The "Austerity Myth": Gain Without Pain?

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10th BIS Annual Conference

Fiscal policy and its implications for monetary and financial stability

23-24 June 2011

Lucerne, Switzerland

Fiscal consolidations:

Keynesian view => contractionary

"**Expansionary fiscal consolidation**" view: spending-based consolidations can be expansionary even in short run.

Intuition: **"confidence view"** => positive effect on private consumption and investment

Expansionary fiscal consolidations: Alesina and Perotti (1995) and Alesina and Ardagna (2010)

On yearly panel of OECD countries

On **cyclically adjusted surplus**: $\Delta s^{CA} = \Delta s - \alpha \Delta y$

1. Define a **consolidation year** if $\Delta s^{CA} > 1.5$percent of GDP

2. **Compare averages** across all episodes of consolidations: before, during and after year of consolidation

Main conclusions: if consolidations implemented by **cutting government spending => GDP, private consumption, and private investment** higher "after" than "before".

IMF criticism:

1. Cyclical adjustment **highly imperfect**. Fails to clean effect

of important determinants of tax revenues, especially **asset booms**.

2. Policymakers respond to exogenous cyclical developments: for instance, cut spending in good times => **builds in negative correlation between growth and government spending**

=> Better to resort to **“narrative”** measures to estimate “true exogenous” changes to fiscal policy

With these measures, IMF finds that **all fiscal consolidations** are **contractionary**, including spending based ones

Valid criticisms, but implementation problems

1. Cannot per se explain main results of AP and AA, i.e. expansionary effects of **spending-based** consolidation

2. **Censoring** problem

3. In estimating "narrative measures" of fiscal policy changes, exclude all changes officially motivated by **countercyclical considerations** => can give **wrong picture of a consolidation.** And true motives of policymakers **very difficult to detect**, and almost certainly not relevant for the debate at the time.

On the other hand, consolidations are typically **multi-year affairs**.

"Means comparison" method based on yearly changes **cannot deal** with them.

Example: if year t and t+2 both fiscal consolidations, treat t+2 **both as "after" consolidation at t and "during" consolidation at t+2** => confusion between "after" and "during".

Table 1: Business investment during consolidations

# obs.	mean	t-stat.	# obs.	mean	t-stat.
Expansionary consolidations					
"during" – "before"			"after" – "during"		
16	8.65	2.82	16	-5.90	-2.13
Contractionary consolidations					
"during" – "before"			"after" – "during"		
48	.44	.27	48	2.01	1.43

Alesina and Ardagna (2010) dataset

⇒ **Case studies** of large, multi-year consolidations

Denmark	1983-87	exchange rate based
Ireland	1987-89	
Finland	1992-98	after floating
Sweden	1993-98	

Denmark, Ireland: **more relevant for EMU members today**

1) Lessons for **current situation**

2) Focus on **short run**: even if non expansionary in short run, consolidation may be desirable in itself.

(i) Re did narrative estimates, paying attention to supplementary budgets

1. **smaller** consolidations

2. much **larger share of revenue increases**

Table 2: Finland, discretionary budget measures

	spending	revenues	surplus	spending	revenues	surplus
				IMF	IMF	IMF
1992 total	0.91	0.00	-0.91	-0.91	0.00	0.91
cumulative	**0.91**	**0.00**	**-0.91**	**-0.91**	**0.00**	**0.91**
1993 total	-2.17	0.00	2.17	-3.71	0.00	3.71
cumulative	**-1.25**	**0.00**	**1.25**	**-4.62**	**0.00**	**4.62**
1994 total	-0.86	2.27	3.12	-2.76	0.69	3.45
cumulative	**-2.11**	**2.27**	**4.38**	**-7.38**	**0.69**	**8.07**
1995 total	2.61	-0.09	-2.70	-2.28	-0.63	1.65
cumulative	**0.50**	**2.18**	**1.68**	**-9.66**	**0.05**	**9.71**
1996 total	-1.44	1.75	3.19	-1.48	0.00	1.48
cumulative	**-0.94**	**3.93**	**4.87**	**-11.14**	**0.05**	**11.19**
1997 total	0.38	-0.14	-0.52	-0.94	-0.71	0.24
cumulative	**-0.57**	**3.79**	**4.35**	**-12.08**	**-0.65**	**11.43**
1998 total	-0.29	0.26	0.55	0.00	0.00	0.00
cumulative	**-0.85**	**4.05**	**4.90**	**-12.08**	**-0.65**	**11.43**
1999 total	0.48	-0.55	-1.03	0.00	0.00	0.00
cumulative	**-0.37**	**3.49**	**3.87**	**-12.08**	**-0.65**	**11.43**

(ii) All stabilizations associated with expansions in GDP.

Except in Denmark, expansion of GDP was initially **driven by exports**.

Private consumption typically increased 6 to 8 quarters after the start of the consolidation.

Ireland: Consumption picked up only at end of 1988, business investment even later.

Difference from standard story. Reason: mostly used OECD data, but turned out to be **wrong** => now discontinued.

National source data show that the expansion in the most famous consolidations of all - Ireland – turned out to be **much less remarkable** than previously thought.

Important **differences with first (failed) stabilization**

a) **Composition** of consolidation (but now less stark)

b) **Wages and unit labor costs**

c) **High real interest rates** during first consolidation, because of fast decline in inflation as **sterling depreciated**.

During second consolidation, **sterling appreciated** => still decline in nominal interest rates, but inflation was already low **=> decline in real interest rate AND improvement in relative unit labor costs**

(iii) Denmark: stabilization relied most closely on the **exchange rate as a nominal anchor** (=> of particular interest for small EMU members today).

Internal devaluation via wage restraint and incomes policies as a substitute of a devaluation.

All the **typical features of an exchange rate based stabilization**: inflation and interest rates fell fast, **domestic demand initially boomed**; but as **competitiveness slowly worsened**, the **current account started worsening**, and eventually growth ground to a halt and consumption declined for three years. **The slump lasted for several years**.

(iv) In Ireland, the government depreciated the currency before starting the consolidation and fixing the exchange rate within the ERM.

Again **wage restraint and incomes policies** played a major role: **return to centralized wage setting.**

Key feature: **concomitant depreciation of the sterling** and the expansion in the UK, that **boosted Irish exports** and contributed to **reducing the nominal interest rate**.

(v) Finland and Sweden **floated before consolidating** => experienced **large real depreciation and an export boom.**

Also, in both countries **inflation targeting** was adopted at the same time as the consolidations were started.

(vi) The budget consolidations were accompanied by **large decline in nominal interest rates**, from very high levels.

=> Large **wealth effect** (Denmark)

(vii) **Wage moderation** was essential to maintain the **benefits of the depreciations** and to make possible the **decline of the long nominal rates.**

In turn, wage moderation probably had a powerful effect as a **signal of regime change.**

(viii) **Incomes policies** were in turn instrumental in achieving wage moderation, and in signaling a regime shift from the past.

Often these policies took the form of an **explicit exchange between lower taxes on labor and lower contractual wage inflation.**

However, the international experience suggests that incomes policies are **effective for a few years at best**. The experience of Denmark is consistent with this.

Results **cast doubt** on some versions of the “expansionary fiscal consolidations” hypothesis, and on its **applicability** to many countries in the present circumstances.

1) A **depreciation is not available to EMU members**, except possibly vis à vis non-Euro members.

2) An expansion based on net exports is not available to the world as a whole.

3) A **further decline in interest rates is unlikely** in the current situation.

4) **Incomes policies are not popular** nowadays, and in any case probably **ineffective** for more than a few years.

However, even in the short run **budget consolidations** were probably a **necessary condition for output expansion** for at least three reasons:

1) Instrumental in **reducing the nominal interest rate**;

2) made **wage moderation possible** by signaling a regime change that reduced inflation expectations;

3) instrumental in **preserving the benefits of nominal depreciation** and thus in generating an export boom