Fiscal Governance of the EU:
Do we have what we want?

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Revised version of slides used to accompany presentation

1 Introduction: Difficult Choices about Governance

The Five Presidents' Report on Completing EMU comes at a time when there are difficult choices to be made about governance, and about rules governing policy, within the Eurozone.

- These choices will be especially difficult for Germany
- My comments today follow those made by Massimo Suardi, Andreas Georgiou, and Wilfried Steinheuer
- The comments by these earlier speakers were mainly about *process*
  – who is responsible for what, how rules are enforced, and accountability
- My comments will be about *content*
  – About how the system is actually meant to work
  – About the mechanisms by which those who responsible are meant to actually influence the outcomes
  – About what we can *expect* the outcomes to be – as distinct from what we *hope* the outcomes to be
- This requires both economic theory and economic analysis
  – It s no surprise – given my job as an economic theorist - that I think that economic theory is important!

….Difficult Choices about Governance (continued)

- The Euro framework was meant to work like this.
  - (a) Macroeconomic stabilisation: ECB responsible, at European level
    - Has worked well - and I will not discuss today
  - (b) Disciplined wage and price setting: national actors responsible
    - Otmar Issing set out the requirements very clearly (Issing, 2002, 2006)
    - Wolfgang Munchau *Financial Times* (1 Nov 2015) describes the failures
  - (c) Fiscal Discipline: Stability and Growth Pact to be administered nationally
    - I will argue that this has been both badly designed and badly administered
  - (d) Financial integration: light-touch regulation to be administered nationally
    - This has led to a bad outcome – which, mainly, I will not discuss here
- This four-part framework allowed things to go badly wrong
  - – Undisciplined overlending to GIIPS countries during 1999 - 2007
  - – Fiscal laxity in GIIPS countries from 2003 onwards
  - – Huge divergence in unit labour costs in GIIPS countries (up to 30% or 40%)
- Suddenly crisis arrived in 2010
  - – Uncompetitive GIIPS countries became vulnerable to sovereign debt crisis
- Europe survived ("we will do whatever it takes")
  - – But the recovery has been very, very slow
  - – And now there is a new question: how to deal with the migration shock?

2 Difficult Choice I: Adjustment of Relative Unit Labour Costs

Underlying long run difficulty puts sustainability of Eurozone at risk

- German model: using nationally semi-coordinated wage determination which bids down nominal wage costs, firm by firm, lowers prices, and raises German competitiveness
  - in EMU (with fixed exchange rates) this undercuts other countries in union.
- Other countries in periphery of union are not like this
- A continuing monetary union between Germany and those other countries will be difficult to sustain in the longer term
  - With floating-exchange rates this would be called “beggar thy neighbour”
  - But in a fixed exchange rate world others cannot fight back
  - The longer term outcome appears fragile and may and may require a sustained “reserve army of unemployed” in the periphery (c.f. Martin Wolf)
  - This kind of Eurozone my not be politically sustainable
- This German model goes way back
  - to the days of the pre-EMU European Monetary System
  - to the pre-fixed-exchange rate days when the Bundesbank ensured anti-inflation discipline
- The New Competitiveness Authorities must deal with this problem

Difficult Choice I continued....

Short run adjustment difficulties put sustainability of Eurozone at risk

- Adjustment of relative unit labour costs between GIIPS countries and Northern Europe still necessary
  - Still requires >3 percent difference in inflation rates for >5 years.
- How is this adjustment to be achieved?
  - At present deflation in much of the European periphery, with attendant costs
  - What is needed it more inflation in Germany – by 2 or 3 pp per annum
  - The new Competitiveness Authorities should be required to act
  - And the Macroeconomic Imbalances Procedure should also be required to act
- QE is helping to achieve this adjustment by causing Euro to devalue
  - This will help lead to higher inflation in Germany
  - But this is "beggar thy neighbour" devaluation vis a vis rest of world
- Why not instead much looser fiscal position in Germany?
  - There is concern in Germany about the long run debt position
  - In addition, such action would undermine the German wage-fixing model

Thus there is a serious challenge to the sustainability of the Eurozone

- In both the long-run and the short-run the German wage-fixing model challenges the sustainability of the Eurozone
- The Competitiveness Authorities and Imbalances Procedure should act on this

3 Difficult Choice II: Need for Revision of the Stability and Growth Pact and the Imbalances Procedure

- Economics 101
  - in a monetary union management of aggregate demand by fiscal policy is necessary in the face of asymmetric shocks
- A first deep criticism of the SGP: fiscal policy was *too loose* in the periphery during the Great Moderation
  - The problem in the GIIPS was not just undisciplined over-lending
  - SGP allowed insufficiently tight fiscal policy in GIPPS countries at this time
  - It also forced the opposite on Germany, even although Germany and France did not fully obey. (If they obeyed the problem would have been worse!)
- A second deep criticism of SGP: fiscal policy has been *too tight* across the periphery during the Great Recession
  - See remarks today by Wilfried Steinheuer
  - He is hesitant to allow more fiscal stabilisation than the automatic stabilisers
  - And he is only happy to allow that kind of stabilisation if satisfactory progress is being made towards the longer term debt objective
  - This effectively rules out fiscal stabilisation for high-debt countries in GIIPS
- Of course looser fiscal policy now must be consistent with longer term fiscal solvency, and a satisfactory long run debt level

….Difficult Choice II continued…

- Economics 101
  - in all countries - and in the Eurozone as a whole - management of demand by fiscal policy is necessary at the zero bound
  - at the zero bound fiscal policy should stabilise demand (See Allsopp and Vines "Fiscal and Monetary Policy in the Great Moderation and the Great Recession" *Oxford Review of Economic Policy*, Vol 31, No 2, 2015)
  - "…a full recovery will not emerge until the private sector invests strongly again, creating the financial assets which a deleveraging private sector wishes to hold. Then, and only then, should fiscal consolidation begin."
  - Of course such looser fiscal policy now must be consistent with longer term fiscal solvency, and a satisfactory long run debt level
- By contrast, see statements today by Mr. Steinheuer and Mr Suardi
  - Both argue that stabilisation by fiscal policy only appropriate if there is *already* satisfactory progress towards the medium-term debt objective
  - This constrains further stabilisation at the European level; the current Eurozone-wide fiscal position is one of approximate fiscal balance
- Thus a further deep criticism of SGP: fiscal policy is now *too tight* across Europe *as a whole.*
  - The effects of this are very large – of the order of 4percent of GDP according to the OECD . (See *Economic Outlook.* OECD, Paris, November 2014.)

….Difficult Choice II continued…..

- Macroeconomic Imbalance Procedure is adding to overly tight fiscal policy
  - Procedure is designed to assist with internal intercountry adjustment
  - The procedure imposes surveillance on all countries with a current account deficit of more than four percent of GDP, forcing them to curtail fiscal deficits
  - But it allows countries with surpluses of up to six percent to escape surveillance, rather than forcing them to expand fiscally
  - And why is it that Germany, with a surplus of nearly eight percent, has escaped surveillance and pressure to expand, and that Holland is doing the same, with an even greater surplus?
  - This asymmetry means that the procedure adds to deflationary pressure
- With tight fiscal policy in Eurozone demand can only grow externally
  - QE is (partly) helping to achieve this by causing Euro to devalue
  - This stimulates net exports
  - But this is "beggar thy neighbour devaluation" vis a vis rest of world

Thus a sustainable European Monetary Union requires the rewriting of both the SGP and the Macroeconomic Imbalances Procedure

4 Difficult Choice III: Need for Sovereign Debt Write-downs

- Think of Latin American debt crisis, which struck in 1981.
  - In the late 1970s, US banks had over-lent to Brazil, Argentina, Mexico.
  - Then US raised interest rates to fight inflation
  - This led to potential bankruptcy of US banks, but banks charged high margins and earned their way out of difficulty. Eventually debt was written down
  - It took 8 years; this was Latin America's 'lost decade'
- A similar write-down is inevitable in Europe, and necessary soon
  - Think of difficulty of Greece in 2015, which followed failure to write down Greek debt in 2010
  - Since then banks have wriggled – not earned - their way out of difficulty: debt is now largely helped by European governments, the IMF, the ECB and the ESM
  - The repayment period has been extended and interest rates lowered
  - But this is not enough, vulnerability remains from the debt overhang
  - A write-down is necessary to avoid a Southern European 'lost decade'
- There is opposition to debt relief in Northern Europe
  - Who will bear the fiscal burden?

A sustainable EMU requires a sovereign debt reconstruction mechanism

  - A write down of GIIPS sovereign debt needs to happen within the monetary union, notwithstanding Wolfgang Schauble's claims that this is not possible.

5 The Migration Shock

- The very large influx of migrants into Germany might – paradoxically – ease the European macroeconomic position
  - This is likely to give rise to very large fiscal expenditures in Germany – much larger than those sanctioned by the SGP
  - This might significantly assist with intra-European macroeconomic adjustment by greatly loosening fiscal policy in Germany
  - There is a parallel here with German reunification which took place at a time when the Bundesbank was in control of German (and European) monetary policy and raised interest rates
  - That will not happen this time
- But two additional things point in the opposite direction
  - The influx is likely to reinforce downward pressure on wages and prices in Germany, which will not assist with the relative cost position
  - It is also likely to create very large fiscal obligations in particular countries in the European periphery. Dealing with these will require European solidarity , given the fiscal pressures on these countries.

6 Implication : The political economy implications of EMU

- My overall point is that, when setting up European Monetary Union
  - the European policy community set in place a liberal structure of cross-European integration (namely integration of the European financial market)
  - without there being the cross-country solidarity required to see this system through
  - without there being a clear understanding of the constraints that would need to be placed on the ability of Germany to achieve its preferences.
- I have discussed three issues necessary for a sustainable EMU
  - the need for greater coordination of wage fixing institutions across Europe
  - the need for greater fiscal stabilisation, both in the GIPPS, and Europe-wide
  - the need for a procedure to ensure sovereign debt write downs
- The sustainability of EMU requires a clear understanding of
  - how to establish the political solidarity in relation to these three issues
  - how to place the necessary political constraints on the ability of Germany to achieve its preferences, in relation to these issues, when these preferences are opposed to the interests of the other members of the monetary union
- There are also related questions to do with the European Banking Union, which I have not had time to discuss.

7 Conclusions

- My conclusion is that, in EMU, the European policy community set in place a liberal structure, to ensure financial market integration, without an understanding how to see it through.
- A wider point, going beyond today's meeting, is that, in Schengen, the European policy community has also set in place a liberal structure, this time to ensure a borderless labour market, without there being the cross-country solidarity required to see this system through, or an understanding of the constraints that this would need to place on Germany's ability to achieve its preferences
  - I will not discuss here the very significant ramifications of this idea
- A much more general point, for the economic governance of the EU, is that European policy process should only set in place, at the European level, policy commitments where there is the cross country solidarity necessary to see the commitments implemented.
  - This is important in relation to the UK and other non-Euro members; it bears on the exemptions which the UK and other non-EMU member countries are seeking in relation to their economic and financial policies.