

# Restoring Trust and Confidence in Times of Soaring Public Debts and Deficits: The Case of the Euro

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## 1. Fiscal Conservatism is the Flavour of the Week

Fiscal conservatism is back, in particular in Europe where the Greek malaise and its enforced austerity response kick-started a serious round of fiscal austerity packages not only in crisis-prone economies such as Ireland, the UK, Portugal, etc but also in Germany and the Netherlands. This paper will analyze the EU and Euro zone members' response to the rise in public debt in the aftermath of the Great Recession and the sovereign debt default crisis in Greece. The paper begins with some general observations on public finances and then turns to a discussion on the European efforts to restore trust and confidence into the Euro. Trust is an essential part of economic transactions organized by markets. Even though repetitively successful market transaction may confirm 'advanced' trust of market actors, it is sound to assume that markets cannot produce the level of trust that is needed to minimize transaction costs. Unlike economic orthodoxy argues this paper assumes that economic transactions reflect social structures and are in dire need of being adequately socially embedded<sup>2</sup>. I follow Fehr (2009: 238) with his concept of trust:

An individual...trusts if she voluntarily places resources at the disposal of another party...without any legal commitment from the latter. In addition, the act of trust is associated with an expectation that the act will pay off in terms of the investor's goals. In particular, if the trustee is trustworthy the investor is better off than if trust were not placed, whereas if the trustee is not trustworthy the investor is worse off than if trust were not placed.

Trust in this sense also plays a central role in the proper working of institutional arrangements such as currency and monetary regimes, and usually is expressed in terms of reliability and calculability. It has been argued that, for example, the Stability and Growth Pact and its rules regarding public deficits and public debts, as well as the

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<sup>2</sup> See Granovetter 1985, Hübner 1989.

associated so-called excessive debt procedure, was meant to build reputation and trust on the side of global financial markets (Hübner 1999). The crisis demonstrated that this exercise was not very successful.

This paper proposes that the Great Recession and its after-effects have undermined the trust into the common currency in Europe<sup>3</sup>. This is due to the levels of public deficits and debts, and the failure of the institutional mechanism and procedures in avoiding a build-up of this ‘ugly situation’ as well as to successfully deal with it. Financial markets in particular see the state of public finances in the Euro zone as unsustainable, and politicians respond to this view by strengthening their efforts to restore public finances and thus return trust to the institutional architecture of the Euro. I will make the argument that the chosen strategic response on the side of European governments as well as the European Commission does not produce the intended outcome and that the associated economic and social costs of the turn towards austerity are unduly high. Governments are in a difficult situation, though. In order to regain the trust of financial markets they favour fiscal discipline despite its adverse macroeconomic effects. I will argue that this political short-termism undermines trust in Euro zone institutions, and thus contribute to the current and coming turbulences.

## **2. The State of Public Finances**

Fiscal conservatism comes as an inherent economic necessity or as a deep-seeded political belief. The former can be found in parts of Southern Europe; the latter are prominent in North America. Both are being played out in the aftermath of the Great Recession. Reasons given to reduce overstretched fiscal exposure and to return to the virtues of the *Schwaebische Hausfrau*, as German Chancellor Angela Merkel famously has argued, are abundant. The most obvious reason refers to empirical figures that indicate unsustainable debt levels. It is argued that debt levels are much too high, and would even rise further without a change in the underlying dynamic. As long as the underlying debt dynamic is not broken, financial markets would stay suspicious and ask for relatively high-risk premiums.

That states have to act like private households and must make sure that over time receipts balance expenditures seems to be a truism. However, not all truisms have to be accepted as truth. Even though microeconomics and also everyday-economics seems trump theoretical insight and thus dominates the public narrative on public debt, I will argue that this view is unfounded. It is argued that high and rising debt levels undermine investor confidence, as they fear second-round effects in the form of sudden public policy U-turns. It is also argued that public debt competes with private debt about a given pool of savings, and that public debt may crowd out private investment, and thus undermine economic growth. Financial markets, so goes the additional argument, are sensitively watching deficit and debt developments of nation-states, and as well-respected financial watch-dogs, they have the functional duty to

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<sup>3</sup> It needs to be stressed that the exchange rate is no adequate marker for trust. See more on this in Hübner 2011.

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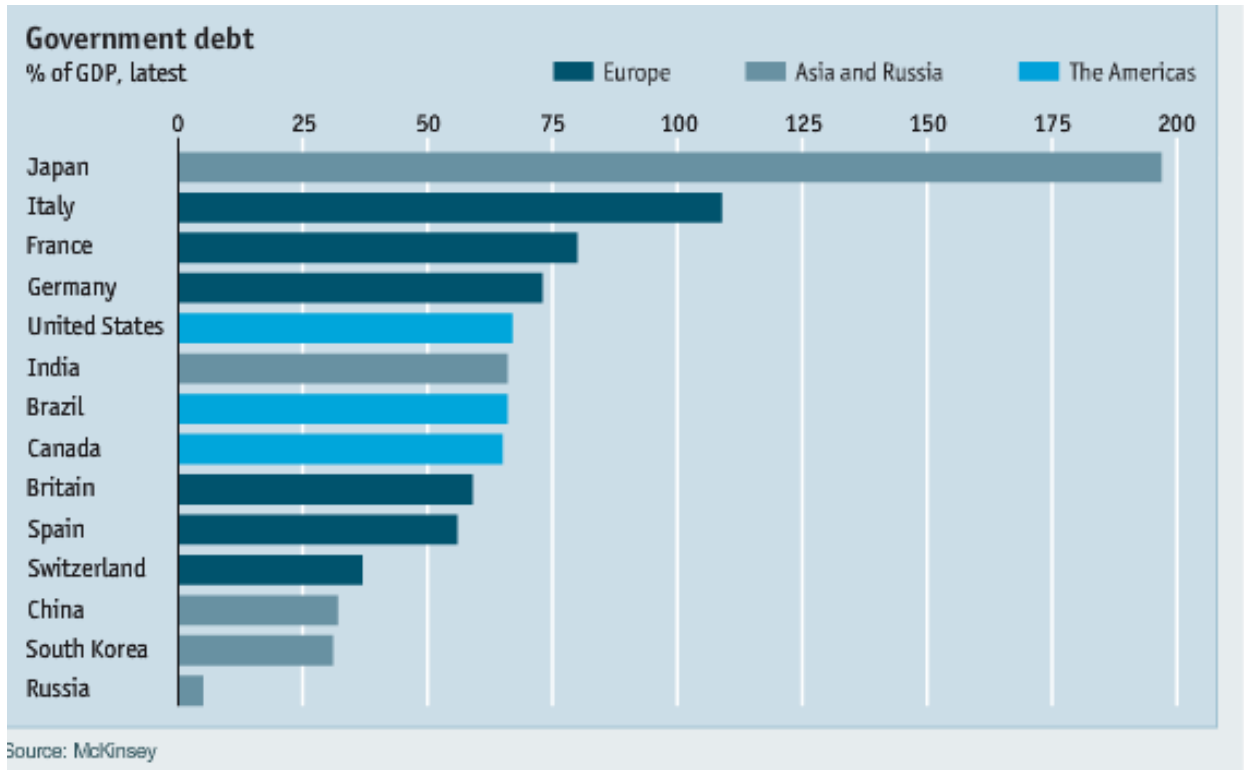
engage in punishing runs against governments of nation-states that violate those iron principles of economics 101. Greece, Ireland, Spain, Italy, Portugal-- the list of usual suspects is well-known, and financial markets have acted accordingly in order to educate politicians and the public at large.

**Table I.1.1: Budget balances in EU Member States (% of GDP)**

	Budget balance					Structural balance					Structural primary balance				
	2007	2008	2009	2010	2011	2007	2008	2009	2010	2011	2007	2008	2009	2010	2011
BE	-0.2	-1.2	-6.0	-5.0	-5.0	-1.3	-2.1	-3.9	-3.8	-4.0	2.5	1.7	-0.3	0.0	-0.2
DE	0.2	0.0	-3.3	-5.0	-4.7	-1.2	-1.1	-1.7	-3.6	-3.5	1.6	1.6	0.9	-1.0	-0.8
IE	0.1	-7.3	-14.3	-11.7	-12.1	-1.6	-7.0	-9.4	-9.3	-10.2	-0.6	-5.7	-7.3	-6.5	-6.7
EL	-5.1	-7.7	-13.6	-9.3	-9.9	-6.8	-8.7	-13.0	-8.5	-8.2	-2.7	-4.2	-8.0	-3.2	-2.4
ES	1.9	-4.1	-11.2	-9.8	-8.8	1.2	-4.1	-8.9	-7.8	-7.0	2.8	-2.5	-7.1	-5.7	-4.4
FR	-2.7	-3.3	-7.5	-8.0	-7.4	-3.8	-3.8	-6.2	-6.2	-6.2	-1.1	-0.9	-3.9	-3.6	-3.3
IT	-1.5	-2.7	-5.3	-5.3	-5.0	-3.2	-3.5	-4.0	-3.7	-3.6	1.8	1.6	0.7	0.9	1.2
LU	3.6	2.9	-0.7	-3.5	-3.9	1.1	2.0	1.2	-1.4	-1.9	1.3	2.3	1.7	-1.0	-1.3
NL	0.2	0.7	-5.3	-6.3	-5.1	-1.0	-0.5	-3.6	-4.9	-4.0	1.2	1.6	-1.4	-2.6	-1.7
AT	-0.4	-0.4	-3.4	-4.7	-4.6	-1.6	-1.7	-2.4	-3.6	-3.6	1.1	0.8	0.3	-0.8	-0.7
PT	-2.6	-2.8	-9.4	-8.5	-7.9	-3.1	-3.8	-8.1	-7.7	-7.0	-0.3	-0.8	-5.2	-4.6	-3.4
SI	0.0	-1.7	-5.5	-6.1	-5.2	-2.9	-4.8	-3.7	-4.4	-3.8	-1.6	-3.7	-2.3	-2.5	-1.8
FI	5.2	4.2	-2.2	-3.8	-2.9	2.6	2.1	0.4	-1.3	-1.0	4.1	3.5	1.6	-0.2	0.2
MT	-2.2	-4.5	-3.8	-4.3	-3.6	-3.1	-5.2	-3.8	-4.0	-3.4	0.2	-1.9	-0.5	-0.7	-0.2
CY	3.4	0.9	-6.1	-7.1	-7.7	2.5	-0.4	-5.8	-6.3	-7.1	5.5	2.4	-3.3	-3.6	-4.2
SK	-1.9	-2.3	-6.8	-6.0	-5.4	-3.7	-4.7	-6.6	-5.4	-4.7	-2.3	-3.5	-5.1	-3.9	-3.2
EA-16	<b>-0.6</b>	<b>-2.0</b>	<b>-6.3</b>	<b>-6.6</b>	<b>-6.1</b>	<b>-1.9</b>	<b>-2.8</b>	<b>-4.7</b>	<b>-5.0</b>	<b>-4.8</b>	<b>1.0</b>	<b>0.2</b>	<b>-1.8</b>	<b>-2.1</b>	<b>-1.6</b>
BG	0.1	1.8	-3.9	-2.8	-2.2	-1.5	0.0	-2.8	-1.1	-0.8	-0.5	0.9	-2.0	-0.3	0.1
CZ	-0.7	-2.7	-5.9	-5.7	-5.7	-2.9	-4.5	-5.4	-4.9	-4.9	-1.7	-3.4	-4.1	-3.2	-2.8
DK	4.8	3.4	-2.7	-5.5	-4.9	3.1	3.3	0.6	-2.7	-3.1	4.7	4.7	2.6	-0.6	-1.0
EE	2.6	-2.7	-1.7	-2.4	-2.4	-1.1	-4.3	-0.6	-2.1	-1.8	-0.9	-4.1	-0.2	-1.6	-1.4
LV	-0.3	-4.1	-9.0	-8.6	-9.9	-4.5	-6.4	-6.9	-6.7	-9.0	-4.2	-5.8	-5.3	-4.3	-6.1
LT	-1.0	-3.3	-8.9	-8.4	-8.5	-3.1	-5.6	-7.1	-6.8	-6.8	-2.4	-5.0	-6.1	-5.2	-4.9
HU	-5.0	-3.8	-4.0	-4.1	-4.0	-5.5	-4.7	-2.2	-2.3	-3.0	-1.4	-0.5	2.6	2.3	1.1
PL	-1.9	-3.7	-7.1	-7.3	-7.0	-2.8	-4.6	-7.2	-6.3	-5.7	-0.5	-2.3	-4.6	-3.5	-2.6
RO	-2.5	-5.4	-8.3	-8.0	-7.4	-4.7	-7.7	-8.3	-7.1	-6.4	-3.9	-7.0	-6.8	-5.2	-4.4
SE	3.8	2.5	-0.5	-2.1	-1.6	1.6	1.1	1.9	-0.2	-0.5	3.3	2.8	2.8	0.7	0.3
UK	-2.8	-4.9	-11.5	-12.0	-10.0	-3.9	-5.2	-9.5	-10.4	-8.7	-1.7	-2.9	-7.5	-7.6	-5.6
EU-27	<b>-0.8</b>	<b>-2.3</b>	<b>-6.8</b>	<b>-7.2</b>	<b>-6.5</b>	<b>-2.1</b>	<b>-3.1</b>	<b>-5.2</b>	<b>-5.6</b>	<b>-5.2</b>	<b>0.6</b>	<b>-0.3</b>	<b>-2.5</b>	<b>-2.8</b>	<b>-2.2</b>

Note: The structural budget balance is calculated on the basis of the commonly agreed production function method (see European Commission (2004)).

**Source:** Commission services' Spring 2010 European Economic Forecast. The figures for Greece are based on information available prior to the finalisation on 2 May 2010 of the agreement on the conditionality negotiated between the Greek authorities and the Commission, ECB, and IMF.



However, things are not as simple as those arguments suggest. Four considerations require reflection. (1) Fiscal conservatism is as much political rhetoric as it is a political attitude towards public finances and the role of the state. The current political anti-state and anti-tax revolt led by the Tea Party in the US demonstrates that fiscal conservatism must not be accompanied by economic rationality. On the contrary, the political stance against macroeconomic intervention seems willingly to accept rising public deficits. The case is different for Canada where the minority government of Stephen Harper takes uses fiscal austerity as a tool to reduce the overall role of the state in economic and social affairs. In all those cases it is not so much about sound public finance as it is about transforming capitalist regimes into solely market-driven systems. Concerns about public deficits and debts are actually used for transformational political purposes.

(2) Since the Great Recession, it should be a well-known fact that financial markets are by no means rational entities. Rather, they are driven by sentiments, greed and irrational expectations. Why then, one ought to ask, should financial actors be seen as financial watchdogs who bark when governments violate expectations? A brief glance at statistics shows (graph 1) that not all states are born equal. Quite a number of states with very high (and rising) debt-GDP ratios are treated by financial markets as stable members of the global financial community. If we accept, for the sake of argument, the debt benchmark of the Euro zone, Japan, the US but also emerging market economies

like Brazil and India, they are all serious violators. And even much praised Canada would not jump across the hurdle. However, none of these economies are subject to punishments on the side of financial markets. Obviously, financial markets are not acting as Pavlovian Dogs but as selective discriminators. This is not a problem as long as discrimination is rooted in transparent and rational arguments.

(3) Absolute debt levels and non-contextualized debt-GDP ratios are no convincing pointers towards an unsustainable situation of public finances. In empirical terms, Reinhart and Rogoff (2010) showed in a lengthy time series analysis that the relationship between government debt and real GDP growth is weak, at least as the debt-GDP ratio is smaller than 90 %. Above this threshold, median GDP rates start shrinking by one-percentage point p.a. In other words, public debt is not per se a growth-impeding obstacle.

Looking at public deficits, sustainability obviously depends on the level of the underlying interest rate,  $r$ , and the growth rate of GDP  $g$ . As long as the  $r < g$ , any budget deficit  $d$  (expressed as share to GDP) would result in a debt ratio  $b$ , where  $b = d/(g-r)$ , and  $b$  would shrink in relative terms. In the case  $r > g$ , a growing public deficit automatically results in an increase of  $b$ . Deficits can go hand in hand with both rising and declining debt levels.

(4) Projections by the IMF point to an on-going rise in public debt ratios from 60 % of GDP at the end of 2007 to 85 % on average by 2015 (Cotarelli/Schaechter 2010). The concept of fiscal space has been recently used to generate a point estimate when an economy moves towards or even beyond a sustainable debt ratio. For this purpose, a historically based relationship between the primary balance and thus fiscal policy of an economy and the development of the public debt ratio is being constructed that eventually leads to the estimation of a public debt limit. The difference between the projected debt ratio for 2015 and the estimated debt limits produces the fiscal space available (Ostry/Ghosh/Kim/Qureshi 2010). The results of this exercise hint that Greece, Italy, Portugal and also Japan have an extremely low probability for additional fiscal space. The situation is slightly better for Iceland, Ireland, and Spain where the probability for additional fiscal space until 2015 is in the range of 50-70 percent. A third group consists of the US and the UK where the probability for remaining fiscal space is estimated between 70 and 80 %. It needs to be stressed that those figures are the outcome of a strongly modelled exercise with strong assumptions, but also uncertainties.

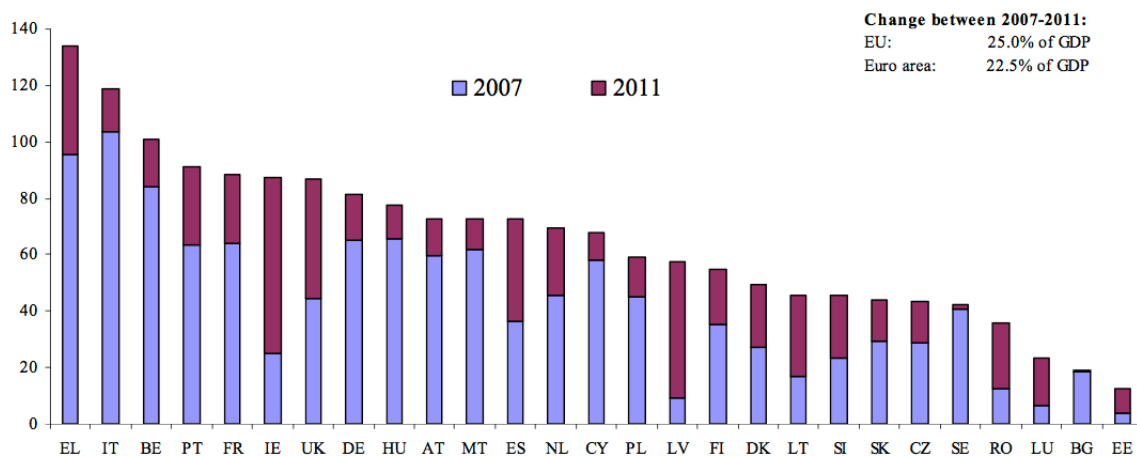
### **3. An Alternative Narrative**

In light of these considerations, it can be argued that fiscal conservatism is not automatically the correct response to high public deficits and debts. It is true though that at a first look, the situation in the EU and in particular for Euro zone member states

looks dire (see table 1). Ireland, Greece, Spain, France, Portugal, Cyprus are all poised to violate the 3 % hurdle of the Stability and Growth Pact (SGP), and this despite already having strict austerity programs in place.

The list continues with EU member states outside the Euro zone: the UK, Latvia, Lithuania, Poland, and Romania would currently not fulfill the Maastricht criteria. Given that not all of those economies benefit equally from the low (short-term) interest rate policy of the ECB, and also taken into consideration that long-term rates vary according to risk-evaluations by financial market actors, even economies with positive but decreasing public deficits may end up with an increase of b. In other words, austerity programs can go hand in hand with an increase in public debt ratios, and thus

Graph III.1.1: Public debt in EU Member States, 2007-2011 (in % of GDP) 1/



Source: Commission services Spring 2010 forecast

further undermine financial investors' confidence and trust. Greece seems like a model case for such a development. According to the first assessment of Greece's austerity program, the debt ratio is expected to rise from 130.2 % at present to 143.9 % in August 2014, and this despite a reduction of the public deficit from 13.6 % in 2009 to 2.6 % in 2014 (DG Financial and Economic Affairs 2010).

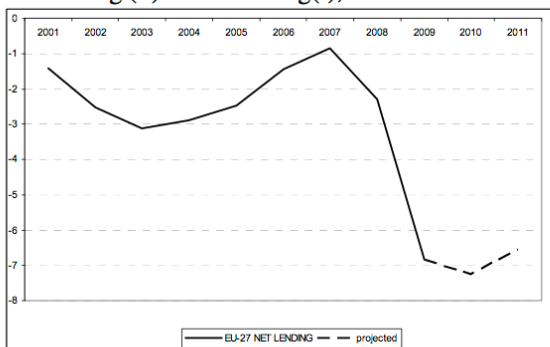
High public deficits and debts are attributed to several factors. One reason for the lately observed increases, and in some cases the most important one, is the financial and economic crisis that turned even conservative governments into big-spenders (see graph 2; Roeger/'t Veld 2010). Public deficits in the EU 27-economies started to dive in 2007; and this is reflected in a surge of the public debt ratio<sup>4</sup>.

<sup>4</sup> The graph also shows that public deficits relatively improve but that the public debt ratio still climbs. See for an explanation below.

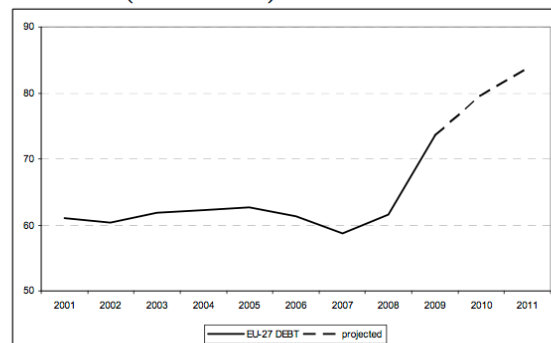
The mostly involuntary Keynesianism was often accompanied by the working of automatic stabilizers that helped move public finances even deeper into the red zone. Regardless of the reasons for the Great Recession, it was a fact that the vast majority of the private sector and private households were financially overstretched. In order to get the balance sheets right again, those actors needed de-leveraging, and this was the route taken since 2009 in most of the advanced capitalist market economies.

Restoring order in financial accounts is a decisive step towards re-energizing economic growth. However, as the paradox of thrift tells us, it can only work if the reductions of debt level by private actors are accompanied by government efforts to simultaneously *increase* their debt levels. In normal times, higher savings by all actors will increase investment due to the negative interest rate effects of a higher supply of savings. In times where the interest rate is close to zero, an across-the board increase in savings leads directly to a decrease in overall demand and thus in a slow-down of economic growth. Insofar as higher savings lead to lower consumption and investment, and thus to lower production and income, the de-leveraging strategies of the private sector may even fail. The insight of such a perspective is obvious: Not all economic actors can de-leverage at the same time. Government debt and budget deficits may be seen as unsustainable and yet they are necessary in order to allow a managed and controlled de-leveraging of the private sectors.

Net lending (+) net borrowing(-), as % of GDP:



Gross debt (as % of GDP)

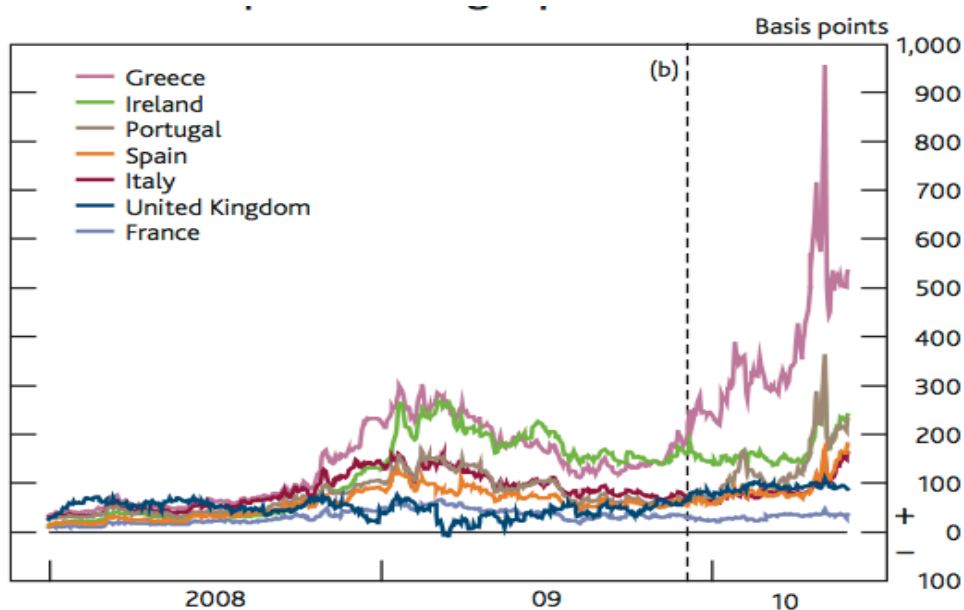


Source: Commission services.

#### **4. Why the drive towards fiscal austerity?**

The most straightforward answer to this question is 'financial markets'. The case of Greece and other European economies made it crystal-clear that financial markets have the power and determination to declare the margins of non-sustainability of public finances. A closer look reveals that it is credit rating agencies that play a key role in the *watchdog function* of financial markets. Financial market transactions of all kinds come with regular concerns whether the lender is likely to service and eventually settle the transaction. Information is the critical variable, and it is distributed asymmetrically. In

order to fill at least certain parts of the information gap, financial institutions outsourced this task to newly emerging credit rating agencies<sup>5</sup>. The link between credit rating and financial market response is straightforward. Changes in the rating leads to the reassessment of the particular underlying financial product on the side of lenders. Changes of ratings also can be read as ‘new news’ for investors and generate a regrouping of investments. Last but not least, rating changes can kick-start speculation against lenders as it is expected that markets will follow the herd, and being in front of the herd pays off. Even though the massive downgrading of Euro zone economies like Greece and Ireland is not at the roots of the sovereign debt problem of those countries, the point can be made that the rating behaviour added to the increasing nervousness of financial markets. Von Hagen/Schuknecht/Wolswijk (2010) show in their analysis of government bond yield spreads that the Lehman Brothers default of September 2008 fundamentally changed the responses of financial markets in the case of high and increasing public deficits. The Greek socialist government’s public declaration in late 2009 that it miscalculated Greece’s budget deficit kick-started an accelerated process of mutual downgrading and punishment of governments by financial markets, as graph 5 shows (Bank of England 2010).



Sources: Thomson Reuters Datastream and Bank calculations.

- (a) Spread of ten-year government bond yields over German bunds for selected countries. Data to close of business on 10 June.
- (b) December 2009 Report.

<sup>5</sup> White, 2010, gives a good and historically informed overview on credit rating agencies. He also points out that for legal reasons those agencies form ‘opinions’ rather than ‘judgements’ about the quality of lenders.

The high yield spread in the Euro zone reflects the anxiety of global investors about the ability of national governments to successfully return to sound public finances and/or to operate a fiscal austerity program that would reduce the deficit exposure of those economies. Moreover, the increasing spread was interpreted as the inability of the Euro zone to deal with sovereign debt defaults, and thus resulted in a strong depreciation of the Euro against the US-Dollar and other currencies. So far, all the governments were able to refinance their bonds, albeit to much higher interest rates than before the crisis. Investors are simply requesting higher risk premiums, and thus benefit from the downgrading as long as the worst-case is of sovereign debt default or even a haircut is prevented.

In other words, financial markets have the power to ‘punish’ governments and push them towards austerity programs in order to escape the downgrading of credit agencies. In case of the Euro zone economies they also had the power to kick-start a rally against the Euro and to push the common currency to the brink. Immediate responses by governments and the EU were chaotic, un-coordinated and often unsophisticated. Still, the direction of political responses is quite obvious today: *Bringing public deficits down, strengthening monitoring and supervision of national public finances, increasing fines in case of violations, and thus installing a new fiscal discipline beyond the Stability and Growth Pact* (see under 4.).

In order to avoid a flight from the Euro, it was necessary to provide emergency funding for ailing economies. After hefty and controversial debates, national governments came up in May with the launch of a European Financial Stability Facility. This new institution, terminated in 2013, sees the provision of overall 750 bn Euro as emergency funding in case of sovereign debt default crises. It is foreseen that 440 bn (59%) should be provided as credit guarantees by member states, another 60 bn by the EU, and 250 bn by the IMF<sup>6</sup> (see graph 4).

This approach was so far helpful in the sense that the severe speculation against the Euro came to a halt and the currency even started to appreciate against the US-Dollar. The latter may have been supported by the financial markets reception of the outcome of the European Bank Stress Test in the summer of 2010. According to this exercise only six European banks would sink below the six % threshold of tier 1 capital in case of a sovereign debt default of one of the Euro zone members. It is interesting and alarming at the same time to note that the positive attitude of financial markets has not

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<sup>6</sup> In line with the decisions taken May 9, 2010 within the framework of the Ecofin Council to safeguard financial stability in Europe, Ministers have established the European Financial Stability Facility (EFSF). The EFSF was set up by the 16 countries whose currency is the euro to provide a funding backstop should a euro area Member State find itself in financial difficulties. The EFSF will have the capacity to issue bonds guaranteed by euro area members for up to € 440 billion for on-lending to euro area Member States in difficulty, subject to conditions to be negotiated with the European Commission in liaison with the European Central Bank and International Monetary Fund and to be approved by the Euro group.

even been disturbed by the news that the facility will provide far less funding than initially planned. In order to get the highest ratings from Moody's, Fitch and Standard & Poor, the new fund had to agree to an asset backing that took up 20 % of the 440 bn Euro. Moreover, as not all guaranteeing states enjoy a triple A rating, the actual amount which can be guaranteed will be only around Euro 250 bn<sup>7</sup>. This changes the composition of contributions between the three financial supporters. The member states now represent 45 %, as does the IMF; the EU share is 10 %.

Such a significantly lower war chest should have alerted financial watchdogs. The same holds for the outcome of the stress test. It has been argued (Blundell-Wignall/Slovik 2010) that the stress test was only considering debt exposures of EU banks held on so-called trade books while missing the much larger amounts of sovereign debts in the much larger so-called banking books. Given the chosen procedure, the outcome of the stress test showed that even in case of haircuts the funds of the EFSF would easily cover losses. The picture differs as soon as sovereign debt in the banking books are taken into consideration. The loss amounts then to Euro 165 billion of tier 1 capital in both books. The national banking exposure to sovereign debt of Greece, Portugal, Spain, Ireland, Italy, and Hungary is shown in the table taken from (Blundell-Wignall/Slovik). It shows that banks are extremely exposed to sovereign debt of their own countries; an exposure higher than 5 % of tier 1 capital can be seen for example for German banks (Greece, Portugal, Spain, Ireland; Italy). German banks also hold sovereign debt above the 5 % threshold from economies like Hungary that is not covered by the EFSF. Still, even the smaller funds available for the EFSF will cover haircuts of the size assumed in this exercise, at least as a sovereign debt default does not kick-start a stampede. In the short-term it can be argued that the umbrella will work. It is unclear yet what will happen after the EFSF runs out in 2013. Will national governments then be on a public finance track that is seen as sustainable by financial markets?

The answer to this question depends not least from perceptions of financial market actors. For the moment they seem to be pleased with the efforts of national governments and the EU to move towards stricter rules of public finance. The path to financial soundness, however, is long and winding. Moreover, whether this will become a relatively smooth journey depends from a broad range of factors of which only a very few are in control of governments.

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<sup>7</sup> See Frankfurter Allgemeine. FAZ.Net, 21 September 2010: Euro-Rettungsfonds kann nur 250 Milliarden Euro verleihen.

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**Table 2.** National banking exposure to sovereign debt of Greece, Portugal, Spain, Ireland, Italy, and Hungary

EUR millions	Exposures to Greece	Exposure / Tier 1 Capital	EUR millions	Exposures to Portugal	Exposure / Tier 1 Capital
Greece	56,148	226%	Portugal	13,707	69%
Germany	18,718	12%	Germany	10,888	7%
France	11,624	6%	Spain	6,807	4%
Cyprus	4,837	109%	France	4,864	3%
Belgium	4,656	14%	Belgium	2,982	9%
United Kingdom	4,131	1%	United Kingdom	2,571	1%
Netherlands	3,160	4%	Netherlands	2,272	3%
Italy	1,778	2%	Italy	304	0.3%
Portugal	1,739	9%	Austria	272	1%
Spain	1,016	1%	Ireland	257	1%

EUR millions	Exposures To Spain	Exposure / Tier 1 Capital	EUR millions	Exposures To Ireland	Exposure / Tier 1 Capital
Spain	203,310	113%	Germany	12,922	8%
Germany	31,854	21%	United Kingdom	5,580	2%
France	6,592	4%	Ireland	5,322	26%
United Kingdom	5,916	2%	France	2,476	1%
Belgium	3,530	11%	Portugal	839	4%
Netherlands	1,685	2%	Denmark	675	4%
Italy	1,383	2%	Belgium	593	2%
Ireland	391	2%	Netherlands	559	1%
Portugal	345	2%	Cyprus	440	10%
Austria	239	1%	Italy	239	0.3%

EUR millions	Exposures To Italy	Exposure / Tier 1 Capital	EUR millions	Exposures to Hungary	Exposure / Tier 1 Capital
Italy	144,856	157%	Germany	8,215	5%
Germany	72,717	48%	Hungary	4,931	133%
France	48,185	26%	Austria	4,335	21%
Belgium	25,194	76%	Italy	2,253	2%
Netherlands	10,313	14%	Belgium	2,189	7%
United Kingdom	10,029	4%	France	1,881	1%
Spain	6,017	3%	United Kingdom	452	0.2%
Luxembourg	2,505	158%	Spain	251	0.1%
Austria	1,474	7%	Netherlands	188	0.2%
Portugal	1,179	6%	Greece	80	0.3%

Source: OECD and bank reports.

The case can be made that the *Powell Doctrine* has been a necessary step at the time of strong speculative attacks against the Euro. Today we know that the funds announced are not available, and may even shrink further<sup>8</sup>. The calm of the markets (end-September 2010) should not be read as a sign of regained trust and confidence due to the EFSF. This calmness has more to do with two other factors: (i) The first two quarters of 2010 has shown surprisingly resilient growth in the Euro area, mainly driven by the strong export-led growth dynamic of Germany. This growth spurt impressed markets and resulted in a recovery of the exchange rate of the Euro. (ii) Even more important in calming financial markets was the turn-around of the ECB announced in May 2010, to buy government bonds of strongly indebted economies and thus to monetize public debt. Financial markets correctly interpreted this policy change as the end of any no-bail out approach for the ECB.

<sup>8</sup> The problem of actual availability was early mentioned by Charles Wyplosz in his piece: "European Stabilisation Mechanism: Promises, realities and principles, VOX 12 may 2010, <http://www.voxeu.org/index.php?q=node/5031>"

The first factor already slips as growth prospects across the Euro zone start to shrink<sup>9</sup>. The negative effects of de-leveraging of private actors in combination with the turn towards fiscal austerity and the slower growth of the global economy have led to the relatively weak recovery. The paradox of thrifts starts to show up big time in some economies of the Euro zone. The decision of the ECB to purchase stressed government bonds definitely helped exposed banks but also has led to deep tensions in the Bank's board, and fed fears of a inflation rate far above the target rate of the ECB. The German head of the Deutsche Bundesbank, Axel Weber, even made his disagreement public. Whether this policy will hold in case of a return to instability and increasing tumult therefore needs to be seen<sup>10</sup>.

## **5. Institution Building and Trust**

The EU relies mainly in institution renovation and institution building for its project to restore trust and confidence in the EU and its underlying architecture. Initiatives are abundant, and some steps have already been made in the last couple of months. At the time of writing, not all concrete details of the renewed mode of economic governance are not known. The overall direction taken, though, outlined in the Commission's communication from May 12, 2010, and in a second communication from June 30, 2010, as well as by proposals of national governments is obvious: (i) Overcoming the patchwork of financial sector regulation and supervision by creating an independent European institution that cooperates with the ECB. The 'European Banking Authority' jointly with a 'European Insurance and Occupational Pensions Authority' and a 'European Securities and Markets Authority' will act as pan-European regulators. The 'European Systemic Risk Board', located in Frankfurt, will provide macro-prudential oversight. (ii) Closer regulation of particular financial products and services, including a tax on financial transactions are in the making. (iii) Launch of a totally renovated version of the preventative arm of the SGP by introducing a so-called European Semester. This exercise will deeply intrude on national public budget preparations and greatly influence national budgets in size and breadth. The proposed new principle of financial prudence will come with stricter enforcement: "This principle implies that annual expenditure growth should not exceed – and if the MTO (Medium-term budgetary objectives, KH) has not been achieved should be clearly below – a prudent medium-term rate of growth of GDP, unless the MTO has been significantly overachieved or the excess of expenditure growth over the prudent medium-term rate is matched by discretionary measures on the revenue side....failure to respect keep to the agreed rate of growth of expenditure, in conjunction with the stipulated revenue

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<sup>9</sup> The storm seem to build up again, as the Financial Times lines out: "he weak data added to evidence that [gloomier global prospects](#), a strengthening euro, and the crises conditions facing the Greek and Irish economies are taking a toll on eurozone prospects. They did not point to a double-dip recession in continental Europe as a whole – but highlighted the vulnerability of countries still struggling to bring their public finances under control. "The turn in the world trade cycle has finally reached the eurozone," said Nick Kounis, economist at ABN Amro in Amsterdam."

<sup>10</sup> That the EU is no homogenous club with a shared belief in fiscal solidarity was stressed by the vote of Slovakia's parliament in August 2010 not to participate in the conditional loan for Greece.

measures, will make the Member State concerned liable to a warning from the Commission and, if persistent and/or particularly serious, a Council recommendation to take corrective action issued under Article 121 of the Treaty. Such a recommendation...would be backed, for the first time and for euro-area countries only, by an enforcement mechanism under Article 136 of the Treaty, in the form of an interest-bearing deposit, amounting to 0.2 % of GDP” (European Commission COM (2010) 526. (iv) Strengthening the corrective arm of the SGP, mainly via monitoring and supervision and in particular by enforcing higher fines in case of violations. The new element that asks governments with debt ratios above the 60% margin to cut debts at a rate of 1/20<sup>th</sup> of the excess debt is the most important innovation in the arena of the corrective arm. Fines will be of monetary form but may also include strong political fines as temporary loss of voting power and loss of eligibility of EU funds.<sup>11</sup> (v) Possible introduction of national debt brakes as already introduced in Germany through a change in the EU Treaty. (vi) Enforcing structural reforms in order to overcome gaps in competitiveness and costs by means of a scoreboard.

These plans will result in a fundamentally new economic mode of governance in the Euro zone. It can be safely assumed that the implementation efforts will carefully avoid that this new regime requires a new Treaty. In material terms, this new mode of governance undermines drastically the national base of democratic principles (representation-taxation link), in particular with regards to the planned pre-emptive budget procedures and the European Semester. It also means the end of the current soft mode of governance, in particular of the well-known Open Method of Coordination type. Centralization of power in Brussels is back in.

In terms of economic policy, this change gives the wrong answer to establish an adequate new mode of economic governance, as it is a deliberate surrender to the wrong-headed benchmarks set by global financial markets. First, the announced policies will give the paradox of thrift a visible European face, and thus weaken Europe and the Euro zone as a stabilizing force for the global economy. Greece and Ireland are the most prominent cases where courageous efforts to reduce public deficits result in the reduction of economic growth and thus in an increase in the debt ratio. For the short-term, this policy will add to the global growth problems. Second, it will create vicious circles for some Euro zone economies and thus undermine the stability of the zone itself. Greece in particular will not only socially suffer from the planned programs of fiscal austerity, but will not be able to achieve credible debt ratios in the near future. A haircut decision may be unavoidable. Third, rather than making its mode of governance more flexible by adding discretionary elements, it will add inflexibility and establish a purely rule-based mode of governance. Adding to the already problematic one-size-fits-all practice of monetary policy a one-size-fits-all fiscal rule will add a strong recessive moment and thus undermine a return to a sustainable growth path in Europe. Additionally, it will make the Euro zone to the most inflexible policy regime in the global economy.

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<sup>11</sup> An economy with a debt ratio of 120%, for example, would need to execute cuts of 60/20, i.e 3 % points of GDP on a yearly base. It is unlikely that such cuts produce macroeconomic stability.

The EMU is not automatically destined for a doomsday scenario. As long as other parts of the global economy continue to grow, Euro zone economies will benefit, and will be in a position to successfully deal with the default of individual member economies. However, the situation is tippy and filled with uncertainty. By making the reduction or even elimination of public deficits and the shrinking of public debts to central targets of the mode of economic governance, the EU runs the risk of creating, at least short-term, more problems than solving problems. In the current economic situation, the planned turn towards an even stronger fiscal austerity is wrong politics. Indications are already out that this approach does not generate trust and confidence. Rather, it pushes governments into a hare-turtle race where governments are set to lose.

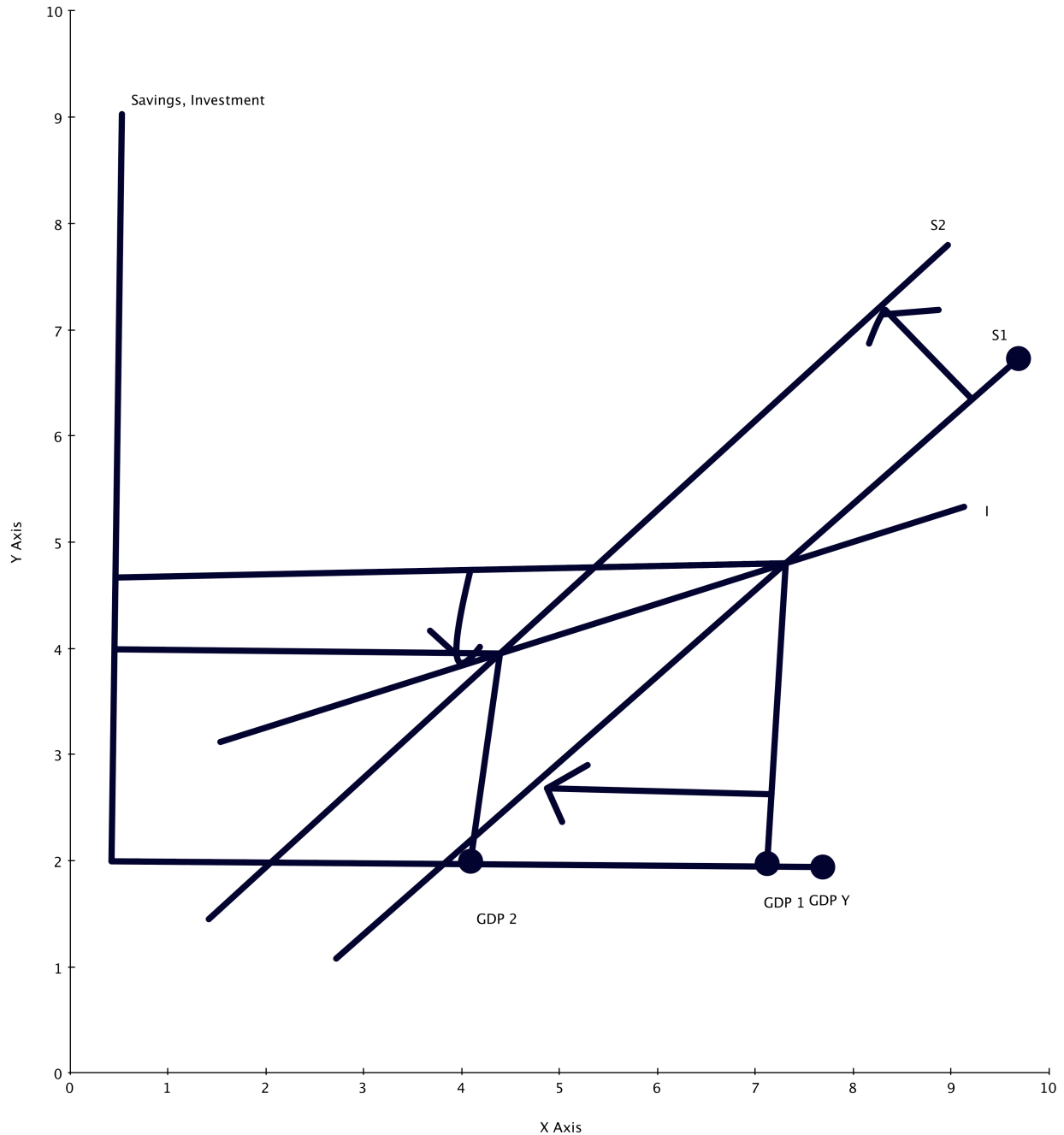
Besides such short-term prospects, the emerging new mode of governance does not pass a social litmus test. The envisaged ‘structural’ reforms aim to add more flexibility to labor markets and thus shift labor market power in favour of employers. The possible shrinking of the public sector already generated strike and social unrest in some European nation-states. Insofar as differences in competitiveness are interpreted by the Commission and national governments as driven mainly by differentials in unit labor costs, the reforms risk kick-starting a wage cost race inside the Euro zone that runs the risk of undermining social compromises. Institution building does not automatically restore trust in the Euro. The proof is in the pudding. In this respect, I fear that the new mode of governance will not deliver what is actually needed.

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## **Annex: The Paradox of Thrift**

The amount of investment depends on the development of economic growth, indexed as GDP. With an increase in GDP, investment increases albeit with a decreasing rate. If the original savings-GDP relation is depicted by S1, and S2 shows an upward shift of savings due to the planned higher savings, this implies at any given level of GDP a fall in the actual amount of savings and investment, and thus of GDP. In other words, planned savings and investment are generating a drop in economic output.



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