

Two, six or more?

# **What fiscal discipline/coordination in Europe**

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## Economic governance : change in the good direction, but too slowly

### ■ From dogmatic rules to economic analysis

- Stability and growth pact (1998,1999): yearly constraint. Too dogmatic: Free market insures growth and stability.
- 2005 Reform of preventive and corrective arm : Medium Term Objective
- 2011 Reform : More ex ante coordination, better assessment of Macroeconomic Imbalances (MIP).
- Definition of a scoreboard to detect Macroeconomic imbalances. Some problems (Asset prices are missing, two asymmetric - 4% vs + 6%, still procyclical), but...

### ■ ...now the rules can be flexible or rigid according to the interpretation.

Flexible rules are a substitute for economic policy, who is deciding with what mandate?

- **Cosly institutional learning** . Cost in terms of credibility; Economic, social cost (Fiscal consolidation too fast in the South); Political cost: The European support is eroding . **We must anticipate**

## Two challenges and two risks

The two challenges

1. **Lack of demand, lack of investment:** 10 years process to reduce public debt in an heterogenous Europe.
2. **Supply problem Internal imbalances**

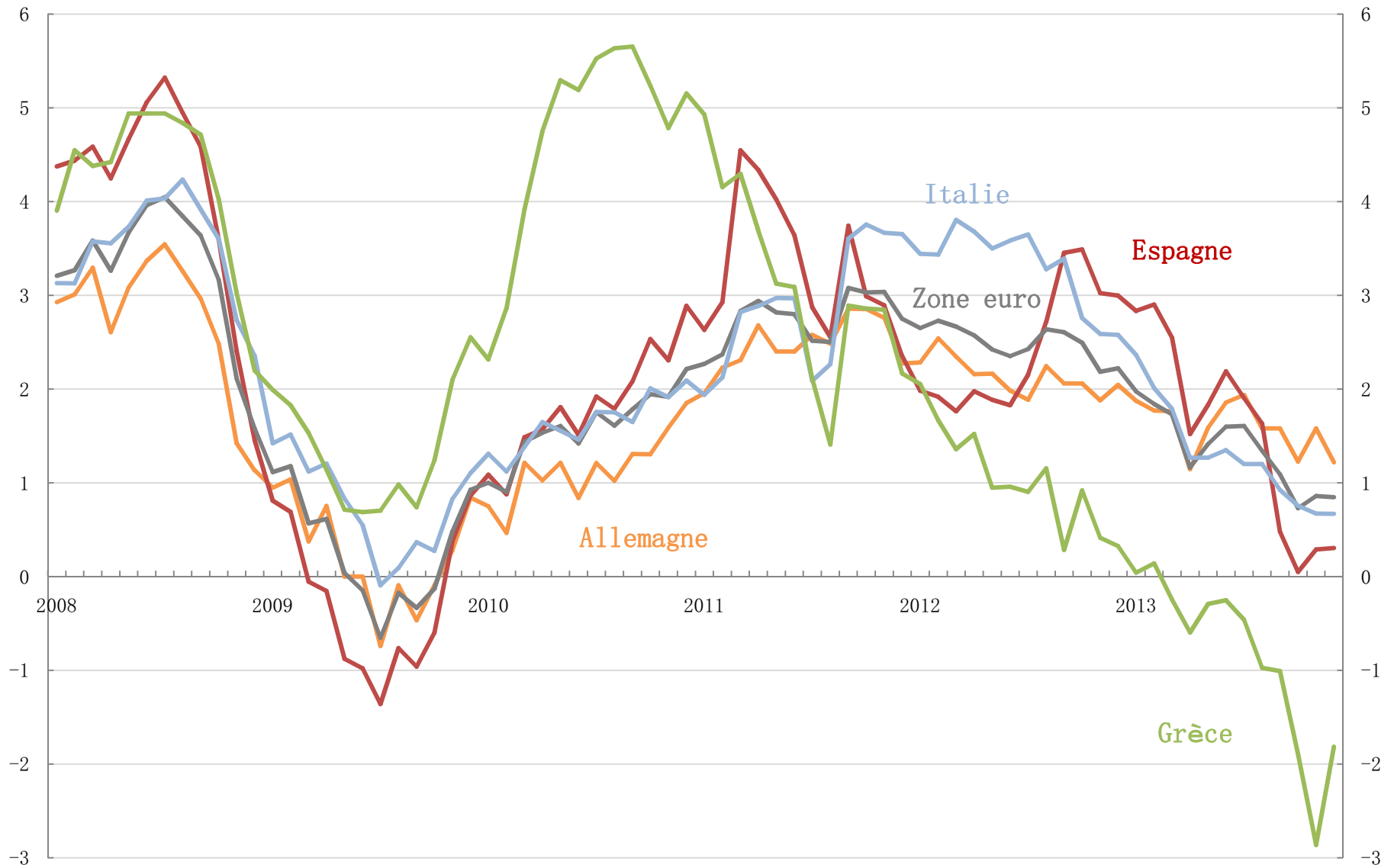
If these challenges are not managed:

1. The **deflation risk**, debt overhang/debt deflation
2. Lost decade

Even worse

# The Demand problem. Inflation

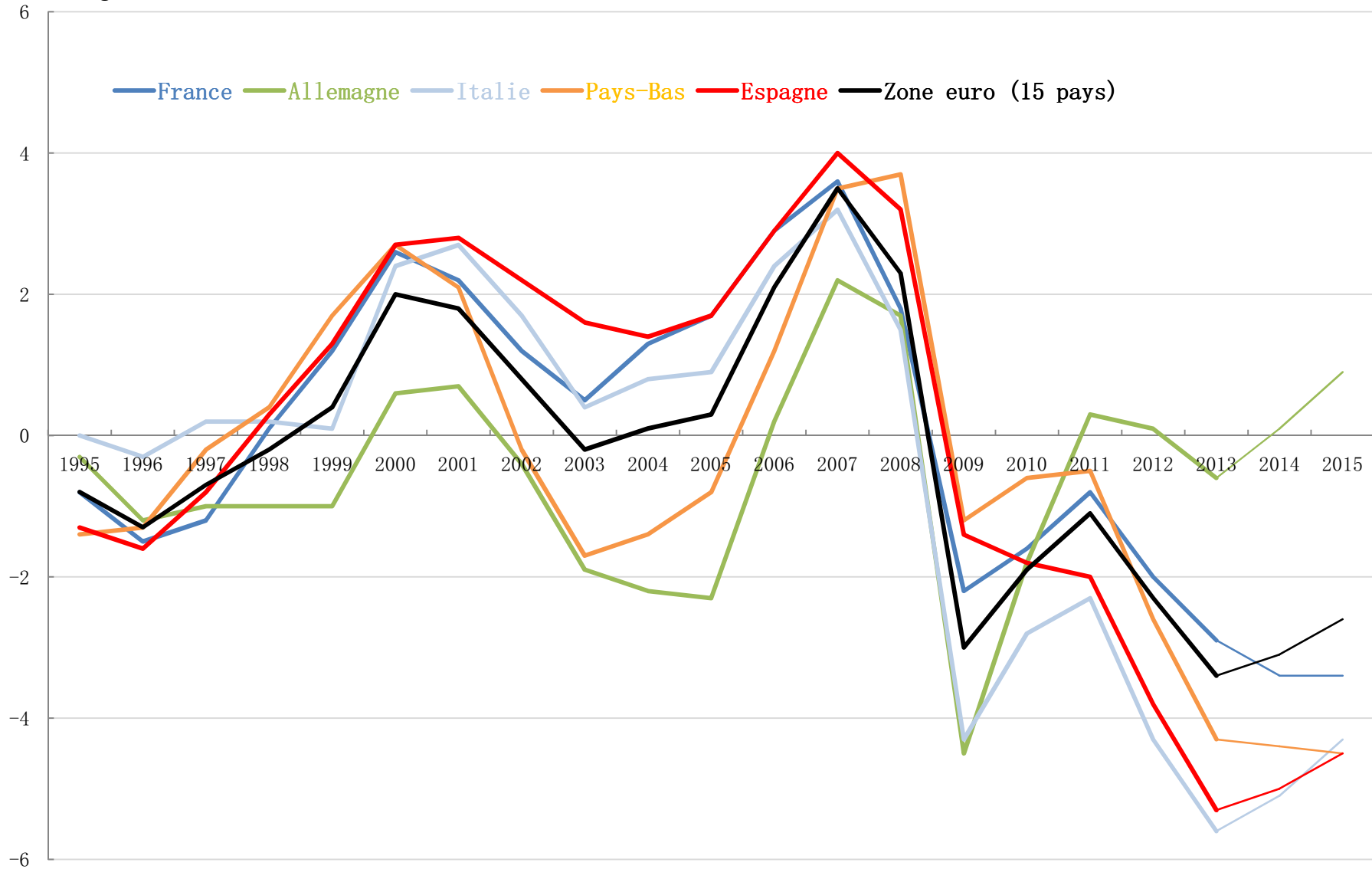
En glissement annuel, en %



Source : Eurostat

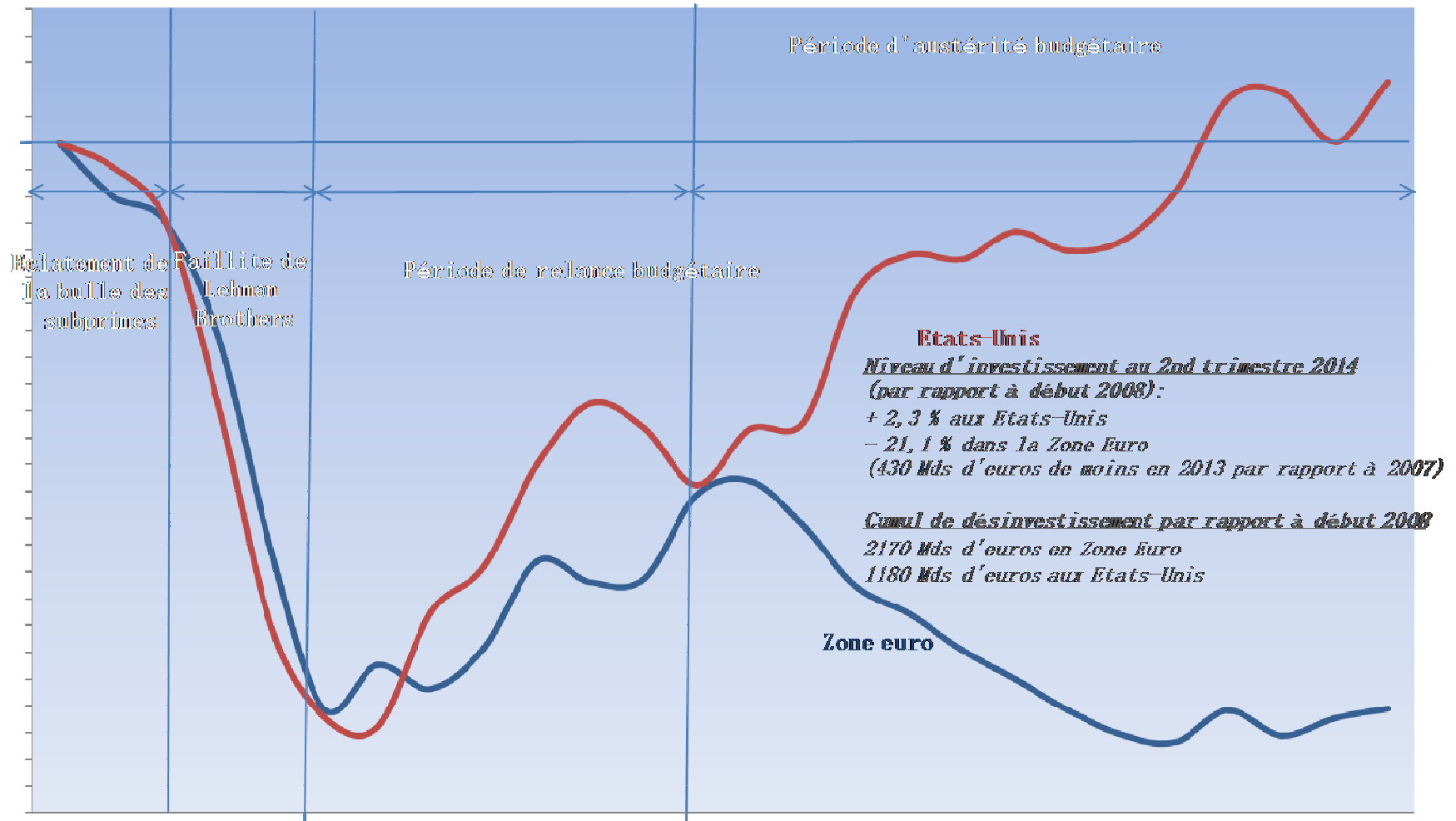
# The Demand Problem. Output gap en zone euro

Percentage of GDP



Source : OCDE

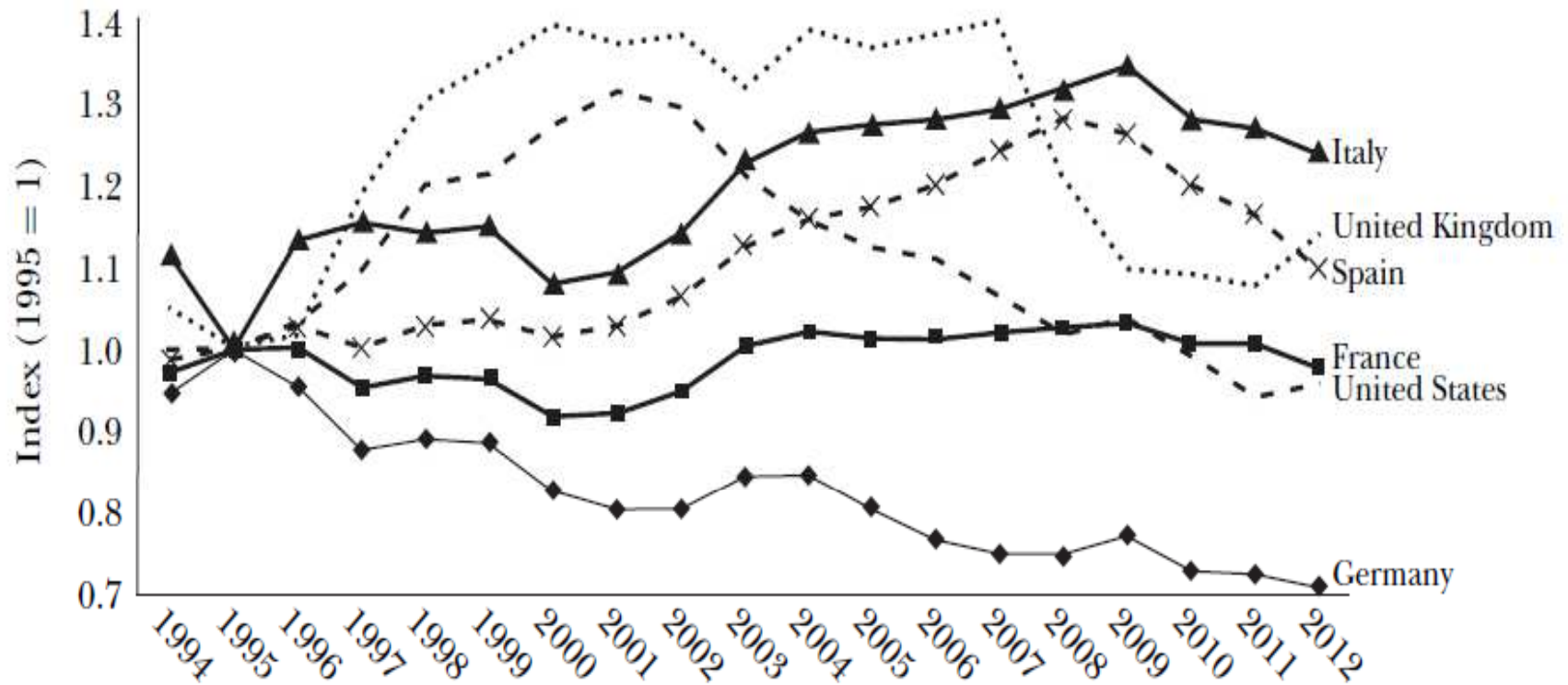
# Investment in the US and Euro area (2008= 100)



## The Supply Problem : Internal Nominal divergence

- Price level has diverged in European countries, 20 years
- Germany is an outlier : underevaluated by 20%
- How to correct such a price mis-alignment (never observed in monetary zone)
- Slow moving process

# Weighted Unit Labor Cost



Source : Dustmann, Fitzenberger, Schönberg, et Spitz-Oener (2014)



## Necessary adjustments... The internal devaluation

Horizon	10 years	20 years	50 years	Infinite
<b>Austria</b>	+14.2%	+14.9%	+15.3%	+15.5%
<b>Belgium</b>	-16.9%	-16.1%	-15.6%	-15.3%
<b>Finland</b>	-15.5%	-14.3%	-13.7%	-13.3%
<b>France</b>	-4.3%	-4.5%	-4.7%	-4.7%
<b>Germany</b>	+21.8%	+21.8%	+21.8%	+21.8%
<b>Greece</b>	-43.7%	-13.7%	+4.3%	+14.8%
<b>Ireland</b>	-0.8%	+5.6%	+9.4%	+11.4%
<b>Italy</b>	+5.7%	+5.8%	+5.8%	+5.9%
<b>Netherlands</b>	+19.1%	+19.5%	+19.7%	+19.8%
<b>Portugal</b>	-17.4%	-3.2%	+5.3%	+10.1%
<b>Spain</b>	-5.4%	+2.9%	+7.9%	+10.6%

Source: iAGS, preliminary

## Wage cuts are not the solution : Deflation risk

- **Induce nominal adjustment (higher nominal growth in Germany, Austria, Netherlands slower in France, Spain, etc.)**

European Union had no competence concerning wage policy but there have been a long debate at the EU level to introduce minimum wage norms. Besides, in the MIP recommendations can also concern wages

- **Investment Demand/Supply side policies to avoid deflation and to preserve potential growth:**

- Extend the Juncker plan. Much too small.
- Exclude public investment from debt assessment (proposition of Juncker for the European Fund for Strategic Investment)
- Coordinated slow fiscal consolidation (Debt target is out of reach)

- **Time for European green public investment (iAGS report)**