



## EPOG INTERNATIONAL MASTER'S COURSES

EPOG STUDENTS AND ALUMNI ASSOCIATION

### *Policy Debate - Special Issue*

*"Policy Mix in the Eurozone facing Covid-19"*

## **An essay of rejoinder: searching for a consensus on the new macroeconomics**

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*"The views and opinions expressed in this policy brief are those of the author and do not necessarily represent the views of the EPOG Students and Alumni Association"*

**This policy brief intends to highlight the consensual points between the contributors to the three previous policy briefs #10, #11 and #12. In particular, we point out what the authors do not want, and on the contrary what they want for the future in the domains of fiscal policy and monetary policy.**

### **1. PRELIMINARY REMARK: THE GOAL**

**T**he 'mission' that was assigned to me is to discuss the three contributions. Make a synthesis would be too pretentious because questions are too complex, and most of the authors' arguments seem right, even if authors sometimes disagree. It also could be judged arrogant to pretend to give the good and bad points to one or the other. Pretending to go beyond the three contributions would also be highly pretentious, and I have too much respect for the authors to do that. So, what I propose to do is to try to find a core of heterodox macroeconomics they all agree on. I will be positive and highlight the consensual points between the contributions.

All the policy briefs share the same goal: escaping from the current crisis and the gigantic crisis which is coming. This goal is not restricted to heterodox economics: New Classical or New Keynesians also want to achieve that. What is heterodox is how to do that: the rejection of the usual mainstream way. In the three policy briefs, I see a consensus, a common ground that can be proposed as an alternative to mainstream macroeconomics. I will first present the 'negative' consensus: what the contributors do not want. Then I will highlight the 'positive' consensus, what I consider that they all propose.

## 2. THE CONSENSUS IN NEGATIVE: WHAT THEY DO NOT WANT

All the contributors agree on what is not relevant. They agree that we cannot use the traditional New Classical way of doing, based on anti-Keynesian expansionary fiscal contraction à la Alesina (2012). They all agree that fiscal consolidation and the austerity fiscal criteria (3%; 60%) and the European Stability and Growth Pact are not the solutions. We do not need fiscal adjustment. We need a revolution compared to what has been done in Europe with the public debt criteria. We need something different. We need change, urgently.

All the contributors agree that the critique of fiscal policy, but also the critique of its corollary public debt, should not continue. The contributions are more or less clear on that point, but it seems that the basic idea is that we should reject the hypothesis that high debt levels lead to a) inflation and b) low growth. To be clear, the simplistic idea of Reinhart and Rogoff (2010), and their big mistake, should not continue to be the doxa of fiscal policy. The corollary is that we should not follow the idea that the debt to GDP ratio is a good indicator of future growth or financial instability. On the contrary, a basic idea of the policy briefs seems to be that we should reverse the mainstream proposal: we need fiscal policy (deficit, debt) to avoid a) deflation and b) secular stagnation.

On the monetary policy side, they all agree that central bank independence à la Alesina and Summers (1993), and monetary policy austerity are not the solution. We do not need a conservative central banker à la Rogoff (1985) that is obsessed with fighting inflation, notably because now the main risk is the opposite: deflation. It implies that we need to go beyond inflation targeting. The contributors all agree that we cannot escape from the crisis with central bank communication alone: we need action. We cannot escape from the crisis just simply with fine words, contrary to what the New Keynesian expectations management and “open mouth operations” recommend (Woodford, 2003). A lesson from the subprime crisis is that central bank communication without intensive actions is not the right policy; it is a “flash in the pan”. Who can pretend that we can escape from a severe crisis with only ‘forward guidance’? It can be useful, but it is not enough. Identically, we cannot escape the crisis with some kind of technical targeting by the central bank, such as the price level targeting recommended by New Keynesians (Eggertson and Woodford, 2003). We cannot continue to simply conduct monetary policy by following a Taylor rule, augmented of financial stability or not. Indeed, to deal

with the Covid-19 crisis, central banks use massively not only their interest rate instrument, but also their balance sheet instrument; and more generally the Taylor rule is not enough compared to the challenges we face.

Yet, the three policy briefs propose more than a simple negative consensus. They make positive proposal

## 3. THE CONSENSUS IN POSITIVE: WHAT THEY WANT

There is a positive consensus on what should be done and how it should be done, even if it is not a perfect consensus. All the contributors agree that fiscal policy and monetary policy should work together: they all agree on a real policy-mix. Monetary dominance should not continue: fiscal policy must be active. Inside the eurozone, fiscal policy should be active not only at the national level but also at the supranational level. It is implicit in the three contributions that various forms of fiscal federalism are required in the euro area, and the level of the euro area federal budget should be much higher. Albeit an old proposal, it is even more relevant in times of crisis (financial crisis or Covid-19 crisis) and ecological transition. This fiscal federalism would alleviate the debt constrain of euro area countries. More generally, an expansionary fiscal policy is required for two other reasons. First, because it is now commonly admitted that the fiscal multiplier is higher in crisis times (Creel et al., 2011). Secondly, it is now established that the path of economic growth can be lower after a severe crisis, without automatic return to the previous path, so a form of hysteresis. This suggests that public expenditures could reduce this growth gap. Yet, fiscal policy would have some difficulty in solving a post-Covid depression alone. Fiscal policy needs the help of monetary policy.

Regarding monetary policy, I agree that in theory, the central bank can set an infinitely negative interest rate to help the recovery of the economy, but that in practice it is debatable to cut the interest until it reaches the Marianas pits. Identically, there is a priori no limit to the increase of central bank balance sheets. In three months, from March to June 2020, the European Central Bank's (ECB) balance sheet has increased by more than 900 billion of euros, an increase of about 20% to deal with Covid-19. If this rhythm continues, the balance sheet of the ECB will be around 3,000 billion euros bigger by the end of 2020. These liquidity injections are welcome in trying to limit the risks of deflation and recession following the Covid crisis. Unfortunately, we had no alternative than using intensively monetary policy because the Stability and Growth Path blocked fiscal policy in Europe. Unconventional monetary policy was one of the few emergency

solutions we had. Yet there are reasons to think that there are decreasing returns, rather than increasing returns, to this central bank balance sheet increase (Goodhart and Ashworth, 2012). There are also potentially negative redistributive effects of the unconventional monetary policy that I will discuss later (Montecino and Epstein, 2015). The central bank can do a lot, as stressed by the contributions, but it cannot do everything alone. The resulting stimulus of the economy could be more massive and efficient if fiscal policy played its full role. Researchers working on monetary policy should re-think its links with fiscal policy, and change the hierarchy between them if necessary.

All the contributors agree that we need a liberal central banker injecting money liberally. We all agree that the central bank should support fiscal policy. Hence, we all agree that one of the main transmission channels of unconventional monetary policy is the “fiscal channel” (Bernanke et al., 2004): the central bank buys government’s bonds so that their yields is decreasing (the cost of public debt is decreasing), and that there is a buyer of public debt in last resort. All contributors suggest that the liberal central banker should not be restricted to a couple of months. We do not want just a lender of last resort à la Bagehot (1873) that injects liquidity only during the financial panics. The ecological transition is long, so the central bank should support fiscal policy in the long-run. In this area, we have a lot to learn from the Japanese experience of the 1990s-2000s, as we want to avoid the so-called ‘Japanese scenario.’

Therefore, all contributors agree that monetary and fiscal policy should focus on the goal of ecological transition. However, it should not be just a long-run objective. The fiscal authorities should take advantage of the room of maneuver given by the central banks in the current situation to accelerate the ecological transition. This is a typical Keynesian investment policy, a ‘Green Deal’ to use the wording of the New Deal. Hence, the money support allocated to the State by the central bank should go to green investment. And we should not be scared of using a New Classical argument: State investment in green infrastructures is good for growth according to endogenous growth theory (Barro, 1990). Green investment should be presented as a positive investment, like all the positive investment highlighted by the endogenous growth theory (public infrastructures, education, R&D, etc...). And we have to go further. It is not explicitly said in the three contributions, but it is in the air: We need an industrial policy for ecology that goes beyond green fiscal policy. Industrial policy is not a taboo, a swear word or a thing from the past. The Covid-19 crisis has shown the importance of industrial policy. We need real ecological planification, not the market setting the priorities. We

need to define democratically the industrial priorities, as was shown by the Covid-19 crisis.

All the contributions agree that we need to use a political economy approach to make all this sustainable from a political, democratic, and social justice point of view. We all agree that we should tackle the redistributive effects of unconventional monetary policy, and of the policy mix. Once again, researchers on monetary policy should work harder. Hence, we all agree that we need to come back to income policy and a really redistributive fiscal policy à la Piketty (2013). We all agree that expansionary unconventional monetary policy should not lead to increasing wealth inequalities<sup>1</sup>. To connect with the previous point, we all agree that fiscal policy should use part of the room of maneuver given by the central bank, via the “fiscal channel”, to reduce inequalities. Of course, this means that we should think even more about the link between the ecological transition and inequalities. For instance, some of the contributors of the policy briefs deals with employment. Why not linking ecology, education, unemployment, and inequalities? They could be combined by providing ecological work training to the people who are put at the margins of the society by markets mechanisms, and to unemployed too. This is a big education plan for the State and the local authority that are stressed as important actors for employment in one of the three policy briefs.

Finally, what else could make consensus in the policy briefs, and that we should develop even more? Maybe we need to use more history of economic thought and economic history than we do now. They will help us to make assumptions based on historical grounds that would strengthen our theory and proposals. We need to use the history of debt (Charles V, 16th century), the history of financial crises and financial cycles (Venice crisis in the 14th century, Great Depression), and the history of pandemics (plague) and their economic consequences. We need to re-read works on the land banks in Scotland in the 17-18th centuries. We need to re-read Tooke, Thornton or Fullarton and the 19th-century monetary controversy, and also the economic history of secular stagnation. We need to understand the periods of deflation such as the Great Deflation of the end of the 19th century. Finally, we could be inspired by the economic history of the industrial revolution to deal with the ecological transition; with all the books (Kindleberger notably) and articles available online, we are, more than ever, dwarfs on the shoulders of the giants.

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