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Is fiscal union (or strong fiscal integration) a requirement for a successful monetary union?

NO

Is austerity self defeating: killing growth, increasing the debt to GDP ratio, making default more likely?

NO

Popular claims: True or False

- <u>Monetary union</u> cannot succeed without some sort of a <u>fiscal union</u> (US example).

- The design of the monetary union was flawed because it did not contain institutional mechanisms for <u>controlling fiscal</u> policies.

- In order to <u>prevent crises</u> in the future it is essential to centralize fiscal policy.

They are all false in the sense that they confuse *sufficient* with *necessary* conditions.

Fiscal centralization would have prevented the crisis.

But there are *simpler ways* to satisfy the same objective.

For instance, Maastricht type of criteria:

- Fiscal deficits of 3%
- Debt to GDP ratios of 60%

are quite adequate for preventing such crises.

Design vs execution.

Why were the criteria ignored?

The markets were misled by EU politicians. They were led to believe that:

- either the Maastricht criteria would be eventually enforced by Germany

- or, that Germany would bail Greece out, if necessary

Spreads on 10 year Greek government bond relative to German were 10 to 20 basis points from 2003 to 2007! with a reported Greek public debt to GDP ratio of 1 (compare to non-EU countries)

Germany (the *guardian* of the system) has a big share of the blame.

Cannot introduce strict rules and then ignore them.

So what are we to do now?

If we want to have fiscal integration for other reasons (such as regional risk sharing) then you may go for it.

But for preventing a repetition of the crisis, a simpler, much less intrusive alternative is available:

Require for Euro membership the amendment of constitutions to give debt service priority over all other expenditures (like in US states).

Enforce by expelling from the Euro zone (or even the EU) countries that violate this constitutional obligation.

Main advantage of this scheme: Solve the fiscal time consistency problem with *no loss of fiscal sovereignity*.

Austerity and growth

- Widespread view that austerity is fundamentally flawed:

- Self-defeating in the sense that it leads to an increase in the public debt to GDP ratio and makes default more likely.

- What is this belief based on?

- Keynesian Fiscal Multiplier.

- Implausible: Contradicted by empirical work on the multiplier.

Why is austerity essential?

- In order to prevent debt from becoming unsustainable.

- Also as a signal of government type.

Why is the recession so deep?

- Greece is structurally a banana type of economy. Its growth in the last few years has relied on foreign handouts.

- Uncertainty about the future (Grexit). Private investment has collapsed. Brain drain.

- Higher taxes, discouraging economic activity.

- If Greek politicians had shown commitment to reforming the Greek economy and keeping Greece in the Euro zone, if they had actually implemented reforms in the product markets and if they had applied austerity more on the spending rather than on the tax side, Greece would be now growing very fast.

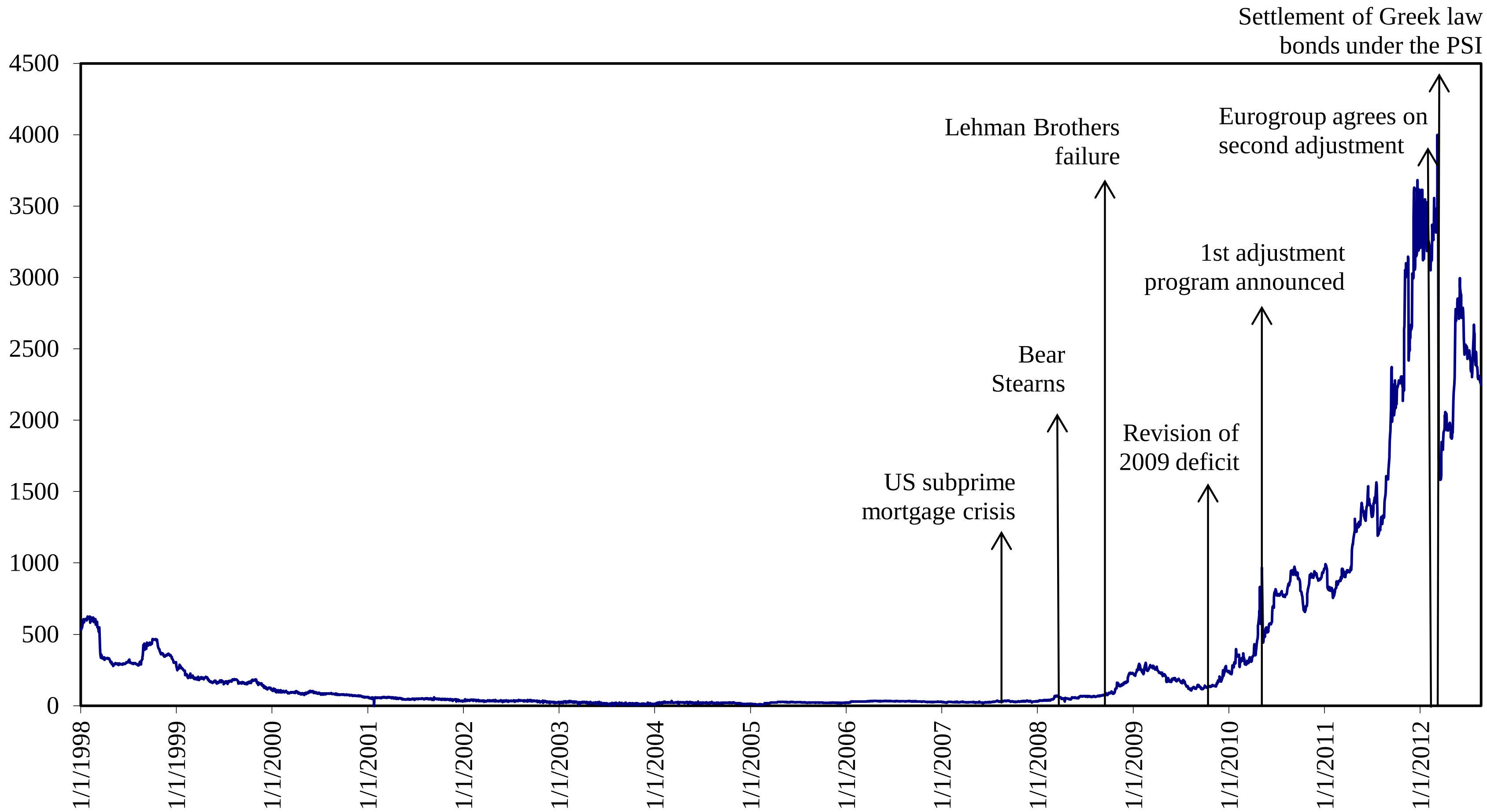
The present experience in Greece is in line with the experience from large fiscal consolidation in OECD countries with a government sector that accounts for well over 40% of GDP (Alesina and Giavazzi):

1. Cuts to government spending have smaller recessionary effects than tax increases.
2. To the extent that spending cuts have a negative effect on output, this can be offset by enacting structural, growth-enhancing measures.

Greece

	2001	2002	2003	2004	2005	2006	2007	2008	2009
Government debt (% of GDP)	103.7	101.7	97.4	98.9	110.0	107.7	107.5	113.0	129.3
Level of government debt (billions of euros)	151.9	159.2	168.0	183.2	212.4	224.9	239.5	263.3	299.7
Change in government debt (billions of euros)	10.9	7.3	8.8	15.2	29.2	12.5	14.6	23.8	36.4
change domestic	4.4	0.0	-8.2	-4.6	-5.0	-0.2	-9.8	-1.1	6.9
change foreign	6.5	7.3	17.0	19.4	34.3	12.7	24.5	24.9	29.5
Share of debt held by residents (% of total)	56.6	54.1	46.3	40.0	32.1	30.2	24.2	21.6	21.3
of which:									
domestic banks	26.9	25.1	21.6	18.3	18.5	19.2	17.1	15.2	15.5
Share of debt held by non-residents	43.4	45.9	53.7	60.0	67.9	69.8	75.8	78.4	78.7

Greek spreads: yields on Greek over German 10-year benchmark bonds (basis points)



Greece: Evolution of General Government's deficit and debt (% of GDP)

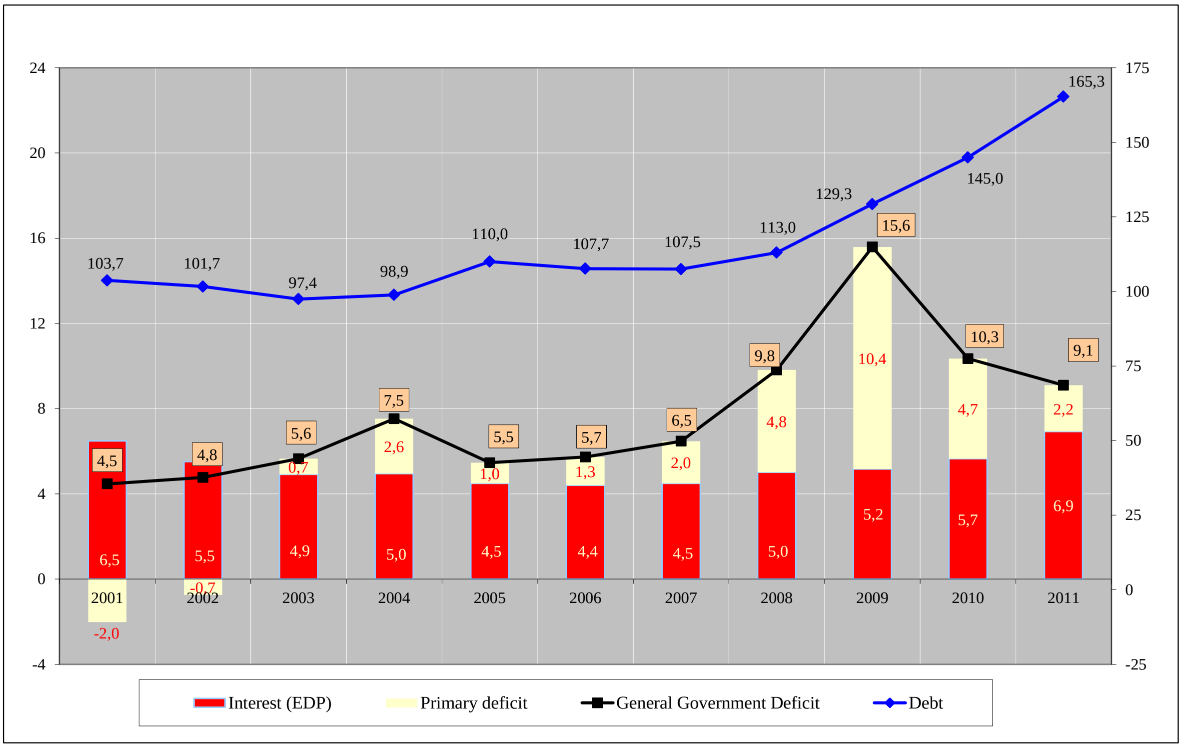


Table 8.1: Debt-to-GNP Ratios and Country Premiums Among Defaulters

Country	Average Debt-to-GNP Ratio	Debt-to-GNP Ratio at Year of Default	Average Country Spread
Argentina	37.1	54.4	1756
Brazil	30.7	50.1	845
Chile	58.4	63.7	186
Colombia	33.6		649
Egypt	70.6	112.0	442
Mexico	38.2	46.7	593
Philippines	55.2	70.6	464
Turkey	31.5	21.0	663
Venezuela	41.3	46.3	1021
Average	44.1	58.1	638

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