Comment

Exploring the boundaries of greater fiscal activism

- *Too much of a burden has been put on the shoulders of central bankers to support demand*
- *The requirement is for a more balanced macro policy mix embracing more fiscal activism*
- *Historically low interest rates indicate some fiscal policy space almost everywhere*
- *Other metrics suggest the case for macro policy rebalancing is strongest in Europe*
- *An internationally co-ordinated fiscal expansion would help to maximise its impact*

Monetary cul-de-sac

Central bankers are increasingly running out of road …

There is a growing perception that monetary policy is close to exhaustion in the advanced economies. Policy rates are for the most part set around the zero bound, if not some way through it. Asset purchase programmes are commonplace, often accounting for unprecedented shares of peacetime GDP, and increasingly extending to private sector securities. Forward guidance statements confirm policymakers' widespread expectation that benchmark interest rates will remain historically low over forecast time horizons.

… while the next downturn may not be far away …

Yet the distortionary costs of these increasingly unorthodox strategies are building, while their potency seems to be waning. For all the fertility of mind of central bankers since 2007, growth remains lacklustre, and inflation typically below target. Furthermore, the recovery from the global financial crisis, modest though it may be, is now long in the tooth. Based on historical experience, the statistical probability of a renewed downturn is therefore inexorably rising, while there is likely to be precious little, if any, orthodox monetary ammunition left with which to combat it.

Fiscal opportunity

Fiscal policy is therefore back on the agenda …

In such unprecedented circumstances, there would appear to be a strong *a priori* case for greater reliance on fiscal policy in the management of aggregate demand,[1] and for some time now, many economists, ourselves included, have been calling for the development of improved 'automatic stabilisers'[2] and public infrastructure programmes that would have the added attraction of improving productivity and supply-side potential.[3] Indeed, there might be little or no alternative to fiscal initiatives if macro stabilisation policy is to remain a fact of life, as it surely must.[4]

This begs a number of questions, however. In particular: which countries have the most financial latitude to ease fiscal policy? Where is the case for a rebalancing of macro policy towards fiscal activism strongest? And where is, and how is, fiscal expansion likely to be most effective?

Measurement matters

… but there are issues of 'space', urgency, and effect …

In an effort to answer these questions, Llewellyn Consulting has developed a 'heatmap', which pulls together a range of relevant public finance metrics.[5] These are divided into three sub-categories pertinent to the three questions raised above, ranked relative to certain recognised[6] benchmarks or our own informed judgement, and divided into four colour-coded groups, which indicate the degree of fiscal flexibility, or the strength of the case for more fiscal activism, an individual country enjoys in each area. Dark green shading is applied to the most positive or encouraging scores, and dark red shading to the least. Light green and pink shading apply to the categories in between. The individual metrics are then used to produce an average score (between 0 and 1, with equal weights applied to each metric) and colour coding for each of the three sub-categories. Finally, the metrics across the three sub-category rankings are themselves averaged into an overall fiscal activism ranking and colour coding.

Both the sub-category and overall rankings should be treated cautiously, however. Some might question the appropriateness of the benchmarks used, for example. The system of equal weighting of the various metrics is also contentious, and no doubt some observers might prefer to see alternative metrics employed. Clearly, therefore, the messages delivered by the heatmap, while potentially illuminating, come with caveats and leave considerable scope for interpretation.

… which require the review of a range of pertinent data …

To evaluate the fiscal space or financial leeway available to individual governments, the general government budget balance as a percentage of GDP;[7] the general government gross debt to GDP ratio; general government net interest payments as a percentage of GDP; the net present value (NPV) of future age-related spending out to 2050 as a percentage of GDP; the share of government spending in GDP; and 10-year government bond yields were reviewed. Together, these indicators should capture debt stock and flow dynamics, structural pressures on government balance sheets, and market perceptions of fiscal risk premia.

To assess the strength of the case for a rebalancing of macro policy away from monetary initiatives, the level of policy rates; the size of central bank balance sheets; the 10-year average share of public investment in GDP; and the size of the output gap were examined. Together, these series should capture the reliance to date on monetary policy, any deficiency of public sector investment, and the amount of residual excess capacity in the economy.

Finally, to determine the potential potency of fiscal stimulus, the household debt burden; the tax share in GDP; the openness of economies to imports; and the marginal efficiency of capital were assessed. These indicators should capture the likely responsiveness of the consumer and the private sector more broadly to tax breaks and public expenditure increases, how much of any fiscal expansion is likely to flow abroad, and the productivity of investment spending.

North and south, east and west

Bond yields indicate some fiscal space almost everywhere

Some economists argue that with long-term interest rates close to historical lows, and the rate of return on most reasonably efficient public investment projects running into high single digits, if not higher in the case of urgently needed repair and maintenance, the financial case for greater fiscal largesse is clear-cut.[8] There is much to be said for these arguments, and perhaps only in Greece does the level of long-term borrowing costs currently potentially conflict with such judgements. If Greece were to relax fiscal policy, it might well need the explicit support of its EU partners to underwrite it.

Notwithstanding the important signals sent by market interest rates, a more detailed and nuanced assessment of fiscal space nevertheless has its merits. This is particularly so in the context of Europe's recent public debt crises and the longer-term pressures on the public finances.

Other metrics suggest it is greatest in northern Europe …

Reviewing the heatmap, it would appear that the economies with the most financial latitude to ease fiscal policy are, with the exception of Korea, in Europe, and in particular in northern Europe. There would appear to be little, if any, financial constraint on Germany, Holland, Switzerland, Sweden, Norway, Denmark, or even Ireland, embracing a more expansive budgetary stance.

Much of this, is already widely appreciated, however. It is the political premium attached to budgetary rectitude, especially in northern Europe, rather than pecuniary constraints, that typically stands in the way of greater fiscal laxity in these countries. Whether such obstacles can be overcome, at least without the onset of a major downturn, remains moot.

… and most limited in southern Europe

For their part, the economies that appear to be most financially constrained are also to be found in Europe, although largely in the south and around the periphery. The US, the UK, and Belgium score relatively poorly, too however. In the UK, the major problem is its 'twin deficits'. In the US, the issues are broader: its debt ratio, external deficit, and the huge future burden of age-related spending. It should be stressed, however, that the 'exorbitant privilege' afforded the US as the home of the world's primary reserve currency, probably serves to offset these considerations; at least for the present.

Japan's position is better than generally perceived: its large budget deficit and extraordinary burden of outstanding liabilities offset to a significant degree by its current account surplus, very low bond yields, and limited debt service costs.

Where the pendulum should swing most

Policy rates are generally low, and QE often extensive

Turning to issues of macro policy asymmetry, historically low policy rates are ubiquitous. Hence, on this narrow basis, there is a case for fiscal expansion everywhere, even for example in Korea, Australia and New Zealand, where there is some residual leeway before the zero bound is reached.

The case for fiscal stimulus is further reinforced where asset purchase programmes have been aggressively employed and central bank balance sheets have already expanded dramatically. These traits are most conspicuous in Switzerland and Japan. However, only in Canada, Australia, and New Zealand are central bank balance sheets still at 'normal' levels.

Meanwhile, public investment shares seem especially low in Germany and Belgium, although they are also below appropriate levels in a number of other euro area economies and the UK. In contrast, they are highest in Korea, Canada, New Zealand and, surprisingly, Greece (this reflects the extent of the collapse in GDP over recent years), along with France, Sweden and Norway.

Output gaps are largest in the euro area, with the conspicuous exception of Germany and Ireland. Greece's rock bottom level of macro resource utilisation (-12% of GDP) is particularly noteworthy.

The macro policy mix is least optimal in Europe

Overall, the strongest case for greater reliance on fiscal expansion appears to be in Switzerland, Greece, Italy, Japan, Portugal and Belgium, with the case for policy inertia in Germany anything but clear cut. The weakest case for fiscal stimulus is in Australia, New Zealand, Korea, and Canada.

Bang for the buck

Finally, there is the matter of the potential efficiency of fiscal stimulus. Here the picture is complex.

High levels of household debt could easily reduce the effectiveness of tax cuts in Norway, Denmark, Ireland, Holland and Australia, but could act as a positive catalyst in Germany, Italy, and Austria.

Many cross currents affect fiscal policy efficiency

Tax revenue shares in GDP are already low in a number of economies, including Switzerland, Ireland, Korea, the US, and Australia. However, they are high and potentially acting as a dead-weight on growth in many European economies, not least in Sweden, Austria, Italy, France and Belgium. Here, reducing tax burdens could therefore achieve significant positive effects.

Import penetration is also high in a lot of European countries, but especially in Ireland, Holland, and Belgium, suggesting that a co-ordinated fiscal boost across the region is likely to achieve the best results. On the other hand, Japan, the US, and Australia are relatively closed economies that should benefit disproportionately from unilateral fiscal expansion.

Germany stands out as candidate for more fiscal largesse

For its part, the marginal efficiency of capital is especially low in Switzerland, Italy, Austria, Japan, France, Finland, Greece, and Canada. The US, UK, Spain, Sweden, and Ireland, do rather better.

Overall, fiscal policy efficiency is likely to be highest in Germany, Sweden, Italy, Austria, France, Spain and Finland, and lowest in Switzerland, Ireland, Holland, and Korea.

… and the winners are

Across the three sub-categories, the prime candidates for fiscal easing are Germany, Switzerland, Sweden, and Norway, while it seems least appropriate for Canada, Greece (at least without external financial support of its neighbours in the Eurozone), Australia, and New Zealand. Overall, however, resort to an internationally co-ordinated fiscal expansion makes the most sense.

Watch fors

- More pleas from central bankers for government assistance in supporting final demand.
- Louder government rhetoric to the effect that public infrastructure is a supply side policy.
- A greater focus on improving fiscal automatic stabilisers, or temporary fiscal stimuli.
- Louder calls for an internationally co-ordinated fiscal expansion.

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Figure 1: Fiscal policy heatmap

	Germany	Switzerland	Sweden	Norway	Austria	Italy	France	Denmark	Finland	Japan	Spain	Ireland	Belgium	Netherlands	UK	Korea	Portugal	US	Canada	Greece	Australia	New Zealand
A. Fiscal room																						
Budget balance (% of GDP)	0.6	-0.2	-0.9	5.4	-1.6	-2.6	-3.6	-2.0	-3.3	-5.2	-4.5	-1.6	-2.8	-1.9	-4.4	-0.2	-4.4	-3.7	-1.7	-4.2	-2.8	0.3
Debt to GDP (%)	71.0	45.6	44.1	27.9	86.2	132.6	96.8	45.6	62.4	248.1	99.0	95.2	106.3	67.6	89.3	35.9	128.8	105.8	91.5	178.4	36.8	30.4
Debt servicing costs (% of GDP)	1.2	0.2	-0.1	-2.8	1.9	4.0	1.9	0.8	0.2	0.6	2.7	2.8	2.6	0.9	2.0	-0.1	4.2	2.8	1.0	3.4	0.6	0.8
Current account balance (% of GDP)	8.5	11.4	5.9	9.0	3.6	2.1	-0.1	6.9	0.1	3.3	1.4	4.5	0.5	11.0	-4.3	7.7	0.5	-2.7	-3.3	0.0	-4.6	-3.0
NPV of age-related spending (% of GDP)	76.7	121.6	-9.6	81.7	76.4	37.6	13.0	7.1	65.0	54.7	90.6	66.7	126.0	151.2	63.6	154.4	105.3	152.9	63.7	58.8	73.8	145.1
Government expenditure (% of GDP)	44.0	33.0	49.3	47.7	51.9	50.4	56.9	53.8	58.5	39.3	43.0	34.4	53.9	45.9	40.2	21.1	48.2	35.7	40.3	50.0	37.2	34.7
Q2 10-year gvt bond yields	0.1	-0.4	0.6	1.3	0.4	1.4	0.4	0.3	0.4	-0.2	1.4	0.7	0.5	0.3	1.4	1.7	3.1	1.7	1.3	8.8	2.3	2.7
Total [0 (lower) to 1 (higher)]	0.63	0.69	0.68	0.77	0.50	0.42	0.47	0.63	0.48	0.44	0.42	0.55	0.38	0.55	0.42	0.66	0.30	0.36	0.49	0.23	0.50	0.49
B. Case for fiscal stimulus																						
Monetary policy rate (15/04-15/07)	-0.4	-0.8	-0.5	0.5	-0.4	-0.4	-0.4	0.0	-0.4	-0.1	-0.4	-0.4	-0.4	-0.4	0.5	1.4	-0.4	0.5	0.5	-0.4	1.8	2.3
Central Bank assets (% GDP)	31.4	107.8	18.6	18.6	31.4	31.4	31.4	24.9	31.4	85.3	31.4	31.4	31.4	31.4	22.0	30.4	31.4	24.9	5.3	31.4	10.1	10.6
Public investment (% of GDP)	2.2	2.9	4.4	4.1	3.0	2.8	3.9	3.3	3.8	3.4	3.7	3.1	2.3	3.8	2.7	5.1	3.3	3.4	4.0	4.2	3.4	3.9
Output gap (% of potential GDP)	0.2	-2.0	-0.3	-0.8	-2.8	-3.7	-1.8	-1.7	-3.7	-0.3	-5.0	0.6	-1.2	-2.5	0.0	-1.5	-5.5	-2.0	-1.3	-12.0	-2.0	0.1
Total [0 (lower) to 1 (higher)]	0.54	0.73	0.34	0.29	0.53	0.57	0.43	0.43	0.48	0.56	0.51	0.45	0.56	0.45	0.40	0.17	0.56	0.39	0.28	0.61	0.25	0.12
C. Efficency of fiscal policy																						
Household debt (% Net disposable income)	93.6	197.8	173.4	224.7	89.1	90.2	104.7	308.0	126.9	131.8	127.3	207.4	111.9	277.0	155.8	164.3	141.3	113.5	166.4	115.0	205.8	159.5
Tax revenues (% of GDP)	39.4	27.2	44.1	38.0	44.4	43.4	47.5	47.5	44.2	32.0	34.1	28.8	46.1	37.4	34.6	26.7	36.9	27.3	31.6	39.5	27.6	32.3
Import penetration (% GDP)	29.3	35.9	29.2	22.0	33.6	21.7	24.4	32.1	28.8	13.2	22.3	50.9	46.7	42.2	25.1	33.3	30.9	14.0	24.6	23.1	17.3	24.8
Marginal efficiency of capital	0.08	0.04	0.16	0.07	0.04	0.05	0.05	0.06	0.03	0.02	0.15	0.35	0.06	0.10	0.14	0.09	0.09	0.12	0.05	-0.02	0.10	0.10
Total [0 (lower) to 1 (higher)]	0.61	0.27	0.63	0.48	0.62	0.69	0.71	0.43	0.60	0.54	0.60	0.39	0.54	0.30	0.54	0.35	0.52	0.57	0.44	0.56	0.43	0.49
Candidacy for fiscal easing [0 (lower) to 1 (higher)]	0.60	0.59	0.57	0.57	0.54	0.53	0.52	0.52	0.51	0.50	0.49	0.48	0.47	0.46	0.45	0.45	0.43	0.42	0.42	0.42	0.41	0.39

#Comment: Historically low interest rates support fiscal policy flexibility. Other metrics suggest the case for macro policy rebalancing is strongest in Europe

[1] This is not to deny, however, that some monetary policy departures – such as the purchasing of corporate debt or common stock – already embody some quasi-fiscal policy elements.
[2] Automatic stabilisers have grown out of social programmes, as much as being a deliberate tool to manage aggregate demand. They could be improved in terms of both timeliness and effect by re-orientating them away from initiatives such as unemployment benefits, and towards the cyclical variation of investment tax deductions, property taxes, VAT, transfers to local governments (especially where balanced-budget rules apply), and the substitution of estimated current-year based income tax collection for previous year-based income tax collection. Such adjustments might, however, require predetermined 'cyclical triggers' set by some independent fiscal authority.
[3] See, for example, Jones. R. and Llewellyn. J., *Pushing the envelope.* Llewellyn Consulting Comment, 6 May 2015; Jones. R., *The end is nigh.* Llewellyn Consulting Comment, 13 November 2015; and Jones. R., *Time to get fiscal: bridging the UK's infrastructure gap.* Llewellyn Consulting Focus, 16 March 2016.
[4] The notion of leaving the business cycle to its own devices is just not a practical public policy option in a democracy, or for that matter in any political system with an eye on survival.
[5] We have used IMF and OECD data, most of which is available in the regular IMF Fiscal Monitor, and OECD Economic Outlook publications.
[6] There is necessarily an arbitrary element about these benchmarks, although they are broadly consistent with consensus thinking and/or our own experience as long-standing observers of the global international scene. We consider, for example, budget or current account deficits of more than 4% of GDP to be troubling, a government debt ratio of 100% of GDP to be a red line, sub-zero policy rates to be generally extreme, and tax or government expenditure ratios above 50% to be dangerously high. We also characterise an economy with a negative output gap of more than 2 percentage points of potential as depressed, and one with a positive output gap of the same magnitude as enjoying an unsustainable boom. Finally, the OECD's recommendation that advanced economies should target total infrastructure spending equivalent to 3.5% of GDP was a useful yardstick to evaluate government investment programmes. All the benchmarks used in the heatmap are available upon request.
[7] The general government definition of the budget is a broad measure that extends beyond central government, to local government and social security accounts. It does not, however, include public enterprises.
[8] Former US Treasury Secretary Lawrence Summers is perhaps the most outspoken proponent of such a view. There are various articles on his website that address the issue. http://larrysummers.com/category/blog/