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## Weapons of mass distraction

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### Can monetary and fiscal policy eliminate the business cycle?

THE ability of macroeconomic policy to erase the business cycle has in turn been greatly over- and underestimated over the decades. The broad consensus now is that monetary and fiscal policy can moderate the ups and downs, but they will never abolish the cycle altogether.

In the 1950s and 1960s policymakers believed that by increasing government spending, trimming taxes or cutting interest rates they could avert recessions and control unemployment. But as inflation took off in the 1970s and public debt exploded, Keynesian fine-tuning went out of fashion. Policy in the 1980s and 1990s was aimed largely at reducing inflation, not stabilising output. Governments rejected active monetary and fiscal policies in favour of adherence to rules. Central banks were made independent, and many were given explicit inflation targets. Meanwhile, governments laced themselves into fiscal straitjackets. America set balanced-budget targets in the 1990s and the euro area adopted a fiscal stability pact with strict limits on government borrowing. The notable exception was Japan, which embarked on a decade of fiscal expansion.

In the past year, interest in fiscal policy has revived. The American government administered its biggest budget stimulus for two decades. In the euro area, too, there has been a vigorous debate about whether governments should stick to their medium-term fiscal targets or allow budget deficits to widen as their economies weaken. So why did governments abandon fiscal policy in the first place?

The first reason was that public debts were on an unsustainable path. But after a decade of fiscal rectitude, by 2000 budgets in most rich countries had moved close to balance, if not surplus. That allows governments to have a more flexible fiscal policy. A second reason for disenchantment with fiscal measures was a widespread conviction that they did not work. Extra government borrowing, the argument went, would push up long-term interest rates and crowd out private investment. In addition, as public debts mount up, households expect taxes to rise in future so they may save more, offsetting the stimulus—the so-called “Ricardian equivalence” effect. In practice, most studies have found that an increase in government borrowing does indeed boost demand. However, recent research suggests that fiscal policy may pack a smaller punch than it used to.

Roberto Perotti, an economist at the European University Institute in Florence, examined fiscal policy in five countries (America, Britain, Canada, Germany and Australia) and estimated the impact on GDP of discretionary fiscal-policy changes after stripping out the automatic movements in taxes and spending over the cycle. He found that the effects of fiscal policy on GDP have become much weaker in the past 20 years compared with the previous 20. Also, increases in public spending have less effect on demand in smaller economies than they do in America.

Identifying the size and impact of discretionary fiscal policy is a tricky business, so it would be unwise to place too much weight on the exact size of the fiscal impact estimated by Mr Perotti. But the evidence that fiscal policy is becoming less effective is worth bearing in mind. This does not seem to be due to a change in monetary policy. Mr Perotti finds that real interest rates increased by less in response to bigger budget deficits in the later two decades than in the first. Nor can it be explained by households saving more for fear that unsustainable public debts will force governments to raise future taxes: personal saving rates have fallen over the past two decades in most economies.

One possible explanation lies in the increased openness of economies and greater international capital mobility. This means that a larger share of any increase in spending leaks into imports, and that a fiscal stimulus may be offset by a stronger exchange rate as higher bond yields attract capital inflows. A recent IMF paper on the

impact of fiscal policy during recessions in 29 countries since 1970 found that in relatively closed economies (where imports amounted to less than 20% of GDP), such as America and Japan, fiscal policy did boost output during recessions, although by less than generally assumed. But in open economies with floating exchange rates a fiscal stimulus had little effect.

Even where fiscal policy still works, getting the timing right is tricky. In some countries, notably the United States, it can take months to get political approval. By the time a stimulus is administered, the economy may have already recovered. In contrast, interest rates can be cut without delay, and swiftly reversed if the economic outlook suddenly improves.

Discretionary budget measures are therefore usually best avoided. Built-in fiscal stabilisers may be more effective. The automatic fall in taxes and rise in jobless benefits in recessions help to support spending. An OECD study estimates that in the 1990s automatic fiscal stabilisers on average reduced cyclical fluctuations in rich economies by a quarter. In countries with large government sectors, such as Finland and Denmark, they output volatility by more than half; in Japan and America, where taxes and spending are smaller relative to GDP, their effect was more modest. A study by Alan Auerbach, at the University of California, Berkeley, finds that in America fiscal stabilisers remain just as potent today as in the 1960s.

Ideally, budget deficits should be broadly balanced over the cycle, but automatic fiscal stabilisers should be allowed to take full effect. There is nothing wrong with a budget deficit in a recession, so long as it moves into surplus during the boom. In the euro area an individual country cannot cut interest rates to counteract a shock that affects only its own economy, so allowing automatic fiscal stabilisers to operate is especially important.

Europe's stability pact is too rigid. It sets a limit of 3% of GDP on budget deficits and requires budgets to be balanced in the medium term. That does not leave enough room for budget deficits to widen in a recession. Portugal broke the 3% ceiling last year and is now having to tighten its fiscal policy severely, despite weak growth. Germany also seems almost certain to bust the 3% ceiling this year.

Given the difficulty of timing a fiscal stimulus correctly, most economists agree that monetary policy is a better tool for stabilising growth. Yet how does this fit with the widely held view that central banks' prime goal should be price stability? According to Ernst Welteke, the president of the German Bundesbank, "The European Central Bank doesn't have the job of steering the economy. The best contribution monetary policy can make to growth and employment is to keep prices stable."

## **Inflation isn't everything**

In practice, however, central bankers do not concentrate on inflation to the exclusion of everything else. Benjamin Friedman, an economist at Harvard University, argues that although central bankers strenuously deny having any policy objective other than price stability, in practice they all take growth into account. For example, if inflation rises above target, a central bank will generally aim to reduce it gradually rather than suddenly, to avoid inflicting too much damage on growth.

Besides, by aiming to keep inflation stable a central bank will, in effect, also stabilise output. When the economy is producing below potential, inflation will fall and the central bank will cut interest rates, helping to boost growth. When output is above potential, inflation will rise and the central bank will increase interest rates, thereby dampening down growth.

The popular perception is that America's Fed takes more account of growth than the ECB. Whereas the Fed often explains its interest-rate cuts in terms of propping up demand, the ECB always puts inflation first. Yet an analysis by the Bank for International Settlements (BIS) suggests that differences between the two central banks' policies are much exaggerated.

Chart 5 compares actual interest rates with those that would be required under the "Taylor rule". Named after its inventor, John Taylor, now at America's Treasury, this offers a method of calculating the appropriate interest rate, taking into account the difference between actual and target inflation and the size of the output gap (the amount by which actual output is above or

below potential output).

The chart shows that, allowing for different movements in output and inflation in each economy, the Fed and the ECB seem to set interest rates in fairly similar ways. The ECB cut interest rates by less than the Fed last year because the economic slowdown in Europe was less severe than in America and because inflation was higher. The BIS's chart also shows that, judged by the Taylor rule, the Bank of Japan cut interest rates just as fast after Japan's bubble burst in the early 1990s as the Fed did last year.

In recent years Americans have placed excessive faith in the ability of the Fed, and particularly of Alan Greenspan, to tame the economic cycle. But monetary policy cannot be used with surgical precision. Not only are there long and variable lags before changes in interest rates affect output, but there is also much uncertainty about the potential growth rate and the size of the output gap.

Many people believe that the sharp increase in inflation in the 1970s could have been avoided if only the Fed had been using today's monetary-policy framework. But work by Athanasios Orphanides, an economist at the Fed, suggests that if the central bank had used the Taylor rule, inflation in the 1970s would have been just as high. It was not the monetary framework that caused inflation to surge, he argues, but a misperception of the size of the output gap. Official estimates of potential output at the time failed to spot the slowdown in productivity growth in the late 1960s and early 1970s. Partly as a result, monetary policy tried to stabilise output at too high a level, causing inflation to rise.



In 1973 the output gap was estimated at minus 3%, implying considerable economic slack. With the benefit of hindsight, it is now put at plus 4% for that period, implying massive upward pressure on inflation (see chart 6). With such measurement errors, a monetary policy that tries too hard to smooth the cycle could easily increase output volatility.

## Too low for comfort

Nevertheless, compared with the double-digit inflation rates in the 1970s, low and less volatile inflation has helped to deliver greater economic stability. In many economies inflation is at its lowest for 40 years. Might it now be too low?

Once inflation is around 3%, squeezing it even lower will do little to improve an economy's growth performance. Indeed, as inflation approaches zero, the risks of greater economic volatility start to rise. One reason is that interest rates cannot be negative, so if inflation is close to zero there is no way to achieve the negative real interest rates that may be needed to stimulate an economy. This is the so-called "liquidity trap" into which Japan has fallen.

If real interest rates are too high, the risk of deflation increases. Deflation is much more damaging to economic stability than inflation. It deepens recessions because it increases the real burden of debt and encourages consumers to delay purchases in the hope of even lower prices later.



The lower the average inflation rate, the greater the risk of falling into the liquidity trap. Simulations by the IMF conclude that given the range of economic shocks experienced over the past 40 years, the probability of interest rates hitting zero—and hence the risk of deflation—increases markedly if average inflation targets are set below 2%. Moreover, as inflation falls below 2%, the volatility of output starts to increase. This suggests that the mid-point of an inflation target should be set well above 2%. The Bank of England and the Reserve Bank of Australia both have mid-points of 2.5%, but the ECB's target is "less than 2%", which is far too strict. If central banks set their inflation sights too low, warns Olivier Blanchard at MIT, at some point in the next decade another country is likely to join Japan in a liquidity trap.

That fate may yet befall the United States. Its inflation rate, measured by the GDP deflator, is currently running at only 1%. If America's recession were to resume, the Fed's ability to act would be limited.

The bank seems to be well aware of this risk. In a recent Fed study of Japanese deflation, it argues that monetary policy in Japan in the early 1990s was not too tight, given the forecasts of growth and inflation at the time, and fiscal policy was generally expansionary. However, growth and inflation forecasts consistently proved too high. At the time, nobody in Japan or abroad was predicting deflation. The Bank of Japan's big mistake was to fail to take out the necessary insurance against downside risks when its bubble had burst.

The Fed concludes that as interest rates and inflation move closer to zero and the risk of deflation rises, central banks need to cut interest rates by more than would normally be justified by prevailing economic conditions. Once deflation emerges, monetary policy can do little to pull the economy out of a slump. If, on the other hand, a central bank injects too much stimulus, it can correct this later.

Keynes argued that even when deflation has taken hold and monetary policy is "pushing on a string", fiscal policy can still stimulate demand. Japan has tried this, running a huge budget deficit over the past decade, yet its economy remains sick and prices continue to fall. Why?