Transcript

OU Economics seminar series: essential for what?

Fiscal policy in the post-financial crisis era: debates and lessons learnt

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In this particular talk, I just want to take a snap at some of the things I've learned, and what we have learned, generally, about conducting fiscal policy, and how this works. We've had two major recessions, globally, the first being the Great Recession of 2009, following the global financial meltdown in 2008, and the second being the COVID-19 recession of 2020, which spilled into 2021. But the degree of the recovery of these recession differs sharply.

Let me quickly show you something. Look at this figure here. In the first one here, you see that-- This is the real GDP of G7 countries. I could have plot all the seven there, but I chose these five so that we can really get a clear picture. Even look around the 2007, we find a very sharp fall. But after that period, the extent of the recovery was quite slow. And in fact, some countries, including the UK, never recovered back to the pre-crisis trade.

But if you look at the second recession we have more recently, you can see that it was even much more sharper than the previous one we had in two 2007. And this is the same for all the countries, but one thing is very clear. Not only have many of the countries recovered. Some of them are simply recovered beyond the pre-crisis trend, for example, the United States. So, we then ask yourself why does this really matter?

It matters because it depends-- the degree of this recovery across countries really depend on how governments views and uses fiscal policy across those decades. I want to talk about fiscal policy. I mean the use of government spending and taxation to influence the economy, either directly by spending directly into the economy in terms of direct government spending or indirectly by influencing the behaviour of the private sector.

How government reacted precisely, you will notice a very sharp difference, as well. In the first case of the 2007 financial crisis, you notice that when government responded by trying to bail out firms and accumulate have some debt in order to restore the economy back to normalcy, it was gradual and quite slow. On the other hand, if you look at the last part here, at the COVID-19 pandemic spending, you can see a very sharp rise in government debt.

We've never seen such a sharp rise in the post-war era, never before. When we talk about the government, one question that people often ask us is what is the difference between government deficits and government debt? When we talk about government deficits, we are talking about the difference between government expenditure and government revenue. When we talk about government expenditure, we are talking about every form of expenditure government have, the wage bills, investment spending, transfer spending, like social benefits and [INAUDIBLE].

And when we talk about revenue, we're talking about the taxes, deductions, public venture income, or royalties. So, what about the difference between these? That is what gives us the government deficit or surplus. It is deficit if it is negative. It is surplus if it is positive. OK, so that is exactly what deficit means. But then what about debt? So, debt, it's simply the accumulation of government borrowings over time. When government borrows last year in order to plug the hole in government finances, there will be some accumulation of interest on that.

So, by this year, you then have last year debt, plus the interest rate, and plus the new borrowings this year. That becomes the new standing of the government in terms of debt position. So, in a simple way, so the total stock of government debt at any point in time, based on what I was showing you earlier, is simply the government surplus or deficit, whichever it is at any period, plus the initial stock of debts, plus the interest payment on existing debts.

So that means that the change in government debt, that is the current level of debt minus existing stock of debt, would depend on three things, the initial stock of debts, the green one here, the net borrowing, or deficit for that-- the new borrowing of deficits for that period, that is the G minus T, and the interest rate on debt. So that means even if government is not borrowing any new thing this year but interest rates is quite high, then that simply means the change in government is still going to be quite high.

When the financial crisis came, the story changed. We saw the government coming actively to the rescue of the economic, government bailing out the private sector, businesses like we have never seen before with. And as a result of that, government deficit surged to record levels. But then there was this fear, the debt fear, across Europe and many other emerging markets, and a lot of economists, including Reinhart and Rogoff, started calling for fiscal austerity.

And as a result of that, we saw austerity measures in a lot of countries, including in the UK, with tax hikes, cutting public spending, public sector pay freeze, cutting welfare benefits, and so on. But then the question then is this. Why the austerity? Many of the government then believe that if you reduce your depth and put an active fiscal measures in place to reduce it, it will help to boost your GDP growth and help the economy to bounce back quickly from the recession.

In fact, many of you will remember this slogan from George Osborne, the former chancellor in the UK. It said we are all in this together. The assumption was that because this debt is affecting everybody, then we all must pay our part to be able to pay back this debt. So, for every meeting you meet with George Osborne, you will always have this slogan in his speech then. But the question is did the austerity policy work then?

The short answer is no. But then why? To understand why, let's look at this. This Is a case for the UK. So, I'm showing the UK data here. If I look from 1990-- I plotted the data from 1995 to 2019, fourth quarter. So, the first line-- the first red line you're seeing is when the financial crisis started. The second red line you are seeing is when the Tory came in and started imposing austerity. Notice immediately after the financial crisis, governments increased spending sharply, not only for consumption spending but even for investment spending.

And you will also see a very sharp rise in social benefits. I have normalised the scale of each of these variables, the first three variable, consumption spending, venture spending and social benefit spending to 100 for 2008, Q1. So, what you are seeing here is by how much government spending increase between 2008, first quarter, to 2010, second, quarter when the Tory government came in. And if you can see here, during the financial crisis, we see government spending a lot to help people, nearly up to 20 percentage point increase in social benefits here.

And even investment spending also increased by as much as by 10 percentage points, and we also see consumption spending increasing by about five percentage points. And as a result of that, government deficits increased sharply from about -4% to about minus -10 percentage points as a percentage of GDP. But then, immediately, the Tory government came in. They believe that austerity is the way, just like in many other European countries, and the story is not different from many other European countries.

Suddenly, we saw that government consumption spending grow flat. Remember the government consumption include the public sector wage bill, which was frozen for nearly about a decade. You can see that here, flat out completely. Then you say the same thing for investment, a very sharp fall in investment, nearly 20 percentage fall in investment spending for the first about three, four, five years. And even after that, when it increased, it did not return back to the pre-crisis trend.

And the same thing you see for the benefits spending. The benefits spending, although, flattened out, but it still increases marginally. So, what is really happening here? So, the government is trying to reduce its spending and its commitment to the economy in order to reduce debt. So, what did that do? We saw that as a result of cutting all the spending, we see a sharp rise and increase in the improvement of government's balance position. And you can see that here.

So, we see an improvement in the government budget balance. And how did that feed into government debts? That's what we see here. You can see the government debt sharply rose during the crisis, during the financial crises, but then slowed down initially. But the other initial slowdown, it is not until about 2015 it started really falling. But what about the GDP that the government really used as the excuse, the GDP growth?

You can see our GDP growth here, the pre-crisis trend is what you see here, the dotted line, while the solid line is our actual GDP. And what did you notice? You say that even after 2019, which is just before the pandemic, we are at least 10 percentage points, or 10%, lower than where we should be if there were no crisis. So, what do we know now based on those things, governments data, and our own research during those periods?

So, we now know three key things, first, that fiscal policy is still very effective, especially during period of slack, as in recessions. And the second thing we know now is that any austerity within a recession will often be self-defeating, the reason being because the burdens of this austerity often weigh more on the hand-to-mouth household. So let me just quickly look at our fiscal policy in the COVID-19 era. In the COVID-19 era, we see that government is no longer afraid as much of debt.

For example, look at the way the debt to GDP for UK increased sharply here. And you can see that we have a sharp recovery, as well, here. So, two things we learned here, one, governments can borrow at very much lower rate and can borrow beyond the self-imposed limits that we saw before. And secondly, the conventional interest rate and our fiscal policy is now broken. So, government need not to be afraid that increasing government spending will crowd out private sector demand.