Eurozone Economics are Simple. It's the Politics Stupid!

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The European authorities have had a year to address the sovereign-debt-come-banking crisis in the euro area. They have failed. The situation is much worse than a year ago, the latest manifestation being another downgrade of Greek sovereign debt. There is a real and present danger of contagion and the disorderly break-up of the euro area. The economics of the problem are very simple. The economics of its solution scarcely more complicated. Alas, the political problems are thorny. For political, not economic reasons, default is looking as if it may be the default option. A break-up of the euro area is a distinct possibility. No-one can seriously assess the outcomes of such a scenario – although that does not stop some commentators pronouncing on the issue as if they did. In my view, it is highly risky. Above all it is completely unnecessary. It can and therefore should be avoided.

Let's start with the simple, but often neglected, basic economic facts about sovereign debt.

Government debt dynamics depend on precisely four variables. The existing level of debt, the size of primary deficits or surpluses (where 'primary' means excluding interest payments), the nominal interest, and the economic growth rates (where 'nominal' means at current prices).

A country that owns its own currency can never go broke and need never default. (At least not in its own currency: it can, of course, if it unwisely takes on debt denominated in another currency.) Whatever the government's debts and deficits, and quite apart from its capacity to oblige the private sector to pay taxes, it can create the currency to service its debts. 'Printing money' drives the interest rate down and the nominal growth rate (that is real growth plus inflation) up thus reducing nominal debts as a share of nominal GDP. Such a policy may have negative consequences (notably inflation), but the point remains that a monetary and fiscal sovereign can always service its own-currency-denominated debts. And that very fact reassures investors. It makes a run on government bonds unlikely and is the reason why genuine, in the monetary sense, sovereigns pay a lower interest rate than private sector actors. This is why the US, Japan and the UK can still issue bonds at very low rates of interest despite debt and deficit numbers that are, on the face of it, as bad or worse than those of euro area countries facing default and exorbitant bond rates.

A country that does *not* control its own currency, such as a member of a currency union, cannot avoid the inexorable logic of the mathematical link between the debt and deficit and the interest and growth rate variables; specifically, lacking control of the nominal interest rate, it is forced, on its own, into a real rather than nominal adjustment. The problem facing euro area members – Greece, Ireland, then Portugal, and prospectively also Spain, Italy and Belgium, can be stated succinctly as follows. The post-crisis combination of high government debt and large current deficits is such that, *given the prospects for nominal GDP growth, and at the prevailing interest rates demanded by the market*, government debts cannot be brought under control. (The italicised caveat is crucial: statements as to whether a country's debt is sustainable or not are meaningless without specifying the interest and growth rate.) This is because, under these prevailing conditions, fiscal policy would have to be tightened (in order to achieve the required primary surpluses) to an extent that is either politically impossible, or that will damage growth prospects so badly that even drastic enforced consolidation will not ensure sustainability. (The second point is also crucial: it is not just a question of lily-livered governments unwilling to wield the knife.) Once markets perceive a risk of unsustainability, investors become unwilling to lend; the interest rate demanded rises, substantially worsening the problem. The prospect of consolidation worsens further and the country is essentially shut out from market finance. In the absence of outside intervention it must default.

And that is where the politics starts to come in.

The essence of the EU/ECB/IMF packages for Greece, Ireland and Portugal is to avoid the country having to access private capital markets to roll-over its debts (i.e. to pay creditors as their bonds fall due). Instead, the needed refinancing is provided, in various ways, and by a combination of public authorities; the precise form is irrelevant in economic terms, but may be important politically. This support is provided at a *politically determined* rate of interest and conditional on a set of fiscal consolidation measures required by the lending authorities and designed to bring government debt dynamics under control such as to permit a subsequent return to the markets.

Yet the provision of such support alters nothing about the fundamental requirement that the combination of debt level, primary deficits/surpluses, interest and growth rates be such as to ensure debt sustainability. The simple fact is that with the EU/IMF packages this is not the case. And that is why the crisis is getting worse and not better. The interest rate is too high, and the austerity measures are either unfeasible or self-defeating by virtue of the damage they wreak on growth prospects. This failure was predicted (Greece, Ireland). The failure manifests itself either in ever more bail-out packages, and possibly contagion to other countries, and very possibly in the default that the packages were intended to avoid.

The economics of the implied policy choices are thus simple. If the debts are to be repaid in full, the interest rate must be lower and/or the nominal economic growth rate must be higher. If not, there will have to be some form of default (call it restructuring, voluntary, forced, what you will). And that is what the whole confused and confusing political debate is, at heart, about. Eurobonds, Brady/Trichet bonds, blue bonds, restructuring, reprofiling, privatisation, even selling the Acropolis; it is all about these basic choices.

But, in economic terms, it is, or should be, a non-debate. For the balance of costs, benefits and risks is so blindingly obvious. Consider:

One, collectively the euro-zone countries and the ECB *are* in control of their common currency. Two, the three currently affected countries account for a mere 6% of euro area GDP. And three, getting these countries on their feet quickly is in the interest of all of Europe, not just of the citizens directly affected. Taking these three basic facts together, the economic solution is self-evident. Some combination of the Member States and the ECB, who can, respectively, borrow and create money more or less at will announce that all sovereign debts in the euro area will be honoured in full. Immediate effect: the massive interest-rate spreads, which are a function of default fears (and not a conspiracy by ratings agencies) melt away. External finance is provided for a defined but extended period at a low interest rate and steps are taken to shore up nominal growth such that the balance between interest and growth rates puts debt ratios on a credible downward path. The government agrees to a politically feasible medium-run trajectory for the primary budget balance that ensures sustainability over a reasonable time-frame. This system is maintained for until such time as the markets are willing to resume lending at 'normal' rates of interest. This will not be very soon, but it will be for a limited period: all that markets need, in addition to the short-run no-loss guarantee, is to see debt ratios credibly falling.

In an appendix to this column I provide an illustrative and simplified calculation, using round numbers that approximate to the Greek case.

It's really that simple. It costs nothing: other eurozone governments merely have to lend on what they themselves can borrow on the markets. For the euro area economy the magnitudes are entirely manageable. The euro area could, in theory, pay off every last euro of the combined government debt of Greece, Ireland and Portugal overnight, by borrowing some 9% of GDP. The peripheral countries stabilise quickly and begin to grow, avoiding the threat of a collapse in export demand from other eurozone countries. Avoiding the risks of banking collapses. Avoiding the risk of contagion.

Given this option, why take the risk of even talking about various default options? All they do is push up spreads further. Risk-averse financial institutions dump the government paper of the peripheral countries as fast as they can, ensuring more of it ends up in (quasi)public institutions anyway. (According to reports in the German media, German insurers have sold around half of their holdings of Greek bonds, and banks around one third).

The answer, in short: it's the politics stupid. Core-country politicians have utterly failed to explain to voters the basic facts: properly conceived, bail-outs are costless. Pro-cyclical austerity policies are not in the interests of either peripheral or core countries. They are a senseless waste of resources and a serious threat to the future of the European integration project.

Currently, nationalistic parties fan the flames of resentment, unchallenged by mainstream parties who either don't understand the issues or are running scared of voters (or both). Some on the Left see an opportunity to 'hit the banks and the speculators' by calling for a default. I agree that hitting the speculators is preferable to hitting public sector workers and the users of public services. But it is a high-risk strategy and it is, in principle at least, unnecessary. The banks are not separate entities from the economy. All will be hurt if they come crashing down. It is not the real alternative. The real alternative is between nationalistically inspired austerity policies and European growth-oriented policies. The former has been tried and has failed. It will continue to fail if policymakers persist with it. The task of progressives is to fight for the second strategy.

Frankly speaking, I don't have an answer to how to overcome the political barriers to European solutions Europe. There is certainly no way forward as long as the debate is couched in terms of 'the core won't lend any more and the periphery won't reform any more'. The fact is that most Member States and all the European institutions are in the hands of conservative-liberal majorities. Elsewhere I have proposed a 'blueprint' which, if implemented, would enable the various problems afflicting the euro area as a whole and its individual countries to be tackled together. In that way burdens can be shared and political solutions found on the basis of a common understanding of common interests.

The purpose of this column was more limited. To make the economic arguments clear, and to point out where the problems lie. In the politics, stupid!

Appendix: An illustrative and simplified calculation using round numbers that approximate to the Greek case

The debt to GDP ratio is 150% and the current deficit is 10% of GDP[1].[1]

The EU lends the country sufficient funds to shield it from capital markets at the same rate at which Member States can borrow on the markets (roughly 3%), a costless transaction. This is instead of the penal roughly 6% being charged under EU/IMF programmes.

What about the nominal growth rate going forward? On the one hand there is a massive output gap implying a large potential for rapid catch-up real economic growth. On the other, the peripheral countries have an overblown nominal price and wage level, implying a need for low inflation. Real growth could be stoked by EU-supported investment. Price and wage inflation could be held in check with an incomes policy. Let us suppose an average of 3% real growth and 1% inflation. (3% real growth may seem high to some, but we are talking about the future, not the past. Depressed economies do bounce back, once confidence is restored. Encouragingly Greece grew at an annual rate of 2.4% in the first quarter of 2011, even if this is not expected to continue.)

This growth-interest-rate constellation would mean, taken by itself, that the country's debt would fall every year by around 1½ pp of GDP a year. This is already a start: the debt ratio is on a declining, rather than an exploding trend, although the pace of improvement is slow.

Now what about the primary balance? The interest rate burden is 4.5% of GDP (3% * 1.5). If the country posts, on average during a consolidation phase, a balanced budget, then it is running a primary *surplus* of 4.5%. Add to this the 1.5% resulting from the growth-interest differential, and every year Greece would reduce its debt by 6 percentage points. Note: This requires merely that the government spends no more than it takes in in current taxation. This would represent a sensible average pace of debt reduction, comparable to that achieved, for instance, by Belgium

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[1] The actual figures for Greece for 2010 are debt: 143% and deficit -10.5%. The figures for Ireland and Portugal respectively are: debt: 96% and 93% and 32% and 9%. The calculation simplifies somewhat: after the first year the basis is no longer 150%, but 146%, but the basic dynamic is unchanged.

during the 1990s and 2000s, which steadily brought its deficit ratio from around 120% to 80% of GDP. As such it would be convincing to market actors, who would be willing to lend money again to the government in question on favourable terms, once the effective consolidation became apparent.

The figures mentioned are averages over the consolidation phase. In fact, because it takes time to reduce current deficits if growth is not to be unduly stifled, the consolidation path would not be at this average rate across the period; initially debt to GDP ratios will in fact rise, and it is precisely during this crucial period that external financing is needed. However, as confidence returns and growth picks up, fiscal policy can be tightened further, accelerating the path of debt-paydown.

I have made some simple simulation calculations (to be presented in the near future) which show how a low interest-rate support strategy, coupled with measured fiscal consolidation (and ideally some externally financed, growth-enhancing public investment) might compare with the current strategy of high interest rate and enforced and pro-cyclical fiscal consolidation. On plausible assumptions, fiscal consolidation performance, in terms of the debt-to-GDP ratio, is *worse* under the growth-inhibiting austerity approach, in spite of the faster reduction in current deficits and the much higher primary surpluses than under one based on European solidarity and growth. And it goes without saying that real incomes recover much faster under the latter strategy and also perform much better in a longer term perspective.