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Money Deficits and Inflation Evidence and Policy Issues of Euro Zone during Debt Crisis

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Abstract: **An important lesson from the euro area sovereign debt crisis is that the need for sound economic policies does not end once a country has adopted the euro. There are no automatic mechanisms to ensure that the process of nominal convergence which occurs before adoption of the euro produces sustainable real convergence there after. The global financial crisis that started in 2008 has showed that some countries participating in Economic and Monetary Union (EMU) had severe weaknesses in their structural and institutional set-up. This has resulted in a large and protracted fall in real per capita income levels in these countries since 2008. While there has been real convergence in the European Union (EU) as a whole since 1999 owing to the catching up of central and eastern European (CEE) economies, there has been no process of real convergence among the 12 countries that adopted the euro in 1999 and 2001. This lack of convergence is related to several factors, notably weak institutions, structural rigidities, weak productivity growth and in sufficient policies to address asset price booms. Against this background, several factors appear crucial for ensuring real convergence in EMU: macroeconomic stability, and sound fiscal policy in particular; a high degree of flexibility in product and labor markets; favorable conditions for an efficient use of capital and labor in the economy, supporting total factor productivity (TFP) growth; economic integration within the euro area; and a more active use of national policy tools to prevent asset price and credit boom-bust cycles.**

Keywords: **Money Deficits, Inflation, Policy, Euro Zone,Sustainability, Monetary Policy, Investments.**

Jel codes: H62, H68, H6, E41, E42

1. INTRODUCTION

From the start, the euro has rested on a gamble. When European leaders opted for monetary union in 1992, they wagered that European economies would converge toward one another: the deficit-prone countries of southern Europe would adopt German economic standards—lower price inflation and wage growth, more saving and less spending—and Germany would become a little more like them, by accepting more government and private spending and higher wage and price inflation. (Lucas, 1988).

This did not occur. Now, with the euro in crisis, the true implications of this gamble are becoming clear. (Acemoglu, Robinson,2012)

Over the past two years, the euro zone members have done a remarkable job managing the short-term symptoms of the crisis, although the costs have been great. Yet the long-term challenge remains: making European economies converge, that is, assuring that their domestic macroeconomic behaviors are similar to one another to permit a single monetary policy at a reasonable cost. For this to happen, both creditor countries, such as Germany, and the deficit countries in southern Europe must align their trends in public spending, competitiveness, inflation, and other areas. (Acemoglu, Robinson,2012)

Sustainable real convergence is the process whereby the GDP per capita levels of lower-income economies catch up with those of higher-income economies on a durable basis. (Barro, Sala,1992) For convergence to be sustainable, long-term potential per capita growth must be consistent with an expansion of demand. Indeed, GDP growth that results from

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external factors such as a strong global demand shock, or a more benign shock such as the decline in interest spreads that occurred upon the launch of the euro, may prove to be unsustainable if not matched by higher growth potential. (European Commission, 2015)Sustainable real convergence supports the smooth functioning of Monetary Union over the medium term. First, achieving sustainable real convergence by means of sound national economic policies is important to support the economic and social cohesion of EMU, especially since euro area countries do not share fiscal transfer mechanisms similar to those in the US federal budget. (Lucas, 1988)

While the Structural Funds and the Cohesion Fund – the financial instruments of EU regional policy – aim to narrow the development disparities among regions and Member States, they are more limited in scope than similar instruments in a federal state. (European Commission, 2015)

Second, the sustainability of real convergence is important because for some euro area economies the process of catching up tends to drive up their inflation differential vis-à-vis the euro area average over the medium term. In a monetary union, this is usually associated with a lowering of real interest rates in the economies that are catching up, since short-term nominal interest rates are determined by the central bank's policy rate. Given this essential feature of monetary policy in a single currency area, great importance needs to be attached to fiscal and macro prudential policies that tame macro-financial cycles and ensure stability, so as to prevent countries becoming exposed to boom-bust cycles.

A greater degree of cyclical divergence within the euro area would complicate the conduct of the single monetary policy (Monteagudo, *et al* ,2012).

2. EVIDENCE OF REAL CONVERGENCE

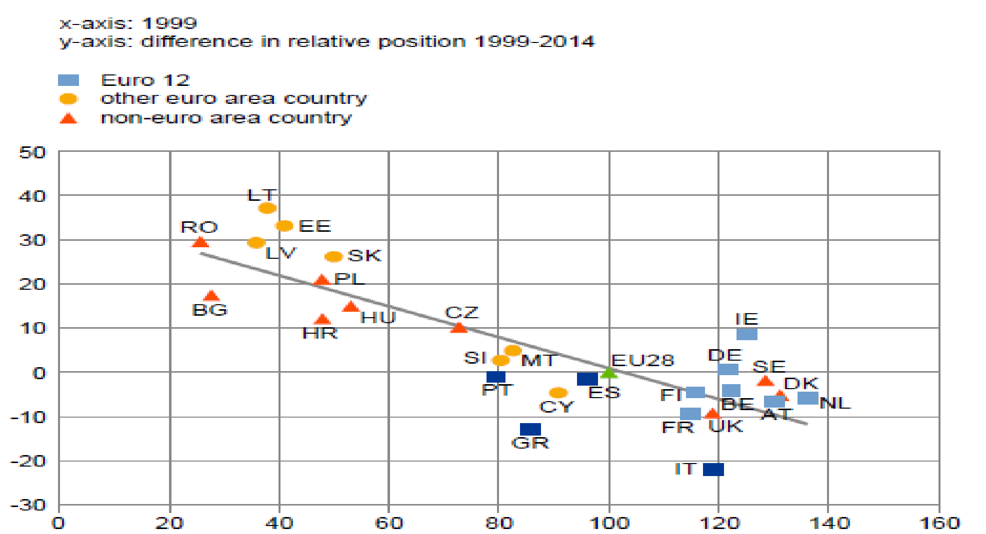
Between 1999 and 2014 some degree of real convergence took place among the 28 countries that now make up the EU (the EU28). As shown in Chart 1,

both non-euro area EU countries (orange triangles) and countries that adopted the euro after 2002 (yellow circles) performed better over the period 1999 to 2014 than the rest of the EU countries, i.e. the 12 countries (Euro 12) that adopted the euro before 2002 (blue squares). Estonia, Latvia, Lithuania, Romania and Slovakia have recorded the highest degree of convergence among the EU countries so far, followed by other countries in the CEE region. (European Commission, 2015)

Chart 1:

GDP growth per capita relative to the EU28

(GDP per capita in PPS; EU28=100).



Sources: European Commission and ECB staff calculations.
Notes: Luxembourg is excluded because GDP per capita computations are distorted by the high number of cross-border workers. The dark blue squares represent those of the catching up economies in the Euro 12 that showed no convergence over this period (Greece, Spain and Portugal), and Italy, the Euro 12 country with the largest divergence.

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Little real convergence has taken place among the euro area economies since the establishment of the euro, despite initial expectations that the single currency would act as a catalyst for faster real convergence. There is no clear relationship between relative GDP per capita levels in 1999 and their relative growth between 1999 and 2014. In fact, looking at the period as a whole, there is some evidence of divergence among the early adopters of the euro, given that over 15 years a number of relatively low-income countries have maintained (Spain and Portugal) or even increased (Greece) their income gaps with respect to the average. Moreover, Italy, initially a higher-income country, recorded the worst performance, suggesting substantial divergence from the high-income group. (European Commission, 2015)

While the crisis following the collapse of Lehman Brothers can partly explain the divergence observed in these countries, more deep-rooted factors were also at play. Ireland, for example, in spite of its severe financial crisis in the period 2008-12,

Shows some improvement, remaining among the higher-income countries (Moravcsik,2012)

Dispersion of per capita income levels has increased overall for the Euro 12, after a temporary narrowing between 2006 and 2008 (see Chart 3). Some convergence in terms of reduced income dispersion is detected when looking at the EU28 as a whole, thanks to the catching up of CEE economies. However, the pace of the reduction of income dispersion seems to have slowed during the crisis period, i.e. since 2008. (European Commission, 2015)

Chart 2:

Real GDP per capita in the Euro 12.

(GDP per capita in 1,000 PPS).

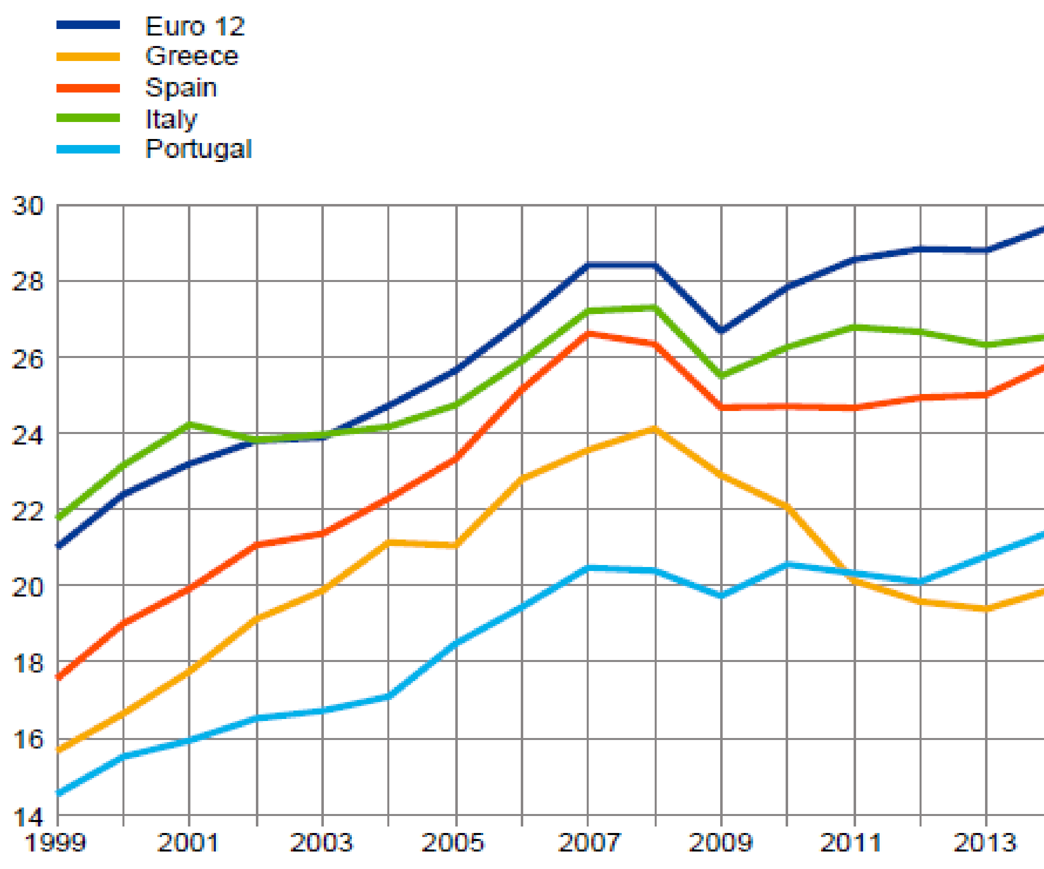

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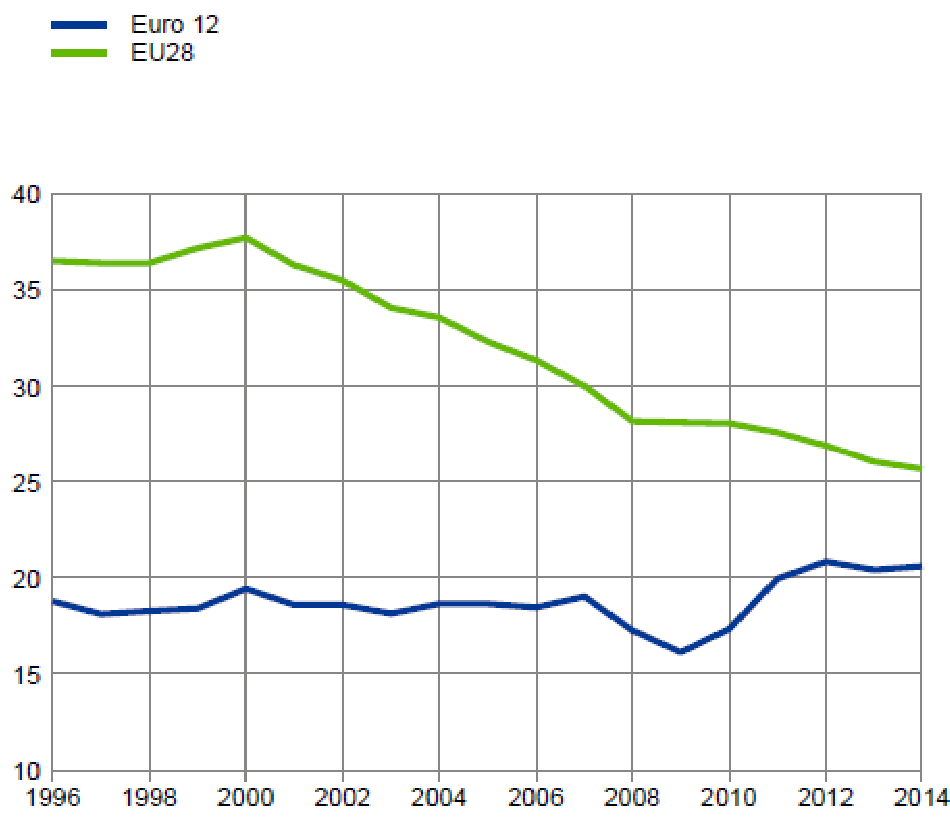
Chart 3:

Standard deviation of GDP per capita

(GDP per capita in 1,000 PPS)



Sources: European Commission and ECB staff calculations.
Note: Luxembourg is excluded (see the note to Chart 1).

3. REASONS FOR THE LACK OF REAL CONVERGENCE

At the start of EMU many observers expected that deeper monetary and financial integration would trigger faster real convergence. As theory would predict, gross private capital inflows in the pre-crisis years were sizeable in those Euro 12 countries with per capita income levels significantly below the euro area average, including Greece, Portugal and, to a lesser extent, Spain. In the case of Italy, capital inflows were much lower, as with most other high-income countries. Capital inflows to these countries mainly consisted of investment in debt instruments and banking flows, whereas inward foreign direct investment (FDI) was less significant. In principle, private capital flowing to lower-income euro area countries should have supported productivity gains and sustainable long-term increases in income levels in these countries. (Moravcsik ,2012)

When the global financial crisis started, the amount of external private financing began to fall, and continued to decline substantially over the crisis period.

The lack of sustainability in the process of real convergence in the pre-crisis years was mainly due to the combination of three factors. First, institutional conditions in some countries were not supportive of business innovation and underlying productivity growth. (Monthly Bulletin, 2005)

Second, structural rigidities and a lack of effective competition (especially in the non-tradable sector) contributed to a misallocation of capital. This in turn prevented the supply potential of the economy from catching up with demand. Third, the sharp drop in real interest rates favored exuberant credit growth and pushed up demand, engendering misguided expectations about future income. (Moravcsik ,2012)

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First, as regards institutional factors, the quality of domestic institutions and governance affects economies' per capita income growth. Countries with a higher ranking in terms of governance tend to exhibit higher income levels. The euro area countries that did not show convergence (or even diverged) in the pre-crisis years (Greece, Spain, Italy and Portugal) are also the countries with the lowest ranking in terms of governance in the Euro 12. (Moravcsik ,2012)

This low ranking reflects a combination of factors including the effectiveness of government, the quality of the regulatory environment and the size of the informal economy. All these factors have a significant bearing on long-term growth. (Uzawa, 1963)

Second, countries with structural rigidities were hit particularly hard during the global financial crisis, which contributed to the sharp reversal of convergence during this period. (Sondermann, 2012)

In the labor market, these rigidities included a high degree of employment protection and wage bargaining systems that were not supportive of flexible wage adjustments. In the product markets, several sectors, including network industries, were sheltered from competition, which slowed down the adjustment of profit mark-ups during the crisis. The rigidities that hampered the adjustment of wages and prices significantly lengthened the process of reallocating labor and capital from crisis-hit sectors (e.g. construction) to faster growing sectors and increased the costs of the adjustment in terms of unemployment and income losses. (Sondermann, 2012)

Third, in the pre-crisis years, a credit-driven domestic demand boom and erroneous expectations about future economic growth prospects masked the weak growth potential in a number of countries. Compared with the average of the pre-euro area years (between 1995 and 1998), real interest rates dropped very sharply, especially in the southern euro area countries, and also in Ireland. (Sondermann, 2012)

The substantial drop in real interest rates in these economies was a result of two factors: (Acemoglu, Robinson,2012)

(i) substantial convergence in nominal interest rates before and after the introduction of the euro, and (ii) a rise in inflation in these countries above the euro area average during the early years of EMU.

Moreover, the credit-driven domestic demand boom that continued for many years led to an overestimation of growth potential in a number of countries, particularly in Greece and Spain. As a result, fiscal policy was too pro-cyclical during the boom years, as budgets were based on the assumption that the high revenues generated by unsustainable domestic demand would continue to be generated in the years to come. With the onset of the severe crisis, fiscal revenues dropped sharply in a context of insufficient fiscal buffers, resulting in a rapid increase of public debt. (Sondermann, 2012)

The excessive private sector credit growth in some countries led to rising debt levels in the corporate and/or household sector. Ireland, Spain and, to a lesser extent, Greece and Portugal recorded a substantial increase in private sector indebtedness. The risks related to the sharp credit growth and increasing indebtedness were insufficiently addressed by the national authorities. (Sondermann, 2012)

In particular, macro prudential tools to limit excessive borrowing were either not used or were too weak to dampen credit growth sufficiently in these economies. (Acemoglu, Robinson, 2012)

Excessive growth of credit and domestic demand also led to the accumulation of very large external imbalances in the pre-crisis years. The current account deficit increased significantly over the pre-crisis years in Greece, Spain and Portugal. In Italy, a higher income country, the current account deficit remained moderate. Large cumulative current account imbalances in economies that are catching up are not necessarily problematic if the accumulation of large foreign liabilities is later matched by current account surpluses. (European Commission,2015)

If such current account deficits finance productivity-enhancing investments that lead to higher export revenues in the future, a temporary increase in current account deficits can turn out to be sustainable. However, the convergence pattern of these euro area countries did not meet this condition in the pre-crisis period, since the accumulation of capital was heavily biased towards low-productivity, non-tradable sectors. While the expansion of external imbalances in Spain mainly reflected excessive investment in some segments of the private sector (particularly construction), in Greece overspending in the public sector was the main contributor to the gap between savings and investment. In Portugal low public and private savings played a significant role. (European Commission,2015)

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4. DEMOCRATIC SURPLUS ISSUES

Many Europeans complain that the crisis has revealed the euro to be undemocratic. European institutions can appear distant, technocratic, and unfair to the common people. (Monteagudo, *et al* ,2012)

In most cases, such claims contain little truth. The euro remains tightly controlled by elected national politicians. True, each country surrenders some unilateral control over its domestic policy, but in exchange it secures influence over the policies of other countries that affect it. In the eu, concurrent decision-making by national officials and directly elected European parliamentarians amounts to a form of limited government that would make John Locke and James Madison proud. (Monteagudo, *et al* ,2012)

No one's democratic rights are restricted as long as the people of every member state freely choose to act in union, and cooperation preserves the same public input and transparency that Europeans expect in domestic policymaking. (Monteagudo, *et al* ,2012)

Judged by this standard of democracy, however, the single currency has always come up short. The problem is not the role of technocratic central banks, or even temporary technocratic governments. Nearly every modern country accepts that a credible commitment to monetary stability requires that national central banks be more autonomous than parliaments or presidents. The problem is rather that the European Central Bank is more independent than any comparable national bank—without any obvious technocratic or democratic justification. The reason is instead political; it was

Germany's price for creating the euro. The result is a system tilted toward German priorities: low inflation, austerity, and the repayment of creditors. (Monteagudo, *et al* ,2012)

The political and social costs of adjusting to a common currency, meanwhile, have fallen disproportionately on the poor and the powerless. (Solow, 1956)

Over the past two years, the eu has called for cuts in the minimum wage and government spending, but it has asked less of wealthy citizens, bankers, and the citizens of surplus countries. A fairer system would demand better enforcement of income tax collection (on average, rich Greeks illegally withhold one-quarter of what they owe), as well as reforms to housing and business practices. Watching technocratic governments in Greece, Italy, and elsewhere agree to impose what appear to be one-sided policies, backed by European authorities, naturally makes many citizens nervous. (European Commission,2015)

This problem makes clear that a more balanced euro zone, in which as much is required of Germany as of debtor countries, is not just a pragmatic necessity; it is a democratic imperative. Still, despite its serious structural biases, at the end of the day, if the euro zone collapses, it will be because of an abundance of democracy as much as a lack of it. Divergence among European states reflects local priorities and preferences. No long-term solution to Europe's woes can be imposed on a member state without the consent of its government, and any government—even the technocratic governments that now sit in Athens and Rome—requires an electoral mandate. (Ireland went even further to secure democratic consent when, in February, it announced that it would put the eu fiscal compact to a referendum later this year.)

Democratic governments often find it difficult to commit to the types of long-term reforms that both northern and southern Europe require today. In this case, if they cannot, then the euro will not remain viable. (European Commission,2015)

5. HOW SUSTAINABLE REAL CONVERGENCE CAN BE ACHIEVED

Against the background of the above evidence of lacking real convergence within the Euro 12, this section reviews the ways in which economic policies could foster sustainable convergence and resilience to negative shocks. (Romer, 1986)

The analysis of the evidence for and causes of the lack of convergence shows that three main conditions need to be met to achieve sustainable convergence:

(i) macroeconomic stability must be maintained, (ii) the affected economies must increase their degree of economic flexibility, and (iii) conditions for TFP growth must be improved. (Moravcsik,2012).

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The first condition for sustainable real convergence is macroeconomic stability.

The previous section showed how domestic institutions and structural features contributed to the accumulation of imbalances in a group of euro area countries, leading to an increasing gap between demand growth and supply-side potential.

Since the crisis, the euro area countries subject to an EU-IMF financial adjustment program have made progress in restoring their macroeconomic balances and have also implemented significant structural reforms. In most of these countries,

The current account imbalances have largely disappeared. This has partly reflected a marked adjustment in unit labor costs. Fiscal balances have also improved substantially compared with the very high fiscal deficit-to-GDP ratios observed during the crisis years. However, stock imbalances, such as high external, private and public sector debt, still remain very high in many countries. In order to fully overcome these legacies of the crisis, it is important to consolidate the competitiveness gains achieved during the crisis and to maintain a stability-oriented fiscal policy stance that ensures that public indebtedness returns to sustainable levels in the coming years. (Sondermann, 2012)

6. CONCLUDING REMARKS

While CEE countries have been catching up to the EU average over the past 15 years, progress towards real convergence among the 12 countries that formed the euro area in its initial years has been disappointing. Experience has shown that initial convergence can unravel quickly in the face of exogenous shocks if it is not underpinned by a sound institutional framework and structural conditions that are conducive to productivity growth.

The crisis has shown that large capital flows to low-income countries can only contribute to sustainable real convergence if resources are efficiently allocated in the economy. One of the key factors that ensure success in a monetary union is a sufficiently flexible economy where price signals allow resources to be properly channeled towards high-productivity sectors. It is equally important to complement the single monetary policy with counter-cyclical fiscal and macro prudential tools at the national level in order to address at an early stage the risk of boom-bust cycles in euro area economies that are catching up.

Pursuing sustainable convergence is mainly a national responsibility. However, efforts at the national level should be complemented by structural reforms at the European level aimed at deepening the Single Market. Deepening the Single Market would allow country-specific shocks, especially to low-income countries, to be better absorbed. This is particularly important for the capital markets union, where substantial and swift progress is still needed.

The euro crisis will shape not just the fate of the single currency but also the future of the whole continent. The recent turmoil has made clear that the alignment of European domestic policies is a prerequisite for mutually beneficial cooperation. This is typical of the eu. Where basic national interests and regulatory styles have converged, as in the area of trade, governments have developed strong rules to coordinate their policies, and these policies have remained stable through the crisis. In the areas where countries have not brought their policies in line, regulation remains voluntary and largely national.

So the outcome to the euro crisis will depend on how well northern and southern Europe can close the gaps in their macroeconomic behavior. But the difficulties in getting European countries to adopt similar monetary policies suggest that the eu's leaders may have pushed integration as far as it will go.

In this regard, the euro crisis is only the latest development in a two-decade-long trend toward the leveling o of European integration.

At the time the Maastricht Treaty was ratified, many observers expected the eu to start regulating more and more policies, including those on social welfare, health care, pensions, criminal justice, education, issues of culture and language, local infrastructure, national politics, and above all, taxation and fiscal priorities. Little of this has occurred and Europe now puts forward few policies that open up new areas to centralized regulation. Today, European states retain far more control than Brussels over justice and home affairs, immigration, intellectual property, and social policy. And when the eu does launch a new centralized policy, it is rare for every government to sign on or implement it entirely. Not every eu member uses the euro, just as not every eu member adheres to the Schengen agreement, which eliminated bordercontrols, or participates in all eu foreign policy and defense actions.

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Yet none of this vindicates the Euro-pessimists. No country has issued a serious challenge to any of the eu's core activities. Nor has a single prominent European politician advocated withdrawal from the eu, as that would amount to economic suicide. Brussels continues to manage about ten percent of national policies, from business regulation to European migration, under a unified legal system. The union has recently expanded, from 12 members at the time of the Maastricht Treaty to 27 today, leaving lasting movement toward open markets, democracy and the rule of law in its wake. Countries have not responded to the euro crisis by turning to protectionism or refusing to enforce eu policies, because cooperation in these areas is firmly grounded in common interests. The euro crisis itself has even allowed European policy to intensify in existing areas, such as monetary and banking regulation.

And even a collapse of the euro would not jeopardize the existence of the eu. Whatever the outcome of the crisis, the eu will remain without rival the most ambitious and successful example of voluntary international cooperation in world history.

Still, the crisis does signal that the process of European integration is reaching a natural plateau, at least for the foreseeable future, based on a pragmatic division between national policy and supranational policy.

The movement toward the "ever-closer union" of which the eu's founding fathers dreamed when they signed the Treaty of Rome in 1957 will have to stop at some point; there will never be an all-encompassing European federal state. But within the increasingly clear mandate of a stable constitutional settlement, Europe will continue to respond to the challenges of an increasingly interdependent world.

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