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for Europe**

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The **Policy Paper** series of the Centre for Studies on Federalism includes analyses and policy-oriented research in the field of national and supranational federalism. The papers aim to stimulate scholarly and political debate on topical issues by presenting original data, ideas and proposals.

The relevance of Keynesian economics for Europe

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This year is the eightieth anniversary of *The General Theory of Employment, Interest and Money* by John Maynard Keynes. At a time of profound crisis for both the global economy and economics as discipline, Keynesian economics continues to reveal its relevance as an alternative to the practical and theoretical shortcomings of mainstream approaches.

The nature of unemployment

The EU is currently experiencing a modest economic recovery: real GDP growth is expected to rise from by 1,95% in 2016, and in 2015 the unemployment rate slightly decreased to 9,3% in the EU and to 10,8% in the Eurozone. However, what threatens the labour market and growth in Europe is the nature of unemployment. In the EU, half of the unemployed (23 million people) have not been working for more than a year, one-fifth are young, and nearly 40% of the latter are in both conditions, i.e. young and unemployed for more than one year. All those people are more likely to become discouraged and leave the labour market with an erosion of skills, a decline of capacity and a lower, if any,

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probability to find a new job when the labour market will begin to recover.

We are also facing, at the global level, a problem of what Keynes called “technological unemployment,” that is unemployment “due to our discovery of means of economising the use of labour outrunning the pace at which we can find new uses for labour.” According to a recent World Bank report, middle-skilled routine labour with well-defined procedures, such as assembling or accounting, can be completely automated by machinery¹. People in these jobs are bound to become technologically unemployed.

Neoclassical and Keynesian economics on potential output

The problem of structural unemployment can be seen through the concept of “potential output,” an indicator estimated by economic practitioners to measure the level of output in the long run. Potential output is considered a desirable objective, towards which economies should tend. If actual output is lower than the potential, a negative output gap exists, meaning that the production is below what the level of capital equipment and existing technology would permit. The 2015 IMF World Economic Outlook reported that the growth trend of the potential output has started to decline for both advanced countries (since 2000) and emerging ones (after 2009)². In 2015 the Eurozone suffered an average negative output gap of 2%, with Greece at -7,4%, Spain -5%, Italy -4,5%. Germany is the only country that has closed its gap. The resulting picture is not encouraging, as in addition to the potential growth

slowing down globally, those Eurozone countries worst hit by the crisis are failing to close their output gap and get back on a positive path. In sum, as Larry Summers put it, it seems that we are currently in a situation of “secular stagnation.”

One of the differences between neoclassical and Keynesian economics is about the determinants of long run growth. According to neoclassical economists, the effective level of production tends automatically towards its potential—a trajectory determined by supply-side factors, such as factor productivity, wage flexibility and factor mobility. Increasing these factors will improve efficiency and thus the level of production. Conversely, Keynesians think that the effective level of aggregate demand does not converge automatically towards its potential. Indeed, there is no natural mechanism producing converge towards an economy’s potential state. Keynes believed that entrepreneurs do not plan their production on the basis of what they can produce, but on expectations about what they can earn, hence on demand. If demand is weak, production and employment will fall below the potential, until demand will pick up again.

Causes and solutions: supply or demand?

An example of supply side measures are structural reforms, which can be defined as those reforms that bring an economy closer to the ideal of a free market economy. In this sense, the European Commission, with its strong focus on structural reforms (in particular in the labour market) follows a neoclassical approach. From this perspective, insisting on structural reforms with the aim of making wages

more flexible (i.e. lower) to tackle shocks, means believing that with flexible wages potential output will increase and, as a consequence, actual production will rise too. Yet we are not living in normal times: Europe is experiencing higher productive capacity than demand, as the negative output gaps show. Any reform that further increases efficiency, and thus the potential output, will just increase the gap, creating just more labour supply with lower wages, without solving the problem of unemployment absorption.

This is not the first time that the nature of a crisis is misunderstood³. During the oil shocks of the 1970s, policy makers educated within a Keynesian framework reacted to what was a supply shock with demand management, implementing expansionary economic policies that in turn fed an unprecedented problem of high inflation and lack of growth. The result was the complete disrepute of Keynesian-inspired demand models. This suggests that a policy should not be judged as “good or bad” in ideological terms. Rather, it should be considered “appropriate or not appropriate” to solve a specific crisis. This logic has recently been adopted by a group of prominent economists, who believe it is crucial to create a new consensus narrative of the causes of the euro zone crisis, concluding that “[t]o avoid a lingering recession, active aggregate demand management at the level of the euro zone would have been needed.”⁴

A critique of the investment plan for Europe

The investment plan for Europe—the “Juncker plan”—is not a genuine Keynesian measure. First of all, the program is temporary. As Andrea Terzi states, when the crisis

burst, governments throughout the world implemented fiscal packages. But this was mainly a “moment of political emergency” rather than a “Keynesian moment,” intended as a true reassessment of the policy regime⁵. In the same way, the plan risks being a one-off measure, whereas it should envisage longer-term interventions. Following Keynes, since capitalism fluctuates consistently below its potential capacity, permanent instruments able to periodically adjust actual production upward are needed.

Second, the financing of the Juncker plan’s investment projects critically depends on the degree to which the private sectors matches the limited resources allocated by public institutions, the Commission and European Investment Bank (EIB). According to Keynes, historically the tendency to save is stronger than the inducement to invest, because of the uncertainty of the future. In other words, on average people tend to save money in order to get some financial security, rather than investing them in some risky enterprises. Today this lack of confidence needs more than ever to be countered by public authorities by means of direct public investments.

Finally, the Juncker plan is a (private sector) demand-driven mechanism. As the EIB vice president Ambroise Fayolle stated, the EIB makes risk-absorbing financing available but it cannot make the projects happen. Leaving the private sector alone could lead to a suboptimal level of investment.

Alternatives in a Keynesian fashion

What could be done, in a Keynesian perspective, in the present macroeconomic setting? Keynes was in favour of a golden rule on public investment. He thought that public utility investments should not be under the budget rule, but be instead financed through bond issues. True, it can be argued that the EU's Fiscal compact does grant countries facing a serious economic recession more time to reach their medium-term debt objectives, therefore giving them some fiscal room for manoeuvre. Or that contributions made by member states to the Juncker plan are not counted against fiscal rules. Yet, in the current zero interest rate situation, a genuine golden rule would be better than these measures. As Paul De Grauwe argues, a government that issues bonds at close to 0% and channels the money into projects that will have rates of return exceeding 0%, promotes economic growth and makes future debt repayment easier⁶.

More coherence between monetary and fiscal policy is also desirable in the EU. Although the mainstream vision is against any “attempts to co-ordinate macroeconomic policies ex ante in order to achieve an overall policy mix favorable to growth and employment”⁷, in a deflationary period an expansionary monetary policy can only be effective if coupled with an expansionary fiscal policy. To be truly Keynesian, quantitative easing should involve the financing of expansionary government spending. Based on existing measures, a coordinated policy could include, for instance, new bonds issuance by the EIB purchased by the European Central Bank within its quantitative easing program, and the new money allocated to the Juncker plan,

at least for riskier projects like those involving the transition to a carbon-free economy (which the private sector would probably not finance alone).

In the longer run, a specific permanent institution, like a European Industrial Agency with a mandate of reshaping the European economy through direct public investment, would probably be needed⁸. And instead of avoiding geographic pre-allocation, as envisaged by the Juncker plan, the distribution of such investments between countries should also be explicitly defined with the aim of reducing unemployment levels below a certain threshold. Until now, beneficiaries of the Juncker plan are countries like Ireland, Denmark, Netherlands and Belgium—certainly not the ones in most need of additional investments.

Although there is growing consensus in economics about the nature of the crisis, any alternative proposal to tackle it faces strong ideological obstacles. One of the most unorthodox ideas in this context is probably the simplest, although revolutionary, insight by Keynes that markets are not able, by themselves, to guarantee economic prosperity. On the contrary, the preservation of a free economy is only possible through effective economic governance aimed at pursuing the common good. And the only way to do so is through full employment.

Notes

- 1 World Bank (2016). World Development Report 2016: Digital Dividends
- 2 International Monetary Fund (2015). World Economic Outlook. Uneven Growth: Short- and Long-Term Factors, April 2015
- 3 De Grauwe, P. (2014). Yes, it's the economy, stupid, but is it demand or supply?, 24 January, *CEPS Commentary*
- 4 Rebooting Consensus Authors (2015) "Rebooting the Eurozone: Step 1—Agreeing a Crisis narrative", Vox, 20 november
- 5 Terzi, A. (2010). The "Keynesian Moment" in Policymaking, the Perils Ahead, and a Flow-of-funds Interpretation of Fiscal Policy, Working Paper no. 614, Levy Economics Institute of Bard College
- 6 De Grauwe, P. (2015). Quantitative Easing (QE) And Public Investment, 7 December, Social Europe
- 7 Issing, O. (2002). On Macroeconomic Policy Co-ordination in EMU, *Journal of Common Market Studies*, Vol. 40 (2), p. 345-58
- 8 Pianta, M. (2015). What is to be produced? the case for industrial policy, *Intereconomics: review of European economic policy*, Vol. 50 (3), p. 139-145

CENTRE FOR STUDIES ON FEDERALISM

The **Centre for Studies on Federalism (CSF)** was established in November 2000 under the auspices of the Compagnia di San Paolo and the Universities of Turin, Pavia and Milan. It is presently a foundation.

The activities of the CSF are focused on interdisciplinary research, documentation and information on internal and supranational federalism, the developments of regional and continental integration (notably, of the European Union), the issues related to the world order and the democratization process of the international system.

The CSF promotes an annual **Lecture**, named after Altiero Spinelli, on topical European issues. The CSF publishes **Research and Policy Paper**, as well as its own “**Federalism**”, **The Federalist Debate** (also online), the **Bibliographical Bulletin on Federalism**, the online-journal **Perspectives on Federalism**, the **International Democracy Watch**.

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