Fiscal Policy

Nouriel Roubini
Stern School of Business, NYU

Paper presented at the Rethinking Macro Policy II: First Steps and Early Lessons Conference
Hosted by the International Monetary Fund
Washington, DC─April 16–17, 2013

The views expressed in this paper are those of the author(s) only, and the presence of them, or of links to them, on the IMF website does not imply that the IMF, its Executive Board, or its management endorses or shares the views expressed in the paper.

FISCAL POLICY - IMF Conference

Nouriel Roubini

The recent global financial crisis has brought back the attention of analysts and policy makers on the role of fiscal policy during the crisis and its aftermath. Several important questions need to be addressed. What is the relation between levels of public debt and economic growth? What are the causes of high debt and deficits? Loose fiscal policy or weak economic growth? What is the size of fiscal multipliers and how it depends on the business cycle conditions? Is there a risk of fiscal dominance? How to reduce a debt overhang and achieve a smoother deleveraging from high debt ratios? What is the optimal pace of fiscal consolidation? Certainly the question of fiscal policy is an important and critical one. So, this paper will to try to answer the questions above.

The first that one needs to address is the question of the relationship between high public debt and economic growth. And the one of what are the costs of that high debt. Economic theory suggests that at some point in time high public debt can have a negative effect on economic growth. It can lead to high real interest rates and crowd out investment and consumption. It can increase the risk of a debt crisis with all the collateral damage of a debt default occurring. It can force policy makers to increase taxes to avoid a debt crisis; but high

taxes cause distortions that negatively affect economic growth.

So those are the factors that can lead to lower growth in the presence of high and rising public debt levels. And certainly recently the research work that's been done by a number of scholars, especially Carmen Reinhart and Ken Rogoff, had suggested that actually there could be a significant empirical relationship between high public debt and lower economic growth. According to them the critical threshold was when in advanced economies debt is higher than 90 percent of GDP (lower in emerging markets); this is when those negative effects on economic growth become allegedly significant. And indeed the median debt ratio for advanced economies has gone from about 60 percent od GDP before the crisis to a level closer to 100 percent today.

When you consider those empirical results of Reinhart and Rogoff there are two important things to keep in mind. One is of course the causality issue. Is it the high debt ratios that cause lower economic growth or rather situations where shocks that lead to significant recessions or financial crisis that causes economic weakness and thus lead to an increasing debt ratio? So, the first question is the causality one.

The second one is that there is a recent academic paper that has shown that there some serious methodological problems with the results that Reinhart and Rogoff obtained.

Actually that relation between high debt economic growth might not be as robust as they thought it was. Thus, the recent conventional wisdom that high debt leads to lower growth rates has now been seriously challenged empirically.

Now as Olivier Blanchard et al. (2013) suggest another big risk and potential effect of high debt is the risk of multiple equilibria. If you have a lot of public debt and it has to be rolled over then there is the risk that you may end up in a situation in which there is a self-fulfilling run on public debt; then, the spreads become higher and unsustainable. And then you may thus end up in a situation in which a liquidity problem leads to insolvency as an illiquid but solvent sovereign may end up in default if such run does occur; this is a bad equilibrium that you cannot rule out. And therefore everything else equal, having a lower debt ratio and having less of a liquidity risk with a longer maturity debt can reduce the risk of such a bad equilibrium.

Of course there is a solution to a liquidity crisis. We know it in the case of bank runs but the same thing occurs in the case of a run on government debt. If you have a lender of last resort, a Central Bank that can provide liquidity to a sovereign by monetizing its debt you can avoid that bad run equilibrium. This was certainly the situation, for example, of the Eurozone in the summer of 2012 when interest rates on

Italian debt rose to almost seven percent and those of Spain were closer to eight percent. Then when Mario Draghi gave his "whatever it takes" speech and the ECB announced its OMT program a significant reduction in those yields and spreads occurred as both the currency redenomination risk of a Eurozone break-up and the risk of a run on public debt were sharply reduced. This suggests there was an element of self-fulfilling bad equilibrium in the case of Spain and Italy in the summer of 2012 when spread kept on rising to unsustainable levels. Therefore the existence of that lender of last resort can help avoiding those bad equilibria.

Similarly, are rates in the US and Japan low because these markets are "safe haven" during periods when tail risks are high and risk is off? Or are those low rates the result of large scale quantitative easing that is effectively a form of debt monetization that reduces the risk of runs on public debt and keeps long rates lower than otherwise?

Of course, one needs then to address the moral hazard problems that such intervention/insurance against liquidity runs on public debt may induce.

The second question that is worth discussing is the one of what are the causes of high debt problems. Indeed, the policy answer on what we should do about high debt ratios depends in part on what led to debt to increase and reach such a

high level. When one looks at the experience of the last few years, of course there are examples of countries in which fiscal policy was loose and reckless. The most typical example might be the one of Greece that was running very large and unsustainable budget deficits till the onset of their debt crisis in 2010. Policy makers there effectively cheated and lied about the true size of the deficit that turned out to 15 percent of GDP, much higher than otherwise previously announced and known.

Of course if you run very large budget deficits for reasons that have to do with political distortions that lead to an increase of debt that becomes unsustainable you are in a typical situation where you're going to have a debt crisis due to reckless fiscal policy. And thus those high debt ratios will have sharply negative effects on economic growth.

However, if we're looking at the experience over the last decade many of the financial crises have led to a large increase in public debt and deficits that started initially with private – not public - sector financial excesses; these were credit, housing, asset bubbles of one sort or another that eventually went bust; and once they went bust they caused a significant increase in budget deficits and public debt. That increase in public debt and deficits was first driven by the ensuing recession that induced the kick in of automatic

stabilizers. Thus, revenues fell sharply over time while spending rose.

Secondly, whenever that financial crisis does occur, there's also the risk like - like the one 2008-09 that a Great Recession may turn into another Great Depression; therefore the optimal policy response to avoid such depression was the one of a fiscal stimulus that was most necessary in a situation in which private demand is collapsing. If private consumption and investment are free falling, if you don't have a large fiscal stimulus (an increase in spending or reduction in taxes or a combination of the two) an economy could get into a situation like the Great Depression. And one of the lessons of the Great Depression was that you need a fiscal stimulus when private demand is collapsing.

Third, the fiscal cost of cleaning up, bailing out, backstopping the financial system or even corporates (GM, Chrysler bailouts) and or households implies that there will be large fiscal cost of such bailouts. In these cases of financial crises there will be lots of contingent liabilities that emerge and that will be the source of additional increases in public debt.

And if you look at the experiences over the last few years I would say the examples of Ireland, Iceland, Spain, UK, and the US, and even emerging markets such as Dubai are all

essentially private sector induced excesses that led to bubbles. Those were private sector financial excesses that eventually led to a bust. Then the resulting increase in public debt and deficit was the result of that severe financial crisis. So, that implies that maybe the policy response to a balance sheet crisis might be different from a situation in which you had reckless fiscal behavior in the first place. In balance sheet crises where the bust leads the private sector to sharply deleverage by cutting spending on consumption and investment, a large fiscal stimulus is necessary to prevent the collapse of private demand from causing an even more severe recession. Thus, fiscal stimulus rather than fiscal contraction is the appropriate policy response – together with aggressive monetary easing – to a private sector induced balance sheet crisis. This is the policy insight that folks like Richard Koo have correctly identified as appropriate following balance sheet crises.

The third question to discuss is the one about the size of fiscal multipliers. One question is whether a fiscal expansion increases GDP and how large are those fiscal multipliers? Are they greater than one or not? The related question is whether fiscal consolidation is expansionary. There is a popular hypothesis that a fiscal consolidation will have positive confidence effect - a confidence "fairy" – on economic growth; ie the view that reducing the fiscal deficit will

increases economic activity even in the short run. Is that view correct?

If one looks at the empirical evidence there are four results that emerge. First, as Roberto Perotti (2013) has shown there is no real evidence that fiscal consolidation is expansionary in the short run; rather it tends to have negative effects on economic activity. This is the case even in the Eurozone where fiscal consolidation may be of course needed over time to avoid a debt crisis. Indeed, the front-loading of the fiscal austerity in the Eurozone periphery is one of the reasons why this region fell into a double dip recession in 2011-2012.

Second, the work that IMF has done is also consistent with the view that fiscal austerity is contractionary at least in the short run. If you raise taxes and thus reduce disposable income, if you cut government spending - even unproductive government spending - you are reducing aggregate demand. Therefore reducing disposable income and aggregate demand will have a negative effect on economic activity in the short run. Also, when you have synchronized fiscal austerity in many parts of the world the fiscal multipliers will be larger. Indeed, till 2012 the fiscal austerity was limited to the periphery of the Eurozone and to the United Kingdom. But in 2013 even the US will have a significant fiscal drag and, given the Eurozone Fiscal Compact, even the core of the Eurozone (Germany and others) will

implement fiscal austerity. Then, in a situation where many countries are doing austerity at the same time, those fiscal multipliers could end up being actually larger than when fiscal austerity is less synchronized globally.

Third, there are about a dozen econometric/statistical studies about the US 2009 fiscal stimulus; most of these studies find out that such fiscal stimulus was expansionary on GDP and that the results were large and significant.

Fourth, there is increasing evidence that the fiscal multipliers are larger when you are at the zero interest rate bound (into a ZIRP region) and when there is a meaningful slack in the economy, i.e. when you are in recession or you are growing very slowly.

So a fair reading of the empirical evidence suggests that fiscal stimulus is effective in stimulating growth especially after a financial crisis when the economy has a large slack and is in a liquidity trap; conversely, excessively front-loaded fiscal consolidation has negative effect on growth.

Thus, considering the above empirical evidence and the conceptual arguments about how to appropriately respond to a balance sheet crisis with a fiscal stimulus, one can explain some of severe economic contraction that, for example, the Eurozone economies experienced. For example, take Spain and Ireland where there was clear evidence of a balance sheet crisis

driven by the private sector behavior. Then, how much of the severity of the crisis in Spain in 2013 – where the unemployment rate was 27 percent and rising and 55 percent and rising among the young - was due to the fact that there was initially very limited fiscal expansion and then – when spreads rose - there was significant frontloaded fiscal austerity?

An argument has been made by Roberto Perotti (2013) that the optimal response to high deficit and debt depends in part on whether a country has "fiscal space" or not. Meaning whether there are active bond market vigilantes that have increased the country's sovereign spreads and led to a loss of market access or not. And the argument has been made that in the case of the Eurozone periphery there was not a fiscal stimulus option: if the markets are punishing a country and spreads are high and rising or if the country has lost market access then the only option I that fiscal adjustment as the country doesn't even have a choice.

This argument is only partially valid as there are at least three important caveats to be made. First of all, whether a country has fiscal space or not depends in part on whether the country has a central bank that is willing to effectively do quantitative easing and monetize public debt. And in the case of the Eurozone, if the behavior of the ECB had been different and more dovish, then the implication for fiscal space would

have been different.

The second point is the existence of the central bank that is willing to avoid a self-fulfilling bad equilibrium implies that that a run against the public debt or the widening of the sovereign spread can be avoided even if actual debt monetization doesn't occur but is only available as an option. Think about the ECB’s OMT program: in some sense this has been the most successful monetary policy tool ever because not a single euro has been spent yet to backstop Italy and Spain or any other country. But the spreads of Italy and Spain had fallen sharply by 250-300 basis points in 2013 compared to what they were in the summer of 2012.

So, just even the mere existence of a potential lender of last resort can lead to a better equilibrium even if that lender doesn’t act. So, that's an important factor in determining whether a country does have market access or not.

Third, even if a country (its sovereign) doesn’t have market access because it has lost market access or because the private sector is imposing market discipline, the existence of official creditors (and those official credits can be the IMF, the EU, the EFSM, ESM and so on) can provide a sovereign with some fiscal pace. So, given the existence of official external creditors that can substitute for the private ones the question is what is their optimal use? And that has been of course even

in the past the debate about a country – say an emerging market that gets in trouble - and the existence of an IMF providing it with financial support conditional on austerity and reforms. And the IMF lending allows a country under financial stress to have a better path of fiscal consolidation compared to a situation in which that official financing doesn't exist.

In the case of the Eurozone, of course, the existence of official creditors – Eurozone wide lending and liquidity mechanism - also gives sovereigns under pressure some degree of flexibility. Therefore, if one thinks about the issue of whether a country has fiscal space or not the considerations above matter: in places like the US, UK, Japan there are still very low interest rates in spite of large fiscal deficit and debt in part because central banks have been willing to do quantitative easing and effective debt monetization. While in countries in the Eurozone where the debt ratio are on average not higher than the US, UK or Japan and in some cases lower, spreads were high and widening when the ECB was essentially refusing to provide that type of monetary easing.

The next question worth discussing is that of "fiscal dominance" and how much one should be concerned about it. In a situation in which budget deficits are large and there is a political bias towards deficits there is always the risk of fiscal dominance. The risk is that a central bank is going to

be forced essentially to monetize these deficits to prevent a debt crisis. In a game of chicken between a fiscal and monetary authority it is the latter who blinks if fiscal dominance rules.

On the issue of fiscal dominance there is a difference between the views on one side of the European Central Bank and of the BOJ under Shirakawa that were worrying about this fiscal dominance effect and the views of the Fed and the BOJ under Kuroda that don't seem to be worrying about such risk.

If one were to try to interpret the Fed views they would be the following ones. First, the central bank cannot really bully fiscal authorities into fiscal discipline. A central bank can’t threaten the fiscal authority - and tell it to do fiscal adjustment – by actively denying a necessary monetary easing as a way to force fiscal adjustment.

Secondly, if the central bank tries to bully the fiscal authorities it might actually end up into a political clash with them. And the ensuing backlash may lead to a formal loss of central bank independence.

Third, if the central bank withholds a necessary monetary policy stimulus because it wants to force the fiscal authority to adjust, it may not succeed and may actually cause a severe recessions. So, monetary policy should do what's necessary for the economy regardless of what's happening on the fiscal side.

Thus, the best that a central bank can do – as Fed Chairman has done – is to verbally jawbone fiscal policy makers to do the necessary fiscal adjustment. Using the threat of withholding necessary monetary stimulus to induce fiscal adjustment has negative and perverse effects.

Now the ECB and German view on the issue of fiscal dominance has been vwery different. For example, in the case of the Eurozone the OMT has been made conditional on strict and effective conditionality, fiscal and structural conditionality as a way of actively limiting fiscal dominance.

Secondly, the existence of the OMT by reducing spread has led to concerns in Germany and even in the Bundesbank that there is now policy delay and slack in the EZ periphery. According to this view, there is now complacency and moral hazard in the Eurozone periphery: both austerity and reforms are not occurring at the pace desired by the ECB and the core of the Eurozone. Therefore, the German and Bundesbank view is that market discipline is sometimes good and necessary to force governments to implement without delay the necessary policy action. On the other hand, excessive market discipline – in the form of higher spreads – is destabilizing attempts to reduce deficits and make debts sustainable. Thus, market discipline is a double edged sword.

Now, certainly there are risks of fiscal dominance in

the presence of the liquidity support of the central bank. And there is also risk of moral hazard whenever you have other official resources like the ESM, EFSF and IMF loans to support sovereigns under pressure. But the argument about moral hazard is a bit excessive: assume that you are a government and you have to do painful fiscal austerity but suppose that the confidence fairy does not occur – spreads don't fall in spite of austerity and reforms - because there is uncertainty on the credibility of the government actions and about how long a government is going to stick with such policies. Then, there is a serious risk that doing fiscal adjustment and reform may fail in a situation in which market do not yet find the country policies fully credible. In this case if you don't have official support - whether from the central bank or from official creditors - then the incentive to do those painful austerity and reforms may be low because even if you attempt them you might fail and end up into a debt crisis. Therefore, moral hazard rather than being increased with the presence of official money is reduced because you have a carrot induce the government to implement painful policies that are likely to fail in the absence of official financing. Here, the carrot that induces positive policy action is that if the government implement the necessary and painful efforts then there will be provision of liquidity that reduces the risk of a bad equilibrium.

Therefore, in the presence of official finance a self-fulfilling crisis is avoided and therefore moral hazard is reduced rather than increased.

I wrote a few years ago a paper with Giancarlo Corsetti (2004) where we showed formally – using the analytical framework of global games a la Morris and Shin - that the existence of official finance can reduce moral hazard rather than increase it. Official finance gives a carrot that incentivates a government that would otherwise feel like "if I do the policy effort and I am likely to fail why should I do the effort in the first place?" to actually do the effort as the presence of official finance reduces the probability of a bad equilibrium. So, the arguments official support causes moral hazard and fiscal dominance might be actually incorrect.

The next question to address is the one of how to reduce a debt overhang, i.e. what is the optimal approach to deleveraging from high levels of public and private debts. There are several options. The first one is fiscal austerity: a government can cut spending, raise taxes, and thus increase public savings. But that option, if too front-loaded - leads to the Keynesian paradox of thrift; if the fiscal adjustment is too fast the economy may contract again and the goal of reducing deficits and debt may fail; this is partly what has been happening in the Eurozone and the UK. The second option is to

do a coercive debt restructuring/reduction; that option might become necessary and unavoidable if you have an issue of solvency rather than liquidity.

Another option is very aggressive monetary policy (zero policy rates and quantitative easing); this is effectively a form of debt monetization that leads to low nominal interest rate and possibly negative real interest rates. This debt monetization option may actually not be inflationary if the country is in a liquidity trap and there is large slack in the goods and labor markets. A variant of this option is finance from official creditors (the IMF, the EU) that provides breathing space for a slower adjustment of spending and savings.

Another option is to cause expected or unexpected inflation to wipe up the real value of nominal public debt. Another option might be to use capital levies on wealth or on creditors as a way of resolving the debt overhang. A variant of that is to use financial repression and capital controls to keep government bond yields lower than otherwise.

Now, with the exclusion of the first option that is essentially one of adjustment and higher savings, all the other options effectively imply some redistribution of wealth from creditors and savers to debtors and borrowers (such as an indebted government). But the adjustment from a debt overhang that depressed the spending of debtors necessarily implies that

that such a transfer of wealth should occur over time. The political question is who should be doing such redistribution policy decisions? Should it be a decision done by fiscal authorities through capital levy on wealth or debt restructuring or should one give this power to the central bank that can accomplish the same result via debt monetization?

Some argue that such a power should not be given to the central bank as these eminently fiscal and thus political decisions. But if low nominal rates an negative real ones from debt monetization allow a smoother deleveraging process that reduces the risks of a recession deriving from excessive austerity and that prevents a more disruptive debt restructuring or the distortionary costs of financial repression, capital controls and capital levy, the option of debt monetization could be the least costly.

The final issue that is worth addressing is the one of the optimal pace of fiscal consolidation following a financial crisis that has led to a large increase in public debt.

In most case where market access has not been lost or where official financing (from the central bank or from official external creditors) is available the optimal pace of fiscal consolidation would be one of a fiscal stimulus in the short run while the economy is weak and the private sector is deleveraging its indebted balance sheets and a credible plan for medium-long

term fiscal consolidation to be implemented when the economy has recovered strongly enough and private balance sheets are mostly mended. This short to medium-long term adjustment is helped by effective debt monetization by a central bank that makes the deleveraging process smoother and prevents the risks of runs on banks and governments. Delaying fiscal adjustment forever risks causing a zombification of governments and private agents and eventually a debt crisis even in cases where the initial surge in the public deficit is due to a private sector balance sheet crisis. Conversely front-loading excessively the fiscal consolidation risk pushing a fragile economy into a double dip recession that will make such deficit and debt problems only worse.

Compared to this optimal path of fiscal consolidation the major advanced economies, the Eurozone, the UK and the US have followed a sub-optimal path. In the Eurozone and the UK the fiscal austerity has been front-loaded in the short run. This is one of the reasons – together with a monetary policy that wasn't loose enough and zombie banks that have not been appropriately recapitalized thus driving a credit crunch – why both regions have fallen into a double dip recession.

In the United States instead gridlock and lack of bipartisanship in Congress has implied that the US has no credible path for medium-long term fiscal consolidation as

Republicans veto further tax increases while Democrats veto spending and entitlements reforms. While in the short run – given the same gridlock – this year the fiscal drag will be excessively given a front load of the fiscal consolidation that the sequestration of spending deadlock engenders. So, the US is doing the opposite of the optimal path: too much short run fiscal drag this year and next with no credible plan for consolidation in the medium term. Still, compared to the Eurozone and the UK that front-loaded their fiscal austerity since 2011, the fact the US successfully postponed its central government austerity till 2013 explains why the US is growing – however anemically – while the Eurozone and the UK have been contracting.

The fiscal adjustment in the Eurozone has been an example of poor policy planning that explains why the periphery of the region is still stuck in a recession that is becoming a near depression in some countries (Greece, Spain) and why this recession is now spreading even to some parts of the core (France, Belgium, etc.). A few remarks are important on the Eurozone fiscal adjustment.

First, the austerity has been excessively front-loaded in the EZ periphery with seriously damaging effect. It should be significantly back-loaded.

Second, the flexibility that the EU Commission

provided to achieve cyclical adjusted target and provide fiscal relief for countries that end up in a recession is a palliative that occurs after the patient has been nearly killed. Saying that countries should achieve very aggressive structural fiscal targets that cause a recession and then allow some cyclical slack on those fiscal targets once the austerity caused a recession that worsened the deficit is no rational solution. Structural fiscal targets need to be realistic in the first place to avoid such austerity-induced recession.

Third, the adjustment in the EZ is asymmetric between periphery and core and thus recessionary and deflationary. If countries and governments that overspent an undersaved should spend less and save more, then the countries like Germany that oversaved and underspend should spend more and save less (in part through fiscal policies of tax reduction and spending increase). Otherwise the adjustment is asymmetric and recessionary as it leads to a shortage of aggregate demand for the whole region.

Fourth, there is fiscal space in the core of the EZ, especially countries like Germany where interest rates are low and where market access is ample. It is true that the public debt in Germany is 80 percent of GDP and that implicit liabilities from aging are additional fiscal burdens. But sovereign spreads are so low in Germany that if the country were

to implement for a couple of years a fiscal stimulus in the form of reduction of taxes and increases in government spending as a way of boosting its own economic growth and that of the overall Eurozone such policy action would not lead to any loss of fiscal credibility as long as the country has a plan for medium-long term fiscal consolidation. What we are speaking about is a short-term program to try to jumpstart economic growth in a Eurozone that is in a deep recession.

Fifth, while the growth problems of the Eurozone are more structural than cyclical compared to the United States, in 2012-2013 the Eurozone didn't even grow at its low potential growth rate as it was in a recession. While potential growth is low in the EZ, the fact that the region was stuck in a recession suggests that the lack of aggregate demand – not just supply side constraints – explains this persistent economic downturn.

Moreover, some of the necessary structural reforms are – like fiscal austerity- contractionary in the short run. Suppose for example that a country flexibilizes its labor market and reduces hiring and firing costs. The first impact of such reform will be a rise in the unemployment rate as the firms that could not fire redundant workers will not be able to do so. That surge in the unemployment rate is exactly what happened in Germany when it implemented its structural in the early 2000s. The implication of this observation is there has to be a

tradeoff between structural reforms and fiscal austerity rather than a damaging recessionary front-load of both. Ie. if a country does more rapid structural reforms that are recessionary in the short run, it should be given greater fiscal flexibility as such reform may make the recession worse in the short run. That is exactly what Germany was claiming when they were implementing their Agenda 2010 and their unemployment was rising; they told the EU to be given a fiscal break as their reform was causing a rise in the unemployment rate that was leading to a larger fiscal deficit. The German argument then was correctly that such reforms would eventually increase potential growth. They were thus leading to an increase in deficit in the short run but eventually that deficit would go away once the effects of the reforms on growth would materialize in the medium term.

So, there has to be a tradeoff between austerity and reforms. You cannot just frontload both the austerity and the structural reforms: if you do more on the structural side you have to provide for greater fiscal flexibility in the short run; otherwise the recession is likely to become more severe.

A final observation about the Eurozone: there is absolutely no talk about a growth agenda. There is talk about a banking union, a fiscal union, a political union. But if you're not going to have economic growth and the austerity makes the

recession worse then you will eventually have a social and political backlash against the austerity. Also, sovereigns are trying to stabilize their public debt, domestic and foreign, as a share of GDP. But if frontloaded austerity implies that the GDP keeps on falling, one can work as much as one wants on the numerator of the debt ratio; but if the denominator – GDP – keeps on falling, those debt ratios will keep on rising and become unsustainable. That is what is happening right now in the Eurozone: in spite of draconian fiscal adjustment high public debt ratios are still rising and they may eventually become unsustainable.

Thus, excessively front-loaded fiscal consolidation both in the periphery and in the core of the Eurozone has been counter-productive and an important factor in explaining why the region was stuck in a deep double dip recession in 2012-2013.