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Inappropriate Fiscal Rules and Euro-zone Austerity[1]

Some introductory remarks

Thus, we, the Europeans, are confronted with the intellectual challenge of understanding how a monetary union functions in practice and the role played by public sector economics, independently of ideology. This is a difficult exercise, because until the euro-crisis evolved, there was only one theory in town - euro-monetarism. When the rationality of the EMU occasionally was on the agenda, all governments of the Eurozone, independently of whether they were left- or right-leaning promoted the common currency using euro-monetarist arguments. So, as we have seen the main, not to say sole, argument, for making the EMU work properly was to ensure a balanced public budget.

However, reality tells a different story: public deficits are common practice. Why, at least until recently, does reality run counter to the recommendations offered by the macroeconomic theory that has generally been accepted? Why are there so often deficits in public budgets? In the eyes of the Euro-monetarists, the answer is simple. Politicians might be driven by self-interest to spend public money to buy voters and to promote re-election.

Such 'rational' political behaviour makes it necessary for cool-headed economists to recommend constitutional restrictions on the politicians' use of public money. We see it in the call for an *independent central bank* and a *limit on public sector deficits* in all the EU member-countries. These requirements are implemented in the EU Treaty and are applicable to all EU member-states. Being a member of the euro-zone makes these rules more binding. If public sector budget rules are not respected, then the EU Commission

1 This paper will appear in a slightly edited form as Chapter 5. *Public Sector Deficit and Debt: Cause or Effect?* In my forthcoming book *The Euro: Why it failed*, Palgrave/Macmillan, 2016

can recommend that a number of fines be imposed and that the ECB stop providing lending facilities to the banks concerned.

Hence, Euro-monetarism has defined the 'rules of politics' with regard to public finances and monetary policy (chapter 7). What are the consequences when Euro-realities differ from the macroeconomics of euro-monetarism?

Public finances are a part of 'the economy as a whole'

From a socio-economic perspective, it will be necessary to view the entire macroeconomic system as a whole (or ‘the economy as a whole’). In other words, government budget deficit cannot be analysed in isolation from the rest of the economy. Purely accounting principles tell us that a deficit has to be matched by a surplus of exactly the same size elsewhere in the economic system considered as a whole. This principle was highlighted in Chapter 4 with regard to the balance of payments. When the public sector has a deficit, there must by definition exist a surplus of equal size. The question is where? The answer is simple: the private sector(s).

Nonetheless, before going in search of the 'missing' surpluses, we need to discuss the causes and consequences of public deficits and private surpluses. It is only when the Euro-monetarists assume the private sector to be self-adjusting that this causality chain is 'one way'. In reality it could be the imbalance between financial savings and real investment in the private sector that stands as a persistent cause and is consequently mirrored in the public sector (and/or the balance of payments). In such cases, a public deficit could better be understood and therefore analysed as the derived effect of a financial surplus in the private sector. It is analytically then a crucial matter to detect which direction causality will take; that is, the relationship is not, in reality, one-way.

Therefore, from the perspective of causality and pluralistic macroeconomic theories, it is striking that this is the only concern connected to the public sector deficit and debt. The above dominated the political arguments when the institutional set-up was launched back in 1989 and did so again when the present Euro-crisis culminated in 2012. No one, in this prolonged period, really cared about other macroeconomic imbalances, such as the balance of payments, let alone unemployment. This is one reason why the Euro has failed insofar as it has caused so much social distress without any serious attention from Brussels, Frankfurt or Berlin.

Are politicians guards of the common good?

From the perspective of Euro-monetarist theory, national politicians easily become the target for criticism when public deficits are on the agenda. Since the Euro was introduced, such criticism has often been expressed by the EU’s institutions, mainstream economists and by ‘unionists’. These arguments were made explicit as paragraphs in the EU Treaty and considered as preconditions for securing the success of the euro and economic development or prosperity within the Eurozone countries. They have been

repeated by almost every stakeholder in and around Brussels (EU-Commission) and Frankfurt (ECB) while the argument remains monotone: it is not the euro, which causes the problems, but Euro-governments failing to balance their budgets. Hence, the success of the euro relies heavily on the institutional framework to ensure that governments restrict their public sector deficit and constantly aim for a balanced budget. As we have seen, this has been a part of the original convergence criteria (Treaty of Maastricht), the added Stability Pact (Treaty of Amsterdam) and lately, when the crisis had unfolded, the even stricter Fiscal Compact (not yet incorporated into the EU-Treaty).

This single-minded focus on the public sector and a balanced public budget demonstrates that the fathers of the EMU did not only have pure economic arguments on their agenda. They did, of course, know that there was more than one macroeconomic tale in town. However, only the Euro-monetarists were considered to be 'politically correct' in EU terms and became the academic fig-leave supported by the populist argument that 'one market needs only one currency'. Hence, the Euro-monetarists' arguments have also become an intellectually respectable way to discipline the use of public finances by left-leaning politicians. The same academic arguments have provided the undercurrent behind the Euro-monetarist requirement of making the European Central Bank independent of the political decision-making process.

Euro-monetarists seem, through their models, not to trust politicians as guards of the common good. Using theoretical arguments which take individual optimisation as a behavioural axiom, it is not surprising that monetarists fear that politicians are also maximizing their self-interest rather than the common good. I have always wondered about the above – why have these suspicious on the part of many conventional economists been directed at the politicians and not the economists themselves? How can it be that economists feel themselves to be elevated above self-interest? In defence of the monetarist view, it has to be said that hardly any politician within the Brussels elite has objected to this view – not even the socialist government. However, I will leave this thought aside until the very conclusion of this chapter.

Here, I want only to investigate the macroeconomic consequences of imposing strict rules on public sector finances within the European monetary union. As explained in the previous chapters, when macroeconomic instability increases as a consequence of adopting a common currency in a non-optimal environment, what role should the public sector and fiscal policies adopt in serving as a stabilising counter weight? Should they hereby act to reduce the risk of the failure of the Euro?

Fallacy of composition (I): 'you can't live beyond your means'

It is common practice on the part of euro-monetarists to use house-keeping arguments within the sphere of macroeconomic reasoning. Indeed, it is a popular approach to win the argument in a political contest by claiming: "As all of us know from our own household experience, one cannot go on living beyond one's own means. So, what counts for the individual should also count for the government. Therefore, the public sector budget should be balanced, if not every year then as an average over the short term business cycle".

For people who have not studied macroeconomics, this argument appears correct, if not trivial, at least. Yet macroeconomists studying the economy as a whole should know better. In reality, the macroeconomic outcome cannot be deduced only from the idealised

behaviour of individuals, assuming that macroeconomic behaviour has been described by just one representative rational agent (i.e. self-optimising) with rational expectations (i.e. perfect foresight). Although individuals are assumed to behave rationally, their aggregate activity has to take into account diversity and interaction while, of course, perfect foresight is outside the realm of realism, (see Jespersen, 2009).

As a macroeconomist, you have to apply reason to figure out what, in reality, is likely to occur in the economy as a whole. Individual behaviour takes place within the private sector, while the outcome of the economic activities of the private sector is determined by millions of households, i.e. wage-earners (who spend and save), firms, entrepreneurs (who produce and undertake real investment) and financial institutions (providing money and credit). Within a modern, globalised economic environment there is no *a priory* reason to believe that these millions of decisions taken individually should end up making the private sector in each country secure full resource utilisation, i.e. full employment and a stable financial environment.

As we have already seen in Chapter 4, when there is a mismatch between demand and supply, and where savings are larger than real investment within the private sector, this imbalance has to spill over into an unbalanced public sector budget (and/or a balance of payments imbalance). In the end, this indisputable notion of book-keeping is derived from the national accounting system, where the sum of all surpluses and deficits within the economic system as a whole has to add to zero.

If the private sector cannot be expected always to match its intended financial savings with real investment at full employment, there will be a lack of effective demand, which a deficit at the public budget may counter-weight and thereby act as a kind of real economy stabiliser. Fortunately, the built in automatic stabilisers (related to welfare state arrangements) is doing a part of this job, preventing the fall of demand to some extend. Anyhow, in such cases, any predetermined limit with regard to the size of the public sector deficit set too narrowly could have a destabilising effect on the private sector causing more unemployment and a prolonged recession.

The above represents one set of macroeconomic imbalances which does not occur by itself. In fact, out of fear and uncertainty private household may start to increase savings and therefore impose a deficit on the public sector. From this realistic perspective it hardly makes sense to have a fiscal rule which requires that the public sector should also increase savings just to balance its books. The behaviour of 'double-saving' would only further destabilise the economy as a whole.

There are many other instances of fallacies of composition in macroeconomics. For instance, when it is argued that macroeconomic outcomes can be derived from a simple aggregation of individual (micro)economic behaviour analysed with a general equilibrium framework. Such a fallacy could sound like: 'There is a job for everyone, who is willing to accept the market determined wage rate'. The Euro-monetarists express the above slightly differently: 'The supply of labour creates its own demand' (i.e. full employment arrives by itself). This fallacy is well-known in neoclassical macroeconomics; here it is called Say's Law.

It is correct that one person may reduce his/hers wage claim to take a job, but only at the expense of another wage-earner. Moreover, this tends to happens when the number of jobs is limited. In such cases, two people swap their situation of employment and unemployment, but at the price of a lower wage income. Hence, the aggregate wage

income available to be spent on the consumption good has been reduced. At the end of the day, this may cause reduced demand for consumption goods, less production and even cause more workers to be made redundant.

Fallacy of composition (II): 'The sun is moving around the earth'

Allow me to present another empirical parable to explain why, when arguments are applied to macroeconomic issues, the 'obvious' is not necessarily the 'real'. Anyone looking up the sky can see the sun is moving during the day from east to west, while this movement repeats itself next morning. In the Middle Ages, only a few scientists challenged the orthodoxy that the earth was centre of the universe with the sun revolving around. That is to say, they dared to challenge the obvious and were so considered heretics which, to say the least, made life difficult for them. It took several hundred years and many, many careful empirical measurements before doubts arose.
The similarities to macroeconomics are striking. Macroeconomic phenomena cannot be observed directly. Only theoretical models of the economy as a whole, combined with skilful and careful use of econometric methods used on data from national accountancy, can reveal the most likely explanation of the macroeconomic dynamic forces. Indeed, the similarities to astronomy are striking. It was not until very precise predictions were made possible by the Newtonian planet model that the public and the Church were at last convinced that the sun were in the centre. Yet macroeconomics is lagging far behind astronomy with regard to precise forecasts. In fact, macroeconomics will never be like (natural) sciences because social phenomena are 'man made' without any eternal laws of movement.
On the other hand, many macroeconomists have the aspiration to set up a model capable of giving reliable answers to what different policies and institutional reforms may bring in the future. A macroeconomic model is a system with many intertwined relationships at the national level and at the international level, where a common currency forces a far-reaching institutional change, which makes the consequences of fiscal rules deviate from past experiences.
For those governments that do not have an independent currency and central bank, the public sector budget - i.e. fiscal policy - is almost the only tool which is left to stabilise the economy as a whole. Hence, it is even more crucial to understand the role of public debt and deficits correctly.

Let me now summarise the two sections on the ‘fallacy of composition’. They have provided simple examples of why macroeconomic results cannot, in general, be derived from microeconomic arguments assuming individual optimisation and fully flexible and self-adjusting markets. These conclusions are important because they provide theoretical arguments as to why monetarism cannot, in most cases, provide a realistic understanding of macroeconomic dynamics in terms of the economic consequences of the public sector.

Different concepts related to the public sector budget

To understand what we are referring to when speaking about the public sector, we have to navigate some rather dry definitions and concepts related to public sector finances, budget and debt. Having reached a decent level of understanding, we are ready to see the

public sector as an integrated part of the ‘economy as a whole’.

1. **Current public sector budget** (**deficit)** i.e. public sector borrowing requirement: (expenses: public consumption, public real investment, social benefits and interest payments) minus (income/revenue: taxes, consumer charges and privatisations). In fact, this includes all cash flows except financial transactions and is the definition used when fulfilments of convergence criteria and the Stability Pact is considered. The sole focus here is on public sector borrowing requirement. If real sector activity were the main concern related to the public sector budget, then one would instead recommend a split between public consumption (continuous stream) and public investments (a one shot effect). Likewise, social expenditure can be separated into a structural part related to, among other things, old age pensions and a varying part dependent on unemployment benefit and related to the business cycle of the specific year.
The EU’s convergence criteria and the Stability Pact limit the size of the current deficit at 3 percent of GDP – except for extraordinary cases with negative GDP growth.

2. **Primary public sector budget** is defined as the current budget, minus net interest payments. It is short hand for the public sector’s financial capacity to serve the already accumulated public debt without borrowing. For instance, a condition of the Troika (EU-Commission, ECB and IMF) has been made to demand a considerable surplus of the Greek primary budget of 3½ percent of GDP.

3. **Automatic stabilisers** in regard to the budget refer to the social benefits caused by unemployment and to changes in tax revenues caused by the deviation of actual GDP from potential GDP. Automatic stabilisers will have a deteriorating effect on the budget, when unemployment is higher than the structural level and the output-gap is positive (i.e. potential output larger than current output). The calculation is dependent on the macroeconomic model and on the definition of structural unemployment and the potential output-gap.

4. **Structural (underlying) budget** is the current budget corrected for the effect of automatic stabilisers. The outcome of the calculation is often interpreted as a measurement of the discretionary fiscal policy undertaken. A balanced structural budget is seen as a neutral fiscal policy, while a deficit and surplus are considered as an expansionary/contractive fiscal policy.
The fiscal compact agreed upon by 26 EU-member states has limited the size of the deficit to ½ percent of GDP at any time, independent of the size of the output-gap. In practice, this means that expansionary fiscal policy is ruled out at any time, even when the output-gap is considerable.

5. **Public sector financial gross debt** is the measurement over time of the aggregate Public Sector Borrowing Requirements in relation to current GDP. In the Stability Pact and the Fiscal Compact, the upper limit is set to 60 percent of GDP. Under normal conditions, GDP is expected to grow by, for instance, 4 percent each year, which means that the nominal public debt could also grow by 4 percent without any change to the debt/GDP ratio.

6. '**Sustainable public finances**' means that a longer term perspective is taken on the development in public finances under consideration of changes in the demographic structure. In periods when the population grows older due to increased average life expectation, the labour force shrinks as a proportion of the population and public finances come under pressure. The question then to be asked is whether the public debt/GDP ratio will stay constant during a longer term period; given the present tax rates and the norms and standards of public expenditures related to the welfare state.

Box 5.1 Summary of concepts related to public sector finances

(1) Current budget: all tax income + revenue from the privatisation of public property – public consumption – public real investment – social expenditures – interest payments

(2) Primary budget: current budget before payment of interest

(3) Structural budget: current budget corrected for the impact of the automatic stabilisers. (A change in the structural budget can in principle only happen as a consequence of an *active* fiscal policy).

(4) Primary structural budget: structural budget before payment of interest (considered as short hand for the impulse from fiscal policy)

(5) Sustainable budget: calculated of a structural budget, which could keep the public debt/GDP ratio constant in the long run taking demographic changes into consideration.

Public sector and the 'economy as a whole'

The next question related to the public sector is: What are the statistical counterparts to the public sector? As we have already seen in Figures 4.2 and 4.3, they are the private sector savings/real investment balance and the balance-of-payments current account. Within the national accounting system these three sector balances add up to zero. This principle is then simple to demonstrate using the national accounting system.
Looking at table 5.1 it becomes obvious that the private sector is not balancing its books. In fact, there has been a savings surplus in most cases over the last 20 years. Private real investment could not catch up with the potential private financial savings at full employment.
Moreover, equilibrium within the private sector is not only a matter of balance between savings and real investment. Low unemployment, low price inflation and the absence of a balance of payments deficit are even more important. We have already discussed the above in the previous chapter, but unemployment and low inflation will be addressed in

the next chapter.
For the moment, we will focus on the interrelationship between the private and public sector, leaving the balance of payments aside. The main question is to ask is whether the two sectors are self-adjusting. If one sector can balance its saving/investment account by itself, then the other one would be forced to have a balance budget.
We have already discussed the two different schools of macroeconomics and their fundamentally different theories in order to explain the origin of macroeconomic imbalances and the role of the public sector:

1. Euro-monetarists assume (and this is a pure assumption) that the private sector is self-adjusting. This is not an empirically proven theory but a conclusion deducted and built on the axioms of rational individuals, of perfect foresight and of a well-behaved and competitive private market system. If the above were to be the case, then the private sector would adjust to full employment and a saving/investment balance. Hence, within a macroeconomic system where the private sector is self-adjusting, it is only external events, originating from within other sectors, which can disturb the smooth development of the private sector. In this case, we would expect to see low figures of unemployment and a balanced private sector account.
However, we see by looking at Table 5.1 it is clearly not the case that the private sector has been in macroeconomic balance in any of the larger Eurozone member-states. Nonetheless, according to the reasoning of the Euro-monetarists, these macroeconomic imbalances must be caused by a political mismanagement of public finances. In rarer cases disturbances might originate in other sectors such as the financial sector (banking crisis) or the foreign sector (collapse of export markets). Hence, following the logic of the Euro-monetarist model, the short-circuit of the self-adjustment process in the private sector can be explained in terms of political activity that destabilises the private sector and the economy as a whole. This destabilising activity is registered statistically as deficits (and surpluses – but seldom mentioned) at the current and/or structural budget.
As mentioned above, the **structural budget** is a (rough) measurement of the destabilising effect of the aggregate public sector activities undertaken by a government. To prevent the politicians of this government opting for self-optimising and public expenditures to seek re-election instead of looking for the common good, the rules compel the government to balance the structural budget. According to the Fiscal Compact, the deficit must not be more than equal to ½ percent of GDP in any of the EU member-states (where Great Britain and the Czech Republic are exempted). In practice, this limit means that EU-countries are prevented from undertaking any significant expansionary policy even during the trough of the business cycle.
The agreed size of the **current budget deficit** is less restrictive. The maximum is 3 percent of GDP set by the EU Treaty and the Stability Pact. This leeway is made possible to allow the automatic stabilisers to ‘work’ during unavoidable business cycles caused by external shocks and short term private sector misalignments. In rare cases where GDP falls by more than 1 percent, an even larger deficit may be accepted by the EU Commission if a credible plan for the reduction of the current budget deficit is put forward by the government of the deficit country.
In addition, a maximum limit has also been set for the acceptable size of the **public (gross) debt**. Here the upper limit is 60 percent of GDP. Indeed, not much attention had

been devoted to this limit until the financial crisis swept the European countries. From the very beginning, EMU countries like Italy, Belgium and Greece had public debt ratios far above this limit without any consideration being given to them. However, during the crisis a number of the more conservative countries, Germany prominent amongst them, had to acknowledge that their debt ratio also exceeded the 60 percent limit, partly because their GDP fell(!) and the current deficit swelled to a level far above 3 percent(!).

The excesses outlined above have been recognised and addressed by the Fiscal Pact. Here the Pact requires that any public debt ratio exceeding 60 percent should be reduced each year by at least two percentage point; for instance, from 84 percent of GDP to 82 percent. Such a reduction of the ratio between the debt and GDP can be achieved either by growing GDP or reducing the debt through a current budget surplus. Within monetarist reasoning, GDP will growth by itself (due to the self-adjustment assumption), reducing unemployment and improving the current budget. This adjustment will come by itself if politicians understand and restrict themselves to securing a balanced structural budget.

Finally, it has to be mentioned that within these fixed limits of the structural budget, the current budget and public debt ratio are arbitrarily chosen. There is no scientific explanation for this 'magic' size of ½ percent, 3 percent and 60 percent of GDP, or an explanation for why this number should be the right one permanently for all EU countries. This concept, if is one at all; is built on the vision that all countries are alike and a 'one size fits all' approach is possible. This attitude which has been echoed within Bruxelles ever since the early 1990s, exemplified by the publication by the EU commission of 'One market, One currency'.
Looking at the economy as a whole, one could ask: why has the balance of payments not been mentioned above by a single word? Two reasons can be given here. When the private sector has adjusted to equilibrium and where private financial savings equal real investment, then this is not considered as a theoretical, political or practical issue (whether or not these real investments have been undertaken domestically or abroad) because they are, by assumption, matched by private savings. If one country experiences a net outflow of direct investments, then it will automatically have a surplus at the current account i.e. it will have private savings larger than domestic real investment. If the public sector has a balanced budget, then these excess savings are channelled abroad via the capital account at the balance-of-payments. Similarly, if one country experiences a balance of payments deficit, then this is to be explained by individual actors' *rational* decisions to invest more than they save in the private sector.
Monetarists assume that the accompanying balance of payments surplus abroad is automatically re-circulated and made available to finance the excess of real investment. This equalising mechanism is only broken in the monetarist model, if one country experiences a rise or fall in the demand for money, which is usually considered as a rare case. See for instance, *The Monetary Approach to the Balance of Payments* by Johnson, which we will discuss further in Chapter 7.

2. Euro-realists: What do we know about the public sector and the economy as a whole? Here, we have to be cautious about determining what 'as a whole' mean? The Euro-monetarists looking at one country at a time with focus only on the public sector budgets.

Realists look at the entire economic system because no such thing as private sector equilibrium is assumed a priori which, in fact, may be substantiated by examining Table 5.1.
In addition, countries which trade a lot and share the same currency cannot be analysed independently of each other. Instead, they are highly integrated via the balance of payment current and capital accounts. As we explained in Chapter 4, the current account registers real activity but mainly the export and imports of goods and services and interest payments abroad. All of the above have a derived impact on GDP, employment and real income in all the participating countries. Meanwhile, a surplus has an expansionary effect and a deficit the reverse. Therefore all countries aim at a surplus which, by definition, is not possible. However, this does not prevent countries from undertaking policies to improve the current account and, in doing so, become victim of the 'fallacy of composition'. The capital account of the balance of payments registers capital flows, where short term financial flows have become the dominant part, given ample possibilities for speculative transactions destabilising the financial sector under attack.

Therefore, Euro-realists would ideally have to set up an interlinked model of all Eurozone countries split into at least three sectors: public, private and financial. Such a model has yet to be set up. However, the late Wynne Godley stock-flow modelling approach has been an important step in this direction. A number of post-Keynesian scholars in Greenwich, Berlin, Paris, Kingston and recently Aalborg have further elaborated a number of important ideas, see for instance Madsen & Olesen (eds), 2016. In the view of these studies, instead of assuming general equilibrium, the entire euro-zone is being analysed in a dynamic perspective and path dependent process where 'one size does not fit everyone'. In reality, countries are different and they develop differently through time, making macroeconomic imbalances differ, which can be seen in Table 5.1.
Taking the realists' view on the Eurozone then, there is no reason to assume that the private sector in each country should be self-adjusting. Persistent unbalancing effects derived from the private sector provide a mismatch between financial savings and real investment. These substantial mismatches have financial consequences mirrored in the balance of payments current account surpluses (in some countries) and deficits (in other countries), in the financial sector and, finally, at the public sector budget deficit or surplus (depending on circumstances and policies).

Table 5.1. Private sector: excess savings

Percent of GDP	1995	2000	2005	2010	2015
France	5,7	2,5	3,2	6,0	3,4
Germany	8,2	-2,7	8,0	9,6	7,9
Italy	9,6	1,4	3,2	0,8	4,8
Poland	4,9	-3,3	1,4	2,1	2,4
Spain	6,1	-3,4	8,7	5,5	6,5
United Kingdom	4,7	-3,4	2,3	6,9	-0,7
Euro area (15 countries)	7,7	-0,5	2,9	6,6	5,9

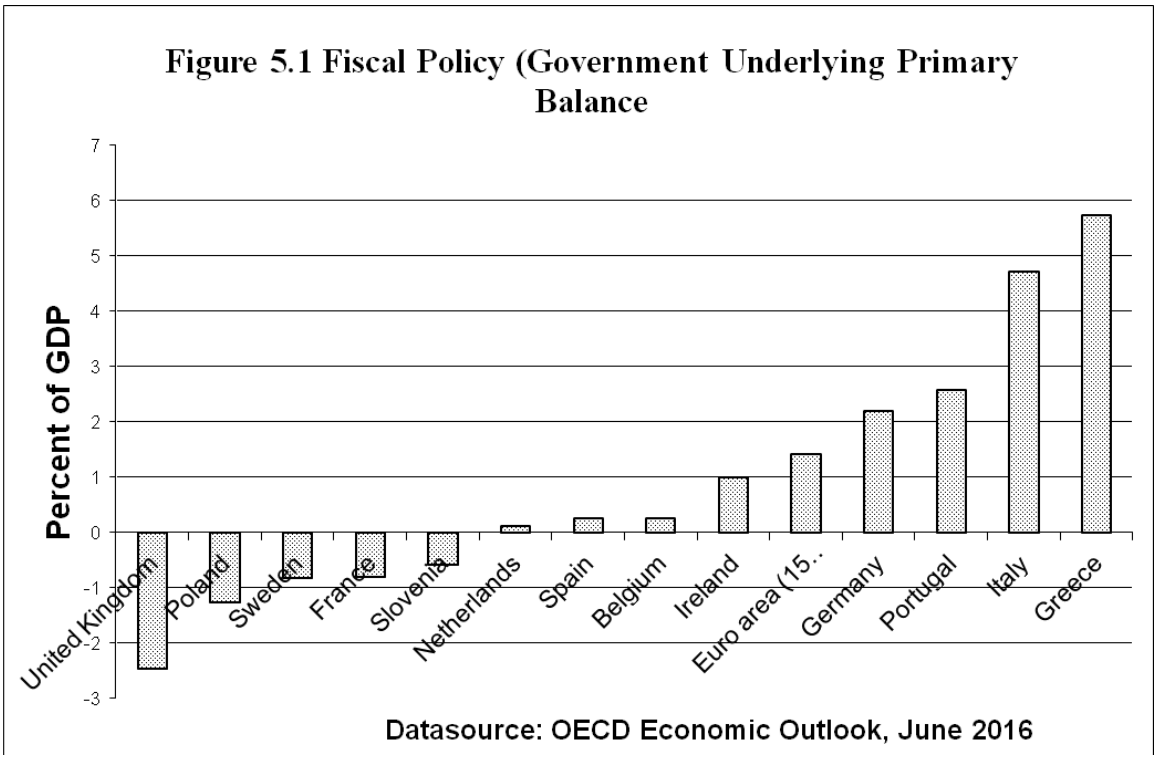
Source: OECD, Economic outlook, 2015

In this chapter, we will focus upon the role of the public sector and fiscal policies, analysing the impact of the different budgets on macroeconomic development. Euro-monetarists and Euro-realists are in least disagreement about the working of the **automatic budget stabilisers**. From both perspectives, they perceive the stabilisation of private sector real activities during booms and troughs. However, the importance of the size of the stabilisers differs because they relate to welfare institutions designed by the politicians and therefore scrutinized with some scepticism by the monetarists. A social safety net consisting of unemployment benefit, high marginal income and consumption tax rates do serve to stabilise the macroeconomic system. At the same time, some economists claim that this causes a negative impact on individuals' incentive to supply labour and to undertake business initiatives. Monetarists then accuse the welfare state of making the economy smaller and less dynamic which, for them, is an argument for recommending an upper limit on the current account of the public budget.
The Euro-realists would then counter-argue that some of the best performing EU countries are those with the most extended welfare state institutions. The overall workings of the labour market cannot only be judged only by the individual economic incentives to work, i.e. real disposable wage compared to social benefit. In relation to the labour market then, the overall institutional framework also makes a difference: generous social benefit and high marginal tax rates make disposable income more stable. The magnitude of these social phenomena is related to the welfare state ideology. There is also a different view with regard to the significance of inequality as Euro-realists recognise that the more equal societies are also the most harmonious, see Wilkinson & Pickett (2010).
With regard to **fiscal policy** the two schools have opposing views. As we have seen, the euro-monetarists recommend a neutral fiscal policy represented by a balance structural budget all way through because of the a priori axiom of a self-adjusting private sector. Euro-realists cannot accept this axiom which, according to their view, remains a theoretical 'special case' relying on the ideal assumption of individuals having perfect foresight and the market economic system being extremely well behaved; that is being attracted to a simultanous/general equilibrium. As Table 5.1, shows both assumption cannot be supported or substantiated by empirical studies.
If **the Euro-realist** view is accepted then there is an important case to be made for fiscal policy stabilising the private sector and the labour market, particularly within a closed economy where the balance of payments plays a minor role. **Fiscal policy** is a more double-edged sword, being that unemployment, the balance of payments and the current account deficit all appear at the same time. It has been confirmed quite recently that fiscal policy is a (very) potent policy instrument, especially in recessions (see IMF 2012, 2016). The potential impact is even reinforced when more countries undertake fiscal contraction (or expansion) at the same time. As long as a single country model has been used to calculate the economic impact, the effect has been underrated for three reasons: 1. No feed-back effect from abroad, although a fiscal contraction in one country has a negative

impact on trading partners' economic performance, 2. Reduced exports to neighbouring countries will increase unemployment and weakened public sector finances, and 3. current budget and balance of payments, which may call for fiscal consolidation. Hence, we are witnessing a vicious circle somewhat similar to the beggar thy neighbour policies undertaken in the 1930s.
Euro-realists have debated whether the best shorthand for the character of fiscal policy in one country is the structural budget or the primary structural budget (see above). The OECD has recently calculated that if the primary structural budget is used, then the upshot is that, in the year 2014, the EU country with the most contractive fiscal policy was Greece and – surprise – the most expansionary fiscal policy was Great Britain!

One should also recall that, within the Eurozone, fiscal policy is the only demand management instrument which has been left to the member countries to decide upon. That is, it is fixed arbitrarily within narrow limits by the 'fathers of the Euro'.
Hence, public finance is not only a matter of the current budget where imbalances are mainly related to the working of the automatic stabilisers. If unemployment were to go away by itself, then most countries would have a balanced structural budget. Then, if interest payments were to go away), most countries would still have a surplus today, see figure 5.1, i.e. they are measured by primary structural budget clearly pursuing a restrictive fiscal policy.
The above should make us wonder: how can we be in a situation when unemployment is extraordinarily high, due principally to excess savings in the private sectors. Hence, is not fiscal policy supporting macroeconomic expansion by activating the excess private savings by real public investments? Is this not especially the case when we encounter the huge number of public projects required to improve infra structures, durable energy, schools, hospitals and nursing homes, which unemployed people are ready to undertake. In any case, when unemployment benefit is paid, society gets nothing in return other than a good conscience. Finally, if unemployed people were to receive a proper job, then society as a whole would obtain a real investment for future use.

Figure 5.1 Fiscal Policy: Underlying primary budget, 2014



Note: I have a number of reservations related to the practice of OECD uses to calculate the underlying public budget (underestimating the output gap)[2]. Even with this reservation in mind, it is telling that the Eurozone as a whole undertakes a restrictive fiscal policy, while unemployment is still above 10 percent of the labour force.

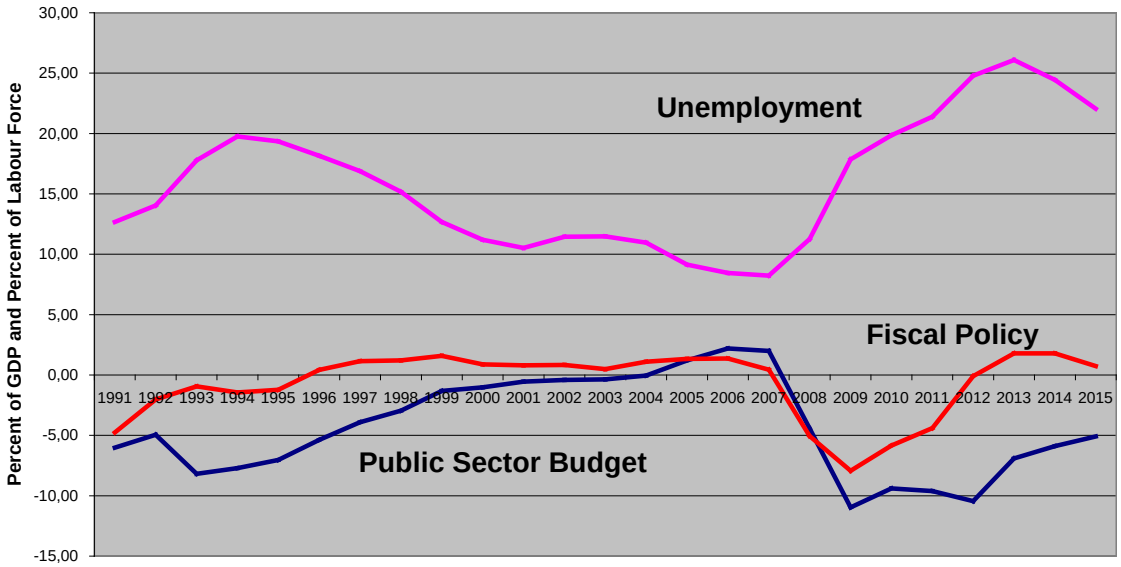
Spain: a telling case of macroeconomic causality

Spain is a telling case of why the single minded focus at the public sector deficit has led to an understanding of macroeconomic imbalances (and risks) astray. When we look at Figure 5.1 showing the public sector budget (according to the Maastricht definition), we will see a continuous improvement year by year ending with a surplus in 2007. Indeed, Spain was used as the prime example of how a country could benefit from being a member of the Eurozone.

The red line shows the fiscal policy which, until 2007, was nearly neutral and did not contribute to the seemingly positive development of the Spanish economy. The driving force was a real investment boom in the private sector, as being a member of the Eurozone meant a loose monetary policy. The rate of interest set by the ECB in Frankfurt was influenced by the low rate of inflation in Germany. Moreover, Northern European banks were more than willing to lend whatever was demanded of foreign liquidity. Due to this excess demand from the private sector, unemployment was falling and according to the OECD calculation, even closing the output gap in 2005 where the blue line crossed the red one. Pressure in the labour market contributed to the deterioration of the Spanish international competitiveness, which had a negative impact on the balance of payments, cf. Chapter 4.

2 The underestimation of the output gap might also explain why United Kingdom according to this calculation has a rather expansionary fiscal policy.

SPAIN: Unemployment, Public Sector and Fiscal Policy



Source:OECD, Economic Outlook, 2016

A closer look at the Spanish economy (see Appendix) unveils a macroeconomic causality, which is very different from the Euro-monetarist assumption of private sector equilibrium. Changes in the rate of unemployment can, to a very great extent, be explained by the private sector excess savings, which may also have a significant impact at the balance of payments (current account).

The problem in the Spanish case was the squeeze between unemployment and the balance of payments deficit which, at an early stage, should have been recognised by the Spanish government and, of course, the EU's institutions. The accumulating balance of payments deficits were unsustainable. For any realist point of view, it was obvious that Spain (like Portugal, Greece and Italy) had to improve on her international competitiveness, entailing that she needed to improve on her structural balance of payments. This proved a difficult task to accomplish, because it should not only be a matter of reducing wage costs in the tourist industries and agriculture, which would not solve the problem. In fact, the opposite could easily be the case. So, it is a matter of improving the structures of the more advanced sectors through a much more complicated process supported by political initiatives, where education, research, innovation and strategic public investments are integrated. The aim should be to combine these public expenditures to improve productivity and ultimately to create higher value added per working hour, which unfortunately is prevented by the requirement of a reduced public sector deficit.

Nonetheless, such a policy change from traditional production to industries of the future does not arrive by itself. It requires political leadership with focus on innovative processes, the balance of payments and employment opportunities for young people. If such a policy is successful then the public sector budget will close by itself, given a

reasonably effective tax administration. Hence, the public sector budget balance should be viewed more as a mirror of success or failure of overall economic policy, where the Euro and the restrictive budget requirements have not been helpful in any respect.

Does the Juncker-plan of 2015 signal a (minor) change?

The rising unemployment and severe social crisis experienced in Southern Europe have had a more direct impact on politics rather than economic arguments.
In the wake of the financial crisis in 2008, the immediate policy response of all the EU countries to the economic downturn was the provision of quite significant fiscal packages. They have concentrated on increased public investment and, where needed, the recapitalisation of private banks. For a while, these policies caused a structural deficit, adding rather large lump sum payments to the already rising public expenses incurred by the automatic stabilisers. As a consequence, the budget deficits in most countries have reached a scale never before seen in peacetime and have been considered by the monetarists to constitute a severe and unsustainable situation.
The realist argument in favour of these stimulus packages considers that, without this expansionary effect, unemployment would have continued to rise further. Looking at the development in the US and UK, it is undeniable that where fiscal policy has stayed on an expansionary path, there has even been a continuous fall in unemployment.
In any case, with the exception of Greece, by 2013 the rise in unemployment had come to an end in most Eurozone countries. One could almost hear the sigh of relief in the corridors of power of Brussels, Frankfurt and Berlin, when employment at last started to grow in the Eurozone as a whole. The medicine was right, it was subsequently claimed. However, the turn-around from falling to increased employment was weak. The excess savings of the private sector were still depressingly high, making economic recovery fragile. Hence, the new EU Commission appointed in 2015 put forward real investment plans for infrastructures, renewable energies, urban renovation and sustainability activities, mainly financed by private funds. The idea is right to activate parts of the private excess savings. Furthermore, national governments have been tempted to seek exemption from the Stability Pact of funds contributed to the Plan. Unfortunately, the realisation of the so-called Juncker-Plan is dragging on because adequate finance is not yet available.

Public debt dynamics

However, unemployment will not go away by itself, especially not when the fiscal policy is rather restrictive. Although there has been some reshuffling of employment between North and South, the average unemployment rate is still above 10 percent of the active labour force and the public sector deficit is still in the aftermath of the prolonged crisis exceeding 3 percent of GDP in a number of Euro countries. Therefore, the fulfilment of the Stability Pact requires that the deficit is reduced by undertaking further public sector reductions, which had a negative impact on GDP and employment.
This negative development of reduced GDP has made it difficult to reduce the public

debt/GDP ratio as long as there is a deficit in the public sector. In fact, a number a countries are caught in vicious cycle, where the current public sector deficit adds year by year to the public debt; but austerity policies make the GDP to stagnate or even to fall causing the debt ratio to go up.
Hence, in all the major Eurozone countries, except Germany, the public debt ratio has risen since 2008, independently of the rather restrictive fiscal policy which has been undertaken with the aim of balancing the public sector deficit.

Box 5.1. Debt dynamics
The mathematics of public debt dynamics are pretty simple. If the starting point is the maximum allowed by the Stability Pact of 60 percent of GDP and, say, a current deficit of 3 percent of GDP, then GDP in nominal terms has to grow by 5 percent to make the debt-ration unchanged at 60 percent.

Year 1, DEBT/GDP = 60 euro/100 euro = 0,60

Year 2, DEBT [60 + 3]/ GDP [100 + 5] = 63 euro/105euro = 0,60

Year 3, DEBT [63 + 3]/ GDP [105 + 5] = 66 euro/110euro = 0,60

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However, the dynamics are not as simple. When debt accumulates it draws a tail of interest payments behind, which adds to the current deficit next year. As a rule of thumb, it is often said that a rate of interest above the growth rate in GDP (5 percent p.a. in the case above) causes interest payments to grow as a proportion of GDP.

A final, but equally important, remark concerns how public debt is financed. It is crucial to separate the public debt financed by debt instrument denominated in the country's own currency and/or by domestic savings e.g. pension funds. As we have explained in the previous chapter, a country running a balance of payments surplus has excess financial savings. They are often accumulated in private pension funds or banks used by government bonds issued in the domestic currency. If we examine any Eurozone country, as long as it has a surplus at the current account, then there will be excess savings which the public sector can borrow if the business cycle is weak.
As long as the private sector has a financial surplus the public sector is not forced to pay back any debt because the private sector is accumulating a growing financial wealth. The situation is the reverse in Eurozone countries with a balance of payments deficit. If the government runs a current public deficit, then it has to borrow abroad and in a currency that it does not control itself, i.e. in a 'foreign currency'.

Conclusion: Public Finance - cause or effect?

Having presented and explained the two opposing theoretical views on the role of fiscal policy, it is little wonder that the policy recommendations put forward are diverging. By fiscal policy, we mean active policies decided by government and approved by parliament with regard to the size and changes of the *underlying structural budget balance*[3]. This measure of the public balance is chosen as a condensed measure of the expansionary/contractionary effect imposed on private sector activity by government expenditures and tax-revenues.

Euro-monetarists consider such an active policy as, in the best case scenario, superfluous because the private sector will adjust by itself.

Euro-realists would argue that an active fiscal policy can support the private sector and contribute to a reduced balance of payments imbalance. In the cases where effective demand in the private sector is too small, an expansionary fiscal policy can substitute for the lack of private investment. However, the use of fiscal policy becomes double-edged if the balance of payments shows an unsustainable deficit. A contraction can be needed to reduce the deficit, but at the expense of reduce growth and increased unemployment. This dilemma is exposed in the Southern European countries.

In Figure 5.1 you can see the dilemma unfold. The fiscal policy measured by underlying primary budget has been rather restrictive since 2011 in most Eurozone countries. As a consequence, GDP has been falling or stagnant in those countries, which have been hardest hit by a structural budget surplus and balance of payments deficit. The combined impact was a steep rise in unemployment which has activated the automatic stabilisers. We can also see that the public sector current budget has only improved a little. Hence, it is difficult to maintain the view that fiscal policy has no impact on private sector imbalances.

The Structural Budget: a policy goal or a macroeconomic instrument?

The structural budget balance is considered by Euro-monetarists to be a measure of fiscal strength. Increased surplus is a sign of ’sound’ and ‘responsible’ fiscal policy. Conversely, a reduced surplus on the structural balance indicates that the fiscal policy has been relaxed. However, the size of a surplus cannot be taken as a measure of whether fiscal policy is *too* 'lax' or 'tight'. The structural balance is a calculation showing the balance of public budgets at 'full employment'. However, no consensus on how to define full employment or how to establish full employment is currently on offer. Furthermore, the calculation of the structural budget is very dependent on the macroeconomic model used and upon the analytical practice.

The Euro-monetarist model assumes that full employment and the balance of the structural budget coincide. As we have already discussed, ‘full employment’ is assumed

3 . I have chosen to use the underlying primary budget in a number of cases, therefore avoiding that only a single instance of public income or expenditures, automatic stabilizers and interest payments disturb the overall picture of the size and direction of discretionary fiscal policy.

to come by itself via the 'invisible hand'. Therefore, fiscal policy should be oriented towards balancing the structural budget. Indeed, this is the thinking behind the Financial Compact's very narrow margin for deviations of the structural budget, even during recessions! Only a deficit of a half percentage point of GDP may be accepted, no matter how high unemployment has risen.

The Euro-realists view is different. Here, the public sector is an instrument to secure better macroeconomic balance. When unemployment is high and the balance of payments is more or less under control, then the choice of an expansionary fiscal policy to counterweigh excess savings in the private sector is a relevant policy option. It might increase both the structural deficit and the current deficit. In any case, it could be the right policy to initiate a process of falling unemployment and growing GDP, which could kick-start a recovery and cause the public debt ratio to fall

How do governments avoid public debt ratios to go on growing?

Once again the two views differ.

The Euro-monetarists only look at the public sector. If the budget shows a deficit then public debt is growing, although it is necessarily measured as a percent of GDP. It is the debt-GDP ratio which matters. Here, the development in the GDP is at least as important as the budget deficit. Just after the Second World War the British debt-GDP ratio was around 200 percent, but the end of the 1960's, the debt ratio had been reduced to less than 40 percent mainly due to growth in nominal GDP.
However, a falling or stagnant GDP combined with a substantial current public sector deficit is a venomous cocktail. In this case, the public debt ratio is growing despite attempts to undertake a restrictive fiscal policy. If growth does not resume within a short period, then the public finances measured by the debt-ratio is not sustainable. In that case the automatic stabilisers have to be reduced together and the other current public expenditures and tax rates increased. A vicious spiral will then be set in motion.

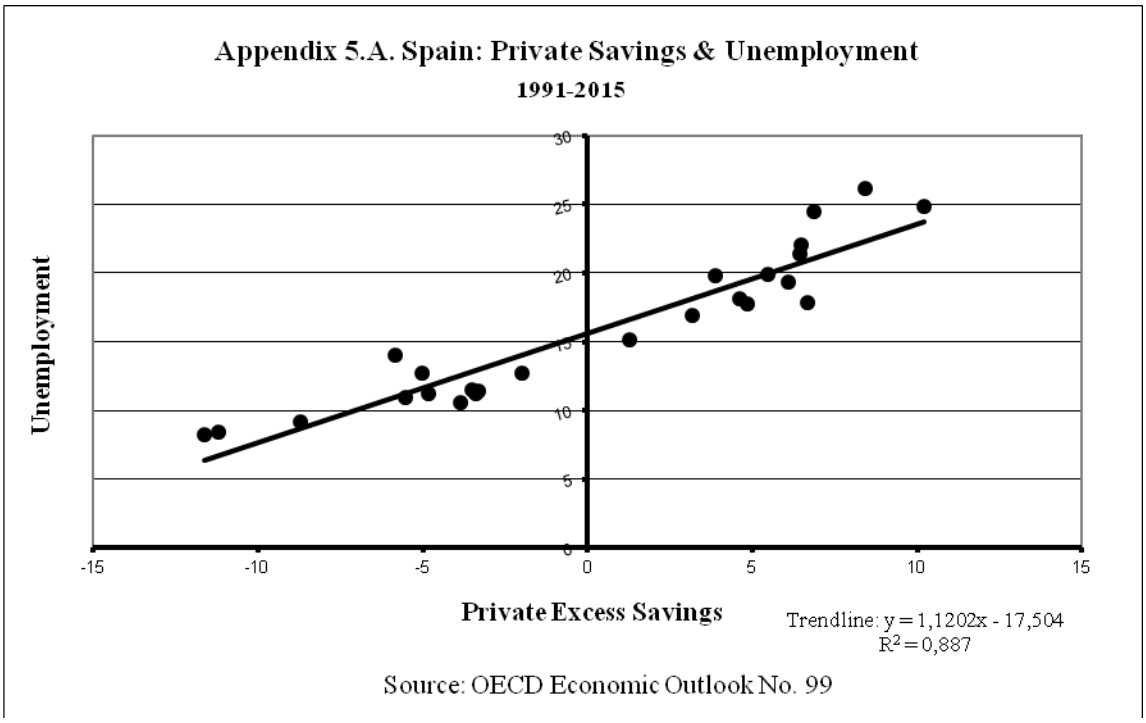
The Euro-realists start looking at the private sector and the balance of payments and then asking themselves: where should we find the cause of excess private savings? If the balance of payments shows a (substantial) deficit – an improvement has to be undertaken by increased competitiveness. However, those countries with a structural balance of payments surplus should be committed to undertaking an expansionary fiscal policy as long as unemployment is above any reasonable definition of 'full employment'. This expansionary policy could go hand in hand with a controlled deterioration of the international competitive position or foreign direct investments in Eurozone countries with a structural balance of payments deficit. This latter initiative could be organised through the European Investment bank providing funds for the Juncker Plan.

In the end the best medicine to avoid a continuous growth in public debt is a prosperous private sector and a reduced rate unemployment and external balance, so

'*Look after Unemployment, and the Budget will look after itself'*
Keynes, 1933

Appendix. Spain: getting causality right![4]

To add some further empirical support to my arguments related to 'Macroeconomic imbalances: cause and effect', I have calculated correlations for the main relations. Of course, I know that statistical significance is not a proof of causality, but it may constitute support for realist arguments put forward in the theoretical sections of the chapter.

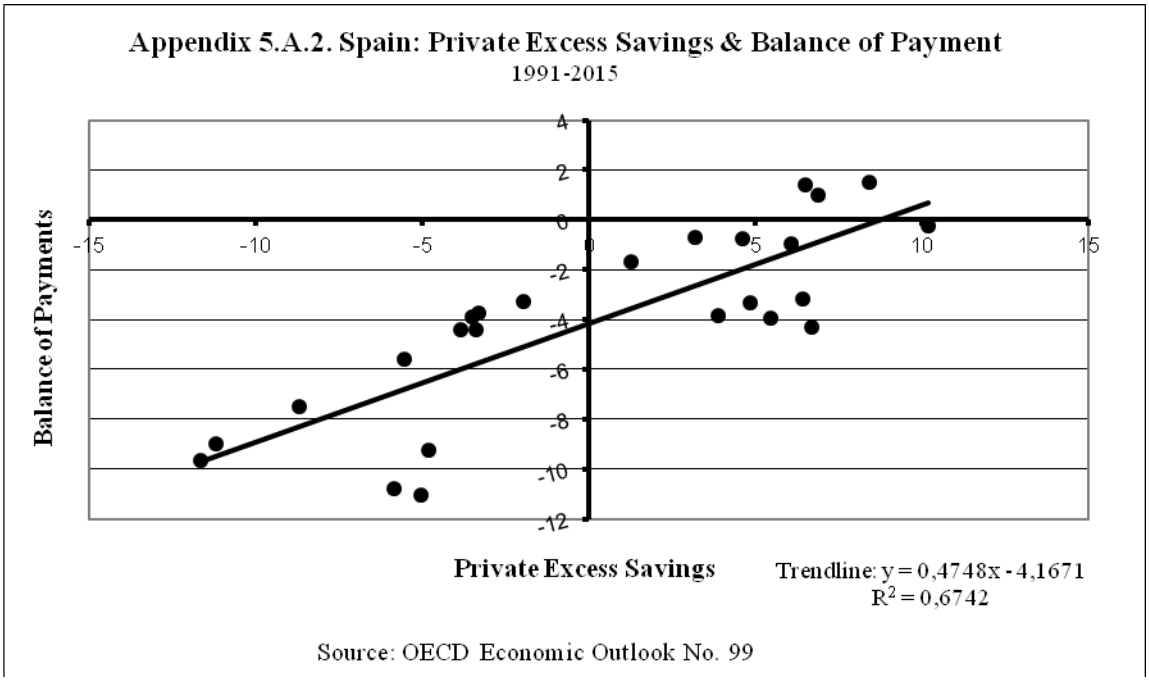


In Figure A.1, we see a relationship where the level of private sector excess savings causes unemployment. In fact, an increase of 1 percent point of excess savings has made unemployment go up by 0,71 points in the historical period examined here. The significance of this result is pretty high with an R2 of 0,91.

There is also a significant relationship between private excess savings and the balance of payments. When savings rise, less goods and services are imported and the current account is improved. This is the most likely explanation looking at Spain because if the

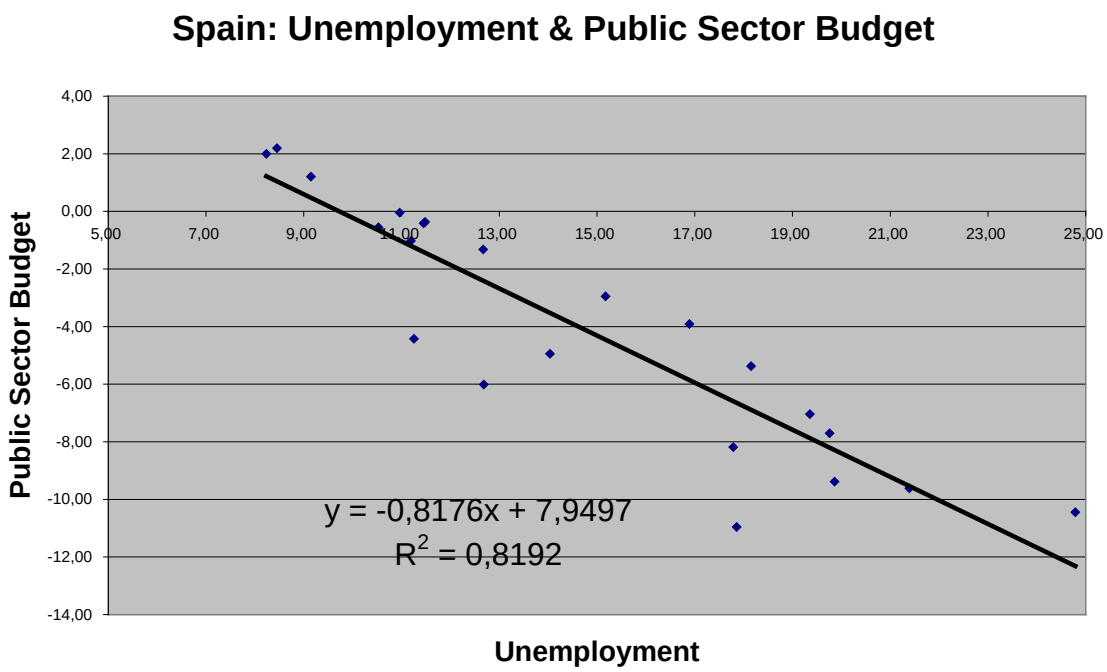
4 There was a significant shift in Spanish fiscal policy as a consequence of the Euro crisis, causing a break in the time series and the underlying policy structures, which according to the Lucas critique lends support to the view that the time series analysis should be concentrated on a homogenous period.

positive correlation had been caused by increased export then it would have had a reducing impact on employment, which was not the case cf. Figure A.2



Now we have established a causality chain in the Spanish case from excess private savings via unemployment and rather strong automatic budget stabilisers to public finances. As can be seen in Figure A.3, an increase in unemployment by one percentage point made the public sector budget deteriorate by 0,81 percent point (measured as proportion of GDP). The statistical correlation is quite significant with an R2 of 0,81. Hence, no wonder that the Spanish public sector budget improved during the booming period of 1998-2007, which unfortunately made government to relax and the EU-Commission to give the wrong recommendation.
This missed opportunity to restructure the Spanish economy is a disgrace for which Spain and the EU-institution may share the responsibility. However, in view of the institutional set-up framing the Eurozone members, there are few opportunities to overcome this missed opportunity.

Figure A3


Spain: Unemployment & Public Sector Budget
Public Sector Budget
4,00
2,00
0,00
-2,00
-4,00
-6,00
-8,00
-10,00
-12,00
-14,00
5,00
7,00
9,00
11,00
13,00
15,00
17,00
19,00
21,00
23,00
25,00
y = -0,8176x + 7,9497
R2 = 0,8192
Unemployment