

Thinking the unthinkable: The effects of a money-financed fiscal stimulus

Jordi Galí 03 October 2014

Many unconventional policies adopted by central banks in response to the Crisis failed to boost the economy. This column discusses the effects of a temporary money-financed fiscal stimulus. When a more realistic model is allowed, such a stimulus can have a strong effect on output and employment, and a mild effect on inflation.

24

A A

“The prohibition of money financed deficits has gained within our political economy the status of a taboo, as a policy characterised not merely as in many circumstances and on balance undesirable, but as something we should not even think about let alone propose.” Lord Turner (2013)

Related

Deflation, debt, and economic stimulus
Richard Wood

Must fiscal stimulus policies put a burden on the future?
Max Corden

The recent economic and financial crisis has reminded us of the limits to conventional countercyclical policies. The initial response of the monetary and fiscal authorities to the decline of economic activity – through rapid reductions in interest rates and substantial increases in structural deficits – left policymakers without ammunition well before the economy had recovered. Policy rates hit the zero lower bound at a relatively early stage of the Crisis, while large and rising debt-GDP ratios forced widespread fiscal consolidations – still underway in many countries – that have likely delayed the recovery and added to the economic pain. What is more, and leaving aside its likely contribution to the stability of the financial system (and the profitability of banks), the kind of unconventional monetary policies adopted by the main central banks have failed to provide a sufficient boost to aggregate demand and bring output and employment rates back to their potential levels, especially in some of the countries hit hardest by the financial crisis.

Against this background, there is a clear need to think of policies that could stimulate the economy without relying on lower nominal interest rates (unfeasible) or further rises in the stock of government debt (undesirable, given the historically high – and growing – debt ratios). The option of an increase in government spending financed through higher taxes is not an appealing one either, given the high tax rates prevailing in many countries and the likely self-defeating effects of higher taxes. On the other hand, proposals focusing on labour cost reductions or structural reforms have been recently called into question by several authors on the grounds that their effectiveness at raising output hinges on a simultaneous loosening of monetary policy, an option no longer available.¹

Money-financed fiscal stimulus

In a recent working paper (Galí 2014), I study the effects of an alternative policy intervention aimed at reviving the economy – a temporary increase in government purchases, financed entirely through money creation. As the above quote by Turner suggests, such a policy is viewed in policymaking circles as ‘unspeakable’, nothing short of a ‘taboo’. But as academics, we should not feel bound by such conventions. It is our responsibility to explore the consequences of any policy that may help attain widely shared social goals (e.g. full employment and price stability), and to let our findings be known (though always with the necessary caveats).

- A central message of my recent work is that the implications for output and inflation of a money-financed fiscal stimulus are highly model-dependent.

Thus, when that fiscal intervention is analysed in the context of an ‘idealised’ classical monetary economy with perfect competition in all markets and fully flexible prices and wages, the money-financed fiscal stimulus has a very small effect on output and employment and a huge, frontloaded

Jordi Galí

Director of CREI, Universitat Pompeu Fabra; Research Fellow, CEPR

Don't Miss

Where danger lurks
Blanchard

Deep roots matter for prosperity, but so do current policies

Secular stagnation: Facts, causes, and cures – a new Vox eBook
Teulings, Baldwin

The Federal Reserve in the run-up to the Global Crisis

How to jumpstart the Eurozone economy
Giavazzi, Tabellini

Long-term damage of the US court's Argentinian debt ruling
Frankel

Why standard macro models fail in crises
Hendry, Mizon

Most Read

This Month | All Time

Secular stagnation: Facts, causes, and cures – a new Vox eBook
Teulings, Baldwin

The Geneva Report on global deleveraging
Lane, Reichlin, Reinhart

Finance sector wages: high and rising rent extraction

Systemic risk in Europe
Engle

Is the ECB doing QE?
Wylosz

Vox Talks



Complexity and the art of public policy

Kuperus, 25 July 2014

Listen | Open Player

More Vox Talks

Subscribe



@VoxEU



RSS Feeds



Weekly Digest

impact on inflation. Private consumption declines. A desirable effect, on the other hand, lies in the implied reduction in the debt ratio resulting from the erosion of the debt's real value caused by the initial spike in inflation. All things considered, a money-financed fiscal stimulus is clearly unappealing if one takes such an idealised classical model as a reference framework.² I conjecture that it is that kind of 'classical' reasoning that has shaped the widespread prejudice against money-financed fiscal expansions.

But such judgments may not be entirely justified. As I show in my recent paper, when I deviate from an ideal classical world and use instead a more realistic model allowing for imperfect competition and nominal wage and price rigidities to evaluate the impact of a money-financed fiscal stimulus, the effects are very different.

- Such an intervention is predicted to have very strong effects on economic activity with relatively mild inflationary consequences spread over several years.

The large increase in activity is due to a crowding-in of private consumption and investment, caused by the persistently lower real interest rates due to higher expected inflation.

- The debt-GDP ratio is also predicted to go down over time, largely as a result of the lower interest rates.
- Finally, if output is sufficiently below its efficient level, a money-financed fiscal stimulus is shown to raise welfare even if based on purely wasteful government spending.

A fiscal stimulus programme that focuses on productivity-enhancing public investment projects would likely have even more desirable effects.

The previous predictions contrast with the experience with quantitative easing and other unconventional monetary policies, which do not affect aggregate demand directly and which, as a result, have failed to jumpstart the depressed economies of many countries, especially in the Eurozone. An additional advantage of a money-financed fiscal stimulus, particularly relevant for a monetary union, is that the associated increase in government purchases may be targeted at the regions with higher unemployment and lower inflation (or higher risk of persistent deflation).

The time may have come to leave old prejudices behind and come to terms with the urgent need to increase aggregate demand in a more foolproof way than tried up to now, especially in the Eurozone. The option of a money-financed fiscal stimulus should be considered seriously.

References

Eggertsson, G, A Ferrero, and A Raffo (2013), "Can Structural Reforms Help Europe?", Brown University, mimeo

Galí, J (2013), "Notes for a New Guide to Keynes (I): Wages, Aggregate Demand and Employment", *Journal of the European Economic Association*, 11(5), 973-1003.

Galí, J and T Monacelli (2014), "Understanding the Gains from Wage Flexibility: The Exchange Rate Connection", CREI working paper.

Galí, J (2014), "The Effects of a Money-Financed Fiscal Stimulus", CEPR Discussion Paper 10165, September.

Footnotes

1 See Eggertsson et al. (2013), Galí (2013) and Galí and Monacelli (2014), among others.

2 In the model, implementation of such a policy reduces households' utility unambiguously.

Topics: Global crisis Macroeconomic policy Monetary policy

Tags: fiscal stimulus, government purchases increase, money creation

Related

Deflation, debt, and economic stimulus

Richard Wood

Must fiscal stimulus policies put a burden on the future?

Max Corden