Hochschule für
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The Economics and Politics of Managing the Euro Crisis
–
A Post-Keynesian Perspective

Eckhard Hein

Literature

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Fundamental flaws of European monetary integration and its design

- Misunderstanding of the fundamentals of money and currency
- Misunderstanding of the role of (macro)economic policies

Fundamental problems of economic development since 1999 associated with ‚financialisation'

- Redistribution of income
- Rising (current account) imbalances without sustainable recycling of surpluses

1. Misunderstanding of the fundamentals of money and currency (Goodhart 1998)

Money as a creature of the market: metallism

- Money as means of exchange/circulation
- Currency union has to focus on flexible (labour) markets, wage and price flexibility, labour mobility, etc. ➔ OCA

Money as a creature of institutions/state: chartalism

- Money as money of account/standard of value
- Currency union has to focus on appropriate institutions, central bank as LoLR for banks and state, fiscal federalism, etc.

2. Misunderstanding of the role of (macro)economic policies

Table 1: Macroeconomic policy recommendations of New Consensus models (NCM) and of post-Keynesian models (PKM) compared

	NCM	**PKM**
Monetary policy	Inflation targeting, which affects unemployment in the short run, but only inflation in the long run	Target low interest rates affecting distribution, and stabilise monetary, financial and real sectors
Fiscal policy	Support monetary policy in achieving price stability, balance the budget over the cycle	Real stabilisation in the short and in the long run, no autonomous deficit target, distribution of disposable income
Labour market and wage/incomes policy	Determines the NAIRU in the long run and the speed of adjustment in the short run, focus should be on flexible nominal and real wages	Affects price level/inflation and distribution, focus should be on rigid nominal wages and steady nominal unit labour cost growth
Co-ordination	Clear assignment in the long run, co-ordination only in the short run	No clear assignment, co-ordination required in the short and the long run

3. Redistribution of income

Labour income share as percentage of GDP at current factor cost, 1991-2014

Source: European Commission (2014a)

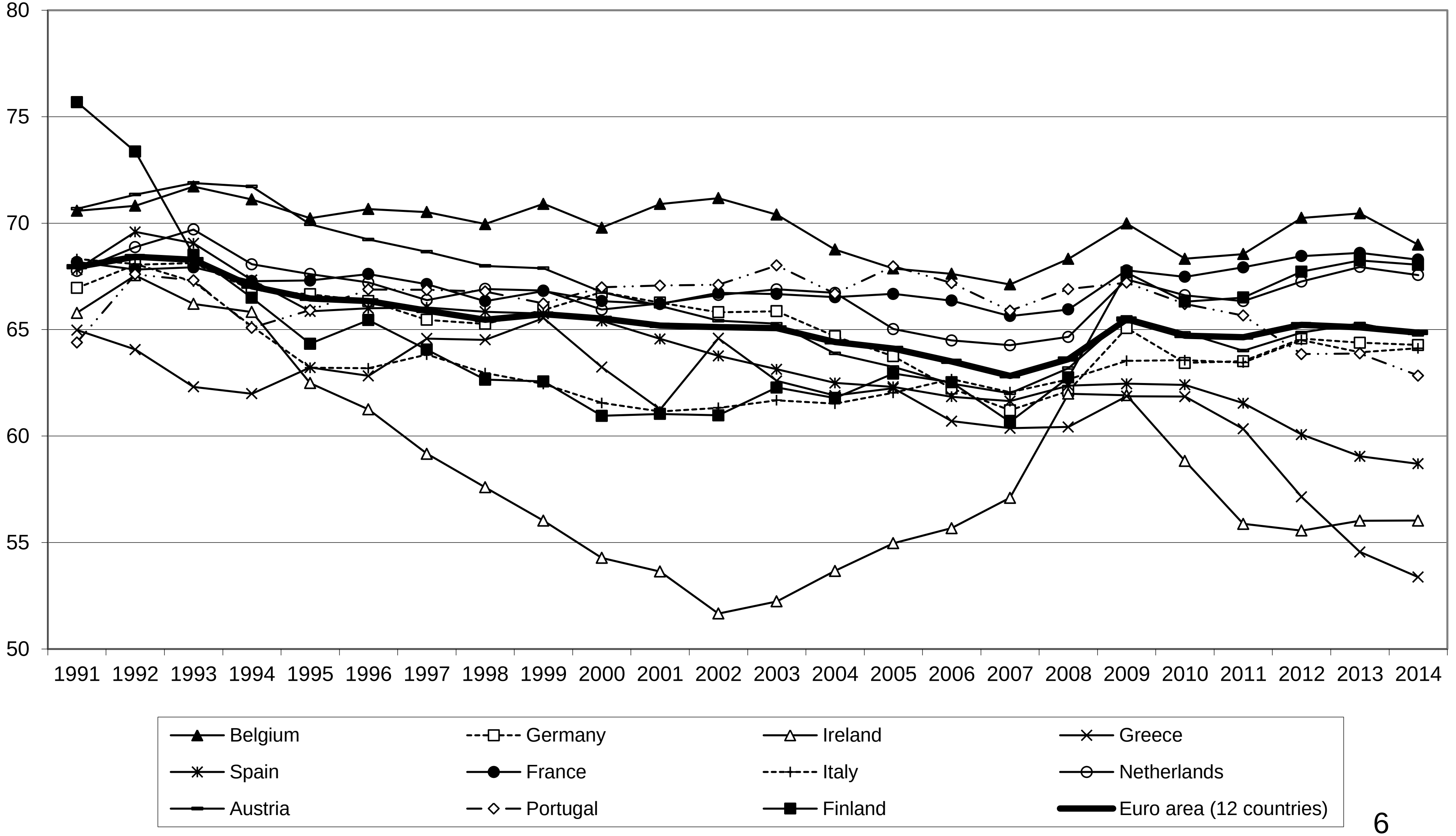


Table 1

Gini coefficient before taxes for households' market income							
Country	mid-80s	around 1990	mid-90s	around 2000	mid-2000s	late 2000s	Change from mid-80s/around 1990/mid 90s until late 2000s
Austria	..	..	..	..	0.433	0.472	..
Belgium	0.449	..	0.472	0.464	0.494	0.469	0.020
Finland	0.387	..	0.479	0.478	0.483	0.465	0.078
France	..	..	0.473	0.490	0.485	0.483	0.010
Germany	0.439	0.429	0.459	0.471	0.499	0.504	0.065
Greece	0.426	..	0.446	0.466	0.454	0.436	0.010
Ireland	..	..	..	..	..		..
Italy	0.420	0.437	0.508	0.516	0.557	0.534	0.114
Netherlands	0.473	0.474	0.484	0.424	0.426	0.426	-0.047
Portugal	..	0.436	0.49	0.479	0.542	0.521	0.085
Spain	..	..	..	..	..	0.461	..

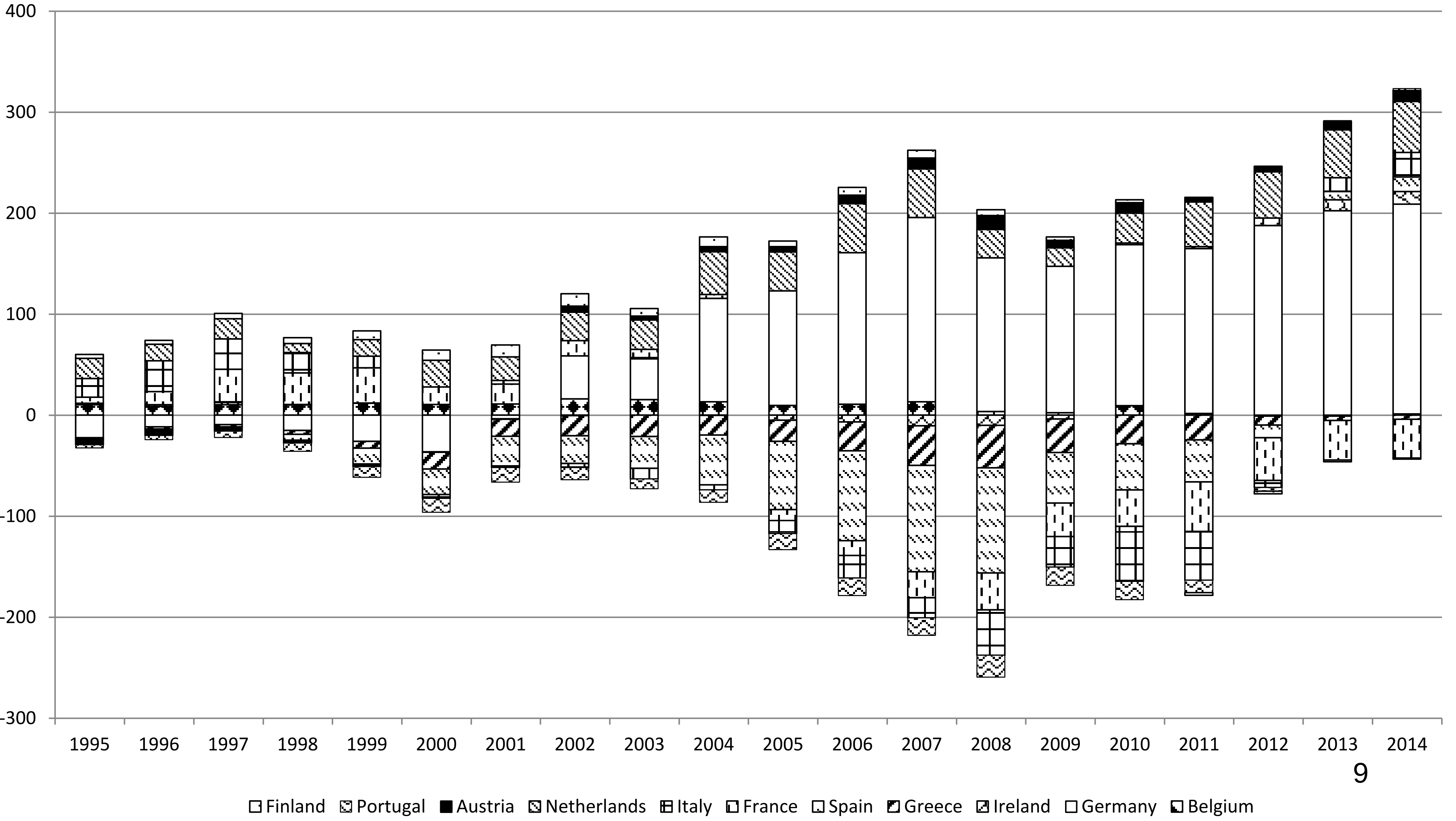
Table 1 continued

Gini coefficient after taxes for households' disposable income							
Country	mid-80s	around 1990	mid-90s	around 2000	mid-2000s	late 2000s	Change mid-80s/around 1990 until late 2000s
Austria	0.236	..	0.238	0.252	0.265	0.261	0.025
Belgium	0.274	..	0.287	0.289	0.271	0.259	-0.015
Finland	0.209	..	0.218	0.247	0.254	0.259	0.050
France	0.300	0.290	0.277	0.287	0.288	0.293	-0.007
Germany	0.251	0.256	0.266	0.264	0.285	0.295	0.044
Greece	0.336	..	0.336	0.345	0.321	0.307	-0.029
Ireland	0.331	..	0.324	0.304	0.314	0.293	-0.038
Italy	0.309	0.297	0.348	0.343	0.352	0.337	0.028
Netherlands	0.272	0.292	0.297	0.292	0.284	0.294	0.022
Portugal	..	0.329	0.359	0.356	0.385	0.353	0.024
Spain	0.371	0.337	0.343	0.342	0.319	0.317	-0.054
Note: Gini coefficient is based on equivalised household income Source: OECD (2012), author's calculations							

4. Rising (current account) imbalances without sustainable recycling of surpluses

Current account in billions ECU/euro, selected Euro area countries, 1995 – 2014

Source: European Commission (2014a), author's calculations



‘Types of capitalism under financialisation’ before the crisis

1. **‘debt-led consumption boom’** type

➔ Greece, Ireland, Spain

2. **‘export-led mercantilist’** type

➔ Austria, Belgium, Finland, Germany, Netherlands

3. **‘domestic demand-led’** type

➔ France, Italy, Portugal, EU-12

Table 2a

Key macroeconomic variables for 'debt-led consumption boom' economies, average values, 1999 – 2007			
	Greece	**Ireland**	**Spain**
Annual change in labour income share, as percentage of GDP at current factor costs	-0.5	-0.1	-0.5
Financial balances of external sector as a share of nominal GDP, per cent	11.7	1.4	5.7
Financial balances of public sector as share of nominal GDP, per cent	-5.3	1.6	0.2
Financial balance of private sector as a share of nominal GDP, per cent	-6.4	-3.0	-5.9
Financial balance of private household sector as a share of nominal GDP, per cent [a)]	-9.3	-6.3 [b)]	-1.1
Financial balance of the corporate sector as a share of nominal GDP, per cent	2.9	3.3 [b)]	-4.7
Real GDP growth, per cent	4.1	6.6	3.7
Growth contribution of domestic demand including stocks, percentage points	4.8	5.3	4.8
Growth contribution of private consumption, percentage points	2.6	2.9	2.3
Growth contribution of public consumption, percentage points	0.7	0.9	0.9
Growth contribution of gross fixed capital formation, percentage points	1.5	1.5	1.6
Growth contribution of the balance of goods and services, percentage points	-0.8	1.3	-1.0
Net exports of goods and services as a share of nominal GDP, per cent	-11.5	13.4	-3.8
Growth rate of nominal unit labour costs, per cent	2.6	3.6	3.0
Inflation (HCPI growth rate), per cent	3.2	3.4	3.1
Growth rate of nominal effective exchange rates (relative to 35 countries), per cent	1.1	0.9	0.7
Growth rate of real effective exchange rates (relative to 35 countries), per cent	0.8	2.7	1.7

Note: [a)] adjusted such that private household plus corporate balances sum up to private sector balance, [b)] average value for 2002-2007
Source: European Commission (2012a), author's calculations

‘Debt-led consumption boom’ type: Greece, Ireland and Spain

- considerable increases in residential property prices and/or in wealth-income ratios
- soaring consumption demand and hence considerable growth contributions of private consumption and domestic demand
- relatively high real GDP growth
- negative financial balances (as a share of nominal GDP) of the private household sector and thus increasing private household debt
- negative balances of the private sector as a whole
- public sector contributed to the negative domestic financial balance in Greece, whereas public sector balance is positive in Ireland and Spain
- current account deficits, i.e. the financial balances of the external sector were positive
- negative growth contributions of the balance of goods and services in these countries but Ireland
- above Euro area average unit labour cost growth and inflation accompanied by nominal appreciation of the euro contributed to the deficits in the balance of goods and services and in the current account

➔ Euro area demand engines

Table 2b

Key macroeconomic variables for 'export-led mercantilist' economies, average values, 1999 – 2007					
	Austria	**Belgium**	**Finland**	**Ger-many**	**Nether-lands**
Annual change in labour income share, as percentage of GDP at current factor costs	-0.7	-0.3	-0.2	-0.5	-0.3
Financial balances of external sector as a share of nominal GDP, per cent	-1.5	-4.4	-6.1	-2.7	-6.8
Financial balances of public sector as share of nominal GDP, per cent	-1.8	-0.4	3.8	-2.2	-0.5
Financial balance of private sector as a share of nominal GDP, per cent	3.2	4.8	2.3	4.9	7.3
Financial balance of private household sector as a share of nominal GDP, per cent [a)]	4.3	4.2	-2.3	5.2	0.1
Financial balance of the corporate sector as a share of nominal GDP, per cent	-1.2	0.6	4.7	-0.2	7.0
Real GDP growth, per cent	2.6	2.3	3.6	1.7	2.5
Growth contribution of domestic demand including stocks, percentage points	1.6	1.9	2.8	0.8	2.0
Growth contribution of private consumption, percentage points	0.9	0.8	1.7	0.5	0.8
Growth contribution of public consumption, percentage points	0.3	0.4	0.3	0.1	0.7
Growth contribution of gross fixed capital formation, percentage points	0.3	0.6	0.7	0.2	0.4
Growth contribution of the balance of goods and services, percentage points	0.8	0.4	0.7	0.9	0.5
Net exports of goods and services as a share of nominal GDP, per cent	3.5	4.3	7.1	3.8	6.7
Growth rate of nominal unit labour costs, per cent	0.5	1.6	1.1	-0.1	2.2
Inflation (HCPI growth rate), per cent[a)]	1.7	2.0	1.6	1.6	2.4
Growth rate of nominal effective exchange rates (relative to 35 countries), per cent	0.6	0.6	0.8	0.8	0.5
Growth rate of real effective exchange rates (relative to 35 countries), per cent	-0.7	0.4	0.0	-1.5	1.1

Note: [a)] adjusted such that private household plus corporate balances sum up to private sector balance
Source: European Commission (2012a), author's calculations

‘Export-led mercantilist’ type: Austria, Belgium, Finland, Germany, the Netherlands

- surpluses in balances of goods and services and in current accounts, i.e. the financial balances of the external sectors were in deficit
- although some of these countries (Belgium, Finland, the Netherlands) had seen considerable increases in wealth-income ratios and/or in residential property prices, whereas others had not (Austria, Germany) financial balances of private households remained in surplus (except Finland)
- financial balances of the private sectors were strongly positive
- growth contributions of private consumption and domestic demand were moderate or weak
- positive growth contributions of the balance of goods and services
- low unit labour cost growth and low inflation

➔ ‘free riders’ of demand growth in debt-led consumption boom economies, but GDP growth in the export-led countries remained well below GDP growth in the debt-led economies

Table 2c

Key macroeconomic variables for 'domestic demand-led' economies, average values, 1999 – 2007				
	France	**Italy**	**Portugal**	**EU-12**
Annual change in labour income share, as percentage of GDP at current factor costs	-0.1	-0.1	-0.1	-0.3
Financial balances of external sector as a share of nominal GDP, per cent	-0.5	0.4	9.4	-0.5
Financial balances of public sector as share of nominal GDP, per cent	-2.7	-2.9	-4.1	-1.9
Financial balance of private sector as a share of nominal GDP, per cent	3.2	2.4	-5.3	2.4
Financial balance of private household sector as a share of nominal GDP, per cent [a)]	3.8	3.8	0.4	…
Financial balance of the corporate sector as a share of nominal GDP, per cent	-0.7	-1.2	-5.6	…
Real GDP growth, per cent	2.2	1.5	1.8	2.2
Growth contribution of domestic demand including stocks, percentage points	2.5	1.7	1.9	2.1
Growth contribution of private consumption, percentage points	1.4	0.7	1.4	1.1
Growth contribution of public consumption, percentage points	0.4	0.4	0.4	0.4
Growth contribution of gross fixed capital formation, percentage points	0.7	0.5	0.0	0.6
Growth contribution of the balance of goods and services, percentage points	-0.3	-0.1	-0.1	0.1
Net exports of goods and services as a share of nominal GDP, per cent	0.4	0.6	-9.0	1.6
Growth rate of nominal unit labour costs, per cent	1.8	2.3	2.7	1.5
Inflation (HCPI growth rate), per cent	1.8	2.3	2.9	2.1
Growth rate of nominal effective exchange rates (relative to 35 countries), per cent	0.7	0.9	0.4	1.5 [b)]
Growth rate of real effective exchange rates (relative to 35 countries), per cent	0.6	1.2	1.2	0.3 [b)]

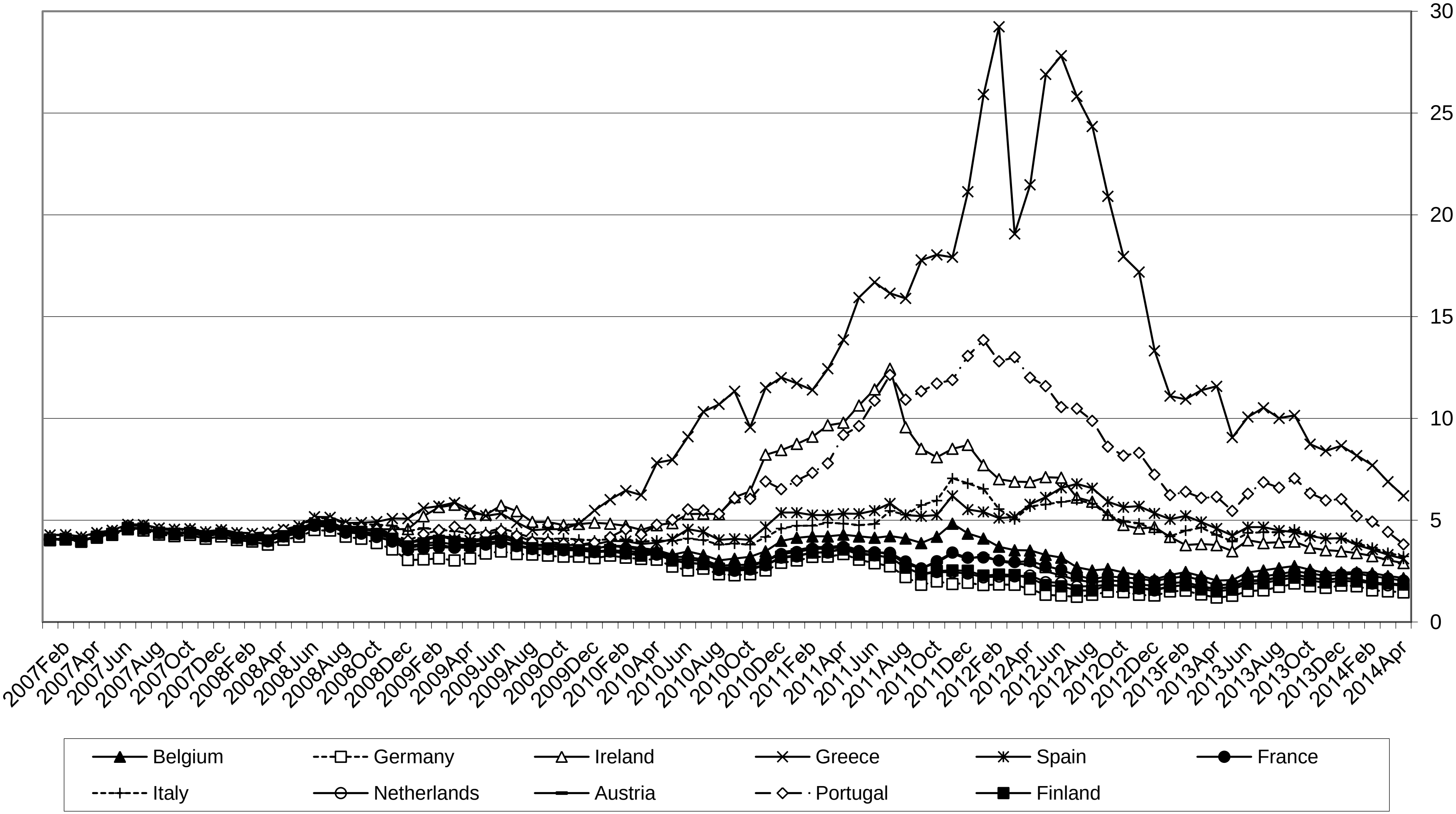
Notes: [a)] adjusted such that private household plus corporate balances sum up to private sector balance, [b)] relative to 21 countries
Source: European Commission (2012a), author's calculations

‚Domestic demand-led‘ type: France, Italy, Portugal – and EU-12

- although France and Italy saw significant increases in net wealth-income ratios and in residential property prices, whereas Portugal did not, financial balances of private households remained positive
- corporate sector with negative balances, private sector in surplus in France and Italy, but in deficit in Portugal
- negative public sector balances,
- huge current account deficits in Portugal, whereas France and Italy are close to balance but with a rising trend for external sector balance
- Positive net exports in France and Italy with falling trend, highly negative net exports in Portugal
- negative growth contributions of external demand
- higher unit labour cost growth and higher inflation than export-led economies, although France is in line with EU-12
- Weak growth, in particular in Portugal and Italy, but less so in France

Euro crisis – indicated by rising government bonds spreads

10-year government bond yields, Feb 2007 - Apr 2014
Source: European Central Bank (2014a)



Prevention of collapse of financial market

- Greek rescue facility, EFSM, EFSF, ESM
- Extension of stabilisation tools of EFSF and ESM: Re-capitalize financial institutions via governments, intervene in secondary government bonds markets
- ECB responses: lower interest rates, ‚Big Bertha‘, intervention into secondary government bonds market, Draghi 2012 „whatever it takes …“, OMT, Covered Bonds Purchase Programme, Securities Market Programme, Asset Backed Securities Purchase Programme, …

➔ but no *unconditonal* and *explicit* guarantee of Euro area member countries‘ government debt

Crisis is interpreted as sovereign debt crisis

„ (…) the hole in a flat tire must always be on the bottom, because that is where the tire is flat.“ (Solow 2000)

➔ **therefore:**

- Austerity policy as a condition for access to rescue packages, and for future ECB interventions
- Tighter SGP (Six-Pack and Two-Pack)
- Euro Plus Pact
- Fiscal Compact

➔ Structural budget deficit below 0.5 per cent of GDP to be introduced into constitutions

➔ Automatic sanctions, if 0.5 per cent (structural deficit) or 3 per cent (overall deficit) is breached

➔ reduce government debt exceeding the 60 per cent of GDP threshold by 1/20 per year

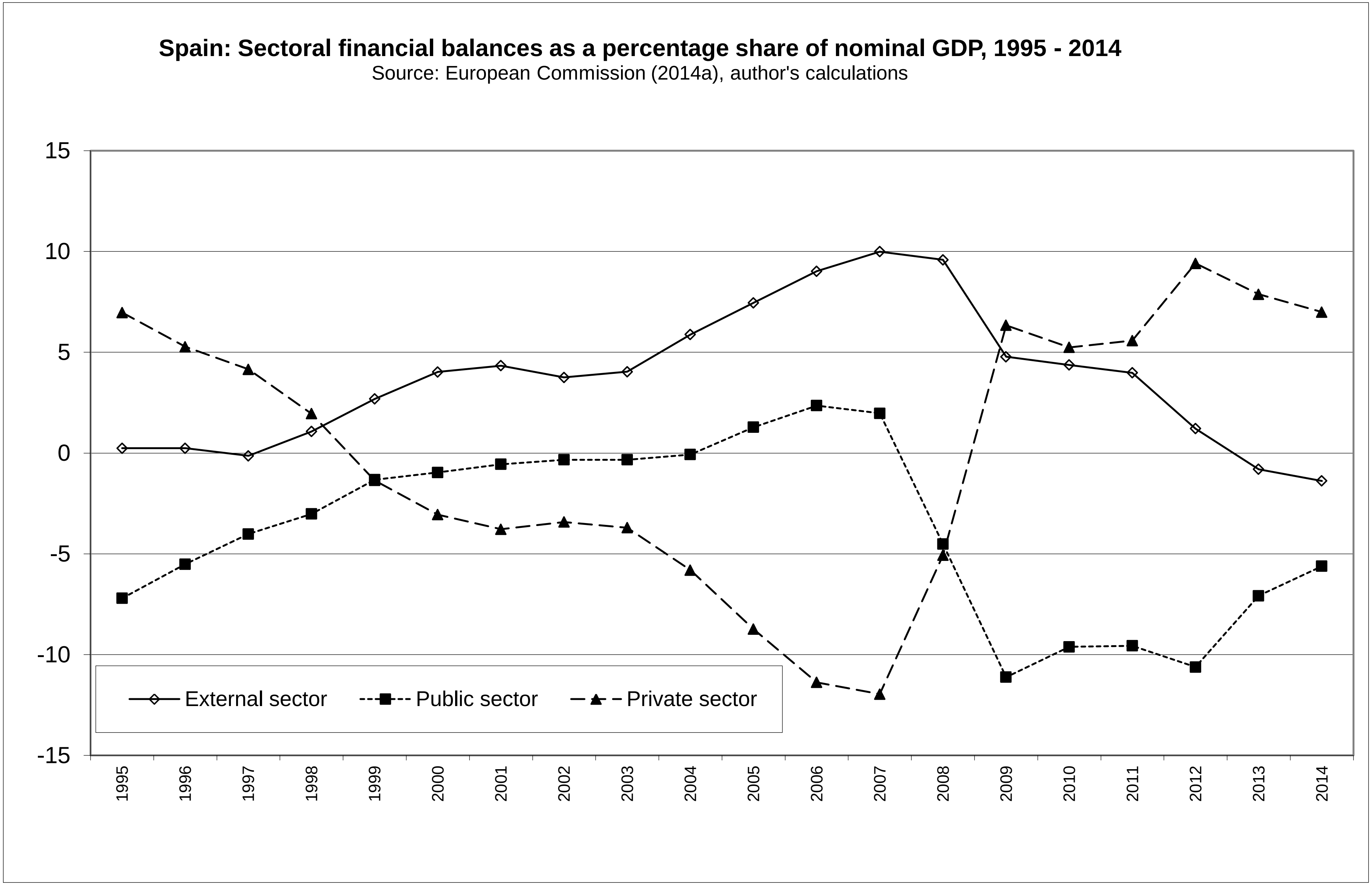
➔ improve competitiveness through wage moderation, use public sector wage contracts as a tool

Problems

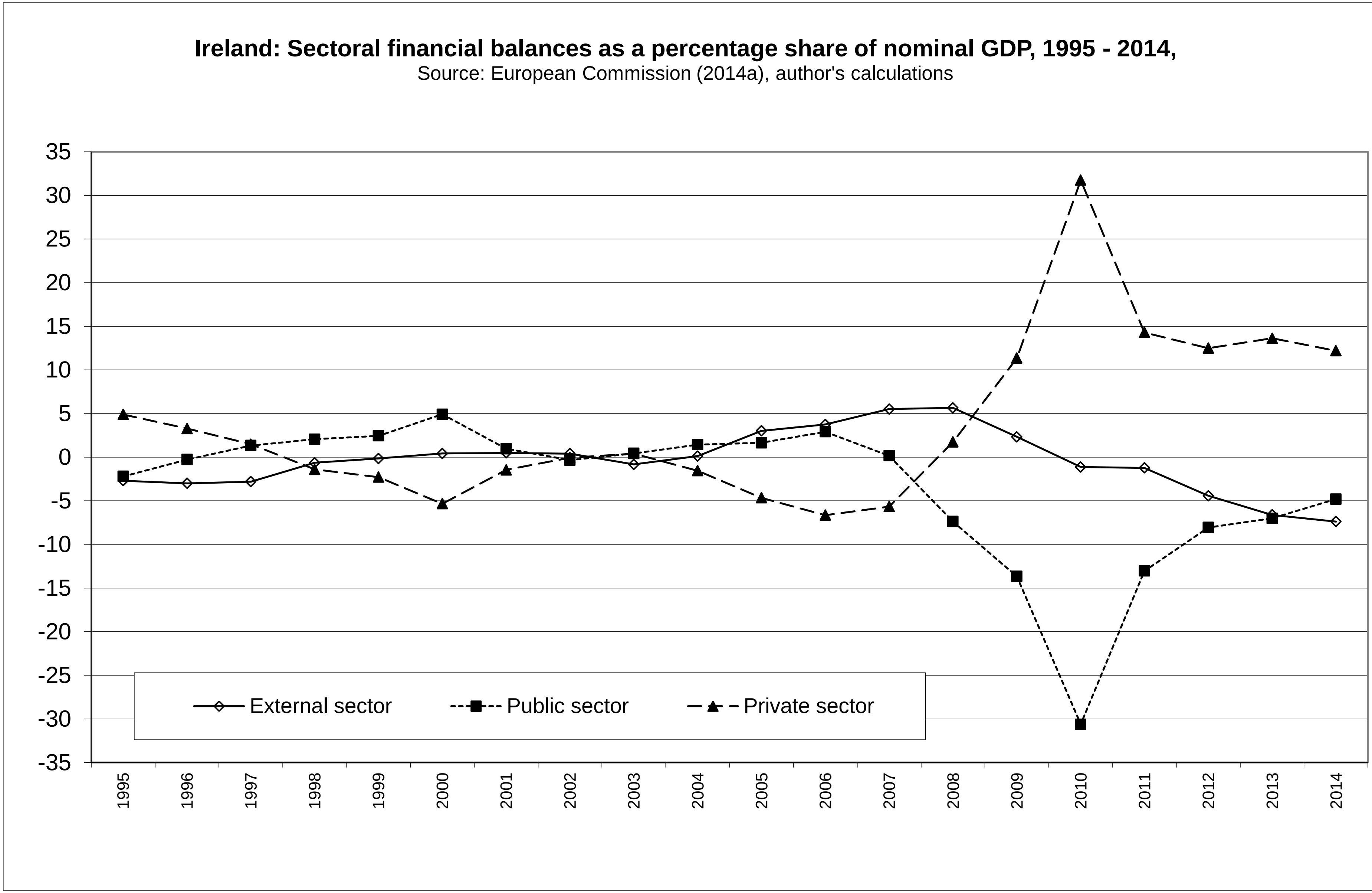
Measures do not properly address institutional deficiencies - and they are not based on sound macroeconomics either

  Public sector financial balance
+ Private sector financial balance
+ Foreign sector financial balance
= 0

➔ Public sector deficit (debt) maybe a consequence, but not the cause of the crisis



Public sector surpluses before the crisis turn negative when private sector turns positive in the crisis … problem was private sector deficit covered by current account deficit (external sector surplus)



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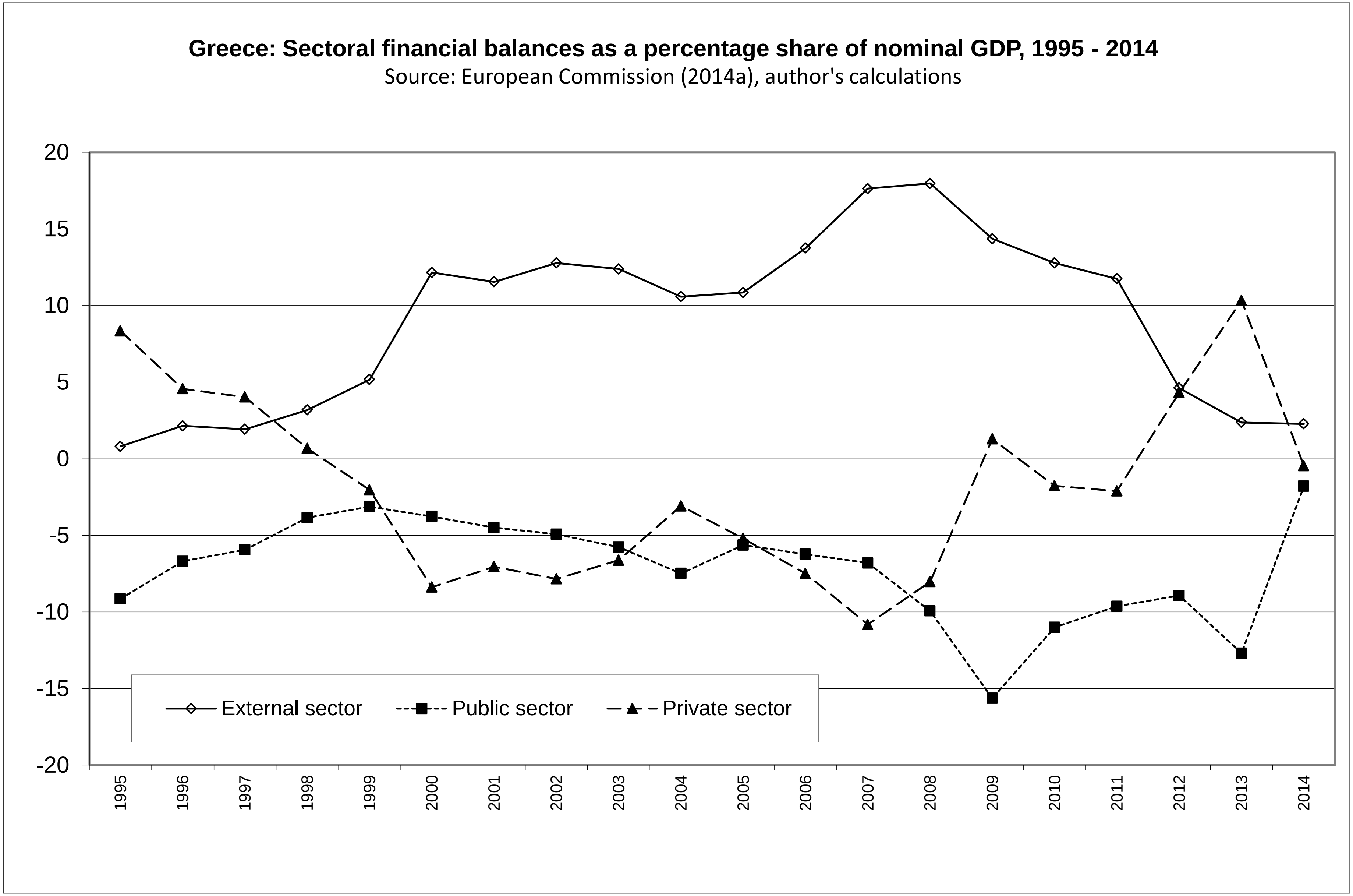
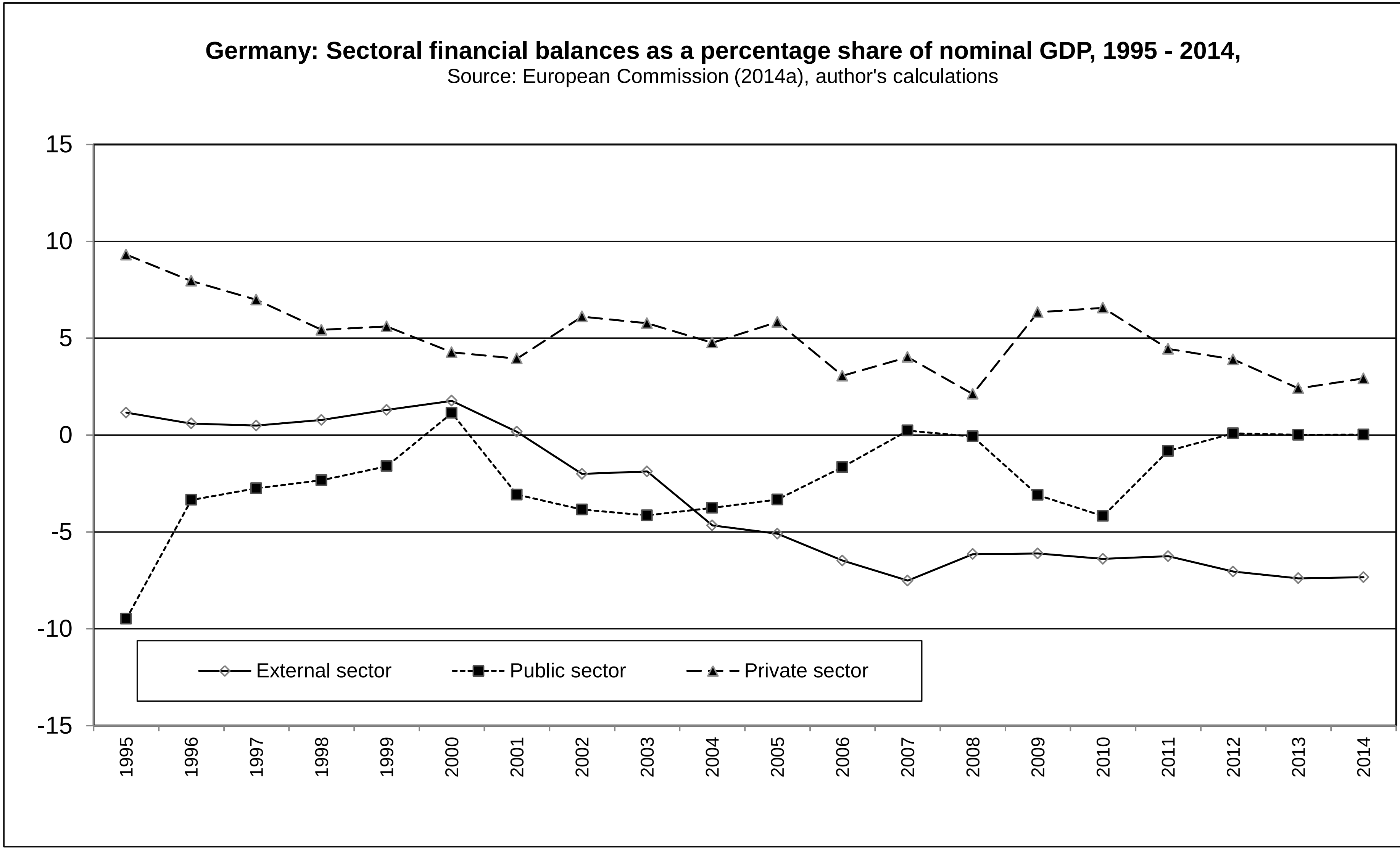


Private and public sector deficits before the crisis, public sector deficits increase when private sector improves in the course of the crisis … problem was current account deficit (external sector surplus)



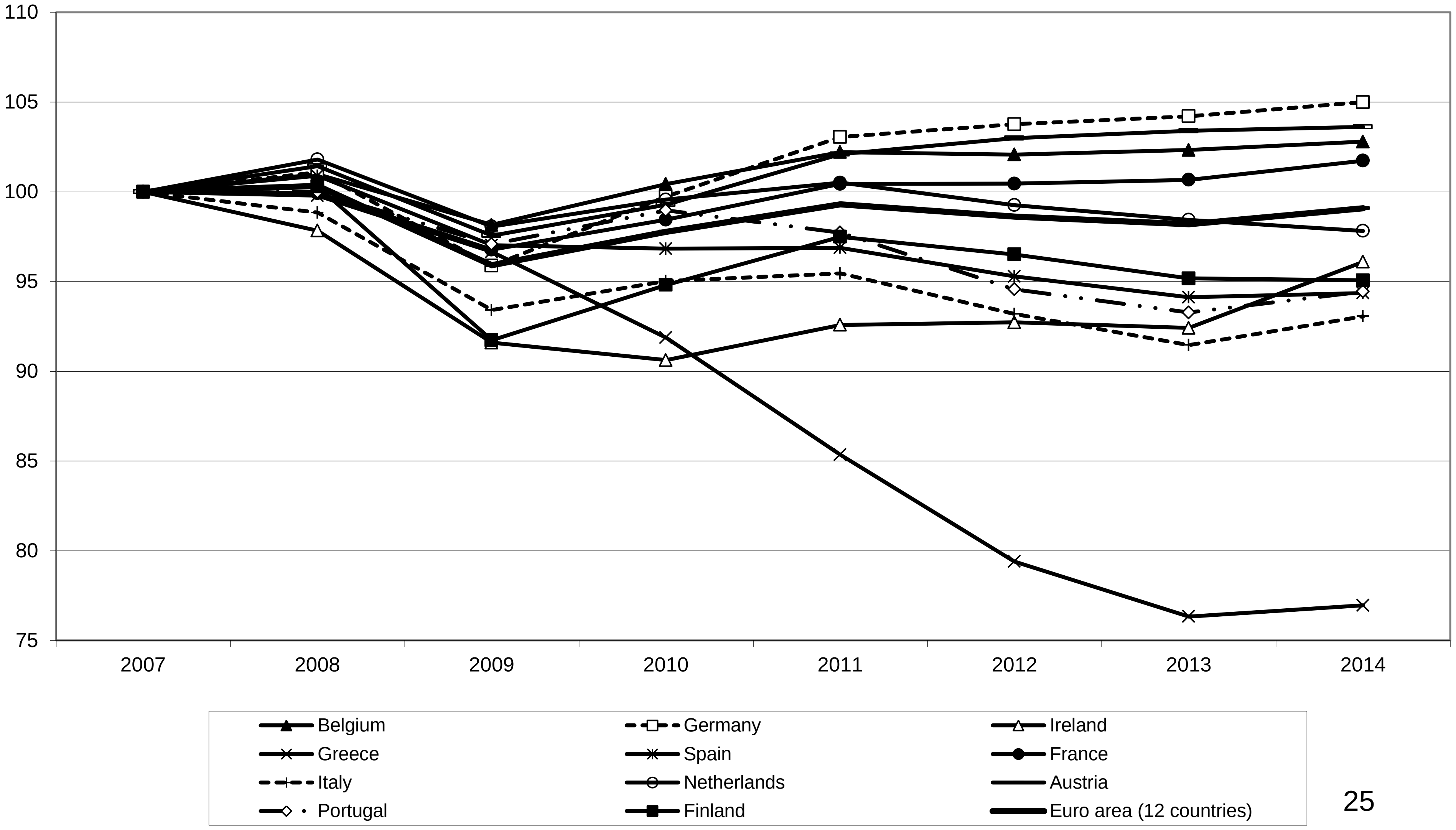
Germany, and the other ‚export-led mercantilist‘ economies as counterparts …

Private sector surpluses and current account surpluses (external sector deficits)

The effects of deflationary stagnation policies ➔ Paradox of thrift!

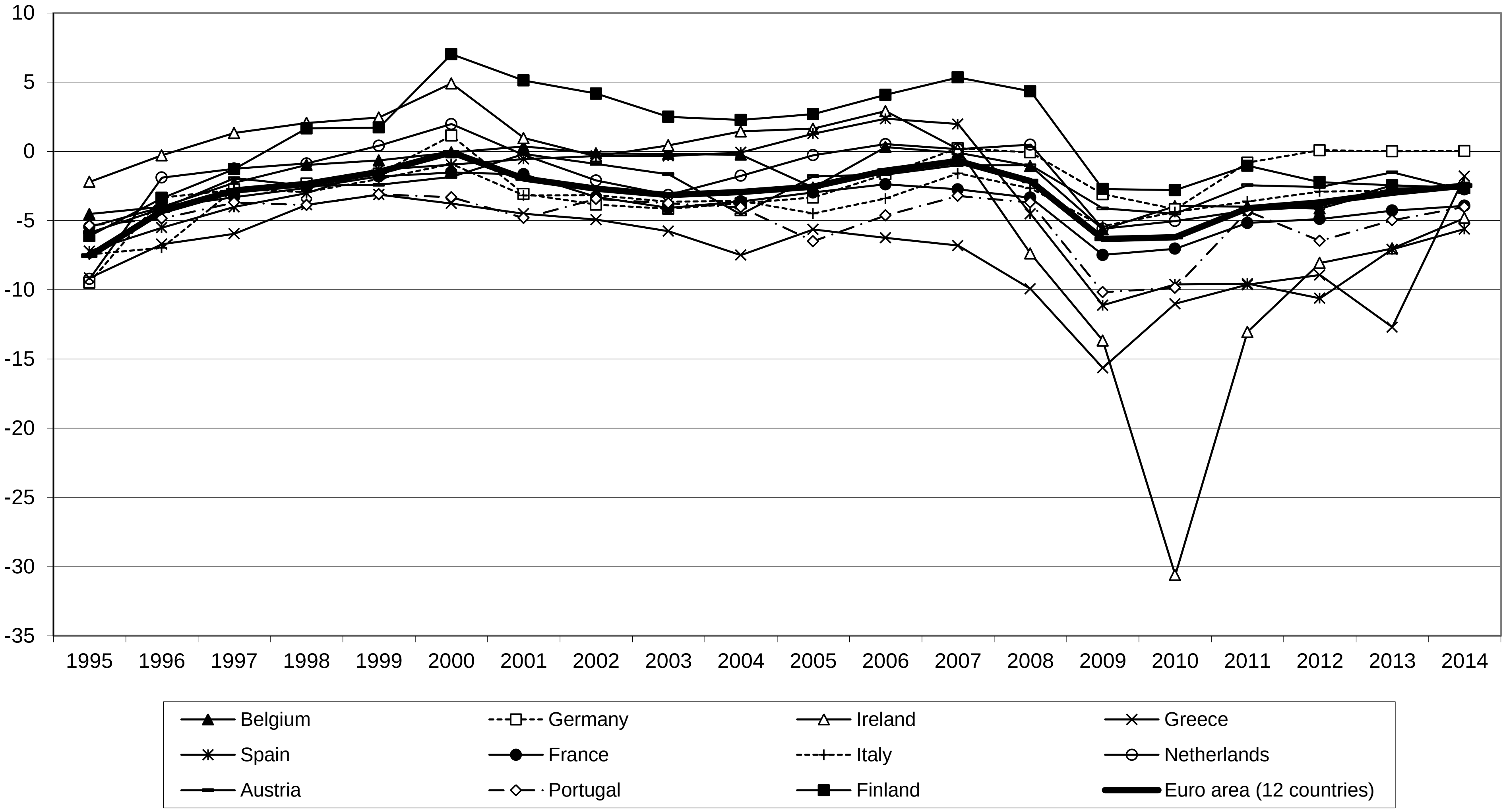
Real GDP, 2007-2014, 2007=100

Source: European Commission (2014a), author's calculations



Reduction in government deficit-GDP ratios …

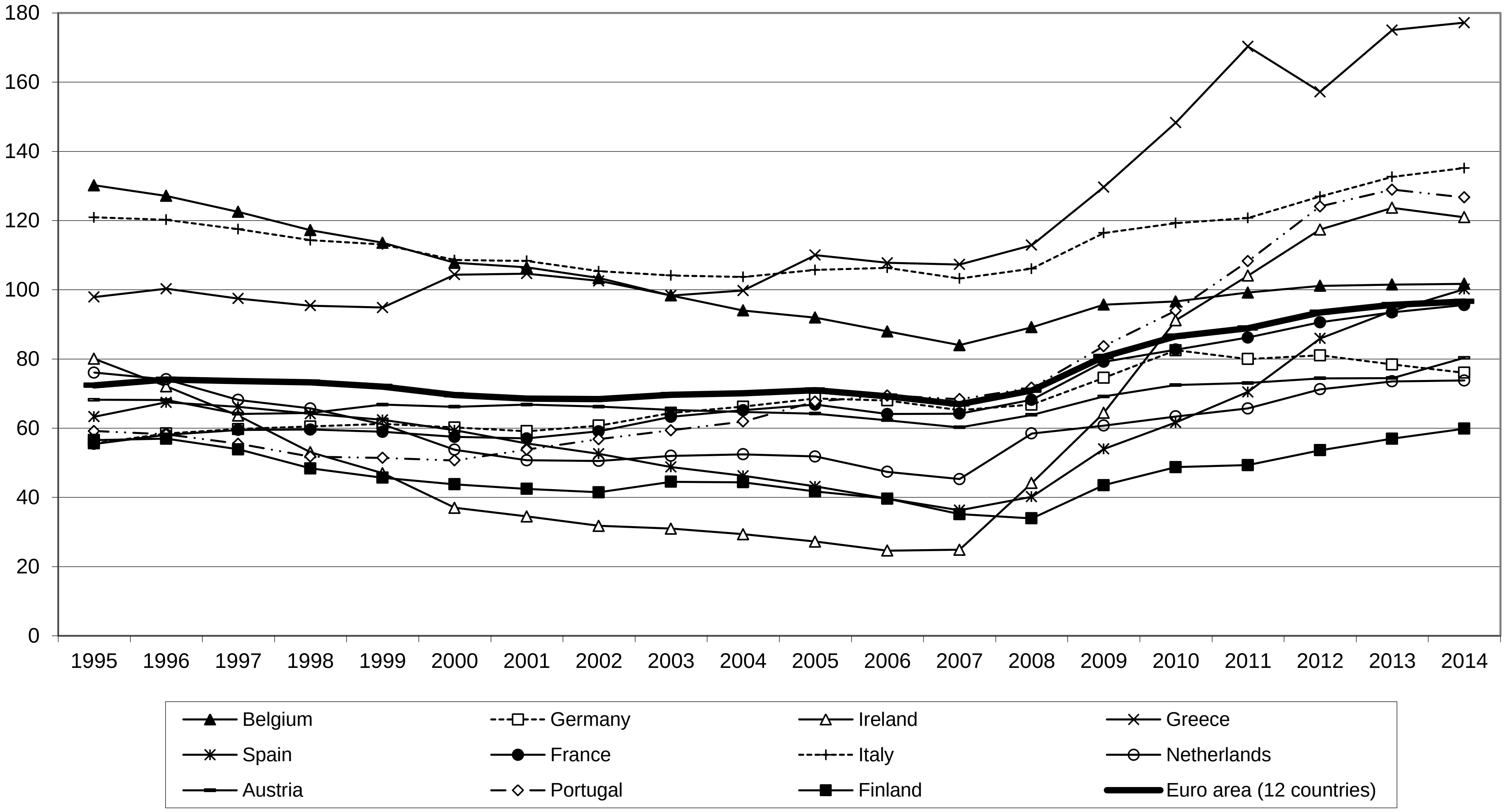
General government financial balance relative to GDP, in per cent 1995-2014
Source: European Commission (2014a), author's calculations



but increasing government debt-GDP ratios … ➔ paradox of debt!

General government gross consolidated debt relative to GDP, in percent, 1995-2014

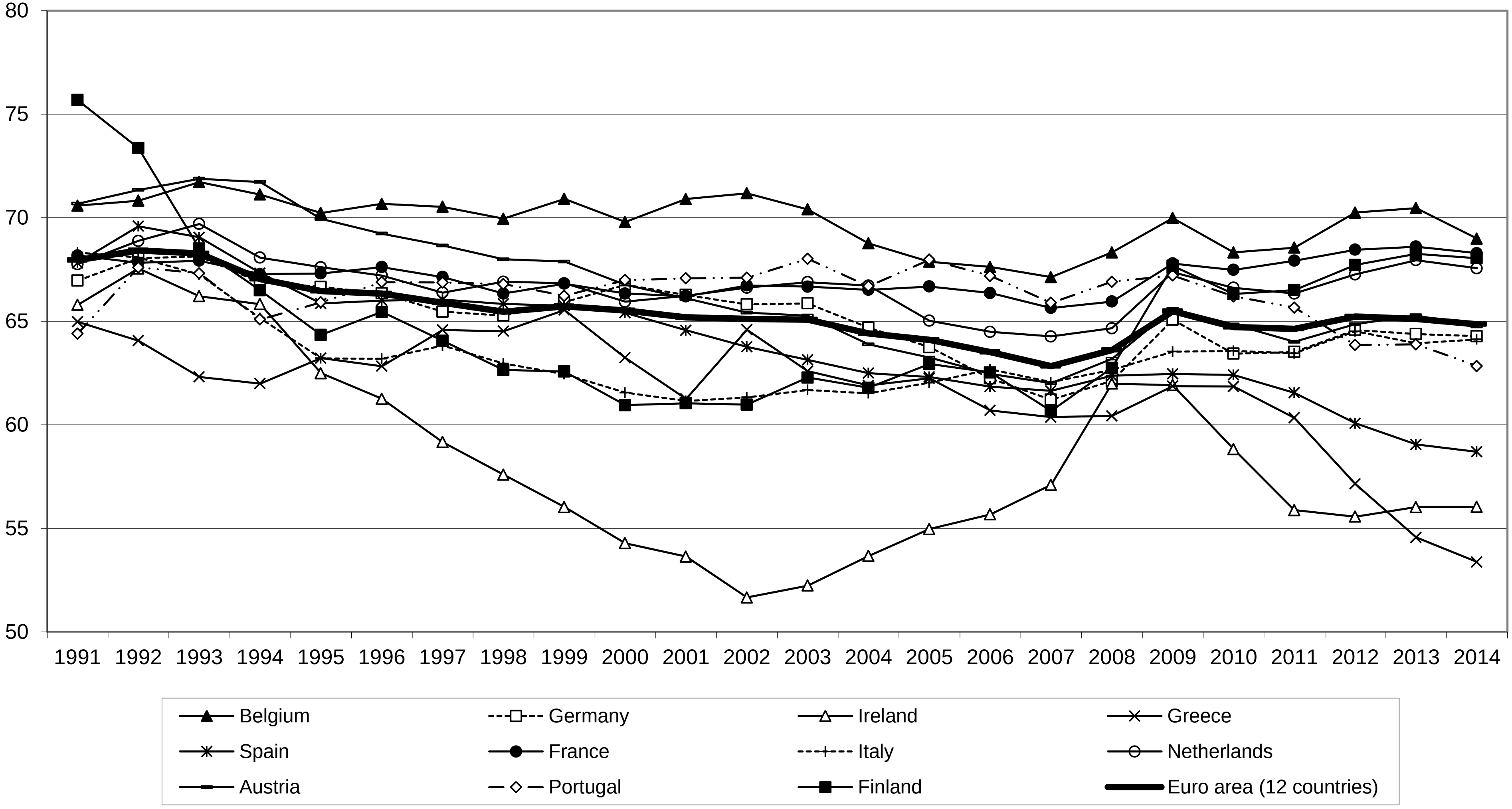
Source: European Commission (2014a), author's calculations



Redistribution of income in crisis countries ➔ paradox of costs

Labour income share as percentage of GDP at current factor cost, 1991-2014

Source: European Commission (2014a)



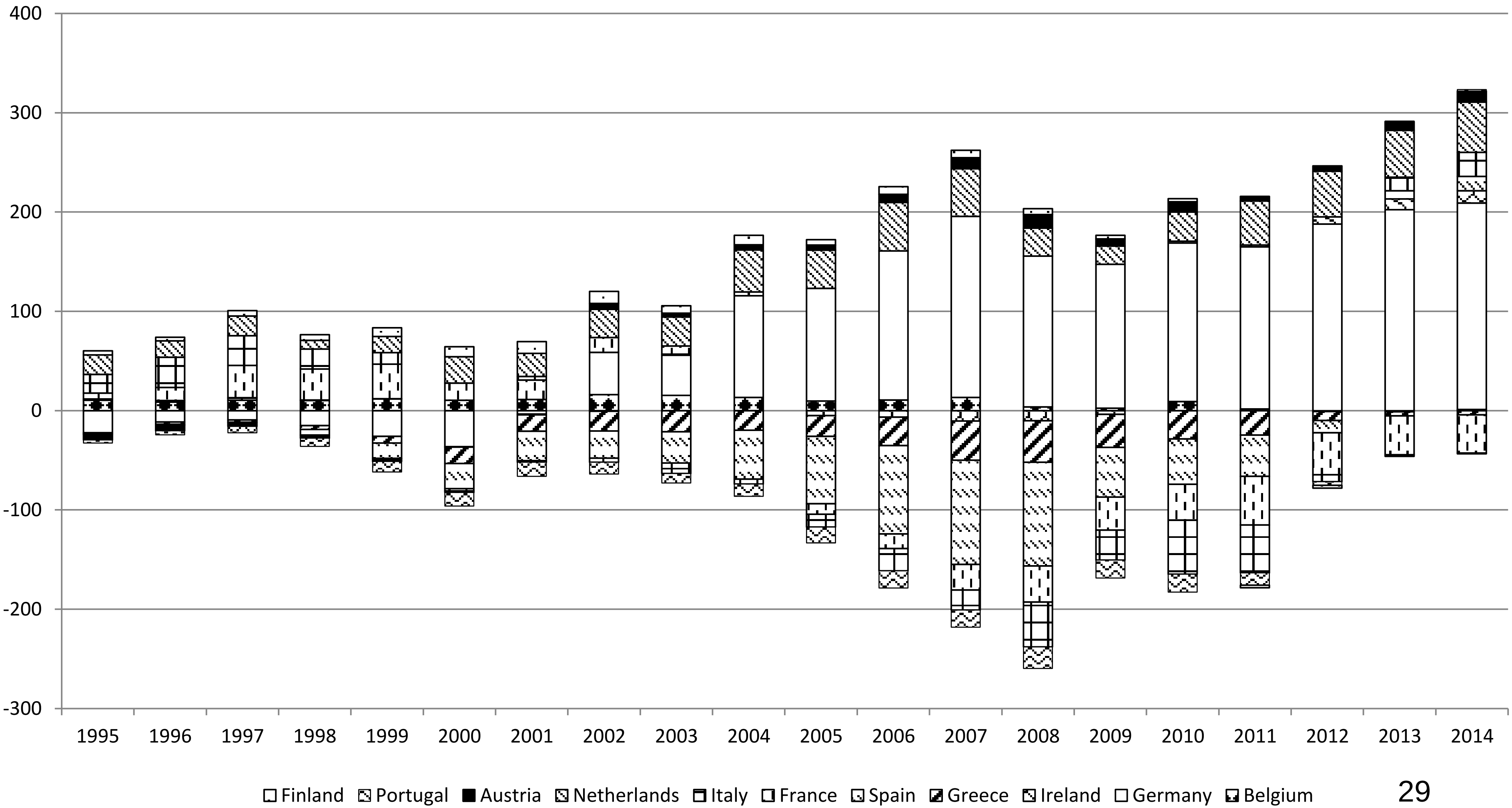
Current account defcits tend to disappear – but surpluses remain

CA surplus of EA 12: 1.5 % GDP in 2012, 2.3 % of GDP in 2014

➔ Euro area as a free rider of world demand (enlarged Germany?)

Current account in billions ECU/euro, selected Euro area countries, 1995 – 2014

Source: European Commission (2014a), author's calculations



Deflationary stagnation policies in the Euro area since 2010 have meant

- Massive real GDP losses (and related increases in unemployment not discussed here) in the former debt-led consumption boom economies as well as in Portugal and Italy, due to a policy induced (further) collapse of domestic demand;
- Some improvement in price competitiveness of these countries due to deflationary wage developments, with the exception of Italy;
- Some improvements in the current accounts, however, with considerable current account imbalances persisting in the Euro area as a whole and with rising surpluses of the Euro area with RoW;
- Reductions in government deficit-GDP ratios but continuously rising trends in government debt-GDP ratios;
- Persistent differentials in government bond yields;
- A further recession for the Euro area as a whole in 2012/13;
- An increasing risk of a final collapse of the euro as a currency.

PK Alternatives to deflationary stagnation policies

1. A central bank which convincingly guarantees public debt of Euro area member countries and which contributes to improved Euro area growth by means of targeting low real interest rates,

2. Fiscal policies along functional finance lines will have to be applied and coordinated across the Euro area, i.e. public deficits should mop up private sector surpluses at high employment levels of economic activity,

3. Wage and incomes policies should contribute to nominal stabilisation, prevent mercantilist strategies and the related imbalances, as well as falling wage shares,

4. Active industrial and regional policies will have to be applied in order to facilitate stable catch-up processes of the less developed countries and regions within the Euro area. This requires stable transfers from “North” to “South”.

➔ Hein/Detzer (2015a; 2015b)

- **ECB monetary policies**

a) Guarantee public debt

- The ECB should not only act as a lender of last resort for the banking system, it should also guarantee public debt of the Euro area member countries, allowing these countries to issue debt in their 'own currency'

- Announce that it will intervene into secondary government bond markets as soon as the rate of interest on government bonds exceeds the long-run nominal rate of growth of the respective country

b) Reform of ECB monetary policy strategy

- Take into account long-run distribution, employment and growth effects and refrain from fine-tuning inflation or other macro-variables
- Target low real long-term interest rates

c) Focus on financial stability

- **Fiscal policies and their coordination**

- **Abandon SGP and replace it by coordination of fiscal policies along functional finance** lines taking into account balance of payments considerations or establish a relevant EU (Euro area?) budget

- **Coordinate expenditure paths for non-cyclical government spending** such that aggregate demand in each country allows for non-inflationary full employment

- Actively coordinated **counter-cyclical policies** in case of shock

➔ on average over the cycle, and the average net tax rate given, government deficits in each country should roughly balance private sector surpluses (or deficits) G-T = S-I
➔ contribute to GDP growth close to BoP constrained growth rate (X-M = 0)

- **Labour market and wage setting**

- **Abandon the dominating policies of labour market flexibilisation** and of gaining competitiveness by means of nominal wage restraints (cuts)

➔ Re-regulation of labour market, stabilisation of labour unions and employer associations, Euro-area wide minimum wage legislation

- **Wage norm for wage bargaining co-ordination**: *nominal wage growth = national average trend of productivity growth + inflation target*

➔ contribute to stable wage share
➔ prevent neo-mercantilist strategies

- **Apply a symmetric approach to reduce imbalances**

Current account surplus countries:
- Expansionary fiscal policies beyond the norm for fiscal policies
- Increase inflation rates relative to deficit countries, i.e. increase nominal wages beyond the norm for wage setting

Current account deficit countries:
- Reduce inflation differential to surplus countries, i.e. lower unit labour costs growth below target inflation rate for the Euro area as a whole
- Increase income elasticity of exports (Italy, France, Portugal)
- Decrease income elasticity of imports (Greece, Spain, Portugal)
➔ Industrial, structural + regional policies ➔ transfers

ECB: Increase inflation target to allow for adjustment without deflation

- **Accept imbalances due to growth differentials and provide stable recycling of surpluses**

Criterion for tolerable CA deficits: growth of deficit country is sustainable and exceeds average growth of surplus countries

➔ Foreign liabilities-GDP-ratio of deficit country will not explode

Provide stable financial transfers from slowly growing mature economies to catching up economies

- Avoid asset price inflation and credit bubbles ➔ financial regulation
- Accelerate catching up ➔ industrial an regional policies
- Integrate private and public recycling in a coherent development strateg: European Investment Bank, European Regional and Structural Funds, …

THE END