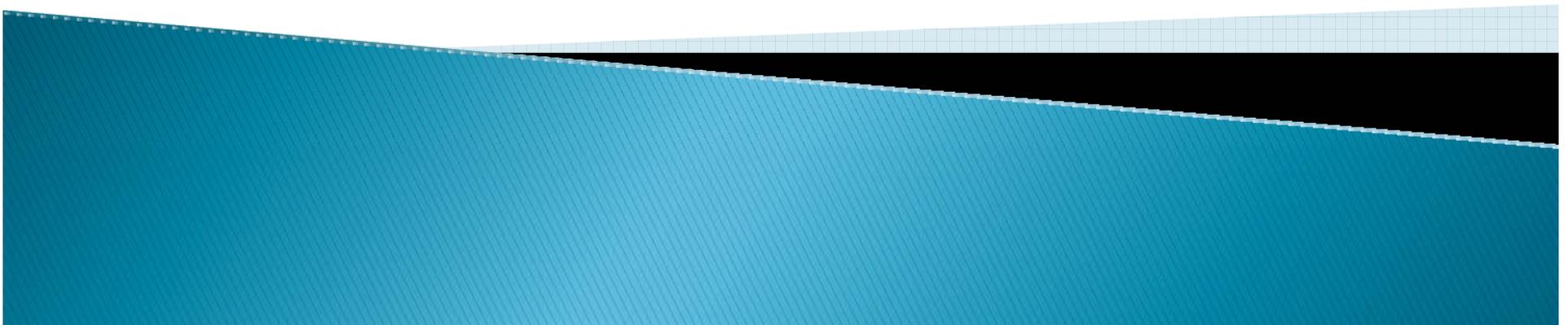


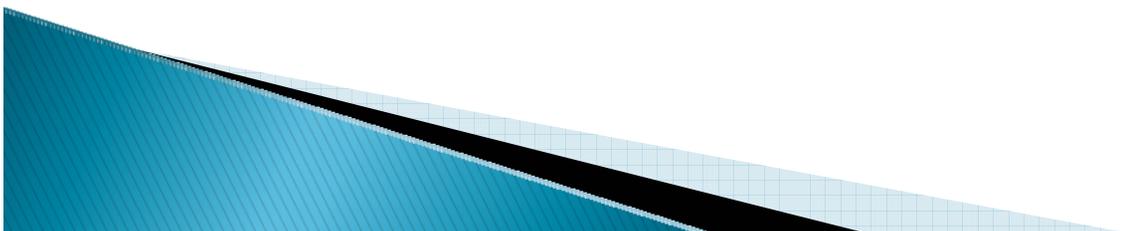
The European Fiscal Crisis

Alberto Alesina
Philadelphia FED Policy Forum
December 2 2011



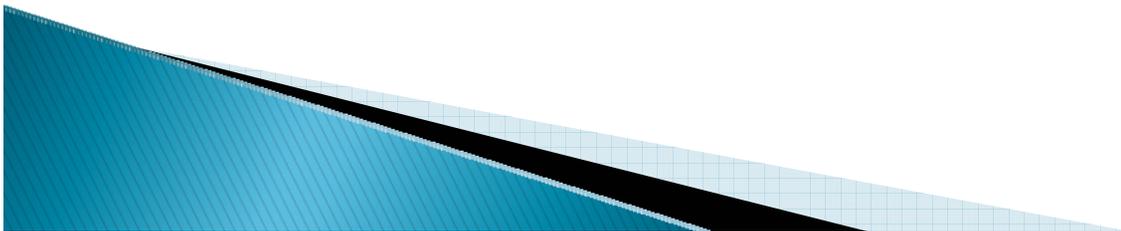
Original sins

- ▶ Low interest rates with Euro; elimination of currency risk
- ▶ Borrowing binge in the periphery.
- ▶ Spain Portugal Greece Ireland with CA deficit Italy without them but Italy with an already large stock of debt
- ▶ ECB non differentiating between debts of different countries
- ▶ Market asleep and waking up too suddenly



Consequence

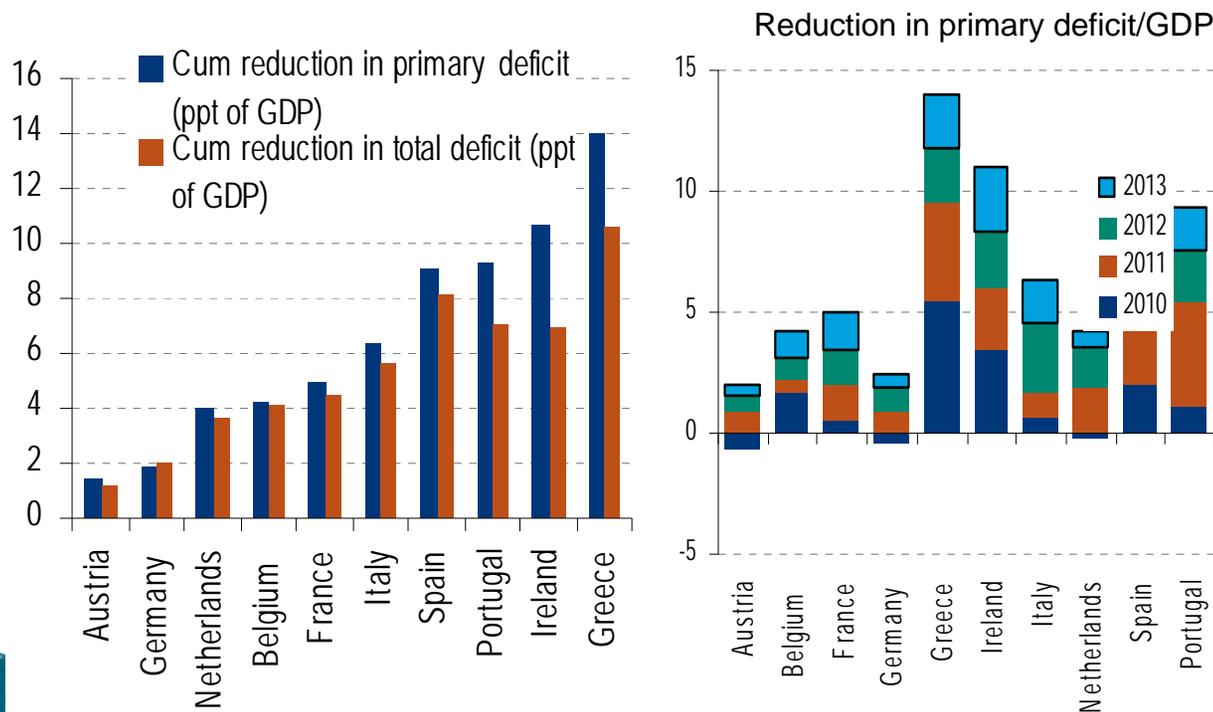
- ▶ Need of sharp fiscal tightening very soon after the Great Recession
- ▶ Between a rock and a hard place: need of austerity and growth



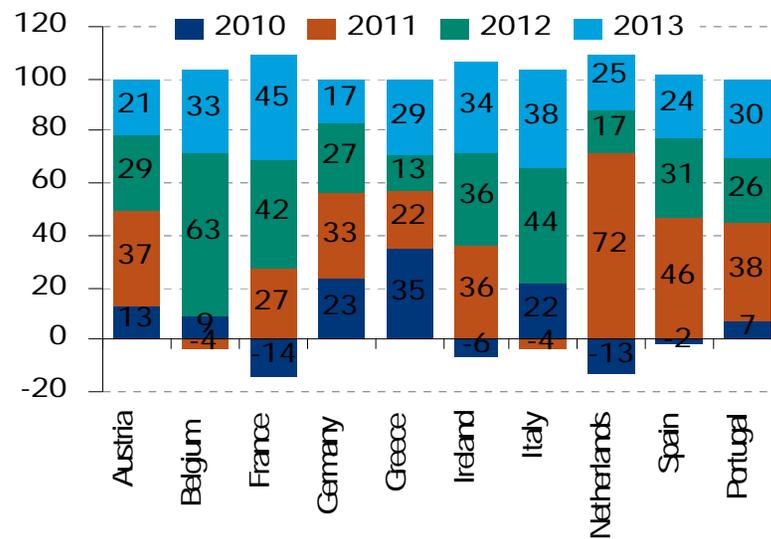
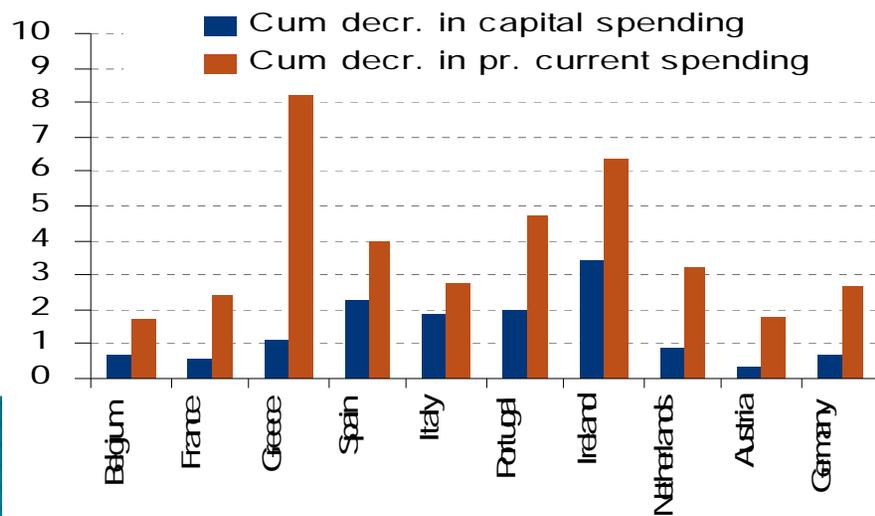
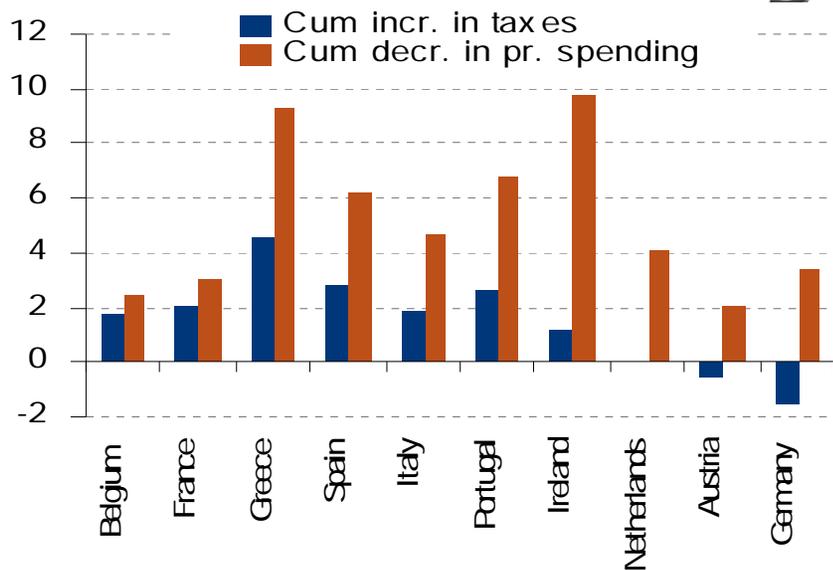
Size of fiscal tightening

Decrease in primary deficit/GDP 2010-2013 (ppt of GDP)

	Austria	Belgium	France	Germany	Greece	Ireland	Italy	Netherlands	Spain	Portugal
2010	-0.65	1.63	0.56	-0.49	5.41	3.40	0.63	-0.22	2.02	1.07
2011	0.85	0.57	1.44	0.89	4.14	2.60	1.09	1.92	3.53	4.43
2012	0.70	0.90	1.40	1.00	2.20	2.30	2.82	1.60	1.90	2.10
2013	0.50	1.10	1.60	0.50	2.20	2.70	1.78	0.70	1.60	1.70



Composition of fiscal tightening



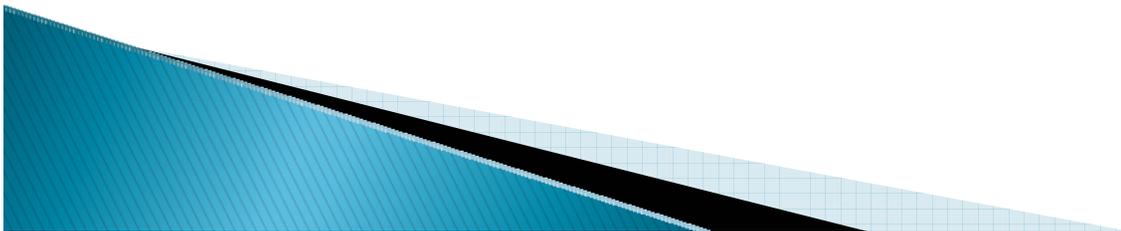
Fiscal plans

Total government balance/GDP

	Austria	Belgium	France	Germany	Greece	Ireland	Italy	Netherlands	Spain	Portugal
2009	-4.1	-5.9	-7.5	-3	-15.4	-14.3	-5.4	-5.5	-11.1	-10.1
2010	-4.6	-4.1	-7	-3.3	-10.5	-32.4	-4.6	-5.4	-9.2	-9.1
2011	-3.90	-3.60	-5.70	-2.50	-7.60	-10.00	-3.75	-3.74	-6.00	-5.90
2012	-3.30	-2.80	-4.60	-1.50	-6.60	-8.60	-1.27	-2.20	-4.40	-4.40
2013	-2.90	-1.80	-3.00	-1.00	-4.80	-7.30	0.24	-1.80	-3.00	-3.00
2014	-2.40	-0.80	-2.00	-0.50	-2.60	-4.70	0.54	-1.40	-2.10	-2.40

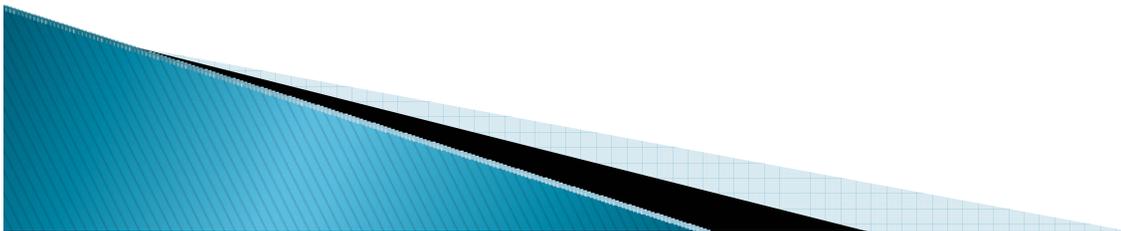
Case studies of large fiscal adjustments

- ▶ Lively revival of a literature started by Giavazzi and Pagano and Alesina and Perotti in the early nineties about the possibility of expansionary fiscal adjustments.
- ▶ Recent papers by Weo, (2010) Alesina Ardagna,(2010) Perotti (2011), IMF volume (2011)



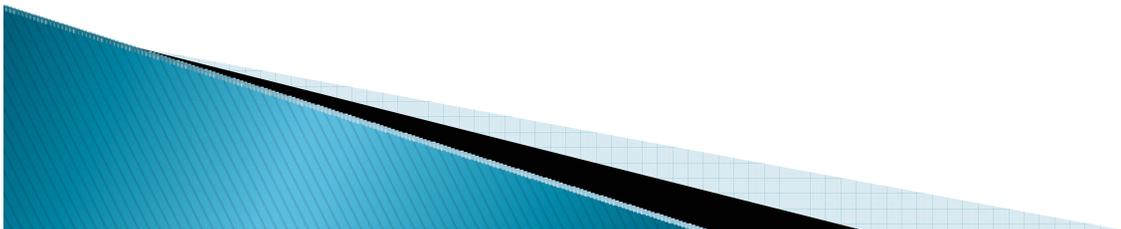
What are the issues?

- ▶ Are spending based adjustments less contractionary in the short run than tax based adjustments?
- ▶ Some fiscal adjustments have been expansionary even on impact. Why? What is the channel?



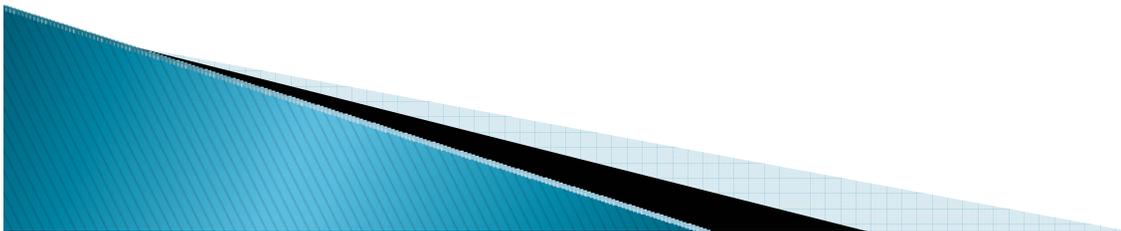
My take

- ▶ Spending based adjustments in OECD economies with close to 50 per cent of G/Y are preferable and very likely to be less costly than tax based ones (This may not hold for developing countries)
- ▶ A large fiscal consolidation accompanied by appropriate policies (wage moderation, friendly monetary policy, stabilizing inflationary expectations) can be much less costly than we normally think not only in the medium run but also in the short run



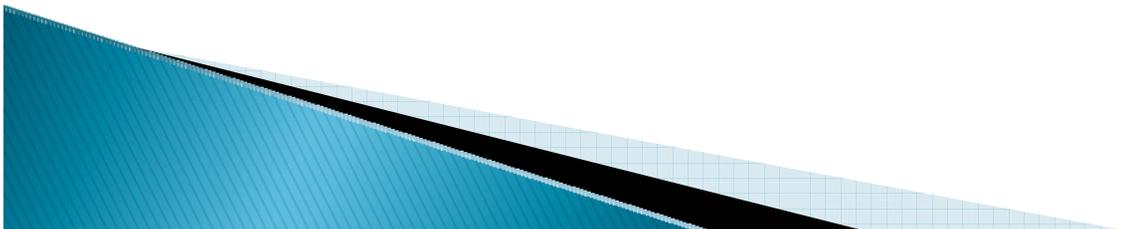
Growth and austerity

- ▶ Many countries and especially Italy needs more growth rather than more austerity.
- ▶ Supply side reforms, politics?
- ▶ Italy is about to announce on Monday a major reform package. It could imply a sharp drop of spreads if political consensus on though and progrowth measures are reached



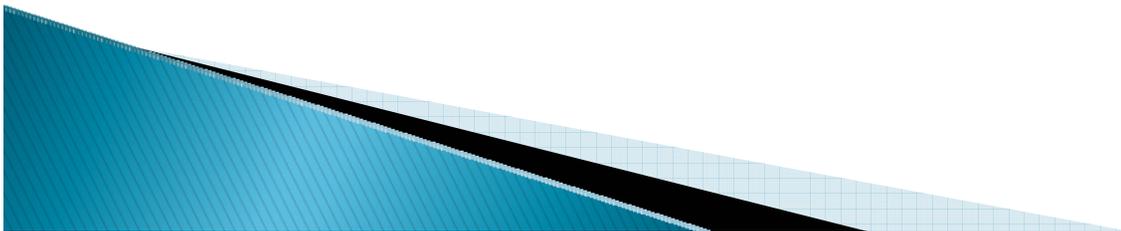
Italy: the issues

- ▶ Deficit is close to zero (and needs to be kept there) the key issue is to spur growth to work on the denominator of the DEBT/GDP ratios
- ▶ Key reforms issues: pensions, labor market, tax systems, competition and liberalization. burocratic costs of doing business.
- ▶ Can credible announcements have immediate effects?



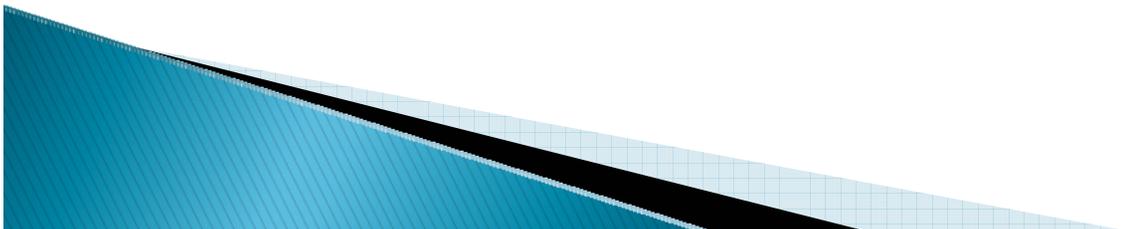
Systemic problem

- ▶ We are in a “bad equilibrium”: markets expect default
- ▶ They require high rates
- ▶ They make default more likely



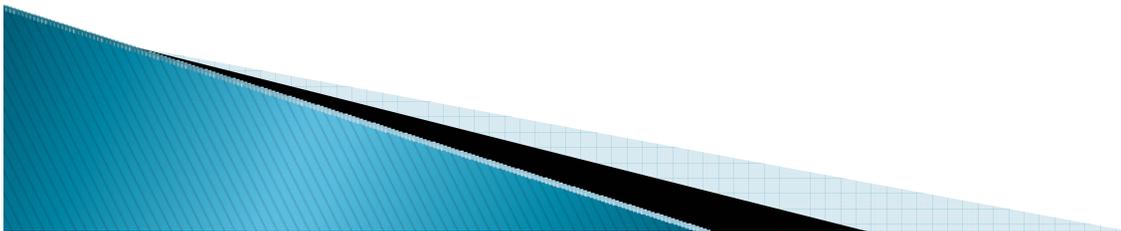
Why did we get here?

- ▶ Comedy of errors starting with the Greek crisis.
- ▶ Confusion about political feasibility of sharing fiscal burdens
- ▶ Confusion about willingness to delegate fiscal policy to EU institutions.
- ▶ Arrogance and denial. “We can do it without the IMF!” (It lasted two weeks !)



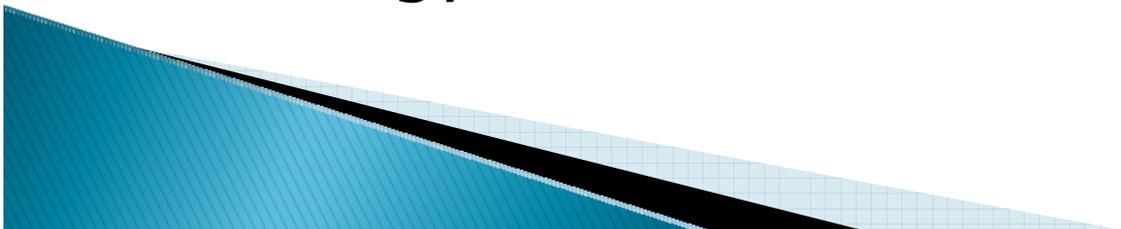
What to do now?

- ▶ The time for financial engineering is over
- ▶ ESFS is not enough to save Italy.
- ▶ Eurobonds are not enough (flow versus stock) and in any case opposed by Germany



What to do now?

- ▶ ECB announces buy out scheme
- ▶ Review Treaties in order to allow delegation of some aspects of fiscal policy and delegate more to EU. Or: bilateral agreements (faster)
- ▶ Or no delegation to EU but bilateral agreements between national governments bypassing EU institutions (the France preferred solution)
- ▶ Domestic balanced budget rules in domestic laws or constitutions
- ▶ Analogy with US states and US federal debt



Can the Euro be saved?

- ▶ Yes it can
- ▶ But they are doing everything they can to make it as bad a possible.
- ▶ Dec 8 meeting is crucial, we said this before but this time it is REALLY crucial.
- ▶ Some sign of progress. Moderate optimism.

