European debt crisis and the fiscal exit strategies

Catherine Mathieu (OFCE) et Henri Sterdyniak (OFCE et Université Paris Dauphine)

The 2008-2009 financial crisis was caused by the blindness and the greed of financial markets and institutions, by unsustainable macroeconomic strategies undertaken in one hand in mercantilist countries (China, Germany) and in the other in Anglo-Saxon countries, and not by the high burden of public expenditures, debts or deficits.

The financial crisis has shown that fiscal policy, public interventions and regulations remains necessary. The crisis provoked a sharp rise in public debt and deficits as States had to intervene to rescue the financial system, recorded tax revenue losses (and higher spending on unemployment) and had to finance measures to support activity. The debt growth in 2008-2010 was not due to extravagant fiscal policies, but was the result of active fiscal policy necessary during the crisis.

In 2010, financial markets pretend to have doubts about the sustainability of public finances, even for developed countries, and require deep cuts in budget deficits even as they are needed to support the activity.

The situation is particularly worrying in the euro area where the economic policy framework is not satisfactory. The Stability and Growth Pact has no economic basis ; Members States cannot and do not want not to obey to s*tupid* rules ; national economic policies are not really coordinate ; disparities in economic situations are growing ; theses disparities are not taken into account in European policies coordination ; the ECB independence is problematic in times of financial crisis.

What are the responsibilities, in the actual debt crisis, of too lax fiscal policies of some European countries, of the poor organization of economic policy in the area and of the dysfunctions of our sophisticated and speculative financial markets?

What will be the end of the crisis? Could Euro zone escapes to break-up? Can European Institutions and MS put in place a more satisfying economic framework?

In 2010, virtually all OECD countries experienced large public deficits and large increases in their public debts. Should they rely on growth to reduce government deficits? Should they, under the pressure of the Financial Markets, quickly reduce spending to restore sustainable public finances at risk to slow the recovery? Will the financial crisis allows leading classes and European technocracies to impose to populations restrictive economic policies, liberal reforms and social spending cuts?

1. European fiscal policy before the crisis

At the beginning of 2008, the EU's struggle against *excessive public deficits* appeared to have been successful. In June, the ECOFIN Council announced that no euro area country was under an excessive deficit procedure (EDP), while five countries in the euro area were under an EDP in 2006 (table 1).

Table 1. The Excessive Deficit Procedures

	2002	2003	2004	2005	2006	2007	2008	2009	2010
Portugal	24/9	EDP	11/5	22/6	EDP	EDP	3/6	07/10	EDP
France		2/4	EDP	EDP	EDP	30/1		18/2	EDP
Germany	19/11	EDP	EDP	EDP	EDP	16/5		07/10	EDP
Netherlands			28/4	7/6				07/10	EDP
Greece			19/5	EDP	EDP	16/5		18/2	EDP
Italy				16/6	EDP	EDP	3/6	07/10	EDP
Spain								18/2	EDP
Ireland								18/2	EDP
Belgium								07/10	EDP
Austria								07/10	EDP
Finland									12/5

In fact, fiscal consolidations were not undertaken in the euro zone MS during the 1998-2000 period where growth was satisfying (table 2). The cyclical adjusted public balance (CAPB) deteriorated. The cyclical improvement of public finances and the reduction of interest charges allowed public balances to move away from the excessive deficits threshold. The European authorities deplored that Member States did not use the cyclical upturn to bring more rapidly their deficits close to balance

Table 2. Public finances in Euro Area

	Growth rate	Public balance	Interest charge	Cyclical component	CAPB
1998	2.8	-2.3	4.2	-0.5	2.4
1999	2.8	-1.4	3.7	-0.1	2.4
2000	4.0	-1.1	3.5	0.8	1.6
2001	1.9	-1.9	3.3	0.7	0.7
2002	0.9	-2.6	3.1	0	0.5
2003	0.8	-3.1	2.9	-0.6	0.4
2004	1.9	-3.0	2.8	-0.7	0.5
2005	1.8	-2.6	2.7	-1.0	1.1
2006	3.1	-1.3	2.6	-0.4	1.9
2007	2.7	-0.6	2.6	-0.1	2.1
2008	-0.5	-2.0	2.7	-0.8	1.5
2009	-4.0	-6.1	2.8	-3.8	0.5

But, Members States refused to agree with the Commission’s estimate of equilibrium unemployment rates (9.3% for the zone). Countries with high unemployment, rapid GDP growth and no inflationary pressures wished to maintain this growth for as long as possible to reduce their unemployment rate. They estimated that the euro area had significant budgetary room for manoeuvre, as the CAPB was of around 2 percentage points.

Public deficits appeared excessive (in the Treaty definition) in 2003-2004, when the activity level was weak and when the restrictive policies, required by the Commission, would be contra-productive. This situation induced stresses in the euro zone in November 2003 when the Commission tried to obliged France, Italy, Germany and Portugal to change their fiscal policy. In 2005, six countries were under an EDP, even if the fiscal impulse was small in the Euro Zone in 2002-2004.

From 2004 to 2007, finances publics situations globally improve (2.4 points of GDP), part due to cyclical components reduction (0.6 point), part due to fiscal efforts (1.6 points), mainly due to Portugal (2.8 points), Germany (2 points), and Italy (1.7 points). These reductions induced relatively low growth in these three countries.

During this period, inflation rates were low in the zone. Globally, the real interest rate was equal to the growth rate. The wage share in GDP decreased from 2.3 points between 1999 and 2007. The zone external balance was in surplus. There was no evidence that fiscal policies have globally been too expansive. Fiscal deficits were necessary to sustain activity: they were, what we name, regulation deficits. They are not the effect of too lax fiscal policies, what we name autonomous deficits.

Structural deficits before the crisis?

In 2007, most MS had a primary public balance (PPB) in surplus: 2 % of GDP for the zone (table 3). If we compare the level of the PPB with the level required to stabilize the debt/GDP ratio, we can see that only France had problems; neither Greece, nor Spain. Countries like Spain, Greece or Ireland beneficed from a low level of interest rate relatively to their growth rate. Their debts were stabilised, but the equilibrium was fragile, as it depends from the discrepancy between interest rate and growth. In 2007, financial markets did not discriminate among MS public debt. They thought that the euro zone was robust.

Table 3. Debt stability in 2007

	Public balance	Primary public balance	Net debt	Real Interest rate growth corrected	Debt stability gap
Germany	0.2	2.6	42.9	1.6	1.9
France	-2.7	-0.2	34.0	0.2	-0.3
Italy	-1.7	3.0	89.6	0.9	2.2
Spain	1.9	3.0	18.7	-3.2	3.6
Netherlands	0.2	1.8	28.0	0.3	1.7
Belgium	-0.2	3.5	73.4	-0.2	3.6
Austria	-0.7	1.3	30.7	-0.3	1.4
Greece	-5.1	-0.9	70.4	-2.9	1.1
Portugal	-2.3	0.6	44.1	0.6	0.3
Finland	5.2	4.6	-71.1	-0.3	4.4
Ireland	0.2	0.9	-0.3	-3.4	0.8
Euro Zone	*-0.6*	*2.0*	*43.3*	*0.1*	*2.0*
United Kingdom	-2.7	-0.7	28.8	-0.3	-0.6
United-States	-2.8	-0.8	47.2	-1.1	-0.3
Japan	-2.5	-1.9	80.4	0.7	-2.6

The crisis has caused a sharp deterioration of fiscal balances, but this deterioration reflects the fall in activity and the use of fiscal policy to support growth. Fiscal deficits are not indicators of pre-crisis structural imbalance of public finances that should be cured by a policy of fiscal restraint.

2. Disparities in the Euro Zone

The financial crisis of 2008-2009 can be considered as a test of the ability of the euro zone to react adequately to shocks affecting the global economy. However, even before the crisis erupted, the Euro zone was marked by swelling of the imbalances between two groups of countries engaged in two instable macroeconomic strategies : the neo mercantilist strategies of some virtuous Northern countries (Germany, Austria, The Netherlands), experiencing competitiveness gains and accumulating external surpluses with huge as the unbalanced high growth strategies driven by strong negative real interest rates in Southern countries, who accumulated huge external deficits (see Deroose *et al.,* 2004, Mathieu and Sterdyniak, 2007) . The economic policy framework introduced by the Maastricht Treaty was unable to prevent the widening of these imbalances that the crisis has rendered unsustainable. The area is thus confronted with global problems – is the area condemned to poor growth? How to avoid the swelling of public debts without plunging the region into recession? - as to specific problems: how to avoid the widening of disparities among countries in the area? Is it possible to put in place a more satisfying governance framework?

Growth differentials

GDP growth was relatively satisfactory in the euro area between 1985 and 1991 (+3.1% per year, see table 1), but it decelerated by 1.3 percentage points per year from 1992 to 1998 due to a bad management of the German reunification and to contractionary fiscal policies implemented in the convergence process to meet the Maastricht criteria. The launch of the single currency in 1999 did not enable the area to reach a more satisfactory growth. Since 1991, GDP has grown less rapidly in the euro area than in the UK or in the US (1.9% per year, versus respectively 2.7 and 3.3).

Since 1999 to 2007, GDP growth has remained strong in Ireland and has accelerated in three countries: Spain, Greece and Finland. Looking at average GDP growth rates in 1999-2007 and 1985-1991, the winners are Ireland, Greece and Finland; the losers are Portugal, Germany, Italy, and the Netherlands. Three countries had growth rate below 2% (Italy, Germany and Portugal); three countries had growth rates above 3% (Finland, Spain, Greece and Ireland). During the crisis, the more hit countries were the successful ones (Ireland, Finland, Spain) as the more open (Germany).

Greece and Spain have been converging towards the area average in terms of GDP per head (in PPP) while Portugal and Italy have been diverging downwards and Ireland upwards: in 17 years (from 1991 to 2007), the GDP per head relative to the euro area rose by 70% in Ireland, 26 % in Greece, 21% in Spain whereas it remained stable in Portugal. Among the largest economies, the GDP per head relative to the euro area declined by 10.5 % in Italy, by 5% in

France, by 3.5% in Germany, whereas it rose by 14% in the UK. Non euro area EU countries performed better than euro area ones.

Table 4. GDP Growth rates

	1985-1991	1992-1998	1999-2007	2008-2010
Euro area	**3.1**	**1.8**	**2,1**	**-0.8**
Belgium	2.7	1.8	2.3	-0.3
Germany	3.5	1.5	1.6	-0.8
Greece	1.7	1.8	4.1	-0.1
Spain	3.9	2.3	3.7	-1.0
France	2.6	1.8	2.2	-0.2
Ireland	4.0	7.2	6.6	-3.8
Italy	2.9	1.3	1.5	-1.7
Netherlands	3.6	2.7	2.5	-0.4
Austria	3.1	2.2	2.5	-0.1
Portugal	5.1	2.4	1.7	-0.8
Finland	1.8	2.5	3.4	-1.8
Denmark	*1.5*	*2.7*	*1.9*	*-1.6*
Sweden	*1.9*	*2.7*	*3.2*	*-1.0*
UK	*2.6*	*2.7*	*2.8*	*-1.0*
US	**2.8**	**3.6**	**3.0**	**0.4**

Source: European Commission.

Table 5. PPP GDP per head

	PPP GDP per head, Euro area=100	
	1991	2007
Euro area	**100.0**	**100.0**
Belgium	108.7	105.3
Germany	108.9	105.4
Greece	67.0	84.4
Spain	79.2	95.5
France	104.2	98.7
Ireland	78.8	134.5
Italy	105.3	94.2
Netherlands	107.0	120.3
Austria	113.8	111.9
Portugal	68.6	68.8
Finland	97.6	107.8
Denmark	*106.7*	*110.3*
Sweden	*108.2*	*111.7*
UK	*93.6*	*106.2*
US	**131.1**	**141.6**

Source: European Commission.

Inflation differentials

A good functioning of the monetary union requires avoiding disparities in terms of price levels. Different price levels will generate competitiveness differentials and will need to be corrected later through output growth differentials. In practice, inflation differentials have remained substantial in the euro area (see table 4). Countries running higher inflation were mainly catching-up ones, with higher output growth and low initial price levels, due to the Balassa-Samuelson effect (Greece, Ireland, Spain and Portugal). However Italy and the Netherlands also had relatively high inflation rates. The Dutch economy ran above capacity for several years and inflation was increased by several rises in indirect taxes. Even when accounting for the Balassa-Samuelson effect, which may explain 1 percentage point of inflation in Greece, 0.7 in Portugal and 0.5 in Spain (for a discussion, see ECB, 2003), prices seem to have risen too rapidly in these three countries and this has led to price competitiveness losses. Inflation has been extremely low in Germany, which has prevented other countries from restoring their price competitiveness. In 2007, inflation disparities remained large in the euro area: inflation was 1.6 % in the three countries running the lower inflation, and 2.9 % in the countries running the higher inflation. Wage and price formation processes have not yet converged.

Euro area groups countries at different development level (table 5); catching-up countries have structurally higher output growth and inflation rates than more ‘mature’ ones[2]. Thus it is difficult to run a single monetary policy even in the absence of asymmetric shocks. With a single nominal interest rate, euro area countries have had different real interest rates corrected for growth (see table 4). The single monetary policy was contractionary for Germany and Italy, and expansionary for Ireland, Greece and Spain where companies and households had a strong incentive to borrow and invest, which boosted domestic GDP growth and inflation.

Table 6. Inflation and real interest rates

	Inflation (GDP deflator)	Real interest rate less GDP growth rate	
	1999-2007	1992-1998	1999-2007
Euro area	**2.0**	**2.5**	**0.0**
Belgium	1.9	1.6	0.25
Germany	0.8	1.6	1.5
Greece	3.2	6.7	-2.2
Spain	3.9	2.1	-2.9
France	1.8	2.9	0.2
Ireland	3.5	-3.5	-5.2
Italy	2.4	3.9	0.7
Netherlands	2.6	0.9	-1.0
Austria	1.5	1.3	0.5
Portugal	3.1	1.6	-0.1
Finland	1.4	1.3	-0.7
UK	*2.4*	*3.7*	*-0.5*
US	**2.4**	**-0.1**	**-0.55**

Wage competition

The wage share in GDP decreased at the euro area level from 2.3 points between 1999 and 2007 (table 7), the *best* performers were Austria (-4.4 points), Spain (-4.3 points), Germany (-3.9 points) and Netherlands (-2.7 points). Increasing company profitability and price competitiveness through downwards pressure on wages became a major strategy in several countries, like in Germany. This strategy boosted exports but put a drag on private consumption in these countries, thus dampening demand in the whole euro area. No attempt was made by the Member States or the European Commission to harmonize wage growth.

Table 7. Adjusted wage share in GDP, 1998/2007

	Change in percentage point, 1998-2007
Euro area	**-2.3**
Belgium	-1.9
Germany	-3.9
Greece	-2.1
Spain	-4.3
France	-0.2
Ireland	-2.1
Italy	-0.5
Netherlands	-2.7
Austria	-4.4
Portugal	-1.6
Finland	-0.9
Denmark	*-0.8*
Sweden	*-0.1*
UK	*0.6*
US	**-1.9**

Table 8. GDP and Internal demand 1999-2007

	GDP	Domestic demand
Euro area	**2,1**	**1.7**
Belgium	2.3	2.0
Germany	1.6	0.65
Greece	4.1	4.2
Spain	3.7	4.6
France	2.2	2.7
Ireland	6.6	6.15
Italy	1.5	1.7
Netherlands	2.5	2.0
Austria	2.5	1.6
Portugal	1.7	1.65
Finland	3.4	3.1
Denmark	*1.9*	*2.1*
Sweden	*3.2*	*2.6*
UK	*2.8*	*3.5*
US	**3.0**	**3.1**

In this non-cooperative game, Germany, Austria, the Netherlands (and Sweden) succeeded in supporting their GDP growth through a positive contribution of net exports (by 1 point of GDP per year for Germany and Austria). On the contrary, Spain, France and UK suffered from a negative external contribution.

Fixed exchange rates and rigid inflation rates induce persistent exchange rates misalignment periods. In the euro area countries can no more devalue their currency. Wage moderation policies are the only tool left but take a long time to play and are painful, since they depressed demand both at home and in the area. Wage moderation policies would be all the more difficult to implement in euro area countries that they are already implemented in Germany, where domestic inflation is very low which makes it harder for partner countries to gain competitiveness against Germany.

In 2007, some countries ran substantial current account surpluses (table 9): the Netherlands (8.6% of GDP) and Germany (7.9%), Austria and Finland (3.5%) whereas some others ran large deficits: Portugal (-9.4% of GDP), Spain (-10.0%) and Greece (-14.4%). The 260 billion euro surplus of Germany, Netherlands, Austria and Belgium as the 40 billions euro surplus of the Scandinavian countries generate and finance the 180 billion euro deficit of Mediterranean countries and the 50 billion euro deficit of the NMS.

Table 9. Current account balance in 2007

	Billions of euros	% of GDP
Sweden	29.8	8.9
Netherlands	48.6	8.1
Germany	192.1	7.9
Finland	7.3	4.9
Belgium	12.8	3.5
Austria	9.1	3.3
Denmark	1.6	0.7
Italy	– 27.7	– 1.7
Czech Republic	–3.3	–1.9
France	–43.0	– 2.2
United-Kingdom	–55.1	– 2.5
Slovenia	–1.6	–4.6
Slovakia	–2.8	–4.7
Ireland	–10.1	– 5.3
Hungary	– 6.6	– 5.5
Portugal	– 16.0	– 8.5
Spain	– 105.1	– 9.6
Greece	– 33.4	– 12.5
Romania	– 17.0	– 13.1
Lithuania	– 4.3	– 13.1
Estonia	– 2.8	– 15.0
Bulgaria	– 6.5	– 21.3
Latvia	– 4.8	– 20.6
Total	– 53.5	– 2.5

Do these divergences in current accounts reflect an equilibrium process (oldest countries' savings being invested in younger and more profitable countries) or a disequilibrium one (European savings being spoiled in non-profitable investment, such as housing, in Southern countries)? In the euro zone, this situation cannot be considered as optimal since real interest rates corrected for output growth differ across the area. Deficits can widen because they are not financed by financial markets but by transfers within the European banking system and hence can hardly be visible. Foreign Direct Investments (FDI) cover only a small part of these deficits: In 2005, Portugal receives a small amount of net FDI (1 % of GDP), but net FDIs are negative for Spain (-1.4% of GDP) or Greece (-0.4%). National saving rates are very low in Greece, Spain and Portugal which is unusual for countries growing at a rapid rate.

The relation Germany-NL-Austria *versus* Portugal-Spain-Greece is the same at the Euro-zone level than the relation US *versus* China, with the same instability. It raises the same issues: how to convince the virtuous countries to spend more and to increases their real exchange rates so that sinner countries can reduce their external deficits without depression? The financial crisis has made it impossible to continue this debt accumulation.

An inappropriate economic framework in the Euro Zone

The Euro zone economic framework includes three elements. The Stability and Growth Pact is the only component where the Commission has effective disciplinary power. But it is poorly designed (see Mathieu and Sterdyniak, 2003 and 2006):

1. Its numerical rules (the 3% deficit limit, 60% of the public debt, medium-term balance of public finances) have no economic basis ;
2. They do not permit to the Commission to influence MS policies on top of the cycle, when fiscal efforts should and could be made ;
3. They do not allow to take action against countries that carry out too restrictive policies or that accumulate imbalances like real estate or financial bubbles ;
4. They do not take into account external balances, competitiveness or private debts.

The process of coordination of economic policies (under the Articles 121 and 136 of the TFEU) is purely formal. There are no concerted macroeconomic strategies for the short or medium term, adapted to the circumstances and the specificities of each country.

The program of structural reforms consisted essentially in liberalizing markets for goods, labor market and financial markets The Commission put pressure on MS to introduce these reforms, which allows national governments to invoke this pressure to impose unpopular reforms. The Lisbon agenda, which was adopted by the European technocracies, without any public open debate, did not succeed to impulse a common economic strategy. Moreover, the crisis is calling into question this program. Is competition policy more important than industrial and innovation policies? Must Europe maintain the objective of full liberalization of financial markets?

3. Fiscal policy during the crisis

The fiscal imbalances have been caused by the economic crisis of 2008-2009, which induced a deficit of activity of 6% to 10% compared to the trend before the crisis. For many countries all improvements in net public debts level, made between 1998 and 2007 were loosed (table 10).

Table 10. Net public debt in % of GDP

	1998	2007	2010
United States	45	43	65
Japan	46	87	105
United Kingdom	33	29	59
Euro Area	*53*	*45*	*58*
Germany	37	43	55
France	41	34	61
Italy	107	87	101
Spain	54	19	42
Netherlands	48	28	37
Belgium	108	73	85
Austria	37	31	43
Greece	73	70	100*
Portugal	33	44	63
Finland	-15	-71	-46
Ireland	43	0	38
OECD	*43*	*39*	*58*

The Euro Zone situation is less deteriorated than those of UK, US, Japan. For instance, public deficit in 2010 should be 6.7 points against 12 points in the UK, 11.3 in the US, 8.2 in Japan (table 16).

It is not easy to evaluate the amount of national stimulus plans. The output fall has been so large that it is difficult to assess potential output. The *ex ante* impact on public finances is also difficult to measure due to the importance of the fall in GDP (which has non-linear effects on some tax revenues) and to the fall of asset values.

The euro area deficit widened by 6.3 percentage points in 2010 (10.2 in the UK and 10.3 in the US). Under the assumptions that the crisis does not affect potential growth and that the cyclical balance equals 50% of the output gap, the fiscal impulse cumulated from 2007 to 2010 would be 4 percentage points of GDP in the US, 6.5 points in the UK and 1.8 in the euro area (table 11). The fiscal stimulus was dramatically lower in the euro area. Our estimations are lower than the estimations of the European Commission, which include a dramatic fall of the potential growth due to the financial crisis.

Large increases in public deficits and debt did not led to higher interest rates because they have only offset the collapse of private debt and the increase of private saving. In the United States, the 10-year rate fell from 4% in July 2008 to 2.2% in December, before rising to 3.7 in January 2010. In Germany, the 10-year yield rate fell from 4.6% in July 2008 to 3.0% in mid-2009, and rose to 3.2% in January 2010 (figure 1). In April 2010, the 10 year public interest rates remained near the growth and inflation anticipated for the next 10 years by *Consensus forecast* forecasters for all large countries (table 12). So it is unwise to pretend that high public debt will bring high interest rates

Table 11. Fiscal impulse (cumulated since 2007)

	2008	2009	2010
Belgium	0.6 **(0.5)**	3.0 **(3.1)**	2.6 **(2.0)**
Germany	0.4 **(0.2)**	0.8 **(0.3)**	2.4 **(1.7)**
Ireland	5.2 **(3.1)**	6.5 **(1.4)**	7.3 **(0.7)**
Greece*	3.4 **(2.7)**	6.7 **(6.2)**	4.7 (**3.7**)
Spain	5.6 **(4.7)**	11.0 **(8.0)**	8.9 **(5.9)**
France	0.0 **(-0.3)**	3.2 **(2.4)**	3.1 **(1.8)**
Italy	0.4 **(0.0)**	0.8 **(-0.6)**	1.1 **(-0.7)**
Netherlands	-0.2 **(-0.4)**	1.7 **(1.5)**	2.9 **(2.0)**
Austria	0.2 **(-0.1)**	1.4 **(0.3)**	2.3 **(0.8)**
Portugal	-0.3 **(-0.7)**	3.7 **(2.2)**	3.6 **(1.6)**
Finland	0.3 **(0.3)**	3.6 **(2.7)**	5.3 **(2.8)**
Euro area	1.0 **(0.7)**	3.1 **(2.1)**	3.3 **(1.8)**
UK	1.8 **(1.2)**	7.0 **(5.1)**	7.1 (**4.1**)
US	n.a.**(2.8)**	n.a.**(5.2)**	n.a **(6.5)**
Japan	n.a.**(0.3)**	n.a.**(0.6)**	n.a **(1.3)**

Source: European Commission, with own calculations of output gap in bold. ; * in autumn 2009

Figure 1. 10 years public bonds interest rates

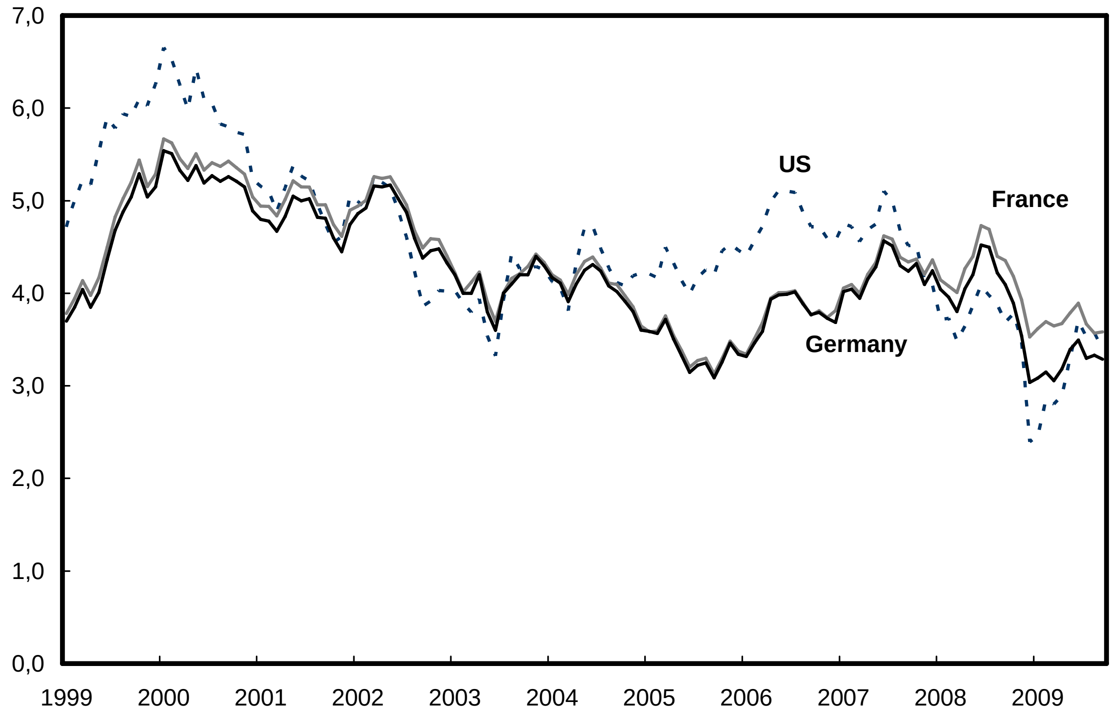


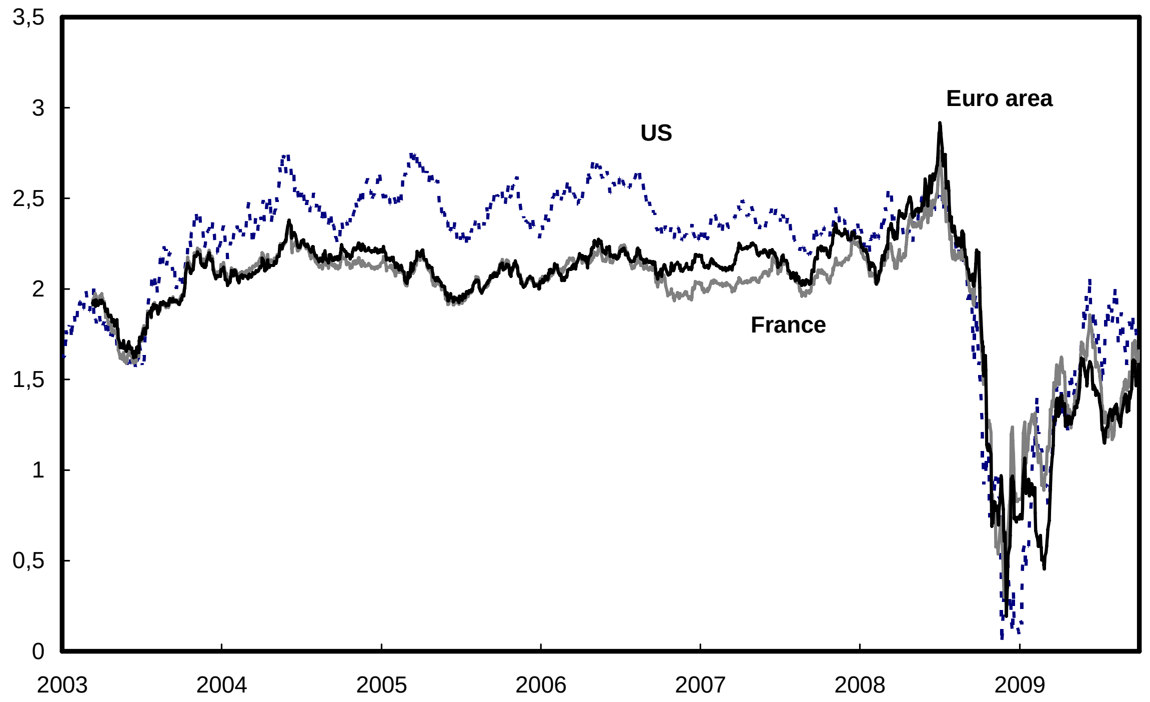
Table 12. 10 years public interest rates and 10 year Consensus Forecast in April 2010

	10 y rates	GDP*	Inflation*	Real interest rate growth corrected
United States	3.8	2.8	2.2	–1.2
Japan	1.3	1.4	0.8	–0.9
UK	4.0	2.3	2.4	–0.7
Germany	3.05	1.4	1.6	0.05
France	3.4	1.9	1.85	–0.35
Italy	3.9	1.2	1.7	1.0
Netherlands	3.3	2.3	2.4	–1.4

* 10 year growth expectations according to Consensus Forecast (April 2010).

Markets do not believe in a risk of inflation: comparing the profitability of non-indexed securities to the securities indexed to inflation shows that expected inflation is currently around 1.8% for the 10 years, in the United States as in the euro area.

Figure 2. Inflation expectations



Sources : AFT, US Federal Reserve.

Three scenarios can be considered for the coming years:

1. In the grey scenario, domestic demand does not accelerate, GDP growth remains low and there is no factor pushing inflation or interest rates up.
2. In the pink scenario, private demand accelerates vigorously, GDP growth generates a strong rise in tax revenues and a fall in some public expenditure; governments reduce deficits and output growth is satisfactory, although not excessive. There are no inflationary pressures and hence no significant rise in interest rates.

3. In the red scenario, private demand accelerates, but governments maintain an excessive deficit which leads to an acceleration of inflation and hence interest rates to rise.

The red scenario is not currently anticipated by markets. Markets anticipated probably the grey one, without tensions on interest rate or inflation.

A technical issue which becomes a political one…

The evaluation of the structural deficit, the fiscal effort to realize when fiscal policy will focus on reducing deficits depend of the level of growth output, that is to say, the maximum level of activity achievable without inflationary pressures. However, the DG Economic and Financial Affairs of the EC (DG ECFIN) and OECD have dramatically lowered their estimates of potential growth and output since the crisis (table 13).

These revisions concern also the period before the crisis. The estimate of potential growth in the euro zone for 2000-2007 was reduced by 0.3% per year by the OECD, and by 0.4% by rear by the DG ECFIN. The estimate of the potential output in 2009 was lowered by 3.5% by the OECD, by 5.4% by DG ECFIN. The rate of growth potential of the area would be only 0.9% annually in 2009-2011, according to the DG ECFIN.

Table 13. Potential growth and output gap estimations

	Output gap		Potential growth						
	2007		2000-2007		2008		2009		2011
Estimation in…	2007	2009	2007	2009	2007	2009	2007	2009	2009
…by OECD									
US	0,4	1.0	2,6	2,4	2,5	2,3	2,5	1,5	1,7
Japan	0,2	3,5	1,4	0,9	1,0	0.5	0,6	0,5	0,9
Germany	0,0	2,6	1,5	1,0	1,7	1,2	1,6	1,0	0,8
France	-0,3	1,8	2,0	1,9	1,9	1,7	2,0	1,7	1,0
Euro Area	-0,3	1,9	2,1	1,8	1,9	1,7	2,0	1,2	1,0
UK	0,4	1,8	2,6	2,4	2,7	2,4	2,7	1,5	0,9
…DG ECFIN									
Germany	0,3	2,7	1,2	1,0	1,8	1,0	1,9	0,7	1.2
France	-0,3	1,9	2,1	1,8	2,0	1,5	2,1	1,2	1,4
Euro Area	-0,2	2,5	2,1	1,7	2,1	1,2	2,2	0,8	1,0
UK	-0,1	2,6	2,8	2,4	2,5	1,5	2,7	0,8	1,1

In 2007, France had an unemployment rate of 8.4% without inflationary pressures. The Commission considered that France had an output gap of -0.3%. Can he decide two years later that France was above its production capacity by 2.2% and its equilibrium unemployment rate was around 10.5%?

These estimates significantly increased the size of the structural deficits. In 2010, the output gap in France is -2.5% according to new estimates of potential output; -7.0% according to the previous one. The primary structural deficit would be 4.5% in the first case, 2.2% in the second. The efforts required to reduce the structural deficit in the balance are quite different.

At the end of 2010, the euro area unemployment rate should be at 10.5 % (i.e. an over-unemployment of about 3%); productivity losses relatively to productivity tend will amount to 3.5 % (i.e. an over-labour force of 3.5%); the number of discouraged workers will be about 1%. Should these 7.5% be considered as permanently lost?

What will be the target of GDP growth in the euro area in the coming years: 2.2% or 1.0% per year? The risk is that the choice of a low target will be self-fulfilling, if soon as growth exceeds 1%, restrictive fiscal policies are implemented. For instance, according to the statement of the Commission in November 2009, MS should initiate a "fiscal consolidation policy" in 2011 because growth projections (1.5%) are significantly higher than potential growth (1%). But should MS resign to this loss of 7.5 % of activity?

These uncertainties are questioning the concept of potential growth and its use for economic policy. Either, potential growth is independent of the actual growth and we do not understand why the OECD and the Commission have lowered it at this point after the crisis. Either, it depends of the actual growth : a recession causes a decline in investment, thus a lower production capacity, a decrease of the potential labour force (as seniors, youth, mothers give up looking for work); a slowdown of labour productivity. Should we conclude that we must avoid any surge in demand or, conversely, that MS need a strong growth to boost production capacity, to encourage discouraged workers and prevent their ability to working from deteriorating? The euro zone can not resign to an unemployment rate of 10%.

Economic policy should aim to reduce the current output gap, then find again a growth of about 2% by year. So OCDE or DG ECOFIN estimations should not be use to define targets or constraints for public deficit as they are volatile and not reliable

What structural deficits in 2010?

During the 2008-09 crisis, public finances have suffered from the automatic fall of tax revenues and from the increase of certain publics expenses such as unemployment benefits (the cyclical deficit), from measures implemented to support the activity (the deficit discretionary), and from specific measures to support the financial sectors.

Due to the magnitude of the recession (whose impact has been particularly dramatic on some taxes) and its characteristics (falling property and stock prices have also contributed to the decline in tax revenue), it is difficult assess the amount of structural deficits in 2010.

One part of the deficit in 2009/2010 is due to temporary stimulus package or to the overreaction of tax revenue. It must not be included in structural deficit.

For the euro area, according to our estimates in 2011, the deficit would be 5.2 percentage points of GDP: 4.0 points cyclical deficit, 2.9 points of interest charge and 1.7 points of structural primary surplus. The structural primary surplus did not decrease since 2007 (table 14).

Let us suppose that the objective is to stabilize public debt at 80% of GDP. Averaged from 1997 to 2007, the real interest rate of long-term was higher than the rate of GDP growth by 0.4 percentage points. So Euro zone need to have a structural primary surplus of 0.3 percentage points of GDP. No major effort is needed. The cyclical deficit must be reduced by growth, which should be for a long time higher than the 2% of the growth potential to reduce the 8 points of negative output gap. Euro zone countries had a growth issue, not a public finance one.

Table 14. Public finances in the euro area

% of GDP except *	2007	2008	2009	2010	2011
*GDP growth in %**	*2.8*	*0.5*	*-3.9*	*1.3*	*2.1*
Output gap based on pre-crisis trend	0.0	-1.5	-7.4	-8.1	-8.0
Government balance	-0.6	-2.0	-6.4	-6.6	-5.2
Net interest payments	2.6	2.6	2.7	2.8	2.9
Cyclical balance		-0.7	-3.7	-4.0	-4.0
Stimulus packages		-0.2	-1.3	-0.8	
Overreaction of tax revenues			-0.7	-0.4	
Structural primary balance	2.0	1.3	2.0	1.4	1.7
Cumulated fiscal impulse	0.0	0.0	1.3	1.4	0.3
Gross debt	66.4	69.8	78.7	84.6	86.5

Due to the uncertainties about output gap, it remains difficult to evaluate the Primary structural Balance (table 15). If we take the OECD measure, PSB is negative by 1.7 points of GDP in the Euro Zone (but by more than 5 points in Spain and Ireland), by 6 points in the UK and Japan, 7.5 points in the United States. If we think that it would be possible to fully recover from the crisis, PSB is nil for Euro Zone ; it remains negative by 3 points or more for Spain, Ireland, UK, Japan and US.

Table 15. Public finances stability in 2010

	Public balance	Primary public balance	Output gap*	Primary structural balance**
Germany	-5.5	-2.8	-2.7/- 7.7	-1.4/1.0
France	-8.0	-5.3	-3.7/-7.4	-3.5/-1.6
Italy	-5.0	-0.1	-4.9/- 9.9	2.3/4.8
Spain	-9.6	-8.5	-6.0/-10.4	-5.5/-2.8
Netherlands	-6.3	-4.4	-3.4/- 6.0	-2.7/-1.3
Greece	-10.3	-5.6	-7.3/-9.1	-2.0/ -1.6
Belgium	-4.8	-1.2	-6.3/-7.7	2.0/2.6
Austria	-4.7	-2.0	- 3.4/-4.4	-0.3/0.2
Portugal	-8.3	-5.3	-3.1/-8.9	-3.8/-0.9
Finland	-3.6	-4.1	-9.3/-12.5	0.6/2.2
Ireland	-12.9	-12.6	-6.6/-16.2	-8.3/-3.5
Euro Zone	*-6.7*	*-3.9*	*-4.5/-8.1*	*-1.7 /0.1*
United Kingdom	-12.0	-9.2	-6.6 /-11.5	-5.9/-3.5
United States	-11.3	-9.5	- 3.9/-8.4	-7.5/-5.3
Japan	-8.2	-7.1	-1.8/-9.3	-6.2/-2.8

***** before crisis trend/OECD : ** according to the two output gap measures.

So the required fiscal efforts depend of the output gap estimation and of the real interest rate growth adjusted. If a country is able to finance at a interest rate near its growth rate and if the objective to fully recover is credible, the required effort is low, even nil at the global zone level. If a country has to stabilize its debt with an interest rate 3 point above its growth rate and if it has to resign to the output gap measured by OECD, the required effort is high : for instance, 6.5 points for Spain (rather than 3 points), 5 points for Greece (rather than 1.6 points).

Our intention is not to deny that some European countries will have to change their growth regime which was unsustainable: Germany and Netherlands (too high external surplus), Greece, Spain and Portugal (too large external deficit), Finland and Ireland (too much depending of foreign markets), United Kingdom (too much depending of financial sectors). This change will be harmful and will take a long period, but the problem is not fundamentally a fiscal one. There is no argument to prove that the potential output of Euro area should be really affected in the medium term.

In a pink scenario, the growth will revive in 2012; the growth will allow for a reduction of public deficit (table 16); the negative fiscal impulse will be small (0.4 GDP by year) ; public deficit will remain near 3% of GDP in 2013/2014 ; public debt near 90%. This scenario is fragile: it supposes a strong revival of private or external demand: it supposes that MS will resist to the pressures from EC or from financial markets to decrease more quickly their deficit.

Table 16. Euro area public finances; a pink scenario

% of GDP except *	2011	2012	2013	2014	2015
*PIB in %**	*2.1*	*2.5*	*3.0*	*3.0*	*2.5*
Output gap	-8.0	-7.6	-6.6	-5.6	-5.0
Government balance	-5.2	-4.8	-4.1	-3.3	-2.6
Net interest payments	2.9	3.1	3.3	3.4	3.4
Cyclical balance	-4.0	-3.8	-3.3	-2.8	-2.5
Structural primary balance	1.7	2.1	2.5	2.9	3.3
Public debt	86.5	87.5	87.4	86.5	85.4

4. About fiscal exit strategies.

The FMI views

During the crisis, the IMF exhorted governments to undertake large stimulus programmes. Nevertheless, two IMF economists, Cottarelli and Viñals (2009), proposed now an exit strategy which is not satisfying. They argued that public debts should come down to their pre-crisis levels, but without providing any analysis of their optimal level. They write that we must avoid that "concerns about deficits and debt levels cause a rise in interest rates", but rates have not increased. They proposed that countries adopt a debt ratio target of 60% of GDP in 2030. But why this precise level ?

They evaluate the structural primary balance of advanced countries at -3.5% of GDP in 2010 (including 1.5 percentage point of temporary fiscal stimulus). But from where come the two other points of structural deficit ? In our view, from an under-estimation by the IMF of the cyclical deficit (by not taking into account the over-reaction of the tax revenues, by understating the potential output). They estimate that primary balances should increase to

4.5% of GDP in 2020 for debt ratios to reach 60% of GDP, which requires a negative fiscal impulse of 0.8% per year. Their policies would lead to strong public surplus and total disappearance of the public debts in 2040. But the authors do not prove that a world without public debt is possible.

According to FMI (2010), advanced economies must return to pre-crisis debt level, because there is a ling between the level of public debt and the level of real interest rate (and a link between the level of interest rate and the rate of potential growth). But the first link does not hold if the level of public debt is high because the private debt is low and because private agents want to hold public debt. It does not hold if the Central banks maintain a low real interest rate and the Governments maintain the public deficit required to sustain activity. There is no evidence that real interest rates will increase due to excessive public debts and deficits. The econometric results presented mix autonomous and regulation deficits.

In fact, even if the interest rate is 0.5 percentage point higher than output growth, a primary public surplus of around 0.5 % would stabilize the public debt at the level reached in 2010 (around 90% of GDP): the required effort (after the end of the fiscal stimulus and revenues overshooting) is only about 0.5 percent of GDP.

The authors do not analyse the impact of this restrictive policy on growth. They must assume implicitly that there will be a deficit of private spending and that there will be a boom in investment or consumption, but we do not see why such a boom would occur and the authors do not say explicitly that the adjustment strategy depends on this boom.

The evaluation of the multiplier effect of fiscal policy remains controversial. We are in a situation where we cannot expect that a decrease of interest or exchange rates will compensate the impact of the restrictive fiscal policy. If we suppose that a world generalized fiscal policy will have a multiplier of 2.0, a negative impulse of 0.8% of GDP will decrease the GDP by 1.6% and will not improve public balances.

Of course, the authors advocate for structural reforms (more competitive goods markets, removal of labour market and tax distortions, but no financial markets reforms), but recognise that: “there is too much uncertainty on both the magnitude and timing of the effects structural reform on potential growth to build a fiscal adjustment strategy primarily around this”.

Of course, they advocate for ‘fiscal rules and fiscal councils’. However, the crisis has shown that fiscal policy can not obey automatic rules and must be decided by a political government, with determination and courage that will never be the characteristic of a committee of experts.

They proposed to keep health and pensions spending constant in relation to GDP, but households would have to pay premiums to private financial institutions to obtain a satisfying coverage. They did not give evidence that this will be less expensive. It would be somewhat ironic that the financial crisis leads to the development of pension funds, whose crisis has shown the fragility. The question of the desirable level of social spending has nothing to do with the public deficit macroeconomic management, if such expenses are structurally financed by social contributions. A country may decide to keep its public pension system, to arbitrate between pension levels, social contribution rates and retirement age.

They propose to freeze, in real terms, all other primary public spending, which implicitly supposes that these expenditures are less useful than private ones, which remains to be proven. It is difficult to understand why the financial crisis should lead to a decrease in the share of public spending in GDP.

In its recent paper, Blanchard (2010) made two suggestions. Central banks should have an inflation target of 4%, to allow a more pronounced decrease of anticipated real interest rate during the depression period. But, as the Japanese case showed, it is difficult to make rise inflation expectations in a depressive situation. Governments would have more *marges de manoeuvre* in depressive situations if they had a smaller public debt in good times. So Blanchard claimed for a long period of public surplus. But, how the demand will be sustained during this period? Blanchard did not study what it the optimal level of public debt. If people want to accumulate safe financial assets, public sector has to issue them. Blanchard did not propose any measures to fight against the instability of the world economy induced by the weight, the greed and the blindness of financial markets.

The OECD views

The OECD has very similar views as IMF (see OECD, 2009, 2010). It underestimates output gaps in 2010 and potential output growth. It overestimates structural primary deficit: 7% of GDP in United States in 2010 against 1.4% in 2007 ; 4.4 % in the Euro Area against 1.1% in 2007 (in Autumn 2008, OECD estimated that the Euro Zone has a structural primary surplus of 1.6% of GDP). OECD estimates that “excess supply of government bonds may put upward pressure on interest rates”. But there is no “excess supply”.

It calls for tightening fiscal policies (1 percent of GDP per year from 2012 to 2017) to and to avoid Ricardian behaviour from households and to reassure financial markets, while recognizing that these policies will dampen growth. But should fiscal policy be used to reassure financial markets?

Should we fear Ricardian behaviour? The actual rise of public deficit is cyclical; it is not due to structural increase of public spending or decreases of taxes. So taxes will not have to rise. It is the increase of activity which must equilibrate the public balance. But we must admit that the rise in deficits generates a climate of uncertainty. Firms and salaries may fear that government will be obliged to reduce too quickly its deficit, which may have a depressive effect. Governments need to explain that budgetary positions will be brought back to balance thanks to higher output growth, not through higher taxation or social expenditures reduction. Paradoxally, it is the OECD-type discourse for rapid consolidation which may induce Ricardian behaviour.

OECD recommends a coordination of the consolidation strategies, as a consolidation in one county will decrease the activity of its partners. But a coordination is not possible is all countries has to consolidate.

According to the OECD, the effect could be reduced through structural reforms (fewer regulations on the labour and goods markets, less taxes, reforms of financial market ate not proposed).

OECD recommends social spending (health and pensions) cuts rather than tax increases. Should we hide a social choice (less public spending) by questionable economic considerations (social spending cuts would be less harmful to activity than taxes increases because they would induce people to work contrary to taxation)? Can structural reforms effectively increase supply when there is a lack of demand?

OECD estimates that pension reforms could have a triple dividend: to improve public finances, to decrease households savings (as people will have to project to work older, so will need less saving for retirement), to increase the supply of labour, and so the potential growth. But, the effect can be the opposite: people will save more as public pension will decreased and that they will fear to be unemployed during a long time before retiring.

Two *European* economist views

In October 2009, two distinguished European economists were invited to give papers at the ECOFIN meeting at Götenborg.

Francesco Giavazzi (2009), usually hostile to active fiscal policies, recognized that they were effective during the crisis because they were companied by an accommodative monetary policy and because the output gap was largely negative (but it is precisely in these circumstances that a fiscal stimulus is needed). According to him, governments should announce that they will end the fiscal stimulus when the output gap comes back to zero to reassure financial markets and the ECB and to avoid a rise in interest rates. But, who have doubts about this? But long-term interest rates did not increase during the crisis.

Giavazzi proposes cuts in future public retirement pensions to show the credibility of this announcement. At the same time, he recognises that there is a need to induce households resume spending. How is it possible if households have to save more in view of their pensions?

According to Giavazzi, public debts should return to their pre-crisis levels, but is this economically possible if households want to own more public debt assets? Giavazzi proposes to counterbalance the fall in potential output by increasing labour force participation through labour taxation cuts, but, in a mass unemployment situation, is employment really constrained by the unwillingness of people to work?

Pisani-Ferry (2009) presented again his old and unwise proposals. He asked for a commitment by governments to undertake consolidation strategies, according to “fiscal sustainability plans”, which would be implemented from 2011 to 2014, with debt target for 2014. But how to design these plans, regardless of the economic situation ? One fond again the failure of the Pact of Stability and Growth Pact: a country cannot commit to five years and renounce to adjust its fiscal policy according to circumstances. Pisani-Ferry proposes to establish "independent Budgetary Councils to monitor the development of public finances, but what is their political and scientific legitimacy? He proposes to reduce public pensions.

Pisani-Ferry pretend to fear that expansionary fiscal policies will provoke inflationary pressures, which will induce the ECB to increase too quickly the interest rate and so coordination is needed. But this fear is not justified: inflation will accelerate only if there is strong demand revival which is unlikely in the years to come. It would not be wise that, to conjure an imaginary peril (the resurgence of inflation), governments gave up the struggle against a present imbalance (unemployment). The coordination of economic policies should not be designed to oblige countries to achieve arbitrary public finances criteria under pressure from the Commission and the ECB.

The European Commission view

During the crisis, the Commission found useful to submit 24 of the 27 EU countries to the excessive deficit procedure. The Commission applied the rules of the SGP with flexibility for 2009 and 2010, but the crisis shows that these rules are inappropriate.

On 20 October 2009, the ECOFIN Council recognised that “it is not yet time to withdraw the government support”, but announced that he will prepare “a coordinated fiscal exit strategy”. But which coordination? The consolidation should start in 2011 at the latest and go beyond the benchmark of 0.5% of GDP per year. But the Council did not explain what countries should do if the recovery is not sufficient in 2011. The positive point is that the SGP and its 3% of GDP constraint are forgotten in the short and medium run. The ECB requested that consolidation begins in 2011, whatever the economic situation, and be at least 1% by year.

In November 2009, the Commission required that countries with higher than 3% of GDP public deficits bring their deficits below this limit in 2012, 2013 or 2014, according to some arbitrary criteria. The deadlines are long but it remains unrealistic to set fiscal policies constraints independently of economic developments. Is it useful to require to the MS a commintement to reduce their public deficit below 3% of GDP in 2013 rather than in 2014, when the evolution of deficits depends on the dynamism of private demand, that neither the Commission nor MS could control? MS should refuse to make precise commitments on the level of their future deficits and debts, irrespective about growth evolution.

One can worry when the Commission declared that consolidation should be implemented as soon as growth is above potential growth, estimated at only 1% per year.

The Commission writes: "The PSC should be an anchor for fiscal exit strategies", even if the crisis has shown that pact centred on a blind constraint on public deficits should be replaced by a process of coordination of fiscal policies taking into account the necessities of economic regulation.

The Commission continues to call for wage restraints, as if wage increases were responsible for the crisis. However, the wage share in value added declined by 2.3 percentage points from 2000 to 2007 in the euro area. The Commission does not see that growth should be based on wages and social benefits and not on competitiveness or financial bubbles.

The Commission keeps on repeating that public debts should come down to 60% of GDP. But the crisis increases the need for households to own safe assets, especially to fund their pensions (as the Commission advocates also for lower public pensions). Companies are reluctant to borrow in view of the risk premium embedded in today's interest rates. The equilibrium level of the public debt has increased due to the crisis. Debts cannot come down to the levels they had before the crisis.

Fiscal policy can not be managed by itself, with arbitrary rules. It must have the target to maintain (or to regain) the desirable level of employment while allowing for inflation and interest rates to remain at satisfactory levels Public debt and deficit must derive from this target. . The “exit strategy” should be that Central Banks maintain low interest rates and the Governments maintain public deficit as long as it is necessary to sustain activity. If in the coming years, private demand increases significantly, it will be necessary to reduce public deficit (and this will be largely automatically). If private demand stagnates, that is to say, if companies refuse to go into debt and if households want to save, it will be necessary to maintain some deficit and accept some growth of public debt. It is absurd to project public debt and deficit independently of private demands evolutions and to worry about the too high level of public debt (as Cecchetti and *al.* (2010) or Becker and *al.* (2010)) : public debts will be high if they were desired.

5. MS strategies…

According to their 2010 Growth and Stability Programs, all countries in euro zone have accepted the thesis that the crisis has dramatically reduced their potential output growth. If we make the average of the national estimates, the euro zone potential growth would be only 1.0 % en 2010, 1.2% in 2011, 1.4% in 2014.

In 2010, all countries have to choose between the reduction of public deficit to prevent a too big increase of public debt and the pursuit of an expansionist policy as the recovery remains weak (table 17). Germany (2.4 percent of GDP), Austria (1.2 percent) and Finland (0.4 percent) maintain a positive fiscal impulse. It is a good configuration that the less constrained countries sustain EU activity. On the contrary, Greece (-5.5 percent of GDP), Ireland (-4.3), Spain (-3.2); Belgium (-1.6) and Portugal (-1.3) have been obliged to undertake restrictive fiscal policy. Globally, the fiscal policy would be neutral in the euro area.

Table 17. Fiscal impulses, in 2010-11

	Fiscal balance*			Fiscal impulse**	
	2009	2010	2011	2010	2011
Germany	-3.2	-5.5	-4.5	2.4 (2.7)	-0.7 (-0.5)
France	-7.5	-8.0	-6.4	0.0 (0.1)	-1.7 (-1.7)
Italy	-5.3	-5.0	-3.9	-0.5 (0.0)	-0.5 (0.0)
Spain	-11.2	-9.3	-6.0	-3.5 (-2.3)	-3.9 (-2.9)
Netherlands	-5.3	-6.3	-5.0	0.2 (1.6)	-1.5 (-0.8)
Belgium	-6.0	-4.8	-4.1	-1.6 (-1.2)	-1.0 (-0.6)
Austria	-3.4	-4.7	-4.0	1.2 (1.7)	-0.9 (-0.6)
Portugal	-9.4	-7.3	-4.6	-2.8 (-2.1)	-3.5 (-3.3)
Finland	-2.2	-3.6	-3.0	0.4 (1.4)	-0.7 (-0.1)
Ireland	-14.3	-12.9	-10.0	-3.5 (-0.8)	-3.3 (-1.2)
Greece	-13.8	-9.9	-6.8	-5.5 (-4.7)	-4.7 (-3.9)
Slovenia	-5.7	-5.7	-4.2	-0.4 (-0.3)	-1.3 (-1.3)
Slovakia	-6.3	-5.5	-4.2	-1.6 (-0.9)	-1.6 (-0.8)
Euro area	-6.3	-6.7	-5.2	-0.1 (0.4)	-1.5 (-1.1)
United Kingdom	-11.4	-12.0	-11.1	-0.8 (-0.4)	-1.9 (-1.8)
United States	-11.1	-11.3	-9.0	-0.1	-0.5
Japan	-8.3	-10.0	-9.4	1.9	-1.3

* for the MS, according to SGP (2010) ; **The first number gives our evaluation based on trend potential growth; the second gives, for EU countries, the national evaluation as in their 2010 Stability Programme. Source: National SP (2010) or OECD, OFCE calculations.

In 2011, all countries announced restrictive fiscal policies, by often more than 1 percent of GDP. In Japan the fiscal effort would be 1.3 percent of GDP; 1.5 point in the Euro zone; 1.9 in the UK and only 0.5 in the US. This raises three questions: will countries will able to dramatically reduce their public expenditure? What will be the impact of generalized restrictive plans on activity? Some economists have exhibited the case where consolidation fiscal policies do not have a negative effect on economic activity. But in the present situation, we can neither expect a decrease in interest rates nor exchange rate depreciation nor a private demand boom. What is the macroeconomic logic of these strategies: they seem to accept the thesis that potential output is durably smaller. But why? If the euro zone has not a global problem of excess demand, the restrictive policies that some countries must undertake should be compensated by more expansionist policies in other countries.

However, many countries have already decided or were obliged to dramatically decrease their public spending. Some countries (Netherlands, Ireland) reduce social benefits. Some (Ireland, Greece, Spain, Portugal) reduce public servants wages; most reduce the number of public servants. Some (Greece, Ireland, Spain) reduce public investment. Some (Spain, Germany) announced that the retirement age will be postponed until 67 years even if there is no evidence that most workers will be able to work until this age. Some (Greece, Spain, Belgium, Portugal) dramatically increase taxes.

Some countries have tightened the constraints on fiscal policy. Hence Germany has adopted a law creating a "debt brake", which prohibits any structural deficit higher than 0.35% (?) of GDP from 2016, the cyclical deficit being estimated by the Commission method, which is questionable, as we have already seen. According to this method, the German structural deficit would almost always been excessively each year since 1974. But can one believe that a country with a higher than 6.5% of GDP current account surplus, with an higher than 8% unemployment rate and a 1.5% inflation rate had have excessive deficits ? The EU countries should not deprive themselves of weapons that were helpful during the crisis.

Three fears

The European governments and the Commission have been forced to pursue policies of fiscal stimulus during the crisis. But they refuse to learn all lessons from the crisis. Instead of questioning the responsibility of past policies in the emergence of the crisis, they demand a return to such policies as if nothing had happened!

Also, the debate on fiscal exit strategies now raises three fears. The first is that the ballooning deficits and debt during the crisis lead some governments to implement restrictive policies too early, which would weigh heavily on the recovery. The EU countries should forget the objectives in terms of deficits and public debts to adopt goals in terms of unemployment rates. No restrictive fiscal policies when the unemployment rates do not decrease with a sufficient pace to the full employment level.

The second is that fiscal austerity obliges MS to renounce to growth-enhancing public expenditure as research, R&D, education, support for innovative industries and support for the green economy.

The third is that public finances problems are used as a pretext to introduce dramatic public spending cuts (especially social spending), which is a structural target of the European technocracy. It is not an excessive increase of social spending which are responsible for the current deficits.

It would be disastrous for the European cohesion that the European authorities use the threat of markets to impose to countries and to peoples restrictive economic policies, liberal reforms and social spending cuts

Policies to reduce the welfare system would be socially and economically dangerous. They would decrease the households incomes and increase the rate of their savings. How to compensate for declining demand? by a new financial bubble ? Households would have to buy their health and pensions insurance to the financial institutions which are responsible for the crisis.

Should we undermine the European social model which showed its effectiveness during the crisis? The crisis has highlighted the risks arising from growing inequalities, which argues for higher taxes on highest incomes, on highest wealth, on financial and real estate gains, and on financial sectors, if public deficits would have be reduced. Thus should be allowed by the struggle against "tax and regulation heavens" and by the progress of tax coordination.

6. Public finances and financial markets

Since the beginning of 2010, financial markets have found a new concern: the level of deficits and public debts. All developed countries, even the largest, are suspected of being able to default on their debt. On April 2010, CDS had reached 5.3 points for Greece, 2.5 points for Portugal, 1.7 points for Ireland and Spain, 1.5 points for Italy, 0.8 point for the United Kingdom, 0.65 for France and 0.5 for Germany and for the United States (table 18). Bankers, rating agencies or investment funds pretend to worry about the sustainability of public finances and requires countries to reduce their debt by cutting government spending, especially social spending (as, given competitiveness or incentives issues, it is not be possible to raise taxes).

Table 18 . 10 years public interest rate and CDS

	June 2007		April 2010		
	10 y rate	CDS	10 y rate	CDS	S& P. notations
Germany	4.5	0.04	3.05	0.42	AAA/stable
France	4.55	0.07	3.4	0.64	AAA/stable
Italy	4.65	0.18	3.9	1.44	A+/stable
Spain	4.55	0.07	3.95	1.69	AA/negative
Netherlands	4.5	0.02	3.3	0.42	AAA/stable
Belgium	4.55	0.03	3.55	0.75	AA+/stable
Austria	4.5	0.06	3.45	0.71	AAA/stable
Greece	4.65	0.20	8.7	5.32	BB+/negative
Portugal	4.6	0.08	4.9	2.47	A-/negative
Finland	4.5		3.3	0.27	AAA/stable
Ireland	4.45	0.13	4.8	1.70	AA/negative
Denmark	4.45	0.13	3.3	0.41	AAA/stable
U. Kingdom	5.3	n.c.	4.0	0.79	AAA/negative
Sweden	4.3	0.34	2.95	0.43	AAA/stable
United-States	5.0	0.13	3.8	0.43	AAA/stable
Japan	1.85	0.23	1.3	0.83	AA/negative

States are thus subject to two conflicting requirements: to support economic activity and to ensure their own financial situation. Globally, capital owners want to hold significant financial assets. These were obtained through a financial bubble. After its collapse, the demand deficit must be filled by public deficits and low interest rates. If financial markets do not accept this logic, by raising interest rates long term, under the pretext of risk premium, when the State supports the activity, if is spreading the thesis that "deficits today are tomorrow's taxes ; we must save more in public deficit situation”, economic policy becomes powerless and the world economy becomes uncontrollable.

In a world economy where the mass of financial capital is enormous, debts are automatically high. Many, private or public, agents are indebted and some are more indebted than others. So there are always doubts about the creditworthiness of borrowers and debt crises. Lenders want to invest large sums, but then worried that borrowers are too indebted. It is the malediction of lenders. Countries, companies or households that receive large inputs of external funding are vulnerable, as they become heavily indebted and dependent on capital markets. It is the malediction of borrowers.

Markets are herding, their expectations are self-validating and operators know that. They are now vigilant, but their vigilance increases the risk of crisis. A slight doubt on the creditworthiness of a borrower may lead to withdrawals of capital and increase in interest rates that precipitated the crisis.

The current crisis in public debts do not generally come from too much government spending, it is the perverse consequence of financial globalization. Development of CDS on the debt of developed countries is paradoxical and dangerous. Since 1945, no developed country has defaulted on its debt. Markets buy and sell assurances against a risk which has never materialized.

In the past, the State could always use money creation, which means credit from the central Bank. The markets might fear the depreciation of debt by inflation, not the State bankruptcy. Admittedly, the situation has changed since the independence of central banks (and especially since the creation of the ECB) which might lead to conflict situations where the central bank refuses to finance the State. The crisis of 2007-2008 has showed the ability of central banks to intervene in case of danger. How imagine that a central bank would not intervene to rescue his State, as it has done to save the banks?

At the same time, the crisis of 2007-2008 showed that unimaginable events could occur, so that markets are more nervous, more prompt to consider extreme scenarios, increasing their volatility.

Furthermore, in an extreme situation which would be a great country going bankrupt (U.S., UK or Germany), it is unlikely that any financial institution would be able to pay compensation corresponding to the CDS that he sold.

Financial institutions have found a new source of profit by creating the CDS market on the sovereign debt, a speculative, parasitic and disruptive market. It boosts the government securities market, which was relatively inert, therefore which had no interest for the markets. It allows them to speculate on the failure of States. It becomes possible to buy protection against a failure of the Greek State even if we do not own Greek government bonds. By sowing doubt on the ability of countries to fulfil their commitments, some financial institutions oblige pension funds to buy their CDS. The losers are the Greek state, who must pay more for its debt, who is obliged to undertake excessive fiscal policies and the Funds who already held Greek bonds, which should now downgrade their debt, sell it cheap or cover it. The risk is to eliminate the market for developed countries debt, as has disappeared, largely, the market for less developed countries debt. Countries will be reluctant in future to issue debt knowing that this puts them under the control of markets.

In the global finance world, economic policies must be dedicated to reassure markets, although markets have no relevant vision of macroeconomic developments, as evidenced by the large fluctuations in financial markets (stock exchange or exchange rate). It is absurd to claim for a sharp reduction of public deficits in a situation where global demand is low and short-term interest rates close to nil.

Countries like Spain, Ireland or even Greece have experienced strong growth before the crisis, the crisis forces them to change their growth strategies, markets do not help them shouting at risk of bankruptcy.

Against the speculation crisis, Europe had the choice between two strategies:

- The euro zone members accept to help Greece by opening unlimited lines of credit to guarantee its debt in exchange of its commitment to implement a medium-term public finances consolidation (but not too strong in the short term);the ECB open unlimited credit line to menaced countries ; the determination of MS, ECB and EC should be strong enough to discourage the speculation ; spreads should fell sharply. The issue of “moral hazard” or of the reform of the European framework should be forget for a while
- The euro zone members give an insufficient help to Greece order to give a lesson and to show to all MS the risk to not obey to the Stability Pact. The risk is high that markets continue to speculate until Greece is obliged to declare itself in default. The speculation will increase against the others considered fragile countries, which will be obliged to maintain high interest rates. Many financial institutions in the Euro zone will have to depreciate their Greek, Spanish and Portuguese bonds, which will deteriorate their financial situations. Euro zone will plunge again in a new financial crisis. If the crisis ends by a restructuring of Greek debt, or worse, by the exit of Greece, the euro area will be permanently impaired because speculators will have objective reasons to discriminate between the debts in euro and to demand significant risk premiums.

The February 11th, the European Council gave a too limited support to Greece and asked a reduction by 4 point of its public deficit, which was too much.

In March 2010, the support given to Greece by the European institutions and other member countries has not been sufficient. Aid to Greece remains conditional, subject to the rule of unanimity (so not insured) and the rate will incorporate "adequate pricing of risk". But what risk? Finally, some German leaders did not hesitate to discuss a possible exit from the Euro zone, which fed directly speculation.

On May 3rd, the ECB finally decides to accept as collateral all Greek government debt.

On May 2nd, MS, EC, ECB and IMF decides a 110 billions euro rescue plan (in three years) for Greece. But Greece should undertake a huge restrictive fiscal plan (decreases in public wages, in public consumption and investment, increases of VAT and excises rates, reform of its pensions system) to reduce its fiscal deficit from 14% of GDP in 2009, to 8.1% in 2010, 7.6 % in 2011, 6.5% in 2012, 4.6 % in 2013, 2.6 % in 2014.

According to the government, the GDP will fall by 4% in 2010. A fiscal effort of 4%, with a multiplier of 1, will decrease GDP by 4% and improve by 2% only the fiscal balance. The debt/GDP ratio shall increase from 3%, as the GDP will fall.

Spain and Portugal undertake also dramatic restrictive fiscal programs. The risk is that financial markets are not reassured by these programs since the loss of growth and prospects for several years of stagnation will make not credible the finances publics targets. The financial markets doubts are self-fulling, as they induce high interest rates, which increase the bankruptcy risks. As the fiscal policy in the Euro zone taken globally is not too expansionist in 2010, restrictive fiscal measures required in some Southern countries should have been accompanied by expansionary measures in most Northern countries. The EC should have be able to present Economic projections which prove that this measures are compatible to the return of an equilibrate growth in Euro zone members states.

The present situation illustrates the instability of the global economy driven by financial globalization. Political and economic leaders should acknowledge: financial globalization does not work. The global economy cannot be dominated by the games and the moods of financial markets. The essential issue for the crisis exit strategy is not public debts, but the finance speculative. The measures taken by three successive G20 in 2009 did not go far enough; one must not only regulate international finance, but also drastically reduce its importance to prevent the global economy to be paralyzed or disrupted by the game of financial markets. One need to reduce the financial market weight and to increase the weight of a banking sector controlled and refocused on the financing of productive activities.

One cannot let the financial markets to speculate on the bankruptcy of sovereign states as on the bankruptcy of banks. The central banks must have the obligation to finance the public debt, even in the euro area. No ambiguity on this point can be allowed.

If a country suffers from a persistent weakness of its private demand, the Central Bank must decrease its interest rates and the Government must accept a public deficit. Long-term interest rates must be low, which supports the activity and reduces the growth of public debt. They are low if fiscal policy is credible and if monetary and fiscal policies are coordinated. In a flexible exchange rate regime, theses policies lower the exchange rate, which is stabilizing. Stabilizing mechanisms do exist. On the contrary, economic policy is paralyzed if the markets anticipate a bankruptcy of the State and maintain high interest rates. Therefore, the risk of bankruptcy should be nil; the Central Bank should guarantee the public debt. In a financial globalization world, the Euro zone will not survive if not.

The crisis lessons.

Although Greece has been particularly lax in terms of public finances, but this is not the case with other countries attacked: Spain or Ireland. The single currency is not compatible with too large differences in inflation and in growth rates, as it tends to exacerbate disparities. The Pact of Stability and Growth has not allowed either to detect imbalances, or to remedy them The Financial globalization allows the swelling of imbalances until they burst. The Euro zone deficient framework has created the possibility of speculation as a MS is no more able to finance its debt by monetary creation.

Financial markets have built a scenario where the austerity measures induce weak growth and social troubles so that some countries still have to leave the Euro Zone. If a country suffers from high interest rate, low growth, high unemployment and is obliged to submit its policy to EC and to others MS, without recovery perspectives, the exit may be looked as a alternative. Moreover, Financial markets question the credibility of the recue Plan, the German Constitutional Court may refuse that the TFUE was violated; the Greek people can reject austerity measures, which may lead Germany to refuse the continuation of the plan

Financial markets know their strength; they know that their expectations are self-fulfilling. They have obliged Argentina to abandon the currency board; they have obliged in 1992-93 many countries the leave the EMS; why not the Euro zone, which is politically and institutionally fragile?

A new economic policy framework in the Euro zone?

Several propositions were made to improve the public finances and debts monitoring in Europe, even if the public debt increases was, from a general point of view, the effect of the financial crisis, not its cause.

Some economists, Jean-Claude Juncker or Yves Leterme has proposed to established an European Debt Agency (EDA) which would issue debt for all Euro Zone members, but Germany is hostile because he refuse to have to pay higher interest rate and to be obliged to bail out other members states. The EAD would have to control the national fiscal policies and would have the power too refuse to finance too lax country. It would be a more rigid SGP, with the same problems. How to decide that a public deficit is too large if the Member State says that this deficit is required to sustain activity (like France and Germany in 2002-05) or to rescue its banks?

Gros and Mayer (CEPS, 2010) propose a European Monetary Fund. Each sinner country would have to pay a contribution: 1% (debt -60% GDP)) +1% (Deficit-3% GDP). A country in distress could lend, without conditions, an amount corresponding to its past contributions. To obtain more, he would have to accept an adjustment programme. If he does not respect this programme, it would incur penalties like suppression of its structural funds, suppression of the acceptance of its debt as collateral by ECB, suppression of its voting rights, and could to be thrown out the Euro zone. But 3% and 60 % remains arbitrary. It is difficult to impose fees on a State who already has financial difficulties. Too much conditionality, too much fees will increase the speculation on the Markets, which may make impossible to restore the situation. Often, this State is not totally responsible of these problems. The proposal does not deal with the countries which practice too restrictive policies.

Delpla and von Weizsäcker (2010) propose to introduce a *blue debt*, collectively issued and guaranteed, limited at 60 % of each country GDP. Each year, each country parliament will have to vote to accept the emission of new debts (which mean that German parliament would have to agree about French deficit, for instance, and conversely). Each country could issue *a red debt* on its own responsibility. As the red debt will have a higher interest rate, it would discourage public debts. But public debt may be useful; 60 % remains an arbitrary level. The discrepancy between the blue and the red debt will be observed and will influence fiscal policies?

In the next years, the importance of public debts increases the risk to have a strict monitoring of public finances by the financial markets. But is it not satisfying as financial markets do not have a macroeconomic perspective, are pro-cyclical (they will impose effort in bad times) and self-fulfulling. They have there own view about the required economic policy; is it the good one? The risk is that member states make enormous efforts to escape to the financial markets powers by too much contracting public deficits. What would happen in 2009 if States have refused to help banks to avoid to borrow on the financial markets? Can we let to the financial markets the task to appreciate the sustainability of public debt and the usefulness of public deficit?

The crisis requires a rethink of European economic rules and of national policy coordination. The current financial speculation thrives on failures of the European economic framework.

The uniqueness of monetary policy and exchange rate is not compatible with the disparities between fiscal policies, wage developments and economic situations. The Greek crisis shows the implicit solidarity that currently unites the Member states public finances in the euro area. However, there is a deep divergence between two views:

- For a *German* view, we must first strengthen the SGP and its ability to effectively influence fiscal policies. Countries should be forced to return quickly to public finances equilibrium. Countries should adopt the German fiscal brake. Those who refuse and who practice too lax fiscal policies should be excluded from the Euro zone. “Orderly default” of a member state should be prepared. Countries should focus on structural reforms and competitiveness improvement to recover growth. As the present situation will oblige many countries to ask for the financial guarantee of the others members states, particularly of the member states the best quoted by the markets, these virtuous members will be able to impose their views. The risk is that the maintenance of the euro will be paid by the strengthening of absurd rules, which will keep the area in recession and deprive it of the fiscal policy. .

- For a *French* view, the coordination of economic policies must lead to a macroeconomic strategy designed primarily to support growth and return to full employment. Public deficits are necessary to support economic activity, so we must replace the rigid rules of the SGP by a coordinating process taking into account the circumstances (inflation, unemployment and external deficits); the coordination should include policy wage policy and financial policy. The euro area should be strengthened by removing the institutional barriers to an efficient coordination of economic policies and by developing a comprehensive and flexible strategy which will take into account national differences. But, such a strategy will not be easy to implement: MS will refuse to transfer more powers to Europe, without guarantee on its policy. Managing diversity is very difficult: how convince the Germans to increase their wages, Spanish and Greek to reduce theirs? The member states, the EC and the ECB will have to recognize that they guaranty all member public debts (but this is against the Treaty and how to act against really too lax country?).

The 25th March 2010, the European Council stipulated: “We commit to promote a strong coordination of economic policies in Europe. We consider that the European Council must improve the economic governance of the European Union and we propose to increase its role in economic coordination and the definition of the European Union growth strategy. The current situation demonstrates the need to strengthen and complement the existing framework to ensure fiscal sustainability in the euro zone and enhance its capacity to act in times of crises. For the future, surveillance of economic and budgetary risks and the instruments for their prevention, including the Excessive Deficit Procedure, must be strengthened. Moreover, we need a robust framework for crisis resolution respecting the principle of member states' own budgetary responsibility.”

This text can be seen as a compromise between the German and the French views. But is an ambiguous compromise what we need?

On May 12th, the European Commission publishes a communication: “Reinforcing economic policy coordination”. It proclaims that “the rules and principles of the SGP are relevant and valid”. It estimates that “national fiscal framework should better reflect the priorities of EU budgetary surveillance”. It proposes to improve the functioning of the EDP, to give more prominence to public debt criterion, to use the EU budget to oblige MS to obey to the SGP rules. But why and how reinforce a Pact which appears inadequate? It proposes to reinforce the surveillance of macroeconomic imbalances by considering currents accounts, employment, competitiveness, asset prices and private sector credit, by covering macro-prudential aspects, by addressing the functioning of labour, product and services markets. It proposes a "European Semester", where all MS would present their fiscal and structural policies to the Commission and the European Council before the votes of their national parliament.

This project will be an evolution towards more fiscal federalism, but it raises three issues: fiscal decisions will be more and more taken by non-elected bodies; EC do not give up the non-economic based components of the SGP, as the 3% and 60% rules, the equilibrium medium term objective, or fiscal policies cannot be based of theses arbitrary rules; EC want to increase the *surveillance* of national policies, which mean that EC will not try to introduce a comprehensible macroeconomic strategy, which should include more expansionist policies in some countries and higher public deficit and debts if necessary. In theses times of economic crisis and of financial markets frenzy Euro zone need effective economic policy coordination.

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