Chapter Two
European Heterogeneity and the Crisis: The Need for Good Macroeconomic Policy

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This chapter considers the economic crisis from a macroeconomic perspective. It does not dwell on financial instability or the changes that need to be made in financial regulation. The first part focuses on macroeconomic problems raised to understand how much room there is for demand-side policies. The second part presents some key dimensions of European heterogeneity, which calls for fiscal transfers. Such transfers, between countries or between banks, can be achieved only after political consensus. Rarely has political uncertainty been as strong as it is today: macroeconomic outcomes in Europe depend heavily on political options, mainly through levels of transfer within Europe.

The Nature of the Problems We Face

Today, consumption is very low, savings rates are increasing and unemployment is high. The first step is to understand why private demand is low. There are two main viewpoints. It could be a necessary adjustment process for U.S. households to restore their wealth after a financial bust and expected increasing taxes. A second view is that high unemployment and precautionary savings may be detrimental to economic activity and welfare.

I will first consider the cause of low private demand and then discuss the uncertainty about potential output. I will then discuss the limits of the macroeconomic tools that can be used to increase private demand: fiscal and monetary policies. Both are highly constrained in Europe today.
1) **Low Private Demand**

There are three main explanations for low private demand in the United States today, and their impact on policy action varies greatly.

a) **Uncertainty about future taxes (Ricardian Equivalence)**

The first explanation is that the uncertainty of fiscal policy in the future is the main cause of low private demand today. Public intervention to sustain the economy has created huge public debt, which must be reduced. If not, high future taxes will only cover the interest payments on the public debt. Will taxes rise in the short run or not? Faced with such questions, households are inclined to save now to cope with a possible increase in taxes later. This is the classical Ricardian Equivalence argument.¹ The main issue here is thus the macroeconomic impact of fiscal consolidation. A lot of theoretical and empirical work has been done on the effects of changes in the level of public debt. Two works that stand out in the literature and present opposing viewpoints are Alesina and Ardagna and that of the International Monetary Fund.² In their 2009 study, Alesina and Ardagna find that in many cases fiscal adjustments that relied on spending cuts spurred growth, even in the short run. The IMF, on the other hand, in its October 2010 World Economic Outlook, states that fiscal consolidation will not increase private consumption, but will in fact decrease it, and decrease growth. Most importantly, the data showing that increasing taxes increases private consumption are not convincing. Although there may be a few specific cases in which that may be true, most works, such as that of Olivier Blanchard and Roberto Perotti,³ tend to show the opposite.

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¹ According to this economic theory, when a government tries to stimulate demand by increasing debt-financed government spending, demand remains unchanged. That is because the public is saving its excess money to pay for future tax increases that will be initiated to pay off the debt.


b) Reduction in permanent income: correction of a wealth effect after the housing bubble—deleveraging

The second explanation is that low private demand in the U.S. and Europe may be the effect of a re-evaluation of before-tax wealth by households. From Europe, the diagnosis is simple: the crisis originated in the United States, with a big macro shock, and then reached Europe. Europe in turn responded to the shock. There was no real European macroeconomic crisis, however, before the sovereign debt problem. The U.S. crisis destroyed a lot of wealth due to its real consequences and the correction of past expectations of high growth, which may have been too optimistic. Now we are seeing a correction of the wealth effect: people thought their wealth was high, so they consumed a lot, and now they are correcting for that period. This is a deleveraging issue, that is, people decrease their debt, because they realize that they are less rich than they thought they were.

These first two explanations do not require major policy intervention. Low private demand is a necessary response of households that realize that they are poorer than before. Implementing demand-side policy in this case would be like swimming against the current. In other words, there are no market failures in these first two explanations.

c) Precautionary savings (Paradox of thrift)

The third explanation is based on a Keynesian viewpoint, in the more modern sense of the term, which may be called “precautionary savings.” There is a lot of uncertainty on European labor markets. Consequently, households save to self-insure against unemployment risk. Faced with demand uncertainty, firms stop investing in order to keep some cash, as a form of self-insurance. Low investment reduces employment, which negatively affects consumption. In response to the precautionary savings issue, some arguments support active fiscal or monetary policy.

One could have a statistical debate about the relevance of the three viewpoints presented here. For me, the first view lacks relevance, the third is the most pertinent, but the second also deserves consideration.

2) Uncertainty about the output gap

Broadly speaking, the output gap is the difference between actual growth and the highest growth possible given technical progress, capi-
tal stock and labor market forces. A low output gap means that the economy is functioning below its potential growth. There is a lot of uncertainty about what the output gap is today in Europe. More precisely, we do not know what current potential output is, and the situation appears to be similar in the U.S. from what I have read about the debates going on in central banks. This is thus a highly debated issue. What will be the long-run growth and productivity trends in the coming periods? Will it be the same as the past growth trend? In central banks, a lot of policy mistakes were made in the 1970s—a period of high inflation—because central banks did not realize that the productivity trends had been drifting downwards for a very long time.\(^4\) Defining the long-run productivity trend and long-run growth is crucial for assessing the cyclical component. Numerous studies by the IMF and central banks confirm the high uncertainty about the relevant output gap. This is problematic, because one’s assessment of the output gap defines the monetary and fiscal policy action to be taken.

Now I will consider this issue along two dimensions: capital stock and the composition of the labour force.

**What type of capital has been destroyed by the crisis?**

Since the burst of the housing bubble, consumption has been collapsing and GDP has been falling. Nonetheless, nothing has been destroyed in the economy: plants are still running and a lot of human capital remains. Studies were carried out to examine which type of capital had been destroyed. In the U.S., one focus was to look at the destruction of human capital in the labor market due to long-term unemployment. In Europe, debate centered on the sclerosis of labor markets and how long-run unemployment is destroying human capital, which will eventually lead to a collapse of potential growth in output. Reviewing such studies a few years later reveals that long-run unemployment does not convincingly explain a huge fall in human capital.

**Human capital destruction, skills mismatching, break in the Beveridge Curve**

Some argue that skills mismatching and a break in the Beveridge Curve are sufficient for explaining that the current problems lie

within the labor market. Those who believe that a lot of capital has been destroyed in the crisis will favor supply-side economics rather than demand-side economics, which are fiscal or monetary policies. This broad debate may seem abstract, but it is necessary for assessing how far to go with demand-side tools in Europe and the U.S. today.

Although no hard data favor the supply or demand side today, many economists think that some demand-side policies are necessary to foster investment and consumption. The Federal Reserve Board (the Fed), for instance, has engaged in strong monetary actions to sustain growth. The U.S. federal government has delayed fiscal consolidation in order to avoid reducing demand in the short run. Once again, no strong quantification has prescribed the optimal demand-side policies that need to be implemented. Such policies are rather the result of a global macroeconomic assessment.

I will now turn to the constraints facing demand-side policy.

3) High public debt

It is difficult to identify whether high public debt is a problem or not. There used to be a consensus that high public debt requires high taxes to pay interest on the debt, the only problem being the distortion raised by those taxes. After the crisis, a new fear emerged—the default of a large country. A lot of focus has been on Greece, but it is not a big country, and a partial default on its debt would not have a huge impact on the banking sector outside of Greece. More frightening would be the default of a country such as Italy. Although unlikely, the fear alone of a default by world investors would be enough to prevent the proper allocation of capital in Europe.

In Italy, public debt has been above 100% for over 10 years now. Nevertheless, it is inaccurate to say that public debt is Italy’s main problem. No one will deny that it is a problem, but it is not the main one. The same is true for Japan and Greece, which also have public debts of over 100%. A closer look at Greece and Italy shows that the problem is not the public debt per se, but the fiscal base and political stability, in other words, those countries’ ability to raise fiscal revenue through political consensus in order to pay the taxes by way of their citizens.
There is more room for maneuver in countries like Germany. The condition for delaying fiscal consolidation is a credible commitment to raising taxes in the medium run. The main economic problem in Europe, however, is this lack of credibility. Indeed, delaying fiscal consolidation generates a high transitory public debt. This high public debt can be financed at a low interest rate only if the countries can credibly announce that they will raise taxes in the near future. One must recognize that some European countries have not shown in the past a strong ability to reduce public debt. In sum, fiscal consolidation needs to be on the agenda, but there is still some room for maneuver in the very short run. There needs to be a communication strategy of the EU countries to anchor expectations about sovereign default. A short-run increase in public debts can be used to sustain economic activity only if Europe as a whole finds a way to commit to fiscal consolidation in the countries with high public debts. This is now a European problem, which does not necessarily involve transfers among European countries.

I will now turn to monetary policy and what it could do when the aim is increasing private demand in the short run.

4) Zero lower bound

The zero lower bound—that the nominal interest rate cannot decrease below zero—is another problem to be addressed. The issue is bigger than is currently being presented. The eurozone is very close to the zero lower bound. Before that, however, other tools can be used, such as quantitative easing—buying bonds or private debt, or injecting money into the banking system or the economy as a whole. Careful examination shows, however, that the goal of quantitative easing is difficult to define. Is it to fight deflation, for which it has proved a powerful tool? Is it to provide liquidity to the banking sector? Unconventional monetary policies, such as quantitative easing, were used successfully in Europe to restore financial stability and avoid banks from going bankrupt (like those too big to fail). Such policies were used as a fiscal transfer towards some banks, which proved to be much more efficient than using drawn-out political processes. Quantitative easing is also used in demand-side economics to increase credit, through the credit channels, and private spending.
The unconventional monetary policies of quantitative easing are efficient in two cases—fighting deflation and providing liquidity to the banking sector. The latter was particularly used in Europe. They are less effective, however, for creating short-run expansionary policies. The problem with quantitative easing in the latter case is that it does not ensure that the money being injected will end up where planned. In the wrong hands, it may end up on the markets to increase individuals’ balance sheets and financial returns, rather than to increase the credit of firms and households. The transmission channels of monetary policy close to the zero lower bound are thus very low. Fiscal policy, on the other hand, is a more efficient tool when trying to increase private demand in the short run. I will now present the nature of problems that Europe is facing.

The Need for Transfers Inside Europe

1) The dimensions of heterogeneity

Heterogeneity is the main problem in the eurozone. It contains both one of the strongest economies in the world—Germany—and one of the weakest—Greece. In this section, I will explore the dimensions of Europe’s heterogeneity that are problematic today.

a) Strong and weak banking systems

The eurozone has countries with strong banking systems, which are often helped by their governments, and fragmented banking systems. Such heterogeneity strongly affects the transmission mechanism of monetary policy and the actions that need to be taken.

b) Exchange rate exposure

Different industrial structures of eurozone countries can cause wide variation in their exposure to the exchange rate. Germany, for example, does not fear exchange rate movement much, because it exports high-quality goods and produces mostly in Germany. Its neighbor France, on the other hand, is much more vulnerable to such movements, because it produces abroad and repatriates its profits.
Within the eurozone, there are also large differences in countries’ public debt level. Some, like Greece and Italy, have high public debt while others, like Germany and France, have relatively low public debt of around 60-70%.

All this heterogeneity therefore creates a problem for the eurozone, which is often reduced to the moral hazard issue. The moral hazard arguments can be summarized as follows: one should prevent any transfers that could create incentives to cheat in the future, so as to benefit from these transfers a second time. There is some truth to that, but I will also criticize this viewpoint. To understand moral hazard, one has to grasp the dimensions of heterogeneity described above. Within this framework, the next section first explores monetary policy and the issue of “persistent banks,” and then turns to the subject of fiscal policy.

2) Heterogeneity and moral hazard

a) Monetary policy and persistent banks in the euro area

First, let us look at monetary policy. The moral hazard described above is that of persistent banks. There is an interbank market, which works well from time to time. Recently, the sovereign debt crisis has created fears within the interbank market, in which the same bank lends to the others. The market is segmented, because some banks rely heavily on money from the European Central Bank (ECB). In that case, they are excluded from the interbank market, because they are weak and the other banks are afraid to lend to them.

The ECB believes that applying loose monetary policy over a long period of time will result in such banks not being able to clean up their balance sheets. The fear is that they will have lots of hidden risks, so that even a small adverse shock will end up being a great credit risk on the asset side of such weak banks. In response, the ECB has asked national governments to help those banking sectors by injecting public money. This has political costs, however: given the recent financial turmoil caused by the banking system, it is difficult for governments to justify to voters that they now need to help that same banking sys-
tem. If governments decide not to help, they can rely on the money of the ECB, which does not cost them much in the short run. There is thus a complicated game going on between national governments and the ECB as they try to clean up the whole banking system in the eurozone. This is the first dimension of moral hazard. It also explains the recent extreme discourse of some top Bundesbank executives on whether or not national governments should take the responsibility of putting citizens’ money into the banking system.

\textit{b) Fiscal policy in the euro area}

The second moral hazard issue concerns fiscal policy. There will be fiscal transfers to some indebted countries to cope with the crisis. Many countries fear that such transfers will become structural due to those countries’ inability to pay back the borrowed money within the given time limit. A lot of sanctions are being put on such countries to pay back their debt, rather than default.

This moral hazard issue is a new way of putting old arguments about political economy in front of the heterogeneity of interests across the euro area. Germany is rich and powerful and can deal with its banking system problems on its own. Like France, however, it must inject money into other countries in order to diffuse the crisis that is taking over its neighbors. But what is Germany, or France’s interest in doing that? Which rules can be enforced to ensure, for example, the long-run interests of the German tax payer? This is a very difficult issue, and a political one: what are German voters’ long-run interests in building Europe? The rise of nationalism that is scaring Europe shows that there is a serious need for European governments to understand long-run interests when dealing with the short-run problems caused by the crisis.

\textbf{Conclusion}

In sum, the central problem in the euro area is the political one of understanding what the common project is today for the European Union. It is the only way to justify the transfers that need to take place within Europe. Fiscal tools are more efficient in times of crises than monetary ones, and they need to be used. Indeed, there are some
arguments about increasing private demand in the short run. Consolidation must happen, but in incremental steps. The next big step for Europe is to agree on fiscal governance. Many economists would like to see an agreement reached fast, but this is a complex process that will take some time. It is vital to find the right institutional tools for dealing with these moral hazard issues in the euro area.

Europe is moving in the right direction, because there is discussion at the political level about transfers in this time of crisis. EU policymakers are focusing on how to obtain a more homogenous economy and reach an optimal currency area. This nonetheless remains only a goal today, and does not represent the current state of affairs in the euro area.