COMMENTS ON SESSION 1
THE SHORT-TERM IMPACT OF FISCAL POLICY

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First of all, I would like to thank our host for the excellent organisation of this event and the lavish supply of food for thought. As in past years, the variety of insights presented and the breadth of items discussed has provided us all with an intellectually enriching atmosphere. I have been invited to discuss two papers from the first session: "Fiscal Consolidation in the Midst of the Crisis: Lessons from Latvia", by Francesco Di Comite, Gabriele Giudice, Julia Lendvai and Ingrid Toming, and "Fiscal Adjustment, Job Creation, Job Destruction" by Alfonso Arpaia and Alessandro Turrini. However, I will focus primarily on just one of them, namely Di Comite *et al.*'s paper about the short-term impact on growth of the huge fiscal consolidation package that was implemented in Latvia in mid-2009.

The first session of this workshop revisited the long-standing discussions about the short-term impact of fiscal policy on growth. In our most recent discussion in 2010, we dealt with the issue of whether EU-coordinated fiscal stimulus packages (alongside an expansive monetary policy) would have short- and medium-term growth-enhancing effects. This time, however, the discussion centred on the growth impact of indispensable fiscal adjustment measures in response to – in some cases, exceedingly – worrisome fiscal developments. Budget deficits and government debts have soared in nearly all advanced countries on account of the economic crisis and unprecedented fiscal measures taken to limit demand shortfalls and support the financial sector. The rapid worsening of public finances in some countries, notably Latvia, Hungary, Greece, Ireland and Portugal, has resulted in rapidly rising financing costs, as investors have lost confidence in the countries' ability to service their debt. In many cases, international and/or supranational financial assistance measures have become necessary. As investors' trust has waned, fiscal policymakers have been faced with the enormous challenge of finding ways to mitigate the problems.

What can be done in the face of unsustainable deficit and debt developments and rapidly rising financing costs, coupled with a weak macroeconomic environment at risk of falling back into recession, is "a matter of bitter controversy" (see Perotti, 2011) – as has also been observed in recent debates about finding effective solutions to the European debt crisis.

According to traditional Keynesian views, fiscal adjustment measures typically entail short-term costs in terms of economic growth and rising unemployment – a view that recent literature on the topic tends to confirm (see also IMF, 2010). According to this paradigm, the aftermath of a recession is the worst time to start fiscal consolidation. So what then is the proper fiscal policy reaction if an undue delay of indispensable fiscal adjustments would ultimately give rise to even greater adjustment costs, as the government debt accumulated in the interim would necessitate an even greater fiscal correction later on? Above all, what are the short-term costs of fiscal consolidations pursued in a credible and consistent manner in cases where the starting position of a country is particularly precarious or when financing conditions on the markets have already become prohibitive? Could not properly designed fiscal adjustment measures in such precarious circumstances pave the way back to growth?

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Some economists – based on arguments derived from the literature on non-Keynesian fiscal effects and on “successful fiscal consolidation” – have proposed that governments should rapidly curb deficits, even if the country concerned has not yet fully recovered. If done properly, namely by reducing spending rather than by increasing taxes, and perhaps also with the support of necessary growth-stimulating structural reforms, fiscal adjustments would not be harmful; on the contrary, they might even result in a boost to GDP – although it should be stressed that there is “scarce” empirical evidence to support this view.

Di Comite *et al.* found that non-Keynesian fiscal effects have emerged in Latvia. They investigated the economic impact of the huge fiscal consolidation package that Latvia had had to implement in 2009 and called for lessons to be learned from that experience. The global economic and financial crisis had hit Latvia comparatively hard. Like Estonia and Lithuania, Latvia had become increasingly vulnerable already before the crisis due to a gradually overheating economy caused by huge booms in credit, construction and housing, and consumption, accompanied by high or steadily rising current account deficits and external debts. In addition, the high private sector net external debt was held in foreign currencies.[1] Even before the onset of the crisis, it was already clear that these imbalances would have to be corrected; however, the start of the crisis simply amplified the magnitude of correction. When the crisis unfolded, Latvia experienced the sharpest GDP contradiction of all countries worldwide. The country even had to ask for international help to stave off possible insolvency. However, Latvia managed to resist giving up its fixed exchange rate peg to the euro.

In the middle of 2009, the newly elected Latvian government implemented a second, truly sizeable consolidation package that amounted to about 15 per cent of GDP, with the bulk of the measures coming into effect immediately. The package comprised drastic expenditure cuts, including painful nominal wage cuts in both the public and private sectors. But after a few quarters, the Latvian economy had started to rebound slowly.

Growth implications of fiscal consolidations are dependent on the size and, in particular, the composition of the consolidation measures; the speed with which measures are implemented is probably also a key factor. Thus looking first at the composition of the fiscal adjustment, I would agree with Di Comite *et al.* that “the (growth-) favourable composition of the adjustment in Latvia has contained the negative effects of Keynesian fiscal multipliers”.

According to the study, the lessons to draw from this case are:

1) with respect to timing, that “a rapid response is crucial”,
2) with respect to size, that “going big can set mindsets and attitudes”,
3) with respect to composition, that it is necessary to “do it in a growth-friendly way with a priority on spending cuts”,
4) that “credible policies” are decisive,
5) and that “prudence and effective communication” are also of the essence.

In addition, I would also add “ownership, commitment and fairness” to this list of essential prerequisites.

Di Comite *et al.* concluded that the Latvian experience has shown that the trade-off between short-term pain and long-term gain can be avoided if intervention is sufficiently well-designed. The

1 The credit, housing and consumption boom was fuelled by capital inflows in the form of FDIs, portfolio investments and loans. The highly credible fixed exchange rate peg to the euro created an incentive to borrow in foreign currency; due to a rising domestic inflation, negative real interest rates pushed up demand for loans and amplified the boom. The observable rapid economic growth fuelled expectations that high growth would continue; this also encouraged people to borrow. Moreover, fiscal policy also behaved in Latvia in a highly pro-cyclical manner. Consequently, both supply and demand factors contributed to the emergence of substantial credit booms, housing booms and consumption booms and an overheated economy (see also Darvas, 2009).

hypothesis that Latvia's huge frontloaded fiscal adjustment triggered non-Keynesian effects or growth-stimulating effects is debatable, however. An antagonistic, if not sarcastic, take on this issue was expressed by Krugman: "a few more successes like this and Latvia will be back in the Stone Age";[2] in other words, the economic and social cost of Latvia's fiscal adjustment was actually very high, despite its "growth-friendly" composition.

Non-Keynesian effects would arise if GDP growth shows an immediate positive reaction to a negative fiscal shock via positively affecting consumer confidence, business confidence and/or external competitiveness. However, according to Latvijas Banka's Macroeconomic Developments Report, Latvia's GDP decreased by nearly 20 per cent (year on year) and by almost 7 per cent (quarter on quarter) in the third quarter of 2009. Gross fixed capital formation slumped by nearly 40 per cent (quarter on quarter, in real terms) in the first quarter and showed negative growth rates until the second quarter of 2010; the private consumption level shrank by more than 30 per cent between the first quarter of 2008 and the second quarter of 2009 and continued to shrink by about 3 per cent (quarter on quarter) also in the third quarter of 2009. From 2007 to 2010, Latvia's GDP fell by about 25 per cent, while unemployment rose to more than 20 per cent and poverty increased dramatically.

Household sentiment started to improve in the fourth quarter of 2009, but only at an exceptionally low level. Given this extraordinary reduction in GDP, and thus in income, the more optimistic perception of households *vis-à-vis* future developments in their budgets and the economy probably arose from a conviction that the lowest point of the economic downturn had been reached. The following development would therefore be consistent with a mean-reverting process that had started in early 2010. The "recovery" of the Latvian economy at the beginning of 2010 was actually very weak: in the third quarter of 2010, private consumption reached the same level as in the second quarter of 2009; with gross fixed capital formation, it was not until the third quarter of 2011 that it reached a level comparable with that of the second quarter of 2009. Moreover, other countries – notably some of Latvia's important trading partners – picked up in the third quarter of 2009; according to the IMF's Fifth Review Report, exports had already started to increase in the second quarter of 2009. Moreover, at the beginning of 2010, household sentiment may have been affected positively by a ruling of the Constitutional Court of the Republic of Latvia in favour of pensioners, stating that the part of the pensions that had been withheld would have to be reimbursed and that no further withholding of pensions would be allowed.

The second presentation, submitted by Arpaia and Turrini, focused on the impact of fiscal adjustment measures on job creation and job destruction and the share of long-term unemployment in high-versus-low employment protection environments. The findings were based on a dynamic panel regression for EU countries, mostly from the mid-1990s until 2009-10. The regressions were run for four different dependent variables – cyclical unemployment, job separation rates, job finding rates and long-term unemployment shares – with two different kinds of fiscal explanatory variables, namely "action-based" as opposed to "structural-based", and were run separately for countries with low employment protection and those with a high level of protection. The presentation encompassed only the bunch of regressions. The main result from the regression exercise was that the impact of fiscal adjustment on worker flows and share of long-term unemployment is different with respect to the employment protection regime. As this impact seems to be worse in countries with high levels of employment protection, the authors conclude that liberalising the labour market (*i.e.*, easing employment protection legislation), while at the same time consolidating public finance, does not need to be associated with higher unemployment; indeed it may actually mitigate the impact of consolidation on long-term unemployment.

2 See http://krugman.blogs.nytimes.com/2011/07/18/lats-of-luck/

Growth implications of employment protection regimes and labour market regulations feature strongly in the debate on EU-2020. Their interaction with fiscal adjustment measures is of primary interest to policymakers. Thus, the absence of any theoretical foundation or discussion is problematic. Given this shortcoming, the authors would be well-advised to abstain from too strong – and probably premature – policy conclusions. Furthermore, it is even more problematic to try to draw policy conclusions with respect to the intensity of employment protection legislation without taking into account their interaction with other labour market institutions, such as unemployment benefits.

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