



Central Bankers' Fiscal Constraints

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With policy interest rates near zero in most advanced economies (and just above 2% even in the fast-growing US), there is little room for monetary policy to maneuver in a recession without considerable creativity. But those who think fiscal policy alone will save the day are stupefyingly naive.

CAMBRIDGE – If you ask most central bankers around the world what their plan is for dealing with the next normal-size recession, you would be surprised how many (at least in advanced economies) say “fiscal policy.” Given the high odds of a recession over the next two years – around 40% in the United States, for example – monetary policymakers who think fiscal policy alone will save the day are setting themselves up for a rude awakening.

Yes, it is true that with policy interest rates near zero in most advanced economies (and just above 2% even in the fast-growing US), there is little room for monetary policy to maneuver in a recession without considerable creativity. The best idea is to create an environment in which negative interest-rate policies can be used more fully and effectively. This will eventually happen, but in the meantime, today's overdependence on countercyclical fiscal policy is dangerously naïve.

There are vast institutional differences between technocratic central banks and the politically volatile legislatures that control spending and tax policy. Let's bear in mind that a typical advanced-economy recession lasts only a year or so, whereas fiscal policy, even in the best of circumstances, invariably takes at least a few months just to be enacted.

In some small economies – for example, Denmark (with 5.8 million people) – there is a broad social consensus to raise fiscal spending as a share of GDP. Some of this spending could easily be brought forward in a recession. In many other countries, however, notably the US and Germany, there is no such agreement. Even if progressives and conservatives both wanted to expand the government, their priorities would be vastly different. In the US, Democrats might favor new social programs to reduce inequality, while Republicans might prefer increased spending on defense or border protection. Anyone who watched the US Senate confirmation hearings last September for Supreme Court Justice Brett Kavanaugh cannot seriously believe this group is capable of fine-tuned technocratic fiscal policy.

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