Fiscal Policy for the Crisis

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Introductory remarks

The current crisis, which started in the housing and financial sectors, has now led to a strong fall in aggregate demand. There are indications that this fall could be larger than in any period since the Great Depression. A successful policy package should address both the financial crisis and the fall in aggregate demand, and thus should have two components: one, aimed at getting the financial system back to health; the other, aimed at increasing aggregate demand. There are obvious interactions and synergies between the two. Financial measures, from recapitalization to asset purchases, have important implications for credit flows and aggregate demand. Measures to support aggregate demand, for example by helping homeowners and improving the housing market, have clear implications for the health of financial institutions. Nevertheless, our focus in this article will be primarily on measures aimed at sustaining aggregate demand.

The fall in aggregate demand is due to a large decrease in real and financial wealth, an increase in precautionary saving on the part of consumers, a "wait-and-see" attitude on the part of both consumers and firms in the face of uncertainty, and increasing difficulties in obtaining credit. A further fall in demand will increase the risk that the perverse dynamics of deflation, rising debt, and associated feedback loops to the financial sector, may materialize.

Two macroeconomic policies often used to support aggregate demand are less effective in the current environment. First, while each single country can, on its own, adopt an export-led recovery strategy, this is clearly not an option open to the world as a whole.[1] Second, the financial nature of the crisis weakens the traditional monetary transmission mechanism. Furthermore, many countries have already used monetary expansion, and the room to lower central bank policy rates is limited. In these countries, the role of monetary policy should be to support the fiscal stimulus by avoiding increases in the policy interest rate until output begins to recover.[2]

In these circumstances, the Managing Director of the IMF has called for a sizable fiscal response at the global level. Its precise magnitude should depend on the extent of the expected decline in private sector demand and should therefore be reviewed in light of developments. Moreover, while a fiscal response across many countries may be needed, not all countries have sufficient fiscal space to implement it since expansionary fiscal actions may threaten the sustainability of fiscal finances. In particular, many low income and emerging market countries, but also some advanced countries, face additional constraints such as volatile capital flows, high public and foreign indebtedness, and large risk premia. The fact that some countries cannot engage in fiscal stimulus makes it all the more important that others, including some large emerging economies, do their part.

This article, rather than focusing on the precise magnitude of the required fiscal response and its distribution across countries, focuses on some general features that fiscal stimulus should have in the present context. More specifically, we argue that a fiscal stimulus should be timely (as there is an urgent need for action), large (because the drop in demand is large), lasting (as the recession will like-

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[1] In the context of Japan, Lars Svensson argued that a way out of the slump was to achieve exchange rate depreciation, a policy that would work even if interest rates were already down to zero. Exchange rate depreciation was indeed a key factor behind economic recovery after some financial crises. Unfortunately, this cannot work in case of a global crisis (and indeed the beggar-thy-neighbor devaluations of the 1930s were definitely not helpful).

[2] This statement refers to traditional monetary policy, and the use of the policy rate, not to less traditional dimensions, such as quantitative easing. We think of quantitative easing, that is, direct intervention by the central bank in dysfunctional financial markets, as part of the financial measures, and do not discuss it further in this note. We return, however, to related policies in the last part of the article.

ly last for some time), diversified (as there is uncertainty regarding which measures will be most effective), contingent (to indicate that further action will be taken, if needed), collective (all countries that have the fiscal space should use it given the severity and global nature of the downturn), and sustainable (to avoid debt explosion in the long run and adverse effects in the short run). The challenge is to provide the right balance between these sometimes competing goals – particularly, large and lasting actions versus fiscal sustainability.

Fiscal policy in financial crises – lessons from history

A survey of the countries that have experienced severe systemic financial crises shows that these episodes are typically associated with severe economic downturns (see IMF 2008). The survey also demonstrates that countries have reacted to these downturns quite differently, depending on economic and political constraints. The list of countries that have experienced both financial and economic crises is long and includes the United States during the Savings and Loans crisis in the 1980s, the Nordic countries in the early 1990s, Japan in the 1990s, and Korea in 1997.

Several lessons can be drawn from all these previous crises. First, successful resolution of the financial crisis is a precondition for achieving sustained growth. The archetypal example here is Japan, where fiscal actions following the bursting of its asset bubble failed to achieve sustained recovery because financial sector problems were allowed to fester. Delaying interventions, as was also done in the United States during the Hoover administration and during the Savings and Loans crisis, typically leads to a worsening of macroeconomic conditions, resulting in higher fiscal costs later on. Prompt and sizeable support to the financial sector by the Korean authorities limited the duration of the macroeconomic consequences thus limiting the need for other fiscal action. Second, the solution to the financial crisis always precedes the solution to the macroeconomic crisis. Third, a fiscal stimulus is highly useful (almost necessary) when the financial crisis spills over to the corporate and household sectors with a resulting worsening of the balance sheets. Fourth, the fiscal response can have a larger effect on aggregate demand if its composition takes into account the specific features of the crisis. In this regard, some of the tax and transfer policies implemented early in the Nordic crises did little to stimulate output.

Fixing the financial system and supporting aggregate demand are, thus, both of the essence. It is for this reason that the authorities in several advanced countries have unveiled a series of unprecedented initiatives to rescue the financial sector. We leave these aside in this note, and turn now to the fiscal component.

Composition of a fiscal stimulus

Two features of the crisis are particularly relevant in defining the appropriate composition of the fiscal stimulus.

First, as the current crisis will last at least for several more quarters, the fiscal stimulus can rely, more than is usual, on spending measures: the usual argument that implementation lags are long is less relevant when facing the current risk of a more prolonged downturn. Such expenditure measures may also have advantages over tax cuts or increases in transfers, which operate by raising the purchasing power of households and firms in the economy, given the highly uncertain response of the latter to an increase of their income in current circumstances.

Second, in the current context, characterized by a number of events and macroeconomic conditions not experienced in recent decades, existing estimates of fiscal multipliers are less reliable in informing policymakers about which measures will be relatively effective in supporting demand. This provides a strong argument for policy diversification, that is, for not relying on a single tool to support demand.

Public spending on goods and services

In theory, public spending on goods and services has larger multiplier effects and, most important in the current circumstances, its first round effects are more certain than those related to transfers or tax cuts. In practice, the appropriate increase in public spending is constrained by the need to avoid waste. What are the key policy prescriptions?

First, and quite simply, governments should make sure that existing programs are not cut for lack of resources. In particular, central governments or subnational governments that are facing balanced budget rules may be forced to suspend various spending programs (or to raise revenue). Measures should be taken to counteract the pro-cyclicality built into

these rules. For sub-national entities, this can be mitigated through transfers from the central government (suspending the rules for sub-national governments would not be appropriate as it will be difficult to reverse the suspension later.) In the United States, for example, increased transfers from the federal government would help states avoid cutting various spending programs.

Second, spending programs, from repair and maintenance to investment projects delayed, interrupted or rejected for lack of funding or macroeconomic considerations, can be (re)started quickly. A few high-profile programs, with good long-run justification and strong externalities (e.g. for environmental purposes) can also help, directly and through expectations. Given the higher degree of risk facing firms at the current juncture, the state could also take a larger share in private-public partnerships for valuable projects that would otherwise be suspended for lack of private capital.

Public sector wage increases should be avoided as they are not well targeted, difficult to reverse, and similar to transfers in their effectiveness. Nevertheless, a temporary increase in public sector employment associated with some of the new programs and policies may be needed.

Fiscal stimulus aimed at consumers

The support of consumer spending also needs to take the present exceptional conditions into account. Three specific factors affect consumption at this juncture:

- Decreases in wealth, be it housing, financial, or human (i.e. declines in current and expected disposable income), leading consumers to cut consumption.
- Tighter credit constraints, as some consumers see their credit lines eliminated or face much higher interest rates, forcing them to cut consumption.
- High uncertainty, leading consumers to increase precautionary saving, and to take a wait-and-see attitude and delay purchases until uncertainty has cleared.

Each of these three factors has different implications for the marginal propensity to consume out of transitory tax cuts or transfers. The first and the third suggest low marginal propensities to consume, the second a high one. Assessing the relative importance of the three is hard,[3] but the list suggests two broad recommendations.

The first is to target tax cuts or transfers at those consumers who are most likely to be credit constrained. Measures along these lines include the greater provision of unemployment benefits, increases in earned income tax credits, and the expansion of safety nets in countries where such nets are limited. Where relevant, support for homeowners facing foreclosures, including a write-down of mortgages using public resources is particularly appealing from a macroeconomic viewpoint as it helps not only to support aggregate demand, but also to improve conditions in the financial sector.

The second is that clarity of policy together with a strong commitment by policy makers to take whatever action may be needed to avoid the tail risk of a depression, are likely to reduce uncertainty, induce consumers to decrease precautionary saving, as well as stop waiting and start spending again.

What about other measures? Some countries are considering broad-based tax cuts. For reasons explained earlier, the marginal propensity to consume out of such tax cuts may be quite low. Some countries have already introduced, or are considering, temporary decreases in the VAT. If the termination date is credible and not too distant, the intertemporal incentives implied by such a measure are attractive, but the degree of pass-through to consumers is uncertain, and its unwinding can contribute to a further downturn. It is also questionable whether decreases in the VAT of just a few percentage points are salient enough to lead consumers to shift the timing of their purchases. Along these lines, larger but more focused incentives, such as cash transfers for purchases of new, more efficient cars, a measure adopted in France, may attract more attention from consumers and have larger effects on demand.

Fiscal stimulus aimed at firms

In the current environment, firms face not only a sharp fall in demand, but also a lot of uncertainty on how bad things could turn out to be. In this very uncertain environment, firms, just like the consumers, are taking a wait-and-see attitude with respect to their investment decisions. Subsidies or

[3] Micro and macro evidence on the effect of the recent US tax rebates give conflicting answers. Macro evidence suggests most of it was saved. Micro evidence shows some increase in consumption.

measures to lower the tax adjusted user cost of capital (such as reductions in capital gains and corporate tax rates) are unlikely to have much effect. Rather, the key challenge for policy-makers is to avoid that firms have to cut down their current operations for lack of financing, including reasonably-priced credit.

This is, of course, primarily the job of monetary, not fiscal, policy. However, there is also some scope for governments in supporting firms that are facing particularly difficult problems, could survive through restructuring, but find it difficult or impossible to receive the necessary financing from dysfunctional credit markets. In particular, there is an argument for allowing the restructuring of firms that are facing economic distress, with government guarantees on new credit (given the non availability of private financing for such firms). This can facilitate the development of a plausible restructuring plan, and is very much the approach underlying IMF-supported program lending to countries: lending plus policy adjustment.

It has been argued that governments should provide support to entire high-visibility sectors of the economy because of the potential effect that bankruptcies in these sectors may have on expectations and thus on demand. While there is some validity in this argument, its inherent arbitrariness, and risk of political capture, would make implementation too difficult. Its end result may, in fact, be to add uncertainty, and raise questions about domestic protection.

Indeed, direct subsidies to domestic sectors lead to an uneven playing field with respect to foreign corporations, and could lead to retaliation and possibly trade wars. In this context, an important principle of support should be to minimize interference with operational decisions. For example, following the earlier argument that public provision of credit guarantees to firms may be needed as long as the credit markets remain dysfunctional, it is clear that such provision should not be sector specific.

Sustainability concerns

It is essential for governments to indicate from the start that the extent of the fiscal expansion will be contingent on the state of the economy. While a sizable upfront stimulus is needed, policy makers must commit to doing more, as needed, if conditions so warrant. It is important to announce this at the start, so later increases do not look like desperation repairs.

However, it is also essential that fiscal stimulus not be seen by markets as seriously calling into question medium-term fiscal sustainability. This is key, not only for the medium run, but also for the short run, as questions about debt sustainability would undercut the near-term effectiveness of policy through adverse effects on financial markets, interest rates, and consumer spending.

Financial markets do not seem, at present, overly concerned about medium-term sustainability in the largest advanced countries, though there has been some widening of borrowing costs within the euro zone that likely reflect sustainability concerns.[4] This is however limited comfort, as markets often react late and abruptly. Thus, a fiscally unsustainable path can eventually lead to sharp adjustments in real interest rates, and these in turn can destabilize financial markets and undercut recovery prospects.

What can be done to avoid this danger? The following features can help:

- implementing mostly measures that are reversible or that have clear sunset clauses contingent on the economic situation;
- implementing policies that eliminate distortions (e.g. financial transaction taxes);
- increasing the scope of automatic stabilizers that, by their nature, are countercyclical;[5]
- pre-committing to identified future corrective measures – e.g. letting the current administration's upper income tax cuts expire (the US case) – and to future increases in upper income tax rates (a part of the UK package);
- pre-commitment to unwinding stimulus measures either at a specific date (like lowering VAT for just two years as Britain recently did) or on a contingent basis (reversing the VAT cut once GDP growth has risen above a certain level). Consideration should be given to a smooth unwinding to avoid cliff effects;

[4] Econometric estimates for the United States indicate that a 1 percentage point increase in the expected or current federal debt-to-GDP ratio increases long-term real interest rates by only 2 to 4 basis points (Laubach 2003). There are good reasons to believe, but no strong empirical evidence to support, the notion that the effect is nonlinear in the level of debt. In early December 2008, Italian and Greek government papers were facing interest rates of around 150 basis points over comparable German rates.

[5] There is evidence of a secular decline in the role of automatic stabilizers in the United States since their historical peak in the 1970s – see Auerbach (2008).

- providing more robust medium-term fiscal frameworks. These should cover a period of four to five years and ideally include: accurate and timely projections of government revenues and expenditures; a government balance sheet reporting data on government assets and liabilities; a statement of contingent liabilities and other fiscal risks; and transparent arrangements for monitoring and reporting fiscal information for central and sub-national governments, other public sector entities, and central bank quasi-fiscal operations, on a regular and timely basis. Such frameworks should be designed to give confidence that increases in public debt resulting from the stimulus are eventually offset;
- strengthening fiscal governance. For example, independent fiscal councils could help monitor fiscal developments, thus increasing fiscal transparency, and could also advise on specific short-term policies or medium-term budgetary frameworks to reduce the public's perception of possible political biases; and
- improving expenditure procedures to ensure that stepped-up public works spending is well directed to raise long-term growth (and tax-raising) potential.

Moreover, we should not forget that the main threat to the long-term viability of public finances in rapidly-aging countries comes from the trend increase in the net cost of publicly funded pension and health entitlements, whose net present values far exceed the magnitude of conceivable fiscal stimulus packages. Finally, structural reforms to boost potential growth, by removing distortions, including those arising from taxation and other public interventions, can also help in strengthening medium-term sustainability: many countries have succeeded in reducing their public debt burden through growth. A credible commitment to address these long-term issues can go a long way in reassuring markets about fiscal sustainability.

Some proposals for discussion

The gravity and singularity of the current crisis may require new solutions that address specifically the issues of financial disintermediation and loss in confidence. Some proposals that could be considered further are:

(1) Greater role of the public sector in financial intermediation

One of the characteristics of the current financial crisis is an extreme shift in investors' preferences towards liquid T-bills and away from private assets. To the extent that the state is in a better position than private investors to buy and hold these private assets, it may want to do so, in effect, partly replacing the private sector in financial intermediation. In the US context, the government could issue T-bills and use the funds to provide financing for some of the ultimate borrowers.[6] The issue is clearly that the public sector does not have a comparative advantage in evaluating credit risk, nor in administering a diverse portfolio of assets. A possible solution may be to outsource the management of the banking activities to a private entity.

(2) Provision of insurance by the public sector against large recessions

In the present environment of extreme uncertainty, there may be a high private value to delaying consumption and investment decisions until part of the uncertainty is resolved. Equally important, banks may delay their decisions on which projects to finance for similar reasons. In this context, the government could provide insurance against extreme recessions by offering contracts, with payment, for example, contingent on GDP growth falling below some threshold level. Banks could condition loan approvals on firms having purchased such insurance from the government. This is analogous to the flood insurance that mortgage companies often require from borrowers. While such contracts would most likely be attractive to firms that suffer disproportionately during large recessions, they could be open to individuals as well. Widespread use of such contracts would provide an additional automatic stabilizer because payments would be made when they are most needed, namely in bad times.[7] Such a market would also provide a market-based view of future output, and the likelihood of severe shocks. (GDP-linked bonds, which have been discussed in the academic literature for some time, would also go some way towards the same goal.) An obvious worry about such a scheme is counterparty risk, i.e. that the government may not be able or willing to honor its obligations. The contingent liabilities created by providing insurance should be included appropriately in the budget and

[6] This was done in the 1930s during the Great Depression. We describe it as a Treasury operation but it is closely related to the "quantitative easing" policies followed by the Fed and other central banks. The differences are in whether these assets are bought or used as collateral, and whether their purchase is financed through government bonds, or through money creation (as is currently the case).

[7] Note that this proposal has some resemblance with the ideas on country insurance discussed in Becker et al. (2006).

should be taken into consideration when calculating the medium-run fiscal sustainability.

A collective international effort

The international dimension of the crisis calls for a collective approach to providing fiscal stimulus. There are several important spillovers that could limit the effectiveness of actions taken by individual countries, or even create adverse externalities across borders:

- Countries with a high degree of trade openness may be discouraged from fiscal stimulus; the more open a country, the less it will benefit from a domestic demand expansion, and the more the fiscal expansion will translate into a deterioration of the trade balance. The amount of stimulus needed to achieve a given level of increased output can be large in open economies. The flip side of these spillovers is that if all countries act, the amount of stimulus needed by each country is reduced (and provides a political economy argument for a collective fiscal effort). At the same time, this collective fiscal effort must be tailored to individual country circumstances to take account of external imbalances, the effects of automatic stabilizers and the degree to which each country has fiscal scope of action.
- Some interventions currently discussed such as subsidies to troubled industries may be perceived as hidden (unfair) industrial policy by trading partners. Such a race would bring significant costs in terms of efficiency.[8]
- The history of the Great Depression shows that, as the crisis deepens, there is increasing pressure to raise trade barriers. While it is improbable that trade tariffs will be increased because of the commitments to WTO, there is a distinct possibility that organized groups may advocate non-tariff protection to limit imports, or introduce various forms of export subsidies, especially if some fiscal measures are misconstrued as unfair industrial policy (see previous point).

All these factors point to the need for a concerted effort by the international community, and stricter coordination among countries with closer economic and institutional ties (e.g. the European Union).[9] The recent decision to finance some of the national expenditures from the EU budget is clearly a step in this direction.

Some countries have questioned the *need* for fiscal action and whether it can be effective. The most recent data are pointing more and more to a worldwide growth slowdown. This suggests that the action should be widespread to maximize its effectiveness. To maximize the demand impetus, policies across regions should be tailored to those actions that are likely to provide the largest multipliers. In the United States, that is likely to be investment, other spending on goods and services, and some targeted transfers. In Europe, with its relatively large automatic stabilizers, the additional fiscal impulse can probably be somewhat less than in the United States.

Conclusion

The current crisis calls for two main sets of policy measures. First, measures to repair the financial system. Second, measures to increase demand and restore confidence. While some of these measures overlap, the focus of this article is on the second set of policies, and more specifically, given the limited room for monetary policy, on fiscal policy.

The optimal fiscal package should be timely, large, lasting, diversified, contingent, collective, and sustainable: timely, because the need for action is immediate; large, because the current and expected decrease in private demand is exceptionally large; lasting because the downturn will last for some time; diversified because of the unusual degree of uncertainty associated with any single measure; contingent, because the need to reduce the perceived probability of another “Great Depression”

[8] Attempts to save jobs in troubled sectors of the US economy, e.g. the automobile industry, through increased trade protection come with a potentially large cost in terms of lost efficiency. Some estimates suggest that the cost of saving one job far exceeds the average annual wage in the protected sector. For example, in 2002, the Federal Reserve Bank of Dallas published estimates of the annual cost incurred per job saved in 20 sectors in the US economy as a consequence of protection and they concluded that the average annual cost per job saved exceeded 230,000 US dollars.

[9] So far, the European Commission has recommended a fiscal stimulus of 1.5 percent of GDP. France has announced a 19 billion euro plan, which includes a boost for the construction and car sectors; moreover, the government has promised 20 billion euros for small business and the construction industry. Germany has announced a package that includes generous amortization rules for companies, and incentives for climate-friendly home renovation; the package will cost 12 billion euros in two years but it is expected to trigger 50 billion euros in private investment. Italy proposes a nominally large stimulus that will only amount to 5 billion euros in ‘new’ money (i.e. not previously announced). Spain has announced measures for 40 billion euros to support infrastructure investment and the car industry. Britain has announced a temporary reduction of VAT rate from 17.5 to 15 percent until December 2009 at an estimated cost of 12.5 billion pounds; in addition, the government plans to invest 3 billion pounds on infrastructure and has offered temporary targeted tax breaks for 3.5 billion pounds.

requires a commitment to do more, if needed; collective, since each country that has fiscal space should contribute; and sustainable, so as not to lead to a debt explosion and adverse reactions of financial markets. Looking at the content of the fiscal package, in the current circumstances, spending increases, and targeted tax cuts and transfers, are likely to have the highest multipliers. General tax cuts or subsidies, either for consumers or for firms, are likely to have lower multipliers.

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