Martin Feldstein (Roundtable)

I will comment on 4 macroeconomic subjects, each of them touching upon various aspects of macro-coordination and cooperation. First I will briefly discuss the G20 process of macro-coordination. Second, I will say a few words on fiscal versus monetary policy and cooperation. Third, I will look at macro-policy in the Eurozone. Finally, I will conclude by a few comments on European policies to assist the struggling peripheral countries.

As I already mentioned in my earlier discussion, countries tend to act on their own self-interest, so macroeconomic policy coordination, as usually emphasized and encouraged by the IMF, is inherently difficult to achieve. When the G20 reached an agreement on a global stimulus, it was a relatively easy goal to achieve: every participant had something to gain because it was in the interest of all countries. Moreover, there was no agreement on the specific details of the stimulus packages so countries had sufficient leeway to design them in a way that best suited their needs. The US is a special case because participating in such global agreements is in a way impossible, in another way easy but meaningless for it. The US President simply can't commit to any specific policy because of the need to obtain Congress' approval and because of the independence of the Fed. Therefore, when the US delegation arrives to these meetings, they simply tend to restate the administration's existing policy. In the current context, the US will certainly seek to reduce its fiscal deficit over time to attenuate global imbalances. Such commitment disregards the IMF's view according to which one countries' adjustment should be accompanied by expansionary policies elsewhere to help the adjusting country's export sector. While few would dispute this advise, I have hardly heard such talk in American policy circles. The US policy process simply doesn't look too deeply into what other countries are doing, partly because international trade is relatively unimportant for the large American economy.

In my view, the stimulus package that the Obama administration finally agreed on was too small not because of considerations of global imbalances but because of the politics of deficit spending. There was very little information on what shape foreign fiscal policy will take and what it would imply for US GDP and balance of payments. Moreover, economic advisers in the US have very little clue about the size of the domestic multiplier. When I asked my friends in the National Bureau, I got estimates ranging between 0 and 2. Such uncertainty makes coordination with our trading partners all the more difficult.

Turning to my second theme, most of the talk these days – in the context of an ineffective monetary policy - is about fiscal policy. Until very recently, however, it hasn't been the case. In the two decades leading up to 2008, macro-stabilization in the United States meant monetary policy. Fiscal policy had been discredited because of its well-known lags. It takes time to recognise a business cycle downturn, it takes further time to design an appropriate fiscal response and it takes yet more time to implement it. Monetary policy, by contrast, has been aided by the Taylor rule (which ties interest rates to inflation and the GDP gap), a pretty accurate description of what the FED was doing during this era. The Taylor rule, however, makes no reference to the fiscal stance.

Thirdly, on macro-policy in the Eurozone, it basically amounts to monetary policy as conducated by the ECB. What it means, essentially, is an agreement on a single interest rate that is judged to suit best for the whole currency area, best being defined as achieving price stability. In principle, an easier monetary policy in the US could help achieve price stability in the Eurozone by weakening the dollar versus the euro. Yet I've never heard Jean-Claude Trichet saying that he has coordinated monetary policy with the FED. It seems to me that the ECB takes other countries' interest rates as given. As for fiscal policy, we now know that the creation of the euro led to excessive fiscal deficits in the Eurozone. Before the launch of the euro, high deficits had led to higher interest rates and declining currencies, useful market signals that the deficits were too large. This market feedback, however, has been eliminated with the euro. Interest rate spreads, which should normally be read as warning signals, have stayed very low (about 30 basis points above German rates) for too long. Now that the spreads have massively increased, there is a movement towards imposing tough fiscal rules on each country, leaving only automatic stabilizers to deal with business cycle fluctuations. Germany just passed a constitutional amendment in this regard, and Spain should follow suit in principle. If this movement is completed, there will be little room left for discretionary policies and the need for coordination will hardly surface.

Finally, on multilateral cooperation to assist Greece and other economies in the European periphery, I find Greece to be in an impossible situation. Greece has to default, every market participant knows that. Greece needs to reduce its debt dramatically, probably by around 50%, significantly above the 20% haircut imposed on private creditors. The bailouts and the ECB's intervention in the bond markets serve one purpose only: postponing the inevitable. Why postpone? If Greece defaults, it will hurt German and French banks. Postponing it will buy them time to rebuild their capital and perhaps sell the toxic bonds on their balance sheets to the ECB. A bigger concern is contagion to Portugal then to Italy and Spain, which collectively would add up to a financial disaster. The situation in these countries will become clearer in the coming years. We will learn if Spanish banks have become healthy again and whether Italy can veer itself back to a cyclically adjusted balanced budget path. In a nutshell, postponing a Greek default will provide European policy-makers with more information whether the other peripheral economies can survive such an incident. If they can't demonstrate that they are healthy during this period, a default will mean sharply rising interest rates and insolvency soon after. There will be no way for Germany and the EFSF to deal with that and these countries will have to default and leave the euro. That would surely mark the end of the euro in its current form. Thank you.

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Finally, on multilateral cooperation to assist Greece and other peripheral economies. It think Greece is an impossible situation, it will default (the market thinks that as well, if politicians don't I hope its because they are taking advantage on the high interest rates). Greece needs to reduce its debt dramatically, probably by more than 50%, 20% haircut involving the private sector was just the start. European governments are trying to prevent/postpone this default: IMF bailout, ECB buying junk bonds etc. The goal is just to postpone the inevitable. Why postpone? If Greece defaults, it will hurt German and French banks. Postponing it buys them time to build up capital and sell some of their bonds to the ECB. A bigger concern is a potential for contagion to Portugal, Italy, Spain, which would be a financial disaster for euro banks and other institutions. The situation in these countries in the coming years will become clearer. We'll see if Spanish banks are fine, whether Italy can veer itself back to a cyclically adjusted balanced budget path. So postponing the Greek default will give us time to tell whether Italy and Spain can make it. If they can, Greece and Portugal can default with fear of contagion. If they are not ok, however, default will mean sharply rising interest rates in Italy/Spain and they will also become insolvent. There is no way for Germany and the EFSF to deal with all that, they will have to default, leave the Eurozone and the game will be over.