Comments on Perotti's paper

Perotti's paper provides an excellent contribution to the debate on the effects of fiscal policy. The paper is extremely rigorous and effective in scrutinizing previous results obtained by Alesina, Ardagna and Perotti himself, as well as by work included in the Fall 2010 issue of the IMF's World Economic Outlook. And Perotti is equally tough in criticizing his own earlier work as he is with the work undertaken by IMF staff.

This paper is convincing and his message is, in many respects, sobering. The evidence from the case studies presented casts significant doubts on the hypothesis that the current fiscal problems of advanced countries can be addressed without implications for economic growth simply by focusing the fiscal adjustment on the spending side rather than the revenue side. In this respect, while Perotti's criticism of some aspects of the methodology followed by the IMF paper is valid his policy conclusions are not very different: we should not expect a painless fiscal adjustment. Fiscal tightening will have to be carefully managed because it is likely, in a number of cases, to lead to a slowdown of economic activity. Let me be clear about one point: the fact that fiscal tightening—even one focused on cutting expenditure—is likely to have a negative impact on demand and growth does not mean it should not be implemented (failure to do so would imply the risk of even more negative effects on economic stability and growth). But it does imply that the issue of demand management when fiscal policy is tightened cannot be disregarded.

How concerned should we be? I prefer to be optimistic, so I will list three factors that may help in achieving fiscal consolidation in a relatively satisfactory growth environment. None of them in itself is sufficient, but, altogether, they may give rise to some optimism.

The first relates to the timing and magnitude of the fiscal adjustment. Fiscal policy was expanded as private sector demand weakened. As the latter strengthens less support from fiscal policy will be needed. In this respect coordination with monetary policy will be essential. While it is true that interest rates will not be able to fall further, the fiscal tightening should imply that they should rise less than what would normally be expected in an economic upswing. We should also keep in mind that, even in the absence of a decline in policy interest rates, the strengthening of credit markets should help reduce the cost of borrowing, or increase the availability of credit, for the private sector (of course the strength of the process will depend on the pace at which bank's capital is rebuilt). This withdrawal of fiscal support as private sector demand recovers is essentially what we project to happen in our World Economic Outlook at the aggregate level. Let's however keep in mind one thing: that a simple reversal of the process that took place since 2007 will not bring the fiscal accounts back to where they were for a number of reasons, the most important being the step loss of potential output—and related revenues (about 3 percentage points of GDP for the average of advanced economies)—that has taken place during the great recession, which is not expected to recovered any time soon. This means that the fiscal tightening would have to go well beyond the reversal of the fiscal stimulus and of the automatic stabilizers.

The second reason for some moderate optimism refers to the role of emerging economies. They can potentially increase their role as engine of demand and growth for the world. Of course, this requires an increasing reliance by these economies on domestic demand, including as a result of exchange rate appreciation. As noted by Perotti's paper, exchange rate depreciation cannot help all countries at the same time. But advanced countries can collectively depreciate vis-à-vis emerging economies. Their fiscal accounts are in a much better shape and much less fiscal adjustment, if any, is needed for them. Here the problem is that, while rising, the share of emerging economies in world demand is not big enough to fully offset fiscal tightening in advanced economies. Yet, some positive support will come from here.

One small digression: countries with a pegged exchange rate can restoring external equilibrium—and ultimately long-term growth—through internal devaluation, through decline in prices and wages or increases in productivity that boost competitiveness. This, in a way, is the German approach: its competitiveness is leading to an export-led recovery. It is also the approach followed by some Easter European countries (the Baltics, Romania, Bulgaria). A variant of this is the so-called, fiscal devaluation: a revenue-neutral switch between labor taxation to consumption taxation. This is being attempted in Portugal. The effects on employment and output of such a switch have been studied for decades. The conclusion of this literature is that, typically, these effects are fairly small and take a long time to materialize. But, in the current conditions of high unemployment, the effect could be stronger: a switch from, say, employer's social security contributions to consumption taxes may be the way to achieve a decline in real wages that, in the presence of downward rigidity of nominal wages, would not take place.

The third factor that can make us be hopeful relates to reforms to boost potential output growth. Here of course I am aware of the fact that fiscal contraction acts by reducing aggregate demand. But the point is that by boosting potential growth, and the related revenues, countries will need less fiscal contraction. A corollary of this is that any fiscal tightening that is implemented should be designed to improve—or at least not damage—potential growth: so cutting distortionary tax expenditures is better than increasing headline rates; and targeted spending cuts are better than cuts across the board. Targeted spending cuts are more sustainable and were at the core of some successful fiscal consolidations like the one implemented by Canada in the second half of the 1990s. The problem here is that all these reforms that affect potential growth typically take time to yield results.

The bottom line is that, ceteris paribus, a fiscal tightening will reduce economic activity, but the factor I listed—the cyclical recovery of private sector demand, a rebalancing of demand towards emerging economies, and reforms aimed at boosting potential output—while probably insufficient taken in isolation, can all together help advanced economies in addressing their fiscal problems without necessarily jeopardizing the prospects for medium-term growth.

One last point: many of the mechanisms I describe require time and, therefore, the fiscal adjustment should be relatively gradual whenever this is possible, that is whenever financing problems are unlikely to arise. It is therefore critical that, while gradual adjustment takes place, credibility is not shaken. Hence the need for clarity in the definition of medium-term fiscal adjustment plans, as well as for fiscal institutions that will ensure their implementation.