The economy

The next front is fiscal

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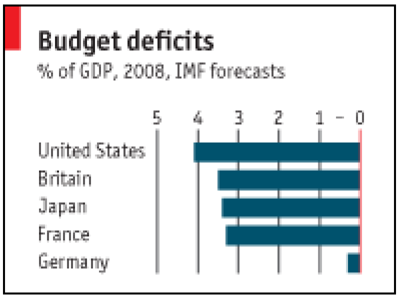
Interest-rate cuts are welcome; but as a global recession looms, the case for fiscal stimulus grows



THE good news is that the world seems to have dodged a catastrophic banking collapse. It is too early to know for sure—some emerging markets are in trouble and stockmarkets are behaving violently (see article). But interbank and commercial-paper markets suggest that the blind panic is abating.

The bad news is that the world economy is weakening fast. Across the globe falling asset prices, tighter credit and declining confidence have left firms and consumers unable or unwilling to spend and invest. In America consumer confidence has collapsed to its lowest-ever reading (see article). In Germany the Ifo index, a gauge of business confidence, has sunk to a five-year trough. Because the downturn is now global, it is harder for exports to make up for weak domestic demand. The odds of a long, nasty recession are growing. So, too, is the case for more government action to counter weak private demand.

The usual mechanism is through interest rates. Economic orthodoxy looks to central bankers to smooth demand, because short-term interest rates are easier to calibrate than tax and spending and are controlled by technocrats rather than politicians. America's Federal Reserve cut its policy rate by a further half point, to 1%, on October 29th. Held back by fears of inflation, Europe's central banks have cut much less—a timidity that ought to be abandoned now that the risk of inflation is evaporating: both the European Central Bank and the Bank of England should cut rates boldly at their meetings next week.

But it would be a mistake to expect too much from rate cuts. The financial system's stresses have made them less effective, as banks hoard cash and scale back lending. And in America, at least, short-term rates have little room to fall further. So the next policy front should be fiscal (see article).

When credit markets are dysfunctional, private demand is fading and confidence weak, a fiscal jolt is a good option. Cutting taxes puts extra cash straight into people's pockets. By stepping up their own spending, governments can directly boost demand and employment. True, stimulus increases short-term government deficits—but the fiscal damage from a prolonged slump would be greater still, as Japan showed in the 1990s. With the private sector unwilling to spend and nervous investors clamouring for safe government bonds, there is little risk of crowding out private investment.

Some countries have more scope for fiscal stimulus than others. Many governments in emerging markets, especially those with big external deficits, will be limited by investors' unwillingness to hold their debt. That is why Hungary tightened its budget this week. At the other extreme lies China—with huge foreign-exchange reserves, and a current-account and budget surplus. Within the rich world, countries such as Italy, with ageing populations and high debt burdens, have less room. So, too, do those with smaller, less liquid debt markets.

America has the greatest scope for short-term stimulus, despite running the world's biggest current-account deficit. That is because dollars and Treasuries rank as safe havens nowadays. Also, because its taxes are lower and social-safety nets less generous, America has fewer "automatic stabilisers" than Europe, where spending on unemployment benefits automatically rises further in a downturn. America's fiscal federalism tilts in the opposite direction: most states must run balanced budgets and so cut spending in hard times. It has already had a boost worth $168 billion or just over 1% of GDP (mainly through tax rebates). Sensibly, Congress is planning another, of 1-2% of GDP, soon after the election.

Europe, too, may need a fiscal stimulus before long. Spain already has a package; Germany is considering one. Britain's Chancellor, Alistair Darling, paved the way on October 29th by scrapping the government's old fiscal rules (see article). The next day, Japan unveiled a ¥5 trillion ($51 billion) package, much of it supposed to go directly to families and small firms.

Let's get fiscal

A stimulus should be timely, targeted and ideally contain credible plans for long-term fiscal health. But there are no magic recipes. Tax cuts get cash to consumers, but people may choose to save the money or spend it on imports. Government spending, say on infrastructure, might have lasting benefits, but it has a long lead time and is often wasted. Help for particular groups, such as homeowners or car firms, has political appeal and, for over-indebted homeowners, an economic logic. But, in general, helping a specific industry is a bad idea.

The scale and mix of a stimulus will differ by country. In America federal aid to the states makes a lot of sense. In Europe a cut in value-added taxes would be good. China should boost social spending. So far, governments have courageously fended off financial catastrophe. The darkening outlook means that they may soon have to show fiscal courage too.