Comment

Wrong diagnosis: wrong cure

- *The long-successful German economic policymaking doctrine is out of its depth*
- *The whole of Europe is suffering from a chronic shortage of aggregate demand*
- *US-style QE is likely to prove insufficient: major fiscal support may well be needed too*
- *For Germany to accept this, its situation would first have to worsen materially further*
- *Investment in European energy security might square the economic and political circle*

The development of a pre-crisis consensus

A policy consensus emerged in the run-up to the GFC …

Prior to the global financial crisis (GFC), the post-WWII experience in managing the advanced economies had resulted in a *modus operandi* that was broadly accepted as appropriate for the great majority of circumstances:

- **Aggregate demand.** A combination of moderate adjustments in official interest rates; allowing free rein to the operation of automatic fiscal policy stabilisers; and, perhaps, selective macroprudential initiatives, would generally be sufficient to keep the average level of real activity high, and any fluctuations within reasonable bounds.
- **Aggregate supply.** The continual pursuit of structural policies that encourage the flow of resources from declining and less productive activities to growing and more productive activities, serves to enhance efficiency, dynamism and growth potential, and thereby living standards.

Over the decades that it took to reach this consensus, many mistakes were made. The English-speaking, so-called Anglo-Saxon, countries, applying Keynes-like policy prescriptions to issues, and in ways, that he himself might well not have done, often tended to indulge in excessive, destabilising 'fine-tuning' of demand. In over-emphasising the importance of discretionary demand-side policy, and in particular discretionary fiscal policy, they under-emphasised the importance of the supply side. Moreover, on occasion, even governments who portrayed themselves as anti-Keynesian, actively indulged in the short-term manipulation of the business cycle through tax cuts and other measures designed to bolster their electoral support.[1]

In contrast, again generalising for the extended period leading up to the crisis, Germanic policy, with its greater emphasis on the supply side, its scepticism about fine-tuning, and its inherent aversion to deficits and inflation, proved more conservative. And this, in our judgement served the German economy, and others which trod a similar path, relatively well, most of the time.

This time is different

… but it is inadequate for Europe today …

There are occasions, however – perhaps once every fifty or so years – when, rather than dealing with relatively modest perturbations, policy has to grapple with something much more serious: a major, confidence-sapping, debt-augmenting, demand-destructive shock. Under these circumstances, a much more radical response is required than the mid-noughties conventional wisdom. And in that special circumstance the Germanic policymaking doctrine can be found seriously wanting, if not counterproductive.

This, in our judgement, looks increasingly as if it is becoming the situation in Europe. Six years on from the initial crisis, the Continent is suffering from a chronic deficiency of aggregate demand. That is not to say that the supply side does not matter. Nor is it to deny that supply-side reform is important – essential even – if the recovery, when it finally arrives, is to prove durable. It is simply to say that, right now, Europe's over-riding problem lies on the demand side.

… which faces a chronic shortage of aggregate demand

The level of real GDP, particularly around the periphery, remains below its previous cyclical peak and far removed from its pre-crisis trend. Germany aside, labour markets and other measures of macro resource utilisation are acutely depressed. Current account surpluses in the stronger and more fiscally conservative European economies are at historically high levels when expressed as a proportion of national output. Inflation is well below target, and in some cases is negative. Inflation expectations are gravitating downwards. Interest rates are historically low across the maturity spectrum.

Inadequate response

Even if the response to the initial stages of the financial crisis was marked by a certain amount of hesitancy, if not a number of mis-steps (the ECB's unfortunate decision to tighten monetary policy in August 2008, for example), following the Lehman Brothers debacle there was a widespread recognition that the large economies were confronted by a major traumatic event, and policymakers subsequently reacted in impressive concert.

Official interest rates were rapidly slashed towards the zero bound, and in a number of cases central bank liquidity support operations evolved into outright asset purchase programmes. Then in 2009, most government adopted an unambiguously reflationary fiscal stance – expansions of two percentage points or more of GDP were common, and some – notably in the US and the UK – were even bigger than that. Monetary policy, meanwhile, continued to journey down an increasingly unorthodox and expansive path. And this worked. By year end, OECD output had stabilised and begun to recover.

This in part reflects premature attempts at normalisation …

In 2010, some countries continued with fiscal expansion. Others moved to an approximately neutral stance. The one conspicuous exception was the UK, which tightened considerably. Monetary policy meanwhile remained expansive in every sense, with official rates historically low and a number of central bank balance sheets dramatically inflated.

Thereafter, however, the game changed. Although recovery was fragile and by historical standards hesitant and uneven, over the period 2011-13 all countries bar perhaps Japan tightened fiscal policy, and some – especially those around the euro area periphery – by very large amounts indeed.[2]

Monetary policy responses were mixed. While the US, the UK, and Japan continued with variations on the theme of quantitative easing, the ECB, true to the Germanic policymaking tradition, was determined to remove the patient from intensive care and return to normality – to move policy rates away from the zero bound and begin to rein in its balance sheet.

This proved unwisely premature, especially as the difficulties of peripheral euro area sovereigns left commercial bank balance sheets in tatters. Rather than progressively returning monetary policy to neutrality, the ECB has been obliged to do an about-turn and ease further, belatedly taking official rates down to their irreducible minimum and seeking to re-inflate its balance sheet.

Where now?

On the basis of OECD calculations, the current and announced policies of the majority of countries are for continued fiscal restraint. IMF calculations, by contrast, portray the majority of fiscal stances as nearly neutral. Crucially, however, neither institution evaluates current and announced fiscal policy for 2014 and 2015 as in any measure expansionary.

… that Germany is showing no signs of wishing to reverse

Moreover, the rhetoric emanating from Germany is that continuation of the present consolidative thrust of fiscal policy is the only viable option. Germany's Finance Minister Schäuble put it this way last week:

> "*Calls in Europe to use more and more public money while accepting higher and higher deficits and debt is leading us astray… growth and jobs aren't a result of higher deficits, because we shouldn't have any problems if that was the case ... The only way out is innovation, structural reforms, investment, reliable conditions and trust in the sustainability of public finance*."[3]

In our judgement this is a mistaken analysis and a wrong prescription. It stems from a policy recipe that applies most of the time, and particularly to individual economies small enough to export their way out of aggregate demand deficiency by capturing some of the domestic demand of others. But it cannot, and will not, work to increase aggregate domestic demand in a region as large as the euro area. It is extraordinarily difficult for an economy to deflate its way out of a debt problem, and to export its way out of an aggregate demand problem. A policy prescription of seeking to reduce deficits through tight fiscal policy when an economy is in recession generally makes the existing problem worse.

Such an attitude threatens secular stagnation or worse

More seriously still, however, it is in our judgement indicative of a failure to grasp the severity and potential implications of the current situation. It is the voice of those who, despite the last six years, see Europe's current problem as still predominantly on the supply side.

In present circumstances, there is a risk that:

- The longer the recession persists and becomes progressively built into expectations; and
- The more that expenditure, particularly investment expenditure, ratchets down in the light of that; then
- The greater is the likelihood that low-growth expectations become self-fulfilling, and that social and political tensions, contained (so far) by Europe's welfare systems, boil over.

QE is now unlikely to provide an adequate answer …

Despite eschewing any outright regime change and remaining wedded to incrementalism, the ECB has recently taken unconventional monetary policy into areas considered to be out of the question just a few years ago. Moreover, a round of outright QE may be just around the corner. While such an initiative would undoubtedly be better than policy inertia, and we would applaud it, not least because it would help to reinforce the credibility of the ECB's commitment to its inflation target, the risk is that it would be too late.

Moreover, given the paucity of acceptable private sector financial instruments to buy, and the tendency for any GDP-weighted or ECB-capital-weighted programme of sovereign debt purchases to be skewed to German Bunds, where yields are already at rock bottom levels, we doubt that ECB QE could prove up to the (increasingly difficult) job.

On fiscal policy, while individual countries – not least France and Italy – have made clear their desire to apply the Stability and Growth Pact and existing deficit targets 'flexibly', the willingness of Germany and other fiscally conservative nations to use their budgetary latitude to sanction further discretionary stimulus is thus far absent.

… rather, the need is for large fiscal action too …

Others, including new Commission President Juncker and Poland's Finance Minister, are more open to the idea of fiscal action. But all the indications are that little will happen unless or until conditions in Germany get materially worse. Then, and only then, and only if monetary policy falls short, will an overt fiscal stimulus be deemed necessary and appropriate.

Squaring the circle

Assembling a conventional fiscal expansion, i.e. tax cuts and expenditure increases, would be difficult. It would take time to agree even the principle. The policy would have to be differentiated across countries: this is hard to devise, and even harder to coordinate. Such packages usually end up doing too little or are too late.

The challenge, therefore, will be for policymakers to coalesce around a necessarily German-sponsored policy package that supports aggregate demand while at the same time meeting German objections to classic Keynesian deficit finance. Politically, it would also be necessary to be able to assert that the package stands to increase productive potential over the longer term.

It would be ideal if it could also meet other broader and over-riding policy objectives too: remember the way that Germany found itself politically able to throw fiscal, and to some extent also monetary, caution to the wind on the occasion of German unification.[4] If the will is there, it can be sold, as has been done in the past (the 1980s), as a supply-side policy to help small firms.

… for which, Europe's energy security could provide the catalyst

What form might such a policy take? Our best guess – and it is only a guess – is that it could take the form of a pan-European infrastructure investment Special Purpose Vehicle, perhaps put together under the auspices of the European Investment Bank, and financed at least in part by the ECB (albeit with indemnification against losses by member state governments).

It could be oriented principally towards the geo-political goal of reducing Europe's dependence on energy imported from Russia, a matter that is now uppermost in the minds of many European leaders, not least Mrs Merkel. And it would lie comfortably with Finance Minister Schäuble's desire to encourage innovation.

Watch fors:

- German GDP weakness as precondition for any pan-European quasi-fiscal action.
- Escalating rhetoric about the desirability of infrastructure investment.
- Talk of innovative financing, say by the EIB backed by the ECB.
- Parallel emphasis on the need to reduce Europe's energy dependency on Russia.■

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[1] Political manipulation of the business cycle was hardly confined to the Anglo-Saxon economies, however. The dressing up, when it suited, of essentially Keynesian stimulus policies as something else – usually something supposedly altogether more worthy and long-term – but in reality an electoral bribe, was and is, a global phenomenon.
[2] Heat maps showing the IMF and OECD data are available upon request.
[3] As quoted in the *Wall Street Journal* 9 September 2014 http://online.wsj.com/articles/higher-deficits-dont-create-stronger-economic-growth-says-germanys-schauble-1410256939
[4] Then Bundesbank President Tietmeyer, upon being asked by one of us whether this package of policies risked Germany losing is credibility, remarked sagely "Credibility is there to be used once a generation."