Getting fiscal stimulus and central bank independence in synch

By Adair Turner
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Until early last autumn, the global economy seemed stuck in a deflationary trap. For five years in a row, the International Monetary Fund had downgraded its medium-term growth forecast. In February 2016, *The Economist*'s front cover depicted central bankers "Out of Ammunition." In October, the IMF's *World Economic Outlook* was entitled "Subdued Demand: Symptoms and Remedies," though there seemed to be more of the former than the latter. The overhang of private debt left behind by excessive credit creation before 2008 remained unresolved.

Only six months later, prospects seem transformed, with widespread upgrades to growth and inflation forecasts. True, disappointing first-quarter growth in the United States casts doubt on the recovery's true strength. But at least we seem to have escaped from years of serial disappointment.

Growth forecasts are up because fiscal policy has been relaxed. Advanced economies eased their fiscal stance in 2016 by 0.2% of GDP, on average, ending five years of gradual consolidation. More significantly, China's fiscal deficit increased from 0.9% of GDP in 2014 to 2.8% in 2015 and 3.6% in 2016. Upgraded US growth forecasts assume a 2018 deficit of 4.5% of GDP, versus the 3.5% that was previously projected. As the IMF notes, this reflects "a reassessment of fiscal policy", and a rejection of the belief that monetary policy alone can drive recovery.

In fact, fiscal policy has played a vital role ever since 2008. US fiscal deficits averaging 11.2% of GDP from 2009 to 2011 produced a faster recovery than the eurozone's average deficit of 5.7% of GDP. After a harmful sales-tax increase in April 2014, Japan's growth has depended on a series of fiscal stimulus packages. But from 2011 onward, US fiscal policy was slowly tightened, and from March 2012 the eurozone's "fiscal compact" committed member countries to sustained deficit reduction. Tight fiscal policy seemed essential to limit future public debt; but ultra-loose monetary policy could still, it was assumed, ensure adequate demand growth and bring inflation back up to target.

That assumption was wrong, because monetary policy alone is ineffective when economies are stuck in a deflationary debt trap. Central banks can cut interest rates, but investment and consumption are insensitive to rate reductions if private debt levels are high and rates are already low. Cutting interest rates in one country can drive currency depreciation, but the world cannot devalue all its currencies against that of other planets to offset deficient global demand. And while low interest rates produce higher equity, bond, and property prices, the trickle-down benefit to the real economy is weak. From 2007-2015, wealth in the United Kingdom grew 40%, but real (inflation-adjusted) wages stagnated: Brexit, Donald Trump's election as US president, and strong support for Marine Le Pen are the inevitable result.

But if loose monetary policy facilitates fiscal expansion, it can still help stimulate the economy, making it possible to run large deficits without provoking interest-rate hikes. As Christopher Sims of Princeton University argued in an important paper presented at the 2016 Jackson Hole conference, once an economy is in a deficient-demand trap, there is "no automatic stabilizing mechanism to bring the economy back to target inflation," unless "interest rate declines generate fiscal expansion."

But if loose monetary policy makes it easy to issue public debt, how will that debt be repaid? Advanced economies' aggregate debt-to-GDP ratio, which increased by two percentage points in 2016, is, as the IMF notes, "expected to remain elevated and relatively flat in the medium term, in contrast to [previous] projections of moderate and steady decline." If the response to these debt projections is renewed fiscal consolidation, today's limited recovery may be aborted: indeed, the economic theory of "Ricardian equivalence" suggests that fiscal stimulus might be ineffective, because taxpayers rationally anticipate that higher current deficits imply higher future taxes.

And yet, even if we assume people are rational, fiscal deficits can still stimulate nominal demand, if people anticipate that tomorrow's debt might be eroded by inflation or eliminated through some variant of permanent monetization. As Sims argues, to ensure that fiscal expansion is effective, "the deficits must be seen as financed by future inflation, not future taxes or spending cuts." If, instead, there is a strong official message, as there is in the eurozone, that current deficits imply future austerity, the stimulative impact can be stymied.

In some countries, monetization of public debt is now inevitable, with the central bank buying government bonds and either writing them off or rolling them over perpetually. In Japan, for example, there is no credible scenario in which public debt will ever be paid down to so-called sustainable levels. In China, the distinctions between public and private debt are blurred, but monetization will probably occur in some indirect fashion. And the stimulative effect of monetization will, through international trade channels, contribute to demand even in economies where monetization does not occur.

The current upturn in growth may peter out. Trump's anticipated fiscal expansion may disappoint, with minimal infrastructure investment and stimulus coming only in its most inefficient form – tax cuts for the rich. But if the advanced economies do achieve more robust growth, it will be because large fiscal stimulus is facilitated by ultra-loose monetary policy.

Some economists wrongly fear that this implies the end of central-bank independence and the return of "fiscal dominance." Central banks' independence is threatened if fiscal authorities can instruct central banks to finance public deficits and monetize debt, even in circumstances where harmfully high inflation results. But it is not threatened if central banks independently decide to facilitate fiscal expansion through ultra-low interest rates and quantitative easing when inflation is running below target. If we had recognized that reality sooner, and provided more fiscal stimulus, recovery from 2008 could have been more robust and its benefits more widely spread.

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