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## Article

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European Journal of Economics and Economic Policies: Intervention (EJEEP)

## Provided in Cooperation with:

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*Suggested Citation:* Zeza, Gennaro (2020) : Fiscal policies in a monetary union: the eurozone case, European Journal of Economics and Economic Policies: Intervention (EJEEP), ISSN 2052-7772, Edward Elgar Publishing, Cheltenham, Vol. 17, Iss. 2, pp. 156-170, <https://doi.org/10.4337/ejeep.2020.02.05>

This Version is available at:

<https://hdl.handle.net/10419/277474>

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# Fiscal policies in a monetary union: the eurozone case

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*We argue that the institutional framework of the eurozone was designed to deny a role for fiscal policy. However, the Great Recession of 2008–2009 forced governments to intervene, mainly to avoid the collapse of their financial systems. At the same time, the severe recession implied a decrease in tax revenues, and an increase in some components of public expenditure – such as unemployment benefits, which implied an increase in public deficits. When the crisis seemed to be over, the Maastricht rules gave priority to restoring fiscal targets, even at the cost of prolonged unemployment and stagnation in countries like Greece and Italy. Using the three-balances approach pioneered by Godley, we argue that such policies require the achievement of an external surplus, or else fiscal austerity will worsen the financial position of the private sector. We show that this is indeed how most eurozone countries moved, and argue that such policies are fragile, and possibly not sustainable in the medium term. We suggest the introduction of fiscal currencies as one way of introducing a degree of freedom in the sustainability of the eurozone.*

**Keywords:** *fiscal policy, monetary union, eurozone, austerity, sectoral balances*

**JEL codes:** *E62, F41, F45*

## 1 INTRODUCTION

The Maastricht Treaty, which established the rules of the game for the institutions of the European Union, devoted considerable attention to the new institution which would govern monetary policy – the European Central Bank (ECB) – but did not envision any new institution for fiscal policy, which was implicitly left at the discretion of each member state. On the contrary, the Treaty introduced binding limitations to the conduct of discretionary fiscal policies, whenever the public sector deficit was exceeding a given threshold (of 3 per cent of GDP) or public debt was higher than 60 per cent of GDP, on the presumption that an expansionary fiscal policy in such cases would harm the stability of the new currency.

Godley (1992: 3) noted presciently that

[t]he central idea of the Maastricht Treaty is that the EC countries should move towards an economic and monetary union, with a single currency managed by an independent central bank. But how is the rest of economic policy to be run? As the treaty proposes no new institutions

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Received 18 January 2020, accepted 28 May 2020

other than a European bank, its sponsors must suppose that nothing more is needed. But this could only be correct if modern economies were self-adjusting systems that didn't need any management at all.

The theoretical approach behind the Treaty therefore ran contrary to the standard Keynesian view, which maintains that without active economic policy the system will not achieve full employment, to embrace a form<sup>1</sup> of the *ordoliberal*, monetarist approach which claims that the government should not interfere with market mechanisms. This approach is coherent with the *New Consensus* in mainstream macroeconomics, where the non-accelerating wage rate of unemployment (NAWRU) is eventually reached thanks to the optimizing behaviour of agents, and a central bank as the only institution conducting economic policy by fixing the interest rate according to the Taylor rule. Although this approach had been discredited by the 2008–2009 global financial crisis, its influence had been pervasive, so much so that the measurement of potential output, and of the output gap, had been introduced into the legislation of the European Union with the revisions to the Stability and Growth Pact (SGP). The 2012 'Fiscal Compact' Treaty<sup>2</sup> states in Article 3 that 'the budgetary position of the general government of a Contracting Party shall be balanced or in surplus', translating this strict rule in a maximum 'structural deficit' of 0.5 per cent of GDP, where the estimate of the structural deficit requires the evaluation of the current level of the output gap, based on the mainstream assumption of an aggregate production function.<sup>3</sup>

The fear that government deficits could translate into requests for financial means from the ECB implied the strict prohibition to the ECB to purchase Treasuries in the primary market for any country: the possible role of the ECB as lender-of-last-resort for governments in trouble was completely ruled out.

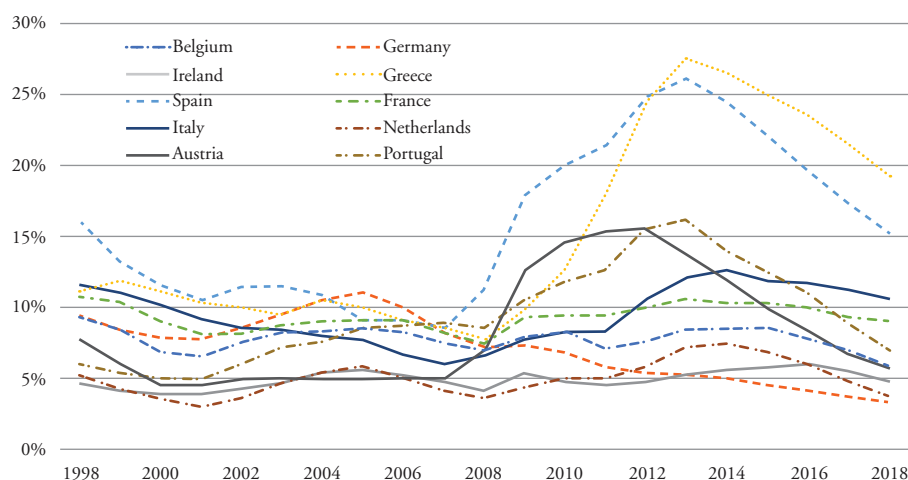
Summing up, in the institutional framework of the institutions of the European Union there was no space for a common fiscal policy, and there was a large number of restrictions to the ability of individual countries to run a budget deficit to increase aggregate demand and employment.

In Section 2 we will provide a short overview of the different phases of the economies which adopted the euro, focusing in particular on how fiscal policy was mainly targeted at reducing 'excessive' levels of public debt, but had to change its course with the Great Recession first, and the sovereign debt crisis later. In Section 3 we will frame the discussion of the targets for public deficits in the macroeconomic approach provided by the analysis of financial balances, showing that the only way to achieve the desired goals for public debts and deficits requires the achievement of surpluses in the current-account balances, or else will imply a deterioration in the financial position of the private sector in each economy. In Section 4 we briefly discuss an authoritative proposal for a 'budget neutral' fiscal policy based on the reduction of public expenditure and taxation, arguing that it will not be effective, and in Section 5 we will briefly suggest an alternative proposal to introduce degrees of freedom in the conduct of fiscal policies in the monetary union. Section 6 concludes, and provides some preliminary suggestions arising from the COVID-19 health (and economic) crisis.

1. Feld et al. (2015) claim that a stricter adherence to ordoliberalism would have implied a different institutional set-up for the ECB.

2. See [https://www.consilium.europa.eu/media/20399/st00tscg26\\_en12.pdf](https://www.consilium.europa.eu/media/20399/st00tscg26_en12.pdf).

3. See Ciucci/Zoppè (2017), who also cover the criticism to the procedures adopted to estimate potential output, and document how the official measures of structural balances have been heavily revised over time for some countries, notably Italy.



Source: Eurostat.

Figure 1 Unemployment rates

## 2 A SHORT HISTORY OF FISCAL POLICY IN THE EUROZONE

The period following the introduction of the euro, up to 2008, may be labelled – in retrospect – as the ‘glory years of the euro’ in terms of economic growth for most participating countries.

The average growth rate for the 12 countries forming the eurozone (EZ from now on) was 2.0 per cent in the 2000–2007 period (Table 1), and unemployment rates were somewhat lower than in the previous period, and stabilized (Figure 1). Some countries in the periphery, notably Greece and Spain, experienced a period of rapid growth, with real GDP increasing by 4.6 per cent and 3.8 per cent, respectively. Germany was instead the ‘sick man of the euro’, as an article from *The Economist* (1999) labelled it, given its troubles in coping with the reunification, and the introduction of labour market reforms, which resulted in a growth rate of only 1.4 per cent in the 2000–2007 period.

It later became clear that many EZ countries which enjoyed faster growth rates were driven by an unsustainable accumulation process.<sup>4</sup>

With the adoption of the common currency, banks in each EZ country could refinance at the ECB at the same interest rate. This implied a substantial reduction in the cost of borrowing for countries – like Greece – where interest rates were much higher, and access to credit was sometimes rationed. Besides, inflation rates had converged before the adoption of the common currency, but not completely: countries with a higher inflation rate – again like Greece – were therefore enjoying a lower real interest rate than countries at the core.

Easier access to cheap credit fuelled a credit-led boom of domestic demand in the EZ periphery. At the same time, the adoption of the common currency implied that EZ

4. There is a rich post-Keynesian literature on the polarization in the eurozone between export-led growth regimes in the core and the debt-led regimes in the periphery, and the connection of such growth models to neoliberalism. See Hein (2013), Stockhammer (2016), Stockhammer et al. (2020) and Zezza (2012), among many others.

*Table 1 Eurozone countries, average growth rates in real GDP*

	2000–2007	2007–2009	2009–2014	2014–2018
Euro area	2.0%	–2.1%	0.8%	2.1%
Austria	2.4%	–1.2%	1.2%	2.1%
Belgium	2.3%	–0.8%	1.3%	1.6%
Cyprus	4.9%	0.8%	–1.9%	4.9%
Finland	3.5%	–3.7%	0.6%	2.1%
France	2.0%	–1.3%	1.2%	1.6%
Germany	1.4%	–2.4%	2.3%	2.1%
Greece	4.6%	–2.3%	–4.5%	0.7%
Ireland	6.2%	–4.7%	2.5%	12.9%
Italy	1.2%	–3.1%	–0.5%	1.1%
Luxembourg	4.6%	–2.8%	3.2%	3.6%
Malta	2.5%	0.4%	4.5%	8.4%
Netherlands	2.1%	–0.8%	0.6%	2.5%
Portugal	1.2%	–1.4%	–0.8%	2.5%
Slovenia	5.0%	–2.1%	0.2%	3.8%
Spain	3.8%	–1.5%	–0.7%	3.2%

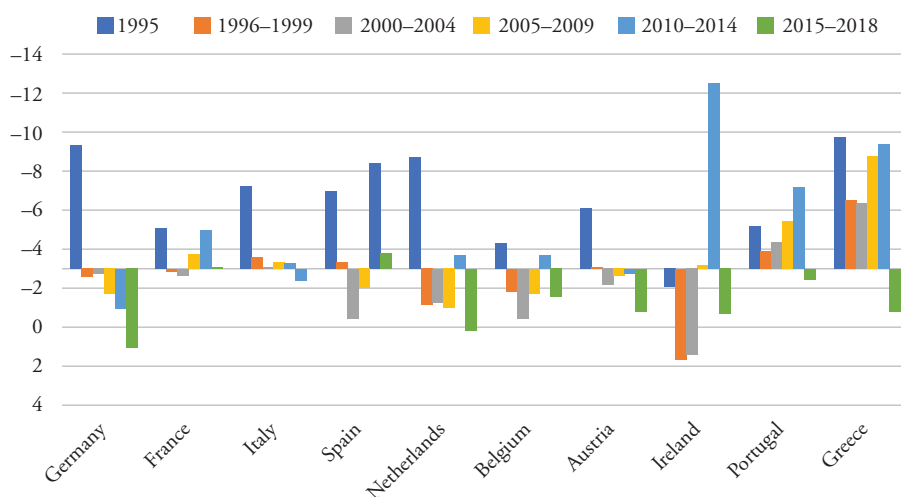
*Source:* Eurostat.

countries could no longer realign their exchange rates to restore price competitiveness. Small differentials in the inflation rates of the EZ periphery started to deteriorate its competitiveness against the EZ core, while the exchange rate of the euro against other currencies would not move enough to support the competitiveness of higher-inflation EZ countries against the US and other economies: the euro was therefore a strong currency for the EZ periphery, and a weak currency for the EZ core.

The intrinsic instabilities resulting from the adoption of a common monetary and exchange policy for the EZ translated into growing trade imbalances between the periphery and the core: such imbalances were not considered to be a cause of concern as long as EZ financial markets were willing to lend to those countries experiencing the credit-led boom.

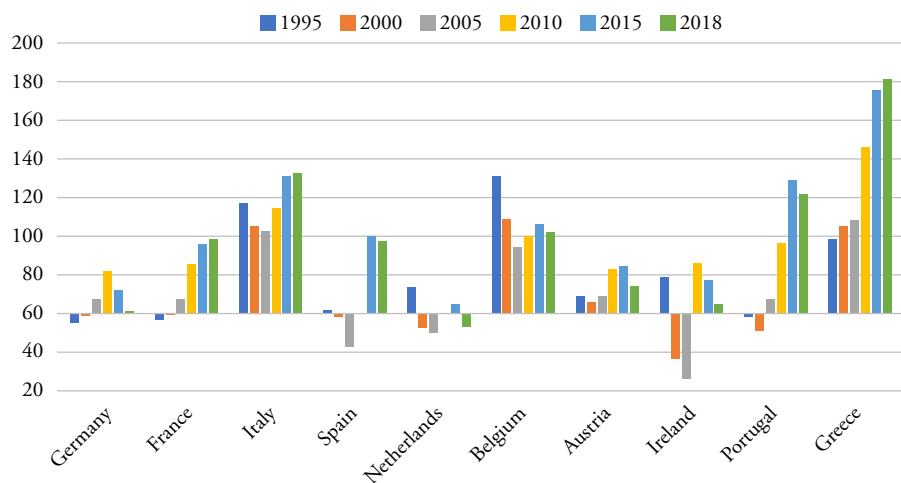
In the years before monetary unification, and until the Great Recession (GR from now on), fiscal policy in EZ countries was apparently not aimed towards macroeconomic targets as before, when it was a crucial tool for pursuing full employment. Indeed, the required process of convergence to the target deficit and debt ratios defined by the Maastricht Treaty meant all countries struggled to reduce larger government deficits and debt. In Figure 2 we report the average government deficit over different sub-periods: notice that the bars are drawn relative to the Maastricht limit of 3 per cent of GDP, so that the bars on the top show deficits exceeding the threshold. The chart clearly shows how deficits shrank from a still-high level in 1995 to what was required before 2000 to join the eurozone, and remained on target during the ‘glory years’ of the euro.

Lower deficits implied, for many countries, a reduction in the stock of public debt relative to GDP (Figure 3). Again, the bars in Figure 3 have been drawn with respect to the Maastricht limit of 60 per cent of GDP, so that the bars above the line highlight countries which need to reduce their debt. While the deficit limit was enforced from the beginning of the common currency, there was no pressure on countries exceeding the debt limit to comply with the requirements in a short time period – as it was clear that for some countries, like Italy, this would have required very restrictive fiscal policies – but a tendency to reduce the debt-to-GDP ratio over time was considered to be sufficient. Indeed, countries



Source: Eurostat.

Figure 2 Government deficit (percentage of GDP)



Source: Eurostat.

Figure 3 Gross government debt (percentage of GDP)

with a high level of public debt, such as Belgium and Italy, managed to reduce its size in the period up to the GR.

At the end of 2006 the bubble in US housing prices ended, and house prices started to drop in 2007, leading to foreclosures, and the exposure of a very opaque mechanism for

pricing mortgage-backed securities (MBSs). When the market evaluation of securities linked to mortgages collapsed, financial turmoil started, which eventually led to the bankruptcy of Lehman Brothers in September of 2008, and of other financial institutions, starting what has been called the GR, which officially began in December of that year.

EZ countries were hit in a different way by the crisis, and therefore their policy responses varied. In some cases, notably in Ireland, financial institutions suffered heavy losses from the collapse in the market value of the US securities among their assets. Countries like Spain and Greece had seen a housing bubble similar to that experienced in the US, and possibly financed by foreign capital, and experienced a similar destiny with a fall in the market prices of homes, and an increase in non-performing loans (NPLs) which hit the balance sheet of the financial sector. Financial institutions in other countries, like Italy, were not as exposed on US MBSs, but the recession hit through the fall in US imports.

When the GR hit, deficits soared, as the data in Figure 2 show. It is well known that government deficits will automatically increase during a recession, with no change in policy. This is because the tax base is shrinking, and some components of expenditure, like unemployment benefits, increase. On top of these effects, it became clear to governments in Europe and the US that monetary policy would not have been effective by itself to offset the damages of the financial crisis. The discount rate was brought to 0.5 per cent at the beginning of 2009 in the US, down from 5 per cent at the beginning of the recession (November 2007), while the ECB reacted more slowly, even increasing the discount rate by 25 basis points in 2008 to 5.25 per cent, and lowering to 1.75 per cent only in May of 2009.<sup>5</sup> The Federal Reserve recognized the lack of efficacy of a conventional monetary policy, and started a quantitative easing (QE) programme of purchases of MBSs at the end of 2008. The ECB again followed later, starting its QE programme only in May of 2009.

With monetary policy struggling to cope with the impact of the financial crisis, fiscal policy was rehabilitated, but in the EZ it was not implemented following the Keynesian suggestion of creating jobs to counter the fall in employment. Rather, many countries saw it as a priority to save their financial system which had a substantial amount of US securities among their assets, or had financed an unsustainable housing bubble and were experiencing an increase in NPLs. Given the different abilities of interest groups in lobbying their governments, policies were aimed mainly at repairing the damage suffered by creditors, rather than helping debtors get back to solvency, and this myopic approach did not eliminate the underlying financial fragility.

The data from the capital account on the non-financial statistics of the government sector can be compared to the same data for the financial sector to evaluate the magnitude of what each country transferred to banks and other financial institutions.<sup>6</sup> Main results from this exercise are displayed in Table 2. The largest interventions between 2009 and 2012, in terms of GDP, were made by Ireland and Spain, but Germany also intervened substantially.

Although the Maastricht Treaty prohibited the ECB from intervening in the primary market for Treasuries, up to 2009 there must have been a presumption that the ECB would have backed up governments in case of troubles, and therefore that the risk on government bonds for all EZ countries would be negligible. This is confirmed by the spread between the government bonds of countries with a high public debt, like Italy and Greece, against Germany. At

5. Data from <https://fred.stlouisfed.org> on the basis of IMF, International Financial Statistics data.

6. One way in which such transfers are realized is when the government purchases financial assets from a bank at a value higher than the current market price.

*Table 2 Capital transfers to the financial sector*

	Million euro (averages)			% of 2008 GDP		
	2000–2008	2009–2012	2013–2017	2000–2008	2009–2012	2013–2017
Germany	1 419	10 730	2 240	0.06%	0.42%	0.09%
France	1 798	1 699	3 205	0.09%	0.09%	0.16%
Italy	287	1 168	6 504	0.02%	0.07%	0.40%
Spain	611	13 577	3 691	0.06%	1.22%	0.33%
Netherlands	80	876	348	0.01%	0.14%	0.05%
Belgium	310	2 113	157	0.09%	0.60%	0.04%
Austria	126	1 872	1 620	0.04%	0.64%	0.55%
Ireland	37	11 906	459	0.02%	6.34%	0.24%
Portugal	8	945	2 481	0.00%	0.53%	1.39%
Greece	0	1 270	4 814	0.00%	0.52%	1.99%

Source: Eurostat.

the end of 1995 the spread was more than 9 per cent for Greece and 5 per cent for Italy, and went down to less than 0.5 per cent between 2001 and 2008. Since the shock from the GR was asymmetric, the spread increased somewhat from 2008, but interest rates started to diverge dramatically with the Greek crisis, when EZ institutions refused to bail out the Greek government, and the prospect of defaults on sovereign debts could no longer be avoided. The spread on Greek debt soared to more than 27 per cent in 2012, and that of Italy and Portugal also increased substantially. A new phase in the life of the EZ had started, with austerity and ‘structural reforms’ being forced on all governments with a high level of public debt.

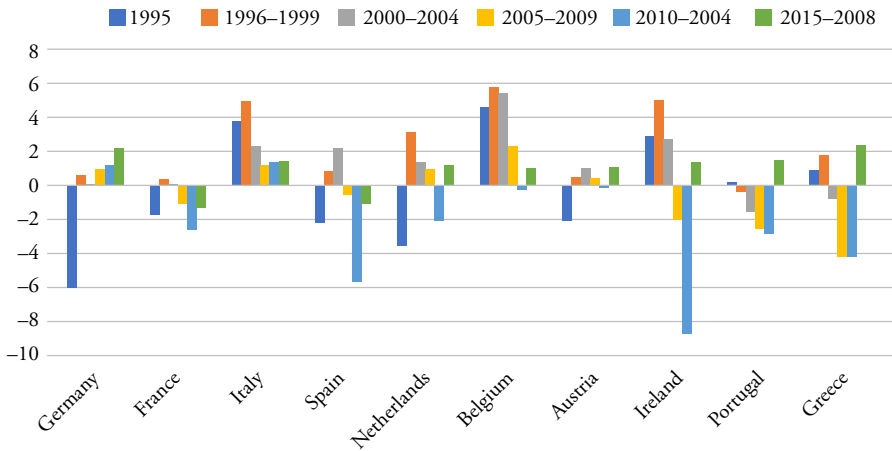
Since markets were now placing a risk premium on sovereign debts, this implied larger interest payments, and therefore larger deficits, for countries like Italy, Portugal and Spain, which were partly avoided by running larger government primary surpluses (Figure 4).

As Godley (1997) noted presciently, ‘[t]he danger, then, is that the budgetary restraint to which governments are individually committed will impart a dis-inflationary bias that locks Europe as a whole into a depression it is powerless to lift’. This prediction materialized, in particular for EZ periphery countries which followed austerity policies, like Greece, Italy, Portugal and Spain, bringing the EZ average GDP growth rate below 1 per cent in the 2009–2014 period (Table 1), much lower than that of the US over the same period (2.2 per cent).

With the exception of Spain, the growth rate in the EZ periphery remained lower than that in the core in the following period (Table 1), especially for countries like Italy and Greece where fiscal primary surpluses were not achieving a reduction in the public-debt-to-GDP ratio.

As Kregel (2018: 40) pointed out, ‘[t]he necessity of an EU level response to the crisis should have made it obvious that the existing framework of fiscal policy management at the national level was incompatible with the new system’. But rather than admitting the recessionary architecture of the common currency, EZ institutions and governments opted for making the rules even more stringent, with the introduction of the European System of Financial Supervision (ESFS) in 2010, the ‘Six Pack’ in 2011, and the European Stability Mechanism (ESM) in 2012, along with the ‘Fiscal Compact’ which required countries with a public debt in excess of the 60 per cent limit to reduce it progressively over time, obviously through the implementation of ‘structural reforms’ and more austerity. Structural reforms were mainly aimed at increasing the flexibility of labour markets and increasing competition: the former, when implemented, increased the precariousness of jobs and reduced real wages





Source: Eurostat.

Figure 4 Government primary surplus (percentage of GDP)

substantially, with positive consequences on price competitiveness but adverse effects on domestic demand, while the latter increased the market penetration of multinationals and foreign companies in the EZ peripheral markets, possibly putting additional pressure on real wages.

### 3 FISCAL POLICY AND FINANCIAL BALANCES

EZ countries with a high level of public debt are required to run primary surpluses, and possibly overall surpluses, in order to reduce their public-debt-to-GDP ratio. We can frame a discussion of the consequences of such policy with an analysis of financial balances of the three main sectors of the economy: the private, public and foreign sectors.<sup>7</sup>

Starting from the GDP identity

$$Y = C + I + G + E - M \quad (1)$$

and subtracting from both sides taxes and net transfers from the private sector to the government ( $T$ ) and net transfers from the private sector to the rest of the world ( $TR$ ), we obtain:

$$Y - T - TR = C + I + (G - T) + (E - M - TR). \quad (2)$$

Using the definition of saving of the private sector ( $S = Y - T - TR - C$ ), government deficit ( $GD = G - T$ ) and the current-account balance ( $CAB = E - M - TR$ ), and rearranging, we get the measure of the net acquisition of financial assets (NAFA) by the private sector:

$$NAFA = S - I = GD + CAB. \quad (3)$$

7. This section builds on the inspiring contribution by Kregel (2018).

The ‘Cambridge hypothesis’<sup>8</sup> promoted by Godley and his associates at the Department of Applied Economics, Cambridge (UK) in the 1970s posed that the private sector as a whole aimed at keeping a stable ratio between its (positive) stock of financial wealth and disposable income, which in turn implies that the NAFA should also be positive in relation to GDP or disposable income. Since an increase in credits requires an equal increase in debts by another sector, a positive NAFA should be matched either by a GD, or a positive CAB, or a combination of both. If the CAB turns negative, and the government does not offset the balance with a GD larger than the negative CAB, the private-sector NAFA will be negative, implying that the private sector is either borrowing from abroad, or reducing its financial claims on the rest of the world. In either case, a negative NAFA will sooner or later prove to be unsustainable, and this was the main insight behind Godley’s (1999) projection of the 2001 crisis, and our projection of the GR (Godley/Zezza 2006).

A positive NAFA matched by a GD and a balanced CAB should be sustainable, and this was the configuration reached by most European countries during the period of floating exchange rates which preceded the introduction of the euro. A positive NAFA matched by a positive CAB and a balanced account for the public sector, by contrast, is implying that other countries are building up debt, and this may eventually lead to a financial crisis.

In the charts in Figure 5 we have reproduced the data for the financial balances of the four major countries in the eurozone. The charts show that in the 1990s NAFA was close to the government deficit. With the introduction of the common currency, as we have argued, Germany moved to a mercantilist stance, with a growing CAB and a declining government deficit, while Spain and Italy, having lost their ability to adjust price competitiveness through exchange-rate realignments, experienced a declining CAB which reduced their NAFA and, in the case of Spain, brought it deeply into negative territory. The adoption of austerity policies forced these countries to return to a positive CAB through internal devaluation.

Using a framework suggested by Parenteau (2010), and used for a purpose similar to ours in Kregel (2018), we can plot the three financial balances on the diagram shown in Figure 6, which we can use to analyse the position of a country and the sustainability of its growth path.

Using the horizontal axis to report the government balance, and the vertical axis to report the CAB, the main diagonal of the chart allows us to split the diagram into six sectors: those above the diagonal imply a net borrowing position for the private sector, while those below the diagonal imply a net lending position, that is, a positive NAFA.

The requirement in the Fiscal Compact for countries with a high public debt, like Italy, require the country to move to the upper part of the diagram, that is, to a government surplus, and the only sector where this does not imply a net borrowing position for the private sector is the first one, where the current-account surplus is higher than the government surplus.

In the charts in Figure 7 we have plotted the path of the 19 countries forming the EZ, along with three countries which had to adjust through austerity and structural reforms: Italy, Spain and Greece.

It is interesting to note that all countries follow a counter-clockwise path. In the second half of the 1990s they had to bring their government deficit below the 3 per cent threshold and stabilize their currency: this implied a movement towards the top-left quadrant. In the ‘glory years’ up to 2007, countries which were growing through borrowing kept moving towards the left, with Spain and Greece getting into a net borrowing position for the private sector. The increase in the GD due to the crisis moved countries down (because of a larger

8. See Zezza (2011), and also Zezza (2009).

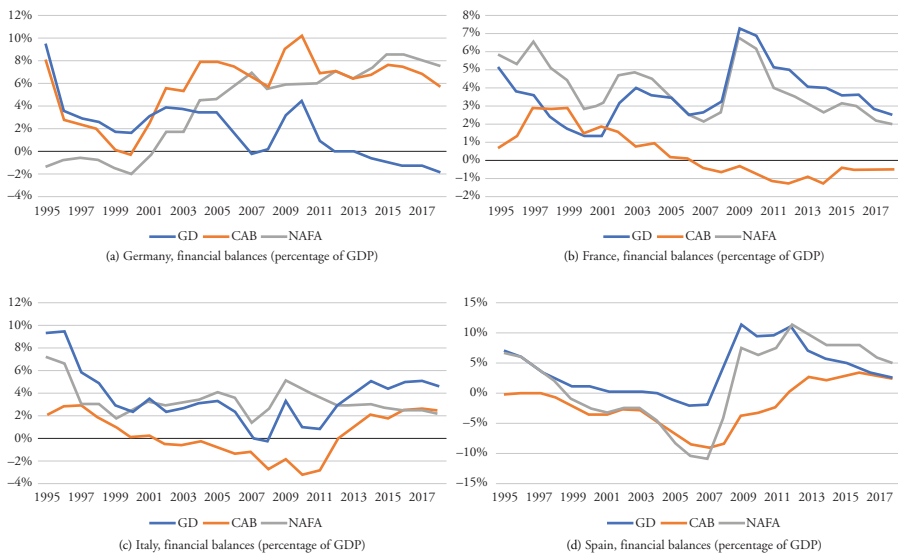


Figure 5 Financial balances for the four major EZ economies

GD) and to the right (because of lower imports), and the adjustments which followed were meant to achieve the first sector of Figure 6, that is, a position where the current-account surplus offsets the damages arising from a government surplus.

The condition for the eurozone as a whole to achieve the external surplus necessary to offset the government surplus required to reduce public debts is that other countries – notably the US – are willing to run persistent current-account deficits, and this cannot be taken for granted. We agree with the conclusion in Kregel (2018: 55) that ‘[h]ighly indebted countries can grow their way out of debt, they cannot export their way out of debt by domestic depreciation and raising exports. But to do this requires a reform of the conditions on fiscal policy in the EU to support and share domestic growth and employment’.

#### 4 A MAINSTREAM PROPOSAL

Mario Draghi, the ECB president, has repeatedly stressed that monetary policy is insufficient to meet the goals of the European Union, and that fiscal policy should support it. In his Jackson Hole speech, Draghi (2014) said that

since 2010 the euro area has suffered from fiscal policy being less available and effective, especially compared with other large advanced economies. This is not so much a consequence of high initial debt ratios – public debt is in aggregate not higher in the euro area than in the US or Japan. It reflects the fact that the central bank in those countries could act and has acted as a backstop for government funding. ... There is a leeway to achieve a more growth-friendly composition of fiscal policies. As a start, it should be possible to lower the tax burden in a budget-neutral way.

Draghi (2019a) repeated his call more recently:

[I]f there were to be a significant worsening in the eurozone economy, it’s unquestionable that fiscal policy – a significant fiscal policy, mostly in some countries but also at the euro area level –

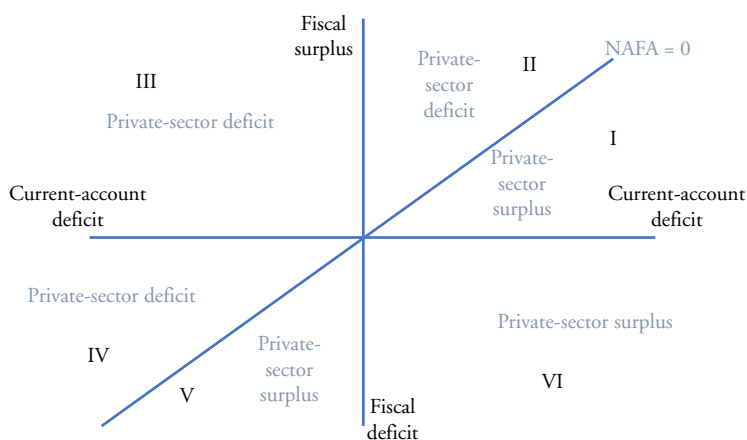


Figure 6 Financial balances

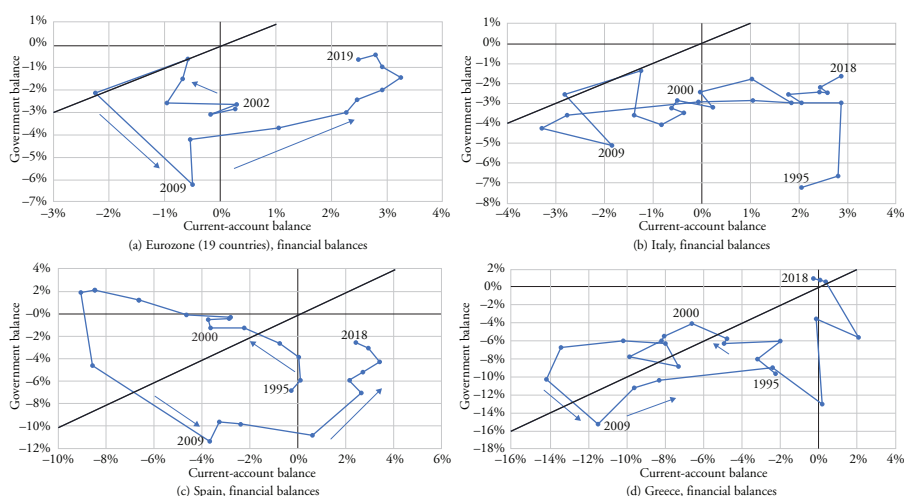


Figure 7 Movement in financial balances for EZ19 and selected EZ countries

becomes of the essence. ... I started making this point way back in 2014 in a Jackson Hole speech: monetary policy has done a lot to support the euro area ... but if we continue with this deteriorating outlook, fiscal policy will become of the essence.

Draghi (2019b) even argued that 'fiscal policy should become the main instrument ... we made the case for fiscal policy to sustain demand and we make this case on and on, even more frequently in the coming future'.

But what type of 'budget-neutral' fiscal policy has Draghi in mind? In his Jackson Hole speech, Draghi mentions a 2013 working paper, later published as Alesina et al. (2015), which concluded that '[w]hile tax-based adjustments are associated with deep

and long-lasting recessions, expenditure-based adjustments are not. The output losses associated with the latter are very small, on average very close to zero'.

It seems therefore that what mainstream economists have in mind is that the multiplier of public expenditure is smaller than that of taxes, so it should be possible to boost the economy through a reduction in taxes and social contributions, while keeping public deficits stable by reducing 'unproductive' public expenditure.

But the excellent meta-analyses by Gechert (2015) and Gechert/Rannenberg (2018) point to the opposite conclusion, and therefore the mainstream suggestion for a budget-neutral fiscal policy seems to be inspired more by the defence of specific interests than by macroeconomic efficacy. Should it be implemented, as is likely, the implications of the findings by Gechert (2015) are that it will further reduce the growth rate in domestic demand, and make countries even more dependent on (volatile) foreign markets.

## 5 IS THERE AN ALTERNATIVE?

The adoption of a common currency has removed too many degrees of freedom in the conduct of economic policy in the EZ: the possibility of letting the exchange rate adjust to offset the deterioration in price competitiveness; the possibility of using expansionary fiscal policy to pursue full employment; the ability to run an independent monetary policy. This was done intentionally, since the economic ideology behind the Treaties suggested that fiscal policy should no longer be used for macroeconomic stabilization, and full employment would be guaranteed by market adjustments; and exchange-rate changes and separate monetary policies were incompatible with the formation of a unified European financial market.

In our view this economic ideology has shown its pitfalls, and the only way to overcome the recessionary stance of the Treaties is to reintroduce some degrees of freedom. A first possibility is to create a European Treasury, with a budget of adequate size to accelerate convergence among member states. This option does not seem politically viable, first of all because of the strong opposition against fiscal transfers which has been stressed again and again by some member states. And, as we have tried to argue, because the economic ideology behind the EZ institutions has clearly rejected the Keynesian view that fiscal policy should actively be used to achieve full employment, which should be insured, instead, by market forces, including the quest for competitiveness on international markets.

Another possibility requires the return to national currencies. It is quite clear, however, that if a country like Italy moves in the direction of abandoning the euro to return to its currency, it will create deep financial turmoil, given the size of its liabilities held by foreign institutions and by the ECB: the spread between an Italian Treasury and a German one is reflecting the possibility of such an outcome, accompanied by the expectation that a new Italian currency would depreciate against the euro. The fact that German long-term bonds now carry a negative interest rate can be explained, at least partially, for the same reason: should Germany exit the euro, its new currency would revalue against the others. The size of the realignment may be assessed by the cumulated differential between the German inflation rate and that of the rest of the EZ, and may be as high as 30 per cent.

In Amato et al. (2016) we have proposed an alternative, namely the coordinated introduction of fiscal currencies, which would not be legal tender, and therefore would not represent a breach of the Maastricht Treaty, but would be accepted by each government in payment of taxes at their nominal value, and should therefore be as liquid as the common currency within domestic borders, while the euro will slowly be transformed into a Bancor-like currency, following the proposal by Keynes at Bretton Woods.

As long as tax credits, that is, the new fiscal currencies, are accepted by governments at their nominal value, there should be no reason for the private sector to refuse them to extinguish debts, even though they are not legal tender. As we have argued above, the private sector has a demand for safe financial assets which should be satisfied by financial instruments which are a liability of the public sector, but avoiding external imbalances, that is, large portions of private or public debt held by foreign institutions.

This solution would not require a redenomination of existing public and private debts, and should therefore increase the sustainability of public finances, as long as the introduction of fiscal currencies is targeted at increasing the growth rate of the economy, and calibrated to keep an inflow of euros in government budgets sufficient to meet their commitments with foreign creditors.<sup>9</sup>

While the introduction of a EZ Treasury would be a strong move towards European integration, the reintroduction of domestic currencies would move in the opposite direction, but it is not meant to deny the need for a strong coordination of European policies. Rather, it aims at changing the current rules, which have proven to lead to instability, and to strengthen the force of new nationalist movements which may indeed be detrimental for Europe as a whole, should they force a breakdown in any major EZ country.

## 6 CONCLUSIONS AND AN UPDATE

This paper was prepared for the FMM conference ‘The Euro at 20’ which was held in Berlin in October 2019, but it has been revised in 2020, when the pandemic from COVID-19 deeply changed the scenario in the EZ, and made several problems of the EZ architecture become more visible.

Most countries decided to freeze non-essential sectors of the economy to reduce contagion, and this implied that firms could no longer access their markets, and their workers would not be receiving any income. This prompted governments to sustain the economy, usually by postponing tax payments and providing transfers or loans to both households and firms, with a large impact on public finance. How the growing deficit should be financed is currently being discussed at all levels in domestic and European circles, and the discussion brought to the fore the conflicting interests of high-income countries with a low public debt, against those of countries with a high public debt and a lower growth rate, with the latter demanding solutions based on transfers, and the former preferring loans, to be granted under strict conditionalities for debtors to adopt appropriate austerity policies, as soon as the emergency ends.

The damage caused by austerity policies, in this case through the reduction in government expenditure on the provision of health services, has been recognized as a main cause of the dramatic toll taken by the virus, but this apparently has not been sufficient to convince Europeans of the need to strengthen the ability of the public sector to improve the quality and quantity of health care, research and education expenditure.

What should have been the logical next step in the process of European integration – the creation of a common fiscal institution for managing a much larger European budget to be used as an automatic stabilizer – has been strongly opposed, and does not seem to be on the agenda. It remains to be seen whether the new Recovery fund proposed by the European commission at the end of May 2020 will materialize, and could therefore be the start of a new course.

Some of the requirements of the Treaties have been suspended, mainly the limit to deficit spending, and the prohibition of state support to firms in trouble, but the ability of different

9. For more details, see Amato et al. (2016).

governments to exploit the suspension is currently depending on their ability to raise funds, where the magnitude of such funding depends on the damage caused by the epidemic, while the support from the ECB has remained proportional to the capital key of each member.

The crisis has created an opportunity to understand that the current rules of the EZ's game are unsustainable, for the reasons we have discussed, and forward-looking governments should use this opportunity to change the rules in the direction of inclusive growth and sustainability.

In an alternative, pessimistic scenario, core countries will not be deflected by their request for austerity on debtor countries, and the probability of nationalist movements to win the next round of elections will increase, leading to even more turbulent times for Europe and Europeans.

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