

Fiscal Space and Fiscal Stimulus

Council of Economic Advisers

Jay Shambaugh, Member



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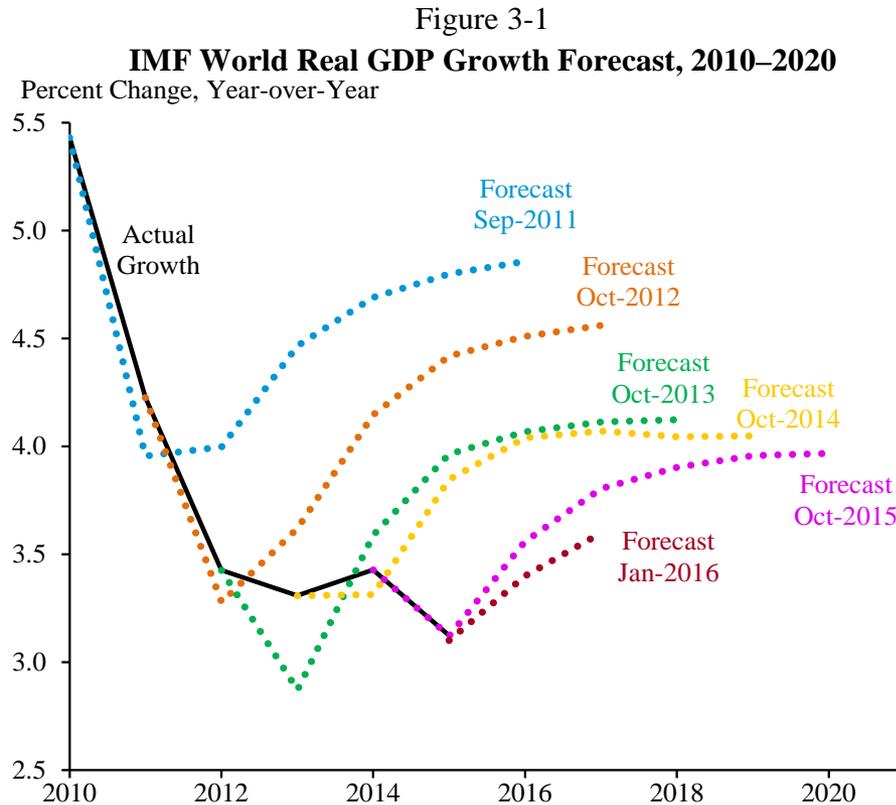
Does the WORLD Need Fiscal Stimulus: If So, Where?

- **Why and When would you want more fiscal stimulus:**
 - If demand in an economy is too low (fiscal policy can also boost supply if done correctly)
 - Especially if monetary policy is limited and/ or will not crowd out the stimulus
 - Especially if there is “fiscal space”
 - Positive global spillovers / redress imbalances
- **This talk:**
 - Do we have a shortfall in aggregate demand in the global economy?
 - Is there reason to think fiscal policy might be helpful compared to other tools?
 - Is there fiscal space
 - Where are the conditions met

Does the WORLD Need Fiscal Stimulus: Other Views

- **G-20:** “The global recovery continues, but it remains uneven and falls short of our ambition for strong, sustainable and balanced growth.... We will use all policy tools – monetary, fiscal and structural – individually and collectively to achieve these goals.monetary policy alone cannot lead to balanced growth. Our fiscal strategies aim to support the economy **and we will use fiscal policy flexibly to strengthen growth, job creation and confidence.**”
- **Former Fed Chair Bernanke:** “When the central bank is out of ammunition or ammunition is low, **fiscal policy has a role to play.**”
- **IMF:** “The not-so-good news is that the recovery remains too slow, too fragile, and risks to its durability are increasing.... It is clear that monetary policy can no longer be the alpha and omega to recovery. **Indeed, it will be much more effective with support from structural and fiscal elements**” (Recent WEO argues that structural policies are more effective if supported by fiscal policies in the short run)
- **OECD:** “**Many countries have room for fiscal expansion** to strengthen demand. This should focus on policies with strong short-run benefits and that also contribute to long-term growth.”

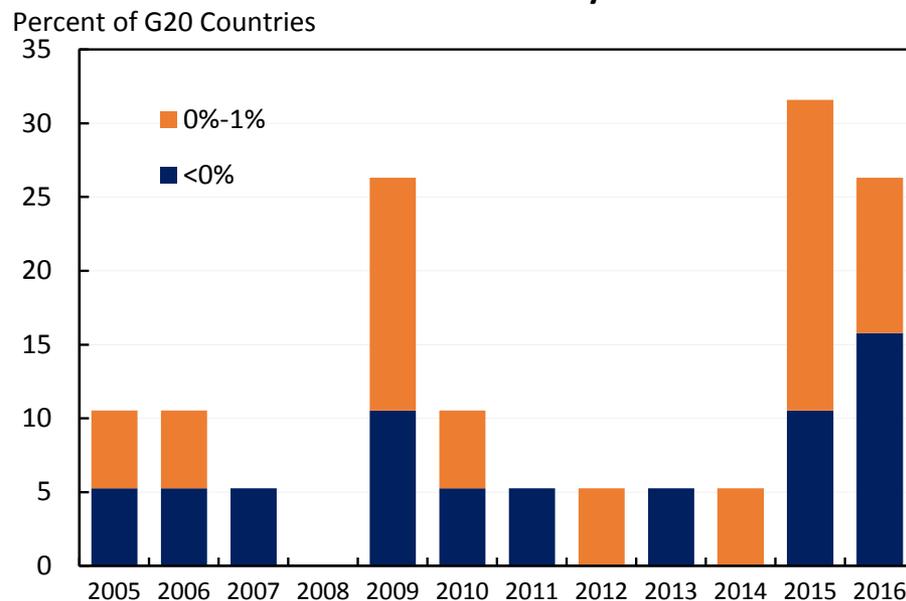
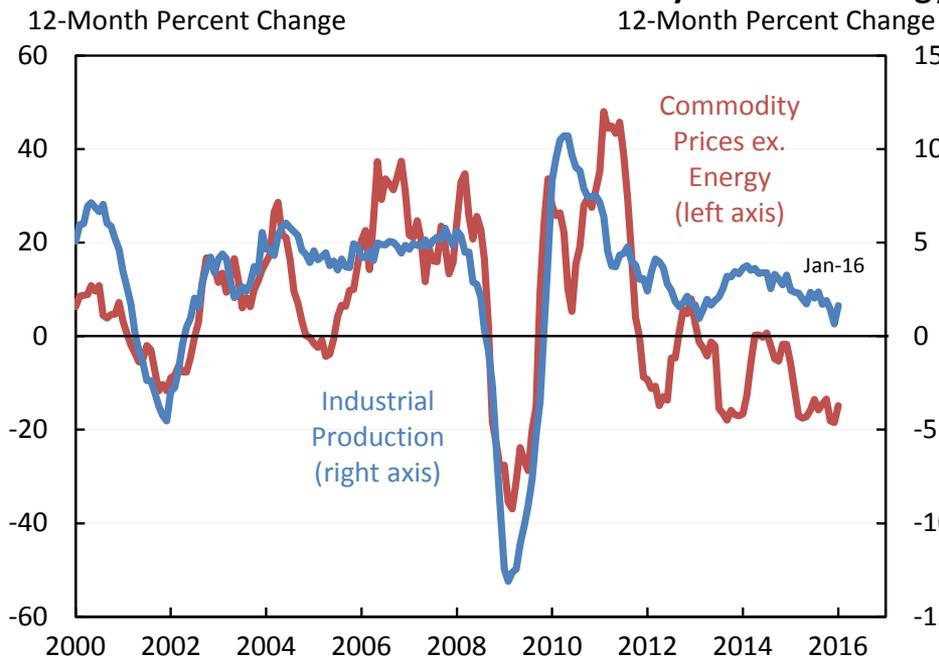
Global Growth has Consistently Fallen Short of Expectations in the Last Five Years



- **The IMF estimates global real GDP grew 3.1 percent in 2015 and forecasts growth of 3.x percent in 2016, well below the forecasts made over the last five years.**
- Growth in 2015 of 3.1 percent is slightly lower than growth over the last three years and well below both the growth rate earlier in the recovery and the pre-crisis average of between 4 and 5 percent.
- Slower output growth post-crisis is related to slower growth in working age population and productivity, weaker investment, and weak aggregate demand in many countries.

The Steep Decline in Commodity Prices is Related to a Decline in Global Industrial Production. Low Inflation, Suggests Supply Side Not Constraint

Global Industrial Production and Commodity Prices ex. Energy Consumer Price Inflation in G-20 Countries over the 12 Months Ended in February



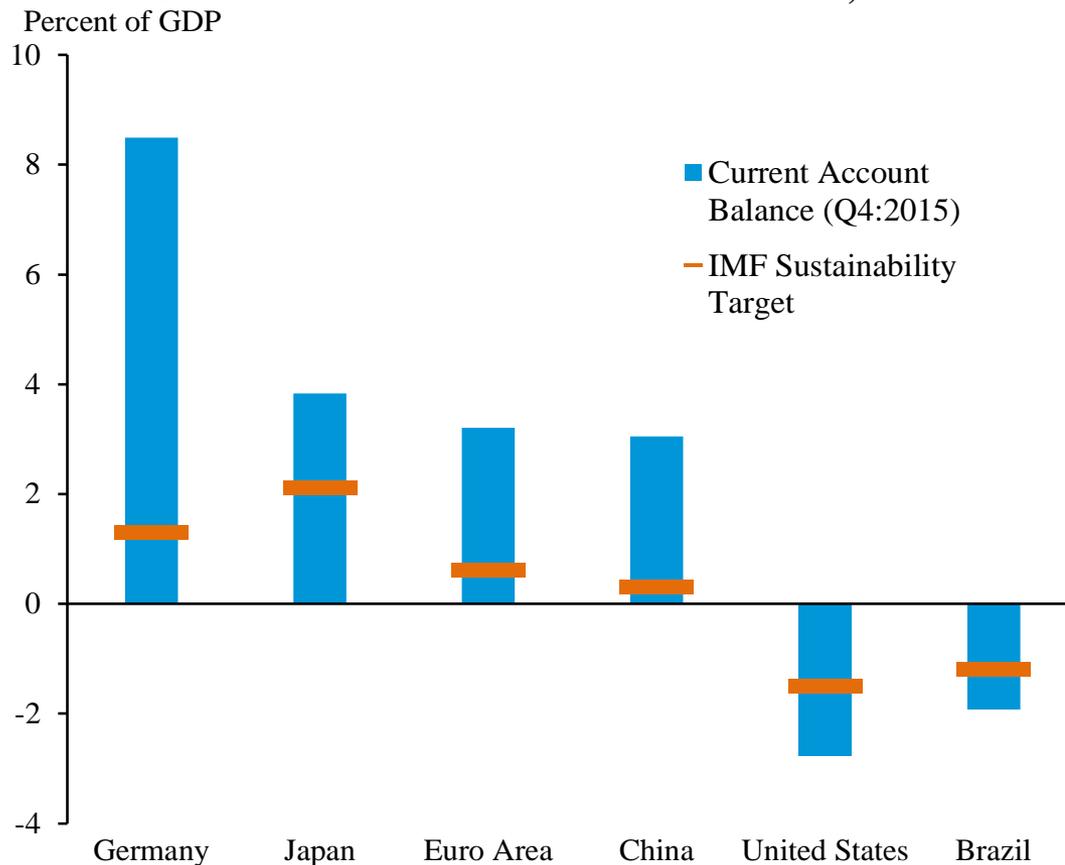
Note: Inflation in 2016 for Argentina is for the 12-months ended October 2015. Inflation for Australia is quarterly through the fourth quarter of the preceding year. The EU as a group is excluded.

- **Global industrial production (IP) rose a modest 1.6 percent over the 12 months ended in January 2016, well below the average pace of 3.8 percent between December 2001 and December 2007.**
- Inflation has trended down across many G-20 countries in recent years. Inflation in roughly one-fourth of G-20 countries was less than 1 percent over the 12 months ended in February.
- Most major central banks are below their inflation target.

Current Accounts Show Demand < Supply in Many Major Economies

Figure 3-5

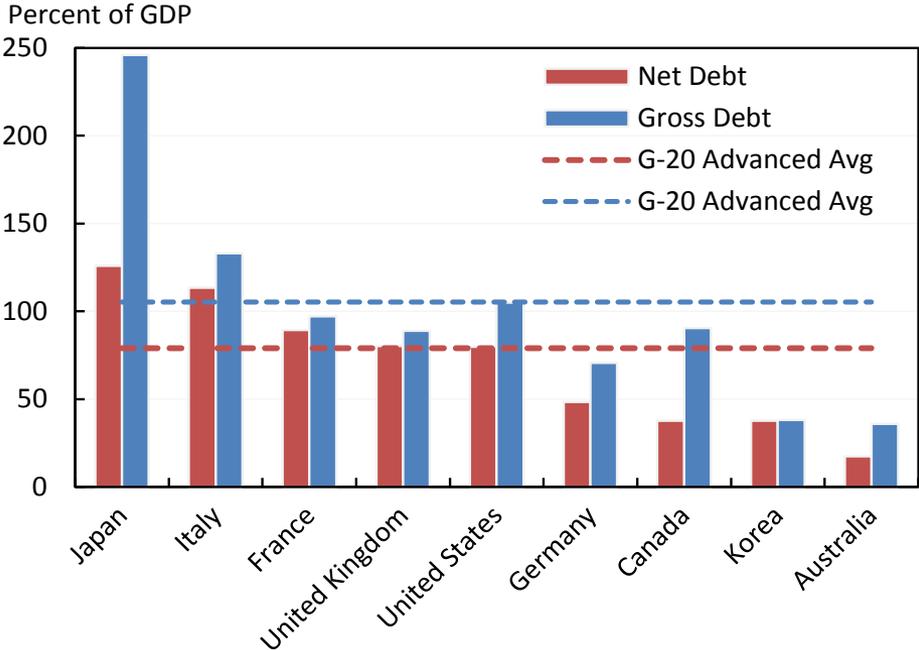
Current Account Balance as a Share of GDP, 2015



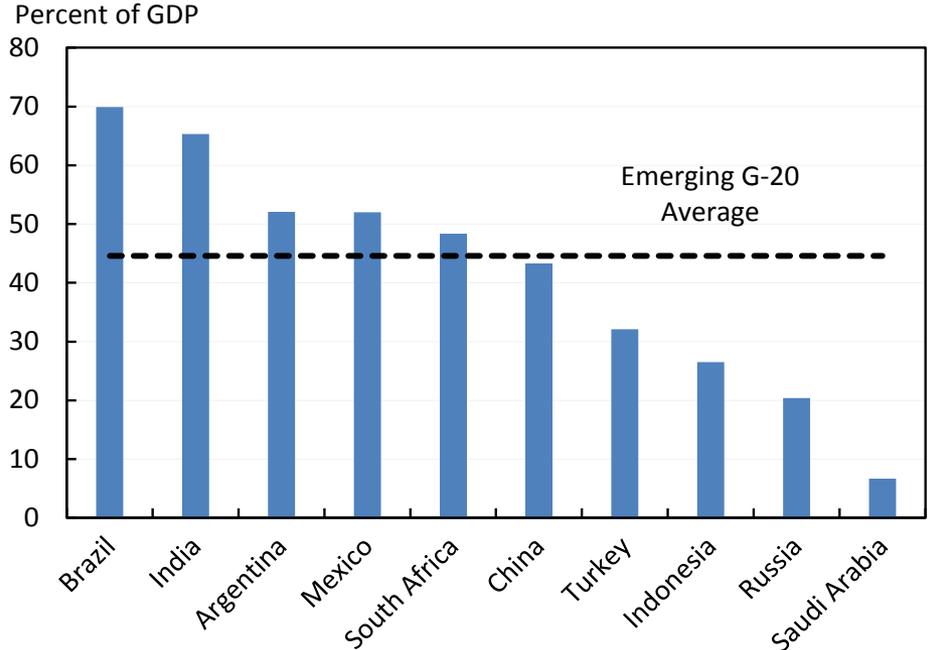
- Large CA surplus in a number of major economies: producing more than they consume and invest.
- Even more than IMF targets in all cases.

Gross Debt is High in Many Countries, but NET Debt Suggests More Fiscal Space than Assumed in Some Countries (and EM Sovereign Debt Levels Much Lower)

Advanced G-20 General Government Net and Gross Debt



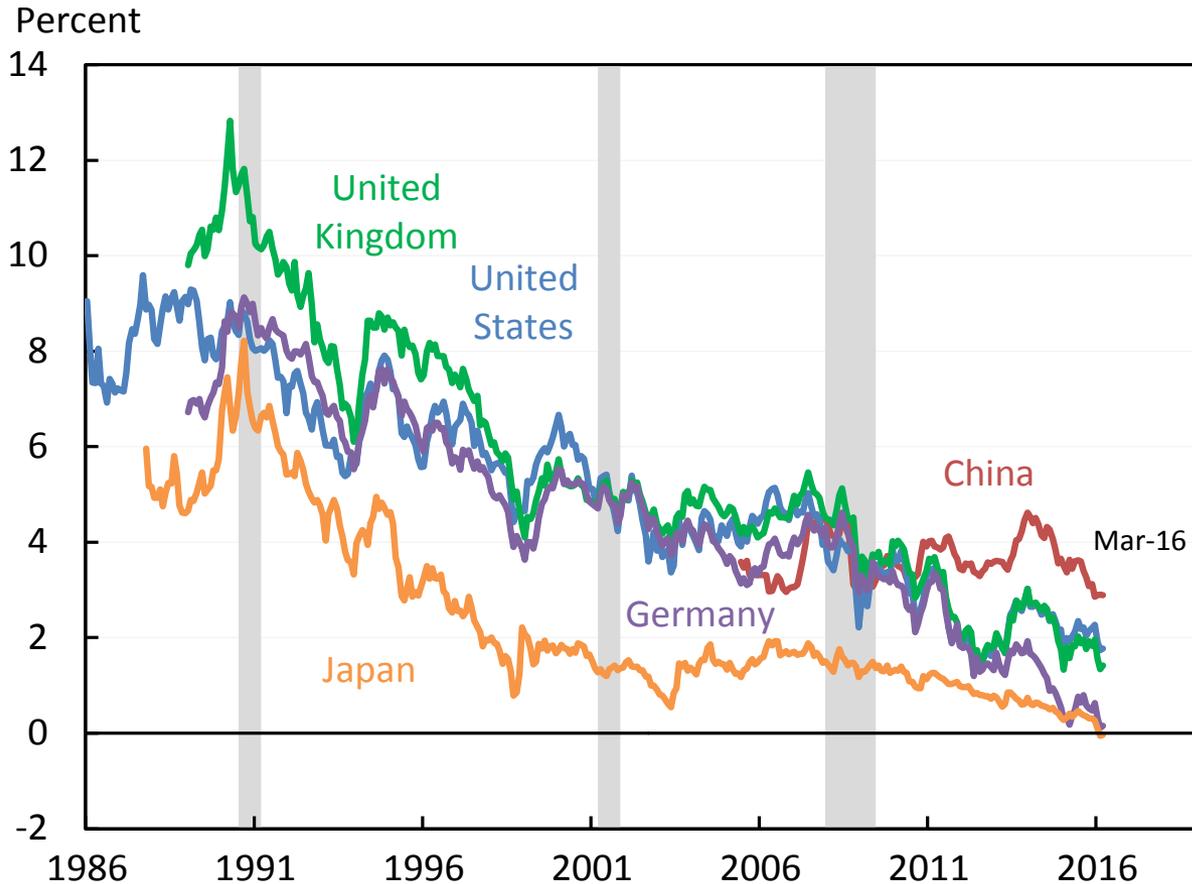
Emerging G-20 General Government Gross Debt



- **Gross debt may overstate the lack of space.**
- A number of countries have debt levels that seem quite manageable – especially in light of the ability of other countries to maintain much higher debt levels without crisis.
- Most major EM carrying much lower sovereign debt levels

Government Bond Yields are Trending Down and are Near Zero in Some Major Advanced Economies

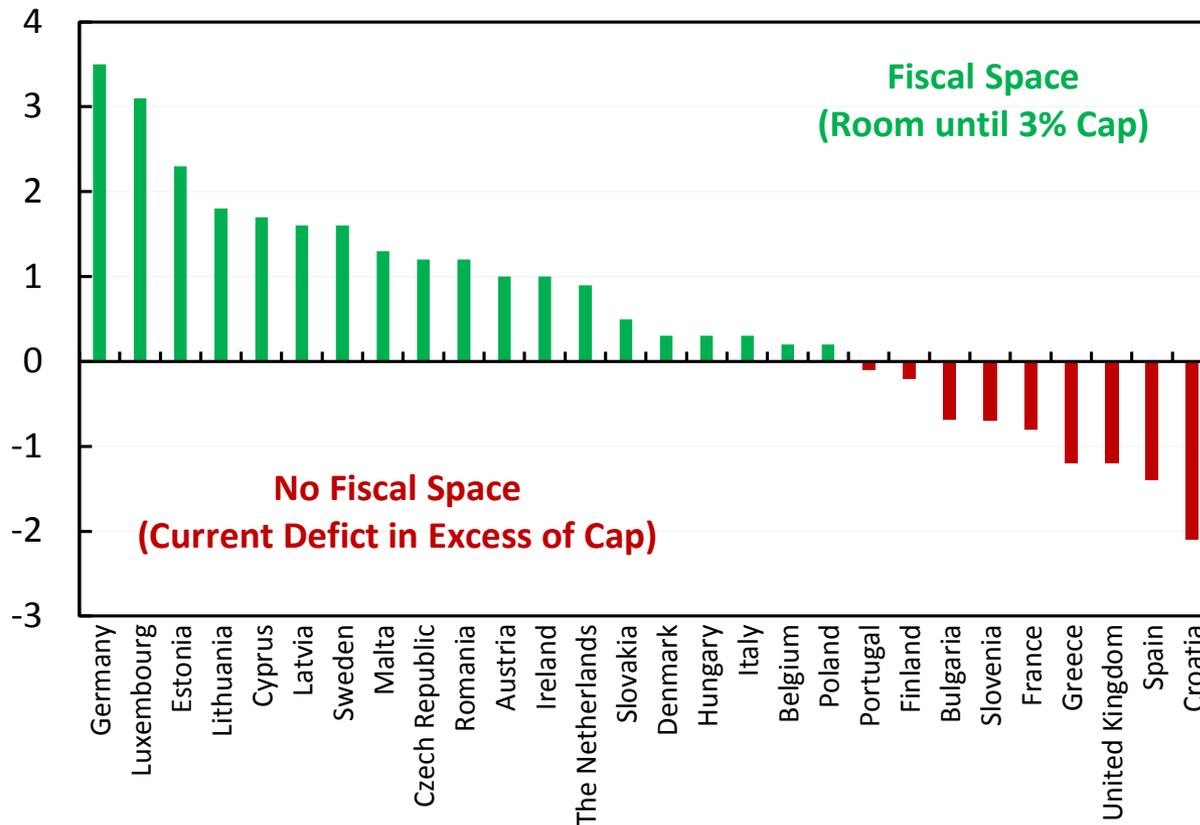
10-Year Government Bond Yields



- **Government yields have fallen considerably over time.**
- This can change the optimal level of debt.
- The markets seem to believe there is ample fiscal space.

Fiscal Rules in Europe Constrain Fiscal Space in Many Countries

EU Fiscal Space, 3% Cap minus 2015 Government Balance
Percent of GDP

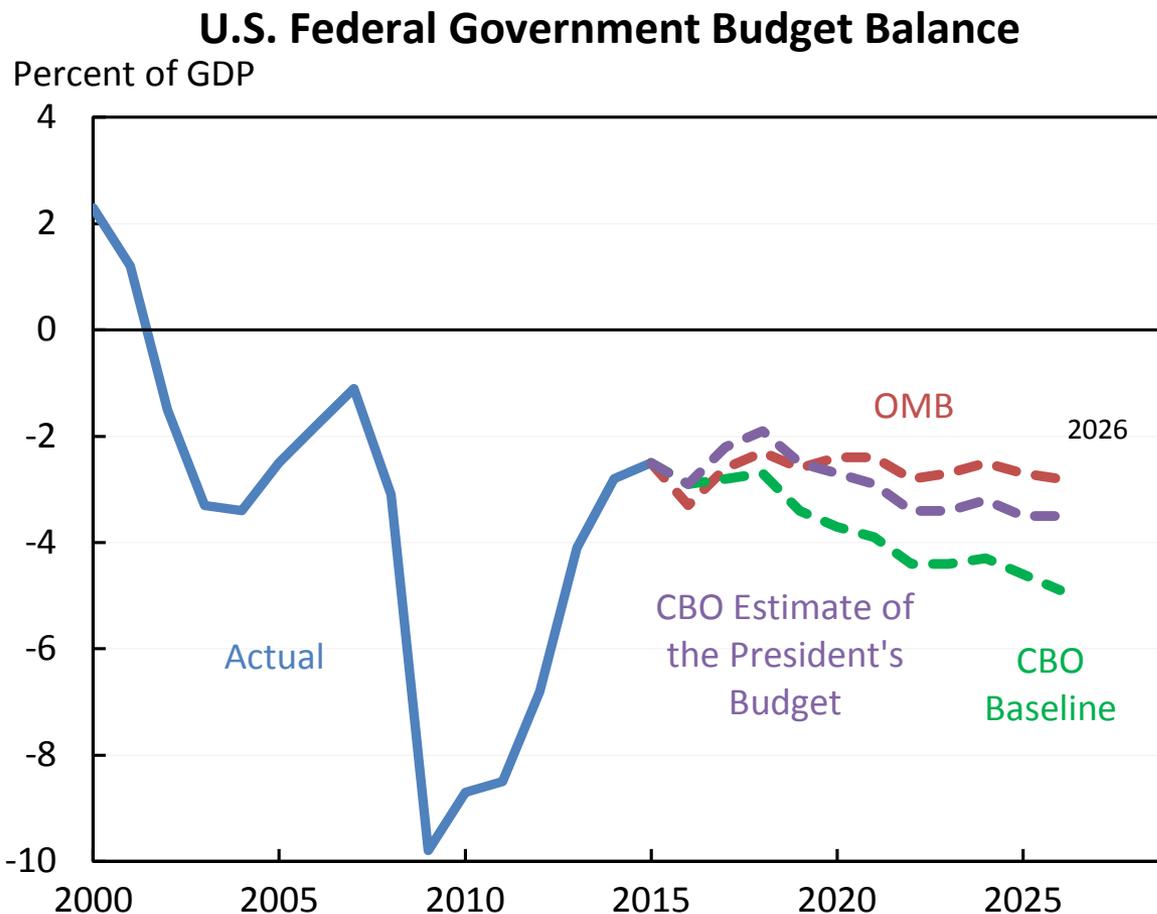


- While Europe as a whole may need some fiscal support, there is no coordinated agency to provide macroeconomic control on the fiscal side.
- The rules limit a number of countries (and national rules limit others).

The U.S. Economy

- There is fiscal space (i.e. it could be done)
- Fiscal is actually a bit more supportive now
- Economy looks good in some ways (labor markets), but softening in others (GDP)
- BUT: monetary policy is normalizing, and CA in deficit
- Suggests WORLD needs more AD, United States may not be the first place to start
 - But stimulus is available (in an economic sense) if things were to turn quickly

The U.S. Federal Government Budget Deficit has Fallen to its Lowest Level Since 2007



- **The federal budget deficit has fallen for six straight years and was 2.5 percent of GDP in 2015, its lowest level since 2007.** The deficit remains above its average of 1.8 percent between 2001 and 2007.
- The pace of deficit reduction has slowed over the last year and a half as fiscal policy has returned to a more neutral stance. OMB expects the deficit to be 3.3 percent in 2016 and 2.8 percent in 2026.

U.S. Federal Government Debt Held by the Public Rose Sharply During the Crisis but Stabilized in 2014

U.S. Federal Government Debt Held by the Public

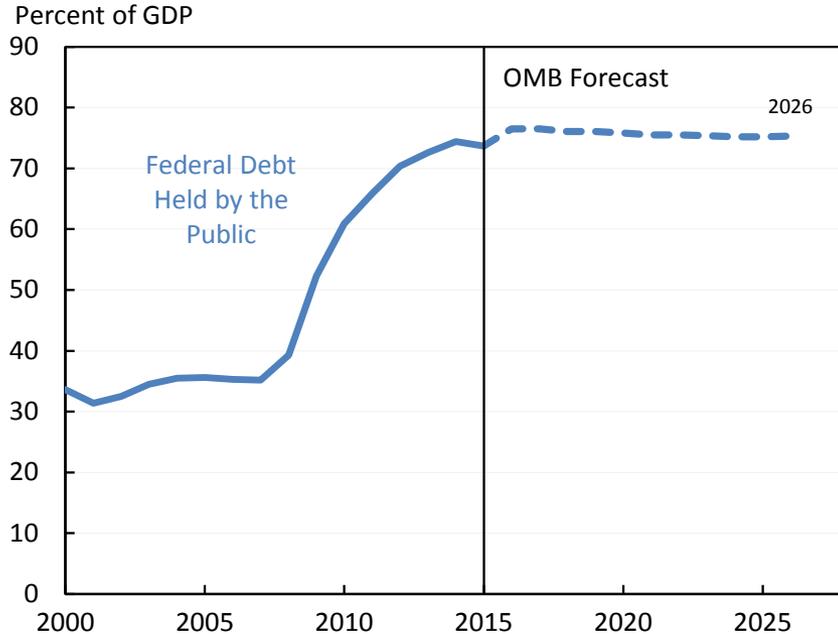
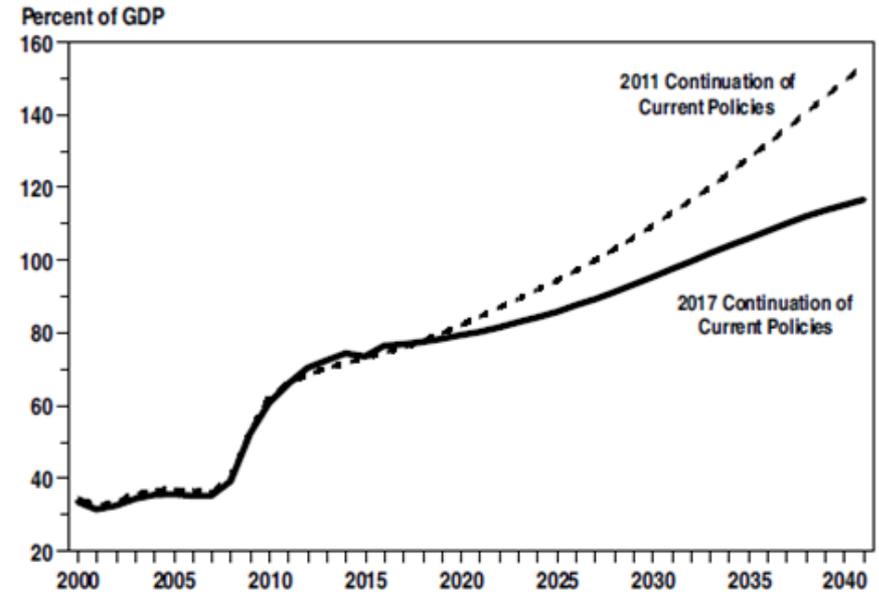


Chart 3-3. Comparison of Publicly Held Debt

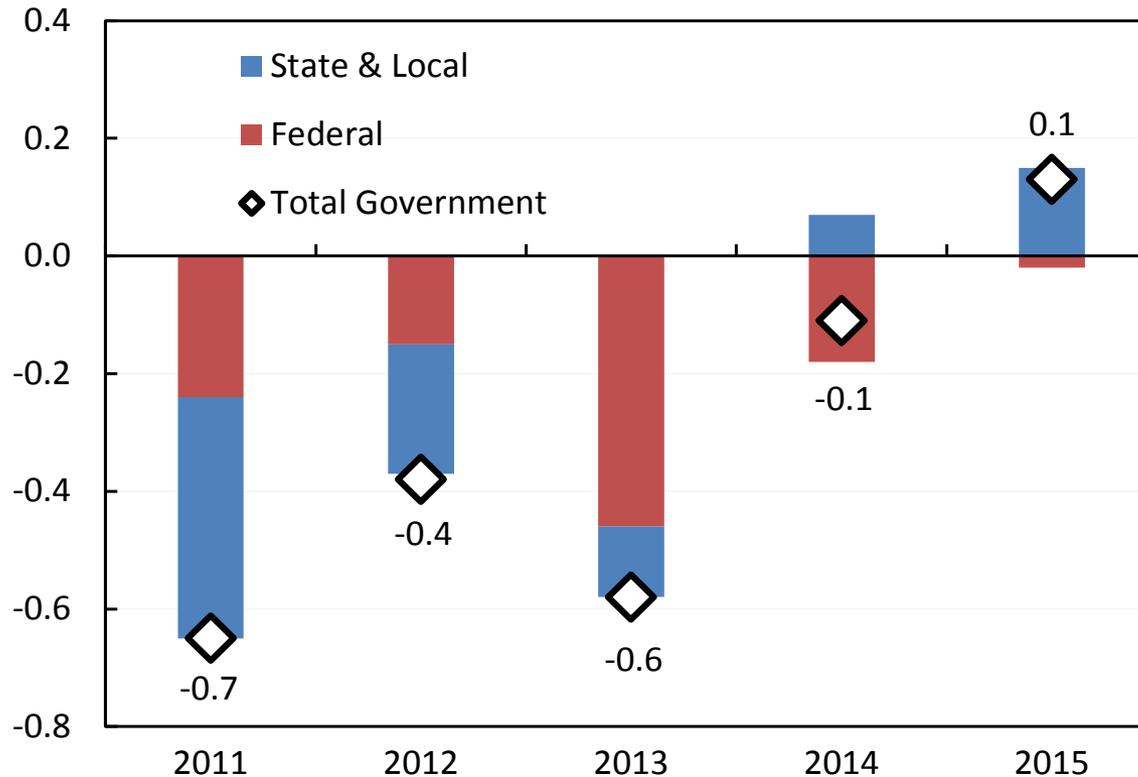


- **U.S. federal government debt held by the public is projected to be stable going forward in the medium term.** The long run projections have improved dramatically even under current law (without savings in the budget that are not yet law).
- In a downside scenario, no reason that one could not do stimulus.
- Stimulus can be paired with long run reductions that prevent long term debt/GDP from rising.

Government Purchases Added to GDP Growth in 2015 After a Sizeable “Fiscal Drag” in Recent Years

Contribution of Government Spending to Real GDP Growth

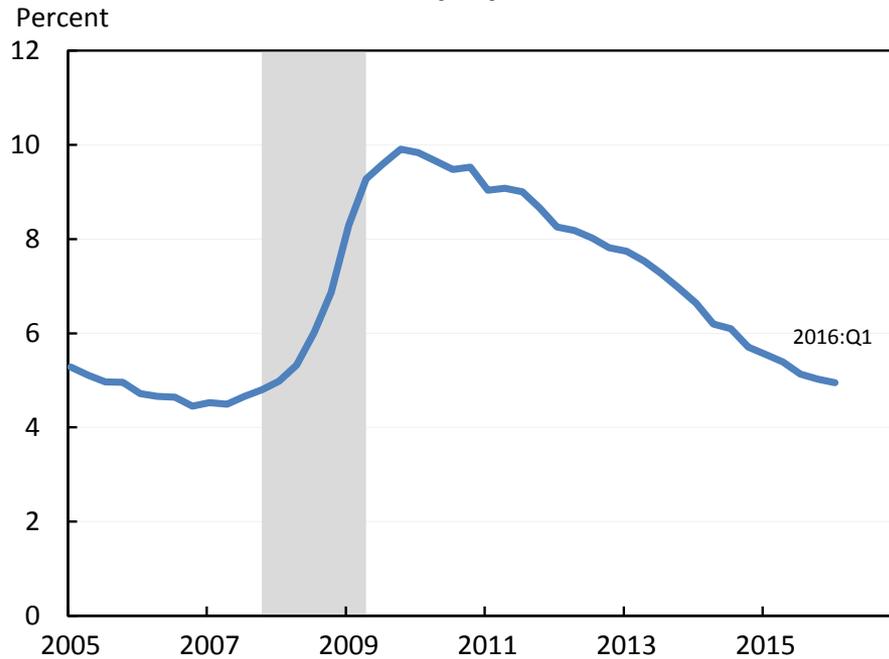
Percentage Point, Annual Rate



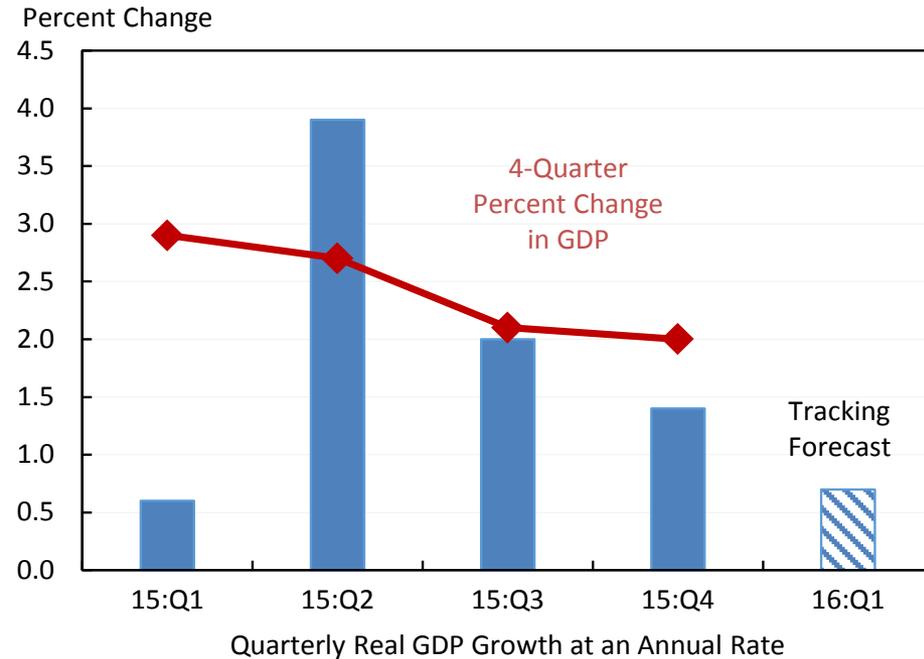
- **Between 2011 through 2013, declines in government purchases subtracted 0.5 percentage point per year on average from GDP growth.**
- State and local government purchases began contributing to growth in 2014 and 2015. Federal purchases were roughly neutral for GDP growth in 2015.
- 2016 should be positive as well.

The U.S. Economy has a Broadly Healing Labor Market but, Output Growth has Slowed Some Lately

U.S. Unemployment Rate



U.S. Real GDP Growth



- **U.S. real GDP is expected to remain weak in the first quarter, the second straight quarter of slower growth.**
- Both the unemployment rate and jobs growth are strong indicators.

Summing Up

- There is evidence the world is still struggling with low demand
 - Not the only reason for slower growth, but likely a contributing factor
- There is a reason to think fiscal policy could be helpful, especially in many countries
- There is also reason to think there is fiscal space
- United States has more supportive fiscal policy right now, and not the most likely candidate to try to stimulate the world (given monetary policy and current account).
 - No reason U.S. could not take action if needed.
- **Potential collective action problem**

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