20th Anniversary of the Monetary Independence of the Republic of Macedonia

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Fiscal policy and its implication in a small open economy with data constrains.

Bank of Albania

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Motivation

The role of fiscal policy and economic growth in Albania.

What is the appropriate policies to stimulate economic growth?

How fiscal policy affect growth, inflation and financial stability ?

It is fiscal policy sustainable ?

Outline

I. Fiscal performance in Albania from 1991-2011.

II. Research work at Bank of Albania

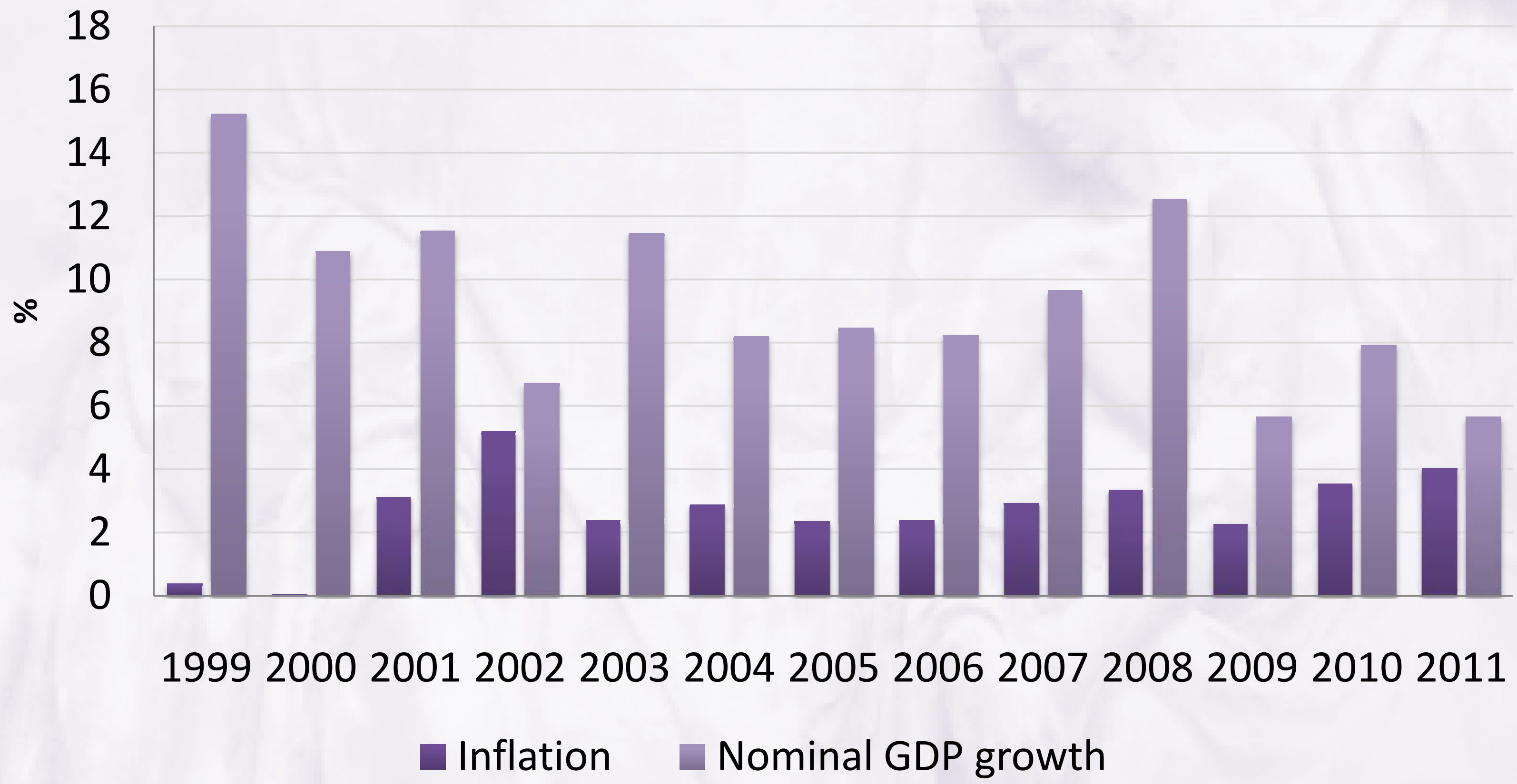
III. Data constraint

IV. Concluding remarks

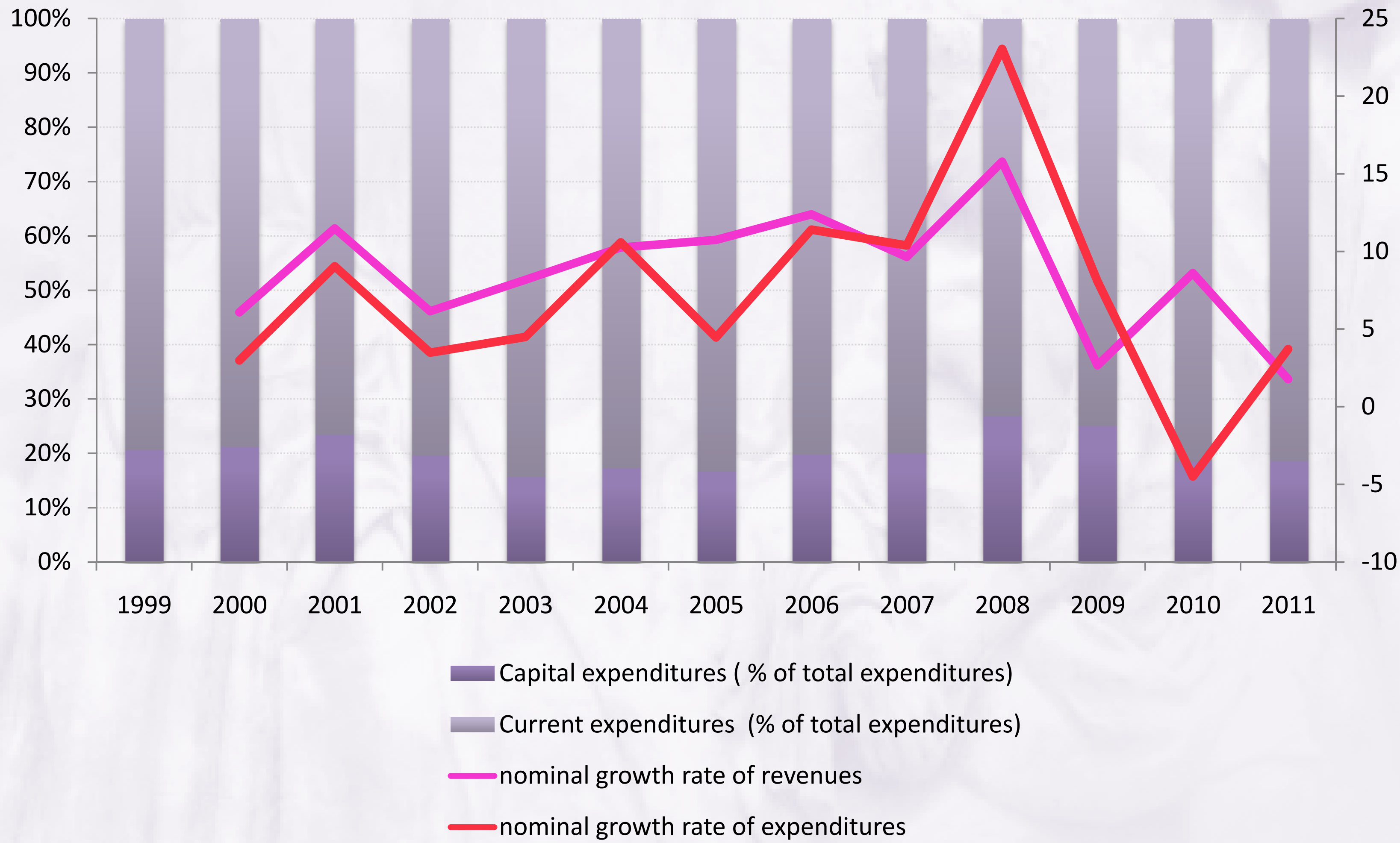
I. Fiscal performance in Albania

- Post transition Slump and re-establishment of Macro economic stability (1991-1995).
- Uncertain policies (1996-mid 1997)
- Stabilization and renewed reform (1998-2001)
- Consolidated period with some specific elements (2002-2011); global crises, wtht IMF program

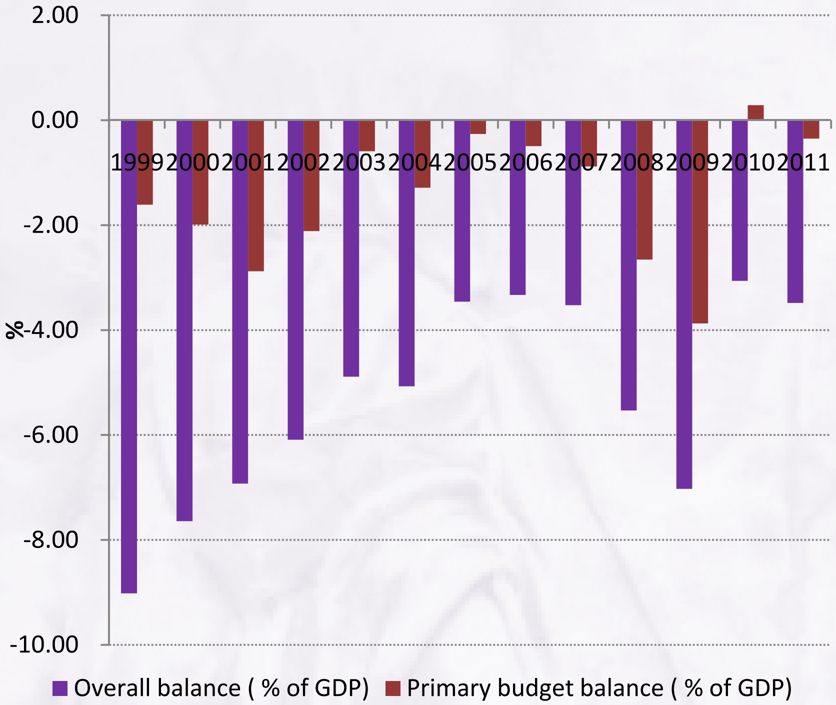
I. Fast economic growth and low inflation environment

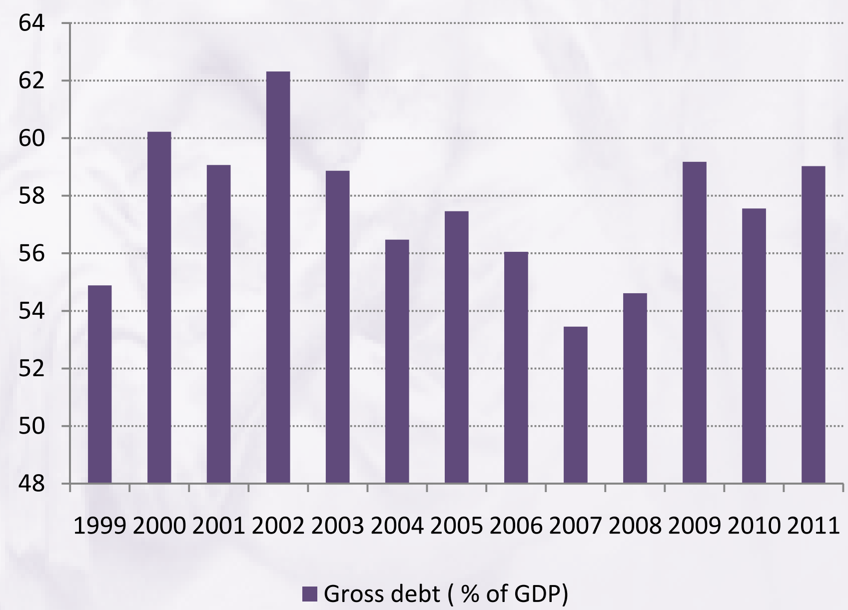


I. Fiscal indicators



I. Budget deficit and public debt as % of GDP





II. Research work at Bank of Albania

i. Government size and economic growth.

ii. How government improve the efficiency of public spending and reduce distortions in the tax system of economic growth

iii. Investigation of the sustainability of fiscal policy

iv. Impact of fiscal policy on monetary policy, through yield curves and inflationary pressures

II. Research work at Bank of Albania

i. Government size and economic growth

Goal-Investigation of effects of fiscal policy on GDP, interest rate, prices -Mancellari, 2011

Data; 1998q1-2009q4

Variables:

real government primary expenditures, real government net revenues, real GDP, CPI, and real 12-month T-bills interest rates.

Methodology:

SVAR approach following Blanchard and Perroti (2002)

II. Research work at Bank of Albania

i. Government size and economic

Main Results:

- A tax cut stimulus has the highest cumulative GDP multiplier, reaching 1.65 after five quarters, no evidence of Ricardian equivalence in Albania consumers.

- Among capital and current spending, the GDP multiplier of capital spending is 0.95 after one quarter, and higher than the current spending multiplier

- No statistically significant responses of interest rates following fiscal spending shocks are found, but they do increase after a tax cut

- A current spending shock slightly increases prices after one quarter, while a cut in net revenues significantly decreases prices by 55 bps on impact, settling at 40 basis points after four quarters

Estimated multiplier are also consistent with the structural Macro Econometric Model (MEAM) of the Bank of Albania.

II. Research work at Bank of Albania

ii. Role of fiscal policy on economic growth based on endogenous growth model

Goal-identification of elements of tax and government expenditures that affect long-run; Shijaku and Gjokuta, 2012

Data; 1998q1-2010q4.

Variables;

real GDP growth, fixed gross capital formation, employment growth rate, trade openness to GDP ratio, government revenues excluding grants , expenditures, debt to GDP ratio

Methodology;

GMM approach based on Kneller et. al growth model

II. Research work at Bank of Albania

ii. Role of fiscal policy on economic growth based on endogenous growth model

Summary of results ;

- Employment growth and fixed gross capital formation have positive effect on production growth, while economic openness effects growth negatively.

- Thus growth is affected negatively by government revenues and positively by expenditure policies.
  - increasing distortionary taxation has much larger effect in decreasing growth rate rather than non-distortionary taxation.
  - growth is positively affected by productive expenditures and negatively by non-productive expenditures

- Rising debt burden reduces growth.

II. Research work at Bank of Albania

iii. Sustainability of fiscal policy

Goal-Sustainability of fiscal policy is based on the inter temporal budget constraint (IBC) of the government, meaning that future debt will be mature and repaid full, Shijaku2012

Data; 1998q1-2010q4.

Variables;

primary surplus to GDP ratio and debt to GDP ratio as endogenous variables, while output gap, inflation and cost of debt servicing as exogenous variables

Methodology;

The transversality conditions of Trehan and Walsh, (1991), Taylor, (2002) and on VAR approach of Barro,(1979) and Uctum, (2006).

II. Research work at Bank of Albania

iii. Sustainability of fiscal policy

Results ;

- Unit root test confirm that debt to GDP ratio is stationary, fiscal policy is sustainable.
- Pro-cyclical link between primary surplus and output gap putting more risk relating to the position of fiscal stance.
- There is some coordination between fiscal and monetary policy in terms of exchanging information on long-term fiscal and monetary strategies
- Raising costs of debt servicing would lower the primary surplus, but this effect would be statistically insignificant.

Results from both approaches imply that fiscal policy is sustainable, but the profligacy of fiscal authorities is putting it at risk, considering that the pursued fiscal policies do not avoid excessive debt burden.

II. Research work at Bank of Albania

iv. The impact of fiscal policy in interest rate and other variables

Goal: Investigation of fiscal policy and yield curve in Albania, Abazaj (2012).

Data;

2001q1-2010q4.

Variables;

annual change of debt to GDP ratio and fiscal balance as % of GDP, real growth, inflation, yield curve (slope and level)

Methodology;

VAR approach

II. Research work at Bank of Albania

iv. The impact of fiscal policy in interest rate and other variables

Results ;

- Both fiscal variables affect the yield curve, through this effect is temporarily significant.
- Variance decompositions show that the debt variable has more explanatory power in the variance of error in forecasting the slope factor
- Fiscal balance explains most the level factor.
- Also the author concludes that innovations to monetary policy do have a considerable explanatory power in forecasting level and slope.

III. Data constraints

- Time series include only 11-12 years of observations
- Structural break, unit root test confusing results, loss degree of freedom
- Very low frequencies data, annual vs. quarterly
- Investigation of time series does not seem to be a suitable instrument measuring sustainability of fiscal policy, since it completely neglects predictable future trends of government spending and revenues.
- VAR approach is backward looking, since it completely neglects future trend of fiscal policy, and are subject of Lucas critique.
- Fiscal policy shock on economic activity are likely not linear, so this possibility of nonlinearities need to be take on account.

IV. Concluding remarks

- Throughout the period of transition, fiscal policy has gone through several different stages of development, accompanied by various structural reforms.
- During 1998-2011 fiscal policy in Albania is considered as a consolidated fiscal policy, although in recent years it has been characterized by a high level of debt.
- Most appropriate policies to stimulate economic growth are those by reducing the tax burden than the growth of government spending.
- The decomposition of expenditure showed that productive expenditures have the highest impact in increasing the growth, compared with non-productive expenditures.
- Annual change of debt-to GDP ratio affect most the slope of yield curve, while fiscal balance as per cent of GDP affect the level of yield curve

IV. Policy implication

- A sound fiscal position appear to be a key prerequisite for higher growth, therefore lower fiscal imbalances are associated with greater macroeconomic stability less business uncertainty and stronger investment climate.
- An important lesson from the crisis therefore is that fiscal policy should be more prudent non only in short run but also in the long run.
- Implementation of a clear medium-term fiscal adjustment plan is a key requirement for sustainable growth, with the support of fiscal institutions.

IV. Policy implication

- Fiscal rules may help anchor fiscal policy
- Long term fiscal challenge remains a potential risk in the future, not only in Albania.
- To ensures not only short term but also long term fiscal consolidation requires in addition clear communication of policies and objectives. The philosophy of coordination between all the actors is the key to achieved macroeconomic stability in good and bad time.

Thank you!