Fiscal responsibility and monetary policy

Fiscal Response and Stimulus

Nick Crafts:

Well the scale of the recent fiscal stimulus in the United States is much greater than the 1930's. We're talking about something of the order of ten times as big. For an economy which has probably gone through a downturn at the most a fifth as big as that in the 1930's. So the proportions are completely different.

We this time have a quite big fiscal response to what has happily turned out to be a nasty recession rather than a further depression. In the 1930's we had a very weak fiscal response to what was a very large downturn in GDP.

Interviewer:

Can we get, reach a judgement on the effects of the US stimulus package now?

Nick Crafts:

I think it's a bit early to be sure of that. The thing that is really I think interesting at the moment is that the profession has no real consensus on what the value of the fiscal multiplier generally is. I think we've learned that it's quite likely that the fiscal multiplier's value varies according to circumstances. We can identify some of the circumstances in which it seems potentially to be large and potentially to be small. But actually until we have the historical evidence in any particular case its difficult to say. So I think at the moment the jury is out on quite how much fiscal stimulus may have achieved in the United States. I don't think generally speaking economists believe that fiscal contraction is expansionary but I think there is a big argument to be had as to whether the fiscal multiplier in a given case is point five or one point five. There are quite reasonable grounds for thinking that much of our historical experience would lie between those bounds. But exactly what causes the multiplier to vary I think remains a topic for further research.

We do know something about the arithmetic of the circumstances in which a fiscal stimulus might be self-financing. It's most likely to be self-financing if the fiscal multiplier is large and if the economy in the absence of such stimulus is prone to lapse into unemployment, which creates, so called hysteresis effects. That is to say workers who lose their jobs lose their skills, lose their enthusiasm for work whatever it may be. They tend to exit the labour force. If you can prevent that exit then there's a gain in future output. We have seen recent calculations that suggest it is quite possible that the circumstances in which a fiscal stimulus could be self-financing, have been in operation in the United States recently. And big voices have been saying that that would be the case. If that argument works I think it works in circumstances where you can be fairly sure that there won’t be an adverse response in interest rates, which offsets the fiscal stimulus. And probably the United States is in a better position to enjoy that than perhaps the typical OECD economy is.