Commentary: Monetary Science, Fiscal Alchemy

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I shall start with a metaphor appropriate both to Eric's thought-provoking paper and to Jackson's stunning surroundings: The golden rule of mountain climbing. The golden rule in the Alps—but I think it applies to the Tetons as well—is that your hands should always have a firm grip. If you have a firm grip, you can take some license with your feet—make an attempt to reach a ledge that's still covered with the morning dew, or scale a crossing that might be a little too wide for your legs. But if your grip is unsure, you can take no risks; a single error could be fatal. Not only that, but if your grip is unsure, your legs tend to lose their balance and even the easiest step suddenly becomes hard.

What does the golden rule of mountain climbing tell us about the appropriate stance of fiscal policy at this point in the crisis?

Step No. 1, as Eric's paper suggests: Anchor fiscal expectations, which means adopting a credible plan to stabilize the public debt. Once expectations are anchored—but only then—governments could afford to take some risk with current deficits. Some countries could delay removing the fiscal stimulus (for instance, extending unemployment benefits), or even add some additional stimulus if private demand is slow to recover, for instance, helping local governments avoid laying off more civil servants.

The "only then" condition is crucial. If fiscal expectations are not anchored, a fiscal expansion can be counterproductive, inducing a fall in private demand. We don't know much about the effects of fiscal policy, but one thing we know, and Eric's paper shows it very clearly: The dynamics of future fiscal policy matter a great deal in determining the effects of fiscal policy today. Multipliers vary (even in sign) depending on fiscal expectations.

To put it more simply, one could use the words of Peter Orszag: "It would be foolish to dramatically reduce the deficit immediately, but it would be equally foolish not to reduce the deficit significantly by 2015."

As I said, anchoring fiscal expectations means adopting a credible plan to stabilize the debt. There is a discussion, including at the International Monetary Fund (IMF), on the appropriate level at which debt should be stabilized: the pre-crisis level, the current level, 60 percent of gross domestic product (GDP), or some other number. In my view, this discussion misses the point. In almost all advanced economies (as shown in Table 3 in the paper), the fiscal costs implied by aging populations are startling. For the United States, the IMF estimates that the present discounted value (PDV) of the fiscal cost of aging is about five times current GDP. In Spain, 15 years from now, aging will add 5 percent of GDP to yearly government spending. Fiscal expectations will not be anchored so long as governments don't explain how they are going to deal with the rising cost of entitlements. I am therefore puzzled by the finding by Carmen Reinhart and Ken Rogoff [1] of a non-linearity in the relationship between debt and growth when debt reaches 90 percent of GDP. The debt measure they use excludes unfunded liabilities; it also excludes the debt of local governments. I doubt we have the data to do this, but it would be important to re-do the exercise with a wider measure of debt.

Are reforms of entitlements politically possible? Here I disagree with Eric. The advantage of reforms in the area of age-related expenditure is that the rules that need to be put in place only start biting after 15-20 years: This changes political incentives. My own country, Italy, provides a good example. Fifteen years ago, a relatively weak government, led by a former central banker, Lamberto Dini, adopted a pension reform that's responsible for the fact that the PDV of the cost of age-related spending in Italy today is one-third the estimated cost in the United States and half that in the United Kingdom. How did Lamberto convince Parliament to adopt this law? By making the change in pension rules very gradual. Little happened for 15 years, but that law is now exactly 15 years old.

In the current U.S. debate on the pros and cons of additional fiscal stimulus, an argument one often hears is that the administration should not worry about letting the deficit grow even larger because long rates are falling: There is no sign that bond markets are becoming worried about the future of fiscal policy. I believe that this argument totally misses the point. What is a source of concern is not—at least in the United States today—the reaction of bond markets, but that of consumers and firms. And how both would react to an additional fiscal stimulus depends on their expectations, more generally on the uncertainty they perceive about the future of fiscal policy. Let me explain this with two examples drawn from the European experience—but the point is pretty simple, it is just an example of the permanent income hypothesis; Marty Feldstein made it 30 years ago.[2]

In Denmark in the early 1980s, following a sharp fiscal contraction, households' disposable income fell four years in a row. In the same period, private consumption boomed, growing almost 4 percent per year. How could this stark non-Keynesian outcome happen? The most likely explanation is a shift in fiscal expectations. Prior to the fiscal consolidation, government spending had been growing (in real terms) at 4 percent per year, but this large stimulus didn't help the economy, which remained depressed. The new fiscal plan didn't cut the growth of spending abruptly; it took a few years for spending to start falling as a fraction of GDP. Eventually it did, and so, eventually, did the tax burden on the economy. But consumers didn't wait.

One way to make sense of the surprising response of Danish consumers is that the spending reductions announced at the time of the fiscal turnaround, although implemented gradually, were credible, and households perceived that they would eventually imply lower taxes. To be fair, two additional channels played an important role in the Danish stabilization. First, interest rates collapsed: The long real rate fell from 7 percent to 3 percent. Second, the low level of household debt and the health of the banking system allowed an expansion of consumer credit, the channel through which consumption grew notwithstanding the fall in disposable income. While both factors were probably a result of the shift in fiscal expectations, the jump in consumption would not have been possible if these channels hadn't worked.

The second example illustrates another channel through which fiscal expectations can influence consumption. They do by affecting the uncertainty households perceive. In Germany, in the late 1990s, Chancellor Kohl had convinced his citizens that the German pension system was unsustainable. The payroll contribution rate necessary to keep the system balanced would eventually have approached 100 percent. In 1996, his government adopted a pension reform that over time stabilized the contribution rate at around 21 percent. In the campaign for the general election of September 1998, Kohl's opponent, Gerhard Schröder, promised that, if elected, he would revoke the new law and reestablish the old system—which eventually he did. (Only later, in his second term, did Chancellor Schröder address the sustainability of German pensions, proposing to raise the retirement age.)

The possibility that Schröder might win the election—and the pension system return to an unsustainable path—induced a sharp increase in the uncertainty perceived by households (which is measured in the German Households Survey). This was accompanied by a fall in private consumption, which contributed to the slowdown of the German economy at the start of this millennium. In a paper with Michael McMahon[3], we come to this conclusion, comparing (with a diff-in-diff technique) the behavior of households who were affected by the reform's revocation and that of civil servants, whose pensions were unaffected either by Kohl's reform or by its revocation.

The effects of the increase in the uncertainty about the future of pensions are striking. A household that previously was saving 10 percent of disposable income, in a few years would have raised its saving rate to as high as 16 percent. (Footnote: An interesting side effect is that households affected by the revocation of the law also exploited the margin provided by part-time employment to work more. For instance, a head of household working part-time, who previously worked 10 hours per week, increased her hours to nearly 19 hours per week.)

In normal times, consumers don't have the time or the patience to look far into the future, and fiscal expectations are not very important. Today, however—as it happened in Germany a decade ago, when the election brought the sustainability of pensions to the center of the public debate—one need only watch the nightly news to become aware and concerned about the buildup of debt and the future cost of entitlements.

When the future cost of entitlements becomes the subject of lunchtime conversations, lack of transparency adds to the uncertainty. One example is the different rules adopted by pension funds in this country to discount their future liabilities. The Government Accounting Standards Board requires corporations to discount using a risk-free rate, but allows public pension funds to discount using their own estimate of the expected rate of return on their portfolio, thus a risky rate. Of course this reduces the reported value of the funds' liabilities and thus the contributions required to keep the fund balanced, at least on paper. Because public funds are defined-benefit plans de facto guaranteed by taxpayers, discounting using a risky rate means that if portfolios don't perform as well as expected, the risk is transferred to taxpayers. (Attempts by the Accounting Board to force public funds to adopt the same rules as corporations have so far failed.)

If there has ever been a time when fiscal expectations are important, that is today. This could be very good news. The more households concentrate on long-term fiscal sustainability, the larger the effect on their expectations of a reform of entitlements, and the easier it becomes to buy room for some fiscal flexibility at the short end. At the same time, however, a failure to act and wars of attrition that delay reforms would have an even greater depressing effect on consumers.

Endnotes

[1]Carmen Reinhart and Ken Rogoff (2010), "Debt and Growth Revisited," *Vox-eu.org*, Aug. 11.

[2]Government Deficits and Aggregate Demand," Journal of Monetary Economics, January 1982: 9, 1, pp 1-20.

[3]Francesco Giavazzi and Michael McMahon (2010), "Policy Uncertainty and Precautionary Savings," mimeo, IGIER-Bocconi University.