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Fiscal consolidation under imperfect credibility

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ABSTRACT

This paper examines the effects of expenditure-based fiscal consolidation when credibility as to whether the cuts will be long-lasting is imperfect. We contrast the impact limited credibility has when the consolidating country has the means to tailor monetary policy to its own needs, with the impact when the country is a small member of a currency union with a negligible effect on interest rates and on nominal exchange rates of the currency union. We find two key results. First, in the case of an independent monetary policy, the adverse impact of limited credibility is relatively small, and consolidation can be expected to reduce government debt at a relatively low output cost given that monetary policy provides more accommodation than it would under perfect credibility. Second, the lack of monetary accommodation under currency union membership implies that the output cost may be significantly larger, and that progress in reducing government debt in the short and medium term may be limited under imperfect credibility.

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1. Introduction

The global financial crisis and ensuing slow recovery have put severe strains on the fiscal positions of many industrial countries, especially those of many peripheral economies in the euro area. Between 2007 and 2014, debt/GDP ratios climbed considerably in many euro area countries, including the peripheral countries shown in Fig. 1, with debt rising by 61 percent of GDP in Spain and by as much as 74 percent of GDP in Greece. Mounting concern about high and rising debt levels, especially in the wake of the rise in borrowing costs, spurred efforts to implement sizeable fiscal consolidation plans. So far, many of the fiscal consolidation plans that have received legislative approval in the peripheral euro area economies appear to have shared broadly similar features – they have typically been fairly front-loaded and more oriented towards spending cuts than tax hikes (see IMF, 2012; European Commission, 2014).

However, despite significant consolidation efforts, the debt ratios of peripheral economies have not improved much, as can be seen in Fig. 1, although deflation has largely been avoided (except in Greece – see bottom left panel in Fig. 1). The only exception is Ireland, where the debt/GDP ratio fell almost 13 percentage points between 2012 and 2014, mainly due to a snapback in economic activity as shown in the top right-hand panel in Fig. 1. In all other countries, output performance has been subpar to core countries and debt has continued to rise or has remained roughly unchanged. Hence, the evolution of debt and output during this period does not seem to support the popular policy recipe – notably advocated by Alesina and Ardagna (2010), Alesina and Perotti (1995, 1997) and Giavazzi and Pagano (1990) – that large spending-based fiscal

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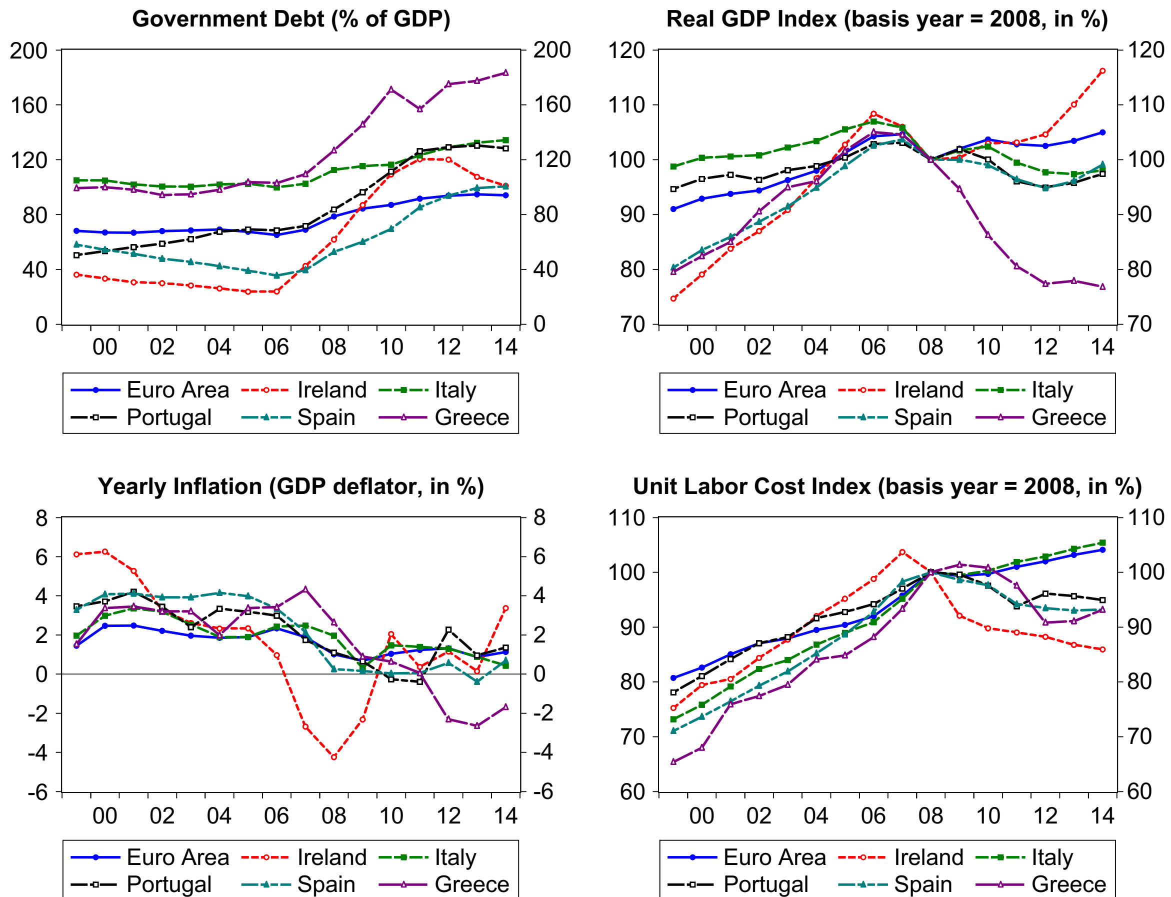

Fig. 1. Debt, output, inflation and ULC in peripheral economies and the euro area.

consolidations have expansionary effects on the economy. Ireland may offer a counterexample, but the evolution of unit labor costs shown in the bottom right-hand panel in Fig. 1 suggests that the favorable performance of Ireland may partly be due to an internal devaluation as opposed to the expansionary effects of fiscal consolidation.

In this paper, we seek to analyze the impact that imperfect commitment to following through on the announced consolidation efforts has on the output cost of fiscal austerity and on the effectiveness in reducing debt/GDP ratios in the short and medium term. Given the sizeable consolidation plans, we believe that economic actors – both households and investors – may have had considerable doubts about the ability of politicians to follow through on their implementation, and we seek to understand how these doubts may have affected their efficiency. Our paper makes a purely positive examination of this issue by, first, assessing whether imperfect credibility is empirically important, and second, by investigating how the economic impact of expenditure-based consolidation depends on the degree of credibility that the spending cut will be permanent and not transient.

To examine the first issue, we decompose data on government spending (as a share of trend output) into permanent and temporary components for a selected set of peripheral euro area economies.[1] Our simple decomposition supports the notion that credibility is imperfect for some of these economies; in particular, we find that credibility for permanent spending cuts is impaired for Greece.

Given this finding, we then address the second issue, which is to quantify the economic impact of imperfect fiscal credibility in two variants of a dynamic stochastic general equilibrium model (henceforth a DSGE) of an open economy. We start our analysis using the analytically tractable benchmark model of Clarida et al. (2001), and then check the robustness of our findings in a fully fledged workhorse open economy model used by Erceg and Lindé (2010, 2013). Following Erceg et al. (2006), this model features "rule-of-thumb" households that simply consume their disposable income every period, as ample micro and macro evidence suggests that such non-Ricardian consumption behavior is a key transmission channel for fiscal policy.[2] In other respects, the model is a relatively standard two-country open economy model with endogenous

[1] To provide a point of comparison for our procedure, we also perform the decomposition for Germany and the United States.

[2] Using micro data from the Consumer Expenditure Survey, Johnson et al. (2006) and Parker et al. (2011) find evidence of a substantial response of US household spending to the temporary tax rebates of 2001 and 2008. On the macro side, Galí et al. (2007) present evidence from structural VARs that

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