Back from the Closet: Fiscal Policy after the Crisis

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The Source of Trouble: Fundamentalism in Macroeconomics

- The battle of ideas of the 20th century yielded a "New Consensus" in macroeconomics that dominated until the crisis
- New-Keynesian model: supply-side driven growth and business cycles, *cum* rigidities
  - Real rigidities: Natural output deviates from Walrasian first best
  - Nominal rigidities: demand-driven fluctuations around natural output
- The system converges to the natural (long run) output through market forces
- **Bottom line: Dichotomy between the short run (demand driven) and the long run (supply driven)**

The New Consensus Policy Prescriptions

- The New-Keynesian model is not very Keynesian:
  - **Structural reforms** (reduce real rigidities) to boost competitiveness and exports
  - **Nominal stability** is key to reduce uncertainty
  - **No role for macroeconomic policy** in boosting growth
    - *Monetary policy* should only anchor inflation expectations
    - *Fiscal policy* should not crowd out private expenditure
  - **Rules** anchor expectations predictability, and are the preferred policy tool
  - **Monetary policy to be preferred** because it is not subject to biases and lags
    - Political cycle
    - Decision and implementation lags

→ The kingdom of technocracy!

The Main Objections to Fiscal Policy

1. "Ricardian Equivalence". Consumers smoothing consumption will reduce expenditure in response to changes in government deficit, thus making fiscal policy ineffective.
2. Multipliers are small in an open economy (the Mitterand curse).
   - In a small open economy there is "leakage" of expenditure towards imports. Not all expenditure increases will go into an increase of income.
   - The increase of interest rates will cause an appreciation of the exchange rate and the increase of government expenditure will result in crowding-out of exports rather than GDP growth.
3. Biases and lags in fiscal policy make it unfit to tackle cyclical downturns: decision and implementation take time, and policy may end up being procyclical

The Crisis has Shaken the Consensus

- Balance sheet recession: Aggregate demand is paramount:
  - Deleveraging: increase in savings by firms and households
  - Credit crunch decrease of credit supply/demand
- The Zero Lower Bound and the size of the downturn required the return of discretionary policies
  - Unconventional monetary policy: Quantitative Easing, forward guidance, negative interest rates
- The liquidity trap called for **fiscal policy** to sustain aggregate demand
  - Keynes' liquidity preference; hoarding makes monetary policy "pull on a string". The Taylor rule broke down

Discretionary Policy or Automatic Stabilization?

- Automatic stabilization has in principle a number of advantages
  - No lags
  - No decisions/distortions
  - It reduces inequality (progressivity of the tax system, welfare expenditure)
- Nevertheless, it cannot be counted on in the case of large shocks
- Furthermore, the size of automatic stabilization is linked to the social contract (just look at the current discussion on French pension system)

→ Discretionary policy cannot be ruled out

Objections to the objections to Fiscal Policy

1. Ricardian Equivalence?
   - Not all consumers smooth consumption (especially in a crisis). Rule-of-Thumb consumers estimated to be as many as 50% in the current crisis.
   - Ricardian equivalence only implies that *long term* multipliers are zero. This is compatible with short term policy effectiveness
2. Multipliers are small in an open economy.
   - Appreciation of the exchange rate following an increase of G only happens without monetary accommodation (or outside the ZLB)
   - A coordinated fiscal expansion would limit leakage
3. Biases and lags in fiscal policy
   - Long-lasting recessions, when the economy is at the ZLB, reduce the risk of pro-cyclicality.
   - Governments may design the stimulus package in order to prioritize the so called "shovel-ready" projects. (Case study: Obama's ARRA)
   - Some fiscal measures (for example, temporary VAT reductions) may have considerably shorter lags

The Game Changer After the Crisis

- The end of the dichotomies?

*"Are there circumstances in which changes in aggregate demand can have an appreciable, persistent effect on aggregate supply? [...] Prior to the Great Recession, most economists would probably have answered this question with a qualified 'no.' [...] This post-crisis experience suggests that changes in aggregate demand may have an appreciable, persistent effect on aggregate supply–that is, on potential output. " (*Janet L. Yellen, October 14, 2016)

- Demand and supply dynamics are not independent
- The short run cannot be neglected
- Is the natural output dead? (Blanchard 2018)

2008: Fiscal Policy (temporarily) takes the Stand

- The Stimulus Plans

Country	Date	Amount (US$ Billions)
US	Early 2008	168
Japan	October 2008	260
Germany	November 2008	63
China	November 2008	573
UK	November 2008	30
EU Commission	November 2008	163 (nat. governments)
France	December 2008	26 (bn euros)
Germany	January 2009	50
US	February 2009	700

- Fiscal activism was short-lasted. **By 2010 reversal to austerity**

Fiscal Policy Effectiveness: The Multiplier

- Gechert and Will (2012) meta-analysis
  - Estimated multipliers of overall public expenditure (current and capital) vary between -2.2 and 4, with mean 0.8.
- The variability is explained by
  - Country/period
  - Underlying hypotheses, which vary greatly according to the model: New Keynesian (NK); Real-Business-Cycle (RBC), Macro-Keynesian (MACRO-K), or VAR

	TOTAL	MACRO-*K*	RBC-*NC*	DSGE-*NK*	VAR
N	**743**	94	54	278	255
Mean	**0,8**	1,0	0,5	0,8	0.9
s.e.	**0,8**	0,5	0,8	0,7	0.9

- Therefore, even before the crisis, there was not much consensus on the value of multipliers

Fiscal Policy: The Size of Multipliers

Blanchard, O.J. and D. Leigh (2013) 'Growth Forecast Errors and Fiscal Multipliers', *American Economic Review*.

- Austerity costs in Europe significantly higher than expected In peripheral Europe (Greece, Spain, Ireland, Portugal) fiscal consolidation led to a much stronger than anticipated recession. The debt-to-GDP ratio remained large and unsustainable
- Pre-crisis OECD-IMF consensus: multipliers around 0.5 (lower than 0.8!) ⇒ **austerity could work**.
- Blanchard and Leigh argue that during the crisis it has been rather 1.5 or higher ⇒ **austerity painful and possibly self-defeating**

Why the underestimation of multipliers?

- Models estimating multipliers in "normal times" pose problems:
  - They underestimate the number of liquidity constrained agents in the economy, as well as the fact that this number is not exogenous. The number of agents not smoothing consumption increases in a crisis. As a consequence, they cannot react to the fiscal consolidation by increasing consumption.
  - They assume that monetary policy reacts to fiscal policy changes. But in a crisis, and even more so at the ZLB, monetary policy does not turn contractionary facing a fiscal expansion
  - They neglect the impact of recessions (especially long-lasting and deep ones) on the potential growth rate of the economy

Multipliers are larger in bad times

- A few examples with public consumption or investment

Authors	Model	Elasticity θ	Multipliers
Hall (2009)	DSGE	0	1.7
Christiano et al. (2011)	DSGE	0	2.0
Eggertsson (2011)	DSGE	0	2.3
Auerbach and Gorodnichenko (2012)	SVAR	0	2.5
Bouakez et al. (2014)	DSGE (T=3Y)	0 0,08	2,26 3,78
Creel et al (2011)	SVAR	0	1,5

- This is consistent with standard Keynesian theory!

Getting the Multiplier Wrong: The Permanent Cost of Austerity

Fatàs and Summers (2017) "The permanent effects of fiscal consolidations" *Journal of International Economics*

- Shocks have effects both on current and potential GDP
- Fiscal consolidation impacts both current and potential output
- Hysteresis is key
- Multipliers are large so fiscal consolidation has strong impact (see above)
- Fiscal consolidations are self defeating (lends support to Delong and Summers, 2012; see also Fatàs 2018)

The need for a public investment push

- As expected, fiscal consolidation mostly happened through reduction of public investment
- This is a regularity that has a political economy explanation:
  - Current expenditure (wages, government purchases, etc.) is politically more sensitive, and reducing it faces more opposition
  - Investment (in human and physical capital alike) while more important for long-run growth, is less "visible" and may be easily reduced
- The deterioration of the capital stock has eventually surfaced in the academic and in the policy agenda
- Ecological transition: The Green New Deal

The Need for a Public Investment Push

- The IMF (2014, chapter 3) and the OECD (2016) have highlighted the need for more public investment:
  - The stock of public (and often private as well) capital has been deteriorating in most advanced and in some emerging economies
  - The quality of infrastructure, harder to measure, also has decreased
  - Among many other factors, this contributes to the slowdown of long-term growth prospects (the so-called "secular stagnation")
  - Current growth is disappointing in most advanced and emerging economies
  - The ZLB, and sometimes negative long-term rates mean that
    - the internal return on public investment is certainly positive, even abstracting from social returns
    - public investment would not lead to an increase of public debt ratio, thus paying for itself (investment today is a "free lunch")
- Public investment today would be beneficial for short and long run growth alike

A Few Concluding Remarks

- From Rathin Roy: Fiscal policy cannot act alone.
  - Structural policies to deal with sector specific issues
  - Industrial policy and targeted investment to reduce bottlenecks

- From Charles Sabel: The importance of *stability* to avoid labour market segmentatio
  - The lesson from the Regulatory State period: macroconomic stability lengthens the planning horizon of all agents,
  - Higher private investment rates
  - Long term firm relationships
    - With banks
    - with workers → accumulation of skills, employability, high cost of precariousness

Thank You!

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