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The Role of both IMF and ECB in the current European Economic Crisis: A Critical Essay

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ABSTRACT

The International Monetary Fund (IMF) would well be embracing for a US$400 billion fund raising to boost a global firewall. The injected funds rose from the various emerging power such as Britain, South Korea, Australia, Russia, Brazil, Japan, US, and other parts of European countries, etc are committing enough funds to fulfill IMF chief Christine Lagarde's request for at least US$400 billion to draw a line under the euro-zone crisis. (The Straits Times, World Money, pp. C12, April 21, 2012)

Keywords: *Global crisis, euro zone crisis, International Monetary Fund, European Central Bak, Greece*

1. INTRODUCTION

IMF has warned that the euro zone's debt crisis presents the gravest risk to the global economic expansion, and financial markets worry that Spain and Italy may next require bailouts, following Greece, Ireland and Portugal. Many believe a fortified IMF firewall will hardly inspire confidence in European's economy. Singapore has pledged $5b to IMF's emergency loan fund, as part of measures to help the global lender tackle any fresh financial crisis as it seeks extra firepower to deal with the European debt crisis. (Source: The Straits Times, Front page. April 21 2012)

There are threats that the European debt crisis might turn into a global financial crisis in recent months, and there are still worries about the ability of Spain and Italy to settle their debts. In the past few weeks, Spain and Italian bond yields have risen, which signals that investors are not convinced that the two countries will be able to pay off their debts. (Source: The Straits Times. April 21 2012)

Since November 2011, the European Central Bank (ECB) has reduced its policy rates and undertaken two injections of more than €1 trillion of liquidity into the euro zone banking system. The led to a temporary reduction in the financial strains confronting the debt endangered countries on the euro zone's periphery such as Greece, Spain, Portugal, Italy and Ireland, sharply lowered the risk of a liquidity run in the euro zone banking system, and cut financing costs for Italy and Spain from their unsustainable levels of last fall.

At the same time, a technical default by Greece was avoided and the country implemented a successful if not coercive restructuring of its public debt. A new fiscal impact and new governments in Greece, Italy and Spain spurred hope of credible commitment to austerity and structural reform. The decision to combine the euro zone new bailout fund which the European Stability Mechanism with the older ones – the European Financial Stability Facility may have significantly increased the size of the euro zone's firewall. But these activities would only be temporary brief ones.

2. WIDENING OF THE RECESSIONARY GAP

Interest rate spreads for Italy and Spain are widening while borrowing costs for Portugal and Greece remained high all along. Inevitably, the recession on the euro zone's periphery is deepening and moving to the core, namely France and Germany. As when the recession get worsen throughout this year, attributed from the cause of many other reasons. First, the front loaded austerity however necessary is accelerating the contraction as higher taxes and lower government spending and transfer payments reduce disposable income and aggregate demand. As recession deepens, there is another round of austerity would be needed. For the euro zone periphery, the value of the exchange rate would have to fall to parity with the US dollar to restore competitiveness and external balance.

With the painful de-leveraging spending less and saving more to reduce debts, in depressing domestic private and public demand, the only hope of restoring growth is an improvement in the trade balance which requires a much weaker euro. The credit crunch in the euro zone is intensifying, attributed from ECB's longer-term cheap loans, where banks do not a liquidity problem, but a massive capital shortage now. As Europe is facing with the difficulty of meeting their 9% capital ratio requirement, they will achieve the target by selling assets and contracting credit, which is not an ideal scenario for economic recovery.

The matter gets worse off when the euro zone depends heavily on its oil imports which is even more than the US does, and oil prices are rising, even as the political and policy environment is deteriorating fast. As France may elect a President who opposes the fiscal compact and whose policies may scare the bond markets. Greece on the other hand, have an elections which may give about 50% of the more popular vote to parties that favour immediate default

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and exit from the euro zone. Irish voters may reject the fiscal compact in a referendum and signs of austerity and reform fatigue both Spain and Italy where demonstrations, strikes and popular resentment against painful austerity are mounting. There are structural reforms that will eventually increase productivity growth can be recessionary in the short run such as the increasing labor market flexibility by reducing the cost of shedding workers will lead in a short run to greater layoffs in the public and private sector.

The point is that the euro zone has an austerity strategy but no growth strategy. Without that, all it has is a recession strategy that makes austerity and reform self defeating. This happens if output continues to contract, deficit and debt ratios continue to rise to unsustainable levels. Thus the social and political backlash eventually will become more overwhelming. This account for the reason why interest rate spreads in the euro zone periphery are widening again. The peripheral countries suffer from severe stock and flow imbalances. The stock imbalances include large and rising public and private debt as a share of GDP. The flow imbalances include a deepening recession, massive loss of external competitiveness and the large external deficits that markets are now unwilling to finance. Without a much stabilized monetary and fiscal policy, the euro will not weaken, external competitiveness will not be restored and recession would run deeper that results in more euro zone countries will be forced to restructure their debs, and or exit the monetary union (N. Roubini, 2012).

The Fiscal policy is to ensure fiscal stabilization, which is used as an instrument of economic policy to achieve the various EU's macro-economic objectives so as to stabilize market price, economic growth and reduce unemployment rate.

The European Central Bank (ECB) uses its monetary policy to control price inflation and market stability. This means the ECB will have a very rigid system of independent policy on their European exchange rate. It would be necessary to fine-tune the various economy factors by using the fiscal policy to regulate certain practical difficulties. Doing so, would involve some very long time lags and the time taken on policy matters before any gaps are closed. (Friedman, 1953).

There are issues from the multinational framework from Economic and Monetary Union (EMU) in the European Union (EU). The changes needed in governmental expenditure and taxation could undermine any efficiency of government policy. It is therefore necessary for EMU to be established a foothold on the ground of fiscal positions close to any balance so that automatic stabilizers could operate effectively. (Buti and Sapir, 1998).

The severe macroeconomic problems across the European zone areas or Eurozone would require a good fiscal equation as well as a balanced monetary policy to response to the arising issues. In application of the Keynesian theory over an economic depression however, interest rates must not fall lower to certain conditions so that monetary policy could offer a positive boost to economic activity.

There are suggestions that the problems of economic deflation, currency speculation and unemployment have certain influential and correlation to the 1990s (Krugman, 1999). Therefore, economic deflation and money wage inflexibility with a fiscal activity boost would be necessary to restore the confidence of institutional investors (Sims, 1999).

Fiscal policy is needed in this condition because other adjustment mechanisms like real wage changes may not be adequate. The Stability and Growth Pact (SGP) makes no provision for coordination of the fiscal policies and have little maneuvering activities especially the inability to reduce deficits to balance.

The SGP is viewed as a necessity tool to achieve a complementarily linkage to the monetary and fiscal policy which would reinforce the credibility of the ECB which comments with certain advantages such as it has a legal independence but however, it lacks the needed publicity support and other stability culture which has otherwise been called an 'empty shell' (Artis and Winkler, 1998). The un-cooperative behavior of the central bank and the fiscal authorities may undermine economic policy (Hall et al, 1999, Andersen and Dogonowski, 1999). "Sound government finances are crucial to preserving stable economic conditions in the Member States of the Community.

They lessen the burden on monetary policy and contribute to low and stable inflationary expectations such that interest rates can be expected to be low." (Ecofin, 1996; para 18).

The SGP has a centralized authority but limited in relation to a particular member. As there is no single fiscal authority for the creation and adjustment within the Euro-zone, which would otherwise give rise to one possible advantage of which there is no direct institutional competitor for ECB. Thus the creation of a serious policy gap at the European level and with the interdependence of a stable monetary policy and fiscal policy (Sims, 1999).

The European authority is thus seen as having a responsibility for its monetary and fiscal policy fragmented and a potential possibility for a policy change which would become evolving between the fiscal and monetary authorities (Nordhaus, 1994).

Varying degree of preferences with the fiscal

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authorities would have a various combination of unemployment and inflation would create a correlation and possible of an output-inflation trade-off while the monetary authorities are based more on price stability. The assumption thus kicks in where there are two instruments of economic policy- monetary policy, which is represented by interest rate (I/r), and fiscal policy which is from the public sector deficit.

Whenever there are differences in preferences between the monetary and the fiscal authorities, the non-cooperative regime is ascertained as monetary dominance and fiscal dominance (Canzoneri and Diba, 1996). Monetary dominance would relate the central bank is ensuring of price stability and forces the authority to adjust its spending and taxes while Fiscal dominance would relate the authority decides its net deficit and the central bank would print money to finance those deficits.

The excessive deficit system can be seen as reinforcement of the market, which has a belief that the primary surplus would respond quickly to a rising debt thus heading off any need for inflationary bailouts. The SGP is now seen to build some of ECB's credibility by reinforcing additional mechanism to ensure monetary dominance. On the other hand, it helps to limit the possibility of a conflict between the leadership of monetary and fiscal policy, which can be effectively costly as witnessed by the contradictory policy pursued by the authority of German and Bundesbank after German unification. Ever since the fiscal authorities have set a certain regulation under which monetary policy operates in EMU, it is already running in parallel along the lines of national governments' long term preferences.

The fiscal policy preferences can be embedded in the SGP, which in effect dominates over what the long run fiscal stance have to be. In such a case monetary policy would impose costs for a deviation from the agreed policies, thus this potential cost becomes a deliberate and necessary part of the system.

The process of multilateral crosscheck and surveillance in the SGP and the broad economic policy guidelines would ensure that fiscal policy achieves those desirable outcomes. The Luxembourg, Cardiff and Cologne processes consolidated at Lisbon seek to ensure structural reform and flexibility. This ensures that the long term fiscal and monetary positions are consistent with the desired performance of the economy in terms of growth, interest rate and employability.

The long-term cooperative solution does not offer a long term solutions to the problems in the short term under two varying circumstances. Firstly any fiscal consolidation may require a budget surplus where public finances could be in extreme tight. This is a transitional issue but given the size of some countries' debts the situation could persist.

The recent experiences of the Eurozone and the UK are interesting, as the Euro zone countries have gone through a fiscal retrenchment to meet the requirements of convergence and the SGP. There are also high levels of unemployment and subdued inflation would lead to an easing of interest rates. The incidence from 1995 to 1999 was a falling value of the currencies that make up the Euro and since then in 1999 a falling value of the Euro. The falling real exchange rate was helpful in the mid-1990s as a catalyst to kick start growth in 2000 in the EU which it has become a problem. It is undermining the credibility of the ECB and is a factor in the upward creep of inflation.

3. GREEK EURO ZONE LEAVES OF ABSENCE

The Greek government, the European Commission, and the International Monetary Fund are all denying what markets perceive clearly: Greece will eventually default on its debts to its private and public creditors. The politicians prefer to postpone the inevitable by putting public money where private money will no longer go, because doing so allows creditors to maintain the fiction that the accounting value of the Greek bonds that they hold need not be reduced. That, in turn, avoids triggering requirements of more bank capital.

But, even though the additional loans that Greece will soon receive from the European Union and the IMF carry low interest rates, the level of Greek debt will rise rapidly to unsustainable levels. That's why market interest rates on privately held Greek bonds and prices for credit-default swaps indicate that a massive default is coming.

And a massive default, together with a very large sustained cut in the annual budget deficit, is, in fact, needed to restore Greek fiscal sustainability. More specifically, even if a default brings the country's debt down to 60% of GDP, Greece would still have to reduce its annual budget deficit from the current 10% of GDP to about 3% if it is to prevent the debt ratio from rising again. In that case, Greece should be able to finance its future annual government deficits from domestic sources alone.

But fiscal sustainability is no cure for Greece's chronically large trade deficit. Greece's imports now exceed its exports by more than 4% of its GDP, the largest trade deficit among euro zone member countries. If that trade gap persists, Greece will have to borrow the full amount from foreign lenders every year in the future, even if the post-default budget deficits could be financed by borrowing at home.

Eliminating or reducing this trade gap without depressing economic activity and employment in Greece requires that the country export more and import less. That, in turn, requires making Greek goods and services more competitive relative to those of the country's trading partners. A country with a flexible currency can achieve that by allowing the exchange rate to depreciate. But Greece's membership in the euro zone makes that impossible.

So Greece faces the difficult task of lowering the prices of its goods and services relative to those in other countries by other means, namely a large cut in the wages and salaries of Greek private-sector employees.

But, even if that could be achieved, it would close the trade gap only for as long as Greek prices remained competitive. To maintain price competitiveness, the gap between Greek wage growth and the rise in Greek productivity – i.e., output per employee hour – must not be greater than the gap in other euro zone countries.

That will not be easy. Greece's trade deficit expanded over the past decade because Greek prices have been rising faster than those of its trading partners. And that has happened precisely because wages have been rising faster in Greece, relative to productivity growth, than in other euro zone countries.

To see why it will be difficult for Greece to remain competitive, assume that the rest of the euro zone experiences annual productivity gains of 2%, and while monetary policy limits annual price inflation to 2%. In that case, wages in the rest of the euro zone can rise by 4% a year. But if productivity in Greece rises at just 1%, Greek wages can increase at only 3%. Any higher rate would cause Greek prices to rise more rapidly than those of its euro zone trading partners.

So Greece faces a triple challenge: the fiscal challenge of cutting its government debt and future deficits; the price-level challenge of reducing its prices enough to wipe out the current trade gap; and the wage-productivity challenge of keeping future wage growth below the euro zone average or raising its productivity growth rate.

Ever since the Greek crisis began, the country has shown that it cannot solve its problems as the IMF and the European Commission had hoped. The countries that faced similar problems in other parts of the world always combined fiscal contractions with currency devaluations, which membership in a monetary union rules out.

A temporary leave of absence from the euro zone would allow Greece to achieve a price-level decline relative to other euro zone countries, and would make it easier to adjust the relative price level if Greek wages cannot be limited. The Maastricht treaty explicitly prohibits a euro zone country from leaving the euro, but says nothing about a temporary leave of absence (and therefore doesn't prohibit one). It is time for Greece, other euro zone members, and the European Commission to start thinking seriously about that option.

4. CONCLUDING REMARKS

The SGP seems responding to the problem by reinforcing the monetary dominance of the ECB over the fiscal prerogatives of national governments. SGP fails when there is no mechanism to provide for aggregate fiscal outcomes that are compatible with monetary policy.

It seems the greater independence of the economic policy achieved through EMU would lessens the potential impact on the Euro zone economy of fiscal policy errors although there is need to coordinate monetary and fiscal policy which may remain largely unresolved it has not been revealed as a fundamental flaw in the design of EMU. However, if an economic depression occurs when its ability to respond to a recession would reveal the questions where there are the lacking of an EMU mechanism to smoothen monetary and fiscal policy conflict.

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