Box 2.1

US fiscal policy developments after the Great Recession of 2009

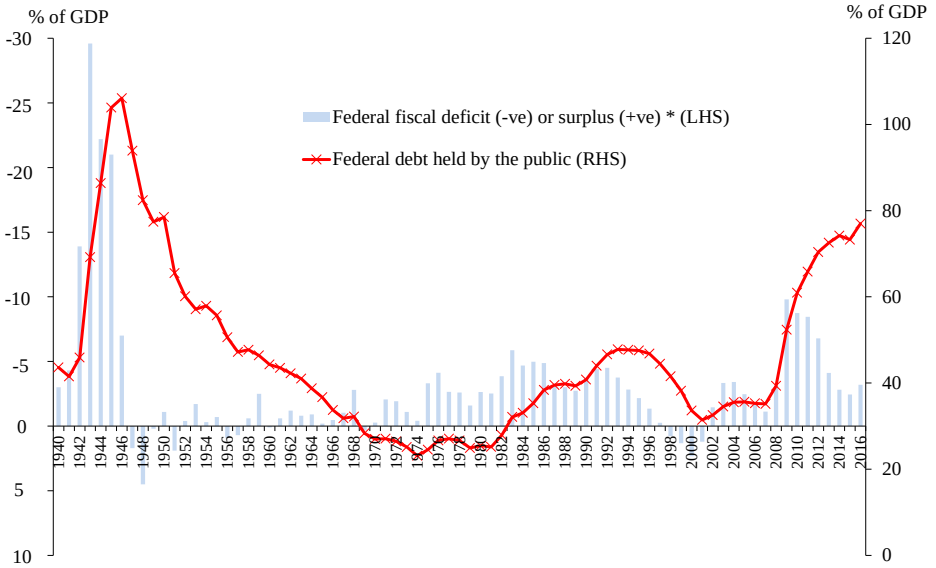
US fiscal landscape has undergone significant changes over the past decade, reflecting the far-reaching impacts of the Great Recession during 2008 and 2009 and the ensuing efforts to fix the public finance. Moreover, the influences of demographic shifts in the US will likely become increasingly visible in the longer term. This article reviews the changes in US federal fiscal balance and debt position after 2008, and analyses their possible implications for the US economy.

In late 2008 and 2009, the US economy suffered the worst recession since the Great Depression, with millions of people losing their jobs. To avert the economic crisis, bold fiscal packages were rolled out, with attendant surge in discretionary spending. Unemployment benefits also rose in tandem with the marked deterioration in the US labour market. Over the same period, government revenue dropped amid economic contraction, and tax cuts exacerbated the declines. Consequently, federal fiscal deficit leapt to 9.8% of GDP in Fiscal Year (FY) 2009[(1)], the highest in the post-Second World War era (***Chart 1***). The deficit continued to hover above 8% in the subsequent two years, despite some recovery of the US economy during the period.

The high fiscal deficits resulted in a notable jump in the US government debt. By end-FY2011, federal debt held by the public[(2)] reached US$10.1 trillion, amounting to 66% of GDP and representing the double of the debt level at end-FY2007.

Persistently high fiscal deficit and ballooning government debt aroused concern, triggering intensive debate about how to contain it in the US Congress. Yet, the road to action was bumpy, as the Republican lawmakers then controlled the House of Representative only, while the Senate was led by the Democrats. The two parties had very divergent stances on the deficit reduction strategy and wider fiscal reform issues. The confrontation between the two parties had heightened market concerns, cumulating in a downgrade on US sovereign credit

Chart 1: Federal fiscal deficit surged after the outbreak of Global Financial Crisis



Note: (*) Deficit is inverted in scale for easier comprehension.
Source: Congressional Budget Office.

(1) Federal budget related statistics are compiled on a fiscal year basis, referring to the period from 1 October to 30 September, unless otherwise specified. Fiscal year 2009 refers to 1 October 2008 to 30 September 2009.

(2) Federal debt held by the public is made up of public debt securities issued by the US Treasury and a small amount of securities issued by government agencies, excluding the portion of the debt that is held by the government accounts.

Box 2.1 (Cont'd)

rating by Standard and Poor's in 2011 and global financial market turbulence. In the end, the fiscal issues were temporarily resolved by sequestration, which set caps on government spending and additional reductions to reduce fiscal deficit over US$1 trillion in ten years.

The targeted reduction in discretionary government spending mandated by sequestration was rather visible, resulting in a corresponding fall of US$84 billion in FY2013. Moreover, some of the Bush era tax cuts were no longer extended. Together with some revival in government revenue amid continued US economic expansion, the federal fiscal deficit shrank distinctly, to 4.1% of GDP in FY2013 and further to 2.8% and 2.4% respectively in FY2014 and FY2015, before rising slightly to 3.2% in FY2016.

While the fiscal deficit fell to a level closer to the average picture between 2002 and 2007, the debt position facing the federal government was radically different. With continued deficit and moderate economic growth, federal debt held by the public increased further, albeit at a moderated pace, reaching 77% of GDP by the end of FY2016. In the past few years, the net interest outlay did not rise, as the aggressive unconventional monetary policy has pressed Treasury bond yield to extra-ordinarily low level. The US 10-year Treasury Notes yield stood at a low level of around 2% in 2016, much less than that of around 4% in 2007. But if US interest rate normalisation continues, the interest payment burden by the federal government will rise.

The long-term budget outlook also looks less sanguine than a decade ago given the gradual shift in demographic structure. As population ages, the ensuing rises in health care and social security spending would contribute to an increase in fiscal deficit over time. According to Congressional Budget Office's (CBO) Budget and Economic Outlook Report released in January 2017, even assuming that current laws governing taxes and spending generally remaining unchanged, the federal fiscal deficit was projected to increase to 4.5% of GDP in FY2025, and the federal debt held by the public is estimated to rise to over 80% of GDP in end-FY2022.

Recent changes in US political situation have put US fiscal policy in the coming years in the market spotlight. In particular, the newly-elected US president has advocated for radical tax cuts and massive infrastructure investment plan to bolster the US economy. With Republican lawmakers controlling both the House and Senates in Congress, a smoother legislative process in support of the Republican president is now possible in the period ahead. In addition, there are worries that financial risks could become more threatening the longer the unconventional monetary easing measures are extended, thereby justifying the shift to the use of fiscal policy tools to boost economic growth.

Fiscal stimuli, if finally rolled out, would bring support to US economic growth, despite the fact that fiscal stimulus could have implementation time lag. However, there are still considerable uncertainties about US fiscal policy and its possible impacts on the US economy. Obviously, it will depend on the scale and duration of the fiscal stimuli. The US government would have to strike a balance between stimulating the US economy while taking account of the long-term fiscal sustainability, particularly in light of the likely increases in government spending in social security and health care in the period ahead and the relatively high US federal government debt. The legislative process in Congress could still be bumpy and lengthy, especially when touching on wider fiscal reform matters.

Box 2.1 (Cont'd)

The effects of US fiscal policy on US economic growth would also depend on the monetary policy response. As the minutes of the Federal Open Market Committee meeting in December 2016 rightly pointed out, fiscal stimuli might raise aggregate demand above sustainable level, necessitating a faster rate hike pace. In this scenario, a tighter monetary policy would in turn offset the positive impacts of fiscal stimuli on US economic growth.

The impact of fiscal policy on the economy will depend on its scale and composition, for which the lack of details about the US fiscal stimuli to be implemented by the new US administration has hampered a further assessment at this juncture. Economists at the International Monetary Fund as well as many other institutions generally projected that US economic growth in the coming two years will pick up from the subdued situation in 2016, with fiscal stimuli widely cited as a supporting factor (***Table 1***).

Table 1: Economic growth forecasts for the US

	IMF January 2017	Consensus Forecast January 2017	US Federal Reserve December 2016	OECD November 2016
2016	1.6%			
2017	2.3%	2.3%	2.1%	2.3%
2018	2.5%	2.3%	2.0%	3.0%

The more favourable economic outlook for the US economy, as projected at this moment, is still subject to considerable uncertainties, including the ambiguity about the US fiscal policy at this stage, not to mention other US economic policies under the new administration, particularly its policies on trade and investment. These policy factors will interact with other US and international economic forces and shape the US economic performance in the period ahead. Potentially, the pace of US monetary policy normalisation could also be affected. As the US economy has a prominent position in international trade and finance, its growth prospects and policy changes would have notable repercussions on the global economy. The Government will stay tuned to these developments.