Fiscal Policy Challenges and Global Equilibrium

James Mirrlees

Chinese University of Hong Kong

Pioneer Colloquia Beijing, April 2013

What is the trouble?

- High unemployment in developed economies. Very high in some. Low in others.
- Low or negative growth.
- Trouble began for many in 2007 or 2008.
- In others unemployment had been high for years.
- The variety of experience is notable.

	Unemployment % 2013	GDP growth % 2006-11	Investment/GDP 2011	Investment 2011 over 2006
Switzerland	3.1	9	21	1.00
S Korea	4	19	29	1.15
Japan	4.3	-1	20	0.86
Australia	5.6	14	27	1.10
Iceland	5.7	-1	14	0.38
Germany	6.9	6	18	1.06
Netherlands	7.7	5	18	0.94
U.S.A.	7.7	3	15	0.77
U.K.	7.8	1	15	0.89
Belgium	8.1	5	22	1.05
Sweden	8.5	8	20	1.14
France	10.8	2	21	1.02
Italy	11.6	-3	20	0.88
Ireland	14.2	-5	10	0.34
Portugal	15.8	-1	17	0.73
Spain	26.3	1	22	0.71
Greece	26.4	-12	16	0.57

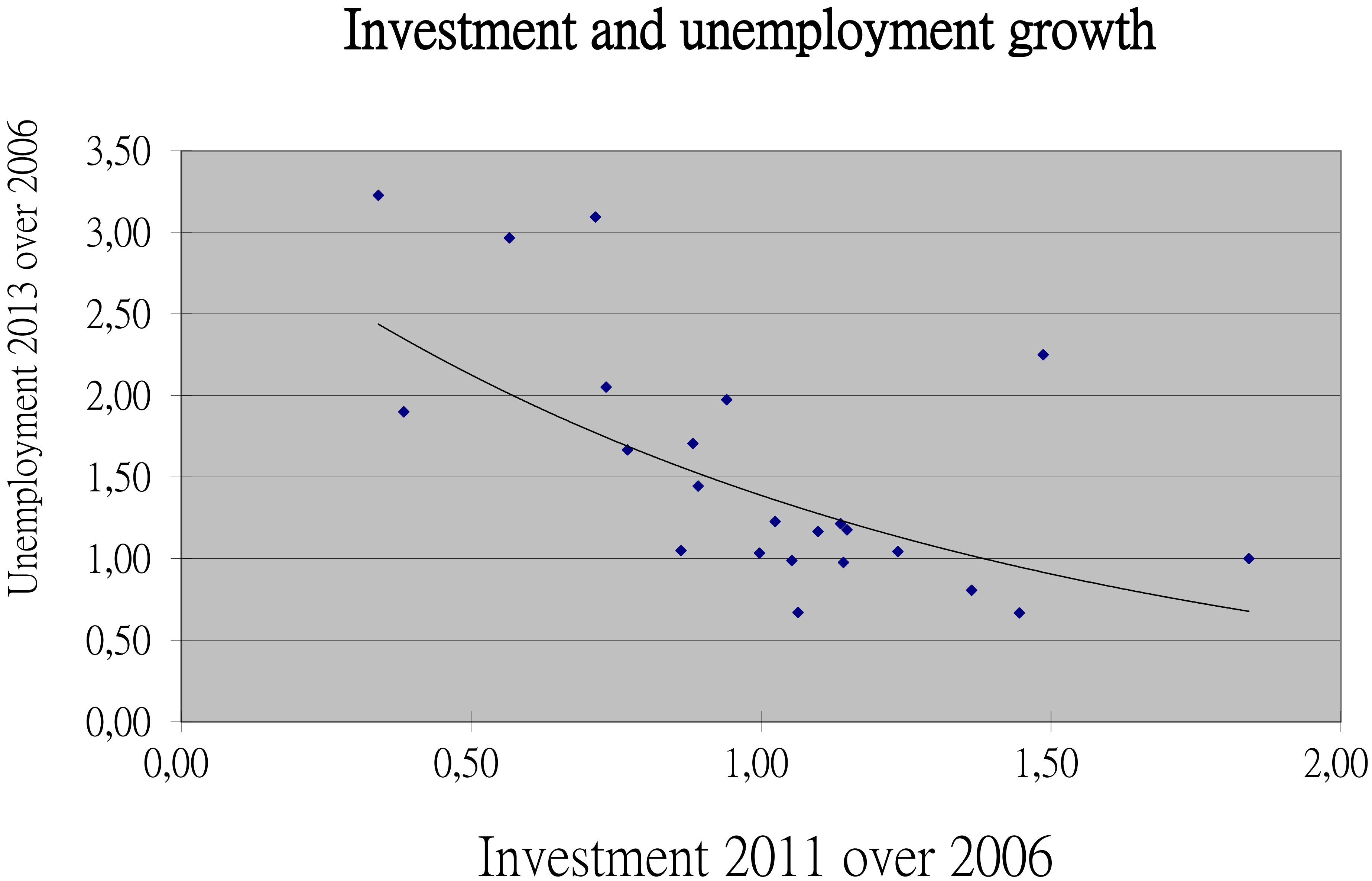
Emerging economies

- The emerging (and developing) economies had less trouble.
- There was an impact from the Western demand cuts.
- But government policy seems to show how to absorb them without adverse effects.

	Investment/GDP 2011	Unemployment % 2013	GDP growth % 2006-11	Investment 2011 over 2006
Brazil	20	5.6	23	1.45
China	48	4.1	65	1.84
India	37	9.9	45	1.49
Poland	21	14.4	24	1.24
Russia	25	5.8	14	1.36
S Africa	20	24.9	14	1.14

What was the cause?

- Low demand, initially for investment, including durables.
- Due to:
  - High commodity incomes, and other inequality
  - Sharply lower capital formation, initially because of credit squeeze
  - Multiplier, as incomes stopped rising
  - Wealth effects of bursting bubbles and expectations turning pessimistic
- Consider the effect of falling investment.


Investment and unemployment growth
Unemployment 2013 over 2006
3,50
3,00
2,50
2,00
1,50
1,00
0,50
0,00
0,00
0,50
1,00
1,50
2,00
Investment 2011 over 2006

What can be done?

- Demand has to be increased.
- Increased spending in one place becomes increased demand in many places.
- The biggest impact is almost everywhere local.
- Relative costs in different countries matter too. Fixed exchange rates and sticky wages create a problem: as in the Eurozone.

Monetary policy

- Central Banks can determine interest rates, short and long.
- Low rates may not much encourage investment or consumption.
- Low rates probably discourage lending to finance expenditure.
- It looks as though monetary policy has been ineffective. Except for China? Where banks were instructed to lend.

Fiscal Policy

- Possibilities:
  - Public expenditure, financed by borrowing or monetary expansion;
  - Subsidies, financed by taxation of high incomes and wealth (e.g. an oil tax);
  - Investment insurance;
  - Employment subsidies.

Deficit spending

- Note big differences within Europe in needed demand expansion.
- Perhaps best done by monetary expansion – creating money not to buy shares and other assets, but to buy goods and services.
- Not possible within a monetary union, except by central agreement.
- If a country left the Euro, it could do it. Its exchange rate would depreciate.

Deficits and Sovereign Default

- Deficits financed by borrowing eventually increase borrowing costs. Borrowing is still desirable: there are costs and benefits.
- The Mediterranean countries may be close to the maximum point. Anyway they are constrained so long as they remain in the Eurozone.
- More spending should reduce the deficit period. Difficult to get the balance right.

The future of the Euro

- Current European policies are unlikely to get out of recession.
- Sufficient demand expansion by the Northern countries would probably be inflationary.
- Surely Mediterranean peoples will not put up with current unemployment and incomes for ever. End of Euro?
- I hope governments are planning how.

Soaking the rich

- Limited possibilities. A lot of wealth is out of reach.
- The total taxable income of the very rich is not a large proportion of GDPs in Europe.
- Taxation of commodities from rich owners is a serious possibility. Oil wealth, for low spenders, has contributed to the trouble.

Investment insurance

- The best way out is restoration of investment levels.
- Investment may be encouraged by insurance against risks. If the incentive is successful, risk will be reduced.
- Fanny Mae and Fanny Mack did this. They were not the main problem. USA and UK have made moves to do it for bank loans.
- Loans for spending, not loans to lenders.

Employment subsidies

- Minimum wages may be a major cause of unemployment, in low-income regions of the EU.
- Subsidy of low-pay jobs could counteract that, and should not reduce the efficiency effects of minimum wages.
- Countries that have not learned how to tax may have difficulty financing them.

Continuing financial instability

- The financial system still looks fragile – once it starts doing enough lending again.
- Excessive insurance provided by derivatives, other inter-institution lending, and bail-out prospects, will not be eliminated by current and proposed regulation.
- If banks are made to restrict to real banking business, that will be very good.

The emerging economies

- Are there system-hitting risks that have still to emerge in the BRICs?
- The volume of non-performing loans in China is high. That must encourage the Chinese government to keep growth going as fast as is technically possible.
- They have shown great skill in doing so.
- The rate of return to capital will fall, but capital should go to the BRICs for a while.