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Supporting the Global Recovery While Ensuring Fiscal Solvency: A Delicate Balancing Act

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(The views expressed herein are those of the author and should not be attributed to the IMF, its Executive Board, or its management.)

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A. To Tighten or Not to Tighten

1. **Fiscal deficits in advanced countries remain historically high.** Deficit levels in these countries are projected to average 8.7 percent of GDP in 2010, up from only 1 percent in 2007. General government debt is expected to average 100 percent of GDP by the end-2010— its highest level in 50 years (Charts 1 and 2). This surge takes place ahead of major increases in pension and health care spending which will further exacerbate debt sustainability challenges.

2. **Most advanced economies face a difficult balancing act.** On the one hand, delaying the fiscal adjustment could increase the risk of roll over problems, at least in some countries. Interest rates are currently low for most advanced countries, but market views can change quickly (Chart 3). Moreover, even if roll over risks do not materialize, higher public debt could jeopardize long-term growth prospects.[1] On the other hand, private demand remains fragile, reflecting weak consumer and investor confidence. In this context, a premature and aggressive fiscal tightening might derail the recovery, depress growth, and worsen an already bleak unemployment situation. What should policymakers do?

[1] Stabilizing debt at high levels could have adverse consequences on long-term growth and employment as high public debt levels are associated with higher long-term interest rates and greater vulnerability to crises. Recent analytical work by IMF staff suggests an inverse relationship between debt and subsequent growth. On average, a 10 percentage point increase in the initial debt-to-GDP ratio is associated with a decline in annual real per capita GDP growth of around 0.2 percentage points per year (0.15 for advanced countries); see "Public Debt and Growth," by Manmohan S. Kumar and Jaejoon Woo; IMF Working Paper 10/174; July 2010.

B. History Provides Some Clues

3. **The diverging views about the timing of fiscal consolidation reflect, at least in part, a lack of consensus on the short-term effects of fiscal consolidation.** There is widespread agreement that a reduction in debt levels below current levels has long-term benefits. The supporting arguments include the implications of high debt for roll over risks, the detrimental effect of high debt on interest rates and growth, and the need to rebuild room for future fiscal stimulus. However, there is less consensus on the short-term effects of fiscal consolidation. The conventional Keynesian view is that cutting spending or raising taxes slows economic activity. An alternative view is that consolidation— including improved household and investor confidence and lower interest rates—can be expansionary even in the short term. What does the empirical evidence tell us?

4. **New evidence presented in the recent *World Economic Outlook* shows that, historically, fiscal consolidations in advanced economies were mildly contractionary.** Over two years, a fiscal adjustment of one percentage point of GDP typically reduces domestic demand by one percent although it decreases real GDP by only 0.5 percent, owing to an expansion in net exports, as interest rates decline and the exchange rate depreciates. Unemployment declines by 0.3 percentage points.[2]

5. **However, the historical evidence discussed above may not fully apply to the current crisis.** Exchange rate adjustments, which have in the past served to mitigate the negative consequences of country specific consolidations, would not be available if all countries (or at least all advanced countries) acted at the same time to shrink their deficits. Likewise, in the presence of a zero interest rate floor, countries cannot ease monetary policy to soften the impact of fiscal retrenchment. Therefore, a front loaded fiscal adjustment across all advanced economies could be more costly than past experiences suggest.

C. Optimal Fiscal Exit Strategy

6. **Given the evidence of a negative short-term impact of fiscal adjustment on growth, the optimal strategy would obviously involve combining a relatively loose fiscal stance in the short run with a credible medium-term adjustment plan.** This, however, raises two (related) questions:

- How can a medium-term plan be made credible?

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[2] Expenditure-based adjustments have lower output and unemployment effects compared to revenue-based adjustments. The reason for this is that, historically, policymakers responded more forcefully with larger cuts in interest rates and greater exchange rate depreciations than in the case of revenue-based adjustments. Furthermore, expenditure-based adjustments may be perceived as a stronger signal of fiscal discipline and therefore lead to a sharper decline in risk premia.

- Should (and could) any short-term tightening be avoided?

7. **Regarding the first question, policymakers can do several things to strengthen the credibility of their medium-term fiscal adjustment plan**.[3]

- Countries could adopt credible **fiscal rules** that constrain future behavior. Ideally, these rules should be embedded within a transparent legislative framework that imposes strong penalties—at least in terms of political costs—in the event that rules are infringed. However, fiscal rules that are appropriate for the long run—say a balanced budget—could not be enforced immediately, not for countries where deficits are sometimes in double digits. A transition path would be needed and the issue is how to ensure the credibility of such a path.

- Policymakers could announce medium-term **spending limits.** To secure maximum political support, these limits should be endorsed by parliament. In countries where expenditure-to-GDP ratios are high, a large part of the adjustment will have to come from lower public expenditures, which underscores the importance of expenditure ceilings. These ceilings should be properly designed, avoiding, for example, a constraint on cyclically-sensitive expenditures, like unemployment benefits.

- **Budget preparation and execution** should be transparent and accountable. The private sector should, for example, be confident that macroeconomic assumptions and projections are grounded in reality. Furthermore, financial markets and the private sector must be convinced that any needed adjustment to medium-term plans is warranted and due to overriding macroeconomic considerations rather than political expediency. For this, the creation of a politically independent agency that monitors fiscal policy could help. **Budget** preparation and execution should also be more disciplined. Budget preparation should be driven by the overall medium-term deficit and spending ceilings. That is, it must be "top down." Budget execution should be underpinned by processes that minimize the risk of slippage.

8. **Of course, in addition to good fiscal institutions, the content of medium-term consolidation plans is also important.** In this respect, two points are worth making. First, reforms to address long-term fiscal challenges, such as pension and healthcare reform, are critical to the credibility of the consolidation plan. However, concerns about age-related spending pressures predate the global financial crisis. Reforms here are needed simply to avoid further increases in public debt ratios, not to bring them down. This means that additional

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[3] See Blanchard and Cottarelli (2010) "How to bake a (cr)edible medium-term fiscal pie," iMFdirect Blog (http://blog-imfdirect.imf.org/2010/11/04/how-to-bake-a-credible-medium-term-fiscal-pie); see also Blanchard and Cottarelli (2010) "Ten Commandments for Fiscal Adjustment in Advanced Economies," iMFdirect Blog (http://blog-imfdirect.imf.org/2010/06/24/ten-commandments-for-fiscal-adjustment-in-advanced-economies).

spending and tax reforms are required. Second, in identifying these reforms it will be important to focus on those that are more conducive to improved economic efficiency and potential growth. Indeed, the point is more general: given the huge impact that strong potential growth can have on public finances, growth-friendly product and factor market reforms will be critical for strengthening long-term fiscal trends.

9. **On whether any fiscal tightening should (and could) be avoided, two considerations are relevant.** First, a promise of future action, even if backed up by the appropriate fiscal institutions discussed above, is less credible in the absence of some immediate down payment. Second, the down payment needs to take into account the short-term cyclical considerations discussed above. Given the fragility of the recovery, a front-loaded adjustment is inappropriate.[4] Is some tightening consistent with the continuation of the economic recovery?

10. The projected narrowing of the output gap in 2011 makes it possible for a fiscal tightening to take place next year (Chart 4). Indeed, a fiscal tightening of about 1 percentage point of GDP—the improvement in the cyclically-adjusted balance currently planned by advanced countries in 2011—is consistent with a continuation of the economic recovery according to the most recent *World Economic Outlook* projections.

D. Current Adjustment Plans[5]

11. Most countries have now announced adjustment plans covering the period up to 2013. These plans usually envisage sizable deficit reductions. The advanced G-20 economies on average plan to improve their cyclically-adjusted overall balances by 1¼ percent of GDP over the next three years, a speed of adjustment that should not impede the continuation of medium-term recovery. In emerging market economies, the planned adjustment is lower: this largely reflects the fact that fiscal deficits and debt levels have not deteriorated by as much as in advanced countries. While the intended retrenchment varies across countries, in general, countries with the large long-term adjustment requirements tend to be those with large average adjustment during 2011–13 (Chart 5, green regression line).[6] Of course, with only a few exceptions, the adjustments envisaged in this period fall short of what would be needed to complete the fiscal adjustment process (Chart 5, red line).

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[4] Except in countries where market conditions are such that failure to front-load the fiscal adjustment would lead to a confidence crisis, and hence to an even larger shock to growth.

[5] More information on fiscal adjustment plans can be found in *Fiscal Monitor*, "*Fiscal Exit: From Strategy to Implementation," November 2010.* (http://www.imf.org/external/pubs/ft/fm/2010/02/fmindex.htm)

[6] Long-term adjustment needs reflect the improvement of the primary cyclically-adjusted fiscal balance needed to lower the debt-to-GDP ratio below certain thresholds by 2030. The most recent *Fiscal Monitor* shows that to achieve a debt-to-GDP ratio of 60 percent by 2030—the median debt level in advanced economies on the eve of the crisis—advanced countries would need to improve their cyclically-adjusted primary balances by 8¼ percentage points of GDP by 2020. For details on the calculations, see chapter 3 in the *Fiscal Monitor*.

12. **While all these are positive features, adjustment plans have various shortcomings.** First, they lack specificity. For most countries, specific measures have been identified only for 2011 and only a few countries have announced their long-term public debt objective, raising uncertainties about the medium-term fiscal anchor. While it is normal that fiscal plans are less specific over longer time horizons, these are not normal times. More specificity, concrete medium-term measures would strengthen the credibility of the plans, hence improving the trade-off between short-term and medium-term fiscal tightening. Second, many countries have not yet clarified the final goal of the fiscal adjustment strategy: do they intend to stabilize the debt ratio at post-crisis levels, or do they intend to lower it, say, to pre-crisis levels? Third, nothing much is envisaged to address the rising pressure from pension and, especially, health care spending.

E. What if…?

13. **Altogether, the approach followed by most countries—an initial tightening in 2011 embedded in a credible medium-term adjustment plan—seems to be appropriate, although the quality of the plans needs to be improved.** Nevertheless, the uncertain economic outlook requires maintaining some margins of flexibility. Should economic growth fall short of what was projected in the most recent *World Economic Outlook*, countries with fiscal space should allow the automatic stabilizers to operate and slow down the pace of short-term fiscal adjustment. In such an event, it would be even more important to strengthen the medium-term component of the fiscal adjustment plan, so that the smaller "down- payment" does not jeopardize the credibility of the fiscal adjustment effort.

Selected Fiscal Indicators

Chart 1.

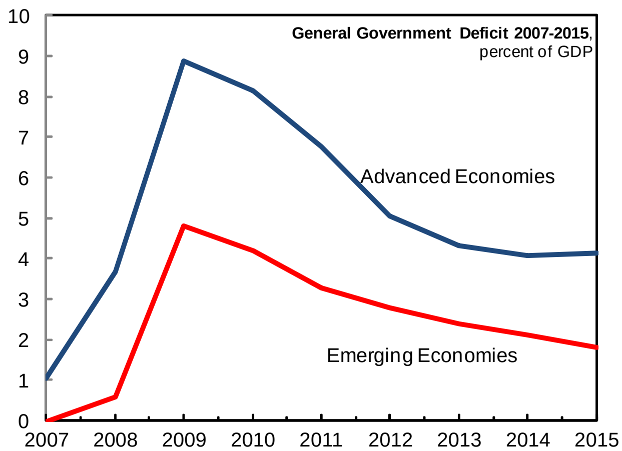


Chart 2.

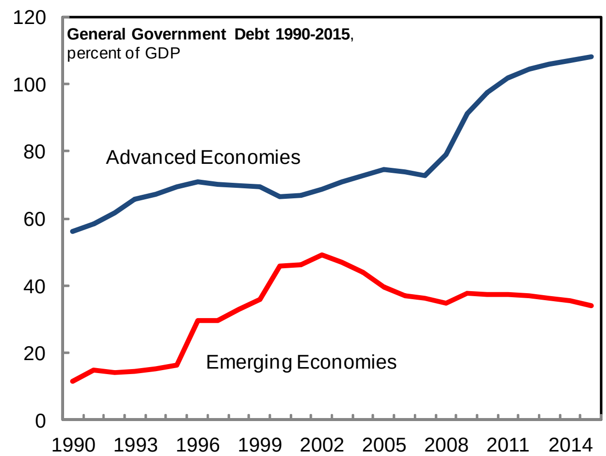


Chart 3.

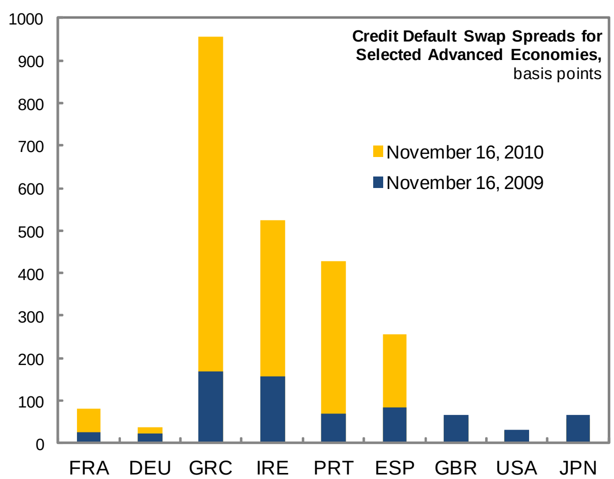


Chart 4.

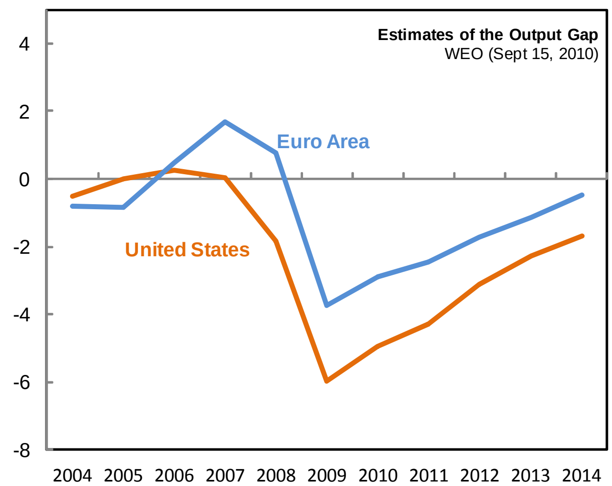
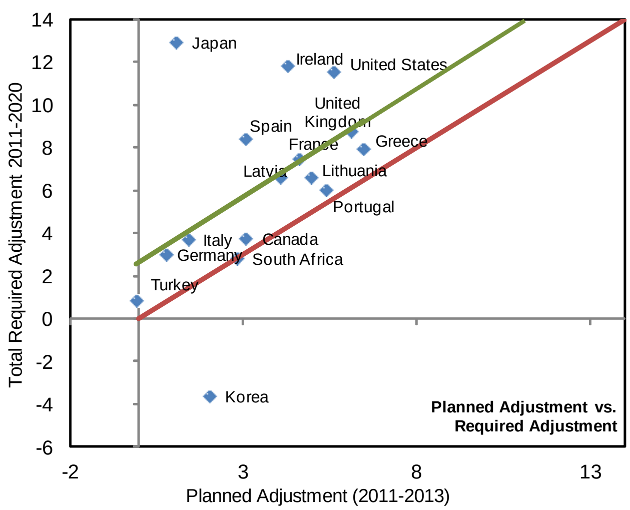


Chart 5.



Sources: IMF; Datastream