CHAPTER 11

Monetary, Fiscal, and Structural Policy in the European and Greek Economy

11.1 Introduction

The chapter deals with the possibilities of setting monetary, fiscal, and structural policy in an era of low growth and low inflation. Monetary, fiscal, and structural policies are three active policies that can be used when we aim to fill the output gap and increase the productive capacity of the economy. The evolution of the Covid-19 crisis has added to the picture of high unemployment and short-term output gap.

Of course, the Greek economy is a member of the Eurozone and, therefore, there is no potential to pursue independent economic monetary policy. However, observing the Eurozone contributes to reaching necessary conclusions for the Greek economy.

Fiscal policy has wider potential but also greater limitations versus monetary policy. For the next years after exiting fiscal adjustment programs, Greece will be subject to an enhanced surveillance procedure by EC, as the level of public debt owed to European institutions makes it necessary for the Greek economy to be supervised long-term. Adversely, structural policy has greater possibilities for implementation, especially after the 2010–2018 memorandum supervision period.

At the same time, the Covid-19 pandemic crisis is creating a new global economic policy environment, where the need to support economies is changing established monetary and fiscal policy rules.
The chapter includes five sections. In Sect. 11.2, monetary policy is presented, and in Sect. 11.3, the implementation of fiscal policy conditions is created after the Great Recession of 2008. In Sect. 11.4, structural reforms are analyzed, beyond fiscal and monetary policy. In addition, in Sect. 11.5, reference is made to specific economic policies to address the issue of development and growth in combination with the needs to cover the output gap and, finally, in Sect. 11.6, the impact of Covid-19 on economic theory and politics is assessed.

### 11.2 Monetary Policy

During the Great Moderation (1980–2008), the world economy experienced particular stability. Low and stable inflation, steady growth in advanced economies, and the rapid development of emerging economies shaped the landscape.

The synchronization of central banks to exercise common monetary policy leads to inflationary stability and a reduction in fluctuations for output produced. During the Great Moderation (1980–2000), the models used to conduct monetary policy followed Taylor’s rule and were based on the Central Bank’s style model. According to Taylor’s rule, interest rates adjust to changes in inflation and output. Low product and inflation volatility were largely due to the application of rules on interest rates (Taylor, 2013).

In a globalized environment, however, the size of cross-border impact from policy spillovers is geographically more extensive, in comparison with the 1980s. Additionally, the results of applied policies tend to spread more when periods of recession and intense uncertainty prevail, but ultimately with weak effects. As a result of the above two factors, the effectiveness of national policies is now less than it was in recent decades, while policies applied to wider transnational organizations play a major role. In addition, the implementation of demand reduction policies or the deleveraging of public and private sectors by members of a monetary union may serve as a stabilizing policy for the economy without, however, increasing its development prospects.

In general, the joint implementation of macroprudential policies is expected to lead to better results, compared to policies that are limited
to each national economy (Constancio, 2014). Despite this, the benefits of policy coordination are not empirical highlighted (Obstfeld & Rogoff, 2002). Figure 11.1 shows the evolution and convergence of key interest rates from central banks as an effort to manage the 2008 crisis on the part of monetary policy.

Coordinating macroeconomic policies is not an easy task as a number of factors need to apply, given that at an institutional level every economy is distinguished by different organizational and administrative structures. At the same time, uncertainty and external shocks are conditions that cannot be predicted, making any attempt to carve out a common economic policy difficult.

The two guiding axes of monetary policy are quantitative easing (QE) and forward guidance. Although quantitative easing is popular, given its heavy and unusually extensive use on both sides of the Atlantic, it has undetermined, ambiguous, and highly controversial—according to the different schools of economic thought—effects on the real economy. On the one hand, there are economists (mostly central bankers who have

Fig. 11.1 Basic interest rates from central banks (Source Bank of England [2019], Bank of Japan [2019], Board of Governors of the Federal Reserve System [2019], European Central Bank [2019], Swiss National Bank [2019] and author’s own creation)
adopted QE, such as former Federal Reserve chairman Ben Bernanke) who argue that this monetary policy tool has a strong impact on the real economy. On the other hand, those who embrace the concept of monetary neutrality disagree with QE, both in terms of its effective impact on the real economy and its contribution to the gradual push of long-term interest rates downwards.

Although the organic composition of QE theory remains controversial and, consequently, its method of operating in general, its effectiveness seems to be achieved through the restructuring of the asset portfolio, as the reduction in government bond yields motivates investors to shift their investments to private-corporate bonds and/or stocks, a step which reduces the cost of capital for businesses and also triggers more investments.

But beyond the controversial nature of QE, forward guidance also seems to have several flaws. More specifically, the hypothesis that financial actors, i.e., businesses, households, and investors, make decisions with their eye on the distant future, is rather defective, if not utopian. Furthermore, this view seems to be in conflict with credibility issues, as it assumes that financial actors have included in their expectations central bank promises that will be implemented over a long-term horizon. Perhaps, central banks should adopt more unconventional tools, without necessarily putting aside their two pillars of monetary policy (QE and forward guidance), in an effort to tackle the next recession and ease shocks resulting from it. Can such a thing be achieved? If yes, in what way?

One option seems to be sacrificing certain inflationary units above the highest limit, which may change the perception of investors who consider achieving the inflation target to be Heraklion achievement. The modern world is going through a large phase of demographic change. Given the impact of life-cycle patterns on a range of activities—such as savings, consumption, education, and retirement—it is particularly interesting to consider the impact demographic change will have on the effectiveness of policies being implemented. Characteristic of this is the work of Leahy and Thapar (2019), who examine whether the effects of monetary policy depend on the demographic structure of the population, which they divide into three different age groups. More specifically, in response to an increase in interest rates, the effects of private employment and personal income are weaker the greater the share of population under 35 years of age, are stronger the greater the share of population between 40
and 65 years of age, and are relatively unaffected by the share of population older than 65 years. They find that all age groups become more responsive to monetary policy shocks when the proportion of middle-aged increases.

Finally, there is the choice based on the fairly popular concept introduced by Milton Friedman in the 1970s, “helicopter money“ (Friedman, 1969), which emphasizes that the central bank should distribute cash to economic actors with the hope that they will spend it, thus boosting inflation. This idea, although it reflects fiscal expansion, does not identify with it, since the financing of the helicopter is carried out by creating new money and not with public spending. It is easy to see that this policy is completely unconventional and, in addition to requiring reforms at a legal level, may create conditions that lead to hyperinflation. Consequently, “money from heaven” is the last solution, while it seems that it can only be applied in conditions of intense deflation—in a period of deep recession. The crisis of Covid-19 creates similar short-term situations.

If we accept and find that monetary policy—initially applied in the transnational (European) field—is effective in the short-term, and ultimately in the medium term, which over time organizes a much longer period of these policies being implemented, it is important to understand that in the end the Greek economy is also affected. The main channels are central bank interest rates and the banking system’s liquidity. Through these channels, the liquidity and financing conditions of the Greek private sector are affected.

The role of the Phillips Curve is important, regarding the limits of monetary policy effectiveness. In the 1960s, low unemployment pushed prices higher. In the 1970s, high oil prices put upward pressure on general price levels. In the 1980s, the deep recession that was followed by rising unemployment, pushed prices down. On the contrary, in the last three decades, inflation (excluding food and energy) has remained low in Western countries, especially in the United States, despite the recovery after 2007–2009.

The reasons attributed to the low inflation are low expectations in combination with persistent slack in labor and product markets, monetary policy which is followed by forward guidance that cultivates quantitative expectations, labor market changes, the weakening power of worker groups, changes in the global economy, global production lines, technological changes (online pricing) that relate to low productivity, and finally shortcomings in measuring inflation.
11.3 Fiscal Policy

With limited opportunities for conventional monetary policy options, central banks and governments may need to turn to alternative approaches to combat slowing global development and tackle economic crises. Governments in advanced economies have limited room for interest rate cuts, but this tool has proved less effective in boosting development in recent years. This increases the need to look at alternatives such as negative interest rates, QE renewal, and fiscal incentives. While negative interest rates have helped reduce borrowing costs in some economies, the impact on banks has been ambiguous. Also, lowering interest rates to negative levels would have significant costs.

In the form that has been applied up until today, QE is likely to be less effective than in the past due to lower returns, narrower risk spreads, and higher asset valuations. Therefore, a deeper recession (like of Covid-19) requires more radical QE (buying corporate bonds, bank loans, and stocks), that present, however, significant disadvantages.

Some central bankers are beginning to recognize the limits of monetary action, and the next step is to consider fiscal action as a more effective alternative solution. Fiscal policy is likely to be particularly effective in a climate of weak development and low growth rates, with major multiplier effects. Advanced economies have more room for fiscal incentives than is often thought and could fund a large public investment program based on excessively cheap long-term debt.

The big central banks actively used both QE and forward looking guidance after the financial crisis. Although these tools have helped alleviate the economic impact of the crisis, their implementation has often been hampered by excessive concerns over their costs and risks and need for improved restructuring and implementation (Bernanke, 2020). Better execution of new policy tools, combined with increased public understanding and acceptance, should make them more effective in the future. New tools, in addition to QE and forward looking guidance, such as financing lending programs, negative policy interest rates and controlling the yield curve, could in some cases also be useful. For now, however, major changes seem premature. A logical intermediate approach may involve trying to increase the anti-cyclicality of fiscal policy, for example, through increased use of automated stabilizers. And of course, expectations should not be set below the inflation target, thus giving room to exercise policy. In a world where low nominal interest rates threaten
the ability of central banks to respond to recession, excessively low inflation can be dangerous. According to the declared inflation targets, central banks will have to defend inflation that is particularly low.

The architecture of the euro area requires the completion of the banking union, the union of capital markets and a central fiscal capacity (Gaspar, 2020). The revision of the ECB’s monetary policy strategy is timely. There is ample room for simplifying Eurozone fiscal rules using a single debt anchor that will be clear, taking into account the approved surplus target and a single operational (nominal) expenditure target. Additional complications associated with policy interest rate constraints, the temporal dimension of population dynamic, and green and digital transformations require:

- better information based on accrual accounting and
- strengthening of the role of an independent national tax advisory system centered on an independent European fiscal council.

The improvement of the fiscal framework concerns:

- the consolidation of preventive and corrective “weapons,”
- the shift to a single fiscal anchor and a single operational goal, and
- some central fiscal capability.

Fiscal space expresses the flexibility of a government to increase government spending and, more generally, to promote its financial well-being (Roy & Heuty, 2009). Heller (2005) defined fiscal space as, “the availability of budgetary room that allows a government to provide resources for a desired purpose without any prejudice to the sustainability of a government’s financial position” (p. 3). However, there are different views on how to measure this as it is difficult to identify the current, future, and potential obligations of a country. An approach to measuring fiscal space can be taken by measuring the loss of access to capital markets or as a benefit of achieving long-term sustainability. Both approaches are interconnected. The difference between the current level of debt and the debt limit at which the government loses market access can be considered to be fiscal space. On the other hand, fiscal space can be defined in terms of long-term fiscal sustainability (Botev, Fournier, & Mourougane, 2016). Figure 11.2 summarizes the approaches to measuring fiscal space.
But why is fiscal space so important? The answer is simple. The higher it is, the less necessary it is for central banks to intervene through unconventional policies to tackle a recession. The ECB’s QE program has helped, following the crisis, to reduce government bond yields and debt service costs. However, the use of fiscal space is the one that will be able to boost weak demand.

Table 11.1 shows the fiscal space of the Greek economy. It is typical that the structural surplus, i.e., the Greek primary surplus and the output gap, is the largest in the EU. But all these was valid before the outbreak of Covid-19.

A central concept of fiscal policy is that of the fiscal multiplier. It is the relationship that connects public spending to gross domestic product (GDP). The size of fiscal multipliers is particularly critical, as the effects on GDP caused by an exogenous change in the budget deficit depend on these multipliers. Therefore, the smaller the multipliers, the lower the cost of the fiscal suspension compared to the output. Thus, there is a large debate about whether the negative short-term effects of fiscal consolidation are more serious than expected because of the underestimation of fiscal multipliers, as was the case after the Great Recession of 2008 (Alesina & Ardagna, 2011).
The QUEST model used by the European Commission (Boussard, de Castro, & Salto, 2012) shows that under normal circumstances the short-term multiplier for the whole of the EU is about 0.4 and can increase to 0.5 through to 0.7, in times of crisis.

The debate concerning fiscal multipliers and their size should focus on the observation that different types of expenditures have different multipliers. What matters is not how multipliers were formed in the past, but the impact of a well-designed expansionary policy today (Stiglitz, 2014). If fiscal easing is the only option, it is important to understand through multipliers which countries can benefit from such a prospect. Countries with the highest multipliers are the ones that stand to benefit from fiscal expansion. Finally, it is of particular importance to note that the coordinated implementation of an expansionary fiscal policy becomes more effective, as many countries expand at the same time. Adversely, when only one economy is pursuing fiscal expansion, then its trading partners are very likely to benefit, and not the country itself.

Eurobank (2012) has estimated the size of the Greek economy’s fiscal multipliers. This study uses two different methodologies to calculate Greece’s multipliers, one of which is the classical estimation method introduced by Blanchard and Perotti (2002). Based on this methodology, Eurobank’s (2012) estimates for public expenditure and revenue multipliers are not far from those previously used by the IMF in its estimates for the Greek economy, i.e., close to 0.5.

Despite this, estimates based on the second methodology, which is applied in times of great economic crisis, show that the multiplier of

| (% of GDP)                      | 2018 | 2019 | 2020 |
|---------------------------------|------|------|------|
| General government balance      | 1.0  | 1.5  | −6.4 |
| Primary balance                 | 4.3  | 4.4  | −3.4 |
| Output gap                      | −6.5 | −4.4 | −13.0|
| Cyclically-adjusted balance     | 4.4  | 3.8  | 0.4  |
| Structural balance              | 5.0  | 2.8  | −0.1 |
| Structural primary balance      | 8.3  | 5.7  | 2.9  |

Source: European Commission (2020) and author’s own calculations

Note: Output gap (in % of potential GDP) and cyclically-adjusted balance as recalculated by European Commission. Structural (primary) balance corresponds to cyclically-adjusted (primary) balance excluding one-off and other temporary measures.
**Table 11.2** Investment, government consumption, and tax multipliers

|                      | 1 year | 2 year | 3 year | 4 year | 5 year | 6 year |
|----------------------|--------|--------|--------|--------|--------|--------|
| Investment multiplier| 0.52   | 1.08   | 1.08   | 0.64   | 0.3    | 0.05   |
| Government consumption multiplier | 0.60   | 1.34   | 1.32   | 0.54   | 0.10   | -0.22  |
| Tax multiplier       | -0.78  | -1.08  | -0.29  | 0.00   | 0.00   | 0.00   |

Source: Oxford Economics (2017) and author’s own calculations

Public spending on wages, pensions, and benefits may be more than 2, while for other (current) expenditures it is calculated at being close to 1.4.

This does not seem to be fully confirmed by The Centre of Planning and Economic Research (KEPE) study (Papaioannou, 2015), which relates to the years 1995–2013 on the effects of government spending on GDP. The magnitude of the output response, after a government spending shock, is highly positive in Cyprus, Greece, and Italy, with the cumulative multiplier being higher than one. In Greece, a positive shock in government spending increases GDP, with the cumulative multiplier reaching 0.33 four quarters after the shock, 0.71 after eight quarters, and 1.08 after twelve quarters. Under conditions of economic crisis in Greece, the impact seems to be marginally lower, increasing by only 0.03 in three years.

Based on the Global Economic Model provided by Oxford Economics, the impact on GDP (multipliers) of three key macroeconomic data in the Greek economy is presented over a period of six year (Table 11.2).

The issue of the size of multipliers, combined with the available size of fiscal space, is very important, as it affects the ability to exercise fiscal policy aimed at the output gap. The issue is of particular value to the Greek economy, due to its size, which has been kept high for many years.

### 11.4 **Structural Policy**

The theoretical framework of supply-side economics argues that, when it is not possible and efficient in the long term to use macroeconomic tools to influence potential output (because there is no available fiscal space and state intervention should be kept to a minimum so as to not have a structural impact on the economy), the path opens for the introduction of structural changes.
Structural changes concern the process of intervening in product and labor markets, in a bid to create incentives that will improve the investment climate and productivity and reduce transaction costs. At the same time, they seek to reduce subsidies and social transfers as long as they claim that they create disincentives for labor and productivity.

Figure 11.3 shows the course of the Greek economy from 2003 until today, in terms of (net) external investment position, showing the consolidation of the country as a debtor country. As can be seen, the course of Portugal is similar. Adversely, Germany is the lender of the European economy, accumulating high surpluses from regional economies.

The implementation of a policy program on the supply-side requires the adoption of a series of structural reforms related to production and consumption, as well as consumer sensitivity to price changes.

Proponents of austerity and supply-side programs believe that troubled economies should be in a position to reliably increase their net external investment position or reduce the ratio of net external investment position to GDP. However, the size and speed of this should be large enough to accelerate the Adjustment Objective (AO). Obviously, achieving this goal depends (a) on the size of private and public debt levels (stocks)

![Graph showing Net External Investment Position (% of GDP)](image.png)

**Fig. 11.3** Net External Investment Position (% of GDP) *(Note: Net positions at the end of period [partner: rest of the world]. Source: Statistical Office of the European Communities [2020a] and author’s own creation)*
and (b) on the net result of the current account (flows) (Roubini, 2011), particularly the net result of current account of international marketable items. So, this last size (flow) should be positive, in order for it to also reduce the stock. If there were flexible exchange rates, an initial devaluation of the real exchange rate would be enough, with the other conditions being stable. If there is no possibility of a change in exchange rate, proponents of austerity policies argue that devaluation should be completed mainly by reducing labor costs (internal devaluation). This is true, if a fixed exchange rate system prevails.

Since 2010, the Greek economy has made very significant effort to address its fiscal problems and low competitiveness through structural reforms, as part of fiscal adjustment programs. During the period from 2011 to 2014, the Greek economy carried out the most structural reforms (Fig. 11.4), in comparison with other countries in the European Union (EU).

In fact, from Fig. 11.5 it is clear that the reform effort remains important and even above the OECD average for the years 2015–2018.

Ceteris paribus the intensity to which the economy should adapt, depends on five basic parameters: (a) the share of tradable goods and

![Fig. 11.4 Structural Reform Implementation Index (2011–2014 average)](Note The Structural Reform Implementation Index is based on a scoring system, according to which a country scores 1 if it has made significant effort to take into account the 2011 and 2013 Going for Growth recommendations and 0 if it has not. Source Organisation for Economic Co-operation and Development [OECD, 2015] and author’s own calculations)
services in production; (b) the share of non-tradable goods in consumption; (c) the elasticity of demand for tradable versus non-tradable goods and services; (d) the share of domestic production in the total of tradable goods and services; and (e) the elasticity of demand for domestically produced tradable goods, versus tradable goods that produced abroad.

Essentially, in the transition period to achieving the adjustment target, the resulting restructuring produces signals (changes in relative prices, disasters in certain sectors and industries) that reactivate entrepreneurship, which will shape the new production model. It is clear that this interval period will not be less than 3–5 years. The reason is very simple: it takes 3–5 years for a new business endeavor to be organized and yield profits. If, during this period, we add one to two years of policy model implementation, we conclude that the period of returns cannot be shorter than two to six years. As long as, of course, there are no external slowing effects. These take various forms that are connected with the acceptance of reform programs by citizens, the rate of required change to institutions, and cultural backgrounds, etc.

Structural adjustment can be achieved through changes in demand between internationally tradable (commercial products) and internationally non-tradable goods (housing, land). For this reason, structural
changes must be made, despite structural rigidities. However, these structural changes require and lead to resource shifts (between marketable and non-marketable sectors), while time is required for them to occur. Hence, this creates, at least temporarily, unemployment and underemployment of capital capacity.

Observed, therefore, in the economy will be (a) reduction of wages, (b) change in relative prices, (c) unemployment and underemployment of capital capacity. The above lead to decrease of demand in the economy and recession.

Thus, the reduction in demand is ultimately an expected result, which accompanies the process of restructuring economies in the short to medium term.

From the analysis of theories by supporters of austerity policies, it becomes clear that the general development of the relationship between NEIP and GDP, with the aim of reducing the size, requires a lot of time. This is mainly because the denominator, GDP, declines, making it very difficult for the NEIP/GDP ratio to stabilize on a downward trend.

Regarding the investigation of changes to real production capacity, it is interesting to consider whether the relative change in prices is effective in the productive restarting of the economy, through the improvement of competitiveness. This analysis is based on the Phillips curve. Shifting the Phillips curve down and to the right is the opposite to what is needed in order to reduce the cost of macroeconomic adjustment. Prices fall sharply, while the unemployment rate rises sharply, instead of falling. Ideally, the target is to move to the left—as has been the case since 2015 (Fig. 11.6)—in order to maintain reduced prices, but also to reduce unemployment.

The policy of internal devaluation in the Greek economy has gone through two phases: A “hard” one, which lasted from 2010 to 2015 and a “milder” one that lasts until today. This is reflected in the movement of the Phillips curve. The first period is characterized by movements along the length of the curve, as the decrease in inflation is associated with rising unemployment. However, in the second period, there is a shift in the curve, as for a given level of inflation the unemployment rate is lower, compared to the period 2010–2017. This is linked to the implementation of structural reforms that have eased the cost of internal devaluation in terms of employment.

In any case, the magnitude of the angle in the Greek Phillips Curve, which is not in line with the international findings (see Sect. 11.2) on
monetary policy, is impressive. According to this, a drop in unemployment rate will lead to a significant increase in inflation! It should be noted, however, that this angle has been created by increasing steps in unemployment (a phase of rising unemployment) and a structural change in the economy. When unemployment begins to fall sharply, the question that arises is whether we will have movements on the same curve so that inflation increases or will it be linked by continuous movements to the left?

### 11.5 Economic Policy in the Eurozone Until Covid-19

Buti (2020), in referring to lessons and policy implications for policymaking in EMU, found that the way the crisis unfolded altered the narrative in its nature. He believes that due to the crisis in the Greek economy, the problem of economies in other countries has been diagnosed insufficiently and/or incorrectly as fiscal. If, for example, the Irish economy had collapsed before the Greek one, crisis management in the Eurozone would probably have been different.

Financial crises, even in small countries, can have powerful implications and potential for spreading. As painfully seen in the case of Greece, a crisis...
in a relatively small corner of the Eurozone could have had devastating effects on a lack of monetary union, without the suitable use of emergency lending and risk-sharing mechanisms.

Financial markets do not put gradual pressure on borrowers. On the contrary, the stance of markets is rapidly changing toward the extremes, and due to this, risk is exacerbated, if there are no measures to share it. At the same time, any fiscal misconduct can be severely punished, in a warning to high-debt countries about the need to reliably maintain debt on a downward trajectory. The required risk sharing in the Eurozone can be achieved directly through the distribution of fiscal risks (through national budgets, a central fiscal capability in the euro area, or a common secure asset) or—in a less transparent way—through the ECB’s balance sheet, a method which is selected.

As monetary policy faces increasing constraints, there is a growing consensus today that a more active role of fiscal policy is needed, especially from countries with fiscal space to do so. It is a fact that, unless countries pursue prudent fiscal policy, the independence of monetary policy can be challenged through pressure to monetize debt. Paradoxically, however, excessive fiscal prudence can also be a form of tax domination: when monetary policy is at the effective lower bound, fiscal inaction hinders Central Bank’s attempts to meet its objectives (Buti, 2020).

With the world economy likely to be in recession in the future and the Eurozone still relying heavily on the ECB’s monetary expansion (QE program), maybe should we turn to the opposite side of macroeconomic stabilization policy and fiscal policy in particular? At the same time, should member states, in this case, adopt structural policies to maintain supply opportunities? To what extent, however, a policy change is possible given the multifaceted structure of the Eurozone’s economic policy framework?

In general, the reality of the Eurozone’s economic policy framework seems to be a double-edged sword. On the one hand, interest rates tend to fluctuate negatively and the volume of bonds accumulated by the ECB on its balance sheet (2.6 trillion euros or 22% of Eurozone GDP) puts restrictions on further expansion of its asset purchase programs (APP). On the other hand, the fiscal finances of Eurozone countries, on average, are quite consolidated (government deficits below 1% of GDP in 2018, with a simultaneous reduction in gross debt since 2014) and ready to play a more vital role in the next recession, as it does happen during Covid-19, given the adequacy of the fiscal space. Furthermore, the low interest rates fluctuations in the near future are likely to be presented as
the driving force behind the activation of fiscal policy, as they leave room for further debt accumulation, easing the Eurozone’s fiscal constraints. Thus, forward looking has been materialized during the Covid-19 crisis of early 2020.

However, the Eurozone displays relative heterogeneity among its member states, while the absence of a common fiscal policy vehicle across the geographical area it covers leaves the Eurozone economy exposed to future adverse developments. The situation we have described often creates conflicts of interest between member states over the course of economic policy to be commonly adopted, as heterogeneity in the structure of member economies implies differentiated business cycle models and, therefore, separate and specialized (per country) economic policy needs.

In particular, the preparation should focus, in addition to the current monetary policy, on triggering fiscal policy, with the ECB playing a critical role in encouraging member states to pursue more intensive fiscal policy. Additionally, it should be noted here that fiscal policy is also characterized by internal time lag, as it takes time before it is drawn up as a plan and voted on by parliaments of member states.

Despite the fact that there should be an emphasis placed on fiscal policy, the way it is implemented is quite complex, due to the Eurozone’s existing institutional constraints, while procedures for amending statute and governance contain political elements, making the transformation rather impossible in the short-term.

The establishment of an economic policy program with anti-cyclical fiscal aspects and structural policies is not new to the European Commission, given that in 2014 the Junker Package was set up, using public sector guarantees from the European Commission and the European Investment Bank. However, any plan attempts to rely financially on the European budget and the European Commission is rather doomed to suffer due to political nervousness felt across the Eurozone. Beyond this, because there is existential no risk of the Eurozone system collapsing economically, the euro area appears to be threatened by the possibility of being trapped for a prolonged period in a climate of persistent deflation, insufficient domestic demand, and weak, if not zero, growth as part of uncertainty in international trade that affects foreign demand.

Factors that are mainly short-term and have a demand side character at a pan-European level include four key elements: the global slowdown, the complexity of the US economy, technological changes in Asia, and
the slowing of emerging economies. For the Greek economy we should
add the output gap, which it inherited from the ten-year great recession
following the 2008 global financial crisis.

Factors that are mainly short-term, but also have mainly supply-side
characteristics, at a pan-European level, include the steady increase in
trade restrictions and regulations changes in industrial products, such
as cars. For the Greek economy, the regulatory backwardness in many
sectors of the economy could be noted.

Factors that are mainly long term, but are classified as having demand
side characteristics, include mainly two elements: the structural change in
China, with the main feature being the slowdown in growth rate, and the
rearrangement of supply changes around the world.

Finally, among the factors that have a medium term and mainly supply-
side nature is ageing and the slowing down of Total Factor Productivity
(TFP) that is associated with the slowdown in technology being intro-
duced into the production process. On the Greek side, there are certain
forces that maintain a high level of systemic risk, and finally, the long-term
effect of certain behaviors (e.g., liquidity preference, high risk avoidance).

Of course, in the European and Greek economies, as in any economy,
no issue is necessarily a demand side or supply-side problem alone. At
the same time, none of the problems are easily classified as short-term or
long term. Also, each of the issues concerning the European economy, to
a different degree, are also of concern to the Greek economy, while the
opposite is not the case.

Therefore, the policies that need to be developed to address the
problems must belong to broad and complex portfolios of economic poli-
cies with a horizontal and long-term nature of implementation, such as
demand and supply characteristics.

11.6 The Reflection of Covid-19
on Economic Theory and Policy

Covid-19 is creating new data on the macroeconomic figures of states.
Fiscal deficits in developed economies are expected to reach historic highs
in 2020, due to the need to support supply (business and employment)
and demand (consumption) in economies, but also due to the expected
reduction in tax revenues, which in fact can be extended to a period
beyond 2020, in a scenario in which economic actors have formed nega-
tive expectations. At the same time, the country’s debt-to-GDP ratio (and
debt levels) will rise globally and, despite cheap borrowing, many vulnerable economies will be exposed to the prospect of fiscal constraint as of 2021 onwards.

As the economic impact of the pandemic increases, more emphasis is being placed on policies that address the immediate economic impact, at the cost of long-term estimates, such as government debt and fiscal deficits.

The Covid-19 pandemic crisis, however, has prompted governments to apply monetary and fiscal policies supporting and maintaining economic activity in order to prevent distortions in economies that could outweigh the effects of the virus itself.

In this context, policy-makers have taken steps on conventional economic policy standards, reactivating policies from the previous decade. Central banks are participating by continuing to use monetary instruments and interventions in financial markets, such as forward guidance, QE and low interest rate policies, and measures to boost liquidity in economies. At the same time, national governments have strengthened the role of fiscal policy through targeted tax measures and increased spending.

In the EU, however, the Covid-19 crisis has also highlighted positions, along with the leadership of regional member states, supporting the issue of a common European bond (Baldwin & di Mauro, 2020) guaranteed by the Community budget (corona bond) to finance support measures provided to states. This idea of debt mutualization is not new but has returned to the forefront in the midst of the Covid-19 pandemic, on the grounds that the health and consequent economic crisis from the lockdowns has been a symmetrical and exogenous threat to the economies of member states, the treatment of which now requires a type of joint fiscal policy at a European level.

The mutualization of debt at an EU level is capable of resulting in a low interest rate (without posing a risk to debt dynamics) needed to allow member states (particularly those with a high debt-to-GDP ratio) to secure their public finances at a healthy level, paving the way for a return to economic growth. At the same time, sharing the risk within the union—transferring it from high-debt to low-debt states—entails the moral risk of transforming individual into collective responsibility of member states in regards to their fiscal targets (free ride), making the acceptance of the corona bond politically impossible.
Extraordinary circumstances, however, demand extraordinary measures. The aftermath of the epidemiological crisis has challenged many stereotypes of economic thought, broadening consequential policy proposals. Special circumstances concerning Covid-19 come to reinforce views on non-conventional economic policy that had drawn interest in public debate in recent years.

Such is the case, for example, with Modern Money Theory (MMT) (Mankiw, 2020), which is a new approach to macroeconomics. In MMT (Wray, 2015) the public sector’s critical role of determining economic stability and growth is decided by the sovereignty of states over national currency, balance between an economy’s institutional sectors, and the achievement of full employment, which is the ultimate goal of economic policy.

The main points of the theory are the principles in which the budget deficit can be financed by the central bank, state expenditures do not burden the trade balance and the tax revenues do not affect the resources of the general government. This is because the amount of money is determined by the financial securities issued by the public sector, while inflation is a complex phenomenon that is primarily influenced by the institutional characteristics of an economy.

Money here consists of a legal relationship between citizens and the state, which operates via taxation—while losing control of the currency is the biggest obstacle to the smooth running of an economy (Wray, 2015). Thus, according to MMT, monetary unions and independent central banks contribute to the instability of the economy, preventing growth.

The alternatives for central banks proposed in public discourse for dealing with the financial implications of Covid-19 touch on the logic of a broader unified government and a single state balance sheet. Until the 2008 financial crisis, the distinction between monetary and fiscal policy and the independence of central banks was, in economic thought, an inviolable condition in exercising economic policy. However, in the midst of adverse economic conditions, finance ministries may have the appropriate policy tools without the necessary resources, which are held by central banks with a limited ability to make use of (Caballero, 2010).

So, according to MMT, the fact that there is no time limit on state budgets, the issuance of money and its direct, non-binding transfer to citizens’ accounts is deemed to be a viable (and not just extraordinary) solution. This is “helicopter money”² and is a radical idea that has come to the fore academically over the last two decades³ and, more recently,
as an extraordinary policy proposal in the midst of the Covid-19 crisis (Gali, 2020; Sandbu, 2020; Yashiv, 2020). It is a fact that some governments (e.g., Japan, Singapore, and the United Kingdom), in order to deal with the epidemiological crisis, made direct transfers of state money. These, however, are not necessarily forms of “helicopter drops.” For this to happen (Gali, 2020) there needs to be a fiscal transfer of money which, however, will weigh on the central bank’s balance sheet without increasing public or private debt. So under certain extreme conditions, where traditional monetary policy has exhausted its scope for stimulating the economy (Caballero, 2010; Perrotti, 2014; Selgin, 2016; Turner, 2015) and while there is a reluctance or inability to support fiscal policies by increasing public debt, such a practice may be considered to be the best available alternative solution (Bernanke, 2016).

An equivalent economic policy tool emerging from the Covid-19 crisis is (Baldwin & di Mauro, 2020) the financing of government operations through debt monetization. The dominant position over time is that the purchase of government securities amounts to a risk for central banks because it can create the perception (Mishkin, 2011) that the central bank is willing to support “irresponsible” fiscal policies with debt monetization.

Large-scale government bond purchases have become part of the central banks’ toolkit, including, in the context of “do whatever it takes” to support the economy amid the pandemic crisis, and now form direct funding (Financial Times, 2020) of government spending (direct debt monetization). Thus, concerns do not stem from this practice itself, as it may not necessarily be harmful to economies, but from its excessive use or exploitation for the wrong reasons (Blanchard & Pisani-Ferry, 2020).

The Covid-19 pandemic crisis has sharply increased the liquidity needs of states. The implementation of the support to mitigate unemployment risks in an emergency (SURE) program by Commission to support employment, the new pandemic credit line from the European Stability Mechanism (ESM), and the pandemic emergency purchase program (PEPP) by the ECB providing credit to member states contributed to meeting these needs. But the bottom line is that all of this increases the debt of excessively indebted countries.

Thus, it is now considered that the provision of necessary liquidity flows to EU countries (Vihriälä, 2020) must be combined with a drastic relief from the ECB on debt levels of countries to meet the extraordinary fiscal needs, even if this raises expectations for a repeat of this (moral hazard) as a solution of last resort. This is because the given collapse in
growth rate EU countries are projected to see in 2020, in combination with the increased uncertainty in markets and a refusal to share the burden (reduce the risk of borrowing) between member states, is sufficient in the medium to long term to threaten the sustainability of debt among fiscally vulnerable countries, some of which suffered a double disaster, in the economy and in health.

Additionally, this prospect raises concerns that Covid-19 will trigger the development of a Minsky Moment. According to Minsky (1981, 1983), the financial system is inherently unstable (Financial Instability Hypothesis), as periods of economic stability and prosperity cultivate conditions of economic instability on their own. This “paradox of stability” is due to the risky and speculative behavior of financially active people during periods of extended expansion (looser criteria for lending terms, low preference for liquidity among household and business, and high debt that boosts the price of real estate and securities). The Minsky Moment sets the peak where speculative activity reaches a point that is no longer sustainable, leading to rapid price deflation and an unhindered market collapse. Without the intervention of the state, the crisis in the financial system has a devastating effect on the real economy.

It is a fact that in most economies worldwide, public debt (as a percentage of GDP) was at high historical levels (Badia & Dudine, 2019) before the outbreak of the pandemic, while in advanced economies corporate debt gradually increased from 2010 to 2019 (Badia & Dudine, 2019) reaching 2008 levels—its maximum level.

Although the Covid-19 crisis did not start as a financial crisis, it could turn into one, acting as an accelerator of the underlying trend of rising asset prices, leverage, and debt (Lance, 2020). This could arise due to delays in the recovery of economic activity, as high debt levels make borrowers vulnerable to shocks that disrupt revenues and inflows of financing. As a result, banks are increasing lending criteria, while higher risk premiums are being added to government bonds, creating self-fulfilling negative expectations.

Covid-19’s exogenous supply shock, which also evolved rapidly and into demand shock, can therefore be internalized by causing a financial collapse to the extent that many individuals (businesses and households) and public borrowers (governments) around the world are unable to repay debts due to the imminent global recession.

In general, in the new era after the outbreak of the second global crisis of the twenty-first century (Covid-19), the challenge of economic policy is
twofold: aiming to support economies in the short-term, but also prevent permanent effects that the crisis may have. This necessity, therefore, has formed a broad consensus on overcoming the established rules of monetary and fiscal policy, with the implementation of innovative and distinct measures of economic policy, thus expanding the scope of the former and giving again a decisively active role in the latter decades later.

Notes

1. It was originally proposed by the Commission in 2011 (Eurobond) to address the European crisis of the three years 2009–2012.

2. The current use of the term differs as a concept from Friedman’s (1969) imaginative parable of a helicopter from which money falls and is distributed to citizens. The aim was to describe the mechanism of quantitative theory, namely, that any increase in money supply automatically leads to a proportional increase in prices without any change in the product produced and that central banks can always avoid deflation by printing and putting money into circulation.

3. More specifically, it began to be seen as a serious policy proposal in the late 1990s, in the light of the fact that it could be a useful means of combating deflation in Japan.

4. Through the conversion of a part of the debt (debt conversion) into perpetuity with zero coupon.

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