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Θεματική Ενότητα

What We Have Learned

- The Neo-Keynesians and the Supply Side. The Theoretical Conflict in the Aftermath of the Crisis.
- The Multipliers
- The Spillovers Issue
- The 1937 Moment
- The Political Economy of Primary Surpluses

The Neo-Keynesians and the Supply Side. The Theoretical Conflict in the Aftermath of the Crisis

Reconstructing Macroeconomic Theory to Manage Economic Policy

Stiglitz (2014) Reconstructing Macroeconomic Theory to Manage Economic Policy, NBER Working Paper 20517

- Macroeconomics has not done well in recent years.
  - The standard models didn't predict the Great Recession; and even said it couldn't happen.
- After the bubble burst, the models did not predict the full consequences.
- Prior to Keynes, there was, among classical economists the general belief that markets worked well, that they were stable and efficient.
- Indeed, so strongly were these beliefs held that in the midst of the Great Depression, a majority of American economists supported the notion that government should do nothing. Markets would self-correct.
  - These economists did not, of course, explain why matters had gone so disastrously.

Reconstructing Macroeconomic Theory to Manage Economic Policy

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- Keynes provided an answer—a theoretical model, or perhaps more accurately, a set of theoretical models, with clear policy implications, the central tenets of which were:
  - markets were not self-correcting, at least in the relevant time span—unemployment could persist;
  - in deep downturns, monetary policy was ineffective; and
  - fiscal policy—government spending—could stimulate the economy, by a multiple of the amount that was spent.
- But Keynes was never liked by those who believed in unfettered markets—who wanted to minimize the role of government—and the counterattack that began in the 1960s had remarkable successes in the ensuing decades.

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- Modern macroeconomics can be viewed as growing out of an attempt to reconcile traditional Keynesian macroeconomics with micro-economics.
- There were two ways to achieve such a reconciliation:
  - try to adapt macroeconomics to the micro-economic model of the time, or
  - try to glean from macroeconomics insights about what was wrong with the traditional micro-economic models and reform them accordingly.
- Much of the mainstream of economics took the former course—just at the time that standard micro-economics was itself under attack, from the proponents of theories of imperfect and asymmetric information, game theory, and behavioral economics.

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- Mainstream macroeconomics came to be dominated by two "churches".

Classical Economists

- One school returned to the doctrines of the classical economists, holding that markets worked well, and that accordingly policy intervention was unnecessary. Some suggested that what was widely viewed as unemployment was actually just leisure. Their theories were designed to explain the wide fluctuations in the demand for leisure. When challenged with the observation that normally, when individuals are experiencing a period of extensive leisure, they feel happy, and yet there were ample indicators that in recessions, that was not the case, they responded: that was a matter for psychologists, not for economists.

- They held two further, somewhat contradictory positions: government policy was likely to be ineffective, and if and when it had effects, it was counterproductive.

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The second church

- The second of the two mainstream "churches" was a little—but only a little—better. It too relied on variants of the representative agent model, maximizing utility over an infinite lifetime, with rational expectations. Accordingly, it too largely ignored financial markets, credit, and a host of other behavior hard to reconcile with observed macro- and micro-behavior.

- It can be thought of growing out of the Hicksian fixed wage/price interpretation of Keynes. While basing itself on the standard competitive equilibrium framework, the proponents of this model recognized that there could be unemployment, and the challenge was how to reconcile this reality with the standard competitive equilibrium model.

- With those two schools, it should be clear then why a reconstruction of macroeconomics is necessary.

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The central questions of macroeconomics:

- What is the source of the disturbances?

  The standard models assumed that they were exogenous technology shocks—by implication, the Great Depression was marked by an episode of acute amnesia, where in large parts of the world, people got less productive! The reality was that this, and most other major downturns are man-made events.34 The system creates them. And that means it may be possible for us to at least reduce their frequency and depth.

- Why do seemingly small shocks have such large effects?

  Standard theories describe the economy's buffers—how, for instance, price and inventory adjustments help stabilize the economy. Instead, it seems that the system often amplifies shocks. And shocks spread, like a contagious disease.

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The central questions of macroeconomics:

- Why do deep downturns last so long? Why does there seem to be such persistence?

  After all, we have the same human, physical, and natural resources today as we had before the crisis. If markets worked well, we would quickly be restored to full employment. Debt can't be the problem: after all, debt is just money that we owe to ourselves. It is a matter of distribution, and in the standard models, distribution doesn't matter. And even if debt did matter (because distribution matters), standard theory says that there is still a new full employment equilibrium. The standard equilibrium theory provides no explanation for why we don't quickly get there, other than wage and price rigidities. We should note that the losses after the breaking of the bubble are far larger than those associated with the massive misallocation of capital prior to the crisis.

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Policy frameworks

A. Austerity and contractionary expansion

- By now, it should be clear that austerity has not worked in Europe—with unemployment reaching record levels. This is true even though there are some who have seen in the end of the recession proof that austerity works.

- The real test of the success of an economic policy is not whether the economy eventually returns to full employment: every economic downturn eventually comes to an end. It is the depth and duration of the downturn and the magnitude of the long term damage.

- Austerity, in these terms, has been a failure: the cumulative gap between actual and potential output is already in the trillions.

- Austerity has been a key factor in contributing to Europe's poor performance in the years since the crisis.

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- Long-run convergence will require parallel increases in costs of production in the different countries:
  - it can be achieved only through convergence of productivity and, given well-recognized downward rigidities in wages, faster wage increases in countries with higher increases in productivity.
- Convergence of productivity increases will require the laggard countries to embark on industrial policies—more than just creating a “conducive environment”.
- Convergence and growth could also be facilitated by more infrastructure investment, financed by the EU as a whole.
- Instead of creating a framework that would facilitate convergence, they created one that exhibits dynamic instability:
  - with each country responsible for its own banking system, and with confidence in a country’s banking system inevitably depending on the country’s ability and willingness to bail out troubled banks, money flees weak countries and its banks, making them even weaker.
- Private contraction amplifies the effects of public austerity. So too, the obligation of citizens to pay for their parents misdeeds—but only if they remain in the country—induces skilled labor to leave, increasing the burden on those remaining.

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B. The multiplier

- There has been considerable discussion of the magnitude of the multiplier associated with government spending, with critics of expansionary government spending suggesting that it is low, zero, or even negative.

- They look at the experience of different countries over long time periods. Such analyses should be an important warning of the foolishness of mindless regressions. Of course, when the economy is at or near full employment, the multiplier (correctly measured) will be low. Even then, measurement problems and econometric problems bedevil such analyses.

- Economic theory, though, provides a compelling framework for analysis. The problem is lack of aggregate demand. Government spending increases aggregate demand. We can identify leakages (from savings and imports) and, on the basis of that, calculate the multiplier.

- A good multiplier analysis takes into account the fact that different kinds of expenditures have different multipliers.

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- What matters is not what the average multiplier has been in the past, but the effect of a well-designed expansionary policy today.
- Traditional analyses suggested that the balanced-budget multiplier is unity.
  - But well-designed increases in taxes and expenditures can have a balanced-budget multiplier that is much larger, plausibly twice the traditional number.
- Taking advantage of crowding in of consumption and investment can further enhance the balanced-budget multiplier.
- Indeed, there are some taxes that might even stimulate demand.
  - An increase in the estate tax would encourage the elderly to consume more today; the imposition of a carbon tax would encourage investment in buildings and equipment that reduced carbon emissions. So too might an increase in a tax on dividends.
- In short, there is every reason to believe that well designed government policies could be very effective in stimulating the economy. Keynes was right about there being a multiplier—and advances since then have shown how that multiplier can actually be increased.

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C. Debt and deleveraging

- There are many in Europe and America who believe that our current troubles arise from excess debt, at both the household and national level. Those focusing on debt at the national level have warned that debt financed spending will *in the long run be counterproductive.*

- Much of this view has been based on work of Reinhardt and Rogoff, who contended that once debt exceeded 90%, the adverse effect on growth increased significantly.

- It is noteworthy that the debt pessimists have never come up with a coherent theory for why debt itself should lead to lower growth—except if countries listened to the debt pessimists and adopt austerity measures in response.

- Private indebtedness can, however, have significant effects—though in the neoliberal framework, whatever the private market decides is by definition “right”.
  - That ignores the pervasive market failures that we noted earlier, associated with imperfect and asymmetric information and imperfect risk markets.

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- Many have pinned their hopes for a quick recovery on deleveraging. There was excess private (mainly household) debt prior to the crisis—especially so once the housing bubble had broken. This indebtedness puts a damper on household spending. However, households are working down this debt.
- High levels of indebtedness do have an adverse effect on consumption, both because of the real wealth effect and because of the effect it has in imposing borrowing constraints.
- Still, there are reasons to believe that even after deleveraging, consumption will return to anything like it was before the crisis.
- If, of course, we do get recovery of the economy through consumption, we should be worried: it would mean a return to unsustainable patterns of the kind that marked the pre-crisis days.
- The representative agent model without financial constraints would suggest that leverage doesn't matter at all.
  - Debt simply reflects an ownership claim on a stream of returns—a transfer of money from debtors to creditors; but such transfers have no effects in this model.

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D. The liquidity trap and the zero lower bound

- Before the crisis, many economists argued that monetary policy was, and should be, the main vehicle for regulating macroeconomic activity, which the government carried out by manipulating interest rates.
- Indeed, the relationship between real interest rates and investment (especially outside of real estate) is hard to establish.
- Moreover, the notion that monetary policy is non-distortionary -or at least less distortionary than fiscal policy- is a fiction that arises from the simplistic aggregative models commonly employed.
- As Keynes' view of the inefficacy of monetary policy has seemed to triumph, those who believe in the standard model have suggested that its fundamental problem is the "zero lower bound" on interest rates, a variant of the Keynesian liquidity trap.
- Again, the use of overly simplistic models has obscured some potentially important adverse effects of lower interest rates, including lower long-term interest rates achieved through quantitative easing.

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- The traditional mechanism by which lower (long term) interest rates might benefit the economy is an increased flow of credit at better terms—but that does not seem to be playing a major role today, perhaps for five reasons.
  - The firms that are most constrained by borrowing, small and medium-sized enterprises, remain constrained, because the supply of funds is constrained—while the big banks were given huge amounts of money, and repaired their balance sheet through monopoly profits and speculative activities.
  - Large multinationals are awash with trillions in cash, small changes in interest rates are not likely to induce them to invest when they were reluctant to do so before, and when they do invest, it is likely not in the US.
  - The consolidation of banks as part of the attempt to preserve the banking system has led to non-competitive markets, so that rather than just passing on lower interest rates to customers, lenders have enjoyed larger spreads.
  - In a world of globalization, money goes to where the returns are highest (US and Europe), money is going where it's not needed and not going where it is needed.
  - In a globalized world, what one central bank does can (and often will) be undone by other central banks: one adds liquidity to the global financial system, while others take it out.

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- Finally, in the standard putty-clay model, firms, able to get access to long-term capital at a very low interest rate, will invest in highly capital-intensive technologies, because wages have not fallen as much as the cost of capital.
- But this means that, at any given level of demand for output, employment will actually be reduced.
- Thus, loose monetary policy today *may be setting up the conditions for a jobless recovery in the future. Even today, the outlines of such a situation are already visible. The knowledge that weaker demand for labor lies ahead affects consumption demand directly and indirectly, as it puts further downward pressure on wages, worsening the distribution of income.*
- The importance of this is *not that we should have tight monetary policy.*
- *It is that we cannot rely on monetary policy for our recovery, and that other government policies have to be put in place to offset the potential and real adverse effects that we have described.*

Reconstructing Macroeconomic Theory to Manage Economic Policy

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- As Keynes rightly pointed out, policy is shaped by theories. In Keynes's day, it may have been theories promulgated decades earlier.
- In today's world, it seems that lags have been reduced, with policy subjected to the ebb and flow of the fads and fashions in the economic profession.
  - The fads and fashions that dominated in the decades preceding the current crisis have not served us well—the models/theories that guided policy were not just innocent bystanders in the crisis that unfolded beginning in 2008.
- They were critical in the creation of the crisis and in the inadequate responses to it.
- Moreover, these theories were also not innocent bystanders to the growth in inequality that has marked recent decades;
  - the policies based on these theories were an important factor in the marked increase in inequality over the past thirty years.

A New Macroeconomic Strategy

Sachs (2014) A New Macroeconomic Strategy, Project Syndicate

I am a macroeconomist, but I dissent from the profession's two leading camps in the United States: the neo-Keynesians, who focus on boosting aggregate demand, and the supply-siders, who focus on cutting taxes. Both schools have tried and failed to overcome the high-income economies' persistently weak performance in recent years. It is time for a new strategy, one based on sustainable, investment-led growth.

- The core challenge of macroeconomics is to allocate society's resources to their best use: 1) Workers who choose to work should find jobs; 2) factories should deploy their capital efficiently; and 3) the part of income that is saved rather than consumed should be invested to improve future wellbeing.
- It is on this third challenge that both neo-Keynesians and supply-siders have dropped the ball.
  - Most high-income countries are failing to invest adequately or wisely toward future best uses. There are two ways to invest – domestically or internationally – and the world is falling short on both.

A New Macroeconomic Strategy

Sachs (2014)

The Neo-Keynesian Approach

- The neo-Keynesian approach is to try to boost domestic investment of any sort.
  - Indeed, according to this view, spending is spending.
- They have tried to spur more housing investment through rock-bottom interest rates, more auto purchases through securitized consumer loans, and more “shovel-ready” infrastructure projects through short-term stimulus programs.
- When investment spending does not budge, they recommend that we turn “excess” saving into another consumption binge.
- Neo-Keynesians see investments, public and private, as merely another kind of aggregate demand.
  - Thus, they promote gimmicks (zero interest rates and stimulus packages), rather than pressing for the detailed national policies that a robust investment recovery will require.

A New Macroeconomic Strategy

Sachs (2014)

The Supply-siders

- Supply-siders, by contrast, want to promote private (certainly not public!) investment through more tax cuts and further deregulation.
- They have tried that on several occasions in the US, most recently during the George W. Bush administration.
- Unfortunately, the result of this deregulation was a short-lived housing bubble, not a sustained boom in productive private investment.
- They seem utterly oblivious to the dependence of private investment on complementary public investment and a clear policy and regulatory framework.
- They advocate slashing government spending, naively believing that the private sector will somehow magically fill the void. But, by cutting public investment, they are hindering private investment.

A New Macroeconomic Strategy

Sachs (2014)

- Though policy alternates between supply-side and neo-Keynesian enthusiasm, the one persistent reality is a significant decline of investment as a share of national income in most high-income countries in recent years.

- Neither neo-Keynesians nor supply-siders focus on the true remedies for this persistent drop in investment spending.
  - Our societies urgently need more investment, particularly to convert heavily polluting, energy-intensive, and high-carbon production into sustainable economies based on the efficient use of natural resources and a shift to low-carbon energy sources. Such investments require complementary steps by the public and private sectors.

- Neither the neo-Keynesians nor the supply-siders have exerted much effort to improve the institutions of development finance.

A New Macroeconomic Strategy

Sachs (2014)

- These considerations are reasonably clear to anyone concerned with the urgent need to harmonize economic growth and environmental sustainability.
- Our generation's most pressing challenge is to convert the world's dirty and carbon-based energy systems and infrastructure into clean, smart, and efficient systems for the twenty-first century.
- Investing in a sustainable economy would dramatically boost our wellbeing and use our "excess" savings for just the right purposes.
- Yet this will not happen automatically. We need long-term public-investment strategies, environmental planning, technology roadmaps, public-private partnerships for new, sustainable technologies, and greater global cooperation.
- These tools will create the new macroeconomics on which our health and prosperity now depend.

Οι Φυλές Οικονομολόγων στην Ελληνική Οικονομία

Πετράκης Π.Ε. (2013) Οικονομολόγων Διαφορές, Blog Οικονομικές Αντιλογίες, in.gr

- Η μεταπολεμική περίοδος κυριαρχείται από δύο βασικές γραμμές: τη λεγόμενη νεοκλασική και τη λεγόμενη μετακεϋνσιανή / θεσμική.
- Στην Ελλάδα το Μάιο του 2010 εμφανίστηκαν τρεις φυλές οικονομολόγων.
- **Τι ισχυρίστηκε η πρώτη φυλή (ισχυρό νεοκλασικό υπόβαθρο):**
  - Η ισχυρή θεωρία είναι η νεοκλασική (δημοσιονομική προσαρμογή και αύξηση της προσφοράς).
  - Η Ελλάδα πτώχευσε και μπορεί να μας διώξουν από το ευρώ.
  - Η κρίση είναι μία «ευκαιρία» για την αλλαγή του μοντέλου της οικονομίας και της κοινωνίας.

Οι Φυλές Οικονομολόγων στην Ελληνική Οικονομία

- **Υπήρξε μία δεύτερη φυλή με τις εξής θέσεις:**
  - Η προοπτική της συνεργασίας εντός της Ευρωζώνης ήταν η καλύτερη δυνατή.
  - Ακόμα και αν ήταν συζητήσιμο εάν έπρεπε να μπούμε στο ευρώ, το να βγούμε από το ευρώ θα είναι ένα καταστροφικό γεγονός. Η διαπραγμάτευση να έχει όρια (διότι απλούστατα μπορεί να μας αφήσουν να διαπραγματευόμαστε για πολλά (!) χρόνια χωρίς χρήματα – βλέπε Ουγγαρία).
  - Θα πρέπει να ασκηθεί ένας συνδυασμός διαρθρωτικών πολιτικών (με έμφαση στην άμεση ανακεφαλαιοποίηση του τραπεζικού συστήματος) και νεοκεϋνσιανής δημοσιονομικής πολιτικής στο βαθμό που το επιτρέπει η συσσώρευση υγιών δημοσιονομικών και ιδιωτικών πλεονασμάτων.
- Οι απόψεις της δεύτερης φυλής εντάσσονται στη μετακεϋνσιανή / θεσμική γραμμή.

Οι Φυλές Οικονομολόγων στην Ελληνική Οικονομία

- **Τέλος υπήρξε μία τρίτη φυλή οικονομολόγων η οποία αθροιστικά ισχυριζόταν περίπου τα εξής:**
  - Δεν υπάρχει πιθανότητα να μας διώξουν από το ευρώ, άρα μπορούμε να διαπραγματευόμαστε όσο θέλουμε.
  - Μπορούμε να γυρίσουμε στη δραχμή και μέσω της ραγδαίας υποτίμησής της να επιτύχουμε τη βελτίωση της ανταγωνιστικότητας.
  - Δεν υπάρχει λόγος διαρθρωτικών μεταβολών. Εξάλλου με βάση τη μελλοντική δραχμή μπορεί ν’ ασκηθεί μία μετακεϋνσιανή οικονομική πολιτική.
- Όπως διαπιστώνει κάποιος οι απόψεις της φυλής αυτής είναι ένα ισχυρό μίγμα νεοκλασικής αντίληψης (υποτίμηση, ανταγωνιστικότητα) και μετακεϋνσιανής δημοσιονομικής πολιτικής που βασίζεται στην έκδοση νέου νομίσματος.

Οι Φυλές Οικονομολόγων στην Ελληνική Οικονομία

- Η πρώτη φυλή έχει δει μέρος από τα κηρύγματά της να επιβεβαιώνονται σε ορισμένες οικονομίες (κυρίως Βαλτικές χώρες και Ιρλανδία) για πολλούς και διαφορετικούς λόγους. Όμως η εμπειρία από την εφαρμογή τους στην Ελλάδα (και όχι μόνο) ήταν καταστροφική.
- Οι οικονομολόγοι της δεύτερης φυλής ήταν και είναι ακόμα μειοψηφία σε παγκόσμιο και ελληνικό επίπεδο και γενικώς αποτελούν μειοψηφία περίπου από το 1980 και μετά. Προβλέπω όμως μία πύκνωση των γραμμών της δεύτερης φυλής με «λιποτάκτες» από τις δύο άλλες φυλές. Είναι καλοδεχούμενοι.
- Παρατηρώ μία κατατρόπωση της τρίτης φυλής και στο εσωτερικό (καταστροφολόγοι και δραχμολόγοι) και στο εξωτερικό (Roubini κ.α.) Τώρα ο κόσμος συνειδητοποιεί το αδιέξοδο των απόψεών τους και αναρωτιέται γιατί έκαναν τόσο επίμονα και συστηματικά λάθος.

Οι Φυλές Οικονομολόγων στην Ελληνική Οικονομία

Πετράκης Π.Ε. (2013) Η Μάχη των Δύο Φυλών
Blog Οικονομικές Αντιλογίες, in.gr

- Μέχρι και τον Απρίλιο – Ιούνιο του 2012 η πρώτη και η δεύτερη φυλή, μπροστά στον απύθμενο κίνδυνο της επικράτησης του απόλυτου παραλογισμού, ουσιαστικά είχαν συμπαραταχθεί αποκρούοντας με όσα θεωρητικά μέσα διέθεταν την επικίνδυνη διάχυση του εύηχου λαϊκισμού στις μεγάλες κοινωνικές μάζες.
  - Κατάφεραν να αντιληφθεί ο κόσμος ότι η αχαρτογράφητη περιοχή της πτώχευσης και της δραχμής θα αύξανε κατακόρυφα τον κοινωνικό πόνο με άγνωστες προοπτικές.
- Αφού λοιπόν έχει εξαλειφθεί ο μεγαλύτερος κίνδυνος, οι δύο φυλές κοιτάζουν πλέον τις διαφορές τους, που είναι σημαντικές. Η σύγκρουσή τους διαρκεί δεκαετίες. Από το ποια φυλή επικρατεί κάθε φορά στην πολιτική σκηνή εξαρτάται το επίπεδο ζωής εκατομμυρίων ανθρώπων.
- Τι χωρίζει τις δύο φυλές; Διαφορές σε οικονομικό, πολιτισμικό και πολιτικό πεδίο.

Τι Διαχωρίζει τις Δύο Φυλές

A1) Ευρωπαϊκό επίπεδο - Οικονομία

- Οι βασικές θέσεις της Πρώτης Φυλής
  - Τα χρέη (ως ποσοστό του ΑΕΠ) πρέπει να μειωθούν, διότι από ένα επίπεδο και πάνω αποτελούν απειλή για τη μεσο- και μακρο-πρόθεσμη μεγέθυνση.
  - Με τη λήψη διαρθρωτικών μέτρων (συμπεριλαμβανομένης της εσωτερικής υποτίμησης) επιδιώκεται η απελευθέρωση της παραγωγής και η αύξηση της εμπιστοσύνης στο οικονομικό σύστημα (Supply Side Hypothesis).
  - Με την αύξηση σήμερα των φόρων ή του χρέους (άρα των φόρων στο μέλλον) θα έχουμε το ίδιο αποτέλεσμα, καθώς το επίπεδο ζήτησης θα παραμείνει αμετάβλητο (Ricardian Equivalence). Συνεπώς, δεν είναι λύση η επεκτατική δημοσιονομική πολιτική.
  - Η χρησιμοποίηση υπερβολικής επενδυτικής νομισματικής πολιτικής εγκυμονεί κινδύνους πληθωρισμού και αύξησης του κόστους χρέους.
  - Η μείωση της ελλειμματικής καθαρής εξωτερικής επενδυτικής θέσης αποτελεί εξαιρετική προτεραιότητα. Έτσι θα μειωθούν τα δίδυμα ελλείμματα, δημοσιονομικό και εξωτερικό. Γι’ αυτό επιβάλλεται και η εσωτερική υποτίμηση (εφόσον δεν υπάρχει δυνατότητα εξωτερικής υποτίμησης).

Τι Διαχωρίζει τις Δύο Φυλές

- Οι βασικές θέσεις της Δεύτερης Φυλής
  - Τα χρέη πρέπει να μειωθούν. Όταν όμως ο πολλαπλασιαστής κυμαίνεται γύρω στο 1,5, τότε η λύση δεν βρίσκεται στη ραγδαία μείωση των δημοσιονομικών δαπανών, γιατί επιτυγχάνει το αντίθετο αποτέλεσμα, αφού το ΑΕΠ μειώνεται αναλογικά πολύ περισσότερο από ό,τι τα χρέη.
  - Εφόσον έχεις στην οικονομία σοβαρή αργούσα παραγωγική δυναμικότητα, έλλειψη δηλαδή ζήτησης, τότε επιβάλλεται απελευθέρωση της ποσοτικής νομισματικής και δημοσιονομικής πολιτικής. Αυτό ισχύει ιδίως υπό συνθήκες χαμηλών επιτοκίων (liquidity trap), απομόχλευσης του ιδιωτικού και του δημόσιου τομέα και ταυτόχρονης διεθνούς ύφεσης.
  - Η ελλειμματική καθαρή εξωτερική επενδυτική θέση είναι πράγματι πρόβλημα. Ωστόσο, η βελτίωσή της θα έπρεπε να γίνει με τρόπο συνετό, αφού η καλυτέρευση της ανταγωνιστικότητας δεν είναι ζήτημα μόνο των μισθών αλλά κυρίως του θεσμικού πλαισίου.
  - Χρειαζόμαστε μεγαλύτερο ρυθμό πληθωρισμού στον πυρήνα της Ευρωζώνης, και χαμηλότερο στην περιφέρεια, για να είναι η εξισορρόπηση της ανταγωνιστικότητας ευκολότερη.

Τι Διαχωρίζει τις Δύο Φυλές

Α2) Ευρωπαϊκό επίπεδο – Πολιτισμικό πεδίο

- Η Πρώτη φυλή επικαλείται με ένταση την αξία της ζωής των επόμενων γενεών. Επίσης θεωρεί ότι οι άνθρωποι που ζουν σήμερα είναι εξαιρετικά «προβλεπτικοί» και άρα «βλέπουν» με απόλυτη ακρίβεια το μέλλον.
- Η Δεύτερη φυλή ισχυρίζεται ότι τα μεγαλύτερα εγκλήματα στην ανθρωπότητα έγιναν στο όνομα της αξίας του μέλλοντος (δεν μπορεί να ελέγξει κανείς το αποτέλεσμα).
  - Μία ισορροπία ανάμεσα στο παρόν και το μέλλον είναι η καλύτερη λύση. Εξάλλου όχι μόνο δεν έχουν επαρκή προβλεπτικότητα οι άνθρωποι αλλά και τα μέσα που χρησιμοποιούν (τιμολόγηση από τις αγορές) δίνουν λάθος πληροφορίες, όπως π.χ. τα spreads και ο κίνδυνος των ομολόγων. Δημιουργούνται λοιπόν αυτοεκπληρούμενες διαδικασίες που καταστρέφουν λαούς και κοινωνίες, αφού για την αντιμετώπισή τους εφαρμόζονται σκληρότερα δημοσιονομικά προγράμματα.

Τι Διαχωρίζει τις Δύο Φυλές

A3) Ευρωπαϊκό επίπεδο – Το Πολιτικό Πεδίο

- Πρώτη φυλή
  - Οι αμοιβές του κεφαλαίου κατευθύνονται στις επενδύσεις και δημιουργούν ανάπτυξη και μεγέθυνση. Άρα το να συμπιέζεται η τιμή της εργασίας δεν είναι απαραιτήτως αρνητικό.
  - Οι διοικητικές δομές (Νομισματική πολιτική, Κεντρική τράπεζα, Εκτελεστικές Επιτροπές κ.τ.λ.) έχουν μεγαλύτερη αποτελεσματικότητα.
- Δεύτερη φυλή
  - Οι αμοιβές εργασίας ενισχύουν απευθείας τη ζήτηση.
  - Η δημοσιονομική πολιτική που αναπτύσσεται από αντιπροσωπευτικά σώματα (εκλεγμένες κυβερνήσεις) είναι καταλληλότερη για την έξοδο από την κρίση.

Τι Διαχωρίζει τις Δύο Φυλές

Β) Ελληνικό επίπεδο:

- Η πρώτη φυλή δέχτηκε τη λογική της ανθρώπινης θυσίας ως υπέρτατη προτεραιότητα, αφήνοντας την ανακεφαλαιοποίηση των τραπεζών για μετά. Ουσιαστικά η διαφωνία της δεύτερης φυλής βρίσκεται στο ότι υποστήριζε πως η ενεργοποίηση του προγράμματος σταθεροποίησης χωρίς ενεργό τραπεζικό σύστημα και ενεργή νομισματική πολιτική θα οδηγούσε σε βαθύτατη ύφεση. Από το σημείο αυτό πηγάζει και η διαφωνία των δύο φυλών για τους πολλαπλασιαστές.
- Είναι ακατανόητο γιατί το προϊόν των ιδιωτικοποιήσεων θα πρέπει να οδεύει στη μείωση του χρέους και όχι στην ανάσχεση του ρυθμού προσαρμογής της οικονομίας και στη μείωση της ανεργίας
- Δεν θα έπρεπε τα κερδοσκοπικά κέρδη της ΕΚΤ από τα Ελληνικά Ομόλογα (€10 δις περίπου) να χρησιμοποιηθούν στο πλαίσιο ενός μοχλευμένου προγράμματος μέσω του τραπεζικού συστήματος για την τόνωση της ενεργού ζήτησης; Δεν θα έπρεπε κάθε ίχνος πόρου που εξοικονομείται, πέραν των υποχρεώσεών μας από την εκτέλεση του προγράμματος που εκτελούμε μέχρι το 2016, να επιστρέφεται στην εσωτερική ζήτηση;

Τι Διαχωρίζει τις Δύο Φυλές

– Η απομόχλευση των ιδιωτικών στεγαστικών κυρίως χαρτοφυλακίων θα πρέπει να διευκολυνθεί. Ένα μέρος του ποσού που ενίσχυσε την ανακεφαλαιοποίηση των τραπεζών θα έπρεπε να κατευθυνθεί προς το σκοπό αυτό (και όχι μόνο προς τις τράπεζες) χωρίς να ενισχύσει όμως τον ηθικό κίνδυνο (μία πράξη ρύθμισης λόγω εξαιρετικής ύφεσης και όχι πλαίσιο διαρκών ρυθμίσεων).

– Η απομόχλευση ιδιωτικών επιχειρηματικών χαρτοφυλακίων (στρατηγικού για την οικονομία χαρακτήρα) θα έπρεπε κατ' αντίστοιχο τρόπο να διευκολυνθεί.

– Θα πρέπει να υπάρξει ουσιαστική παρέμβαση στο σύστημα παιδείας και ιδιαίτερα στη δευτεροβάθμια εκπαίδευση, έστω και σε βάρος άλλων τμημάτων του δημοσίου.

The Multipliers

The Size of Fiscal Multipliers

Petrakis et al. (2013) European Economics and Politics in the Midst of the Crisis; From the Outbreak of the Crisis to the Fragmented European Federation, Springer

- The size of fiscal multipliers is particularly critical, as the impacts on gross domestic product (GDP) caused by an extrinsic change in the fiscal deficit depend on these multipliers.
- A multiplier of 1 means that a 1% increase in government spending raises GDP by approximately 1%.
- Therefore, the smaller the multipliers are, the smaller the cost caused by a fiscal tightening will be in terms of product.
- A debate has recently emerged as to whether the negative short-term influences of fiscal consolidation were more severe than anticipated because the fiscal multipliers were underestimated.

The Size of Fiscal Multipliers

Petrakis et al. (2013)

- Several policy documents, including various reports by the IMF, mention that to forecast the results of the adjustment programs in various countries, multipliers of almost 0.5 were used.
- The fact that the shrinking of economic activity in certain countries was more intense than anticipated raises questions as to whether the size of the fiscal multipliers had been underestimated.
- In reality, many studies (Auerbach and Gorodnichenko 2012a, Batini et al. 2012, IMF 2012) claim that in situations of economic retardation (where monetary policy is limited by the zero lower bound and where many countries are attempting to correct their fiscal imbalances, as is the situation today) fiscal multipliers are likely to exceed one unit.

The Size of Fiscal Multipliers

Petrakis et al. (2013)

- This view is corroborated by Blanchard and Leigh in the World Economic Outlook (IMF 2012, Coping with High Debt and Sluggish Growth, World Economic Outlook, October).
- Using data from 28 countries, they ascertain that the multipliers were significantly underestimated;
  - from the beginning of the recession, they reached values of between 0.4 and 1.2 percentage units, depending on the forecast source and the estimation approach.
  - Their new estimates for multipliers range between 0.9 and 1.7.
- This suggests that the austerity policies implemented are the direct reasons for the deep recession that many European countries are experiencing.
- This finding is consistent with studies suggesting that in today's environment of substantial economic slack, monetary policy is being constrained by the zero lower bound and synchronized fiscal adjustments across numerous economies, and hence multipliers may be well above 1 (Woodford 2011, Batini et al. 2012, IMF 2012).

The Size of Fiscal Multipliers

Petrakis et al. (2013)

- Eichengreen and O'Rourke (2012, Gauging the Multiplier: Lessons from History, VoxEu) claim that there is no surprise over the size of the mistake in the IMF's calculations, given that such calculations are consistent with the theory that "*the fiscal multiplier will be unusually large when there is little monetary response to the fiscal impulse, whether because interest rates are at the zero lower bound or for other reasons*".
- A new wave of econometric studies (Auerbach and Gorodnichenko 2012a, 2012b, Baum and Koester 2011, Fazzari et al. 2012) estimate that the fiscal multipliers are even bigger than previously thought (Frankel 2013).
- Most of this research claims that other factors are responsible for the size of the fiscal multipliers such as the fact that small open economies have lower multipliers because of the crowding out of net exports (Ilzetzki et al. 2011).

The Size of Fiscal Multipliers

Eurobank (2012) Fiscal multipliers in deep economic recessions and the case for a 2-year extension in Greece's austerity programme, Economy and Markets, VIII, 4, October

- Prior theoretical and empirical work on the response of main macroeconomic aggregates to exogenous fiscal shocks has shown that the *size and, in certain instances, the sign of the fiscal multiplier can be country-, estimation method- and economic conditions-specific.*

- *In* general, it appears that quite diverse views continue to exist among professional economists and policy makers as regards the quantitative and qualitative effects of fiscal policy.

- But, what if the size of fiscal multipliers in the present deep recessionary conditions proves out to be much higher than that assumed by the official sector? What would be the ramifications for domestic output and, by implication, public debt dynamics and the evolution of the government's borrowing requirement in the years ahead?

The Size of Fiscal Multipliers

Eurobank (2012)

- This paper attempts to address these and other relevant issues, by presenting two distinct empirical methodologies for deriving estimates of fiscal multipliers in Greece during periods of economic expansion and recession.
- The results seem to provide support to the findings of some recent empirical studies documenting much higher fiscal multipliers in recessionary conditions than in expansionary output phases.
- Yet, this study contains a number of interesting novel features related not only to the data series and variables used, but also as regards its technical aspects.

The Size of Fiscal Multipliers

Eurobank (2012)

- In particular, the Structural Vector Autoregression (**SVAR) models estimate government *spending multipliers that are not far away from*** what has been estimated for Greece in a number of earlier empirical studies (i.e., multipliers in the vicinity of 0.4-0.5).

- However, the (regime-switching) Smooth Transition Vector Autoregression ***(STVAR) models estimate strongly significant government spending*** multipliers that are as high as 1.32 in recessionary phases along with negative (and broadly insignificant) multipliers for periods of economic expansion.

- This finding is particularly pronounced for government *wage expenditure, where the estimated multiplier is found* to be as high as 2.35 (and strongly significant) in recessionary regimes and negative (and largely insignificant) in economic expansions.

- Hence, the depth of the recession faced by the Greek economy should not be surprising, as it had a high sensitivity to changes in fiscal policies.

Determinants of the Size of Multipliers

Batini et al. (2014) Fiscal Multipliers: Size, Determinants, and Use in Macroeconomic Projections, IMF, Fiscal Affairs Department

- Structural country characteristics that influence the economy's response to fiscal shocks in "normal times;"
  - *Trade openness* (countries with a lower propensity to import tend to have higher fiscal multipliers because the demand leakage through imports is less pronounced).
  - *Labor market rigidity* (countries with more rigid labor markets have larger fiscal multipliers if such rigidity implies reduced wage flexibility, since rigid wages tend to amplify the response of output to demand shocks).
  - *The size of automatic stabilizers* (Larger automatic stabilizers reduce fiscal multipliers, since mechanically the automatic response of transfers and taxes offsets part of the initial fiscal shock, thus lowering its effect on GDP).
  - *The exchange rate regime* (Countries with flexible exchange rate regimes tend to have smaller multipliers, because exchange rate movements can offset the impact of discretionary fiscal policy on the economy).

Determinants of the Size of Multipliers

Batini et al. (2014)

- *The debt level (*high-debt countries generally have lower multipliers, as fiscal consolidation is likely to have positive credibility and confidence effects on private demand and the interest rate risk premium).

- *Public expenditure management and revenue administration* (Multipliers are expected to be smaller when difficulties to collect taxes and expenditure inefficiencies limit the impact of fiscal policy on output).

- Conjunctural/temporary factors (notably cyclical or policy-related phenomena) that make multipliers deviate from “normal” levels.
  - *The state of the business cycle* (Fiscal multipliers are generally found to be larger in downturns than in expansions).

  - *Degree of monetary accommodation to fiscal shoc*ks (Expansionary monetary policy and a lowering of interest rates can cushion the impact of fiscal contraction on demand. By contrast, multipliers can potentially be larger, when the use and/or the transmission of monetary policy is impaired—as is the case at the zero interest lower bound).

FISCAL MULTIPLIERS OVER THE BUSINESS CYCLE

	Spending			Revenue		
	Expansion	Linear	Recession	Expansion	Linear	Recession
Auerbach and Gorodnichenko (2012a), United States, 6 quarters	0	0.4	1.7	N/A	N/A	N/A
Auerbach and Gorodnichenko (2012b), OECD, first year	–0.2	0.2	0.5	N/A	N/A	N/A
Auerbach and Gorodnichenko (2014), Japan, 4 quarters[a]	1	1.2	2.4	N/A	N/A	N/A
Batini and others (2012), 4 quarters[b]	0.82	0.93	2.08	–0.08	–0.17	0.08
Baum and others (2012), 4 quarters[c]	0.72	0.79	1.22	–0.04	0.29	0.35
Canzoneri and others, 2012, DSGE, United States, impact multiplier	0.89	1.3	2.25	N/A	N/A	N/A
Hernandez de Cos and Moral-Benito (2013), Spain, 4 quarters[d]	0.6	0.65	1.3	N/A	N/A	N/A
Owyang, Ramey, Zubairy (2013), United States, 2 year multipliers[e]	0.7	N/A	0.8	N/A	N/A	N/A
Owyang, Ramey, Zubairy (2013), Canada, 2 year multipliers[e]	0.4	N/A	1.6	N/A	N/A	N/A

Source: Batini et al. (2014).

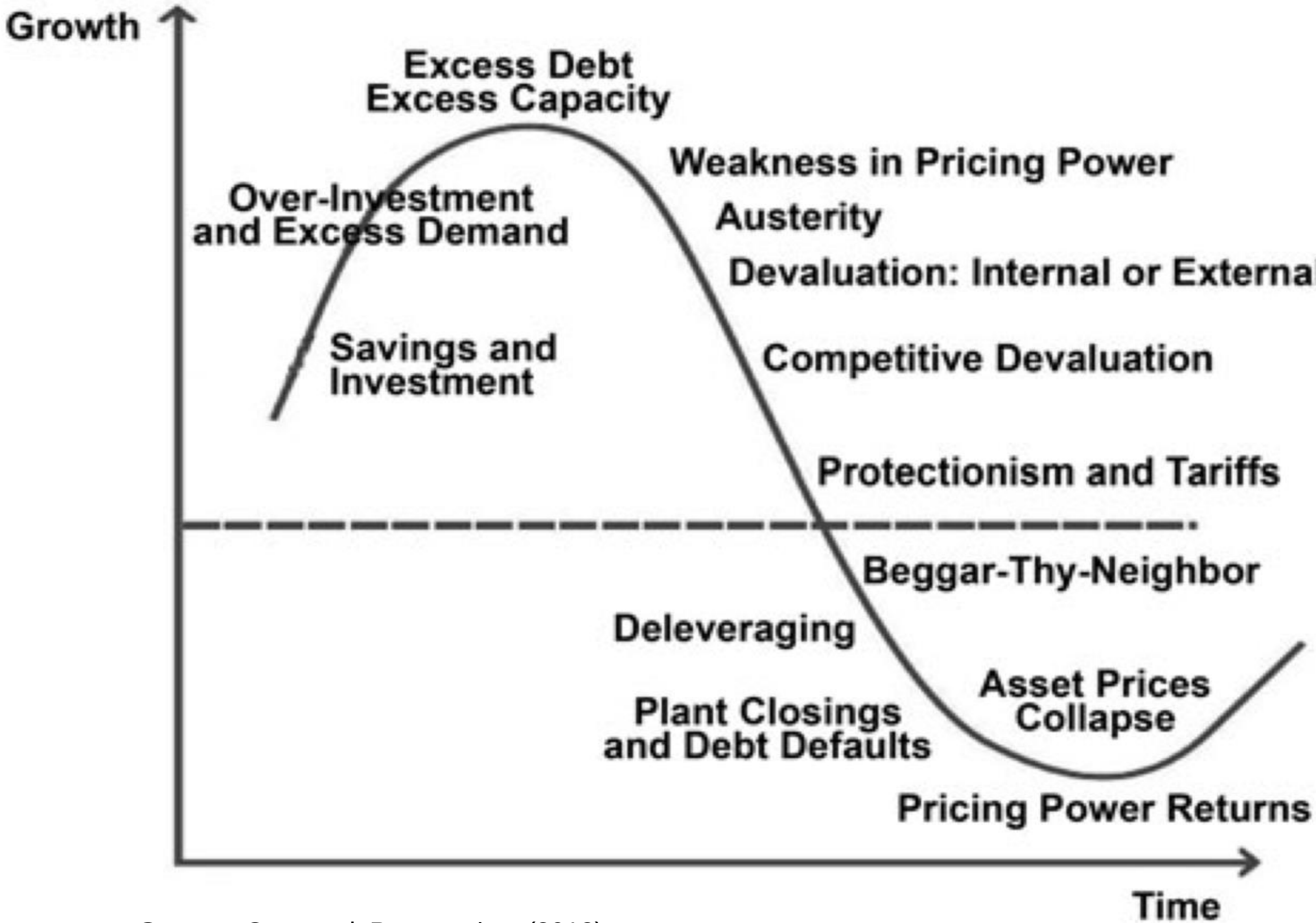
Government Spending Multipliers in Good Times and in Bad: Evidence from U.S. Historical Data

Ramey V.A., Zubairy S. (2014) Government Spending Multipliers in Good Times and in Bad: Evidence from U.S. Historical Data, NBER Working Paper No. 20719, November.

This paper investigates whether U.S. government spending multipliers differ according to two potentially important features of the economy: (1) the amount of slack and (2) whether interest rates are near the zero lower bound. We shed light on these questions by analyzing new quarterly historical U.S. data covering multiple large wars and deep recessions. We estimate a state-dependent model in which impulse responses and multipliers depend on the average dynamics of the economy in each state. We find no evidence that multipliers differ by the amount of slack in the economy. These results are robust to many alternative specifications. The results are less clear for the zero lower bound. For the entire sample, there is no evidence of elevated multipliers near the zero lower bound. When World War II is excluded, some point estimates suggest higher multipliers during the zero lower bound state, but they are not statistically different from the normal state. Our results imply that, contrary to recent conjecture, government spending multipliers were not necessarily higher than average during the Great Recession.

The Spillovers Issue

The cycle of austerity, deleveraging and deflation



Source: Comstock Partners Inc. (2012).

Understanding Spillovers

Blanchard et al. (2014) Understanding Spillovers, iMFdirect

- The global and the sluggish recovery since 2009, are a reminder of the importance of understanding interconnections and risks in the global economy. The increasing trend in global trade, and even more significant, in cross-border financial activities, suggests that spillovers can take many different forms.
- The understanding of transmission channels of spillovers has become essential, not only from an academic perspective, but also policymaking.
- The challenges faced by policy coordination after the initial response to the crisis in 2009 -illustrated by the debate on the impact of unconventional monetary policy in emerging economies- raise wide ranging issues on fiscal, monetary, and financial policies.

Understanding Spillovers

Blanchard et al. (2014)

- Against this backdrop, the IMF's 15th Jacques Polak Annual Research Conference, "Cross-Border Spillovers," on November 14-15 is timely.
- This year's conference program brings together contributions by researchers both inside and outside the IMF, aimed at understanding the different channels through which shocks can be transmitted among economies, and how policies can help mitigate their impact.
- The conference discussed 12 papers on key transmission channels of crossborder spillovers from monetary and fiscal policies, linkages in debt markets and trade integration, as well as policy instruments to manage capital flows and international policy cooperation.

Understanding Spillovers

Blanchard et al. (2014)

- Some of the questions discussed are the following:
  - What is the impact of government spending on the exchange rate? Is it really associated to exchange rate depreciations, i.e. 'beggar-thy-neighbor'?
  - Do sovereign debt defaults in one country trigger defaults in other countries? Do they change the cost of financing and incentives to default in other countries?
  - What are the conditions under which international spillovers effects are Pareto efficient? How does equilibrium with strategic policy setting at the global level compare against equilibrium with global policy cooperation?
  - Is it optimal to restrict international capital flows amid financial markets incompleteness, i.e. prices sending signals that do not induce socially optimal outcomes?
  - Does deeper trade integration through international input linkages amplify crossborder spillovers?
  - Can fiscal and capital market integration dampen the transmission of leveraging/deleveraging shocks within a monetary union –i.e. Europe?
  - Did growth in countries with higher trade and financial integration fall more during the Great Depression?

Changing Growth Trends Carry New Global Spillovers

- The 2014 Spillover Report (IMF Multilateral Policy Issues Report, 2014 Spillover Report, July 29), analyzes the implications of two key trends:
  - First, interest rates are expected to rise as some major advanced economies begin to unwind their extraordinary stimulus as recovery takes hold.
  - Second, emerging market economies are slowing in a synchronized and protracted manner, and average emerging market GDP growth is projected to decline from 7 percent during the pre-crisis period (2003-2008) to 5 percent over the next 5 years.

- These two risks could intersect and interact with each other, the report says. “Markets may reassess growth prospects in emerging markets if there are renewed bouts of financial turbulence as advanced economies normalize monetary policy”.

- Such a reassessment by markets could, in turn, generate further stress. One of the downside scenarios, according to the report, is that tighter financial conditions combined with further weakening of emerging market growth could lower global output by as much as 2 percent.

Monetary unwinding in advanced economies

- Not all spillovers are negative, says the IMF staff report, which stresses that the reason why financial conditions tighten plays a key role in determining the spillover effects.
- When advanced economies normalize monetary policy as their economic outlook improves, interest rates (and thus global yields) will rise.
- While this will tend to tighten financial conditions across the globe, the accompanying boost to growth should potentially offset any negative spillovers resulting from the higher interest rates.
- In other words, faster growth in advanced economies—which translates into higher external demand—could be good for other economies, if managed well.

Monetary unwinding in advanced economies

- On the other hand, if the tightening of monetary conditions is not driven by higher growth but is instead triggered by, for example, financial stability concerns, spillovers could have a negative impact on growth elsewhere, especially in vulnerable emerging economies.

- Similarly, asynchronous adjustment in advanced economies may result in larger swings in exchange rates of major currencies, potentially causing problems for economies with balance sheet vulnerabilities and foreign exchange exposures.

- In terms of impact, spillovers from monetary policy normalization in advanced economies will likely differ across countries.
  - Past experience suggests that those with relatively strong fundamentals—that is, lower inflation, higher current account balances and reserves, and deeper financial markets—can better mitigate spillovers from higher interest rates abroad.

Slowing growth in emerging economies

- While growth in some advanced economies is rebounding, emerging markets are slowing down on a synchronized basis from their highs before the crisis.
  - growth is expected to be below post-crisis rates and longer-term historical averages over the next 5 years.
- “Two features stand out when comparing the current slowdown with other such episodes:
  - medium-term forecasts have been revised down continuously since 2010,
  - a slowdown in productivity is more visible this time around. The slowdown thus appears to have a large structural component.
- Given the significant and rising contribution of these economies to the global economy over the past few decades, such a protracted slowdown will likely weigh on global growth through trade and finance channels.

Slowing growth in emerging economies

- Other important channels where slower emerging market growth could carry spillovers include through global commodity markets and through banks exposed to emerging market borrowers.

- The staff report also highlights local spillovers from emerging markets to other emerging and low-income countries, or the “neighborhood” effect.
  - For example, a slowdown in China and Brazil would impact emerging Asia and Southern Cone countries, respectively, through trade.
  - Russia would have an impact on its neighbors through remittances, while Venezuela would affect its neighbors via potential changes in the provision of favorable financing through energy cooperation agreements.
  - Geopolitical tensions in Russia and Ukraine could spill over to other parts of the world from major disruptions in production or transportation of natural gas or crude oil, and trigger a renewed bout of increased risk aversion in global financial markets.

Managing adverse spillovers

- For *advanced economies undertaking monetary normalization, well-crafted central* bank communication would be key to avoiding large swings in asset prices or market misperceptions of policy intentions to address financial distress.

- Other advanced economies that are susceptible to adverse spillover effects, given low inflation and limited conventional monetary policy space, would need to take action to manage risk and raise inflation back to target.

- For *emerging economies, renewed attention to structural reforms will be* important to lift constraints on medium-term growth.

- The more *vulnerable emerging economies strengthen policy* frameworks and fundamentals to mitigate risks of adverse spillovers.

- Collaboration is needed between advanced and emerging market economies to manage both spillovers and the risks of spillbacks.

The spillovers of fiscal and monetary policies

Cohen-Setton (2014) The spillovers of fiscal and monetary policies - it remains unclear whether emerging economies possess the tools to limit undue fluctuations, Bruegel, 18th November

- Policymakers in emerging economies have repeatedly complained over the spillover effects of advanced economies' policies in the Great Recession.

Spillovers and coordination

- The understanding of transmission channels of spillovers has become essential, not only from an academic perspective, but also policymaking (Blanchard et al. 2014).
- In a globally integrated economy, national economic policies generate international spillover effects (Korinek 2014, International Spillovers and Guidelines for Policy Cooperation, 15th Jacques Polak Annual Research Conference). Korinek finds that the first theorem of welfare applies and that spillovers are efficient if three conditions are met:
  - national policymakers act as price-takers in the international market,
  - national policymakers possess a sufficient set of policy instruments, and
  - there are no imperfections in international markets. If any of the three conditions is violated, spillover effects generally lead to inefficiency, and global cooperation among national policymakers can generally improve welfare.

Spillovers from asynchronous exit strategies

- Normalization proceeding at different times in different advanced economies can have wider implications for interest and exchange rate movements (IMF 2014, Changing Growth Trends Carry New Global Spillovers, IMF Survey).
  - More-synchronized tightening cycles in the past were characterized by higher global interest rates and risk aversion, as well as modestly higher stress in sovereign bond and stock markets in emerging market economies.
  - A less-synchronized tightening cycle this time would partly counteract the impact of higher interest rates from normalization elsewhere.
  - Asynchronous adjustment may result in larger swings in exchange rates of major currencies that could cause problems for some economies with balance sheet vulnerabilities and foreign exchange exposures.

- The ‘tapering talk’ (started in May 2013) had a sharp negative impact on economic and financial conditions in emerging markets (Eichengreen and Gupta 2014, *Tapering talk: The impact of expectations of reduced Federal Reserve security purchases on emerging markets, VoxEu*).
  - Based on a cross-country empirical exercise, the authors find that there is little evidence that countries with stronger macroeconomic fundamentals (smaller budget deficits, lower debts, more reserves, and stronger growth rates in the immediately prior period) were rewarded with smaller falls in exchange rates, foreign reserves, and stock prices starting in May.

The macroprudential view of capital controls

- Central banks in emerging markets have responded to the recent surge in capital inflows by pursuing active capital flow management policies (Bengui and Bianchi *(2014)* Capital Flow Management when Capital Controls Leak, 15th Jacques Polak Annual Research Conference).
  - The hope is that current efforts to curb capital in flows will reduce the vulnerability of the economy to sudden reversals in capital flows.
  - A growing empirical literature casts doubt on the effectiveness of such policies. Their analysis indicates that while leakages create risk-shifting in the unregulated sphere, a planner may, nonetheless, find it optimal to tighten regulation on the regulated sphere in order to achieve higher stabilization effects.

- Governments have rarely imposed or removed capital controls in response to short-term fluctuations in output, the terms of trade, or financial-stability considerations (Eichengreen and Rose 2014, Capital controls in the 21st century, VoxEu).
  - Once imposed, controls stay in place for long periods. Once removed, they are rarely restored.
  - Rather than fluctuating at a business cycle frequency, the intensity of controls tends to evolve over long periods in line with variables like:
    - domestic financial depth and development, the strength of democratic checks and balances, and the quality of regulatory institutions, which similarly evolve slowly over time.

The exchange rate response to fiscal shocks

- The magnitude of fiscal spillovers is likely to depend heavily on how exchange rates respond to fiscal shocks (Auerbach and Gorodnichenko 2014, Effects of Fiscal Shocks in a Globalized World, 15th Jacques Polak Annual Research Conference).

- They find that unanticipated shocks to announced military spending, rather than actual outlays on military programs, lead to an immediate and tangible appreciation of the U.S. dollar.

- This finding is broadly consistent with a variety of workhorse models in international economics and it suggests that fiscal shocks can have considerable spillovers into foreign economies.

- At the same time, this finding contrasts sharply with the results reported in previous studies.
  - Specifically, the earlier work routinely documented that the domestic currency depreciates in response to government spending shocks, which is hard to square with the predictions of classic and modern open-economy models.
  - This difference in results is likely to arise from the mis-timing of shocks in previous papers and their use of actual spending rather than news about spending.

The 1937 Moment

A recession to remember

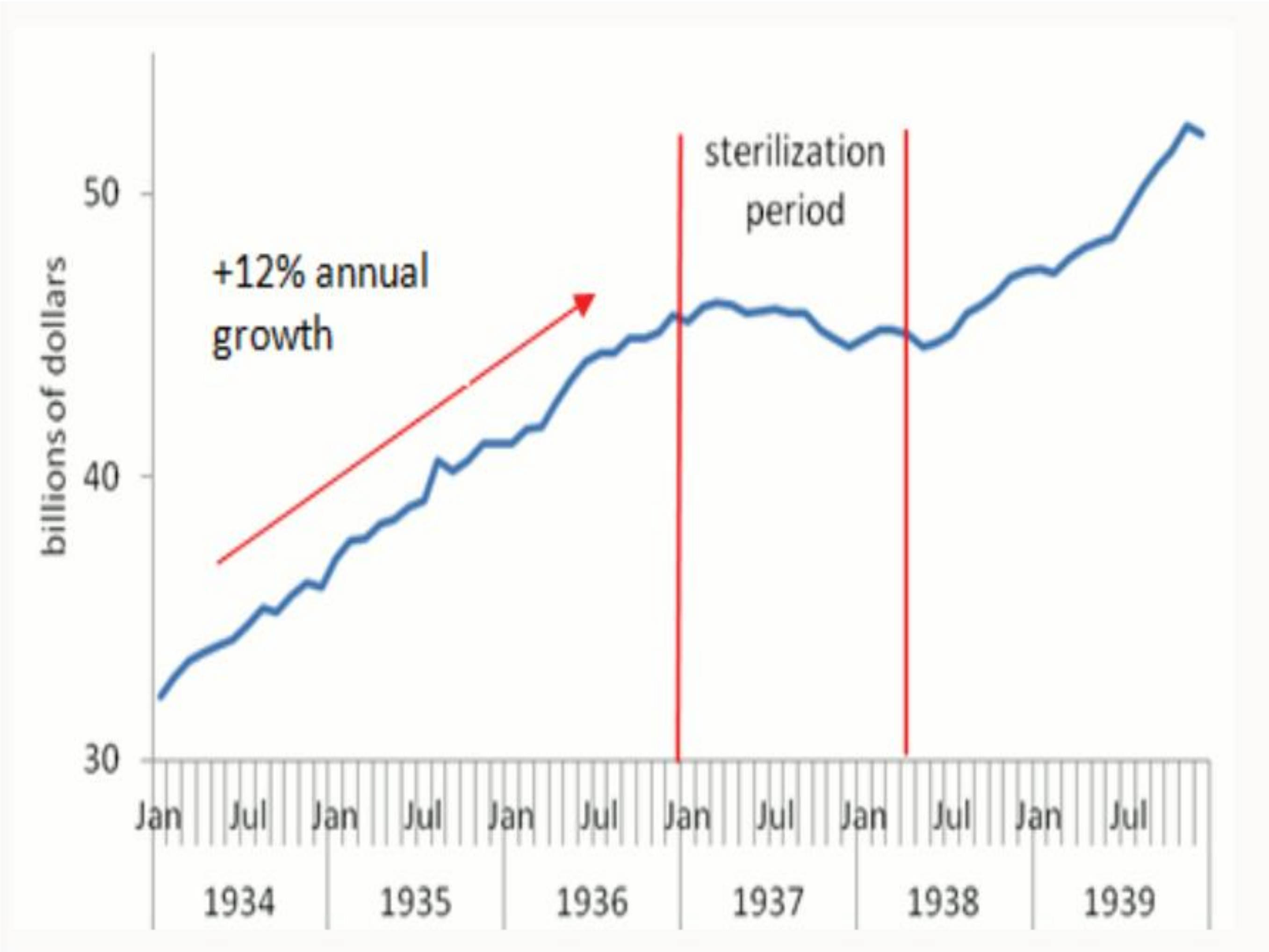
What caused the recession of 1937-38? (Irwin 2011, VoxEu)

- The recession of 1937-38 is sometimes called "*the recession within the Depression*".
  - ➢ It came at a time when the recovery from the Great Depression was far from complete and the unemployment rate was still very high. In fact, it was a disastrous setback to the recovery. Real GDP fell 11% and industrial production fell 32%, making it the third-worst US recession in the 20th century (after 1929-32 and 1920-21).

- The recession is often attributed to a tightening of fiscal and monetary policy. It is relevant to today's situation because it illustrates the dangers of a premature withdrawal of stimulus when the economy is still weak (Romer C. 2009, "The Lessons of 1937", The Economist, 18 June).

- But the recession remains somewhat of a mystery because the two most frequently mentioned causes – the reduction in the fiscal deficit and the Federal Reserve's decision to double reserve requirements – do not appear to have been powerful enough to generate a recession of the magnitude seen.

If fiscal retrenchment and higher reserve requirements cannot fully explain the recession, then what can?



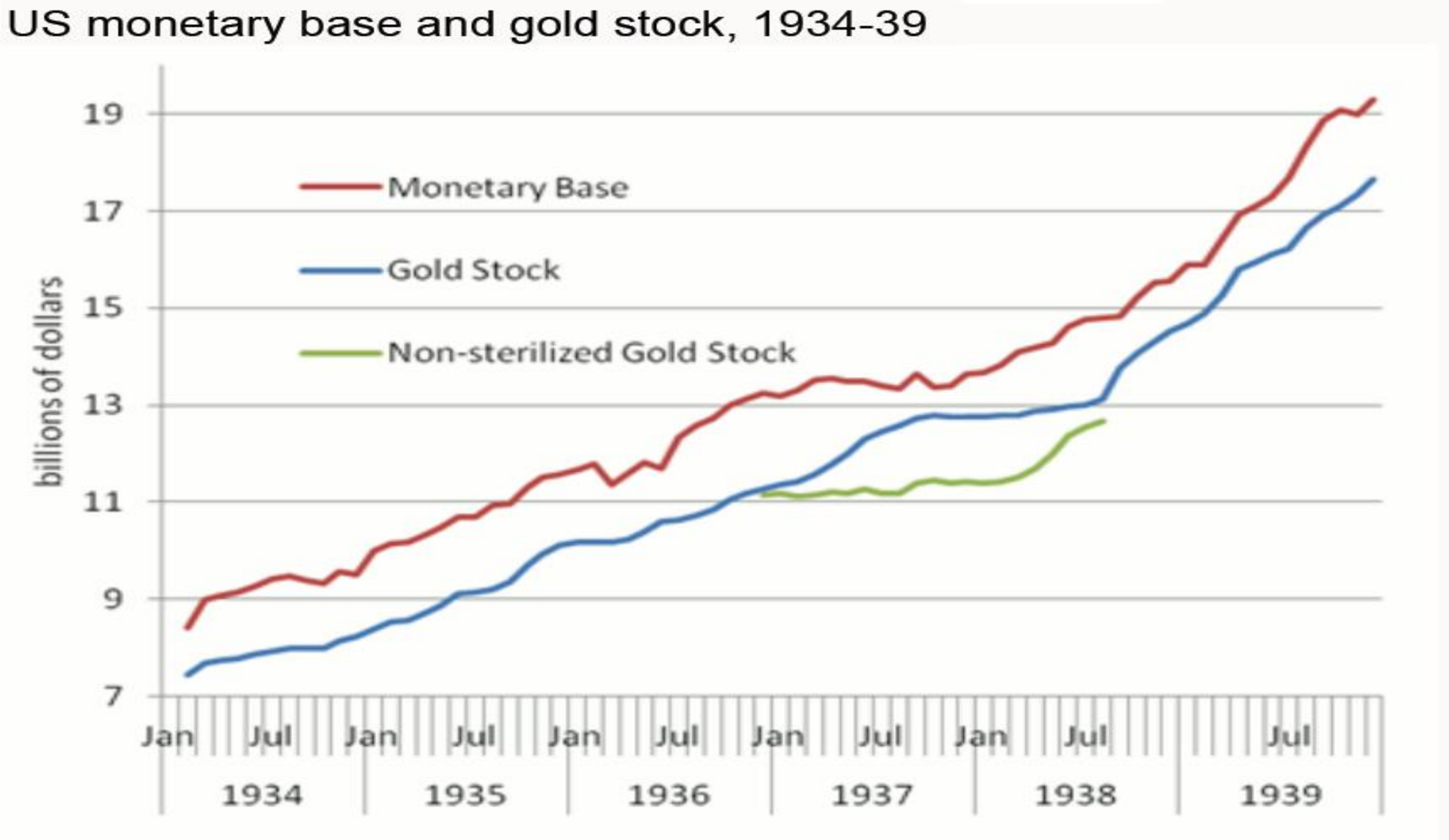
Source: Irwin (2011).

The money supply (M2) grew at a consistent rate of about 12% a year from 1934 to 1936, but then suddenly stopped growing in early 1937 and even fell later in the year. The monetary shock, however, was not the Federal Reserve's decision to increase reserve requirements, but the often overlooked Treasury Department decision to sterilise all gold inflows starting in December 1936.

- When the dollar was re-pegged to gold at $35 per oz. in January 1934, the US essentially went back on a gold standard. Gold reserves constituted 85% of the monetary base and changes in those reserves accounted for most of the changes in the monetary base. Because the US received large gold inflows in the mid-1930s, monetary policy was expansionary. This was the primary reason for the economic recovery (Romer 1992, "What Ended the Great Depression?", Journal of Economic History,52:757-784).

- But when the Roosevelt administration began to worry about the potential for higher inflation, the Treasury Department decided to sterilise all gold inflows starting in December 1936. In essence, its new gold holdings were held in an inactive account rather than with the Federal Reserve, where it would have become part of the monetary base and money supply. Thus, instead of allowing the monetary base to grow with the inflow of gold, the monetary base was essentially frozen at its existing level.

- The economy faltered in the spring of 1937 and tanked in the autumn of 1937. In February 1938, having realised its error, the Treasury ended its policy. In April 1938, the Treasury implemented its exit strategy and began desterilising its inactive gold holdings. The economy began to recover in June 1938.



Source: Irwin (2011)**.**

The effect of the gold sterilisation policy on the monetary base is shown in Figure. The gold stock and monetary base grew consistently from 1934 to 1936. Although gold stocks continued to grow in 1937, the monetary base flatlined because of the sterilisation. The non-sterilised gold stock is flat until the Treasury began desterilising its gold holdings in April 1938.

- The impact of gold sterilisation and higher reserve requirements on the money supply can be separated by noting that gold sterilisation affects the monetary base while reserve requirements affect the money multiplier.

- In a recent paper (Irwin 2012), there is found that changes in the monetary base were much more important than changes in the money multiplier in explaining the abrupt end to the growth of the money supply in 1937.

- Notice also that gold inflows into the US essentially ceased in late 1937 until mid-1938.

- The sudden halt to gold inflows was due in part to fears that the Roosevelt administration would respond to the recession by devaluing the dollar, just as it had done in response to the Great Depression in early 1933. (Fool me once, shame on you, fool me twice, shame on me, seems to have been the view of financial markets.)

- However, gold began surging back into the US in September 1938 when Hitler's territorial demands on Czechoslovakia (the Munich crisis) set off fears of a European war.

- If we are to avoid the mistakes of the past, it is important to have an accurate assessment of what those past mistakes were.
- The severity of the Recession of 1937-38 was not due to contractionary fiscal policy or higher reserve requirements.
- By contrast, the policy tightening associated with gold sterilisation was not modest – it did not simply reduce the growth of the monetary base by a few percentage points, it stopped its growth altogether.
- While the Federal Reserve is often blamed for its poor policy choices during the Great Depression, the Treasury Department was responsible for this particular policy error.
- The recession of 1937-38 occurred long ago, but it does have policy lessons for today.
  - It suggests that, in a weak recovery, a pre-emptive monetary strike against inflation (which was very low at the time, as it is today) is capable of producing a devastating recession.

The global crisis has been frequently compared to the Great Depression

What lessons it can teach today's policymakers?

- *Key message is that while fiscal consolidation should not be postponed, the exit strategy needs to focus on providing monetary support for aggregate demand as fiscal stimulus is withdrawn.*

- Policymakers' problems are now those of designing the right exit strategy.
  - Withdraw stimulus too soon and tip the economy back into recession; leave it too late and see inflation take off.

- While interest rates are at or near the lower bound, fiscal multipliers are probably high. Yet in the medium term, fiscal sustainability needs to be restored at a time when structural budget deficits have been raised by the adverse impact of the banking crisis on potential output.

- In this context, it is timely to revisit the severe recession that rudely interrupted the strong US recovery from the depression in 1937/8. This episode is relatively little-known to most non-US economists but offers lessons that we should heed.

The recovery from the Great Depression

Crafts and Fearon (2010) A recession to remember: Lessons from the US, 1937–1938, VoxEu.org

- Recovery from the depression was vigorous in the years after 1933.
  - ➢ By 1937 real GNP was nearly back to its peak and more than 40% higher than the nadir of the depression in early 1933.

- The recovery was largely a result of the new policy regime established when the US left the gold standard in March 1933.
  - As Christina Romer pointed out, this was followed by very strong growth in the money supply (Romer 1991, 2009). Crucially, the new regime meant a return to inflationary expectations which Gauti Eggertsson's DSGE model sees as fundamental to an escape from the liquidity trap (Eggertsson and Pugsley 2006, Eggertsson 2008).

- With nominal interest rates near the lower bound, Roosevelt's strategy of seeking to return prices to mid-1920s levels represented dramatically lower real interest rates. Although federal government expenditure rose sharply, the New Deal was at most a very modest fiscal stimulus but it may have contributed to changing inflationary expectations. Budget deficits of 3% or 4% of GDP reflected the weakness of tax revenues in years of weak economic activity.

The recovery from the Great Depression

- In early 1937, there was still an output gap, estimated by Balke and Gordon (1986) to be around 15% of GNP, but there was a widespread feeling that the depression was over.

- The focus of policymakers was shifting to concerns about future inflation and a return to a balanced budget.
  - The Federal Reserve was worried by the build up of substantial excess reserves in the banking system while on the fiscal side the ratio of the national debt to GDP had risen from 16% in 1929 to 40% by 1937.

- The Federal budget was returned close to balance in 1938 following increases in income tax rates in 1936, and the introduction of social security taxation from January 1937.

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The recovery from the Great Depression

- There was also a cut in spending from a 1936 spike caused by a one-off payment of Veteran's Bonus.
  - The implication was a discretionary fiscal tightening amounting to over 3% of GDP, according to estimates by Larry Peppers (1973).
- On the monetary side, a new policy of sterilising gold inflows was adopted in December 1936 and reserve requirements for the banks were doubled in three stages from August 1936 through May 1937.
- The Federal Reserve Bank's rhetoric changed to highlighting dangers of inflation.
  - An analysis by Velde (2009) suggests that these policy changes were sufficient largely to explain the recession which NBER dates as running from May 1937 to June 1938.

The recovery from the Great Depression

- It is reasonable to suppose that the fiscal multiplier is quite high when interest rates are low and there is less scope for crowding out, as is confirmed by the review of theory and evidence provided by Robert Hall (2009).

- This was probably true in the late 1930s as Robert Gordon and Robert Krenn's estimate of a multiplier of 1.8 in 1940 suggest (Gordon and Krenn 2010).

- If fiscal consolidation was to be attempted, then expansionary monetary policy was needed to compensate for its deflationary impact. Instead, the American economy was hit with a double whammy.
  - An important aspect of the changes in policy stance in 1936/7 was the impact through undermining inflationary expectations with the implication that real interest rates rose steeply according to Romer.

- Eggertsson and Pugsley (2006) find that quite small changes in public beliefs about the government's future inflation target would have had significant effects on output with nominal interest rates abnormally low.

Key message for today's policymakers

- The key message here for policymaking in the current situation is not that fiscal consolidation should be postponed.

- Rather, it is that exit strategy needs to focus on providing monetary support for aggregate demand as fiscal stimulus is withdrawn.
  - This has been a feature of successful fiscal consolidation efforts in OECD economies in recent times when interest rate cuts have been part of the overall package.

- Now, as in the 1930s, there is no scope to cut nominal interest rates.
  - The requirement then is to operate on real interest rates and to seek to embed expectations that prices will rise. This suggests that further quantitative easing may be appropriate and that thought should be given to suspending inflation targets in favour of price level targets.

Key message for today's policymakers

- In the recent crisis, the aggressive response made by US and other policymakers was a massive improvement compared with the catastrophic errors made in the early 1930s.

- Accordingly, we have gone through a Great Recession rather than a re-run of the Great Depression.

- However, the 1930s has more to offer in terms of relevant experience for today with regard to managing the recovery.

- Those who would like to learn more can turn to our survey paper written as an introduction to a collection of articles which seek to bring the lessons of the 1930s from the specialist literature to a wide audience (Crafts and Fearon 2010).

The Political Economy of Primary Surpluses

Can large primary surpluses solve Europe’s debt problem?

Eichengreen and Panizza (2014) Can large primary surpluses solve Europe’s debt problem? 30 July 2014, VoxEu.org

For the debts of European countries to be sustainable, their governments will have to run large primary budget surpluses. But there are both political and economic reasons to question whether this is possible. The evidence presented is not optimistic about Europe’s crisis countries. Whereas large primary surpluses for extended periods of time did occur in the past, they were always associated with exceptional circumstances.

- Europe’s economies have heavy debts and gloomy growth prospects.
  - This fact raises obvious concerns about the sustainability of public debts, concerns that have manifested themselves periodically in increases in the yields that investors demand to hold governments’ debt securities.
- Investors are relatively sanguine.
  - The question is whether they will remain so. It is whether – and if so, when – worries about debt sustainability will be back.

Can large primary surpluses solve Europe’s debt problem?

- The IMF, in its Fiscal Monitor (2013), sketches a scenario in which the obligations of heavily indebted European sovereigns first stabilise, and then fall to the 60% level targeted by the EU’s Fiscal Compact by 2030.
  - It makes assumptions regarding interest rates, growth rates and related variables, and computes the cyclically adjusted primary budget surplus (the surplus exclusive of interest payments) consistent with this scenario.
- The heavier the debt, the higher the interest rate and the slower the growth rate, the larger the requisite surplus.
- The average primary surplus in the decade 2020-2030 is calculated as 5.6% for Ireland, 6.6% for Italy, 5.9% for Portugal, 4.0% for Spain, and 7.2% for Greece.
- These are large primary surpluses. There are both political and economic reasons for questioning whether they are plausible.
  - When tax revenues rise, legislators and their constituents apply pressure to spend them.

Can large primary surpluses solve Europe's debt problem?

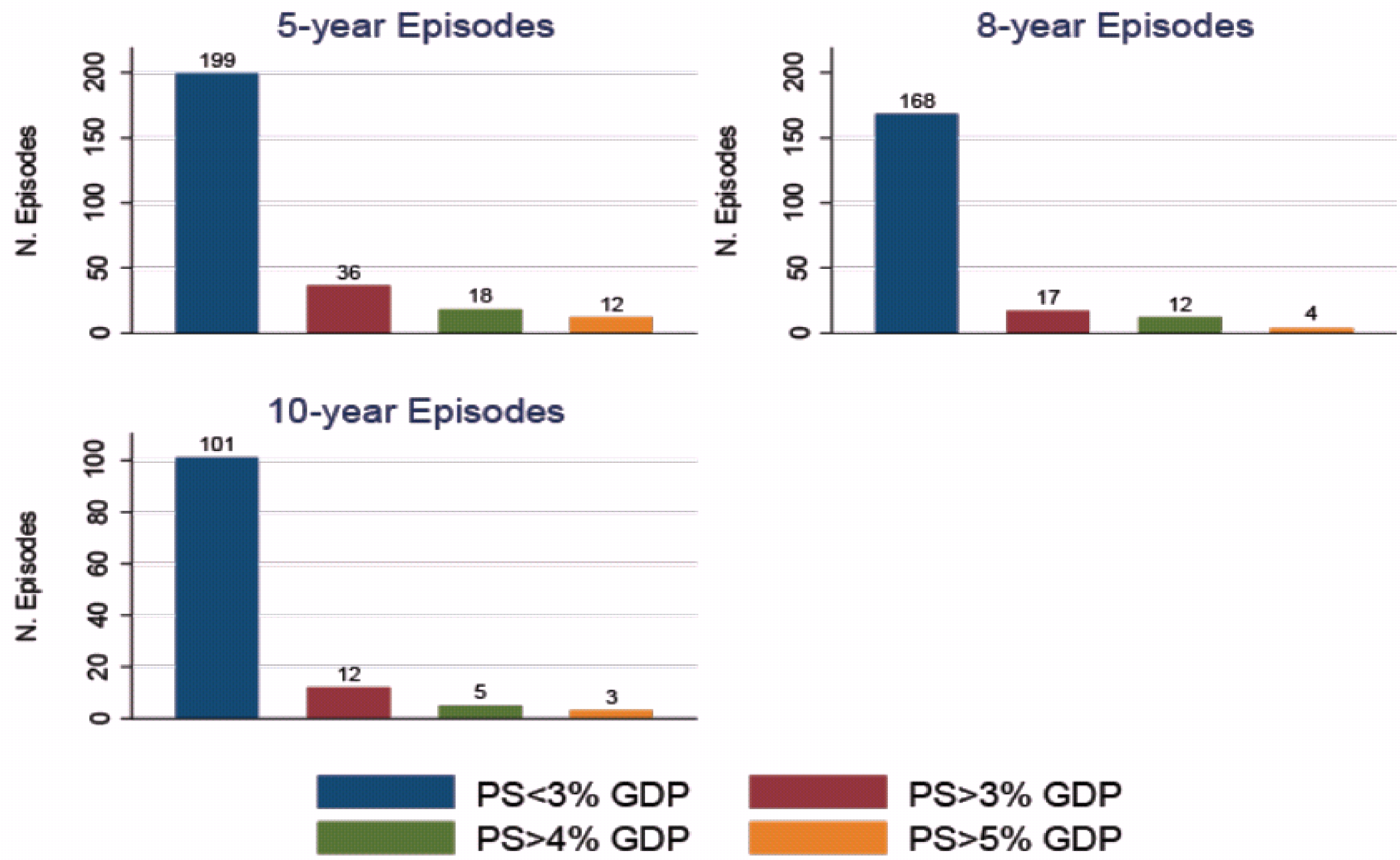
- In 2014, Greece enjoyed its first primary surpluses after years of deficits and fiscal austerity;
  - the government immediately came under pressure to disburse a 'social dividend' of €525 million to 500,000 low-income households.
- Budgeting, creates a common pool problem, and the larger the surplus, the deeper and more tempting is the pool.
  - Only countries with strong political and budgetary institutions may be able to mitigate this problem (de Haan et al. 2013).
- Turning to the economics:
  - a slowdown in global growth, worsening terms of trade, and a recession can all disrupt the efforts of even the most dedicated governments seeking to run large primary surpluses for a decade.
  - Recession depresses tax revenues, and the spending cuts needed to maintain the surplus above promised threshold may further depress activity and revenues.
  - The government may prefer to let its automatic fiscal stabilisers operate. Whatever the other merits of that choice, it too will prevent the string of primary surpluses from being maintained.

Can large primary surpluses solve Europe's debt problem?

- Eichengreen and Panizza (2014), explore whether the expectations, that European countries will be able to run such large surplus, are realistic.
- They use a sample of 54 emerging and advanced economies over the period 1974-2013 to study what type of economic and political variables are associated with large and persistent primary surpluses.
- In this sample there are 36 such episodes (about 15% of the 235 5-year periods included in our sample) of primary surpluses of at least 3% of GDP that last for at least five years.
- Larger and longer primary surplus episodes are rarer. Primary surpluses as large as 4% of GDP that last for at least a decade are extremely rare

Can large primary surpluses solve Europe's debt problem?

Five-, eight-, and ten-year episodes of primary surpluses as percentages of GDP



Can large primary surpluses solve Europe's debt problem?

- Looking at surplus episodes that average at least 3% of GDP and last for 5 years, their estimates for advanced economies suggest that
  - a one percentage point increase in domestic growth is associated with a 12 percentage point increase in the likelihood of a large and persistent primary surplus.
  - A ten percentage point increase in the debt-to-GDP ratio is associated with a 2 percentage point increase in the likelihood of a large and persistent primary surplus episode.
- Focusing on political variables:
  - surplus episodes are more likely when the governing party controls all houses of parliament or congress and in countries with proportional representation (which can give rise to encompassing coalitions).
  - left-wing governments are more likely to run large and persistent primary surpluses.

Can large primary surpluses solve Europe's debt problem?

- For the debts of Europe's problem countries to be sustainable, absent restructuring, foreign aid or an unanticipated burst of inflation, their governments will have to run large primary budget surpluses, in many cases in excess of 5% of GDP, for periods as long as ten years.
- History suggests that such behaviour, while not entirely unknown, is exceptional.
- Countries that have run such large surpluses for such extended periods have faced exceptional circumstances.
- On balance, this analysis does not leave us optimistic that Europe's crisis countries will be able to run primary budget surpluses as large and persistent as officially projected.