The European Fiscal Crisis

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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)

<table>
<thead>
<tr>
<th>Year</th>
<th>Austria</th>
<th>Belgium</th>
<th>France</th>
<th>Germany</th>
<th>Greece</th>
<th>Ireland</th>
<th>Italy</th>
<th>Netherlands</th>
<th>Spain</th>
<th>Portugal</th>
</tr>
</thead>
<tbody>
<tr>
<td>2010</td>
<td>-0.65</td>
<td>1.63</td>
<td>0.56</td>
<td>-0.49</td>
<td>5.41</td>
<td>3.40</td>
<td>0.63</td>
<td>-0.22</td>
<td>2.02</td>
<td>1.07</td>
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<tr>
<td>2011</td>
<td>0.85</td>
<td>0.57</td>
<td>1.44</td>
<td>0.89</td>
<td>4.14</td>
<td>2.60</td>
<td>1.09</td>
<td>1.92</td>
<td>3.53</td>
<td>4.43</td>
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<tr>
<td>2012</td>
<td>0.70</td>
<td>0.90</td>
<td>1.40</td>
<td>1.00</td>
<td>2.20</td>
<td>2.30</td>
<td>2.82</td>
<td>1.60</td>
<td>1.90</td>
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<tr>
<td>2013</td>
<td>0.50</td>
<td>1.10</td>
<td>1.60</td>
<td>0.50</td>
<td>2.20</td>
<td>2.70</td>
<td>1.78</td>
<td>0.70</td>
<td>1.60</td>
<td>1.70</td>
</tr>
</tbody>
</table>
Composition of fiscal tightening

Source: IMF, European Commission, BofA Merrill Lynch Global Research
# Fiscal plans

## Total government balance/GDP

<table>
<thead>
<tr>
<th>Year</th>
<th>Austria</th>
<th>Belgium</th>
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<th>Greece</th>
<th>Ireland</th>
<th>Italy</th>
<th>Netherlands</th>
<th>Spain</th>
<th>Portugal</th>
</tr>
</thead>
<tbody>
<tr>
<td>2009</td>
<td>-4.1</td>
<td>-5.9</td>
<td>-7.5</td>
<td>-3</td>
<td>-15.4</td>
<td>-14.3</td>
<td>-5.4</td>
<td>-11.1</td>
<td>-10.1</td>
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<tr>
<td>2010</td>
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<td>-4.1</td>
<td>-7</td>
<td>-3.3</td>
<td>-10.5</td>
<td>-32.4</td>
<td>-4.6</td>
<td>-5.4</td>
<td>-9.2</td>
<td>-9.1</td>
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<tr>
<td>2011</td>
<td>-3.90</td>
<td>-3.60</td>
<td>-5.70</td>
<td>-2.50</td>
<td>-7.60</td>
<td>-10.00</td>
<td>-3.75</td>
<td>-3.74</td>
<td>-6.00</td>
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<td>-4.60</td>
<td>-1.50</td>
<td>-6.60</td>
<td>-8.60</td>
<td>-1.27</td>
<td>-2.20</td>
<td>-4.40</td>
<td></td>
</tr>
<tr>
<td>2013</td>
<td>-2.90</td>
<td>-1.80</td>
<td>-3.00</td>
<td>-1.00</td>
<td>-4.80</td>
<td>-7.30</td>
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<tr>
<td>2014</td>
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<td>-2.00</td>
<td>-0.50</td>
<td>-2.60</td>
<td>-4.70</td>
<td>0.54</td>
<td>-1.40</td>
<td>-2.10</td>
<td>-2.40</td>
</tr>
</tbody>
</table>

Source: IMF, European Commission, BofA Merrill Lynch Global Research
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.

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 pro-growth measures are reached
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. Bureaucratic costs of doing business.

Can credible announcements have immediate effects?
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 as possible.
- Dec 8 meeting is crucial, we said this before but this time it is REALLY crucial.
- Some sign of progress. Moderate optimism.