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Discussion Paper

The European Economy and the prospects for enhanced macroeconomic coordination

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Inflation has been elevated in 2021-22 in Europe and elsewhere, driven by higher energy and food prices, from exogenous influences, but also driven more by mark ups on profits, than by wage adjustments. However, the balance of risks remains relatively even in the short-term. The expected recession may be avoided. Inflation is more resilient than expected of course, but it may return to 2% by 2025 according to forecasts from the ECB. But still, output growth is surrounded by uncertainties linked with geopolitics, the evolution of the Ukrainian conflict, the possible impact of the Chinese recovery, especially on the prices of energy and raw materials and so on.

The short term issues and outlook

The financial tensions we have witnessed, following the failure of two US Banks, Silicon Valley and the Signature banks, and the troubles and eventual demise of with Credit Suisse, have raised the spectre of a new financial crisis in the future, which may affect household and business confidence, and their financial conditions.

It is worth noting that so far, European banks have been relatively preserved from market turbulence. A stronger regulatory framework than in the United States, and the strict application of Basel 3, after the global financial crisis of 2008-09, played a role in the relative resilience of the European banking sector. More than 400 European banks are subject to supervision by the Single Supervisory Mechanism in the ECB, compared to only 15 banks in the United States, since the so called Tailor act, of 2019. The Tailor Act is a set of regulations for domestic and foreign banks, for matching their risk profiles more closely. However, the rules reduce compliance requirements for firms with less risk, while maintaining the most stringent requirements for the largest and most complex banks.

Besides, the ECB's decision of 16 March, to maintain the course of monetary policy normalisation, and thus raise its interest rates by 50 basis points, despite the heavy pressure from the market, worked as a signal of confidence and finally helped stabilise bank stocks and sovereign debt yields as well.

Looking back to the start of this inflation bout, the ECB's and also the Federal Reserve's late reactions to the inflation shocks may now appear surprising. First of all, there was a sort of misdiagnosis of the nature of the shocks, which were perceived in the beginning as purely exogenous and transitory. Until December 2021 the ECB expected inflation to return to around 2% by the end of 2022. While core inflation had been rising since the summer of 2021, the ECB waited until July 2022, to raise interest rates, which was a one year delay.

But the delay was consequential. Given the relatively long lags in the monetary policy transmission channels, estimated to between 12 and 18 months, the normalisation process had to be more violent and faster than if it had started earlier as we discussed. This is now exposing fragilities in a financial industry that has become accustomed to more than ten years of quasi free liquidity. As a result, the financial sector has now accelerated the transmission channels of monetary policy, certainly on the yield curve and also on the supply of credit, beyond what the persistence of the negative real rate would suggest.

Regarding aggregate fiscal policy in the Euro area, it remains broadly expansionary, unlike in the United States. So, while the monetary-fiscal policy mix is convergent and coherent in the United States, it is less so in the Euro area, where we have these large responses of member states to the triple shock of Covid, the Ukraine war and inflation. That of course illustrates once again the coordination flaws in the Euro area, and the failures of governments to define a fiscal stance in the face of the ECB's monetary stance.

Note also, the ECB's controversial decision, once again, that on the very day that it first raised rates in July 2022, it also set up the Transmission Protection Instrument. This is in reality an anti-fragmentation instrument, designed to limit spreads between sovereign rates by purchasing the bonds of governments under financial distress even when the overall monetary stance is restrictive.

Long term challenges

Beyond these short term issues, Europe in general and the Eurozone in particular, are clearly facing several long-term structural challenges. I will discuss a few of these.

The first is the gradual decline of potential growth, which is linked to both demographics and falling productivity gains. If you look at the real potential growth in the EU, it has slowed steadily from 2.4% per year in the 1990s to around 2% in the 2000s, and even to around 1% between 2010 and 2022. This is a steady and gradual fall.

This is very worrying when considering that public debt to GDP ratios, have at the same time risen sharply, particularly since the global financial crisis of 2008-09. In many countries debt ratios exceed the 100% mark, and the average debt ratio in the Eurozone was 95% in 2021 from 65% in 2008.

The interest-rate-growth differential as a way of understanding long-run fiscal sustainability, which has been popularised by Olivier Blanchard, is used by some of the people in economics. Lower interest rates in comparison with economic growth, will tend to lower the debt-to-GDP ratio. Lower interest rates since the global financial crisis have allowed member states to sustain rising debt levels. But this trend is likely to reverse in the coming years and inevitably, governments will then have to reduce their primary deficits.

Then, on top of all this, we would have to finance massive investments for the ecological and energy transitions. This process will also involve a social safety net. So, the favourable period of low interest rates and high GDP growth, is probably over.

A second challenge, which is also linked with the previous one, is Europe's relative decline in the global economy. Since the early 1990s, real GDP in the Euro area was growing at a much slower pace than in the US. In the period since to the present, real GDP more than doubled in the US and has grown by slightly more than 50% in the Euro area. That points to a growth gap of around one percentage point per year. If this gap were to persist until say 2060, Europe’s GDP would grow by half, compared to the US not to mention China.

Evolution of real GDP

	US	EA	EU	G7	EMDE	World
1994	100	100	100	100	100	100
2008	151	136	141	138	212	173
2022	193	153	165	164	389	266

Source: IMF World Economic Outlook, April 2023

One could also mention the gaps in some other fields, like the share of research expenditure in GDP, or the leadership of American and Asian companies in the global stage. It remains to be seen if Europe will be able to reverse these trends.

Third reason for concern is the convergence dynamic which has reversed totally since the global financial crisis of 2008, and since the eurozone crisis of 2010-12. This has effectively aggravated the heterogeneity of the eurozone and makes the management of the common fiscal framework more problematic, of course.

This seems to validate to some extent, the disease of the economy, according to Paul Krugman, who argued the idea that the European monetary union, instead of evolving towards a kind of optimal monetary zone over time, would actually favour the polarisation of productive activities towards the areas or countries, best endowed with physical and human capital. The economies of the South have lost most of the ground they had gained before 2010. Even the major economies are dramatically diverging.

Per capita income

There is great diversity in per capita incomes across member states, including between large states. If you look at the per capita GDP between 2009 and 2022, for instance, it lagged by 15% and 20% respectively, in France and in Italy vis-a-vis Germany. So, this means that you have also an increasing divergence, not only in the periphery of the Eurozone, but even in the centre and the core of Europe.

And, of course, the dynamic of public debts seems inversely correlated to the growth rate, which is another issue. This is not a perfect correlation because of the complexity of economic relationships, but there is a strong linkage. For example, of the six countries with the lowest average growth rates in the period 2009-22, five had the highest ratios of debt to GDP in 2021.

Economic coordination and the policy mix

So now, I will briefly address economic coordination and the policy mix in the euro area, because I think it raises a lot of interesting issues.

I think no one disputes the usefulness of having an EMU fiscal framework. This has been suspended in 2020 in the wake of the Covid pandemic, to avoid first, negative externalities between member states, and second, to encourage governments to maintain adequate counter-cyclical fiscal policies, and finally to guarantee the sustainability of sovereign debt. The suspension of the fiscal framework will end on 1 January 2024. The question then arises, what fiscal framework should be formulated to take its place.

Let's recall that the Maastricht treaty was conditioned on the absence of political union of course and excluded budgetary transfers between states. It was also founded on the basis of an independent single monetary policy, that precluded, the so called monetary financing of public debts. Last but not least, the Maastricht treaty, presupposed an implicit code of good conduct that excluded free riding behaviour.

Under these conditions, it was deemed that a minimal and essentially prudential fiscal framework could be adequate. But the fact is, the said framework, has clearly failed. Its rules most often were not being respected. The relevance of a uniform threshold of debt to GDP ratio of 60%, has been questioned, not only by some member states, but also by economists and public opinion.

The basic principles of the Treaty such as the no bailout clause, the prohibition of monetary financing, and so forth, had to be circumvented to some extent during crisis times.

Macroeconomic surveillance by the European Commission, didn't perform its prevention role. As a result, the safety net put in place by the ECB, to effectively compensate for coordination

failures between member states, may have favoured a kind of moral hazard, not conducive to the respect of collective discipline.

Finally, the growing heterogeneity of the euro area after 2010, which I already mentioned above, has certainly given rise to centrifugal forces, hampering the management of the common fiscal framework.

Fiscal reform

How can this system be reformed? In a communication dated November 2022, the Commission has proposed to make the fiscal framework simpler, more transparent, and more flexible in order to encourage the return of fiscal ownership to the member states. The idea is, according to these proposals, that the member states would set government spending targets compatible with maintaining or returning debt to a sustainable path.

The proposal entails uncertainties and ambiguities which need to be discussed. In particular concerning the horizon of the adjustment toward debt sustainability, we don't know exactly if it will be four, five or may be even seven years, provided governments set credible programmes of reform.

Another thing is that the 3% budget deficit target, and the 60% debt to GDP ratio benchmark, remain the same, but their role in the new fiscal framework has not really been specified. And finally, we may get the feeling that the Commission have kept these benchmarks in, for political reasons, especially vis-a-vis some member states in the North, including Germany.

And there is also, the issue of what the operational variable in this framework, will be and how it will be applied. The operational variable of course, which will be crucial in the new mechanism, as proposed by the Commission, will be the primary expenditure. The definition of this operational variable excludes benefits, which are, by nature cyclical. And it excludes also net taxes, which, again, exposes the system to reasonable accounting manipulation.

Certainly, the current fiscal framework needs to be reformed. It's very difficult to contest that. But the Commission's proposal for a new fiscal framework, makes it even more complex, and less comprehensive than the current one, leading to a kind of re-nationalisation of the framework altogether. Above all, the Commission proposals avoid the fundamental issue of the dys-functioning of the economic branch of EMU. And I remember Jacques Delors, the former President of the European Commission, who said that the economic branch of EMU was its Achilles Heel, and I think he was right. Jacque Delors said that, in 1989, long before the introduction of the euro.

The current framework, as already said, cannot provide a common fiscal stance, in the face of the ECB’s monetary stance, and so it cannot ensure a consistent policy mix in the Eurozone.

Ensuring a consistent policy mix in the Eurozone, would require less of an inter-governmental and more of a federal model of policy coordination. It would also require a real economic executive of the Eurozone, separate from the economic union. Certainly, we have to create a mechanism for the macroeconomic coordination of the Eurozone, which will be distinct from the economic coordination within the EU. That mechanism would replace the current

Eurogroup. This idea was in fact proposed as early as 2015, by the so called five presidents report for completing Europe's economic and monetary union - the presidents of the European Parliament, the Eurogroup, the Commission, the Council, and the ECB - and in order to draw the lessons of the first two decades of monetary union. Today, unfortunately, we don't see any governments willing or daring to propose it. So, I'm afraid there is no short term solution in order to respond to that to that issue.

Discussion

Below is a summary of questions raised and answers.

Ioannis Tirkides: The fiscal framework being proposed by the European Commission, it entails a debt sustainability framework that potentially allows for a long period of time for countries to reduce their debts. Thus, high public debt ratios can stay high for long. What might happen if the macroeconomic environment is less supportive of a slow adjustment, which will be the case if inflation stays higher for longer and interest rates are relatively high for long. How might the proposed framework be applied in an environment where inflation and interest rates are relatively high.

Pierre Jaillet: This is quite a broad and complex issue. I think, beyond the current shock, inflation shortens the forecast horizon. There is an issue, which is crucial for the future of monetary policy. This is the possible change in the inflation regime in the future. Could it be structurally higher than 2%? While there is no consensus among economists on this issue, it should be noted that even a return to an average inflation of 2%, it would be a substantial mark-up on the inflation experience of the previous ten years prior to the Covid crisis. This might mean that interest rates will never return to the zero bound. This is already a fundamental and serious change from the previous macroeconomic reality. Intuitively, several factors, could play in favour of higher long-term inflation in the future. First higher energy costs. Probably as well, a more competitive division of the value added between employees and companies. Thirdly, lower productivity gains across industry. All of these factors clearly advocate in favour of having higher inflation in the future, but it is something that needs to be confirmed.

So, the issue is, what would be the attitude of central banks in a situation of higher long-term inflation? It should be noted that the reaction to the current inflation shock, has been relatively moderate, particularly from the ECB. If central banks in the advanced countries were to react as they did in the 1980s or the 1990s, or even in the 2000s, interest rates would certainly be much higher than where they are today, not at 3% and 5%, but certainly higher than maybe 10%. Remember Paul Volcker raised the Fed Funds rates to 19% in 1981. In comparison, the reaction of central banks to the current inflation shock has been moderate so far.

Another question relates to the inflation target, which some, like Olivier Blanchard, the former chief economist of the of the IMF, have proposed to raise to 4% in order to offer monetary policy more space to deal with potentially higher inflationary shocks. But here again, there is no consensus at all, and the central banks clearly do not wish to enter into this debate.

However, central banks have already given themselves, some room for flexibility, the so called flexible inflation targeting by the federal reserve in the US, and the so called symmetric target around 2% in the new monetary framework, by the ECB, which has been set up in 2020.

The financial stability aspect of the question and the related issue of debt sustainability are tightly related. And debt sustainability is not only about public debt. Private debt must also be included in the equation. The difficulty for central banks, which are also responsible for banking and macro prudential supervision, is to avoid the double trap of market dominance and fiscal dominance.

However, their modest response to the inflation shock, since real interest rates are still strongly negative, suggests that this is a very delicate risk to manage. President Lagarde in her recent speech, after the ECB meeting of March 16, stressed that there was no trade-off between price stability and financial stability. But this is a very contentious issue.

In the case of the Eurozone, we should also keep in mind that the ECB has at their disposal, powerful instruments to limit the impact of its monetary policy on interest rate spreads, and particularly with the recent implementation of the TPI, the transmission protection instrument, which actually, as I said before, is a kind of anti-fragmentation instrument. And this instrument is supposed to compensate for the flaws of the common fiscal framework and of economic coordination, pushing the ECB to the limit of its mandate. But this is another story.

Michael Sarris: I would like to go back to something you said both in your speech and in your answers. Madame Lagarde came to Cyprus several months ago. She downplayed the demand component in the inflation and focused primarily on supply side reasons. In fact, she told us, the ECB would be flexible, and that their actions would be data driven. I would like to ask you what happened? Was something wrong with the inflation models that they were using and needed to be revised? Why this hesitance, that was shared across the Atlantic? Why did they delay monetary tightening to respond to inflation? Ms Lagarde is categorical now that there is no trade-off between price stability and financial stability. But there is. We are talking about price stability, about not raising unemployment, and not pushing banks over the brink. So, it is a more difficult situation, which to a degree it is of the making of the central banks. Can you explain a little more? Or what really happened?

Pierre Jaillet: What really happened is within the discretion of the of the ECB. I have said it before, there was a mistake in the diagnosis on inflation until the end of 2021 at least. If you look at the forecasts of the ECB until the end of 2021, the ECB just expected inflation to come back to around 2% at the end of 2022. And those were mainstream ideas. The view in the Fed also was that it was an exogenous shock, that the inflation was transitory. This was clearly a misdiagnosis.

So clearly, during the first quarter of 2022 the diagnosis was changed, leading the fed to start raising interest rates in March of 2022, and the ECB in July of 2022. If you look at the forecasts made by the OECD, the IMF and also by private organisations, the mistake was largely shared around the world.

But central banks are responsible for price stability. So, if you do that kind of bad diagnosis, you have a delayed response, which can explain the vigour of the tightening that followed. The Fed raised its fed funds rate, from near zero to 5% in the span of about one year. The reaction of the ECB was more moderate, but again for the standards of the ECB it was violent as well, going from zero to 3.5%. And so certainly, it could have added to the tensions. When you have financial tensions, the transmission mechanism of monetary policy, which normally are supposed to play out with a delay between 12 and 18 months, could be more rapid and more violent, and that is typically what we saw.

George Strovolides: Comparing with the inflation of the 1970s and 1980s, the present situation is different. One difference is that now we have overborrowing at all levels, the state level, the company level, the family level. Overborrowing was not a problem then, like it is now. On the other hand, we are ignoring completely the effects of COVID measures, and secondly, the war in in Ukraine. In these conditions shouldn't monetary tightening, have been even more steep than it has been?

Pierre Jaillet: I think a lot of people in the markets and in the public opinion already find the reaction of the central banker too violent and too rapid. So, the reaction of markets if they have raised interest rates from zero to 5%, or to 3.5% in the case of the ECB, within a shorter period of time, would have been more violent as well, may be event to the point of more financial turbulence.

At the same time, an important point to stress again, is the fact that the reaction function of Central Banks has changed dramatically. If they had the same reaction function as in the 1980s, certainly the interest rate would be much higher than it is now, maybe higher than 10%. With the current inflation, now at 6-7%, down from 9-10% at the peak, monetary policy especially in Europe and also Japan, despite the violent tightening, it is still accommodative. Real interest rates are still negative.

We have had what I call the triple shock, which is the COVID pandemic, plus the Ukraine war, plus the inflation that followed. Covid pushed governments to adopt a lot of very costly measures, which has affected the state of public finances and the public debt. Governments and the public authorities were confronted with a kind of dilemma, to fight inflation or to preserve the purchasing power of households and the profits of companies. The articulation of the policy mix, of monetary policy and fiscal policy, is quite coherent in the US, because the two have become, to some extent restrictive. In the Eurozone, you have a fight between the beginning of making monetary policy restrictive, while the aggregated fiscal policies of member states, are still accommodative. We have an internal problem in the Eurozone, where we have a single monetary policy by the ECB, but now 20 different fiscal policies as pursued by the 20 Eurozone member states. These polices are not very well coordinated.

Ioannis Tirkides: Referring to the impact of the sanctions, short term and long term, to what extent te change in the industrial cost structure may be accelerating the process of de-industrialisation in Europe?

Pierre Jaillet: The impact of sanctions on the Russian economy has been very modest so far. Whereas in the early stages the IMF was forecasting that the Russian economy would contact

by 6 to 10% in 2022, in actual fact the contraction was limited to less than 3%. Also, in Europe the implications of the sanctions against Russia remains marginal for now. This raises the issue of the effectiveness of sanctions. A lot of studies have shown that only a quarter of them are really effective in changing the behaviour of targeted countries and so sanctions are to a large extent, a communications tool. Moreover, sanctions can paradoxically, strengthen the targeted countries by encouraging them to adapt their economies to make them more autonomous.

It is important to stress that energy prices have moderated significantly since their peak in the aftermath of the war in The Ukraine, and that the dependence of Europe on Russia energy imports has been steeply reduced. Europe has also reduced its consumption of energy which suggests a rather strong flexibility of its industrial processes.

Another important point is the great diversity of the energy mix in the EU. This diversity also explains the quiet divergent responses to the energy crisis among government as well as the challenges of coordinating, often divergent national interest.

So, the coordination exercise is a very tricky one. If we take a longer term perspective and look at the global economy now, it's clear that everyone will have to pay more for energy in the future. And according to the International Energy Agency, for instance, reserves have already started to decline, while consumption remains on upward trend, which is not good news for prices.

And moreover, climate transitions will require a sharp rise in the price of carbon, and certainly massive and costly investments to develop renewable energy and storage capacities. So, concerning the competitiveness structure of the European industry, I think energy is a very important point, maybe a second problem. And we should probably be more concerned, for instance, by the fierce competition from the United States and China, with the support of rather aggressive government policies, like for instance the Inflation Reduction Act of the US, which is a kind of protectionism instrument as well. And we should be also concerned by the control of supplies of certain raw material, for instance, rare earths and the ability to maintain a competitive capacity in high technology. We have a lot of weak points in Europe, which relate not only with institutional coordination problems, not only with the coordination of energy policies but with the future of potential growth.

Polis Eliofotou: On the forward looking part of what you mentioned earlier, the figures you mentioned of potential growth, considering the lack of convergence, or increasing divergences, the high level of public debts, and also these twin transitions, in fact triple transitions, the green, digital, and the social, which has to adjust in the process. How do you see things going on what do we need to do to ensure that we bring convergence back on the table? Because, we will have a group of industrialised countries which have unknown intrinsic capacity like France and Germany, which they will benefit from these transitions and then you will have the smaller member states, which they will try to catch up. What is needed to be put in place to ensure that these divergences stop, and the convergence path re-emerges on the on the scene?

Pierre Jaillet: We don't have enough time to engage the question. The debt scene in Europe is quite diverge but there are many big countries withy a high public debt like Italy but also France. And as far as the industrial capacity is concerned, this relates with a previous question, we are witnessing a gradual but dramatic decline in the manufacturing output and the share of manufacturing output in GDP over the last 20 years. And so, the share of manufacturing output in GDP is around 10%. In France. It remained above 20% in Germany and about 13-14% in Italy.

So, I think the problem of de-industrialization is not only in small countries, I think it is also a problem in some large economies in the Eurozone. And the solution is not easy to find. I would say, the Green Deal initiative or decision, is the first time that the European Union really think seriously about having a common industrial policy, which has been totally forgotten.

This is not a problem of the single monetary policy. The real problem is the functioning or dys-functioning of the single market, especially the financial side of the single market. If you look at the single market, it was decided 30 years ago. And so, when you look at the financial markets or banking sectors market, we are in a totally fragmented area, which means that you have a problem of allocation of the excess savings we have, in the European Union, especially in the Eurozone to countries which really need investment and savings. And so, I think the first thing we could enhance in the coming years would be to clearly work on de-fragmenting the financial markets. While we have a single monetary authority, centralised supervision authorities, centralised resolution authorities, we have a kind of ring fencing at different stages. So, we really now need the political will in order to solve that.

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