

Fiscal policy in Europe: What is the appropriate stance?

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ETLA fiscal policy seminar
Helsinki, October 16, 2012

Fiscal stance in Europe

Public debt is high (as elsewhere in the world...)

- ▶ Fiscal austerity to reduce debt levels

Appropriate stance?

- ▶ More austerity necessary to reduce debt levels
- ▶ Or, rather, is austerity self-defeating

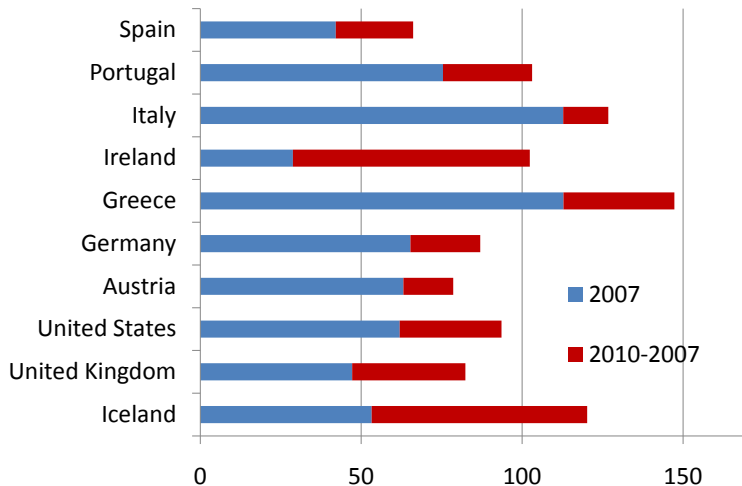
Outline of the talk

Basic facts on current fiscal stance in Europe

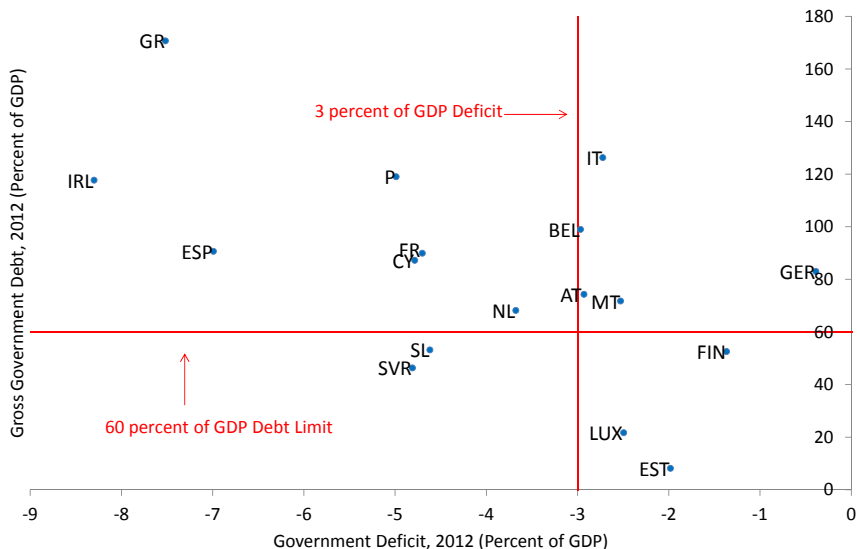
Assessment of appropriate stance tricky

- ▶ What determines government spending multipliers? with G. Corsetti and A. Meier (Economic Policy, October 2012)
- ▶ Sovereign risk, fiscal policy and macroeconomic stability. with G. Corsetti, K. Kuester and A. Meier (Economic Journal 2013)
- ▶ New results for small open economies (work in progress)

Public debt 2007 and 2010 (% of GDP)



European deficit and debt levels well above targets



Fiscal stance changed considerably since 2011

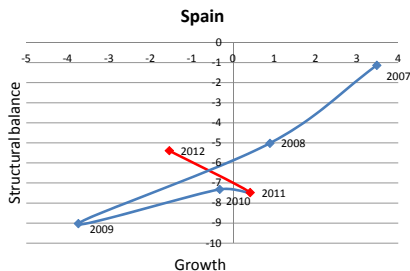
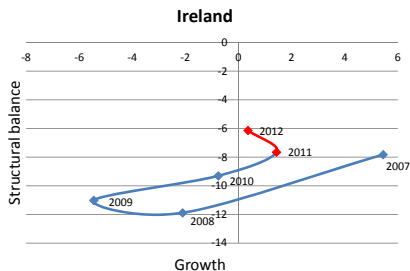
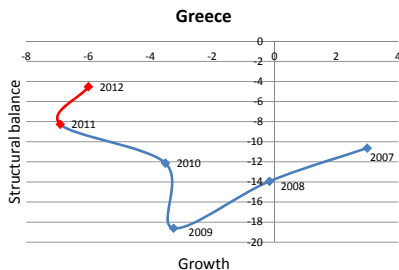
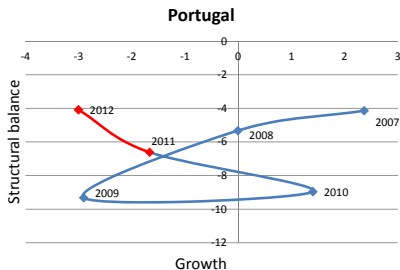
Early response to crisis expansionary: European Economic Recovery Programm

- ▶ Discretionary spending/tax cuts by about 1-2 percent of GDP 2009 and 2010

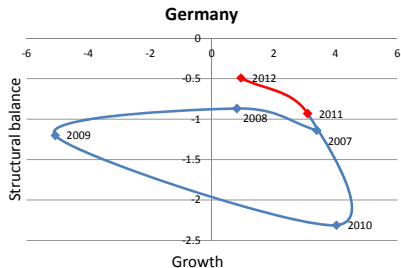
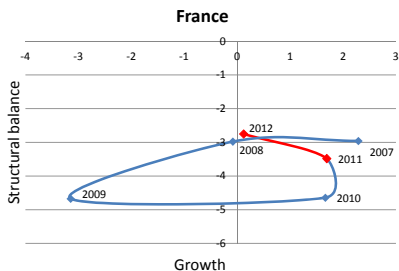
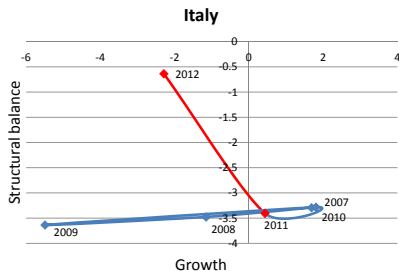
By 2011 most European countries shifted to austerity

- ▶ Response to rising concerns regarding solvency
- ▶ Implication is pro-cyclical fiscal stance

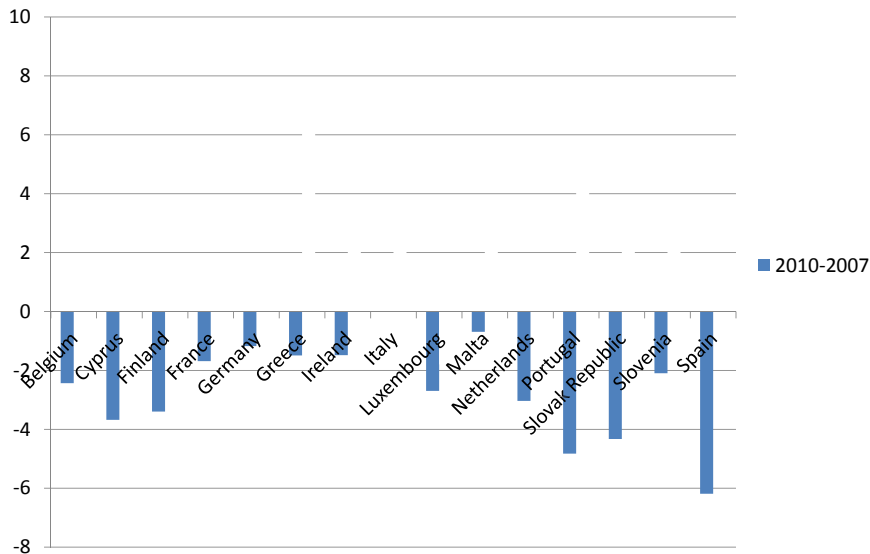
Since 2011 structural balances rise, even as growth declines



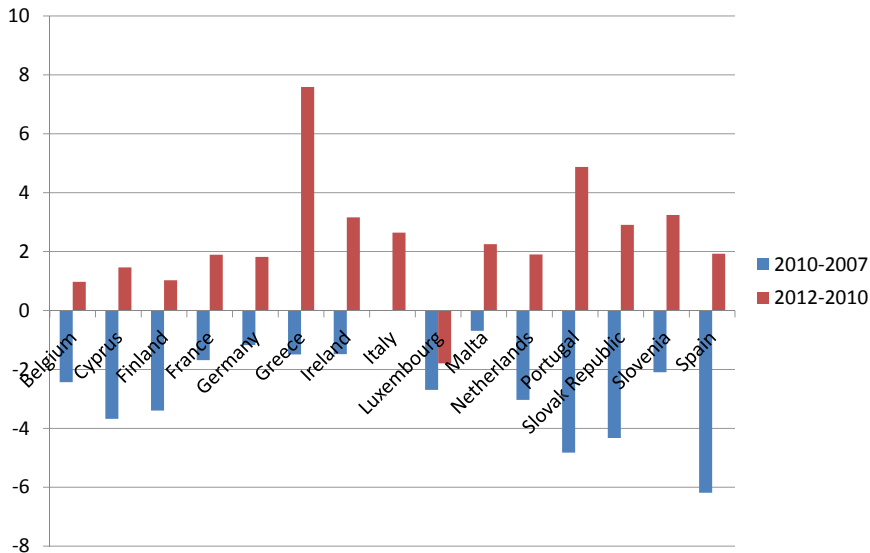
A tendency “to go northwest”



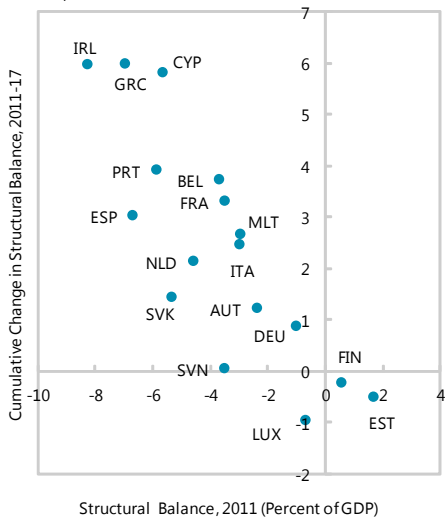
Actual fiscal stance: structural government balances



Structural government balances (percent of GDP)



Planned fiscal consolidation substantial



Will it work?

Austerity may be self-defeating...

- ▶ Reduces economic activity: **multiplier** measures percentage change of output, given increase in spending/tax cut equal to 1% of GDP
- ▶ Semi-elasticity of the budget ranges 0.3–0.6 in OECD countries
- ▶ Overall decline in revenues larger than savings?

Size of the multiplier key

- ▶ Multiplier above 2: austerity possibly self-defeating
- ▶ Notoriously difficult to assess

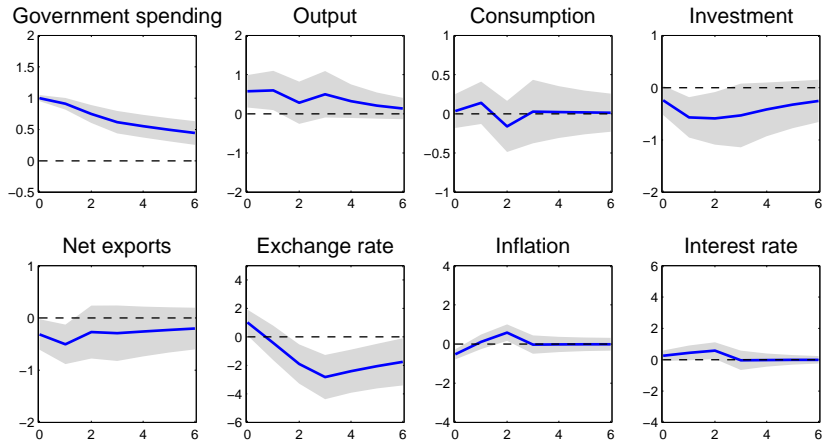
Estimating multipliers

Time-series studies differ in terms of approach and sample period

- ▶ Estimated multipliers vary, but more so for taxes

	data	spending	taxes
Blanchard/Perotti 2002	US	1.3	0.78
Mountford/Uhlig 2009	US	0.61	3.57
Romer/Romer 2010	US	...	3.0
Ramey 2011	US	1.1	...
Barro/Redlick 2011	US	0.7	1.1
Beetsma/Giuliodori 2011	EU	1.5	...

Corsetti/Meier/Müller: **unconditional** effect of government spending shock (panel of OECD countries)



Government spending multiplier – common findings of unconditional effects

Government spending

- ▶ Multipliers are probably below 1 (certainly $\ll 2$)
- ▶ Robust across approaches and sample periods

If it were for these findings

- ▶ Fiscal stimulus of limited use
- ▶ But also: austerity not self-defeating

However, findings may be **not very informative** for issue at hand

After all, no such thing as “the” multiplier

Effects of fiscal policy likely to differ depending on

- ▶ Monetary policy (and exchange rate regime)
- ▶ Unemployment
- ▶ Health of banking and financial system
- ▶ Credibility of fiscal policy, fiscal stress
- ▶ Expansion versus contraction
- ▶ Openness (trade and capital)

Findings of studies that **average across these conditions, hide differences** in effects across different states of the economy

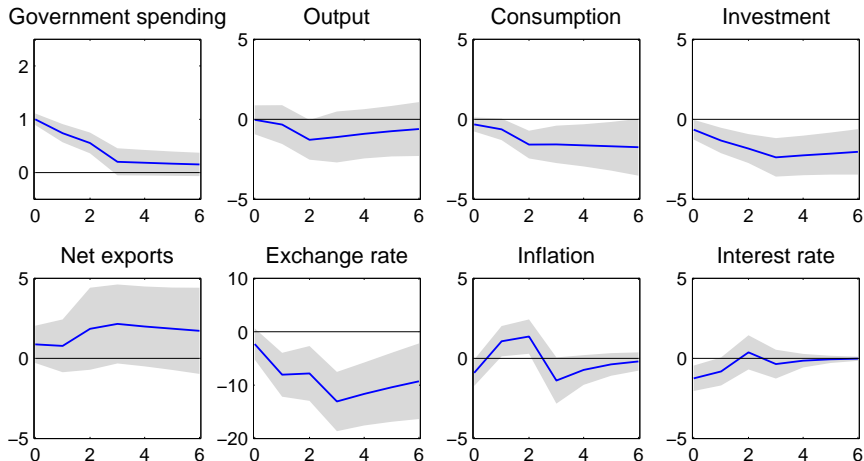
Recently, this has been recognized among others by Perotti 1999, Tagkalakis 2008, Ilzetzki/Mendoza/Vegh 2012, Auerbach/Gorodnichenko 2012

In Corsetti/Meier/Müller we explicitly consider

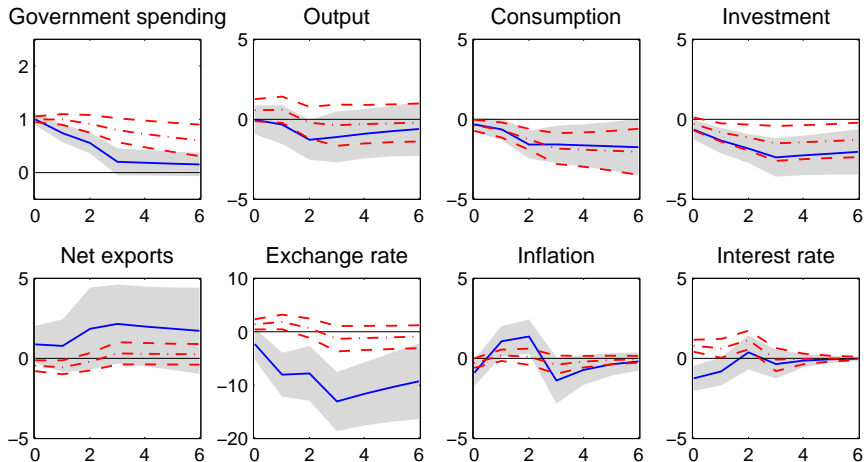
- ▶ Exchange rate regime (Peg vs float)
- ▶ Financial crisis (Reinhart-Rogoff dummies)
- ▶ Fiscal stress (critical debt and/or deficit levels)

Our baseline: floating exchange rate in good times (no fiscal/financial stress)

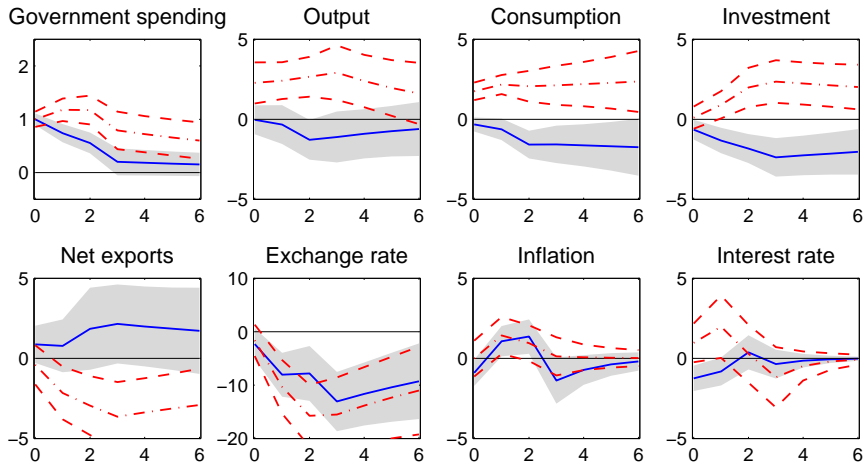
Baseline scenario – not much of a multiplier



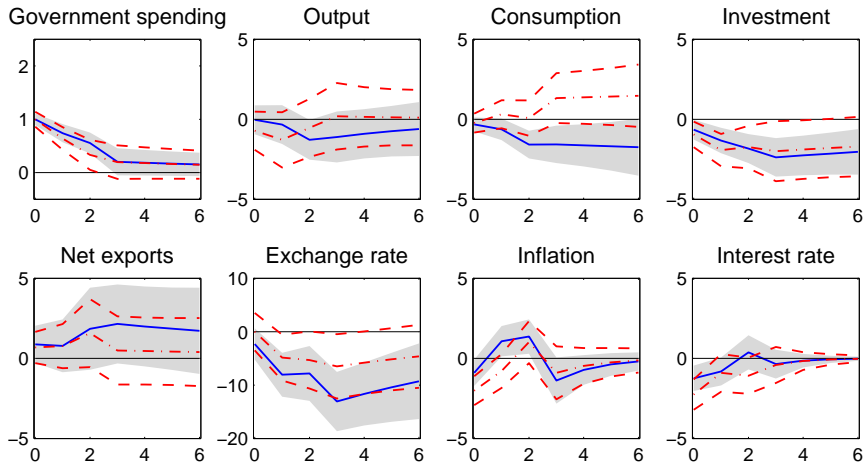
Baseline scenario vs peg



Baseline scenario vs financial crisis



Baseline scenario vs fiscal strain



Output multipliers for baseline specification

	Impact	Maximum	Cumulative ($\sum Y_t / \sum G_t$)		
	Y_0 / G_0	$\max Y / G_0$	year: 2	4	6
Baseline	-0.0	-0.0	-0.2	-1.1	-1.5
Currency Peg	0.6	0.6	0.6	0.2	0.0
Financial crisis	2.3	2.9	2.2	2.5	2.6
Weak Public Finances	-0.7	0.2	-1.2	-1.1	-0.8

Caveats

Limited number of observations/heterogeneity of circumstances makes identification difficult

Particularly true for what defines “a” financial crisis, “a” peg, but also fiscal strain/weak public finances

- ▶ Need to spell out specifics
- ▶ Focus on weak public finances/sovereign-debt crisis in what follows

Fiscal policy and sovereign risk

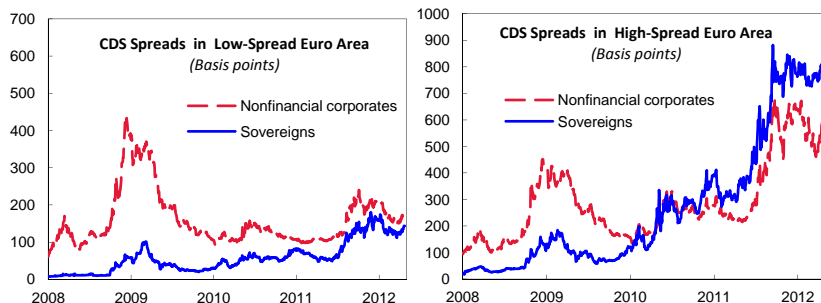
How a sovereign-debt crisis can alter the effects of fiscal policy:
joint work with Corsetti/Kuester/Meier

- ▶ Closed economy model
- ▶ Constraint on monetary policy: zero lower bound

Key feature of current crisis: “sovereign-risk channel”

- ▶ Sovereign debt crisis: risk premium very sensitive to fiscal outlook
- ▶ Adverse effect on borrowing conditions of private sector

Sovereign risk channel in the euro area



Causation can run either way

- ▶ Sovereign risk driven by private risk (ailing banks)
- ▶ Sovereign risk creates jurisdiction risk (balance sheet effects, taxation risk, tariffs increase, social unrest, ...)

Canonical macro model

Phillips curve relates inflation to expectations and activity

$$\pi_t = \beta E_t \pi_{t+1} + \kappa y_t - \gamma g_t$$

Aggregate demand relates activity to real interest rate

$$y_t = E_t y_{t+1} - E_t \Delta g_{t+1} - [i_t - E_t \pi_{t+1}]$$

Taylor rule approximates the way central bank sets its rates ...

$$i_t = \phi_\pi \pi_t$$

Canonical macro model with sovereign risk

Phillips curve relates inflation to expectations and activity

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Taylor rule approximates the way central bank sets its rates ...

$$i_t = \phi_\pi \pi_t - \phi_\omega \hat{\omega}_t$$

... plus a link between sovereign risk and fiscal outlook

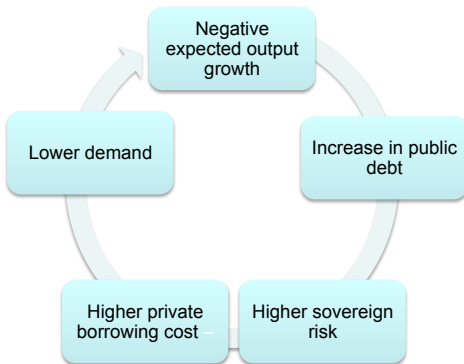
$$\hat{\omega}_t = \zeta E_t (\text{deficit}_{t+1})$$

Implications of sovereign risk channel

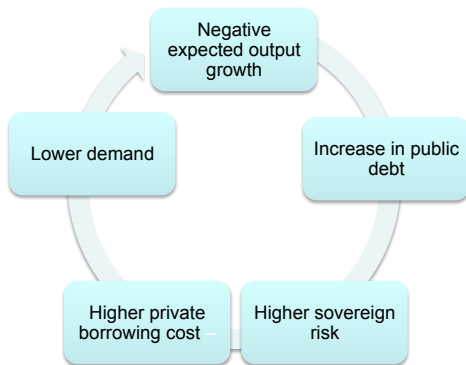
If monetary policy can/does not offset change in sovereign risk

- ▶ Amplification of business cycle
- ▶ Risks to macroeconomic stability due to self-fulfilling expectations
- ▶ Fiscal multiplier very sensitive to state of the economy

Adverse expectations become self-fulfilling



Adverse expectations become self-fulfilling



- Systematic spending **cuts in a recession** (pro-cyclical policy) can prevent expectations from becoming self-fulfilling

Multiplier depends on state of the economy

Constraints on monetary policy, as severe recession pushes economy at zero lower bounds – preventing further cuts of policy rates

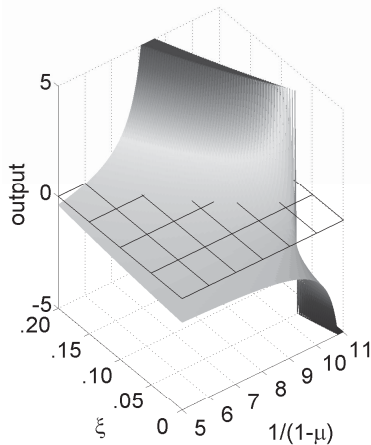
- ▶ Expected duration of zero lower bound episode: $1/(1 - \mu)$ quarters

Initial level of public debt determines strength of sovereign risk channel

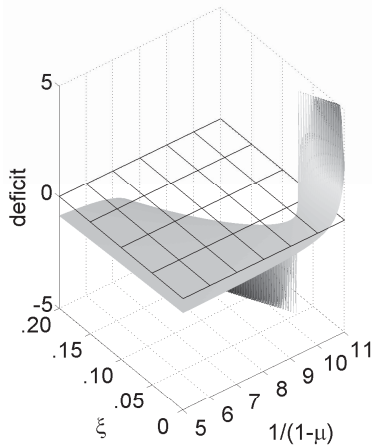
- ▶ Sensitivity of risk premium to fiscal outlook: ξ

Effect of spending cuts depends on state of the economy

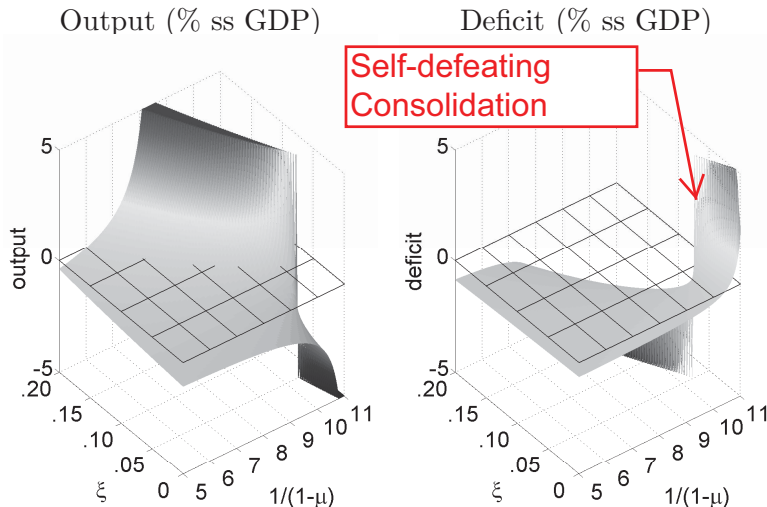
Output (% ss GDP)



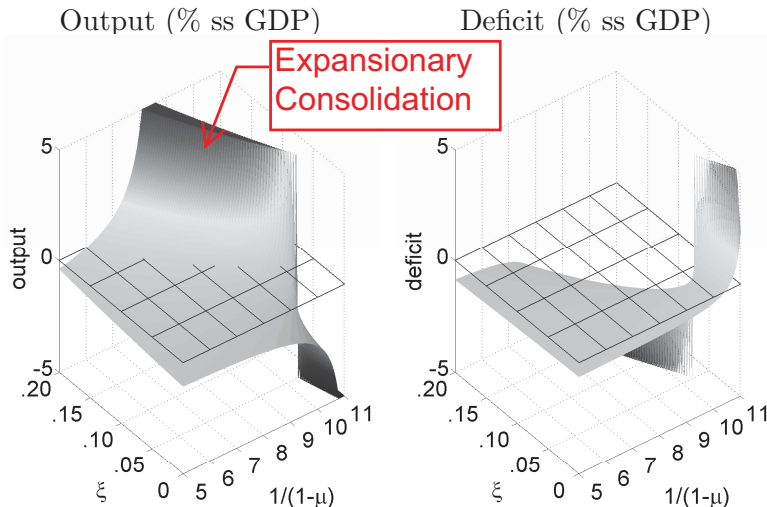
Deficit (% ss GDP)



Effect of spending cuts depends on state of the economy



Effect of spending cuts depends on state of the economy



Sovereign debt crisis alters fiscal policy transmission profoundly...

... provided that monetary policy may not contain the effects of sovereign risk on private sector borrowing

Both, “self-defeating” and “expansionary” austerity possible

- ▶ Sovereign risk channel very strong and monetary policy constrained: multiplier negative – austerity is expansionary
- ▶ Sovereign risk channel weaker and monetary policy constrained: multiplier large – austerity is self-defeating

Financial assistance in a monetary union

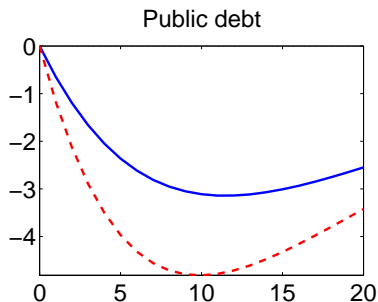
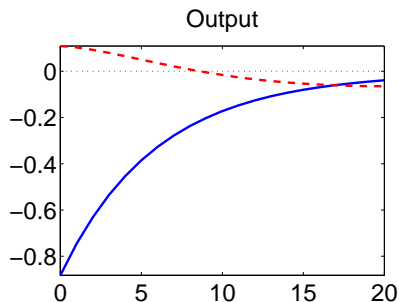
Fixed exchange rate arrangement such as EMU

- ▶ Constraints on monetary policy, but multiplier limited (Corsetti/Kuester/Müller)
- ▶ Sovereign debt crisis may change sign of the multiplier such that austerity is expansionary

ESM/ECB-style intervention which puts a ceiling on sovereign risk may be effective in eliminating the sovereign risk channel

- ▶ Multiplier positive, but austerity unlikely to be self-defeating

Austerity in member country of currency union **with sovereign risk channel** and without (preliminary result)



- Public debt declines even in the absence of sovereign risk channel (“financial assistance”)

Final remark

In principle, austerity can be self-defeating

- ▶ Government spending multiplier can be large if monetary policy constrained by the zero lower bound

Sovereign risk channel emerges as a result of sovereign debt crisis; provides a rationale for pro-cyclical stance

- ▶ May help anchoring expectations
- ▶ Multiplier tends to decline

Final remark

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Fiscal stance in Europe about right