What role for fiscal policy in case of an economic downturn?

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View of fiscal policy in the Great Moderation age

- Role for fiscal policy (FP) as a stabilization tool mainly limited to automatic stabilizers. Not much room for discretionary policies. Two reasons:
- Monetary policy is more effective (fiscal policy suffers of delays, uncertainty, etc.)
- Emphasis on sustainability of public finance as the main macro role for FP

FP is actually perceived as ancillary to monetary policy.

The Great Recession

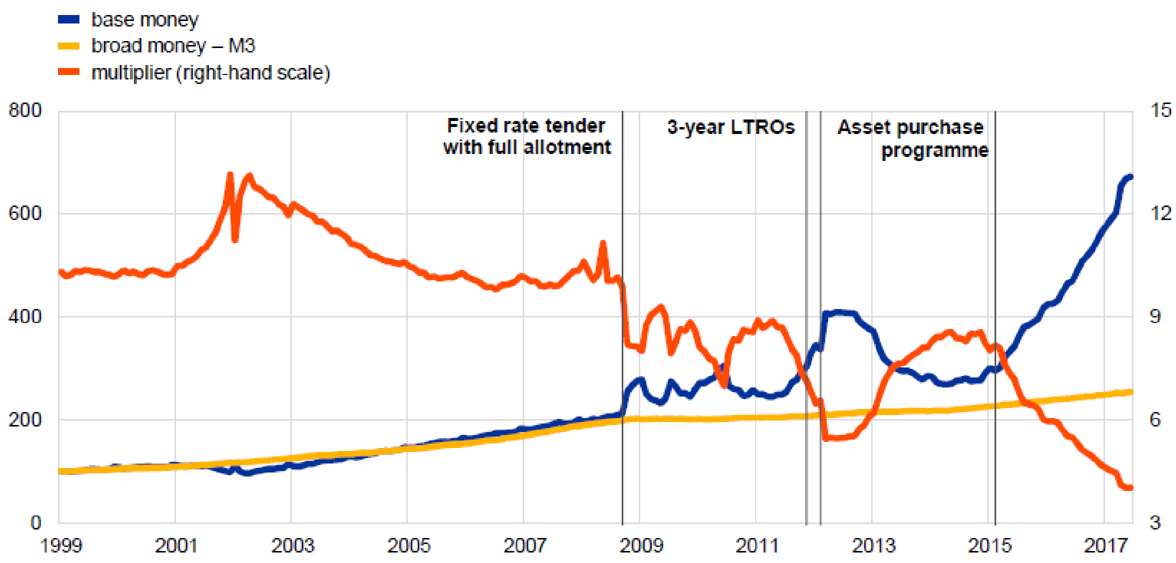
- In 2008-2009 revival of discretionary FP: large fiscal stimuli in most advanced countries.
- Changed perceptions of the size of fiscal multipliers
- ZLB makes monetary policy less effective. Even in the unconventional version (grafico sul QE, BCE)

Base money and broad money in the age of QE

- Base money more than tripled since 2008
- Money multiplier reduced by almost 2/3 (increase in banks reserves) → growth of broad money M3 slowed

Base money and the money multiplier

(left-hand side: index: 1999=100; right-hand side: money multiplier)

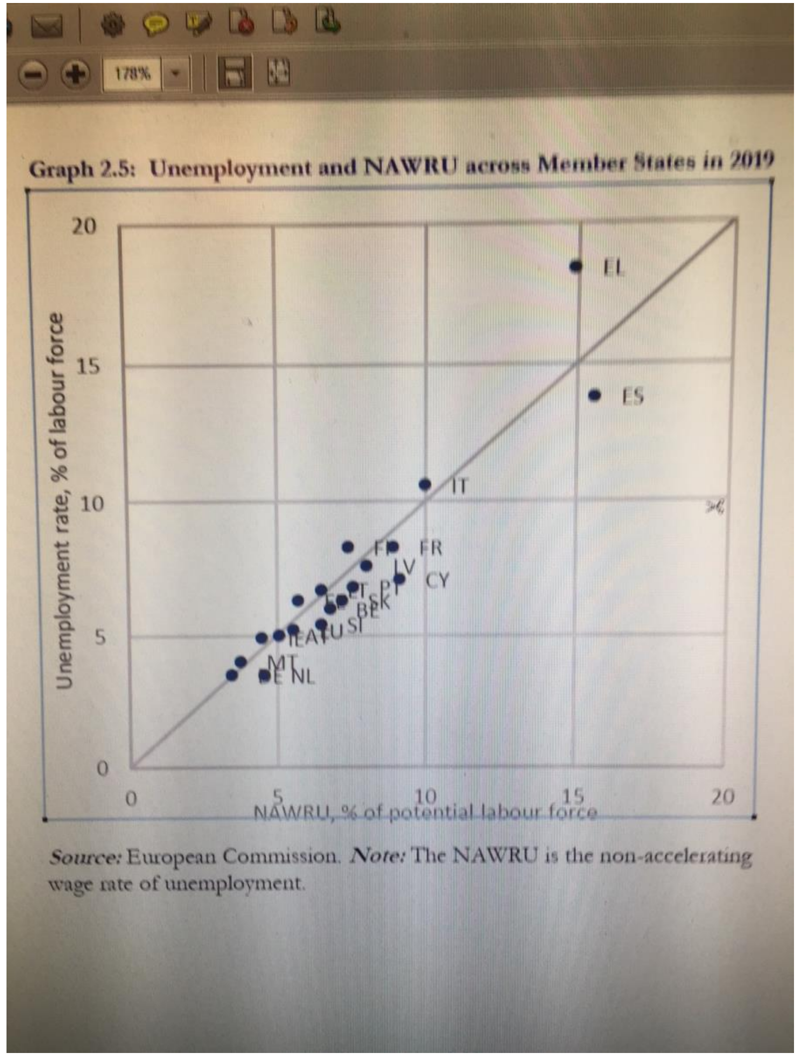


Source: ECB.
Notes: The money multiplier is the ratio of broad money to base money. The latest observation is for July 2017.

The EU fiscal framework (1)

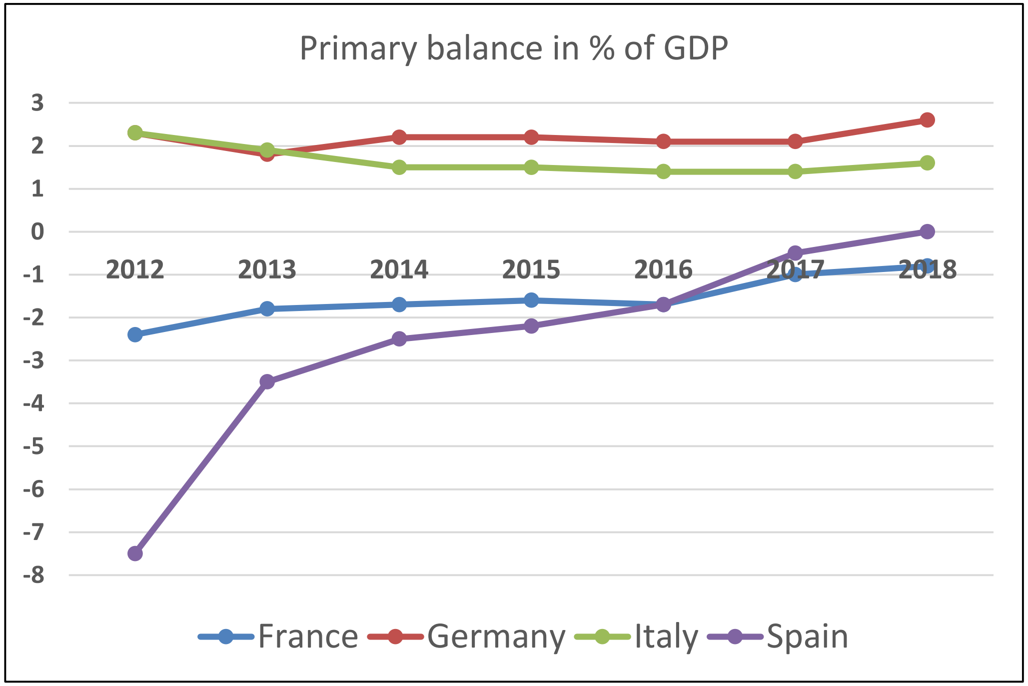
- Consistently with the revised view, it gives some role to discretionary FP.
- The change in structural balance is the key indicator to assess countries' fiscal stances.
- Measurement of potential output and output gap: consensus view is procyclical (see Figure). Implications are important for countries like Spain, Italy, France.

Nawru and unemployment rate in 2019 (EFB 2018)



The EU fiscal framework (2)

- This helps to understand the "margin of appreciation" used by the EC in assessing the fiscal plans for some countries (quite slow path toward exit from the EDP for France and Spain; substantial degrees of flexibility allowed to Italy after its exit from EDP in 2013).



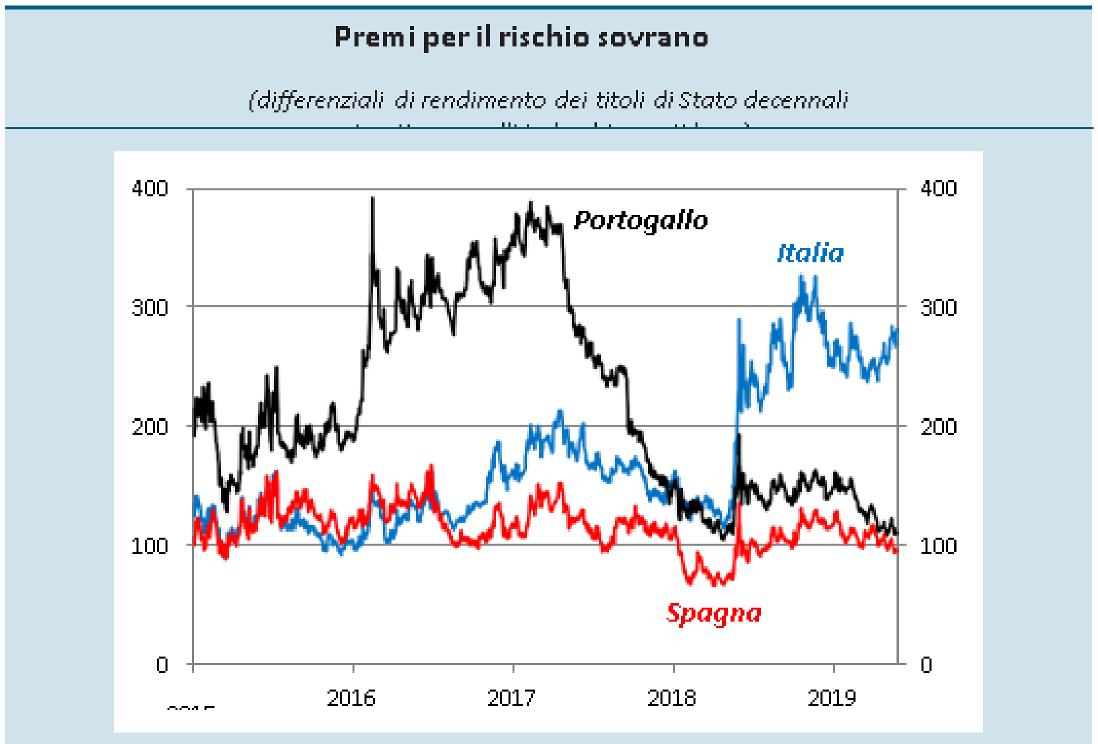
The EU fiscal framework (3)

- The way out is to work on the reform of the system of fiscal rules along the lines indicated by the EC proposal (2017) for a Directive and other. Main ingredients: a medium term fiscal plans consistent with reduction in public debt at a satisfactory pace and yearly rules based on observable variables (non cyclical expenditure).
- The plan should be credible in terms of political commitment and, most important, consistent with the actual fiscal space as signaled by markets.

Digression on Italy

- Italy’s 2019 Budget illustrates what may happen if a country announces its intention to use fiscal space beyond market perceptions of its actual size.
- At the announcement (October 2018), Btp-Bund spread went well beyond 300 bp, offsetting (at least partially) the effect of expansionary fiscal policy on demand (which contributed to PBO’s non endorsement of official macro forecasts).
- The increase has shown a tendency to persist even after the original Budget plan was revised in December: throughout 2019 the interest spread has fluctuated around 250-260 bp, some 150 bp higher than it was in Spring 2018 (the spread with Spain and Portugal bonds is now oscillating in the range 150-200 bp)
- In 2018 the implicit cost of debt has been higher than nominal GDP growth by 1.2 pp

Interest spread Italy, Spain, Portugal



What if it is not just a downturn?

- Hysteresis effects: negative effects of contractionary FP can be long lasting leading to self-defeating fiscal consolidations (De Long and Summers 2012).
- Secular stagnation. Neutral real rates have not increased and have likely declined even as the crisis receded (Blanchard and Summers 2019):
  - Now FP is strongly expansionary in the US, expansionary in Japan, mildly expansionary in Europe without any sign of overheating.
  - This makes “increasingly likely the re-emergence of FP as a primary stabilization tool”.

Secular stagnation: implications for Europe

- Need to improve fiscal and monetary policy coordination. Monetary policy cannot do the job alone
- The Euro zone should relax fiscal rules and rely on market discipline. The EC should intervene only when a government is on an unsustainable debt trajectory.
- Fiscal expansion, through:
  - either a coordination device through which each country (where interest rates are extremely low and **public debt is considered safe** by investors) commits to a larger self-financed fiscal expansion or
  - a common budget funded by euro bonds.

(Blanchard, Project syndicate, June 2019)

Secular stagnation (2)

- The Blanchard-Summers hypothesis about the future level of interest rates is debatable (but not be easily dismissed at least in the medium term).
- In any case, for a country perceived by markets as void of fiscal space (i.e. $g<r$ and high debt ratio) is bad news…