ARTICLE – Expansionary fiscal policies abroad are contributing to the recovery

In the United States and several European countries, major fiscal policy measures have been put in place to support households and companies, thereby mitigating the economic damage caused by the crisis. Estimates suggest that these measures succeeded in dampening the fall in GDP during the most acute stage of the crisis, when the closures hit economic activity hardest, and that they are now accelerating the recovery. In addition, several countries are discussing further fiscal packages that could lead to even higher growth and, overall, there seems to be a new political will to implement major general government stimulus.

The expansionary fiscal policy abroad means that Swedish export companies are facing higher demand, thus strengthening economic activity in Sweden too. However, the public spending increases also entail risks. The reforms and investments now being planned will take time to implement. Going forward, it may therefore be difficult to rapidly to adjust the degree of fiscal policy stimulus to changes in the economic outlook, thereby creating a risk of overheating. In many countries, public indebtedness is also increasing substantially. This may limit the scope for action in any future crisis, particularly if interest rates were to rise more than expected.

Extensive fiscal policy support during the crisis

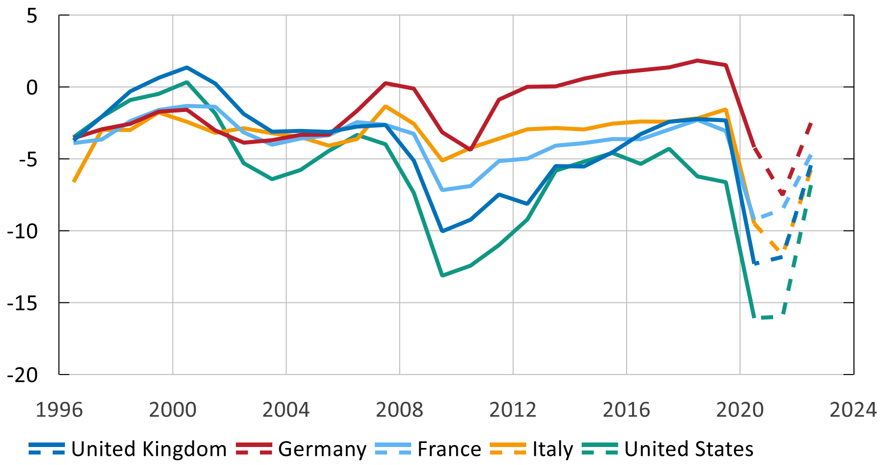
During the coronavirus crisis, public expenditure has risen sharply in most developed economies and in several of the major emerging economies, such as China. A large part of the expenditure increases have been used to support households and firms in various ways. This includes unemployment and sickness benefits, for example. In the United States, large sums have also been paid out in direct cash transfers to households. Companies hit by large revenue losses have received grants and, in many countries, thanks to public guarantee schemes, they have also been able to raise loans at relatively low expense. In addition, many wage-earners in Europe have been saved from dismissal thanks to public short-time work allowance.

At the same time as expenditure has increased, tax revenues from household incomes, companies' profits and elsewhere have fallen. Overall, this has meant that general government net lending has declined substantially. Figure 55 shows net lending as a proportion of GDP for France, Italy, Germany, the United States and United Kingdom. Last year's deficit in the United States, which corresponded to approximately 16 per cent of GDP, is the largest measured in the past 60 years. The deficit was also unusually large in the United Kingdom and the largest euro area economies.

In the Nordic countries, too, extensive measures have been taken to protect businesses and households that have been financially affected by the crisis. Overall, however, the financial effects of the crisis have been smaller in the Nordic countries than in many countries on the Continent and the deficit has also been smaller here (see Figure 56).[35]

Figure 55. General government net lending

Per cent of GDP



Note. The forecasts for net lending are based on the Commission's May 2021 forecast.

Source: European Commission.

The measures have mitigated the downturn and accelerated the recovery

How great an effect have the various support measure had on GDP, employment and unemployment? An extensive body of empirical research literature documents that GDP rises when expenditure for public sector consumption increases and when taxes are cut. Significantly fewer studies have investigated how economic activity is affected by increased transfers to households, but those published show a positive effect.[36] It is difficult to say how large the effects of different fiscal policy initiatives will be, particularly under the special conditions that have prevailed during the present crisis, with large parts of the economies being closed.

Nevertheless, calculations based on US data show that last year's fall in GDP was significantly counteracted by the support measures. During the second quarter of 2020,

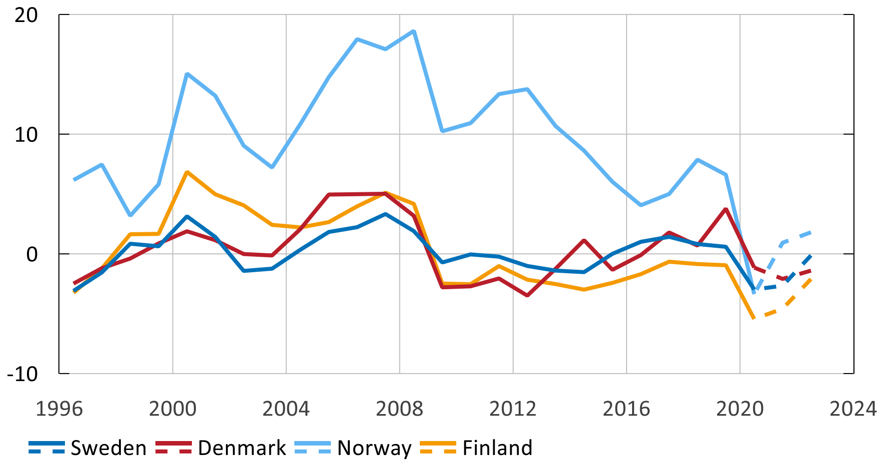
[35] In Norway, general government net lending fell last year by slightly more than NOK 340 billion compared to the level in 2019. A significant part of the decline is explained by a fall in tax revenues from the petroleum sector. See the Article "Government deficit continues" from March 2021 and Table 10721 in the StatBank of Statistics Norway.

[36] For an overview of the empirical literature, see V. Ramey (2019), "Ten years after the financial crisis: what have we learned from the renaissance in fiscal research?", *Journal of Economic Perspectives*, vol. 33, No. 2. The effects of increased public sector investment are analysed by C. Boehm (2020), "Government consumption and investment: does the composition of purchases affect the multiplier?", *Journal of Monetary Economics*, vol. 115. For estimates of fiscal policy multipliers on Swedish data, see G. Hjelm and P. Stockhammar (2016), "Short run effects of fiscal policy on GDP and employment: Swedish Evidence", *Working Paper* No. 147, National Institute of Economic Research.

the GDP of the United States fell by 9 per cent compared to the level in the preceding quarter. Estimates indicate that the fall in GDP would instead have been between 12.5 and 16 per cent if fiscal policy had not restrained the negative effects of the crisis.[37] In March of this year, the US Congress voted through a new, major stimulus package including money for expanded unemployment benefits, direct cash support for households, tax relief for companies offering their employees sickness benefits and other measures. Calculations taking these measures into account indicate that fiscal policy will continue to have a decisive effect on economic activity in the United States over the first six months of this year.[38]

Figure 56. General Government net lending in the Nordics

Per cent of GDP



Note. The forecasts for net lending in Denmark, Finland and Norway are based on the European Commission's May 2021 forecast. For Sweden, the Riksbank's forecast is used.

Sources: European Commission, Statistics Sweden and the Riksbank.

In Europe too, the support measures contributed to restraining last year's fall in GDP.[39] This year, several euro area countries decided to extend the support and also to implement new initiatives.[40] The fiscal policy packages in Europe are certainly

[37] The Hutchins Center on Fiscal and Monetary Policy at the Brookings Institution in the United States makes regular calculations of the effects of fiscal policy on US GDP growth. According to their method, which does not take account of so-called multiplier effects, fiscal policy contributed to raising GDP growth in the second quarter of 2020 by 3.4 percentage points (see Hutchins Center Fiscal Impact Measure). Chudik et al. (2021) uses a VAR model to estimate the effects on GDP of discretionary fiscal policies in 33 countries. Their results show a contribution to US GDP growth of just over 7 percentage points in the second quarter of last year. See A. Chudik, K. Mohaddes and M. Raissi (2021), "COVID-19 Fiscal Support and Its Effectiveness", *Globalization Institute Working Paper* No. 408, Federal Reserve Bank of Dallas.

[38] See Hutchins Center Fiscal Impact Measure.

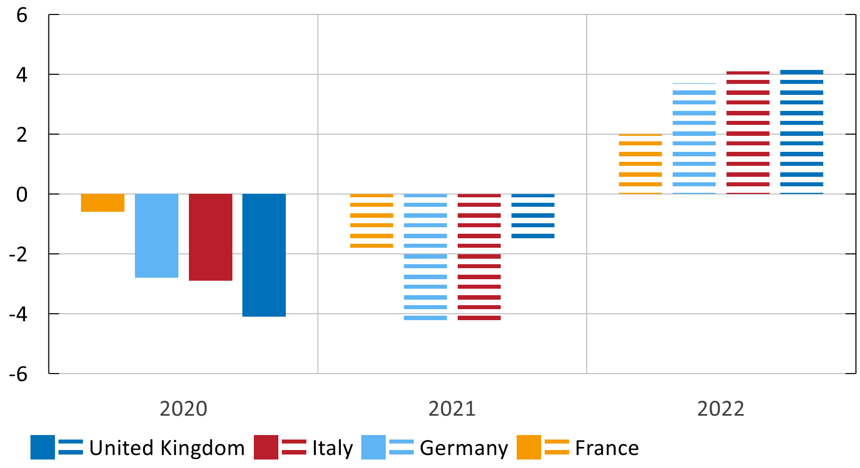
[39] See reference to Chudik et al. (2021) in footnote 37.

[40] An overall description of the fiscal policies of the EU Member States is given in the European Commission's forecast from May of this year (see *European Economic Forecast*, Spring 2021). More detailed information can be found in the national stability programmes. In Germany, the increased deficit in 2021 is primarily due to increased appropriations for various types of support payment to companies and households. Italy's new government has proposed changes to this year's budget entailing increased support measures to households and companies, investment initiatives and other measures. In the stability programme adopted in April, the Italian government expects a deficit of 11.8 per cent of GDP this year, which can be

smaller than those in the United States, even taking the respective size of the economies into account. Even so, the measures are expected to provide significant support to demand this year. Figure 57 shows the European Commission's calculation of the change to the cyclically-adjusted general government net lending for Germany, France, Italy and the United Kingdom. The downturns in the cyclically-adjusted balance this year give an idea of how important the fiscal policy initiatives are for demand.[41] In addition, there are the stimulus measures paid for by grants from the EU's joint recovery fund, Next generation EU (NGEU). They are expected to represent several per cent of GDP per year for some countries.

Figure 57. Change in cyclically adjusted net lending

Per cent of potential GDP



Note: The forecasts for cyclically-adjusted net lending are based on the European Commission's May 2021 forecast.

Source: European Commission.

Fiscal and monetary policy are pulling in the same direction

During the crisis, monetary policy has also been made more expansionary, both abroad and in Sweden. In addition, several central banks have announced that they plan to continue to keep policy rates low and to purchase interest-bearing assets, even if inflation risks being above the target for a while. There is therefore reason to assume that the fiscal policy measures now being implemented in the United States and Europe are strengthened by the expansionary monetary policy.[42] There are also

compared with a deficit of 7 per cent of GDP in the last government's draft budget act for 2021 from last autumn.

[41] The calculation for this year and next year is based on the European Commission's forecasts and on fiscal policy measures that either have been agreed or for which credible detailed plans have been published. See *European Economic Forecast*, Spring 2021, published by the European Commission in May.

[42] Both empirical and theoretical studies show that fiscal policy initiatives have a greater effect on growth and resource utilisation if the policy rate is held unchanged when the initiatives are implemented, compared with a situation in which the policy rate is instead raised. See V. Ramey and S. Zubairy (2018), "Gov-

many indications that the European Central Bank's crisis programme for asset purchases (the Pandemic Emergency Purchase Programme or PEPP) and the EU joint fiscal policy initiative (NGEU) have been of great importance for restraining interest rates on government loans in the euro area's most heavily indebted countries. In this context, it is remarkable that the gross public debt in Italy increased last year by over EUR 160 billion (9.9 per cent of GDP) at the same time as the average interest on the outstanding promissory notes fell.[43]

Economic policy thus managed to restrain the fall in GDP during the most acute phase of the crisis and the Riksbank's assessment is that both fiscal and monetary policies are now accelerating the recovery. Higher demand abroad means that Swedish export firms are also facing higher demand, thus strengthening economic activity in Sweden too. The size of the estimated effects on GDP growth abroad, as cited above, also gives an indication of the significance that fiscal policy will have in the period ahead, when support is eventually discontinued. How rapidly general government net lending will increase over the coming years will have important implications for growth prospects in both the United States and the euro area. In its latest forecast for the euro area, the European Commission assumes that fiscal policy will become contractionary as of next year. As yet, however, we know fairly little of the various governments' concrete budget plans for 2022 and it is possible that this tightening will occur at a slower pace, compared with the assumptions in the forecast. Overall, there seems to be a new political will to implement major fiscal policy initiatives. The United States is debating two extensive new packages that the government has put forward, while several EU countries have published ambitious, multi-year recovery packages, parts of which will be funded by NGEU.

Difficult to calibrate the size of new initiatives

In most cases, the new packages planned have a different focus from the acute support measures taken last year, which largely consisted of transfers to households and companies. In the period ahead, there will instead be a greater focus on reforms, public sector investment and green transition. These efforts will take a longer time to implement, sometimes several years, and it may therefore be difficult to adjust the degree of fiscal policy stimulus to changes in the economic outlook. The strength and speed of the recovery that has now begun is difficult to assess. If the economic outlook is overestimated and the decision is taken to reduce public expenditure too

---

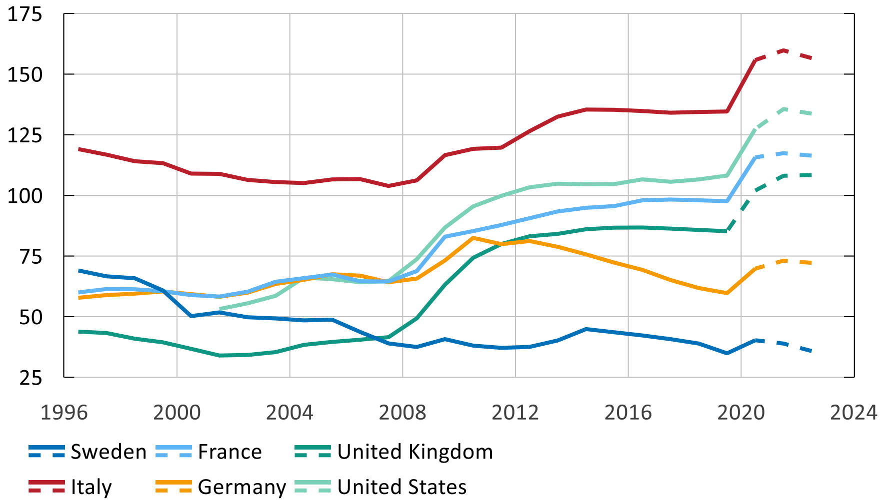
ernment Spending Multipliers in Good Times and in Bad: Evidence from US Historical Data" in *Journal of Political Economy* 126(2) and G. Coenen et al. (2012), "Effects of Fiscal Stimulus in Structural Models", *American Economic Journal*: *Macroeconomics*, 4 (1).

[43] During the first weeks of March 2020, it became increasingly clear that the pandemic would have serious economic consequences and at that point in time the world's financial markets were hit by heavy turbulence. Interest rates on government loans rose in several of the euro area's most indebted countries. On 18 March, the ECB made public a new, comprehensive programme for purchases of assets, PEPP, and, over the following trading days, interest rates fell back. In April and May, the turbulence returned, with new rapid rises in interest rates for Italian government securities, for example. However, this development was reversed on Monday 18 May, when the German Chancellor and French President presented a proposal for a joint EU recovery fund of EUR 500 billion. The Franco-German initiative became the start of the 750 billion euro recover plan named Next Generation EU. As of 18 May and during the following months, interest rates on government loans fell back and, since the turn of the month August/September 2020, the Italian government has been able to raise loans at interest rates that have been lower than those prevailing before the outbreak of the crisis.

quickly, there is a risk that the recovery would slow down too strongly and that unemployment would remain high for a longer period. However, if the strength of the recovery is instead underestimated, the new fiscal policy package now being debated may lead to an increased risk of overheating in the long term. However, it is worth mentioning that the new packages have a more structural than cyclical aim, which reduces the risk that they will overheat the economies.

Figure 58. Consolidated gross debt in the public sector

Per cent of GDP



Note. The forecasts for France, Germany, Italy, the United Kingdom and United States have been taken from the European Commission's forecast from May 2021 and refer to unconsolidated gross debt in the public sector. For Sweden, the Riksbank's forecast is used.

Sources: Eurostat, European Commission and the Riksbank.

Larger public sector debts entail a risk of reduced scope for action

The large budget deficits and the rapidly growing national debts have breathed new life into discussions of which level of public sector loans is sustainable (see Figure 58). During the crisis, the rules of the EU's Stability and Growth Pact have been temporarily suspended. Of course, the forecast for the general government primary balance is an important factor in the assessment of what is a sustainable level of debt.[44] However, the sustainability assessment is also affected by the rate of growth in the economy and by the interest rate on the central government debt. The lower the interest rate is in relation to the growth rate, the smaller the budget surplus that is needed to stabilise a given debt-to-income ratio.[45] In recent decades, interest rates have fallen and, in several developed economies, the average government borrowing rate since

[44] The primary balance is net lending excluding capital income and interest expenses.

[45] For more detailed discussions of the factors affecting the debt-to-income ratio, see O. Blanchard, Á. Leandro and J. Zettelmeyer (2021), "Redesigning EU fiscal rules: from rules to standards", *Peterson Institute for International Economics Working Paper*, and O. Blanchard (2019), "Public debt and low interest rates", *American Economic Review* vol. 109(4).

the start of the millennium has been lower than the average growth rate.[46] This has led many economists to reassess their view of what a sustainable level of debt is.

Central bank communication indicates that policy rates will remain low for several years, which suggests that interest rates on government loans will also remain low. The direction of monetary policy is determined by the prospects for inflation, and the rate of price increases has certainly risen recently in the United States and a number of countries in the EU, but the upturns are viewed as temporary. Most forecasts indicate that policy rates will remain low and that inflation will then be close to the inflation targets a few years ahead. In addition, policy rates are affected by the global trend that, for several decades has pushed down real interest rates.[47] Consequently, even if monetary policy in the period ahead will be less expansionary, this need not mean that policy rates will be raised to the levels that prevailed during previous economic upturns.

However, economic forecasts are uncertain and inflation prospects can change, particularly if private consumption grows faster than expected and bottlenecks arise in production. In such a scenario, the central banks may be forced to raise their policy rates to defend their inflation targets. There is also disagreement among economists concerning the exact causes behind the trend in global real interest rates and the required rates of return may start to rise again. With the large public debt that has arisen in several countries, even a comparatively modest increase in interest rates may lead to high borrowing costs and a shrinking scope for further borrowing. Such a reduction of the scope of fiscal policy action may have substantial consequences, for example if a new crisis should occur or a government should be forced to assume responsibility for debts that have arisen in the private sector. In addition, if interest rates were to rise more than expected, investors could reconsider the assessment of what debt levels are sustainable, which in turn could lead to even higher government lending rates and more directly force fiscal policy to be tightened and hence lead to weaker economic development.

[46] P. Barrett (2018), "Interest-growth differentials and debt limits in advanced economies", *IMF Working Paper* No. 18/82.

[47] For an overview and discussion of the research literature that has studied the trend towards lower required rates of return, see H. Lundvall (2020), "What is driving the global trend towards lower real interest rates?", *Sveriges Riksbank Economic Review,* Sveriges Riksbank.