

# An Investment Strategy in EU: A Means to Compensate for the Lack of Fiscal Transfers<sup>1</sup>

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Since May 2010, Greece followed by Ireland and Portugal, receive financial support from other Euro-area Member States as well as the International Monetary Fund (IMF) in the context of a sharp deterioration of their financing conditions<sup>2</sup>. With Italian spreads<sup>3</sup> currently on the rise, as well as an outlook of weak growth for the already fragile European economy, Europe's sovereign debt crisis has entered another decisive phase.

In this contribution my arguments will make use of the following theoretical foundation: An optimal currency area (OCA)<sup>4</sup> requires a system of sufficient fiscal transfers to deal with asymmetric shocks. Such a system could be a social security system (e.g. an unemployment benefit scheme) or funds that are allocated to regions negatively affected by an asymmetric shock. The counterpart of this theoretical foundation implies that if such a system is not in place or will not be envisaged in the near future, a currency area will most likely not survive severe and repeated asymmetric shocks.

In the next section I will provide an overview of the short- and medium-term economic outlooks based on recent international reports. I will then focus on the economic and sovereign debt situations in select Member States. In the last section I will describe the necessary policy reaction.

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1. All data has been collected before December 2011

2. I am grateful to Roland Freudenstein, John Lageson and Vit Novotny for comments and suggestions.

3. On November 10<sup>th</sup> 2011, Italian 10-year government bond yield was higher than 7%, German 10-year government bond yield was below 2%.

4. In the early 1960s, before the euro came into existence, the theoretical foundations for currency zones were laid out by Robert Mundell, Robert McKinnon and Peter Kenen. A country that gives up its own currency can no longer change the value of its currency (mainly devaluations were used in the period before the introduction of the euro). The cost of losing this policy instrument can be mitigated via, amongst other elements like labor mobility, a system of fiscal transfers.

## Economic outlook for the Euro-area

The September 2011 World Economic Outlook by the IMF projects real GDP growth worldwide at 4.0 % for 2011 and 2012. Within the European Union, due to growth coming to a standstill in the second quarter in several Member States, real GDP growth is projected to be 1.7% in 2011. According to the IMF, the deceleration was partly the result of global shocks, but also the escalation of the Euro-area crisis, which is having a more wide-spread effect on domestic demand, as the confidence shock spreads beyond the periphery to core countries' consumers, bankers, and investors<sup>5</sup>.

The European Commission's Autumn forecast confirmed the IMF forecast and put forward even worse real GDP growth projections (see Table 1). The Commission states: "Against the background of increased uncertainty and ongoing market turmoil, the risk of stronger and more adverse feedback loops threatening the EU economy is substantial. It accentuates the downside risks to the growth outlook."<sup>6</sup>

**Table 1**  
**Real GDP growth**

	Real GDP Growth (IMF, October 2011)				Real GDP Growth (European Commission, November 2011)			
	2009	2010	2011	2012	2010	2011	2012	2013
World	-0.7	5.1	4	4	5	3.7	3.5	3.6
Europe	-4.6	2.4	2.3	1.8				
Advanced EU economies	-4.1	1.7	1.6	1.3				
Emerging EU economies	-6	4.4	4.4	3.4				
European Union	-4.2	1.8	1.7	1.4	2	1.6	0.6	1.5
Euro area	-4.3	1.8	1.6	1.1	1.9	1.5	0.5	1.3
France	-2.6	1.4	1.7	1.4	1.5	1.6	0.6	1.4
Germany	-5.1	3.6	2.7	1.3	3.7	2.9	0.8	1.5
Italy	-5.2	1.3	0.6	0.3	1.5	0.5	0.1	0.7
<sup>1</sup> Average weighted by GDP valued at purchasing power parity								
Emerging EU economies: Bulgaria, Hungary, Latvia, Lithuania, Poland, Romania								

Source: Eurostat, different tables consulted on 13 November 2011 on <http://epp.eurostat.ec.europa.eu> and the author's own calculations.

5. International Monetary Fund, Regional Economic Outlook, Europe – Navigating stormy waters, October 2011, p. XI.

6. European Economic Forecast Autumn 2011, European Commission, p. 11.

The same IMF Regional Economic Outlook for Europe stated: “With fiscal consolidation ahead, an additional concern is that public investment in research, education, and infrastructures will be curtailed, harming future growth performance”.<sup>7</sup>

In the European Commission’s forecast, we read that growth differences across Member States were one of the key elements in Europe’s recovery in 2010. Germany, due to its significant exports to non-EU Member States, was able to reach output levels above those in pre-crisis periods. Moreover, this generated positive spill-over effects to other Member States. It is interesting to note that also Sweden and Poland were able to reach higher output levels than before the crisis. In the same forecast, we read the following: “Survey indicators point to a slowing of economic activity in all Member States and across almost all sectors.”<sup>8</sup> Based on its analysis, the Commission expects a slowdown of economic growth or even periods of contraction for almost all Member States in 2012. However, the Commission also notes that, due to low sovereign refinancing rates of certain Member States, fiscal consolidation might be spread over a longer period, which would have a positive impact on growth<sup>9</sup>.

### **Economic and sovereign debt situations in select Member States of the Euro-area**

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In the previous section we found that growth prospects for the European Union look grim. Moreover, we found that the real growth predictions for the members of the Euro-area are mostly the cause of the overall deterioration in this negative outlook. We found that one of the main reasons for this is the worsening of confidence caused by the sovereign debt crisis. We could also read in the Commission’s outlook that Germany has been an important driver of the recovery in 2010, but that this will no longer be the case in 2012.

Let us therefore focus on the economic and sovereign debt situations in two Member States of the Euro-area: Germany and Italy.

As can be seen in Table 2, both German and Italian real GDP growth is predicted to be (much) lower in 2012 than in 2011, with German growth falling from 2.9% to 0.8% of GDP in one year<sup>10</sup>. As Germany and Italy together represent over 40% of the Euro-area’s GDP, a relative decline in the real GDP growth of both countries will have a huge impact on the overall growth performance of the Euro-area. This could also be predicted based on the large spill over effects from the German economy to other Euro-area members (see earlier point).

We also find in Table 2 the evolution of general government gross debt as a percent of GDP. Table 2 shows the significant relative increase of Germany’s general government debt since the introduction of the common currency (from 60.9% in 1999 to 83.2% of GDP in 2010) compared to Italian general government debt (from 113.7% in 1999 to 118.4% GDP in 2010).

Table 2 also shows the main challenge of the current sovereign debt crisis: the yield on Italian 10 year government bonds was 6.5% on 11 November 2011, where 7% is considered to be unsustainable in the medium run.

What do all these numbers tell us?

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7. International Monetary Fund, Regional Economic Outlook, Europe – Navigating stormy waters, October 2011, p. 21.

8. European Economic Forecast Autumn 2011, European Commission, p. 30.

9. European Economic Forecast Autumn 2011, European Commission, p. 34.

10. Based on the European Commission’s Autumn 2011 Economic Forecast from 2.9% real GDP growth in 2011 to 0.8% in 2012.

First: The current yield on Italian government bonds implies that the Italian government has no choice but to bring the general government deficit down as fast as possible, as borrowing costs are close to unsustainable levels. Moreover, borrowing at over 6% implies huge interest payments that cannot be invested in growth enhancing measures.

Second: A “normal” exit strategy would imply austerity, structural reforms and investments. However, due to the high level of debt and the high yield, the Italian government might not have room for investments in growth enhancing areas.

Third: With the German general government deficit at 4.3%GDP and gross debt up to 83.2% GDP, the German government might rely on the recipe imposed on Italy: austerity and, where necessary, some structural reforms. In doing so, Germany will respect the Maastricht criteria<sup>11</sup> as well as the German Schuldenbremse<sup>12</sup>.

**Table 2**  
**Real GDP Growth, relative importance in Euro-area GDP, general government gross debt as % GDP and Yield on 10 year government bonds for both Germany and Italy**

	Real GDP Growth (European Commission November 2011)		Country represent X% of Euro area's GDP		General government gross debt as % GDP			General government deficit/surplus %GDP			Yield government Bond 10 Year
	2011	2012	2011	2012	1999	2009	2010	1999	2009	2010	11/nov/11
Euro-area	1.5	0.5	100%	100%	71.60%	79.80%	85.40%	-1.40%	-6.40%	-6.20%	
Germany	2.9	0.8	27.21%	27.26%	60.90%	74.40%	83.20%	-1.50%	-3.20%	-4.30%	1.89%
Italy	0.5	0.1	16.82%	16.80%	113.70%	115.50%	118.40%	-1.70%	-5.40%	-4.60%	6.50%

Source: International Monetary Fund, *Regional Economic Outlook, Europe – Navigating stormy waters*, October 2011, p. XII and *European Economic Forecast Autumn 2011*, European Commission, p. 9.

## The necessary policy reaction?

Historically speaking, a large spread between German and Italian yields is not exceptional. The Italian 10 year government bond yield reached a historic high of 13.75 % in March of 1995, whilst German 10 year government bond yield reached 9.61 % in the same period (a spread of 4.14%). However, the German and Italian economies were not part of the same currency union at that time.

Within a currency union, we should look at the differences in yield on German and Italian government debt as an asymmetric shock. And, as the theoretical foundation mentioned in the introduction teaches us, in order to have a sustainable currency area, we need a system of sufficient fiscal transfers to deal with these asymmetric shocks. However, apart from the structural funds, such a system (like a European unemployment benefit scheme) is not in place and not envisaged.

Therefore, I would argue that Italy and Germany, representing over 40% of Euro-area GDP and suffering an asymmetric shock, cannot undergo the same economic policy reaction at the same time. As the Italian government will be forced to merely focus on

11. Max 3% GDP deficit and 60% GDP general government debt.

12. A balanced-budget amendment to the German constitution.

increasing its primary surplus, the German government, as well as other countries with room to manoeuvre, should delay their consolidation efforts and engage or continue their stimulus plans for their own economies.

The main objective of these stimulus plans should be to restore market confidence via public investments as well as measures to stimulate household consumption and to increase business investments within the country as well as in countries like Spain, Italy, Greece, etc. As we can see in Table 3, most indicators related to those areas show Germany's positive room to manoeuvre compared to pre-euro or pre-crisis levels.

**Table 3**  
**General government fixed investment as % GDP, Gross fixed capital formation by the private sector as % GDP, Investment rate of non-financial corporations and household saving rate. All indicators for the Euro-area as well as Germany and Italy**

	General government fixed investment as % GDP				Gross fixed capital formation by the private sector as a percentage of GDP			Investment rate of non-financial corporations (The gross investment rate of non-financial corporations is defined as gross fixed capital formation divided by gross value added)			Household saving rate (The gross saving rate of households is defined as gross saving divided by gross disposable income)			
	1999	2008	2009	2010	2008	2009	2010	2008	2009	2010	1999	2008	2009	2010
Euro-area	-0.7	5.1	4	4	19%	3.7	3.5	22.86	20.45	20.56	NA	NA	NA	NA
Germany	-4.6	2.4	2.3	1.8	17.50%	16.10%	16.40%	19.38	17.40	17.78	15.31	17.41	17.05	17.05
Italy	-4.1	1.7	1.6	1.3	18.40%	16.50%	17.30%	24.63	22.29	23.79	15.77	14.56	13.44	12.06

Source: Eurostat, different tables consulted on 13 November 2011 on <http://epp.eurostat.ec.europa.eu> and the author's own calculations

Other more structural and long-term investments could include policies that increase both public as well as private investment in education and research and development. As one can see with the example of Germany in Table 4, public and private investment in tertiary educational institutions is the lowest of the countries mentioned, whilst German private investment in R&D is low compared to that of Sweden, the USA and Japan.

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In conclusion, I refer to what we have seen earlier: when countries with room to manoeuvre engage in an investment strategy to stimulate growth, there will be positive spill over effects to those economies not in a position to invest. This additional growth will make the necessary consolidation effort in those countries more feasible and yields on government bonds will come back to sustainable levels. Together with a more flexible use of structural funds (amounting to up to 2.29% of Greek GDP in the coming three

years<sup>13</sup>), this strategy might compensate for the absence of a system of fiscal transfers between different regions of the same currency area. It could be, so to speak, a second-best and politically acceptable option. However, if both Italy and Germany engage in policies to increase their primary surpluses in the short run, Italy might be forced to partly default on its debt and, even worse, the currency area might be forced to break apart.

**Table 4**  
**Investment in higher education and gross domestic expenditure on R&D as % GDP**

	Expenditure on tertiary educational institutions as a percentage of GDP (2006)			Gross domestic expenditure on R&D (2008)		
	Public	Private	TOTAL	Public	Private	TOTAL
EU27				0.665	1.235	1.9
Germany	0.94	0.16	1.10	0.79	1.84	2.63e
Poland	1.18	0.12	1.30	0.42	0.19	0.61p
Sweden	1.56	0.04	1.60	0.98	2.78	3.75e
UK	0.98	0.32	1.30	0.64	1.24	1.88p
France	1.18	0.12	1.30	0.73	1.29	2.02p
Italy	0.83	0.07	0.90	0.54	0.64	1.18p
USA	1.97	0.93	2.90	0.63	2.13	2.76
Japan	1.00	0.50	1.50	0.69	2.75	3.44

Source: *Education at a Glance 2009: OECD indicators* accessed at [www.oecd.org/edu/eag2009](http://www.oecd.org/edu/eag2009) on 14 November 2011 and Eurostat Pocketbooks, *Science, technology and innovation in Europe, 2011 edition*, page 35. e = national estimate, p = provisional. USA data: Excludes most or all capital expenditure; GOV sector includes federal or central government only; provisional data.

13. The fast track for EU structural funds investments in Greece amounts to 15 billion euro until the end of the current programming period (2011, 2012, 2013), which represents an annual investment of 5 billion euro. With a forecasted GDP of 217828.8 million euro, this represents 2.29% in 2011 (<http://epp.eurostat.ec.europa.eu>).