



Fiscal rules and the structural balance – the case of a small open economy

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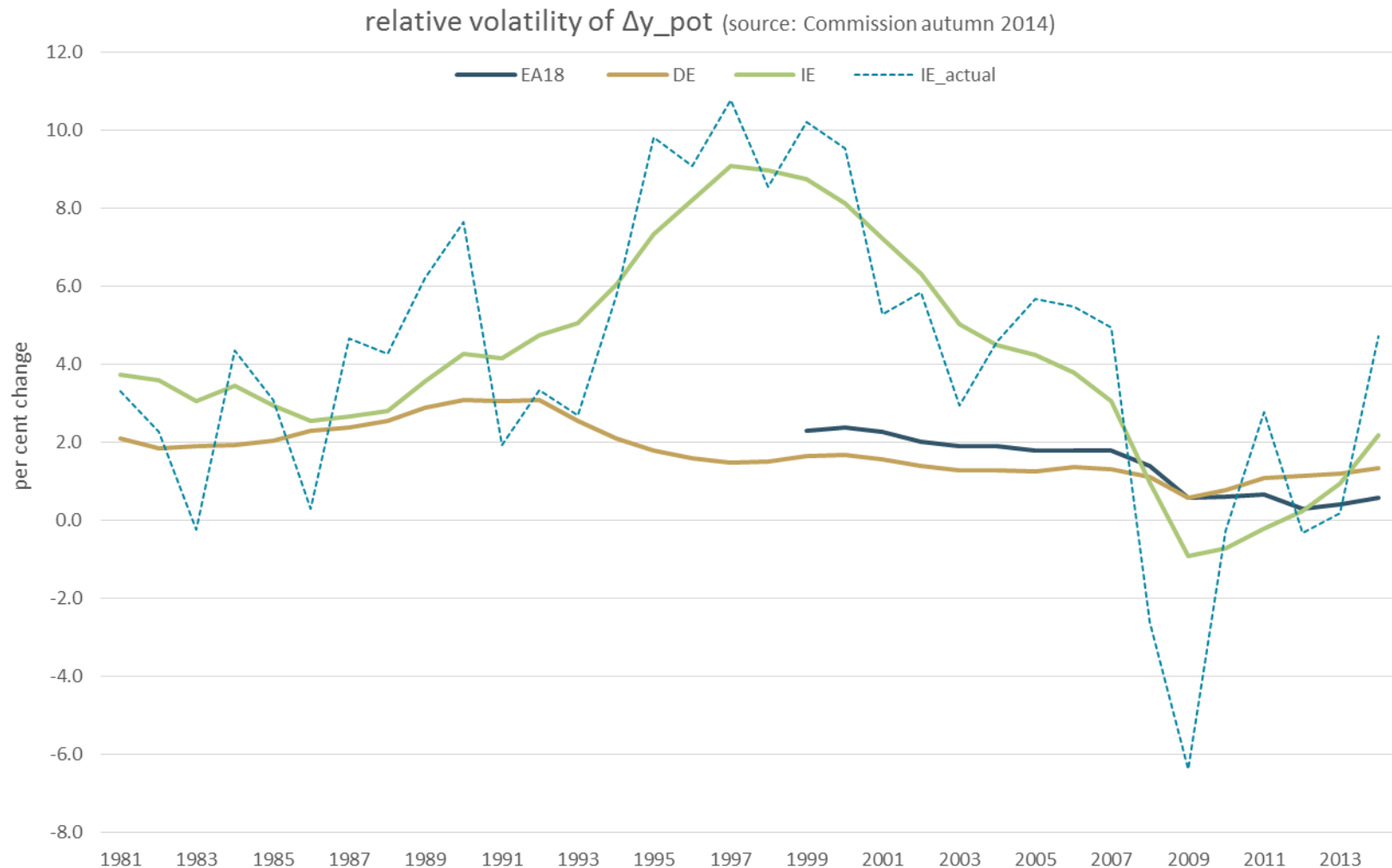
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Department of Finance

Key issues

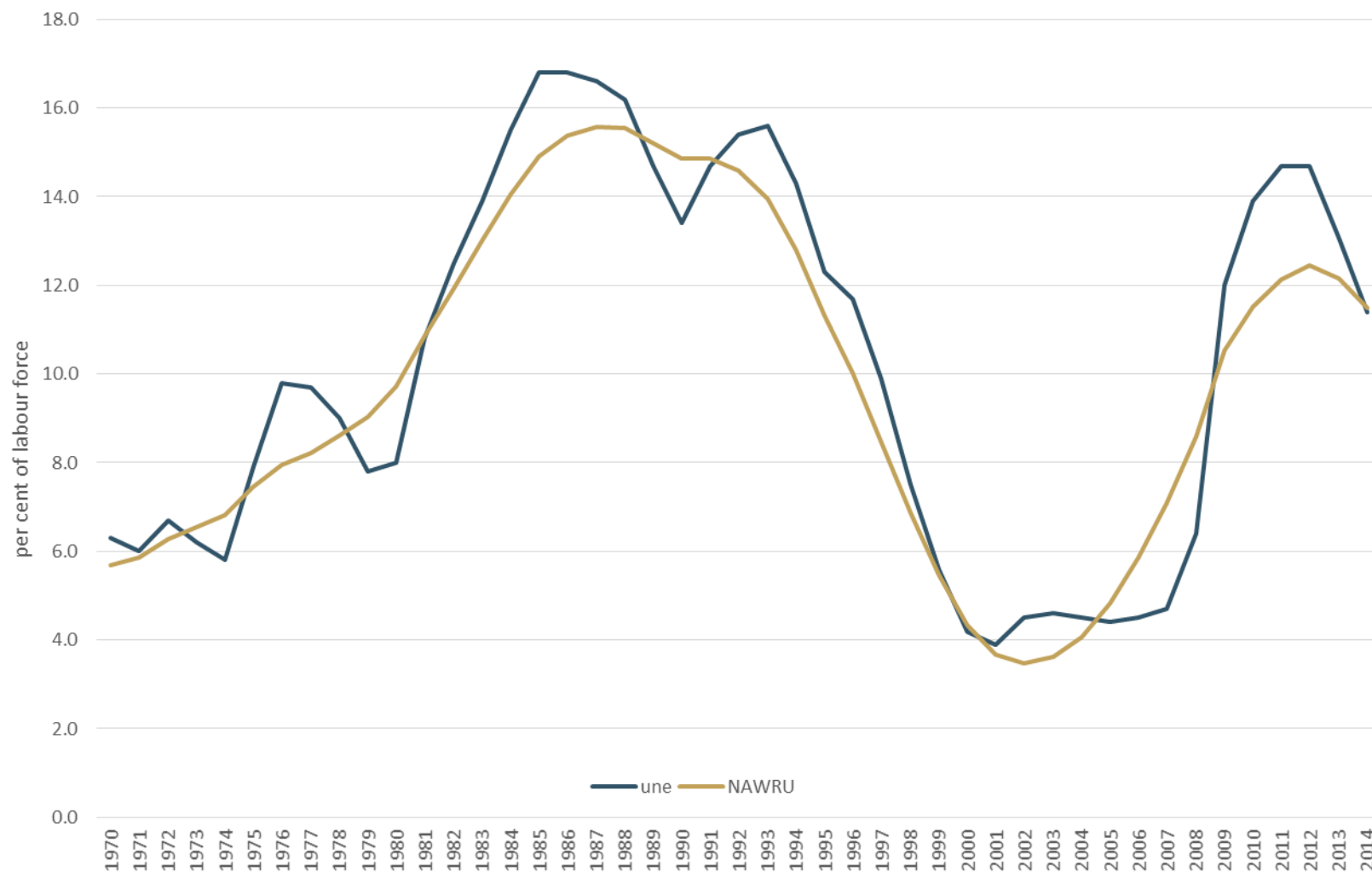
- Public finances in Ireland – ‘corrective arm’ 2009-2015
- Rules of ‘preventive’ arm apply from 2016
 - structural budget balance (SBB) moves centre-stage
- But SBB unobservable
 - harmonised approach applies for SGP
 - : relies on concept of ‘potential output’
 - : one-size does not fit all
 - : what is potential output in a regional economy?
- Estimates of SBB often counter-intuitive for small open economy
 - rules can lead to poorly-designed policies

Potential output in Ireland – serious shortcomings

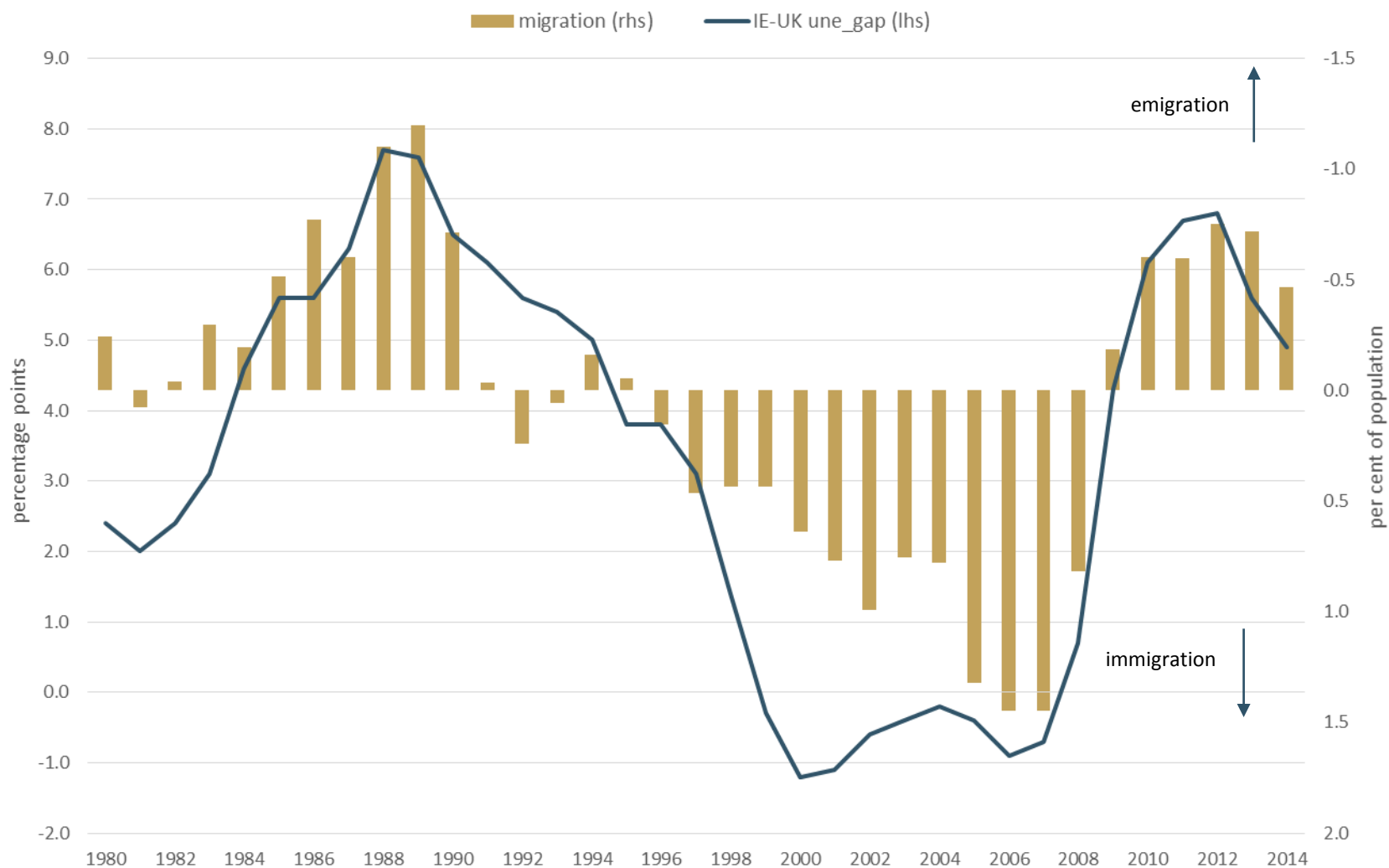
Potential output should be relatively stable – in reality pro-cyclical bias



NAWRU estimates strongly pro-cyclical – LM apparently overheating now!

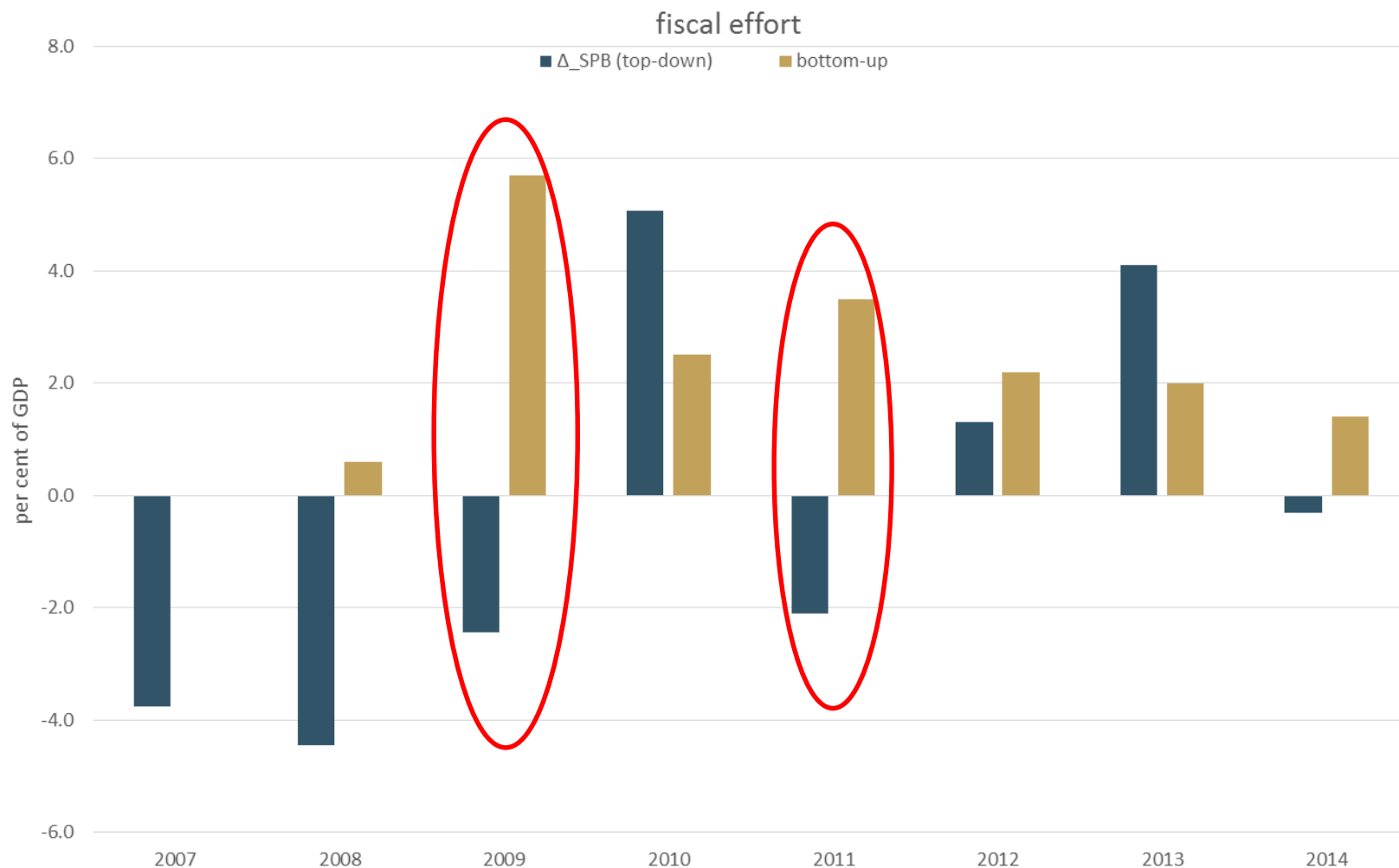


Shock absorption in a regional labour market – role of migration channel

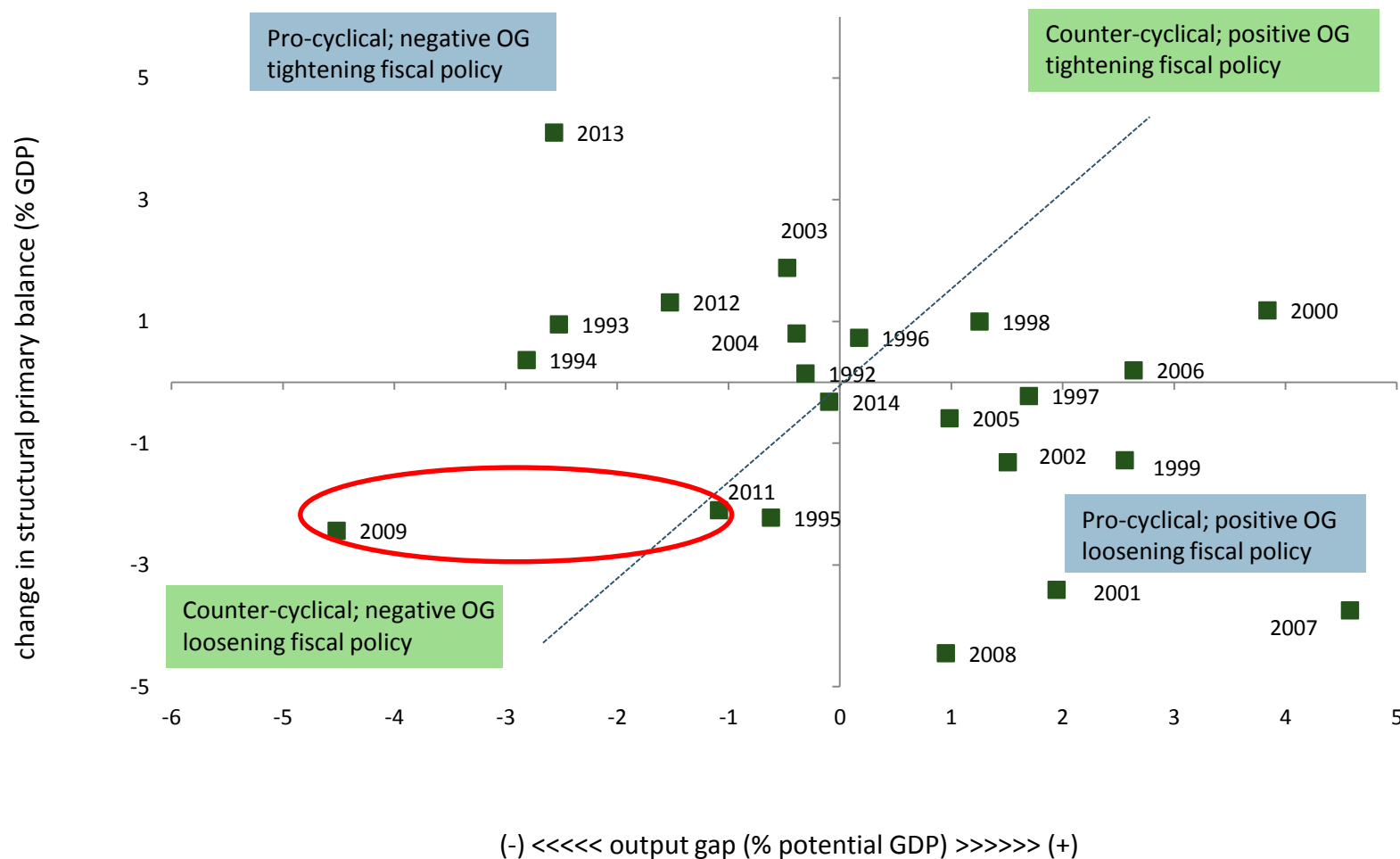


Implications for the structural budget balance

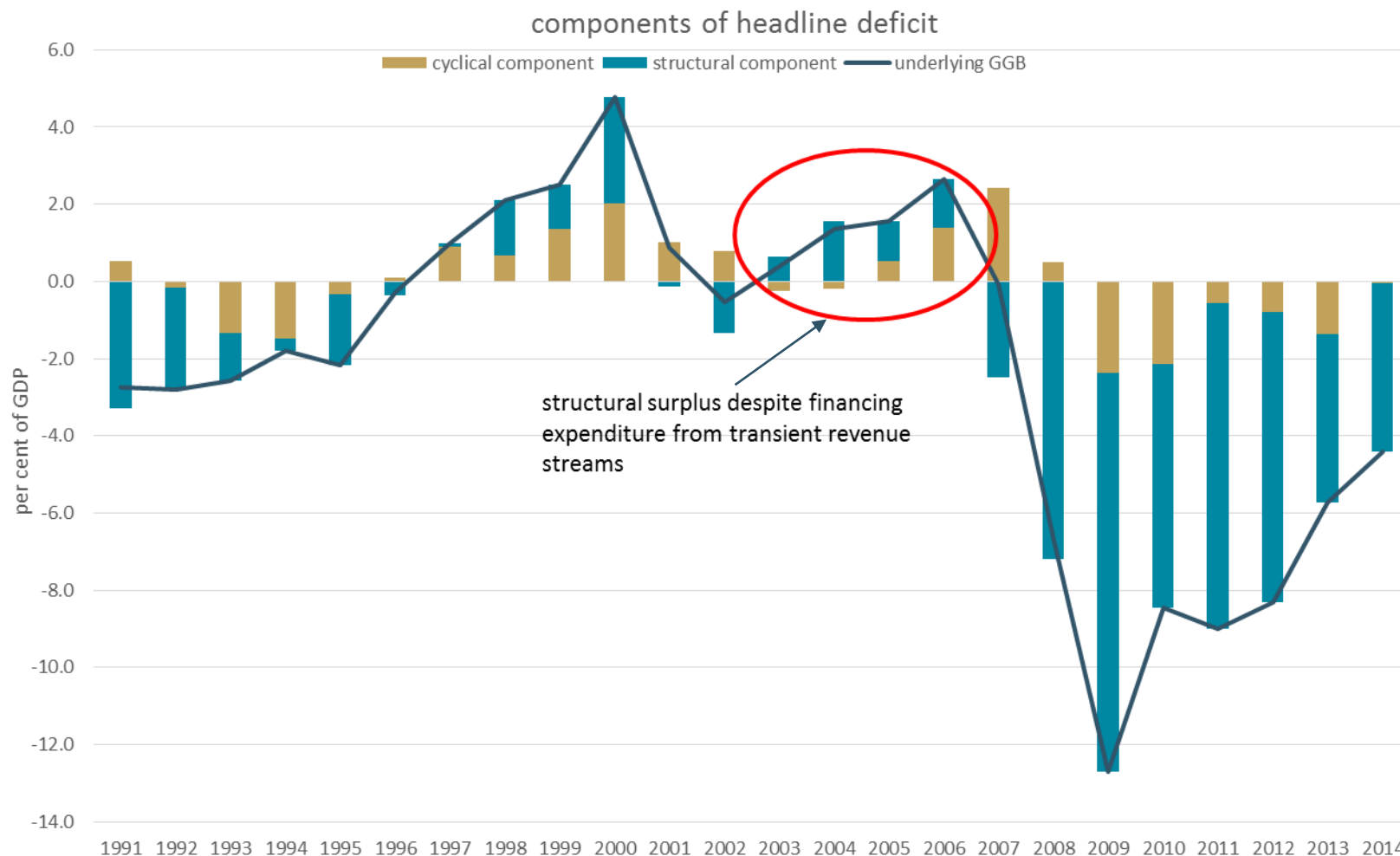
The theory – the change in the SPB should approximate fiscal **effort**



The theory – the change in the SPB should approximate fiscal stance



Litmus test: *ex post* no red flags in 2000s !



Conclusions

- **In a small open economy, *real time* estimates of structural balance**
 - uncertain
 - often counter-intuitive
 - subject to revision (especially at abrupt turning points)
- ***Ex post* assessments are far from perfect also!**
- **No longer purely theoretical issue**
 - firmly in the policy space
 - very real prospect of sub-optimal fiscal policies
 - sanctions apply in preventive arm
- **Solution?**
 - more subjectivity / increased focus on bottom-up
 - greater complexity (in rules, methodology) is not part of the solution