# Euroland Put to the Test

## Can European Monetary Union Still Be Saved?

May 2010

- **Thomas Fricke**
  After the Greek disaster: Monetary Union needs fundamental reform
- **Niels Kadritzke**
  Greece – Radical reforms need European solidarity
- **Ricardo Paes Mamede**
  Portugal – Austerity policy with no guarantee of success
- **Santiago Fernández de Lis and Emilio Ontiveros**
  Spain – The growth of the construction boom will not return
- **Philipp Fink**
  Ireland – In the grip of the economic and financial crisis
- **Michael Braun**
  Italy – Fears of a domino effect in the Eurozone despite a sound budgetary policy

# Content



This analysis represents a new edition of the IPA publication »Euroland auf dem Prüfstand – Die Währungsunion und die Finanzmarktkrise«, which appeared in May 2009. Available at: http://library.fes.de/pdf-files/id/ipa/06376.pdf.

Thomas Fricke

## After the Greek disaster: Monetary Union needs fundamental reform

Ideas about the functioning and non-functioning of a monetary union are diverging dramatically. Germany has a keen interest in a redefinition.

The bar-room version goes like this: the Greeks and others have messed things up, lived beyond their means for years and, in the end, acquired so much debt that they should be punished for their sins. No doubt about it. It's their own fault. Nothing can be done about it. In the crisis months of winter 2009/2010, this was the view of German commentators. This also appeared to be the basic stance of the German Chancellor and the German government, at least until the whole thing got out of hand and something had to be done.

Have the Germans really nothing to do with the crisis? Was it really only the others, the Southerners, whom we never really trusted and who now are being properly punished for their delinquency? That would simplify matters. In that case, we should either expel the others or just step up the punishments, the deterrents and the threats until everyone is brought into line. And all would be right with the world.

Even after months of escalation, that appears to be the preferred solution, if one asks German politicians, or perhaps Jürgen Stark, Chief Economist of the European Central Bank, who finds himself vindicated in the view that it was wrong not to make the Stability Pact, which he co-authored, much stricter, with more penalties and sanctions.

But would monetary union work properly, in that case? Could the current crisis have been avoided? There are reasons to think so. However, there is much more reason to think otherwise. How one answers the questions posed here makes a vast difference – for the future of the Eurozone and drawing the right lessons from the crisis. What happens if what the Germans are proposing does not eliminate the deeper causes of the crisis? If the Germans have unwittingly contributed to the crisis with their particular economic policy stance? If, in reality, what is needed is to bring the financial markets under control, markets which are increasingly losing touch with reality, giving rise to increasingly alarming and all too real effects? In that case, it would only be a matter of time before the euro-experiment came down to earth with a crash. And the Germans might end up being the biggest losers.

### Greece as Whipping Boy for External Failures

As far as Germany is concerned, all that is required in economic terms is for all countries in a monetary union to concentrate their economic-policy energies on improving their competitiveness and maintaining balanced budgets. This view also entails an astonishingly high level of confidence in the judgement and efficiency of financial investors, the motto being: if the market bankrupts Greece, there must be a good reason for it. This is the crux of the euro-drama.

Take competitiveness. Needless to say, it is not good for the economy if it loses its competitiveness and costs rise more sharply than elsewhere. The question is whether this is the case under all circumstances. And whether it is a good thing if everyone competes with everyone else to bring costs down. After all, Greece has not experienced particularly dramatic wage rises; otherwise, unemployment would not have fallen more sharply in the 2000s than in Germany. It is just that they have not been able to keep their costs down as rigorously as the Germans. And if the Germans were fairly successful in forcing costs down so much, it was ultimately also because the others in the euro-area grew relatively strongly and did not do the same.

Turning to the financial markets, it is true that Greek governments over the years have had more deficits than permitted under the Stability Pact. It is also true that it was a medium-sized disaster when it came to light that bad budget figures had been suppressed. The question is only whether it is enough to drive a whole country into bankruptcy. Furthermore, does it suggest that financial markets are efficient?

Against this, it can be argued that, for a long time now, Greece has not been the only country in which the budget deficit has exceeded 10 per cent of GDP. Why isn't as much fuss made about the UK, whose public finances, according to EU studies, are less sustainable than those of virtually any other country? Why have the financial markets so quickly come to terms with Irish promises of consolidation, despite the fact that deficit reduction there is likely to proceed more slowly than in Greece? And incidentally, why did the leading economic experts for months take the view that Greece was in no danger of going broke, when the signs were allegedly so evident?

A further argument against it is the one-sided condemnation of everything concerning Greece and its economy. This is an almost criminal example of selective perception. Less than two years ago, orthodox economists from international organisations enthused over the fact that, over the past 15 years, Greece had registered the second-highest per capita growth in the industrialised world. Now the Greek economy is supposed to be all washed up. However, when the crisis of Greece's public finances broke out, risk premiums on corporate bonds remained low.

The efficiency or justice of financial market judgements is also called into question by the fact that, since the outbreak of the crisis, there has been no more terrible news about the foundations of the public finances – but even so risk premiums have continued to surge. If the markets had only responded moderately efficiently, premiums would rather have fallen. After all, the Greek government had staked everything on meeting demands for a drastic consolidation package. The fact that there were – perfectly understandable – protests against it is no reason to drive the country into bankruptcy. There were protests and obstruction even in Germany, and with much less cause, when the Agenda 2010 reforms were pushed through.

All the signs are that the drama on the financial markets has taken on a life of its own, with dire consequences. There are many indications that hedge funds and other investors have speculated heavily against Greek bonds and the euro, in order to profit handsomely from betting on Greek bankruptcy. Such attacks have been accompanied for several weeks by a phenomenon which is having an increasingly detrimental influence on financial markets: pro-cyclical waves develop, in reaction to which everyone, perfectly rationally, follows the trend, pockets the profits and thereby further intensifies the herd behaviour. Otherwise, it can scarcely be explained why – in the absence of more bad news – risk premiums on Greek government bonds in April shot up to as much as 10 percentage points.

## Germany's Contribution to the Crisis

If this is the case, Germany's share in the Eurozone disaster is much greater than the current self-congratulation with regard to economic policy would lead one to believe. That also applies to the fundamental causes of the crisis. Naturally, it cannot be good if a country obtains the lion's share of its economic growth – as Germany has in the 2000s – by constantly exporting more than it imports. This imbalance cannot be simply blamed on the negligence of others.

German governments have for 10 years devoted almost all their energies to bringing down costs further and further, making it look as though improving German competitiveness was virtually the solitary goal of economic policy and in doing so, generally acting as if it was enough if others bought our goods, while we de facto constrain domestic consumption – and demand for imports – by means of higher VAT. In fact, German exporters were in fairly good shape as early as 2003, despite interludes of panic in the country. No wonder, therefore, that German surpluses sometimes mean corresponding deficits in other countries, which in turn sometimes lead to deeper crises for all. Look at Greece.

Economic studies of mercantilism show that, in the long term, it leads to crisis when a country amasses surpluses. This also applies to the modern German variant. It amounts to a form of protectionism – which is justified in terms of *Ordnungspolitik* – to increase VAT (which importers also have to pay), as in 2007, in order to use the money to bring down social security contributions, which benefits only domestic companies. This has rightly given rise to considerable ill-feeling among the other euro states.

The same applies with regard to financial market panic. Quite possibly, the Germans' well-intentioned actions only contributed to the disaster. According to traditional German thinking, it was a good idea to keep the Greeks guessing as to whether Germany would help out because it put them under pressure. In the event, uncertainty may have been the precise outcome. Investors speculating against bankruptcy have received constant »encouragement« from the German government: for every instance in which the German Chancellor talked about what conditions might be imposed, government politicians expressed scepticism about undertakings or professors announced that they were filing new petitions in Karlsruhe (seat of the German Constitutional Court). No doubt about it: speculation flourishes in the face of uncertainty. This makes it possible to lay bets, for or against. The crisis would not have peaked so dramatically in the absence of Mrs Merkel's inconstancy and hesitation. The fact that there is a lot of corruption in Greece is not sufficient reason.

## A New Set of Rules for the Eurozone

None of this means that no blame lies with the deficit countries or that rule violations should not be penalised. It is only to suggest that that is not enough. It is also to suggest that Germany should be called upon when it comes to avoiding such disasters in the future. That will not be possible if economic policy coordination in the euro-area is limited to mutual demands for the soundest possible budgetary policy.

Spain provides a good example of why that alone – with the best will in the world – is not enough. According to the Stability Pact, Spain was a model student. The only thing is that the Stability Pact does not really envisage other causes of crisis. At the same time, it has long been clear that, sooner or later, Spain would have to pay for its massive construction boom and that this would lead to severe repercussions. A smarter Stability Pact should seek to ensure that even such hidden excesses should be addressed early. Shouldn't its EU partners have compelled Spain much earlier on to counteract the overheating of the property market by putting on the financial brakes, instead of reducing taxes even more – with EU approval – as the overheating continued.

A more economically viable Stability Pact might also seek to coordinate the reduction of enormous surpluses and deficits in intra-European trade. Even if there are always reasons for one imbalance or another, in the long term it cannot come to any good if a country such as Germany, using all its economic-policy resources, helps it along and, as a result, brings about almost constantly increasing bilateral surpluses – in other words, tries to deprive the euro partners of market share, while their deficits creep up and up. US economists once advised imposing penalties if a country maintains a long-term surplus or deficit over three per cent in its current account. That could also serve to impose discipline in the Eurozone.

The naïve recommendation that the others should also improve their competitiveness and bring down costs is of little use. That always sounds good, but if the others wish to shrink their deficits by means of such cost reductions they must export more than they import for a sustained period – and the Germans sell less than they import. That would involve the others gaining market share – and the Germans losing it. Otherwise, the sums would not add up. The question is whether this is the best option, particularly if the real macroeconomic danger grows that, in the event of a downward correction, a perilous deflationary spiral might emerge, as countries compete to bring down costs. This would be a disaster. It would be better to agree on whether the Germans should, in moderation, do more to increase domestic demand, while the others, in moderation, consolidate.

A more brutal Stability Pact in accordance with the existing fiscal logic would rather exacerbate the problem. This would also require new coordination mechanisms. It would also not have to involve constraining German exports. It would suffice if Germany were exhorted to stop concentrating almost exclusively on improving its own competitiveness and instead to ensure more stable domestic demand. It would suffice, at the very least, to refrain from higher taxes or, in some instances, even to reduce them. Then the Germans, in turn, could follow their instincts and teach others a thing or two about saving.

## Help Out More Quickly – Don't Delay

The most recent worsening of the Greek crisis alone makes a convincing case for taking solidarity a lot further – and if need be, that it should pursue an entirely different logic, in contrast to the economic policy orientation still considered self-evident in Germany.

According to the analysis of US Nobel prizewinner Joseph Stiglitz, Greece, based on the common experience with other bankrupts in 2009/10, would not have been a candidate for insolvency if interest rates and risk premiums on the financial markets had not risen so dramatically. In other words: at relatively normal interest rates, the refinancing of the national debt would probably never have become a problem.

If that is true, it would have been a matter of urgency to halt market panic taking on its own momentum, alongside steeply rising interest rates, as rapidly as possible, instead of poring over different formulations for weeks. If it had been clear and unambiguous as early as December that, when it came to it, the major EU governments – with or without the International Monetary Fund – would pull out all the stops to prevent a Greek bankruptcy under any circumstances (and to solve the debt problem internally), investors would have had no reason to bet on such an eventuality. Furthermore, there would have been no reason for a panic-driven investors' boycott of Greek bonds and the herd behaviour could have been halted early on. Then the Germans would only have had to »threaten« to give support, without actually having to provide it, because the markets would have been deterred from heavy speculation.

If that is the case, the German government was catastrophically misguided in its threatening gestures toward the Greek government and people, and very much barking up the wrong tree.

This alone gave rise to serious economic-policy consequences. Also in the future, it will be of little help in acute crises to range a succession of threatening gestures against a government which can only look on in astonishment as the financial markets go off the rails until excessive interest rates leave it unable to service its debts. In future, a decision must be made quickly on whether a country unwarrantedly threatens to be caught up in a spiral of bankruptcy and then to do everything possible to support it and to ward off speculative attacks. Europeans should therefore move fast to set up a stabilisation fund and an early warning system. In future, it must be possible to spring into action in an emergency with pre-allocated funds, without having to overcome parliamentary obstacles, which only fuels market speculation, as the events of spring 2010 show all too clearly.

Given the events of the past few weeks, there is every reason to believe that reports of the Eurozone's death are by no means exaggerated, unless it is re-established on a new footing. It cannot be sustained indefinitely that a heavyweight such as Germany insists on a simplistic approach to economic policy, in terms of which every country is responsible for its own problems. That is every bit as absurd in a globalised financial world as it is in a monetary union, in which the successes of one can rapidly turn into the crises of others.

The agonising over whether to help Greece or not stands proxy for a dramatic falling-out over theoretical paradigms among the euro-states. And the Germans and their model pretty much stand alone, and not only in the euro-area. It is simply negligent naïvely to put all one's faith in the alleged efficiency of financial markets when betting on the economic ruin of a whole country can so rapidly turn into a self-fulfilling prophecy. It is equally naïve to believe that it will work out fine for everyone if each country tries to capture market share from the others. It simply wont work unless someone also spends money instead of only saving it – best of all, in moderation.

If the euro-countries do not feel responsible for one another, an enormous crash is in prospect. And it's no good talking about the existing rules if they are the product of old ways of looking at things. The euro-ban on mutual financial assistance is a fair-weather rule. It assumes that if countries get into such difficulties, it's their own fault. If that was the case, it would make perfect sense. But what if a country falls victim to speculative attacks, against which it is unable to defend itself, even with the harshest austerity package imaginable? Then it would be absurd to let that country go under, if only to prevent the disaster from spreading.

Niels Kadritzke

# Greece – Radical reforms need European solidarity

## Introduction

The precarious state of the public finances is the dominant factor determining both the economic and the political situation in Greece and eclipses all the country's other problems. The discovery of the gigantic deficit in the 2009 budget and the doubts concerning whether the Greek government will be able to implement the requisite austerity programme have caused the international financial markets to view Greece as a high risk debtor. On this view, in the event that the Papandreou government is unable to report rapid success in its efforts to put things right, the possibility of state bankruptcy looms.

And Greece has already looked into the abyss. On 28 April, the spread – the interest premium demanded for Greek government bonds in comparison to German government bonds – rose above 19 per cent or 1,000 basis points, after rating agency Standard and Poor's had downgraded Greek government bonds to the status of junk bonds (BB+). As a result, it was unable to find international investors on the international financial market for the 8.5 billion euros which it had to find by 19 May for the redemption of previous bonds. The Greek government had to face the fact that the markets approached its assessments »not on the basis of the most probable scenario, but the worst-case scenario«, as Prime Minister Giorgos Papandreou, somewhat bitterly, put it.

Only under the influence of this development – and the downgrading of Portugal's and Spain's credit rating – did the German government make up its mind to announce what not only the Greeks, but also most of its Eurozone partners had been urging on it for weeks (see the Introduction by Thomas Fricke). Encouraged by ECB President Trichet and IMF head Strauss-Kahn, Chancellor Merkel declared that Germany will assume its responsibilities and promised a decision on the German portion of the loan before 9 May. The Greeks had expected a commitment of this kind from 23 April at the latest, when Prime Minister Papandreou officially asked for the activation of the assistance programme arranged by the IMF and the Eurozone.

The aid package for Greece will finally be adopted at the summit of euro member states on 10 May. A new decision is also needed because the aggressive distrust of »the markets« towards Greece means that, in addition to the 45 billion euros already promised since 25 March (30 billion from the euro countries), a support package for a total of three years is necessary amounting to around 110 billion euros. In return for this credit line, a binding austerity programme was demanded of the Greeks for the period 2010–2012, which envisages even more drastic measures than the Programme for Stability and Development (in Greek: PSA) already agreed.

This more extensive programme, agreed by the Papandreou government on 2 May, was negotiated with the representatives of the IMF, the ECB and the European Commission, who were already in Athens. This »troika« was originally supposed to evaluate how realistic the PSA was and how it was to be implemented. Now it had to negotiate with the Greek government what the Eurosummit of 7 May is to sign off on as the basis for the new assistance programme.

The near bankruptcy of 28 April left the Greek government little room to manoeuvre in its negotiations with the »troika«. This was made painfully clear to the Greek people by Papandreou in his speech of 2 May: the country stands at a historic parting of the ways and it involved nothing less than »rescuing our country« from bankruptcy, which would hit all Greek families much harder than the austerity programme, to which there is no alternative.

With this development, Greece – also because of the already visible effects on the euro – has become both a historic test and a problem case for the European Union and, in particular, for the Eurozone.

## Reasons for the Current Situation

Only a few weeks after its election victory on 4 October 2009, the new Pasok government under Prime Minister Giorgos Papandreou was forced to realise that the outgoing government of the conservative Nea Dimokratia (ND) party had left behind a budget deficit of 12.7 per cent for the current year. In April, this figure was corrected upwards to 13.6 per cent, on the one hand because of newly revealed debts of public hospitals, and on the other hand, because 2009 GDP shrank more than had been expected. Since the 2009 deficit was more than double the estimate communicated to Brussels by Athens in September, the credibility of Greece and its statistical office was severely shaken among the country's partners in the EU as a whole and in the Eurozone, and not for the first time. The combined budget and confidence deficit was also reflected in a downgrading of Greek government bonds by two of the three major rating agencies.

The enormous budget deficit, which has driven up the accumulated public debt to 303 billion euros or 115 per cent of GDP, stems not only from the clientelistic plundering of the public coffers, as is usual in an election year in Greece. It is primarily the result of the structural imbalance of the public finances, which derives from rising unproductive government spending (especially for the overstaffed public sector) and a notoriously high shortfall in tax revenues (primarily because of widespread tax evasion). The economic collapse as a consequence of the global recession, which in Greece hit the three most important branches – tourism, construction and merchant shipping – hardest, intensified this structural crisis of public finances: the contraction of GDP by 2 per cent in 2009 led to falling tax revenues and rising social spending, for example, for the unemployed (the unemployment rate rose from 8.2 per cent to 10.2 per cent in the course of 2009).

## Stability and Development Programme

The Papandreou government's response to the nightmare scenario of state bankruptcy was the »Programme for Stability and Development« (PSA), presented by Finance Minister Papaconstantinou, which was adjusted several times under pressure from the European Commission and the European Central Bank (ECB). In mid-February, the PSA was passed to the European partners, who accepted it as a blueprint for restructuring Greece's public finances. Since then, Greek budgetary policy has been under »more stringent monitoring« by the European Commission, the euro states and the ECB.

The declared aim of the PSA was to reduce the deficit to below 3 per cent of GDP within three years. Two points in particular are key to this austerity plan: first, the short adjustment deadline of only three years, which is even more ambitious than, for example, Ireland's four-year austerity programme; second, the particularly deep incision of 4 per cent in the first year (as against 3.1 per cent in 2011 and 2.9 per cent in 2012). This is intended to signal to the European supervisory authorities and the international financial markets that Greece is ready to accept a drastic cure in order to recover from the »Greek disease«. At the same time, it offered the government the added bonus that the toughest measures would be behind it well before the next election (in autumn 2013).

The target for the 2010 budget entails economies of around 9.6 billion euros. About half of this is supposed to be achieved by spending cuts and increased revenues. The following measures have been agreed upon to reduce spending:

- linear cuts of 10 per cent in the individual budgets of all departments;

- a hiring freeze for the public sector for 2010, to be followed by strict limits on new hiring (one hire for every five arising vacancies);

- drastic pay cuts (backdated from January 2010) for public sector employees, including the cutting back of »bonuses« for all pay groups, such as holiday pay and so-called »Easter bonuses« (on average by 15 per cent – by up to 20 per cent for senior civil servants).

Furthermore, the PSA envisages a radical reduction in state transfers to the social security funds (pensions and health insurance). This assumes that, in the short term, it will be possible to collect employers' outstanding contributions (currently about 35 per cent) and, in the medium term, to integrate a large proportion of those working in the shadow economy into the formal labour market. The corresponding draft law is aimed at raising the average retirement age from 61.5 to 63.5 years. Moreover, from 2018, pensions are to be calculated on the basis of the past 10 years' income rather than the past five years, while the long-term plan is to base them on lifetime earnings. For pensions over 1,400 euros a (progressive) solidarity contribution will be levied. Above all, however, in future the pension will be split: the mandatory minimum pension of around 360 euros will be topped up by an amount based on pension entitlements. Altogether, the pension reform involves the lowering of the already modest pension level (around 520 euros, on average) by 20–30 per cent.

In order to improve revenues the Stability Programme is relying, in the short term, on higher taxes, and in the longer term on combating tax evasion. It envisages:

- a new eight-level income tax with a top rate of 45 per cent (for annual incomes over 100,000 euros);

- higher inheritance and gift taxes, as well as taxation of dividends;

- 20 per cent higher taxes on petrol, alcohol and tobacco, as well as on luxury goods;

- effective taxation of the self-employed (previously dealt with inadequately by the tax authorities) on the basis of their visible assets;

- an increase in general VAT from 19 to 21 per cent; higher VAT on luxury goods of 23 per cent;

- abolition of VAT exemption for certain categories of the self-employed (such as lawyers);

- taxation of the revenues of the Orthodox Church.

Tax law has created new instruments to combat tax evasion, which is key to the medium-term consolidation of public finances. The penalties for tax evaders have been drastically increased. Long prison sentences also await tax officials who are found to be accepting bribes. The investigation of tax evasion will be stepped up, with special training for staff involved in combating »economic crimes«. And in future, all traders will have to verify their sales completely, in other words, provide receipts, from which whole occupational groups, such as taxi drivers and kiosk operators, were previously exempt.

The »battle for receipts« is a central – and the most novel – aspect of tax reform. The full recording of VAT will be achieved by motivating all taxpayers: they can reduce their tax liabilities by presenting receipts for their daily expenditure (even an annual income of between 6,000 and 12,000 euros will remain tax-free if 10 per cent of this sum is verified as expenditure, while above 12,000 euros receipts for above 30 per cent are necessary). The declared aim of this regulation is to turn all taxpayers into tax inspectors and to raise awareness that tax evaders do not cheat only »the state«, but everyone.

## Effects of the Reform Programme

This comprehensive reform programme was acknowledged by the European partners and the authorities in Brussels and Frankfurt, but also by the IMF and the OECD as convincing and »ambitious«. Nevertheless, the competent bodies of the EU and the Eurozone hesitated for weeks before backing up the praise for the courage of the Papandreou government with a concrete aid plan. Only at the Brussels summit on 25 March did the EU, the Eurozone and the ECB reach an agreement which provides for a combined credit programme involving the IMF and a »coalition of the willing« of EU countries for the »worst-case scenario«. The IMF was brought on board at the insistence of Germany, and in the face of opposition from the ECB. But even after 25 March the conditions and technical details of the Greece programme remained unclear, including the interest rate which Athens would be required to pay. With regard to the latter, the Germans at first talked of the »usual market« interest rate. However, Berlin had to give way somewhat because on 11 April the Eurozone finance ministers agreed on a possible loan package for Greece amounting to 30 billion euros, at the – far from charitable – interest rate of around 5 per cent. It still remained unclear whether Athens can fall back on this credit line only if the interest burden remains »barbaric«.

The Greek media consider these numerous delays – and in particular the »stonewalling« of the German government – responsible for the fact that Greek bonds can be sold on the financial markets only with high interest premiums, even after the adoption of the Stability programme. In fact, the spread for Greek bonds which, at the end of February – the last major issue of Greek securities – had still been 3 per cent, in the course of April went from one record high to another. On 23 April, after the announcement of the corrected budget deficit for 2009, the spread exceeded 6 per cent for the first time.

This made it clear that Greece, with regard to its borrowing requirements of over 8 billion euros falling due on 19 May, would risk a level of interest that in government circles has been dubbed »barbaric«, alluding to the role of the country's northern EU partners. The Papandreou government's PSA has therefore failed to exert the expected »shielding effect« with regard to the financial markets. This extremely disturbing development was accelerated on 27 April when the rating agency *Standard* *and Poor's* downgraded Greek bonds by three notches to BB+. The spread exploded, climbing by over 300 basis points to over 10 per cent for the first time. As a result, Greece, without the cheaper credit from the IMF–Euro programme, faced insolvency.

Who and what are responsible for this is a matter of some controversy in Greece. It is currently fashionable to blame »speculators«. Most economic experts recognise, however, that the scepticism of »the markets« is also due to policy errors on the part of the government and very real problems in the Greek economy and society:

■ The government recognised the seriousness of the situation too late and did not act decisively, partly hampered by internal differences.

■ The PSA remained on the drawing board too long: the tax law was adopted by parliament only on 14 April, while the pensions law was presented on 15 April and will be adopted only in the second half of May.

■ Public acceptance of the measures is not certain. In particular, the effects of the trade union protests remain to be seen.

■ No one knows, at present, whether the austerity programme will achieve its aims. That depends on two uncertain factors: the development of the spread and the future course of the economy. Also crucial is whether the measures to boost tax revenues start to take effect in the short or the medium term.

The last two points are particularly important for assessing the further course of the crisis. The issue of public acceptance of the crisis measures has been exaggerated (particularly from the standpoint of foreign observers). It is true that the trade unions are putting up fierce resistance and with good reason – a good two-thirds of the population consider the austerity programme »unfair«. However, a similarly large majority are resigned to the fact that there is no alternative and that the crisis is the result of the »sins« of the past. The general strikes will continue, but can do nothing to change the grim reality of empty coffers. The PSA is in little danger of derailment from this quarter. Potentially more serious in this respect are strikes by smaller groups, such as tax or customs officials, which could have dire consequences, since increasing fiscal revenues depends on them. This is already apparent from the tax revenues realised in the first quarter of 2010. According to the Finance Ministry, only three out of the 67 tax offices in the most important economic region Attica were able to collect the projected sums.

The arrears in tax revenues, in any case, already reflect the negative economic developments. The original PSA was based on the assumption that GDP would shrink by 0.3 per cent in 2010. In the meantime, the economic institute IOBE predicts negative growth of 3 per cent, although –5 per cent seems more realistic. Even more serious is the fact that the recession will continue into 2011, albeit easing off to some extent, and real growth can be expected only in 2012 at the earliest.

The prolongation and probable deepening of the economic crisis – in a period of general economic recovery in the EU and the Eurozone – is primarily the result of a decline in consumer spending, which in turn is a direct consequence of the austerity programme. Since private consumption makes up 70 per cent of Greek GDP, the contraction in people's incomes – wages and pensions – is having a dramatic effect, which even a hoped-for revival of the tourist economy will not be able to compensate. One alarm signal is the fact that retail turnover during the Easter period was 22 per cent down on the previous year.

The PSA's budget targets are therefore already unrealistic, as reduced tax revenues combine with higher spending, for example, as a result of higher unemployment which, according to Labour Minister Loverdos, could rise to 17 or 18 per cent. As a result, the whole basis of the stabilisation programme may turn out to have been built on sand. Furthermore, an intensification of the austerity plan, with further cuts in the primary budget, would plunge Greece even deeper into recession and possibly into a »death spiral«, which George Soros warned of in the middle of April on Greece's Skai TV channel. This warning has become even more topical, because at the beginning of May the troika consisting of the European Commission, the ECB and the IMF was able to dictate to the Greek government even harsher conditions for its three-year assistance programme.

## The European Partners' Belated Bail-out Programme

This situation was able to evolve also because the Papandreou government did not demand the immediate implementation of the assistance programme worth 45 billion euros promised on 11 April. Eminent Greek economists, such as Yiannis Stournaras (Director of the economic research institute IOBE), at that time called on Papandreou to proclaim an emergency »sooner rather than later«, also in view of the Greek banks' liquidity problems, caused by the withdrawal of private deposits which in the meantime has risen to around 15 billion euros. Although the banks have taken advantage of the government's guarantee funds (with reserves of 17 billion euros), which is covered by the ECB, if there is a run on the banks the reserves will not cover it.

There is no rational explanation for the Greek government's hesitation. In Athens, however, the assumption of most observers is that an informal agreement had been reached with the German Chancellor: in return for her agreement to the credit programme of 25 March, Papandreou had to promise that he would not activate the mechanism before the regional election in North-Rhine Westphalia on 9 May. After the expansion of the spread in the second half of April, however, this promise could no longer be kept.

The result is a new stability programme, to be implemented over a longer period, which intensified the PSA on the following points:

- a reduction of administrative expenditure via local government reform in accordance with the »Kallikratis« plan (by almost 2 billion euros a year);

- a freeze on all wages and salaries in the public sector for three years; reduction of Christmas, Easter and holiday bonuses (the so-called thirteenth and fourteenth wages) to 1,000 euros altogether, but total abolition with regard to salaries above 3,000 euros; cuts in other bonuses of another 8 per cent;

- for public sector pensioners a corresponding reduction of the thirteenth and fourteenth pensions to 800 euros, with complete abolition for pensions over 2,500 euros;

- for the private sector, bringing forward the planned reduction in general pension levels and a switch to the calculation of pension levels in accordance with life-time earnings; a gradual increase in the retirement age based on rising life expectancies; drastic cuts in early retirement (in no circumstances below 60).

Turning to the revenue side:

- increase in VAT from 21 per cent to 23 per cent;

- further 10 per cent increase in taxes on petrol, alcohol, tobacco and luxury goods;

- surtax on very high company profits;

- penalty tax on illegally erected buildings (estimated at over a million nationwide).

Two points in particular are crucial to this programme: on the one hand, in comparison to the first PSA there is a stronger emphasis on »fairness«, primarily by means of the uniform (cut back) thirteenth and fourteenth salaries, which involves a higher percentage cut for higher salaries; on the other hand, it was possible to avoid cuts in the thirteenth and fourteenth salaries in the private sector completely. This was called for by Labour Minister Loverdos in particular, namely with reference to the negative consequences for the financing of pension funds, but also for the economy. For the same reason, even the employers' association argued against wage cuts in the private sector.

The relative protection afforded to incomes in the private sector – which in any case are much lower than those in the public sector – was important for the government for another reason: so far, it has been able to prevent the development of a broad-based solidarity between wage-earners and public employees. The distance between the two groups largely explains the relatively low participation in the strikes and demonstrations which are backed mainly by public sector workers. This gap is also reflected in the latest opinion poll (Kappa-Research, 28 and 29 April), according to which almost 80 per cent of the population are in favour of severe cuts in the public sector (with regard to the number of people employed and/or incomes), while 70 of those working in the public sector reject any wage cuts.

## Current Debates on the Future of Europe

The severe crisis dominates the European debate in Greece, alongside the actions of individual partner states. For most commentators, »European solidarity« more or less boils down to »help for Greece«. Serious media coverage, however, extends this to encompass the intensive discussion of the future of the EU and the Eurozone.[1]

In principle, the governing Pasok has long advocated closer European integration, including a coordinated fiscal and tax policy, with an emphasis on Social Europe. This pro-European stance has intensified in the current crisis, with the – as they see it – »hostile« attitude of the German government characterised as »anti-Community«. In contrast, German Finance Minister Schäuble's idea of a European IMF made up of experts and leading politicians was acknowledged as a good starting point, although coming too late for the current Greek crisis.

None of the political parties represented in parliament – apart from the orthodox communist KKE – question Greece's membership of either the EU or the Eurozone. This is also the case among the broad public, despite considerable disappointment with the European partners' hesitancy. Although the »socially unjust« bias of the government stability programme is attributed to »pressure« from Brussels and Berlin, this criticism implies that the sole conceivable and desirable framework for a solution is the European one. Even the nostalgia for the drachma, which people remember as an inflationary currency, is rather muted: in recent opinion polls doubts about the euro were expressed by only 17 per cent of respondents.

The dominant theme of the current debate is the role of the IMF, which was roped in to the EU's solution package by Brussels. Originally, the IMF was brought into the picture by premier Papandreou himself as a last resort, in the event the EU could not agree on a solidarity mechanism. Critics of the government regarded this as a bluff that misfired, cleverly avoided by Angela Merkel when she managed to get the IMF to participate in a European bailout plan.

The version also put around by opposition leader Antonis Samaras, that Papandreou had only tabled this solution as a ruse, while believing it would be a catastrophe, is certainly false. One of the prime minister's most important advisers is Nobel prize winning economist Joseph Stiglitz, who early on declared (*Kathimerini,* 7 February 2010) that the IMF would function as a good »safety net« against financial market speculation: the International Monetary Fund has changed »dramatically« under the aegis of Dominique Kahn-Strauss and no longer relies on the old recipes of »shock therapy«.

Furthermore, Athens makes the point that IMF experts have been advising on the PSA from the beginning. In any case, the notion was leaked via the pro-government press that the ECB was insisting on stricter conditions than the IMF (*To Vima,* 18 April).

One clear argument in favour of IMF participation concerned interest rates. For the IMF's share of the combined assistance programme Greece would only pay just under 3 per cent interest, much less than for the loans from the euro-partners. That means that the combined interest rate burden for the whole package would fall below the 5 per cent mark.

Having said that, it remains to be seen how the donors in the Eurozone will calculate their interest rates for the new three-year assistance programme. In this period, the Greek government will have to raise as much as 240 billion euros (for debt conversion, new borrowing and interest payments). If individual donor countries charge a flexible interest rate, the financing of the Greek deficit will be possible under bearable conditions only if the Athens government provides solid proof by the end of the year of the successful implementation of the PSA.

This holds out some hope for the Greek government. Since it can take up its loans at a fixed rate of interest until the end of this year, it gains not only a welcome breathing space, but possibly also an opportunity to reopen discussions on its decisive structural defect. This consists of the fact that its lasting effects on the revenue side will only kick in in the medium term. A substantial increase in tax revenues, which so far only make up 32 per cent of GDP (against an EU average of 40 per

1. Sources: For the domestic debate in Greece the most important Greek dailies were used: *Kathimerini* (which also has an English-language edition: ekathimerini.com), *To Vima* and *Ta Nea*. Data come predominantly from the last quarterly report (first quarter of 2010) of the economic research institute IOBE (Foundation for Economic and Industrial Research) and the international business press *(Financial Times, Financial Times Deutschland, Frankfurter Allgemeine Zeitung, Süddeutsche Zeitung)*.

cent), cannot be achieved in three years. Nor does the campaign against tax evasion promise to bring in new revenues immediately, as the abovementioned figures from the first quarter of 2010 show.

These figures indicate an economic collapse, which the economic experts of the ECB, the OECD and the IMF, as well as the analysts of the rating agencies and the major banks, regard as the biggest question mark against Athens' »ambitious« plan.

Greece's European partners should therefore discuss how this danger might be alleviated. If they wish to help bring about the PSA's medium-term sustainability, they should advocate a correction of the austerity measures. From today's standpoint, the three-year duration of this programme is »over-ambitious« and so, counterproductive. Greece's economic recovery would be much more likely if achieving the 3 per cent limit on the budget deficit were to be extended over four years, that is, by the end of 2013. A model which has been seriously discussed by experts – and in the Athens economic press – would have a similar effect: namely, extending the maturities of Greek government bonds which will fall due in the next three to five years. This would also give the Papandreou government »a breathing space to implement its austerity programme and structural reforms« (Tony Barber in the *Financial Times,* 27 April).

There is no danger that the Greek public would mistake such a correction for an »all-clear«. At the latest, since the Greeks looked into the abyss on 28 April they have been painfully aware that state bankruptcy cannot be averted from the country's own resources alone. Furthermore, international control of the austerity programme will prevent any deviation from the goals laid down. Certainly, public acceptance of this programme could increase markedly if some of its parameters were corrected, which would have a positive effect on the future development of the economy.

Public acceptance largely depends on three conditions. First, an understanding of the gravity of the situation. Second, the feeling that the sacrifices are being shared »fairly«. And third, the hope that these sacrifices will not be in vain, but will pay off at some time in the future, however distant. While the first condition has undoubtedly been met, the second and third have not. They will probably only be fulfilled if a government, whose honest intentions are beyond doubt, is given more time to implement the necessary radical reforms.

Ricardo Paes Mamede

# Portugal – Austerity policy with no guarantee of success

## The economic and political situation

Like most European countries, the Portuguese economy is experiencing a modest and still uncertain recovery from the crisis that affected the world economy in 2008–2009. While the fall in GDP in 2009 (–2.7 per cent) was less pronounced than the EU average (–4.2 per cent), the latest data suggest that sustained recovery is not an immediate prospect. In the fourth quarter of 2009, GDP shrank by 0.2 per cent in comparison to the previous quarter, and unemployment is growing steadily, having reached 10.5 per cent in January 2010.

Also in line with most EU countries, there was a deterioration of public finances, due to the loss of revenues and the increase in expenditure associated with the kicking in of automatic stabilisers, as well as the implementation of specific anti-crisis measures. Thus, between 2007 and 2009 the budget deficit grew 6.7 percentage points to 9.3 per cent, with public debt reaching 77.2 per cent of GDP. The country's net international investment position is now at –108.5 per cent of GDP, which is the result of the steady increase in external indebtedness by both the public and the private sectors over the past decade.[2] The economic situation helps to explain the results of the general election that took place in September 2009, in which the Socialist Party remained in power, but lost the majority it had held since 2005. The government now has to count on the opposition parties in some crucial votes, namely on budgetary matters. For the time being, the sense of national urgency has helped to keep social and political tensions at relatively low levels, notwithstanding the frailty of the present conditions.

## Reform measures

The Stability and Growth Programme 2010–2013 (SGP) presented by the government in March is aligned with the EU goal of bringing the budget deficit to below 3 per cent by 2013. The stated aim is to reduce the deficit by 6.5 percentage points from 2009 to 2013, through the adoption of specific measures that are expected to significantly reduce public expenditure and modestly increase revenues, while relying on moderate economic growth. The most important contribution to containing public expenditure will come from a reduction in the public sector wage bill, which the government intends to bring down to 10 per cent of GDP in 2013 (from 12.9 per cent in 2008). This is to be achieved through a number of measures, including: restricting the recruitment of civil servants to one new recruitment for each person who retires or ceases employment for some other reason (this measure was already in place before the crisis, but is to be reinforced), and increasing wages below the rate of inflation (although this has been the rule for the past decade). A second domain in which the government expects to obtain significant benefits for the public finances is social spending. The measures announced here include: setting an upper limit for non-contributory social benefits (for example, the minimum income scheme); accelerating the convergence of special pension arrangements for civil servants with the general (and less generous) social security regime; changing the rules on unemployment benefits in order to reduce the incentives to remain unemployed; setting limits on spending in the national health care system; and extending means-testing to other non-contributory social benefits.

Third, public investment is being curbed, namely by cancelling a number of planned road-building projects and postponing the building of two high-speed railway tracks.

Fourth, the government intends to reduce intermediate public consumption, namely by decreasing military spending and setting an upper limit for outsourcing contracts (for example, consultancy). Finally, a new privatisation cycle is on the agenda, involving state-owned firms in such sectors as: postal services, energy, defence, ship building, air transport, railways, financial services, industry and mining. The announced privatisations are expected to yield 6 billion euros, which will be used to reduce public debt by 2 per cent by 2013. On the revenue side, the Portuguese SGP includes: the reduction of tax benefits for household spending on education and health care; reductions in the tax benefits on higher pensions; the introduction of a new 45 per cent income tax rate; the introduction of a new tax on stock market capital

2. For a discussion of the causes of these developments, see R. Mamede (2009), »Portugal – Zu schwach für die Gemeinschaftswährung? Der Januskopf des Euro«, *Euroland auf dem Prüfstand – Die Währungsunion und die Finanzmarktkrise,* Friedrich-Ebert-Stiftung.

gains; and extending the base of social security contributions to previously excluded forms of compensation.

Three points in particular should be considered with regard to the recent reform measures.

■ First, the burden of budgetary adjustment is distributed unevenly. As is immediately apparent from the list of measures put forward in the SGP, the largest contribution to reducing the budget deficit will come from a cut in expenditure. In fact, this amounts to more than three times the contribution arising from increased revenues. The government has explicitly excluded from the package increases in corporate taxes (this also applies to the financial sector), arguing that they would hamper the competitiveness of domestic firms. An increase in VAT has been put aside because there have already been three VAT rises since 2005 and the present rate (20 per cent) is already relatively high by EU standards. As far as the taxation of personal income is concerned, although there has been no general increase in tax rates, most individuals and households (except for those on the lowest incomes) will actually experience a rise in the amount of tax paid because of changes to the tax base. Considering this together with the fact that, on the expenditure side, a significant part of the budget is set aside for public sector employees' wages and social benefits of a non-contributory nature, it is hard to escape the conclusion that the burden of adjustment will fall mainly on the middle and parts of the lower classes.[3]

■ Second, the Portuguese Stability and Growth Programme 2010–2013 does not represent a dramatic break with the recent past as regards the adoption of reform measures aimed at improving the sustainability of public finances. In fact, significant measures have been adopted in recent years, including thorough reform of the social security system, the public administration, the labour market, the regulation of economic activities and budgetary planning and control, all of which have been acknowledged by international institutions as pointing in the right direction. Furthermore, moderate (that is, below inflation) increases in public sector wages have been common in the past decade, and privatisations have taken place every year since 1987. In other words, rather than a break with the recent past, the Portuguese SGP 2010–2013 represents the acceleration of a number of structural reforms along the lines typically advocated by international institutions, such as the OECD, the IMF or the European Commission, in order to improve the sustainability of public finances. The most symbolic break with the past is related to the priority attached to containing spending on non-contributory social benefits, which has been a defining ingredient of the Socialist programme since the mid-1990s.

■ Finally, notwithstanding the efforts of the Portuguese government with regard to the SGP 2010–2013, there is no guarantee that the deficit target of 2.8 per cent by 2013 will actually be achieved. On the one hand, the political situation – with the government depending on the opposition parties to pass important laws, the two left-wing opposition parties being overtly hostile to the SGP, and the continuing uncertainty of the new leadership of the main right-wing party with regard to its political strategy – creates some doubt about the political viability of the measures announced in the SGP. Nevertheless, it is hard to believe that either of the two right-wing parties (each of which has a sufficient number of MPs to help the Socialist Party to pass laws in Parliament) will significantly undermine the SGP, since the latter largely overlaps with their own agenda. More important than the political situation are the risks massing on the economic front.

## Economic and budgetary outlook

Economic growth in Portugal is expected to be modest in 2010 and 2011 (below 1 per cent), with the most recent forecasts differing mainly on the foreseen evolution of investment (see Table 1). While the government expects investment to fall slightly in 2010 (after a reduction of 11.1 per cent in 2009), the Portuguese Central Bank expects the fall in gross fixed capital formation to continue in the current year. The differences are explained partly by the way public investment is estimated: the Bank of Portugal considers only those measures that are already in place or the details of which are already known. The Portuguese central bank also expects lower investment in housing and in the productive sector, as a result of the economic contraction experienced by private agents in 2009.

3. The abovementioned introduction of a new 45 per cent income tax rate is essentially symbolic, since it will affect only a few thousand households, representing a marginal increase in revenues.

Table 1 Forecasts of GDP and main components in 2010 and 2011 (annual change)

| | SGP 2010–2013 (March) | | Bank of Portugal (March) | |
|---|---|---|---|---|
| | 2010 | 2011 | 2010 | 2011 |
| GDP | 0.7 | 0.9 | 0.4 | 0.8 |
| Private consumption | 1.0 | 0.8 | 1.1 | 0.3 |
| Public consumption | –0.9 | –1.3 | –0.7 | –0.2 |
| Gross fixed capital formation | –0.8 | 1.0 | –6.3 | 0.3 |
| Exports | 3.5 | 4.1 | 3.6 | 3.7 |
| Imports | 1.7 | 1.9 | 0.2 | 1.4 |

Since (i) public consumption is expected to contract (according to the announced budgetary measures), (ii) the growth of private consumption is limited by high rates of unemployment (forecast by the government to be 9.8 per cent in both 2010 and 2011), slow wage growth (especially in the public sector) and cuts in social benefits and (iii) there will be an increase in savings rates and investment is being stalled for the reasons mentioned above, the only source of growth that is envisaged by recent forecasts is net exports.

This constitutes the first and most important downside risk with regard to the development of the Portuguese economy. About three-quarters of Portuguese exports are directed to the EU, which means that the growth of the Portuguese economy in the coming years is largely dependent on the economic growth of its EU partners. Given the fact that domestic austerity is being imposed in every EU country (with the aim of meeting the deficit target of below 3 per cent of GDP by 2013), the forecast export growth may be overly optimistic.

Another important downside risk with regard to the economic outlook is related to the costs of public financing. After decreasing for most of 2009, the spread between Portuguese and German 10-year bonds has increased again since December 2009, following the development of the Greek sovereign debt crisis, reaching 150 basis points by the beginning of March 2010. After the EU agreed, later that month, on a scheme to assist member states with severe sovereign debt problems, the pressure on Portuguese sovereign debt diminished slightly. Nevertheless, given the structural weaknesses of the Portuguese economy, some (albeit moderate) degree of uncertainty regarding the political viability of the measures included in the SGP, the country's economic outlook and the prevailing weakness of the international financial system, one cannot exclude the possibility that the financial markets will demand higher interest rates for acquiring sovereign debt in the coming months (which would not only complicate the budgetary adjustment process but also give a negative signal to investors, with deleterious implications for economic activity).

## Role of the EU

Given the prevailing constraints, it is hard to escape the conclusion that Portugal will have to go through a relatively long process of adjustment (in fact, under way since the turn of the millennium), marked by slow economic growth and high unemployment. Some of the most important factors underlying the dismal performance of the Portuguese economy in the past decade – namely, the poor qualifications of the labour force and the vulnerability of its productive structure to competitive pressures from new EU member states and emerging economies (that is, from countries with similar productive structures and lower labour costs) – will take time to overcome. In addition, in the absence of monetary autonomy, external imbalances cannot be smoothly corrected; the prospect of a reduction in real wages, as a means of improving competitiveness, not only faces the usual political obstacles, but is also confronted by the reality of a country with one of the highest poverty levels and one of the lowest minimum wages in the Eurozone (475 euros, at present). The high levels of private indebtedness (which resulted from excessive borrowing by households during a period of low interest rates and an economic boom that proved to be temporary, in anticipation of joining the euro) will entail the slow growth of household consumption and investment in the coming years. Finally, the crisis of 2008–2009 is expected to have a long-term effect on potential growth, through the destruction of productive capacity and the postponement of new investments by both the public and the private sector.

This low growth/high unemployment scenario has been present in Portugal since the early 2000s, when the country's levels of GDP per capita started to diverge from the EU average (contrasting with the long period of catchingup in previous decades). The attempt to remedy this state of affairs is based on putting forward a number of, more or less thorough, structural reforms (see above), as well as a strong commitment to improving education levels and upgrading the productive structure (taking advantage of EU structural funds, which were reoriented in the current programming period from physical infrastructure to those two domains). The discussion on the role of the EU in the present situation must be seen against this background.

Before the 2008–2009 crisis, there was a general consensus among the main political parties in Portugal – the centre-left Socialist Party and the centre-right Social Democratic Party – concerning the EU. Put simply, these parties assumed that the benefits related to lower interest rates and easier access to international financial markets, together with the structural funds received by Portugal as part of the EU Cohesion Policy, outweighed the costs of diminished autonomy in macroeconomic management – and there was barely any discussion of the need to adjust the coordination of economic policies within the EU.[4] It was assumed that the adjustment to the new macroeconomic management framework (that is, EMU) and the new competitive challenges (arising from EU enlargement to the east and from the growth of emerging economies in world trade) would have to be dealt with domestically. The advent of the international crisis and the subsequent sovereign debt problems on the EU's periphery have contributed to the introduction of new issues in the public debate on the role of the EU. In particular, the Socialist government, through its Prime Minister José Socrates, has joined other voices in Europe urging stronger coordination of economic policy. The details of the official Portuguese position are not known. However, three main themes have been to the fore recently in the public discussion.

The first is related to the need to coordinate the exit strategies for anti-crisis measures and fiscal consolidation in the coming years. In fact, in the present situation we may be facing a collective action problem, in which every country is imposing domestic austerity (through wage compression and cuts in public expenditure), while expecting the other countries to generate enough demand to stimulate its own exports, the result being that aggregate growth is depressed and economic recovery is postponed. Given the prevalent weakness of some segments of the financial sector and the uncertainty surrounding the evolution of private investment, the decision taken at the EU level to immediately start the fiscal consolidation effort in all member states may turn out to be counterproductive.

4. The exception is the debate on corporate tax harmonisation in the EU, which some sectors of the Socialist Party have raised as a result of the impact of tax competition on FDI flows.

Second, and most obviously, there is a growing perception that the EU should help to reduce the risk faced by several member states of entering a vicious circle in which escalating interest on government bonds lead to growing, domestically imposed austerity in order to pay off sovereign debt, marring the country's economic outlook and justifying even harsher conditions for external borrowing. During the domestic discussion on the SGP 2010–2013 it became clear that the strategy adopted to reduce the public deficit has been strongly influenced by the pressure imposed by the financial market, in particular, the rating agencies. The distribution of the fiscal consolidation burden could arguably be fairer and even more growth-oriented, if the country was not facing permanent pressure from that quarter. Having the means to ensure that member states are able to obtain credit at reasonable interest rates and avoid being forced to adopt inadequate measures, the EU should be equipped with the mechanisms it needs to meet those goals.

Finally, the idea that the prevailing framework for macroeconomic management is responsible for a disinflationary trend in EU economies is becoming increasingly influential. The nature of this problem is illustrated by Figures 1 and 2, which depict the evolution of productivity and real wages in Portugal and Germany since 1995:

Two elements in particular are worth emphasising.

- First, contrary to what is often argued, the general evolution of productivity growth in Portugal during the period does not compare too badly with that in Germany. True, productivity in Portugal is much lower than in Germany, and if the former is to catch up with the latter it will need to improve its productivity much faster. Still, the current problems facing the Portuguese economy cannot be associated with a stagnation of productivity in any sense.

- Second, although wage profligacy on the EU periphery has often been cited as a major source of problems

Figure 1

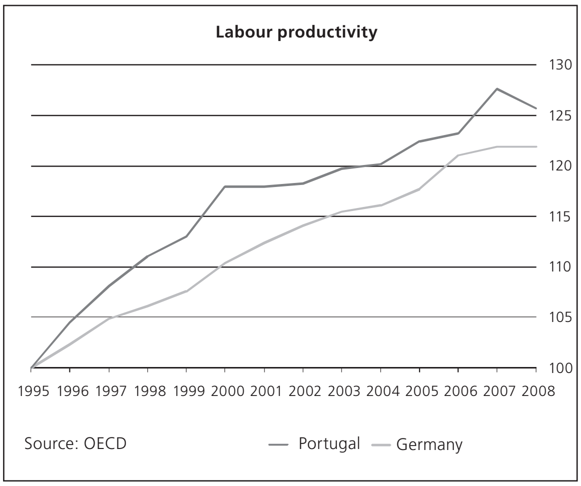



Figure 2


for those economies, Figure 2 suggests a different interpretation. In the case of Portugal, real wages per employee have grown below productivity, leading to a stagnation of the wage share of aggregate income, despite an increase in total employment during the period. In this light, it seems that the problem of imbalances inside the EU is due less to excessive wage growth on the periphery, and more to insufficient wage growth in the centre. Especially in the case of Germany, the use of wage moderation to improve competitiveness is probably having deleterious consequences for the EU as a whole – not only by failing to stimulate demand, but also by inviting the other countries to pursue the same course. The lack of mechanisms at the EU level to coordinate wage adjustments across member states (for example, by aligning wage growth with productivity growth) is thus leading not only to insufficient aggregate demand, but also to unfair social distribution of gains and losses in the continent as a whole.

In sum, while Portugal has been closely following, and with considerable success, the reform agenda that has become virtually the consensus among international institutions, its economic (and social) outlook for the coming years is not favourable. Without changes in the prevailing framework for macroeconomic management in the EU, there is hardly any alternative route for development but the one marked by slow growth, high unemployment and the severe risk of harsh credit conditions (which would negatively impact on growth prospects). There is room, however, for institutional reforms at the EU level that would reduce the risks of financial instability, support economic recovery and promote sustained growth and social justice, without jeopardising sustainable public finances. Such reforms include: coordination of wage setting, increased flexibility in budgetary rules (accompanied by stricter enforcement procedures) to accommodate asymmetric developments in business cycles, corporate tax harmonisation and the introduction of financial instruments that help to prevent speculative attacks on member states' sovereign debt.

Santiago Fernández de Lis and Emilio Ontiveros

# Spain – The growth of the construction boom will not return

## Introduction

Since our contribution to the first part of this volume was written, in spring 2009, the economic situation in Spain has worsened considerably, albeit according to expectations. More worryingly, a serious institutional crisis has developed in the Eurozone, as a result of the fiscal sustainability problems of Greece and its spread to other vulnerable peripheral countries, such as Portugal, Spain, Italy and Ireland. At the time of writing (mid-April 2010), the latest announcement of a package by the EU authorities and the IMF to support Greece – after several failed attempts – seems to have had a positive impact on hitherto sceptical international financial markets; the final outcome of this episode remains unclear, however.

Spain's recent macroeconomic performance can be summarised as follows:

■ GDP contracted by 3.6 per cent in 2009, with a much increased negative contribution on the part of domestic demand (–6.4 per cent), which was partly compensated by a very positive contribution from net external demand (2.8 per cent), in turn the result of a much bigger fall in imports (–17.7 per cent) than in exports (–11.3 per cent), in the context of shrinking global trade.

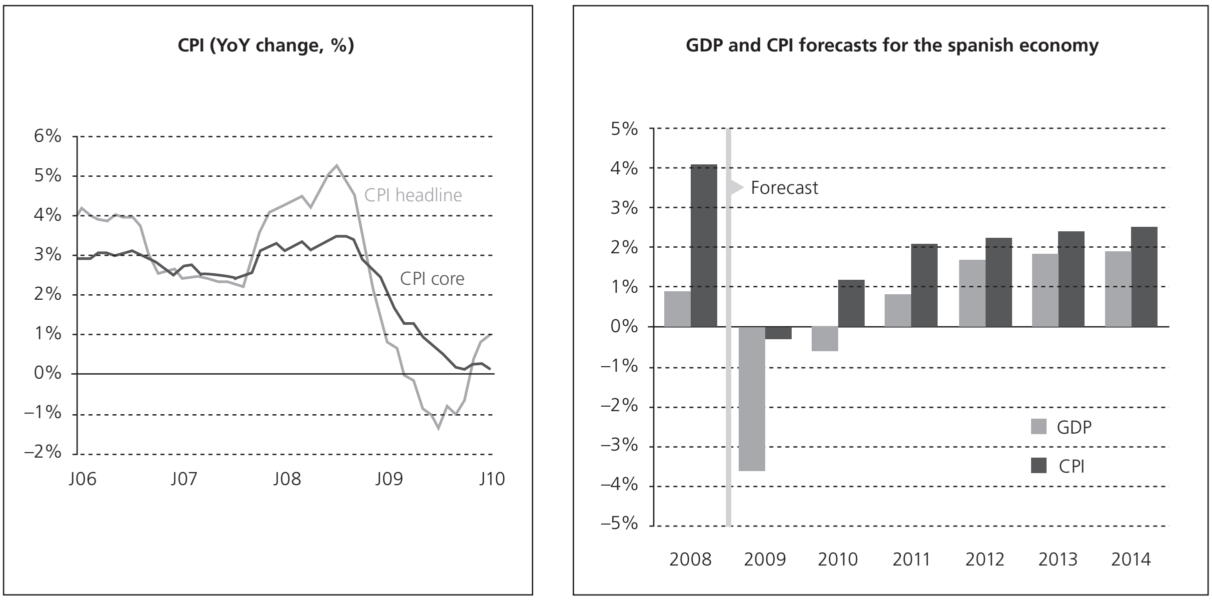
■ Recent industrial production data point to a negative figure in February 2010 (–1.9 per cent), but considerably higher than the very negative rates recorded one year earlier (–22 per cent).

■ Unemployment continues to be by far the most serious problem of the Spanish economy, with more than 4 million unemployed, nearly 20 per cent of the active population.

■ As in other EU countries, inflation was in negative territory during most of 2009, which allowed – for the first time since the adoption of the euro – for a modest recovery in competitiveness vis-à-vis other euro-area members. In February 2010, inflation stood at 0.8 per cent (see Figure 1 for a detailed overview).

■ The correction of the current account deficit has been remarkable, from a maximum of 10 per cent in 2008 to around 5 per cent in the 12 months up to February 2010. The expectations are that this process will continue in the coming quarters, up to a level of around 3.5 per cent or lower. This correction is partly a result of the rapid increase in private savings, in reaction to the uncertainty of the economic situation and, in particular, the employment prospects: the household savings rate, as a percentage of disposable income, rose from 10.5 per cent in the

Figure 1



first half of 2007 to 18.8 per cent in the last quarter of 2009.

■ As a result of the weakness of the economy, the fiscal situation has experienced a sharp deterioration, related to the effect of the automatic stabilisers and discretionary measures. From a certain fiscal comfort before the crisis (reflected in a debt-to-GDP ratio of only 35 per cent, one of the lowest in the EU), Spain moved very rapidly to a state of fiscal vulnerability, as reflected in the perception of international financial markets (see Section 3).

## Recent Reform Measures

Over the past few years, the Spanish government has announced several packages of measures with different objectives: (i) economic stimulus, such as a plan for public works in municipalities in the amount of 8 billion euros, already implemented; (ii) fiscal austerity, to correct the dangerous drift of the public finances (see Section 3); and (iii) reform of certain structural weaknesses in the economy. In this third line of action, recent efforts have been concentrated in the labour market. The proposals announced so far are very generic and must be discussed with the social partners. The key themes are as follows:

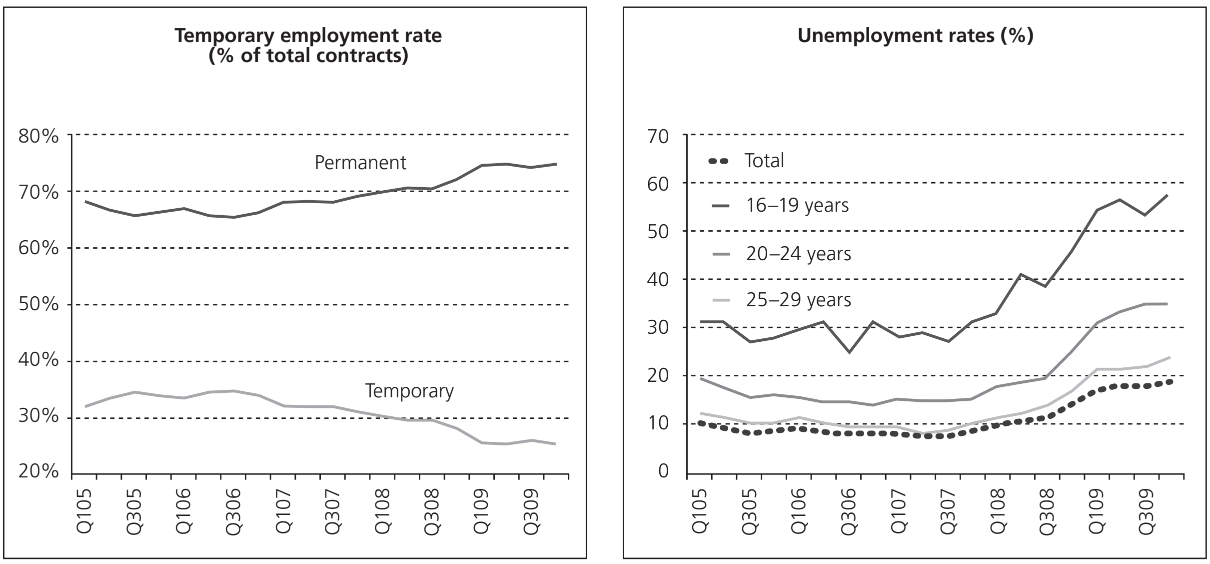
1. Reducing the segmentation between temporary and permanent contracts – the main structural problem of the Spanish labour market (see Figure 2) – by: (i) increasing severance payments and/or types of social security contributions on temporary contracts; (ii) promoting a type of permanent contract (which in 2007 only represented 17 per cent of total permanent contracts); (iii) setting up a clear distinction between types of layoffs, and in particular between those considered »appropriate« (with compensation of 33 days per year worked) and »inappropriate« (for which the compensation amounts to 45 days), the latter being the most common in Spain; (iv) reviewing the criteria that define a contract as »fixed-term«; (v) encouraging part-time employment through reform of its regulation.

2. Promoting the reduction of working hours per day during the crisis as an alternative to temporary employment adjustment: implementation of the »German model«.

3. Reviewing the current policy of subsidies for hiring: these are almost universal and do not generate any incentive to hire groups who find it more difficult to enter the labour market.

4. Promoting youth employment (through active policies and greater use of training contracts). The youth unemployment rate (people between 20 and 24 years) stood at around 30 per cent in the last quarter of 2009 (see Figure 2).

Figure 2




Source: Afi form INE

5. Reducing labour discrimination between men and women.

6. Strengthening the role of public employment services and improving employment intermediation through private agencies.

Besides the labour market reform, the government has announced a »Sustainable Economy Plan«, which encompasses several lines of action in different fields: improvement in competitiveness, environmental protection (through incentives to use renewable energy sources), the recovery of the housing sector (including incentives to refurbish old dwellings and renting, especially by youngsters), innovation, training and the financing of small and medium-sized enterprises (SME) through the Instituto de Crédito Oficial (ICO), a public, second-tier bank.

## Economic and Budgetary Outlook

The sharp deterioration of the public finances in various economies in the Eurozone led to strong tensions in the public debt markets of the region in early 2010. As a consequence, the spread between the interest rate paid by the Greek, Spanish, Portuguese and – to a lesser extent – Irish debt vis-à-vis Germany has widened markedly in recent weeks, fuelling doubts related to the sustainability of the Eurozone in the medium term. Spain's position has lain somewhere in between the core and the periphery countries.

The Spanish government recently published its budget deficit forecasts for the various administrations (state, regional and local, as well as social security) for the period 2010–2013. The increase in the borrowing needs of the Regional Authorities both in 2010 and 2011 – which could reach 3.2 per cent and 4.2 per cent of GDP respectively – is especially noticeable. According to these forecasts, the deficit will return to 3 per cent of GDP by 2013, in line with the limits of the Stability and Growth Pact (see Table 1 below).

Table 1 Public balance: total public administrations. Government forecasts

| % of GDP | **2009** | **2010** | **2011** | **2012** | **2013** |
|---|---|---|---|---|---|
| Government | **–0.9** | –6.2 | –2.5 | –3.8 | –1.9 |
| Social Security | **0.8** | 0.2 | 0.2 | 0.2 | 0.2 |
| Autonomous communities | **–2.2** | –3.2 | –3.2 | –1.5 | –1.1 |
| Local authorities | **–0.5** | –0.7 | –0.7 | –0.3 | –0.2 |
| **Public sector** | **–11.4** | **–9.8** | **–7.5** | **–5.3** | **–3.0** |

Source: Afi from Ministery of Economy

In a situation of unrest and tensions, however, international financial markets have been demanding measures not only to restore growth, but also to limit budget deficits in the future. These measures should be both ambitious and credible. In this context, and after confirmation of a budget deficit of 11.4 per cent of GDP in 2009, the Spanish government announced a consolidation plan to restore the confidence of financial markets.

The measures proposed aim at reducing public spending by 45 billion euros from 2010 to 2013 (see Table 2 below). The bulk of the adjustment will rely on the central administration, with a reduction in spending of about 32 billion euros. This consolidation will take the form of (i) an immediate action plan, which consists in a reduction of 5 billion euros during 2010 (in addition to the 8 billion euros already contemplated in the budget approved in October 2009) and (ii) an austerity plan between 2011 and 2013 amounting to 27 billion euros, the details of which are still pending, but that will affect subsidies, current transfers, investment and, to a lesser extent, the wages of civil servants.

The remaining improvements are related to the gradual recovery of public revenues, estimated at around 3 per cent annually in 2012 and 2013 (on top of the increase in VAT from 16 to 18 per cent from 1 July 2010, already included in the original budget). The main uncertainties about the credibility of the plan are related precisely to the revenue forecasts, and also to the capacity of the regional administrations to reduce their spending levels.

Table 2 Budget consolidation scheme

| | % of GDP | EUR bn |
|---|---|---|
| Budget deficit (2009 estimate) | 11.4 | 119.9 |
| **Estimated structural public debt** | **5.7** | **59.9** |
| Adjustment measures in 2010 budget | –2.1 | –22.1 |
| **(1) Medium term fiscal adjustment** | 3.6 | 37.9 |
| **(2) Objective for 2013 primary surplus** | 0.1 | 1.1 |
| **(3) Commited spending** | 0.6 | 6.3 |
| **(1) + (2) + (3) Total adjustment of public sector spending** | **4.3** | **45.2** |
| Compensation of employees | 1.9 | 20 |
| Intermediate consumption, transfers and others | 1.0 | 10.5 |
| Investment | 0.9 | 9.5 |
| Subsidies | 0.5 | 5.3 |

Source: Afi from Ministery of Economy

## The Future of the Euro and the Coordination of Economic Policies

This crisis is the result of the contravention of two crucial aspects of the Maastricht architecture:

1. The domestic flexibility of the economies, especially in the most vulnerable countries of the periphery. The loss of the exchange rate as an adjustment instrument needed to be compensated in the form of more flexible domestic markets, to facilitate the necessary adjustment in the real exchange rate through domestic prices and wages. The peripheral countries were more vulnerable for several reasons: (i) they were exposed to a higher increase in the prices of non-tradeables, due to the well-known Balassa-Samuelson effect, and the ensuing risk of spillovers to other sectors of the economy, thus undermining their competitiveness; (ii) they experienced a formidable expansionary shock as a result of the decrease in the real interest rate entailed by the adoption of the euro (estimated at 5 basis points in the case of Spain), which fostered economic growth but also inflation, ever-growing current account deficits and housing booms; and (iii) their labour markets were particularly rigid, even by European standards. Although some countries adopted certain reforms in these directions, the efforts were far too timid and, when the crisis hit, those countries that accumulated more imbalances (in competitiveness, house prices and the public sector accounts) were harder hit.

2. The fiscal rules. The Maastricht architecture was based on two pillars for fiscal discipline, the Stability and Growth Pact (SGP) and the no-bail-out rule. The transgression of the SGP by Germany and France in 2004 deprived the euro area of one of its cornerstones. After this, the arguments for discipline in smaller countries were seriously undermined. The loss of credibility of the Pact also explains in part the increasing lack of reliability of the figures used in the EU budgetary exercises (if the Pact was not enforceable, why should we be purist with the debt and deficit statistics?). As for the no-bail-out rule, the jury is still out, but the declarations of EU leaders on their willingness to help Greece amount to a rejection in practice. There is probably no alternative, since a Greek default would have had much worse effects on the euro area, but the fact is that the rules of the euro architecture need to be changed in a much more profound sense.

The insufficient progress in domestic flexibility and – especially – the contravention of the fiscal stability rules open a new scenario for the euro that requires new rules. It is very unlikely that the euro will resist a deterioration of fiscal discipline rules unless a much tighter fiscal coordination framework is implemented. This requires also a sharper institutional differentiation between Eurozone members and EU members, with an appropriate institutional setting for the former. Those Eurozone countries willing to share fiscal sovereignty to a greater extent should not be prevented by others that do not share the objective of a common currency. Eurozone members should make progress towards a certain degree of centralisation of fiscal policies and more fiscal harmonisation and possibly establish mechanisms for the common issuance of European (or Eurozone) public debt.

The suggestion to establish a European Monetary Fund is worth exploring, but its design and implementation could also introduce a higher degree of complexity in the EU institutional framework. The involvement of the IMF in rescue packages for euro-area members (as apparently imminent in the case of Greece) is not normal and requires a certain adaptation of the Fund, as well as the EU's functioning. To avoid the impression that Europe is not able to deal with its domestic problems, EU countries should explore mechanisms to avoid similar cases in the future, while at the same time ensuring that the basic architecture of the euro remains in place.

Philipp Fink

# Ireland – In the grip of the economic and financial crisis

## Introduction

The Irish Republic, once the EU's star performer in terms of economic growth, is now leading the way with regard to austerity. In contrast to other industrialised countries, which have reacted to the economic and financial crisis with economic stimulus packages, the Irish coalition government, led by the centrist *Fianna Fáil* and including the Irish Greens and the market liberal *Progressive Democrats,* has announced strict austerity measures for the budget year 2010. Overall, spending cuts of 4 billion euros – or 2.4 per cent of Irish GDP – were decided on, three-quarters of which concern current expenditure (EUCOM 2010: 8).

The budget for 2010, adopted in December 2009, marks – after the emergency budget of April 2009 – the high-water mark, so far, of the draconian austerity measures which are intended to bring the mounting national deficit under control. The dramatic fall in exports, together with the bursting of the real estate bubble in 2009, has caused economic growth to collapse by 7.5 per cent and a record rise in unemployment to more than 12 per cent. As a result, in 2009, tax revenues plummeted to 31 per cent below those of 2007 (ESRI 2009: 19).

At the same time, government spending has increased sharply, due to the rising unemployment and the rescue measures agreed on for domestic banks. The collapse in the housing market left Irish financial institutions facing large write-downs on loans (Fink 2009a). As a result, Ireland was among the first industrialised countries to launch a rescue of its financial system, issuing a state guarantee worth 400 billion euros. As the crisis developed, recapitalisation loans had to be granted to two banks and another institution was even fully nationalised. The purchase of non-performing mortgages by the National Asset Management Agency (NAMA), recently established as a »bad bank«, will impose a further 81 billion euro burden on the state budget, according to first estimates (ESRI 2009: 19).

At the beginning of April 2010, the central bank's financial supervision announced the conditions on which NAMA would assume the first tranche of mortgage write-offs from failing banks. The financial institutions concerned will have to swallow substantial discounts – or »haircuts« – averaging 47 per cent of the book value. The equity ratio was also announced, set at seven per cent. According to the calculations of the financial supervision, Irish financial institutions need 21 billion euros in additional liquidity in order to shoulder the loss in value of transferred mortgages and to meet the equity capital requirements, or face nationalisation. There is already speculation that one of the largest banking groups in the country, Allied Irish Banks (AIB), will have to take this route sooner or later. This would lead to a further deterioration of the budget situation (*Irish Times* 2010b).

The Irish government justifies the drastic austerity measures on the basis of the higher interest rates which the Irish state has had to offer for new bond issues on the capital markets since the outbreak of the economic and financial crisis. The spending cuts are intended to signal to the market that, in future, the government can pay its debts, enabling it to lower the interest burden with regard to financing the budget deficit. For this purpose, the dual – current account and budgetary – deficit is to be cut, so that by 2014 Ireland will once again be able to comply with the Maastricht criteria.

Despite the spending cuts, however, in 2009, according to the calculations of the Irish Economic and Social Research Institute (ESRI), the national debt (debt ratio) rose to 65.5 pc of GDP and the budget deficit was 11.75 per cent of GDP (ESRI 2009: 18). Although the spending cuts were able to reduce the interest rate differential in relation to the risk premium on German government bonds, the risk premium for Irish debt securities remains considerable, surpassed only by the interest rates on Greek government bonds.

## The Crisis-Prone-Ness of Irish Growth

Large sections of the Irish and international public lay the blame for the economic crisis, essentially, on credit financed and excessive consumption. On closer examination, however, the country's dramatic situation proves rather to be the result of the crisis-prone-ness of the chosen export-oriented and foreign investment dependent growth model.

Furthermore, from a historical standpoint, it turns out that the current recession is neither a one-off event nor entirely unexpected. Simultaneous current account and budgetary crises have recurred periodically in the Irish post-war economy. The export-dependent growth model has already experienced systematic crises in the past, which almost led to state bankruptcy and occasioned a recalibration of the growth path. However, as far as the fundamental problem of the Irish economy is concerned – namely the lack of a significant domestic industry and so the development of organic and self-sustaining growth – nothing has changed, despite the increase in prosperity.[5]

The first serious post-war crisis took place in the 1950s. With the introduction of free trade, imports rose sharply. At the same time, the livestock and food export branches, which were important for what was then an agrarian country, suffered considerable losses. Previously protected domestic companies fell into decline. The growing trade deficit devoured the country's low foreign currency reserves. The then government's economic policy response focussed on reducing demand for imports by applying radical austerity measures and controlling consumption. The result was a drastic intensification of the recession and the highest emigration levels since the great famine in the nineteenth century. The solution to the crisis was the pursuit of an export-oriented industrialisation strategy and a moderate increase in government intervention: this was the so-called »revolution« of 1958. The aim of the policy was, in the absence of an internationally competitive domestic industry and export sector, to achieve growth and employment by attracting foreign firms from the processing industry.

This economic policy laid the foundations for the boom of the 1960s. Ireland was able to benefit from the post-war growth of Western industrialised countries as a low wage location for exports to the USA and Europe. This growth period for Ireland came to an end with the oil crisis in 1973. Fourteen years of economic misery ensued, characterised by the attempt to breath new life into the export-oriented growth model in the teeth of a crisis-stricken world economy and uncertain foreign demand. As a result, in the 1980s the Irish state faced bankruptcy and was hard put to finance the high current account and budgetary deficits.

5. For an overview of recent Irish economic history, see Fink (2009b), O'Riain (2004), O'Hearn (2001) and Lee (1989).

The turnaround came in 1987, when a minority government under the leadership of the centrist *Fianna Fáil* and with the participation of the *Progressive Democrats* and the connivance of the largest opposition party, the conservative *Fine Gael,* adopted a painful austerity programme. Between 1987 and 1989 current expenditure was cut by 11 per cent, social transfers by 3.6 per cent and investment by almost 5 per cent. At the same time, in particular, indirect taxes and duties were raised. In defiance of all the prophesies of doom, the economy recovered and the boom period of the »Celtic tiger« commenced.

## The Fairy Tale of Expansionary Cuts

This achievement was lauded by a host of market liberal economists – including the experts of the IMF – as a prime example of how cutbacks in government spending and public sector reorganisation can lead to long-term growth (Giavazzi/Pagano 1990). On this interpretation, the state's reduced demand for borrowing led to a reduction in total capital demand. As a result, a surplus arose on the capital market, causing a fall in interest rates and boosting private investment (the theory of so-called »expansionary fiscal contraction«). Furthermore, the austerity policy and the successful social dialogue brought about a lowering of unit wage costs and thus helped the Irish export sector to regain its international competitiveness.[6]

It is therefore scarcely surprising if the current government, in defending its austerity measures, harks back to the policy of those days. However, this favourable interpretation of the events of that time has considerable flaws. On the one hand, its account of the causes of the emergence of what later became the Celtic Tiger is dubious. Increased domestic demand was not responsible for overcoming the recession at that time or for building the foundations of Ireland's high growth rates, but rather the demand for Irish export goods as a consequence of the recovery of the world economy after 1991. This is overwhelmingly attributable to foreign firms which, supported by a massive devaluation of the Irish punt, took advantage of Ireland as a favourable production location

6. On this interpretation, see Giavazzi/Pagano (1990) and MacSharry/White (2000).

for the European Single Market. Sophisticated location marketing, involving low corporate taxes, extensive transfers from Brussels for Irish infrastructure, a highly qualified workforce and favourable wages as a result of national wage agreements attracted foreign firms, in particular in the processing industry and computer software and hardware, to the former basket case of Europe.

On the other hand, these conditions no longer exist. As a consequence of its meteoric economic development Ireland now receives less from the Structural and Regional Funds. This means that urgent infrastructure investments have to be postponed due to severe budget consolidation. With the accession of the member states from central and eastern Europe many foreign companies have moved away in search of more favourable locations. The Irish government has failed to provide for the strengthening of value-added-intensive activities in foreign subsidiaries and thus for a long-term commitment on the part of firms to remain in Ireland (Fink 2008).

This is made worse by the fact that domestic firms are unable to fill these gaps. With few exceptions, the attempts to build up a strong domestic industrial sector have failed. On the one hand, the presence of foreign firms did nothing to increase the competitiveness of Irish companies. As a result, strategic knowledge was not transferred and Irish firms did not gain access to lucrative markets. The export activities of Irish firms were neither expanded nor made more sophisticated and their capacity to innovate could not be improved (Fink 2006; Paus 2005).

Finally, in contrast to 1987, the Irish economy finds itself trapped by nominal price rigidity. Entry into the Eurozone has taken away the option of currency devaluation in an attempt to reduce relative prices in relation to Ireland's main trading partners. With a negligible inflation rate the scope for reviving national wage negotiations within the framework of social dialogue is virtually nil. Although the state has made substantial cuts in the wages of public sector employees it is unlikely that the trade unions would agree to a reduction of nominal wages in the private sector. There is also the fact that deflation is driving up the debt burden of firms and households. As a result, insolvencies are rising and firms' propensity to consume and willingness to invest are declining further. This is intensifying the difficulties of Irish banks because the volume of non-performing loans and mortgages is increasing. The government austerity policy, in this context, is having a pro-cyclical effect and, according to ESRI's calculations, is strengthening deflationary developments in the short to medium term. Ireland thus finds itself in an economic vicious circle.

## Ireland's View of the EU: Caution with regard to Further Economic Policy Integration

Given these dramatic events, it is surprising that the debate on heightening coordination of European economic policy and the proposal to establish a European monetary fund has met with a rather lukewarm response among the Irish public. However, after the extremely complex and prolonged process of endorsing the Lisbon Treaty all political parties are shying away from any possible changes to European treaties. After the painful experience of recent referendums none of the main political parties has any wish to reopen old wounds. Given the tensions between the coalition partners and the current weakness of the ruling government coalition in the opinion polls there is a real possibility that the government will throw in the towel early and there could be new elections before they are next due, in two years' time. In light of the general public scepticism concerning further losses of sovereignty, grounded in Ireland's long and bloody struggle for independence, calls for intensified European integration could have an adverse effect on the outcome of the election.

Furthermore, with regard to the immense economic difficulties at present, the current debate on the possibility of increasing the EU's economic policy competences is not considered to be particularly beneficial. Misunderstood statements by the government could lead to a speculative increase in the risk premiums on Irish government bonds. The government coalition wishes above all things to avoid »Ireland« becoming a synonym for »Greece«.

Social democratic actors in Ireland find themselves in a similar dilemma. Although the opposition Labour Party and the Irish Congress of Trade Unions (ICTU) accept the need for cuts, they have criticised, together with progressive critics, the one-sidedness of the austerity policy, which concentrates mainly on the spending side, without increasing tax revenues. For example, social transfers, such as tax subsidies for child care, have been severely cut. On the other hand, income and capital income tax rates remain almost unchanged – in the country with the lowest average direct tax burden in the EU. Observers reckon on a marked increase in income inequality in a society which is already characterised by high inequality with regard to wealth distribution.

Progressive critics fear that the government, with its »slash and burn« policy, is gambling away Ireland's future by postponing investments which might have stimulated the domestic economy. The opposition and the trade unions are calling for a change in the current policy in the direction of a fairer distribution of the burden of debt reduction. There are also loud calls for a criminal investigation of bank failures. Initial inquiries point to an unholy alliance between the building sector, bank managers and the successful centrist party *Fianna Fáil*. Over the years, the close links between the building industry and Ireland's main political parties have time and again been a source of scandal. In the end, Prime Minister Bertie Ahern was forced to resign after allegations were made that he had accepted payments from building contractors.[7]

While Ireland's political class argues over who is to blame, society's »safety valve« seems to be functioning again, namely migration by young people. The number of Irish emigrants has risen for the first time since 1997. An estimated 60,000 Irish citizens left the country for Australia, Canada and New Zealand. Another 50,000 are illegal immigrants in the USA (TAZ 21 March 2010). Given Ireland's continuing economic travails, how long they remain abroad depends on how things develop economically with the country's most important trading partners, the USA, the UK and Germany.

7. For example, on 8 March 2010, 28 prominent Irish economists, academics and analysts published an open letter to the Irish government in the *Irish Times* (*Irish Times,* 2010a). On the close links between the building industry and politics, see O'Toole (2010).

## Literature

Economic and Social Review (ESRI) (2009): *Quarterly Economic Commentary,* December. Dublin: ESRI.

European Commission (EUCOM) (2010): Recommendation for a Council Opinion: On the Updated Stability Programme of Ireland, 2009–2014. Brussels: European Commission.

Fink, Philipp (2009a): Late Development in Hungary and Ireland: From Rags to Riches? Baden-Baden: Nomos.

Fink, Philipp (2006): FDI-led Growth and Rising Polarisations in Hungary: Quantity at the Expense of Quality, in: *New Political Economy* 11 (1): 47–72.

Fink, Philipp (2008): Länderanalyse Irland: Ein Erfolgsmodell auf dem Prüfstand? Berlin: Friedrich-Ebert-Stiftung.

Fink, Philipp (2009b): Irland: Erfolgsmodell in der Krise: Ist der »keltische Tiger« bankrott?, in: Petra Pinzler et al. (eds): Euroland auf dem Prüfstand – Die Währungsunion und die Finanzmarktkrise. Berlin: Friedrich-Ebert-Stiftung, pp. 7–10.

Giavazzi, F.; Pagano, Marcello (1990): Can Severe Fiscal Contractions be Expansionary? The Tale of Two Small European Countries, in: Oliver Blanchard and Stanley Fisher (eds): *NBER Macroeconomic Annual,* New York: NBER, pp. 75–110.

Lee, John J. (1989): Ireland, 1912–1989: Politics and Society. Cambridge: Cambridge University Press.

MacSharry, Ray; White, Padraic A. (2000): The Making of the Celtic Tiger. The Inside Story of Ireland's Boom Economy. Cork: Mercier Press.

O'Hearn, Denis (2001): The Atlantic Economy: Britain, the US and Ireland. Manchester: Manchester University Press.

O'Riain, Séan (2004): The Politics of High Tech Growth: Developmental Network States in the Global Economy. Cambridge: Cambridge University Press.

O'Toole, Fintan (2009): Ship Of Fools: How Stupidity and Corruption Sank the Celtic Tiger. New York: Faber & Faber.

Paus, Eva (2005): Foreign Investment, Development, and Globalization: Can Costa Rica Become Ireland? Basingstoke–New York: Palgrave Macmillan.

*Irish Times* (2010a): All the wrong options have been pursued, *Irish Times,* 8 March 2010. Available at: http://www.irishtimes.com/newspaper/opinion/2010/0308/1224265794036.html (last accessed on: 16 March 2010).

*Irish Times* (2010b): State Moves into Position of Taking Control of Main Financial Institutions, *Irish Times,* 31 March 2010. Available at: http://www.irishtimes.com/newspaper/ireland/2010/0331/1224267401862.html (last accessed on: 16 April 2010).

*TAZ* (2010): Grüne Insel in rote Zahlen, in: *TAZ* 21.03.2010. Available at: http://www.taz.de/1/zukunft/wirtschaft/artikel/1/gruene-insel-in-roten-zahlen/(last accessed on: 16 April 2010).

Michael Braun

# Italy – Fears of a domino effect in the Eurozone despite a sound budgetary policy

## Economic and Political Situation

In common with most other countries, Italy's real economy experienced a severe downturn in 2009. GDP fell by 5.2 per cent, while industrial production fell by around 20 per cent. This primarily reflected the impact of the global crisis on the country, while endogenous growth factors played a far smaller role than elsewhere.

For example, in 2008–2009 Italy did not experience significant problems in the banking sector. The fact that Italy's banks are, in may respects, more »provincial« than those of other countries and, for example, had largely refrained from derivatives trading, now proved to be an advantage. Also advantageous was the fact that the financial sector has traditionally acted fairly conservatively in granting loans and mortgages to private households. For example, Italy did not experience the bursting of a property bubble. Around 80 per cent of Italian families own their own homes, which are mostly paid off. There were no significant loan defaults, either in this area or with regard to consumer loans, credit cards and so on. This is not surprising, given that the indebtedness of Italian households, at 43 per cent of GDP, is below that of France and Germany (just below or above 50 per cent) and far below that of Spain, Portugal and Greece (around 75 per cent), to say nothing of the UK, which in 2008 exceeded 200 per cent.

Nevertheless, Italy is heavily »mortgaged« with an enormous national debt, making it one of the most highly exposed countries in the Eurozone. Before the crisis, it amounted to 105 per cent of GDP. Because of the massive downturn, however, in 2009 – with new borrowing of around 5 per cent – it shot up to 115 per cent of GDP. For 2010 the IMF expects it to reach 117–118 per cent. Italy is paying for this mortgage from the past – this debt mountain was accumulated mainly in the 1970s and 1980s – not least with an interest rate differential and costs arising from credit default swaps (CDS) which set it alongside such acutely endangered countries as Greece, Spain, Portugal and Ireland, despite the fact that the international rating agencies have not lowered Italy's rating in the past two years.

For example, the spread for 10-year government bonds in relation to Germany rose from 0.4 per cent in February 2008 to 1.4 per cent in February 2009, before falling again in August 2009 to 0.8 per cent, which is where it still stands in April 2010. Similarly, the cost of CDSs for 5-year government bonds was 101 basis points on 4 March 2010, in comparison to 103 basis points for Spain, 124 basis points for Ireland, 127 basis points for Portugal and 306 basis points for Greece (by way of comparison, the figure for Germany is 34 basis points).

It was possible to mitigate the consequences of the crisis for the labour market considerably thanks to the »Cassa integrazione«, which is very similar to the German short-time allowance. The unemployment rate rose from 6 per cent in 2008 to 8.7 per cent at the end of 2009: the Banca d'Italia estimates that, without the deployment of the Cassa integrazione, the figure would have been 1.2 per cent higher. Having said that, the Banca d'Italia also calculates that a further 1.6 per cent has been shaved from the total simply due to the fact that many people are currently not seeking work because they see no prospect of employment. For 2010, the Banca d'Italia expects a further increase in unemployment to 10.5 per cent.

So far, the crisis has not had any discernible effects on the political situation in Italy. The Berlusconi government managed an outright win in the regional elections on 27–28 March 2010. It is clear that the majority of voters do not hold the national government responsible for the current crisis – it is also clear that the government's blend of professed optimism about the future and strong fiscal discipline in the present has so far been successful.

## Government Measures to Combat the Crisis

Italy's Minister of the Economy and Finance, Giulio Tremonti, set his course on the assumption that, given the country's debt mountain, there was simply no leeway for massive state intervention aimed at boosting purchasing power, such as tax cuts or public investment programmes. In 2009, crisis intervention accounted for only around 0.1 per cent of GDP. The only thing worth mentioning in this connection is the scrappage scheme for cars, similar to the one in Germany, which made it possible to stabilise car sales. The funds allocated to combating the crisis in 2010 will again represent a meagre 0.1 per cent of GDP.

This strict budget policy made it possible to limit new public borrowing to 5 per cent in 2009, a level similar to that of Germany and significantly below the levels of Greece, Ireland, Portugal, Spain and the UK. With figures of 0.6 per cent in 2009 and an expected 0.7 per cent in 2010, Italy currently has a low primary deficit (in other words, the public deficit without taking into account expenditure related to bonds for interest and repayments), while in 2010 the figure expected for Germany is 3.4 per cent, with 6 per cent for France, 9.6 per cent for the UK and 5.5 per cent for Spain. In the immediate future, this budget policy orientation will remain unchanged. Although the government parties are discussing reform of income and corporation taxes, they have stated that this would be feasible only when there is some room to manoeuvre with regard to financial policy.

## Prospects

In 2009 and the first months of 2010, the Italian public appeared singularly unimpressed by the European debate on the Eurozone states particularly exposed to the global crisis. While elsewhere Italy is mentioned in the same breath as the so-called »PIGS« (or even »PIIGS«) – Portugal, Ireland, Greece and Spain – this nomination of the country for membership of the club of potential candidates for state bankruptcy receives little attention in the Italian media. Underlying this is the indisputable fact that Italy has no reason to reproach itself for any of the sins which caused the crisis or exacerbated it in the recent past or the present, as already mentioned. The Italian media – for example, *La Repubblica*'s *Affari e Finanza* supplement, 8 March 2010, or *Il Messaggero,* 2 March 2010 – generally emphasise Italy's differences from the other PIGS countries: the extremely low primary budget deficit and the significantly lower consolidated national debt – in other words, the combined total debt of the state, private households and companies.

However, this changes nothing with regard to the decisive figure for valuation via capital markets, namely total public debt. Italy is in no immediate danger, thanks to its strict budget discipline, of being punished, first by the rating agencies and then by the markets, in such a way that would lead to ever deeper budget deficits as a result of constantly growing interest rate spreads. Nevertheless, Italy does face a potentially alarming scenario: a euro crisis which triggered speculation, first against the weakest countries – first and foremost Greece, at present – and then possibly forced the expulsion of one or more countries from the euro. In this case, Italy would certainly be one of the most exposed countries, with barely calculable consequences for the country's budget stability and creditworthiness.

## Government and Public Expectations with regard to the EU in Italy

There has probably been less public – for starters, by the political establishment – debate in Italy about the crisis and its consequences, but also about strategies for combating it, than in any other Eurozone country. It is significant that the first parliamentary debate on the global crisis and Italy's policy response took place only on 15 March 2010 (!) – eighteen months after the collapse of Lehman Brothers. Underlying this is a specific strategy of Silvio Berlusconi's right-wing government, based on the belief that talking too emphatically about the crisis would merely create disquiet among the public.

On the other hand, Enrico Letta, deputy leader of the largest opposition party, the centre-left Partito Democratico, has complained, with good reason, of a »culpable lack of interest in the Italian debate«, also concerning the European dimension of possible anti-crisis strategies. This lack of interest, however, is not an expression of scepticism or even hostility in Italy towards stronger Europe-wide coordination of economic and financial policy or even the creation of specific European instruments.

For example, Minister of the Economy and Finance Giulio Tremonti is among the advocates of Jacques Delors's proposed issue of Euro-bonds, to which the opposition is not adverse, either. Tremonti argued in March 2010, in a letter to the *Corriere della Sera* (published on 6 March 2010), that these Euro-bonds could constitute a first step in the direction of a European economic government: »Once the economic barriers have fallen, political barriers shouldn't be allowed to get in the way. The crisis is systemic and requires a political solution.« According to Tremonti, this means a European solution. Besides Euro-bonds he mentions the proposal to establish a European bank rescue fund, a proposal which Italy has supported, even if it would be among the net contributors. In general, according to Tremonti, Europe can no longer rely on the free and open market as the sole economic-policy horizon; for example, investment programmes are conceivable – for example, in the energy sector – under European control.

If anything, Tremonti stands accused by the opposition of excessive caution in this regard, while there is unanimity concerning the basic assumption that the crisis calls for »more« Europe. Enrico Letta, who, besides being deputy leader of the PD, is also one of the party's leading economic experts, presented his vision in an article which appeared in the business daily *Il Sole 24 Ore* (26 March 2010). In this article, Letta harshly criticises the involvement of the IMF in the Greek rescue package. In his view, this represents a failure on the part of Europe: the EU should have dealt with this crisis alone and should consider the establishment of a European monetary fund. What is needed in the crisis is to overcome »the asymmetric nature of the Community, with full monetary union on the one hand and an uncertain economic and political union on the other«.

With this, Italy has resumed a position which has become customary since the mid-1990s in Europe: it welcomes and supports all initiatives aimed at deepening the Union, but it does not enter the debate with proposals and initiatives of its own.

## About the authors

**Michael Braun** works as a correspondent for the daily *taz* in Italy.

**Philipp Fink** is an expert on Ireland and works for the Friedrich-Ebert-Stiftung.

**Thomas Fricke** is chief economist of *Financial Times Deutschland*.

**Niels Kadritzke** is an expert on Greece and works as a freelance journalist for *taz* and *Le Monde diplomatique*.

**Santiago Fernández de Lis** is in charge of the International Department of the Spanish consultancy firm *Analistas Financieros Internacionales (Afi)*. **Emilio Ontiveros** is President of *Afi*.

**Ricardo Paes Mamede** is an economist and lecturer at the *Instituto Superior de Ciencias do Trabalho e da Empresa* of the University of Lisbon

## Imprint

Friedrich-Ebert-Stiftung
International Policy Analysis
Hiroshimastraße 28 | 10785 Berlin | Germany

Responsible:
Dr. Gero Maaß, Head, International Policy Analysis

Tel.: ++49-30-269-35-7745 | Fax: ++49-30-269-35-9248
www.fes.de/ipa

To order publications:
info.ipa@fes.de



**ISBN 978-3-86872-335-9**