AT A GLANCE

Debt sustainability and economic convergence of euro-area Member States: Challenges and Solutions

This note provides a summary of external briefing papers presented in view of the Economic Dialogue with Eurogroup President Jeroen Dijsselbloem of 24 February 2015. The main objective of these papers was to analyse and suggest the most appropriate policy measures at the euro area and national levels so as to help bringing debt dynamics on a sustainable path and fostering economic convergence.

The paper by **Paolo Mauro** *(Peterson Institute of International Economics)* provides policy recommendations to foster economic convergence and debt sustainability for the Member States, given the present macroeconomic situation and the public finances. The global economic and financial crisis that took place in 2008 has led to a deep risk of prolonged stagnation and to a more substantial divergence among the countries. Moreover, the public debts of advanced economies reached the highest levels since the Second World War. This scenario demonstrated the need of low debts to afford fiscal stimulus (respecting the provisions of Stability and Growth Pact - SGP) and highlighted the vulnerability of several countries. The economic growth appears to be sluggish up to the next twenty years. The author's recommendations are the following:

- The fiscal planes should be based on realistic projections. The cyclical economic history shows that crises were caused by slowdowns in economic growth because they were not recognized in time by policymakers;
- Improve monitoring, disclosure, and management of the materialization of fiscal risks;
- Simplify the SGP rules in order to avoid unclear understanding of the architecture and to better benefit from fiscal rules. Technically speaking, the escape clauses should be based on numerical criteria and the estimation method for potential output growth should be changed;
- Cut taxes on labour, consumption, property, and on social security contributions for youth. Moreover, increase the share of infrastructure and education;
- Improve official lending to increase the investors trust on indebted countries, plus the coordinated issuance of growth-indexed bonds, so that countries would pay higher interest during a strong economic growth and lower interest during weak times.

In his paper, **Clemens Fuest** *(Zentrum für Europäische Wirtschaftsforschung, ZEW)* looks at the sustainability of public finances and debt levels in the euro area against the backdrop of the provisions of the SGP. He shows that the budgetary surpluses required for many countries to bring down their debt levels to the reference value of 60 % debt-to-GDP are simply unrealistic. Hence he turns his attention to enhancing economic growth instead, specifically focusing on public investment and growth oriented tax reforms.

Regarding the former, he shows that in many countries public investment has been sharply reduced to improve public finances, noting that the contribution of such reductions to sustainability are smaller than the contribution of equivalent cuts to consumption expenditure would have yielded, although it also means that there should be many viable investment projects available in these countries. However, he rules out financing these projects via additional debt, referring to the 'golden rule' of public finances; only net public investment should be debt financed, whereas many member states already now are incurring more debt even though net public investment is negative. In light of this he also is sceptical of introducing any more flexibility into the SGP, since it may undermine its credibility, lessen the commitment to fiscal sustainability and thus raise risk premia in government bond markets, rendering fiscal sustainability even harder to achieve. Turning to tax reforms, he

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proposes shifting the tax burden from e.g. labour and corporate income taxes onto consumption and property taxes, while taking into account revenue constraints and distributional implications. Such a tax structure would be better able to support growth. Also, if countries need to temporarily boost consumption or investment, he suggests using tax instruments to that end, such as a temporary cut in the standard rate of VAT or a temporary increase in tax allowance for investment in equipment.

The paper by **Paolo Manasse** *(Università di Bologna)* argues that there is a trade-off between debt sustainability - the main goal of fiscal discipline - on the one hand, and the real economic convergence on the other hand. Based on statistical and econometric evidence, the author suggests that the current fiscal framework does not improve this trade-off as convergence in debt-to-GDP ratios and structural balances across the euro area has been associated with real economic divergence in terms of unemployment, investment and, at least temporarily, output growth. In other words, the current fiscal framework has remained pro cyclical. If this aspect remains unaddressed, the author warns it could undermine the existence of the monetary union. In this regard, the recent flexibility guidelines are a step in the right direction but their overall impact is to be limited as 1) the structural reform clause (which exchanges fiscal flexibility for reforms) may have a negative impact on the economy in the short term - therefore further accentuating the pro cyclicality of the framework; 2) the investment clause is likely to be ineffective (it will concern only a limited number of projects); and 3) the cyclical clause is excessively complex and does note remover the pro-cyclical bias of the framework. Therefore, the author proposes:

- Creation of inter-European transfers, such as a European Unemployment Insurance Scheme with harmonised criteria across Member States and funded for example via shares of Member States' VAT receipts;
- Reform of the present SGP framework along three dimensions, namely simplification and focus on debt targets, more incentives for structural reforms and more discretion for individual Member States to allocate the agreed consolidation effort over time.

The paper by **Xavier Ragot** *(Observatoire Français des Conjonctures Économiques)*, singled out three main challenges that euro area faces today. The first one is nominal divergence, i.e. differing price levels across Member States, driven mainly by diverging wages following in particular an extraordinary wage moderation in Germany. The second challenge is a lack of aggregate demand as evidenced by low inflation and the large current account surplus of the euro area. In his view, this is due to fiscal consolidation and failed demand management at a European level, noting that country-specific recommendations (CSRs) are set for individual countries without regard to their aggregated impact. The final challenge is high level of public debt. Taken together, these elements form a trilemma for policymakers: lowering public debt through fiscal consolidation constitutes a drag on aggregate demand, which is the same problem if nominal divergence is addressed through wage cuts, while aggregate demand stimulus means taking on more debt or raise wages.

Concisely, he advocates for deficit countries to invest more to increase productivity while maintaining wage moderation, with surplus countries simultaneously raising their wage levels. Specifically, all the flexibility in the SGP should be used to sustain aggregate demand in the southern countries, while aggregate demand in the euro area should in the future be managed in a more centralized fashion using for example the Annual Growth Survey as a tool, with CSRs then drawn up to support this aggregate stance. Nominal divergence could be tackled by creating national councils reporting on wage dynamics. Their work would be coordinated at a European level. Also, a credible path should be defined for Germany to raise its price level. Finally, he calls for a programme of investment in southern Europe, much larger than the Juncker Plan.