

Rethinking Fiscal Policy

Jay C. Shambaugh
Hamilton Project, GWU, NBER

Overarching View

- Big things we have seen/learned in last decade:
 - Fiscal policy “works” especially near ZLB
 - We may be at ZLB more often (unless first panel fixes everything)
 - A big policy problem was a reluctance to do enough stimulus
 - Another big problem was pivot to austerity when not appropriate
- From my view, the “rethink” needed is how do we ensure appropriate policy stimulus happens when needed and in effective manner

Quote from our moderator

- “It does not appear that the problem of dynamically inconsistent CB yielding to the temptation to inflate and lacking credibility is really the problem we face”
- Similar story for Fiscal??
- Should fear of an irresponsible fiscal agent be the core of how we design rules.
 - “we study a model in which the government is present-biased in terms of public spending...”
- NOTE: it still is a problem:
 - Greece, U.S. tax cuts now
- BUT: need to rethink the other side of the coin: how do we prevent the government from being insufficiently present biased when it is needed

Alan's Paper

- Nice tour of where we are and what we know about fiscal policy right now:
 - Rules
 - Fiscal policy to stabilize
 - How low r and fiscal policy inter-relate
 - Coordination with monetary policy
- Second section quite important:
 - Fiscal policy can be effective at generating economic activity, especially at ZLB.
- Seems to suggest if we have rules, first order issue is to make sure they don't stop stimulus when needed
 - Even better would be to make sure it happens somehow

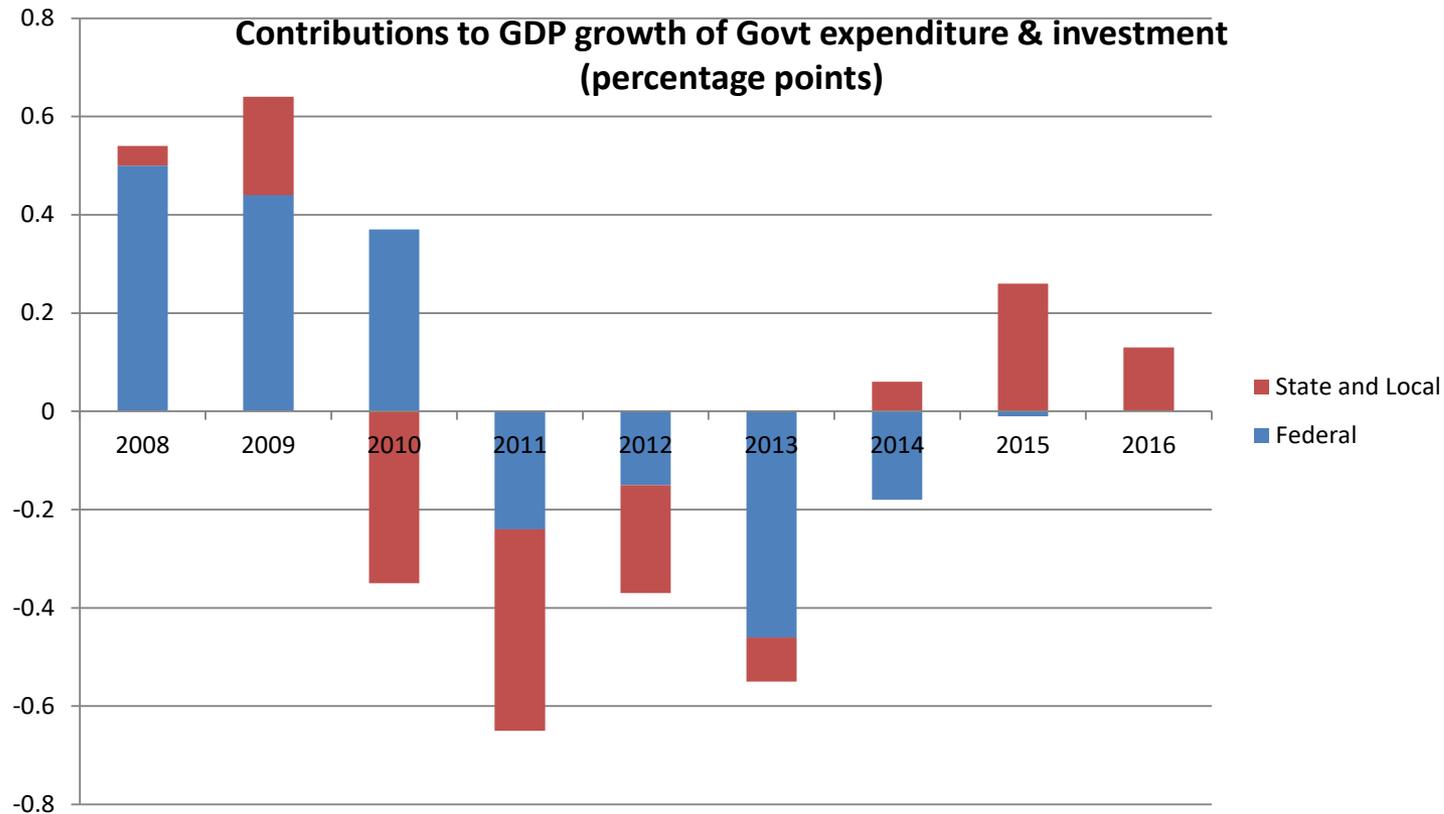
Stimulus can work

- Stimulus has worked
 - Chowderow-Reich et al, Feyrer & Sacerdote, Nakamura & Steinsson
 - ARRA reports
 - Auerbach & Gorodnichenko
- Stimulus can even lower D/GDP
 - Delong and Summers
 - Auerbach & Gorodnichenko
- Contractionary policy can be contractionary
 - Blanchard & Leigh (& other studies of euro experience)
 - Especially if no way for exchange rate or interest rate to cushion
- Conditions needed
 - Increasing deficit does not lift R (or cuts don't lower R)
 - Underutilized resources / possible hystereses
 - Solvency not under challenge (or long run growth as big a worry as long run debt)

Fiscal Policy was inadequately pro-growth:

- United States:
 - ARRA
 - Push back on size
 - Removing school construction for AMT
 - Big resistance to more (e.g. December 2009 bill)
 - State and Local cuts immediately
 - Fiscal cuts start too early
- Europe:
 - Some countries very hesitant to spend
 - Sharp turn to austerity in many countries
 - No central stimulus to offset
- G20 push needed to make sure countries did things early on, but international advice turns hawkish early on
 - June 2010 Leaders' statement pivoting towards fiscal cuts (though conflict apparent in the document)
- Note: EM's probably a bit better on this front

Example: United States cuts too soon



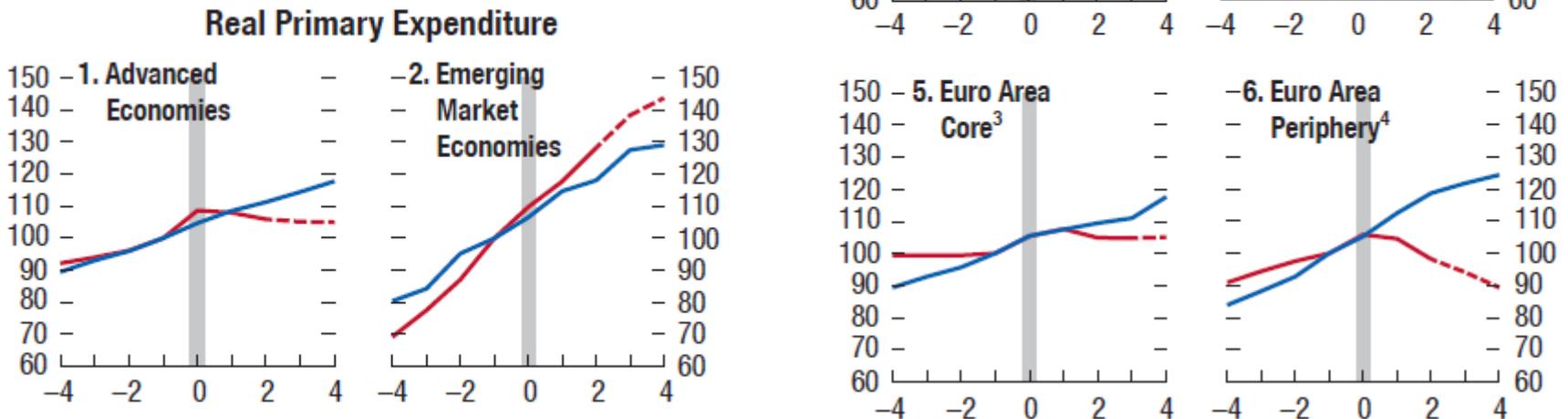
- US pivot to tightening is quick
- State & local makes it even quicker
- Note: only spending (there was more tax stimulus)

This time was different in ADV: quick pivot

Figure 1.1.2. Government Expenditures during Global Recessions and Recoveries¹

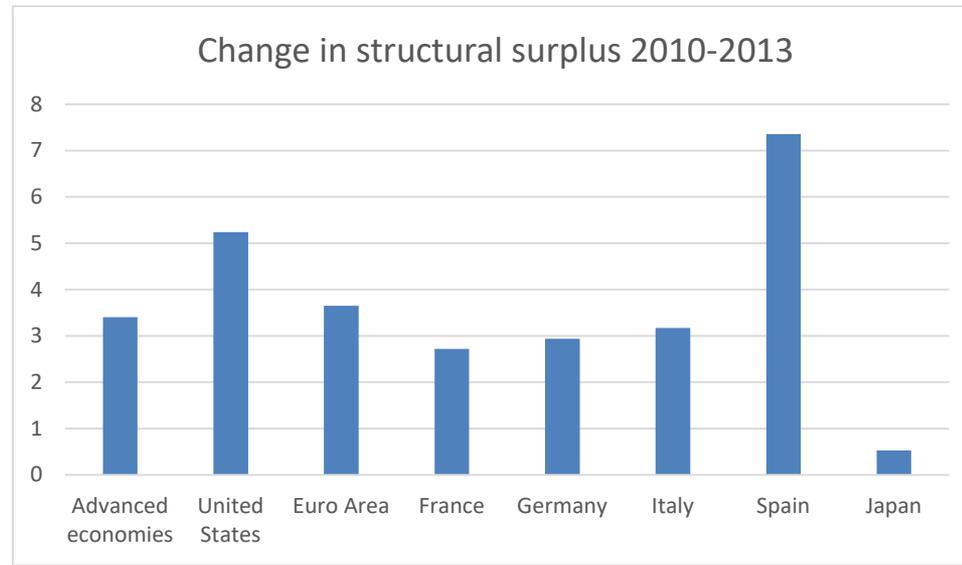
(Years from global recession on x-axis; indices = 100 in the year before the global recession)

- Recovery from the Great Recession²
- Average of previous recessions (1975, 1982, 1991)
- Global recession year



- Shift to cuts are counter to historical patterns
- Caveat: different trend population rates could be at play

Pivot too soon seen another way



- Note:
 - Unemployment at recent highs as this is starting
 - One of the largest consolidations in U.S. history (& UR was 10% when started)
 - Spanish UR > 20% during this contraction
- Shortly after this, Japan hikes VAT to tighten

Policy Advice (circa 2010)

- *“There is a pressing need, in general, for fiscal consolidation in G-20 advanced Economies”*
 - *IMF background document for the G20 June 2010*
 - Major advice was:
 - Fiscal consolidation in ADV
 - Structural reforms in EM & ADV
 - A lack of concern about adequate demand
- Not just IMF, similar advice from others
 - OECD
- European Commission explicitly had nearly every country in an excessive deficit procedure & advised large scale austerity for many countries
 - “Most Member States do not have room for a new fiscal stimulus because they need to give top priority to fiscal consolidation.” - 2011

Policy Advice 2016

- “Our fiscal strategies aim to support the economy and we will use fiscal policy flexibly to strengthen growth, job creation and confidence.” – G20 2016
- “It is clear that monetary policy can no longer be the alpha and omega to recovery. Indeed, it will be much more effective with support from structural and fiscal elements” – IMF 2016
- “Many countries have room for fiscal expansion to strengthen demand. This should focus on policies with strong short-run benefits and that also contribute to long-term growth.” OECD 2016
- NOTE: Economies in much better shape in 2016. We seem to have internalized the lessons, but are we ready to act differently

Coordination: Fiscal & monetary

- Low interest rates forever means different debt process, but possibly due to different growth too.
 - Growth relative to R may mean more fiscal space
 - & long maturities at low R almost certainly give more time to react
 - Long bond yields certainly suggest world more worried about low growth than solvency
- Another issue is coordination at / near ZLB.
 - We now know it is really hard to get out of low inflation slow recovery
 - Fiscal needs to help
 - Bernanke's pleas to Congress
 - Japan VAT hike
 - ***Can we make a new rule: spend the QE proceeds?***

Coordination: Global

- April 2009 G20 was a triumph.
 - Push for stimulus worldwide
- Difficult to maintain momentum
- At ZLB, demand is in short supply, large countries must consider spillovers
 - E.g. German consolidation problematic for others
 - Need to help forestall “fiscal fatigue”

Rethinking

- **Any fiscal rule must have adequate escapes to make sure stimulus CAN happen**
- **Fiscal policy should happen at level responsible for business cycle**
 - Problem with U.S. states: business cycle management at center can be undermined. Needs to have better support
 - Problem in Europe: no central fiscal, rules preventing support, fiscal problem: those that can, don't need to, those that need to can't.
- **We should try to re-orient fiscal rules to make sure stimulus DOES happen**
 - *Strengthen automatic stabilizers*
 - Infrastructure funds
- **We need to be READY to do stimulus**
 - Tried and true methods more helpful
 - Speed matters
 - Create channels so we are ready

See also Furman 2016 & Blinder 2016