The euro area’s fiscal position makes no sense

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March 14, 2018 By: Matthew C Klein

Collectively, the 19 nations of the euro area are running a fiscal policy about as tight as they were at the peak of the boom years:

The bloc’s elites may have convinced themselves this is appropriate, but the euro area’s economy is still far weaker now than it was ten years ago.

The overall jobless rate has barely recovered to where it was at the trough of the recession in the early 2000s. The share of Europeans aged 25-54 with a job looks a little better, but is still depressed:

The situation is even worse if you look at the euro area excluding Germany. The aggregate unemployment rate across the other 18 countries is still *4 percentage points* higher than before the crisis. That may be an improvement compared to a few years ago but it is still a catastrophe:

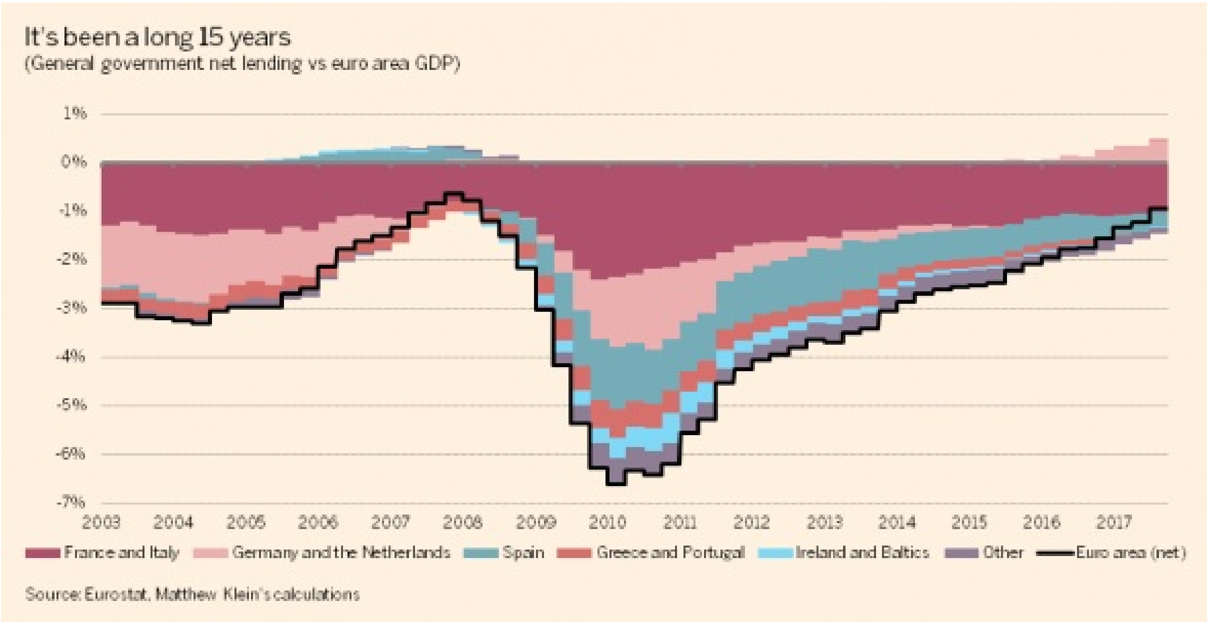
Governments normally run larger deficits when the economy is weaker because tax revenue is lower and safety net spending is larger. As an added bonus, this automatically creates additional financial assets to satisfy the private sector's heightened desire to save. While there is no rule that says what the budget deficit should be at any point in time, it's reasonable to think the 19 governments of the euro area are collectively taxing too much and spending too little by several percentage points of gross domestic product — perhaps around €500bn each year.

For perspective, the euro area's governments never loosened fiscal policy nearly as much as the United States. They have since tightened policy far more:

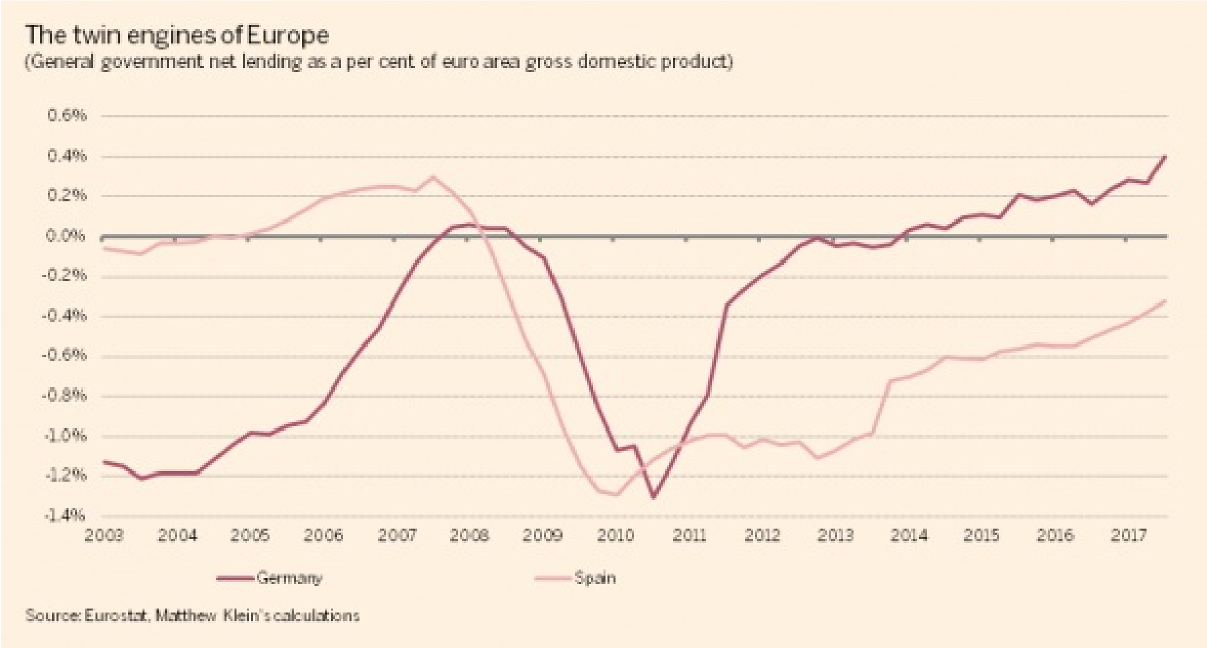
It’s common to blame Germany’s large budget surplus for the euro area’s excessive fiscal rectitude, but the governments of Greece, Cyprus, Latvia, Lithuania, Luxembourg, Malta, and the Netherlands also have budget surpluses. Almost *every* government in the bloc has slashed its net borrowing to the lowest levels since the creation of the single currency, irrespective of the health of the economy.

Since the euro area’s aggregate fiscal deficit peaked at the start of 2010, the budget tightening has been distributed mostly according to the size of each country’s economy. Germany was producing about 27 per cent of the bloc’s total output at the start of 2010 and has contributed about 26 per cent of the total fiscal tightening since then. The main exceptions have been Ireland, Greece, and Spain, which over-contributed to the bloc’s tighter fiscal stance, and France and Italy, which did less than would have been expected given their economic heft.

The chart below decomposes the aggregate fiscal balance of the euro area into several country groups that had similar experiences:



Germany and Spain have been responsible for the bulk of the volatility in the overall fiscal balance. Strikingly, Spain’s general government budget surplus in 2007-8 was about as large relative to the euro area’s economy as Germany’s surplus in the past few years:



There are some important differences between Spain then and Germany now. Back when the consolidated Spanish government was running its massive budget surpluses, the country was experiencing rapid real wage growth, booming investment spending, and a private-sector borrowing binge. The German economy today is strong by recent standards, but wage growth, investment spending, and private borrowing remain muted.

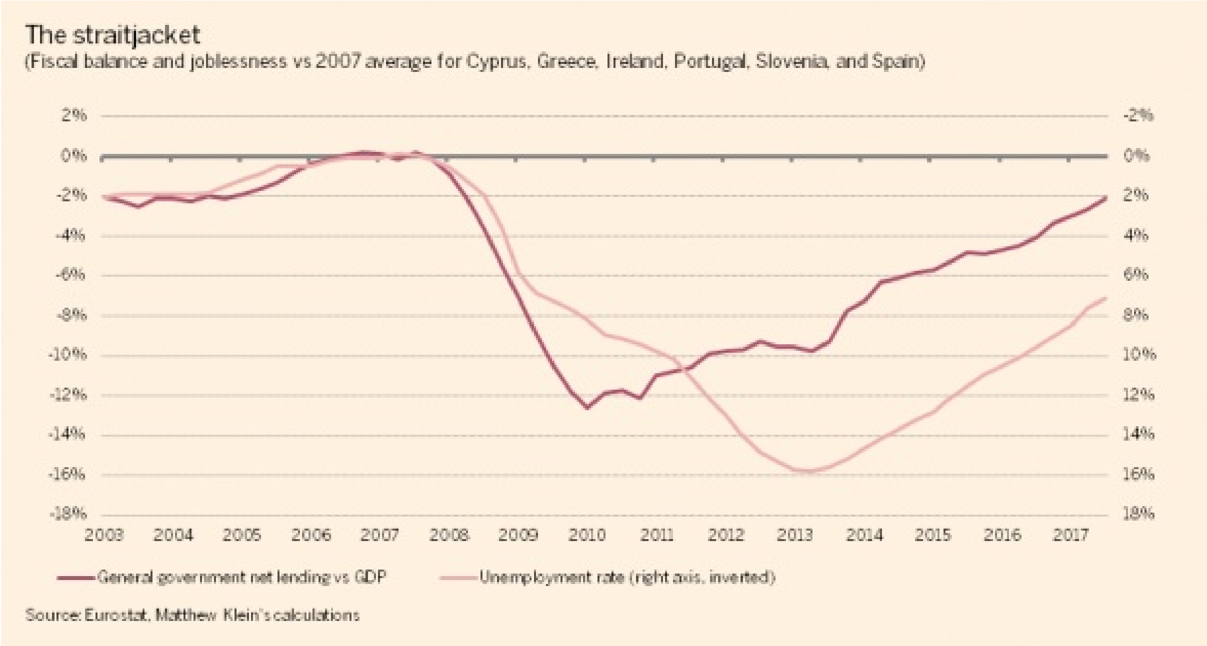
Despite these differences, the simple comparison suggests German fiscal policy is not wildly out of line with what is best for the euro area as a whole.

Yes, German citizens would benefit from a looser fiscal policy because they are overtaxed and saddled with subpar infrastructure, but this would only do so much to the bloc's aggregate government budget position. Even if the German government cut taxes and boosted investment spending enough to swing its budget balance from +1.5 per cent of German GDP to -1.5 per cent, the euro area's *combined* budget balance would only widen by about 0.8 percentage points.

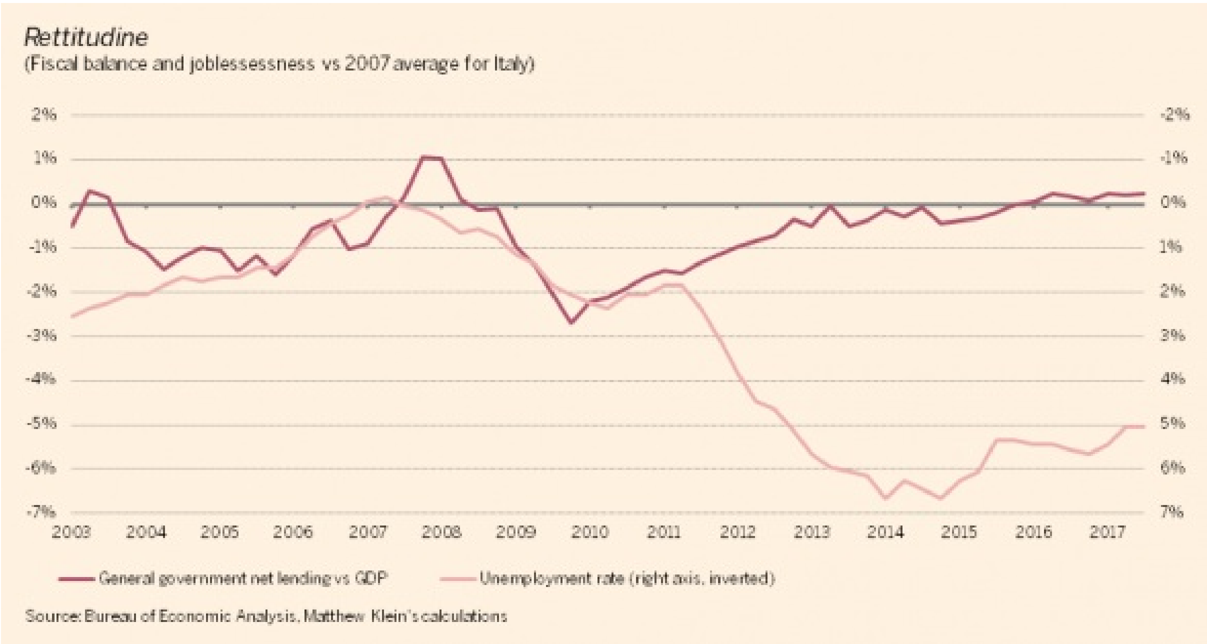
Germany's needless austerity is regrettable, but the bigger problem is that the governments in *the rest of the euro area* are either unwilling or unable to borrow more.

Suppose you think the governments of the single currency should collectively have a budget deficit of about 4.5 per cent of GDP, as opposed to the current figure of roughly 1 per cent of GDP. That would widen the aggregate fiscal deficit from about €100bn to €500bn. For Germany alone to make up this difference would require its federal, state, and local governments to run a combined budget deficit of *11 per cent* of the country's GDP. That would be hard to justify.

On the other side are Greece and Spain, which both have jobless rates above 15 per cent. The Spanish government has a deficit of around 3 per cent while the Greek government has a modest budget *surplus*. Combining these countries with the other crisis countries of Cyprus, Ireland, Portugal, and Slovenia produces this picture:



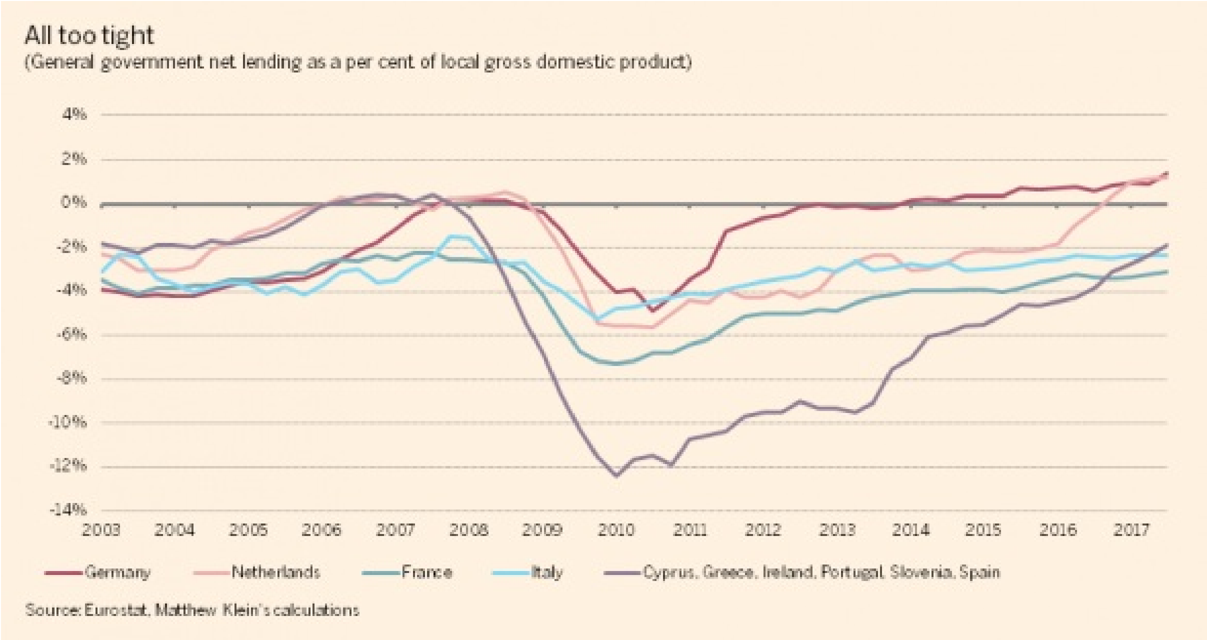
Italy missed the pre-crisis boom and never let its budget deficit expand during the bust, which makes it fundamentally different from the other crisis countries shown above. Yet the government has run a consistently tight fiscal policy over the past few years even as the economy has failed to improve much:



The Netherlands — a country more Germanic than the Germans when it comes to macro policy — has quietly suffered almost as much as Italy because of its housing bust. The share of workers aged 25-54 with a job is still around 4 percentage points lower than in 2007/8.* Yet it too has refused to let fiscal policy help smooth things out and now runs a budget surplus comparable to Germany.

France is the outlier. The country that invented the phrase "exorbitant privilege" has managed to consistently run larger budget deficits than almost every other country in the rest of the euro area, particularly Italy and, more recently, Spain. This has been good for France considering the mediocre performance of its economy, but is nevertheless surprising considering the tightening imposed on the crisis countries.

The chart below puts all this in perspective:



There is, of course, a reason why the euro area's governments aren't taxing less and spending more: they have become convinced that this is what is necessary to remain members of the single currency. Failure to comply means banking panics and capital flight. The European Central Bank will only intervene in exchange for tax hikes and spending cuts.

Elite European consensus seems convinced that:

- Debt and deficits are bad
- The ECB must be strictly limited in the support it provides to governments
- The solution to "excessive" borrowing in the past is some combination of default and forced repayment, rather than mutualisation

European officials seem to believe the only way to maintain the integrity of euro-denominated safe assets is to sharply limit the volume of these assets. They also believe fiscal policy should be set by national governments with input from Brussels, rather than coordinated across the bloc.

The places that would benefit the most from looser fiscal policy are therefore the places least able to provide it. Italy and Spain should probably have budget deficits at least twice as large as they do now, but they would have difficulty doing that without risking the ire of the ECB. Meanwhile, the few countries that have "fiscal space" — mostly Germany but also the Netherlands and Luxembourg — cannot reasonably be asked to stimulate their own economies to the extent required to push the European aggregate to something sensible.

The net effect has been to depress sovereign debt issuance. When combined with the ECB's asset purchase programme, the result has been massive capital outflows. As long as the rest of the world, particularly the English-speaking countries, are willing to absorb these flows, the euro area can (sort of) get away with its bonkers fiscal policy. But the Europeans cannot depend indefinitely on the largesse of strangers to accommodate their peculiar desires.

The cleanest solution is for the euro area to federalise fiscal policy. There are three** basic ways to do this:

National governments with fiscal space could run large deficits to directly transfer resources to the countries with the highest unemployment. Germany and the Netherlands would run double-digit deficits to pay for extra spending and lower taxes elsewhere. Done at sufficient scale, this would fix the bloc's aggregate fiscal position. It would also boost the supply of euro-denominated safe assets by effectively mutualising all sovereign debt under Dutch and (mostly) German guarantees. While this approach might be popular in certain parts of Europe, it's hard to imagine Dutch or German politicians agreeing to it.

Alternatively, each national government could set fiscal policy and issue bonds according to its perceived needs, as in the pre-crisis period. The innovation would be that the ECB would *explicitly* stand behind all sovereign obligations. The central bank could adjust monetary policy by issuing its own bonds to sterilise any "excess" purchases of national debt. The downside is this may be difficult to square with Article 123 of the Treaty on the Functioning of the European Union, which explicitly prohibits "overdraft facilities" for governments at the ECB as well as direct sovereign debt purchases. Moreover, it leaves governments vulnerable to the caprice of the ECB leadership.

The better approach would be for the 19 members of the single currency to create new institutions backed by a common Treasury that would take over some of the main functions currently performed by national governments.

One new institution could take over the selection and funding of investment projects across the bloc, another could cover bank deposit guarantees, and another could handle unemployment insurance and old-age pensions. Funding could come from a mix of pan-EA taxes, user fees, remittances from the ECB, and, most importantly, bond issuance by the new common Treasury.

This would be a major change, but it seems far more consistent with the spirit of the European project than either the status quo, the breakup of the single currency, or widespread debt monetisation by the ECB. The longer the Europeans delay in accepting the inevitable, the greater the chance they find themselves faced with far worse options later.

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**The Dutch* un*employment rate looks better than the employment/population ratio because of the post-crisis boom in part-time jobs and cuts to pension benefits that have encouraged the elderly to delay retirement.*

***In recent speeches, Yanis Varoufakis has suggested expanding the capacity of the existing European Investment Bank to cover more infrastructure spending within the euro area while encouraging the ECB to buy the extra EIB bonds needed to fund this spending. This is a moderate suggestion that could be easier for European elites to accept but probably does not go far enough.*