

Where Will Fiscal Stimulus Lead G7 Economies?

BY RODNEY SULLIVAN, CFA

The Great Recession has produced a decline of US\$10 trillion in U.S. household wealth alone, mostly from declines in real estate and equity markets. Faced with the real possibility of depression and prolonged stagnation, G7 countries have been providing significant countercyclical relief in the form of large-scale fiscal stimulus and financial rescue packages. Given such serious downside risks, substantial discretionary capital injections by government—to substitute for missing capital injections from the private sector—appeared to be a prudent approach for tempering the decline and sowing the seeds of recovery. But will the forceful fiscal stimulus guarantee a return to growth, or will the cost of the stimulus impede recovery and hamper medium-term prospects? Evidence suggests that policymakers must carefully weigh the aggressive use of fiscal policy against the sustainability of public finances. Pulling the fiscal-stimulus lever brings important negative consequences as well as benefits, especially over the medium term.

Most agree that the response by governments and global monetary authorities has helped to stem the economic and financial market turbulence. At the very least, when short-term credit markets froze in the fall of 2008, the public sector helped unfreeze them. Convincing progress has been made to restore confidence in the financial sector. The once wobbly legs of the economy have been stabilized, at least temporarily, and the banking sector no longer appears in imminent danger of collapse. These hopeful signs come at a cost. The ongoing stimulus will likely push the U.S. budget deficit for 2009 to about US\$1.75 trillion, exceeding 12 percent of U.S. GDP. In all, according to the International Monetary Fund (IMF), as of June 2009, developed global economies have infused direct support amounting to nearly 10 percent of global GDP.

Why then does the economy remain in such a precarious position? The answer is that while the various policies have offered a glimmer of hope in the short term, the repercussions of such massive fiscal intervention (the mainstay policy prescription of Keynesian economics) for the intermediate term are unclear. The result has been accelerating fiscal deficits around the globe and greatly increased issuance of government bonds. Upfront discretionary stimulus imposes costs that can only be recovered over time through taxation, rendering the prospects for medium-term economic growth uncertain. Here, unfortunately, little historical guidance exists. The lesson from Japan is that a shift to monetary growth in 2001 (quantitative easing), not fiscal stimulus, is what provided a way out of the “lost decade” of the 1990s.

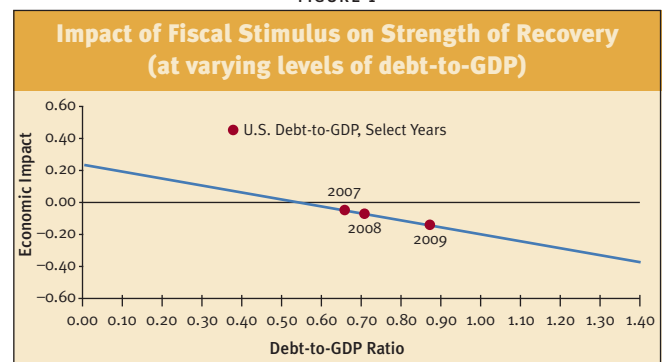
Exploring how the United States and other nations will fare in the current Great Recession requires deeper analysis. The issue rests with the fact that all government spending

must be financed through taxation, borrowing, or inflation. Any government's ability to borrow and tax is limited. The stimulus debt must be repaid. Thus, if the stimulus is spent wisely on projects that truly expand output and hence yield a stream of revenue and if these projects would not have been undertaken without government intervention, the medium-term effects will be positive. If the new debt is frittered away, however, the outcome will be problematic. It all depends on how productive the spending is.

The inconsequential effects of the 2001 and 2008 Bush fiscal stimulus packages on economic growth have been well documented. Likewise, the current U.S. stimulus is being allocated in ways that are unlikely to meaningfully expand output. Rather, the current stimulus reallocates resources (via taxes) away from the most productive segments of the economy (information technology, healthcare) and towards less productive segments (autos, insurance, banking, home buyers). The auto and financial service sectors are unlikely to provide the robust economic growth engine required in the long run to provide the government with the revenue it needs to service its increased debt burden. Making matters worse, additional new spending related to carbon emissions and expanded health care programs will place increased cost burdens on businesses in an already challenging economic environment. U.S. debt-servicing ability is further hampered by an aging demographic that will assuredly put immense pressure on the viability of social programs, such as Social Security and Medicare.

The challenge of producing a positive outcome via pulling the fiscal-stimulus lever is compounded by the fact that the degree of public indebtedness weighs heavily on the effectiveness of discretionary fiscal policy. As shown in **Figure 1**, the impact of fiscal policy on the strength of recovery is weaker for economies that have higher levels of debt relative to GDP. Because of the combination of a higher cost of debt, the crowding out of private investment, and reduced consumer spending, a high debt burden neutralizes the extent to which fiscal policy influences the strength of recovery.

FIGURE 1



Source: IMF staff calculations, author analysis

The tradeoff cannot be determined precisely, but fiscal policy becomes fully impotent when debt reaches approximately 60 percent of GDP. Beyond that level, discretionary fiscal stimulus actually *detracts* from economic recovery. Interestingly, the U.S. debt level was recently hovering right at this 60 percent level in 2007 and is now rapidly rising, which will make fiscal policy even less useful (the problem is even worse for other G7 countries). This all suggests muted medium-term growth prospects for developed countries. In short, G7 countries cannot spend their way out of debt. At current debt levels, the so-called Keynesian economic multiplier is at best equal to 1, which makes for a blunt stimulus tool. The recommendation of some that governments around the world pursue another round of significant stimulus to decrease the margin of uncertainty seems imprudent. Evidence suggests that the potency of fiscal stimulus is counterbalanced by doubts about the stability of public finances.

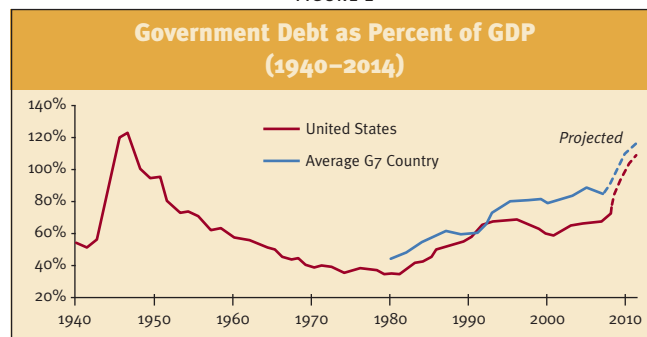
A historical view of debt-to-GDP ratios, as shown in **Figure 2**, indicates that developed countries are fast approaching historically high debt levels not seen since the Second World War. According to a recent IMF outlook, U.S. GDP growth of -2.8 percent for 2009 and zero for 2010 would translate into a rising U.S. government debt-to-GDP ratio of 70 percent in 2008 and nearly 100 percent by 2010, a 40 percent increase. And the problem is global. The G7 economies face a similar challenge. Obviously, fiscal deterioration becomes greater under a more prolonged slowdown. Should GDP growth slow further by 2 percent a year over the next few years, these debt-to-GDP estimates would increase an *additional* 20 percentage points. Clearly, the effects of the current global economic crisis will be long lasting, with debt ratios expected to continue to climb as far out as 2030.¹

The key question is, Will the current aggressive stimulus generate the necessary growth to improve our fiscal stability going forward? After the Second World War, the U.S. economy entered its halcyon days, with vigorous growth led by the manufacturing sector (e.g., autos, steel). The current decade has been quite different. An emphasis on financial services, which have much weaker prospects, has been combined with a policy of borrowing from the emerging nations in exchange for future promises (debt). Thus, investment in industries that will fuel the future growth engine—if we can know which these are—is our most urgent priority. This growth could very well come from innovations in health care—say, for the aging populations of the developed world—or maybe it will come from technology innovations targeted at the emerging workforces in China or India. The prospects for growth are uncertain, but one thing is clear: Continuing to invest in the relatively less productive auto and financial sectors while continuing the debt binge will not provide a bright future.

1. Estimates include both the direct intervention as well as the cost of automatic economic stabilizers (unemployment benefits, Medicaid, etc.).

The data in Figures 1 and 2 offer compelling evidence that the current explosive path of stimulus will hamper recovery and weaken confidence in government solvency. Bailouts and stimulus instill short-term confidence as long as the state of public finance remains credible, but expectations of future long-run economic performance also influence how people behave today. On that basis, monetary policy should be favored over fiscal stimulus. Yet, given the expansive fiscal

FIGURE 2



Source: International Monetary Fund, U.S. Office of Management and Budget

programs, monetary authorities in the near future will likely need to raise short-term rates to fend off inflation.

The long end of the Treasury curve is also critical. Although a modest rise in long-term rates is probably not very harmful, significantly higher long-term rates will prove a serious detriment to economic stability. As such, fiscal sustainability must be strongly emphasized to ensure policy effectiveness. Any fiscal stimulus should be temporary and, to remove uncertainty, should be immediately declared to be so. Furthermore, a prompt and specific plan for ensuring fiscal responsibility is critically important. Policymakers must put in place an exit strategy for paying off this massive debt. To some degree, a partial strategy already exists in the form of automatic stabilizers that will self-reverse as employment declines and output recovers. The same can be said for some of the recently initiated government lending programs (TARP, TALF, TSLF). Some of these debts are likely to be paid off in due course.² If the massive and growing debt is to be paid off by higher future taxes, the likely outcome will be stagnation similar to the “lost decade” of Japan. Worse, if the debt cannot be paid for via economic growth resulting from stimulus investment or, worse yet, if the ability to tax is lost (that is, higher tax rates result in lower tax revenues), conditions will be ripe for a period of inflation. ▀

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2. According to IMF estimates, Japan recovered only 1 percent of bank intervention expenditures after five years following the 1997 crisis and had recovered only 58 percent by 2008.