

Appeal launched by the Cournot Centre
and its president Nobel Laureate Robert Solow (MIT)

Towards a Common Fiscal Policy: Relaunching the Eurozone Economies

(1) In February 2008 we launched a manifesto to reinvigorate macroeconomic policy in Europe. The main aim was to challenge the Frankfurt–Brussels consensus, which claims that discretionary fiscal policy is largely of no avail. Diagnosing at that time a “US economy on the verge of a substantial downturn”, and in view of the significant current account imbalances, we called for “fiscal policies in Europe which should stimulate demand while, at the same time, carrying the seeds of their own sustainability”. The U.S. and Europe are now in full recession. The U.S. is already in a deep recession, and matters are getting worse by the month in Europe. The new U.S. administration is proposing a large fiscal package to replace the fall in demand for housing, business investment and consumption. The magnitude of discretionary stimulus under discussion in the U.S. is about 3 per cent of GDP each year, maintained for two years. This amount is expected to increase. The European response to date has been too weak, too cautious, and above all, too uncoordinated. The Euro-zone countries need a net stimulus of at least 2 per cent of GDP. It must come soon, last as long as needed, and come from all countries. Waiting while a new coordination architecture is negotiated will only allow the recession to become more deeply entrenched and to last longer.

(2) Monetary policy has responded quickly in the Eurozone. Since August 2007, the ECB has provided liquidity substantially above the banking sectors’ needs. With a crisis that has been deepening since September 2008, ever more forceful interventions have been needed. Nonetheless, the ECB has stuck with its distinction between the policy rate and liquidity management for too long. Even early on, it was obvious that the problem was ultimately not one of liquidity but of credit risk. Interest rate cuts have not been sufficient to sustain the economy of the Eurozone.

(3) Monetary policy now needs the support of a strong fiscal policy. The problem is that fiscal policy, as argued in our Appeal of last year, is conceptually hamstrung by the ill-conceived Stability and Growth Pact. According to a literal reading, it prohibits the automatic stabilizers from doing their job even when clearly needed. The political process will most likely prevent such an outcome, that is, deficits will respond to the cycle, if only in a restricted way. Given the global economic disaster the Eurozone is facing, such a passive response could have dire consequences. Japan’s wavering approach during the 1990s shows how imperative it is to prevent economies from sliding ever deeper into persistent stagnation. The opportunity costs of timidity are very high.

(4) The goal of a fiscal stimulus package is to replace the private demand for goods and services that disappears in a recession. The stimulus can be withdrawn as private demand strengthens. In choosing a fiscal package, the overriding consideration should be that each action must either directly involve public spending on goods and services or reliably generate private spending on goods and services, and should do so as soon as possible. It is always desirable that public spending and tax incentives provide valued benefits to society and promote long-term growth. Within that broad mandate, the immediate goal is to increase aggregate demand, create employment and add to incomes. In view of all the big numbers that have been projected, unassertiveness no longer appears to be the problem. This holds true even for Germany. It took a long time, especially for the German government, to accept reality. Even then, it is disquieting to see the speed at which positions — held ferociously until very recently — are being reassessed. Moreover, many programmes appear to be largely driven by political expediency. To be effective, however, they should be guided by economic principles. A principled approach to macro-stabilizing fiscal policies would start by breaking the downward spiral.

(5) From this viewpoint, relying on budgetary instruments with the highest multiplier effects is of the essence. It is not sufficient to consider only the total amount of public interventions. Their nature and macroeconomic impact also matter. The following aspects are worth emphasizing in this context.

First, public sector expenditures should focus on capital expenditures with a high job content and maintain and renew public infrastructure. They are called for on cost-benefit and on stabilization grounds. Infrastructure here also includes the education system, which in a number of EMU countries is chronically underfunded. Moreover, investing in appropriately labour-intensive projects to deal with ecological problems is a double-dividend proposal, making sense by both supporting the economy and coming to grips with environmental challenges.

Second, tax cuts, if not targeted mainly at liquidity-constrained households, will, in the present context of uncertainty, hardly contribute to recovery.

Third, a significant effort must be made to lessen the gap between actual and potential output, which, if unaddressed, could reach enormous dimensions and be long lasting. In Europe, with its set of small and open economies, the immediate issue is coordination. Also, the large economies must take the lead and stop passively free-riding through incremental exports on the policy activism of others. Europe as a whole is too big an economy to sit and wait for world trade to bail it out. Against the need to rein in untenable current-account deficits as well as the attendant net external debt positions, surplus countries in Europe, such as Germany, have to wean themselves from their reliance on net exports. They must buttress domestic economies in order to close the gap between internal and final demand.

Fourth, flaws in the institutional design of fiscal policies in Europe have now become more than evident. While the current crisis calls for an intensive coordination of policies, Europe's macro-impact comes essentially by default. The Stability and Growth Pact (SGP) is only about negative coordination, aimed at controlling deficits and debt at arbitrary levels. Cooperative, discretionary fiscal policy activism is difficult to achieve given the current institutional set-up. The European Commission, understanding its purpose mainly as a technocratic guardian of formal rules, does not fit that role. Uncoordinated national activities – the outcome of which has been shown to serve mostly national political interests – are not up to the task either. Given the current set-up, beggar-thy-neighbor policies are too plausible an outcome. As a minimum this calls for an enhanced and institutionalized role of the Eurogroup of Finance Ministers. Ultimately, a common currency requires for its own protection a reasonable level of common fiscal policies.

Fifth, the need to respond forcefully should not prevent timely thinking about medium-run sustainability issues. Debt to be accumulated during the recession-fighting phase has to be honoured. Over the long haul, current expenditures should be paid out of current tax income. Only investments may be funded, over the medium run, with debt. Therefore, a credible commitment to medium-term consolidation should be part of any serious counteracting fiscal policy programme. To write down balanced budget rules, which are often disregarded in practice, is too soft an approach. It is paramount to muster enough political might to control fiscal policies according to a golden rule: current income over the medium run limits current expenditures.

(6) The crisis we are facing owes its severity in large part to an extreme over-leveraging of our economies. Balance sheets have a macroeconomic importance as James Tobin made clear in the early 1960s. Today, however, lending or financing practices are much more reliant on credit derivatives, allowing for a much more aggressive leveraging. The financial deceleration we are currently witnessing has been allowed to build its deconstructive power through regulations built on false conceptions of financial markets. Given their inherent information asymmetries and loosely aligned incentives, markets are intrinsically imperfect. They can generate massive negative externalities. The ongoing implosion of the shadow banking system may entail major real economic opportunity costs. To move forward, financial markets have to be regulated much more rigorously. Simple rules are needed. Minimum capital requirements have to be raised again. A leverage ratio, which would have made most of the flawed activities unattractive, has to be added as a supplementary constraint. Liquidity cushions must be reinforced. Most importantly, these rules have to be applied functionally, including all those who engage in the relevant activities, regardless of the institutional framework. Encompassing rules under financial globalization call for cooperation between the major players, who up to now have been preoccupied with regulating their own markets.

(7) Significant spillovers – stimulus leakages – limit the effectiveness of fiscal policy actions taken by each individual country on its own. The more open a country is, the less it will benefit from domestic demand expansion, and the more vulnerable it will be to negative spill-ins from abroad. The loss in trust resulting from the crisis could worsen if the present stimulus packages do not deliver on their promises. Countries will be tempted to use exchange rate devaluations as a way to gain competitive advantage, and the risk of protectionism could rise. A decisive strength of the Euro area is that competitive devaluation is ruled out by design – thanks to the common currency. Other types of free-riding do occur nonetheless. They can result especially from the fact that the relative size of countries' stimulus packages varies. We thus strongly urge the Euro-zone countries to commit to a coordinated net stimulus level of at least 2 per cent of their GDP.

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