CASE Network E-briefs

12/2009 December 2009

# From fiscal stimulus to fiscal crisis

By Marek Dąbrowski, CASE President

As the global financial crisis entered its most dramatic phase, in the second half of 2008, the International Monetary Fund (IMF), many governments and several distinguished scholars advocated expansionary fiscal policy as the second most effective tool (after monetary stimulus) to fight deep recession and deflation. Now, more than a year later, the previous excitement surrounding the supposed power of fiscal stimulus largely disappeared and instead has been replaced by rising concerns over the sustainability of public finances in many countries. Unfortunately, the previous enthusiasts of the active counter-cyclical fiscal policy have not always realized the causality between the two.

## Automatic vs. discretionary stimulus

Conceptually, a countercyclical fiscal policy consists of two components: (i) the so-called automatic fiscal stabilizer, and (ii) discretionary fiscal stimulus. The first one originates from pro-cyclicality of budget revenues (which remain in more or less proportional relation to GDP) and counter-cyclicality of public expenditures (especially in social welfare spending). Thus, when the economy enters a downturn revenues decline and expenditures increase thereby automatically deteriorating the fiscal balance. In terms of demand management, the automatic fiscal stabilizer signifies that government demand remains at its previous level while private sector demand receives some support through increased social transfers.

The second component assumes special demand-support measures going beyond automatic fiscal stabilizers. They may include both additional public spending such as social benefits, subsidies, extra public investments and tax cuts. Depending on the composition of stimulus packages they are intended to increase government demand, private demand, or both. While conceptually clear, in operational and statistical terms it is not always easy to distinguish these two components, i.e. determine where automatic stabilizers end and discretionary fiscal stimulus starts to work.

## Pitfalls of countercyclical fiscal policy

Enthusiasts of fiscal stimulus usually refer back to the 1930s when, as they claim, the substantial expansion of government expenditures helped to overcome the Great Depression (at least in countries such as the United States and Germany). However, we now live in a much different world. The global economy is much more integrated and the effects of fiscal expansion in one country easily spill over to others through both trade and financial channels. This is why last year advocates of fiscal stimulus called for coordinated action among all major governments in order to avoid the danger of free riding.

However, such a coordinated fiscal response has not happened even within the European Union (EU). First, the temptation of free riding played a certain role, especially in the case of smaller countries easily benefiting from stimulus plans launched by larger neighbors or trade partners. Second, some governments were constrained by domestic fiscal rules or did not share political enthusiasm in respect to discretionary fiscal policies. Third, and most importantly, several countries faced borrowing constraints within financial markets and, as a result, they could not allow even automatic fiscal stabilizer to work at full scale[1].

The failure of cross-country coordination provoked a wave of so-called economic nationalism and other forms of beggar-thy-neighbor policies. From the domestic political economy point of view it is easy to understand governments' desire to avoid leakage of taxpayer money outside national borders. However, from a global point of view, we witnessed the emergence of destabilizing protectionist policies including "buy American, French, etc." accompanying public expenditure programs, limitation of financial support to local subsidiaries of trans-national corporations at the expense of those located in other countries, and discrimination of migrants against local employees. Fortunately, one can hope that forthcoming economic recovery, on the one

[1] See more M. Dabrowski "The Global Financial Crisis: Lessons for European Integration", CASE Network Studies & Analyses, No. 384, 2009.

hand, and necessity to address fiscal imbalances, on the other, will decrease this appetite for protectionist support.

The list of distortions caused by stimulus packages is much longer. First, they slowed structural adjustment in sectors and industries that overgrew in the period preceding the crisis, particularly the auto, finance and real estate sectors. Second, they financed an increasing share of public ownership in these troubled sectors, not always determining the clear strategies of returning to private ownership. Third, many ad hoc government spending programs were simply a waste of public money. Fourth, they ruined the culture of fiscal constraint, which had been built up over years and decades. This is perhaps most visible in respect to EU fiscal surveillance rules determined in both the Maastricht Treaty and Stability and Growth Pact. As of December 2009, 20 out of 27 EU member states remain under the excessive deficit procedure and a few more will join them in 2010. Finally, fiscal stimulus can be launched quite easily but its withdrawal usually meets significant political resistance.

## On the way to debt trap

There is no certainty whether fiscal stimulus was effective in achieving its intended macroeconomic goals. Advocates of fiscal activism refer to signs of economic recovery as the proof that this was the correct policy choice. However, recovery could be caused by monetary rather than fiscal stimulus, which usually works with a longer time lag. At the moment, we do not have enough macroeconomic data to verify who is right. Nevertheless, whatever answer will be given by future analyses, there is no doubt that the price of countercyclical fiscal policies in 2008 and 2009 has been extremely high.

As seen in Table 1 the gross public debt-to-GDP ratio increased dramatically in all major developed economies in 2008 and 2009 and will continue to grow over the next several years. In other words, we are losing control over the dynamics of public debt. It is worth noting that the IMF projection presented in Table 1 is based on an optimistic growth assumption for the periods 2010-2014. Thus, the actual trend may be even worse than the one presented in this projection.

**Table 1: Gross public debt, in % of GDP**

| Country | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 |
|---|---|---|---|---|---|---|---|---|---|---|
| France | 66.4 | 63.6 | 63.8 | 67.5 | 76.7 | 82.6 | 86.6 | 89.6 | 91.5 | 92.6 |
| Germany | 66.4 | 65.9 | 63.4 | 67.1 | 78.7 | 84.5 | 87.8 | 89.7 | 90.1 | 89.3 |
| Italy | 105.8 | 106.5 | 103.5 | 105.7 | 115.8 | 120.1 | 123.5 | 126.0 | 127.9 | 128.5 |
| Japan | 191.6 | 191.3 | 187.7 | 196.6 | 218.6 | 227.0 | 231.9 | 237.2 | 241.8 | 245.6 |
| UK | 42.1 | 43.2 | 44.1 | 52.0 | 68.7 | 81.7 | 89.3 | 94.1 | 96.9 | 98.3 |
| US | 61.4 | 60.9 | 61.9 | 70.4 | 84.8 | 93.6 | 97.7 | 100.9 | 104.3 | 108.2 |

Note: data for 2009 and next years represent IMF estimates

Source: International Monetary Fund, World Economic Outlook Database, October 2009

**Table 2: General government balance, in % of GDP**

| Country | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 |
|---|---|---|---|---|---|---|---|
| France | -4.1 | -3.6 | -2.9 | -2.3 | -2.7 | -3.4 | -7.0 |
| Germany | -4.0 | -3.8 | -3.3 | -1.5 | -0.5 | -0.1 | -4.2 |
| Italy | -3.5 | -3.5 | -4.3 | -3.3 | -1.5 | -2.7 | -5.6 |
| Japan | -8.0 | -6.2 | -5.0 | -4.0 | -2.5 | -5.8 | -10.5 |
| UK | -3.3 | -3.3 | -3.3 | -2.6 | -2.6 | -5.1 | -11.6 |
| US | -4.8 | -4.3 | -3.2 | -2.2 | -2.8 | -5.9 | -12.5 |

Note: data for 2009 and next years represent IMF estimates

Source: International Monetary Fund, World Economic Outlook Database, October 2009

Tables 1 and 2 also allow for another unpleasant observation: these economies ran unsustainable fiscal policies prior to the crisis (apart from Germany, which made a fiscal consolidation effort in 2006-2008). Thus, they did not have room for countercyclical fiscal policies when the crisis began.

Going further, one can argue that the traditional indicator of fiscal sustainability, i.e. debt-to-GDP ratio revealed serious analytical weaknesses in the recent crisis . It is enough to have a sharp GDP decline (shrinking denominator) and associated deterioration of fiscal balance, to automatically lead to higher public debt

(rising nominator) and the dramatically deteriorating debt-to-GDP ratio. The additional negative shock can come from currency depreciation in countries that have a substantial portion of their public debt denominated in foreign currency. For example, four EU economies, which in 2007 represented low to moderate levels of public debt-to-GDP, deteriorated their record dramatically over the two crisis years: by 18.2% of GDP in Spain, by 24.2% of GDP in Latvia, by 24.4% of GDP in the UK, and by 50.7% of GDP in Ireland.

## Challenges ahead

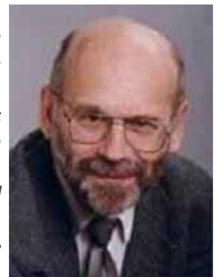
Unless radical fiscal adjustment measures are adopted soon several developed countries will face the danger of a debt trap. This danger will be increasingly noted by financial markets and rating agencies. The latter has already started to downgrade ratings (raising the risk premia on government bonds) of some developed economies.

All these unfavorable trends will not remain without negative consequences for the world economy. First, higher public sector borrowing requirements in the largest economies will result in a smaller portion of savings available for private sector investments and for emerging-market economies. Sooner or later real interest rates must increase. This will harm economic growth worldwide but especially in Western Europe and Japan, which face serious structural and institutional rigidities. In turn, slower growth means fewer opportunities to “outgrow” the debt (as result of automatic fiscal stabilizers working in opposite direction).

The increasing public debt may create pressure for looser monetary policy to provide enough liquidity to roll-over debt instruments in the short term or even inflate out part of the past debt stock. However, such a temptation would be very dangerous for macroeconomic stability and growth prospects. Most likely, the potential lenders would preempt such a maneuver by asking higher yields for newly issued government bonds. Market interest rates, both nominal and real, would deteriorate borrowing conditions in the private sector, especially for small and medium size enterprises. The inflation pressure (before being felt domestically) would be first exported to emerging markets as it happened between 2003 and 2008.

The danger of inflationary policy may appear in the U.S. where the Federal Reserve Board used to compromise its anti-inflationary mission in favor of other policy goals. Fortunately, the European Central Bank, which is constrained by its quite rigid statutory rules, is less likely to choose this course of action. However, taking into consideration the role of the U.S. dollar as the global currency, it may be enough to push the global economy into another macroeconomic and/or financial crisis.

*__Dr. Marek Dabrowski__ is President of CASE. From the end of the1980s, he has been involved in policy advising and policy research in Central and Eastern Europe, Central Asia, Africa and the Middle East, as well as numerous international research projects on monetary and fiscal policies, currency crises, international financial architecture, EU and EMU enlargement, European integration, European Neighbourhood Policy and the political economy of transition.*



The opinions expressed in this publication are solely the author’s; they do not necessarily reflect the views of CASE - Center for Social and Economic Research, nor any of its partner organizations in the CASE Network.

CASE E-Brief Editor: Ewa Błaszczynska