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

- 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—stinger 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