

WRITTEN TESTIMONY
OF

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Madame Chairwoman, Distinguished Members, Ladies and Gentlemen,

Introduction

I am deeply honored to appear before this committee and grateful at the opportunity to express my views on Europe’s sovereign debt crisis at this Public Hearing.

My testimony today aims to present my perspective on the nature of the crisis, to offer my assessment of the EU/IMF crisis response, and to discuss a possible alternative.

Diagnosis: nature of the crisis

I would like to note that the European Union, the world’s largest economy, is presently, a source of great instability to itself and to the world economy. The policy framework put in place through the EU/IMF adjustment programs is, in my view, inconsistent and dangerous.

Europe’s sovereign debt crisis is really a balance of payments and external debt crisis.¹ While the European Union, as a whole, does not have external imbalances to speak of, the external imbalances of numerous individual member countries have reached levels which are unprecedented in prior balance of payments and external debt crises. In fact, Exhibits 1, 2, and 3 suggest that possibly 12 member countries may have excessive net external liabilities.

Many experts would argue that a country could afford to pay and sustain a level of gross external debt of up to about 40% of GDP (Reinhart et al. 2003, Manasse and Roubini 2009). Several EU member countries have levels of net (rather than gross) external debt more than twice that large, much higher than historical precedents (Cabral, 2010). Their external debt is on an unsustainable trajectory. Past precedents indicate that these countries external debt will inevitably be restructured.

The EU/IMF policy response to the crisis

¹ While I focus my remarks on the role of external imbalances and external debt on the sovereign debt crisis, total debt levels may also have been a factor. In fact, private plus public debt levels have reached historically high levels in developed countries.

In recent years, the EU and the IMF have put in place adjustment programs in 6 member countries.² Hungary, Latvia, Romania, Greece, Ireland, and Portugal have high net external debt and, with the exception of Ireland, have or had high trade deficits. Hungary, Greece, Ireland, and Portugal also have high income balance deficits. These arise mainly, but not only, from large interest and dividend payments on the outstanding stock of external liabilities.

$$\text{Net borrowing reqs. (Pub + Prtv)} \cong (\text{Trade} + \text{Income}) \text{ deficits} + \text{other}$$

Now a country's public plus private net borrowing requirements are approximately equal to the sum of the trade and the income balance deficits, plus two other smaller components. Since the intervened countries have high trade and income balance deficits, they also have high net borrowing requirements (Ireland is again the exception).³

The EU/IMF's focus is on measures to reduce and bring budget deficits into compliance with the Stability and Growth Pact targets. However, this is, in my opinion, misguided and counterproductive. To understand why, note that this formula which determines a country's (public plus private) net borrowing requirements is an accounting identity: it is the closest thing in macroeconomics to $1+3=2+2$. The EU/IMF adjustment programs do not sufficiently target reductions in the trade and in the income balance deficits (the two largest components of the affected countries net borrowing requirements). Therefore, it is hard to see how it is possible to lower public sector net borrowing requirements in a sustainable manner. In such a context, budget reduction measures are unlikely to succeed.

For example, Portugal's trade deficit in 2010 was 6.5% of GDP. Its income balance deficit was 4.6% of GDP. Much because of these two large deficits, Portugal's net borrowing requirements (public plus private) were approximately 8.5% of GDP. To achieve a sustainable reduction in the budget deficit, the EU/IMF adjustment program should have targeted a reduction in the trade deficit. If done well, such a reduction would have had a marginal impact in Portugal's economic activity (just about corresponding to the reduction in the trade deficit). In addition, the adjustment program should have targeted a reduction in the income balance deficit through a realistic debt restructuring.

Instead, the EU/IMF adjustment program affects the entire internal demand indiscriminately (106.5% of GDP). It is like using a sledge-hammer to crack a nut. Only by chance or accident, or through drastic reduction of economic activity, will the adjustment program be able to reduce the trade deficit by anything close to 6.5% of GDP and thus achieve, as necessary, a sufficiently large reduction in the country's net borrowing requirements.⁴

In addition, the EU/IMF adjustment programs pay insufficient attention to the income balance deficit. Average interest rate on the peripheral countries' external debt may rise, rather than fall.⁵

² Though not yet an EU member country, Iceland has also requested a stand-by arrangement (\$2.1 billion loan) from the IMF.

³ Ireland's net borrowing requirements and budget deficit are lower in part because Ireland benefits from a large subsidy through Eurosystem liquidity providing operations. I have estimated that the Eurosystem loans resulted in improvements in Ireland's net borrowing requirements of about 4.3% of GDP (Cabral, 2011). Thus, the Irish government budget deficit is probably significantly lower than it would have been otherwise. Moreover, the impact on the IMF/EU adjustment program on the Irish economy is thereby likely softened. Greece and Portugal also benefit from Eurosystem provided liquidity at low interest rates, but in much smaller proportion of GDP.

⁴ Moreover, given the sheer number of measures, the likelihood for policy mistakes is very high.

⁵ The initially agreed interest rates on the EFSF loan was around 5.8%, which was much higher than the average interest rate these countries paid on maturing sovereign debt (Portugal: 3.5% in 2010; Greece: 4.4% in 2009). This issue has been to some extent addressed by the July 21st, 2011 European Council decision that lowered interest rate on EFSF loans to approximately 3.5%. However, the EU/IMF loans only cover a fraction of these countries external borrowing requirements. Some of the borrowing is done through the Eurosystem liquidity

Therefore, the income balance deficits of these countries may increase, putting upward pressure on net borrowing requirements and thus on the budget deficit.

In practice, the EU/IMF adjustment programs are not likely to result in a substantial reduction in net borrowing requirements, but instead in a change in their composition. Public sector net borrowing requirements may fall in the short run, but private sector net borrowing requirements will likely increase. Since the private sector is unable to increase borrowing in the current context,⁶ the adjustment programs will simply result in an unprecedented and pointless destruction of private sector activity. This will cause unnecessary and self-defeating hardship upon the populations of these countries.⁷

Moreover, the EU/IMF adjustment programs, by refusing to consider the option of significant debt restructuring, allow no adjustment through the income balance. Therefore, in practice, the only “safety-valve” through which the affected countries can sustainably reduce their public deficit is through massive improvements in the trade balance. This is tantamount to promoting beggar-thy-neighbor policies. By definition, not all countries can run a trade surplus. The current attempt to do so by a growing number of EU member countries is likely to throw most of the EU into recession.

A possible alternative to reduce budget deficits in the peripheral countries

Ladies and gentlemen, the European Union faces a situation where less is actually more: implementing smaller, more targeted adjustment programs and treading more carefully is likely to yield far better results than drastic action.

The aim of the adjustment effort should be to stabilize the peripheral countries’ external debt levels by reducing these countries’ (private plus public) net borrowing requirements.

I believe the external adjustment effort for the peripheral countries should be designed to minimize the impact on domestic economic activity as well as on the economies’ of these countries trading partners in the EU and elsewhere.⁸

In Portugal’s case, for example, the external adjustment that is currently necessary to stabilize its external debt levels may be around 8% of Portugal’s 2010 GDP. A combined reduction in the trade and in the income balance deficits of that magnitude would, all other things equal, reduce Portugal’s net borrowing requirements to approximately 0% of GDP.⁹ Under these conditions, Portugal would be able to slowly reduce its external debt burden through nominal economic growth. A budget deficit reduction policy would then be far more effective. Moreover, the Portuguese government would be able to fund a far greater proportion of its budget deficit domestically.

About half of the adjustment suggested above should be done through improvements in the trade deficit (through fiscal devaluation policy), with the remainder accomplished through improvements in the income balance deficit (through a debt restructuring).

Fiscal devaluation policy aims at replicating, through the rebalancing of a country’s tax structure, the effect of currency devaluation. In contrast to earlier proposals, the proposal I make (Cabral, 2011)

providing operations at much lower rates. But the remainder is financed at increasingly higher interest rates in the market. Therefore, it seems likely that the average interest rate on these countries external debt will rise.

⁶ Among other reasons, because the EU/IMF adjustment programs mandate the deleveraging of the peripheral countries banking system.

⁷ These businesses failures will also reduce tax revenue exacerbating the situation. This is, by the way, what we have seen in Greece and to some extent in Ireland. It is what we are about to see in Portugal.

⁸ External adjustment by so many countries on the geographic periphery of the EU is nonetheless bound to have a substantial macroeconomic impact at the EU level, and to affect the peripheral countries’ economies harshly.

⁹ This is an approximation. Net borrowing requirements were 8.5% of GDP in 2010. However, the trade deficit has since fallen in part through robust export growth, reducing the country’s net borrowing requirements somewhat.

argues for a far greater rebalancing of the existing tax structure, and argues that VAT rates should be reduced, not increased. The idea is that, since tax and social security receipts represent, on average, around 40% of GDP in eurozone economies, then they represent, on average, the largest cost factor of every single economic activity.

On the demand side, the aim would be to rebalance taxes to increase the price of imports and to reduce the price of domestic products. On the supply side, the aim would be to lower the tax costs of firms in tradable goods and services sectors, and to increase the tax costs of firms in sectors of the economy that do not face international competition.¹⁰

The aim of the debt restructuring would be to lower income balance deficits to more sustainable levels. It could be based mainly on maturity extension and interest rate (coupon) reductions. However, it should be sufficiently large to ensure that the peripheral countries would be able, on their own, to return to the international credit markets, even if subject to much higher interest rates on any new loans. In addition, a US-type bank resolution process (Special Resolution Regime) should be rapidly legislated and implemented (Nguyen and Praet, 2010; Strauss-Kahn, 2010; Cabral, 2010).

Concluding remarks

Ladies and gentlemen, in my concluding remarks I would like to emphasize the need to change course. The current policy response to the crisis is misguided and dangerous. The EU/IMF adjustment programs are bound to fail to achieve sustainable budget deficit reductions. In the process, they will result in an unprecedented and pointless destruction of private sector economic activity. This will result in unnecessary and self-defeating hardship.

The peripheral countries, in practice, can only reduce their budget deficits if they are able to significantly improve their trade and income balances, and as a result, improve their economies' net borrowing requirements. Therefore, the EU policy response to the crisis should explicitly target improvements to these balances.

It should focus on the small share of internal demand associated to the trade deficits, rather than to seek radical changes to the country's entire public and private economic structure. It should also seek to address these countries high external debt directly, through debt restructuring designed to reduce the income balance deficit.

Such an approach is far more likely to succeed by directly addressing what is, in my opinion, the main cause of Europe's sovereign debt crisis.

Thank you for your attention. I am now available to answer your questions.

References

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Manasse, Paolo and Nouriel Roubini (2009), "'Rules of thumb' for sovereign debt crises", *Journal of International Economics*, 78:192-205.

Nguyen, Gregory and Peter Praet (2010), "Which banking resolution authority for Europe?", *VoxEU.org*, 16 April.

¹⁰ This is accomplished through changes in tax rates, rather than through changes in the tax structure. This means that the policy measures could be put in place quickly and would yield results in the short run. In contrast, the EU/IMF adjustment programs foresee so-called structural measures, which, it is argued, might result in improvements in competitiveness in the long-run.

Reinhart, Carmen, Kenneth Rogoff, and Miguel Savastano (2003), "Debt Intolerance", *Brookings Papers on Economic Activity*, 1:1-74.

Strauss-Kahn, Dominique (2010), "Crisis Management Arrangements for a European Banking System: Building a Crisis Management Framework for the Single Market", Keynote speech, European Commission conference on Cross-Border Crisis Management, Brussels, 19 March.

Exhibit 1. Net External debt/ liabilities for 12 peripheral countries are much higher than levels considered sustainable (of up to about 40% of GDP)

Country	Net External Debt Position (- for net creditor) (% of GDP)	Net external liabilities (- for net external assets) (% of GDP)	Country	Net External Debt Position (- for net creditor) (% of GDP)	Net external liabilities (- for net external assets) (% of GDP)
Austria	16.2	-0.6	Latvia	42.1	81.3
Belgium**	-29.5	-44.5	Lithuania	28.3	56.0
Bulgaria	1.8	97.6	Luxembourg**	-2909.7	-82.9
Cyprus	-24.1	10.1	Malta**	-102.0	-13.2
Czech Republic	-7.6	50.5	Netherlands	37.1	-19.9
Denmark	27.9	-9.6	Poland	24.7	63.2
Estonia	24.8	73.3	Portugal	85.3	107.9
Finland	25.3	-6.9	Romania	21.2	63.9
France**	21.5	10.9	Slovakia*	9.0	63.8
Germany	-22.7	-42.0	Slovenia	26.9	37.0
Greece	102.4	98.2	Spain	82.9	87.1
Hungary	51.6	108.0	Sweden	41.7	23.5
Ireland	116.6	99.4	Switzerland**	-114.5	-138.9
Italy	34.9	17.1	United Kingdom	30.0	13.2

Source: National Central Banks/National Statistical Offices IMF SDDS program. Data for 4Q2010, except * 3Q2010 and ** 4Q2009. Net external debt data excludes FDI debt claims. Net external liabilities is the symmetric of the International Investment Position. Ireland: non-IFSC data only. Luxembourg: includes financial center data. See Cabral (2010) for methodology.

Exhibit 2. Peripheral countries with relatively high trade and income balance deficits, but trade deficits have improved

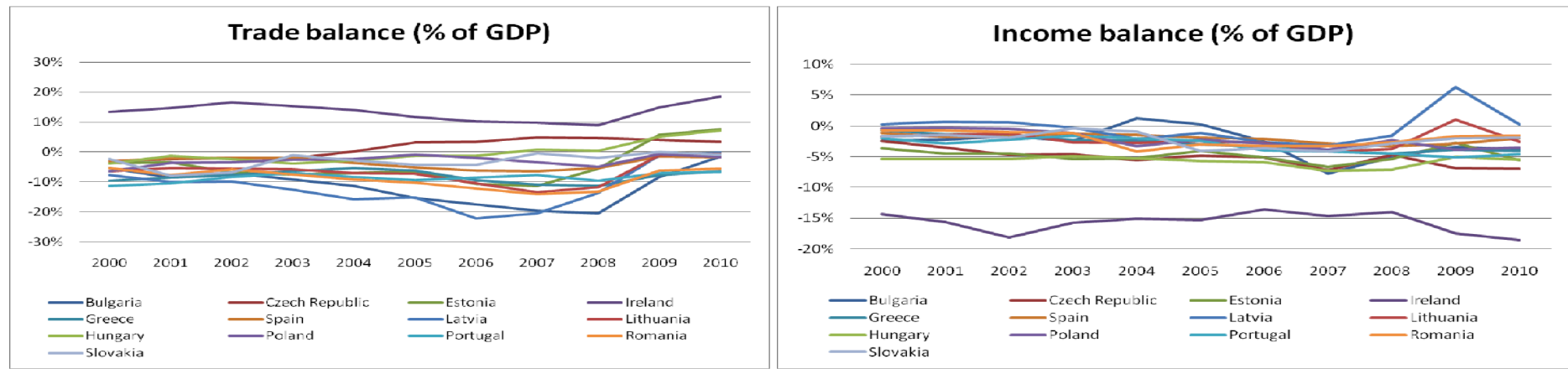


Exhibit 3. Peripheral countries total and public sector net borrowing requirements

