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Is it time to talk about unconventional fiscal policy?

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With interest rates at all-time lows and global monetary policy clearly nearing extremes, it could soon be time to start talking about unconventional fiscal policy.

Since at least the 1990s, 'fiscal responsibility' has been the catchword in New Zealand. Under this approach, the focus has been to keep government debt to GDP low and manageable, typically aiming to bring the budget back to surplus in good time.

Within this framework, there were three main reasons that governments tried to avoid using an active fiscal stance to manage the economy.

First, the so-called economic stabilisers already did the work for them. So in a recession government spending would automatically rise as benefit payments increased and tax revenues shank. In this case, the fiscal sector was already supporting the economy without having to make any active choices.

The second reason against tinkering was that it was much better to keep the fiscal books in good order and keep the rating agencies happy. This helped to maintain the capacity to act in extreme circumstances. The Canterbury earthquakes are a prime example. New Zealand went into those disasters with very low government debt by international standards, which made it much easier to fund the rebuild.

Finally, it was widely accepted that fiscal policy was too slow as an active tool to manage the economy. Keynesian ideas about using fiscal stimulus were largely discredited by the 1990s. This was replaced by a view that monetary policy was a much more speedy, effective, and broad-based way to manage aggregate demand, in the safe hands of technocrats.

But what if global monetary policy is nearing the end of its capacity to stimulate demand?

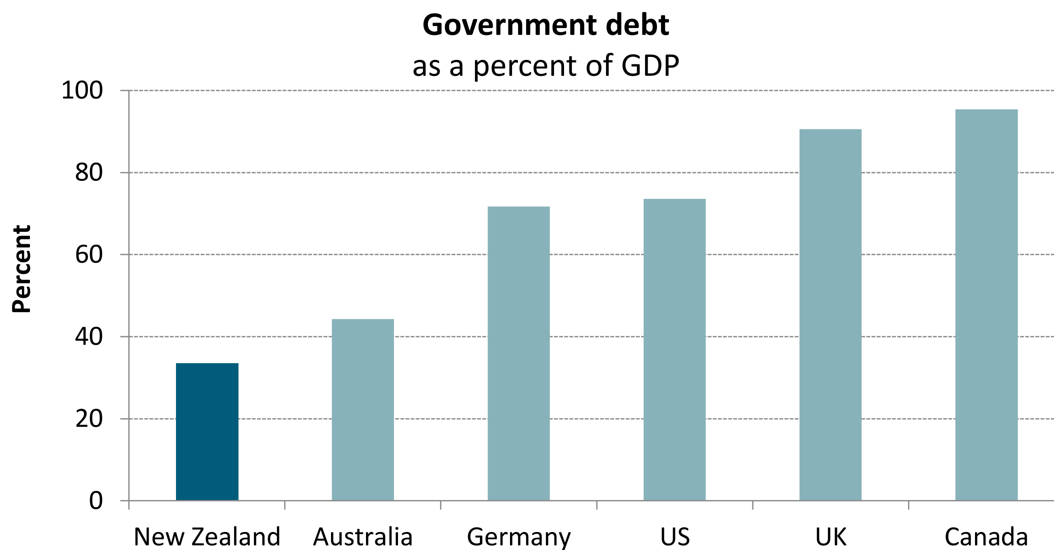
It is widely accepted that the build-up of household debt was a major cause of the GFC. For much of the 2000s, households in the western world lived beyond their means. Cutting interest rates to all-time lows since the GFC has helped cushion the servicing costs of household debt, but it has not encouraged more prudence from households. In many countries, including New Zealand, household debt to income is higher than before the GFC. So it remains a continuing vulnerability.

Instead, it could be time to re-examine the role of fiscal policy.

The conversation is certainly changing in an international context. At the height of the European sovereign crisis, there was almost a macho drive for fiscal austerity, even in countries like Germany and the United Kingdom who were not under pressure from markets. Thankfully 'austerity' is no longer the catchword, and stimulatory fiscal policy is now helping to lift aggregate demand and avoid deflation in Europe.

To be absolutely clear, taking a new approach to fiscal policy does not have to mean needless spending or running perpetual government deficits. In recent years the New Zealand government has done an important job making departmental spending more efficient. So-called 'big data' from government agencies has also made social programs more targeted. These microeconomic reforms can make a real difference to improve lives.

At a macroeconomic level, an alternative approach to fiscal policy could involve the government playing a bigger role in funding infrastructure projects. There has arguably been no better time to borrow at ultra-low interest rates to fund an investment in real assets that could push out the economic growth frontier for generations to come. There is no shortage of possible new transport and infrastructure investment opportunities.



Source: Bloomberg.

Funding these projects would result in a higher level of government debt; but at the same time government assets would also increase. Interest rates may need to be higher than otherwise to entice global investors to hold more New Zealand government bonds. However, we start from a position of strength with a low level of government debt to GDP by international standards. Furthermore, if higher interest rates crowded out some private sector investment, it may not be a bad thing: especially if it helped with a much needed rebalancing away from borrowing for residential mortgages, and towards investment in productive assets.

Since the 1990s, it has almost been blasphemous to talk about an alternative approach to fiscal policy, but with monetary policy nearing its limits it could be time to consider adopting a less conventional approach to fiscal policy.

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