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### The Rising Public Debt in the EU: Implications for Policy

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# The Rising Public Debt in the EU: Implications for Policy

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**ABSTRACT** *The current financial and economic crisis is of unprecedented proportions and intensity. Given the piecemeal approach of the EU institutions to economic policy, their reaction to the mounting crisis has been slow and hesitant.*

*The much feared financial meltdown in the E.U. has been avoided. However this came at the cost of increasing pressure on public finances in most member states, leading to a public debt crisis in a number of them. Financial liberalization and the lagging financial policy reform exacerbated such pressure, bringing certain member states such as Greece to the verge of default. Even more importantly, the stability of the eurozone appears to be in danger.*

*This has led to an avalanche of new measures, including the newly instituted “European Stabilization Mechanism”, as well as proposals for the adjustment of fiscal policy co-ordination, under the general heading of ‘reinforcing economic governance in Europe’ as announced by the European Commission in May 2010.*

*So, what next? Past experience confirms that a financial crisis is usually followed by a sovereign debt crisis. Is this what is happening in the EU? With what social and economic implications? Further, what are the implications of rising sovereign debt for economic policy?*

*These are some of the questions we discuss in the present article. In particular, we examine (i) the concept of the sovereign debt and its relevance to the EU and to the eurozone; (ii) the historical experience of crises; (iii) the response of the EU to the current crisis and (iv) the prospects for policy.*

**KEY WORDS:** sovereign currency, public debt, bank support, financial policy reform, Economic and Monetary Union, European integration

## Introduction

The year 2010 saw attention shift from the financial crisis to the public debt crisis in the EU and especially in the eurozone. The first five months of the year were marked by suspense, as the Greek debt crisis escalated, threatening to engulf other eurozone countries. The suspense was temporarily ended in May 2010, when EU leaders decided on a mechanism to support the euro and to hold at bay the prospect of default by a eurozone country. It returned in November 2010, as the newly created support mechanism was activated in support of Ireland, facing increasing difficulties in the sovereign bond market.

‘Fiscal consolidation’ and ‘long-term sustainability’ are two key words of current EU economic and social policy. Concerns over rising public debt levels across the EU have

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legitimized a frontal attack by the EU on workers' rights of past, present and future generations! The 'stupid' Stability and Growth Pact has been taken out of the closet. Public expenditure is being drastically curtailed, including pensions, while taxation is being raised, especially indirect taxation, which is easier and faster to implement.

In the following sections of this paper we shall argue that:

- Policy concerns over the risk of sovereign default are justified only under certain circumstances. In the case of a sovereign currency, such concerns are largely the result of 'superstition'.
- It is an historical fact that financial, and especially banking, crises are followed by steeply rising public debt levels.
- Whereas the EU fiscal response may have averted a financial meltdown, its financial policy response, in terms of introducing the necessary reforms, has so far been at best hesitant.
- The euro support mechanism agreed by the EU leaders provisionally in May 2010 and permanently in December 2010 does not adequately defend the currency at a time of crisis.
- The architecture of the Economic and Monetary Union is in urgent need of being restructured, in order to survive the present crisis and to avoid a future one. This is imperative for the survival of the European integration project itself.

### **The Dangers of a Rising Public Debt: Fact or Myth?**

Paul Samuelson has been quoted as saying the following:

I think there is an element of truth in the view that the superstition that the budget must be balanced at all times (is necessary). Once it is debunked (that) takes away one of the bulwarks that every society must have against expenditure out of control. There must be discipline in the allocation of resources or you will have anarchistic chaos and inefficiency. And one of the functions of old fashioned religion was to scare people by sometimes what might be regarded as myths into behaving in a way that the long-run civilized life requires. . . . I have to say that I see merit in that view. (Paul Samuelson in Mark Blaug's documentary film, 'John Maynard Keynes: Life/Ideas/Legacy' from 1995, quoted in Nersisyan & Wray, 2010, p. 2)

So, how far are the dangers of rising public debt levels a 'myth'? Are policy concerns over the 'sovereign debt crisis' justified? Under what conditions?

Various theoretical arguments have been advanced with regard to the dangers implicit in rising public debt levels. In particular, it is feared that high public debt ratios reduce the rate of growth through a rise in savings and through the crowding-out of private investment. In the first instance, it is assumed that, as people see that taxes are going to rise, they increase their savings, thus reducing growth. Furthermore, increasing public debt competes with private debt for the allocation of savings, thus crowding out private investment from the capital markets.<sup>1</sup> If the resources employed by the State are less efficiently used in comparison with the private sector, there is going to be a loss in output.

Both the debt/tax neutrality hypothesis,<sup>2</sup> which has been intensely debated, and the crowding-out effect of rising public debt ratios reflect a supply-side approach to growth,

thereby ignoring the role of fiscal policy and the policy objectives of rising public deficits and debt ratios. Such an approach is clearly inadequate at a time of recession.

Additional policy concerns refer to the risk of sovereign default, due to escalating interest rates and loss of investor confidence in a government's creditworthiness, that is, in the sustainability of its fiscal position. However, as Nersisyan & Wray (2010) have argued, 'sovereign debt', issued in a floating, non-convertible currency, needs to be distinguished from 'non-sovereign debt', issued with a promise of conversion at a fixed exchange rate. In the first case, a sovereign government faces no insolvency risk, since it has undertaken no promise to convert its currency at a fixed exchange rate. It can thus increase the volume of its currency in the face of increased pressure from the financial markets. Although this carries the risk of inflation, it is not a principal concern at a time of recession.

On the contrary, a politically sovereign government, with a currency that is pegged or convertible at a fixed exchange rate, faces the risk of default under pressure from financial markets. The eurozone member states have surrendered their currency-issuing monopoly to a supranational institution, the European Central Bank (ECB). Thus, they can only finance their spending through taxation and borrowing on the market. This makes them vulnerable to the pressures applied by financial investors looking for high risk/high yield securities. As soon as such investors sense possible default, they embark on a self-fulfilling prophecy!

This is the situation EU member states, especially in the eurozone, currently find themselves in, starting with Greece in the early part of 2010 and followed by other high public debt member states. The fact that financial markets continue to operate unfettered adds to the pressures exerted on governments.

Overall, the risks associated with rising public debt levels need to be viewed in the particular institutional context, in which they arise. Their implications for growth are a function of the overall policy objectives. Further, the default risk these carry needs to be examined in relation to the currency in which they are expressed. Countries with a sovereign currency cannot be forced into default. This is not the case for countries with a non-sovereign currency. Thus, concern with rising public debt levels in the EU is justified on the assumption that the EMU architecture remains constant. However, such an assumption is too dangerous for the future of the European Monetary Union (EMU) and indeed of the European integration project more generally.

### **The Historical Experience of Financial Crises**

The present financial and economic crisis bears all the hallmarks of a banking crisis turned into a public debt crisis. In this sense, history provides some interesting insights with respect to both the triggers and the impact of such a crisis. So, what does history tell us about such crises?

Reinhart & Rogoff (2009) have found that the aftermath of severe financial crises shares three characteristics:<sup>3</sup>

- First, asset market collapses are deep and prolonged.
- Second, banking crises are associated with profound declines in output and employment.
- Third, the real value of government debt tends to explode, while the main cause of this is the collapse in tax revenues following the prolonged output contractions, as

**Table 1.** Summary of the cost of banking crises.

	Direct fiscal costs <sup>c</sup>	Increase in public debt <sup>c</sup>	Output losses <sup>c</sup>
	Medians (% of GDP)		
<i>Crises 1970–2006<sup>a</sup></i>			
Advanced economies	3.7	36.2	32.9
Emerging economies	11.5	12.7	29.4
<b>All</b>	<b>10.0</b>	<b>16.3</b>	<b>19.5</b>
<i>Crises 2007–2009<sup>b</sup></i>			
Advanced economies	5.9	25.1	24.8
Other economies	4.8	23.9	4.7
<b>All</b>	<b>4.9</b>	<b>23.9</b>	<b>24.5</b>

*Notes:*

<sup>a</sup>‘Crises 1970–2006’ include all systemically important banking crises over this period, namely, forty-two such crises in thirty-seven countries.

<sup>b</sup>‘Crises 2007–2009’ include Austria, Belgium, Denmark, Germany, Iceland, Ireland, Latvia, Luxembourg, Mongolia, Netherlands, Ukraine, the UK and the USA.

<sup>c</sup>Direct fiscal costs include fiscal outlays committed to the financial sector, mainly through recapitalizations; output losses are computed as deviations of actual GDP from its trend; the increase in public debt is measured as the change in the public debt-to-GDP ratio over 2007–2009.

well as ambitious countercyclical fiscal policies aimed at mitigating the downturn.

Laeven and Valencia (2010, p. 22) provide some further insights into the historical experience of banking crises in the more recent past (Table 1).

Based on the observations in Table 1, Laeven and Valencia conclude that the economic cost of the 2007–2009 crises is on average much larger than that of past crises, both in terms of output losses and an increase in public debt, although the direct fiscal costs of dealing with the crises appear to be lower. These differences are attributed to (1) the fact that the recent crises are concentrated in high-income countries; (2) the increased size and interconnectedness of the financial systems in these countries; (3) the swift response by governments and central banks to the 2007 crisis, which limited the direct fiscal outlays;<sup>4</sup> (4) the extensive indirect support provided to the financial system through expansionary monetary and fiscal policy, the widespread use of guarantees on liabilities and direct purchases of assets that helped sustain asset prices, which however bore heavily on the size of the public debt.

Overall, past experience of financial crises points to a prolonged period of distress, both in the financial sector and in the economy more generally, the social implications of which must not be underestimated. In such circumstances, public debt ratios are expected to increase as a result of the automatic stabilizers coming into play, falling output, as well as fiscal stimulus policies.

## EU Policy Reaction to the Financial and Economic Crisis

We shall look into the policy response of the EU to the present crisis and its implications for public debt in the areas of financial policy reform, support provided to the banks and fiscal stimulus. The role of the ECB will also be examined.

### *Financial Policy Reform*

Generally, the financial crisis management arrangements of the EU, as provided by its supervisory and regulatory framework, are fragmented and diverse across both sectors and member states. Such co-ordination as exists concerns information flows and the distribution of roles. The global financial crisis that erupted in 2007 brought out the inadequacies of the present system. This is, however, not surprising in view of the fact that the financial integration policy, which was vigorously pursued in the past ten years, has had no counterpart in the area of stability. In the words of the European Commission, ‘The crisis has exposed unacceptable risks in the current governance of international and European financial markets, which have proved real and systemic in times of serious turbulence’ (European Commission, 2009b, p. 4).

In the autumn of 2008, as the full impact of the crisis was realized, a group of high-level experts—the De Larosière Group—was convened, with the urgent mandate of proposing measures to amend the supervisory and regulatory financial policy framework of the EU. The relevant report was submitted in February 2009. Accordingly, a number of new policy initiatives are underway. These include the following:

- *Macro-prudential supervision*: completely neglected until now, it is going to be the responsibility of a European body, the European Systemic Risk Council to be set up, under the auspices of the ECB.
- *Micro-prudential supervision*: a network of European financial supervisors—the European System of Financial Supervision—is to be set up, operating on the basis of harmonized rules.
- *Regulatory framework*: new rules on hedge funds and private equity (previously unregulated); early intervention; increasing transparency for derivatives; increasing the quality and quantity of prudential capital for trading book activities and complex securitization are being discussed.

The actual decision-making process is expected to be long drawn-out, largely due to the strength of the financial sector interests, which are lobbying vigorously against any changes to the status quo.

Overall, EU and indeed global financial policy reform is lagging. The urgency with which such issues were discussed in 2008 and 2009 has been significantly toned down. Generally, the slow rate of financial policy reform both at the European and at the global level exacerbates the pressures financial markets exert on governments in need of funding. In the case of the eurozone countries, operating with a non-sovereign currency, such pressures may give rise to fears of default.

### *Bank Support*

Since the start of the crisis, EU member states have committed very considerable funds to their financial systems, mainly the banks. Table 2 shows the bank support schemes by type of intervention in relation to GDP, adopted at the EU and the eurozone level.

We observe that the largest part of the measures European governments have taken to support their banks consists of guarantees on bank liabilities. These are best described as ‘contingent liabilities’, insofar as they determine an outlay only if and when they are called upon. In view of the fact that less than one-half have been granted, it may reasonably be

**Table 2.** Public interventions in the banking sector (% GDP).

	Capital injections		Guarantee on bank liabilities		Impaired asset + Liquidity support		All approved measures	
	Total	Effective	Total	Granted	Total	Effective	Total	Effective
Eurozone	2.6	1.4	20.6	8.3	13.3	1.4	36.5	11.1
EU-27	2.6	0.5	24.7	7.8	16.3	3.5	43.6	11.8

*Source:* E.C. Economic Crisis in Europe: Causes, Consequences and Responses (2009, p. 63).

expected that the continuation of the crisis will significantly augment the amount of funds spent by EU governments to prop up their banks. In addition to the above, bank support took the form of increased coverage of retail deposit insurance. This is another type of ‘contingent liability’, which has not yet materialized in the present crisis.

More generally, according to the data in Table 2, European governments are committed to spending a significant part of their GDP (considerably more than one-third) to support the banking system, while no expiry date has been attached to the duration of such measures.

It is worth noting that, in supporting the banks unconditionally, the EU member states have violated the ‘principle of the firm owners’/shareholders’ primary financial responsibility’, as stipulated in the 2003 Memorandum of Understanding on crisis management and confirmed by the ECOFIN Council of October 2007. Namely, that:

- (i) the objective of crisis management is to protect the stability of the financial system . . . not to prevent bank failures; (ii) in a crisis situation, primacy will always be given to private sector solutions and (iii) the use of public money to resolve a crisis can never be taken for granted. (European Central Bank, 2008, pp. 82–83)

### *Fiscal Stimulus*

By contrast to the support provided to the banks, the EU institutions were slow to respond by way of a fiscal stimulus of the economy. It was only after the Lehman debacle in the autumn of 2008 that a ‘European Economic Recovery Plan’ was officially approved in December 2008. This was essentially an attempt at policy co-ordination, in view of the fact that member states were already handling the crisis on their own terms and with their own means. What was at stake was the long-standing competition framework of the EU, the custodian of which is the European Commission.

Thus, it was agreed that €200 billion would be spent by way of fiscal stimuli, financed by both the member states (€170 billion) and the EU (€30 billion). It is worth noting that such stimuli were regarded as temporary from the start, so that all member states are expected to return to the medium term budgetary objectives by 2011. By the end of 2009, it was estimated that the fiscal stimulus measures taken or planned by member states amounted to a total of 1.5 per cent of annual GDP for 2009 and of 1.4 per cent for 2010, while the actual size of the stimulus package varies across countries (European Commission, 2010a). By comparison to the bank support measures, detailed in Table 2, the cost of the European Economic Recovery Plan (EERP) (p. 10, 1.254) fiscal stimuli is strikingly low. Further, it is time-constrained, since such stimuli are expected to expire by 2011.

### The ECB Response

The ECB responded promptly with significant adjustments in its liquidity management operations, as early as in August 2007. When interbank trading came to a virtual halt in September 2008, the ECB started to engage in a new mode of liquidity provision, known as ‘enhanced credit support’, which is due to be phased out in the course of 2011.

While it is believed that the ECB policy measures have had certain beneficial effects on crisis management, they are far from what would be expected of a central bank safeguarding a sovereign currency. In particular, the ECB is constrained by the Treaty of the Union from lending directly to governments. This places the latter in the hands of the financial markets making them thus vulnerable to the pressures exerted by them at a time of crisis.

### The Public Debt Crisis and the Response of the EU

Both the historical experience of past financial and banking crises and the policy measures taken to support the EU banks during the present crisis lead to the conclusion that public debt is expected to rise in the aftermath of the crisis. As Reinhart & Rogoff (2009) have observed, when a credit bubble bursts, private debt becomes public debt. Table 3 shows the actual and forecast EU public debt as a percentage of GDP between 2005–2011.

As we can see in Table 3, public debt as a percentage of GDP is expected to rise significantly in the EU, as well as in the eurozone, which is going to have a higher debt ratio by comparison to the EU average. Furthermore, in certain member states a particularly large percentage point increase in public debt is expected:

- Ireland—79.6 (107% from 27.4%).
- Greece—49.9 (150.2% from 100.3%).
- Spain—27.0 (70% from 43%).
- Portugal—27.0 (89% from 62%).

The increasing public debt and its differentiation across EU member states has meant that sovereign credit default swap (CDS) premia for euro area countries have increased sharply, while certain countries have been more affected than others. This is evidenced by the trend in government bond yields relative to Germany, which reflect liquidity and credit risks. Compared to the start of the crisis (2007), by 2009 ten-year bond yields had fallen for Germany, France, the Netherlands, Belgium and Finland, remained broadly stable for Austria, Spain, Italy and Portugal and increased for Greece and Ireland (European Central Bank, 2009, pp. 63–74). This trend continued into 2010. This is to a certain extent indicative of the role of speculation, whereby financial actors exert pressure where they sense a risk of default.

In other words, while the problem of the rising public debt is a serious one, it is exacerbated by the games financial markets and actors play. Such games are mostly of a

**Table 3.** Gross debt, general government (% GDP).

	2005	2006	2007	2008	2009	2010	2011	Change in debt ratio 2005–2011
Eurozone	70.0	68.4	66.0	69.7	79.1	84.1	86.5	16.5
EU-27	62.7	61.5	58.8	61.8	74.0	79.1	81.8	19.1

Source: EC Statistical Annex of *European Economy*, Autumn 2010, Table 78.



speculative nature. It is in this respect that the delay in financial policy reform has been critical in not providing governments with the necessary instruments to deal with an extraordinary situation. This is especially so in the case of the eurozone member states, which cannot resort to monetary measures, as they have no control over their currency.

### *The Greek Debt Crisis*

In the first half of 2010, a massive speculative attack on Greek government bonds almost led to the destabilization of the eurozone. According to the Laeven & Valencia (2010) typology of countries by type of banking crisis, Greece is considered to be a ‘borderline case’, that is, one in which the crisis was not systemic, in the sense that there were no significant signs of financial distress in the banking system (as indicated by significant bank-runs, losses in the banking system and bank liquidations), neither were there any significant policy intervention measures in response to significant losses in the banking system. For example, the fiscal cost of public interventions in the Greek banking sector amounted to 11.6 per cent of GDP, of which 4.7 per cent became effective, by comparison to an average 36.5 per cent and 11.1 per cent respectively in the eurozone (Table 2).

Greece entered the crisis with a high public debt and deficit (− 5.1 per cent and 95.7 per cent of GDP respectively in 2007), as well as a large current account deficit in relation to GDP (− 14.7 per cent of GDP in 2007). It is these twin deficits that exposed Greece to the pressures of the financial crisis and to the vagaries of the financial markets. At the same time, the hype created by the media, especially in Germany, against the ‘lazy’ Greeks and so on, served to conceal the fact that the real target was the eurozone, rather than Greece. It was the missing links in the eurozone architecture that attracted investors’ attention to the potential gains to be made from betting against it.

More specifically, the eurozone is a rules-based economic union of sovereign states, within a market-oriented economic environment. Fiscal discipline by peer pressure is at the centre of the euro construct. It has been shown to be dramatically short of the needs of dealing with a crisis. Greece may have been an extreme case. However, it laid bare the inadequacies of the foundations of the euro. The EU leaders realized this fact many months after the Greek debt crisis had hit the headlines worldwide. On 2 May 2010, the Eurogroup (the finance ministers of the eurozone countries) formally launched a financial assistance mechanism, conditional on the implementation of a programme of economic adjustment negotiated with the Greek authorities, in liaison with the ECB and the International Monetary Fund (IMF). Accordingly, Greece has undertaken to reduce its public deficit from 15.4 per cent of GDP in 2009 to below 3 per cent by 2013 and to keep primary balances in surplus of at least 5 per cent of GDP up to 2020, in order to reduce its public debt. The programme is front-loaded, while further privatization and market liberalization are being pursued in relation to pensions, healthcare and education. A public financing gap of €110 billion has been projected for the period 2010–2013, to be covered through matching bilateral loans from eurozone member states (€80 billion) and the IMF (€30 billion).

### *The European Financial Stabilization Mechanism and Facility*

The Greek rescue package was soon followed by the establishment of a eurozone-wide financing mechanism, aimed at stabilizing the euro. On 10 May 2010, the European Council

decided on a comprehensive package of measures, including a European Financial Stabilization Mechanism (EFSM) and a European Financial Stability Facility (EFSF), providing total support of €500 billion.

The Mechanism, which is based on Art. 122.2 of the Treaty, allows the Commission to borrow in financial markets up to about €60 billion on behalf of the Union under an implicit EU budget guarantee. The Commission then lends on the proceeds to the beneficiary member state. All interest and loan principal is repaid by the beneficiary member state. Further, eurozone member states may complement the resources of the Mechanism through the Facility, up to a volume of €440 billion.

The European Financial Stability Facility takes the form of a Special Purpose Vehicle that will issue bonds on the markets with the pro rata guarantee of euro area member states, in accordance with their share in the paid-up capital of the ECB.<sup>5</sup> The Facility then lends on the proceeds to the beneficiary member state. The activation of these mechanisms is subject to strong policy conditionality; that is, in order to receive the funding instalments, the concerned member state has to implement a wide ranging set of policy measures designed to restore its fiscal viability. The EFSF is due to be liquidated by mid-2013. The IMF is also participating in the funding arrangements and is expected to provide at least half as much as the EU contribution, that is, €250 billion.

The EFSF was first activated in relation to *Ireland*, which came under extreme pressure in the bond market in late November 2010. The assistance package amounts to €85 billion, to be provided by the EFSM (€22.5 billion), the EFSF (€17.7 billion), the UK (€3.8 billion), Sweden (€0.6 billion), Denmark (€0.4 billion), the IMF (€22.5 billion) and Ireland itself (€17.5 billion). This is to be drawn over a period of 7.5 years, while Ireland is to implement a €15 billion austerity package over the next four years. Of the total amount, €50 billion is aimed at bolstering Ireland's public finances while, of the remaining amount (€35 billion), €10 billion will be used to recapitalize Irish banks and €25 billion will be a contingency fund to help support the banking system further.

### *The European Stability Mechanism*

At the European Council meeting of 16–17 December 2010, political agreement was reached on the creation of a permanent instrument, the 'European Stability Mechanism' (ESM), which is to replace both the EFSF and the EFSM, as of 1 January 2013, whereby:

The Member States whose currency is the euro may establish a stability mechanism to be activated if indispensable to safeguard the stability of the euro area as a whole. The granting of any required financial assistance under the mechanism will be made subject to strict conditionality. (European Council Conclusions, Annex I, p. 6: 15 December 2010)

Accordingly, the use of Art. 122(2) of the Treaty on the Functioning of the European Union (TFEU) (p. 13, 1.388), whereby member states in difficulty may seek financial assistance, is made redundant.

A special feature of the ESM is that it will involve private creditors, whose claims are subordinated to those of the IMF and the ESM (in this order). In this respect, 'collective action clauses' (CACs) will be included in the terms and conditions of all new euro area

government bonds as of June 2013. The ESM will continue to involve the IMF. The new provisions are to be added to Art. 136 of the Treaty on the Functioning of the European Union through intergovernmental arrangements ('simplified revision procedures', Art. 48(6) of the Treaty of the European Union). In other words, the decision will be finalized by the European institutions without involving the European citizens.

Overall, the ESM is a financial assistance mechanism to be activated under extreme circumstances (insolvency) and to be linked with extraordinary austerity measures and neoliberal reforms, as Klaus Regling (2010), the current head of the EFSF, has made clear in a recent article in the *Financial Times*.<sup>6</sup> In so doing, not only does it overlook the question of social cohesion and of democratic control, but it actually exacerbates both the social and the democratic deficits, already inherent in the EU institutional architecture. In this sense, the effectiveness of the ESM in helping to solve a financial crisis and to prevent it from turning into a social and political crisis is at best questionable.<sup>7</sup>

### *The ECB in a New Role?*

On 9 May 2010, the ECB launched its Securities Markets Programme, in response to the tensions in the sovereign debt markets. This is a time-bound policy measure, consisting of interventions in the euro area's public and private debt securities markets and focusing on those markets which are worst affected by severe disruptions.

In order to enhance its capital base, the ECB decided to increase its subscribed capital by €5 billion, from €5.76 billion to €10.76 billion with effect as of 29 December 2010. Euro area national central banks will contribute approximately 70 per cent of the total amount, to be paid up in three equal annual instalments, with the rest coming from the non-euro area NCBs.<sup>8</sup>

The ECB's Securities Markets Programme effectively means that the ECB has started buying the government bonds of the fiscally more vulnerable eurozone member states. This is the so-called 'nuclear option' (Baldwin & Gross, 2010, p. 16), so much so, that Barry Eichengreen (quoted in Baldwin & Gros, 2010, p. 16) has remarked that: 'The ECB, recent events remind us, is a lender and market maker of last resort and not just the steward of a monetary rule.'

In moving in this direction, the ECB is in fact making up for a major missing link in the euro architecture. However, to the extent that this is a temporary measure due to extraordinary circumstances, speculation is unlikely to be easily diminished, as the continued fiscal fragility of the eurozone shows.

## **EU Economic Outlook**

### *The EU 'Exit Strategy'*

At the first sign of 'green shoots', the EU leaders laid down the policy principles of exiting from the fiscal measures necessitated by the crisis. At the ECOFIN October 2009 meeting, these principles were specified as follows:

- The exit strategy should be co-ordinated across countries in the framework of the Stability and Growth Pact.
- Fiscal consolidation should start in 2011 at the latest. A number of countries need to consolidate even earlier.

- The pace of consolidation should be well above the benchmark of 0.5 per cent of GDP per annum.
- National budgetary frameworks need to be strengthened and structural reforms should be undertaken to enhance productivity and support investment.

By June 2010, the EU Council affirmed that: ‘The EU has met the worldwide financial crisis with united resolve and has done what was necessary to safeguard the stability of the Economic and Monetary Union.’<sup>9</sup> In the spirit of ‘business as usual’, the EU Council adopted a set of policy orientations regarding economic governance in relation to budgetary and macroeconomic surveillance, as well as the new strategy for the forthcoming decade 2010–2020, labelled ‘Europe 2020’. Generally, the focus of EU policy has shifted from the provision of fiscal support to avert the crisis to fiscal consolidation to mitigate the impact of the increasing public debt. Special concern is further expressed in relation to age-related expenditure, which is expected to increase as a result of the ageing population. The need for structural reform, meaning further privatization and market liberalization, is part of the long-run EU fiscal consolidation policy.

The rationale of the fiscal consolidation policy pursued by the EU at the present time is that: ‘Rising government debt ratios may harm growth prospects through reduced capital accumulation, i.e. via a crowding out of private investment’ (European Commission, 2009a, p. 50). As argued earlier in section one, this view overlooks certain facts, pertinent at a time of recession, namely: (1) low interest rates do not necessarily induce productive investment; (2) central banks can influence interest rates by creating credit; (3) public revenues may be boosted by a variety of taxes which do not lead to efficiency losses, such as property taxes, and so on.

### *A Fragile Recovery*

In view of the fact that the recovery is considered to be ‘tentative’, ‘sluggish’ and ‘unevenly distributed across the EU member-states’, as well as ‘jobless’, the emphasis placed on fiscal consolidation runs the danger of producing a double-dip recession, while it will certainly increase economic and social inequalities within and among regions, at the obvious expense of social cohesion (European Commission, 2010b). Table 4 displays the main features of the 2010 autumn forecast for the EU-27 and for the eurozone.

As we can see from Table 4, GDP growth dipped heavily in 2009, while it moderately resurfaced in 2010. The rate of inflation is low and expected to remain so. Unemployment, on the other hand, is rising, as is the government balance and debt. The current account balance does not display any major changes over the period under review.

Overall, the economic outlook is at best uncertain. The economy of the EU appears to have recovered from the plunge it took in 2009. However, it is a fragile recovery, based to a great extent on the fiscal support provided by governments over the past year. Withdrawing such support will add to the strains imposed by the global crisis, which is in no way over yet. Thus, the prospect of a double-dip recession cannot be excluded. Should this happen, the social and political implications of a yet again run-down economy should be taken into account at least as seriously as the projected pension expenditure in 2060.

**Table 4.** Main economic indicators, EU-27 and Eurozone.

	2006		2007		2008		2009		2010		2011	
	EU27	EUZ	EU27	EUZ	EU27	EUZ	EU27	EUZ	EU27	EUZ	EU27	EUZ
GDP (% annual change)	3.2	3.0	3.0	2.9	0.5	0.4	-4.2	-4.1	1.8	1.7	1.7	1.5
Unemployment (% of the labour force)	8.2	8.4	7.2	7.5	7.0	7.5	8.9	9.5	9.6	10.1	9.5	10.0
Private consumption deflatory* (annual change)	2.3	2.2	2.5	2.3	3.0	2.7	0.3	-0.2	2.1	1.7	1.9	1.7
Government balance (% GDP)	-1.5	-1.4	-0.9	-0.6	-2.3	-2.0	-4.9	-6.3	-5.3	-6.3	-3.9	-4.6
Government debt (% GDP)	61.5	68.4	58.8	66.0	61.8	69.7	74.0	79.1	79.1	84.1	81.8	86.5
Current a/c balance (% GDP)	-0.4	0.3	-0.5	0.2	-1.0	-0.8	-0.6	-0.7	-0.5	-0.5	-0.1	0.1

Note: \*Defined as ratio of private consumption at current prices to private consumption at constant prices.

Source: EC Statistical Annex of *European Economy*, Autumn 2010, Tables 96 and 108.

## Concluding Remarks

The EU, and especially the eurozone, is grappling with a crisis of major proportions and many facets. It is an economic and social crisis, as well as a political and institutional one. The neoliberal order that was globally challenged in 2007–2008 is doing its best to hold on to its privileges and to pass the cost of the crisis on to society at large. Further, the fact that the European ruling elites appear unable to master the critical point reached by the European integration project endangers its very viability.

The rising public debt of the EU member states in general and of the peripheral countries in particular presents one of the most demanding challenges. Containing the public debt crisis within the EMU framework is an even more challenging task. Nothing less than restructuring the euro architecture is going to suffice. Monetary union cannot work without an accompanying fiscal union, smoothing out differences between member states not only at a time of crisis, but also in the everyday workings of the Union.

The current fiscal policy reforms are aimed at deterring member states from diverging from the Stability and Growth Pact's arbitrary fiscal limits. It is a crisis prevention approach, which deals with the symptoms of a crisis without addressing its causes. Further, it treats such symptoms in a socially unjust and politically unsustainable way. In this sense, its viability is open to question.

On the other hand, pushing forward with long-overdue financial policy reforms is going to gain governments the necessary time to proceed with the radical reform of the euro project, as well as averting further risks to the stability of the financial sector and of the economy at large. Such reform is, however, lagging both at European and at the global level.

The crisis is still working its way through the EU, turning from finance to the rest of the economy and back again. Unemployment and social discontent are on the increase. The already fragile legitimacy of the EU is being called into question. It is the responsibility of the European leaders to realize the seriousness of the situation and to rise to the challenge. However, the exit strategy selected by the European leaders and the long-term, economic and social policy they have adopted, under the general heading of 'Europe 2020', suggest that they are seriously discounting the dangers of the present situation for the economic, social and democratic cohesion of the Union.

## Notes

- <sup>1</sup> According to the European Commission (2009a, p. 52), 'in a context of a generalized soaring of public debt, the global increase in supply of sovereign bonds is sizeable, increasing competition for the allocation of global savings. Furthermore a combination of high global risk aversion and a perception of low sovereign default risk despite public debt ratios ratcheting up can result in intensified *crowding out* of corporate sector investment, even in the face of low sovereign yield'.
- <sup>2</sup> Also known as the 'Ricardian Equivalence Hypothesis', as it was originally presented by David Ricardo in *The Principles of Political Economy and Taxation*.
- <sup>3</sup> The historical comparison group includes five major postwar banking crises Spain (1977), Norway (1987), Finland (1991), Sweden (1991), Japan (1992)), the 1997–1998 Asian crisis (Hong Kong, Indonesia, Korea, Malaysia, the Philippines and Thailand), Colombia (1998), Argentina (2001), as well as two earlier historical cases, Norway (1899) and the USA (1929).
- <sup>4</sup> For example, in previous crises it took policy makers about one year to implement recapitalization measures, from the time liquidity support became extensive. This time, such measures were implemented at the same time that liquidity support became extensive.
- <sup>5</sup> Council Regulation (EU) No. 407/2010 of 11 May 2010.

<sup>6</sup> ‘(implementing) ... structural reforms to improve competitiveness and enhance growth potential through labour market and pension reforms, liberalising services and professions and downsizing the public sector and state enterprises’ (Regling, 2010).

<sup>7</sup> It is worth noting that the ESM was decided on the insistence of Germany and France. An alternative proposal floated before the summit meeting by the Luxembourg prime minister, Jean-Claude Juncker, and the Italian finance minister, Giulio Tremonti, concerns the issuing of European sovereign bonds (“E-bonds would end the crisis” *Financial Times*, 5 December 2010). This was not even discussed at the December 2010 European Council meeting.

<sup>8</sup> ECB Press Release, 16 December 2010.

<sup>9</sup> European Council, Conclusions, EUCO 13/10/17-6-2010, p. 1.

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