Right here, right now: The quest for a more balanced policy mix

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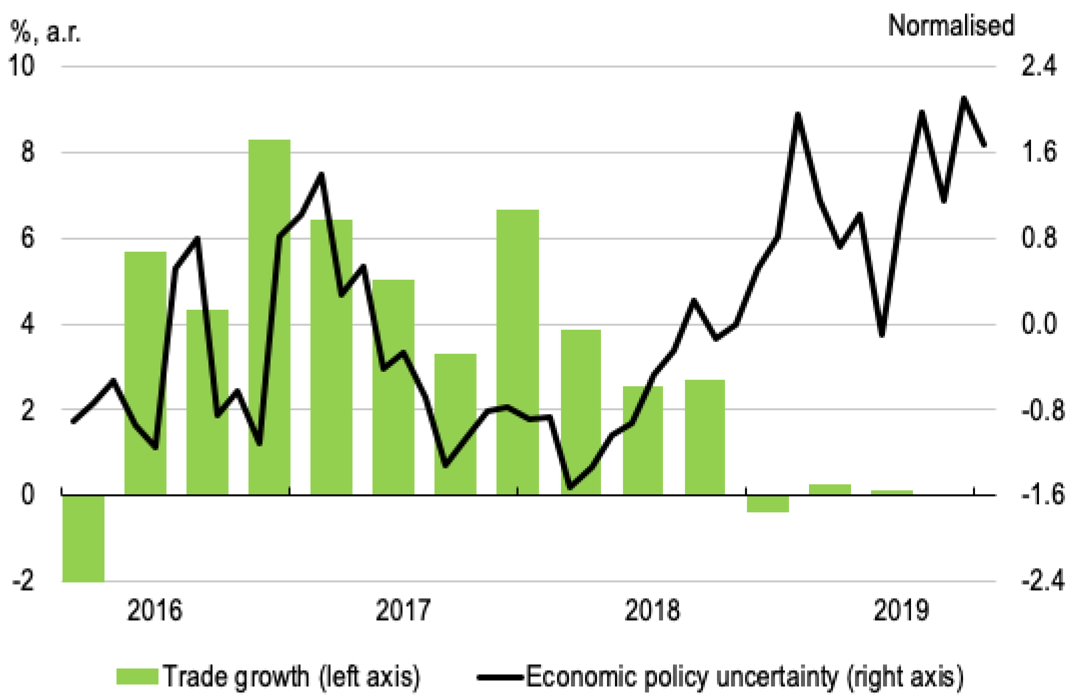
After years of solid growth, worldwide economic activity has slowed down sharply in 2019 while global trade has stalled. Policymakers have the difficult task of addressing the immediate policy challenges to support economic growth while also preparing our economies for the future. This column argues that while monetary policy is widely recognised as facing increasing constraints, fiscal policy and structural reforms need to play a stronger role. In particular, fiscal policy could become more supportive, notably in the euro area. Undertaking the right type of public investment now – in infrastructure, education or to mitigate climate change – would both stimulate our economies and contribute to making them stronger and more sustainable.

Over the past few years, economies in the OECD and in particular in the EU had been growing at cruising speed, after having seemingly shrugged off the remains of the global financial crisis. The US is experiencing its longest bout of uninterrupted positive GDP growth on record. Similarly, despite lower growth performance, the EU has been growing for 25 quarters and its unemployment rate is now at its lowest since 2000.

Yet, worldwide growth has been decelerating sharply in 2019, dragged by a global trade and investment slump along with, in Europe and most notably in Germany, a steep drop in manufacturing activity. Recent indicators suggest that growth could weaken further (IMF 2019). Rising uncertainty has been driving this slowdown, as a result of increasing economic tensions between China and the US, geopolitical developments in the Middle East (with the associated risk of a sharp rise in oil prices), and the political deadlock over Brexit. The materialisation of these risks could put the world economy on a collision course. Even if they remain only looming threats, high and increasingly entrenched uncertainty is sufficient to put a brake on investment and growth.

Figure 1 Global trade growth and policy uncertainty



Note: Global uncertainty index normalised to 0 over the period
Source: www.policyuncertainty.com and OECD Economic Outlook database.

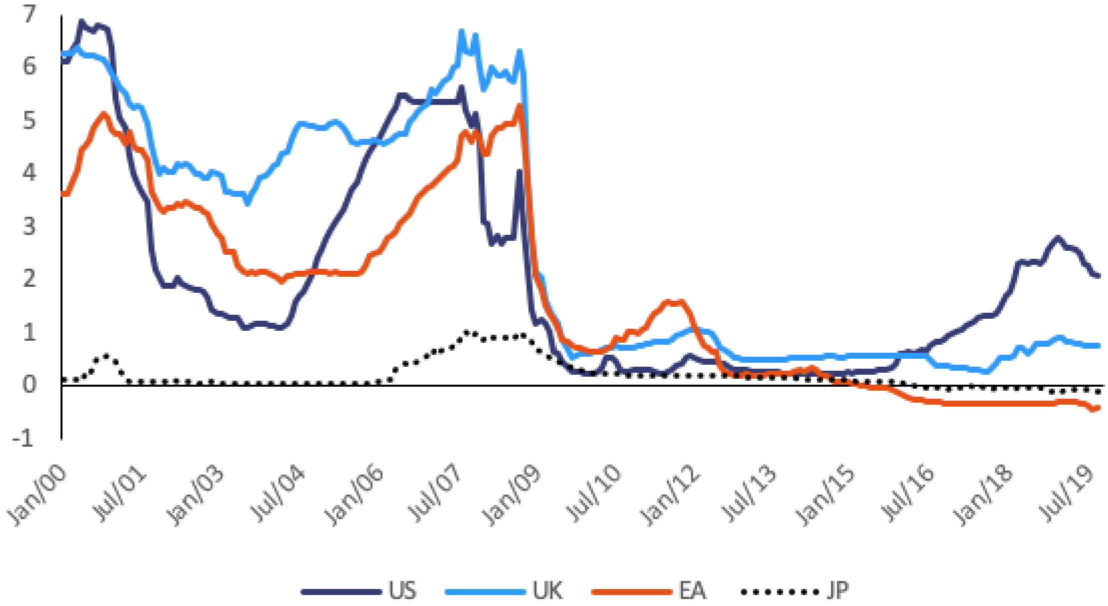
The impact of these tensions is exacerbated by a number of structural developments, in particular in Europe. The drop in potential growth, evident since the 2000s, has prompted concerns of 'secular stagnation' affecting the US and Europe. An important driver could be the slow diffusion of technologies: as Anzoategui et al (2019) argue, much of the slowdown in productivity after the recession can be attributed to lower technology adoption. In addition, demographic change is taking a toll on growth potential while the appetite for reforms has slowed.

A better policy set-up is needed to lift economies back to growth

The conjunction of cyclical and structural impediments to growth calls for a review of the customary economic policy response to a deteriorating economic climate. Current inflation and policy rates, which are expected to remain at their low levels, suggest that ever more accommodative monetary policy will not be enough to revive GDP growth. At the same time, nominal GDP growth rates being above interest rates paid on public debt for most countries, and set to remain there for long, increase the space for public investment.

Since the outset of the financial crisis, monetary policy has remained exceptionally accommodative, bringing interest rates close to zero (see Figure 2). In particular, the Fed continues to take expansionary measures, while the Bank of Japan maintains an extraordinary degree of monetary accommodation. Zooming in on the euro area, the ECB announced a fresh stimulus package in September as it cut the deposit rate further by 10 basis points and relaunched its quantitative easing (QE) programme, together with expanded forward guidance. However, monetary policy faces increasing constraints.

Figure 2 Three-month interbank interest rates (%)



Source: Bloomberg

The other policy instruments in the toolbox – both fiscal and structural – thus need to help. Together with the structural reforms needed to lift productivity durably, public investment could be put to use to halt the ongoing slowdown and prepare the ground for stronger and more sustainable economies. In fact, the same factors that constrain monetary policy are a bonanza for fiscal policy, which jointly with structural reforms can lift growth in a sustainable way.

Fiscal interventions are more powerful when inflationary pressures are low and monetary policy is likely to accommodate fiscal expansions as long as inflation remains below target. The euro area as a whole has fiscal room to manoeuvre, even though the situation differs markedly across countries. But while the slowdown is becoming entrenched, under current plans, fiscal levers are not being activated: on average in the euro area, the fiscal stance is expected to be broadly neutral in the next two years.

At the same time, the appetite for reforms with potential to lift growth and employment in the longer term – such as easing barriers to entrepreneurship, improving and expanding training, and supporting R&D and technology adoption – has waned, as shown by the implementation of the Going for Growth recommendations (OECD 2019a) or EU country-specific recommendations. Yet, such reforms are needed to reverse the slowdown in productivity that started even before the crisis but was exacerbated by the hysteresis effects of the Great Recession on investment and skills. Structural reforms are also needed to make growth more environmentally sustainable, by aligning policies and regulation with the goal of transition to a low-carbon economy (OECD 2015).

In addition, reforms are easier to implement when accompanied by a supportive policy mix, while in times of faltering demand, structural reforms alone may weigh on inflation and already weak demand (Eggertsson et al. 2014). In effect, reforms introduced when the economy is weak have a better chance of succeeding when undertaken together with supportive macroeconomic policies and renewed public investment, and when they put more weight on measures that also boost demand in the short term, such as strengthening job search assistance and training and improving the tax structure (Caldera Sanchez et al. 2016). Simulations on the euro area run by the OECD for its Economic Outlook illustrate how combining a temporary public investment push with productivity-enhancing reforms can help bring forward the long-term benefits of reforms (OECD 2019b,c).

There is a strong case for a more supportive fiscal policy in the euro area

In the euro area, the inadequacy of a policy mix relying exceedingly on the monetary policy pillar is becoming particularly obvious, as notably emphasised by the institution itself (Draghi 2019). Meanwhile, the ‘reflationary’ efforts conducted by the ECB are meeting increasing resistance both within and outside the institution.

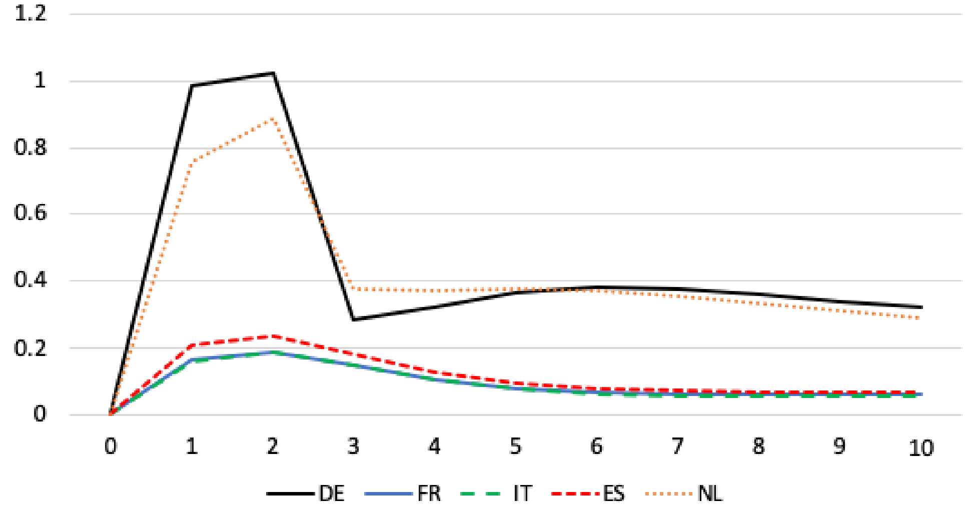
Consequently, the usual arguments for relying mainly on automatic budgetary stabilisers and monetary policy when dealing with adverse shocks to the euro area may have to be reconsidered. In particular, modelling work done by the European Commission (In’t Veld 2019) shows that when monetary policy is constrained by the zero-rate floor, fiscal stimulus has a stronger impact on growth in the short term and a more benign effect on the debt ratio in the long term.

While the benefits of a more supportive fiscal policy already appear sizeable at the current juncture, depending on how events unfold, the failure to act could result in snowballing negative effects going much beyond those captured in the usual simulations. In particular, the lack of action may increase the risk of the economy moving to inferior equilibria where deteriorating expectations of growth, employment and price developments, as well as private sector balance sheet effects, may further add to the current downward spiral. In these circumstances, the costs of too little stimulus in a worsening economy are likely to outweigh the costs of too much stimulus should a more favourable scenario materialise. The large compounded downward risks call for a risk-based approach to fiscal policy, with more pre-emptive rather than reactive policy action.

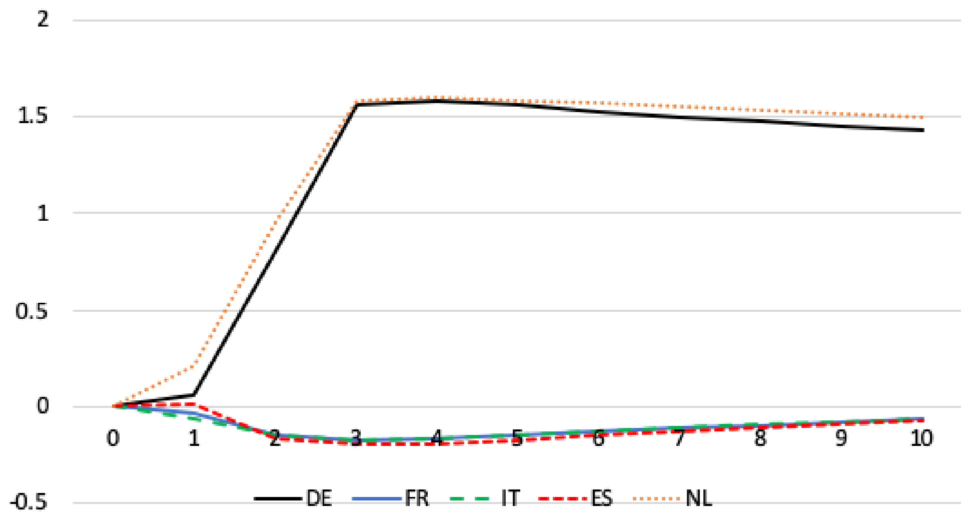
In absence of a common euro area budget, the current situation offers an opportunity for a truly coordinated approach to a supportive but differentiated fiscal stance in the 2020 budget plans. A more active role for fiscal policy in the policy mix would require differentiation between Member States with fiscal space and Member States with high debt, taking into account the divergent sustainability challenges. Furthermore, it is also important to improve the quality and composition of public finances, in particular boosting investment to ease the climate transition, and step up structural reforms.

Figure 3 Effects of differentiated fiscal expansion: Germany and the Netherlands

a) GDP



b) Debt-GDP ratio



Note: GDP effects as percentage difference and debt-GDP ratios as percentage-point difference from baseline for a 1% of GDP increase in public investment for two years in DE and NL. Default assumptions for debt profile: r^g =0 (i^g=2, π=2, g=1.7).

Source: In't Veld (2019)

Illustrative simulations with the Commission's QUEST model suggest that an increase in public investment of 1% of GDP for two years in Member States with fiscal space, with monetary policy at the zero lower bound, leads to GDP increases of around 1% during that period in the concerned Member States and slightly less for more open economies (Figure 3). In the medium run, even after the stimulus has been removed, output remains above the baseline due to productivity gains from higher investment. Spillovers to other euro area Member States are modest at around 0.1-0.2% of GDP. The resulting effects of a temporary fiscal stimulus on debt to GDP ratios are benign, thanks to higher growth. In the Member States with fiscal space, the debt-to-GDP ratio would increase around by 1½ percentage points in the short run, fading out in the long run. A more persistent expansion in public investment in surplus countries, which would correct past cutbacks, would give a bigger boost to the euro area economy, with larger spillovers to other countries and still a manageable increase in debt ratios compared to the baseline scenario (In't Veld 2016). Where interest rates are negative, as is presently the case for most countries, the debt dynamics are even more favourable.

High fiscal multipliers and benign effects on debt developments rely on the nature of the fiscal impulse. Investment spending, which supports the economy's productive capacity and is time-limited in nature, has a stronger impact. A differentiated investment stimulus in line with the spirit of the EU fiscal framework would be most effective.

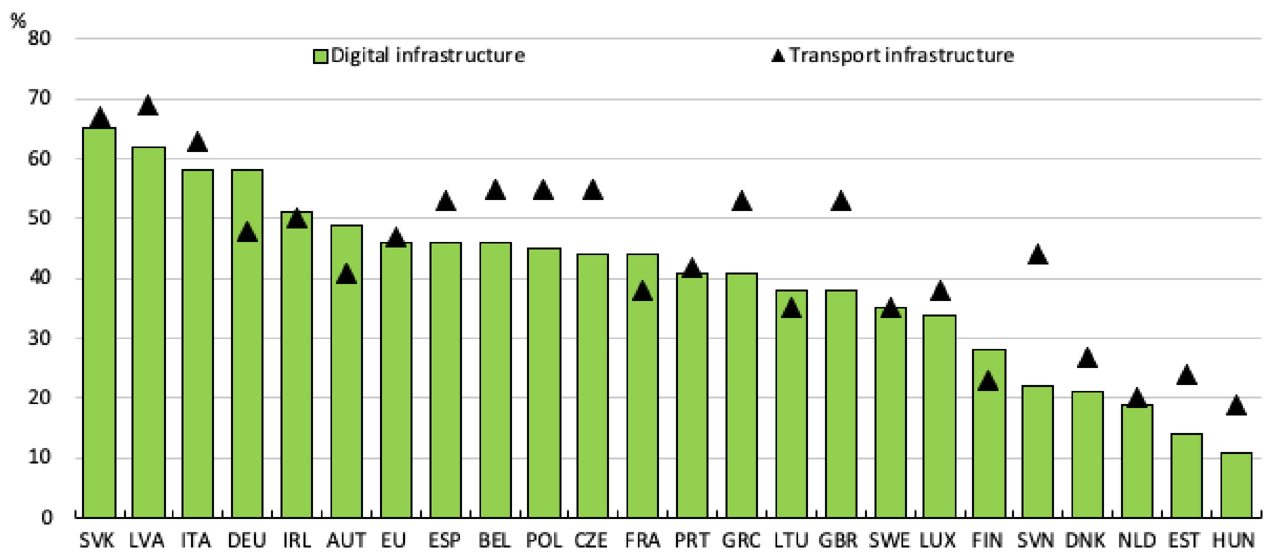
Now is the time to invest in stronger and more sustainable economies for the future

The case for a more active use of fiscal policy is not only rooted in the critical role it must play to drag weak economies out of the risk zone. The current situation also offers an opportunity not to be missed to address deep economic challenges and invest in the future. The low interest rates at which governments are borrowing, even at long maturities, mean that many of them can more easily undertake investments to raise long-term growth, sustainability and wellbeing without putting strain on public finances.

In the aftermath of the global financial crisis, governments often resorted to cuts in public investment to achieve fiscal consolidation in a way deemed less painful than raising taxes or cutting social spending or the public sector wage bill. Throughout the post-crisis period, this shortfall in public investment has not been made up for. A decade of infrastructures that were not built or were not properly maintained has been taking its toll on productivity and growth potential. It risks turning into persistently missed chances to better connect people, firms and regions to opportunities.

Some countries, such as Germany, are in dire need of stronger investment. Across the EU, almost half of firms are held back in their investment decisions by the inadequacy of transport infrastructure, and the same number by the lack of access to digital infrastructure (Figure 4). High-speed networks are the backbone of a knowledge economy and a pre-condition for firms to innovate and thrive in the near future. Bridging the rural digital divide is also key to reduce regional disparities and improve social cohesion. Further investment in health, education and skills would also support a more durable and more inclusive growth.

Figure 4 Firms reporting that infrastructure is an obstacle to their investments (%)



Source: European Investment Bank Investment Survey, 2018.

At the same time, the need to invest in greening our economies is becoming ever more pressing, as delaying action will entail steeply rising costs of climate change mitigation (IPCC 2018).

The growing scale and reach of climate-motivated demonstrations and civil disobedience actions in recent months have given a political urgency to the issue. The energy transition will require more investments – and different investments than under the current trajectory – to decarbonise entire sectors starting with energy, industry and transport. In the EU, President-elect van der Leyen has announced a "Green Deal" to accelerate the transition towards achieving carbon neutrality by 2050 (van der Leyen 2019). Such an initiative could mobilise public and private resources to lift innovation and investment in low-carbon technologies and build more sustainable economies.

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