# Consequences of New Macroeconomic Insights for Economic Policy and Economic Performance in the Europe

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# Idea of this talk

- Discuss some new economic insights
- Discuss potential impact on economic policy
- Discuss relevance for economic growth in Europe

# Four Areas of Macroeconomic Research

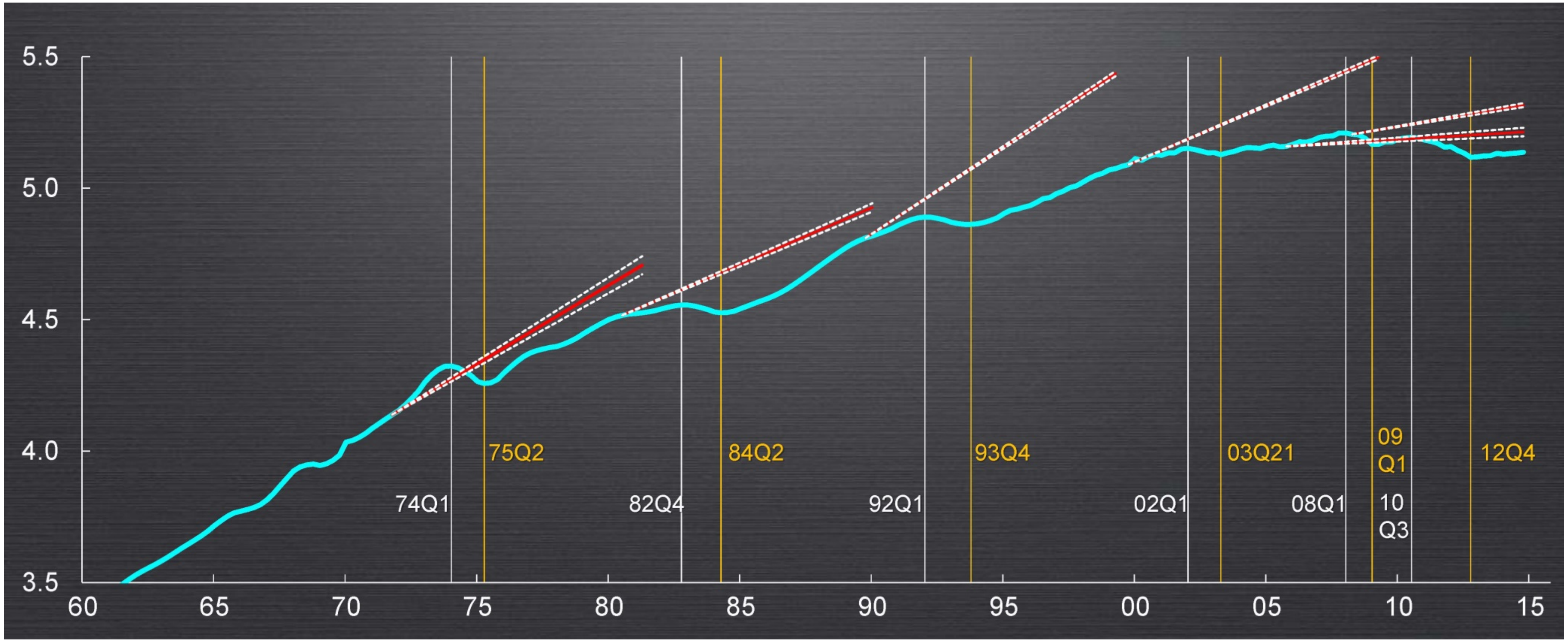
1. (Super) hysteresis & secular stagnation
2. Causes of the Euro crisis
3. Keynesian economics & fiscal policy
4. Monetary policy

# (Super) hysteresis &

# Secular stagnation

# Growth before & after recessions

## Portugal log real GDP




Source: Blanchard, Cerutti, and Summers (2015)

# Hysteresis versus Secular Stagnation

**Hysteresis:**

- Recessions, especially unemployment, has permanent damage
  - (Regular) hysteresis: pemananent level effects
  - Super hysteresis: growth rate affected
  - Many stories: Loss of human capital, loss of networks

**Secular stagnation:**

- More than just a long recession or period with low growth
- Some **disequilibrium** that does not automatically disappear

# Secular Stagnation Example

- **Young:**
  - Work
  - Borrow funds
- **Middle-aged:**
  - Work & run firms
  - Save to invest
  - Save by lending to the young
- **Old:**
  - Eat their savings

# Secular Stagnation Example

- Suppose supply of savings middle-aged $\uparrow$

  supply of savings $>>$ demand for funds

- Standard mechanism:
  $\Rightarrow$ interest rate $\downarrow$ $\Rightarrow$ demand for funds $\uparrow$

# Secular Stagnation Example

- Standard mechanism **less likely** to happen if

need for funds not very sensitive to interest rate
and/or
equilibrium real interest rate low or negative

- Standard mechanism **impossible** if

equilibrium real rate < - inflation $\Rightarrow$ negative nominal rate

# Secular Stagnation Example

- If savings middle-aged $\uparrow$ $\Rightarrow$ less demand for consumption goods
- If standard mechanism does not work

  $\Rightarrow$ reduction in demand for goods **not** compensated
  $\Rightarrow$ middle-aged sell & produce less
  $\Rightarrow$ middle-aged have less income
  $\Rightarrow$ actual outcome attained by middle-aged **not** saving more

# Consequences for Economic Policy

**Fiscal policy:**

- Really good time for
  - Government investment: infrastructure, education, health care
  - Structural reforms

**Monetary policy:**

- Increase inflation target

# Consequences for growth in Europe

- Increase in government investments highly unlikely
- Increase in inflation targets unlikely
- $\Rightarrow$ secular stagnation remains a concern
- $\Rightarrow$ pessimistic outlook

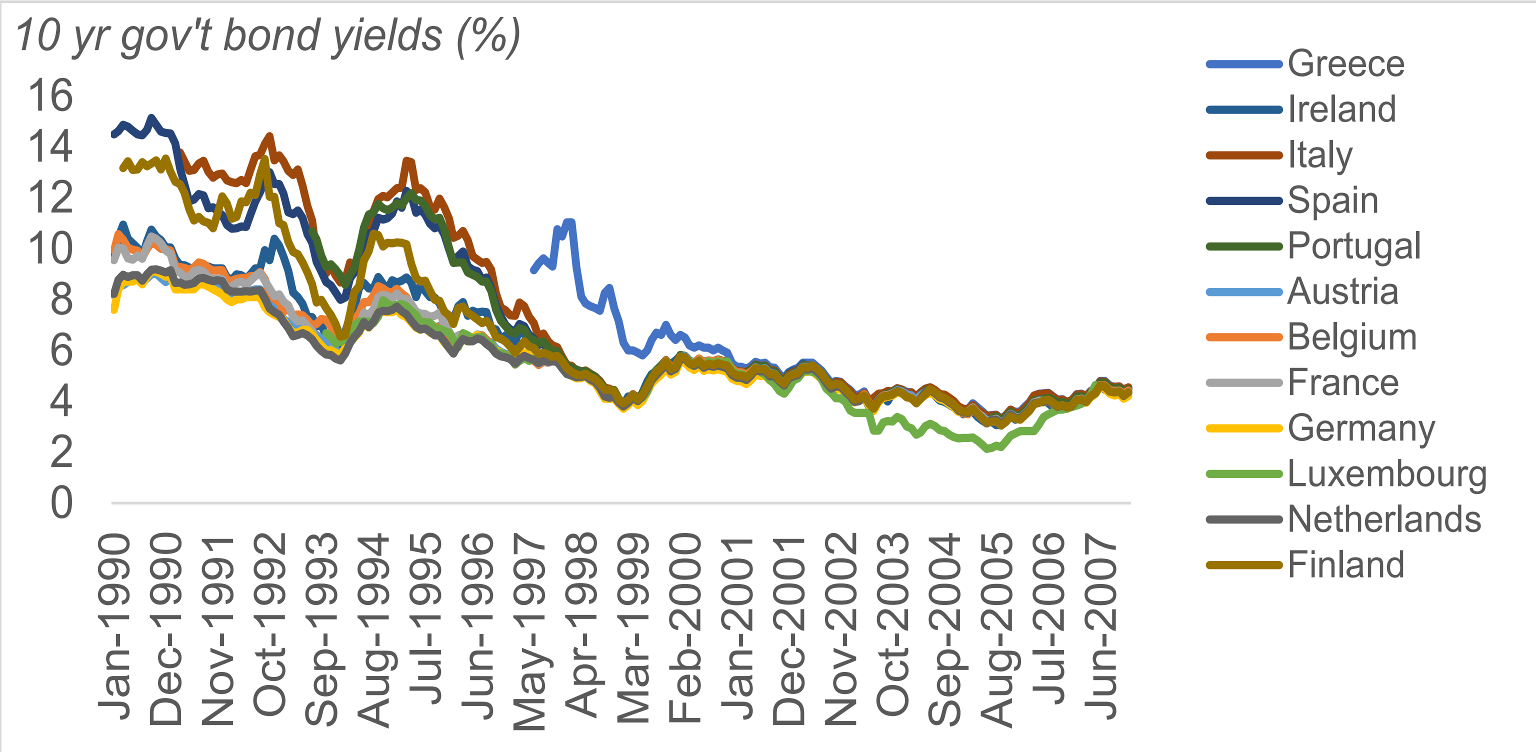
# Causes of the Euro Crisis

# Causes of the Eurozone crisis

**Not** irresponsible sovereign debt accumulation!

- Except Greece

1. Large current-account imbalances
2. Large/unhealthy financial sector
3. No governance structure to detect risk and deal with crisis

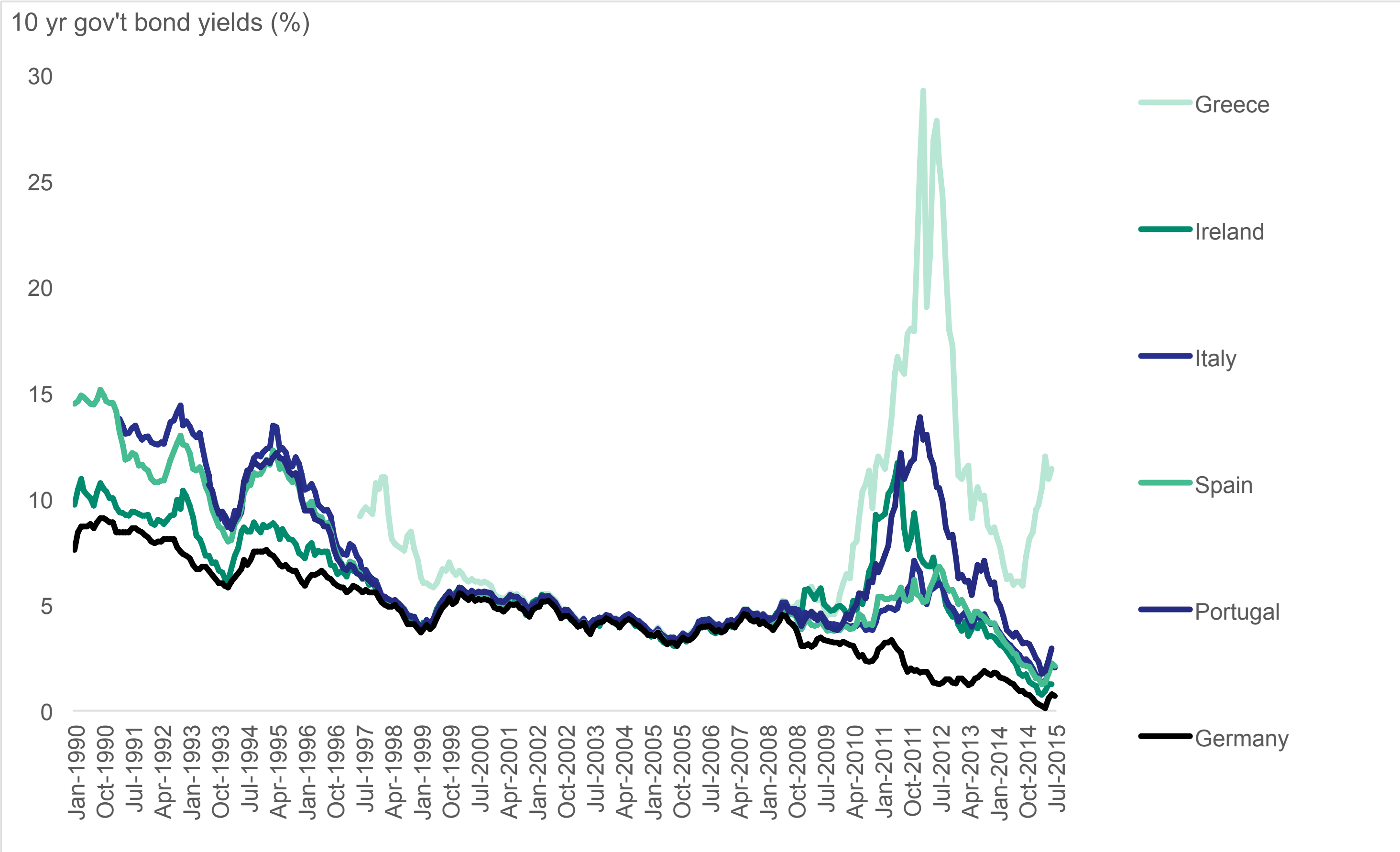



Eurozone sovereign debt yield spreads vanished, …

# Cumulative current-account balance
## 1999-2007 (% of own GDP)

| GIPSI countries | |
|---|---|
| Greece | -84% |
| Ireland | -21% |
| Portugal | -96% |
| Spain | -60% |
| Italy | -8% |

| FANG countries | |
|---|---|
| Finland | +61% |
| Austria | +16% |
| Netherlands | +48% |
| Germany | +27% |




But spreads reappeared!

# Eurozone Imbalances

Large current-account imbalances

- $\Rightarrow$ Periphery financed deficits by borrowing from core countries
- Capital flows went to non-tradable sectors
- When confidence plummeted $\Rightarrow$ foreign lending stopped = **"sudden stop"**

# Eurozone Financial Sector

- Large financial sector; in some countries very large
- Unhealthy balance sheets: low equity and bad assets
- Very exposed to own government sector

# Large financial sector

# Governance Problems

- Periphery countries did not have the usual lender of last resort:
  - Central banks can guarantee that sovereign debt can be rolled over; ECB not allowed to do this $\Rightarrow$ Euro-denominated borrowing similar to borrowing in foreign currency
- Stability and Growth Pact did not work
- Eurozone banks were overleveraged, but oversight left to individual countries
- No joint response mechanism $\Rightarrow$ ad hoc crisis management

# New Theoretical Insights?

The are several, but many macroeconomists stress **old wisdom** that the Eurozone is not an **optimal currency union**

# Consequences for Economic Policy

1. Banking union
2. Euro exits?
3. Substantial financial reform?
4. Fiscal union?
5. Euro bonds?

# Consequences for Eurozone growth?

- Lots of uncertainty!
- No convincing structural improvements any time soon
- $\Rightarrow$ at best low growth

# Keynesian Economics &

# Fiscal Policy

# New & Old Keynesian Macroeconomics

**New Keynesian** paradigm:

- All about sticky goods prices

**Old Keynesian** paradigm:

- Firms do not hire because of concerns they cannot sell & consumers do not buy because of job concerns

# “Old” Keynesian Models

Simplest possible macroeconomic model:

$$C_t = a + b(Y_t - T_t) + \cdots$$

$$Y_t = C_t + I_t + G_t$$

- $C_t$ : consumption
- $I_t$ : investment
- $G_t$ : government expenditure
- $T_t$ : taxes
- $Y_t$ : **current-period** income

If $b$ large $\Rightarrow$ effect fiscal policy strong

# Fiscal policy in Keynesian Models

Traditional view about "*b*":

- **High *b*: Poor** people that cannot borrow: $C$ depends on **current** income **(hand-to-mouth consumers)**
- **Low *b*: Rich** people: $C$ depends on **life-time** income
- Rich people more important for aggregate
- $\Rightarrow b$ not that high $\Rightarrow$ fiscal policy not very effective

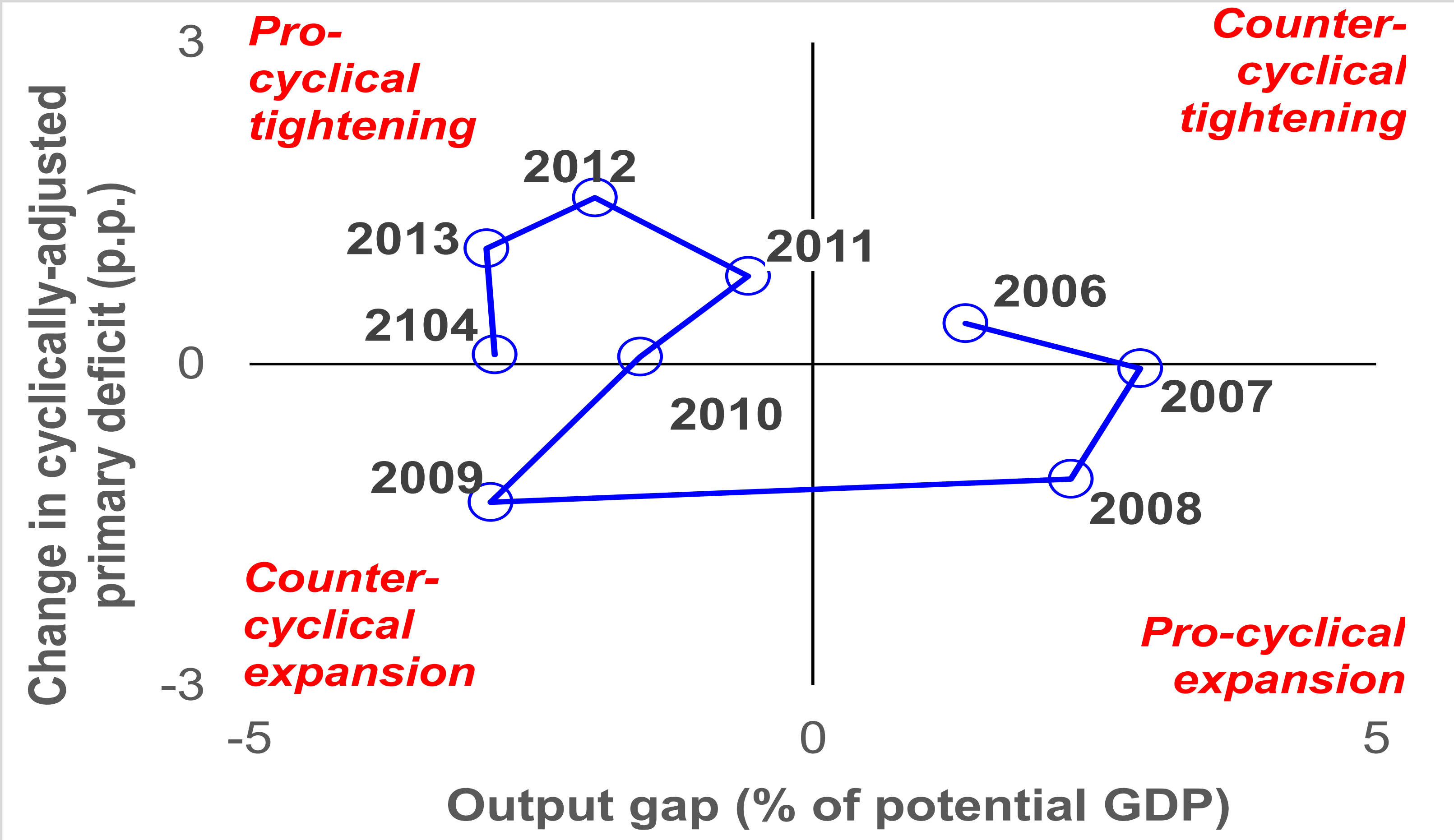
New evidence:

- **Empirical:** There are many **rich** hand-to-mouth consumers
- **Theoretical:** If central bank's policy interest rate $\approx 0 \Rightarrow$ fiscal policy can be effective even if there are not many hand-to-mouth consumers

# Consequences for Economic Policy

- Keynesian fiscal policy has become very popular again among academics
- What about politicians?

# Financial Crisis & European fiscal policy




Source: Baldwin and Giavazzi (2015)

# Consequences for growth in Europe

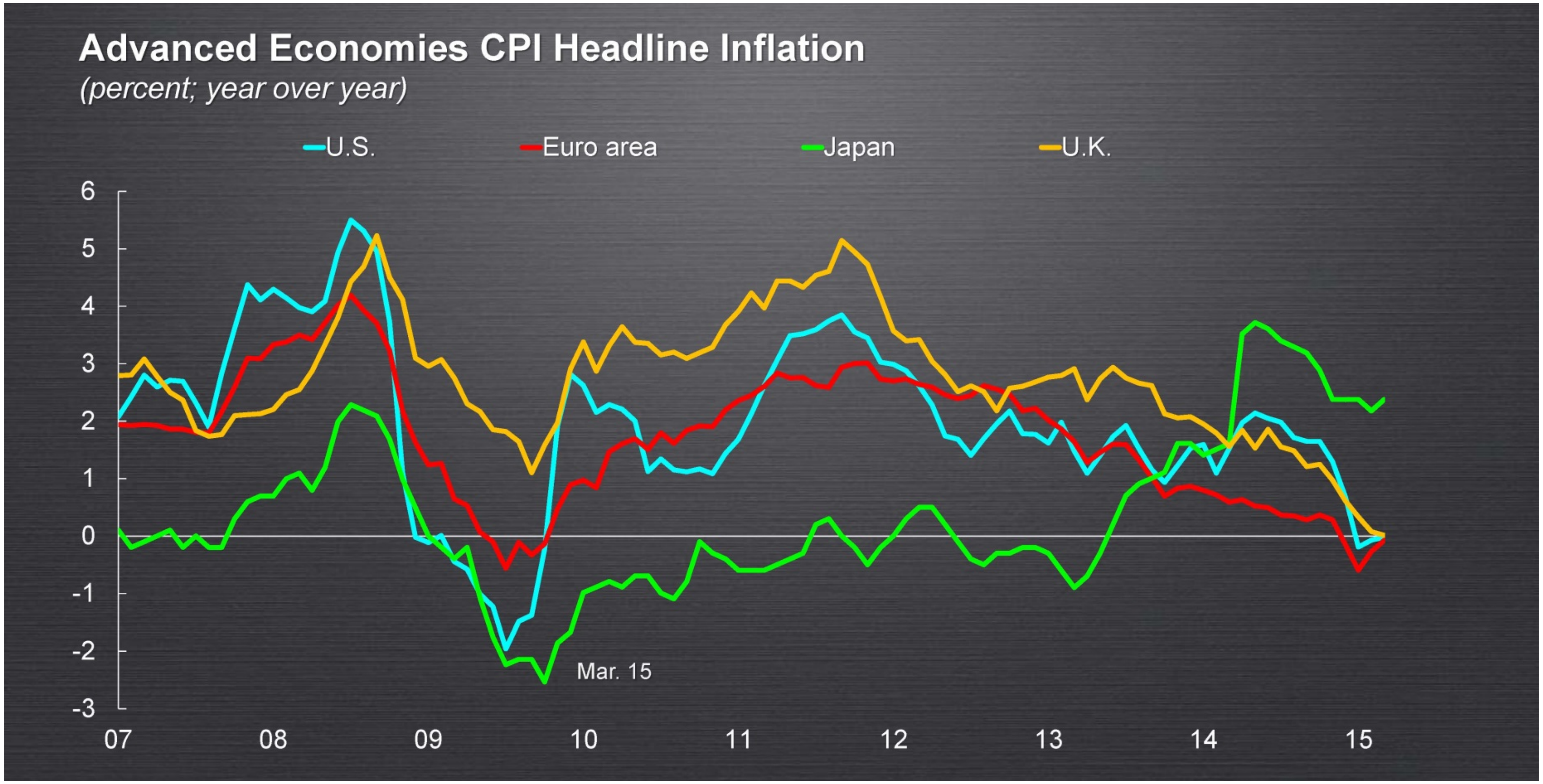
- Austerity popular among European politicians
- $\Rightarrow$ pessimistic short-term outlook for economic growth

# Monetary Policy

# Monetary Policy During Financial Crisis

- Flattening of Phillips curve:
  - Large unemployment fluctuations, **but**
  - Inflation remained relatively stable
- Very expansionary monetary policy
  - Policy interest rates close to zero
  - Large asset purchases: Quantitative easing
  - Forward guidance

# Crisis and Deflationary Pressure?




Source: Blanchard, Cerutti, and Summers (2015)

# Theoretical developments

- How to stimulate an economy when policy interest rate is at zero lower bound
- Forward guidance can be very powerful when
  1. policy interest rate is at zero-lower bound and
  2. central bank commits **now** to future policy that will be wrong policy in the future
- Forward guidance can also be helpful in better explaining central bank's views & intentions
- Theoretical support for QE based on old-fashioned models

# Consequences for Economic Policy

- Flattening Phillips curve: Target real activity not inflation?
- Structural changes to allow more easily for negative interest rates?
  - Increase the target inflation rate?
  - Wörgl Experiment 1932-33
- Will monetary policy be more responsive to signals of financial risk such as increased leverage

# Consequences for growth in Europe

1. More experienced central bankers & new tools
2. Future monetary policy uncertain

- Unclear what set of policy tools will be used in practice
- Unclear how and when central banks asset positions will be unwinded
- Unclear how prudential policy will interact with traditional monetary policy

#1 is probably good for economic growth

#2 is probably good **not** for economic growth