Fiscal Consolidations Make Crises Worse

By Antonio Fatas , INSEAD Professor of Economics

Post-crisis fiscal consolidations can have persistent and permanent effects on growth. More aggressive fiscal and monetary policy is needed, not less.

It has been more than six years since the global financial crisis began and advanced countries are still suffering from its aftermath. Relative to previous business cycles, the current one was hobbled by a recession that was much more protracted and persistent without a strong recovery to allow it to return to trend.

GDP today is still very low, about 13 percent lower than the levels experienced in the Euro area since the launch of the Euro in 1999, and potential growth has been revised down. Today, the IMF expects that by 2019, the Euro area will be about 15 percent below the level of its pre-crisis trend.

Kenneth Rogoff of Harvard argues that the world economy is suffering from a debt hangover rather than deficient demand. The argument and the evidence are that financial crises tend to be more persistent than downturns

caused by other reasons. However, there is still an open question about whether this is the fundamental reason for growth being so anemic and whether other potential reasons (deficient demand, secular stagnation) matter as much, or even more.

In the article, Rogoff dismisses calls for policies to stimulate demand as the wrong actions to deal with debt; the ultimate cause of the crisis. He insists that given government expenditures have continued to expand (he uses the number for France at 57% of GDP) it is hard to argue in favour of more spending.

GDP is not exogenous

But there is a perspective that is missing in that logic. The ratio of debt or government spending to GDP depends on GDP, and GDP growth cannot be considered as exogenous. Assuming the path of GDP is independent of the cyclical stance of the economy does not sound reasonable but, unfortunately, it is the way most economists think about a crisis. A crisis is seen as a temporary deviation of output but the trend is assumed to be driven by something else (innovation, structural reforms). This logic runs contrary to evidence on the way investment and even R&D expenditures behave during a crisis. If growth is interrupted during these times, output will never return to its trend. The level of GDP depends on its history, what economists call hysteresis. Reducing the depth of a crisis or shortening the recovery period has enormous benefits because it affects long-term GDP.

[To be fair to economists, we are all aware of the persistent dynamics of GDP, but at the theoretical level we tend to explain it with models where the stochastic nature of the trend is responsible for the crisis itself, rather than assuming that other factors caused the crisis and the trend reacted to them.]

In a recent **paper** Olivier Blanchard and Eugenio Cerutti of the IMF and Larry Summers of Harvard, show that persistence and long-term effects on GDP is a feature of any crisis, regardless of the cause. Even crises that were initiated by tight monetary policy leave permanent effects on trend GDP. Their paper concludes that under this scenario, monetary and fiscal policy need to be more aggressive given the permanent costs of recessions.

Fiscal consolidation worsens things

Using the same logic, in an **ongoing project** with Summers, I have explored the extent to which fiscal policy consolidations can be responsible for the persistence and permanent effects on GDP during the Great Recession. Our empirical evidence very much supports this hypothesis: countries that implemented the largest fiscal consolidation have seen a large and permanent decrease in GDP. And this takes into account the possibility of reverse causality (i.e. governments that believed the trend was falling the most could have applied stronger contractionary policy).

While we recognise that there is always uncertainty when estimating these types of macroeconomic dynamics using one particular historical episode, the size of the effects that we find are large enough not to be ignored as a valid hypothesis. In fact, using our estimates we calibrate the model of a recent paper by **Summers and Brad DeLong** of U.C. Berkley to show that fiscal contractions in Europe were very likely self-defeating. In other words, the resulting (permanent) fall in GDP led to an increase in debt to GDP ratios as opposed to a decline, which was the original objective of the fiscal consolidation.

The evidence from both of these papers strongly suggests that policy advice cannot ignore this possibility, that crises and monetary and fiscal actions can have permanent effects on GDP. Once we look at the world through this lens what might sound like obvious and solid policy advice can end up producing the opposite outcome of what was desired.

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