In-Depth Analysis

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

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Fondation Nationale des Sciences Politiques (FNSP)

Provided at the request of the Economic and Monetary Affairs Committee

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IN-DEPTH ANALYSIS

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

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Provided in advance of the Economic Dialogue with the President of the Eurogroup in ECON on 24 February 2014

Abstract

Countries within the euro zone are facing three main perils. The first is the problem of nominal divergences, which materialize in unit labor cost differences. The second is the lack of aggregate demand in Europe. This is the main issue in the short run. The third is the high level of public debt, which generates an issue of sustainability in some countries, like Greece. The exclusive focus on both public debt and unit labor costs has produced a demand crunch in the euro area, which is the main cause of the deflation risk and the high current account. The lack of demand is creating concerns about debt sustainability. A sustainable debt is not in fact a low public debt or a rapidly decreasing public debt. It is a public debt for which there is no risk of default. The default risk in advanced countries is not an economic risk, but a political risk. High unemployment and a long-lasting recession are eroding political support for the European project, which can ultimately reduce countries’ ability to generate a sufficiently high primary budget. All the flexibilities in the current treaty should be used to boost demand in Europe, without increasing the public debt burden of the heavily indebted countries. As some surplus countries, like Germany, have decided not to use their fiscal space, one efficient way to promote public demand is to design a public investment plan that is much bigger than the initial Juncker Plan and is financed by funds backed by either national or European debt, which could be bought by the central bank. In addition, the European Semester should clearly start with an assessment of the aggregate fiscal and monetary stance in the euro area so as to provide the desired orientation for the European policy mix. This orientation should be consistent with country-specific recommendations.

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LIST OF ABBREVIATIONS

CSR(s)  Country Specific Recommendation(s)
ECB    European Central Bank
EDP    Excessive Deficit Procedure
IMF    International Monetary Fund
MIP    Macroeconomic Imbalance Procedure
OECD   Organisation for Economic Cooperation and Development
SGP    Stability and Growth Pact
TFEU   Treaty on the Functioning of the European Union

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EXECUTIVE SUMMARY

The euro zone countries are facing three main perils. The first concerns nominal divergences, which materialize in unit labor cost differences, among other things. In Germany, the unit labor cost is very low relative to European standards, whereas the Italian unit labor cost is still high. The second peril is the lack of aggregate demand in Europe. This is the main issue in the short run. The third is the high level of public debt, which is generating an issue of sustainability in some countries, like Greece. Europe’s poor macroeconomic performance is the result of an imbalance in policies in the face of these three perils. First, the exclusive focus on both public debt and unit labor costs has produced a demand crunch in the euro area (EA), which is the cause of the low inflation and high current account. Second, European procedures under the European Semester are not well equipped to assess the spillovers across countries of various macroeconomic policies. For instance, the joint rapid reduction of public deficits and wages in some countries has reduced demand and inflation, and thus the State’s fiscal revenues.

The lack of demand is creating an issue of debt sustainability. A sustainable debt is not in fact a low public debt or a rapidly decreasing public debt. It is a public debt for which there is no risk of default. The default risk in advanced countries is not an economic risk, but a political risk. High unemployment and the lengthy recession are eroding political support for the European project, which ultimately could reduce countries’ ability to generate a sufficiently high primary budget.

All the flexibility of the current treaty should be used to boost demand in Europe, without increasing the public debt burden of heavily indebted countries. As some surplus countries, like Germany, have decided not to use their fiscal space, one efficient way to promote public demand is to design a public investment plan that is much bigger than the initial Juncker Plan and is financed by funds backed by either national or European debt, which could be bought by the central bank.

In addition, the European Semester should clearly start with an assessment of the aggregate fiscal and monetary stance in the euro area so as to provide a desired orientation for the European policy mix. This orientation should be consistent with country-specific recommendations.

Finally, the reduction of nominal divergences, which are the cause of the impressive differences in current accounts between European countries, will be the main issue over the next ten years. Some new national institutions should contribute to putting this issue at the center of every national debate so as to affect wage formation in each country. Whereas Germany’s unit labor cost should increase by a relatively significant amount, Italy’s should decrease. The differentiation between the tradable and non-tradable sector should also be discussed.
1. INTRODUCTION

Europe’s record in terms of growth, convergence and debt sustainability is poor. European countries did not perform well in any of these aspects. Europe’s average growth is lower than in the US or the UK. Debt sustainability is not ensured in some countries, Greece being the obvious example. The divergence between regions and countries in the north and south of Europe is still larger than what it was ten years ago. These poor outcomes are not the result of a lack of regulation at the European level. The Stability and Growth Pact (SGP), the “two packs”, the Fiscal Compact and the European Semester are known to generate a fabulous amount of information, numerous reports, and recommendations to apply strict rules.

Before providing policy advice and proposing some institutional changes at the European level to contribute to a solution to these three problems (European divergence, low growth, high debt), we must clearly identify the destabilizing and diverging forces in Europe. A first key intuition of this briefing is that the main challenges require three sets of policies but over different time horizons. Growth is a short-run issue; European convergence is a long-run issue (ten-year horizon); and debt sustainability is a short-run issue for some countries and should be a long-run one for others. Mismanaging the timing of the necessary reforms can lead to the failure of all of them. Timing is key. A second claim is that the current procedures may underestimate economic spillovers between European countries. The first part of this briefing identifies the diverging economic forces concerning growth and debt. The second part presents some policy recommendation and some propositions to improve the European Semester.

2. THE DIAGNOSIS: THE THREE EUROPEAN PERILS

Any evolution of European policy or the production of new directives should first identify the main economic imbalances that must be reduced. What are the relevant instruments and time horizons for which one can assess the efficiency of the policies? Even if it is only a matter of small steps, we should be sure that they are in the right direction. This section presents the three main economic problems in Europe. Facts are first presented, and then causalities are discussed.

2.1 Nominal divergence

The introduction of the euro and the deepening of the single market did not produce nominal convergence across European countries. On the contrary, the divergence of prices since the late 1990s is impressive. Between 1999 and 2012, the annual average inflation rate (HICP) was 0.9% in Germany, 1.7% in France and 2.6% in Spain, just to take a few examples. These differences in inflation translated into differences in real interest rates, as nominal interest rates were very similar across countries. This creates a heterogeneous monetary stance across European countries for the same monetary policy.

With regard to the causes of this, the evolution of wages offers a first explanation. The divergence of unit labor cost across European countries is known to be impressive (Figures 1). The next graph is taken from Dustmann, Fitzenberger, Schönberg and Spitz-Oener (2014). It plots the unit labor costs of a selective sample of countries relative to their trading partners, using the structure of both exports and imports as a weighting scheme.
Figure 1: Weighted Relative Unit Labor Costs 1994-2012

Source: Dustmann, Fitzenberger, Schönberg, and Spitz-Oener (2014). The index is the evolution of the relative unit labor costs of a country compared to a weighted average of its trading partners. The weighting scheme reflects the structure of both imports and exports. See OECD Economic Outlook (2012, Issue 2, No. 92) for a description of the method.

The divergence starts in 1995, not long after German reunification. Germany experienced an impressive decrease in its unit labor cost. It is known that this fall was due mainly to the wage moderation that followed reunification. Although the fall was concentrated in the non-tradable sector, the tradable sector also experienced an evolution in nominal wage that was lower than in productivity (and thus a decrease in the unit labor cost). In addition, as the tradable sector uses non-tradable goods as inputs, these developments increased the competitiveness of the German economy (see Dustman et al. for a discussion). In addition, as German wage moderation dates back to the mid-1990s, it is difficult to claim that labor market reforms (Hartz IV reforms, which were adopted in 2003/2004) were the cause of this wage moderation.

The nominal adjustment started in Greece, Spain, and Ireland. France and Italy experienced much smaller changes in wage dynamics. It should be clear though that the main European outlier is Germany, where the wage moderation was extraordinary by any historical standard. This phenomenon was not intended. It was probably the most realistic way to integrate former East Germany after reunification. According to the German Council of Experts (SVR 2004), the cost of reunification paid by Germans was around 1 000 billion euros, which is roughly three times the total Greek debt.

Unit labor costs have two components: the nominal wage and productivity. The divergence in unit labor costs stems from a divergence in nominal wages for some countries (Germany), and from low productivity in others (Italy and Spain). As a consequence, nominal divergence should be thought of as arising from the relative dynamics of wages and productivity.

Assessing equilibrium exchange rates

An additional explanation of nominal divergence involves a direct assessment of equilibrium exchange rates between European countries. Two main approaches are used to compute equilibrium exchange rates in international economics. One should first recognize that these estimations are fragile because of the short time period under consideration and the existence of possible breaks in trends (see Bénassy-Quéré et al., 2010). The first approach, called the Fundamental Equilibrium Exchange Rate (FEER), tries to estimate the fundamental determinants of the current account to derive the long-run equilibrium level of prices. When applied to the European economies, this approach concludes that there are sizable
misalignments in internal exchange rates (e.g. Aflouk et al., 2010). The 2015 iAGS report¹ (Chap 5) uses the FEER and estimates the over or undervaluation of the internal exchange rate needed to stabilize the country’s Net International Investment Position (NIIP) (which means that a country’s net saving does not increase or decrease forever). This is a weak definition of the sustainability of current account imbalances. In addition, it is assumed that a realistic corridor for the NIIP should be in the range of ±50% of GDP, and that the adjustment must be made in 10 years. The following table provides the results.

<table>
<thead>
<tr>
<th>Countries</th>
<th>Necessary Adjustment (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>AUT</td>
<td>+14.2</td>
</tr>
<tr>
<td>BEL</td>
<td>-16.9</td>
</tr>
<tr>
<td>FIN</td>
<td>-15.5</td>
</tr>
<tr>
<td>FRA</td>
<td>-4.3</td>
</tr>
<tr>
<td>DEU</td>
<td>+21.8</td>
</tr>
<tr>
<td>GRC</td>
<td>-43.7</td>
</tr>
<tr>
<td>IRL</td>
<td>-0.8</td>
</tr>
<tr>
<td>ITA</td>
<td>+5.7</td>
</tr>
<tr>
<td>NLD</td>
<td>+19.1</td>
</tr>
<tr>
<td>PRT</td>
<td>-17.4</td>
</tr>
<tr>
<td>ESP</td>
<td>-5.4</td>
</tr>
</tbody>
</table>

Source: iAGS Report 2015. Note: a positive number is an undervaluation. For example, Germany is undervalued by 21.8%.

A final indicator of significant nominal misalignments in Europe is the large divergence in current accounts across European countries. The next graph, also taken from Chapter 5 of iAGS 2015, plots the current account of a number of European countries. Germany’s contribution to the European current account is significant.

Figure 2: Current account in some selected European countries

Although each piece of evidence presented in this section may not be conclusive if taken separately, their accumulation indicates an extreme nominal divergence of European economies. This being said, the

¹ The iAGS report is an annual analysis of European economies performed by the OFCE (France), ECLM (Germany) and IMK (Denmark) with contributions from the AK, IDDRI and Cambridge econometrics.
causalities are still an open question. Some economists (such as Wyplosz, 2013) argue that these divergences are the outcome of the international misallocation of capital. International capital flows (together with a lack of fiscal discipline) have financed the accumulation of non-productive assets, such as in the housing sector. Rising property prices due to housing bubbles may have fueled increases in wages. The original sin could thus be capital flows. Another perhaps more plausible explanation is that wage dynamics are shaped by labor market institutions, which are known to be very heterogeneous across European countries (as a legacy of the postwar social dialogue, including with respect to unionization, the centralization or decentralization of the wage-setting process, i.e. at the firm level or industry-wide). This generates a great deal of heterogeneity in the way wages respond to unemployment, productivity or inflation.

As a consequence, such extreme nominal divergence cannot be reduced in a few years. It will take at least ten years to reduce these imbalances significantly. If the adjustment is made only by nominal wage cuts in overvalued countries, the average nominal wage in the euro area will decrease, which will generate deflation. Due to nominal downward wage rigidities, inflation would significantly help the adjustments (obviously a higher inflation rate in Germany compared to other countries). The goal of so-called "structural reforms" should be to contribute to reducing these imbalances, which are not sustainable (as indicated by the FEER approach).

2.2 Lack of aggregate demand

Unfortunately, nominal divergence is not the only problem in Europe. A second issue is the lack of aggregate demand, which is the consequence of the poor management of fiscal consolidation in Europe.

The lack of demand in the euro area as a whole can be easily identified by two indicators. First, the current account in the euro area is now very positive (see Figure 2). Second, the inflation rate in Europe has decreased steadily since 2011 to well below the ECB target of 2%.

Figure 3: Inflation rate in selected European countries, moving annual average

![Inflation rate in selected European countries, moving annual average](image)

Source: Eurostat, November 2014.

These trends in the current account and inflation are two clear indications of the lack of aggregate demand in Europe. This diagnosis has been clear after 2011, which is the beginning of the period of rapid fiscal consolidation in Europe. Table 2 presents the fiscal impulses, i.e. the changes in the structural deficits, in certain selected countries. These changes represent the fiscal stance in each country and in Europe. A
negative sign indicates that the government is raising taxes or reducing public expenditures (in addition to any endogenous change coming from the cyclical aspect of the business cycle).

**Table 2: Fiscal impulses (% of GDP), selected countries**

<table>
<thead>
<tr>
<th>Countries</th>
<th>2010-2013</th>
<th>2014</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>DEU</td>
<td>-0.7</td>
<td>0.2</td>
<td>0.1</td>
</tr>
<tr>
<td>FRA</td>
<td>-4.6</td>
<td>-0.3</td>
<td>-0.3</td>
</tr>
<tr>
<td>ITA</td>
<td>-4.0</td>
<td>0.2</td>
<td>0.0</td>
</tr>
<tr>
<td>SPA</td>
<td>-9.1</td>
<td>-1.0</td>
<td>-0.4</td>
</tr>
<tr>
<td>NLD</td>
<td>-5.9</td>
<td>-0.9</td>
<td>-0.5</td>
</tr>
<tr>
<td>GRC</td>
<td>-19.3</td>
<td>-1.7</td>
<td>-1.9</td>
</tr>
<tr>
<td>POR</td>
<td>-11.4</td>
<td>-1.0</td>
<td>-0.5</td>
</tr>
<tr>
<td>FIN</td>
<td>+0.2</td>
<td>0.1</td>
<td>-0.4</td>
</tr>
<tr>
<td>EUZ</td>
<td>-4.3</td>
<td>-0.2</td>
<td>-0.1</td>
</tr>
</tbody>
</table>

*Source: iAGS 2015, from National Stability programmes.*

It can be seen that the fiscal stance in the euroarea was massively negative from 2010 to 2013, which is known to reduce economic activity heavily. The link between the fiscal impulse and economic activity is called the fiscal multiplier. Before the crisis, some economists argued that the fiscal multiplier was low (i.e. a reduction in the public deficit would have a small impact on economic activity). The consensus now is that this was a mistake and that the fiscal multipliers are high (slightly above 1). Fiscal consolidation is the major cause of the lack of economic activity in Europe. As the Annual Growth Survey (AGS) puts it, in 2015 Europe’s fiscal stance is roughly neutral. This is indeed the case, but this occurs after a long period of a negative fiscal stance, which will have long-lasting economic consequences. Moreover, this statement hides some heterogeneity between European countries. The fiscal stance is still negative in the southern countries but slightly positive in Germany.

One implication of the lack of economic activity is unemployment and rising poverty. These social costs can become an economic problem (in addition to an obvious social problem) when this erodes political support for the policies needed either to reduce nominal divergences or to stabilize public debt. The ECB has recently taken important decisions to help sustain economic activity. There is ongoing debate about how to evaluate the economic effect of the central bank’s purchase of public debt, but comparison with the US and UK case indicates that it is hard to believe that this alone will solve the demand problem in Europe.

### 2.3 High public debts

The third European problem is obviously the question of public debt and fiscal sustainability. As is explained in Part IV on the institutional aspect of European economic governance, debt sustainability is still the main focus of European procedures.

An analysis of the macroeconomic imbalances shows that 16 countries are experiencing "identified imbalances" (COM(2014) 904). The two pillars of fiscal monitoring are that the government deficit must be below 3% of GDP and the public debt below 60% of GDP. Note that after the Six Pack, there is also the debt reduction benchmark, meaning that countries no longer need to meet the 60% of GDP threshold, but rather the debt reduction benchmark after a transition period. Breaching these criteria opens an Excessive Deficit Procedure (EDP). Even with a loose understanding of this so-called fiscal discipline, 11 countries are still under an EDP.

Public debt increased by 34% in the EA15 between 2008 and 2014. If the goal of European governance was to limit the stock of public debt, one cannot claim success in Europe. Public debt is certainly an issue
in some countries and in Europe overall. The public debt issue is discussed further in Part IV below, along with debt sustainability. Some simple implications can be derived at this stage. As public debt is a stock that depends on an endogenous flow (the nominal deficit), the speed of any decrease in the public debt is not under the government’s control in the short term. A focus on the structural deficit, which takes into account the deviation from potential growth, is an obvious improvement. One should nevertheless recognize that the measure of potential growth is uncertain and may be affected by frequent revisions.

2.4 The need for European coordination

Low aggregate demand, nominal divergence and high public debt constitute the three European perils. Reducing public debt by raising taxes or lowering public spending generates a negative fiscal stance, which reduces aggregate demand. If the reduction of nominal divergence is realized by nominal wage cuts, this also contributes to reining in aggregate demand. Increasing aggregate demand can be done by using either wage policy (at the cost of nominal convergence) or fiscal space (at the cost of a higher public debt).

Moreover, two of the three European perils are general by nature. Nominal divergence is obviously a relative concept. It can arise either through surplus countries increasing their wages (in Germany for instance with the minimum wage) or through deficit countries decreasing their prices by supply-side reform (which is known to cut demand). Second, aggregate demand is a euro area concept due to trade spillovers. Countries with fiscal space (typically Germany) can contribute to sustaining European demand.

The three European perils are not mutually independent. For instance, Germany’s wage moderation after reunification generated a trade surplus and thus external demand. High external demand generates growth and a tax base that allows reducing the public debt. The reverse can also be true. High wage dynamics in the trade sector decreases exports and reduces economic activity and growth. This reduces both inflation and the tax base, which increases the public deficit and debt. This may be the case for France.

The policies for tackling each peril have different time horizons. Aggregate demand is a short-term issue. Nominal divergence and public debt can be solved only in the long term, say ten years. Trying to solve the public debt issue before dealing with aggregate demand can be counterproductive.

This note cannot discuss all the aspects of the current economic situation. Monetary policy and low investment have not been discussed. My view is that the ECB’s current expansionary monetary policy is necessary, but far from sufficient. Second, low investment is an outcome of nominal divergences (low returns on investment because of overvaluation in France, for instance) and of low aggregate demand. It is thus a consequence of the three European perils identified, and not a cause.

Some of these issues have been identified by the Commission and are now being discussed in the procedures to analyze macroeconomic imbalances (see below). Next, we discuss how to solve these problems. It is interesting to observe that the analytical note "Preparing for Next Steps on Better Economic Governance in the Euro Area" from Jean-Claude Juncker (Feb. 2015) identifies only two of the three perils indicated above. The lack of demand in Europe still seems to be a taboo.

3. WHAT SHOULD BE DONE: AN UTOPIA?

How can we solve these imbalances and foster growth? Before making some proposals about what could be done within the current treaty, it is useful to describe the optimal policy to solve these imbalances. This description may seem Utopian, but it is necessary to identify the institutions that are missing.

The first best is the following. Deficit countries with high unemployment rates and high price levels should invest to increase productivity and issue debt backed by growth-enhancing investment. This would
sustain demand in the short-run and help convergence by increasing labor productivity in countries with high unit labor costs. Second, wage increases should be favored in surplus countries and wage moderation in deficit countries. The central bank would help the adjustment by ensuring that real interest rates remain low and inflation at 2% to favor investment and to reduce the cost of public debt during the transition.

Any European proposition to implement these policies should consider two constraints: the political economy constraint and the legal constraint (the current treaty). The political economy constraint is itself twofold. First, the conditions needed to improve Europe growth may generate some redistributive effects across countries. Some countries may gain more than others during the convergence process – just as some will gain more than others if divergence continues. It is easy to identify winners and losers for alternative policies, but this is still a taboo in the European debate.

The second political economy issue concerns the credibility of some European governments with respect to taking such a path. For some countries, gains (investment) may come before costs (wage moderation), so it is obviously crucial to be sure that all policies will actually be implemented. The legal constraint is real but many things can be done under the current treaty. For instance, this optimal policy plan could be implemented through the coordination of national policies, without a European budget. A European budget may be necessary to solve certain political economy issues (internalization of the European interest, i.e. spillovers), not for economic reasons.

Before describing what can be done under the current treaty (and what mistakes can be avoided), the next section focuses on public debt sustainability. The following analysis proves that debt sustainability cannot be considered from a technical viewpoint by relying solely on public finances. Debt sustainability is a political concept for advanced countries. Analyzing the three European perils is the first step for an economic contribution to a sound political analysis.

4. DEBT SUSTAINABILITY

4.1 A narrow view of fiscal discipline

The Stability and Growth Pact defined an acceptable level of public debt: it is a ratio of public debt to GDP of below 60% (a nominal public deficit of below 3% of GDP). These rules are very hard to justify economically, and they have been significantly amended after the introduction of the Two Pack and the Six Pack and the recent change in the interpretation of fiscal discipline.

It should be clear that these thresholds do not define a sustainable public debt. A sustainable public debt is not a "low" public debt or a "decreasing" public debt. A sustainable debt is a debt for which there is no risk of default. In all advanced countries, default is a political choice, it is not an economic constraint.

To make this point clear, I first describe the standard analysis of debt sustainability and then summarize the research on sovereign default. The goal of this section is to make clear that one cannot discuss debt sustainability without considering the two other European perils. Analyzing the three economic problems together is the first step for a sound political analysis.

4.2 The standard approach to debt sustainability analysis

The analysis of debt sustainability is based on a simple accounting exercise for the accumulation of debt. The real interest of the analysis is that it is rigorously true, as it based on the State’s real budget constraints. The drawback of the analysis is that it is based on economic forecasts over very long horizons (growth, inflation, interest rates) for which the uncertainties are huge and over which the government has little control (see Wyplosz, 2013, fora critical view of standard debt sustainability analysis). An optimistic forecast over a five year horizon may serve merely to postpone the problem, as is shown by the case of the Greek economy, discussed below.
Debt sustainability is based on the simple equation (see ECB, 2012):

$$\Delta b_t = \frac{l_t - g_t}{1 + g_t} b_{t-1} - pb_t + dd_a_t$$

where $\Delta b_t$ is the change in the ratio of public debt over GDP. The first term on the right-hand side is the increase in debt, taking into account interest rate payments on debt, which depend on the real interest rate and the real growth rate of GDP. The second term $pb_t$ is the primary budget. The last term is the "deficit-debt adjustment". This last term summarizes all changes in the public debt that are not the result of the primary deficit, such as direct public financial support to financial institutions, as in Ireland, or receipts from privatizations, or the purchase of assets by the State.

This last term is not a minor adjustment in thinking about sustainability. The (gross) public debt can be high and sustainable if the State has high-value assets to sell. This is precisely the difference between gross debt (without taking the value of the public assets) and net debt (which is the gross debt minus the value of the public assets). As it is very difficult to value public capital, it may be relevant to consider gross debt, but we should not forget that we are then considering only part of the State's balance sheet.

This equation has been used to forecast public debt in various quantitative exercises. There exists a real danger in using this equation, which is to think that the terms are independent. For instance, a decrease in public spending to increase the primary budget balance (and reduce the public debt) contributes to slower growth (fiscal multiplier) and to reducing inflation (Phillips curve), which reduces the fiscal base and increases the relative interest payments on previous debt (see iAGS 2015 for a discussion).

The Greek case is a fascinating example of the kind of optimistic thinking that can be generated by a debt sustainability analysis based on this equation. For instance, the valuation of Greek financial assets by the IMF was 49 billion euros in 2010, which is 22% of Greek GDP. A year later the IMF valued these assets at 0! Such a change in valuation has a first-order impact on the assessment of debt sustainability. The Greek debt is claimed to be sustainable under three conditions (Zsolt and Huttl, 2014; Cline, 2014): an average growth rate of 2.5% for the period 2015-2020, a primary surplus of more than 4% for the same period and low real interest rates (see Cline 2014, Chap. 7). Under this optimistic baseline scenario, Greek public debt would be around 130% of GDP in 2020 (much lower than the current level, which is above 170% of GDP). Under a more pessimistic scenario (a smaller growth by 1%, a smaller primary surplus by 1% and a higher interest rate by 1%, which may be called realistic), the public debt will be around 153% of GDP in 2020 (Zsolt and Huttl, 2014). Are these levels sustainable? If not, then why not consider an even higher primary budget? The answer to this question is, at which point would the Greek state choose to default?

4.3 Default is a political choice

Debt sustainability is a loose concept. It implies the lack of default by a State on its public debt. But default is not easily grasped. In the narrow sense, default occurs when a debtor violates the legal terms of the debt contract. But, as Tomz and Wright (2013) write, in some cases lenders choose to "voluntarily" change the terms of the debt contract, which does not generate a default in the legal sense. The restructuring of Greek debt in 2012 and its Private Sector Involvement did not generate a default event.

This being said, sovereign default is a political choice in advanced countries. In the euro area, all countries can choose not to default in a broad or narrow sense if they want. In 2013, Buiten and Rahbari (2013) found that the primary surplus allowing stabilization of the Greek debt was 2.1% of GDP. This is not a very high number (it is half the surplus considered in the IMF simulations). Greek debt can be made sustainable, if it is accepted that Greece would live with a high level of debt for a very long time, thus violating the Stability and Growth Pact. The requested primary surplus can be made even smaller if one considers a one-for-all transfer from other countries.
The gains and costs of a default for advanced countries are discussed in a vast literature (Tomz, 2007; Wright and Tomz, 2013; Buitter and Rahabari, 2013, among others). It is worth noting that, studying 16 sovereign defaulters between 1820 and 1870, Tomz (2007) found that only Greece was able to borrow while in default. In addition, Tomz and Wright (2013) consider that the Greek "default" in 2012 is the largest sovereign default in their database (1820 to 2013). Among the many costs of default, exclusion from financial markets is often cited. Gelos, Sahay and Sandleris (2011) found that the average exclusion period is between 2.9 years and 4.7 years, which could be considered a small period of time.

Ultimately, a default by a European country would indicate the political failure of the European project: either a lack of the solidarity needed from other countries to consider a transfer or a debt restructuring, or a lack of support from domestic citizens to repay their debt, which would obviously create a forced tax imposed on creditors (who are other European citizens). Any economic decisions intended to ensure that the debt is sustainable must be made subject to the constraint of domestic political support. The Greek example is a spectacular failure in this dimension.

5. ENHANCING GROWTH AND MAKING EUROPE CONVERGE AGAIN

5.1 Changing the view of fiscal policy: The Spirit is still there

The Maastricht Treaty introduced a very narrow view of fiscal supervision. Public debt should be lower than 60% of GDP and nominal public deficit lower than 3%. Since then many improvements have been introduced, such as the Two Pack, the Six Pack and the Fiscal Compact. The recent Macroeconomic Imbalance Procedure (MIP) proposes a very complex but possibly comprehensive approach to macroeconomic imbalances. Although many additional layers have been introduced, the European approach is still biased toward identifying high public debt as the cause of many European problems and not as the consequence of poor crisis management. The examples of Spain and Ireland, where public debt was low before the crisis, are known to illustrate possible upsurges of public debt in a short period of time, independent of the government’s fiscal choices. In addition, the initial approach to fiscal discipline introduced an original sin: A country-by-country approach that lacked sound economic analysis of interdependencies.

5.2 Demand management in Europe

The main failure of Europe’s management of the crisis has been demand management, which is the main short-run issue. Poor demand management generates unemployment, the erosion of political support for the European project, and ultimately the possibility of sovereign default. While a focus on both public debt and unit labor costs is obviously legitimate, the uncoordinated country-by-country approach of the “Country Specific Recommendations” (CSR) produced a demand crunch.

The main lesson of the crisis is that fiscal policy should be used in the euro area to react to symmetric shocks. Monetary policy alone cannot absorb big symmetric shocks so as to ensure the stabilization of economic activity and thus of the inflation rate. This is how one may understand Mario Draghi’s speech in Jackson Hole in 2014.

This has numerous implications. First, the average output gap and its heterogeneity in Europe should be clearly set forth. The aggregate fiscal stance should be identified, and a consistent targeted fiscal stance in each country should be proposed to the Eurogroup (ECOFIN) by the Commission. A good publication for doing this is the Annual Growth Survey (AGS) if the content is more focused and precise. Currently, and as Bofinger (2014) notes, the report refers to vague indications such as "growth-friendly" fiscal consolidation, without describing what it really implies.

The recommendation on the implementation of CSR for euro area countries (COM(2014) 401 final) evokes “… the need for stronger coordination of fiscal, financial and structural policies among euro area
Member States to ensure a coherent policy stance for the euro area as a whole”. It is hard to disagree with this. The next step is to implement this by setting precise targets country by country. Although fiscal policy is decided at the national level, it is now the responsibility of the European Commission to present a common view and target for the aggregate fiscal stance.

The tradeoff that the AGS must resolve to determine the orientation of the aggregate fiscal stance is between aggregate demand management (taking into account multipliers) and the speed of public debt reduction.

This AGS report should start the European Semester. It should be discussed in the Eurogroup before any country-specific recommendation (CSR) is made. Moreover, any CSR should obviously be consistent with the AGS report, which is not always the case.

The European Parliament should be able to produce an assessment of the orientation of the AGS report, as it may affect the desirable use of the European budget. It may not be necessary to consider only the euro area Members in this statement, as the economic implications of the euro area’s fiscal stance would impact the entire European Union.

**Recommendation 1:** The AGS report should be used as a coordination device

Due to EU Regulation 473/2013, euro area Member States should have in place “independent bodies which produce or endorse national medium-term fiscal plans and draft budgets as well as their underpinning macroeconomic forecasts”. These bodies could coordinate their analysis to help produce a fiscal stance at the European level.

**Recommendation 2:** The independent fiscal bodies used to monitor national budgets should coordinate their analysis and provide a European assessment as an input to the AGS report.

**Recommendation 3:** Use all the flexibility of the Pact to sustain aggregate demand in the countries of the south. The public debt target of 60% of GDP should be considered a very long-run target.

### 5.3 European nominal divergence

The other main long-run issue concerns convergence in unit labor costs, which is only able to reduce current account imbalances within Europe, and thus the permanent borrowing of deficit countries. This will be a difficult task, as labor market institutions (and the process of wage formation) differ greatly across countries. A first step could be to create an independent council for social dialogue and competitiveness in each euro zone country so as to produce reports on the evolution of wage dynamics and competitiveness in the country. These councils would coordinate their analysis at the European level, and could produce inputs for the AGS report.

**Recommendation 3:** Create councils for social dialogue and competitiveness in euro area countries in order to inform the public debate and consider competitiveness with respect to wage formation (both in the tradable and non-tradable sectors).

A final remark on convergence: The European Commission should clearly indicate that Germany is an outlier in Europe. Wage moderation has made it so competitive that German exports are driving the euro exchange rate and it has become one of the world’s biggest exporters. The analysis of the first part of this paper indicates that German prices should increase by 20% to get back to equilibrium values. All other prices could of course also go down by 20%, but it is hard to understand how deflation could be prevented in this case.
**Recommendation 4:** Define a credible path for Germany to return to an equilibrium price level.

Finally, it is not clear whether low investment in Europe is the consequence of a lack of demand there. Nevertheless, the stimulation of investment in deficit countries would help both to stimulate economic activity and to boost labor productivity. An implementation at a much bigger scale of the Juncker plan, with a bias in the investment decision toward growth-enhancing investment in the southern countries, would be welcome. These investments could be financed by the issuance of bonds, backed either by national budgets, when possible, or by the European budget.

**Recommendation 5:** Implement an investment program in the southern European countries that is much bigger than the initial Juncker Plan. Investment could be financed by European project bonds.

The lack of investment in Europe is of course difficult to assess. The European Investment Bank computes that the current investment level in the EU is 230 to 370 billion Euros the historical norm for two or three years. This corresponds to a cumulative investment deficit probably around 700 billions euros to provide a low estimate. This amount is much larger than the one considered by the Juncker Plan, which is 315 billions Euros. Moreover, the Juncker Plan assumes a very high leverage, which is difficult to consider realistic without substitution effects. The financing of such investment could be done by the issuance of debt by national countries, but those debt would not be consolidated in the total debt computation in the Stability and Growth Pact. Indeed, this debt would be backed by some asset and some future economic activity (and hence some future tax revenue). Of course, the assessment of the socio-economic returns of those investments should be carefully done. Another possibility to finance those investments is to use the future seignorage rents of the ECB, in the Spirit of Paris and Wyplosz (2014). In this case, the bonds could be European bonds. The profits of the ECB could be used to pay interest on the bonds issued to finance these investments. Indeed, under realistic assumptions, the present value of seignorage is well above 1000 billions Euros.
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