Stagnation policy in the Euro area and economic policy alternatives: A Steindlian/neo-Kaleckian perspective

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Aalborg
1. Introduction

2. Economic stagnation made in the Eurozone

3. A Steindlian model of growth and ‘stagnation policy’

4. ‘Stagnation policy’ made in the Eurozone: main failures of Eurozone macro policies

5. Elements of a Steindlian/neo-Kaleckian/post-Keynesian alternative for the Eurozone
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Eurozone recovery particularly weak ...

Real GDP, 2007-2016, 2007=100

Source: European Commission (2017), author's calculations
Several Eurozone countries still under water...

Real GDP, 2007-2016, 2007=100
Source: European Commission (2017), author's calculations
Some stabilisation of Eurozone income distribution...

Labour income share as percentage of GDP at current factor cost, 1991-2016

Source: European Commission (2017)
... but LIS still falling in crisis countries: Greece, Spain, Portugal, Italy, ...
Eurozone fiscal austerity policies ...

General government financial balance relative to GDP, in per cent 1995-2016

Source: European Commission (2017), author's calculations
... in particular in crisis countries ...

General government financial balance relative to GDP, in per cent 1995-2016

Source: European Commission (2017), author's calculations
No general reduction of the government debt-GDP ratios...
... in particular in crisis countries

General government gross consolidated debt relative to GDP, in percent, 1995-2016

Source: European Commission (2017), author's calculations
Current account deficits tend to disappear – but surpluses remain ➔ Eurozone as a free rider of world demand

CA surplus of EA12: 0.5% GDP in 2010, 3.6% of GDP in 2016
Eurozone driven by foreign demand and deficits...
Eurozone as enlarged Germany

Germany: Sectoral financial balances as a percentage share of nominal GDP, 1995 - 2016,
Source: European Commission (2017), author’s calculations

- External sector
- Public sector
- Private sector
... similar to small open Swedish economy ...

Sweden: Sectoral financial balances as a percentage share of nominal GDP, 1995 - 2016,
Source: European Commission (2017), author's calculations
... all benefiting from stabilisation elsewhere, i.e. the US ...
United Kingdom: Sectoral financial balances as a percentage share of nominal GDP, 1995 - 2016,
Source: European Commission (2017), author's calculations

- External sector
- Public sector
- Private sector
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• Steindl (1979, CJE): „Stagnation theory and stagnation policy“

• (Steindl 1976, p. xvii): ‘[…] thus we witness stagnation not as an incomprehensible fate, as in the 1930s, but stagnation as policy’

• Kalecki (1953, 1971, p. 139): Political Aspects of Full Employment

‘The reasons for the opposition of the ‘industrial leaders’ to full employment achieved by Government spending may be subdivided into three categories: (i) the dislike of Government interference in the problem of employment as such; (ii) the dislike of the direction of Government spending (public investment and subsidising consumption); (iii) dislike of the social and political changes resulting from the maintenance of full employment.’
A Steindlian model of growth and stagnation
here: simplification by Hein (2016)

Assumptions:

• Closed private one-good economy
• Fixed coefficients production technology
• No overhead labour, no depreciation
• Harrod-neutral technological change
• Three classes: rentiers, managers/capitalists, workers
• No labour supply constraint
• Mark-up pricing in oligopolistic markets
Pricing and distribution

(1) \[ p = [1 + m(\rho, \gamma)]w, \quad m > 0, \quad \frac{\partial m}{\partial \rho} \geq 0, \quad \frac{\partial m}{\partial \gamma} \geq 0, \]

(2) \[ h = \frac{\Pi}{pY} = 1 - \frac{1}{1 + m(\rho, \gamma)}, \quad \frac{\partial h}{\partial \rho} \geq 0, \quad \frac{\partial h}{\partial \gamma} \geq 0, \]

(3) \[ r = \frac{\Pi}{pK} = \frac{\Pi}{pY} \frac{Y}{Y^{p}} \frac{Y^{p}}{K} = hu \frac{1}{v}. \]

P: price, m: mark-up, \( \rho \): rentiers’ rate of return, \( \gamma \): outside finance-capital ratio, w: nominal wage rate, a: labour-output ratio, h: profit share, \( \Pi \): profits, Y: real output, r: profit rate, K: real capital stock, \( Y^{p} \): potential output, u: rate of capacity utilisation, v: capital-potential output ratio
Financing of the capital stock and rentiers income

(4) \[ pK = B + E_R + E_F, \]

(5) \[ \gamma = \frac{B + E_R}{pK}, \]

(6) \[ \phi = \frac{E_F}{pK}, \]

(7) \[ \Pi = \Pi_F + R, \]

(8) \[ R = \rho(E_R + B). \]

B: debt, \( E_R \): equity held by rentiers, \( E_F \): accumulated retained earnings, \( \gamma \): outside finance-capital ratio, \( \phi \): inside finance-capital ratio, \( \Pi_F \): retained earnings, \( R \): rentiers’ income, \( \rho \): rentiers’ rate of return
Saving, investment and equilibrium

(9) \[ \sigma = \frac{S}{pK} = \frac{\Pi - R + s_R R}{pK} = h \frac{u}{v} - (1 - s_R) \rho \gamma, \quad 0 < s_R \leq 1. \]

(10) \[ g = \frac{pI}{pK} = \alpha + \omega \hat{y} + \beta(u - u_0) + \theta \left( h \frac{u}{v} - \rho \gamma \right), \quad \beta, \theta, \omega > 0, \theta < 1, \]

(11) \[ g = \sigma, \]

(12) \[ \frac{\partial \sigma}{\partial u} - \frac{\partial g}{\partial u} > 0 \quad \Rightarrow \quad (1 - \theta) \frac{h}{v} - \beta > 0. \]

\( \sigma \): saving rate, \( S \): saving, \( s_R \): propensity to save out of rentiers’ income, 
\( g \): accumulation rate, \( I \): investment, \( \alpha \): autonomous investment, animal spirits, \( \hat{y} \): productivity growth, \( u_0 \): target rate of utilisation.
Responses of equilibrium rates of capacity utilisation ($u$), capital accumulation ($g$), profit ($r$) towards changes in exogenous variables and parameters

<table>
<thead>
<tr>
<th></th>
<th>$u^*$</th>
<th>$g^*$</th>
<th>$r^*$</th>
</tr>
</thead>
<tbody>
<tr>
<td>$\alpha$</td>
<td>+</td>
<td>+</td>
<td>+</td>
</tr>
<tr>
<td>$\omega \hat{y}$</td>
<td>+</td>
<td>+</td>
<td>+</td>
</tr>
<tr>
<td>$u_0$</td>
<td>-</td>
<td>-</td>
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</tr>
<tr>
<td>$s_R$</td>
<td>-</td>
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<tr>
<td>$h$</td>
<td>-</td>
<td>-</td>
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</tr>
<tr>
<td>$\rho$</td>
<td>?</td>
<td>?</td>
<td>?</td>
</tr>
<tr>
<td>$\gamma$</td>
<td>?</td>
<td>?</td>
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### Effects of a change in the rentiers’ rate of return or the outside finance-capital ratio with interest- and dividend payments-inelastic mark-up and profit share

<table>
<thead>
<tr>
<th>‘normal case’ ‘debt-burdened’ economy</th>
<th>‘intermediate case’</th>
<th>‘puzzling case’ ‘debt-led’ economy</th>
</tr>
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<tbody>
<tr>
<td>$1 - s_R &lt; \theta$</td>
<td>$\theta &lt; 1 - s_R &lt; \theta \frac{h}{\beta + \theta \frac{h}{v}}$</td>
<td>$\theta \frac{h}{\beta + \theta \frac{h}{v}} &lt; 1 - s_R$</td>
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<tr>
<td>$\frac{\partial u}{\partial \rho}, \frac{\partial u}{\partial \gamma}$</td>
<td>$-$</td>
<td>$+$</td>
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<tr>
<td>$\frac{\partial g}{\partial \rho}, \frac{\partial g}{\partial \gamma}$</td>
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<td>$-$</td>
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<td>$\frac{\partial r}{\partial \rho}, \frac{\partial r}{\partial \gamma}$</td>
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Note: Assuming the stability condition (12) for the goods market equilibrium to hold implies $(h/v)/[\beta + \theta(h/v)] > 1$, because from $(1-\theta)(h/v) - \beta > 0$, we get $(h/v) - \theta (h/v) > \beta$, and hence $(h/v) > \beta + \theta(h/v)$. 

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Endogenous technological progress


• Kaldor’s (1957, 1961): technical progress function
• Kaldor’s (1966): Verdoorn’s Law
• Marx (1867), Hicks (1932): wage push

\[ \hat{y} = \eta + \varepsilon g - \psi h, \quad \eta, \varepsilon, \psi > 0. \]

\( \eta \): basic innovations, learning by doing
Figure 1: Stagnation with endogenous productivity growth
Stagnation policy or stagnation as a political trend

• decreasing $\alpha$ (decrease in autonomous government expenditure growth, falling animal spirits),

• falling $\omega y^\gamma$ (lower growth enhancing public investment, lower investment in R&D),

• rising profit share $h$ (weakening workers’ and trade union bargaining power, higher interest and hence overhead costs),

• rise in the households’ propensity to save (rising inequality in the distribution of household incomes, higher uncertainty triggering precautionary saving).

• a rise in the rentiers’ rate of return, hence the interest rate and/or the dividend rate, and/or the outside finance-capital ratio, hence the debt- and/or the rentiers’ equity-capital ratio, if the economy is in the ‘normal case’ and in a ‘debt-burdened’ regime
Steindlian anti-stagnation policies

- Stabilising and raising public autonomous expenditure growth, as well as discretionary anti-cyclical fiscal policies,
- Raising growth enhancing public investment, focusing on infrastructure, technology, education and R&D expenditures,
- Stabilising and raising the wage share by full employment policies, improving workers’ bargaining power, by low interest rate policies, reducing overhead costs, and by the re-regulation of the financial sector reducing the power and income claims of rentiers and shareholders,
- Lowering the households’ propensity to save by means of redistributing income, both pre-tax via higher wage shares and a more compressed wage structure and after-tax by progressive taxation and social transfers, as well as by removing uncertainty triggering precautionary saving,
- Improving international economic and monetary policy coordination in order to avoid severe current account imbalances, ‘beggar thy neighbour’ strategies, on the one hand, and rising indebtedness in foreign currencies, on the other hand.
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| **Macroeconomic policy recommendations: New Consensus models (NCM) and post-Keynesian models (PKM) compared** |
|-----------------|-----------------|-----------------|
| **NCM** | **PKM** |
| **Monetary policy** | Inflation targeting by means of interest rate policies, which affects unemployment in the short run, but only inflation in the long run | Target low interest rates affecting distribution, and stabilise monetary, financial and real sectors applying other instruments (LLR, credit controls, ABRR) |
| **Fiscal policy** | Support monetary policy in achieving price stability, balances the budget over the cycle | Real stabilisation in the short and in the long run, no autonomous deficit target, distribution of disposable income |
| **Labour market and wage/incomes policy** | Determines the NAIRU in the long run and the speed of adjustment in the short run, focus should be on flexible nominal and real wages | Affects price level/inflation and distribution, focus should be on rigid nominal wages, steady nominal unit labour cost growth and compressed wage structure |
| **International economic policies** | Free trade, free capital flows, flexible exchange rates | Regulated capital flows, managed exchange rates, infant industry protection, regional and industrial policies |
| **Co-ordination** | Clear assignment in the long run, co-ordination at best only in the short run | No clear assignment, economic policy co-ordination required in the short and the long run, both nationally and internationally |
Limitations of NCM policies in Eurozone

1. In normal times no mechanism to prevent internal current account imbalances:
   single nominal interest rate $\Rightarrow$ divergent real rates;
   structural reforms in low growth countries made things worse in these countries

2. Great Recession: limits to macro management by interest rate policies (zero lower bound, rising risk + liquidity premia, investment trap); QE has been like 'pushing on a string'

3. Lack of a 'lender of last resort' and guarantee of last resort for government debt $\Rightarrow$ euro crisis, gradual movement of ECB (OMT) towards LLR has been linked with austerity measures as prerequesite
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Presuppositions

• United States of Europe and proper fiscal federalism are not an option for the near future.

• Alternative policies have to start from existing institutions gradually developing them towards a workable CU
More concrete policy proposals for the Euro area

Coordination is required: ‘policy package’

• Vertical coordination of national, as well as European institution within the respective policy area

• Horizontal coordination among areas of policy making at national and European levels,

  ➢ Aggregate demand management
  ➢ Industrial and regional development strategy
  ➢ Macroeconomic Dialogue, European Semester, financing institutions for regional and industrial policies (EIB, EIF)
Monetary policy

- refrain from fine-tuning inflation or other macro-variables
- target low real long-term interest rates \((i < r)\)
- contribute to financial stability: credit standards, reserve requirements, credit controls
- most important: lender of last resort for the banking system but also for Euro area member countries

ECB announcement: intervention into secondary government bond markets as soon as the rate of interest on government bonds exceeds the long-run nominal rate of growth of the respective country

\[ i_j \leq \hat{p}_j + \hat{Y}_j. \]  

(De Grauwe 2011: Euro area wide cap – 2 per cent above German rate)
Wage and incomes policy

- Contribute to stabilising income shares and inflation at Euro area target rate

\( \hat{w}_j = \hat{y}_j + p^T, \)  

- Contribute to rebalancing (Stockhammer/Onaran 2012):

\( \hat{w}_j = \hat{y}_j + p^T + \alpha(U_{LC_{EA}} - U_{LC_j}), \)

- Abandon the dominating policies of labour market flexibilisation and of gaining competitiveness by means of nominal wage restraints (cuts)
- Re-regulation of labour market, stabilisation of labour unions and employer associations
- Euro-area wide minimum wage legislation: ETUC (2012)
- Increase minimum wage by inflation target plus national productivity growth each year
Rebalancing via wage policies?

Price competitiveness seems to be of little relevance for CA imbalances within the Euro area:

- Arghyrou/Chortareas (2008, p. 752) for Euro area member states (1975-2005): “relative incomes have been playing a more prominent role than real exchange rates in long-run current account determination.”
- European Commission (2010, p. 10): “[a] large part of the cross-country divergence in the current account since the late 1990s is rooted in domestic demand factors.”
- and several others ...

Schröder (2011), Storm/Naastepad (2014), Kollmann et al. (2014): only small effects of price competitiveness on German trade, which is almost completely explained by foreign demand vs. domestic demand.

- Major burden for internally rebalancing the Euro area falls on demand management and industrial restructuring!!
- Fiscal policy + industrial + regional policies
Fiscal policy

Focus on real stabilisation, full employment and also a more equal distribution of disposable income, taking into account a balanced current account target:

(20) \[ S - I = X - M + G - T. \]

With a balanced current accounts government deficits in the long-run perspective (D) have to permanently take up the excess of private saving over private investment:

(21) \[ D = G - T = S - I. \]

(22) \[
\frac{B}{Y^n} = \frac{D}{\hat{Y}^n} \quad \text{or} \quad \frac{B}{Y^n} = \frac{D'}{\hat{Y}^n - i}
\]

Low interest rates \((i \leq g)\) are important for distributional reasons.
Permanent government deficits for public investment in a wider sense + short-run stabilisation in case of cyclical shocks:

(23) \[ D = D_L + D_S(Y^T - \hat{Y}), \quad D_S > 0. \]

Progressive income taxes, relevant wealth, property and inheritance taxes, as well as social transfers reduce excess saving and improve automatic stabilisers.
• Coordination of long-run expenditure paths for non-cyclical government spending in order to generate a long-run ‘structural’ government deficit/surplus balancing the long-run ‘structural’ private sector surplus/deficit at high levels of non-inflationary employment and a roughly balanced current account

• Expenditure paths should be coordinated and monitored by the European Commission and the unwillingness to correct deviations should be finally sanctioned (ultimately, the ECB could withdraw its guarantee)

• ECB keeping nominal interest rates in each country below trend nominal GDP growth of the respective country, will make sure that debt services will not have restrictive distributional effects

• Domestic demand in CA surplus countries will be raised, allowing CA deficit countries to reduce CA deficits without constraining domestic demand
European industrial and regional policy

• Required for catching up and long-run rebalancing ➔ improvement of non-price competitiveness

• Short-run effects: growth differentials and hence tendencies towards current account imbalances

• CA deficits and surpluses related to catching up should be tolerated by coordinated fiscal policies

• Criterion for acceptable CA deficits: growth of deficit country is sustainable, exceeds average growth of surplus countries, and also the long-term interest rate

➤ no ‘one size fits all’ as in Dullien/Schwarzer (2009) (+/- 3 per cent) or Horn et al. (2010) (+/- 2 per cent)
General prerequisites for a sustainable catching up process:

• prevent unsustainable credit-driven bubbles and private demand booms ➔ regulation

• capital inflows should be focused on productivity enhancing investment and the development of export capacities ➔ role for EIB, EIF etc.

• and they should be integrated into a European regional and industrial development strategy
Thank you
Further readings


