Zoltán Szalai: A crisis of crisis management? Debates over fiscal adjustments in the European Monetary Union*

In response to increasing market pressure, EMU countries embarked on a robust consolidation process in 2010 in order to reduce their fiscal deficits and sovereign debt levels. Although – relying on external help in a number of cases – they have been implementing aggressive adjustment programmes, their public debt-to-GDP ratio is unlikely to change or change very much this or next year. Consequently, a debate has evolved over the effectiveness of fiscal tightening.

INTRODUCTION

The financial crisis which emerged in 2007 and intensified in 2008 spread from the US to other regions, including the Economic and Monetary Union (EMU). Terms of financing changed significantly, credit risk premia rose dramatically and lending declined. Although the European Monetary Union as a whole is less indebted than other global regions, it has become the riskiest region since the outbreak of the Greek crisis at the end of 2009. In earlier MNB publications, we have discussed the (mainly institutional) deficiencies which can explain this apparent contradiction.[1] This article attempts to provide a brief overview of the debates related to the success of crisis management in Europe and, within that, the effectiveness of fiscal consolidation.

THE GLOBAL CREDIT CRISIS AND THE RESPONSE OF THE EUROPEAN MONETARY UNION

In response to the deteriorating global macroeconomic situation, after the G-20 summit in Washington in the autumn of 2008,[2] governments and central banks intervened decisively to put an end to developments which threatened to lead to general panic. On a number of occasions, they resorted to unconventional economic policy tools only used during crisis periods. As for fiscal policy, they adopted the European Economic Recovery Plan (EERP), which enabled governments to swiftly mitigate the consequences of the crisis and put their respective economies back on a growth path by means of country-specific fiscal measures which could handle the crisis, temporarily 'suspending' the strict fiscal regulations designed for 'normal times'. As an independent institution, but working in unison with the governments, the European Central Bank (ECB) resorted to non-standard tools to prevent financial panic from leading to the collapse of the banking system.

From 2009 onwards, when the first signs of global economic stabilisation were discernible, policymakers in the developed countries began considering the possibility of gradually abandoning non-standard measures. In September 2009, the G20 decided to implement a 'back-to-normal' process in a concerted, but country-specific manner.[3] However, encouraged by the results of immediate crisis management, the individual global regions soon started to increasingly diverge in terms of economic policy priorities. Europeans, who were especially worried about their fiscal deficit and sovereign debt, which were inconsistent with the operating principles of the EMU, decided to embark on a path of fiscal consolidation. This intention became stronger with the outbreak of a fiscal crisis in Greece at the end of 2009 and mounting financial market tensions in the other periphery countries. Whilst also seeking ways 'normalise' conditions, other major advanced regions, primarily the US and Japan, were more cautious about launching the process of fiscal consolidation.

Since the second half of 2011, fears of another recession have become more pronounced. The European Monetary

* The views expressed in this article are those of the author(s) and do not necessarily reflect the offical view ot the Magyar Nemzeti Bank.

[1] For a more detailed discussion of the global crisis, see MNB (2011).

[2] G20 was expressly founded to manage the global crisis in a co-ordinated manner. The rationale for this was that it became clear in the crisis that major developing countries were not represented in a manner that is commensurate with their weight within the current global institutional framework.

[3] G-20 (2009) Pittsburgh Summit: Framework for Strong, Sustainable and Balanced Growth

Union has become the most important risk to global economic stability. Fiscal consolidation in the EU member states under market pressure has resulted in little improvement and other larger member states have also come under pressure. The looming possibility of another recession also calls into question the sustainability of fiscal policies. Accordingly, a debate on the following issues has erupted again: *Is fiscal tightening a reasonable solution when, due to balance sheet adjustments, the private sector's propensity to save is much stronger than it used to be and when growth is fragile? Is there any likelihood that such a policy results in an unintended outcome of GDP falling so steeply that debt either cannot be reduced or even rises to a level that is higher than before the tightening? Or, on the contrary, is fiscal policy supposed to help the private sector with balance sheet adjustments by allowing the deficit to grow further? Is this a feasible policy in those countries where sovereign debt is already high? Why should markets assume this additional risk if there are investments that carry lower credit risks?*

Neither the aggregate debt nor the fiscal deficit of the EMU countries explains Europe's eagerness to implement speedy fiscal consolidation: the corresponding indicators for both the US and Japan are worse. Nevertheless, in respect of the EMU member states, Ireland, Greece, Spain and Portugal will need to make more marked fiscal adjustment than the US or Japan.

Before the crisis, yields on government securities in Greece and other countries which later came under market pressure hardly featured any risk premium in excess of German yields which were seen as a safe investment. A sovereign default by an advanced country has not been a serious possibility since the end of WW II. Therefore, the government securities of such countries were considered to be practically default risk free and were held by many investors which were allowed to hold only a limited number of risky securities (e.g. pension funds, certain investment funds and central banks such as the ECB). However, when fears that sovereign debt in Greece and other EMU countries is not as risk free as in Germany, as these countries may not necessarily be bailed out by other member states if faced with repayment difficulties, markets started to take a closer look at the sustainability of their debt.

The renewed appearance of sovereign default risk in advanced economies had a profound impact on Greek government securities, which also spread to the government securities markets of countries facing high debts for other reasons (e.g. Ireland, Portugal, Spain, Italy and Cyprus, etc.). The underlying reasons for the indebtedness of these countries vary and so does their macro-economic situation. The common denominator is that yields on their government securities reached levels that called into question the sustainability of their debt and several of them had to resort to external help. Fears developed that deposits in the individual countries were also risky to varying degrees. As a result, a flight to safety soon ensued, with deposits flowing out from periphery countries into the strongest member states. Speculation emerged about sovereign defaults and bank bankruptcies, with the threat of becoming self-fulfilling prophecies, and the individual periphery countries were unable to manage these problems on their own.[4] *In light of the uncertainty that had evolved, member states in a stronger fiscal position concluded that further rapid fiscal consolidation in all countries was the only viable solution to restore market confidence and to prevent panic about a disintegration of EMU.* Accordingly, the condition for a bail-out to be met by each crisis-stricken country was stringent fiscal adjustment.

This article presents the debate over fiscal adjustment in connection with Greece, Ireland, Spain, Italy and Portugal (EMU 5). The situations in all of these countries are not the same: for example, Greece has already received several bail-out packages and been granted debt relief, whilst Italy is not in a crisis yet, but can only access financing at unsustainably high yields. What they have in common is that they are both a risk to the stability of the EMU as a whole, due to either the size of their economies alone or the potential contagion risks.[5]

FISCAL ADJUSTMENT AND THE SUSTAINABILITY OF DEBT

The outlook for a slowdown in the global economy – which first emerged in 2011 and then became more definite from the summer of 2012 – points to an even more unfavourable fiscal path in the GMU-5 countries, compared to the earlier forecasts. Especially in light of their longer-term growth

[4] See De Grauwe (2011), who provides evidence that even if Spain's debt is lower than that of the UK, its sovereign default risk indicator is much higher. He attributes this contradiction to the fact that neither Spain nor the other EMU member states enjoy monetary independence, and markets fear that the common central bank will not intervene in their respective government securities markets if a market failure materialises (market maker of last resort).

[5] Slovenia found itself under similar pressure for a while, but its growth prospects have improved and its sovereign debt is not too high either. Cyprus turned to the IMF for help in the summer of 2012. Given that these two countries are relatively small and that their problems are less serious, they attract less attention in respect of the stability of the EMU as a whole.

Table 1
Indicators of the sustainability of sovereign debt in five EMU countries

	2008	2009	2010	2011	2012*	2013*
Greece						
GDP growth	−0.1	−3.3	−3.5	−6.9	−4.8	
Debt rate	113	129	145	165	163	
Yields on government securities	7.4	5.7	8.2			
PSB**		−9.6	−3.4	1.2	3.4	1.9
Ireland						
GDP growth	−3	−0.7	−0.4	0.7	0.5	1.9
Debt rate	24.4	42.2	74.9	96.4	105.6	109.5
Yields on government securities	4.4	4.9	9.2	8.5	6.9	
PSB		−7.6	−6.5	−4.9	−4.1	−2.4
Italy						
GDP growth	−1.2	−5.5	1.8	0.4	−1.9	−0.3
Debt rate	105.8	116.1	118.1	120.1	125.8	126.4
Yields on government securities	4.5	4.1	4.8	5		
PSB		0.7	1	1.3	4.7	5.5
Spain						
GDP growth	0.9	−3.7	−0.1	0.7	−1.5	−0.6
Debt rate	40.2	53.9	61.6	68.5	90.3	96.5
Yields on government securities	4.4	4	4.3	5.5	7.1	
PSB		−6.9	−5.4	−4.9	−1.6	−1.5
Portugal						
GDP	0	−2.9	1.4	−1.6	−3.3	0.3
Debt	71.6	83.1	93.4	107.2	112.4	115.3
Yields on government securities	4.5	4.2	5.4	10.1	11.7	8
PSB		−5.8	−5.6	−2.3	1.8	3.7

** IMF forecast.*
*** Primary structural balance.*
Source: IMF (2012b, 2012c, 2012d, 2012e, 2012f).

potential, debt in these countries seems unsustainable. Market conditions for borrowing by them make this obvious; it follows then that fiscal adjustment is inevitable in these countries. There are debates about the ways in which GMU-5 countries should respond to the bleaker outlook: should they introduce further austerity measures to maintain the previously designated fiscal path or would doing so result in further burdens on economic agents to the degree that they cannot or will not bear such burdens? Or, in an even bleaker scenario, would the adoption of such measures backfire and lead to an outcome that is just the opposite of what is intended, due to its disproportionately adverse impact on business activity?

In order to be able to answer these questions, we need to know how a reduction in budgetary expenditure affects growth in terms of its size and composition. This impact depends on the value of multipliers. The influence of fiscal tightening on the 'snowball effect' must also be assessed (See Box 1).

Box 1
Fiscal balance, economic growth and cycles

Fiscal balance and economic growth interact via a number of channels.

$$D(t) = D(t-1)*(1-G(t))-E(t) = D(t-1)*(1+R(t)-G(t))-EE(t)$$

In the formula, *D* denotes the debt-to-GDP ratio, *G* is the rate of nominal growth, *R* stands for the average rate of interest on sovereign debt and *EE* is the primary fiscal balance. The formula describing annual dynamics reveals that, fundamentally, trends in debt are shaped by the *primary structural balance and the snowball effect*.

There may also be instances of revaluation, e.g. the revaluation impact of exchange rate changes or one-off transfers such as the take-over of the assets of the private sector; however, they are not fiscal adjustment items and are, in part, exogenous attributes as far as consolidation is concerned. The budgeting process also takes into account these changes that are beyond control.

The *primary balance* is the recorded fiscal balance minus interest payments, which reveals more about trends in fiscal policy, because interest payments are subject to past indebtedness and market interest rates, with the latter two left unaffected by current economic policy. The *structural primary balance* shows what the balance would be if tax bases were at their medium-term levels. Thus, from this point of view, medium-term economic performance, i.e. potential GDP, is of key importance.

The primary balance should cover current interest payment obligations if debt were to remain sustainable. As the primary balance changes in conjunction with long-term growth and interest depends on government securities market yields, the primary balance should be higher than debt, i.e. the snowball effect (the difference between interest on debt and the growth rate of the economy).

Snowball effect means that if the primary balance is in equilibrium, and the debt-to-GDP ratio is exactly 100 per cent, then if growth is lower than interest rates, debt grows and cannot be sustained. It follows then that a surplus is needed to stop the snowball.

Table 1 shows the trends and developments in the variables key to sustainability in the countries under market pressure: due to the rate of growth and interest on debt – i.e. the snowball effect – the sustainability of their debt is in question. The debt-to-GDP ratio is unlikely to decrease this year and next year due to high risk premia and the deteriorating growth outlook. This is attributable, in part, to short-term multiplier effects, which, in response to fiscal consolidation, trigger a more marked fall in growth than the extent of the improvement in the fiscal balance.[6] They also reflect market uncertainty about the success of consolidation, which, in turn, leads to high yields on government securities.

Box 2
Assessments of fiscal multipliers

The European Commission's 2012 *Report on Public Finances in EMU* provides a useful and exhaustive summary of the assessment of fiscal multipliers. Multipliers show how a unit change in the fiscal balance affects output. If the relationship is in the positive domain, the direction of the change in both is identical: if the deficit decreases, then GDP declines as well; if the multiplier is higher than one, then GDP will fall to a greater extent than the deficit. As a rule, the interpretation is symmetrical, i.e. an increase in deficit will raise output. Non-Keynesian effects materialise if there is an inverse relationship in the negative domain, when a change in the deficit results in an increase in output; this can counterbalance the adverse impact of weaker demand by favourably influencing long-term interest rates. If non-Keynesian effects are dominant, fiscal consolidation does not result in growth sacrifice: fiscal stabilisation results in an increase in output; by contrast, when classic Keynesian effects are dominant, there is, at least for a temporary period of time, growth sacrifice. There are also expenditure and revenue-side multipliers, and the impact of the individual items also varies.

[6] European Commission (2012), pp. 138–144.

Research shows that the value of multipliers depends on a number of factors. Impacts are stronger if an economy is closed, i.e. there is no 'import leakage', consolidation is consistent and lasting, and economic policy is credible, etc. There may be a difference between the impact of multipliers in the first year and in subsequent years (persistence). Given the context of the current crisis, it is especially important that the impact of multipliers varies to a large degree depending on the prevailing phase of the business cycle. If the proportion of unused capacities is high, so is the impact. This also works symmetrically: in theory, consolidation reduces output to a large extent, while expansion boosts it even more markedly, relative to non-crisis periods.

Estimates in studies range rather widely: In non-crisis periods, expenditure multipliers range between 0.4 and 1.2, with tax multipliers showing a somewhat lower value (often below 0.7). In crises, especially in financial ones, they usually stand at 1.4 or even 1.6. The European Commission's own estimate also corroborates these values. Results vary considerably from one country to the next; however, this is attributable to not only the different characteristics of the individual countries, but also to the uncertainties of the estimates.

In light of such uncertainties, the values of a *critical multiplier* serving as a benchmark have also been calculated. These threshold values are the values of the multiplier where, at any given level of interest rates and debts, fiscal consolidation will increase debt in the first year. This indicator depends on the original amount of debt, the flexibility of the fiscal balance to trends in growth, which weakens the ability of consolidation to reduce deficit, and the value of the multiplier itself. If debt-to-income ratio is 100 per cent, then, with automatic stabilisers standing at 0.5, the value of the critical multiplier is around 0.6 to 0.7.

The Commission calculated critical multiplier values for 27 member states, with the values ranging between 0.5 (Greece) and 2.8 (Estonia). A comparison of these threshold values with the estimates in empirical literature reveals that figures for Greece are unequivocally critical already in normal times. If the values are higher as is the case in crises, in the Commission's judgement, the multiplier is expected to reach the critical value in around two-thirds of the member states; accordingly, consolidation will result in higher debt in the first year. The EMU countries that are the hardest hit by the crisis are in this group.

Table 2
Critical first-year multipliers in the context of unchanged 2011 interest rates

Greece	0.5
Ireland	0.7
Italy	0.6
Portugal	0.7
Spain	0.9

In simulations of debt sustainability, subsequent to a short-term increase in debt in response to consolidation, sustainability can be restored in two or three years, i.e. debt either stops growing or starts declining. The same factors explain medium- and longer term developments in debt as short-term ones except that, over these horizons, the debt-reducing impact of consolidation is dominant in terms of its adverse influence on GDP (denominator effect).

However, simulations cannot take into account a few important impacts, because such effects cannot be quantified to a satisfactory degree. Under certain circumstances, these impacts can trigger an effect that runs counter to the one intended by consolidation. One such impact is when the multiplier is persistent, i.e. its impact continues for several years. This can be the case if consolidation fails even after a number of attempts. With its size and direction depending on a number of factors, the impact on interest rates is of key importance. Consolidation is a primary source of impact through reduction in deficit and debt. As these impacts also influence GDP, interest rates also reflect the expectations that are the outcome of these interactions. In other words, interest rates reflect market expectations regarding the success of consolidation. A scenario where expectations foil consolidation cannot be ruled out either. If, for instance, significant long-term adjustments are needed, markets expect societies to resist austerity measures and governments give in. Another possibility is that planned consolidation is implemented, but GDP falls to a larger-than-expected extent and consolidation has to be repeated.

DEBATES OVER CRISIS MANAGEMENT

The relationships described above facilitate the interpretation of debates over crisis management. Some recommend that, in response to deteriorating growth prospects, the countries affected should implement consolidation in a *protracted* manner. Fiscal tightening along with excessive saving by the private sector would increase the *economic downturn* disproportionately and unnecessarily. This recommendation seems to push at an open door, because the new economic co-ordination framework accords higher importance to the structural

balance, of all the fiscal policy objectives.[7] This means that if there is an adopted fiscal path and a related growth path, then, if the latter turns out unfavourably, no further consolidation measures need to be taken automatically. It follows then that it is the cyclically adjusted balance rather than the headline deficit that needs to be maintained; the former may be higher than the original fiscal objective calculated for higher GDP as is the case in the example that we offer. This is, however, not automatically done, as the consent of the counterparties and the Commission needs to be obtained.

Agreement with counterparties can improve credibility as perceived by the markets and mitigate the threat that a modified objective may rule out the possibility of a *less painful adjustment* through increased interest and the mass withdrawal of deposits. There have been a number of instances consolidations slowing down recently. In July 2012, Spain was given the following relief in light of deteriorating growth prospects: the Spanish government was allowed to postpone reducing the deficit to below 3 per cent by one year until 2014. Similarly, in Portugal the new deficit target allows a 0.5 percentage point larger deficit in 2012 and a 1.5 percentage point larger deficit next year. In the past, Greece had also been granted similar relief. In fact, there seems to be agreement on this issue; the question is when relief should be granted and to which countries.

Other proposals seek to manage the *'denominator effect'*, i.e. *growth*. Those in favour of fast consolidation wish to improve the longer-term growth prospects of the countries via fiscal and other austerity measures. In their opinion, one important factor threatening long-term growth is excessively high government debts, which, once they have reached a certain level, reduce or even hinder growth. By contrast, those arguing for slower consolidation are also afraid that longer-term growth may also fall victim to a shorter-term downturn: referring to what is called hysteresis, they worry that downturn may lead to a marked loss in output and capacity, leading to a permanent deterioration in potential growth.

Closely related to this are debates over *structural* (product and labour market) *reforms*. Those in favour of fast consolidation argue that the crisis should be turned into an advantage. Reforms that would hardly be accepted by stakeholders under other circumstances should be implemented and governments themselves would also be unwilling to adopt unpopular measures ('Let's not waste a perfectly good crisis.'). Those against the idea argue that reforms make stakeholders even more wary and, hence, urge them to save more heavily and postpone capital investments in economies that are already suffering from slack demand. In the absence of demand, boosting supply and competition cannot succeed. In a dynamically growing economy, losers of reforms can be compensated for the losses that they suffer, which helps reforms gain acceptance and makes it easier to manage the impacts that put a brake on growth.

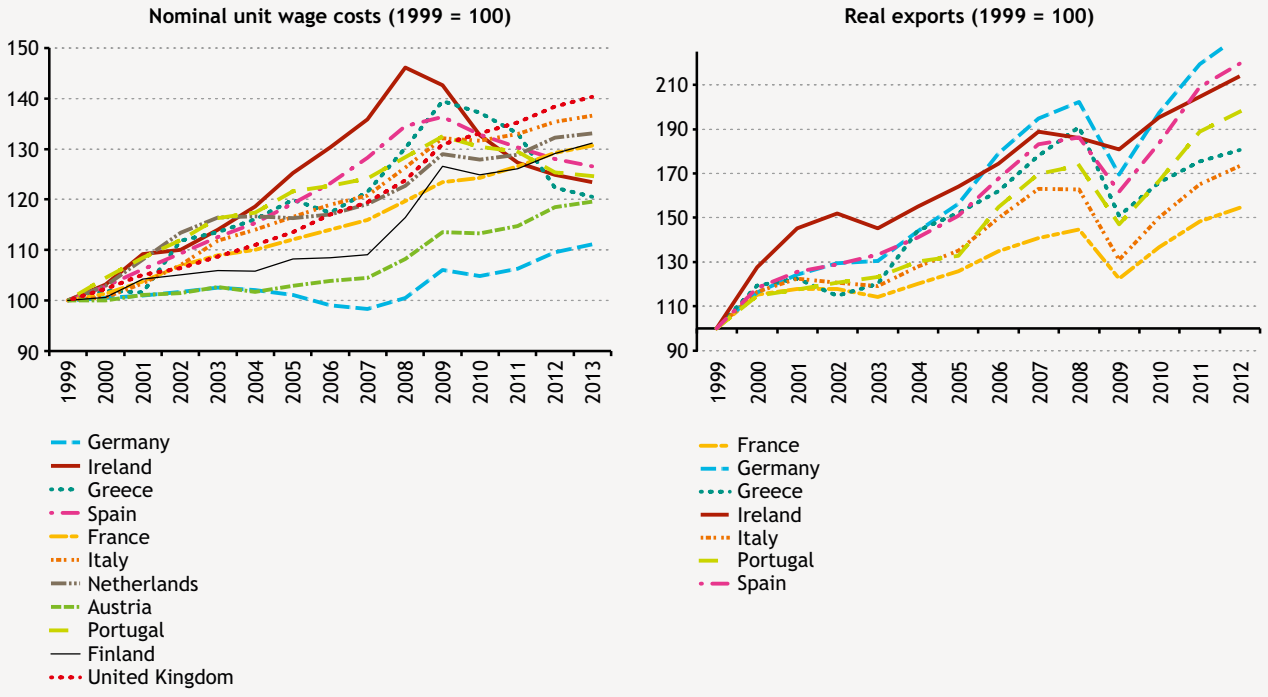
Another even more intriguing debate is being held about the competitiveness of indebted countries. According to the most widely held view, the problem of the indebted countries is that their competitiveness is weak, which cannot be remedied through depreciation due to the common currency. This raises the issue in both the longer and the shorter run, as to whether satisfactory performance can be achieved within EMU. Others doubt that, except for Greece, there is anything the matter with competitiveness. In their opinion, competitiveness in the EMU-5 countries is unlikely to have deteriorated before or during the crisis, as wage competitiveness and export sales were similar to those in the rest of the EMU member states.[8] This is shown in the two graphs in Chart 1. Competitiveness is relative: the chart reveals that there is 'overcompetitiveness' in Germany rather than a blatant lack of competitiveness in the crisis countries. If, however, the opinion that the EMU-5 countries are uncompetitive gains ground, then this may become a self-fulfilling prophecy in the form of higher prevailing interest rates and may make the establishment and operation of a sustainable debt path difficult.

A number of analysts claim that indebtedness and, within that, the indebtedness of the private sector offer a more plausible explanation for overheating and the absence of external equilibrium in the EMU countries, although fiscal deficit was a more important contributor in Greece[9] (see Chart 2).

According to this opinion, austerity measures and fighting overheating would have made sense in the pre-crisis period. Therefore, the European Commission, the ECB and the European Council have worked out a group of macro-economic indicators, on the basis of which they may, in the future, for preventive purposes, stipulate macro-economic

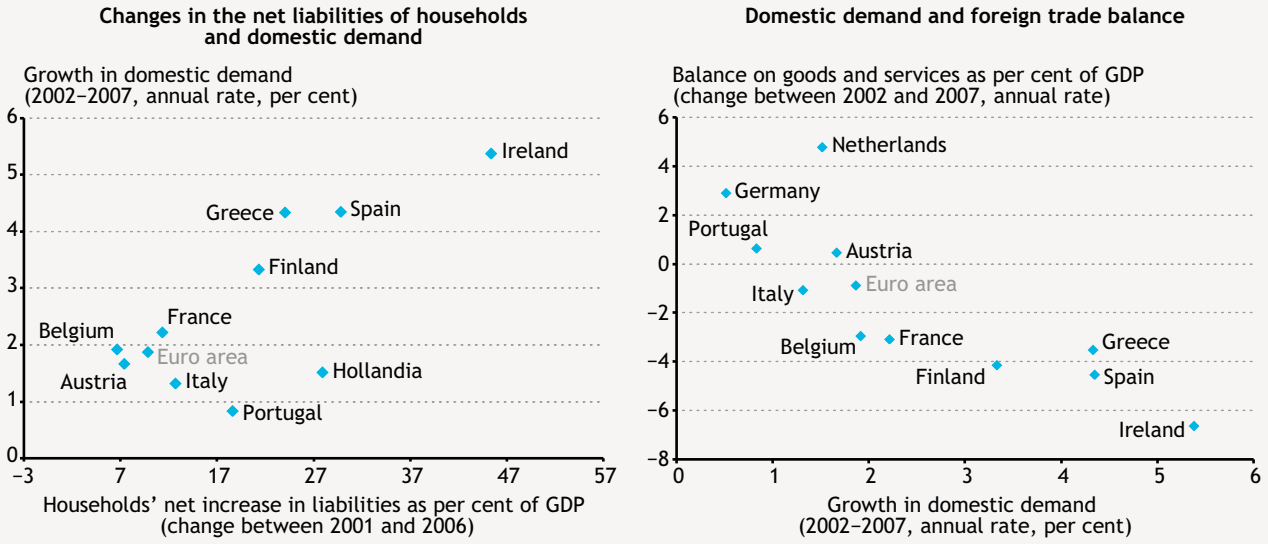
[7] Buti and Pench (2012a, 2012b).
[8] See, e.g. Fatás (2011).
[9] See, e.g. Brender et al. (2012).

Chart 1
Competitiveness indicators



Sources: AMECO, Eurostat.

Chart 2
Components of domestic demand



Sources: AMECO, Eurostat.

adjustments for the countries where they detect and identify unsustainable processes.[10] However, austerity measures presently fail to achieve their objectives, because they only make the situation of an already adjusting private sector even worse by putting a brake on the output potential of the economy and may even lead to mass bankruptcies.[11]

At this juncture, we have returned to the issue of a major deficiency in the institutional framework of the EMU/EU.

[10] In response to the crisis, the European Commission has adopted a scoreboard. Based on this, the potential macro-economic vulnerability as well as the internal and external imbalances of the member states are checked starting from 2012.

[11] See, e.g. Koo (2012).

EMU is a monetary region in which – although the member states have discretion over their respective fiscal policies, restricted by certain regulations as the case may be – they have lost their monetary independence. In other words, monetary sovereignty has been fully centralised, as a result of which the participating countries relate to their own currency as if it were a foreign currency. This explains why markets perceive the sovereign default risk in Spain higher than that of the much more heavily indebted UK.[12] Due to the current mode of operation of the ECB, weaker EMU participants are faced with a situation that is similar to that of the non-participating countries, which raised debt in euro or other foreign currencies rather than their own sovereign currency.

The large degree of integration in the financial sector failed to be followed by the integration of fiscal policy to a corresponding extent. Therefore, some of the recommendations for institutional changes are focussed on balancing out this asymmetric integration and urge *community* rather than national *solutions*. A higher level of co-ordination in fiscal stimuli would be achieved, if aggregate demand were redistributed within the EMU. In such an arrangement, countries with greater room for manoeuvre would ease their fiscal policy or at least slow down consolidation. They could help the countries that have to implement consolidation faster by serving as export markets for them.

Another more centralised solution is *increasing aggregate demand* via the EIB (European Investment Bank). Expenditures could target increasing the growth potential of less competitive countries, e.g. infrastructure development. Others claim that in order to handle high unemployment at the same time, activities *capable of creating a large number of jobs* at any unit cost should be financed; infrastructure development is not among them, because too large a proportion of expenses is allocated to

Table 3
Fiscal adjustments: a summary of pros and cons

Austerity measures and resultant impacts	Pros	Cons
Short-term decline in GDP	Probable, but inevitable. Growth soon returns (1 or 2 years).	The private sector already saves heavily, as a result of which the fiscal multiplier is higher and the resultant sacrifice is greater.
Impact on yields on government securities	Only austerity measures can convince the markets. Credible tightening brings down yields to a sustainable level.	Markets only think short term and soon start panicking. The short-term growth impact may deteriorate how sustainability is perceived. Investments flow out of the countries experiencing protracted weakness.
Longer-term growth	No or no significant adverse impact. Reduction in debt and lower interest rates help long-term growth.	Unnecessarily permanent loss in output and capacity (capital and labour). If growth can be contained, then both debt burden and the amount of the debt start to reduce steadily.
Necessary, albeit unpopular, reforms	Market pressure may also help governments implement such structural reforms that they would not dare/want to but for the crisis (theory of 'good crisis').	Crises are not the best time for carry out reforms – as a rule, it is easier to compensate losers for their losses if the economy grows. Their short-term impact on GDP amplifies negative feedback.
Encouragement and EMU participation	The EMU functions well if all adopt a stability-oriented policy. This must be corroborated – otherwise lack of discipline re-emerges.	It is not lack of discipline that led to the current crisis. The scoreboard will prevent imbalances in the future. Extinguishing fire is not the right time to find and preach to the 'culprits'. Fire must be extinguished first.
Balance sheet crisis/competitiveness	Improved competitiveness is one of the conditions for recovery from crises even if underlying reasons for the evolvement of the crisis were different, e.g. build-up of external debt and excessive domestic consumption.	Competitiveness is a must; however, wage competitiveness does not always help faster growth. This may emerge at each other's expense within the EU. During balance sheet crises income must be stabilised because of tax burdens; internal depreciation may backfire.

[12] De Grauwe (2011). For the avoidance of doubt, it should be added that this is not completely analogous with the case of foreign currencies. As regards distressed countries, the ECB could also act in the same way as did the respective central banks of the USA or the UK. This is a selected mode of operation, which can be changed. A number of proposals aim at just this.

capital goods.[13] IMF analysts[14] claim that even structural reforms would be easier to implement if fiscal policies were supportive.

Various forms of debt relief (e.g. partial debt forgiveness and restructuring) entail greater sacrifices and solidarity. We have already seen an example of this kind when an agreement was reached with private creditors to cancel part of the Greek debt. This, however, can hardly be a solution in large countries with sizeable debts. The only way out for them is to render debt sustainable by restoring growth and to reduce debt servicing burdens by mitigating risk premia. The most recent recommendations that look to the ECB for reducing yields on government securities may help prevent the panic that emerges during the downturn in the first phase of consolidation and gain some time. That said, a viable solution should come in the form of further community measures.

SUMMARY

So far, crisis management has failed to restore the eroded confidence in the sustainability of the fiscal situation in some countries. There seems to be a consensus that consolidation in the current crisis situation is leading to a serious economic downturn at least over the short term, i.e. on a one- to three-year horizon. The underlying reason for this is that too many participants strive to make adjustments concurrently, the aggregate result of which is weak economic performance. The problem is that the countries that are the most in need of fiscal adjustment have the least room for reducing the costs of consolidation. Furthermore, wary of contagion and strongly risk averse, even the participants that, in theory, have room for manoeuvre opt for tightening. Some propose that in order to find a solution to the crisis, and for market stress to be eased, balance sheet adjustment should be facilitated through proper coordination, and such a solution would also benefit net lenders. This strategy also carries risk, however; therefore, countries in a stronger position show little willingness to adopt it. As long as markets see certain countries teetering on the verge of default, while others are true safe havens, capital flows will reinforce this chasm. Therefore, in order to resolve this situation, we need to stabilise market expectations permanently, dispel fears of the disintegration of the EMU and demonstrate growth potential.

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[14] IMF (2012a, 2012g).

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