



Fiscal Rules, Policy and Macroeconomic Stabilization in the euro area

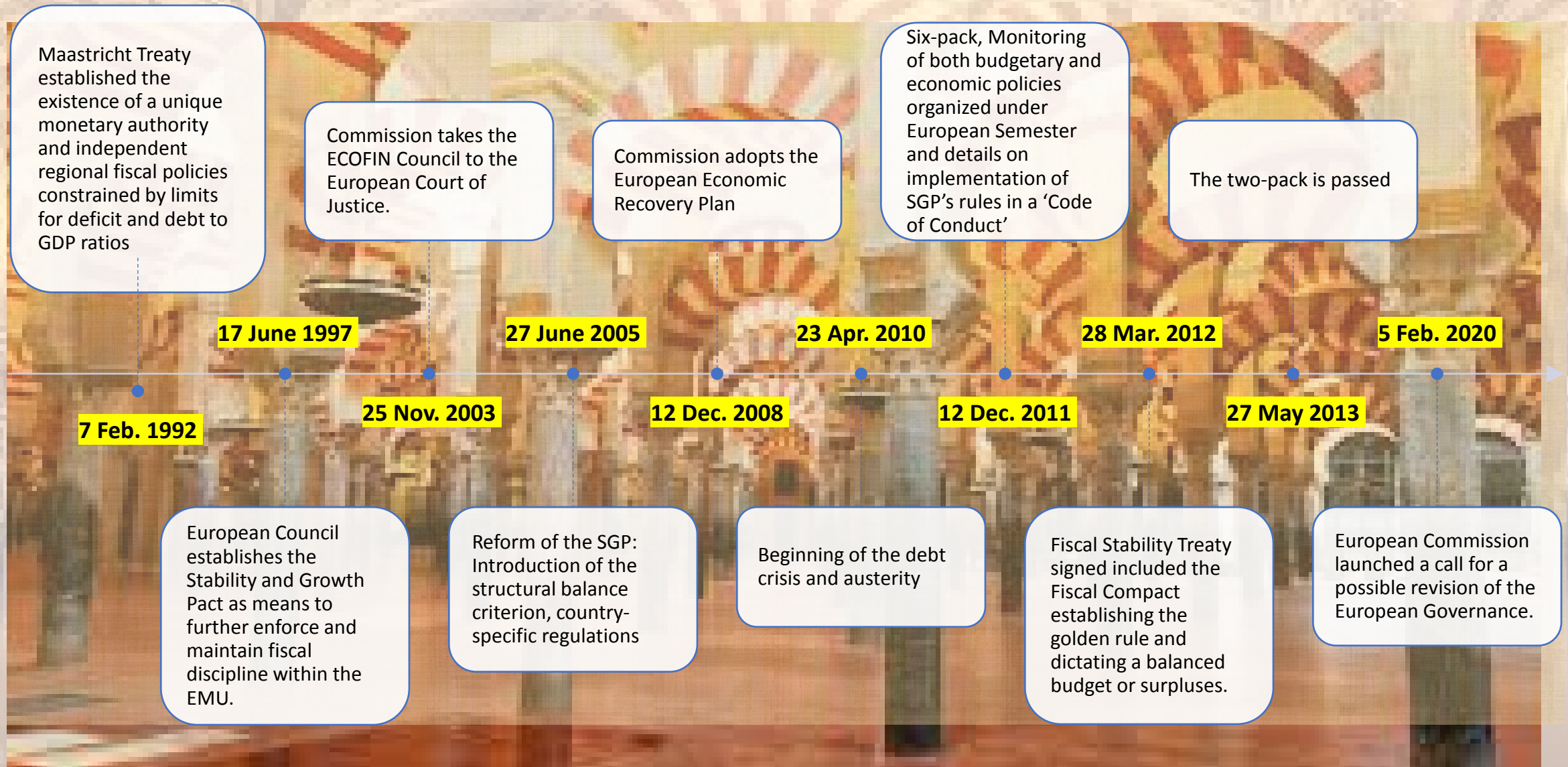
Evi Pappa

Universidad Carlos III de Madrid and
CEPR



The abduction of Europe, National Museum of Beirut, city of Byblos (Lebanon) 3rd century AD.

The Fiscal Framework evolution 1992:2020



Reforming the Pact

- European Fiscal Board (2020) suggests:
- **Permanent central fiscal capacity to address large exogenous shocks**
- **Simplification of EU Fiscal Framework:**
 - I. A differentiated debt anchor adaptable in the medium run
 - II. A single operational expenditure rule laying down credible, country-specific adjustment speeds to reach the debt anchor
 - III. General escape clause, to be activated on basis of *independent* analysis and advice.
- **Protection of growth-enhancing expenditure**

Reforming the Pact

- EFB took notice of previous proposals (Debrun et al. (2018), Bénassy-Quéré et al. (2018)- “7+7 Franco-German economists”, Darvas et al. (2018), Arnold et al. (IMF, 2018), De Grauwe (2013), and many others!)
- Suggested debt rule simple and easy to implement
- Framework recognizes limitation of one-size-fits-all and allows for differentiation depending on countries’ needs and capacities
- Flexibility to reduce the use of sanctions, or exemptions, and, hence reduce policy uncertainty
- Expenditure rule has optimal features – induces countercyclical deficits
- Central fiscal authority proved necessary during the last two crises
- Given that the access to the central capacity funds will be conditioned on fiscal discipline, no free-riding
- Growth-enhancing expenditure typically crowded out in consolidation periods, need of effective shield for this kind of expenditure in the future.

Daring
suggestion:

Some
house
cleaning
with the
reform:

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- Achille's heel of Europe's financial markets is the high level and risky nature of (national) government debt
 - Will growth-enhancing policies be enough?
 - What about debt restructuring by the ECB/ESM on *all* countries' debt?
(PADRE plan, Pâris and Wyplosz (2014), Vihriälä (2020))

With monetary policy tight at the zero lower bound, we need a new hero:

Discretionary Fiscal Policy



Ulixes mosaic at the Bardo Museum in Tunis, Tunisia. 2nd century AD.

The fiscal multiplier

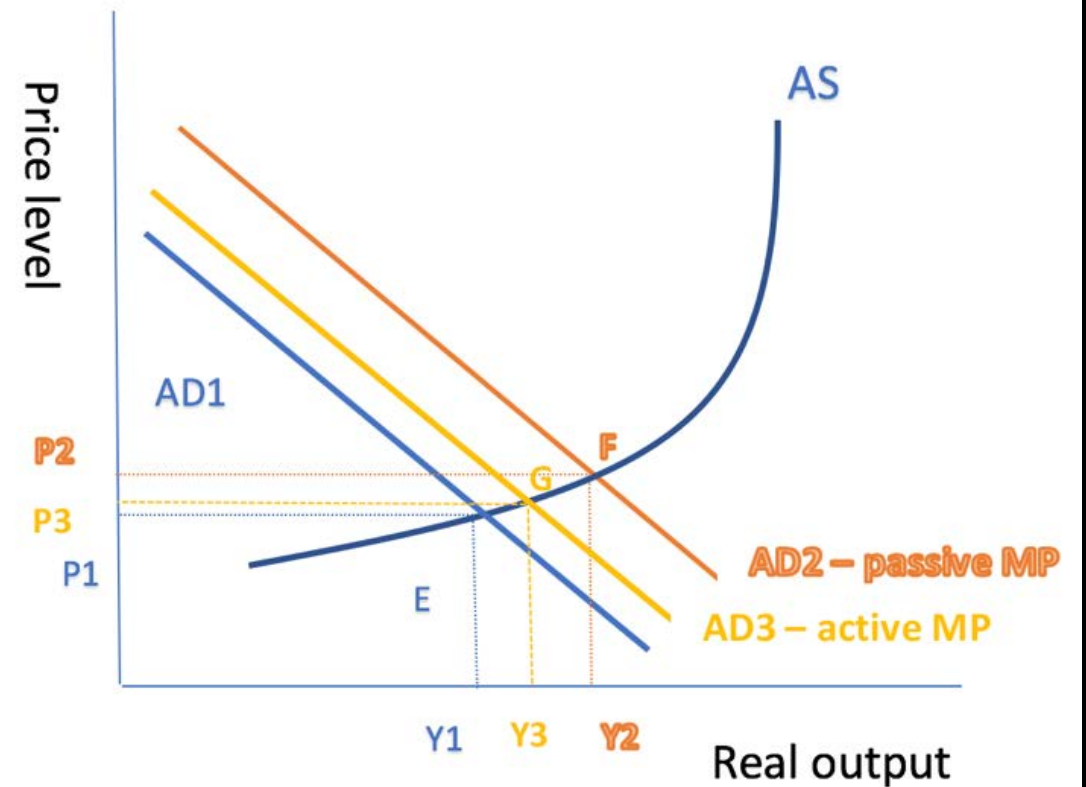
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- The fiscal multiplier: how much one euro of spending increases translates in terms of GDP increases.
 - No unique fiscal multiplier, effects of fiscal policy depend on:
 - The tool used for the government expansion;
 - The persistence of the fiscal change;
 - The level of the country debt;
 - The fiscal policy financing;
 - The implementation lags;
 - The monetary policy stance;
 - The state of the economy;
 - Uncertainty, consumer confidence, etc.
- The literature on this topic is ever growing.

Good news, in general, estimated general spending multipliers are positive => substantial amount of government spending can still help lift the economy out of a severe recession.

Fiscal and Monetary policy interactions at the ZLB

Theory: Christiano et. al (2011), Canova and Pappa (2011), Eggertson (2011), Woodford (2011), Coenen et. al (2011), Blanchard et al. (2017), Farhi and Werning (2016), and Leeper et.al (2017)

Empirics: Miyamoto et al. (2018) **multipliers [1.5, 2.5]**
Ramey and Zubairy (2018) multipliers around 1.5 for historical samples in the US.

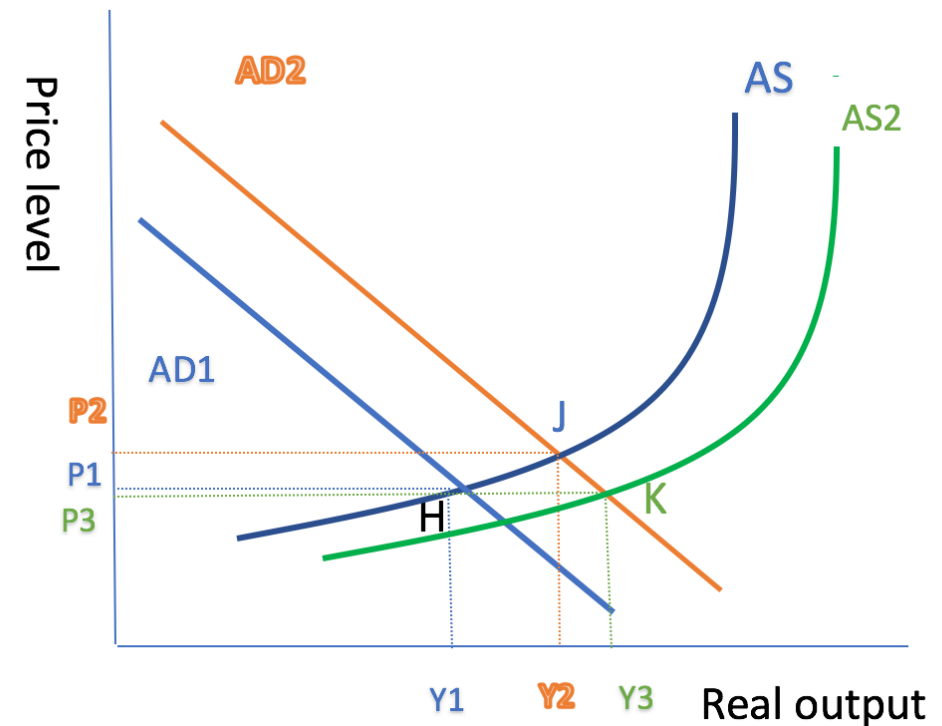


Words of caution

- **Mind the debt**: Trade-off between active use of a fiscal expansion and risk of triggering unsustainable public debt dynamics is of key importance (Blanchard 2019). Ilzetzki et al. (2013), Nickel and Tudyka (2014) and Fotiou et al. (2020) present evidence that fiscal multipliers are lower, or even turn negative, in countries with high debt-to-GDP levels.
- **Low confidence**: Mertens and Ravn (2014) if liquidity trap induced by loss in confidence, demand stimulating policies become less effective. Demand stimulus leads agents to believe that things are even worse than they thought. In contrast, supply side policies, such as cuts in labor income taxes, lead to relative optimism and become more powerful.
- **Uncertainty** might reduce fiscal impact. Basu and Bundick (2017) and Fernandez-Villaverde et al. (2011)) agents respond moderately to positive policy stimuli because they adopt a wait-and-see or precautionary behavior. Alloza (2017) and Bertolotti and Marcellino (2019) provide empirical evidence.

Government investment: consensus on high long-run multiplier, debate on short-run effects

- Aschauer (1982 and 1989), public capital is productive
- Ramey (2020) positive long-run effects of infrastructure investment, but short run effects ambiguous.
- Pappa (2009) increases in government investment increase output persistently
- Leeper et al. (2010) Time to build might render short-run multiplier negative
- Boehm (2020) crowding out of private investment in the short-run



What are the likely macroeconomic effects of the EU Recovery plan?

Canova and Pappa (2020)

- The kind of fiscal expansion of NGEU fund is not unprecedented
 - Provide evidence on the dynamic macroeconomic effects of structural funds that the EU granted to member states (and regions) over the last 30 years.
 - Analysis based on 314 European NUTS2 units between 1980 and 2017
- **Regional development fund (ERDF)**
 - Innovation and research;
 - The digital agenda;
 - Support for small and medium-sized enterprises (SMEs);
 - The low-carbon economy.
 - **European social fund (ESF)**
 - Investment in Education
 - Health
 - Projects fighting poverty

The econometric model

- Local projections:

$$y_{i,t,h} = a_{i,h} + b_{i,h}y_{i,t-1,h} + c_{i,h}x_{i,t,h} + e_{i,t,h}$$

where i refers to region, t to time and h to region and

$$y_{i,t,h} = \sum_{j=1}^h \frac{Y_{i,t+h-1} - Y_{i,t-1}}{Y_{i,t-1}} \text{ and } x_{i,t,h} = \sum_{j=1}^h \frac{G_{i,t+h-1} - G_{i,t-1}}{GVA_{i,t-1}}$$

The instrumental variable regression:

$$x_{i,t,h} = \alpha_{i,h} + \beta_{i,h}w_{t,h} + u_{i,t,h}$$

where $w_{t,h}$ are aggregate Euro area variables: GDP, employment, GDP deflator, nominal interest rate, and nominal effective exchange rate.

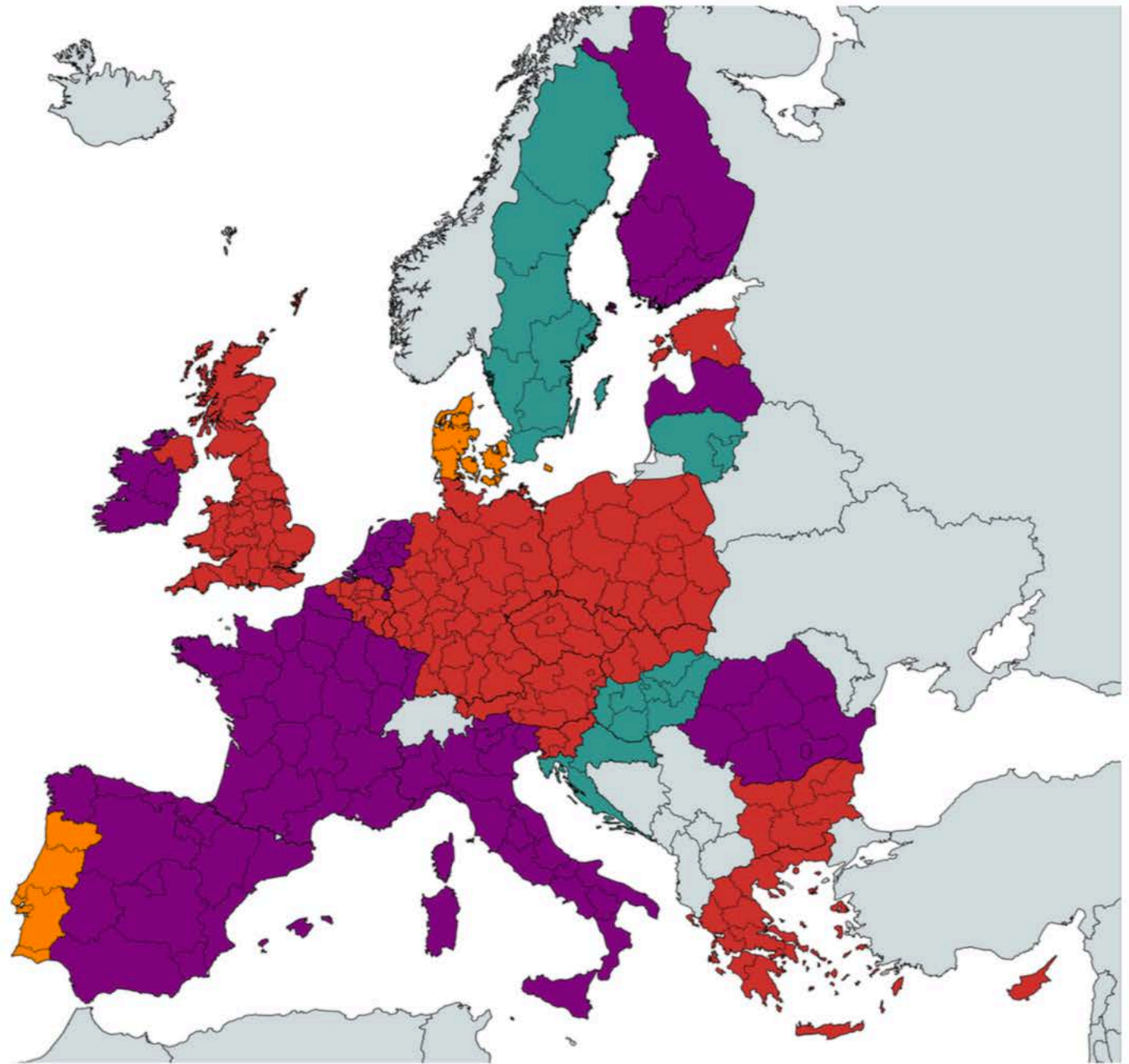
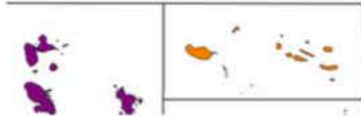
Average Cumulative Multipliers from European Structural and Investment funds

Macroeconomic variables,	ERDF funds			ESF funds		
	1 year	2 years	3 years	1 year	2 years	3 years
GVA	2.42 (0.19)	1.56 (0.32)	0.56 (0.32)	-0.14 (0.63)	2.70 (0.79)	5.05 (0.82)
Employment	0.86 (0.15)	-0.03 (0.27)	-0.42 (0.29)	-0.33 (0.23)	-0.62 (0.34)	0.96 (0.36)
Investment	8.07 (1.71)	0.53 (2.68)	-1.40 (2.69)	2.13 (1.65)	2.75 (1.63)	3.58 (1.88)
Labor productivity	3.66 (0.37)	-3.65 (0.78)	-4.45 (0.75)	4.09 (0.70)	0.22 (0.83)	3.26 (0.85)
Real Compensation	3.85 (0.36)	-2.62 (0.85)	-4.50 (0.84)	2.95 (0.32)	-1.54 (0.62)	4.54 (0.69)

- ERDF funds have an important positive short-term effect
- ESF funds have positive and sizeable medium-term impact

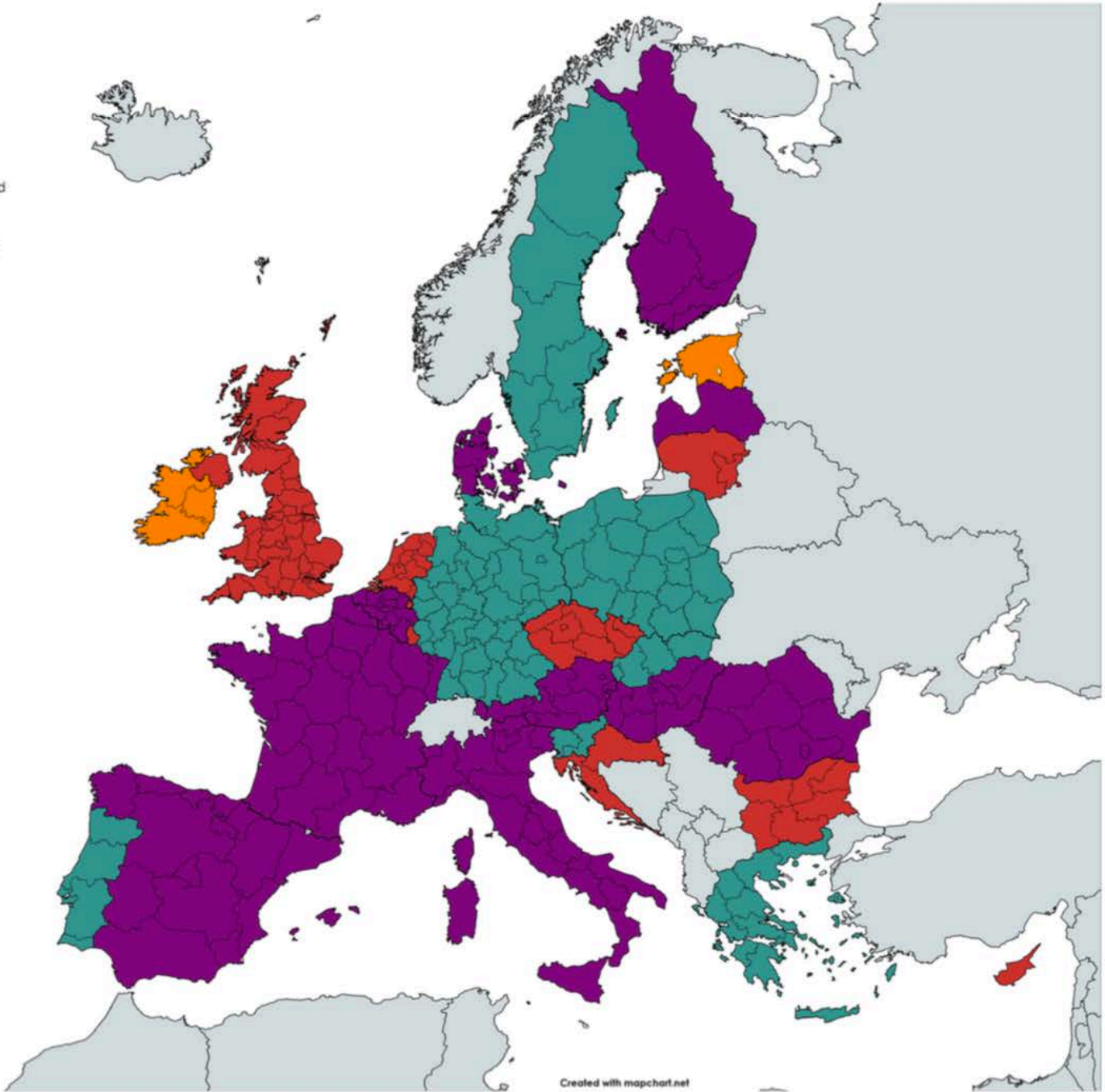
ERDF funds

- 3 years GVA and employment multipliers negative
- 3 years GVA multiplier negative, 3 years employment multiplier positive
- 3 years GVA multiplier positive, 3 years employment multiplier negative
- 3 years GVA and employment multipliers positive



ESF funds

- 3 years GVA and employment multipliers negative
- 3 years GVA multiplier negative and 3 years employment multiplier positive
- 3 years GVA multiplier positive and 3 years employment multiplier negative
- 3 years GVA and employment multipliers positive



Summing up

- The NGEU funds have a high probability of success on average.
- The current recession may be effectively contrasted by an appropriate combination of grants and loans, for both short-run stabilization (through ERDF) and medium run growth (through ESF).
- Historical evidence suggests that the new funds will *not* have uniform regional effects, nor help to catch up those who currently lag most behind. They have to be combined with specific catchup measures.
- The threat that regional inequalities will increase, and that growth and debt disparities might emerge is real.

Magnanimous Fiscal policy can work!

With caution on:

- The instruments used and the policy objective,
- Debt accumulation
- Consumers sentiment and degree of uncertainty
- Possible effects on regional disparities

Mosaic floor (detail), villa in the countryside of Antioch. Hatay Archaeological Museum, 5th century AD.