

# After the Polycrisis: The Return of Fiscal Policy and the European Governance Reform

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# Polycrisis

- 2007-2009: The Global Financial Crisis
  - Endogenous Shock (oversized finance – speculative bubbles– private debt)
- 2010-2014: Eurozone Debt Crisis
  - Capital flights from the periphery– Public debt crisis
- 2014-2019: Secular Stagnation?
  - Chronic excess savings – insufficient demand – zero lower bound – quasi-deflation
- 2020: Covid
  - Lockdowns and simultaneous drop of demand and supply – The economy in an artificial coma
- 2021-2023: Inflation
  - Post-Covid recovery – Sectoral reallocation – Energy (and war)
- 2024: ???

# The Policy Response

- 2007-2009: Global Financial Crisis
  - Keynesian Policy Mix: Monetary Policy for the Financial Sector + Fiscal Policy to Jump-Start Demand
- 2010-2014: The Sovereign Debt Crisis
  - The Troika: Assistance in exchange for austerity + reforms
- 2014-2019: Secular stagnation?
  - Quantitative Easing (zero lower bound)
- 2020: Covid
  - Subsidies, financing, Job Retention schemes (Fiscal policy)
  - EU acted as a facilitator
    - European financial Assistance
    - New QE (PEPP)
- 2021-2023: Inflation
  - Restrictive monetary policy – limited fiscal measures



# State vs (or with) Markets: The Battle of ideas

- Pre-Keynesian theory: Efficient markets and no role for economic Policy
    - Optimization and rationality: (Homo Economicus)
    - Price variations allow all full employment production to be completely absorbed by demand (Say's Law)
  - The crisis of 1929 launches the Keynesian era
    - Role of economic policy to ensure growth and convergence: New Deal
    - Regulation: Glass Steagall Act
    - Welfare State, social protection: Beveridge
    - Industrial policy, the Entrepreneurial State
- Three decades of stable and strong growth

# Nobody's Perfect. Keynes Beyond Caricature

- Keynes is more about proactive than about big government
- The economic process is the sum of two imperfections, government and the market. The policy maker navigates by trial and error
- The dichotomy between the State and the Market is fallacious and ideological
- Temporary role of the government to compensate market failures
- The concept of stability is more important than that of optimality
  - Macroeconomic policy to smooth fluctuations
  - Stability to support expectations and private spending
  - Complementarity of public and private investment
  - "Patience and deep pockets": the entrepreneurial state
- The examples of public investment and industrial policy

# The Return of Neoclassical economics

- 1970s: Oil shocks and the crisis of Keynesian theories
- The return of supply-side economics: Monetarism, Rational Expectations
- 1990s, a “New Consensus”: Markets are **fundamentally efficient** (rational agents)
- The economy fluctuates around a **natural equilibrium** that it can reach with no help from policy
- **Structural reforms** (reduce real rigidities) are the main tool to:
  - Improve long run growth (increase the natural equilibrium)
  - Ensure faster response to shocks
- **No role for macroeconomic policy** in boosting growth
  - Monetary policy should only anchor inflation expectations
  - Fiscal policy should not crowd out private expenditure
- The preferred policy tools are **Rules** ensure predictability and anchoring of expectations



# The EMU and the New Consensus

- The EU institutions are created in the 1990s. Therefore, they embed the New Consensus market optimality doctrine. Besides reforms, not much to be done
- The Maastricht Convergence Criteria
  - **Inflation:** not to exceed by more than 1.5 per cent the average of the three lowest rates among EU countries.
  - **Long-term interest rate:** not to exceed by more than 2 per cent the average in the three lowest countries.
  - **ERM membership:** at least two years in ERM without being forced to devalue.
  - **Budget deficit:** less than 3% of GDP
  - **Public debt:** less than 60% of GDP, or decreasing at a sufficiently fast pace
- These criteria are just *nominal*: stable inflation and public finances allow to focus on structural reforms and the supply side
- Markets take care of *real* convergence

# The EU and the New Consensus

- **Fiscal Policy:** the Stability and Growth Pact requires budget balance over the cycle: no discretionary policy
- **Monetary policy:** strict inflation targeting for the ECB
- **Strong emphasis on competition (level the playing field!)**
  - Elimination of oligopolistic rents
  - Very strong focus on the abuses of dominant position
  - Doctrine on State aid and distortion of competition
  - The consequence: the death of industrial policy

⇒ Very limited role for public policies at large!!



# 2008: The End of the Old World

- After the financial crisis, a loss loss of confidence on market optimality (or capacity to converge to the natural equilibrium)
- New work on old dogma
  - Fiscal policy and public investment
  - Supply-side and demand-side linkages
  - 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
- At least, outside Europe! (does the Sovereign debt crisis ring a bell?)

# After 2008: 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 and Zero lower bound
  - Inflation: not always and everywhere a monetary phenomenon!



# 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)



# US Industrial Policy: The case of IRA

- Inflation Reduction Act, Passed in August 2022. Part of a package aimed at reindustrializing the US:
  - CHIPS and Science Act, which dedicates funds toward cutting-edge R&D,
  - Infrastructure Investment and Jobs Act
- More industrial policy than inflation reduction
- Subsidies for:
  - Production of clean energy sources (wind, solar) - uptake of electrical vehicles (EVs) - carbon sequestration - production of renewable fuel - clean manufacturing - heat pumps
- Demand-pull measures that allows these technologies to reach market maturity
- Innovative features
  - US input requirements
  - Long lasting financing
  - Significant part of the burden on (large) corporates: 15% minimum corporate tax
- Uncertain cost (in the range of \$400 to \$1,200 billion)

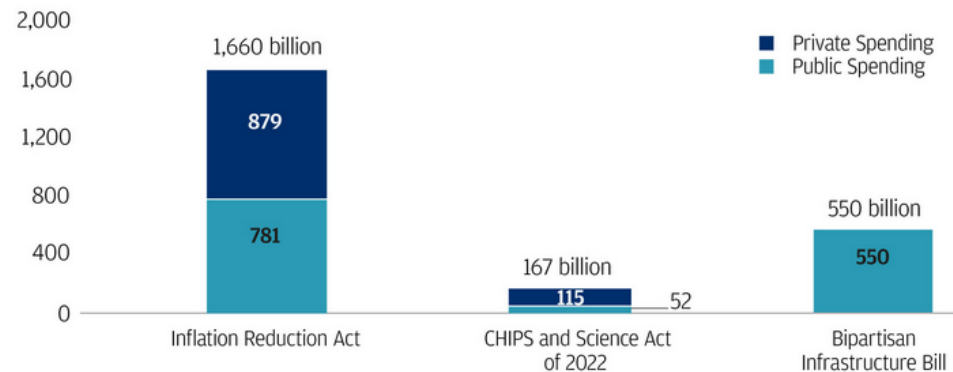
# The Need for a Multidimensional Strategy

Saraceno, F. (2024) *UE: il treno green non è frugale* Ispionline, 26 gennaio

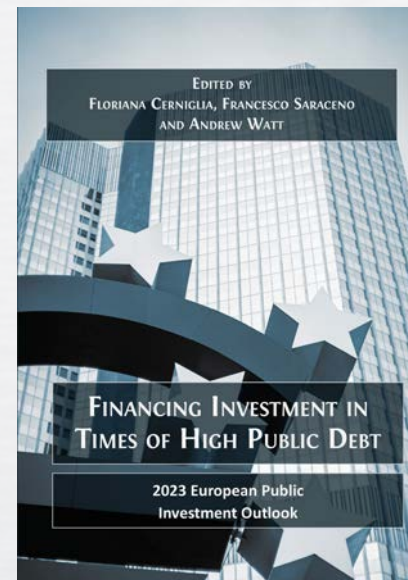
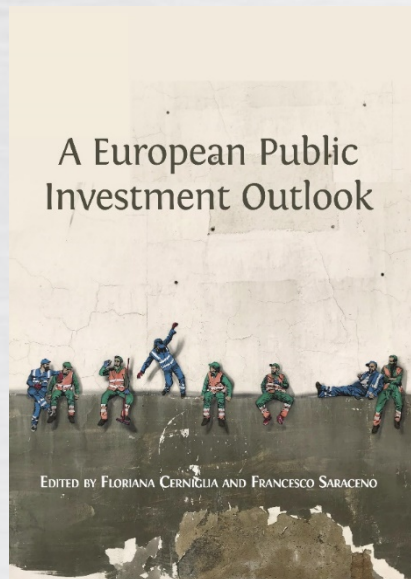
- Industrial policy is much more than competition policy
  - Incentives - Public Investment - Trade Policies - Regulation - etc
- Europe moves mainly with regulation. Not necessarily a problem, but without investment...
- IRA + Infrastructure Act + Chips Act: about \$1400 billion (NGEU: €750)
- If we regulate and others invest, they are the ones who will come out on top.
- Relaxing state aid rules. A false good idea?

Three recent policy bills include almost \$2.4 trillion in funding

Public and private spending (USD billion) over the next 10 years



# Public Investment. The Outlooks



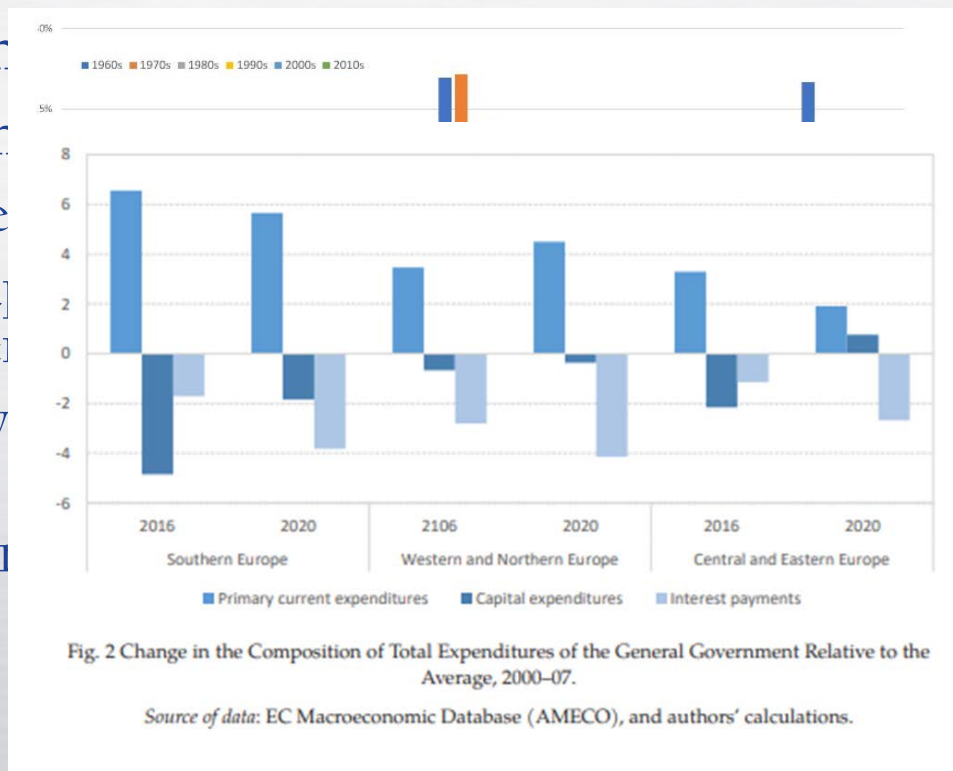
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# Public Investment at the Centre of the Stage

- Draghi Jackson Hole speech (2014)
  - Monetary policy cannot replace fiscal policy
- Public Investment in the EU declined since the 1980s with an acceleration from 2010

- Fiscal consolidation
- The German model
  - Severe decline in public investment
  - Demographic pressures
  - Sector by sector
  - decade.
- At the current juncture



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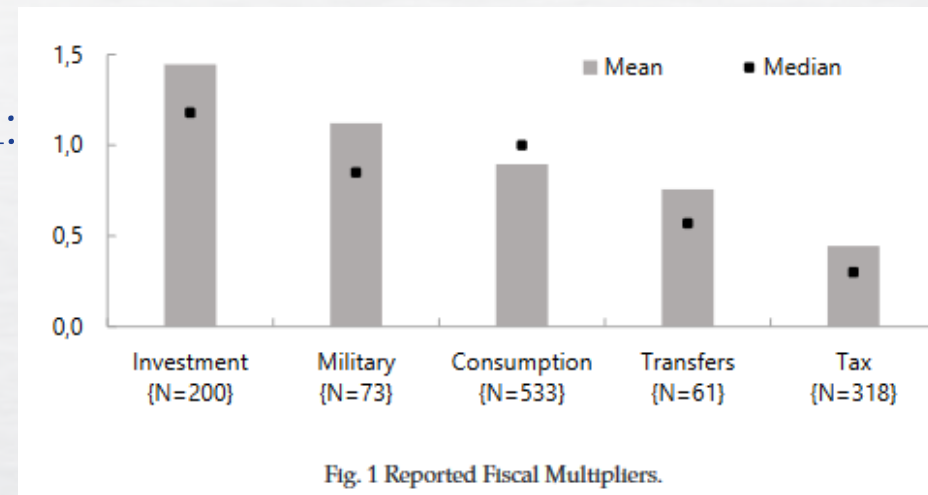
# Recurring themes in the debate on public investment

- The need for a “broad” definition of public investment: expenditure that increases both **tangible and intangible** public capital stock
  - Emphasis on social capital and public goods (health, education, cohesion)
- The shortfall of public capital is widespread (rich and poor countries alike)
- Very important distributional impact of insufficient public capital
- Complementarity of public and private capital
- Need to revise EU rules

# Crowding In-Out of Private Investment

Durand, L., et al. (2021) 'Crowding In-Out of Public Investment', in Cerniglia F. and Saraceno F. (eds), *The Great Reset: 2021 European Public Investment Outlook*. Cambridge: Open Book Publishers.

- Short (Keynesian) term + Long (supply) term impact on activity
- Quite large value of multipliers
- Conditions for larger crowding-in:
  - ZLB and negative output gap
  - Uncertainty
  - Composition (emphasize green infrastructure)
  - Institutional quality
- NGEU (lessons from previous programs' assessment)
  - The conditions above apply
  - Slow impact on growth (small impact multipliers)
  - Larger impact on poorer regions





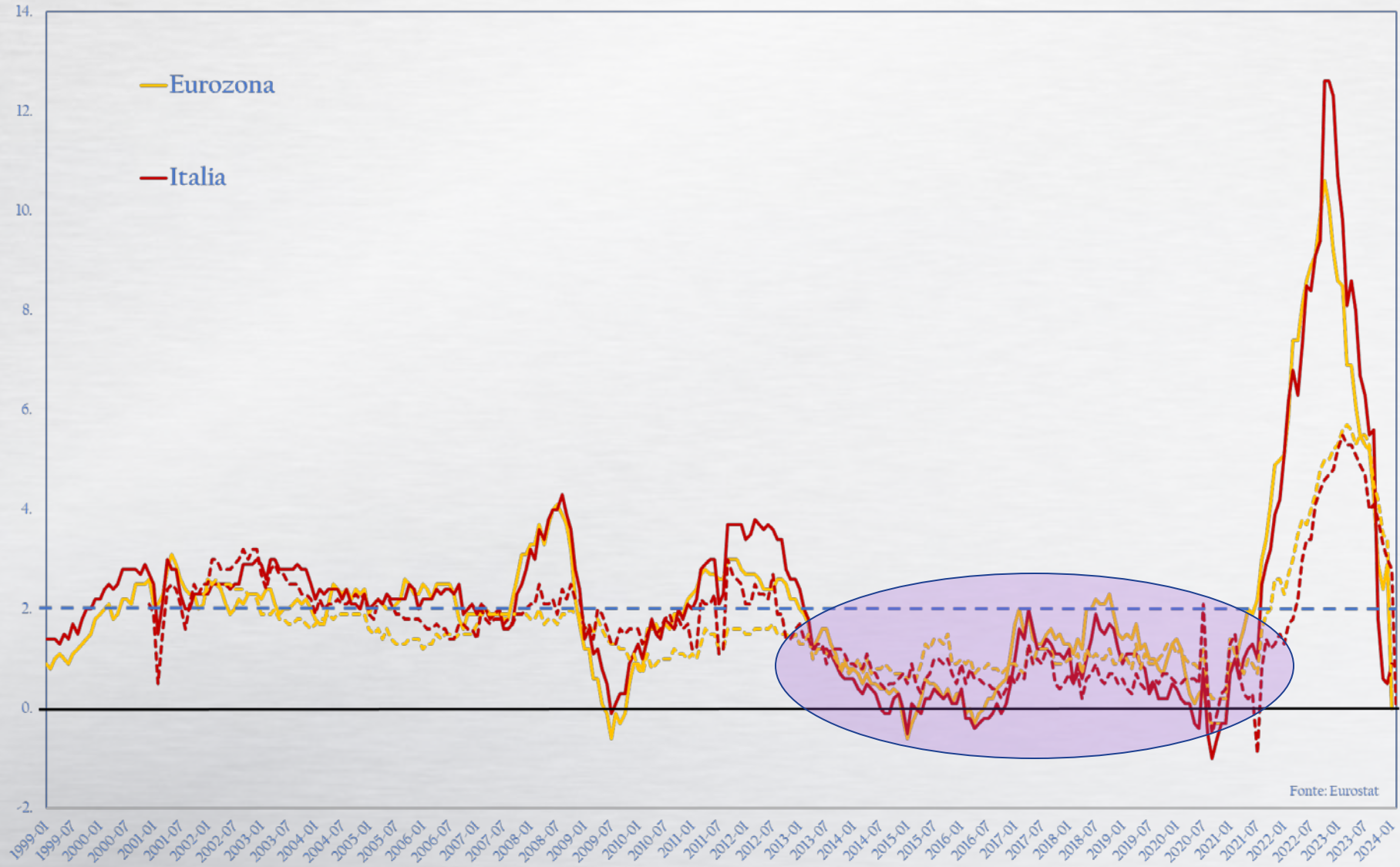
# Green Public Investment is Better than you Think

Batini, N., et al (2022) 'How Big Are Green Spending Multipliers?' in Cerniglia F. and Saraceno F. (eds), *Greening Europe. 2022 European Public Investment Outlook*. Cambridge: Open Book Publishers.

- IMF researchers estimate multipliers for categories of expenditures
  - Every dollar spent on key carbon-neutral or carbon-sink activities can generate more than a dollar's worth of economic activity ( $\frac{\Delta GDP}{\Delta Exp} > 1$ )
  - Multipliers associated with spending on renewable are larger than fossil fuel energy investment ones (1.1-1.5 versus 0.5-0.6)
- Stabilizing climate and reversing biodiversity loss are not at odds with continuing economic advances.

# A Step backward to understand the future

## Inflazione



Fonte: Eurostat

# The Lessons of the Crisis

- 2007-2009: The Global Financial Crisis
  - Governments and central banks work together
- 2010-2014: The Sovereign Debt Crisis
  - Synchronisation instead of coordination, between the centre and the periphery (German frugality)
- 2014-2019: Secular stagnation?
  - The ECB does its job with Quantitative Easing. But without governments...
- 2020: Covid
  - Governments in the front row with the EU and the ECB having their back
- 2021-2023: Inflation
  - Monetarism: Inflation is always and everywhere a monetary phenomenon

The importance of the Policy Mix!



# Lessons from the Crisis for Reform #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

# Restoring Fiscal Space in the EU: Choose where, but create fiscal capacity!

- 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
- Two possible ways
  - Keep most of fiscal policy national and radically reform fiscal rules
  - Create fiscal capacity at the center and constrain Member States (the US model)
- The debate on the reform of rules should go hand in hand with the debate on the creation of a central fiscal capacity

# 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 New Stability Pact. Much Ado about Nothing?

- A decent proposal by the Commission (November 2022)
  - Country-specific Debt Sustainability Analysis
  - Country ownership of fiscal adjustment path
  - Medium run perspective
- The return to the past of the German Government
  - Commission proposal transformed in an empty shell
  - Yearly targets and one-size-fits-all are resuscitated
- The new Pact leaves the hands of governments tied. No possibility to tackle the challenges

# A European Central Fiscal Capacity

Buti, M. and M. Messori (2022) 'A Central Fiscal Capacity in the EU Policy Mix', *CEPR Discussion Paper Series DPI17577*(October).

- With the new rule Members States' fiscal space will remain very limited. We must create capacity to act at the center
- The European central fiscal capacity (CFC) should be endowed with the classic roles of fiscal policy
  - Stabilization
  - Enhancing structural change
  - Global public goods
- The CFC is more efficient than national policies on the three counts
  - Lower Pressure on Member States with demand shocks
  - Supporting reforms and provision of public goods in the case of supply shocks (avoid stagflation)

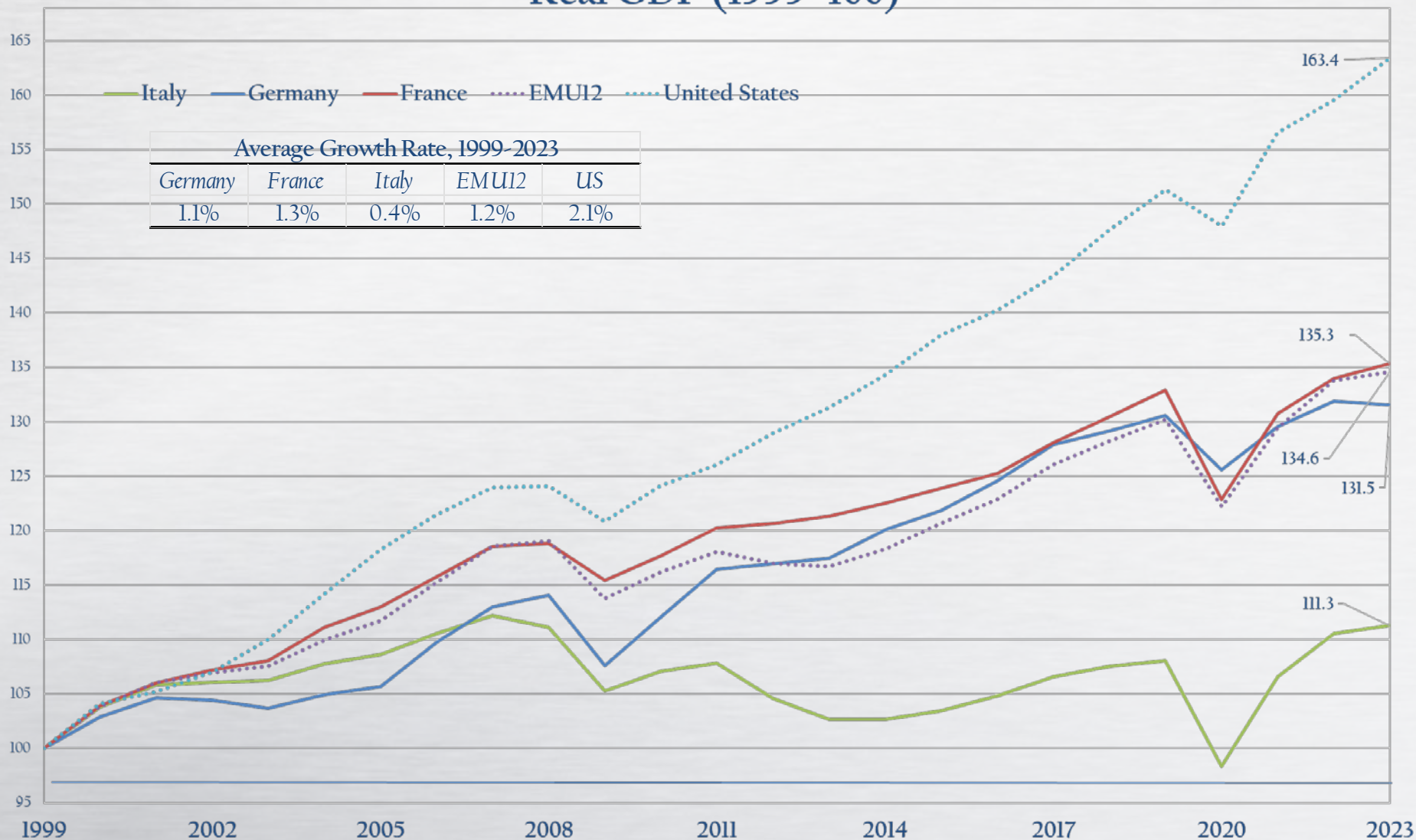
# Some Comments

- The issue of resources: the taxation of multinationals is one of the central topics of the coming years.
- *Attention to the democratic deficit!*
  - To whom does the European Minister for Economic Affairs answer?
  - Make sure that checks and balances exist, even at the price of some cumbersomeness of the mechanism



# Conclusion. A Structural Problem

## Real GDP (1999=100)



Source: European Commission

# A Gloomy Conclusion.

- The old world (tie the hands of the State! be frugal!) is still very much present in Europe
  - The reaction to inflation
  - The reform of the Pact
  - Public Investment.
- Europe is not endowing itself with the instruments to face the challenges of transition and sustainability.
- While we look backwards the world is not waiting. After EVs and solar cells, in what other sectors will we be outpaced by China?
- Germany's involution weighs on the rest of Europe.





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## Francesco Saraceno La scienza inutile

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Tutto quello che non abbiamo  
voluto imparare dall'economia  
Con un saggio di Martin Wolf



5/7/2024

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Francesco Saraceno

Oltre le banche centrali

Inflazione, disuguaglianza  
e politiche economiche



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## Francesco Saraceno La riconquista



Perché abbiamo perso l'Europa  
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