Box B: Fiscal Policy Support for the Recovery Phase in Advanced Economies

Fiscal policy has played a key role in supporting economic activity in advanced economies during the COVID-19 pandemic, with the shock to private demand smoothed by a strong countercyclical fiscal response (Graph B.1). In the early stages of the pandemic, transfer payments to households were the main focus of this fiscal support. By bolstering household incomes, these transfers prevented a larger than otherwise contraction in private consumption, and enabled a faster recovery.

As the acute phase of the pandemic has started to pass, the emphasis of government support measures in some advanced economies has begun to extend beyond household transfer payments to directly stimulating aggregate demand through public consumption and investment. More generally, at a time of significant spare economic capacity and low interest rates, a sustained period of expansionary fiscal policy – aimed at stimulating aggregate demand both indirectly and directly – will be important in keeping the global recovery on track.

Expansionary fiscal policy is broadening in scope in some cases as focus turns to the recovery phase

The initial phase of the fiscal response to the pandemic in advanced economies was significant, exceeding 10 percentage points of GDP in a number of economies. Fiscal deficits were even larger as tax revenues also declined sharply. While public expenditure on health services and related equipment increased, much of this fiscal support comprised transfer payments from the government to households, including through increased unemployment benefits and wage subsidies (for further discussion, see ‘Box A: Using Wage Subsidies to Support Labour Markets through the COVID-19 Shock’).

In recent months, a number of advanced economies have announced new fiscal measures in addition to the income support that have been aimed at directly supporting demand in the recovery phase. This has mainly comprised increased public investment, but has also included consumption and investment incentives and retraining programs (Graph B.2). To date, the extent of this new phase of fiscal support has ranged from ½ per cent to 7 per cent of GDP. While more modest than the initial phase of the fiscal response in these economies, the new ‘recovery phase’ of fiscal support is significant and is scheduled to commence in the second half of 2020 and extend into the next couple of years.

Graph B.1
Change in Structural Deficits*
Per cent of advanced economies’ GDP

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* 2020 estimate based on IMF October 2019 forecast and announced fiscal responses
** GDP-weighted average of France, Germany, Italy and Spain
*** High-income east Asia (HIA) is GDP-weighted average of Hong Kong, Singapore, South Korea and Taiwan

Sources: IMF; national sources; RBA; Refinitiv
New Zealand was the first advanced economy to announce fiscal measures focused on the recovery phase, after its strict containment measures brought infection levels down to negligible levels relatively quickly. In May, New Zealand announced its COVID-19 Response and Recovery Fund, which sets aside the equivalent of 16 per cent of GDP. A significant share of the fund, around 6½ per cent of GDP, is available to support the recovery phase, with specific public investment and training programs equivalent to 2 per cent of GDP.

In June, Germany, where the number of cases were brought down to low levels quicker than in other large euro area economies, announced the equivalent of 2 per cent of GDP for its recovery phase through temporary reductions in the consumption tax rate and increased public investment. South Korea, which managed to bring down and keep infections low after a large pandemic wave in February, has announced public investment and training programs equivalent to around 7 per cent of its 2019 GDP. The United Kingdom has also announced a small recovery-focused fiscal package, including increased public investment, job training and consumption incentives.

In July, the European Union (EU) agreed the largest fiscal stimulus for the recovery phase so far – the Next Generation EU Recovery and Resilience Facility – at around 5 per cent of GDP. This is focused on investment between 2021 and 2023.[1] The facility will be funded by EU-issued bonds, with the proceeds distributed to EU members as grants and loans. These grants effectively allow for increased fiscal transfers within the EU to its members that are less developed and that entered the crisis in worse economic positions. The lending facility is designed to subsidise borrowing costs for the EU’s member economies with more elevated government debt levels and sovereign bond yields. The details of the fiscal spending are yet to be decided, with EU member economies required to first submit investment proposals to the European Commission before receiving funding; the proposals will be assessed based on their ability to strengthen growth, create jobs and meet EU initiatives for ‘green and digital’ development.

To support the recovery in consumption, temporary reductions in consumption taxes (VAT) and consumption subsidies have also been implemented. Germany has applied a broad-based reduction in its consumption taxes, reducing the key rate from 19 per cent to 16 per cent until December 2020. The United Kingdom has reduced its consumption tax (VAT) from 20 per cent to 5 per cent until January 2021 focused in hospitality, accommodation and attraction industries. Consumption subsidies in hospitality have also been announced in the United

Graph B.2
Fiscal Responses in Select Advanced Economies*
Per cent of 2019 GDP

![Graph showing fiscal responses in select advanced economies](image-url)
Kingdom, and in South Korea they have focused on domestic products and energy-efficient durable goods.

**Public investment is featuring prominently in the transition to direct stimulus of economic activity**

In general, the public investment component of the recovery initiatives announced to date bring forward ready-to-go projects to help stimulate demand over the next couple of years. Many of the investments are focused around environmental initiatives – reducing carbon emissions, increasing renewable energy use and developing vehicle electrification infrastructure – and the development of information and telecommunication technologies.

Germany’s investment package aims to modernise infrastructure, support structural change in industries such as automotive manufacturing and make significant investment in hydrogen technology. Germany has also allocated ½ per cent of GDP towards expanding and modernising transport networks and vehicles. South Korea’s package, which is split into the Digital and Green New Deal investment initiatives, includes 28 projects including energy and health care investment, and improvements to the energy efficiency of public buildings. The United Kingdom is focusing public investment on local community infrastructure to support construction activity from 2020 until 2022. The government in New Zealand will invest in the construction of 8,000 public houses over the next four to five years, as well as regional environmental projects, including revegetation and habitat protection. The investment measures in the EU’s Recovery and Resilience Facility are to be proposed by individual countries for approval by the European Commission.

Training programs will also be funded to up-skill workers and limit the negative effects of longer-term unemployment. For economies entering the recovery phase, ensuring the workforce has the required skills as demand picks up is a key priority. These programs tend to focus on supporting youth employment by incentivising employers to provide apprenticeships, work placements and internships. South Korea is also retraining workers for technology sectors and middle-aged workers; this is to support the transition to digital and green industries outlined in South Korea’s New Deal.

**Large output gaps and low interest rates are conducive to public investment**

As long as advanced economies have a significant amount of spare capacity, low interest rates and moderate public debt profiles, public investment can reduce long-term ‘scarring effects’ without generating high inflation, crowding out private investment or raising debt sustainability concerns. In addition to the direct effect of government spending on GDP, such spending also acts as a catalyst for further growth given the positive spillovers it creates. For example, the profits earned by firms and the incomes earned by workers involved in government-sponsored infrastructure projects boosts business investment and private consumption. These spillovers are more powerful when there is ample spare capacity and monetary policy is already accommodative, as is the case presently.[2] Public investment that increases the productive capacity of the economy can be self-financing as projects will generate
returns exceeding government borrowing costs.
In most advanced economies, government bond yields are currently below expected GDP growth rates, which will allow advanced economies to run fiscal deficits without raising concerns over debt sustainability (Graph B.3). A number of economies that have begun to transition the recovery phase of their fiscal support toward public investment – such as Germany, South Korea and New Zealand – also entered the crisis with relatively modest government debt levels, suggesting they have considerable scope to maintain or expand such programs into the future.

The international experience following the global financial crisis, and during recoveries from earlier deep recessions, suggests that economies that withdrew fiscal support or undertook fiscal consolidation too quickly experienced slower growth afterwards.\(^3\) With these considerations in mind, international organisations such as the International Monetary Fund and the Organisation for Economic Co-operation and Development have urged governments to maintain substantial fiscal support through the recovery phase, where they have space to do so, including by stimulating aggregate demand directly through public investment as a complement to transfer programs aimed at supporting household income.\(^4\)  

Endnotes


