Monetary and Fiscal Policy Interactions and the Labor Market

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This commentary discusses the role of fiscal policies in core and periphery countries for economic rebalancing in the euro area.

JEL Codes: E32, E62.

1. Introduction

The papers by Bandeira et al. and Jacquinot, Lozej, and Pisani (both in this issue) study the effects of fiscal policies in a heterogeneous monetary union. Both papers deepen our understanding of the functioning of labor markets in the private and public sector and their role in the transmission of fiscal policy shocks in normal times and liquidity-trap situations. The papers also are complementary: while Bandeira et al. analyze fiscal consolidation in the periphery, Jacquinot, Lozej, and Pisani analyze fiscal stimulus in the core. This commentary focuses on this complementarity between the two papers.

There is general consensus that the euro area needs further rebalancing to ensure that the imbalances that built up before the 2008 financial crisis will be resorbed (see Cœuré 2016 for a discussion of rebalancing). There is less agreement on whether rebalancing should be asymmetric—with the onus on net debtor countries—or symmetric—with the burden shared between debtor and creditor countries. The European Union's governance framework—as amended by the "six pack" of 2011—by and large focuses on asymmetric adjustment. Yet, the European Commission has in recent

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years tried to introduce elements of symmetric adjustment, by inviting euro-area member states with fiscal space in the context of the—non-binding—country-specific recommendations to use this space, while asking member states without fiscal space in the context of the—binding—Stability and Growth Pact to continue consolidating their public finances.

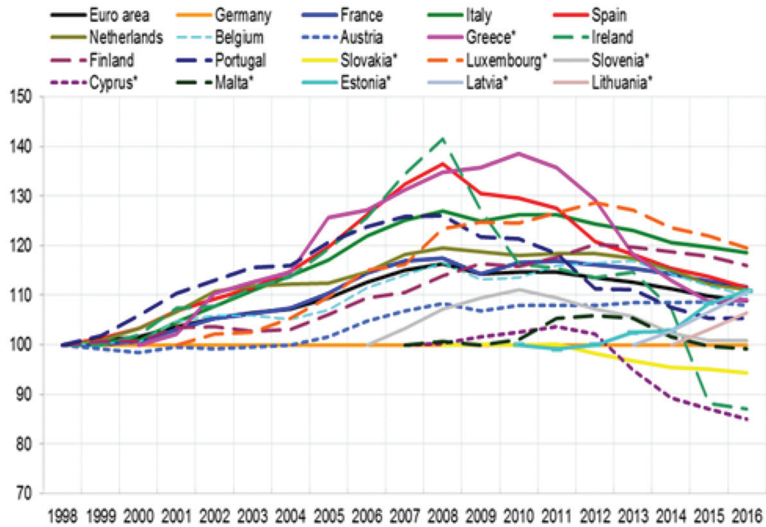
The remainder of this commentary is organized as follows. Section 2 provides context, reviewing the economic situation and macroeconomic policy debate in the euro area. Section 3 presents the results of a specific model-based policy coordination exercise, combining the policy experiments considered in the two abovementioned papers, i.e., a fiscal expansion in the core—via a cut in labor tax rates—and a fiscal contraction in the periphery—via a cut in public-sector wages. Section 4 concludes.

2. Context: Macroeconomic Imbalances and the Policy Debate in the Euro Area

Financial crises have historically often been followed by a prolonged period of subdued economic growth and inflation. The 2008 financial crisis and the subsequent sovereign debt crisis in the euro area are no exception. While output growth has in the meantime recovered, inflation has been subdued over recent years and is only gradually picking up despite unprecedented monetary policy accommodation, including negative short-term interest rates since mid-2014.

One factor behind these aggregate economic developments is the rebalancing of the euro-area economy. Macroeconomic imbalances in the euro area have declined over recent years, but they remain sizable and are a source of vulnerability. Figure 1 shows competitiveness developments since the start of EMU, as captured by developments in cumulated unit labor costs relative to Germany. Competitiveness gaps peaked around the 2008 financial crisis; they have narrowed since then and in some cases—e.g., Ireland and Greece—very significantly. At the same time, as shown in figure 2, those countries that recorded high current account deficits before the crisis have brought their current accounts into surplus in recent years. This has reduced their vulnerability to adverse shocks, although these improvements in flow variables (current accounts) have not yet translated into significant improvements in stock variables (net

Figure 1. Cumulated Unit Labor Cost Trends across Countries (Index 1998=100, relative to Germany)

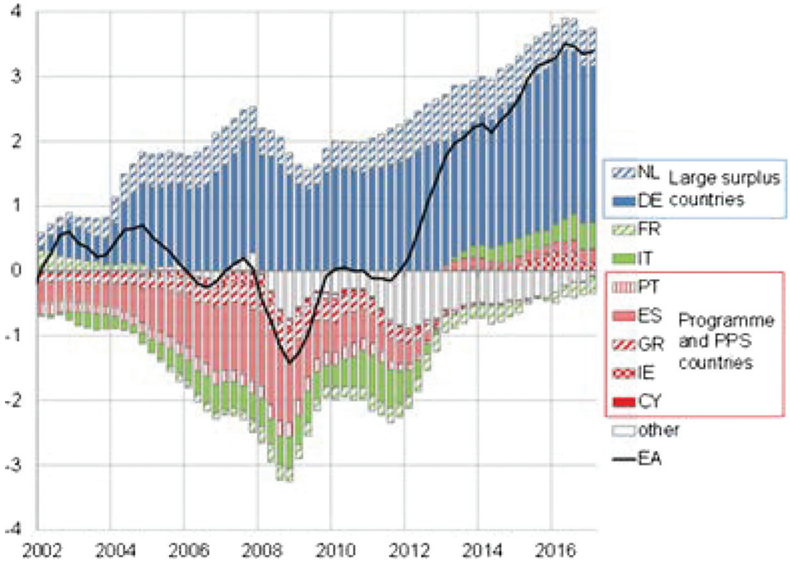


Source: Eurostat.
Note: Unit labor costs are calculated using measures of total employment and employees on the basis of persons.
*For Estonia, Greece, Cyprus, Malta, Slovenia, Slovakia, and Latvia the last year before euro-area accession equals 100. For Luxembourg the series starts in 2001.

international investment positions). Figure 2 also shows that the adjustment has been highly asymmetric, with former deficit countries having eliminated their deficits, whereas surplus countries have further increased their surpluses. Whereas the euro area as a whole recorded a roughly balanced current account until 2012, since then the current account has turned into surplus, reaching around 3 percent of GDP in 2016.

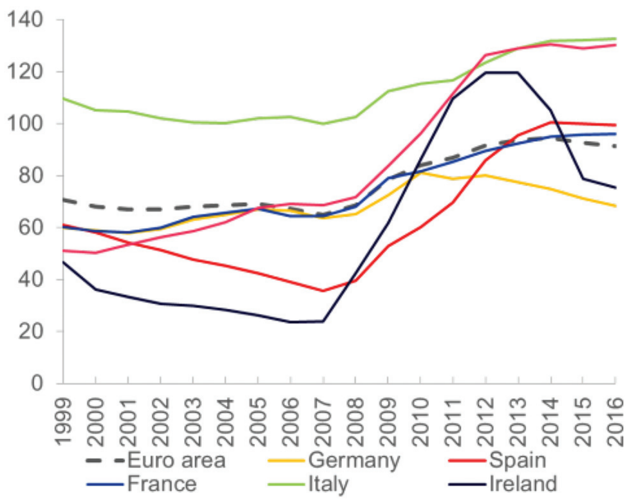
Likewise, fiscal imbalances in the euro area have declined over recent years, but there is considerable heterogeneity across the euro area. Public debt ratios have strongly increased in the euro area in the aftermath of the 2008 financial crisis, especially in countries hit by the burst of real estate bubbles, such as Ireland and Spain (figure 3). Still, at the aggregate level the euro area's fiscal situation has deteriorated less than in other major advanced economies, and both government deficit and debt ratios of the euro area are today

Figure 2. Current Account Balance (Percentage of GDP)



Source: European Central Bank.

Figure 3. General Government Gross Debt (Percentage of GDP)



Source: European Commission, AMECO database, spring 2017.

considerably lower than those in, e.g., the United States and Japan. However, since 2012, debt developments within the euro area have started to diverge. While debt ratios have continued to increase and only recently stabilized in France, Italy, and Spain, debt ratios have come down rapidly in Germany and Ireland (and—not shown—in the Netherlands). Fiscal space is thus very unequally distributed across euro-area countries; it is lacking in those countries where stabilization needs are highest and available in those countries in which output gaps are closed.

Against this macroeconomic background there has been an intense policy and academic debate in recent years on how member states' policies should be coordinated to achieve a smooth rebalancing of the euro-area economy. Regarding fiscal policies, this debate has centered around two aspects: first, the desirability of fiscal expansion at the aggregate euro-area level with monetary policy constrained by the effective lower bound in a low-growth/low-inflation environment; second, how to achieve a more accommodative euro-area fiscal stance in the decentralized EMU setup with significant heterogeneity in available fiscal space across countries without jeopardizing debt sustainability.

The notion of aggregate euro-area fiscal stance was absent in the EU fiscal governance framework until 2013, although the Delors Report of 1989 had stressed its relevance (see Kamps et al. 2017). Before 2013 the EU fiscal framework largely reflected the pre-crisis consensus view that the best contribution fiscal policy could make to balanced growth and price stability was to let automatic stabilizers work freely over the cycle, while ensuring overall sound fiscal positions and abstaining from discretionary fiscal actions (see, e.g., Taylor 2000). Monetary policy was seen as the more effective tool to stabilize economic fluctuations, while discretionary fiscal policy was seen as ill suited to deal with normal cycles and possibly even complicating the conduct of monetary policy if fiscal interventions were ill timed, e.g., due to implementation lags. The crisis, however, has led to a rethinking, with recent literature stressing that in an environment in which monetary policy in many advanced countries is constrained by the effective lower bound on nominal interest rates, the effectiveness of discretionary fiscal stimulus may have increased (see, e.g., Farhi and Werning 2016). At the same time, the literature also points out that the effectiveness of fiscal stimulus depends very much on the soundness of the underlying fiscal position, with fiscal stimulus unlikely to be effective and possibly even counterproductive in countries at high risk of debt sustainability (Corsetti et al. 2014).

The recent policy debate has by and large taken these considerations into account. When the European Commission (2016) in November 2016 issued a recommendation for a mildly expansionary aggregate euro-area fiscal stance, it also emphasized the difficulty of operationalizing such stance within the existing fiscal governance framework—without central fiscal capacity—and given the heterogeneity in available fiscal space across euro-area member states. Against this background, the Commission called on countries with fiscal space to use it, while countries without space should continue consolidating in line with the requirements of the Stability and Growth Pact. Fiscal expansion in countries with fiscal space would be beneficial for the entire area if cross-country spillovers were sufficiently large. Again, the literature suggests that there are important differences between normal and exceptional times. While spillovers tend to be rather small in normal times (see, e.g., Beetsma et al. 2006), they can be sizable in exceptional times. Blanchard, Erceg, and Lindé (2016), for example, show that when monetary policy remains accommodative for a prolonged period, a fiscal expansion by the core economies of the euro area could have a large and positive impact on periphery GDP.[1,2]

According to the euro-area recommendations adopted by the Ecofin Council in March 2017, the euro-area member states should collectively and individually pursue policies that support sustainable and inclusive growth in the short and the long term, to improve adjustment capacity, rebalancing, and convergence. More specifically, member states with current account deficits or high external debt should raise productivity while containing unit labor costs, while member states with large current account surpluses should implement, as a priority, measures, including structural reforms and fostering investment, that help to strengthen their domestic demand and growth potential.

[1] See also in‘t Veld (2016).

[2] Gomes et al. (2013) and Gomes, Jacquinot, and Pisani (2016) show the gains of coordinating economic policy in general—structural reforms and fiscal policies—in a monetary union.

The Commission proposals for country-specific recommendations addressed to Portugal and Germany illustrate how the euro-area recommendations are translated into objectives for individual countries (European Commission 2017a and European Commission 2017b, respectively). While Portugal is advised to pursue its fiscal policy in line with the requirements of the preventive arm of the Stability and Growth Pact, which translates into a substantial fiscal effort for 2018, Germany is advised to use fiscal policy to support domestic demand and achieve a sustained upward trend in both public and private investment. To this end, Germany should create conditions to promote higher real wage growth and reduce the high tax wedge for low-wage earners. The Portuguese authorities meanwhile are invited to ensure, together with social partners, that minimum wage developments do not harm employment of the low skilled.

3. Fiscal Policy Coordination: Results of a Model-Based Exercise

The two papers are highly topical, as they resonate well with the policy debate in the EU forums. Bandeira et al. analyze the effect of fiscal consolidation in the periphery in the form of cuts in the public-sector wage bill—a policy which is intended to simultaneously contribute to address fiscal and macroeconomic imbalances via internal devaluation. Likewise, Jacquinot, Lozej, and Pisani analyze the effect of fiscal stimulus in the core in the form of labor income tax cuts—a policy which is intended to strengthen domestic demand via higher after-tax wages, contributing to macroeconomic rebalancing via higher imports. Both papers also deepen our understanding of the functioning of labor markets in the private and public sector, distinguishing between normal times and liquidity-trap situations.

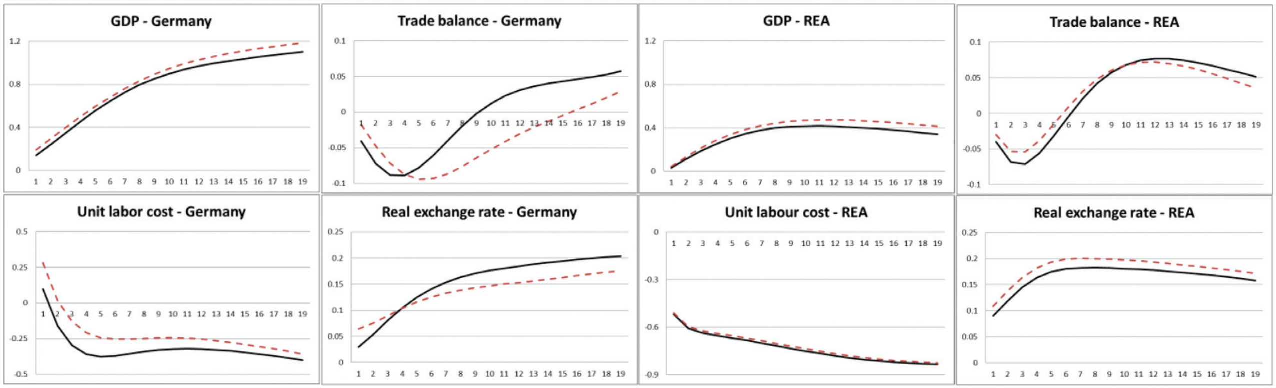
More specifically, the paper by Bandeira et al. studies the effects of cuts in the public wage bill in the periphery in normal times and at the zero lower bound (ZLB). Main results suggest that, in normal times, a reduction in the government wage bill—be it in the form of wage cuts or vacancy cuts—induces a reallocation of labor supply towards the private sector, pushing down private-sector wages. This leads to an internal devaluation within the monetary union. In normal times there are immediate benefits from a cut in the wage bill in terms of lower unemployment and higher output. However, in a low-inflation environment with monetary policy constrained by the ZLB, their analysis suggests that fiscal consolidation and internal devaluation via the public wage bill is costly in the short term.

The paper by Jacquinot, Lozej, and Pisani studies the effects of a permanent labor income tax cut in Germany as well as a coordinated tax cut across the whole euro area. An asymmetric tax cut in Germany stimulates employment and output in Germany, with mild positive spillover effects on the rest of the euro area as the positive effects of trade rebalancing outweigh the contractionary effects of mild monetary tightening. A symmetric tax cut stimulates employment and output across the euro area, with all countries also benefiting from a depreciation of the euro real effective exchange rate vis-à-vis the rest of the world. The results are broadly similar for normal times and for times when the zero lower bound is a binding constraint; the reason is that in the Jacquinot, Lozej, and Pisani model a labor income tax cut does not have a strong impact on euro-area inflation, which in turn implies that there is no significant monetary policy tightening in normal times.

Given that coordinating fiscal stimulus in the core and fiscal consolidation in the periphery is at the heart of the current policy debate, it is tempting to combine the policy experiments analyzed in Bandeira et al. and Jacquinot, Lozej, and Pisani, respectively. This is what the remainder of this section does, showing the results of an illustrative policy-coordination experiment, combining the labor income tax cut in Germany with a cut in the public-sector wage in the rest of the euro area. These results were prepared using the Jacquinot, Lozej, and Pisani model. Figure 4 shows the results for three alternative scenarios. In the first and the second, reforms are implemented unilaterally. The third scenario shows the potential gains of coordinating the reforms.

In the first scenario (solid line), there is no coordination. In this scenario Germany unilaterally decreases temporarily (four years) the taxes on labor paid by households by an amount equivalent to 1 percent of nominal GDP. The reduction in labor taxes paid by households increases their after-tax take-home pay and thus the value to be employed. At the same time, due to lower taxes, households have an incentive to increase their labor supply, which leads to a reduction in real wages, which in turn stimulates labor demand. The result is higher employment and reduced unemployment, stimulating both

Figure 4. Fiscal Reforms in the Euro Area: Coordination vs. No Coordination



Notes: Horizontal axis: quarters. Vertical axis: percentage deviations from the baseline; ratio of trade balance to GDP in percentage-point deviations. Solid line: no coordination scenario. Dotted line: coordination scenario.

private consumption and investment. Consumption benefits from the favorable evolution of households' permanent income. Investment adjusts to higher employment. The increase in domestic demand translates into higher imports. At the same time, the depreciation of the euro's (multilateral) real exchange rate due to the expansion in the German supply stimulates exports vis-à-vis the rest of the world. The trade balance initially deteriorates but after about two years starts improving. In both the short and the medium run, the overall impact on GDP and employment (not shown) is positive. Spillovers are positive, although small, for the rest of the euro area due to larger exports towards Germany. These results are in line with those shown in the Jacquinot, Lozej, and Pisani paper.

In the second scenario (solid line), also not coordinated, the rest of the euro area consolidates by cutting public wages (for four years) by an amount equivalent to 1 percent of nominal GDP. The public-sector wage cut in the rest of the euro area—like in the Bandeira et al. model—induces a reallocation of workers from the public to the private sector, with the increased labor supply in the private sector putting downward pressure on private-sector wages and unit labor costs, which stimulates demand for labor in the private sector. Employment in the private sector and economy-wide output both increase significantly in the rest of the euro area. The subsequent excess supply of domestic goods triggers a real effective exchange rate depreciation (the relative price of non-tradable goods becomes lower), which in turn stimulates exports with a positive impact on the trade balance after six quarters, due to the short-term dynamics of imports.

In the third scenario (dashed line), fiscal policies are coordinated and combine the two previous shocks. For the euro area as a whole the exercise is budget neutral, as the fiscal stimulus in Germany is exactly offset by fiscal consolidation in the rest of the euro area. Figure 4 illustrates the potential benefits of policy coordination for the euro area as a whole. Simulations suggest that stimulating economic activity in Germany and the rest of the euro area simultaneously can create positive spillovers. For Germany, domestic demand is stimulated by the cheaper goods imported from the rest of the euro area while at the same time exports are slightly losing competitiveness as unit labor costs fall less than in the rest of the euro area.

Instead, for the rest of the euro area, the dynamics are driven more by external demand. Given the high share of Germany in exports, the trade balance of the rest of the euro area slightly improves compared to the unilateral fiscal scenario. This shows that fiscal policy coordination can help trade rebalancing between euro-area member states, although the magnitudes are rather small.

4. Conclusion

There is widespread consensus that the smooth functioning of EMU requires that national economic and fiscal policies ensure that member states' economies can cushion economic shocks. Resilient economic structures and growth-friendly fiscal policies are two important ingredients to ensure this. The two papers in this session provide the granular fiscal sectors needed to study the composition of budgets and the impact of different budgetary compositions within but also across countries.

More work is needed to better understand the benefits and limits of coordination of national fiscal policies in the euro area with respect to rebalancing and convergence. For example, investigating further the impact of non-linearities related to the zero lower bound constraint and vastly different initial conditions in terms of macroeconomic and fiscal imbalances appears a promising avenue for further research.

At the same time, experience shows that there are limits to what can be achieved by the coordination of national policies which sometimes concentrate exclusively on domestic objectives and fail to internalize the euro-area dimension. Therefore, further modeling work could look at a euro-area fiscal capacity—as proposed by the "Five Presidents' Report" (see Juncker et al. 2015)—which may complement the macroeconomic stabilization function today provided by national budgets.

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