# Börsen-Zeitung[*]


## Debt Crisis in Europe – Guest Column:

## The International Monetary Fund has underestimated the reaction of the markets

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A huge increase in public indebtedness by the industrial countries is perhaps one of the most distinctive and worrisome features of the current global economic situation. The onset of the financial crisis was met by calls from leading economists such as Paul Krugman and Larry Summers to respond to the contraction of demand with fiscal stimulus. It was essential to avoid repeating the mistakes of the Great Depression when the authorities in a misguided fashion sought to balance budgets and did not relax monetary policies to the extent that was necessary to revive domestic demand.

The problem with fiscal stimulus in the middle of a crisis is that the authorities need to strike a careful balance between optimizing the benefits of increased expenditure, against the risk that too much stimulus might undermine investor confidence because the increase in public debt is perceived as potentially unsustainable. This difficult balancing act is particularly important in countries that already have high levels of public debt and where there is greater vulnerability to shifts in investor sentiment.

If investors begin to question the solvency of the government then what started out as an exercise aimed at softening the adjustment until consumer and investor confidence picked up and improved the economy’s growth prospects, can quickly turn into a vicious circle in which the increase in the cost of debt becomes rapidly prohibitive, confidence is undermined and economic revival is put off. This is what happened in Greece earlier this year and, in the context of a highly integrated region using a common currency, the Greek crisis led to contagion in Portugal and Spain, countries where the authorities were in the middle of implementing their own stimulus packages.

In my opinion the IMF played a somewhat unhappy role in the instability which the financial crisis precipitated in the Euro area. The Fund’s managing director Mr. Strauss-Kahn abdicated on behalf of the Fund its traditional role as the guardian of the soundness of its members’ public finances, giving implicit support for massive fiscal loosening in countries like Greece, Portugal and Spain, countries where fiscal stimuli involved a fair amount of populism and inefficient expenditures. The IMF underestimated the response of the markets to double digit fiscal deficits in these countries and its responsibility for the mess that followed is not diminished by its financial contribution to the subsequent rescue package put together with the EU for Greece.

### Failed Reforms

The problem with high public indebtedness is that it creates a terrible dilemma for governments. Scarce public resources which could be allocated to education, public health or to improve countries’ infrastructure—all areas that help to improve competitiveness—have to be increasingly dedicated to debt service. The primary aims of economic policy get subverted. Instead of worrying about reforms aimed at boosting productivity, governments increasingly

[*] Börsen-Zeitung is a Frankfurt Stock Exchange newspaper and the only exclusively financial sector-oriented paper published daily in Germany. It reports on current developments in German and international financial centers.

have to worry about keeping the markets happy, making sure that debt rollovers take place smoothly and so on—day-to-day cash management.

In Spain, after having allowed the deficit to widen to 11.2 percent of GDP in 2009 (a deficit without recent historical precedent) and having lost the confidence of investors, the government is now negotiating an adjustment package consisting of expenditure cuts and increases in taxes. This 180 degree turn in policy has created social and political tensions and undermined the credibility of the government and detracted attention from more urgent reforms, for instance in the labor market. Similar situations have emerged in Greece, Portugal, Italy and the United Kingdom.

Fortunately, not all countries paid attention to the IMF in 2009. Sweden, for example, is as integrated to the global economy as any other country in the world but in 2009 it had a tiny budget deficit of 0.5 percent of GDP, having registered surpluses during much of the past decade. The authorities understand that the country's demographics are leading to the ageing of the Swedish population. If the country is to be able to finance future pensions and other social commitments it has to save now. This demographic reality was not altered by the global financial crisis and hence they opted for a cautious response to the crisis, not an irresponsible loosening of fiscal policies. Other countries in Europe—Germany, Austria, Finland, Denmark, Estonia, Luxembourg—all acted cautiously in 2009 and, not surprisingly, have better growth prospects for 2010-2011 than Greece and Spain.

## More Coordination Needed

Some analysts have written about the possible collapse of the Euro area and the disappearance of the euro, with potentially grave consequences for the global economy. I do not share this pessimism. The 53 years of European Union history are characterized by severe crisis followed by institutional innovations which have strengthened the Union.

The current crisis has demonstrated that you cannot have a single currency without much higher levels of coordination of fiscal policies among members. This means that if Greece and Spain want to continue to remain in the euro area they will, in the future, have to accept a much higher level of supervision of their budgets and, of course, they will also have to sustain several years of austerity to undo the damage done in 2009. Both countries will also have to implement structural and institutional reforms that will reduce their vulnerability to shocks and future crisis.

The worry at the moment is not the immediate future of the euro, nor the pace of economic recovery which I expect to continue in coming quarters. The worry is that the response to the 2008-2009 crisis has dramatically reduced our room for maneuver in the future. With public debt levels in the advanced economies soon to exceed 100 percent of GDP, a future crisis will find us far less prepared than we were at the end of 2008, when the gates of public spending were unleashed and governments rushed to bailout their banking sectors from decades of incompetence and excess.

## Ammunition Used

This response was made possible in no small measure by the fact that levels of debt were not unsustainably high, particularly in the United States. This is no longer the case. We have used much of our ammunition and one can only hope that future shocks to the global economy will not put onerous demands on public resources since, unfortunately, we no longer have them.


Augusto López-Claros
Honorary Professor
European Business School—Frankfurt