EMU Governance and Eurozone Fiscal Stance

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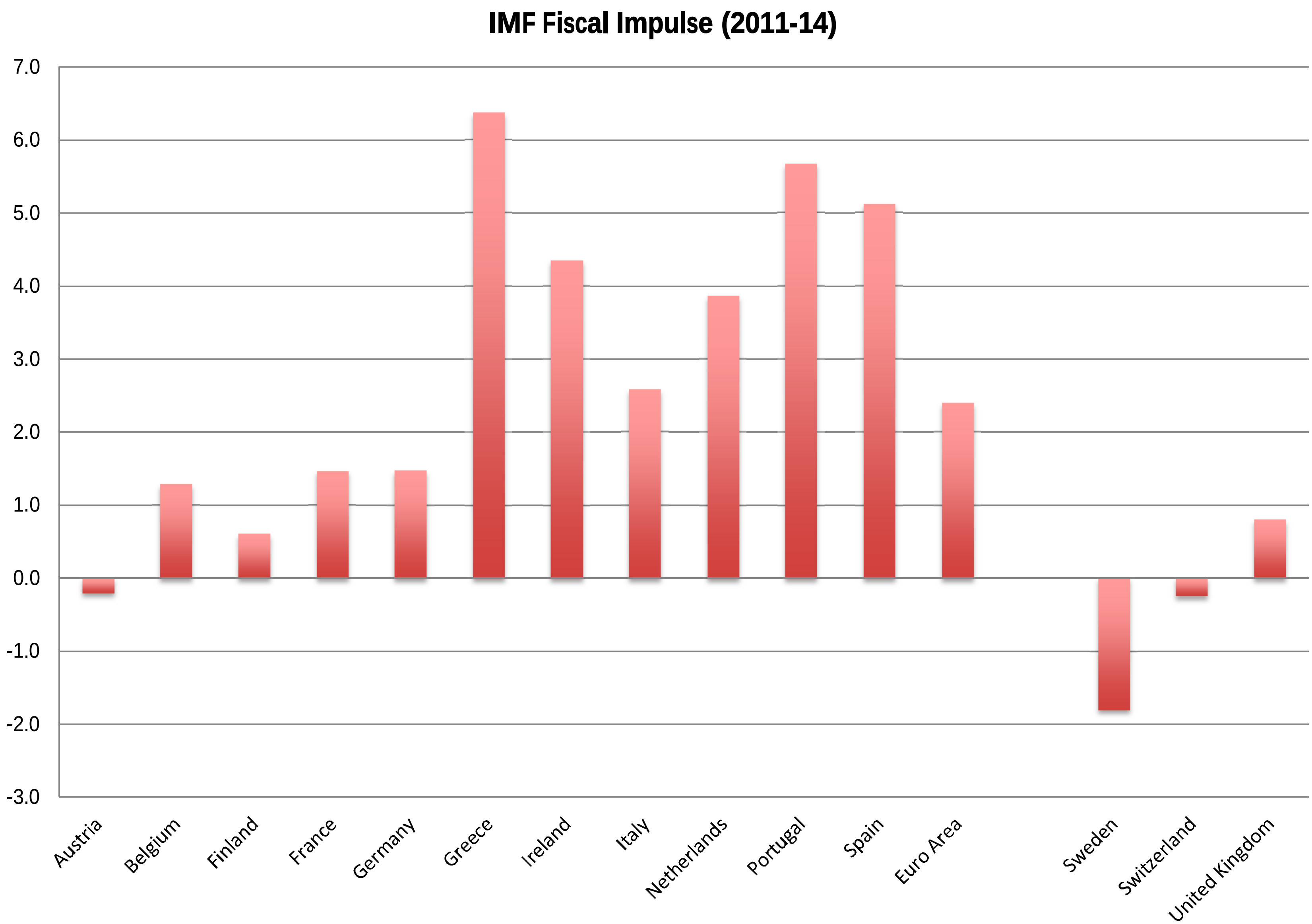
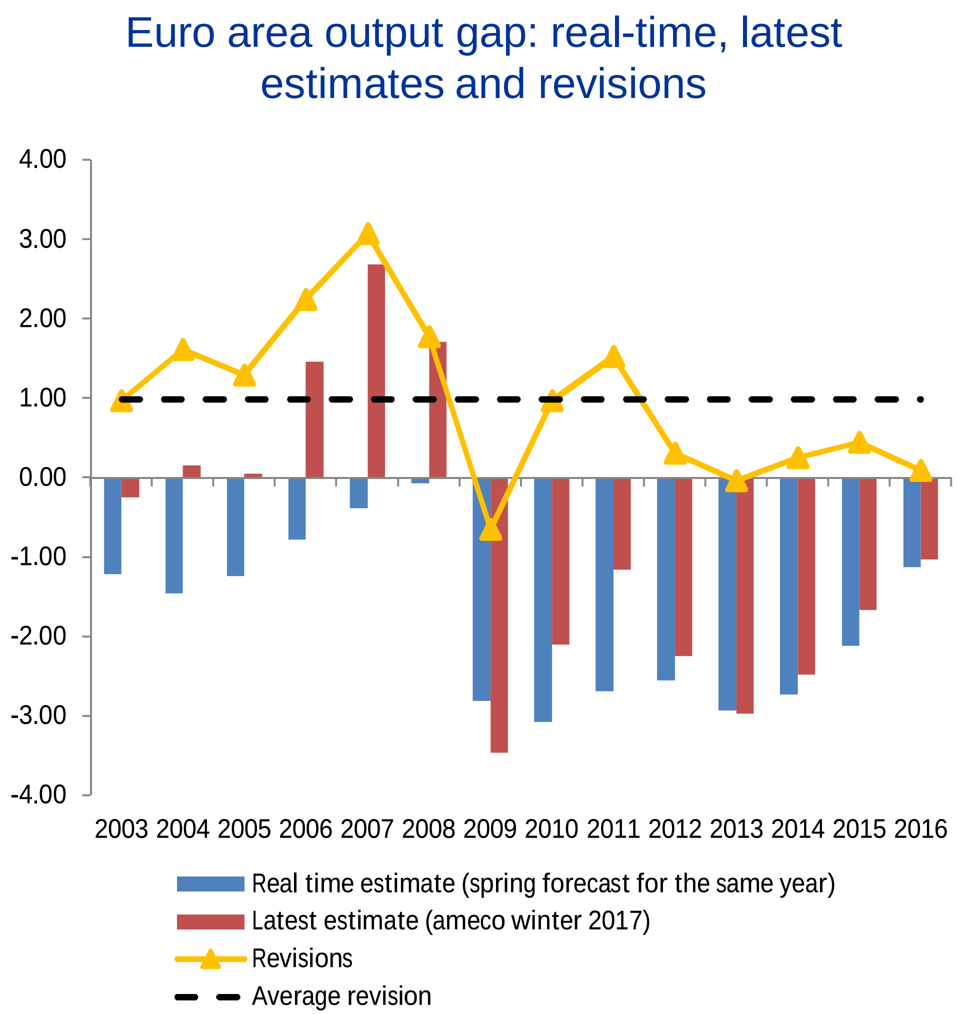
LSE and CEPS

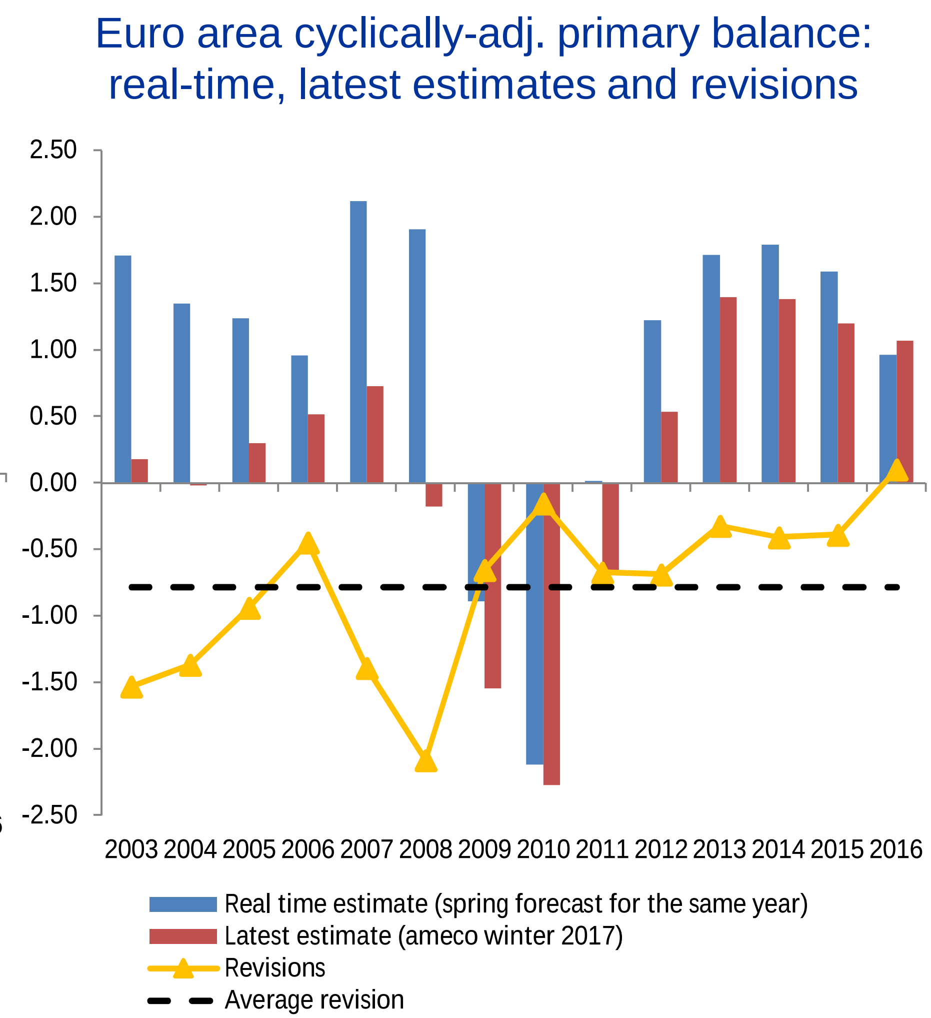
- Major policy mistakes during 2011-14
- Why did this happen?
- Continuing major policy mistakes resulting from fiscal compact



IMF Fiscal Impulse (2011-14)
7.0
6.0
5.0
4.0
3.0
2.0
1.0
0.0
-1.0
-2.0
-3.0
Austria
Belgium
Finland
France
Germany
Greece
Ireland
Italy
Netherlands
Portugal
Spain
Euro Area
Sweden
Switzerland
United Kingdom



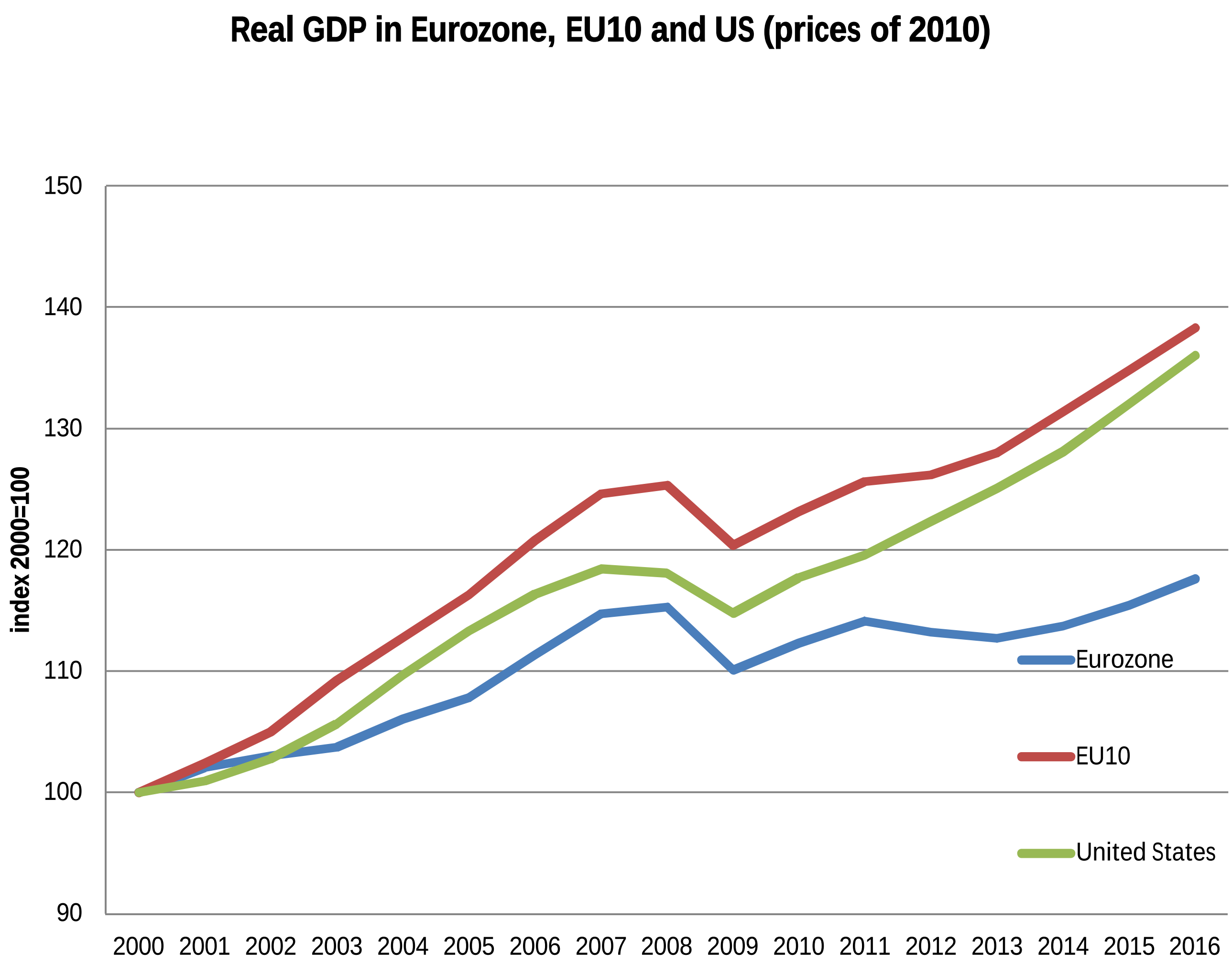
Source: AMECO, ECB staff calculations.



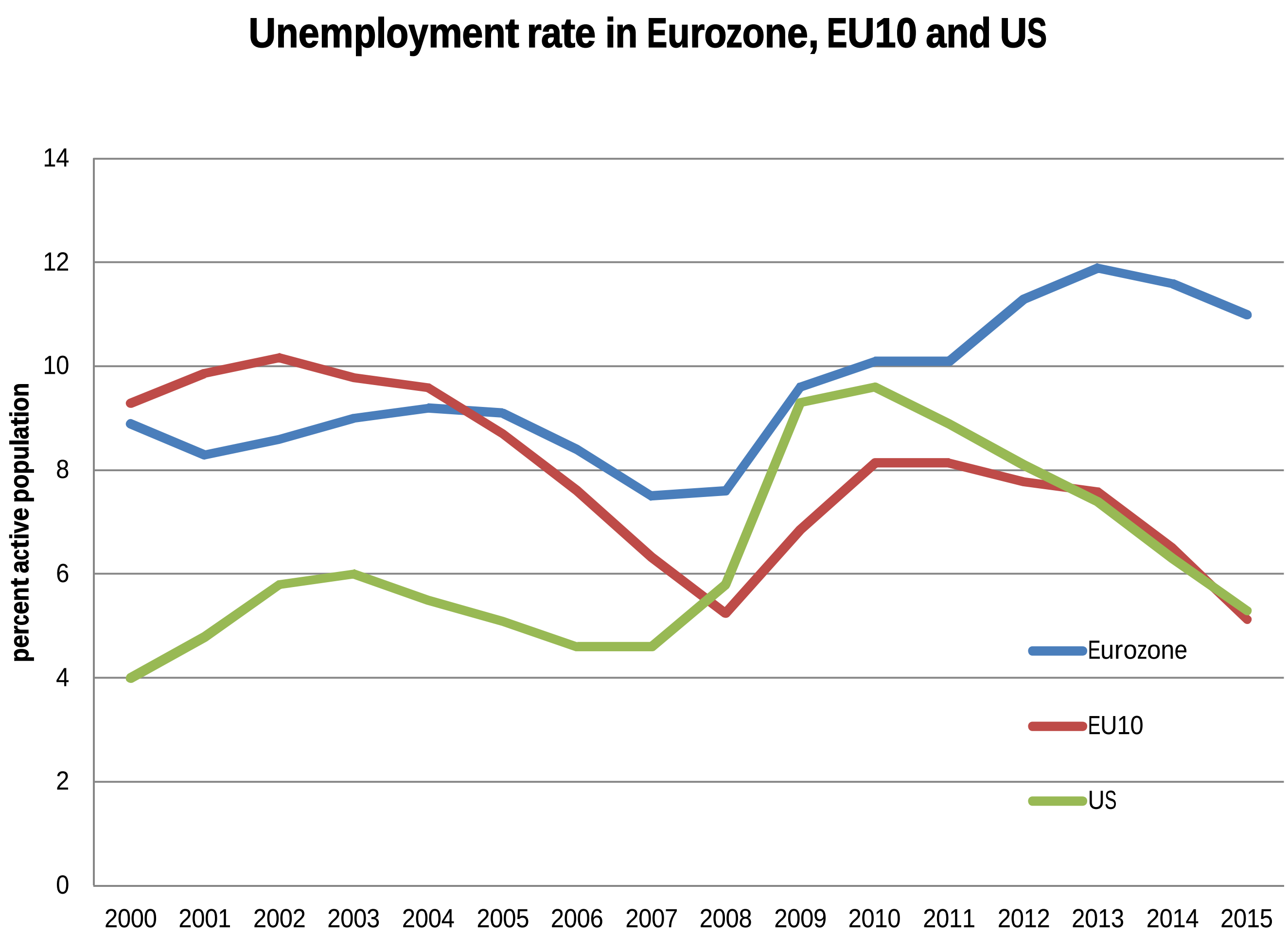
Source: AMECO, ECB calculations

- Real-time output gap missed the pre-crisis boom.

Stagnation in Eurozone

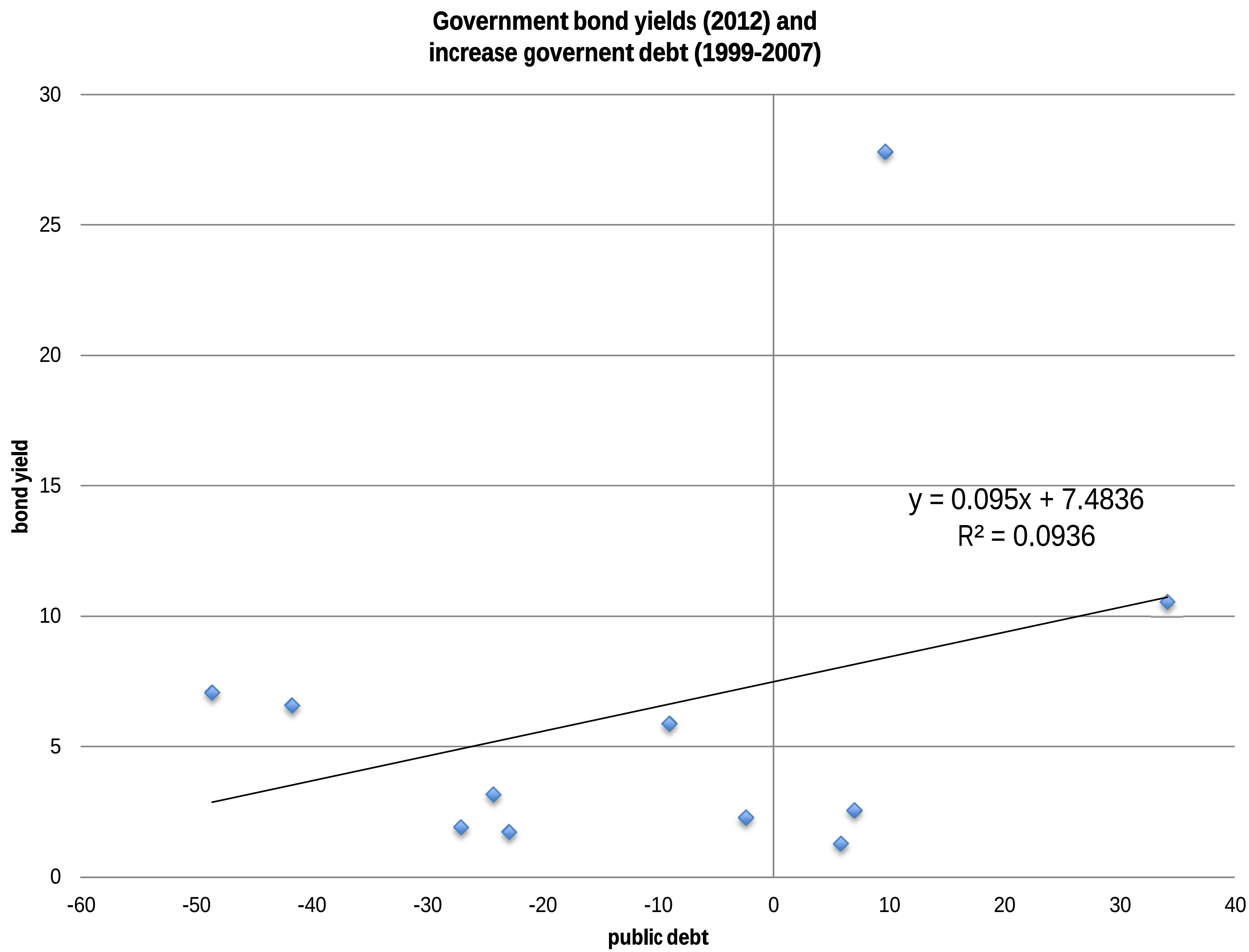


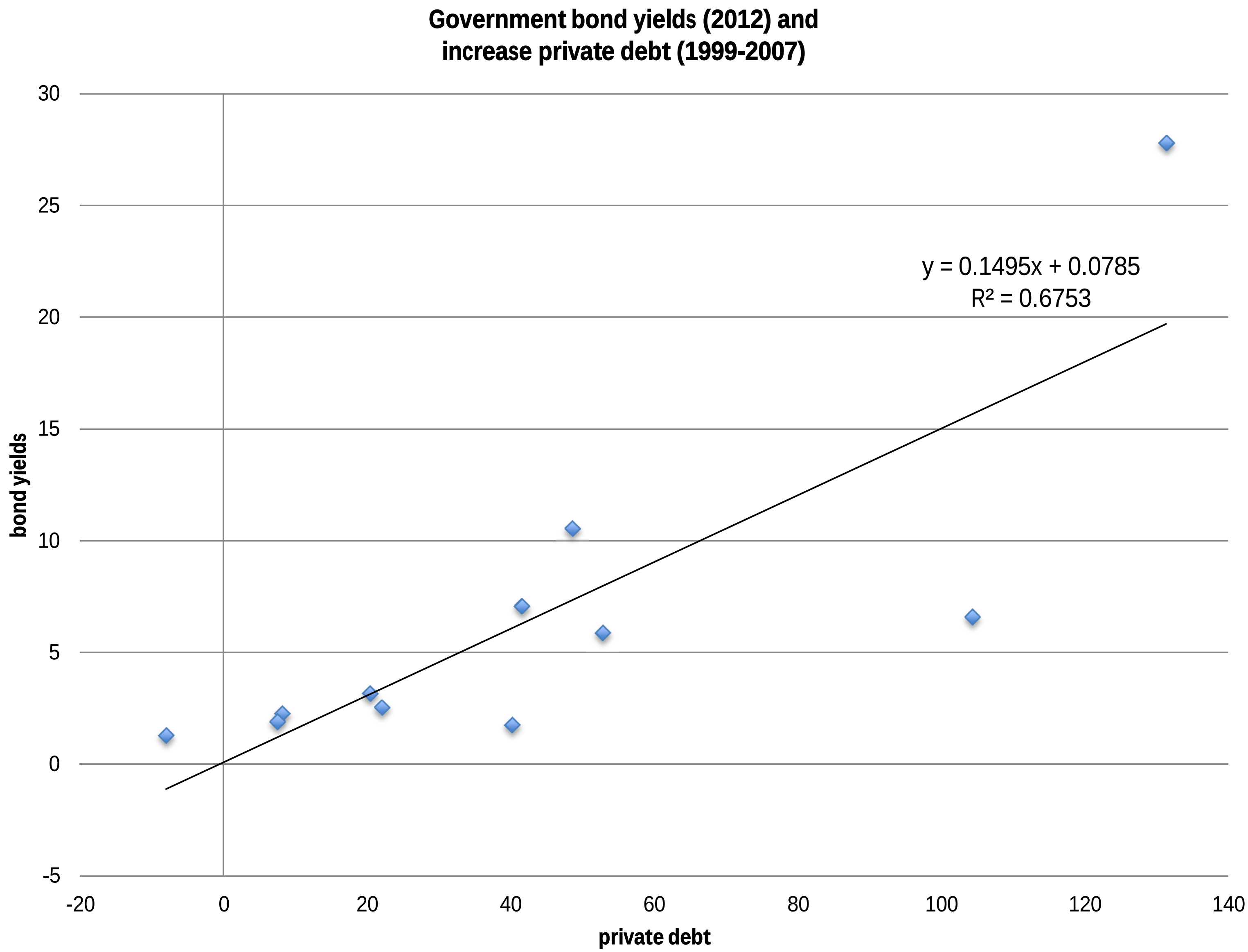
Increasing unemployment

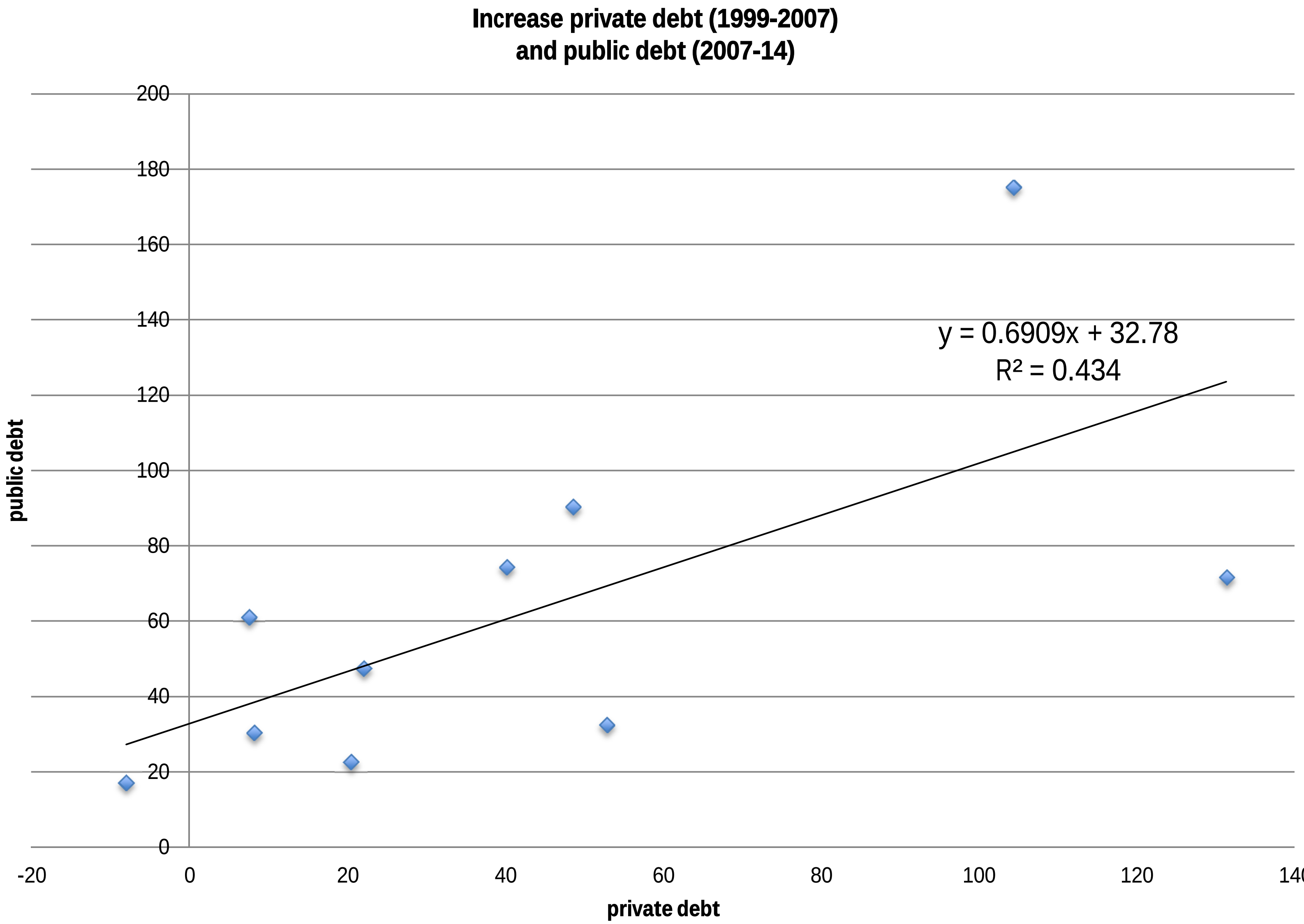


Why these policy errors

- Misdiagnosis of the sovereign debt crisis


Government bond yields (2012) and
increase governent debt (1999-2007)
30
25
20
15
10
5
0
bond yield
-60
-50
-40
-30
-20
-10
0
10
20
30
40
public debt
y = 0.095x + 7.4836
R² = 0.0936


Government bond yields (2012) and
increase private debt (1999-2007)
30
25
20
15
10
5
0
-5
bond yields
-20
0
20
40
60
80
100
120
140
private debt
y = 0.1495x + 0.0785
R² = 0.6753



Increase private debt (1999-2007)
and public debt (2007-14)
y = 0.6909x + 32.78
R² = 0.434
public debt
private debt
200
180
160
140
120
100
80
60
40
20
0
-20
0
20
40
60
80
100
120
140

Continuing policy errors

- Fiscal compact imposes countries to move to structural budget balance
- Implication: “Thou Shall Not Borrow” even if this is to finance public investment
- This has been imposed during period of record low interest rates
- And sluggish growth
- This was the right time to boost public investment by allowing bond financing
- Not only in Germany

Throw away dogmas

- We have to free ourselves of dogmas
- One such dogma: balanced budget, i.e. no bond financing of investments
  - All investments should be financed by current revenue
  - No well run company follows such a rule
- Result: governments are reducing their responsibility to provide essential public goods (infrastructure, energy investments, environmental investments)
- This reduces long-term growth of the Eurozone

Gross and net debt

- Need to distinguish gross and net debt
- Europe imposes governments to care only about gross debt
- What matters is net debt
- When governments invest in productive assets and issue debt to finance this net debt does not increase
- If productive assets have higher rate of return than cost of borrowing, future debt burden is alleviated
- Thus our grand children will not understand why governments today did not issue more debt to invest in productive assets that earn more than the cost of the debt

- One main design failure Eurozone
- Monetary union has stripped member-states from their capacity to stabilize the economy.
- Booms and busts will come back
- No stabilization capacity has been created at Eurozone level
- This leads not only to economic problems and much suffering for millions of people

- It also undermines legitimacy of national governments
- And phenomena of rejection
- First best solution: budgetary union that reinstates capacity to stabilize
- Far away:
- Re-nationalize part of fiscal capacity by abolishing fiscal compact

Business cycle component of GDP