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Fiscal Policy Facing the Crisis

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Summary

The immediate causes of the crisis are evident and traceable to the collapse of financial markets and the ensuing debt deflation and credit crunch. Nevertheless, the current crisis is the mirror of a more fundamental structural imbalance, namely the trend of redistribution from low and middle incomes to high and very high. This has created a chronic demand insufficiency that in the US has been hidden by mounting private and public indebtedness. The high savings of other parts of the world made this possible, creating a fragile equilibrium. To put the global economy back on a path of sustainable growth, this structural trend will have to be reversed.

The fiscal stimulus packages should have three features. (a) they should primarily be addressed to (public) investment which is likely to increase potential growth, and especially to research on the new technology of environment and energy; (b) they should target the categories in distress, notably the working poor and those who have lost their home in order to minimize the social costs of the crisis, and sustain aggregate demand; (c) they should address the mounting unemployment (and unemployment duration) problem by extending benefits duration and eligibility.

The size of the stimulus will depend on how coordinated the measures are, knowing that the efficacy of a joint, coordinated fiscal stimulus is much larger than the one of an isolated one or an uncoordinated one.

The plans announced so far by western countries are mostly oriented towards public investment. Two issues seem relevant. The first is the actual size of these plans. For 2009 only a fraction of what is announced will be spent; the second issue is the lag in producing effects on the economy. Thus, our governments are taking a risk by letting the crisis unfold at least until the half of 2009.

OFCE estimations point to a significant but by no means exceptional impact of the announced measures on growth and GDP. Thus, a second wave of fiscal stimula is likely to be necessary

That the present crisis shows itself as one of global demand deficiency is recognized by almost all economists and policy makers. The burst of the housing bubble and the correction of stock markets have caused, via a negative wealth effect, a sharp reduction in private consumption. But this would have been a “normal” crisis if the severe malfunctioning of financial markets – excessive risks taken by what were considered as serious institutions—would have not transformed it into a systemic crisis. In almost all countries, the interbank market came virtually to a halt, and as of today it is still far from having recovered a normal functionality. In this situation, credit conditions are considerably tightening both for firms and for households. And despite huge interventions by the central banks and by the fiscal authorities, a credit crunch is still probable.

Thus, the combination of a negative wealth effect and of increasingly tight credit constraints has caused the private expenditure to drop and is thus the immediate causes of aggregate demand deficiency that we are observing today and likely in the coming months.

Nevertheless, the deep roots of the current situation do not lie in the financial meltdown, or in the debt deflation. These are only the events that triggered the crisis. Three major macroeconomic sources of the crisis were (a) underlying global imbalances; (b) inequalities in the global economy; and (c) the increased global instability resulting from certain policy choices in recent decades. Point a and c are documented in the chair’s summary of the macroeconomic group (UN Commission)

Here, I will concentrate on the second.

One of the main origin of the present crisis is the imbalance that has built up during the past three decades, related to a long term trend of redistribution from low and middle incomes to the high and very high. In most advanced countries the average wage stagnated, while inequalities surged in favour of the upper quintile of the distribution.

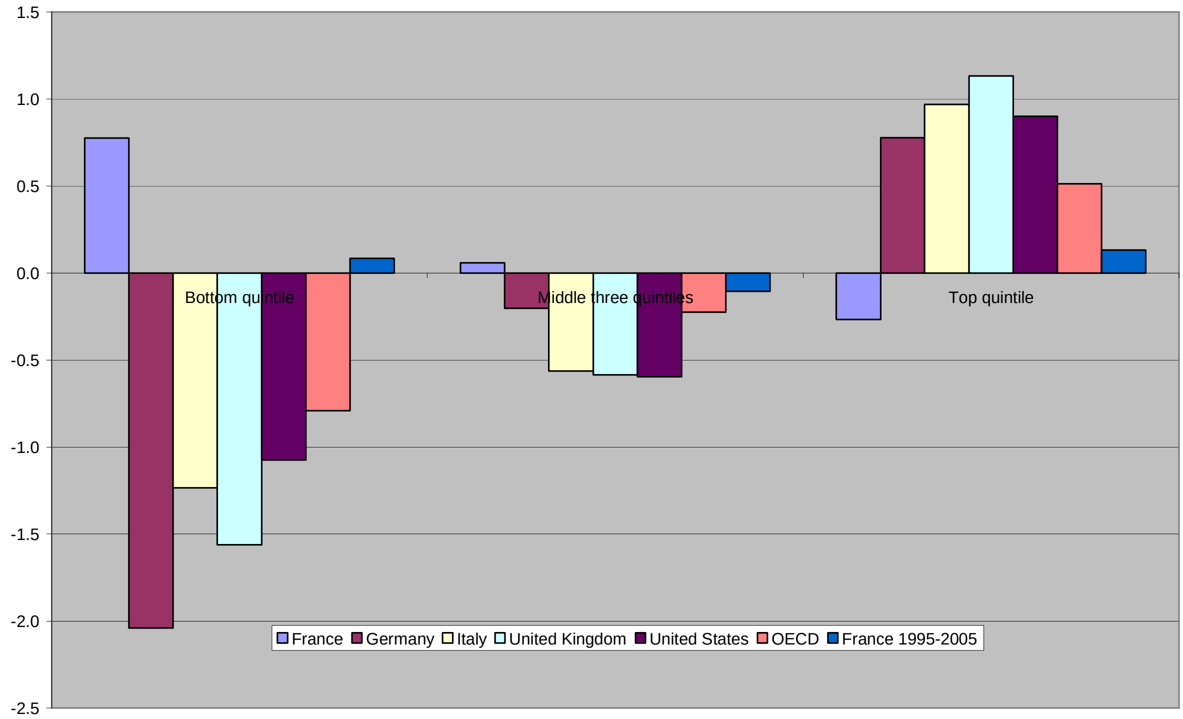

Figure 1 : Average yearly growth of income minus growth of average wage.

Source: OECD (2008).. My calculations

Figure 1, taken from OECD data (2008), shows the difference between the average growth of real income for each quintile (or group of quintiles) and the growth of average income, over the two decades mid-1980s to mid-2000s. The figure clearly depicts redistribution from the four bottom quintiles to the fifth, which is the only one that shows an increase over the period above average real income. While we only took the most representative countries, the OECD study shows this trend to be common to most countries in the group.

Over the twenty years we observe only one exception, France, where growth for the lower quintile was larger than for the average wage. Nevertheless, even for France this trend was reversed in the last decade.

The phenomenon of redistribution is even more marked than the figure shows. Dew-Becker and Gordon (2005) speak of "superstar economy", showing that in fact, those benefiting more from the redistribution are those at the very top of the income distribution (top 1%). This was more than confirmed by the work of Piketty and Saez ( )

This long term trend of income redistribution by itself would have had the macroeconomic effect of compressing aggregate demand: as the propensity to consume out of low incomes is generally larger, distributing income away from them tends to lower average propensity to consume.

Interestingly, this tendency originated different behaviours and different outcomes on the two sides of the ocean.

In the US, where the social protection system is less important, the compression of low incomes and of aggregate demand was compensated by the sharp reduction of household savings and by mounting indebtedness, that allowed to keep the spending (consumption) patterns virtually unchanged. At the same time, the limited safety nets forced the government to pursue active macroeconomic policies to keep unemployment low, thus increasing government debt as well. Thus, growth was maintained, and the structural loss of aggregate demand was "hidden" by increasing public and private indebtedness.

Most of European countries walked a different path. The redistribution to higher incomes resulted in an increase of national savings and in depressed growth. The safety nets embedded in the welfare systems exerted a pressure on public finances, but the institutional setting, notably the constraints to deficit embedded in the Stability and Growth Pact, resulted in fiscal policies that contributed to depress aggregate demand. In the meantime, high interest rates, and a financial sector less prone to innovation, limited consumer borrowing. As a result, the shift in distribution resulted in soft growth for most of the past two decades; even if national (public plus private) debt resulted substantially lower than in the US.

These two paths were mutually consistent, because the savings from the EU zone contributed to the financing of US borrowing, along with surpluses of other regions that for different reasons also experienced high saving rates (notably East Asia and Middle Eastern oil producing countries). Thus the combination of structural disequilibria that goes under the name of global imbalances (see also my Briefing Paper of June 2007) resulted in a fragile equilibrium that temporarily solved the aggregate demand problem on a global scale.

Today's crisis, which originated in the financial markets, broke this fragile equilibrium, and revealed the structural lack of aggregate demand that most countries face. It is important to stress once again that the financial crisis was only the factor that brought into surface the structural problem. (Quite a part from the fact that the level of remunerations in the financial sector contributed significantly to the rise of income inequality).

Thus I firmly believe that, once the necessary action to tackle the current crisis will be undertaken, a serious and in-depth debate on the structural causes of the current imbalances and on global measures to invert the global trend in income distribution will be necessary and urgent. These are the real structural reforms that OECD countries need, and not as it was broadly believed before the crisis, those structural reforms aimed at increasing wage flexibility and decreasing the generosity of the social protection system. It has to be emphasized, that the sheer existence of social protection systems at least in rich countries would be in the next months or years, one of the better instruments against further deepening of the crisis. It is why it is in the interest of OECD countries to help the building of social protection systems in developing countries.

While the diagnosis of the deep roots of the crisis that I outlined above may not be consensual, the profession is almost unanimous on the necessity to address the current crisis with an important and coordinated fiscal stimulus.

Today we experience a typical liquidity trap situation: Private savings massively went into government securities, in a "flight to safety". The objective must be to transform these savings in demand in order to curtail deflationary expectations, to restore the value of assets, and ultimately to escape a potentially deflationary process.

I will briefly analyze the plans already announced by the main economies below, but before I'd like to focus on the elements that a stimulus package should contains, on the global problems it poses, and also on what should be done to guarantee long term sustainability.

Three main principles and elements of an effective stimulus package should be highlighted:

1) A large part of it should take the form of public investment, to build and modernize infrastructures, to avoid rent seeking, pork in the barrel projects, and to lay the foundations for future growth. An important part of this investment should address the problems of environment degradation and climate change.

2) The current crisis is leaving on the ground many casualties, like home owners, blue collar workers, and entire sectors. An important part of the planned expenditure should be targeted at relieving their conditions and at sustaining their income and capacity to spend.

3) Unemployment is likely to increase significantly in most countries, both in the existing workforce and among those who will enter in the workforce in the next months. Everything should be done to avoid them to become discouraged, and to provide them with safety nets. In particular, I believe that a *temporary* extension of unemployment benefits, both in size and in duration, would relieve the pressure on laid-off workers; furthermore, loosening

eligibility condition could allow supporting the young who are entering into the workforce.

As for the size of the stimulus needed to avoid free riding one should aim for a similar percentage of GDP in all OECD countries; If it were not the case differences between countries would reflect their degree of openness (and hence the value of the multiplier), that ultimately depends on their size. If such a common commitment is not taken, free riding would almost be inevitable, each national multiplier being lower when the reshuffling of the economy is isolated than when it is global. I would also emphasize that this risk should not lead to paralysis. I have to underline that it is the first time since long that we are observing such a generalized and simultaneous fiscal stimulus in big countries, so that the risk of free riding is minimized.

The actual numbers on the size of the stimulus depend furthermore on how coordinated the effort will be. What we know from textbook multiplier analysis is that in presence of a generalized fiscal expansion the multiplier is larger than it would be for each country in isolation. For example, the model *imode.fr*, used at OFCE for economic forecasting, gives an estimate of the fiscal multiplier that for European countries goes from 0.9 to almost 2 when the fiscal expansion happens simultaneously. Thus a joint (if not coordinated) effort would more than double the multiplier.

Estimates at the IMF point at a size of the needed stimulus of around 2% of GDP. Our own estimations at OFCE confirm that this is the order of magnitude that countries should aim to. But in actuality, we don’t know. We are confronted to a radical uncertainty. Past episode of similar crisis which are not many (i.e. Japan) taught us that it is better to act quickly and to do too much that not enough.

There is in effect a real difficulty in measuring the amplitude of the crisis, and the effects of macroeconomic policies aimed at dampening it. This difficulty is reflected by the continued revisions of policies and forecasts by national governments, even before the plans are put in place. This makes it rather difficult to give a quantitative assessment of the needed stimulus. While of course it depends on the fact that the crisis is still unfolding, this uncertainty is at least in part an unavoidable consequence of the dismissal of tools that allowed in the past to evaluate policy in the global economy, notably multi country models. Today only a few institutions have multi country models and use them for policy analysis and forecasting. Their dismissal in the past, because Keynesian and hence “out of fashion”, was a mistake that we are paying today. We have lost part of the technology for building a stimulus programme!

It is worth noting that some countries, notably developing ones, may not be in the position to afford a fiscal stimulus of several points of GDP. It is of foremost importance that the international community helps these countries to carry out the needed measures exactly as it needs to help them with the banking rescue packages (see my Briefing Paper of January 2009). OECD countries should resist the temptation to cut foreign aid spending; ideally, foreign aid should actually be increased.

Even if difficult to determine its optimal size, the size of the stimulus that most countries will implement in the next future will be certainly important. Thus, it is normal to respond to the concerns about the long term sustainability of current policies that emerge in the speeches of the heads of state and government around the world.
While the issue of sustainability is important, we should bear in mind that in this case we are talking about a countercyclical policy, and that no long term sustainability concern will appear, as long as policy will remain countercyclical. This means that as soon as the economy will enter in an expansion phase, fiscal policy should turn restrictive. It is very important that this does not happen too late, but it is at least as important that it does not happen to early. Turning to budgetary restrictions before the crisis is over could undermine all the previous effort to sustain growth. Also, the importance of the composition of public expenditures as regards sustainability should be underlined; public investment, if it succeeds in increasing the growth potential of the economy and hence future growth, may pose less sustainability problems. It may be so also for all expenditures aimed at increasing social cohesion.

The European Commission published on November 26, 2008 a rescue plan of around 200 billion euros, representing 1.5% of gross domestic product (GDP) of the EU27.
Each member state commits 1.2% of GDP, 0.3% being provided by European funding. Given the exceptional circumstances, the Commission has put on hold the Stability and Growth Pact. However, the Commission requires the fiscal stimulus to be temporary, over a period of a maximum of two years (2009-2010), after which "the budgets of the Member States should undertake to correct the fiscal deterioration and return to the medium-term objective" of balancing public accounts. Table 1 shows a summary of the measure in the main European countries.

Table 1: Announced Fiscal Stimulus Plans

	France		Spain		Germany		Italy		UK	
	€ bln	% of GDP	€ bln	% of GDP	€ bln	% of GDP	€ bln	% of GDP	€ bln	% of GDP
Total public investment	8	0.4	8	0.7	7.2	0.3	1.4	0.1	2.3	0.15
Enterprise cash advances support	13.9	0.7	7.7	0.7	15	0.6	0.2	0		
Sectoral Aid	2	0.1	3	0.3	nc	nc	nc	nc	0.7	0.05
Employment policies and aid to households	2	0.1	5.9	0.5	23	0.9	3.3	0.2	4.4	0.29
Estate tax suppression			1.8	0.2						
TVA reduction	-	-	-	-	-	-	-	-	11.5	0.8
Other					4.8	0.2	1.5	0.1		
Total	26	1.3	24.7	2.2	50	2	6.5	0.4	18.8	1.3

Source: OFCE calculation from national sources

European governments, like the new US administration, chose to focus on investment. On average, nearly 40% of expenditure in 2009 will be in the form of public investment. At the extremes we find France, where it reaches 75%, and the UK, where it represents only 16% of GDP. In the UK, in fact, most of the engagement (60%) is towards the reduction of VAT. As I noted before, the choice of government investment is sensible: it boosts the activity and employment, and helps improve productivity and therefore growth potential. Nevertheless because of delays in the implementation of projects, the impact in the next six months, if any, would be week.

The VAT reduction impacts rapidly on economic activity. It is adapted to the current situation of the British economy, because by lowering consumer prices, it should help reduce inflation to a level closer to 2%. But it is unclear how much of the VAT reduction will be reflected in consumer prices, and how much will be used by firms to increase margins. For this reason, widespread reduction of VAT across European countries and making it the main item of the fiscal stimulus plans is not advisable, especially considering that inflation is rather weak in most countries of the Euro area and that it is on a decreasing path. What is emphatically considered as a stimulus of consumption (VAT reduction) may in actuality be an aid to enterprises.

With the notable exception of Italy, the major European countries have kept their commitment on the amounts involved in the various national plans. But this may be misleading: the cash advances for example are not new spending. Thus, in the French plan, almost 14 billion Euros are earmarked for supporting the cash flows of businesses. Of this amount, only 5%, i.e. about 700 million euro - the interest that would have been paid if the companies had borrowed (on normal conditions) the money - is likely to impact on economic activity. According to OFCE calculations, nevertheless, this amount will have a high multiplier (estimated at 2.5) because it will allow some credit constrained small businesses to finance investment and other not to fail for liquidity constraints. It is not after all a bad idea for a state to ameliorate the cash flow of enterprises by playing on the delay of tax payments, when the banking system is deficient.

The announced funds allotted to investment programs will not be fully committed during 2009. Additional public expenditure should be in 2009 around 60% of pledges (40% for the French plan). In 2009, the effort would eventually be less than 1 percentage point of GDP on average, with significant differences between countries: less than 0.5 percent of GDP for Italy against 1.7 for Spain (Table 2).

Table 2 : Impact of Expenditure on GDP

	France	Spain	Italy	Germany	UK	US[1]	Japan[2]
Announced Expenditure							
Bln National Currency	26	24.7	6.45	50	18.8	450	38 600
% of GDP	1.3	2.2	0.4	2	1.3	3.1	7.7
Effective Expenditures							
Bln National Currency	13.5	18.7	4.42	35	18.8	390	7 000
% of GDP	0.7	1.7	0.3	1.4	1.3	2.7	1.4
Effective Expenditures 2009							
Bln National Currency	9.5	18.7	4.42	16.5	18.8	390	5 000
% of GDP	0.5	1.7	0.3	0.7	1.3	2.7	1
Impact on GDP in 2009							
Yearly average	0.3	0.4	0	0.3	0.8	0.9	0.4
Year to year	0.5	0.6	-0.1	0.4	0.8	0.9	0.85
Impact on deficit in 2009							
ex ante	0.8	1.7	-0.1	0.6	1.3	3.1	0.8
ex post	0.6	1.5	0.1	0.4	0.95	2.7	0.6

1. The US plan was not voted by Congress as of today.
2. This column does not take into account the last plan, announced in December 2008, that would amount to 4.6% of GDP (2.6% of effective expenditure)

Source: National sources, OFCE estimation.

The average effort in the EU is also lower than the one of Japan (1.4% of GDP) and especially than what could implement the United States with the new administration (2.7% of GDP). According to estimations done at OFCE, the impact of the European plans will range from 0 in Italy to 0.8% of GDP in the UK, the latter being similar to the impact forecasted for Japan (0.85%) and the United States (1%). The deficit of the Member States increase by 0.1 percentage points for Italy, by almost 1 point for the United Kingdom and by 1, 7 point in Spain.

According to our estimations, then, the currently announced plans will have no major impact, and a second wave of stimulus measures is to be expected. The American plan is not yet in force, the president having just taken office. The European plans announced until today are far from having sufficient impact in the short term.

By relying on public investment, the plans on both sides of the Atlantic are betting on the double benefit of a recovery in the short run and the building up of a capital stock for the future. But they are imposing a significant risk to the global economy. As no immediate and significant impact is to be expected, the recession will have time until the summer of 2009 to develop unchallenged, multiplying the situation of distress. The contagion of the crisis in the emerging countries adds a channel of transmission and increases the likelihood of an even worse situation.

To conclude, while the current plans pose the foundations for higher growth in the future, they may fall short of what is expected from fiscal stimulus in the very short run. Different measures, more targeted to the short run, should be quickly and boldly taken..

References

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