Fiscal and Monetary Policy in Europe

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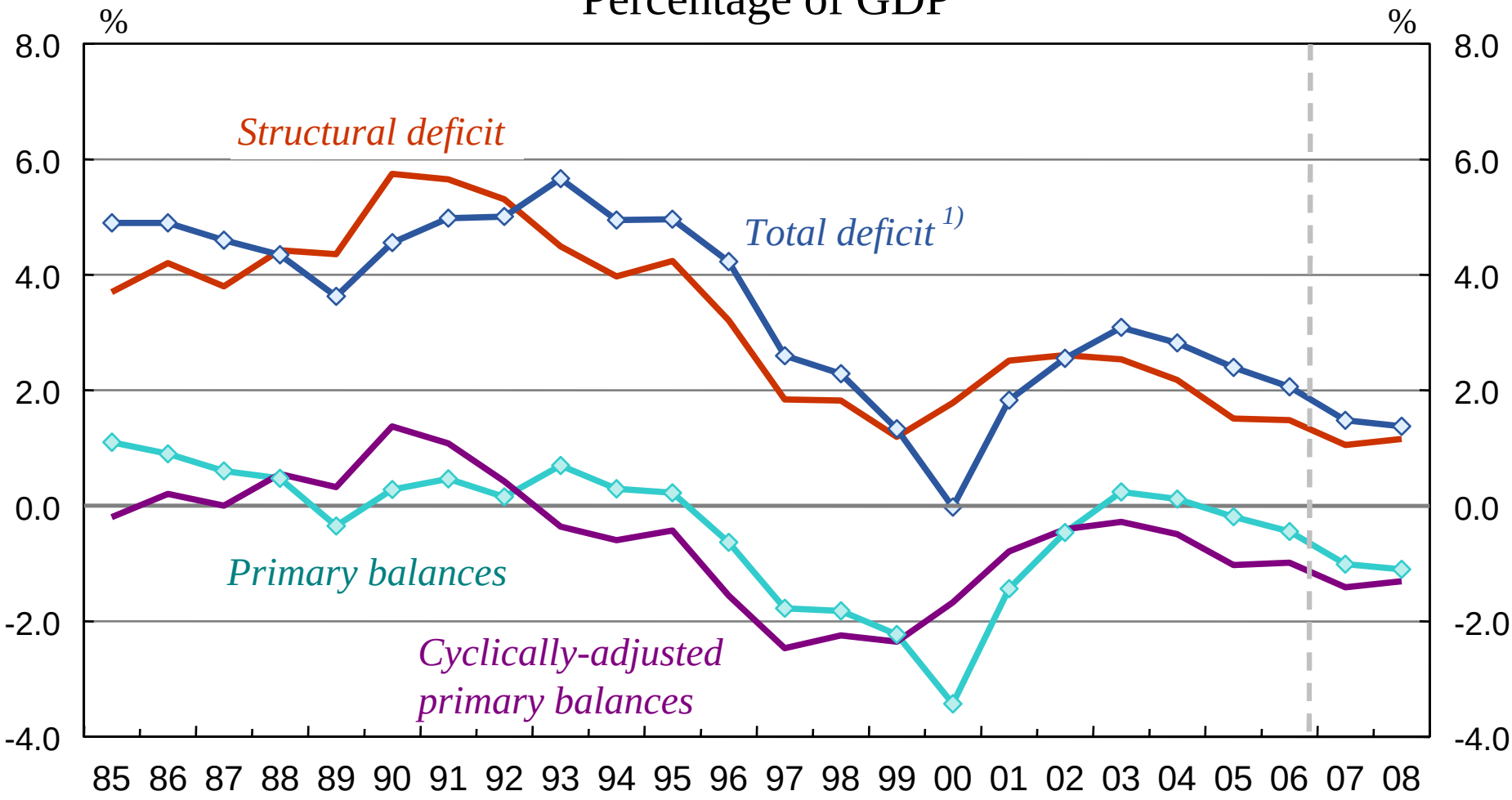
Fig. 1.18

Government budget deficit in the euro area

Percentage of GDP



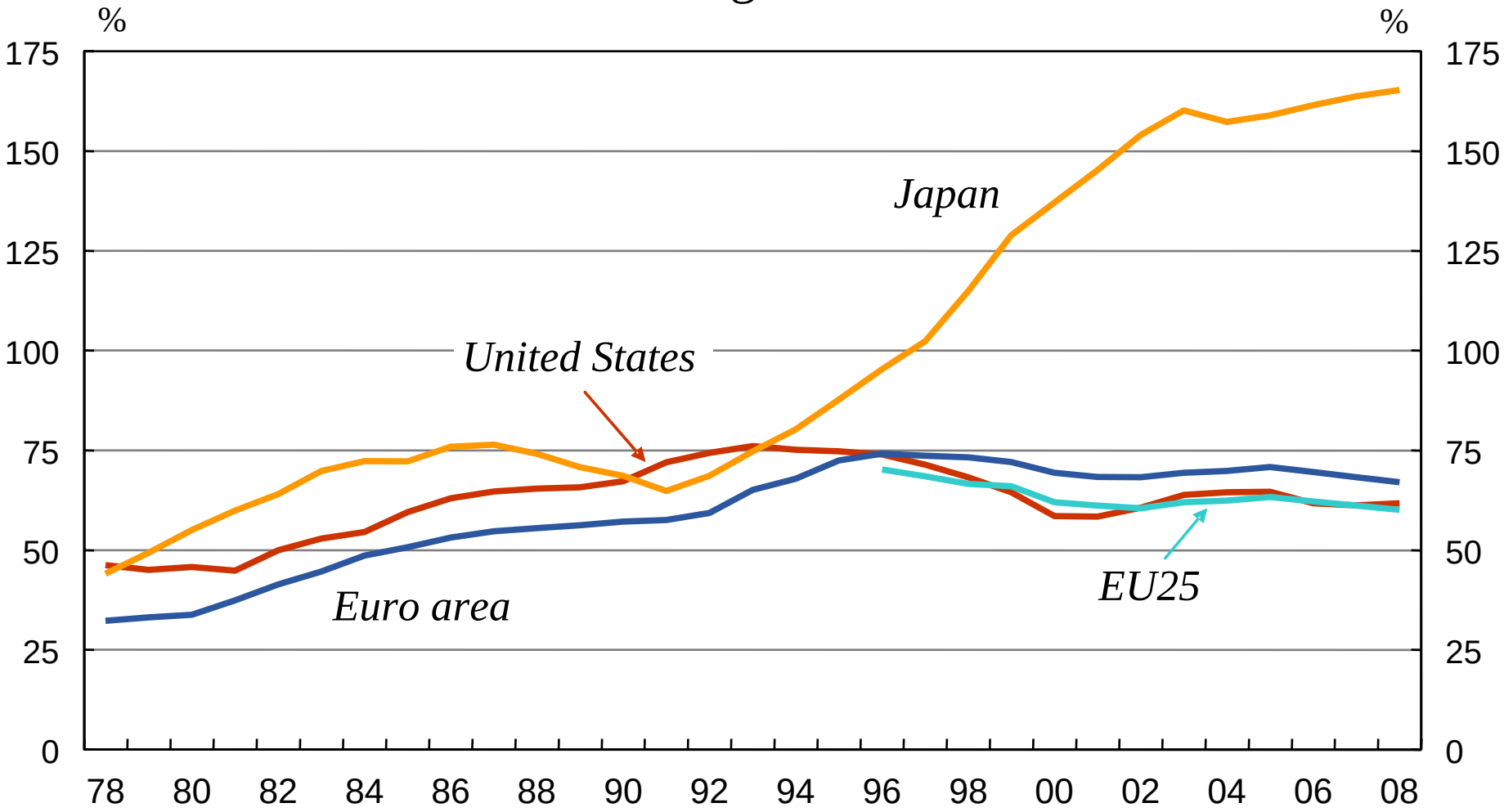
1) Excluding one-off revenues from the sale of the mobile telephone licenses in 2000.

Source: OECD, Economic Outlook 80, December 2006.

Fig. 1.5

Gross government debt

Percentage of GDP



Source: Eurostat; European Commission: Statistical Annex of the European Economy, Autumn 2006, Table 76.

The deficit bias of fiscal policy

- Political business cycles
- ”Tragedy of the commons” – the common pool problem
- Strategic considerations
- Time inconsistency
- The deficit bias is likely to be aggravated in a monetary union

  - costs of deficits and indebtedness can be shifted on to the other members

The EU fiscal rules

- The no-bail-out clause
- Government budget deficits below three per cent of GDP
- Gross government debt below 60 per cent of GDP or approaching this level ”at a satisfactory pace”
- Medium-term objective of budget ”close to balance or in surplus”

The fiscal rules

- Maastricht Treaty
- The stability and growth pact

- Preventive arm
- Corrective arm

The working of the fiscal rules

- Empirical evidence that the rules have reduced deficits
- Initially the rules were observed
- But later a large number of violations

  - Portugal (2001, 2005-)
  - France (2002-04)
  - Germany (2002-2005)
  - Netherlands (2003)
  - Greece (1997-2005)
  - Italy (2003-)
  - UK (2003-04)
  - Several of the new member states (Hungary 10.1 per cent of GDP in 2006)

2005 revision of the stability pact

- Changes strengthening fiscal discipline refer mainly to the soft parts of the pact

  - increased emphasis on the debt criterion

  - ”commitment” to enhanced budgetary discipline

    in good times

  - minimum fiscal efforts

- The crucial changes are those that apply to the hard parts: the excessive deficit procedure

  - extension of deadlines

Main changes in excessive deficit procedure

- Widening of ”severe cyclical downturn exemption” is OK
- ”Other relevant factors”
  - “policies in the context of the Lisbon agenda”
  - “policies to foster R&D and innovation”
  - “budgetary efforts towards increasing or maintaining at a high level financial contributions to fostering international solidarity and to achieving European policy goals, notably the unification of Europe”
- Use of exemption possibilities restricted by stipulation that deficit must remain *close* to the deficit ceiling and that the excess must be *temporary*
- The main problem is the possibilities to *extend the deadlines* for correction of excessive deficits

Table 9 Theoretically possible scenarios for the excessive deficit procedure in case of non-compliance (time until first fine)

Year	Old pact as originally envisaged and strict application of new pact	Lax application of new pact	Very lax application of new pact	Super-lax application of new pact	Maximum laxity according to new pact
t	Budget deficit above 3 % of GDP	Budget deficit above 3 % of GDP	Budget deficit above 3 % of GDP	Budget deficit above 3 % of GDP	Budget deficit above 3 % of GDP
t+1	Council decision on excessive deficit and recommendation	Council decision on excessive deficit and recommendation	Council decision on excessive deficit and recommendation	Council decision on excessive deficit and recommendation	Excessive deficit exception
t+2	Deadline for correction				Council decision on excessive deficit and recommendation
t+3	First deposit	Extended initial deadline	Extended initial deadline	Extended initial deadline	
t+4	Second deposit	First deposit	Repeated recommendation and new extension of deadline	Repeated recommendation and new extension of deadline	Extended initial deadline
t+5	First deposit converted into fine	Second deposit	First deposit	Repeated notice and further extension of deadline	Repeated recommendation and new extension of deadline
t+6		First deposit is converted into fine	Second deposit	First deposit	Repeated notice and further extension of deadline
t+7			First deposit converted into fine	Second deposit	First deposit
t+8				First deposit converted into fine	Second deposit
t+9					First deposit converted into fine

Note: The table has been constructed under the assumption that a deficit above three per cent of GDP is identified the year after its occurrence. Later identification would lengthen the period before fines should be imposed according to the new rules.

Widened scope for discretionary decision-making in the excessive deficit procedure

- Very far from the original German proposal of automatic sanctions
- The idea was to constrain discretionary fiscal policy decisions at the national level
- But discretionary decisions are now back at the enforcement level
- Discretionary political decision-making is the root of the enforcement problem
- More discretion cannot be the solution: it will only aggravate the enforcement problem

Main credibility loss

- Demonstration that the fiscal rules are endogenous
- The rules are likely to change in response to violations of at least the large countries

The short-term outlook

- Budget deficits will be reduced, but they will not be reduced enough
- Unfortunate stabilisation policy mix represents a coordination failure
  - fiscal policy is tightened too little
  - monetary policy is tightened too much
- Even though Germany reduced its deficit in 2006 below three per cent of GDP, the credibility loss has already been suffered
  - three-year extension despite no ”unexpected adverse events”
  - establishment of the principle that consent must be obtained from the perpetrator (at least if it is a large country)
- Short-term budget improvements are not a cause for optimism: they are likely to be an excuse for complacency which will exacerbate future problems

Fiscal balance in percent of GDP		
	2006	**2007**
Germany	-2.3	-1.6
France	-2.7	-2.6
Italy	-4.7	-2.9
Spain	1.5	1.1
Netherlands	0.0	0.1
Belgium	-1.2	-0.5
Austria	-1.3	-1.2
Greece	-2.6	-2.6
Finland	2.9	2.9
Ireland	1.2	0.9
Portugal	-4.6	-4.0
Slovenia	-1.6	-1.6
Luxembourg	-1.5	-0.5
Euro area	-2.0	-1.5
United Kingdom	-2.9	-2.8
Sweden	2.8	2.4
Denmark	4.0	4.3

Gross debt in percent of GDP		
	2006	**2007**
Germany	67.8	67.7
France	64.7	63.9
Italy	107.2	105.9
Spain	39.7	37.0
Netherlands	50.5	47.8
Belgium	89.4	86.3
Austria	62.1	60.9
Greece	104.8	101.0
Finland	38.8	37.3
Ireland	25.8	24.4
Portugal	67.4	69.4
Slovenia	28.4	28.0
Luxembourg	7.4	7.3
Euro area	69.4	68.0
United Kingdom	43.2	44.1
Sweden	46.7	42.6
Denmark	28.5	24.5

Possible ”technical” solutions

- Depoliticisation of the enforcement procedure
  - EEAG proposal to transfer decisions on sanctions in the EDP to the European Court of Justice
- Stronger political incentives to employ sanctions
  - member states with excessive deficits should not be allowed to vote in the EDPs for others
  - smaller and more gradual deposits (fines) would strengthen the incentives to use sanctions
  - non-pecuniary sanctions (loss of voting power?)

Table 8 The size of deposits/fines

Deficit (per cent of GDP)	Deposit/fine (per cent of GDP)	
	Year 1	Subsequent years
3-4	0.3	0.1
4-5	0.4	0.2
5-6	0.5	0.3
6-7	0.5	0.4
7-	0.5	0.5

A dysfunctional system of economic policy making in the euro area

- Too weak incentives for fiscal restraint
- Too low an inflation target (which is never attained) and lack of transparency for the monetary policy framework
- It would be desirable to reform the frameworks for both fiscal and monetary policy

  Step 1: Restore a stringent fiscal policy framework

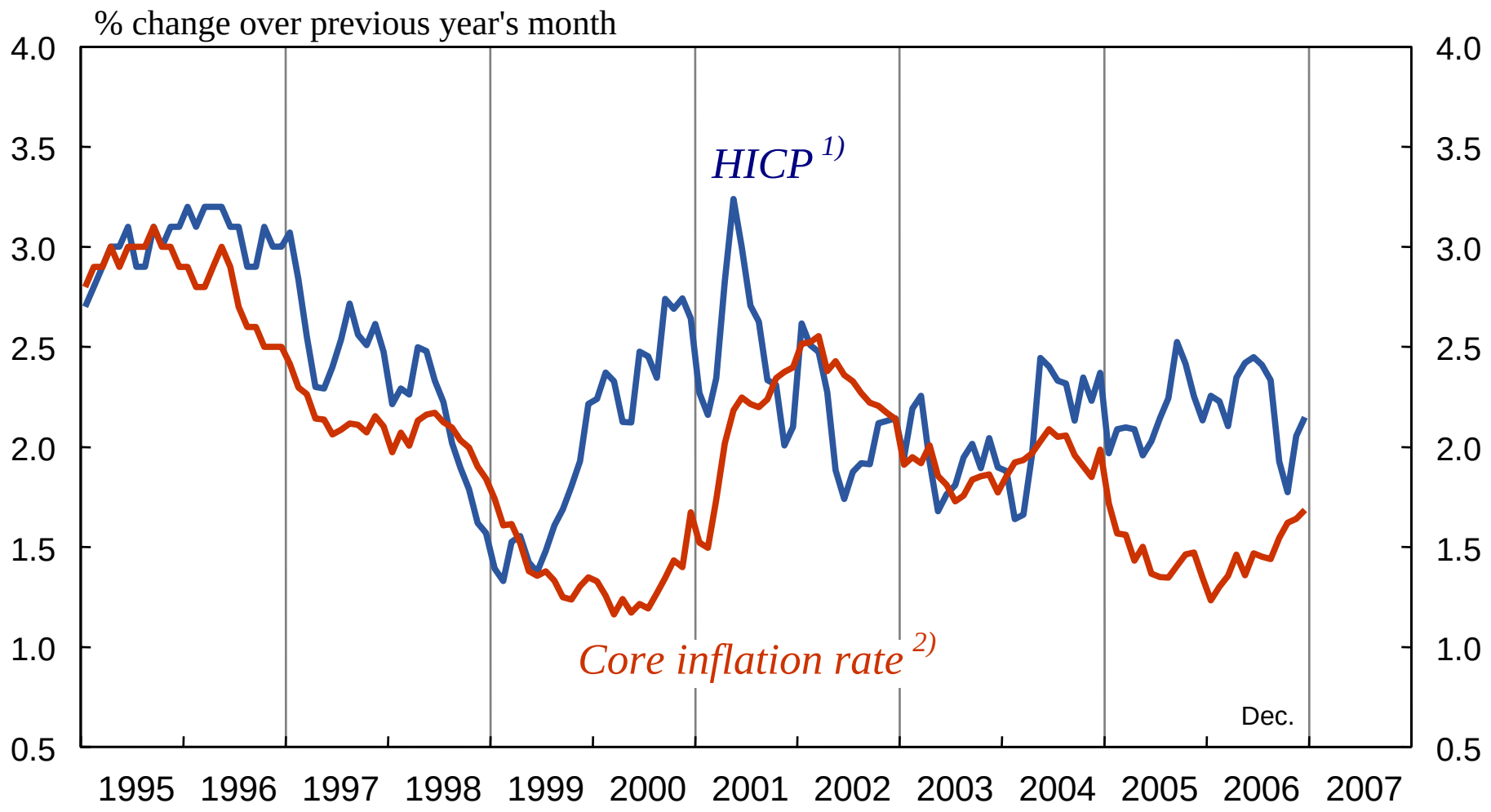
  Step 2: The ECB could reward fiscal policy makers by reforming the monetary policy framework

Stronger incentives for fiscal discipline may have to be established at the national level

- Too weak incentives for governments to adhere to own fiscal objectives
- National fiscal policy councils
  - monitor that *ex post* government policy is consistent with *ex ante* objectives
  - recommendations on the fiscal policy stance
  - forecasts forming the basis for the government budget proposal
  - evaluation of government budget proposal
  - basis for the parliamentary decision-making process
  - increased transparency of the budget process and higher reputation costs of fiscal profligacy

Fig. 1.9

Price developments in the EU25

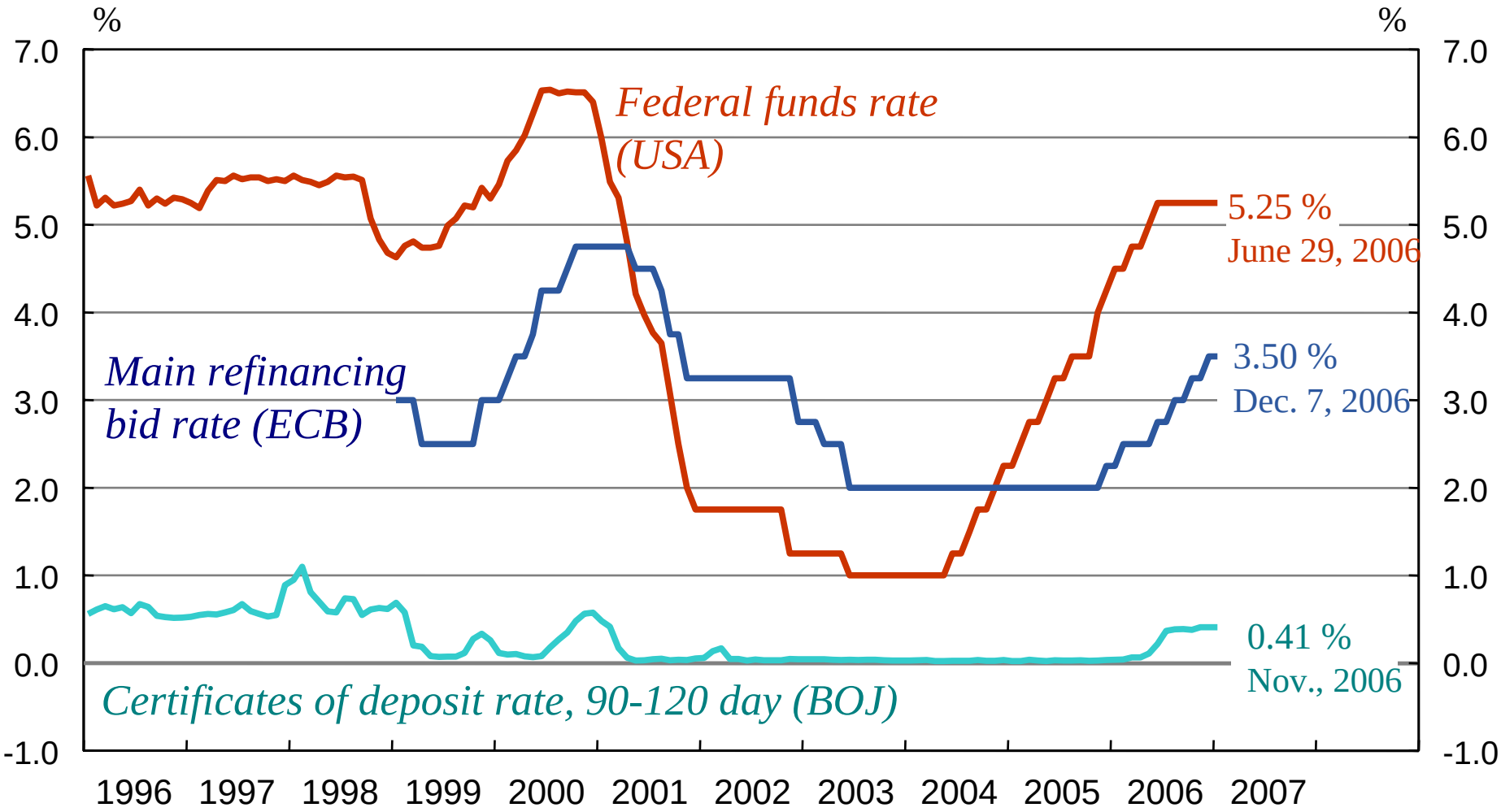


1) Harmonised Index of Consumer Prices.
2) HICP excluding energy and unprocessed food.

Source: Eurostat.

Fig. 1.4

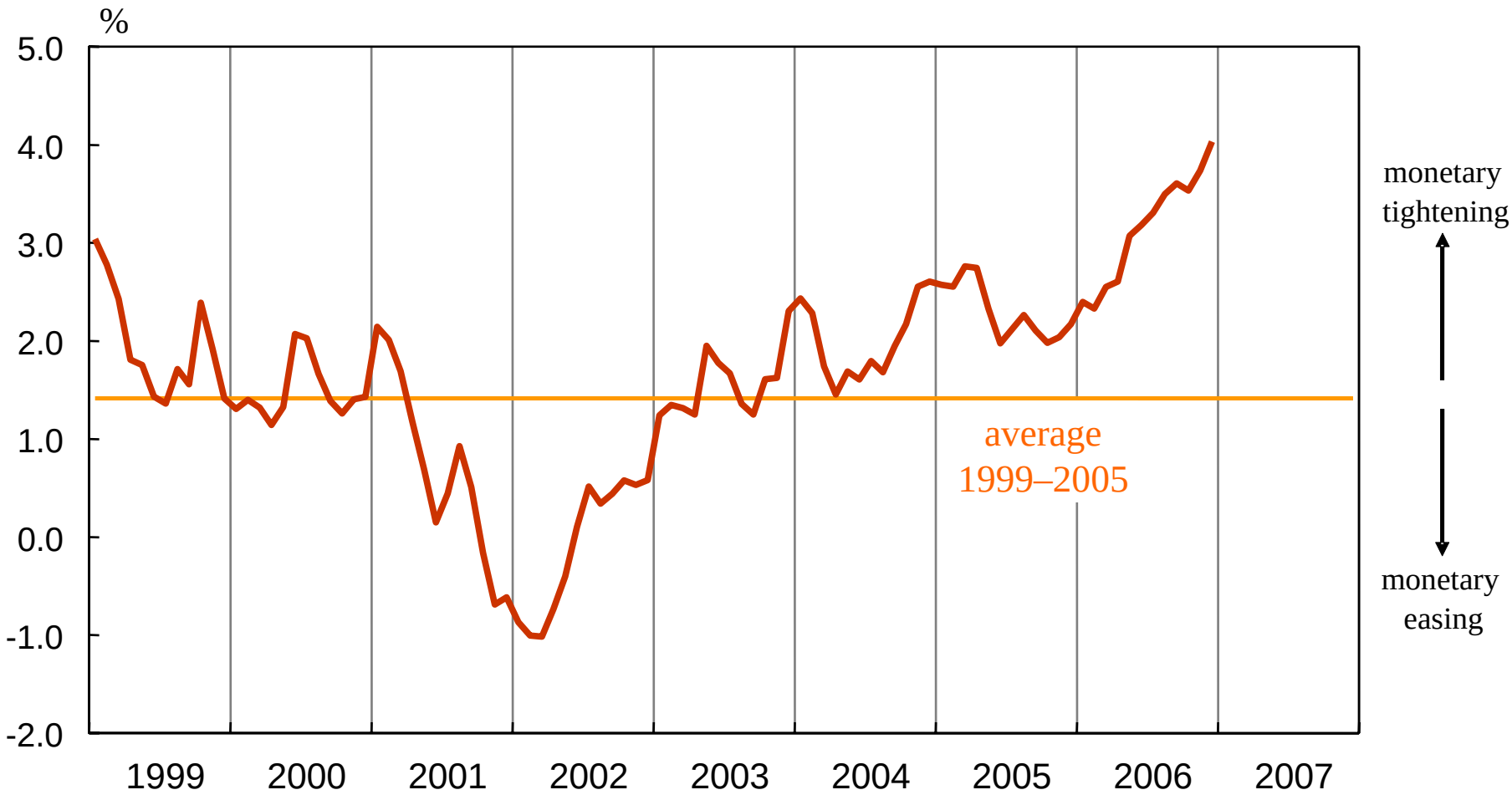
Central bank interest rates



Sources: Bank of Japan; European Central Bank; Federal Reserve Bank of St. Louis.

Fig. 1.29

Monetary conditions index in the euro area

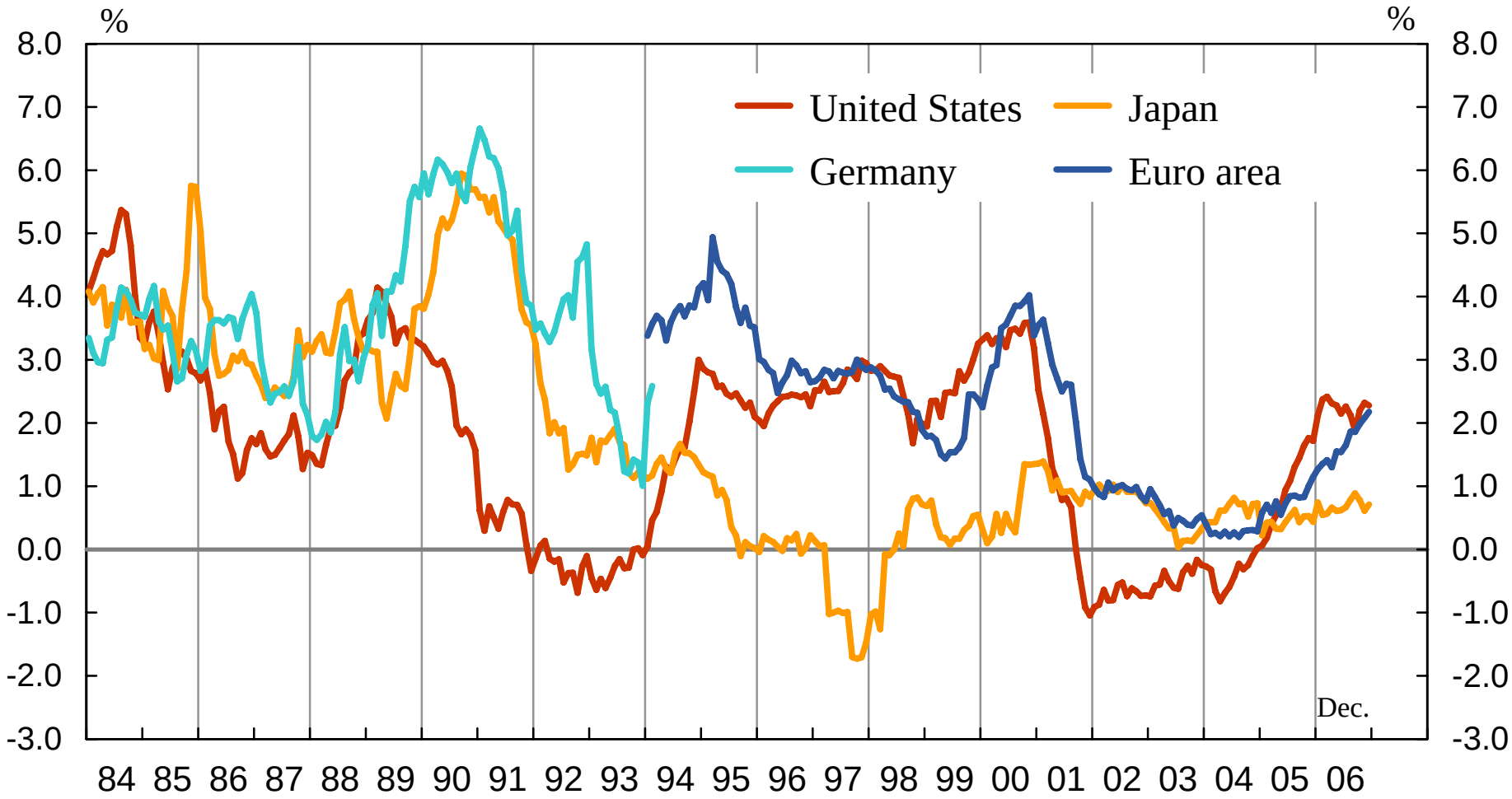


Note: The MCI index is calculated as a weighted average of the real short-term interest rate (nominal rate minus core inflation rate) and the real effective exchange rate of the euro.

Sources: European Central Bank; Ifo Institute calculations.

Fig. 1.10

Real short-term interest rates[1)]

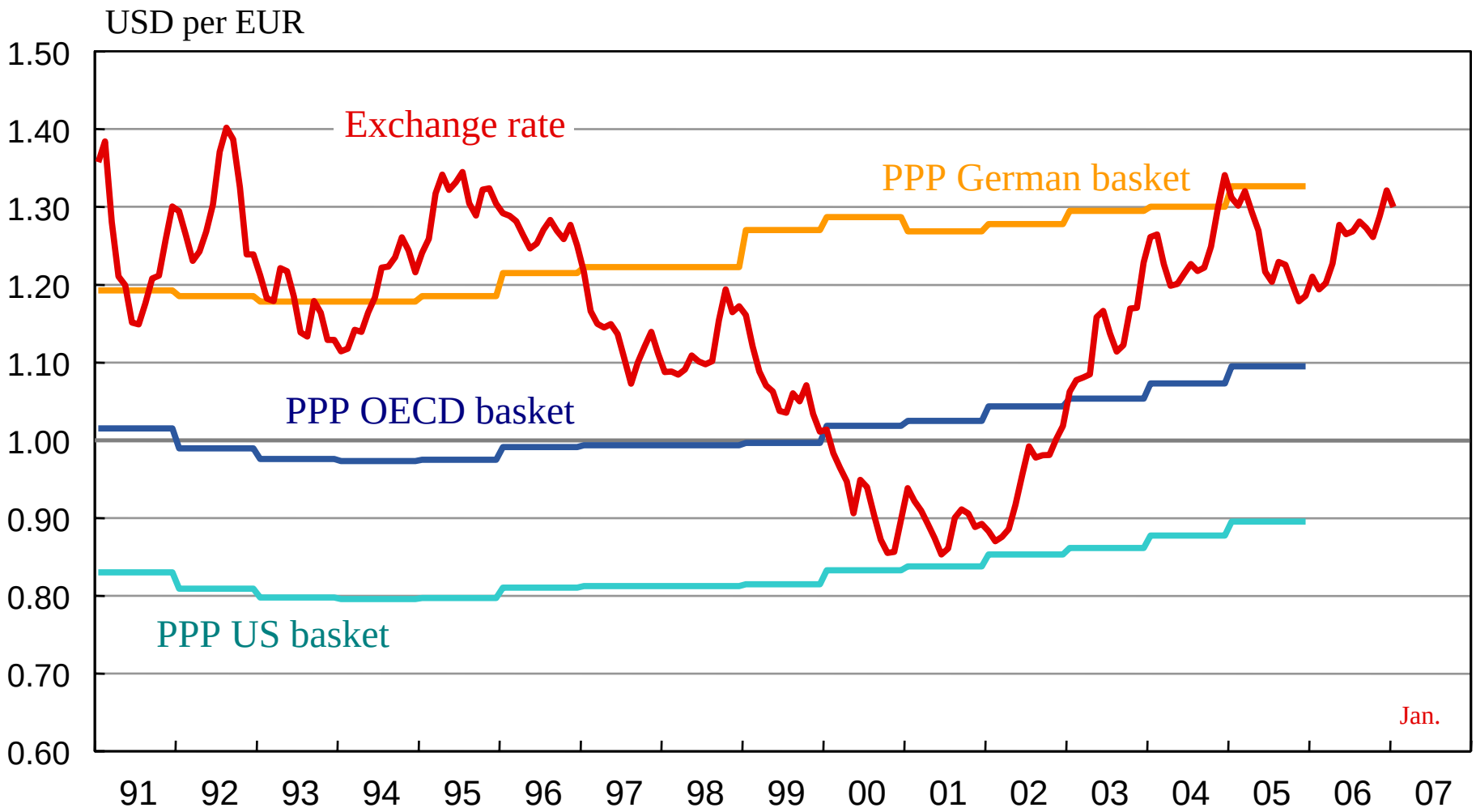


1) 3-month interest rates minus core inflation rate (CPI excluding food and energy).

Sources: Deutsche Bundesbank; European Central Bank; Eurostat; Federal Reserve Bank of St. Louis; Federal Statistical Office, Germany; OECD; Ifo Institute calculations.

Fig. 1.2

Exchange rates of the euro and PPPs [1)]



1) Exchange rate are monthly data, while PPPs are given at an annual frequency. Different PPPs are computed with respect tot the different consumption baskets in the United States, the OECD and Germany.

Sources: European Central Bank; Federal Statistical Office; OECD; Ifo Institute calculations.

A forward-looking Taylor rule

$$i^* = \bar{i} + \alpha(\pi^e - \pi^*) + \beta(y^e - y^*)$$

$$y^e - y^* \approx \Delta y^e - \Delta y^*$$

$$i^* = \bar{i} + \alpha(\pi^e - \pi^*) + \beta(\Delta y^e - \Delta y)$$

Interest-rate smoothing:

$$i = \delta i_{-1} + (1 - \delta) i^*$$

Parameter values according to EEAG (2007)

$\delta = 0.87$

$\bar{i} = 2.96$

$\alpha = 1.54$

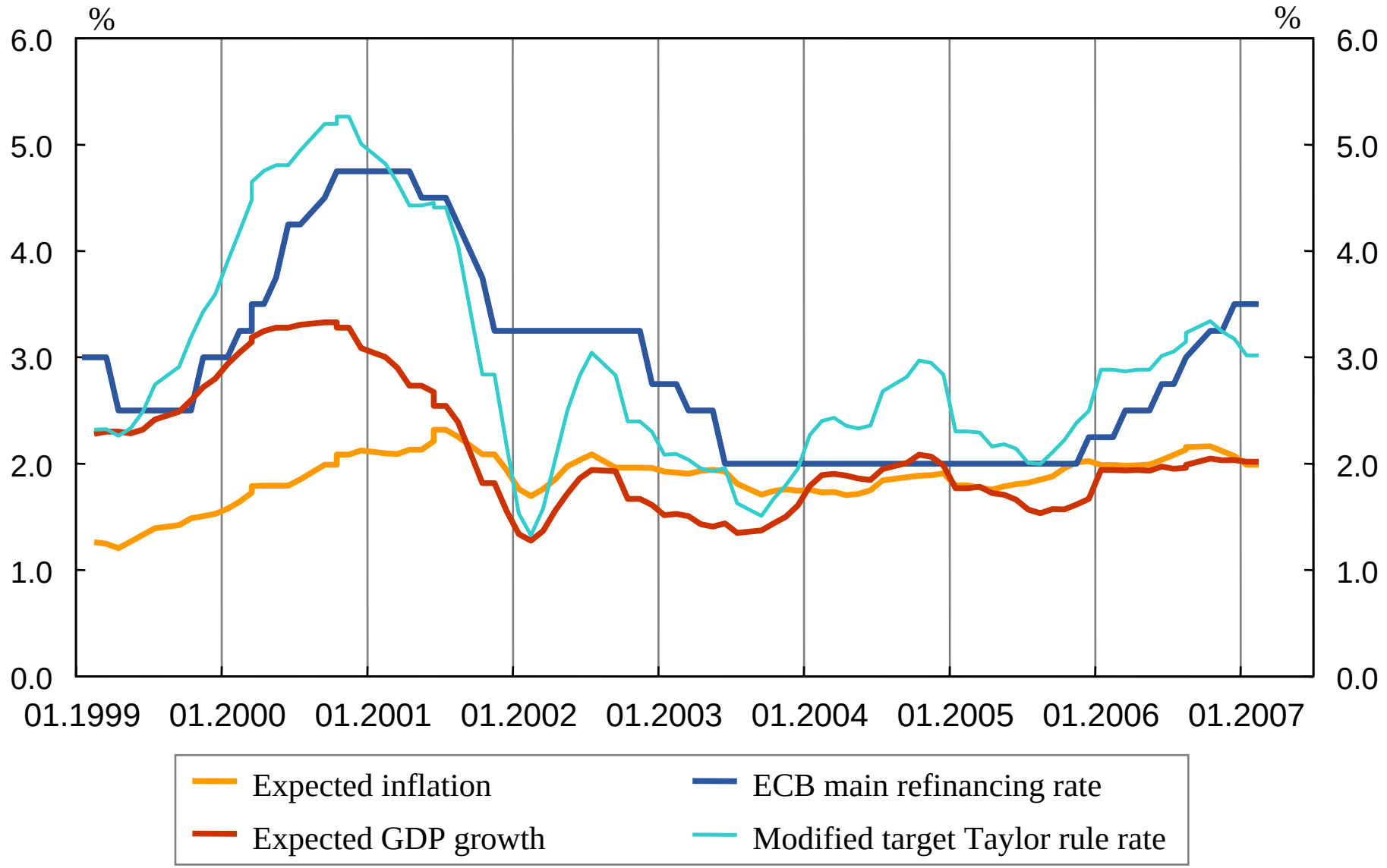
$\beta = 1.65$

$\pi^* = 1.87$

$\Delta y^* = 2.11$

Fig. 1.30

Interest rates and expectations in the euro area



Sources: European Central Bank; Consensus Economics; calculations by the EEAG.

How well does ECB policy fit individual countries?

- Assumption: the optimal policy rule is given by the ECB rule with country-specific inflation and output growth expectations
- Considerable stabilisation policy costs
- On average 1.2 percentage points higher interest rate in Ireland and 0.4 percentage points lower in Germany
- Large cyclical discrepancies at times
  - Ireland 2000-01: +3.4 percentage points
  - Greece 2003: +2.8 percentage points
  - Netherlands 2001: +2.2 percentage points
  - Netherlands 2004: -1.7 percentage points
  - small discrepancies for Sweden
  - large ones for the UK
- Weigh interest rate differences by country size
  - no trend towards more synchronised cycles
  - ECB attaches too small weight to large countries

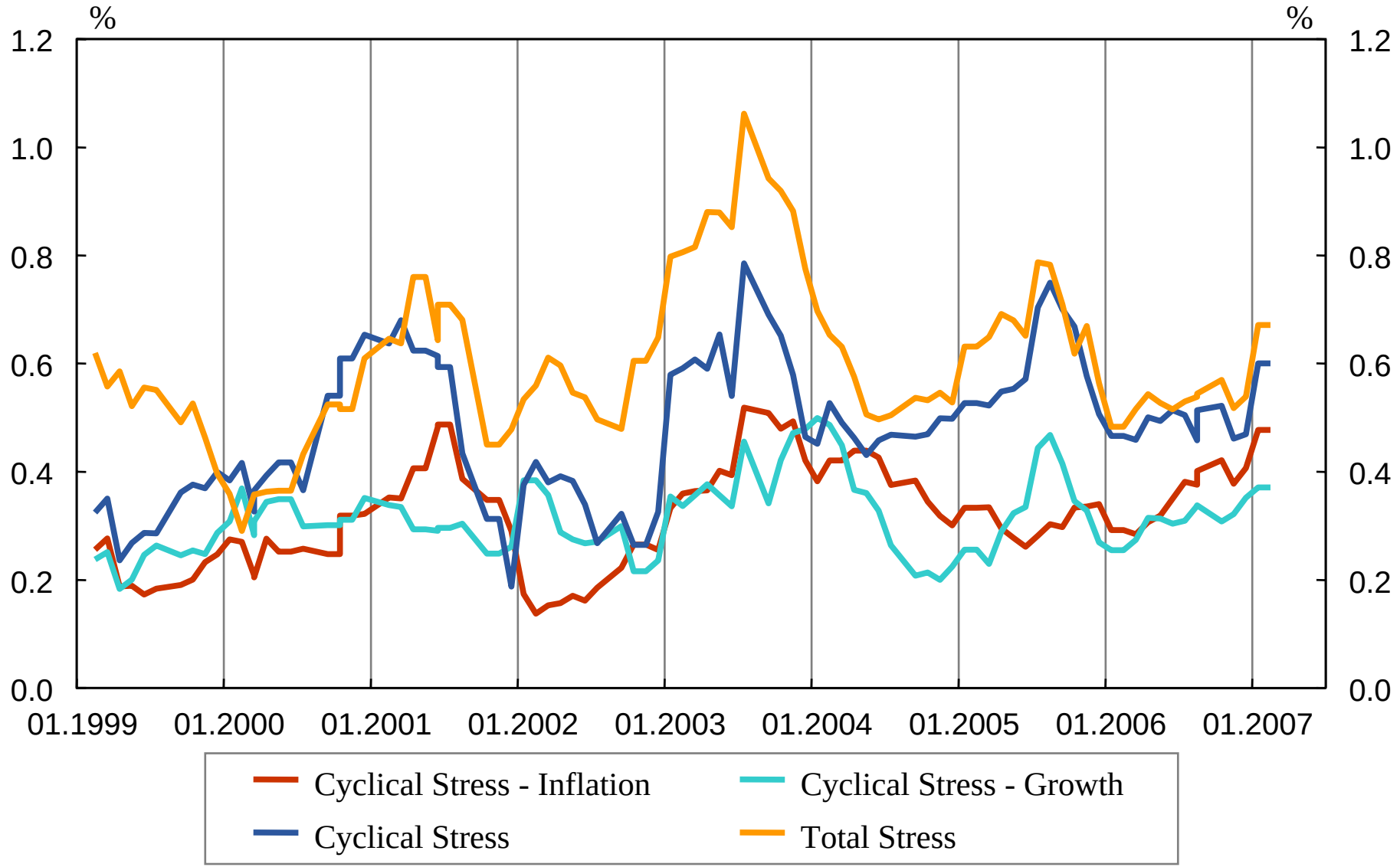
Table 1.3

Decomposition of country stress level

	Structural	Cyclical								
	99–06	1999	2000	2001	2002	2003	2004	2005	2006	RMSE
Austria	0.24	0.42	0.67	0.21	0.20	0.05	0.27	−1.27	−0.48	0.65
Belgium	0.12	0.39	0.18	0.24	0.39	0.57	−0.02	−0.96	−0.63	0.57
Finland	0.19	−0.18	−0.90	−0.83	0.77	0.16	0.96	0.07	0.08	0.72
France	0.36	0.27	0.19	0.60	−0.03	−0.15	−0.52	−0.46	0.12	0.40
Germany	0.37	−0.15	−0.27	−0.13	0.18	0.69	−0.08	0.17	−0.35	0.35
Greece	−1.08	0.52	1.72	0.49	−0.68	−1.70	−0.78	0.06	0.09	1.10
Ireland	−1.20	−1.88	−2.36	−2.07	0.81	0.41	2.74	1.08	1.31	1.88
Italy	−0.16	0.27	0.14	−0.09	−0.41	−0.83	−0.30	0.41	0.72	0.54
Netherlands	−0.29	−0.72	−1.35	−1.92	−0.68	0.83	1.94	1.64	0.27	1.39
Portugal	−0.65	−1.93	−0.21	−0.45	−0.46	−0.12	0.62	0.40	1.80	1.04
Spain	−0.92	0.16	0.95	0.80	0.41	−0.66	−0.04	−0.77	−0.86	0.74
Denmark	−0.19	0.06	0.86	0.96	−0.28	−0.79	0.13	−0.57	−0.43	0.68
Sweden	0.29	1.07	0.08	0.73	−0.55	−0.68	0.21	0.05	−0.75	0.75
United Kingdom	−0.44	1.24	1.08	1.18	−0.25	−1.26	−1.36	−0.62	−0.03	1.10

Fig. 1.31

Decomposition of weigthed absolute sum of stress in the euro area



Sources: European Central Bank; Consensus Economics; calculations by the EEAG.

Risks of asymmetric (country-specific) shocks

- Types of shocks
  - demand shocks
  - supply shocks
- Recessionary shocks
- Expansionary shocks
  - overheating
  - overshooting of the real exchange rate
  - Walters effect: higher (anticipated) inflation reduces the real interest rate

Adjustment mechanisms (according to OCA theory)

- Temporary migration
- Nominal wage flexibility
- Fiscal policy
- Internal exchange rate changes (changes in payroll taxes)

Macroeconomic adjustment in the euro area

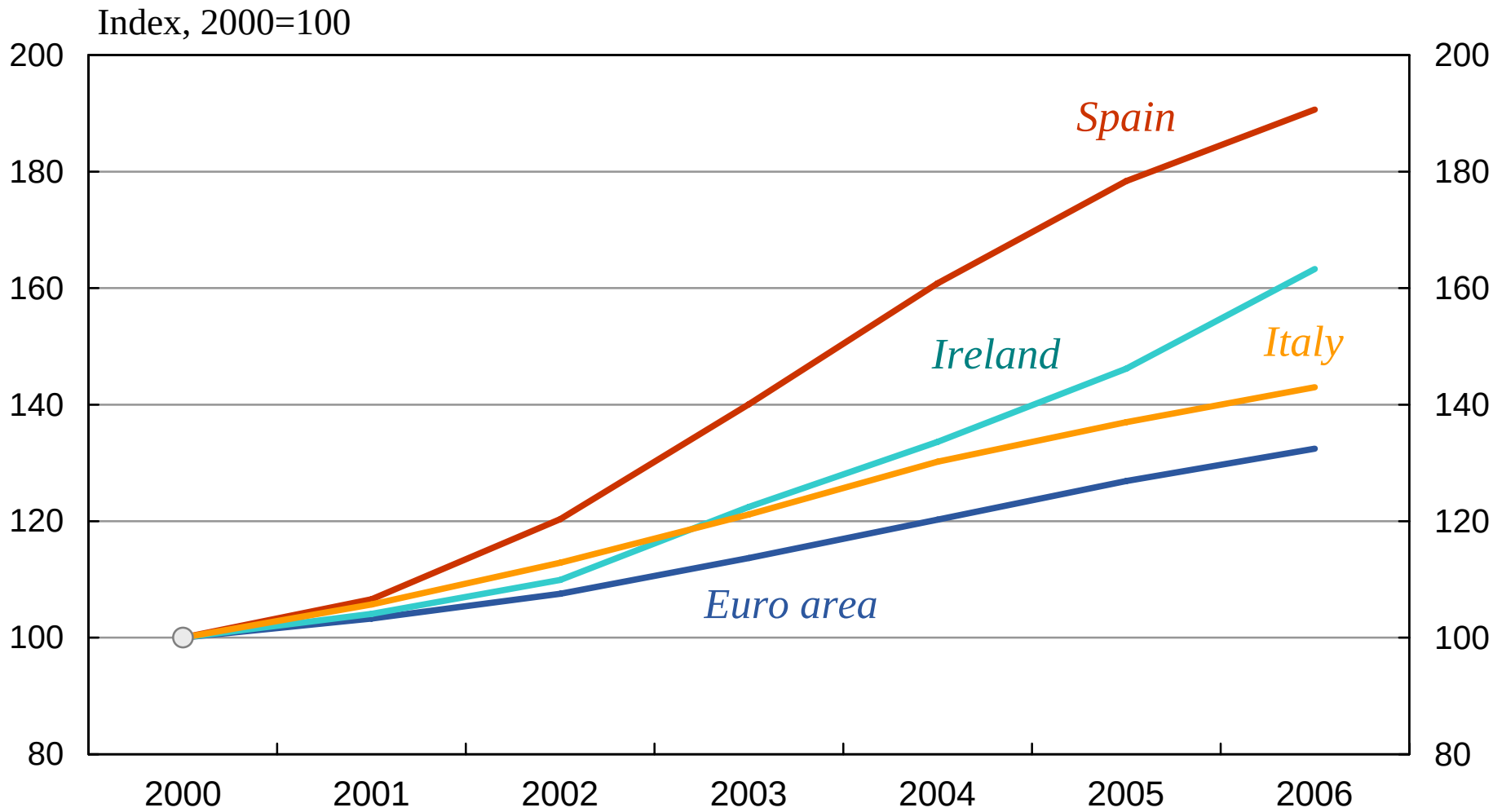
- What have we learnt from actual experiences?
  - Ireland: a booming economy
  - Italy: competition shocks from emerging economies and negative productivity growth

Six lessons

1. Interaction between ordinary wage-price dynamics and housing price dynamics (Ireland)
2. Migration flows contain labour shortages but also add to aggregate demand (Ireland)
3. Not so easy to use fiscal policy (mostly procyclical in Ireland, little room for manoeuvre in Italy)
4. Adverse productivity developments in combination with persistent wage growth may gradually build up competitiveness problems over time (Italy)
5. Internal devaluations do not suffice (Italy)
6. Productivity-enhancing deregulations may be necessary not only for long-term growth but also for short-term adjustment (Italy and **Sweden**)

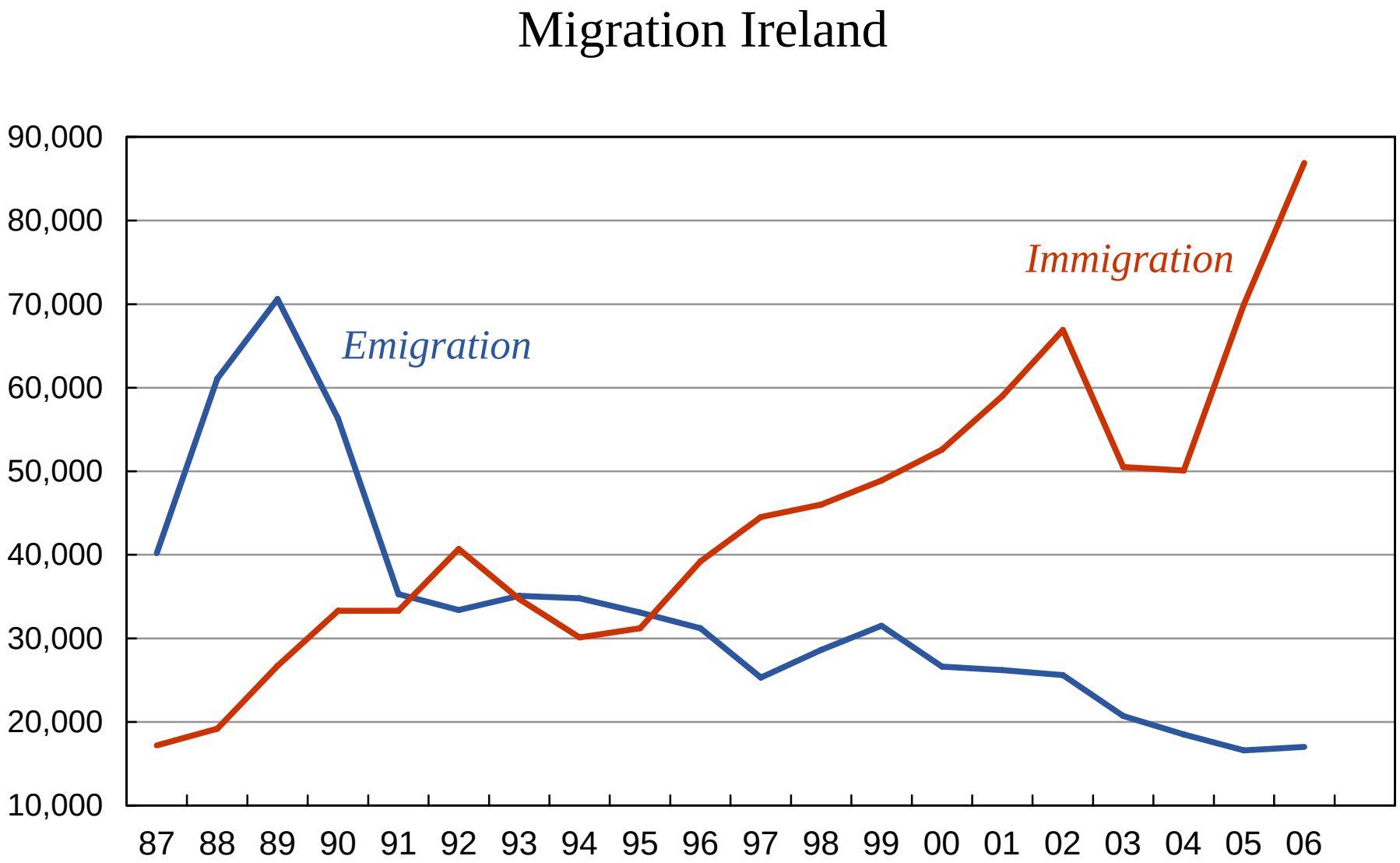
Fig. 2.1

Real house prices



Source: OECD (2006).

Fig. 2.4



Source: Central Statistics Office Ireland (2006).

The development of various measures of wages and wage costs

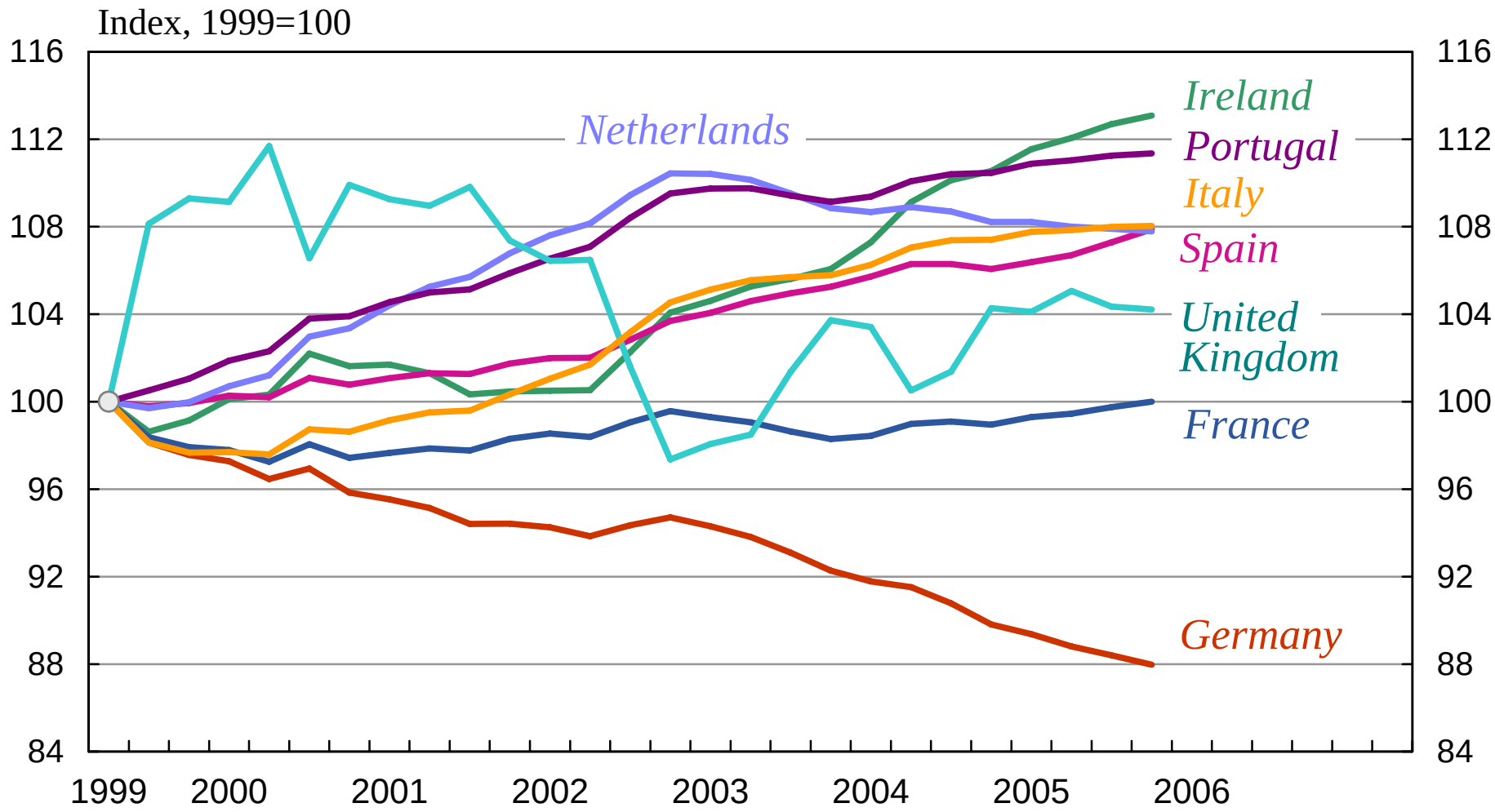
Average annual changes in percent

		Nominal wage	Labour productivity	Unit labour costs	Relative unit labour costs
EURO	**2003-05**	**1.6**	**0.6**	**1.3**	**5.1**
	2006	**1.9**	**1.2**	**0.9**	**-1.1**
Germany	**2003-05**	**0.6**	**0.8**	**-0.5**	**-0.6**
	2006	**0.6**	**2.0**	**-1.5**	**-4.0**
Italy	**2003-05**	**2.0**	**-0.3**	**3.5**	**4.6**
	2006	**3.4**	**0.2**	**3.7**	**2.7**

Source: OECD Economic Outlook 80 database

Fig. 2.2

Real effective exchange rates versus EU15 members

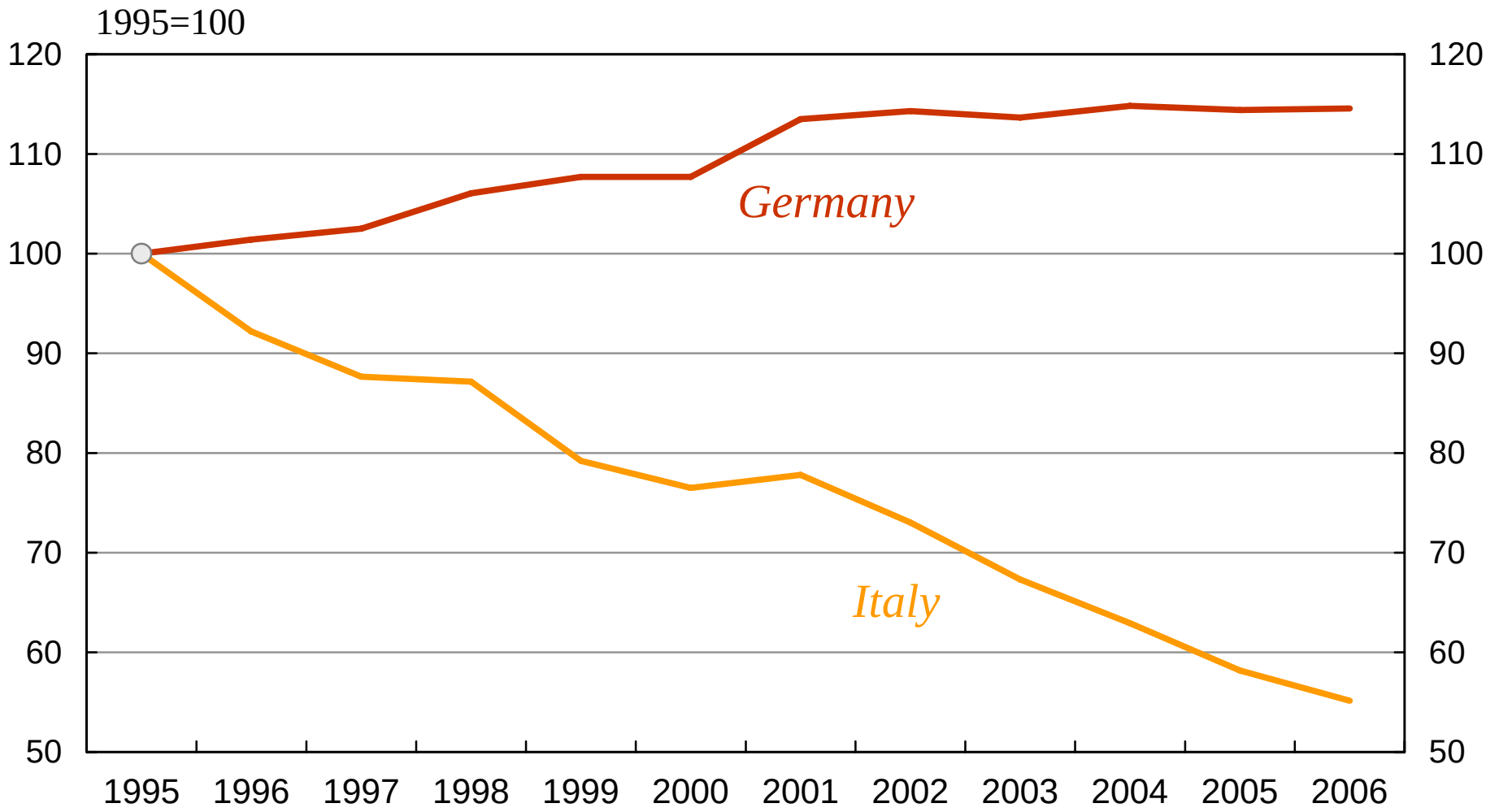


Note: Real effective exchange rate is defined as relative unit labour cost.

Source: Eurostat (2006).

Fig. 2.5

Share in world merchandise exports in volume terms



Source: Banca d'Italia (2006b).

Table 4.4

Growth in GDP per hour (annual averages), percent, 1970–2004

	1970–79	1980–89	1990–94	1995–99	2000–04
Denmark	3.6	2.4	2.4	1.8	1.4
Finland	3.8	2.9	2.1	2.7	2.8
Sweden	2.4	1.5	2.0	2.4	2.6
Weighted average Scandinavian countries	**3.1**	**2.1**	**2.1**	**2.3**	**2.3**
Austria	4.4	1.4	0.9	3.2	1.4
Belgium	4.0	2.1	2.9	2.7	0.6
France	4.0	3.0	1.5	2.1	1.5
Germany	4.0	2.2	3.0	1.9	1.2
Greece	4.9	0.1	0.1	2.2	2.9
Ireland	4.8	3.6	3.2	6.3	4.2
Italy	4.0	2.1	2.0	1.2	-0.4
Netherlands	3.7	2.2	1.0	1.7	0.7
Portugal	3.7	2.0	3.9	2.1	0.5
Spain	6.0	3.2	2.7	0.1	0.1
Weighted average euro area	**4.3**	**2.4**	**2.2**	**1.7**	**0.8**
UK	3.1	2.4	3.2	1.9	2.0
US	1.7	1.5	1.4	2.3	2.8

Sources: Groningen Growth and Development Centre, Total Economy Growth Accounting Database and Total Economy Database.