Blame it on the Multiplier

Ronald Janssen, 16 octobre 2012

The latest IMF World Economic Outlook is causing quite a stir. It contains a three page text box basically saying that the IMF, together with other international institutions such as the OECD and the European Commission, has heavily underestimated the impact of fiscal austerity on economic activity. When formulating policies and making forecasts over the past years, it was assumed that a fiscal cut of 1% of GDP would result in a drop in economic activity of 0,5%. Technically, this amounts to a multiplier of 0,5. Comparing past forecasts for growth with actual outcomes, the IMF now finds effects that are two or even three times higher: In other words, a fiscal squeeze of 1% of GDP drags economic activity down by 0.9 or even 1,7%, and not the 0.5% that until now was being assumed.

These are huge numbers and they imply that the IMF and other 'very serious institutions' got things completely wrong. By thinking that fiscal cuts would only have a relatively minor impact on economic activity, governments were given bad advice and being pushed into policies administering overdoses of austerity. This austerity overdose shattered the already fragile recovery in Europe and the Euro Area, transforming it into a renewed recession.

The IMF's 'mea culpa' is certainly admirable and hopefully helpful in introducing a bit more modesty in the attitude and positions of the 'Austerians' over here in Europe.

The IMF, however, is not telling us everything. In particular, the reference at the end of the text box stating that 'more work on how fiscal multipliers depend on time and economic conditions is warranted' is rather cryptic. The fact is that the IMF has already done such research. This research, published this summer in a working paper, is simply devastating for traditional and mainstream recommendations on fiscal policy and austerity. (http://www.imf.org/external/pubs/ft/wp/2012/wp12190.pdf).

First, the IMF paper completely discredits the usual mantra that if consolidation is to be successful, then it's public and social expenditure that need to be cut. The IMF now finds that, especially in downturns, expenditure multipliers are up to ten (!) times larger than tax multipliers. This implies that a fiscal consolidation that is primarily based on the expenditure side will have substantially more negative effects on the economy than a consolidation based on raising taxes.

Second, the IMF working paper finds absolute values for multipliers that are even higher than those mentioned in its World Economic Outlook. A fiscal squeeze of 1% of GDP operated in an economic downturn and based on expenditure cuts will, in the case of the Euro Area, shave 2.5% of from economic activity. This actually also implies that such type of fiscal consolidation will increase the deficit instead of bringing it down! In line with shrinking economic activity, public revenues will fall while unemployment benefit payments increase. If, as in a typical European member state, a loss of 1% of real GDP involves a deterioration of the deficit by 0.5%, then the second round effects of a 1% of GDP expenditure squeeze more than offset the initial improvement in the deficit. In our 'back of the envelope' calculus, the final deficit would increase by 0.25% and this despite (or exactly because of!) an expenditure based consolidation of 1% of GDP. It's as if policy makers, by trying to get the economy out of a hole, are digging an even deeper hole.

This is highly relevant for the Euro Area at this very moment: Many member states are now already facing a recession and, despite this, are being forced by the European economic policy consensus to enforce fiscal cut after fiscal cut in what will prove to be a vain attempt to respect unrealistic deficit objectives. The trap of a vicious spiral is clearly there.

Third, aggressive consolidation plans which 'frontload' the fiscal cuts at the beginning of the period have harsher and more protracted negative effects on output than gradual consolidation. It is less costly for the economy to administer a 0.5% of GDP cut each year over the next 4 years than to cut 2% of GDP at once.

The previous three points are already rather spectacular. However, the IMF working paper goes even further by debunking the myth that, even if it has a recessionary impact, hard and tough consolidation is necessary and unavoidable to restore financial market confidence. Here, the working paper uses a simulation to illustrate how a fiscal consolidation policy that is misguided will unchain the demons of financial markets instead of calming them down.

In this simulation, a country with a 120% of GDP debt ratio reacts to a negative shock to its economy by going for a fiscal squeeze of 5% of GDP over one and half years, and with the entire consolidation being based on public spending cuts. The result is that debt continues to explode. The reason for this has to do with the 'denominator' effect. Even if the annual deficit (which is part of the nominator) is being reduced, this consolidation policy triggers a prolonged recession depressing nominal GDP (which is in the denominator), thereby pushing the debt to GDP ratio up, not down! After four years, the debt to GDP ratio is still 14% of GDP higher compared to another scenario in which the consolidation is done in a gradual way and equally based on expenditure cuts and tax hikes.

In turn, the failure to get debt dynamics under control makes the economy even more vulnerable to deteriorating market sentiment. Despite aggressive consolidation, markets observe that the debt to GDP ratio keeps increasing. They lose confidence and dump sovereign bonds, thus pushing interest rates up. From that moment on, markets organise the self fulfilling spiral of excessive interest rates leading to totally unsustainable debt dynamics. In this way, markets defy fiscal austerity efforts altogether: The only effect of austerity is that it deepens the recession while at the same time intensifying financial market turmoil.

In short, the IMF's working paper, even if formulated in technical language, is crying out loud serious warnings to European policy makers: End austerity now! Stop frontloading austerity! Stop cutting social benefits and public services! Do not cut spending in the middle of a recession! Shift deficit targets over a longer time horizon! Consolidate by ending tax dumping in Europe! End the ECB's 'malign neglect' of irrational financial markets pushing distressed member states even deeper into the abyss!

Anyone listening in Brussels, Frankfurt, Berlin or Paris?