IMF backs counter-cyclical fiscal activism in times of crisis

Fiscal stimulus had powerful effects in the wake of the financial crisis, but monetary policy is better suited to keeping the economy on an even keel in normal times, says IMF

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Fiscal policy can help combat crises when monetary policy is constrained by the zero lower bound, but is less suitable in more ordinary times, according to an IMF policy paper published today.

The paper examines the fiscal stimulus employed in the wake of the recent financial crisis and finds that it had "powerful effects" on advanced economies in the short term.

This finding is at odds with the pre-crisis scepticism over the size of fiscal multipliers and the ability of governments to boost output by increasing their spending or cutting taxes.

However the IMF pointed to the stimulus packages employed around the world from 2008 onwards as evidence that policy-makers can "rapidly deploy substantial fiscal stimulus" to good effect.

The paper questions whether this discovery implies a fundamental change in the way fiscal policy should operate in the future when the global economy is back on track, or whether it should be consigned to the past.

It cites numerous studies that suggest fiscal multipliers increase when central bank interest rates are approaching zero and that fiscal policy becomes an "appropriate counter-cyclical policy tool".

However, it is not just size that matters. Beyond the multiplier there are a host of other criteria that governments must fulfil if fiscal policy is to be an effective counter-cyclical tool.

According to the IMF, a government must have room to manoeuvre with its level of public debt and should be able to respond to shocks in a timely and temporary manner.

But, as a senior IMF official explained, it can be difficult to change the course of fiscal policy, while it is far easier to expand spending than it is to contract it.

These characteristics of fiscal policy detract from its efficacy outside of a crisis. "In normal circumstances, monetary policy should be sufficient," the senior official said.

Fiscal dominance

The paper also considers the relationship between fiscal and monetary policy and the degree to which they can and should complement one another.

Its principal finding is that central banks purchasing government debt have bought time for governments, allowing for a "more gradual" fiscal adjustment than would have otherwise been necessary.

The IMF warned against central banks expanding their balance sheets in isolation and with no regard to the progress of fiscal adjustment. If countries were to retain their high debt levels while exploiting the easier economic conditions, this could erode central banks' credibility and subsequently their control over inflation.

"Even if central bank purchases of government debt in pursuit of monetary policy goals can also support fiscal adjustment, they are not a substitute for it," the paper said.

The senior official said central banks were in a good position to assess whether governments were progressing with their adjustments and, by extension, the level of reputational damage they risk by purchasing government debt.

Gradual adjustment

Regarding the pace of that adjustment, the IMF reiterated its position that “front-loaded” fiscal adjustment is inappropriate for most countries.

The theory is that a more “gradual” pace of adjustment within the context of a credible medium-term plan should limit the short-run impact of tighter fiscal policy on growth.

Front-loading may be more suitable for countries under immediate market pressure, the paper said, but even then there are “speed limits” on the “desirable pace of adjustment”.