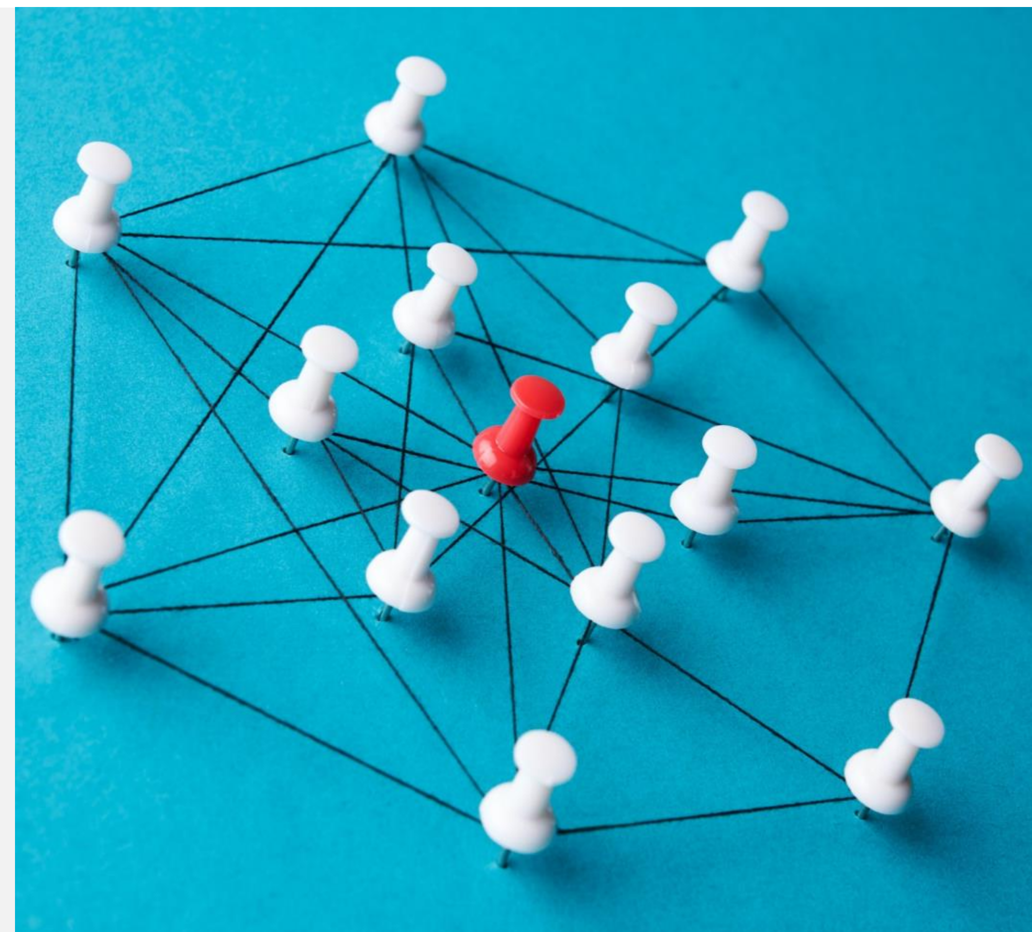
European Macroeconomics

Lecture 10

The institutional challenge

- The Euro area is a **hybrid entity**:
  - **Supranational** monetary policy (European Monetary Union)
  - 19 independent **national** fiscal policies
- Is a single monetary policy possible without political integration?
  - **German view before Maastricht**: Monetary union is the last step of integration after political union ("Krönungstheorie": monetary union is the coronation of political integration)
  - **Traditional French view**: Monetary union leads to political union ("Grundsteintheorie": monetary union is a foundation of political integration). Jacques Rueff (French economist, 1896-1978): "*L'Europe se fera par la monnaie ou ne se fera pas* »



Fiscal policy externalities due to the lack of political integration

Positive externalities:

In case of negative demand shocks, especially smaller countries try to free-ride in anti-cyclical fiscal policies

→ Solution in the Maastricht Treaty: Weak coordination of national fiscal policies

Negative externalities:

A country follows unstable fiscal policies with negative effects on EMU and other member states as the discipline by foreign exchange markets is absent in a monetary union:

→ Solution in the Maastricht Treaty: Political discipline plus market discipline:

- **Rules** with limits for budget deficits and debt to GDP ratios. Procedures for sanctioning member countries.
- No-bail-out clause which should foster market discipline by capital markets

The insolvency problem for governments due to EMU membership

- Key insight of Modern Monetary Theory:
  - Large countries have no financing constraint as they can issue debt denominated in their own currency.
  - The national central bank supports the government by purchasing government bonds (“Quantitative Easing”)
- EMU member states issue debt in euro and their national central bank is unable to support them
- They are de facto in the situation of an emerging market economy which can only issue debt in a foreign currency („original sin“)
- Euro crises (2010/12) show that in a crisis of confidence, EMU member states are faced with severe liquidity and solvency risks

VI. I) The difficult task of fiscal policy coordination in a monetary union

Insights of the Delors-Report (1989)[1]

- The Delors Report was the **blueprint European Monetary Union**. It was written in 1988/89 by Jacques Delors (President of the Commission), the EU central bank governors and academics
- **Insights** on the need for cooperation:
  - "(…) **uncoordinated and divergent national budgetary policies** would undermine monetary stability and **generate imbalances** in the real and financial sectors of the Community.
  - Moreover, the fact that the **centrally managed Community budget is likely to remain a very small part of total public-sector spending (…)** will mean that the task of setting a Community-wide fiscal policy stance will have to be performed through the **coordination of national budgetary policies**.
  - Without such coordination it would be impossible for the Community as a whole to establish a fiscal/monetary policy mix appropriate for the preservation of internal balance (…). **Monetary policy alone cannot be expected to perform these functions**."

[1] http://ec.europa.eu/economy_finance/euro/origins/delors_en.pdf

Macroeconomic shocks and policy assignments in EMU

	Shock affects **all member states**	Shock affects only **a single country** (idiosyncratic shock)
Monetary Policy	ECB can react in optimal way: Fast response and no need for cooperation at the national level	ECB reacts only to the degree of the share of the country in the EMU-GDP. For smaller countries very weak interest rate effect
Fiscal Policy	In a strong crisis and when zero-lower-bound of interest rates is reached, additional fiscal policy response is necessary, but strong coordination problems	A response of national fiscal policy is required which has to be stronger than without EMU as monetary policy response is insufficient

Institutional mechanism for the coordination of fiscal policies in EMU

Article 121 TFEU

1. Member States shall regard their economic policies as a matter of common concern and shall coordinate them within the Council, in accordance with the provisions of Article 120.

2. The Council shall, on a recommendation from the Commission, formulate a draft for the broad guidelines of the economic policies of the Member States and of the Union, and shall report its findings to the European Council. The European Council shall, acting on the basis of the report from the Council, discuss a conclusion on the broad guidelines of the economic policies of the Member States and of the Union. On the basis of this conclusion, the Council shall adopt a recommendation setting out these broad guidelines. The Council shall inform the European Parliament of its recommendation.

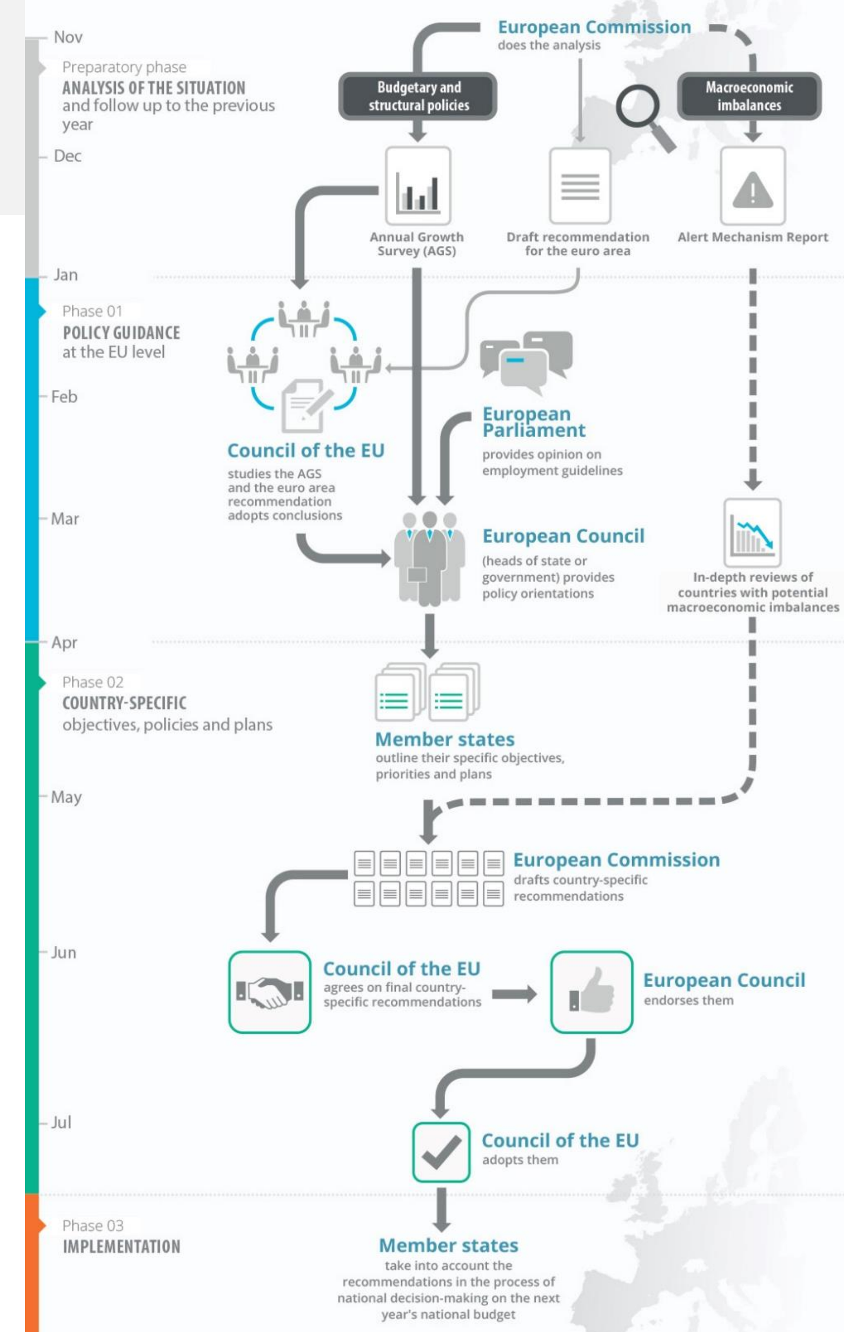
In practice: Very general recommendations

"**Coordination of national fiscal policies remains crucial to underpin the recovery.** The overall fiscal stance, taking into account national budgets and the Recovery and Resilience Facility, **should remain supportive in 2021 and 2022**. Fiscal policy should remain agile and adjust to the evolving situation as warranted, and **a premature withdrawal of fiscal support should be avoided**. (…) Finally, given the expectation of economic activity gradually normalising in the second half of 2021, Member States' fiscal policies should become **more differentiated** in 2022, taking into account the state of the recovery, fiscal sustainability and the need to reduce economic, social and territorial divergences. "

Source: European Commission (2021), Economic policy coordination in 2021: overcoming COVID-19, supporting the recovery and modernising our economy, Brussels, 2.6.2021 COM(2021) 500 final

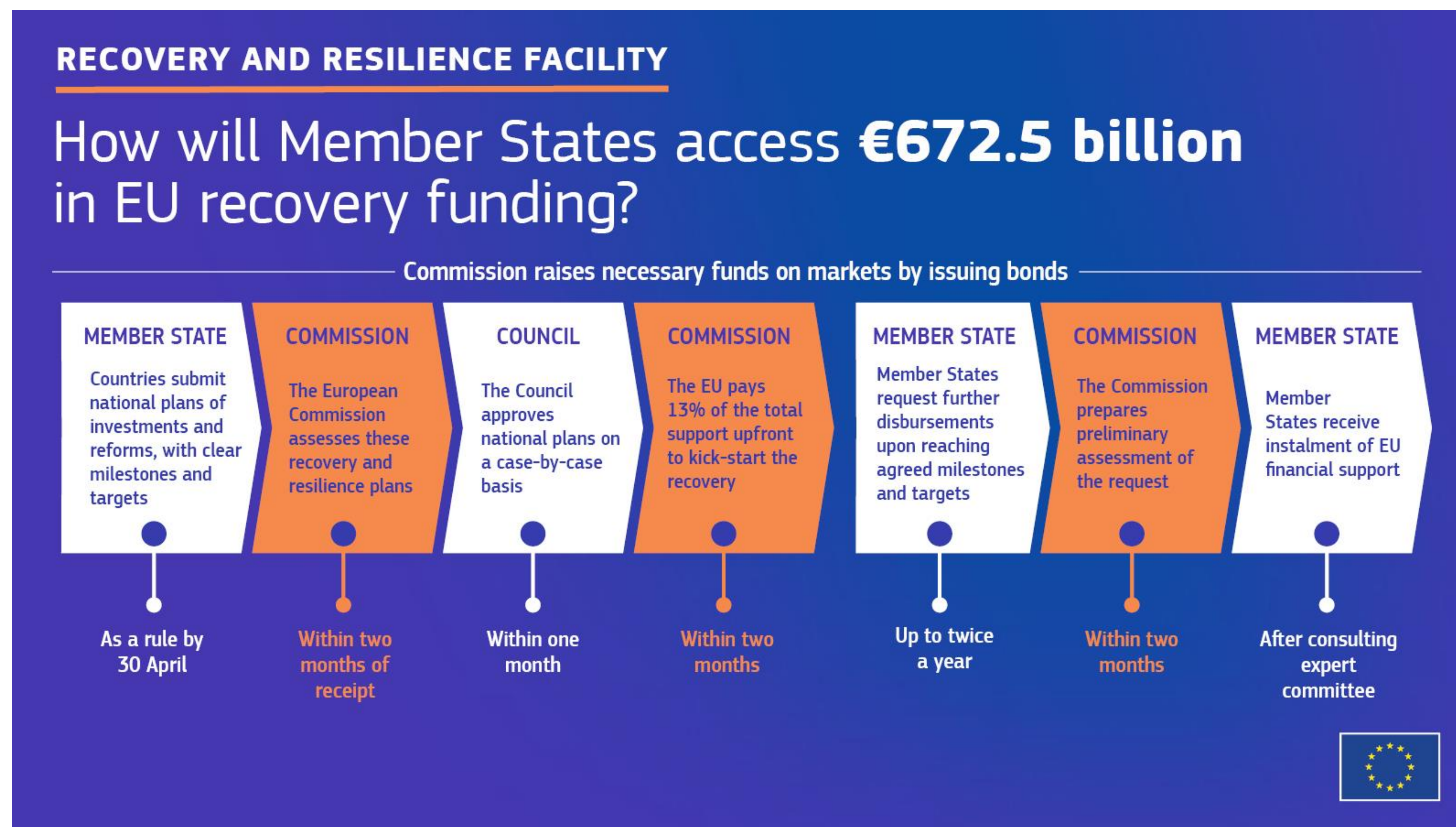
The **European Semester**: A complex and very broadly-based mechanism for policy coordination focusing on

- structural reforms, focusing on promoting growth and employment,
- social and labour policies, in line with the principles of the European Pillar of Social Rights
- structural reforms set out in the national recovery and resilience plans
- fiscal policies, in order to ensure the sustainability of public finances in line with the Stability and Growth Pact
- prevention of excessive macroeconomic imbalances



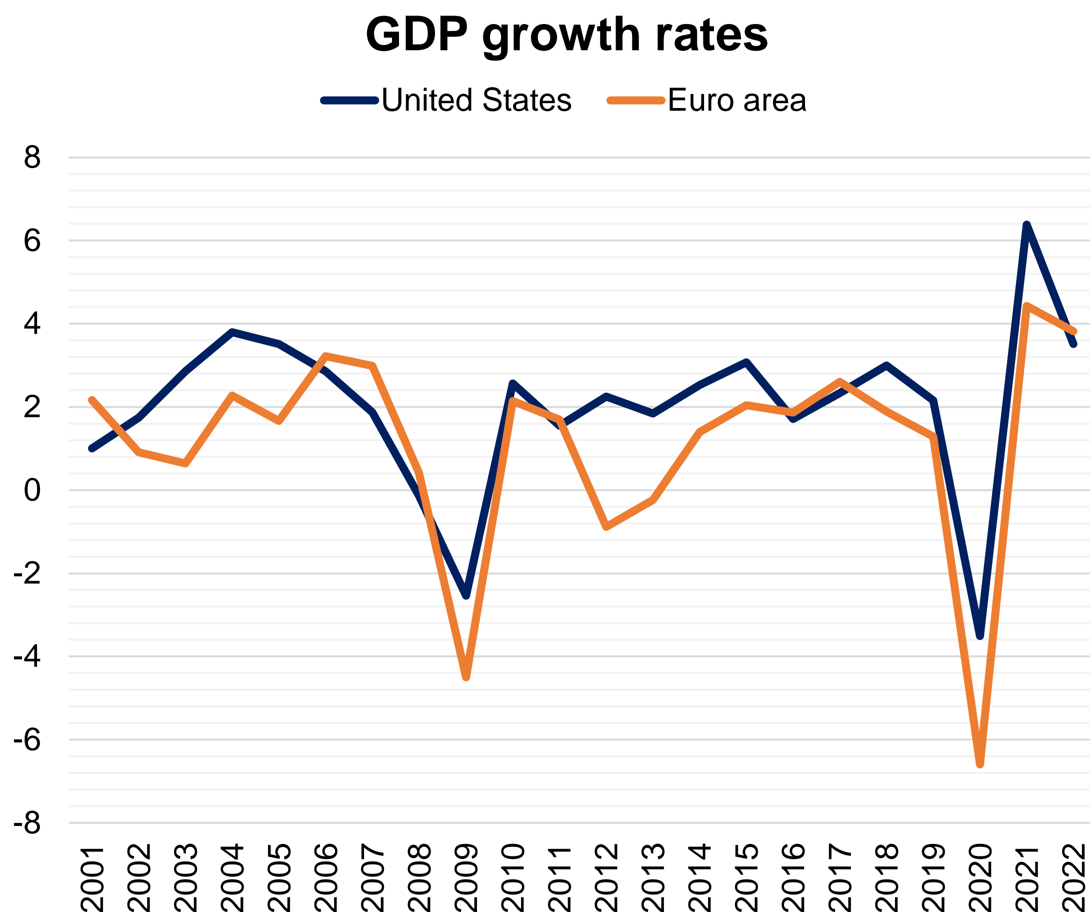
Source: https://www.consilium.europa.eu/en/infographics/european-semester/

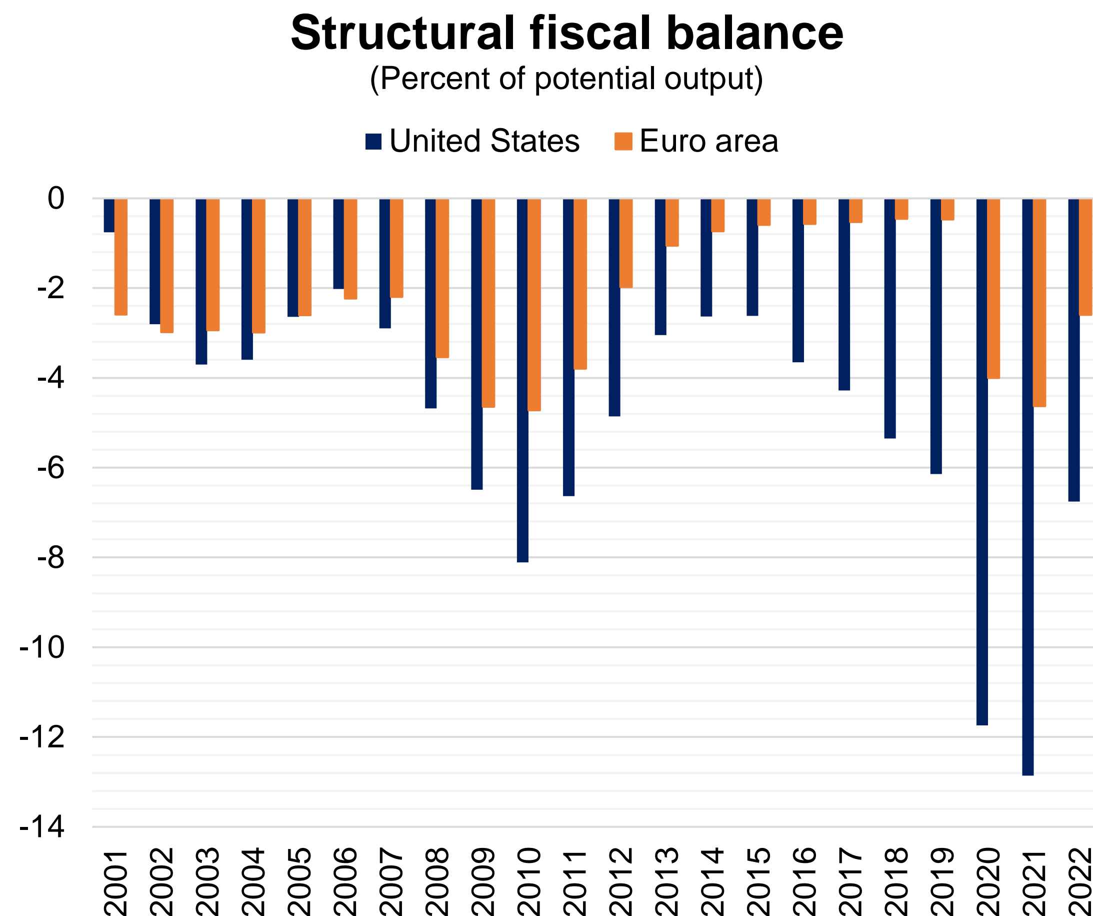
This year the assessment was made in the context of the Recovery and Resilience Facility



Source: https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eueconomyexplained/recovery-and-resilience-facility_en

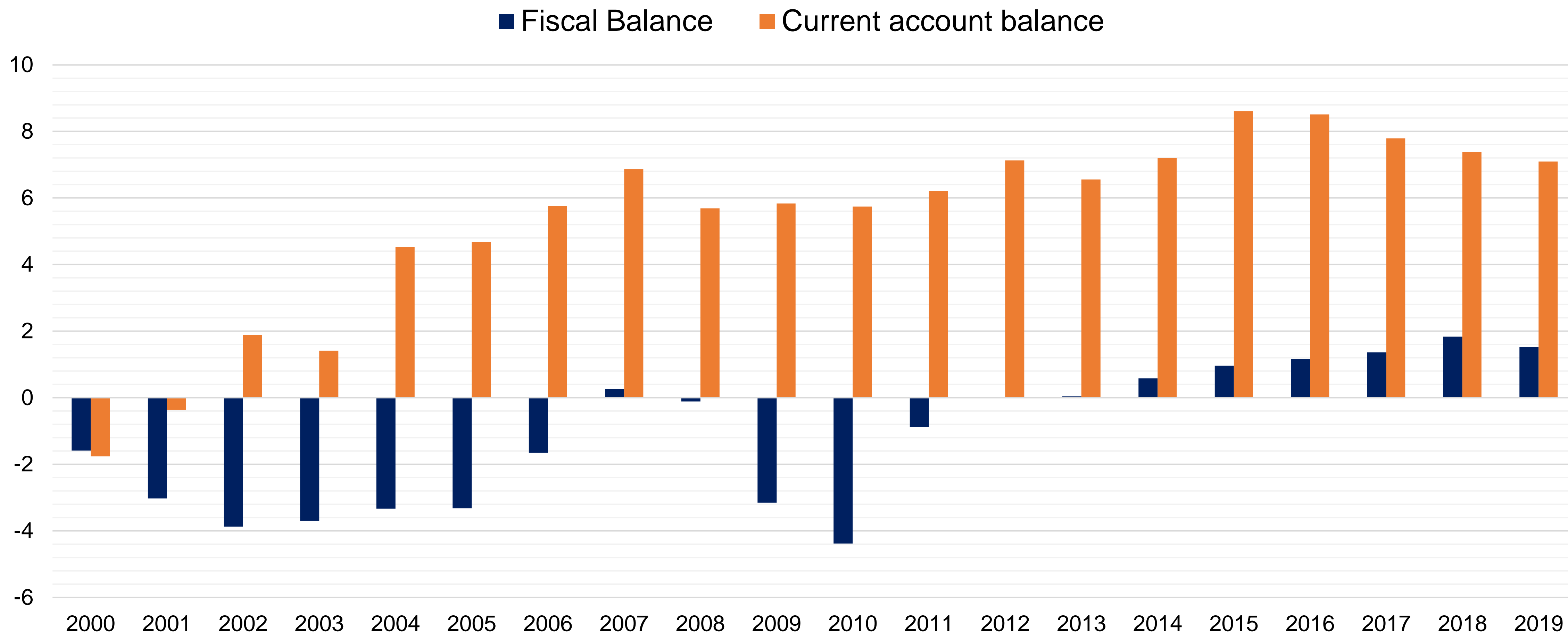
US versus Euro area: US fiscal policy with stronger impulses and more stable US GDP growth





Source: IMF, World Economic Outlook

In the 2010s, Germany could not be persuaded to stimulate the euro area



Source: IMF, World Economic Outlook

VI. II) How to set limitations for national fiscal policies?

The rationale of the Maastricht Treaty

Fiscal discipline provided by two pillars:

- **Market discipline** enforced by the no-bail-out clause

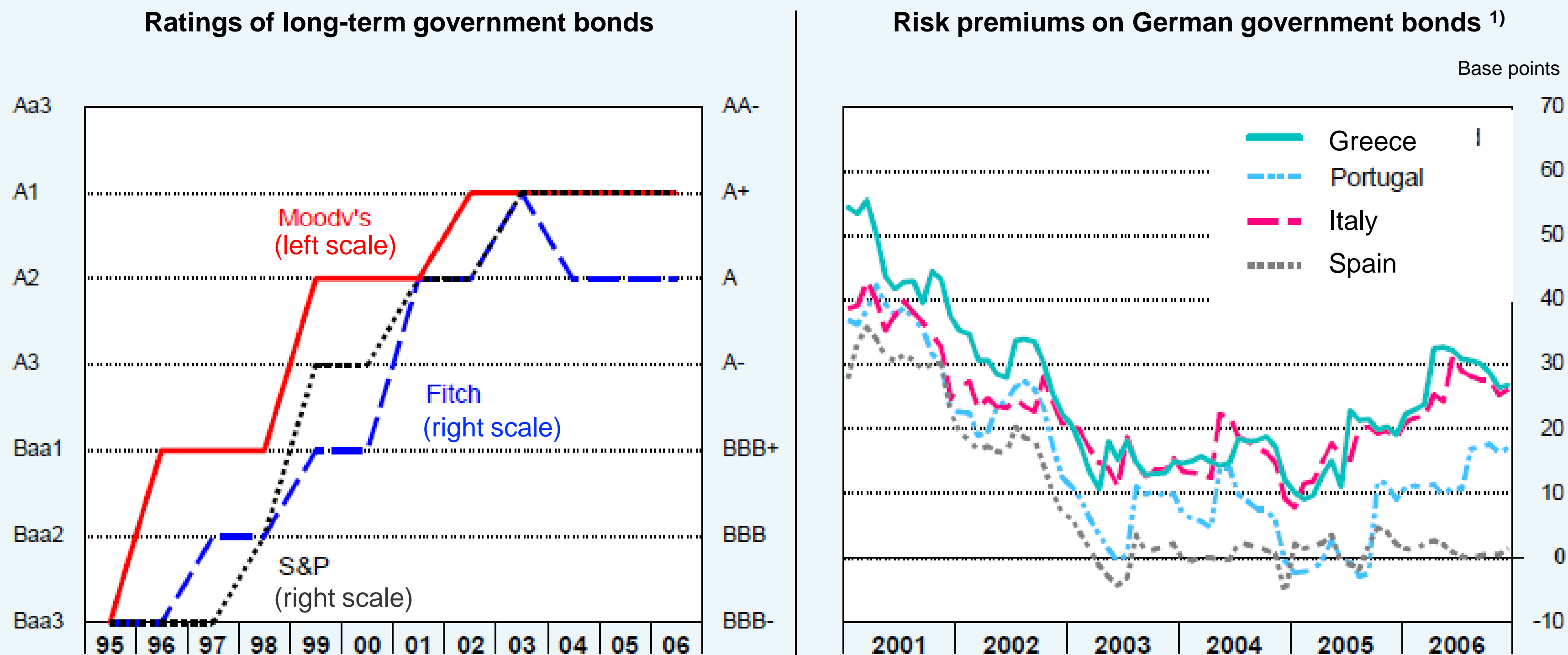
Art. 125 TFEU: "The Union shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of any Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project. A Member State shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of another Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project .

- Additional safeguards by a **rule-based approach** (Stability and Growth Pact)

Justification for fiscal rules in the Delors-report: Market reactions too late or too abrupt

- „To some extent **market forces can exert a disciplinary influence**. Financial markets, consumers and investors would respond to differences in macroeconomic developments in individual countries and regions, assess their budgetary and financial positions, penalize deviations from commonly agreed budgetary guidelines or wage settlements, and thus exert pressure for sounder policies.
- **However, experience suggests that market perceptions do not necessarily provide strong and compelling signals and that access to a large capital market may for some time even facilitate the financing of economic imbalances.**
- **Rather than leading to a gradual adaptation of borrowing costs, market views about the creditworthiness of official borrowers tend to change abruptly and result in the closure of access to market financing.**
- **The constraints imposed by market forces might be either too slow and weak or too sudden and disruptive**. Hence countries would have to accept that sharing a common market and a single currency area imposed policy constraints.“ (S. 20)

Market failure in 2005/2006
Ratings improved and risk premiums for Greece were very low



Source: Annual report 2010/11 of the German Council of Economic Experts. Figure 19.

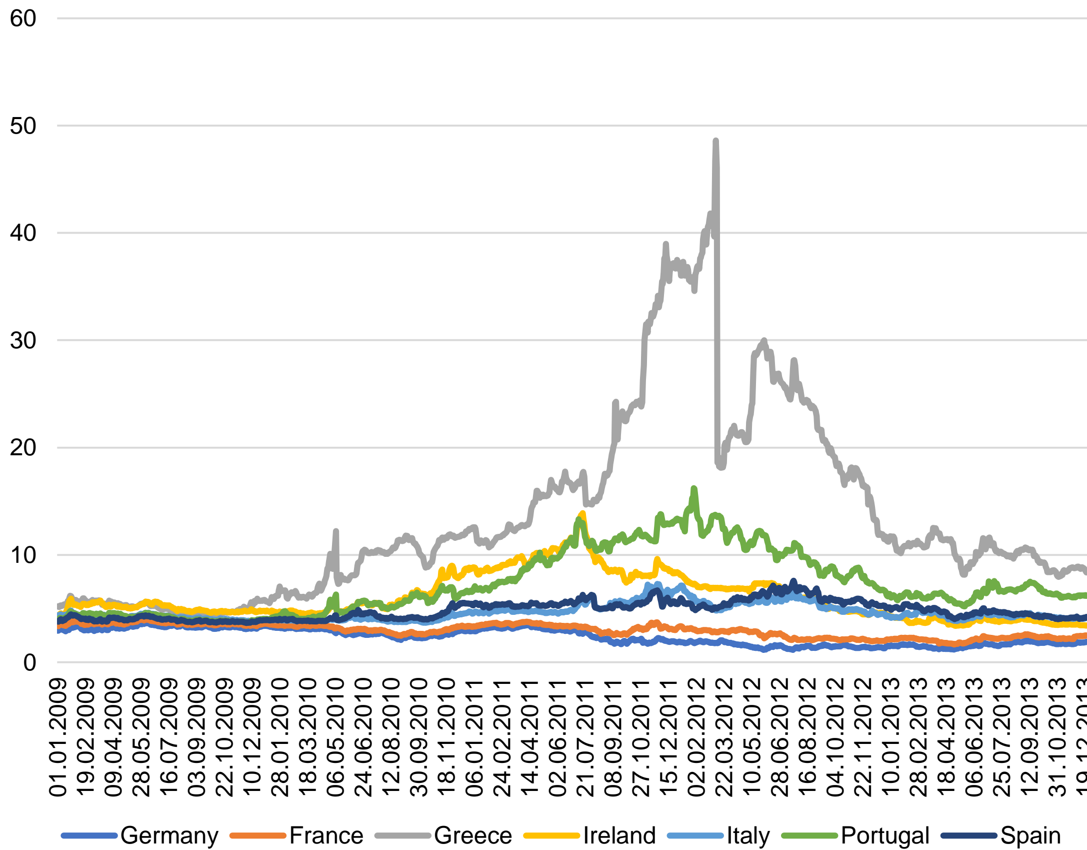
Already in 2007, one could see that Greek fiscal data are very unreliable

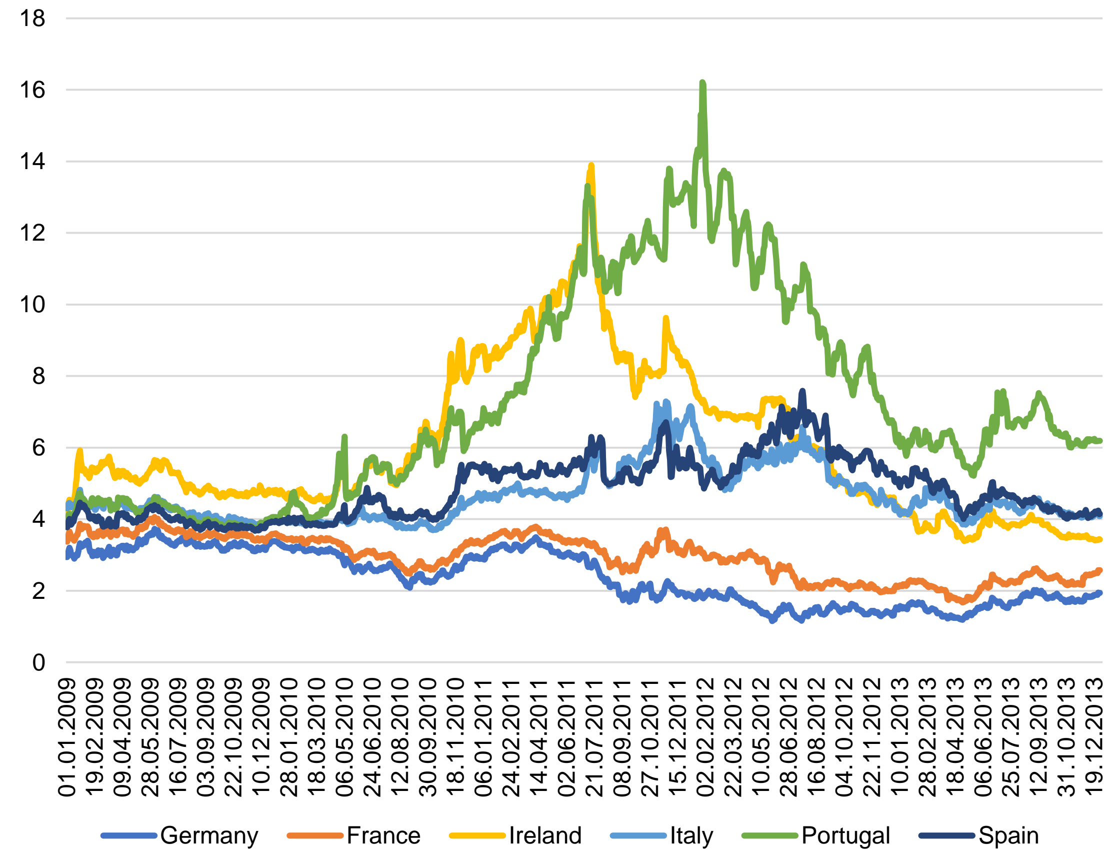
Table 2: The revision of Greek data between the figures reported in EDP March 2004 and April 2007

% of GDP	2000	2001	2002	2003	2004	2005	2006
General Government Deficit							
2004 March	-2.0	-1.4	-1.4	-1.7			
2004 September	-4.1	-3.7	-3.7	-4.6			
2005 March		-3.6	-4.1	-5.2	-6.1		
2005 September		-6.1	-4.9	-5.7	-6.6		
2006 April			-4.9	-5.8	-6.9	-4.5	
2006 October			-5.2	-6.1	-7.8	-5.2	
2007 April				-6.2	-7.9	-5.5	-2.6

Source: Recommendation for a COUNCIL DECISION abrogating Decision 2004/917/EC on the existence of an excessive deficit in Greece

In 2010, the financial markets abruptly woke up and panicked





Legal framework for fiscal rules in the EMU

- Maastricht Treaty: Article 126 TFEU (1992)
- Stability and Growth Pact (1996), which restrains Article 126 TFEU
- Reform of the Stability and Growth Pact in 2005 and in 2011 (Sixpack)
- Fiscal compact (2012)

Article 126 TFEU

1. Member States shall avoid **excessive government deficits**.
2. The Commission shall monitor the development of the budgetary situation and of the stock of government debt (…) on the basis of the following **two criteria**:

   (a) whether the ratio of the planned or actual **government deficit** to gross domestic product exceeds a **reference value**, unless:

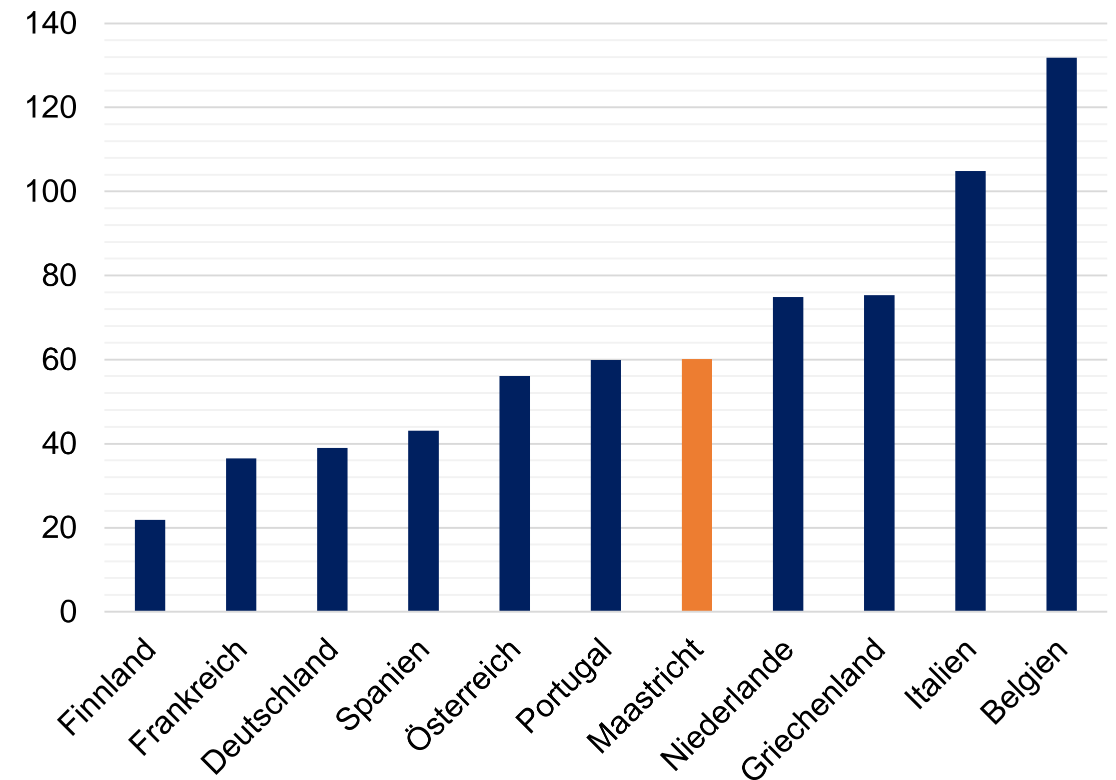
   - either the ratio has declined substantially and continuously and reached a level that comes close to the reference value,
   - or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value;

   (b) whether the ratio of **government debt** to gross domestic product exceeds a **reference value**, unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace. The reference values are specified in the Protocol on the excessive deficit procedure annexed to this Treaty.

How the reference values were derived

- **Debt/GDP ratio of 60 %:** derived as average of EU member states in 1990
- **Deficit/GDP of 3%:** derived under the assumption of 5 % nominal GDP growth. The 60 % debt/GDP ratio can be held constant with a deficit relative to GDP of 3%
- **Arithemitics**: the deficit/GDP ratio (b) which holds the debt/GPD ratio (d) constant for a given nominal GDP growth rate (g) is:

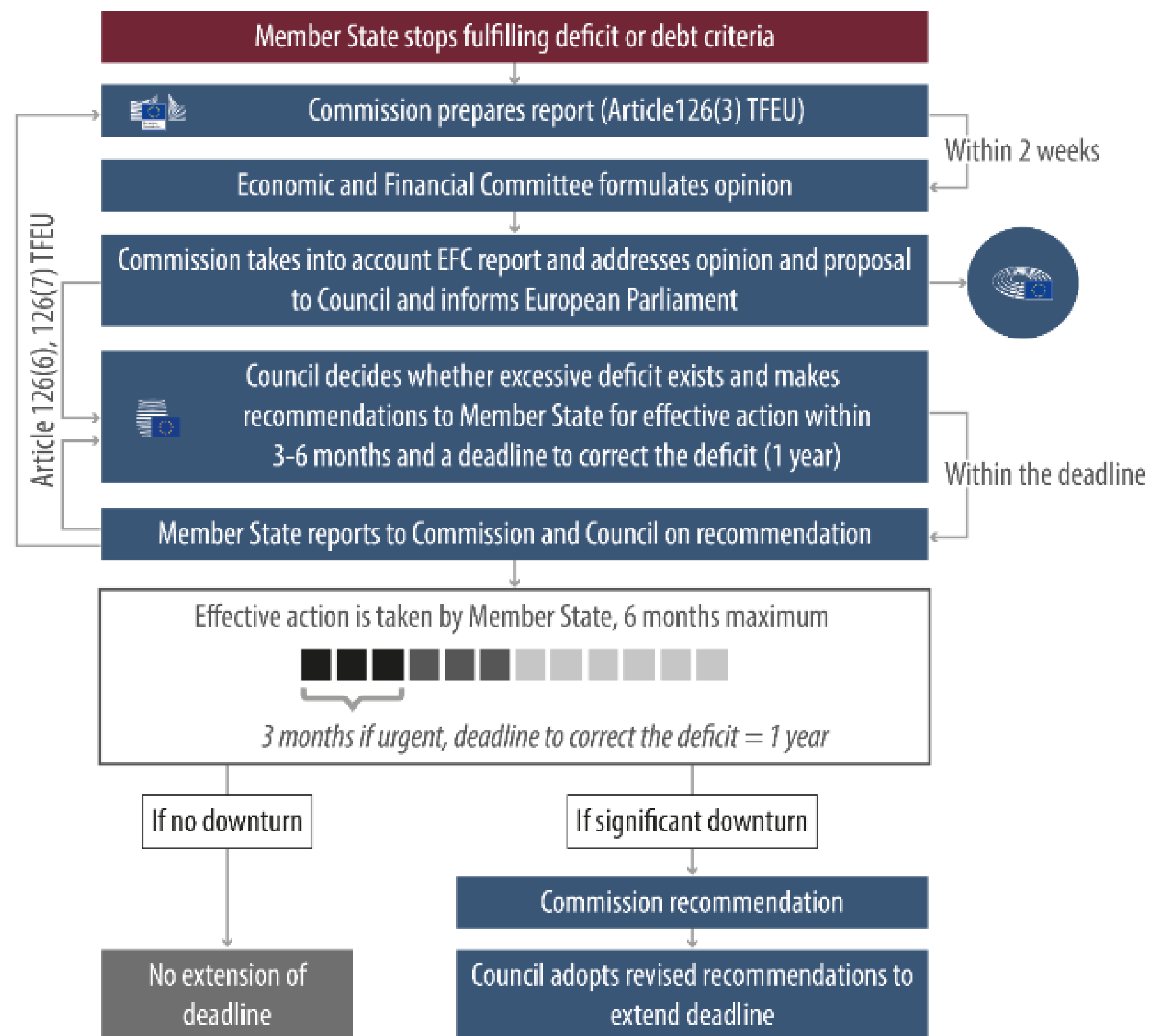
$$b = g\,d$$



Stability and growth pact (1997): The preventive arm aims at balanced budgets in normal times

- Each Member State shall have a differentiated **medium-term objective (MTO)** for its budgetary position.
- These country-specific medium-term budgetary objectives may diverge from the **requirement of a close to balance or in surplus position**, while providing a safety margin with respect to the 3 % of GDP government deficit ratio.
- The medium-term budgetary objectives shall ensure the sustainability of public finances or a rapid progress towards such sustainability while allowing **room for budgetary manoeuvre**, considering in particular the need for public investment
- Countries who do not meet the medium-term objective must present a **convergence programme** with the adjustment path towards the MTO
- The pact has become **extremely complex** over time

Corrective arm of the excessive deficit procedure

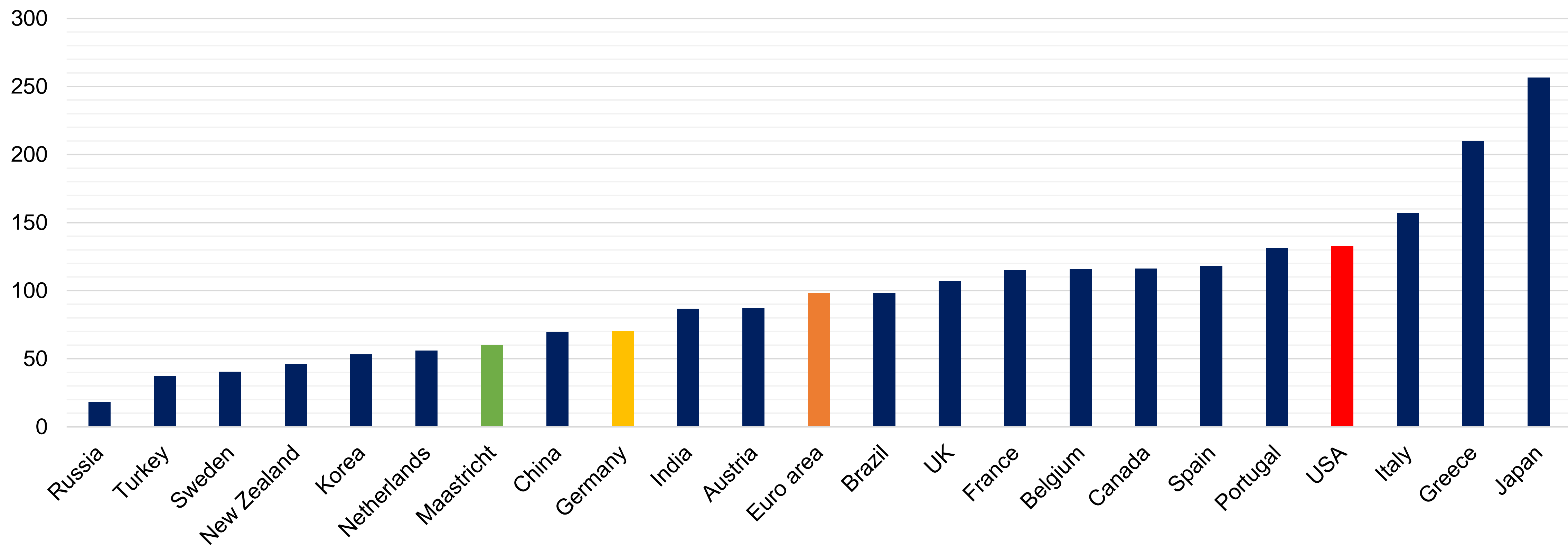


Source: https://www.europarl.europa.eu/RegData/etudes/BRIE/2020/649351/EPRS_BRI(2020)649351_EN.pdf

„Six pack“ (2011)

- If the **60% reference for the debt-to-GDP ratio** is not respected, the Member State concerned will be put in excessive deficit procedure (even if its deficit is below 3%!), after taking into account all relevant factors and the impact of the economic cycle, **if the gap between its debt level and the 60% reference is not reduced by 1/20th annually** (on average over 3 years).
- In case a euro area Member States does not respect its obligations, a financial sanction can be imposed by the Council on the basis of a Commission recommendation, unless a qualified majority of Member States vote against it. This is the so-called “**reverse qualified majority**” voting procedure

How realistic is the 60 % debt threshold today?



Source: OECD, Economic Outlook Annex Tables

“Functional Finance”: Science opposed to scholasticism

Abba P. Lerner (1903 – 1982)

“(…) government fiscal policy, its spending and taxing, its borrowing and repayment of loans, its issue of new money and its withdrawal of money, shall be undertaken with an eye only to the *results* of these actions on the economy and not to any established doctrine of what is sound and unsound.

The principle of judging only by the effects has been applied in many other fields of human activity, where it is known as the method of science as opposed to scholasticism.”

Is 90 % a reasonable limit?

Image source: http://www.imf.org/external/photo/allphoto.asp?g=40 & http://terpconnect.umd.edu/~creinhar/

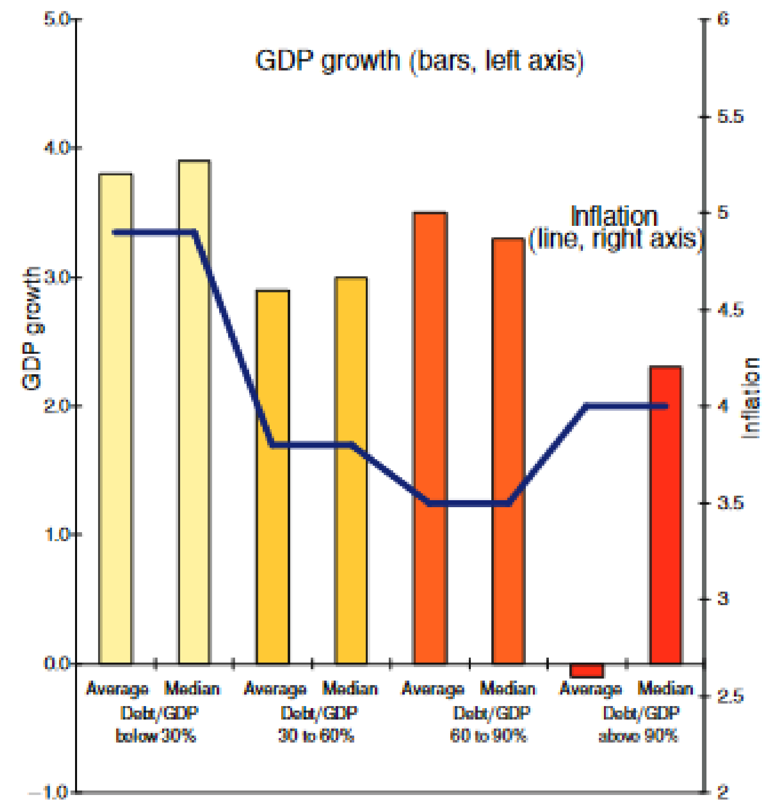


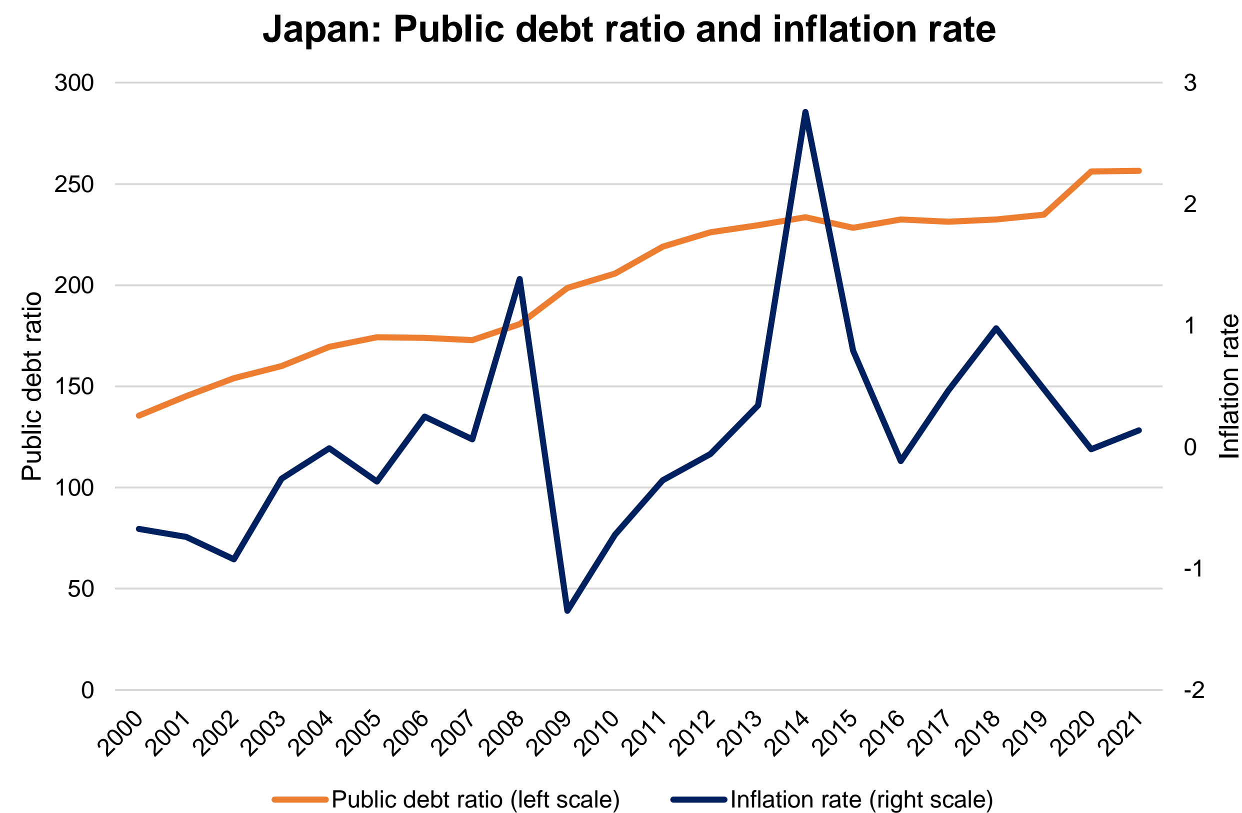
FIGURE 2. GOVERNMENT DEBT, GROWTH, AND INFLATION: SELECTED ADVANCED ECONOMIES, 1946–2009

Source: Growth in a Time of Debt, Carmen M. Reinhart and Kenneth S. Rogoff
American Economic Review: Papers & Proceedings 100 (May 2010): 573–578

IWF Working Paper 14/34

"Our results **do not identify any clear debt threshold** above which medium-term growth prospects are dramatically compromised. On the contrary, the association between debt and medium-term growth becomes rather weak at high levels of debt, especially when controlling for the average growth performance of country peers."

Source: WP/14/34 Debt and Growth: Is There a Magic Threshold? Andrea Pescatori, Damiano Sandri, and John Simon



Source: International Monetary Fund, World Economic Outlook Database, April 2021

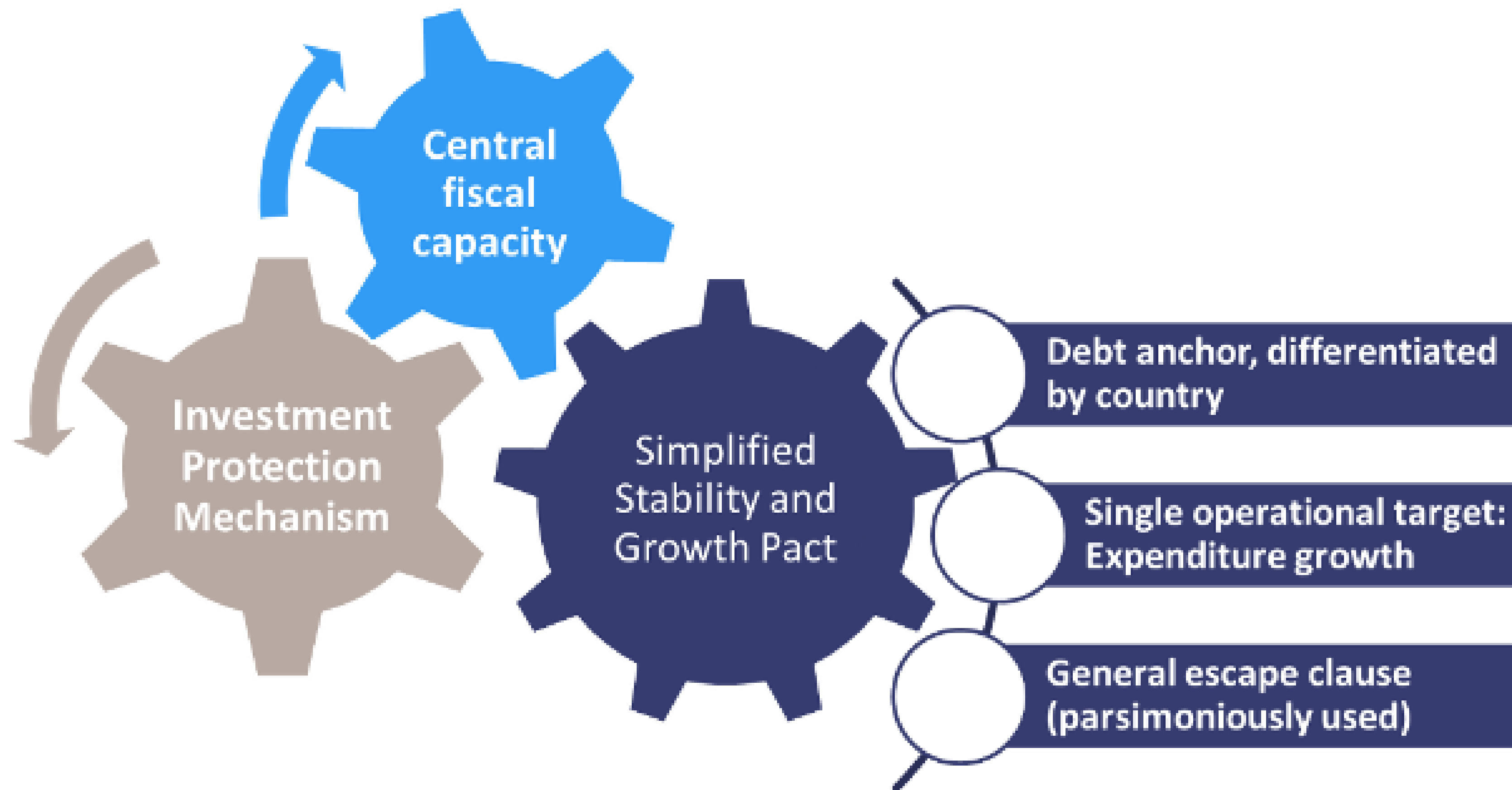
Expertise of the German Council of Economic Experts (2007) A plea for the „golden rule“

- „Deriving from this the demand for **a general ban on debt** would be as economically **nonsensical** as prohibiting private individuals or companies from borrowing.
- Such a ban would be accompanied by **welfare losses**(...)
- [A] **permanent public debt** (...) may be justified to some extent from an intergenerational distributional point of view, namely in the context of **public investments** that increase the wealth of future generations or, mediated by their productivity effects, leave future returns and thus make them 'richer'.
- The intergenerational redistributive effect of public debt is a desired outcome here, so that **future beneficiaries** of today's spending also **share in the burden of financing**. This is the intention behind the '**Golden Rule of Fiscal Policy**,' which allows credit financing of investment."

The members of the Council handing over the 2007 report to Chancellor Angela Merkel

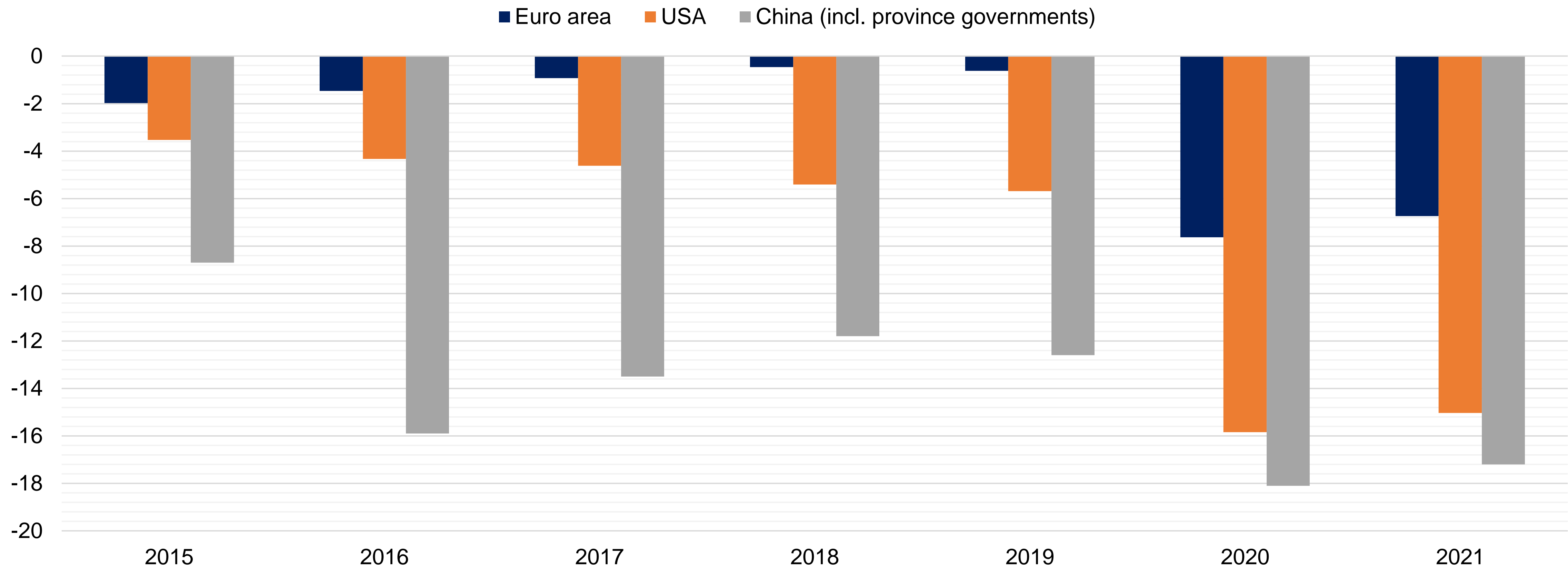
Image copyright: Sachverständigenrat

The model of the European Fiscal Board



Source: https://voxeu.org/article/reforming-eu-fiscal-framework-now-time

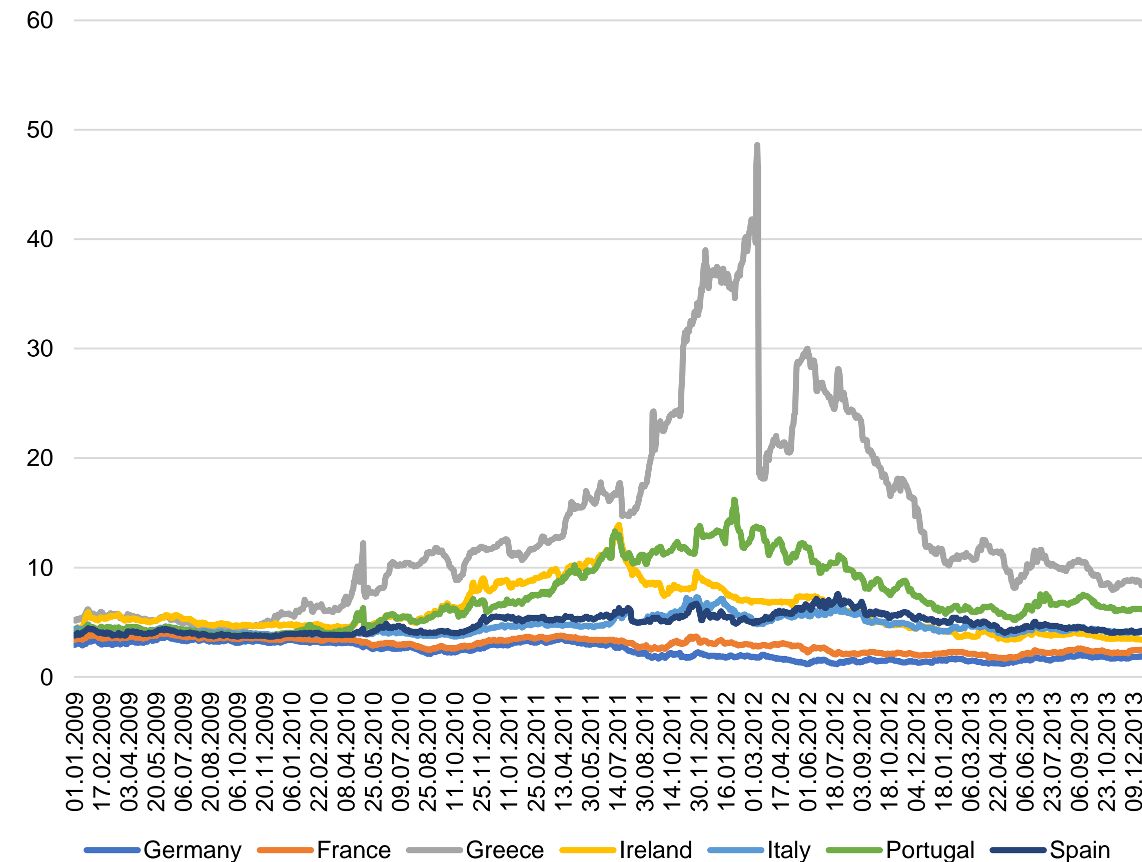
Can the euro area compete with China and the United States?



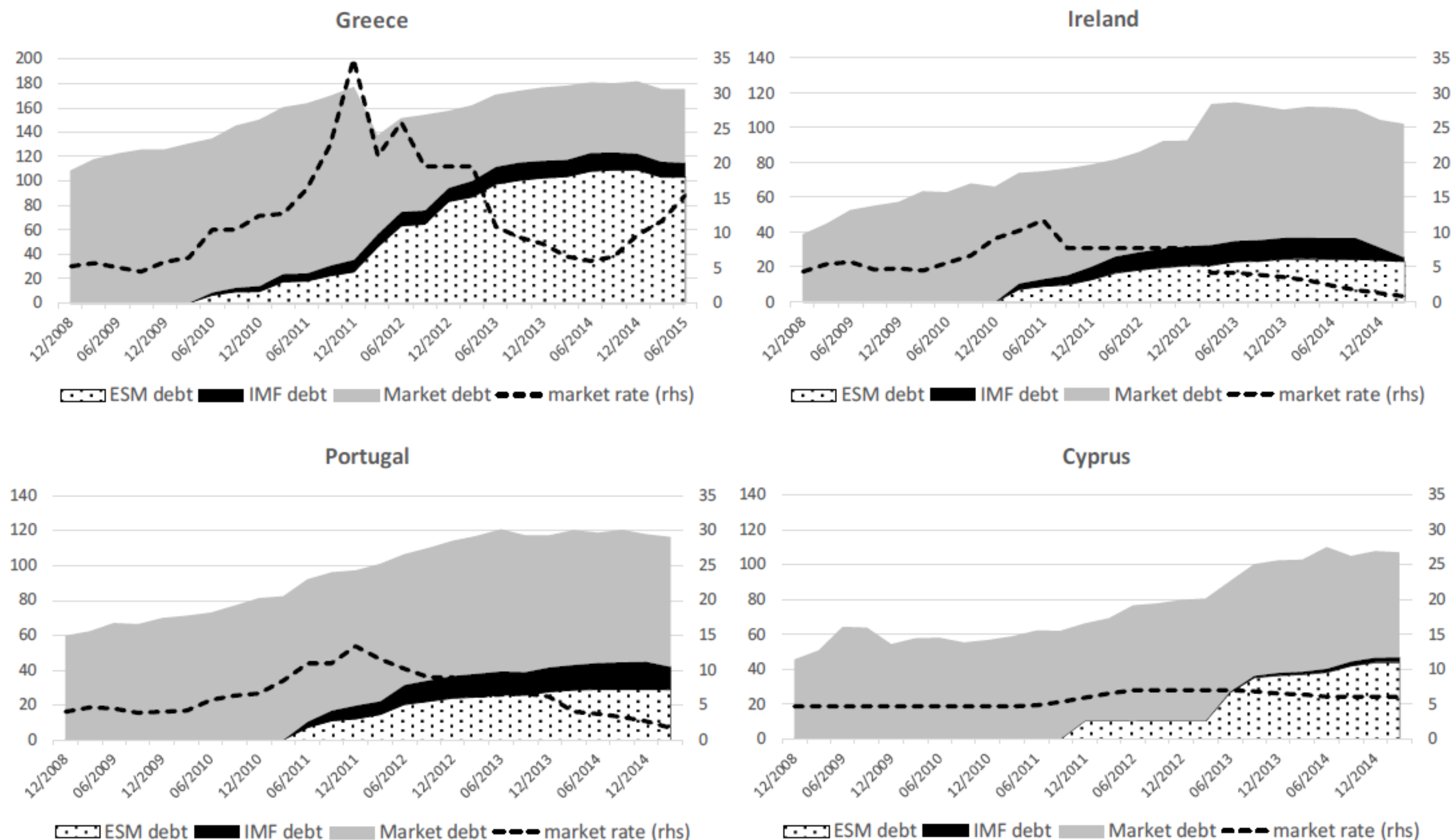
VI. III) Rescue mechanisms

Euro area rescue programmes

- In the years 2010-2012 countries were losing „market access", i.e., the ability to finance itself on the capital market at reasonable rates
- The European Financial Stability (EFSF) and, since 2012, the European Stability Mechanism (ESM), which are backed by capital from all member states, provide long-term loans with low rates. ESM refinances itself at low rates on the capital market.
- EFSF/ESM loans are conditional. Countries receiving loans must implement a structural adjustment programme which was monitored by IMF, EU and ECB (the so-called ‚Troika')



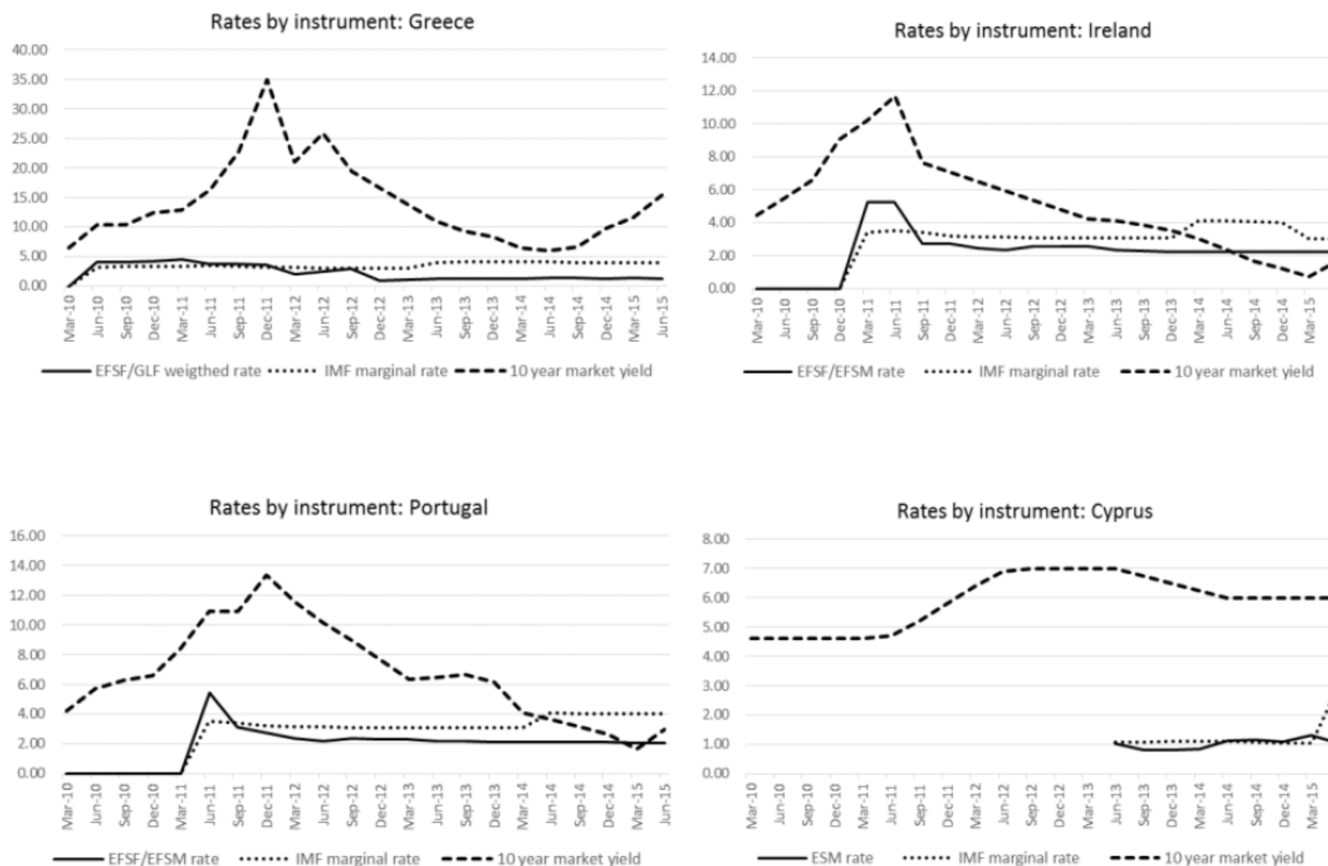
Official loans to problem countries



Source: International Monetary Fund, European Commission, European Stability Mechanism, various countries Central Banks and Bloomberg. Debt is measured as percentage of GDP. Market rates, measured on the right hand side axis, refer to the spread on benchmark 10-year sovereign bonds. ESM debt collects all euro area official loans (GLF, bilateral loans, EFSF, EFSM and ESM).

Borrowing costs

Figure 2. Dynamics of borrowing Costs by Creditor Type



Source: International Monetary Fund, European Commission, European Stability Mechanism and Bloomberg.

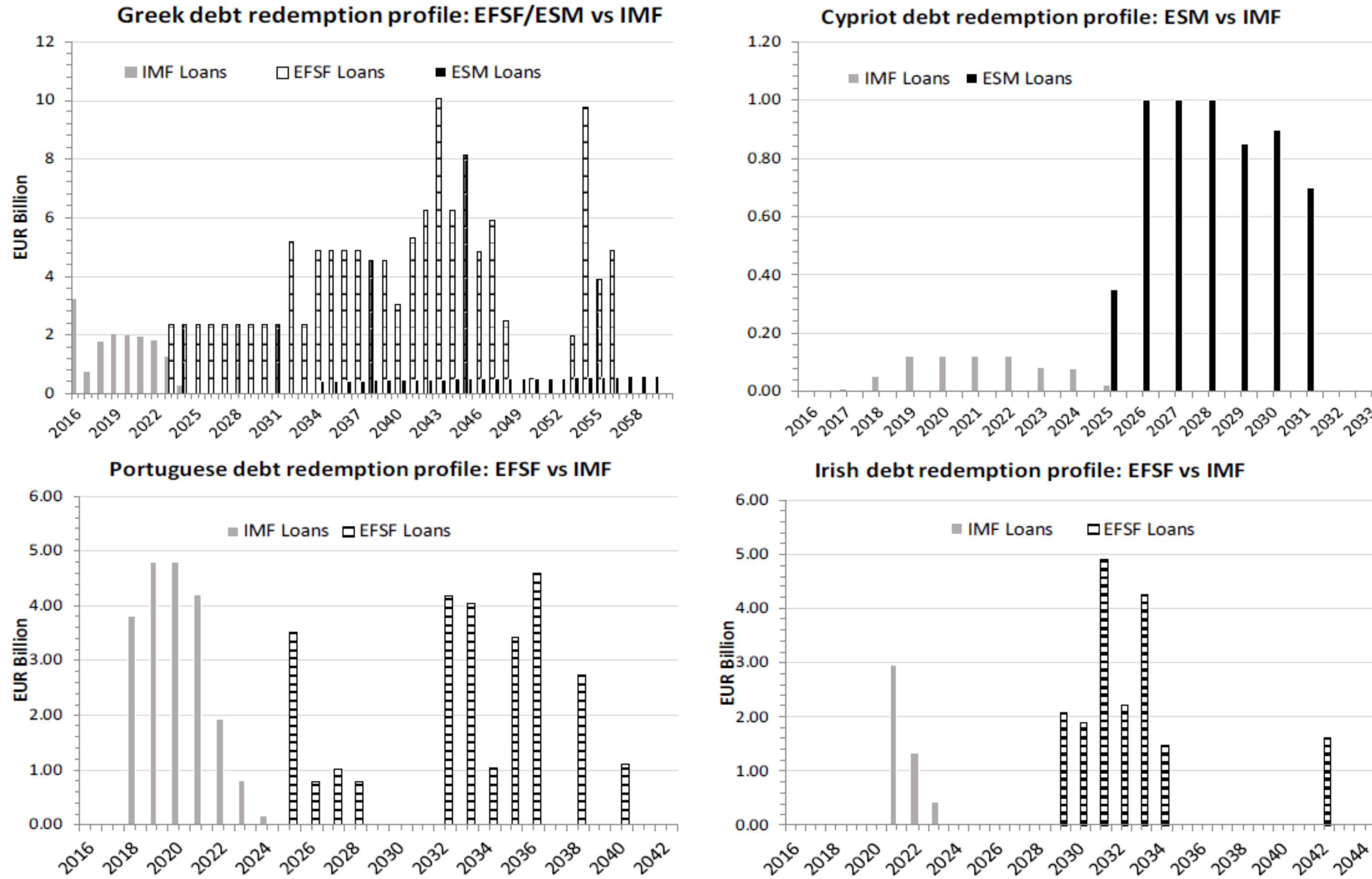
Detailed borrowing costs

Table 2. Evolution of the terms of official support in the euro area

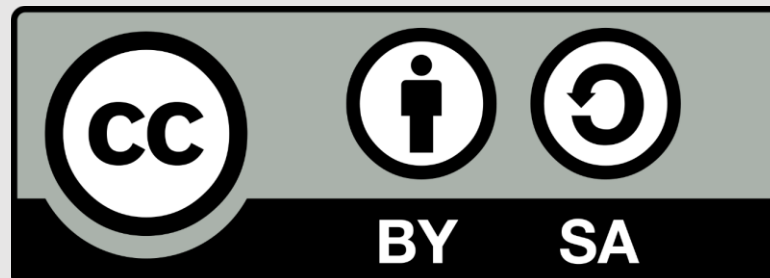
		European Official Support					International Monetary Fund Support				
		Vehicle	Program Duration	Size	Loan Maturity	Spread over reference rate[1]	Program Type	Program duration	Size	Loan Maturity	Spread over 3-month SDR
Greece	May-10	GLF	3 years	80 bill	5 years (+3 grace period)	300-400 bps	SBA*	3 years	30 bill	3 years	200-300 bps
	June-2011	GLF			10 years	200-300 bps					
	March-2012	GLF			20 years	150 bps					
	March-2012	EFSF	3.5 years	144.7 bill	20 years	150 bps	EFF	4 years	28 bill	8 years	200-300 bps
	December-2012	EFSF			30 years (+10 grace period)	0 bps					
	December-2012	GLF			30 years (+10 grace period)	50 bps					
Ireland	December-2010	EFSM	3 years	22.5 bill	7.5 years	250 bps					
	December-2010	EFSF	3 years	17.7 bill	7.5 years	250 bps	EFF	4 years	22.5 bill	8 years	200-300 bps
	July-2011	EFSF/EFSM			15 years	0 bps					
	June-2013	EFSF/EFSM			22 years						
Portugal	May-2011	EFSM	3 year	26 bill	7.5 years	215 bps					
	May-2011	EFSF	3 year	26 bill	7.5 years	210 bps	EFF	4years	26 bill	5 years	200-300 bps
	July-2011	EFSF/EFSM			15 years	0 bps					
	June-2013	EFSF/EFSM			22 years						
Spain	Nov-12	ESM	2 years	100 bill**	12.5 years	30 bps	-	-	-	-	-
Cyprus	May-13	ESM	3 years	9 bill	15 years	10 bps	EFF	4 years	1 bill	4 years	200-300 bps
Greece	Sep-15	ESM	3 years	86 bill	32 years	10 bps					

Sources: International Monetary Fund, European Commission, European Financial Stability Facility (EFSF) and European Stability Mechanism (ESM). EFSM stands for European Financial Stability Mechanism.* The SBA program was replaced by the susequent EFF. [1] For EFSM loans the reference rate is the EU funding cost, for the EFSF the EFSF's funding cost and for the GLF the 6 month Euribor. ** Only 41.3 billion were actually disbursed. *** On December 2021, the EFSF waived Greece the payment of the guarantee commitment fee and deferred interest payments for 10 years.

Redemption profiles



Source: International Monetary Fund and European Stability Mechanism.



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