



# Fiscal Policy at the Zero Lower Bound

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- “Global economy is at risk from a *monetary policy black hole*” – Larry Summers, FT, October 11<sup>th</sup>, 2019
- “Monetary policy has done everything it could, from QE to negative rates, but it turns out it is not enough. In this context, the case for using fiscal policy to prop demand is a strong one. Very low interest rates, current and prospective, imply that both the fiscal and economic costs of debt are low. And the *benefits of public deficits, namely higher activity, are high.*” Blanchard and Tashiro, PIIE ,(2019)
- “The *fiscal policy frameworks in use today, including the Stability and Growth Pact (SGP), were created for a world that no longer exists*: a world where interest rates were positive, the main risk was higher inflation, and fiscal policy had the luxury of being passive and ignoring cyclical stabilisation.” Ubide, *Intereconomics*, (2019)

# The “Paradox of Risk” in fiscal policy

- Inertia and behavioral biases -> “Paradox of Risk” -> policy that is too “conservative” increases risks
  - A fiscal policy that is too tight can be risky -> policy framework for wrong economy
- Monetary and Fiscal policies do cooperate -> it is not “unconventional”
  - The Great Moderation may have been the exception to the rule
- Four states of the world:

**Table 1**  
**The optimal relationship between monetary and fiscal policy**

	Monetary policy	Fiscal policy	Example	
State 1	$\pi \gg \pi^*$	Tight, leads	Tight	1970-80s
State 2	$\pi \approx \pi^*$ and $r > 0$	Manage cycle	Focus on sustainability	Great Moderation
State 3	$\pi \approx \pi^*$ and $r = 0$	Manage cycle	Neutral	
State 4	$\pi \ll \pi^*$ and $r \leq 0$	Easy	Easy, leads	Japan, euro-zone today

- In State 4, fiscal policy must lead, and monetary policy accommodates

## A (well designed) expansionary fiscal policy at the ZLB...

- Increases neutral rates -> makes monetary policy more effective
- Increases potential growth
  - Reduce hysteresis
  - Increase productivity via (well designed) public investment
- Helps reduce inequality
  - The main source of inequality is unemployment
  - For a given level of unemployment, fiscal policy can reduce inequality
- Helps reduce financial stability risks
  - Low rates and flat yield curves, if lasting a very long time, may reduce the profitability of the banking sector

# Fiscal space as a flow concept

- Fiscal space is not a function of a specific level of debt or deficits
  - It is a function of the flow of payments.
- Fiscal space depends on the relationship between  $r$  and  $g$

$$\frac{d}{y}(t) = \left( \frac{1+r}{1+g} \right) * \frac{d}{y}(t-1) - pb(t).$$

- Lower  $r$  or higher  $g$  create fiscal space
    - If  $r < g$ , **any** primary balance will lead to stable debt/gdp
  - Public investment, if it increases potential growth ( $g$ ), creates fiscal space
  - Central bank forward guidance, if it lowers interest rates ( $r$ ), creates fiscal space.
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- Of course, this is symmetric:
    - Bad policies, if they lower  $g$  or increase  $r$ , reduce fiscal space.

# Principles for fiscal policy at the ZLB

- No output gap, debt, or deficit rule
  
- Four principles:
  1. **Bygones are bygones for debt/GDP**. At the ZLB, focus should be on restoring demand and inflation, not on reducing debt/gdp at all costs
  
  2. **Golden Rule for public investment**. Whatever increases potential growth and reduces growth bottlenecks, different across countries.  
TTP principle: (T)argeted, (T)imely, (P)ermanent.
  
  3. **PAYGO for non-investment budget on 5yr forward basis**. Scored by independent fiscal councils. Increases efficiency
  
  4. **Mandatory spending reviews**. Focus on quality, not quantity of deficits.

# Principles for fiscal policy at the ZLB

- **Primary balance gap rule**: for as long as the economy is in State 4 ( $r = 0$  and  $\pi \ll \pi^*$ ), the ex-ante primary balance must not lead to a reduction in debt/GDP.
  - **For as long as  $r=0$  and  $\pi \ll \pi^*$ , fiscal policy must be expansionary.**

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