EUROPE!

PRIZE WINNER

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Rebooting Europe

Abstract

The European Union is mired in a bad economic equilibrium of stagnation and deflation – stag-deflation. While the problem is excess supply and inadequate demand, current policy, premised on private-sector-investment-led growth, aims to expand supply further through ultra-low interest rates. This is demonstrably not working. The reason is that it raises the cost of labour relative to capital, thereby destroying jobs and demand, which negates the incentive for private-sector investment. The next interest rate cut simply intensifies the deflationary pressures. At the same time, this policy is generating a debt burden that is a tinderbox for crisis. Incremental reforms will not work. Europe's policy settings need to be reset to a configuration that has worked in the past. This involves the following:

- First, re-price labour: recognizing that monetary stimulus, including quantitative easing, has not triggered interest-sensitive consumption and investment but has priced labour out of factor markets (as interest rates fall, the ratio of wage rates to cost of capital rises), remove the subsidy for investment and price labour back into the market by normalizing interest rates.

- Second, defuse the debt bomb: since raising interest rates in the context of a debt bubble would lead to a crisis, have the European Central Bank buy up excess public-sector debt and cancel it. This would remove the tourniquet on fiscal policy, allowing a return to the job-creating expansions of the Keynesian era. Moral hazard? In crisis, ignore.

- Third, redefine industrial policy by addressing the problem of adverse selection of investment opportunities: the current consensus supports investments with risk/return metrics that appeal to the private investor, leaving on the table investments that do not, but that may have strong public good characteristics. There is money on the table; Europe should seize it to restore growth, using its new-found fiscal room to manœuvre.

In Europe, as in the global economy more generally, growth has been too slow for too long. In Europe, unlike elsewhere in the global economy, this is setting up an existential crisis.

Incremental, marginal reforms that could yield a growth dividend by 2020 will be too little, too late. Brexit and electoral trends on the continent towards fringe parties, each of which is fuelled by economic dysfunction, coupled with the implications for open borders of the refugee crisis and of individual acts of terrorism stemming from the horrific consequences of regime change policies for the Middle East and North Africa, mean that the European Union—as we know it—will not live to see 2020.

Restoring growth now is critical for the European experiment. This requires a discontinuous policy shift to break the European economy out of the bad economic equilibrium of stagnation and deflation – stag-deflation – in which it is mired. Stag-deflation emerges from excess supply and inadequate demand. However, current policy, premised on private-sector-investment-led growth, aims to expand supply further through ultra-low interest rates. This is demonstrably not working. The reason is that it raises the cost of labour relative to capital, thereby destroying jobs and demand, which negates the incentive for private-sector investment. This leads to further interest rate cuts which intensify the deflationary pressures. At the same time this policy is generating a debt burden that is a tinderbox for crisis.

In every crisis lies opportunity. In existential crisis lies opportunity for transformative renewal. Europe can break out of this equilibrium by pro-active policy or wait for its hand to be forced by the onset of a full-blown economic or political crisis. Europe's economic computer needs to be rebooted and its policy software refreshed with settings restored to defaults that are known to be functional from experience. This essay sketches out how this can be done.

A Bad Equilibrium

The combination of slow growth and deflationary pressures in which Europe is currently mired is the mirror image of the stagflation – the combination of slow growth and inflation – that the industrialized world faced in the 1970s.

At the end of the 1970s, the solution to stagflation was to switch from Keynesian demand-management policies to supply-side policies. The logic was powerful: given the breakdown of the relationship between unemployment and inflation that informed Keynesian stabilization policy, the only way to achieve both lower prices and higher output was to shift the supply curve outwards.

In today's context of stag-deflation, the only way to achieve higher output without adding to deflationary pressures is to shift the demand curve outwards. The current consensus fails to see this: it recommends shifting the supply curve out, thereby hoping for growth but intensifying the deflationary pressures that are destroying growth.

This point needs underscoring. For example, the three major MGI prescriptions are investing for the future, boosting productivity, and mobilising the workforce. All aim to increase supply.

- The investments the diagnostic contemplates are by a private-sector that is sitting on trillions of dollars of excess cash and not investing because, from a private-sector perspective, it sees no profit in what is on the table.
- Boosting productivity implicitly means capital deepening – increasing capital-labour ratios at a time when business enterprises see no reason to add to overall productive capacity and when capital deepening reduces demand for labour.
- Mobilizing the workforce, including of the greying elderly, in a context of massive unemployment and under-employment of young people, simply adds to the un- and under-employment.

These prescriptions would be effective if today's problems were those of the 1970s – too much demand chasing too little supply. But today's problems are not those of the 1970s, they are exactly the reverse. Simply put, supply-side policies are the cause of stag-deflation, not the exit strategy.

To exit from stag-deflation necessarily involves a break with the current consensus on economic policy. There is no shortage of examples of such major breaks with previous policy: Roosevelt's New Deal; the creation of the Bretton Woods system; the break from the Bretton Woods system; Russia's post-Soviet "cold turkey" privatisation and marketisation; and China's opening up policy. Going back further in history, we have other examples: Britain's move to free trade with the abolition of the Corn Laws, Japan's post-Meiji Restoration embrace of western technology, and Germany's adoption of the gold standard in 1871, which ushered in a new era of globalization. Europe has arrived at such a moment.

To understand what needs to be done to shift to a new and functional equilibrium requires an appreciation of how the current policies are reinforcing the current bad equilibrium. The key factors are the relationship between wage rates and interest rates, the implications of normalized interest rates for debt burdens, and identifying neglected sources of growth. Out of this diagnosis emerges naturally the policy remedy.

The path to a new equilibrium

Repricing Labour

Since the supply side revolution, when monetary policy assumed the main responsibility for macroeconomic stabilization, recoveries have been jobless, and increasingly so from cycle to cycle. This contrasts with the Bretton Woods era, when fiscal policy was the main tool for macroeconomic stabilization and recoveries were not jobless. The very term "jobless recovery" was coined to capture this change in the behaviour of the economy.

The reason for the changed behaviour is that using monetary stimulus (lowering interest rates) to engineer a recovery works not only on interest-sensitive expenditure and investment, but also distorts the pricing of factors of production, providing an artificial incentive to substitute capital for labour. Job destruction due to technological progress or to trade liberalization leads to efficiency gains; job destruction due to subsidization of capital leads to economic inefficiency, including most importantly through the resulting under-employment of the non-subsidised factor – labour.

Job creation is the linchpin for the exit strategy since increased number of jobs translates directly into increased demand for goods and services, which in turn drives corrections across the board. This is a version of Fordism: Henry Ford recognized that mass production of automobiles depended on the masses having the income to purchase them. His solution was to pay his workers enough that they could buy the products they laboured to produce.

Appropriately restated for the European context today, the issue is to increase demand for labour. To accomplish this in the current environment requires in the first instance that labour be re-priced relative to capital. Since cutting wages is counter-productive, and since it is impractical to rewrite countless labour contracts, the expedient is to reprice the cost of capital by raising interest rates.

The structural implications of this break are profound: the focus shifts from mobilizing supply of labour to mobilizing demand for labour; from generating productivity to generating jobs; and from investing in machines to hiring people to meet new demand.

Good solutions in one area have positive spillovers in others; bad solutions create new problems in other areas. Consider how repricing labour by removing an unfair subsidy to capital redresses other manifest problems that are tearing at the fabric of today's Europe; all effects of this policy shift are positive:

- It redistributes income from capital to labour, thus reversing the income redistribution from the European equivalents of Main Street to Wall Street that quantitative easing has effected. Details aside, quantitative easing fuels price increases for equities which are disproportionately held by the wealthy, while drying up returns on bank accounts which are the principal vehicle for savings of the rest.
- It expands the tax base for governments, since the shift of income from capital – which avoids tax through technically legal tax planning, including the use of offshore accounts – to labour, which pays taxes, has a positive structural effect on tax revenues.
- By raising the returns on bank savings accounts, the principal source of household asset income, not to mention fixed income assets that support pension funds, it enables households to increase the percentage of current income allocated to expenditure – which drives aggregate demand and growth.
- It undermines the (false) claim that European integration (the four freedoms) is the cause of local job woes by correctly identifying the subsidy to capital as the culprit.

- And all this is done through market forces, through the removal of a destructive subsidy, undermining any (false) claim of heavy-handed government intervention.

Repricing labour is the linchpin for the exit strategy. However, there are other critical steps that need to be taken to enable this.

Defusing the debt bomb

The practice during the monetarist/supply side era of engineering recoveries by making money cheap has had the side effect of creating the conditions for debt crises – an excessive build-up of debt. Once an engineered recovery is deemed to have become self-sustaining, monetary stimulus is withdrawn. As interest rates rise, a debt crisis ensues, because some borrowers, somewhere in the world, overdid the borrowing, on the advice of lenders that the debt was prudent and manageable, with the encouragement of Central Banks seeking to generate productive activity.

Given the role of the US dollar as the main vehicle for international transactions and reserves, the timing of events has generally followed the US business cycle, which featured recessions in 1981-82, 1991, 2001, and for all intents and purposes in 2011 as well. The monetary stimulus introduced to counter these recessions resulted in rising interest rates in mid-decade. Shortly thereafter a financial crisis ensued: 1987 ("Black Monday"); 1997 (The Asian Crisis); 2007 (the Subprime Crisis). The 2017 crisis awaits, unless events such as Brexit extend the agony of stag-deflation by pre-empting Central Bank moves to restore normal interest rates. The epicentre of the next crisis is likely to be Europe; the trigger (Brexit, Italian banks, whatever) is not germane to the point: the debt tinderbox is there and there are plenty of potential sources of sparks. In particular, raising interest rates to reprice labour would constitute a spark.

Accordingly, Europe must defuse the debt bomb by cancelling the dangerous excess debt as part of the policy package to reprice labour. Details aside, the European Central Bank would buy up excess public-sector debt, printing euros to pay for the purchases, and would cancel the debt it has acquired. There would be no haircut for investors in government bonds. The reduction in the nominal debt burden and the budgetary allocations for debt service would render fiscally sound a number of EU member states thought to be bankrupt.

The monetary shock from debt cancellation would not be inflationary. A simple thought experiment based on the quantity theory of money explains:

QUANTITY TIMES PRICE = MONEY TIMES VELOCITY OF CIRCULATION

In an economy operating at full capacity, an increase in the money supply cannot raise the quantity of output and so must raise prices, if velocity is treated as a constant. In an economy operating with considerable slack and facing external constraints on price increases, the increase in the money supply translates primarily into an increase in output.

Europe can tolerate a significant monetary shock of the approximate scale required to restore fiscal soundness (about €2 trillion, the amount of net debt of France, Greece, Italy, Portugal and Spain above 60 percent of GDP, the Maastricht benchmark) without inflationary consequences; given the desirability of countering deflationary pressure, Europe's €15 trillion economy could tolerate an even higher shock to restore fiscal flexibility to make the growth-generating investments that have been neglected under the current orthodox industrial policies.

This may not be enough since Europe's banking system is also vulnerable. In the event of a banking crisis, the banks should be immediately nationalized, the creditors paid off, with excess debt created by national authorities purchased and written off by the European Central

Bank. After a management shake-up, the nationalized banks would be privatized; Sweden has shown how this can be done efficiently, with minimal problems to third parties.

The immediate reaction to such a proposal would be to ask "What about moral hazard?" Moral hazard theory holds the consequences of excessive risk-taking should be visited on the risk-takers. It is an important factor for the design of public policy in any area where risk is entertained by economic actors, be they individuals, firms, or governments. Well-designed policies promote sound behaviour in the normal course of events. However, in managing a potential economic crisis, especially a potentially existential crisis, conditioning policy responses on concerns over moral hazard gives this factor a weight completely out of proportion with its importance.

In three recent cases—the Asian Crisis, the subprime crisis and the Eurozone crisis—authorities have made bad situations far worse by acting in line with the moral hazard doctrine: consider in this regard the results of the IMF-dictated closure of Indonesian banks, the Lehman Brothers closure, and the transformation of the Greek debt molehill into a Eurozone mountain.

But a counter-example may work better for the reader. During the Latin debt crisis, the major money centre banks in the United States and Canada had their capital more than wiped out by bad loans. The authorities in both countries exercised "regulatory forbearance" – that is, they looked the other way, while the banks rebuilt their balance sheets. Accordingly, neither country triggered a banking crisis because of moralistic angst over moral hazard. For the United States this can be said to be the only available opportunity in its history for a banking crisis that it did not seize. Unfortunately, it did not learn from this episode and thus triggered the subprime crisis by closing Lehman Brothers. In Canada, however, where bank closures were avoided like the plague, the lessons from the "near miss" were learned and applied in subsequent regulatory reforms, enabling Canada to emerge from the subprime-triggered global financial crisis with the soundest financial system in the world. Look to Canada to understand why it is best to deal with moral hazard between crises rather than in crises.

In short, there is no reason for Europe to hit the rocks over debt, least of all because of concerns about moral hazard; all countries learn from near misses, and systemic issues of moral hazard can and should be dealt with once Europe has been restored to a new and viable equilibrium.

A second reaction would concern the fairness of such a debt cancellation. The narrative would be: "Why should countries that paid their taxes participate in a bailout of those that did not?" The short answer is that there are no tax implications of the debt cancellation and all parts of Europe will benefit enormously from the avoidance of a full-blown crisis – some directly (the Mediterranean fringe which will account for the vast majority of debt write-offs) and some indirectly, through the growth dividend which that cancellation will provide to all of Europe.

A third reaction would be concern about the reaction of financial markets. This proposal does not constitute a major break with the current consensus in favour of continued quantitative easing. However, it does transform the nature of quantitative easing by shifting the benefits from the private-sector to the public-sector. The monetary shock would imply a lower valuation for the euro; the normalization of interest rates would imply a higher valuation, as would the growth dividend from the relief from austerity policies. On balance, the euro would remain in the vicinity of parity with the US dollar, which the European Central Bank should encourage, since the last time Europe had good growth was the last time the euro was in this range.

Redefining industrial policy

Under the current consensus view of economic policy, the role of the public-sector in the economy is restricted to creating a conducive environment for private-sector activity; thus, "horizontal" economic infrastructure investment is encouraged but "vertical" or sector-specific interventions are discouraged, on grounds that governments cannot "pick winners" and other similar aphorisms and arguments based on theories about public versus private-sector governance and incentives. While governments have hardly been pure in applying this doctrine, it has had a pervasive impact on which investments are actually undertaken.

Investments do not come with horizontal or vertical stripes. They come with risk/return metrics. Some investments have risk/return metrics that will be attractive to the private-sector and some will not, for various reasons: the project might be too speculative and the risks accordingly too great or not readily quantifiable; the returns might not be realizable in a short enough time span; or the benefits might not be appropriable by the investor.

Notably, these characteristics—especiall non-appropriability—do not mean the investments lack value to society. Quite the reverse: such projects might have the greatest value to society as they are by definition projects with large public good characteristics, hence large spillovers.

Pursuing this line of thought one step further, it is important to note the combinatorial nature of innovation. As observed long ago by Henri Poincaré, new ideas emerge from combining existing ideas. The idea of recombination is actually well established in economics. Usher, in his encyclopaedic survey of inventions during the golden age of industrialization commented that "invention finds its distinctive feature in the constructive assimilation of pre-existing elements into new synthesis, new patterns or new configurations" (cited in Hargadon and Sutton, 1997; 716).

There are many examples to illustrate the point. For example, Thomas Edison's phonograph combined ideas developed by engineers working in Edison's laboratories on the telegraph, telephone, and electric motor (Hargadon and Sutton, 1997; 716). Weitzman (1998; 334) comments on the recombinant nature of Edison's inventions:

"One is struck in such stories by the central role of the hybridization of ideas. Notwithstanding the overarching importance of Edison's own inspirational genius, the very concept of an 'electric candle' appears right from the beginning as a deceptively simple cross-pollination of the idea of a 'candle' with the idea of 'electricity'… the Edison System for a complete domestic electric lighting network operating from a central power station was explicitly patterned in the inventor's mind by combining the then-novel idea of an electric candle with the established idea of a gas distribution system".

Further, the channelling of research and development into the private-sector also meant fragmentation and a consequent pass on investments that required a scale too great for private capital.

Against this background, consider the following simple thought experiment. Given the available set of ideas or inventions seeking investment, suppose there are several that can be recombined to produce new ideas or inventions. Let us further suppose that these new ideas and inventions do not meet the risk/return metrics that will appeal to private-sector investors, or are not feasible for the private-sector to undertake. Accordingly, they are passed over. However, the recombination of the passed-over ideas/inventions yields an idea/invention that is quintessentially suited for the private-sector.

One simple example suffices to illustrate that this is not a null set. The silicon chip and the Internet both emerged from the US government's defence research programme. Both projects fall into the category of investments that the private-sector would not/could not have made. Together, they enabled the creation of Google, eBay, Pokemon Go, and countless other successful private-sector computer/Internet-enabled ventures.

It is, accordingly, safe to assert that there exists an investment space that has been systematically excluded from exploration because of today's industrial policy orthodoxy. It is populated by projects that have risk/return metrics that do not appeal to the private-sector and lack the horizontal stripes that orthodoxy has mandated for selection by the public-sector. Europe has the knowledge assets to explore this space and drive new private-sector dynamism through downstream recombination of the resulting outputs.

Importantly, the selection criterion for investments is not whether they lead to immediately commercially successful projects but whether they generate new, interesting, and potentially enabling capabilities. For a working model of what this would look like in practice, Europe need look no further than the US Defense Advanced Research Projects Agency (DARPA). This programme funds a wide range of often "blue sky" projects with uncertain prospects and unclear commercial potential. Yet it is widely considered in innovation circles to be the backbone of US innovation success because of the knowledge spillovers it generates for the private-sector participants. It is the talk of the European conference circuit. Europe need simply embrace it.

Using the newly found fiscal room to manoeuvre generated by the debt cancellation to implement this investment programme would shift Europe from the path of austerity to the path of prosperity.

Discussion

The proposal outlined above is tangible – it involves a one-time debt purchase and cancellation programme by the European Central Bank to restore fiscal soundness in EU Member States that are or would be put into crisis with normalization of interest rates, coupled with a normalization of interest rates to reprice labour in European factor markets. The scale of the proposed monetary shock is within bounds that would be absorbed by increasing utilization of existing capacity, employing currently unemployed persons, and removing current deflationary pressures. Accordingly, it would not excite new inflationary impulses. The fiscal room to manoeuvre which this would create would be used for knowledge/capability generation by exploring an innovation space that current industrial policy orthodoxy has wrongly cordoned off. A working model for the industrial policy instrument is available. The combination represents a growth and jobs package tailored to Europe's current circumstances.

The proposal also responds to the risks that presently loom for the European experiment on both the economic and political fronts. Europe will not have three to five years of quiet time for reflection and refinement of potential options. The problem identified is that Europe is circling a bad point of equilibrium; the policy prescription involves a discontinuous, one-time shift to a new equilibrium. Delivering the policy shock to move Europe to a new equilibrium – in point of fact, returning Europe to a previous equilibrium that was both viable and prosperous – is feasible within weeks and months. Hopefully this will be done before Europe careens into crisis, but certainly it can be done quickly if and when crisis erupts.

Critically, the core ideas are simple and can be easily communicated to the informed lay person in the proverbial elevator conversation.

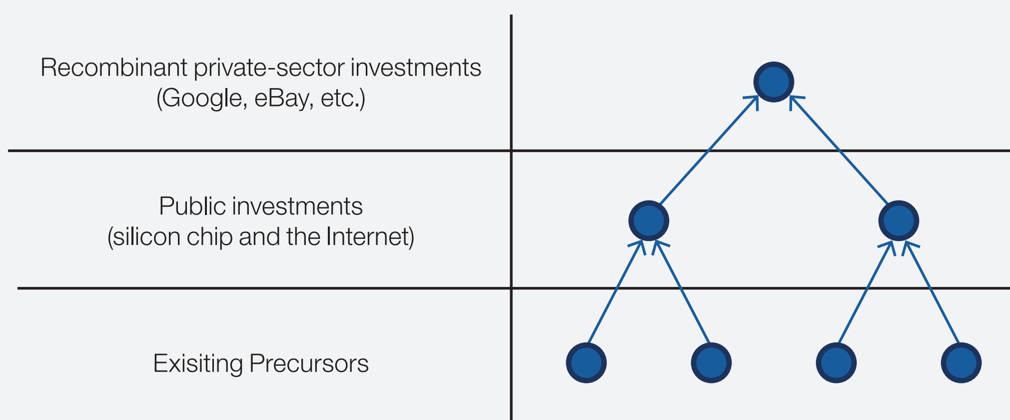
It accords with intuition that subsidization of one factor of production can lead to under-employment of a competing factor of production and general economic inefficiency. It remains to point out that cheap money subsidizes capital, leading to an artificially high capital/labour mix in production. Jobless recoveries and high unemployment are the logical consequence. This is double the 25-word limit of the board game, but short enough for the elevator ride.

It is also well understood that bankruptcy procedures, by removing crushing debt, enable renewed entrepreneurial activity. The debt cancellation proposed here, coupled with the proposal for new public investment in enabling ideas/innovations, does precisely that. This stands in opposition to, and neutralizes, concerns about moral hazard. Moreover, the idea that a debt jubilee will be required has been long in gestation and growing in acceptance, and an informed reading of economic history supports the case of addressing moral hazard when formulating rules, not when dealing with crisis situations.

The proposal for redefining industrial policy is more fundamental and the ground is less well prepared. However, it breaks out of a dysfunctional and polarized debate about industrial policy by introducing a new lens. Importantly, the key idea can be sketched on the back of an envelope (see Exhibit 1).

EXHIBIT 1

An illustration of how passed-over investments with public good characteristics screen out potential investments with private good characteristics



The proposals involve no new taxes. Taxpayers in some EU Member States will not have to pay to bailout debtors in others. This is a rather critical point in today's Europe. There will be a need, however, to explain why printing euros will not destroy the euro. The vast body of writing explaining quantitative easing and Central Bank procedures for ensuring it does not result in hyper-inflation provides the raw material for the communications programme.

The twist in the quantitative easing proposed here is that it does not benefit Europe's version of Wall Street, but Europe's version of Main Street. It redistributes wealth from the one percent to the 99 percent, as a just restitution for the massive transfer of wealth from the 99 percent to the one percent under the previous version of quantitative easing. But it does so through the impartial hand of the market as normalization of interest rates restructures returns on asset portfolios.

Similarly, while the proposal redistributes purchasing power from Europe's "haves" to Europe's "have nots" by diluting the claim of the former on overall European and indeed global production, the removal of the tourniquet of austerity policies and the resulting growth dividend for all of Europe mean that this will not be experienced as an out-of-pocket expense. Rather, it will re-invigorate intra-EU trade and investment to the benefit of Europe's north and south. There is a ready-made catchphrase here: from austerity to prosperity. And in this case, it truly is prosperity for all.

The acceptance of this policy, and the repudiation of the failed policies of austerity, are also necessary precursors to rebuilding trust throughout Europe in the European experiment.

This proposal is far from comprehensive. However, these core measures will create the enabling environment for the many useful suggestions for incremental reform in Europe that have been produced and will continue to be produced through exercises such as the present essay contest. Europe is mired in a bad equilibrium in which nothing works well. It needs to be jolted into a new and viable policy space. This essay suggests how Europe can be rebooted.

References

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