Free Market Road Show
European Stability Mechanism ESM

April 27th 2012
Assoc. Prof. Dr. Barbara Kolm

Austrian Economics Center
A-1010 Wien, Jasomirgottstr.3/4
office@austriancenter.com

Structure

- An Experiment of Thought: All Europeans are equally the same
- Reality Check: Europe means and is Diversity
- Combating the Crisis by ESM, EPP and a “European Economic Government” – other fire brigade ideas and recent developments
- A Solution and a Vision of the Future

„What is prudence in the conduct of every private family can scare be folly in that of a great kingdom."

Adam Smith (1776)

How Does Europe Fit In?

We See Europe as One of the Key Members of the New G7

US

Europe

China

India

Brazil

Russia

Japan

South East Asia

Sub-Saharan Africa

Middle East & North Africa

Europe Together is the Largest Economy in the World –

apart it is Irrelevant

Creeping Socialism in Europe: Government Spending in GDP, 1870-2009

AUSTRIAN ECONOMICS CENTER

It can't go on

Government* spending, % of GDP

1

	1870	1913	1920	1937	1960	1980	1990	2000	2005	2009
Austria	10.5	17.0	14.7	20.6	35.7	48.1	38.6	52.1	50.2	52.3
Belgium	*na*	13.8	22.1	21.8	30.3	58.6	54.8	49.1	52.0	54.0
Britain	9.4	12.7	26.2	30.0	32.2	43.0	39.9	36.6	40.6	47.2
Canada	*na*	*na*	16.7	25.0	28.6	38.8	46.0	40.6	39.2	43.8
France	12.6	17.0	27.6	29.0	34.6	46.1	49.8	51.6	53.4	56.0
Germany	10.0	14.8	25.0	34.1	32.4	47.9	45.1	45.1	46.8	47.6
Italy	13.7	17.1	30.1	31.1	30.1	42.1	53.4	46.2	48.2	51.9
Japan	8.8	8.3	14.8	25.4	17.5	32.0	31.3	37.3	34.2	39.7
Netherlands	9.1	9.0	13.5	19.0	33.7	55.8	54.1	44.2	44.8	50.0
Spain	*na*	11.0	8.3	13.2	18.8	32.2	42.0	39.1	38.4	45.8
Sweden	5.7	10.4	10.9	16.5	31.0	60.1	59.1	52.7	51.8	52.7
Switzerland	16.5	14.0	17.0	24.1	17.2	32.8	33.5	33.7	37.3	36.7
United States	7.3	7.5	12.1	19.7	27.0	31.4	33.3	32.8	36.1	42.2
Average	**10.4**	**12.7**	**18.4**	**23.8**	**28.4**	**43.8**	**44.7**	**43.2**	**44.1**	**47.7**

Sources: Vito Tanzi and Ludger Schuknecht; IMF; OECD

*1870-1937 central government, 1960-2009 general government

No decisions

Who Deserves the Blame?

- In Europe, besides having been affected by the U.S. recession, the crisis is basically a debt crisis.
- The “hidden liabilities” of welfare states within the EU are now obvious and finally need to be dealt with.
- “Socialist governments traditionally do make a financial mess. They always run out of other people’s money”. (Margaret Thatcher)
- Erosion of Creditworthiness of the Euro Member States (Rating Agencies)

Who deserves the blame?

- PIGS-countries have spent more funds in the past decade (thanks to the common currency of the Euro and cheap money) than Northern and Central regions of Europe countries which have acted more responsibly.

- This drift has created a Europe of two paces.

- Economic and Currency Union created a dependency among the players in the Euro area such that a disturbance or bankruptcy of any could pose a systematic risk for the entire EU.

- Thus, PIGS countries lead to a bank crisis in all Europe.

Chicago Tribune 1934

A free society is the form of social organization that best provides prosperity and economic growth.

The same principles that enable a market economy to prosper could also work when applied in a company.

Market economies are highly effective at communicating what people value and how best so satisfy those values, needs and demands.

PORTRAIT
HOW THE NEW RIGHT GAINED ITS POWER
US CONNECTION
The man who is Mrs. Thatcher's bedside reading
HUGH HEBERT meets the veteran economist who counts Mrs Thatcher as a convert
The guru who still aims to get it right
Guardian 28.4.79
TIME
Teddy Kennedy
Carter Says 'Baloney'
Britain's Fighting Lady
Prime Minister Margaret Thatcher
10 DOWNING STREET
LONDON SW1A 2AA
THE PRIME MINISTER
5 May 1989
Dear Professor Hayek
It is with the greatest pleasure that I send you my warm congratulations on the occasion of your 90th Birthday. It is a tremendous milestone, especially for someone who has achieved so much.
It is ten years this week since I was privileged to become Prime Minister. Many people have been most kind in their comments on what the Government has been able to achieve in that time. There is of course still so much to do. But none of it would have been possible without the values and beliefs to set us on the right road and provide the right sense of direction. The leadership and inspiration that your work and thinking gave us were absolutely crucial; and we owe you a great debt.
With every good wish
Yours sincerely
Margaret Thatcher
Professor Friedrich August Hayek, C.H.

The “Age of Hayek” – started the late 1970s

May 20
1978

TIMES PAST
THE TIMES
New Printing House Square, London, WC1X 8EZ. Telephone : 01-837 1234

WHERE KEYNES WAS WRONG

The republication of an anthology of Professor F. A. Hayek's writings on inflation and Keynes is an opportunity to reassess the impact of a man whose greatest influence has come towards the end of his life. The third quarter of this century has been described as "the age of Keynes" not just because of the influence which he had on economics and public policy but also because it was above all a time when his predictions of the beneficial effects which would flow from his policies seemed to be triumphantly justified.

In terms of the economic problems now facing us, the current period might more accurately be termed "the age of Hayek". Inflation has, on occasion, spiralled out of control and is still too high. Attempts to remove unemployment by stimulating demand have become more and more obviously ineffective. Professor Hayek tends to be linked with the other school of opponents of Keynes who are generally described as monetarists and whose chief exponent is Professor Friedman. There are in fact important differences in the economic analysis which underlies his position from the views of traditional monetarism, even though many of the political and social judgments are the same.

At the heart of Professor Hayek's disagreement with Keynes is a concern for the relative movements of prices in the economy rather than the performance of overall aggregates. In practical terms, Keynes made the mistake of arguing that the unemployment which he saw in the 1930s was caused by a simple insufficiency of overall demand when it was in fact caused by the failure of relative prices to adjust to changed circumstances. Attempts to use monetary means to deal with this problem by increasing overall demand would have the exactly opposite effect to that intended. For by increasing in the short run the demand in the economy, the government would be luring more and more workers into a pattern of employment and wages which is not sustainable in the long run.

Attempts to use expansionary means to cure unemployment can only, in Professor Hayek's view, work if the real wages of those in a sector for which demand has fallen are adjusted downwards through a failure of money wages in that sector to keep pace with rising prices. But in a world where society does not have the will or the means to force unions to accept money wage cuts it is most unlikely that it will be possible to bring about real wage cuts through inflation. As unions push for higher wage settlements to recoup the ground governments are forced to induce ever faster inflation. This is the "tiger by the tail" which is pulling the western economies and the societies which rest on them to destruction.

The picture is in many ways a much gloomier one than that which emerges from the writings of some monetarist economists. At the heart of the more optimistic versions of monetarism is the belief that if money supply is kept in check then the market mechanism will work and work relatively painlessly. In order to ease the transition from a period of high inflation to a stable form of economic activity, a gradual rather than a sudden deceleration of the growth of money supply is urged. Professor Hayek is sceptical of this part of the prescription and of the optimism which underlies it. A concern not to inflate the money supply is crucial; but he at least has no doubts that this alone will not solve the problem.

The role of the trade unions as monoplies interfering with the working of the labour market lies at the very heart of his thinking. Correct monetary policy can ensure that inflation is not made worse from monetary causes, but it cannot ensure that inflation is abolished. Only a willingness to force unions to become governed by the rule of law can do that, he argues.

The question of whether, in a free society, monetary policy can by itself be sufficient to prevent inflation and produce stability must to some extent still be an open one. What is clear is that the warnings of the dangers to which an uncritical acceptance of Keynes's teaching were exposing us voiced by Professor Hayek some forty years ago have been proved right. They were forgotten for too long.

“The Times” in May 1978

Dr. Laurence Hayek is receives this award on behalf of his father from President George Bush and Mrs Bush, 1991

The Europe Crisis

- Attempt to make a common currency zone out of extremely diverse countries
- Stability Pact has not been complied with; violations were not sanctioned
- Moral hazard, tragedy of the commons
- The Euro = Monopolistic and unsound money
- Expansive monetary policy (low interest rates)
- In the peripheral countries result bubbles are developed
- Since 2007: Bursting bubbles, bank losses are socialized
- No corrections are allowed, instead, expensive time is bought
- Inflationary monetary policy to burden the lower income level of the population;

  "Race to the Bottom"

Sovereign debts

Big Government

Problems and Causes

- Violation of the Commission against the “No Bail-Out" clause (Article 125 of the Treaty of Lisbon
- The Commission infringed the prohibition on the purchase of debt securities (Article 123 of the Treaty of Lisbon)
- Consequently new contracts and regulations are urgently needed (leaving the EU must be a possibility) as well as the possibility of bankruptcy of a government (at a local level as it is possible in Leukerbad (CH), Marseille (F), NY).
- This would lead to an automatic withdrawal from the Euro and a monetary reform in this country.

Problems and Causes

AUSTRIAN ECONOMICS CENTER

- The problem in terms of competitiveness in Europe is the gap between two large regions in Europe (North/South). Neither ESM nor EPP solve the competition problem, apart from the fact that both plans draw massive deficits.
- The differences in unit labor costs continue to grow (N-S).
- Unit labor costs are too high and productivity is too low.
- The export performance fluctuates greatly between countries (e.g. Greece 60 to 70% of all exports, while less than 10% in the U.S.)

Problems and Causes

- Change in current account balances of some countries (Greece, Italy, Portugal, and Spain) are negative in contrast to other countries (Germany)

- Lack of competition leads to problems for economic growth

- Standards of market integration are still not met (labor mobility and manpower, etc.)

- Population anxiety is not counteracted with reliable and solid information

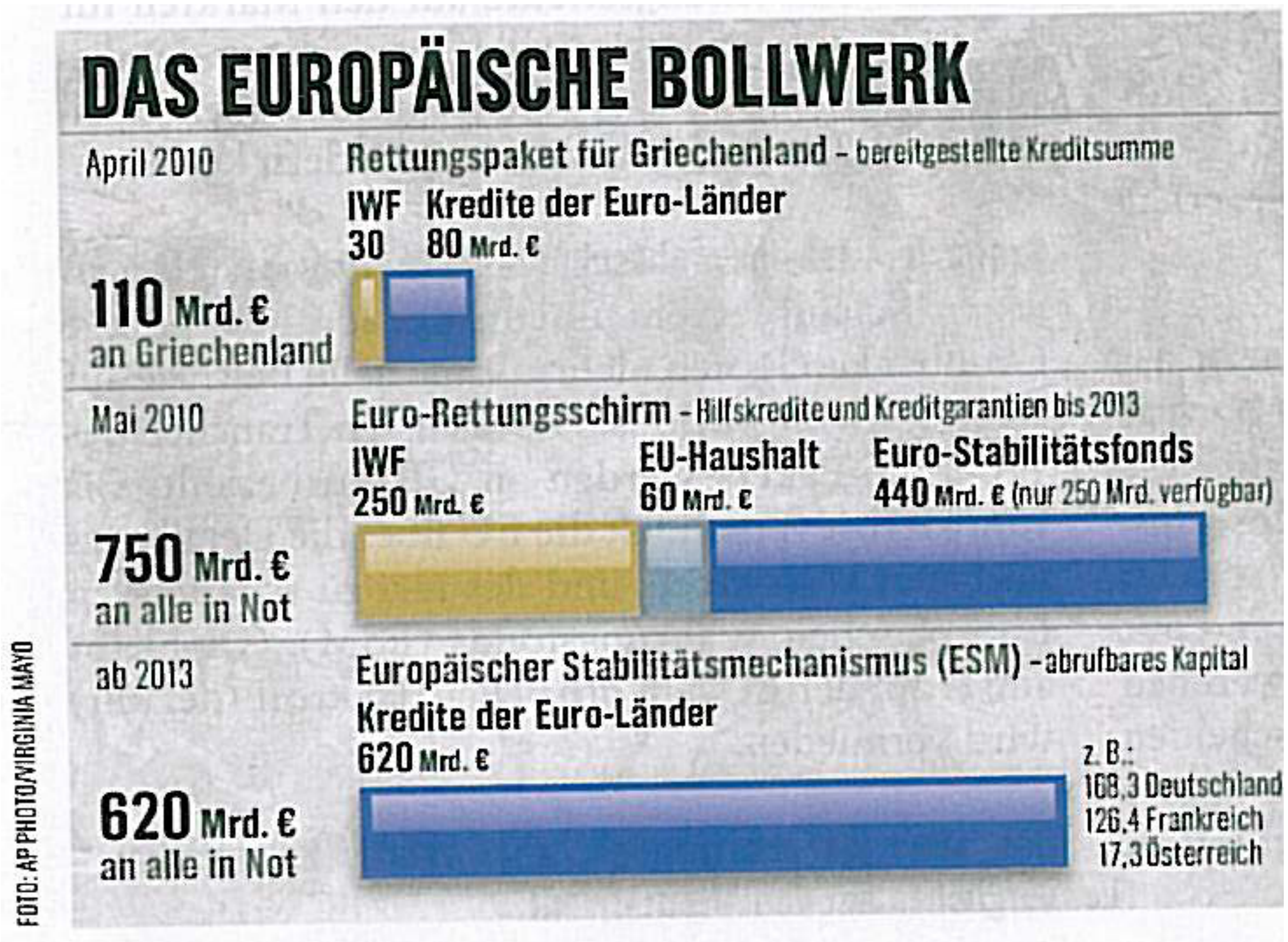
Rescue Packages 2010 1.0

- **Germany**: 500 Bn. Euro
- **US**: 700 Bn. Euro
- **Austria**: 100 Bn. Euro
- **UK**: 500 Bn. Pounds
- **France**: 360 Bn Euro

- International Monetary Fund (**IMF**) suspects **more than 3 Tr. Euro losses** (overdue loans, a.s.o)
- **High risk of additional losses** due to State Liabilities (not only banks, also Sectors Industry, Insurance, a.s.o.)

Rescue Package for the €-crisis: 1.0

- EU and IMF together 750 billion € (guarantees)
- That means for all EU countries an extra fiscal-political burden:
  - **Austria** (1,9%)
  - **Germany** (19%)
  - **France** (14%)


DAS EUROPÄISCHE BOLLWERK
April 2010
Rettungspaket für Griechenland – bereitgestellte Kreditsumme
IWF
30
Kredite der Euro-Länder
80 Mrd. €
110 Mrd. €
an Griechenland
Mai 2010
Euro-Rettungsschirm – Hilfskredite und Kreditgarantien bis 2013
IWF
250 Mrd. €
EU-Haushalt
60 Mrd. €
Euro-Stabilitätsfonds
440 Mrd. € (nur 250 Mrd. verfügbar)
750 Mrd. €
an alle in Not
ab 2013
Europäischer Stabilitätsmechanismus (ESM) – abrufbares Kapital
Kredite der Euro-Länder
620 Mrd. €
z. B.:
168,3 Deutschland
126,4 Frankreich
17,3 Österreich
620 Mrd. €
an alle in Not
FOTO: AP PHOTO/VIRGINIA MAYO

AUSTRIAN ECONOMICS CENTER

DIE EURO-WACKELKANDIDATEN

Die Wackelkandidaten:	Staatsschulden in Prozent des BIP	Haushaltsdefizit in Prozent des BIP	Arbeitslosigkeit in Prozent
Griechenland	142,8	10,5	12,6
Italien	119,0	4,6	8,4
Irland	96,2	32,4	13,7
Portugal	93,0	9,1	11,0
Spanien	60,1	9,2	20,1
Zum Vergleich:			
EUROLÄNDER DURCHSCHNITT	85,1	6,0	10,0
MAASTRICHT-GRENZE	60,0	3,0	–
Österreich	72,3	4,6	4,2

PIIGS-STAATEN. Während Griechenland mit der Staatsverschuldung kämpft, hat Irland ein exorbitantes Haushaltsdefizit und Spanien eine Rekordarbeitslosigkeit. Kracht Griechenland, stellt sich unweigerlich ein Domino-Effekt ein.

ELLE: STATISTIK AUSTRIA NEWSinfografik

Reality

- EU financial rescue funds, the European Stability Mechanism (ESM) and Euro Plus Pact (EPP) do not offer solutions to the current structural imbalances.

- Neither of them solve the competition problem while both plans bear massive deficits.

- They simply move the date on which policy makers will have to deal with the inevitable financial truths and declare bankruptcy.

- Meanwhile, European tax payers must bear the burden.

Reality

- March 23rd 2011 officially made the EU a tranfser union
- European Stability Mechanism ESM basically allows governments to request financial aid
- Neither of them solve the competition problem while both plans bear massive deficits.
- They simply move the date on which policy makers will have to deal with the inevitable financial truths and declare bankruptcy.
- Meanwhile, European tax payers must bear the burden.

Problem of ESM

- Targeted to (national) governm. Deb when credibility and the ability ot refinance on the market is not given anymore

- In a normal market process you would go bust (like any business)

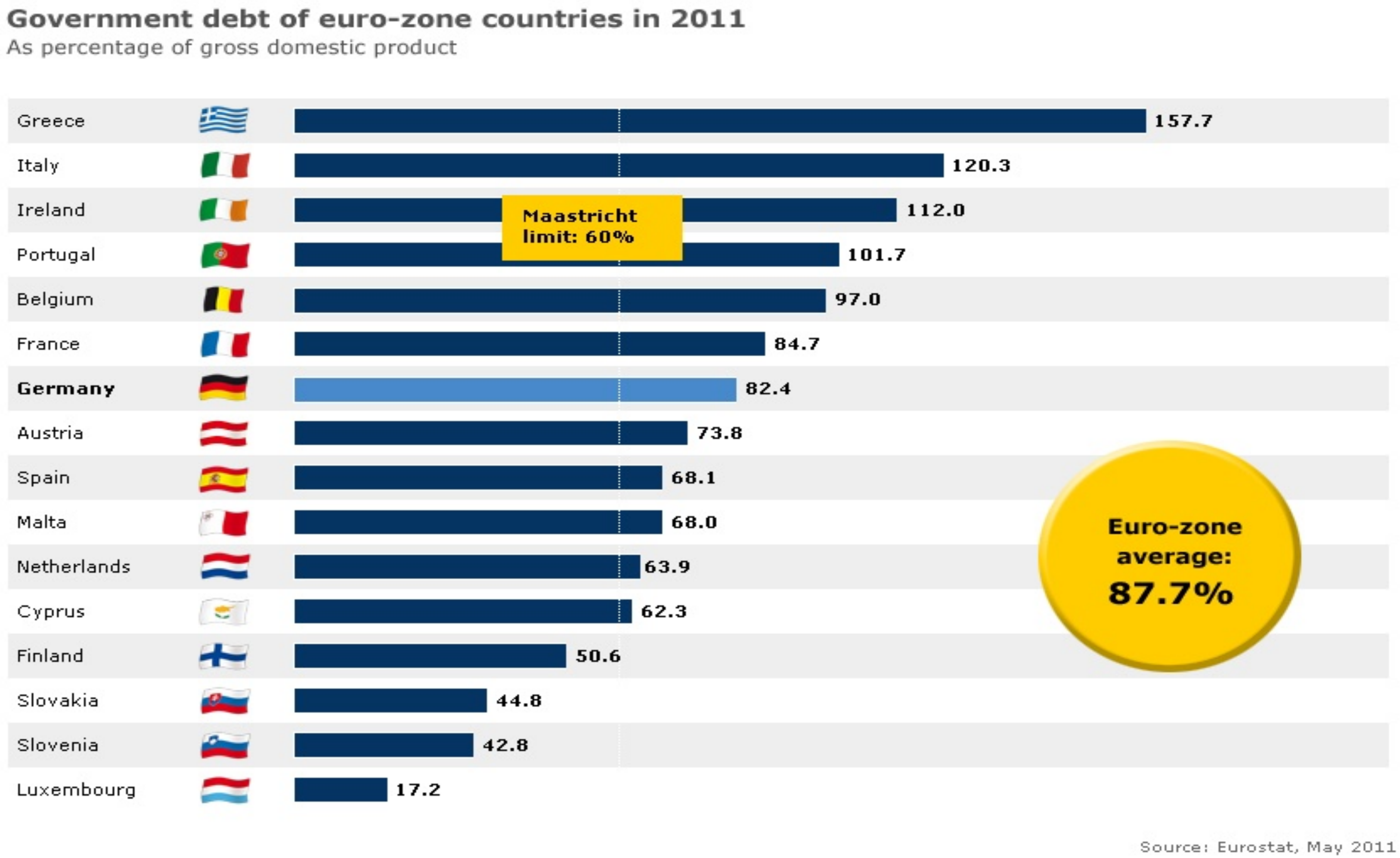
- Reforms are only forced on gov. When it is too late

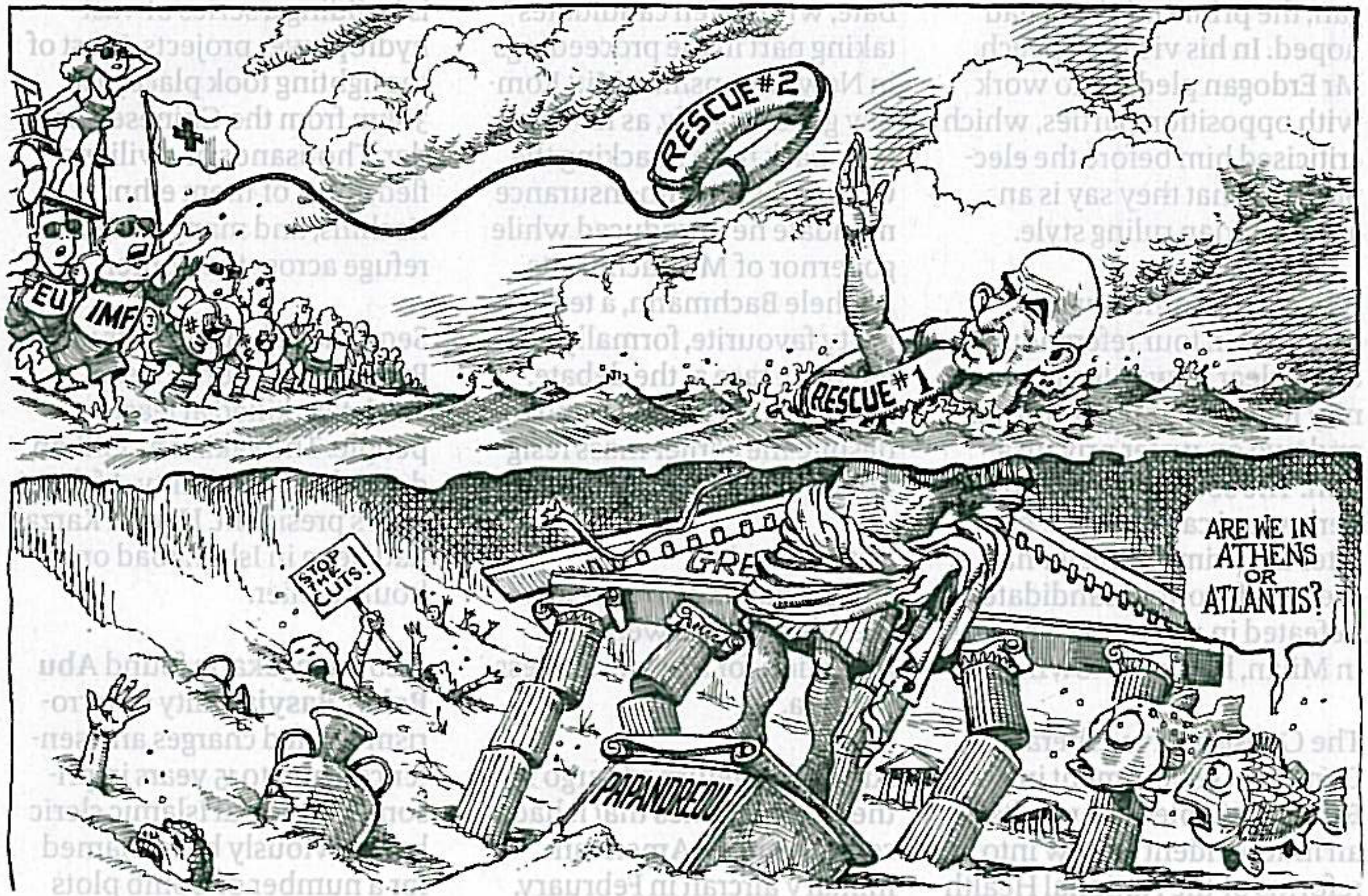
- It actually incentives not to solve the problems and get structural reforms on track

Problem of ESM

- Like more governments (and the bigger they are) make use of ESM the least effectively and the smaller it is and the consequences are penalties for gov.
- Problems that ESM is provided even if IFM decides not to
- No private creditors are held responsible
- A regular check by federal ministry of finance whether the 500 billions are sufficient and the outcome is big enough they are checking themselves

AUSTRIAN ECONOMICS CENTER




RESCUE #2
EU
IMF
RESCUE #1
STOP THE CUTS!
GRE
PAPANDREOU
ARE WE IN ATHENS OR ATLANTIS?

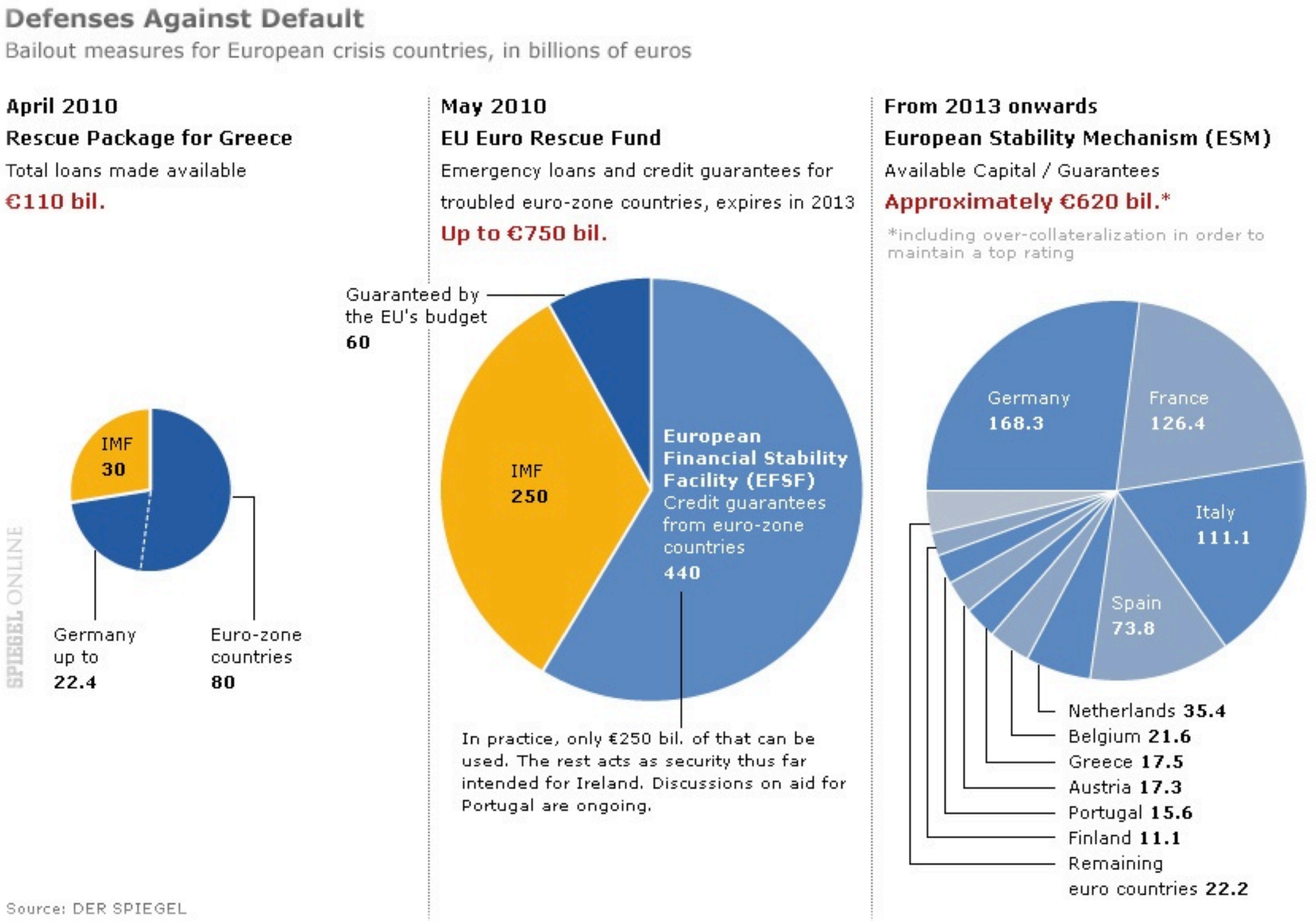
Reform of the EFSF

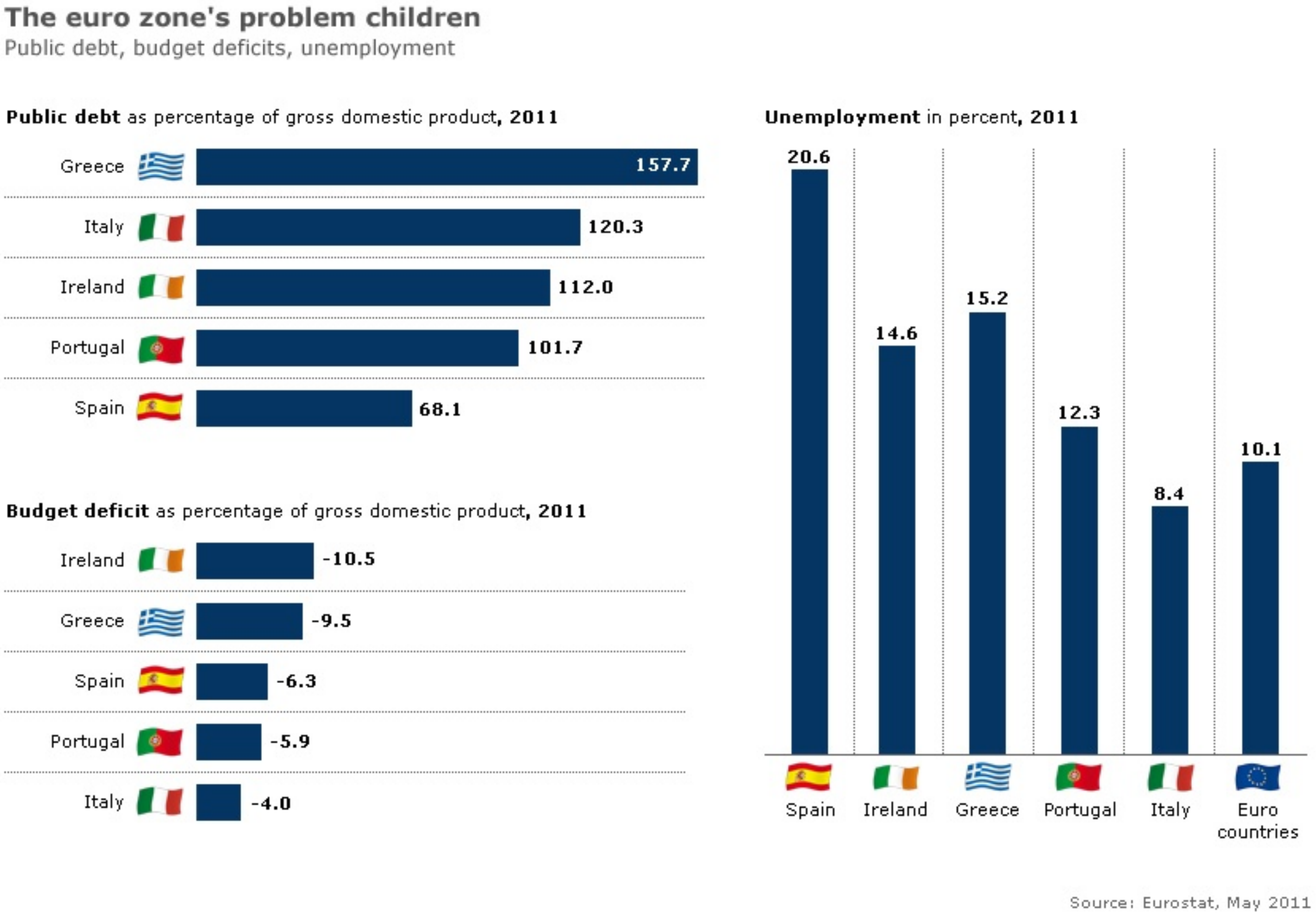
- Unenthustiastic – Member states will still finance their speding via debts
- Preventive and corrective component – past experience
- Macro-economic tools as warning system
- Sanctions if:
  - Stuctural deficit higher than 0.5% of GDP
  - Must use higher income to reduce deficits

Problems with the new rules

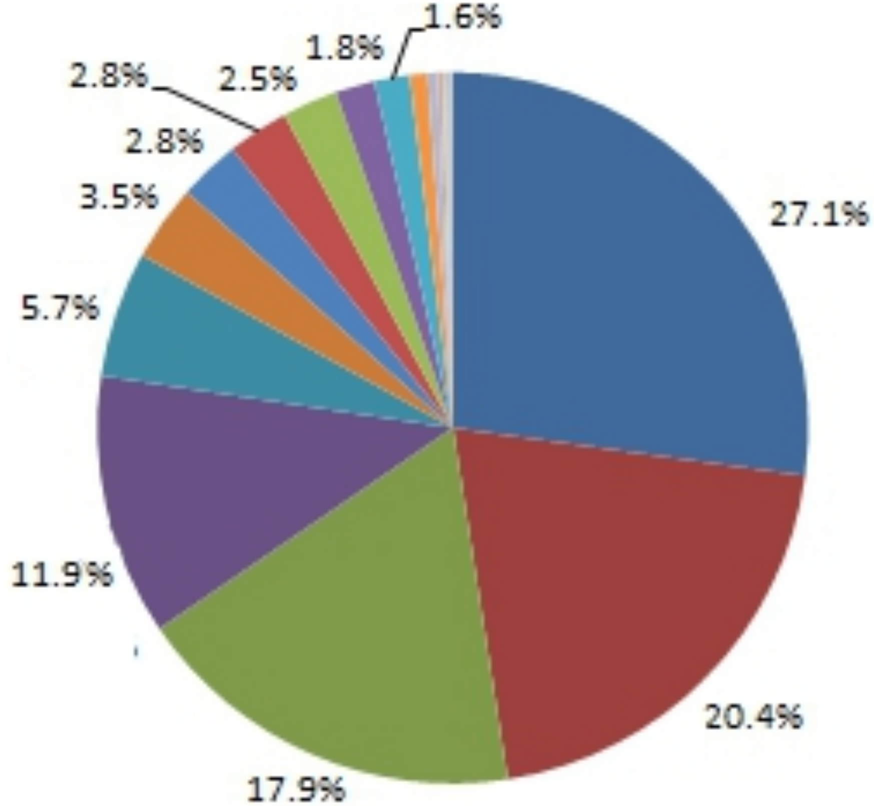
- Will not prevent violations
- Sanctions remain without consequences
- Impossibility to identify imbalances – Lack of knowledge (Hayek)
- Imbalances are politically motivated & can be directly infuenced
- Political bargaining
- Commission can stop deficit procedure by qualified majority
- Early warning system should identify imbalances at early stages

ESM 3.0; April 2012


Defenses Against Default
Bailout measures for European crisis countries, in billions of euros
April 2010
Rescue Package for Greece
Total loans made available
€110 bil.
IMF 30
Germany up to 22.4
Euro-zone countries 80
May 2010
EU Euro Rescue Fund
Emergency loans and credit guarantees for troubled euro-zone countries, expires in 2013
Up to €750 bil.
Guaranteed by the EU's budget 60
IMF 250
European Financial Stability Facility (EFSF) Credit guarantees from euro-zone countries 440
In practice, only €250 bil. of that can be used. The rest acts as security thus far intended for Ireland. Discussions on aid for Portugal are ongoing.
From 2013 onwards
European Stability Mechanism (ESM)
Available Capital / Guarantees
Approximately €620 bil.*
*including over-collateralization in order to maintain a top rating
Germany 168.3
France 126.4
Italy 111.1
Spain 73.8
Netherlands 35.4
Belgium 21.6
Greece 17.5
Austria 17.3
Portugal 15.6
Finland 11.1
Remaining euro countries 22.2
SPIEGEL ONLINE
Source: DER SPIEGEL


The euro zone's problem children
Public debt, budget deficits, unemployment
Public debt as percentage of gross domestic product, 2011
Greece 157.7
Italy 120.3
Ireland 112.0
Portugal 101.7
Spain 68.1
Budget deficit as percentage of gross domestic product, 2011
Ireland -10.5
Greece -9.5
Spain -6.3
Portugal -5.9
Italy -4.0
Unemployment in percent, 2011
20.6
14.6
15.2
12.3
8.4
10.1
Spain
Ireland
Greece
Portugal
Italy
Euro countries
Source: Eurostat, May 2011

€ 700bn ESM guarantee



Country	Perc.(%)	Amount (€ bn)
Germany	27.1	190.0
France	20.4	142.7
Italy	17.9	125.4
Spain	11.9	83.3
Netherlands	5.7	40.0
Belgium	3.5	24.3
Greece	2.8	19.7
Austria	2.8	19.5
Portugal	2.5	17.6
Finland	1.8	12.6
Ireland	1.6	11.1
Slovakia	0.8	5.8
Slovenia	0.4	3.0
Luxembourg	0.3	1.8
Cyprus	0.2	1.4
Estonia	0.2	1.3
Malta	0.1	0.5

Freedom– social Responsibility

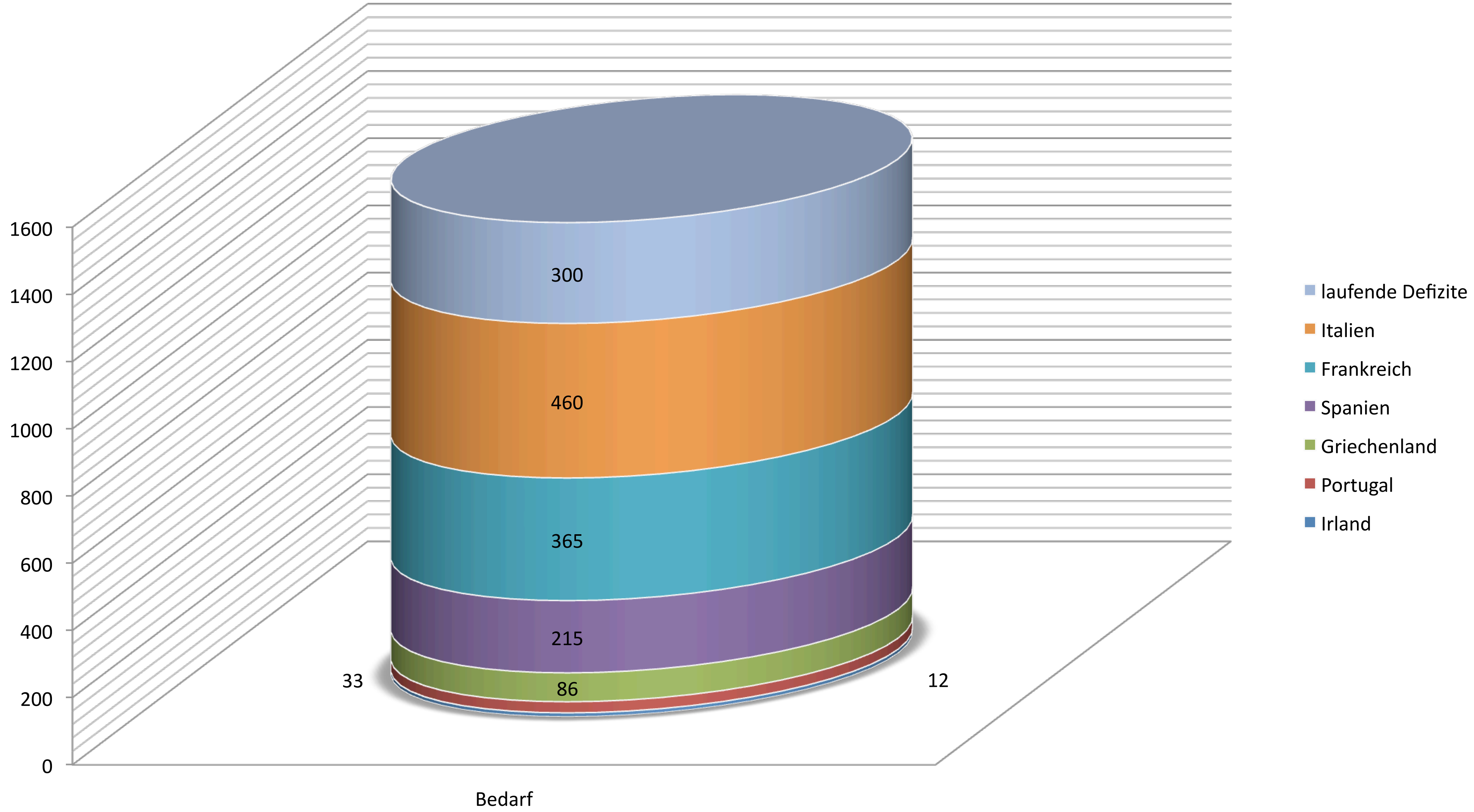
- Long-term consequences of the damage, now caused to combat the recession: Who will pay or be responsible for this debt?

- Budget deficit forecast for EU countries in 2012 an average of 3.9% (For comparison: 2008: 2.4% 2009: 6.9% 2010: 6.6% 2011: 4.7%)

- Self-interest in the 21 Century is, to care for one another "(Horst Köhler)

Central planning in Brussels

ESM



1600
1400
1200
1000
800
600
400
200
0
300
460
365
215
86
33
12
Bedarf
laufende Defizite
Italien
Frankreich
Spanien
Griechenland
Portugal
Irland

Crash Course

- The transfer payments by the EFSF strengthen the current crisis by reducing the pressure for reform on the recipient countries. These painful, but necessary and unavoidable reforms are delayed.

- The willingness to reform is very limited, due to the fact that countries which already refer to the help of EFSF could codetermine about the payments to other countries.

- Moreover, the willingness to reform is reduced by the purchase of government bonds and further changes nothing in the fundamental data of the country.

- In the event of a loss of the AAA rating of a country, the possible additional payments into the fund could lead to uncontrolled costs for the national budget.

Crash Course

Only free markets and real structural reform can solve the current crisis - more bureaucracy and transfer payments have never worked!

Competing Regions!

Europe Believes in Responsibility

- Living within your means
  - Limited government debt
  - Limited individual debt
  - Limited government Future Obligations
  - Individual responsibility
- Maintaining Competitiveness
  - Single Market for Goods and labour
  - Tax Competiveness
  - Limited government regulation
  - Quality education
- Rule of Law

www.freemarket-rs.com

www.friendsofaec.com