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Nicos Christodoulakis

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Aspects of Economic Governance in the Euro Area:

Restoring Internal and External Balances

Nicos Christodoulakis[1]

Abstract: The Economic Governance for the Euro Area is envisaged to be both an overseeing framework that enables the timely identification of oncoming trouble, as well as a correction mechanism that puts an economy hit by major shocks back in order. The paper discusses the relevance of prevention and correction mechanisms, and finds that exclusively focusing fiscal policy on debt sustainability may be misleading for all and more harmful to the weaker economies in particular, unless internal and external imbalances are taken into account. The fiscal rule should be designed so as to be compatible with debt sustainability in the medium run but also allowed to respond to short term output and current account fluctuations. The micro-management of fiscal components with regards to political feasibility and social equity is also discussed.
Keywords: Euro Area, public debt, fiscal policy, external balance. *JEL-codes:* E63, F15, H63.

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[1] Athens University of Economics and Business (AUEB) and Hellenic Observatory, London School of Economics. Address for correspondence: AUEB, 76 Patission street. Athens, GR10434.

1. Introduction

The Economic Governance (EG) for the European Union (EU) is envisaged to be both an overseeing framework that enables the timely identification of oncoming trouble, as well as a correction mechanism that puts an economy hit by major shocks back in order. Though the framework covers the whole of EU, the debate is particularly intense within the Euro Area and the reason is that the global financial crisis of 2008 and the subsequent debt crises in 2010 have had far more dramatic consequences for its economies, especially after some of them asked for extensive rescue programs and the rest had to bail them out. Since both crises escaped the early detection of European surveillance, it is natural to expect that the new framework would primarily enable both debtor and creditor nations of the Euro Area to avoid similar adversities in the future. This has led several to see the current debate simply as a wiser-after-the-event reaction to the crises, but fair is to say that the roots of the subject go back at the inauguration of the Economic and Monetary Union (EMU) or even before; a summary of the main steps in improving fiscal surveillance in the European Union during 1994-2008 can be found in Noord et al (2008, Table 1).

The reason for the early acknowledgement of the issue was no other than the famous 'incompleteness' of EMU, in the sense that the full integration of monetary policy through the creation of the European Central Bank (ECB) was not matched by a similar institution of fiscal union as that envisaged by Mundell (1961) for a currency area to be viable and optimal. A politically feasible substitute amounted to the enforcement of the Stability and Growth Pact (SGP) plus a number of overseeing and consultation processes between EU authorities and national Governments which were constantly debated and improved ever since.

As noted by Noord et al (2008) these improvements resulted in a better fiscal position for the overall EU: for example, in 2006 the debt ratio came back on a declining trend, while in 2007 the aggregate EU government deficit was at the lowest level for more than thirty years. Even fiscally-hawkish institutions, like the IMF, were positively assessing the early period of EMU decision-making and did not feel obliged to suggest a further centralization of fiscal policy. For example, Annett et al (2005) saw no case for major changes to Europe's fiscal rules and advised that the Excessive Deficit Procedure (EDP) focus more on policies rather than outcomes,

while staying operationally simple and transparent. But then the financial and debt crises hit the Eurozone and made all the early complacency to melt in the air.

The aim of the new framework is not to marginalize its precursors, such as the SGP, but rather to enrich them by introducing more concrete and effective ways of enforcing them in practice. The proposals that have been put forward include a continuous monitoring and evaluation of economic imbalances of member states, both domestic and external ones. After several intermediate steps have been taken over the recent years (including financial mechanisms, the Fiscal Compact, and monitoring procedures), the main pillars of the new framework were crystallized in the so-called 'Five Presidents' Report (FPR) by Juncker et al (2015) and include the following:

One set of proposals concerns fiscal management in member-states so as to enhance credibility, transparency and efficiency in applying the rules of SGP. The national institutions entitled with the implementation of fiscal policy are going to be supervised by an independent Fiscal Council, while the implementation mechanism will rely on an Automatic Fiscal Stabilizer within the fiscal jurisdiction of the country concerned. In case that a national budget is overwhelmed by a severe crisis, the possibility of union-wide Treasury is tentatively discussed, though its creation and function are left for the longer term.

Another set includes the monitoring of external balances of member-states in conjunction with developments in unit labour costs and competitiveness. As with the fiscal front, a National Productivity Council is envisaged to gauge developments and lay out the appropriate reforms through the Macroeconomic Imbalance Procedure (MIP). In addition, the European Fund for Strategic Investments is expected to support growth efforts by member states, while the Banking Union will be completed by a European Deposit Insurance Scheme that provides stability in the financial sector and thwarts contagion effects from fiscal imbalances to the banking sector and vice versa.

After the publication of FPR, a number of academic and policy studies dealt with many aspects of the new framework. Fully covering the literature is beyond the aim of the present article but a concise description of Economic Governance can be found in, for example, De Streel (2013) and also in Delivorias (2015). The present paper

focuses on a few questions with regards to the applicability and effectiveness of EG as described below:

First issue is whether EG predominantly concentrates on budgetary targets and fiscal management or should embrace a wider set of economic indicators. Recently, an official report by the European Commission[2] stated that Economic Governance 'aims to detect, prevent, and correct problematic economic trends such as excessive government deficits or public debt levels, which can stunt growth and put economies at risk". The priority that is given to the budgetary situation will inevitably result to stringent fiscal management and intertemporal adjustment programs in order to strengthen credibility and achieve debt sustainability in the medium run.

Additionally, concern is expressed on external imbalances either between member-states or with regards to the rest of the world. There exist a number of proposals on how competitiveness is monitored, but they are yet to be seen how effective they will be in avoiding over-accumulation of external surpluses. The fact that budgetary targets are specifically set, as opposed to the vagueness of facing external asymmetries, may lead to a contractionary bias in fiscal management that will not be helpful in enhancing growth or reduce imbalances in the monetary union.

Whatever the causes that led a budgetary indicator to derail in a specific country, a correction through prolonged fiscal contraction may totally miss the point if its economy is, at the same time, hit by deep recession. A 'positive-feedback' situation may occur if public surpluses are raised to reduce indebtedness but – thanks to Keynesian multipliers - activity slows down to a greater extent, thus making the debt-to-GDP ratio to rise further and new measures to be needed perpetuating the crisis. The experience of such 'doom-loop' austerity policies in the European periphery since 2010 is too recent to be ignored; for a discussion see De Grauwe and Ji (2013), and Christodoulakis (2014) among many others. Even under less extreme circumstances, Fitoussi and Saraceno (2012) warn that if too much emphasis is given

[2] http://ec.europa.eu/economy_finance/economic_governance/index_en.htm

in achieving intermediate targets of macroeconomic stability it risks ignoring the pursuit of the ultimate objectives of growth and full employment.

Second issue is whether policy actions should (or even be allowed to) be symmetric with regards to the direction of deviations from targets. Why, for example, a country that pursues competitive policies that result to external and/or budgetary surpluses, instead of being hailed as champions, must be penalized in a similar way with a member-state which, by neglecting such policies, suffers from current account and/or fiscal deficits? The implication of this argument is that only deficit-ridden economies should have to be corrected without expecting any burden sharing by those in surplus, not even in the form of an expansion that would mitigate their own cost of adjustment. In a regime of fully-fledged fiscal federalism, burden sharing would be much easier to be handled collectively but, as noted by Catania (2011), this entails some transfer of sovereignty and is currently beyond any realistic consideration. For the time-being, Verhelst (2011) argues that the existing Treaty provides that a member state is solely responsible for its debt, thus commitments on undertaking support of other members cannot be assumed, nor are they allowed to explicitly share the debt burden of others.

Despite such formal clarity of the Treaty, the recent experience of bail-out programs suggests that if crisis spillovers hit the Euro Area as a whole, it is preferable that emergency collective action is undertaken by all members of the union rather than let everyone face the consequences alone. Another reason of burden sharing is that, sometimes, the origins of a crisis in the public finances of a particular country may lie outside the public sphere or even the country itself.

The notable example is the banking sector. An informative report prepared by the House of Lords (2011) on the roots of the crisis and the future of Economic Governance in the EU, notes that 'one of the principal elements that contributed to the current crisis' was the '*interconnection* of the sovereign debt and banking sectors', (my emphasis). Accordingly, the report suggests that '[m]echanisms must be put in place to control the behavior of banks and to ensure that the public sector does not end up carrying the cost of failing banks'. In such cases, burden sharing should involve other sectors of the economy and other countries as well, otherwise fiscal correction will unduly suppress economic activity in the particular country.

A final issue concerns the applicability of Economic Governance and which member-states are obliged to implement it. As the framework mainly aims at averting another debt-crisis in the Euro Area, the non-Euro countries will probably oppose the uniformity of stringent fiscal rules that might be irrelevant for their priorities or even hinder growth and employment. In fact, little progress toward more economic governability was achieved even during the smoother pre-crisis period: De Areilza (2013) notes, for example, that member-states strongly resisted the implementation of Lisbon Strategy though it was mostly a consensual growth-agenda rather than a despicable recipe of fiscal contraction. More recently, there has been a clear differentiation between Euro Area and non-Euro economies in the attempt to qualm the fears that EG would entail surrendering UK's economic sovereignty to Brussels.[3] In the aftermath of Brexit, it is likely that the remaining non-Euro economies would rather distance themselves even more from the provisions of EG. Hence, it is perhaps more productive to concentrate on how Economic Governance is primarily applied to the Euro Area economies. If the implementation is successful, it will then create an ambitious benchmark that none of the non-Euro economies will be able to ignore.

In view of the above, the present paper focuses on Economic Governance in the Euro Area (EGEA for short). After discussing the relevance of prevention and correction mechanisms for the weaker economies that were engulfed in the 2010 crisis, it finds that letting fiscal policy to exclusively focus on debt sustainability may turn out to be overly expansionary in good times or insufficiently active in bad times. To avoid the costs of inflationary or deflationary pressures respectively, it suggests that fiscal management incorporates targets for internal and external balances. To this purpose, the fiscal rule should be designed so as to be compatible with debt sustainability in the medium run but also allowed to respond to short term output fluctuations and current account imbalances.

The rest of the paper is organized as follows: Section 2 discusses the macroeconomic indicators that are likely to be used as warnings for oncoming troubles in the economy and examines their usefulness in detecting the 2010 crisis. Section 3 examines how current account deficits were dealt with in the bail-out programs,

[3] In February 2016, then UK Prime Minister Cameron got an important concession that EU is differentiated from the Euro Area so that economic governance rulings for the common currency do not affect pound sterling; see https://www.gov.uk/government/speeches/prime-ministers-speech-on-europe

while Section 4 argues that policy action should be undertaken to correct both deficit and surplus deviations. Section 5 proposes that fiscal policy should address sustainability in the medium term but must be also tuned to fight off deviations from internal and external balance in the short term. Section 6 discusses how the various components of fiscal policy have to be combined so as to increase efficiency and equity, and finally Section 7 concludes.

2. Looking for trouble? The limitations of fiscal indicators

A crucial choice in the design and implementation of EGEA is the set of indicators that are going to be monitored in the hope that they provide an early alertness against oncoming trouble. As they currently stand, the provisions of EG focus specifically on the size and sustainability of public debt so that the limit 60% of GDP becomes truly operational in the future as opposed to the vague attention it has received in the past; see (EC, 2015, p3). In the same spirit, a recent IMF paper deals with the operational aspects of EG and proposes that "[a]s a stock variable, the public debt-to-GDP ratio is considered a natural anchor for capturing repeated (cumulative) fiscal slippages that flow variables, like the budget deficit, would not capture"; see Andrle et al (2014).

Though the above suggestions look inevitable after the experience of exploding debt episodes in the Euro Area, they may not necessarily represent the key issues that have to be addressed in a crisis. This may happen because a future crisis may not necessarily stem from the same sources and imbalances. Moreover, debt and budgetary indicators proved to be quite misleading even with regards to the 2010 crisis as discussed below.

By now it has become common wisdom that the crises that took place in Greece, Ireland, Portugal, Spain and Cyprus between 2010 and 2015 were not mainly due to the stock of debt per se but to the lack of liquidity brought about by the international credit shortage that made large external imbalances impossible to be financed any more. In this line, Krugman (2011) explained that the crisis in the southern Euro area countries was triggered by the sudden stoppage of capital inflows that were required to finance their huge *external deficits* rather than through cumulative imbalances of the past. More specifically, Barrios et al (2009) note that the explosion of sovereign

spreads that sparked the crises of the European periphery occurred in countries with large *external deficits* even if their fiscal position looked healthy.

To further illustrate the point, it is logical to assume that a minimum requirement of a prevention framework is that it must be found appropriate in foretelling the Euro Area crisis if applied retro-actively. A simple demonstration is presented below by looking at three sets of indicators over the pre-crisis period 2006-2008:

Fig. 1 shows the average of public debt to GDP in the years preceding the crisis for the 12-member Euro Area. Of the bailed-out countries, only Greece would have been spotted for trouble, while Portugal, Spain and Ireland seemed to be safely away from the hazardous zone. The alarms would have rather sounded for Italy and Belgium, though subsequently none of them experienced a fiscal pressure big enough to be unable to control. As noted by Belke (2011), such an alarm would have "misse[d] the point because the fundamentals of Spain and Italy, especially in their self-financing capacities, appear[ed] much stronger than those of, for instance, Greece, and Portugal". The irony was that although the dramatic events were dubbed as a 'debt crisis', public indebtedness was in fact seriously deteriorated by the front-loaded austerity programs applied in these countries.[4]

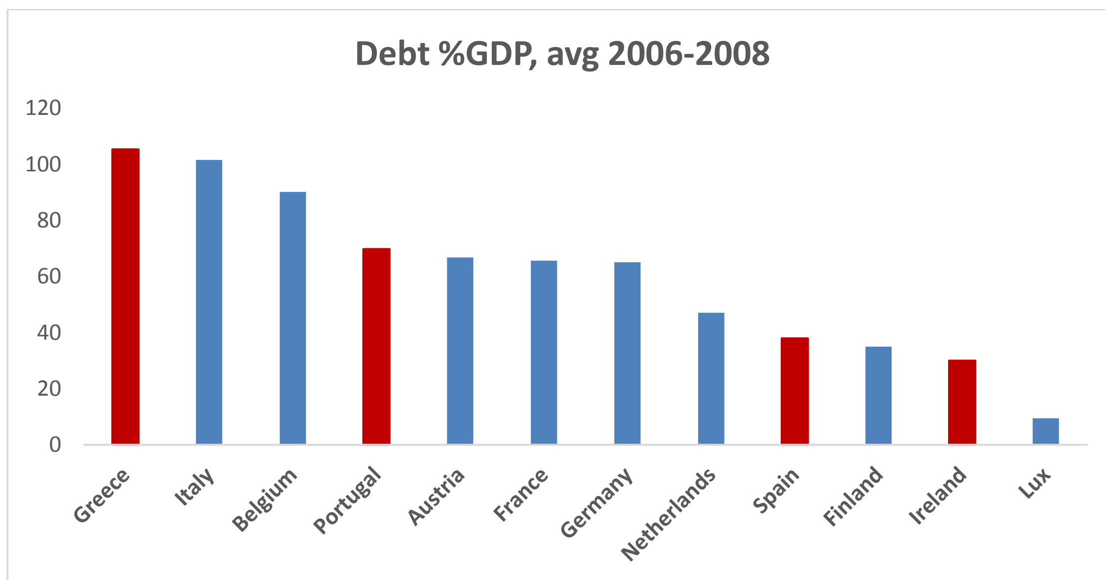

Fig. 1. Debt to GDP ratios, prior to the debt crisis

[4] As opposed to the debt levels shown in Fig. 1, in 2015 Greece had a debt-to-GDP ratio of 177%, Ireland 79%, Portugal 128%, Spain 101% and Cyprus 107%; figures from AMECO database.

Note: Red bars indicate the bailed-out countries. *Source:* Ameco Database

Fig. 2 shows the average of General Government balances as a percentage of GDP prior to the crisis. Again, only Greece is found to be in the spotlight. Portugal had a deficit marginally smaller than the SGP threshold of 3%, while Spain and Ireland looked to be fiscally healthy economies with no sign pointing to the oncoming pressures. Begg (2011) states that at that time 'the Irish and Spanish economies were poster boys of the euro area [and] nothing in their budgetary indicators predicted … the surge of debt'. In fact, the overall position of the Euro Area but Greece seemed to be fiscally robust rather than in peril.

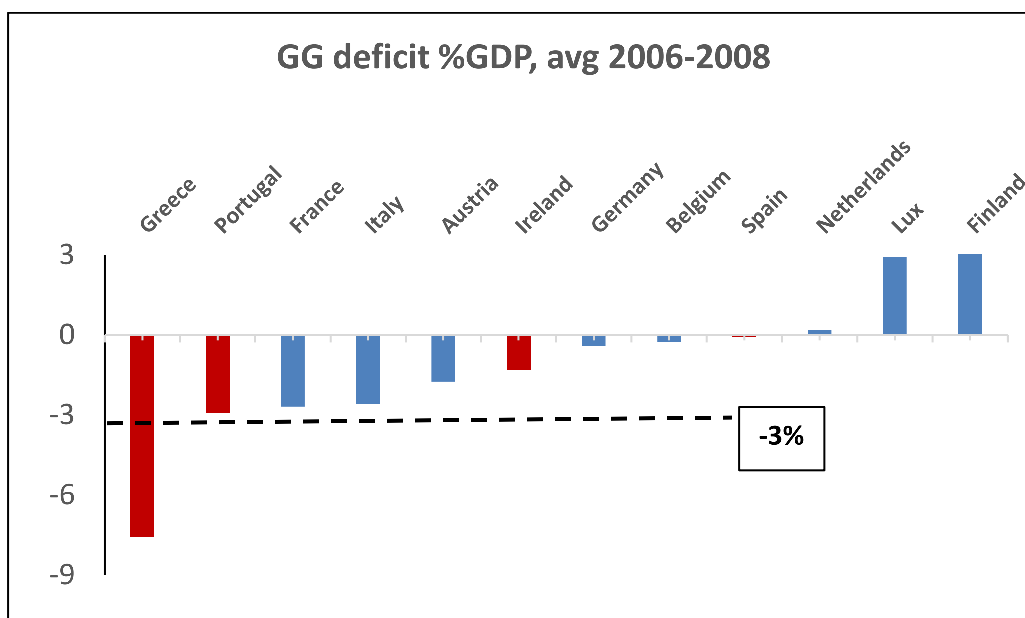

Fig. 2. General Government deficits as percent of GDP, prior to the debt crisis
Note: Red bars indicate the bailed-out countries. *Source:* Ameco Database

Finally, Fig. 3 shows the average of external deficits over the same pre-crisis period. Now, all of the bailed-out countries are found to be the most vulnerable among the Euro Area economies.[5] At the time of the crisis, this was perhaps a big surprise for a union where external imbalances were thought of never being able to threaten its

[5] Similar conclusions apply for Cyprus, where the current account deficit was -10.9% of GDP in average during 2006-2008. Again, budgetary indicators looked healthy indeed: public debt was 52% of GDP, while General Government balance was at a surplus +1.03% of GDP.

coherence since the common currency had ruled out hostile devaluations. It took a painful realization for the Euro Area to admit that ruling out a traditional response to an old problem is one thing, while dealing with the problem itself remains quite another.

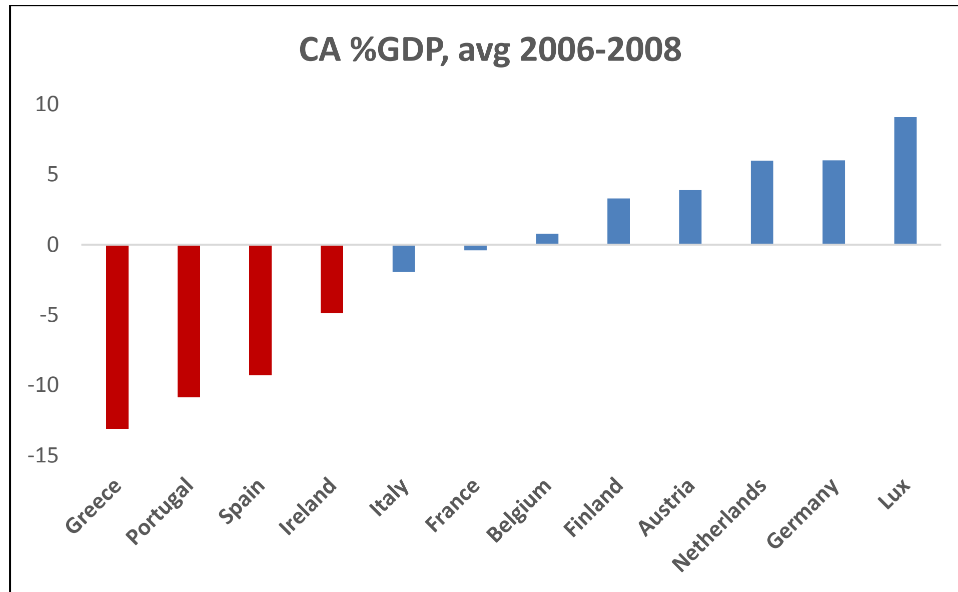

Fig. 3. Current Account balances deficits as percent of GDP, prior to the debt crisis
Note: Red bars indicate the bailed-out countries. *Source:* Ameco Database

Summing-up, one can easily see that, with the exception of Greece, the use of public debt and deficits would have very little usefulness in the prognostication of the crisis that hit the Eurozone in 2010. Portugal, Ireland, Cyprus and Spain would have passed unnoticed as none of them was posing any serious budgetary problem at that time. Even for debt-ridden Greece, it seems that the crisis accelerated due to confusion over its true character: according to Feldstein (2012), 'what started as a concern about a Greek *liquidity problem* – in other words, about the ability of Greece to have the cash to meet its next interest payments – became *a solvency problem*, a fear that Greece would never be able to repay its existing and accumulating debt', (my emphases).

The retroactive inspection shows the limitations of using only fiscal indicators as warning signals for an oncoming crisis in the Euro Area. In contrast, paying attention to the external imbalances could have provided policy-makers with much sounder warnings on the nature and severity of oncoming trouble.

3. Addressing the External Balance

Gauging adverse developments in the external position and design appropriate policy actions was never central in the agenda of EU policy-making either before or after the creation of the EMU. As noted by Christodoulakis and Sarantides (2016), the issue was never formally considered as an explicit target in the EMU Treaty, probably because it was difficult to imagine that external imbalances would diverge so dramatically after the launch of common currency. The EMU project was in fact based on the optimistic assumption that - as a result of the monetary unification - increased factor mobility would foster growth and competitiveness across countries, to an extent enough to redress any serious imbalances emerging in their current accounts.

To correct the omission this time, the Economic Governance framework now includes the Macroeconomic Imbalance Procedure (MIP) as a surveillance mechanism for detecting serious deviations that may threaten the functioning of the Euro Area. Regarding the external sector, imbalances are seen as critical if the current account is in a deficit larger than -4% of GDP or in a surplus above 6% of GDP on a three-year average; see EC (2012, p4). To monitor developments in competitiveness and devise appropriate policy actions, the Ecofin has already suggested the creation of the National Productivity Council (NPC) in each country.[6]

The key factor to be considered seems to be the unit labour cost (ULC) on the assumption that it is the main determinant of competitiveness in world markets; see EC (2012, p 14). Therefore policy recommendations will likely focus on the implementation of an 'internal devaluation' process that includes wage-setting agreements and labour market flexibility as the quick antidote to the deterioration of

[6] http://data.consilium.europa.eu/doc/document/ST-10083-2016-INIT/en/pdf

competitiveness. For countries with external surpluses a correction mechanism is not yet specified.[7]

Hence, it is interesting to see whether and how external deficits were indeed corrected in the bail-out countries after such policies were implemented. Fig. 4 shows that improvements in the ULC-based productivity index are moderately correlated with the reduction of labour costs in Greece, Portugal, Italy and Spain, thus the effect of internal devaluation is only partially corroborated by evidence.

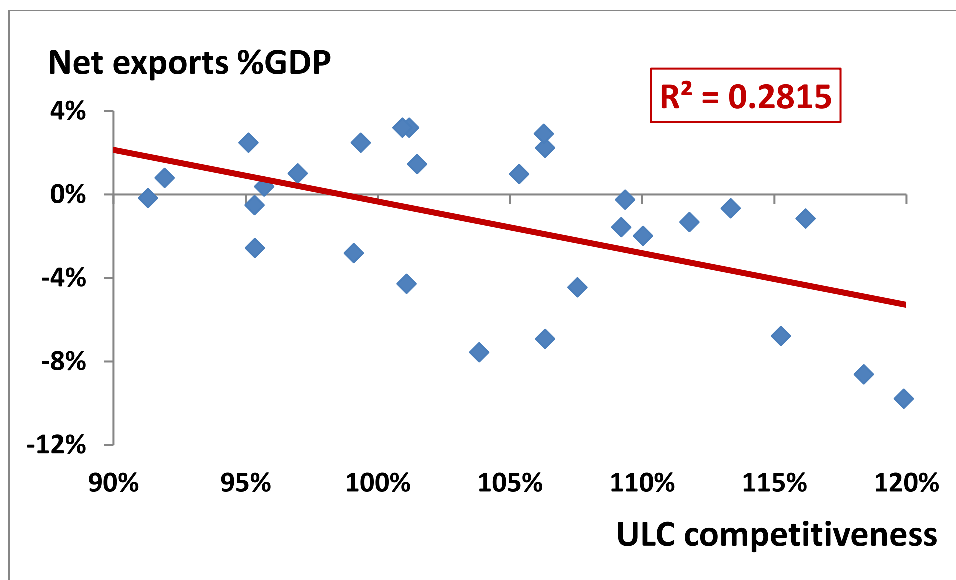

Fig.4. Correlation of net exports and ULC-based competitiveness

Note: Countries include Greece, Italy, Spain and Portugal over the period 2009-2015. ULC stands for the harmonized competitiveness indicator based on Unit Labour Cost for the total economy, (1999q1=100). Annual average. *Source:* Ameco Database; ULC competitiveness from ECB.

Another factor for improving trade imbalances in those countries was the implementation of austerity measures that helped to contain aggregate demand and imports. Taking primary public surpluses as a measure of austerity applied in those countries, Fig. 5 shows a similar moderate correlation with net exports.

[7] As noted by Breuss (2013), the present framework leaves surplus Germany without sanctions. Whether it turned out to be so accidentally or by design is not investigated.

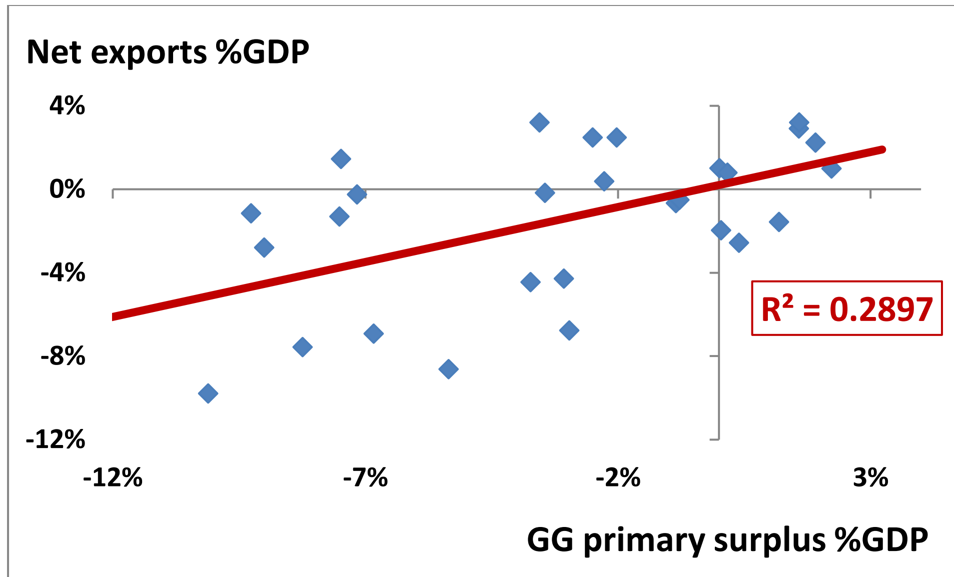

Fig.5. Correlation of net exports and public primary balances

Note: Countries include Greece, Italy, Spain and Portugal over the period 2009-2015. GG stands for General Government. *Source:* Ameco Database

In some cases the austerity effect was, in fact, much stronger than that of competitiveness, and the experience of Greece is quite didactic on this matter. The implementation of austerity measures brought the external deficit from an alarming level of around -15% of GDP in 2008 to an almost balance in 2015, but the correction was by cutting imports not raising exports. Despite wage cuts that were implemented as part of the internal devaluation and led to an improvement of ULC-based productivity by 24%, the level of exports has hardly improved, as clearly demonstrated in Fig. 6.

The above examination suggests that ULC or austerity policies have only partial effects on containing external imbalances and must be used with prudence and in conjunction with the overall economic situation so as not to exacerbate austerity in case of a downturn. Moreover, an integral approach to external imbalances should focus on attracting investment and introducing appropriate reforms in deficit countries. Christodoulakis and Axioglou (2016) show that most of the Euro Area economies suffer from extensive underinvestment after the global crisis and the need to undertake EU-wide initiatives to restore investment activity is more urgent than ever.

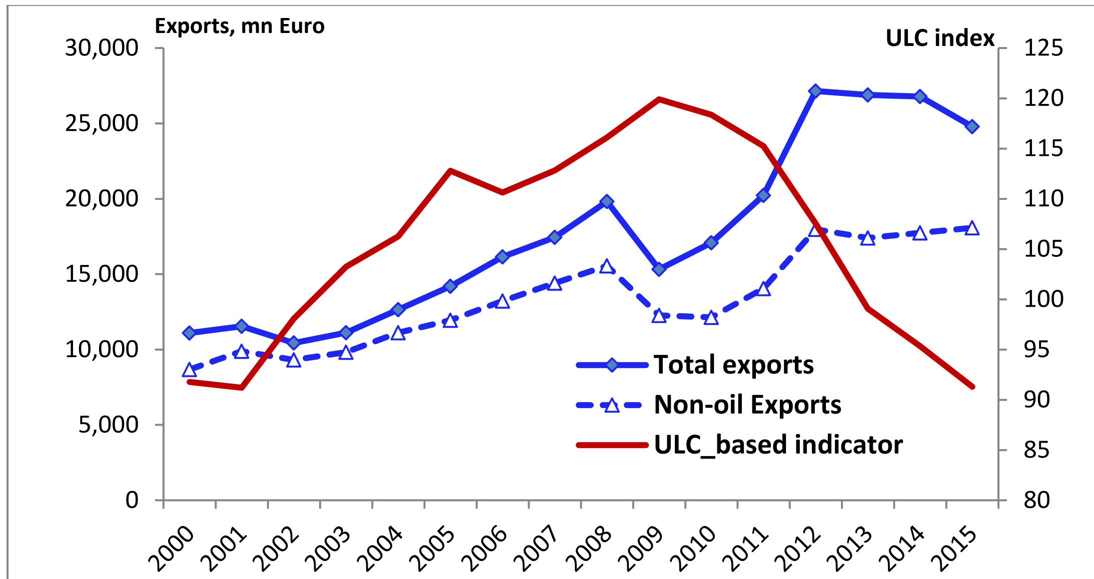

Fig.6. Exports (Lhs) and competitiveness (Rhs) in Greece, 2000-2015.
Note: Exports in Euro millions. ULC index is defined as in Fig. 4 and referred to the right-hand scale. *Source:* Bank of Greece and ECB

Reform initiatives are also crucial for enhancing competitiveness and raise growth potential, and a study by Kolev et al (2013) for the European Investment Bank describes a priority list –from the acceleration of reforms to industrial restructuring to financial support– to mitigate the current slackness.

Combining reforms with new investment is necessary to avoid deepening recession through a mere wage reduction. Repeated calls for post-EMU reforms paid attention to changes in both the labour market so as to raise ULC competitiveness and, at the same time, the liberalization of product markets so as to reduce oligopolistic structures and induce a higher output. According to Everaets and Schuele (2006) traded-goods market reforms alone have immediate positive effects on output, wages, and welfare, while labor market reforms alone lead to output gains but cause a decline in real wages. The synchronization of labour market and product market reforms could smooth the adverse effects on real wages and significantly improve external imbalances.

4. Are all sins the same?

Another problem that will be encountered with the implementation of Economic Governance is the policy asymmetry shown between the members with excessive public and/or external deficits, and those with surpluses. In the first place, it seems unreasonable to consider taking policy measures penalizing such macroeconomic outcomes that every single country would hail as an achievement. For example, external surpluses due to technological innovation, productive investment and the containment of labour costs should rather be seen as policy or even moral benchmarks for those who neglected such policies in the past. [8]

However solid and persuasive such arguments might have sounded in a single economy, they are considerably mitigated if expressed in the context of a monetary union where the weaker member-states are by definition excluded from resorting to currency devaluation as a means to contain external deficits. In an optimal currency union, capital and labour mobility would have had sufficed to catalyze an efficient factor allocation but this seldom happens in practice. The first decade of the EMU showed that labour mobility was only marginal, while the provisions of free capital flows did not prove to affect all member-states in a positive way. As shown by Christodoulakis and Sarantides (2016), productive foreign direct investment increased in all Euro Area countries after the establishment of EMU, though in a highly diverging pattern. The countries in northern Europe were able to attract most of the FDI in the form of productive capital, while most of the FDI flown to the peripheral economies was routed to the real-estate. As a consequence, the competitive edge of the first group was further strengthened, while external deficits in the second group were even more deteriorated.

This finding calls for some feedback mechanism to control excessive accumulation of surplus countries, while at the same time helping to improve the deficit countries. The most efficient way to carry this out is surplus countries to allow for fiscal ease that will be reducing external surpluses through the rise of imports. Besides, this restores some symmetry in deficit-containing member-states by raising their exports and, thus, mitigating the recessionary effects they face by their own correction.

[8] For example, in praising surplus states, Dyson (2014, p 294) attributes their success to the '[a]scetic culture, frugality, hard work, and discipline'.

Similar arguments hold for excessive fiscal surpluses. In the first place, such cases are the result of disciplined management and efficient tax collection, hence they should provide policy benchmarks for other countries rather than being used as a buffer stock to facilitate the redemption of the errant members. Again, the moralistic argument is mitigated if considered in the context of a monetary union, where the coexistence of surplus and deficit excesses is not sustainable. Sooner or later, the deficit country will pay the price by following an austerity program that drives the economy into recession or else exit the union. But surplus countries too will feel the consequences in both cases and the experience of the recent debt-crises has shown that they are more likely to choose sharing the burden of adjustment rather than remaining inactive and risk break-outs.

A compromise is to introduce fiscal discipline at the country level in combination with a collective action mechanism in case that excessive fiscal effort is needed. The former includes *ex ante* fiscal limits and *ex post* austerity measures if budgetary targets are violated. To this effect, Annunziata (2010) argues that in order to avoid the recession in the future that unavoidably would accompany fiscal consolidation measures if limits are trespassed, national governments might well prefer to take action in advance. The collective mechanism will have to deal with the downswings of the business cycle by using reserves accumulated during the upswing periods, as suggested by Dullien and Schwarzer (2011). This mechanism avoids the problem of counter-incentives: surplus countries would not be hindered toward pursuing competitive policies by seeing that part of their savings will finance the irresponsibility of other partners in terms of debt-burden sharing. But in the face of a deep recession, some assistance in the errant countries would in fact benefit the surplus countries by keeping up aggregate demand and mitigating the transmission of the downward effect.

5. An Extended Fiscal Rule

The most appropriate framework to design fiscal policy and avoid adverse side-effects is to explicitly recognize the twin pillars of internal and external balance as the ultimate goal of macroeconomic policy for either deficit or surplus countries. The internal balance requires that the economy is at, or close to, full employment and

price stability, while the external one is respected as long as there are not excessive deficits or surpluses in the current account transactions with the rest of the world.

The need for keeping the twin balances under control was advocated by Meade (1977), before becoming a standard reference in modern textbooks; see, for example, Krugman and Obstfeld (2003, Ch. 18). In this respect, an early deficiency of the Euro Area was that from all the requirements of the twin balances only price stability was formally – and forcefully - addressed in the Treaty. The remaining targets of enhancing economic activity, raising employment and controlling the external imbalances were left without any specific targeting in the hope that market integration and increased factor mobility would accomplish the task.

Though a number of projects and reform initiatives, such as the Structural Funds, the Lisbon Strategy for Growth or the most recent Juncker Investment Fund, were designed to speed-up such a process for the members lagging behind, the outcome was never satisfactory enough. The reason was that these are open-ended policies, in the sense that there is no binding commitment for a specific outcome to be achieved within a given period of implementation.

The history of EMU so far shows that the Eurozone as a whole nearly achieved an external balance, though activity remained throughout far from reaching full employment. For individual countries, the record is mixed: several southern Eurozone economies experienced a combination of high growth and vast external deficits, while northern economies enjoyed external surpluses albeit at moderate growth rates. A new framework for EGEA should provide policies that enhance the internal and external balances at both the individual country level and the Eurozone aggregate as briefly sketched below.

Since the ECB is taking care of price stability, achieving internal balance in EMU amounts to keep activity at a level capable to generate close to full employment. Deviations from target can be measured by the gap between actual and potential output as a percentage of the latter. If variable GAP is positive (negative), the economy is working above (below) capacity. External deviations are simply measured by the Current Account Balance as percent of GDP, (variable CAB). For simplicity, the bliss point is set at $GAP=CAB=0$, though other combinations of desired levels or wider bands can be considered in the same manner.

Using these two indicators, fiscal policy is designed into two steps, so as meet a sustainability target in the medium run and then allowed to be activated in response to deviations from activity or external targets, as follows:

Step I: Design a fiscal plan

A fiscal plan $\{S_t^*\}$ is defined as the time-path of primary surpluses that is required to stabilize the debt-to-GDP ratio (say variable *DY*) at a target level *DY** in the medium term *(T)* under a baseline scenario for the economy. Formally:

$$S_t^* = \{S_t, t = 0, \dots, T \mid DY_t \rightarrow DY^* \text{ as } t \rightarrow T\} \quad (1)$$

The calculation of the fiscal plan can be carried out by employing optimal control methods or by trial-and-error simulations on empirical models until the target is satisfied. However, this is left out for future research and only a qualitative discussion is included here. Given that fiscal policy thus far is predominantly determined so as to confront budgetary imbalances, the plan $\{S_t^*\}$ can be roughly approximated by the current medium-term plans of fiscal consolidations that are applied in member-states.

Step II: Fiscal activism

In case those internal and external balances are kept within the prescribed levels, fiscal policy follows the plan with no deviation. But if any of them is in imbalance, a component of fiscal policy that takes into account deviations from internal and/or external balances is tuned around the plan. The tuning would imply that primary surpluses are pro-cyclical with activity, rising during booms and lowering in recessions, and counter-cyclical vis-à-vis external balances in order to raise domestic demand for imports when in surplus and contain them when it runs an external deficit. A simple Taylor-like rule guiding the deviation of primary surpluses from the medium-term plan is written as:

$$S_t - S_t^* = \alpha \cdot [\beta \cdot GAP_t - CAB_t] \quad (2)$$

In the above expression, (S_t) denotes the actual primary surplus as percent to GDP, parameter *($\alpha>0$)* the degree of fiscal activism, and *($\beta>0$)* the relative importance of internal over external balances.

Rule (2) becomes expansionary or contractionary as long as $S<S^*$ or $S>S^*$ respectively: economies with strong growth and large external deficits (i.e. $CAB<0<\beta GAP$), should clearly adopt measures of fiscal contraction; economies in recession and external surpluses (i.e. $CAB>0>\beta GAP$) should expand fiscally. The other cases depend on the relative size of policy parameters. Control parameter $(\alpha>0)$ is set so as to optimally satisfy a chosen policy index, under the constraint that gross public deficit is kept lower than the SGP limit of 3% of GDP.

To get an idea of how fiscal policy would have reacted if such a rule was in place prior to the debt crisis, the combinations of historical output gaps and external balances of the Euro Area countries are depicted in Fig. 7 for the period 2006-2008. Interestingly enough, there was no country in the pre-crisis period that was in slackness and at the same time enjoying external surpluses. This can be taken to suggest that pre-crisis fiscal policy was lax enough so that Governments could exploit it and fight off such a possible outcome.

The majority of Euro Area countries lie in the southeast quarter of Fig. 7, suggesting that a more rigorous fiscal policy should have been adopted at the time. The largest consolidation programs should had been applied in Estonia, Latvia, Lithuania, Cyprus and Greece, while milder ones were appropriate for Ireland, Spain, Portugal, Slovenia, Slovakia and Malta. Italy and France experienced a rather low growth and marginal imbalances, thus no serious alteration of fiscal policy was necessary.

It is noteworthy that some surplus countries in the northeast quarter of Fig. 7 did not enjoy adequate growth and a more satisfying outcome could have been achieved by allowing more fiscal activism. Setting, for example, $\beta=2$ to denote that output slackness matters twice as much as the external balance, a policy contour is derived as shown in Fig. 7. Under this policy weighting, Finland too had to be fiscally more cautious, while Germany, Luxemburg and the Netherlands should have been more expansionary. Austria and Belgium turned to be just about right.

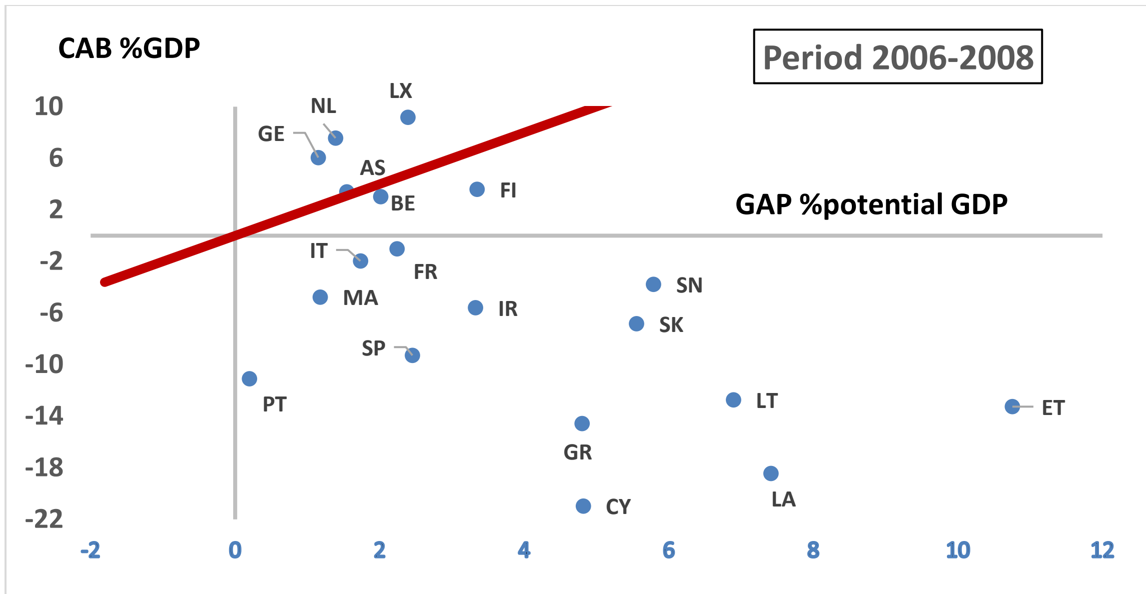

Fig. 7. CAB and Gap for EA19, 2006-2008, in percent.
Note: Labels are for country acronyms. The borderline contour is drawn for β=2; countries below the line are over-expansionary. *Source:* Ameco Database

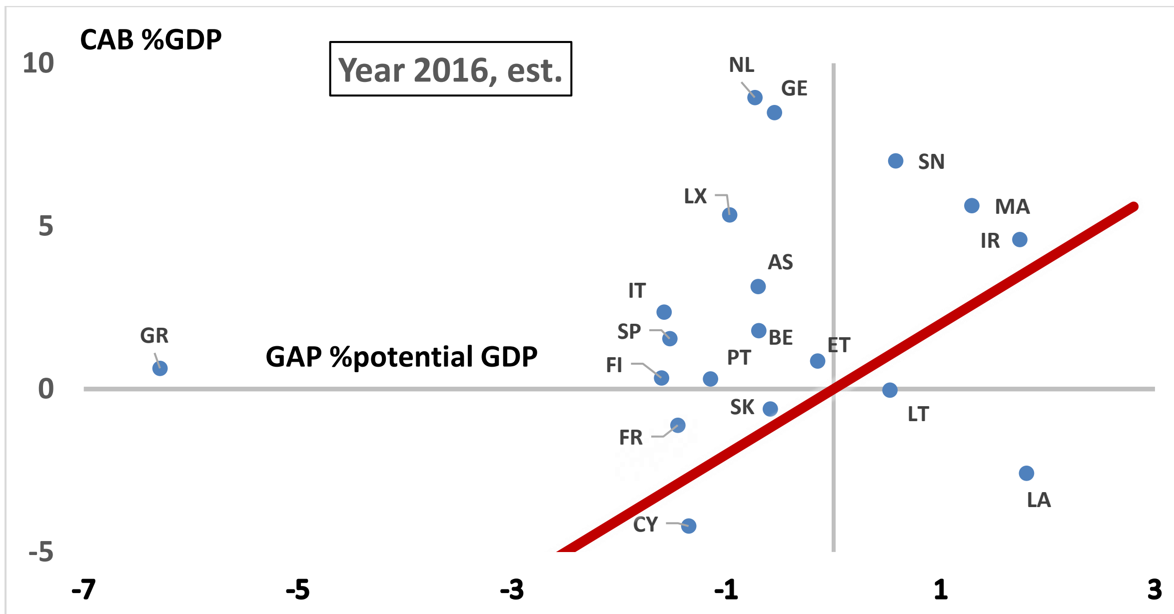

Fig. 8. CAB and Gap for EA19, 2016, in percent.
Note: The borderline contour is drawn for β=2; countries above the line are over-contractionary. *Source:* Ameco Database (estimates).

The fiscal rule can be further explored by examining its implications in the current situation. Using data estimates for 2016, Fig. 8 reveals that the majority of Euro Area economies now lie in the northwest quarter, suggesting that a more expansionary fiscal policy would have resulted to a higher fulfillment of internal and external balances. Drawing a similar policy contour for $\beta=2$, it is clear that only Latvia, Cyprus and Lithuania should now adopt some small fiscal contraction, while all others would be better off by expanding fiscally. The largest fiscal expansion should be undertaken by Germany and the Netherlands due to high external surpluses, and also by Greece due to the extreme slackness of activity.

The previous analysis shows that, before the crisis, fiscal policy in the Euro Area was unwisely expansionary for several economies. Unless the internal and external balances are seriously pursued, it risks being unduly contractionary for most of them in the post-crisis period. The new component can be either implemented as a deviation from the medium term plan or, else, financed by collective action through union-wide accumulated surpluses as described by Dullien and Schwarzer (2011) and discussed in the previous section. Symmetrically for the case of a surplus country, the deviation can be either implemented as an expansion of national aggregate demand or, else, saved in the collective facility.

6. Choosing the fiscal mix

A further issue concerning the implementation of fiscal policy is which specific component of primary balances of General Government should be used as the key instrument in managing public finances. Three components are considered in turn:

- *Public ordinary expenditure*
- *Public capital formation*
- *Taxation*

Choosing among them entails some differentiation regarding implementation speed, effectiveness, as well as social equity and political viability. The following remarks on the merits and problems of using each particular component on demand management are discussed:

Adjusting ordinary expenditure:
Government expenditures are designed for specific purposes (e.g. defense, health, education, social benefits, etc.) and are directed toward certain groups, thus their change is bound to have asymmetric effects across the various sectors of society. This makes it operationally risky and/or politically difficult to turn these flows of expenditure on and off in the interests of general control over aggregate demand and the debt burden. The impact differentiation may pose extra political difficulties in fine-tuning a downward adjustment of public expenditure as this would result to unequally spreading the burden of adjustment.

Public capital formation:
If public investment programs are curtailed as part of a fiscal correction program, the economy will not only experience further recession but competitiveness may also weaken and thus prevent a quick return on a growth path. In view of the extensive underinvestment currently witnessed in the Euro Area, public capital formation should be examined only when a fiscal expansion is considered and not be subjected to further cuts.

Tax adjustment:
The adjustment of tax rates may include the general rate of income tax, the VAT rate, lump-sum taxation, or compulsory national insurance contributions. A change in indirect taxation is impacting –though not in a perfectly symmetric way - across all sectors of the economy, and this can be considered as a more fair intervention in terms of equity. It is accompanied by price rises and these in turn may impact upon competitiveness, and the external balance. On the other hand, changes in direct taxation cause distortions in factor markets and may seriously affect investment activity.

Taking into account the above characteristics, Weale et al (1989) had suggested that in order to minimize the adverse effects, a combination of fiscal instruments should be chosen with the following criteria:

- In public expenditure, mark some categories as flexible and make them conditional upon the overall fiscal stance. Examples include performance bonuses in the public sector, overtime pay, auxiliary benefits, travelling allowances, etc.

- In the tax-revenue side, the Government should adopt a flexible margin on VAT, income tax and social security contributions that will vary conditionally on the overall fiscal stance. Changes in the VAT rates are more easily accepted by the public to serve short-term objectives, while longer-term targets such as growth-inducement or social insurance viability are better supported by changes in income taxes.

A periodic review (e.g. an annual budget) of expenditure plans which takes account of the forward probabilities of a general fiscal expansion or restriction, combined with arrangements for frequent and prompt feedback adjustments of certain general tax rates, may well be the most satisfactory procedure.

Cuts in crucial spending components that may be held responsible for affecting competitiveness, such as investment spending, innovation and human capital upgrading, should be avoided in order to avoid the detrimental effect on future potential output. The countries entering a downward spiral should be given priority for participating in EU-wide investment schemes and thus assisted in exiting the recessionary cycle. Otherwise, they will be forced to rely on labour market liberalization policies and/or wage cuts that will further strengthen the recessionary spiral rather than suppressing it.

7. Conclusions

The paper discussed some aspects of policy prevention and correction that are designed in the framework of Economic Governance in the Euro Area. Although the list of leading indicators of an impending crisis, as well as the composition and operation of the corrective policy mix, are still debated, there is an overwhelming view of endorsing public debt as the key indicator for assessing the criticality of economic developments. The paper argues that a prevention mechanism heavily

relying on public indebtedness may miss critical characteristics of a future crisis, thus due attention is also required to be put on external imbalances and other structural characteristics of the economy.

With regards to the correction mechanism, a distinction should be drawn according to the phase of the business cycle. In an upward cycle, fiscal redress should be the key for fiscal stabilization, while the recovery of competitiveness will require a mix of wage restraint, labour and product market reforms, and production innovations. But in a downward cycle all these measures are likely to accelerate recession and should be kept at a minimum or applied in conjunction with investment initiatives so as to enhance economic potential and speed-up the exiting from the crisis. The symmetric application of adjustment rules for surplus countries will mitigate the recessionary effects in the errant economies and thus help the implementation of their adjustment programs.

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