Fiscal Policy

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Whereas much of the policy innovation during the financial crisis focused on monetary policy—and especially unconventional monetary policy—there has since been renewed attention to fiscal policy. The monetary focus manifested in part because monetary authorities were able to move quickly and decisively during the crisis, whereas fiscal policy tends to be slower, both in decision making and in implementation. But the renewed attention to the potential power of fiscal policy has come as the severity of the crisis demanded that all available tools be brought to bear and also as the limits of monetary effectiveness may have been reached. The nature of the financial crisis and the use of unconventional monetary tools brought about a conceptual rethinking in monetary economics, particularly to incorporate financial markets into monetary models. There has not been such a ground-up rethinking so far in fiscal policy, although recent work suggests that we might consider fiscal policy differently in a world where monetary policy is at the zero lower bound.

I will break out the questions for this session into the phases of the business cycle, which implicitly focuses our thinking on the cyclical role of fiscal policy. However, I will return to the potential role of fiscal policy in economic trends at the conclusion of this introduction.

Starting with the pre-recession or boom period in an economy, how much headroom should a country maintain in its debt-to-GDP ratio? This question is the counterpart to the corporate finance concept of debt capacity and the question of how much spare debt capacity should be held in abeyance. The crisis taught us that while policymakers cut taxes, increased spending, and ran deficits during cyclical booms—either out of political expedience or as a strategy to put downward pressure on the size of government—they used up borrowing capacity that was needed later when the crisis eventually hit. Downturns are naturally associated with larger deficits, at the least from automatic stabilizers and even more from active fiscal policy, and with the need to tap debt markets. This task is typically easier and cheaper when the debt-to-GDP ratio inherited from boom times is relatively low. Such a precautionary approach to debt capacity is less controversial than the thorny quantitative question that follows: *how much* borrowing capacity should a country build up outside of downturns, and if it depends on state-specific factors, what determines how large this capacity should be?

Second, coming to the downturn, how large are the fiscal policy multipliers, and if they are state-contingent, what do they depend on? Research so far emphasizes that fiscal multipliers can be much larger when monetary policy reaches the zero lower bound. Other work has shown that excess capacity or output gaps in the economy increase fiscal multipliers. This analysis is crucial to policymakers' approaching fiscal consolidation when an economy is still weak, either in the aftermath of a crisis or worse, during a crisis itself associated with structural fiscal imbalances. Policymakers face the essential conundrum that financial markets are looking for credible improvements in the structural fiscal stance at the same time that the economy will suffer most from fiscal tightening.

One approach to these questions is to put in place fiscal rules, just as central banks have proposed monetary rules to develop credible policy. In principle, such rules can allow for deficit spending when the economy is weakest and the multipliers are largest, with a credible commitment to fiscal sustainability as the economy improves. Rules can also help to impose discipline during “good times” to rebuild debt capacity and bring down the debt-to-GDP ratio after a cyclical downturn. Similarly, such rules can allow for cyclical deficits during downturns, along the lines of automatic stabilizers, which naturally roll off as the economy strengthens. Rules can also ease the decision-making lags that limit the effectiveness of fiscal policy at typical business cycle frequencies. The effects of these stabilizers can be large: The Congressional Budget Office (CBO 2013) estimates that spending and foregone revenue associated with automatic stabilizers averaged over $350 billion per year in the United States from 2009 to the present (FY 2013), totaling more than 2.5 times the total stimulus included in the American Recovery and Reinvestment Act (ARRA). Although the use of automatic stabilizers is well established, strengthening and broadening fiscal rules can be problematic. More general fiscal rules have well-known problems, because they are rigid by design and difficult to customize to particular economic conditions; indeed, allowing judgment or “escape hatches” to accommodate unforeseen circumstances can undermine the credibility that a rule is designed to develop.

Finally, once the downturn has eased, how rapid should fiscal consolidation be during a recovery? Policymakers often undertake rapid fiscal consolidation under pressure from financial markets to reduce sovereign debt, or at least their borrowing. Countries not under immediate pressure argue that a reduction in borrowing is needed to forestall such pressure eventually. When should policymakers start to take this concern into account? Should policymakers react before reaching an upper bound on the debt-to-GDP ratio that they should not breach, or similarly, that financial markets will not tolerate? Concern about investors' appetite for sovereign risk can lead policymakers to tighten too early or too much, because the costs are perceived to be asymmetric: Waiting too long and risking a withdrawal of lending can be very costly.

These questions are almost entirely focused on cyclical management of debt and deficits. Yet the severity and persistence of the recent recession and the slow pace of subsequent recovery raise the concern that the crisis will have a lasting effect on the macroeconomy, perhaps by reducing potential output. The possibility that output may be permanently affected profoundly raises the stakes of a downturn, yet the mechanism through which a financial crisis or a severe downturn affects the productive capacity of the economy is not yet well understood. There is evidence that long-term unemployment causes deterioration of a worker's skills and reduces the probability of re-employment. Other potential mechanisms are less clear-cut. Is there a reduction in innovation or in technological change embodied in investment in physical capital? Does reduced labor mobility or reallocation hurt productivity? Some of these mechanisms would benefit from fiscal intervention, either broadly to increase economic activity, or specifically, for example, to promote skill development and job matching. Yet without understanding what causes the long-term damage to the economy, any policy intervention is largely speculative.

Finally, I began by emphasizing the ground-up rethinking in monetary economics to explicitly incorporate financial markets. Monetary policy has embraced credit markets as a mechanism for monetary stimulus, and the same may be true for fiscal policy. Fiscal use of credit policy has been employed primarily for microeconomic reasons: to remedy market failures and support social benefits where they exceed private benefits. In practice, however, credit policy was widely used in the crisis by fiscal authorities, particularly in the housing market and to support small business. As we rethink fiscal economics, policymakers could likely benefit from a better conceptual and empirical understanding of the potential role of credit and macroprudential policy in countercyclical fiscal policy.

Reference

Congressional Budget Office (CBO), “The Effects of Automatic Stabilizers on the Federal Budget as of 2013” (Washington, DC, March2013).