EUROPEAN CENTRAL BANK
EUROSYSTEM

Scarring effects of major economic downturns: the role of fiscal policy and government investment

Martin Larch (European Fiscal Board, European Commission), Peter Claeys (Economics Department, College of Europe, Bruges), Wouter van der Wielen (European Investment Bank)

Discussion by S. Hauptmeier* (European Central Bank)

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** The views expressed do not necessarily reflect those of the ECB or the Eurosystem.*

Summary

- **Empirical analysis of major economic downturns** in 26 OECD countries since the 1970s
- **Evidence points to significant economic scarring**:
  - recessions often followed by downward shift in economic activity
  - Average annual shortfall of around 2% of pre-shock trend GDP
- **fiscal policies tend to mitigate the lasting impact of major economic downturns on real GDP**:
  - dampening (but relatively small) effect of budgetary expansion in the year of the downturn
  - fiscal accommodation mainly via automatic stabilisers and current spending
  - high government debt weighs on scope for fiscal stabilisation policies

Methodology

- **Step 1: Identification of recessions**
  - based on Harding and Pagan (2002) and two alternative metrics (standard deviation / output gap)
  - around 130-160 major downturns (real GDP growth between -1.5 and -2.5%)
- **Step 2: quantifying the degree of economic scarring**
  - building on Ball (2014) and Blanchard et al. (2015)
  - average difference between (pre-crisis) trend real GDP and the actual evolution of real GDP in the years t+3 to t+7
- **Step 3: regression analysis of the determinants of economic scarring**
  - fiscal variables: change in GDP ratios compared to average over last three years (budget balance, current spending and investment)
  - other: private investment, dummy variables capturing (banking) crises / macro conditions
  - second stage regressions (impact of debt)

Measurement issues

- **How to disentangle scarring from other sources of growth slowdown?**
  - quantification of scarring rests on strong assumption that "absent a significant shock, economic growth would continue along a stable trend"
  - but: growth deceleration due to other factors incl. demographic change, declining productivity , etc.
  - Blanchard et al. (2015) address this with de-trending
- **Exogeneity of fiscal variables**
  - changes in fiscal ratios capture automatic stabilisers and discretionary response to economic downturn
  - persistence in GDP series could cause problems of reverse causality
  - Fatás and Summers (2018): identification of fiscal shocks based on Blanchard and Leigh (2013) / additional controls related to the size of the initial shock

Policy implications (I)

- **What can we learn regarding an optimal fiscal response to a recession?**
  - paper stresses emphasis of governments on automatic stabilisers / current expenditure but insignificant role of public investment ("This is clearly unfortunate, as public investment can reduce scarring.").
  - but: should governments really rely on investment for short-term macroeconomic stabilisation given well-known implementation lags?

- **What about the policy sequencing / interaction with other policies?**
  - Fatás and Summers (2018) document strong fiscal policy-related hysteresis following the GFC
  - interaction with monetary policy
  - institutional factors

Policy implications (II)

- **What can we learn for the discussion on SGP reform?**
  - Analysis suggests vicious circle: adverse effect of economic scarring on debt sustainability ... high debt results in limited scope to address future shocks ...
  - Paper argues that move to expenditure-based rule (as proposed by many stakeholders) would not imply a material improvement (if reference rate is biased):
    - need for regular assessment whether government expenditures follow a sustainable path or whether there is a need adjust in line with updated assessment of potential output
    - possible alternative: built-in safety margin (could be estimated based on past experience and compared to bias of structural balance indicator)
  - Analysis seems to provide strong arguments for building buffers in economic normal / good times and protecting investment spending
    - Could this be tested empirically?

Additional comments

- Readability of the paper could be improved by front-loading a concise methodological section that describes the three-step approach (with reference to existing studies and where the paper deviates in terms of method).
- Rich dataset could be exploited to provide more (descriptive) insights on country experiences / regional differences
- Would be interesting to learn whether certain recessions (notably the GFC) are driving the results on economic scarring?