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# Institutional challenges and alternatives:

# Revision of fiscal rules in the EU

Mogens Ove Madsen, Aalborg University

**Abstract**

Fiscal policy in the EU crisis management has been given an overly restrictive role. Even the fact that the ECB has, at its own discretion, launched a QE policy - to notice after the fiscal tightening - has not had the expected impact on investment activity or inflation rate in Europe. Similarly, public investment has not been used sufficiently as an anti-cyclic instrument. Financial policy must be given a greater role in EU cooperation.

## Introduction

At the beginning of the 1990s, it was not easy to see the way in which economic integration in the European Community would go. But from the mid-eighties a so-called Eurosclerosis was replaced by an initiative to release market forces. This happened with the establishment of the single market. It was a political decision that had far-reaching consequences, which it later would prove to be in the context of the financial crisis.

These kinds of initiatives ultimately challenge the economic textbooks of the day, as the intentions, but not all the consequences of implementing the Internal Market, were known. On the other hand, the notions of the following monetary union were at this time a pure desktop exercise (Delors and Christophersen, 1989). And since then, the EC has become the EU, EMS has become Euro and a Growth and Stability Pact was introduced - all while one treaty replaced the other.

The formation of the single currency - the euro - has of course, as a reality experiment attracted much interest. This applies to both a political debate, but also as an economic theoretical debate. There are simply widely different perceptions as to whether a sustainable single currency can survive in Europe. This is reflected, inter alia, in the difference between a Keynesian-inspired theory of what constitutes an optimal currency area (OCA) and a monetarist-inspired concept for the creation of the Euro.

However, the OCA-criteria was abandoned in the Commission's 1989 report, 'One Market, One Money', and it referred to recent developments in macroeconomic theory. Here the question of the credibility and effectiveness of economic policy was questioned, and it could be perceived as a badly hidden monetarist criticism of OCA theory.

The Delors/Christophersen report contains the criteria proposed by the EC Commission for the preparatory period in the form of 3 phases of economic and monetary union and the euro area, ranging from 1990 to 1999.

The interesting thing about these phases was primarily how the convergence requirements look. There was no reference to economic conditions such as production, investment or unemployment - confirming the monetarist approach, where market forces are given great significance which can smooth the real economic imbalances. Instead monetary convergence requirements was formulated, in particular the requirements of inflation, interest and public finances.

An interesting question was whether the countries were ready to determine the critical level of economic integration with the exchange of own currency for a single currency? Thus, consideration should be given to gains and losses by changing the regime for each candidate country. In such circumstances, consideration should be given to whether gains from EMU in terms of transaction costs, increased cost transparency, etc. would be offset by potential losses in production and employment.

Trade between countries could be difficult to use as an argument. From the mid-80s to the envisaged start of the euro, inter-regional trade in the EU is only between 10-20% of GDP (Eurostat Yearbook, 1997, 2000).

In terms of workers mobility, many studies from the 1990s shows that there was much less geographical mobility in Europe compared to the United States. Some of the explanations for this were that the housing market is differently designed, that there is high long-term unemployment and different forms of job protection (Eichengreen, 1991; Peter Huber, 2004). Linguistic and cultural differences could also respond to the lesser extent of mobility in Europe.

Fiscal integration was not a focus point of the phase-in of monetary union. The EC/EU budget was at this time approximately 1% of the total GDP of the countries and divided widely into two main areas, agricultural policy and structural funds. This was not changed before or after the introduction of the Euro, but there was an addition in the form of the Growth and Stability Pact, which gave the participating countries two main requirements for fiscal policy compliance with the requirement of a maximum 3% deficit on the public budget of GDP and a maximum of 60% government debt of GDP. That was, the same sizes as those contained in the convergence requirements.

**Launching the euro**

The first years of the euro were striking in the sense that the economic conditions, such as prices and interest rates, converged between the participating countries, but it looked more problematic regarding real GDP, competitiveness and unemployment. The latter therefore pose problems for the two other convergence requirements, government budget deficit and debt ratio and thus the possibilities of securing autonomy around fiscal policy and in case of economic crisis, let the automatic stabilizers work fully.

In addition, the differences in competitiveness between the participating countries in the euro-area resulted in two classes of countries. On the one hand, competitiveness was improving in Germany, Austria, the Netherlands, Luxembourg and Finland and, on the other hand, there was a deterioration in the competitiveness in the so-called PIIGS countries (Portugal, Ireland, Italy, Greece and Spain). As a consequence, the first group of countries got a current account surplus, while the other group of countries got a deficit.

The development of a budget deficit in the years to the financial crisis was just a part of the problem. Both Germany and France exceeded the 3% deficit rule in the period 2002-2005. And even though the Commission initiated a financial punishment in 2003, the Council did not approve the amount of the fine - instead, it was subsequently taken an initiative to ease the Growth and Stability Pact slightly.

Apparently, there was no incentive to reduce the debt ratio in the period 2001-2008. Countries like Italy, Belgium, Austria and Greece remained more than 60% of the debt line. They should not really be admitted to the Union in the first place. Apart from 2001 and 2002, Germany and France make the same. From 2005 onwards, Portugal also exceeds this rule. There is no critical view of creditors on lending to a country in the Euro-area as it would be in a single country with its own currency. Risk of devaluation and state bankruptcy may be eliminated by the fact that the countries in the monetary union are respectively excluded from devaluing and not wanting a participating country goes bankrupt.

**The euro in crucial exam**

The Growth and Stability pact's fiscal rules were challenged in 2008 (Madsen, 2008). Deficit and debt problems, especially in the PIIGS countries, resulting from both housing bubbles that bursted and what we now know of derived interbank issues from the US subprime crisis (Tooze, 2018) provided a special occasion. European politicians in 2012 tightened up the sovereign requirements, as they have been formulated in the Growth and Stability Pact so far.

It is suddenly clear that the transition from a fixed-rate cooperation to a single currency sat a new agenda for which economic policy instruments could be used. Competitiveness policy was no longer handled as an exchange rate instrument, but was replaced by internal adjustment of salary and price levels. That was a special requirement in those countries that encounter refinancing problems in relation to their sovereign debt. Thus, these countries must face a long recession period.

The following tightening of the common fiscal rules was put in place in order to curb the sovereign debt problems: First, the so-called Six-pack is being established, which aimed at tightening up the rules for monitoring national budgets. Subsequently, a so-called Stability Pact was adopted, which intends to tighten up the deficit criterion by introducing a new structural deficit, where a structural public deficit purified by cyclical fluctuations should not exceed ½%. At the same time, a debt crunch was established, which meant that countries with a higher debt ratio than 60% over a number of years had to bring this percentage down to the limit value of 60%. If these rules not were respected, sanctions would be imposed on this policy.

These latest measures should be seen as an attempt to set stronger limits for the long-term fiscal system. It is not a presentation of a growth-promoting policy. On the contrary, both the Six-Pack and Stability Pact would immediately be anticorrosive and thus help to prolong the economic crisis that followed the financial crisis.

In summary, one can say about this period that economic integration succeeds in terms of monetary convergence in terms of inflation and interest rates. On the other hand, it is becoming increasingly clear that other economic conditions are worsening in the form of stagnant growth and rising unemployment in most countries.

**Austerity and unemployment**

This divergence between nominal and real economic conditions challenged the monetary union. Therefore, it is not surprising that in recent years there has been a debate about how to handle the high unemployment rate and especially the high youth unemployment rate in the EU and whether the Euro-structure is the right form of monetary cooperation in Europe.

The point of tightness policy or austerity policy is that the government budget deficit must be reduced despite the high level of unemployment in the private sector (Grauwe, 2012).

The attempts to reduce a consequent public deficit are closely related to a political desire to demonstrate the ability to honor the diverse creditors' expectations and to create goodwill with dominant credit rating agencies

Total government debt in relation to gross domestic product in EU had also moved in the wrong direction, rising from 80 per cent in 2010 to 93 per cent in 2014. Thus, the austerity policy had broken the link between stability and growth in the euro area.

The interesting thing here is the order. First, fiscal rules were tightened and then monetary policy was facilitated, so that the arguments for tightness policy are reduced. The European Central Bank could have prevented the panic that led to the spread of interest rates on the various countries' government bonds, but obviously it awaited the further tightening of fiscal policy.

The European economy was double hit. On the one hand, there was an extreme tightened policy in southern Europe with sharp worsening of welfare benefits and, on the other hand, the lack of demand stimulation in the northern European countries (Smaghi, Lorenze Bibi, 2013).

Overall, the strong fiscal tightening for a number of countries will cumulate by 2020 and presumably correspond to about five percent of the euro area gross domestic product. The situation is that this average of five percent is very different among the countries. Germany will be hit least, while countries such as Greece, Ireland, Spain and, to a lesser degree, Portugal and Italy are affected the most.

This will further reinforce the differences between the center and periphery of the euro area and Europe as a whole. And thus it will also sharpen the opposites between Germany and a large number of other countries in the EU. Not surprisingly, there is not much gain in the EU's limited regional policy, which should be a counteracting force in relation to the increasing distortion and freezing of major unemployment populations.

It has never been in Germany's interest that regional policy focused on industrial development in the periphery. Instead, there has been a focus on the development of infrastructure and the tourism industry. And even the unused regional funds, as mentioned regularly, have no weight at all for reading a change in unemployment figures.

It is indeed the fierce irony of fate that Europe has had hard time learning from historical experience. It is no coincidence that some economists now re-read John Maynard Keynes's "The Economic Consequences of the Peace" of 1919, where Keynes argues that it has no reason to impose very large war injuries on Germany because it would ultimately result in too big financial problems for Europe as a whole. In fact, Keynes describes in the book that it would be sensible to form a trade union with Germany as anchor country. Such a union should go all the way to Russia to get this economy integrated into Europe as well.

This time the belt is not tightened around Germany, but mainly around the peripheral countries of the EU and especially the southern European countries. Proposals for a salary reduction in Denmark and other countries that will follow the German road will, together with the procedural requirements of the tighter growth and stability pact lead to further deflation in Europe by 2020.

The agenda for Europe must be changed.

**Prospects for debate**

There was clearly no obvious economic theory behind the establishment of Economic and Monetary Union. This can be decoded by reading the Delors/Christophersens report and later in the Maastricht Treaty. The political program formulation regarding the establishment of a single currency emphasized the importance of monetary and non-real convergence criteria which meant the level of long-term interest rates and inflation combined with restrictions on the participating countries budget and gross debt. In particular, the long-term interest rate was assigned a crucial and corrective role, as this reflects whether a country is able to maintain fiscal discipline.

Fiscal discipline is linked to the primary purpose of ensuring a low and stable development in inflation, which in the long term can lead to convergence in the countries' long-term interest rates.

But this has not been successful. The European growth rate with 8 years of zero growth is so weak that unemployment is 8.5% in the euro area ten years after the Global Financial Crisis, but now below 4% in the United States.

The political mix that the EU authorities respond to is fiscal tightening and wage cuts. This is a policy that is responsible for the depth and duration of the economic slowdown in Europe. This is further underlined by fiscal tightening in response to the Global Financial Crisis in the form of Six-Pack, Fiscal Compact and Two-Pack.

From a post-Keynesian point of view, fiscal policy in the EU crisis management has been given an overly restrictive role. Even the fact that the ECB has, at its own discretion, launched a QE policy - to notice after the fiscal tightening - has not had the expected impact on investment activity or inflation rate in Europe. Similarly, public investment has not been used sufficiently as an anti-cyclic instrument.

When it comes to the common crisis management 10 years after the outbreak of the Global Financial Crisis, there are good reasons to discuss whether the fiscal framework should be re-designed from scratch.

It will require treaty changes, but it will probably be easier to change the Stability and Growth Pact.

The starting points for discussing a change in fiscal policy rationale are due to several factors: Firstly, the relationship between the EU budget and the national public budgets. Secondly, the possibilities for providing space for the automatic stabilizers to be able to fully play. Thirdly, the relationship between the center and peripherals in the EU, including Germany's special role.

The idea of a further work could be to list a number of scenarios for change in fiscal rules. As an example public investment could be given a special status and also to elaborate on a proposal that leaves greater degree of fiscal independence to the individual countries combined with a cyclical stabilization mechanism at the European level.

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