

A simulating notion

The Economist

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“I am a Keynesian now”

- Richard Nixon (1971)
- Keynes's *General Theory*:
Government tax and spending as the prime tool for smoothing the cycle
- The modern consensus:
Monetary policy, by an independent central bank, makes a better weapon against recession than the whims of politicians

US tax cut 2008.2.13

- Individual tax rebates and temporary investment incentives worth \$168 billion in total
- passed in record time by the Congress

- IMF is pushing for broad fiscal loosening
- Many others are sceptical, including ECB's president and Ken Rogoff

Who is right?

- Room for counter-cyclical fiscal policy?
- What is the evidence?

Fiscal status

- Many of the rich economies have healthier budget than before recent downturns
- In 2007 almost half of the countries within OECD ran **structural fiscal surpluses** — adjusted for the state of the business cycle
- The euro zone: from a combined structural deficit of 2.1% of GDP before the 2001 recession to a deficit of only 0.7% of GDP in 2007

Different fiscal pressures

- Japan has a big deficit, a large debt and the oldest population
- Britain has a bigger structural budget deficit than Italy, but much less debt (43% of GDP vs. 105%)

Countercyclical fiscal policy?

- Sceptical economists argue that counter-cyclical stimulus often does more harm than good
- Timing is the key: fail to recognize recession and then take too long to enact stimulus
- People will hardly **adjust spending in response to a one-off tax cut**
- Unwilling to tighten fiscal policy in a boom
- Result: **permanently higher debt**

Evidence

- There is evidence to support all these worries
- But not all the evidence is negative
- One study suggested that people spent between 20–40% of their rebates in the quarter in which it was received, and over 60% of it within six months
- Morgan Stanley's study: the effect will not last long, however

Automatic stabilizers

- American has fewer automatic stabilizers—stringer unemployment benefits and a lower federal tax rate
- Many American states are forced, by law, to run balanced budgets
- So local government cut spending or raise taxes in a downturn—the opposite of Keynesian pump-priming
- Federal-stimulus packages, in part, counter those trends

Infrastructure spending

- Less clear is how far America's experience is applicable elsewhere
- In many developing countries, infrastructure spending may be the most promising way for governments to boost the economy's long-term potential