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IMF Spotlight on Balance Between Adjustment and Growth

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The appropriate balance between adjustment and growth has long been at the center of the debate on the response to the euro crisis, dominating also Italy's current electoral campaign. The terms of the debate are, however, often Manichaean, if not largely emotional, as reflected in words such as "rigor" and "austerity." If the choice were simply between austerity and growth, who would ever favor the first? Clearly, matters are not quite so simple and cannot be reduced to an easy choice between two binary alternatives.
Against this background, in-depth research that attempts to shed light on the issue is most welcome. All the more so when such research is authored by as eminent an economist, and key player in crisis management, as is Olivier Blanchard, the International Monetary Fund's chief economist. The topic is tackled in his latest paper, co-authored with Daniel Leigh of the IMF's Research Department, that comes with a scholarly title ("Growth Forecast Errors and Fiscal Multipliers") but a real-world content. The research follows, and largely confirms, an earlier study in last October's World Economic Outlook, which indicated that the euro area's fiscal adjustment programs had exerted a much larger negative impact on growth than initially estimated.

To begin with, credit is due to the IMF for being ready to question its work and duly recognize possible errors. Paul Krugman, not one to be soft on the Fund, has indeed recognized this merit, adding: "The really bad news is how few other players are doing the same," pointing to the unchanged position of European leaders.
What should we in essence take away from the Blanchard-Leigh paper? Is it, as brashly headlined by the Washington Post, "an amazing mea culpa from the IMF's chief economist on austerity" or, more modestly, a technical study whose policy implications are limited, as suggested by the Financial Times? Both readings have some truth. The work focuses on the estimation of fiscal multipliers, i.e., the relationship between a reduction in the public deficit and economic growth. The troika's models for the euro area countries' adjustment programs were generally based on a multiplier of around 0.5: they thus estimated

that a one percentage point cut in the deficit would reduce growth by about half a percentage point. The Blanchard-Leigh study, however, finds that the "multipliers implicit in the forecasts were, on average, too low by about 1." Moving from a multiplier that is less than 1, to one that is above it, is a critical shift. It means that a cutback in the deficit compresses growth in a larger measure than the fiscal correction itself - in the specific case at hand, by one-and-a-half times more. A major forecast error, with dramatic consequences.

To explain the blunder, Blanchard points to a number of exceptional conditions determined by the Great Recession: interest rates already close to their zero lower bound, and the related inability of monetary policy to offset the effects of fiscal restraint; a poorly functioning financial system, implying that consumption may have depended more on current than on future income; the presence of large unused resources; and the continent-wide synchronization of adjustment policies. All elements of the euro area crisis that undermined the prevailing estimates of fiscal multipliers.
Does the study therefore validate the arguments of the many opponents – including in Italy – of adjustment policies? They stand to be disappointed. Blanchard emphasizes that fiscal adjustment remains essential in virtually all advanced economies, and that "the short-term effects of fiscal policy on economic activity are only one of the many factors that need to be considered in determining the appropriate pace of fiscal consolidation." At the same time, he warns that - although multipliers may have declined in 2011-12 relative to the early phases of the crisis – it seems safe for the time being to assume that they are still high. Against this background, the Fund has for some time been stressing that fiscal consolidation is a marathon, not a sprint and, within the troika, has supported a measured gradualism in the pace of adjustment – provided there are credible (i.e., legislated) consolidation measures over the medium term.

What does this imply for Italy? It may be recalled that the IMF has already deemed the pace of adjustment for 2012-13 to be "appropriate," and has supported the focus on structural (i.e., cyclically-adjusted) targets, so as to take account of developments in the real economy. However, it has widely criticized the composition of adjustment, pressing for further spending cuts to allow, among other things, a reduction in the labor tax wedge – which is the real Italian anomaly (and not the property tax , IMU, present in all countries). It also repeatedly called for a better mobilization of public assets, including through asset disposals. Finally, it pressed that adjustment be "locked-in" via medium-term legislation. These are the key points on which the political parties should be judged in their competition for the vote in Italy's upcoming elections.