The consequences of European economic policies on real economic variables and public debt

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Alternative economic policies in Europe

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The original sins -1

- **There are *four original sins* in EU's institutions and policies that have heavily affected the depth and duration of the crisis:**

- **1) The executive power in the EU is mainly given to the councils of prime ministers and of treasury ministers. So, the national interests are usually prevailing and any controversial economic decision requires months or years of difficult compromises. The measures are often tardive and ineffective. Since during the crises the financially stronger countries get more power, if nationalism prevails, a solidarity approach is usually banned.**

- **2) There is no EU's treasury minister and the EU's budget is only about 1% of EU's GDP. It is completely insufficient to make effective anti-cyclical and development policies. It ought to be at least around 10%. Moreover, the euro was created without any kind of protective devices. In 2007-8 there were no EU institutions devoted to face major financial crises and BCE's statute makes it extremely difficult to pursue effective monetary expansionary policies. For example, quantitative easing policies have been introduced years later than in the United States, after a tough confrontation with the Bundesbank.**

The original sins - 2

- **3) The EU political leaders and their economic advisers are often inspired by the monetarist- neoclassic- anti- keynesian approach prevailing in the last four decades in most Western countries.**

- **4) As a consequence, in the 1990s there was the adoption of the "Maastricht parameters" including the Public deficit/GDP ratio and the Public debt/GDP ratios, and then the "fiscal compact". All this, in cases of severe and prolonged crises, can lead to disastrous and fully anti-keynesian "austerity policies".**

- **Too few economists had at that time criticized those parameters, technically very weak, or, if they had, as for example Luigi Pasinetti, their voice has been very feeble and has been suffocated by the main-stream consensus and the clamour of mass-media.**

Stocks and flows - 1

- **From the analytical point of view, both main-stream and critical economists have heavily overlooked the importance of the *relations between stocks and flows*, which consist in a complex series of dynamic feedbacks.**

- **The analyses of most economists have been principally based on flow-variables.**

- **I give here *seven examples* of the importance of the values of stocks in determining the passage from financial to real crises and then to public debt crises. These relations can contribute to a better comprehension of Japan's severe structural crisis since the 1990s and of the great world financial crisis of the 2008-2015 period.**

- **Since 2007-2008 there has been *seven vicious circles*, at first occurring in the U.S. and then rapidly spreading to most other industrialized countries.**

- **1) a *negative wealth effect:* A sharp fall in the prices of housing, due to the explosion in the US of the structural sub-prime bubble => financial crisis and then a fall in the price of shares => fall in private total wealth (both real wealth and financial wealth) => fall in consumption => fall in investment => fall in aggregate demand => fall in GDP and income => fall in wealth due the weaker demand for housing and financial assets => further fall in consumption, etc.**

- **2*) a collaterals effect:* initial reduction in wealth => fall in the value of collaterals (housing subject to mortgages, or shares) => fall in loans given by the banks => fall in investment and failures of weaker enterprises => rise in nonperforming loans and crises of several banks => reduction in GDP and Income => further reduction in wealth, etc .**

Stocks and flows -2

- **3) a *financial effect.* Fall in the prices of housing => fall in the values of toxic assets incorporating sub-prime loans => crisis of several financial institutions => crisis in the confidence in most banks and in the inter-bank liquidity market => liquidity crunch => fall in stock exchange index and strict rationing of banks' loans to firms => fall in real investment => fall in GDP and income => further fall in the value of real and financial wealth, etc. All this was greatly amplified by the "ex-post unnecessary" bankruptcy of Lehman brothers.**

- **4) the *total wage effect.* In each country the heavy fall in wealth, and then in real GDP and investment, determines a stagnation in real unit wages and, with a certain delay, a sharp reduction in employment => fall of total wages at constant prices => further fall in consumption => further fall in investment and exports => fall in real GDP => fall in wealth, etc.**

- **5) the *public finance* effect. Fall in wealth and then in GDP => fall in tax revenues and increase in some social expenditures (such as unemployment compensations, subsidies to poor households, etc.), plus a rise in interest rates, due to an increase in the spread => rise in public deficit, public debt and the public debt/GDP ratio => if the government tries to react through an increase in tax rates and /or a cut in public expenditures => further fall in consumption, investment and GDP => further reduction in the value of wealth, etc.**

Stocks and flows - 3

- **6) The *socio-political effect*, which may occur after a very deep and prolonged economic depression, as happened in Greece and partly in Portugal, Ireland, Spain and Italy. Economic depression and public finance in growing distress => repeated macroeconomic restrictive measures => further fall in GDP and rise in the public debt/GDP ratio => social unrest and political instability => decline in economic international confidence and attempt to stabilize the economy through new restrictive measures => further fall in GDP and in the value of wealth, etc.**

- **7) *The distributive effect.* At the beginning of the crisis in most Southern European countries there was *a large inequality in income* distribution and *even more in wealth distribution*. The financial, real and public debt crises have increased these inequalities, especially in South Europe. This happened mainly through a sharp rise in unemployment, and especially in youth unemployment, the stagnation in real wages, a cut in several social expenditures, the failure of many micro-firms, the increase in tax rates; only in part balanced, in income and wealth distribution, by the fall in profits, housing prices and other assets more concentrated in the hands of rich people. All this has had powerful effects on consumption, saving and investment choices and even more in intergeneration problems.**

Table 1. Net household wealth in % of disposable income (Source OECD, 2013)

	2006	2007	2008	2009	2010	2011	2012
Italy	862	856	859	882	880	852	
Japan	813	809	777	779	772	766	
United Kingdom	792	820	693	734	749	736	747
France	792	805	755	751	794	805	
United States	671	646	520	539	563	549	577
Canada	668	676	600	636	660	658	679
Germany	580	610	598	621	624	622	638

Short-termism and the public debt crisis

- **Most political leaders, financial institutions, rating agencies, several top managers and entrepreneurs suffer from acute *short-termism.***

- **However, the creation of *structural bubbles* in the values of real and financial stocks and the *accumulation of public debt* usually happen in several years and requires long-run, gradual, solutions.**

- ***Or tu chi se', che vuo' sedere a scranna Per giudicar di lungi mille miglia Con la veduta corta di una spanna?***
- ***Now who art thou, that on the bench wouldst sit In judgment at a thousand miles away, With the short vision of a single span?***

  (Dante Alighieri, Divine Comedy, Paradise, XIX), quoted from Borio (2012).

- **Stocks imbalances grown up in several years cannot be solved with drastic short-time austerity measures. It is necessary a set of new policies, a complex combination of short-time and long -time interventions.**

Table 2. The three crises

Sources: Eurostat, OECD, NBS of China (China: urban unemployment rate)

Countries	Annual % rates of change of real GDP								Unemployment rates (%)						
	2007	2008	2009	2010	2011	2012	2013	2014 (p.)	2007	2008	2009	2010	2011	2012	2013
U.S.	1.8	-0.3	-2.8	2.5	1.8	2.8	2.2	3.1	4.6	5.8	9.3	9.6	8.9	8.1	7.4
Japan	2.2	-1.0	-5.5	4.7	-0.5	1.5	1.5	0.4	3.8	4.0	5.0	5.0	4.6	4.3	4.0
Germany	3.3	1.1	-5.1	4.0	3.3	0.6	0.2	1.5	8.7	7.5	7.8	7.1	6.0	5.5	5.3
U.K	3.4	-0.8	-5.2	1.7	1.1	0.3	1.7	3.0	5.3	5.7	7.6	7.9	8.1	8.0	7.6
France	2.3	-0.1	-3.1	1.7	2.0	0.0	0.4	0.4	7.7	7.1	8.8	8.9	8.8	9.4	9.9
Italy	1.7	-1.2	-5.1	1.5	0.7	-2.3	-1.9	-0.4	6.1	6.8	7.8	8.4	8.4	10.7	12.2
Spain	3.8	1.1	-3.6	0.0	-0.6	-2.1	-1.2	1.3	8.2	11.3	17.9	19.9	21.4	24.8	26.1
Greece	3.4	-0.4	-4.4	-5.3	-8.9	-6.6	-4.0	0.8	8.3	7.7	9.5	12.6	17.7	24.3	27.3
Ireland	4.9	-2.7	-6.4	-0.3	2.8	-0.3	0.2	4.3	4.6	6.0	11.7	13.9	14.7	14.7	13.1
Portugal	2.5	0.2	-3.0	1.9	-1.8	-3.3	-1.4	0.8	8.0	7.6	9.5	11.0	12.9	15.9	16.5
S. Korea	5.1	2.3	0.3	6.3	3.7	2.0	3.0	3.5	3.2	3.2	3.7	3.7	3.4	3.2	3.1
China	14.2	9.6	9.2	10.4	9.3	7.8	7.7	7.3	4.0	4.2	4.3	4.1	4.0	4.1	4.1

Table 3. Some indicators for selected EU countries

Sources: Eurostat (A, B) and OECD (C, D)

Countries	A- Public deficit/GDP (%)				C- Annual average rate of change of real GDP (%)			
	2007	2011	2012	2013	2007-10	2011	2012	2013
Greece	-6.7	- 10.1	- 8.6	-12.2	- 2.7	-8.9	- 6,6	- 4.0
Ireland	0.2	-12.6	- 8.0	-5.7	- 3.2	2.8	- 0.3	0.2
Portugal	-3.0	-7.4	- 5.5	-4.9	- 0.3	-1.8	- 3.3	-1.4
Spain	2.0	- 9,4	-10.3	-6.8	- 1.1	-0.6	- 2.1	-1.2
Italy	-1.5	-3.5	- 3.0	-2.8	-1.7	0.7	- 2.3	-1.9
Countries	**B-Public debt/GDP (%)**				**D- Youth unemployment rate: years 15-24 (%)**			
	2007	2011	2012	2013	2007	2011	2012	2013
Greece	103.1	171.3	156.9	174.9	22.9	44.4	55.3	58.3
Ireland	24.0	111.1	121.7	123.3	10.3	29.1	30.4	26.8
Portugal	68.4	111.1	124.8	128.0	16.6	30.1	37.7	37.7
Spain	35.5	69.2	84.4	92.1	18.2	46.2	52.9	55.5
Italy	99.7	116.4	122.2	127.9	20.3	29.1	35.3	40.0

Some differences among selected EU countries in the pre- crisis period

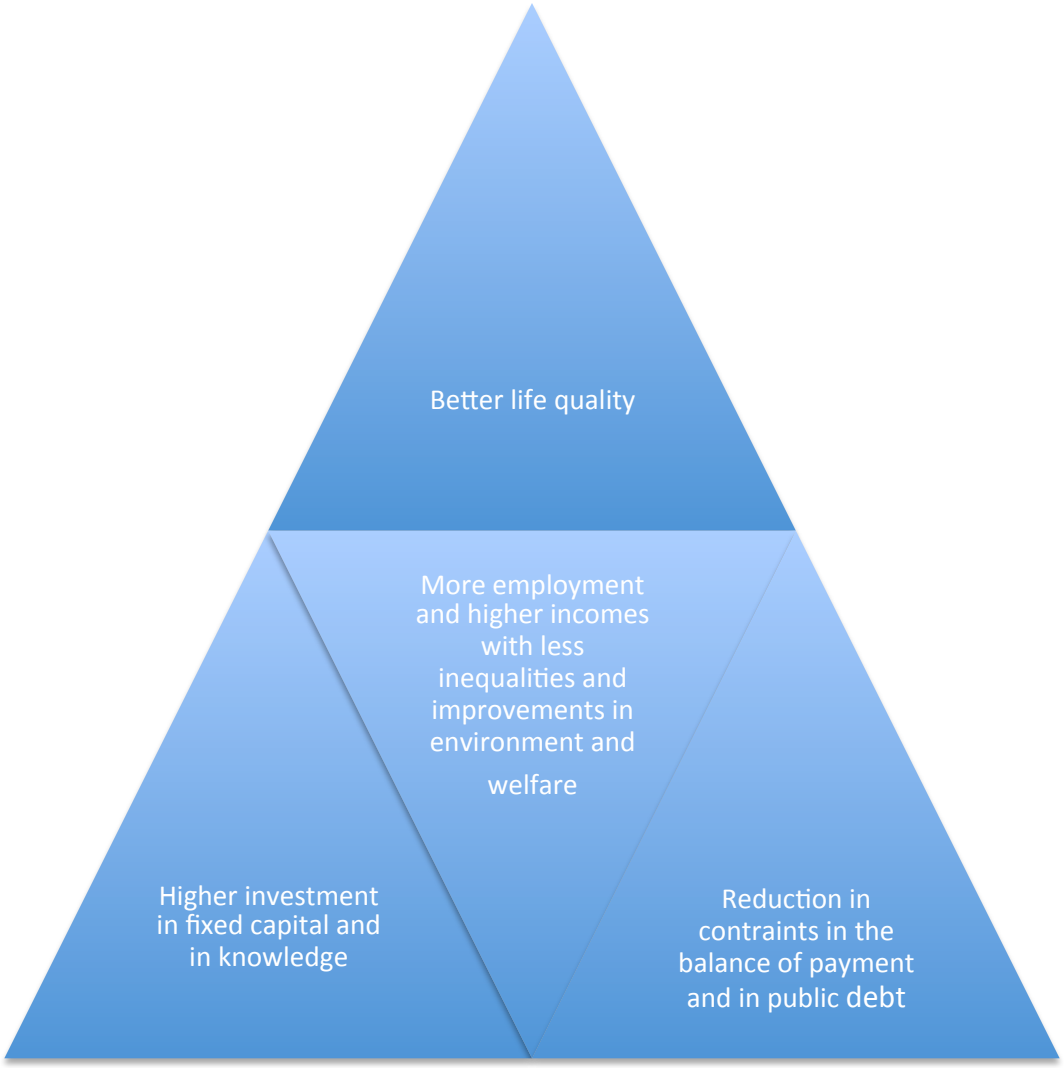
Countries	Current account of the balance of payments before 2007-8	Public debt/ GDP ratio	Housing sector	Banking system
Greece	Heavy and very prolonged structural deficits (from the 1990s up to 2012)	Very high and high % in foreign hands	Short bubble (2003-2007)	Weak
Italy	Prolonged structural deficits (from 2000 up to 2011)	Very high and substantial % in foreign hands	Modest bubble (borderline)	Relatively solid, with some exceptions
Portugal	Heavy and very prolonged structural deficits (from the mid 1990s up to 2012)	Slightly exceeding Maastricht's parameter	Containment in the growth of housing prices	Exposed to financial bubbles
Spain	Very prolonged structural deficits (from the mid-1990s up to 2011)	Low	Great structural bubble	Greatly exposed to the housing bubble
Ireland	Deficits from 2004 up to 2009	Very low	Great structural bubble	Greatly exposed to the housing bubble
Germany	*Structural surplus (since 2001)*	*Acceptable, but higher than Maastricht's parameter since 2003*	*Containment of housing prices*	*Exposed to financial bubbles*

Public debt: a stock- to- stock and a flow- to- flow approach

- It might be useful to use *a long-run stock to stock approach*, together with a *short-run flow-to- flow approach*.
- An example might be the case of countries with an excessive public debt.

Long-run problems		Short-run problems	
Stock- to- stock approach		Flow-to flow approach	
Excessive public debt	It would be important to create 30-40 years bonds (*euro-bonds*) with some real guarantees given by the debtor countries. The reimbursements might be partly financed with a share of the revenues of a progressive wealth tax, whose tax rates will increase in expansionary years, by a carbon tax and a well designed Tobin's tax on international transactions. Substitution of the 60% public-debt/GDP ratio with an engagement to reach within 30-40 years a 80% ratio.	Public deficit	It is essential to give to the countries in difficulty the possibility of a monetary *and fiscal stimulus* during severe recessions. The latter might require the substitution of the public deficit/ GDP ratio 3% rule with a rule which will reduce the rate of increase of public expenditures well below the rate of growth of real GDP *only during expansionary phases* in order to re-establish the budgetary equilibrium in the medium run.

The pyramid of development



Alternative policies - 1

- **For the EU countries with a lack of competitiveness and a structural deficit in the balance of payments (as Greece, Italy, Spain, Portugal, etc.) it is essential trying to *increase the growth both of real physical investment and of knowledge.***
- **For *physical capital* it would be necessary*:***
- **a) *a drastic reduction of social contributions* paid both by the firms and the employees, financed by a Tobin tax, a carbon tax, part of a wealth tax;**

b) *incentives for real extensive investment* (with creation of new employment, and in particular youth employment). On the mid-term this will lead to higher productivity and higher tax revenues and to less unemployment compensations, or, in Italy, less expenditures for CIG.

c) a reduction of taxes on firms' profits and of personal taxation on low and medium incomes when superior to the EU average level. This will lead to higher consumption and higher expenditure of the firms and families in R.&D. and education. The rise in public expenditure might be financed by the fight against tax evasion and the submerged economy, particularly large in Greece, Italy, Portugal and Spain.

c) in Italy a new locally- based tax on consumption instead of IRAP.

Alternative policies - 2

- **It would be also important to finance, with a part of the revenues of the Tobin tax, a new carbon tax and other means, a substantial increase im the EU budget to be devoted to investment in infrastructures and *knowledge (education, R &D*., etc.) and to the temporary assistance of countries in deep crisis, such as Greece.**

- **A common monetary and exchange rate policy without an effective EU common fiscal and budgetary policy has proved to be very dangerous. In the mid-term, it would be necessary to transfer from the national budget to the EU budget at least 2% of EU's GDP, with a sort of a EU finance minister fully in charge of this budget. A Tobin tax and a carbon tax whose revenues might partly go to EU and partly to national governments would contribute financing the rise in the EU budget. On the long run this budget ought to pass to at least 10% of GDP in order to effectively make both anti cyclical and development policies.**

- **There is also a deep need for some EU common grounds on the labour and industrial relations policies in order to move towards a common flex-security model, which has proved to be to be more efficient than other models in providing employment (or income) security and flexibility for the firms.**

- **There is the necessity of better regulations on banking and the financial markets. The European stability mechanism and the Banking Union are not enough. Little has been done to prevent too risky speculative activities of banks and dangerous conflicts of interest.**

Alternative policies - 3

- **It would be a difficult and impervious process, but a first step in the field of economics might be to introduce a EU minimum wages, and a minimum EU set of unemployment compensations, active labour market policies and social contributions. This minima could be naturally improved by collective agreements and national minimum wages, more generous unemployment compensations and social contributions in richer countries, but they could constitute the basis for the gradual building of a common EU social and labour market platform.**

- **But in order to do so, we must fight against strong nationalistic currents, and gradually build a common social Europe and more integrated European Labour Unions and political parties.**

- **Naturally this would require profound political and institutional changes in the EU, with the long-term objective to move towards a real *United States of Europe*.**

See also…

- **V.Valli, *New economic policies in a changing world: a stock-flow approach*, in "Annali della Fondazione L. Einaudi" di Torino, XLVII, Olschki, Firenze, pp. 37-56, 2013.**

Thanks for your attention