



Department SEMINARS

Days of future past? The reform of the European fiscal framework, the (enduring) role of the structural balance and the pro-cyclical bias of potential GDP endogeneity

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A B S T R A C T

The European fiscal framework has recently been reformed, yet the concept of structural balance still plays a crucial role within it. This paper proposes a multidimensional approach to scrutinize the pro-cyclical tendencies embedded in European economic policies arising from the European Commission's calculation methodology of potential output and structural balance. Initially, a theoretical model shows the vicious cycle dynamic that characterises the fiscal adjustment process during a recession when potential output is dependent on actual output. Subsequently, numerical simulations juxtapose this dynamic with a counterfactual scenario where potential output is only influenced by long-term supply factors. Finally, employing dynamic panel data analysis covering 26 EU countries from 1995 to 2023, on an annual basis, empirical evidence is presented to show the pro-cyclical nature of fiscal policies adopted by European governments. Importantly, these estimates facilitate the isolation of the proportion of the pro-cyclical effect attributed solely to the bias stemming from the endogeneity of potential GDP.