PRESS POINTS FOR CHAPTER 3:
WILL IT HURT? MACROECONOMIC EFFECTS OF FISCAL CONSOLIDATION
World Economic Outlook, October 2010

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Key Points

- **To restore fiscal sustainability, many economies need to reduce their budget deficit. This chapter analyzes the impact of fiscal consolidation—tax hikes and spending cuts—on growth in advanced economies.**

- **Fiscal consolidation typically lowers growth in the short term. Using a new data set, we find that after two years, a budget deficit cut of 1 percent of GDP tends to lower output by about ½ percent and raise the unemployment rate by ⅓ percentage point.**

- **Interest rate cuts and a fall in the value of the currency usually soften the impact of fiscal consolidation on growth. However, this cushioning effect is lower when interest rates are already near zero, or when many countries consolidate at the same time.**

- **Over the long term, debt reduction can raise output by bringing down real interest rates and allowing taxes to be reduced.**

This chapter focuses on the short-run effects of fiscal consolidation—tax hikes and spending cuts—on economic activity in advanced economies. We assess the impact of fiscal consolidation during the past 30 years on output and unemployment.

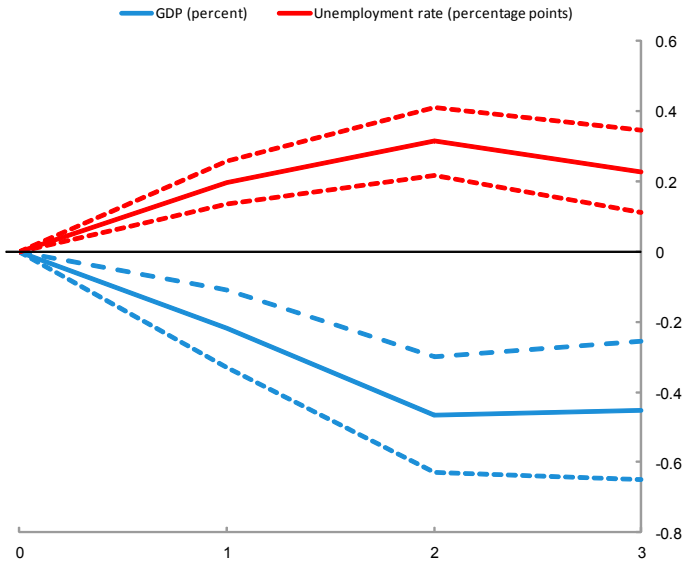
Given the importance of the topic, this chapter is not the first to address it. A number of studies present evidence that fiscal adjustments can be expansionary in the short run. However, these studies often identify periods of fiscal consolidation in a way that, as this chapter shows, tends to downplay contractionary effects and overstate expansionary ones. To obtain more accurate estimates of the effects of fiscal consolidation, we focus on historical accounts and records of tax hikes and spending cuts motivated by deficit reduction.

Our analysis suggests that fiscal consolidation usually dampens economic activity in the short term. Within two years of cutting the budget deficit by 1 percent of GDP, domestic demand—consumption and investment—is about 1 percent lower, and the unemployment rate is about ⅓ percentage point higher. Because net exports—exports minus imports—tend to rise when budget deficits are cut, the overall impact on GDP is a decline of ½ percent.

A number of factors usually soften the short-term impact of fiscal consolidation. First, central banks usually cut interest rates and the currency falls in value. This helps cushion the impact on consumption and investment, and boosts exports. Second, fiscal consolidation is less costly when markets are more concerned about fiscal sustainability. Third, consolidations based on spending cuts are less painful than those based on tax hikes. This is largely because central banks cut interest rates more after spending cuts.

Impact of a 1 Percent of GDP Fiscal Consolidation on GDP and Unemployment

Fiscal consolidation is normally contractionary. A fiscal consolidation equal to 1 percent of GDP typically reduces real GDP by about 0.5 percent and raises the unemployment rate by about 0.3 percentage point.



Source: IMF staff calculations.
Note: *t* = 1 denotes the year of consolidation. Dotted lines equal one standard error bands.

Over the long term, we find that fiscal consolidation has a positive impact on output. In particular, lower debt tends to reduce real interest rates and debt service costs, which allows for future tax cuts. By boosting private investment, this increases output in the long term.

Our findings suggest that in today's environment, fiscal consolidation is likely to have more negative short-term effects than usual. In many economies, central banks can only provide a limited monetary stimulus because interest rates are already near zero. Moreover, if many countries adjust simultaneously, the output costs are likely to be greater—since not all countries can reduce the value of their currency and increase net exports at the same time. Our simulations suggest that the contraction in output may be more than twice as large as our baseline estimate when central banks cannot cut interest rates, and when the adjustment is synchronized across all countries. But for economies considered at high risk of sovereign default, short-term negative effects are likely to be smaller.

There are a number of ways to reduce the impact of needed fiscal consolidation on the recovery. As is discussed in Chapter 1 of the WEO, measures that are legislated now but only reduce deficits in the future—when the recovery is more robust—would be particularly helpful. Examples include linking statutory retirement ages to life expectancy and improving the efficiency of entitlement programs.

PRESS POINTS FOR CHAPTER 4:

DO FINANCIAL CRISES HAVE LASTING EFFECTS ON TRADE?
World Economic Outlook, October 2010

Prepared by Abdul Abiad, Prachi Mishra, and Petia Topalova

Key Points

- **Imports tend to decline sharply in the first two years after a financial crisis and remain depressed even in the medium term, according to 40 years of historical evidence. In contrast, exports are relatively unaffected.**

  - **Countries with higher current account deficits tend to experience a larger reduction in imports. Imports also fare worse when the crisis is accompanied by greater currency depreciation, higher exchange rate volatility, and relatively weak credit conditions.**

  - **Our findings suggest that imports in countries that recently suffered a banking crisis—which include the United States and much of advanced Europe—may stay below pre-crisis trends for several years. The reduction of their current account deficits in 2009 may thus prove long-lasting.**

  - **They also imply that economies that have relied heavily on demand from the crisis-hit countries in the past will need to bolster domestic demand to support growth in the future.**

Trade is recovering well from the global downturn, but has not yet recovered the ground lost during the crisis. This is particularly the case in economies hit by a banking crisis. Because the recent banking crises occurred in economies that account for a substantial portion of global demand, the speed and extent of the recovery in their imports will have a significant impact on growth in their trading partners.

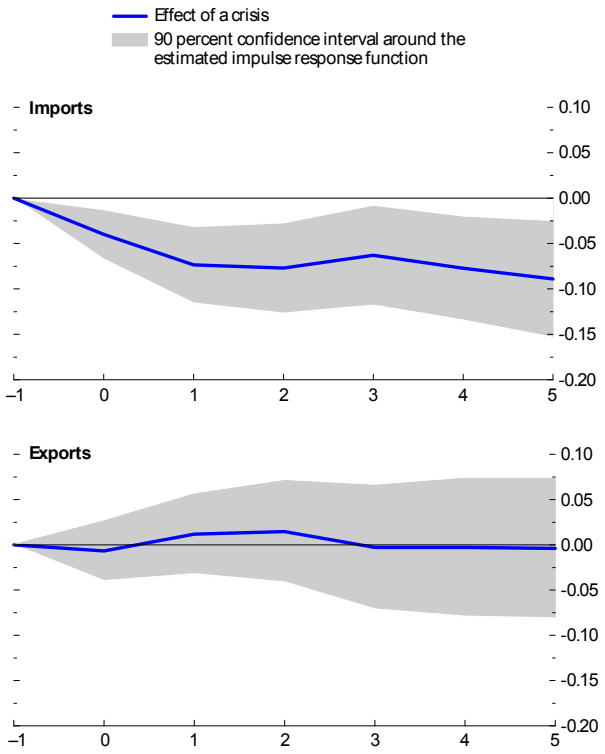
The chapter analyzes trade dynamics following past banking and debt crises to help us understand how trade might evolve in the wake of the recent global downturn. We look at 169 episodes of banking and debt crises in advanced, emerging, and developing economies over the past 40 years. We track the behavior of imports and exports after these crises, both to estimate the overall trade declines and to assess the associations of various factors—such as output and exchange rate dynamics—with trade.

We find that imports fall sharply after a financial crisis and remain below normal (that is, below their predicted level) even over the medium term, while exports are relatively unaffected. And it is not just because crises lower output; a number of other factors also explain the decline in imports. The decline in output accounts for roughly half of the post-crisis fall in imports. In the early post-crisis period, increased exchange rate volatility and currency depreciation contribute to the import fall. Over the medium term, poor credit conditions are also a factor. "Composition effects" may also play a role: during crises, demand for products that comprise a larger share of trade than of output experience a particularly large decline—for example, consumer durables or investment goods. This may be explained by the fact that demand for these goods relies heavily on credit, which is tight after a crisis.

Post-crisis Import and Export Losses, Controlling for Output

(Percent deviation from normal; years on x-axis; crisis begins at t=0)

Following a financial crisis, imports of the crisis country fall sharply and remain depressed, even after controlling for output. But exports of the crisis country behave no differently from normal.



Source: IMF staff calculations.
Note: Blue lines indicate the impulse response function – the effect of a crisis on imports and exports relative to what would be predicted in the absence of a crisis. Predictions are based on a collapsed gravity model in changes, with contemporaneous and lagged crises, home and trade-weighted partner output, a trade-weighted partner crisis dummy, and country and time dummies.

Our results imply that imports of many advanced economies will remain below pre-crisis trends for years to come. This has clear implications for emerging economies that have relied on export-led growth. The full recovery of import demand in countries that recently suffered a banking crisis—including the United States, the United Kingdom, and much of advanced Europe—may be more protracted than suggested by their tempered output projections. The recent narrowing of the large current account deficits of crisis countries may thus prove to be quite durable—which is consistent with the medium-term projections in the WEO. For economies that experience a crisis, the chapter underscores the importance of embracing structural reforms that support the recovery of output. For economies that have relied heavily on demand from these countries, our findings highlight the urgency of boosting the contribution of domestic demand to growth—so that their economies are fired by "twin engines".