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journal homepage: www.elsevier.com/locate/jempfinIn search of the Euro area fiscal stance[☆]Alice Albonico^a, Alessia Paccagnini^b, Patrizio Tirelli^{a,*}^aUniversity of Milano Bicocca, Italy^bUniversity College Dublin, Ireland

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ABSTRACT

This paper investigates the role of fiscal policies over the aggregate EMU business cycle. Previous studies, based on the assumption of non-separability between public and private consumptions, obtain a large public consumption multiplier, a small fraction of non-Ricardian households and, consequently, a relatively small multiplier for public transfers. We provide motivations for assuming separability and, on these grounds, we estimate a relatively large share of non-Ricardian households. As a result, we obtain that both multipliers are large. We also find that, in spite of their potentially strong effects, fiscal policies were substantially muted during the EMU years. This result is confirmed even for the post 2007 period. In fact fiscal policies did not complement the monetary policy stimulus in response to the financial crisis. Further, we cannot detect any substantial aggregate effect of austerity measures. Finally, the post-2007 surge in expenditure-to-GDP ratios was apparently determined by non-policy shocks that reduced output growth.

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1. Introduction

Following the apparent inability of monetary policies to avoid the recession that hit all advanced economies during the 2007 financial crisis, fiscal policies have been used to provide additional stimulus. The fiscal expansion was particularly large in the US and in the UK. By contrast, governments in the Euro area have been criticized for timid action in the 2007–2009 period (IMF, 2009) and for the “austerity” measures that were imposed onto peripheral countries after the beginning of the Greek crisis in 2010 (Cottarelli, 2012; Krugman, 2012; De Grauwe and Ji, 2013; Wolf, 2013; Stiglitz et al., 2014).

One specific feature of the Euro area is that national fiscal policies were constrained by the Stability and Growth Pact (SGP). According to Lane (2012) the Pact did not enforce sufficient discipline during the 1999–2007 period, characterized by a relatively

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favorable growth performance and by low cost for government finance. Then, after the onset of the Greek crisis in 2010, the SGP in its revised form imposed an unduly rapid fiscal correction in peripheral countries, accompanied by conservative fiscal stances in the rest of the area. This, in turn, caused an over-restrictive fiscal stance for the Euro area as a whole, that jeopardized the debt-reduction objective and left a legacy of higher than normal debt levels even in core countries. As a matter of fact, in 2014 the combination of persistently slow growth, high unemployment and declining inflation expectations induced the ECB to announce a large-scale asset purchase program, including purchases of sovereign bonds.

This paper investigates the role of fiscal and monetary policies over the aggregate EMU business cycle, with a specific focus on fiscal policies. The issue is important for at least two reasons. First, by looking at aggregate fiscal policies it is possible to understand the global implications of the Stability and Growth Pact, that was designed to impose a certain mix of discipline and discretion on individual countries. We shall therefore investigate the role played by fiscal feedbacks to business conditions and by discretionary actions, identified by shocks to fiscal variables. Second, over the next few years EMU policymakers will be confronted with the twofold task of reducing accumulated debt and, at the same time, of providing adequate stimulus to an economy that will be characterized by high unemployment and slow growth for several years to come. A correct assessment of fiscal multipliers and of the transmission channels associated to each fiscal instrument is therefore crucial to design fiscal policies that preserve macroeconomic stability for the Euro area as a whole. Achieving this goal should also facilitate the task of achieving fiscal adjustment in peripheral countries.

A vast literature, based on DSGE models, has analyzed the role of shocks and monetary policy in determining the EMU business cycle, starting from the seminal work of Smets and Wouters (2003, 2007, SW henceforth). Empirical evidence on fiscal policies is instead sparse. The relatively few models that incorporate analysis of fiscal policies extend the SW framework by introducing Limited Asset Market Participation, that is, a distinction between a fraction of households who are asset holders and smooth their consumption over the business cycle, and the remaining share of non-Ricardian households who do not participate in financial markets and entirely consume their current disposable income in each period. This allows to incorporate the possibility that public consumption shocks stimulate private consumption, as in Galí et al. (2007), and that transfers shocks provide a demand stimulus, as documented in Oh and Reis (2011). Coenen and Straub (2005, CS henceforth) investigate the effects of government spending shocks on aggregate consumption over the 1980–1999 period. Forni et al. (2009, FMS henceforth) focus on a slightly longer period, essentially restricted to the pre-crisis years. Both studies find that the share of non-Ricardian households is too small to establish a positive reaction of private consumption to public consumption shocks and therefore also assign a limited role to public transfers policies. Coenen et al. (2012, 2013, CST henceforth) estimate their model over the 1985 first quarter to 2010 second quarter sample and focus on the role played by fiscal policies during the 2008–2009 recession period. They estimate a far smaller share of non-Ricardian households. They also show that this result is crucially determined by complementarity between private and public consumptions in households preferences. As a consequence, Ricardian households raise their consumption in response to a public consumption increase. In this framework public transfers inevitably play an even more limited role than in CS and in FMS. Relative to these studies, we differentiate our contribution in certain crucial aspects of the theoretical model and in the focus of the empirical analysis.

First, instead of imposing that only Ricardian households preferences shape wage setting decisions, in our model wage-setting labor unions maximize an objective function that takes into account the marginal rate of substitution of all labor market participants, weighted by the shares of the two household types, as in Motta and Tirelli (2012, 2014). As shown in Motta and Tirelli (2013), this specification of the wage-setting mechanism has important implications for wage sensitivity to business cycle conditions. Therefore excluding this effect here might well bias the results.

Second, and more important, we do not “force” nonseparability between private consumption and total public consumption, as CST do. By and large the analysis of aggregates may be misleading, because different components of public expenditures might exert opposite effects on private individual consumption decisions (Karras, 1994). For instance, Fiorito and Kollintzas (2004) show that in a panel of twelve European countries “public” goods (defense, security, judicial system expenditures) are substitutes for private spending, whereas complementarity arises for “merit” goods (expenditures for services also available in the market, such as health and education). Thus, to identify the effects of public consumption shocks one should consider separately the “merit” and the “public” goods.¹ Further if one postulates that private and public consumptions enter a CES utility bundle, then the weight associated to public consumption should be estimated along with the elasticity of substitution between the two goods. Unfortunately it is hard to identify these two parameters even in medium scale DSGE models (McGrattan et al., 1997; Cantore et al., 2014). In fact CST set the public consumption weight at the average sample value of the public-consumption-to-GDP ratio, and obtain a relatively strong degree of complementarity. As shown in Ercolani and Valle e Azevedo (2014), fixing the weights in the utility bundle may severely bias the sign of the public consumption externality. In fact they find that the complementarity result is fully reversed in a small RBC model of the US. Unfortunately we cannot replicate their approach in the paper because, just like CST, we could not identify the large DSGE model by estimating both the public consumption share and the elasticity of substitution between private and public goods.

Finally, the third distinctive feature of our model is that we are able to discuss the contribution of fiscal shocks during the post-2010 sovereign bond crisis. In fact post 2010 evidence is crucial to understand the current EMU predicament and the implications of the controversial decision to implement austerity measures.

¹ Unfortunately disaggregate data are not available at the Euro-area level.

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