Headline: A note of caution about hasty bailouts
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ASK: NUS ECONOMISTS

A note of caution about hasty bailouts

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Are political leaders moving too slowly in the bailout of debt-ridden euro-zone countries?

THE European Monetary Union (EMU) is facing a serious dilemma.

In order to calm markets today and temporarily alleviate economic hardship, it is under pressure to make large transfers to debt-ridden member countries such as Greece and Spain.

But these transfers have to be paid for by other member countries, which are concerned about moral hazard problems threatening reforms, which are necessary in the debt-ridden countries to ensure responsible economic policies in future.

EMU members such as Germany are reluctant to shoulder a significant part of the cost of the bailout.

Does this reluctance simply reflect incompetence by politicians? Or is there an economic rationale behind it?

Agreement on bailouts takes time, and one reason is related to the difficulty of achieving political consensus.

Reaching such a consensus is particularly difficult in the EMU, where members are sovereign states and there is no fiscal union yet.

According to this view, the bailouts are too slow and too small to end the crisis.

It is not difficult to see why, according to this view, some economists put the blame for the European debt crisis on political leaders.

Another view is that a slow-paced, small-scale bailout has certain aspects which are economically desirable.

The two key phrases here are "moral hazard" and "structural reform".

When a sovereign state receives bailout money, this alleviates its budgetary problem – but there is no guarantee that this one-time improvement in the fiscal budget will have any long-lasting positive effects on the economy.

Once the bailout money is received, there is little incentive for the government to undertake structural reforms, especially if these are related to the size and composition of the government sector, or require reforms and regulation of an industry that has strong political influence.

Slow-paced, small-scale bailouts leave at each point in time a significant burden of the fiscal debt with the debtor country. But there are benefits associated with such a bailout scheme; they are analogous to those of partial insurance.

Pensioners protesting against health spending cuts in Athens this week. Greece paid a lower rate of 4.54 per cent on Tuesday to raise €1.137 billion (S$1.8 billion) in six-month funds as the market eased on hopes that the European Central Bank would announce a round of debt purchases. PHOTO: AGENCE FRANCE-PRESSE

Consider the importance of the bailout's timing. As time passes and no transfers are made, the debt problem becomes more severe and holds back the economic growth of the debt-ridden economy.

The temporary decline in economic activity – for example, a credit crunch and an increase in unemployment – is, of course, undesirable from a short-run perspective.

As economic hardship becomes more severe, it is likely that pressure will build up from the people for a change in economic policies. Some of those demands may be detrimental to long-run economic growth.

However, the key point is that an economic crisis creates a window of opportunity for politico-economic change.

The more severe the economic crisis, the more likely that a drastic change in economic policies will take place.

The hope is that a severe crisis will create a willingness by the people to reform – or, at least, a willingness to vote in political leaders able to carry out reforms that are conducive to economic growth.

The punchline is that political leaders of fiscally strong countries may be holding back full-scale bailouts in order to ensure willingness in debtor countries to reform.

Once this willingness is there, the bailout money will be provided to support the recovery.

Such a partial insurance scheme could solve the moral hazard problem: A country tempted to risk irresponsible fiscal policy in the future will realise that it will be hit by economic hardship for some time.

The country whose irresponsible fiscal policy is creating the mess will learn fully well that it has to pay a cost.

Thus, delaying full-scale bailout transfers is one way for the fiscally strong European countries to reduce the moral hazard involved.

This type of strategy may explain the delay in transfers to debt-ridden countries.

This does not imply that debtor countries such as Greece should leave the EMU. If structural problems are the root cause of the economic crisis in these countries, leaving the EMU will hardly achieve anything.

Certainly, a country that leaves the EMU will regain control over monetary policy as an additional policy instrument.

It may choose to pursue an inflationary policy coupled with a depreciation of the nominal exchange rate – say, because of a hope that this will at least temporarily increase economic growth and create employment by increasing internal and external demand. But such a policy may lead to payments on external debt – that is, debt denominated in foreign currency – becoming a serious problem.

The country could then end up defaulting on its external debt.

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