Fiscal Policy and Secular Stagnation: Lessons for EMU Governance

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Outline

The Pre-crisis Consensus in Macroeconomics

- New Keynesian model: supply-side driven growth and business cycles, *cum* price rigidities
- Structural reforms to boost competitiveness and exports
- No role for macroeconomic policy. **Rules** anchor expectations predictability, and are the preferred policy tool
- **Monetary policy to be preferred** because it is not subject to biases and lags

The Crisis

- The crisis has shaken the Consensus
  - A balance sheet recession: Aggregate demand is paramount
  - The ZLB and the size of the downturn required the return of discretionary policies
  - The liquidity trap called for fiscal policy to sustain aggregate demand
- Many tenets of the Consensus are being reconsidered (capital mobility, income distribution, fiscal policy effectiveness/size of multipliers, sequencing of reforms)

The Surrender of Monetary Policy

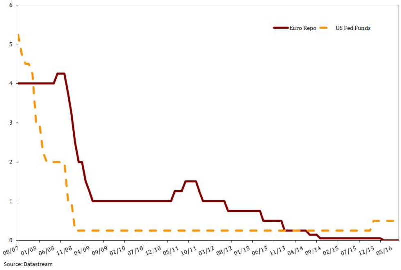
Last week's Jackson Hole Symposium is a cry for help:

- Monetary policy is failing to bring the economy out of deflation
  - Confidence does not return
  - Credit demand, not supply, is the problem: *liquidity trap*
- Central banks are running out of weapons (Larry does not seem to agree!)
- What if a new crisis hit now?
- Is the current situation a "new normal"? (Larry seems to agree!)
- (Underneath the surface): How to heal the sick man of the world economy, the EMU?

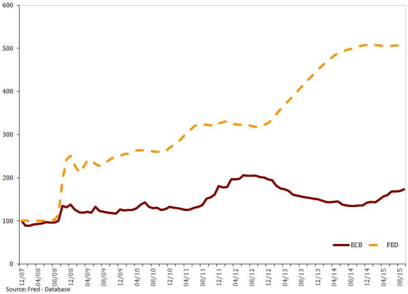
The EMU Response to the Crisis

- The initial response to the crisis in the EMU was more timid, but substantially similar than in the rest of the world
- Greece triggered a change of narrative. From private to public debt crisis. **Austerity** was the answer
- The reversal of fiscal stance is not specific to Europe (the sequester soap opera), but it was much more marked in the EMU
- The EMU had the privilege of a double dip recession
- Faced with a stagnant economy (monetary) policy authorities changed stance in 2014. **Too little and too late**

Too Little and too Late: Monetary Policy



Central Bank Interest Rates
2007-2016



Central Bank Total Assets
December 2007=100

Too Little and too Late: Fiscal Policy

- Flagship program: **The Juncker Plan**, implemented through the newly established (2015) European Fund for Strategic Investment (EFSI)
- Public-private partnership financing scheme (working through risk sharing)
- Objective: trigger 315bn of new investment in Europe over 3 years
- Fields:
  - infrastructures
  - R&D
  - environmental projects
  - support to SMEs (through partnerships with intermediary banks)

Too Little and too Late: Fiscal Policy

Le Moigne Saraceno and Villemot (2016)

- DSGE model of the Euro area in a ZLB. Assessment of the Juncker Plan in comparison with Obama's ARRA (2009)
  - Even under very favorable hypothesis on leverage and time-to-build, the impact of Juncker plan is moderate
  - Had it been implemented earlier, could have been effective against ZLB ("certainly too late")
  - Had it been bigger (size of the Obama Plan), it would have been effective against ZLB even today ("probably too little")

The Long Term: Chasing the US

- Poor EMU performance is not recent
- Since 1999, the EMU lagged behind the US in terms of output and employment.

Yearly Changes: US vs EMU

		1999-2015	1999-2007	2008-2015
CPI	*USA*	2.4%	2.8%	1.5%
	EMU	1.9%	2.2%	1.3%
GDP	*USA*	2.3%	2.9%	1.4%
	EMU	1.3%	2.2%	0.1%
UNEMP	*USA*	6.1%	5.0%	7.6%
	EMU	9.5%	8.6%	10.4%

Source: European Commission - Fred

EMU Performance: Chasing the US

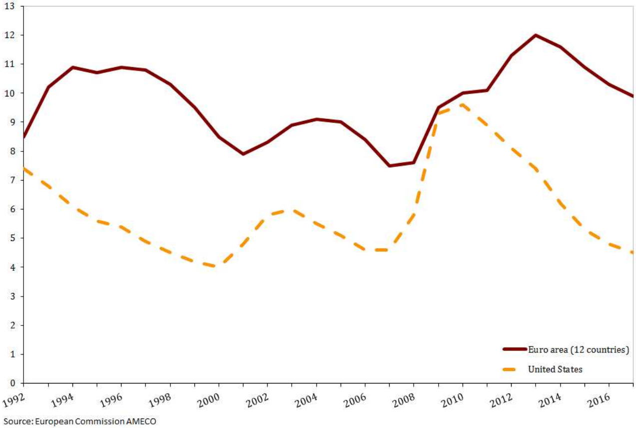


Figure: Unemployment Rates - 1992-2015

EMU Performance: Chasing the US

- The US outperformed the EMU since the 1990s
- The US model has problems (instability, inequality, etc), but from a macroeconomic viewpoint it shows strong resilience
- The Consensus highlights US market flexibility as an explanation
- But we learned that (labour) market flexibility is a less powerful driver of growth and employment than previously believed
- Another difference is too often neglected: ***Policy Inertia***

EMU vs USA: A Tale of Policy Inertia

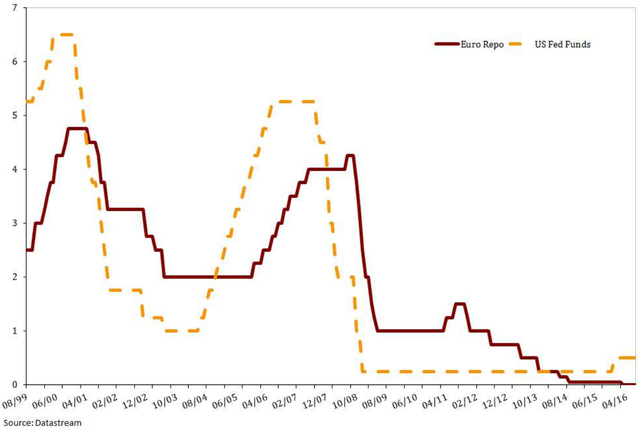


Figure: Short Term Interest Rates - 1999-2015

Fiscal Policy was also Inertial

Fiscal Impulse: Descriptive Statistics 1999-2010

	GER	*ITA*	*ESP*	*FRA*	*EU4**	*UK*	*USA*	*JAP*
Mean	-0.15	0.04	-0.30	0.23	-0.03	0.51	0.44	-0.73
s.e.	1.80	1.20	0.65	0.58	0.90	2.69	1.28	1.86
Max	4.39	2.72	1.03	1.23	2.27	5.25	2.88	1.51
Min	-2.08	-1.29	-1.09	-0.43	-0.70	-4.76	-0.92	-3.64

*Source: Datastream - *EU4 (Ger, Fra, Ita, Spa) is weighed with GDP*

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The Reasons for Policy Inertia

- The Maastricht Treaty and subsequent EU legislation embed the Consensus
  - Fiscal policy is constrained by the Stability Pact (now Fiscal Compact) $\Rightarrow$ Automatic stabilizers
  - Monetary Policy is limited to price stabilization (strict inflation targeting for the ECB)
- Notice that The ECB statute, and the fiscal rules, have constitutional strength, as they are enshrined in the Treaties.

Policy Inertia and EMU Governance

To sum up:

- EMU policy stance diverged from ROW in 2010
  - Austerity led to pro-cyclical national fiscal policies
  - Double dip recession
  - ECB walked the Fed path, but too little and too late
  - National fiscal policy is still unused ("flexibility"?), and the Juncker Plan (public-private) is too little and too late
- The policy inertia dates back from way earlier, and may help explain the difference in performance
- EMU institutions (fiscal rule plus ECB statute) help explain policy inertia
- Therefore, EMU institutions need to be changed especially if we head into **secular stagnation**

Secular Stagnation

Gordon (2016): Six headwinds keeping potential growth low:

1. Demographic dividend in reverse motion, that imposes a burden on public finances
2. Rising inequality that reduces human capital accumulation
3. Combined effect of globalization and the IT revolution $\Rightarrow$ more competition in labour markets, lower wages and productivity
4. Increasing cost of global warming, that also imposes a burden on public finances
5. High debt burden (public and private), bequeathed by the crisis
6. Deterioration of educational attainment (US in particular)

Secular Stagnation

Larry Summers' IMF Speech (2013). Emphasis on aggregate demand

- Savings schedule shifted to the right (inequality, debt hangover, accumulation of reserves)
- Investment schedule shifted to the left (slowdown in productivity, debt hangover)
- Low (negative?) natural interest rate
- Semi-permanent excess savings: $S > I \Rightarrow AD < AS$
- This leads to the Scylla and Charybdis of policy makers:
  - Stagnating growth
  - Sequence of bubbles to artificially lift AD

Secular Stagnation: Implications for Policy

- Blanchard's Rethinking Macro (2016)
  - Monetary policy has a harder job (higher inflation target? Permanent unconventional monetary policy? Nominal GDP targeting?)
  - Fiscal policy is, or should be, back in the policy makers' toolbox
- Blanchard fails to (explicitly) draw the conclusion: Semi-permanent excess savings $S > I$ requires semi-permanent filling of the gap:
  - The German way: Semi-permanent $CA > O$ (Aliens to the rescue?)
  - Semi-permanent **government negative savings**: $G > T$

Adapting EMU Institutions

How to obtain $G > T$? Going from less to more realistic:

- Restore complete national budget sovereignty (scrap the SGP): This would mean relying on market discipline alone for maintaining fiscal responsibility.
- Create a federal expenditure capacity (EMU finance minister, Eurobonds, etc). This would imply risk sharing that is unacceptable to some countries
- Implement at the EU level a **Golden Rule** similar to the UK in the 199Os: Balance the *current* budget over the business cycle
  - $Debt/GDP \rightarrow K_g/GDP$
  - Intergenerationally fair
  - The burden of fiscal consolidation falls on current expenditure

The Golden Rule

- The Golden Rule is not a new proposal
- In the past it was rejected for a number of reasons:
  - It introduces a bias on physical capital
  - Public investment is a slippery concept (risk of creative accounting)
  - Treaty changes seem politically as unviable as a pan-European investment plan
- These weaknesses can nevertheless be turned into strengths

The Golden Rule

Dervis and Saraceno, *Brookings blog*, September 2014

- The Golden Rule as an instrument for Industrial policy
- Periodic democratic assessment about the needs in capital (physical, human, immaterial) for example after EU elections
- Council, Commission and Parliament jointly decide what items of public expenditure are EU priorities, and can therefore be excluded from deficit figures
- Countries implementing joint projects could be given incentives (EIB loans?)

Financing Semi-permanent deficits

Broadly speaking, financing of deficit will not be a problem as long as excess savings exists. It is only a matter of channelling savings into government bonds without creating instability

- "Restricted" special public investment bonds (Koo, 2011; Fazi and Iodice, 2016)
- Scrap the no-bailout clause (allow debt monetization)
- Finance pan-European projects through EIB bond issuance financed within QE
- "Long Term" (perpetual?) green/infrastructure bonds (Sachs, 2014; Flaherty et al, 2016)
- Accepting these bonds as collateral, central banks would ensure that they become desirable even when market return is substantially lower than social return

Thank You!

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