Comments on

“Fiscal Challenges and the Great Recession”

by Vito Tanzi

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Overview of Tanzi's paper

- Powerful critique of recent experiments with monetary and fiscal expansion
- QE increases wealth and income inequality and raises savings rate
- Rising public spending creates inefficiencies but does not increase wellbeing
- Fiscal expansion has little impact on output and may even be contractionary, as it raises concerns about debt sustainability

Scepticism vis-à-vis magicians

- Tanzi: “If there were a realistic choice between ‘growth’ and ‘austerity’, would any reasonable person choose austerity? But is there really such a choice? Those who push for what they call ‘growth policies’ must truly believe in two kinds of free lunches: the one that comes from presumably costless fiscal expansion and the one that comes from the costless printing of money.”

Risk of contractionary expansions

- Tanzi: “You would worry about changes in ‘spreads’ and in ‘ratings’ for the country ... One who lived in the United States would worry about government shutdowns, about a possible government default on its debt.”

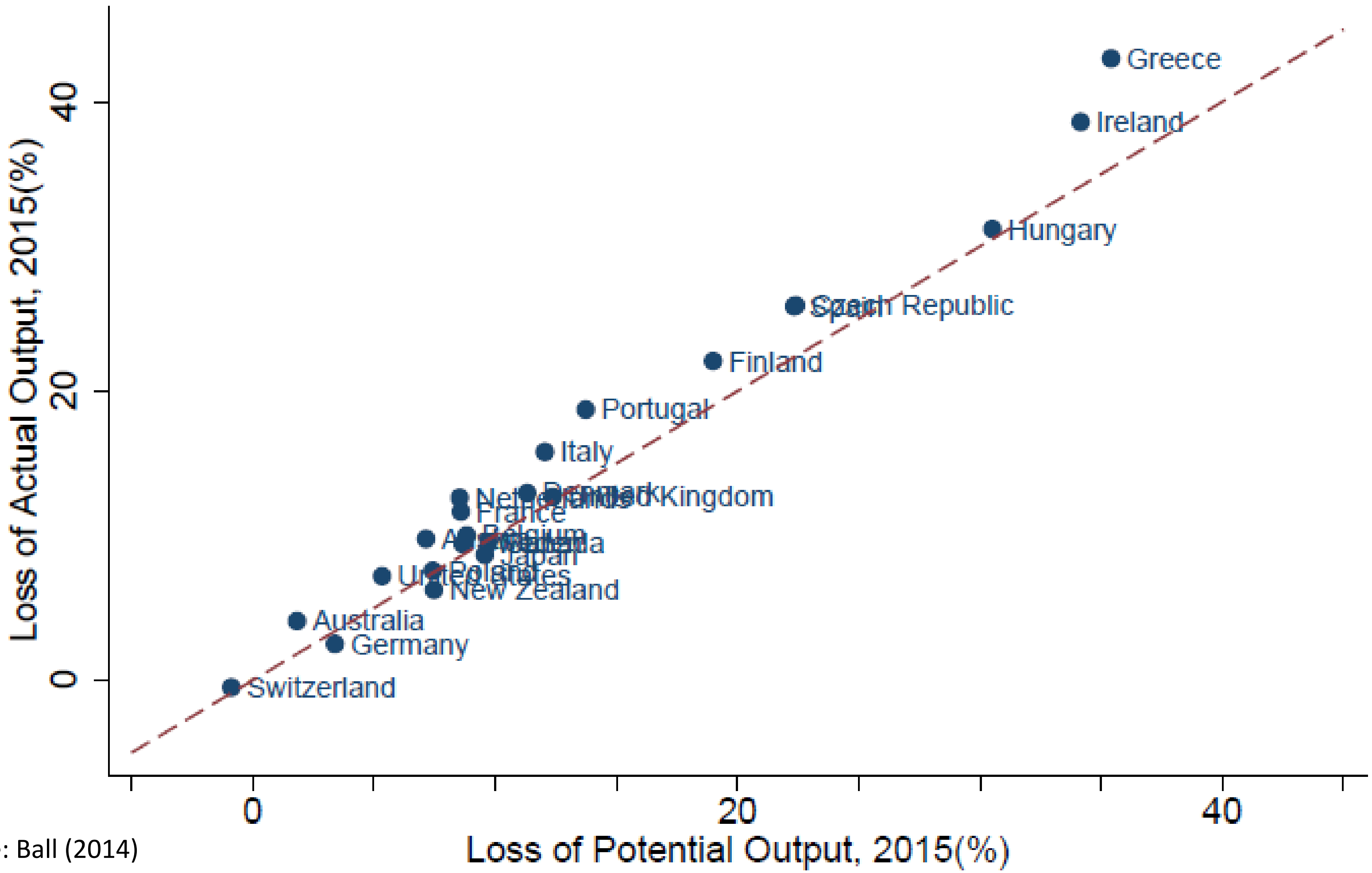
Critique of monetary expansion

- Tanzi offers a thoughtful corrective to public debate that is dominated by bankers longing for a bubble.
- Central Bank balance sheet expansion has strong link to asset prices and bank profits, but weak link to activity and employment (apart from beggar-thy-neighbour effect via FX devaluation).
- Central Bank balance sheet policies raise questions of democratic accountability. Independence was instituted to deal with problems of time inconsistency, Central Bank has no mandate for income redistribution.

Critique of fiscal expansion

- Tanzi presents an important counter-point to discussion on fiscal policy at DEC18 (papers by Laurence Ball and Karel Mertens).
- Sustainability risk depends on choice of monetary regime. Countries with floating FX and debt in domestic ccy face very weak intertemporal budget constraint, countries with fixed FX that issue debt in ccy they don’t control face strong budget constraint.
- Is there a case for counter-cyclical fiscal policy for countries with a favourable monetary regime?
- Can there be a “free lunch” for the sovereign?

Discussion:
Is there merit in output stabilisation?

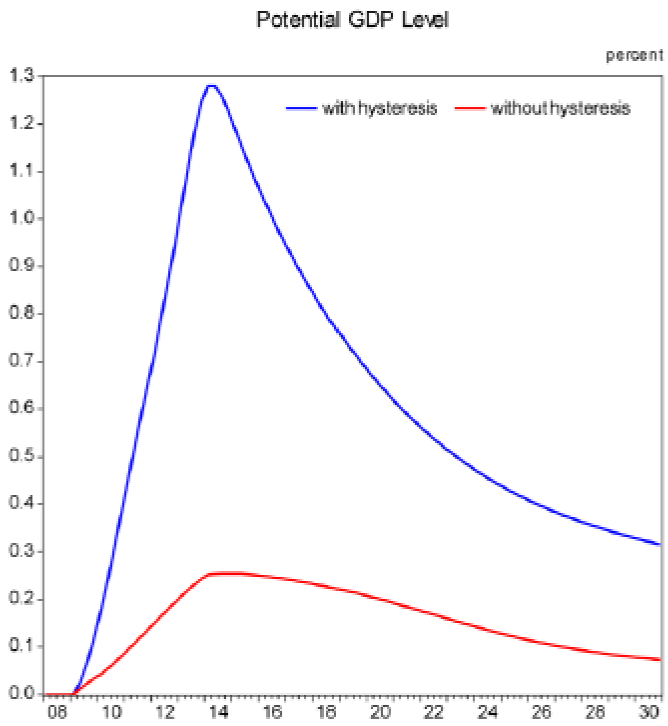


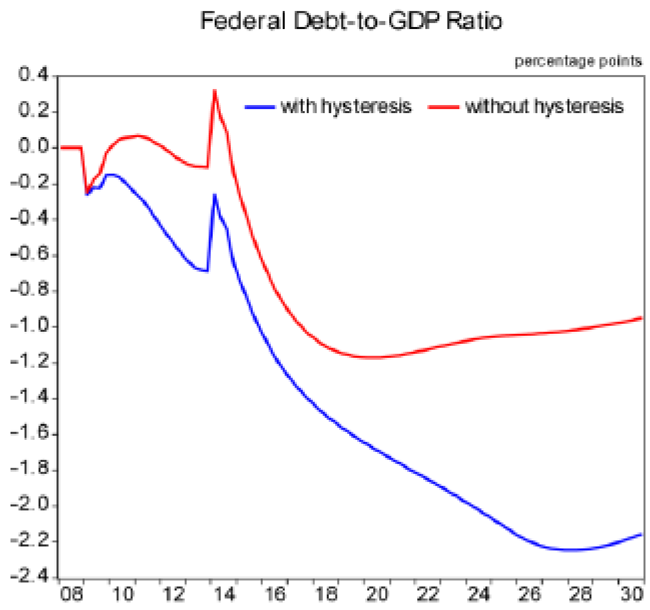
Source: Ball (2014)

Can there be a self-financed fiscal expansion?

- DeLong and Summers (2012): Fiscal expansion is self-financing if $\mathbf{r < g + \mu\eta\tau/(1-\mu\tau)}$
  with $\boldsymbol{\eta}$ = degree of hysteresis
  - $\boldsymbol{\mu\eta\tau}$ = permanent increase in tax revenues caused by a unit increase in current output
  - $\mathbf{(1-\mu\tau)}$ = net cost of fiscal expansion
- Let's assume $\boldsymbol{\eta}$ = 5%. With a fiscal multiplier $\boldsymbol{\mu}$ of 1, nominal trend growth **g** of 2.5% and a marginal tax rate $\boldsymbol{\tau}$ of 33%, fiscal expansions become self-financing as long as the government pays a nominal interest rate **r** of less than 5%

Simulated effects of a 1% of GDP increase in public purchases for 5 years, with and without labour market hysteresis





Source: Reifschneider and Summers (forthcoming)

Projected interest-growth differential, for 2014 - 2019

	r	g	(r-g)
Australia	3.5%	3.3%	0.2%
Canada	2.4%	2.8%	-0.4%
Germany	2.0%	2.2%	-0.2%
Greece	2.4%	2.2%	0.2%
Ireland	2.9%	2.2%	0.7%
Italy	3.4%	1.6%	1.8%
Japan	0.4%	1.5%	-1.1%
New Zealand	3.0%	3.5%	-0.5%
Norway	1.1%	2.6%	-1.5%
Portugal	3.4%	1.9%	1.5%
Spain	3.3%	1.2%	2.1%
Sweden	1.2%	2.9%	-1.7%
Switzerland	1.4%	2.0%	-0.6%
United Kingdom	2.6%	3.0%	-0.4%
United States	2.7%	3.2%	-0.5%

Source: IMF, author's calculations

Concluding thoughts

- What explains trend decline in real interest rates in the presence of rising public debt? Is this only due to excess credit creation in a fiat money system or could there be an excess of savings over private investment due to population ageing?
- Would the real interest rate still be positive in the absence of government debt?
- Do we need fiscal deficits and public debt creation to avoid deflation?
- Carl Christian von Weizsäcker poses deeper questions than Larry Summers or Alvin Hansen

References

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