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Economic policies and growth strategies after the crisis in USA, Japan and EU.

Will the Euro project survive?

Pasquale Tridico

Università Roma Tre Dipartimento di Economia tridico@uniroma3.it

Abstract

The objective of this paper is to investigate how the United States of America (US) and Japan managed relatively better than Europe to emerge from the crisis, which caused a deep recession in 2009, and why instead Europe or more appropriately, the Euro Area (EA) of the European Union (EU), did not. I will examine the main policies implemented by the main fiscal and monetary authorities in the US, i.e., the Federal Reserve (Fed), and the Federal Government; in Japan: the Bank of Japan (BoJ) and the Japanese Government (focusing in particular on the so called “Abenomics”); and in Europe: the European Central Bank (ECB) and EA Member State Governments; and I will try to understand how in the US and Japan these policies caused sustainable recovery in terms of GDP growth and employment, while on the other hand they did not manage to bring about the same results in Europe.

The paper will also propose a political agenda for the EA which would favour economic recovery and sustainable development in the next decade, similar to that witnessed by the other two countries (we refer to the Euro Area as a country, at least from an economic point of view, despite the strong weakness of this definition from a political point of view). In this context, the case of Japan (with the so called “Abenomics”), along with the recovery strategy embarked in the US are better examples that Europe should follow.

Finally the paper will critically discuss whether the new economic and financial governance implemented between 2012-2016 in EU (from the Fiscal Compact to the Banking Union) is sufficient to overcome the crisis and would be able to continue further the process of EU integration, or could indeed bring about more dangers for further disintegration, in particular after the UK referendum?

Key words: Economic policies, crisis, austerity, economic growth

Jel: E5; H63; O4;

1. Economic crisis and recovery strategies in advanced economies: an overview

The economic crisis which started in the United States' financial sector in 2007 spread quickly around the world, particularly to advanced economies and to Europe. It became a global crisis and involved, between 2009 and 2012, almost all sectors of the economies and caused high levels of unemployment (Posner, 2009; Stiglitz, 2010; OECD, 2010). Mass unemployment emerged in the US and in Europe (Krugman, 2008; Wolff, 2010). After a recession of the GDP in the European Union with an average of -4.2% in 2009, many EU Members States have still not recovered. In 2012, several European countries, particularly in the South and in the East of Europe, experienced a double dip in terms of GDP recession and unemployment, while in other European countries in the core of Europe, GDP is stagnating and the level of unemployment is not declining (Fitoussi and Stiglitz 2009; Barba and Pivetti, 2009; Tridico 2012). Besides that, other problems exist such as low levels of consumption, bank liquidity problems, low levels of private investment, a lack of trust and negative expectations in the financial market and between banks and investors, as well as high public deficits and debts. Despite the variety of problems, the governments of member states and EU institutions (in particular the EU Commission and ECB) focused mostly on a single problem, as I will argue below: the sovereign debt of member states (Fitoussi and Saraceno, 2010).

In order to recover from the crisis, governments in Western economies, particularly the US and the EU, initially in 2007-2009, put in place fiscal stimuli and bank rescue packages. These policies were supported by a great consensus among the policymakers, politicians, and academics who had begun to look at Keynesian policies in a favourable way.

United States

In the US under the Bush administration the TARP (Troubled Asset Relief Program) Act was launched in order to purchase “troubled” assets and equity from financial institutions and to strengthen trust in the financial sector (Lowenstein, 2010). The Act allowed the Treasury to purchase illiquid, difficult-to-value assets from banks and other financial institutions as a first reaction to the subprime mortgage crisis, for a value of \$700bn US (or 2.3 of US GDP).¹ Similar savings plans were implemented in the UK. It is, however, debatable whether the policies introduced in the US and the UK over the period of 2007-2009 represent orthodox Keynesian policies at all. Certainly, as was the case

¹More than a Keynesian fiscal stimulus, TARP was an Act made in order to save, in a direct way, financial institutions. Several commentators and newspapers in the US criticized TARP for being a paradoxical representation of a sort of “financial socialism” (Wolff, 2010).

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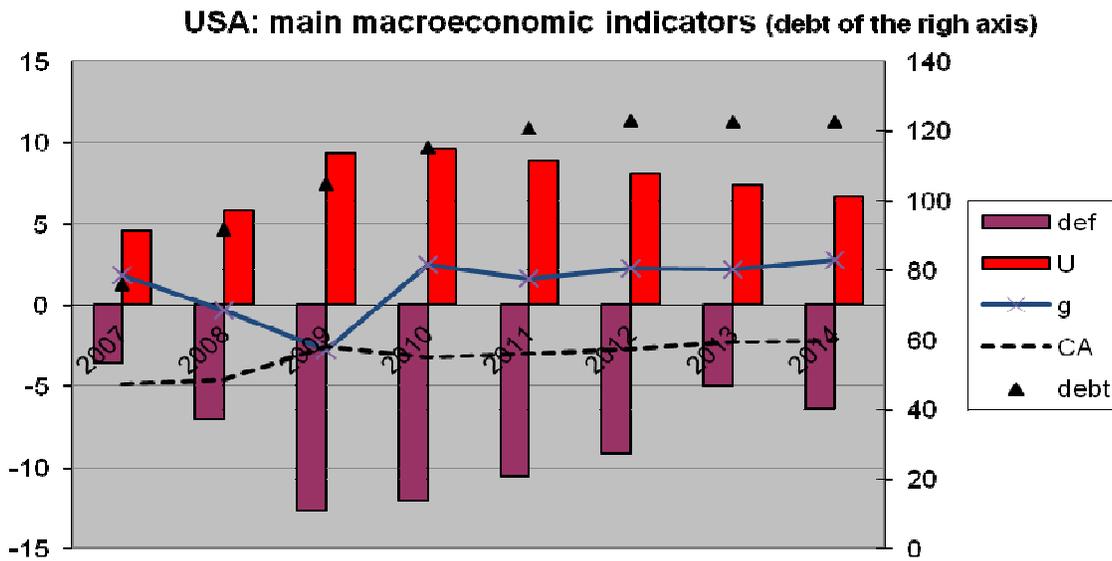
in the UK, much of this intervention involved direct and indirect handouts to banks with remarkably few strings attached on the assumption that this would enable the latter to rebuild their balances, and encourage them to resume lending to the non-financial sector. In practice, much of this money appears to have leaked out to fund new rounds of speculative activity, whilst the promised ‘trickle down’ has proved limited.

Monetary policies were simultaneously manipulated by Western central banks. A combination of actions by the Fed, the European Central Bank (ECB), the Bank of England and the Bank of Japan, provided a huge amount of liquidity to the private sector, and to the banking sector in particular, in order to avoid the crunch of the inter-lending among banks. The first injections came in the summer of 2007, with the leading role going to the Fed and the Bank of Japan. The ECB and the Bank of England reacted by releasing similar proportions of liquidity into their own financial markets. Moreover, the interest rate in the US had been reduced from 5.25 to 0.25 per cent. In Japan it used to be always at very low levels. Similar action was taken in the UK. In the Eurozone, given that the greatest priority of the ECB was to foster price stability, the interest rate was lowered to 2.5% in 2009 and to 1% in 2010 (Tropeano, 2010; Sawyer, 2010).

Regarding fiscal policy in the US, Obama’s fiscal stimulus, (the ARRA - American Recovering and Reinvestment Act) for a value of \$775bn US (or 2.7 of US GDP), entered onto the scene in February, 2009, after much debate in Congress (Romer and Bernestein, 2010).² The stimulus aims to promote, in the Keynesian tradition, job creation, investment, and consumer spending during the recession. To some extent it represents a breakdown of the main economic consensus which favored spontaneous recovery, i.e., recovery driven by the market or, in the less conservative case, monetary policy (quantitative easing) over fiscal stimulus. However, economic recover, in terms of GDP, was immediately guaranteed, with growth of around 2% since 2010.

² No Republicans in the House voted for the bill, while in the Senate only three Republicans voted for it

Figure 1 – US: economic crisis and recovery



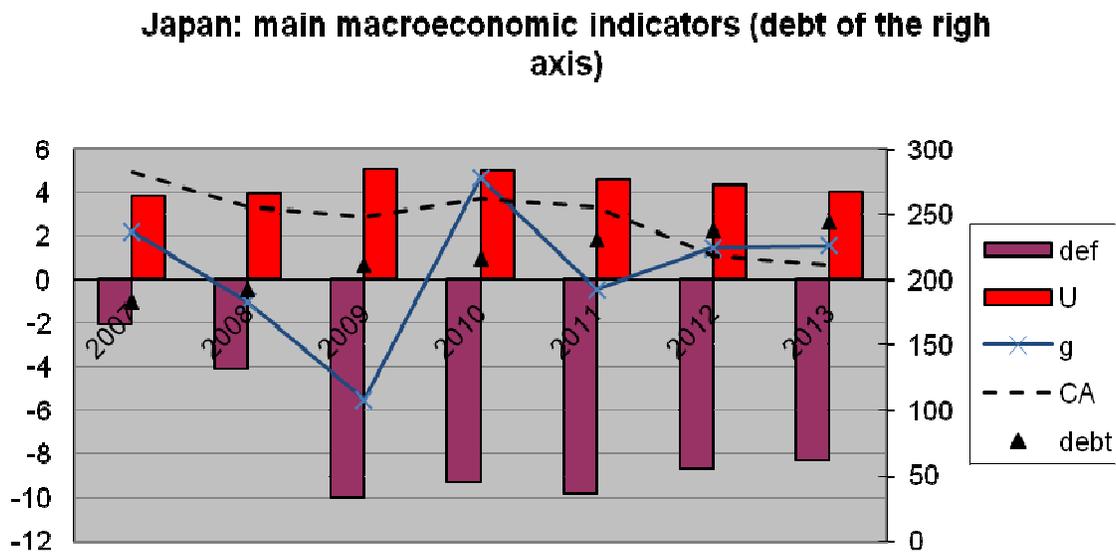
Source: own elaboration on Eurostat and IMF data

Japan

In Japan the situation before the global economic crisis was very different than in USA or in EU. Japan's economy during the 1990s experienced a serious stagnation of GDP, which started after the burst of the housing bubble at the end of 1980s and the beginning of the 1990s. Deflation and lower growth characterized Japan for almost two decades, and the consequences on the explosion of public debt were enormous: today Japanese public debt is a bit less than 250% of GDP. In 2008 and in 2009, during the global economic crisis, Japan's cumulative recession was about -6% of GDP. However, since the end of the global crisis, and particularly after the 2011 recession caused mainly by the terrible Tsunami and earthquake which destroyed the nuclear power plant in Fukushima, the Japanese economy seems to have embarked on a path of economic recovery clearly linked, according to many economists, to the so called “Abenomics” (Irwin, 2013; The Economist, 2013a; IMF, 2013). Abenomics refers to the economic policies implemented by Shinzō Abe, the Japanese Prime minister since 2012. Abe was Prime Minister already in 2006-2007 and also during these two years. His attempt to boost the Japanese economy with monetary expansion and fiscal stimuli, although less strategically organized since 2012, was able to produce economic growth of about 2% a year. Abenomics is based on three pillars: fiscal stimulus, monetary quantitative easing and structural reforms. In other words, Abenomics *is a* program characterized by a “mix of reflation, government spending and a growth strategy,” as The Economist (2013b) argued, aiming to raise the economy from two decades of

suspended stagnation. Abenomics consists of monetary policy, fiscal policy, and economic growth strategies to encourage both public and private investment. Since 2012 Japanese policymakers have implemented a strategy which includes inflation targeting a 2% annual rate, the correction of excessive yen appreciation, the setting of negative interest rates, huge quantitative easing, expansion of public investments, buying operations of treasury bonds by the Bank of Japan (BOJ), and the revision of the Bank of Japan Act which impeded higher inflation targets. During 2013 the Yen devalued 25% over the US dollar, boosting exports and increasing the trade balance. However, after the 2011 nuclear disaster in Fukushima and the subsequent political decision to shut off all nuclear power in Japan, energy started to be heavily imported. This may have negative results in the long run with the Yen continuously devalued. Nevertheless, the results of this program are positive so far: the economy started to grow; and deflation seems defeated, with a new target of 2% which both the Bank of Japan (BoJ) and the Government seem to pursue simultaneously and coordinately³. Unemployment decreased further, reaching below 4% in 2014. (Haidar and Hoshi; 2014; Wolf, 2013; Irwin, 2013).

Figure 2 – Japan: economic crisis and recovery



Source: own elaboration on Eurostat and IMF data

The Euro Area

³ The new behavior of coordination and cooperation between BoJ and Government was heavily criticized by some orthodox analysts and economist, as this is a violation of the independence of the Central Bank (Weidmann, 2013)

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In the EU the fiscal stimuli, implemented singularly by MS, mobilized around \$300bn US of resources (or 1.5% of EU GDP) (IMF, 2009). However, fiscal policies among member states are fragmented and often uncoordinated. Moreover, the EU is a supranational organization with much less power than the US federation and little possibility of economies of scale. Seventeen countries adopted the Euro and, consequently, the ECB and the Maastricht criteria which impose common monetary policies, fiscal constraints and harmonisation. Nine other countries maintain their own currency and sovereignty over their monetary policy, financial systems and fiscal policies.⁴ This means that Europe has ten different currencies.⁵ This represents a concrete difficulty in policy coordination. However, the biggest problem in this context, relates to the fact that the UK is not part of the Eurozone. The UK is the second largest economy in the EU and the British Pound is still an internationally important currency, with London as the biggest financial centre in Europe (Wahl, 2010). Market capitalization in London is €1,962 trillion (2010 data), while Frankfurt and Paris have around €0.900 trillion each in market capitalization (Eurostat 2010). When national interests are on the table, EU members states, and in particular the UK, demonstrate a strong opposition to EU financial regulation and supranational power (UK Treasury Committee, 2010).

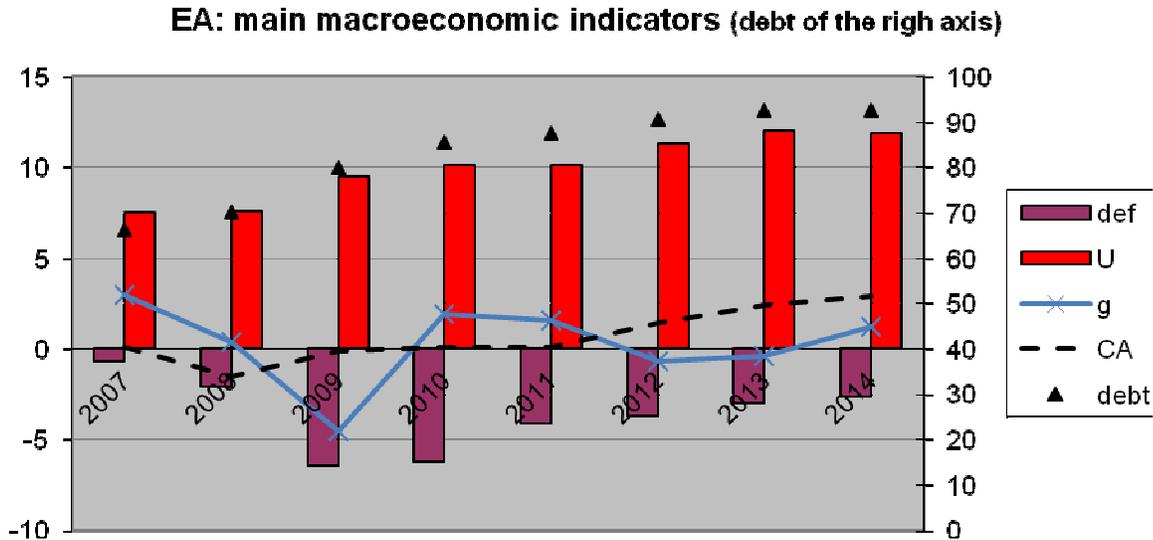
The total EU fiscal stimulus in 2009 was around 1.5% of the total EU GDP, but not all countries acted on the suggestions of the EU Commission. Spain, which was one of the countries hit hardest by the crisis, put in place the biggest stimulus in Europe, favoured by a socialist government, of 3.7% of GDP. This plan focused on €40 billion to support infrastructure investments and the automobile industry. France's plan was smaller, €26 billion, which includes a boost for the construction and automobile sectors; moreover, the government has promised €20 billion for small businesses and the construction industry. Germany's package includes generous amortization rules for companies and incentives for climate-friendly home renovation; the total package is expected to reach €82 billion, including private investments. Italy proposes a nominal stimulus for unemployment subsidies and firm support that will only amount to €9 billion. The UK has announced a temporary reduction of the VAT rate from 17.5% to 15%. In addition, the government plans to invest €31 billion on infrastructure.

The outcomes of these stimuli were quite positive: in the second quarter of 2010, Germany grew at an extraordinary rate of 8.8%, and the UK at 4.8%. Similar stories, although of less magnitude, occurred in other European economies.

Figure 3 – The Euro Area: economic crisis and recovery

4 Bulgaria, Czech Rep., Denmark, Hungary, Lithuania, Poland, Romania, Sweden and UK are outside the Euro Area.

5 The currencies of Bulgaria, Denmark, Latvia and Lithuania are pegged to the Euro.



Source: own elaboration on Eurostat and IMF data

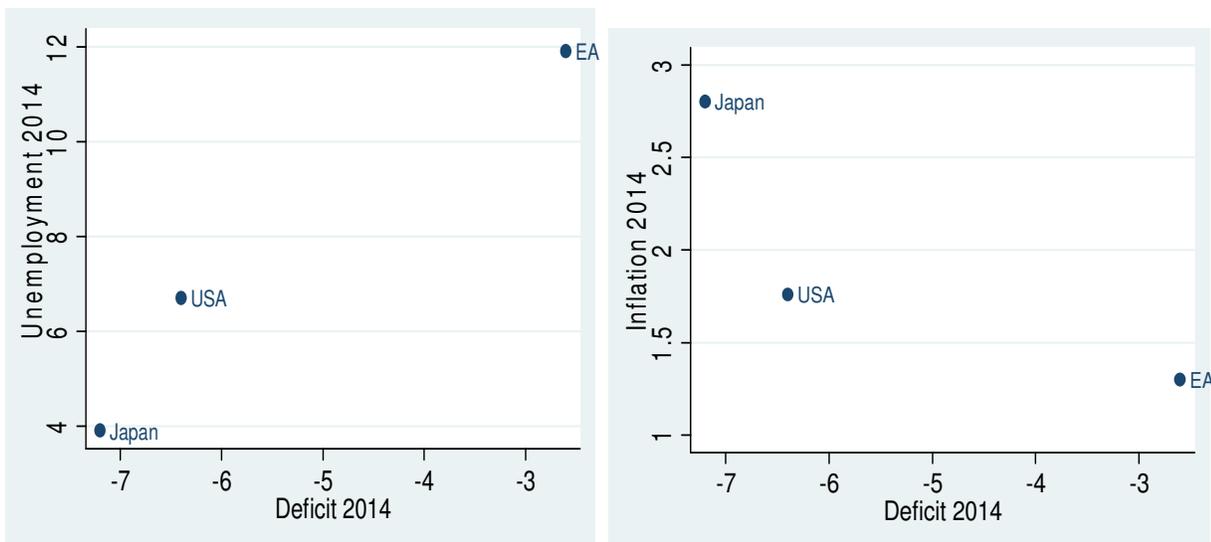
Nevertheless, in the US and Japan, expansionary policies, quantitative easing, a continuous and program of buying Treasury bonds, and lower interest rates continued to the present. In the EU, already after the spring of 2010, the policy consensus switched towards austerity measures. After the Greek crisis, governments turned their interests, irrationally, toward budget cuts and policies of contraction (Arestis and Pelagidis, 2010). In the fall of 2010, the new Liberal-Conservative government in the UK implemented an austerity plan with cuts in public expenditures and a freezing of public employment wages and jobs for the next three years. Chancellor Merkel proposed similar restrictive plans in Germany, and other continental European countries are preparing financial laws very much focused on restrictive fiscal measurements. The objective is to reduce deficits. This seems more like a reaction to the Greek and Irish crises, rather than a rational decision which would help economic recovery (Arestis and Pelagidis, 2010).

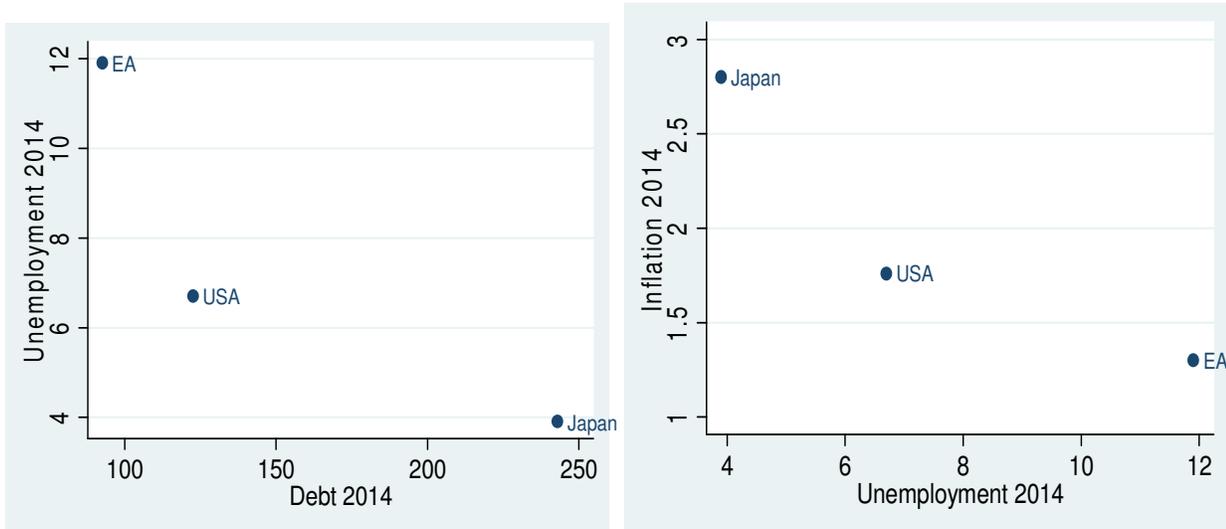
At the same time, the actions of the member states, particularly in the South of Europe, were, and still are, strongly limited by the tough rules of EU treaties such as the Maastricht Treaty and the Stability and Growth Pact which were reinforced, as we will argue later, in the last 3 years. They became tighter in terms of austerity and public expenditure rules with the introduction of the so called “Fiscal Compact”, the “Six-pack”, and the “Two-pack”, which impede member states from implementing deficit policies if they have macroeconomic imbalances. This is a vicious circle which does not allow MS policy makers room for maneuvers unless the treaties are violated or changed.

2. Quantitative easing in US, Abenomics in Japan and Austerity in Europe

Two major challenges emerged during the crisis: the rise of unemployment with growing public deficits and financial instability threatening economic development. In this context, Europe, and the Euro Area in particular, seems stuck in a stagnation trap, without private investments, and with policy makers refusing to increase public deficits and public investments which would help the economic recovery. In fact, while the other major advanced economies managed, through expansionary policies to end the crisis, the Euro Area is very much worried about price stability. In 2014 the situation is very clear: Japan and the USA are emerging from the crisis. They reduced unemployment and started economic recovery through expansionary policies which are visible in both the increasing of the public spending, resulting in higher deficits, and the loosening of monetary policies, resulting in lower interest rates. Finally, deflation was defeated in Japan after 20 years and new targets of inflation rates deliberately met by the BoJ were reached above 2%; similarly, in the USA there are no worries about inflation nor deflation. On the contrary, in the EA, the spectrum of inflation mostly spread by Germany, and the consequent more prudent monetary and fiscal policies operated by the ECB, lead instead toward the specular and major problem of deflation. In 2014 the risk of a deflation spiral is real, with the average price index close to zero, and in some countries, like Italy, below zero.

Figure 4 - Japan, USA and EA public debt, unemployment and deficit in 2014

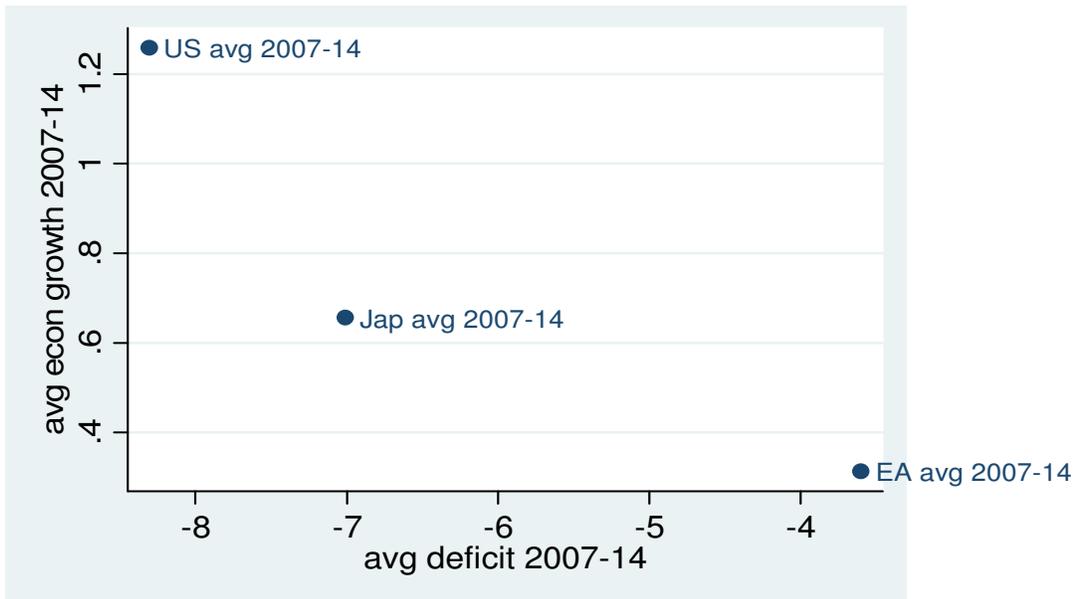




Source: own elaboration on Eurostat and IMF data

From these four graphs above, there is evidence of a strong relation, of the Keynesian type, between deficit, debt, inflation and unemployment: Japan, followed by the USA, is increasing public expenditure and it is getting the expected results, in terms of reducing unemployment and boosting economic growth; moreover, Japan managed, thanks mainly to the quantitative program easing and more generally to the “Abenomics” described above, to escape two decades of deflation and restore economic growth. On the contrary, the Euro Area prefers lower deficits and debt at the expenses of higher unemployment and stagnation. It is also possible to identify a clear Philips curve between (higher) inflation and (lower) unemployment among the countries analyzed, which give hope to policies makers who are willing to reduce unemployment. As far as economic growth is concerned we can observe the same results: the USA, followed by Japan, is recovering in terms of economic growth, while the Euro Area is lagging behind.

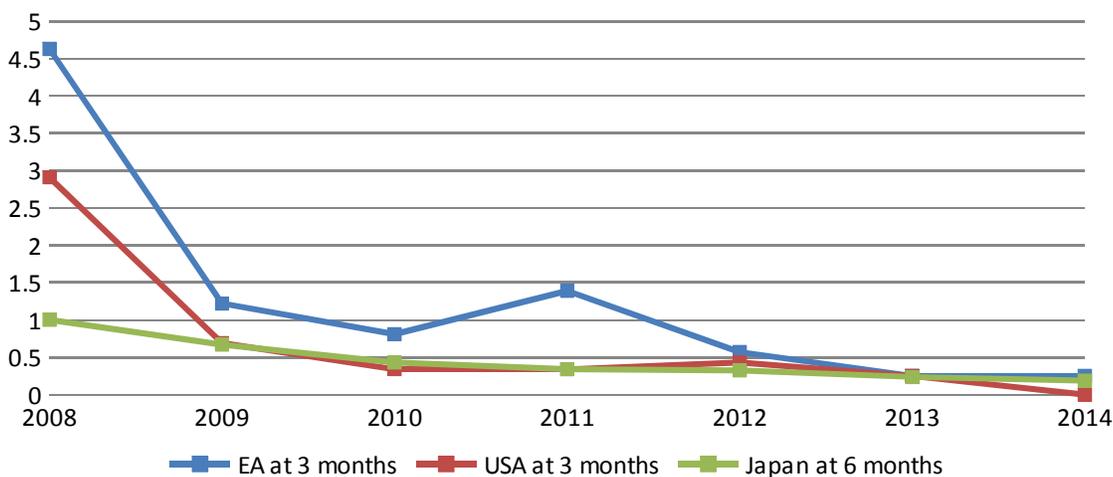
Figure 5 - Japan, USA and EA government deficit and economic growth in 2007-14



Source: own elaboration on Eurostat and IMF data

Despite its well know high public debt(around 240%), the Japanese economy, as well as the US economy (which has a debt of 125% of GDP today), did not avoid implementing fiscal expansionary policies in order to recover from recession after 2008/09, and to foster employment. Both the Central Bank in Japan and the Fed in the US cooperate with their Governments, loosening monetary policies, decreasing the interest rates, pumping money into the systems and contributing to the accomplishment of better performances than in Europe.

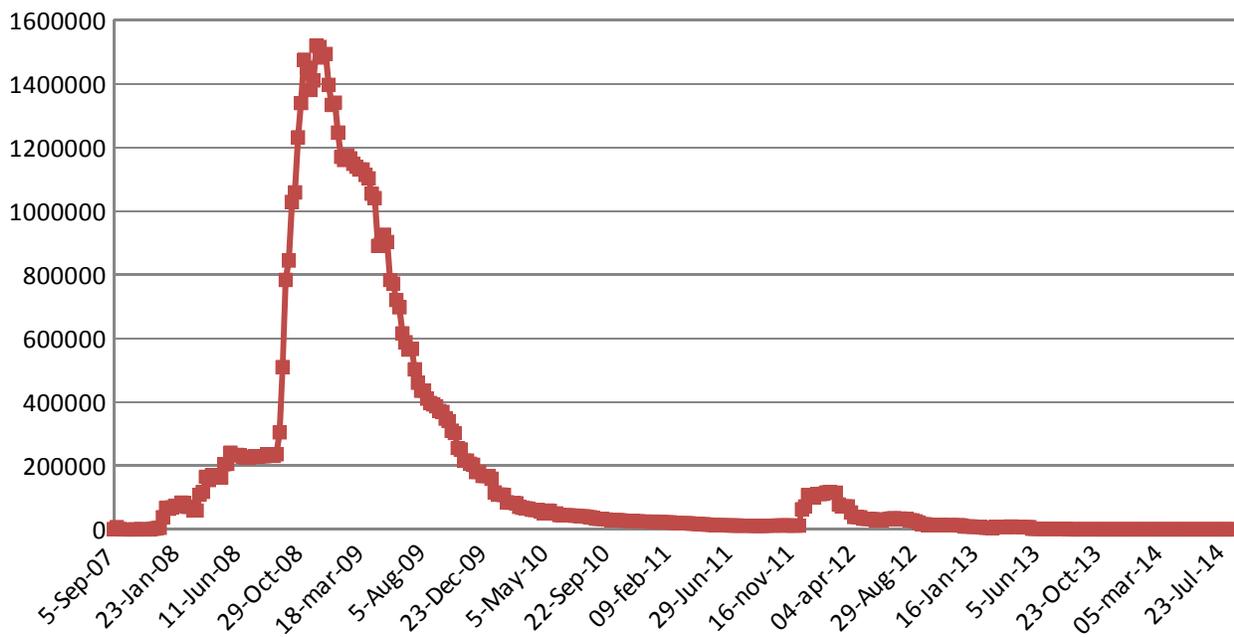
Figure 6 – Money market in EA, US and Japan



Source: Eurostat

Of particular interest is the extraordinary monetary policy implemented by the Fed in the USA called quantitative easing, i.e. the systematic introduction into the system of huge amounts of liquidity. With this strategy, the Federal Reserve responded aggressively to the financial crisis that emerged in the summer of 2007 from different angles; not only in the reduction of the target federal funds rate from more than 5 percent in 2007 to effectively zero in 2014, but also in implementing a number of programs designed to support the liquidity of financial institutions and foster improved conditions in financial markets. The figure below shows the quantitative easing program with all the liquidity facilities used weekly to stimulate the economy (i.e, the Term Auction Facility, the Commercial Paper Funding Facility, the Central Bank Liquidity Swap, the Term Assed-backed Securities Loan Facility). These liquidities reached the extraordinary peak of \$1.5 trillion US in the weeks of December 2008 and January 2009, and then declined towards lower levels in 2010, below \$100 billion US weekly in 2010 and in 2011. However, at the end of 2011, the weekly liquidity increased again above \$100 billion US weekly in 2010 and in 2011, and then decreased in 2013 and in 2014 to an average of \$3 billion US weekly. In general, during the whole period since the beginning of the crisis in the Summer of 2007, up to today, the Fed introduced into the system an amount of liquidity of around \$200 billion US per week.

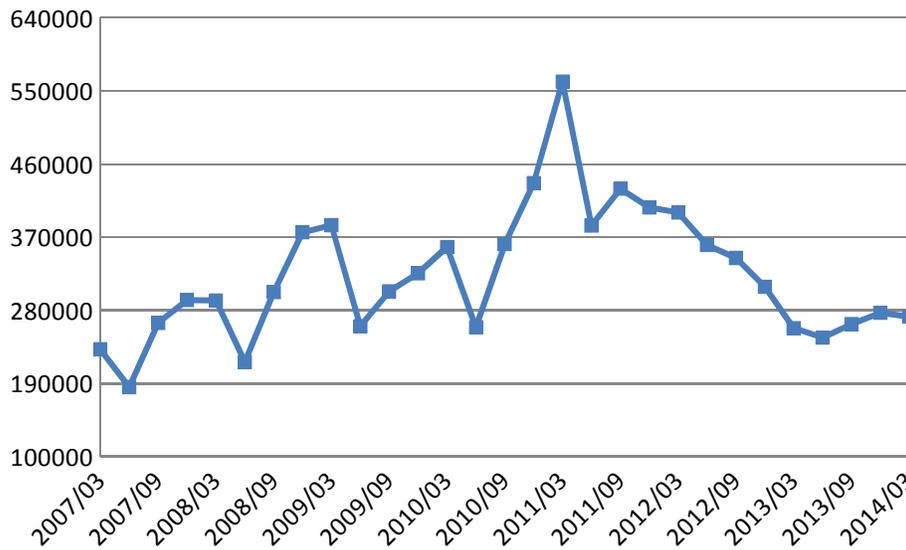
Figure 7 – FED Quantitative easing



Source: FED balance sheet

A similar aggressive monetary policy was followed in Japan in the framework of Abenomics. In Japan, quantitative easing took the form, mainly, of loans to financial institutions through long-term funds at a very low interest rate (the interest rate on loans is fixed at 0.1 percent per annum for 4 years) and a vast program of buying, without prior limits, Japanese treasury bonds (Bank of Japan, 2014). The figure below shows these measures during the whole period from the beginning of the crisis until today. Liquidities increased in 2009 to 370 billion of weekly funds being introduced into the system. However, the peak was reached after the Fukushima disaster in 2011 and continued in 2012 during the second mandate of the premier Shinzō Abe at a similar speed and magnitude of the liquidities introduced by the Fed in the USA.

Figure 8 – BoJ Quantitative easing



Source: Bank of Japan

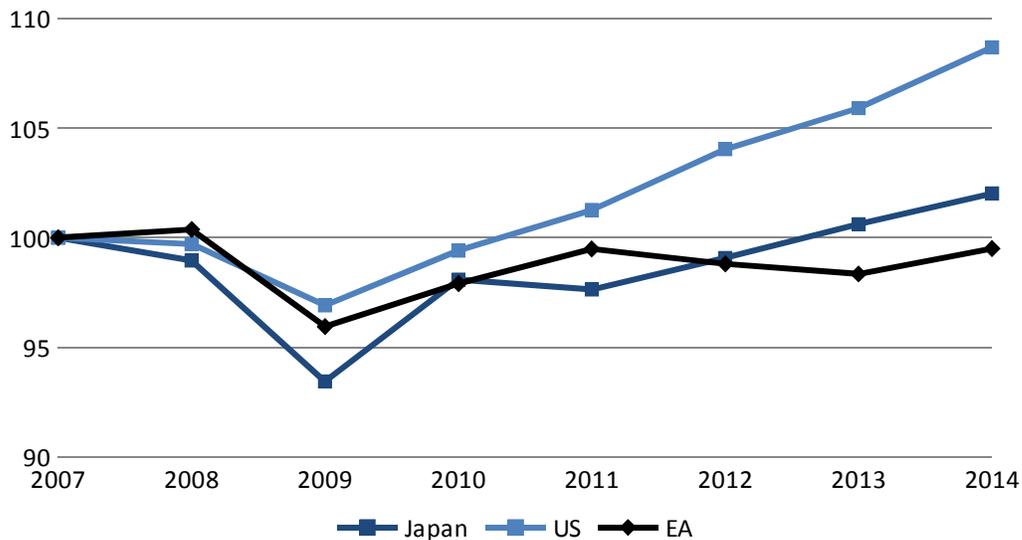
Contrary to the Fed and to the BoJ, the EU, and in particular the Euro Area, and its monetary institutions, kept relatively higher interest rates⁶. It put into the system less liquidity and did not put forth the main tools that the economy required, such as the issuing of Euro bonds and a program of buying members states' debts, particularly the ones in difficulty.

The cost of these actions, or more appropriately these inactions, is exemplified by the figure below, particularly with respect to the US recovery, which in 2014 reached a GDP per capita higher

⁶ Only in September 2014, the ECB cut finally the interest rate to the historical low level of 0.05%, overcoming the German resistance. This was an overdue measure, took late, however welcomed.

than nearly 10% of the one of 2007, the year when the crisis started. The EA, on the contrary, is still below its 2007 level. Japan is collocated in an intermediate position between the two countries, and its projections for growth are currently the same as the US. This gap, along with mass unemployment and deflation, which worsen indebted countries' situation even further, represents the cost of the EU failure in managing the current crisis.

Figure 9 - The cost of EA inaction



Source: IMF World Economic Outlook, database summer 2014

At the same time, the EU moved toward tighter rules concerning austerity and public expenditure. Policies for austerity were imposed with new intergovernmental treaties. Several agreements were signed within the EA between 2011 and 2013. A so called “Fiscal Compact” (more formally Treaty on Stability, Coordination and Governance - TSCG) was signed in 2011 and entered into force in January 2013. The TSCG commits countries which signed the treaty (all EU MS except the UK and Czech Republic) to amend national law to guarantee budget balance, newly defined as an “adjusted structural deficit”⁷ below 0.5% (for a country with a debt above 60%; and below 1% for countries with a debt below 60%). To complement the TSCG other rules were set to sync procedures (sanctions) against “excessive deficits”: the so called “Six-pack”, “Two-pack”, and “Euro plus”. Collectively, these provisions and rules are known as the “European Semester”. The six pack refers to

⁷ The adjusted structural deficit refers to the deficit cyclically adjusted and it is calculated with respect to the potential rate of economic growth.

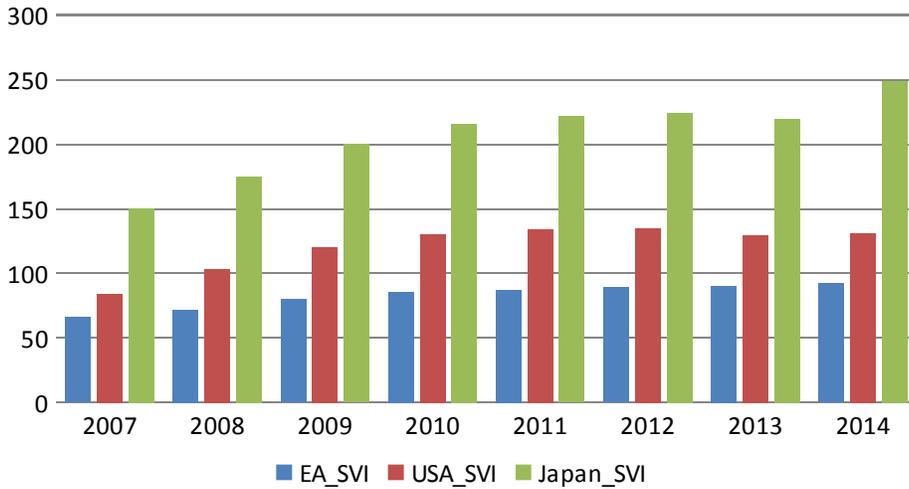
five regulations and a directive to control budget deficits and macroeconomic imbalances; the two-pack refer to the provision to monitor and if necessary to require change to national budget by the European Commission. These provisions are subject, if not respected, to European sanctions which can take the form of monetary sanctions (up to 0.2% of MS GDP), freezing of European Structural Funds and reduction of the right to vote in the EU institutions (these are more stricter rules and more effective sanctions than the ones already stated in the Maastricht Treaty). Finally the Euro Plus pact signed by six other EU countries beside the EA MS, concerns broader economic co-ordination.

3. Policies and results: the DDC index and the Performance Index

To synthesise the economic policies implemented and the results obtained by Japan, the USA and EA in the last years of the economic crisis, I introduce two indexes: the DDC index which proxies the policies implemented during 2007-2014, and the Performance index (PI) which accounts for the performance obtained by Japan, USA and EA in the same period.

The DDC (Deficit-Debt-CurrentAccount) index is obtained through the algebraic sum of Government Deficit (+), Public Debt (+) and Current Account balance (-). The index is constructed in a way that shows that the higher the index the “worse” it is for the country, at least in the orthodox view that considers deficit and debt necessarily negatively. In other words, according to this view, the higher the index the weaker the position of the country and more vulnerable the economy is in future. It follows that a higher index would be a worse option. Advocates of this view would argue that public spending is not a good option for recovering from the crisis. At the same time, the DDC index can be considered a proxy of macroeconomic policies or, more correctly, of macroeconomic policy preference. Thus, in Japan and the USA, governments prefer to keep lower unemployment, boost economic growth and therefore are willing, more than in Europe, to increase deficits and debt. On the contrary, in the EA, austerity and fiscal constraints oblige the MS to implement tight fiscal policy, and to reduce the deficit.

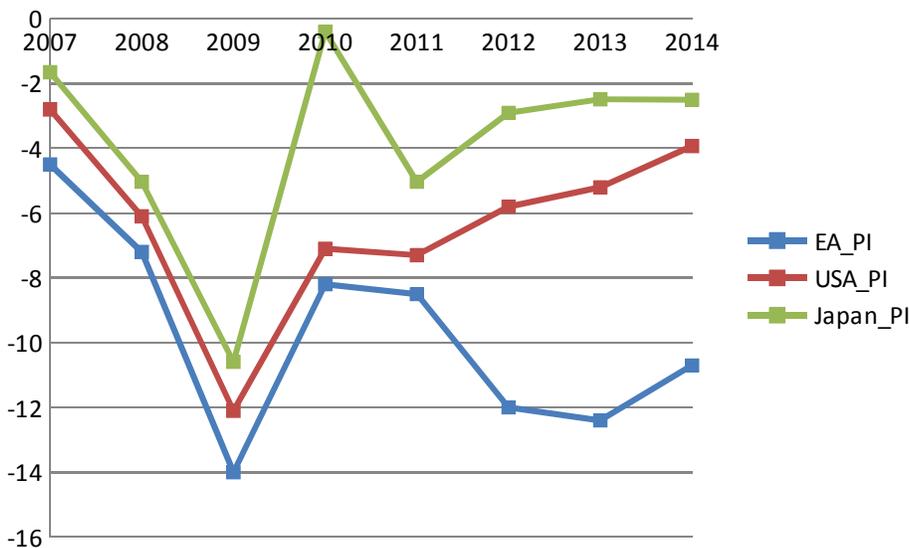
Figure 10 – The DDC index



Source: own elaboration on Eurostat and IMF data

In the end, the results of these policies were higher unemployment and lower economic growth (or stagnation) in Europe, and recovery with economic and employment growth in Japan and in the US after 2010. The Performance Index (PI) below, which is a combination of economic growth rates and unemployment rates, highlights these differences.⁸

Figure 11 – The Performance Index



Source: own elaboration on Eurostat and IMF data

⁸ The reason why it is preferred here to take into account a composite index rather than the GDP growth or the unemployment rate only is because the Performance Index takes into consideration both employment and GDP aspects simultaneously. Using such an index would allow for better consideration of the performance of countries during the crisis, and it avoids biases and distortions such as the fact that countries could have experienced low recession but very bad unemployment or employment reduction (and vice-versa).

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In particular, policies between Europe and the US (and the rest of the world's advanced economies) started to diverge after the Greek crisis, which began in May 2010. This crisis showed how EU member states are much more concerned with national issues than EU integration during times of crisis (Frangakis, 2010) and showed the fragilities of the EU and the EA.⁹ A lack of coordination and financial solidarity emerged dramatically, and the issue of European imbalances was wrongly regarded as a problem of laziness against effort; virtuous balance against poor discipline; Mediterranean corruption against Northern European integrity (Cesaratto 2011). This does not help us to see the real problem behind the deficit-surplus issue within the EU, which is an imperfect single market. A single market (with many imperfections) and a common currency within a non-Optimal Currency Area (OCA) at the very least needs labour coordination, budget centralisation, and fiscal policy harmonisation (Wray and Randall, 2010). In addition, the strong “internal devaluation” (i.e., wage moderation) that Germany carried out in the past ten years, along with other mercantilist policies and the cooperation of the ECB's strict monetary policies before Draghi took over in 2010, allowed German exports to increase dramatically (Cesaratto, 2011). Such policies were not really in the spirit of EU integration and solidarity. Consequentially, the EU situation today looks fragmented. On one side, Greece and the other Mediterranean countries suffer vis-à-vis the efficiency of Northern European firms. Free competition and the imperfect single market affected the domestic markets in those countries, which were lagging behind in terms of competitiveness and technology at the creation of the Eurozone and the single market. Moreover, the Maastricht criteria and stability pacts appreciated the euro and contributed to the declining foreign competitiveness of Southern European economies. On the other hand, the poorer economies in the EU cannot use monetary policies and exchange rate manipulation to gain competitiveness. They are unable to use state aid and firm subsidies, nor fiscal policies which are constrained by Maastricht criteria. Hence, markets have to regulate imbalances despite the fact that labour mobility, single markets, and budget centralization are strongly limited in the EU. It follows that surplus and deficit are the two malaises of the same problems: an imperfect single market and an imperfect currency union. In the EU, Germany's surplus could not exist without Greece's deficit (and similar). Greece should accept, within the EU rules, the German market's super-competition, which is historically rooted and state supported, despite the fact that they cannot use

⁹ Media pointed out how an election in the small Lander of Lower Saxon in Germany during the Greek crisis in the Spring 2010 was enough to keep German chancellor Angela Merkel far away from an idea of integration and financial solidarity, which populists in Germany objected.

policies to enhance their firms' competitive advantage. Unless these imbalances are covered by a central EU plan, it would not be convenient for Greece to accept European monetary union constraints.

4. A new strategy to overcome the European impasse of austerity without growth

The longevity of the current economic and financial crisis confirms that its nature is different from the one observed after the great depression in the 1930s. In Europe, because of the common currency shared by a number of EU member countries and differences in their economic competitiveness, currency devaluation is not a simple tool for recovery. Massive public interventions in the market at the beginning of the financial crisis were connected with huge increases to public deficits. If we add to these high levels of public debts, which in some European countries like Ireland, Portugal, Belgium, Italy and Greece are higher than 100% of GDP, and in others like Spain, France, UK and Germany are a bit less than 100% of GDP, it is obvious that stimulating economic recovery by increasing public spending is not a simple solution.

Given these two major limitations existing in the EA concerning the impossibility for all MS to implement currency devaluation and the difficulty to implement expansionary policies in deficits, both caused by the existence of an imperfect EU single market and of a non-Optimal Currency Area (beside the strict rules of the treaties), a EU/EA strategy is required in order to solve the issue in a coordinated way. This strategy, which I will discuss at the end of this piece, should go beyond austerity.

In fact, the experiences of implementing austerity measures in the EA which can reduce the public deficit in the short term are negative. They are accompanied by increases in unemployment and the decline of GDP, which can also lead to political destabilization, weakening social cohesion and to further increases of public debt instead of a reduction of it. The consequences of cuts in public spending can therefore cause more negative impacts on economic growth and essentially increase budgetary problems.

The creation of the European Stability Mechanism¹⁰ (ESM) along with the Outright Monetary Transactions (OMT) program proved to be very effective in solving the European crisis and saving the

¹⁰The ESM is a EU agency created in October 2012 with the mission to safeguard financial stability in Europe by providing financial assistance to euro area Member States . The ESM is a permanent institution which followed the creation of the European Financial Stability Mechanism (EFSM), an EU institution created in the April of 2010 able to borrow on behalf of EU in capital markets and to lend to MS in difficulty. It was exceptionally created to save Ireland and Portugal, with a very limited resource of 60 bln of Euros. The EFSM was immediately followed by the European Financial Stability Facility (EFSF) which was a much bigger (but temporary fund), also with the participation of private financial institutions, guaranteed by the Euro Area MS, created during the Greek crisis in the Spring-Summer of 2010, providing an initial support of €500 billion and with the objective to provide loans, bond purchases in primary markets, bank recapitalization,

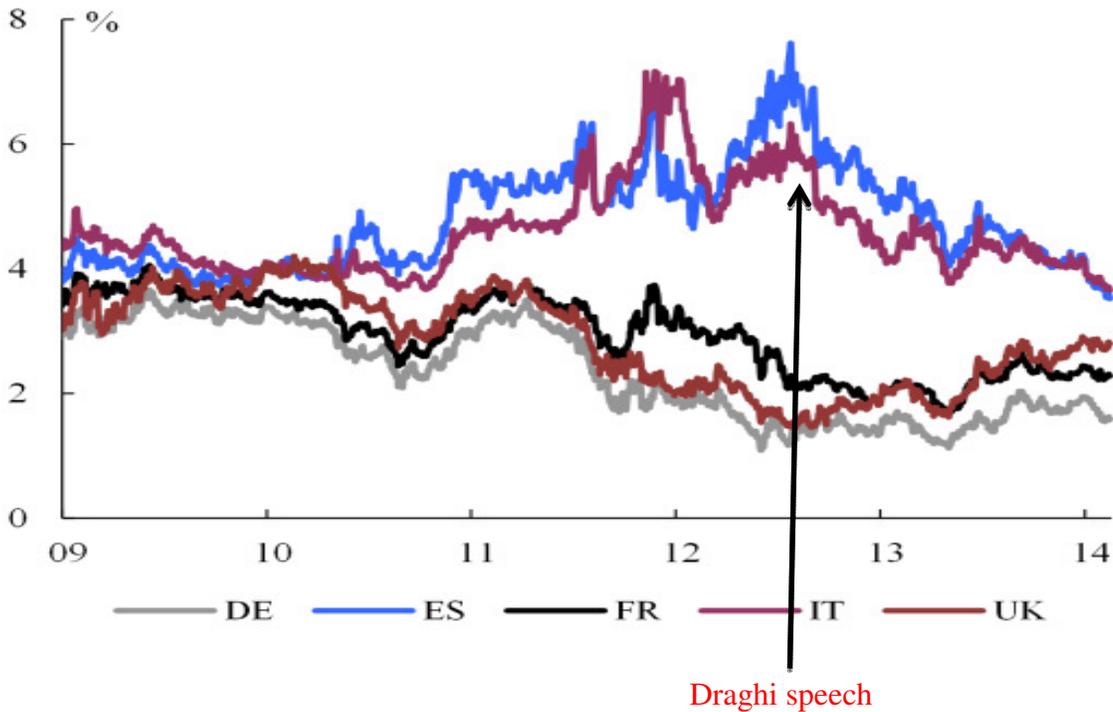
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Euro currency in 2012; much more than any other austerity program implemented before and after this date in the EU. These two institutions, with all the limitations that they have, show what should be the most appropriate road to follow in the EU to fill the missing spots and to fix the flaws of the European Economic Monetary Governance¹¹. However, the problem with the ESM and the OMT is that they are not guaranteed by treaties as EU institutions: the ESM is an intergovernmental organisation financed mostly by the richest MS (Germany, France, Italy), created in an emergency circumstance, and it is not clear yet whether this will be a permanent fund or it will disappear (because of lack of funds from MS) after the crisis. Moreover, the ESM is not a Fund acting on regular basis as a lender of last resort buying government bonds of MS, and it is far from having a regular program of issuing European Bonds. It has limited resources (750 bln Euros), which are used in particular circumstances of crisis.

The OMT theoretically is even weaker than the ESM as far as permanent EU institutional guarantees are concerned. The OMT is neither based on a treaty nor guaranteed by EU institutions. It is mostly based on a famous speech of the ECB president, Mario Draghi, who in the Summer 2012 in London stated: “Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough”. Then, a program of OMT was officially announced in September 2012 as a program of conditional sovereign bond purchases on secondary markets without prior limits, subject to strict conditionality under the ESM programmes. The most important novelty of this program, which in the end was never activated because the crisis circumstances attenuated, was the objective to buy MS bonds without limits. It was a speech of a president of a Central bank which stated for the first time something extremely important and which proved to be extremely effective. However, everybody, and in particular the Germans who strongly objected Draghi’s speech and informal strategy, knew that the statement was contrary to the spirit of the ECB statutes which do not allow the ECB to act as a lender of last resort. Its unique objective is to stabilize prices and to guarantee against inflation spiral as the Germans prefer. However, this statement, more than any other policy was probably enough to guarantee markets, to increase trust in the Euro, to stabilize and protect national bond markets of MS in crisis from speculators, to reduce the spread between South and North interest rates on treasury bonds, and to avoid further sovereign debt defaults (see figure below).

secondary market interventions and Financial Assistance in particular to Greece, Portugal and Ireland. The EFSF borrows in capital markets, issues debt and then lend to MS in difficulty. It expired in June 2013. Both the EFSM and the EFSF involved the participation of the IMF.

11 In this period was also initiated a Banking Union (BU) among EU MS and negotiations are still continuing. The BU aims to set a single supervision and rescue mechanism for big banks at EU level, in order to reduce the vicious loop-circle between national sovereign debts and national banks whose cost of rescue (or of recapitalization) can sometimes be excessive for one country in isolation (UK, Czech Republic and Sweden chose to remain outside of this Union).

Figure 11 – Ten-year treasury bonds yields – selected MS (2009-14, %)

Source: EU Commission

All this shows that a strong institution working as a lender of last resort, guaranteed by EU institutions and by the ECB statute, without conflicts, should be created for the EU or at least for the Eurozone as soon as possible.

For instance, Italy, in order to respect EU recommendations, reduced public spending, raised taxes, operated maneuvers for deficit reduction, and stayed, even when not strictly necessary, as in recent years, under 3% of the deficit (or close to the structural deficit of 0.5% imposed by the new Treaty on Stability, Coordination and Governance (TSCG)). Today it is clear to many that these restrictive maneuvers of austerity, have not led to the two main advantages it was implemented for, i.e.: reduction of public debt and economic growth. On the contrary, performances in this respect are quite negative as the table below shows.

Table 1 – Italy’s main macroeconomics indicators

	2012	2013	2014	2015
GDP growth	-2,5	-1,9	0,6	1,1
Deficit	-3,0	-3,0	-2,6	-2,3
Structural Deficit	-1,4	-0,8	-0,8	-0,7
Primary balance	2,5	2,3	2,7	3,1
Debt	127	133	135	135
Unemployment	10,7	12,2	12,6	13

Source: EU Commission

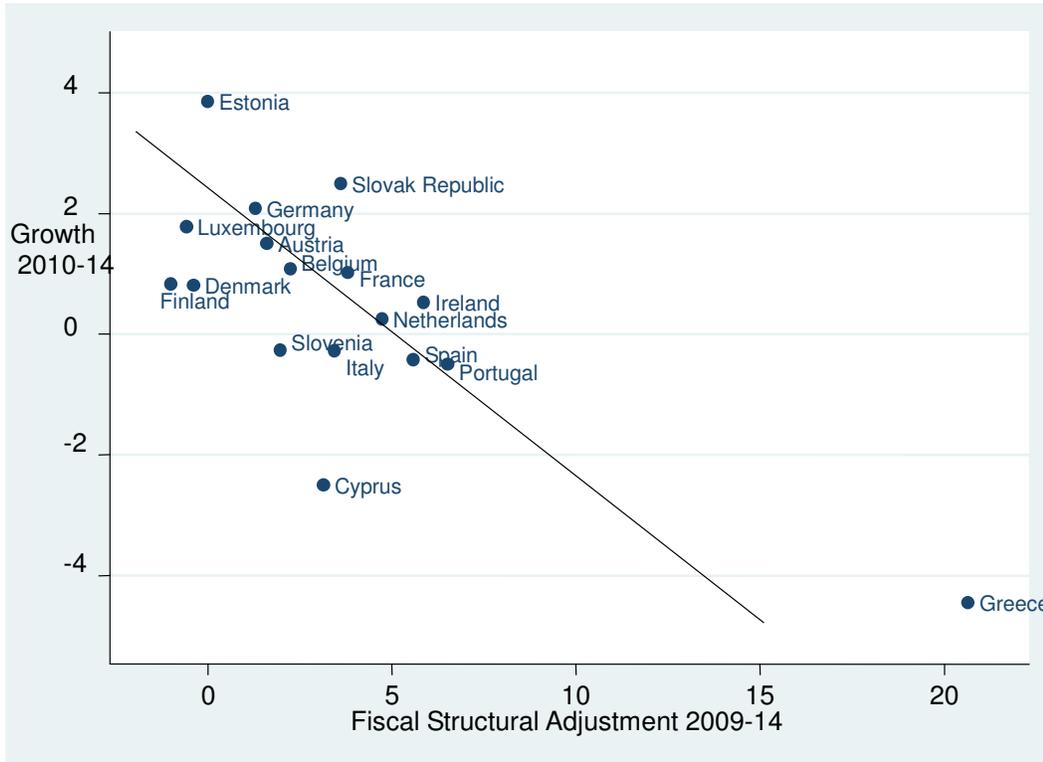
The reason is simple: policies of deficit reduction, carried out during periods of recession, reduce further aggregate demand and thus contribute to the further decline of the GDP. The debt/GDP ratio then worsens as a result of the denominator of the fraction which decreases. In addition, it also contributes to lessening the reduction in tax revenues, due to a decline in income and employment. In recent years, countries in the EU such as Italy that have practiced austerity policies have seen worsening public debt and GDP dynamics. This process which is well known as a “Keynesian multiplier” is very often undermined by policy makers and is not taken into account in the EU. Lately, however, the International Monetary Fund (which in the previous years had been very conservative on these issues) also stated that there is a positive Keynesian multiplier of the expenditure with a value between 1.5 and 2. In other words, economic policies which increase the public deficit may have an overall positive impact on growth, on the reduction of unemployment and also on the reduction of Public Debt because, with a multiplier of the expenditure bigger than 1, the positive effect on income is able to compensate the increase of deficit. Conversely, deficit reduction in recessions worsens through lower GDP dynamics and unemployment, also through the Public Debt.

The graph below is clear on this issue - as I repeated an exercise first conducted by Martin Wolf in 2012 with available data at that time. The same exercise undertaken with today's data confirms Wolff’s hypothesis¹²: the bigger the structural tightening, the larger the fall in GDP. In 2012, Wolf estimated that every percentage point of structural fiscal tightening lowered the GDP by 1.5 per cent of its 2008 level. In my estimate, the results are essentially the same over a slightly different period of the crisis. First I calculated, among EA MS the structural balance adjustment from 2009 to 2014 (IMF,

12 Martin Wolf (27 April 2012) "The impact of fiscal austerity in the eurozone" *Financial Times*

World Outlook Report, 2014)¹³. Austerities policies started between 2009/2010; then, I evaluated their impact on economic growth from 2010 to 2014. The same negative relation is identified between structural balance adjustment and GDP: the tighter the fiscal adjustment (i.e. the deeper the austerity) the lower the GDP growth (or the deeper the recession).

Figure 12 – The impact of austerity on GDP growth in the Euro Area



Source: own elaboration on IMF data

Hence, austerity policies contribute to dramatically worsening the situation. They contribute to squeezing economies and to creating smaller ones, able to deliver fewer jobs. They contribute to destroying the capacity of production and reducing further industrial production. Moreover, from a social point of view, one can observe consequences of aging populations on social security systems and in many countries the real decline of welfare state instruments. The drop of fertility rates in most EU countries during the economic crisis may also significantly weaken the competitive potential of Europe. Effects of public spending and related fiscal, budget and monetary policies should be calculated from the perspective of social aims such as poverty reduction or employment. Employment, specifically,

¹³The Structural balance adjustment is the general government deficit cyclically adjusted. In this way the change in fiscal policy represents the results of policy, rather than cyclical effects.

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requires decisive actions as in some EU countries like Spain and Greece where the unemployment rate among people below 25 is higher than 50% and total unemployment is close to 25%.

The long period of the current crisis also has a strong impact on citizens' state of mind and may lead to different kinds of frustrations and protests. We have observed in the last few years in Europe violent protests and riots in Spain and in Greece. Also in Central and Northern Europe one can observe the emergence of anti-European and extreme right wing parties. These were obviously the consequences of disappointment, frustration, lower standards of living and above all mass unemployment in those countries. Hence, austerity not only proves to be ineffective in stimulating economic recovery, but it also increases social tensions within MS and anti-EU movements within the Union.

In Europe, in the end, the biggest problem seems to be mass unemployment. On average, among all 28 MS, the unemployment rate is around 11%, with strong differences among countries and huge variations: from 4-5% in Germany and Austria, to around 25% in Greece and Spain. Obviously the latter figures underline, in the South of Europe, the existence of problems related to lack of investments, and insufficient aggregate demand. In the north of Europe, the very low unemployment rates underline different problems identified by the structural surplus in the balance of payments. These problems cannot be solved with a single agenda of structural reforms (i.e., labour market flexibility) and austerity policies that the EU has carried out. In the best case, labour flexibility will increase turnover of employees, and probably will bring about poorer performance of productivity. This will not increase the employment levels, in particular in the South of Europe. With this perspective one can easily explain the very high youth unemployment rates in many countries in the EU, where the agenda of labour flexibility showed its complete failure. It contributed to creating no additional jobs, therefore, young people remain unemployed. In the EU a wide strategy, similar to the one implemented in US and in Japan, is needed, and it should be organized around the four following pillars:

1. A Euro Area central budget of at least 5% of GDP which should allow for automatic compensation of macroeconomic imbalances due to the imperfections of the non-Optimal Currency Area of the EA.
2. Differentiated fiscal policies and budget flexibility for MS (beyond the current EU treaties) in recession time
3. Buying operations without prior limits of treasury bonds by the ECB for MS in difficulty.

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4. Issuing of EU bonds to back public investments in countries with unemployment higher than 10% (a similar proposal, without the objective concerning public investments, and the limits of 10% of unemployment, was made by Tremonti and Juncker proposal¹⁴)

This strategy should also involve public investments along with public policies such as reform of labour markets (i.e., integration of labour and development policies), financial regulation, sustainable development, innovation stimuli, sound combinations of coordinated monetary and fiscal policies, and an institutional strategies towards a better governance for both public issues and private business. Moreover, this strategy should also be diversified at the MS level to give enough flexibility, in fiscal and budgetary terms, to MS and to allow them room for manoeuvres beyond the strict fiscal rules of the Stability and Growth Pact and of the even stricter TGSC.

In this context, labour market policies and development policies need to be considered “two sides of the same coin”, and need to be faced with a single approach focusing on the demand side of the economy. As De Long (2010), Arestis and Pelagidis (2010), and many others underlined, surplus countries such as Germany, Austria and the Netherlands need to implement expansionary policies rather than austerity measures by spending more and taxing less. To sum up, in Europe, the ECB should practice a policy of zero interest rates for several years to come as modeled by the Fed and by the Bank of Japan. It also should start a regular program of buying national bonds. A program of issuing European Union Bonds should be introduced in the Euro Area as soon as possible. In order to overcome the German veto in this matter, the EU Bonds should focus merely on new productive investments in order to boost employment where needed in the EU.

5. New developments: quantitative easing and other firewalls of the new EU governance

To be completed

Conclusion TBC

14 Jean-Claude Juncker and Giulio Tremonti made a proposal on the financial Times for a European Union bond, issued by a European Debt Agency (EDA). Each country can issue European bonds up to 40% of GDP. This would create, over time, a sovereign bond market of similar size to the US one. Initially the EDA would finance 50% of member states' debt issues – but this can be raised to 100% during crises. The proposal also envisions a mechanism to switch between national and European bonds for countries in trouble at a discount rate. This would avoid the problem that secondary markets in many EU sovereign bonds are not sufficient liquid during crises.

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This paper discusses the different strategies for economic recovery after the financial crisis of 2007/08 in Japan, in the US and in Europe, (more precisely in the Euro Area). These three “countries” (the EA was considered as a “country” in this paper, meaning that aggregate average data were used for the EA) implemented very different policies in the past years. Japan and the US followed a policy of monetary expansion and fiscal stimuli continuously since 2008. In Japan this rule became more consistent in after 2011 and was characterized by quantitative easing, currency devaluation, higher inflation targeting, buying of Treasury bonds and public spending to support investments. In the US after the TARP (implemented by the Bush administration in 2008 mainly to save banks and financial institutions), a second plan called ARRA was implemented by the Obama administration in 2009 to sustain investments and jobs. These two plans together accounted for about 7% of US GDP. Moreover, the Fed during the whole period of crisis, until today, has been continuously practicing a policy of zero interest rates, buying operations of US Treasury bonds, and huge inflows of money into the system through a quantitative easing approach. In Europe, instead, the situation looked very different. After a brief period of fiscal and monetary expansion in 2008/2009, the consensus turned back toward more conservative policies which became clear austerity measures after 2009. The ECB, pressed in particular by Germany and other North and Central European Countries, remained worried mainly about inflation, and implemented more prudent monetary policies. Only in September 2014 did the interest rate in the EA reach the same level as the one in US (0.05%). At the same time, severe austerity policies were implemented in Europe, in particular in the South, with dramatic and negative effects on the GDP performance and on the unemployment rate. The DDC index (a proxy for policies implemented) and the Performance Index built in this paper for Japan, the US and the EA showed clear differences in policies and subsequent poor performances in the EA during the crisis.

The ECB cannot issue European Bonds nor buy MS national bonds, and this had very negative consequences on the sovereign debt of EA MS during the crisis. They were left practically without a lender of last resort. This contributed dramatically to increasing the cost of debt repayment and debt allocation by MS in difficulty like Portugal, Italy, Ireland, Greece and Spain, with further negative consequences on the public budgets of these countries. A very limited, and complex, operation of buying national bonds within strict rules was indirectly practiced by the ECB during the period of austerity in Europe. This was done through the cooperation of national banks which borrowed cheap money from the ECB and eventually bought Treasury bonds of MS in difficulty. A new institution was created, the ESM, to save countries in difficulty, and a new program of OMT was announced but never implemented by the ECB. All these measures contributed to “save the Euro” from a default which

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would have resulted from the exit strategy from the Eurozone of the MS in the South of Europe. However, these measures are far from being a definite solution and will not avoid further crises. Moreover these measures do not solve the main flaws of the architecture of the EA which is a non-Optimal Currency Area, and are far from useful for economic recovery and restoring growth and employment in Europe.

In this paper I have proposed some solutions and I have also showed that austerity policies worsened the situation caused by the financial crisis. These solutions require a new form of governance in the EA which should be organized around 4 pillars: a EA central budget of at least 5% of GDP; differentiated fiscal policies for MS; buying operations of treasury bonds; and the creation of EU bonds to back public investments in countries with unemployment higher than 10%.

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