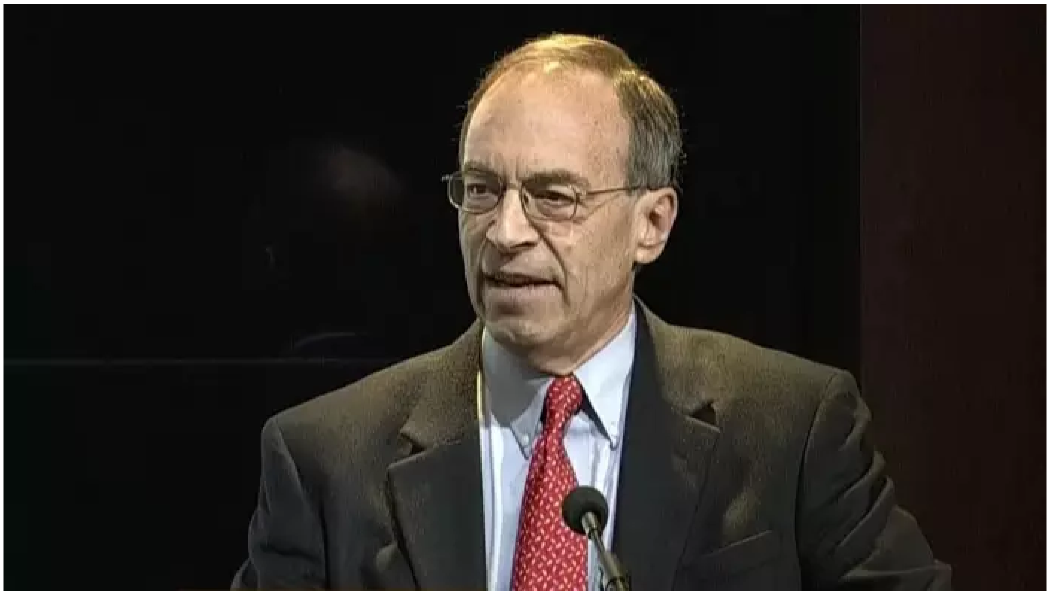
World Economy

Global economic growth

Rebound revives questions over the value of fiscal virtue

A shift among economists on spending and tax is not shared by policymakers



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Faster economic growth last year coincided with smaller tax rises and public spending cuts in many countries. That is at least partly why many economists are so keen on the use of fiscal policy — spending and tax — to stabilise economies.

Growth in 2016 and 2017 has been faster than many predicted early last year, when fear of a potential new global downturn played a role in fiscal policymakers loosening the purse strings last year.

Although this loosening coincided with an acceleration in growth, it was not the only explanation for the rebound. "It does seem that most of the action was related to other factors," says Vitor Gaspar, director of the fiscal affairs department at the International Monetary Fund.

Growth was also helped by businesses and individuals having easier access to credit as banks continued rebuilding their balance sheets. In the eurozone, the European Central Bank expanded quantitative easing and business confidence increased, which helped boost private investment. An increase in commodity prices helped ease pressure on countries that rely on production of those goods.

There was broad agreement in 2008 and into 2009 that borrowing should be allowed to rise to cushion the impact of the financial crisis. But by 2010, with growth returning, policymakers were keen that it should be scaled back to reassure markets that government debt would not get out of hand, and so head off a sharp rise in borrowing costs.

Many economists agreed, but their views have since shifted. “We’ve learned over the past 10 years that fiscal policy can have pretty powerful effects in deep recessions when central banks have hit very low policy interest rates,” says Alan Auerbach, professor of economics at Berkeley. “We’ve also learnt, at least from the experience in the UK and the US, that we would have benefited from . . . turning less immediately to measures aimed at deficit reduction.”

The evolution of thinking on fiscal policy has been less radical than the soul-searching among monetary policymakers, who are reassessing the models they use to inform interest rate setting.

However, the period since the financial crisis has been unusual in three main ways that have affected some economists’ views on when and how to use fiscal policy. The effects of the crisis have lasted much longer than after previous downturns; many monetary policymakers believe they are close to the limits of their policy toolboxes; and the interest rates on debt issued by many governments, including long-term debt, remain extremely low despite a big rise in debt levels.

Under these circumstances, there is a strong case for loosening fiscal policy and borrowing more. This is especially true for policies that put money directly into the hands of people who will spend it quickly and counteract sluggish demand, and for investments that have long-term benefits.

“Economies do not self-stabilise,” said Olivier Blanchard, senior fellow at the Peterson Institute for International Economics, reflecting at a conference on macroeconomic policy, on lessons of the financial crisis for monetary and fiscal policy.

But politicians and advisers in the developed world still emphasise reining in government deficits and cutting debt, particularly if there appears to be little spare capacity in the economy.

“Markets can ignore or underweight risks, including fiscal risks, for long periods,” said Robert Rubin, former US Treasury Secretary at the Peterson Institute conference. “Until they don’t — and then the reaction can be rapid and savage.”

As for the low level of interest rates charged on the debt issued by many major economy governments since 2008, policymakers say they cannot rely on this being repeated.

Eswar Prasad, a senior fellow at the Brookings Institution think-tank, is sympathetic to policymakers’ concerns about abrupt market reactions. But he hopes that in the next recession, “governments would test markets a little more . . . instead of letting a desire for fiscal virtue get in the way”.

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