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The “stimulus debate” and the golden rule of mountain climbing

Francesco Giavazzi

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The global macroeconomy is at a juncture; some economists argue for continued fiscal stimulus to avoid a double dip recession while others argue for fiscal prudence. In this column, one of the world's leading macroeconomists argues for continued stimulus combined with a plan to ensure long-run sustainability by reforming the funding of pension liabilities.

The golden rule in mountain climbing is that your hands always need to have a good hold. If you have a good grip, you can take some license with your feet-- for example, make an attempt to reach a ledge that's still covered with the dew, or scale a crossing that might be a little too wide for your legs. But if your hold is uncertain, you can take no risks: a single error could be fatal.

A mountain climbing analogy seem apt given that the upcoming Kansas City Fed’s Jackson Hole conference is focusing on fiscal policy. It also helps us understand what the stance of fiscal policy should be at this point in the crisis. It suggests that governments should commit to future spending cuts large enough to stabilize debt levels over the medium term. But, once future sustainability is locked in, they could afford to take some risks with current deficits. They could delay removal of the fiscal stimulus, or even add some additional stimulus if private demand is slow to recover.

Putting the fiscal cost of the crisis in perspective

The IMF has computed the fiscal cost of the crisis and compared it with the fiscal cost of aging (IMF 2010). In almost all advanced economies the fiscal cost of the crisis is an order of magnitude smaller than the fiscal cost of aging (health, pensions and old age care). In the average advanced G-20 country the present value of the fiscal cost of the crisis amounts to about 30% of GDP; the present value of the fiscal cost of aging is estimated at close to 400%. In Holland, to make just one example, the estimated increase in age-related spending over the next 15 years amounts to 7% of GDP per year.

This suggests that policymakers should forget about the crisis and get on with reforming entitlements. A good reform of entitlements would allow them to postpone the date of fiscal exit, if needed, for a long time.

The point is not new. It was made for the US by Ben Bernanke in Dallas last spring in a speech dedicated to fiscal exit strategies (Bernanke 2010). And it was reiterated by Larry Summers this week (Summers 2010).

The difficulty with commitments is that they need to be credible, and this requires two conditions.

- Legislation needs to be passed, and;
- Projections need to be reliable.

Larry Summers obviously understands the point about the importance of entitlements reform, but unfortunately he fails on both conditions (Summers 2010). He ‘forgets’ to mention Social Security reform, which is by far the largest item in the growth of entitlements in the US. And on health he notes that the legislation adopted last spring “offers the potential to contain health costs”: Offering a potential is not exactly the reassurance markets are looking for. With such an uncertain handhold, governments like mountain climbers can take no risks -- a single error could be fatal. That’s why markets are concerned with the current stance of US fiscal policy.

Europe's situation

Europe in this respect seems to be ahead of the US. Reforms of age-related spending are being discusses in almost all capitals, ranging from Rome to Paris and Berlin.

An interesting characteristic of the European reforms is that they focus on the age of retirement. Unlike a reduction in benefits or an increase in contributions, raising the retirement age probably won’t affect current consumption and it has a positive effect on supply. If workers anticipate that they are going to work longer, and hence have higher lifetime incomes, consumption will increase now. This will help offset the recessionary impact of the crisis. Raising the retirement age has a powerful scissors effect on the fiscal challenge of aging. It boosts the future stream of tax revenues while reducing the future stream of pension spending. The National Institute for Economic Research has estimated that an across the board two-year increase in the retirement age would reduce long run debt levels in the UK by as much as 40% of GDP.

Avoiding Ricardian offsets

Committing to future spending cuts by reforming entitlements today may also be the condition for making sure that the increases in government spending still in the pipeline (not all stimulus money has been already spent) continue being expansionary.

Empirical research on spending multipliers suggests that the response of private consumption to an increase in government spending depends on households' expectations about offsetting fiscal measures in the future. To induce a positive response of private consumption to a spending increase you need to accompany it with a commitment to cut spending in the future. If a current increase in public spending appears to be permanent, and households expect that the budget will be balanced via increases in taxes, private consumption falls and the increase in public spending is self-defeating.

References

Bernanke, Ben (2010)

IMF (2010)

Summers, Larry (2010)