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THE DEFLATIONARY BIAS OF EXIT STRATEGIES IN THE EMU COUNTRIES

N. Acocella

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Università degli Studi di Roma "La Sapienza"
Via del Castro Laurenziano 9, 00161 Roma (RM)
T (+39) 06 49766433 F (+39) 06 4957606
www.memotef.uniroma1.it

The deflationary bias of exit strategies in the EMU countries.

Nicola Acocella

Department of Methods and Models for Economics, Territory and Finance
Sapienza University of Rome

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Summary

In this paper we investigate the roots, nature and consequences of the exit strategies that have already been implemented or are likely to be implemented in the EMU countries after the financial and economic crisis. We show that there is a deflationary bias in the current institutional architecture of the EMU that will be exacerbated by the way governments are going to fix it, i.e. by means of premature and particularly stiff exit strategies. This will have a non-negligible extra-contractionary effect on European economy.

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JEL classification numbers: E52, E62, F33, F42, H62.

1.Introduction

In this paper we investigate the roots, the nature and the consequences of the exit strategies that have been implemented or are likely to be implemented in the EMU countries. Exit strategies are those required to manage a return to 'normal' *conditions* after the adoption of policies to combat the financial and economic crisis. Exit strategies need, however, more than a return to 'normal' *policies* when the crisis is over. The reason for this is twofold. On the one hand, exit policies must somehow 'repair' the damages of the crisis. From this point of view a stressed rise in the interest rates and contractionary fiscal policy should be enacted, for the reasons we will explain later. On the other hand, exit policies should include those aimed at repairing the structural 'holes' in the institutional architecture of the economic systems emphasized by the crisis. This second reason for exit strategies is particularly compelling for the EMU.

We will show that there is a deflationary bias in the current institutional architecture of the EMU that will be aggravated by the way governments are going to fix it, i.e. by means of premature and particularly stiff exit strategies. This will have a non-negligible extra-contractionary effect on European economy.

The plan of the paper is as follows. In the next section we illustrate the foundations of exit strategies. In section 3 we deal with the timing of exit strategies. Sections 4 and 5 will describe the development of the EMU crisis in 2010-2011 and non-standard monetary policies in the EMU, respectively. In Section 6 we investigate the root of the crisis. Section 7 deals with the different exit strategies that can be adopted in a currency union with no common fiscal policy and other harmonized institutions and illustrates the deflationary bias of exit strategies in a similar area. Section 8 deals with issue of the role of markets and governments in the EMU. Section 9 concludes.

2. *The foundations of exit strategies*

Exit strategies need to be implemented by any country hit by the financial and economic crisis for two main reasons: the high quantity of currency in circulation and the increase in public deficit and debt as a ratio of GDP in almost all the main developed countries and, although to a reduced extent, in some LDCs (IMF, 2010: 18). Both these circumstances are, at least partly, the result of the expansionary monetary and fiscal policies used to combat the crisis.

A reduction in the currency in circulation and the debt-GDP ratio, by means of obvious restrictive monetary and fiscal policies implies a monetary and fiscal stance more contractionary than a 'normal' one. The possibility should be mentioned that an alternative strategy is followed, i.e. resorting to an inflationary course as a way to reduce the real burden of public debt, not only as an exceptional and unforeseen policy, but also as an optimal long-run policy (Acocella *et al*, 2011). However, at least in the case of the European Union, this option would contradict the ECB mission, which makes it unfeasible.

Exit policies are needed in order to avoid a new acute phase of financial instability. First, to explain the need for a reduction in the quantity of currency, two negative effects could materialize if no action is taken. In fact, existence of a large quantity of currency in circulation raises fears not only of inflation, which can develop when economies are again along their expansionary course, but also of financial instability, since the excess of currency in circulation might be used for speculative operations. Also the rise in the debt/GDP ratio can give way to instability, as it can raise the expectations of sovereign state insolvency.

Exit strategies are also required in order to eradicate the conditions that caused the financial crisis and its development. If the crisis derives (also) from the conduct of financial intermediaries and the way financial markets operate, appropriate regulation and/or adoption of structural policies such as a tax on financial transactions would be needed, in order to avoid the possibility of a repetition of the crisis. Again these policies – unless monetary authorities compensate for them (see below) - could have a negative impact on the level of economic activity (think, e.g., of the new prudential regulation of banks), while generating strong negative opposition and reaction.

In addition to these reasons, holding for any country, for adopting exit strategies, other circumstances, specific to the EMU, must be added asking for appropriate exit policies. In fact, according to some authors (EEAG, 2011; but see also Zemanek et al, 2010), the rise in public deficit and debt in the EMU is also the outcome of a process deriving from some deficiencies of European institutions, encouraging moral hazard: in a nutshell a too mild Stability and Growth Pact (SGP), a not sufficiently credible no-bailout clause in the Treaty of the EMU and a lax attitude of the ECB. Other authors agree that at least some aspects of the crisis and its heavy impact on public deficits and debt in the area were the effect of some inconsistency of European institutions, but of a quite different nature, i.e. the incompleteness of the EMU institutional architecture, and specifically the absence of a federal state (von Hagen, 1996, quoted by De Grauwe, 2009; Krugman, 2011; Attali and Pamboukis, 2010). These issues will be discussed at length in sections 5 to 7.

3. *The timing of exit strategies*

Many exit policies – such as absorbing excessive currency in circulation or reducing public deficits - are thought to be urgent for the reasons explained above. However, they cannot be taken – or even announced in some cases (see below) - before the crisis is over, as they would further depress activity level; as a matter of fact, financial instability itself could be fed by an enduring economic crisis or even grim expectations of a rapid and substantial recovery of the real activity.

This counterargument for exit strategies, i.e. their depressionary effect, may be emphasized by their possible impact on income distribution, if the exit strategies adopted mainly hit low-middle income earners[1].

Balancing the opposite needs of adopting a restrictive stance, on the one hand, and avoiding depressing effects, on the other, is a delicate matter that involves not only a proper evaluation of the existing situation, but predictions about the expectations induced by announcements of future actions.

From the latter point of view, announcements of a future restrictive stance, especially of a fiscal nature, can have opposite effects. On the one hand, in fact, they can stimulate current expenditure, as taxes are now lower and income is higher. On the other, consumption smoothing may induce to lower current expenditure. The former or the latter will prevail according to a number of circumstances, in particular the type of fiscal restraint object of the announcement.

[1] Policies reducing the welfare state and public consumption might be preferred to those emphasizing progressive taxation for political economy reasons.

Announcement of an expenditure tax will tend to make the former effect more relevant. Announcement of an income tax might reinforce the latter[2].

A final issue has to do with monetary policy in an area such as the EMU, where there are macroeconomic imbalances and divergences in unemployment and inflation rates: presently, while Germany has a recent record of inflation above normal and low unemployment, the GIPS countries are experiencing very low inflation and double-digit unemployment rates (higher than 20% in the case of Spain). Difficulties in devising a common monetary exit strategy reflect the principle that one-size monetary policy seldom fits all in conditions of the kind existing for the EMU. Decisions by the ECB will indeed reflect political considerations about the kind of long-term reshaping of European institutions to introduce in the next months, namely whether to make rules more stringent and oriented to price stability or not.

4. *The development of the EMU crisis in 2010-2011*.

The balance between the need for restoring normality and that of avoiding a prolonged depression is even more difficult to reach in a currency union, such as the EU, that is not a federal state and has no common fiscal policy. In the next sections we will show that in the current institutional setting exit strategies in the EU have a bias, tending to be premature, thus aggravating the risk of a prolonged depression. The bias arises from the possibility that in fixing some deficiencies of the institutional architecture of the EMU a certain view prevails and impatience – or the pressure of markets – asks for a premature adoption of exit strategies. In this section we will only describe the chronology of the crisis in the EU, which will be of help for later considerations.

The development of the crisis that has hit the EU, spreading from Greece to Ireland, Portugal and other countries clearly shows this. Since September 2008 spreads among interest rates in different EMU countries had emerged after a long time (really they had hit record lows after the creation of the EMU). In Greece spreads rose to a maximum of almost 200 basis points at the beginning of 2009 but had gone down to a little more than 100 basis points by the Summer of that year. In October 2009 the new Left government of Greece notified Eurostat of the existence of a much higher public deficit than that reported a few months earlier by the previous government. The spread (over the interest rates of German bonds) for 10-year bonds grew step by step from 134 basis points soon after the announcement to more than 1000 basis points in May 2010. The effects of the announcement were not confined to spreads between interest rates paid on the Greek government bonds vis-à-vis Germany's. Also a crisis of confidence in the euro, speculation against the euro and an increase in the risk premium of other countries with a high deficit and debt took place.

[2] By applying a New Keynesian model with non-Ricardian consumers to a small open economy Almeida et al (2010) shows that announcement of different exit strategies has no significant differential impact effects. However, when considering also medium-term effects, exit strategies based on Government consumption cuts tend to dominate over other alternatives, such as transfers cuts or tax rate increases.

The reaction of fiscal policy to the prospects of an increase in the deficit and debt has led to a restrictive fiscal policy in practically all EMU countries, Germany included, and a strengthening of the SGP[3]. However, the general deflationary context has had a depressive effect on the denominator of the deficit and debt/GDP ratios, thus raising the prospect of a future crisis of confidence. The euro area economy expanded by only 1.7 percent in 2010, but the forecast for 2011 are of a growth of 1.6% at most[4].

By contrast, the reaction of monetary policy has been expansionary until recently (March 2011). The ECB has kept the interest rate low and has adopted a Securities Markets Programme (SMP) and, as we will see in the next section, has absorbed some of the bonds issued by the countries under speculative attack (Greece, Ireland, Portugal) for an amount of 76 billion euros (as of mid-January 2011). From this point of view, European monetary policy has some similarity with the quantitative easing, QE, policy of Fed, but we will see below that similarities are only apparent. The possibility to sterilize this intervention will be discussed in the next section

In summary, in the last 12-18 months the EU has been characterized by a contractionary fiscal policy, in contrast with a monetary policy still expansionary until April 2011. From this point of view an exit strategy in the EU has already initiated, even if the economic recovery is still timid, with the exception of Germany[5]. The prospects are for a more drastic deflationary action for both monetary and fiscal policy

5. Non-standard monetary policies in the EMU

In May 2010 the ECB adopted the SMP (ECB, 2010b). This consists of interventions by the Eurosystem in public and private debt securities markets *officially* designed 'to ensure depth and liquidity in those market segments that are dysfunctional. The objective is to restore an appropriate monetary policy transmission mechanism, and thus the effective conduct of monetary policy oriented towards price stability in the medium term. The impact of these interventions is sterilised through specific operations to re-absorb the liquidity injected and thereby ensure that the monetary policy stance is not affected' (ECB, 2010a).

According to the ECB 'the design and implementation of such measures remains focused on the ECB's primary objective', i.e. the maintenance of price stability. Officially, they tend only 'to

[3] In March 2011 the SGP has been strengthened, requiring drastic actions in order to reduce the debt/GDP ratio and ex ante surveillance of national budget policies.

[4] The past record of growth of the Euro-area countries is not much more brilliant, as compared with those not only of the Usa, but also of other European non-EMU countries such as Denmark, Sweden and the UK. But this past low growth profile in our opinion is to some extent the consequence of the deflationary bias introduced by the Maastricht Treaty first and the SGP later.

[5] In fact, not only the peripheral EMU countries hit by speculation but also Germany are currently reducing their deficit.

remove the major roadblocks' for the effectiveness of standard policies and, 'by their nature, are temporary to the extent that they have to be strictly commensurate to the degree of dysfunctionality of markets that is hampering the transmission mechanism. The central bank must guard against the danger that the necessary measures in a crisis period would evolve into a dependency as conditions normalise' (Trichet, 2010). This requires non-standard measures to be fully accompanied by an environment aiming at reactivating the private markets and guaranteeing a sound conduct of banks and public finances.

One could debate whether the program, as it has developed, is such as not to have an impact on monetary conditions, because of its rather large scale and difficulty to sterilise buying of securities by conducting a reserve-draining operation with the banking system. The ECB has time and again denied that, but doubts have been raised[6].

This would obviously be relevant for the claim that the ECB has acted consistently with its official primary target, i.e. maintenance of price stability. But our main point has to do with the true final objective of the program. Our focus will then be on whether designing and implementing the program has been consistent with the spirit of the Treaty. In the EEAG (2011) opinion, it is not, as it has 'potentially' violated the no-bail out clause. More specifically, the ECB might have acted against article 125 of the Consolidated version of the Treaty on the functioning of the European Union.

According to Henderson Global Investors (2010), the ECB has been at pains in distinguishing its SMP from US- and UK-style quantitative easing (QE). In their opinion, in practice the differences look minor. To be sure, the program has been directed only to the bonds issued by some European peripheral states, whereas QE in the US (and UK) has targeted the whole debt issued by these countries. To us the immediate objectives of the interventions in the EMU look similar to those of the US, as they attempt to get down the interest rate on government bonds. However, the meta-objectives of the interventions are different in the two cases: in the case of the Federal Reserve the main ultimate target is to get down the long-term interest rate in order to foster private investment, whereas the ECB final target was to make up for the lack of a fully consistent and credible institutional architecture of the EMU and to ensure the survival of the euro, which at some point along the process of the crisis appeared as the true issue at stake. Really, the apparently inappropriate (for the ECB) task of buying government bonds has emerged when the

[6] Henderson Global Investors (2010) doubt that this is possible. 'A purchase of bonds from a non-bank investor results in an increase in both the investor's bank account balance, included in the broad money supply, M3, and bank reserves, a component of the monetary base. If the ECB sterilises the purchase, the rise in the monetary base is reversed but not that of M3. (The M3 increase is reversed only if sterilisation involves a sale of assets to the non-bank private sector. Note that M3 is unaffected if the initial purchase is from a bank rather than non-bank)'. The validity of these remarks very much depends on the extent to which the SMP does not alter the demand for money in a significant way.

ECB has realized that its true primary – although not explicit and officially stated – goal was to ensure the survival of the euro which was put at risk by the crisis of confidence in some of the European countries. This represented a threat not only for some of the marginal ones, but also for some larger ones, notably Spain and Italy, and could lead to a break-down of the EMU. As a consequence it enacted the so-called 'non-standard' policies, designed to keep the euro-zone glued together. If this is true, the ECB has not violated the Treaty, as EEAG (2011) claims. On the contrary, its action has allowed for the working of the European monetary institutions in a situation of emergency.

6 . At the root of the crisis

6.1. *The role of institutions*.

The specificity of the evolution of crisis in the EMU countries is usually linked to the dynamics of public debt in some countries, in particular, Greece, Ireland, Portugal and Spain (the so-called GIPS countries).

The questions to be raised in this respect are numerous. First, was this dynamics caused by a wrong institutional setting of the EMU or bad management of the crisis? According to some authors the answer is affirmative for the first question. In our opinion it is affirmative also for the second question. If so, which were the relevant wrong institutions or what went wrong with the policies to combat the crisis? Among the institutions usually held responsible for the crisis are: the soft budget constraint introduced by the Treaty; the common monetary policy in a currency area too differentiated from the point of view of the economic dynamics and without other common governing institutions [7]; the Keynesian recovery programmes and the generous bank rescue operations enacted by some countries at least up to 2009. In order to answer the questions already stated, we must deal in a preliminary way with the dynamics of private debt, which can be linked to that of public debt. We will do this in the following subsection.

6.2. *The trend in private debt*.

When dealing with debt, private debt should be discussed separately from public debt. To be sure, the former has fuelled accumulation of the latter, at least to some extent, as we will see later, in this and the following subsections.

In the whole euro zone private debt as a ratio of the GDP has risen from about 55% in 2000 to about 70% in 2008. Its rise has been fostered by the deregulation of banking and financial activity taking place not only in the Usa, but also in Europe since the Eighties and the very low level of

[7] In fact, the area lacks not only a federal state, but also common financial regulation and financial assistance. A rescue mechanism was invented in the course of the crisis, as we will see later. Its structural policies are also weak.

interest rates that was guaranteed after the euro came into existence throughout the EMU. This led to the formation of a bubble in the assets market. Some deficiencies in the European institutions (too much insistence by the ECB on its predominant target, i.e., price stability, to the detriment of economic and financial stability[8]; absence of an EMU-wide financial supervision authority) made it possible for the bubble to grow and finally burst (De Grauwe, 2009).

In addition, accumulation of private debt in some countries (not only the GIPS, but also other countries) was built in in the way the euro area institutions were shaped: differences in real rates of interest due to a practically equal nominal rate of interest throughout the area and different inflation rates (due to the Balassa-Samuelson effect[9] and other factors for which see subsection 6.4) tended to stimulate indebtness and speculative operations in the real estate and stock markets in the less-developed countries of EMU (De Grauwe, 2010a). Expectations of a high real growth convinced people of the sustainability of debt (EEAG, 2011)[10]. Free capital movements and a common monetary policy that was expansionary until 2006 fuelled this process. Again, absence of common supervisory, regulatory and rescue bodies in the financial sphere made it possible for the bubble to grow and burst, asking for the intervention of national governments, but threatening the whole European financial system. In the next subsection we will discuss an alternative explanation of the surge in private debt, as deriving from moral hazard behavior by bankers.

6.3. *The trend in public debt.*

Contrary to private debt, public debt had reduced in practically all Euro-zone countries, except Germany and Portugal, before the crisis. In the whole area, it decreased from about 69% of GDP in 2000 to 67% in 2008 (De Grauwe, 2009). As to the GIPS countries, their past history is very different. Spain had and still has a very low Debt/Gdp ratio. Portugal after 1999 had a record of negative fiscal balances, higher than Germany's and France's (-3.6% against -2.1% and -2.6%, respectively, in the years 1999-2007), but lower than those of other EMU countries such as Slovakia. As for Ireland, even if it had a rather high ratio until 1985, it succeeded in reducing it to record lows in the following years, as an effect of the rapid Gdp growth. Really Greece is the only case of a high and rising Debt/Gdp ratio in the last 15 years. Then it is difficult to accept the EEAG (2011) statement according to which in these countries there was excessive public spending and borrowing. Practically Greece is the only such country. Then, the conclusion is warranted that, all in all, it does not seem that relevant tensions have originated *before the crisis* in the process of European unification as to public debt, with the exception of Greece, as reported during the

[8] Typical of this attitude is the rise in interest rates in July 2008, when the financial crisis was on and about to explode. Apparently, the ECB did not even take account that the rise in the oil price was to a large extent dependent on the further appreciation of the euro vis-à-vis the dollar, which would have been induced by its restrictive monetary stance.

[9] This is however of small empirical relevance (see Egert, 2010)

[10] An expression of this is the analysis by Blanchard and Giavazzi (2002) about the sustainability of current account deficits.

development of the crisis, but with reference to previous behavior. It is thus incorrect to explain, as the EEAG report does[11], the crisis as a result moral hazard, i.e. by a too lax attitude GIPS governments determined by the expectation of being bailed out by other European countries[12]

Things are somewhat different when it comes to the management of the crisis. Many countries were compelled to increase their deficits to counteract it. In general terms, an increase in private debt should trigger an accumulation of government debt, according to the debt deflation dynamics analysed by Fisher (1933) and Minsky (1982). As De Grauwe (2010b: 3) reminds us, this derived from two channels: first, by the governments relieving banks and other institutions from their debt; second, by the increase in public deficit deriving from action of automatic stabilizers and the initial Keynesian policies. *In addition, we hold that the amount of deficits is in some way endogenous to the type of response given to it, specifically to the deflationary fiscal stance initiated towards the end of 2009 by all the EMU countries and caused by the attempt of each government to avoid or reduce prospects of insolvency*.

Then tensions in the EMU exploded almost by chance (in the case of Greece, where the new Government made it public the wrongdoing of its predecessor) or as a direct consequence of the crisis and the need of intervention by national authorities (as for Ireland).

Some (e.g., EEAG, 2011) claim that the shocks would have been avoided simply by a less lax SGP and a credible no-bail out clause. However, this would have been ineffective in the case of Greece, which could have equally violated it while un-reporting the true state of its public finances. In the case of Ireland, that would have simply made it more difficult rescuing banks. In addition, a further deflationary effect would have been introduced, causing additional difficulties to other countries. In fact, the burden of the financial rescue of banks has been aggravated by the bad design of financial assistance offered through the Euro- area's main bailout fund, the European Financial Stability Facility, EFSF[13], because of the high interest rates charged and the negative signal to the market of the existence of a significant risk of default (De Grauwe, 2011). Finally, strengthening the SGP will aggravate the deflationary effects.

Really, the true institutional shortcoming appears to be absence of a federal government and of an appropriate rescue mechanism, not based only (or mainly) on punishment [14]. Were these

[11] The underlying idea is in Sinn (2010), quoted by De Grauwe (2011).

[12] De Grauwe (2011) notices that also the explanation of the crisis as ultimately determined by moral hazard by banks is untenable. In fact, it is difficult to think that at the core of the excessive risks taken by private banks there was the expectation of being bailed out by the governments, in Europe and elsewhere.

[13] This facility was established in Spring 2010 for a period of three years. In December 2010 the European Union decided to extend the EFSF to an indefinite length of time and with new governance rules (see below), giving this fund the new name of European Stability Mechanism (ESM). The new facility requires a "case-by-case participation of private sector creditors" and unanimity among the financing countries. In March 2011 the amount of the facility has been increased to 500 bn euros starting 2013.

[14] On the negative effect of punishment mechanisms see De Grauwe (2010).

institutions in place, the Greek and Irish shocks would have arisen, but would also have been smoothly absorbed.

6.4. The incapacity of dealing with imbalances in the EMU.

Euro zone macroeconomic imbalances derive from a number of circumstances. We will concentrate on the different dynamics of wages and prices. From this point of view we could speak of an asymmetric shock causing a divergent trend in wage rates and prices as between Austria and Germany, on the one hand, and the other countries, on the other. In the former the rate of increase in wages declined after the formation of the EMU, while rising in the latter, creating or raising inflation differentials.
Contrary to Blanchard and Giavazzi's (2002) conclusions[15], there should not have been a position of benign neglect with respect to the consequences of this trend on current account imbalances, as these are a potential source of problems and disruption for at least two reasons. First, they cannot be properly dealt with by the existing institutional setup of the euro zone (see in particular De Grauwe, 2009, Harashima, 2011). Second, each country separately implementing policies to deal with them risks creating deflationary effects in a snowball fashion. In fact, the various countries tried to cope with imbalances in different ways. Some countries reacted by adopting a contractionary budget stance. Others did not so because they preferred a higher short run level of employment and introduced reforms of their labour markets, to cope with the deteriorating real exchange rate. Labour market flexibility has thus increased substantially in a number of EMU countries (most recently, Damiani et al, 2011). Contrary to the opinion of many authors (Zemanek et al, 2010 and references therein) this has not reached substantial effects for overcoming inflation differentials first because Germany has reacted by cutting further wage increases (De Grauwe, 2009). In addition, the reforms that were adopted were not really effective in the wake of the crisis, in some countries such as Spain at least, as they created an army of temporary workers that added to the crisis when this erupted. Some countries, like Greece, did neither contract their budget nor introduce any labour market reform in the last decade or so[16], which might explain the strength of the tensions accumulated.

7. Exit strategies in a currency union with no common fiscal policy

7.1. Quantitative policies
These refer to changes in the amount of interest rates, public expenditures and taxes. As said above, there is a problem of timing first. Decisions on the appropriate timing of the various interventions are taken by the authorities in charge of it separately. Exit strategies on the fiscal side have already begun and are likely to intensify their pace as an effect of the prevailing view about the way to fix EMU institutional holes. The exact nature of the fiscal consolidation policy is a

[15] For a recent reappraisal of the relevance of the issue see Giavazzi and Spaventa (2010).

[16] The proportion of temporary jobs has indeed decreased from 1999 to 2006 (see Lampousaki, 2008)

matter to investigate further. Almeida et al (2010) are among the few authors that do so. As said above, they find that short term impact multipliers of the different policies are rather undistinguishable, while in the medium term expenditure cuts seem preferable with respect to tax increases, in particular payroll taxes, as the former induce a competitive disinflation, whereas the latter induce a real exchange rate appreciation. IMF (2010) finds a similar effect in the short run, contrary to the results of previous studies, such as Alesina and Perotti (1995, 1997), Alesina and Ardagna (2010), Broadbent and Daly (2010). But, overall, considering the way the SGP has been recently amended, the simultaneous fiscal consolidation path that must be followed by practically all the EMU countries - since the debt ratios exceed 60% of GDP almost everywhere in Europe - will 'impart a very strong recessive bias to Europe as a whole. The size of the cuts for high-debt countries may be so high that the credibility of the adjustment may be compromised' (Manasse, 2010).

As to monetary policy, the expansionary course has already come to an end in April 2011. On the one side, the ECB has deemed it necessary to raise rates, as inflation is climbing in the area (annual inflation rate was 2.2% in December 2010 and is forecast to rise even higher in the next months, 2.6% in March 2011). On the other, the ECB is going to be relieved of the bonds bought in order to reduce the risk premium of the countries under attack. As said above, the decision of ECB to buy bonds of the GIPS countries has certainly contributed to an expansionary stance until April. But recently the euro area's main bailout fund, the European Financial Stability Facility, EFSF[17], has been asked to buy bonds of the distressed countries, thus relieving the ECB of the task of supporting deficit financing of those countries and protecting them from even greater difficulties. When this task is over the ECB will be absolutely free to adopt a restrictive attitude. Nominal interest rates will soar. Real rates, which have never been negative in the EMU during the recession, contrary to the United States, where they have been mildly negative, will rise too. The reason explaining this difference is not in the different dynamics of inflation in the two areas, but simply in the different conduct of monetary policy, inspired by the different targets of monetary authorities in the two countries. Starting a contractionary monetary policy might be ineffective, however, if, once again (as in July 2008), it stimulates a further rise in the dollar price of oil and asks for another round of monetary restriction. In any case, it will cause some additional fiscal restraint, particularly for countries with a higher debt burden, which are already operating a fiscal contractionary policy. This will be a penalty imposed on such countries over and above the spreads on interest rates imposed by markets.

7.2. Qualitative and reform policies: towards political integration?

[17] This facility was established in Spring 2010 for a period of three years. In December 2010 the European Union decided to extend the EFSF to an indefinite length of time and with new governance rules (see below), giving this fund the new name of European Stability Mechanism (ESM). The new facility requires a "case-by-case participation of private sector creditors" and unanimity among the financing countries. In March 2011 the amount of the facility has been increased to 500 bn euros starting 2013.

As said above, exit strategies include also policies geared to structural changes deemed to be necessary to avoid a repetition of the crisis in the future. Obviously, such exit strategies will be different according to the explanation of the real roots of the crisis that will be accepted by European policymakers. The crisis has made it clear what some authors suspected even before it: the inconsistency of existing European institutions. However, the details of this inconsistency differ according to different authors. In this section we deal with the exit strategies consistent with the explanation focusing on inexistence of a federal state and, more generally, of political integration for the currency union. In the next section we will investigate the strategies consistent with the idea that incompleteness of the European institutions derives only or mainly from a moral hazard problem (non credibility of the no-bail out clause).

The inconsistency between a unified monetary policy and absence of other common policies, notably of federal fiscal policies, has been recognized by the President of the ECB himself. In fact, he says: 'We must remain mindful that the euro area consists of 16 sovereign states. It is not a fully-fledged political union or a fiscal federation, within a unified government bond market. The SMP programme has been designed to help restoring a more normal functioning of the monetary policy transmission channels in countries where the sovereign debt markets were starting to be dysfunctional' (Trichet, 2010).

The SMP has certainly been useful to help dealing with the crisis. However, the matter is much deeper and has relevant implications for exit strategies. In fact, in a currency union with no common fiscal policy and diversified national histories of public deficits and debts, pressures can arise against the financial position of some countries that may threaten the credibility of the whole union, thus obliging the various countries to take a too early restrictive stance.

A euro area with common fiscal policies would be able to cope with those asymmetric shocks that are counteracted now by national fiscal policies, possibly leading to the deterioration of the deficit and debt position of some countries from which speculation draws its nourishment[18].

In fact, the euro area organized as a federal state would not be obliged to take a tough contractionary stance in order to counter speculation against the bonds issued by a few countries. First, each country would tend to have a lower amount of public expenditures, being relieved of the task of providing some services by the federal level of government (Krugman, 2011). In addition, speculation tends to attack one after one not only countries with a historical record of high deficit and debt, which are a reduced number[19]. By contrast, a federal state of the size of

[18] The need for common budgetary policies was recognized well before the crisis erupted, really at the time when the Euro-zone institutions were in the process of being built. See, e.g., Mélitz and Vori, 1993; von Hagen and Hammond, 1995.

[19] It is true that it could also be directed against those with 'sound' public finances, as, in due time, the latter might be asked to bail out the former, but certainly the strategy is that of attacking one country after another.

EMU would be too big to be the object of a speculative attack, as this would require a huge amount of funds in order to be successful.

Exit strategies inspired, in particular, by the need to construct a European federal state would require a substantial change in the size of the European budget for the purpose of making, among others, anti-cyclical and structural policies possible. The former purpose is clear. As to the latter the main aim should be that of strengthening European integration and reducing structural imbalances. However, similar policies seem to be completely out of the current targets of the various European governments. The likelihood of their acceptance might improve as the European economy improves.

In addition to the construction of a federal state, other kinds of political integration can help in coping with other sources of asymmetric imbalances in the Euro-zone. In fact, a tougher and common regulatory and supervisory policies to deal with financial shocks and common wage and labour market policies would help avoiding those common and asymmetric shocks that have to a large extent put stress on the budgets of some EMU countries, directly or indirectly. Lack of such policies is thus also responsible for the deflationary bias of EMU institutions.

7.3. *Qualitative and reform policies: removing the soft budget constraint*

The most likely solution to the inconsistency of a currency area without a federal state is that of some rather limited, but important, changes in the rules coping with the moral hazard issue arising in these conditions. Some of these rules have already been introduced when the new EFM has been created last December in substitution of the EFSM: the need for all countries to provide their bonds with Collective Action Clauses (CAC), starting 2013, the need for an insolvent country to be negotiate a comprehensive restructuring plan with its creditors, the possibility that the ESM provides liquidity help if debt sustainability can be reached, introduction of a creditor participation in the plan, unanimity of the member states in the approval of the plan. All such rules, apart from reinforcing conditionality of funds (which could be accepted or even advocated, per se: see De Grauwe, 2011), will introduce high interest rate spreads penalizing the most indebted countries. This will substantially increase the deficit/Gdp ratio of GIPS countries[20], thus requiring a further restraint, following the logic of the policy orientation that has prevailed in the EMU countries. Additional rules include a strengthening of the SGP that imposes adoption of stiffen and more rapid exit strategies (as done in March 2011) and conditioning financial aid to adoption of such strategies by the countries that experience public finance difficulties.

[20] It has been calculated that in the case of Greece, an increase in the interest rate paid on the EFSF funds from 3.5% to 6% implies a rise from 5.1% to 6.0% in the primary surplus needed to stabilize debt ratios. For Spain the analogous rise would be from 2.5% to 4.2%. Obviously, this implies a deflationary stimulus to the economy (see De Grauwe, 2011). If one adds to this deflationary effect that deriving from the (much higher) increase in the interest rates that GIPS countries must pay to private subscribers of their bonds as a consequence of the negative signal given by this high interest rate to be paid on the EFSF funds.

This will certainly introduce highly deflationary policies not only by the GIPS countries, but also by other countries with more sound public finances. It may also eventually increase, rather than reduce, the debt/GDP ratio and thus the prospect of further speculative attacks against some member countries' debt and the euro. The financial protective networks created in 2010 could no longer be sufficient to guarantee a return to financial stability, because of an inappropriate exit strategy.
This argument is at the very heart of the deflationary bias featuring the euro area's exit strategies.

7.4. The deflationary bias of EMU institutions and the debt snowball effect

The first deflationary bias featuring EMU institutions derives from the ultimate objectives of monetary institutions. For statutory reasons during the crisis the ECB has never pursued a target of nominal and real interest rates so low as in the U.S., thus adding to what is a major reason for a prolongation of the 'Great Slump' (see Hall, 2011).
The second deflationary bias derives from absence of a federal EMU. The decision taken by European countries to take a contractionary fiscal stance could be defended on the argument that, while this implies *small* negative short-run effects, there are positive long-run effects from policies of fiscal consolidation. The negative effect of a 1% contraction of budget deficits could be as low as a .5% contraction of output after 2 years[21] and positive effects could begin after 5 years in some ideal conditions, such as a high level of interest rates and *no simultaneous adoption of deflationary policies by other countries*. However, the figures indicated above change, it these conditions are not met. In fact, the negative effect on output after 2 years of a 1% fiscal consolidation is 1%, when interest rates are low, and rises to 2%, if interest rates are low and, in addition, also other countries contract their economies (IMF, 2010: ch. 3). These are really the conditions now prevailing in the EMU: interest rates are very low and all countries have taken consolidation measures. As said, the new SGP and the way the institutional hole in the EMU is being fixed will reinforce the restrictive outcome of exit policies. One could assess the deflationary impact of the exit programmes that will be adopted as an effect of both the existence of separate fiscal authorities in the EMU and the reform of the SGP, on the basis of these multipliers.
It is more difficult to compute the deflationary effects of the lack of other common policies, such as wage and labour policies, regulation and supervision. However, the deflationary policies that GIPS countries (and, even if to a reduced extent, other EMU countries) have been asked to implement will most likely create a snowball effect. The GIPS countries are asked to correct their imbalances (both the violation of the SGP and their wage and price imbalances) by means of debt consolidation. The ensuing deflationary policies will cause a reduction in the dynamics of both prices and real GDP, thus leading to a very low (even negative for some time) rate of growth of nominal GDP. This, when compared to the nominal interest rates paid by such countries on their debt, will most probably cause a rise in the debt/GDP ratio, even with a primary surplus. (for the

[21] This is really an average effect, as spending cuts are less contractionary than tax hikes also from a medium-long run perspective (see Almeida et al, 2010).

concept of debt snowball see Hugh, 2010 and, for an assessment of its relevance, Vistesen, 2010)[22].

8. The crux of the matter: more (financial) markets or more (federal) state?

Let markets restrain lax governments and make private and public institutions fail or make governments to drive changes and avoid failures?
This was the real issue behind the choice between a federal state and permanence of the current system of national fiscal responsibility with some fixing of the institutions governing moral hazard by national governments. Relying on punishment by markets in order to reduce moral hazard is at the heart of this way of fixing EMU institutions, in particular for stiffening the mechanism of the SGP and devising the bailout mechanism. This not only is a partial remedy to the crisis[23], but can even be a further factor of systemic crisis: in fact, bondholders will run for cover every time they fear the possibility of a default, with the possibility of creating a self-fulfilling mechanism of crisis. The recipe that has been chosen does rely on an inaccurate analysis of the roots of the development of the financial crisis in Europe. In addition, it seems to be at odds with the way a financial crisis develops anywhere, relying on the efficiency of financial markets and neglecting all the failures they can originate[24].

9. Conclusions

We have shown that exit strategies in the EMU countries have already been adopted both on the fiscal consolidation side, since 2010, and on the monetary policy side, more recently. Such contractionary policies are the outcome of an incomplete institutional architecture in the EMU. In our opinion the incompleteness derives from absence of a federal state, which tends to generate a deflationary bias. By contrast, others think that a federal state is either unnecessary or politically unfeasible, at least in the current situation. According to this strand of opinion, the EMU simply needs fixing an issue of moral hazard by private and public agents, by introducing a hard budget constraint and restoring the inter-country interest rate spreads that had almost disappeared after the introduction of the euro. This seems to be the view prevailing in the sphere of EMU policymaking, which explains adoption of fiscal consolidation strategies in practically all countries. Such strategies have a highly deflationary effect, as they are taken simultaneously in the various countries and interest rates are currently still low. In fact, under these conditions the restrictive effect of consolidation strategies rises in a significant way. A restrictive monetary policy is now pending that will soon add deflationary effects of its own.

[22] Greece is paying interest rates of the order of magnitude of more than 12% on 10-year bonds, which is certainly by far higher than the likely rates of growth of the Greek economy in the medium-long run.
[23] De Grauwe (2011) notes that a system of stick and carrot would have been more effective.

[24] A problem that cannot be neglected is the power of financial markets are given by the current EMU institutions to punish democratically elected governments that blameless, as in Portugal (for this see Fishman, 2011).

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