Eurozone stimulus: A myth, some facts, and impact estimates

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Eurozone governments have engaged in substantial fiscal stimulus. This column argues against further fiscal measures, claiming that forward-looking firms and households will cut their expenditure in response to governmental expansions. It warns that further fiscal efforts risk eroding financial and monetary policies that are combating the crisis.

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Fact: Fiscal stimulus packages put together by Eurozone governments were much smaller than the US package (American Recovery and Reinvestment Act, ARRA).

Announcements of discretionary fiscal measures by Eurozone governments only add up to about 1% of GDP in 2009 and a little less in 2010. The $787 billion stimulus by the US government amounts to over 5% of US GDP.

Myth: It's the fault of the German government. If only they had followed the example set by the Americans, the Eurozone economy would have enjoyed a big boost, and the recession would have been much smaller.

This view still appears to be widely held. To give just one example, as recently as July 20, the German business daily *Handelsblatt* reported on an interview with Robert Shiller under the front-page heading "We need more stimulus" as follows:

> *Handelsblatt: Nobel prize winner Paul Krugman accused the German government some months ago of "boneheadedness" in fighting the recession. How do you judge the crisis management in Germany?*
>
> *Shiller: My impression is that the stimulus program of the German government was weak. Though the money from the stimulus package in America was also flowing with some delay, it has at least strengthened confidence. In this regard the US was more active.*

Fact: The German government, which was heavily criticised in the fall of 2008 for not spending enough, quickly followed up with a second "Konjunkturpaket" in January 2009. The two fiscal packages, together, imply additional spending, transfers, and tax cuts of about 1.5% in 2009 and 2% in 2010. This is actually quite close to the US stimulus for those two years, since the ARRA measures are spread over five years.

The German stimulus is about 50% of the Eurozone stimulus, quite a bit more than its share in Eurozone GDP. Given that Germany is a country with much more pronounced automatic stabilisers than the US, this is a strong sign of fiscal activism. Thus, the German government should get good grades from those who trust in the boosting power of fiscal stimulus.

How much of a boost to Eurozone GDP should we expect?

Proponents of discretionary fiscal stimulus hope for a Keynesian multiplier effect. It follows from the national accounts spending identity when combined with the textbook Keynesian consumption function. The latter has current income as the main driver of consumption spending. A government-induced increase in total spending then raises income and boosts private consumption, which in turn raises total spending further.

Does the multiplier work? The recent debate in the US indicates quite some disagreement even among Keynesian economists. President Obama's advisers Christina Romer and Jared Bernstein estimate that 1% of government spending would generate a 1.6% increase in GDP. They give much weight to the type of traditional macro models used by some forecasting firms. As a result, they believe the ARRA stimulus is good for 3% to 4% additional growth by end of 2010. A robustness analysis with New-Keynesian models conducted by Cogan, Cwik, Taylor, and Wieland (2009) indicates only about one-sixth of this effect. Our analysis suggests government spending quickly crowds out private consumption and investment, because forward-looking households and firms will consider eventual increases in future taxes, government debt, and interest rates.

New evidence on the multiplier

In a recent paper, Tobias Cwik and I assess the magnitude of Eurozone stimulus and construct a range of impact estimates (Cwik and Wieland 2009). We use a database of macroeconomic models that includes several models developed and used at important policy institutions such as the ECB, the EU Commission, and the IMF.

Our findings confirm the earlier analysis with models of the US economy. Once you allow for a significant role of forward-looking behaviour by households and firms, there is no multiplier. The expectation of future tax increases, or rising government debt and future interest rate increases leads to a reduction in private consumption and investment spending. This holds in particular for the three New Keynesian models developed by economists at the ECB, the IMF and the EU Commission (see Smets and Wouters 2003, Laxton and Pesenti 2003, and Ratto, Roeger and in't Veld 2009). These models include extensive Keynesian features such as price and wage rigidities, but also employ up-to-date microeconomic foundations. The model of EU Commission researchers is especially interesting because it is recently estimated and one-third of its households do not care about the future and follow a traditional Keynesian consumption function.

Broadly similar results are obtained in the multi-country model of Taylor (1993), a slightly older vintage of New Keynesian economics with price and wage rigidities and forward-looking households and firms. Only the ECB's area-wide model delivers the desired multiplier effect. However, all its firms and households look backwards. Its developers therefore caution that it is adequate for short-term forecasts but not the evaluation of major policy changes (Fagan et al. 2005).

Likely implementation lags make things worse. If anticipated, the initial effect of fiscal stimulus may even be negative. Monetary accommodation, of course, helps. For example, if the ECB puts off the usual interest rate increases for a year, the fiscal stimulus gets more play, but not enough to generate a substantial multiplier.

Spillovers to Eurozone neighbours and a conclusion

Additional spending may partly be diverted to imports. For this reason, proponents of fiscal stimulus in Europe have talked much about spillover effects and lobbied for coordinated measures. As it turns out, Eurozone stimulus remained limited because most Eurozone members did not really follow the US example.

Using Taylor's multi-country model, we tried to estimate likely spillovers from the major stimulus package in Germany to France and Italy. This model exhibits significant direct demand effects for French and Italian exports. Nevertheless, the spillovers are negligible. Readers who remember the impact of the German unification spending boom on members of the European Monetary System in the early 1990s will not be surprised. The direct demand effects are offset by the upward pressure on the exchange rate with countries outside the

Eurozone, as well as the expectation of somewhat higher future interest rates.

Conclusion

In light of these findings, European policy makers ought to ignore calls for further stimulus packages. Instead, they should carefully monitor the impact of decisions already taken on the burden imposed on future taxpayers. If governments exhaust their fiscal space in measures that have little aggregate effect, their continued capability to back up the financial system will be questioned. At the same time, the economy is likely to benefit more from the increases in base money engineered by the ECB than traditional Keynesians would tend to believe (see Orphanides and Wieland 2000). In addition, fiscal responsibility on behalf of Eurozone governments would help avoid a premature exit from unconventional measures by the ECB.

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Typo

On September 7th, 2009 Francis.Bator says:

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If you decide to post my question/comment of a few minutes ago, please correct typo to its instead of it's. Thank you.