Recovery in Europe – The outcome of successful crisis policies?

Discussion

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EUROPE AFTER THE CRISIS:
WHERE IS THE ECONOMIC AND MONETARY UNION HEADED?
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Introductory remarks

Peter Bofinger's presentation: Europe' economic upswing after some serious policy mistakes in the immediate crisis.

- ***I agree very much with Peter Bofinger's analysis,***
- ***I will not really challenge his interpretation, but rather give additional views.***

Europe back to growth after some serious policy mistakes in the crisis

EMU and Europe have had different economic outcomes after the 2007 crisis - more rapid rebound in EU non euro area countries than in euro area countries.

In EMU: slow recovery - slower than elsewhere in advanced economies

- After the burst of the financial crisis, the euro area was unable to implement a coherent macro-economic strategy to recover the 8 percentage points of GDP lost during the crisis.
- Financial markets even bet on the sovereign default and euro area exit of several MS. The EU authorities and MS did not respond sufficiently rapidly and strongly. They denied to guarantee public debts, implementing limited financial solidarity only, under strict conditionality. Guaranteeing public debts would have implied to re-think and explicit the euro area framework.

- **Under the Commission's pressure, under financial markets and rating agencies threat, MS had no choice but implement restrictive policies in times of austerity.**
- **In the euro area as a whole, fiscal restriction measures amounted to 1.6% of GDP in 2011, 2.3% in 2012, 1.1% in 2013 and 0.7% in 2014. This strategy halted the nascent economic recovery in 2010 (where GDP grew by 2.2% on a y-o-y basis in the last quarter. Euro area GDP fell in 2012 and 2013.**
- **Euro area GDP per head reached its 2008 level only in 2016.**
- **Although the economic situation has improved, the scars of the crisis remain in many countries (high unemployment, large public debts, increases of income inequalities, financial instability, deindustrialization).**

Table: some economic indicators

	GDP growth 2017-2019*	Unemp. Rate ; % April 2018	Current account, % of GDP 2007	Current account, % of GDP 2017
Germany	2.2	3.4	6.8	7.9
The Neths.	2.8	3.9	6.3	8.5
Austria	2.6	4.9	3.3	2.0
Ireland	5.2	5.9	-6.4	1.2
Belgium	1.8	6.3	3.7	-0.8
Finland	2.5	8.1	4.2	-1.1
France	2.0	9.2	-1.0	-3.1
Portugal	2.3	7.4	-8.9	1.0
Italy	1.4	11.2	-1.3	2.3
Spain	2.7	15.9	-9.2	2.0
Greece	1.8	20.8	-13.4	1.7
Euro area	***2.2***	***8.5***	***0.2***	***3.6***
UK	1.6	4.1	-3.8	-5.2
Denmark	1.9	5.2	1.5	8.4
Sweden	2.4	6.2	8.4	4.8

*Average 2017 – and 2018-19 Forecasts
Source : EUROSTAT, OECD, OFCE's forecasts

- In 2017, the euro area current account surplus was 3.6% of GDP. For the euro area as a whole, the euro is undervalued. In an area with high unemployment and current account surplus, monetary policy should not be expansionary (as this lowers the exchange rate) but fiscal (or wage) policy should be expansionary.
- However, intra-area current account imbalances have declined: Germany and the Netherlands keep high current account surpluses, but except for France, no MS runs a higher than 1% of GDP surplus.
- This results not only from austerity policies, but also from internal devaluation strategies. Southern economies have improved their situation to some extent, but Germany maintains a substantial competitiveness advantage.

Unit wage costs (whole economy), 1997 = 100

	2007	2017
Germany	85,0	85,7
Austria	94,9	97,8
Finland	99,2	97,3
France	104,7	98,1
Belgium	106,2	102,1
The Neths.	110,0	100,8
Italy	110,2	106,4
Portugal	112,5	103,3
Ireland	123,7	77,4
Spain	125,2	106,8
Greece	126,1	109,8

Source OECD

Industrial production 2017 1998=100	
Austria	175
Belgium	163
Germany	134
Finland	121
Netherlands	119
Sweden	*114*
Denmark	*105*
France	93
UK	*93*
Portugal	91
Spain	90
Italy	84
Greece	83

Back to growth after some serious policy mistakes in the crisis

Policy mistakes during the crisis:

Monetary policy: only stabilisation tool used : ZLB, QE

Incapacity to reduce intra-zone imbalances, no incentive for banks to lend to productive sectors rather to speculation, no clear public debt guarantee

Fiscal policies: were kept restrictive for too long

- role of fiscal policy underestimated (size of multipliers, …)

- Fiscal rules in place did not allow for countercyclical policies

Need for economic policy coordination and differentiated policies among MS (economic contexts differ according to MS, with a single exchange rate and monetary policy, fiscal policies should differ)

Public debts and deficits

% of GDP	Public debt, Maastricht criteria		Public balance		
	2007	2017 (and max.)	2007	Highest deficit 2007-17	2017
Germany	64	65 (81)	0.2	-4.2	0.9
France	64	97	-2.5	-7.2	-2.6
Italy	100	132	-1.5	-5.3	-2.1
Spain	36	98 (100)	1.9	-10.5	-3.1
The Neths.	42	58 (68)	0.2	-5.4	0.7
Belgium	87	104 (108)	0.1	-5.4	-1.5
Austria	65	79 (84)	-1.4	-5.3	-1.0
Greece	103	180	-6.7	-15.1	-1.2
Portugal	68	126 (131)	-3.0	-11.2	-1.4
Finland	34	63	5.1	-3.2	-1.4
Ireland	24	70 (120)	0.3	-32.1	-0.4
Euro area	***65***	***89 (94)***	***-0.6***	***-6.3***	***-1.1***
UK	44	87	-2.6	-10.1	-2.1
USA	64	108	-3.5	-12.7	-5.0
Japan	183	240	-2.8	-9.8	-4.3

Source: Ameco.

Back to growth after some serious policy mistakes in the crisis?

Maybe the recovery is behind us.

Euro area GDP slowed in the first quarter of 2018 (0.4% instead of 0.7% previous quarters), in part temporary phenomena but slowdown seems underway – at least suggested by Business survey data, up to end May: +0.4

GDP would grow by 2.2% (q/q-4) instead of 2.7% at the end of 2017

More importantly: a new euro area crisis may be around the Corner: Italy and financial markets

Back to growth after some serious policy mistakes in the crisis

Two doctrines differ over the conduct of economic policy : a Keynesian policy requests a precise coordination of national (fiscal, social, taxes and wages) policies ; a liberal one requests economic policies competition and financial markets supervision.

Northern MS refuses unlimited guarantee which is indispensable for a single currency.

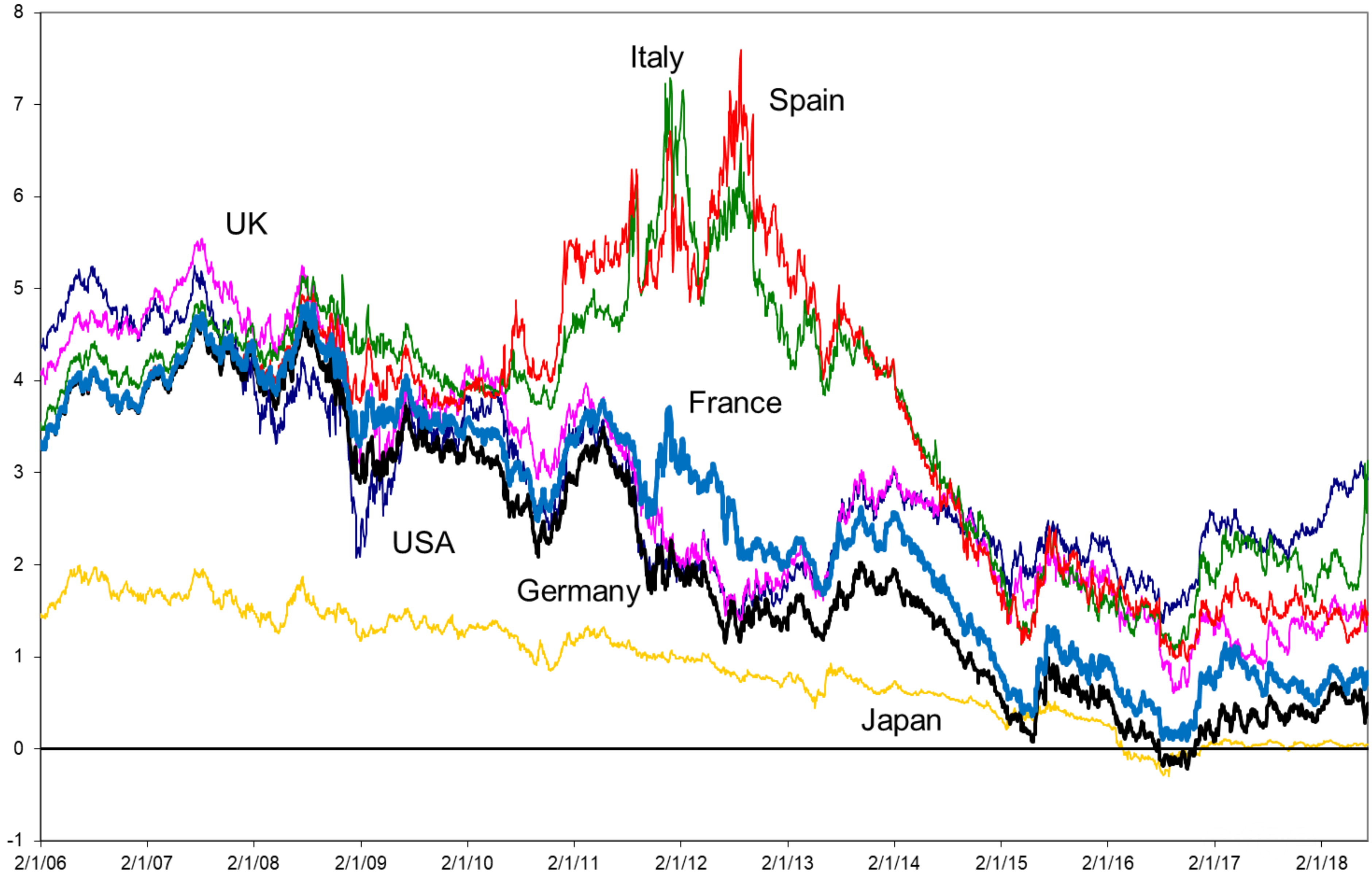
Fragility

- The euro area is fragile. If Northern countries are doing well, many countries (among them notably Italy, Greece and even France) suffer from de-industrialisation and are in trouble.
- Parties opposed to the current orientation of European Institutions have more and more influence in some MS.
- Anti-European Governments (Hungary, Poland, Italy) come to power, which may destabilize the EU or the Euro area.
- Financial markets are nervous. The Italy-Germany government spread rose to 2.4 percentage points. The Spain-Germany spread is 0.95 p.p.
- The following question remains unsolved: can the euro area functioning be improved, accounting for divergent situations, interests and views in MS?

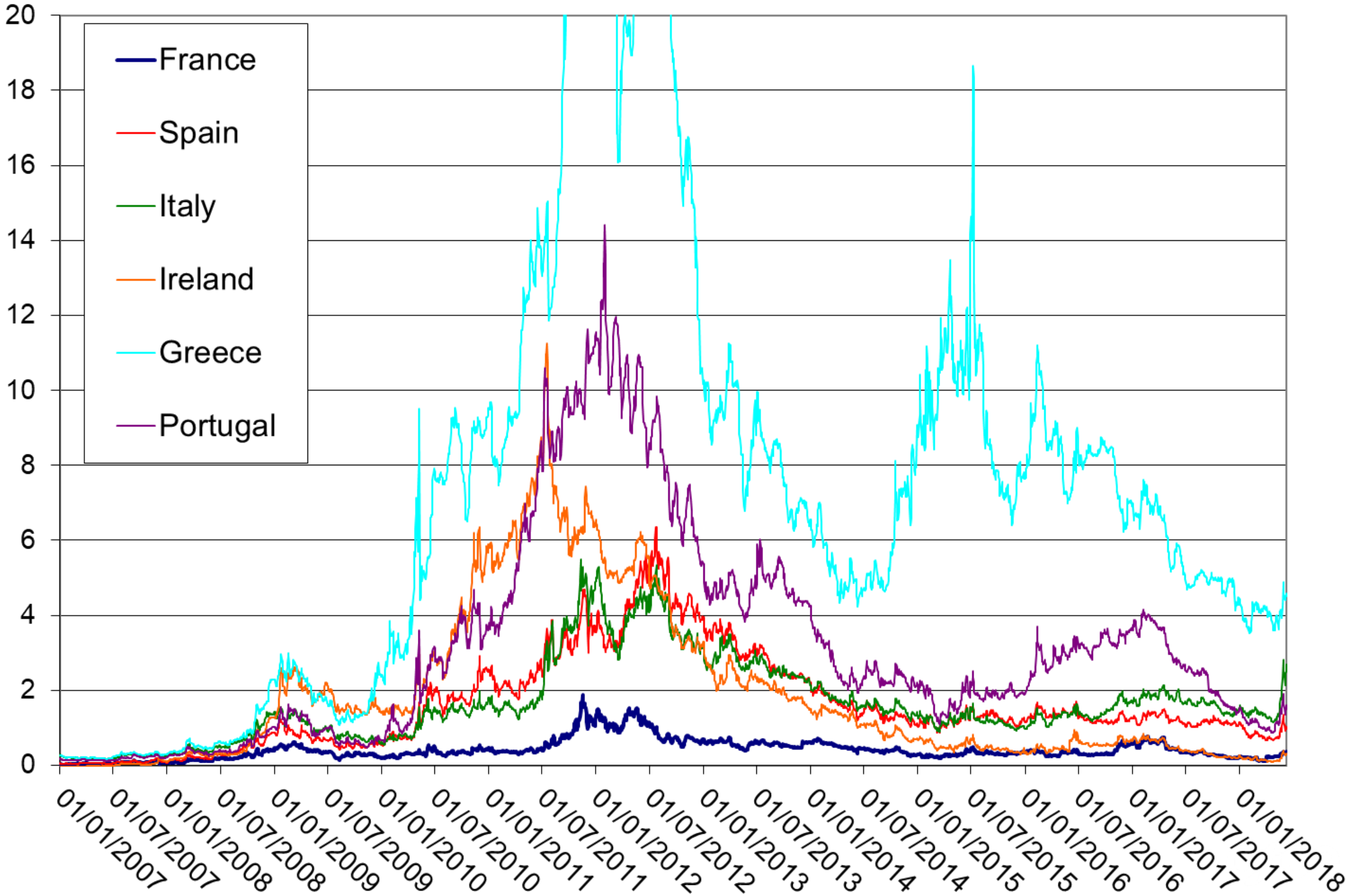
10-year government interest rates

	February 2012	May 2016	June 2018
Greece	40.8	7.4	4.5
Portugal	12.3	3.1	2.0
US	*2.0*	*1.75*	*2.95*
Spain	5.05	1.55	1.45
Italy	5.5	1.45	2.95
UK	*2.1*	*1.4*	*1.4*
Ireland	7.8	0.8	1.05
Sweden	*1.8*	*0.75*	*0.6*
France	2.95	0.5	0.9
Belgium	3.65	0.5	0.9
Finland	2.3	0.4	0.65
Austria	2.85	0.35	0.75
Netherlands	2.2	0.35	0.65
Germany	1.9	0.15	0.45
Japan	*1.0*	*-0.1*	*0.05*

Interest rates on 10-year government bonds (percent)



Inflation



France
Spain
Italy
Ireland
Greece
Portugal
20
18
16
14
12
10
8
6
4
2
0
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01/07/2007
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Which proposals?

- Proposals emanating from EU institutions generally tend to increase EU authorities' power. They face reluctance from MS, who wish to keep their power and some autonomy: Northern MS are against EU transfers; smaller countries wish to keep their specificity, and refuse ruling from the larger MS and from the Commission.
- EU institutions generally tend to place MS under surveillance, either as concerns macroeconomic management or structural reforms, which comes in contradiction with domestic democratic sovereignty, as could be seen from the Greek crisis, from Brexit, from the last election in Italy.
- Besides, EU institutions do not wish to question the Stability and Growth Pact and the Fiscal Compact, which constrain fiscal policy coordination, as they do not wish to undermine the absence of explicit coordination between fiscal and monetary policies.

- to achieve the Banking Union (SRF, EIDS)
- To limit the domestic publics bonds owns by banks **No**
- A riskless asset **No**
- A European Minister of economy and finance **which powers ?**
- The capital market Union **No**
- More MS fiscal discipline **No**
- A fiscal capacity and a stabilisation mechanism at the EU level **Yes if no more constraints on MS**
- A reform support programme **No**
- A single seat at the IMF **strange**
- The ESM become a EMF **which powers?**
- **One challenge is that any major reform would require a change in the Treaties, and unanimity, and in several countries a referendum – with no guarantee about the results, as European construction is not currently popular.**

Economists' view points

- **Some propose to oblige MS to comply with the SGP and the TSCG;**
- **Some rely on financial markets to control domestic economic policies,**
- **Others to change the fiscal rules.**
- **Some suggest a Euro zone budget and a minister of finance to control MS fiscal policy and/or to put in place a fiscal capacity and/or to organise transfers between MS.**
- **Others refuse a transfers Union or a liabilities Europe**
- **Some push for moving towards a federal EU with increased democracy**
- **Some claims for public investment programme for ecological transition.**
- **Some make original suggestions to cut public debts (monetisation, fiscal money)**
- **Some advocating economic policy coordination with Keynesian targets**

Some hot issues

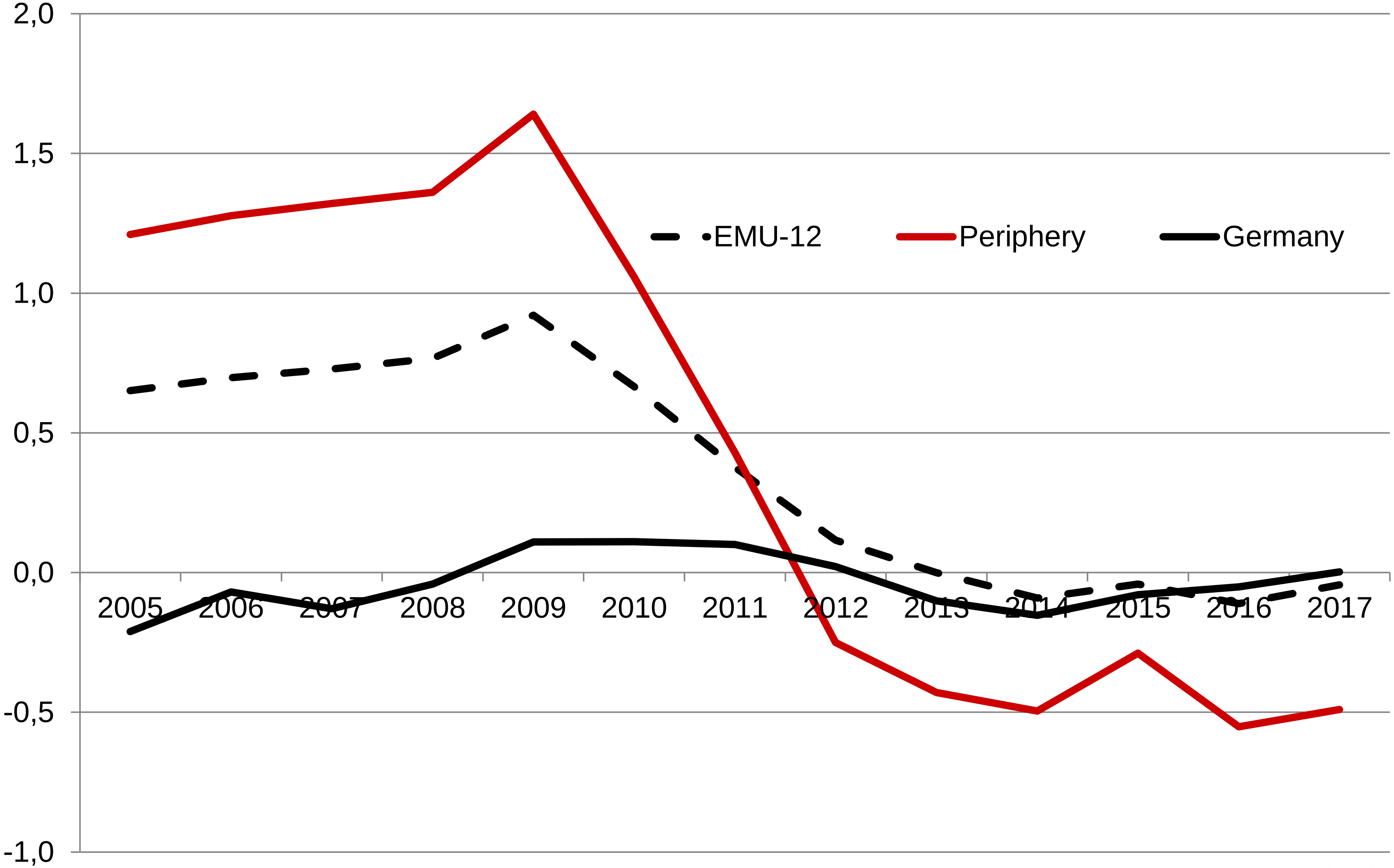
- Should MS try to bring public debt back to 60% of GDP (even if it implies fiscal restrictive policies during 20 years)? Our answers : **No.**
- Can we accept the ECB to change its policy because the next governor is expected to be a German? **No**
- Do we need macro-prudential measures to avoid real estate or financial bubbles ? **Yes**
- Do we need un-prudential measures to encourage banks to finance innovative investment or ecological ones? **Yes**
- OG evaluations should be reviewed. **Yes**
- In order to cut public debts, combating tax avoidance, tax optimisation and tax competition should be a priority
- The ECB should progressively normalize interest rates and bonds purchase policy. But at the same time, public debts should remain guaranteed; coordinated fiscal, wage, and tax policies should reduce imbalances among MS.
- Europe has to make political choices which are impossible/difficult in a multi-country framework.

- Is the euro zone actually well prepared for a next crisis, maybe as a result of recent developments in Italy?

- No

- The euro area needs:
- A lender of last resort – to avoid speculative crises - sovereign bonds should remain safe assets
- Scrapping the numerical ‘stupid’ fiscal rules: 3% of GDP, 60% of GDP
- Implementing instead a golden rule for public finances, allowing to borrow to invest

Net public investment, % of GDP



Source: Achim Truger (calculations based on Ameco)

- Is Draghi's "whatever it takes" enough to avoid a new panic?

- Issue of last resort (again)
- There is a need for solidarity beween MS

- Do current regulations and deficit rules allow enough flexibility to avoid procyclical policies in future?

- NO – they allow for very limited contra-cyclical policy
- Countries already committing with the rules cannot be constrained to run counter-cyclical policies
- Countries not committing with the rules cannot run counter-cyclical policies

- What is needed : golden rule for public finances (at least)
- Plus economic policy coordination

What is needed to normalize ECB's policy?

- So far the ECB's does not meet its own inflation target of close to two percent (this was the case in May, but due to higher energy prices, core inflation close to 1.1% only)
- There are no signs of accelerating domestic inflationary pressure, even in countries with low unemployment: Germany, the Netherlands…
- There are obviously no sign of accelerating inflation is countries where unemployment is high (and higher than before the crisis)
- There is still a negative output gap at the EA level

Still no reason for the ECB increase its interest rate

- Is the current growth solid enough to reduce the damages caused by the crisis in terms of regionally high unemployment, reduced investment, etc…
- **Euro area countries should become able again to issue safe public debts, at an interest rate controlled by the ECB.**
- **They should be able to run a government deficit in line with their macroeconomic stabilisation needs.**
- **The mutual guarantee of public debts should be entire for countries agreeable to submit their economic policy to a coordination process.**

- **Economic policy coordination cannot consist in fulfilling automatic rules (like the SGP rules).**
- **A coordination process needs to be organised between MS. Coordination should target GDP growth and full employment; it should account for all economic variables;**
- **Countries should follow an economic policy strategy allowing to meet the inflation target (at least to remain within a target of around 2%), to meet an objective in terms of wage developments (in the medium-run real wages should grow in line with labour productivity, in the short-run adjustment processes should be implemented by countries where wages have risen too rapidly, or not sufficiently).**

- **As the real targets are full employment, external balance and inflation rate, a target on public balance or public debt is not useful in this framework**
- **Countries should announce and negotiate their current account balance targets; countries running high external surpluses should agree to lower them or to finance explicitly industrial projects in Southern economies. The process should always reach unanimous agreement on a coordinated but differentiated strategy.**

- **It should however be recognised that our proposal is politically impossible to implement, since Germany and many Northern countries refuse to depart from the European Treaties, the SGP or the TSCG; they require that financial markets exert control on MS, and that the EU authorities can impose structural reforms to MS. If one adds the refusal of a EU of transfers and the refusal of tax harmonisation, it seems unlikely that ambitious projects, such as Emmanuel Macron's, for instance, may be implemented.**
- **Besides, three political choices need to be made. Does the EU want to maintain and develop its social model, with its specificity in terms of social and fiscal systems and labour rights or is its objective it to oblige reluctant countries to accept the constraints of a liberal globalization? Should EU MS keep different national social and tax systems, or is the objective to make them converge? Or does the EU want the national systems to converge? Which part of public spending should be done at the EU level? Can the EU make progresses without any precise agreement on these three issues?**

- **One of the causes of the crisis was the rapid expansion of the financial sector, financial incomes and wealth. Taxes on financial incomes, wealth should be increased to restore public finances, instead of cutting social spending like European institutions usually recommend. At the EU level, this requires a strategy of tax harmonisation, to set minimum tax rates for firms and high incomes, to tax higher wealth, and to ensure that each country may be able to tax its firms and its residents.**
- **Euro area's survival requires that the European project becomes popular again, carrying a specific social model, an objective of convergence and solidarity among MS and turn towards a development taking fully into account the ecological constraints. It is only within this framework that institutional progresses could be made. But can all Member countries share this common project? Where are the political and social forces capable of imposing it?**