

Economic Policy in the Crisis

Lars Calmfors

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My involvement

- Professor of International Economics at the Institute for International Economic Studies, Stockholm University
- Chair of the Swedish Fiscal Policy Council
 - government agency with the remit to evaluate the government's fiscal and other economic policy
 - how does fiscal policy relate to its fundamental objectives of long-run sustainability, the surplus target and the government expenditure ceiling as well as to the cyclical situation?

Topics

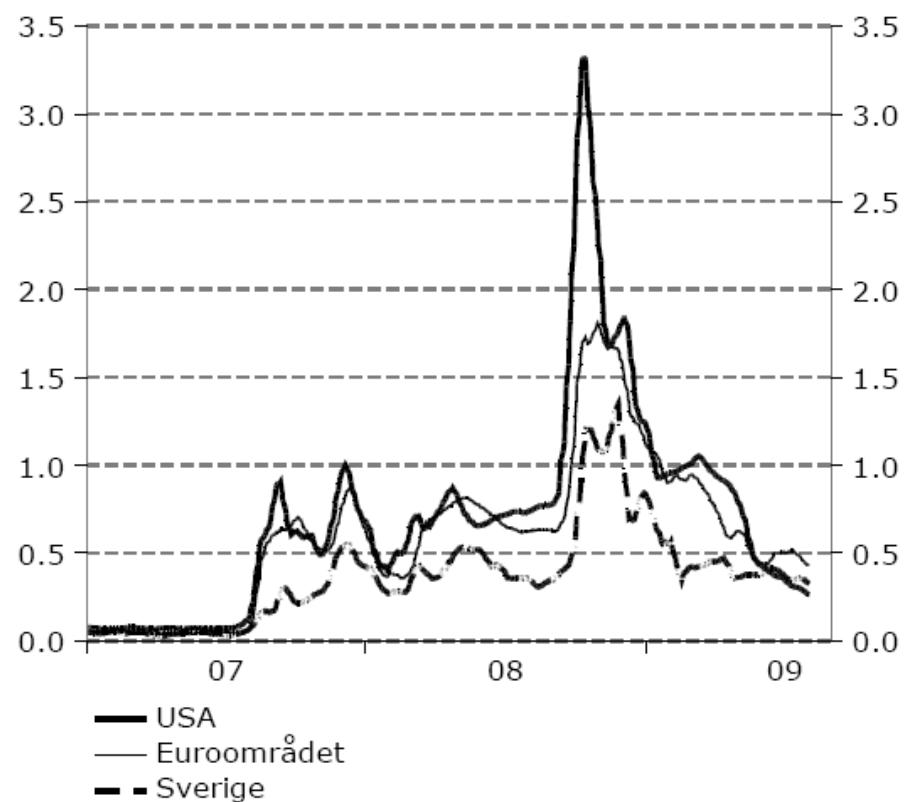
- The anatomy of the crisis
- Measures against the financial crisis
- Monetary policy
- Principles of fiscal policy
- Sustainability of fiscal policy
- The fiscal policy debate in Sweden
- The 2010 Government Budget Bill
- Overall evaluation of Swedish fiscal policy in the crisis
- Lessons from the crisis
- Challenges for the future

The current economic crisis

- First what looked as an ordinary downturn (2007)
- Then an exploding financial crisis
 - falling house prices in the US and subprime loan crisis (2007)
 - transmission to large parts of the financial system in the US and the rest of the world (autumn 2008)
 - bankruptcies and huge interest rate spreads
 - interbank transactions came to a halt
 - deleveraging and credit contraction
- An unusually deep economic downturn
- Sweden not hit so much by the financial turmoil but rather by fall in world demand and exports

Diagram 47 Ränta på interbanklån, differens mot förväntad styrränta (basis-spread)

Procentenheter, dagsvärden, 10-dagars glidande medelvärde

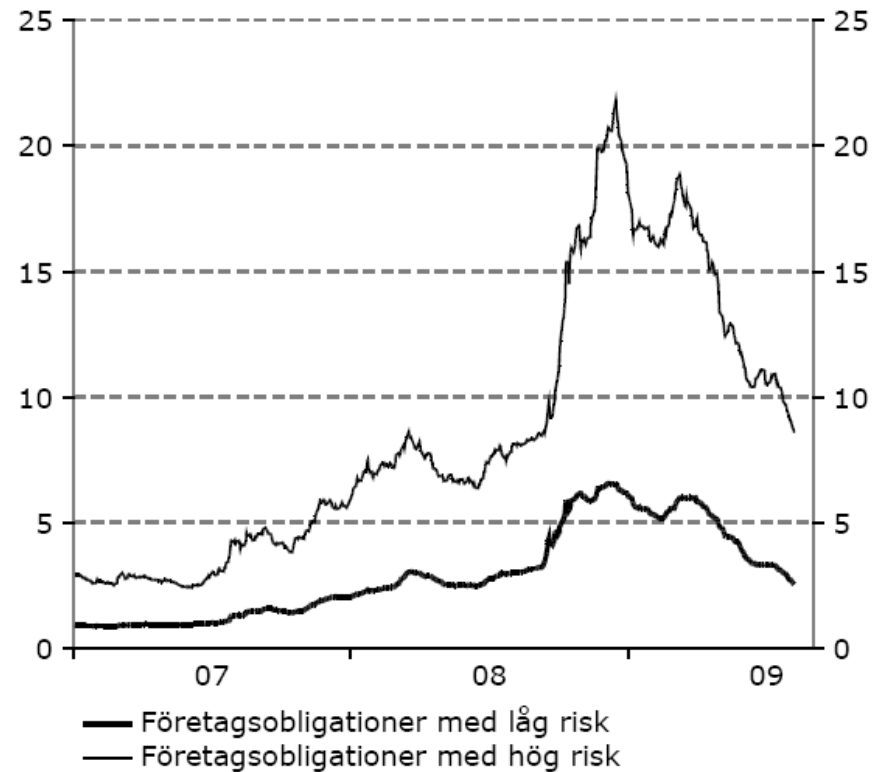


Anm. Löptid: 3 månader.

Källor: British Bankers' Association och Reuters.

Diagram 48 Ränta på företagsobligationer, differens mot statsobligationsräntan, USA

Procentenheter, dagsvärden



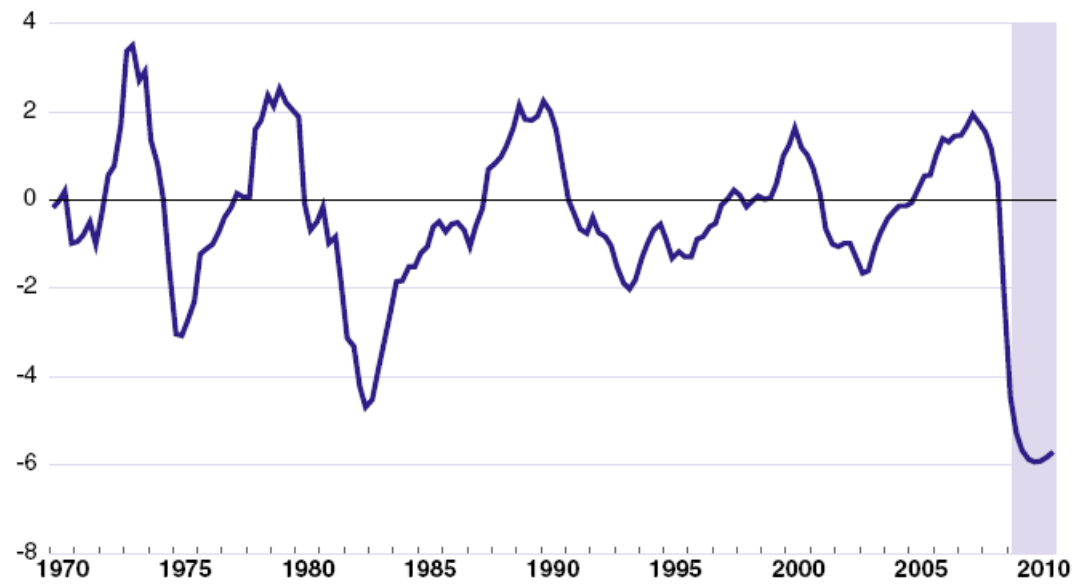
Anm. Hög risk: Ba/BB eller lägre. Låg risk: Baa/BBB eller högre. Båda klassificeringarna enligt Moody's/Standard & Poor's

Räntorna avser index över ett flertal löptider.

Källa: Merrill Lynch.

Figure 1.16. **The OECD output gap will be the largest in four decades**

In percentage of potential output



Source: OECD Economic Outlook 85 database.

Diagram 142 BNP-gap

Procent av potentiell BNP, säsongrensade kvartalsvärden



Källa: Konjunkturinstitutet.

The first line of defence: to deal with the financial crisis

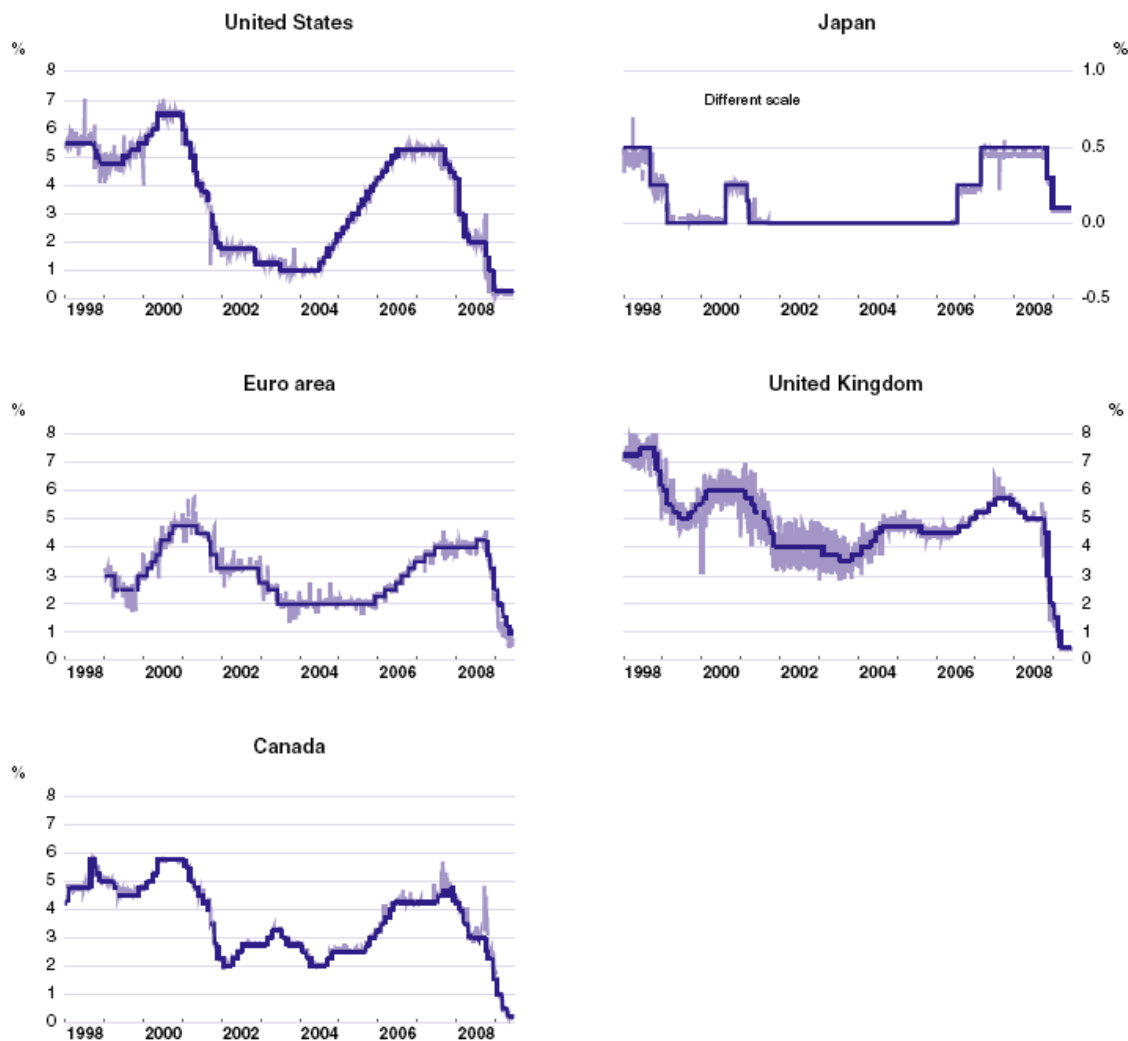
- Government support to bank take-overs
- Government take-overs of insolvent banks
- Higher deposit insurance
- Government guarantees of bank lending
- Government capital injections
- Substantial bail-outs
 - ring-fencing strategies (guarantees to cover losses above a certain level – UK)
 - purchases of toxic assets (but at what price?)
 - moral-hazard problems

Second line of defence: monetary policy

- Interest rate cuts – basically zero policy rates
 - one would have liked to achieve highly negative real interest rates (nominal interest rates minus inflation)
 - but this is impossible to achieve when inflation is close to zero or negative since nominal interest rates cannot be negative
- Unconventional methods – quantitative easing
 - purchases of government and commercial bonds
 - unlimited provision of liquidity to banks
 - lending to banks against lower-quality collateral and on longer horizons than normally

Figure 1.19. Policy rates are very close to zero in most major OECD economies

Last observation: 10 June 2009

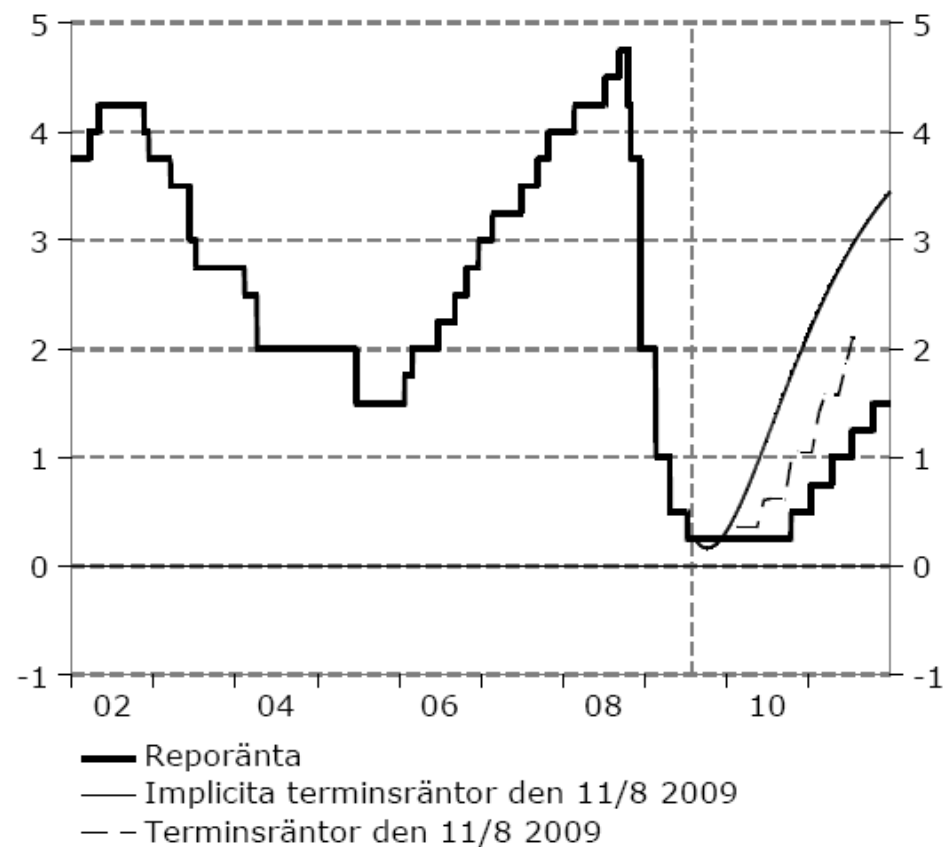


Note: The dark line represents the main policy rate of the central banks. The light line plots the effective overnight rate.

Source: Bloomberg, Bank of Japan, Datastream, ECB.

Diagram 60 Reporäntan i Sverige

Procent, dagsvärden



Anm. Enligt avkastningskurvan den 11/8 2009.

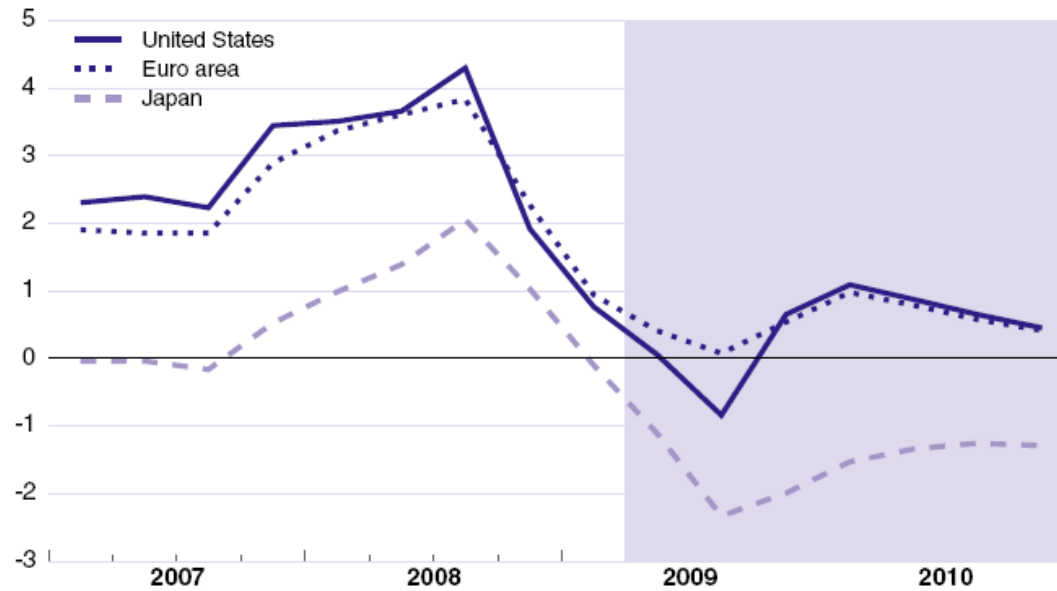
Källor: Reuters, Riksbanken och Konjunkturinstitutet.

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Figure 1.18. **Inflation will fall to very low levels**

Year-on-year growth rate, %

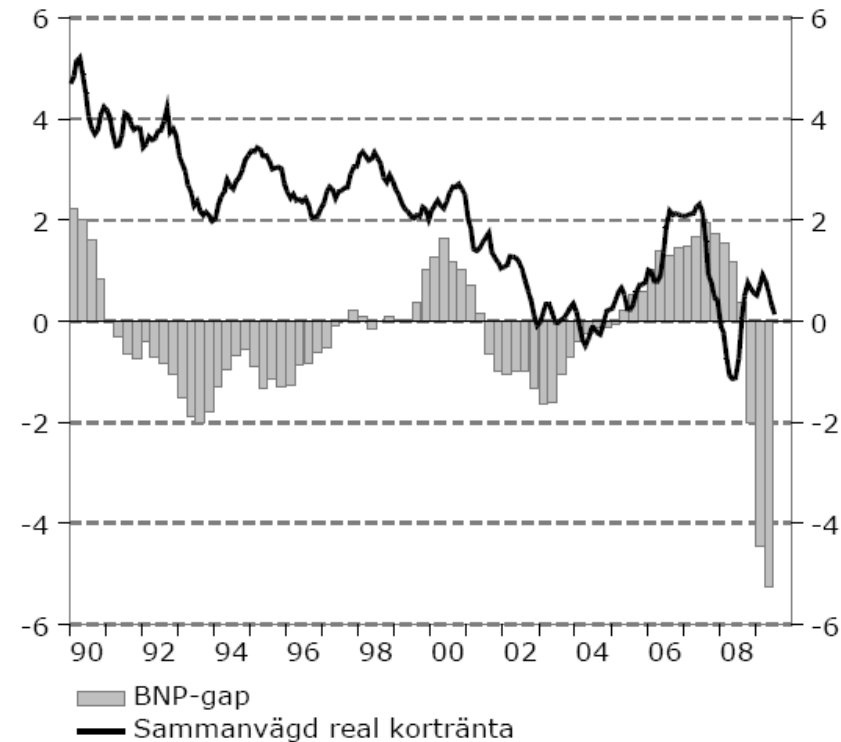


Note: Personal consumption expenditures deflator for the United States; Harmonised index of consumer prices for euro area; Consumer price index for Japan.

Source: OECD Economic Outlook 85 database.

Diagram 57 BNP-gap och sammanvägd real kortränta för OECD-området

Procent av potentiell BNP, kvartalsvärden
respektive procent, månadsvärden

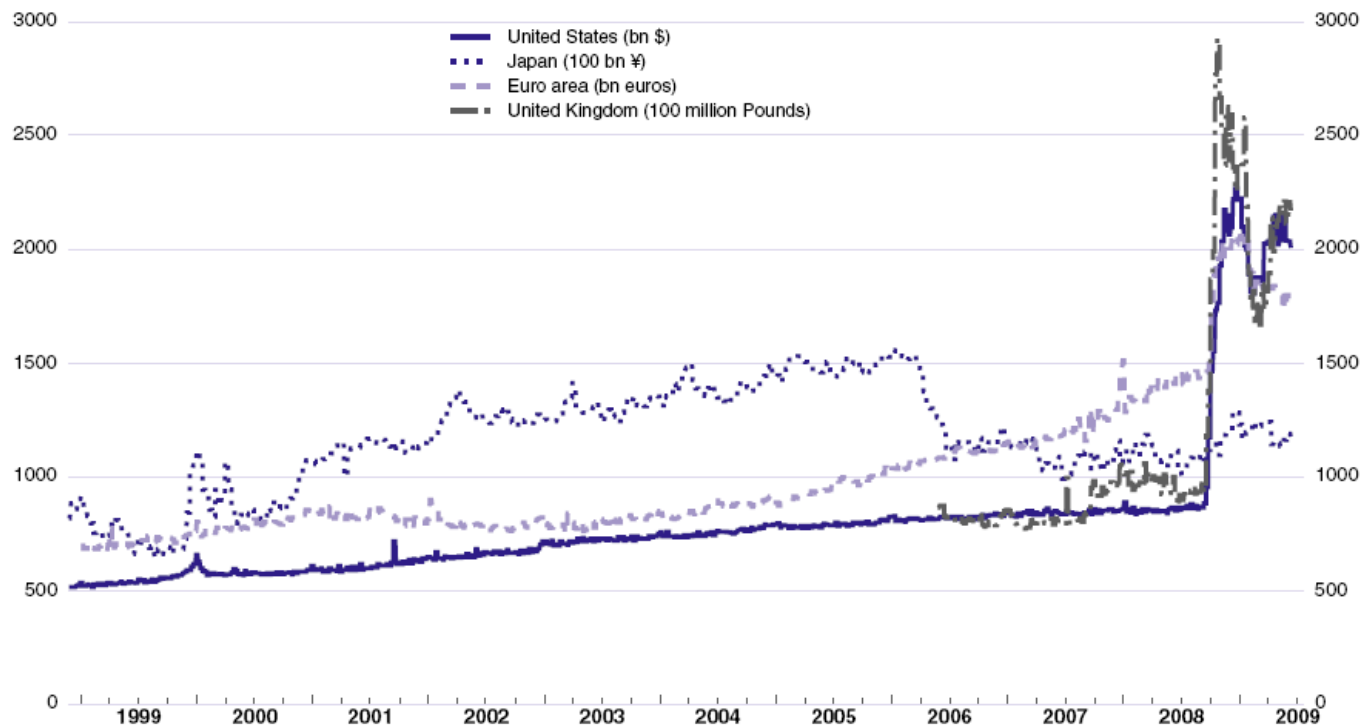


Anm. Sammanvägd med BNP-vikter. Realräntan beräknad som räntan på en tremånaders statsskuldväxel minus genomsnittlig inflation under växelns löptid.

Källor: Reuters, OECD, IMF och Konjunkturinstitutet.

Figure 1.20. **Unconventional measures have led to expansion of central banks' balance sheets**

Latest available date: 11 June 2009



Source: Datastream.

Conventional wisdom on fiscal policy

- Under normal circumstances only monetary policy should be used as a stabilisation policy tool
 - delegation to independent central bank gives short decision lag
 - small risk of expansionary bias
- Under normal circumstances discretionary fiscal policy should be avoided
 - long decision lag
 - risks of political misuse ("political business cycles")
 - expansionary bias may create long-run sustainability problems
 - rely only on the automatic stabilisers (automatic variations in tax revenues and transfers over the cycle)

Fiscal policy can be ineffective

- Doubts about long-run sustainability lead lenders to require high risk premia, which raise long-term interest rates
 - contractionary effects
 - crowding out of private investment
 - potentially dangerous government debt dynamics if interest rate increases increase interest payments at the same time as growth is stifled (Sweden in the 1990s)
- Ricardian equivalence effects
 - if tax cuts/transfer increases cause expectations of compensating tax rises/transfer decreases in the future, households will not increase spending but save instead
 - this risk is larger if government deficits and debt are large to begin with so that fiscal consolidation is expected in the near future

Third line of defence: fiscal policy

- Doubts were cast aside
- Unusually deep recession and situation where monetary policy could not do so much more because of zero-interest rate bound

Guiding principles – 3T

Policies should be:

- Timely
- Temporary
- Targeted

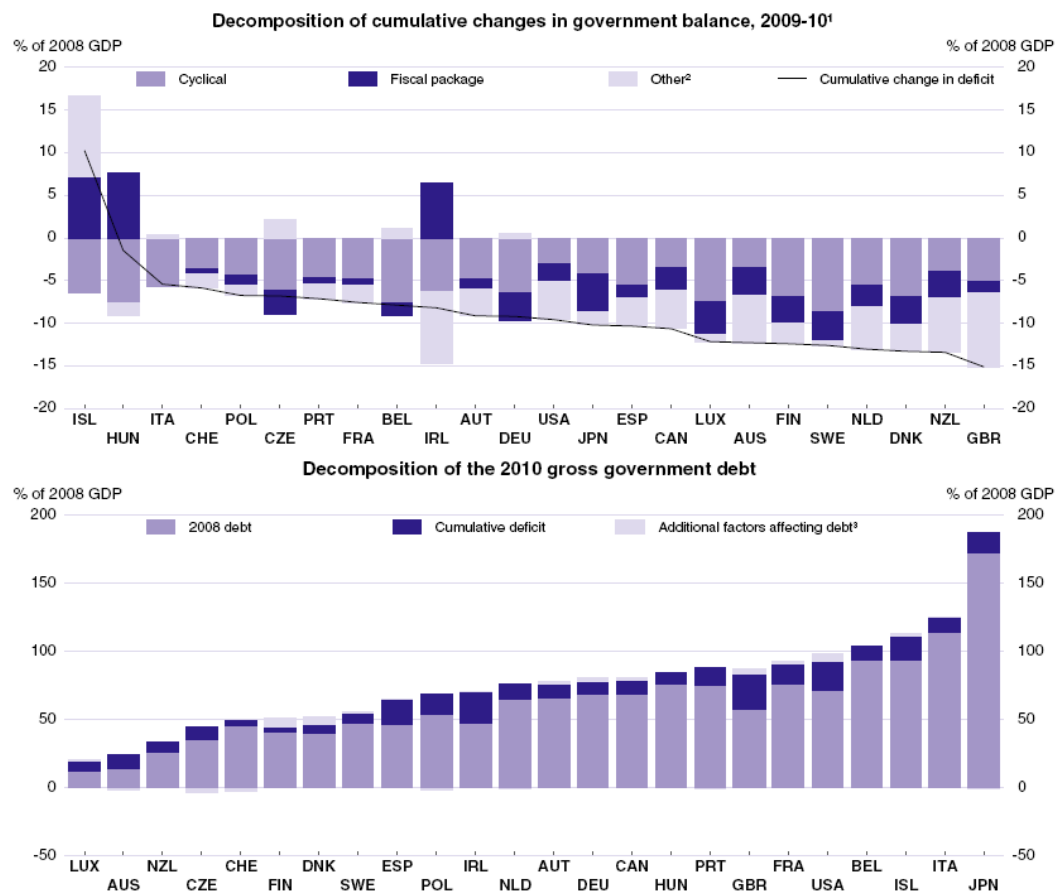
Debate on what fiscal policies are most effective: varying research results

- High multipliers for government investment
 - but difficult to increase government investment rapidly
- Much – but not all – research suggest higher multipliers for government consumption than for tax cuts
- Tax cuts and transfer increases should be targeted at low-income earners
 - higher propensity to spend than high-income earners
 - low-income earners are likely to be credit-constrained to a larger extent
 - appropriate groups: unemployed, pensioners with low incomes, low-wage groups
- Temporary VAT cuts to reallocate consumption over time

Large fiscal stimulus programmes in many countries

- Especially the US and the UK
- But the fiscal stimulus programmes are problematic in many countries
 - high government debt already to start with
 - long-run sustainability problems due to an ageing population
 - little room for manoeuvre
- Sweden is in a more favourable situation because of strong public finances after fiscal consolidation after the crisis in the 1990s

Figure 1.21. Fiscal positions are worsening markedly



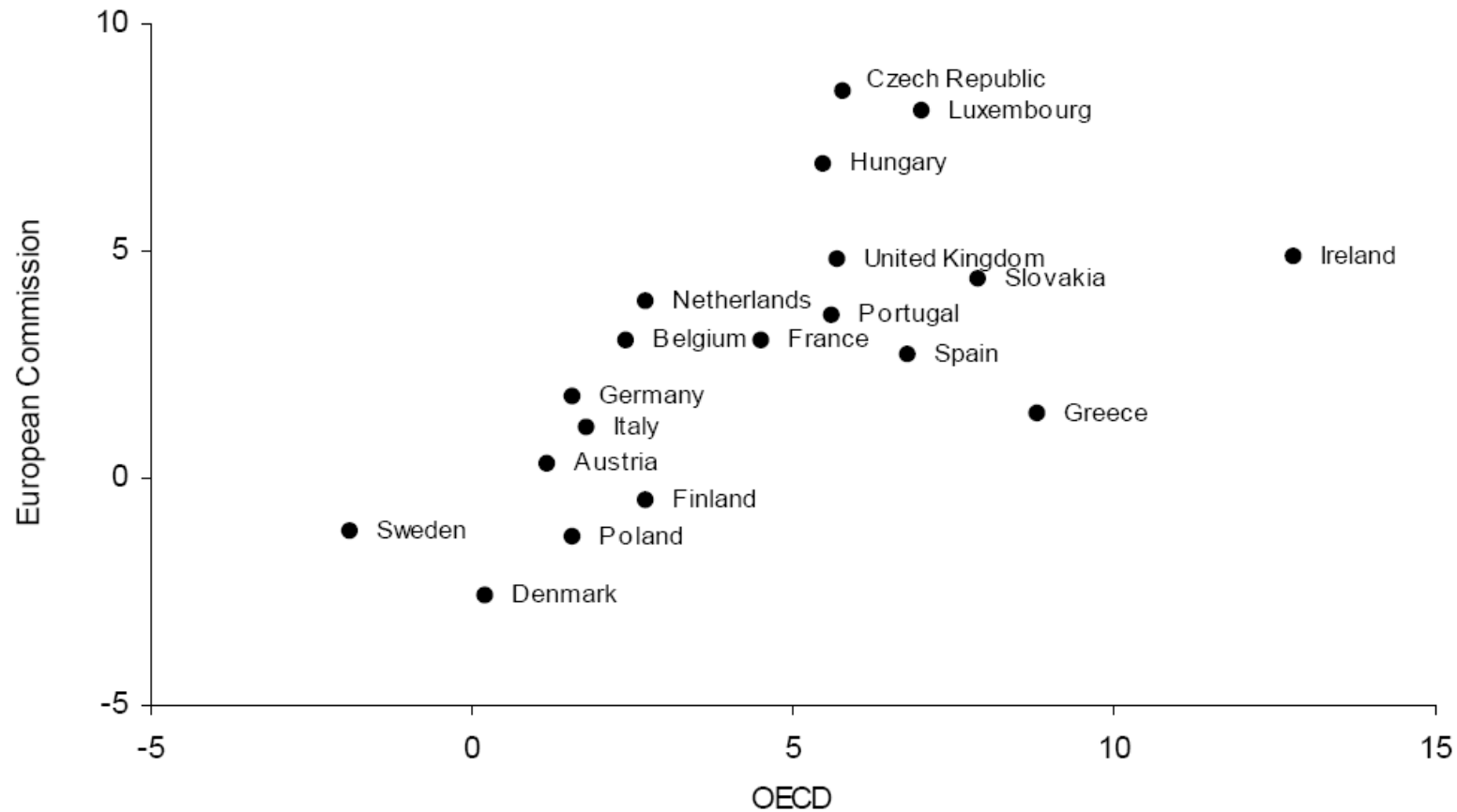
1. Sum of 2009 and 2010 deviations from 2008 levels of government balances.
2. Cumulative changes in deficit minus the sum of the fiscal package and the cyclical components. This captures effects such as discretionary fiscal policy measures other than those in response to the crisis and the disappearance of exceptional revenue buoyancy.
3. 2010 debt minus the sum of 2008 debt and the cumulative deficit for 2009-10. This includes debt-increasing equity participations in companies.

Source: OECD Economic Outlook 85 database.

Indicators of long-run fiscal sustainability

- A government must meet its **intertemporal budget constraint**
 - future primary surpluses (tax revenues minus government expenditures excluding interest) must be at least as large as current debt
 - one can calculate future primary surpluses at given tax rates and given assumptions on future transfers and future government consumption (which depend on demographic developments)
 - the **S2-indicator** measures the need for a permanent tax rise in per cent of GDP necessary to meet the government budget constraint

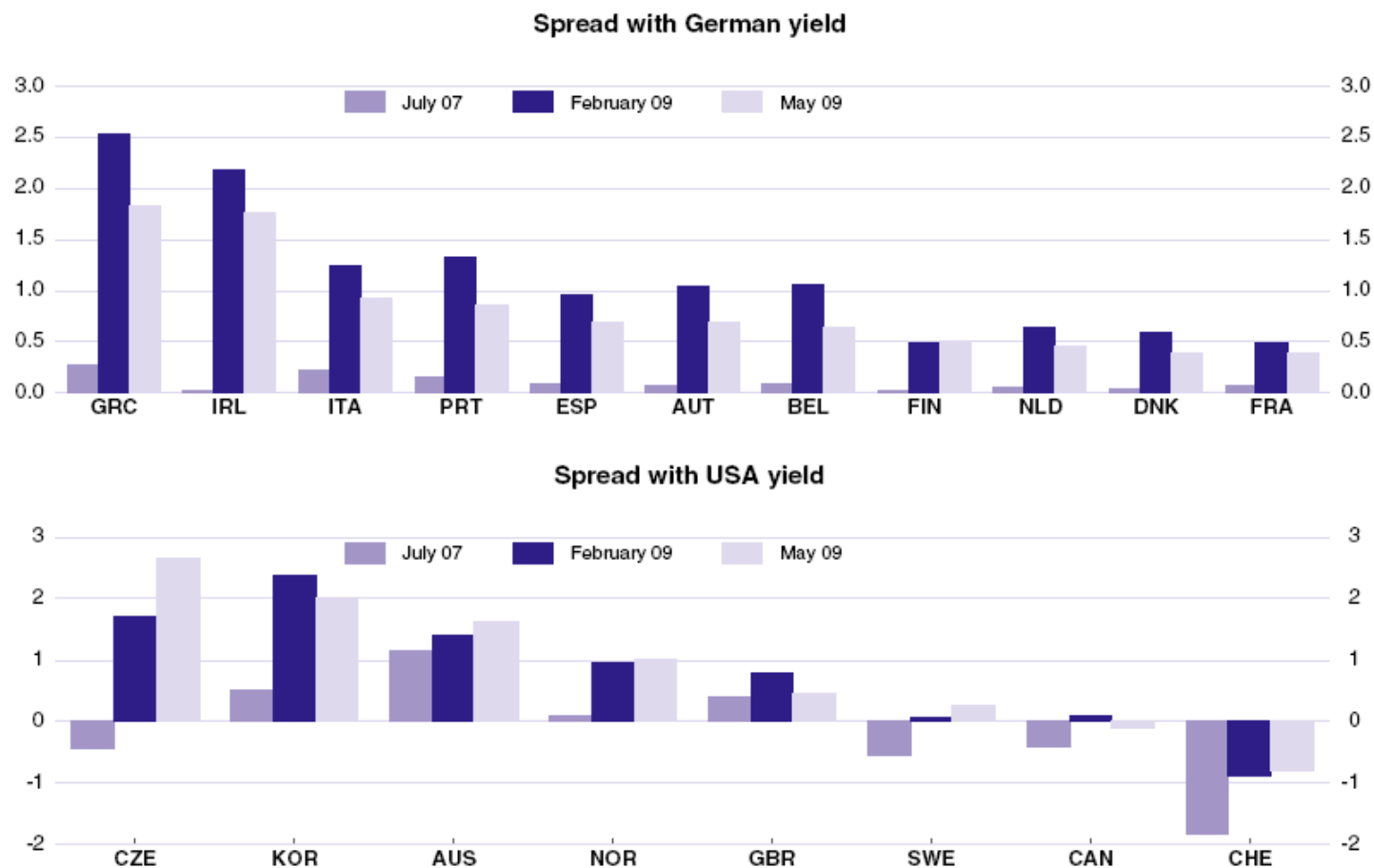
Figure 1.9 Long-term sustainability of public finances (S2 indicator)



Note: The European Commission figures refer to 2007 and the OECD's to 2008.

Sources: European Commission (2008) and OECD (2009).

Figure 1.22. Sovereign bond spreads have increased in most countries

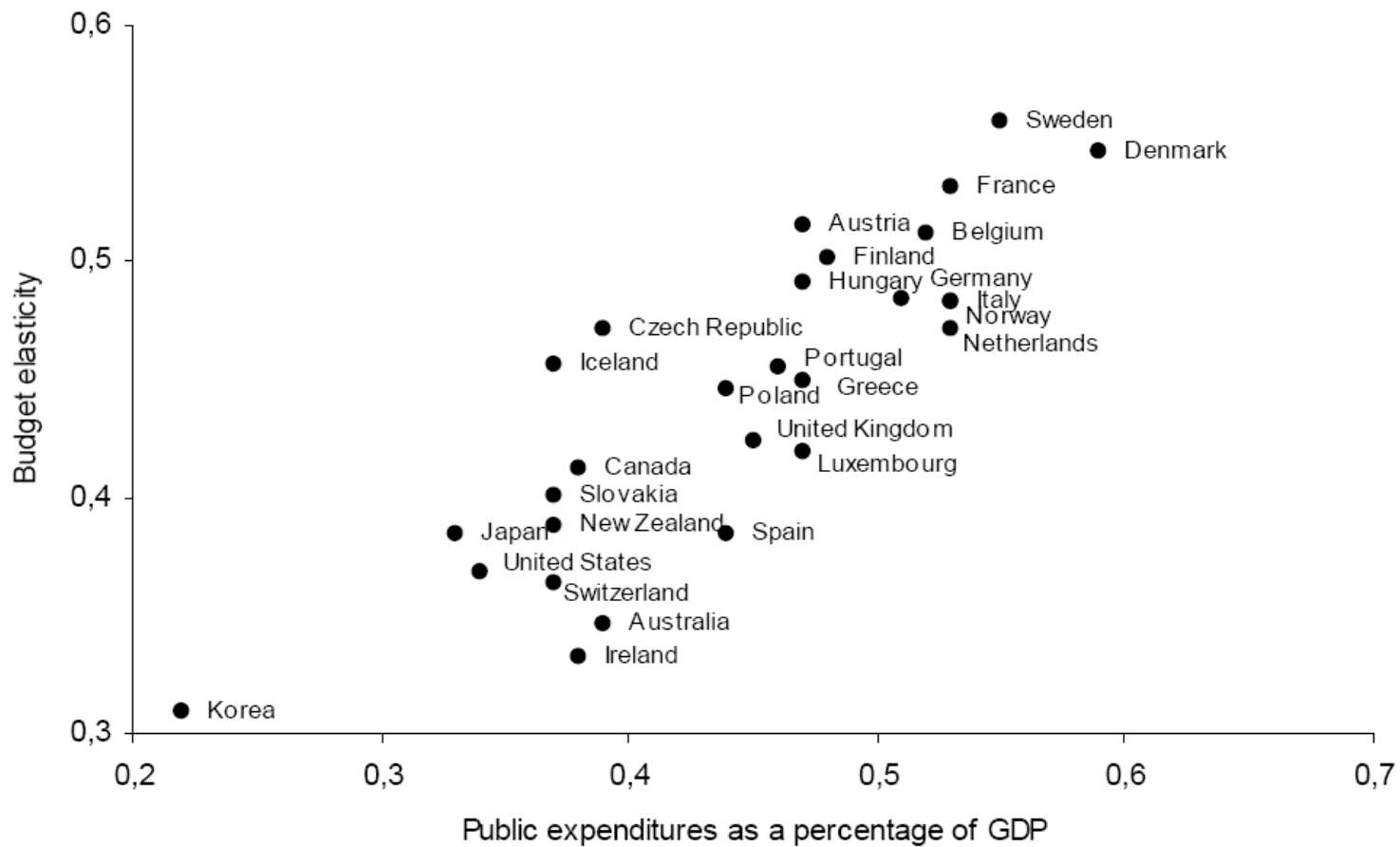


Source: Datastream.

Debate in Sweden on fiscal policy

- Discretionary fiscal policy stimulus in 2009 of around 1 per cent of GDP (reduction in cyclically adjusted fiscal surplus)
 - decided already in the early autumn of 2008 before the depth of the crisis was known
- The government was unwilling to take more discretionary action
 - fear of debt increases (costs of bank support)
 - fears that policies would be ineffective (Ricardian equivalence)
 - reliance on strong automatic stabilisers

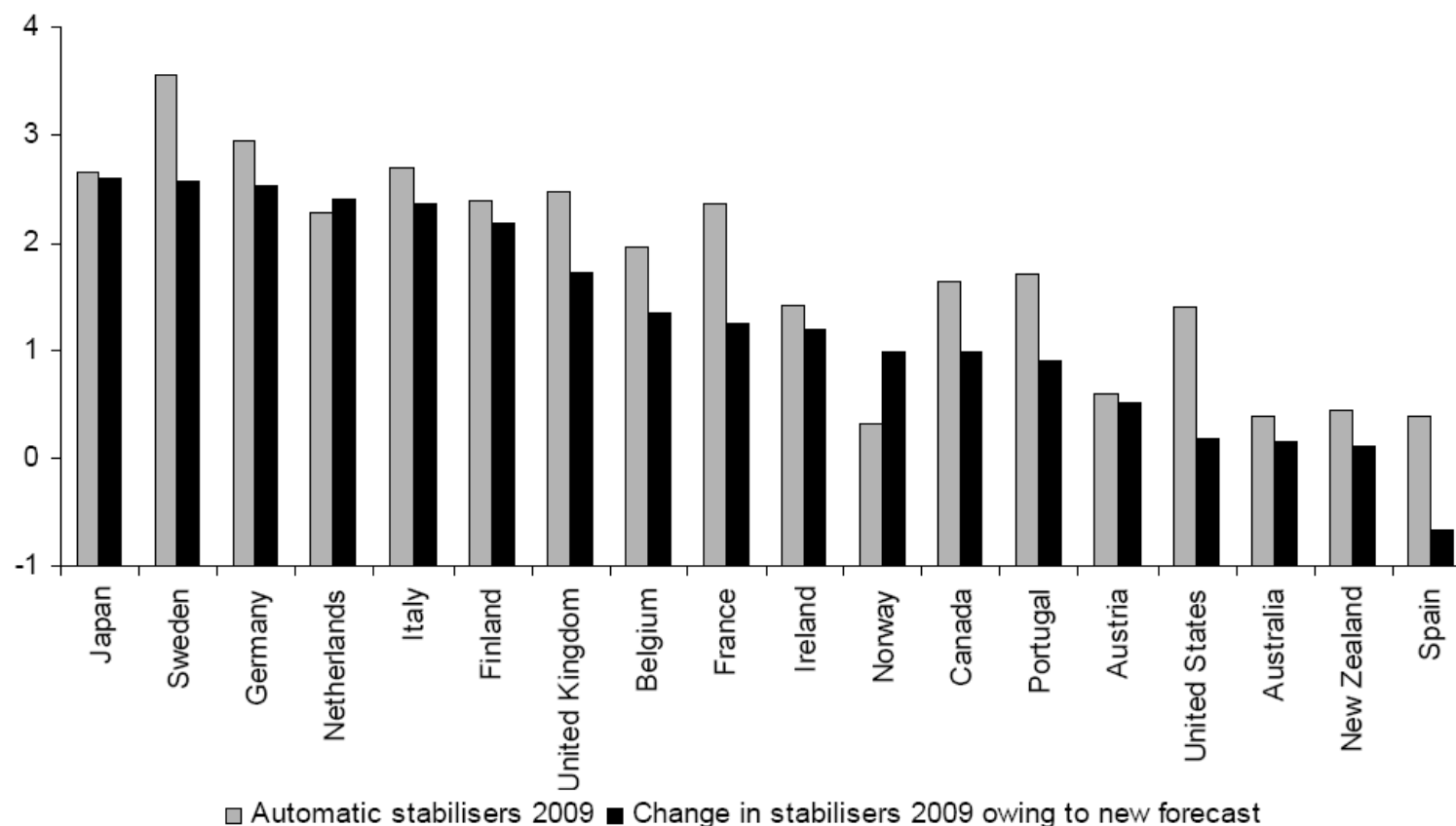
Figure 1.5 Budget elasticity and the size of the public sector



Note: Public expenditure refers to total expenditure as a percentage of GDP in 2005.

Sources: Girouard and André (2005) and OECD (2008a).

Figure 1.11 Automatic stimulus measures



Note: Percentage of GDP. The grey bars show the size of the automatically generated stimulus measures, calculated as the OECD’s budget elasticity multiplied by the IMF’s estimate of the production gap in 2009. The black bars show how much these automatically generated stimulus measures have increased as a result of the IMF’s revision of its estimate of the output gap in the past year.

Source: Fiscal Policy Council calculations.

The need for fiscal stimulus

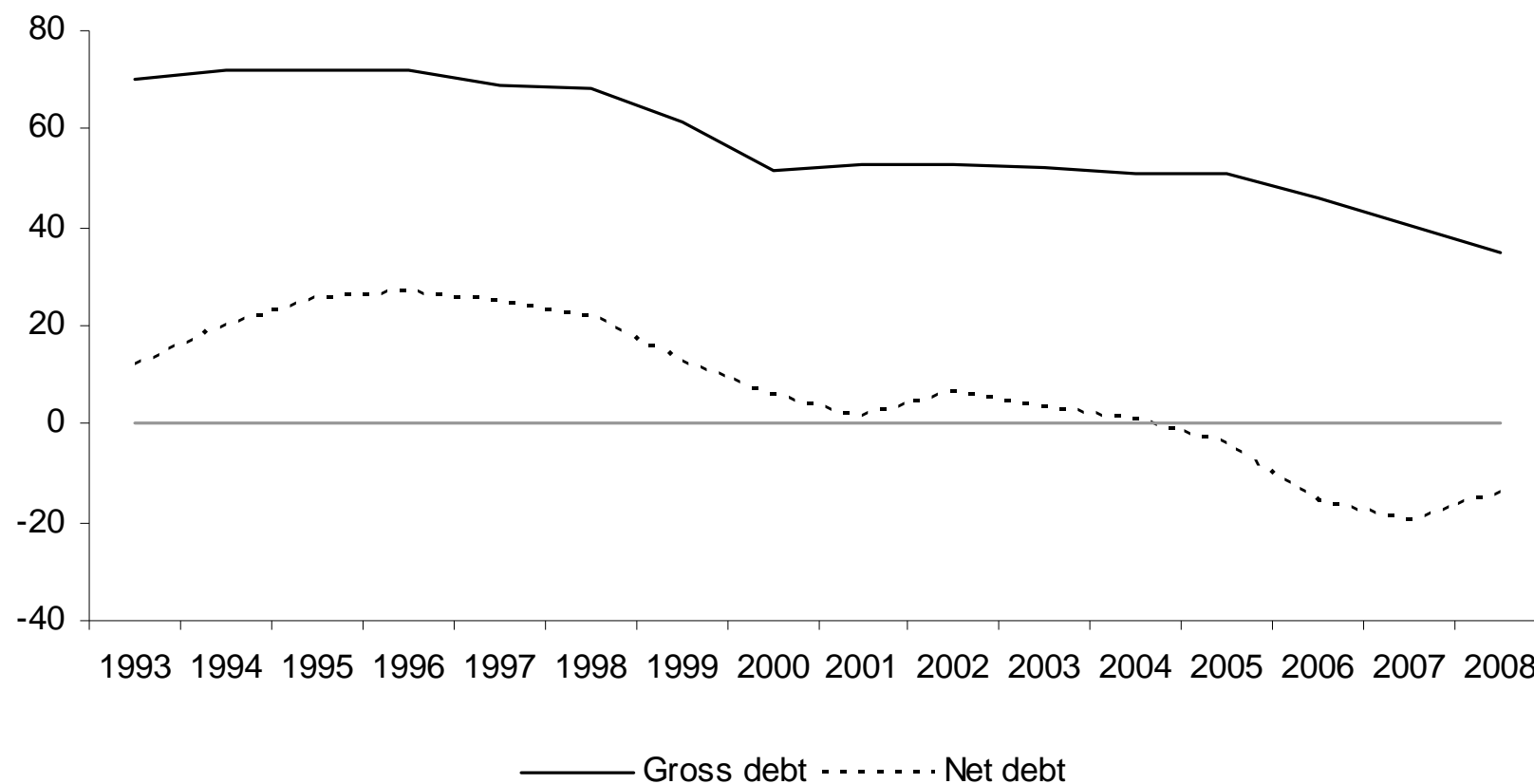
1. Deeper recession than when fiscal policy for 2009 was planned
2. Some of the tax cuts for 2009 were more designed to increase supply than to stimulate demand
 - earned income tax credit
 - (marginal) tax cuts for middle-income earners
3. Reforms of unemployment insurance has meant lower income protection for the unemployed
 - more important than before to avoid that people become unemployed because of insufficient aggregate demand

The room for fiscal stimulus

1. Room for fiscal policy because of low debt and favourable sustainability indicators
2. Consensus on fiscal policy rules
 - fiscal surplus of one per cent of GDP over the cycle
 - central government expenditure ceiling set three years ahead
 - balanced budget requirement for local governments
3. Good fiscal track record

General government gross and net debt

Per cent of GDP



The Council's proposals

- Higher central government grants to local governments
 - local governments act procyclically because they are required to balance their budgets
 - hence they reduce their expenditures when the tax base shrinks
- Temporary rise in unemployment benefits
- Higher study support
- Possibly tax rebates to low-income earners



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The 2010 Government Budget Bill

- Reduction of cyclically adjusted fiscal balance by around 1.2 per cent of GDP
 - in line with the Council's judgement
- Higher central government grants to local governments
 - good that they are temporary
 - good that they are general so that there is no bailing-out of individual municipalities/regions
- Potential problem: 2/3 of stimulus measures are **permanent**
 - earned income tax credit, tax cut for old people, increased resources for the judicial system
 - some risks for long-run sustainability
 - very difficult to judge the cyclically adjusted fiscal balance in such a deep recession

Fiscal balance in Sweden

	2005	2006	2007	2008	2009	2010
Actual fiscal balance	2.0	2.4	3.8	2.5	-2.2	-3.4
Cyclically adjusted fiscal balance	0.6	0.5	1.6	2.3	1.4	0.2
GDP gap	1.3	2.5	2.6	0.0	-6.4	-6.5
Change in cyclically adjusted fiscal balance	0.9	-0.1	1.1	0.7	-0.9	-1.2

Source: Budgetpropositionen för 2010

Overall evaluation of the Swedish Government's economic policy in the crisis

- Good handling of the pure financial crisis
- A bit slow to adjust thinking from a situation where the focus should be on the supply side to a situation when deficient demand was the main problem
 - but in the end substantial stimulus measures
 - 2010 stimulus measures could have been announced earlier so as to influence expectations
 - genuine concern over the risks of increasing debts (cf the 1990s) or election tactics?

Credit for not giving selective support to individual sectors so far despite pressures

- Automotive industry
- Instead local collective agreements on work sharing (lower pay in exchange for shorter hours)
- Selective subsidies would either lead to distortions or open up for subsidies to many sectors

Criticism for bending the rules regarding the central government expenditure ceiling

- Research on public finances indicates crucial role for such ceilings
- Expenditures for 2010 are paid out in December 2009 to circumvent the ceiling (13 billion SEK are in this way moved to year with larger budgeting margin)
- Such manipulations threaten the credibility of the ceiling
 - no limit to manipulations once one starts
- Better with transparent **escape clause** as in the EU's stability pact
 - permission to break the ceiling if negative growth or large negative output gaps

Lessons from the crisis

- Illustration of how fast the situation can change
 - in the summer of 2008 Sweden was still in a boom with rather too high fiscal surpluses
- Illustration of how difficult forecasting and evaluations of macroeconomic risks are
 - warnings of unsustainable global macroeconomic imbalances and too high house prices
 - but instability of financial system and depth of recession came as a surprise
 - self-criticism on the part of economists is necessary: earlier debate was on "the Great Moderation"
 - too little integration between macro economics and finance

Conventional wisdom may have to change very quickly

- In the 1970s and early 1980s it took far too long to move from a focus on the demand side to a focus on the supply side
- Now demand-side policies and policies to deal with the financial crisis were adopted quite fast

Major challenges

- Exit strategy for fiscal policies reducing deficits again
- Exit strategy for return to more normal monetary policy so as not to induce new asset price bubbles
- Trade-off between future risks of unsustainable fiscal policy and inflation and current risks of prolonging recession
- Need for major rethink of policies
 - successful inflation targeting is not enough for successful monetary policy if asset price bubbles cause instability
 - need for more monetary policy instruments (cyclical variations in capital adequacy ratios)
 - better financial regulation
 - need for stronger public finances in normal times
- Not clear how countries like the US, UK, Germany and France will cope with the situation
- Sweden is in a better situation than most other countries but would be affected by financial turmoil in the rest of the world and if deficits in other countries push up long-term interest rates