Global Economy

Is there room for expansionary fiscal policies?

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Last week, the annual economic policy symposium was held in Jackson Hole. This classic event organized by the Kansas City Federal Reserve serves as a meeting point for central bankers, politicians and economists from around the world. This year's theme was the challenges for monetary policy. Although fiscal policy was not the subject of debate, it cast a shadow over the event. As Mark Carney, the Governor of the Bank of England, said in his speech, given the limited space most central banks have to respond to adverse situations, fiscal policy must play a much more active role. Mario Draghi also placed emphasis on this strategy several months ago in Sintra. On the same day, in an article about this symposium, Lawrence Summers and Anna Stansbury justified the use of fiscal policies in a context of decelerating global growth to increase demand, rather than for central banks to continue reducing interest rates, a strategy they consider to be ineffective or even counterproductive at this point.

These are only the most recent examples of a discussion that has, for several years, already been part of the economic debate that followed the international financial crisis, in which institutions such as the IMF or the OECD have also become involved. The notion of using fiscal policy to stabilize the economy is not a new idea. For many decades, this instrument has formed part of the set of tools used by economic policymakers to combat recessions. As we saw at the time, it was widely used in 2009 at the height of the international financial crisis. What may seem more paradoxical is that the discussion has attracted increasing interest and advocates while the world economy has been approaching historically low unemployment levels, below those recorded in 2007.

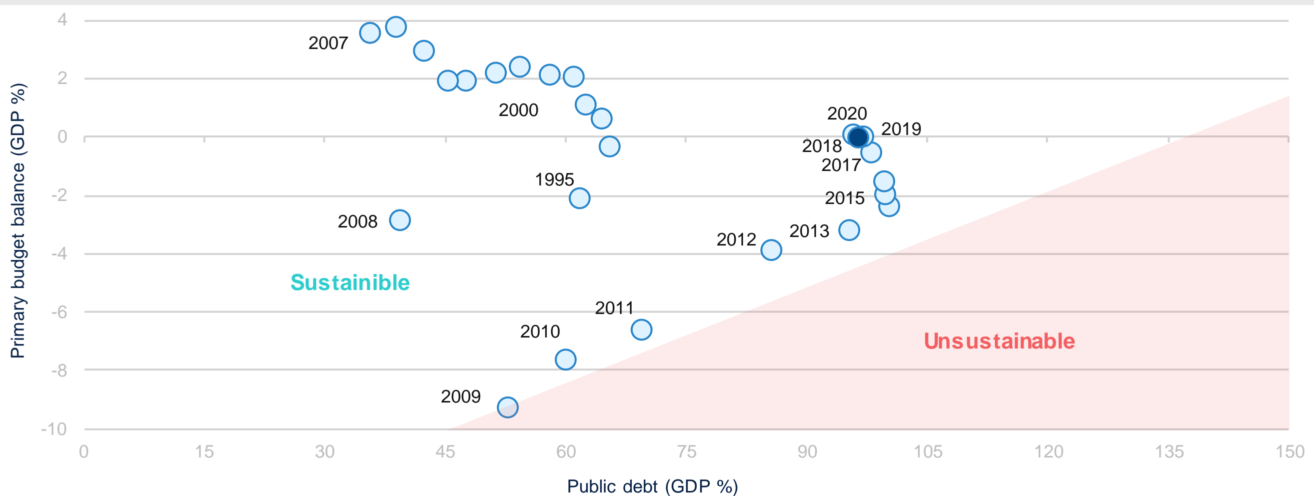
There are, however, substantial grounds for this. The economic recovery has taken place in a context in which real interest rates are at historically low levels (even negative in many countries), inflation has remained below the targets set by many central banks, and the potential growth of advanced economies has declined significantly over the past two decades. As Olivier Blanchard argued in his presidential address to the American Economic Association, interest rate cuts reduce the cost of public debt; not only its financial cost, but also in terms of social welfare. Furthermore, Japan's experience over the past two decades shows that when monetary policy reaches its limits, it becomes increasingly necessary to coordinate it with fiscal policy to try to bring inflation closer to target levels. Moreover, if public spending policies financed with debt in a low interest rate environment serve to carry out investments that increase the productivity of the economy (e.g. digital infrastructure, human capital and innovation), they also contribute to increasing potential growth. All of these arguments justify a more relaxed attitude toward public debt and fiscal deficits than the prevailing approach a couple of decades ago. However, as argued by Juan Francisco Jimeno and Marcel Jansen a few months ago, or Olivier Blanchard and Ángel Ubide more recently, by no means do they justify the implementation of expansionary policies in any country and under any circumstance. Blanchard and Ubide explicitly point out that both Japan and the eurozone should prepare themselves to stimulate aggregate demand with public debt. However, in the United States, as a result of the Trump administration's fiscal stimuli, the current trend of deficits and public debt is far from optimal.

Even in Europe, the implementation of more expansionary fiscal policies is not exempt from issues. Unlike Japan or the United States, the eurozone has a common monetary policy while fiscal policies are set on a national level, without the existence of a European treasury or "risk-free asset". The lack of a real fiscal union significantly limits the effectiveness and coordination of monetary and fiscal policies and, in practice, constrains the use of fiscal policy depending on each country’s capacity. The problem is that, until recently, the countries that have least needed to make use of these policies have been those with the most fiscal space, while those which most need or

want them are the countries with the least fiscal space. In Germany, public accounts had a surplus of 1.7% of GDP in 2018 and forecasts suggest that this will remain close to 1% in 2019, with public debt below 60% of GDP and negative interest rates on bonds with maturities below 30 years. By contrast, Italy has a persistent public deficit (forecast to reach 2.5% of GDP in 2019) in an economy with a meager growth rate (0.1%), public debt close to 134% of GDP, and a risk premium that skyrockets every time doubts arise about its sustainability. In any case, even in countries with less fiscal space, fiscal rules in Europe require automatic stabilizers to be allowed to act in order to prevent fiscal policy from becoming procyclical and aggravating the economic situation in recessions.

So, where does this leave Spain? The country's fiscal space is somewhere between Germany and Italy. The interest rate on 10-year bonds is close to zero, while the risk premium compared to German bonds stands at approximately 80 basis points, slightly less than half that of Italy. The forecasts of BBVA Research and the European Commission for 2019 and 2020 are very similar and, by and large, suggest that public debt and the primary budget balance of the public sector (excluding debt interest) will be very similar to those of 2018. In terms of sustainability, the situation is better than it was between 2009 and 2014. However, it seems clear that fiscal policy relaxation compared to the norm a couple of decades ago has already occurred: public debt is currently about 30 percentage points of GDP higher than at that time, with the same primary budget balance level. Furthermore, public accounts are coming under increasing pressure from the pension system deficit. In 2018, the pension system deficit reached 1.6% of GDP, accounting for almost two thirds of the public deficit, with all signs suggesting that this figure will continue to increase. With appropriate sustainability measures that guarantee the long-term balance of the pension system, we could gain valuable space to increase our long-term potential growth (as the Netherlands intends to do) with effective policies in areas such as education, research and innovation, the labor market or investments to make the most of the digital revolution. These investments would also serve to stimulate aggregate demand in the short term. In terms of fiscal space, rather than relaxing, the real challenge for Spain is to improve the composition of public debt that future generations will receive.

PUBLIC SECTOR PRIMARY BUDGET BALANCE AND PUBLIC DEBT IN SPAIN, 1995-2020



Source: Doménech and González-Páramo (2017), updated on the basis of the European Commission spring forecast (2019)

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