Challenges for fiscal policy during turbulent times

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Thank you for inviting me to participate in this panel. It is also an honour to share this panel with my former professor Peter Diamond, who unfortunately will not be a central banker owing to problems in his confirmation by the US Congress for "lack of monetary policy expertise". This is really incomprehensible, and it shows that the irrationality of politicians afflicts not only less developed economies but also the most advanced economies.

It is difficult to add further insights after two days of very interesting discussions on fiscal policy and its relationship with monetary policy, and on issues such as commodity booms, financial stability, and sustainability. My plan is to talk first about the state of the world economy, which sets the stage for discussions of fiscal policy, and then I would like to talk in more detail about fiscal policy around the world.

The world economy

In the last few months the world economy has deteriorated. The big issue right now is whether we are in a "soft patch", caused by high oil prices and disruptions in the supply chain stemming from the earthquake in Japan, or if we are facing a more persistent deterioration – a "double-dip" or a phase of non-recovery. This currently a problem mostly for the advanced economies, but the repercussions for emerging markets could also be very relevant. In emerging markets, we have experienced many recessions coupled with financial crisis, and they are different from the usual cyclical downturns faced by industrial countries. Recessions are much more costly when combined with a financial crisis.

Domestic demand is growing slowly in advanced economies, particularly in the US. It is likely that this weakness will continue due to excessive levels of debt. Households face a debt overhang, and prospects for recovery are gloomy. Cautious consumers threatened by high unemployment cannot provide a source of increasing domestic demand. Recovery is much slower after a financial crisis, as the balance sheets of economic agents need to be repaired.

From a policy point of view, advanced economies are hampered by a lack of instruments to provide macroeconomic stimulus. Monetary policy rates are at minimum levels or close to them. Meanwhile, fiscal policy has little room for manoeuvre given the problem of sustainability.

Implications for advanced economies

I would like to emphasise two concerns from our discussions over these two days. First, although there are many historical examples of expansionary fiscal contractions, we have learned from Roberto Perotti's research that the conditions needed for them to spur economic activity do not hold today. Therefore we can conclude that any fiscal retrenchment at this juncture will be contractionary. Second, we learned from Eric Lepper's presentation

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that many countries may be entering into an “F” regime, in which monetary policy is subordinated to monetary policy, and that this could become particularly problematic for the credibility of central banks that are committed to an inflation target, limiting their ability to conduct expansionary monetary policy.

What are the current challenges for fiscal policy in the world? The starting point is heterogeneous. There are countries that are in an extremely weak position, where servicing current debt is clearly unsustainable. The clearest case is Greece. Fiscal consolidation is needed; increased taxes and lower expenditure are the only way to make debt levels sustainable. Although undesirable from the point of view of growth, there is no space for further stimulus and growth should come from structural reforms that ensure competitiveness. This will take time, as evidenced by the experience of many emerging economies in the postwar period. Perhaps the most similar case is the early 1980s debt crisis in Latin America. It was long and costly. Moreover, in the euro zone, the problem is more acute since exchange rates cannot help the adjustment. Markets know this and increase the risk premium, making the sustainability problem even more acute.

However, adjusting the primary balance is not enough, since the magnitude of the adjustment is clearly not feasible given the ensuing decline in demand. Some reduction of public debt is needed. Excessive public indebtedness cannot be solved with more debt. Moreover, creditors that made a poor decision of lending to sovereigns beyond their capacity to service the debt should also bear the cost. This adjustment can take the form of “re-profiling”, “re-phasing”, “private sector involvement”, or plain default. The longer this is postponed, the more likely becomes a messy default. This will not only damage the economies in trouble, but will also create severe contagion effects throughout the euro zone. We cannot rule out a case of multiple equilibria in which contagion increases the cost of financing to levels where current debt levels become unsustainable.

Fiscal positions in many countries are vulnerable to market sentiment and economic performance. Low growth may further erode the fiscal position. Central banks can act as lenders of last resort to governments that are finding it difficult to borrow. This is an issue that was discussed with insight by Guillermo Calvo. Buying public debt, or even some toxic assets, is not, of course, part of normal monetary policy, but represents central banking under extreme conditions. In normal times, central banks should only provide liquidity against good collateral, and conduct open market operations without bearing credit risk. But the purchase of risky assets (or the acceptance of them as collateral) may be necessary during emergencies. However, these actions entail serious risks that must be taken into account. Beyond the subordination of monetary policy to fiscal policy needs, central banks may become trapped in their conduct of monetary policy. Raising interest rates against the prospect of higher inflation increases the cost of borrowing, and could erode the central bank’s balance sheet of the central bank if it holds public debt.

Another challenge for fiscal policy in advanced economies is the impact that changes in the global economy may have on fiscal sustainability. Let just consider one example of the additional complications that may arise. Suppose that the world goes through a much-needed global re-balancing and that, as part of this adjustment, commodity exporters’ and emerging markets’ currencies appreciate further. Interest rates may rise and there could be a lack of demand for advanced countries’ public debt. Who will buy the debt from the advanced economies? And what are the implications of higher world interest rates on fiscal sustainability?

As these remarks show, the challenges for fiscal policy in advanced economies are enormous, and a poor resolution of the sovereign debt problem could have disastrous consequences for the world economy.

Implications for emerging markets

Fiscal policy across emerging markets is much sounder than in the industrial world, but the global financial crisis has also driven home lessons on the conduct of fiscal policy over the business cycle. Of course, there are also some cases of fiscal weaknesses, in particular those that are concealed by good fiscal results stemming from a strong cyclical position or high commodity prices. However, I want to focus on countries with sound fiscal policies. This is, for example, the case in Chile, which has had a prudent fiscal policy for more than 20 years.

After many years of lax fiscal discipline that led to procyclical fiscal policies which magnified recessions, emerging markets have made serious progress on the fiscal front. This is true of most Latin American countries, even those that were once famous for fiscal profligacy. As Cespedes and Velasco argue, the commodity price boom has been much better managed than in the past.

During the financial crisis, fiscal policy was allowed to be expansionary. This, together with monetary expansion, let emerging markets mitigate part of the external shock and sow the seeds for a strong recovery. The fiscal balance deteriorated not only for cyclical reasons, but also because expansionary fiscal programmes were implemented.

Nevertheless, the current challenge for policymakers in emerging markets is how to manage a rapid recovery, given the resumption of capital inflows, and the pressures on their currencies. From the fiscal point of view, this requires withdrawing the fiscal expansion, and this has not happened at the speed required. The reason is that many avowedly temporary fiscal programmes have become permanent. To make fiscal policy more flexible, temporary expansions of government expenditure should be implemented through automatic stabilisers. The issue today is that, given a deterioration of the global economy, more macroeconomic stimulus could be necessary, but the space for implementing that fiscal expansion may be more limited than before due to the partial adjustment that has taken place after the crisis.