EU fiscal rules, real-time uncertainty, and stabilization

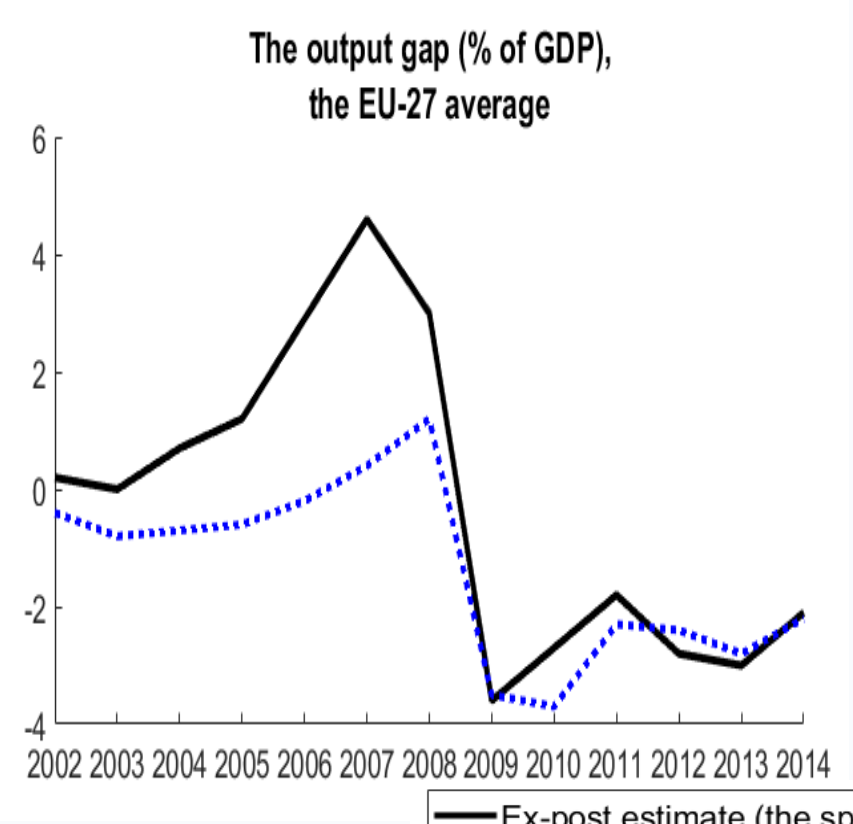
Tero Kuusi, ETLA

Firstrun project meeting, Helsinki

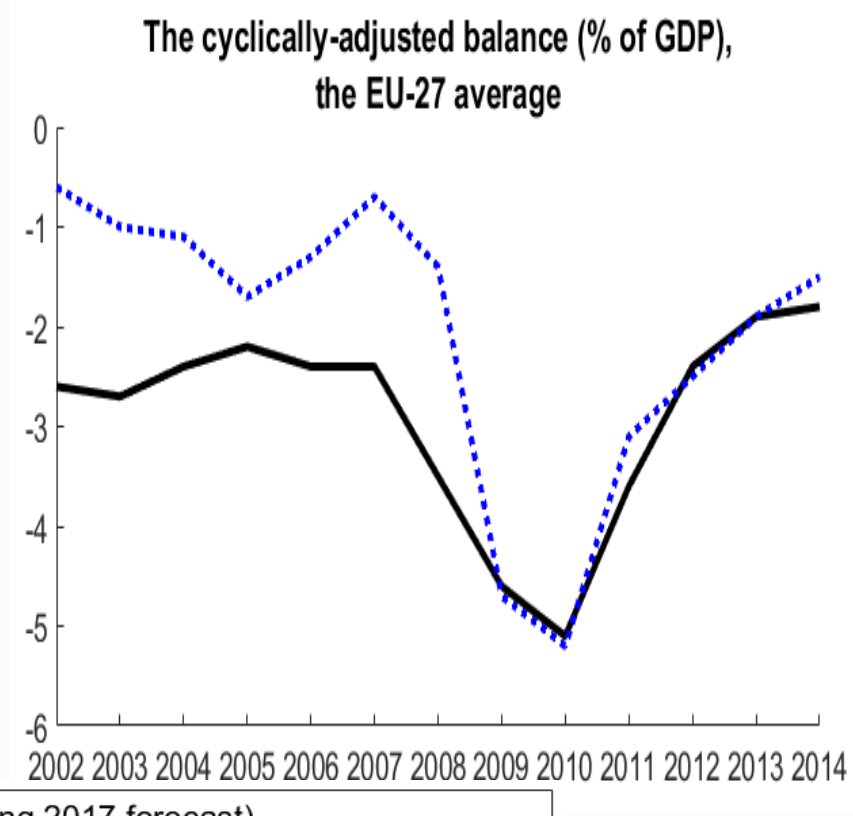
October 3, 2017

Real-time uncertainty affects the EU's key fiscal policy indicators

EC's real-time vs. ex post estimates of the output gaps.



Corresponding revisions of the cyclically-adjusted balance.



Ex-post estimate (the spring 2017 forecast)
Real-time estimate (forecasted in the autumn of the same year)

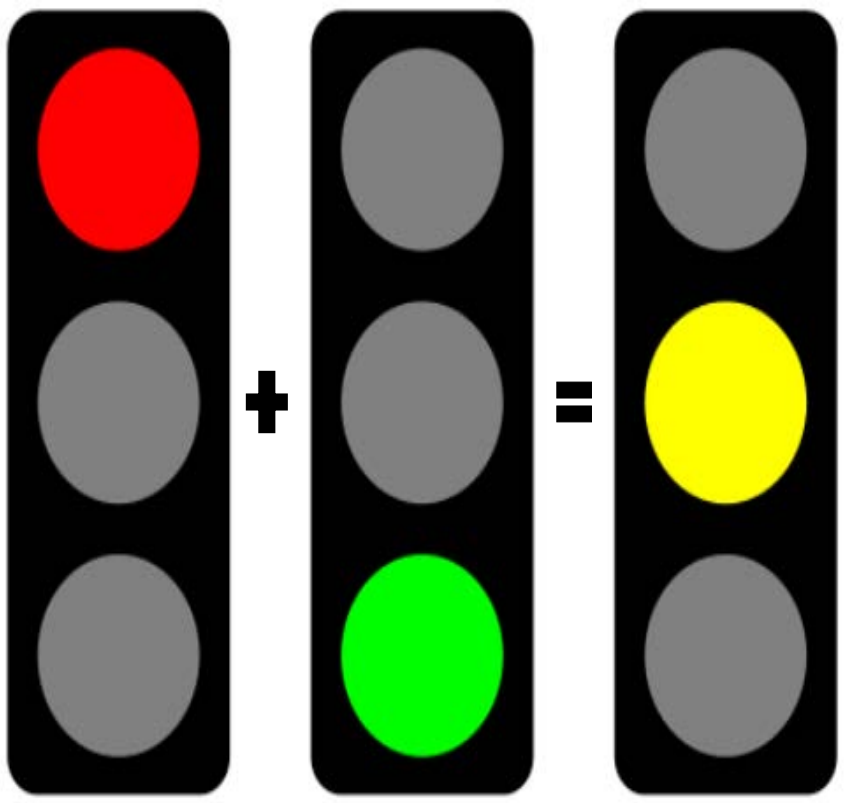
Real-time uncertainty and fiscal policy - key findings

- Cyclically-adjusted indicators less useful, less countercyclical policy, higher cost of the business cycle.
- Unavoidable problems, but some remedies:
  1. Precautionary savings
  2. the “bottom-up” fiscal indicators
  3. Anticipation of the fiscal policy feedback

Output gap uncertainty and optimal fiscal policy

- A DSGE model, policymaker makes inferences on the output gap.
- Uncertainty matched with the EU's output gap revisions.
  - Kalman filter, real-time data vintages of the Ameco dataset (2002-2017, 27 countries)
- Intuition: the permanent income hypotheses.
  - cyclical → stabilization that counters the GDP.
  - structural → adjustment to new normal in parallel with the GDP.

Policy implications

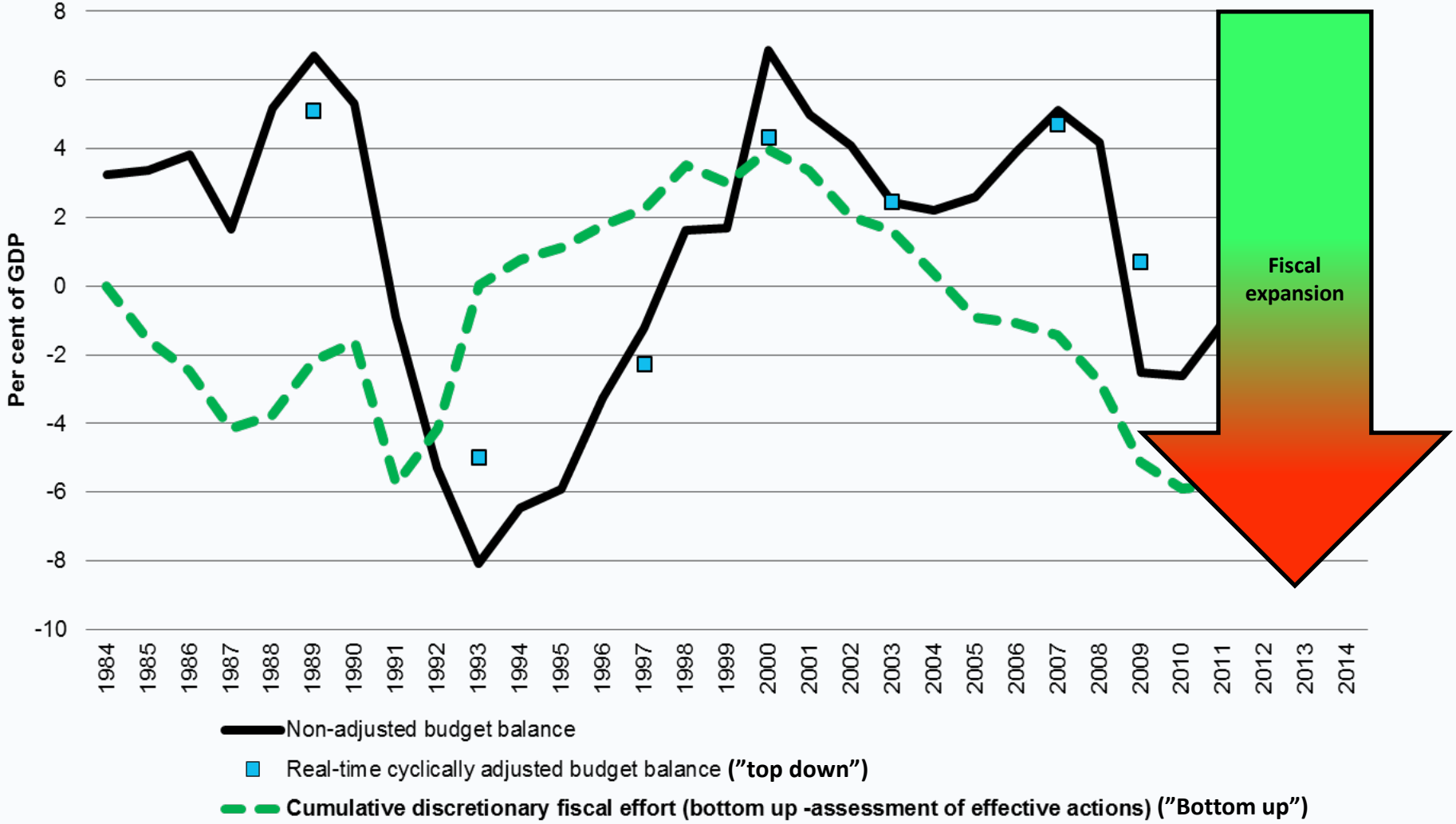


- Weak response to the cyclical indicators.
- Strong response to changes in the debt-to-GDP ratio.
- Low average net debt-to-GDP ratio.

”Bottom-up” vs.”top-down” indicators

- How useful are the EU’s alternative structural balance (SB) indicators?
  - Case Finland 1984-2014, including the Finnish Great Depression of the 1990s.
- Methodological alternatives.
  - ”Top-down”: SB based on the output gap and the elasticity of revenue and cost items (the Commission’s production function methodology).
  - ”Bottom-up”: Expenditure growth net of discretionary revenue measures (actual decisions) compared to medium-term potential GDP growth (the bottom-up measures in the SGP)

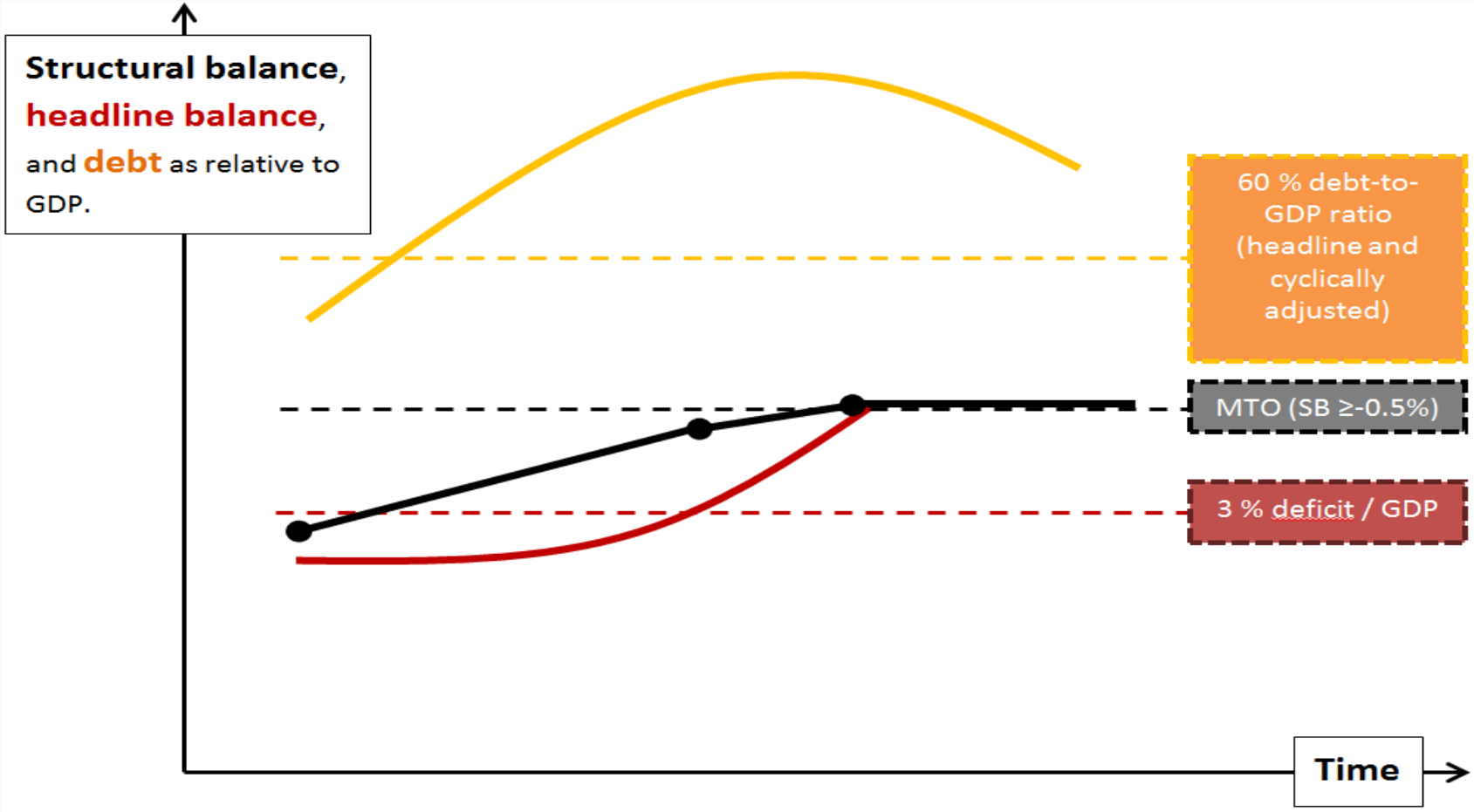
”Bottom-up” provides more countercyclical guidance



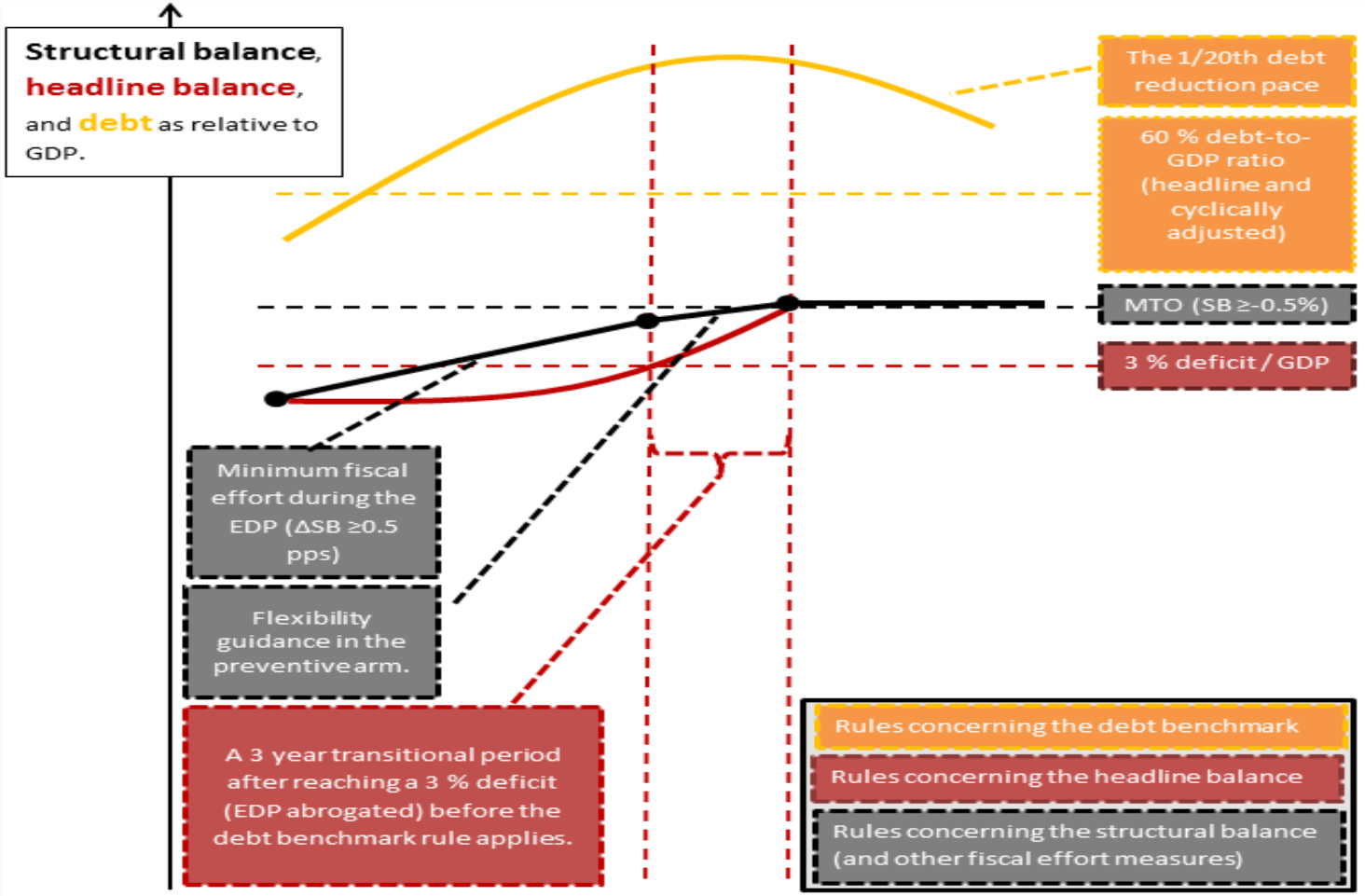
Anticipation of the fiscal policy feedback

- Setting fiscal goals that are consistent with both the EU's fiscal framework and the feedback effects.
  - Motivation: the early 2010s' optimism in the forecasts.
  - Problem: The EU's fiscal framework has multiple, long- and short-run rules and target measures.
- A novel, dynamic simulation model to quantify the constraint that the rules impose on fiscal policy during consolidations.
  - Solve for multi-year adjustment programs that minimize the need of fiscal adjustments while being compliant with the framework.
  - Takes into account fiscal multipliers.

A typical adjustment program spans over many years



The rules are considered here as dynamic constraints



Results

- Forecast revisions have a large effect on fiscal goals, and may generate policy and economic volatility.
- Initial optimistic forecasts → ambitious fiscal goals, similar to the ones in the early 2010s, and larger economic responses
- Fiscal plans reconstructed using forecasts that accounts for (downturn) fiscal multipliers → lower pace of fiscal adjustment and smaller economic responses.

Conclusions

- Under output gap uncertainty, cyclically-adjusted indicators less useful, less countercyclical policy, higher cost of the business cycle.
- Unavoidable problems, but some remedies:
  1. Precautionary savings
  2. The “bottom-up” fiscal indicators
  3. Anticipation of the fiscal policy feedback

Thank you for your attention!

More details:

The optimal fiscal policy.

- Kuusi (2017): Output gap uncertainty and the optimal fiscal policy in the EU. Firstrun deliverable 2.7.

The EU's alternative fiscal indicators.

- Kuusi (2017): Does the structural budget balance guide fiscal policy pro-cyclically? Evidence from the Finnish Great Depression of the 1990s. The National Institute Economic Review, No. 239.

The design of EU's medium-term fiscal plans.

- Kuusi (2017): Finding the Bottom Line: A Quantitative Model of the EU's Fiscal Rules and their Compliance. Firstrun working paper.