Research Note 10-02

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Is Fiscal Policy Pointless?

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In their meeting on June 4-5 2010 in South Korea, finance ministers of G-20 abandoned their collective commitment to Keynesian deficit spending that they had been supporting since the onset of the crisis. The group that supported fiscal stimulus packages in their April meeting, stated that "countries with serious fiscal challenges need to accelerate the pace of consolidation" given the recent fiscal problems in Greece and the fact that recovery from the global crisis has started.

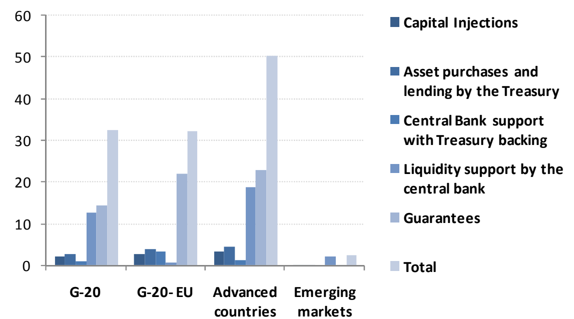
In this policy note, we want to summarize the arguments on whether fiscal stimulus packages were useful during the crisis and the correct timing of exiting from these expansionary measures as well as compare the effects of the crisis on the fiscal positions of advanced and emerging markets.

During the global crisis, many countries used expansionary fiscal and monetary policies and announced fiscal stimulus packages. For example, the Troubled Assets Relief Program (TARP) which entailed the purchase of toxic assets worth 750 billion dollars by the US Treasury was one of these packages.

During the global crisis, expansionary fiscal policy was used to support the financial sector especially in advanced economies.

In international arenas, more precautions were taken to increase the confidence in the global economy. In the G-20 meeting in London on April 2, 2009, the funds of the IMF were increased to 750 billion dollars. Furthermore, stimulus packages such as the American Recovery and Reinvestment Act (ARRA), which was passed in February 2009 and included 787 billion dollars worth of tax breaks, expansion of unemployment benefits and expenditures on education, health and infrastructure, were announced.

Figure 1. The ratio of support to the financial sector to 2008 GDP (May 2009)



Source: IMF

In many advanced economies, both the Treasury and the central bank provided support to the financial sector which was in distress, carrying the problems of the private sector to the public one. In Figure 1, we see that such a large support

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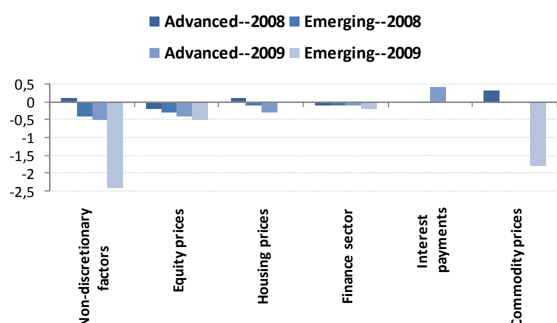
to the financial sector was not provided in emerging markets. This is in line with the speedier and better recovery that is being experienced by these economies today.

Figure 2 shows the differences among the advanced and emerging economies of the G-20 group. When we look at the distribution of non-discretionary spending, we observe that in 2009, emerging markets were mainly influenced by commodity prices. While profit shares and housing prices affected both groups of countries, the advanced economies were largely not affected by commodity prices. Another interesting fact observed in Figure 2 is that the crisis was felt in 2008 in advanced economies, but only started to influence the emerging markets in 2009.

Figure 2. G-20 countries: Non-discretionary factors (% of GDP, annual percentage change)



Source: IMF

There are three factors that lead to an increase in fiscal debt during a crisis: the decrease in fiscal revenues due to a decline in asset and commodity prices and automatic stabilizers, direct fiscal support and discretionary fiscal packages.

In this brief note, we conclude that the fiscal weakening of emerging economies can be linked to falling commodity and asset prices, whereas that of the advanced economies is due to the support provided to the financial sector, revenues lost due to the crisis and fiscal stimulus packages.

Whether fiscal stimulus packages contributed to the recovery from the crisis has been highly controversial.

Among these factors, the effects of fiscal stimulus packages have been debated heavily, especially in the US, due to their discretionary nature. The value of the fiscal multiplier, which measures the effect of government expenditures on output, and how it should be calculated during a crisis was an issue raised in many articles. In theory, the value of the multiplier is high when `leakages` are low, monetary policy is loose and the fiscal position is sustainable after the support package.

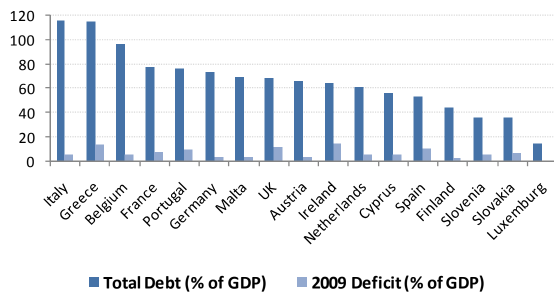
In order to have low leakages, it is necessary to use government expenditures rather than tax cuts in the fiscal stimulus packages, to have a high marginal propensity to consume, to have the support directed to consumers with liquidity problems, to have consumers who do not take into consideration future tax increases, to have a low propensity to import, small automatic stabilizers and a large output gap. If fiscal sustainability reduces the effects of increasing debt levels on long term interest rates and an expansionary monetary policy prevents crowding out of private investment as a result of increased interest rates due to fiscal expansion, the value of the multiplier will be higher.

While the increase in precautionary savings caused by the uncertainty created by the crisis

reduces the value of the multiplier, the increase in the number of consumers and firms with credit constraints and expansionary monetary policy increases the multiplier. The uncertainty of the net effect of these two opposing forces has caused many debates regarding the usefulness of Keynesian fiscal policies.

Although it is difficult to know the counter-factual of how deep and severe the crisis would have been without the fiscal stimulus packages, the negative consequences of the rise in debt levels and the high unemployment levels prevailing in some countries despite large fiscal stimulus packages has raised some questions.[§]

Figure 3. Debt and budget deficits in selected European countries



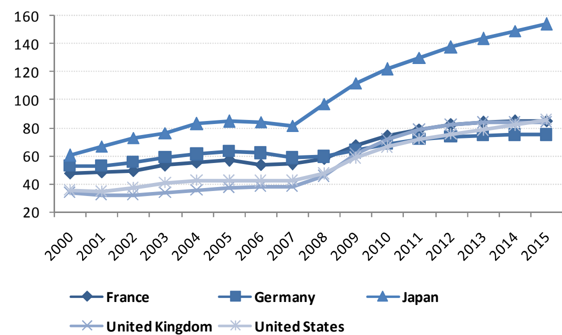
Source: *Eurostat*

Nowadays, the debate has shifted to the timing of the exit from expansionary fiscal policies due to the start of the recovery from the crisis and the rise of public debt and fiscal deficits, particularly in Europe (Figure 3). IMF Staff Note titled "The Fiscal Consequences of the Global Economic and Financial Crisis" forecasts that between 2007 and 2009, the ratio of the fiscal balance to GDP has deteriorated %8 and %5 in advanced and emerging economies, respectively. In advanced economies, the ratio of public debt to GDP has increased 20% in the 2008-2009 period to record the largest rise in the last few decades.

[§] Cottarelli and Vinals (2009).

Figure 4 that records the net debt to GDP ratio in some advanced economies, shows that these data that have been increasing with the crisis, is forecast to rise further by the IMF.

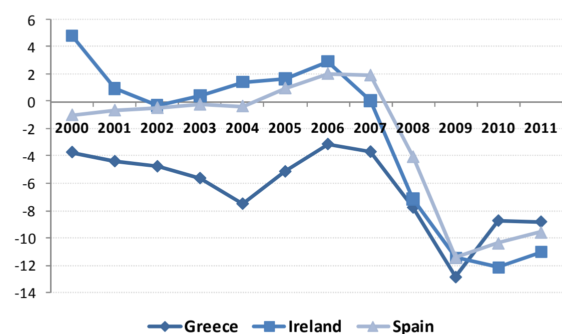
Figure 4. Net Debt/GDP



Source: *IMF World Economic Outlook April 2010 database. Data after 2009 are forecasts.*

Although fiscal balances are expected to improve in the medium run, in the absence of tightening of the loose policies of the crisis, the fiscal balances of advanced economies might end up being higher compared to 2007 and the effect on debt ratios could be permanent. In advanced economies that already faced long-run fiscal challenges due to an aging population, the situation could be even worse.

Figure 5. The ratio of public net lending/borrowing to GDP in selected countries



Source: *IMF World Economic Outlook April 2010 database. Data after 2009 are forecasts.*

In previous crises, countries that managed to grow while decreasing their budget deficits were

rewarded with a falling exchange rate or a decline in borrowing costs. However, Eurozone countries do not have such an option and face difficult challenges.

In the aftermath of the debt crisis in Greece, attention has turned to Ireland and Spain where the ratio of net debt to GDP has risen to similar levels. Figure 5 shows that while the debt problems of Greece existed before the crisis, the debt ratios of Ireland and Spain rose due to the global crisis.

Under these circumstances, Greece, Spain, Portugal and Ireland have already announced some fiscal restrictions. In its `emergency budget` of June 22nd, The UK has taken some measures such as an increase in VAT, tightening of social benefits, a pay freeze of public wages and increases in several other taxes.

Nowadays, the debate has shifted to the timing of the exit from expansionary fiscal policies due to the start of the recovery from the crisis and the rise of public debt and fiscal deficits.

Those who believe in the necessity of such restrictions, advocate that other countries should adopt contractionary fiscal policies in order to improve the future state of their economies. However, it is politically difficult to adopt policies such as an increase in the retirement age which would help government finances in the medium run without decreasing demand in the short run. Thus, in the debates surrounding fiscal tightening, emphasis is on budget discipline rather than structural reform.

In his column at the Financial Times on June 15th, Martin Wolf states that the advocates of tight fiscal policy have four main arguments: the risk that investors can turn on the UK and the US after Greece, Portugal and Spain; the crowding out of private investment due to public debt; the inflationary effects of budget deficits and that fiscal deficits don`t necessarily stimulate demand.

However, Wolf claims that there is no inflation threat due to the fact that recovery from the crisis is not yet complete and that public expenditures don`t automatically lower private expenditures. Wolf is not the only one to believe that a premature fiscal tightening can destabilize the global economy.

In a letter addressed to G-20 leaders last week, US president Barack Obama stated that despite the need for definite plans to decrease budget deficits, it is dangerous to prematurely end fiscal stimulus programs. He said that although the US targets to halve its budget deficit to GDP ratio by 2013 and bring it down to %3 by 2015, it must be noted that there are historical examples when early tightening of expansionary fiscal policies led to a slowing down of recovery from the crisis.

During the Great Depression, the US recovery started with the use of expansionary fiscal and monetary policy after the abandonment of the gold standard. However, the government pulled the newly recovering economy back to a severe recession with the balanced budget policy in 1937.

Krugman, who gives the Great Depression example in his column dated June 17 at the New York Times, criticizes the fiscal `hawks` who want to balance the budget now to solve the long

run fiscal problems due to an ageing population. He claims that such a policy would not only solve the long run fiscal problems, but also adversely affect the fragile and weak recovery that is underway currently and points to the low levels of interest rates on borrowing as a sign that fiscal tightening is not yet necessary.

We also believe that a well-defined exit strategy that would provide confidence on the debt payment capacity of the government by investors and markets is more useful than a hasty fiscal tightening. In such a strategy, four factors are important[**]: (1) Fiscal stimulus packages should not have permanent effects on deficits; (2) transparent medium term plans on fiscal discipline should be announced; (3) structural reforms that will lead to growth should be made and (4) countries under demographic pressure should announce health and pension reform strategies.

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