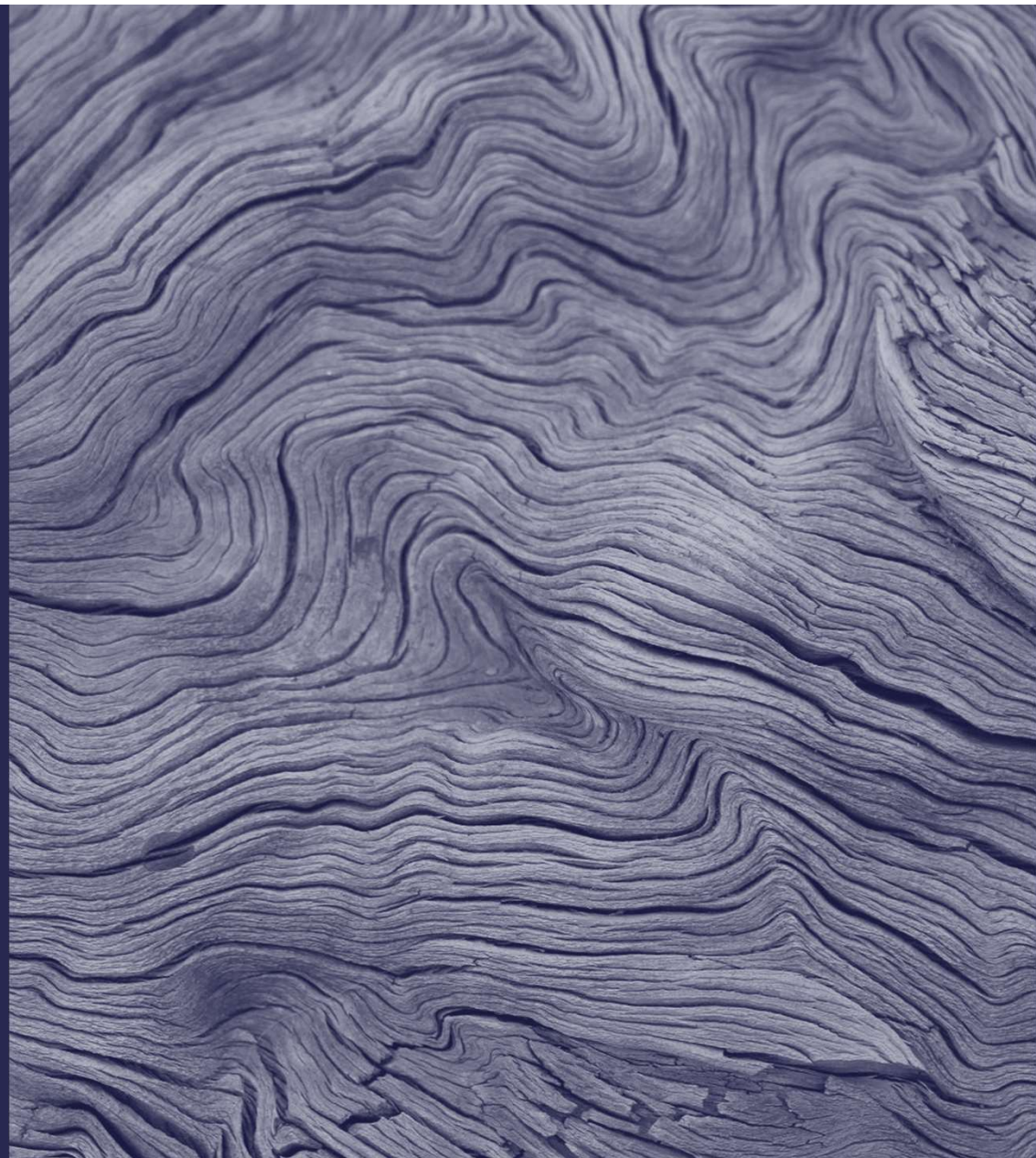


Monetary and fiscal policies: on a shared path or parting ways?

Mārtiņš Kazāks

7 September 2023





Presentation outline



Why are changes in fiscal framework needed?



Fiscal-monetary policy mix and the role of fiscal policy as a stabilization tool



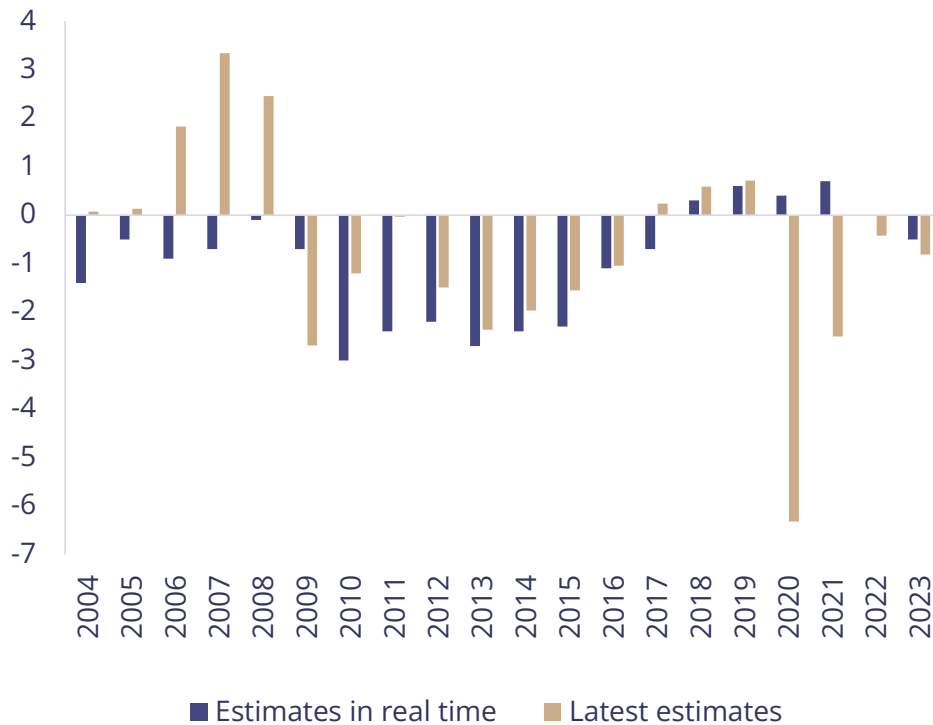
What fiscal rules should Latvia follow?

New fiscal framework –
a step in the right
direction

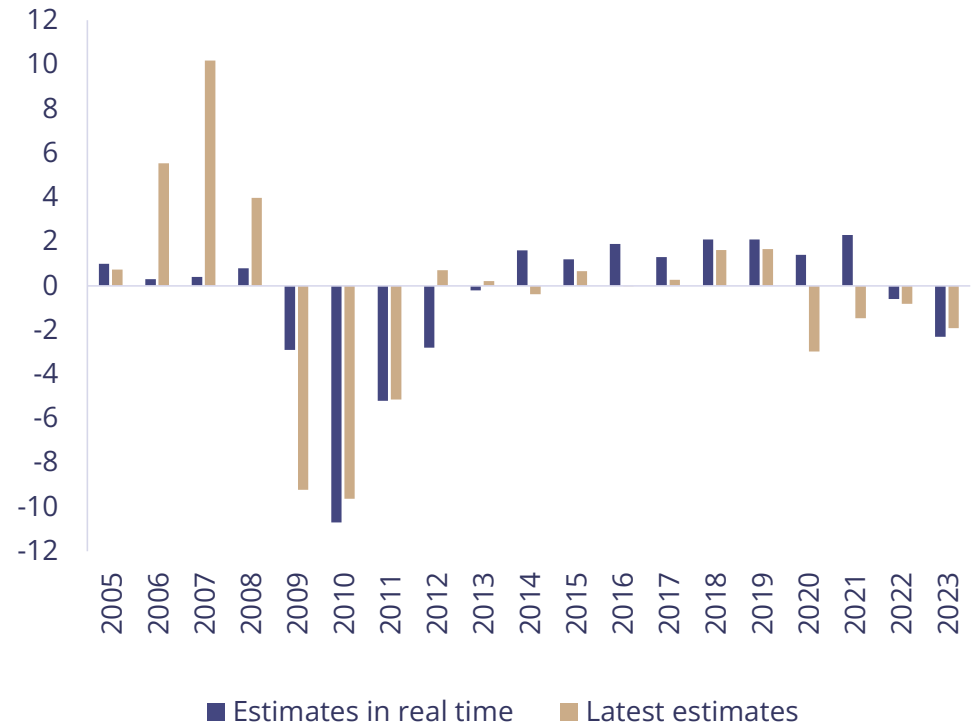


Output gap estimates are highly uncertain, making the framework that relies on these estimates prone to policy errors

Euro area



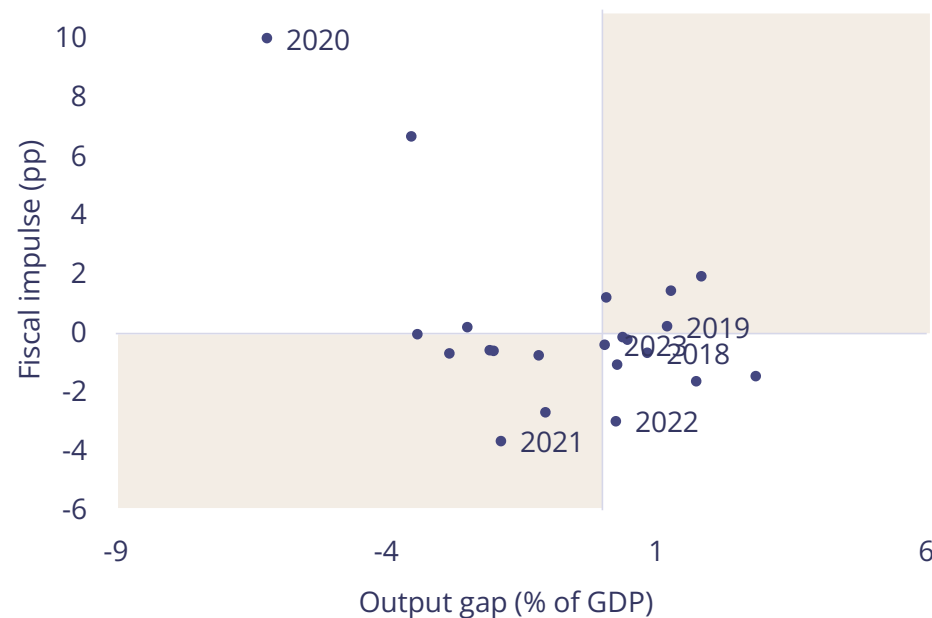
Latvia



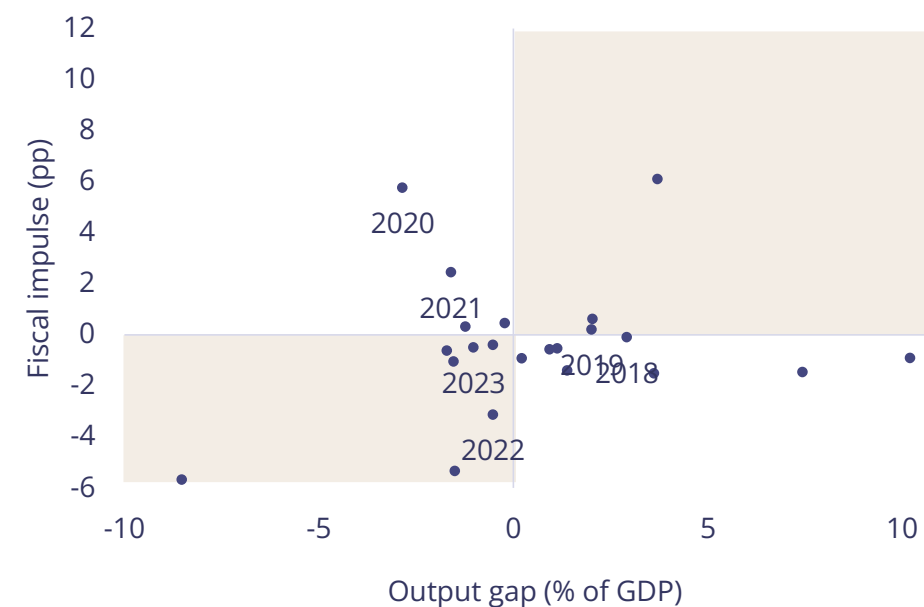
How well fiscal policy has worked as a shock absorber?

Due to uncertainties about output gap, actual fiscal policy has often been procyclical

Fiscal impulse and output gap in EA
(% of GDP; pp.)



Fiscal impulse and output gap in Latvia
(% of GDP; pp.)

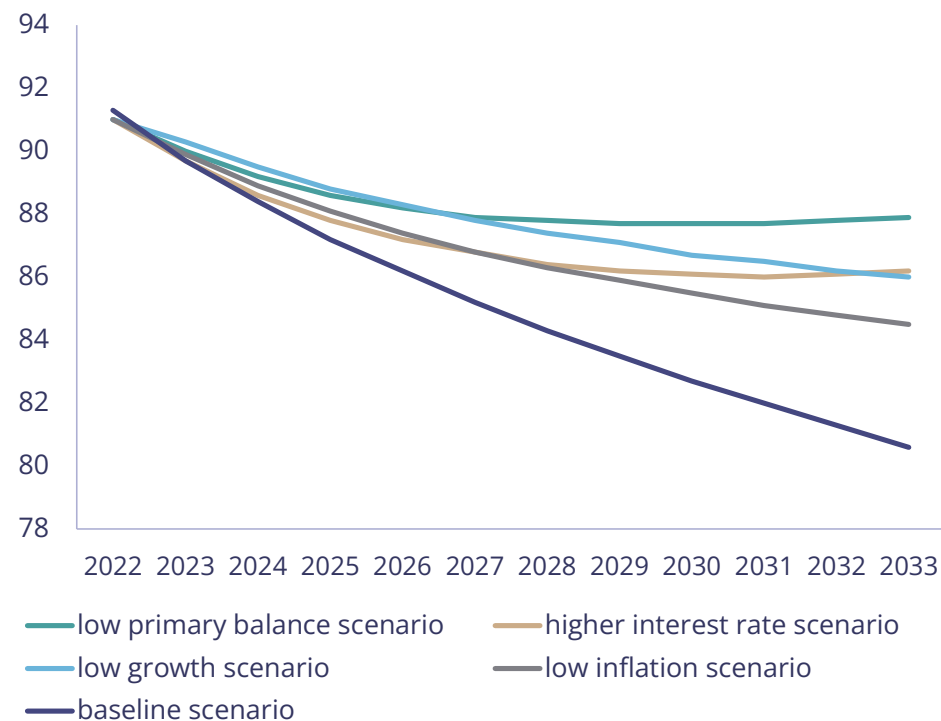


Fiscal policy stance: Counter-cyclical fiscal stance
 Pro-cyclical fiscal stance

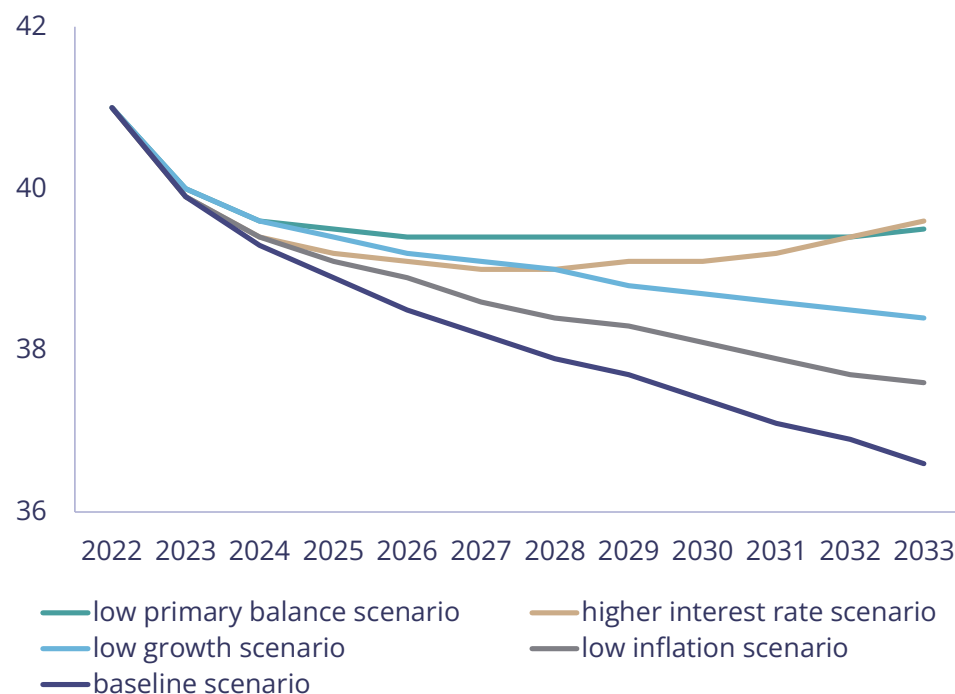
New approach: instead of a «magic number», look at scenarios

Given uncertainties, conceptually this is a more robust approach, but has to be tested in practice

Euro area government debt scenarios (% of GDP)



Latvia government debt scenarios (% of GDP)

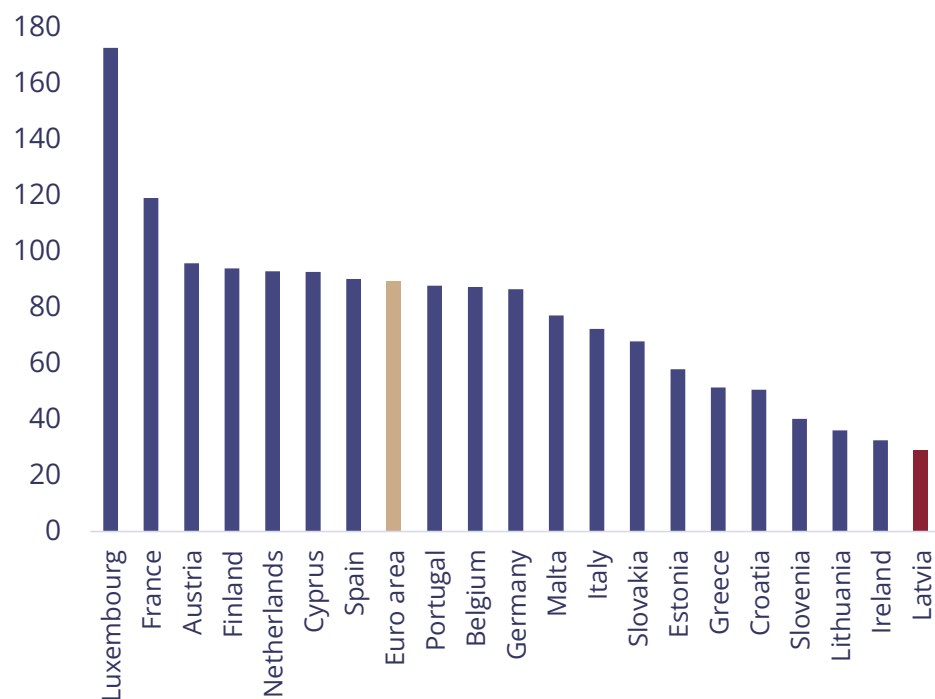


Monetary-fiscal mix

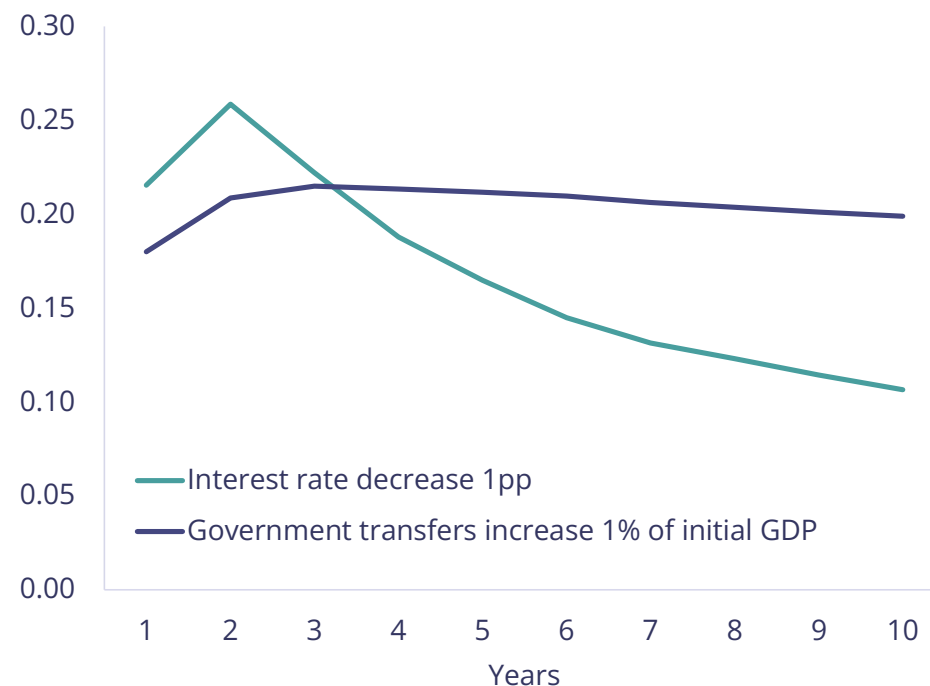


Due to shallow financial markets, fiscal policy is a useful complimentary tool to stabilize the Latvian economy

Credit to resident households and NFC in EA countries
(% of GDP)

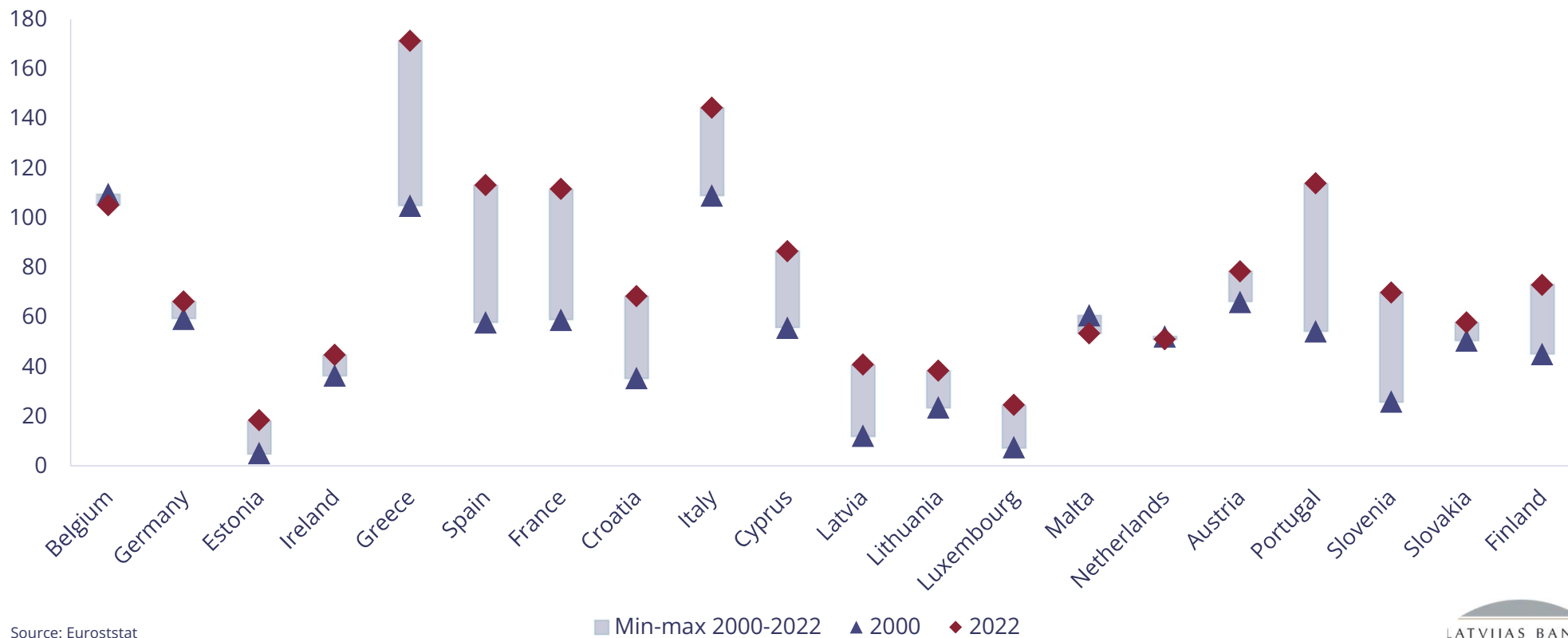


Model simulations: impact of fiscal and monetary policy on the economy (GDP, % deviation from initial level)



But too much of a good thing can be dangerous

Public debt in euro area countries (% of GDP)

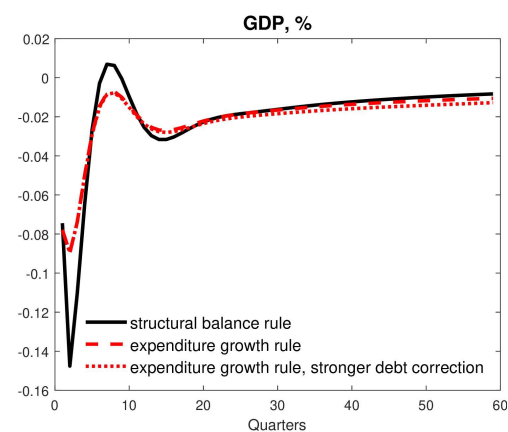
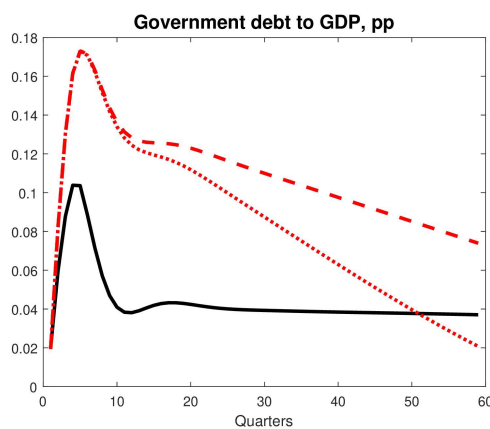
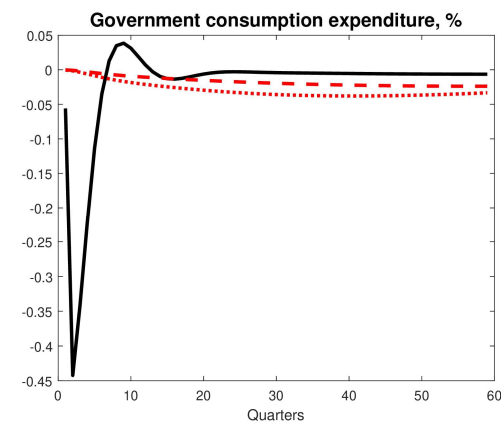
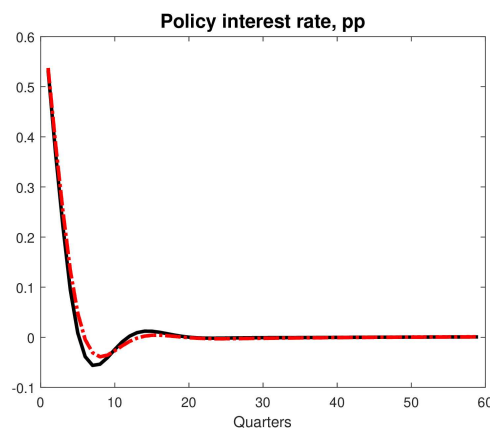


Fiscal rules for Latvia



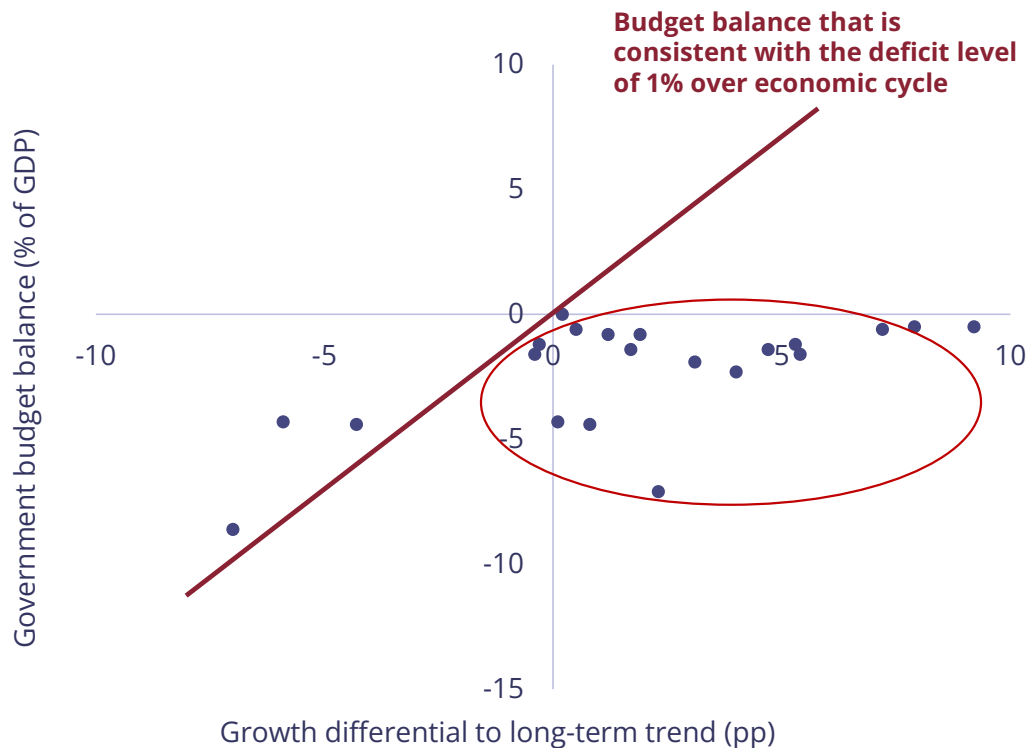
Expenditure rule - a good starting point

- Expenditure growth rule helps to stabilize public expenditure and GDP.
- Convergence of the government debt to its target is ensured by strong-enough debt-correction term inherent in the expenditure growth rule.



To avoid deficit bias, strict enforcement of rules during the good times is crucial

Economic cycle vs budget balance in Latvia, 2000-2022



Source: Eurostat.

LATVIA:

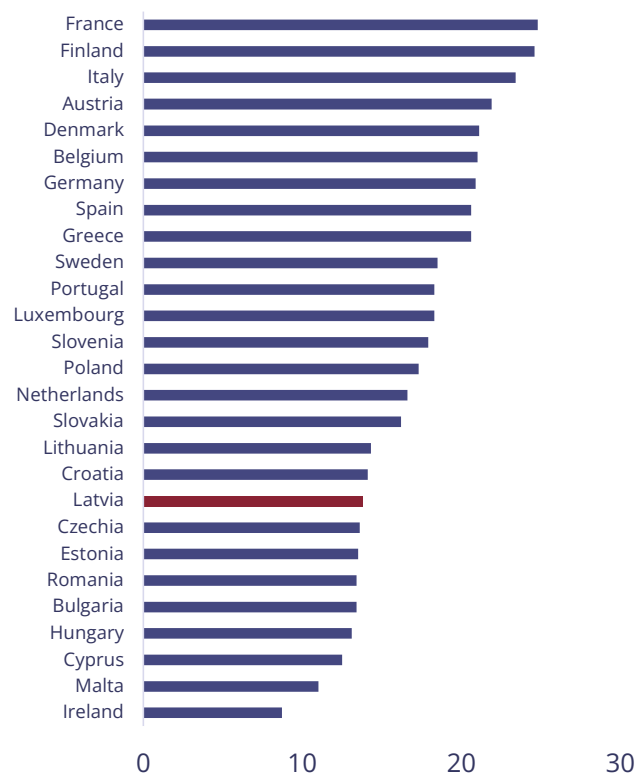
- Budget deficit when growth above long-term trend: 1.6% of GDP
- Budget deficit when growth below long-term trend: 3.3% of GDP

EURO AREA:

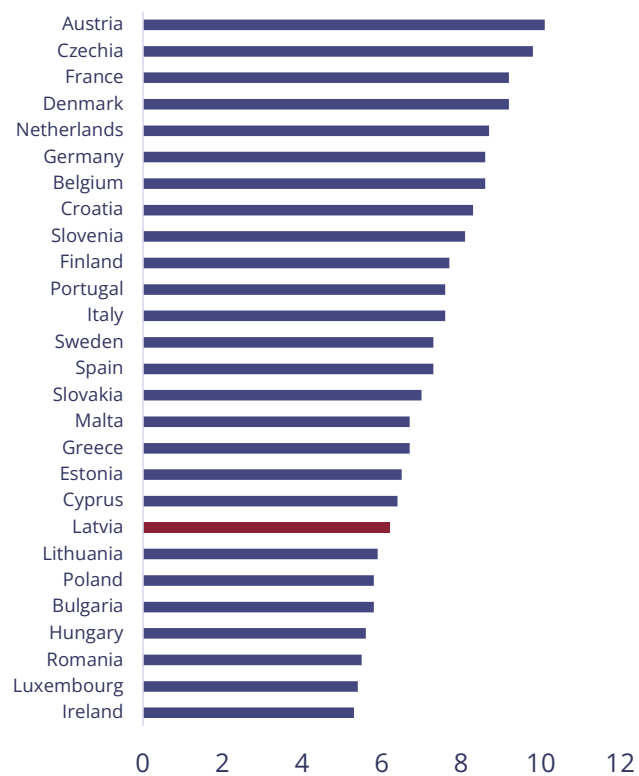
- Budget deficit when growth above long-term trend: 1.9% of GDP
- Budget deficit when growth below long-term trend: 3.6% of GDP

Size of government: small or larger?

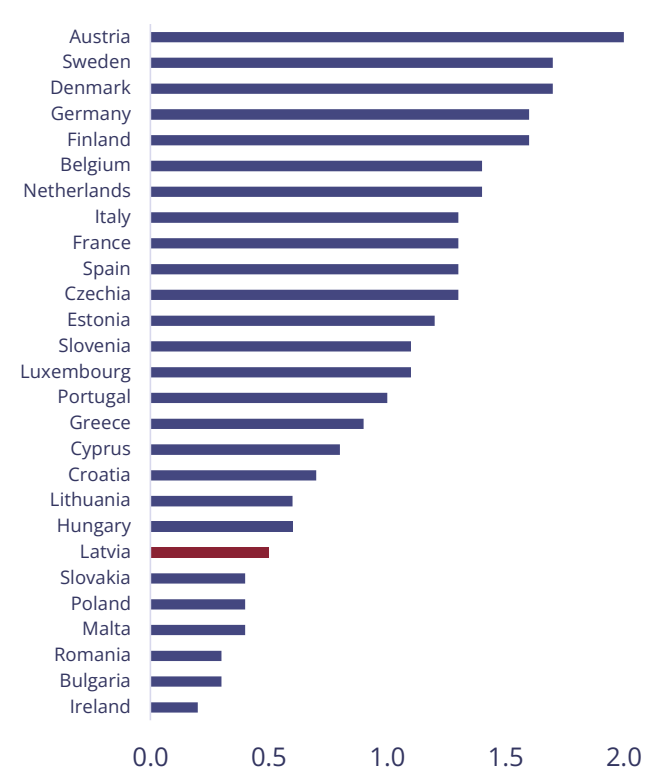
Government expenditure on social protection (% of GDP), 2021



Government expenditure on health (% of GDP), 2021

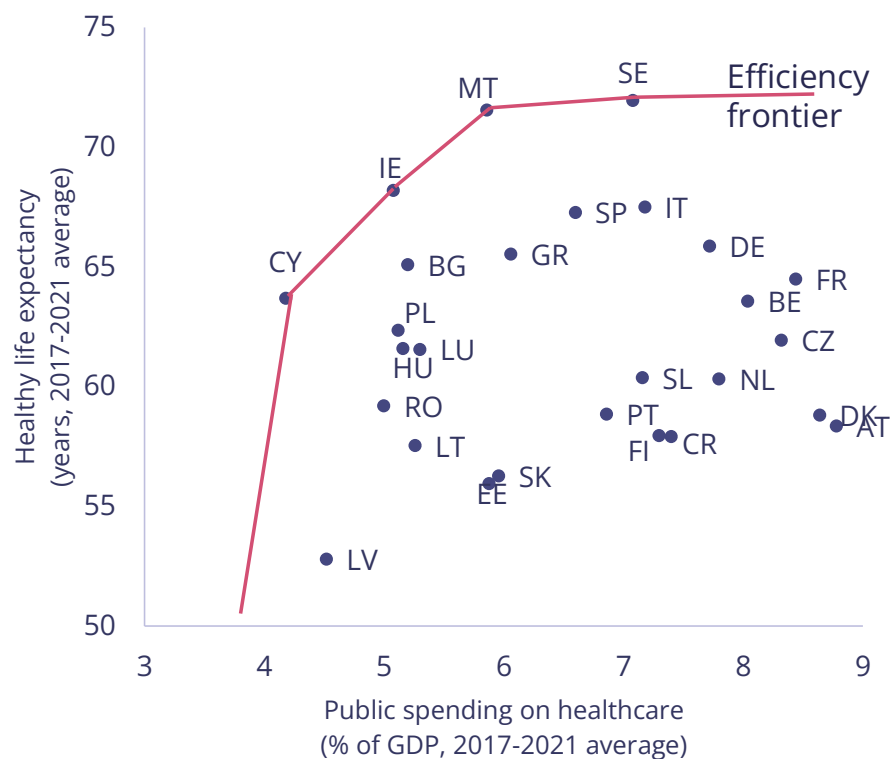


Government expenditure on R&D (% of GDP), 2021

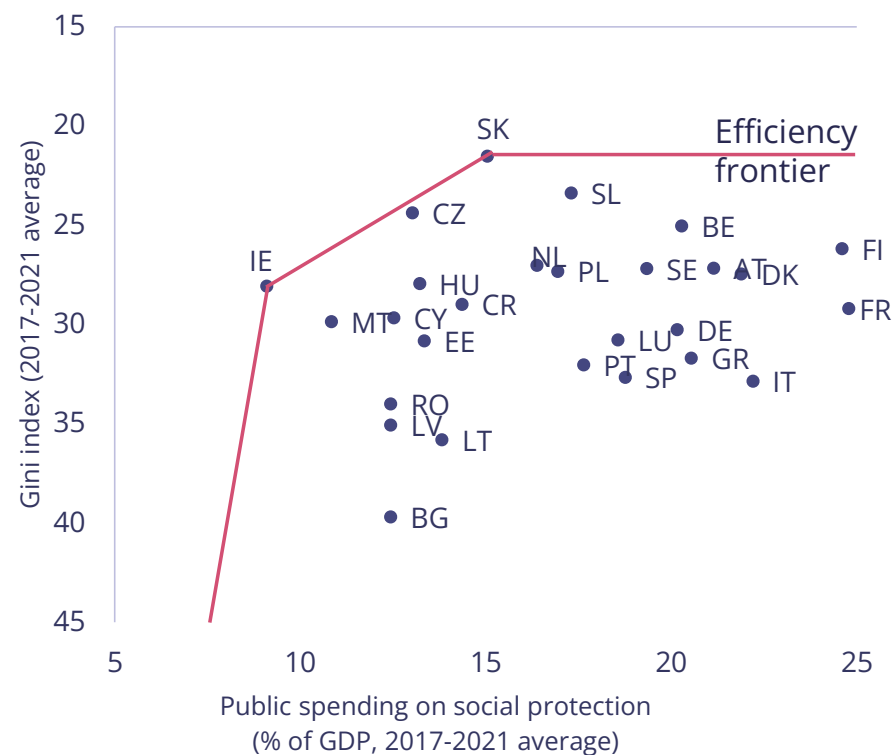


There is a room to raise public spending efficiency

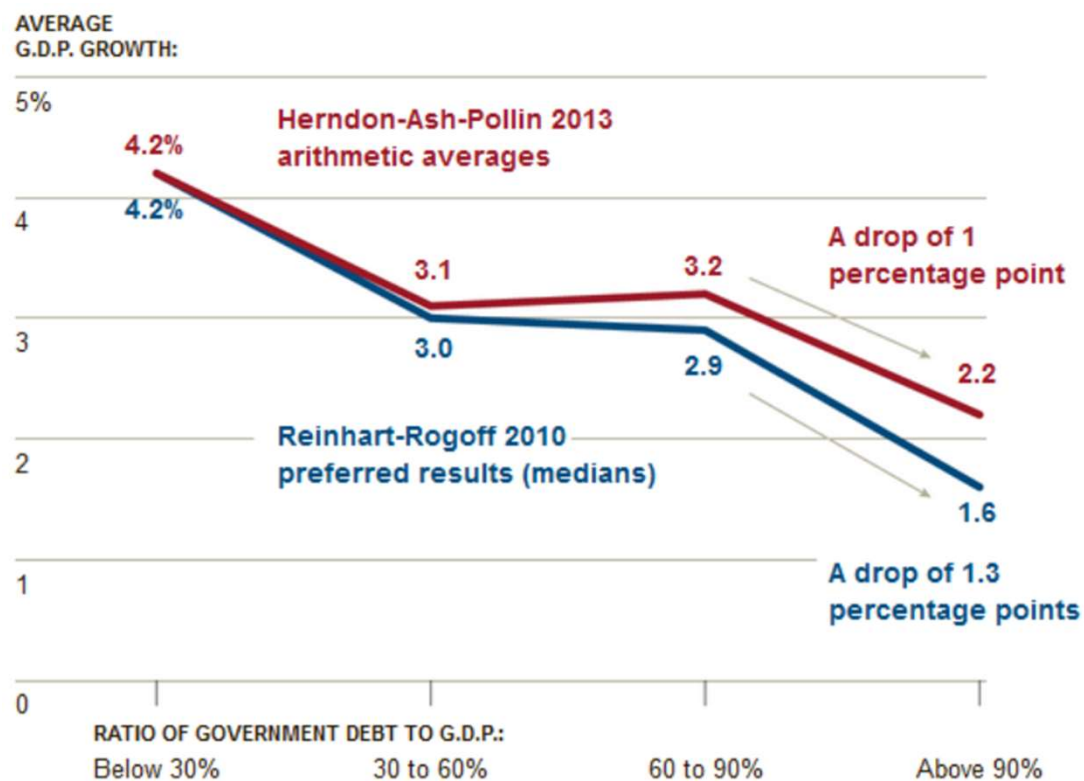
Public spending efficiency in healthcare



Public spending efficiency in social protection



Can high public-debt-to-GDP reduce economic growth?



Key takeaways

- Fiscal support may be needed to stabilize the economy
- Expenditure rule in combination with debt rule may be promising avenue
- Procyclical fiscal loosening in good times needs to be avoided as likely to lead to unsustainable debt accumulation and lower economic growth
- Spending needs to be financed by additional revenue or rationalization of spending





Our country, our bank

