Putting the Budget on a Sound Footing

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CBI-CEPR-IMF Conference
Dublin, January 2015

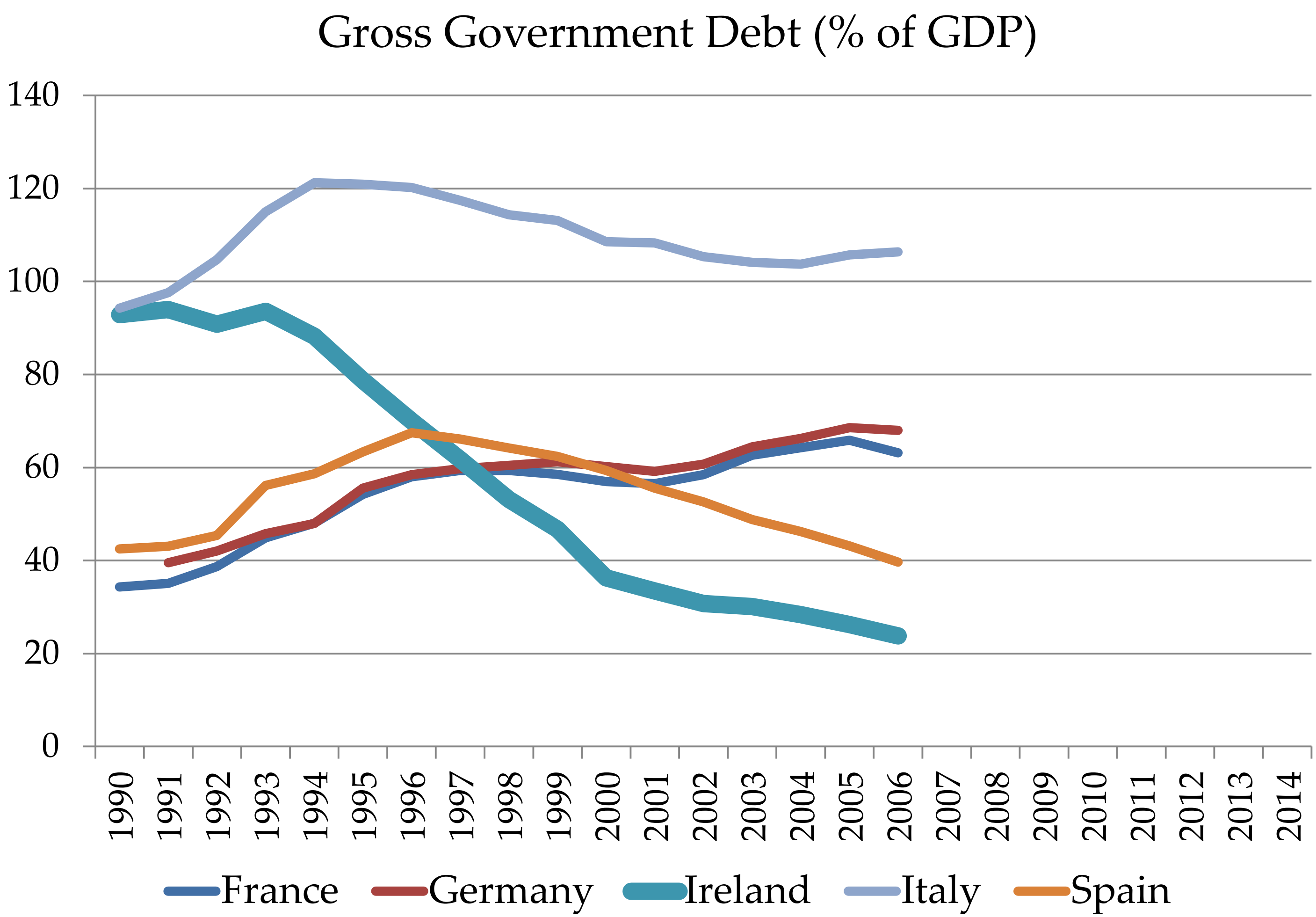
Approach of the Paper

Focus on macroeconomic aspects of fiscal consolidation.

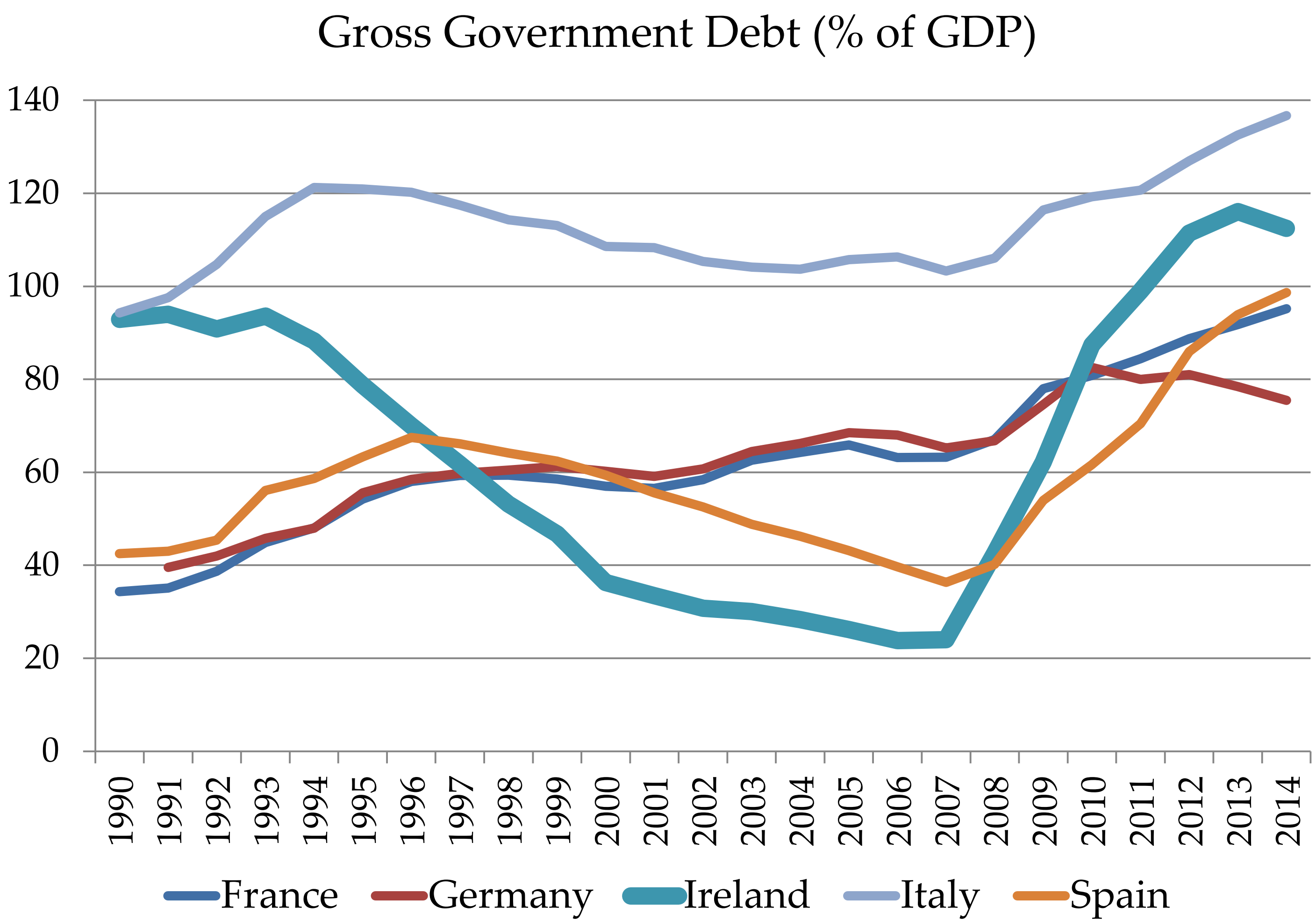
Take as given the “debt surprise” including financial support to banks.

Assuming there were options despite the difficult circumstances.

Before the Crisis



The Crisis


Gross Government Debt (% of GDP)
140
120
100
80
60
40
20
0
1990
1991
1992
1993
1994
1995
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012
2013
2014
France
Germany
Ireland
Italy
Spain

The Debt Surprise

Unexpected large, global and persistent economic crisis.

Large correction to housing market.

Support to financial institutions.

Collective inability to see the risks (in Ireland and elsewhere).

The Debt Surprise

On September 25, 2007, IMF Article IV:

“Directors commended Ireland’s sustained strong fiscal performance, and the authorities’ firm commitment to fiscal discipline.”

“…welcomed the indicators confirming the soundness of the Irish banking system, including the stress tests suggesting that cushions are adequate to cover a range of shocks even in the face of large exposures to the property market.”

How to React to a Debt Surprise

Need to adjust budgetary plans to ensure sustainability.

This might (or might not) require a significant reduction in the level of debt.

Two separate arguments:

- Adjustment in current or future spending/taxes required.
- Reduction in debt needed because it is costly.

The Costs of High Debt

Not obvious.

Pragmatic approach: target a level that is prudent.

- Ensures sustainability with primary balances that are reasonable (and politically feasible).
- Allows for next crisis shock.

EU rules set that level for Ireland.

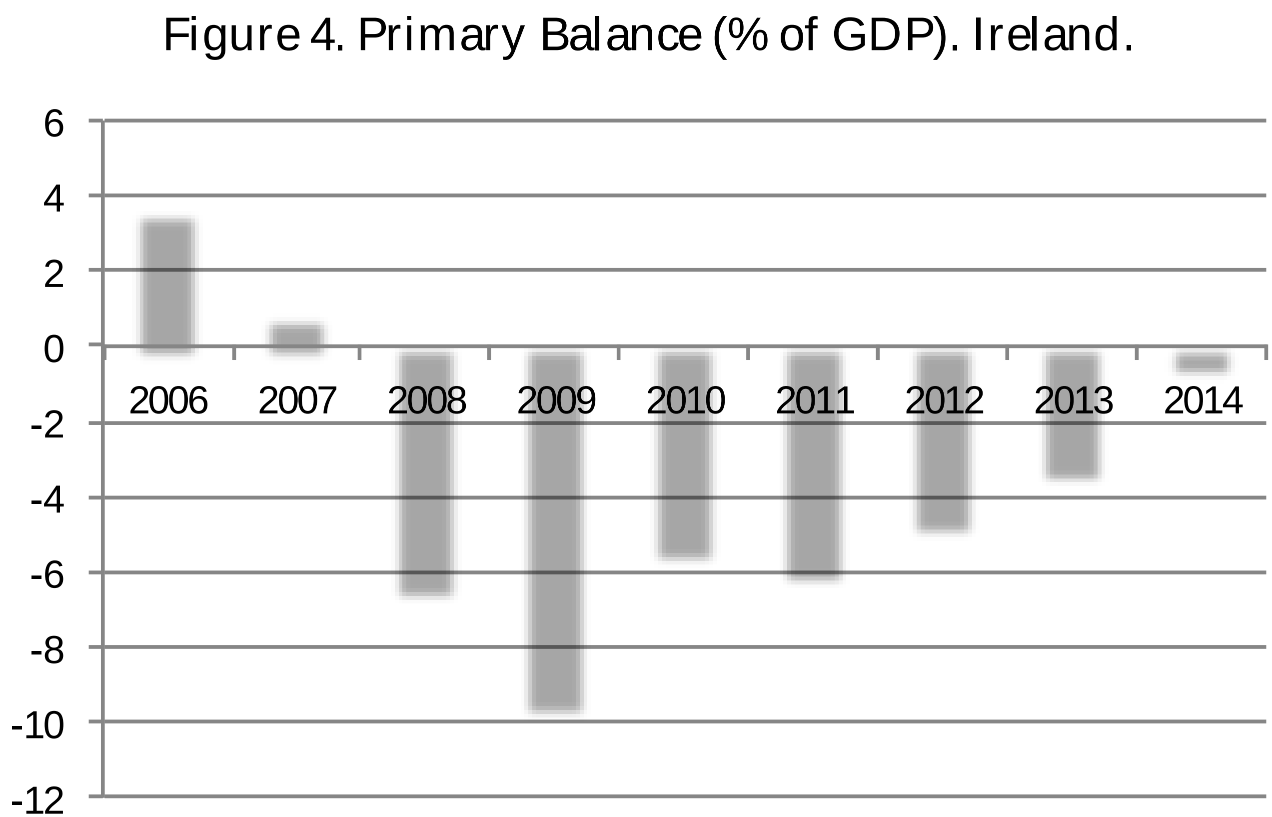
The Optimal Speed of Adjustment

Not obvious.

EU rules set an adjustment path.

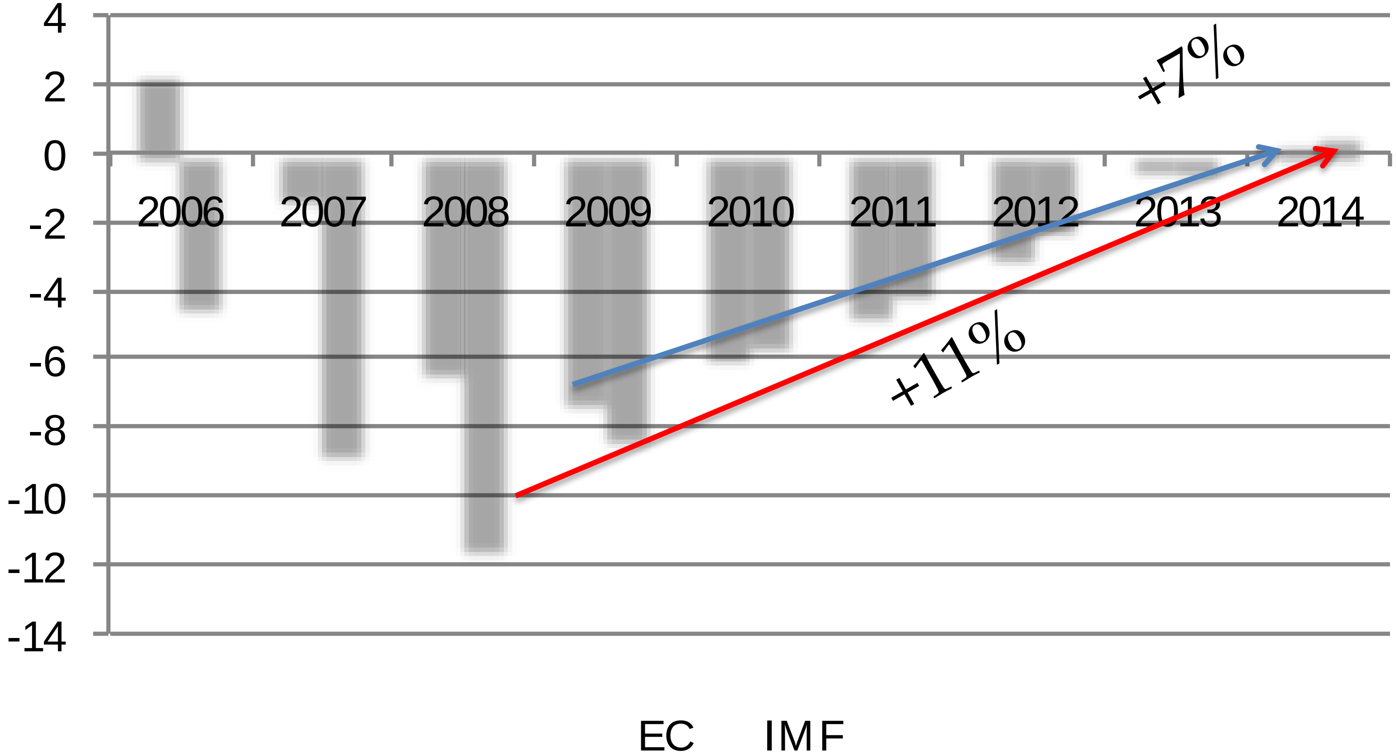
The Macroeconomic debate: How to adjust the speed of adjustment taken into account cyclical conditions?

The Speed of Adjustment



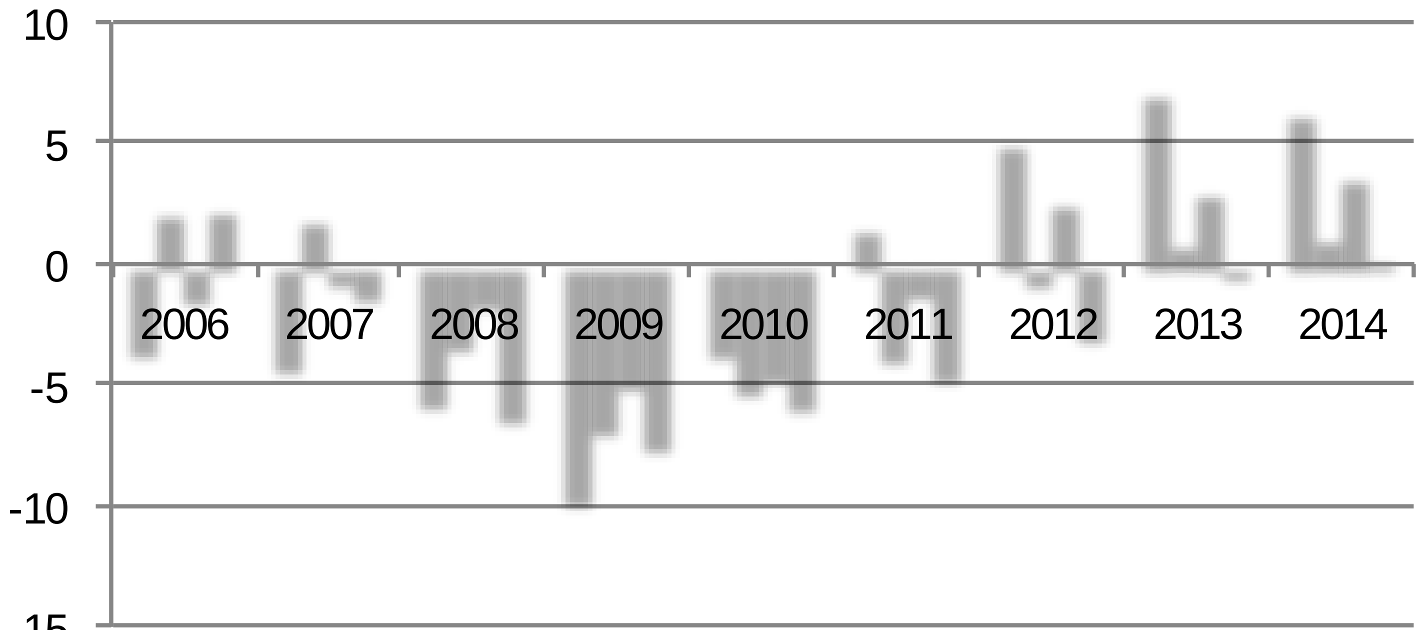
The Speed of Adjustment

Figure 5. Cyclically-Adjusted Primary Balance.



The Speed of Adjustment

Figure 7. Cyclically-Adjusted Primary Balance. Source EU.



Greece	Spain	Portugal	Ireland
+16%	+7.9%	+8.7%	+7.5%

The Speed and Composition of Adjustment

Significant reduction in structural balance. According to plan.

In par with Spain, not as large as Greece or Portugal.

Stronger reliance on government spending cuts relative to tax increases.

The Size of the Adjustment

Irish Government: About €12-15 billion in 2008-10, similar amount in 2011-2014 ≈ 20% of GDP.

Fiscal Advisory Council ≈ 18.4% of GDP

IMF ≈ 14.2% of GDP

Actual change in Structural Budget:

- IMF ≈ 11% of GDP
- EC ≈ 7% of GDP

Understanding the Size of the Adjustment

Adjustment

$$\frac{\Delta G_t}{Y^p} = \frac{G_{t+1} - G_t}{Y^p}$$

Multiplier

Impact on GDP

$$\Delta Y_t = \mu \Delta G_t$$

Marginal
Tax

Change in Budget Balance

$$\frac{\Delta B_t}{Y^p} = (1 - \mu\tau)\frac{\Delta G_t}{Y^p}$$

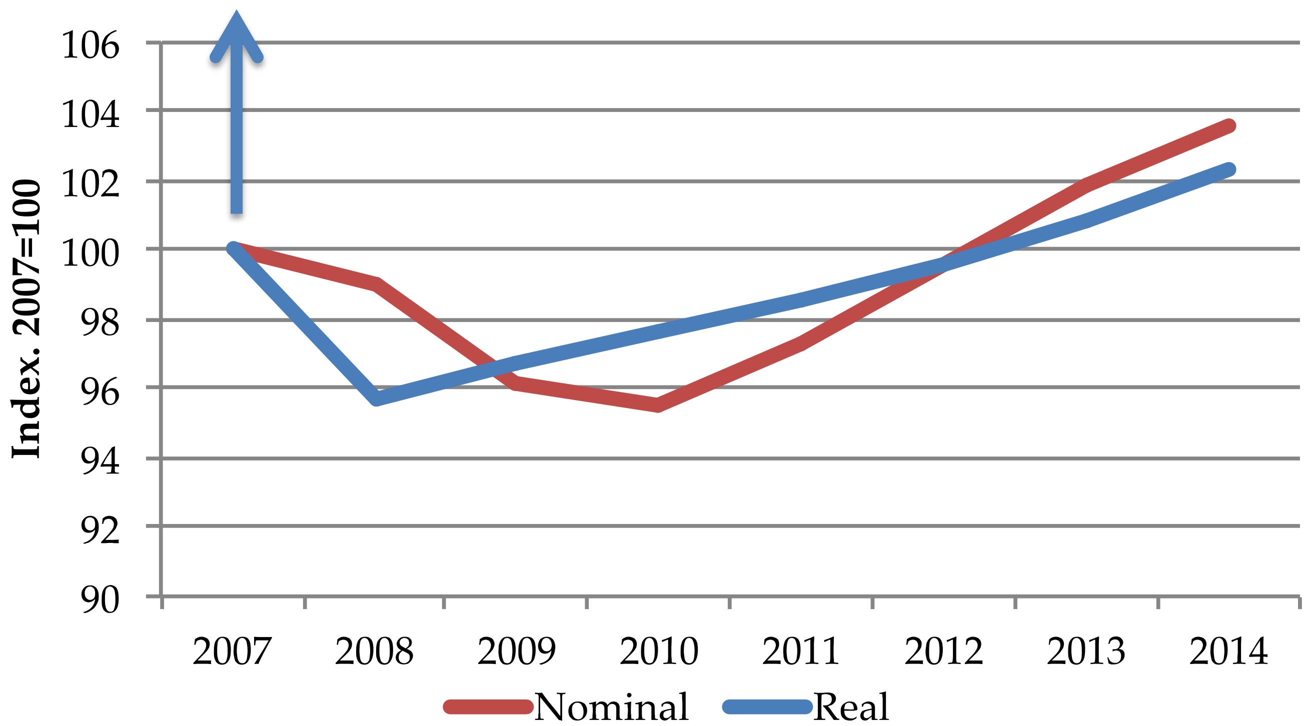
Change in CAB

$$\frac{\Delta CAB_t}{Y^p} = \frac{\Delta G_t}{Y^p}$$

This cannot be a normal cycle, potential output must be changing.

The Change in Potential Output

Figure 13. Potential Output (IMF). Ireland.



Potential Output and Fiscal Adjustment. Three Interpretations.

#1. Potential output was falling in 2008-2014. Need for adjustment kept growing. Policy was fine.

#2. Potential output did not fall as much (mismeasurement). Policy was too tight.

#3. Potential output fell as a result of the fiscal consolidation. Policy was too tight, very costly and possibly ineffective.

Can a Fiscal Contraction Affect Potential Output?

Fiscal contraction lowers output. More than what we thought (Blanchard and Leigh (2013)).

Multipliers are larger in recessions and ZLB.

Size of GDP contraction correlates with decrease in potential output across Euro countries.

Causality? Econometric evidence suggests there are permanent effects and they are large.

Can a Fiscal Contraction Affect Potential Output?

Table 1. The Effects of Fiscal Consolidations.

	Dependent Variable: Forecast Error of	
	GDP Growth	Potential
Fiscal Consolidation	-1.170**	-1.376**
	(0.437)	(0.548)
Constant	0.951**	-2.277***
	(0.439)	(0.701)
Observations	15	14
R-squared	0.550	0.406

Robust standard errors in parentheses
*** $p<0.01$, ** $p<0.05$, * $p<0.1$

Blanchard and Leigh (2013)
Multiplier = 1.67

Fatás and Summers (2014)
Permanent Multiplier = 1.376

The Permanent Effects of Fiscal Consolidation

Estimated long-term multipliers are large.

Much larger than what is needed to have a self-defeating fiscal consolidation (DeLong and Summers (2012)).

Consistent with the view that consolidation was too fast.

Consolidation should take place when multipliers are smaller.

The Road Ahead

The recipe: Long-term Fiscal sustainability + Cyclical flexibility.

Biggest concern: Our poor understanding of potential growth (and how it is affected by cyclical conditions).

Ireland fiscal crisis is the outcome of a large unexpected shock (very different from Italy).

The real risk is either another similar shock or that Ireland becomes Italy (low potential growth rate).

The Road Ahead

Reduction in debt driven by European fiscal framework.

Potential to go faster if positive growth surprises.

Criticisms of budget 2015 for not taking advantage of growth conditions. Are economic conditions back to normal?

Conclusions

Exit of crisis (as planned) and stabilization of debt is a success.

But empirical results raise concerns about speed of adjustment and the possible effect on potential output.

Current path of debt reduction sensible (…until the next large crisis).