Розділ 4

Макроекономічні механізми

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The role of fiscal and monetary policy during and after recent crisis

Different views on the role of fiscal and monetary policy are discussed in terms of history of economic thought. Fundamental features of fiscal and monetary policy are identified and analyzed with respect to recent financial and economic crisis. Lessons from variety of fiscal and monetary stimulus used by different countries to overcome recent crisis are summarized.

Key words: fiscal and monetary policy, economic crisis, economic system, history of economic thought

Introduction

The National Bureau of Economic Research (USA), an independent group of economists, announced that officially recent recession ended in June 2009 lasting for approximately 18 months. However, the state of the U.S. economy is still weak. The same can be said about the European Union (EU) economy. In fact, recent financial and economic crisis of 2008-2009 has raised many questions about durability of market economy and the capitalist system in general as the best economic system. The debate is still on. However, we leave ideological aspects of the debate to political scientists while focusing on pure macroeconomic aspects.

As we saw, the US and European Union - two largest market economic systems in the world - were hard hit by the crisis. As a result, they used a variety of economic tools to first mitigate the impact of the crisis and later to fine-tune the economies on their way to recovery. Both economic systems applied fiscal and monetary stimulus to do so. And now we can draw first conclusions and identify first lessons learned from these actions. It is useful from a standpoint of economic theory to prevent future crises. It is also helpful to find some useful insights for emerging economies like Ukrainian.

History of Economic Thought Regarding Recessions

It is helpful to begin with some history associated with different views on crises and the role of the government. In a nutshell, there are two competing views in terms of history of economic thought:

(i) Classical (later neoclassical and new classical) view
(ii) Keynesian (later new Keynesian) view

According to the first view, government does not have to intervene, and markets can do the job on their own. During recessions, when aggregate demand decreases adjustment in wages and prices leads to a new equilibrium which is economically efficient with all real

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macroeconomic variables unchanged. Classical approach is based on the so-called built-in stabilizers of market economies which eventually work through flexible price-wage mechanism. Austrian school of economic thought takes extreme view within this approach stating that everything (all goods and services) should be provided through free markets, and government is just a group of bureaucrats who can make things only worse. So, active role of the government is completely rejected by this view.

According to Keynesian view, during recessions economy is out of equilibrium and can stay that way for awhile. Keynes argued that in the short-run prices are fixed (later new Keynesians replaced fixed prices by sticky or sluggish prices), and any decrease in aggregate demand leads to disequilibrium. Moreover, any decrease in wages and prices at that time could make things even worse. This view accepts that in the long-run market economy can recover from a recession on its own but it would take a long time, and it would be painful. Instead the so-called demand side management is proposed to fine-tune the economy. And demand side management is based on fiscal and monetary stimulus discussed later.

So, this is a long-lived theoretical debate between two mainstreams in economics. Amazingly, all developed economies during latest crisis have acted according to the Keynesian view! Therefore, let us take a closer look at this so-called demand side management approach.

Fiscal Policy during Recession

In general, when a recession occurs people become scared of future uncertainty, and they reduce their spending on consumer goods and services. In a market economy, consumption accounts for 2/3 or 66% of the gross domestic product (GDP), and therefore, reduction in consumption decreases aggregate demand significantly. Since demand is lower, producers cannot sell their products, and they accumulate inventories. Eventually they have to reduce their level of production and the associated costs. Workers get laid off which contributes to further decrease in disposable income and consumption by households, which in turn leads to further decrease in aggregate demand, and the process repeats itself. This is known as Keynesian multiplier process which works by the way in both directions.

Therefore, if at this time government stays idle a long recession would follow with decreasing wages and prices to reach new equilibrium. Keynesian approach suggests an increase in government spending to stimulate the economy at this point. According to this approach, if government can introduce and finance some infrastructure projects or other "public works", this will keep economy going since laid off workers from private sector would be employed in a public sector earning extra income. This income should stimulate consumption and eventually production in a private sector. Economy would grow out of recession.

As a matter of fact, during 2008-2009 all developed economies introduced fiscal stimulus packages in one way or another. This was exactly what Keynes argued for. U.S. introduced a fiscal stimulus package in 2008 (Bush administration) and later in 2009 (Obama administration). Countries of the European Union (EU) introduced similar packages in 2009. It turns out that while the size of the U.S. package was 1.8% of GDP, in EU it was just 0.9% (for comparison, the size of a stimulus package in China in 2009 was 7.1% of GDP).

As an example, the U.S. 2009 stimulus package included:

– Repair and renewal of U.S. infrastructure, including highways and roads, the electric power grid, dams, bridges, levees, water mains and sewer systems, airports, and more;

– Vital aid to beleaguered local school districts plus $300 million for increased teacher

salaries

– Expansion of public transportation systems, building new high-speed passenger rail systems

– $116 billion in payroll tax relief for individuals making less than $75,000 annually, and for couples jointly making less than $150,000.

– $40 billion to extend unemployment benefits, and to increase benefits by $25 weekly

– Increased medical coverage for military members and their families, and $1 billion for the Veteran's Administration, which suffered major cutbacks under President Bush

– Food programs for low-income Americans, including $150 million to help refill food banks, $100 million for meals programs for seniors, and $100 million for free school lunch programs.

Economic historians argue that Keynesian-style spending was largely instrumental in pulling the U.S. out of the Great Depression, and in propelling growth of the U.S. and world economies in the 1950s and 1960s. Under current circumstances, according to economic community in the U.S., if the stimulus package worked to shock the U.S. economy out of its steep 2008-2009 recession, and decreased the unemployment rate, then it would be judged a success. Unfortunately it did not happen. Experts concluded that the size of the stimulus package was too small on the one hand, and by trying to do everything at once, it did nothing well enough on the other.

In particular, some economists argue that fixed investment provided by the U.S. government through the stimulus package was too small. In general, fixed investment fell in all developed economies. While fall in private fixed investment was unavoidable due to financial market troubles and low economic activity, fall in state fixed investment could have been addressed through fiscal stimulus packages. Chinese experience showed that tremendous growth in state fixed investment resulted in high economic growth during 2008-2009. Of course, here we have two different economic ideologies: The prevailing ideology in the U.S. is that state intervention is bad; therefore a large scale programme of state investment should not be implemented even when private investment was falling precipitately. On the other hand, there are no mechanisms in the U.S. capable of delivering a large programme of state led investment.

Monetary Policy during Recession

Traditional Keynesian view supports active fiscal policy first. It is so since when interest rates are low during recessions, economy is in the so-called "liquidity trap" in which monetary policy, according to Keynesian view, is useless. As we already commented, all countries followed Keynesian advice about active role of the government in terms of fiscal policy. However, all stimulus packages were coupled with active monetary responses. Why? First of all, there is a strong link between financial sector and real sector, and monetary instruments do affect real economy. Second, there is different time lag in implementation and impacts of fiscal policy and monetary policy. Third, 2008-2009 crises has started in housing market but proceeded as financial crisis.

With regard to monetary policy, while sharing a common purpose of keeping high level of liquidity and stability of financial markets in general, the European Central Bank (ECB) and the Federal Reserve have relied on different channels of transmission which is justified by the profound differences in the financial and economic structures of the euro zone and the United States. The U.S. has a primarily market-based financial system. In contrast, the financial system of the euro zone is largely bank-centred. A few numbers illustrate these differences. At

the beginning of recent crisis (end of 2007), the stock of outstanding bank loans to the private sector amounted to around 145% of GDP in the euro zone. The corresponding proportion of bank loans to GDP in the United States was only 63%. This means that the banking sector is more than twice as important in the euro zone than as is in the United States. It also means that to be effective, ECB policy had to focus first and foremost on the banking sector.

Similarly, direct debt securities account for 81% of GDP in the euro zone. The corresponding proportion in the U.S. is 168%. This means that market-based financing plays a much smaller role in the euro zone and is only half as relevant as in the U.S. Therefore, the structures of private credit outstanding in the euro zone and the U.S. are almost mirror images: recourse to banks in the EU makes up two-thirds of non-equity external finance. On this side, the equivalent proportion is only around 30%. That is why it is natural that the Federal Reserve's policies of "credit easing" mainly targeted markets for debt securities, whereas ECB policies of "enhanced credit support" focused on banks.

In technical terms, acknowledging the existence of structural differences between the euro zone and the U.S. is crucial for understanding the mechanisms behind the policy models and concepts used in terms of monetary policy. Structural differences imply that the monetary policy response has to be calibrated to the structure of the economy.

Let us now explain these differences. There are three basic differences:

1. Very important role of small and medium-sized enterprises (SMEs) in the euro zone economy. These SMEs in general cannot access credit markets directly. Therefore, allowing continued access to bank loans is vital for SMEs to be able to finance their activities.

2. The housing market in the crisis. In the U.S., the housing market was at the epicentre of the crisis. This was not the case in the euro zone. Nevertheless, the euro zone was indirectly affected as banks there held toxic assets partly backed by mortgage loans originated in the U.S. Therefore, forcefully addressing the toxic asset problem is a pre-condition for reviving credit on both sides of the Atlantic. However, it should be addressed by means of fiscal policy, not monetary policy.

3. Flexibility of the economy. Prices of goods and services and wages are more sluggish in the euro zone than in the U.S. This sluggishness, on the one hand, has drawbacks as it slows down the adjustment of the euro zone economy to adverse shocks. At the same time it offers some protection against very bad outcomes, since it provides a solid anchor for private sector expectations. In the euro zone, the institutional framework provides such an anchor through the medium-term stability orientation of fiscal policies and monetary policy geared towards fiscal sustainability and price stability. In this environment, overly activist policies risk destabilising expectations which leads to them being counterproductive.

These structural differences lead to the EU monetary policy focussed on quantitative definition of price stability. ECB aims at an inflation rate of below, but close to 2% over the medium term. The precise quantification of monetary policy objective has proved an invaluable asset, a fail-safe mechanism against excessive swings in inflation expectations, downwards as much as upwards. Long-term inflation expectations in the euro zone, whether based on surveys or extracted from financial indicators, have thus far been exceptionally resistant to sudden short-term price changes. Therefore, the ECB's responses to the financial crisis were in line with the above described structural differences as well as with the EU medium-term objectives.

In the euro zone, six-month and twelve-month euro interbank offered rates are important benchmarks, which are widely used by banks to set floating rate loans to households (for example, for setting mortgage rates) and companies,. These six- and twelve-month rates are

actually slightly lower in Euros than the corresponding rates for contracts denominated in U.S. dollars. At the same time the benchmark ten-year government bond yield in the euro zone – the German bund yield – is broadly comparable to the yield on the ten-year US Treasury bills. This shows that under current circumstances, international comparisons of policy rates provide limited information about the effective credit conditions prevailing in individual markets. One key reason for lower market rates in euro zone is the fact that spreads are lower in the euro zone, implying lower risk as well as lower credit and liquidity risk premium.

Let us take a closer look at specific measures undertaken by the ECB.

1. Under normal circumstances, the ECB auctions a given amount of loans (mainly in refinancing operations with a one-week maturity) and lets competition among bidders (private banks) determine the interest rate at which these loans will become available to the banking system as a whole. When financial markets dramatically ceased to allocate liquidity, the ECB has turned that practice around. The ECB has been determining the lending rate – at a very low level – and was standing ready to fill *any shortage* of liquidity that might occur at that interest rate for up to six months. In a sense, these actions by the ECB replaced financial markets.
2. Before the crisis, the ECB had a long list of assets that it would take as collateral. During crisis the ECB expanded the list to accept a wider range of securities as collateral. Currently, government securities account for only 44% of the nominal value of securities on the list. The rest are private securities.
3. Before the crisis, 1,700 financial institutions in euro zone satisfied all relevant EBC criteria for re-financing. Following the changes in the ECB operational framework in October 2008, this number increased: In 2009, 2,200 financial institutions in the euro zone had the opportunity to refinance themselves with the ECB, and for most of the remaining 4,300 financial institutions it was not a problem to become eligible.

The U.S. monetary policy was conduced through other channels. Since mid-September of 2008, the Federal Reserve has embarked on a policy of direct “credit easing”. This policy involved, first, the provision of liquidity directly to borrowers and investors in key financial markets (for example, the so-called “quantitative easing”) and, second, the purchase of debt instruments such as commercial paper or asset-backed securities. These measures are targeted at directly addressing instability or declining credit availability in critical *non-bank channels* of intermediation.

In particular, monetary policy conducted by the Federal Reserve during the crisis included the following:

1. Interest rate policy. Starting from a target for the Federal Funds rate of 5.25% for the first half of 2007, the Federal Reserve has gradually reduced it to 0.25% by December of 2008. In its policy announcements, the Federal Reserve has made it clear that it expects to keep the rate at this level for a sustained period of time.
2. Quantitative policy. It concerns the size of the Federal Reserve’s balance sheet and the composition of its liabilities. Historically, the bulk of the liabilities of the Federal Reserve have consisted of currency in circulation, with a tiny amount of reserves by banks and deposits from the government and foreign central banks. With the crisis, the first change is that the Federal Reserve’s balance sheet more than doubled. Reserves have accounted for much of this increase, and they are now mostly voluntary, since the penalty in holding reserves instead of lending in the federal funds market has effectively disappeared once the rates on both became the same. The final significant change in quantitative policy is that the main individual creditor of the Federal Reserve is now the U.S. government. As a means to provide the Federal

Reserve with quick access to Treasury securities, the Treasury has greatly expanded the amount in its account, so it now holds more than one tenth of the Federal Reserve's total liabilities.

3. Credit policy. This consists of managing the composition of the asset side of the Federal Reserve's balance sheet. At the start, the assets of the Federal Reserve were mostly U.S. Treasury securities, with a little over one third in Treasury bills, and the remaining two thirds in notes and bonds. It also had a few foreign reserves, other assets (e.g., gold) and almost no direct loans. By January of 2009, this picture had changed dramatically, with several new asset-purchasing programs announced. First, the Federal Reserve significantly shifted the maturity of its Treasury securities from short to long-term assets. Second, the Federal Reserve for the first time made direct loans to entities other than banks. Third, the Federal Reserve entered a swap agreement with foreign central banks to temporarily provide them with dollars against foreign currency, increasing the amount of foreign reserves on its balance sheet by a factor of almost 30. Fourth, the Federal Reserve started lending to banks for terms of 28 and 84 days against collateral at terms determined in an auction. These provided a means to lend to banks that kept the recipients anonymity in order to prevent these loans from being seen by the market as a signal of trouble by the debtor bank. In January of 2009 these credits over banks accounted for more than one quarter in the financing many companies directly without going through banks. Sixth, it created three limited liability companies to acquire and manage the assets associated with the bail-outs of AIG and Bear Stearns.

Is Recent Crisis a Crisis of Capitalism?

The above described policies point to an increased role of authorities in the EU economy as well as in the U.S. economy and the so-called command-and-control style rather than market allocation or pure incentive-based policies. Is this a new feature of a new capitalism? Command-and-control policy is a feature of the so-called centrally planned economies (CPEs) like the Former Soviet Union. However, nothing is wrong with central planning: All market economies have been doing this in modern history. What is more important is that the so-called CPEs are centrally managed economies or the role of the government is absolute.

So, as it appears, a pure market economy (or pure capitalist system) is subject to the "invisible hand" of the market or is subject to no central management rule while CPEs are 100% centrally managed. Recent history had shown that the latter was not sustainable. In our opinion, current crisis has shown that the former is not sustainable either. Where is the truth then? As usual, it is somewhere in between. On the other hand, does it mean that economic systems with bigger role of the government like, for example, Chinese (or to a lesser extent the EU or Canadian economy) are more robust to withstand current economic challenges?

As one of the most important causes of current financial and economic crisis, many economists name the following: Traditional financial markets based on traditional capitalist features such as selfishness, individualism, greed led to huge misallocation of funds. Therefore, the problem was not the lack of funds but rather their misallocation. In a nutshell it implies that markets failed to allocate resources efficiently. According to the Keynesian view, when this happens there is a role for authorities to intervene.

According to Buiter (2009) the current crisis is not a crisis of capitalism, defined as an economic system characterised by private ownership of most of the means of production, distribution and exchange, reliance on the profit motive and self-enrichment (i.e. greed) as the main incentive in economic decisions, and reliance on markets as the main co-ordination mechanism. The crisis is a crisis of a specific manifestation of financial capitalism – a largely

self-regulating version of the transactions-oriented model of financial intermediation (TOM) over the relationships-oriented model of financial intermediation (ROM).

Every real-world financial system is a combination of the TOM and the ROM. In the USA and the UK, the TOM model became too dominant. Buiter (2009) believes that this error will be corrected and the world will move towards a greater emphasis on ROM and financial capitalism will be with us a long time yet. However, he does not explain how and especially by whom this error should be corrected.

In the context of our earlier discussion with regard to degree of management of an economy, the financial sector is a critical component of a decentralised market economy. It permits the saving decisions of individuals, institutions and other economic entities to be decoupled from their investment decisions. When it performs well, it transfers resources efficiently from financial surplus units to financial deficit units. It facilitates the efficient allocation of the existing stock of financial wealth among competing financial instruments. And it permits risk trading in all its many manifestations. Without the specialised financial intermediaries - banks, pension funds, insurance companies, investment funds, pawn brokers, loan sharks, hedge funds, venture capital funds etc. - and without the steadily expanding range of financial instruments and organised financial markets, our inter-temporal allocation of resources and our allocation of resources across states of nature would be much less efficient. Society as a whole and most of its individual citizens and households would be worse off.

However, starting in the 1980s, the financial sector began to proliferate and expand in a way that defied common sense and logic. With passage of time traditional ROM-type financial intermediation has been replaced by TOM which was characterized by the so-called "excessive behaviour". As a result, this excessive behaviour of financial intermediaries coupled with financial market failure, time inconsistency and incomplete information led to almost collapse of the whole system.

On the other hand, the crisis brought understanding that financial stability is a public good which public authorities are mandated to safeguard. It is essential to do so because of the link between financial sector and real economy. The failure of a number of important banks has been at the core of budgetary problems in many countries. There are various channels through which banking problems can affect budgets and the real economy. For example, during booms tax revenues increase dramatically which adversely affects budget discipline in terms of government spending. It leads to misallocation of resources which, in turn, hurts real economy.

Because of the current crisis many economists argue that banks need to return to the "first principles of banking", i.e. they need to be a safe place for customers' savings, be responsive to customers', the economy's and society's needs, take less risks, diversify their loan portfolio better, and work more closely with regulators, the government and all stakeholders. Rather than focusing on short-term gains, banks need to focus on the longer-term future. Rather than relying on profits in the real estate sector, banks should develop expertise in modern growth centres and develop their services for SMEs. Lending should focus more on cash flow rather than property or other assets.

The link between financial sector and real economy is two-directional since there are also pressures from the budget on banks. High and unsustainable public debt can sharply raise funding costs for banks. Furthermore, cross-border holdings of sovereign debt can put pressure on bank balance sheets. Finally, the introduction of various forms of bank taxes to consolidate budgets can be the source of future financial risks if it prevents banks to build up sufficient safeguards or triggers circumvention.

In economic terms it means that the link fiscal policy- monetary policy works in both directions and optimal combination of the two should be at the heart of any public policy. Moreover, since our world is not perfect there is always some role for authorities, and this role increases during crises. Therefore, even in a capitalist economy the role of the government is strong. Of course, it should not be the command-and-control style but rather a supervisory style when authorities stand by with fiscal and monetary instruments to correct market failures and imperfections.

Lessons and Conclusions

So, what lessons can be learned and what conclusions can be drawn from current financial and economic crisis?

Lessons:

1. "Excessive behaviour" of economic agents based on personal agenda should be prevented
2. Banking system should go back to fundamental principles of banking
3. Financial stability is a public good and should be provided by the government
4. Better not more regulation of financial markets
5. It is easier to negotiate modifications to a framework characterised by over-regulation than it is to add regulation to a framework characterised by under-regulation.
6. Counter-cyclical fiscal and monetary policy

Conclusions:

1. Classical capitalism characterised by private ownership of the means of production, distribution and exchange, reliance on the profit motive and self-enrichment as the main incentive in economic decisions, and reliance on markets as the main co-ordination mechanism is not capable of dealing with current challenges associated with international trade liberalization and globalization
2. Active role of the government is needed not only during crises but also during normal economic activities. It is needed (i) to correct market failures and imperfections, (ii) to prevent "excessive behaviour" of economic agents especially in financial markets, (iii) to achieve sustainable path of economy in terms of economic, environmental and social goals
3. Fiscal policy and monetary policy should be complementary and should be well tailored to special macroeconomic conditions in individual countries
4. During crisis, the role of fiscal and monetary policy increases:

4.1 Fiscal policy should be of the right size to have economic impact depending on the size of the fiscal multipliers; it should be very detailed and focused on specific public projects as well as specific tax cuts.

4.2 Monetary policy should be based on the existing structure of economy and should supplement fiscal policy to stimulate aggregate demand through three basic channels: (i) interest rate policy, (ii) quantitative expansion, and (ii) credit policy.

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Роль фіскальної та монетарної політики під час та після останньої кризи

Стаття присвячена дослідженню особливостей застосування фіскальних та монетарних інструментів регулювання ринкової економіки під час та після економічної кризи. Визначаючи роль фіскальної та монетарної політики у подоланні фінансово-економічної кризи, автор вважає необхідним проаналізувати погляди на способи подолання кризових явищ в економіці з позиції різних теоретичних систем – класичної та кейнсіанської концепцій. Згідно класичної концепції, ринкові механізми саморегулювання здатні забезпечувати рівновагу в економіці, яка автоматично встановлюється за відсутності державного втручання. На противагу такому підходу, автор є прибічником кейнсіанської системи, суть якої полягає у можливості заходами державного регулювання ринку (фіскальними та монетарними) стимулювати попит в умовах спаду і сприяти на основі цього досягненню макроекономічної рівноваги. Автор акцентує увагу на тому, що означені види кейнсіанської стабілізаційної політики активно застосовувалися усіма країнами у 2008-2009 рр. з переважною орієнтацією на фіскальні інструменти.

Особливості застосування фіскальних інструментів подолання всесвітньої економічної кризи аналізуються автором у напрямку порівняння обсягів та структури державних видатків у розрізі таких країн як США, Європейський Союз та Китай. Додатково автором здійснюється аналіз ряду причин, в силу яких застосування фіскальних регулюючих заходів в США не призвело до очікуваного результату. Незважаючи на поширення бюджетних заходів виведення економіки зі спаду, у статті підкреслюється необхідність поєднання фіскальних та монетарних інструментів для подолання економічної кризи. Аналізуючи монетарну політику країн Євросоюзу та США, автор припускає, що відмінності у способах здійснення монетарного впливу визначаються структурними особливостями економічного устрою зазначених країн. Так, ускладнення доступу до отримання кредитів більшою частиною підприємців Євросоюзу внаслідок переважання частки малого та середнього бізнесу, а також повільне пристосування цін та заробітних плат до мінливих умов ринку обумовили вибір кількісних методів монетарного впливу у країнах Єврозони, що передбачали зниження ставки позичкового відсотка та рефінансування комерційних банків. В той же час автором досліджуються особливості монетарної політики США, які під час кризи полягали у наступному: зниження облікової ставки з 5,25% до 0,25%; збільшення валютних запасів; зміна умов кредитування комерційних банків тощо.

Поряд з цим, автор зосереджує науковий пошук на виявленні причин фінансово-економічної кризи, і серед найбільш суттєвих її чинників називає «провали» фінансових ринків, чим підкреслює виняткову роль держави у регулюванні сучасної ринкової економіки і забезпеченні її сталого розвитку. Підсумовуючи, автор зазначає, що дієвим елементом фіскального механізму державного регулювання економіки є втілення соціальних програм і зниження рівня податкових ставок, в той час як монетарна політика повинна здійснюватися через регулювання облікової процентної ставки на позики, банківських резервів та кредитної політики.

Ключові слова: фіскальна та монетарна політика, економічна криза, економічна система, історія економічної думки.

Підготувала ***І.С. Мареха***

Ю.В. Евдокимов

Роль фискальной и монетарной политики во время и после последнего кризиса

Автор рассматривает различные подходы к роле фискальной и монетарной политики в истории экономической мысли. Проанализировано основополагающие особенности использования фискальной и монетарной политики во времена экономического кризиса. Проанализирован опыт использования фискальной и монетарной политики различными странами во время текущего кризиса.

Ключевые слова: фискальная и монетарная политика, экономический кризис, экономическая система, история экономической мысли.