Fiscal convergence and economic divergence in the Euro area

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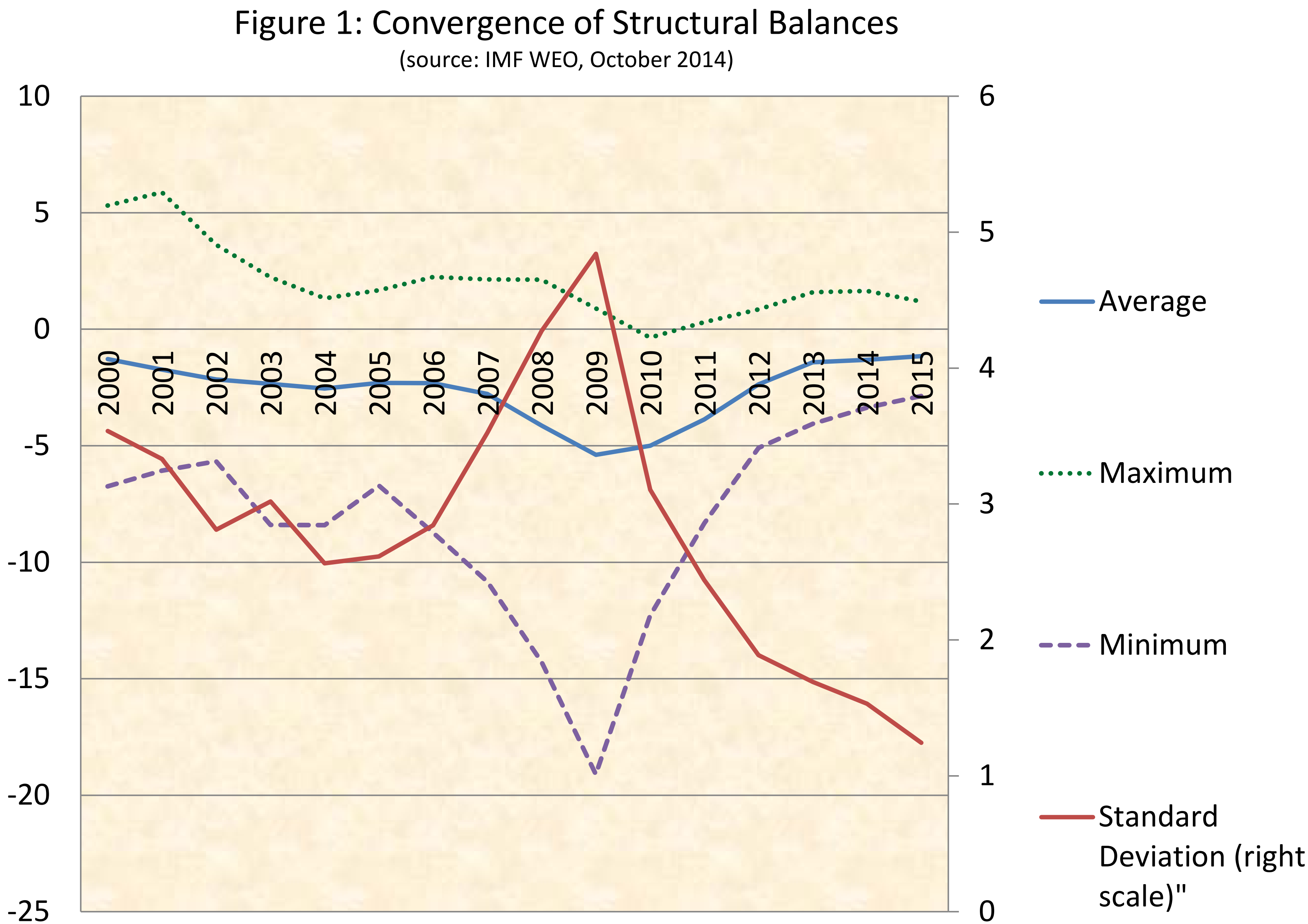
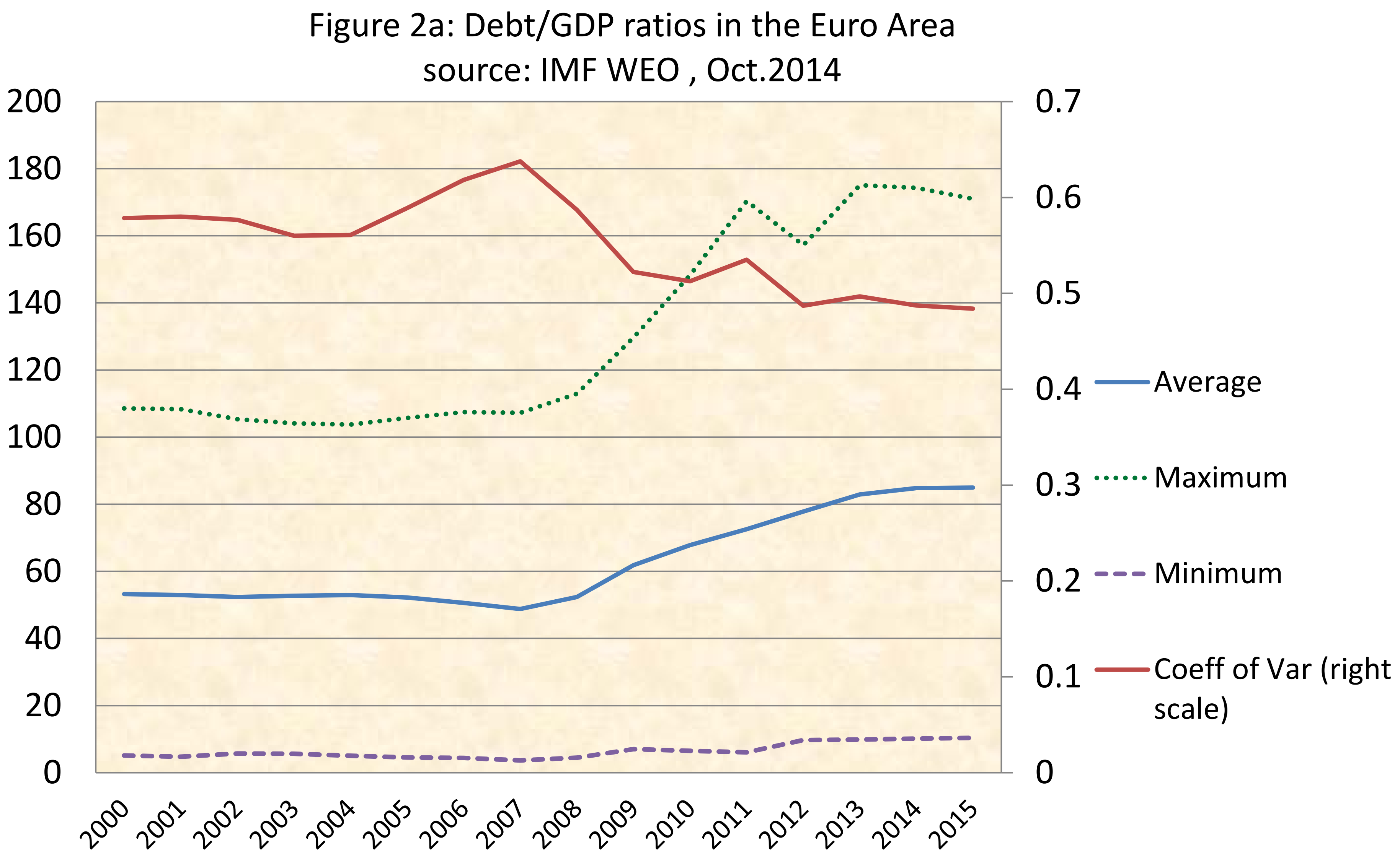
Outline

1. Evidence of Convergence in Fiscal Positions / Divergence in Unemployment, Investment , Growth in Euro Area since in the crisis : Trade-off
2. Is the Fiscal Framework to Blame?
   - variance decomposition exercise
   - fiscal reaction function estimates
3. New guidelines for SGP enough?
4. Proposals for Reform of Fiscal framework

1a. Fiscal convergence

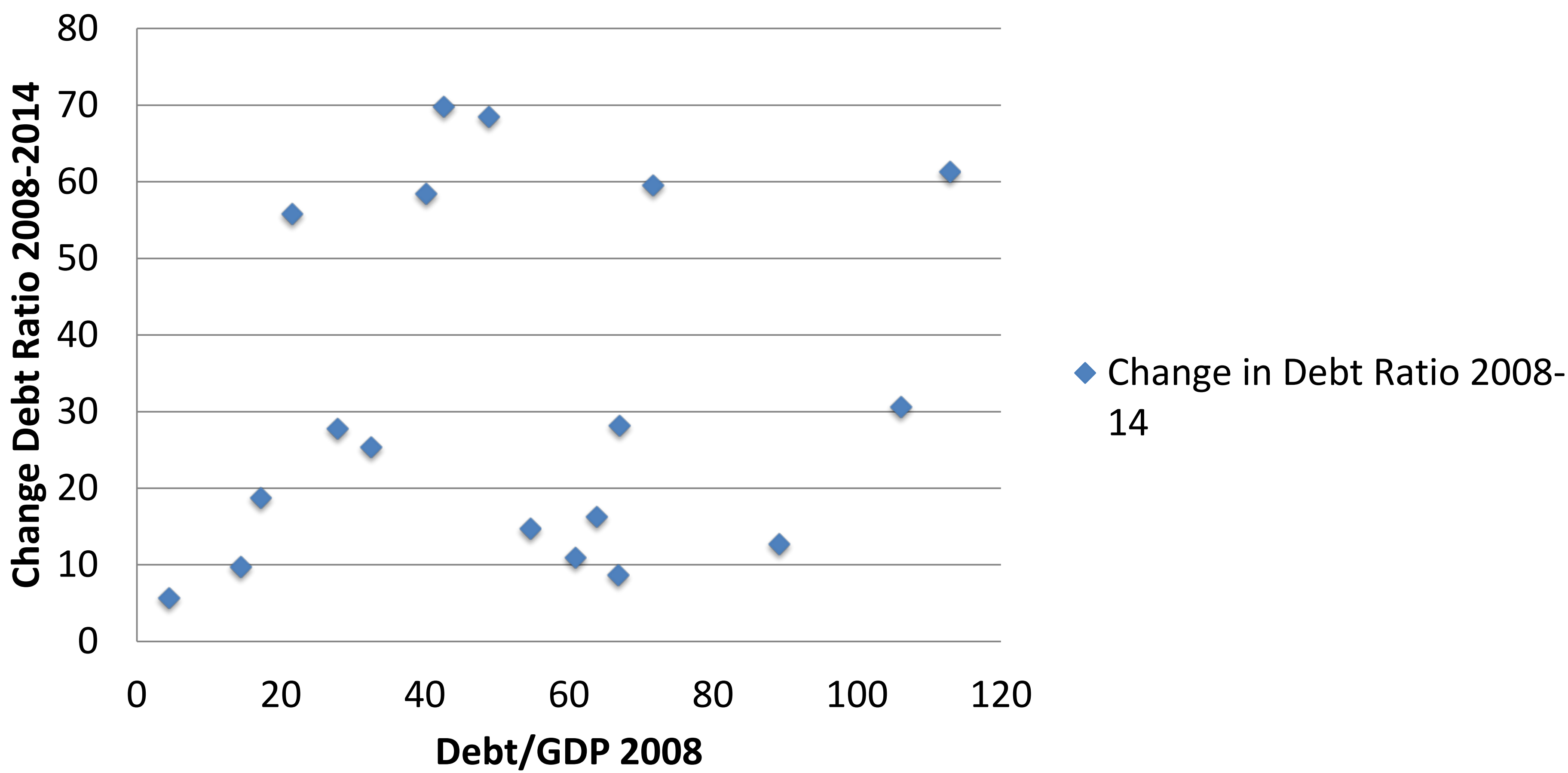


1a. Fiscal Convergence: Debt/GDP ratios?

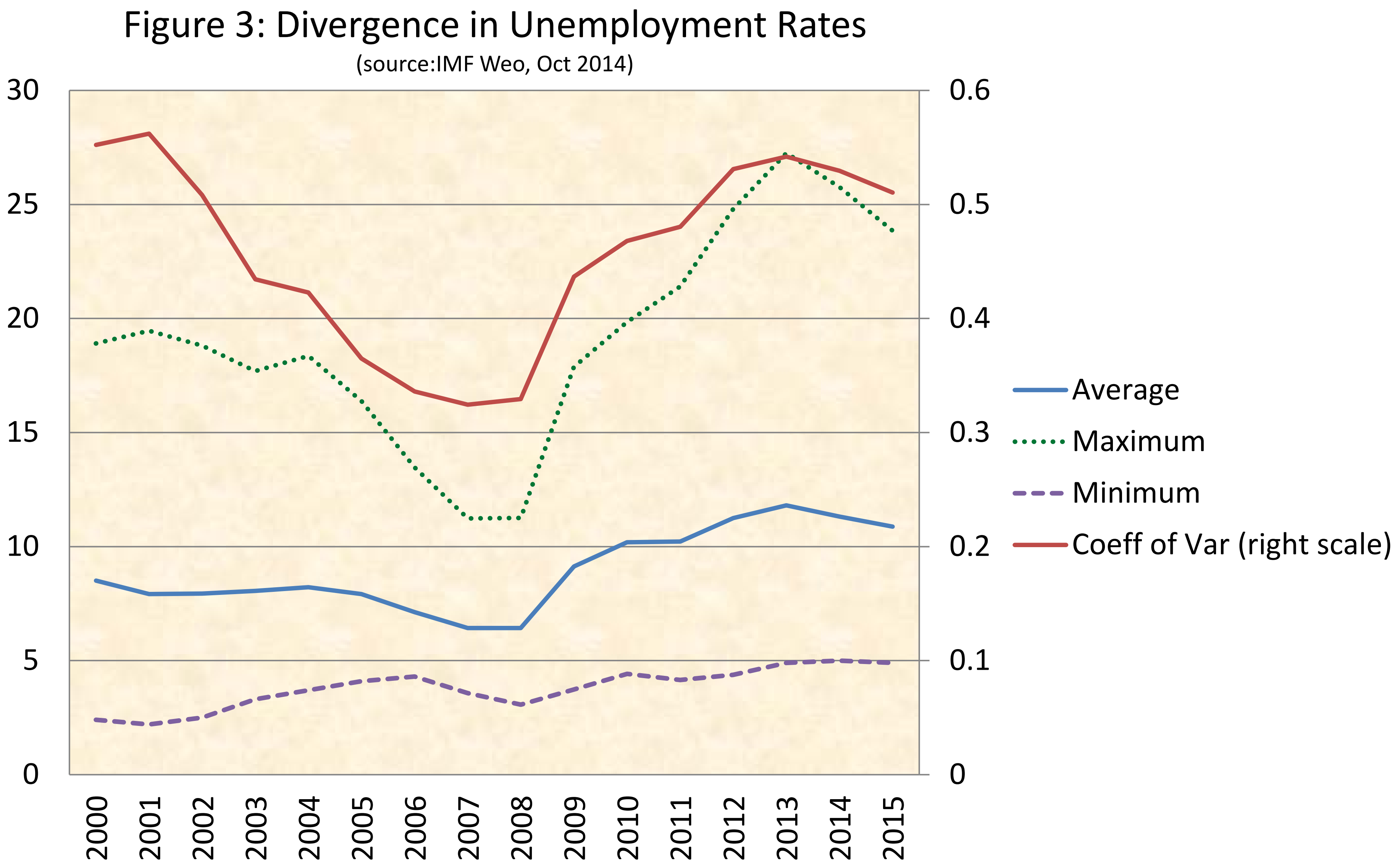


1a.Debt Ratio Convergence?

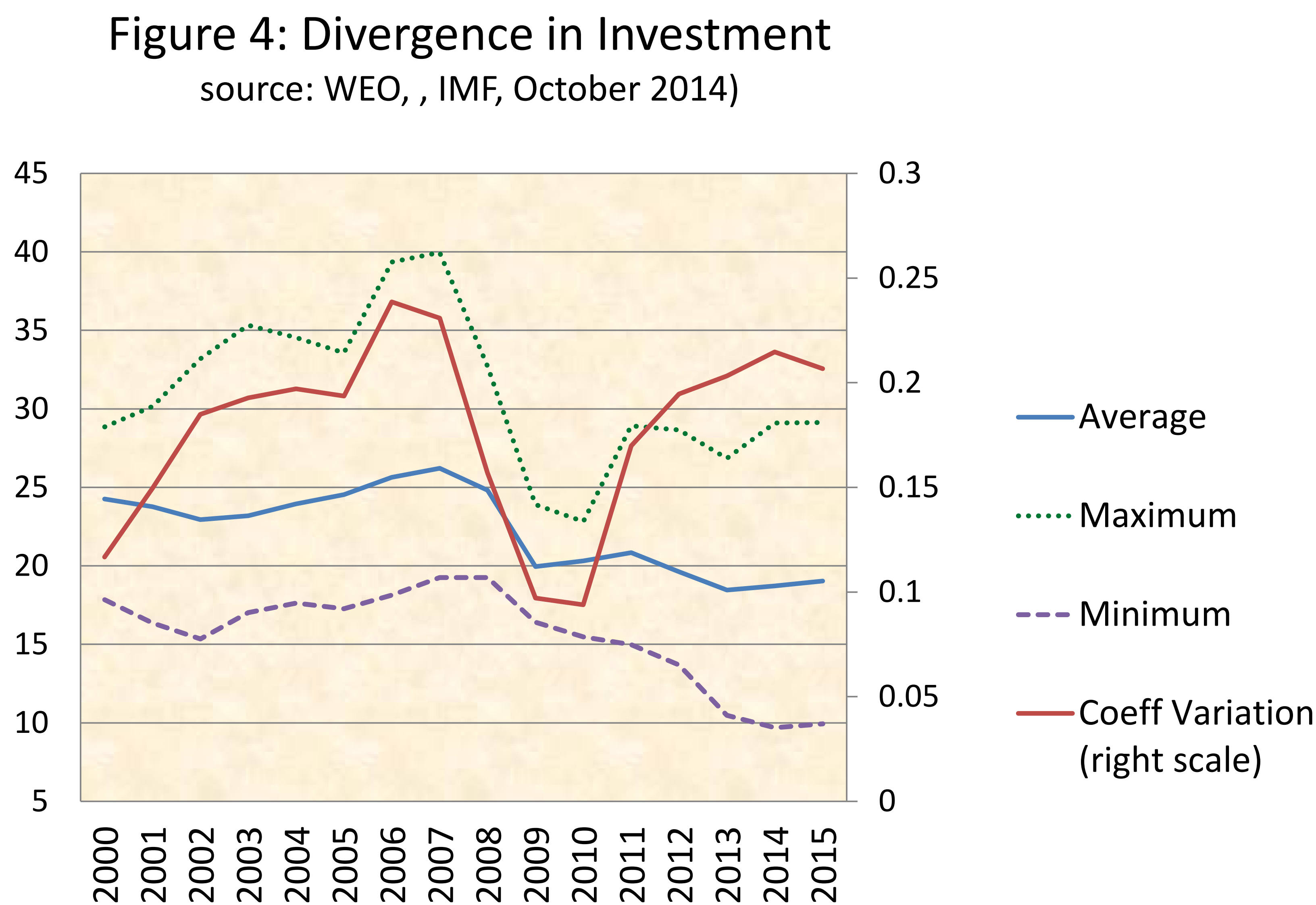
Figure 2b: Change in Debt GDP Ratios in Eurozone, 2008-14
source: IMF WEO , Oct.2014



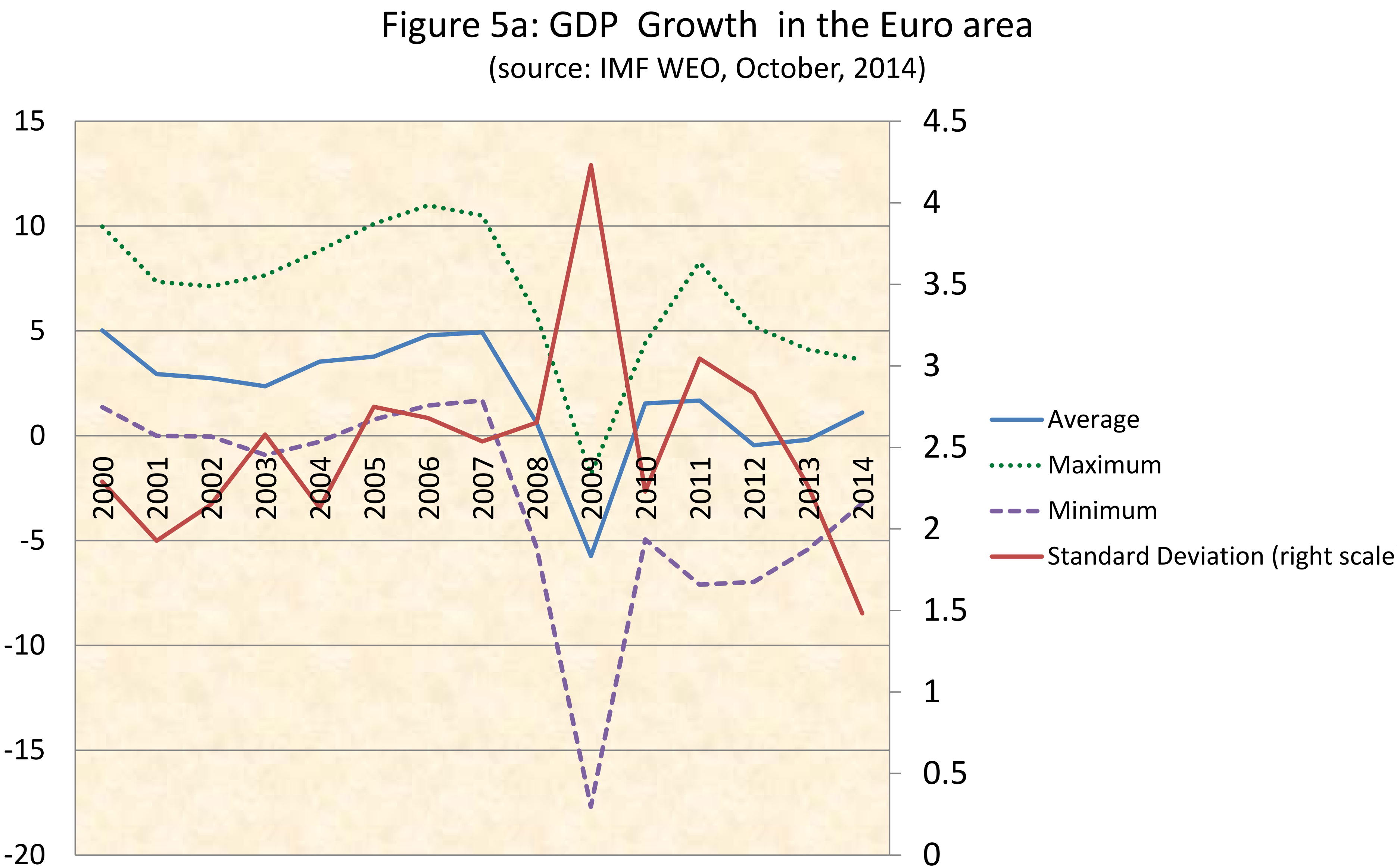
2. Economic Divergence: Unemployment



1b. Economic Divergence: Investment



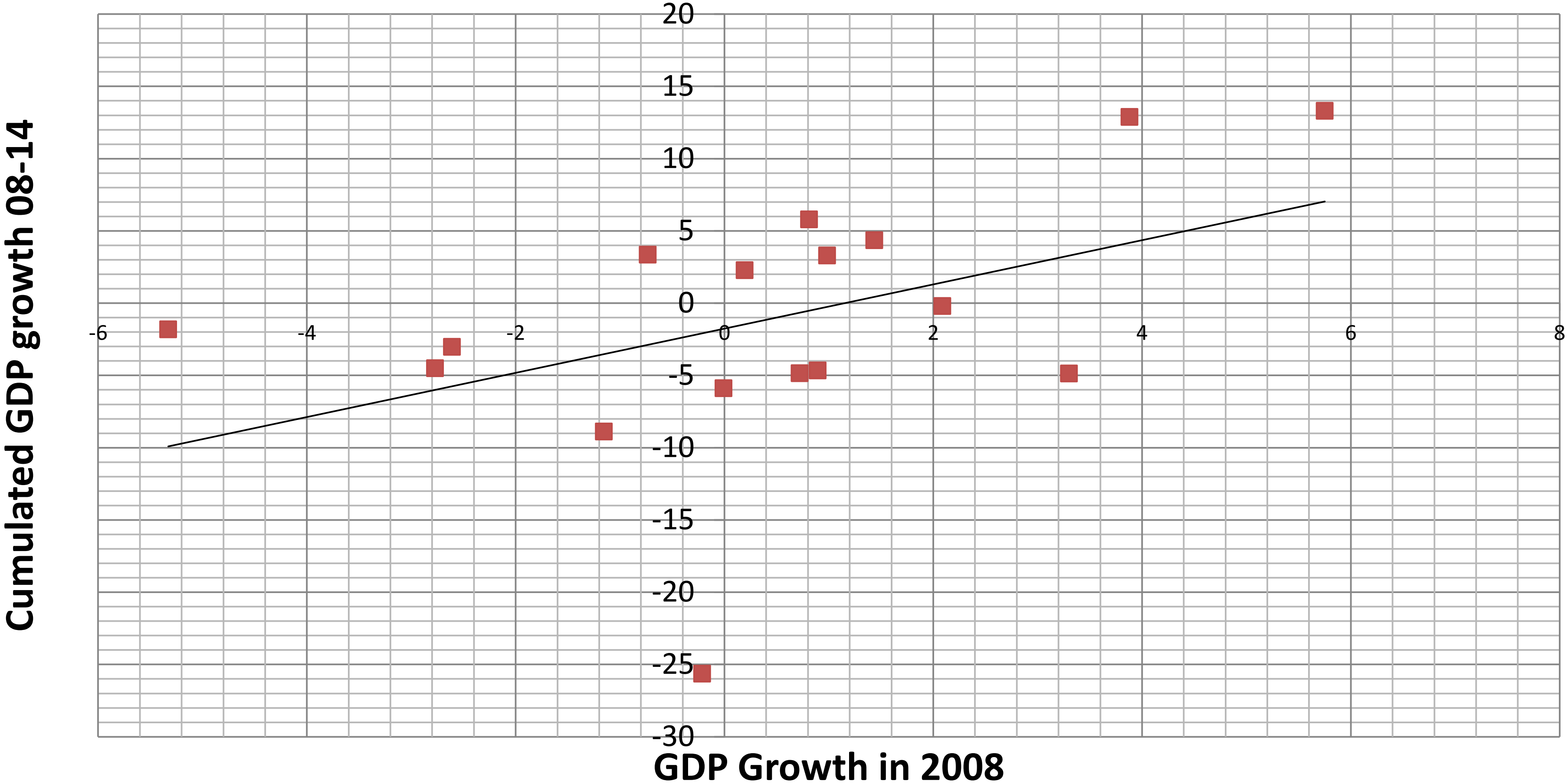
1b. Economic Divergence: Growth?



1b. Economic Divergence: Growth again

Figure 5b: Divergence in GDP growth, 2008-2014

(source: IMF, WEO, April, 2014)



2.Explanations for Divergence

1. Supply Side/Country specific

Evidence that the countries which experienced a larger rise in unemployment between 2008-12

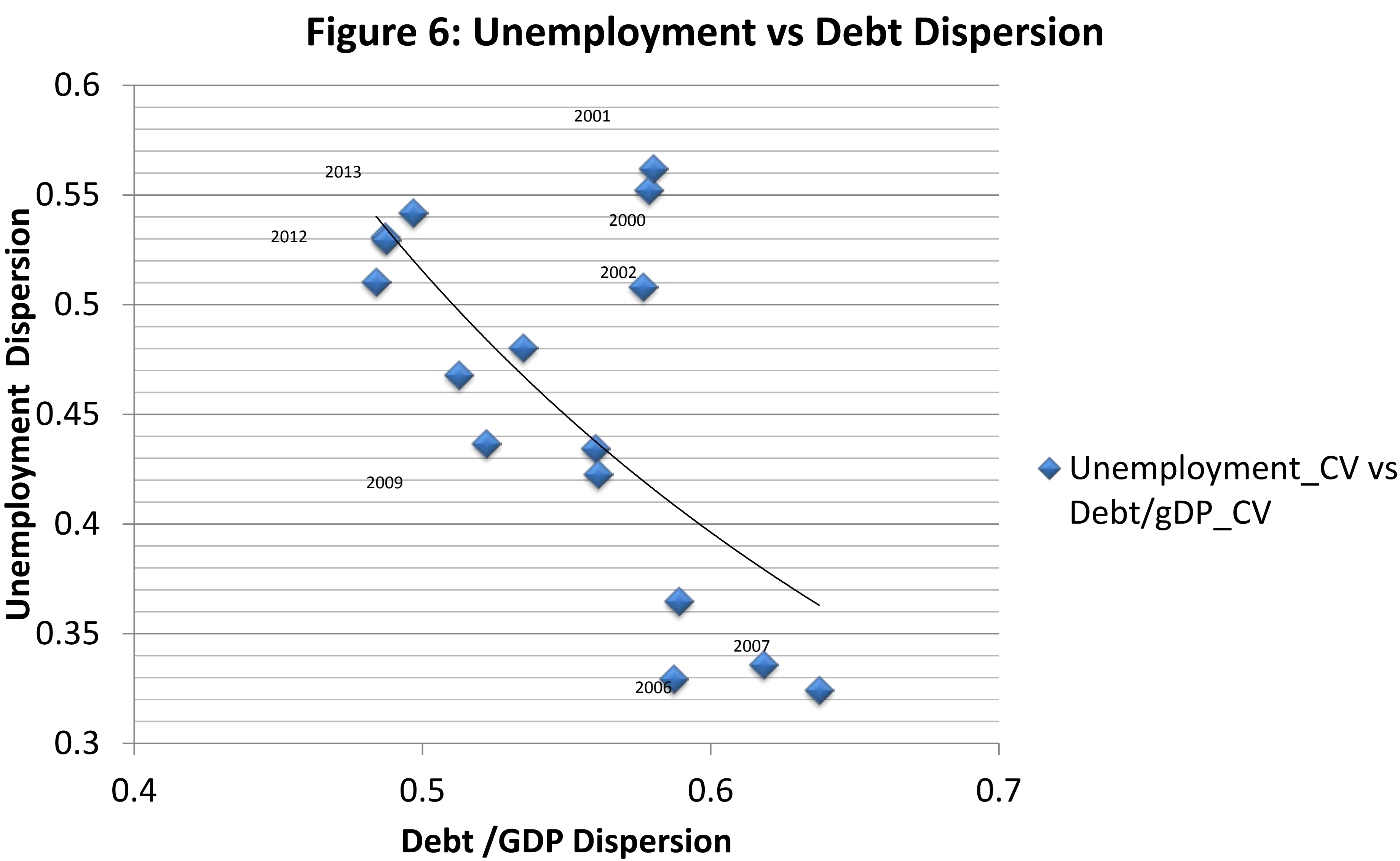
- are those where unemployment was higher in 2000-2008
- are the countries where per capita GDP declined more or grew less during the in the crisis are those where total factor productivity had risen less before the crisis
- Degree of competition in the banking industry and the perceived riskiness of banks in high debt countries, together with the widening of interest spreads during the crisis

Explanations for Divergence

Demand Side:

- Contry Specific Fiscal Policy (Budget Cuts) Credit crunches
- Common Shocks (Monetary policy)

Trade-off Debt vs Unemployment Convergence

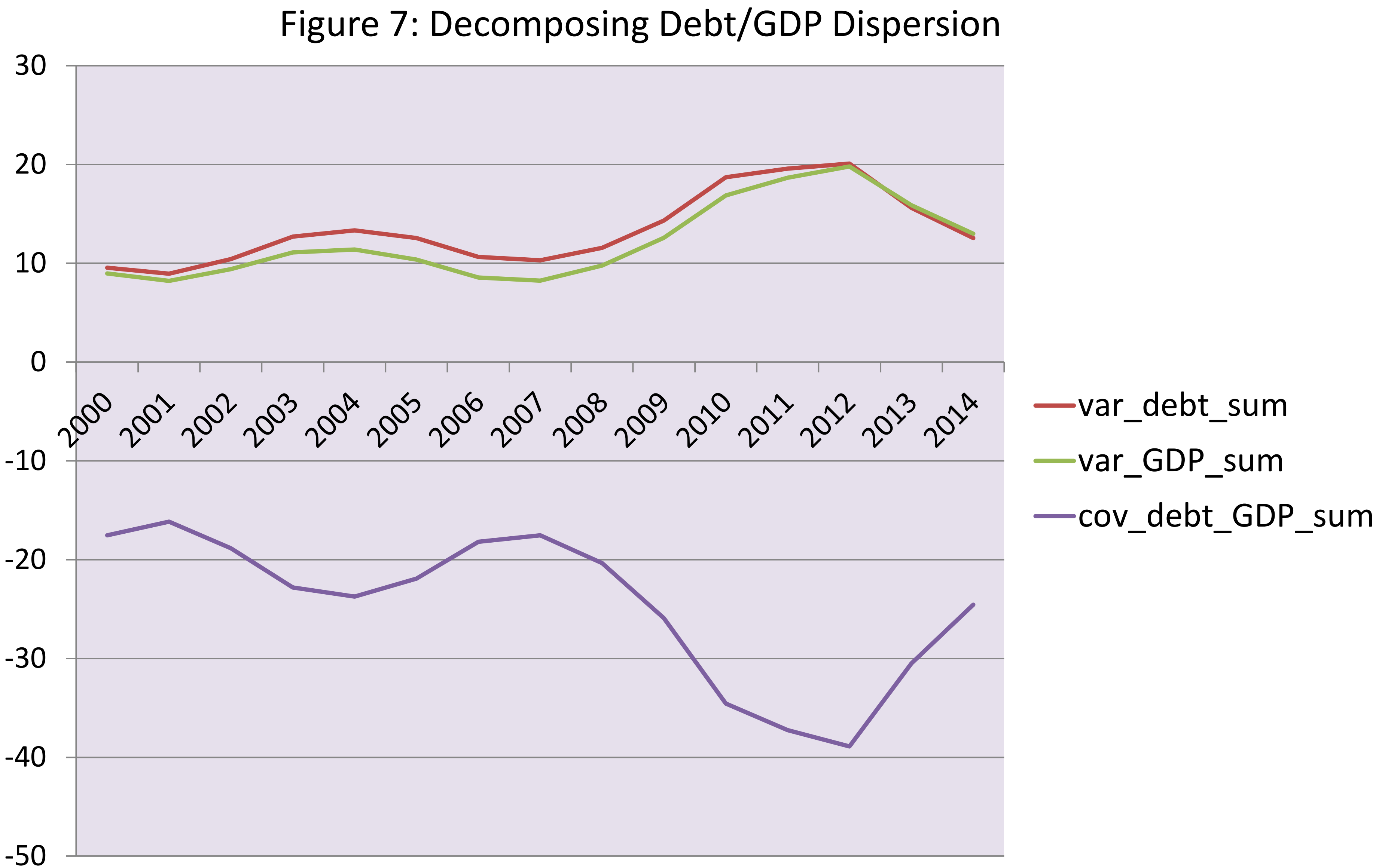


2. Variance Decomposition Exercise

$$(1)\ Var_t\left(\frac{B_{i,t}}{Y_{i,t}}\right) = \frac{\mu_{B,t}^2}{\mu_{Y,t}^2}\left[\frac{\sigma_{B,t}^2}{\mu_{Y,t}^2} + \frac{\sigma_{Y,t}^2}{\mu_{Y,t}^2} - 2\,\frac{Cov_t(B_{i,t}, Y_{i,t})}{\mu_{B,t}\ \mu_{Y,t}}\right]$$

$\sigma_{B,t}^2$ = country specific debt shocks
$\sigma_{B,t}^2$ =country specific income shocks
$Cov_t(B_{i,t}, Y_{i,t})$= policy induced common shocks

2.Variance Decomposition Results



2. Fiscal Reaction Function

(2) $\Delta\, CAPB_{it} = \alpha + \beta CAPB_{i\,t-1} + \gamma DEBT_{i\,t-1} + \delta GROWTH_{i\,t-1} + \theta_i +$
$+ \mu_t + \varepsilon_{it}$

γ –> debt sustainability concern

δ –> cyclical concern

β –> persistence

θ_i –> country fixed effect

μ_t –> common time effects

Fiscal Reaction Function: Estimates

DCAPB	Coefficient	Standard error	t	P>|t|	[95% confidence interval]	
$CAPB_{-1}$	-0.552	0.100	-5.52	0.000	-0.752	-0.353
$GROWTH_{-1}$	-0.229	0.089	-2.59	0.012	-0.406	-0.053
$DEBT_{-1}$	0.011	0.010	1.18	0.242	-0.008	0.0302

- a 10% debt/GDP rise leads to an extra adjustment of 1% GDP
- 1% fall in growth eads to extra tightening of more than 0.2 of GDP

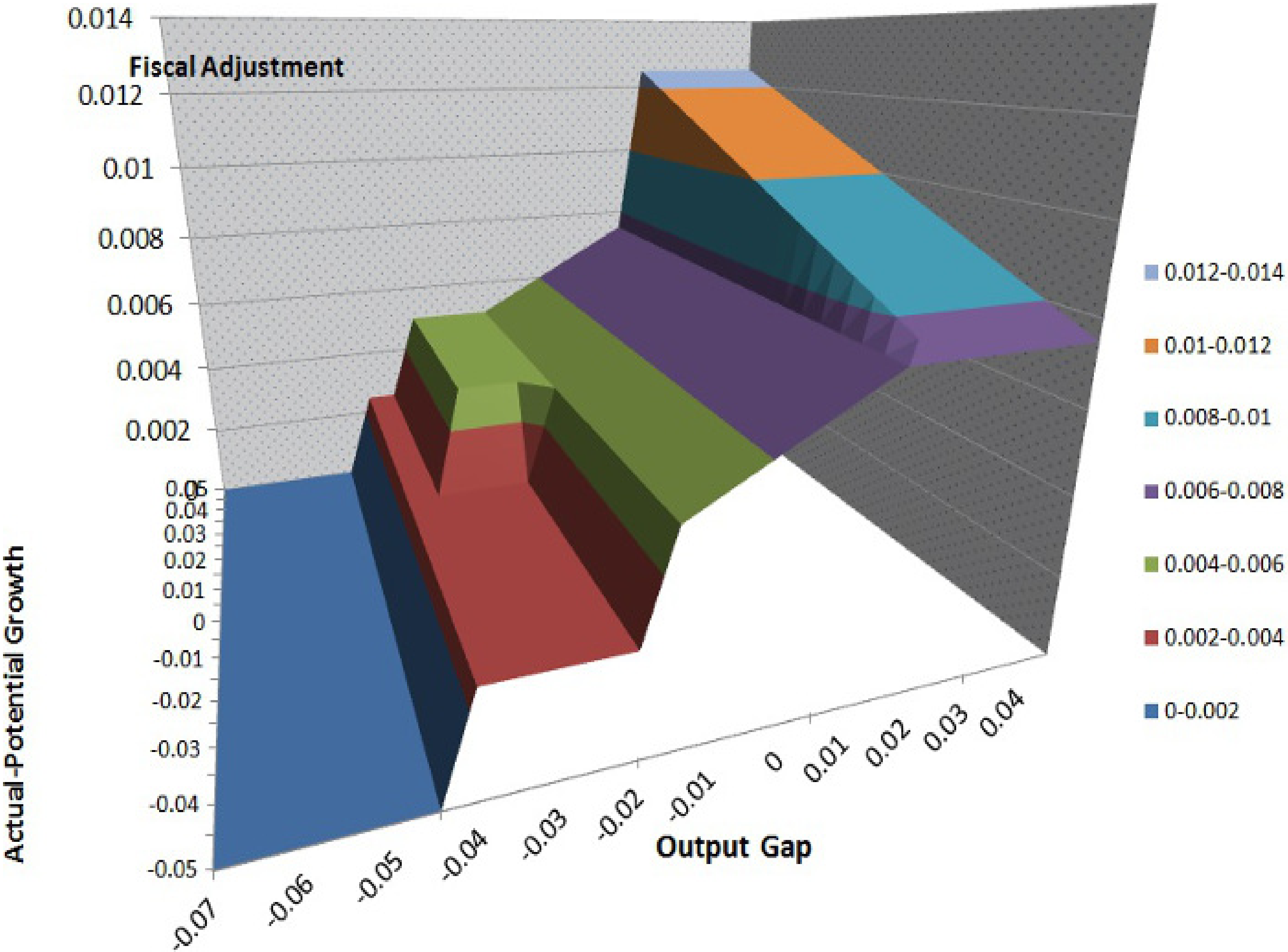
3. Stability and Growth Pact New Guidelines

Address right issues: pro-cyclical policy, investment, structural reforms.

Exchange More «Flexibility» in fiscal consolidation for

- Structural Reforms: ok
- Investments: limited effects
- Bad Cyclical Conditions: complex, non transparent, «unfair», pro-cyclical bias, relies on unreliable indicators

Cyclical conditions



4.Proposals of Reforms

Ex-post:

- Euro budget for counter cyclical policy, funded by shares of VAT. For example

European Unemployment Insurance Scheme, common eligibility criteria, balaced position over 3-4 years, voluntary participation, conditional on labor market reforms

Ex-ante:

- Concentrate on few indicators: domestic and external debt, set targets over ¾ years, penalties and rewards, no need for cyclical correction, allow for structural reforms
- No bail-out clause: trasform ESM into SDRM

->Move from bureaucratic centralized control with no transfers and bail-out to incentive-based system with transfers and no-bail out