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Intervention of Francesco Papadia

Mistakes

Irrend lernt man
(Learning through mistakes)
Johann Wolfgang von Goethe

"In the following speech I illustrate six macroeconomic mistakes, three of too loose policies in Italy and three of too tight policies in Frankfurt/Brussels and I delineate my position as trying to avoid the pitfalls of both. Unfortunately, the current action of the Italian government is affecting the nice symmetry of my speech, adding a fourth mistake to the Italian side, ruining the prospects of a lacklustre, but safe, correction of too high public debt."

1. Introduction

I have started my central banking career at the beginning of the 1970s and I have spent approximately half of it in Rome, at the Banca d'Italia, and the other half in Frankfurt, at the European Central Bank. During these decades I had vast opportunities to observe many mistakes and even to actively participate in some of them.

[SLIDE 2]

In the hope that the great German poet is right, I want to selectively review some of these mistakes to try and see what we can learn from them. I will limit my selection to the macroeconomic domain, and even within this domain my selection is very personal and open to criticism. Still, I hope it will provide some stimulus for a useful discussion.

[SLIDE 3]

My selection of mistakes will be divided in two sections, those that took place in Rome and those that took place in Frankfurt or Brussels.

After having gone through these mistakes, I will try and draw some simple lessons from them, just in the hope to make new mistakes and not repeating the old ones.

2. Rome mistakes
    a. Italian fiscal policy 1965-1994

[SLIDE 4]

This first mistake, which I am really tempted to call a madness rather than just a mistake, requires very little space to be documented, given its extreme nature.

In the mid-1960s Italian public finances entered onto an unsustainable path, which continued until the 1990s (Figure 1), as monetary union approached and the need to qualify for it, through a correction of public finance, took priority.

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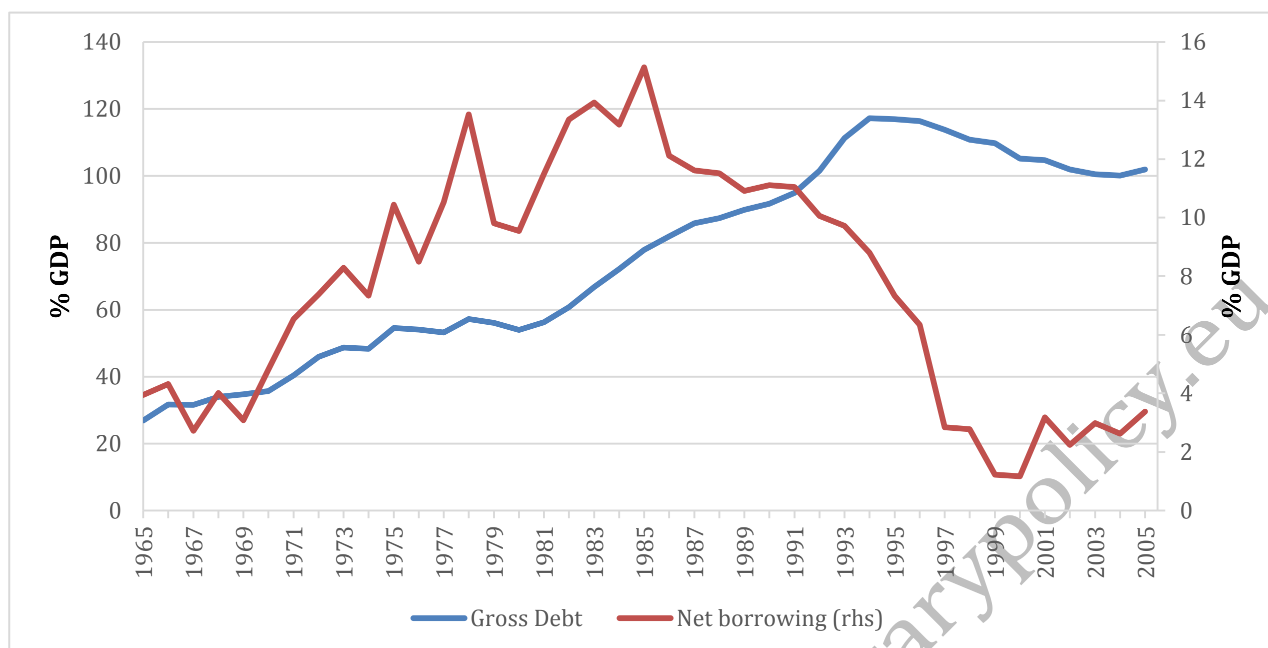
Figure 1. Fiscal deficit and Government debt. Ratio to GDP. 1965-2005.



Source: I deficit di Bilancio dello Stato Italiano nella Ragioneria e la finanza pubblica. Renato Camodeca e Armando Canziani.

The fiscal deficit rose from under 1 per cent in 1965 to a peak of 15 per cent in 1985 and then started a descent until the end of the 1990s. Government debt, which had been less than 30 per cent of GDP in the mid-1960s, rose rapidly, hitting 80 per cent in the mid-1980s and rising another 40 points by 1994 to close to 120 per cent of GDP. The fiscal deterioration in this period was essentially brought about by an increase in social expenditure, not covered by higher revenue, against the background of social changes and instability, which the Italian political system tried to counter with fiscal hand-outs. The attempt to move away from the unsustainable fiscal path started in the mid 1980, but achieved only partial success over about the following decade. The recourse to revenue increases, often only of a temporary nature, the reduction of investment rather than current expenses, the increased cost of public debt explain the limited success in reducing the deficit and in imparting a decisive downward path to the debt to GDP ratio. What followed, to these days, was a panting attempt to regain less worrying debt conditions, with limited success so far, given that the debt to GDP ratio is today ten percentage points higher than it was at the previous local peak in 1994. I will revert back to post-euro fiscal developments in Italy to document the third Roman mistake.

Let me stress already here, however, that looking at Italian fiscal history the overriding problem was not austerity but rather the tendency to go for unsustainable policies. From this point of view, I struggle to understand the policy of the current Italian government.

b. Italian monetary policy 1972-1995

[SLIDE 5]

Between the abandonment of the fixed exchange rate of the lira against the dollar, in 1973, and the approximation to the Euro in the second half of the 1990s, monetary history in Italy was a sorrow experience of high and variable inflation and devaluation, against a trend deterioration of economic growth and unemployment.

[SLIDE 6]

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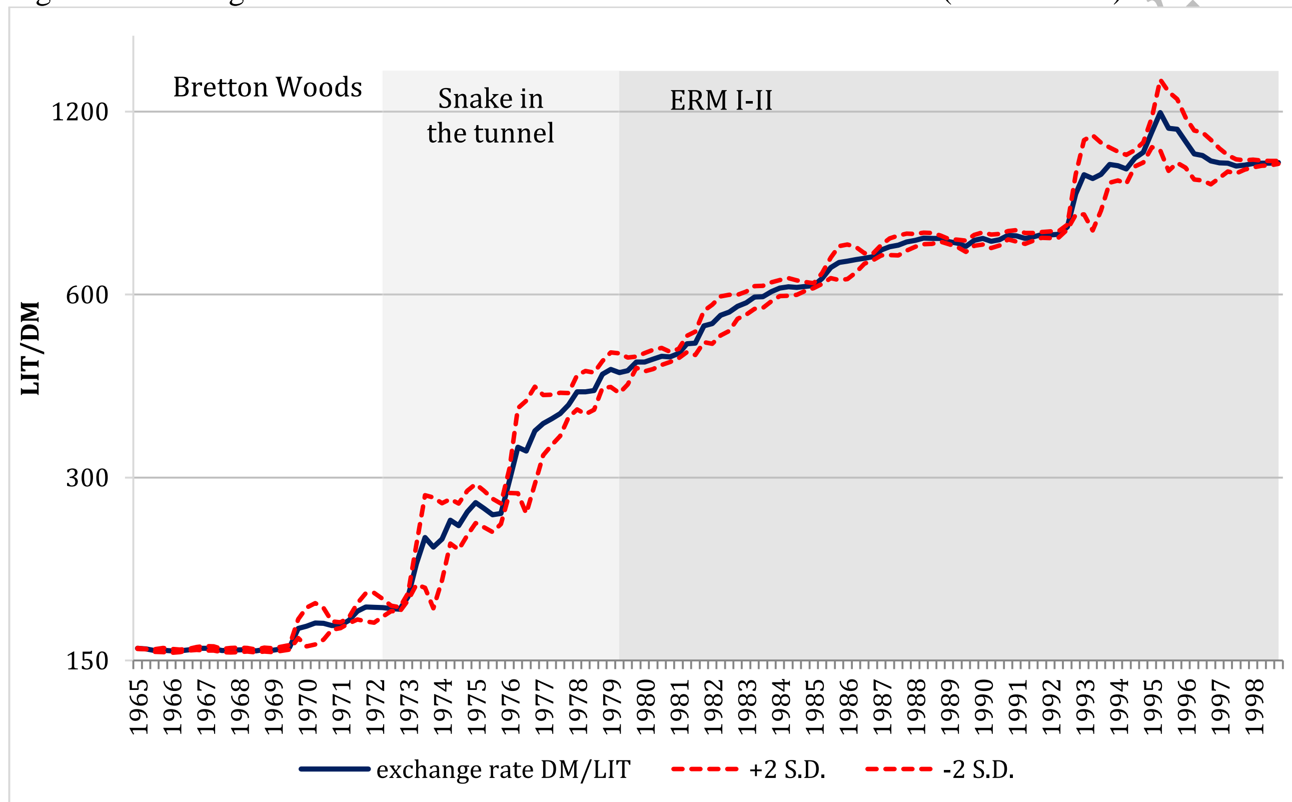
Figure 2 is divided in three areas denoting the different exchange rate arrangements of the lira before the adoption of the euro: first, the Bretton Woods system, then the so called Snake, i.e. the first attempt of European countries to stabilise their reciprocal exchange rate, and, finally, the Exchange Rate Mechanism. The figure shows the relentless devaluation of the lira against the Deutsche Mark since the lira lost its link to the dollar, with the demise of Bretton Woods, and until the prospect that it would be substituted by the Euro towards the middle of the 1990s: at the beginning of the 1970s one Deutsch Mark bought 160 lira, towards the end of the 1990s it bought about one thousand. And the trend devaluation of the lira was accompanied, albeit with different intensity, by substantial variability all through the three decades, as shown by the two red lines around the blue line of the devaluing exchange rate.

Figure 2. Exchange rate between the Italian Lira and the Deutsche Mark (1965 – 1998).



Source: IMF-International Financial Statistics. Note: the exchange rate is bracketed by 2 standard deviations above and below it calculated over the previous three years.

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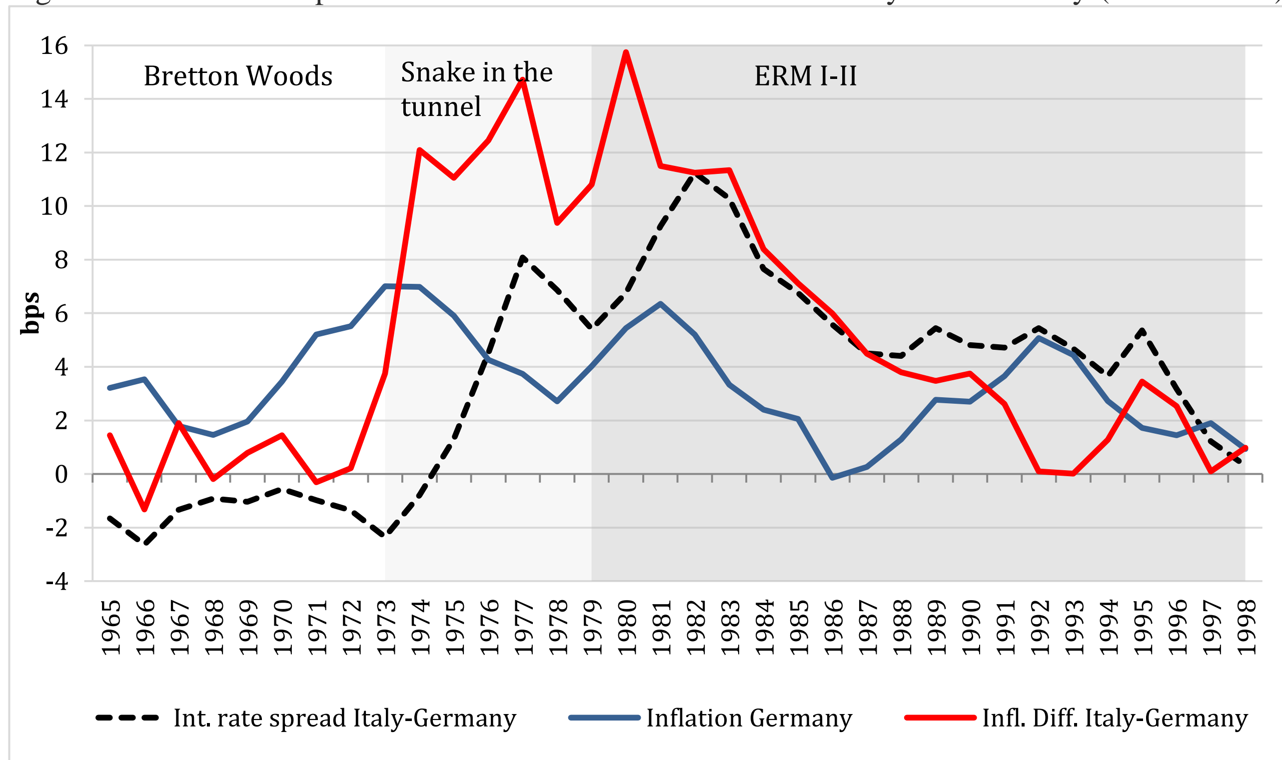
Figure 3. Interest rate spread and inflation differential between Italy and Germany (1965 – 1998).



The repeated devaluation of the exchange rate was accompanied, until the second half of the 1990s when the prospect of monetary union started to have its effects, by much higher interest and inflation rates in Italy with respect to Germany.

[SLIDE 7]

This evidence shows that the way to keep interest rates low on a sustainable basis is to have low inflation on a sustainable basis, which means raising rates when this is necessary to keep inflation in check. Just to make it specific, and painful for someone having spent many years at the Banca d'Italia, notwithstanding much undocumented commentary to the contrary, the Bundesbank was much better at keeping interest rates consistently low than the Banca d'Italia.

Of course the symmetric statement, which many in Germany find difficult to accept, also holds: in order to avoid excessively low inflation and interest rates on a permanent basis, sometimes, as now, interest rates have to be brought and kept at exceptionally low levels.

[SLIDE 8]

As the lira was going through its instability, there was a trend deterioration of unemployment, more than doubling between the mid 1970s and the mid 1990s, and of growth, more than halving in the same period (figure 4). The current account swung between surplus and deficit in the three decades between 1970 and 2000 depending on the progressive loss of competiveness due to the higher inflation followed by sharp recovery of competitiveness due to devaluations.

Given this history, I find it very hard to understand how some people, close to the two parties supporting the current government in Italy, seem to have nostalgia for the lira and propose that Italy should leave the euro.

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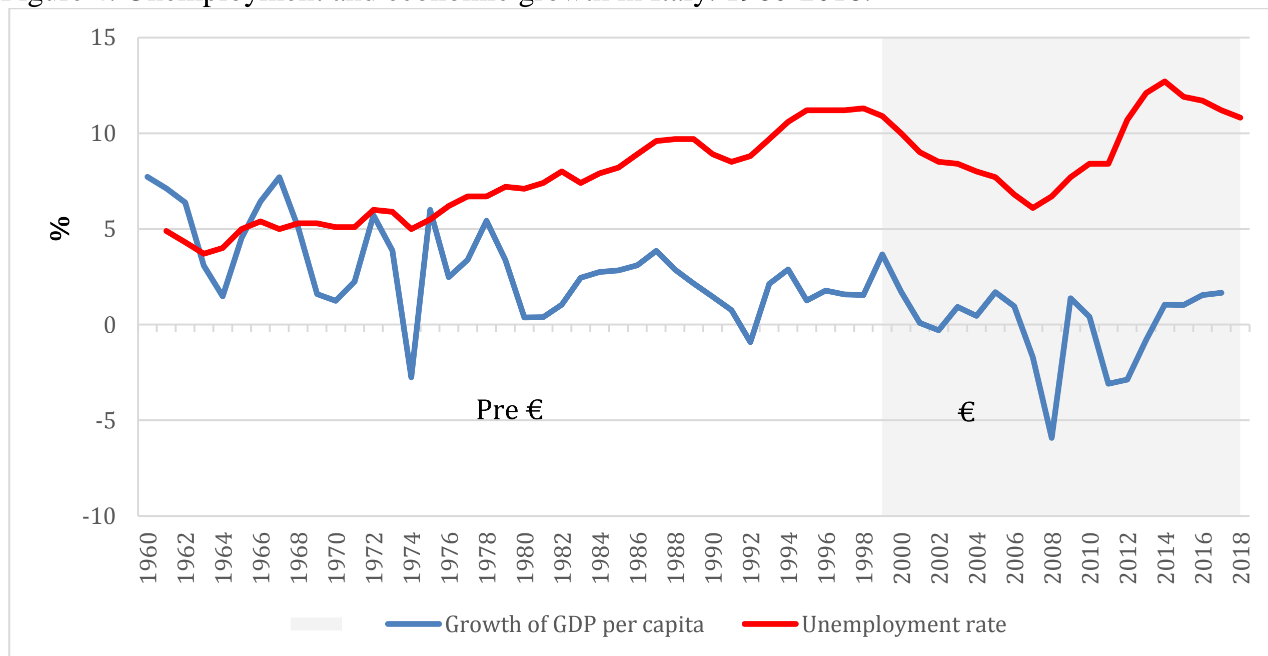
Figure 4. Unemployment and economic growth in Italy. 1960-2018.



c. Squandering the € bonus 1995-2007

The approximation to the €, as monetary union became increasingly likely, brought a double bonus to Italy: a fiscal bonus and a macroeconomic bonus.

The fiscal bonus resulted from the sharp reduction of the cost of debt: in the first half of the 1990s Italy paid the equivalent of 11.6 per cent of its GDP for debt service. In the second half of that decade the cost had gone down to 6.1 per cent, in the first five years of the new century this percentage had gone further down to 4.5 per cent. As debt kept increasing over these 3 five year periods, the € fiscal bonus was at least 7 per cent of GDP.

The macroeconomic bonus resulted from the sharp reduction of nominal interest rates, down to the level of Germany, while inflation and inflationary expectations adjusted only imperfectly to the new monetary policy run by the European central bank. This asymmetry caused a reduction of real rates of interest and can be explained by the ability of the financial sector to jump to a new equilibrium while the real sector is characterized by inertia and gradual adjustment, i.e. the characteristic that is normally dubbed as sticky prices, one of the most well established macroeconomic features.

The squandering of the fiscal bonus is illustrated in figures 5 and 6.
[SLIDES 9 AND 10]

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Figure 5. Primary surplus/deficit as a ratio of GDP, 1990 – 2017.

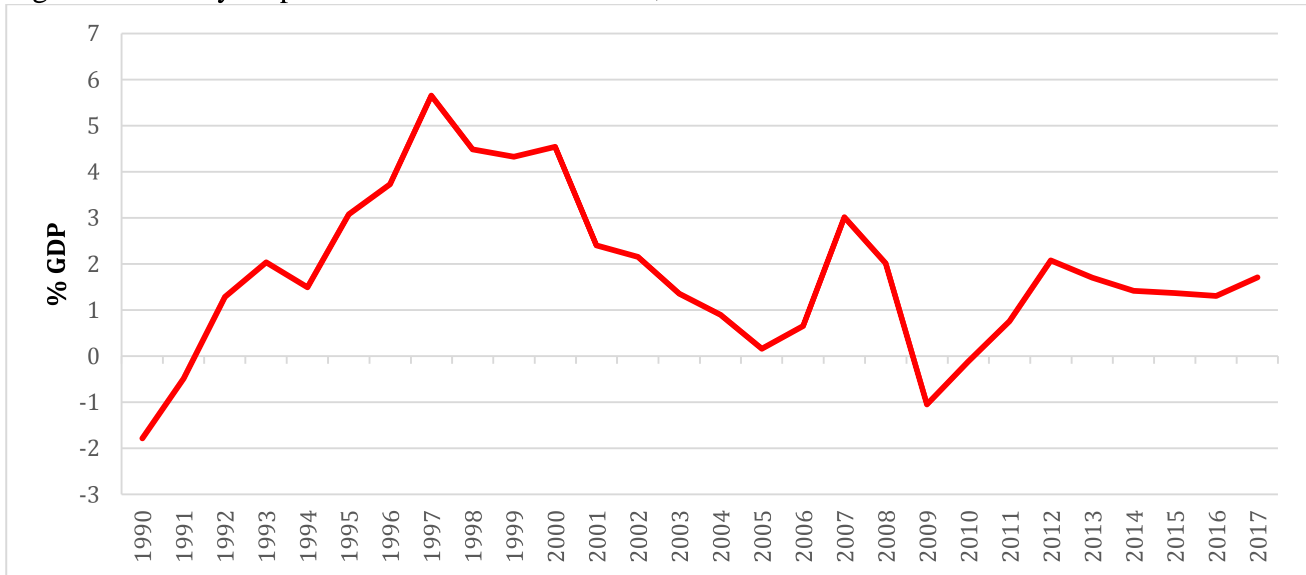
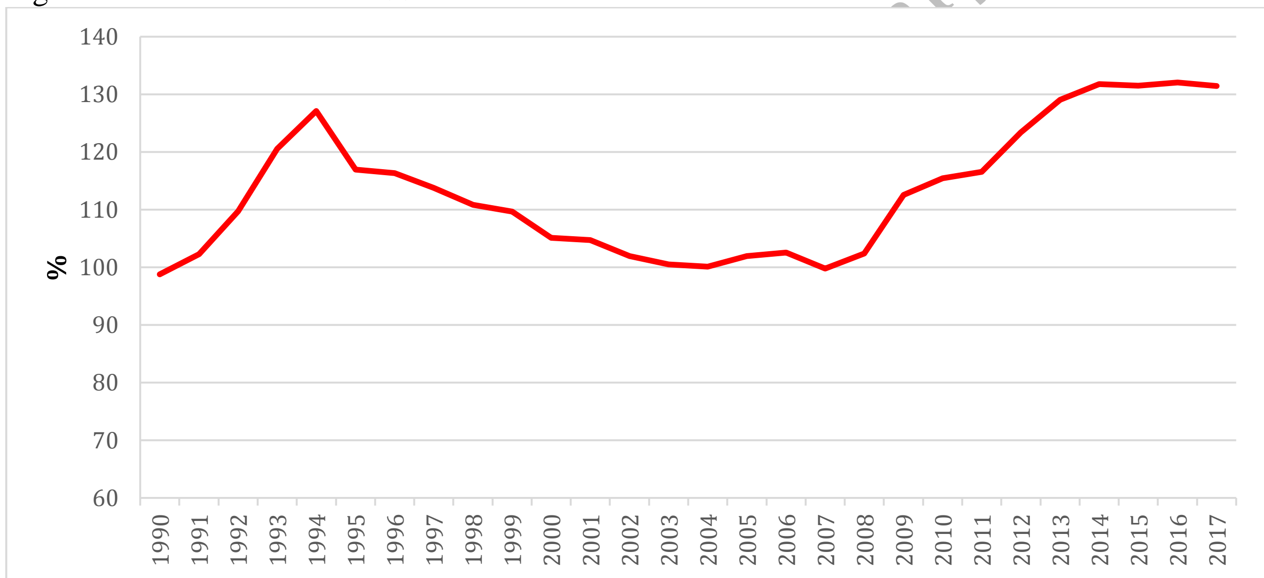


Figure 6. Debt to GDP ratio 1990-2017.



Source: IMF World Economic Outlook, April 2018.

Figure 5 shows that the primary surplus came down from a peak close to 6 per cent in 1997, when Italy was making its maximum effort to qualify for the €, down close to zero just before the beginning of the Great Recession. This means that Italy did not fully use the reduction of saving on the cost of debt to reduce the fiscal deficit. This also implies that the reduction of the debt to GDP ratio was lower than it could have been and that the Great Recession hit Italy while it was in a still vulnerable fiscal situation. Indeed one sees in figure 6 that the debt to GDP ratio stopped improving just after the beginning of the new century.[1]

The squandering of the macroeconomic bonus can be seen looking at figure 7. In the figure

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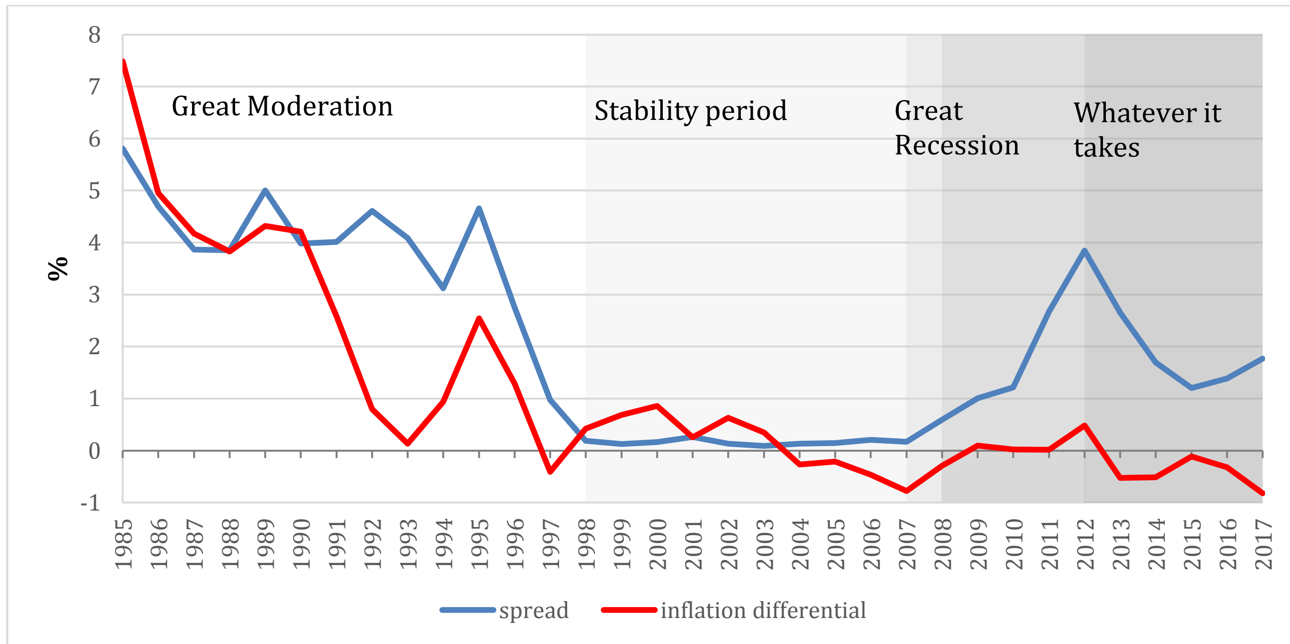
[1] The contrasting experience of Italy and Belgium is documented by A. Sapir in: High Public Debt in Eurozone Countries: The Case of Belgium and Italy, draft of 20 August 2018.

[SLIDE 11]

Figure 7. Differentials between Italian and German expected inflation and 10-year government bond yields (1985 – 2017).



Source: Author's calculations based on European Commission Business and Consumer Survey and OECD (2017), Main Economic Indicators (database). doi: http://dx.doi.org/10.1787/data-00052-en (Accessed on 12 March 2017). Note: both the expected inflation and the interest rate differential are calculated as the difference between Germany and Italy).

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there is clear evidence that the inflation differentials between Italy and Germany persisted for a number of years, after the end of the 1990s and until the mid 2000s, even when the interest rate differential had, for all practical purposes, disappeared.

Table 1. reports for three periods (1985–1997, 1998–2008,[2] 2008–2016), the average ten-year yield, inflation expectations, and real interest rates in Italy and Germany. The evidence in Table 1 confirms that there was full bond yield convergence between Italy and Germany in the stability period, while the convergence of inflation expectations was less than perfect. Hence, unlike in the previous and subsequent period, real rates of interest were lower in Italy than in Germany during the Stability Period (1998-2008) During the Great Recession/Whatever it takes period, as also shown in Table 1, there was instead full convergence of inflation and inflation expectations between Italy and Germany, but interest rates diverged again, with those in Italy significantly higher than those in Germany.

[2] The stability period is made to start in 1998, since by that time the approximation of the euro had already led to a perfect alignment of interest rates.

Table 1. Average 10-year government bond yield, average inflation expectations and average real interest rates (%).

	1985-1997		1998-2008		2009-2016	
	Germany	Italy	Germany	Italy	Germany	Italy
10-year yield	7.7	11.6	4.4	4.5	2.4	4.3
Inflation Expectations	2.0	4.0	1.1	1.7	0.9	0.8
Real interest rates	5.7	7.6	3.2	2.8	1.5	3.5

Source: Author's calculations based on European Commission Business and Consumer Survey and OECD (2017), Main Economic Indicators (database). doi: http://dx.doi.org/10.1787/data-00052-en (Accessed on 31 May 2017).

[SLIDE 12]
In figure 4 again we see that, while unemployment recorded a substantial improvement in the first decade or so after the introduction of the euro, growth continued on its seemingly inexorable downward trend, pointing to a dismal productivity development. Basically the story is that Italy did not seize the occasion of lower interest rates and unemployment coinciding with the first years of the € to launch a strong and sustained program of structural reforms that would have led to higher productivity and growth. Indeed the World Bank indicator shows that Italy is still below the euro area average on the ease of doing business, while on some institutional aspects, like government effectiveness, rule of law and control of corruption, there has been a trend deterioration of performance between the end of the 1990s and now. Thus, while Italy would have needed to accelerate its growth, as many countries in the €-area have done on a persistent basis, it continued on its disappointing growth path, because of very poor, indeed mostly negative, total factor productivity growth. Anaemic growth also inevitably impacted the debt to GDP ratio, this time limiting the dynamics of the denominator, further impacting the fiscal position, just as the Great Recession stroke.

Let me now turn to the mistakes I have seen, again in some cases with my active involvement, in Frankfurt and Brussels.

3. Frankfurt/Brussels mistakes.

   a. ECB interest rate increases 2011

[SLIDE 13]
As it can be seen in Figure 8, the ECB MRO rate was increased in April and again in July 2011, interrupting the stability period that had followed the sharp downward move that had started in 2008 and that would be taken up again in November of that year. The April and July increases by the ECB contrasted with the action of the FED, which maintained its target range for the federal funds rate at 0-0.25 per cent.

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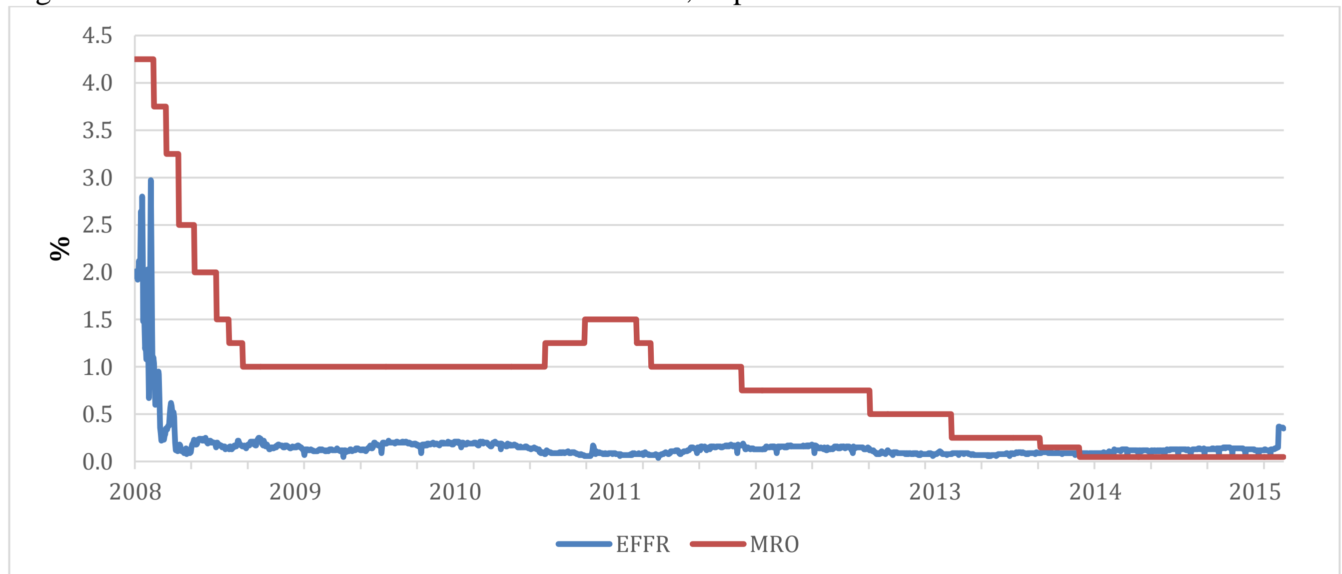
Figure 8. Effective Federal Fund Rate and MRO rate, Sept. 2008 – Dec. 2015.



Source: ECB Statistical Data Warehouse. Note: MRO- Main Refinancing Operations rate; Federal Reserve Economic Data. Note: EFFR – Effective Federal Fund Rate

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One would think that the quite dramatic ECB move to tightening from the easy policy that had prevailed until April 2011 and that would start again later in that year would have required strong motivations.

Such motivations are not to be found in subsequent developments: inflation in 2013 and 2014, went down to 1.5 and 0.5 per cent respectively. Economic activity, on its side, stagnated between 2011 and 2013 and grew by just 1.8 per cent in 2014.

But of course, the ECB did not have the information about future inflation and growth. It knew inflation was higher than its objective in 2011, at around 2.5 per cent, but it recognized that this was due to oil and commodities price increases. It also knew that monetary and credit developments were subdued, within a range of 2 to 3 per cent.

Of course, monetary policy has to be set, given the lags with which it works, with a forward-looking approach. But also looking at the Eurosystem staff projections prepared in 2011 for the two following years, one does not find the motivations for the tightening: inflation projections elaborated in 2011 for the subsequent calendar year were in a range between 1.8 and 2.0, spot on the inflation objective; growth projections for 2012 were brought gradually down in the course of 2011, from 1.8 per cent in the first quarter to 0.3 per cent in the last quarter of the year.

[SLIDE 14]
Overall, it is difficult to understand why the Governing Council of the ECB came to the unanimous conclusion, in April and July of 2011, that there were "*upside risks to price stability … identified in our economic analysis"* that required a tightening of monetary policy. Nor was the risk of "second-round effects", following the oil and commodities price increase, so clear that it would require a pre-emptive tightening of monetary policy.

One is pushed towards the conclusion that the Council got afraid of its own boldness in having brought interest rate to the historically very low rate of 1.0 per cent and wanted to move away from that level and found in the risk of " second round effects" the intellectual excuse for doing so.

b. Euro-area fiscal policy 2011-2013

In the book I have written with Tuomas Välimäki[3] I put forward an interpretation of the European phase of the crisis, which flared up after the revelation of the mis-reporting of fiscal data by Greece, that combines parts of the interpretation prevailing in northern Europe with parts of the interpretation mostly favoured in southern Europe.

In northern Europe, the prevailing interpretation was, and probably still is, that the origin of the crisis was the imprudent fiscal and/or banking policies of the peripheral countries. The therapy followed the diagnosis: fiscal austerity and restraining the banking system were the necessary and sufficient answers to the crisis.

In southern Europe the prevailing interpretation was that a pure and unwarranted change of lenders expectations, towards both sovereign and banks, was behind the crisis. How could one explain that, without any change in national fundamentals, the fiscal situation of countries like Italy and Spain had abruptly become unsustainable because Greece had misreported its fiscal data? Consistently with this analysis, the answer was identified in the provision of liquidity to the affected countries to quell sustainability fears and bring them back to a good equilibrium.

[SLIDE 15]

My interpretation combines the two different views by using the multiple equilibrium model of Diamond and Dybvig. My story is that peripheral countries put themselves in a vulnerable position because of excessive public debt, either directly or indirectly through the need to bail-out banks that had over extended their loans to real estate speculation. Then the Greek spark changed expectations and moved the peripheral economies from a good to a bad equilibrium, in which debt became potentially unsustainable because of its much higher cost. Without the imprudent excessive debt there would not have been a change of expectations. Without a change of expectations, there would not have been a crisis and a risk of debt unsustainability. Consistently, my interpretation would have required the provision of liquidity to convince lenders that their money was safe and remedy the "coordination failure" that had moved the economy from the good to the bad equilibrium, but also a tightening of fiscal policies by peripheral countries, to impress on the market their determination and ability to sustain public debt.

At the same time that peripheral countries had to try and convince investors that their fiscal policies were sustainable, the euro-area was, in aggregate terms, going through a deep recession, as seen in figure 9.

[SLIDE 16]

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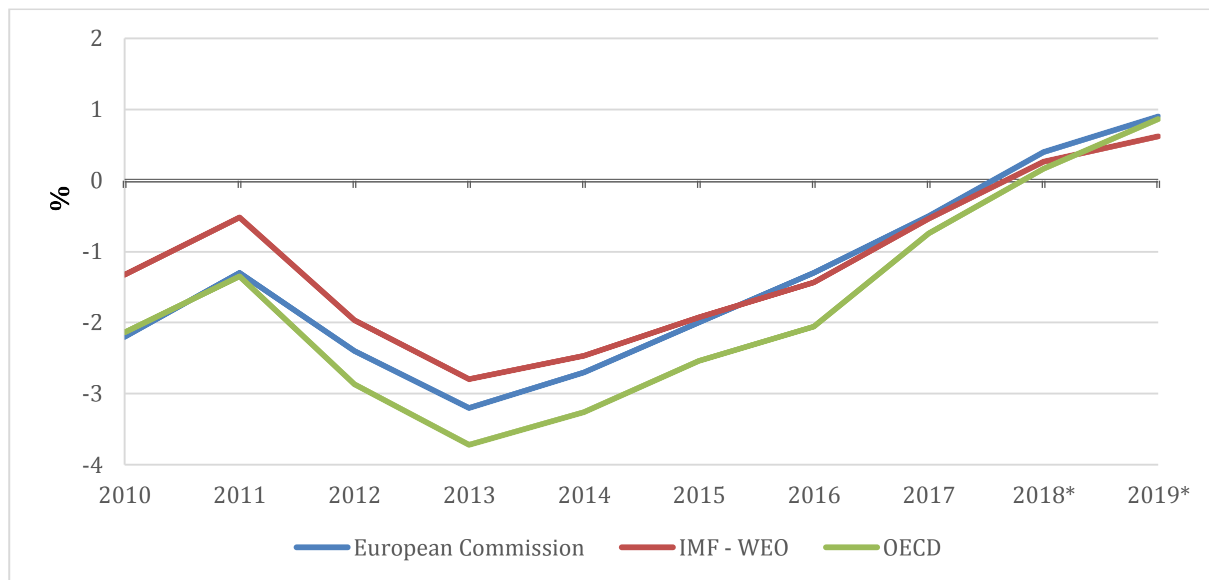
[3] F. Papadia with T. Välimäki, Central Banking in Turbulent Times, Oxford University Press, 2018.

Figure 9. Output gap in the € areas.



Source: European Commission, IMF, OECD. *Notes:* * Estimated values. Data are in percentage of potential output.

Indeed the euro-area had a negative output gap continuously between 2011 and 2017, with a trough in a range of 2.5 to 3.5 per cent, depending on the measurement, in 2013. [4]

This would have required letting automatic stabilizers fully operate and, if insufficient, actively expanding fiscal policy.

[SLIDE 17]
Figure 10 shows that this was exactly the contrary of what was done in the aggregate of the euro-area. Indeed there was a tightening of fiscal policy between 2011 and 2014, with a peak in 2012.

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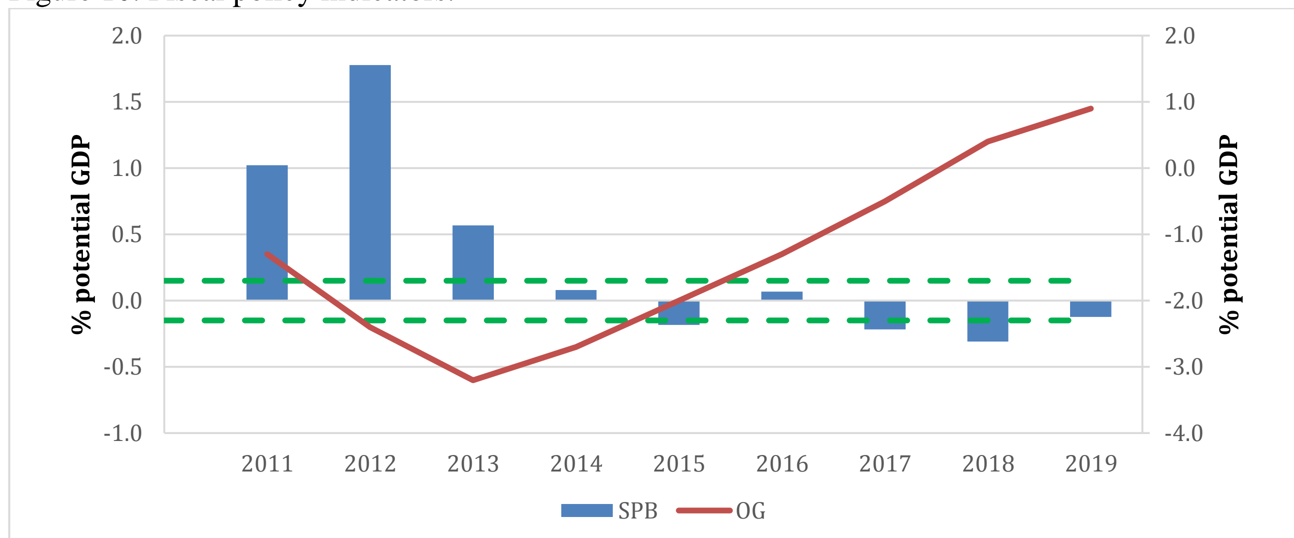
[4] The output gap reported in the figure is the one estimated with current data, not the real-time one available in the past. However, the typical pattern is that potential output is revised down as time passes and therefore slack is smaller than originally estimated.

Figure 10. Fiscal policy indicators.



Source: European Commission, OECD Economic Outlook 2018. The two broken green lines define a broadly neutral fiscal policy. SPB=Structural Primary Balance. OG = Output Gap Slack.

As you know, an attempt is currently being made to establish a countercyclical fiscal tool at the euro-area level. In 2011-2013 it would already been a progress if we would have had a fiscal equivalent of the Hippocratic oath: do no harm. This would have avoided a strong pro-cyclical policy, aggravating the recession. The responsibility for this perverse policy can be found in the absence of any tool at euro-area level to carry out appropriate fiscal policies and in the wrong fiscal policy of core countries that did not expand, as it would have been needed, their stance.

A useful way to look at fiscal policy in the crucial 2011-2014 period is that peripheral countries had reached the limits of their fiscal capacity and were forced to adjust, but the countries that had fiscal capacity did not use it appropriately to achieve an acceptable fiscal stance a the level of the euro-area. The euro-area fiscal framework, on its side, was not capable of bringing the aggregate stance to a reasonable position.

c. German current account surplus 2000-2018

[SLIDE 18]

The next mistake is just a few steps away, and this is about the current account surplus of Germany. The case of the Netherlands is similar, but I will concentrate on Germany. While I agree with Jens Südekum[5] that the excessive current account is more a symptom of deeper problems rather than a problem in itself, still it is useful to look at it as a macroeconomic mistake.

One first observation about the German current account surplus is just its exceptional size and persistence. Guntram Wolff, my colleague at Bruegel, observed that: "*of the 193 countries listed in the IMF's World Economic Outlook between 1999 and 2017 (totalling some 3,570 available observations of current accounts), there were only 238 episodes of three consecutive surpluses of more than 7.8% of GDP. Among those 238, the vast majority were countries that are either raw material and/or oil producers, with only a handful of countries other than raw material producers.*"

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[5] At the IMF-Bundesbank conference of January 18 2018.

In the same direction goes the observation that, while with the onset of the Great Recession the current account of Italy and other peripheral countries moved towards surplus, in Germany the current account moved up practically in a continuous way since 2001 to a surplus of around 8 per cent. This level is expected to persist practically unchanged over the next five years, according to IMF forecasts.

As a result, the current account surplus of the euro-area is now at around 3 per cent, much higher than in China, and is expected to remain around this level for the foreseeable future.

To move from just recording a fact to assessing it, we can first look at IMF estimates of excess current account disequilibria. The IMF clearly qualifies the German current account surplus as *"substantially stronger" than justified by medium-term fundamentals and desirable policies."* Indeed the IMF recognizes that a surplus is justified in the case of Germany, particularly because of demographics, but its norm is estimated within a range of 2-4.5%. Analogously, the European Commission in the Macroeconomic Imbalances Procedure finds a persistent imbalance relating *"in particular to the large and persistent current account surplus, reflecting excess savings and weak private and public investment.'*

When it comes at identifying the causes of the excessive surplus, two emerge from most analyses: too low investment and too high corporate profits. As regards investment, higher public and, particularly, private investment would mechanically influence the saving-investment imbalance that translates into an excessive current account surplus. As regards corporate profits, if there was a move from profits to wages, there would be less export of capital from corporations and more consumption, again leading to a more reasonable current account surplus. Guntram Wolff even connected too low wages and investment as causes of too high a surplus: low investment led to a low capital/income ratio and, with labour and capital complements rather than substitute, this led to low wages.

What strikes me here is the unwillingness of policy makers and many economists in Germany to provide an articulate and convincing rebuttal of the argument that the current account surplus is too high. For instance, the German Council of Economic experts[6] provided a very detailed explanation of why the current account is high, but did not even try to deal with the issue whether it is too high, as the IMF and the EU Commission concluded. I fear this is the consequence of the fact, well established over the decades, that the international adjustment mechanism is asymmetric: there is no effective pressure on surplus countries to adjust and thus the adjustment tends to be concentrated on deficit countries. If the criticism about the excessive current account has no teeth, why bother about providing a counter argument?

4. Symmetric mistakes

[SLIDE 19]

At this stage of my presentation, you must have identified the common pattern of the Roman mistakes, on one side, and of the Frankfurt/Brussels mistakes, on the other side. Mistakes in Rome consistently led to too loose policies, in both the fiscal and the monetary domain. Mistakes in Frankfurt/Brussels consistently led to too tight policies, again on fiscal and monetary issues.

The different interpretations prevailing in Rome and in Frankfurt/Brussels led to different policy prescriptions: the former stressed the need to provide liquidity, the latter the urgency to re-establish

[6] The German Current Account — Actionism Is Inappropriate. Annual Economic Report 2014/15 – German Council of Economic Experts.

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solvency. No hybrid situation could be conceived, in which solvency and liquidity would need to be addressed at the same time.

Two questions emerge at this point, for which I am afraid I have no definitive answer, but just the hope that one could emerge from the debate we may have.

The first question is whether the word "mistake" that I have used so far is the correct one. A mistake presupposes a wrong analysis, a macroeconomic mistake derives from a wrong macroeconomic model. But can we exclude that the analysis was correct but there was an inability to act consistently with it? Or may be there was the explicit choice to depart from it because of some non-economic consideration? For instance, may have Italy after 1965 conducted its apparent nonsensical fiscal policy to appease social tensions? As I said, I do not have a definitive answer, but, at this stage, I am more inclined towards the "mistake" interpretation. If this is right, underlying the pattern of mistakes there would be two opposing, equally wrong, intellectual frameworks.

The second question is whether the accumulation of mistakes was more damaging in Rome or in Frankfurt/Brussels. To reach a conclusion on this issue one would need an exhaustive list of mistakes and weigh them appropriately, taking into account that some lasted longer than others, that some affected only one country while some other impacted the entire euro-area. I find it difficult to carry out this exercise. Just looking at the economic conditions in Italy compared to those in Germany, one would have to conclude that mistakes south of the Alps were more serious than those north of the Alps. But, again, I do not pretend to have a definitive answer here.

5. Settling on the Alps, or maybe in Finland

The issue on which I have a fairly clear view is that I am comfortable in an Alpine position, or may be I should say, having been exposed to quite some Finnish thinking, in a Suomen-like position.

[SLIDE 20]

The tenets of my Alpine/Suomen macroeconomic beliefs are, in their simplest formulation, the following:

- There may be episodes of insufficient (as well as excessive) demand that should be addressed with appropriate countercyclical fiscal and monetary tools. Some of these episodes, like the Great Recession, can be particularly acute and require very strong policy reactions,
- Episodes of insufficient demand can have persistent negative effects if, as it seems likely, recessions are followed by hysteresis and super-hysteresis periods,
- Cases of shifts from "good" to bad" equilibria, as during the Great Recession, require providing liquidity as well as re-establishing solvency,
- Sustainable fiscal policies and stability oriented monetary policies contribute to long-term growth and welfare,
- The determinants of long-term growth and welfare are appropriate structural policies, promoting the efficient use of resources.

6. Conclusions

[SLIDE 21]

Many would regard the tenets of my macroeconomic beliefs as trivial. Still, if my illustration of Rome and Frankfurt/Brussels mistakes is broadly correct, they were repeatedly violated in recent European history. Thus they may be trivial in principle but hard to implement in practice. Still, counting on the wisdom of the great German poet, we hope to make new mistakes, not the old ones, next time.

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