The fiscal instrument: How it got lost, how it can be reclaimed

Andrea Terzi
Franklin University Switzerland

Europe at the Crossroads:
A Union of Austerity or Growth Convergence?
Session: Threats to European Recovery

Athens, November 21–22, 2014
The European recovery that never really was

Factors backing up EC and ECB forecasts of recovery:

“Less” negatives: uncertainty, financing conditions, deleveraging needs, neutral fiscal stance

Positives: low commodity prices, weaker euro, lower precautionary savings

Structural policies impact: lower unit labor costs

Monetary policy impact: low interest rate environment
Are the “thrusters” out of fuel?

Less uncertainty and yet less confidence?
Banks unwilling to raise exposure in a stagnant economy?
Business reluctant to borrow-to-invest in a stagnant economy?
Consumers not keen to lower their precautionary savings?
Low interests typically failing to fuel demand?
Will the single market be begging for exports?
Fiscal stance neutral or rule-consistent?
Euro Area’s low growth and high unemployment: A neutral fiscal stance?
The economic significance of government budget management

**Structural and allocation decisions**
- Size and quality of public spending $\rightarrow$ Creating incomes, providing services
- Tax rates and subsidies $\rightarrow$ Redistribution and net removal of financial assets

**Macro fiscal instrument**
- Fiscal balance acting counter-cyclically as a buffer during business cycles

**Two meanings of “austerity”**
- State governments should cut wasteful spending and/or improve the quality of spending
- State governments should meet “savings targets” by reducing deficits without the helping hand of the central bank
The alleged logic of why the fiscal instrument offers no sustainable help

All individuals and entities are subject to a *budget constraint*

and an economic nation is only a sum of economic agents

Net government spending creates demand by *absorbing private savings*

and may momentarily provide artificial fuel (‘automatic stabilizers’)

and yet, only doable insofar as savings in government hands remain safe

A government with no “*fiscal space*” loses the fiscal instrument to counter a slowdown

and policy should turn to increasing overall efficiency and potential output

Long-run growth is genuinely fueled by *low production costs* and *low debt*

and the faster reforms are implemented, the sooner austerity can end
EC and ECB models fail to use all available information

Two major facts are missing:

- Government budget constraints are institutionally-driven
- Government borrowing-to-spend adds to private savings
Public budget constraints are institutionally-driven

Any government acting both as money creator and spender poses a potential threat:

- Governments (and voters) are biased towards overspending
- To avoid inflation, governments borrow (rather than print money)
- When debt becomes unsustainable, governments ‘monetize’ and inflate

*M. Friedman, 1968; J.M. Buchanan-R. Wagner, 1977; S. Fischer, 1989*

Solution is creation of an institutional budget constraint (IBC):

- Transfer monetary power to a central bank with no spending authority
- Set deficit and/or debt limits to the spending (government) authority
Is deficit reduction in Europe aimed at avoiding inflation?

S. Fischer: “Inflation is almost always a fiscal phenomenon”

And a central banker concedes: “It’s very difficult for us to reach the objective [of inflation] only based on monetary policy”

(M. Draghi, 4 September 2014)

The IBC solution

- was tailored to prevent inflation
- offers little justification for austerity at this time
- supports the narrative: “we really ought to monetize to see a recovery”

Except monetization is not enough ... →
Government borrowing-to-spend funds private savings

When government borrows and spend (i.e., trades debt for deposits and spends deposits for output), it boosts private sector’s net financial assets.

This is expressed in:

‘National saving’ = Net private saving – Government deficit

‘National saving’
- is zero with a balanced foreign trade account
- gets positive when the private sector net exports and acquires new claims abroad
- gets negative when the private sector net imports and transfers its claims abroad

Let’s see private savings in action … →
Euro area: Sectorial balances: **Households’ net financial savings** (Source: ECB)
Euro area: Sectorial balances: **Financial corporations’ net financial savings** (Source: ECB)
Euro area: Sectorial balances: **Non-Financial Corporations’ net financial savings** (Source: ECB)
Euro area: Sectorial balances: **Foreign sector’s net financial savings** (Source: ECB)
Euro area: Sectorial balances: **National governments’ deficits** (Source: ECB)
Euro area: **Sectoral balances and corporate investment** (Source: ECB)
Households’ net savings moving anti-cyclically
Euro area: **Sectoral balances and corporate investment** (Source: ECB)
Euro area: **Sectoral balances and corporate investment** (Source: ECB)

Government net spending moving anti-cyclically
Euro area: Sectoral balances and corporate investment (Source: ECB)
Euro area: **Sectoral balances and corporate investment** (Source: ECB)
The fiscal instrument can be actively engineered, set free to adjust, or blocked

- Monetary unions responsibly block the fiscal instrument at the local level to avoid uncontrolled expansion
- The euro area had let it free to adjust insofar as ‘excessive deficits’ were considered national episodes
- The euro area has irresponsibly blocked the fiscal instrument when this was providing the needed correction
Falling stock of NFS

Increasing stock of NFS

Falling stock of NFS

World

Net Financial Savings
When demand declines

When demand increases

Net Financial Savings

Government Deficit

World
Concluding remarks and policy recommendations

Deficit reduction policy (aka ‘austerity’)

- Dramatically underestimates its direct stagnation effects
- Considerably overestimates the power of ‘monetization’
- Pressures governments to downsize, with no political legitimacy

Any effective ‘solution to the euro’ should be

- Using the fiscal instrument at Union level within a credible framework
- Boosting institutions to include a new Economic Council that evaluate overall fiscal impact
- Consider *(before dis-integration!)* an additional 5% deficit/GDP through a comprehensive 50% cut of VAT and a consented plan for public infrastructure, both funded by *(EMS? EIB?)* bonds guaranteed by the ECB