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Alternatives to Renew Monetary Policy and the Stability and Growth Pact in the Euro Area

SUMMARY: Due to radical fiscal adjustments and the overdue monetary easing, the lag of the European economy behind the United States has grown by more than 7 per cent in the past five years, although the source of the crisis was not the EU but the US. The efficient method of crisis management would be if the ECB were also to announce a “*quantitative easing*” Securities Markets Programme and were to begin buying government bonds of peripheral countries where the unemployment rate is higher than natural. It would also be necessary for the ECB to not only apply inflation targeting, but – just like the FED – to take into consideration the unemployment rate as well when shaping its monetary policy. In addition, the criteria of the Stability and Growth Pact should also be changed: it would perhaps be better to define targets for the rate of net country debt and the balance of payments rather than creating rules for gross public debt rate and public finance deficit.

KEYWORDS: public debt, European Central Bank, Securities Markets Programme, Stability and Growth Pact

JEL CODES: E58, E62, E63, F34

Who would have thought in 2008 that the economic performance of the European Union would not reach the pre-crisis level even after five years? Has anybody ever thought that Europe would perform in 2013 compared to 2008 as it did in 1934 compared to 1929? (See *Chart 1*) Would anybody ever have imagined that several EU politicians and the leaders of the ECB would be celebrating growth around 0 per cent as a triumph in 2013–2014? Has anybody ever thought it would be possible for the gap between the US and the EU economies to widen significantly (by over 7 per cent) in a period of five years, even though the hotbed of the crisis was the US rather than the EU?

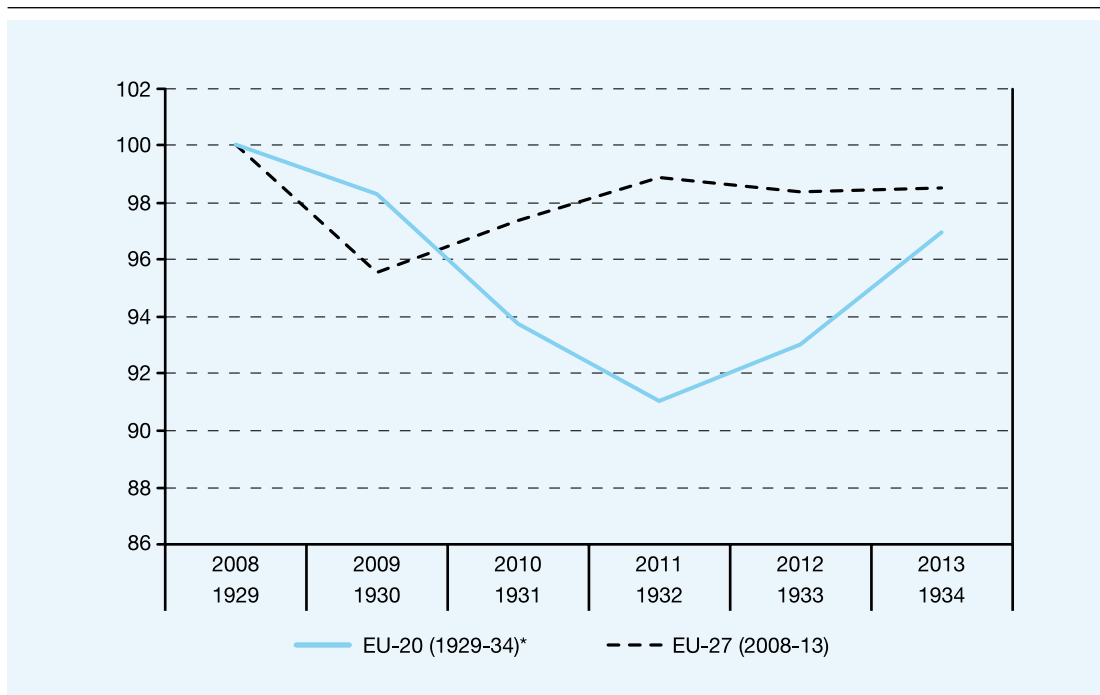
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In 2008, only very few people might have expected that such a scenario would occur. How did we get ourselves into this situation after all?

Why has Europe performed so poorly in the last five years and why are the future prospects so extremely dim? Essentially, the problem can be traced back to three causes.

① The fact that the euro area is not an optimal currency zone (Mundell, 1961), and as such it is unable to rapidly and flexibly adapt to asymmetric economic shocks constitutes a structural problem. On the one hand, the reason for this is the inflexible labour market that stems from linguistic and cultural differences, and on the other, the lack of a federal budget and economic policy.

REAL GDP IN THE EUROPEAN COUNTRIES IN 1929–1934 AND 2008–2013



*The EU-20 does not include Cyprus, Estonia, Latvia, Lithuania, Malta, Luxembourg and Slovenia. There are no data available for the period between 1929 and 1934 for these countries.

Source: Eurostat and Maddison Historical Database

2 Europe applied a considerably less successful mix of fiscal and monetary policy than the US, Japan or Great Britain. The introduction of strict fiscal austerity measures and the lack of a lax monetary policy, that is, quantitative easing, resulted in a radical decline in aggregate demand.

3 There were no macro-economic indicators prescribed for the member states of the euro area which could ensure balanced growth and prevent debt crises. (The Maastricht convergence criteria and the Stability and Growth Pact prescribed an erroneous set of conditions already at the very beginning.)

The present article will address the issues listed under points 2 and 3 in more detail.

THE FAILURE OF THE “TORONTO TURN”

As I have explained in one of my earlier papers (Kertész, 2013) and in agreement with *Dedák* (Dedák, 2013 [2]), the economic turnaround that occurred in June 2010, which was adopted at the economic summit in Toronto with the participation of 20 developed countries, had a crucial role in the failure of European crisis management. According to this new view, the economic challenges had changed and a new economic policy was needed. At the time, decision makers believed that the economies were recovering after the 2008–2009 financial crisis, economic growth was picking up again, unemployment was on the decline, so there

was no need for further economic reflation and fiscal support for growth; quite the contrary, the “right direction” is to reverse the whole process. As the participants of the summit put it: “*Advanced economies have committed to fiscal plans that will at least halve deficits by 2013 and stabilise or reduce government debt-to-GDP ratios by 2016.*” (The G-20 Toronto Summit Declaration, point 10 [page 3], June 2010)

According to the new approach, the real enemy is now the indebtedness of states, saying that “*government debts are on an unsustainable course, and therefore, the right way to prosperity is to recover the confidence of investors and financial markets.*” Jean Claude Trichet, former governor of the ECB said the following in this context: “*The idea that austerity measures could trigger stagnation is incorrect.... I firmly believe that in the current circumstances, confidence-inspiring policies will foster and not hamper economic recovery, because confidence is the key factor today.*” (Trichet, 2010)

While the level of government debt regulated by law was raised year after year in the United States, and the FED, acting as the American central bank, announced the quantitative easing programme to stimulate the economy on four occasions,¹ EU Member States introduced severe austerity measures rather than implementing the long overdue monetary easing. In the meantime, the common monitoring system and compliance with the Stability and Growth Pact were rendered more stringent in order to supervise the Member States’ budgets and public debt processes by introducing the so-called “six-pack regulation.”² As a result, not only was financial confidence not recovered but by 2011, the peripheral countries of the euro area (Greece, Spain, Portugal, Ireland and Italy) ran into a massive debt crisis, the whole of Europe fell into recession again, and the long-term sustainability of Europe as a whole was questioned. The night-

mare of lasting stagnation and a “lost decade” is still the most likely, if not the most realistic scenario even today, in 2014 (*see Chart 2*).

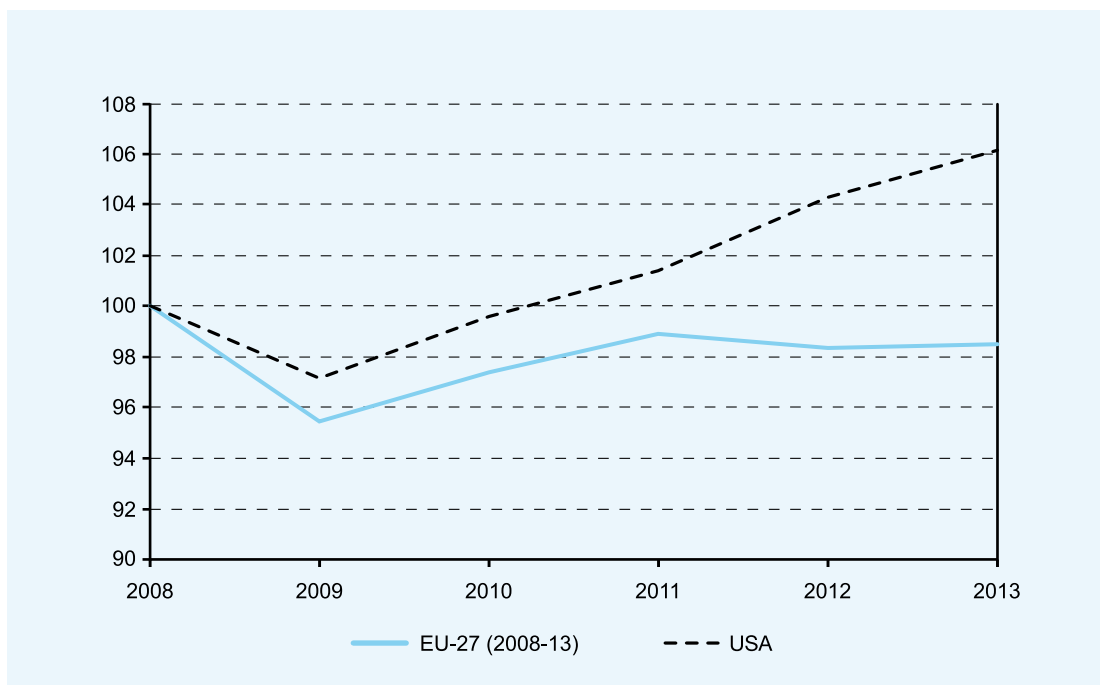
WHY WAS THIS MISTAKEN POLICY ADOPTED?

Contrary to what economic policy achieved in the United States, why did Europe champion a stringent fiscal policy rather than a lax monetary policy? After the severe recession in 2009, the economy was just starting to pick up momentum, unemployment stayed at a high level and European economies had a lot of surplus capacity. In such a situation, why did European governments immediately introduce very stringent austerity measures?

Misguided economic approaches to the reorientation of economic policy, psychological factors stemming from human nature and the often conflicting interests arising from the social and political diversity of the European Union may all have been decisive factors. The fear of indebtedness is rooted deeply in human nature. Everybody knows what it means if a household runs up a debt. It must be paid back, in other words, we cannot freely spend some of our future income but must use it for debt repayment. In case of default, we must take responsibility for the accumulated debt with our property, so we can bequeath less to our children. All these concerns can be easily translated into the state’s debt, as for example British Prime Minister *David Cameron* put it: “*Government debt is the same as credit-card debt, it’s got to be paid back*” (Skidelsky, 2012). But we can also look at it as a violation of solidarity between generations: today’s debt will be the burden for the future generation.

It was easy for the politicians to communicate the turn to fighting indebtedness, and it was also simple to ensure social support for the programme since there was no need for

TRENDS IN REAL GDP IN THE EU AND THE US BETWEEN 2008–2013



Source: Eurostat

a complicated economic explanation. The general public was presented with an objective that appeared to be true and credible on the basis of the people’s personal experience: if the debt of a household increases, you should tighten your belt; why should it be different in the case of a state? This political vogue led to a change in approach and courage which questioned the former theoretical achievements of economics. In order to support this view, we can quote EU Commissioner for Economic and Monetary Affairs *Olli Rehn*: “*We cannot solve our growth problems by accumulating new debts over our old ones. John Maynard Keynes himself would not be a Keynesian in this situation*” (Krugman, 2013). In the meantime, it escaped his attention that in 1936, when the English *Keynes* published his *General Theory*, Great Britain’s public debt was over 150 per cent, that is, much higher than today, but this

did not prevent Keynes from arguing for a fiscal policy which may lead to a temporary increase in the deficit but which can help overcome the severe crisis and promote growth.

Of course, the policy aimed at reducing public debt cannot be explained by general fears, psychological factors and a mistaken approach to economic policy only. Another factor that may have played a role in it is that the euro area is not functioning within the framework of a supranational institutional system, but it can still be viewed as an alliance of nation states in which budget policy is determined at the national level. Political, cultural and social diversity also entails that the national politicians who want to satisfy their voters are mainly interested in reducing the risk of having to support and bail out the economies of other countries from their own national resources. This interest also ensures

that the Member States set budgetary restrictions and rules for one another with the aim of reducing public debt in all Member States.

Most of them recognised that a serious mistake had been committed only several years later when the protracted recession and the lag of the continent became all too obvious. Even in this case, the adjustment of economic policy is made difficult by the fact that it is hard to persuade the voters of the Member States that introduced a more economical and stringent budget policy and which have less public debt to accept any policy which has the potential risk or even the outcome for them to have to reach into their pockets and bail out the countries struck by the crisis.

WHY IS THE NIGHTMARE OF PUBLIC DEBT FALSE?

When we consider debt not at the individual's level (e.g. from the point of view of a household) but at the macro level or even at the level of the global economy, the first thing we need to understand is that net debt at the global level is always zero. This is not a statement on the operation of the economy but a simple statement on the identity of accounting. On the other hand, the debt of a particular economic player is always the financial wealth of another economic player, so in a macro-economic sense, debt is not something negative at all which should be "chased with fire and sword." (Dedák, 2013 [1]) What, for instance, is a debt for a state embodied in the form of government bonds, is financial wealth for the bondholders. *As Wolf* put it this very appropriately: "Contrary to what is often said, the present is not simply bequeathing larger debts to the future. It is bequeathing both larger debts and larger financial claims in order to sustain a larger economy, now and in future."

In order to provide further support for the

claim that the goal is not to eliminate debt in full, we may want to consider that in the modern financial system, virtually any money is credit money (including cash) which represents both financial wealth and debt. If we were to reduce or eliminate debt in full, we might come to the extreme and obviously irrational conclusion that 'money itself should also be eliminated.'" (Kertész, 2013) On the contrary, constantly growing economies indeed require a continuously growing amount of financial wealth as well.

We should also note that the potential reduction of public debt under normal conditions of economic cycles never creates any problems. When doing so, the base rate cut ensures that the state, which is reducing its expenditure and cutting its debt, is replaced by the spending as well as the debt of other private or foreign players (who are less indebted), ensuring that the amount of financial wealth does not decrease.

① In practice, this means that although public expenditure and debt decrease, due to the falling base rate it is worth it for the private sector to take out loans and spend more on investments, hence the debt of the private sector will rise. In other words, in place of the government bonds, the banking system begins to create new (credit) money, again pumping liquidity and financial wealth back into the economy.

② The other possibility is that as a result of the depreciating national currency, foreign agents will buy more domestic products and net export will grow, so domestic economic agents will own financial assets of foreign origin instead of the former government bonds.

It is worth considering this train of thought regarding the cutting of public spending not

only in terms of debt vs. financial wealth, but also in terms of the macro-economic income formula ($Y=C+I+G+X-IM$): if public expenditures are cut, income can only stay the same if the interest rate is cut and/or the national currency is depreciated to the necessary extent, resulting in an increase in investments and/or net exports.

Troubles begin to emerge when the interest rate has reached the zero lower bound (ZLB), that is, a liquidity trap has set in, and the crisis is global, in other words, there is no way to remedy the problems through the surplus in the balance of payments, so the debt cannot be “migrated abroad.” In such an environment, the primary goal of economic policy should by no means be the reduction of public debt. This is because if public debt is reduced, with the already zero interest rate and the liquidity trap it would not be possible to create other financial assets to replace the government bonds either, resulting in a decrease in financial wealth in the economy. As a result, the economic players would cut back on their current purchases, thereby further decreasing macro-economic demand. This way, some of the economic capacities would become unused (creating unemployment and decreasing the utilisation of machinery, equipment, real properties and production capacities) and economic performance would drop. This, therefore, would lead to an extremely negative, self-generating spiral, ending in a general shortage of liquidity and economic collapse, while debt rates (total debt proportionate to income) would not necessarily fall.

We can consider the same train of thought not only in terms of debt vs. financial wealth, but also in terms of the macro-economic income formula ($Y=C+I+G+X-IM$): if government expenditures are cut, but the decline in demand is not offset either by investment or by a rise in net exports, because there is low demand and zero interest rate all over the

world, macro-economic income is bound to fall. That is what we have basically observed in the peripheral European countries hit by the crisis. For example, the IMF–EU–World Bank troika tied its financial assistance to radical budgetary constraints and public debt reduction in the case of Greece. However, this led to a larger than expected setback in the Greek economy, and eventually the public debt-to-GDP ratio continued to rise despite the fiscal adjustments. This is also true for the whole of the euro area: despite significant fiscal adjustments, the public debt rate of the euro area countries was considerably higher at the end of 2013 (93.4 per cent) than in 2010 (80 per cent). In addition, it was coupled with several years of recession.

So, with zero base rate and high excess workforce and capacity, the burden of public debt presents a very different picture from the conventional one. What we are dealing with is something that physicists are also aware of: close to the speed of light, different rules are at work than in the case of normal (everyday) speed conditions.

THE REAL BURDEN OF GOVERNMENT DEBT

Contrary to certain views (e.g. David Cameron’s statement cited before), the real macro-economic burden of public debt is not that it has to be repaid sometime in the future. On the one hand, this would at best mean reallocating financial wealth from one actor to another, and on the other hand, in theory the states can continue to renew their debts over an indefinitely (or very) long period, so perhaps this debt does not necessarily need to be repaid.

The real burden of public debt according to the standard economic theory is that the public finance deficit drives down corporate

investments through increasing interest rates, sucks away funding resources and, as a result, reduces the growth potential of the economy.³ Therefore, it is important to stress that the public finance deficit and public debt are a real burden on the real economy if and only if they generate an interest rate rise and jeopardise growth. Because in this case, the economy produces a smaller GDP and a lower level of social welfare than, *ceteris paribus*, a deficit and government debt would entail. This is the real burden of public debt rather than the fact that the generations living sometime in the distant future will have to pay it back. Moreover, the real burden of public debt is not an intertemporal reallocation at the expense of future generations and for the benefit of the present generation; the real burden is that the lower increase in annual GDP hits both the present and the future generations equally hard.

SECURITIES MARKETS PROGRAMME INSTEAD OF FISCAL AUSTERITY!

In contrast to the crisis management applied so far in the euro area, what the Member States with massive unemployment and free capital capacity but also struggling with a general shortage of demand and economic crisis require is not budgetary constraints, a painful reduction of public debt and financial wealth, an additional cutback on macro-economic demand and liquidity; much rather, just like the monetary expansion introduced by the central banks of the US, Britain and Japan, they would need extra money, a government bond purchasing programme followed by a “final incineration” of the repurchased government bonds, that is, the monetisation of government debts (Kertész, 2013).

Technically, this could be done by the European Central Bank by exchanging repurchased government bonds for zero interest rate cred-

its with indefinite maturity. In other words, the ECB would return the repurchased bond to the issuing country and would in turn receive a zero interest bearing bond of the same exchange rate value with no maturity⁴ (Paris – Wyplosz, 2013). The Paris–Wyplosz article cited before also shows that in the current European situation, no other strategy for the reduction of public debt (e.g. running up budgetary surpluses or privatisation revenues, or the reallocation of budgetary resources from more successful member states of the euro area to states hit by the crisis) could be successful. On the other hand, creating money does not involve any significant inflation risk in an economy with excess capacities and high unemployment.

From all this, it follows that in the current situation with quasi zero interest rate the European Central Bank should be actively and boldly buying the government bonds of the countries hit hard by the debt crisis as well as those of other countries where there are free capacities in the economy and unemployment exceeds the natural level. Due to the massive indebtedness of the private sector, corporate demand for loans is very low in these countries even with a zero interest rate. In such a situation, only the state can take the initiative and take out loans and invest, which the central bank (with its virtually unlimited ability to create money) is able to fund. Furthermore, it should be noted that the Securities Markets Programme implemented by the central bank is the only tool of monetary policy which can continue to reduce the (still higher than zero) interest of long-term bonds even with the short-term interest rate cut to zero. It is true that corporate demand for loans and investment can mostly be influenced by the interest rate of long-term rather than short-term loans. In addition, in a political sense it would also be much easier to assist Member States through monetary expansion and creat-

ing new money, rather than having taxpayers of economically more successful countries finance the debts of countries hit by the crisis.

Economists usually come up with only one single counter-argument against the monetisation of public debt. Namely, if it is priced into expectations that the European Central Bank is willing to “bail out” Member States in trouble, in other words, it is ready to monetise debt and spread the burdens all over the entire euro area, there will be a higher moral hazard that the governments of these Member States will manage their economy even more irresponsibly and will be even more inclined to overspend and become even more indebted. This risk factor, which should indeed not be neglected, can however be controlled by the ECB by tying assistance to specific conditions in each case. For instance, the given Member State could be required to spend a particular amount of money which corresponds to some part of the total debt monetised by the ECB on growth-enhancing investments, creating jobs or improving its balance of payments. Incidentally, this requirement would not only be very important for eliminating the moral hazard but for the stimulation of the economy as well. If the private sector does not begin to invest even with a zero interest rate (e.g. because of an overly pessimistic sentiment and the intention to reduce former debts), another actor (the state) becomes indispensable, which can and is willing to think in anti-cyclical terms, that is, to become indebted and launch investments that boost demand.

The monetisation of public debts has been taking place in massive volumes in the United States, Great Britain and Japan; however, in the euro area it has appeared only in words so far. However, even mere words have already produced some positive results. When the ECB announced its Securities Markets Programme for the peripheral countries in the summer of 2012, the risk premiums began to

decline abruptly and sharply. In this context *Olivier Blanchard* said the following at a recent conference organised by the IMF: “... it is essential to have a lender of last resort, ready to lend not only to financial institutions but also to governments. The evidence on periphery sovereign bonds in the Euro area, pre and post the European Central Bank’s announcement of outright monetary transactions, is quite convincing on this point” (Blanchard, 2013).

THE LIMITATIONS OF A “NON-CONVENTIONAL” SECURITIES MARKETS PROGRAMME

At this point, the reader might wonder whether such a Securities Markets Programme could only be successful in the current situation with a zero interest rate or whether monetary expansion through creating money could also be useful in an economic situation when the interest rate is higher. The answer is straightforward: the Securities Markets Programme – as a “non-conventional” tool for the central bank – is only useful when the interest rate is zero and it can achieve the desired goal only in this environment. This is because when an economy is in recession but has free capacities, technological innovations and free workforce, then the base rate cut can in the same way create demand for loans that is necessary for investments. If, however, an economy does not have free workforce, technological innovation and willingness to invest, then even a monetary expansion implemented with unchanged central bank base rate would not boost investments but the newly created surplus money would, at best, be accumulated on the accounts of commercial banks held with the central bank. If there are no profitable investment opportunities with a promising prospect for profitability, and in the meantime interests do not decline and

consequently loans do not become cheaper, companies will not take out loans and banks will not extend more loans even if the central bank repurchases the government bonds owned by the banks. The only change is that the banks will make a profit by depositing their financial wealth at the central bank rather than by buying government bonds.

If the central bank base rate is higher than zero, the central bank, by cutting the interest rate, can create an environment which encourages the commercial banks to create more money, enabling the central bank to implement the necessary monetary easing. If the market interest rate falls, more investments will produce returns, more enterprises will be able to afford to take out loans, so it will be worth it for the commercial banks to create more credit money and money supply will grow in the economy. So, if the interest rate is higher than zero, the central bank can use the base interest rate to adjust (have the commercial banks adjust) money supply to the needs of the economy. Accordingly, with free capacities, high unemployment rate and recession, the central bank has nothing else to do but cut the base interest rate and watch how the growing loan demand, competition among the commercial banks, flexible credit supply, in other words, the effective operation of the credit market can ensure the liquidity that the economy needs.

In connection with the previous sentence, some economists tend to come up with the following (in my view mistaken) counter-argument: higher loan demand due to lower interests is not sufficient for boosting the economy because it is not sure that the commercial banks will be flexible enough in expanding their credit supply. I firmly believe, however, that this is a mistaken assumption and the key is in each case the ensuring of loan demand since this is what always creates a bottleneck. It is true though that credit supply

and the bank's ability to create money are constrained by the rules on the minimum reserve rate, the Basel rules and healthy risk aversion. The banks do not wish to use high leverage in their operations because even with only some of the loans failing, they may easily lose their entire equity capital and go bankrupt. However, the banks can easily get around all the three problems through the increase of capital. If due to the reduced central bank base rate the market interest rate is low in an economy and many new investments become profitable, the banks can extend their lending opportunities through increasing their equity capital by issuing new shares. This option is always available on a healthy market. If an economy is booming and there are lending opportunities for the banks which promise really high returns, private individuals and investors will subscribe the newly issued shares of the banks, providing fresh capital for them.

It is not realistic and goes against economic theory to assume that only investing companies which represent loan demand can rationally foresee economic prospects, that is, only these companies can assess that new investments could be profitable, while the management and the shareholders of banks cannot recognise it even in the long-term. Of course, there may be times in the short-term when knowledge is asymmetric, but in the long-term it can hardly be assumed that the enterprises are always better informed and more optimistic about the future than the management and the shareholders of the banks. Naturally, in the short-term, for example in a crisis period after an overheated period of lending, at the time of balance sheet adjustment, the banks may decide to temporarily curb their lending activity and some sectors or small and medium-sized enterprises that are seen as more risky may not get a sufficient amount of loans even if they are believed to be competitive (Hosszú – Körmendi – Tamási

– Világi, 2013). However, in the long-term and in a healthy economic environment, the banks can acquire the necessary equity capital to cover the loans and their profit-oriented mentality also drives them to lend to competitive enterprises. Since in the long-term, the management and the shareholders of the banks can foresee economic processes just as well as investing companies, we can conclude that with properly forecast and profitable investment opportunities not only will loan demand increase, but loan supply will also be able to adapt to this higher demand.

Problems arise only when there are free capacities in the economy (free workforce and technological innovations) and the central bank has already cut the central bank base rate to zero but loan demand has not recovered yet (for example because of excessive pessimism and the intention to downsize previous loans). In this case, the only option is to increase public investment followed by quantitative easing, that is, to increase money supply through a Securities Markets Programme. This is the point when the state has to intervene, the actor which can and is willing to act in an anti-cyclic way and become indebted and invest at a time when other actors are busy downsizing their debts. The Securities Markets Programme and public investments covered by monetary expansion should not be seen as a wonder drug that can cure anything, but rather as a tool to be used when the base rate cut cycle runs into the zero lower bound, that is, when conventional tools for boosting demand have been exhausted, but have not yet accomplished their goal.⁵

“INFLATION TARGETING” MIGHT ALSO NEED TO BE ABANDONED

The key objective of the monetary policy of the European Central Bank is very different from

that of the American central bank. The ECB solely focuses on “inflation targeting” (IT), its primary goal is to maintain price stability (2 per cent HICP) and it can promote any other secondary objective only if the achievement of its rigidly fixed primary objective is not exposed to any kind of risk. In contrast, the FED weighs its objective at its own discretion and does not use a straightforward hierarchy for weighing the importance of the natural rate of unemployment, the output gap and price stability. It should be noted that the ECB is not alone in using inflation targeting in its policy, as on the one hand numerous studies have been published in relevant literature on the theoretical advantages of this system since the beginning of the 1990s, and on the other, a number of countries have already introduced this policy in practice. However, the most recent studies – such as the IMF working paper (Filho, 2010) – tend to show that although these countries have undoubtedly been successful in containing inflation and anchoring inflation expectations, the benefits of IT cannot be seen as far as economic growth and boosting employment are concerned

Furthermore, it is easy to see that considerably greater social damage is created in countries struggling with excess capacity and unemployment because of falling output due to the lack of demand and its long-term spillover effects than any damage caused by a possibly few percentage point higher inflation due to the monetisation of debts. According to standard macro-economics, inflation incurs only the following social costs (Mankiw, 2002):

① In an inflationary environment, companies often have to change their prices, which incurs additional administrative costs (metaphorically speaking: menu cost).

② In order for the people to preserve the purchasing power of their money, they often have to go to the banks, which entails costs

and effort (metaphorically speaking: shoe-leather cost).

③ In an environment of high inflation, the prices of products relative to one another change more rapidly, which makes financial planning more difficult for consumers.

④ In an environment of high inflation, legislators have to amend tax rates and tax brackets if they want to avoid increasing real tax burdens. Accordingly, the frequent changes impose additional administrative burdens on society,

⑤ unexpectedly high inflation may rearrange financial relationships between debtors and creditors. Namely, if interests (and other, even implicit future benefits, such as pensions) are not indexed with inflation, unexpected inflation practically means the rearrangement of wealth to the benefit of debtors and to the detriment of creditors.⁶

Readers constantly being frightened by the nightmare of inflation may be surprised to read that the social cost of inflation recognised by macro-economics is only this much. In addition, it is also easy to see that with an inflation rate of just a few per cent per year, and in the world of the internet-based society, these costs become negligibly small. When the prices are often not even indicated on paper and internet banking and purchasing are becoming widespread, related transaction costs continue to fall. If we compare these costs to the long-term costs of unemployment,⁷ the low social cost of inflation becomes even more striking. The rise in unemployment does not only entail temporary output problems but, according to the so-called hysteresis theory, the natural rate of unemployment may lastingly increase due to the recession and, as a result, the potential output level may also fall (Blachard – Summers, 1988). Moreover, all this has been substantiated by European examples (Blachard – Summers, 1986). The theory explains this by claiming that during the pe-

riod of unemployment, people may lose some of their abilities, which leads to their lower productivity in the future, and on the other hand, their attitude to work may also change for the worse, reducing their willingness to find a job. Thirdly, unemployed people trying to find jobs face further challenges because if those without a job lose their membership in trade unions, they will have less influence on wages. Therefore – since those with trade union membership are interested in more rapid wage increases –, the demand for higher wages may lead to higher unemployment than what is socially warranted and to lower potential output levels (the literature calls this conflict of interest between the employed and the unemployed the *insider-outsider* problem). According to the hysteresis theory, the rise in unemployment rate may bring about a long-term increase in the natural rate of unemployment as well. Econometric analyses and empirical studies also point out that hysteresis is much more likely to occur in Europe than in the United States (León – Ledesma, 2002).

The fact that the long-term social costs of a rising unemployment rate and the shortfall of the potential output level in the economy are much higher than those of an inflation rise of a few percentage points also entails that the European Central Bank should follow not only its inflation target but, like the FED, it should also focus on several objectives simultaneously: price stability, output gap and the deviation of unemployment rate from the natural rate. (One of the special ways of realising this is the nominal GDP objective method proposed e.g. by *Frankel* [2012]). Recently Nobel Laureate economist *Joseph Stiglitz* explained his similar opinion to the socialist parliamentary group of the European Parliament: “*The European Central Bank should scrap its target to keep price inflation at 2 percent... central banks should look to strike a balance between controlling inflation and supporting job creation... the*

ECB's mandate needs to be changed (Stiglitz, 2014). Incidentally, Stiglitz has also been proposing for some time to both the ECB and the developed and developing countries that their central banks should abandon their system of inflation targeting (Stiglitz, 2008).

MORE RELEVANT DEBT REGULATIONS ARE ALSO NEEDED

In addition to the management of the actual crisis, it would also be necessary for the regulatory authorities in the euro area to put more emphasis on the prevention of asymmetrical debt crises similar to the present one. In my view, the gravest mistake of economic policy is that economists and politicians responsible for the economy (also including the highest decision-making and regulator levels, such as the EU, IMF, World Bank, the Maastricht convergence criteria) usually regulate the debt rate of only one economic player, namely the state, disregarding both the internal structure of public debt and the total debt of other economic agents. [The summary written by Fischer – Jonung – Larch (2006) and published by the European Commission presents and analyses 101 (!) reform proposals published before 2005 which proposed the reformation of the Stability and Growth Pact in 2005.]

Both the Maastricht convergence criteria and the Stability and Growth Pact assumed responsibility solely for the total gross debt ratio of the state and the annual balance of public finances. However, they failed to take into account for instance the following:

- ① how large the share of the government debt owed to foreigners is,
- ② how large the state's foreign currency reserves and its claims against foreigners are,
- ③ how large the state's total implicit liabilities for the future (such as those arising from

the pension system or the bailing out of large public companies and commercial banks) are,

- ④ how large the net financial wealth of the private sector is,

- ⑤ how large the total debt of the private sector due in foreign currency is, etc.

All these factors have a strong impact on the financial vulnerability of a given country. Accordingly, the higher the share of debts due in foreign currency and to foreign economic agents, the more vulnerable the given national economy is, since it is exposed to the volatility of the exchange rates and the willingness of foreign investors to fund the economy.

It follows from all this that a bad system of conditions was laid down at the very outset when the euro area was created and economic decisions have been based on mistaken macro-economic analyses ever since. As *Buti* (2007) put it, the Stability and Growth Pact was written primarily on the basis of political rather than professional factors, and the goal of the rigid criteria was, on the one hand, to convince the German public of the stability of and the need for the monetary union and, on the other, to convince the northern states that the southern states should also be included in the monetary union because their budget would be centrally regulated by strict measures. However, what would really be needed is a new set of convergence criteria and new economic regulations which define more efficient incentives for the countries in a professional sense. In what follows, I want to argue that it is the consolidated net debt of a country (state + the private sector) owed to foreign investors rather than the state's gross debt ratio that should be monitored as the most important debt ratio along with one subset of it, the country's net foreign currency debt ratio.

- ① The difference between the gross and the net ratios is represented partly by the loans extended by the given country and

partly by its foreign currency and gold reserves. If, however, the reserves and the debts are in the hands of “good debtors”, there is no maturity mismatch between the debts, and the credit market is also sufficiently liquid, the net debt ratios are more relevant than the gross ratios.

② The country’s total debt ratio (including both the state and the private sector) paints a considerably more realistic picture of the macro-economic situation than the public debt ratio. If, for example, the saving ratio of the private sector is high in a given country and, at the same time, the private sector is not willing to invest (even after the central bank has cut the base rate to zero), as Keynesian logic also dictates, as it has been mentioned in this paper before and as is explained in detail by Dedák (Dedák, 2013[1]), the accumulation of public debt is not only not harmful but is actually inevitable. Otherwise, the reduction of the debts would result in the reduction of wealth as well as the slow-down of the economy.

③ Public debt can be seen as a real burden only if it is due to foreign investors. Since, in theory, states can renew their debts for an indefinitely long period of time and can even monetise them through the creation of money by the central bank, the real burden is not the repayment of the debt at a future time, but only the lasting income transfer from debtor to creditor, namely the servicing of interest payments. However, in countries where the saving ratio of households is high and the state is indebted only to internal actors, the same transfer of income simply means the redistribution of income among domestic actors, which does not generate any macro-economic imbalances (and which can easily be corrected by means of taxing and social assistance if there is a social and political need for it). (It should be stressed that this statement continues to hold true in a “chemically pure” man-

ner only with zero base rate and the liquidity trap. With a positive interest rate, the public finance deficit reduces private investments through a crowding-out effect and may do damage to the real economy even if it can be financed without any problem.)

④ Although it is true that private debts cannot be renewed for an indefinite time, nor can they be monetised (unless these debts are assumed by the state), regardless of this the claim is still true in this case that the transfer of income stemming from the interest burden creates a macro-economic imbalance if and only if the debt is due to foreign actors. Lending between domestic actors at the worst generates a domestic redistribution of income, which can be corrected at any time, if necessary, by taxing and social assistance.

⑤ It is also worth devoting increased attention to a country’s net foreign currency debt within its net foreign debt. If this debt is exposed to an increased depreciation risk of domestic currency, it represents a high risk for the national economy.

If we accept that from the point of view of macro-economic balance the most important indicator for stock variables is the consolidated net debt of the national economy due to foreigners rather than gross government debt, then it directly follows from this that for flow variables, the most important indicator is the status of the balance of payments rather than the public finance deficit. The most relevant external balance indicator within the balance of payments can be derived by calculating the aggregate balance of current balance of payments, capital balance and foreign direct investment (FDI) within the financial balance.⁸ (The reason why only the direct capital investments apparently involving long-term ownership and a strategic goal should be considered within the financial balance is because short-term portfolio investments do not necessarily represent lasting, predictable and stable funds

for the country.) In the event that this aggregate balance is not negative, it means (disregarding short-term portfolio investments) that the external debt of the country is not growing, that is, the aggregate balance of the changes in the country's foreign loans and foreign currency reserves is not negative. However, in a country where this balance is permanently negative, said country's net foreign debt continuously increases too. And this will, sooner or later, lead to a deterioration of investor confidence, a rise in real interests, capital flight and a decline of investments. In addition, because there are no national currencies in the euro area, this cannot result in the depreciation of the domestic currency; however (unless there is financial help from abroad), very painful processes could begin, coupled with a decrease in real wages, deflation and recession in the real economy, in order to adapt to the new conditions (like e.g. in Greece).

SUMMARY

In order to ensure long-term development and balanced growth for the euro area, the approach to economic policy should definitely change. The economic performance of the euro area still falls behind the level seen before the 2008–2009 crisis and it lags significantly behind the United States, which will likely exceed the 2008 performance level by as much as 9 per cent this year. The most important reason for this is that the US carries out a much more efficient crisis management: the government debt ceiling was raised constantly and the American central bank implemented monetary expansion as well.

The European approach to economic policy, which holds that stringent fiscal discipline coupled with the conservative inflation targeting policy of the central bank will recreate investor confidence, which will in turn pave the

way for rapid economic growth, has turned out to be entirely mistaken. Not only did it not pave the way for growth, but today economic stagnation goes hand in hand with the increase in total debt and a deflation risk. It is also a mistaken view that the real burden of public debt is that it will have to be repaid by the future generations. As a matter of fact, in theory, states can renew their debts practically for an indefinitely long time, and public debt has real macro-economic burden only if it results in higher real interests and the state crowds out private investments, thereby reducing current and future output.

Since the euro area is not an optimal currency zone and the global economic crisis has produced an asymmetrical shock (while unemployment rate is lower than the natural rate in the centre states and it is over 20 per cent in some peripheral states), the monetary policy of the European Central Bank should be targeted and differential. On the one hand, the central bank should have a much more active approach which provides more support for growth, but on the other hand, the ECB should buy government bonds to increase money supply in the peripheral countries hit hard by the crisis where unemployment is high and huge free capacities as well as massive government debts have been accumulated. With zero base rate and a liquidity trap, there is no inflation risk in it and, on the other hand, there is no other solution available for monetary policy (interest cannot be decreased any further).

Of course, it is also important to stress that quantitative easing has its own limitations and can only be applied with zero central bank base rate to achieve its goal. If the base rate is positive, commercial banks can increase money supply once the central bank cuts rates. On the other hand, the money supply provided by the central bank would not necessarily achieve its goal because the extra money would go into central bank deposits rather than into new investments.

Economists tend to forget that according to macro-economics, the social cost of inflation is not actually high. They paint a much more frightening picture of inflation in practical economic policy than what is warranted by the theory. In addition, more recent research seems to prove that the countries using inflation targets cannot really take advantage of boosting economic expansion and reducing unemployment. This is why it would also be important for the ECB not only to focus on its inflation target, but also take into consideration unemployment rate and the fluctuations in business cycles as well when shaping its monetary policy.

The reasons for economic stagnation in the euro area and its lag behind other regions should not only be sought in crisis management but also in the failure to lay down efficient rules and convergence criteria at the time the monetary union was created. Instead of maximising public debt, it would be a much more relevant goal to maximise and reduce the net external debt of the entire national economies. It does matter a lot to what extent the private sector, apart from the state, is indebted or how much wealth it can accumulate. For the very same reason, Member States should be given targets for their balance of payments rather than for the public finance deficit.

NOTES

¹ As a result of quantitative easing, the FED's balance sheet total grew by four and a half times (!) over the last five and a half years, swelling to about 4,500 billion dollars from 1,000 billion. Incidentally, the FED continues to create money even today although the American economy is really growing quite nicely these days.

² For more details see e.g.: <http://www.eu2011.hu/package-six-legislative-proposals>

³ The crowding-out effect is equally present in both closed and open economies. In a closed economy, public spending results in a higher base rate, which reduces the willingness of corporations to take out loans and invest. In an open economy with a floating exchange rate system, the crowding-out effect is that the temporarily higher base rate generates an influx of capital, resulting in the appreciation of the exchange rate and a fall in net exports, in other words, the performance of companies producing for export decreases. In an open economy with a fixed exchange rate system, only the monetary expansion of the central bank can stop the appreciation of the exchange rate, that is, there is no crowding-out effect, only if the central bank creates new money to

maintain the fixed exchange rate. As shown in the next section, I propose this expansive monetary policy for the common currency zone as well.

⁴ This technical exchange is necessary to ensure that the given Member State does not have to declare bankruptcy on the government securities owned by the ECB and that basic accounting rules are observed (the amount of assets and liabilities should be the same in the accounts of each player).

⁵ Many propose even more radical solutions in the relevant literature, pointing out that in addition to quantitative easing, the euro area would need a banking union, common euro bonds and common fiscal policy. (For more details see for example: Valiante, 2011; Tilford – Whyte, 2011). I fully agree with these views too. This paper does not discuss this aspect because in a political sense, it appears to be extremely difficult and only a remote possibility to implement this type of policy today; it is only relevant as a kind of vision these days and it would also go beyond the space limitations of this paper.

⁶ However, it should be noted that this effect on the rearrangement of wealth should not necessarily

be viewed as cost in a macro-economic sense. On the one hand, because the rearrangement of wealth in itself does not necessarily lead to the deterioration of efficiency even according to the neoclassical economic theory, the second theorem of welfare economics. On the other hand, because the fact that wealth flows from creditors to debtors practically offers a solution for the structural debt crisis because it reduces the wealth gap between social groups and aggregate real debt. So, according to this approach, inflation can be seen as an automatic adaptation process taking place in the economy in order to overcome the debt crisis. It should also be noted though that the quantitative easing proposed in this article could be an even more efficient tool.

⁷ The Phillips curve, well known in macro-economics, shows that there is a trade-off between inflation and unemployment.

⁸ The current balance of payments consists of the sum of the foreign trade balance of goods and services, the balance of incomes earned abroad and the balance of unreciprocated current transfers. Those transactions without compensation are accounted for in the capital balance which are tied to some recapitalisation, debt relief, capital investment or the delivery of some intangible assets (such as a brand name, know-how, concession right, etc.) For example, a foreign parent company recapitalises its Hungarian subsidiary or investment funding is received from the EU Structural Funds, etc.

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