Transcript

OU Economics seminar series: essential for what?

Fiscal policy in the post-financial crisis era

Moustafa Chatzouz:

I will like to focus first on the causes of the financial crisis because that is at the heart of what good policies need to be in the future, as well. We have seen a version of those playing out in the pandemic but are not necessarily efficient, or not necessarily the right approach to the problems before the financial crisis. So let me start first by reminding-- if you ask people what have caused their financial crisis, most will point to greedy financial bankers, the housing market, and all that.

However, behind that, what triggered all this mechanism and cascade of defaults that we see in the finance sector is essentially it started and ended with the change in the interest rate regime early 80s. Since then, the world moved into a regime where interest rates are declining and right now are in the lowest level ever seen. That is essentially the root cause for much of what we have seen before the crisis.

And by this, I mean low interest rate are a threat to financial stability, and sooner or later, a financial crisis would have come. And it came. However, the problem that caused it, that effectively caused the financial crisis, is still here. However, what we should learn from that is that fiscal policy has a great role to play here. And the reason is that we have to ask why low interest rates persists for so long. And the main reason, the main answer here, is that markets don't work.

It's not said explicitly. Low interest rate is equivalent to a failure of capitalism. It's the supply of savings do not match the demand for them. So, there is some imbalance that persists, and that is a problem that the markets cannot solve. So, you need some form of intervention. And to solve that problem, you need some plan, and governments, they don't have it. They don't have it even if they have understood the benefits of that in terms of how sustainable public debt might be.

What we have seen in the post-financial crisis area, it was the deficiency of aggregate demand. Low interest rate contribute to that. And although we have seen, as I have shown, a rise of deficits, that rising deficits were not enough. It might sound a little bit of a paradox here. We have that much of leverage after the financial crisis, and still, we haven't solved the problem of aggregate demand. But it's not that crazy if you think about most of that leverage, and here I add also the leverage the private sector, so both public and private sector, necessary was allocated to solve a structural problem. Most of that leverage, it effectively went to solve temporary, or cyclical, things that don't touch the heart of the problem, the structural issue of low interest rate, which, of course, like many people have already said, it roots back to demographics, to technological innovation, back to globalization, and so on.

And my interpretation is it's some secular trend. So, it's essentially characterizing that economies have changed the way that are working. So that's broadly speaking, how I will fit here a definition of a structural problem. And of course, it might spill over to low wages, less bargaining power for workers, and so on. So, all these kind of problems are what I would also call structural problem. So doesn't really relate to something temporary here and deeply ingrained on how the economies are working at the moment.

If we look at the fiscal framework-- and fiscal framework, as I said before, is essentially the main culprit, if you like, for governments on how the fiscal policy should be conducted. And of course, there, the focus remains on how to solve such cyclical things, business cycle things, like some recession, for example. They are not designed well enough to think about actual problems the society has.

And after the global financial crisis, we have seen that a lot of that burden fell into monetary policy. And of course, nothing changed. Aggregate demand, it's still deficient, and the reason is because the heart of that deficiency goes back to low interest rates, which is really only the government's fiscal policy that can solve.

Bank, or central banks, they responded with some new forms of regulation, but we can still see here why the problem stayed because we might think that the financial system has become more robust, but exactly because the low interest rate environment has stayed, markets have found the new ways on trying to get around the problem of risk or low interest rates.

Governments have learned to respond to recessions, but the main lesson about the structural problems that the financial crisis has caused still need to be learned, I will say.

There was, and there is at international level, discussion in some sense, the reason that the governments responded with that amount of stimulus during the pandemic, it roots back to things that Ayobami also mentioned about the effectiveness of fiscal policy during recessions, or the benefits for public finances when interest rates is low.

Another issue related to that, it has to do with much more, let's say, socioeconomic issue here on governments. They also didn't really learn how to respond to recession in a much more fair way. One thing that we noticed, and we know since the great financial crisis, is that it amplified wealth and income inequality.

And although the support was quite extensive and direct to low-income households during the pandemic, overall, the picture that we see is that inequalities worsen. And again, we can say that it roots back to how fiscal stimulus is designed and how fiscal consolidation and the path to sustainable debt is designed, as well.

If I have to say whether fiscal policy has changed fundamentally since the financial crisis, I would say no. We have took some minor lessons, but I don't think that the main problem is part of the agenda, or in the toolkit, on fiscal policy, at least not the academic side, on the actual policy making.