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Policy Lessons from the Crisis and the Way Forward

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The analysis in previous chapters makes clear that the global financial crisis has reshaped our understanding of the role of fiscal policy and has refocused the attention of the economics profession on fiscal sustainability issues. Had such a focus existed prior to the crisis, many countries might have been better prepared to deal with its impact than has turned out to be the case: fiscal policy, particularly in advanced economies, was far from optimal prior to the crisis due in part to gaps in fiscal frameworks. As a result many advanced economies' fiscal position was relatively weak even before the crisis and worsened significantly thereafter, leading to open fiscal crises in some countries and subjecting others to the vagaries of financial market jitters. The crisis has also affected our thinking about the role of fiscal policy in responding to shocks. Fiscal policy was given a more prominent stabilization role during the crisis, and the question is whether this was just the appropriate response due to the exceptional circumstances that prevailed at the onset of the crisis, or whether the experience of the last few years has implied a paradigmatic shift regarding the role fiscal policy should play in offsetting cyclical fluctuations. This crisis has exposed important structural and institutional weaknesses in the eurozone that can only be addressed through deep reforms. A path to full recovery and long-term fiscal sustainability exists, but it is likely to be a long and bumpy one. While it is too early to write a definitive history of the crisis, it is not, however, too early to begin drawing lessons from it to provide guidance for fiscal policy makers as they continue to deal with its effects. The goal of policy makers should be not just to recover from the current crisis but to minimize the likely costs of the next one.

Policy Lessons from the Crisis

This section presents ten preliminary conclusions from the post-crisis experience, a long list and yet certainly one that is neither complete nor final.

Lesson 1: No Country Can Defy Fiscal Gravity, at Least Not Forever

Prior to the global crisis a false sense of security had settled among advanced countries supported by a benign global economic environment (see chapter 6). A conventional fiscal risk threshold for public debt in emerging economies was believed to be in the 40 to 50 percent of GDP range. There was no well-established equivalent threshold for advanced economies because they had not experienced severe fiscal crises over the past few decades, perhaps contributing to complacency. But reality settled in with the recent experience of Cyprus, Greece, Iceland, Ireland, Italy, Portugal, and Spain, reminding us that advanced economies too can run into trouble if markets perceive countries' fiscal policy to be unsustainable. Admittedly, the experience of advanced economies has been more diverse than that of emerging economies. For instance, Japan and the United States have run debt ratios of 100 percent of GDP or more while facing record low borrowing costs thanks to the idiosyncratic nature of their investors' base (the unusually strong home bias of Japanese investors and the reserve currency status of the dollar). But, ultimately, equilibria based on the attitude of investors to finance lenders at low interest rates are precarious. Indeed, also, sovereign spreads for economies of the eurozone seemed disconnected from their economic fundamentals during the period leading up to the crisis. And, yet, recent events in Europe have shown how rapid and abrupt financial market responses to fiscal fundamentals can be.

Lesson 2: In Good Times, Prepare for Bad Times

Fiscal balances should be stronger in good times, so that their deterioration in bad times will not be seen as worrisome. While this principle is well understood and generally accepted, its application is far from universal. Deviations from this principle stem from two main reasons. First, political economy considerations tend to confer to fiscal policy a deficit bias. In other words, policy makers face popular pressure to increase spending or cut taxes when growth slows, but receive little political reward for tightening the purse strings when output recovers. Second, the tools for measuring the cyclical position of the economy have been deficient, meaning that policy makers may not always have been able to separate structural from cyclical factors that were affecting fiscal outturns. While the traditional focus has been on GDP cycles, fluctuations in asset markets, commodity prices and the sectoral composition of output are also relevant in determining the underlying state of public finances (see chapter 6). For instance, the United Kingdom benefited from high tax revenue during the period leading up to the crisis as a result of the high profitability and high labor incomes in the financial services industry. Similarly Ireland's tax revenue was buoyed by transactions-based taxes in the property sector and by capital gains taxes during the rapid asset price appreciation of the pre-crisis period. More generally, high asset prices can amplify tax revenues directly through capital gains and wealth taxes and indirectly through wealth and balance sheet effects. Accordingly, the underlying state of the fiscal accounts cannot be assessed just by looking at the output gap. Well-designed fiscal rules built around a notion of structural fiscal balance (which would correct for transitory fiscal revenue related to the output gap, asset or commodity price movements, and output composition shifts) along with independent fiscal monitors (such as fiscal councils) could help avoid procyclicality and enhance macroeconomic and financial stability. In this context, more research is needed to address the challenges in operationalizing such rules.

Lesson 3: Fiscal Policy Can Be an Effective Stabilization Tool in Some Cases

Before the crisis there was broad agreement among macroeconomists and policy makers that short-run stabilization was almost exclusively the domain of monetary policy while fiscal policy was given a more medium-term focus. While practice sometimes deviated from this paradigm, monetary policy was regarded as the main tool for countercyclical policy because it was more flexible, less prone to political pressures, and more easily delegated to independent experts. In addition monetary policy was thought to be a potent instrument in most, if not all, cases of weak aggregate demand. While economists were aware of the zero-bound problem, it was regarded simply as a peculiar textbook case. However, the size of the shock during the great recession was so large that many countries hit, or came close to, the lower bound for the policy interest rate and had to resort to both fiscal stimuli and unconventional monetary policy. In fact, as shown in chapter 10, almost every major country adopted a substantial fiscal stimulus after the crisis. While a broad consensus on the role of fiscal policy has not yet emerged, it is clear that fiscal policy is now regarded with much more interest as a tool to regulate the economic cycle. This more pragmatic approach is a positive development, although the risk of excessive fiscal activism remains a significant one. We do not advocate a more activist role for fiscal policy in general. Monetary policy should remain the primary stabilization tool. However, there may be circumstances such as the ones that prevailed during the current crisis that would warrant a more activist role for fiscal policy. This point is also supported by the reassessment of the size of fiscal multipliers discussed next.

Lesson 4: Fiscal Multipliers Could Be Relatively Large When Output Gaps Are Sizable and Monetary Policy Is Constrained

The comeback of fiscal activism during the crisis has sparked a great deal of work on the short-run effects of fiscal policy, particularly on fiscal multipliers. As Robert Solow stressed in his remarks in a recent IMF conference, it is futile to try to find "the" multiplier since the effects of fiscal policy are highly regime dependent—a central feature of chapter 11. Recent research at the IMF and elsewhere has indeed documented important asymmetries of fiscal policy over the cycle with significantly higher multipliers during recessions than periods of expansion. To some extent, this is obvious. On the one hand, when the economy is running at full potential, boosting aggregate demand through a fiscal expansion will result primarily in higher inflation (and/or a larger external current account deficit). On the other hand, if there is spare capacity a surge in demand will be met by higher output. Fiscal multipliers seem indeed to have been relatively large (greater than one) at the onset of the crisis when aggregate demand collapsed while many central banks had no further room left for lowering policy interest rates and the credit channel was impaired by heightened uncertainty and the weak state of the financial sector. High fiscal multipliers also have implications on the pace of fiscal consolidation underway. The adjustment needs to be gradual, to the extent made possible by market conditions, to limit the potential drag on growth by postponing a large portion of the fiscal adjustment until the recovery has taken hold and multipliers are lower.

Lesson 5: Growth Can Greatly Facilitate Fiscal Sustainability

Faster growth helps bring debt ratios down more rapidly though denominator effects (as shown in chapter 2). In addition faster growth helps because the data show that countries with faster growth rates typically also run stronger primary balances (according to the results of chapter 4). Indeed consider a country with an initial debt ratio of 100 percent and a revenue-to-GDP ratio of 40 percent, not too far from the average ratios in advanced European countries. If such a country manages to raise its potential growth rate by one percentage point and saves all the additional revenue, its debt-to-GDP ratio will fall to about 70 percent within ten years. Faster growth can also help reduce the social costs of fiscal consolidation and enhance its political sustainability, at least as long as the benefits of growth are fairly distributed. Thus, fiscal consolidation in advanced economies could be significantly less painful if they implement rapidly the necessary structural reforms in goods, labor, and financial markets to boost potential growth.

Lesson 6: Credibility Is Essential in Explaining Why Some Countries Can Sustain Higher Debt Ratios More Easily Than Others

This fact is also a direct consequence of the simple debt dynamics equation mentioned above. More specifically, the debt stabilizing primary balance (i.e., the primary balance that would keep the debt ratio constant) is equal to the debt stock times the difference between interest rate on public debt and the growth rate. A doubling of the growth-adjusted interest rate, say from 1 to 2 percent due to a loss of fiscal credibility, thus has the same effect on the debt stabilizing primary balance as a doubling of the debt ratio from 50 to 100 percent. Countries that are punished by financial markets through huge sovereign spreads are precisely those that have lost their fiscal credibility. Of course, maintaining credibility is much more important and difficult when the debt ratio is high. This underscores the importance of having a reliable medium-term consolidation plan with clear policy intentions, the fiscal institutions to support the adjustment, and a good communication strategy.

Lesson 7: Political Economy Considerations and an Appropriate Mix of Revenue Increases and Spending Cuts Are Essential for the Success of Fiscal Consolidation Plans

In advanced economies a substantial consolidation effort is in progress which will have to be maintained over the medium term to bring debt levels to more appropriate levels. The success of this effort hinges critically on the consolidation plans being perceived by all stakeholders as fair and equitable. This will require a delicate balancing act in the design of such plans and an effective communication strategy to ensure buy in by all interested parties. Countries with already high tax rates (as in many European countries) will have to act primarily on the spending side, while countries with relatively low revenue ratios (as is the case of the United States and Japan) will need to act also on the revenue side.

Lesson 8: A Monetary Union Cannot Be Sustained without Adequate Fiscal Integration

The crisis has underscored that the interplay of fiscal and banking risks, together with deep financial linkages across countries, can turn country-specific shocks into systemic ones. Avoiding a recurrence of these problems over the medium term will require a much deeper degree of fiscal integration than the one existing in the euro area before the crisis. There has been much concern in the past about the difficulty of having countries that could be subject to large idiosyncratic shocks in the same currency area. But many of the shocks that hit euro area member countries since 2007 reflected policy mistakes and lack of coordination, including with fiscal policy, rather than idiosyncratic shocks. The proper working of the euro area requires that fiscal policies become less fragmented. This recognition has been reflected in the new Fiscal Compact. More integration is needed in other policies too, particularly those affecting productivity growth and competitiveness. This said, countries will still be affected by sizable (and genuine) idiosyncratic shocks and the euro area as a whole should provide adequate insurance mechanisms against these shocks to avoid that they lead to problems for the whole area.

Lesson 9: Budget Institutions Need Strengthening in Most Countries

The global crisis has underscored the importance of strengthening fiscal institutions. To support the consolidation effort and enhance policy credibility, many countries have started or are considering reforms to better anchor fiscal policy over the medium term; strengthen budgetary planning, reporting, analysis, and execution; and improve risk management. In addition to specific measures in public financial management, reforms center on rules-based fiscal frameworks and independent fiscal agencies. However, a lot of work remains to be done. In particular, while most advanced and emerging market economies have basic fiscal reporting, limited coverage and reporting delays reduce its impact on policy-making. Similarly an increasing number of countries report multiyear macroeconomic and fiscal forecasts but only a few countries report risk assessments around the baseline scenario. Fiscal consolidation plans need to be supported by more comprehensive and binding medium-term budget frameworks with clear objectives, a more rigorous top-down approach to budgeting, more robust contingency arrangements, and greater independent scrutiny. Defining those plans in cyclically adjusted terms can provide some flexibility to respond to cyclical fluctuations.

Lesson 10: Financial Sector Risks Warrant Particular Attention due to the Devastating Effects of Financial Crises on Fiscal Accounts and More Generally on the Economy

In the past, fiscal risk analysis had focused too much on contractual obligations arising for the public sector, including guarantees. We now have clear evidence that non contractual obligations can be even more important. The financial sector is too important to fail, and therefore governments have no choice but to support it, potentially at a huge cost during a crisis. How should fiscal policy respond to these risks? Lowering public debt in good times is necessary but insufficient to address these risks: in fact Ireland had a debt ratio of 20 percent of GDP before the crisis. The solution is to minimize risk through appropriate financial regulation and supervision.

Conclusion

The global crisis has severely shaken the world economy as well as our understanding of fiscal policy. Some of the widely held fiscal principles in the economics profession have been challenged by facts, including those related to the size of fiscal multipliers, the interaction of monetary and fiscal policies, and more generally the role of fiscal policy itself. What has not changed, however, is the fact that sound fiscal accounts are a necessary condition for macroeconomic and financial stability and sustainable growth. The magnitude of the fiscal challenge ahead requires a multiyear adjustment effort, putting a premium on the credibility and equity of the process.

We hope that this book contributes to efforts to identify the challenges ahead for fiscal policy and begins to chart a course toward full economic recovery and fiscal sustainability.