

Lessons about Fiscal Policy from the 2000s¹

Comments at the 2011 RBA Annual Conference by

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Looking back on the decade of the 2000s provides an opportunity to reflect on what has changed, what has not, and what the experiences of the decade can teach us. For fiscal policy, the decade has been an eventful one, not only in Australia, but across the world.

In the time available, I thought I would focus on what I see as the main lessons about fiscal policy from the 2000s. I have five broad lessons.

Lesson 1

Currency union without fiscal union is an accident waiting to happen.

The euro was created just over a decade ago in 1999, and by 2003, investors were buying 10-year bonds from the central governments of all the members of the euro area at an interest rate premium of less than 20 basis points over German 10-year bonds.

What was insufficiently appreciated at the time was the fragility of the euro area arrangements, in the absence of a fiscal union. One problem was the lack of effective mechanisms to discipline government borrowing. In the good times before 2007, the governments of some countries used their newly found capacity to borrow cheaply in international capital markets to accumulate levels of government debt that would prove unsustainable in the aftermath of the severe adverse shock of the 2008–2009 financial crisis. Certainly, neither bond markets nor rating agencies imposed such discipline in the good times.²

But the problems of currency union without fiscal union have turned out to be more serious than the problem of fiscal profligacy by some members. Currency union without fiscal union has meant that some countries with a track record of paying down government debt to quite moderate levels in the good times could no longer rely on even the automatic fiscal stabilisers when a big shock arrived.

A comparison of the evolution of sovereign debt levels and bond yields in Spain (within the euro area) and the United Kingdom (with its own currency and independent monetary policy) reveals this point starkly. Despite Spain's better fiscal track record over the past decade, in the aftermath of the financial crisis, markets responded to Spain's lack of control over the currency in which its debts are denominated, and its inability to reignite domestic growth via expansionary monetary policy and currency depreciation, by imposing a much larger risk premium on Spanish bonds than on UK bonds. This self-fulfilling loss of confidence left Spain with little choice but to override the automatic fiscal stabilisers and impose pro-cyclical fiscal austerity at a time of high unemployment (De Grauwe 2011).

² Over the five years from 2003 to 2007, 10-year sovereign bonds issued by Greece, Ireland, Italy, Portugal and Spain all traded at an average interest rate premium of less than 25 basis points above 10-year German bonds. Furthermore, none of the major rating agencies downgraded the sovereign debt of any member of the euro area despite some building up levels of debt that would ultimately prove unsustainable. The first downgrade occurred in mid January 2009, when Standard & Poor's downgraded Greek sovereign debt from A to A-.

Lesson 2

The longer-term goal for monetary policy remains much clearer than for fiscal policy.

The global move to independent central banks with price stability mandates was a major achievement of the 1980s and 1990s.³ Most independent central banks achieved and sustained low single-digit rates of consumer price inflation, which has become the widely agreed longer-term goal for monetary policy. (Although there is, of course, more to monetary policy than that!)

For fiscal policy, however, the appropriate longer-term goal for the stock of government debt is less clear. In good economic times, should governments aim for a level of net government debt that is a small fraction of annual GDP? Alternatively, should they aim for zero, or even negative net government debt?

The financial crisis certainly suggests that the Maastricht criterion for gross government debt to be no higher than 60 per cent of GDP, or even the UK's net government debt ceiling of 40 per cent of GDP, are probably too high, because they leave insufficient fiscal space to respond to unforeseen adverse economic shocks. But beyond that, the experience of the 2000s has not provided much guidance about what should be the appropriate longer-term goal for net government debt.⁴

In Australia's case in the late 2000s, this issue has been couched in terms of whether Australia should save significantly more of the bounty from the mining boom in a sovereign wealth fund, to further improve the already strong balance sheet position of the Australian public sector. Curiously, that question has often been discussed without reference to the high and rising stock of financial assets in the Australian superannuation system, part of which represents accumulated contributions from the public sector (Gruen and Soding 2011).

Lesson 3

The achievement of monetary policy's longer-term goal of low single-digit inflation has important benefits, but also one serious drawback. It means that some economic shocks are now too big for monetary policy and the automatic stabilisers to cope with on their own. A significant discretionary fiscal stimulus is also desirable in response to such shocks.

But does discretionary fiscal stimulus work?

³ Indeed, this global change in monetary policy governance is taken sufficiently for granted that it didn't rate a mention at this year's Conference. It remains to be seen whether it will continue to be taken for granted.

⁴ There are other considerations that further complicate the issue. Governments that face more serious medium-term fiscal pressures because of a strongly rising age dependency ratio, and/or public health costs, should presumably aim for lower levels of government debt before these pressures become acute. There are also conceptual issues about whether government debt is the appropriate 'stock' concept for fiscal policy, as opposed to a broader measure such as government net worth.

In the important case of a country with a floating exchange rate and high capital mobility, the standard Mundell-Fleming model predicts that discretionary fiscal stimulus will have little or no expansionary effect on domestic economic output because it is crowded out by an appreciation of the exchange rate and the associated deterioration of net exports.

This standard Mundell-Fleming result seems broadly correct for countries with very high levels of government debt, when fiscal solvency may be brought into question, and also for countries with high trade shares.⁵

A well-known empirical study defines a threshold of exports plus imports equal to 60 per cent of GDP, and estimates that for countries with trade shares above this threshold, fiscal multipliers are actually negative on average (Ilzetki, Mendoza and Végh 2010).

But for less open economies with low government debt like Australia, fiscal multipliers for temporary discretionary fiscal stimulus appear to be positive and sizeable. For example, the International Monetary Fund's (IMF) Global Integrated Monetary and Fiscal model has fiscal multipliers for temporary discretionary fiscal stimulus for Australia of 0.5 for transfers to liquidity-constrained consumers, and 1.2–1.5 for government investment (personal communication – Werner Schule, Deputy Division Chief, Asian and Pacific Department, IMF, 1 August 2011).⁶

Notwithstanding the evidence to the contrary, the standard Mundell-Fleming result for countries with a floating exchange rate and high capital mobility – that discretionary fiscal stimulus has little or no expansionary impact on domestic GDP, even for the first few years – is sometimes still invoked, even for countries like Australia with relatively small trade shares. For example, Valentine (2011, p 40) argues that the Australian discretionary fiscal response to the financial crisis was 'ineffective and, therefore, unnecessary', a conclusion he suggests is 'consistent with the accepted doctrine (at least outside Australia) that fiscal multipliers are close to zero in small open economies with a floating exchange rate'.

Valentine supports this statement with reference to the study mentioned earlier – Ilzetki *et al* (2010). In fact, however, that study provides evidence supporting the *opposite* conclusion: that fiscal multipliers are instead positive and sizeable for countries like Australia. Bear with me for the explanation.

Among other things, Ilzetki *et al* establish two interesting sets of results for their large sample of countries. First, for countries with flexible exchange rates, fiscal multipliers over the first few years are effectively zero on average, while they are positive and sizeable for countries with fixed exchange rates (see their Figure 7). Second, as explained above, on

⁵ For countries with high trade shares, the standard Mundell-Fleming result applies only for unilateral fiscal actions. By contrast, for a global fiscal response to a global economic shock, fiscal multipliers are positive and sizeable, even for these countries, because spillover effects via trade work both into and out of the country in response to global fiscal stimulus.

⁶ By comparison, the Australian Treasury has used a somewhat larger multiplier for transfers (0.6) and a smaller multiplier for government investment (0.85) when estimating the domestic output effects of the Australian discretionary fiscal response to the financial crisis.

average for countries with high trade shares (exports plus imports greater than 60 per cent of GDP) fiscal multipliers over the first few years are estimated to be negative, while they are positive and sizeable for countries with low trade shares (their Figure 10b). With both a flexible exchange rate and a low trade share, Australia fits into the first category for the first set of results and into the second category for the second set of results.

For this sub-sample of countries, with both a flexible exchange rate and a low trade share, the results are virtually identical to those for the full sample of low trade share countries – with fiscal multipliers that are estimated to be positive and sizeable over the first few years. That is, when it comes to fiscal multipliers, the trade share dominates the exchange rate regime (although the results have larger standard errors because the sub-sample of countries with both characteristics is smaller than the full sample of low trade share countries – personal communication, Ethan Ilzetzki, 6 September 2011).

Lesson 4

What about fiscal consolidation? Can it be expansionary for the economy?

The answer to this question is yes, but mainly in countries where doubts about solvency have raised borrowing costs, and the consolidation could reduce these costs sharply. For example, fiscal consolidations in Denmark in 1983 and Ireland in 1987 (countries that had experienced rapid deterioration in their sovereign debt ratings) both appear to have been expansionary for their economies and were associated with big falls in long-term bond rates (Giavazzi and Pagano 1990).

However, these cases are rare (IMF 2010) and in most examples in the historical record, fiscal consolidation has been contractionary for the economy for the first few years.

Importantly, the contractionary effects of fiscal consolidation have been smaller in countries with a flexible exchange rate and independent monetary policy. For these countries, on average, the domestic output effects of fiscal consolidation have been reduced significantly by lower policy interest rates and a depreciation of the exchange rate (IMF 2010).

Of course, the interest rate offset is not available if interest rates are already effectively zero, and the exchange rate offset will be muted or absent if fiscal consolidation is occurring simultaneously all across the globe.

Lesson 5

In countries with high levels of government debt, political economy considerations can lead to a chosen path for fiscal policy that appears far from optimal.

In many advanced countries, a long history of fiscal deficits followed by the big adverse shock from the financial crisis has led to high (though not unprecedented) levels of

government debt as a share of GDP. Countries in this position that are part of a currency union then have very limited options: markets demand pro-cyclical fiscal austerity.⁷

But even in countries with their own currencies where governments are now borrowing long-term at extremely low interest rates (indeed, with CPI-indexed bond yields around zero), the political process has delivered fiscal responses that seem far from optimal.

Thus, for example, both the United Kingdom and the United States have embarked on significant fiscal consolidation while their economies remain stuck in liquidity traps. There can be little doubt that substantial long-term fiscal consolidation and reform are needed in both countries. But the optimal fiscal response is surely *contingent* on economic outcomes – just as is the case for optimal monetary policy.

From an economic viewpoint, there are undoubtedly substantial benefits from announcing and legislating far-reaching fiscal consolidation that begins once the economies have emerged from liquidity traps, and resumed good economic growth. But it seems clear that in both countries, political considerations have rendered anything close to this optimal contingent fiscal response well-nigh impossible.

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⁷ Even though Spain did not follow this path – its average fiscal balance was a surplus of 0.9 per cent of GDP over the five years to 2007 – markets have nevertheless demanded pro-cyclical fiscal austerity in Spain more recently, as discussed earlier.