Back from the Closet: Macroeconomic Policy after the Crisis

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Taking stock of the COVID-19 crisis: The impact on the labour market and how countries have responded

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International Labour Organization

IZA Institute of Labor Economics

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The Source of Trouble: Technocracy and Macroeconomics

- The battle of ideas of the 20th century yielded a "New Consensus" in macroeconomics that dominated until the crisis
- The New Consensus is centered around the concept of **market efficiency**: The system converges to the natural (long run) output through market forces: **It exists a "first best" for the economy**
- Supply-side economics: no role for aggregate demand beyond the short run
- Therefore:
  - **Structural reforms** (reduce real rigidities) to boost competitiveness, exports and potential growth
  - **No role for macroeconomic policy** in boosting growth
    - *Monetary policy* should only anchor inflation expectations
    - *Fiscal policy* should not crowd out private expenditure
  - **Monetary policy to be preferred** because it is not subject to biases and lags

This is not Ivory Tower Economics

- The Washington Consensus three pillars:
  - Labour and product markets reforms
  - Small government: Privatization/liberalization
  - Nominal targets (inflation, deficit, exchange rate)

- In the EMU, the Maastricht Treaty embeds the Consensus
  - Fiscal policy is constrained by the Stability Pact (now Fiscal Compact): Automatic stabilizers
  - Monetary Policy is limited to price stabilization (strict inflation targeting for the ECB)

The Global Financial Crisis has shaken the consensus

- Balance sheet recession: Aggregate demand was paramount:
  - Deleveraging: increase in savings by firms and households
  - Credit crunch decrease of credit supply/demand
- Liquidity injections are effective in saving the financial sector, but do not trigger the recovery: **liquidity trap**
- The liquidity trap called for **fiscal policy** to sustain aggregate demand
- Stimulus plans of 2009 (too quickly reversed afterwards)

Then came "Rethinking economics"

- Almost any old dogma is today reassessed and re-discussed
  - Multipliers and the debate on austerity
  - Fiscal (and monetary) rules
  - Public investment
  - The role of inequality
  - Reforms
  - Public debt sustainability
- The potential game changer: **the end of the natural equilibrium**?
  - Demand and supply dynamics are not independent
  - The short run cannot be neglected
  - Macroeconomic policy has an impact on long term growth

The permanent cost of austerity

Fatàs and Summers (2017) "The permanent effects of fiscal consolidations" *Journal of International Economics*

- Shocks have effects both on current and potential GDP
- Fiscal consolidation impacts both current and potential output
- Hysteresis is key
- Multipliers are large so fiscal consolidation has strong impact
- Fiscal consolidations are self defeating

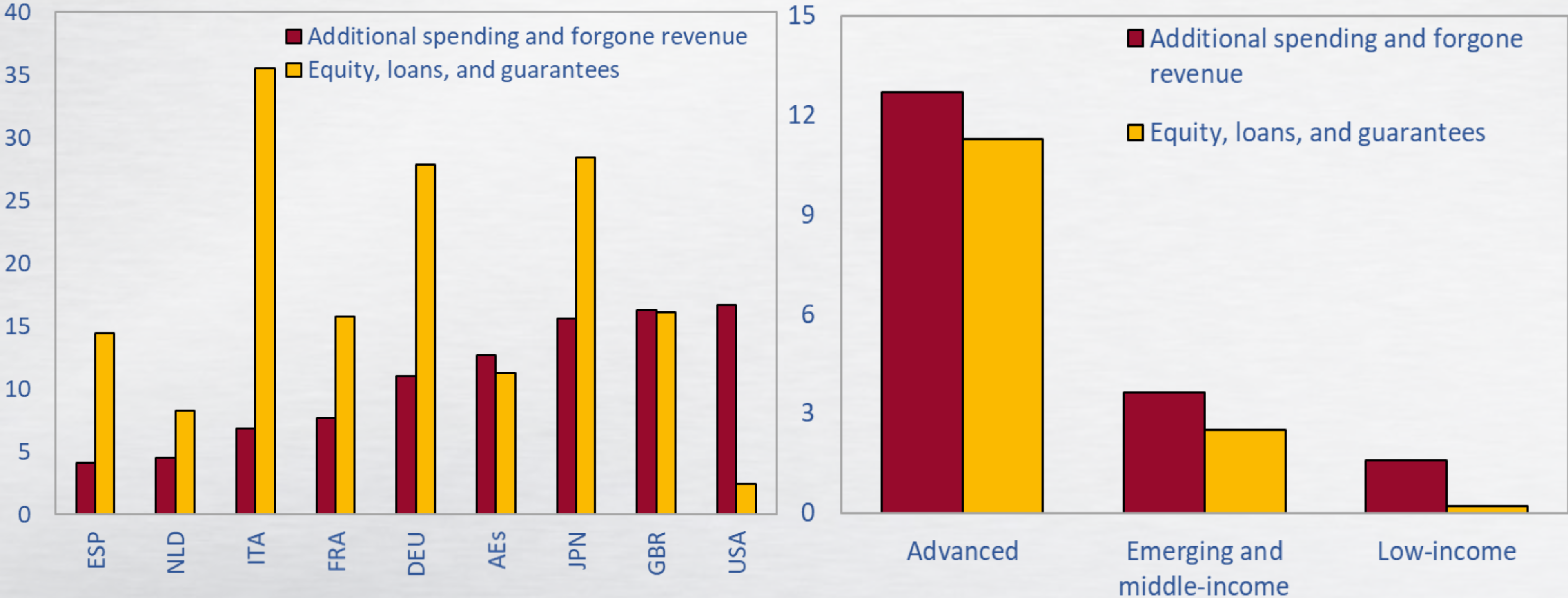
Macroeconomic policy after Covid

- In March 2020 the consensus was definitely wiped out in all advanced economies (only there??)
- Policies set up a dam against the tsunami
- Massive fiscal effort to:
  - Sustain incomes (partial employment schemes, unemployment benefits etc)
  - Provide firms with liquidity (guarantees, loans deferral of payments, subsidies)
- Massive monetary effort to ensure debt sustainability
  - Bond purchases to keep rates low
  - Forward guidance: keep rates at zero as long as necessary, and accept higher inflation in the medium term

Fiscal policy: A massive effort, but…

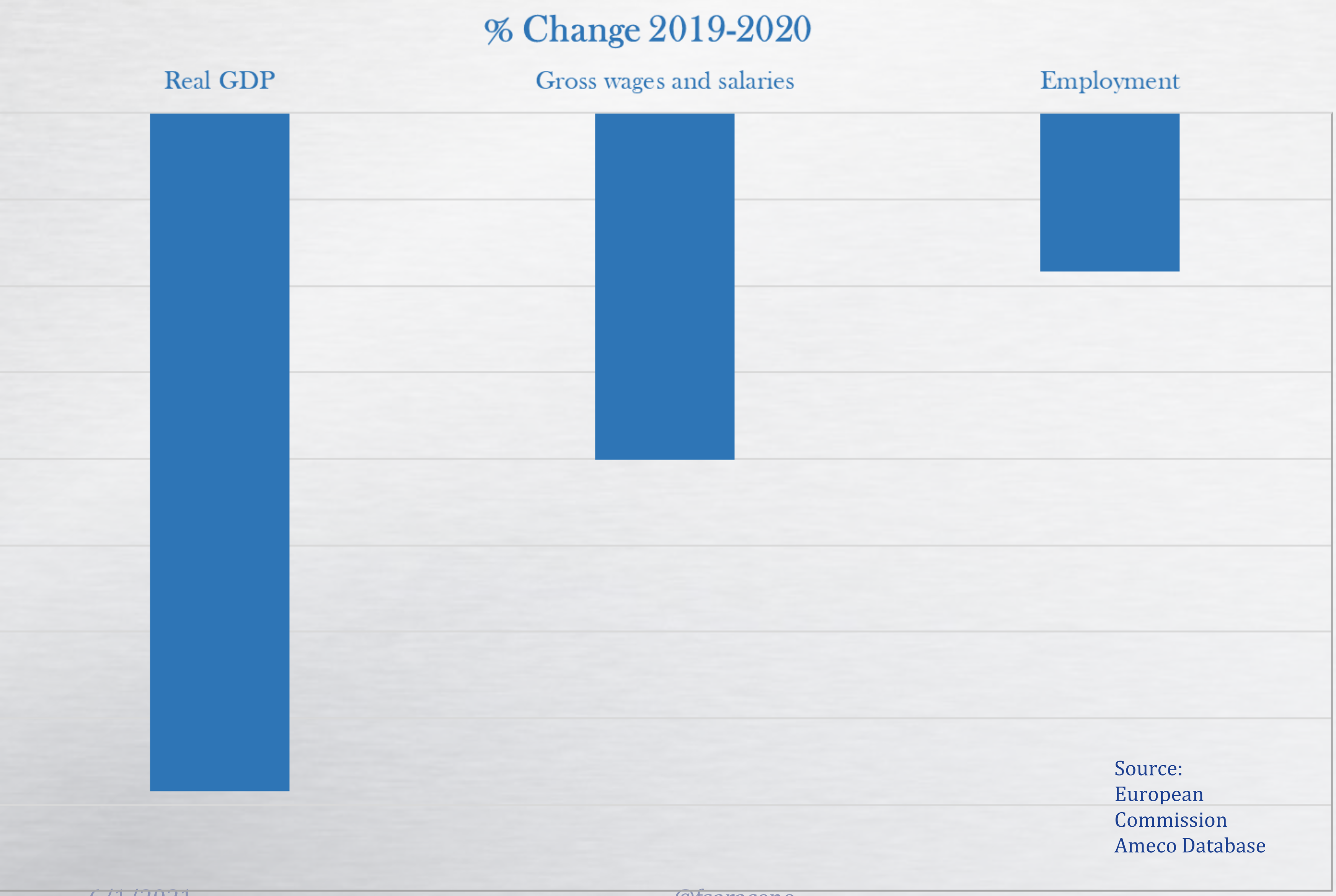
Discretionary Fiscal Response to the COVID-19 Crisis in Selected Economies *(Percent of GDP)*

Estimates as of end-December 2020



Sources: Database of Country Fiscal Measures in Response to the COVID-19 Pandemic; and IMF staff estimates

Quite a Successful Dam: Eurozone

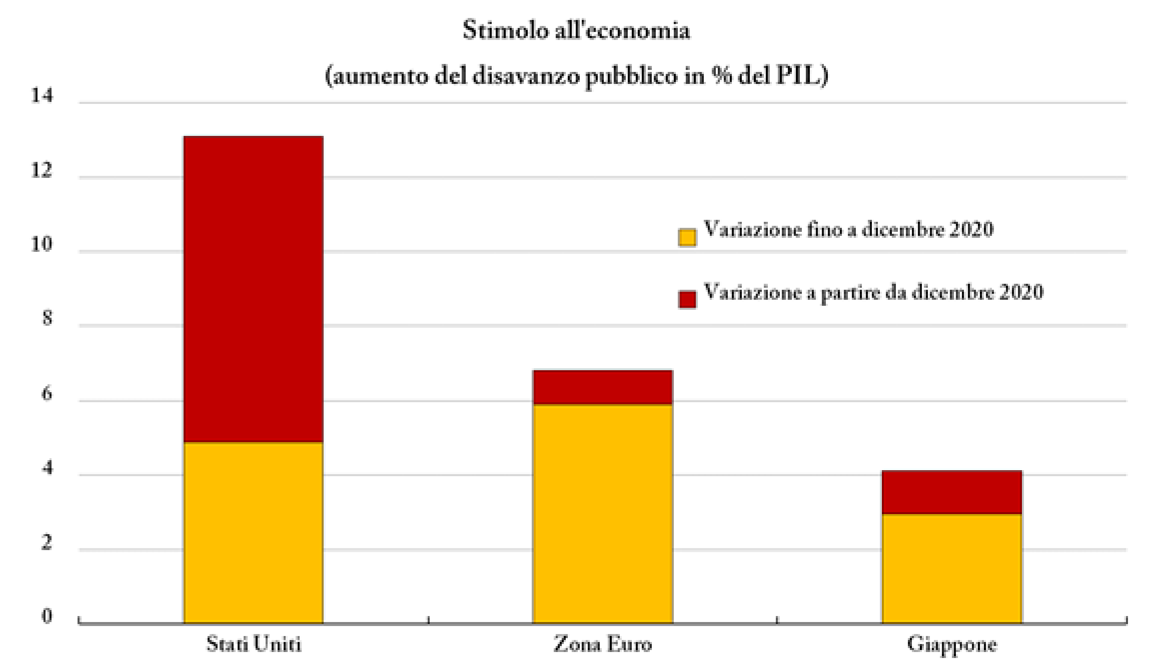


Source: European Commission Ameco Database

Brave Americans? The US vs the EU

- Joe Biden's first 100 days: Fireworks!
  - $1.9trillion relief package (passed): checks, expanded unemployment subsidies funding in childcare
  - $1.8 trillion recovery package: Green transition - global coordination on corporate taxes
  - $2 trillion package to rebalance the economy: childcare and health care, increase in top incomes tax rates. The end of trickle down

- Comparison with the EU: Do not be fooled the headlines!
- Different institutions play an important role (automatic stabilization



Bidenenomic's real revolution

- America 2020: back to the real Keynes
  - Growth requires markets ***together with*** proactive structural and cyclical public policies
    - Cyclical support (no more short-long run dichotomy)
    - Incentives for innovation
    - Public investment
    - Correcting market excesses
  - International coordination is crucial
    - Fair taxation
    - Fair trade
  - Fairness is good for growth, not for the good conscience of the rich
  - Word of caution: There is a lot that remains to be done: the vaccines' stain

Lessons for Emerging and Developing Countries

- Fiscal space: market confidence
  - g-r
  - Prudent policies during upturns
  - Improve tax collection capacity
- Increase the multipliers
  - Coordination of fiscal policies with trading partners
  - Public investment and industrial policy
- Strengthen automatic stabilization

Thank You!

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