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Author(s)	M. Villa, A. Villafranca (with substantial contributions from all RAstaNEWS partners)
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Abstract	The RAstaNEWS project is based upon the premise that rethinking the future of macroeconomic and monetary integration in Europe requires a substantial revision and integration of underlying macroeconomic models, and a new vision about what markets and policymakers can accomplish. In a nutshell, since its inception the project has aimed at providing two different but interrelated policy outputs to EU and Eurozone policymakers: 1) a proposal to reform EMU policies in a way that would contribute to decrease the likelihood of the occurrence of future crises, while at the same time supporting overall growth in the currency union; and 2) a proposal to pinpoint or devise new early warning signals (EWS), in order to spot problematic disequilibria at the macro level, with the aim to act as early as possible to rebalance national economies or the Eurozone as a whole before a full-fledged crisis ensues. In this Annual report, we will focus on the former proposal. A second Annual report will then aim at contributing to the EWS literature.

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1. Introduction

The RAstaNEWS project is based upon the premise that rethinking the future of macroeconomic and monetary integration in Europe requires a substantial revision and integration of underlying macroeconomic models, and a new vision about what markets and policymakers can accomplish.

In a nutshell, since its inception the project has aimed at providing two different but interrelated policy outputs to EU and Eurozone policymakers:

1) a proposal to **reform EMU policies** in a way that would contribute to decrease the likelihood of the occurrence of future crises, while at the same time supporting overall growth in the currency union; and
2) a proposal to pinpoint or devise new **early warning signals** (EWS), in order to spot problematic disequilibria at the macro level, with the aim to act as early as possible to rebalance national economies or the Eurozone as a whole before a full-fledged crisis ensues. This also

includes a focus on identifying systemically important financial institutions (SIFIs).

In this Annual report, we will focus on the former proposal. A second Annual report will then aim at contributing to the EWS literature.

1.1. EMU: the economic and policy context

In the years following the launch of the RAstaNEWS project in early 2013, the Eurozone crisis seems to have somewhat subsided, barring further contagion from the currently ongoing Greek crisis. However, economic growth levels in the Eurozone is still a far cry from the healthy recovery recorded in other advanced economies, above all the United States.

At the policy level, EU Institutions and Eurozone national governments have painstakingly taken a number of important steps in the direction of reforming EMU policies and the overall EMU governance framework, often at the cost of long debates and deep political divisions.

EU Institutions have mainly focused on fiscal policy sustainability, over which they enjoy greater latitude since the formalization of debt and deficit rules within the Stability and Growth Pact (SGP). In the last few years, the "six-pack" and "two-pack" legislation reformed and strengthened the excessive deficit and debt procedure (European Commission, 2011, 2013). More recently, in a 13 January 2015 communication, the EU Commission clarified the space for flexibility available in the SGP (European Commission, 2015b).

EU Institutions have also:

- launched the Macroeconomic Imbalance Procedure (which, *inter alia*, will play a central part in our second Annual report);
- institutionalized a sovereign bailout fund in the form of the European Stability Mechanism;
- laid out the first building blocks for a Banking Union by launching the Single Supervisory Mechanism in 2014, with the Single Resolution Mechanism set to become effective on 1 January 2016.

1.2. Reassessing the success of fiscal consolidation in the Eurozone

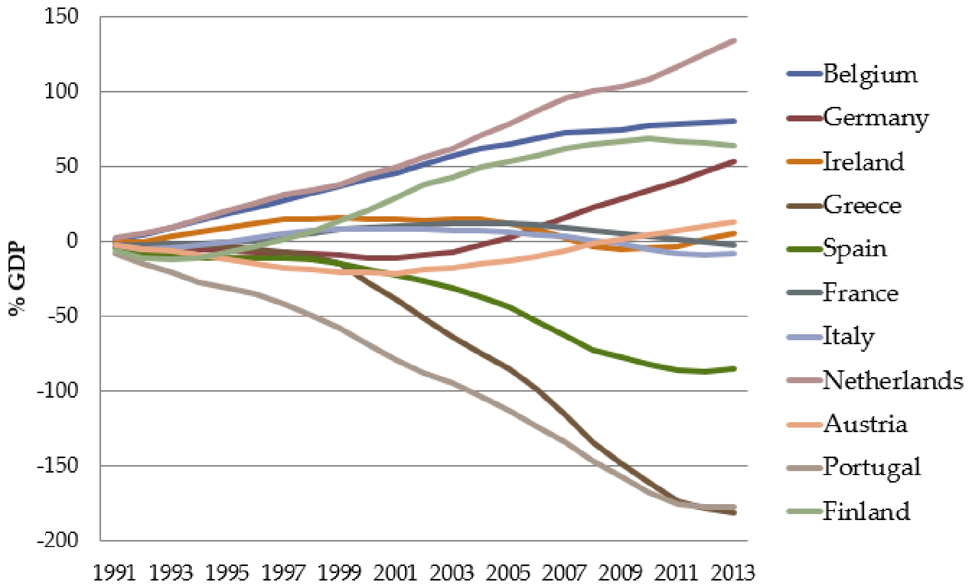
As of early 2015, renewed optimism about the Eurozone seemed to comfort the policies followed so far, especially on the fiscal sustainability side (although it is so far unclear whether the ongoing Greek crisis can significantly hinder the current recovery path of the Eurozone).

Today, austerity partisans claim vindication of their view that austerity and structural reforms, however painful in the short run, are necessary to improve the fundamentals of troubled economies, thus allowing them to take advantage of the recovery later on (Schauble, 2013, 2015). The short-term pain of austerity and recession has been justified as the price to pay to obtain the long-term gains of improved competitiveness and the consequent rebalancing of current account positions, which together would allow each Member State to converge towards the benchmark represented by virtuous and successful EMU countries like Germany.

It is clear, however, that the way austerity has been characterized does not perfectly fit with reality. First, some Eurozone Member States have kept diverging (Saraceno 2013b; see Figure 1); and second, recent recoveries have been driven mostly by exports, and are therefore intrinsically fragile.

There are two reasons why an export-led model is fragile. The first is the well-known fallacy of composition: not everybody can be a net exporter at the same time, which means that, by definition, the German model cannot be generalized and its success rests on other countries absorbing Germany's excess savings. The second reason, more grounded on politics, is that by betting on an export-led growth model Germany and Europe will be forced to rely on growth elsewhere to ensure their prosperity. This is of course a source of economic fragility, but also of relevance in the political arena, where influence goes hand in hand with economic power. In spite of the recent boost to economic activity from

Fig. 1 – Cumulated current accounts (1991-2013)



Source: Eurostat

the crash in the oil price and the euro depreciation, real GDP for the Eurozone is forecasted to return above its pre-crisis peak only in 2016.

In the meantime, the United States are well above their pre-crisis peak (+8%). Even the most successful among EMU economies, Germany, is barely above its 2008 levels (+3%), and its growth in the next two years is forecasted to be rather disappointing. Meanwhile two large EMU economies, Italy and Spain, are about 8% below their pre-crisis peaks.

The persisting weakness of the Eurozone economy has slowly pushed the area towards deflation. The RAstaNEWS consortium therefore sees no reason to be unduly optimistic: even if favorable external conditions were to persist, and the ECB stick to quantitative easing (QE), it will take several years before unemployment, the true barometer of dissatisfaction with EMU in many countries, is brought back to pre-crisis levels.

For these reasons, the RAstaNEWS consortium interprets the current EU predicament as a temporary rebound, and maintains that new policies to foster a stronger and more resilient recovery remain necessary.

But exactly what policies are needed? Looking at the crisis years in retrospect, there is a clear asymmetry between the Eurozone and the US.

In the latter, both monetary and fiscal policy have been far more aggressive. Results speak for themselves, and RAstaNEWS partners believe that we can learn from the US experience and adapt the US' most successful policies to the complex EMU institutional framework.

Further, our analysis points out (Bagliano and Morana, 2015) that the global economy is once more characterized by excess liquidity. This excess liquidity is necessary to prevent the collapse of the financial system, but tends to inflate asset prices instead of fostering and supporting firms' investment and growth. We believe there is also a chance that reformed EMU policies may contribute to assuage this problem.

1.3. Presenting RAstaNEWS policy proposals

In light of the persistent need to reform EMU policies, the challenge for the RAstaNEWS consortium is to single out what is still missing from the EMU policy framework – something the consortium has consistently referred to as “holes in the cheese” – in order to spot weak points and propose desirable solutions.

Drawing from current ongoing RAstaNEWS research, the consortium partners propose here **a three-pronged strategy** to reform EMU macroeconomic policies and avoid the fate of recurring crises **in the short-to-medium term**. The strategy includes the following elements:

1. A **revamped Juncker plan**;
2. Much **closer coordination of national fiscal policies** at the supranational level;
3. An even more **accommodating monetary policy**.

The said accommodating monetary policy should be cast in the perspective of the jobless growth phenomenon, a persistent feature of the global business cycle (Camacho et al., 2011). In fact, the shape of recoveries after recessions has changed since the mid-1980s: nowadays, in their initial phase recoveries are sustained by an increase in labor productivity, much more than by an increase in hiring. Eurozone stabilization policies should take these features into account. This means that unconventional monetary policy should last sufficiently long to allow for the dissipation of recessionary and deflationary trends not only at the euro area level, but also at the Member State level, in order to allow for the unemployment rate to come down considerably.

In this regard, it is also crucial to reverse cumulated competitiveness imbalances as soon as possible during the correction and stabilization phases. This way, it would be possible to support balanced inter-country growth once the economic policy stance goes back to neutral.

In the longer run, RAstaNEWS partners consider that there is a need to **set out a new course** for EMU policies and governance. Such new course should have the following objectives as priorities:

1. Sketch out sustainable and viable ways to **achieve economic convergence** between EMU countries;
2. **Depoliticize the ECB's decision-making process**;
3. Reconsider the proper role of fiscal policy within the EMU, especially with regards to the **overall fiscal stance of the Eurozone**, which should be significantly more accommodative in times of crisis;
4. Direct specific effort towards studying the **interaction between fiscal policies and redistributive outcomes**, both at the EMU and at the Member States level, especially during recessionary episodes.

2. A three-pronged strategy to avoid the fate of recurring crises

2.1. A revamped Juncker plan

The Juncker plan, aiming at revitalizing growth by leveraging public and private investment while avoiding the issuance of new public debt, could be regarded as the first step towards the implementation of broader pro-recovery policies. Of the €315 billion planned increase in investment envisaged by the Juncker plan, €21 billion are going to be financed by means of existing resources; the rest should come through a multiplier effect, relying on the participation of the private sector, as well as institutional investors and sovereign funds.

Recent estimates put the Eurozone investment gap at €200 billion, or 2% of GDP, per year. Some countries in clear need of fiscal consolidation have cut public investment in order to preserve current consumption levels, in an effort to limit public opinion dissent towards government austerity policies.

Weak investment spending can significantly stifle a country's short-term growth outlook by depressing aggregate demand. Moreover, it tends to decrease (or not raise fast enough) the capital stock, thus lowering a country's growth potential in the medium run.

Given current trends in the demand for safe assets, the euro area is now facing a unique opportunity to start a big push in public investment-based pro-recovery policies. Skeptics might argue that, given its limited dimension, the Juncker plan per se is unlikely to produce a big push. In the consortium's view, the plan should only be regarded as the trigger of the recovery.

In order to encourage new private investment, we need to find ways to reduce financial fragmentation within the Eurozone, all the while encouraging investment in countries – like Germany – that have considerable residual fiscal space. Ultimately, to be sustained, the recovery will require the creation of new debt, possibly in the form of eurobonds, which would boost capital inflows. RAstaNEWS partners are therefore advocating a partial demise of the traditional export-led growth model, in favor of a more debt-driven growth model at least in the short term.

2.2. Closer fiscal policy coordination

Public investment has been the predestined victim of austerity. One of the reasons is that political controversies are less likely to arise when expenditure cuts produce undesirable effects only in the long run, so that policymakers will prefer to cut investment spending rather than government current consumption.

For this reason, public investment should be financed from resources that are not part of the shrinking national fiscal budgets, thus escaping control of national policymakers.

However, recognizing that at the current state of play this would be wishful thinking, RAstaNEWS partners wish to stress that there is room for better use of fiscal flexibility already at the national level.

The current EMU predicament is characterized by negative cyclical gaps in most countries (certainly in the periphery) and by negative structural output gaps that require far-reaching reforms in many countries (not just in the periphery). There is a tension between a center (core EMU countries, generally supported by the European Commission) and a periphery. The center insists on structural reforms and fiscal consolidation. The periphery calls for “flexibility” in the use of budgetary policy as a tool that should limit the adverse cyclical gap and buy consensus for reforms. However, in the eyes of the center, cyclical relief would in fact delay reforms (possibly indefinitely).

There is little doubt that if national economic policies were centralized in the hands of a planner, the optimal policy package would contemplate a combination of budgetary flexibility and structural reforms. In fact, several national governments did not undertake the necessary reforms during the favorable economic conditions of the pre-crisis years. Concern for moral hazard problems is therefore justified.

However, given the persistent slack in economic activity, allowing for more flexibility might prove beneficial. Given the growing unease of citizens with EMU macroeconomic policies, an additional and transitory fiscal space might even facilitate governments’ efforts to win consensus for efficiency-enhancing reforms. Under current conditions, better coordination of national fiscal policies might prove very effective in stimulating the recovery.

Better coordination of national fiscal policies should also be a key ingredient of the EMU macroeconomic policy framework in the future, as recently stressed by the Five Presidents' Report (European Commission, 2015a). But what do RAstaNEWS partners mean for fiscal policy coordination in the Eurozone?

At present, coordination implies that Member States stick to a set of rules, where budgetary discipline (debt reduction) is paramount, and "flexibility" in response to shocks is achieved through harsh and lengthy negotiations. This has been only slightly tempered by the recently published Commission's guidelines for making the best use of the flexibility contained within the Stability and Growth Pact (European Commission, 2015b).

Anecdotal evidence suggests that fiscal discretionary actions in the EMU are subject to the "too little, too late" criticism. RAstaNEWS was motivated by one key research question: are fiscal policies necessary to stabilize cyclical conditions in the Eurozone?

As RAstaNEWS research progresses, the consortium's answer is an unqualified yes, for two reasons. The first is contingent to the current crisis, and revolves around the fact that the ECB nominal interest rates are constrained at the zero lower bound (ZLB).

The second reason is related to the structural features of financial markets in the Eurozone, and in advanced countries in general. Namely, a large fraction of EMU households cannot react to the fall in disposable income by decumulating wealth or by borrowing. Due to this (old-fashioned but evergreen) Keynesian multiplier effect, adverse shocks cause output and employment losses that are larger than predicted by standard macroeconomic models.

RAstaNEWS therefore challenges the pre-crisis common wisdom that fiscal policies should target debt-to-GDP ratios and the ECB should implement countercyclical actions. Implementing fiscal stabilization policies in a monetary union characterized by important asymmetries requires that policymakers identify both the EMU global fiscal stance and national policies that are consistent with it.

Did EMU fiscal rules produce an appropriate global fiscal stance? RAstaNEWS research (Albonico, Paccagnini, Tirelli, 2015) shows that fiscal policies played a negligible role in determining aggregate cyclical conditions in the Eurozone. Since 1999, fiscal shocks did not matter for cyclical output growth and there is no evidence of countercyclical fiscal stabilization policies. Further, during the crisis years and up to 2012, the observed growth in fiscal ratios (i.e., debt/GDP and deficit/GDP) is entirely explained by non-fiscal shocks that slowed down output growth.

Therefore, RAstaNEWS partners call for a new thinking in the design of fiscal policies. At a time when the Eurozone is close to deflation, the global fiscal stance should become much more accommodative.

This then poses a further question: how should Member States contribute to the formation of this global fiscal stance? RAstaNEWS partners think that countries that experienced large output losses since the onset of the crisis should be freed from the obligation to implement corrections to their structural budgetary balance, as long as the output gap is negative and Eurozone inflation remains below the 2% target, provided that promised reforms are implemented at the pace agreed with the European Commission. Meanwhile, countries where fiscal space exists should undertake expansionary stimuli.

Is there fiscal space somewhere in the EMU? Eurozone current account (CA) surplus forecast for 2015 is around 2.8% of GDP, and reaches 7% in Germany. In Bernanke's words, these figures are a clear sign of a "savings glut". Should we reverse this mercantilist trend? And could we, or is it politically unfeasible?

For one thing, the 6-pack legislation envisages that a 3-year average CA surplus above 6% of GDP is evidence of external imbalance. In recognition to this, in its Alert Mechanism Report 2015, the European Commission identified Germany as one of the countries experiencing "imbalances" and prepared an In-Depth Review (IDR; European

Commission, 2014). In Germany's 2015 IDR, the EC found that the country is experiencing macroeconomic imbalances "in light of the persistence of insufficient private and public investment, which represents a drag on growth" (European Commission, 2015c). Because IDRs, together with Country-Specific Recommendations, must be endorsed by Member States convened at the European Council to become official EU policy, this is direct evidence that the problem is acknowledged both at a technical and supranational level, and at a national political level.

To conclude, another reason why asymmetric national stimuli should be encouraged is the fact that they are essential to close the competitiveness gaps that have accumulated before and during the crisis without imposing a deflationary burden on countries that need a real depreciation. In short, they support the reduction of imbalances between Eurozone countries, while keeping the rebalancing process sufficiently sustainable.

2.3. A robust accommodating monetary policy

The European version of the quantitative easing (QE) was motivated by increased risks of a de-anchoring in inflation expectations from the "below but close to 2%" target, which might unleash a debt-deflation spiral within the Eurozone. However, monetary policy should be more ambitious in order to foster a sustained recovery.

This, in turn, requires that we spell out how monetary policy could contribute to the removal of competitiveness imbalances and to a structural increase in investment.

The first RAstaNEWS proposal regarding monetary policy is that the ECB should announce a new inflation target, temporarily above 2%. The ensuing higher inflation expectations would facilitate the process of internal devaluation when downward nominal wage rigidities are widespread (i.e. when wage reductions are difficult to implement). In addition, a higher inflation target would facilitate deleveraging.

Is this unthinkable given the hype on inflation as the sole policy target for the ECB? Certainly, the implementation of a higher inflation target poses some problems. The first relates to the possibility that — once the transition away from the ZLB is over — inflationary expectations remain at an excessive level. The second pertains to the political arena, given the likely political resistance by core countries against this proposal.

RAstaNEWS partners' answer to these objections is that it will take a long time before the recovery becomes structural and evenly distributed (US history *docet*). The risk we currently face is the very opposite than the one feared by skeptics: namely, that an isolated ECB President might fail to convince the markets that the ECB's accommodating stance will persist even when the economy will have reached the grey area where deflation is no longer a threat but recovery is still anemic and, above all, uneven. In sum, if there is any lack of credibility in Eurozone policies, this relates to willingness to adequately stimulate the economy, not the other way around. In this context, RAstaNEWS partners see a temporarily higher inflation target as a very useful tool in the ECB forward guidance.

The second RAstaNEWS proposal concerns the interaction between QE and the Juncker Plan. Suppose moral hazard was not a binding constraint for the design of EMU policies. One might argue that, given the current shortage of demand for investment goods from the private sector and the paucity of public sector resources, the best way to stimulate growth would be for the ECB to directly finance the surge of investment.

The QE program currently envisages purchases of securities of European institutions that can finance European investment projects (like the European Investment Bank) up to a limit equal to 12% of the whole program. Extending this limit beyond 12% would make it possible to:

a) Keep the yield on EIB bonds issued to finance the Juncker Plan at a very low level (the Juncker Plan might enjoy a self-financing condition like the one recently envisaged by DeLong and Summers (2012) and by the IMF (WEO, October 2014);
b) boost European demand with no additional burden for national budgets; and
c) increase the degree of risk sharing currently envisaged by the QE program. Indeed, the purchases of securities issued by institutions like the EIB are subject to loss sharing between NCBs and the ECB, therefore risk sharing would be automatic.

3. When the dust settles: A new way forward for EMU policies and governance?

Looking ahead, the post-crisis features of the Eurozone economy are expected to be substantially different from current conditions.

The crisis has indeed thrown light on the relevance of asymmetric shocks and the lack of economic convergence across Member States. While nominal and financial integration have progressed since the creation of the euro, real convergence has not (de Haan et al., 2008; Camacho et al., 2005; Crespo-Cuaresma and Fernandez-Amador, 2013; Lee, 2012).

It has also put the spotlight on Europe's inability to implement a coordinated recovery policy and to act as a single sovereign entity within the global economy.

As the Eurozone economy is still struggling along the road to recovery, a perspective on the "return to sacrifice" should be given to its citizens, meaning that citizens should be shown how their acceptance of current unpopular policy measures may benefit them in the near future.

Being necessarily focused on the short-term management of the Eurozone crisis and weak recovery, policymakers have put aside the need to provide a broader perspective on the crisis and on its potential hidden dividend.

In fact, the crisis has provided the Eurozone with the unique opportunity to uncover weaknesses and sources of divergence across euro area countries and therefore to stimulate a deeper reflection on viable solutions to foster convergence. The ultimate aim of this big debate should be to put the post-crisis Eurozone on a more viable and sustainable path, with the goal of achieving a more integrated economic bloc, capable of playing an important role on the global stage.

In order to achieve this goal, and also to convince European citizens of the merits of real convergence, RAstaNEWS partners believe an innovative effort is needed in redesigning EU Institutions and, above all, in reshaping the philosophy and political legitimacy of EMU economic policymaking.

Below, RAstaNEWS partners wish to touch upon specific topics which may need further discussion and reflection, and are meant to trace a way forward for the EMU in the longer term.

3.1. Achieving convergence

The crisis forced Member States to conceive, adopt and carry out several structural reforms, which most of the time proved very painful. The product of structural reforms is that a more harmonized and convergent Eurozone economy could emerge in the post-crisis phase. At the same time, in order to foster this process of convergence and safeguard it in the future, RAstaNEWS partners hope that policymakers will muster sufficient personal commitment and political space to complete the EMU integration process. The recent “Five Presidents Report” goes in the right direction in terms of the necessary steps needed to complete the EMU at the economic, fiscal, financial, and democratic legitimacy level (European Commission, 2015a).

However, it is important that policymakers avoid a fundamental mistake made in the past, that is, to rely on financial markets as the main driver of convergence. In fact, although before the EU sovereign debt crisis capital did flow from richer to poorer countries within the Eurozone, this was not sufficient to generate structural changes in productivity growth patterns and foster convergence.

Moreover, by making banking sector supervision and regulation more and more “federal”, the banking union could be an important tool to efficiently regulate the financial sector, decreasing the likelihood of financial crises, but could be insufficient to foster convergence by itself.

Indeed, if we maintain that international capital flows are key to promote convergence, then we must accept that the growth model in periphery countries of the Eurozone should be more debt-driven, and that macroeconomic policies should support accumulation of productive capital, both at the national and at the supranational level. This is a controversial and still unresolved issue, because the emphasis on (public and private) borrowers’ discipline, justified by past excesses, is *de facto* promoting the export-led model adopted in the Northern countries, not the debt-driven development preferred by periphery countries before the financial crisis.

However, even by considering the experience of Japan since the 1990s, it is clear that a growth model focused only on exports might not succeed. Since the 1990s, Japan has gone through two decades of lost growth, despite the QE pursued by the Bank of Japan, a devalued currency and the expansionary fiscal and monetary policy mix lastly implemented within the "Abenomics" framework. Neither economic growth has been revived, nor the deflationary trend has been curbed so that Japan returned to recession in 2014.

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3.2. The future of the ECB

Regarding the future of the ECB, several issues call for a thorough discussion.

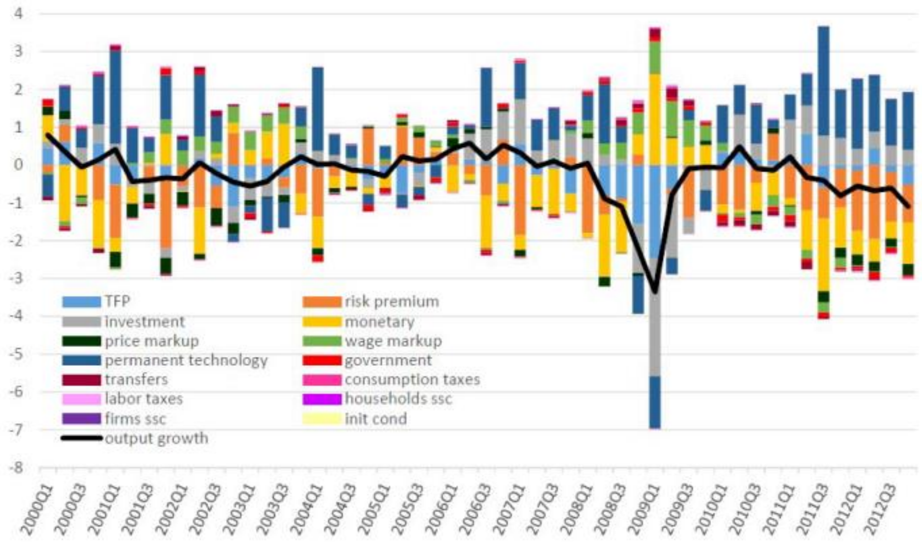
First, it is important to acknowledge that the crisis is likely to produce a new normal for monetary policies, as scholars and policymakers strive to reach a new consensus. Namely, experts are more and more convinced that inflation targeting should go hand in hand with concerns for financial stability, asset prices, and real targets such as unemployment (and, possibly, the analysis of distributional effects of monetary policy).

In addition, in the EMU context it is also important to address the issue of national differences, as a one-size-fits-all monetary policy becomes highly unstable without real convergence, given that the global monetary stance might be too accommodative for some countries while being too restrictive for others *at the very same time*, unless business cycles converge in the euro area.

Finally, the ECB governance model should be reconsidered. Formally, the ECB's decision-making processes closely resemble those adopted by the Fed's Federal Open Market Committee (FOMC). However, governors of EMU Member States' national central banks have increasingly played the role of national representatives within the ECB. During the Eurozone crisis, the politicization of the ECB's decision-making has increased, to the point that each governor's power in practice closely tracks the political power of the Member State it represents (instead of being one head, one vote). It therefore appears urgent to disentangle as much as possible central-banking decision-making – which should be independent and evidence-based, also in light of its forward guidance function which requires policy predictability – from national political pressures.

All this could make the ECB much more responsive to deflationary trends. In this respect, Albonico Paccagnini and Tirelli (2015, APT henceforth) estimated a DSGE model over a sample that accounts for the

Fig. 2 - Euro area GDP growth, variance decompostion (2000-2012)



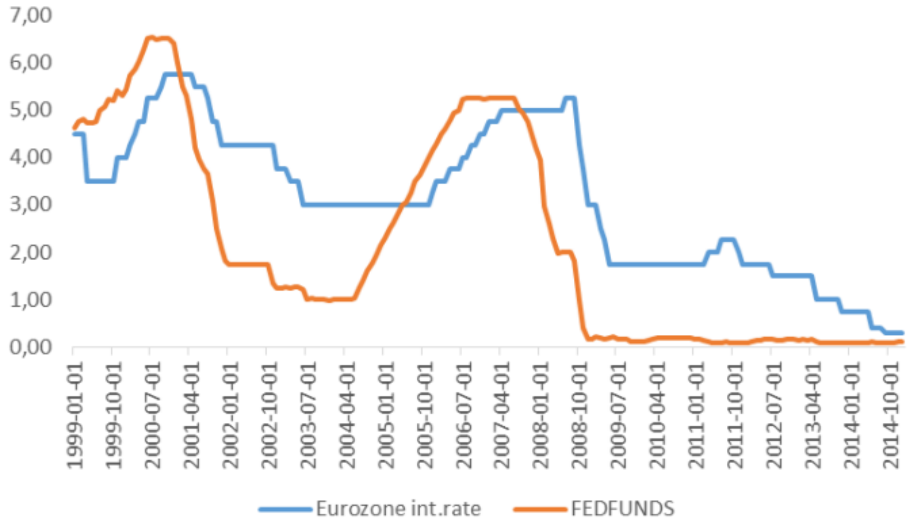
Source: APT 2015

crisis period up to 2012. Their model departs from the standard representative agent assumption to incorporate the Limited Asset Market Participation hypothesis (LAMP henceforth), where a fraction of Non-Ricardian households do not hold any wealth and entirely consume their disposable labor income in each period. In addition, they estimate the contribution of fiscal policies to the EMU business cycle. Results are striking.

First, APT estimates that 53% of households have almost no means to spread their consumption over time, so that they cannot react promptly to changes in macroeconomic conditions by arbitrating between current consumption and saving a part of this for future periods.

Second, they find that, unlike in the US case (Leeper et al. 2011), in the Eurozone it is impossible to identify the systematic reaction of tax rates and public consumption to the Eurozone output gap and to debt accumulation. There seem to be no fiscal Taylor rules for the Eurozone as a whole, meaning that the fiscal stance has not become more accommodative in times of crisis, when it should have been expansionary in order to foster the economic recovery.

Fig. 3 – Eurozone and US interest rates (1999-2014)



Source: Fred

Third, and most importantly, they find that monetary policy shocks turn out to be very important, accounting for about 30% of total volatility in GDP growth. ATP estimate that monetary policy turned expansionary and contributed to the temporary recovery in 2008-2009. However, since the first quarter of 2010 monetary policy turned contractionary, and remained so throughout the end of the sample (see Fig. 2).

Therefore, the "double dip" Eurozone recession was characterized by a reversal of discretionary monetary policies, that turned contractionary once more. This pattern is confirmed by casual inspection of Eurozone interest rates dynamics in comparison with the US, where it is easy to see that it took a long time before EMU interest rates were driven down to the ZLB, in sharp contrast with Fed policy (see Fig. 3).

In order to restore confidence on financial markets, EMU countries embarked in fiscal consolidation well before the recovery could consolidate and this, in turn, had painful consequences. Monetary policy, most probably against the will of ECB presidents Trichet and Draghi, came to be at the forefront of the fight against the crisis, but was to slow to react also due to the encumbering policymaking process, which too often has allowed national interests to prevail over the stability of the Eurozone as a whole.

3.3. Fiscal policies: rethinking the fiscal stance

One key lesson RAstaNEWS partners draw from the EMU crisis is that the set of EU fiscal rules, as set out within the SGP and further amendments, is too rigid, while flexibility should be preferred in order to create room for a countercyclical fiscal buffer (which was patently absent during the current crisis). Even the flexibility that the Commission has recently managed to carve out from current legislation and treaties, while being an important step forward, is not enough to support an economic recovery (European Commission, 2015b).

Moreover, being exceedingly focused on debt and deficit restraint, EU fiscal rules are unable to enforce symmetrical adjustments within the Eurozone. In fact, the rules are currently designed neglecting that an optimal currency area requires either fiscal centralization or coordination of fiscal policies with a clear emphasis on implementing symmetrical adjustments when needed.

A central tenet of the RAstaNEWS approach is that, for the economic and monetary integration process to be completed, fiscal policies (defined in terms of targets and tools) and the allocation of powers for their practical implementation should be jointly reconsidered and integrated in a new fiscal compact.

This is in line with the discussion in the Blueprint for a deep and genuine EMU, where it is emphasized that an EMU-level stabilization tool to support adjustment to asymmetric shocks should promote economic integration and convergence. The Blueprint also argues that such a tool might be used to target shocks that are common to the euro area (European Commission, 2012).

In both cases, the issue of providing strong safeguards in order to maintain fiscal credibility and avoid the setting up of a long-term transfer union is important. In this regard, it is necessary to create additional fiscal space at the EMU level, while at the same time enforcing strict budgetary discipline at the national level.

3.4. Fiscal policies: focusing on redistributive effects

RAstaNEWS research shows that inequality might have contributed significantly to the Great Recession (Cardaci, 2014; Cardaci and Saraceno, 2015). We know that inequality reduced the average propensity to consume (Kaldor, 1955), and chronically depressed aggregate demand, as savings leaked away. The same phenomenon led to two opposite effects in the US and abroad, conditional on political, monetary and financial institutions. In the US (but also in peripheral Europe), a debt-financed credit boom supported aggregate demand, misleading non-core Europe policymakers that everything was fine, and that the convergence process was indeed happening. In core Europe, East Asia, and the Middle East, excess savings financed the excess spending of deficit countries. The result was a fragile equilibrium that exploded with the crisis (Fitoussi and Saraceno 2011).

However, the opposite – that recession and the ensuing fiscal consolidation in the Eurozone might have an impact on income redistribution, especially increasing inequality – is also of great importance to RAstaNEWS partners. In a 2014 policy paper, the IMF underlined different mechanisms through which a restrictive fiscal policy can and does increase income inequality, especially in the short run. The long-term effect of fiscal contractions depends on whether automatic stabilizers are in place, and on their net effect on income redistribution, especially for low-skilled workers whose wages tend to be compressed most as employers hoard skilled labor (IMF 2014).

Ongoing RAstaNEWS research shows that monetary and fiscal policy contractions can generate a persistent increase in income and consumption inequality, unless fiscal actions are designed to avoid this outcome (Saraceno 2013a). Recent empirical studies (Rawdanowicz et al. 2013) appear to confirm that austerity did in fact increase inequality. The effects austerity has had upon the Greek economy show that inequality was not a central concern for the Institutions that negotiated austerity measures with the national government, while it should have probably been in order to support the legitimacy of such measures.

This is why it is crucial to devise ways to reduce public debt while at the very least limiting harm to the poorest strata of the population. More research is needed to explore both the substantive effects that fiscal policies do have on income redistribution within the Eurozone, and specific remedies that may limit the redistributive effects of such policies while ensuring the necessary level of fiscal consolidation over the medium term. RAstaNEWS partners believe that fiscal adjustments can be designed to lessen their negative effects on income inequality.

4. Conclusions

During the last year, RAstaNEWS research has progressed to a point where it is possible for the consortium to draw substantive policy recommendations for the Eurozone as a whole.

While the EU (and the EMU in particular) has been reformed to shelter the currency union from the likelihood and impact of future crises, the EMU is still not an optimal currency area. Within and across countries, asymmetries and disequilibria abound, demanding constant monitoring and extensive policy action.

RAstaNEWS partners believe that, in the short term, it would be possible and advisable to support the ongoing nascent (but still tentative) Eurozone economic recovery through bolder action on both the monetary and fiscal side. At the same time, the EMU governance should be reformed by making fiscal rules more flexible in times of crisis and more rigid in good times (in order to force Member States to undertake the necessary adjustments to safeguard their economies from future idiosyncratic crises). Decision making processes should be depoliticized, especially with regards the Excessive Deficit Procedure, the Macroeconomic Imbalance Procedure, and ECB monetary policy decisions.

Moreover, a coherent push in favor of public investment would be advisable both for those core countries that tend to focus on fiscal discipline too early in the economic recovery, and for periphery countries that need to support their own recovery and close the competitiveness gap with the rest of the Eurozone.

The ECB should be allowed to undertake bolder measures, which would support the domestic recovery, bring inflation closer to the official target, and increase the external competitiveness of the EMU by indirectly lowering the real effective exchange rate.

Meanwhile, much closer coordination of national fiscal policies would be strongly advised. In the medium run, the preferred outcome should be to enforce rigid budgetary rules for each Member State, while at the same time making discretionary fiscal spending more and more supranational (and flexible). This would allow for collective decisions on fiscal readjustments for the whole of the EMU, while substantively decreasing moral hazard in the single Eurozone economies and, possibly, increase a sense of common destiny in each Member State and its national policymakers.

In the longer term, reforms should follow the path already sketched out by the recent Five Presidents' Report on Completing Europe's Economic and Monetary Union, while also consider to reform ECB decision making procedures in order to make the central bank an effectively supranational institution, free from political pressure.

To conclude, further RAstaNEWS research will especially focus on exploring the redistributive effects of fiscal policy, and measures to limit their impact on the poorer strata of the population.

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