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Will It Hurt?

With fiscal austerity being introduced around the developed world, a key question is what will be the effect on economic activity? A recent World Economic Outlook (WEO) Chapter studies this issue in detail as well as possible measures to cushion any adverse impacts (available at: http://www.imf.org/external/pubs/ft/weo/2010/02/).

Budget deficits and government debt soared during the Great Recession. In 2009, the budget deficit averaged about 9 percent of GDP in advanced economies, up from only 1 percent of GDP in 2007. By the end of 2010, government debt is expected to reach about 100 percent of GDP—its highest level in 50 years. Looking ahead, population aging could create even more serious problems for public finances. In response to these worrisome developments, virtually all advanced economies will face the challenge of fiscal consolidation. Indeed, many governments are already undertaking or planning large spending cuts and, in some cases, tax hikes.

An important and timely question is, therefore, whether fiscal retrenchment will hurt economic performance. Certainly this question has preoccupied markets recently, with already sluggish growth in the U.S. and the Euro Area in peril of falling further. However, there is no consensus regarding the short-term effects of fiscal austerity. On the one hand, the conventional Keynesian view is that cutting spending or raising taxes reduces economic activity in the short term. On the other hand, a number of studies present evidence that cutting budget deficits can stimulate the economy even in the short term. The notion that fiscal retrenchment stimulates growth in the short term is often referred to as the "expansionary fiscal contractions" hypothesis. A key factor explaining such effects is an improvement in household and business confidence. The truth could be a mixture. For example, it may be that the short-term effects are usually contractionary, but that expansionary effects can occur when government solvency is in question, or when the consolidation is structured in a way that increases confidence.

So, what does the evidence tell us about the short-term effects of fiscal retrenchment on economic activity and unemployment? The WEO analysis finds that indeed fiscal consolidation typically has a contractionary effect on output. A fiscal consolidation equal to 1 percent of GDP reduces GDP by about 0.5 percent within two years and raises the unemployment rate by about 0.3 percentage point. Domestic demand—consumption and investment—falls by about 1 percent.

What factors dampen or exacerbate the short-term effects? In particular, what is the role of monetary policy? Reductions in interest rates usually support output during episodes of fiscal consolidation. Central banks offset some of the contractionary pressures by cutting policy interest rates, and longer-term rates also typically decline, cushioning the impact on consumption and investment. For each 1 percent of GDP of fiscal consolidation, interest rates usually fall by about 20 basis points after two years. However, in the current environment, there is probably less room for monetary policy to support activity and the WEO simulations find that, if interest rates are near zero, the effects of fiscal consolidation are therefore more costly in terms of lost output. To some extent though this could be counteracted by unconventional monetary tools, such as quantitative and credit easing.

What are the consequences of many countries cutting deficits at the same time? A decline in the real value of the domestic currency typically plays an important cushioning role by spurring net exports and is usually due to nominal depreciation or currency devaluation. Because not all countries can increase net exports at the same time, this finding implies that fiscal contraction is likely to be more painful when many countries adjust at the same time.

Does the composition of the package matter? Fiscal contraction that relies on spending cuts tends to have smaller contractionary effects than tax-based adjustments. This result was confirmed in a sample of emerging markets (see: http://www.imf.org/external/pubs/ft/scr/2011/cr1158.pdf). This is partly because central banks usually provide substantially more stimulus following a spending-based contraction than following a tax-based contraction. Monetary stimulus is particularly weak following indirect tax hikes (such as the VAT) that raise prices. Among spending components, cuts to transfers and other politically-sensitive expenditures create smaller output losses than cuts in public investment, likely because it signals a stronger commitment to fiscal retrenchment.

Can contractions be expansionary? Fiscal retrenchment in countries that face a higher perceived sovereign default risk tends to be less contractionary. However, even among such high-risk countries, expansionary effects are unusual, although they might occur in emerging markets with weak initial conditions defined as relatively slow growth and high inflation and debt.

Although costly in the near term, over the long term, reducing debt is found to be beneficial by reducing real interest rates, which stimulates private investment. Also, the lower burden of interest payments creates fiscal room for cutting distortionary taxes. Both of these effects raise output in the long term. Overall, the simulations imply that for every 10 percentage point fall in the debt-to-GDP ratio, output rises by about 1.4 percent in the long term.

All in all then, the idea that fiscal austerity triggers faster growth in the short term finds little support in the data. Consolidation will therefore hurt particularly if many countries implement austerity at the same time. However, the pain can be cushioned somewhat by relying more on cutting current spending rather than hiking tax rates or reducing public investment, while accommodative monetary policy also helps. In addition, strengthening fiscal institutions and reforming pension entitlements and public health care systems could help support activity during the process of fiscal adjustment.

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