Fiscal policy coordination: a necessary step for the Eurozone recovery

Andrea Boitani§, Roberto Tamborini#

On January 21st, 2015, the strict monetary austerity regime of the Euro Zone (EZ) was officially abandoned as the European Central Bank (ECB) launched the Quantitative Easing (QE) programme of State bonds purchases on secondary markets. The European Court of Justice's attorney general has certified that the QE programme is not in contrast with the EZ Treaties, but it certainly breaches the established interpretation regarding the latitude of the ECB room of manoeuvre within its mandate. In November 201 the newly appointed European Commission has launched an investment programme, the most significant impact of which is the message that, in principle, there can be a common pool of resources for governments to spend off the books of the Excessive Deficit Procedure[1]. Also, the "flexibility" issue raised by Italy and France regarding timing and extent of application of the fiscal rules *vis-à-vis* contingent macroeconomic conditions is no longer taboo, and a few steps forward have been made in that direction (albeit the pro-cyclical maze of rules rests untouched). And of course, a major political change took place in Greece and may affect the whole of Europe. These seeds of regime shift come from overwhelming pressure of economic, social and political crises all across Europe, a widening divergence of policy strategies with major partners and official institutions outside the EZ, and the rapid decline of support for the austerity doctrine from leading academic schools outside the "German block".

Is the European austerity doctrine dead, and can we forget about it? Not quite. We all understand that a fast boost to economic activity in the EZ cannot only come from monetary QE plus sparse domestic fiscal stimuli, whatever is the fiscal space to which each government is constrained by the Fiscal Compact or by investors. As argued by President Draghi at Jackson Hole, the road towards a satisfactory recovery rate in the EZ can only be opened by *fiscal and monetary coordination at the EZ level*, and this can only be accomplished if a *fiscal stimulus is coordinated across countries from Brussels*. This view calls into question the design of the economic governance of the EZ, of which the austerity doctrine is as yet one of the pillars.

Awaiting for the United States of Europe, it is urgent fixing the notorious asymmetry between the single monetary policy and 17 national fiscal policies in view of more effective macroeconomic stabilization. As we shall argue, this reform does not need a full-blown federal system, nor deep fiscal solidarity, nor large fiscal transfers. More simply, the creation of a fiscal policy board, a new "Ecofin 2.0", with a clear mandate for fiscal policy coordination *vis-à-vis* the monetary policy stance of the ECB[2]. Ideological and political resistance to take this step is myopic: if we do not move now, the hardship of the European crisis will force us to move later at much higher cost.

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§ Department of Economics and Finance, Catholic University, Milan, Italy, andrea.boitani@unicatt.it.

Department of Economics and Management, University of Trento, Italy, roberto.tamborini@unitn.it

[1] Although there are doubts that the plan is more than smoke and mirrors, Daniel Gros.

[2] For a similar proposal see Guiso and Morelli (2014).

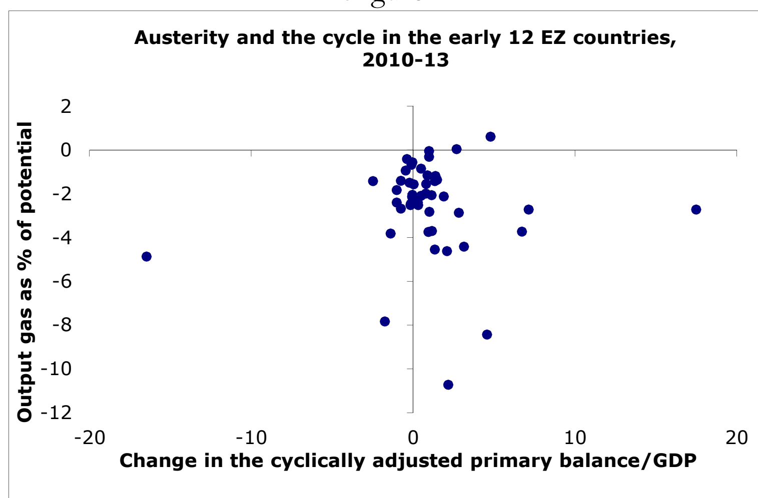
Faulty foundations, faulty narratives

It is largely agreed that the economic governance of the EZ has to a large extent failed since the start of the Great Recession (e.g. De Grauwe, 2013). From the foundational point of view, the key fault lies in two (pseudo-moral) doctrines: the austerity doctrine, and the national responsibility doctrine. It may be argued that these were the *sine-qua-non* pillars of the political agreement with Germany. Nonetheless, those pillars proved unable to generate a viable set of institutions, rules and policy guidelines as made crystal clear by the first true "stress test".

Austerity policies[3], supported by ever more complicated fiscal rules, proved to be pro-cyclical (i.e. contractionary), contrary to the comforting belief that fiscal consolidation in hard times is (or at least may be managed as to be) "growth friendly". Worse, austerity failed even on the very basic front of public finance problems. Well-known examples of the failures of the austerity doctrine can be seen in figures 1, 2 and 3.

First, as shown by figure 1, from 2010 to 2103 in the early 12 EZ countries about 75% of austerity episodes (as measured by positive changes in the cyclically adjusted primary balance) occurred in a year with (large) negative output gap, that is when standard macro-policy principles recommend expansionary policy measures. Since the monetary policy rates were almost at the zero lower bound (and the efficacy of the single monetary policy can be uneven across country), that recommendation means active fiscal policy.

Figure 1



Source: Eurostat, database AMECO

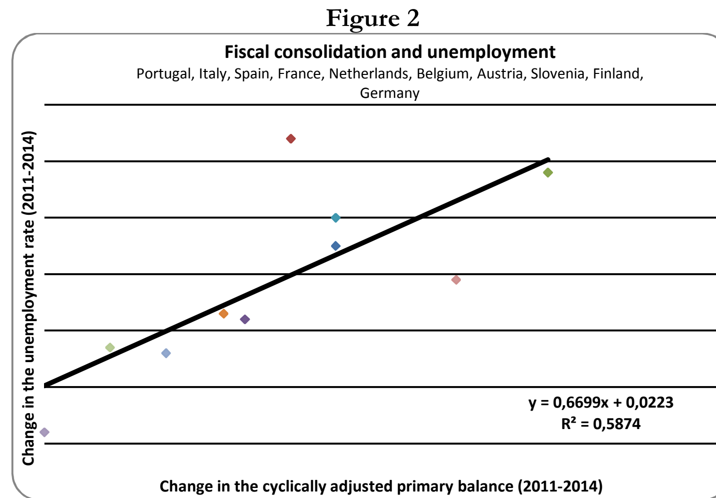
Second, GDP grew less and unemployment grew more (see figure2) in those countries that implemented stronger consolidation policies. Whether or not the latter were also structurally weaker, any positive effect of fiscal consolidation is hardly detectable.

Finally, also the debt/GDP ratio grew more in those countries where stronger consolidation policies were enforced (see figure 3), proving that such policies have been ineffective even at pursuing their foremost target: reducing the debt/GDP ratios that had skyrocketed in 2009-2010 as a consequence of widespread bail-outs of financially distressed banks, GDP plummeting and some timid fiscal stimulus in 2009. The

[3] For an overall assessment for the whole Transatlantic area see Tamborini (2014).

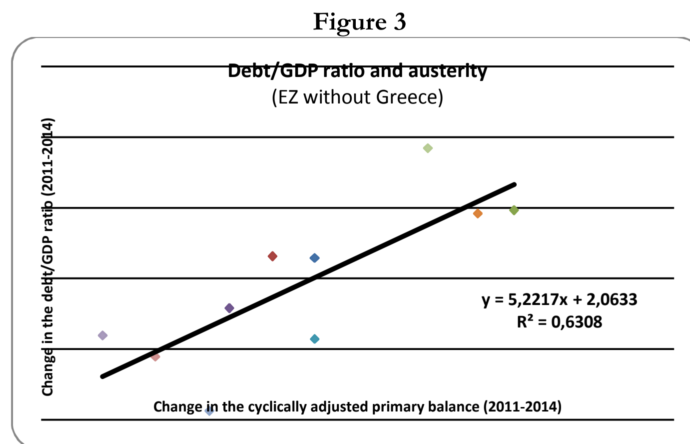
explanation consistent with the above facts is that austerity has reduced GDP growth more than debt growth.

Figure 2



Source: OECD

Figure 3



Source: OECD

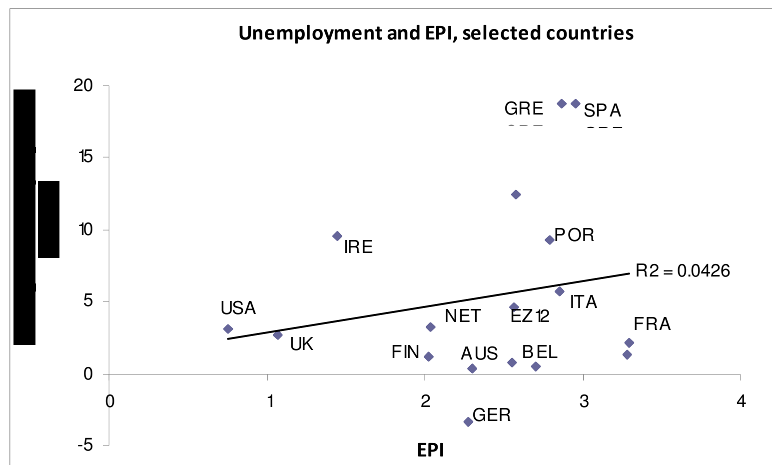
In front of the failures of austerity it has become commonplace blaming specific faults in weaker countries. Two are worth mentioning. One is that growth-unfriendly austerity is the result of the wrong policy mix of too large tax increases instead of expenditure cuts. Yet, as shown by Tamborini (2014), the austerity mix has poor statistical relationship with differences in growth performance. Austerity has been obtained by raising taxes faster than expenditure almost everywhere *except in the countries under the 'Troika' treatment*, where the growth performance has been dramatically worse than elsewhere.

Another key argument is the absence (or the excessively slow implementation) of "structural reforms". Austerity failed - the argument goes - where the governments failed to do their homework correctly. That is, where governments did not comply with the Berlin-Brussels-Frankfurt consensus about national labour market reforms in order to: lowering real wages; adopting pro-competition policies to reduce mark-ups and therefore

prices of tradable goods and non-tradable services, etc. Only structural reforms – the mantra goes – can pave the road out of this deep recession. Sure? Not so much[4].

To begin with, inspection of standard labour market statistics does not lend much support to the structural reforms narrative in two respects. The first is that there is not much evidence that labour markets have remained rigid in the face of falling output and rising unemployment. From 2007 to 2013, real unit labour costs fell by 12.4% in Cyprus, 10.5% in Greece, 5.8% in Spain, 3.3% in Portugal. The second is that differences in rigidity across countries amount to a thin explanation of differences in unemployment performances.

Figure 4



Source: OECD Employment Protection Indicators, Eurostat, database AMECO

Using the Employment Protection Indicators (EPI)[5], we have elaborated a synthetic index for each applicable country based on two EPI: "Strictness of employment protection; Individual and collective dismissal (regular contracts)" (version 3), and "Temporary employment" (version 3). The index is the average of the average value of the two EPI from 2008 to 2013 (actually, EPI have remained constant or have changed very little in this period of time). The relationship between this rigidity index and the change of unemployment is shown in figure 4. If *some* countries with higher index display a greater increase in unemployment than do *some* countries with lower index, this pattern is far from providing an exhaustive explanation of the differences in unemployment performance. True, the more flexible Anglo-Saxon economies have suffered relatively smaller increases in unemployment, but the majority of the European economies, with much higher indices, have done no worse, or even better. Germany's celebrated Hartz reforms have changed little its mid-EPI ranking, and yet its employment resilience has been vigorous. The much worse unemployment performance of the EZ peripheral countries seems unrelated to significant differences in rigidity with respect to the other EZ partners.

[4] Of course, other useful structural reforms may be conceived for Europe, but here we shall use this term to denote the neo-liberal agenda of the Frankfurt-Brussels.Berlin consensus.

[5] http://www.oecd.org/employment/emp/oecdindicatorsofemploymentprotection.htm/.

Getting the Euro Zone economics right

Along the eighty years between the Great Depression and the Great Recession, we have learned that well-functioning market economies usually have public powers doing two things which free market forces may not do: create institutions granting market efficiency and social equity, and keep aggregate demand in line with supply. Radical deviations from this historical wisdom are essentially ideological, and have proved to be disruptive.

Today's elementary Macro textbooks carefully distinguish between a long run in which the supply side matters and a short run in which the demand side matters. Supply side structural reforms affect the long run potential output but only aggregate demand policies can in the short run fill the negative output gap due to financial crisis and consequent aggregate demand shortfalls. Elementary textbooks may be a little too harsh in separating the long from the short run. However, recent theoretical frontier-research (Eggertson, Ferraro and Raffo, 2014) has shown that structural reforms aimed at increasing potential output may become counter-productive in the short run when the economy is at the zero-lower-bound (i.e. nominal interest rates are virtually zero and inflation is close to zero). Only strong real devaluations (due to lower labour costs and prices) may help inducing an export-led recovery in the periphery (Vogel, 2012, among others), provided those effects are perfectly anticipated, there is no financial accelerator and, of course, reforms (which usually come in the form of parliamentary acts or bills) actually have the desired impacts on the crucial variables. That is, the short run effects seem to be highly uncertain and probably not so quick to come about.

Empirical research on the impact of structural reforms is no longer unanimously enthusiastic. An important point made by an extended study by the IMF (2012) is that the cyclical position of the economy and the concomitant policy stance do matter. In countries under fiscal adjustment, the relief from structural reforms is *reduced* with respect to normal conditions. It may be quite modest and stretching over a decade. The interesting explanation put forward by this study is once again related to the output gap. In fact, if the government is cutting aggregate demand and at the same time succeeds in spurring supply, the gap *widens*. Hence, the excess capacity that afflicts firms grows larger and stretches over time. But this runs counter the dogma of rational expectations. If entrepreneurs anticipate growing excess capacity why should they expand it now? Hence supply side policies without proactive demand side polices may be self-defeating.

Not only does the "national responsibility" doctrine stand on such disputable economic bases. It is also more profoundly flawed as a normative principle. Responsibility implies free will and full ability to take, or not to take, a determinate course of action. And on the other hand, a given state of affairs can be attributed to someone's responsibility if such a state is unequivocally and exclusively the result of his/her will and actions. These conditions can hardly hold when we move from individuals to "nations" and their governments in a highly interdependent world.

Take as an example the unwinding of the so-called "macroeconomic imbalances" across the EZ in the years prior to the financial crisis of 2007-08. It is well documented that the current-account surpluses with net foreign lending of the Continental countries were the mirror image of the current-account deficits with net foreign borrowing of the Shore countries[6]. This is a notorious chicken-and-egg puzzle, which has no firm scientific solution, since it is the result of widely dispersed market forces that no one can control in

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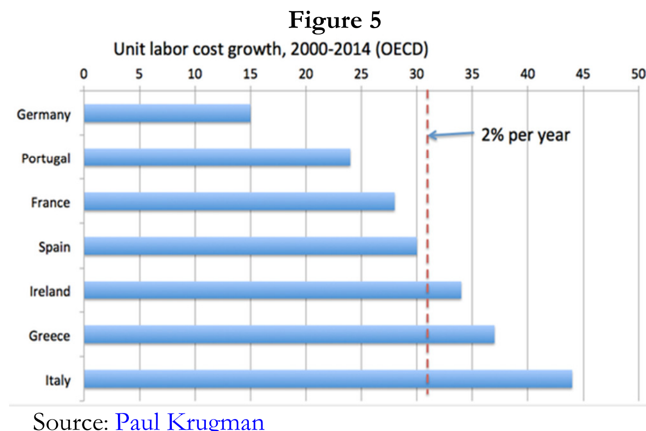
[6] Geographically not all the net borrowing countries (e.g. Portugal and Ireland) were in the South of Europe as is usually said. Instead, for some unknown reason, they all were along the European sea borders.

their entirety. The imbalances were largely originated by the private sectors, with public sectors in slight deficit or close to balance. Blanchard and Giavazzi (2002) argued that those imbalances were not a problem, quite the contrary they were the evidence that free capital movements were doing their job. Later Giavazzi and Spaventa (2010) explained that the imbalances turned out to be a problem because capital inflows were badly used for unproductive uses. Prof. H. W. Sinn (2014) loves to say that a party was going on in the South. One can also say that the North was bringing the bottles. Europe wanted free capital movements because of the widespread faith in the allocative efficiency of private investors. Governments have little, indeed zero, control on them. And "nations" are a void concept in economics: good or bad uses of resources by way of markets is matter of individual responsibility. Yet governments had to intervene to bail out private lenders and borrowers under threat of disastrous default *à la* Lehman taking the threat onto themselves. Where does the responsibility lie? Is there any sense in the statement that macroeconomic imbalances were, or always are, matter of "national responsibility"?

The story of rebalancing the imbalances is alike. Each country doing its own homework independently of the others is no solution to the problem. And a country's failure in doing homework, or getting the expected results, may not only be its own responsibility. For instance, a well-entrenched view is that the EZ should work as the gold standard regime, where "gold" is the stock of euros created by the ECB (e.g. Sinn, 2014). In this view, deficit countries lose "gold" (Target 2 balances) and should rebalance by regaining competitiveness through internal deflation (thus the insistence on structural reforms). Yet the classical theory of the gold standard says that surplus countries which receive excess gold contribute to rebalancing by way of internal inflation. If this does not happen, all the burden is shifted onto the deficit countries, and if this is too large, the mechanism breaks down. Who is responsible?

Asking the EZ deficit countries to pursue their GDP recovery through a deep real devaluation (largely under way with little results) amounts to implying that the pursuit of competitiveness is the duty of each member country. However, as Paul Krugman noted: "if we look at the whole period from 1999 to the present, most of Europe has had cost growth and inflation just about consistent with the ECB's long-standing just-under-2 percent inflation target". And more recently: "what we see is that Italy is somewhat out of line - but the real standout is Germany, which has had much too little wage growth. And this in turn suggests that if we're looking for the key to European problems, it lies in Germany's beggar-they-neighbour relative wage deflation" Paul Krugman[7].

Figure 5



Source: Paul Krugman

[7] See also Francesco Saraceno; Simon Wren-Lewis.

German economists, and the public opinion at large, reject this argument as almost offensive. We are the most competitive manufacturing country in the Western world, they argue, we are not the problem, and you cannot ask us to be less competitive to help lazy countries. This reaction may even be understandable, but it reveals where the problem of rebalancing the imbalances lies. Rebalancing by way of external competitiveness is a zero-sum game or, as said above, there cannot be un-coordinated, non-cooperative solution. This was indeed the hard lesson that international reformers at Bretton Woods drew from the collapse of the gold standard regimes in the inter-war years.

Today, any macroeconomic textbook teaches that the overall aggregate demand within a currency area is the weighted average of the surpluses and deficits of its member states. As well-known in Brussels, with a surplus above 6% of its GDP, Germany is presently violating the Six Pack article tackling the "composition problem", that is the obligation to revive domestic demand for a country that causes the other countries' current account deficit by suckling their domestic demand.

Can smooth rebalancing be entirely engineered by the ECB? The more aggressive QE announced by the ECB may help, but Mr. Draghi is right in warning that the ECB room of manoeuvre is almost exhausted. not so much for the formal opposition of the Bundesbank, as for the practical *beggar-thy-neighbour* policy in which the EZ is entrapped. In a monetary union, given the general monetary stance, differences in demand and price paths across countries depend on local demand management. Hence, though the pressure by Brussels to keep austerity tight is being relaxed, the EZ is still entrapped in the vicious circle where it fell in 2010 and 2011, when it took the road down towards its own double-dip, diverging from the path of all other non-EZ areas. Deficit countries have experienced again in 2014 the dangerous situation whereby the risk of default could be fuelled by disappointing growth, with the possibility that a contagion effect could renew a hike in the spreads also in countries on the right track towards more virtuous public finances. In this unfortunate case the negative externalities would come back, the blindness of the "national responsibility view" would reach its climax. As aptly pointed out by Bastasin (2014), monetary policy independence, exclusive national responsibility, and irreversibility of the euro make an inconsistent triplet: sooner or later any one out of the three has to be dropped.

Ecofin 2.0

The design of the EMU macroeconomic governance born in Maastricht has proved to be founded on shaky pillars. It should be out of dispute that the ensuing policy mismanagement has prolonged and amplified the effects of a crisis originated elsewhere. Insisting on faulty stories will not fix faulty foundations.

What can, and should, genuine reformers do? As in any high politics operation, a unique combination of vision, determination and brinkmanship is needed. First, to conquer mutual trust, it should be clear that the reform will not be a tricky system of bypasses of the fiscal responsibilities, sovereignty limitations, and economic reforms that are necessary to live and prosper in Europe and in the euro. Second, the "democratic deficit" of European institutions at large should be taken very seriously: fiscal policy cannot and should not be delegated to technocratic entities behind the curtain of pseudo-fixed rules. Fully fledged political and fiscal federalism can be shown to Pareto-dominate other institutional arrangements in a monetary union with labour mobility and asymmetric shocks (Baglioni, Boitani, Bordignon, 2015). However, within the present political

constraints, the United States of Europe may well be a mirage, capable of entrapping the Eurozone in a dangerous *status quo*. What is urgently needed is an *effective system of protection and stabilization against large economic and financial boom-bust cycles* wisely articulated at the national and super national levels along the following lines.

1. Complete redesign of the fiscal regulation system: a) substitution of the "country-by-country" approach with a system oriented towards coordination of fiscal policies; b) removal of the apparatus of fixed rules on current fiscal budgets, in favour of direct monitoring of long-term sustainability of public debt; c) flexibility of long-term fiscal plans in relation to the business cycle, domestically and Union-wide, under peer monitoring and coordination; d) transfer of a few national fiscal competences (e.g. defence, supranational infrastructural investments, automatic stabilizers, such as unemployment benefits) to the Union's budget, under the control of the European Parliament, which may be the germ of a fiscal union.

2. Institution of a newly conceived "Ecofin 2.0", a board of national fiscal authorities with a clear mandate to implement the new fiscal rules and coordinate Union-wide fiscal policy in view of stabilization of the aggregate business cycle *vis-à-vis* the monetary policy stance of the ECB. The board should also have a clear and transparent agenda and a system of majority voting. This does not guarantee that the divergent policy interests of the German block with the rest of the EZ can be overcome, but that, as it happened with the ECB architecture, negotiations will be clear and transparent, not predetermined under the shield of fixed rules, so that alternative views may have a chance.

3. Realignment of the ECB statute and latitude of competences in line with those of standard central banks in developed countries (remove prohibitions that are not enforceable when they may endanger the stability of the system).

Last but not least, genuine reformers will need the credible determination to present all the others with a clear-cut alternative: either a serious reform is started here and now, with all the necessary ingredients, those which the *South* dislikes as well as those which the *North* dislikes, or everyone will have to take its own share of responsibility in saying 'No' to the European economic and monetary union.

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