Fiscal Alchemy?
An International Perspective

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“Fiscal alchemy”? 

• Eric Leeper had it backwards:  
  — "Monetary science, fiscal alchemy" (Jackson Hole, 2010).

• It should be *Monetary alchemy, fiscal science*:

• Under post-2008 conditions, we could have been more confident that countercyclical fiscal policy would have speeded the recovery than countercyclical monetary policy.
Fiscal multipliers are relatively high under post-2008 conditions: low output, low inflation, & ZLB.


- **Econometric studies**
  - Ilzetzki, Ethan, Enrique Mendoza & Carlos Vegh (2013), "How Big (Small?) are Fiscal Multipliers?” *Journal of Monetary Economics*.

- **But consider country cases below.**
  - Japan.
  - Euroland.
  - Emerging markets.
Monetary policy is of course relatively less powerful at Zero Lower Bound.

- even though it is still worth doing, via channels other than short-term interest rate:
  - Exchange rate
    - if particular countries need more stimulus than others;
  - Expected inflation;
  - Long-term bonds, equities, and real estate.

- Coordination of monetary policy is *not* especially needed, despite “currency wars.”
How had Keynesian fiscal policy been discredited?

- Not lack of knowledge,
- nor lack of effectiveness.
- Rather: political failure to pursue stimulus only counter-cyclically.
- But that is no excuse for politicians who pursue fiscal policy *pro-cyclically*,
  - as was the norm in developing countries before 2000,
  - and the pattern among some in advanced countries since 2000.
- “Secular stagnation” is not needed to explain recent slow growth; *pro-cyclical* fiscal policy can do it.
Recent cases

1) Japan

2) Euroland

3) Emerging Market economies
(Case 1) Japan

• The three arrows of Abenomics
  – Monetary stimulus (2% inflation target + QQE)
  – Fiscal policy (?)
  – Structural reform (?)
Japan’s monetary easing (QQE) raised the exchange rate (Yen/$) and stock market.

HR dissolved, Nov. 2012 => “Abenomics”
But effects on growth (& inflation) were disappointing.

- Because the 2\textsuperscript{nd} & 3\textsuperscript{rd} arrows haven’t been fired?

- I’d say the 2\textsuperscript{nd} was fired in the wrong direction:
  - Abe went through with the scheduled increase in the consumption tax taking effect April 1, 2014,
    - from 5\% to 8\%.
  - As many had warned, Japan went back into recession, i.e., growth turned negative for next two quarters.
Abenomics seemed to boost growth, at first.

But Japan went back into recession in 2014 Q2, perhaps because of a big increase in the consumption tax.
Can Japan address its serious long-term debt problem, while avoiding contraction in the short term?

Proposal:
Replace the immediate discrete rise in the consumption tax with a pre-announced committed gradual path of increases, e.g., 0.25% every year until reaching 10%.

Advantages:
• If the path is credible, it will preclude a loss of confidence in the sustainability of Japan’s debt.
• The short-term impact will not be contractionary.
• Indeed, it will help generate expectations of inflation.
(Case 2) Euroland

• The three arrows of Mario Draghi
  (Jackson Hole 8/22/2014)

  – Monetary stimulus:
    • QE, launched Jan. 22, 2015.

  – Fiscal stimulus:
    • Those with space should spend.

  – Structural reform:
    • esp. labor markets.
When the ECB launched QE in 2015, the euro depreciated immediately (2% in 3 hours)
But fiscal policy was pro-cyclical, especially in Greece: expansion in 2000-08, contraction in 2010-14

EU fiscal austerity has been contractionary.

What about the critique that fiscal policy responded endogenously (and negatively) to the magnitude of the countries’ difficulties?
The bigger the fiscal contraction, the bigger the GDP loss relative to what had been officially forecast => true multipliers > than multipliers that IMF had been using.

Europe: Growth Forecast Errors vs. Fiscal Consolidation Forecasts


Note: Figure plots forecast error for real GDP growth in 2010 and 2011 relative to forecasts made in the spring of 2010 on forecasts of fiscal consolidation for 2010 and 2011 made in spring of year 2010; and regression line.
In 2015 periphery economies remain weak.

Fiscal austerity hasn’t even achieved the supposed goal of restoring debt sustainability: debt/GDP ratios continued to rise sharply. Declining GDP outweighed progress on reduction of budget deficits.

From Rémi Bourgeot, Fondation Robert Schuman
Data source: IMF WEO (October 2014).
(Case 3) Emerging Markets

Fiscal policy in some EMs
• turned from pro-cyclical to countercyclical after 2000,
  – e.g., Chile, India, Malaysia, Korea, China, Botswana --
• taking advantage of 2002-08 boom to strengthen their budgets,
• and so making “fiscal space” to moderate the 2008-09 recession.
= the opposite from some Industrialized Countries.

Some major EMs are more vulnerable to the next shock
 – because they have backslid on cyclicality since 2010,
   • e.g., Brazil, India, Thailand.
 – or never did graduate from pro-cyclicality at all,
   • e.g., Argentina, Venezuela.
Correlations between Gov.t Spending & GDP 1960-1999

Adapted from Kaminsky, Reinhart & Vegh (2004)

Pro-cyclical spending

Counter-cyclical spending

G always used to be pro-cyclical for most developing countries.
In the last decade, about 1/3 developing countries switched to countercyclical fiscal policy: Negative correlation of G & GDP.
Appendices

• (1) Japan’s Abenomics

• (2) Euroland

• (3) Which Emerging Market countries achieved fiscal counter-cyclicality? – and how?
(1) Japan’s monetary easing weakened the yen, 2012-13

House of Representatives dissolved, Nov. 2012 => “Abenomics”
Unemployment in the euro periphery remains high.
In the decade 2000-2009, about 1/3 developing countries switched to countercyclical fiscal policy: Negative correlation of G & GDP.

DEVELOPING:
43% (or 32 out of 75) countercyclical. The figure was 17% (or 13 out of 75) in 1960-1999.

INDUSTRIAL:
86% (or 18 out of 21) countercyclical. The figure was 80% (or 16 out of 20) in 1960-1999.

DEVELOPING: 37% (or 29 out of 76) pursue counter-cyclical fiscal policy.
INDUSTRIAL: 63% (or 12 out of 19) pursue counter-cyclical fiscal policy.

Thanks to Guillermo Vuletin
The correlation for 2000-09 vs. 2010-14
Who achieves counter-cyclical fiscal policy?

Countries with “good institutions”

"On Graduation from Fiscal Procyclicality,”
Frankel, Végh & Vuletin; J.Dev.Economics, 2013.
The quality of institutions varies, not just across countries, but also across time.

Frankel, Végh & Vuletin, 2013.
How can countries avoid pro-cyclical fiscal policy?

• What *are* “good institutions,” exactly?

• Rules?
  – Budget deficit ceilings (SGP) or debt brakes?
    • Have been tried many times. Usually fail.
  – Rules for *cyclically adjusted* budgets?
    • Countries are more likely to be able to stick with them. But...

• An under-explored problem:
  – Over-optimism in official forecasts
    • of GDP growth rates & budgets.
Countries with Balanced Budget Rules frequently violate them.

Compliance with Fiscal Rules, 1985–2012 (Percent compliance)

- BBR: Balanced Budget Rules
- DR: Debt Rules
- ER: Expenditure Rules

Compliance < 50%
To expect countries to comply with the rules during recessions is particularly unrealistic (and not even necessarily desirable).

Bad times: years when output gap < 0
US official projections were over-optimistic on average.
Greek official forecasts were \textit{always} over-optimistic.

Data from Greece’s Stability and Convergence Programs.
German forecasts were also usually too optimistic.
Most European official forecasts have been over-optimistic.

Figure 1 (F&S, 2013):

Mean 1-year ahead budget forecast errors, European Countries,
Full Sample Period

For 17 Europeans, the bias is even higher than others, averaging:
- 0.5% at the 1-year horizon,
- 1.3% at the 2-year horizon,
- 2.4% at the 3-year horizon
Figure 2 (F&S, 2013):
Mean 2-year ahead budget forecast errors, European Countries, Full Sample Period
The case of Chile

• 1st rule – Governments must set a budget target,

• 2nd rule – The target is structural: Deficits allowed only to the extent that
  – (1) output falls short of trend, in a recession,
  – (2) or the price of copper is below its trend.

• 3rd rule – The trends are projected by 2 panels of independent experts, outside the political process.
  – Result: Chile avoided the pattern of 32 other governments
    • where forecasts in booms were biased toward optimism.

Chile’s official forecasts have *not* been over-optimistic.