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# A Way to Solve the European Balance of Payments Crisis? Take a Chance on Market Solutions!

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For a good two years now, balance of payments disequilibria and government debts have grown into a European balance of payments crisis. This means that payment obligations entered before, i.e. the debts of an individual member state or a group of members, respectively, of the European Economic and Monetary Union (EMU) have proven to be prohibitive. The crisis has deepened further following the Euro Summit at the end of July and end of October 2011 respectively and is still awaiting an effective and sustainable solution.

To elucidate: it is important to emphasise that neither government debt nor balance of payments imbalances as such must generally present a problem. Quite the contrary, under certain circumstances it is economically entirely rational for businesses or government to incur debt. This is in particular the case if the debts are used for investment, i.e. if governments invest in education, health and infrastructure – to mention only some cases – or if private businesses modernise or expand their production facilities. The theory of the debt cycle shows very clearly that it is often imperative to incur debt in order to use the income from the investments that are made with the help of this debt, to repay the debt including interest and to raise one's own welfare. Unfortunately, however, today we are not talking about debt that is used in this way; the governments concerned have used their debts primarily for consumption because it was politically rewarding to impart short-term impetus. The theory of time inconsistency explains this behaviour quite well.

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This paper will deal briefly with the causes of the balance of payments crisis in the euro area, as only knowledge of the causes can bring about a solution of the problem with political means. We then look at the issue of direct price and quantity effects in the course of continuing economic integration of European core and periphery countries that triggered the debt dynamics in the euro area. In particular, we shall deal with institutional flaws of EMU that promote the debt dynamics and impede a solution of the European balance of payments crisis. In the course of discussing institutional weaknesses, the shortcomings of the past European crisis management will become clear. We conclude our discussion by suggesting that alternative approaches be taken to solve the European balance of payments crisis effectively and in a sustained way. In contrast to some arguments in the public debate, our approach is to 'take a chance on market solutions!'

*Causes of the European balance of payments crisis 1: price and quantity effects*

The causes of the debt dynamics in the euro area that have led to a European balance of payments crisis are complex. In economic terms, price and quantity effects can be seen to play a major role.

The fact that the European balance of payments crisis has primarily become visible at the periphery of the euro area can be traced in particular to the initially observable price effects of economic integration. The establishment of a common monetary area led to an extraordinary decline in the risk premiums in the periphery. Such a price effect resulted quasi automatically in an expansion of the credit volume in these countries. In the case of a small open economy in a common currency area, the subsequent excess demand in the goods markets leads to a purely quantitative economic adjustment in the form of current account deficits that in a common currency area cannot be offset by an exchange-rate price adjustment mechanism. The credit-induced increase of purchasing power results in a demand increase even for so-called non-tradable goods, of which prices then rise. These are partly intermediate prod-

ucts of the producers of internationally tradable goods that cannot become more expensive because of the law of one price in international trade. If such cost pressures on domestic suppliers of tradable goods cannot be offset by productivity gains, the corresponding real appreciation will result in declining competitiveness of the firms in the peripheral countries of the euro area and thus in a long-term rising risk of a balance of payments crisis. This risk would be smaller under flexible exchange rates, as a depreciation of the currencies of net debtor countries would stop the capital inflows and would restore, at least in part, price competitiveness.

Under competitive conditions an inefficient expansion of credit may also result. This occurs if, for example, no account is taken of the pro-cyclicality of asset price changes in the context of the collateralisation of borrowing agreements. In such a case a pecuniary externality in the aggregate credit volume exists, which is not internalised on a microeconomic level within the private financial sector (Lorenzoni 2008). Borrowing agreements are incomplete agreements. Especially for the financing of investment projects some form of collateralisation is demanded to counteract the problem of uncertain future repayments. As the future is uncertain *per se,* a real investment may turn out to be insufficiently profitable, so that the borrower's ability to repay the loan diminishes or credit claims may even become uncollectible. Because of the excess demand generated by credit, the asset value of the collateral may increase so that endogenous credit cycles are started. If, because of an exogenous shock, a sufficiently large volume of credits become bad, a problem in the macroeconomic aggregate may ensue, thus, turning the credit cycle into a deflationary phase. The effect of each individual borrowing agreement on aggregate income is of course marginal; that is why under certain conditions the beneficiaries of the contract cannot appropriately price in any economies of scale, resulting in the mentioned pecuniary externality, i.e. an excessive volume of credit. The result is a trend to an excessive degree of indebtedness in the economy: market failure is the result.

Excessive growth of the credit volume and corresponding debt dynamics in the euro area are frequently accompanied by a qualitative deterioration of credit portfolios from a macroeconomic point of view. This may be traced e.g. to behavioural risks (too high a preference for the present, moral hazard). Thus, excessive credit demand may be explained by demanders – be they households, businesses or public authorities – rating present consumption too high. Time-inconsistent behaviour may be responsible for this. Governments choose and publish an optimal level of future debt. After the debt is incurred, the chosen level is no longer optimal, as the market agents react to the announcement. For example, before an election it may then be optimal for the government at a later point in time to incur more debt in order e.g. to increase social spending and to draw the mostly myopic electorate onto their side. Furthermore, it may be possible for governments, against the background of an expected bailout, to assent to a non-sustainable indebtedness. This applies all the more if there are already examples in the euro area or if rules to prevent moral hazard have proven too weak.

Most notably, it were the price and quantity effects in credit transactions that set in train the debt dynamics upon the introduction of the common currency which are currently manifesting themselves in a European balance of payments crisis. Of course, with the no-bail out clause and the Stability and Growth Pact there were also institutional precautions that were meant to inhibit such developments. But the mechanisms turned out to be non-credible and ineffective. Additional institutional flaws have even promoted the current development.

*Causes of the European balance of payments crisis 2: institutional flaws*

Aside from the described price and quantity effects, the debt dynamic in the euro area is due to specifics of the common currency area. The special characteristics of EMU resulting in the European balance of payments crisis comprise, first, lacking institutional safeguards of the credibility of promises to pay especially of demand deposits in the banking sector on the European level. Second, construction flaws in the common monetary transaction system and, third, lacking institutional precautionary measures for the case of a threatening insolvency of individual euro members.

The first aspect concerns the institutional safeguard of promises to pay. From our point of view, a Europeanised financial sector, i.e. especially the banking sector and its deposits, is comparatively more fragile than would be the case in a national framework. The reason is that on the national level – if deposit insurance funds and similar measures should be used up – the safeguard of all promises to pay in the form

of deposits can be guaranteed by the liability of the taxpayer, so that a bank run can be averted. Before the introduction of the euro, there were always the respective central banks as direct lender of last resort (LLR) on the national level. The institutional safeguard of deposits *via* central banks as well as especially that *via* taxpayers, functions only indirectly on the European level or in relatively unreliable ways (Congdon 1998). Admittedly, in a Europeanised or globalised financial sector, it is always more difficult to fulfil the functions of a lender of last resort. Yet, within the euro area there should have been at least more political interest in and serious analyses of this issue. For example, Neumann (2011) has pointed out that the probability of a run on the banks of a euro member is high. His argument is based, however, on the European monetary payment mechanism Target2 offering ideal prerequisites for capital flight into other EMU member states, raising the probability of a bank run. If this problem had been considered early on, a second construction flaw could possibly have been avoided.

From our point of view, the Target2 system consequently represents the second institutional fault of EMU. In the Target2 debate, initiated by Hans-Werner Sinn, Fahrholz and Freytag (2011) have shown that the common payment system *inter alia* permits continued financing of merchandise imports. Thus, the Target2 system indeed represents a kind of 'credit replacement policy' (Sinn 2011; Sinn and Wollmershäuser 2011) for *de facto* insolvent euro members. In general, a transfer of resources transmitted by the private financial sector leads to an efficient allocation of capital between core and periphery countries in Europe; in that case, a current account deficit is, as mentioned, no problem. The Target2 system also permits inefficient and unplanned current account transactions. Prior to the European balance of payments crisis the lack of a price adjustment mechanism could not prevent the build-up of excessive debt. In the crisis private capital flows stopped, but the existing Target2 system permits further financing of non-competitive or non-sustainable production structures, even after a failure of the private financial sector. As a consequence total indebtedness in the euro area will continue to increase. Promises to pay or claims will now be increasingly kept in the form of central bank money in the Eurosystem. That corresponding changes in net asset positions will become even more improbable, given that the additional debt generated by the Target2 system even adds to unsustainable debt levels. Therefore this additional debt only leads to an aggravation of the European balance of payments crisis.

The above-mentioned capital flight within the euro area points to a third flaw. The institutional provisions for a functioning EMU lack credible rules for dealing with balance of payments crises, i.e. especially bankruptcy or exit rules for insolvent euro members. Fahrholz und Wójcik (2010) have pointed out that clearly defined rules for an (even conditional or temporary) exit from the euro area would clarify the opportunity costs of excessive indebtedness or excessive credit growth. Put differently: a future balance of payments crisis could then be prevented as only efficient current account balances would be generated. At the same time, such an institutional provision would ensure that latently insolvent euro members could not play off the still prevailing institutional uncertainty in the euro area against other EMU members. In contrast to the present design of EMU, with clearly defined insolvency or exit rules the build-up of excessive stocks of debt would be made more expensive by the private financial sector and thus prevented. The more credible the institutional provisions for an orderly exit from a common currency area, the less is the potential for a European balance of payments crisis. But also after the event – i.e. without corresponding exit rules today – an exit may be worth considering: for the country concerned, an exit would have the disadvantage of the debts likely becoming much more expensive in domestic currency, assuming that the exit would result in a depreciation of the new (old) currency. But it would have the advantage of the depreciation increasing the competitiveness of the domestic industry.

*Past attempts at solving the problem: too weak and not directed at the causes*

This short analysis in our short paper shows that a solution of the European balance of payments crisis cannot consist of giving and mutually guaranteeing more and more payment promises, i.e. debts. But this is where the past rescue program having been introduced bit by bit since the spring of 2010 is leading. All rescue operations, based on this approach, have only aggravated the European balance of payments crisis. Let us first take a brief look at the proposed solution presently under discussion, to be followed by an alternative approach to effective and more efficient solutions.

The debate following the Euro Summit of 21 July 2011 is dominated by the topics of 'debt restructuring'

and 'leverage of the rescue package', i.e. the present European Financial Stabilisation Facility (EFSF) and the European Stability Mechanism (ESM) from 2013. What has been created with the new mandate of the EFSF, which possibly even provides for preventive credit lines for potentially insolvent euro members, is the fiscal policy counterpart of a monetary policy LLR function. Whereas, however, according to the Bagehot rule, interventions ought to be unlimited in size, the funds of the ESFS are limited in volume. As desirable as a limitation of the solidarity liability in the euro area appears to be, so precarious is the effect of an explicit ceiling on the behaviour of the private financial sector. Because this will only lead to a run on the funds of the rescue package, as within the private financial sector there is competition for shifting 'toxic' government bonds to the public sector, so that the new mandate of the EFSF intensifies the European balance of payments crisis. The result may be a vicious circle: an expansion of the rescue packages – as planned in the October 2011 package – will encourage the banks to transfer ever bigger amounts of government bonds to the periphery. This crisis then perpetuates itself, as the peripheral countries cannot permanently restructure their debts on the markets, but will be dependent on the payments of the other euro members. This phase will not last for long, as a renewed expansion of the rescue packages could soon lead to a downgrading of the creditworthiness of some guaranteeing euro members.

The idea of the EFSF and the ESM, created on the European level, was to raise a guarantee volume that is so big that the private financial sector would never lose confidence in the ability of individual euro members to repay their financial obligations.[1] Of course, there is no such thing as a hundred percent credibility and this applies especially to the European level. But on the national level, i.e. in the case of a legislature legitimised by elections, such guarantees are politically easy to get accepted and therefore largely credible. To be sure, the guarantees given to date on the European level also imply a corresponding liability of the taxpayers. But to warrant an equivalent measure of credibility as in the national framework, the individual euro members would not only have to have the right to take hold of the taxpayers in other member states; all of them would also have to be allowed to actually raise the corresponding tax revenue from the other EMU members. This would turn the European state federation into an economically synchronised federal state with a strongly centralised budget law. Aside from the question whether such a unified state would be politically desirable, this form of political integration of Europe would be an aberration in terms of a market economy.[2]

The aggravation of the European balance of payments crisis has also provided an argument in favour of debt restructuring, as this would seem to relieve the rescue packages. Because of the 'toxic' government bonds still existing in the private financial sector, in the wake of such credit event there still remains a risk of contagion that could exacerbate the European balance of payments crisis to an unfathomable extent. In particular, debt restructuring imparts the wrong inducements for new debts, which – as explained above – can neither be internalised nor effectively constrained in the euro area. In the current debt restructuring the financial sector should be involved as much as possible in order to avoid future moral hazard; the envisaged sums in Greece appear small. This is less a question of punishing financial investors than of dealing normally with nonperforming loans and now worthless assets, for which the creditor is liable. In a market economy, this should be a matter of course. Furthermore, debt restructuring could at least have the effect that in the future borrowers and lenders will have a closer look.

Our discussion shows that neither rescue packages nor debt restructuring minimise the risk of European balance of payments crises. Neither can a collectivisation of debt, as is being considered, in the form of collective debt instruments, the so-called Eurobonds, solve the problem of debt. Although the individual burdens are shifted (i.e. the periphery can shift part of the liabilities to the core countries), this will not raise the willingness of the creditors to grant loans at affordable interest rates to the countries of the euro area. One should not forget that the creditors are still, to a large extent, institutional investors. These will want to save their assets in any case. The bigger the potential burden for the core countries, the bigger will also be the risk premium. It is an illusion to believe that the peripheral countries will be able to borrow with Eurobonds at German interest rates. It is rather likely that in the future Germany itself will have to pay exorbitant interest rates for its refinancing.

[1] It is clear that the currently planned volume of the EFSF will not be sufficient to create this confidence – only a few days after the Summit decisions of 26 October, the markets were putting pressure on Italian government bonds again.

[2] The same is the case for purchases of government bonds by the ECB, which is not in accord with the independence of a central bank.

A few remarks on debt monetization at this stage seem adequate. It has been suggested by some American economists and by the financial industry to use the ECB as provider of an endless 'firewall' by buying unlimited government bonds on the secondary market. This is not only a fundamental shift away from price stability; it also destroys the market for European government bonds for the years to come. Thus, we still assume that it is not an option for European policymakers.

*An alternative approach to solving the European balance of payments crisis*

Ever bigger rescue funds at possibly recurring difficulties regarding imminent debt restructurings of individual euro members are not a permanent solution of the European balance of payments crisis. All past approaches to solve the problems seem rather to have the effect of increasing the frequency and extent of acute balance of payments crises in the euro area. Alternative and sustained approaches should at least comprise the following components: first, a restoration of market-compliant price adjustment mechanisms as well as the abolition of inefficient credit replacement policies; second, understanding about and enforcement of exit and insolvency rules in the euro area; and third, implementation of the currently demanded structural reforms, and the latter not only in the periphery. Today's European balance of payments crisis and the risk of additional crises may in practice probably only be tackled effectively with a catalogue of measures. The focus should remain on dealing with the debt, i.e. the amount of shaky promises to pay in the future.

- Regarding appropriate measures to restore the price adjustment mechanisms – e.g. in the form of significant interest rate differentials on bond markets – one should be aware that an exclusive focus on the public debt will not lead to the desired result, as in the course of a balance of payments crisis private sector debt will be quickly socialised (see e.g. the experience in Ireland or Spain). From the perspective of economic order, far-reaching market-based approaches should be preferred. The theory of market failure presents various instruments regarding an effective reduction of externality problems, here e.g. the problem of excessive debt. Thus, political decision-makers could exogenously fix a preferred rate of credit growth analogous to Friedman's money supply rule, so that a market could be created for debt instruments for the purpose of efficient allocation of debt in the euro area (see Casella 1999).
- In addition, clearly defined exit and insolvency rules could help to reduce the imponderabilities and uncertainties that otherwise may occur in the private financial sector in the course of a emerging European balance of payments crisis. Interventions as in the form of rescue operations (bailouts) and insolvency procedures of the public authorities should occur explicitly and in conformance with rules. The establishment of explicit rules for the orderly exit from the euro area could help to restore the constitutive principle of liability in the euro area. If such rules could be instituted in a credible way, all agents would see clearly in advance the opportunity costs of an 'misguided' discount rates and according moral hazard risks. Furthermore, with corresponding rules, the scope of some euro members could be limited to play off their self-made debt problems against other members in the euro area (Fahrholz und Wójcik 2010).
- Furthermore, existing instruments may be used to permit fiscal solidity to return to the euro area. The European heads of governments could meet at a special summit that focuses on a reactivation and considerable tightening of the Stability and Growth Pact in connection with an also intensified no-bailout clause. The debt brake is a possibility for enforcing a credible commitment, from the point of view of the financial markets, of political decision-makers. The consequence could be a number of structural reforms on the national level in order to improve the competitiveness of industry and to let capital flows be controlled again more by long-term profit considerations. Besides the earlier mentioned fiscal aspects, these comprise re-regulation, reduction of subsidies and tax reforms, so that additional debt will not lead to problems but to future welfare gains.

In this way, the European balance of payments crisis and its worsening in early November 2011 could have at least the positive effect of permitting 'pathological learning' (Karl Deutsch). In history, crises have frequently been the cause of welfare raising reforms, so, for instance, in England the so-called Glorious Revolution (Pincus and Robinson 2011). Other examples of the more recent past are Great Britain, New Zealand and Australia in the 1980s. These reforms shared a stronger commitment to rules and limitation of short-term scopes of action. The weakness of the present approaches to solving the crisis is the insuffi-

cient strategic commitment of political decision makers. Past measures arose mostly from a situational political will. If, in fact, we do not follow an alternative course in Europe in which political control capacities are revoked in favour of market-compliant decision mechanisms, then past solutions will prove more and more part of the problem of European balance of payments crises. The past approach to solving the European balance of payments crisis leads to a dead end, when interest rate differentials of government bonds decline so much that even the last euro member can no longer get refinancing on private financial markets. This would not only simply be the end of the euro as a currency but a climactic event in European history. It is likely, in any case, that the markets will force a solution of the European balance of payments crisis. It is still in the control of policy-makers to let this solution play out positively.

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