



ESRI Research Note

European Fiscal Policy During the Crisis: An Irish Perspective

Kieran McQuinn

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1. Introduction

The ongoing approach of the European authorities to the difficulties in the Greek economy and the broader response to the financial crisis of 2007/2008 reveal significant policy shortcomings, which warrant some comment. This is especially the case from an Irish perspective as Ireland has, on a number of occasions, been held up as an 'example' in contrast to the Greek case, and as an example of the successful response by the European authorities in the post-2007/2008 financial crisis context (Sinn 2015). This characterisation however risks obfuscating one of the major structural weaknesses of the European policy response to date; namely the absence of an adequate counter-cyclical fiscal response at a European level, particularly from 2010 onwards. Moreover, European fiscal policy since that period has actually been decidedly pro-cyclical with the compounding effect of the austerity-type budgetary policies adopted impeding growth prospects and, in so doing, exacerbating the heightened levels of debt-to-GDP observed across many European countries, with Greece being the extreme case.

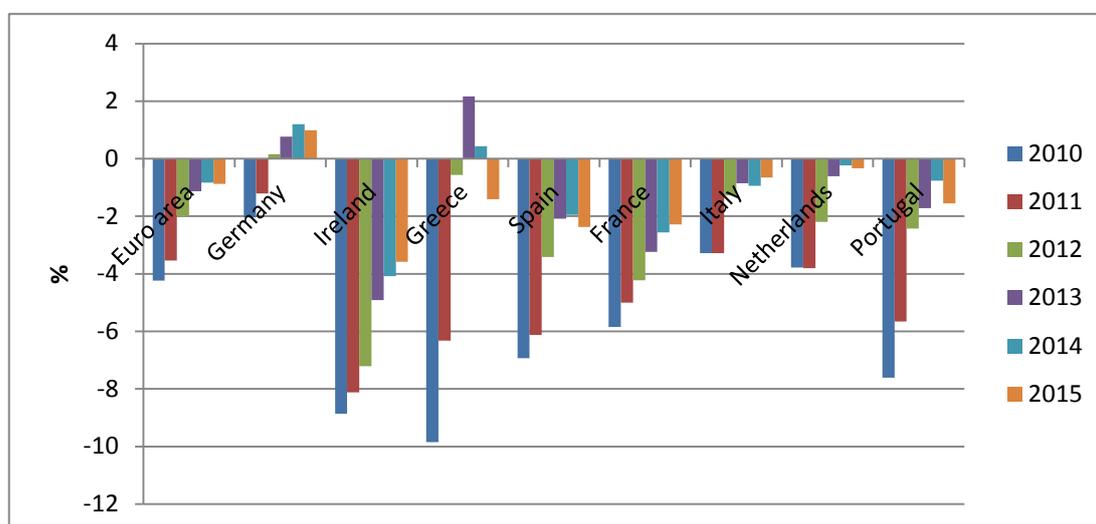
In this note, we review European fiscal policy since the international financial crisis. We initially focus on the rationale for an expansionary European fiscal policy to the international financial crisis, particularly from 2010 onwards. We review some of the more significant contributions advocating a more expansionary policy and contrast the outcomes in both the European and US economies under the differing policy responses. Irish economic performance post-2007/2008 is then discussed in the context of the austerity debate. In light of the fall-out from the financial crisis, we discuss the role an expansionary European fiscal policy could have played in supporting the Irish recovery over that period. In a concluding section, the policy issues concerning the future conduct of European fiscal policy are identified.

¹ Thanks to Alan Barrett, David Duffy and an anonymous referee for comments on a previous draft. Any remaining errors are the responsibility of the author.

2. The European Level

Budgetary policy across Europe since 2010 can be assessed from Figure 1, which plots the structural balances² of a select set of European countries.

FIGURE 1 Structural Balances of Select Euro Area Countries: 2010-2015



Source: AMECO website.

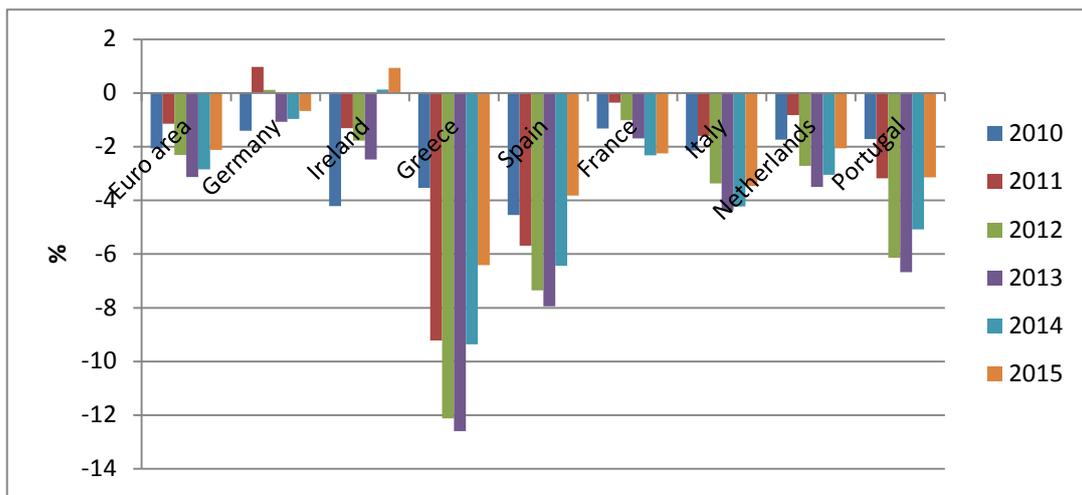
As the structural balance examines the fiscal policy stance independent of the economic environment, it is usually taken as being more reflective of discretionary changes in fiscal policy. Across all countries it is evident that, since 2010, the response of fiscal policy at a European level has been contractionary in nature.

However, in stark contrast to this general tightening of discretionary European fiscal policy, the case for an expansionary fiscal response from 2010 onwards has been made by a wide number of commentators (see Mody, 2015 for a detailed treatment of the issue). One way to capture the degree of underperformance across the Euro Area and, hence, the rationale for an expansionary response is to review the output gaps³ for the same set of countries as in Figure 1 (Figure 2). A negative output gap indicates that the economy in question is performing below trend.

² The balances are adjusted on the basis of the potential GDP excessive deficit procedure.

³ The output gaps are the official Eurostat estimates from the AMECO website.

FIGURE 2 Output Gap of Select Euro Area Countries: 2010-2015



Source: AMECO website.

While the particular underperformance of the countries referred to as the PIIGS (Portugal, Ireland, Italy, Greece and Spain) is clear, it is also evident that nearly all countries are performing below trend over this period.

Blanchard and Leigh (2012 and 2013a) conduct a detailed assessment of the impact of austerity on European growth projections demonstrating the degree to which these forecasts have been steadily lowered since 2011.⁴ At that time most forecasts suggested that the economic slowdown would be subdued and that growth would rebound back. Blanchard and Leigh attribute much of the subsequent unexpected downturn in the Euro Area to the larger than anticipated consequences of fiscal austerity. In a cross-country graphical comparison of fiscal consolidation and the unexpected slowdown over the period 2011-2013, the negative relationship between these two variables would appear to confirm that the lesser growth rates occurred in instances where fiscal consolidation was larger. The harmful impacts on growth of the collective fiscal tightening across Europe are exacerbated by the significant levels of intra-EU trade. Thus, as domestic demand was adversely impacted by the fiscal stance of individual Member States, export demand was also negatively affected by the similar stances of other member countries.⁵

In broader terms, as noted in Ireland's case by Cronin and McQuinn (2014), an increasing number of empirical studies support the notion that fiscal multipliers are large during periods of economic downturn suggesting that fiscal stimuluses

⁴ Note Alesina et al. (2015) provide a somewhat alternative perspective on the role of fiscal policy.

⁵ A point also made by Blyth (2015).

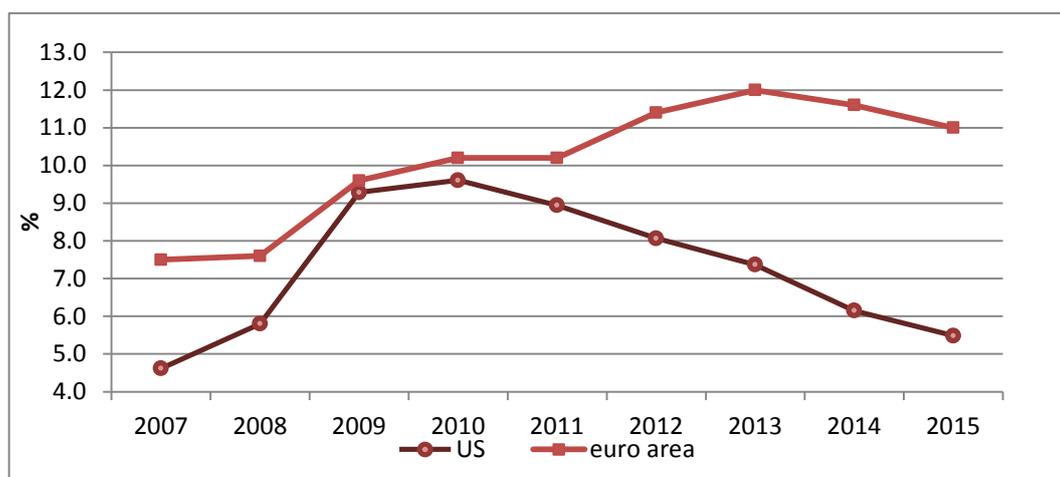
can play an important role; however the corollary is also true; tightening budgetary policy has a more negative effect when economies are below trend. Examples of such studies include Auerbach and Gorodnichenko (2012), Batini et al. (2012), Baum et al. (2012) and Riera-Crichton et al. (2014) and, in a celebrated contribution, DeLong and Summers (2012) who argue that with a zero lower bound lower interest rate, expansionary fiscal policy is self-financing in a depressed economy. In the presence of a liquidity trap, DeLong and Summers (2012) note that the impact of fiscal policy on economic activity and employment is enhanced as the presence of low interest rates minimises the crowding-out effects that often mitigate the effects of fiscal policies.

Of course one consequence of lower than expected growth rates over this period is that, in stark contrast to its intended consequence, the debt-to-GDP ratios (a crucial indicator of fiscal sustainability) actually *disimproved* because of the respective budgetary policy. Blanchard and Leigh (2013b) note that the debt ratios for European countries have been higher than projected. In the case of Greece both Krugman (2015b) and Wren Lewis (2015) have documented how achieving a primary surplus involves adopting an intensely contractionary fiscal policy such that the economy shrinks by a good degree more than the improvement in the primary surplus. Therefore, the debt-to-GDP ratio disimproves quite significantly in the short to medium term. The effect of a tightening fiscal policy is further accentuated by the depressing impact on the GDP deflator, resulting in a greater deterioration in the debt-to-GDP dynamics. As Mody (2015) concludes, the 'evidence is clear and the assessment is rather pessimistic. After the enormously costly austerity, the debt ratios have gone up in most Euro Area countries'.

The fiscal response of the European authorities can be compared with the expansionary policy of the United States over the same period. In 2009, the US Congress passed the *American Recovery and Reinvestment Act* (ARRA) into law, the primary objective of which was to support employment measures in light of the post-2007 economic downturn. The approximate cost of the economic stimulus package is estimated to be \$831 billion between 2009 and 2019. While some commentators, such as Krugman (2009), argued that the stimulus fell short of what was needed to re-stimulate US growth, it is interesting to compare the unemployment rate in the Euro Area and the US since 2007 (Figure 3). Initially, both areas experienced a significant increase in unemployment as the financial crisis unfolded, with the respective elevated jobless rates almost identical through 2009 and 2010. However, thereafter, the rates start to diverge with the US unemployment rate lowering to 5.4 per cent in Q2 2015 contrasting with an equivalent Euro Area rate of 11.1 per cent.

Aizenman and Pasricha (2010), in assessing the effectiveness of the US response, contend that the stimulus mostly compensated for the negative stimulus – at state and local level – associated with the collapsing tax revenue and the limited borrowing capacity of the individual states. While this is a significant accomplishment, as Aizenman and Pasricha (2010) argue, the net effect is that the consolidated fiscal expenditure stimulus is small relative to the sharp fall in private aggregate demand.

FIGURE 3 US and Euro Area Unemployment Rates 2007-2015



Source: AMECO and Bureau of Labour Statistics (BLS) websites.

Over the longer term, the ramifications of the significant European policy miscalculation are compounded by pessimistic growth prospects for the Euro Area. McQuinn and Whelan (2015), in updating analysis from before the financial crisis, find that the long-term growth prospects of the Euro Area have deteriorated further. With TFP growth continuing to fall, Europe’s demographics are now also contributing to a decline in the workforce and hence to economic growth. Against this backdrop, McQuinn and Whelan argue that, even with the successful adoption of certain significant structural reforms, the European economy is still only likely to grow between 1 and 1.5 per cent per annum over the period 2015-2033. Clearly, such a slowdown in growth rates over the longer term raises significant difficulties for the future sustainability of the increased debt levels observed.

3. The Irish Recovery

Given the recent performance of the Irish economy, it is timely to assess how the domestic recovery could have benefitted from a countervailing fiscal policy at the

European level. From a budgetary perspective, the Irish authorities had little option but to pursue a contractionary (and intensely pro-cyclical) budgetary policy from 2008 onwards; the Exchequer balance, which had recorded a surplus of 1.2 per cent in 2006, quickly deteriorated to -7 per cent in 2008 and peaked in a negative context at just under -15 per cent in 2011. With the country priced out of sovereign bond markets and forced into a programme of support, there was little option, given the European policy framework, other than to correct the fiscal accounts. As can be seen in Figure 1, for the countries considered, the contractionary fiscal policy undertaken by the Irish authorities was, over the period 2010-2015, second only to Greece in improving its structural balance.

To understand the nature of the Irish recovery, some insight can be provided by taking the following simplified version of a standard Keynesian model:

$$ygap = \beta_1 X - \beta_1 S \quad (1)$$

$$X = -\beta_2 P \quad (2)$$

$$\Delta P = \beta_3 ygap \quad (3)$$

$$\Delta ygap = -\beta_1 \beta_2 \beta_3 ygap \quad (4)$$

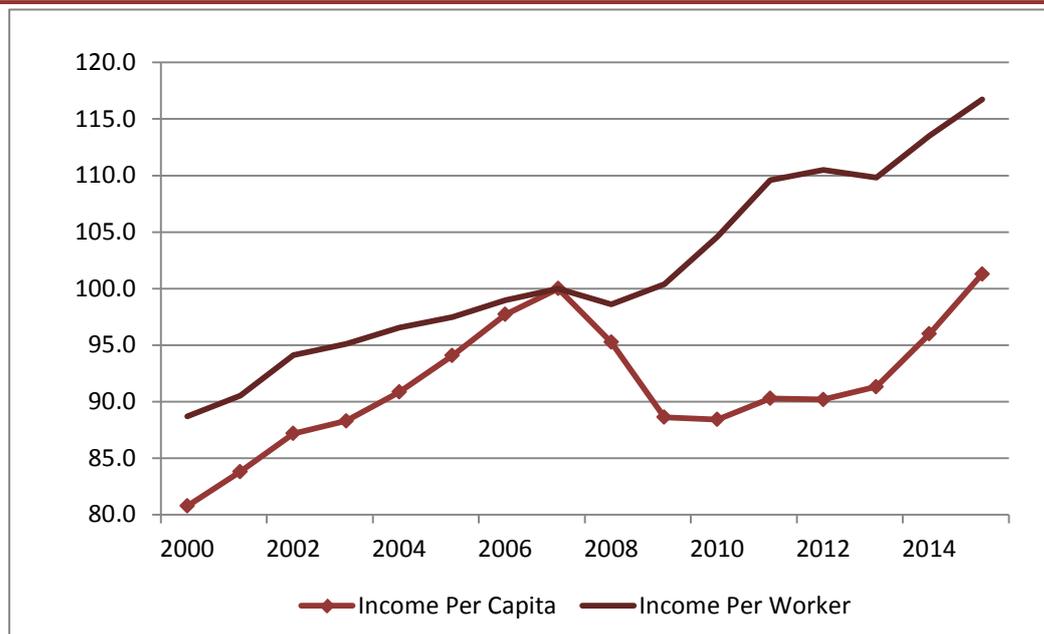
In this highly parsimonious model, the Irish output gap (*ygap*) is assumed to be a function of just net exports (*X*) and the structural balance (*S*). Exports are then a function of the real exchange rate, which in this case we take as the nominal price level (*P*) as foreign prices are assumed to remain constant. The change in prices (ΔP), a form of simplified Philips curve, is a function of the output gap. Taken together this leads to the final expression (4); output self corrects overtime, so if the domestic economy experiences a deflationary period, relative prices decline, competitiveness improves and exports start to increase.

In this model, once the initial deflationary policy ceases i.e. as the Government modifies its fiscal retrenchment to reduce the structural balance, the economy starts to converge back to its long-run level. The convergence process is a function of the output gap and three parameters; the multiplier, the sensitivity of the trade balance to the real exchange rate and the sensitivity of inflation to the output gap. Using plausible assumptions for these parameters, Krugman (2015a) characterises the recent performance of the Irish economy. That is, the fiscal response allied to the initial shock experienced by the economy precipitated a significant decline in output; once competitiveness was improved and the severity of budgetary policy abated, the economy started to increase back towards its steady-state level. Byrne and McQuinn (2014) offer a similar analysis

of recent Irish performance as a case of an economy converging back to its steady-state level.

However, this self-correction comes at some cost in terms of the resulting volatility in economic activity. To that end it's worth examining the scale of changes in the *levels* of key Irish economic variables. In Figure 4, we plot actual (2000-2014) and forecast (2015) income per capita and income per worker in the Irish economy.

FIGURE 4 Actual (2000–2014) and Forecast (2015) Irish Economic Performance (Index 2007 = 100)



Source: ESRI.

While the recent growth rates of the Irish economy are impressive, particularly when compared with other European countries, the chart places the levels of the key economic outcomes in perspective. Even with the strong growth rates, it is evident that the Irish economy will not be back to its pre-crisis income levels until 2016 or 2017 at the earliest. This illustrates the lost capacity of the economy and, hence, the potential for policy at the European level to have ameliorated the decline in output and general activity experienced in the Irish case.

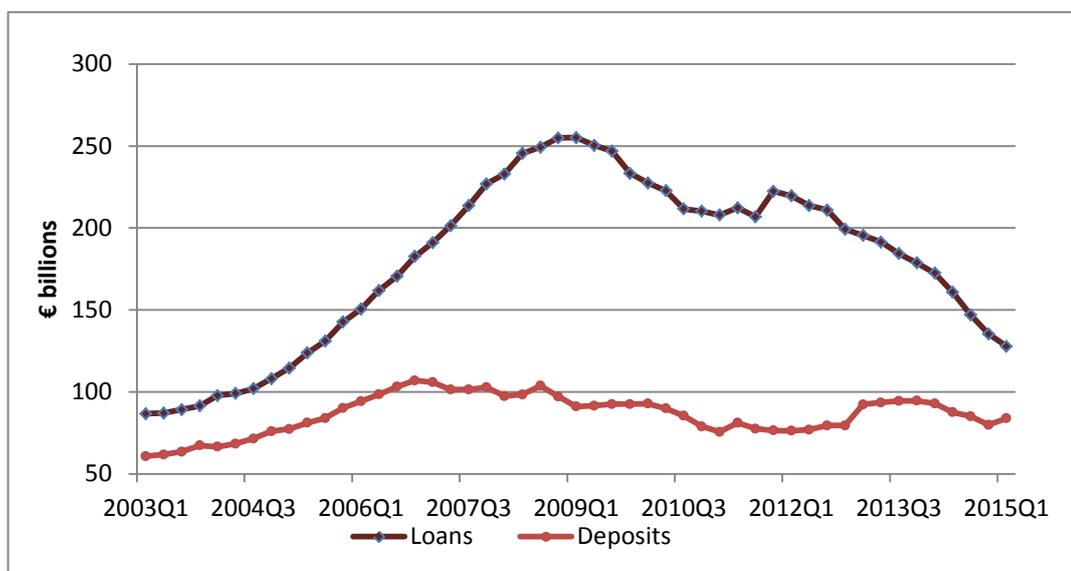
Significant fluctuations in economic activity, such as those experienced in the Irish case, lead to disruption in many areas of the economy; Blanchard and Leigh (2013b), for example, highlight the persistent fall in investment which can accompany a pronounced fiscal co-ordination. In the Irish economy, after 2007, housing construction, for example, went from an annual average of over 80,000

units per annum for the period 2005-2007 to just over 10,000 units per annum between 2012 and 2014. The collapse of housing investment has occurred despite evidence of significant underlying structural demand for housing in the Irish economy (see Byrne et al., 2014).

As well as standard macroeconomic reasons for an EU-wide stimulus, the particular implications of the post-2007 downturn for the Irish financial sector provides ample reasons why such a policy would have yielded a number of benefits in the domestic case.

After 2010, the Irish economy was subject not just to an intensely contractionary fiscal policy but also to a contractionary prudential or banking one. The dislocation caused by the financial crisis resulted in the main Irish financial institutions having to deleverage or reduce their balance sheets in a considerable manner. Indeed, the programme of support negotiated between the Irish State and the Troika (EU Commission, ECB and the IMF) in October 2010 specified a reduction in the loan-to-deposit ratio of these institutions from 177 per cent to 122.5 per cent over a three-year horizon. This highly aggressive target constituted a dramatic reduction in the size of the Irish financial sector as can be evidenced from Figure 5 which plots total lending and deposits to Irish resident private sector enterprises. Although much of this deleveraging was aimed at reducing the non-core elements of banks lending, overall, given the scale of the reduction, it almost certainly exerted a negative impact on Irish economic activity.

FIGURE 5 Loans and Deposits to the Irish Private Sector 2003-2015

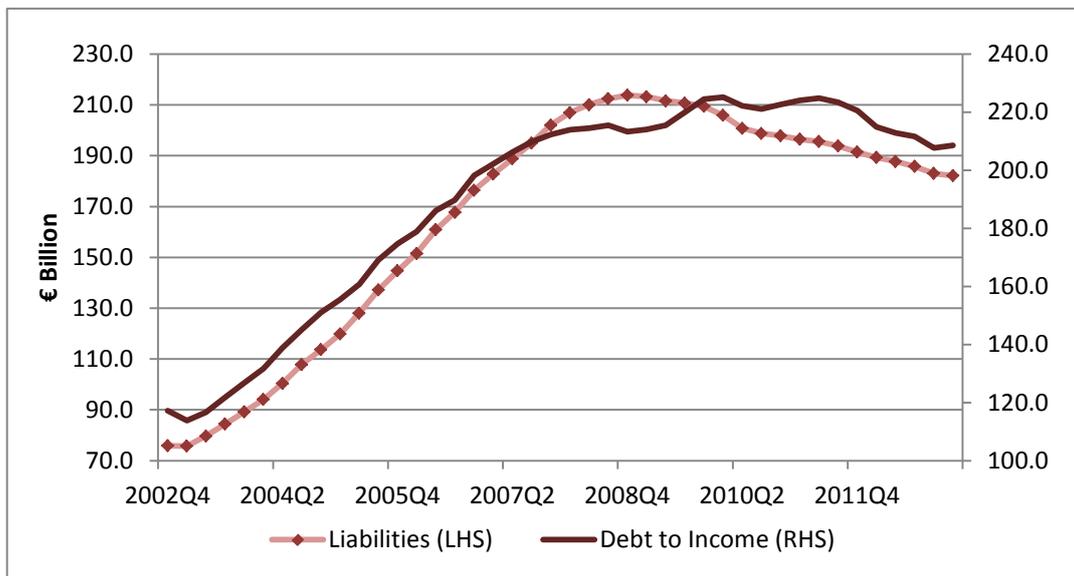


Source: Central Bank of Ireland.

While the scale of deleveraging was not quite so severe across Europe, many economies were confronted by this set of simultaneously contractionary fiscal and prudential pressures.

Support from a countervailing EU-level stimulus would have been particularly beneficial for the Irish economy in dealing with the high degree of private sector indebtedness experienced from 2007/2008 onwards. McCarthy and McQuinn (2015) highlight the degree of household level debt in Ireland vis-à-vis other OECD countries and provide micro-based empirical evidence for the negative impact of household deleveraging on consumption in the Irish market. Mody (2015), for example, criticises the single-minded focus on austerity in the presence of high private debt burdens arguing that Irish and Spanish households who tried to address their debt obligations in the immediate aftermath of the crisis actually saw an *increase* in their debt-to-income ratios initially as their disposable incomes fell. Figure 6 plots total Irish household liabilities along with the ratio of debt to disposable income; from the graph the substantial increase in total household debt in the lead up to 2007 is evident. However, it is also clear that while total household debt peaked in 2008, the ratio of debt to income continued to increase until late 2012 as income levels fell.

FIGURE 6 Irish Household Debt 2002-2012



Source: Central Bank of Ireland.

4. Policy Conclusions

A number of significant policy contributors have advanced the case for a substantial fiscal stimulus at the European level; Sapir and Wolf (2014), in an open letter to the then incoming EU Commission, argue for a new investment programme amounting to at least 1 per cent of EU GDP in addition to investments currently planned. Sapir and Wolf (2014) suggest that part of this investment should be designed and implemented through national fiscal policies by increasing public investment. Countries which have the fiscal space should be encouraged to stop outperforming against fiscal targets, while other countries with limited space should commence a new deficit-financed investment programme. However, the greater component of any such investment response should be financed at the European level, mainly through the European Investment Bank, project bonds and an increase and improvement in the EU budget. Finally, those countries with weaker economic circumstances should disproportionately benefit from such a policy.

McQuinn and Whelan (2015) note that while the Euro Area's current ratio of public debt to GDP is high by modern historical standards, many of its Member States are able to borrow at very low rates and the pricing of ESM-issued securities shows that there are few concerns about the solvency of the Euro Area as a whole. Thus, they argue that a strong economic case exists for a large investment programme aimed at reducing unemployment and raising the supply capacity of the economy, funded by the Euro Area as a whole.

At present, Europe's political constraints clearly rule out such a programme for the foreseeable future with the current 'Juncker plan' with its very limited use of European public funds appearing to represent the limit of what is politically achievable at present.

This inevitably gives rise to the argument for greater fiscal integration in correcting some of the architectural weaknesses in the present European policy set-up. Allard et al. (2013), in addressing the concept of a fiscal union for the Euro Area, argue that more fiscal integration can ultimately provide a greater capacity for country-level shocks, whether exogenous or domestically-determined, to spread across the Euro Area. They note that the origin of much of the present difficulties in Europe are due to the merger of domestic fiscal and banking vulnerabilities, combined with extensive financial linkages across countries which culminated in country-specific shocks propagating into systemic ones.⁶ This mainly occurred due to the absence of any mechanisms to deal with such shocks.

⁶ Gai et al. (2011) illustrate how greater complexity and concentration in the financial network may actually amplify this fragility.

Thus, greater fiscal integration can provide an ex ante framework for enforcing fiscal discipline and temporary transfers. An integral component of such a framework would entail some form of common borrowing (backed by common revenue) to finance better risk sharing and stronger backstops. This ex ante sharing of risk ensures that at a particular point in time those countries experiencing better cyclical conditions support those that are not. Furthermore, Allard et al. (2013) demonstrate that, with such a risk-sharing mechanism in place over a sufficiently long period, all current Euro Area member countries would have benefited from transfers at some point.

Therefore, it is incumbent on domestic policymakers to:

- (a) Address the institutional issues which prevent the formation of an effective fiscal union within the Euro Area. This may well give rise to certain difficulties from an Irish perspective with greater focus on issues such as the harmonisation of corporate tax rates. Ultimately, this will involve some estimation and assessment as to the relative trade offs of the different policy options.
- (b) Equally, if not more important, highlight the economic rationale or lack thereof which has underpinned the fiscal response of European authorities to date. As a number of commentators have pointed out, the relentless pursuit of austerity at a time of contracting economic activity and in the presence of sizeable public debt is not part of traditional mainstream economic policy thinking (see Parenteau (2015) for example) and is at variance with the more successful policy response in other jurisdictions. This point must be clearly understood in terms of both domestic and European wide debate on the future direction of Euro Area-wide macroeconomic policy.

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