Can we exit the crisis through budget adjustments alone?

Will budget adjustments alone suffice to return to reasonable spreads?

Budget adjustments alone would undoubtedly suffice if spreads depended solely on fundamentals. Since 2008, however, panic behaviour has driven spreads well above the levels justified by fundamentals alone (essentially the debt ratio). This justifies the introduction of non-standard monetary measures to try to hold spreads to reasonable levels, which by no means calls into question the need to clean up public finances.

D. Haugh et al (2009) showed that in addition to the effects of the ratio of debt servicing over fiscal revenues and anticipated deficits, the dynamics of spreads in the euro zone also depends on the degree of risk aversion (measured by the corporate high yield spread). Along the same lines, L. Schukenecht et al (2010) show that since late 2008 the markets have been sanctioning deficit and debt overruns much more severely than in the past.

The sensitivity of spreads to deficit and debt overruns has increased from 3 to 4 points and from 7x to 8x, respectively, in addition to the general tendency for spreads to rise in response to greater risk aversion. P. de Grauwe et al (2012) also show that sovereign spreads do not correctly reflect fundamentals (debt ratio). In a period of excessive optimism, the markets ignored fundamentals until 2008, which shows that contrary to the claims of the efficient market theory, the markets do not make use of all available information! As a result, spreads rose much higher in the countries hit hardest by the crisis than the levels indicated by models based on fundamentals.

Since 2008, the surge in spreads goes well beyond that justified by the increase in the debt ratio, even after taking into account non-linear effects. Deviations between observed spreads and theoretical spreads (i.e. those based on fundamentals) are correlated over time, which is characteristic of bubbles. If we use the same approach on OECD countries that are not members of the euro zone, we do not find that debt ratios have a significant impact on spreads (although the impact of exchange rates is significant).

The market does not have the same disciplinary impact on the budget policies of these countries. Market sentiment is different towards the countries of the euro zone, which do not

issue debt in their own currency. Bubbles in the sovereign debt market do not have the same consequences as equity market bubbles.

The bursting of equity bubbles is seen as a correction that brings equity prices back in line with fundamentals. In contrast, interest rate bubbles are more likely to modify the fundamentals themselves, by undermining economic activity and thus fiscal revenues, and a liquidity crunch can degenerate into a solvency crisis. These observations justify taking measures to contain market excesses, in either direction.

Expansionary budget adjustments: a feeble concept

Debt trajectories must be reversed. This is necessary to reduce the weight of interest payments via the debt stock effect and the resulting improvement in financing conditions. Ultimately, this would boost investment and growth potential. In any case, this is the message drawn from the well-known observations of C. Reinhart and K. Rogoff: historically, debts exceeding about 90% of GDP are accompanied by a drop off in growth performances. Moreover, at a time when markets are extremely nervous, the negative impact of renouncing fiscal consolidation would be even bigger than that caused by the adjustment itself.

Questions about the impact of fiscal consolidation on activity are back at the heart of economic policy debates. One of the most controversial themes is the consequences of budget policies, especially since the policies that have been implemented are based on fragile analyses and contradictory estimates at best (Leeper, 2010).

They are frequently the result of political or electoral considerations, which are also based on debateable assumptions (A. Alesina et al 2010)[(2)]. Recent research leads to estimates of low or even negative multipliers for countries with very high debt ratios. For some, under certain conditions, fiscal consolidation not only succeeds (i.e. putting the debt ratio onto a negative slope), but also leads to expansion.

Nearly 20 years ago, in research that has become a reference, A. Alesina and R. Perotti (1995) managed to isolate the characteristics for successful fiscal consolidation (i.e. reducing the debt ratio by at least 5 points of GDP within three years) based on observations of fiscal consolidation efforts undertaken by the OECD countries over three decades.

They concluded that "good" consolidation measures were rapidly accompanied by better performances in terms of activity, investment, competitiveness (unit labour costs) and employment. It was not so much the size of the consolidation measures that counted as their content. In successful cases of fiscal consolidation, the accent was placed on containing current spending (public sector employment and wages; transfer expenses and subsidies) as opposed to raising taxes, notably those pertaining to production factors. A. Alesina and S. Ardegna (2009) confirmed these results by examining the fiscal consolidation efforts of the OECD countries between 1970 and 2007.

Expansionary fiscal consolidation has been called into question recently, including by the above-mentioned authors. One example is R. Perotti (2011): "The IMF criticism is correct in principle and represents an important potential advance".

The method that was used had a fundamental bias that underestimated the negative impact of consolidation measures on activity. The intensity of consolidation is measured by changes in the adjusted primary balance of the cycle. Yet this does not only reflect the discretionary measures designed to clean up public finances.

Some examples are when restrictive measures are taken to avoid the risk of overheating, when support measures are taken after a certain amount of time to limit the impact of consolidation, or when the primary balance is affected by asset prices that could swell (or deflate) the balance via revenues from capital gains taxes or via the consequences of the wealth effect on domestic demand, and consequently, on related revenues.

To offset this distortion, J. Guajardo, D. Leigh and A. Pescatori (2011) isolated the measures specifically designed to turnaround public finances. They show that except on rare occasions, consolidation efforts are likely to depress activity. Their estimates tally with those of the IMF (2010) in their economic outlook published in October 2010.

Typically, a 1-point adjustment in GDP leads to an 0.5 point decline in activity, and the decline would be even sharper if fiscal consolidation were not accompanied by a reduction in the key policy rate (usually 0.2% at two years) and real exchange rates (1.6%), which triggers a positive foreign trade contribution of 0.5 points. The moderating impact of foreign trade differs widely

depending on the type of foreign exchange regime. In a fixed exchange rate system, the loss of activity due to fiscal consolidation is 0.84 points, but 0.33 points in a flexible exchange rate system. In contrast, the differentials based on the content of fiscal consolidation have been confirmed: austerity measures are recessionary, but less so than tax increases (0.43 and 1.29 points of GDP, respectively). Efforts to cut spending, which tend to be more sensitive politically, demonstrate a more credible commitment and the monetary authorities tend to adopt a more accommodating policy.

On the other hand, tax increases, especially higher indirect taxes, generate a price shock, which tends to lead the same authorities to adopt a wait-and-see approach or even to raise key rates. Under these conditions, according to IMF estimates, it is not surprising that a 1-point consolidation effort based on spending cuts results in a 0.9-point decline in end demand in the first case and a 1.9-point decline in the second!

All in all, expansionary fiscal consolidation seems to be wishful thinking. It seems even more so in the current environment. How can we expect an export boom to limit the impact of consolidation when all countries are undertaking the same policy at the same time? We cannot all export more at the same time, when we are all are hit by contracting domestic demand!

Moreover, with interest rates as such low levels, it is impossible to accompany a restrictive fiscal policy with a cut in key policy rates. According to the IMF, without monetary policy support, budget restrictions tend to have twice the negative impact on activity.

Under these conditions, it makes perfect sense to use non-standard measures to contain money market rates and to coordinate fiscal policies between the countries where consolidation is less urgent and the others.