THE LONDON CONSENSUS:
FISCAL POLICY AND PUBLIC DEBT

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Original formulation of Washington consensus

- Fiscal discipline to avoid the macroeconomic instability associated with excessive debt issuance or money creation.

- Public expenditures focused on basic health, education, welfare, and infrastructure, and away from sectoral subsidies of dubious social and economic value.

- A broad tax base and moderate marginal tax rates, viewed as the most desirable way to raise the necessary tax revenue.

But: public debt is high, aggressive countercyclical policy, redistribution. Additions

Fiscal activism

- **Fiscal policy as insurance, completing markets ex post**
  - Uninsurable, heterogeneous, aggregated-driven risks.
  - No macro markets against pandemics, large energy shocks, deep recession.
  - Automatic stabilizers and ex post transfers. Stop animal spirits.
  - More on transfers, less on purchases. Has been large.
  - Insurance is not redistribution. Not about size of government.
  - Differs over borders given social insurance mechanisms

Fiscal activism

- **Fiscal policy as insurance, completing markets ex post**

- **Fiscal policy as market-maker of last resort**
  - Markets sometimes collapse.
  - Focus on institutions, financial imperfections, amplification and bad equilibrium
  - Ability to borrow to be a lender of last resort , not AD management
  - Objections: moral hazard and permanent subsidies.

Fiscal activism

- **Fiscal policy as insurance, completing markets ex post**
- **Fiscal policy as market-maker of last resort**
- **The amplitude of the fiscal balance**
  - More counter-cyclical deficits: intertemporal insurance over time
  - Not larger public debt, rather larger amplitude of balance
  - ZLB and simulates
  - Composition of spending and r* wedges
  - Without compromising centrality of monetary policy

Preserving fiscal space through prudent debt management

- **Build and respect strong fiscal and monetary institutions**
  - Need to address pro-cyclicality and present biases, preserve market access.
  - Institutions, like CB independence and fiscal frameworks.
  - Simple rules with escape clauses

- **Transparency and communication to prevent self-fulfilling debt runs**
  - Multiplicity even at relatively low levels of debt
  - Sustainability is probabilistic and communication is at the centre

Preserving fiscal space through prudent debt management

- **Build and respect strong fiscal and monetary institutions**
- **Transparency and communication to prevent self-fulfilling debt runs**
- **Protecting the special (and potentially fragile) nature of the public debt**
  - Large debt revenue from debt specialness.
  - Preserve liquidity and safety, especially in light of flight to safety in crises
- **The importance of the international financial architecture**
  - Global safety net as insurance across borders and market making.
  - Provide institutions and the credible communication

London consensus: two additional principles

1. Pursue fiscal activism focused on, first, offsetting uninsured shocks to income via targeted transfers, and, second, on preserving markets and the flow of credit through crises, above and beyond standard government purchases meant to regulate aggregate demand.

2. Make sure that these larger cyclical budget deficits are sustained by strong institutions, national and international, which keep debt sustainable and preserve the safety and liquidity of government bonds.