Fiscal Policy in the Eurozone after the Crisis

David Vines

Department of Economics and Balliol College, University of Oxford;
Centre for Applied Macroeconomic Analysis, Australian National University;
Research Director, PEGGED Research Programme on Politics and Economics of Global Economic Governance, European Union; and CEPR

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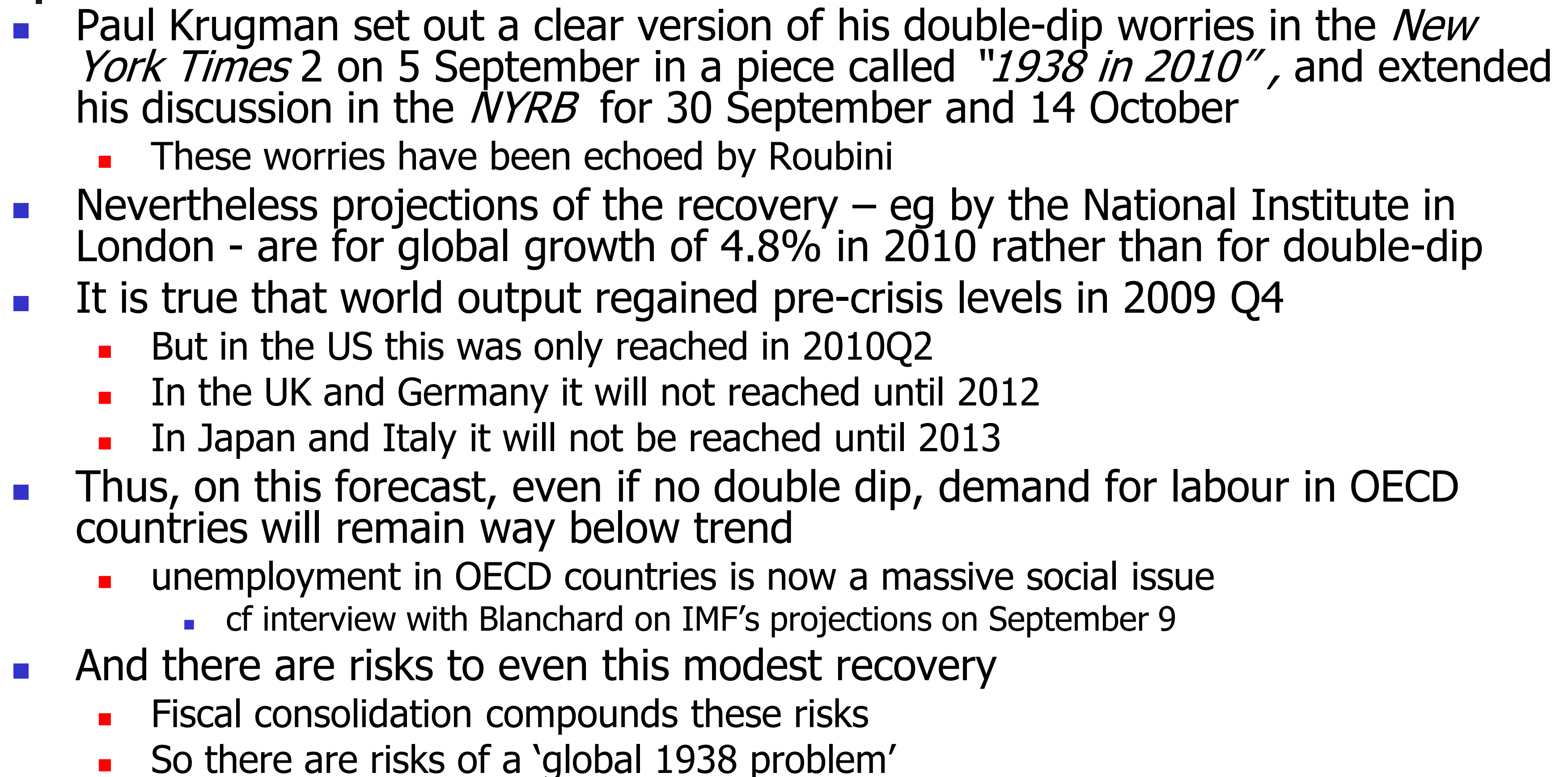
1 Introduction

- The GFC led to unprecedented global cooperation in the setting of macroeconomic policies
- As the G20 meeting in Seoul has just shown, there is a need for this cooperation to be continued, to assist with both
  - the adjustment of global imbalances, and
  - the sustaining the global recovery
- In Europe there has been a follow-up crisis. This crisis now poses risks to the process of recovery and adjustment in Europe.
- The present paper
  - discusses reasons for this follow-up crisis in Europe
  - discusses the resulting changes in financial and fiscal governance in Europe
  - Asks whether these are adequate
    - the answer is not clear

2 The Global Policy Problem : Three Problems, Not Two

- It is clear that we need *global rebalancing.*
  - As is well known*, two* things are necessary for this:
    - Changes in *relative* absorption between deficit and surplus countries
    - Changes in *relative* prices
- But the world also needs *satisfactory global growth*
  - At the London summit in April 2009 the world's leaders promised not to repeat the mistakes of the 1930s.
    - But the policy has involved very large increases in public debt
  - Unemployment in the US, Europe, and elsewhere remains disastrously high. To solve this requires a sustained recovery.
  - Yet the financial markets, and policymakers, are now focused on reducing public deficits and debt. The temporary stimulus packages are unwinding, and fiscal consolidation is setting in.
- Will attempts to rebalance damage global growth?
  - In particular, will fiscal consolidation put growth at risk, as in 1938?



- Paul Krugman set out a clear version of his double-dip worries in the *New York Times* 2 on 5 September in a piece called *"1938 in 2010"*, and extended his discussion in the *NYRB* for 30 September and 14 October
  - These worries have been echoed by Roubini
- Nevertheless projections of the recovery – eg by the National Institute in London - are for global growth of 4.8% in 2010 rather than for double-dip
- It is true that world output regained pre-crisis levels in 2009 Q4
  - But in the US this was only reached in 2010Q2
  - In the UK and Germany it will not reached until 2012
  - In Japan and Italy it will not be reached until 2013
- Thus, on this forecast, even if no double dip, demand for labour in OECD countries will remain way below trend
  - unemployment in OECD countries is now a massive social issue
    - cf interview with Blanchard on IMF's projections on September 9
- And there are risks to even this modest recovery
  - Fiscal consolidation compounds these risks
  - So there are risks of a 'global 1938 problem'

Europe's policy problem

The policy problem within Europe is a microcosm of that faced by the world.

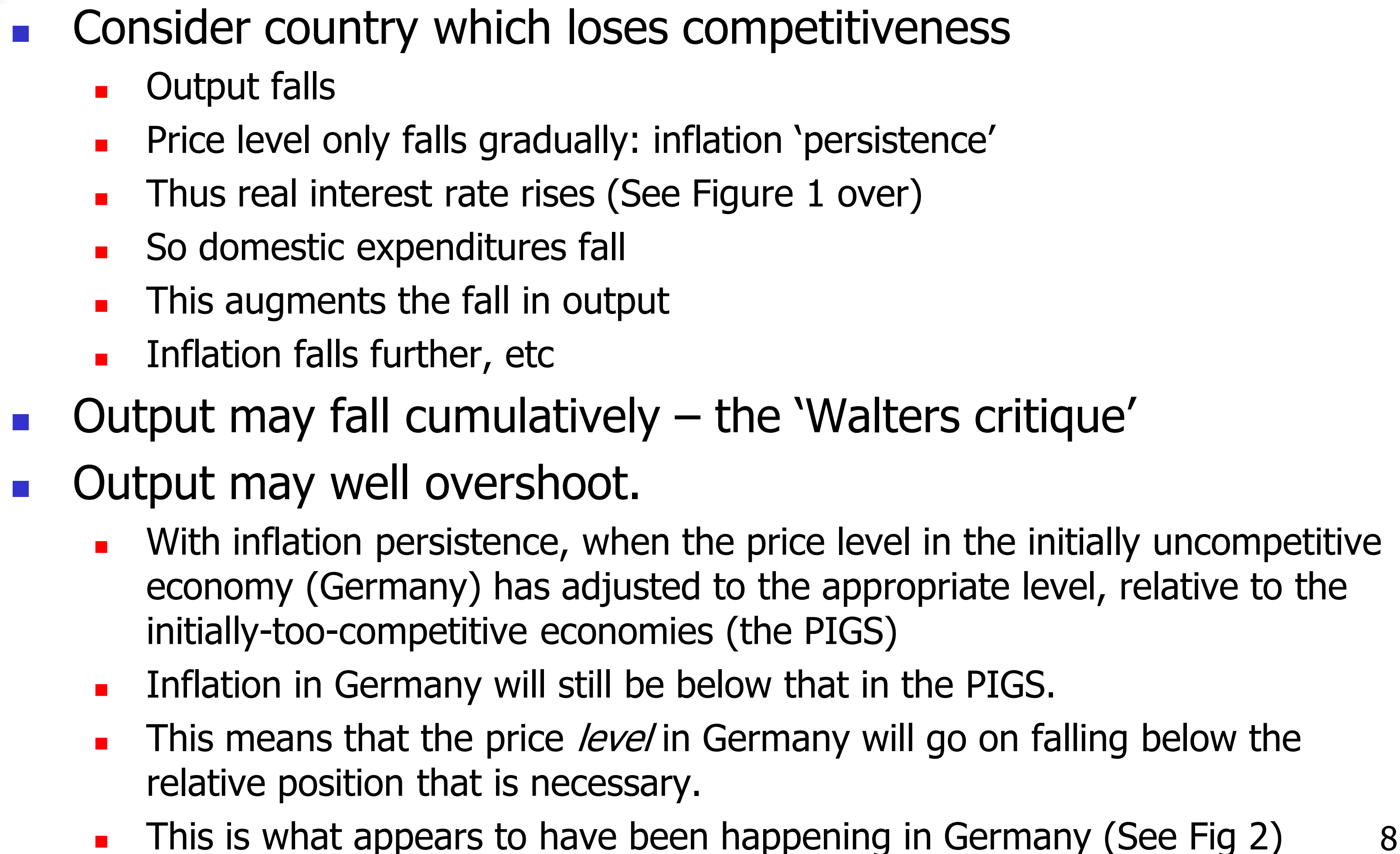
- It is clear that we need *rebalancing within Europe.*
  - As is well known*, two* things are necessary for this:
    - Changes in *relative* absorption between deficit and surplus countries: there must be cuts in absorption in the GIPS – Greece, Ireland, Spain and Portugal – and increase in absorption in Germany
    - Changes in *relative* prices between teh deficit andf ther surplus countries – with below average inflation for a long time in the GIPS countries and above average inflation in Germany
- But there also needs to be a *satisfactory absolute level* of European growth.
- Will Europe be able to achieve these objectives?
  - Most discussions in Europe focus on the former objectives without recognising that actions directed at achieving them might damage the latter objectives

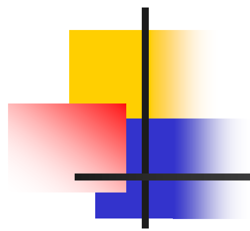
Footnote: Europe's role in the global 'adding up' problem

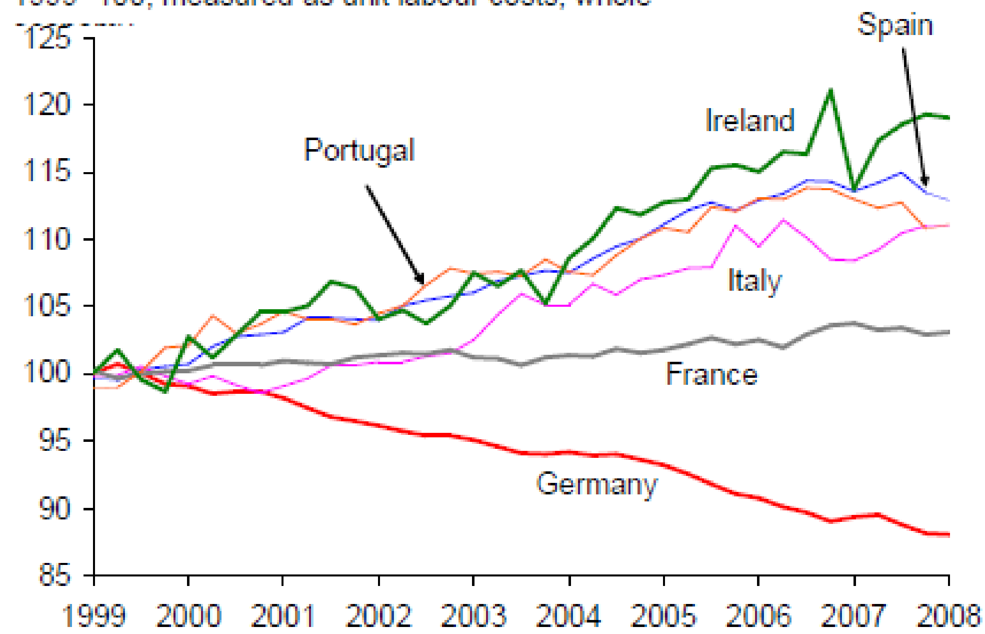
- Overall, within the OECD
  - Private sector continues to repair balance sheets & private demand in 'short supply'
    - True for US, Japan and for some of Europe (ex Germany)
    - In Germany low private sector demand arises for other reasons
  - Financial sector acts to restrain private sector demand
    - Continues to deleverage by means of large markup on loans
    - Balance Sheet risks to German and French banks
    - Additional effects on growth of Basel III
  - In Europe there is a particular adjustment risk
  - All of these regions therefore relying on export-led growth
- Within emerging markets
  - Caution about Chinese rebalancing expressed by Yiping Huang and Bijan Wang
    - This caution echoes concerns expressed by YuYong Ding
    - Simulations by Milesi-Ferretti suggest Chinese net exports will subtract nearly 1% of world GDP from the level of demand facing other countries
- There is thus a significant risk of a global 'adding up problem'
  - with too many people seeking export-led growth
  - I will discuss this in my lunchtime talk
- In this paper we will discuss whether Europe will be able to achieve its objectives.

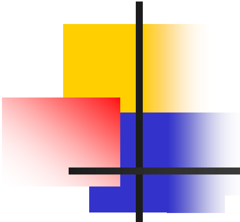
3 The Adjustment Problem *within* Europe: an EMU problem

- The benefits of belonging to EMU have been large, but not evenly shared
- What factors lay behind these European Divergences?
  - Catching up – Greece Ireland and Spain achieved very rapidly rising living standards. But other factors at work:
  - Conventional Microeconomic *explanation: rapid grwoth depends on flexibility of markets. 'EMU after 5 Years* ' (2004) argued this and urged the 'Lisbon agenda'
  - Conventional Macroeconomic View. EMU has a common monetary policy and so differing levels of competitiveness . Differing levels of demand require an adjustment mechanism though relative prices: prices must fall in the uncompetitive economy. Conventional view is that this will work OK.
- Recent events have revealed a new and different adjustment difficulty, due to the dynamics of the competitiveness adjustment process (Allsopp and Vines, 2010)


Consider country which loses competitiveness
Output falls
Price level only falls gradually: inflation ‘persistence’
Thus real interest rate rises (See Figure 1 over)
So domestic expenditures fall
This augments the fall in output
Inflation falls further, etc
Output may fall cumulatively – the ‘Walters critique’
Output may well overshoot.
With inflation persistence, when the price level in the initially uncompetitive economy (Germany) has adjusted to the appropriate level, relative to the initially-too-competitive economies (the PIGS)
Inflation in Germany will still be below that in the PIGS.
This means that the price level in Germany will go on falling below the relative position that is necessary.
This is what appears to have been happening in Germany (See Fig 2)




Real Exchange Rate, relative to the Eurozone
1999=100, measured as unit labour costs, whole
125
120
115
110
105
100
95
90
85
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
Spain
Ireland
Portugal
Italy
France
Germany
Source : Oxford Economics / Haver Analytics



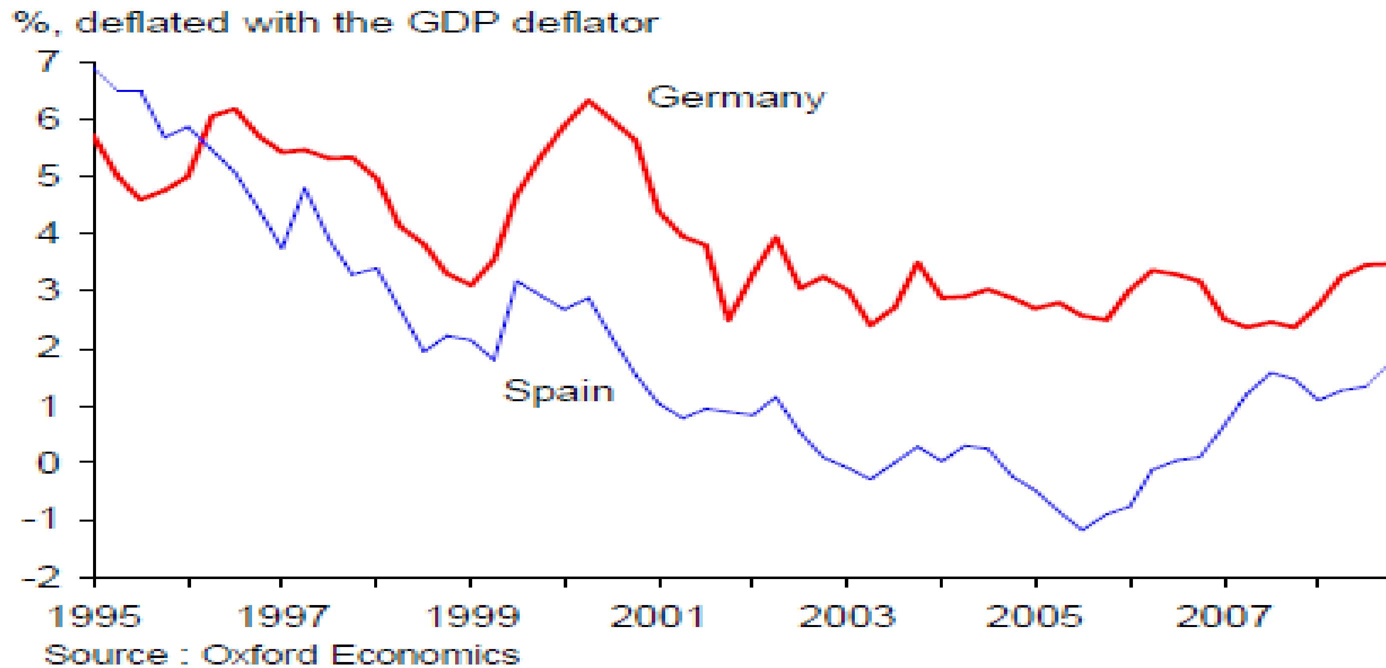
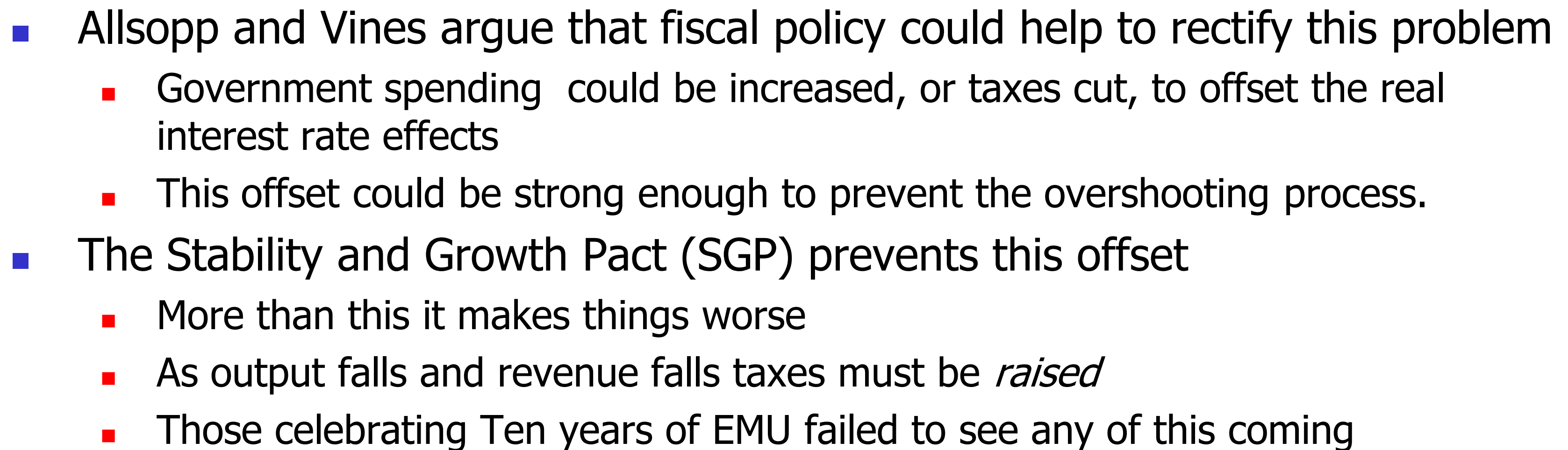
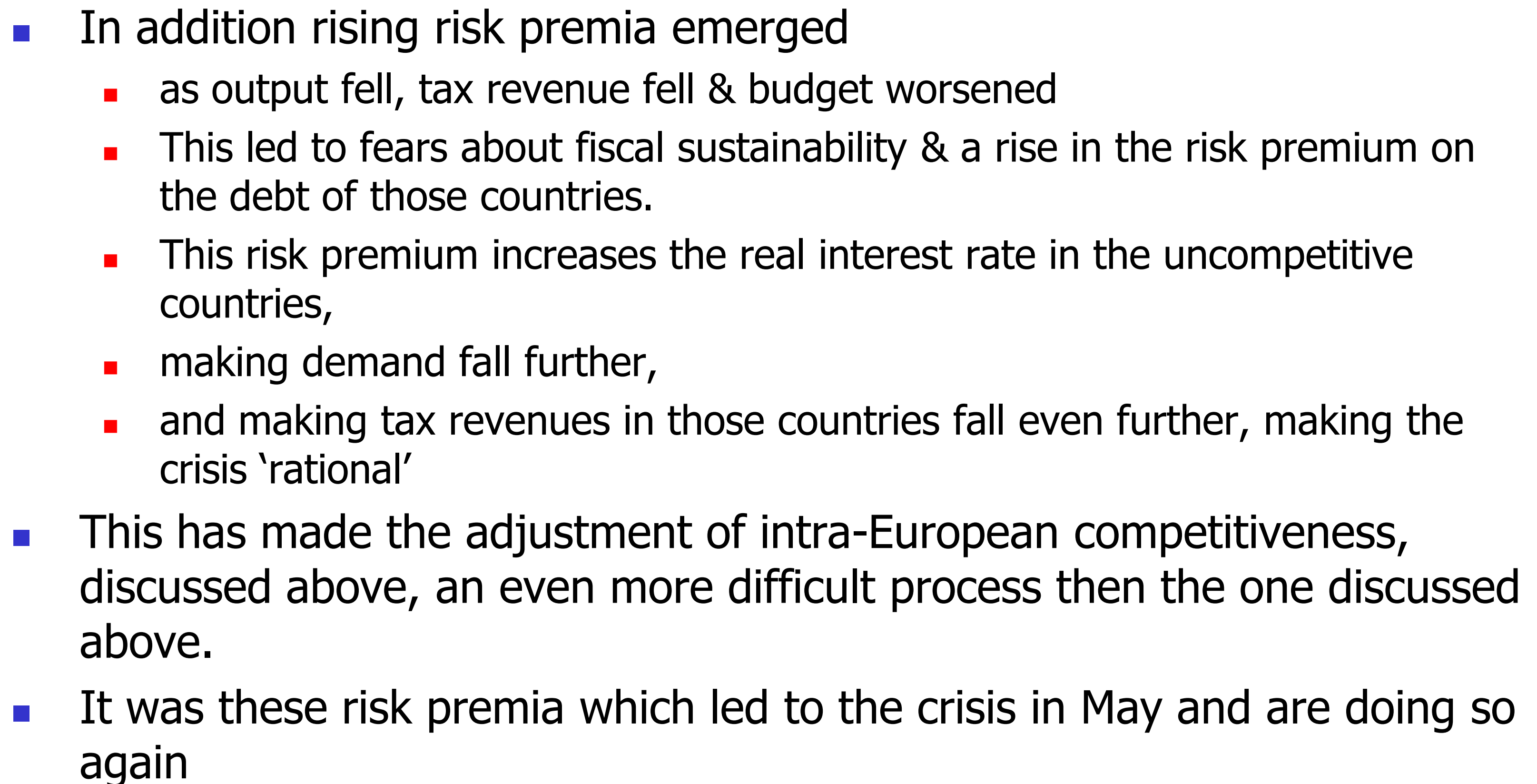


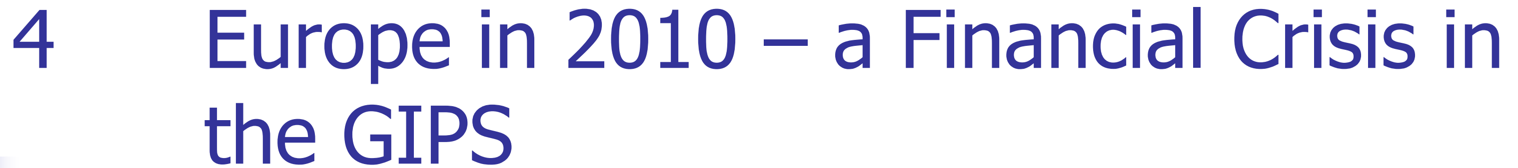
Figure 3: Real long term rate of interest



- Allsopp and Vines argue that fiscal policy could help to rectify this problem
  - Government spending could be increased, or taxes cut, to offset the real interest rate effects
  - This offset could be strong enough to prevent the overshooting process.
- The Stability and Growth Pact (SGP) prevents this offset
  - More than this it makes things worse
  - As output falls and revenue falls taxes must be *raised*
  - Those celebrating Ten years of EMU failed to see any of this coming



- In addition rising risk premia emerged
  - as output fell, tax revenue fell & budget worsened
  - This led to fears about fiscal sustainability & a rise in the risk premium on the debt of those countries.
  - This risk premium increases the real interest rate in the uncompetitive countries,
  - making demand fall further,
  - and making tax revenues in those countries fall even further, making the crisis ‘rational’
- This has made the adjustment of intra-European competitiveness, discussed above, an even more difficult process then the one discussed above.
- It was these risk premia which led to the crisis in May and are doing so again



4 Europe in 2010 – a Financial Crisis in the GIPS

4.1 Introduction

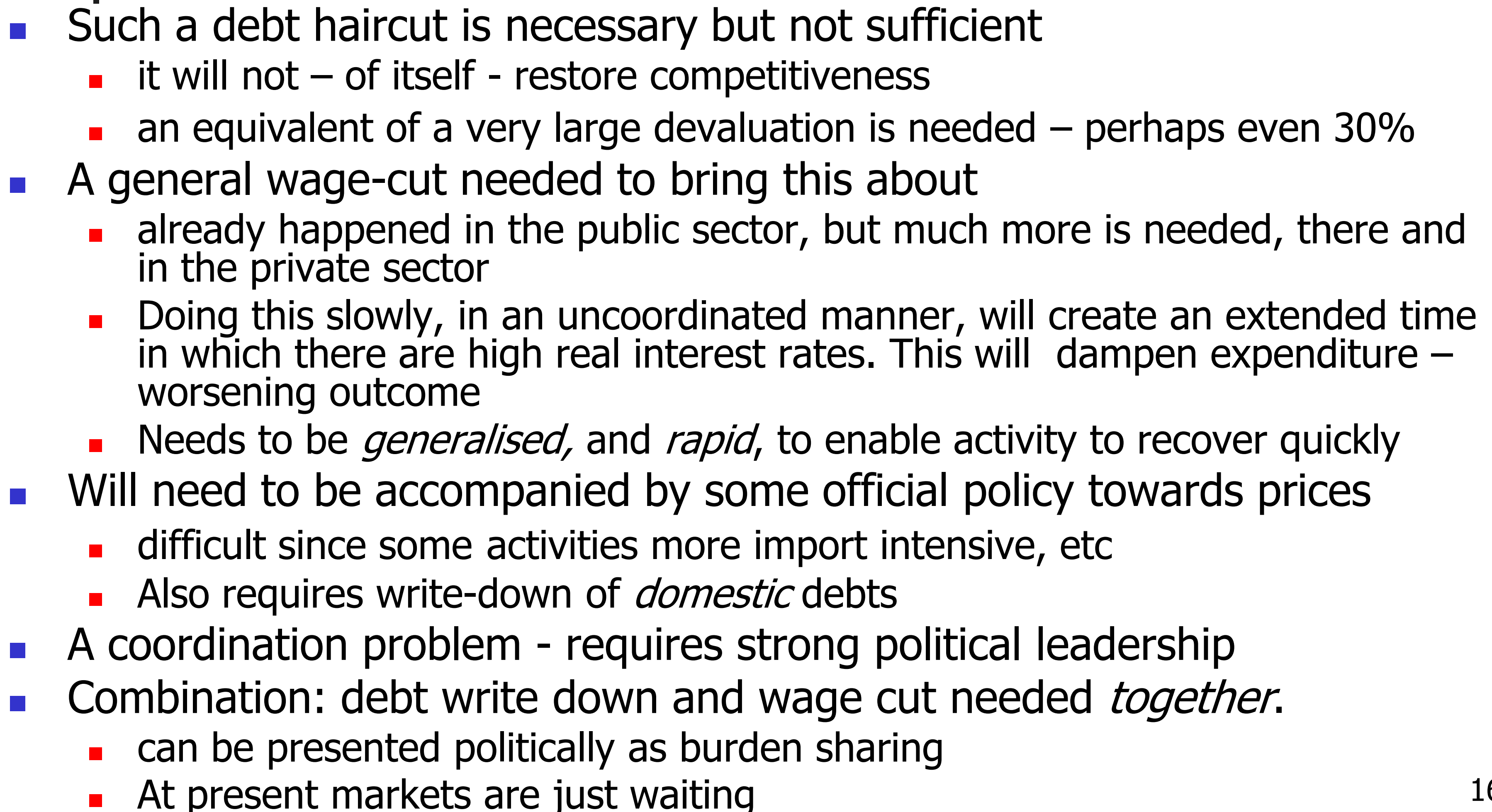
- Within EMU, the GIPS are now in difficulty.
- Only Greece has been forced to seek external support
- But as we meet Ireland is in trouble.
- And there are fears about Spain and Portugal
- The crisis response requires:
  - cuts of absorption in Greece, and elsewhere in the GIPS, coupled with *expansion* of absorption in Germany, and
  - below average inflation in Greece, and elsewhere, for a long time, coupled with *above average* inflation in Germany.
- We will discuss how these objectives are to be brought

4.2 The Current Strategy – Liquidity followed by Austerity

- Severe cuts to public expenditure
  - will take time to get the primary deficit back to zero
  - Debt will rise from 125 percent of GDP to 150 percent of GDP over the next four or five years before beginning to come down
- This strategy is not a bailout of the citizens
- It is a bailout of the financial lenders

4.3 The Greek Adjustment Programme

- The rescue means that Greece will not need to borrow again from private markets for three years.
  - The intention is that debt be serviced, and, over the longer term, repaid
  - The Greek programme requires a great deal of Austerity
  - Recovery needs to come from Greece becoming more competitive and achieving export-led growth
- In my view, this will not work
- Greece cannot devalue
  - Recovery blocked by a lack of competitiveness
  - Projections of low level of activity
  - With low activity tax revenue will remain low
- Fiscal correction requires growth, which this strategy cannot deliver
  - The strategy is likely to run aground politically in the next 18 months
  - It appears that Greek debt may need to be restructured
  - Markets suspect this – which is why risk premia were so high early in the summer and are so high now again now


Such a debt haircut is necessary but not sufficient
it will not – of itself - restore competitiveness
an equivalent of a very large devaluation is needed – perhaps even 30%
A general wage-cut needed to bring this about
already happened in the public sector, but much more is needed, there and in the private sector
Doing this slowly, in an uncoordinated manner, will create an extended time in which there are high real interest rates. This will dampen expenditure – worsening outcome
Needs to be generalised, and rapid, to enable activity to recover quickly
Will need to be accompanied by some official policy towards prices
difficult since some activities more import intensive, etc
Also requires write-down of domestic debts
A coordination problem - requires strong political leadership
Combination: debt write down and wage cut needed together.
can be presented politically as burden sharing
At present markets are just waiting

4.4 Contagion: Spain, Portugal and Ireland

- Financial markets will need to be robust enough to withstand the Greek haircut.
- The contagion effect in the rest of the GIPS countries (i.e., Ireland, Portugal and Spain) will need to be handled
  - The European SPV – the EFSF – *may* come to be very important in managing this trans-border process
- With the EFSF, Europe now has the capacity to deal with forthcoming crises
  - This may mean that dealing with these crises will not need to be delayed – as was the case with Greece – by Angela Merkel and the needs of German politics.
- The important question is whether Europe will use this facility wisely
- We are seeing this issue put to the test in the case of Ireland

5 Europe in 2010: Difficulties posed by the Germany position

The Need for Hegemonic Responsibility

- Crisis has also revealed systemic difficulties in Germany
- Germany has cut costs and prices, taking demand away from other countries
  - It turns out to be very difficult to belong to a monetary union with Germany
  - A intra-European 'competitiveness strategy' is now being discussed: this is a big institution-building task – and conceptually demanding
- Along with this, Germany has also restricted domestic spending
  - condemning Eurozone to low demand
  - or alternatively requiring that this demand will be taken from rest of world – a risk to world like that of
- This is not systemically responsible behaviour
  - serious conceptual issue here:
    - Thatcherite 'fiscal responsibility' is possible in a small open economy,
    - but a hegemonic leader has wider macroeconomic responsibilities.
- Will Germany be wise enough to lead?
  - Maybe not - possible outcome is a collapse of EMU and a two-currency bloc
    - Germany leads the North and France leads the South

6 New Rules for Fiscal Policy in Europe

- We have reviewed the inbuilt dynamic adjustment problem in EMU
- We have described the crisis difficulties
- We have argued that the SGP is no help
  - Need rules, within a framework of ‘constrained discretion’
  - What kind of rules?

For a good outcome, Fiscal policy in EMU must have rules in which:

(i) Only very gradual feedback from the level of debt to the fiscal position – the 'constraint' to be exercised gradually, only so as to ensure solvency

- This will require confidence in the commitment of the authorities

(ii) More expansionary fiscal policy if inflation becomes low, to prevent unstable developments in the price level – this is part of 'discretion'

- ie to prevent 'Walters critique' outcomes
- This is part of the 'discretion'

(iii) Feedback to fiscal policy from the real exchange rate – this is part of discretion

- fiscal policy tightened if the economy is uncompetitive
- fiscal policy becoming more expansionary as the real exchange rate depreciates towards its equilibrium level, to help prevent real-exchange-rate overshooting

(iv) Capability to provide support to EFSF – this is part of 'discretion'

- Liquidity support
- Capacity to support bailout at time of fiscal solvency crisis

- *Constructing such a regime will be politically and institutionally demanding*

7 Political Economy: A New form of European Macroeconomic Governance is required

- The crisis has shown a need to rethink European macroeconomic governance
  - a longer term need for 'Federal Intervention' in National Policymaking within EMU
  - effectively requiring the construction of a much tighter political union
  - Wolfgang Munchau (FT) 'Eurozone will break up unless there is acceptance of this'.
- As discussed in the previous section, the rules for this intervention will need to be more intelligent than the Stability and Growth Pact
    - Requires trust, not mechanical rules
  - I sense a reluctance in German policy-making circles
    - to accept the need for 'constrained discretion' of this kind in the weaker members of the union and a continuing wish for fixed rules
- The crisis has also shown a need for Germany to temper its own policy in the needs of the union.
  - Germany seems reluctant to do this, but there seems to be no alternative
  - There are great risks here – with significant global implications

8 Conclusion – what have we learned?

On fiscal policy and macroeconomic management

(a) Fiscal policy in EMU must pay more attention to competitive positions, and much less attention to the level of debt

(b) Competitiveness is very important for macroeconomic outcomes. If a country's competitive position is inappropriate then, if it seeks to control its own debt, this may have significant negative effects on other countries in the union.

(c) Implementation of fiscal policy needs to be more judgemental, balancing constraint and discretion

On crisis management – we have seen how politically interdependent EMU countries have become

(i) But this crisis-management process has been unsatisfactory. A *fiscal* system must be devised to relieve the ECB of the conditionality burden which it currently bears.

(ii) Germany has signalled that it is prepared to support the EMU project, fiscally if necessary. But the German constitutional court may make this difficult – or even impossible