Europe EconoMonitor

"Fiscal stimuli"- Where do we stand?

Roberto Tamborini | Jun 17, 2009

Fiscal plans aimed at rescuing banking systems and sustaining depressed economies are under way in all major world countries. The fiscal lever has been vigorously activated since last autumn, when it became clear that monetary policy alone was insufficient, and the Japanese disease appeared as a dreadful menace. Apart from few, though authoritative, contrary voices (see e.g. http://www.economist.com/debate/debates/archive/page:2), recourse to activist, or "Keynesian", fiscal policy has also been endorsed by a vast majority of economists and advisors.

In a neat IMF staff paper of December 2008, Olivier Blanchard, chief IMF economist, and other co-authors set out the main rationale for active fiscal policy, and a number of recommendations. In their view,

The optimal fiscal package should be timely, large, lasting, diversified, contingent, collective,

and sustainable (...)

Timely, because the need for action is immediate; large, because the current and expected decrease in private demand is exceptionally large; lasting because the downturn will last for some time; diversified because of the unusual degree of uncertainty associated with any single measure; contingent, because the need to reduce the perceived probability of another "Great Depression" requires a commitment to do more, if needed; collective, since each country that has fiscal space should contribute; and sustainable, so as not to lead to a debt explosion and adverse reactions of financial markets (p. 2)

Let us briefly examine the present state of fiscal policies in the light of these recommendations.

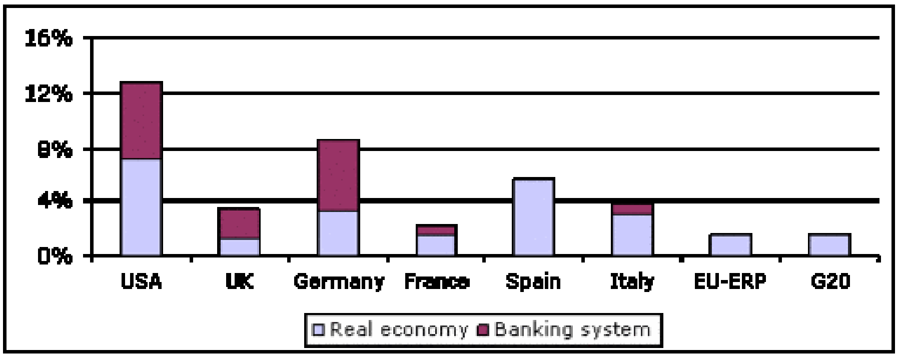
Timely and collective. The message that governments would actively intervene in the crisis arrived when the world was in the eye of the September 2008 storm. One can first mention the Paulson Plan, and then the G7 meeting in October, the EU Economic Recovery Plan in December, the Obama fiscal programme in January 2009, the G20 meeting in April, and other national governements' interventions in a row. Whether all this was timely or too late is open to discussion, though these announcements arguably contributed to stop the bottomless fall of the stock markets.

However, the well-known problem of the lags in the political decision process that plagues fiscal policy cannot be ignored. The problem is now exacerbated by the fact that governments have, at least in principle, agreed that the worldwide dimension of the crisis calls for collective and coordinated action at the international level. As a result, in this moment it is not yet clear by how much announcements and plans have been translated into actual interventions. This appears particularly problematic in Europe, where the Stability and Growth Pact, and the tendency of medium-small countries to free-ride on French-German expansions have historically created notorious collective action problems.

I already commented on this issue (here) soon after the EU released its ERP in December 2008. The half full glass was that the EU (with governments' approval) recommended and endorsed a timely and coordinated action by member countries on the fiscal front, with some common guidelines. Yet I then argued that the glass was still half empty regarding true means and incentives fostering fiscal policy coordination, at the level of both strategies and overall entity. Unfortunately, not much progress can be seen in this respect (additional evidence is provided below).

Large and diversified. These are rather elusive indications. As to the extent of the fiscal stimuli, one may compare them across countries or correlate them with the severity of the recession. Let me start with a few personal elaborations mainly based on *announced* fiscal plans as of March 2009: see Figure 1, which displays the main industrialized countries, the ERP of the EU, and the G20 as a whole.

Figure 1. Fiscal plans as of March 2009 (% of GDP)



Source: International Monetary Fund and press releases

This graph gives an idea of the order of magnitude of the "impact" reaction of governments in the most turbulent phase of the financial crisis. Then we can look at the IMF forecasts collected in Table 1. This reports forecasts of next two years' average government budgets as percent of GDP and their non-cyclical or "discretionary" component. The latter ought to provide information on the additional measures that governments are planning beyond what is normally generated by "automatic stabilizers".

Table 1. Forecasts of government budgets and their "discretionary" component (average values, 2009-10)

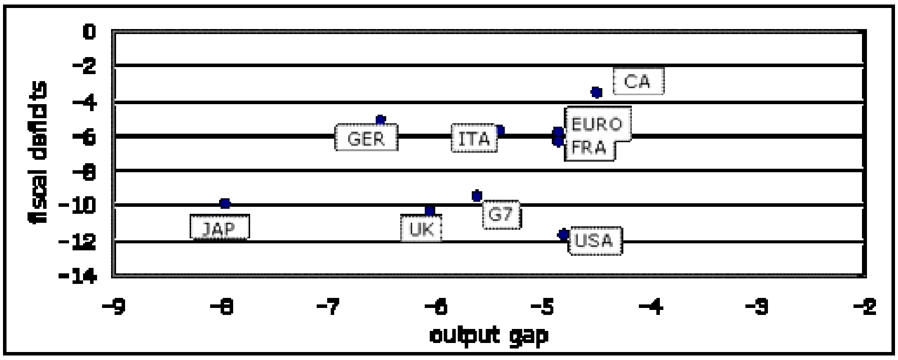
	Budget deficits (% of GDP)	Discretionary component (% of deficit)	Output gap(% of potential GDP)
G7	-9.5	54.5	-5.6
Euro area	-5.8	51.3	-4.9
United States	-11.6	53.6	-4.8
Canada	-3.5	24.3	-4.5
Japan	-9.9	66.0	-7.9
United Kingdom	-10.3	61.8	-6.1
Germany	-5.1	44.1	-6.5
France	-6.3	49.6	-4.9
Italy	-5.6	49.6	-5.4

Source: IMF, *World Economic Outlook*, April 2009.

According to these data, the discretionary component will account for about one half of the total (notable exceptions are Canada, with a tiny one fourth, and Japan and UK pointing beyond two third). That is to say, governments are ready to take measures that double the fiscal stimuli that would have been generated in normal cyclical conditions. This is by all means "large" with respect to historical records in advanced countries (see for example the recollection of fiscal responses to major downturns in the euro-area countries provided by Buti and Sapir[1]).

While it is curious that all governments seem to have the same discretionary reaction function in percent terms, the total results are clearly quite different. The most important explanatory variable of differences in total deficits should be the extent of expected recession, which in the table is measured by the average 2009-10 output gap estimated by the IMF. The scatter in Figure 2 offers a visual grasp of the relationship between fiscal deficit and output gap across countries.

Figure 2. Fiscal deficits and output gaps (% of GDP and of potential GDP, resp.)



Source: IMF, *World Economic Outlook*, April 2009.

If output gaps were the only explanation for differences in fiscal deficits, all countries ought to line up from the upper-right to the lower-left corner. This seems to be the case for a number of countries in the sample, but there are also notable exceptions, possibly not for casual factors.

At first sight, the US deficit response relative to the output gap will be larger, whereas that of Germany, Italy and Japan will be smaller, in comparison with the other countries. These differences are due to institutional and structural factors as well as to political choices. The new US administration has inherited an inertial expansion of fiscal deficits mainly due to military expenditures and low taxes, but Obama also seems determinate to implement a costly health insurance reform. Japan is a high-debt country which may feel constrained in its room of fiscal manoeuvre. The fact that some euro-area countries, too, are responding to output gaps relatively less is certainly related to the constraints imposed by the SGP. Yet this may be more plausible for a high-debt country like Italy than for Germany. Interestingly, however, the euro-area as a whole seems to have a fiscal response in line with other major advanced countries in the G7 group.

This simple glance at the data can only indicate whether fiscal stimuli in different countries are more or less large with respect to the respective output gaps. Whether the extent of these stimuli is also commensurate to the goal of rescuing the world economy from recession is another question.

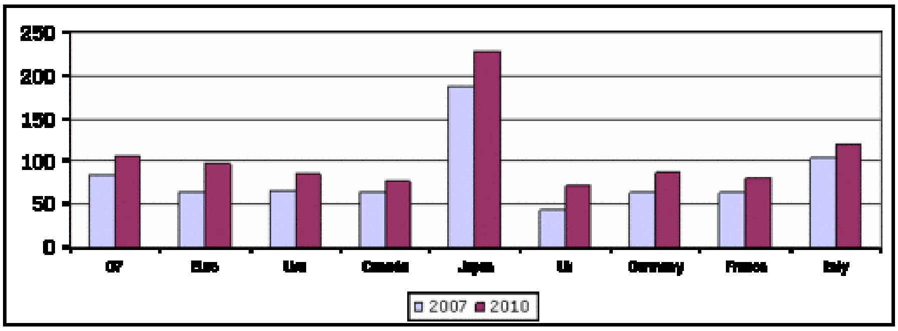
An important element in Figure 1 is the distinction, where available, between fiscal measures directly aimed at the banking and financial system (nationalizations, bail-outs, recapitalizations, etc.), and other measures towards the "real economy". This distinction is worth noting because it relates to the issue of diversification indicated by the IMF paper. Indeed, it highlights one of the most critical aspects of the crisis conditioning the nature, and extent, of the fiscal interventions. As documented by Axel Leijonhufvud in a forthcoming article[2], though the need of fiscal stimuli has been associated with Keynesian principles, the present crisis is not (only) a Keynesian crisis. What we now see looks very Keynesian, that is, a deep fall in aggregate demand, economic activity, and employment. But *this is the result of a financial bust following a financial boom*.This is rather a Minsky crisis or a "balance-sheet crisis" (Leijonhufvud), that is, a crisis that has its seeds in the dramatic deterioration of balance sheets in the private sector (mostly intermediaries and households).

The lessons to be drawn from the opposite stories of Japan and Sweden is that when intermediaries are deleveraging heavily, monetary policy soon becomes ineffective. Yet the kind of fiscal intervention that is needed is not just in support of aggregate demand, but also in support of the banking system's capitalization in such a way that its lending capacity is restored. In fact, the production sector needs both a sustained demand ahead and sufficient means to finance the activity level elicited by prospective demand. Unfortunately, this double front of fiscal policy loads a high burden on governments' shoulders, as can be gauged from the data in Figure 1. Not by chance, US, UK and Germany seem the most engaged countries on the bank front. True, most of those resources are allocated in the budget but not (yet) spent out. However, a serious trade-off is arising between bailing-out the banking system and sustaining the real economy.

Contingent. At first sight, this is an astonishing recommendation coming from the temple of orthodox principles of policy making. Orthodox principles ban contingent policy plans and advocate commitment to predetermined plans. The key point that presently seems to make contingency necessary is that policy authorities may not have all the information to draw time-consistent plans to which commit themselves. If in the near future fiscal stimuli turn out be insufficient, maintaining market confidence will call for governments standing "ready to do as much as necessary". This sounds inescapable, but also dense of future troubles. As recalled by Leijonhufvud in the aforementioned article, recursive additions of fiscal burdens onto unwilling taxpayers in the aftermath of financial crises were the main drivers of major episodes fiscal instability and high inflation in developing countries. This warning leads us to the next two items in the IMF menu.

Lasting and Sustainable. Another instructive reading is a recent study by Reinhart and Rogoff who examine the macroeconomic developments following major financial crises in the 20th century. They invariably include "public debt explosion", on average almost doubling in the medium term, due to prolonged fiscal deficits. These in turn were mainly generated by the long-run bequests of recessions, such as increasing and persistent social expenses and low tax revenues, rather than once-and-for-all bail-outs in the financial sector. Figure 3 reports the IMF projections of debt/GDP ratios in main advanced countries in 2010 compared with the pre-crisis ratios in 2007. For the G7 as a whole, the projected increase is about 25%, well below the Reinhart and Rogoff finding. But the pressure on debt may well stretch into the future.

Figure 3. Debt/GDP ratios, 2007 and projections 2010



Source: IMF, *World Economic Outlook,* April 2009

According to Auerbach and Gale[3], the public finance outlook is particularly alarming for the US. These authors argue that current projections are based on some optimistic premises that may fail to materialize. In a less favourable scenario, the US will present a structural deficit of 5% of GDP per year for ten years. This figure implies that for debt to be sustainable the US will soon face the necessity of a fiscal correction on the primary account from 4% to 6% of GDP. A correction of this order of magnitude ceases to be just an economic problem: it becomes first and foremost a political problem.

The gigantic substitution of private debt with public debt which is taking place all around the world to rescue the private economy from complete wreckage is spreading the seeds of the next financial threat. Managing it, if nothing else, will *ipso facto* change the face of global financial capitalism regardless of what supporters of the return to business as usual may say or hope. The historical lessons exemplified above warn that combining contingent, lasting and sustainable fiscal deficits may turn out be a high-risk endeavour. Sustainability of prolonged fiscal deficits requires an enormous amount of time-consistency of both governments and taxpayers. It is well-known that varying political majorities and feeble intergenerational linkages are major stumbling blocks in the way of long-term fiscal stability. When, in few years time, worldwide complaints will arise against the profligacy of governments, their seizure of financial resources, the increasing burden of real taxes or the threats of inflation taxes, it will at least be honest to remember how all that begun.

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[1] Buti M., Sapir A. (1998), *Economic Policy in EMU*, Oxford, Clarendon Press.
[2] Leijonhufvud A. (2009), "Out of the Corridor: Keynes and the Crisis", *Cambridge Journal of Economics*.

[3] Auerbach A.J., Gale W.G. (2009), "The Economic Crisis and the Fiscal Crisis: 2009 and Beyond", University of California, Berkeley, and Brookings Institution, Washington, mimeo.