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**Can aggregate demand be boosted in the euro area and how?**

*Jean-Paul Fitoussi*

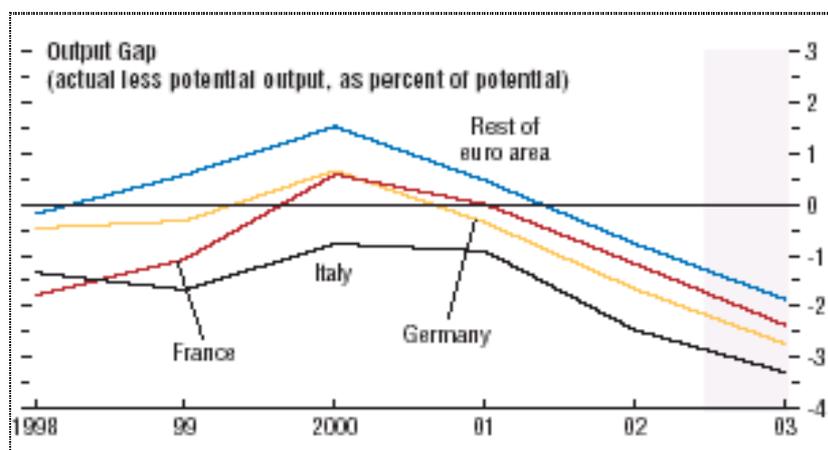
**Executive Summary**

The large (and increasing) output gap that characterizes the euro area suggests that aggregate demand can physically be boosted. Only fiscal policy could fulfil this task though, being monetary policy at the limit, and structural reforms linked to long term growth. The usual arguments against the use of discretionary fiscal policy do not seem to apply in this moment: it is unlikely that in a situation of excess saving and low inflation, government borrowing would cause interest rates to growth hampering medium term growth. On the contrary, fiscal policy has a crucial role in facilitating coordination of the private sector on a high growth equilibrium; a role that now it is not fulfilling.

Though potentially beneficial for sustaining aggregate demand and facilitating the recovery, fiscal policy is constrained by the Stability pact. If governments want to act, they should hence temporarily and conditionally suspend the pact, even if coordination of policies should be maintained. If discretionary fiscal policy could be implemented, the most effective measures for short term effects would be temporary tax cuts, infrastructure investment in projects readily implemented, and an increase of expenditure on social capital (health, dependency, higher education, urban renovation, R&D)

There is a broad consensus about the existence of a deficiency of aggregate demand in the euro area since 2001, and according to the most optimistic forecasts, this deficiency would persist until 2005. According to main estimates (OECD and IMF), the output gap will reach a figure between 2 and 3% at the end of 2003 (taking into account the downward revision of growth forecasts for 2003 since both organisations have published their outlook), that is a level comparable if not higher to the one which has characterised the european recession of 1992/93. And absent massive surprise, it is likely that this output gap will widen in 2004 (see table 1 and figure 1).

Figure 1 : Euro area : Divergences in cyclical positions



Source : World Economic Outlook, April 2003.

Table 1: Output Gap, OECD Definition

	2000				2001				2002				2003			
	T1	T2	T3	T4	T1	T2	T3	T4	T1	T2	T3	T4	T1	T2	T3	T4
<b>Euro Zone</b>	0,5	0,8	0,6	0,7	0,8	0,3	-0,1	-0,7	-0,8	-0,9	-1,2	-1,6	-2,1	-2,4	-2,7	-2,8
<b>USA</b>	2,4	2,8	2,1	1,5	0,6	-0,6	-1,4	-1,5	-1,0	-1,4	-1,1	-1,5	-1,9	-1,9	-1,3	-1,3

Similarly, the utilization rate of productive capacity has remarkably decreased since the first quarter of 2001. Excess capacity and sub-potential growth should normally open a window of opportunity for expansionary public policies. In other words aggregate demands can "physically" be boosted in the euro area. But can it effectively be done? What instruments are today available to European policy makers to increase aggregate demand? And is it worth using them?

## The Pros and Cons of Active Policies

As for the question of what tools could today allow to boost short term growth, monetary policy does not have a wide margin: In a situation of low and (most likely decreasing) rate of inflation and low nominal interest rates, the room for manoeuvre for monetary policy is limited. The ECB may (and should) cut rates further but that will most probably not lead to a sizeable decrease of the real interest rate. Furthermore the effects would be uneven across countries<sup>1</sup>. On the other hand, the much invoked structural reforms would only have medium-to-long run effects and thus are offering no way out to the present slowdown.

The burden of tackling the slowdown, and of trying to close the output gap, would hence have to fall on the shoulders of fiscal policy. Leaving for the moment aside the constraints imposed by the actual set of rules (the Stability pact) on fiscal policy, we have to ask: is it wise, and is it worthwhile to use fiscal policy for boosting demand at this moment? In the current debate we can isolate two arguments against discretionary policy. The first is the common wisdom on fiscal discipline, well summarized by the recent Sapir report<sup>2</sup>: Fiscal discipline reinforces medium term growth, and hence breaking it would hamper growth prospects. Growing deficits would bring about increasing interest rates and crowd out private expenditure, especially for investment. In such a perspective, the short term gains in terms of demand increases would be more than compensated by the long term costs. This textbook argument is reinforced by a consideration specific to Europe, namely the risk of a loss of credibility of the ECB, that would be forced to accommodate fiscal indiscipline. Even if we disregarded this argument, we would have a second problem. In fact, one could argue, the slowdown phase has been lasting for about three years; we could then wonder whether intervening that late would be useful and effective. After all, one might think that the longest the slowdown phase, the closer the recovery. Especially considering that the US seems to be starting to grow again, assuming again the role of locomotive they had in the past.

These arguments can both be dismissed. The output gap and the excess capacity documented earlier on, clearly show that Europe in this moment is characterized by a situation of excess saving: As a consequence it is implausible that budget deficits and government borrowing would cause interest rates to increase, crowding out private investment. This is all the more true if we consider that stock prices are depressed and the inflation rate is extremely low. As for the

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<sup>1</sup> In fact, monetary policy is in this moment acting countercyclically, being less expansionary in countries with lower inflation rates. This is the case especially for Germany and in a lesser extent for France, countries that more than others need an aggregate demand boost.

<sup>2</sup> "An agenda for a Growing Europe. Making the EU Economic System Deliver", Report of an Independent High-Level Study Group established on the initiative of the President of the European Commission, Brussels, July 2003.

"it is too late" argument, we can't be assured that recovery in the US would be strong enough to drag Europe (rather, the consensus is for at least another year of weak growth in the euro area, irrespective of what the US will do); and in any case it does not seem a wise attitude to wait for others to solve our problems.

## **European Rules and Coordination**

Thus, I believe that fiscal policy could and should be used to contrast the present slowdown; it is neither too late, nor too dangerous for future growth. But fiscal policy under the present set of rules is constrained, and does not seem to have room of manoeuvre. In fact, growing public deficits have already prompted the European Commission to threaten to start excessive deficit procedures against the largest countries of the euro area, putting their governments under pressure. The debate around the Stability pact, the calls to amend it, and the proposals of the Commission that guarantee a flexible interpretation of the rules governing budget deficits, are in fact of limited relief as the pressure towards formally sound public finance becomes embedded in governments behaviour. Even by adopting the most flexible interpretation of the Stability pact it is impossible, in the present situation, to design a discretionary fiscal policy aimed at boosting demand. The maximum that can be envisaged is the full deployment of automatic stabilizers, which is far from enough.

Thus, the existing rules prevent the utilisation of the only tool, fiscal policy, that would be desirable (and feasible) to use to contrast the slowdown and accelerate recovery. Unless we modify our definition of "sound public finance" and allow for a government to take action without feeling guilty (demagogic or irresponsible). What is at stake here is the credibility of fiscal policies. The game played between national fiscal authorities and the European Commission – over estimation of the rate of growth, creative accounting, threat of sanctions -- lead most of the times to opacity of policy and of communication. It becomes increasingly difficult for the private sector to decipher the direction of fiscal policy: is it expansionary, neutral or restrictive? And even when they succeed in understanding the content of future fiscal policy, agents will have only faint confidence about its implementation. An early warning from the Commission, or worse the triggering of an excessive deficit procedure, may lead the government to change the course of fiscal policy. In such a setting, the policy loses its announcement effect and cannot serve as an anchor for expectations.

In principle macroeconomic stability may be consistent with two types of equilibrium: a low investment-low growth equilibrium and a high investment-high growth one. Which one of these equilibria will be selected depends on the expectations that the private sector holds about future conditions for business; and among the determinants of these conditions we have to include the ability of public policy to react to shocks. It is then not difficult to understand that the low

equilibrium will be a likely outcome if the private sector believes that the government will cushion only positive demand shocks to avoid their inflationary consequences, and will be prevented from reacting to negative ones because of the arithmetic of public deficits and debt. Private behaviours will adapt to a lower growth path.

The reason is that public policies are not geared to enhance coordination of private sector plans. The main role for fiscal policy is in fact, through demand management, to help the economy coordinate on a "good" equilibrium. It is hard to imagine that, especially in exceptional circumstances like the present ones<sup>3</sup>, a strong and transparent countercyclical fiscal policy, even if financed by borrowing, would be more disruptive of private expectations than the current inertia coupled with daily bargaining about decimals of GDP with the Commission and opaque behaviours.

To sum up, we observe a situation in which public intervention to sustain economic activity and reverse the slowdown would be feasible and desirable. The current set of rules prevents the utilization of the only candidate tool, fiscal policy, with the result that policy in this moment is perceived as inertial, opaque and ineffective. The effect of such a perception on expectations is disruptive. The radical consequence of such a state of affairs is that we should at least temporarily (and conditionally to its full application when growth will resume) suspend the Stability pact, to be able to tackle the present exceptional circumstances. Of course, this should not imply that each country goes by itself. Coordination of fiscal policy at the ECOFIN level should be preserved and encouraged, but in a context in which it is clear to the economic agents that the priority of public action is the return to acceptable rates of growth in the shortest delay. After all, we are quickly moving towards a situation in which the Stability pact is de facto overlooked by the large countries, and it would be better and more credible if this was done in a transparent way.

### **How Can Aggregate Demand Be Boosted?**

If, as is strongly desirable, the European governments agreed on creating a role for discretionary policy, it would remain to be seen how to proceed to sustain short term growth. There can be three lines of intervention:

- (a) The first is to offer tax cuts. As a countercyclical measure, especially in the form that has already been partially implemented by some governments,

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<sup>3</sup> The role of government in facilitating coordination on a high growth equilibrium is all the more important if we consider the number of shocks that have hit the world economy in the past three years, and their nature. The financial bubble burst, September 11, the Iraqi war, are important shocks that have caught economic agents off guard, remarkably increasing their uncertainty. In this framework clarity and a tough countercyclical stance would have been even more necessary to sustain growth expectations and private expenditure.

tax cuts are only partially effective. In fact, theory and empirical evidence alike tend to tell us that permanent income increases tend to be spread over a long period, so that the short term effects on private expenditure may be deceiving. Furthermore, their effectiveness seems to be strongly dependent on who they are targeted to. The US experience shows that if most cuts benefit the richest, the effects on consumption spending are limited. Hence, to respond to the need of boosting aggregate demand, tax cuts should: (a) target expenditure rather than income (*i.e.* VAT reduction instead of personal income tax reduction); (b) be temporary; and (c) be targeted either to the lower brackets of the households (mass consumption goods), or to the firms. A temporary tax credit for investment, for example, would probably be effective to increase demand especially now that inventories are going back to their normal level.

- (b) Another proposal currently debated is a coordinated plan for infrastructure investment (the so called "Tremonti proposal"). This would be desirable and certainly beneficial for increasing long term productivity and the growth potential of the Union. Its short term effects, nevertheless would be much more limited. If this option were to be pursued, as it should, priority should be given to those projects that could immediately enter the operational phase, thus giving a short term impulse to aggregate demand.
- (c) Recent events have shown how the social capital of Europe deteriorated in the past few years, partly as a consequence of reduced public expenditure during the fiscal consolidation of the 1990s. Health, assistance to the elderly, education, basic research, urban renovation, are all fields on which fresh resources are badly needed. Furthermore these are all public goods in which the intervention of the government is necessary. Besides its short term effect on demand, a coherent (and why not, coordinated at the Union's level) program of expenditure on these items of the public budgets also constitutes an investment in human capital that will be reflected in future productivity.

To conclude, incentives to private expenditure (in the form of suitably designed tax cuts), investment in infrastructures, and investment in social capital, are all traditional instruments in the hands of governments whose utilization would in this moment be beneficial for enhancing growth. Furthermore, absent other means of short term demand management like monetary policy, they seem to be the only tools available to the policy makers in the present situation.