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Fiscal policy and the business cycle: the impact of government expenditures, public debt, and sovereign risk on macroeconomic fluctuations

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Chapter 6

Summary and Conclusion

This thesis has studied the relationship between fiscal policy and the business cycle. In particular, based on a combination of empirical macroeconomic techniques and macroeconomic theory, the thesis has analyzed the impact of government expenditure policies, public debt, and sovereign default risk on macroeconomic fluctuations. The aim of this analysis has been to contribute to fill some of the gaps in contemporary macroeconomic research on fiscal policy that have become obvious in the context of the turbulent economic events over the past few years.

Chapter 2 has estimated time-varying parameters time series models for the euro area to examine changes in the macroeconomic effects of government spending. It has also analyzed the driving forces of those changes using regression analysis.

Chapter 3 has demonstrated how expectations on future government spending can be used to address the problems of econometric inference on the effects of spending changes that are caused by policy foresight by economic agents. The proposed expectations-based approach has been applied to estimate the effects of surprise changes in government spending in the United States.

Chapter 4 has assessed the effectiveness of government policies during a financial crisis in a structural macroeconomic model with frictions in financial intermediation. The model takes into account that a large fraction of government debt is typically held by financial institutions instead of directly by households.

Chapter 5 has analyzed the role of sovereign default risk in macroeconomic fluctuations in an emerging market economy based on an estimated quantitative business

cycle model for Turkey.

The results from Chapters 2 and 3 suggest that, on average, expenditure policies falling on government goods purchases are not very effective tools for short-run stabilization. Moreover and especially over time, the medium-term effects of such policies point towards significant crowding-out effects of fiscal expansions. The results of Chapter 4 suggest that, if the macroeconomic context calls for fiscal policy actions, they should be chosen carefully with a view of their financing. This chapter shows that deficit financing through a distressed financial sector can have undesirable consequences for the effectiveness of government policies. The results of Chapter 5, on the other hand, show that the observed dynamics of government debt and monetary policy behavior in interaction with sovereign default premia can explain important aspects of past business cycles in Turkey. The latter indicates that fiscal variables matter for macroeconomic fluctuations when agents view fiscal developments as potentially unsustainable even if fiscal policy remains rather passive.

The overall message that emerges from the analysis in Chapters 2 to 5 of this thesis thus calls for a prudent approach towards the use of fiscal policy, especially government expenditure policies, over the business cycle. The results of the analysis do however not necessarily support total fiscal passivism, but they do the view that fiscal measures are not very effective if they are implemented without taking into account the specific macroeconomic context. At the same time, the results suggest that an important contribution that governments can make to achieve macroeconomic stability is to ensure that fiscal variables follow a sustainable path.

The thesis has not studied a number of other relevant aspects. In particular, the role of tax and transfer policies has not been analyzed, mainly due to significant problems in the empirical measurement of autonomous changes in taxes and transfers (Chapters 2 and 3) but also a relative lack of data (Chapter 3). In addition, the models in Chapters 4 and 5 have not accounted for distortionary taxation. The main transmission channels in those models are however unlikely to be affected by an extension in this direction. Moreover, one could have looked at a broader set of government policies in Chapter 4. The specific choice of policies seems however irrelevant for the characterization and the understanding of the key mechanisms highlighted in this chapter.

On the other hand, while Chapter 5 represents a further step towards an analysis of sovereign default risk in an estimated quantitative macroeconomic model, ongoing concerns related to the exposure of financial institutions to risky government debt suggest that it may be useful to combine the framework in Chapter 4 with the relevant aspects of Chapter 5 to be able to evaluate monetary and fiscal policies in this type of environment. The latter is left for future research.