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# When can fiscal consolidation be expansionary? Evidence from a small open economy

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## Abstract

The paper focuses on the implications of stabilisation policies in a small open economy that were introduced to reverse burgeoning public sector deficit. In particular, I examine the hypothesis that such stabilisation policies can actually have expansionary effects on business investment. While this goes against the standard Keynesian view that the institution of more conservative fiscal and monetary programmes will, at least initially, lead to deflationary outcomes, there are important reasons for believing that such policies will in fact be expansionary. Such predictions are made in a dynamic setting, which weighs the short-term consequences of curtailed government expenditures against their long run implications for future increases in government spending, a reduction in debt burdens and greater stability. With the introduction of expectations, the positive implications of such policies can be immediate. This paper tries to clarify the ‘expectational crowding-in’ process and investigates whether the effects of stabilisation on business investment were due to that process or to other features of the stabilisation programmes. The policy message from my analysis is that budget consolidations producing expansionary effects are more than a theoretical construction. The experience of small open economies mentioned above should be taken into account also in policy making. Empirical findings indicate that EMU countries may need to carry out budgetary consolidations to dispose of room for manoeuvre

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against first the fiscal constraints in smoothing the business cycle imposed by the Stability Pact, and second, the looming budgetary implications of ageing populations.

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## 1. Introduction

During the 1980s, Greece often followed policies that were recognised as infeasible in the long run. The resulting large and continuous budget deficits implied an explosive path of debt that made necessary an immediate stabilisation. However, Greek governments delayed to adopt fiscal adjustment programmes. It has been argued (Alesina & Drazen, 1991) that in cases where stabilisations have significant distributional implications, like Greek stabilisation, socio-economic groups involve into a “war of attrition” to shift the burden onto each other. The result of such a process is a delayed stabilisation, which occurs only when the output losses (e.g., from high inflation) become high enough to induce one interest group to bear the fiscal costs of stabilisation (Easterly, 1996).

To reverse the rapid growth of macroeconomic imbalances and the associated stagflationary trends, a stabilisation programme was introduced in October 1985. It reflected a major policy switch from expansion to restraint. The principal features of this programme were: (a) a sharp devaluation of the drachma, (b) a modification of the wage price indexation scheme, (c) tight monetary and fiscal policies. However, the results achieved by the end of the stabilisation period were very few. The programme did not explicitly tackle microeconomic and structural issues. The Conservatives returned in office in 1990, and announced an economic policy of “gradual adjustment” (see Alogoskoufis & Christodoulakis, 1991, Chapter 9; Kapopoulos, 1996), which had as its main target the reduction of public deficits through a decrease in public spending, an increase in taxes and a programme of privatising enterprises nationalised after 1974. The moderate success of the programme in the fiscal area and the need to meet the Maastricht criteria, induced the preparation of a new “Convergence Plan”. The policymakers relied mainly on the dynamic effects of the cuts in tax rates to boost the supply responsiveness of the economy. In addition, the government increased the tax base and imposed an extraordinary tax levy on buildings in order to offset the revenue losses from the cuts in tax rates.<sup>1</sup>

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<sup>1</sup> For a detailed presentation of the interaction between fiscal developments and macroeconomic performance in Greece, see Christodoulakis (1994), Alogoskoufis (1996), and Demopoulos and Kapopoulos (2000).

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