International Economics 147 (2016) 53–106

Contents lists available at ScienceDirect

International Economics

journal homepage: www.elsevier.com/locate/inteco

Fiscal policy and private investment in Greece

Maria Th. Kasselaki, Athanasios O. Tagkalakis *

Economic Analysis and Research Department, Bank of Greece, 21 E. Venizelos Ave., 10250 Athens, Greece

ARTICLE INFO

Available online 26 April 2016

JEL classification:
E62
E22
E44
O52

Keywords:
Fiscal consolidation
Investment
Output
Financial markets
Economic sentiment

ABSTRACT

This paper investigates the effects of fiscal policy on private non-residential investment and output in Greece. Besides examining the direct effects of fiscal consolidation, we investigate the role of financial markets and economic sentiment in the transmission of fiscal policy shocks. A tax based fiscal consolidation has more pronounced and more protracted negative effects on output and private non-residential investment relative to an expenditure based fiscal consolidation. A government spending-based fiscal consolidation improves financial markets and boosts economic sentiment. This in turn mitigates the direct negative effects of fiscal consolidation on private investment and output leading to a more rapid recovery. On the other hand, a tax hike fails to induce this positive confidence effect magnifying the negative effects of fiscal adjustment.

© 2016 CEPII (*Centre d'Etudes Prospectives et d'Informations Internationales*), a center for research and expertise on the world economy. Published by Elsevier B.V. All rights reserved.

1. Introduction

After the loss of market access in early 2010 Greece applied for EU-IMF assistance. The financial assistance was provided in exchange for the implementation of an ambitious fiscal consolidation and structural reform programme, i.e., the Economic Adjustment Programme (EAP) for Greece which covered the period from May 2010 till the end of June 2015. Since August 2015 Greece has obtained a new three-year financial assistance programme from the European Stability Mechanism (ESM). The goals of these financial assistance programmes, besides covering Greece's financing needs, are to correct fiscal imbalances, and to facilitate the rebalancing of the economy from the non-tradable to

* Corresponding author. Tel.: +30 210 3202442; fax: +30 210 3232025.
E-mail addresses: mkasselaki@bankofgreece.gr (M.Th. Kasselaki), atagkalakis@bankofgreece.gr (A.O. Tagkalakis).

http://dx.doi.org/10.1016/j.inteco.2016.03.003
2110-7017/© 2016 CEPII (*Centre d'Etudes Prospectives et d'Informations Internationales*), a center for research and expertise on the world economy. Published by Elsevier B.V. All rights reserved.

the tradable sector by means of structural reforms. The correction of internal and external imbalances is expected to boost market confidence leading to a rapid and sustained increase in private non-residential investment alongside net exports.

The substantial progress achieved so far in correcting fiscal imbalances has come at a huge cost in terms of output loss and rising unemployment.[1] The cumulative output loss is close to 25% in the period 2009–2014, whereas unemployment has skyrocketed to 26%, with youth unemployment being close to 55–60%. Forecasts at the start of the fiscal consolidation program in 2010 were pointing to a shallow recession and a much more rapid recovery in 2012.[2] However, things turn out to be worse than expected; the recession was much deeper and more protracted.[3] A mild recovery (0.8%) was achieved in 2014 but a new recession is projected for 2015.

This dramatic output contraction reflects, among other things, extreme developments in private investment, which from about 20.4% of GDP in the period 2000–2009 declined to 9.7% of GDP in 2014. This development primarily reflects the dramatic contraction of the construction sector and to a lesser extent the fall in private non-residential investment. Residential investment declined to 1.0% of GDP in 2014 from an average of 9.0% of GDP in the 2000–2009 period. Private non-residential investment declined to a bit less than 8.6% of GDP in 2014 from an average of 11.4% of GDP in the period 2000–2009.

Taking into account that one of the goals of both the EU-IMF financial assistance and the EMS programme is the gradual rebalancing of economic activity from the non-tradable to the tradable sector, the downsizing of the residential investment and consequently of the construction sector is not necessarily that much harmful for long term growth. However, the continued decline in private non-residential investment is detrimental for long term growth prospects.

In view of the recent adverse effects of fiscal consolidation on economic activity, and building on the SVAR approach of Blanchard and Perotti (2002) and Perotti (2005) this paper investigates the effects that fiscal policy changes have on private non-residential investment and output growth in Greece.

Besides examining the direct effects on fiscal policy on private investment and output, building on Ardagna (2010), Laubach (2009), Schuknecht et al. (2010), Barrell et al. (2012) and Bachmann and Sims (2012) we investigate the role of financial markets and economic sentiment in the transmission of fiscal policy shocks. We investigate the widely held view (incorporated in the EAP) that improvements in fiscal conditions will generate a positive financial markets and confidence response, mitigating (or even negating) the direct negative effects of fiscal consolidation on output.

Ardagna (2010) has shown that financial markets respond positively to large fiscal consolidations. Other studies (e.g., Arghyrou and Kontonikas (2011), Attinasi et al. (2009), Barrell et al. (2012), Bernoth and Erdogan (2012), De Grauwe and Ji (2012), Schuknecht et al. (2010), and Laubach (2009)) have shown that government borrowing premia and long term interest rates increase following debt expansions. Konstantinou and Tagkalakis (2011) have shown that fiscal policy can affect consumer and business confidence. On the other hand, as pointed out in Barsky and Sims (2012) surprise changes in consumer confidence are associated with long lasting movements in macroeconomic aggregates, i.e., confidence measures are reflecting changes in future fundamentals. Bachmann and Sims (2012) show that in standard SVARs consumer and business confidence does not react significantly to government spending shocks. However, in non-linear VARs confidence rises following an increase in government spending leading to higher output multipliers in particular in recession times (as in Auerbach and Gorodnichenko (2012)).[4]

[1] In the context of an EU-IMF financed programme Greece achieved a primary surplus of 1.2% of GDP in 2013 and was in primary balance of about 0% in 2014 from a primary deficit of 10.4% of GDP in 2009.

[2] According to the first EU-IMF programme output growth was expected to deteriorate until 2011 and return to positive territory in 2012, i.e., the growth rates were expected to be -2.0% 2009 Greece , −4.0% in 2010, −2.6% in 2011 and 1.1% in 2012 (European Commission, 2010).

[3] According to European Commission (2015) the decline in real GDP was 0.4% in 2008, 4.4% in 2009 5.8% in 2010, 8.9% in 2011, 6.6% in 2012 and, 3.9% in 2013.

[4] This important confidence effect is explained as reflecting future productivity improvements driven by government spending (in particular on investment) shocks in downturns, i.e., the confidence effect reflects beliefs about long term fundamentals (as in the “news” literature) and not pure “sentiment” (i.e. movement in confidence unrelated to fundamentals).

Download English Version:

https://daneshyari.com/en/article/999118

Download Persian Version:

https://daneshyari.com/article/999118

Daneshyari.com