Global Letter — Countries in aggregate risk tightening policy too soon

Simultaneous tightening of monetary and fiscal policies threatens a repeat of post 2008 experience

As private sector demand recovers following its pandemic-induced collapse, government support to aggregate demand becomes correspondingly less necessary. And indeed it is duly declining.

Whereas in 2020 the general government fiscal balance of the G20 economies taken together supported aggregate demand to the tune of 8.8% of GDP, support this year is likely, the IMF estimates, to have fallen back to 7.9% and, on present budgetary plans, to fall further next year, to 5.9%.[1] These figures represent the sum of two effects:

1. **An automatic part** (the effect of the economy on the budget) that comes about as the economy recovers, people and companies pay more tax, and social payments for unemployment fall.
2. **A 'discretionary' part**, (the effect of the budget on the economy) that reflects the extent that governments choose to go beyond the automatic effects, and change the balance between income and expenditure.

Partitioning a country's fiscal policy into its 'automatic' and 'discretionary' components is never straightforward. And the margins of error are likely to be greater when, as at present, the magnitude of economies' potential output is more than usually uncertain. Nevertheless, when the numbers are large they are unlikely to tell a story that is qualitatively misleading.

What the numbers say

The IMF estimates that discretionary fiscal policy will tighten in the G20 economies by around 0.8% of GDP this year, and 2.1% next year (see the table). These are big numbers. And of course they come on top of the monetary tightening that looks increasingly likely to be brought forward by many central banks in response to a pickup in inflation.

Given that economic recovery is by no means yet fully assured, this joint fiscal/monetary tightening looks premature and risky. Amongst the G7 economies individually, only the US looks likely to be cautious about its fiscal tightening in 2022 – although the figure in the table below was calculated on the assumption that the full Biden package would be enacted – which looks unlikely.

All this is reminiscent of what happened after the 2008 crisis when, after a large discretionary easing (2.5% of GDP) in 2009, support was reduced in 2010 (to just -0.7%), and reversed by a discretionary tightening (1.1%) in 2011. Partly at least for this reason, G7 growth between 2009 and 2019 averaged only a lacklustre 1.4% per year.

The world economy has long had an inappropriate policy mix – too much monetary ease and not enough support from fiscal policy. Now the risk is of a compounding of that mistake with joint fiscal and monetary policy tightening that could add up to too much demand being withdrawn too soon.[2]

It may be that this time the recovery is somewhat better established than it was in 2010 following the financial crash of 2008. But it would seem unwise to count on that.■

A tale of two episodes – discretionary changes in fiscal policy

	2007	2008	2009	2010	2011	2018	2019	2020	2021	2022
Canada	-0.2	-1.3	-2.2	-1.1	0.9	0.3	0.3	-9.6	2.2	4.4
France	-0.8	0.1	-2.0	0.0	1.1	0.2	-1.3	-3.3	-1.2	2.9
Germany	-0.2	-1.3	-2.2	-1.1	0.9	0.7	-0.2	-4.4	-2.6	4.1
Italy	1.4	-0.3	0.1	0.0	0.5	0.0	0.7	-5.0	-1.2	3.3
Japan	1.4	-1.3	-3.9	-0.4	-0.5	0.9	0.1	-6.6	1.2	4.4
UK	-0.7	-1.4	-3.5	1.8	2.4	0.2	-0.1	-7.6	0.3	4.8
US	-0.3	-2.2	-3.0	-1.3	1.3	-1.1	-0.9	-4.6	2.0	0.5
G7	0.1	-1.3	-2.5	-0.8	1.2	-0.3	-0.6	-5.2	0.9	2.2
G20	0.2	-1.4	-2.5	-0.7	1.1	-0.3	-0.7	-5.1	0.8	2.1

Source: IMF Fiscal Monitors, various issues, and LlewellynConsulting | Independent Economics
Note: Change in cyclically adjusted general government balance, % of GDP. A positive value indicates a tightening.

[1] See IMF, 2021. Strengthening the credibility of public finances. October. Table 1.1.

https://www.imf.org/en/Publications/FM/Issues/2021/10/13/fiscal-monitor-october-2021

[2] In earlier epochs, efforts would have been made, in OECD and IMF fora, to coordinate policy before a crisis, rather than waiting until after. But not in today's go-it-alone world.