Reform and Macroeconomic Policy for Sustainable Growth and Employment Creation

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This post-crisis experience suggests that changes in aggregate demand may have an appreciable, persistent effect on aggregate supply–that is, on potential output. ”

Janet L. Yellen, October 14, 2016

Outline

- Recent research on the long-short run dichotomy
  - The pre-crisis consensus view: potential vs current growth
  - The economic crisis and the crisis of the consensus:
    - Link between potential and current growth
    - Hysteresis and employability
    - The long term impact of fiscal consolidation
- Reassessing structural reforms
  - Recent findings on structural reforms: sequencing, composition
  - The need for accompanying measures: The Egyptian case study
- Accompanying Measures
  - Tackle Inequality
  - Transition to Formality
  - Composition of Public Expenditure: Protecting Public Investment
- Conclusion: A Golden Rule for Egypt?

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The Pre-Crisis Consensus in Macroeconomics

- Disconnect between (potential) growth and the business cycle
  - Potential Growth is determined by supply side factors
  - Only business cycles may be affected by demand
- *Structural reforms* are the only tool capable of enhancing potential growth through supply side improvements
- Discretionary policy is ineffective. Rules are more efficient as they help agents form expectations
- Monetary policy is the preferred stabilization tool
  - Fiscal policy is subject to political biases and lags
- This is the basis of the Washington Consensus:
  - Labour and product markets reforms
  - Small government: Privatization/liberalization
  - Nominal targets (inflation, deficit, exchange rate)

Economic Crisis and Crisis of the Consensus

- Monetary policy failed to absorb the shock (liquidity trap)
  - Back to fiscal policy!
- Potential output was revised downwards
  - Cycles affect long-term growth!
- The austerity *cum* reforms policy package did not work well, especially in peripheral Europe
  - Structural reforms do not happen in vacuum: the context matters!

Hysteresis and employability

How can crises impact potential output?

- Fatàs and Summers (2015) “The permanent effects of fiscal consolidations” *CEPR Working Paper,* 10902, October
  - GDP Shocks have effects both on current and potential GDP
- Impact on capital accumulation:
  - Physical capital
    - Furceri, D. and A. Mourougane (2012) ‘The Effect of Financial Crises on Potential Output: New Empirical Evidence from OECD Countries’, *Journal of Macroeconomics* 34 (3): 822–32.
      - Investment depends on distance from potential: large and persistent crises affect accumulation
  - Human Capital:
    - Delong, J.B. and L.H. Summers (2012) ‘Fiscal Policy in a Depressed Economy’, *Brookings Papers on Economic Activity* (Spring): 1–52.
      - › Human capital accumulation depends on unemployment duration
      - › Hysteresis: long-term unemployed lose skills and incentives to accumulate human capital

Long Term Impact of Fiscal Consolidations

- Fatàs and Summers (2015) "The permanent effects of fiscal consolidations" *CEPR Working Paper,* 10902, October
  - Fiscal consolidation impacts both current and potential output
  - Multipliers are large so fiscal consolidation has strong impact (see also Blanchard and Leigh, 2013)

- Engler, P. and J. Tervala (2016) 'Hysteresis and Fiscal Policy', *DIW Berlin Discussion Paper*
  - Multiplier large in presence of hysteresis : fiscal policy is therefore more effective (or more harmful in case of consolidation

- Auerbach, A.J. and Y. Gorodnichenko (2017) 'Fiscal Stimulus and Fiscal Sustainability', *Paper Presented at the Jackson Hole Symposium on 'Fostering a Dynamic Global Economy'* (Aug. 24-26).
  - Fiscal expansion in recessions can increase long-term growth and make public finances *more* sustainable

Macroeconomic Policy After the Crisis

To sum up:

- Short-termism is myopic and dangerous
- The design of fiscal (and monetary) policy cannot neglect the effect on potential growth
- More important, allowing crises to evolve into hysteresis, inflicts permanent damage to the economy
- Blanchard Cerutti and Summers (2015) "Inflation and Activity: Two Explorations", *NBER Working Paper,* 21726, November
  - The Phillips curve has become flatter (no deflation!)
  - Hysteresis calls for bolder reaction of monetary policy to recessions: better to err on the "too much" side". Flat Phillips curve implies impact on inflation is lower

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Reassessing Structural Reforms

- IMF (2016) Time for a Supply-Side Boost? Macroeconomic Effects of Labor and Product Market Reforms in Advanced Economies, *World Economic Outlook*, IMF (Chapter 3)
  - Reforms effects are positive in the long run
  - Labour market reforms may be negative in the short run when the economy is weak
  - Supportive macroeconomic policies can maximize the benefits of labor market reforms both directly, through their effect on aggregate demand, and indirectly, by improving the incentives
  - "*Product and labor market reforms are no silver bullet; their growth effects appear to be transitory. Therefore, policymakers should undertake them in combination with other growth-oriented reforms, including in the areas of education and innovation*".

Reassessing Structural Reforms

- OECD (2016), Economic Policy Reforms 2016: Going for Growth Interim Report, OECD Publishing, Paris.
  - Weak demand calls for prioritising reforms
  - These are: (a) reductions of barriers to entry in services; (b) reforms of benefit entitlements in the areas of health and pension; (c) reforms of housing policies; (d) Active labour market policies
  - First reform mentioned: "raising investment in public infrastructure"!!
  - Financial reform to improve access to credit is crucial
  - Countries with very limited budgetary room may have to prioritise on high short-term returns or on low-cost measures and ensure that others are financed through means that are as friendly as possible to employment and growth

Reassessing Structural Reforms

- Rodrik, D. (2013) "Europe's Way Out" *Project Syndicate,* June 12
  - Reforms triggers creative destruction
  - Strong demand is crucial for reabsorbing displaced human and physical capital
- Eggertson et al (2014), "Can Structural Reforms Help Europe?", *Journal of Monetary Economics,* 61, p.2-22
  - Reforms have a positive impact in the long run because they improve competitiveness
  - In the short run, two effects
    - Expected deflation has a negative impact on current consumption
    - Potential output increase has a positive impact
  - The deflationary impact likely dominates in crisis times (at the zero lower bound), because monetary policy cannot react
- The conclusion is *no reforms in bad times!*

Reassessing Structural Reforms

- To sum up:
  - Structural reform and long-term planning should always be *accompanied by appropriate macroeconomic policies*
  - Short-term negative impact can be sizeable, and can harm long-term success
  - Sequencing of reform is crucial. Gradualism is key to success (East-Asia *before* the Washington Consensus!)
  - Prioritization: In a weak macroeconomic context, product market reforms should be preferred
  - Capacity building (mostly investment) needs to remain constant over time. Being aggressive against crises is paramount for potential growth as well!
  - Short-termism is dangerous. Targets and indicators should be linked to the long-run

Case Study: The Egyptian Reform Program

- The plan is in line with the evidence reported above:
  - It focuses on reforming product rather than labour market
  - The objective is increasing long-run potential growth with an eye to the short run transition
  - Gradual implementation (i.e. phasing out of subsidies)
  - (Some) savings devoted to social inclusion and employment

Case Study: The Egyptian Reform Program

- Macroeconomic policies are less supportive than they could
  - Float required monetary tightening
  - Fiscal consolidation could have been more gradual

- More emphasis on ***accompanying measures***?
  - Inequality
  - Transition to formality
  - Composition of government spending

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Tackle Inequality increases

- Float and inflation increases inequality
  - Low deciles consume more tradables (Cravino and Levchencko 2017, on the Mexican devaluation of 1994)
  - Inflation is a tax on fixed incomes

- VAT increase
  - VAT is typically a regressive tax

- Phasing out of energy subsidies
  - In principle these benefit the rich, so taking them away would be good. But….
    1. Poorer households can be thrown below the poverty line
    2. Increase in energy prices can contribute to inflation (Durand-lasserve et al., 2015 on the case study of Indonesia)

Tackle Inequality Increases

"Social protection programs will be strengthened to ease the adjustment process. About 1 percent of GDP out of the achieved fiscal savings will be directed to additional food subsidies, cash transfers to the elderly and low-income families, and other targeted social programs, including more free school meals. The aim is to replace poorly targeted energy subsidies with programs that directly support poor households." (IMF, 2017, p.4)

- In practical terms:
  - Closely monitor the effectiveness of VAT exemptions (staple food and first necessity goods). Be ready to adjust and finetune if necessary
  - Indonesia teaches that phasing out of energy subsidies should be accompanied by cash transfers to the poorest households, to be preferred to food subsidies (new distortions would be introduced) and to income based compensation schemes (too much informal economy)

Transition to Formality

- World Bank (2014): The share of employment in the informal economy went from 30% (1998) to 40% (2014)
- Reducing it would also mean ”better jobs”
- In other countries, Voucher schemes did prove effective
  - In favoring transition to formality
  - In increasing access to social rights (health care, pension)
- Shortcomings:
  - Net cost for public finances (incentive for employers is a tax reduction)
  - Harmful for the establishment of long-term work relationships
  - Distributional impact
  - This is why their use in other countries has been limited
- A Pilot scheme?
  - Home schooling or agriculture
  - One governorate, before generalization

The Composition of Fiscal Policy: Protect Public Investment

- Fiscal adjustment most of the time penalizes public investment
  - Politically less sensitive than current expenditure
  - Its impact is only felt in the long run
- Thus, it is no surprise that after three decades of curbing fiscal policy, public capital shortage is generalized

- IMF *World Economic Outlook* , Fall 2014: Public investment is a *free lunch:*
  - Low real interest rates
  - High productivity (low stock)
  - High multipliers both in the short and in the long run
  - Complementarity with private investment (Creel et al 2015)
  - ➔Increasing public investment *reduces* public debt ratios in the medium run

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Promoting Public Investment and Fiscal Responsability: A Golden Rule for Egypt?

- Fiscal rules enhance government credibility
- But they need to be properly designed (Kopits-Symanski 1998)
  - European case study: a "stupid" fiscal rule (short termism, bias against investment, pro-cyclical fiscal policy)
- A Golden Rule of Public Finances
  - Requires current expenditure to be financed out of current revenues
  - Allows debt only to finance public investment
- Why a Golden Rule?
  - Debt is stabilized at the level of public capital: $\frac{D}{GDP} = \frac{Kg}{GDP}$
  - It is more intergenerationally fair than other rules
  - Forces fiscal consolidation to be focused on current expenditure

The Golden Rule

- The Golden Rule worked fine in the UK (1997-2009)
- Often discussed also for Europe: Dervis, K. and F. Saraceno (2014) 'An Investment New Deal for Europe', *Brookings Blogs - Up Front* (September 3).
- In the past it was rejected for a number of reasons:
  - It introduces a bias on physical capital. Are highways more important than school teachers?
  - Public investment is a slippery concept (risk of creative accounting)
- These weaknesses can nevertheless be turned into strengths

An Augmented Golden Rule for Egypt?

- F. Saraceno (2017) "When Keynes goes to Brussels: a New Fiscal Rule for the EMU?" *Einaudi Annals*
  - The Golden Rule as an instrument for Industrial policy: Periodic democratic assessment about the needs in capital (physical, human, immaterial) for example after EU elections
  - Council, Commission and Parliament jointly decide what items of public expenditure are EU priorities, and can therefore be excluded from deficit figures

- There is no reason why such an augmented rule could not be adopted by ~~another country~~ Egypt.
- Concertation with civil society, business community, parliament, international organizations, to determine the medium term needs of the country