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Fiscal Adjustment and Economic Growth

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Is a unified macroeconomic policy necessarily better for a common currency area?

- It is widely assumed that a common currency makes it desirable to have also a **common** fiscal policy.
- However, if fiscal policy is a **source of shocks**, **independent** national fiscal policies are generally **preferable** because they allow risk diversification.
- "The variance of a **sum** of shocks is the lower the lower the covariance among the **individual** components".

See Belke and Gros (2009): European Journal of Political Economy 25, 98–101.

Expansionary fiscal contractions?

- **Non-Keynesian effects** (Giavazzi & Pagano, 1990, 1996, Alesina, Perotti, 1995, Blanchard and co-authors): fiscal adjustments could affect positively demand through **confidence and wealth effects** and offset the usual Keynesian effects.
- **Improved long-term refinancing** conditions and crowding-in of private investment.
- Increase of public expenditure as observed in financial crisis **casts doubts on sustainability** of debt-to-GDP ratio: Uncertainty leads to option value of waiting with consumption decisions.
- Good example: **Italy versus Spain** - fiscal rules beneficial for lower interest rates and growth.

Expansionary fiscal contractions?

- Existence of non-Keynesian effects **depends on size and persistence** of fiscal adjustment.
- Non-Keynesian effects **if large budget deficit or a very high-debt-to-GDP ratio** (demographics!) and number of **credit-constrained consumers** is low.
- But importance of **swift real EXR depreciations** for economies caught up in a situation with large fiscal deficits, low output growth and an appreciated real exchange rate (Sweden!).
- Without them, tax increases and public expenditure cuts bound to reduce aggregate demand/output. => Tax revenue will fall and fiscal consolidation will be slow.
- Good example: **Ireland versus Greece** (closed economy with low saving rates) – different multipliers!

Public debt and growth

- Large debts **discourage capital accumulation** + reduce growth.
- Occurs through **higher long-term interest rates, higher future distortionary taxation, higher (expected) inflation, greater uncertainty, macroeconomic volatility** …
- … **fueling** accumulation of other macroeconomic (CA) **imbalances**.
- Higher interest expenditure implies **higher taxes** or **constraints on other government spending** items promoting higher growth
- If growth is indeed reduced, fiscal sustainability issues are likely to be exacerbated, with further adverse consequences (debt hysteresis).
- Link between growth and debt weak at “normal” debt levels, median/mean growth rates for countries with public debt > 90 p.c. Of GDP one or more p.c. lower than otherwise.

See Reinhart and Rogoff (2010) and Kumar and Woo (2010).

There is massive monetary accomodation …

- **Two-handed approach**: bazooka-like 3yr monetary stimulus in order to cope with confidence crisis and to make cutback of debt possible.
- Lars Calmfors: **Double dividend hypothesis**. Reforms to avoid inflationary bias (expectations of sustainable non-inflationary growth). = long-run corollary to short-run EXR depreciation (Sweden!).
- In absence of fiscal rules: **inflation** as the only reasonable way out of the debt problem? Fiscal dominance (Sims, Sargent)?
- **Rating agencies**' argument: malus for euro area member countries because they are individually too far away from the ECB in order to inflate their debt away. But this also implies: leeway for debt is lower within the euro area than outside.
- Fiscal compact in order **to avoid credibility and reputation loss of ECB**, the most important pillar of EU governance during the crisis up to now (Flexibility in the short run, but rules in the long run).

Structural funds and growth

- **Not more** than two dozens of econometric estimates of the impact of structural funds on growth available
- Results **not very satisfying** for several reasons: different conclusions, spillover effects between regions not captured and global instead of local econometric approach
- Some regions in the UK, in the Southern part of Italy and in Greece **benefitted**, whereas some core regions in Germany, the Netherlands, Belgium, France and Denmark **did not**.
- Success dependent on **quality of institutions** (Marshall plan).

While cohesion policy has failed if evaluated in terms of effects on long-term growth rates, it may have a different **redistributive** aim (political and social integration).

See Boldrin and Canova (2001), Le Gallo, Dall'Erba and Guillan (2011), Becker, Egger, von Ehrlich and Fenge (2010), Mohl and Hagen (2010).

Stricter capital rules and growth

- More expensive for banks to fund assets with capital than with deposits or wholesale debt.
- Banks facing stronger capital requirements will strive to increase capital levels by retaining earnings and issuing equity as well as reducing non-loan assets.
- But any initial increase in cost and decline in supply of bank loans could have **transitory negative impact on growth**, especially in sectors relying heavily on bank credit.
- In the **longer term, as banks become less risky**, both the cost and quantity of credit should recover, reversing the impact on consumption and investment.
- **Easing of monetary policy** reduces the estimated output losses.

See Macroeconomic Assessment Group - Financial Stability Board and the Basel Committee on Banking Supervision (2010, 2011)

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Thanks for your attention!