

Eurozone: Do the maths right

Higher algebra or simply messing around with numbers? With the most important policy debates in the eurozone right now, it's crucial to get the maths right



President-elect of the European Central Bank, Christine Lagarde

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These days, economists like to talk politics, often to such an extent that you sometimes get the impression they can no longer handle the numbers. However, the eurozone faces two pressing economic issues right now and a look at the numbers would not do any harm.

The two most pressing policy issues for the eurozone economy

What are these issues? With the eurozone, and particularly its largest member state, Germany, flirting with recession and stagnation, the pressure on governments to use fiscal stimulus has increased. The question is whether fiscal stimulus should come at the cost of higher government debt or whether the eurozone's fiscal rules should remain untouched. The second pressing issue is the ECB's strategic review with some observers advocating a lower inflation target, implicitly hoping for a quick rate reversal under the new ECB President Christine Lagarde. The maths, linking these two issues, seem to have been forgotten.

Time warp to the foundations of the eurozone's fiscal rules

In the early 1990s, the founding fathers of the euro agreed on the so-called Maastricht criteria. As far as fiscal policy is concerned, the Maastricht criteria stipulates that the budget deficit should not exceed 3% of GDP and government debt should not exceed 60% of GDP. Contrary to popular belief, these numbers were not the result of long academic research, finding the right level for sustainable public finances. On the contrary. The 60%-threshold was simply the result of average government debt in core eurozone countries at that time. With average nominal economic growth (real GDP growth plus inflation) also at 5%, the mathematics were done quickly, yielding a budget deficit of 3% of GDP in order to stabilise public debt at 60% of GDP in the long term. Why? Three divided by five is 0.6. That's how easy European fiscal rules are. Of course, over time, the interpretation of the rules has become more nuanced, sometimes more complicated or more ambitious, but the basic assumptions remain: 3% and 60%.

Checking the numbers

No one knows whether 60% is the magic level for sustainable public finances. However, what we do know is that the fiscal policy formula of the early 1990s is currently outdated, it no longer matches the economic reality of the eurozone. In fact, there are currently at least three shortcomings or adverse implications of the 3-5-60 formula: 1.) Fiscal policies aimed at always running surpluses (some call it Black Zero) in the long run leads to a complete end of public debt. Zero divided by anything always results in zero. 2.) Since structural nominal growth in the eurozone is currently at 3% or 4% but not 5%, either the debt criterion would have to be set higher (3 divided by 3 or 4 is either 100% or 75%) or 3.) The deficit target would have to be reduced to just under 2%. Already getting a headache from this number juggling?

Why all this number juggling?

The foundations of the eurozone's fiscal rules were the result of coincidences, not scientific research, and need to be adapted to new economic realities. The ECB critics who are currently calling and hoping that the ECB under Christine Lagarde will lower its 2% inflation target, in order to allow for faster interest rate hikes, should think twice. A lower inflation target for the ECB would automatically lower the denominator of the eurozone's fiscal algebra. The same experts would then have to demand a loosening of the budgetary (or rather the debt) policy. Something's gotta give. Either lower the inflation target and allow for looser fiscal rules or increase the inflation target to accommodate for lower structural real GDP growth.

One way or the other, in order to tackle the eurozone's most pressing economic policy issues, it has to get the maths straight.

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