Comment on David Vines "Fiscal Policy in the Eurozone after the Crisis"

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Outline

1. Post-GFC Fiscal Policy Challenges
2. David Vines, “Fiscal Policy in the Eurozone after the Crisis”
3. Some Thoughts on Fiscal Policy Challenges
4. Conclusion

1. Post-GFC Fiscal Policy Challenges

(1) The G20’s concerted response to the GFC, but the US and Europe continue to suffer

- Monetary and fiscal stimulus provided by major economies in the world, together with the avoidance of beggar-thy-neighbor policies, prevented the world economy from slipping into the repeat of the Great Depression of the 1930s.
- The GFC has had ripple effects on the GIPS Eurozone economies and induced declines in the value of the euro
- Unemployment continues to be high in the US and Europe and the risk of a double-dip looming

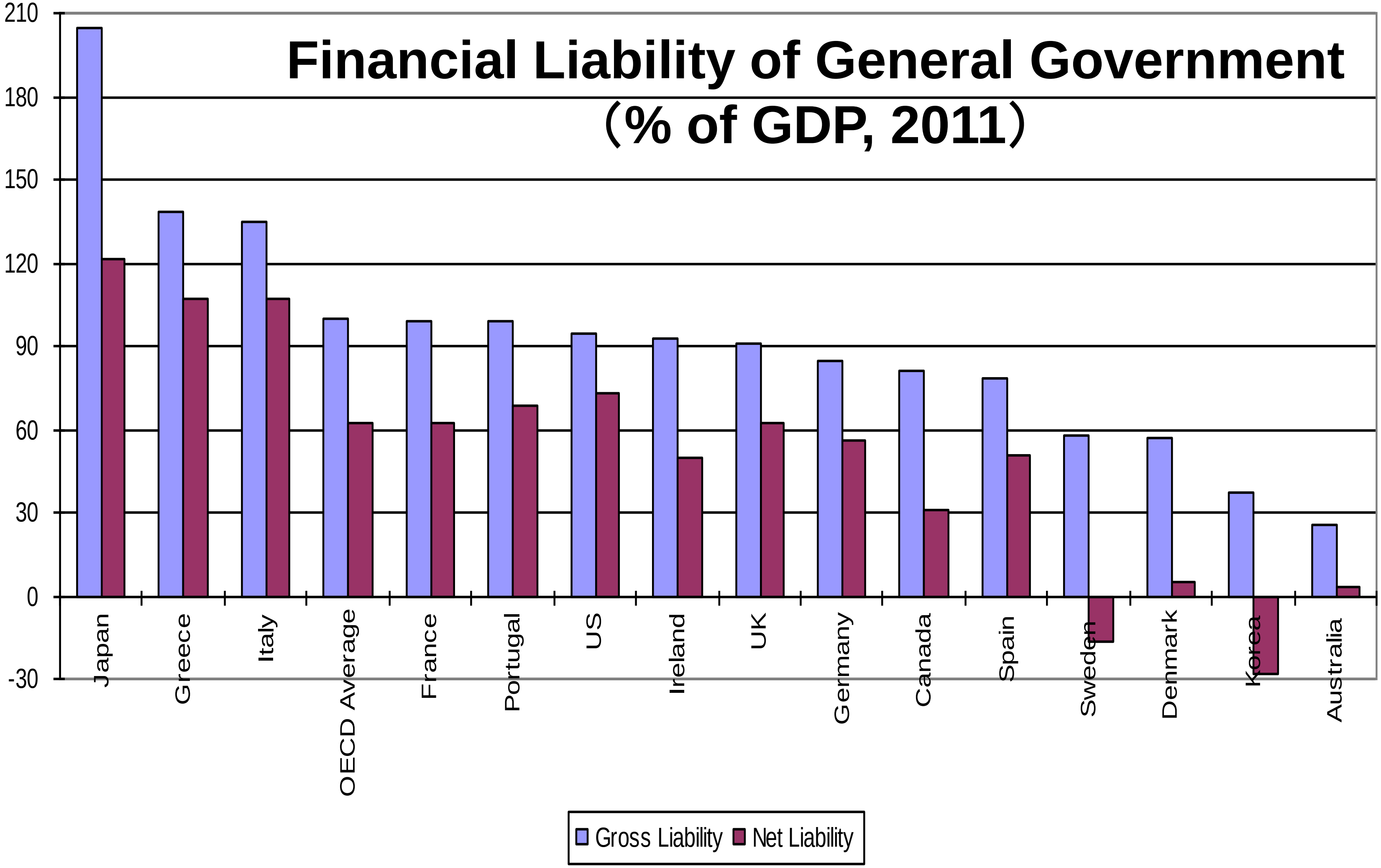
(2) The global economy is decoupling, so are policy directions

- Decoupling of growth and inflation prospects *between* the US and Europe *and* emerging economies (particularly Asian)
- Should the US and Europe unwind fiscal stimulus? Is the UK's recent decision to do so advisable?
- Asian emerging economies are exiting from monetary stimulus to contain inflation and asset price bubbles. Should they do so in fiscal policy?
- The US Fed's QE2 can cause dollar depreciation and have a beggar-thy-neighbor impact

(3) The global economy has accumulated huge public debt

- Public debt consolidation is clearly one of the largest global economic agendas in the post-GFC era
- The GIPS fiscal experience poses a big challenge for the viability of the Eurozone. Should the Stability and Growth Pact (SGP) remain relevant?
- How can highly indebted countries consolidate public debt while pursuing growth?
- In Asia, can the new regional surveillance unit, ASEAN+3 Macroeconomic Research Office (AMRO), conduct meaningful macroeconomic surveillance, particularly in the fiscal area?

Public debt of Japan, Greece, Italy will be the largest among OECD members in 2011



Source: *Economic Outlook* No. 87 Annex Tables - Table of Contents (OECD)

2. David Vines
"Fiscal Policy in the Eurozone after the Crisis"

(1) Global (and intra-Eurozone) adjustment

Prof. Vines claims adjustment requires:

- A change in the relative level of absorption
- A change in the relative prices of goods produced in surplus and deficit countries
- A satisfactory level of global (or Eurozone) growth

This makes sense, but he needs to explain more about why such adjustment is needed:

- It benefits US, UK and others with CA deficits?
- Can CA surplus countries (Germany) benefit?
- East Asia needs rebalancing because it is the only way to sustain growth

(2) Macroeconomic adjustment within the Eurozone

The Walters Critique:

- Intra-Eurozone price convergence requires that the low-price-level countries (GIPS) experience higher inflation than the high-price-level countries (Germany, France)
- But such inflation divergence can create difficulties
- High inflation countries (GIPS) experience (1) real exchange rate appreciation and loss of international price competitiveness, and (2) low real interest rates and high private spending; thereby current account deficits and external borrowing
- Low inflation countries (like Germany) experience (1) real exchange rate depreciation and gains in international price competitiveness, and (2) high real interest rates and low private spending; thereby CA surpluses and external lending

Resolving the Walters difficulties

The solution should be to accelerate price convergence, while managing the transition

- through fiscal policy adjustment, and/or
- through structural reforms (productivity increase in GIPS)

Prof. Vines focuses on fiscal adjustment and suggests to replace the national-based SGP by a fiscal policy framework to require

- Fiscal contraction in low-competitiveness (high-inflation), CA deficit countries (GIPS)
- Fiscal expansion in high competitiveness (low-inflation), CA surplus countries (Germany)

But he advocates the SGP for the Eurozone as a whole

The first-best solution

Prof. Vine's suggestion is a second-best solution. The first best solution would be:

- Complete fiscal integration
- Complete labor mobility (full integration of the pension system)
- Complete integration of financial crisis prevention, management and resolution

Other desirable structural policies in GIPS:

- To enhance productivity
- More labor market flexibility

In the second-best world, the suggestion makes sense, but…

What are the incentives for countries to adopt such policy rules?

- Will high (low) inflation be always accompanied by a current account deficit (surplus)?
- What can Germany gain from fiscal expansion, apart being the hegemonic leader in the region?

How do we measure competitiveness?

- Unit labor cost? At what level?

How about a current account cap?

- Is 4% a reasonable cap?
- Intra-Eurozone lending and borrowing (in particular through banks) can be limited

(3) What needs to be done for Greece in 2010?

Prof. Vines suggests:

- A combination of demand adjustment, cuts in wages and prices (so that the international price competitiveness rises by 20-30%) and debt reduction (affecting German & French banks)

Basically a sound approach:

- It is a good idea to revive the discussion of SDRM in the Eurozone and globally
- But conceptually speaking, a very large financing arrangement, with a very long maturity, could avoid debt restructuring (including debt reduction)

It will be useful to compare Greece with Asia, Argentina (which eventually left the currency board system) and Latvia (which has kept its CBS)

	Asia	Argentina	Latvia	Greece
Demand adjustment	Large	Large	Large	Large
Nominal exchange rate adjustment	Large	(Large)	No	No
Wage and price cuts	No	Some	Large	Large
Financing	Small	Adequate	Large	Large
Debt reduction	No	Some	No	?

(4) Effectiveness of economic and financial surveillance

- What was the source of failure in macroeconomic surveillance in the Eurozone?
- If the European Commission was not effective, what should have been the alternative arrangement?
- What should be the role of the EFSM and the EFSF in macroeconomic surveillance?
- How about IMF Article 4 surveillance?
- What would be the lesson for Asia where economic and surveillance under AMRO will have to be strengthened?

3. Some Thoughts on Fiscal Policy Challenges

(1) Fiscal policy lessons from the GFC

- Secure sufficient fiscal space in order to cope with economic recessions; put your fiscal house in order in normal times
- Prepare a list of priority fiscal spending areas so that in a recession time, the government can deliver quality spending programs
- Establish a credible framework for conditional cash transfer programs, conditional on incomes, family compositions, etc
- Introduce and improve automatic stabilizer functions
- Put in place supporting structural policies (labor market, bank and corporate restructuring, etc)

(2) Size or composition

Prof. Vines seems to focuses on the size of fiscal spending, but the composition matters

- In the middle of a severe crisis, it is important to support aggregate demand through expansionary fiscal policy
- Tax reductions or transfer increases to households may be the first course of action
- But Japan’s experience suggests that it is important to direct fiscal resources to promotion of R&D, science & technology, future industries (like green industry) and preparation for the aging society (Japan) so as to improve potential output and labor productivity

Size & composition of fiscal packages and other supporting structural policies are essential

	Reduce output gap	Avoid permanent loss of potential output	Enhance productivity & potential output
Size of fiscal stimulus	◎	○	○
Composition of fiscal package			
Infrastructure investment		◎	◎
R&D, science & tech	○	◎	◎
Labor market policy		◎	○
Bank and corporate restructuring	○	◎	◎

(3) Timing of fiscal policy exit

- Too early an exist could jeopardize economic recovery, and too late an exit could create a debt sustainability concern and a rise in long-term real interest rate
- The UK's decision to exit from fiscal stimulus may be premature
- Can the US continue fiscal stimulus?
- Japan's premature exit in 1997-98 from fiscal stimulus was one of the factors behind the economic stagnation in 1998-99, which made fiscal consolidation even more difficult

3. Conclusion

- Post-GFC fiscal challenges are significant
- Mistiming of fiscal policy exit can create problems
- Prof. Vines makes a sensical approach to the Walters difficulties, by suggesting the integration of competitiveness (or inflation) policy and fiscal policy in the Eurozone
- But the Eurozone should pursue fiscal integration as the first best solution.
- How fiscal and monetary authorities should tackle the current difficulties in the West (including Greece and QE2) is very important
- East Asia should pursue growth rebalancing on its own sake

Thank you
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