The Crises, Rethinking Macroeconomics, and EU Reform

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Outline

- Introduction. The Reformist Loneliness
- Market adjustment and the Euro
  - European Institutions leave little space to government action
    - Fiscal and Monetary governance, competition policy
    - Structural reforms
  - Does it come from Optimal Currency Areas theory?
  - The theoretical roots of the single currency
- 1990s-2015: The Euro and the New Consensus
  - Growth and imbalances
  - The Greek tragedy: Austerity and Super Mario Draghi
- The Covid crisis: an Hamiltonian moment?
- EMU Reform: a Test for the new world?

Scope of the Talk

- The debate on the euro has been monopolized by Eurosceptics and Euro fanatics
- These two opposite political platforms stem from a common premise: *the Euro is intrinsically neoliberal*. Then:
  - The eurosceptics call for a return to the sovereign state
  - The partisans of the Status Quo call for doubling on reform effort
- This common premise is a victory for euroscepticism: crises and divergence point to the failure of the euro: if it is either this or nothing, well then… Better nothing!
- Challenging this premise is therefore the most important task of those who believe in the European project

Market adjustments and the euro

- Is the euro "neoliberal"? Well, yes
  - Emphasis on markets as main drivers of growth and convergence
  - European institutions (and have left little space to government action
    - The Maastricht criteria are all nominal (real growth is the job of markets)
    - Stability and Growth Pact limits fiscal policy to automatic stabilization
    - The ECB mandate, contrary e.g. to the Fed, is limited to the inflation objective
    - Strong emphasis on competition (let markets work!) and refusal of industrial policies
  - Reforms are the ~~main~~ only path to growth

- But, does it need to be? Hell no!

Neoliberal Euro? A Reminder on Optimal Currency Areas

- The theory dates back to Mundell (1961). When is it optimal to abandon sovereign currency and join a monetary union?
- The main cost is the loss of monetary policy as a tool to absorb asymetric shocks. This is not a problem if:
  - Markets are flexible and adjust (mobility, wages, capital movements, credit markets; in short: any market risk sharing) *or*
  - Government risk sharing (transfers through government budget)
- The choice was made in the 1990s to rely on markets to absorb asymmetric shocks. *But nothing in the theory made this inevitable*
- The choice is due to the intellectual environment (the “mainstream”) that underpinned the construction of the Euro

The Theoretical Roots of the Single Currency

- In the 1980s, after the clashes between Keynesian and Neoclassical economists, the profession settled on a “New Consensus”:
- The New Consensus is basically the old neoclassical school revised
  - Short run fluctuations have little, if any, influence on long run growth
  - Structural reforms are the only tool capable of shifting the natural equilibrium through supply side improvements
  - Discretionary policy is ineffective. Rules are more efficient as they help agents form expectations (automatic stabilizers, Taylor Rule)
  - The preferred tool for policy makers should be monetary policy: Fiscal policy is subject to biases and lags
  - Monetary policy stabilizes output through stable inflation rates (expectations anchoring)
- This is what the drafters of the Maastricht Treaty had in the back of their minds

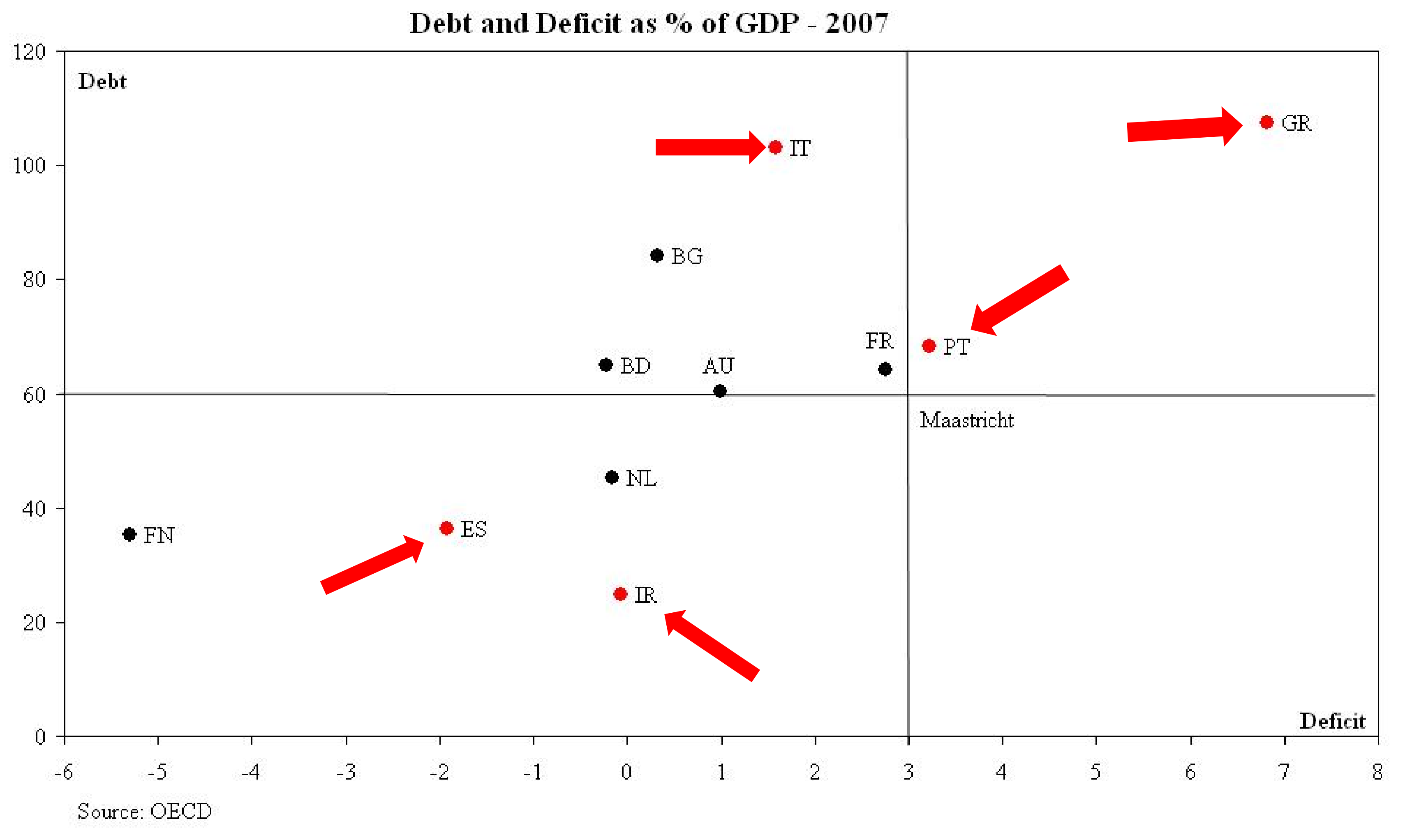
1990s-2015: The Euro and the New Consensus

- 1999-2008 Great convergence
  - Peripheral countries grow faster
  - Their growth and investment is financed by savings by core countries
  - Current account imbalances appear. Excess demand in periphery compensates for excess supply in the core
  - ~~Benign external debt: future growth will allow to repay it~~
- Well, think again!
  - The capital flows are much larger than excess savings
  - They do not finance productive investment but (worldwide) investment in nonproduced assets (housing), and consumption
  - Debt increases but not assets → financial fragility
  - The crisis exposes the "delusion" of markets and policy makers
    - Sudden stop: reversal of capital flows
    - Increase of interest rates in the periphery

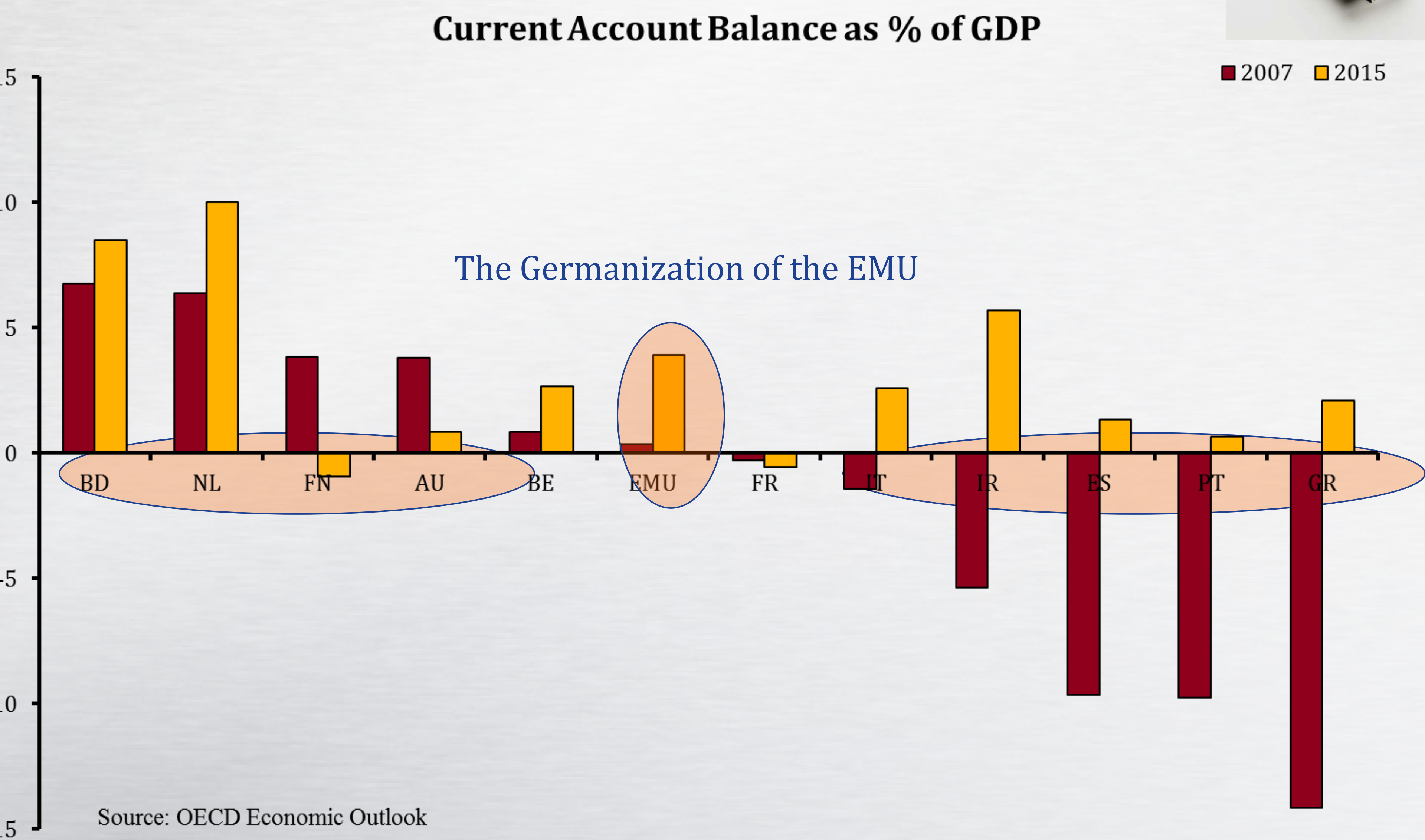
The Austerity Tragedy

- The global financial (GFC) crisis of 2008
  - Excessive private debt (inequality, bubbles, financial deregulation)
  - Housing market crisis (in the US but also in some EU countries)
  - "Deleveraging": the private sector stops spending to reduce debt
  - → Aggregate demand crisis
- The policy reaction is "textbook", and effective!
  - Monetary policy to avoid collapse of the financial market
  - Fiscal policy to restart demand and stop the recession
- 2009-10. The crisis goes to Europe
  - Greek elections (October 2009): frauds in debt and deficit statistics
  - Attention shifts to public debt: *Government is the problem!*
- → Berlin View: Structural adjustment programs in peripheral countries

But is public debt the problem?



The problem is imbalances



The Austerity Season and SuperMario

- Synchronization: Austerity imposed to peripheral countries is followed by core countries too
- →Procyclical fiscal policies. Demand deficiency → Second EMU recession (2013)
- ECB Intervention
  - "Whatever it takes" (2012) to stop speculation
  - Quantitative Easing in 2015
- But monetary policy cannot replace fiscal policy
  - Zero Lower Bound
  - (in EMU): country specific fiscal policy needs (coordination instead of synchronization)

Meanwhile, elsewhere…

- Rethinking macroeconomics
  - After the financial crisis loss of confidence on market optimality (or capacity to converge to the natural equilibrium)
  - New work on
    - Fiscal policy and public investment
    - Monetary/Fiscal policy mix
    - Reassessment of discretionary policies vis à vis rules
    - Timing and type of structural reforms
    - Link between cycle and growth

- In a sentence: the cursor between market and government stabilizations is moving back to the center

Summary: A good crisis wasted

- The Eurozone crisis has been interpreted as a story of fiscal profligacy
- Austerity imposed to peripheral countries was followed by core countries as well
  →Procyclical fiscal policies and demand deficiency
- → Second EMU recession (2013) after the global recession of 2009. The euro survives only thanks to ECB Intervention: SuperMario to the rescue
  - “Whatever it takes” (2012) to stop speculation
  - Quantitative Easing in 2015
- Institutional Reform (2011-2013)
  - Fiscal Compact – Six/Two Pack - Banking Union - ESM
  - In a few sentences: Accent mostly on strengthening compliance to stricter rules (Berlin View /New Consensus)
    - Coordination/control is now continuous and ex ante (EU semester)
    - Refusal to collectively manage country shocks
- *Overall, Europe was impervious to the “rethinking macroeconomics” debate*

L'Europe se fera dans les crises et elle sera la somme des solutions apportées à ces crises.

[Europe will be forged in crises, and will be the sum of the solutions adopted for those crises.]

Monnet, J. (1976) Mémoires (Paris: Fayard)

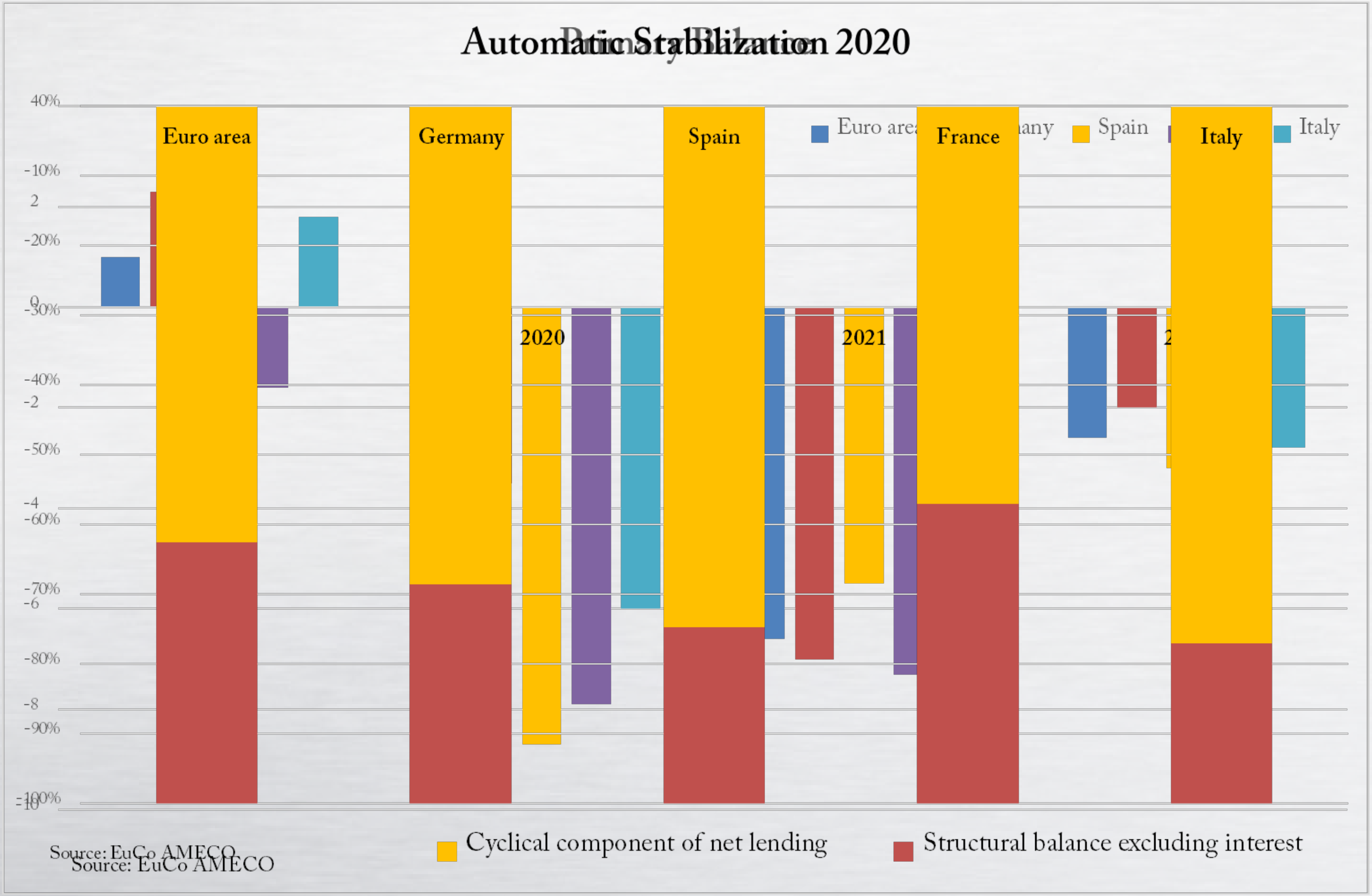
A Game Changer? The Covid Crisis

- Atypical (demand-cum-supply crisis)

- Lockdown challenge: preserve capacity
  - Avoid bankruptcies
  - Preserve incomes
  - Preserve association between workers and firms

- The Dam: National Fiscal Policies. Massive fiscal effort to:
  - Scale up health care capacity
  - Sustain incomes (Job retention schemes, unemployment benefits etc)
  - Provide firms with liquidity (guarantees, loans, deferral of payments, subsidies)

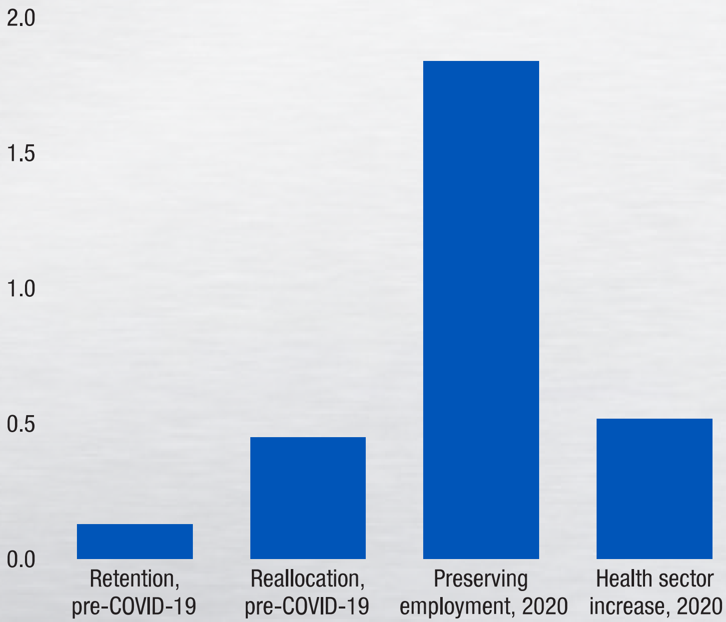
Quite a costly Dam



Unprecedented support for labour markets

Figure 3.9. Public Spending on Retention and Reallocation Policies: Before COVID-19 and Response to COVID-19
(Percent of GDP)

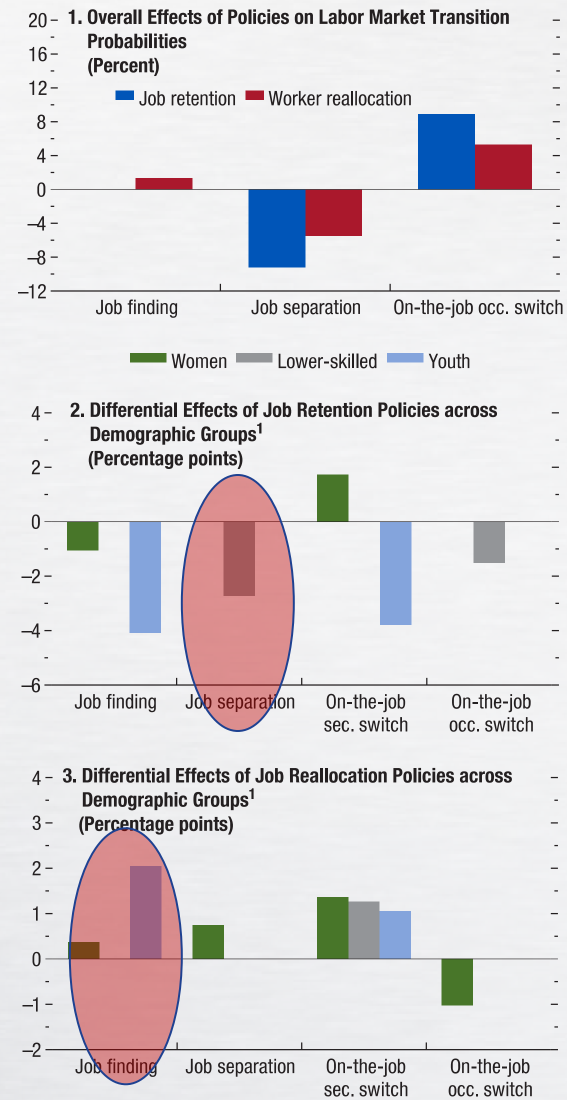
Average public spending to preserve employment after the COVID-19 shock is dramatically larger than job retention spending in the past. The rise in health sector spending alone is on par with average spending on reallocation in the past.



Sources: IMF, COVID-19 Policy Tracker; Organisation for Economic Co-operation and Development; and IMF staff calculations.
Note: Bars show the average public spending on the indicated area as a share of GDP. See Online Annex 1 for further details.

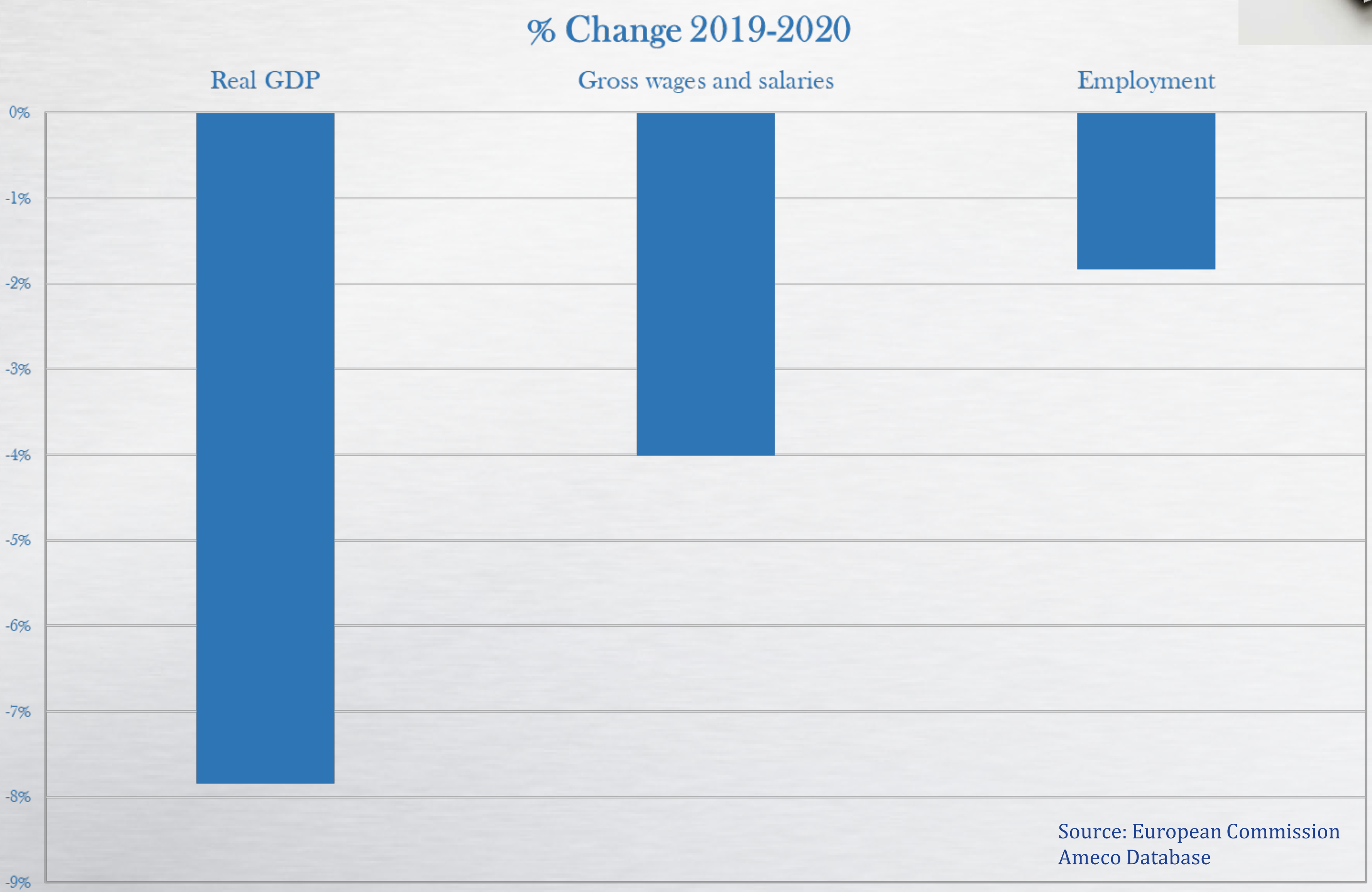
Figure 3.10. Effects of Job Retention and Worker Reallocation Policies

Job retention and worker reallocation policies can help mitigate adverse shocks and improve labor market functioning.



Sources: EU Labour Force Survey; EU Statistics on Income and Living Conditions; Integrated Public Use Microdata Series, Current Population Survey; and IMF staff calculations.
Note: Panel 1 shows the percent change in the indicated transition probability (relative to its average value) associated with a 1 percentage

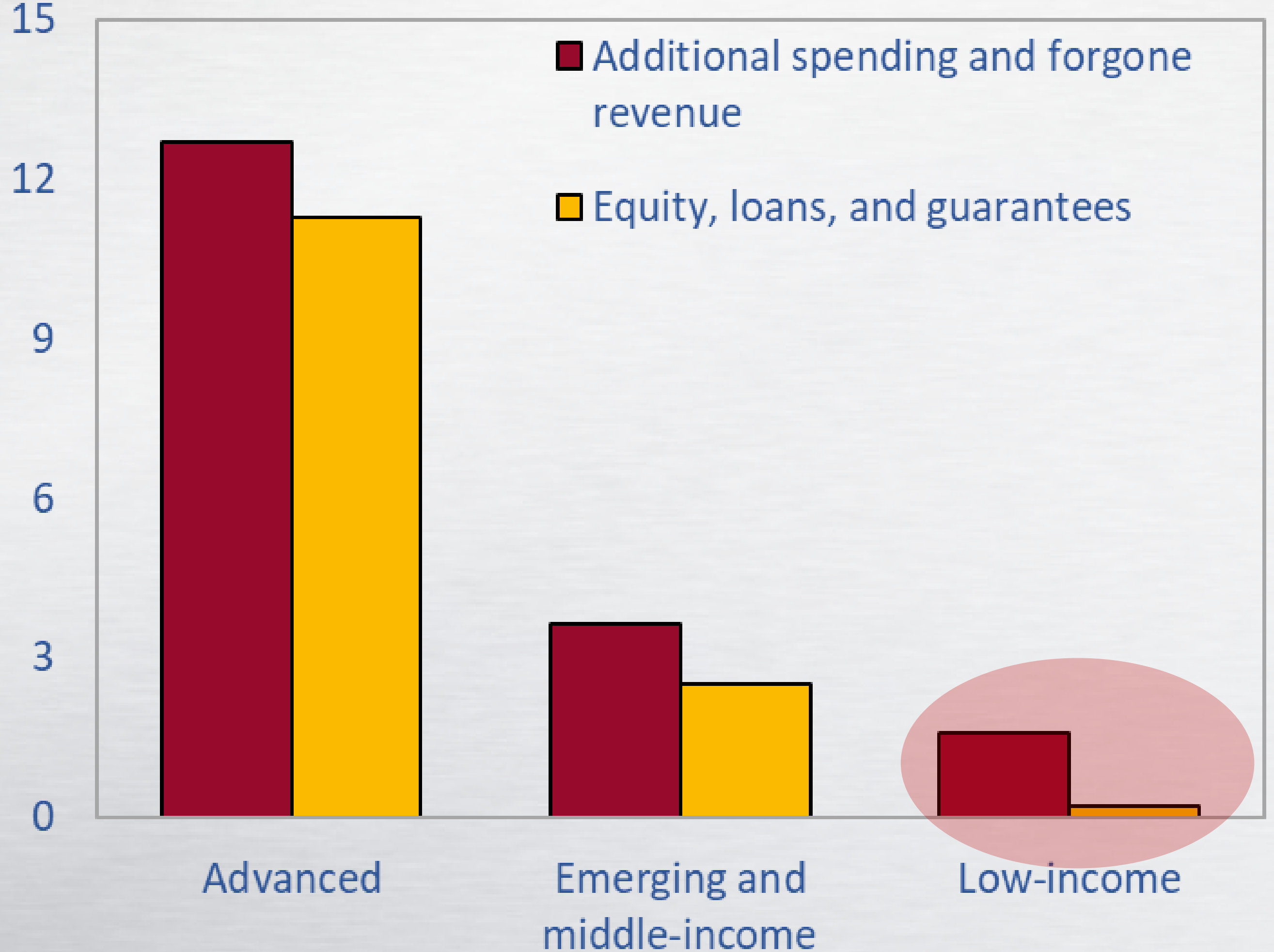
Quite a Successful Dam: Eurozone



Side Note: A massive effort, but just for a few

Discretionary Fiscal Response to the COVID-19 Crisis in Selected Economies *(Percent of GDP)*

Estimates as of end-December 2020



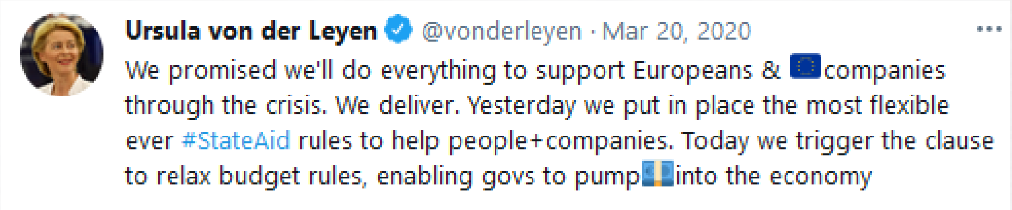
Sources: Database of Country Fiscal Measures in Response to the COVID-19 Pandemic; and IMF staff estimates

The EU and the emergency: a facilitator

- The ECB injected liquidity in the system
  - **Banks and Firms (targeted to SMEs)**
    - safeguarding liquidity conditions in the banking system through a series of favourably-priced LTROs (provided at the deposit facility rate of -0.5%);
    - protecting the continued flow of credit to the real economy through a fundamental recalibration of the TLTROs (access in exchange to lending to SMEs)
    - Extra € 1 tn of bank funding targeted towards firms & households at a rate 25 bp below the deposit facility rate
  - **Governments: The PEPP umbrella is open until the Spring 2022**
    - Extra € 120 bn of "standard" QE over the rest of 2020
    - *Temporary Pandemic Emergency Purchase Programme* (PEPP). The Governing Council decided to increase the initial €750 billion envelope for the PEPP by €600 billion on 4 June 2020 and by €500 billion on 10 December, for a new total of €1,850 billion.
    - A first: PEPP **is flexible concerning the infamous capital keys**

The EU and the emergency: a facilitator

- The Commission #1: get out of the way
  - Stability Pact escape clause activation
  - State aid rules softened



- The Commission #2: Financial assistance
  - €37 billions from the EU budget to finance urgent expenditure
  - Support to mitigate Unemployment Risks in an Emergency (SURE) for labour market-related expenditure
  - ESM Covid line for health-related expenditures
  - EIB €200bn credit line for firms' liquidity needs
- Same principle: Preferential rates thanks to the credit ratings of the Commission. Countries earn the interest rate differential

The medium run: Recovery and structural transformation

- The challenges ahead
  - Restart growth
  - Jump on a sustainable growth path
  - Manage the debt legacy

- These are tasks beyond individual countries' possibilities, for which
  1. Fiscal policy at large will be central
  2. The European dimension is going to be crucial

Resilience and Structural Transformation

- Next Generation EU
  - €750bn of Commission debt guaranteed by the EU budget
  - Allocation (grants and loans) based on needs → **Debt mutualization**
- The Recovery and Resilience Facility (the Recovery Fund): €672.5bn
  - Grants (€312bn) and loans (€360bn)
  - Distributed before 2026 repaid starting in 2028 for thirty years with own resources, possibly (web tax, plastic tax, etc.), or through an increase of Member States' contributions
  - Consistent with the Von der Leyen Commission work program (Green investment, digitalization, etc)
  - (Hopefully) good conditionalities
- Not (yet?) an Hamiltonian Moment
  - Temporary and limited
  - Common borrowing but not common expenditure (investment plans remain national)

A ~~New~~ (Old) Kid in Town

- Fiscal Policy is back in the policymaker toolbox
  - Countercyclical fiscal policy
  - Long-term investment and industrial policy
  - Ecological and digital transition
  - Global public goods
  - Secular stagnation (yes, I am in #TeamTemporary) and Zero lower bound

- Maastricht institutions are relics from the Stone Age

EU Reform
Premise #1: The lessons of the cris~~i~~es

- The single currency cannot function without active macroeconomic policies
  - In particular, the importance of fiscal rules is evident today, not only in affecting short-term (Keynesian) stabilization, but also long-run growth:
    - Industrial Policy
    - Public investment
- There are no symmetrical shocks
- The common response to shocks is more efficient
- Solidarity can be acceptable to all Member States if properly framed
- Coordination of national policies can be achieved efficiently through conditionality

EU Reform
Premise #2. The European construction today looks like an archaeological find

- On paper:
  - Constraints on budgetary policies (Stability Pact)
  - Anti-inflationary monetary policy
  - Industrial policy = competition policy (level playing field)
- In practice
  - Massive intervention to cope with the pandemic and restart the economy (NGEU)
  - Monetary support (from whatever it takes to PEPP)
  - Public investment – Industrial policies

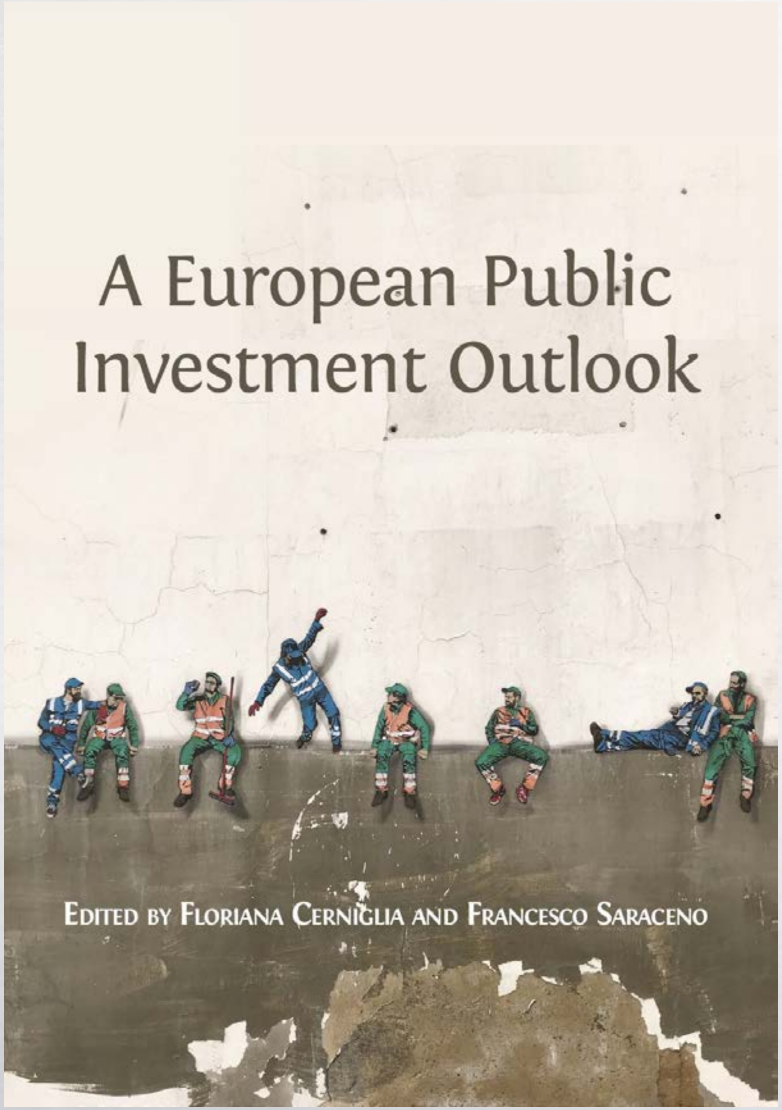
→We need to realign the two, and consolidate/improve recent innovations

Public Investment at the Centre of the Stage

- Public Investment in the EU declined from 2008 to 2016. in 2018 still 15% lower than in 2008 (2.9% vs 3.4%)
- Fiscal consolidation identified as the main driver of the drop
- Infrastructure were particularly hit (-25%). No saturation. The gap increased
- The German case
  - Severe deterioration of public capital stock since 2000
  - Demographic change, decarbonization and digitalization → Additional investment needs
  - Sector by sector analysis leads to the estimation of €450bn over the next decade.

- At the current conditions, public investment is a free lunch (IMF, 2014)

Investment at the Center of the Stage



Industrial Policy

Cherif, R. and F. Hasanov (2019) 'The Return of the Policy That Shall Not Be Named: Principles of Industrial Policy', *IMF Working Paper* 19/74(March).

Aiginger, K., Rodrik, D. Rebirth of Industrial Policy and an Agenda for the Twenty-First Century. *J Ind Compet Trade* 20, 189–207 (2020).

- Industrial policy is much more than competition policy or "European Champions"
- So, what is it?
  - Incentives to boost entry in high value-added sectors Market openness, to avoid rents and to exploit economies of scale
  - Selective (and temporary!) protection
  - Focus on bottlenecks and a constant stream of demand (fiscal policy)
  - Public investment
- **Multidimensional policy**: (taxes/incentives, regulation, trade, competition, monetary policy, finance, regional policies, and… investment)

A Tradeoff will haunt us

- The EU reform worksites should take stock of the renewed importance of fiscal policy. To avoid putting it back in the closet, a permanent capacity to implement discretionary policy needs to be created
- The debate on the reform of rules should go hand in hand with the debate on the creation of a central fiscal capacity

→ Two possible ways

- Create fiscal capacity at the center and constrain Member States (the US model)
- Keep most of fiscal policy national and radically reform fiscal rules

- In both cases, the “Stability and Growth tradeoff” needs to be addressed

The SGP came out of the crisis in shatters

European Fiscal Board (2019) '*Assessment of EU Fiscal Rules*',

- Procyclical fiscal rule
- Built on cyclically adjusted deficits and on natural/potential output
- Impossible to enforce: the bargaining game
- Bias against investment

- Yet, crisis reform did worsen all these flaws
  - 2011: *two-six pack*. Emphasis on structural targets (and lip service to macro imbalances)
  - 2012: Fiscal Compact. Debt is back in the equation
  - 2015: New informal flexibility for investment/structural reforms
- European consultation process *before* the pandemics (February 2020)

The ideal world: Scrap numerical targets!

- *Coordination* on credible public finance trajectories consistent with the common EMU objectives and long term debt sustainability.
- A natural forum for coordination of short term policies and long term goals could be the *European Semester*, that now is just the n^{th} enforcement device of a baroque architecture → "Guidelines, not numerical targets"
- Democratic ownership of common targets needs to be strengthened. These trajectories should be discussed (and validated?) By the Eurogroup and the Council.
- Fiscal policy would remain with Member countries (no representation without taxation…), but coordination and peer pressure should ease possible tensions
- It is somewhat the spirit of the Blanchard et al (2021) Standards proposal

An investment-friendly fiscal rule

- It is unlikely that numerical targets will be scrapped
- View the investment needs, there is political space for a "**golden rule**": Balance the current budget over the business cycle
- Advantages:
  - $\frac{Debt}{GDP} \rightarrow \frac{K_g}{GDP}$
  - Intergenerationally fair
  - The burden of fiscal consolidation falls on current expenditure
- Criticisms:
  - It introduces a bias on physical capital
  - Public investment is a slippery concept (risk of creative accounting)
- These weaknesses can nevertheless be turned into strengths: Make the definition of public investment a *political issue*

An Augmented Fiscal Rule

Saraceno, F. (2017) 'When Keynes Goes to Brussels: A New Fiscal Rule for the EMU?', *Annals of the Fondazione Luigi Einaudi* 51(2): 131–58.

- 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?)
- The introduction of the rule should pose no major legal challenge
- Use the NGEU blueprint?

My bet with the bookmakers

- Possible compromise: a "Green golden rule":

  Darvas, Z. and G. Wolff (2021) 'A green fiscal pact: climate investment in times of budget consolidation', *Policy Contribution* 18/2021, Bruegel

- Good first step, but largely insufficient to restore fiscal space
- Maybe we should look at a central fiscal capacity?

A Central Fiscal Capacity?

- A successful Recovery Fund would pave the way for the debate on a permanent fiscal capacity for the EU
- "How to spend it": pan-European investment plans

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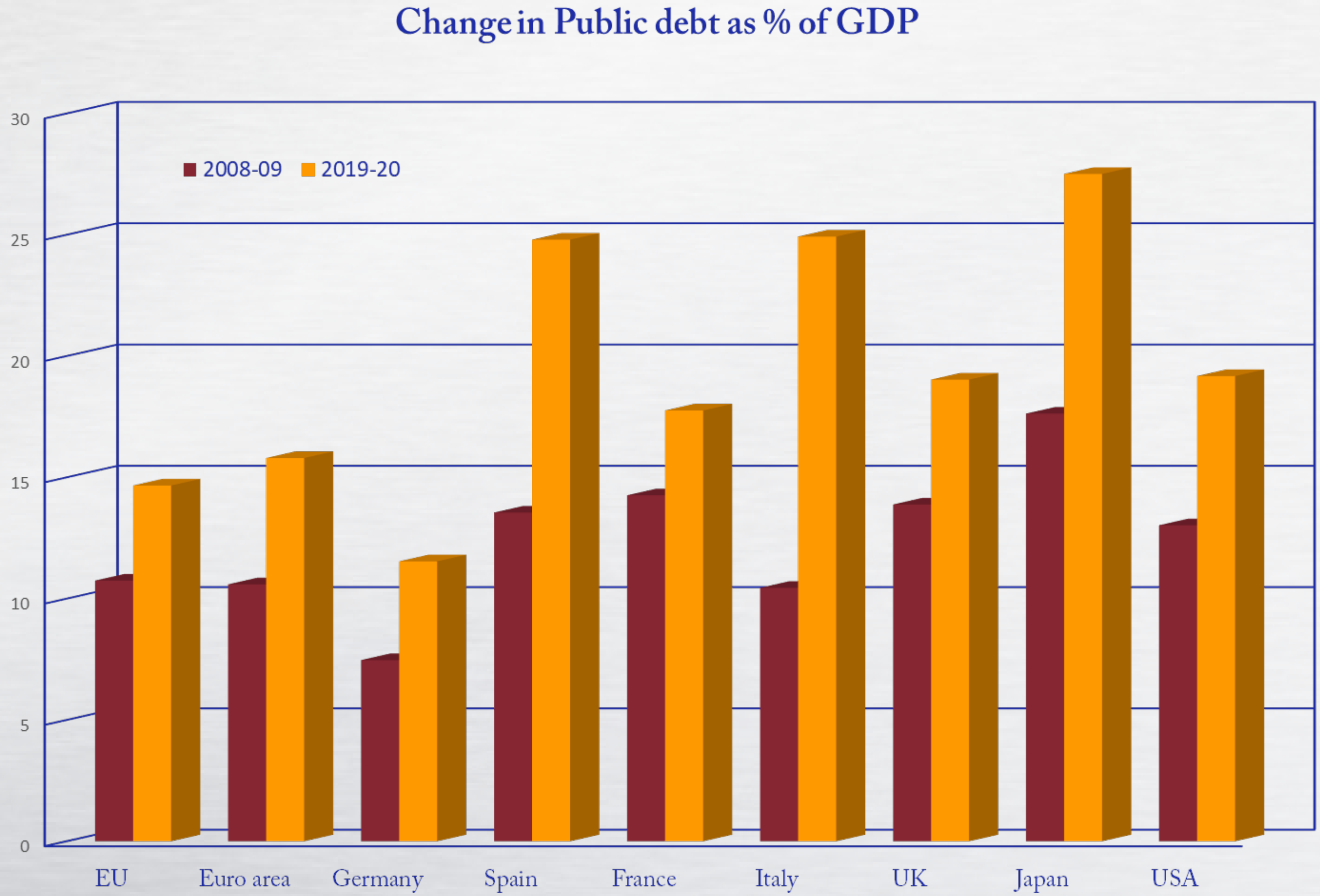
policy brief
IMK
wiiw
72 | 18 juin 2020
HOW TO SPEND IT
A proposal for a European Covid-19 recovery programme
Jérôme Creel, Mario Holzner, Francesco Saraceno, Andrew Watt, Jérôme Wittwer

- The theme of resources: what to spend? The taxation of multinationals is one of the central issues of the coming years.
- On what to spend it? What industrial policy? What role for the entrepreneurial state?
- What about democratic accountability?

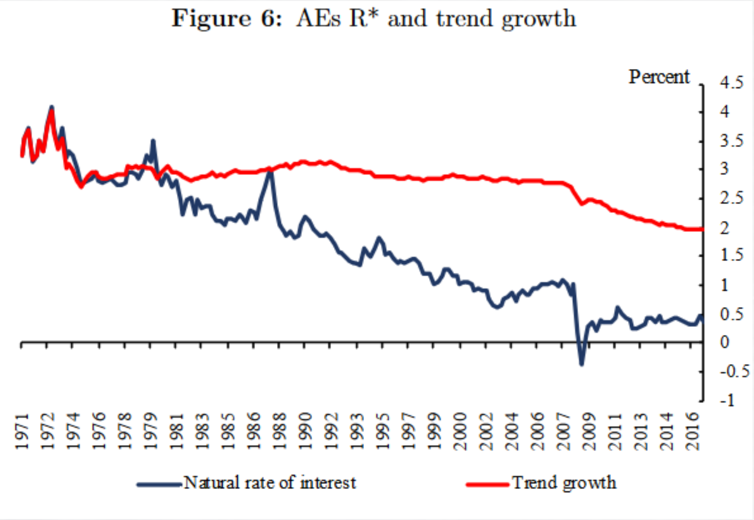
(Large) public debts are here to stay



Source: European Commission AMECO

Managing public debt: move from solvency to sustainability

- Favourable macroeconomic environment:
  - Chronic excess savings (secular stagnation)
  - $g > r$ globally
- Focus should move from paying debt to service it (Blanchard 2019)
- States are perpetual, debt can be rolled over
- Solvency is not a global issue (it may be one for individual countries, though)



Source: Lukasz and Summers 2019

Managing EMU Debt: The ECB option

- Monetization/rolling over of Covid debt
  - Not necessarily inflationary
  - If done properly (ECB autonomous choice) would not lead to fiscal dominance and credibility loss
- Possible problems
  - Reversible at any moment: public debt would not be shielded from market sentiment
  - The objective of stabilizing debt/closing the spreads would make it harder for the ECB to focus on its core business:
    - Closing the output gap
    - Closing the inflation gap

Managing EMU Debt Outside the ECB

- Managing debt at the European debt would have many benefits
  - Safe asset
  - Elimination of liquidity risk for individual countries→increased fiscal space
  - Taking the burden off the shoulders of the ECB
  - Normalize the yields of EMU core countries sovereigns (hooray, German savers!)
- To ensure political feasibility, this needs to be done:
  - Avoiding debt mutualization (no art 125 TFEU)
  - Avoiding elimination of fundamental risk (moral hazard)
  - Avoiding juniority effects (and therefore market pressure/financial instability)

- A European Debt Agency:

Amato, M., E. Belloni, P. Falbo, and L. Gobbi (2021) ‘Europe, Public Debts, and Safe Assets: The Scope for a European Debt Agency’, *Economia Politica* 38(3): 823–61.

Amato, M. and F. Saraceno (2022) ‘Squaring the Circle: How to Guarantee Fiscal Space and Debt Sustainability with a European Debt Agency’, *Baffi-Carefin Working Papers* 172(January)

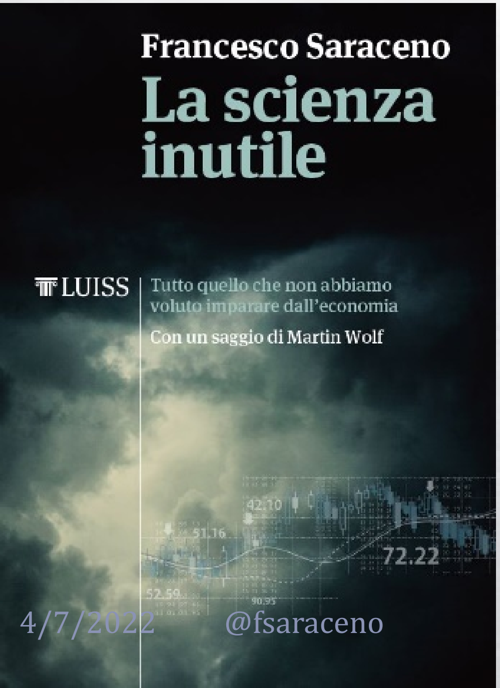
A European Debt Agency

- How would it work?
  - A bank with adequate solvency capital (ESM Blueprint/transformation?): a layer/middleman between States and markets
  - Issuance of AAA bonds to finance perpetual *loans* on new and expiring Member States debt (no purchase of outstanding debt): hence **filtering refinancing and liquidity risk**
  - Member States can redeem at any time
  - All outstanding debt is progressively absorbed (no juniority stigma)
  - Pricing of installments reflects fundamental risk as assessed (by the Commission) through debt sustainability analysis and compliance to fiscal rules. ***States' fiscal accountability is guaranteed: No risk sharing!***

- Other Benefits
  - Neutral with respect to fiscal governance (rules, central capacity, both)
  - Division of tasks
    - The ECB could resort to its core business
    - The (political) assessment about discipline would remain with the Commission/Council as it is today
  - Stabilizes market expectations

Conclusion: Nothing Like Before

- Two crises in a decade have upset macroeconomics. Whether endogenous (GFC) of exogenous (Covid) the cries have challenged the capacity of markets to self regulate and to return to natural equilibrium
- The New Consensus «dogma» such as monetary dominance, structural reforms, industrial policies, role of public investment, are today discussed by mainstream economists
- Are we headed towards a «macroeconomics of imperfection»?
  - Both government and the market are imperfect institutions
  - The policy maker needs to navigate between these imperfections (the essence of the Keynesian message)
- The EU reform of the next few months might be a test for this new world



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