

The basic paradigms of the EU economic policy-making need to be changed

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Abstract

Anaemic growth of the EU/euro area derives from its economic paradigms. The principle *'one size fits all'* behind ECB policy activates centrifugal forces. Diverging trends in unit labour costs, external competitiveness and external balances follow. German policy actively supports this. An *'excessive external surplus procedures'* against countries generating large surpluses at the expense of domestic consumption (and the partners' rising debt) should be instituted. The Stability and Growth Pact needs modification. The 3% fiscal deficit/GDP mark may prevent automatic stabilization. Insistence on the budgetary positions being *close to balance or in surplus* lacks rationale. Observing that requirement must fail when the private sector's propensity to save is larger than its propensity to invest. A permanent fiscal deficit may be secular necessity. Problems related to rising public debt may also need to be addressed. For the euro area these problems could be rendered far less serious than often believed.

Key words: EU, ECB, euro area, external imbalances, Stability and Growth Pact

JEL Classifications: F15, F33, E12

1. Introduction: are we all Keynesians now?

The outbreak of the financial crisis in 2008 – and the ease with which it engulfed the 'old' part of the EU – can be interpreted as conclusive evidence of the inadequacy of much of the fundamental economic paradigm, on which the economic architecture of the European Union has been built. Liberalized, integrating and deepening private financial and capital markets in Europe have failed to minimize and allocate risks efficiently. Financial and capital markets proved capable of generating and accumulating risks instead of reducing and spreading them. Banks and other financial sector institutions engaged on a massive scale in irresponsible practices that were tolerated – or even supported – by 'market forces' (and ignored by the supervisors/regulators). Unleashing the latter forces was – in no small measure – due to the influential doctrine that the financial market tends to be 'efficient' on its own accord (i.e. when free of administrative interference). Significantly, akin to the Asian crisis of the late 1990s, the crisis – at least in Europe – has been generated solely by 'market forces' running amok – and not by governments being fiscally irresponsible. Prior to the crisis, the EU national governments had in general displayed great prudence. The behaviour of Greece was very much the exception. Most European governments (including

those of Spain and Ireland) had been consistently reducing public debt/GDP ratios, lowering the deficit/GDP ratios or generating handsome surpluses. Portugal's fiscal deficit had also been lower than 3% of its GDP. Net general government borrowing was 1.4% of the EU GDP in 2006, followed by 0.8% in 2007¹. The abrupt rise in public debt levels in a number of countries in 2009 has come about in part from the governments being forced to assume huge unserviceable debts created by private financial market institutions. To date, public money amounting to about 2.5% of the EU GDP has been injected into the financial sector – primarily in the form of recapitalization². The possibility of the private sector first engaging in wild speculations only to end up in mass insolvency is ruled out in contemporary mainstream economic theory. Consideration of such an eventuality had, however, featured quite prominently in the original writings of J.M. Keynes and some of his followers (such as Hyman Minsky). Fortunately, when the hour of need came, policy-makers did not resort to inaction that would have been consistent with the mainstream paradigms, but responded to the unfolding disaster with forceful measures that smacked of Keynes. It must be admitted, however, that in some countries, such as Germany, it took a while before steps were ultimately taken.

Extraordinary actions taken by EU governments and the European Central Bank (ECB) averted a catastrophe. However, while these actions are acknowledged to be Keynesian, 'we are not all Keynesians now'. Little has changed in the decision makers' minds. Numerous statements emanating from the ECB and the EU Commission make this point crystal clear. It is worth quoting the opinion of Jürgen Stark, a member of the ECB Board: *'There is no doubt that the exceptional fiscal policy measures and monetary policy reactions to the crisis have helped to stabilize confidence and the euro area economy. Following the substantial budgetary loosening, however, the fiscal exit from the crisis must be initiated... to be followed by ambitious multi-year fiscal consolidation. This is necessary to underpin the public's trust in the sustainability of public finances. The Stability and Growth Pact constitutes the mechanism to coordinate fiscal policies in Europe. ... Sound and sustainable public finances are a prerequisite for sustainable economic growth and a smooth functioning of Economic and Monetary Union.'* (ECB, 2010, p.7)³.

The revival of pre-crisis instincts is manifest also in discussions about 'exit strategies', and hurried fiscal consolidations already underway throughout the EU. According to the European Commission's 2010 Spring Economic Forecast, EU public consumption is projected to rise by about 1% in 2010 and hover around zero in 2011 (it used to rise by more than 2%). The general government's primary deficit in the euro area is projected to fall from 3.6% of the GDP in 2010 to 2.9% in 2011. Interestingly, the fiscal stringency in the USA will be very symbolic, with the primary deficit/GDP ratio dropping from 7.2% in 2010 to 6.8% in 2011. Public consumption in the USA does not show any signs of restraint: it is to rise by 2.3% and 2.7% in 2010 and 2011, respectively. These characteristics should be seen in the real context: GDP growth is expected to remain weak in Europe – and to rise fairly vigorous in the USA.

Even before the global storm is really over, the orthodox opposition to Keynesian economics seems to be gaining the upper hand once more. Is Keynes only relevant under exceptional circumstances? We would claim otherwise. While Keynesian prescriptions have proved invaluable precisely under such circumstances, they may be equally essential during 'normal' times. In particular, what is termed 'sound macro-policy' as conducted in 'normal' times may have led to disappointing results – anaemic or stagnant long-term growth in Europe that has prevailed since the early 1990s. That might change for the better with policies becoming 'more Keynesian'. Moreover, the 'sound macro-policy' paved the way for the external imbalances across the Union. The overall EU economic policy framework seems to be in need of repair. That repair must acknowledge, among other things, the inadequacy of the Stability and Growth Pact as a mechanism for policy coordination in Europe. Of course, the repair of the coordination mechanism requires a depth of analysis

that goes beyond the current economic policy paradigms – and even beyond Keynes. The common monetary policy must be reconsidered first.

2. The single monetary policy unleashes centrifugal forces in the euro area

The litany of complaints and objections aimed at the common monetary policy pursued by the ECB is quite lengthy. Unlike the US central bank (the FED), the ECB displays no sensitivity towards real-economy developments. It focuses on inflation; it adheres to an exotic and outdated monetarist criterion, etc. Furthermore, its policy lacks balance: it is very swift to tighten things up even if the signs of rising inflation are largely imagined, but is very slow to relax things if the threat of inflation is no longer seen. Moreover, the 2% upper limit for acceptable inflation seems too restrictive (and in practice unattainable anyway). While rejecting any outside ‘interference’ in its goals or operating practices, the ECB feels obliged to censure fiscal, social, ‘structural’ or wage policies of individual member countries. Until recently the ECB did not care about the financial stability of the euro area banking system.

The above objections are surely valid, yet they can be constructively addressed, even while leaving the gist of the relevant EU treaties intact. But addressing a fundamental flaw in the design of the ECB policy may require more far-fetched modifications. Carrying through these modifications could well call for a more radical overhaul of the European politics, far beyond the narrow monetary domain. The future will show whether it is realistic to expect such changes. In any event, it is important to realize that the fundamental flaws in the design of the common currency incur the possibility of derailing also the whole European Union.

2.1 One size fits all’?

The original sin of the common monetary policy lies in its being defined as applying uniformly to a vast area comprising countries that had differed greatly in many aspects before switching over to the common currency. The nominal convergence process (the fulfilment of the Maastricht criteria) could not eliminate the deeply-rooted differences. Conditions defined in the theory of Optimum Currency Areas were not met. Different national inflation rates (and the rates of growth of nominal wages and unit labour costs) refused to leave their entrenched paths and align themselves. Inflation in traditionally low-inflation Germany remained lower than in the traditional high-inflation countries such as Italy. The common monetary policy abstracts from the variations in inflation rates. It responds to the *average* inflation calculated for the whole area and determines policy interest rates to control that average euro-area inflation. But the interest rate for controlling average inflation rate may be unsuitable for controlling inflation in each and every individual euro area country. For low-inflation countries, the ECB policy rates may be too high, while they may be too low for the high-inflation countries. The principle of ‘one-size-fits-all’ may not work well in real-life economics. The fiction of one (‘optimal’) currency area with one inflation rate being served by one monetary policy leads to higher (and positive) real interest rates in low-inflation countries and lower (or negative) real interest rates in high-inflation countries. Other things being equal, expansion of lending to the real economy decelerates (or stagnates) in low-inflation countries and accelerates in high-inflation countries. Consequently, real growth in low-inflation (thus presumably slow-growth) countries gets slower, while the opposite happens in high-inflation (thus presumably fast-growth) countries.

The common monetary policy acts pro-cyclically as it strengthens the trend towards stagnation/deflation in weak-growth/low-inflation countries and accelerates growth-cum-

inflation in countries that are close to a boom. Overall, the common monetary policy has the potential to *enlarge* the cross-country differentials in inflation and growth rates. That potential has materialized in the euro area: low-inflation Germany has remained a low inflation (and low-growth) country; high-inflation Spain and Ireland have gone through a decade of high inflation and exuberant (credit-driven) real growth⁴.

The differential effects of the uniform policy have also helped to generate high fiscal deficits in some countries. Low (or negative) real interest rates on public debt facilitated public debt servicing in the high-inflation countries. This may have induced some of them (e.g. Greece) to pursue a rather lax fiscal policy. Servicing public debt in low-inflation countries has been much more troublesome, thus encouraging those countries to undertake renewed attempts at fiscal consolidation. Those attempts, however, did not always succeed (as proven in 2003 when the French and German governments initiated a 'reinterpretation' of the SGP). The reason for the difficulties of implementing fiscal consolidation in low-inflation countries is straightforward: fiscal austerity under overall stagnant growth/very low inflation is almost certain to have a negative impact on both real growth *and* the fiscal position.

2.2 The other side of the (euro) coin: the rise of external imbalances within the euro area

The policy-induced divergence in inflation nurtures diverging trends in average wages. Nominal wages in high-inflation/growth countries tend to rise faster than in low-inflation/growth countries. Diverging price and wage developments erode the high-inflation countries' competitiveness vis-à-vis the low-inflation countries. Devaluation of the nominal exchange rate, which had been the winning strategy for securing the competitiveness of the Italian economy, for example, has been of no avail since 1997⁵. Certainly, rising wages in high-inflation countries need not anticipate losses in external competitiveness against the countries with stagnant (or less rapidly increasing) domestic prices and wages. Under conceivable conditions, labour productivity growth may outstrip the rate at which wages increase. The unit labour costs in the tradable sector of such a high-inflation country might even decline or rise less than in a low-inflation country, thus even strengthening the competitive position of the high-inflation country⁶. But, should productivity keep increasing at more or less equal speeds across the euro area, the low-inflation countries would inevitably gain at the expense of the high-inflation countries. Under the current conditions prevailing in Europe, the differential developments in wages have proved to be quite essential to developments in relative unit labour costs. As expected, Germany has been out-competing Italy and Spain (and most other members of the euro area) on unit labour costs. This, in turn, is well reflected in the growing external imbalances – with Germany becoming a country with a huge external (trade and current account) surplus, while most of its other euro area partners are slipping into high and rising external deficits. These trends temporarily weakened somewhat in 2009 when Germany's partner economies went into recession.

2.3 Germany's revenge for high real interest rates

The tendency of Germany to outcompete others on unit labour costs has *not* been entirely due to the free operation of market forces. Since at least 1995 the successive German governments have pursued policies promoting cuts in unit labour costs. Germany has gone through successive waves of 'labour market reforms' aimed at enhancing the market's 'flexibility'. Increased labour market flexibility is a polite term for greater licence to revoke workers' traditional rights and to 'downscale' the labour codes that had safeguarded employees' living standards. Transfer payments to both low-income employees and the unemployed were curtailed – apparently to increase the labour supply (as if there were a labour shortage, not high unemployment). In its capacity as the employer of a large segment of the workforce active in the public service sectors, the German government has sought to economize on wages and employment levels. This has had a direct influence on wage negotiations between the trade unions and the private business. That the

government mediated in these negotiations and demanded 'wage moderation' goes without saying. High unemployment – and the prospects of production being 'outsourced' to low-wage countries – helped to reduce wage aspirations. All these policies contributed to suppressing the growth of real (and even nominal) wages – despite the steady rise in labour productivity. Finally, these policies were capped by fiscal measures that lowered the non-wage labour costs borne by firms as well as the taxation of company revenues. In exchange, the indirect tax burden on domestic consumption (and imports in particular) has been raised⁷. One direct consequence has been the external hyper-competitiveness of the German economy. However, the country is paying quite a high price for all this. Depressed wages result in depressed domestic consumption also of services which do not need to compete externally. All this helps to compound the overall stagnation/deflation character of growth. Average GDP growth in Germany (over the period 1999-2008) falls short of an unimpressive 1.4% – against 2% for the whole euro area. Germany's partners (taken together) grew much more rapidly, although they too were not very impressive either. However, the differences in the sources of growth are striking. Foreign trade generated most of the growth in Germany (0.9 percentage points out of the overall 1.4%). In the entire euro area (including Germany) the contribution of foreign trade to growth was symbolic (0.2 p.p.). Growth in Germany's partners in the euro area was *reduced* by foreign trade developments. The German '*beggar thy neighbour*' policy does indeed work; however, it has turned out to be a '*beggar thyself*' policy.

2.4 Further unpalatable consequences

The German wage developments have a number of consequences, of which the emergence of huge external imbalances across the euro area is but the first. Those consequences are harmful not only to Germany's euro area partners, but also to Germany itself. Germany's GDP gains actually represent its partners' GDP losses. While actually representing a loss, the trade deficit allows current domestic consumption-cum-gross capital formation to exceed domestic production. However, when a country's actual absorption is in excess of its own production (viz. Greece), it implies incurring foreign debt of whatever kind (or sale of domestic real assets to foreign parties, for example, via privatization). Sustained and rising external deficits are tantamount to accumulating net external debt. Mirroring the situation of a deficit country, a chronic surplus country (such as Germany) produces more than it can actually use (its domestic absorption is lower than domestic production). In effect, the surplus country accumulates claims against its partners; in essence, it is lending to them – one way or another⁸.

A 'normal' chronic deficit country (unlike the USA which – for specific reasons – is quite exceptional) cannot accumulate foreign debt indefinitely. Sooner or later, it becomes obvious that such a country will be unable to service its foreign debt, whereupon it will normally be refused any additional credit. After a decade of sustained and rising external deficits, several euro area countries (that have failed to emulate German wage and fiscal policies) are now becoming bad credit risks. Those countries will now have to pay dearly for the years of domestic consumption-cum-investment in excess of their domestic production.

The debt crisis of countries outcompeted by Germany backfires on Germany itself. Ultimately, a large portion of that debt is owed to Germany⁹. Attempts to service that debt would require that the countries that have lost competitiveness and have followed an import-fed growth path suddenly become major net exporters. Obviously, those countries may be able to suppress domestic consumption and investment. But would this automatically make their tradable goods (assuming they exist) and services attractive – in price/cost terms – to potential foreign buyers? Where are such importers to be found? Surely not in Germany whose formidable competitive advantages will not disappear anytime soon. Ultimately, Germany may have to swallow some losses on these debts.

More precisely, the German government may be forced to recapitalize German commercial banks and other financial market institutions owning large portions of bad foreign debt. Parts of Germany's past current account surpluses (and handsome profits earned by German private-sector exporters) will end up as increments to the German *public* debt.

2.5 *The illusion of orderly 'rebalancing'*

The idea that diverging competitiveness trends within the euro area may have disturbing consequences only dawned on the EU Commission in 2008. The recent Commission Report (EU Commission 2010a) finally acknowledges the problem. However, it fails to recognize its fundamental causes. Worse still, the Report's *main* policy suggestions seem either irrelevant or counter-productive. 'Rebalancing', meaning the reduction of inter euro-area trade imbalances, is to be achieved essentially through the efforts of high-deficit countries which '*...need both to regain competitiveness and address the sources of persistent weakness in domestic savings*' (Report, p. 38). As far as the latter goal is concerned, not much can in practice be achieved, if countries continue to run large external deficits – i.e. *not before* 'rebalancing'. As long as those countries are offered competitively-priced foreign goods (and cheap foreign credits to purchase them) they will run external deficits. Only by regaining competitiveness can they raise domestic savings. As far as the former task is concerned, '*Reforms of labour markets should naturally be top of the agenda to improve the functioning of competitiveness adjustment*' (Report, p. 41). In plain English, the policies of the deficit countries should be to bring about wage *deflation* which to eliminate the unit labour cost advantages that Germany has accumulated over the past 10-15 years. Because of the impossibility of nominal exchange rate adjustments, 'internal devaluation' – or deflation – remains the only route to regaining competitiveness. However, bearing in mind that nominal unit labour costs in Germany have hardly changed since 1999, while rising about 25-27% in the euro area, the Report's advice is unconstructive on practical grounds. Actually, it is destructive. Massive (and/or long-lasting) deflation would throw the economy into a deep and prolonged depression associated with a drop in domestic consumption and investment. This is the danger facing Greece. Besides, the levels of unemployment and overall misery that would have to be engineered in order to coerce labour into accepting double-digit rates of decline in nominal (and real) wages would have to be enormous. Finally, even if successfully completed, 'rebalancing' on this scale would at best make the country concerned similar in character to Germany: i.e. excessively dependent on exports and otherwise displaying anaemic growth. Worse still, the 'rebalancing' may induce others to tighten *their* wage policies still further. Achieving victory through an iron wage policy may be impossible for nations lacking the German standards of discipline.

The Commission Report does not see anything wrong with the competitiveness gains achieved at the expense of domestic wages, consumption and investment. '*The policy response to intra-euro-area macroeconomic imbalances should obviously not include a call for reduced competitiveness in surplus countries...Strong competitiveness in all euro-area Member States, including surplus countries, is in the interest of the euro area as a whole.*' (p. 38). What the surplus countries may try to do is '*...to tackle structural impediments to domestic demand...*' (p. 38)¹⁰.

2.6 *Euro area accession of the new member states: risks underestimated*

When joining the EU, the new member states (NMS) made a pledge to join the euro area: of course, after dutifully fulfilling the Maastricht criteria. (Unlike the UK, the NMS were not granted derogation. But they do not seem to have sought derogation). Two of the NMS (Slovenia and Slovakia) have already become members of the euro area; Estonia is to join in 2011. The benefits of adopting a joint European currency are pretty obvious (though often exaggerated) and do not require any extended exegesis. Countries that give up their *own* fixed-exchange rate regimes gain unequivocally because, shielded by the power of

the ECB, they are no longer potential targets of eventual speculative attacks. The advantages gained by switching over to the euro are less obvious in the case of countries that have had floating exchange rates. Clearly, those countries no longer have to bear with market-driven exchange rate fluctuations that could destabilize things. On the other hand, those countries do not lose a measure of control over their national monetary policy and inflation: they continue to influence domestic interest rates¹¹. Although national monetary policy (e.g. of the inflation-targeting kind) may be unable to prevent directly high capital inflows and the associated strong nominal appreciation that could imply increases in unit labour costs and losses in the external competitiveness, it may also discourage such developments by trying to suppress domestic interest rates (and inflation). They could try making financial capital inflows potentially less profitable. Of course – as is well known – floating exchange rates tend to behave unpredictably (at least in the short term); this fact can restrict financial (or speculative) inflows seeking large rapid returns with a minimum of risk. Finally, the experience of the CEE countries, which have retained flexible exchange rates (Poland, the Czech Republic, Hungary and Romania), has shown that periods of intensified capital inflows (and some currency appreciation) are invariably followed by periods of intensified capital outflows (and some currency depreciation). 2009 has shown that flexible exchange rates can mitigate the impact of a crisis. The periods of rising and falling unit labour costs (in euro terms) alternate. While it imposes certain costs and does not rule out the possibility of appreciation lasting too long or being occasionally too strong, this is definitely a better situation than that all too often observed in countries which have adopted fixed exchange rates (including those in the euro area)¹².

In the fixed exchange rate countries, the losses (or gains) in competitiveness appear to be accumulating over time, without ever (thus far) correcting themselves. The accompanying external imbalances also tend to accumulate over time. The imbalances may undergo temporary correction on account of deep domestic recessions (as is to be currently observed in the Baltic States and Bulgaria). Those recessions, however cannot and do not (and are even unlikely to) eliminate (through deflation in wages and prices) huge real overvaluation levels of their currencies. As soon as lending to those countries resumes, they are certain to start developing large external imbalances once again.

The Maastricht inflation criterion (long perceived as an irrelevant nuisance¹³) is in fact sorely needed. Fairly soon after adopting the euro, a country that cannot meet the criterion is sure to end up badly. Such a country would most likely experience a credit boom. With both interest rates falling abruptly to the levels prevailing in the euro area and domestic inflation still running along its earlier trajectory, the economy is likely to overheat, especially as the elimination of the exchange rate risks would attract high capital inflows. Greece is a good example of a country 'suffering' from a sudden drop in interest rates (upon adopting the euro), with inflation still running high in tandem with rapid real appreciation. Of course, should the resultant credit boom expand export capacities and enhance labour productivity, things may end well. Experience, however, tells a different tale. The credit booms following the adoption of the euro fuel consumption and imports of consumer goods, as well as boost real estate dealings and speculative investments. At the same time, they fuel rapid growth in wages and prices. In short, experience shows that booms of this kind tend to end with the countries pricing themselves out of international competition.

Fulfilment of the Maastricht inflation criterion, though necessary, is not sufficient to guarantee a measure success *after* adopting the euro. First of all, the parity at which the domestic currency is exchanged into euros may be 'too strong' – as evidenced in Portugal whose economy has remained stagnant since 1999. Secondly, the initial undervaluation of the parity (although generally desirable) is not a guarantee of success either. Italy's lira/euro parity was significantly undervalued even in 1997 (after the collapse of the first version of the Exchange Rate Mechanism the lira, like most other European currencies,

was strongly devalued against the DM). Within the EMU, undervaluation 'reserves' were soon depleted as inflation in Italy was consistently higher than in Germany, while German labour productivity rose faster than that of Italy. In effect, price levels in Italy have risen rapidly relative to Germany, while the relative p.c. GDP has been declining ever since¹⁴.

For an NMS (or any other EU country) to fare *reasonably* well while participating in the euro area, it is necessary to be able to match *permanently* Germany's performance on unit labour costs. It is not sufficient to perform well against Germany on any specific date (or even over an extended period of time). What is needed is the ability and determination to emulate, for example, Germany's wage and fiscal policies *indefinitely* into the future – no matter what those policies may entail. In any case, faring *reasonably* well under the euro system in its present form is likely to imply at best a rather *weak* overall growth based on expansion of net exports. A better alternative for the NMS may be to retain a national monetary policy and a *depreciable* currency – and then try to follow a path to *rapid and externally balanced* growth.

2.7 Some constructive proposals to defuse centrifugal forces

The euro-area countries that are unable or unwilling to emulate the Germany's restrictive policies with any degree of success may sooner or later find it expedient simply to withdraw their membership and reintroduce their former currencies. Such decisions may be facilitated by a severance of financial transfers (or lending) needed to service the snowballing foreign debts. Currently, the prospects of such a radical development happening seem remote: the European Council recently decided unanimously to set up a relief fund to provide the necessary support to countries in need. However, saving some countries does little to tackle the reasons for their present plight. Countries, whose governments or private sectors (or both) are saved from bankruptcy by using foreign money do not become more competitive. Either they remain stagnant indefinitely or – if granted new credits – they will resume running external deficits and accumulating foreign debt once again. In due time, they would need yet another bail-out package financed by those who can afford it. This situation will not be tolerated indefinitely. At some point, transfers and new credits will not be forthcoming (or domestic stagnation will become intolerable), and this or that country may default on its foreign debt and leave the euro area. Of course, the costs of all this would be high to both the country deciding to leave and those staying on (as well as the creditors). The likelihood of this possibly triggering the disintegration of the EU as a whole cannot be dismissed.

Countless are the proposals on repairing the Euroland's overall architecture. One vision stipulates the transformation of the *monetary* union into a political union, with a centralized fiscal authority ruling over large cross-country fiscal transfers (De Grauwe 2009). This vision will not materialize anytime soon. If anything, premature attempts at fiscal centralization might derail political unification (which seems to be happening in Belgium). A less ambitious proposal might suggest that countries with external surpluses be requested to draw up (and implement) consolidation programmes aimed at strengthening domestic demand. Failure to bolster domestic demand (or to reduce abnormal savings) could be subject to '*excessive external surplus procedures*' with clearly defined penalties for misbehaviour. Another modest proposal may require member states to enter into binding agreements on avoiding *beggar-thy-neighbour* tax/wage policies. Arguably, all countries might also agree on broad guidelines for national wage policies (e.g. stipulating that wages should be allowed to rise in line with labour productivity – no more, *but also no less*). Agreeing on such guidelines means more policy coordination at the EU level. A labour-productivity driven wage policy, with the individual countries' average nominal wages increasing in line with average labour productivity (augmented by a common ECB target pertaining to inflation) would result in national inflation rates approximating the common target inflation rate. Importantly, such a policy would help narrow divergences within the euro area. It would then be possible to run the *one size fits all* monetary policy, without provoking centrifugal forces within the euro area.

Finally, other hitherto unutilized possibilities exist for accelerating overall growth in both the euro area and in the EU. Drawing on those possibilities may help defuse the centrifugal tension generated to date under the rules currently being followed. Those possibilities are discussed below.

3. The EU economy needs to run budgetary deficits

3.1 *Efficient operation of automatic stabilizers may require fiscal deficits in excess of 3% of GDP*

While it was generally admitted, *after* the crisis broke out back in 2008, that fiscal deficits may have served the purpose of providing 'stimulus' when the slump developed, the mood among politicians and their economic 'experts' already seems to be changing, even though recovery (at least in Europe) is still weak and fragile. The outbreak of the Greek public debt crisis has played a role in all of this. Each day resounds once more to the battle cry of 'fiscal consolidation'. Suspended when events seemed to be spinning out of control, the SGP is being resurrected. Over the period 2009-2010 excessive deficit procedures were initiated for all euro area member countries (and all others except Estonia and Sweden). All these countries are expected to reduce their fiscal deficits to below the 3% of the GDP mark by 2014, at the latest. Interestingly, some non-euro member countries do not seem to be in a rush to embark on fiscal consolidation. The recent (spring) EU Commission's economic forecasts envisage that very high levels of net lending to the general government will still persist in 2011 (in the UK 11.1% of the GDP, in Poland 7.6%, in Lithuania 9.7%, in Latvia 12.2%). The numbers are not much different to those projected for Japan and the USA (9.1% and 13.1%, respectively). Clearly, neither Japan nor the USA qualifies for euro area membership. Nor would they have they qualified before the crisis as both countries had run up high fiscal deficits for a number of years and had amassed public debts much larger in proportion to their GDP than that of the euro area. (Ironically, threats to fiscal sustainability are obviously taken very seriously in the euro area which has been much more prudent in fiscal terms than Japan or the US. Moreover, the 'financial markets' value the latter two countries as lower risks: Japan and the US face no problems over selling their debt – despite the fact that the yields offered are rather symbolic).

Of course, there is no good reason for the 3% deficit/GDP mark being considered the 'norm' and not, for example, 2% or 5%¹⁵. During the cyclical (or accidental) deceleration of growth, people (including even the present EU Commission apparatchiks) reckon with *rising* (or emerging) fiscal deficits automatically reducing the speed or extent of GDP and employment losses on account of decelerated growth. It is now acknowledged that the operation of 'fiscal stabilizers' has beneficial effects. Clearly, attempts at suppressing the deficits emerging (or rising) under growth deceleration may be counterproductive as far as both real growth and fiscal positions are concerned. As there is no evidence that fiscal deficits emerging as the result of the operation of automatic stabilizers must *not* exceed the 3% mark, it seems rather unwise to insist, *unconditionally*, on observing that mark in times of slower (or otherwise weak) growth. The siren calls coming from various corners (including the EU Commission) and urging the need to adopt '*exit strategies*' must be closely analysed.

At this juncture, it should be recalled that the SGP (despite having been relaxed somewhat in the period 2004-2005) still insists on something more than simply not trespassing on the 3% deficit/GDP mark. A deficit of up to 3% is still permitted under certain conditions – in particular in times of unfavourable cyclical developments. But the SGP still '*lays down*

*the obligation for Member States to adhere to the medium-term objective for their budgetary positions of “close to balance or in surplus” (CTBOIS) ...*¹⁶

3.2 ‘Close to balance or in surplus?’ Not an aspect of economic reality

Over the past few decades, all major countries (and a decisive majority of the minor ones) have run fiscal deficits most of time. This also applies to the major EU economies. In 37 years (1970-2007) the UK ran deficits in 30 years, Germany in 31. The average deficit/GDP ratios equalled 2.8% and 2.1%, respectively. Shorter harmonized long-run time series are available for France and Italy (30 and 32 years, respectively). Neither country recorded a single year without a deficit. The average deficit/GDP ratios were 2.9% and 7.4%, respectively. Facts are similar for other ‘old’ EU countries. The Netherlands is an exception. In 19 years – out of the total of 38 – the budget was balanced or showed a surplus; in 18 years it showed a deficit. Even in that country, however, the arithmetic mean for the budget deficit/GDP ratios over the whole period was 2.4%. In the period 1961-2007, the United States only posted a budget surplus four times and ran as many as 43 budget deficits; the average budget deficit for the whole period ran to 2.6% of GDP. Of 10 new EU member states, only two countries ran predominantly ‘close to balance or in surplus’ fiscal policies in 8 reasonably normal years (2000-2007). In Bulgaria (whose statistical reporting is now subject to doubt) a surplus was reported in 5 years and in Estonia in 8. The average surplus/GDP ratios were purportedly 0.7% and 0.9%, respectively. The two remaining Baltic states ran deficits consistently (although the average deficit/GDP ratios were low: about 1%). Incidentally, it is interesting to note that all of the four ‘fiscally relatively prudent’ NMS have run huge current account deficits (all have fixed exchange rates) and ended up with massive levels of foreign debt and huge *fiscal* deficits in 2009-10. Undoubtedly, the old twin-deficits doctrine that stipulates a functional *positive* association between current account and fiscal balances does not apply here. Low fiscal deficits (or even handsome fiscal surpluses) peacefully coexisted with gigantic current account deficits for extended periods of time. The remaining six NMS have run fiscal deficits each year. Average deficit/GDP ratios vary between 2.2% (Slovenia) and 6.6% (Hungary). The average ratios for Poland, Slovakia, The Czech Republic are all around 4% (less than that for Romania). As can be seen, in real life running deficits is a regular long-term affair rather than an exception.

Were the budget only to play the role of a stabilizer of economic fluctuations, the data would suggest that for decades finance ministers took reckless decisions, irrespective whether governments changed from left to right and vice versa. Is it not strange that the world has existed for so long while remaining unaware of the need to respect the *close to balance or in surplus* requirement? Or, perhaps it is necessary to consider whether other rational reasons obtain for the regularity of budget deficit policies. In our view, such reasons are to be found both in the domain of public finance and at the level of national economy as a whole.

3.4 What happens when the private sector intends to save more than it intends to invest?

Each generation enjoys the benefits of public infrastructure funded by past public investments and, in turn, it invests in similar infrastructure (and human capital) that will serve future generations. A constant public debt to GDP ratio could be considered an acceptable and fair inter-generational compromise¹⁷. However, a budget deficit might prove necessary even when public investment is of no consequence. The propensity of the private sector (firms and households taken together) to save measured in terms of the ratio of private saving to GDP (the ‘saving rate’) may happen to be lower than the sector’s propensity to invest (the GDP share of private investment in gross fixed assets, eventually augmented by inventories). This situation is not uncommon (for example, it prevailed in the

USA over the period 1998- 2008 as well as in many NMS – primarily the Baltic states); it implies that the private sector is a net borrower. Lending which makes up for the excess of private investment over private savings tends to come from abroad. It is natural to expect that in such a situation, the public sector's financial balance (i.e. its fiscal deficit) does not add all that much to the demand for foreign loans (even though this has been happening in the USA for many years).

For some countries to be able to borrow externally, other countries must have banks, firms and other institutions that are able and willing to lend. Those lender countries have private sectors that save *more* than they intend to invest domestically in real gross fixed assets. Those countries include Japan, China and Russia, as well as Germany¹⁸. The role that a government's fiscal policy could usefully play in countries with excessively thrifty private sectors is radically different. Generally, those governments should be prepared to run sufficiently high fiscal *deficits*. The reason for this conclusion follows from a rather elementary understanding of national accounting. When the private sector's propensity to save is higher than its propensity to invest, a budget deficit provides the private sector with an opportunity for additional sales – and additional employment – above the level determined by the level of private investment. Without a budget deficit (and/or an export surplus), the private sector's efforts to achieve the desired level of savings would not succeed and thus lead to a decline in GDP and employment down to the level determined by the volume of private investment and net exports.

This core economic principle explains why the budget deficit was a fairly regular phenomenon in the area of roughly balanced external accounts which generally prevailed under the Bretton Woods system and thereafter during the era of floating exchange rates. It is currently the basic reason why it would be rational for countries with high current account surpluses (i.e. with private sector savings in excess of their investment needs) to run large fiscal deficits. Japan – but Germany as well – runs such deficits. Renewed attempts to suppress these deficits do not do any good and at best slow down overall growth. Instead of trying to suppress the fiscal deficit (or engaging in the promotion of net exports and lending to 'the rest of the world'), the policy may try to address the reasons behind the excess of private savings over private investment. Deflationary tendencies may well be simultaneously responsible for too large a volume of savings and too low a level of investments. However, the structure of private sector income may be conducive to high savings (for example, via rising inequality in disposable incomes in the household sector). Alternatively, downsizing or privatization of services traditionally provided by the public sector (health and pensions) may also induce a higher propensity to save – without the requisite rise in the propensity to invest. Apart from this, some secular decline in the private propensity to invest can be expected – with some secular rise in the private propensity to save. The latter may derive from demographic changes (ageing). The former may be contingent on technological change. The productivity of fixed assets is likely to improve secularly owing to the progress of technology – small amounts of real assets invested are capable of producing more output. This trend may be temporarily interrupted by major inventions (such as 'electricity' which calls for high initial investment in the construction of power stations, transmission grids, etc). In the long term, as the supply of goods produced by the private sector can be expected to outstrip the demand for the same, the low private sector investment may need to be progressively supported by the investment of public funds (for example, in infrastructure and environmental protection, as well as in human capital). Of course, that would imply appropriately high levels of secular fiscal deficits.

3.5 Countries with high external surpluses may need to increase their fiscal deficits

As already discussed, high external surpluses impose definite current and prospective costs on high external deficit countries. Accumulation of external deficits in the form of excessive external debt will sooner or later tend to backfire on the surplus country. Even if

external debt is owed primarily to the private sector in the external surplus country (for example, its financial sector), a default on the part of the indebted country will raise the public sector debt in the external surplus country. This is the current situation in Germany which is facing the prospect of having to subsidize Greece (and possibly others) in order to prevent losses accruing to German financial institutions that have been providing credit for the purchase of German exports.

It would have been much more rational for all parties concerned (including the German ministry of finance) to mop up its private sector's excessive savings by increasing fiscal deficit (raising domestic consumption and investment serving useful purposes) instead of pursuing a *beggar-thy-neighbour* policy. One final outcome, higher public debt, would have been very much the same, yet on all other counts sufficiently high fiscal deficits would have served both Germany and its EU partners better.

What has been said above does not mean that budget deficits cannot have any negative effects. Public debt service (like any public good financed with taxes) *potentially* imposes a burden on all households, while the public debt service may mainly benefit households holding government bonds. Another problem is the rate of interest on public debt. If that rate is higher than the growth rate of nominal GDP, a rising share in the GDP will accrue – over the long term – to the wealthy holders of the public debt via interest payments. However, a rising share in incomes on the part of wealthy households does not increase the effective demand for consumer goods sufficiently to compensate for the taxes (also levied on low-income households), out of which interest payments are made. One of the objectives of the policy should be to prevent a situation in which the interest rate exceeds the growth rate of nominal GDP. The ECB should not indulge in excessive austerity. Moreover, the ECB might be instructed and authorized to abandon its aversion to direct lending to governments in the euro area (or even to governments in non-euro area countries).¹⁹

The reduction of budget deficits is possible and, in many cases, necessary. However, it must wait until the economy has returned to normal growth. It is no accident that the rare periods of successful fiscal consolidation in the past were also periods of satisfactory or high growth. Practically, the only means of reducing the budget deficit is to 'grow out' of it. This is not a coincidence. When an economy enjoys strong growth, government revenues increase and government expenditures related to unemployment and social welfare decrease. If the minister of finance does not use the improvement of the budgetary situation to launch new projects, the budget deficit shrinks: i.e. the government borrows less. At the same time, the lending needs of the private sector also diminish. Assuming a constant propensity to save among private households and business, this is caused by increased residential building and, foremost, greater business investment. These expenditures absorb private savings within the private sector and reduce their outflow beyond the private sector. Under these conditions, the reduction of deficit spending does not give rise to deflationary and contraction tendencies and hence may be successful.

3.6 Public debt: an asset rather than a burden

For the private sector, public sector debts represent assets rather than real burdens. Otherwise governments would not be able to float their bonds on financial markets. Of course, the demand for (and yields on) bonds issued by various governments vary. Interestingly enough, the highly indebted countries (such as Japan and the USA) do not seem to have faced serious problems over demand for their debt. (In Japan most of the public debt is owned domestically, while the US debt is sought internationally as being the most secure). Moreover, the costs of servicing their debts have been quite low. In 2009 the ratio of interest payments on public debt to the public debt itself stood at about 2.8% (in the USA and the UK), 1.4% in Japan – but as much as 3.6% in the euro area (and in Germany as well). Public debt is demanded not only – and not primarily – because it offers returns (although they, of course, are always welcome), but because it offers security that no other

form of financial investment can guarantee. That security is highly valued generally and also plays an important role as far as the expansion of private investment is concerned. Banks, for example, gladly accept good government bonds as collaterals for the loans they extend to firms.

Much of the official aversion to fiscal deficits which permeates the EU economic framework seems to derive from the notion that rising public debt may sooner or later become unsustainable (i.e. impossible or too difficult to service). Of course, the high costs of servicing public debt are important in this context because they have the potential to 'snowball' the debt, even if primary deficits are moderate. One critical question should be asked here. Why is it so much more costly to service the public debt in the euro area than in Japan or the USA? Of course, many factors contribute to variations in the costs of servicing public debt. The size of the debt (in relation to the GDP) does not seem to be all that important. Public debt/GDP ratios in Estonia and Bulgaria were very low (in 2009 7.2% and 14.8%, respectively), but the implied interest rates were 4.1% and 5.4%. What might really count is not only the (large) size of the economy in question, but most probably also its ability to run *national* monetary policy and ensure it is properly coordinated with *national* fiscal policy. The UK, Japan and the USA are just such countries – the euro area and Germany are not, despite the large size of their economies. The euro area does not have one single fiscal policy and the ECB monetary policy is unable to address the needs of individual euro area member states. Specifically, the simplest answer to the question why interest on debt is low in Japan or the USA seems to be that the Japanese and the US governments can – and do – *target* low returns on their debt, while the euro area governments lack that option. The US Treasury Department spends in excess of its own financial resources by crediting bank accounts of private sector beneficiaries (and expanding its own debit accounts with the banks). This amounts to being compelled to generate funds that could force interest rates down to zero. It is only (shortly) *afterwards* that the US Treasury Department (in cooperation with the FED) issues and floats its debt in quantities sufficient to keep interest rates at levels considered proper²⁰.

It would be desirable, were the leading euro area governments also able to lower interest rates on their new debt issues. (An '*EU Special Purpose Vehicle*' proposed recently may lower interest rates on new debt issues – yet without giving the governments fuller control over the rates). Governments (acting in concert) should be given more power to create money without having to seek buyers for their debt in advance. That, however, would most probably require some major modifications to the eurosystem's mode of operation (and that of the ECB). Those modifications may necessitate revising some EU Treaties. Ultimately, the ECB should be allowed (and actually persuaded) to 'print money' with which the euro area governments (or the EU Commission) could fund their legitimate and worthy 'deficit spending' projects – without increasing the size of their interest-bearing public debts. Much of the recent '*quantitative monetary easing*' in the USA and the UK boils down to just about that very practice. Used with moderation, 'printing money' need not give rise to a runaway inflation. Instead, it could help accelerate overall growth – even in countries which hitherto could only subsist by resorting to *beggar-thy-neighbour* (and *beggar-thyself*) policies.

4. Summary and conclusions

The secular weakness of growth in the EU/euro area has its roots in the basic paradigms of EU economic policy-making. Not only does the acceleration of growth depend on changes in those paradigms, but the very preservation of the EU, which is exposed to ever stronger centrifugal forces, may also be at stake. This text has attempted to identify some of the key flaws in the current EU economic arrangements and to put forward some suggestions for modest improvements. One issue relates to the way in which monetary

policy has been defined and pursued in the euro area. It is argued that the principle *'one size fits all'* on which this policy rests supports deflationary/stagnation tendencies in low-inflation/low-growth countries and bolsters booms/inflation in high-inflation/high-growth countries. Whereas Germany has fallen victim to this policy, in a number of other countries this policy fed credit and import booms. Diverging trends in unit labour costs, external competitiveness and external balances are the other side of the ECB single monetary policy. Under a common currency, the emerging intra-euro-area divergences cannot be neutralized effectively. Germany has been running increasing external surpluses; its partners increasing deficits. Worse still, the German policy has supported this trend as it allegedly helps to reduce domestic unemployment. The *'beggar-thy-neighbour'* policy turns out to be harmful to Germany itself because it suppresses domestic demand more than it helps advance external surpluses. Weak overall growth in Germany is the result. The external surpluses represent the spiralling debt of the external deficit countries. As that debt proves unserviceable, the German government is forced to take it over in order to save the country's financial institutions.

The intensity of the centrifugal forces within the euro area (and generally in the EU) should be dampened by closer coordination of the member states' fiscal and wage policies. In particular, it may be useful to demand that growing labour productivity be matched by wages at the national level. In addition, it should be possible to institute *'excessive external surplus procedures'* against countries that generate large net exports at the expense of cuts in domestic consumption. Until the mechanisms are in place to limit the divergences in unit labour costs and external imbalances, it is advisable for the NMS to retain their own currencies and floating exchange rate regimes.

The Stability and Growth Pact is also in need of modification. The 3% fiscal deficit/GDP mark may prevent the efficient operation of automatic stabilizers that *today* are rightly considered vital under periodical growth slowdowns. Furthermore, the Pact's insistence that in the medium term the budgetary positions should be *close to balance or in surplus* is not consistent with economic reality. Attempts to observe that requirement are doomed to failure whenever the private sector's propensity to save is larger than its propensity to invest in real (fixed) productive assets. Under balanced external accounts, a permanent fiscal deficit may be a secular necessity. Problems related to rising public debt may also need to be addressed. For the euro area these problems could be rendered far less serious than is often believed.

Footnotes

¹ All numbers quoted in this text come from (or are based on) EU sources (e.g. EU Commission 2010b).

² Moreover, guarantees to the financial sector of over 24% of the EU GDP have been approved, of which almost 8% of the GDP has actually been granted. These guarantees represent contingent liabilities – potential additions to public debt (see European Commission, 2010b, p. 25, ECB 2010, p.15).

³ A more recent ECB document co-authored by Mr. Stark (Rother, Schuknecht and Stark, 2010) went on to invoke ideas such as 'Ricardian equivalence' or 'crowding-out' to prove the necessity of fast and radical fiscal consolidation: *'...all else being equal, a decline in the fiscal deficit improves government savings and consequently national savings. This reduces real interest rates and supports demand for interest-sensitive assets, notably private sector investment...'* (p. 15).

⁴ A question arises as to the conditions under which the uniform monetary policy may not produce these destabilizing effects. The conditions, however, are well known from the theory of optimal currency areas (OCA). The euro area is not – and never was – such an OCA. The so-called 'endogenous OCA theory' which claimed that an area comprising differing countries would become an OCA upon the introduction of a common currency turned obviously inadequate. The conduct of the ECB policy could become easier, if inflation rates throughout the euro area converged to a common, possibly not too low a value. Otherwise, the ECB might perhaps be given 'dictatorial' powers over discriminating

lending in/to individual countries. Making the ECB a genuine central bank (and not only an institution presiding over the determination of policy interest rates for the whole area) is quite certain to encounter just as much resistance as, for example, the idea of setting up of a super-ministry of finance for the euro area (with the national finance ministries being reduced to departments of the super-ministry).

⁵ The lira/DM exchange rate rose continually from 200 in 1971 to about 1000 in 1988. On average it kept depreciating about 10% annually in nominal terms. That development was associated with Italy's rapid real growth ('real convergence') combined with huge current account and trade *surpluses*, still recorded as late as 1998. Under the euro, Italy's surpluses turned into snowballing deficits while real growth has come to a standstill. Conversely, under steadily improving productivity (and chronic trade surpluses) the DM kept appreciating in nominal terms vis-à-vis. the basket of currencies that later became the euro. In 1971 the DM/ECU rate stood at about 3.7 and in 1988 at about 2. Steady nominal appreciation of the DM (3.5% p.a. against the ECU/EUR basket) helped to keep the German trade surpluses in check. With fixed exchange rates (after 1997) and the growing liberalization of capital movements throughout the early 1990s, German unit cost gains translated into growing trade surpluses.

⁶This is not a purely hypothetical situation – but actually that of China.

⁷ The German wage policies are described in some detail in e.g. Bibow (2006, 2009), Flassbeck (2007).

⁸This is abstracted from the variations in the internal compositions of countries' external debts and claims. While the government, firms, banks and households may participate in the national foreign debt (claims) in differing proportions, in the final (macro) analysis, the overall totals are what really matters. The actual composition of debt may matter when it comes to detailed designs for remedying the crisis.

⁹*'The financing of current account deficits seems to have remained mainly intra-euro area during the financial crisis...All things considered, it is likely that euro-area current account deficit countries have been important beneficiaries of German capital outflows before and during the financial crisis'* (EU Commission, 2010a, p. 16).

¹⁰On pp. 45-46 the Report shortly lists macroeconomic challenges and imbalances underlying divergent competitiveness developments in individual euro. For Germany these are '*weak infrastructure investment and domestic demand/high saving rate; underdeveloped competition in service sector/unbalanced growth structure; insufficient wage differentiation*'. It is rather difficult to see how the government could help develop competition in the services sector or promote sufficient (whatever that may mean) wage differentiation – and especially how these developments could reduce Germany's external surpluses. Weak infrastructure investment is due to attempts to satisfy the restrictions of the Stability and Growth Pact and strengthen the 'export front'. Weak domestic demand is part and parcel of the overriding policy of minimizing unit labour costs through the suppression of wages. With falling GDP share of wages and taxation becoming less progressive, higher saving rates are only to be expected.

¹¹Under free capital movements, the national monetary policy is effectively possible, provided the exchange rate is floating (this is the so-called 'impossible trinity' doctrine stating that it is impossible to have independent monetary policy, fixed exchange rate and free capital movements). Of course, free capital movements are one of the 'four basic freedoms' on which the EU is founded (and one of the two taken most seriously).

¹²Even better outcomes could be expected with the policy that controlled inflation while at the same time steering the exchange rates to safeguard the desired degrees of external competitiveness. Such a policy was successfully pursued for a long time in Slovenia (and in Italy prior to the establishment of the Exchange Rate Mechanism). Running such a policy requires effective restrictions on capital flows – outlawed under the EU Treaties.

¹³In particular, the inflation criterion was viewed as absurd and actually harmful as it was incompatible with fast real growth, which was claimed to require higher inflation. It was even claimed to justify real appreciation (in otherwise chronic current account deficit countries). The latter claims were derived from popular misinterpretations of the so-called Balassa-Samuelson Effect. Around the year 2000 it was proposed to ignore the Maastricht criteria – and to introduce the euro unilaterally (without asking anybody's permission). Alternatively, the criteria were to be eased for the NMS. Fortunately, neither proposal was accepted.

¹⁴Podkaminer (2010).

¹⁵The 3% deficit/GDP ratio may be linked with the 60% debt/GDP limit on assumption that inflation is 2% and GDP growth about 3%. This applied 'numerology' fails in the euro area practice if only because the area's GDP had grown on average at close to 2% per year (2002-07).

¹⁶Council Regulation No. 1055/2005 amending the Growth and Stability Pact. *Official Journal of the European Union*, 7 July 2005, L. 174/1.

¹⁷If nominal GDP grows over a given time on average by a certain percentage annually, the nominal public debt should grow by the same percentage. This condition is met, if the budget *deficit* constitutes on average a fixed part of GDP. Secularly balanced budgets in a growing economy would not only imply a drop in the public debt 'burden' for future generations. It would also deprive future generations of the services provided by roads, schools, hospitals, and a healthy and educated labour force, part of which would not have come into existence without previous generations having practised deficit spending.

¹⁸The high excess of savings over investment in China, for instance, is inseparable from the high excess of investment over savings in the USA, for example. However, it is misleading to talk about the Chinese 'savings glut' as the *reason* for the US growing trade deficits vis-à-vis China. The US trade deficits *create* the excess of China's savings over its domestic investment: without the US trade deficits, the Chinese GDP (and savings) would be far smaller, *ceteris paribus*.

¹⁹The ECB has recently bought some (tiny) amounts of the euro area government debt only to claim that it had not done so because the purchase was followed by offsetting liquidity-reducing operations. All the same, Mr. Axel Weber, the head of the German Bundesbank (and the likely next ECB President), has openly criticized the recent 'unorthodox' actions of the ECB. Direct purchases of government debt by the ECB (and by national banks of the euro area) are outlawed under the present EU treaties.

²⁰See e.g. Wray (1990).

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