A QUALIFIED DEFENSE OF FUNCTIONAL FINANCE: SECULAR STAGNATION, GROWTH AND INFLATION

CÔME POIRIER*
XAVIER RAGOT**

In the same way as streams meet to form major rivers, the sum of new issues is bringing back major macroeconomic questions. Uncertainty about growth, inflation, productivity, unemployment and more generally about people's participation in the labour market are all issues, some of them new, that are added to an already long list. Names are emerging to characterise the situation: *secular stagnation*, *stagflation*, *reflation*[1]. All of them only imperfectly grasp the current situation. The purpose of this paper is to identify the seven economic issues of the current period and to then list some policy conclusions thereof. The economic policy put forward herein can be summarised in a few words. It is a measured rehabilitation of functional finance, which is a promotion of fiscal policy as a tool for economic stabilisation, but also of inflation and the affirmation of the secondary, but essential, role of monetary policy.

INFLATION AND GROWTH: THE SEVEN ECONOMIC ISSUES

The concept of secular stagnation was introduced to account for persistently low growth and inflation in an environment where nominal interest rates were close to zero (Hansen, 1938; Summers, 2013). The return of inflation in the post-Covid period is raising new fears.

* PhD Student, Université de Dauphine-PSL. Contact : come.poirier@polytechnique.edu.
** Professor, Sciences Po-CNRS ; President, OFCE (Observatoire français des conjonctures économiques). Contact : xavier.ragot@gmail.com.

However, more than inflation, it is the new mechanisms at work that are essential to shape the renewal of economic policy. Is inflation a supply, demand, or preference shift issue? This section presents seven new causalities affecting inflation and growth, from the most cyclical causalities to the most structural ones.

Supply constraints and production problems during the Covid period

Firstly, the Covid crisis shows that economies can run into supply constraints in specific sectors or for certain goods. The strong recovery period that followed the end of the restrictive measures in most countries highlighted the bottleneck of raw materials and energy when demand abruptly picks up. Inflation in these products (21.6% annual inflation in France in November 2021, according to Insee) spread to all goods as they are essential in the value chains, with a rise in production prices of almost 16% in France in January. The increase in prices allows for an adjustment in demand and this mechanism is assumed to be transient as it is linked to temporary supply constraints. However, the persistence and consequences of such inflation remain a source of much debate and economists partly fear a return to a period of persistence due to the spread of price increases throughout the productive fabric. The analysis of inflation must therefore move from macroeconomics to sectoral economics.

Strong recovery and excess savings

The Covid period has so far been shaped by strong support from countries for household income to maintain an adequate level of demand (more than $5.5 trillion for the various American plans, more than $250 billion for the "whatever it takes" plan in France). After the sovereign debt crisis triggered by austerity measures in 2010, governments opted for a more Keynesian approach to fiscal policy during the pandemic, whether in Europe, Japan or the US. Massive stimulus packages were put in place to keep the economy afloat, which also led to a sharp rise in public debt. As a result of these monetary injections, demand could be stabilised or even increased, as in the United States, for example, where the level of consumption in 2021 slightly exceeded that of 2019, contributing to accelerating inflation. However, the full effects of the stimulus packages on the economy are still unknown. In particular, household savings rates remain at high levels in most developed economies, a lasting symptom of secular stagnation. In France, the OFCE has estimated excess savings in 2020 at nearly €160 billion (OFCE, 2021). The stakes in terms of household dissaving are therefore high. Partial dissaving would increase inflation by 1% according to conservative estimates (OFCE, 2021).

Changes in labour market preferences

The Covid-19 crisis has changed how the labour market works, probably in a lasting way with a new appreciation of the hardship of certain positions. This is reflected, for example, in a massive wave of resignations in the United States, with 4.3 million resignations in August 2021, representing a turnover rate of 2.9%, i.e. half a percentage point above its pre-crisis level according to the Bureau of Labor Statistics. In France, wage demands from key trades and the hotel and catering industry show the current tensions. While these adjustments are legitimate and the expression of social preferences that are indisputable to economists, they result in strong differences in nominal wage increases. The issue that emerges from this development on the labour market is the potential separation of the wage-price spiral, which generates inflation and is therefore undesirable, from the adjustment of relative wages between sectors, which is necessary for the proper allocation of human resources. This medium- and long-term issue is crucial as it determines the dynamics of inflation and therefore the stabilisation of economies.

The role of the wage-price spiral in inflation

In the 1960s and 1970s, the dynamics of inflation are shaped by the wage-price spiral, which is driven by wage indexation. In times of inflation, households are not victims of nominal illusions and are aware that their purchasing power is decreasing for the same income. Price rises therefore generate wage demands that lead to nominal wage increases with minimal actual impact. The increase in labour costs is then quickly passed on to prices again, fuelling inflationary pressures. While this relationship is now questionable in European countries or Japan where wages are less indexed than in the past, the dynamics of U.S. wages suggest that this spiral may also be contributing to US inflation. In the post-Covid period, the question of the second-round effect of wage increases on prices is therefore essential to identify the risks of self-perpetuating inflation.

Low nominal interest rates followed by low real interest rates

One of the most enduring symptoms of secular stagnation is undoubtedly low nominal interest rates, which are now constrained by the effective lower bound (ELB). Lowering interest rates into very negative territory being impossible, central banks are having to use new unconventional monetary policies (quantitative easing, forward Guidance, etc.) to stimulate investment by facilitating access to credit. The problem with the ELB is that nominal interest rates cannot decrease

and therefore, real interest rates are too high in relation to the economic situation, even if they are already low.

The return of inflation is shifting debate. Indeed, it is likely that interest rates will not rise by more than inflation in the coming quarters, suggesting persistently low real interest rates (Ragot, 2021). Thus, the forthcoming rise in nominal interest rates does not invalidate active investment and debt management policies, which are justified by low real interest rates that are lower than the economy's growth rate (see Blanchard, 2021, for details). As a result, fiscal policy is playing an increasing role in regulating our economies, but we will come back to this point in part two.

Uncertainty over productivity

Since the contributions summarised by Gordon (2016), the dynamics of productivity have been under scrutiny. Although the technological discoveries of the third Industrial Revolution have considerably modified lifestyles (means of communication, computers, Internet, etc.), they have only marginally increased productivity compared to the innovations that led to the "forward leap" between 1920 and 1970. The Covid crisis and the generalisation of remote working will permanently change the use of digital tools in companies, but the effect on work productivity is still unknown. The impact on innovation is even more uncertain. As a result, all current economic discussions must be conducted with uncertain growth, probably reduced because of the climate challenges.

Regulation and investment for energy transition

The final key issue in the current macroeconomic environment, which is also crucial for the long-term outlook, is investment in the energy transition. The scientific consensus on climate change calls for action to change the way we produce energy and build a more sustainable economy. In this context of climate urgency, the net effect of the transition is also debated. On the one hand, increased investment in the relevant areas will translate into a positive demand shock that should help boost production (double-dividend concept, see Freire-Gonzalez, 2019, for a meta-analysis). On the other hand, the likely inflation of certain costs suggests a negative supply shock in the energy sector, which may spill over to all consumer goods (Pisani-Ferry, 2021) and thus inflation. Managing environmental regulation and energy transition is therefore one of the most complex economic policy challenges of the 21st century, if not the most complex one.

These seven elements change the growth and inflation outlook in the same way as the standard secular stagnation approach. Monetary and fiscal policies need to adapt to this new environment, with a clear orientation towards the rehabilitation of fiscal policy.

RETHINKING ECONOMIC POLICY

Current debates are revisiting the respective roles of monetary and fiscal policy in economic stabilisation. These debates are crucial for the definition of the mission of central banks, as well as for the size of desirable government deficits (or surpluses).

The old paradigm: monetary policy, above all

The macroeconomic stabilisation of inflation and unemployment is first and foremost thought to be the objective of monetary policy. In the United States, macroeconomic stabilisation is primarily the responsibility of monetary policy, which has a dual mandate: the Fed's objective is to stabilise inflation but also to maintain the full employment of production factors.

These two objectives are generally perceived to be close or even similar because of the joint movement of economic growth and inflation, the so-called Phillips curve: higher economic growth and lower unemployment translate into inflationary pressures. The relative instability of this relationship, however, calls the similarity of these objectives into question. The discussions on the flattening of the Phillips curve (Occhino, 2019) concern the fact that inflation appears to be more independent of changes in economic growth than in the past. In other words, inflation varies little while unemployment fluctuates significantly. If the two objectives are no longer as closely aligned as in the past, this means that a new trade-off is emerging. The central bank can accept more inflation to bring the economy closer to full employment by lowering real interest rates to boost the economy.

In the euro area, the ECB's sole mandate is price stability. It was recently defined as a symmetrical objective around two percent annual average inflation in the euro area[2]. The issue of full employment of production factors is therefore not the ECB's main objective. It can of course contribute to this as a secondary objective, but the ECB cannot contribute to a reduction in unemployment if this requires inflation to rise above its target. The reduction of unemployment must therefore be the objective of other policies.

What alternative policies for full employment? To summarise, there are two possible directions. The first assigns the objective of full employment of production factors to structural reforms. In the case of unemployment, labour market reforms are put forward. The paradigmatic example of this policy is the reduction of unemployment in Germany in the early 2000s. While the unemployment rate was 12% in 2005, labour market reforms, unemployment benefits and the definition of possible types of employment contracts (minijobs) contri-

buted to bringing unemployment down to less than 7% ten years later, among other factors. These structural policies can also be educational policies aimed at providing young people with qualifications, as it is known that the heterogeneity of unemployment according to qualifications is high. This first direction is justified if unemployment is structural rather than cyclical.

The second direction is to give the objective of full employment in the business cycle to fiscal policy, which handles aggregate demand. This orientation consists in promoting countercyclical fiscal policies, which make public debt fluctuate around a well-defined anchor. These policies do not, of course, advocate a permanent increase in public debt, but an intentional fluctuation.

The European Multiannual Financial Framework initially favoured the structural approach with set criteria of deficit and debt under the Maastricht Treaty. As European institutions gradually learned about cyclical instabilities, the treaties moved towards integrating more countercyclical fiscal policies, which can be described as Keynesian policies. To accept the cyclical part of the deficits, the notions of output gap or structural deficits were introduced at the cost of making the European Multiannual Financial Framework more complex (Martin *et al.*, 2021).

Thus, the European movement is shifting towards greater acceptance of countercyclical fiscal policy. As a result, central bankers have regularly called for more expansionary fiscal policy (Draghi, 2018). Empirical evidence on the inflationary effect of fiscal policies is scant but consistent. Another reason for the use of fiscal policy in the euro area is the wide range of economic situations between countries. A single monetary policy cannot fit all countries, a counter-cyclical fiscal policy allows for idiosyncratic national factors. Finally, it is often noted that these effects depend on exchange rate developments, which complicates the analysis for the US but simplifies it for the euro area (Geerolf, 2021).

In summary, the old consensus asserts the central role of monetary policy for price stability but also for the overall stabilisation of the business cycle. Fiscal policy is residual, but potentially important for the ELB or in a heterogeneous monetary area. In the context of the famous Tinbergen principle, which identifies an instrument with a tool, the assignment is clear: inflation monetary policy, residual full employment, fiscal or structural policy.

Rethinking the role of macroeconomic policy

The paradigm shift is based on an affirmation of the central role of fiscal policy for economic stabilisation but also inflation, and a secon-

dary role for monetary policy. Before a more general formulation, it is first necessary to consider concrete policies:

1 – an initial argument in favour of the role of fiscal policy for inflation is, as mentioned earlier, the assertion of the role of fiscal policy in raising inflation when monetary policy is constrained. The European debate on austerity policies (i.e. for the quick decrease of public deficits) and the risk of deflation shows that the role of fiscal policy is symmetrical: an expansionary fiscal policy favours higher inflation, a restrictive policy decreases inflation.The importance of fiscal policy, conditional on limits to monetary policy, is now a consensus. This role is also the result of models known as New Keynesian, which emphasise nominal rigidities and the role of inflation expectations (Michau, 2018). It is also the result of the simplest Keynesian models, of the AD-AS type, in which price increases follow a shift of the demand curve;

2 – the important question is the role of fiscal policy on the cycle when monetary policy is unconstrained, i.e. when the effective bound is not reached. In this area, analyses are evolving. Before putting forward economic elements, let us read some of the views. An interesting example is the recent proposal by Philip R. Lane[3], member of the ECB's Executive Board, made in his personal capacity. Lane proposes that EU public deficit rules allow countries with inflation below the 2 % target to slow down the pace of fiscal consolidation, so that fiscal policy helps countries achieve their inflation targets. Then, after others, he proposes to slow down the pace of debt reduction implied by the current treaties to avoid deflationary biases in some countries;

3 – a second example of the positive effect of fiscal policy on inflation is, of course, the US situation mentioned above. The massive support plans for the US economy have led to public deficit approaching 15% in 2021. On this stimulated consumption, which led to a rise in prices, it is not the nature of the effect that is debated, but its magnitude. For Larry Summers the US budget plans are highly inflationary, while other economists, such as Paul Krugman[4], expect lesser effects;

4 – the two previous examples discussed the positive fiscal effects on inflation. Can negative effects be claimed? Here, an essential discussion needs to be initiated. If in the coming quarters excess savings accumulated by households during the Covid period were spent, representing more than 7% of GDP in additional demand in developed countries (OFCE, 2021), should the response be monetary or fiscal? If a shock of positive demand were to occur, it would be legitimate for the resulting increased tax revenues to contribute at the same time to reducing demand and inflation and deleveraging the governments having financed the increase in private savings with public debt. Thus,

the budgetary tool for the management of aggregate demand and inflation is symmetrical; it serves to fight both against increases and decreases in effective demand.

A modern functional finance?

After these elements, it is necessary to return to the most powerful formulation of the central role of fiscal policy in the business cycle. It was developed in 1943 by American economist Abba Lerner who coined the term functional finance.

Lerner argues that fiscal policy must handle the business cycle and inflation, while the role of monetary policy is to make active fiscal policy possible by buying public debt to help the government budget. This theory abides by Tinbergen's principle but reverses the instruments: fiscal policy deals with inflation and monetary policy with the state budget!

This recommendation highlights a new reality. The first is the role of fiscal policy in the dynamics of inflation, which the examples above have shown to be relevant. The second is the role of central banks in managing interest rates of public debt, and thus the role in the sustainability of public debt.

In its condensed form, functional finance is too extreme. The problem is not so much the essential role of fiscal policy, but the strictly residual role of monetary policy. The issue of the wage-price spiral and the self-sustaining drift of inflation expectations cannot be controlled by fiscal policy. It is up to monetary policy to anchor inflation expectations in a sustainable way, by asserting a long-term target and moving interest rates in a consistent manner. Thus, the role of monetary policy is not residual but essential to anchor inflation expectations. This rehabilitation of monetary policy, however, poses a fundamental problem, which is that of determining who is in charge of what: The practice mentioned above therefore indicates that fiscal policy should be in charge of inflation. What is at stake is therefore an institutional exit from the Tinbergen principle to give both fiscal and monetary policy monetary guidelines.

Political implications

These general principles lead to adjustments of the rules and principles of economic policy. One practical implication is that the central bank's mandate should include support for economic activity, which is the mandate of the Fed. This institutional change would mean that support for economic activity would evolve from a secondary objective to a full-fledged objective. The second implication is that the macroeconomic rules governing European fiscal policies should have explicit

objectives to support economic growth but also inflation, which radicalises Philip Lane's proposal.

The objective is therefore twofold. It consists in separating institutions by instruments (monetary policy on the one hand, fiscal policy on the other), rather than by objectives. Then, it consists in giving the two institutions a dual mandate of economic stabilisation and management of inflationary pressures. On this last point, it must be acknowledged that central banks will have a role in anchoring long-term expectations.

The second implication is to return to the subject of fiscal policy, the description of which was deliberately abstract at this stage. A relevant criticism of Functional Finance is the somewhat naive discussion of fiscal policy. These have strong redistributive effects, and the idea that taxes or public spending can be made to vary over the business cycle to achieve an inflation target is unrealistic[5]: the legitimate time for political debate does not coincide with the time for monetary policy, which can be immediate, due to the operational independence of central banks. An empirical assessment of this challenge is provided by Bénassy-Quéré *et al.* (2016). The authors show that discretionary fiscal policy measures are on average pro-cyclical (i.e. the tax burden increases during recessions and decreases during booms), in contrast to the automatic effect of the existing tax system which is linked to activity (VAT, corporate tax the yield of which decreases in a recession).

Therefore, the rehabilitation of fiscal policy must be understood by clearly separating the 'normal' business cycle from the economic crisis. In normal times, the rehabilitation of fiscal policy should, as far as possible, be embedded in fiscal regulation (such as taxes on pro-cyclical bases, or significant transfers or economic cycle). At European level, the EUR 100 billion SURE unemployment reinsurance project is an interesting example, which could be extended. In times of crisis, additional *ad hoc* support is needed, as in 2009 and 2020. Explicit analysis of the relevance of these tools to stabilise inflation is therefore necessary.

IN CONCLUSION, THE LONG-TERM ASPECT AND ENERGY TRANSITION

The previous section discussed the more cyclical aspects related to the discussion on secular stagnation, which is the evolution of inflation. The second part of the debate concerns the medium-term growth outlook. The debate is deeply renewed by the issue of energy transition. More than the level of productivity, the new issue of economic policy is the transformation of the productive fabric to reduce CO_2 emissions and fight against climate change. It is important to separate the issue

of the long term from that of cycle management, which we tried to do in the previous section. For example, the net effect on growth and employment of energy transition investments alone is under discussion, as mentioned above. In this area, it is important to remember that the role of investments must first be to reduce CO_2 emissions. The investment-driven business cycle must be managed by other components of fiscal policy and by monetary policy. For this reason, investments for the energy transition are not intended to get out of secular stagnation but to reduce CO_2 emissions.

Low real interest rates encourage the financing of part of the energy transition investment through debt rather than taxes, which has a positive effect on business and inflation. However, it would be prudent to consider these investments independently of the cyclical stabilisation of the economy, as the stakes are so high.

NOTES

1. For example, see speech of Isabel Schnabel, https://www.ecb.europa.eu/press/key/date/2021/html/ecb.sp211117~78f0a1f435.en.html.

2. See the ECB's statement: https://www.ecb.europa.eu/home/search/review/html/ecb.strategyreview_monpol_strategy_statement.en.html.

3. See https://www.ecb.europa.eu/press/key/date/2021/html/ecb.sp211112~739d3447ab.en.html.

4. See for example a summary here: https://www.nytimes.com/2021/12/16/opinion/inflation-economy-2021.html.

5. See for example the opinion of Paul Krugman: https://www.nytimes.com/2019/02/12/opinion/whats-wrong-with-functional-finance-wonkish.html.

BIBLIOGRAPHY

Bénassy-Quéré A., Ragot X. and Wolff G. (2016), "Quelle union budgétaire pour la zone euro", *Note CAE*, February.

Blanchard O. *et al*. (2014), "A Prolonged Period of Low Real Interest Rates?", in *Secular Stagnation: Facts, Causes and Cures*, A VoxEU.org, eBook, Centre for Economic Policy Research (CEPR).

Blanchard O. (2021), "Fiscal Policy under Low Interest Rates", https://fiscal-policy-under-low-interest-rates.pubpub.org/.

Creel J. *et al*. (2021), "Dette publique : un changement de paradigme, et après ?", OFCE, *Policy Brief*.

Draghi M. (2018), "Central Bank Independence", First Lamfalussy Lecture by Mario Draghi, President of the ECB, National Bank of Belgium.

Freire-González J. (2019), "Environmental Taxation and the Double Dividend Hypothesis in CGE Modelling Literature: a Critical Review", *Journal of Economic Modeling*, No. 40, pp. 94-223.

Geerolf F. (2020), "The Phillips Curve: a Relation between Real Exchange Rate Growth and Unemployment", *Working Paper*.

GORDON R. (2014), "The Turtle's Progress: Secular Stagnation Meets the Head-Winds", in *Secular Stagnation: Facts, Causes and Cures*, A VoxEU.org, eBook, Centre for Economic Policy Research (CEPR).

GORDON R. (2016), *The Rise and Fall of American Growth: the US Standard of Living Since the Civil War*, Princeton University Press.

HANSEN A. H. (1939), "Economic Progress and Declining Population Growth", *The American Economic Review*, Vol. 29.1, pp. 1-15.

KRUGMAN P. (2014), "Four Observations on Secular Stagnation", in *Secular Stag-nation: Facts, Causes and Cure*, A VoxEU.org, eBook, Centre for Economic Policy Research (CEPR).

LERNER A. P. (1943), "Functional Finance and the Federal Debt", in *Social Research*, Vol. 10.1, pp. 38-51.

MARTIN P., PISANI-FERRY J. and RAGOT, X. (2021), "Pour une refonte du cadre budgétaire européen", *Note CAE*, No. 63.

MICHAU J.-B. (2018), "Secular Stagnation: Theory and Remedies", *Journal of Economic Theory*, Vol. 176.C, pp. 552-618.

OCCHINO P. (2019), "The Flattening of the Phillips Curve: Policy Implications Depend on the Cause", *Economic Commentary*, Vol. 2019-11.

OFCE (Observatoire français des conjonctures économiques) (2021), "La vague espérée de la reprise. Perspectives 2021-2022 pour l'économie française", *Policy Brief*, No. 95, October 13.

PISANI-FERRY P. (2021), "Climate Policy Is Macroeconomic Policy, and the Implications Will Be Significant", *PIIE Policy Brief*, No. 21-20, August.

RAGOT X. (2021), "Plus ou moins de dettes publiques", OFCE, *Policy Brief*, No. 84, January.

STIGLITZ J. E. (2021), "The Proper Role of Government in the Market Economy: the Case of the Post-Covid Recovery", *Journal of Government and Economics*, Vol. 1, p. 100004.

SUMMERS L. H. (2014), "Reflections on the New Secular Stagnation Hypothesis", in *Secular Stagnation: Facts, Causes and Cures*, A VoxEU.org, eBook, Centre for Economic Policy Research (CEPR).

SUMMERS L. H. (2015), "Demand Side Secular Stagnation", *American EconomicReview*, Vol. 105, No. 5, May, pp. 60-65.