Macroeconomic Policy of Growth

“Cyclical Budgetary Policies: Their determinants and effects on growth”

Discussion by
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Linking financial development to investment and counter-cyclical policies is a clever way to search for links between macro-policies and growth:

– credit or cash constraints are non-linearities that may depend both on the level of development of financial markets and the action of public authorities. (Hölstrom and Tirole)

– Financial development or lack thereof and risk-sharing are often related to growth and growth differentials.

Challenge:
Acemoglu and Easterly: in the case of non extreme policies, such link is difficult to make.
ABM makes 3 claims...

Claim 1
Counter-cyclical budgetary policies may increase growth;

Claim 2
A counter-cyclical public investment policy may increase growth, depending on the level of financial development;

Claim 3
EMU discretionary fiscal (and monetary) policies should be more counter-cyclical for the gap between EMU and US trend growth to narrow.
...and follows 3 steps

**Step 1**
calculating indicators of cyclicality based on the Barro tax-smoothing approach for debt, consumption and investment;

**Step 2**
regressing GDP per capita on these indicators of cyclicality and on a few structural variables, including financial development,
noting that these later regressions give a positive impact to the counter-cyclicality of public investment, especially when combined with a low level of financial development;

**Step 3**
public investment, when counter-cyclical, would diminish liquidity constraints on innovative firms and thereby explain this impact of public investment on growth.
My assessment:

- Although a positive impact of public investment counter-cyclicality on growth is not impossible,
- none of the 3 claims is fully convincing.

However:

- EMU has already supported financial development and further financial development and integration in Europe can only accelerate growth.
- EU Growth and Stability Pact and ECB monetary policy are adequately counter-cyclicical.
Some statistical caveats

General caveat:
How to draw conclusions on EMU without integrating Germany in the dataset?

Caveat to Step 1:
Why not use Instrumental Variables to estimate indicators of cyclicality, like Gali and Perrotti?

Caveat to Step 2:
As growth per capita is regressed on results of a regression, results should be corrected from a bias (Feenstra and Hanson, Dumont et al).

→ Significance of results may be exaggerated.

In particular Table 6, which combines a lot of coefficients, may be subject to uncertainty.
The results of Step 1 are consistent with literature:

- **Pro-cyclicality of debt** in EMU countries has not been affected by EMU, but decreased less than in other OECD countries;
- **Pro-cyclicality of investment** is similar in the US and in EMU countries;
- Pro-cyclicality of consumption may be higher in EMU countries, but stabilized in the 90’s

→ EMU countries may have characteristics that distinguish them from other OECD countries.

**But**

EMU in itself and the Growth and Stability Pact in particular do not seem to have unduly influenced cyclicality.

Is pro-cyclicality a problem during recessions?
Should the fiscal balance be counter-cyclical?

Table 5 supports Claim 2:
public investment may impact growth positively.

But

According to Table 5,
The counter-cyclicality of public consumption does not significantly enhance growth.

→ Overall, Claim 1 uncertain
If the counter-cyclicality of public investment has an impact on growth, how to explain it?

That public investment actually supports innovative investments by small innovative firms is unproven:

If true, industrial policies would be easy and successful.

Public investment integrates a lot of construction. Does construction help innovative firms?

Should other explanations be sought?

General efficiency, confidence effect?
If the counter-cyclicality of public investment has an impact on growth, how to measure it?

• The size of the impact depends on the precision of the estimated coefficients.

• Are we sure about EMU level of financial development?

• The increase in financial development created by monetary union and the fixing of exchange rates is not reflected.

• The evolution of credit is fast and highly variable across the euro area: Is financial development in EMU countries not rapidly increasing?

→ Overall, Claim 2 difficult to substantiate
Even if the impact of counter-cyclicality of public investment was certain, could we take advantage of it?

- The measurement of the output gap in real time is very difficult and often misleading.
- Decision making concerning productive investment takes time.
- Policies also have to be sustainable and avoid creating the wrong incentives for policy-makers.
- (The above caveats do not apply to automatic stabilizers)
- (Monetary policy of the ECB, while aimed at price stability, has been counter-cyclical.)

→ **Claim 3 difficult to support**
CONCLUSIONS

• Growth can benefit from the further financial development and integration of EMU.

• Letting automatic stabilizers operate is the best policy: consistent with a well-implemented Growth and Stability Pact. (Very efficient according to Gali and Perotti)

• Diminishing pro-cyclicality of fiscal policy means mostly:
  - avoid excessive spending when growth prospects improve;
  - ensure that public governance leads to good decision making.

• Overall, the passage from Endogenous Growth Theory to Macroeconomic Policy maybe less easy than ABM had hoped for.
Figure 1: Pro cyclicity of government gross debt (AR(1) method).

Note: the graph plots the $\alpha_i$ coefficients, i.e., the coefficients on the output gap composite variable (see equations 1 and 2). For EMU countries (i.e., countries who are or will be part of the EMU), the line represents the average of the estimated coefficients for the EMU countries present in the sample; all EMU countries available are present from 1978 onwards.

Source: OECD Economic Outlook.
Figure 4: Pro cyclical ity of government investment (AR(1) method)

![Graph showing pro cyclical government investment](image)

Note: the graph plots the $a_{1,t}$ coefficients, i.e. the coefficients on the output gap composite variable (see equations 1 and 2). For EMU countries (i.e. countries who are or will be part of the EMU), the line represents the average of the estimated coefficients for the EMU countries present in the sample; all EMU countries available are present from 1978 onwards.

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