessweek.com/news/2011-10-13/german-institutes-cut-2012-forecast-see-no-recession.html>.

¹⁶ Blackston, Brian, "ECB Raises Interest Rates", *Wall Street Journal*, April 7, 2010. <http://online.wsj.com/article/SB10001424052748704013604576248374097070658.html>.

¹⁷ Kollewe, Julia, "ECB raises interest rates despite debt crisis", *The Guardian*, July 7, 2011. <http://www.guardian.co.uk/business/2011/jul/07/ebc-raise-interest-rates-debt-crisis>.

¹⁸ OECD, *Restoring Public Finances*, 2011.

Policy for Countries that Risk Sovereign Default

It is fine to advocate expansionary fiscal policies for countries that have the resources and borrowing capacity to finance the resulting rise in debt, but several European economies face the real possibility of default on their debts. They are caught between Scylla and Charybdis, pursuing fiscal consolidation and pushing their economies further into recession, or fiscal expansion and possible default.

A key question therefore is how much debt is too much? Unfortunately, there is no agreement over a specific debt threshold that threatens the solvency of a government and the health of an economy. A tipping point on debt is difficult to identify since so much of the risk is dependent upon the type and maturity rate of the debt itself, in addition to economic conditions. Carmen Reinhart and Kenneth Rogoff, however, found that

...the relationship between government debt and real GDP growth is weak for debt/GDP ratios below a threshold of 90% of GDP. Above 90%, median growth rates fall by one percent, and average growth falls considerably more.¹⁹

The authors also found the threshold to be lower for emerging economies, at 60%, likely due to these countries' debt typically being denominated in foreign currency.

The Reinhart and Rogoff study has received criticism for a number of issues, notably regarding the question of whether or not the authors assume correlation implies causality in claiming that debt exceeding 90% of GDP *causes* slow growth. The problem is that slow growth could in fact be the cause of increasing debt/GDP ratios. Their study also includes data points from the United States after World War II. There was a spike in U.S. debt during the war, and slow growth immediately at the war's end as troops were demobilized; it took some time for them to be absorbed into civilian jobs. Other critics have pointed out that the authors' threshold levels did not emerge naturally from the data, but were chosen by the 30%, 60%, and 90% buckets

¹⁹ Carmen Reinhart and Kenneth Rogoff, "Growth in a Time of Debt", National Bureau of Economic Research, Working Paper 15639, January 2010.

that the authors used to divide the data—not in our judgment a serious problem. In 2010, Greece, Italy, and Belgium all exceeded the 90% threshold, while France and Portugal got close at 85%, levels high enough at least to raise concern in the respective governments about the dangers they were facing from increased indebtedness.²⁰

The honest answer is that we do not know exactly the point at which a given country will face the prospect of sovereign default, and it surely depends on several factors, not just the debt-to-GDP ratio. Every country must weigh the risk of high levels of debt against the danger of weak demand and anemic growth in a recovery. The European countries are engaging in fiscal consolidation in an unforgiving environment and without the necessary monetary flexibility to cushion contraction. It is possible that one or more countries will be forced into default, even if it is disguised as a form of debt restructuring. In some cases, default may be the best option, better than endless recession. The greatest risk of default and restructuring is the threat of contagion, which could potentially throw the world into another recession. The EU has been reluctant to take bold actions that would either break up the monetary union or force countries to relinquish a significant amount of national sovereignty, but might save Europe, the US, and the world from another recession. It appears that the current series of half measures and patch jobs will be unsustainable and the EU will either be forced to action or suffer through another crisis.

An Uneven Recovery and the Competitiveness Problem

The only ways for a country to service debt held by foreigners, as we noted earlier, are to borrow more to make interest and debt service payments, or to export more or import less. Borrowing to make debt payments can catalyze a vicious cycle, since taking on additional loans only increases the debt burden and provides no clear path to a sustainable, long-run solution.

There is one loophole, however. If a country has issued debt in its own currency, it does have the option of printing money to pay its debts, increasing the money supply rather than borrowing more—

²⁰ From debt/GDP chart.

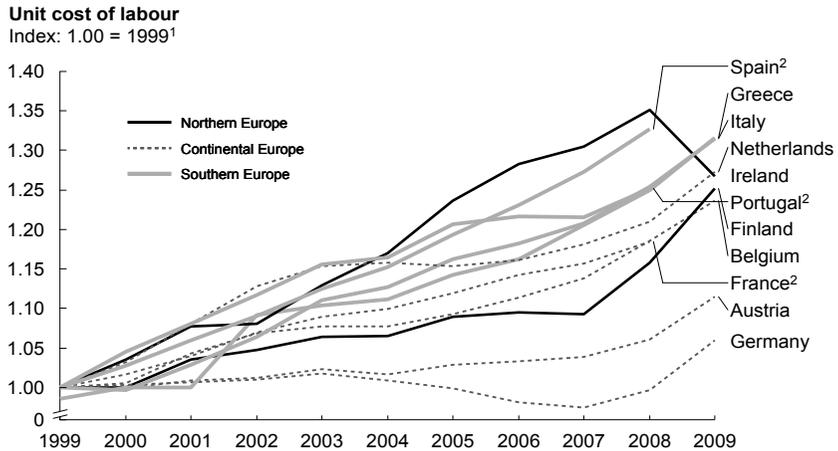
borrowing at a zero nominal interest rate. And this extra degree of freedom has been cited as one advantage for countries like the UK that are not part of the eurozone. With the power to issue money, a country will always have the ability to repay its debt, at least nominally. Although printing money appears to be a simple solution, it has the severe downside risk of inflation. In the case of the UK, for example, inflation is already higher than the target rate set by the Bank of England, and it is very unlikely in practice that the Bank would agree to monetize the UK Treasury debt. So the “printing money” option is of only modest value in practice.²¹

Regardless, the eurozone countries do not have control of their money supplies and do not have the option of printing money. They are thus left with the option of servicing their debt by increasing net exports. Unfortunately, the eurozone countries suffering most under the strain of holding “foreign” debt are also the countries least able to support export-led growth. In addition to facing the growing threat of insolvency, Greece, Italy, Spain and Portugal are also the least labor-cost competitive countries in the EU. High unit labor costs make domestic goods and services costly and exports more expensive relative to other countries’ products (see Figure 3).

To increase the attractiveness of exports, uncompetitive countries need to bring down unit labor costs relative to other EU countries. In the absence of a variable currency, there are only difficult options to do this: increase productivity and/or decrease wages. Increasing productivity quickly implies streamlining production processes and decreasing labor costs through firings. While layoffs may be the quickest way to decrease costs, they aren’t always easy to orchestrate since European labor laws make large-scale firings expensive, if not impossible. Finally, wage decreases for current employees are also impractical since European labor laws often dictate that union wages apply everywhere. Even if the laws were changed to allow easier layoffs and wage cuts, the social and political environment may make these impossible. Moreover, encouraging layoffs and wage cuts when a country is in a deep recession will have adverse effects on its *domestic*

²¹ Japan has suffered from chronic deflation, and so the option of printing money to deal with high indebtedness is of more value to them. Japan’s sovereign debt is also held domestically.

Figure 3. Different Trends in Unit Labor Costs Contributed to Eurozone Imbalances.



¹Instead of 1999 = 1.00, Greece is indexed to 2000 = 1.00. This is because the exchange rate between the Greek drachma and the euro was fixed in June 2000.

²2009 data not available.

Source: OECD.

demand, making its recessions worse for a while and even potentially creating economic instability to go with the likely political instability. The difficulty of improving competitiveness in the absence of devaluation is not unique to the eurozone—even in places where wage and employment cuts are allowed, wages are often “sticky” and difficult to change.

Depreciation is traditionally the least painful option for countries attempting to service debt and decrease labor costs, but eurozone countries cannot follow this route without leaving the euro.

Conclusion

A wave of enthusiasm accompanied the introduction of the euro, which was seen as a sign of a unified Europe. Given the history of conflict in Europe, achieving that unity was an important goal, one worth supporting and sustaining. Nevertheless, there was not enough consideration given at the time to the question of how internal adjustments would take place and how debt crises would be avoided.

A single currency means that all countries face the same monetary policy and they do not have the option of devaluation when they lose competitiveness. The United States has a single currency and has faced some of the problems that the eurozone faces today. Cyclical economic performance has varied by state and region historically, and in the current crisis and recession there is wide variation in unemployment and home prices within the economy. The United States does have the advantages of a powerful federal Treasury, and mobility within the country is greater than it is within Europe. The eurozone must take seriously the need for adjustment mechanisms among member economies in response to disparate performance.

Greece used various budget and accounting devices to meet the criteria for euro membership, but it is certainly facing retribution for its failures now. Ireland has tried to make good on the folly of its banks and follow the path of austerity, but it is still dealing with a very weak economy. Fiscal austerity does not solve the problem of a deep recession, despite what some bankers may tell you. There is no case for turning Keynes on his head.

Our purpose in this chapter is not to tell European policymakers what to do; after all, the U.S. economy has serious problems of its own and has been one source of the problems in Europe, as Wall Street sold bad mortgages to the world. But it is important that we use sound economics to deal with the problems on both sides of the Atlantic. Debt restructuring seems inevitable for Greece, likely for Ireland, and possible for other economies. It is probably the first step towards a slow path to greater competitiveness for the high-cost economies, a path which will involve more labor mobility or more flexible labor markets once stability has been restored. The ECB must set its monetary policy with an eye on the European periphery, not just a focus on Germany.

An Epilogue on Recent Events

The situation in the eurozone is changing so rapidly that what we have written here is somewhat behind the times although the basic issues we raise are still very important. There is an old Irish joke in which a traveler stops at a village and asks directions to Dublin. The

villager says: “Well, if I were going to Dublin, I would not start from here.” Policymakers trying to curb budget deficits and enact structural reforms to improve competitiveness would not have chosen to start their new policy regimes at a time of high unemployment and weak demand. Those policies are making things worse before they have a chance to make them better. Greece has been pushed into a controlled default and this has spread contagion to Italy where interest rates on sovereign debt increased to 7.5%. Creditors are now concerned not only about the viability of Spain, Portugal, and Ireland, but even France, so the threat of a broad financial meltdown is very real.

Is there an optimistic scenario? As this is written, there seems to be progress towards an approach that would unify the eurozone sovereign debt markets (a form of Eurobond, but not using this name). Eurozone countries would place their sovereign bonds, of an amount by which their debts exceed 60% of GDP, into a debt pool that would be guaranteed by all the countries. Rules would be enacted under which this excess debt is paid off over time with supervision of the program by the IMF, the European Central Bank and the European Commission. Inspectors would be posted to participating countries to ensure that tax revenues and other fiscal data were accurate (this has already happened for Greece). The German electorate is clearly very resistant to bailing out other eurozone countries, but the German Council of Economic Advisers has expressed support for the proposal just described and German Chancellor Angela Merkel has said that there has to be a big and comprehensive solution to Europe’s problems. If the program works, Italy and other beneficiaries of the program would pay off their own debts. Germany would only be on the hook if another country were to default, something that is less likely if the plan is able to bring interest rates down.

The European Central Bank in recent weeks has purchased Italian debt to keep interest rates down. Reports indicate that Mario Draghi, the new ECB President, stopped buying Italian debt when Silvio Berlusconi clung to power and made it clear that he would only resume purchases if Italy chose Mario Monti (or someone like him) to succeed Berlusconi as prime minister. As the former European Commissioner for competition policy, Monti understands the structural reforms that Italy must make to become competitive. With Monti now in place, the ECB is likely to provide some breathing room for Italy to

manage its debt crisis. Italy, after all, has a primary budget surplus, so that getting interest rates down is key to a solution.

The pessimistic outcome is the case where the big plan fails and individual countries try to muddle through. In that case, there is a significant danger that financial institutions that have sovereign debt on their books will be liquidity constrained because no one wants to lend to them (this is already a problem). Their own governments could be unable to borrow additional funds to keep the institutions from failing. A cascading series of institutional failures could endanger the whole European financial system and slow or end the U.S. recovery.