

THE POLICY OUTLOOK IN EUROPE: THE MISSING BUILDING BLOCK

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Abstract

The policy framework is unfavorable in Europe. The building blocks of this framework – the Juncker Investment Programme (JIP) and the ECB Quantitative Easing program (EQE) – are not, for different reasons, a sufficient answer to the Euro crisis. We argue that 1) JIP is far from being a way to boost investment demand in Europe; and 2) EQE, even if of a sizeable amount (at least one trillion € in 16 months from March 2015 to September 2016) and properly committed, is not, standing alone, a really powerful mean to end deflation in Europe.

What is required to face the Euro crisis is the coordination of macroeconomic policies. In our view, this implies a policy mix of expansionary monetary policy and accommodative fiscal policy. Under the current extraordinary circumstances (low interest rates and low or even negative inflation rates), without a fiscal stimulus EQE produces effects that need time to materialize. That is, the quantitative easing must be long lasting in order to end deflation, bringing again the inflation rate on its desired (equilibrium) path. This sharpens the risks of financial instability. At the same time, EQE loosens the budget constraint, substituting national debts, a government liability, with money, a not-redeeming asset. This leaves some room for a transitory deviation from the planned pace of fiscal consolidation (i.e, a temporary worsening of nominal government deficit), because it is expected to not affect government structural balances, therefore preserving long run sustainability.

We suggest that the fiscal stimulus can and must be designed so as to target both aggregate demand and potential output. Total investment is the key-variable in this approach. Empirical evidence shows that the declining trend in the rate of capital accumulation in Europe has been worsened by the 2008 financial crisis (incidentally, the evidence on savings is barely compatible with the secular stagnation hypothesis). In some countries like Italy, the net capital stock itself has ceased to grow. Both private and government investment should be furthered, to the extent that the public capital stock is a driver of growth, directly entering in the firms' production function or shifting total factor productivity.

Tax shifting may help in making even more sustainable this strategy. Revenue neutral fiscal incentives, enacted by the individual Eurozone countries in a hopefully synchronized effort, might increase aggregate demand, enhancing at the same time potential output and without raising the government deficit. There are many ways to change (and re-balance) the tax-mix. We think that either the fiscal burden on the new investments or on the personal income should and could be targeted in this re-modeling of tax rules.