

Discussion of „The euro area recovery: Should the core expand spending to help the periphery“ by O. Blanchard, C. Erceg and J. Linde

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1.1. Congratulations!

- Sophisticated technical analysis of the effects of asymmetric fiscal stimulus in currency union.
- Core versus periphery and spillover effects considered, normal monetary policy response versus zero bound.
- Small model to illustrate intuition and study impact on welfare, medium-size New-Keynesian DSGE model to obtain more relevant quantitative results.

1.2. Results.

- When monetary policy remains unconstrained, fiscal stimulus in „core“ countries has negligible or even negative effects on „periphery“ countries.
- When market participants anticipate that monetary policy will be constrained by the zero bound on nominal interest rates for 2 to 3 years, spillovers of a „core“ stimulus to the „periphery“ turn positive and significant.

2. Outline of discussion

- Issues concerning fiscal stimulus and European Monetary Union.
- Issues concerning fiscal stimulus and zero bound.
- Revisit the broader policy question:
 - Is the fiscal stimulus package for France and Germany the solution for the euro area's problems?

3.1. Fiscal stimulus and European Monetary Union

- Some important historical experiences with fiscal stimulus in Europe are ignored by the authors.
- 1989-92 German reunification implied a major asymmetric fiscal stimulus.
- 2009-2010 Euro area economic recovery plan.

3.2. German unification stimulus and EMS

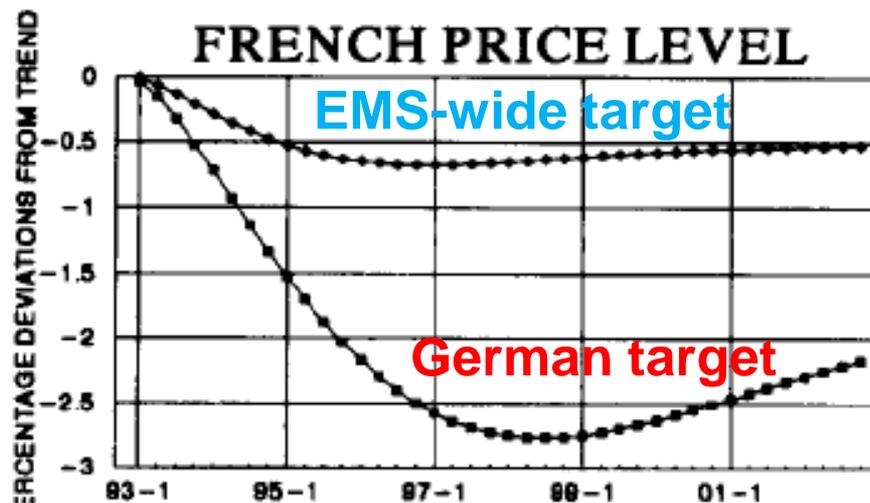
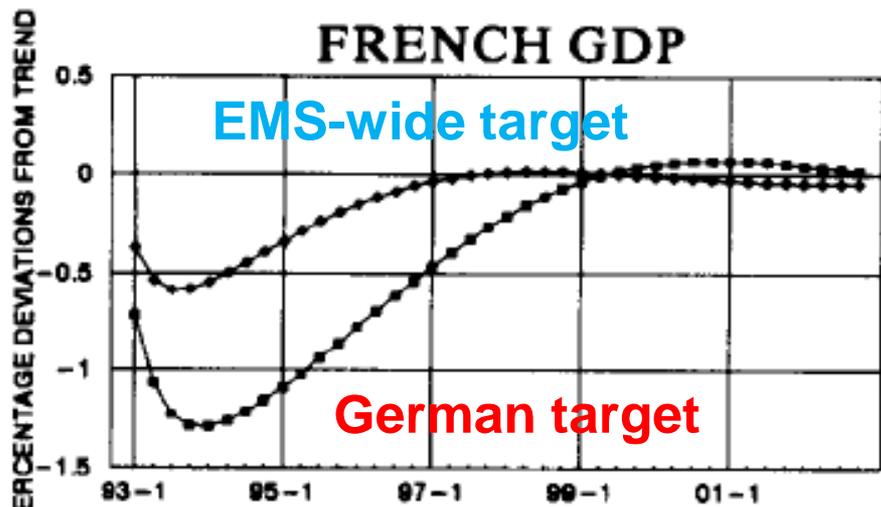
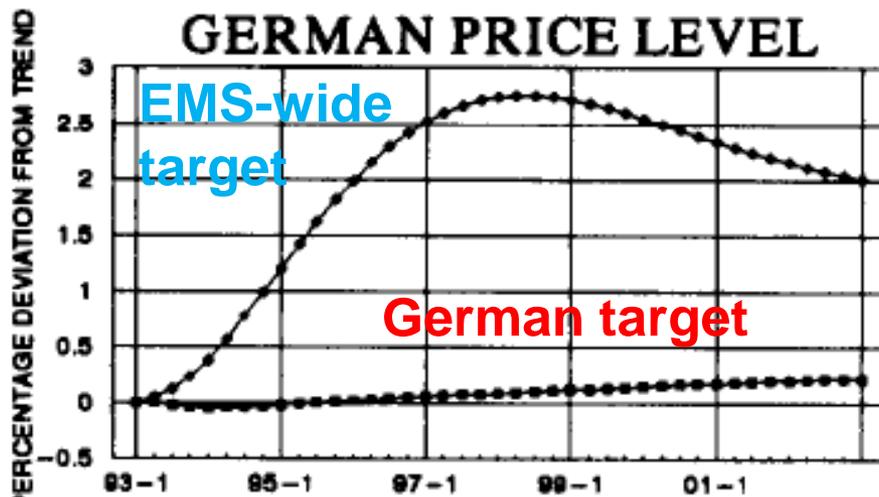
- Bundesbank eventually responded to German unification boom and inflation by raising interest rates.
- Members of European Monetary System tried to keep exchange rates fixed and raised interest rates.
- Negative impact on British, French and Italian economies.
- 1992/3 crisis of the European Monetary System.

3.3. Illustration in Wieland (1996), JIMF.

Monetary policy targets and the stabilization objective: a source of tension in the EMS, *Journal of International Money and Finance*

- Evaluate impact of German fiscal expansion in a structural model of G-7 economies with rational expectations and nominal rigidities (Taylor 1993).
- Germany, France, Italy and U.K. have fixed exchange rates.
- Flexible exchange rates with U.S.A, Canada and Japan.

3.4. 1%GDP spending stimulus - monetary policy with German vs EMS-wide target



3.5. 2009-2010 Euro area economic recovery plan

Country	Total fiscal package (€bn)	
	2009	2010
Austria	4.9	4.6
Belgium	1.3	1.2
Germany	39.4	49.4
Greece	0	0
Spain	26.8	14.7
Finland	2.4	2.4
France	17	4
Ireland	0	0
Italy	-0.3	-0.8
Netherlands	3.1	2.9
Portugal	1	0.4
EU-11	95.5	78.6

Germany: 90 bln€, 3.6% GDP
Spain: 41 bln€, 3.8% of GDP

EU-11: 174 bln€, 1,9% GDP,
thereoff government purchases
increase of 0.7% GDP.

Cwik-Wieland, (2011),
Keynesian government
spending multipliers and
spillovers in the euro area,
Economic Policy.

3.6. Spillovers from German stimulus in monetary union.

- Cwik-Wieland (2011), EP, use G7 model.

	2009Q1	2009Q4	2010Q4	2011Q4
<i>Monetary union</i>				
France	0.037	0.035	0.010	-0.009
Germany	0.700	0.645	0.368	-0.078
Italy	0.014	-0.009	-0.046	-0.052

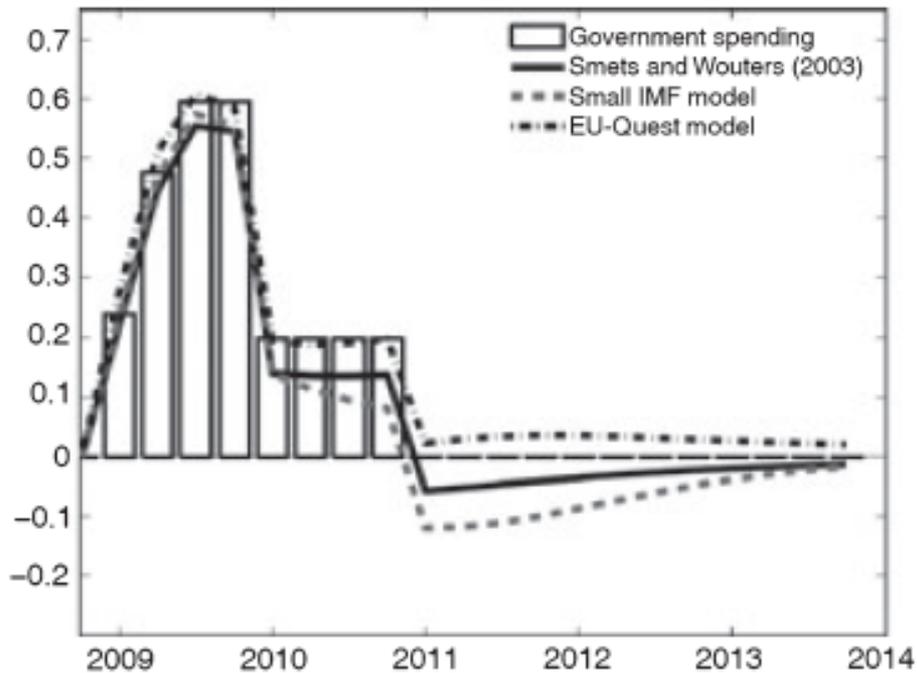
3.5. Lessons

- Asymmetric German unification stimulus a reason for break-up of EMS and for building monetary union with monetary policy focused on euro area targets.
- Appreciation vis-a-vis rest of the world is a key channel that needs to be taken into account → need at least a 3-country model.
- Small positive or negative spillovers in case of European economic recovery plan, 2009-2010.

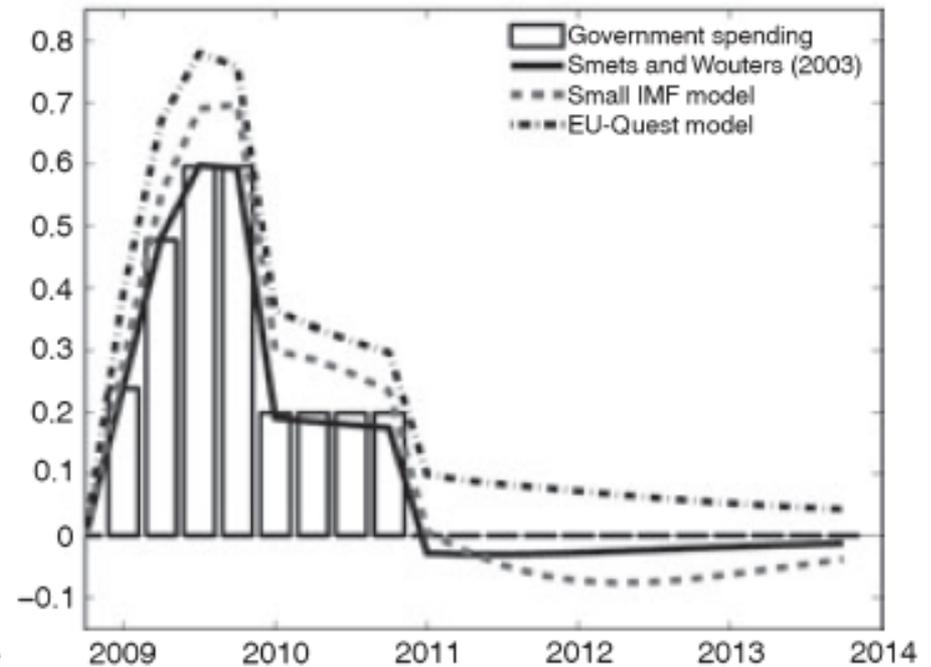
4.1. Fiscal stimulus and zero bound

- Simulation of overall euro area impact of euro area recovery plan, Cwik-Wieland, 2011, Economic Policy, using more recent New Keynesian DSGE models.

Constant rates in 2009



Constant rates in 2009 and 2010



4.2. Big effects with 2-year zero bound – recall CEE outlier! (Coenen et al. 2012, AEJ-Macro)

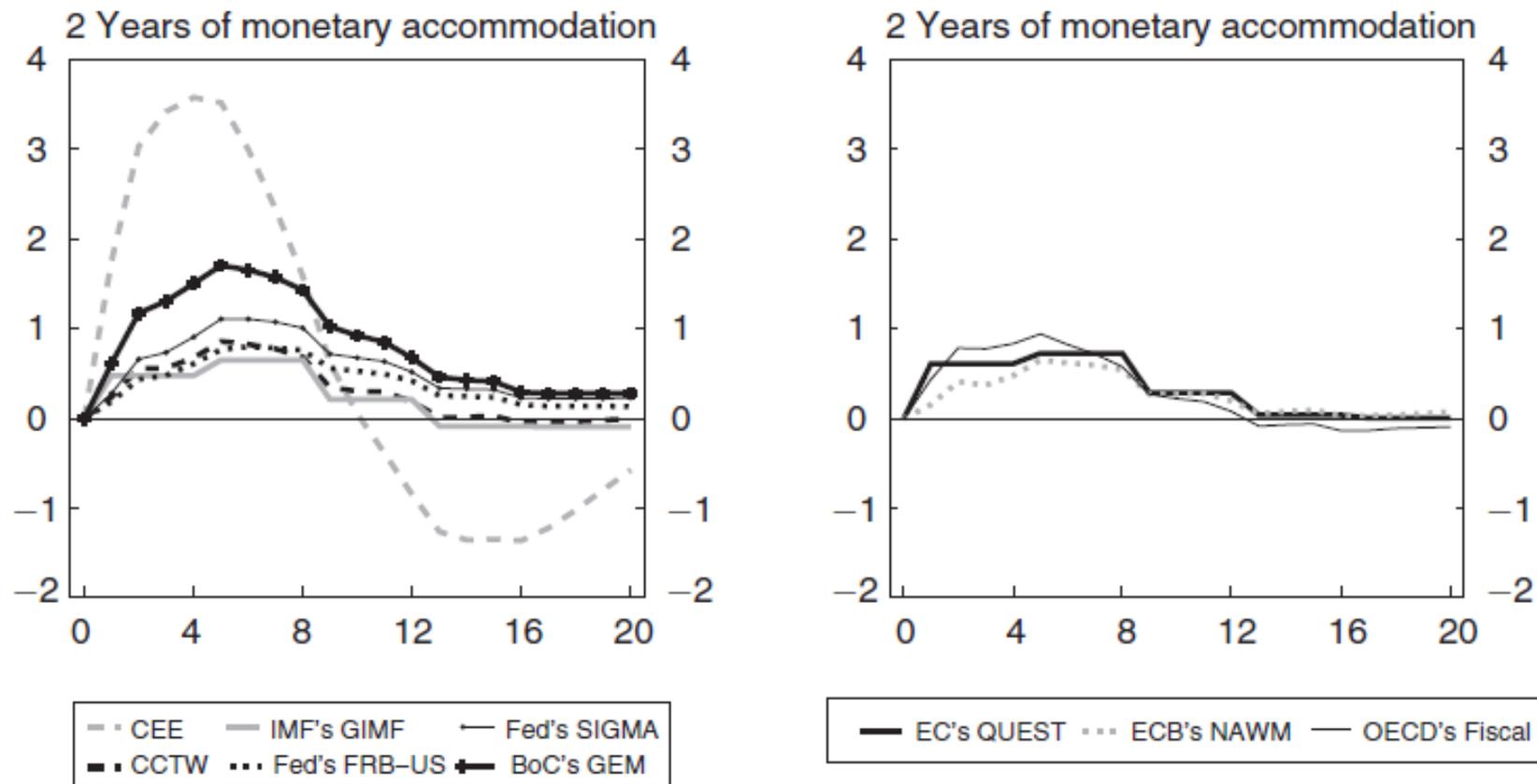
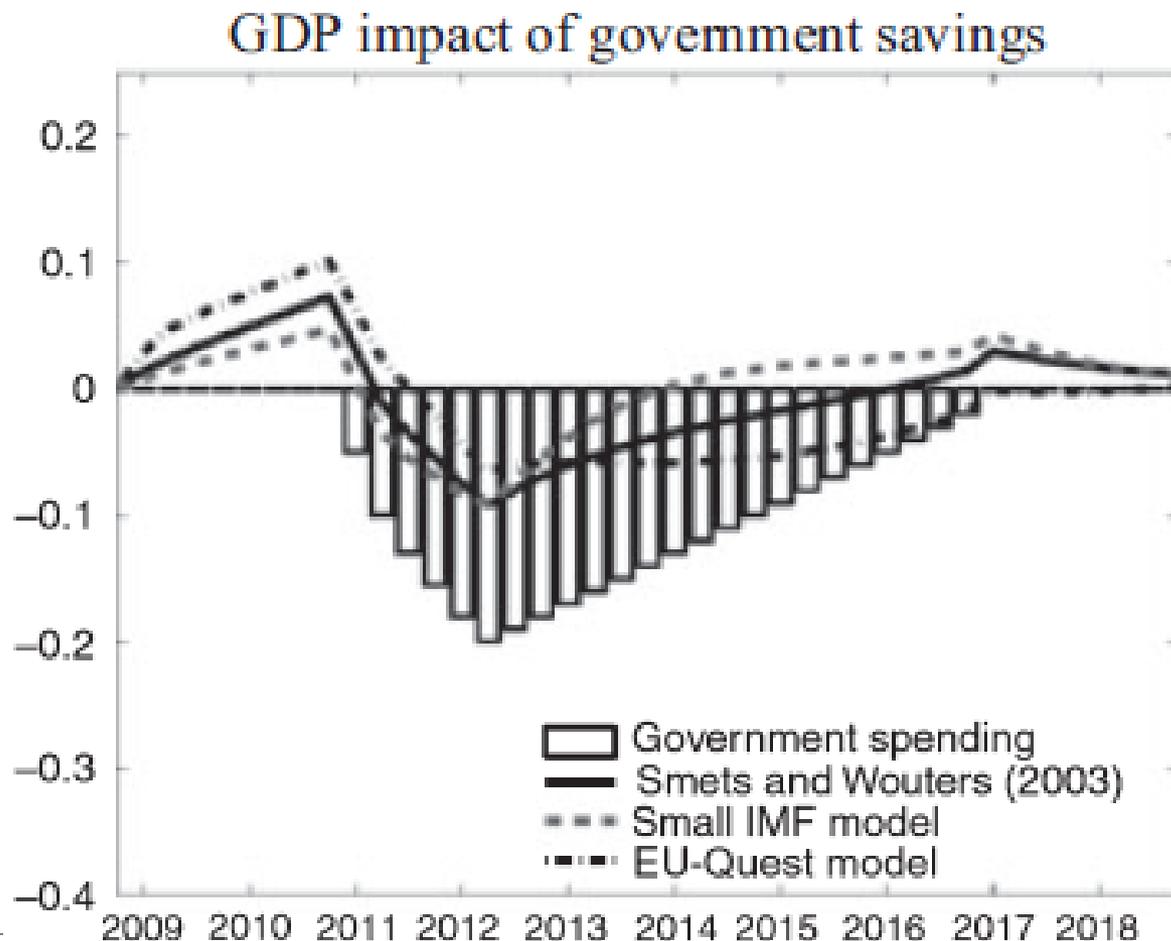


FIGURE 7. INSTANTANEOUS FISCAL MULTIPLIERS FOR THE ARRA STIMULUS PACKAGE

4.3. Anticipated spending cuts (Cwik-Wieland 2011, idea Corsetti, Meier, Müller, IJCB 2010)



4.4. Lessons

- Probably not much crowding-in in case of Euro area economic recovery plan.
- No binding zero bound at the time.
- Possibly resources would have been better spent for fixing banking system (Spain , 40bln).

5.1. French-German fiscal stimulus solution for euro area?

- Implications of paper very sensitive to anticipated length of zero bound.
- What about effectiveness of monetary policy vs fiscal policy?
- Where do we stand in euro area ?

5.2. Is monetary policy really less effective and fiscal policy more effective at zero bound?

- U.S. evidence from Swanson-Williams (AER 2014).

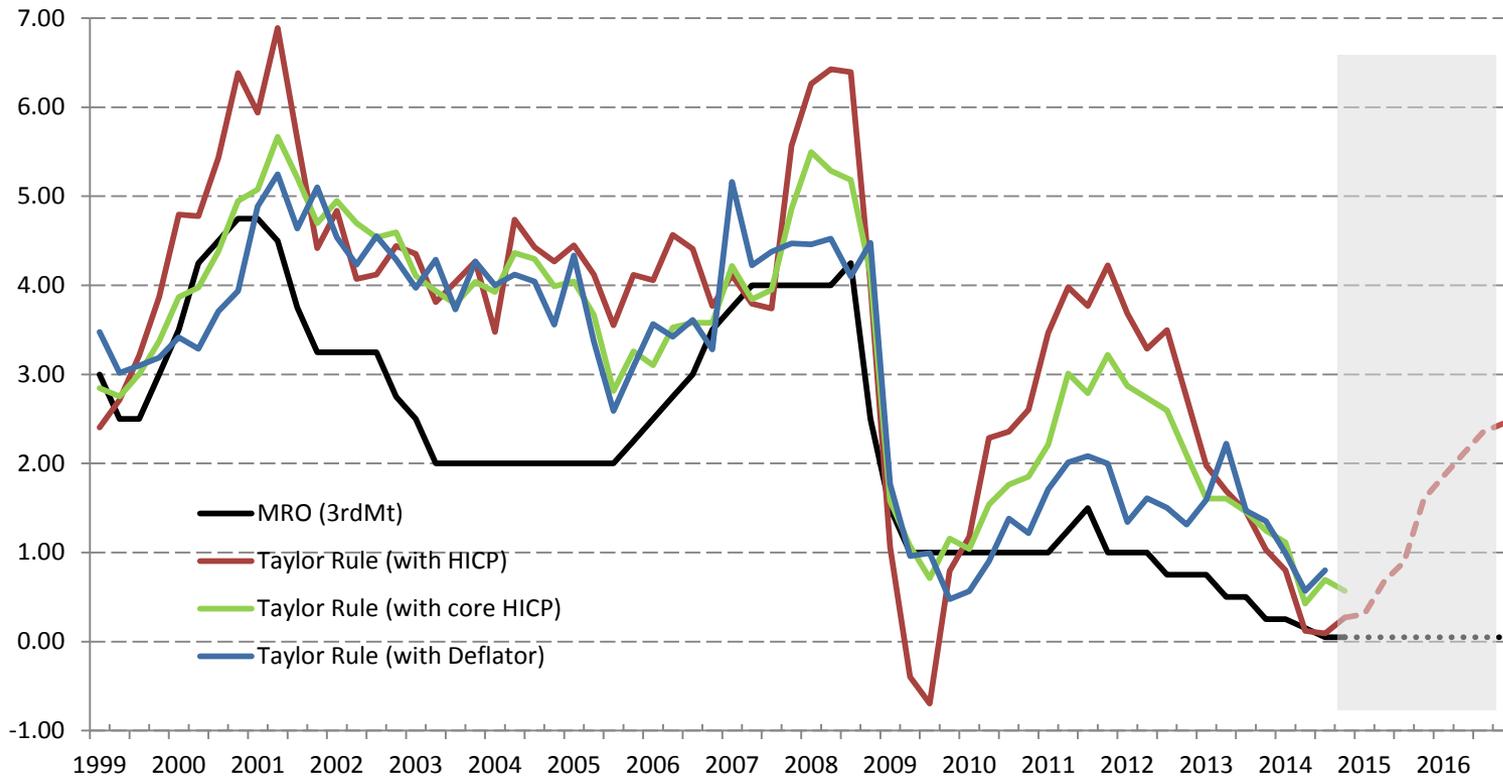
According to standard macroeconomic models, the zero lower bound greatly reduces the effectiveness of monetary policy and increases the efficacy of fiscal policy. However, private-sector decisions depend on the entire path of expected future short-term interest rates, not just the current short-term rate. Put differently, longer-term yields matter. We show how to measure the zero bound's effects on yields of any maturity. Indeed, 1- and 2-year Treasury yields were surprisingly unconstrained throughout 2008 to 2010, suggesting that monetary and fiscal policy were about as effective as usual during this period. Only beginning in late 2011 did these yields become more constrained. (JEL E43, E52, E62)

5.3. Fiscal stimulus effect at zero bound may reverse sign with dispersed information

- Wiederholt (2014), Empirical properties of inflation and the zero bound.
- Key role of inflation expectations and deflationary spiral in generating recession and greater effectiveness of fiscal policy at the zero bound.
- With dispersed information, inflation expectations change only slowly.
- Policy announcement may trigger market participants to increase probability on deflation/recession state.

5.4. Where do we stand in the euro area vis-a-vis Taylor rule?

Taylor Rule for the euro area with ECB real-time data and AMECO nowcasts
Forecast is based on latest ECB staff projections (December 2014)



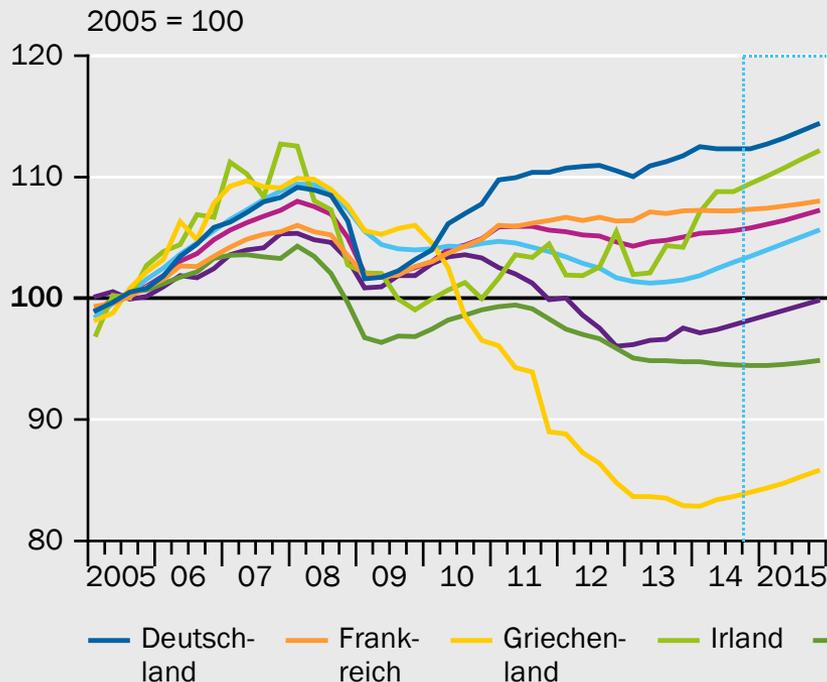
5.5. „Core“ versus „periphery“ stimulus

- Risks large that no spillover effect due to asymmetric fiscal stimulus if zero bound not anticipated for such long period. → Don't do it.
- Instead, it is better to provide credit or guarantees from „core“ to „periphery“ to allow more expansive fiscal stance in „periphery“.
- This is what was done in 2010. EFSF/ESM. Focus not on stimulus packages but to fund deficits resulting from automatic stabilizers.
- Key to maintain credit-worthiness of „core“ and not endanger it with higher debt and fiscal stimulus in „core“.

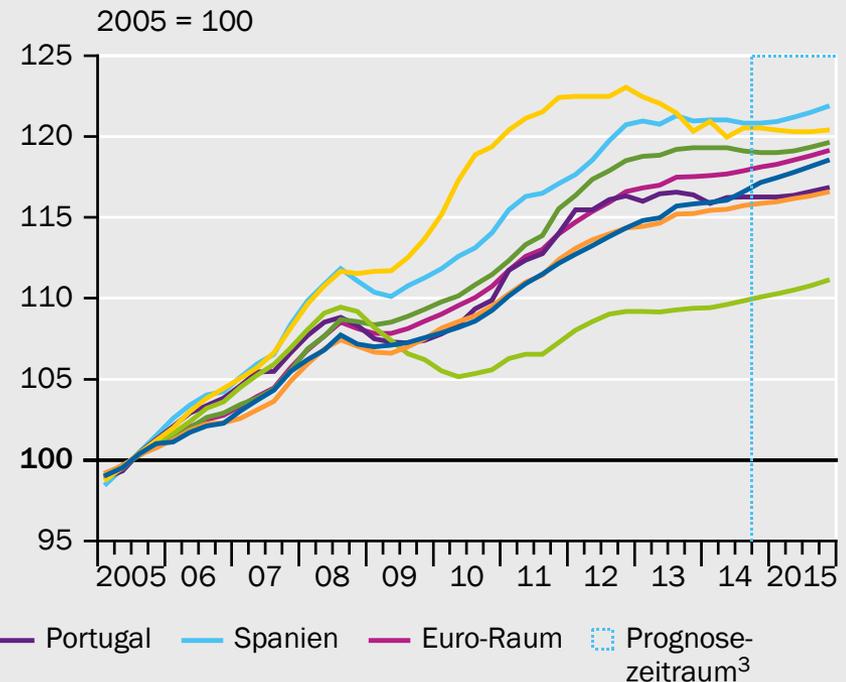
5.6. Adjustment in euro area, program countries improving.

Bruttoinlandsprodukt und Verbraucherpreise ausgewählter Mitgliedstaaten des Euro-Raums

Bruttoinlandsprodukt^{1,2}



Verbraucherpreisindex (HVPI)²



5.7. IMF recommendations

19. Deep structural changes are urgently needed to unleash Italy's growth potential, secure a robust recovery and address debt overhang risks. Implementing structural reforms simultaneously would be self-reinforcing and generate significant growth synergies:

- ***Labor reforms.*** A labor contract with gradually increasing protection would reduce duality and encourage firms to invest in workers. Raising the quality of ALMP to the level of the best regions, with centralized monitoring, would help address long-term unemployment. Promoting firm-level bargaining through greater flexibility under national contracts would better align wages to productivity.
- ***Judicial reforms.*** To speed up the judicial process, consideration could be given to reviewing court fees, limiting excessive appeals, developing performance indicators for all courts, and incentivizing the use of mediation. Disseminating regional best practices would help reduce the performance gap.

5.8. IMF recommendations

- **Competition policy.** Legislative initiatives have been put forward over the years to remove regulatory barriers in many markets, but implementation has been weak. Delivering on the commitment to legislate recommendations of the antitrust authority would enhance competition and lower the cost of services.
- **Corruption.** The 2012 anti-corruption legislation and recent measures to enhance the power of ANAC represent important steps. The legal framework could be further improved, notably by criminalizing the false accounting offense and changing the statute of limitation provisions.

20. A greater push to clean up bad loans would support lending in the recovery... BoI inspections and the European AQR have improved provisioning coverage ratios and strengthened confidence, but NPLs continue to rise, weighing on bank profits and lending. Encouraging more provisioning and write-offs; developing the distressed debt market; and enhancing the insolvency regime would help accelerate the reduction of NPLs and free up resources for the recovery.

5.7. IMF recommendations

ITALY

Staff Advice

Link unemployment support to employability. In deep recessions, the current wage supplementation scheme hampers reallocation of labor from unprofitable firms and should shift to a more universal support system conditional on job search and training.

Simple contracts. A single labor contract with gradually increasing protection would enhance fairness by reducing duality, especially if it were to replace open-ended contracts. Grandfathering could ease adjustment to the new system.

National coordination of ALMP. Build on the experience of successful schemes like Finland's, to reduce regional disparities and improve monitoring and evaluation. Greater information sharing on job openings and seekers could create new markets for more flexible work, especially among women and the elderly, similar to U.K. and U.S. job exchanges.

Decentralized wage setting. To allow firms to adapt more quickly to changing economic conditions, Italy should promote more firm-level wage bargaining, together with greater flexibility in national contracts e.g. on non-wage terms such as shifts and working hours.

Implementation Status

Proposed in Jobs Act but not yet implemented.

Staff proposal goes further than the "trial" contract in Jobs Act.

Staff goes beyond Jobs Act and suggests new market-based institutions for job matching.

The idea is not included in the Jobs Act.

5.8. IMF recommendations