

Economic Policy in Practice

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Outline

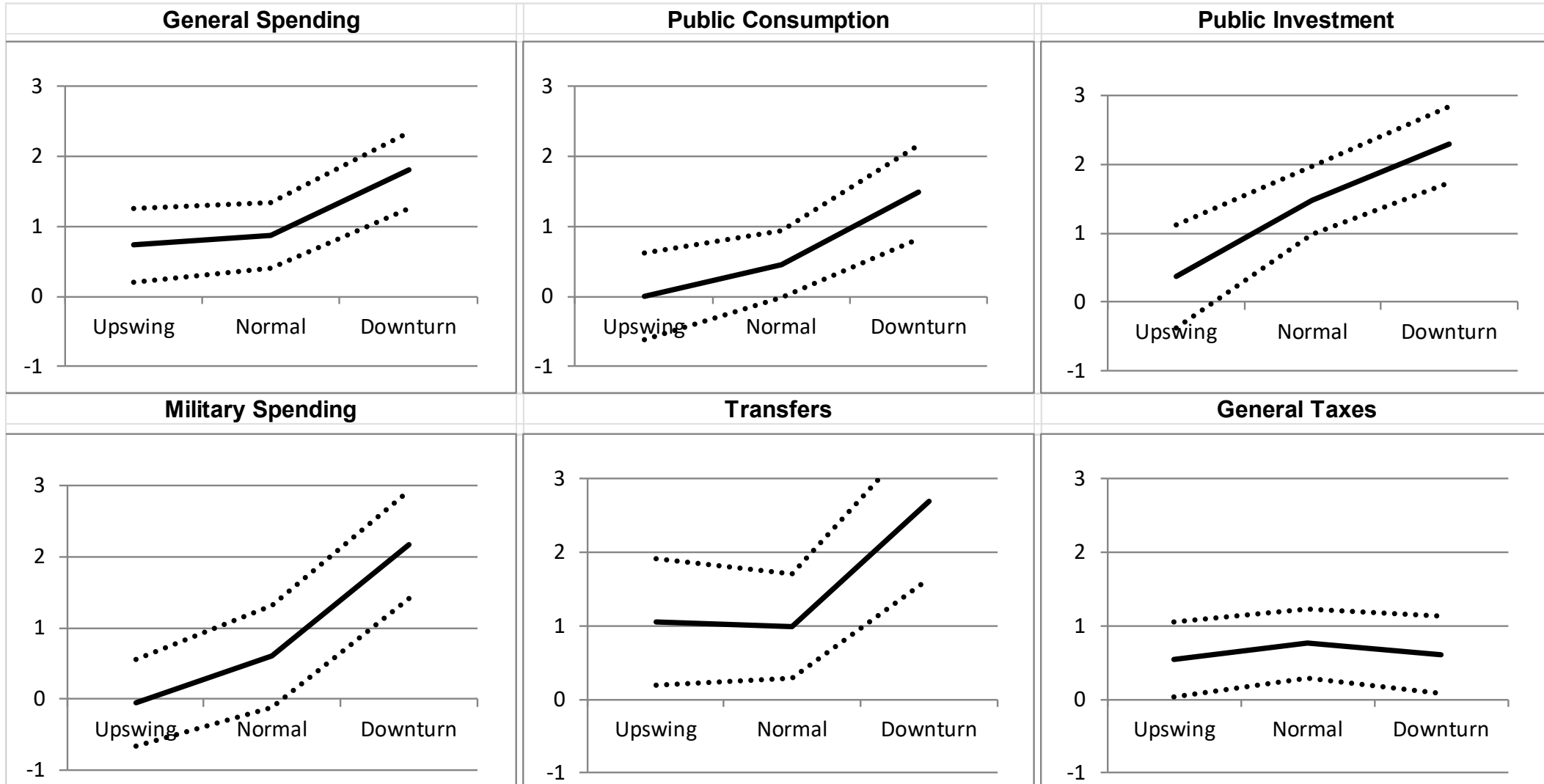
- 1. Fiscal Policy in PK vs NK vs Empirics**
2. Fiscal Rules and Debt Sustainability
3. Conventional Monetary Policy in PK vs NK vs Empirics
4. Energy price shocks: Fiscal and Monetary Policy

PK vs NK: The Main Elements and Distinctions

PK Models (e.g. Palley 2019)	NK Models (e.g. Woodford 2011)
Focus on macro relations (Keynesian Cross, $I \rightarrow S$, paradox of thrift)	Macro from micro-optimization (consumption / leisure / labor)
Aggregate demand (AD) drives output in short & long run, steep IS, flat LM curve	Aggregate supply (AS) multiplier (intertemporal labor supply shift), AD only relevant short run
AS with Leontief PF	AS with Cobb-Douglas PF
Functional distribution important via differential MPCs	Strong role for intertemporal substitution and real interest channel
Quantity >> price adjustments	Price >> quantity adjustments
Crowding- in of consumption + investment	Crowding- out of consumption + investment
FP very powerful, MP weak	FP weak, MP very powerful

Macro Facts: Fiscal Multipliers

Meta Regression Analysis of >1800 multiplier estimates from 98 papers



Fiscal Multipliers

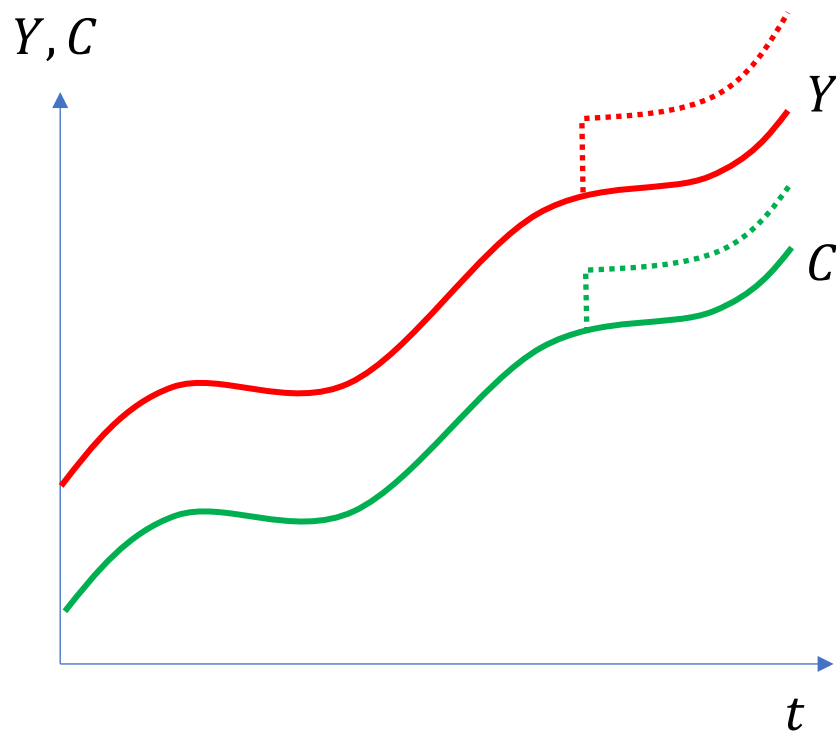
Macro Stylized Fact	PK Model	NK Model
Ma-I. Average spending multiplier ≈ 1	✓ (open economy, income tax, reactive MP)	X (≈ 0.5 with MP Taylor rule)
Ma-II. Average tax multiplier < 1	✓ (see above)	X (>1 with distortionary tax)
Ma-III. Crisis spending multiplier ≈ 2	X (not via consumption)	✓ (ZLB, transitory shock)
Ma-IV. Crisis tax multiplier <1	✓ (but only since non-linearity is weak)	✓ (ZLB, average of heterogenous taxes)
Ma-V. Transfer multiplier $>$ tax multiplier	✓ (targeting to workers / unemployed)	X (distortionary tax, requires high HtM share)
Ma-VI. Multiplier persistence	✓ (though not special to crises)	X (though competing mechanisms under debate)

Micro Theory: Consumption Function

Permanent Income Shock

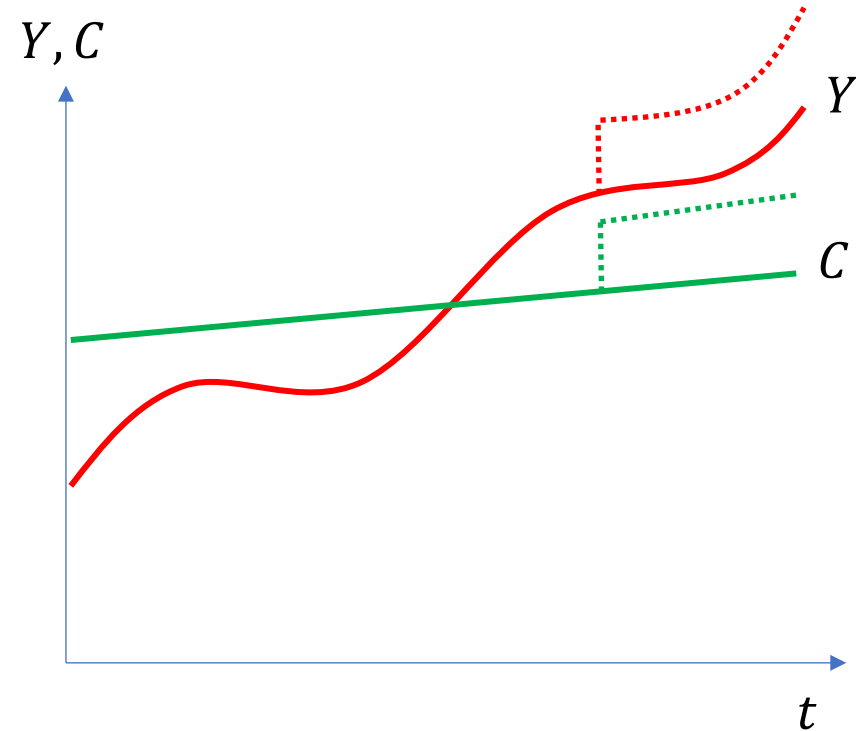
Post Keynesian $C_t = c \cdot Y_t$

$MPC = c$



New Keynesian $\bar{C} = \bar{Y}$

$MPC = 1$

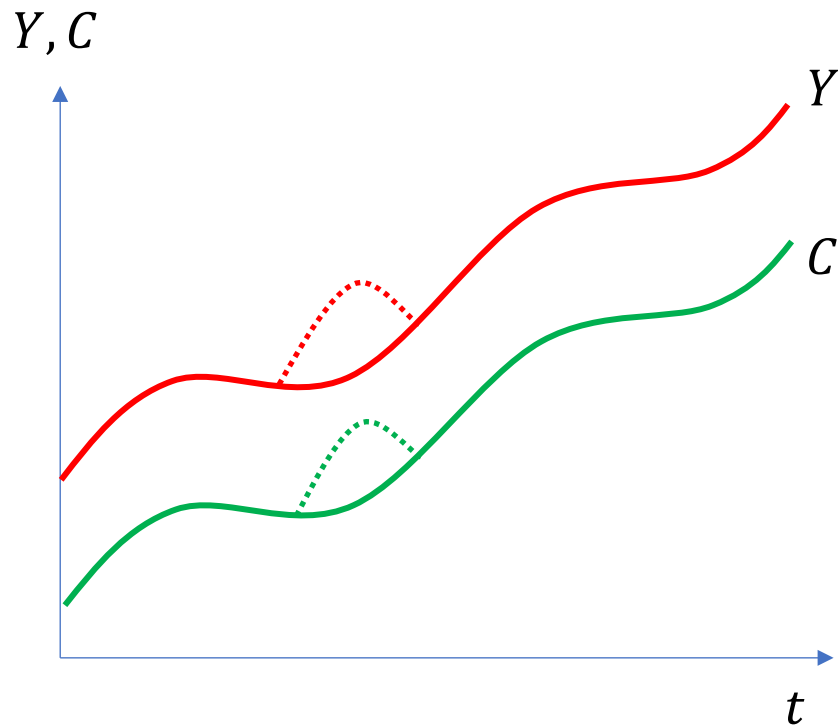


Micro Theory: Consumption Function

Transitory Income Shock

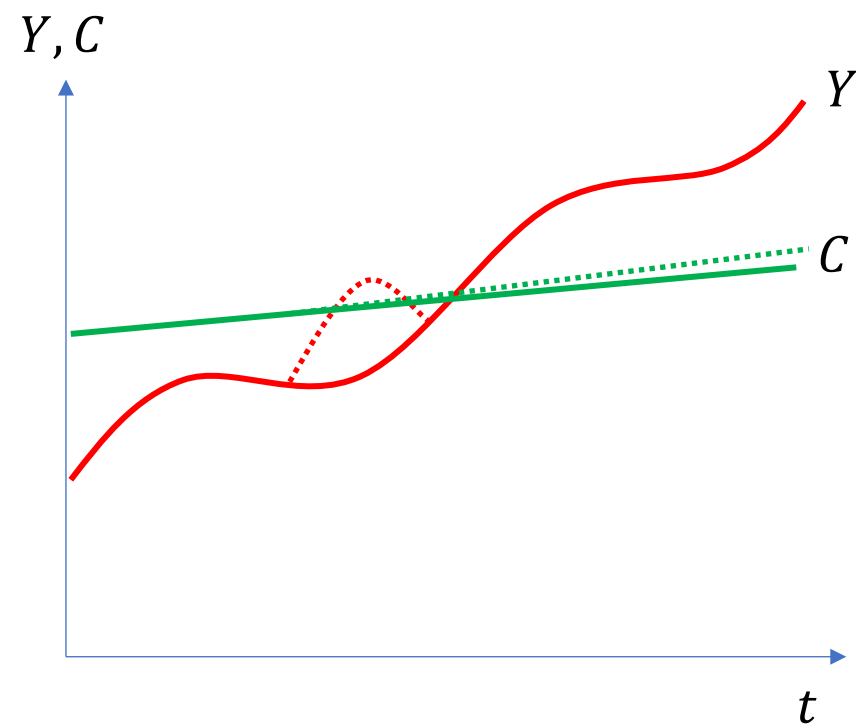
Post Keynesian $C_t = c \cdot Y_t$

$MPC = c$



New Keynesian $\bar{C} = \bar{Y}$

$MPC \approx 0$

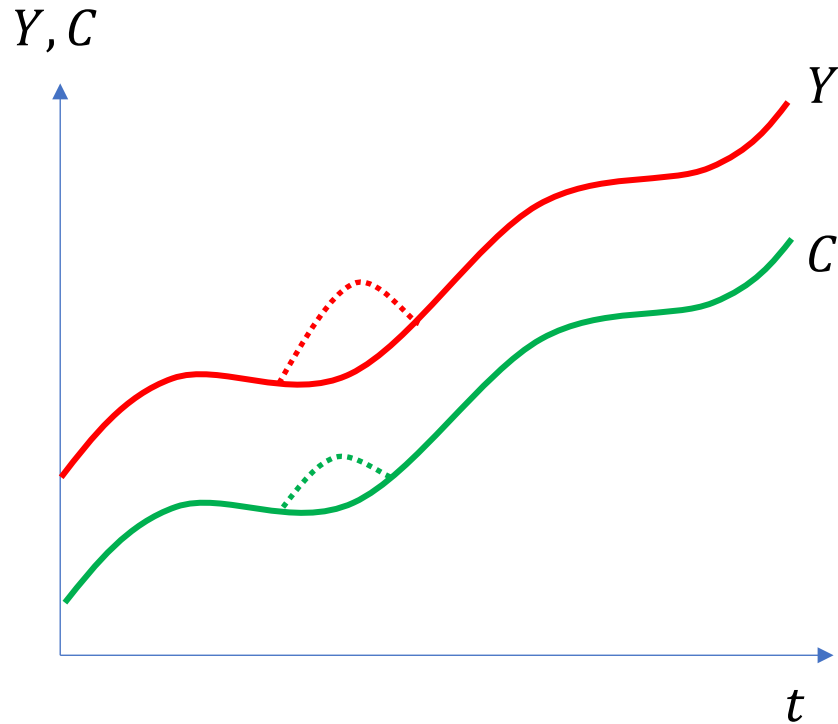


Micro Theory: Consumption Function

Transitory VAT Cut

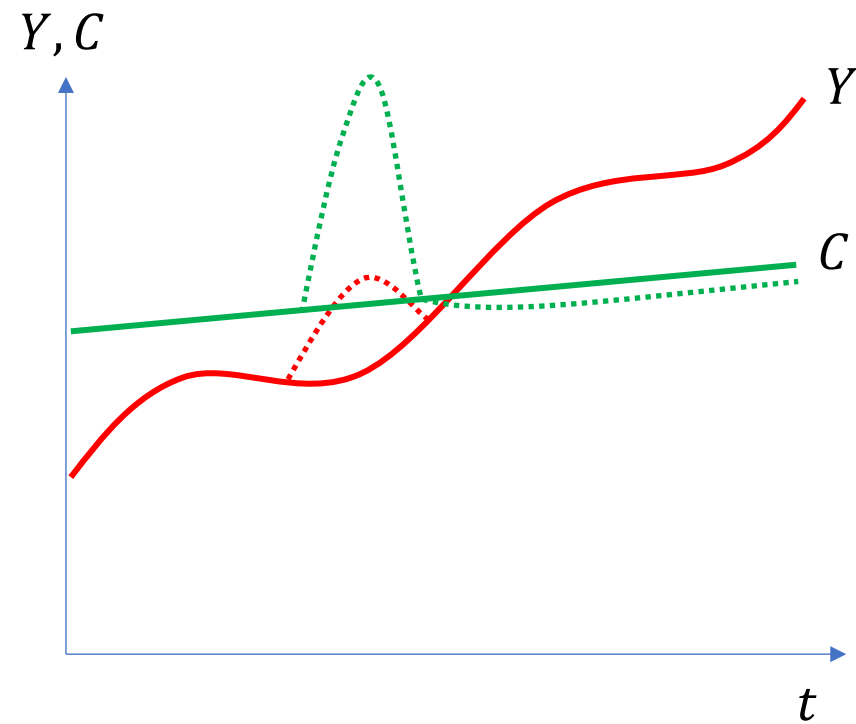
Post Keynesian $C_t = c \cdot Y_t$

$MPC = c$



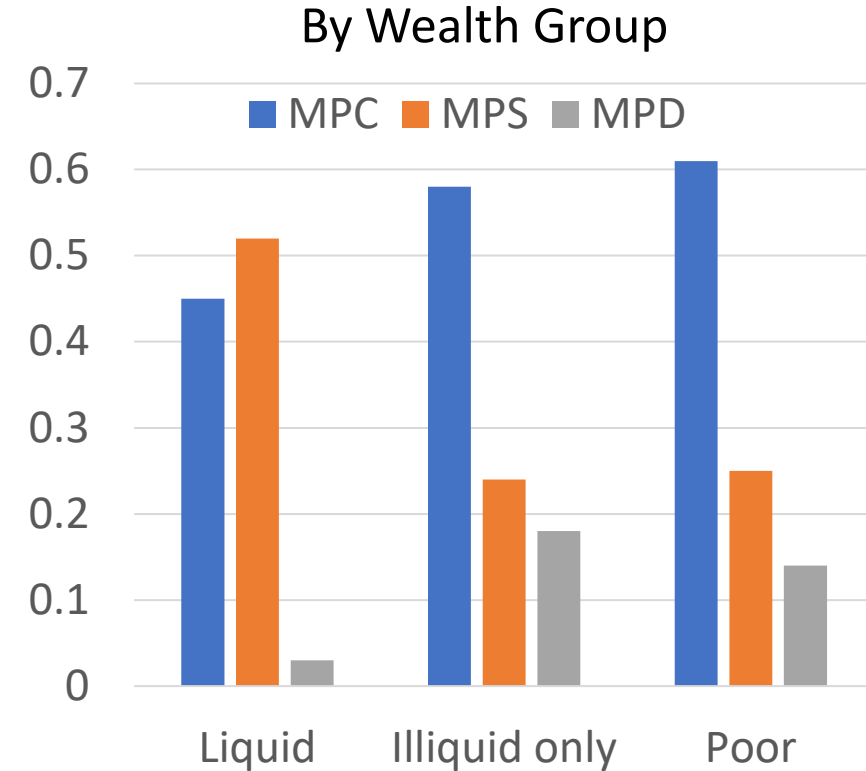
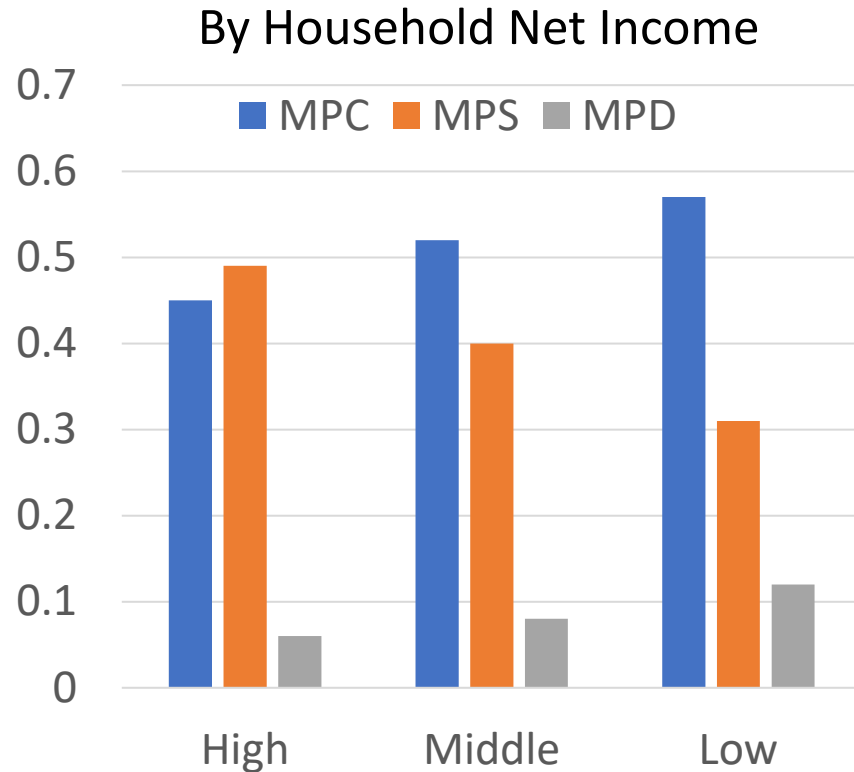
New Keynesian $\bar{C} = \bar{Y}$

$MPC > 1$



Micro Evidence: Kinderbonus 2020 – Consume, Save or Repay Debt

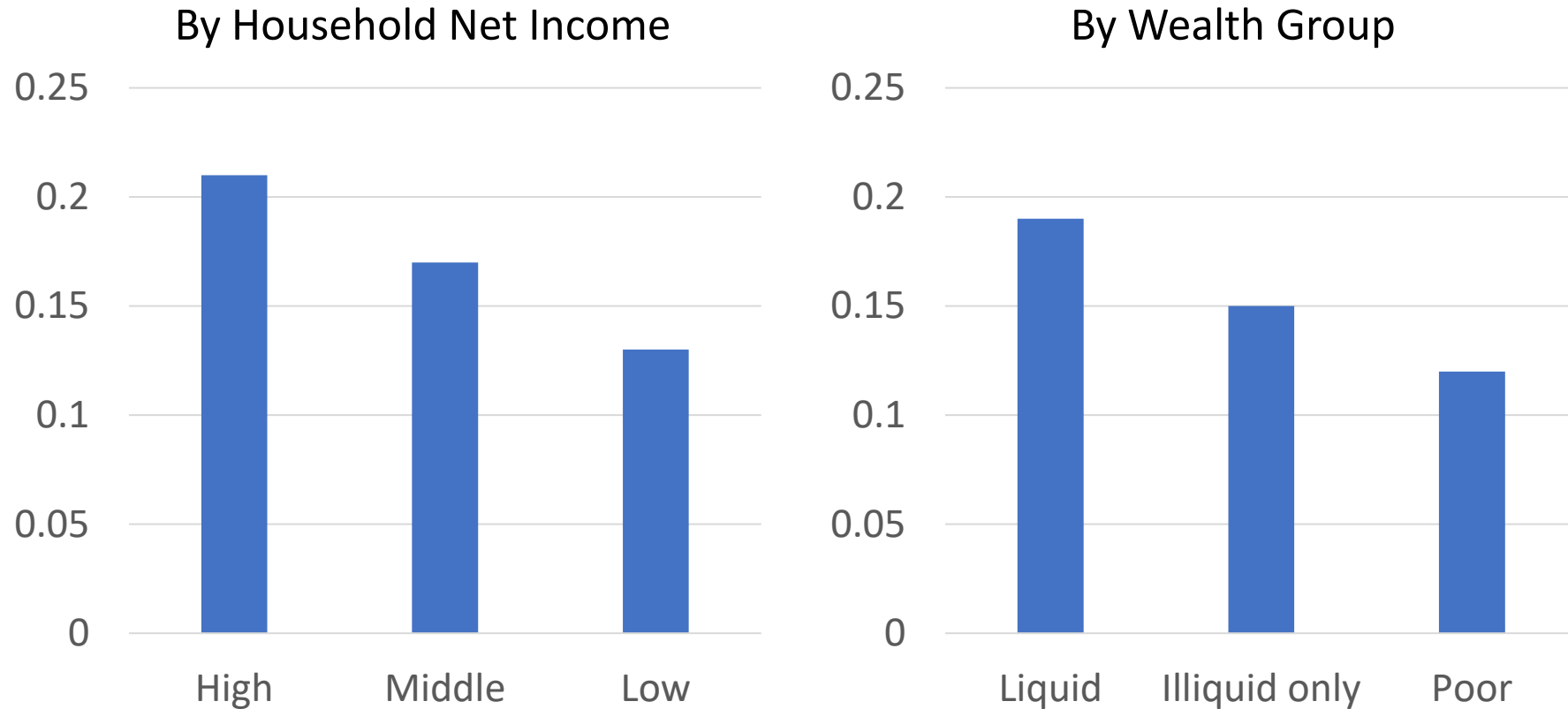
*Survey: „You received [x] Euro as kinderbonus. How did you use this money?“
(consume, save, debt repayment, 3 months after receipt)*



- Average MPC ≈ 0.5
- falling with income and liquid wealth

VAT Cut: Anticipation Effect

Survey: „Did you make a purchase due to the VAT reduction that you would have otherwise made later (or not at all)?“



- Very weak real income effect, rather weak anticipation effect
- Anticipation much stronger with higher incomes, liquid reserves
- While VAT is a regressive tax, temporary cut favored high incomes, wealthy HH

Consumption Behavior

Micro Stylized Fact	PK Model	NK Model
Mi-I. Average MPC ≈ 0.5	✓ (but missing time structure)	X (too low even with HtM households)
Mi-II. MPC falls with current income	✓ (but functional income only and too bimodal)	X (no stand-alone influence from income)
Mi-III. MPC falls with wealth	X (no stand-alone influence from wealth)	✓ (with HtM, but too bimodal)
Mi-IV. MPC rises with perceived debt burden	X (relation would even be negative, if included)	✓ (with credit constraints)
Mi-V. Weak + regressive intertemp. substitution (VAT)	X (no anticipation, progressive income effect of VAT cut)	X (super strong anticipatory effect, progressive effect)

A Keynesian Model of Fiscal Policy

Saving and consumption motives derived from Keynes (1936, Ch 9)

- **Intertemporal** substitution (muted!)
- Stone-Geary-Preferences: basic consumption needs, **saving** as a **luxury good** (Carroll 1998, Campanale 2018)
- **Precautionary** / buffer-stock saving (Carroll 1997, Gechert & Siebert 2021)

Macro circumstances

- **Liquidity constraints** (Deaton 1991, Jappelli & Pistaferri 2014)
- Fundamental income **uncertainty** (Lavoie 2022, Aiyagari 1994)
- **Accommodative** MP in recession

A Keynesian Model of Fiscal Policy

Consequences – Micro

- Consumption **tracks** current income closely,
- but consumption **smoother** than income
- Short-term $MPC \gg 0$
 - Increases intertemporally
 - Even larger in **downturns**
 - Even larger for **low income** / low liquid wealth HH

Consequences – Macro

- Transfer and spending **multiplier large** in normal times
- Larger + more persistent during **downturns**
- Less sensitive to **persistence** of fiscal policy shock
- **Weaker** and flatter **tax multiplier**

Outline

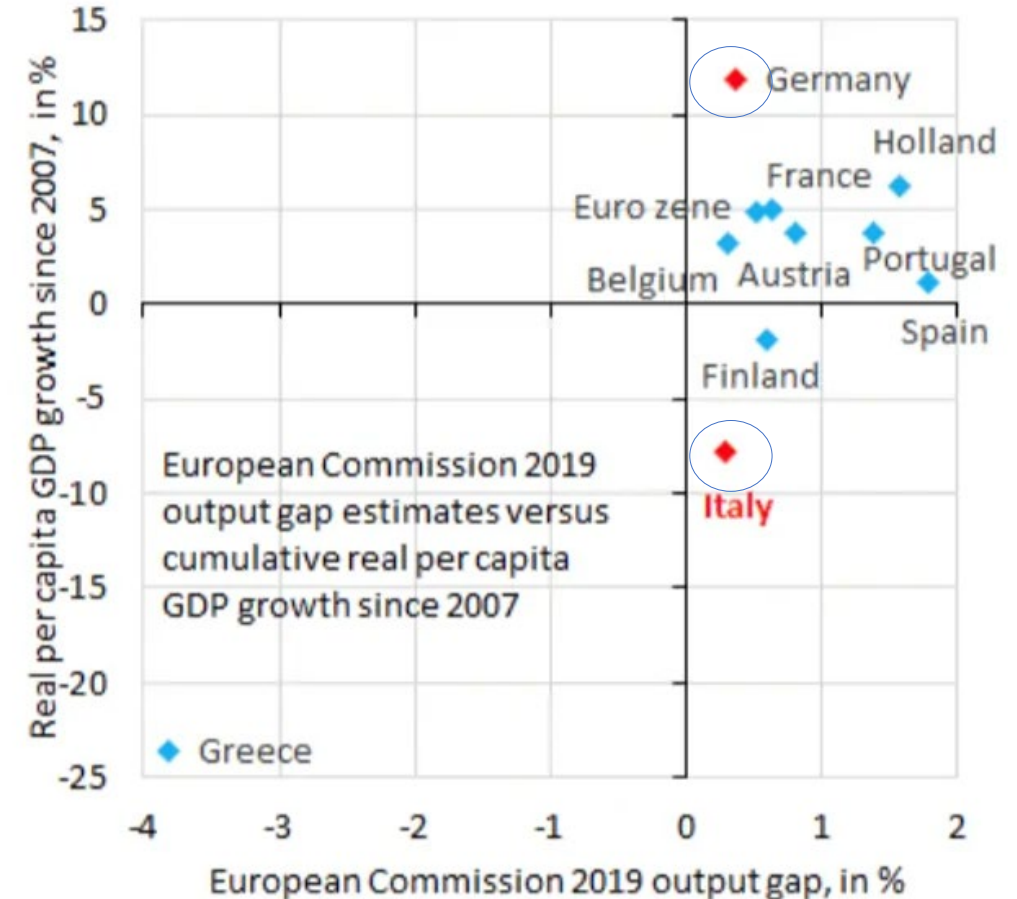
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Reformed EU Fiscal Rules

Main criticisms of previous rulings (see also [Dullien et al. 2022](#))

- Fiscal rules more flexible after Euro Area crisis, but grew much **too complicated**
- No success in reducing public debt/GDP ratios
- Structural balance poorly estimated (“output gap nonsense”, [Tooze 2019](#)) & **procyclical** ([Paetz 2020](#))
- **Public investment** down in recessions under strict rules ([Jürgens 2022](#))
- 60% debt rule + 1/20 reversion rule **too ambitious**
- Not recognizing the dynamics of $r < > g$ relation

Cumulative GDP growth 2007-2019 vs. 2019 output gap



Source: [Tooze \(2019\)](#)

Reformed EU Fiscal Rules

The “New” Rules

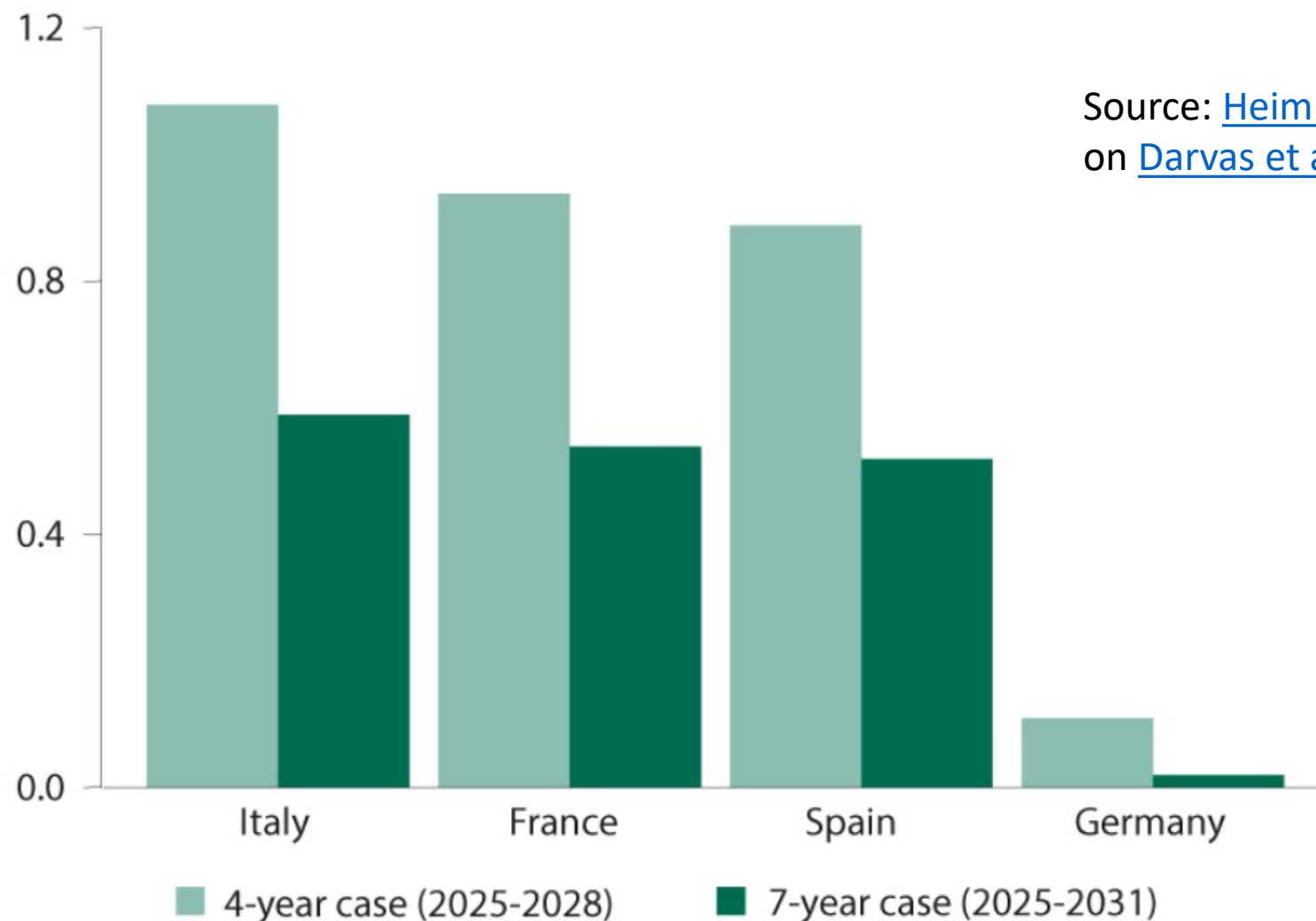
- 60% debt rule + 3% deficit rule still in place
- Debt Sustainability Analysis (DSA) as new game in town: “***debt ratio is put or remains on a plausibly downward path***, or stays at prudent levels below 60 percent of GDP over the medium-term” (Regulation (EU) 2024/1263).
 - different adverse scenarios, 70% probability of debt/GDP downward path
- Additionally: enforced 3% deficit rule + further “safeguards”
- Single operational metric: **net expenditure rule** → less procyclical than structural balance

How is the DSA applied? (Simplified!)

- Standard dynamics of the debt/GDP ratio: $d_t = \frac{(1+r)}{(1+g)} d_{t-1} - pb_t$
- Stabilizing primary balance: $pb^* \geq \frac{r-g}{1+g} d^*$
- Assumptions:
 - r exogenous (though different stress scenarios)
 - g exogenous potential output, output gap closes after 3 years, **no hysteresis!**
 - Short-term multiplier effect from structural pb on g
 - Feedback from g on cyclical component of pb via taxes & transfers (automatic stabilizers)
- Process:
 1. Calculate **expected** debt/GDP path
 2. Calculate **required** fiscal adjustment to meet desired path (including feedback)
 3. Medium-term objectives done country by country, **no spillovers!**

Fiscal consolidation requirements to meet reformed EU fiscal rules

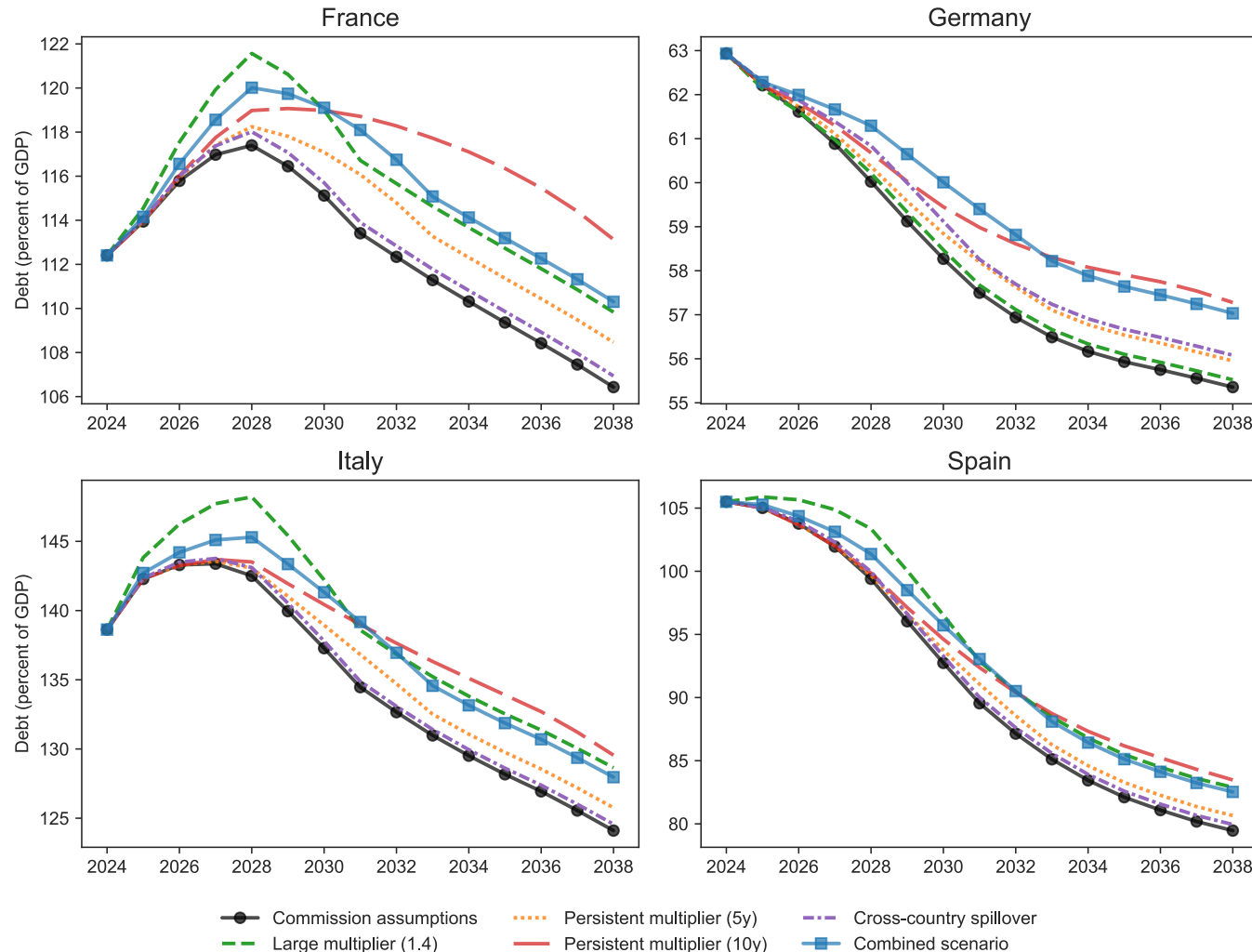
Annual required improvement in the structural primary balance, in % of GDP



Source: [Heimberger et al. \(2024\)](#), based on [Darvas et al. \(2024\)](#)

Simulation of consolidation effects with alternative assumptions

Debt/GDP Ratios



- Larger fiscal multiplier 0.75 -> 1.4
- Hysteresis: longer persistence of multiplier (output gap closure 3 years -> 5 or 10 years)
- Spillovers of consolidation effects from other EU countries according to respective export shares
- Combined (multiplier 0.9 + output gap closure 5 years + spillovers)
- These are not outlandish assumptions!

Source: [Heimberger et al. \(2024\)](#), all code available from [Welslau \(2024\)](#)

Fiscal rules and DSA: Conclusions

New fiscal rules only a small improvement

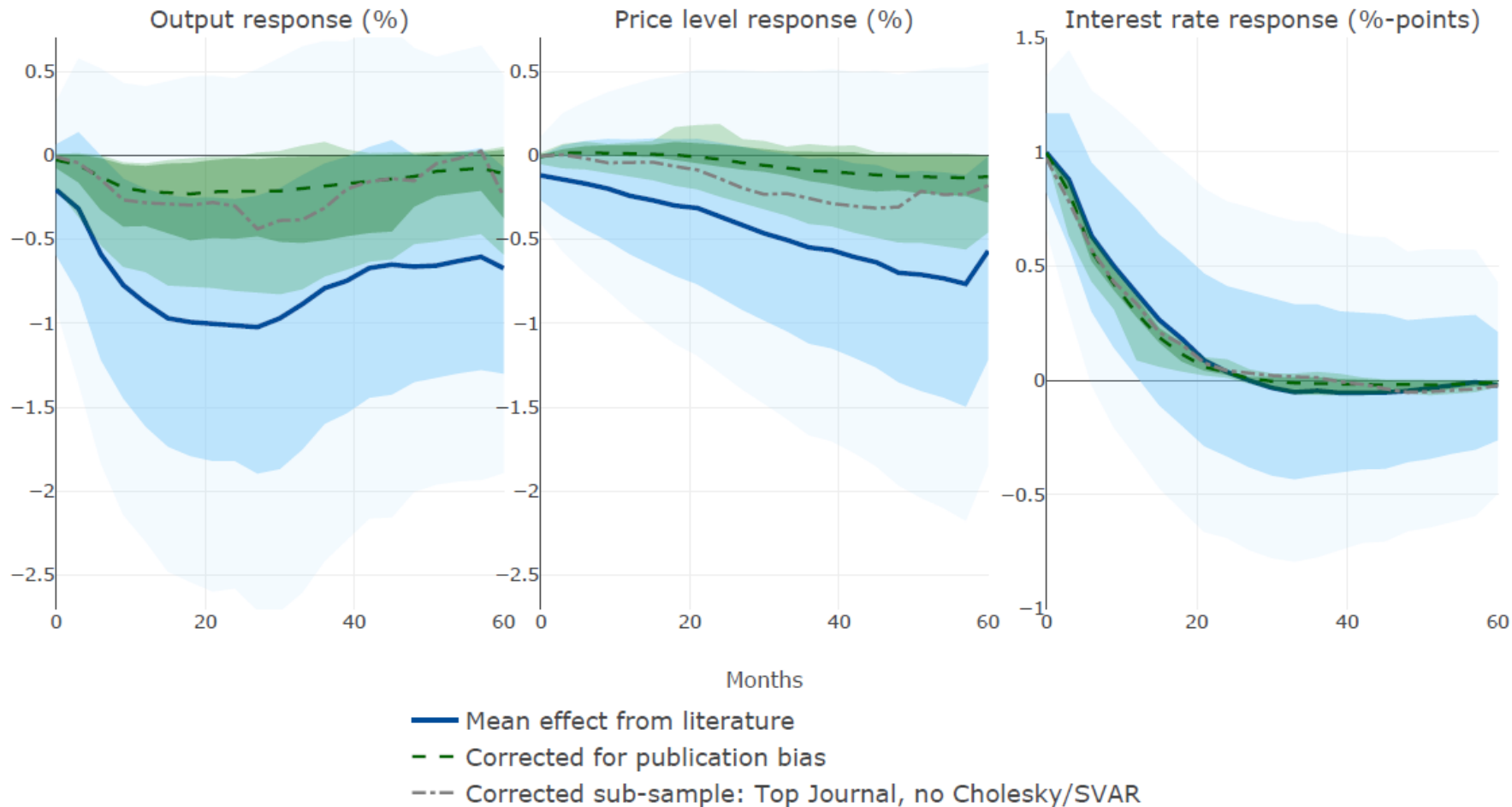
- Expenditure rule useful, but notorious structural balance and output gap nonsense **re-enters** through the backdoor
- 60% debt/GDP target completely illusory + unjustified in $r < g$ world
- With some **hysteresis**, self-defeating effects of austerity on debt/GDP even stronger
- 3% deficit rule should focus on **primary balance** (instead of headline balance), recognizing interest payments / legacy debt (Dezernat Zukunft)
- Missed chance of implementing proper **Golden Rule** of public investment
- DSA likely too optimistic: high risk of doubling down with more **pro-cyclical** consolidation (cf. Euro Area crisis)

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Output and price responses to conventional monetary policy shocks

Empirical Benchmark

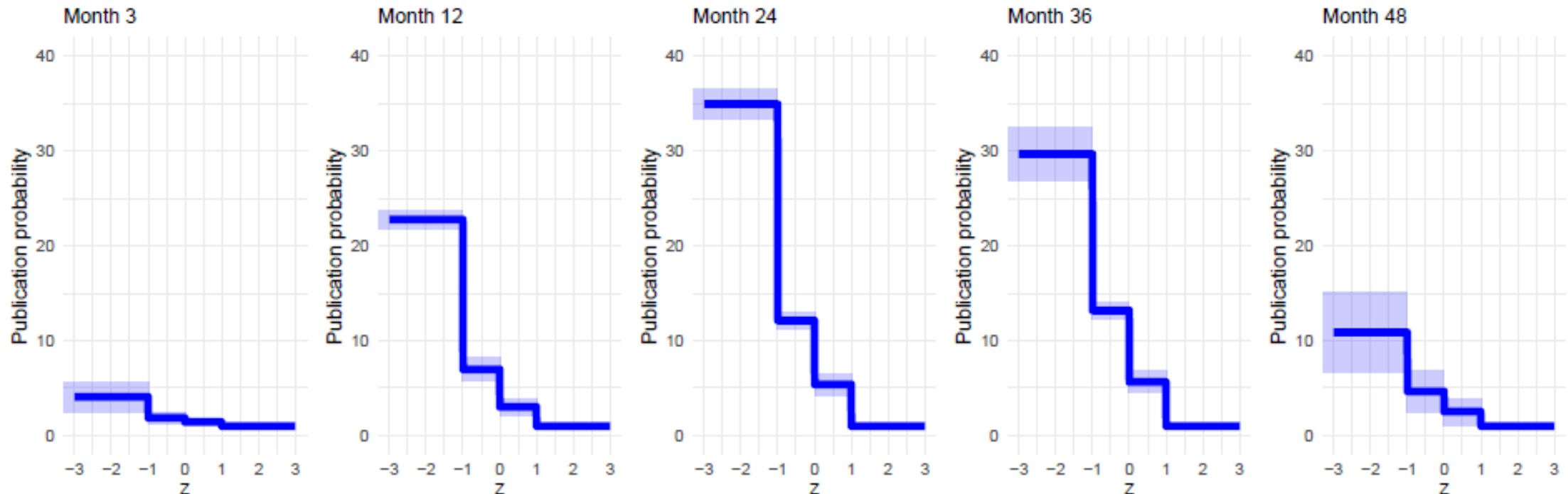


- Pre-registered meta analysis of 409 empirical papers and almost 5000 IRFs
- **Simple mean** shows **strong** (though uncertain) output and price response
- Clear signs of **publication bias**
- **Corrected** effects much **closer to 0**

Source: [Enzinger et al. \(2025\)](#)

What is publication bias?

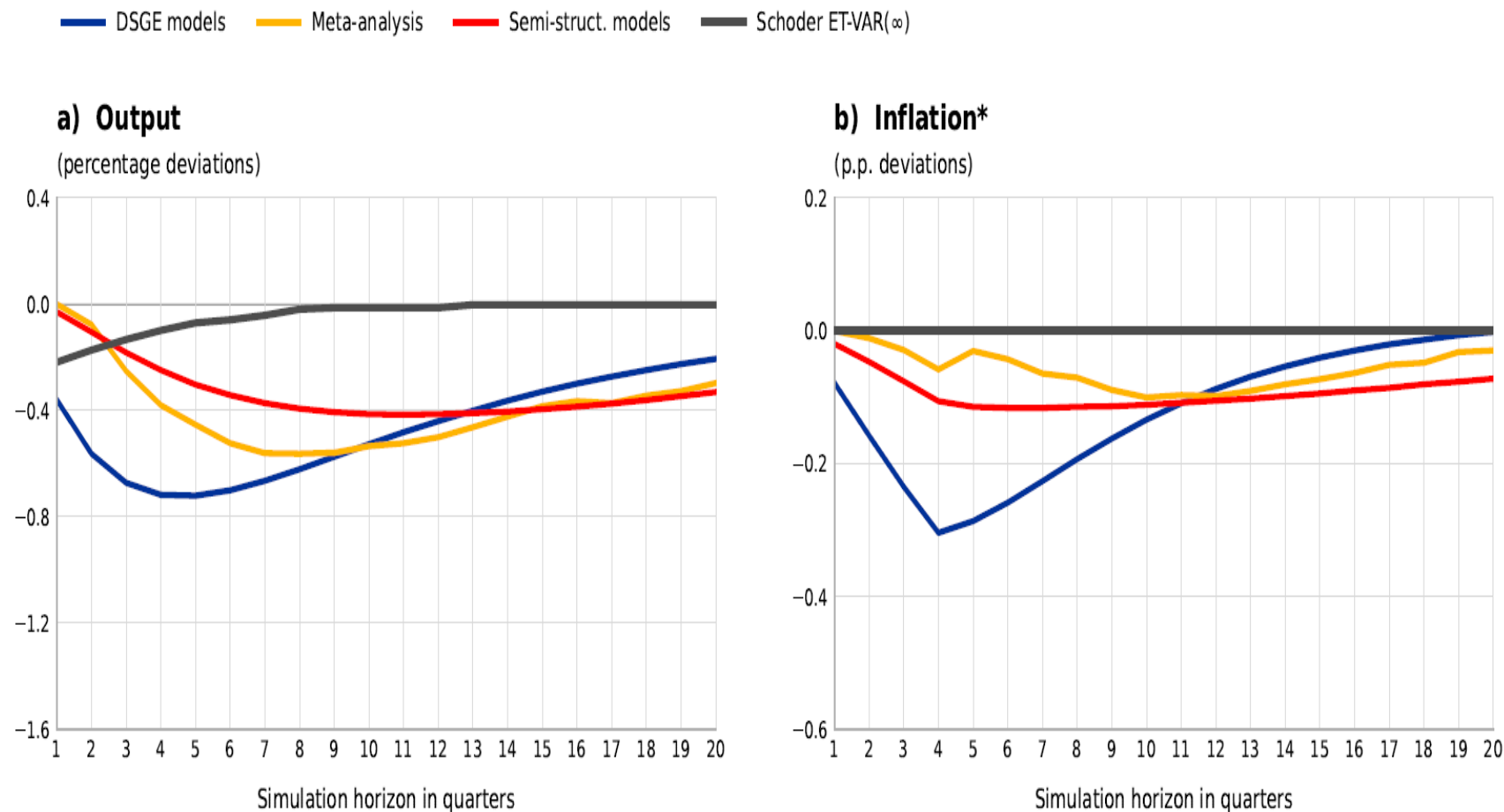
- Preference for statistical significance (**p-hacking**)
- **Confirmation** of dominant theory or seminal papers
- Publishing a stat. significantly negative output response (68% level) is **35x more likely** than positive significant response at 24 month horizon



Source: [Enzinger et al. \(2025\)](#)

Model horserace: DSGE vs PK vs Semi Structural vs Meta

Output and Inflation Response



- Meta benchmark: **conservative** draw after publication bias correction
- **DSGE**: output & inflation response **too strong** and frontloaded
- Schoder **PK** model **too weak** and no hump-shaped response
- Semi-structural largely in line with meta evidence

Source: [Bobasu et al. \(2025\)](#) and [Schoder \(2017\)](#)

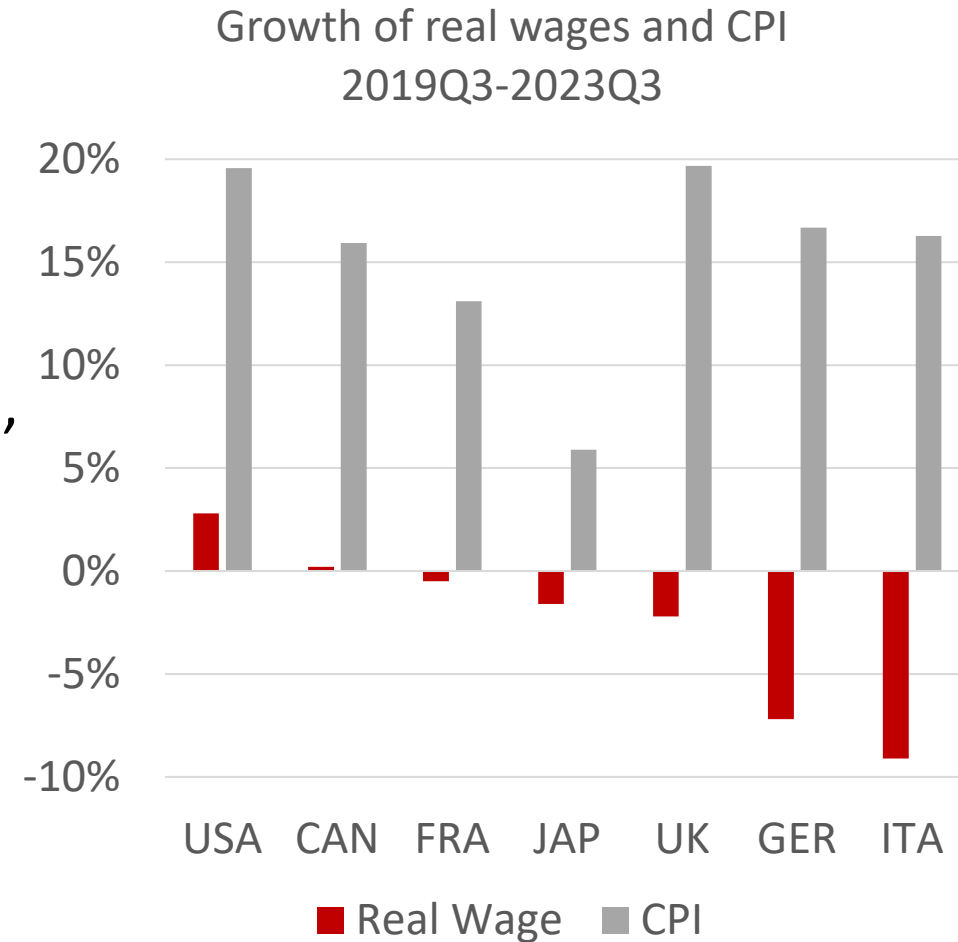
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Energy price shocks

PK diagnosis: inflation as **distributional conflict**

- Imported energy price shock as **terms-of-trade loss** → real income falls
- Loss allocated between wages, profits & gov't budget
- Inflation persists with **unreconciled claims** (Rowthorn 1977, [Hein 2024](#)): firms defend m , workers defend w/p , gov'ts have fiscal rules
 - Unit profits + mark-ups drove inflation (“**sellers’ inflation**”) ([Weber & Wasner 2023](#), [Storm 2023](#), [Lavoie 2024](#))
 - Real wages + gov't budget bore the costs
- Similar NK attempts ([Lorenzoni & Werning 2023](#)); but also standard prescriptions ([Bernanke & Blanchard 2024](#), [Hagedorn 2024](#))



Sources: OECD(2024), [US Treasury \(2024\)](#)

Energy price shocks

PK Monetary Policy Response

- See [this impressive MP power](#) in a NK framework! Sorry, in German, focus on Abbildung 2
- Standard MP main transmission channel: demand → **weaken real wage claims** by rising unemployment
- But countervailing channels to be considered:
 - Short-run: **interest as cost** factor marked up into prices (Tooke 1838)
 - Long-run: rate hikes **discourage green investment** that could relax the next bottleneck
- Rather “parking-it” approaches; [Rochon & Setterfield \(2007\)](#) compare different versions
- However: mind the **exchange-rate** channel! Rate defense vs imported inflation

Energy price shocks

PK Fiscal Policy Response

Short-term

- Redistributive transfers / social security as **income insurance**, not necessarily as stimulus
- Targeted consumer tax cuts (→ basic needs) / subsidies that reduce measured inflation
- no outright price caps to fossils (energy conservation) → **inframarginal price brake** (German “Gaspreisbremse”) ([Dullien & Weber 2022](#)), Spanish **exceptions to merit order** electricity markets ([Bauermann et al. 2026](#))
- **Public buffer stocks** for the “systemically significant” goods ([Weber & Schulken 2024](#))
- Funded by **windfall profit taxation**

Long-term

- **Industrial policies** / public investment to reduce fossil dependence → new growth model
- Expect a higher frequency of negative shocks → public debt concerns? → **Tax the rich**