



Rethinking Macro Policy II

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Recession and risk of “high” debt

Convince markets of solvency / sustainability of debt while, if possible, use fiscal policy as countercyclical tool.

Solvency: future taxes enough to cover future spending + existing debt => must reduce deficits now or later

Sustainability: at current primary deficit, enough growth for debt/GDP ratio to stay constant or even fall => must engineer higher growth or lower interest rate

Question 1:

What are the options for a policymaker with some “fiscal space” (“no active debt vigilantes”)?

Option 1: Reduce government spending now, and fast.

Get lower debt and higher growth NOW => no trade-off

“Expansionary fiscal austerity”, “confidence effect(fairy)”

a) Actual consolidations were often smaller than previously thought, and not spending-based.

Large Fiscal Consolidations in Europe

<u>Denmark</u> <u>1983-87</u>	Actual	Plan - based	<u>Ireland</u> <u>1987-89</u>	Actual	Plan – based
Spending	-4.0	-4.3	Spending	-3.0	-2.5
Revenues	4.9	2.4	Revenues	-0.1	0.4
Surplus	8.9	6.7	Surplus	2.9	2.9
<u>Finland</u> <u>1992-96</u>	Actual	Plan- based	<u>Sweden</u> <u>1993-97</u>	Actual	Plan – based
Spending	-0.9	-12.1	Spending	-4.2	-6.8
Revenues	3.8	-0.6	Revenues	4.6	3.8
Surplus	4.9	11.5	Surplus	8.8	10.6

b) Depreciation and the role of the exchange rate and monetary regimes.

Nominal effective exchange rate

	t-1	t	t+1	t+2	t+3	t+4	t+5
Denmark	-3.4	0.9	-2.3	2.2	5.7	3.6	-1.1
Ireland	8.0	-.4	-1.9	-.7	8.6		
Finland	-2.9	-12.2	-10.0	13.4	15.0	-2.4	-2.09
Sweden	2.4	-17.7	1.2	0.4	10.1	-3.3	-0.2

Negative number is a depreciation

c) Recoveries were mostly export driven.

GDP growth

	t-2	t-1	t	t+1	t+2	t+3	t+4	t+5
Denmark	-0.9	3.7	2.7	4.2	4.0	4.9	0.3	-0.1
Ireland	1.9	0.4	3.6	3.0	5.6	7.7		
Finland	0.5	-6.0	-3.5	-0.8	3.6	4.0	3.6	6.2
Sweden	-1.1	-1.2	-2.1	4.0	3.9	1.6	2.7	4.2

Export growth

	t-2	t-1	t	t+1	t+2	t+3	t+4	t+5
Denmark	8.5	3.2	4.6	3.5	6.0	1.3	4.9	8.8
Ireland	6.6	2.7	13.9	8.1	11.4	9.2		
Finland	1.7	-7.2	10.0	16.3	13.5	8.5	5.9	13.9
Sweden	-1.9	2.0	8.3	13.5	11.3	4.4	13.8	9.0

Private consumption growth

	t-2	t-1	t	t+1	t+2	t+3	t+4	t+5
Denmark	-1.7	1.4	2.0	3.8	4.3	7.5	-1.9	-1.7
Ireland	2.7	2.8	2.1	3.6	3.3	3.2		
Finland	-1.1	-3.7	-3.8	-3.5	2.4	4.5	3.8	3.3
Sweden	0.9	-1.3	-3.6	2.1	1.1	1.8	2.8	3.3

Private investment growth

	t-2	t-1	t	t+1	t+2	t+3	t+4	t+5
Denmark	-17.6	10.3	4.3	11.2	15.3	19.3	2.3	-6.4
Ireland	-7.9	-0.5	-2.3	-0.2	13.5	13.9		
Finland	-5.7	-20.6	-17.9	-13.0	-1.6	18.5	9.3	9.2
Sweden	-8.5	-11.3	-14.6	7.0	9.9	4.7	0.6	8.8

d) Incomes policies were key

Relative unit labor costs in manufacturing

	t-2	t-1	t	t+1	t+2	t+3	t+4	t+5
Denmark	-4.9	-1.2	1.6	0.9	4.1	8.8	11.5	-0.2
Ireland	1.5	9.3	-6.2	-7.3	-6.8	0.3		
Finland	5.3	-0.9	-20.7	-24.2	5.2	16.0	-5.5	-5.9
Sweden	2.9	-2.7	-26.8	-6.4	-4.1	12.8	-7.2	-6.4

e) High and declining interest rate

Long-term interest rates

	t-1	t	t+1	t+2	t+3	t+4	t+5
Denmark	21.2	15.0	14.4	11.6	10.1	11.3	9.9
Ireland	11.2	11.3	9.4	9.2	10.3		
Finland	11.7	12.0	8.8	9.0	8.8	7.1	6.0
Sweden	10.0	8.6	9.7	10.3	8.1	6.7	5.0

Econometric evidence: positive short-run government spending multipliers on total GDP (with lots of caveats).

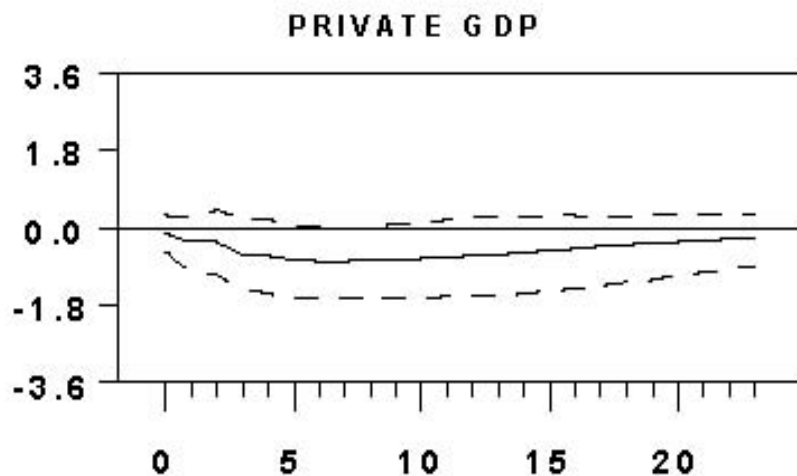
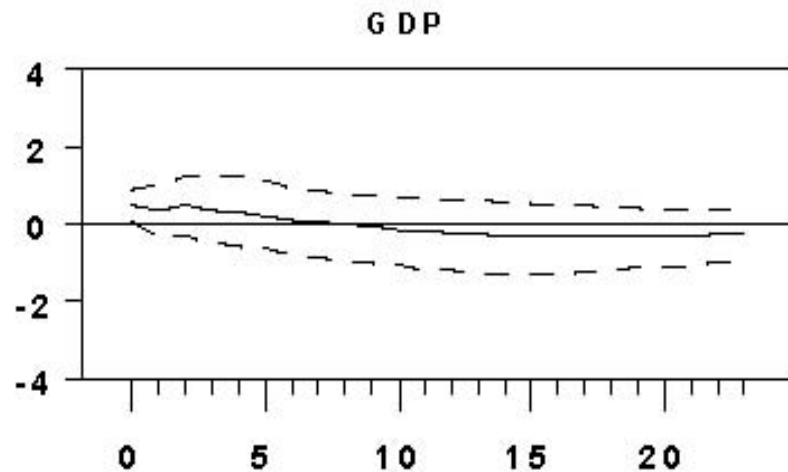
Contrary to widespread opinion, no disagreement on this.

Disagreement on effect on private consumption and private investment (private GDP)

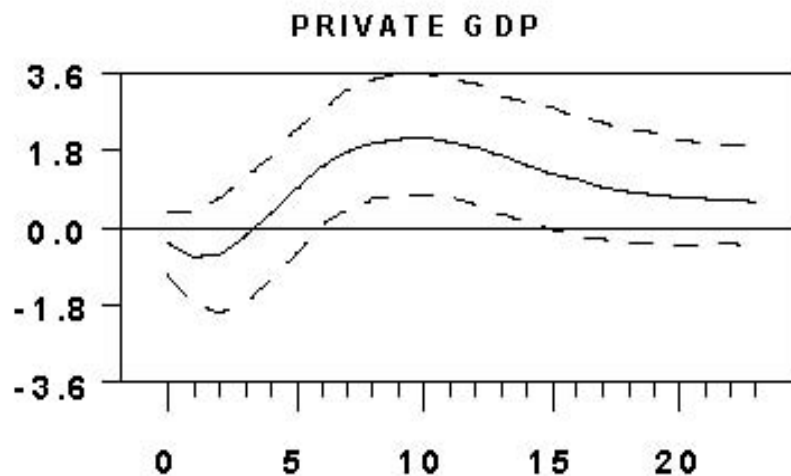
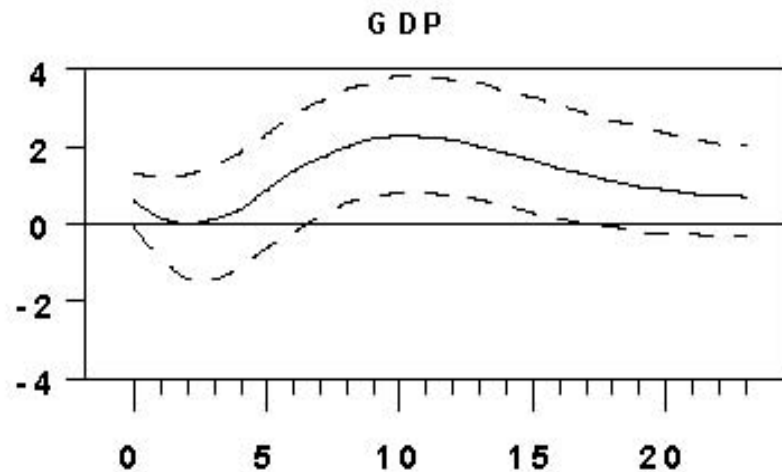
Evidence that government spending crowds out private GDP comes from shocks to defense spending or to total government spending when defense spending shocks dominate.

Response of private GDP to civilian spending shocks: positive and large.

Defense spending shock



Civilian spending shocks



But: this is purchase of goods and services. I know of no econometric evidence on transfer multipliers.

Option 2: increase government spending, and convince markets that will cut back on spending later.

Advantages:

- a) reconcile solvency/sustainability and countercyclical policy
- b) take advantage of higher spending multipliers at ZLB.

Disadvantages:

a) Long run plans with spending reversals hard to maintain => markets are unlikely to believe them.

IMF: Exposed to shocks. More likely, simply time-inconsistent (Sweden, Finland).

Cyclically adjusted targets: subjective and source of endless discussions

Fiscal councils: culture

b) Extra kick from ZLB: must be better understood

Mechanism: higher inflation \Rightarrow lower real interest rate (even higher labor taxes, that increase inflation, would do). Little evidence of this

Higher multiplier, but not necessarily higher welfare

Option 3: lower taxes temporarily.

Advantages:

a) Some evidence of higher tax multiplier

b) Welfare. Suppose there are impatient individuals, who would like to borrow but must deleverage, and patient individuals.

Lower taxes are like a temporary transfer from latter to former => both are better off. Welfare can be higher even at ZLB.

c) Speed

Disadvantages

- a) Might be difficult to protect the bottom deciles if act only on taxes.

Question 2

Distributional issues

Particularly relevant for countries with no fiscal space (“active debt vigilantes”), which can only choose “how” to do a consolidation, not “when” or how “fast”

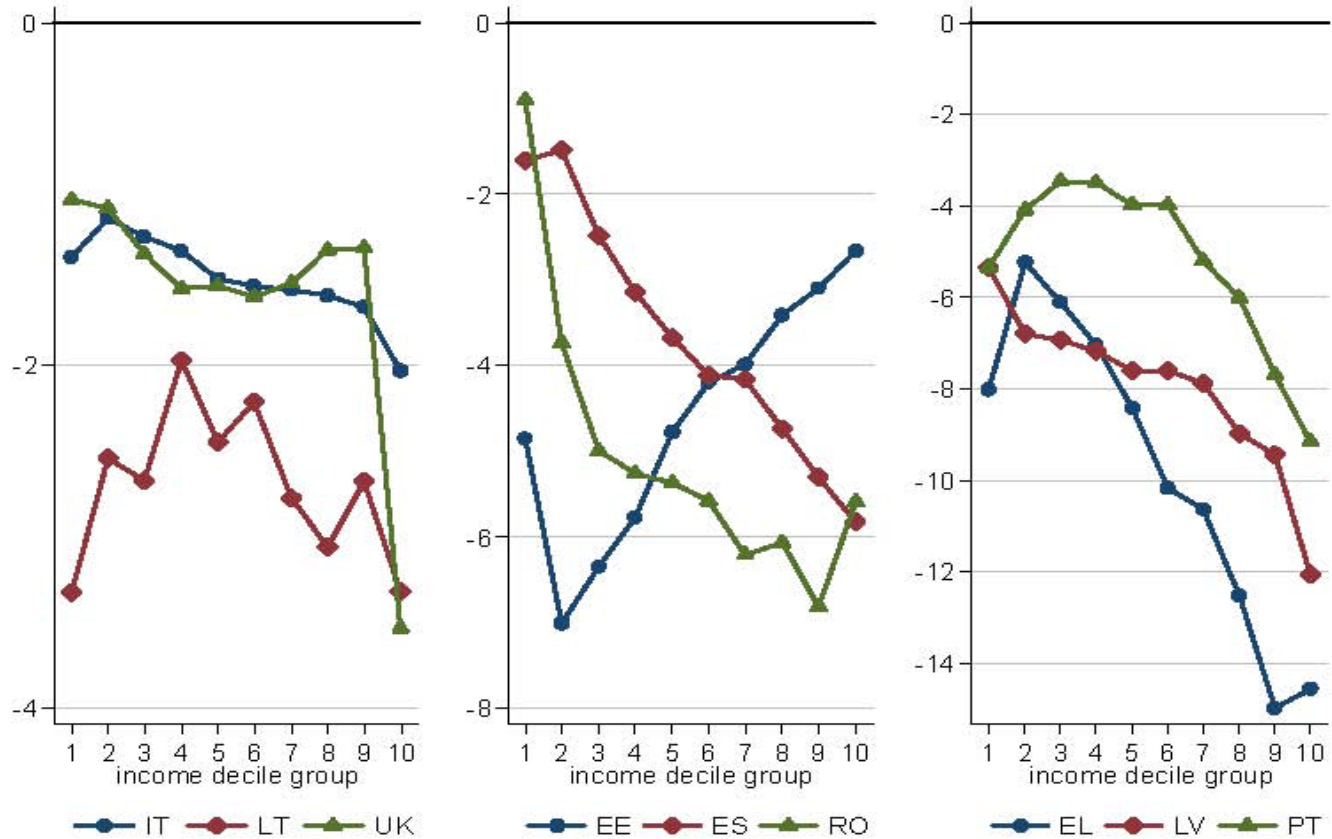
Lessons/issues:

1) Can't improvise a welfare state (as opposed to an often regressive pension system)

2) Political sustainability. Symbolism matters a lot!
Greece, Italy

3) Distribution. Not well understood.

Figure 2: Percentage change in household disposable income due to simulated household income-based fiscal consolidation measures by household income decile group

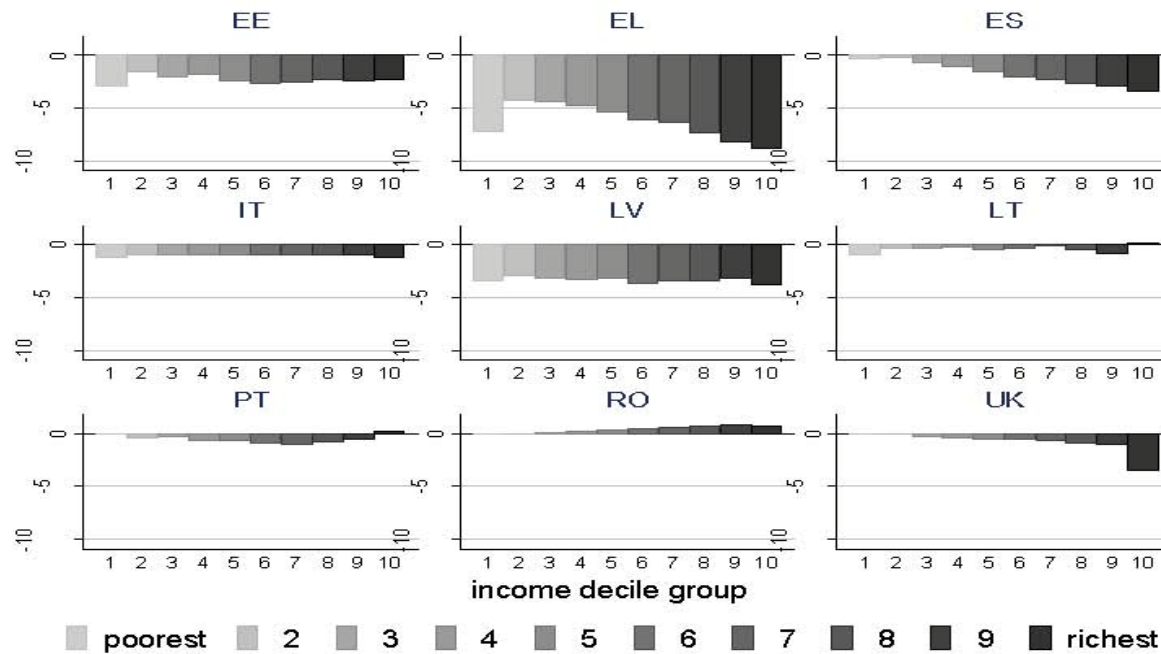


From: Avram, S. et al.: The distributional effects of fiscal consolidations in nine EU countries, EC Research Note 01/2012

Based on MULTIMOD only part of the story: general equilibrium effects are key

a) Tax increases can be better used to fine tune progressivity.....

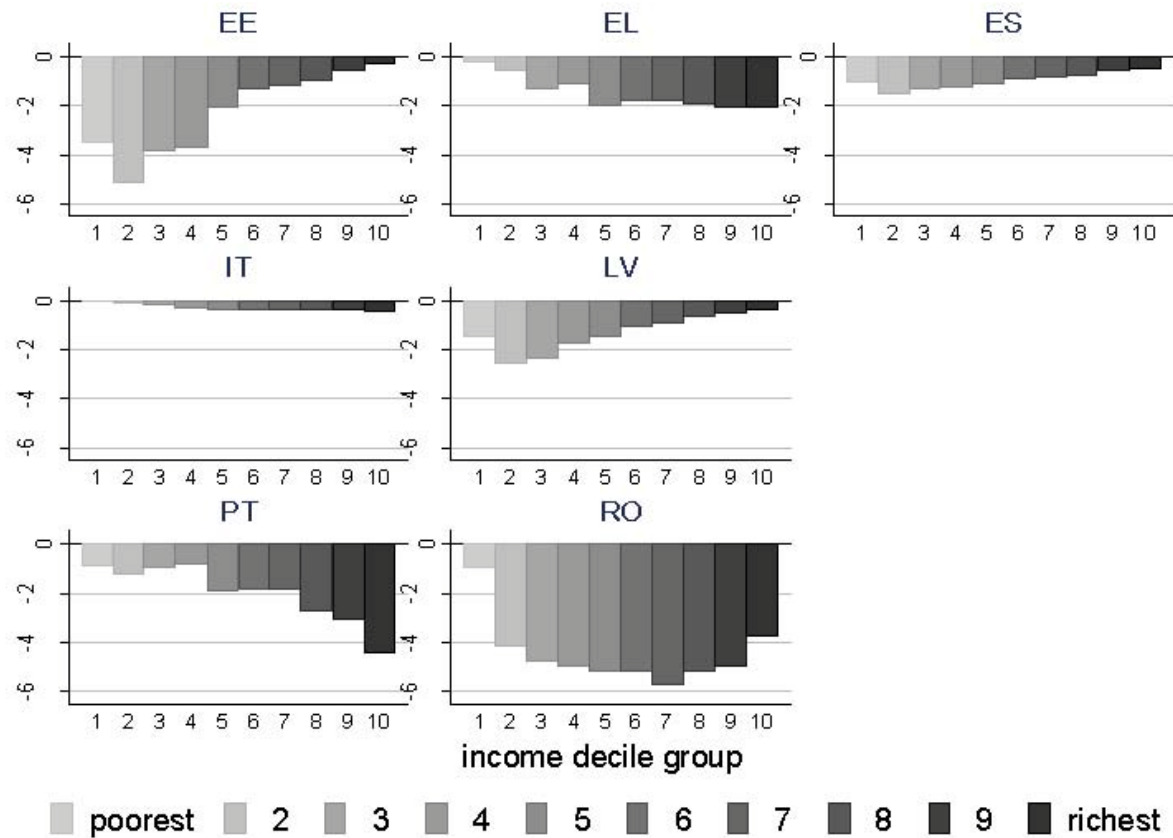
(d) Income tax and worker SICs



...but problems if large tax evasion (Greece vs. Iceland),
difficult to tax wealth, or share of income tax relatively low

b) Pensions: depends on their structure?

(b) public pensions



Increasing retirement age: typically considered effective because

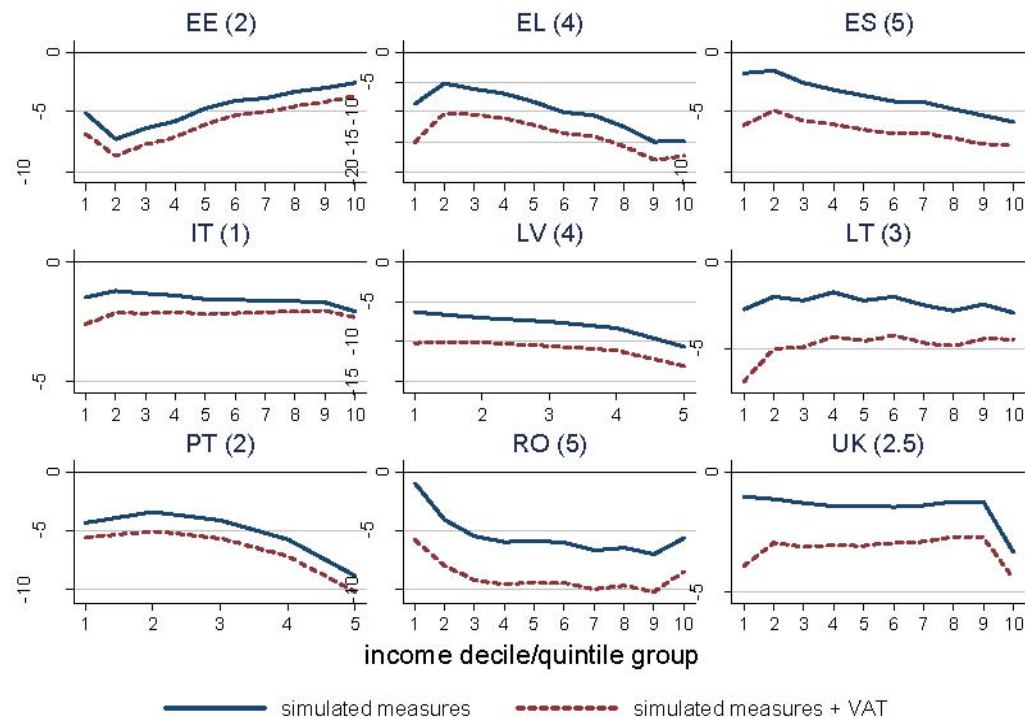
- increases labor supply and
- does not decrease aggregate demand

But: makes sense when high (youth) unemployment?

Evidence that no relation between retirement age and unemployment, but cross sectional.

c) Internal devaluation: reduce social security contribution and income taxes, and increase VAT.....but can be highly regressive.

Figure 5: Simulated household income-based fiscal consolidation measures as a percentage of household disposable income by income decile/quintile group: change including and including VAT increases



Note: The fiscal consolidation measures included here are: (a) limited to those that have a direct effect on

Question 3:

What can monetary policy do to help?

Recent common wisdom: fiscal policy can get a lot of help from unconventional monetary policy. Overrated?

a) Mp can avoid multiple equilibria. Not so easy.

- Quantities involved (off equilibrium path) might be too large for countries like Italy and Spain. Political problems.

- What happens if central bank ends up with substantial negative equity? Unexplored territory. But politically out of the question.

- Receiving governments must submit to conditionality (MTO) => governments unlikely to do this until too late

b) Mp can help break vicious circle between fragility of banking system and perceived riskiness of government bonds by providing liquidity to banks and other intermediaries.

But can backfire. Country risk => high cost of funding for banks => if extra liquidity from Central Bank, invest even more in high-yield, own-country bonds (banks like risk lovers: if sovereign defaults, banks default anyway)

=> even stronger link between sovereign risk and banking system liquidity/solvency problems.