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Eurozone states should coordinate budgets to weather downturn

The latest economic data show that conditions are worsening in the eurozone, not only in the periphery but now also in the core countries. This will further test the political determination to continue to implement the austerity measures and structural reforms required to restore financial stability.

For countries in the periphery like Greece, Portugal and Spain, the delay in economic recovery postpones the date at which debt to gross domestic product ratios stop rising. The reduction in budget deficits is also postponed, in spite of the tight austerity measures that have been adopted. Governments may try to ignore the negative effects of short-term economic data and focus on the structural budget, excluding the impact of the latest slowdown. But that will only be possible to the extent that markets believe that this slowdown is temporary.

As unemployment continues to rise, the light at the end of the tunnel seems to fade away, undermining the political support for protracted austerity and structural reforms.

In the core countries, the slowdown might undermine the political support for providing further financial assistance to other countries, including those which are undertaking a major adjustment effort. Economic hardship pushes public opinion to become more inward looking and focused on domestic problems. As a result, solidarity among eurozone countries may weaken.

What can be done to address the problem?

First, monetary policy should be allowed to function properly, in all parts of the eurozone. At present, monetary transmission is not working in several countries, as the European Central Bank has reminded us several times. This is due partly to the so-called “convertibility risk” in the euro which is reflected not only in the higher interest rates on government bonds of peripheral countries but also in the higher rates that banks in these countries charge on the loans to households and companies. Such high credit risk is transforming the relatively accommodating monetary policy decided in Frankfurt into the very restrictive monetary conditions prevailing in the periphery.

Unless monetary conditions are eased in these countries, the fiscal adjustment those countries are undertaking might become self-defeating. If borrowing rates remain high in peripheral countries, the recovery might be postponed even further. This might over time fuel new centrifugal forces in financial markets.

Given that the ECB has – rightly – made intervention to ease monetary conditions in the peripheral countries conditional on those countries adopting a fiscal adjustment program, the ball is in the court of the peripheral governments. Delaying the request of a programme, on grounds of political pride, ultimately increases the cost for the domestic economy.

On the other hand, it is not clear why countries which have already adopted a programme, like Ireland and Portugal, and are on track, should not benefit from a more accommodative monetary policy. The argument against the ECB buying the bonds of Ireland and Portugal is that these countries’ governments are currently out of the market and do not need such action. However, as long as the spreads on government bonds remain as high as they currently are in those countries, the private sector will not be able to borrow at lower rates. The transmission of monetary policy, which ultimately depends on the private sector’s access to credit, will remain impaired. And the economy will continue to suffer, making the fiscal adjustment last longer and be more painful.

With Irish spreads now at levels similar to those of Italy and Spain, and the Irish fiscal adjustment programme on-track, ECB intervention would improve the prospects for the Irish government and private sector to finance themselves in the markets rather than through loans from other eurozone governments.

The task of supporting growth should not, however, be left to monetary policy alone.

Fiscal policy currently has limited room for manoeuvre in the euro area. Countries have to abide by the constraints exercised either by financial markets or the fiscal compact. This is particularly unfortunate in light of the fact that the euro area as a whole, and most of its members currently, record a current account surplus, that on aggregate is expected to rise by around 1 percent of GDP this year and a further 0.5 percent in 2013.

Even if there is little scope for changing the overall size of the budget envelope in the different countries, there may be grounds for modifying the composition of revenues and expenditures in national budgets countries, with a view to foster growth and reduce imbalances within the eurozone.

For instance, countries which already record an external surplus – like Germany – should aim at reducing taxation on consumption (known as sales taxes in the US or VAT in England) and compensate the lower proceeds from taxes on consumption with a rise in personal income tax or in social security contributions. The opposite should be done by countries – like Italy or Spain – which still record an external deficit and need to restore competitiveness.

The above mentioned symmetrical adjustment would be budget neutral and lead to a reduction in imbalances within the euro area and stimulate overall demand. It would improve market sentiment and facilitate the task of monetary policy.

Such a policy requires strong cooperation between the fiscal policies of the member states. How can this be achieved? One way could be to use the new budget oversight procedures being developed in response to the crisis at the European level to assess the compatibility between the country-level budgets and the overall eurozone position. The initiative to do so is in the hands of the European Commission. Without such coordination individual member states' fiscal policies cannot take into account the impact on each other. They are thus bound to be overly restrictive and further broaden imbalances.

The eurozone certainly needs fiscal discipline. But fiscal discipline can be sustained only if supported by monetary policy and a better coordination of the member states' budgets.

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