European Debt Crisis and Fiscal Exit Strategies

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Résumé : La crise financière de 2007-2009 a été causée par l'avidité et l'instabilité des marchés financiers. Elle a provoqué un fort gonflement des dettes et des déficits publics dans les pays développés. Les marchés financiers comme les institutions internationales réclament une politique de sortie de crise, passant par une réduction rapide des déficits, une forte baisse du niveau des dettes, ceci grâce à une forte réduction des dépenses publiques (et en particulier des dépenses sociales). L'article montre que la situation des finances publiques était globalement satisfaisante avant la crise ; que le creusement des déficits s'explique par les nécessités de la régulation macroéconomique ; qu'il n'annonce ni hausse des taux d'intérêt, ni hausse des taux d'inflation. La stratégie de sortie de crise doit comporter le maintien de bas taux d'intérêt et de déficit publics, tant qu'ils seront nécessaires pour soutenir l'activité, la remise en cause de la globalisation financière et des stratégies macroéconomiques des pays néo-mercantilistes comme des pays libéraux. La crise ne doit pas être l'occasion pour les classes dominantes et les technocraties européennes de réduire les dépenses sociales. Le renforcement du Pacte de stabilité et de croissance serait dangereux s'il privait les pays membres des armes qui ont été utiles durant la crise. La zone euro doit lutter contre la spéculation sur les dettes publiques en affirmant que celles-ci sont collectivement garanties par la BCE et les Etats membres. La stabilité économique mondiale n'est pas menacée par le déséquilibre des finances publiques, mais par le gonflement des activités financières spéculatives.

Abstract: The 2007-2009 financial crisis was caused by financial markets' greed and instability. The crisis led public debts and deficits to rise substantially in developed countries. Financial markets and international institutions claim for a "fiscal exit strategy" through rapid reductions in public deficits and substantial falls in public debts owing to large public spending cuts (especially social expenditure). The article shows that the state of public finances was generally satisfactory before the crisis; the rise in deficits was needed for macroeconomic stabilisation purposes and does not signal higher future interest rates or inflation. 'Crisis exit strategies' should keep interest rates at low levels and government deficits, as long as they are necessary to support activity; they should question financial globalisation and macroeconomics strategies in neo-mercantilist and in liberal countries. The crisis should not be an opportunity for leading classes and European technocracies to cut social spending. Strengthening the Stability and Growth Pact would be dangerous if it deprived Member States of policy tools that were helpful in the crisis. The euro area should fight against speculation on public debts by ensuring that public debts are collectively guaranteed by the ECB and the Member States. World economic stability is not threatened by public finances imbalances, but by growing speculative financial activity.

The 2007-2009 financial crisis was caused by the blindness and the greed of financial markets and institutions, by unsustainable macroeconomic strategies undertaken on the one hand by 'mercantilist' countries (China, Germany) and on the other hand by Anglo-Saxon countries, but not by a high burden of public expenditures, debts or deficits.

The financial crisis has shown that fiscal policy, public intervention and regulation remain necessary. The crisis provoked a rapid rise in public debts and deficits as governments had to intervene to rescue the financial system, recorded lower tax receipts (and higher unemployment expenditure), and had to implement measures to support activity. The 2008-2010 rise in government debts was not due to extravagant fiscal policies but to the combination of lower tax receipts and fiscal measures necessary to stabilise the economy.

In 2010, financial markets pretend to have doubts about the sustainability of public finances, even in industrial countries, and ask for large cuts in budget deficits even though the latter are needed to support activity.

The situation is particularly worrying in the euro area where the economic policy framework is not satisfactory. The Stability and Growth Pact has no economic basis; Member States (MS) cannot and do not want not to obey s*tupid* rules; national economic policies are not really coordinated; economic disparities are growing; these disparities are not taken into account in European policies coordination; the ECB's independence is problematic in times of financial crisis.

In the current debt crisis, what are the responsibilities of too lax fiscal policies in some EU countries, of the poor economic policy framework in the euro area and of dysfunction in sophisticated and speculative financial markets?

How will the crisis end? Will the euro area survive? Can EU institutions and MS implement a more satisfying economic framework?

In 2010, almost all OECD countries experienced large public deficits and large public debt increases. Should governments rely on growth to reduce government deficits? Should they, under the pressure of financial markets, quickly cut spending with a view to restore sustainable public finances at the risk of slowing down the recovery? Will the financial crisis allows leading classes and European technocracies to impose to population restrictive economic policies, liberal reforms and social spending cuts?

1. EU fiscal policies before the crisis

At the beginning of 2008, the EU's struggle against *excessive public deficits* appeared to have been successful. In June, the ECOFIN Council announced that no euro area country was under an excessive deficit procedure (EDP), while five countries in the area were under an EDP in 2006 (table 1).

Fiscal consolidation was not undertaken in euro area countries in 1998-2000 when GDP growth was satisfying (table 2). The cyclically-adjusted public balance (CAPB) deteriorated. The cyclical improvement in public finances and lower interest payments allowed government borrowing balances to move away from the excessive deficit threshold of 3% of GDP. EU authorities deplored that MS did not use the cyclical upturn to bring more rapidly their deficits close to balance.

Table 1. The Excessive Deficit Procedures

	2002	2003	2004	2005	2006	2007	2008	2009	2010
Portugal	24/9	EDP	11/5	22/6	EDP	EDP	3/6	07/10	EDP
France		2/4	EDP	EDP	EDP	30/1		18/2	EDP
Germany	19/11	EDP	EDP	EDP	EDP	16/5		07/10	EDP
Netherlands			28/4	7/6				07/10	EDP
Greece			19/5	EDP	EDP	16/5		18/2	EDP
Italy				16/6	EDP	EDP	3/6	07/10	EDP
Spain								18/2	EDP
Ireland								18/2	EDP
Belgium								07/10	EDP
Austria								07/10	EDP
Finland									12/5

Table 2. Public finances in the euro area

	GDP ggrowth, %	Public balance, % of GDP	Interest payments	Cyclical component	CAPB
1998	2.8	-2.3	4.2	-0.5	2.4
1999	2.8	-1.4	3.7	-0.1	2.4
2000	4.0	-1.1	3.5	0.8	1.6
2001	1.9	-1.9	3.3	0.7	0.7
2002	0.9	-2.6	3.1	0	0.5
2003	0.8	-3.1	2.9	-0.6	0.4
2004	1.9	-3.0	2.8	-0.7	0.5
2005	1.8	-2.6	2.7	-1.0	1.1
2006	3.1	-1.3	2.6	-0.4	1.9
2007	2.7	-0.6	2.6	-0.1	2.1
2008	-0.5	-2.0	2.7	-0.8	1.5
2009	-4.0	-6.1	2.8	-3.8	0.5

But MS refused to agree with the Commission's estimate of equilibrium unemployment rates (9.3% for the area). Countries with high unemployment, rapid GDP growth and no inflationary pressures wished to maintain their growth for as long as possible so as to reduce their unemployment rate. They considered that the euro area had significant budgetary rooms for manoeuvre, with the CAPB standing at around 2 percent of GDP.

Public deficits appeared excessive (in terms of the 3% of GDP threshold of the Maastricht Treaty) in 2003-2004, when the output level was weak and when implementing restrictive policies as requested by the Commission would have been counter-productive. This situation led to tensions in the euro area in November 2003 when the Commission tried to oblige France, Italy, Germany and Portugal to change their fiscal policies. In 2005, six countries were under an EDP, even if the fiscal impulse was small at the euro area level in 2002-2004.

From 2004 to 2007, the situation of public finances improved at the euro area level (by 2.4 percent of GDP in terms of public deficits), partly due to the cyclical component (0.6

percentage point), partly due to fiscal efforts (1.6 percentage points), mainly in Portugal (2.8 percent of GDP), Germany (2 percent of GDP), and Italy (1.7 percent of GDP). These fiscal efforts induced relatively low growth in the three countries.

During this period, inflation rates were low in the area. At the area level, the real interest rate was equal to GDP growth. The wage share in GDP decreased by 2.3 percentage points from 1999 to 2007. The euro area external account was in surplus. There is no evidence that fiscal policies were on the whole too expansionary. Fiscal deficits were necessary to support activity: they were stabilisation deficits. They did not result from too lax fiscal policies: they were autonomous deficits.

From 1997 to 2007, the improvement of the euro area structural balance came from decreases in interest payments and primary public expenditures (table 3). It was limited by lower tax revenues, especially in Germany, Austria, Finland, and France. Most countries adopted tax cut strategies in a context of tax competition. The EU did not adopt a tax harmonization policy to prevent tax competition.

Table 3. Evolution in public finances, 1997/2007 (cyclically adjusted, % of GDP)

	Total revenues	Interest payments	Primary expenditures	Public balance
Euro area	-1.5	-1.6	-1.4	+1.5
Germany	-2.5	-0.5	-3.7	+1.7
France	-1.6	-0.6	-0.8	-0.2
Italy	-1.0	-3.9	+2.2	+0.7
Spain	+2.2	-3.1	+0.3	+5.1
Netherlands	0.0	-2.6	+0.8	+1.7
Belgium	-0.5	-3.4	+2.3	+1.7
Greece	-0.8	-4.1	+1.5	+1.9
Austria	-4.6	-1.2	-5.0	+1.5
Portugal	+3.8	-1.0	+3.5	+1.2
Finland	-2.4	-2.4	-6.4	+6.4

Structural deficits before the crisis?

In 2007, most MS had a primary public balance (PPB) in surplus: 2% of GDP for the euro area (table 4). If we compare the PPB level with the level required to stabilize the debt/GDP ratio, we can see that only France had problems; neither Greece, nor Spain. Countries like Spain, Greece or Ireland benefited from low interest rates relatively to their growth rate. Their debts stabilised, but the equilibrium was fragile, as it depends from the gap between interest rates and GDP growth. In 2007, financial markets did not discriminate public debts among MS. They thought that the euro area was robust.

The crisis has caused a sharp deterioration of fiscal balances, but this deterioration reflects the output fall and the use of fiscal policy to support growth. Current fiscal deficits are not indicators of pre-crisis public finance structural imbalances that should be cured by restrictive fiscal policies

Table 4. Public debt stability in 2007

	Public balance	Primary public balance	Net debt	Real interest rate less GDP growth	Debt stability gap
Germany	0.2	2.6	42.9	1.6	1.9
France	-2.7	-0.2	34.0	0.2	-0.3
Italy	-1.7	3.0	89.6	0.9	2.2
Spain	1.9	3.0	18.7	-3.2	3.6
Netherlands	0.2	1.8	28.0	0.3	1.7
Belgium	-0.2	3.5	73.4	-0.2	3.6
Austria	-0.7	1.3	30.7	-0.3	1.4
Greece	-5.1	-0.9	70.4	-2.9	1.1
Portugal	-2.3	0.6	44.1	0.6	0.3
Finland	5.2	4.6	-71.1	-0.3	4.4
Ireland	0.2	0.9	-0.3	-3.4	0.8
Euro area	*-0.6*	*2.0*	*43.3*	*0.1*	*2.0*
United Kingdom	-2.7	-0.7	28.8	-0.3	-0.6
United States	-2.8	-0.8	47.2	-1.1	-0.3
Japan	-2.5	-1.9	80.4	0.7	-2.6

2. Disparities in the euro area

The 2007-2009 financial crisis can be viewed as a test of the euro area's ability to react adequately to shocks affecting the global economy. However, even before the crisis started, the euro area was characterised by rising imbalances between two groups of countries implementing two instable macroeconomic strategies: neo-mercantilist strategies in some virtuous Northern countries (Germany, Austria, the Netherlands), experiencing competitiveness gains and accumulating huge external surpluses while some Southern countries accumulated huge external deficits under imbalanced high growth strategies driven by strong negative real interest rates (see Deroose *et al.,* 2004, Mathieu and Sterdyniak, 2007). The economic policy framework introduced by the Maastricht Treaty was unable to prevent the widening of these imbalances which became unsustainable under the effect of the crisis. The euro area thus has to face global issues – is the area condemned to poor growth? How to avoid the rise in public debts without plunging the economy into recession? – and specific problems: how to avoid growing disparities among euro area countries? Is it possible to implement a more satisfying governance framework?

Growth differentials

GDP growth was relatively satisfactory in the euro area between 1985 and 1991 (3.1 percent per year, table 5), but decelerated by 1.3 percentage points per year from 1992 to 1998 due to a bad management of the German reunification and to contractionary fiscal policies implemented in the convergence process to meet the Maastricht criteria. The launch of the single currency in 1999 did not enable the area to reach a more satisfactory growth. Since

1991, GDP has grown less rapidly in the euro area than in the UK or in the US (1.9 percent per year, versus respectively 2.7 and 3.3)

. From 1999 to 2007, GDP growth remained strong in Ireland and accelerated in three countries: Spain, Greece and Finland. Looking at average GDP growth rates in 1999-2007 and 1985-1991, the winners were Ireland, Greece and Finland; the losers were Portugal, Germany, Italy, and the Netherlands. Three countries had below 2% GDP growth rates (Italy, Germany, and Portugal); four countries had above 3% growth rates (Finland, Spain, Greece, and Ireland). In the crisis, the more severely hit countries were the previously successful ones (Ireland, Finland, Spain) and the more export-oriented ones (Germany).

Table 5. GDP growth rates (%, per year)

	1985-1991	1992-1998	1999-2007	2008-2010
Euro area	**3.1**	**1.8**	**2.1**	**-0.8**
Belgium	2.7	1.8	2.3	-0.3
Germany	3.5	1.5	1.6	-0.8
Greece	1.7	1.8	4.1	-0.1
Spain	3.9	2.3	3.7	-1.0
France	2.6	1.8	2.2	-0.2
Ireland	4.0	7.2	6.6	-3.8
Italy	2.9	1.3	1.5	-1.7
Netherlands	3.6	2.7	2.5	-0.4
Austria	3.1	2.2	2.5	-0.1
Portugal	5.1	2.4	1.7	-0.8
Finland	1.8	2.5	3.4	-1.8
Denmark	*1.5*	*2.7*	*1.9*	*-1.6*
Sweden	*1.9*	*2.7*	*3.2*	*-1.0*
UK	*2.6*	*2.7*	*2.8*	*-1.0*
US	**2.8**	**3.6**	**3.0**	**0.4**

Source: European Commission.

Greece and Spain have been converging towards the area average in terms of GDP per head (in PPP) while Italy has been diverging downwards and Ireland upwards: in 16 years (from 1991 to 2007), GDP per head relative to the euro area rose by 70% in Ireland, 26% in Greece, 21% in Spain while it remained stable in Portugal (table 6). Among the largest economies, GDP per head relative to the euro area declined by 10.5 % in Italy, 5% in France, and 3.5% in Germany, whereas it rose by 14% in the UK. Non euro area EU economies performed better than the euro area ones.

Table 6. PPP GDP per head

	PPP GDP per head, euro area=100	
	1991	2007
Euro area	**100.0**	**100.0**
Belgium	108.7	105.3
Germany	108.9	105.4
Greece	67.0	84.4
Spain	79.2	95.5
France	104.2	98.7
Ireland	78.8	134.5
Italy	105.3	94.2
Netherlands	107.0	120.3
Austria	113.8	111.9
Portugal	68.6	68.8
Finland	97.6	107.8
Denmark	*106.7*	*110.3*
Sweden	*108.2*	*111.7*
UK	*93.6*	*106.2*
US	**131.1**	**141.6**

Source: European Commission.

Inflation differentials

A good functioning of the monetary union requires avoiding price levels disparities. Different price levels will generate competitiveness differentials which will need to be corrected later through output growth differentials. In practice, inflation differentials have remained substantial in the euro area (table 7). Countries running higher inflation were mainly catching-up ones, with higher output growth and low initial price levels, due to the Balassa-Samuelson effect (Greece, Ireland, Spain, and Portugal). However Italy and the Netherlands also had relatively high inflation rates. The Dutch economy ran at above capacity for several years and inflation was increased by several rises in indirect taxation. Even when accounting for the Balassa-Samuelson effect, which may explain 1 percentage point of inflation in Greece, 0.7 in Portugal and 0.5 in Spain (for a discussion, see ECB, 2003), prices seem to have risen too rapidly in these three countries and this has led to price competitiveness losses. Inflation was extremely low in Germany, which prevented other countries from restoring their price competitiveness. In 2007, inflation disparities remained large in the euro area: inflation stood at 1.6% in the three countries with the lowest inflation and at 2.9% in the countries with the highest inflation. Wage and price formation processes have not yet converged.

The euro area includes countries with different development levels (table 6). Catching-up countries have structurally higher output growth and inflation than more ‘mature’ ones. Thus it is difficult to run a single monetary policy even in the absence of asymmetric shocks. With a single nominal interest rate, euro area countries have had different real interest rates corrected for GDP growth (table 7). The single monetary policy was contractionary for Germany and Italy, expansionary for Ireland, Greece and Spain where companies and

households had a strong incentive to borrow and invest, which boosted domestic GDP growth and inflation.

Table 7. Inflation and real interest rates

	Inflation (GDP deflator)	Real interest rate less GDP growth rate	
	1999-2007	1992-1998	1999-2007
Euro area	**2.0**	**2.5**	**0.0**
Belgium	1.9	1.6	0.25
Germany	0.8	1.6	1.5
Greece	3.2	6.7	-2.2
Spain	3.9	2.1	-2.9
France	1.8	2.9	0.2
Ireland	3.5	-3.5	-5.2
Italy	2.4	3.9	0.7
Netherlands	2.6	0.9	-1.0
Austria	1.5	1.3	0.5
Portugal	3.1	1.6	-0.1
Finland	1.4	1.3	-0.7
UK	*2.4*	*3.7*	*-0.5*
US	**2.4**	**-0.1**	**-0.55**

Wage competition

Wages as a share of GDP decreased by 2.3 percentage points at the euro area level between 1999 and 2007 (table 8). The *best* performers were Austria (-4.4 percentage points), Spain (-4.3), Germany (-3.9), and the Netherlands (-2.7). Increasing company profitability and price competitiveness through downwards pressure on wages became a major strategy in several countries, like in Germany. This strategy boosted exports but put a drag on domestic private consumption, thus dampening demand in the whole euro area. No attempt was made by Member States or the European Commission to harmonise wage growth.

In this non-cooperative game, Germany, Austria, the Netherlands (and Sweden) succeeded in supporting domestic GDP growth through positive net exports contribution (by 1 percent of GDP per year for Germany and Austria). On the contrary, Spain, France and the UK suffered from a negative external contribution (table 9).

Fixed exchange rates and rigid inflation rates induce persistent exchange rates misalignment periods. In the euro area, countries can no more devalue their currency. Wage moderation policies are the only tool left but take a long time to play and are painful, since they depress demand both at home and in the area. Wage moderation policies would be all the more difficult to implement in euro area countries that they are already implemented in Germany, where domestic inflation is very low which makes it harder for partner countries to gain competitiveness against Germany.

Table 8. Adjusted wage share in GDP, 1998/2007

	Change in percentage points, 1998-2007
Euro area	**-2.3**
Belgium	-1.9
Germany	-3.9
Greece	-2.1
Spain	-4.3
France	-0.2
Ireland	-2.1
Italy	-0.5
Netherlands	-2.7
Austria	-4.4
Portugal	-1.6
Finland	-0.9
Denmark	*-0.8*
Sweden	*-0.1*
UK	*0.6*
US	**-1.9**

Table 9. GDP and domestic demand, 1999-2007

	GDP	Domestic demand
Euro area	**2.1**	**1.7**
Belgium	2.3	2.0
Germany	1.6	0.65
Greece	4.1	4.2
Spain	3.7	4.6
France	2.2	2.7
Ireland	6.6	6.15
Italy	1.5	1.7
Netherlands	2.5	2.0
Austria	2.5	1.6
Portugal	1.7	1.65
Finland	3.4	3.1
Denmark	*1.9*	*2.1*
Sweden	*3.2*	*2.6*
UK	*2.8*	*3.5*
US	**3.0**	**3.1**

In 2007, several countries ran substantial current account surpluses (table 10): the Netherlands (8.9 percent of GDP) and Germany (7.9), Finland (4.9), Belgium (3.5), and Austria (3.3) whereas some others ran large deficits: Portugal (-8.5 percent of GDP), Spain (-9.6) and Greece (-12.5). The 260 billion euros surplus of Germany, Netherlands, Austria and Belgium

and the 40 billion euros surplus of Nordic countries generate and finance the 180 billion euros deficit of Mediterranean countries and the 50 billion euros deficit of the new Member States (NMS).

Table 10. Current account balances in 2007

	Billion euros	% of GDP
Sweden	29.8	8.9
Netherlands	48.6	8.1
Germany	192.1	7.9
Finland	7.3	4.9
Belgium	12.8	3.5
Austria	9.1	3.3
Denmark	1.6	0.7
Italy	-27.7	-1.7
Czech Republic	-3.3	-1.9
France	-43.0	-2.2
United Kingdom	-55.1	-2.5
Slovenia	-1.6	-4.6
Slovakia	-2.8	-4.7
Ireland	-10.1	-5.3
Hungary	-6.6	-5.5
Portugal	-16.0	-8.5
Spain	-105.1	-9.6
Greece	-33.4	-12.5
Romania	-17.0	-13.1
Lithuania	-4.3	-13.1
Estonia	-2.8	-15.0
Bulgaria	-6.5	-21.3
Latvia	-4.8	-20.6
Total	-53.5	-2.5

Source: IMF

Do these current account divergences reflect an equilibrium process (oldest countries' savings being invested in younger and more profitable countries) or a disequilibrium one (European savings being wasted in non-profitable investment, such as housing, in Southern countries)? In the euro area, this situation cannot be considered as optimal since real interest rates corrected for output growth differ across the area. Deficits can increase because they are not financed by financial markets but by transfers within the EU banking system and hence can hardly be visible. Foreign direct investments (FDI) cover only a small part of these deficits: In 2005, Portugal received small net FDI amounts (1% of GDP), but net FDIs were negative for Spain (-1.4% of GDP) and Greece (-0.4%). National saving rates are very low in Greece, Spain and Portugal which is unusual for countries with rapid GDP growth.

The Germany-Netherlands-Austria *versus* Portugal-Spain-Greece relationship is the same at the euro area level than the US *versus* China relationship, with the same instability. It raises

the same issues: how to convince 'virtuous' countries to spend more and to increase their real exchange rates so that 'sinner' countries can reduce their external deficits without depressing output? The financial crisis has made it impossible to continue debt accumulation.

An inappropriate economic framework in the euro area

The euro area economic framework embeds three elements. The Stability and Growth Pact is the only component where the Commission has effective disciplinary powers. But it is poorly designed (see Mathieu and Sterdyniak, 2003 and 2006):

1. Its numerical rules (3% of GDP limit for deficits, 60% of GDP for public debts, medium-term equilibrium of public finances) have no economic basis;
2. They do not allow the Commission to influence MS policies in good economic times, when fiscal efforts should and could be made;
3. They do not allow to implement measures against countries running too restrictive policies;
4. They do not account for current account balances, competitiveness, private debts, real or financial bubbles.

The economic policy coordination process (under the Articles 121 and 136 of the TFEU) is purely formal. There are no concerted macroeconomic strategies in the short or medium-term, adapted to the circumstances and specificities of each country.

The structural reforms programmes consisted mainly in goods, labour and financial markets liberalisation. The Commission put pressure on MS to introduce these reforms, which allowed national governments to invoke this pressure to impose unpopular reforms. The Lisbon agenda which was adopted by EU technocracies, without any open public debate, did not succeed in impulsing a common economic strategy. Moreover, the crisis has undermined the relevance of these programmes. Is competition policy more important than industrial and innovation policies? Should Europe maintain the objective of financial markets full liberalisation?

3. Fiscal policy during the crisis

Current fiscal imbalances have been caused by the 2007-2009 economic crisis which led output to fall 6% to 10% below pre-crisis trends. The improvements in net public debts levels achieved between 1998 and 2007 were lost for many countries (table 11).

The situation has less deteriorated in the euro area than in the UK, US, and Japan. For instance, public deficits are expected to reach 6.7 percent of GDP in the euro area in 2010, against 12 percent of GDP in the UK, 11.3 in the US, 8.2 in Japan (table 15).

Table 11. Net public debts in % of GDP

	1998	2007	2010
United States	45	43	65
Japan	46	87	105
United Kingdom	33	29	59
Euro Area	*53*	*45*	*58*
Germany	37	43	55
France	41	34	61
Italy	107	87	101
Spain	54	19	42
Netherlands	48	28	37
Belgium	108	73	85
Austria	37	31	43
Greece	73	70	100*
Portugal	33	44	63
Finland	-15	-71	-46
Ireland	43	0	38
OECD	*43*	*39*	*58*

It is not easy to evaluate the amount of national stimulus plans. Output fell so abruptly that it is difficult to assess potential output. The *ex ante* impact on public finances is also difficult to measure due to the large output fall (which has non-linear effects on some tax revenues) and to the drop in asset prices.

The euro area public deficit widened by 6.0 percentage points from 2007 to 2010 (9.2 in the UK and 8.0 in the US). Under the assumptions that the crisis does not affect potential growth and that the cyclical balance equals 50% of the output gap, the fiscal impulse cumulated from 2007 to 2010 would amount to 4 percent of GDP in the US, 6.5 in the UK, and 1.8 in the euro area (table 12). The fiscal stimulus was much lower in the euro area than in the other large industrial economies. Our estimates are lower than the European Commission's ones, which embed a large fall in potential growth due to the financial crisis.

Large increases in public deficits and debts did not lead to higher interest rates because they only offset the collapse of private debts and the rise in private savings. In the US, the 10-year Treasury bonds rate fell from 4% in July 2008 to 2.2% in December, before rising to 3.7 in January 2010. In Germany, the 10-year government bonds rate fell from 4.6% in July 2008 to 3.0% in mid-2009, and rose to 3.2% in January 2010 (figure 1). In April 2010, 10-year government bond interest rates remained near GDP growth and inflation anticipated for the 10 coming years by *Consensus forecasts* for all large industrial economies (table 12). Hence high public debts cannot be said to announce higher future interest rates.

Table 12. Fiscal impulses (cumulated since 2007)

	2008	2009	2010
Belgium	0.6 **(0.5)**	3.0 **(3.1)**	2.6 **(2.0)**
Germany	0.4 **(0.2)**	0.8 **(0.3)**	2.4 **(1.7)**
Ireland	5.2 **(3.1)**	6.5 **(1.4)**	7.3 **(0.7)**
Greece*	3.4 **(2.7)**	6.7 **(6.2)**	4.7 **(3.7)**
Spain	5.6 **(4.7)**	11.0 **(8.0)**	8.9 **(5.9)**
France	0.0 **(-0.3)**	3.2 **(2.4)**	3.1 **(1.8)**
Italy	0.4 **(0.0)**	0.8 **(-0.6)**	1.1 **(-0.7)**
Netherlands	-0.2 **(-0.4)**	1.7 **(1.5)**	2.9 **(2.0)**
Austria	0.2 **(-0.1)**	1.4 **(0.3)**	2.3 **(0.8)**
Portugal	-0.3 **(-0.7)**	3.7 **(2.2)**	3.6 **(1.6)**
Finland	0.3 **(0.3)**	3.6 **(2.7)**	5.3 **(2.8)**
Euro area	1.0 **(0.7)**	3.1 **(2.1)**	3.3 **(1.8)**
UK	1.8 **(1.2)**	7.0 **(5.1)**	7.1 **(4.1)**
US	n.a.**(2.8)**	n.a.**(5.2)**	n.a **(6.5)**
Japan	n.a.**(0.3)**	n.a.**(0.6)**	n.a **(1.3)**

Source: European Commission, with own calculations of output gap in bold; * in Autumn 2009.

Figure 1. 10-year government bonds interest rates

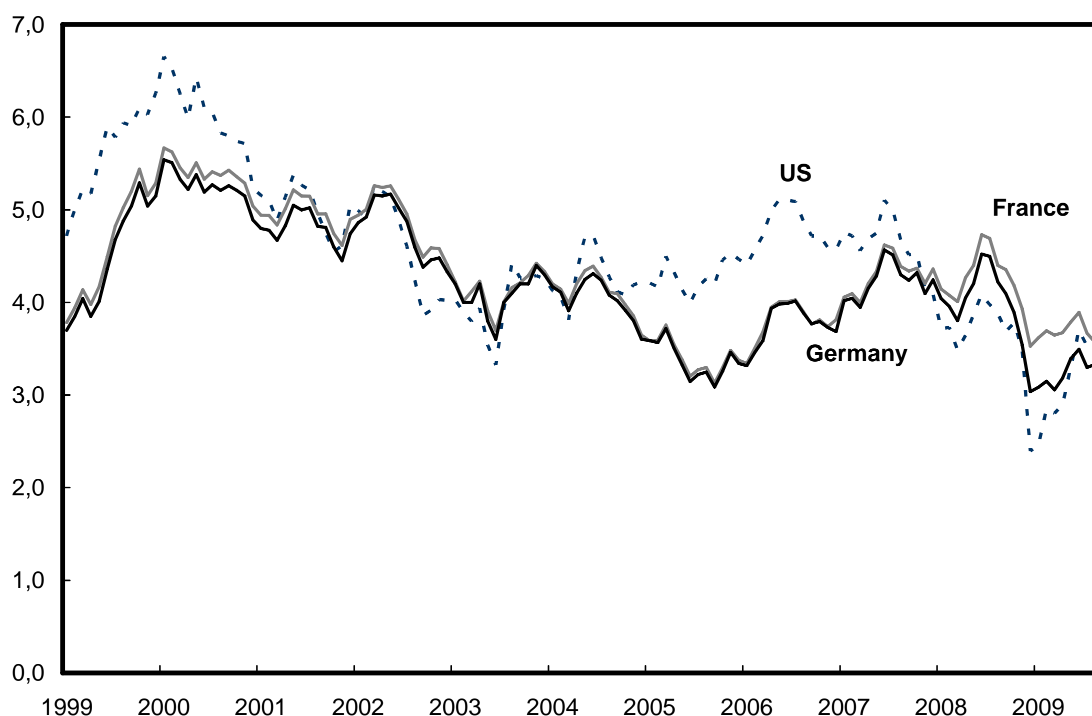


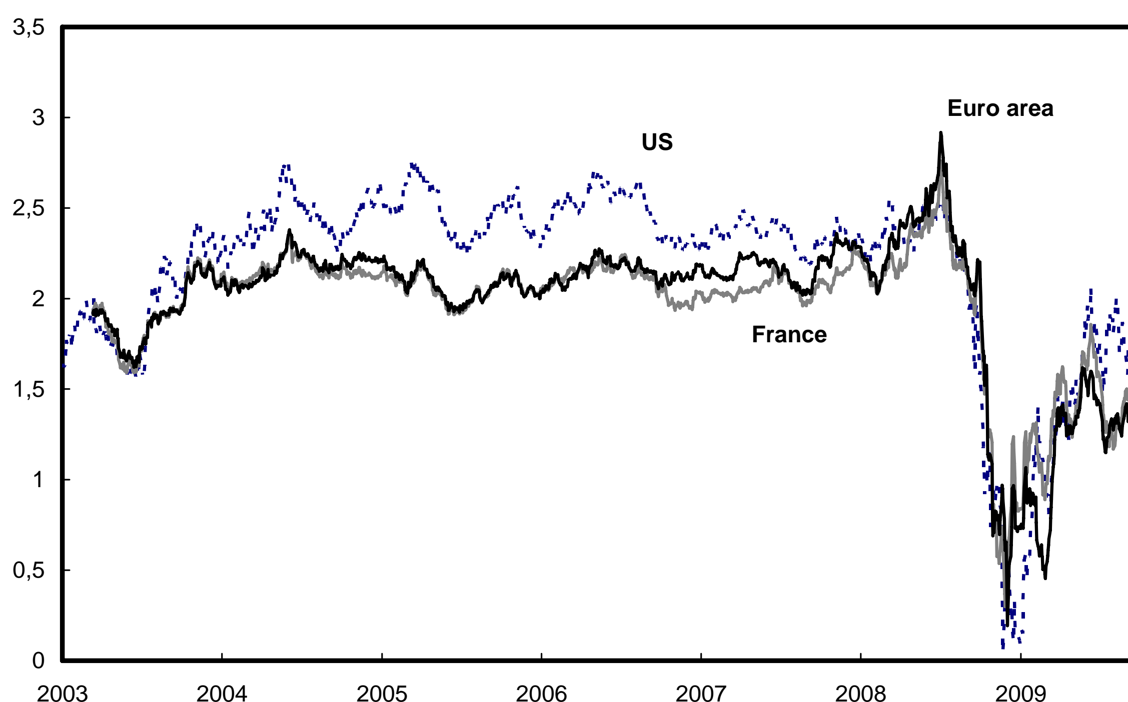
Table 13. 10-year government bonds interest rates and 10-year expectations from *Consensus Forecasts* in April 2010

	10-year rates	GDP*	Inflation*	Real interest rate less GDP growth
US	3.8	2.8	2.2	-1.2
Japan	1.3	1.4	0.8	-0.9
UK	4.0	2.3	2.4	-0.7
Germany	3.05	1.4	1.6	0.05
France	3.4	1.9	1.85	-0.35
Italy	3.9	1.2	1.7	1.0
Netherlands	3.3	2.3	2.4	-1.4

* 10 year growth expectations according to *Consensus Forecasts* (April 2010).

Markets do not believe in an inflationary risk: expected inflation derived from the comparison of non-indexed and price-indexed bonds interest rates stands currently at around 1.8% at a 10-year horizon in the US like in the euro area.

Figure 2. Inflation expectations



Sources: AFT, US Federal Reserve.

Three scenarios can be considered for the coming years:

1. In the grey scenario, domestic demand does not accelerate, GDP growth remains low and there is no factor pushing inflation or interest rates up.
2. In the pink scenario, private demand accelerates vigorously, GDP growth generates a strong rise in tax revenues and a fall in some public expenditure; governments reduce their deficits and output growth is satisfactory, although not excessive. There are no inflationary pressures and hence no significant rise in interest rates.

3. In the red scenario, private demand accelerates but governments maintain excessive deficits which leads to higher inflation and hence higher interest rates.

The red scenario is not currently anticipated by markets. Markets anticipate probably the grey one, without tensions on interest rates or inflation.

A technical issue which becomes a political one…

The assessment of the size of the structural deficit and of the fiscal effort needed when fiscal policy will focus on reducing deficits, depend on potential output estimates, or in other words of the maximum output level achievable without inflationary pressures. However, the EC-DG Economic and Financial Affairs (DG ECFIN) and the OECD have substantially lowered their estimates of potential output levels and growth since the crisis (table 14).

These revisions also apply to the pre-crisis period. The euro area potential growth estimate for 2000-2007 was reduced by 0.3% per year by the OECD, and by 0.4% per year by the DG ECFIN. The potential output estimate for 2009 was lowered by 3.5% by the OECD, by 5.4% by the DG ECFIN. Euro area potential growth would be 0.9% only per year in 2009-2011 according to the DG ECFIN.

Table 14. Potential growth and output gap estimates

	Output gap		Potential growth						
	2007		2000-2007		2008		2009		2011
Estimate in…	2007	2009	2007	2009	2007	2009	2007	2009	2009
…by OECD									
US	0.4	1.0	2.6	2.4	2.5	2.3	2.5	1.5	1.7
Japan	0.2	3.5	1.4	0.9	1.0	0.5	0.6	0.5	0.9
Germany	0.0	2.6	1.5	1.0	1.7	1.2	1.6	1.0	0.8
France	-0.3	1.8	2.0	1.9	1.9	1.7	2.0	1.7	1.0
Euro area	-0.3	1.9	2.1	1.8	1.9	1.7	2.0	1.2	1.0
UK	0.4	1.8	2.6	2.4	2.7	2.4	2.7	1.5	0.9
…DG ECFIN									
Germany	0.3	2.7	1.2	1.0	1.8	1.0	1.9	0.7	1.2
France	-0.3	1.9	2.1	1.8	2.0	1.5	2.1	1.2	1.4
Euro area	-0.2	2.5	2.1	1.7	2.1	1.2	2.2	0.8	1.0
UK	-0.1	2.6	2.8	2.4	2.5	1.5	2.7	0.8	1.1

In 2007, France had an unemployment rate of 8.4% without inflationary pressures. The Commission considered that France had a negative output gap of 0.3%. Can it be said two years later that the French economy was in fact running 2.2% above capacity in 2007 and that the equilibrium unemployment rate was at around 10.5%?

These new estimates have significantly increased the size of structural deficits. In 2010, the French output gap is -2.5% according to new potential output estimates; -7.0% according to the previous ones. The primary structural deficit would be 4.5% in the first case, 2.2% in the second. The efforts needed to lower the structural deficit are quite different.

At the end of 2010, the euro area unemployment rate is expected to reach 10.5 % (i.e. about 3% above the equilibrium unemployment rate); labour productivity losses relatively to labour

productivity trend will amount to 3.5% (i.e. a 3.5% excess in labour force); the number of discouraged workers will be around 1%. Should these 7.5% be considered as permanently lost?

What will the euro area GDP growth target be in the coming years: 2.2% or 1.0% per year? There is a risk that choosing a low target becomes self-fulfilling, if as soon as GDP grows by more than 1%, restrictive fiscal policies are implemented. For instance, according to the Commission's statement of November 2009, MS should initiate a 'fiscal consolidation policy' in 2011 because GDP growth projections (1.5%) are significantly higher than potential growth (1%). But should MS accept this 7.5 % loss in activity as permanent?

These uncertainties are questioning the potential growth concept and its use for economic policy. Is potential growth is independent of actual growth, and if so why did the OECD and the Commission lower their potential growth estimates by such an extent after the crisis? Or potential growth estimates depend on actual GDP growth: a recession leads to a decline in investment, thus to lower production capacity, to a decrease in potential labour force (as older workers, the young, mothers with young children stop looking for a job) and to lower productivity gains. Should we conclude that any rise in demand should be avoided or that, on the contrary, MS need strong growth to boost output capacity, to provide incentives to discouraged workers to come back to the labour market and to prevent their working skills from deteriorating? The euro area can not resign to a 10% unemployment rate.

Economic policy should aim first at reducing the current output gap, and then to bring GDP growth back to around 2% by year. The OECD and DG ECFIN estimates should not be used to define targets or constrain public deficits since they are volatile and not reliable.

What structural deficits in 2010?

During the 2007-09 crisis, public finances suffered from the automatic fall in tax revenues and from the rise in some public expenditure such as unemployment benefits (the cyclical deficit), from measures implemented to support activity (the discretionary deficit), and from specific measures to support the financial sector.

The magnitude of the recession (whose impact was particularly large on some taxes) and its characteristics (falling property and equity prices also contributed to the decline in tax revenues) make it difficult to assess the size of structural deficits in 2010.

In 2009/2010, the rise in deficits is partly due to temporary stimulus packages and to the overreaction of tax revenues. These should not be included in the structural deficit.

According to our estimates, the euro area deficit would amount to 5.2 percent of GDP in 2011, of which: 4.0 percentage points in cyclical deficit, 2.9 percentage points in interest payments and 1.7 percentage points in structural primary surplus. The structural primary surplus did not decrease since 2007 (table 15).

Let us assume that the objective is to stabilise public debt at 80% of GDP. The euro area long-term real interest rate was on average 0.4 percentage points higher than GDP growth between 1997 and 2007. So the euro area needs to run a structural primary surplus of 0.3 percent of GDP. No major effort is needed. The cyclical deficit must be reduced via GDP growth, which should remain higher than the 2% potential growth for a long time in order to reduce the 8 percent of GDP negative output gap. Euro area countries have to address a GDP growth issue, not a public finance one.

Table 15. Public finances in the euro area

% of GDP except *	2007	2008	2009	2010	2011
*GDP growth, in %**	*2.8*	*0.5*	*-3.9*	*1.3*	*2.1*
Output gap based on pre-crisis trend	0.0	-1.5	-7.4	-8.1	-8.0
Government balance	-0.6	-2.0	-6.4	-6.6	-5.2
Net interest payments	2.6	2.6	2.7	2.8	2.9
Cyclical balance		-0.7	-3.7	-4.0	-4.0
Stimulus packages		-0.2	-1.3	-0.8	
Overreaction of tax revenues			-0.7	-0.4	
Structural primary balance	2.0	1.3	2.0	1.4	1.7
Cumulated fiscal impulse	0.0	0.0	1.3	1.4	0.3
Gross debt	66.4	69.8	78.7	84.6	86.5

Due to the uncertainties around the output gap estimates, it is difficult to evaluate the structural primary balance (SPB, table 16). If we consider the OECD measure, the SPB is negative: -1.7 percent of GDP in the euro area (but larger than -5 percent in Spain and Ireland), -6 percent in the UK and Japan, -7.5 in the US. If we consider that it is possible for the economies to fully recover from the crisis, then the SPB is nil for the euro area; it remains negative by 3 percent of GDP or more for Spain, Ireland, the UK, Japan and the US.

Table 16. Public finances stability in 2010

	Public balance	Primary public balance	Output gap*	Structural primary balance**
Germany	-5.5	-2.8	-2.7/-7.7	-1.4/1.0
France	-8.0	-5.3	-3.7/-7.4	-3.5/-1.6
Italy	-5.0	-0.1	-4.9/-9.9	2.3/4.8
Spain	-9.6	-8.5	-6.0/-10.4	-5.5/-2.8
Netherlands	-6.3	-4.4	-3.4/-6.0	-2.7/-1.3
Greece	-10.3	-5.6	-7.3/-9.1	-2.0/-1.6
Belgium	-4.8	-1.2	-6.3/-7.7	2.0/2.6
Austria	-4.7	-2.0	-3.4/-4.4	-0.3/0.2
Portugal	-8.3	-5.3	-3.1/-8.9	-3.8/-0.9
Finland	-3.6	-4.1	-9.3/-12.5	0.6/2.2
Ireland	-12.9	-12.6	-6.6/-16.2	-8.3/-3.5
Euro area	*-6.7*	*-3.9*	*-4.5/-8.1*	*-1.7 /0.1*
United Kingdom	-12.0	-9.2	-6.6/-11.5	-5.9/-3.5
United States	-11.3	-9.5	-3.9/-8.4	-7.5/-5.3
Japan	-8.2	-7.1	-1.8/-9.3	-6.2/-2.8

* OECD estimation/Before crisis trend. ** According to the two output gap measures.

Required fiscal efforts depend on the output gap estimate, and on the real interest rate corrected from GDP growth. If a country pays interest payments at interest rates close its GDP growth rate and if the objective of a full recovery is credible, then the required effort is low, even nil at the euro area level. If a country has to stabilise its debt with an interest rate 3 percentage point higher than its GDP growth rate and if it has to resign to the output gap as measured by the OECD, then the required effort is large: for instance, 6.5 percent of GDP for Spain (rather than 3 percent), 5 percent for Greece (rather than 1.6 percent).

We do not deny that some EU countries will have to change their GDP growth regime when it was unsustainable: Germany and the Netherlands (too high external surpluses), Greece, Spain and Portugal (too large external deficits), Finland and Ireland (too much reliance on foreign markets), UK (too much dependent on financial sectors). These changes will be painful and will take a long time, but the problem is not fundamentally a fiscal one. There is no evidence that euro area potential output should be really affected in the medium term.

In a pink scenario, GDP growth will recover in 2012 and this will lower public deficits (table 17); the negative fiscal impulse will be small (0.4 percent of GDP per year); public deficits will remain close to 3 percent of GDP in 2013/2014; public debts close to 90 percent of GDP. This scenario is fragile: it assumes a strong recovery of private or external demand; it assumes that MS will resist EC's or financial markets' pressures for more rapid cuts in public deficits.

Table 17. Euro area public finances: a pink scenario

% of GDP except *	2011	2012	2013	2014	2015
*GDP, in %**	*2.1*	*2.5*	*3.0*	*3.0*	*2.5*
Output gap	-8.0	-7.6	-6.6	-5.6	-5.0
Government balance	-5.2	-4.8	-4.1	-3.3	-2.6
Net interest payments	2.9	3.1	3.3	3.4	3.4
Cyclical balance	-4.0	-3.8	-3.3	-2.8	-2.5
Structural primary balance	1.7	2.1	2.5	2.9	3.3
Public debt	86.5	87.5	87.4	86.5	85.4

4. About fiscal exit strategies

The IMF views

During the crisis, the IMF exhorted governments to undertake large stimulus programmes. Nevertheless, two IMF economists, Cottarelli and Viñals (2009), proposed an exit strategy which is not satisfactory. They argued that public debts should come back to their pre-crisis levels, but without providing any analysis of optimal debt levels. The authors write that we must avoid that 'concerns about deficits and debt levels cause a rise in interest rates', but rates have generally not increased. They proposed that countries adopt a 60 percent of GDP debt ratio target in 2030. But why this level?

They estimate that structural primary balance is -3.5 percent of GDP in 2010 in advanced countries (including 1.5 percentage point of temporary fiscal stimulus). But where do the other two percentage points of structural deficit come from? In our view, they come from an under-estimation of the cyclical deficit by the IMF (by not accounting for the over-reaction of tax revenues, by underestimating potential output). The authors estimate that primary balances should rise to 4.5 percent of GDP in 2020 for debt ratios to reach 60 percent of GDP, which requires a negative fiscal impulse of 0.8 percent per year. Their policies would lead to large public surpluses and public debts would disappear in 2040. But the authors do not give evidence that a world without public debts is possible.

According to the IMF (2010), advanced economies should return to pre-crisis debt levels, because there is a link between the public debt level and the real interest rate level (and a link between the interest rate level and the potential growth rate). But the first link does not hold if public debt is high because private debt is low and because private agents want to hold public

debt. It does not hold if central banks maintain low real interest rates and governments maintain public deficits required to sustain activity. There is no evidence that real interest rates will increase due to excessive public debts and deficits. The econometric results mix autonomous and stabilisation deficits.

In fact, even with an interest rate 0.5 percentage point higher than output growth, a primary public surplus of around 0.5 percent of GDP would stabilise public debt at the level reached in 2010 (around 90 percent of GDP): the required effort (after the end of fiscal stimuli and revenues overshooting) is only around 0.5 percent of GDP.

The authors do not analyse the impact of this restrictive policy on growth. They must assume implicitly that there will be a private spending deficit and an investment or consumption boom, but we do not see why such a boom would occur and the authors do not say explicitly that the fiscal adjustment strategy depends on this boom.

The evaluation of fiscal multipliers remains controversial. We are in a situation where we cannot expect lower interest rates or exchange rates to offset the impact of restrictive fiscal policies. If we assume that fiscal policy has a multiplier of 2.0 at the world level, a negative impulse of 0.8 percent of GDP will decrease GDP by 1.6% and will not improve government balances.

Of course, the authors advocate for structural reforms (more competitive goods markets, removal of labour market and tax distortions, but no financial markets reforms), but recognise that: 'there is too much uncertainty on both the magnitude and timing of the effects of structural reform on potential growth to build a fiscal adjustment strategy primarily around this'.

Of course, they advocate for 'fiscal rules and fiscal councils'. However, the crisis has shown that fiscal policy cannot obey automatic rules and must be decided by a political government, with determination and courage that will never be the characteristic of a committee of experts.

They propose to keep health and pensions spending constant in relation to GDP, but households would have to pay premiums to private financial institutions to obtain a satisfying coverage. The authors do not give evidence that this will be less expensive. It would be somewhat ironical that the financial crisis leads to the development of pension funds, while the crisis has shown their fragility. The issue of the desirable social spending level has nothing to do with the macroeconomic management of public deficits, if such expenses are structurally financed by social contributions. A country may decide to keep its public pension system, to arbitrate between pension levels, social contribution rates and retirement age.

The authors propose to freeze all other primary public spending in real terms, which implicitly supposes that these expenditures are less useful than private ones, which remains to be proven. It is difficult to understand why the financial crisis should lead to a decrease in the share of public spending in GDP.

Blanchard (2010) made two suggestions. Central banks should have an inflation target of 4%, to allow for a more pronounced decrease in anticipated real interest rates during depression periods. But, as the Japanese case showed, it is difficult to raise inflation expectations in a context of depression. Governments would have more rooms of manoeuvre in depressed situations if they had a smaller public debt in good times. So Blanchard claims for a long period of public surpluses. But how will demand be sustained during this period? Blanchard does not study what the optimal level of public debt is. If people wish to accumulate safe financial assets, the public sector has to offer such assets. Blanchard does not propose any

measure to reduce the instability of the world economy induced by the weight, greed and blindness of financial markets.

The OECD views

The OECD views are very close to the IMF ones (see OECD, 2009, 2010). The OECD underestimates output gaps in 2010 and potential output growth. It overestimates structural primary deficits: 7 percent of GDP in the US in 2010 against 1.4 percent in 2007; 4.4 per cent in the euro area against 1.1 percent in 2007 (in autumn 2008, the OECD estimated that the euro area had a structural primary surplus of 1.6 percent of GDP). The OECD estimates that 'excess supply of government bonds may put upward pressure on interest rates'. But there is currently no 'excess supply'.

The OECD calls for tightening fiscal policies (by 1 percent of GDP per year from 2012 to 2017) to avoid households' Ricardian behaviours and to reassure financial markets, while recognising that these policies will dampen growth. But should fiscal policy be used to reassure financial markets?

Should we fear Ricardian behaviour? The actual rise in public deficits is cyclical; it is not due to structural public spending increases or tax cuts. So taxes will not have to rise. It is the increase in activity which should bring budgetary positions back to balance. But we must admit that the rise in deficits generates a climate of uncertainty. Companies and workers may fear that governments will be obliged to reduce too quickly their deficits, which may have a depressive effect. Governments need to explain that budgetary positions will be brought back to balance thanks to higher output growth, not through higher taxation or social expenditures cuts. Paradoxically, it is the OECD-type discourse for rapid consolidation which may induce Ricardian behaviours.

The OECD recommends a coordination of fiscal consolidation strategies, as consolidation in one country will decrease activity in partner countries. But coordination is not possible if all countries have to consolidate at the same time.

According to the OECD, the effect could be reduced through structural reforms (fewer regulations on labour and goods markets, lower taxes, while no financial market reforms are proposed).

The OECD recommends social spending (health and pensions) cuts rather than tax increases. Should we hide a social choice (lower public spending) behind questionable economic considerations (social spending cuts would be less harmful to activity than tax increases because they would induce people to work contrary to taxation)? Can structural reforms effectively increase supply when there is a lack of demand?

The OECD estimates that pension reforms could have a triple dividend: improving public finances, decreasing households' savings (since people will have to plan to work longer, and so will need to save less for retirement) and so deman, increasing labour supply and so potential growth. But the effect can be the opposite: people will save more as public pensions will decrease and as they will fear to be unemployed for a long period of time before they retire.

Two *European* economist views

In October 2009, two distinguished European economists were invited to give papers at the ECOFIN meeting at Göteborg.

Giavazzi (2009), who is usually against active fiscal policies, recognised that such policies were effective during the crisis because they were associated with accommodative monetary policy and because the output gap was largely negative (but it is precisely in these circumstances that a fiscal stimulus is needed). According to the author, governments should announce that they will end the fiscal stimulus when the output gap comes back to zero to reassure financial markets and the ECB and to avoid a rise in interest rates. But who doubts about this? Long-term interest rates did not generally increase during the crisis.

Giavazzi proposes cuts in future public retirement pensions to show the credibility of this announcement. At the same time, he recognises that there is a need to induce households resume spending. How is it possible if households have to save more in view of their pensions?

According to Giavazzi, public debts should return to their pre-crisis levels, but can this be achieved if households want to own more public debt assets? Giavazzi proposes to counterbalance the fall in potential output by increasing labour force participation through labour taxation cuts. But, in a mass unemployment situation, is employment really constrained by the unwillingness of people to work?

Pisani-Ferry (2009) presented again his unwise proposals. He asked for a commitment by governments to undertake consolidation strategies, according to “fiscal sustainability plans” which would be implemented from 2011 to 2014, with debt targets for 2014. But how to design these plans independently of the economic context? One finds again the failure of the Stability and Growth Pact: a country cannot make commitments five years ahead and renounce to adjust its fiscal policy according to circumstances. Pisani-Ferry proposes to establish ‘independent Budgetary Councils’ to monitor the development of public finances, but what is their political and scientific legitimacy? He proposes to reduce public pensions.

Pisani-Ferry fears that expansionary fiscal policies will provoke inflationary pressures, which will induce the ECB to increase too quickly interest rates and so coordination is needed. But this fear is not justified: inflation will accelerate only if there is a strong recovery of demand which is unlikely in the years to come. It would not be wise that, to avoid an imaginary danger (resurgence of inflation), governments gave up the struggle against a present imbalance (unemployment). Economic policies coordination should not be designed to oblige countries to achieve arbitrary public finances criteria under the pressure from the Commission and the ECB.

The European Commission view

During the crisis, the Commission submitted 24 of the 27 EU countries to the excessive deficit procedure. The Commission applied SGP rules with flexibility for 2009 and 2010, but the crisis shows that these rules are inappropriate.

On 20 October 2009, the ECOFIN Council recognised that ‘it is not yet time to withdraw the government support’, but announced that it will prepare ‘a coordinated fiscal exit strategy’. But which coordination? Consolidation should start in 2011 at the latest and go beyond the benchmark of 0.5 percent of GDP per year. But the Council did not explain what countries

should do if the recovery is not sufficient in 2011. The positive point is that the SGP and its 3% of GDP constraints are forgotten in the short and medium run. The ECB requested consolidation to begin in 2011, whatever the economic situation, and amount to at least 1 percent of GDP by year.

In November 2009, the Commission requested countries with higher than 3 percent of GDP public deficits to bring their deficits below this limit in 2012, 2013 or 2014, according to some arbitrary criteria. The deadlines are long but it remains unrealistic to set fiscal policies constraints independently of economic developments. Is it useful to require MS to commit to bring their public deficit below 3% of GDP in 2013 rather than in 2014, when deficit figures depend on the strength of private demand, which neither the Commission nor MS can control? MS should refuse to make commitments on the precise level of their future deficits and debts, independently of growth developments.

One can be worried when the Commission declares that consolidation should be implemented as soon as growth is above potential growth, estimated at only 1% per year.

The Commission writes: 'The SGP should be an anchor for fiscal exit strategies', even if the crisis has shown that a pact focused on a blind constraint on public deficits should be replaced by a fiscal policies coordination process accounting for the necessities of economic stabilisation..

The Commission continues to call for wage restraints, as if wage increases were responsible for the crisis. However, the wage share in value added declined by 2.3 percentage points in the euro area between 2000 to 2007. The Commission does not consider that growth should be based on wages and social benefits and not on competitiveness or financial bubbles.

The Commission keeps on repeating that public debts should come down to 60% of GDP. But the crisis increases the need for households to own safe assets, especially to finance their pensions (as the Commission advocates also for lower public pensions). Companies are reluctant to borrow in view of the risk premium embedded in today's interest rates. The public debt equilibrium level has increased due to the crisis. Debts cannot come down to their pre-crisis levels.

Fiscal policy cannot be managed on its own, with arbitrary rules. It must aim at maintaining (or reaching) the desirable employment level while allowing for inflation and interest rates to stay at satisfactory levels. Public debts and deficits must be derived from this target. The 'exit strategy' should be that central banks maintain low interest rates and that Governments maintain public deficits as long as they are necessary to sustain activity. If private demand increases significantly in the coming years, it will be necessary to reduce public deficits (and this will be largely automatic). If private demand stagnates, i.e. if companies refuse to borrow and if households want to save, it will be necessary to maintain some public deficits and to accept some rise in public debts. It makes no sense to project public debts and deficits independently of private demand developments and to worry about the excessive level of public debts (as Cecchetti and *al.* (2010) or Becker and *al.* (2010)): public debts will be high if there is a demand for public debt. There is no evidence that public debts will be excessive.

MS strategies…

In their 2010 Stability programmes, all euro area countries have accepted the assumption according to which the crisis dramatically reduced their potential output growth. The average

of national estimates gives a euro area potential output growth of 1.0 % only en 2010, 1.2% in 2011, 1.4% in 2014.

In 2010, all countries have to choose between reducing public deficits in order to prevent a too large increase in public debt and pursuing expansionary policies as the recovery remains weak (table 18). Germany (2.4 percent of GDP), Austria (1.2) and Finland (0.4) maintain a positive fiscal impulse. It is a good configuration that the less constrained countries sustain EU activity. On the contrary, Greece (-5.5 percent of GDP), Ireland (-4.3), Spain (-3.2); Belgium (-1.6) and Portugal (-1.3) have been obliged to undertake restrictive fiscal policies. On the whole, fiscal policy would be neutral in the euro area.

Table 18. Fiscal impulses, in 2010-11

	Fiscal balance*			Fiscal impulse**	
	2009	2010	2011	2010	2011
Germany	-3.2	-5.5	-4.5	2.4 (2.7)	-0.7 (-0.5)
France	-7.5	-8.0	-6.4	0.0 (0.1)	-1.7 (-1.7)
Italy	-5.3	-5.0	-3.9	-0.5 (0.0)	-0.5 (0.0)
Spain	-11.2	-9.3	-6.0	-3.5 (-2.3)	-3.9 (-2.9)
Netherlands	-5.3	-6.3	-5.0	0.2 (1.6)	-1.5 (-0.8)
Belgium	-6.0	-4.8	-4.1	-1.6 (-1.2)	-1.0 (-0.6)
Austria	-3.4	-4.7	-4.0	1.2 (1.7)	-0.9 (-0.6)
Portugal	-9.4	-7.3	-4.6	-2.8 (-2.1)	-3.5 (-3.3)
Finland	-2.2	-3.6	-3.0	0.4 (1.4)	-0.7 (-0.1)
Ireland	-14.3	-12.9	-10.0	-3.5 (-0.8)	-3.3 (-1.2)
Greece	-13.8	-9.9	-6.8	-5.5 (-4.7)	-4.7 (-3.9)
Slovenia	-5.7	-5.7	-4.2	-0.4 (-0.3)	-1.3 (-1.3)
Slovakia	-6.3	-5.5	-4.2	-1.6 (-0.9)	-1.6 (-0.8)
Euro area	-6.3	-6.7	-5.2	-0.1 (0.4)	-1.5 (-1.1)
United Kingdom	-11.4	-12.0	-11.1	-0.8 (-0.4)	-1.9 (-1.8)
United States	-11.1	-11.3	-9.0	-0.1	-0.5
Japan	-8.3	-10.0	-9.4	1.9	-1.3

* According to National stability programmes (2010); **The first number gives our evaluation based on trend potential growth; the second gives, for EU countries, the national evaluation as in their 2010 Stability Programme. Source: National SP (2010) or OECD, OFCE calculations.

For 2011, all countries announce restrictive fiscal policies, often by more than 1 percent of GDP. In Japan the fiscal effort would be 1.3 percent of GDP; 1.5 in the euro area; 1.9 in the UK and 0.5 only in the US. This raises three questions: will countries be able to reduce strongly public expenditure? What will be the impact of simultaneous restrictive fiscal plans on activity? Some economists have exhibited cases where restrictive fiscal policies do not have a negative impact on economic activity. But in the present situation, we can neither expect lower interest rates nor exchange rate depreciation nor a private demand boom. What is the macroeconomic logic of these strategies? They seem to accept the assumption that potential output is durably smaller, but why? If the euro area as a whole does not have excess demand, then the restrictive policies needed to be run by some countries should be offset by more expansionary policies in the other countries.

However, many countries have already decided or were obliged to cut strongly public spending. Some countries (Netherlands, Ireland) cut social benefits. Some countries (Ireland, Greece, Spain, Portugal) cut public servants wages; most cut the number of public servants.

Some countries (Greece, Ireland, Spain) reduce public investment. Some countries (Spain, Germany) announced that the retirement age will be postponed until 67 even if there is no evidence that most workers will be able to work until this age. Some countries (Greece, Spain, Belgium, Portugal) strongly increased taxes.

Some countries have tightened fiscal policy constraints. Hence Germany passed a law introducing a 'debt brake', which prevents any structural deficit higher than 0.35% (?) of GDP from 2016, the cyclical deficit being estimated by the Commission's method, which is questionable, as we have already seen. According to this method, the German structural deficit would have been excessive almost each year since 1974. But can one believe that a country with a higher than 6.5 percent of GDP current account surplus, a higher than 8% unemployment rate and a 1.5% inflation rate has excessive public deficits? EU countries should not deprive themselves of policy tools that were helpful during the crisis.

Three fears

EU governments and the Commission have been obliged to implement fiscal stimulus packages during the crisis. But they do not draw all lessons from the crisis. Instead of questioning the responsibility of past policies in the emergence of the crisis, they demand a return to such policies as if nothing had happened!

Also, the debate on fiscal exit strategies now raises three fears. The first is that the rise in deficits and debts during the crisis leads some governments to implement restrictive policies too early, which would weigh heavily on the recovery. EU countries should forget about deficit and public debt targets and adopt unemployment rates targets. No restrictive fiscal policies should be run as long as unemployment rates do not come down at a sufficient pace to full employment.

The second fear is that fiscal austerity leads MS to abandon growth-enhancing public expenditure such as R&D, education, support for innovative industries and for the green economy.

The third fear is that public finances problems are used as a pretext for introducing large public spending cuts (especially social spending), which is a structural target of the European technocracy. However, no excessive increase in social spending can be blamed for current deficits.

It would be a disaster for EU cohesion that EU authorities use the threat of markets to impose restrictive economic policies, liberal reforms and social spending cuts to countries and people.

Policies aiming at reducing the welfare system would be socially and economically dangerous. They would lower households' incomes and raise their savings rates. How to offset falling demand: by a new financial bubble? Households would have to buy individually their health and pensions insurances from financial institutions which are responsible for the crisis.

Should we undermine the European social model which showed its effectiveness during the crisis? The crisis highlighted the risks arising from growing inequalities, which advocates for higher taxes on highest incomes, highest wealth, financial and real estate earnings, and on financial sectors, if public deficits have to be reduced. This should be allowed by fighting against "tax and regulation heavens" and by more tax coordination.

5. Public finances and financial markets

Since the beginning of 2010, financial markets have found a new matter of concern: deficits and public debts levels. All advanced countries, even the largest, are suspected of being able to default on their debt. In April 2010, CDS had reached 5.3 points for Greece, 2.5 points for Portugal, 1.7 points for Ireland and Spain, 1.5 points for Italy, 0.8 point for the UK, 0.65 for France and 0.5 for Germany and for the US (table 19). Bankers, rating agencies and investment funds pretend to worry about the sustainability of public finances and require countries to reduce their debt by cutting government spending, especially social spending (since, given competitiveness or incentives issues, it is not possible to raise taxes).

Table 19. 10-year public interest rates and CDS

	June 2007		April 2010		
	10 y rate	CDS	10 y rate	CDS	S&P notations
Germany	4.5	0.04	3.05	0.42	AAA/stable
France	4.55	0.07	3.4	0.64	AAA/stable
Italy	4.65	0.18	3.9	1.44	A+/stable
Spain	4.55	0.07	3.95	1.69	AA/negative
Netherlands	4.5	0.02	3.3	0.42	AAA/stable
Belgium	4.55	0.03	3.55	0.75	AA+/stable
Austria	4.5	0.06	3.45	0.71	AAA/stable
Greece	4.65	0.20	8.7	5.32	BB+/negative
Portugal	4.6	0.08	4.9	2.47	A-/negative
Finland	4.5		3.3	0.27	AAA/stable
Ireland	4.45	0.13	4.8	1.70	AA/negative
Denmark	4.45	0.13	3.3	0.41	AAA/stable
United Kingdom	5.3	n.a.	4.0	0.79	AAA/negative
Sweden	4.3	0.34	2.95	0.43	AAA/stable
United States	5.0	0.13	3.8	0.43	AAA/stable
Japan	1.85	0.23	1.3	0.83	AA/negative

Governments thus face two conflicting requirements: supporting economic activity and ensuring their own financial situation. On the whole, capital owners want to hold substantial financial assets. These were obtained through a financial bubble. After the bubble burst, the demand deficit must be filled by public deficits and low interest rates. If financial markets do not accept this logic, by raising long-term interest rates, under the pretext of requesting risk premiums when governments support activity, if the view according to which 'today's deficits are tomorrow's taxes; we must save more in public deficit situation' become more and more common, then economic policy becomes ineffective and the world economy is out of control.

In a world economy where financial capital stocks are huge, debts are automatically huge. Many private or public agents are indebted and some are more indebted than others. So there are always doubts about borrowers' solvency and debt crises. Lenders want to invest large amounts, but then become worried that borrowers are too indebted. It is the malediction of lenders. Countries, companies or households receiving large external funding are vulnerable,

as they become heavily indebted and dependent on capital markets. It is the malediction of borrowers.

Markets are herding, their expectations are self-fulfilling and markets operators are aware about it. They become cautious, but their vigilance increases the risk of a crisis. A slight doubt on the solvency of a borrower may lead to capital withdrawals and increase in interest rates that generate the crisis.

The current public debts crisis does not generally come from excessive government spending but is the consequence of financial globalisation. CDS developments on industrial countries' debt is paradoxical and dangerous. Since 1945, no industrial country has defaulted on its debt. Markets buy and sell insurances against a risk which has never materialised.

In the past, the State could always use money creation, i.e. credit from the central bank. Markets might fear debt depreciation through inflation or currency depreciation, not State's bankruptcy. However, the situation has changed since central banks' independence (and especially since the creation of the ECB) which might lead to contentious situations where the central bank refuses to finance the State. The 2007-2009 crisis has shown central banks' ability to intervene in case of danger. How to imagine that a central bank would not intervene to rescue his State, like it did to save banks?

At the same time, the 2007-2009 crisis showed that unforeseeable events can occur, and consequently markets are more nervous, prompter to imagine extreme scenarios, which increases their volatility.

Furthermore, in an extreme case where a large country (the U.S., the UK or Germany) would default, it is unlikely that any financial institution would be able to pay compensation corresponding to the CDS it sold.

Financial institutions have found a new source of profit by creating a CDS market on sovereign debt, which is a speculative, parasitic and disruptive market. It boosts the government bonds market, which was before relatively inert. It allows markets to bet on States' bankruptcy. It becomes possible for an operator to buy an insurance against a failure of the Greek State without even owning Greek government bonds. By raising doubts on countries' ability to fulfill their commitments, some financial institutions oblige pension funds to buy their CDS. The losers are the Greek state, who must pay higher interest rates on its debt, who is obliged to undertake excessive restrictive fiscal policies and the Funds who already held Greek bonds, and which should now downgrade their debt, sell it at cheaper price or cover it. The risk is to eliminate the market for developed countries debt, like this was mostly the case the market for less developed countries debts. In the future countries will be reluctant to issue debt knowing that this places them under the control of markets.

In a global financial world, economic policies must be dedicated to reassure markets, although markets have no relevant vision of macroeconomic developments, as evidenced by the large fluctuations in financial markets (stock exchange or exchange rates). It is absurd to claim for large public deficits cuts in a situation where global demand is low and short-term interest rates are close to zero.

Countries like Spain, Ireland and even Greece have experienced strong GDP growth before the crisis, the crisis forces them to change their growth strategies, and markets do not help them by shouting there is a risk of bankruptcy.

Against the speculation crisis, Europe had the choice between two strategies:

- Euro area members agree to help Greece by opening unlimited credit lines to guarantee its debt in exchange of its commitment to implement medium-term public finances consolidation (but not too strong in the short term); the ECB opens unlimited credit line to menaced countries; MS, ECB and EC's determination should be strong enough to discourage speculation; interest rates spreads should fell sharply. The issues of "moral hazard" or of the reform of the European framework should be forgotten for a while.
- Euro area members give insufficient help to Greece in order to give a lesson and to show all MS the risk of not obeying the Stability Pact. There is a high risk that markets continue to speculate until Greece has no choice but default. Speculation will increase against the other considered as fragile countries, who will have to maintain high interest rates. Many financial institutions in the euro area will have to downgrade their Greek, Spanish and Portuguese bonds, which will deteriorate their financial situation. The euro area will plunge in a new financial crisis. If the crisis ends by Greek debt restructuring, or worse, by Greece leaving the euro area, then the area will be permanently fragile because speculators will have objective reasons for discriminating between debts in euro and for requesting significant risk premiums.

On February 11th 2010 the European Council provided Greece a too limited support and asked for the Greek public deficit to be cut by 4 percent of GDP, which was too large.

In March, the support given by EU institutions and other MS to Greece was not sufficient. Aid to Greece remains conditional, subject to the unanimity rule (and so not insured) and the interest rate will incorporate 'adequate pricing of risk'. But what risk? Finally, some German leaders did not hesitate to discuss a possible exit of Greece from the euro area, which fed immediately speculation.

On May 3rd, the ECB finally decided to accept all Greek government bonds as collateral.

On May 2nd, the MS, the EC, the ECB and the IMF agreed on a 110 billion euros rescue plan (over three years) for Greece. But Greece has to undertake a huge restrictive fiscal package (cuts in public wages, public consumption and investment, increases in VAT rates and excise duties, pensions system reform) to cut its government deficit from 14 percent of GDP in 2009, down to 8.1 percent in 2010, 7.6 in 2011, 6.5 in 2012, 4.6 in 2013, and 2.6 percent in 2014.

The Greek government expects GDP to fall by 4 percent in 2010. A 4 percent fiscal effort, with a multiplier of 1, will decrease GDP by 4 percent and improve the government balance by 2 percent only. The debt to GDP ratio will increase by 3 percent, as GDP will fall.

Ireland, Spain and Portugal also undertake huge restrictive fiscal plans. The risk is that financial markets are not reassured by these plans since resulting lower GDP growth and prospects for several years of stagnation will make the fulfillment of public finance targets not credible. Financial markets' doubts are self-fulling, as they induce high interest rates, which increase bankruptcy risks. As fiscal policy in the euro area taken as a whole is not over-expansionary in 2010, restrictive fiscal measures required in some Southern countries should be accompanied by expansionary measures in most Northern countries. The EC should have been in a position to release economic projections showing that such measures are consistent with the return of balanced growth among euro area countries. On the contrary, virtuous ccountries that undertake restrictive policies increase pressures on other countries because their policies affect European activity and thus tax revenues in other countries and because

since the markets discriminate between the debt of the virtuous countries and the debt of the spenders ones.

The current situation illustrates the global economy instability driven by financial globalisation. Political and economic leaders should acknowledge that financial globalization does not work. The global economy cannot be dominated by the games and moods of financial markets. The main issue for crisis exit strategies is not public debts, but speculative finance. The measures taken by three successive G20 Summits in 2009 did not go far enough. International finance should not only be regulated, but its weight should also be drastically reduced to prevent the global economy from being paralyzed or disrupted by financial markets. The weight of financial markets needs to be reduced at the benefit of a banking sector controlled and refocused on financing productive activities.

One cannot let financial markets bet on the bankruptcy of sovereign states as on the bankruptcy of banks. Central banks must have the obligation to finance public debt, even in the euro area.

If a country suffers from persistent weak private demand, the central bank should lower its interest rates and the government should accept a public deficit. Long-term interest rates should be low, which supports activity and limits the rise in public debt. Long-term interest rates are low if fiscal policy is credible and if monetary and fiscal policies are coordinated. In a flexible exchange rate regime, these policies lower the exchange rate, which is stabilising. Stabilising mechanisms do exist. On the contrary, economic policy is paralysed if markets anticipate a bankruptcy of the State and maintain high interest rates. Therefore, the risk of bankruptcy should be nil; the Central Bank should guarantee the public debt. In a global financial world, the euro area will not survive otherwise.

Lessons of the crisis

Greece has been particularly lax in terms of public finances, but this is not the case with other countries currently attacked, like Spain or Ireland. The single currency is not compatible with too large inflation and growth rates discrepancies among member states, as it tends to exacerbate them further. The SGP has allowed neither to detect imbalances, nor to solve them. Financial globalisation allows imbalances to rise until they burst. The euro area deficient framework has created the possibility of speculation as a MS is no more able to finance its debt by monetary creation.

Financial markets have built a scenario where austerity measures induce weak growth and social unrest which may lead some countries to have to leave the euro area. If a country suffers from high interest rates, low growth, high unemployment and has to submit its policy to the EC and others MS, without recovery prospects, leaving the union may be viewed as an alternative. Moreover, financial markets question the credibility of rescue plans, the German Constitutional Court may refuse that the TFEU was violated; the Greek people can reject austerity measures, which may lead Germany to refuse the continuation of the plan

Financial markets know their strength; they know that their expectations are self-fulfilling. They have obliged Argentina to abandon the currency board; they have obliged many countries the leave the EMS in 1992-93; why not the euro area, which is politically and institutionally fragile?

A new economic policy framework in the euro area?

Several proposals were made to improve public finance and debt monitoring in Europe, even if public debt rises were a consequence and not a cause of the financial crisis. The debt crisis has strengthened the weight of the advocates of automatic fiscal rules which lack economic foundation. They can rely on the threat of financial markets and on the weight of Germany which wants to counterbalance the strengthening of European solidarity by reinforcing the SGP. Focusing on the Greek crisis is a way to distract the attention from the financial crisis.

Some economists, Jean-Claude Juncker and Yves Leterme proposed to establish a European Debt Agency (EDA) which would issue debt for all euro area countries. Germany is against this proposal, because it does not want to have to pay higher interest rates and to be obliged to bailout other Member States. The EDA would have to control national fiscal policies and would have the power too refuse to finance too lax countries. It would be a more rigid SGP, with the same problems. How to decide that a public deficit is too large if the Member State says that this deficit is needed to sustain activity (like France and Germany in 2002-05) or to rescue its banks?

Gros and Mayer (2010) propose a European Monetary Fund. Each 'sinner' country would have to pay a contribution: 1% (for the part of the debt above 60% GDP)) +1% (for the part of the deficit higher than 3% GDP). A country in difficulty could borrow, without conditions, an amount corresponding to its past contributions. To obtain more, the country would have to accept an adjustment programme. If it did not fulfil this programme, penalties would apply like suppression of its structural funds, suppression of the acceptance of its debt as collateral by the ECB, suppression of its voting rights, and could be thrown out the euro area. But 3% and 60 % remain arbitrary. It is difficult to impose fees on a State who already has financial difficulties. Too much conditionality, too high fees will increase market speculation, which may make it impossible to restore the situation. Often, the concerned State is not entirely responsible of these problems. The proposal does not deal with countries running too restrictive policies.

Delpla and von Weizsäcker (2010) propose to introduce a *blue debt*, collectively issued and guaranteed, limited for each country at 60% of its GDP. Each year, each country's parliament will have to vote to accept new debt issuance (which means that the German parliament would have to agree about the French deficit, for instance, and conversely). Each country could issue *a red debt* on its own responsibility. As the red debt will have a higher interest rate, it would discourage public debts. But 60 % remains an arbitrary level. This project will dramatically reduce the freedom of each country to choose its fiscal policy. Tensions will arise in permanence between euro area countries if national parliaments have to agree on partners' budgets. The gap between the blue and the red debts will be observed, will be subject to permanent speculation and will influence the conduct of fiscal policies.

The size of public debts will increase the risk of a strict monitoring of public finances by financial markets in the years to come. But this is not satisfying because financial markets do not have a macroeconomic perspective, they are pro-cyclical (they will impose efforts in bad times) and self-fulfilling. They have there own views on the required economic policy; is it necessarily the correct one? The risk is that member states make huge efforts to escape financial markets' power by cutting too much public deficits, which will have long and lasting dampening effects on activity. Their capacity to undertake active fiscal policies will be reduced. What would have happened if governments had refused to help banks in order to

avoid them to borrow on financial markets in 2009? Can we leave the task of assessing public debt sustainability and of deciding on the usefulness of public deficits in the hands of financial markets?

The crisis requires rethinking EU economic rules and national policy coordination. Current financial speculation benefits from the failures of the European economic framework. A single monetary policy and exchange rate are not compatible with intra-zone disparities on fiscal policies, wage developments and economic situations. The Greek crisis shows the implicit solidarity that currently unites Member States public finances in the euro area. However, there is a deep divergence between two views:

- From a *German* view, the SGP and its ability to influence effectively fiscal policies should be strengthened first. Countries should be forced to bring quickly their public finances in balance. Countries should adopt the German fiscal brake. Countries fiscal policy should be controlled by the ECB or by Independent expert Committees. Countries refusing to do so and running too lax fiscal policies should be excluded from the euro area. “Orderly default” of a member state should be prepared. Countries should focus on structural reforms and competitiveness improvement to allow growth to recover. Since the current situation will oblige many countries to ask for the financial guarantee of the other member states, particularly of the member states best quoted by markets, these virtuous members will be able to impose their views. The risk is that the maintenance of the euro area will be paid by strengthening absurd rules, which will keep the area in recession and deprive it of fiscal policy.

- From a *French* view, economic policies coordination must lead to a macroeconomic strategy designed primarily to support growth and return to full employment. Public deficits are necessary to support economic activity, so the rigid SGP rules should be replaced by a coordinating process accounting for the economic circumstances (inflation, unemployment and current account balances); coordination should include wage and financial policies. The euro area should be strengthened by removing the institutional barriers to efficient economic policies coordination and by developing a comprehensive and flexible strategy which will take national differences into account. But such a strategy will not be easy to implement: MS will refuse to transfer more powers to Europe, without guarantees on its policy. Managing diversities is very difficult: how to convince the Germans to increase their wages, the Spaniards and the Greeks to reduce their wages? MS, the EC and the ECB will have to recognise that they guaranty all MS public debts (but this is against the Treaty and how to act against really too lax countries?).

On 25th March 2010, the European Council stated: “We commit to promote a strong coordination of economic policies in Europe. We consider that the European Council must improve the economic governance of the European Union and we propose to increase its role in economic coordination and the definition of the European Union growth strategy. The current situation demonstrates the need to strengthen and complement the existing framework to ensure fiscal sustainability in the euro zone and enhance its capacity to act in times of crises. For the future, surveillance of economic and budgetary risks and the instruments for their prevention, including the Excessive Deficit Procedure, must be strengthened. Moreover, we need a robust framework for crisis resolution respecting the principle of member states' own budgetary responsibility.”

This text can be seen as a compromise between the German and French views. But does the EU need an ambiguous compromise?

On May 12th, the European Commission released a communication: 'Reinforcing economic policy coordination'. It claims that 'the rules and principles of the SGP are relevant and valid'. It estimates that 'national fiscal framework should better reflect the priorities of EU budgetary surveillance'. It proposes to improve the functioning of the EDP, to give more prominence to public debt criterion. The Commission wants to be able to punish MS if they do not make sufficient fiscal efforts in good economic times and to use the EU budget to oblige MS to obey the SGP rules by depriving them of Cohesion Funds. But why and how reinforcing an inadequate Pact? The Commission proposes to strengthen the surveillance of macroeconomic imbalances by considering currents accounts, employment, competitiveness, asset prices and private sector credit, by covering macro-prudential aspects, by addressing the functioning of labour, product and services markets. It proposes a 'European Semester', where all MS would present their fiscal and structural policies to the Commission and the European Council before the votes of their national parliament.

This project is a move towards more fiscal federalism, but it raises three issues: fiscal decisions will be more and more taken by non-elected bodies; the EC does not abandon the non-economically based components of the SGP, like the 3% and 60% rules, the medium term equilibrium objective; the EC wants to increase the *surveillance* of national policies, which means that the EC will only increase its pressure for more restrictive policies and will not try to introduce a comprehensible macroeconomic strategy, which should include more expansionary policies in some countries and higher public deficits and debts if necessary. In these times of economic crisis and of financial markets frenzy, the euro area needs effective economic policy coordination.

The Commission (2009) recommended also that MS introduce in their national legislation public expenditure norms, fiscal rules and Independent Fiscal Committees. This would dramatically reduce the autonomy of domestic governments.

There is no urgent need for constraining national fiscal policies in Europe, but there is an urgent need for undertaking reforms in three areas:

- Financial globalisation: how to finance government and companies without allowing lenders to demand excessive returns?
- Economic coordination in Europe: how to implement a common albeit allowing for diversified macroeconomic strategy?
- Industrial policy: what production in Europe in the future?

The risk is that leading classes succeed a "shock strategy" in Europe: to use the crisis to impose liberal and anti-democratic reforms.

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