Growth, Investment and the Golden Rule

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A New Consensus on the EMU Crisis

- 2014 has been (yet another) turning point of the Eurocrisis
- Slow slide towards deflation (and deteriorating expectations)
- 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

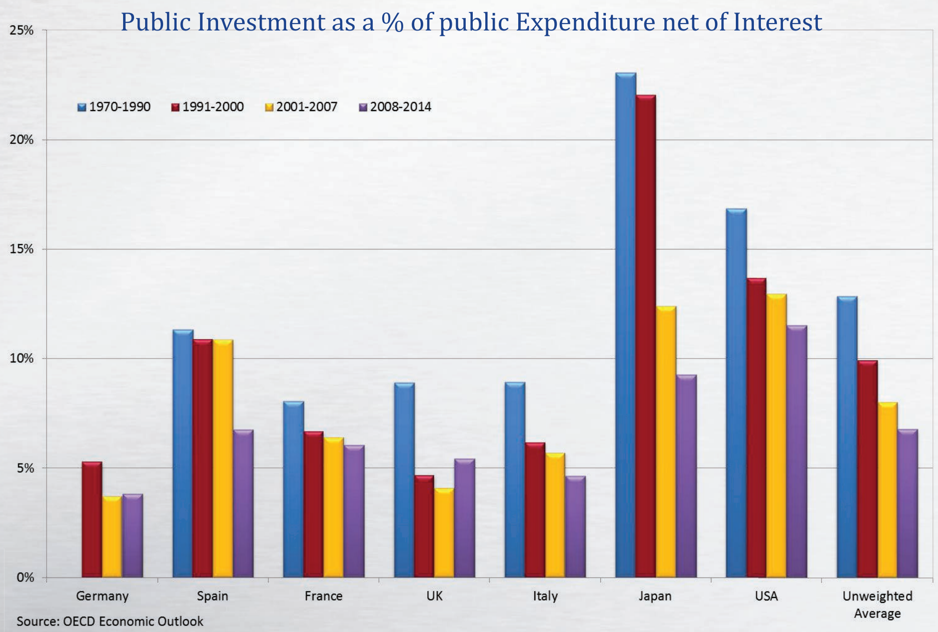
Luckily we Have SuperMario…

- 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 2015, 1% of GDP (1.3% in 2016). A third of the Juncker Plan.
  - Peripheral countries have no margin
- Draghinomics is not really a revolution. Compare Japan with the EMU!

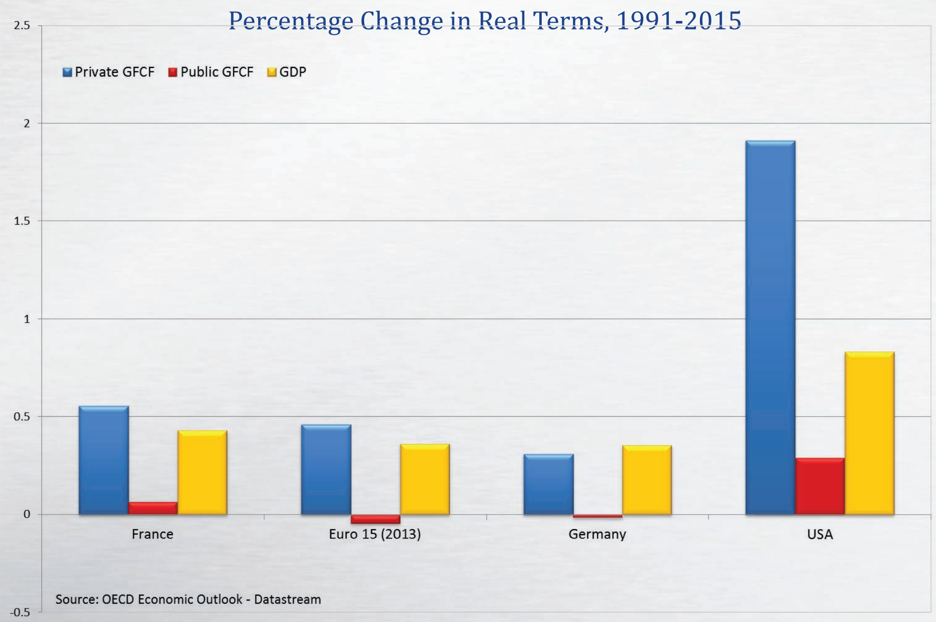
Public Investment is Key

- Yet, even if timid when compared to the US and Japan, the 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, 2013)

The Public Investment Problem



The Public Investment Problem



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 Marshall 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

The Juncker Plan. Much Ado for Nothing?

- Le Mogne Saraceno and Villemot (2015)
- Assessment of the Juncker Plan
  - Simple DSGE model with public capital in the production function (Leeper et al, 2010)

$$Y = Z_t K_{t-1}^{\alpha} L_t^{1-\alpha} G_{t-1}^{v}$$

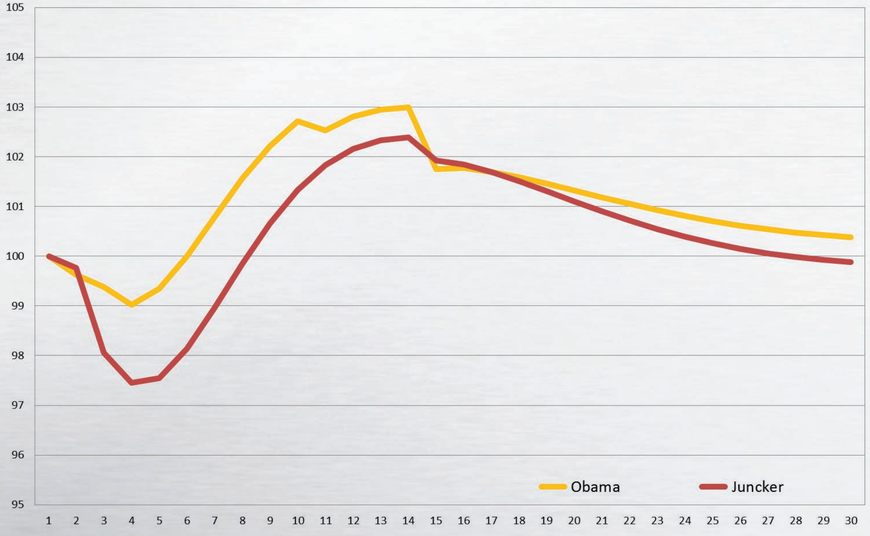
  - Patient/impatient households to calibrate multipliers
  - Time-to-build of public capital
  - Crowding-in of private investment (leverage)
  - Fiscal rule for debt reduction
  - Estimated on EMU Data (source: EABN "Area Wide Model")
- Three exercises:
  - Impact of the plan in normal times
  - Impact of the plan at the ZLB
  - Comparison with the Obama 2009 stimulus plan

The Juncker Plan. Much Ado for Nothing?

- Here I focus on impact of the plan at the ZLB
- We have a negative (preference) shock that brings the economy at the ZLB
- We add a second, public investment positive shock
  - Size can be bn 800 (Obama) or bn 60xleverage (Juncker)
  - Public investment shock can happen immediately (Q2) or with a delay (Q10)
- We played with leverage (= 0, 3, 5). Here I show the case in which leverage is 5 as expected
- Maximum leverage, plus the fact that in DSGE models future shocks are anticipated, puts us in a "best case scenario"

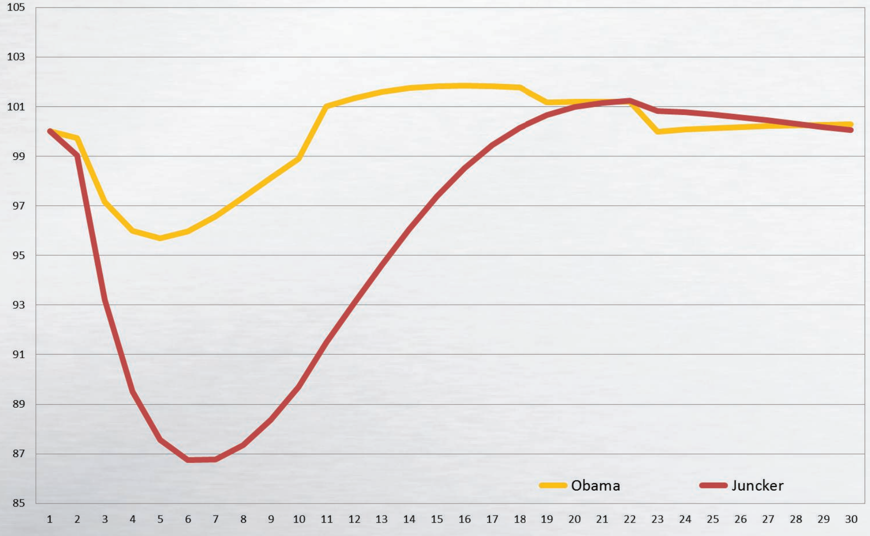
The Juncker Plan. Too Little and too Late?

Juncker vs Obama in ZLB: Output Path with Plan in Period 2



The Juncker Plan. Too Little and too Late?

Juncker vs Obama in ZLB: Output Path with Plan in Period 10



The Juncker Plan. Too Little BECAUSE too Late

- Comparison with the Obama (ARRA) Stimulus Package, the Juncker Plan is too little BECAUSE too late
  - It needed to be more timely, or as an alternative, larger in size
  - This, even assuming the desired crowding-in of private investment (leverage of 5) materializes
- 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: $\frac{D}{GDP} = \frac{Kg}{GDP}$ (with the SGP, $\frac{D}{GDP} \rightarrow 0$)
  - Intergenerationally fair
  - The burden of fiscal consolidation falls on current expenditure

An Assessment of the UK Golden Rule

- Creel Saraceno Veroni (*SJPE* 2009)
- Starting point: Two streams of research…
  - Production Function Approach, originated by Aschauer (JME - 1989)
  - SVAR literature, building on Blanchard-Perotti, originated by Perotti (2004)
- … yielding mixed results
  - Production Function Approach usually finds positive effects
  - SVAR literature usually finds much weaker effects, if any
- Investment features:
  - It takes time to have effects appreciably different from current outlays
  - Has costs and benefits that are spread intertemporally

Hence:

- We built a long run framework to study (public) investment
- Our innovation (in 2009): Explicit consideration of public debt

An Assessment of the UK Golden Rule

- A Simple Theoretical Model

$$y_t = cy_{t-1} + (1-c)[-\tau_t - \delta r_t + \varphi b_t + g_{c,t} + g_{i,t}] \quad \text{(Aggregate Demand)}$$

$$\pi_t = E_{t+1}\pi_t + \nu(y_t - y^*) \quad \text{(Lucas type Agg. Supply)}$$

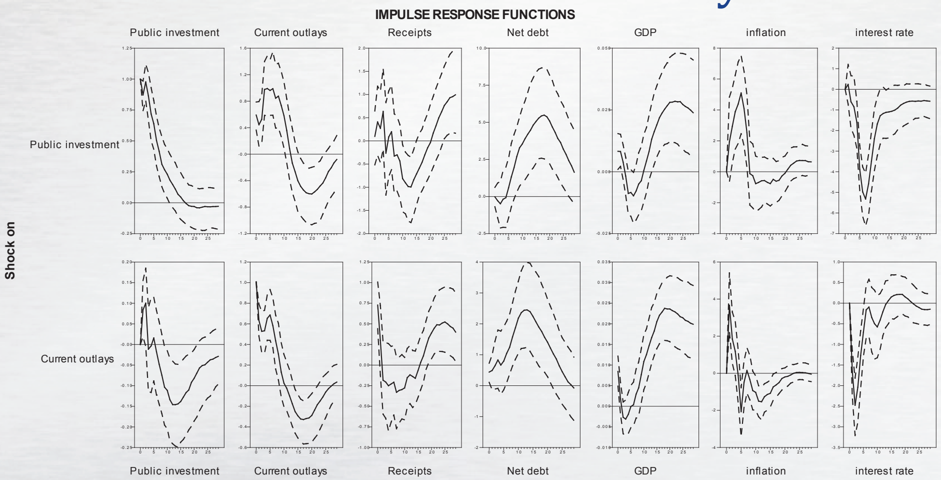
$$b_t = b_{t-1}(1+r_t) - \tau_t + g_{i,t} + g_{c,t} \quad \text{(Debt accumulation)}$$

$$\tau_t = \tau^* + h(b_t - b^*) \quad \text{(Fiscal authority reaction function)}$$

$$r_t = r^* + \alpha(\pi_t - \pi^*) \quad \text{(Monetary policy reaction function)}$$

- Strategic interaction of fiscal and monetary authorities
- Feedback effects of public spending through debt and taxes
- “spend and tax” fiscal rule

A Benchmark SVAR with Debt Dynamics



- Short-mid term effects of public investment as in benchmark
- Long run positive effects (and no long run effects for current outlays)
- Debt goes back to normal: Investment "pays for itself“ (beware IMF, we said it earlier!)

An Indirect Assessment of the Golden Rule

- We used the same model to compare the IRF with two samples 1972:1997 and 1972:2004
- The differences may be attributed to the Code for Fiscal Stability
- Effect of public investment less important in the sample not including the GR years
- We could (indirectly) conclude that the results on the full sample were driven by the years in which the Code for Fiscal Stability was operational

A Golden Rule for Public Investment

- Introducing the Golden Rule for the EU is not a new proposal
- In the past rejected 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 Enhanced 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 SGP deficit figures
- These expenditures are not necessarily in physical capital
- Countries implementing joint projects could be given incentives (EIB loans?)

Where There's a Will There's a Way

- Saraceno and Streho (in progress)
  - For the SGP, excluding investment from deficit figures only required secondary legislation (Blanchard and Giavazzi, 2003)
  - It is unclear whether this carries on to the Fiscal Compact. The two regulations annexed to the Amsterdam Treaty still exist, but there is debate as of whether they are overruled by the Fiscal Compact
  - The fact that the Compact is an intergovernmental Treaty (2 countries did not sign) complicated things
  - But, even assuming a Treaty change is needed, political will may suffice. 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

Conclusion

- Lacking the political space for a truly European budget and investment plan, the introduction of a Golden Rule can be seen as an (imperfect) second best
- A properly designed, Enhanced Rule, could delegate the definition of investment to a democratic process, thus overcoming the main weakness of the "standard" Golden Rule
- The Enhanced Rule may become a tool for coordination of investment. A Surrogate of much needed EU industrial policies
- While the introduction of the rule should pose no major legal challenge, even if it were not the case, the existing framework allows sufficient flexibility to adopt the Enhanced Golden Rule by means of a political decision by the Council