UNIVERSITY OF TECHNOLOGY
IN THE EUROPEAN CAPITAL OF CULTURE
CHEMNITZ

Economic Policies in the EMU

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Outline

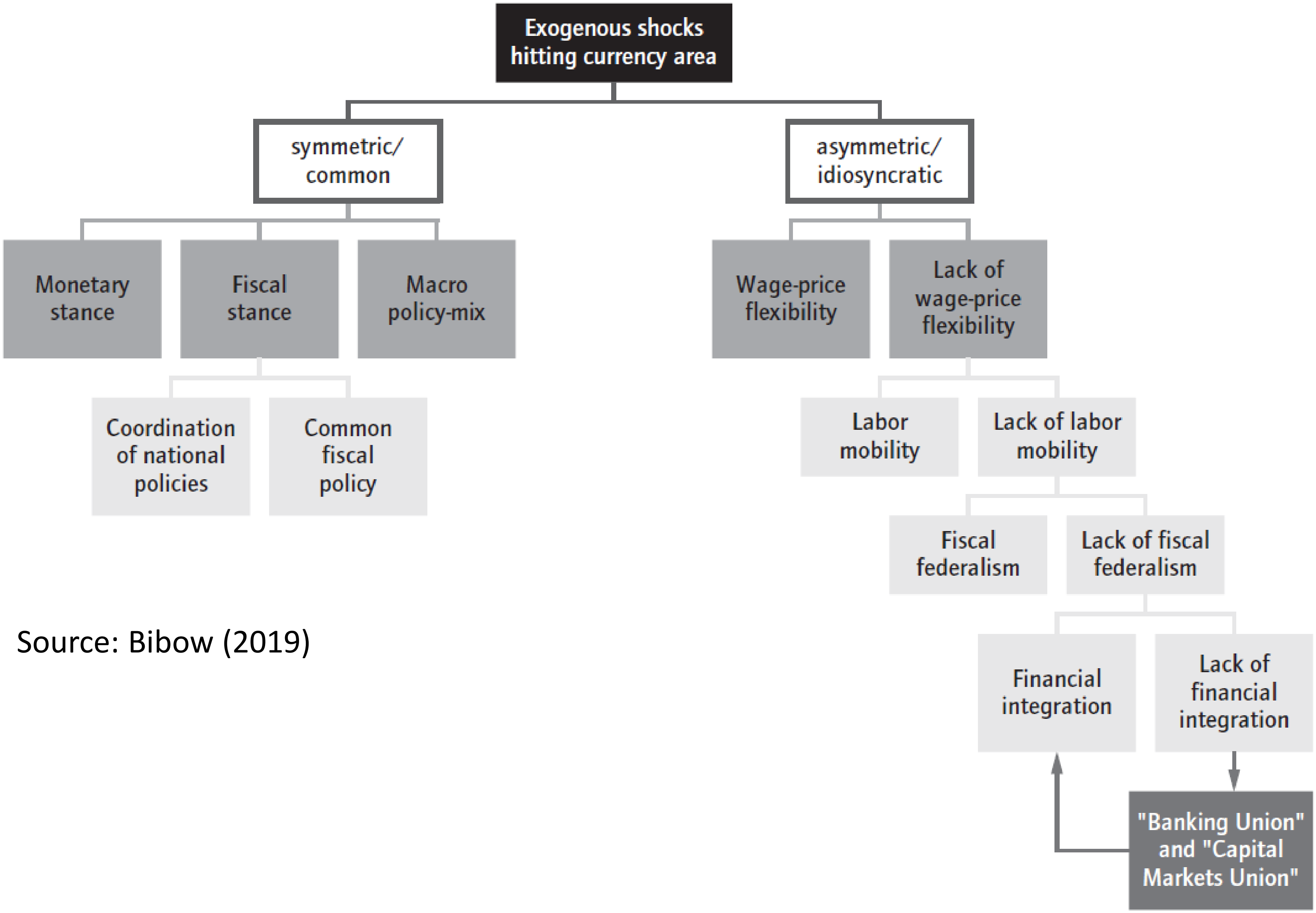
1. The EMU and the theory of Optimal Currency Areas (OCA)
2. The EMU setting and its performance up to the financial crisis
3. EMU crisis events and policy responses
4. COVID 19 Economic Policy Measures
5. EMU Recent Reforms and Proposals

1. EMU and OCA

Why form a currency area / monetary union?

→ For 5min: Please discuss the pros and cons

Shocks and Buffers of an OCA



Source: Bibow (2019)

Is the EMU an OCA?

From the list of buffers of an OCA, the construction of EMU has largely focussed on

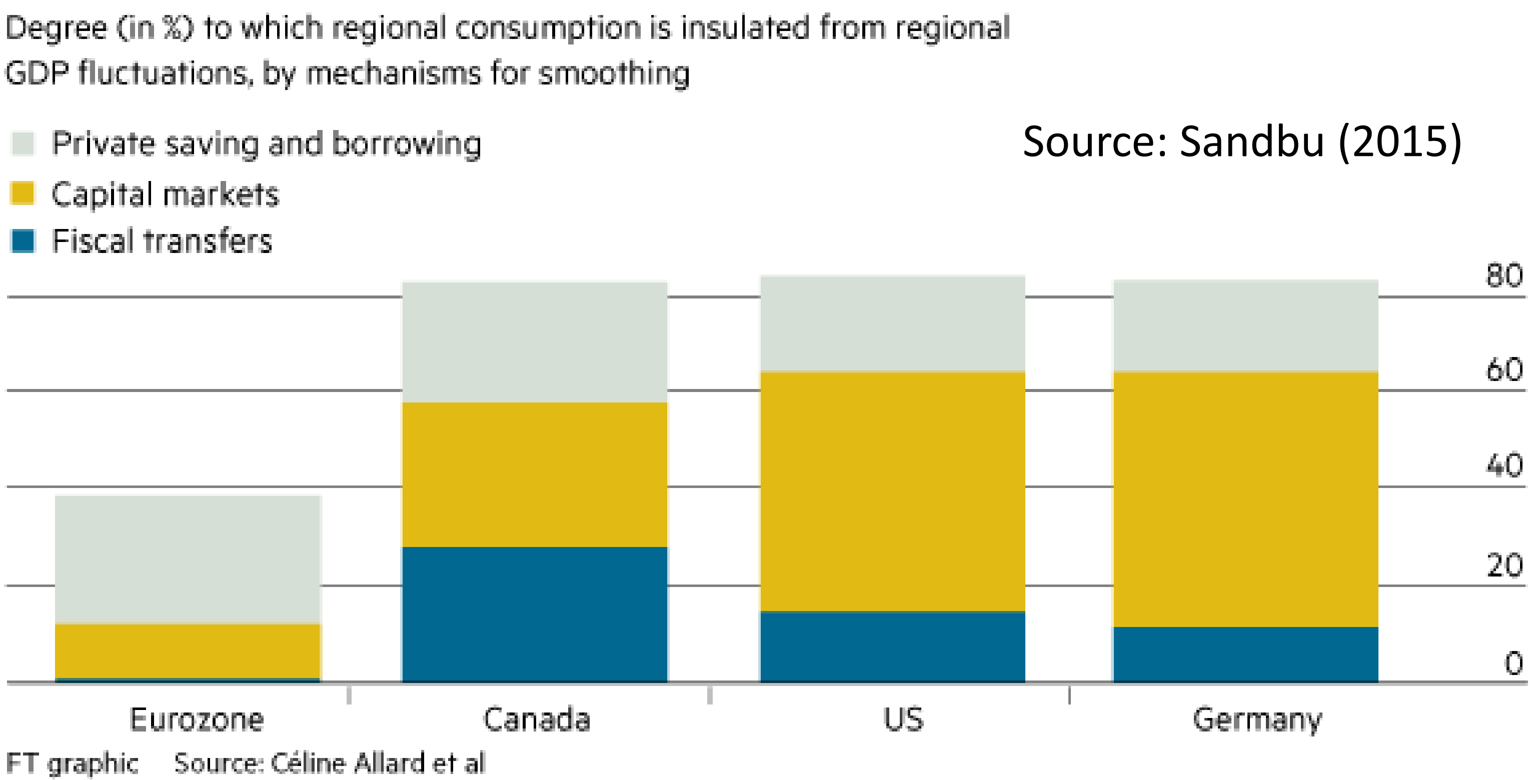
- Labor and capital mobility
- Price and wage flexibility
- Diversification (?)

Largely ignored

- Convergence in inflation rates
- Fiscal federalism
- Political union
- Irrevocability of the decision to enter a currency **union** as compared to currency **cooperation**

Asymmetric shocks and risk sharing facilities

- Fatás (1998): fiscal **interregional stabilisation** in the US only **10-15%**.
  - European national FPs even better equipped for asymmetric shocks (automatic stabilizers) and can coordinate against common shocks
  - But **dysfunctional countercyclical** tools due to SGP → federalism necessary
- Asdrubali et al. (1996): **Capital/credit market integration key** for risk sharing in US: capital markets 39%, credit markets 23%, federal fiscal system 13%



Source: Sandbu (2015)

Asymmetric shocks and risk sharing facilities

- Dullien (2017): critique on Asdrubali et al. measurement
  - **Direct federal** spending in states ignored for fiscal stabilisation
  - **Vertical transfers** ignored
  - Intertemporal **smoothing of profits and consumption** fully counted as cross-border capital and credit market stabilisation
- Farhi & Werning (2017) Interconnectedness / **complementarity** of the above channels? → central fiscal capacity allows other channels to work
- **Inequality** issues: who can rely on capital income spatial portfolio diversification?

2. EMU setting and its performance up to the financial crisis

The Asymmetric Maastricht Convergence Criteria

- Inflation: max 1.5 pp above average of the 3 best-performing (lowest inflation) member states of the EU
- Nominal interest rate: max 2 pp above average of best performers
- FX rate: join ERM and no devaluation within application period
- Public budget deficit: max 3 % of GDP (with exceptions)
- Public debt: max 60% of GDP, at least approaching

→ Asymmetric criteria
→ No mention of
  Real convergence: income/head, unemployment rates
  Diversification
  Current account position, private debt

New Consensus, New Political Economy and Monetarist theoretical underpinnings of EMU

- Inherently stable markets with **frictions** that should be reduced.
- Dominance of inflation target over unemployment target
  - Only short-run trade-off, low stable inflation also conducive to healthy GDP growth in the long run.
  - *„Divine Coincidence“* (Blanchard and Gali 2007)
  - **Inflation** is primarily a **monetary phenomenon** in the medium to long run.
  - NAIRU and potential output are **supply-determined**.
- Active Monetary Policy (MP) **outperforms** active Fiscal Policy (FP) in macroeconomic stabilisation.
  - MP is quicker and rules-based (independence) → (asymmetric) inflation targeting via interest rate tool (and more recently forward guidance) → long term rates follow suit to CB rate.
  - Due to intertemporal optimization and confidence effects, active FP has **low multiplier effects**
- **Passive FP** (automatic stabilisers) is **sufficient** and rules-based **avoids moral hazard →** „**Solid**“ public finances instead of „**functional**“

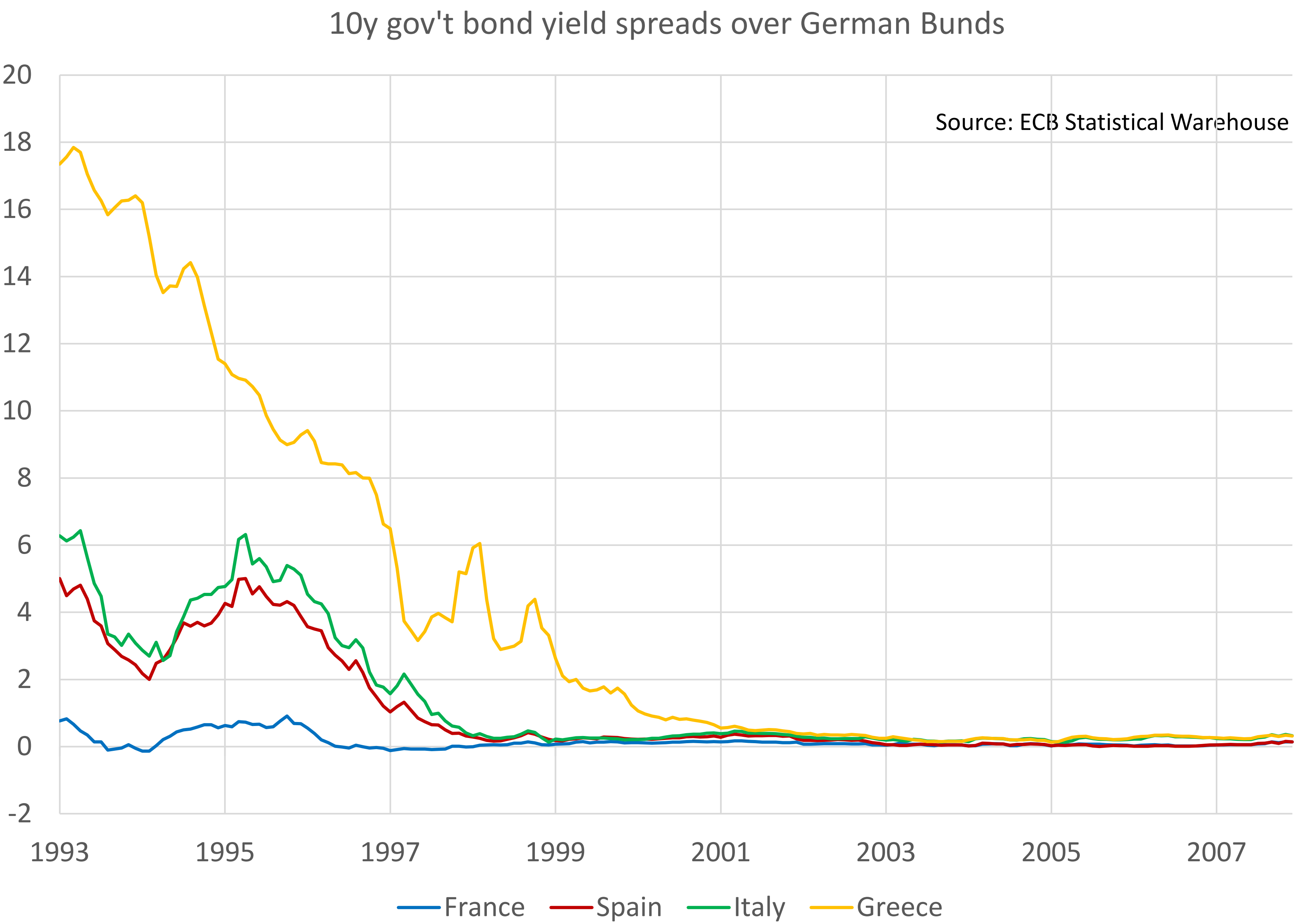
Neoliberal institutional setting at the outset

- MP: One size fits all
  - pursuing (asymmetric) inflation target, <2%
  - 2nd pillar of monetary analysis, M3 growth <4.5% (Bundesbank heritage)
  - "pursuit of additional objectives … would ultimately result in higher inflation and higher unemployment." (ECB 2008)
  - No control over country-heterogeneity in inflation and real interest rates
- FP: Rules based (asymmetric) FP enshrined in SGP
  - Initially (1997): tightening of Maastricht criteria → 3% def rule as exception + "achieve a budgetary position of close to balance or in surplus over a complete business cycle."
  - Reform (2005) to include country-specific Medium-Term Objectives (MTO)
    - Structural balance max. 1% of GDP or balanced for MS with debt sustainability issues. Adjustment path of annualy -0.5pp
    - Excessive Deficit Procedure
    - „Structural reform" exception

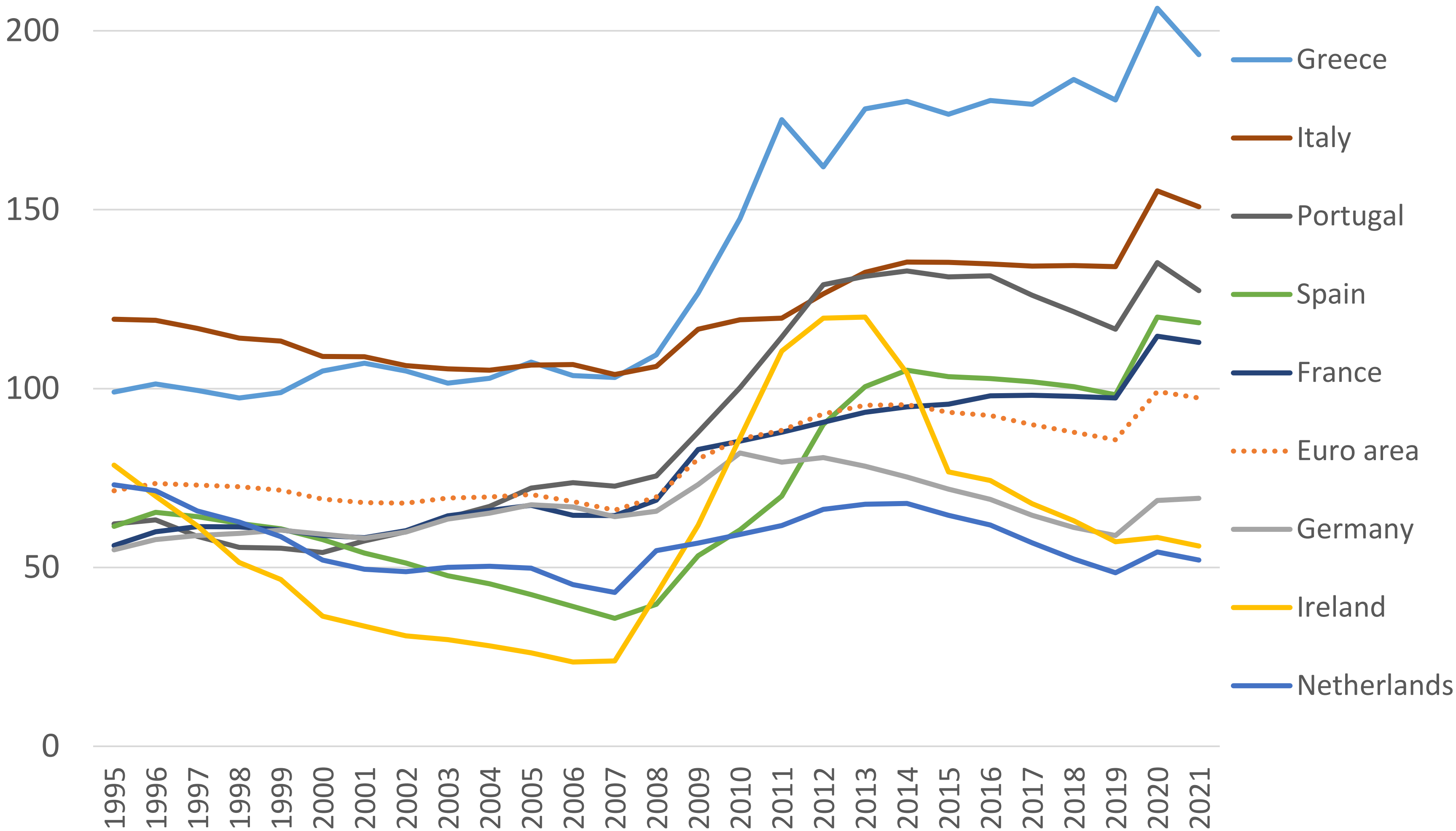
Neoliberal institutional setting at the outset

- „Structural policies“ aiming at more flexible and competitive labor, product and financial markets.
  - **Financial** integration should be market-led. Public policy should not intervene, would create distortions
  - “rigidities in the **wage** and **price-setting** mechanisms or ongoing excessive wage developments may delay the necessary adjustments of relative prices to economic shocks and thereby give rise to inflation persistence.” (ECB 2008)
- “peer pressure and support”, “some degree of policy competition aimed at improving policy efficiency” (ECB 2008)

Bond Yield Convergence



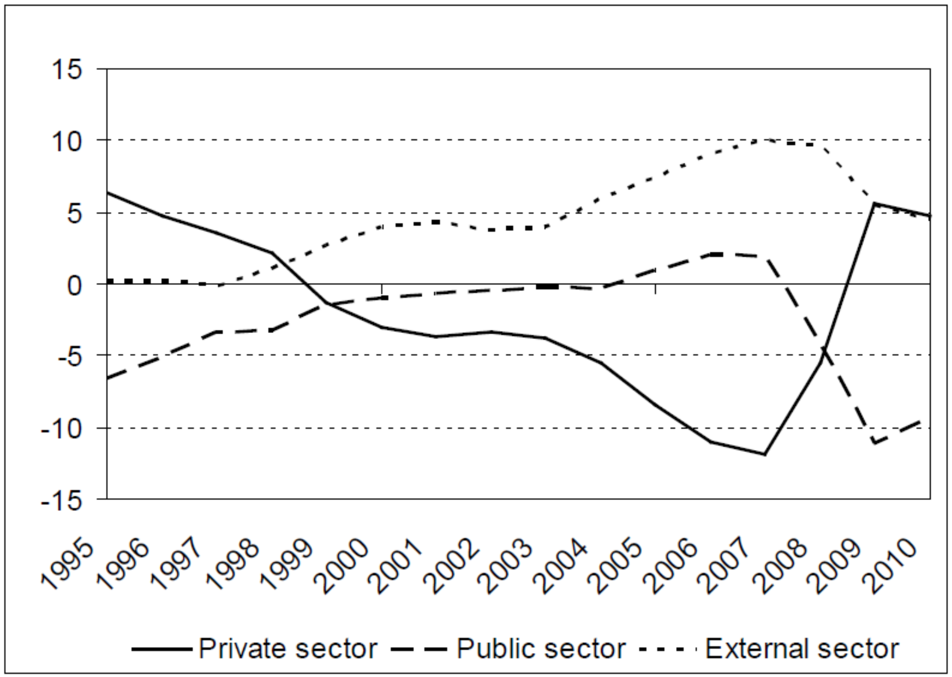
Debt-to-GDP ratio



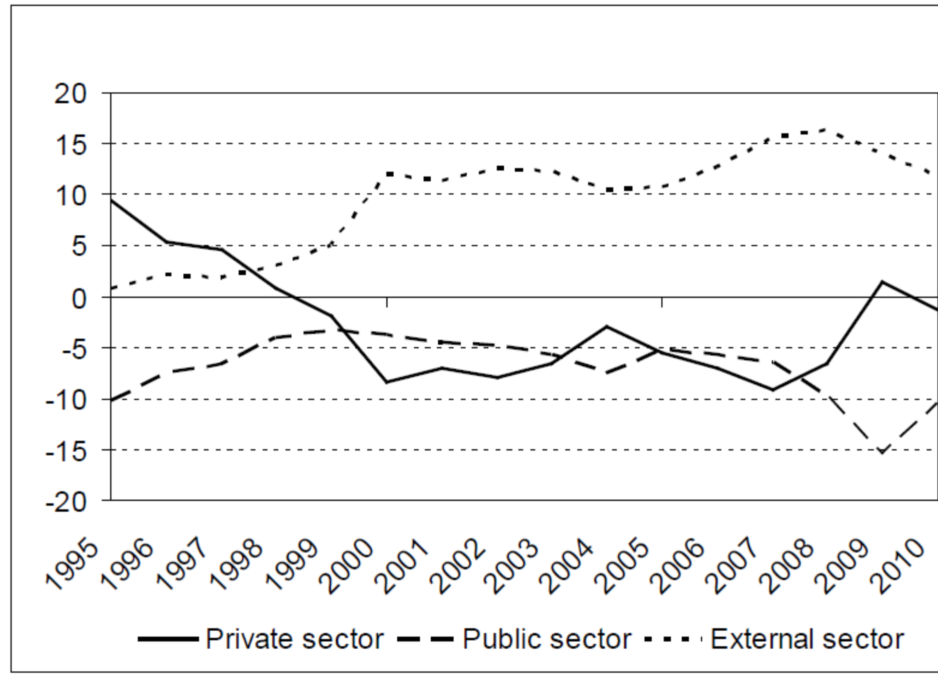
Source: AMECO

Sectoral Financial Balances

Spain

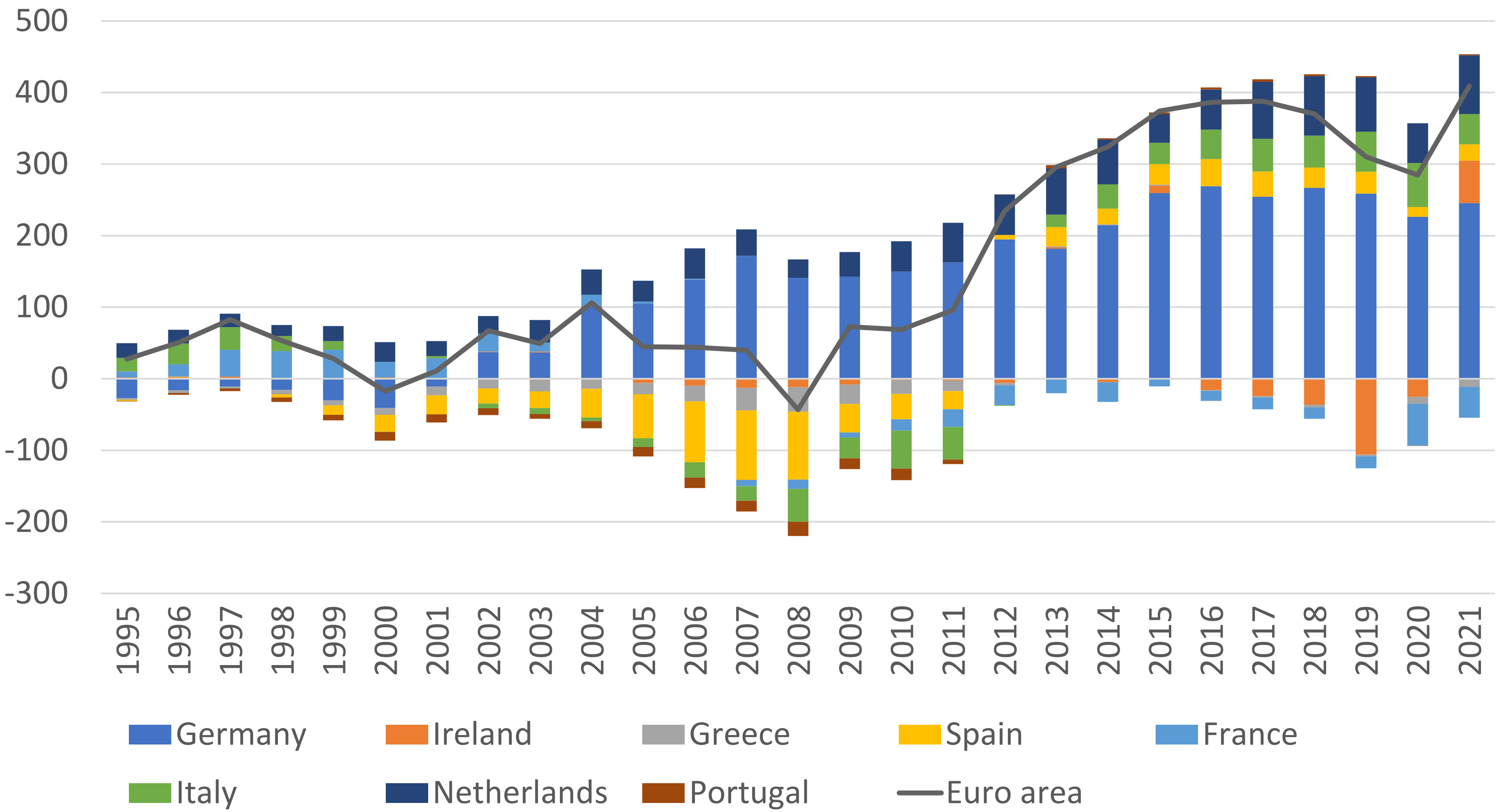


Greece



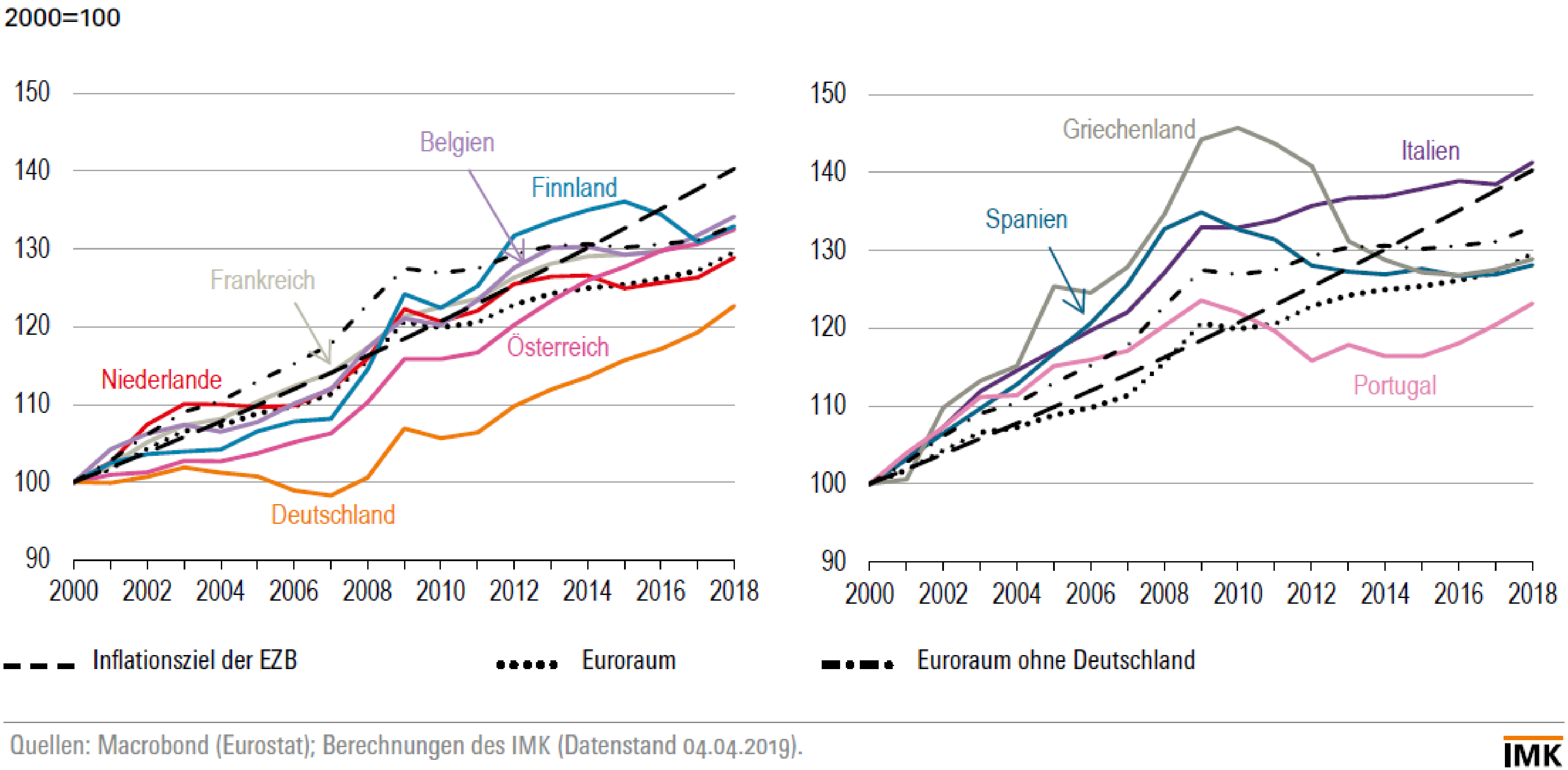
Source: Hein, Truger, van Treeck (2012)

Net Lending (+) / Borrowing (-) Total Economy in Bn. Euro



Source: AMECO

Nominal Unit Labor Costs



Source: Herzog-Stein et al. (2019)

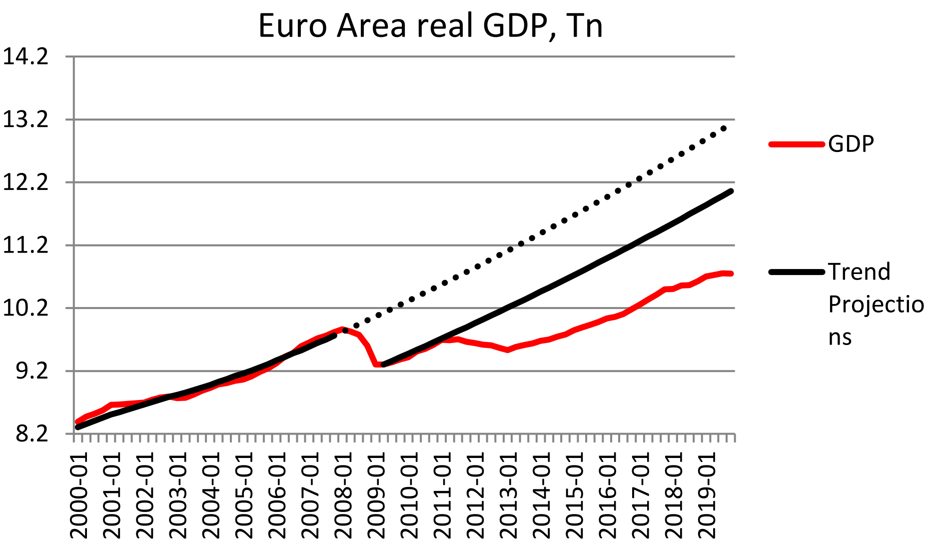
The neclected role of CA imbalances and inflation differentials

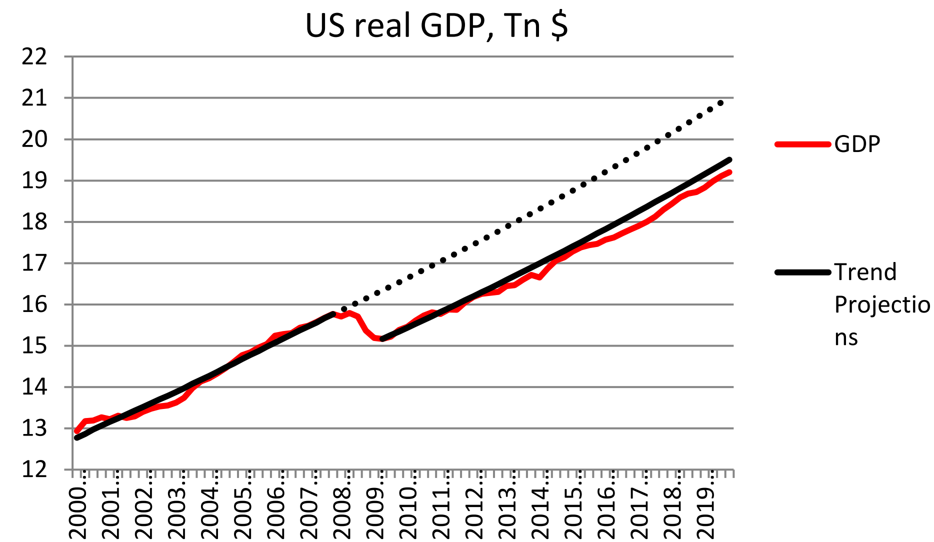
– "To the question whether a single one-size monetary policy could fit all parties involved … my answer was: 'One size must fit all'. …Today, **in light of the evidence gathered so far** in the euro area, I am more confident in saying: **One size does fit all**!" (Otmar Issing 2005)

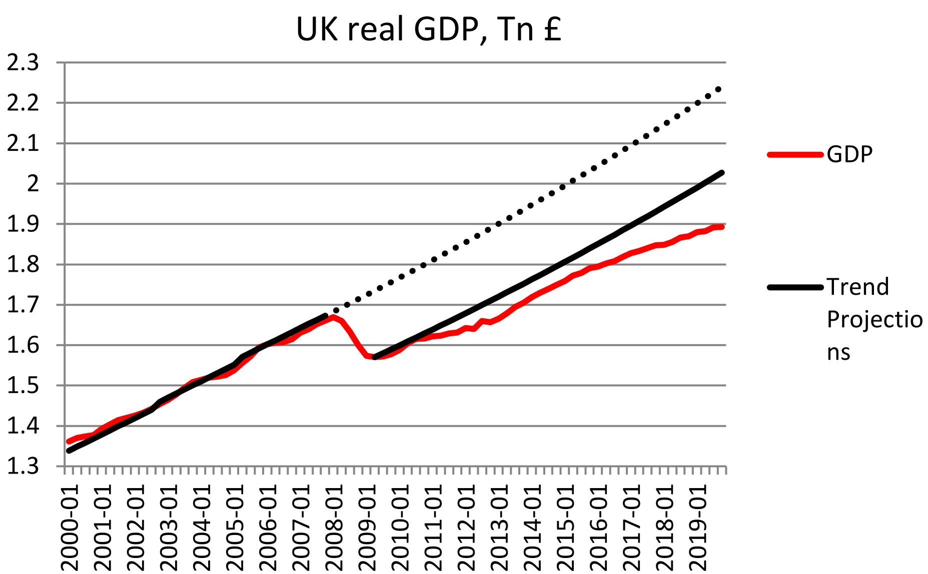
– "in a monetary union, … there are strong market-based forces that work in a stabilising manner. In particular, **if a country has lower than average inflation on account of weak demand, it will become more competitive in relation to other countries.** This tends to increase demand in that country (and reduce demand in others) over time. As has been shown in a number of recent studies, the **competitiveness ('real exchange rate') channel**, although slow to build up, eventually becomes the **dominating adjustment factor**." (ECB 2005)

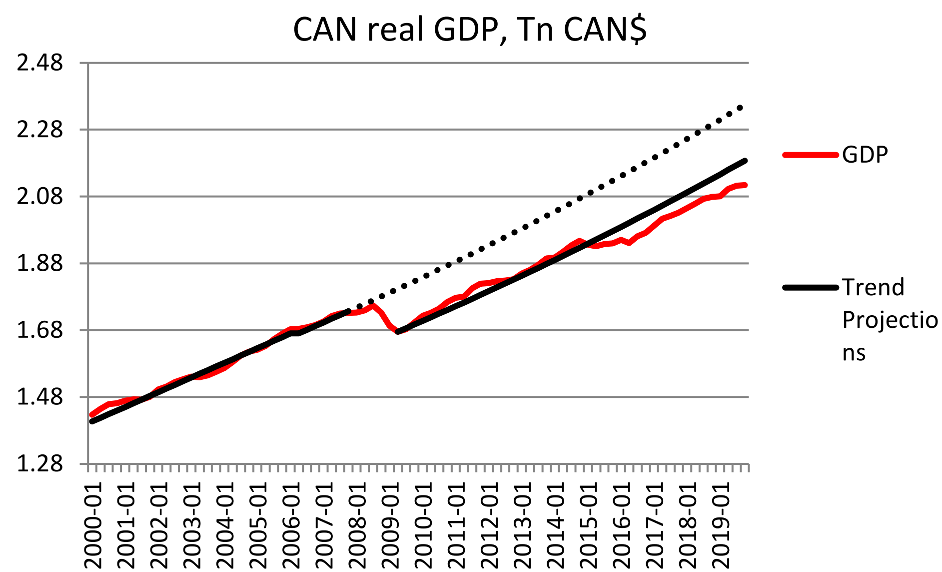
3. EMU crisis events and policy responses

This requires an explanation!









Source: Martin (2014), own updates

Fiscal Policy during EMU Crisis: Vices and Virtues

+ November 2008: European Economic Recovery Plan‟ (EERP): **coordinated fiscal stimulus** of 1.5 per cent of EU27 GDP to be implemented in 2009 (SGP escape clause) → But too little, too late

– From 2010: Strong push towards **austerity** in program and core countries: the **confidence fairy.**

+ June 2010: Foundation of EFSF (since 2012 ESM) **bailout fund** with lending capacity of € 700 Bn,

– but strict **conditionality** (Memoranda of Understanding, MoU)

– December 2011/March 2012**:** Fiscal compact even **tightening the fiscal rules**: debt brakes of the German flavor become part of SGP. 0.5% „structural“ deficit target

+ 2013/2014: Reinterpretation of SGP by EUCO: **easing of austerity**

- Accepting higher deficits for countries in recession
- Widening of structural reform clause, investment clause, Juncker Plan (EFSI)

The Confidence Fairy

- Jean-Claude Trichet (2010) **Stimulate no more - it is now time for all to tighten:** "My understanding is that an overwhelming majority of industrial countries are now in those uncharted waters, where **confidence** is potentially at stake. **Consolidation is a must in such circumstances**." *Financial Times, 22. Juli 2010*
- Wolfgang Schäuble (2010) **Expansionary fiscal consolidation:** "All the eurozone governments need to demonstrate convincingly their own **commitment to fiscal consolidation** so as to restore the **confidence of markets**, not to speak of their own citizens." *Europe's World, 1. Oktober 2010*
- Academic work „substantiating" these views:
  - Reinhard & Rogoff (2010): 90% threshold
  - Alesina et al. (several): spending cuts are expansionary
- General view at European Commission, ECB and IMF → Fiscal multipliers
  - ≈ 0.5 in the short run,
  - ≈ 0 in the long run

Does higher public debt = lower growth?

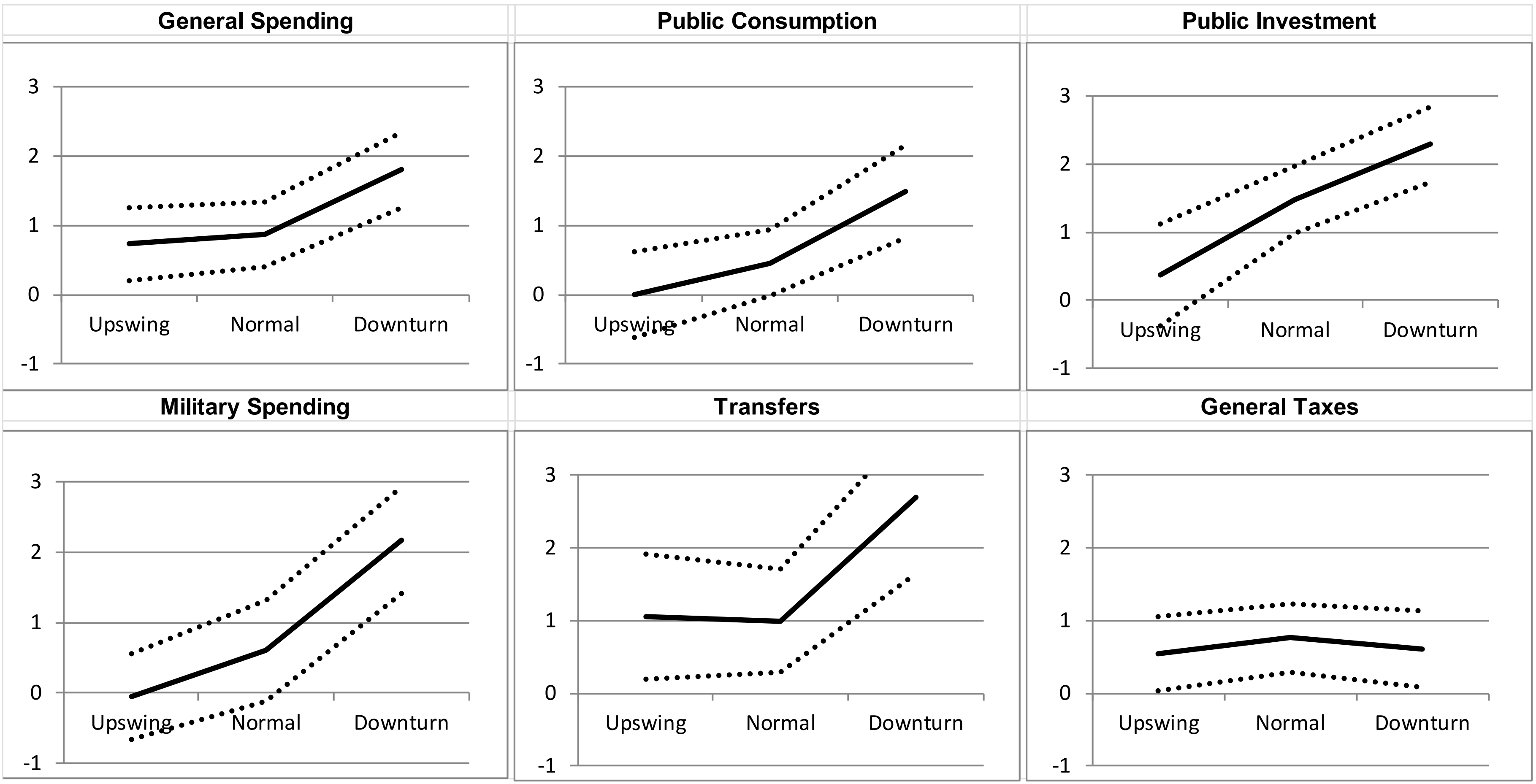
No! According to 47 studies with > 500 estimates

	(1) Unw. avg	(2) Base WLS	(3) Median	(4) Preferred	(5) IV	(6) PCC
β_1	---	-1.360***	-1.903***	-2.305***	-1.361**	-1.912***
[publication bias]	---	(0.359)	(0.607)	(0.374)	(0.640)	(0.518)
β_0	-0.014**	-0.001	0.002**	0.002***	0.006	0.015
[mean beyond bias]	(0.005)	(0.002)	(0.001)	(0.0004)	(0.008)	(0.026)
N	566	566	33	78	566	566

Source: Heimberger (2021)

Regime dependent fiscal multipliers

Results from a Meta Regression Analysis of >1800 multiplier estimates



Source: [Gechert/Rannenberg (2018)]

Cumulative consolidation measures in % of GDP

Discretionary Fiscal Effort (EUCO calculations)

Euro Area

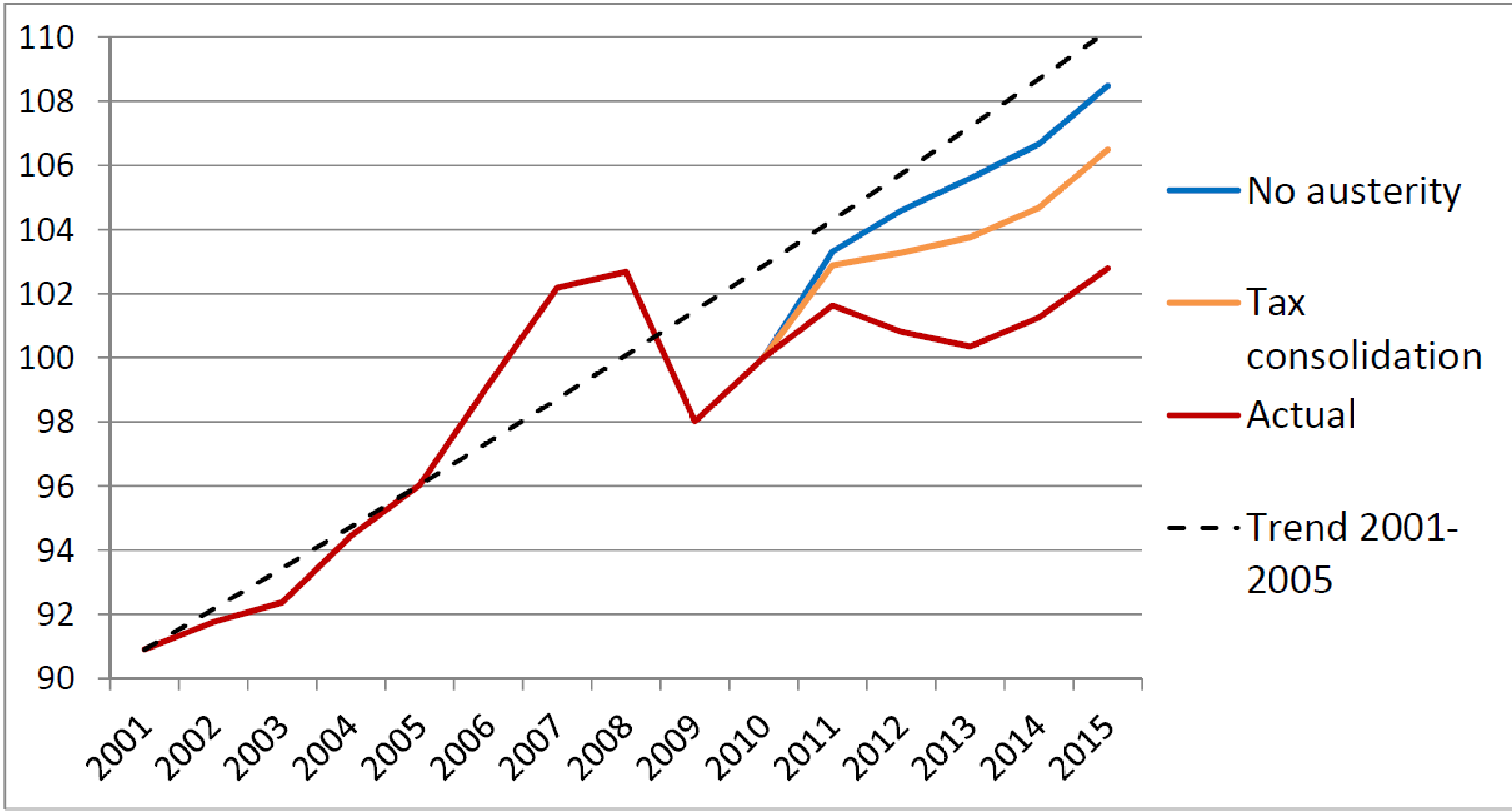
	2011	2012	2013	2014	2015
Total revenue	0.5	1.6	2.3	2.5	2.5
Total expenditure	0.7	1.3	1.8	1.8	2.0
All measures	**1.2**	**3.0**	**4.1**	**4.3**	**4.5**

Greece

	2010	2011	2012	2013	2014
Total revenue	4.2	8.2	10.5	11.9	12.1
Transfers	0.6	0.5	1.1	3.1	3.0
Government consumption expenditure	2.3	4.7	6.1	7.6	7.8
Government gross fixed capital formation	0.9	1.4	1.4	0.9	0.7
Total expenditure	3.8	6.6	8.6	11.6	11.5
All measures	8.0	14.7	19.1	23.5	23.6

GDP effects of austerity - EMU

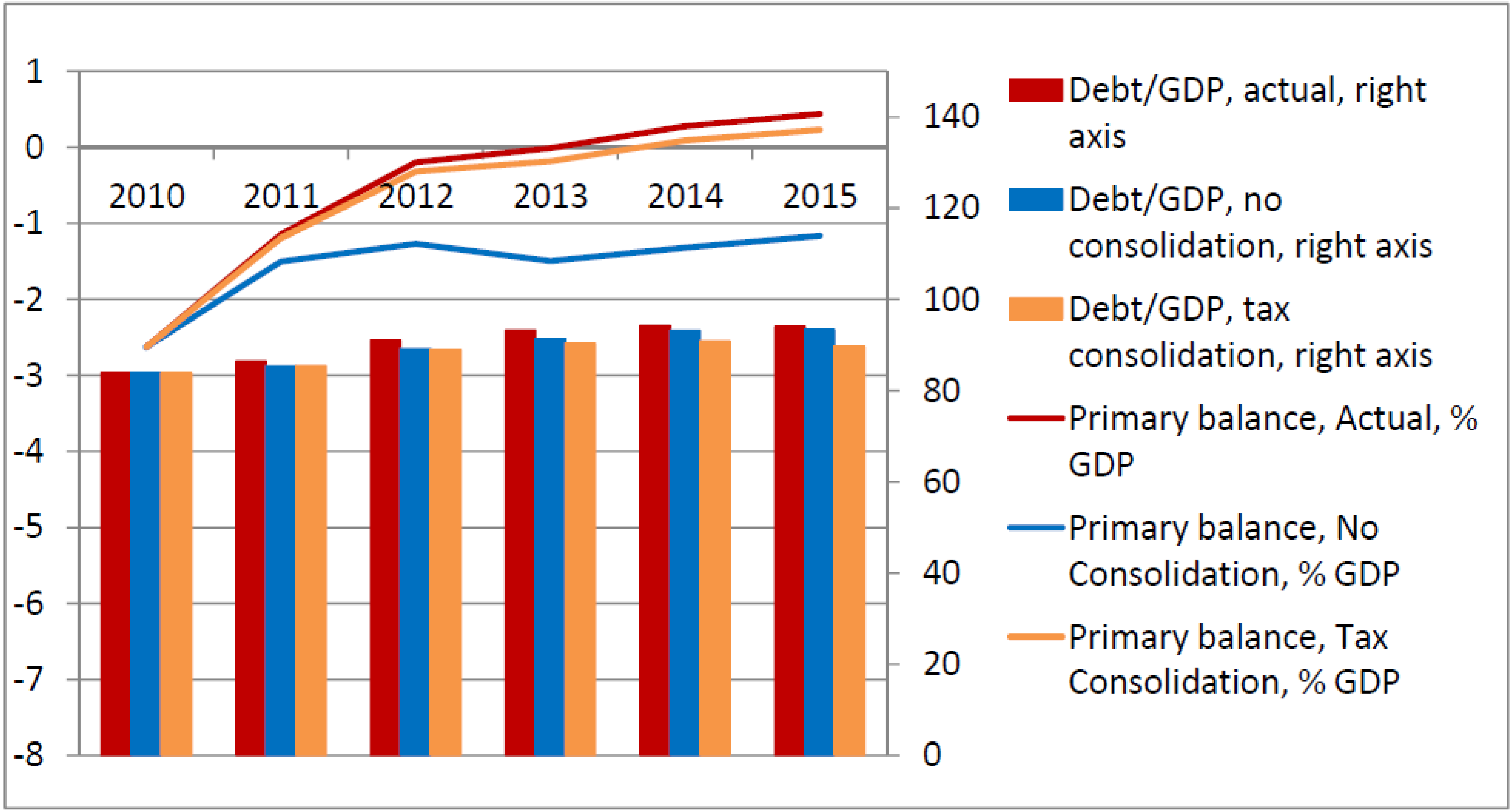
Alternative Scenarios



Source: [Gechert/Hughes Hallett/Rannenberg (2016)]

Effects on public debt and primary balance - EMU

Alternative Scenarios



Monetary Policy during EMU Crisis: Vices and Virtues

– Interest rate hikes prior to crises (2008, 2011)

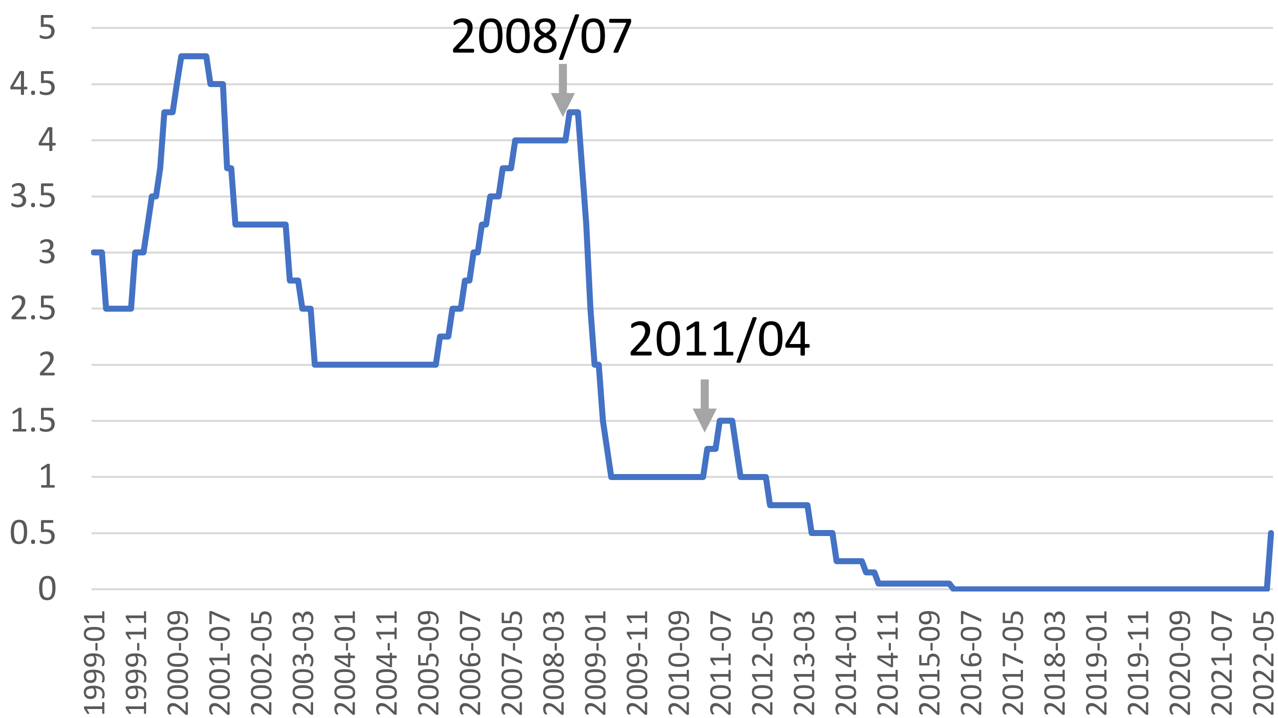
\+ Whatever it takes, OMT (2012) → LOLR light, but conditional on ESM program

\+ TLTRO I-III (2014,16,19), rewarding lending practices

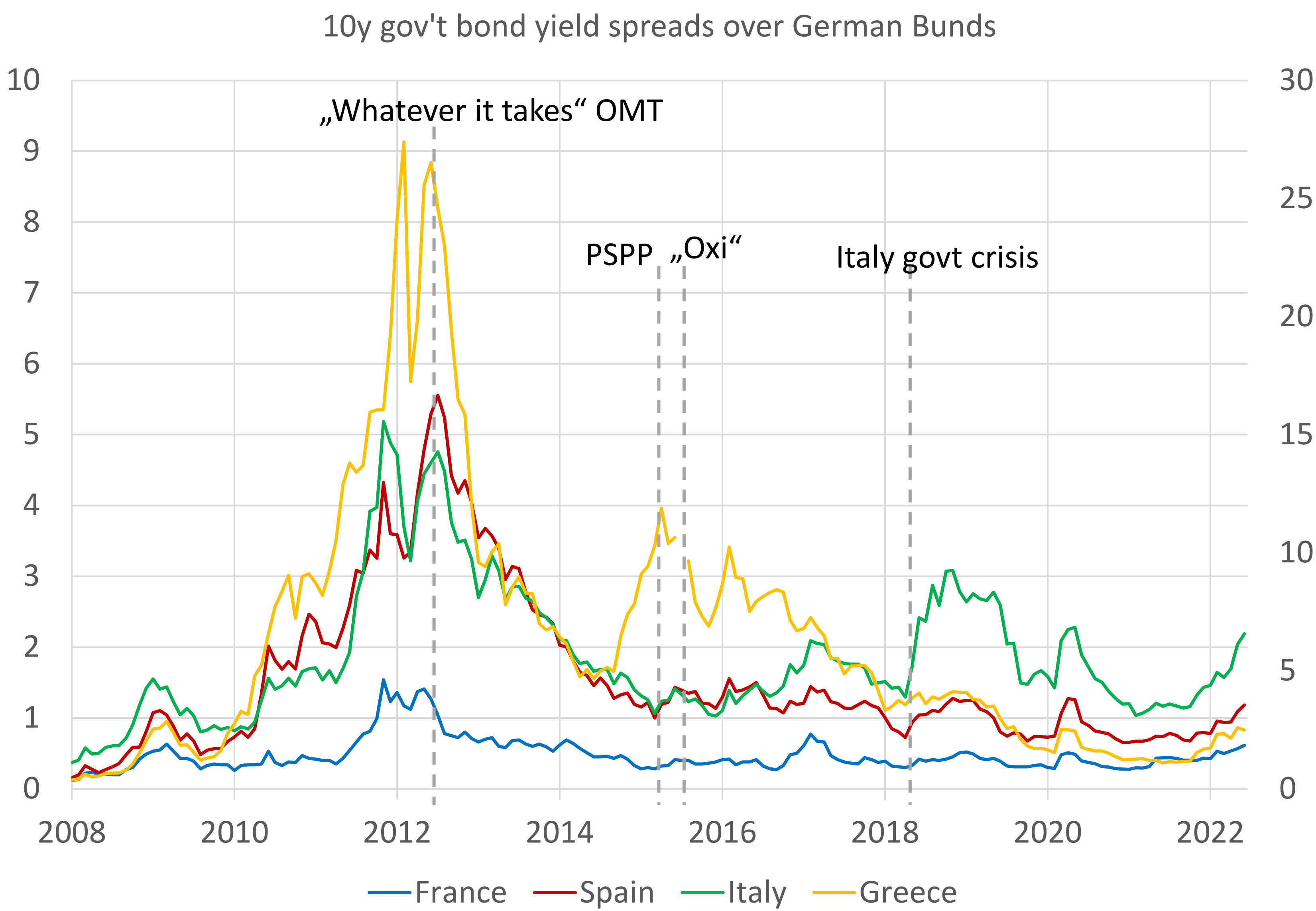
\+ APP including CSPP and PSPP starting 2014

– Greece Emergency Liquidity Assistance (ELA) cap 2015

\+ Constantly asking for more fiscal support



„Whatever it takes“ and QE



Source: ECB Statistical Warehouse

Macroeconomic Imbalance Procedure (MIP) 2011

Acknowledging

- Current account imbalances,
- External and private debt positions

But:

- **Asymmetric** floor and ceiling for **CA**: -4%, but +6% (to allow GER to fit the criteria in the first place, but it managed to miss it still)
- Only upper limit for **NULC** growth
- Essentially **no bite** as compared to the SGP. EIP never been activated.
- Overly **complex**: 14 main indicators, 28 auxiliary indicators

The „mainstream consensus view“ (Baldwin & Giavazzi 2015, Eds.)

- „Eurozone crisis should **not** be thought of as a **sovereign debt crisis**."
- Failure to control **excessive bank leverage.**
- "Extremely unoriginal" crisis cause: too much public and private **external borrowing**, and in particular **unproductive uses** (housing, govt consumption).
- This drove up **wages and costs** impairing competitiveness positions.
- "By contrast, all the core nations except Netherlands and Luxembourg had **inflation below the norm, especially Germany**."
- "When it comes to investment, the **core nations tended to underinvest at home**, … while periphery tended to overinvest."
- "Sadly, the substantial **lower risk premiums**… that came with the Euro implied strong booms but **too little economic reforms**."
- "Governments who got in trouble had **no lender of last resort**."
- **Procyclical** fiscal tightening → mainly harmful due to **tax hikes.**

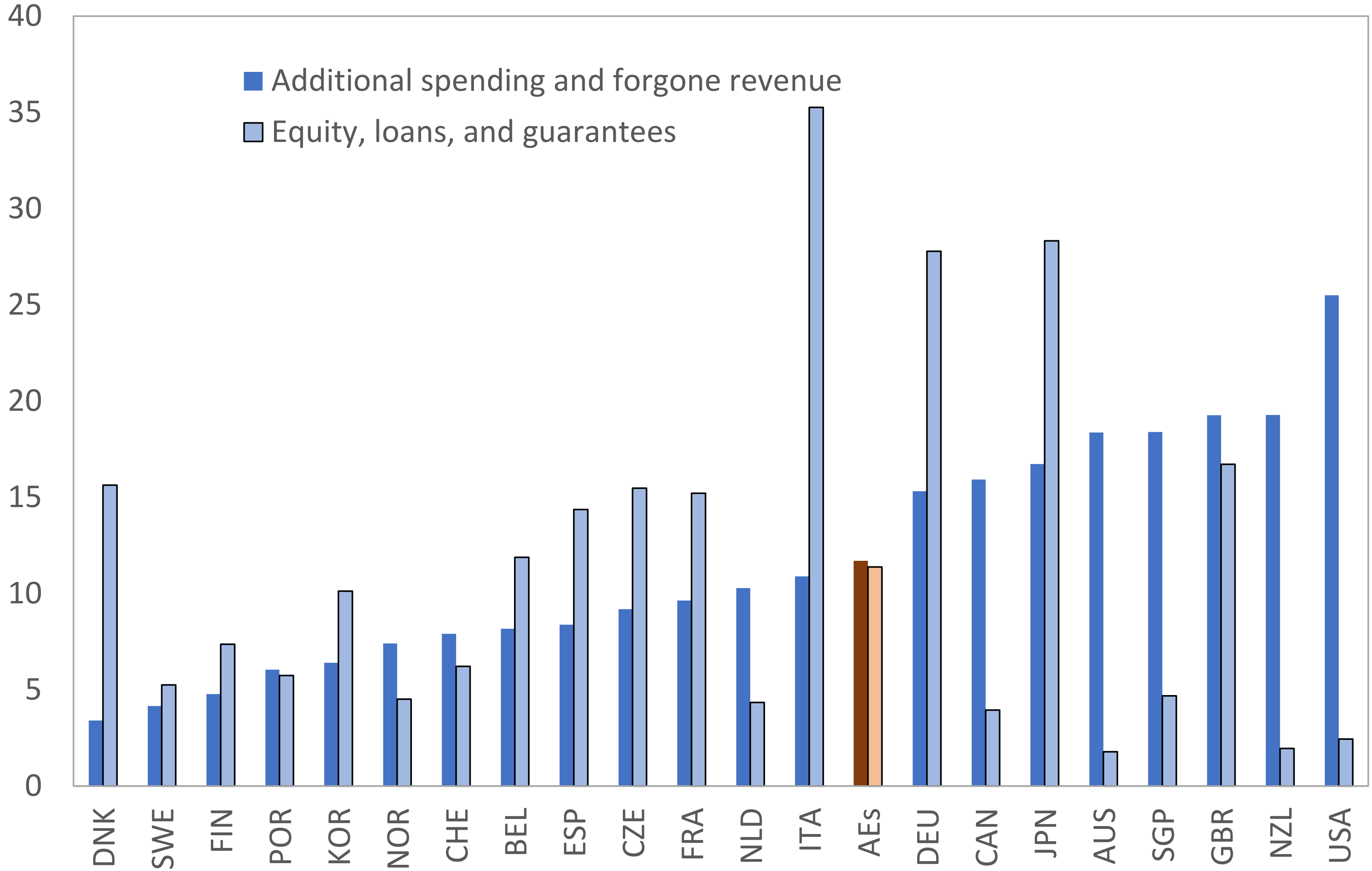
An alternative crisis narrative

There is much to agree with this „mainstream consensus“, but…

- Low inflation and low domestic demand of **surplus countries** (particularly GER) still downplayed**.**
- The **asymmetric adjustments** of periphery vs core since 2010 are ignored.
- **Hesitent ECB policy** early on and its roots not mentioned
- The **procyclicality** of the **fiscal rules** framework is not recognized
- a preference for **tax cuts over public spending** dominates.
- The **hysteretic damage** of sheer policy mistakes that has been done to the living generation in crisis countries remains largely downplayed.

4. COVID 19 Economic Policy Measures

Discretionary Fiscal Response to COVID-19 Crisis (% of GDP)

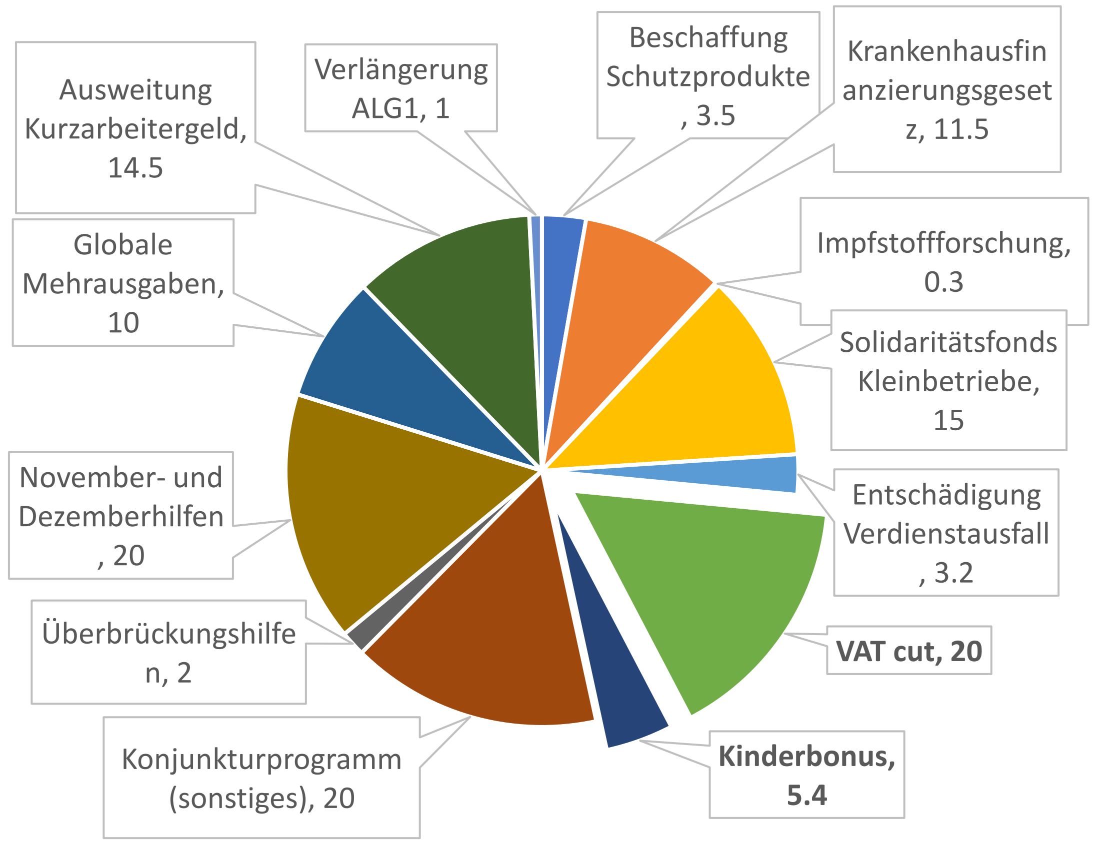


Source: [IMF Fiscal Monitor (2021)]

Measures in Germany

- In sum ca. 3.5% of GDP in 2020.
- „Kinderbonus“ 2020, € 5.4 Bn (0.16% of GDP)
  - Classic one-time stimulus transfer
- Temporary VAT cut ca. € 20 Bn (0.6 % of GDP) Jul-Dec 2020
  - Real income effect
  - New Keynesian intertemporal substitution effect: „Unconventional Fiscal Policy“

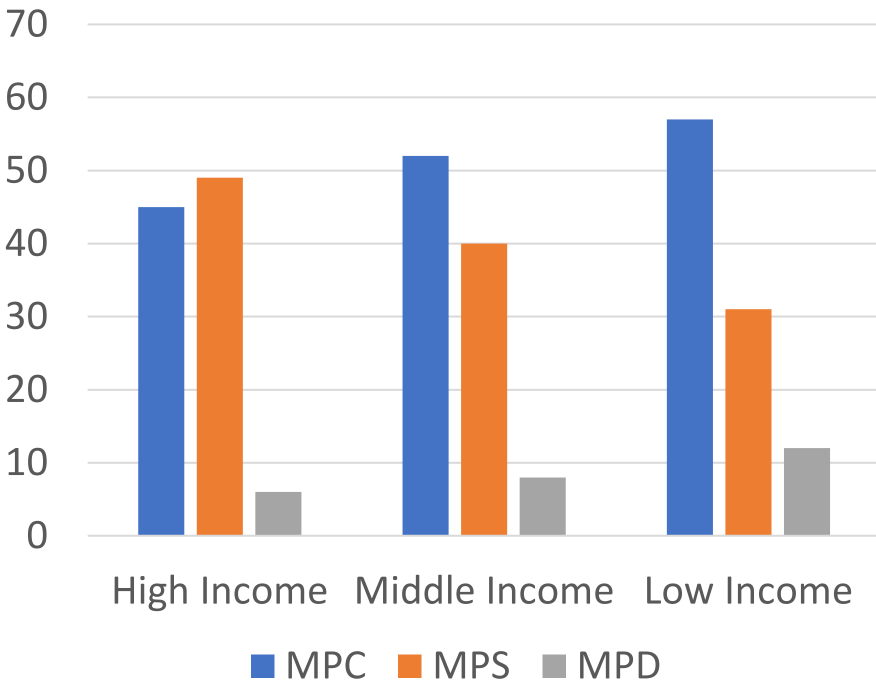
→Interesting test bed for competing consumption theories



Source: DIW (2020), own calc

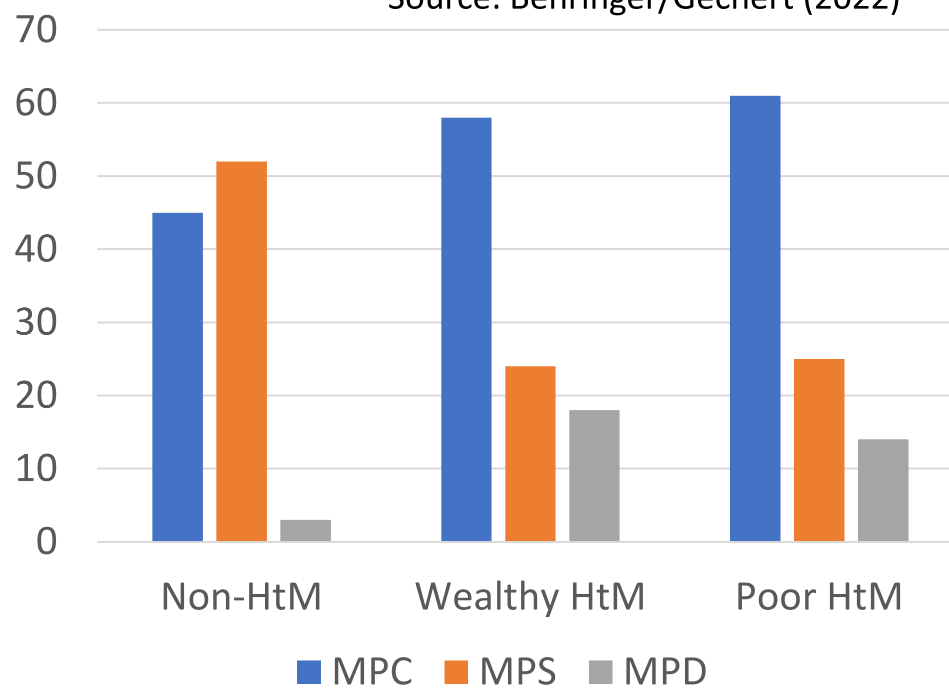
Kinderbonus: Marginal Propensities to Consume, Save, Repay Debt

By Household Income



By Financial Wealth Group

Source: Behringer/Gechert (2022)

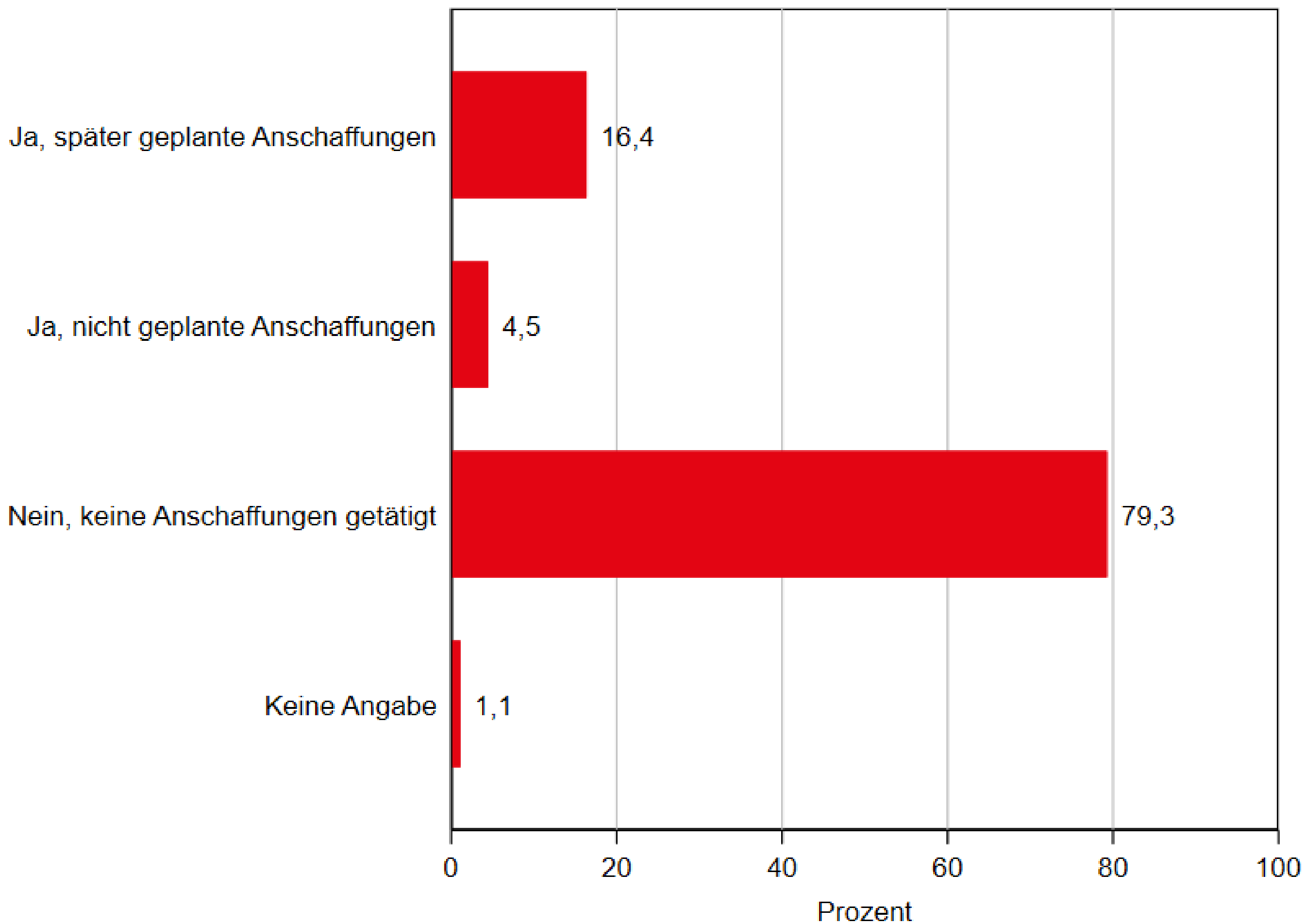


- MPC>>0
- HH with high incomes / liquid reserves tend to save the bonus
- HH with small incomes / no liquid wealth tend to consume / repay debt

Purchases due to the temporary VAT cut

Source: Behringer/Dullien/Gechert (2022)

- *“Did you make purchases due to the VAT cut, which you otherwise would have purchased later or not at all?”*
- Multiple answers permitted
- Question asked in Nov 2020
- Only weak evidence of a New Keynesian preponement effect

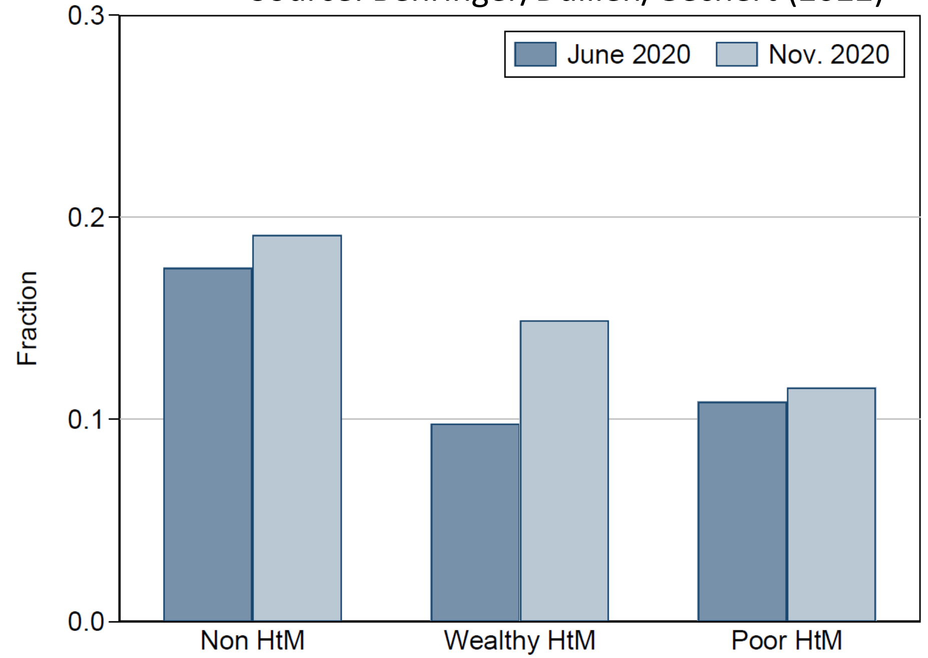


Preponement by HH income / wealth

By income

By Financial Wealth Group

Source: Behringer/Dullien/Gechert (2022)



– Preponement much stronger with higher incomes, liquid reserves
– While VAT is a regressive tax, temporary cut seems to have favored high incomes, wealthy HH.

5. EMU Recent Reforms and Proposals

ECB Monetary Policy

- PEPP, involving non-proportional (to capital key) purchases
- New Monetary Policy Strategy (July 2021)
  - symmetric inflation target, 2% over medium term
  - „forceful and persistent measures“ close to ZLB (accepting temporary inflation overshoot)
- Transmission Protection Instrument (TPI, July 2022)
  - Non-proportional purchases of gov‘t bonds to prevent excessive spreads
  - Conditionality less strict than during EMU crisis.
- Green Monetary Policy: ending preferential financial treatment of carbon-intense sectors.

Common Fiscal Budget

Some small steps in the right direction

NextGenEU and the Recovery and Resilience Facility:
- +0.7% of EU GDP annually (adding to the 1% of GDP general EU budget)
- Debt financed with MS guarantees
- Green, social and investment purposes

SURE transitory short-term work assistance funds
- Facility of €100 Bn (0.7% of EU GDP) in loans to MS
- Debt financed by EU „Social Bonds“

ETS2 as part of „Fit for 55“ starting 2026
- Ca. 0.3% of EU GDP annually.
- CO_2 certificates in buildings and road transport sectors
- Additional revenues for EU funds, in particular Social Climate Fund

EU Fiscal Rules: Main Criticisms of Current Rulings

(see also Dullien et al. 2022)

- Fiscal rules (provisions in EU treaties, secondary regulations) became more flexible recently but grew much too complicated
- No success in preventing rise in public debt/GDP ratios
- Structural deficit rules are still procyclical (Paetz 2020)
- Public investment remains most vulnerable to austerity and is restricted in recessions due to fiscal rules (Jürgens 2022)
- 60% debt rule and 1/20 reversion rule much too ambitious
- Not recognizing the regime change: $r < g$

Structural Balance: Good intentions but bad outcomes

$$PB = SB + CB$$
$$SB = PB - \varepsilon\,(Y - Y^{pot})$$

- Cyclical adjustment of budget balances in principle a good thing to allow for automatic stabilizers under fiscal rules
- But reference to estimated potential output (Y^{pot}) problematic
  - End-point bias: Y^{pot} tends to mimic Y changes at the end of sample – just where it matters for allowed fiscal policies
  - Strong revisions of Y^{pot} ex post

→ Cyclical component is smaller than it should be

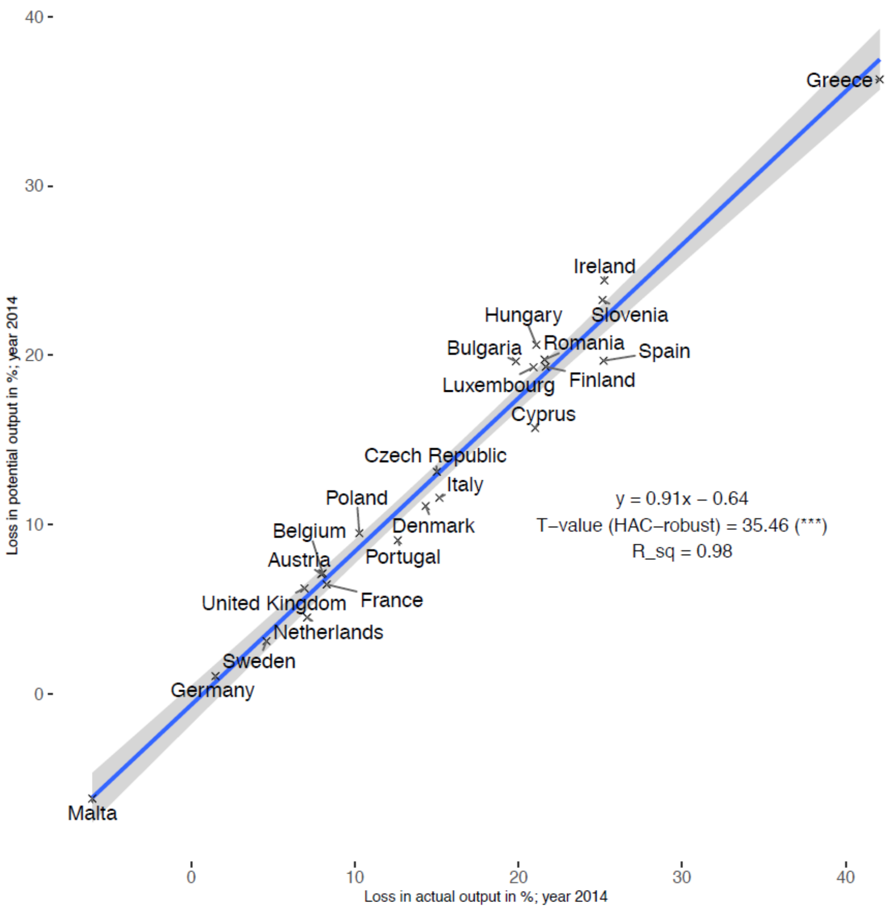
→ Weakening of automatic stabilizers

→ Procyclical fiscal stance

→ Self-fulfilling hysteresis

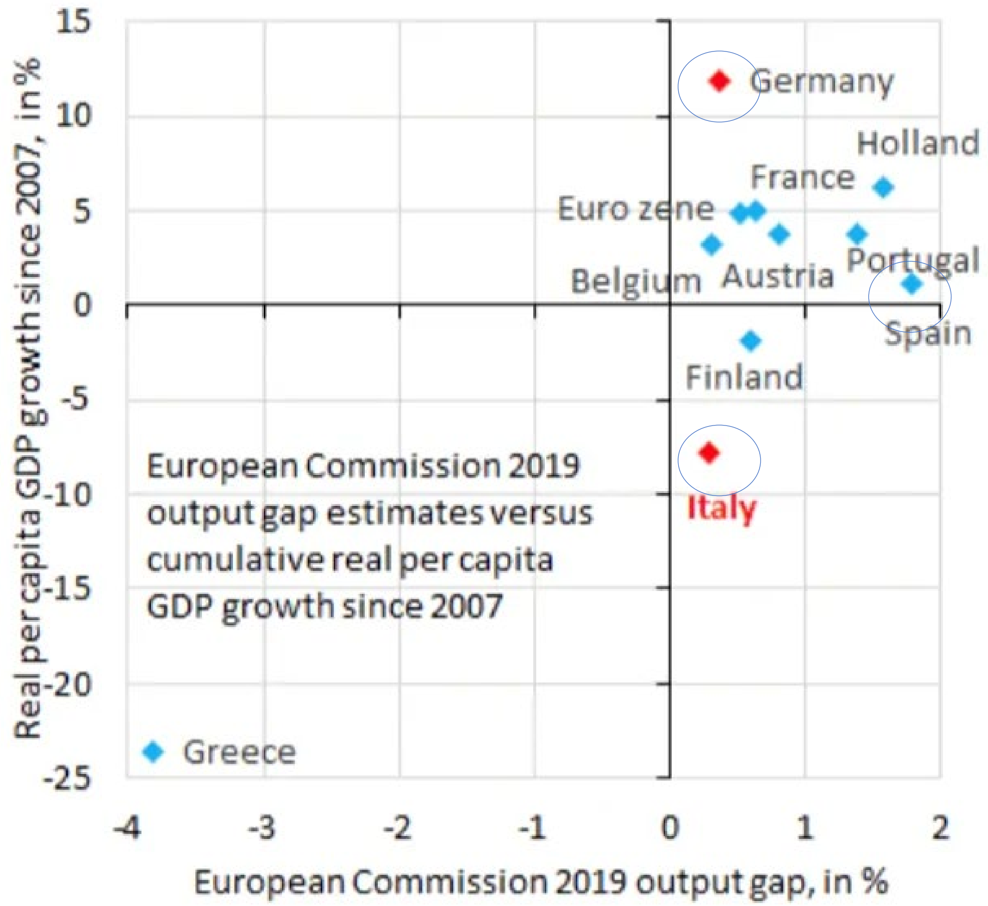
„Output gap nonsense“

Potential vs. Actual output loss 2007-2015



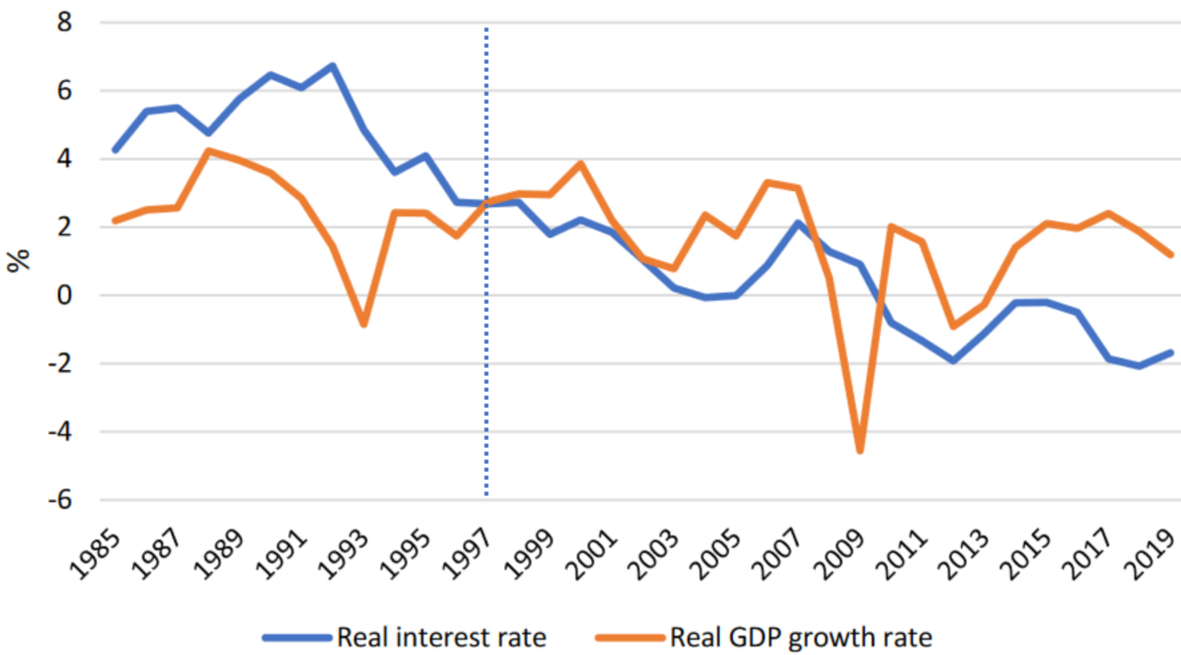
Source: [Heimberger and Kapeller (2017)]

Cumulative GDP growth 2007-2019 vs. 2019 output gap



Source: [Tooze (2019)]

r vs g and debt sustainability



Source: [Blanchard et al. (2020)]

– Debt dynamics: $d_t - d_{t-1} = \left(\frac{r-g}{1+g}\right) d_{t-1} - sb$

– Stable long run debt ratio d^* related to structural balance: $sb = d^* \left(\frac{r-g}{1+g}\right)$

  – Under $r > g$ above a certain debt threshold, debt will spiral out of control, except for sufficient structural surplus.

  – Under $r < g$ **any** deficit is debt-stabilising.

Main Directions of Reform of Fiscal Rules

Given the political and legal constraints

- Replacing structural deficit rule by **expenditure rule** (EFB 2018, 2020)
- Increasing allowed **debt ratio** and slowing **speed of adjustment**, recognizing $g - r$ relation (Dullien et al. 2020)
- 3% deficit rule → focussing on **primary balance** (instead of headline balance), recognizing interest payments / legacy debt (Dezernat Zukunft)
- Shielding public investment via **Golden Rule** with an upper ceiling
- Strengthening / streamlining of **MIP**

Conclusions

- (Post) Keynesians criticized the architecture of the EMU and the „New Neoclassical Consensus“ policies early on.
- The GFC and EMU crisis, low inflation, right-wing populism and Covid have led to gradual and painful learning process in EU macro politics and in mainstream academia.
  - Academia: **inequality, hysteresis, liquidity trap, bank runs** are all recognized issues now.
  - Relative role of **fiscal vs. monetary** policy rethought
  - Politics: Steps towards a **banking union**, relevant **common budget**, more **sensible** fiscal rules and **symmetric** monetary policy are taken.
- But
  - Recent reforms are way too small / incomplete
  - Current stagflation may resurrect the New Classical zombies.