FAIR

MACROECONOMIC
Analysis & Policy Studies

Euro area and Covid -19: From MMT Perspective

Student Research Internship Report

Mansi Gupta

August 2021

Euro Area and Covid -19: From MMT Perspective

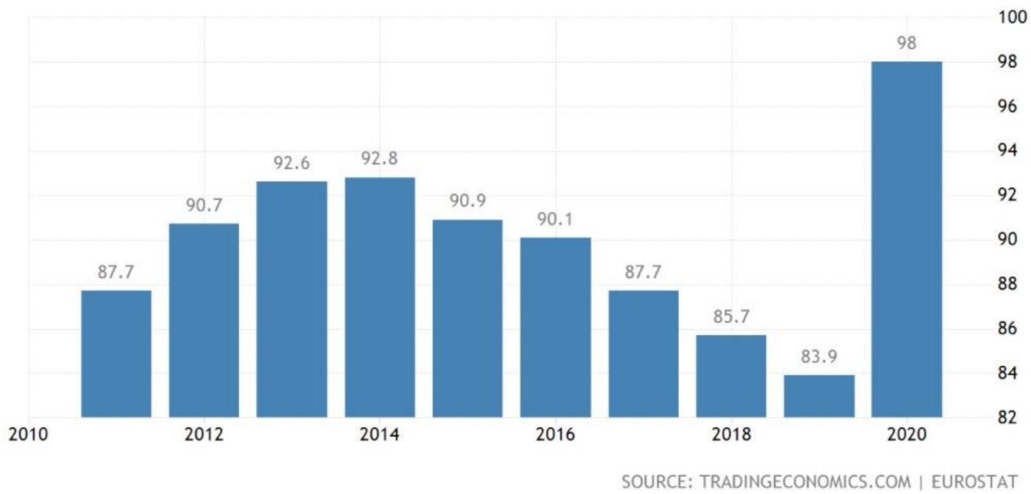
Mansi Gupta

The outbreak of covid-19 has brought many countries economy stand still or even pushed back many years back. Every country is looking for the best major policies to cope with the economic slowdown and how to revive the economy from the covid-19.

Stephanie Kelton is arguably the face of the Modern Monetary Theory. The challenge of Modern Monetary theory has grown recently towards the main stream economist. As there are almost every country who is facing millions or trillions of fiscal debts. The world has never been more indebted than now after the battling of covid-19. The global debt by the end of the 2020 was $281 trillion or we can say more than 355% of global GDP according to the Institute of International Finance. One of the major countries who has highest fiscal debt is Euro area.

Impact on Euro area:

Euro area is the monetary union of 19 countries and had adopted the single currency euro. The fiscal expansion to strengthen the ongoing economic recovery the euro area has reached the highest fiscal debt after so many years. The Government has taken the budgetary and the liquidity measures which leads to the increase in budget deficits hastily. The measures were taken predominantly focused on supporting firms and employment leading the fiscal deficits and the contraction in GDP led to an increase in the euro area debt ratio from 85.9% of GDP in 2019 to a projected 101.7% of GDP in 2020 in the first phase of Covid-19. The government debt to the GDP has also increases from 83.9% to 98.0%.



Euro Area Government Debt to GDP

Source: Trading Economics

1 Mansi Gupta (Master's in Economics) Indian Institute of Foreign Trade, Delhi.
This article is my submission as part of my internship at the Foundation to Aid Industrial Recovery (FAIR), Macroeconomic Analysis & Policy Studies (MAPS).
I, Mansi Gupta, declare that this is my own work and has not been plagiarized.

The debt to GDP ratio is increasing because the government debt is increasing and the GDP is decreasing. Now, the European countries are incurring trillions of debt, In France alone the national debt is expected to soon exceed 120 percent of the economy. The debt is growing so fast that it is outpacing the size of national economies. The governments of Euro area are borrowing heavily resulting into the piles of bonds to finance the economy.

Modern Monetary Theory Perspective:

From Modern Monetary theory perspective, the bond is just a governmental debt which it owes to itself, so from MMT perspective the bond could be deleted from the central bank balance sheet by offsetting the book entries in the accounts of the government and the European central bank. In spending the cash to implement its deficit, the government shifts the economy to full-employment and can recover their economy speedily without having trillions of debts. According to the mainstream economist the budget deficits are sustainable as long as the borrowing costs of the government are lower than nominal economic growth however, Kelton does not completely dismiss this concern, but points out that a government with monetary sovereignty has total control over the domestic rate of interest. The central bank can provide the monetary support to make any level of government borrowing sustainable, at least till inflation begins to accelerate. Euro area does not have the freedom of monetary sovereignty as the only the European Central Bank with the national central banks together in the European System of Central Banks (ESCB) can create Euros meaning state members of euro area does not have the freedom to print their own currency.

The other major proponent of modern monetary theory was that the government does not faces financial constraint but faces only real constraint. However, euro area does faces financial constraint, it is the lack of fiscal authority on the Euro area level combined with the financial constraints individual member states face that is the major cause for the permanent lack in aggregated demand. After spending so much which results in higher debt there is still lack of aggregate demand which result in slower growth of an economy. After spending so much to revive the economy the GDP is now forecast to grow by 4.8% in 2021 and 4.5% in 2022 in the euro area. The improving health situation and ensuing continued easing of virus containment measures are putting the EU economies back in motion.

Conclusion:

The Modern Monetary theory states that government should run deficits to maintain full employment and fund them by money-printing. In spending the cash to implement its deficit the government can shifts the economy to the full employment level. As the economy has used the spare capacity, the deficit expenditure puts no pressure on productive capacity hence, the inflation does not increase. Resulting in the increased GDP without having debt or rising interest rate. Currently, as euro area is still spending large amount this can threaten the economy to turn into the double recission. If the debt piles up year after year the government will have harder time stimulating their economy when the next recession rolls around. Using MMT, a reform of Euro area can be implemented that would stop the rising debts. As long as the inflation is not rising the government can print their fiat currency to revive their economy.

References:

1)Euro Stat, Available at
https://ec.europa.eu/eurostat/documents/2995521/11563051/2-23042021-AP-EN.pdf/a794c696-ae8b-db1e-ba8b-76529919a843

2)Europe's Pandemic debt, Available at
https://www.nytimes.com/2021/02/17/business/europe-pandemic-debt.html

3) World's $281 Trillion Debt Pile Is Set to Rise Again in 2021, Available at
https://www.bloomberg.com/news/articles/2021-02-17/global-debt-hits-all-time-high-as-pandemic-boosts-spending-need

4) Euro Area Government Debt to GDP, Available at
https://tradingeconomics.com/euro-area/government-debt-to-gdp

5) Euro area debt surges in 2020 on pandemic spending, Available at
https://www.reuters.com/article/euroarea-debt-idUSL8N2MF2ZC

6) The COVID-19 crisis and its implications for fiscal policies, Available at
https://www.ecb.europa.eu/pub/economic-bulletin/focus/2020/html/ecb.ebbox202004_07~145cc90654.en.html

7) Modern Monetary Theory Review, Available at
https://www.vox.com/future-perfect/2019/4/16/18251646/modern-monetary-theory-new-moment-explained