

Fiscal and monetary policy: a look at cyclicalities and its impact on Ireland

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When Ireland took the decision to enter the Eurozone, it was thought that the advantages of membership outweighed the loss of sovereignty it necessitated. Although the benefits have been manifest, since the recent financial crisis the loss of control over monetary policy has become a topical issue once more. Amelia O'Connell examines both monetary and fiscal policy in Ireland and makes the case for expansionary fiscal contraction.

Introduction

After the Irish economy contracted for a second consecutive quarter, Ireland became the first Eurozone country to officially enter recession (CSO, 2008). The deterioration in living standards to 2003 levels (CSO, 2010), the demise of social partnership and the uncertainty surrounding the National Asset Management Agency (NAMA) has created a difficult economic landscape. Without tough corrective action, future generations will be left to pay for economic mismanagement for decades to come.

The loss of monetary control as a result of joining the European Monetary Union (EMU) has narrowed Ireland's corrective economic responses and has placed the responsibility of recovery solely on fiscal rectitude. The core objective of any effective action has to be a return to competitiveness (Bergin et al., 2009). To appreciate the nature of this effective action, the policies available to the Irish government will be examined in detail, as well as the application of such policies in the prevailing economic climate.

Fiscal and monetary policy in Ireland

Monetary and fiscal instruments are alternative tools at the disposal of governments, employed to achieve specific economic goals such as full employment, high levels

of investment or as a means to stabilise an economy during economic shocks (Buti, 2003). The focus of this section will be to analyse the way in which both monetary and fiscal policy play a central role in ensuring stability and growth, while the inappropriate application of such policies can adversely affect performance.

Monetary policy: a brief overview

A government that has control over its own currency has the ability to stabilise its economy by altering its interest rates. According to the textbook Keynesian view, in the short run a negative demand shock, such as a drop in investment demand, will cause production to fall. In turn, the stock of savings will also decline. The resulting interest rate will be above the natural level and thus, the goods market will be unable to clear (Sorensen & Whitta-Jacobsen, 2005). Effectively, new Keynesians believe the market will not automatically adjust in the short run. Instead, by increasing the money supply through open market operations, the central bank can artificially lower interest rates so that the economy can converge towards its natural rate thus clearing the goods market.

Monetary policy can work through many channels. For example, a fall in the interest rate reduces the cost of capital and boosts demand for investment. Also by affecting the risk-free rate, the central bank can influence a number of asset prices. For instance, the price of a stock is negatively related to its discount rate (a component of which, is the risk-free rate). Therefore, a fall in the interest rate would increase the value of the stock, making stock holders effectively wealthier. It stands to reason that monetary policy should be countercyclical.

Ireland

By joining the EMU, Ireland relinquished its influence on monetary policy at a national level. A closer look at the cyclical nature of Irish monetary policy shows that there have been, to some extent, asymmetries. Given the size of the economy, its impact on the decision-making process is somewhat limited when negotiating alongside larger economies such as Germany and France. While most of Europe was in recession during the early 2000s, Ireland meanwhile, experienced unprecedented growth due to low interest rates, which offset the negative demand shock.

It is generally accepted that such low interest rates contributed to the boom in the construction industry between 2003 and 2006 (Lucey, 2009). Demand for property surged and house prices increased, as the cost of obtaining a mortgage fell. Honohan and Leddin (2006) found that the Irish economy suffered large exchange rate and interest rate shocks since joining the EMU. However, it is imperative to point out that these shocks, from what is dictated by the Taylor rule (Taylor, 1993), have not been significantly greater than under previous regimes. Instead, the potentially destabilising effects of the large and sustained fall in nominal interest

rates, is reflected in the persistently large contribution to aggregate output and Ireland's heavy dependence upon it. Furthermore, by causing the price of non-tradables to increase, upward pressure was placed on nominal wages. Coupled with the fixed and exogenous price of tradables, the real wage rose. Ireland subsequently suffered a loss in competitiveness of 32 per cent (National Competitiveness Council, 2009).

Another matter for concern when adopting a single currency is the loss of the self-correcting process when faced with the erosion of wage competitiveness. There are three major elements which affect wage competitiveness: the domestic wage rate, the foreign wage rate and the exchange rate. If a country appears to be losing wage competitiveness, its government can increase inflation, thereby reducing the real wage through exchange rate devaluation. However, under the new EMU regime, the exchange rate is now exogenous and the maintenance of wage competitiveness can only be attained through changes in the nominal rate. Honohan and Leddin (2006) found that since joining the EMU no such nominal rate mechanism exists in Ireland.

If monetary policy tends to be procyclical in the coming decade, an increase in the interest rate could have potentially destabilising effects on the Irish economy. Not only will asset prices fall as a result of negative balance sheet effects, but credit rationing will also present Irish consumers with further credit constraints.

Fiscal Policy

Fiscal policy is now the only area over which the Irish government has relatively autonomous control. Its cyclical nature is not only crucial to assessing how Ireland has been adversely affected by the current economic crisis, but it also provides the foundation for proposing ways to stabilise the economy and encourage future economic growth.

According to the traditional Keynesian perspective, fiscal policy should be countercyclical. Individuals prefer a smooth level of government spending if their preferences over this expenditure are strictly concave (Sorensen & Whitta-Jacobsen, 2005). During a boom, governments should reduce the ratio of spending to Gross Domestic Product (GDP) in order to accumulate funds needed to run a budget deficit during economic downturns, without threatening fiscal sustainability. Recent literature has demonstrated the positive effects of public capital on the long-run stock of private capital in an economy. For example, Aschauer (1989b) argues that public capital demonstrates a crowding-in effect on private capital by raising the marginal product of labour, which is inversely related to the interest rate. Therefore, in the long run, lower interest rates lead to higher investment, increasing the private capital stock of the country. Interestingly, a study of 48 American states between

1970 and 1990 found that permanent changes in government variables are consistent with permanent changes in economic growth rates (Aschauer, 2000).

Despite the rationale for countercyclical fiscal behaviour, Lane (1998, 2010) provides empirical evidence showing Irish government fiscal policy to be procyclical. In an attempt to explain such behaviour, Lane (1998: 4) suggests that this fiscal policy is the “rational, albeit suboptimal, outcome of a competitive political process”. Recent works have put a greater emphasis on the political economy in explaining such a procyclical bias. With many interest groups or political powers, the allocation of government finances tends to be less efficient. In times of strong economic performance, these groups increase the rate of appropriation. If this increase did not occur, the result would be procyclical government spending (Tornell et al, 1999). The setting of Irish fiscal policy is influenced by multiple groups, including strong labour unions, coalition parties and public sector unions.

Furthermore, the Maastricht Treaty (1992) may also threaten the countercyclicality of fiscal policy. The imposition of strict fiscal constraints on countries wishing to enter the EMU requires candidates to reduce deficits to three per cent of GDP and public debt ratios to 60 per cent of GDP. This policy did not present a problem during times of economic growth. However, this fiscal conformity leads to more than just destabilisation in times of recessions. A slow down in growth tends to lower tax revenues, raise deficits and therefore, force cutbacks in spending, increasing the procyclical nature of fiscal policy. Recessions are further aggravated by the lack of public capital needed to compensate for the fall in private capital.

Expansionary fiscal contraction

Given the precarious situation that Ireland now finds itself in, what options are available for the Irish government to stimulate growth and improve the bleak economic outlook? It is not an option to alter fiscal policy in a more countercyclical direction. With limited public revenues, the government would need to borrow heavily from the capital markets in order to boost aggregate demand. However, by increasing the budget deficit, the government would be signalling to markets a willingness to use less-sound finances. This would incur a huge cost, as the risk premium attached to the government’s debt would increase substantially. Furthermore, greatly increasing the debt-to-GDP ratio is not permissible under the Stability and Growth Pact, as outlined by the Maastricht Treaty (1992).

Instead, Ireland could try to run a fiscal adjustment that would, in fact, be expansionary. Expansionary fiscal contractions (EFC) were first documented after a series of fiscal consolidations occurred across Europe in the 1980s. In many countries, particularly Ireland in 1987-89 and Denmark in 1983-86, renewed growth

was preceded by sharp fiscal retrenchments. Giavazzi and Pagano (1990) use the above examples to demonstrate the non-Keynesian effects of the fiscal policies.

Channels through which an EFC can occur

There is much debate as to how a fiscal contraction can lead to growth. Although, it is widely agreed that the integrity of the government in question and the length of the contraction should have a positive impact on its success, there is much less consensus on which channel it should most effectively operate through.

Demand Side

Firstly, fiscal policy can exhibit non-Keynesian effects through the consumption channel on the demand side. Assuming that economic agents have rational expectations, an increase in government spending or a decrease in taxes will make consumers wary about the sustainability and viability of fiscal policy. As a result, consumers react by saving more and reducing private consumption in order to insure against an increase in future taxes.

The opposite is true when governments reduce public expenditure. Agents react by reducing their savings. These episodes of expansionary fiscal contractions further reinforce the idea of Ricardian equivalence (Ricardo, 1951). Afonso (2007) demonstrates the effect of raising taxes on the ability of a fiscal contraction to be expansionary. In this model, some proportion of the economy (λ) is credit constrained. The rest of the population ($1 - \lambda$) is not. The author shows that as λ tends to zero, a tax increase can actually have expansionary effects on the consumption level of the non-constrained consumer. By improving the fiscal balance of the country, the risk premium component of the interest rate falls and creates a positive wealth effect.

However, raising taxes also reduces the disposable income of the credit-constrained agents in the economy and therefore, reduces overall consumption levels. As the banking crisis worsens, it is more likely that λ will approach one rather than zero, rendering this analysis somewhat irrelevant in the Irish context. Furthermore, raising marginal tax rates above the optimal rate dictated by the Laffer curve can have a negative impact on growth (Laffer, 2004). The intuition behind this theoretical model is that by taxing the most productive agents in the economy at too high a rate, it acts as a disincentive to work and as a result, creates a decline in growth and tax revenue.

Supply-side

On the other hand, Giudice, Turrini and Veld (2007: 615) argue that non-Keynesian effects of the policy can take place on the supply side: “rather than through

reductions in real interest rates, the link between fiscal policy and investment behaviour is represented by the impact of government spending, in particular of the government wage bill on the labour market". Barry (1999) decomposes government expenditure into two critical elements. There is a general consensus that government consumption, which includes the wage bill as defined by Barro (1991), has adverse effects on economic growth. Barro (1996) discusses the effects of the size of government on growth and in particular, highlights the undesirable effect of non-productive government spending and associated taxation on the economy. Following a study of 48 US states, Aschauer (2000) discovered that government expenditure is actually above the level needed to maximise growth, finding that a given increase in government spending leads to a greater decrease in economic growth.

Assuming rational expectations, the expected present value of the net marginal product of capital, which is negatively related to the real wage, drives investment decisions. By making expenditure cuts in government consumption, less pressure is put on real wages and so, there is an increase in short-run investment (Giudice et al, 2007).

Barry (1999) also demonstrates that by reducing real wage pressures, an economy will become more cost competitive and attract inward investment; note that the real wage is defined by the nominal wage divided by the price level. However, the Irish government can no longer devalue its currency to increase wage competitiveness. Indeed, Akerlof, Dickens and Perry (1996) argue that it is easier to cut real wages through inflationary pressures, than through deflationary aggregate-demand management (Barry, 1999). Ireland can now only rely on the latter, more difficult method of moderating real wages.

To summarise, Alesina and Perotti (1995) found that successful fiscal adjustments¹ across a number of Organisation for Economic Co-operation and Development (OECD) countries resulted from a fall in government expenditure, particularly in public sector wages. While unsuccessful adjustments stemmed from an increase in taxes leading to a deterioration of the economic environment, it was also found that competitiveness improves drastically during and after successful fiscal tightening. A fall in government consumption 'crowds-in' investment and competitiveness, leading to improvements in growth and unemployment. Finally, this paper also suggests that coalition governments are less able to run a successful fiscal contraction. Of 23 strong fiscal adjustments, only two were successful under such governments.

¹ Defined as a relatively permanent consolidation of the budget

Two-part pay scheme

There is significant resistance to downward pressure on nominal wages, making the process of wage moderation particularly difficult. In terms of flexibility, there are asymmetries; wages easily revert upwards in times of expansions, while failing to adjust downward as rapidly in recessions. This extends the negative impact on unemployment beyond the initial negative shock. If the Irish government is successful at moderating nominal wages, it could be advisable to implement a two-part pay scheme, such as that suggested by Lane (2010), in order to enhance the flexibility of wages during economic downturns and eliminate prolonged periods of unemployment.

In short, a proportion of total income is protected against downward pressure on wages so that agents have some level of income insurance for planning purposes. The rest of the income would be state contingent, which would be reduced or eliminated in the case of an adverse shock, such as a fall in GDP beyond a specified level. The composition of total income would depend on negotiations between policymakers and public sector unions. This scheme would ensure that workers would have some form of income insurance, thus dampening the threat posed by unemployment.

Conclusion

This paper has argued that due to the procyclical nature of fiscal policy and to lesser extent, asymmetries in monetary policy, the Irish government should aim to run a fiscal contraction. This would cut government consumption, particularly the wage bill, while leaving tax rates unchanged. Greater government credibility would help to ensure the successful implementation of tight fiscal measures. By putting downward pressure on the real wage, which has been growing at an exceptional rate, the government could ensure cost competitiveness. However, as a result of EMU membership, Ireland can no longer create inflationary pressures through currency depreciation. Therefore, reducing the nominal wage is the only means available for real wage rate adjustment. Furthermore, introducing a two-part pay scheme will reduce the likelihood of the government having to undertake the unfavourable task of reducing nominal wages again. By encouraging competitiveness, the consolidation could eventually become expansionary.

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