Fiscal Crises in the Eurozone:
Assessing the Austerity Imposed by the Bail-outs

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March 2012

Forthcoming in
Joan DeBardeleben and Crina Viju (eds)
The Economic-Financial Crisis in Europe
Palgrave Macmillan

Introduction

In the aftermath of the 2008-09 global financial crisis, the European Union (EU), most especially its Eurozone member states, was hit by a number of fiscal (or debt) crises, which began in Greece in December 2009 before moving on to Ireland and Portugal in 2010 and 2011, respectively. For their part, Spain, Italy, Belgium and even France also ended up facing more or less strong headwinds from sovereign bond market investors as contagion in the form of market and political uncertainty spread throughout the Eurozone. The EU, with the help of the International Monetary Fund (IMF), worked hard to contain the debt crisis (or crises) and prevent it from propagating itself, but with limited success given the political difficulties involved in providing financial assistance to crisis-hit governments and banks (for details, see the chapter by Ross in this volume). In the end, direct financial assistance (i.e., bail-outs) had to be provided to Greece, Ireland and Portugal. In Greece's case, a second bail-out package had to be put together a year and half after the first one, this time involving a restructuring of Greece's public debt in order to avoid an outright (i.e., official) default.

These bail-outs and the economic adjustment programmes that have accompanied them have been highly controversial politically as well as economically. For instance, there are those who claim that no bail-outs should have been forthcoming and that Greece and company should have been left to fend for themselves. Then there are those who argue that the austerity packages imposed on Greece and others as a result of the bail-outs are too harsh and will only make things worse. In light of these controversies, it is worth asking ourselves whether the EU's (and IMF's) response to the fiscal crises in Europe (i.e. the bail-outs and the accompanying adjustment programs) has been appropriate under the circumstances at hand.

In order to answer this question, the present chapter is structured as follows. First, the chapter provides a review of the literature on debt crises in order to tease out the lessons that have been learned from past fiscal consolidation and economic restructuring efforts. Second, applying these lessons, it analyzes the EU's response to the fiscal crises in order to determine whether or not bail-outs and their associated economic adjustment programs have been appropriate to the situations at hand. What we find is that in fact the EU's response to the fiscal crises has been the right one and that the conditions that it imposed on Greece, Ireland and Portugal, in exchange for financial assistance, are in line with the lessons offered by past successful fiscal consolidations. However, there is an important issue that plagues the Eurozone debt crisis, and it is one that the literature does not really address. This is the fact that there have been not one, but many debt crises, with many countries in the same region that adopted austerity measures at the same time, including those countries that did not receive bail-outs. This has had the effect of making the fiscal consolidation process even more difficult, both economically and politically. Finally, the chapter concludes with the implications for the EU and the euro of the fiscal crises in Europe and the way that they have been managed.

Lessons from Past Fiscal Consolidations

If the bailouts of Greece, Ireland and Portugal have prevented these countries from defaulting on their debts, they must nevertheless cut down their fiscal deficits drastically, and do so for a long period of time. Only once public finances are credibly back on a sustainable path will private investors be ready to buy these countries' sovereign bonds at acceptable rates of interest. The need for fiscal consolidation also applies to countries like Italy and Spain, which face serious threats to their public finances. In the end, the goal is to regain, or maintain, sovereign bond investors' confidence that their investments are safe and, as such, will be paid back in full, with interest. The issue of concern here, for policy makers, is to know what the key elements of a successful fiscal consolidation process are, in order to design a proper response to the fiscal crises.

According to studies of past fiscal consolidation efforts, reductions in current government spending are more likely to lead to sustained adjustments than increases in tax revenues or cuts in investment expenditures (Alesina and Ardagna, 2010; European Commission, 2007, p.196; Guichard et al, 2007, p.7). The reason is that cutting government consumption and transfers is more difficult to achieve politically than raising taxes and cutting investment expenditures. As such, they are less likely to be reversed. Moreover, it sends a credible signal to investors that the government is committed to a lasting fiscal consolidation exercise, which will likely lead to a reduction in the yields demanded by investors. If the fiscal consolidation exercise is primarily based on increasing tax revenues, then government spending has a tendency to grow along with the additional revenues that are generated, thereby preventing the desired fiscal adjustment from being achieved (see: Guichard et al, 2007, p.16). On the other hand, in a recent study, Paolo Mauro and his IMF colleagues find that intended or planned revenue-based adjustments grounded in reforms can also sometimes be effective alongside spending cuts (Mauro, 2011).

It is not just the size of the reductions in government spending that matters, their composition is also very important. According to Alesina and Perotti (1997), reductions in social welfare spending, as well as in government wages and employment, not only lead to more permanent fiscal consolidations, but are also beneficial for economic growth, since unit labour costs decrease. This is because cuts in government wages and employment influence wage setting in the private sector. For example, if the public sector is shedding workers or freezing new hirings, then it means that there is more competition for jobs in the private sector, which drives down the price of labour. Moreover, cuts in social welfare spending are likely to force more people to seek or remain in employment, which also contributes to the labour supply in the private sector, thereby pushing wages downwards.[1] Such a decrease in average unit labour costs makes an economy more competitive, which leads to higher exports and investment and, ultimately, overall economic expansion. Combining government spending adjustments with structural economic reforms significantly enhances the chances of a successful consolidation, according to the European Commission (2007) and Mauro (2011). Since structural reforms entail liberalizing markets for labour, products and services in such a way as to improve competition, lower costs and increase innovation and investment, they further contribute to improving competitiveness and growth in the medium to long run, which in turn helps make the fiscal consolidation exercise durable.

If the right mix of government spending reduction is good for economic growth in the medium to long term, tax increases and reduced investment expenditures tend to have a negative impact on growth (Alesina and Perotti, 1997; Ardagna, 2004). This is because they usually hurt an economy's competitiveness, which, as argued previously, is bad for exports and investment.[2] For instance, higher taxes are likely to lead to higher prices for goods and services. This is especially true for direct taxes on income (for both individuals and corporations) and social welfare contributions paid by businesses, whereby workers will ask for higher wages to compensate their loss of purchasing power, and businesses will pass on their increased costs to their customers in order to maintain profitability. As for investment expenditures by government, they are also important for competitiveness since they help maintain, if not improve, an economy's infrastructure (e.g., roads, ports, railways, etc.). Thus, if lowering public investment leads to a continued degradation of a country's productive public infrastructure, then the cost of doing business for firms will only increase, thereby hurting an economy's competitiveness and growth prospects.

Lower economic growth also means lower revenues in the government’s coffers, as well as higher social welfare expenditures.

With regards to improving an economy’s competitiveness, the devaluation of the currency is often considered an easy way to make exports cheaper internationally and, thereby, stimulate growth. According to Alesina and Perotti (1997), many instances of past fiscal consolidation have been preceded by exchange rate depreciations. In fact, Lambertini and Tavares (2005) find that a depreciation of the nominal exchange rate increases the probability of a successful fiscal adjustment. This is why they conclude that countries that have adopted the euro may find it more difficult to achieve a sustainable fiscal consolidation, because they cannot effect any currency depreciation unless they abandon the euro and reintroduce a national currency, which as we will see below is no panacea. Fortunately for Eurozone member states, Ardagna (2004, p.1049) finds that exchange rate devaluations are not a necessary condition for ‘successful and expansionary fiscal contractions’. Hence, a sustainable fiscal consolidation is not impossible for Eurozone countries; it may just be a little harder.

In their study of past fiscal consolidations, Paolo Mauro and his colleagues from the IMF argue that it is not so much whether fiscal consolidation is expenditure-based or revenue-based that really matters; the adjustment must be ‘reform-based’ with a clearly established plan that includes contingencies for the fact that things will not turn out as planned (e.g., lower than expected rates of economic growth or unforeseen political developments) (Mauro, 2011). This is why the authors argue that consolidation plans should have medium term objectives, rather than simply short term ones (i.e. three to five years rather than one year). This would provide policy makers with enough flexibility in the short term to adjust the plan in accordance with changed economic and/or political situations while maintaining the focus on achieving the stated objectives.

> The experience of the past few decades […] shows that plans face sizable risks and often encounter substantial implementation difficulties along the way. Unexpected declines in economic growth, upward revisions in the initial fiscal deficit, changing priorities, lack of support among the general public, poor plan design, all have the potential to derail fiscal adjustment plans. Conversely, when favorable economic and political conditions emerge, objectives are often met or exceeded, even when plans envisage ambitious reductions in deficits and debts (Mauro, 2011, p.178).

The final issue concerning fiscal adjustment programs is whether they should be short and sharp – akin to the shock therapy treatment applied to a number of Central and Eastern European countries after the demise of the Soviet bloc – or more gradual in nature. There are two views on this matter. One the one hand, the political window of opportunity to instil fiscal and structural reforms in the context of a crisis is narrow before reform fatigue sets in and opposition to reforms mounts to such an extent as to make them politically infeasible. That is why it is often recommended to adopt painful measures soon after a new government has been elected. On the other hand, precisely because of the politically sensitive nature of the adjustments and reforms to be put into place, they need to be done gradually over time in order to make them palpable to the electorate and their representatives. According to the European Commission (2007, p.196), the gradual approach seems to be a better fit with a successful fiscal consolidation exercise, most especially when politically-sensitive government expenditures have to be heavily cut and/or the economy is in particularly bad shape at the beginning of the process. Although this may be so, the general evidence in support of fiscal consolidation exercises leading to government unpopularity and ensuing collapse is weak. For instance, Alesina, Perotti and Tavares (1998) find that pursuing fiscal adjustment programs does not negatively affect a government's popularity, or increase the probability that it will collapse. In a more recent study, Alesina and other colleagues obtain similar results, whereby governments are no more likely than usual to be voted out of office if they quickly decrease budget deficits (Alesina, Carloni and Lecce, 2011). These findings are also corroborated by those of Mauro (2011). Even when governments lose power during a consolidation process, the adjustment program's implementation usually remains unaffected. This is because what truly matters is the degree of support for the reduction of the deficit and debt among the general population (Mauro, 2011). It does not mean, however, that austerity measures are not generally associated with social unrest (see: Ponticelli and Voth, 2011), but the latter does not necessarily translate into electoral behaviour against the incumbent government, as unrest tends to be more associated with particular lobbies such as labour unions (Alesina, Carloni and Lecce, 2011). Therefore, although it seems reasonable to conclude that adopting a gradual approach might be more effective at ultimately reducing fiscal deficits and set public finances on a sustainable path, the evidence does cast a shadow on the political cost of 'cold shower' consolidations, as the European Commission calls them. After all, Alesina, Carloni and Lecce (2011) do not find that governments are more likely to lose power if they undertake 'large' fiscal consolidations (i.e. those leading to a reduction in the budget deficit of 1.5 per cent of Gross Domestic Product (GDP) in a given year).

Assessing the EU's Response to the Fiscal Crises

From the above, it is clear that any attempt to consolidate public finances among Eurozone member states affected by a debt crisis should begin with significant (but probably gradual) cuts in current government spending, most especially wages and employment, as well as social welfare entitlements. In addition, structural reforms to make the economy more productive and competitive should accompany fiscal adjustment efforts. Whether the EU and the IMF have adopted such a framework in the conditionality programs that they have negotiated with Greece, Ireland and Portugal in exchange for financial assistance is what this section sets out to assess. Before doing so, however, it is important to assess whether the provision of bail-outs themselves made sense for the EU.

Were the Bail-outs a Good Idea?

The fact that three Eurozone countries have received financial assistance with their sovereign debt is something that will be debated for years to come, and we will only broach the surface of this debate herein as it goes beyond the scope of the present chapter. Opinions are certainly divided on whether bail-outs are the appropriate way to deal with fiscal crises inside the Eurozone.

On the one hand, there are arguments in support of core Eurozone member states (e.g., Austria, Belgium, France, Germany, Luxembourg, and the Netherlands) abandoning those on the periphery – like Greece, Ireland and Portugal – that are experiencing fiscal difficulties. Without financial assistance, the countries on the periphery would eventually be forced to default and, as a result, give up the euro and reintroduce their national currencies (or form their own monetary union). Proponents of this viewpoint argue that only then would true optimal currency areas exist in the EU,[3] because periphery economies are not synchronized with those of the core and, therefore, should not share a common currency and monetary policy (e.g., Feldstein, 2012).

On the other hand, there are those who argue that EU institutions and Eurozone leaders did the right thing in providing bail-out funds to Greece, Ireland and Portugal and setting up the European Financial Stability Facility (EFSF) and European Stability Mechanism (ESM).[4] Otherwise, the Eurozone banking system would have experienced a serious crisis, because Eurozone banks hold the majority of the sovereign bonds issued by Eurozone member states. Defaults by Greece, Ireland and Portugal would have caused serious losses to the Eurozone banking system, creating a panic and credit freeze, such as the one that occurred in the Fall of 2008, when the global financial crisis reached its apex. Investor panic would also spread to Spanish and Italian sovereign bonds, as a result of a contagion effect, which would only compound the crisis. The entire financial system would be jeopardized, and the EU would face another deep recession, just when Member States' economies were beginning to recover from the previous crisis. As during that crisis, EU governments would then have to intervene again by providing financial assistance to their banking systems, while the European Central Bank (ECB) would have to provide massive amounts of liquidity to the financial system. Given the existing weakness among both financial institutions and governments' fiscal capacities, it would not be at all clear that governments and the ECB would have the means to manage the crisis and prevent a great European depression from happening. As a result, the Eurozone and the EU would be at great risk of completely imploding, whereby every EU government would run for the exits and try to save its economy and financial system. History would repeat itself, as such behaviour would be akin to what happened during and following the Great Depression in the 1930s (e.g., see: Eichengreen, 1992).

Given these dire prospects, it seems fair to conclude that providing financial assistance to only a few Eurozone member states, in order to prevent an economic meltdown, was a less risky and less costly option. Furthermore, this approach offered the opportunity to use the bail-outs to finally effect much needed reforms in countries like Greece and Portugal, by imposing strict conditions for the assistance. Let's now examine whether the conditionality programs for Greece, Ireland and Portugal are appropriate under their particular circumstances.

Are the Conditionality Programmes Appropriate?

The now infamously named 'PIIGS' countries (Portugal, Ireland, Italy, Greece and Spain) all faced difficult fiscal situations, even if they were in fact not identical (see: Figures 1 and 2). For instance, Spain's public debt has remained well below the Eurozone's average, and was still within the Stability and Growth Pact's limit of 60 per cent of GDP in 2010; however, its fiscal deficit jumped substantially in 2008 and 2009. As for Italy, although its public debt is the second highest after Greece's, its fiscal deficit is the lowest among the PIIGS and has remained below the Eurozone's average since 2008. Consequently, its public debt has increased less rapidly than in other Member States. But looking at debts and deficits is not enough to understand the fiscal crises.

INSERT FIGURES 1 AND 2 APPROXIMATELY HERE

There are two other factors that need to be considered, in tandem with debts and deficits, in order to fully appreciate the extent to which each member of the 'PIIGS' quintet was in trouble and, consequently, what economic remedies needed to be applied. These two factors are the economy's overall competitiveness, and the degree to which domestic banks made loans to the private sector as a function of the size of the economy. According to Figure 3, as the global financial crisis erupted, Greece and Italy had the least competitive economies among the PIIGS, but their banks were also less exposed to the national economy's performance. On the other hand, Ireland had the most competitive economy but its banks were 2.5 times more exposed to the economy's performance than those of Greece and Italy. As for Spain and Portugal, they stood in between Ireland on the one hand and Greece and Italy on the other. Thus, each country's economic situation at the beginning of the financial crisis, when combined with its level of public debt and the trend in its fiscal performance, explains in good part the outcomes described earlier.

INSERT FIGURE 3 APPROXIMATELY HERE

In the case of Greece, a high public debt with a growing fiscal deficit, owing to uncontrolled spending, tax evasion and low competitiveness, made investors panic and refuse to buy Greek sovereign debt at a sustainable rate of interest. This is why the solution to Greece's problems was to drastically cut government spending, significantly lower tax evasion and introduce reforms that would allow the economy to become more competitive. In Italy's case, the deficit has remained relatively low and the public debt stable; consequently, investors have not forced a bail-out by asking for very high yields. Nonetheless, investors have signalled concern about the low competitiveness of the Italian economy and the associated lack of economic growth by requiring higher yields to buy Italian sovereign debt. Without a decent rate of growth, it has been difficult for the government to see fiscal revenues increase while justifying cuts in welfare spending to balance the budget. This is why Italy's public debt has remained stable throughout the first decade of the 21st century (see: Figure 1) and why it is likely to remain so without appropriate structural reforms, which are needed to make the economy once again competitive.

With regards to Ireland, the problem has not been competitiveness or the government's fiscal performance; it has been a banking crisis caused by the bursting of a major real estate bubble. In Figure 3, we observe that Irish banks had the highest level of exposure to the domestic economy. In addition, their lending had served to fuel a housing boom. According to Hibers et al (2008, p.13), real house prices in Ireland experienced the second largest increase in Europe since 1985, after Spain, with the majority of the increase occurring after 1995. So when the banks went bust, the Irish government had to bail them out to save the financial system, which added close to 50 per cent of GDP to the public debt. This means that the formula for Ireland to bring public finances back to health has been, first, to get the banking system on its feet as quickly as possible, so that it no longer needs the government's help, and, second, to reduce the deficit by cutting government spending and, where possible, increasing tax revenues. These measures are meant to help stabilize the public debt, so that it can begin to decrease again once economic growth returns. In the Irish case, only minor structural reforms should be necessary to make the economy even more competitive.

For Portugal and Spain, as already mentioned, their situation is in between that of Ireland on the one hand, and Greece and Italy on the other. As opposed to Portugal, the only reason why Spain has not been forced (yet) to request a bail-out from the EU and the IMF is because its public debt has remained much lower. The main shadow hanging over Spain has been the continuing weakness of regional and local savings banks, as a result of the bursting of a housing bubble, and the extent to which the government must offer them additional financial assistance and, therefore, add to the public debt. Although Portugal did not have a housing bubble as in Spain (see: Hibers et al, 2008), its banks were similarly exposed to the national economy, and the latter's weakness could force the government to intervene. Since the public debt is about 20 percentage points of GDP higher than in Spain, such intervention could be problematic. Moreover, since the Portuguese economy is less competitive than that of Spain, the fiscal consolidation effort must be greater. Therefore, in the absence of a political consensus on fiscal austerity measures and structural reforms, sovereign bond investors simply panicked – by demanding very high yields for buying Portuguese debt – as they could not see how Portugal's government would achieve fiscal sustainability. The EU-IMF bail-out put the necessary pressure on Portuguese politicians to achieve a political consensus on necessary economic adjustments.

Let's now examine the conditions imposed by the EU and the IMF on Greece, Ireland and Portugal in exchange for receiving bail-out funds and assess whether the content of these economic adjustment programs has in fact been appropriate given each country's circumstances. The Greek program has both short term and medium term commitments to restore fiscal sustainability (European Commission, 2010a). In the short run, the program's aim involves a number of fiscal measures to shrink the country's fiscal deficit in order to stabilize public indebtedness and restore confidence in financial markets. On the expenditure side, the Greek government has committed itself to cutting government expenditures by seven per cent of GDP over the rescue package's duration (i.e., between 2010 and 2013).[5] This reduction in (over)spending is to occur mainly through cuts in public sector wages, employment and pensions. Social programs are also to be reviewed in terms of their appropriateness. On the revenue side, the most important measures adopted by the Greek government were immediate increases of the value-added tax (VAT) rate, from 21 per cent to 23 per cent, and of excise taxes on fuel, alcohol and cigarettes, by ten per cent. Moreover, the government undertook to aggressively tackle tax evasion, which is notorious in Greece.[6]

The adjustment program also includes several structural reforms to the Greek economy, in order to render the latter more competitive in the medium term. These reforms focus on the labour and services markets. For instance, regulations are to be made more flexible so that high unemployment groups, like the young and women, may more easily enter and stay in the formal labour market. In terms of services (e.g., tourism, education, retail, transportation, energy, and professions), regulations are also to be made more flexible through liberalisation, in order to increase competition and to lower prices. For example, Greece was the only country in the EU that restricted entry into the national trucking transportation market and fixed freight rates (Barnard, 2010). The adjustment program also envisages cutting government red tape, in order to reduce the administrative burden that Greek businesses face as they go about their operations and investments.[7]

According to reviews conducted jointly by the European Commission, the IMF and the ECB, the Greek government generally complied with its Economic Adjustment Program in the year that followed the bail-out agreement (see: European Commission, 2010b, 2010c 2011a). This good performance allowed Greece to receive a total of €65 billion in financial assistance as of July 2011. Nevertheless, in spite of the significant progress achieved by the Greek government, the latter has been pressured to do more in terms of fiscal consolidation, since fiscal deficits were higher than expected in 2009, 2010 and 2011 because of deeper recessions than originally anticipated. As a result, the government had to agree to additional fiscal measures of 2.5 per cent of GDP for 2011, over and above those already agreed in May 2010. For the period 2012-14, it had to find an extra six per cent of GDP in new revenues and/or lower spending in order to meet the May 2010 adjustment program's targets for fiscal deficits. This new wave of austerity, in a context of growing unemployment and continued negative economic growth, has only served to enhance an already deep sense of resentment among the Greek population, which makes the implementation of reforms even more difficult. Consequently, sovereign bond investors became increasingly convinced that Greece would not be able to stabilize its fiscal situation and that a restructuring of its debt (or outright default) was the only option. In June 2011, Greece's credit rating was again downgraded, making it the lowest sovereign rating in the world (Oakley and Spiegel, 2011), with a negative outlook towards default (which is the lowest possible rating: D). In response, Eurozone member states and the IMF agreed on a new rescue package that would add more than €100 billion to the existing one, which would allow Greece to meet its public debt commitments until 2015, if not beyond. This package eventually came to be associated with a restructuring of Greece's sovereign debt, whereby private sector investors were asked (with incentives) to voluntarily accept to extend the maturities of their Greek bond holdings, as well as decrease the nominal rates of interest on those bonds. This restructuring of Greece's sovereign debt amounted to about a 50 per cent loss in the value of the holdings of Greek bonds by private sector investors. In spite of this agreement with private-sector investors, there remained, at the time of writing (January 2012), much uncertainty surrounding the ability of the Greek government, now led by former central banker Lucas Papademos, to stabilize Greece's fiscal situation given the depth of the ongoing recession and the heavy political opposition by labour unions and other industry groups to fiscal and structural reforms. In spite of significant accomplishments in terms of fiscal and structural reforms, progress remained insufficient and it was evident that Greece would not be able to meet the medium term objectives set in its adjustment program. The adjustment process and the bail-out period were likely to be extended beyond the current 2015 deadline.

In Ireland's case, in exchange for receiving financial assistance from the EU and the IMF in November 2010, the government unveiled a new four year fiscal consolidation plan,[8] which aimed to reduce the fiscal deficit by €15 billion by 2014, in order to bring it back to a more sustainable three per cent of GDP (Ireland, 2010). The largest part of this deficit reduction exercise was to come in the form of cuts to public spending. This is because government revenues were already hurting, not only owing to the general slowdown of the economy, but also due to the particular difficulties experienced by the financial and construction sectors.[9] For 2011 and 2012, the government planned to cut spending by €6 billion, through reductions in social welfare payments, public service employment and pensions, general purchases of goods and services, and lower capital expenditures. In addition, the Irish government undertook to continue reforming its financial sector, as well as introducing structural reforms to its labour market and domestic services sector (e.g., legal and pharmacy professions). For instance, the national minimum wage was set to be cut by €1 per hour, in order to facilitate hiring by firms. Unemployment and social assistance benefits were also expected to be restricted, in order to create stronger incentives for people to seek paid work, while decreasing pressure on the public purse. In a sense, the idea behind the cuts seemed to be that the Irish welfare state should go back to what it was before it became unduly generous along with the real estate bubble (Alderman, 2010). Overall, the Irish adjustment program appears to have been successful, since economic growth returned in 2011, aided by strong exports. In addition, in spite of lower tax revenues, the Irish government managed to bring its budget deficit for 2011 below the target set by the program. Although Ireland's economic growth forecast was lowered for 2012, as a result of an expected global economic slowdown, most especially in Europe, the European Commission and the IMF remained confident that the Irish government would reach its fiscal deficit target of three per cent of GDP by 2015 (European Commission, 2011b). There were even expectations that the Irish government would return to the financial markets to raise funds by the first half of 2013.

As with Greece and Ireland, the Portuguese bail-out package included a series of undertakings that the government had to commit to in order to receive the promised funds at various intervals over the program's three year duration. These 'conditions' were based on the same general approach (or strategy) as the one applied to Ireland: fiscal consolidation, economic competitiveness, financial sector stabilization; however, in Portugal's case, the relative emphasis was on competitiveness, rather than on financial sector stabilization, with fiscal consolidation playing the same role as in Greece and Ireland (see: Portugal, 2011). Just as in Greece, Portugal's economy had been suffering from a lack of competitiveness for quite some time, making for sluggish economic growth, which in turn led to repeated fiscal deficits and a growing public debt (see: Figures 1 and 2).

In terms of fiscal policy, the goals were to reduce the deficit to three per cent of GDP in 2013, from 9.1 per cent in 2010 (see: Figure 2). Such a deficit reduction was to be achieved through both spending cuts and revenue increases. On the expenditure side of the ledger, savings were to come from a freeze in public employee wages, improvements in the effectiveness and efficiency of the public administration (including the healthcare system and state-owned enterprises), as well as reductions in government services, transfers to public bodies and local/regional authorities, subsidies to private producers, public service employment and benefits (including pensions), and capital investments. On the revenue side, gains were to come from reductions in corporate tax deductions and special regimes, as well as personal income tax benefits and deductions. Additional revenues were also to be generated by increases in the VAT as well as excise taxes on cars and tobacco.

In terms of structural reforms to make the Portuguese economy more competitive, the conditionality program envisaged reforms to the labour market, as well as to the good and services markets. With respect to improving the competitiveness of Portuguese labour, the government committed itself to, for instance, revising unemployment benefits so as to cap their duration at no more than 18 months, while their value would decline over time, except for certain categories of self-employed workers. The government also planned to make it easier for firms to hire and fire employees, while ensuring that severance payments were in line with the EU average. In addition, the government was required to improve the quality of its secondary and vocational education system, as well as its training and support schemes for the unemployed. As for goods and services markets, the Portuguese government was tasked with, *inter alia*, liberalizing its energy (gas and electricity), telecommunications, transport, postal and professional sectors, in accordance with existing EU legislation. Finally, it was deemed necessary for the government to improve the overall business environment, namely making public administration more efficient and effective and removing any special protection from competition accorded to certain sectors or (public and private) enterprises.

According to the European Commission (2011c), the Portuguese adjustment program was generally going well, although significant challenges remained. The main challenge pertained to achieving the targeted fiscal deficits in 2011 and 2012, as it was proving more difficult than expected to rein in government spending. Moreover, it was expected that the Portuguese economy would fall into recession as a result of a slowdown in global economic activity, which would hurt exports. However, the arrival in June 2011 of a new centre-right government strongly committed to fiscal and structural reforms was expected to make it easier to achieve the program's medium term objectives. Based on the new government's budget, the Commission expected that Portugal would meet its targeted deficit of 4.5 per cent of GDP in 2012, in spite of a recession projected to be more pronounced than originally forecast by the program.

Conclusion

The economic adjustment programs imposed on Greece, Ireland and Portugal by the EU and the IMF are generally in line with the lessons offered by past fiscal consolidations, where deep cuts in current government expenditures and structural reforms to make the economy more competitive are deemed essential to a successful outcome. These are certainly the main elements contained in the Greek and Portuguese programs, although tax evasion is a major issue for the Greek government on the revenue side. In the Irish case, deep cuts in public spending are at the core of the adjustment program; however, structural reforms are less predominant than in Greece and Portugal, since the economy is already quite competitive. Cleaning up the financial system to make it self reliant again is much more important. It is important to note that, although they set yearly targets for fiscal deficits, the programs in fact aim to achieve medium term objectives, which are the expected results to be achieved once the program is completed. Furthermore, assumptions about forecasted economic growth and external demand for exports are also revised on a biannual basis. Hence, in line with Mauro's (2011) conclusions, the adjustment programs have flexibility built into them.

The main issue that the adjustment programs are facing are not so much popular opposition to the required fiscal and structural reforms – after all, new governments were elected in Ireland and Portugal on the basis of their commitment to implementing the programs – but deeper than anticipated recessions, which then make achieving the fiscal deficit targets more difficult and, as a result, create a demand for greater austerity, potentially pushing growth further downward. One of the main reasons for this state of affairs is the fact that many EU governments have adopted austerity measures at the same time, something that the literature on fiscal consolidation does not address. As a result, there is less opportunity for governments to get out of their fiscal mess through strong external demand for exports, which is what has happened in many successful consolidations in the past (see: Mauro 2011).

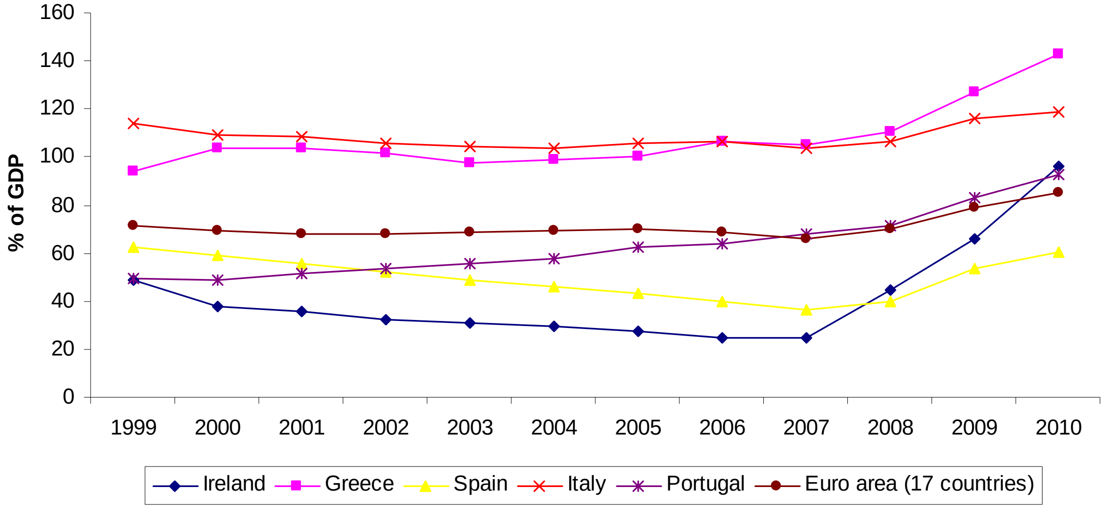
This is why some analysts of the euro crisis have argued that the German government should do more to stimulate its economy so that it can act as a locomotive for other Eurozone countries that have to stabilize their debts and reduce their deficits (e.g., Matthijs and Blyth, 2011). The problem, however, is that it is politically difficult to convince German voters that they should not only provide financial assistance to governments of countries facing fiscal crises, but they should also spend more and, in a way, indebt themselves collectively to stimulate economic growth in the Eurozone. The alternative for Germany, on the other hand, is to provide financial assistance to these countries for longer than originally anticipated as they take more time to reduce their deficits, given that overall economic growth in the euro area is slower to revive.

This is why an intergovernmental approach, as described by Ross in this volume. is ultimately counterproductive. What is needed is a more integrated or supranational approach to fiscal policy in the Eurozone, if not the EU. Such an approach includes not only coordinating national fiscal policies (e.g., through approval of budgets by the Council of Ministers on a recommendation of the Commission), but also creating commonly issued eurobonds. In the latter case, to be effective at keeping interest rates low for all, the eurobonds would have to be issued by a supranational agency that would only issue them for a Member State if fiscal sustainability of the public debt had been ascertained. This is the only way to deal with the moral hazard problem of jointly-guaranteed bonds by all Member States; Member States would thus be prevented from free riding on the system by issuing too many bonds (similarly to the 'tragedy-of-the commons' problem as originally identified by Garrett Hardin [1968]).

Although important steps were taken in this direction at the December 2011 meeting of the European Council, namely in terms of greater fiscal policy coordination, more needs to be done, especially with respect to eurobonds. In spite of Ross' (this volume) scepticism that the EU can move positively in such a direction, we can expect that sovereign bond investors will continue to put pressure on EU/Eurozone governments to achieve a greater degree of fiscal integration at the EU or Eurozone level. The bail-outs may have been successful in preventing outright sovereign defaults and keeping the euro intact, but at the time of writing the 'PIIGS' countries were still facing major fiscal and economic challenges that financial markets were bound to react to for the foreseeable future. The euro's 'fat lady' has yet to sing.

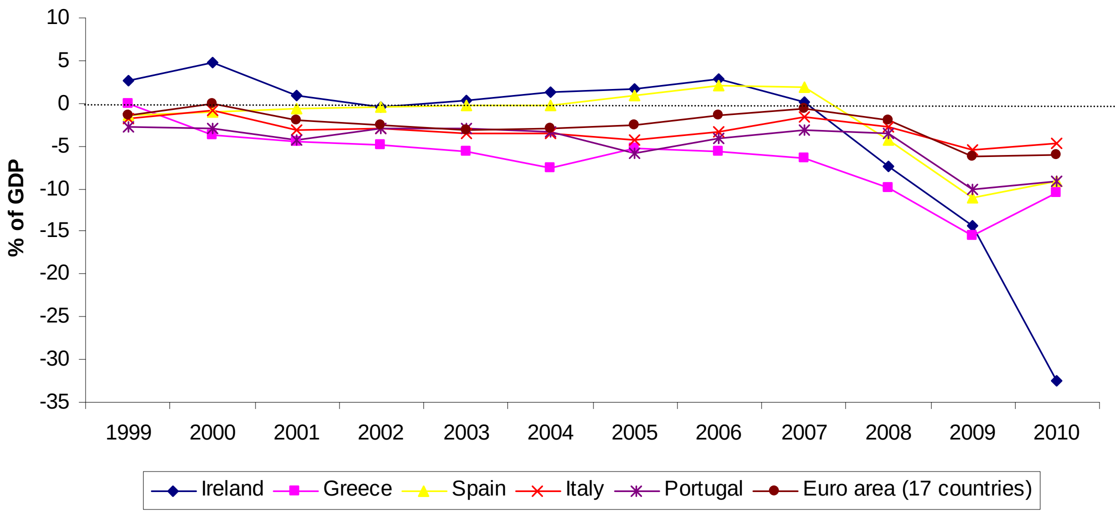
Figures

Figure 1: General Government Gross Debt (% of GDP)



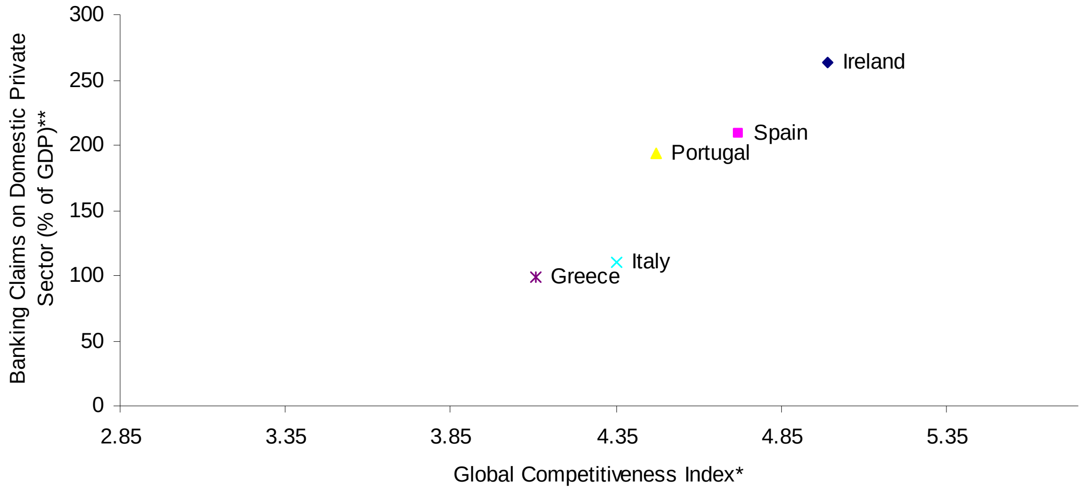
Source of data: Eurostat
(http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&init=1&plugin=1&language=en&pcode=teina225 [accessed 15 March 2012])

Figure 2: General Government Deficit/Surplus (% of GDP)



Source of data: Eurostat
(http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&init=1&plugin=1&language=en&pcode=tsieb080 [accessed 15 March 2012])

Figure 3: Economic Situation of the 'PIIGS' at the Beginning of the Financial Crisis



*2008-2009 **2008 (end of year)

Sources of data: Global Competitiveness Index: World Economic Forum, Global Competitiveness Report 2008-2009, p. 10 (https://members.weforum.org/pdf/GCR08/GCR08.pdf [accessed 15 March 2012]); Banking Claims on Domestic Private Sector: International Monetary Fund, International Financial Statistics (Claims on other Sector/GDP, Line 22s.u/Line99b)

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End Notes

[1] It is true that cutting social welfare benefits is likely to have a negative impact on economic growth as individuals' consumption is reduced; however, if unit labour costs decrease and it leads to greater employment in the private sector, then the negative impact on consumption will be nullified. Moreover, lower labour costs are likely to stimulate investment in the national economy, which will be beneficial to growth. The real issue is one of timing, in terms of the time lag between the removal of social welfare benefits and the positive private sector employment impact following reduced labour costs (see below for a discussion of the this issues).

[2] There are instances where taxes can actually improve competitiveness, especially if they replace more inefficient taxes. According to a study by Widmalm (2001), some taxes have a negative impact on economic growth while others can have positive effects.

[3] For details on the theory of optimal currency areas, see: Kenen and Meade (2008, Chapter 2). In a nutshell, the theory aims to identify the conditions that would mitigate the limited degree of synchronicity between economies should they adopt a common currency. An optimal currency area is one where either the economies are synchronized in terms of their boom-bust cycle or they possess the necessary conditions that mitigate the absence of synchronicity.

[4] For details on the EFSF and ESM, see: Leblond and Paudyn (2011).

[5] In late June 2011, the Greek rescue package was extended to 2015 and beyond, if necessary.

[6] Greece's informal economy is estimated to range between 20-25 per cent of GDP (Katsios, 2006).

[7] According to the World Bank, Greece ranked 109th out of 183 countries in terms of the ease of doing business in 2010 (http://www.doingbusiness.org/rankings).

[8] The Irish government had already adopted €14.5 billion worth of spending cuts and tax rises in order to quell the mounting deficit. In spite of these measures, the deficit was still slated to reach 12 per cent of GDP in 2010, not including bail-out funds to the banking sector (The Economist, 2010, p.79).

[9] Tax revenues dropped by €14 billion between 2007 and 2009 (The Economist, 2010, p.81).