Growth, Investment and the Golden Rule

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The EU Crisis. 2014 and all That

- 2014 is (yet another) turning point of the Eurocrisis
- Slow slide towards deflation (and deteriorating expectations)
- Growth Crisis: A triple dip?
- The Jackson Hole Consensus: Shared Diagnosis
  - Lack of aggregate demand
  - Chronic deficiency of investment, both public and private
    - This is in particular a European problem, as investment is politically less visible than other items of public spending, and it has been the adjustment variable during fiscal consolidations since the 1990s
  - Monetary policy has lost traction (liquidity trap and ZLB)
  - (A bit more controversial) The length of the crisis is seriously impacting potential growth, i.e. the long term potential of the economy

Crisis Management, 2009-2014: A Success Story!

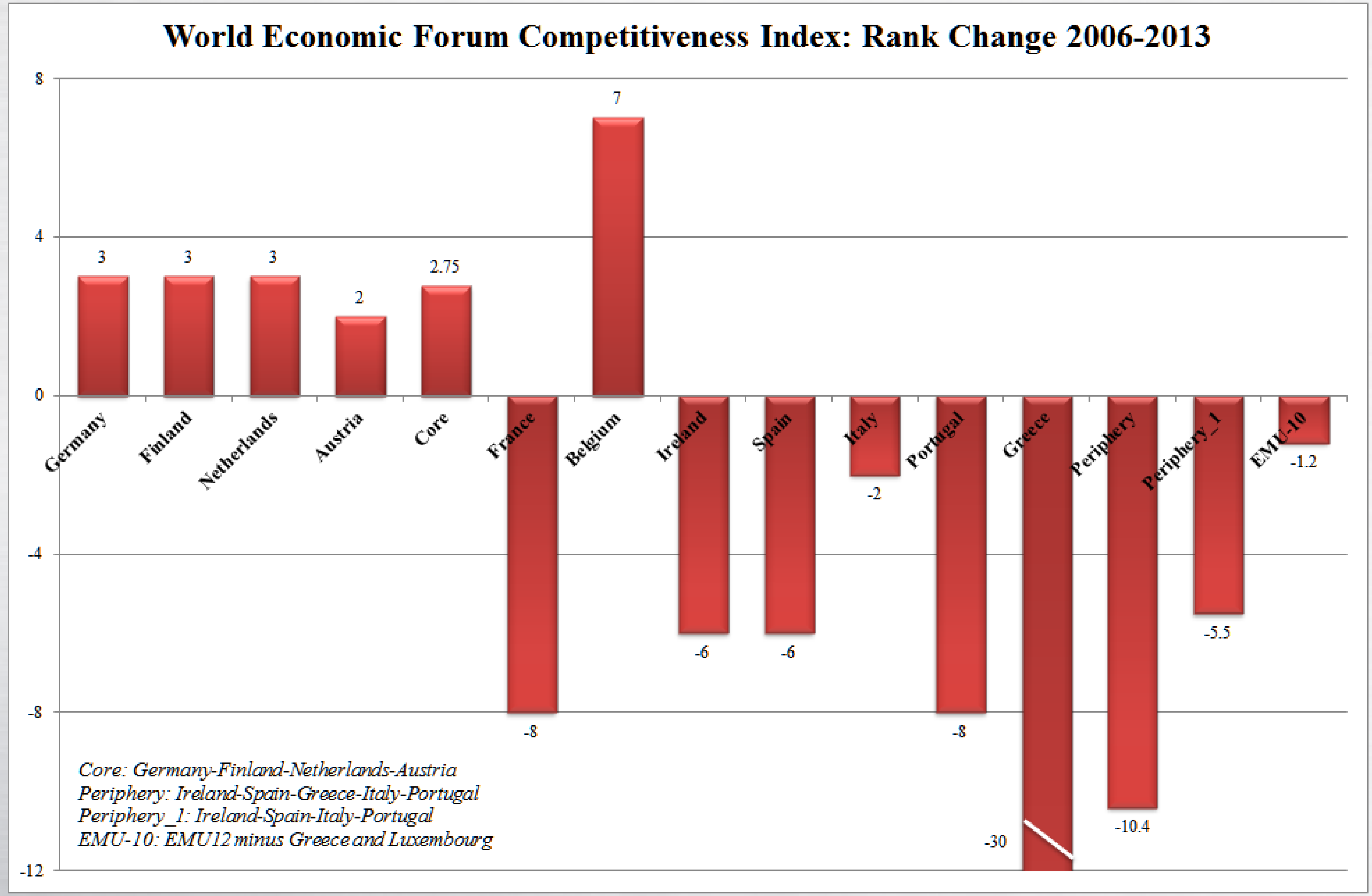
- Berlin View narrative: It’s fiscal irresponsibility, stupid!
- Adjustment so far:
  - Austerity (everywhere!!)
  - Reforms
  - Timid monetary policy (QE EMU version vs QE US version)
  - Asymmetric adjustment (global stance is/has been restrictive)
  - Tightening of rules (fiscal compact)
- So successful, that the patient is almost dead! Austerity and structural reforms do not seem to bring the fruits their proponents hoped for. They actually increased divergence between core and periphery

Structural Reforms. A Solution?

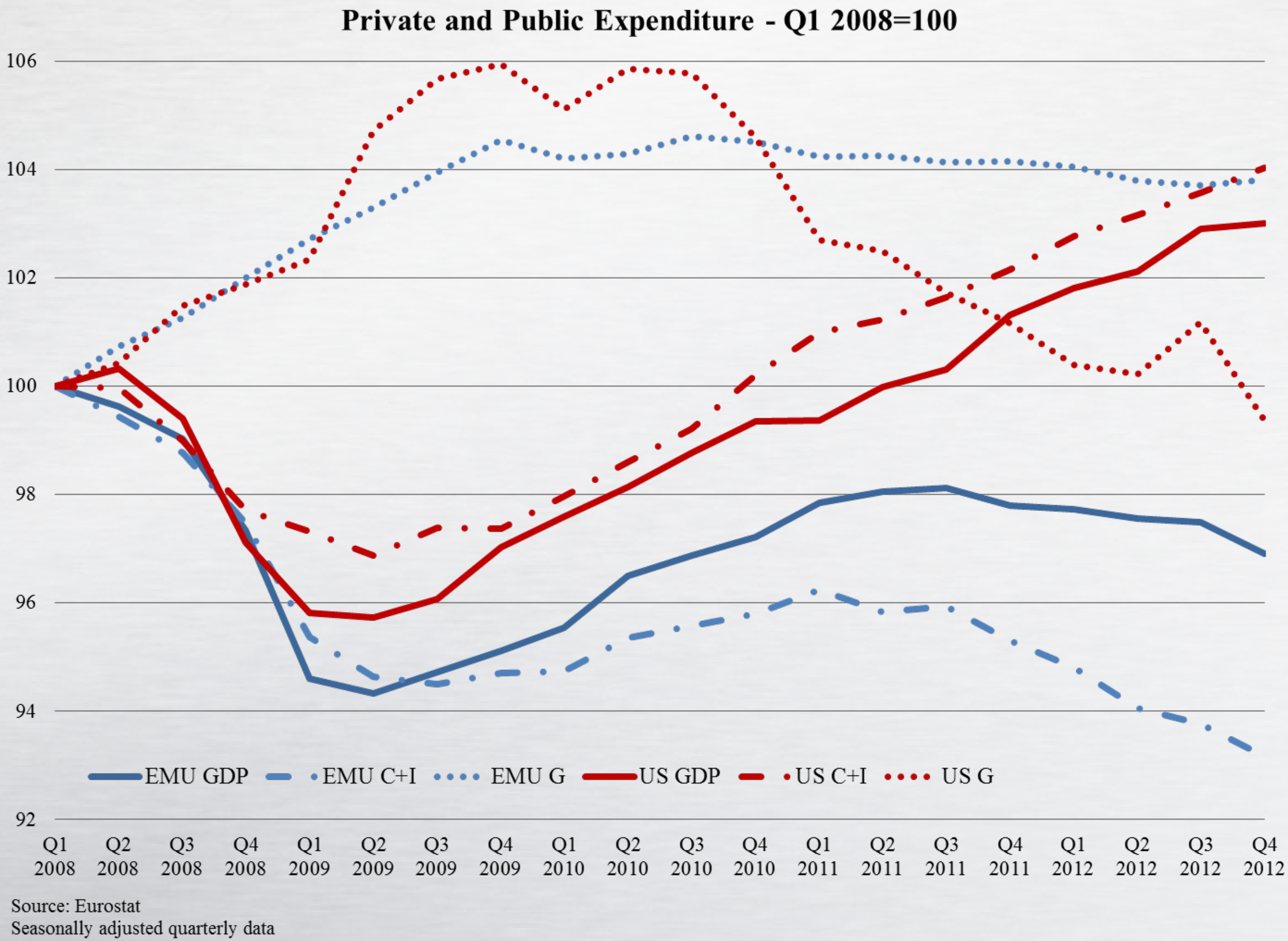
- It is undeniable that EMU countries (especially in the periphery) have structural problems and rigidities
- The main issue with structural reforms is sequencing (See Dani Rodrik, Project Syndicate, June 12, 2013)
- Structural reforms when aggregate demand falters amounts to feeding water to a horse that is not thirsty
- Supply side reforms: A confidence fairy
    - Italy's Jobs Act and France's Pacte de Responsabilité.
- Also:
    - Competitiveness goes beyond price competitiveness
    - Excessive emphasis on labour market is suspicious (political capture?)

Short Term Pain for Long Term… Pain

- More competitive thanks to Austerity?



Austerity, or Pro-Cyclical Fiscal Policy



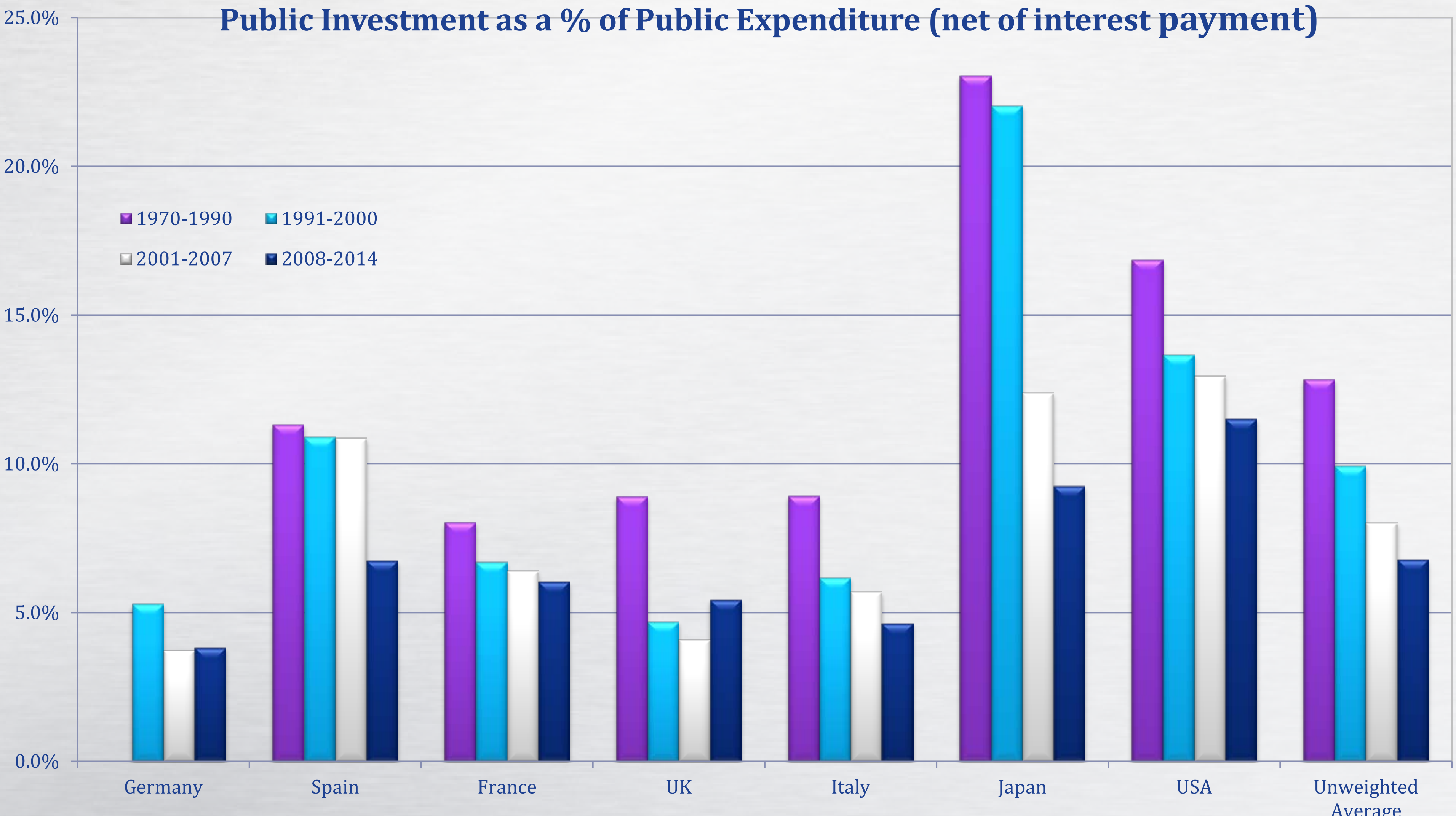
Luckily we Have SuperMario…

- Jackson Hole Speech: Draghinomics' three arrows
  - Continued monetary accommodation
  - Structural Reforms
  - Expansionary Fiscal Policy
- The emphasis on fiscal policy is a revolution for a proponent of the Berlin-Brussels-Frankfurt Consensus
- Or maybe not
  - Fiscal policy can be expansionary only within the limits of current norms
  - This means for 2014, 0.2% of GDP (0.4% in 2015). A fifth of the Juncker Plan.
  - Peripheral countries have no margin
- Draghinomics is not really a revolution. Compare Japan with the EMU!

Public Investment is Key

- Jackson Hole consensus places emphasis on Investment
- October 2014 IMF World Economic Outlook: Public investment today is a free lunch
- Debate on Germany’s poor investment performance and crumbling infrastructures (DIW Report)

The Public Investment Problem



Source: OECD Economic Outlook

How to Restart Public Investment

- European problem: fiscal rule (SGP-Fiscal Compact) prevents investment spending
- A European investment program, financed with European funds (eurobonds, EIB, ECB) would be a first best: *Marshall Plan 2.0*
  - It would allow financing at low rates (remember, EU public finances as a whole *are in excellent shape!*)
  - It would allow to increase connectedness in EU (electric grids, green investment, transport infrastructures, etc.)
- Unfortunately we do not live in a world of first best: Burden sharing and “federalism” are not a viable option today

The Juncker Plan. Much Ado for Nothing

- Lacking better alternatives, can we at least say that the Juncker plan is a Marhall plan 1.something? Nope!
  - Size: €300bn, mostly private, 8 years into the Crisis. Obama's 2009 plan was $800bn public investment, months after Lehman
  - Even with optimistic assessment on multipliers, the impulse is just decimals of GDP, not enough to trigger virtuous expectation circle
- We need a second best solution
- Investment needs to be restarted at the national level
- Uncoordinated breaking of the rules (France's strategy) is dangerous (bond vigilantes) and ineffective

A Golden Rule for Public Investment

- Dervis and Saraceno, *Brookings blog*, September 2014
- Implement at the EU level a golden rule similar to the UK in the 1990s
- Balance the *current* budget over the business cycle
  - Tax revenues finance current spending
  - Debt finances investment spending
- Advantages:
  - It stabilizes public debt at the level of public capital: $\frac{D}{GDP} = \frac{Kg}{GDP}$
  - Intergenerationally fair
  - The burden of fiscal consolidation falls on current expnditure

A Golden Rule for Public Investment

- The Golden Rule is not a new proposal
- In the past rejected based 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 As a Tool for EU Policies

- 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?)

Where There's a Will There's a Way

- The need to change the Treaty is a non-problem
  - First, excluding investment from deficit figures only requires secondary legislation
  - Second, the Council and the Commission could decide overnight to overrule Fiscal Compact provisions for countries implementing commonly agreed investment projects, while the new legislation is worked out by the Commission and subject to Council approval