

## COMMENTS ON SESSION 2 FISCAL IMPULSE

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In this session on Fiscal Impulse it is my task to discuss the two papers “Fiscal Policy and Macroeconomic Stability: New Evidence and Policy Implications”, written by Xavier Debrun and Radhicka Kapoor, and “Fiscal Stabilisation Plans and the Outlook for the World Economy” by Patrick van Brusselen. Before I comment on the two papers, I will make three short remarks. A first remark on the definition of fiscal impulse, a second on the fundamental macroeconomic modelling the analyses in the two papers build on, and a last remark on the data used in the two papers.

### **Definition of fiscal impulse and fiscal impact**

What is the definition of *fiscal impulse* and how do we distinguish between *fiscal impulse* and *fiscal impact* (*effects of fiscal policies*)? In the organisations *Interim Economic Outlook* in March 2009, the OECD made an attempt to measure the fiscal impulses member state governments implemented following in the wake of the economic and financial crises. The OECD, in their analyses used a “down-up” approach. The method was to add policy initiatives on the expenditure and income sides of the budgets, that governments put in place to hamper the effects of the crises on growth and employment. However, these measures of fiscal impulse was also open to some criticism. It was not in all cases obvious which policy initiatives that should be included. For instance, policy initiatives that was taken before the crises, for instance in budget proposals early in the autumn 2008, and which had positive effects on growth and employment during 1009 and 2010, should they be included? This became a matter of choice. An alternative way to measure fiscal impulse could be to use a “top-down” method by measuring the effect on structural budget balances of single fiscal instruments or packages.

The *impact* or *effect* of fiscal policies, on the other hand, are the effects a certain fiscal impulse has on GDP or other macroeconomic variables. Such effects could be measured either by econometric methods or by using macroeconomic simulation models. As I see it, the two papers by Debrun and Kapoor and by Van Brusselen more analyse fiscal impact of fiscal policies than fiscal impulse.

### **Macroeconomic framework**

Both papers lean on *best practices* concerning macroeconomic modelling, the *New Neoclassical Synthesis*. These models, for instance highly sophisticated Dynamic Stochastic General Equilibrium models, combine general equilibrium logics with Keynesian rigidities. An important feature is that market forces tend to move model economies towards equilibrium after shocks.

In the aftermath of the recent economic and financial crises these models have been put a bit in question, although, it must be admitted, so far no comprehensive alternatives has been developed. Leijonhufvud (2009)<sup>1</sup> discusses some of these problems and he proposes that “*Within some corridor around an equilibrium time-path, the usual adaptive market mechanism would*

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<sup>1</sup> Leijonhufvud, A. (2009), “Macroeconomics and the Crisis: A Personal Appraisal”, CEPR, Policy Insight, No. 41.

*operate to coordinate activities (Models building on New Neoclassical Synthesis are adequate to use (The author's remark)). But further away from equilibrium effective demand failures would impair the systems ability to restore to a coordinated state". An interpretation and "application" of such ideas could be that in the current crises situation non-linearities are prevailing and multiple-equilibriums could materialize that could be characterised by high unemployment equilibrium.*

One such problem could be related to levels of public debts. Somewhere, there is a limit on how high debt levels could rise and still getting Keynesian effects from discretionary fiscal policy initiatives. Above a critical level, fiscal stimulus could have totally different effects compared to under that level, even effects with opposite sign. In such cases multipliers has turned non-linear.

### **Data from the great moderation period**

Data used in Debrun and Kapoor's analysis, and which is lying behind parameters in Van Brusselen's model, origins partly from the time period of the "Great moderation". It is plausible that the very deep crises will change several economic relationship, also even after new equilibrium-paths have emerged. Increased capital-costs because of on average higher risk premia and long-term interest rates could have such effects. Labour market relationships such as the Okun's law are other candidates for changes. This would also in the end influence effects of fiscal policy. It would be reasonable to be cautious in using estimates of automatic stabilisers and multipliers from earlier periods – but we have no choice. Both Debrun and Kapoor and Van Brusselen are aware of these uncertainties.

### **Comments on "Fiscal Policy and Macroeconomic Stability: New Evidence and Policy Implications" by Xavier Debrun and Radhicka Kapoor**

Having the reservations stated above in mind, it must be underlined that the paper by Debrun and Kapoor is a very competent piece of work. They analyse the empirical link between fiscal policy and macroeconomic volatility. The relationship is complex, especially related to the size of governments, the degree of development of economies and the maturity of financial markets in single economies.

The results are interesting. Debrun and Kapoor find that automatic stabilisers contributes to stability in all types of economies, but stronger so in OECD countries than in non-OECD countries. In earlier empirical work in this area this was not the result for developing countries. Credible monetary policy, and in what extent consumers have access to credit, seem to contribute to stability, according to the results. However, fiscal activism that is not related to the cycle induce cyclical volatility. Improved maturity of financial markets seems to have foster stability, especially concerning consumption.

On the issue of fiscal activism not related to the cycle it would have been interesting if some examples had been discussed. Could that result for instance refer to structural reforms that were not well timed related to the cycle? Another possibility could be policies related to the political cycle. A third possible example are initiatives implemented on the bases of forecast errors.

An interesting result is also that well formulated monetary policy frameworks are stabilising. Such frameworks are in Debrun and Kapoor's empirical analyses approximated by an index of central bank independence.

The result concerning the degree of maturity of financial markets and stability, is of course partly dependant on data from "the Great moderation" period. If this empirical analyses will be

updated in a few years from now, and with data also including the crises period after 2007, I am not so sure this result will prevail.

A possible extension of the analyses would be to test if the introduction of fiscal frameworks and independent fiscal institutions could have had stabilizing effects on economies. These types of frameworks and institutions have been more and more prevalent over the last decade. I believe it would also in the case of fiscal frameworks be possible to construct indices that could be used in the type of econometric analyses Debrun and Kapoor carries out. In construction of such indices there are of course pit falls. For instance, labelling a policy rule “expenditure cap” could have very different interpretations in different countries. Such rules could be tough or soft and of different time spans. The same goes for independent institutions for surveillance of fiscal policy. They are in different countries very different “animals”.

A very interesting result is that fiscal impulses, not systematically meant to stabilise output, undermine the benefits of central bank independence. My interpretation of this result is that it is important that fiscal policy, at least in “normal” times, paves the way for monetary policy by keeping fiscal policies prudent. This “policy mix” gives the best effect on stabilisation. I fully support Debrun and Kapoor’s conclusion that “*one practical way to do so is subject budget preparation to quantitative objectives or even binding constraints defined in terms of structural balance or expenditure ceilings.*” The successful handling of stabilisation policies in Sweden, before and during the current crises, builds on a rather strict fiscal framework.<sup>2</sup>

### **Comments on “Fiscal Stabilisation Plans and the Outlook for the World Economy” by Patrick Van Brusselen**

In his paper Van Brusselen takes a broad grip on the issue of the impact of fiscal stabilisation plans in the crises and longer run prospects of the major economies in the world. The paper starts with a competent discussion of elements underlying the concept of fiscal multipliers. Based in conventional macro theory, the size of multipliers also in extreme situations such as when credit crunch is prevailing (liquidity trap-situations), are discussed. Van Brusselen’s first conclusion, drawing on his studies of the literature, is that both monetary and fiscal policies have roles to play and that fiscal policies are more potent in “liquidity trap situations”. The task for monetary policy in such situations is to support expectations of positive inflation. His fear is that the US, the UK and the Euro area are all rapidly moving into zero interest rate and, possibly, deflation territory (page 262).

A reference to the failure of fiscal policy in Japan aimed at drawing Japan out of stagnation, should, in my view be a bit qualified. The Japanese stimulative fiscal policies in the 1990s could have been less well targeted. Well targeted public investments and tax reforms could have shown to have been more effective.

On optimal designs of fiscal stabilisation programmes Van Brusselen states that in situations of deep crises, fiscal policies has a role to play to prop up demand. The famous three Ts are the principles to obey to in such cases. Two comments: To begin with, it seems that most governments introduced fiscal stimulus in a timely fashion in 2008/2009, but when it now comes to exit from the stimulus uncertainties make timing and sequencing problematic. Secondly, in many stimulus packages there are elements of permanent measure. This goes especially for tax cuts, which could

<sup>2</sup> For description and discussion of the Swedish fiscal framework, see Hansson-Brusewitz, U. and Y. Lindh (2005), “Expenditure Ceilings and Fiscal Policy – Swedish Experiences”, in *Public Expenditure*, proceedings of the 7<sup>th</sup> Banca d’Italia’s workshop on Public Finances, and Lindh, Y. and G. Ljungman (2007), “Fiscal Rules and Scope for Stabilisation Policy – The Case of Sweden”, in *Fiscal Policy: Current Issues and Challenges*, proceedings of the 9<sup>th</sup> Banca d’Italia’s workshop on Public Finances.

be expected to have more of longer term efficiency gains compared to temporary stimulation effects. In the aftermath of the crises it will be interesting to see research on the effects of such measures. Could such measures for instance improve growth rates in the up-turn after the crises?

Van Brusselen's conclusion in this part of the paper is that fiscal packages should be tailored to individual countries depending for instance on conditions such as openness of economies and of initial government debt levels. Such conditions give different room for manoeuvre for governments. This conclusion could only be supported, but it should be added that some coordination in time between countries policies could strengthening the impact of the packages. It must also be added that in some really severe cases, governments must stick to tough, transparent convergence plans, even if basic conditions change. Such examples are Sweden in the 1990s and Greece today.

On the evaluation of the sizes of fiscal multipliers Van Brusselen carries out a very comprehensive overview. He reports on attempts both with what he calls "the narrative record evaluation" which I interpret as "down-up" methods where discretionary and automatic measures are aggregated separately and than together. Other methods are estimations of VAR-models and lastly, simulations by using macroeconomic models and especially DSGE and other general equilibrium models.

In a large part of the paper Van Brusselen reports simulation results carried out with the NIME model, a world model grounded in the "New Neoclassical Synthesis". By using this model Van Brusselen evaluates the size of multipliers in the euro area, effects of fiscal plans in the euro area and in the US and presents macro economic projections for the major world economies up to 2018. This is an impressive piece of work.

However, although the NIME-model is presented in detail in earlier documentations, as a reader I would have appreciated some more of technical descriptions of the model also in this paper, for instance in a technical appendix. That could have made the interpretation of the results a bit easier for the reader. For the analyses of effects of fiscal policies it is important how a model handles variables and relationships such as monetary policy targets and reaction functions, exchange rate/trade elasticities, liquidity constraints, production functions and formation of expectations. These matters are not much discussed in the paper.

Van Brusselen uses the NIME-model for simulations of the effects of the stimulation packages in the Euro area and in the US for the short and medium terms (up to 2015). The results are interesting. In the euro area, there is a positive effect on GDP, compared to a base line scenario, although this effect fades away after some years. Employment, however, decreases somewhat towards the end of the period, which seems to more or less counteract the positive effects in the first years. The fiscal position deteriorates compared to baseline and so does current account. In my view these are reasonable results and points to the need to rise potential output growth in Europe by structural reforms.

For the US, the policy package induce a more negative effect compared to base line than the results for Euro area. However, budget deficits and current account develops closer to base line. In a comparison it is shown that the NIME model gives a somewhat more negative growth path than that projected by the CBO in the US. As Van Brusselen points out, this shows that there are great uncertainty about the results. Not least the different measures of multipliers that are used.

In simulations for the longer term (up to 2018) Van Brusselen finds that the Euro area's growth prospects are bleak (approximately 1 percent per annum), inflation will be positive but low (1 per cent) and public debt will reach almost 130 per cent of GDP. For the US growth prospects are better (approximately 2 per cent), but this is lower than in recent history. The most striking result is the very low inflation in the US, almost close to zero. This seems to be an affect of

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increased unemployment, and fall in real private take-home wage. At the same time public debt is projected to reach over 140 per cent of GDP in 2018, but the current account deficit shows a stable path. Policies to avoid these development are of course necessary in both the Euro area and in the US.

In the end of the paper Van Brusselen discusses in an interesting way a range of uncertainties around his results. Uncertainties are related to the timing of exit strategies, to adjustments of balance sheets of banks, households and firms and to possible protectionism. Uncertainties are also related to which economy will be the growth engine of the world economy in the coming years and related to that, to demand policies in the large economies, also to the development of international coordination, to the effects implementation of stricter financial regulations and not least to the development of future potential output in our economies. It is difficult not to support the author on all these uncertainties and also that we are living in a very uncertain phase of economic development of the world economy.

