Central bankers' fiscal constraints

By Kenneth Rogoff

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With policy interest rates near zero in most advanced economies (and just above 2% even in the fast-growing US), there is little room for monetary policy to maneuver in a recession without considerable creativity. But those who think fiscal policy alone will save the day are stupefyingly naive.

If you ask most central bankers around the world what their plan is for dealing with the next normal-size recession, you would be surprised how many (at least in advanced economies) say "fiscal policy." Given the high odds of a recession over the next two years – around 40% in the United States, for example – monetary policymakers who think fiscal policy alone will save the day are setting themselves up for a rude awakening.

Yes, it is true that with policy interest rates near zero in most advanced economies (and just above 2% even in the fast-growing US), there is little room for monetary policy to maneuver in a recession without considerable creativity. The best idea is to create an environment in which negative interest-rate policies can be used more fully and effectively. This will eventually happen, but in the meantime, today's overdependence on countercyclical fiscal policy is dangerously naïve.

There are vast institutional differences between technocratic central banks and the politically volatile legislatures that control spending and tax policy. Let's bear in mind that a typical advanced-economy recession lasts only a year or so, whereas fiscal policy, even in the best of circumstances, invariably takes at least a few months just to be enacted.

In some small economies – for example, Denmark (with 5.8 million people) – there is a broad social consensus to raise fiscal spending as a share of GDP. Some of this spending could easily be brought forward in a recession. In many other countries, however, notably the US and Germany, there is no such agreement. Even if progressives and conservatives both wanted to expand the government, their priorities would be vastly different. In the US, Democrats might favor new social programs to reduce inequality, while Republicans might prefer increased spending on defense or border protection. Anyone who watched the US Senate confirmation hearings last September for Supreme Court Justice Brett Kavanaugh cannot seriously believe this group is capable of fine-tuned technocratic fiscal policy.

This does not mean that fiscal stimulus should be off the table in the next recession. But it does mean that it cannot be the first line of defense, as altogether too many central bankers are hoping. Most advanced countries have a considerable backlog of high-return education and infrastructure projects, albeit most would take a long time to plan and implement. If left-leaning economists believe that fiscal policy is the main way out of a recession in 2019 or 2020, they should be lobbying for the government to prepare a pile of recession-ready projects. Former US President Barack Obama wanted to create an infrastructure bank in part for this purpose; tellingly, the idea never got off the ground.

Likewise, many observers advocate bolstering "automatic stabilizers" such as unemployment benefits. Europe, with much higher levels of social insurance and taxation, has correspondingly stronger automatic stabilizers than does the United States or Japan. When incomes fall, tax revenues decline and insurance payments rise, providing a built-in countercyclical fiscal stimulus. But proponents

of higher automatic stabilizers pay too little attention to the negative incentive effects that come with higher government spending and the taxes needed to pay for it.

To be clear, like many academic economists, I favor significantly raising taxes and transfers in the US as a response to growing inequality. But if there were a broad political consensus in favor of moving in this direction, it would have happened already.

A more exotic concept is to create an independent fiscal council that issues economic forecasts and recommendations on the overall size of budgets and budget deficits. The idea is to create an institution for fiscal policy parallel to the central bank for monetary policy. Several countries, including Sweden and the United Kingdom, have adopted much watered-down versions of this idea. The problem is that elected legislatures don't want to cede power, especially over taxes and spending.

One can appreciate why central bankers don't want to get gamed into some of the nuttier monetary policies that have been proposed, for example "helicopter money" (or more targeted "drone money") whereby the central bank prints currency and hands it out to people. Such a policy is, of course, fiscal policy in disguise, and the day any central bank starts doing it heavily is the day it loses any semblance of independence. Others have argued for raising inflation targets, but this raises a raft of problems, not least that it undermines decades of efforts by central banks to establish the credibility of roughly 2% inflation.

If fiscal policy is not the main answer to the next recession, what is? Central bankers who are serious about preparing for future recessions should be looking hard at proposals for how to pay interest on money, both positive and negative, which is by far the most elegant solution. It is high time to sharpen the instruments in central banks' toolkit. Over-reliance on countercyclical fiscal policy will not work any better in this century than in it did in the last.

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