EURO ZONE CRISIS. FROM "OPTIMUM" TO COLLAPSE?

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Abstract

The European leaders adopted a series of measures so that the Euro zone could come out of the crisis. This study demonstrates that the fiscal Treaty, as the other solutions proposed by the European leaders, represents necessary conditions, which are far from being sufficient to surpass the crisis from the actual monetary union. On the background of the critical structural problems, the lack of competitiveness has constituted the main factor leading to a severe aggravation of the public finances. Consequently, the problem of the public finances represents the effect and not the cause of the actual crisis. Moreover, from a technical point of view, the latest economic studies have demonstrated that not even the structural budget balance indicator is enough to correctly assess a country's fiscal position (its limiting to 0.5% being proposed in the fiscal treaty). It has been shown that the structural budget balance indicator should be improved, in order to also take into consideration the deviation of the current account balance from its sustainable level, particularly during the stage of the economic cycle characterized by high absorption. This study has empirically demonstrated this in the case of the Romanian economy.

Keywords: *Euro zone, financial crisis, fiscal treaty, structural deficit, structural deficit corrected for absorption*

1. Introduction

Since from the beginning of its creation, The European Economic and Monetary Union (EMU) has not been what the literature identifies as an *optimum currency area*. The nowadays EMU has been built on a complex frame of economic policies, consisting of a single monetary policy and

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national fiscal policies. Having such a base, the Euro zone seems to assign the role of macroeconomic adjustment to the *national* fiscal policies, as far as it is not an optimum currency area itself, so it does not have adjustment instruments in critical situations. Even though, Euro zone appears in 1999 with the argument that all that is present in the literature is called *endogenous approach* of the optimum currency area theory. The endogenous approach shows that a monetary union can be achieved *even if all the conditions* specified in Mundell's optimum currency area theory *are not fulfilled*, demonstrating that some of them may also be reached *after* the unification. (Socol, 2013)

When he Economic and Monetary Union was launched, people have been appreciated that the fiscal health is an essential condition for the stability of the monetary union. The coordination of the fiscal policies remains essential in order to ensure the macroeconomic stability of all, as a country's fiscal policy actions may help or prejudice other countries. When a country makes a decision, it cannot ignore the effect upon its partners, and vice-versa, taking into account the other countries' political decisions. If a country from a monetary union encounters problems related to the sustainability of the budget deficit, then it generates negative externalities within the monetary union. In case a country allows the increase of the current budget deficit so that the interest rate for the governmental debt exceeds the economic growth rate, then it will have to appeal more and more often to the capital markets from the space of the monetary union, thus generating pressures in terms of the interest rate's increases. Hence, the increase of the interest rates results in the increase of the debt burden for the other countries from that monetary union. (de Grauwe, 2003)

Provided the lack of the national monetary policy or the rigidity conditions of the other instruments (rigidity of the labor market, of wages and of prices, low synchronization of the business cycle), the fiscal policy should thus assume the role of macroeconomic adjustment instrument. Giving up the instrument of the rate of exchange within EMU has involved the granting of a more important role to the fiscal stabilizers at the national level in order to help economies to adjust themselves to the asymmetric shocks. Within the Euro zone, the Stability and Growth Pact wished to be a modality through which the fiscal discipline is supported and induced. Its rules have not succeeded in ensuring enough flexibility so as to cope with the cyclical crises.

2. Solutions proposed to come out of the Euro crisis

Until 2008, when the crisis appeared in USA, the Euro zone recorded pretty good progress. The Euro zone specific problem was that several constituent economies could not finalize the convergence process started before 1999. Moreover, some of them even recorded significant deviations from the levels considered as sustainable. First of all, the competitiveness of the participant states has been extremely heterogeneous, which resulted in unsustainable current account deficits and external debts. Secondly, the deficits in the public sector and, consequently, the levels of the public debt, have not been sustainable in some of the countries. Thirdly, also the deficits in the private sector and, consequently, the levels of the private debts proved to be unsustainable.

When the crisis appeared, the states recording unsustainable positions in terms of what we previously mentioned proved to be extremely vulnerable, with all the risks deriving from here. When the crisis hit the economy of the whole world, it has shaken even the most solid European economies, so that, until the end of 2009, the Euro zone entered the first stage of a strong public debt crisis. The first consolidated form of the undertakings to improve the economic governance in the European Union was "Six Pack", a mix of measures meant to prevent the possibility of occurrence of new crises by means of a cautious fiscal policy and of consolidation in terms of prudential survey and macroeconomic unbalances.

Six Pack has introduced a higher constraint in terms of the public expenditure. It provided the implementation of a rules regarding the expenditure, referring to the fact that it cannot exceed the potential GDP increase reference rate (*in case of significant deviations from the fiscal rule – 0.5% of the GDP in a year or 0.25% of the GDP in 2 consecutive years*), and the European Commission will provide recommendations and, in case these recommendations are not complied with, it will settle sanctions. The Pack also provides requirements regarding large fiscal adjustments under the terms of a public debt exceeding 60% of the GDP and also exoneration clauses in case of a pronounced recession. A major innovation introduced by this pack of measures is the materialization of the adjustment procedure in case of non-fulfillment of the criterion related to the share of the public debt in the GDP. Piana (2012) shows that the operationalizing of the debt criterion has been made by means of settling a numerical target through which the decrease of the debt up to the reference level of 60% of the GDP should be achieved within the next 3 years with a minimum average speed of1/20 a part per year.

$$bb_t = 60\% + \frac{0.95}{3}\left(b_{t-1} - 60\%\right) + \frac{0.95^2}{3}\left(b_{t-2} - 60\%\right) + \frac{0.95^3}{3}\left(b_{t-3} - 60\%\right)$$

Moreover, there has been another proposal to take into account the calculations for the economic cycle in order to accurately measure the public debt related adjustment, this measurement taking into account the dynamics of the denominator in relation with the position of the economy in the economic cycle. “As solutions, we have initiated the taking of the cyclical budget component out of the debt, from the numerator and the use of the potential GDP at the denominator, for the considered time period” (Piana, 2012).

$$\left(\frac{B_t}{Y_t}\right)^{adjusted} = \left(\frac{B_t + \sum_{j=0}^{2}\left(C_{t-j}\right)}{Y_{t-3}\prod_{h=0}^{2}(1+y_{t-h}^{pot})(1+p_{t-h})}\right)$$

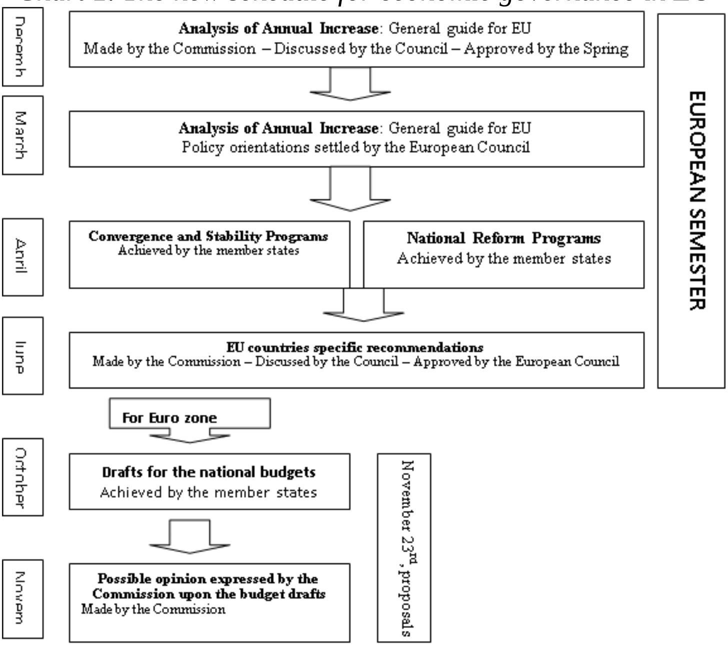
The sanctions for non-compliance with the provisions mentioned in the Six Pack and with the European Commission’s recommendations regarding the required adjustment may go up to 0.2% of the GDP, in certain conditions.

The Euro Plus Pact actually represents the Competitiveness Pact required by Germany and France. It provides a series of measures for economic coordination between its signers. Among them, there are six states outside of the Euro zone: Romania, Bulgaria, Denmark, Poland, Lithuania and Latvia. Great Britain, Sweden, Hungary and the Czech Republic decided to remain out of this pact, at least for the moment. The pact has been developed on four main principles:

1. Macroeconomic competitiveness – measured by means of the price competitiveness’ indicators (e.g., the stability of the labor’s real cost, the compliance with the correlation between the increase of the labor cost with the increase of productivity);
2. Stability of the public finances (settlement of a fiscal rule regarding the stabilization of the public debt’s share in the GDP and mentioning this rule in Constitution or in another important law);

3. Financial stability – stress tests for the banking system; consolidated norms regarding the prudential survey;
4. Minimum thresholds for the share in the GDP granted from the public budget for investments in research, development, education and infrastructure.

Chart 1. The new schedule for economic governance in EU



Source: Piana, 2012

Some measures have been proposed, such as: elimination of the wage indexing with the inflation rate; increase of labor mobility by mutually recognizing the diplomas; increase of the retirement age in order to reduce the demographic pressure upon the social budgets and the obligation to implement a *protocol debt* mechanism and also a crisis cell for the management of the crisis in the banking system. The pact also mentions the consolidation of the European Stability Mechanism. Starting from 2013, the European Stability Mechanism will replace the Financial Stability Facility, by means of which Greece and Ireland received funds. The total value of this mechanism will be of 700 billions euro, out of which 80 billions euro cash and the rest will be available capital, under the form of guarantees. The New Schedule for Economic Governance in EU is shown in the chart above.

3. The European Fiscal Compact, an optimum solution?

A debated and extremely propagated through the media solution has been the European Fiscal Compact (the Fiscal Treaty). It includes provisions confirming the financial discipline in the Economic and Monetary Union. The European Fiscal Compact is a component of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, which was completed in January 2012 and signed by 25 EU member countries (the Czech republic and the Great Britain did not sign it). It includes the provision that the national budgets should be either balanced or in surplus and this constraint will be complied with if the annual structural deficits do not exceed 0.5% of the GDP. The member states will undertake to introduce this "norm on a balanced budget" in their national legal systems, preferably in the Constitution.

The term for fulfilling this obligation is at least one year since the coming into force of the treaty. If a member country has a sustainable public debt, which is significantly below the level of 60% of the GDP and low vulnerabilities in terms of sustainability of the public finances on a long term, its structural deficit may be higher than 0.5% of the GDP, but not exceeding 1% of the GDP (given the macroeconomic conditions of Romania, the target of the structural budget deficit is 0.7% of the GDP until 2014). However, the next priority step in the European development is to create the premises of the fiscal union. Otherwise, the efforts made so far will be useless.

Why does the structural budget deficit become and essential instrument, its limiting being included in a country's Constitution? What is its role, why is it that important? The structural component provides a clear image of the fiscal situation in economy, not distorted by the influence of the economic cycle. How? First of all, during expansion periods, when the analysis of the real budget deficit may mislead us. Here is an illustrative example encountered in the case of the Romanian economy. In 2006, in Romania, the curent budget deficit was -2.2% of the GDP, and in 2007 we were proud to record a budget deficit of only – 2.9%. If we put aside the influence of the economic cycle –

the cyclical component which is highly positive during expansion periods – in reality the budget deficit was -4.4% of the GDP in 2006, -5.9% in 2007 and in 2008 it even reached -8.28% of the GDP (the officially estimated values of the structural deficit).

How could this happen? Automatically benefiting from the increase of the budget revenues during the expansion period, the “necessary” budget expenditure could have been increased (administration’s expenses, costs with goods and services, expenses with grants), instead of accumulating financial resources for hard times / recession, as it would have been appropriately. As long as the current deficit is the sum of the two components, the highly positive cyclical component ”concealed” n increasing structural deficit and, consequently, the real values of the consolidated budget deficit.

Thus, the structural budget deficit is used for the purpose of removing the short-term influence of fluctuations and especially of assessing the fiscal policy’s real performance. Under these circumstances, the current budget component ranges between its two components: the *cyclical component* and the *structural component*. It is necessary to calculate this variable as the current budget balance reflects the influence of the cyclical factors (temporary) as well as of the structural ones (permanent). The cyclical component refers to the variations generated by the cyclical evolutions of the gross domestic product (GDP), while the structural component takes into consideration the modification of the budget balance if the economy produced to the level of the potential GDP. Also, the structural deficit may be regarded as an indicator measuring the discretion degree occurred in the adopted fiscal and budgetary policies.

Moreover, the latest economic studies demonstrated that not even the budget balance indicator is enough to correctly assess a country’s fiscal position in terms of sustainability of the public finance, this indicator being obtained by means of adjustment according to the position of an economy at a given moment on the economic cycle. Based on the results of the researches previously made by Jaeger and Klemm (2007) and Lendvai et al (2011), it has been shown that the structural budget balance indicator should be improved, in order to also take into consideration the deviation of the current account balance from its sustainable level, particularly in the stage of the economic cycle characterized by high absorption. We will give details for Romania’s case, emphasizing the difference between the analysis made for the structural budget balance (cyclically-adjusted budget balance CAB) and the absorption-adjusted budget balance (cyclically and absorption-adjusted budget balance CAAB).

3.1. The Romanian"s case. Results of the estimates

The estimate of the structural deficit is made following three stages, as follows (Hagemann, 1999):
(1) estimate of the gap between the really achieved gross domestic product and the potential gross domestic product (potential GDP) (output-gap);
(2) estimate of the cyclical component according to the output gap and the sensitivity of the budget deficit (in its turn, it will be obtained by means of revenues' elasticities, and of the budget expenditure according to the GDP);
(3) estimate of the structural component by eliminating the cyclical component out of the current budget component.

Lendvai et al (2011) calculate the cyclically and absorption-adjusted budget balance CAAB by using the following sequence of equations:

$$CAB_t = \left(\frac{b}{y}\right)_t - \lambda(ygap)_t$$

where λ_t represents the standard budget elasticity (used in the EU studies UE)

$$CAAB_t = \left(\frac{b}{y}\right)_t - \beta_t(ygap)_t - \gamma_t(agap)_t$$

where γ_t absorption elasticity (given by the share of the indirect fees and taxes in the GDP). Considering the unitary elasticity of the indirect taxes in relation to absorption and linearity of CAB in relation with the output, we obtain as follows

$$\beta_t = \lambda_t - \gamma_t$$

Notations: *b* real budget balance; *y* and *y** real output and potential output; *ygap* and *agap* output gap and absorption gap; *a* and *a** absorption and potential absorption; *ca* current account norm* (sustainable current account); *it* sum of the values from abroad and the net transfers.

Lendvai et al (2011) consider that, based on the equations from above, we may obtain the following relation

$$CAAB_t = CAB_t - \gamma_t(agap_t - ygap_t)$$

This relation is obtained starting from the hypotheses referring to the unitary elasticity of the indirect taxes according to absorption and linear relation of CAB related to output.

Results $CAAB = CAB_t - \gamma_t(agap_t - ygap_t)$

According to this formula, authors reach the conclusion that "CAAB differs from CAB especially when the share of the indirect taxes in the output is high and when the dynamics of absorption significantly deviates from this output".

The obtained results are presented in the table below:

Table 1. Estimates for CAB and CAAB in Romania

– %GDP

YEARS	BD	CAB	CAAB
2005	-1,2	-2.70	-5.25
2006	-2,2	-4.36	-6.26
2007	-2,9	-5.90	-6.45
2008	-5,7	-8.28	-7.68
2009	-9	-9.45	-9.09
2010	-6,8	-5.20	-8.09
2011	-5,5	-3.89	-7.24
2012	-4,9	-1.93	-6.04

Source: *Author's calculations*

The difference between the consolidated budget deficit (DB) and the structural one (CAB) is considerable, this demonstrating the significance of the structural balance's use in order to have a clear image of the Romanian finances. Even though, the results of the previous estimates empirically validate what the above-mentioned studies have demonstrated. In order to correctly assess a country's fiscal position regarding the sustainability of the public finances, not even the structural budget balance indicator is not enough, this indicator being obtained by adjustment according to the position in which the economy is at a given moment on the economic cycle.

The structural budget balance indicator should be improved so as to also take into consideration the deviation of the current account balance from its sustainable level, particularly during the stage of the economic cycle characterized by high absorption. As we can notice, we may say that, during the boom period (absorption gap), there are pretty high differences between CAB and CAAB in Romania, this meaning that the signaling capacity of the structural budget balance indicator CAB seems to be more lower than that of CAAB. The correction of the macroeconomic unbalances would have been less tough than that recorded during the last years, the recession would have been less pronounced, Romania could, probably, avoid entering the Treasury liquidity crisis during the first semester of 2009, a minimum fiscal space would have existed, the losses of competitiveness would have been lower and so on.

4. Conclusions

The fiscal treaty, as the other solutions proposed by the European leaders, represents necessary conditions, which are far from being sufficient. And this is because this fiscal treaty "treats" the effect and not the cause of the crisis encountered by the Euro zone. In my opinion, the main cause of what happens today in the Euro zone may be attributed to the significant development differences between the member states, with all the implications deriving from here. When I say development differences I mean particularly the productivity differences, which subsequently have been explained as competitiveness differences. And there has been only one step from this point up to significant macroeconomic unbalances. On the background of the critical structural problems, the lack of competitiveness has constituted the main factor leading to a severe aggravation of the public finances.

Consequently, the problem of the public finances represents the effect and not the cause of the actual crisis. Moreover, from a technical point of view, the latest economic studies have demonstrated that not even the structural budget balance indicator is enough to correctly assess a country's fiscal position (its limiting to 0.5% being proposed in the fiscal treaty). It has been shown that the structural budget balance indicator should be improved, in order to also take into consideration the deviation of the current account balance from its sustainable level, particularly during the stage of the economic cycle characterized by high absorption. This study has empirically demonstrated this in the case of the Romanian economy.

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