RECHERCHE ET EXPERTISE SUR L'ÉCONOMIE MONDIALE

Stabilization and growth enhancement are intertwined and need new governance approach

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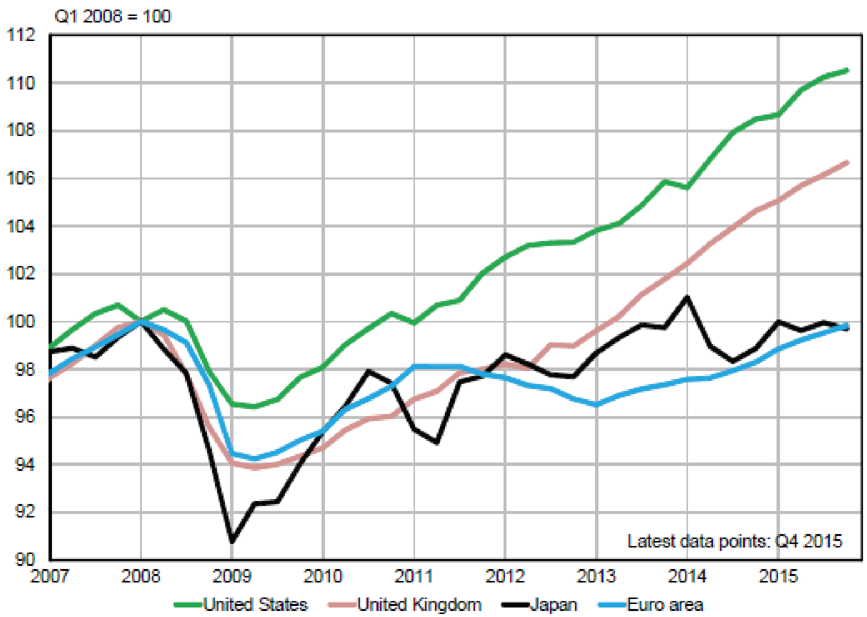
Subpar growth and macro divergences in EA

The dismal performance of EA was self-inflicted

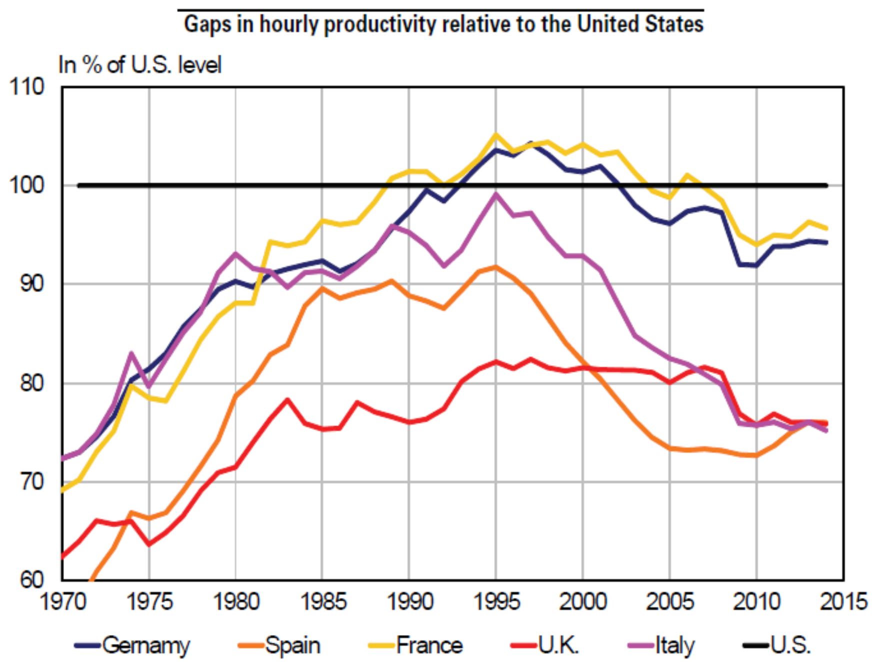
GDP growth in main advanced



Sources: National statistical institutes.

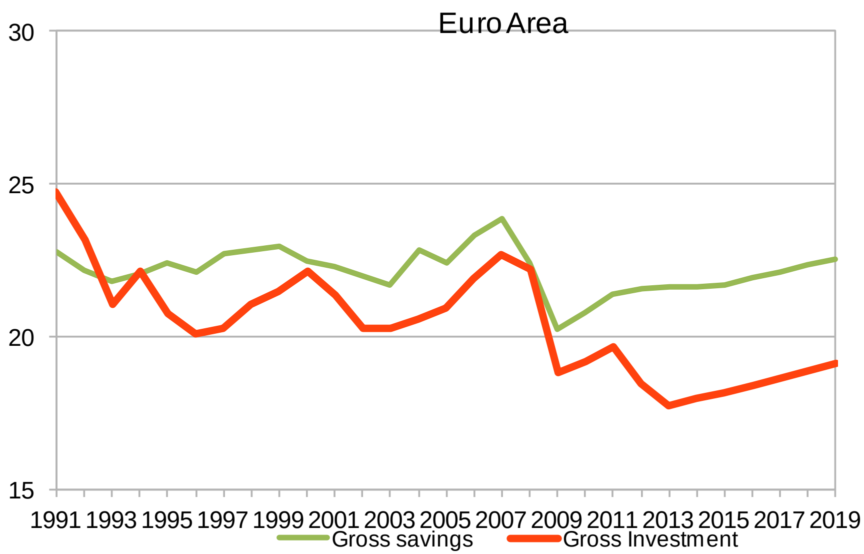
- The lost decade: after 2 years of recession (2011-13) on top of the financial crisis that was much deeper than in the US, GDP in EA will barely reach the 2008 level in end 2016, not taking account of the consequences of Brexit
- 3 major errors of economic policy changed the course of the euro zone:
  - *The cleaning of bank balance sheets was delayed*→ credit paralysis that is still going on nowadays
  - *The Greek crisis was allowed to spread to solvent countries* → vicious circle public debt/ bank net wealth deterioration + money market fragmentation and freezing counterparty trade
  - *Much too fast simultaneous restrictive fiscal adjustments*→ recession (2011-13) → high multipliers and ↑ in public debt ratios because multipliers worked in reverse

Supply side problems focus on the productivity slowdown and are not what is commonly believed



- Germany and France have the same long-run performance: a moderate relative decline/ US after the financial crisis
- The UK (supposed to have the most flexible labor market) has been the worst performer since the mid-1990s
- Italy had strong productivity growth until the mid-1990s and reversed dramatically thereafter:
  - Did their labor market become abruptly rigid ?
  - Or did the huge capital inflows triggered by the perspective of the euro give rise of massive capital misallocation?
- Spain's recovery must be relativized: very modest after the havoc made by capital inflows

The main culprit is the protracted deficiency in investment demand giving rise to chronic excess saving

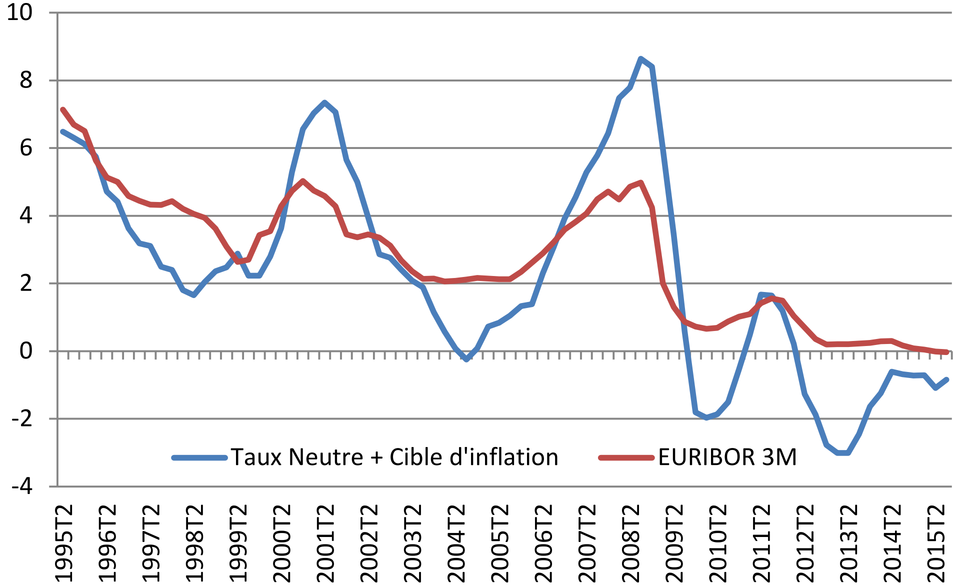


- The imbalance is concentrated in Germany with current account surplus > 8% for several years, violating a basic EMU macro rule for the sake of neomercantilism.
- In a monetary union the consequences are devastating since symmetrical fiscal adjustment, which is the necessary substitute for the lack of exchange rate adjustment, is thwarted.
- The consequence is the unequivocal: run to “competitiveness” of debtor countries, which is the passport for deflation, giving rise to high risk aversion.
- If all EA countries want to become alike Germany, declining world growth will not absorb their aggregate surplus.

CEPII

Long run decline in the real return on capital: the "natural" interest rate that drives investment demand to levels compatible with potential GDP overtime has collapsed after the crisis and never recovered

- US estimate of natural interest rate (Laubach and Williams)
- ECB estimate of natural interest rate in EA

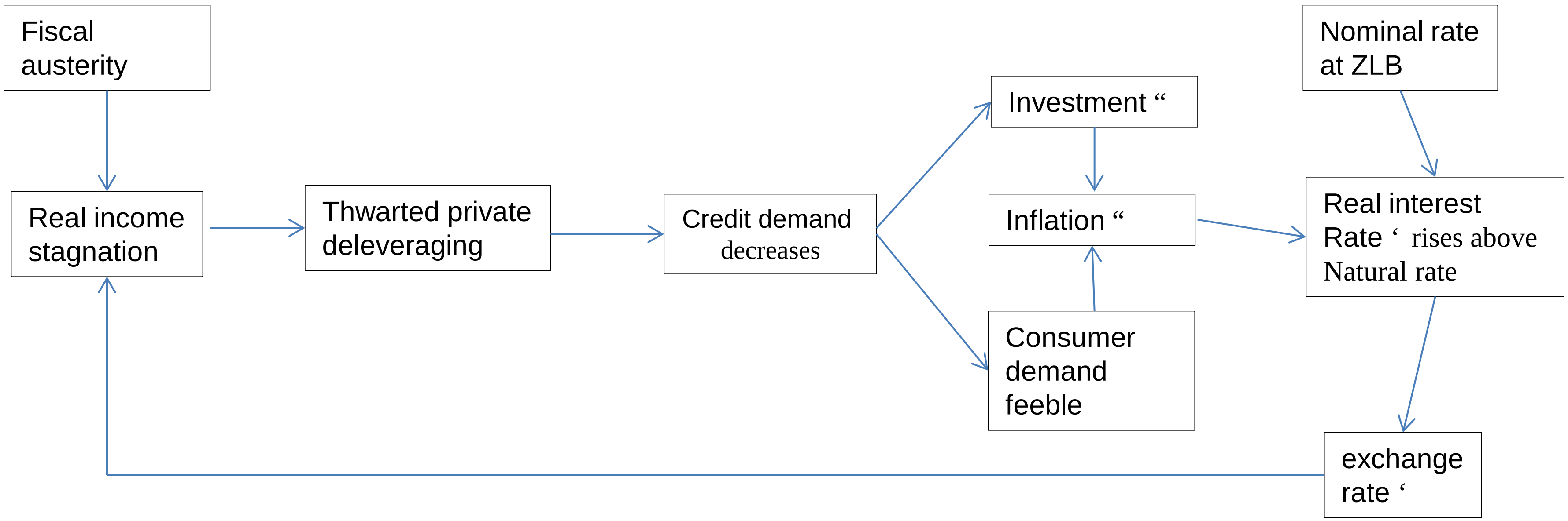


What is the source of the dramatic decline in the net marginal return on capital?

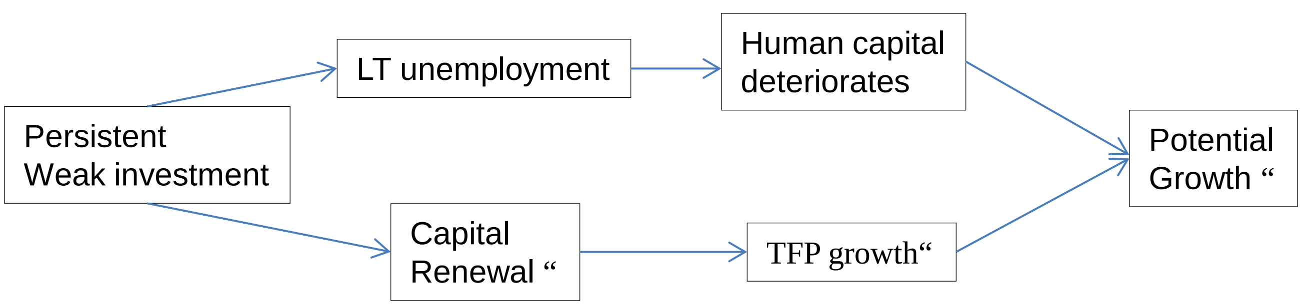
- Under competitive conditions:
  - Net marginal return= gross marginal return- depreciation rate + or - capital gain/loss
  - Gross marginal return= (gross invest/capital)= (invest/ VA)(VA/capital)
  - Real gains or losses=Δ(price of capital goods)- Δ(price of VA)
- Net marginal return on capital ↓ with:
  - Investment ratio ↓
  - VA /installed capital ↓
  - Depreciation ratio ↑ to absorb real capital losses due to crisis
  - Relative price of investment ↓
- After the crisis all factors have contributed to the fall. In the longer run, the decline in the relative price of investment was the principal factor followed by the sagging rate of productive investment everywhere but in the US from 1995 to 2000.
- As long as the return of capital keeps being so low, the cost of capital will not match, considering savers' risk aversion→ low growth becomes a self-sustaining process.
- <0 interest rates (over the min nominal interest rate barrier) are just the symptom of the deficiency in demand expected by markets to last for a long time to come.

The low-growth trap

- Demand side: simultaneous austerity (2011-2013) created a shock that generated high risk aversion and liquidity trap giving rise to self-fulfilling expectation of low growth



- Supply side: protracted weak productive investment thereafter



The two sides of macroeconomic innovation to foster common interest:

- Policy mix for countercyclical action and more symmetrical adjustment (shorter run) *does not require any institutional change*.

- Investor of last resort to raise the real return on capital (longer run) *requires change in Treaty*.

- However both require the awareness of the destructive political forces on the move in Europe and the change in mind necessary to counter them.

Theoretical and political prerequisites for multilateral cooperative governance

- Intergovernmental governance has become a complete mess for many reasons that reinforce one another:
  - Debtor/creditor nations, maximizing their conflicting own interests without taking account of the opposite view, are trapped into *non cooperative* (*Nash*) *equilibria* with multiple shortcomings: half-baked banking union, no countercyclical policy, no medium-term vision.
  - Coordination failures stem from the mix of inflexible rules and intergovernmental negotiations on the brink of fallout.
- Looking at EA as an international political regime (quite ≠ from federalist agenda) requires 2 basic principles to set up a *regime of institutionalized coordination* between sovereigns:
  - *1st principle*: sovereign states can engage in institutional cooperation rather than non-cooperative game without jeopardizing their sovereignty. It can even be enhanced through mutual trust rather than mistrust, trust building up as the side product of ongoing cooperation.
  - *2nd principle*: rules are not logically alternatives to macro management. Rules make the institutional framework upon which policy decisions operate→ regime of constrained discretion
- The political configuration that will emerge is *shared common public goods by differentiated sovereignty*.
- Not all EA countries might be able to agree with the 2 basic principles: a model of an *open club* might be the most feasible to start the process.

Reforming European Semesters for macroeconomic stabilization according to the spirit of the TSCG

- Macro stabilization implies countercyclical policies at both EA and national levels→ *contingent and symmetrical* rules within an EA policy mix is what the TSCG was for. However governments violated 2 basic rules:
  - Start with an overview of aggregate macro conditions whose conclusions determine the overall fiscal stance before sharing the adjustment according to contingent rules
  - Ban excessive current account surplus for minimal symmetry in adjustment.
- Improving institutional framework to operate the rules:
  - Creating an independent *Fiscal European Agency and organizing a network of the High Councils of Public Finances* to assess the macro situation of EA for the year ahead and explore leeway of different countries to determine possible fiscal adjustment for the whole before considering the sharing between countries.
  - *Introducing a measure of democracy*: The Fiscal European agency should be accountable before a Commission made up of representatives of National Parliaments The recommendations of the Commission should be binding for the Council.
- The Fiscal European Agency could be empowered to activating a pure *countercyclical stabilization fund*, based upon relative output gaps between member countries, to take care of asymmetrical shocks within EA, while global shocks are dealt with by the policy mix, i.e ECB and aggregate fiscal policy.

To enter the new industrial revolution for sustainable growth there must be a borrower and investor of last resort

- The new industrial revolution involves *European public goods* and sources of innovation that require massive investments (infrastructural and cognitive) that are transnational to keep a technological leadership in world competition

- Institutionalized cooperation (≠ federal state) better than present non-cooperative game to preserve national sovereignty in a space of shared sovereignty based on citizenship that is both national and European. 2 basic institutional legs and not 1:
  – *Monetary* : the ECB has alone preserved the unity against the destructive forces triggered by the cumulative debtor/creditor divergences in EMU.
  – *Fiscal and financial*: financing the new industrial revolution requires fiscal and financial resources at both the European and coordinated national levels that only a full-fledged Parliament can monitor democratically.

- A full-fledged Parliament is grounded in fiscal authority: *capacity to raise taxes and to issue debt*. What is needed to finance a sustainable growth regime:
  – Democratic public power embedded in the authority of the and issuance of Green Project Bonds under the authority of the European Parliament empowered to raise taxes and issue debt.
  – *Overhauling finance*: promotion of a network of multilateral public development banks under the leadership of EIB, as prime financiers of Lt common public goods.