Fiscal Policy

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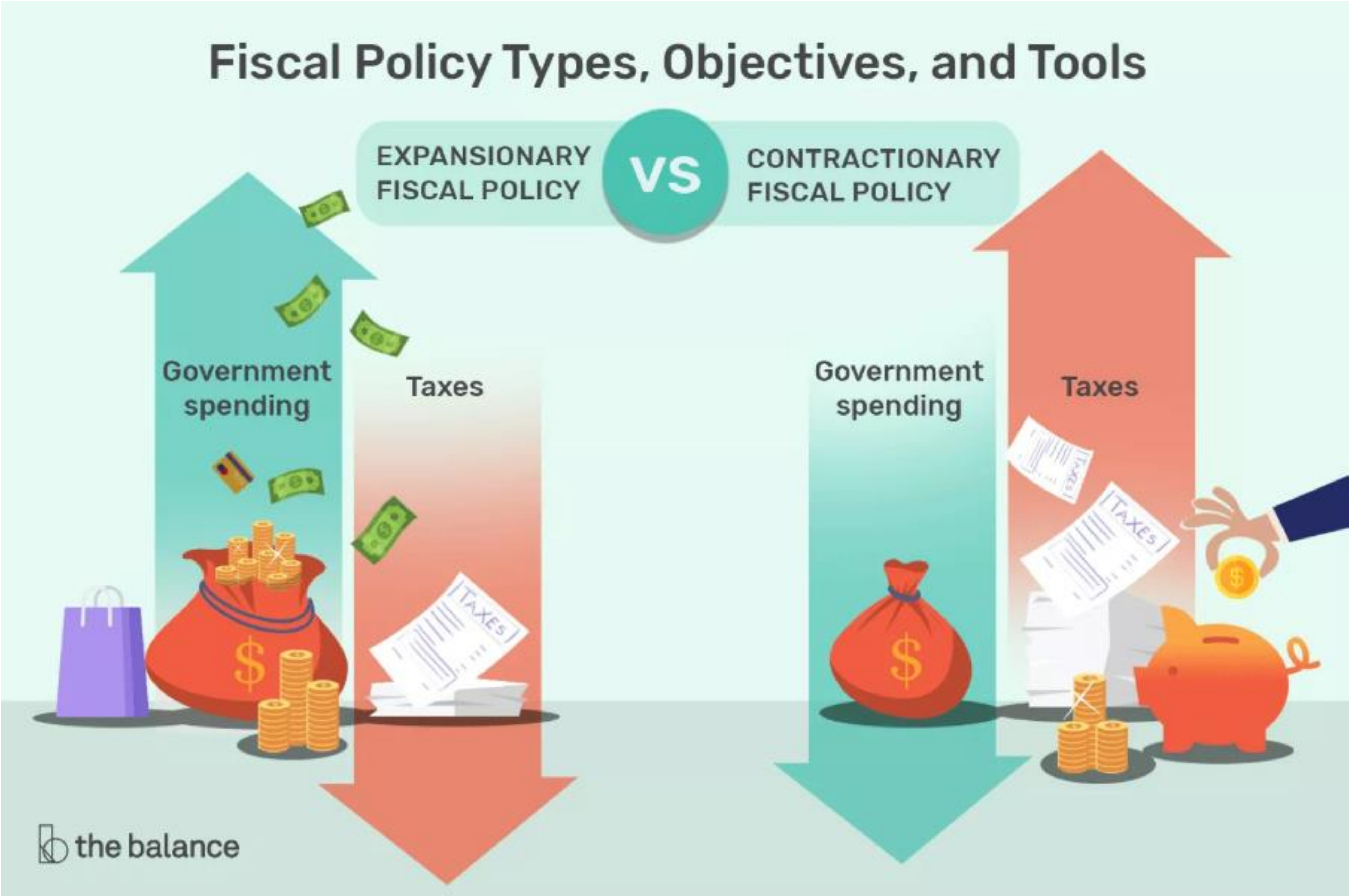

Fiscal Policy Types, Objectives, and Tools
EXPANSIONARY FISCAL POLICY
VS
CONTRACTIONARY FISCAL POLICY
Government spending
Taxes
Government spending
Taxes
the balance

How does the fiscal policy work?

Does the fiscal policy always work?


Case
Study

Global Financial Crisis 2008

10 years later: 4 fiscal policy lessons from the global financial crisis

<u>Views today:</u>

- Introduced as a **temporary stimulus**
- However, efforts were **insufficient to consolidate** public finances as the **crisis faded**
- **Fiscal deficits have persisted**, **debt** has climbed, and **fiscal buffers** have been depleted

Lesson 1

Counter-cyclical fiscal policy can be an effective tool in crises.

- President **Barack Obama's** fiscal stimulus package: **American Recovery and Reinvestment Act 2009**
- **Components of ARRA**:

FP Tools

- Immediate relief for **families** through **tax cuts** and **unemployment benefits** → **Consumption** ↑
- **Infrastructure** projects → **Job** creation
- **Expand healthcare**
- **Improve education**
- Help **small businesses** through **tax deductions** and **loan guarantees**

Lesson 2

USA's General Government Deficit as a % of GDP

Source: OECD National Accounts Statistics

Fiscal policy should be counter-cyclical in both good and bad times.

- Debts accumulated during a crisis must be repaid and buffers should be rebuilt in calm times

Lesson 3

It is important to assess the nature of the shock and the appropriate size of the fiscal stimulus.

- It is often difficult to assess ***a priori*** **if a shock is temporary or structural**
- Nonetheless, if economists estimate growth to be **below potential year in and year out, it is likely that the potential has shifted down**
- **Attempting to return to the stronger growth** before the crisis can lead to **more fiscal expansion than warranted**
- It **distracts governments** from focusing on **productivity reforms**

Lesson 4

Fiscal policy alone cannot fix structural problems, and it may intensify them.

- The **underlying causes** of the financial crisis were **financial imbalances**
- **Fiscal stimulus** was an effective tool for **preventing a sharper contraction** in economic activity
- Thus fiscal stimulus can provide **short-term relief**
- But for the **long-term health** of the economy, we need **structural and productivity reforms**
- **Examples** around the world include governments **baling out banks or supporting uncompetitive industries** to stay afloat
- **In conflict** with country's **long-term goals**

Fiscal Stimulus : India vs China

CHINA	INDIA
Equivalent to **6% of GDP**	Equivalent to **3% of GDP**
Infrastructure investments: railways, highways, airports and electricity grids	**Tax cuts, tax-free bonds** to support public– private infrastructure projects
Massive credit growth to spur the economy	**Social security programs** such as a new pension scheme
Reduction of business processing fees, trade facilitation measures, **tax cuts**, and government support for technological innovation	**Price and income supports**
Support for small and medium enterprises **(SMEs)**	Agricultural development through **debt relief program** for farmers

✓ **INFRASTRUCTURE BASED**

✗ **CONSUMPTION BASED**

Fiscal + Monetary : India vs China

CHINA	INDIA
Easy-money policies have fueled a **potential property-price bubble**	India managed to achieve its substantial growth **without putting its banking sector at risk**
Growing number of **nonperforming loans (NPLs)**	India's growth, though less stellar, does have the reassuring factor that the **risks of asset price bubbles are less**

✗ **MORE RISKY**

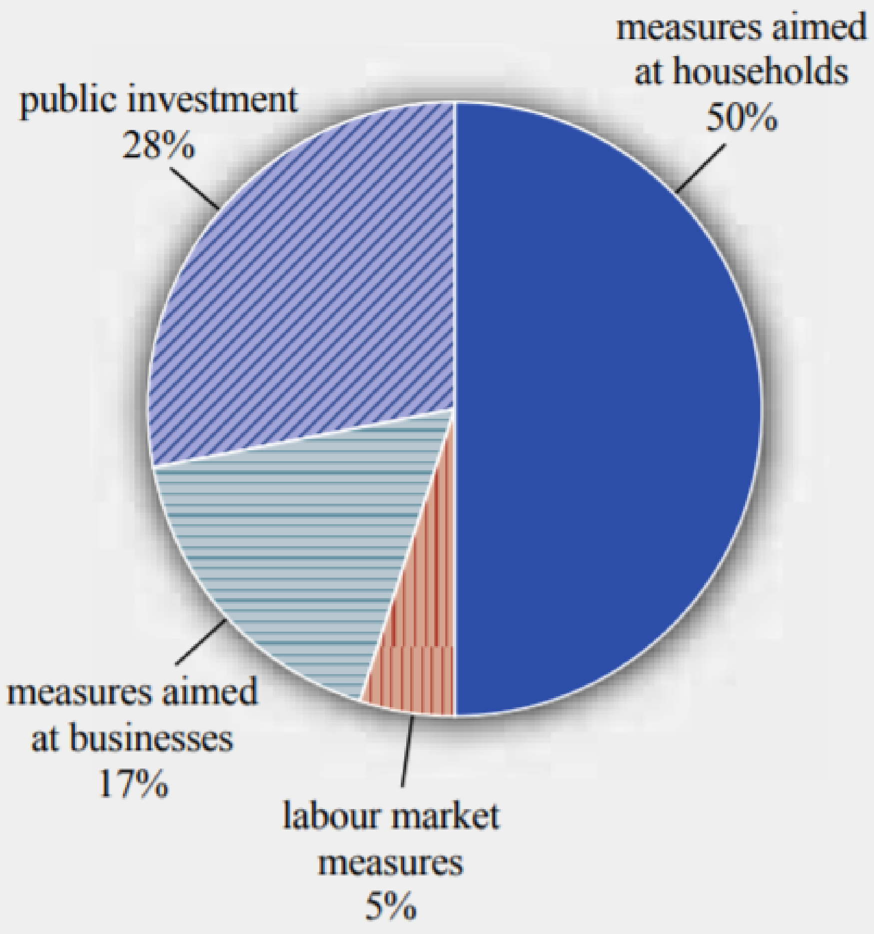
✓ **SLOW AND STEADY WINS THE RACE**

Eurozone Crisis 2009

Fiscal Stimulus

Chart 3 Composition of fiscal stimulus measures in the euro area (2009-10)

(euro area; share in terms of budgetary impact)



Sources: European Commission (2009d), ECB calculations.

Lessons

- After an **initial fiscal policy stimulus**, Eurozone governments **switched** dramatically towards **austerity** in the years **2010-2014**
- Governments were **reducing spending** in order to bring their **debt levels under control**
- But **GDP fell so much** that the actual effect was to **push up the ratio of debt to GDP**
- As a result, **debt** became even **less sustainable than before** the austerity measures were implemented
- Most experts now agree that these policies had such **damaging and persistent negative effects** on **growth** that they were **self-defeating**
- Even **today**, Euro governments continue to **struggle with high debt levels**, leaving **little room** for a **fiscal policy stimulus** if a recession happens

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