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Should fiscal stimulus packages be coordinated in times of crisis?

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Policymakers in the EU member states have recently been shaping rescue packages to prevent the financial crisis hitting their economies with unmitigated force. Each government has been responding to the emerging problems with a country-specific set of measures. Given the global nature of the crisis, would a coordinated action at the European level not have been a better approach? Was the German government – much-criticized for its initial reluctance to adopt massive fiscal stimulation measures – right after all to exploit the option value of waiting in a situation of high uncertainty? The answer to the second question is a qualified "yes". However, the answer to the first one is more complex and crucially depends on how reasonable it appears to model the impact of the economic crisis as an exogenous demand shock which has hit the euro area countries. What are the final implications for the London G20 summit?

On the benefits of fiscal policy coordination in European Monetary Union - the case of a liquidity trap?

Policymakers in the EU member states have recently been shaping rescue packages to prevent the financial crisis hitting their economies with unmitigated force. Each government seems to respond to the emerging problems with a country-specific set of measures. Given the global nature of the crisis, would coordinated action at the European level not have been a better approach? Or can actions by national governments be expected to deal more adequately with the problems facing the national economy than a pan-European set of measures? The Merkel government has even been accused by some of displaying a free-rider behavior in the area of fiscal policy since it was more reluctant in pushing forward large fiscal rescue packages in the fight against the crisis than its euro area counterparts with partly higher debt burdens and often higher fiscal deficits and appeared less prone to European coordinated efforts. The same argument was more recently used by the US government to blame the EU for a lack of fiscal policy support and coordination. But is this negative assessment really

justified?

It is by now widely assumed that a common currency makes it desirable to have also a common fiscal policy (and some go even so far as saying as the euro needs to be backed up by a political union). However, this is not a foregone conclusion if one accepts that fiscal policy can also be a source of shocks. There are a variety of reasons why fiscal policy could be destabilizing in the context of the current crisis: policy makers do not have full control over the outcome, at times the effect of a certain measure (e.g. a tax reform) is quite different from what is anticipated; or, as in the current situation, the economic forecasts underlying fiscal policy might turn out to be wrong. Finally, the large difference between temporary and permanent fiscal shocks means that for the effectiveness of the fiscal policy measures it is of crucial importance that measures are believed by private agents not to become permanent. However, the latter is not always the case.

It is thus reasonable to assume that fiscal policy represents a source of shocks. The key question then is whether a higher correlation of these shocks (presumably because of tighter cooperation) is desirable. The simple model used by Belke and Gros (2009) which was designed for "normal" economic times just serves to illustrate a general idea, which should hold up in more sophisticated models as well. Our main result is that in general it might be better to have independent national fiscal policies that are not coordinated (or at least not correlated) under EMU, because this leads to risk diversification: the variance of a sum of shocks is lower the lower the covariance among the individual components.

The argument that independent national fiscal policies are preferable because of risk diversification is not new and was already documented in the risk sharing literature by Sørensen, Yosha, van Wincoop and many others. Our analytical results suggest that the calls for fiscal policy coordination in ordinary times that are often repeated might be misguided. More fiscal policy coordination is also likely to lead to more correlated fiscal policy shocks and this might increase actual output variability. This result even holds if it is backed by a more complicated variant of the model used here developed by Belke and Gros (2008) who formally disentangle the discretionary component from the endogenous components (i.e. income dependent) of fiscal policies in a monetary union.

However, this conclusion is driven by our simple model structure and holds primarily as long no other large shocks emerge. However, in the case of the current economic crisis it is reasonable to assume that an exogenous shock to demand has hit the euro area countries significantly. With interest rates converging to zero, this negative shock has significant external effects which should ideally be internalized by a coordinated effort of national fiscal policies. However, this way of reasoning decisively hinges on the existence and significance of a liquidity trap in the euro area economies. In case of the latter, the spillovers of fiscal policy are of course positive because the interest rate does not react. Hence, in the Nash equilibrium, the fiscal stimulus initiated by the euro area countries is sub-optimally low.

But the existence of a liquidity trap cannot be taken for granted. As the saying goes, for instance the German economy currently is on the ropes of a liquidity trap. Fearfully, the economic agents are hoarding their cash. Monetary policy, i.e. lower interest rates, is ineffective in this precarious situation. Is the government not able to do better in this situation than to enact counter-cyclical fiscal policy measures? As is well-known but controversially discussed only recently in the ECB's February press conferences after the council meeting, John Maynard Keynes described with the notion of a liquidity trap a scenario in which an increasing money supply is not able to lower bond yields even further. However, actual data do not correspond with this view. The recent interest cuts by the ECB have de facto lowered the returns of government bonds awfully well. Accordingly, the current yield of outstanding German government bonds has fallen to historical lows. Hence, there is no a priori argument – at least from the German perspective - that fiscal policy is needed because monetary policy is helpless.

Fiscal policy as the generic solution to sustain demand?

Taking the dire outlook as a starting point, politicians and economists are pondering about what could be done to keep the real economy from collapsing and to stabilize it? The generic answer which is constantly brought forth since the collapse of Lehman Brothers seems to be *to use fiscal policy to sustain demand*, since monetary policy with its main interest rates approaching zero will not be effective any more. Fiscal policy seems particularly appropriate since our macroeconomic models tell us that fiscal policy multipliers increase when more economic agents become liquidity constrained because they are then likely to spend any additional income they receive. But a closer look at what fiscal policy can actually achieve suggests that one should be very cautious in expecting too much from this policy instrument.

This is a foregone conclusion if one accepts that fiscal policy can also be a source of shocks. There are a variety of reasons why fiscal policy could be destabilizing in the context of the current crisis: policy makers do not have full control over the outcome, at times the effect of a certain measure (e.g. a tax reform) is quite different from what is anticipated; or, as in the current situation, the economic forecasts underlying fiscal policy might turn out to be wrong. Finally, the large difference between temporary and permanent fiscal shocks means that for the effectiveness of the fiscal policy measures it is of crucial importance that measures are believed by private agents not to become permanent. However, the latter is not always the case.

The main driver of the current economic weakness is uncertainty that made firms postpone hiring decisions and investment. But economic and financial uncertainty is now falling, according to all indicators of the financial fear factor. Obviously, the global policy response to the financial and economic crisis has calmed stock markets “as the fears of an economic Armageddon have subsided”. Also political uncertainty has dropped as many world leaders have clarified the details of their stimulus packages.^[1] Hopefully, thus, the economic medicine has not been administered just as the patient is striving to leave the hospital.

The estimated multiplier shrinks and shrinks and ...

Depending on their ideological color, fiscal policy proposals by German political parties varied from deficit-financed spending increases, balanced budget spending increases (financed with higher taxes) to deficit financed tax cuts until the turn-of-year 2008/09. However, these proposals did not become more appropriate the more they were contended with increasing frequency and vehemence. The degree of the liquidity constraint across the EU and, by this, the potential magnitude of the fiscal multipliers proves to be highly different. This finding implies that the effectiveness of fiscal policy will vary greatly across the EU. Moreover, the stabilizing impacts of fiscal policy in general are often largely overestimated. The often emphasized multiplier effect of additional government spending or of temporary tax cuts is according to pertinent studies often hardly larger than one, especially for Germany.

Economists have produced only few empirical studies for Germany so far. While older macroeconomic models in general predict a positive impact of expansionary policies on output in the short term, current SVAR studies disagree on the direction of the expected effects. There is, however, much agreement that the effects are likely to be small. Some studies even come up with numbers lower than one. Robert J. Barro (2009), for instance, calculates a multiplier based on U.S. wartime experiences of 0.8. He even argues that there are reasons to believe that the war-based multiplier of 0.8 substantially overstates the

multiplier that applies to peacetime government purchases. Most recently, Cogan, Cwik, Taylor and Wieland (2009) show that government spending multipliers in an alternative empirically-estimated and widely-cited new Keynesian model are even much smaller than 0.8; the estimated stimulus is extremely small with GDP. Nevertheless, the Team Obama, for instance, is reportedly using an astonishing and incredible number of around 1.5!

How to proceed now?

The view that a wait-and-see-strategy of fiscal policy is beneficial for the German economy appears surprising at first glance and is by far not shared by the majority of economists. Since a few months – after many research institutes immediately followed the IMF in its shockingly negative growth forecast this assessment has surprisingly become clear minority position. Even economists who regard themselves as liberal tend to outdo each other with a bulk of proposals how to cope with the crisis with more government money. In this vein, Martin Feldstein recently observed that not more than two years ago there was a broad consensus among economists that the active usage of fiscal policy does not make much sense. Today - he argued - also those researchers which were rather negatory only some weeks ago are suddenly in favor of the latter. But there are some exceptions from this general observation, among them the German economist Stefan Homburg.

To reject large fiscal stimulus packages may of course not conform to the spirit of the times (Joerg Kraemer has recently published an excellent discussion of the phenomenon of the German „zeitgeist“), but the latter tends to change rather quickly. As soon as it will become apparent that the comparison with the Great Depression was a clear misjudgment, the hangover will follow and the public opinion will change sides again.

Those politically responsible will be asked why they have used the tax payer so unresponsively as a host for the rescue of some large enterprises and banks. Since experience clearly speaks against the success of fiscal stimulus packages. For instance, Germany fell flat on its face with its expenditure programmes in the 1970s. Government debt started to grow at unprecedented rates, but unfortunately unemployment increased in parallel. Only recently, also the US has not made satisfying experiences. The US treasury had distributed in early summer 2008 tax bonuses of around 120 billion \$. However, the citizens have saved more than 75 percent of this package. The effect on total consumption is nearly evaporated by now because the consumers have acted in a sensible way. They have run into much too high debts during the time of cheap money.

As compared with the basically more optimistic assessment of monetary policy efficacy in the current crisis, the perspectives of fiscal policy measures to work are rather bleak. Government fiscal stimulus packages designed in order to fight the crisis have to be rejected not only with an eye on the option value of waiting under uncertainty. Contrary to the beliefs under the regime of the current “zeitgeist”, it will turn out to be a great fallacy to believe that one could really steer the consumption of millions of people. First and foremost, one sells money down the river which could be spent in more useful directions. Just as in the 1980s, when extreme supply-side views on tax cuts were unjustified in the US, it is wrong now to think that added government spending is free.

Second, the old Keynesian argument that stimulating demand in times of crisis is necessary to reduce current account imbalances for instance within the euro area is shortsighted because it simply fades out that the cumulated loss in Italian and other euro area countries' competitiveness has become so severe that its negative effects could no longer be offset by the housing boom which anyway came to a drastic end in the wake of the financial crisis. Again, this is evidence of a further case in which a significant lack of competitiveness simply cannot sustainably be cushioned and covered by stimulating domestic demand. Instead, it can be shown empirically that structural reforms in weaker euro area countries are on the agenda more pressingly than ever. This argument can be generalized for several other euro area member countries as, for instance Portugal and Greece and, later on, also Ireland and Spain.

Finally, global coordination of fiscal stimulus packages which are intended to be increased in lockstep do certainly not change any relative prices, does not at all alter the terms-of-trade among participating countries and, hence, does not help the real sectors of the economies but only burns down external savings of some countries like Germany by inflation. Also from this point of view, it is true that participants in the G20 summit in London will be well-advised to attach more importance to new rules of financial market governance than to a global coordination of fiscal stimulus programmes.

Background Papers

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[1] See Bloem, N., Floetotto, M. (2009), The recession will be over
sooner than you think, VoxEU, January 12,
<http://www.voxeu.org/index.php?q=node/2785>. They report that the
key
measures of uncertainty have dropped so rapidly that they believe
growth will resume by mid-2009.

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