Jeff Frankel comments on

The Euro, Stabilization Policy, and the Stability and Growth Pact
OR
Can Rubinomics work in the Eurozone?

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Conference on “The Euro at Five: Ready for a Global Role?
February 26, 2004
American economists’ skeptical predictions regarding EMU were in some respects too pessimistic, in light of experience so far. But some predictions were accurate:

(1) A permanent 3% ceiling on deficits would not be fully enforceable, without flexibility, e.g., for recessions. The supposed monetary penalties do not increase the credibility of enforcement; they may reduce it.

At the same time, the continuing contradiction between word and deed undermines credibility of other agreed aspects of the European unification project, e.g., vis-à-vis accession of the new 10.

(2) Members of euroland would suffer from occasional asymmetric shocks. In that light, discretionary fiscal policy becomes more necessary now that monetary independence is lost, not less.
Rubinomics properly interpreted a condition to add to Adam’s list of requirements for fiscal consolidation to be expansionary:

Expected future fiscal consolidation, along a credible medium-term path, must be large, relative to the extent of fiscal contraction today, for net effect to be expansionary.

The announcement of future discipline is not credible without tangible steps to bring it about, and thereby will not in itself bring down long-term interest rates much.

The announcement of goals can become increasingly credible over time, if borne out by performance.
**Determinants of long term real interest rates**

<table>
<thead>
<tr>
<th></th>
<th>US</th>
<th>Ger.</th>
<th>Fr.</th>
<th>Italy</th>
<th>Spain</th>
<th>UK</th>
</tr>
</thead>
<tbody>
<tr>
<td>Constant</td>
<td>-0.001</td>
<td>0.122***</td>
<td>-0.022</td>
<td>-0.081</td>
<td>-0.043*</td>
<td>-0.034</td>
</tr>
<tr>
<td></td>
<td>(0.008)</td>
<td>(0.038)</td>
<td>(0.027)</td>
<td>(0.041)</td>
<td>(0.023)</td>
<td>(0.030)</td>
</tr>
<tr>
<td>Inflation</td>
<td>1.00</td>
<td>1.00</td>
<td>1.00</td>
<td>1.00</td>
<td>1.00</td>
<td>1.00</td>
</tr>
<tr>
<td>Debt ratio</td>
<td>0.060**</td>
<td>0.182***</td>
<td>0.027</td>
<td>0.109</td>
<td>0.031</td>
<td>0.067</td>
</tr>
<tr>
<td></td>
<td>(0.019)</td>
<td>(0.047)</td>
<td>(0.040)</td>
<td>(0.062)</td>
<td>(0.051)</td>
<td>(0.044)</td>
</tr>
<tr>
<td>Expected change</td>
<td>0.144**</td>
<td>0.112***</td>
<td>0.177**</td>
<td>0.324**</td>
<td>0.289***</td>
<td>0.066</td>
</tr>
<tr>
<td>in debt ratio</td>
<td>(0.061)</td>
<td>(0.032)</td>
<td>(0.073)</td>
<td>(0.106)</td>
<td>(0.048)</td>
<td>(0.110)</td>
</tr>
<tr>
<td>Output gap</td>
<td>0.388**</td>
<td>0.608**</td>
<td>0.252</td>
<td>0.297</td>
<td>0.218</td>
<td>-0.316</td>
</tr>
<tr>
<td></td>
<td>(0.174)</td>
<td>(0.219)</td>
<td>(0.202)</td>
<td>(0.484)</td>
<td>(0.223)</td>
<td>(0.324)</td>
</tr>
<tr>
<td>Foreign interest rate</td>
<td>0.096</td>
<td>1.529***</td>
<td>0.923***</td>
<td>0.390</td>
<td>1.204***</td>
<td>0.815**</td>
</tr>
<tr>
<td></td>
<td>(0.122)</td>
<td>(0.327)</td>
<td>(0.241)</td>
<td>(0.446)</td>
<td>(0.145)</td>
<td>(0.348)</td>
</tr>
<tr>
<td>N</td>
<td>15</td>
<td>15</td>
<td>15</td>
<td>15</td>
<td>15</td>
<td>15</td>
</tr>
<tr>
<td>Adj.R^2</td>
<td>0.32</td>
<td>0.51</td>
<td>0.82</td>
<td>0.77</td>
<td>0.82</td>
<td>0.55</td>
</tr>
<tr>
<td>DW</td>
<td>2.24</td>
<td>2.50</td>
<td>2.47</td>
<td>1.70</td>
<td>2.47</td>
<td>1.44</td>
</tr>
</tbody>
</table>

Notes: OLS regression using annual data, in levels (Newey-West robust standard errors in parentheses). Percentage variables defined in decimal form. N is the number of observations. Adj.R^2 is the adjusted R-squared. *(**)[***] denotes significance at the 10%(5%)[1%] level.
Lessons from Recent US Experience

• How Did Clinton Eliminate the Budget Deficit?
  – Gramm-Rudman and BBA too rigid to be practical
  – Budget Enforcement Act of 1990: set spending caps and PAYGO
  – Clinton budget of 1993 extended caps and raised some taxes
  – SoTU in 1998 preserved surpluses by “Save Social Security First.”

• How Did Bush Eliminate the Surplus?
  – Existing consensus to preserve SS surplus should have made it hard.
  – It’s always easier to give away money.
  – Recession and September 11 as excuses
  – Claims of large future surpluses
Overly Optimistic Official Forecasts During Bush Years

Forecasted Annual Budget Balance

Source: Office of Management and Budget
Baseline and Adjusted Outcomes as Percentage of GDP, 2003-2014

Source: Alice Rivlin & Isabel Sawhill, Brookings Institution, Jan. 13, 2004
European countries could rely on Bush defense: “yes we’re running big deficits now, but our projections show fiscal improvement in the future.”

US Tricks

Make unrealistically optimistic economic assumptions. (If forecasting high growth is too obvious, play with other parameters that affect tax revenues. In the US, it’s share of wages in income.)

Assert that you will cut spending in the future, even if it has been rising sharply, and even if you are proposing expensive new programs. When spending turns out to be higher than your budget forecast, you can always pretend it is a surprise, and ask for a “supplemental appropriation.”

Move/keep pension funds on-budget while they are running a surplus. (When baby-boomers start to retire, move it back off budget.)

When you reduce a tax, always give it a phony sunset a few years in the future. (If constituents want a permanent tax cut, reassure them this is entirely your intention. Does not mean you have to put the extension in the budget.)

Switch between 5-year and 10-year windows, depending on which allows you to claim that the trend is in the right direction.
### Effects of US Fiscal Policy on Real Growth Over Four Presidential Terms

<table>
<thead>
<tr>
<th>Effects on growth</th>
<th>Clinton Administration</th>
<th>Bush Administration</th>
</tr>
</thead>
<tbody>
<tr>
<td>1st term</td>
<td>2nd term &amp; beyond</td>
<td>1st term</td>
</tr>
<tr>
<td>as, over time, the numbers show the promises of fiscal responsibility ...</td>
<td>to be increasingly credible</td>
<td>to be less and less credible</td>
</tr>
<tr>
<td>(1) effect of contemporaneous fiscal stance, via demand</td>
<td>Mild contraction</td>
<td>Mild contraction</td>
</tr>
<tr>
<td>+ (2) effect of expected future fiscal path, via long-term interest rates</td>
<td>Mild expansion</td>
<td>Strong positive effect</td>
</tr>
<tr>
<td>= Overall impact of fiscal policy on growth</td>
<td>Approx. neutral</td>
<td>Positive</td>
</tr>
</tbody>
</table>
International Dimension: ECB-FRB asymmetry

• Asymmetry of interest rate determination
  – US i has big influence on European interest rates
  – European rates don’t have big influence on US

• Why? The old explanations no longer hold:
  – Individual European countries cared more about ex. rate than US
  – They couldn’t set interest rates jointly

• The future? ECB will gain relative to FRB
  (as euroland > US, and due to US debtor status, as CFB says.):
  – In determination of world interest rates
  – In effectiveness of unilateral fx intervention
  – In int. role of euro vs. $, with a lag, following fate of pound.