Rebalancing Monetary and Fiscal Policies

Peter Abelson and Tim Dalton

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Key Issue

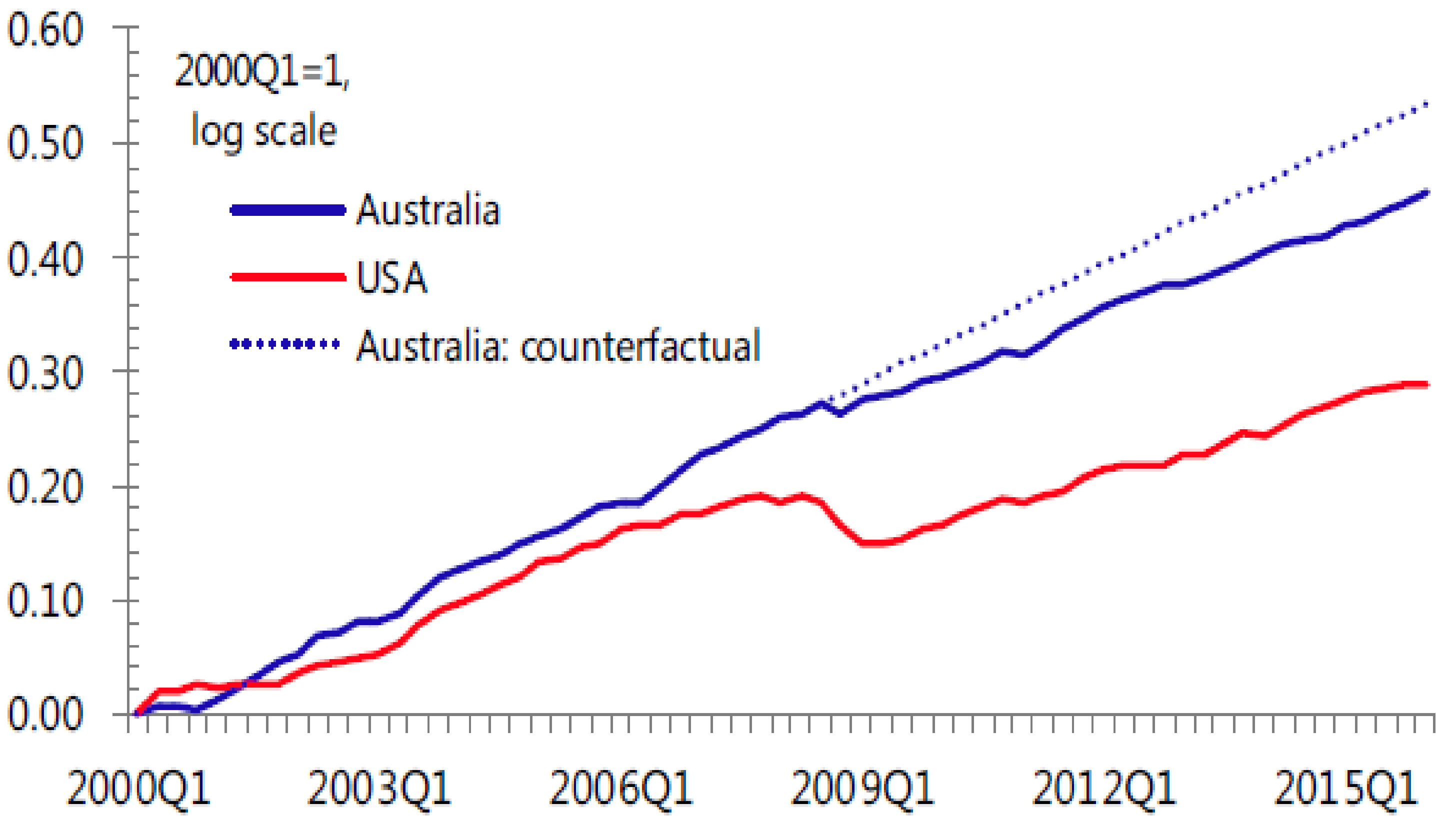
- Does poor economic performance reflect, in part at least, inappropriate macroeconomic management or more specifically over reliance on monetary policy and under-utilisation of fiscal measures?

- We examine these issues in this paper with special reference to the Australian economy.

Paper Outline

- Section 2: international and Australian context.
- Section 3: recent reassessments of the role of fiscal policy.
- Section 4: interaction between fiscal and monetary policies.
- Section 5: costs of overreliance on monetary policy.
- Section 6: critical role of government accounting guidelines in setting fiscal policy.
- Section 7: concept of fiscal space, the amount of public debt that can be tolerated.
- Sections 8: selection of public investments
- Section 9: fiscal rules for the fiscal budget.
- Section 10: conclusions

Figure 1   Real GDP: Australia and the USA



Sources: Haver Analytics and IMF staff calculations.

1/ Counterfactual is based on pre-GFC average growth (2003-07).

Monetary / Fiscal Policy Summary

- Monetary policy across developed world highly accommodative since onset of GFC in 2008-09. In US, Eurozone, UK and Japan, nominal interest rates reduced to effective lower bound and unconventional monetary policies employed.
- Fiscal policy accommodative initially but tightened as many countries become concerned about size of sovereign debt.
- Public investment spending reduced to meet fiscal consolidation objectives (OECD 2015a), despite borrowing costs at all-time lows around 0% in real terms and infrastructure deficiencies holding back growth.
- Australia also relied heavily on monetary policy to support demand after commodity prices softened in 2011. Except for 2009-10, fiscal policy has been slightly pro-cyclical – i.e. fiscal policy tightened in years when output gap suggests slack in the economy (IMF 2017c).

Reassessment of Role of Fiscal Policy

- Many parties have argued for more active fiscal policy.
- Points include exhaustion of monetary policy, there is fiscal space, fiscal policy is effective, more public investment is needed.
- Academics: Romer, DeLong / Summers, Furman
- International institutions: IMF and OECD
- Central bankers: Bernanke, Phillip Lowe

Australian Situation

- Monetary policy has not reached zero nominal lower bound, but it has reached point of limited effectiveness on demand.
- Lower interest rates would risk excessive household debt.
- Given low inflation, fiscal expansion does not have to lead to monetary tightening.
- Private investment is held back by lack of demand and confidence, not by high interest rates.
- Increased public investment would not lead to much crowding out of private investment.

Costs of Over-Reliance on Monetary Policy

- High house prices **across** Australia due to low interest rates. In 2016 $s, interest payments on 80% loan for median houses were lower in 2016 than in 2002. From 2006 to 2016, dwellings rose nationally by 17.5%, population by 16.9%. Housing affordability problem with high deposits required.

- Financial stability: increased household debt, volatile asset prices, flat yield curves / weak intermediation process may impact on bank profits / security.

- Inequality via asset prices / wealth effects. Cf. Fiscal policy can be redistributive / invested in skill developments.

- Industry adjustment harder with over-reliance on interest rates, which affects asset prices and the exchange rate.

Government Accounting

- Fiscal policy: IMF and OECD recommend increasing public investment funded by borrowing (debt), public investment to be more counter-cyclical, restraint be exercised for recurrent government spending.
- This requires accurate accounting for capital and recurrent forms of expenditure.
- Commonwealth budget 2017/18 moved **part way** towards this by distinguishing between underlying cash balance, net operating balance and adjusted net operating balance.
- Net operating balance takes out capital expenditure by the Commonwealth.
- Adjusted net operating balance takes out grants to the states for capital purposes.
- On basis of adjusted net operating balance, Commonwealth now has a low budget deficit of 0.4% of GDP (see Table 1 in paper)

Government Accounting
On-going Issues

- These developments are welcome, but not sufficient. A bias remains against public investment.
- Government retains underlying cash balance as primary measure for meeting objective of returning budget to surplus.
- Some recurrent expenditures are essentially capital investment – notably education and some health and asset maintenance expenditures.
- If capex is excluded from target, there needs to be a strategy for the appropriate level of capex.
- Note also problems with federal – state funding.

Fiscal Space: General Observations

- Fiscal space is distance between current debt level and debt limit beyond which borrowing is not sustainable or economy unstable.
- Again, many articles (OECD, IMF).
- Very low interest rates increase fiscal space.
- Key issue: fiscal space depends on differential between real interest rates and rate of output growth.
- Productivity enhancing investment increases fiscal space.
- Debts in local currency are lower risk than debts in foreign currency.

Fiscal Space: Australia

- IMF, OECD , there is plenty of fiscal space in Australia to justify more reliance on fiscal policy, especially public investment.
- Australia has projected net debt at end of 2017 of 21% of GDP. Cf: UK (80%), US (82%), Japan (120%).
- Fournier and Fall (2015, OECD paper) estimate Australia's debt limit at 250% of GDP.
- Moody's (2016), Australia has remaining fiscal space of 215% of GDP.
- OECD has lower range (120% to 160% GDP).

Selection of Public Investments

- Government would determine the level of public investment (see below). This cannot be done by a bottom-up application of CBA to all projects. This is not a world of perfect information.
- However, CBA would remain the instrument and discipline for selecting projects within this macro setting. The case for increased investment does not imply selecting poor projects.
- The real discount rate may very with the chosen level of investment over the business cycle.
- If there are insufficient public projects that meet the real market rate of return, the Government would make financial investments in the private sector.

Fiscal Rules for the Budget

- There has been much discussion of how to set a fiscal rule for public investment cited in our paper.

- It is easier to establish the principles than to set a fixed formula. Thus the fiscal rule should:

- Specify the structural or average level of public investment over the cycle

- Provide for symmetric variation around this structural level over the cycle: it should target higher investment during a downturn and lower investment when the economy is strong

- Be objective and robust to political pressure. As much as possible, it should be based on observable indicators of the real economy rather than on accounting aggregates or unobservable macroeconomic variables

- Be used in an accounting framework which reflects the economic distinction between investment and recurrent expenditure.

Possible Fiscal Guide

- A rule that varies public investment according to the deviation of real interest rates from an average or neutral level:

- $GI = A + B(r^* - r)$

  - *Where GI = Government Investment as a % of GDP*
  - *A = Parameter for the average level of GI over the cycle*
  - *B = Countercyclical parameter*
  - *r* = Neutral real interest rate*
  - *r = Current real interest rate*

- The current real interest rate *r* could be directly observed as the yield on intermediate term inflation indexed government bonds.

- The neutral real interest rate *r** could be a trailing historical average of the actual real interest rate *r*. This would ensure adjustment is symmetrical over the cycle.

Possible Fiscal Guide Comments

- When r is below r^*, additional government investment would add to demand and to inflationary pressure, cause central bank to raise real interest rates and financial markets to anticipate tightening; opposite would occur when r is above r^*.
- The average or structural level of government investment A should be sufficient to replace depreciation of existing public capital stock and to grow it in line with expected output growth.
- Actual values will depend on accounting framework – in particular whether items that are investment in substance (e.g. education) are treated as investment or as recurring expenditure.
- By responding to interest rates (rather than, for example, an estimate of the output gap) this specification would directly enhance the effectiveness of monetary policy.
- It also reflects the efficiency argument for countercyclical public investment (more projects should pass cost benefit analysis when interest rates are low).
- In practical terms, this could be a strategic guideline to an efficient level of public investment within an efficient macroeconomic policy framework. We would not expect that this to be a mandatory or binding target for government.

Conclusions

- This paper has considered the case for a more countercyclical fiscal policy in Australia, with particular focus on higher public investment.
- Over-reliance on monetary policy has contributed to relatively poor growth rate in recent years.
- It has also contributed to poor housing affordability, inequality and risks to financial stability.
- Monetary policy is not doing enough to support demand, partly because it is constrained by concerns for financial stability.
- Supportive fiscal policy can complement monetary policy and can “crowd in” private investment by improving demand outlook.
- Low interest rates strengthen case for public investment funded by borrowing and greatly increase fiscal space available to finance it.

Conclusions (final)

- Education and infrastructure are important forms of investment in future productivity. Structurally higher levels of spending in these areas is likely to be beneficial providing projects are selected and implemented efficiently.
- Government accounting should distinguish clearly between recurrent spending and investment. The increased focus on net operating balance in 2017-18 budget (especially adjusted net operating budget) is welcome.
- But accounting framework and fiscal strategy seem likely to continue to bias against adequate public investment unless further enhanced.
- Development of a quantitative guideline for the capital budget would assist government to achieve a public investment profile that is appropriate to the macroeconomic context.