The New View of Fiscal Policy and Its Application

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1. **Motivation**
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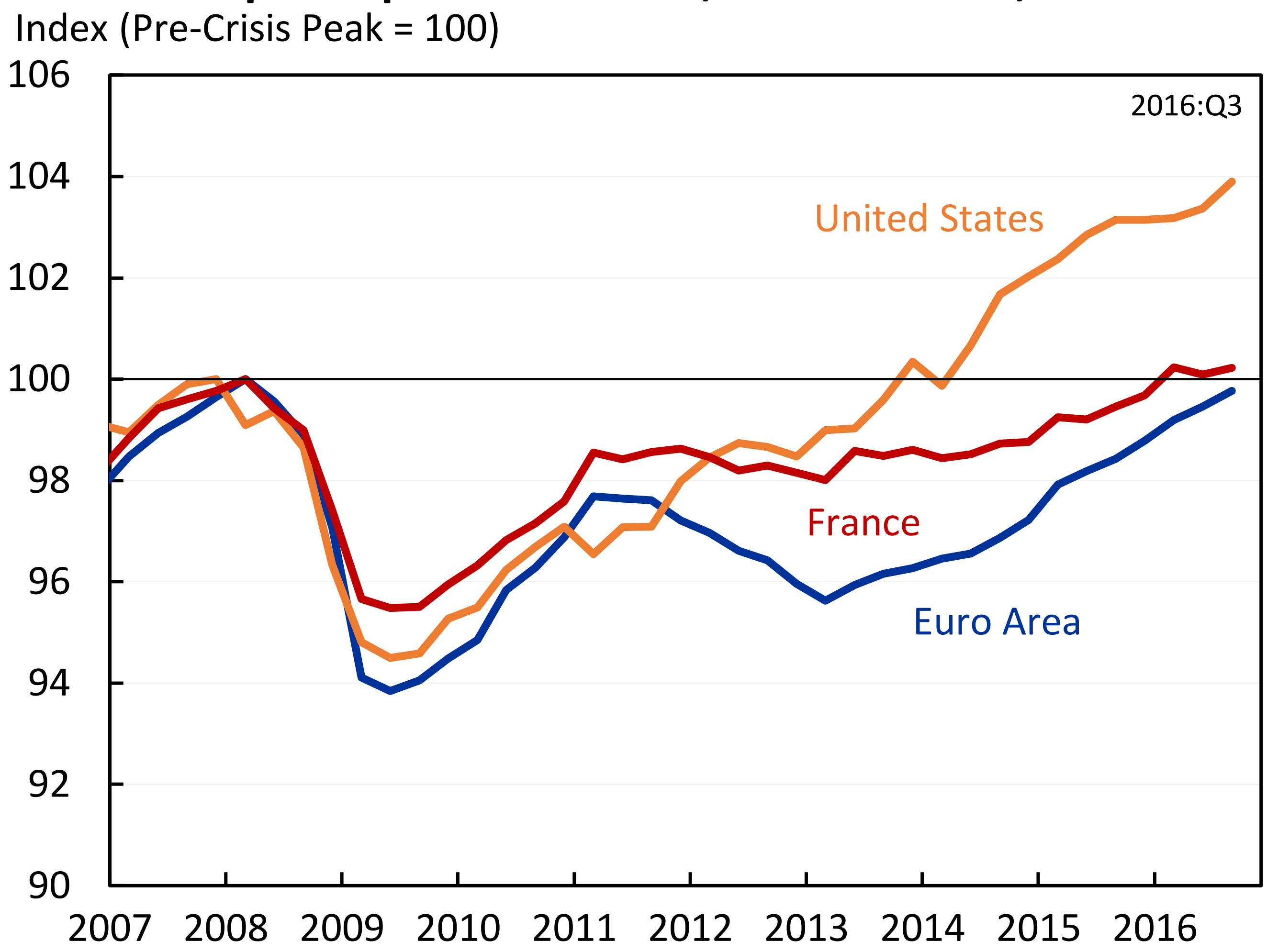
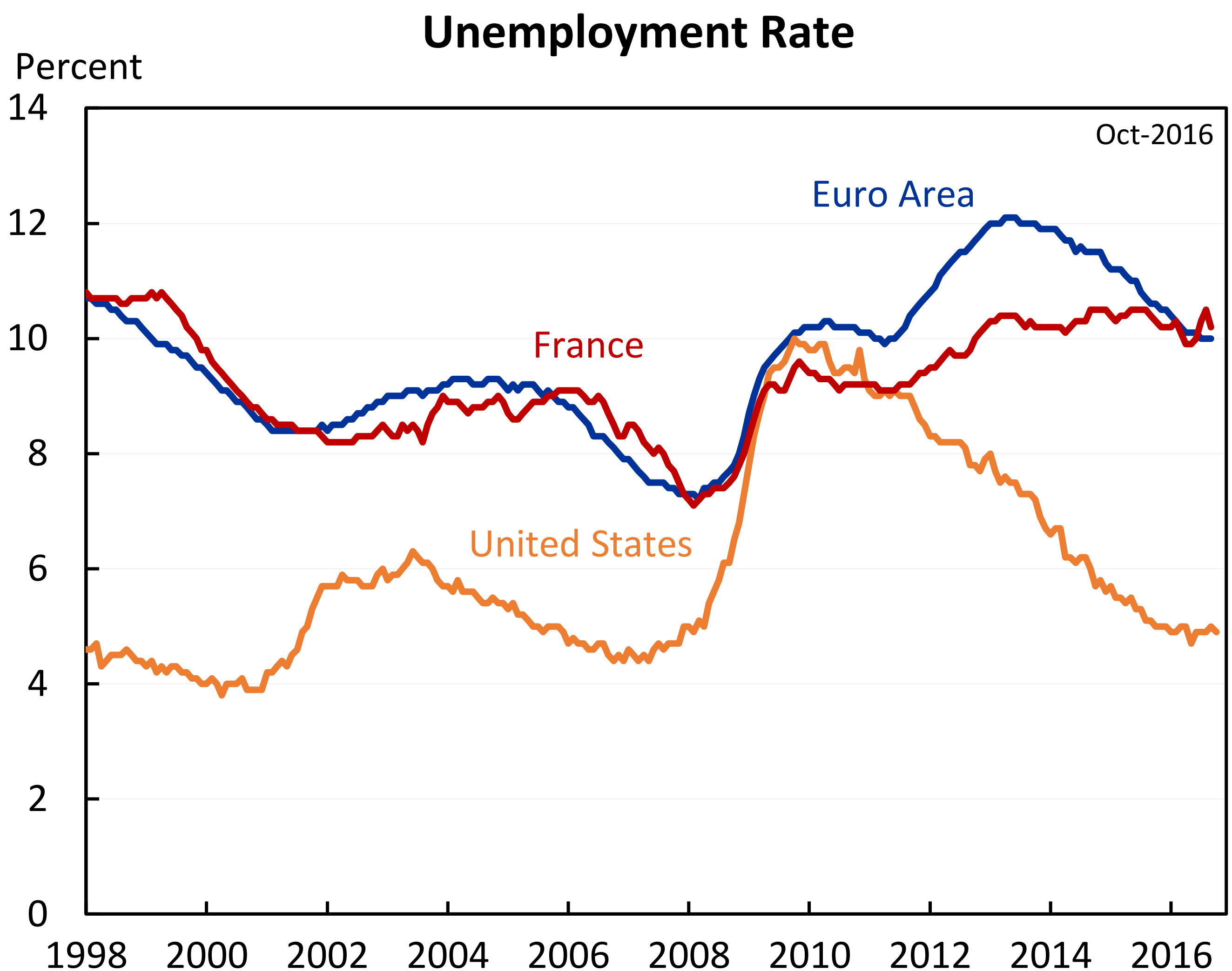
Substantial Slack Remains in Europe: Output

Real GDP per Capita: Euro Area, United States, and France



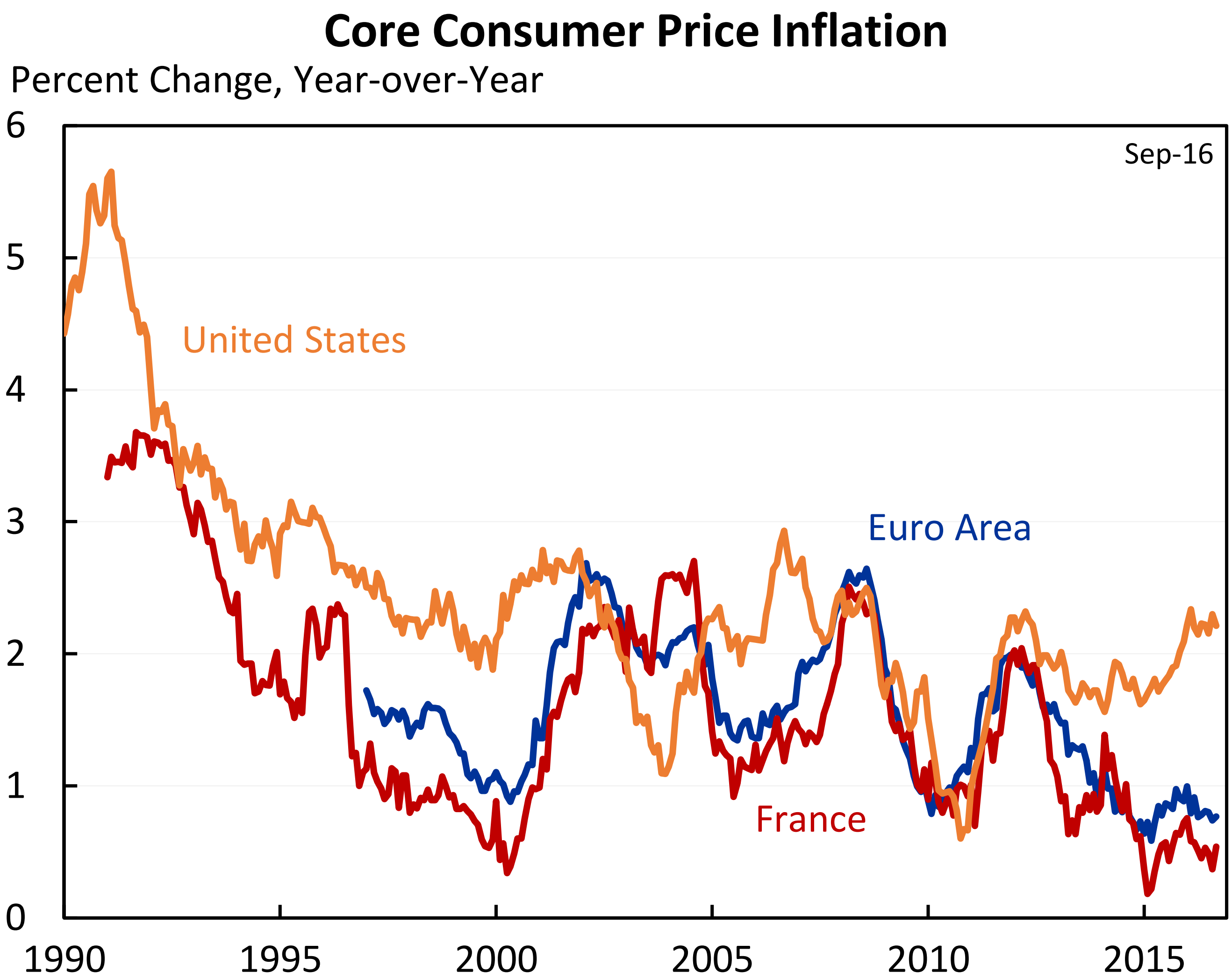
Note: Population data for euro area are quarterly interpolations of annual data.
Source: National sources via Haver Analytics; CEA calculations.

Substantial Slack Remains in Europe: Employment



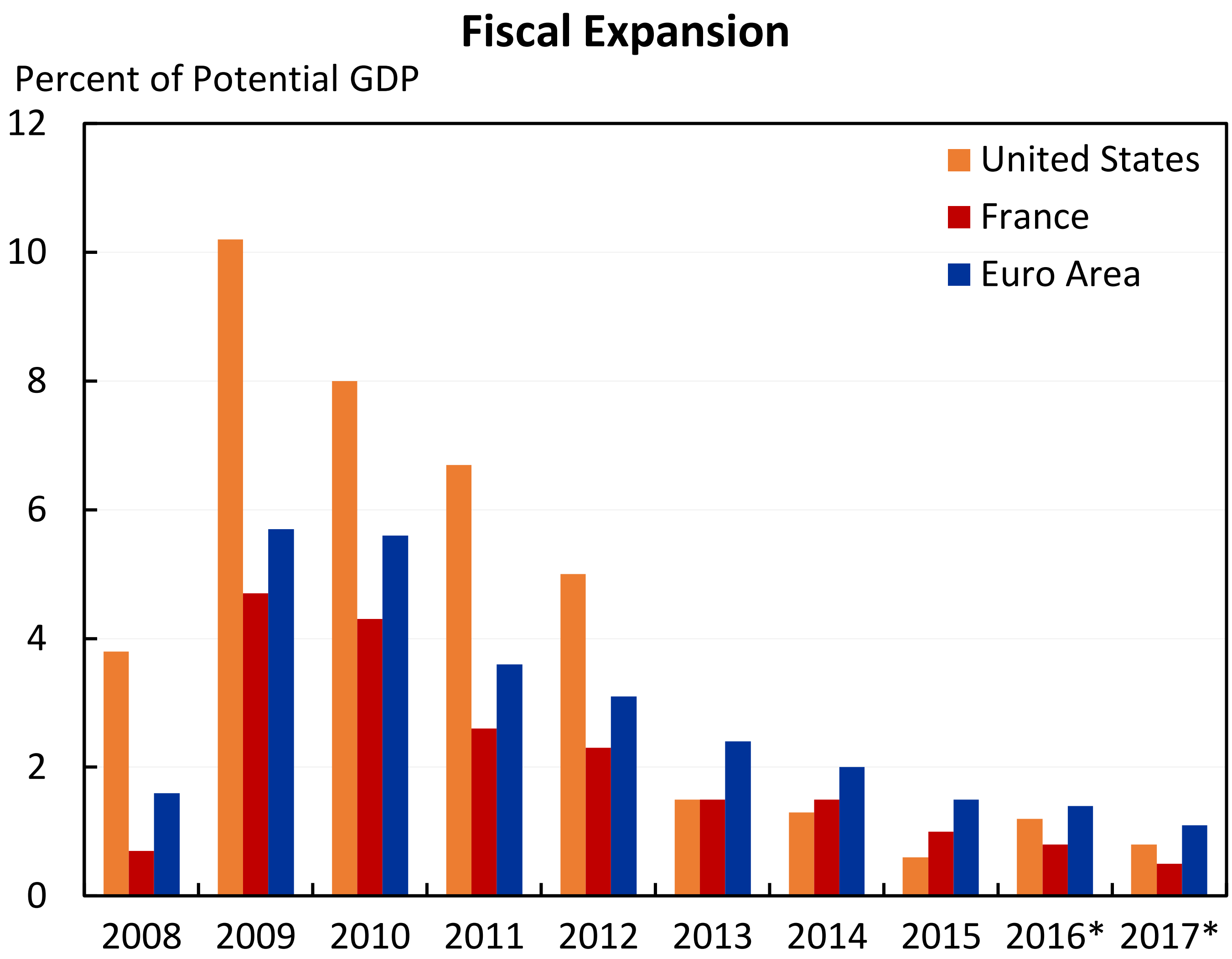
Source: National sources via Haver Analytics; CEA calculations.

Substantial Slack Remains in Europe: Inflation



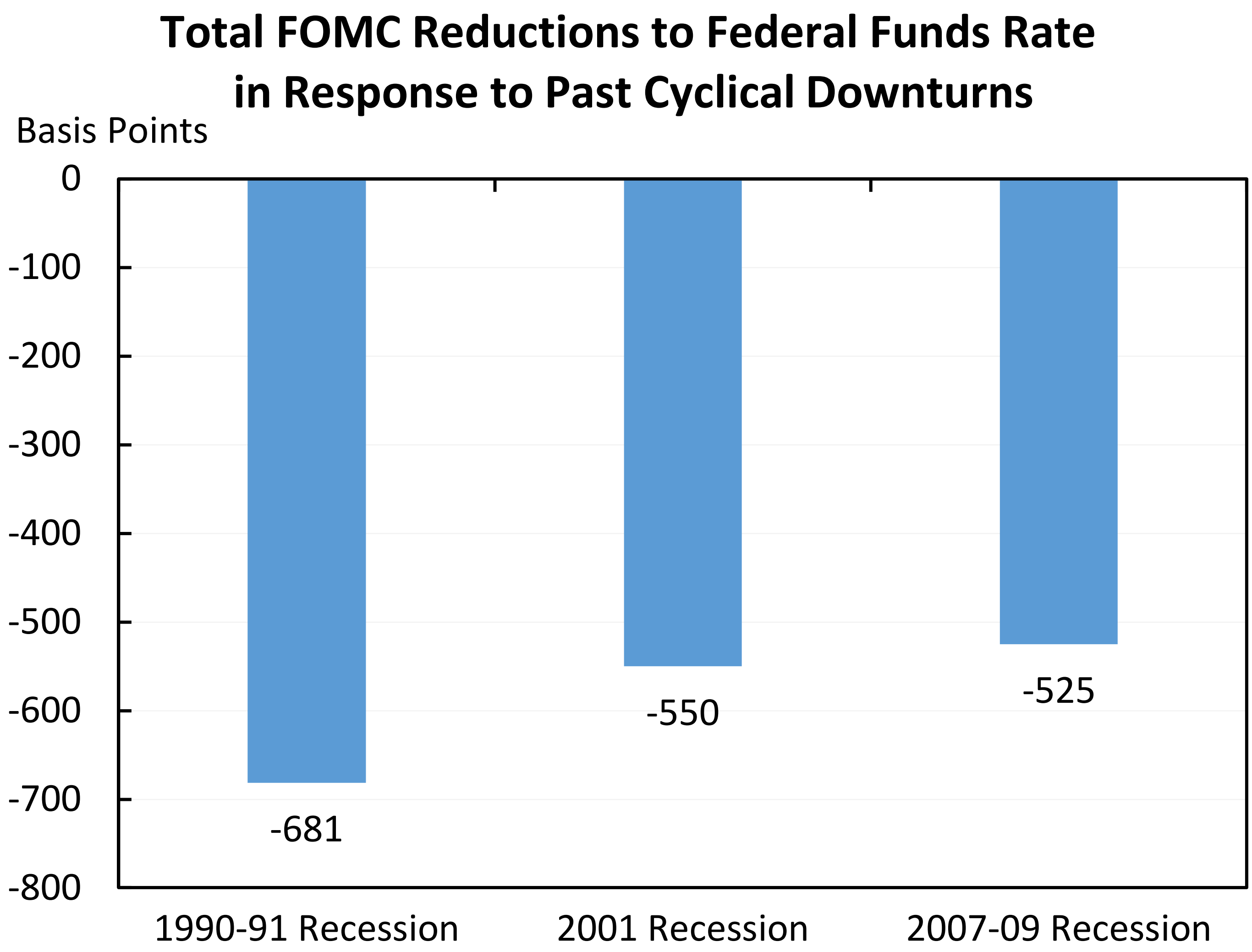
Note: Data for euro area and France are for the Harmonized Index of Consumer Prices (HICP) excluding energy and unprocessed food. Data for United States are for the Consumer Price Index for All Urban Consumers (CPI-U) excluding food and energy.
Source: National sources via Haver Analytics; CEA calculations.

Part of the Difference is Due to More Expansionary U.S. Fiscal Policy at the Onset of the Crisis



Note: Fiscal expansion calculated as the difference between the primary fiscal balance compared to 2007. Asterisks (*) indicate projections.
Source: International Monetary Fund, *Fiscal Monitor* (October 2016).

We All Need to Be Better Prepared for the Next Downturn



Note: Bars represent the difference between peak Federal funds rate prior to onset of recession and trough Federal funds rate during or after recession. For 2007-09 recession, the trough rate used is the lower bound (0.00 percent) set by the FOMC.
Source: Federal Reserve Board; CEA calculations.

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The "Old View" of Fiscal Policy

1. Discretionary fiscal policy is dominated by monetary policy as a stabilization tool.

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3. **The biggest fiscal policy priority should be the long-run fiscal balance.**

The "Old View" of Fiscal Policy

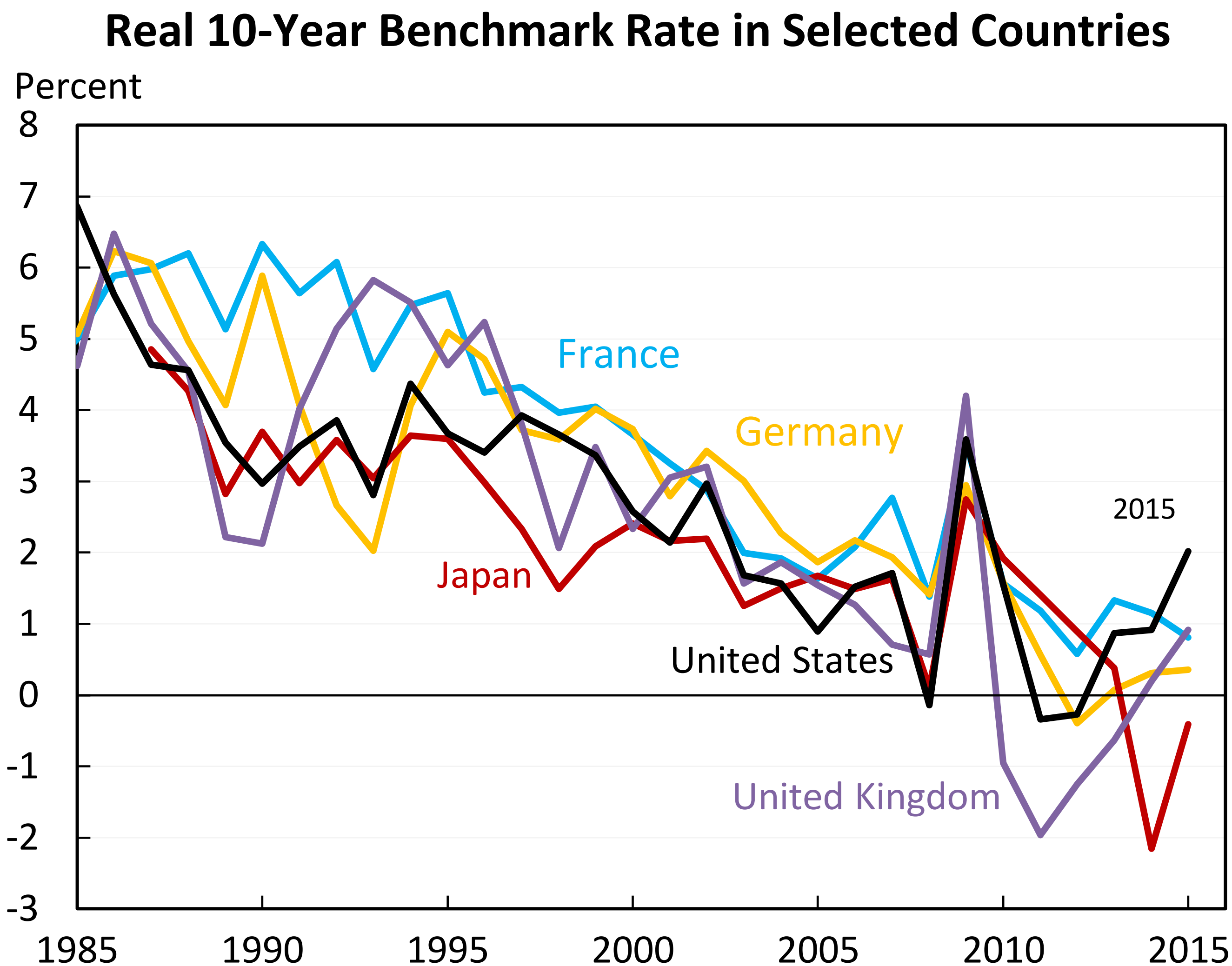
1. Discretionary fiscal policy is dominated by monetary policy as a stabilization tool.

2. Fiscal policy can be ineffective or have bad side effects.

3. The biggest fiscal policy priority should be the long-run fiscal balance.

4. **If fiscal stimulus is done, it should be very short-run.**

Principle #1: Fiscal Policy Can Effectively Complement Monetary Policy



Source: National Sources via Haver Analytics.

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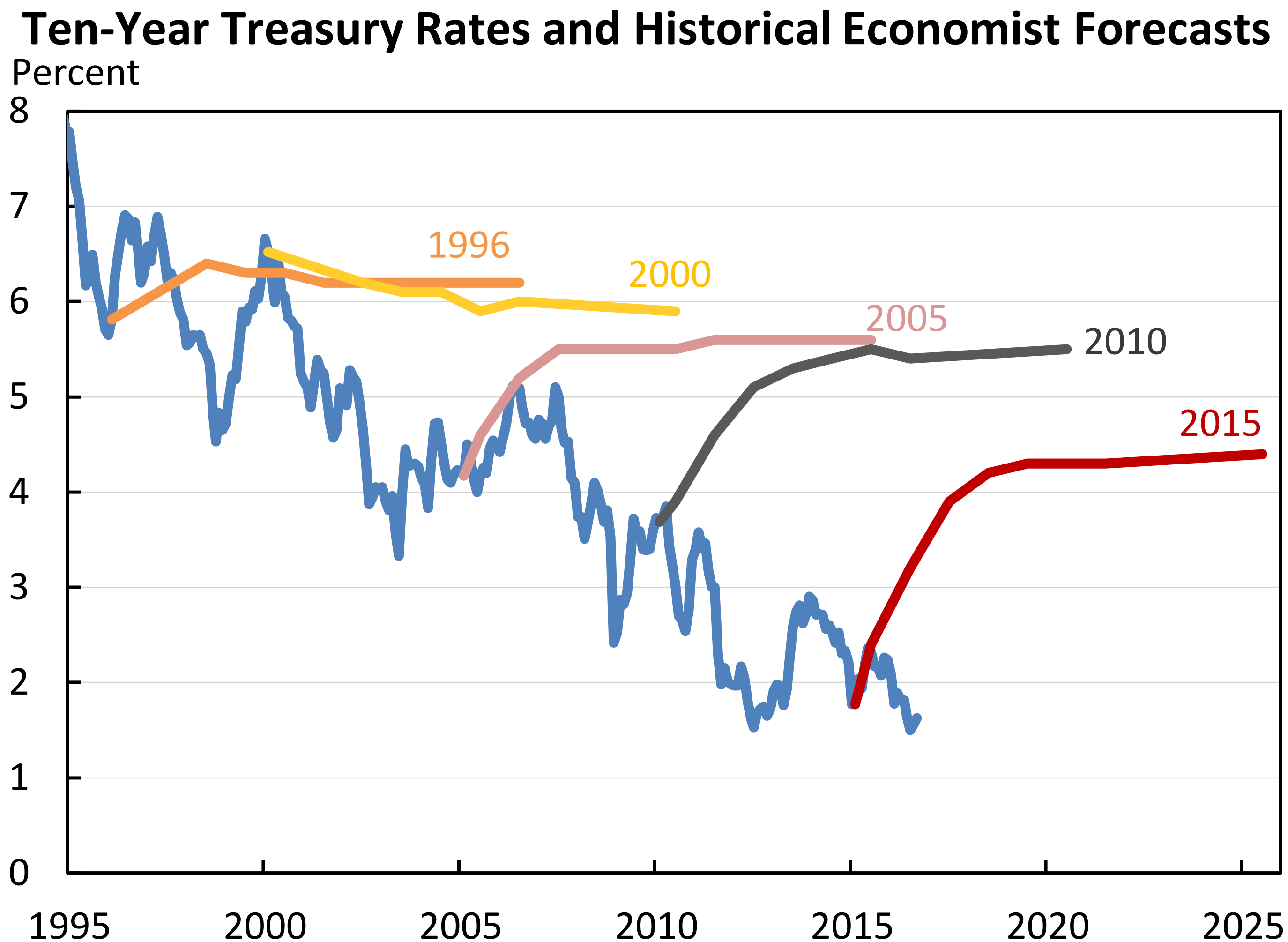


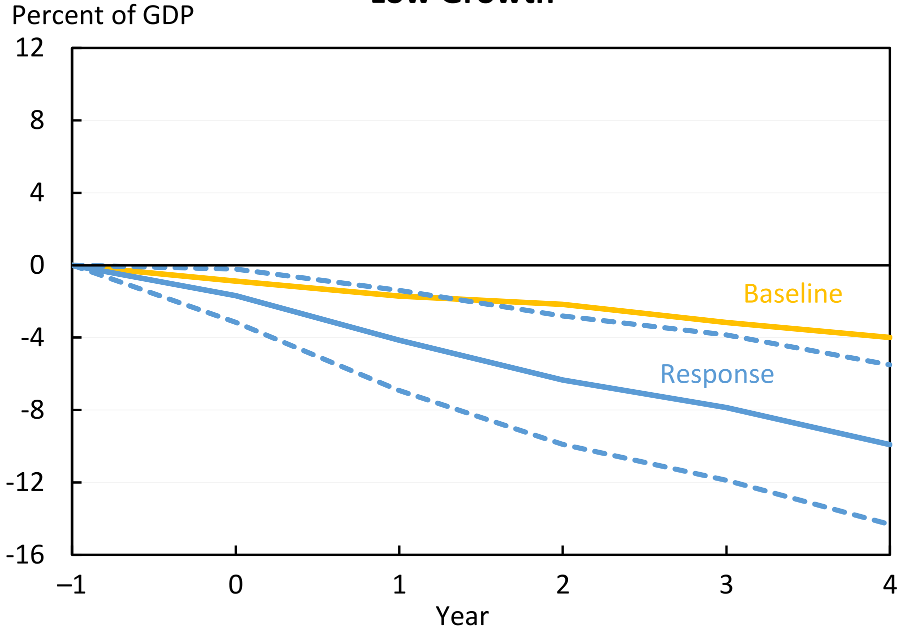
Note: Forecasts are those reported by Blue Chip Economic Indicators in March of the given calendar year, the median of over fifty private-sector economists.
Source: Blue Chip Economic Indicators.

Principle #2: Fiscal Policy Can Be Very Effective in Practice

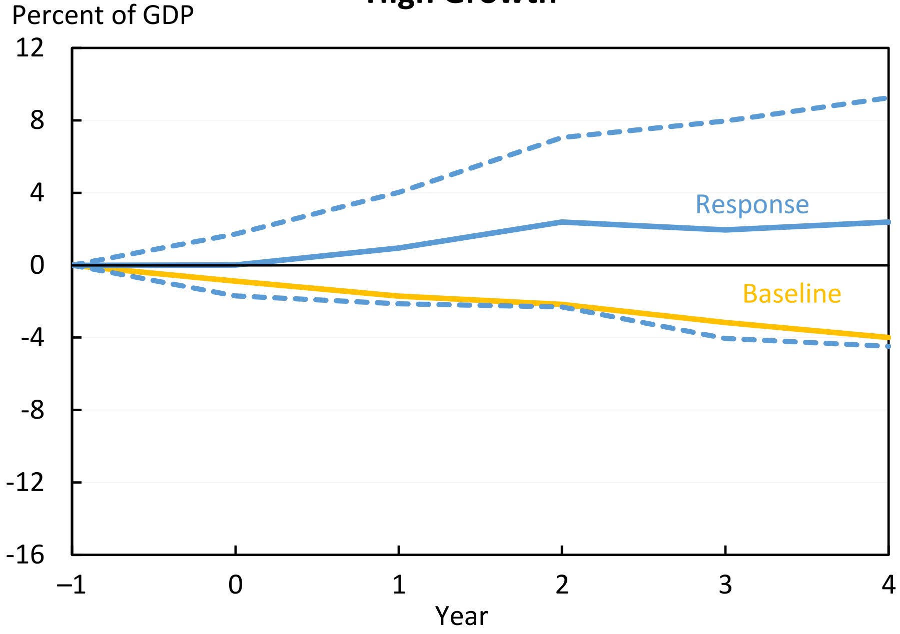
- **Large multipliers (Romer and Romer 2010)**
- **Evidence multipliers are larger in downturns (Nakamura and Steinsson 2014; Parker et al. 2013)**
- **Evidence multipliers are larger at the effective lower bound**
- **"Crowding in" of investment instead of crowding out:**
  - **Via accelerator (IMF 2015; OECD 2015)**
  - **Higher expected inflation → lower real interest rates (Hall 2009; Christiano, Eichenbaum, and Rebelo 2011; Woodford 2011)**

Principle #3: Fiscal Stimulus is Less Constrained by Fiscal Space
A. Growth May Increase Sustainability in a Weak Economy

Effect of Public Investment on Debt in Advanced Economies: Low Growth



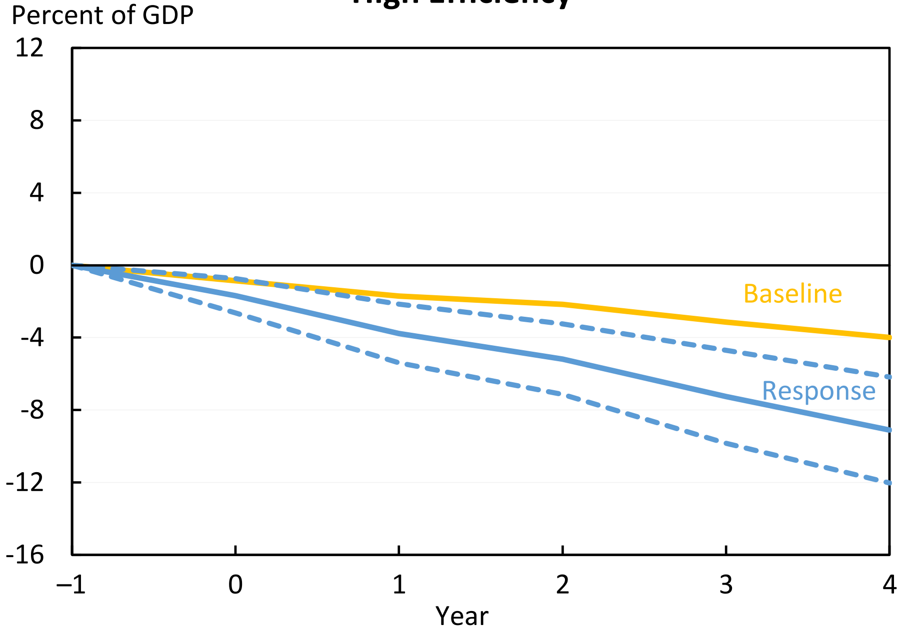
Effect of Public Investment on Debt in Advanced Economies: High Growth



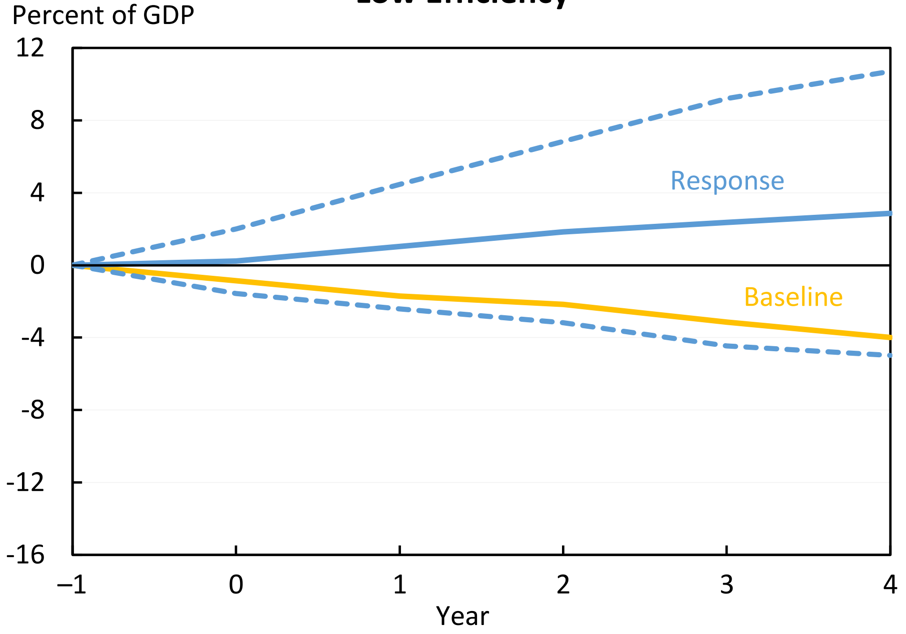
Note: *t*=0 is the year of the shock; dashed lines denote 90-percent confidence bands. Shock represents an exogenous 1 percentage point of GDP increase in public investment spending.
Source: IMF, *World Economic Outlook* (October 2014).

Principle #3: Fiscal Stimulus is Less Constrained by Fiscal Space
A. Growth May Increase Sustainability If It is Effective

Effect of Public Investment on Debt in Advanced Economies: High Efficiency



Effect of Public Investment on Debt in Advanced Economies: Low Efficiency

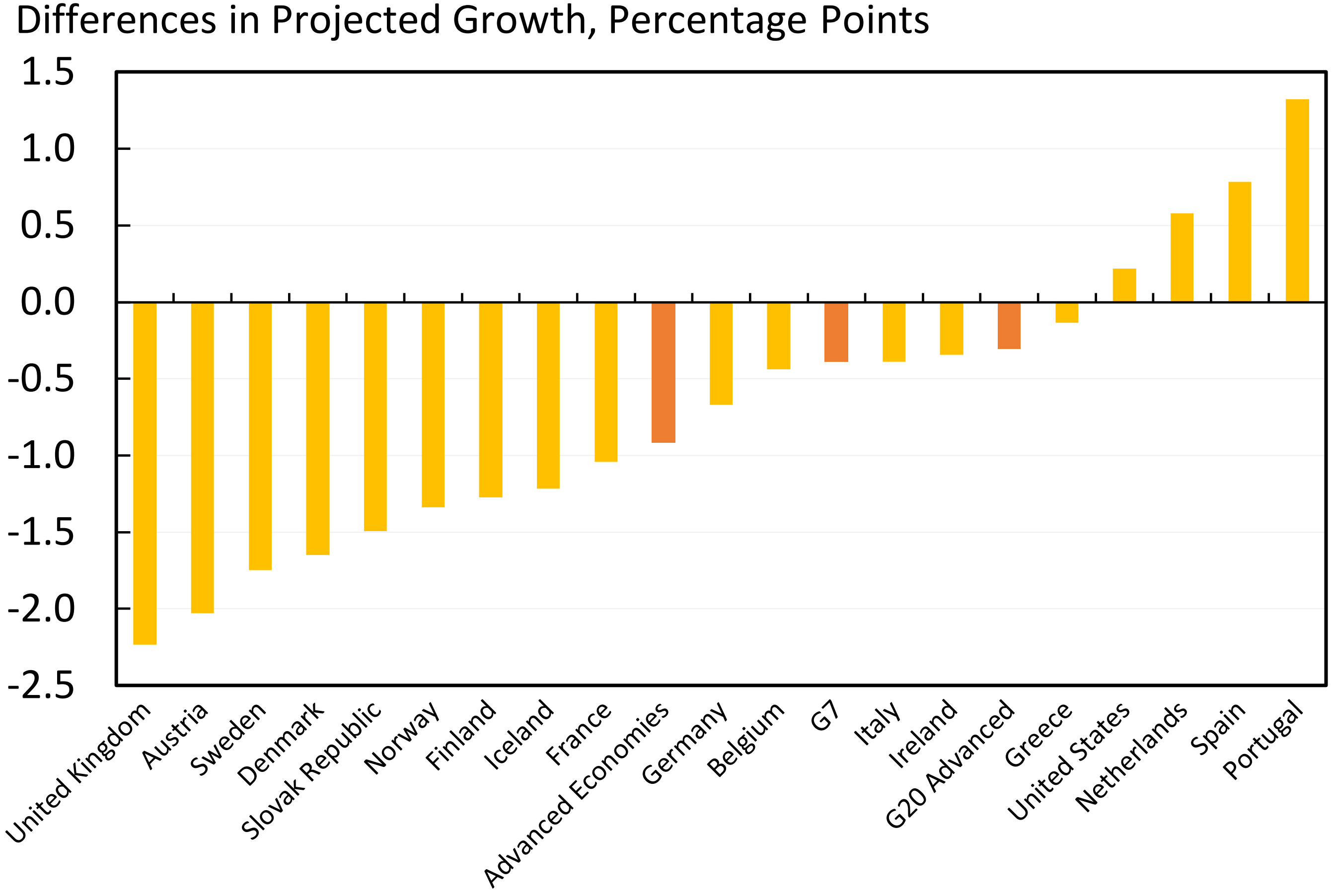


Note: *t*=0 is the year of the shock; dashed lines denote 90-percent confidence bands. Shock represents an exogenous 1 percentage point of GDP increase in public investment spending.
Source: IMF, *World Economic Outlook* (October 2014).

Principle #3: Fiscal Stimulus is Less Constrained by Fiscal Space

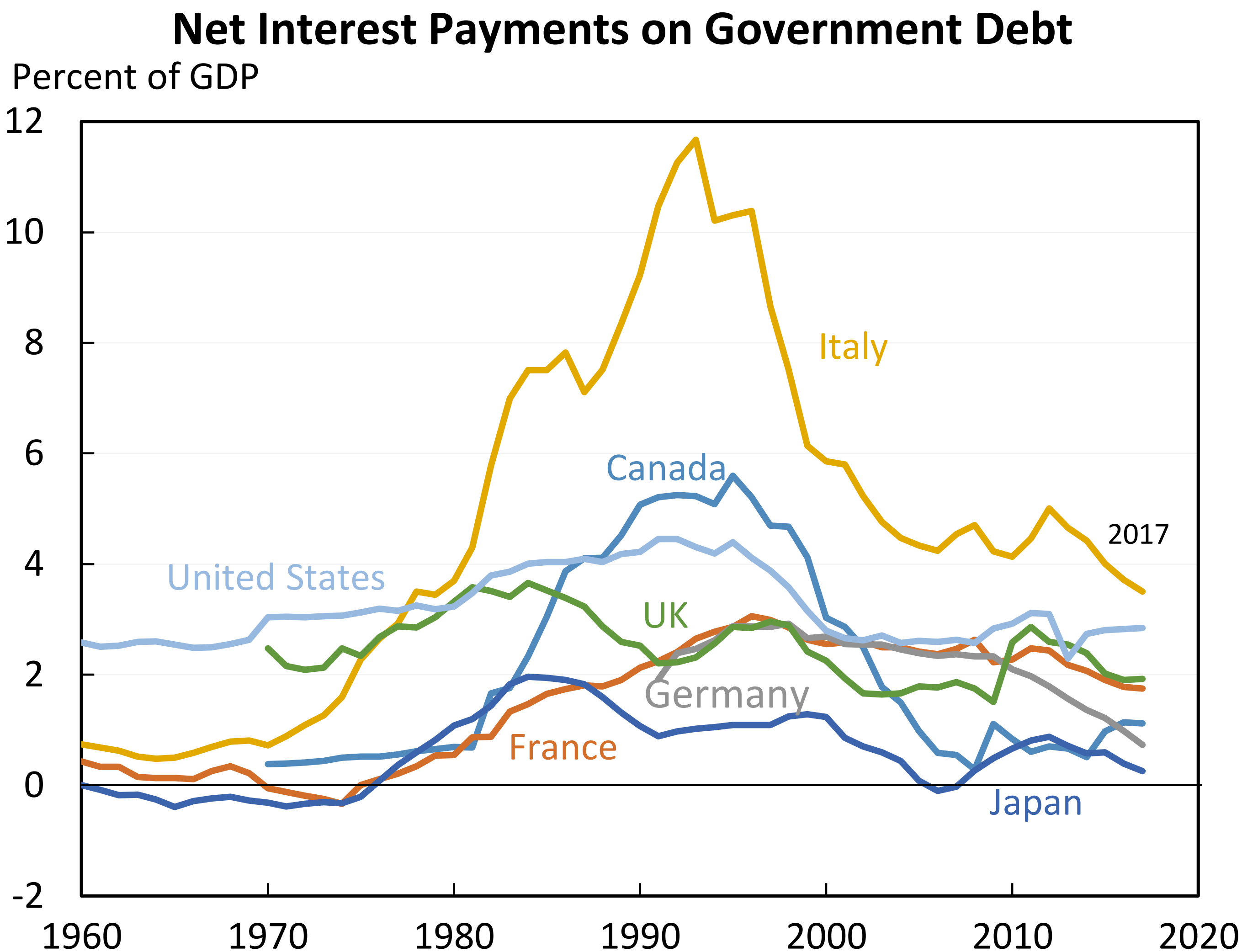
B. Fiscal Progress and Interest Rates

Changes in Spending on Health and Pensions, 2010 to 2030: 2016 IMF Forecasts vs. 2011 IMF Forecasts



Source: International Monetary Fund, *Fiscal Monitor* (April 2011, April 2016); CEA calculations.

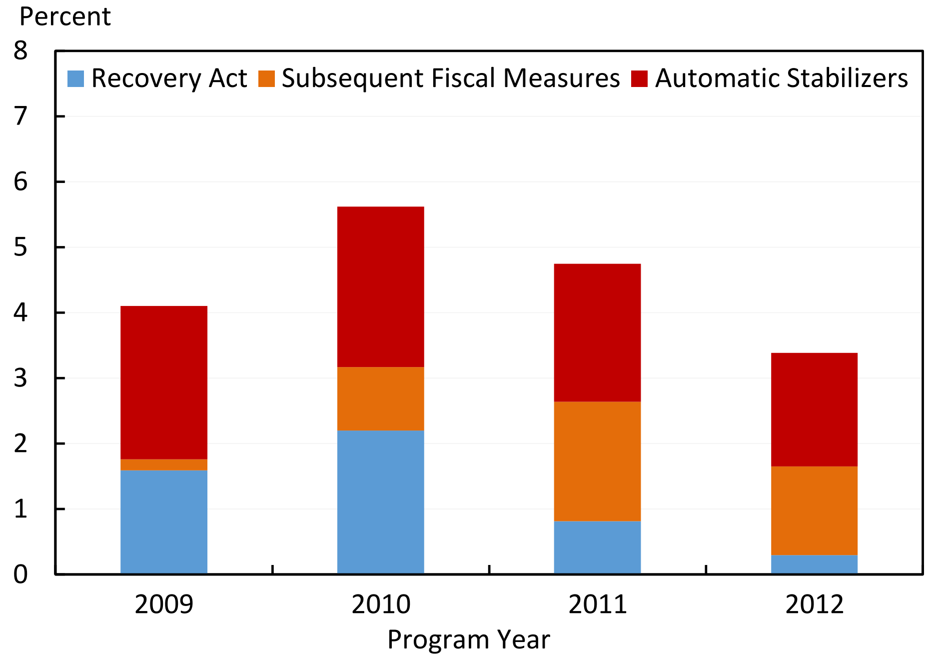
Principle #3: Fiscal Stimulus is Less Constrained by Fiscal Space
B. Fiscal Progress and Interest Rates (cont.)



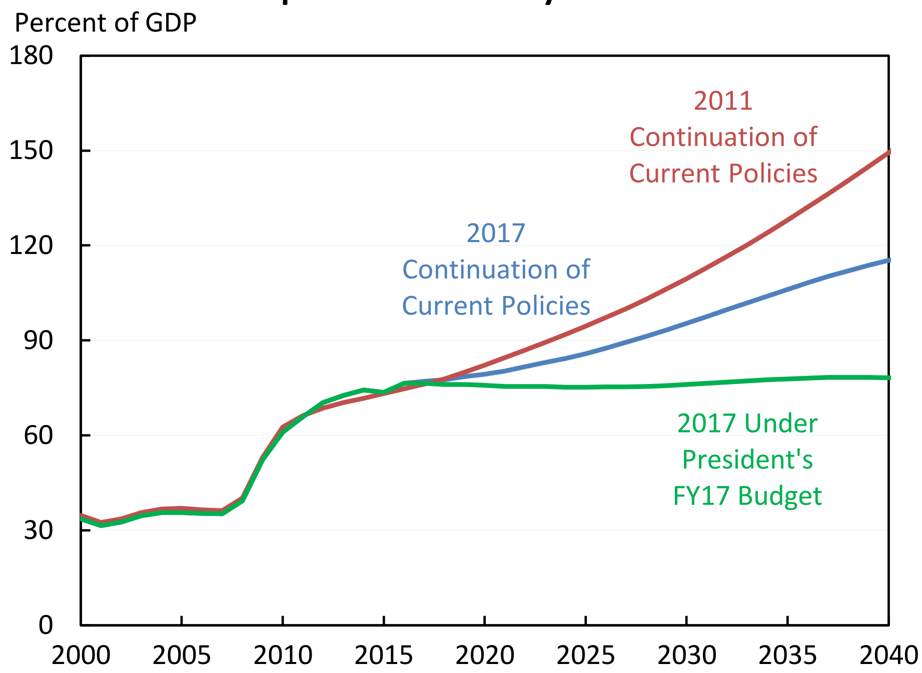
Source: Organisation for Economic Co-operation and Development.

Principle #3: Fiscal Stimulus is Less Constrained by Fiscal Space:
C. Can Combine Short-Run Expansion and Long-Run Consolidation

Fiscal Expansion as a Percentage of GDP in Each Program Year



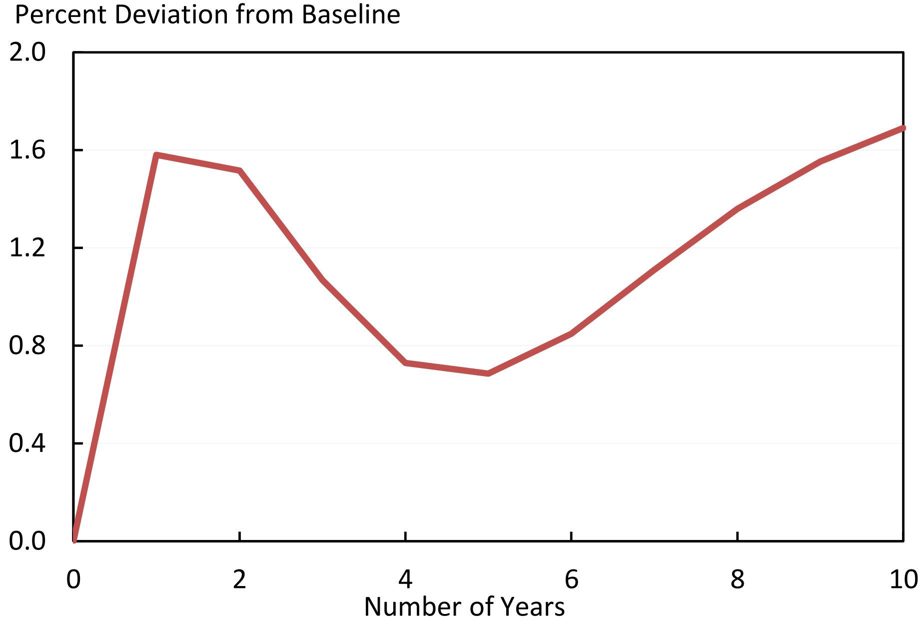
Comparison of Publicly Held Debt



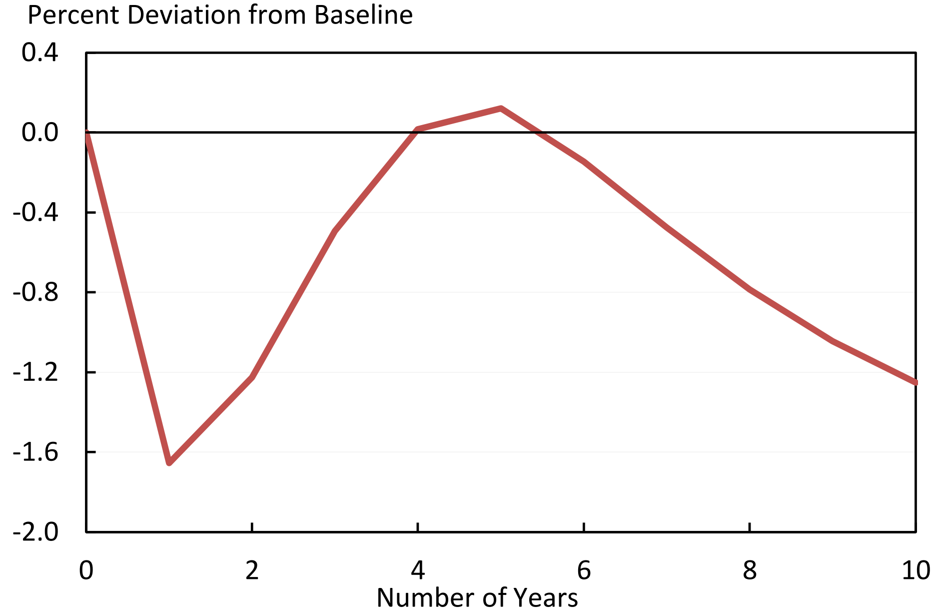
Source: Congressional Budget Office (2014); Bureau of Economic Analysis, National Income and Product Accounts; CEA calculations; Office of Management and Budget.

Principle #4: It May Be Desirable to Pursue Sustained Fiscal Expansion

Effect of Permanent Increase in Government Investment on Real GDP

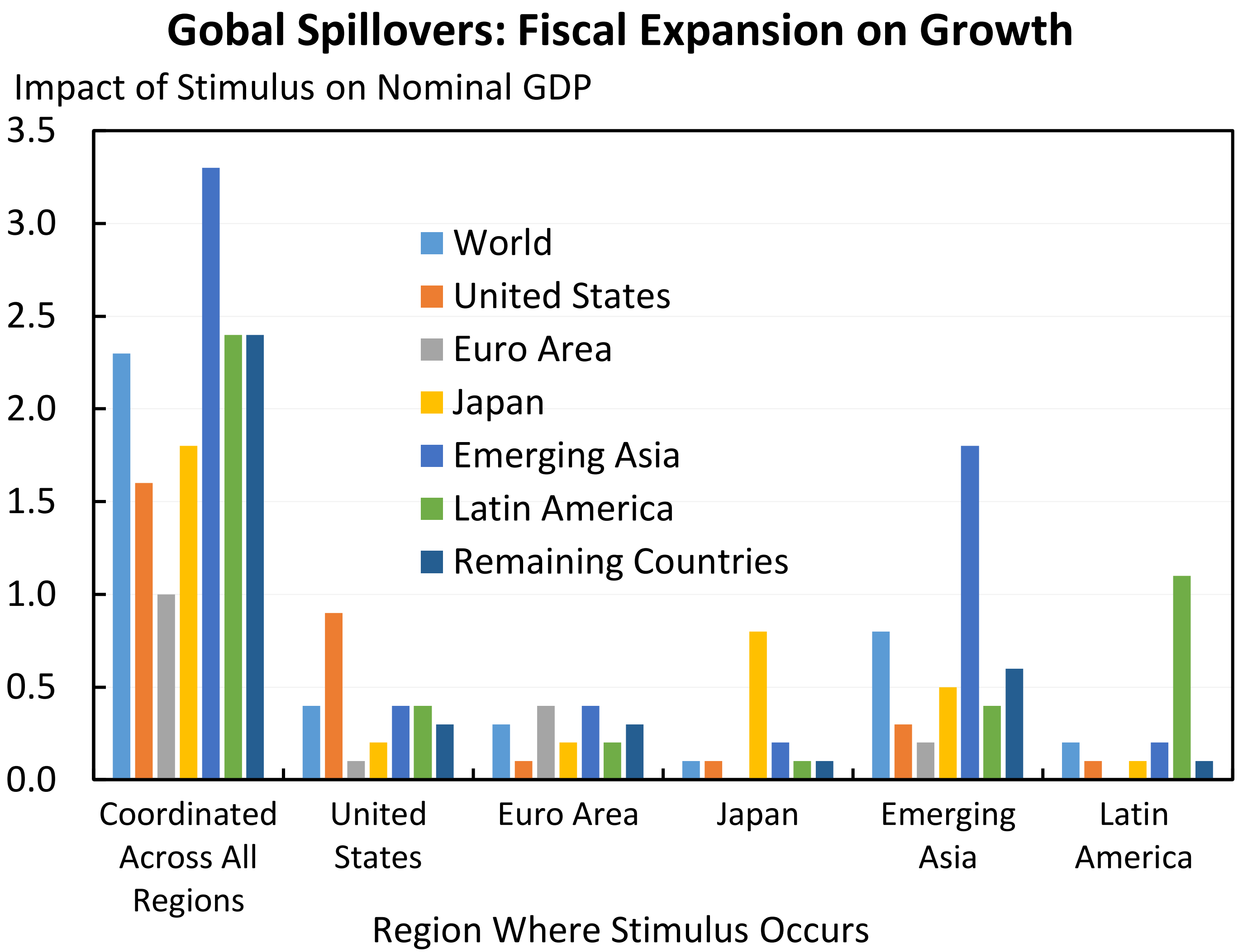


Effect of Permanent Increase in Government Investment on Government Debt-to-GDP Ratio



Source: Gaspar, Obstfeld, and Sahay (2016).

Principle #5: Fiscal Policy Can Have Positive Global Spillovers



Note: Fiscal stimulus is equal to 1 percent of each region's baseline GDP and is composed of government investment (one-quarter of total stimulus), government consumption (one-quarter of total stimulus) and targeted transfers (one-half of total stimulus). Monetary policy accommodates fiscal expansion by keeping the nominal policy interest rate unchanged for two years.
Source: IMF (2016).

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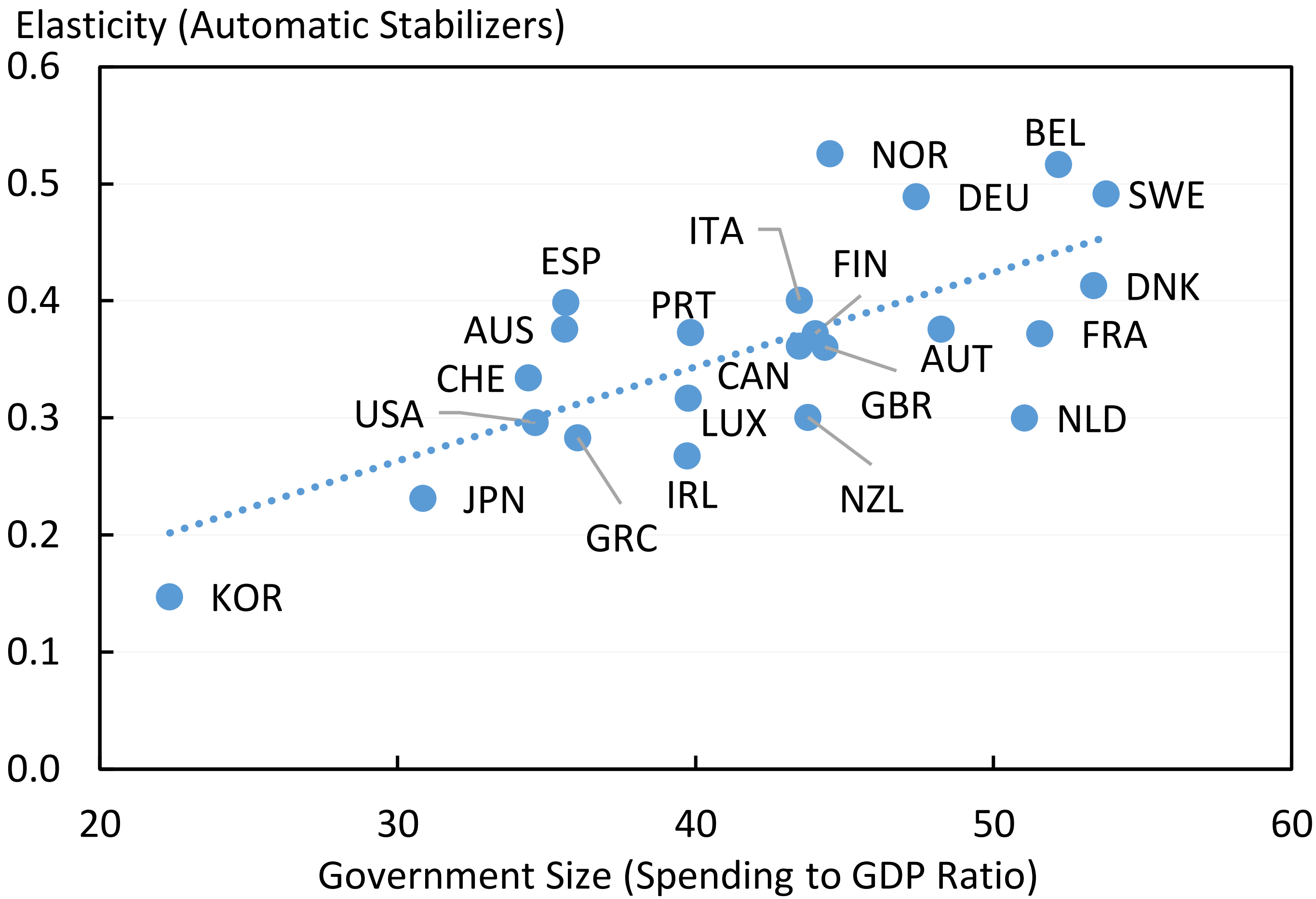
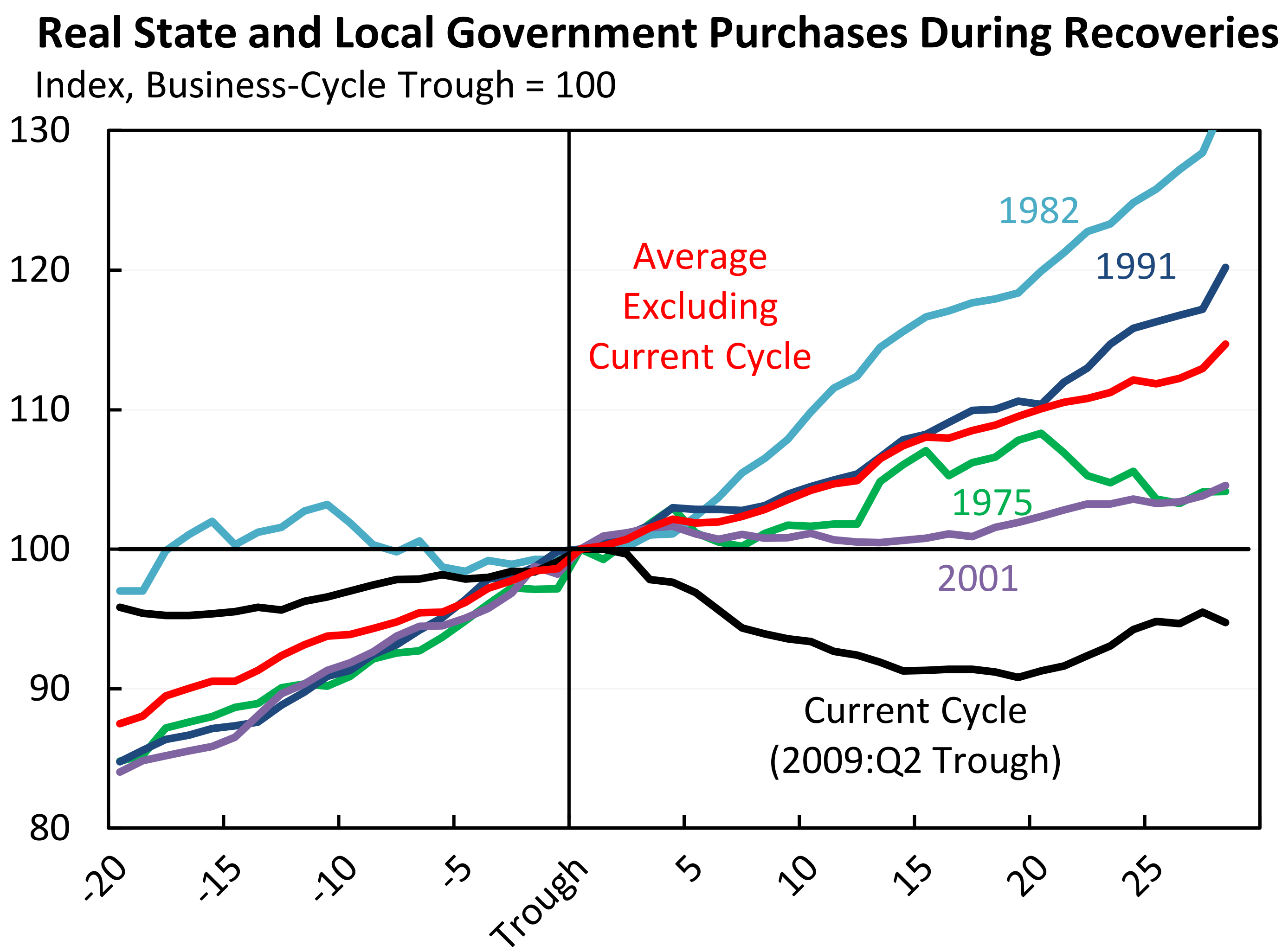
Application to the United States: The United States Has Weak Automatic Stabilizers

Government Size and the Cyclical Semi-Elasticity of Automatic Stabilizers



Source: Fatás and Mihov (2012).

Application to the United States: The Procyclical State and Local Government Response to the Great Recession



Source: Bureau of Economic Analysis, National Income and Product Accounts; CEA calculations.

Application to the Euro Area

- Institutional structure of the euro area—reflecting Old View of fiscal policy—is a barrier to effective policy and has amplified shocks:
  - No bloc-wide management of macroeconomic policy other than European Central Bank
  - Asymmetric coordination via the Stability and Growth Pact (SGP)
  - SGP focused on current deficits/debt, without incorporating future liabilities

- Possible solutions:
  - Do not undermine automatic stabilizers with procyclical discretionary fiscal policy
  - Greater coordination of fiscal expansion, especially infrastructure
  - Enhanced automatic stabilizers, ideally at the euro area-level
  - Revisions to the SGP or a new multilateral agreement
  - Euro area fiscal policy

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