Intelligence MEMOS

From: Martin Eichenbaum

To: Finance Minister Bill Morneau

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Re: **Going Unconventional on Fiscal Policy as a Recession-Fighting Tool**

Canada and the rest of the developed world have entered an era of low interest rates and sluggish growth. We should expect interest rates to remain low by historical standards when the next recession occurs.

Since the Bank of Canada will be unable to cut rates much below zero, monetary policy alone won't be able to effectively fight the next recession. The government will have to use fiscal policy – its spending and taxation powers.

The challenge is to devise a framework for using fiscal policy in a timely, effective and responsible manner. A set of policies known as "unconventional fiscal policy" offers such a framework. This approach explicitly links the expanded use of fiscal policy to situations when we've hit the practical limits of monetary policy.

It is related to the "going direct" **proposal** put forward by the BlackRock Investment Institute, but relies more on changes in laws governing fiscal programs than on the discretion of non-elected bank officials.

The first leg of the policy is a program of asymmetric automatic-stabilizer programs, the transfer programs, such as unemployment insurance and income support payments, that expand during recessions and contract in good economic times. Critically, these put money in the hands of the people most likely to spend it. And they do it just when the economy needs the boost in demand.

Unconventional fiscal policy boosts the power of these stabilizer programs by linking their scope to easy-to-measure and simple-to-communicate macroeconomic targets.

For example, the maximum weekly amount in unemployment benefits of roughly $560 could be raised to $750 when a target variable hits its "crisis" level. The payment would revert to normal levels when the target variable subsides, ensuring expanded programs don't become permanent.

The second leg of the policy would be a series of asymmetric, automatic changes in tax rates in response to the same target variables. For example, the federal GST rate could automatically fall in a severe recession. Other candidates for tax cuts include EI contributions and income tax rates.

All of these tax cuts would spur the demand for goods and services when such a boost is most needed. In effect, we would create a temporary "sale" on consumption during crisis periods, which would end when the target variable returns to its normal level.

An obvious trigger variable is the Bank of Canada's policy rate, because fiscal policy is most powerful and most needed when that rate reaches its effective lower bound, at or near zero. Political considerations might lead us to adopt a different trigger variable. But whatever trigger variable we adopt, it should be set in advance by legislation.

There are four advantages to unconventional fiscal policy.

First, fiscal policy is likely to be particularly powerful in a deep recession when the monetary policy hits its effective lower bound.

Second, expanded automatic stabilizers and tax cuts would switch on and off as economic conditions change. This trigger structure would take the pressure off the politics of the moment. And stimulus would start quickly, when it has the most effect, and end when no longer needed, limiting possible long-term damage to public finances.

Third, policies that are designed outside of a crisis are far more likely to be better thought out, more carefully vetted and better communicated than those designed in the middle of a crisis.

Fourth, because expanded automatic stabilizers and tax cuts would be embedded in our legal framework, households, firms and provincial governments would be more likely to factor expanded benefits and lower tax rates into their decisions. This is potentially very important.

For good reasons, people are afraid of losing their jobs in a severe recession. It's natural to increase precautionary savings, before and during a severe recession.

Even though this saving is privately optimal, it's deeply counterproductive from a social point of view. Fear of recession can make a bad situation worse, and easily become self-fulfilling. But if people are confident they'll get expanded help in a severe recession, they'll feel less need for precautionary savings. Expanding the help offered in such episodes reduces the amount of help actually needed.

I have no idea when the next recession will come. But I know that it will come and we need to be ready to fight it.

The Bank of Canada is assessing its monetary policy framework ahead of the anniversary of its five-year inflation-control agreement with the federal government. Now is the perfect time to think about unconventional fiscal policy, and set its macro triggers.

Martin Eichenbaum, a Canadian citizen, is an international fellow at the C.D. Howe Institute and the Charles Moskos professor of economics at Northwestern University.