

More Gain Than Pain

Consolidating the public finances

Philipp Rother
Ludger Schuknecht
Jürgen Stark

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22 Queen Anne's Gate
London SW1H 9AA
Tel: +44 (0)20 7799 5034
E-mail: info@politeia.co.uk
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THE AUTHORS

Philipp Rother

Philipp Rother is head of the fiscal surveillance section in the European Central Bank (ECB). Before joining the European Central Bank, he worked as country analyst at the International Monetary Fund with a focus on European countries. His published research work focuses on empirical and institutional aspects of fiscal policy making.

Ludger Schuknecht

Ludger Schuknecht is Senior Adviser in the Economics Directorate General of the European Central Bank. His recent research focuses on public expenditure policies and reform and the analysis of economic boom-bust episodes. His publications include *Public Spending in the 20th Century: A Global Perspective* with Vito Tanzi (Cambridge 2000); and, for Politeia, *Reforming Public Spending: Great Gain, Little Pain*, with Vito Tanzi, and *Booms, Busts and Fiscal Policy: Public finances in the future*.

Jürgen Stark

Jürgen Stark is a member of the Executive Board and the Governing Council of the European Central Bank (ECB). Before that he was Vice-President of the Deutsche Bundesbank and served as State Secretary at the German Federal Ministry of Finance. He has held posts at the Federal Chancellery and the Federal Ministry of Economics. His publications focus on public finances, European monetary integration, institution building and the global financial system.

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I

Consolidation and the Public Finances – Loss or Gain?

Governments can confiscate, secretly and unobserved, an important part of the wealth of their citizens (...). There is no subtler, no surer means of overturning the existing basis of society than to debauch the currency.

John Maynard Keynes, *The Economic Consequences of the Peace* (1919)

The curious task of economics is to demonstrate to men how little they know about what they imagine they can design.

Friedrich August Hayek, *The Fatal Conceit* (1988)

Public finances in Europe and other advanced economies are in a serious condition. Public deficits and debt have reached unprecedented peacetime levels and the dynamics are clearly unsustainable. This development coincides with an increased burden of private debt and cross-border commitments. Moreover, the economically and financially interlinked environment in which the debt has been amassed makes the magnitude of the obligations that governments face more uncertain. This creates both significant long-term and short-term risks.

In such an environment, the costs and benefits of consolidation need to be assessed from a comprehensive perspective. First, there is no dispute that fiscal consolidation in the long run supports fiscal sustainability both directly and indirectly by supporting economic growth. This is all the more relevant for the future, given the magnitude and global nature of public liabilities.

Second, the paper¹ revisits the arguments around the costs and benefits of consolidation in the short term. The ‘traditional’ Keynesian view is that consolidation has adverse effects on demand but this view can be countered and important beneficial effects of consolidation can arise also in the short term.

¹ This publication derives from a lecture given by Ludger Schuknecht to Politeia in December 2010. The lecture in turn was based on the ECB occasional paper no 121. The authors would like to thank Krzysztof Bankowski for valuable competent research assistance, and Ad van Riet and the participants in the European Central Bank DG-Economics seminar for their comments on this paper. The views expressed are the authors’ and not necessarily those of the European Central Bank.

Third, the paper looks at the costs and benefits of consolidation from another angle seldom discussed so far in the context of advanced economies. The financial crisis has shown that the credibility of public finances and developments in financial markets are closely interlinked. Concerns about the sustainability of public finances may increase the level and volatility of the price at which markets are willing to finance governments. We now see that sudden stops in the availability of financing are conceivable even in advanced economies and even at debt levels that were previously considered reasonably 'safe'. Moreover, concerns about the sustainability of public finances and the health of the financial sector can mutually reinforce each other and lead to a vicious circle of weakening public finances and financial institutions undermining also the real economy. The immense speed and intensity of market reactions within and across countries in 2010 had previously only been associated with emerging markets. Consolidation would provide clear benefits by guarding against such risks.

There is another 'insurance' dimension to this issue: in a number of countries only when regional (European) and global (IMF) 'insurance' was activated on a major scale (Greek programme, European Financial Stability Facility (EFSF)) did the markets stabilise and only then was access to financing by governments regained. In this environment, consolidation both in countries at risk and in countries providing 'insurance' results in positive externalities: it reduces contingent liabilities for other countries and it strengthens the robustness and 'insurability' of the system. Moreover, broad-based consolidation reduces the political strains on international solidarity that could otherwise undermine the stability of the system. In the absence of consolidation, instability related to public finances will continue. It will increase the risk of continuing bouts of instability, renewed boom-bust cycles, financial repression, protectionism and undue pressure on central bank balance sheets and monetary policies.

In a nutshell, this paper argues for significant (expenditure-based and growth-friendly) consolidation in Europe and other advanced economies without delay. There is a need to reduce unsustainable public liabilities with their deleterious effects on long-term growth and confidence. In an environment with strong and sudden adverse interaction between fiscal and financial instability, the benefits of consolidation are likely to outweigh their costs (notably reduced aggregate demand), even in the short term.

Consolidation based on a strengthened institutional framework is needed to underpin confidence in fiscal solvency at the national level. And it helps prevent adverse international externalities and systemic tail risks. These considerations also suggest a need for fiscal prudence and great caution in any efforts to fine tune the economy via fiscal engineering.

The paper is organised as follows: Section 2 provides a comprehensive account of public liabilities in Europe and other G7 economies. Section 3 reviews the long- and short-term benefits of consolidation. Section 4 discusses the further benefits from consolidation given fiscal-financial linkages. Section 5 concludes with policy lessons.

II

Public Finances in a Global Context: where do we stand?

Against the background of a deterioration in the public finance in many countries, this section takes stock of government liabilities and the adjustment needed in the euro area and other G7 economies. The findings suggest a much more vulnerable position for fiscal sustainability in the euro area and other countries globally existed in 2010-11 than at any time in recent decades.

There is little doubt that public finances in most advanced economies are unsustainable when government deficits, debt dynamics and additional liabilities for the budget (such as from the financial sector or population ageing) are taken into account. Deficits in the euro area are expected to have averaged above 6 per cent in 2010 and deficit peaks will be near or above 10 per cent in several member countries (Table 1). Except for Canada, the situation in other G7 countries is no better: both the United States and the United Kingdom are expected to post double-digit deficits for the year ending in 2010. Projected 2010 deficits would have absorbed about one third of gross savings in the euro area and almost 100 per cent of domestic gross savings in the United States and the United Kingdom.

Table 1: Public finances (per cent of GDP)

	Budget balance	Gross debt			Increase in ageing costs (percentage points of GDP)	Fiscal adjustment needed
		1999	2007	2010	2007-2060	2010-20
Belgium	-4.8	113.7	84.2	98.6	6.9	4.7
Germany	-3.7	60.9	64.9	75.7	4.8	4.0
Ireland	-32.3	48.5	25.0	97.4	8.9	9.8
Greece	-9.6	94.0	105.0	140.2	15.9	9.2
Spain	-9.3	62.3	36.1	64.4	9.0	9.4
France	-7.7	58.8	63.8	83.0	2.7	8.3
Italy	-5.0	113.7	103.6	118.9	1.6	4.1
Cyprus	-5.9	51.8	58.3	62.2	10.8	-
Luxembourg	-1.8	6.4	6.7	18.2	18.0	-
Malta	-4.2	57.1	61.7	70.4	10.2	-
Netherlands	-5.8	61.1	45.3	64.8	9.4	5.5
Austria	-4.3	67.2	59.3	70.4	3.1	4.7
Portugal	-7.3	49.6	62.7	82.8	3.4	7.8
Slovenia	-5.8	23.9	23.4	40.7	12.8	4.0
Slovakia	-8.2	47.8	29.6	42.1	5.2	4.1
Finland	-3.1	45.7	35.2	49.0	6.3	4.4
Euro area	-6.3	71.7	66.2	84.2	5.2	-
Canada	-4.9	91.4	66.5	84.4	-	4.4
Japan	-7.7	127.1	167.1	198.4	-	13.1
United Kingdom	-10.5	43.7	44.5	77.8	5.1	9.0
United States	-10.5	60.5	62.0	92.8	-	12.0
G7 average	-8.5	77.4	78.9	108.7	-	10.0

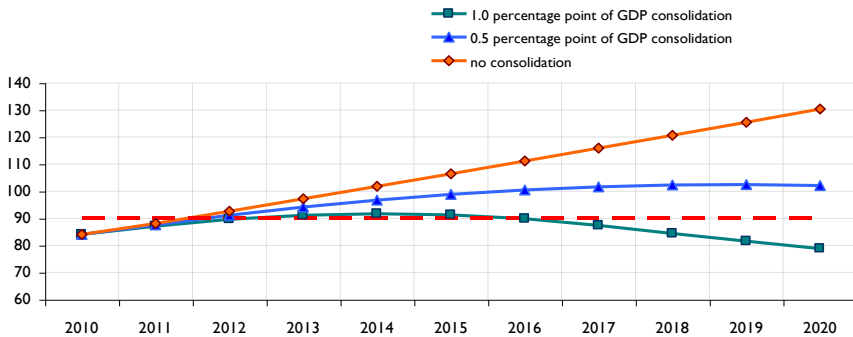
Sources: Autumn 2010 European Commission Economic Forecasts (AMECO database) and OECD Economic Outlook (Dec 2010) in the case of Canada, Japan and the United States. The weights for the calculation of the G7 aggregate are based on GDP data from the OECD Economic Outlook (Dec 2010). The fiscal adjustment needed comes from the IMF Fiscal Monitor (May 2010). The increase in ageing costs data are taken from the European Commission's 2009 Ageing Report.

Consequently, gross public debt ratios have increased rapidly. From 66 per cent in 2007, debt is expected to have risen to 84 per cent of GDP in the euro area in 2010 with levels near or above 100 per cent in three countries. Gross debt in the United Kingdom and the United States will have risen to similar ratios, but their much lower starting positions only three years ago point to more adverse underlying debt dynamics. Japan is expected to post a staggering debt ratio of nearly 200 per cent of GDP, while average G7 debt to have exceeded 100 per cent of GDP in 2010.

In addition, significant implicit liabilities from social security systems are expected to burden future budgets. By optimistic European Commission/Economic Policy Committee (EPC) estimates, public expenditure on health, pensions and long-term care will on average rise by 5.2 per cent of GDP over the next few decades (European Commission and EPC, 2009). Some assessments by other institutions point to much higher future burdens.²

Looking to the future, a continuation of past deficits would imply explosive debt paths as illustrated for the euro area in Chart I. The ‘no consolidation’ line in the chart underestimates the likely development of the debt ratio, if continued fiscal imprudence undermines economic confidence and thus erodes the basis for a return to sound and sustainable economic growth. With GDP growth faltering, public debt ratios would rise

Chart I: Medium-term projections for the average government debt-to-GDP ratio in the euro area (2010-20; per cent of GDP)



Source: ECB calculations.

Notes: All three scenarios use the European Commission’s spring 2010 forecast for general government debt and primary balance up to 2010 as a starting point. Fiscal developments as of 2011 are determined by three alternative scenarios: Scenario 1 assumes a rather rapid fiscal consolidation process, with the primary balance improving by 1.0 per cent of GDP per year until an overall balanced budget is reached. Scenario 2 assumes a less ambitious consolidation path, with the primary balance improving by only 0.5 per cent of GDP per year until an overall balanced budget is reached. Scenario 3 assumes that no consolidation efforts are made. The primary balance remains constant at the forecast value for 2010 over the whole simulation period. The macroeconomic assumptions underlying the three scenarios are as follows: the nominal GDP growth comes from IMF World Economic Outlook (April 2010) up to 2015 and afterwards it is equal to the average nominal potential growth over 1996-2015 of 3.4 per cent, as estimated in the IMF World Economic Outlook. The nominal implicit interest rate on government debt is assumed constant at the value recorded in 2008 (as the values for the period 2009-10 could be distorted by the financial crisis).

² See OECD or IMF studies on this matter. Looking backward, the root of fiscal sustainability concerns lies to a significant extent in the wasted opportunity of putting public finances on a sound footing in the ‘good times’ of 1999-2007 (Schuknecht, 2009).

even more steeply. But even the planned deficit of euro area countries would bring most countries' deficits and the average deficit to 3 per cent of GDP by 2013. This, in turn, would mean a stabilisation of public debt at nearly 90 per cent of GDP on average and for a number of individual countries, well above 100 per cent in the coming years. This implies that even aggregate public balance sheets for the euro area are already far more at risk than the safe threshold of 60 per cent suggested by the founding fathers of EMU. For the United Kingdom, the budget plans of spring 2010 foresee a stabilisation of public debt at above 85 per cent of GDP in 2012/13. The US gross debt ratio will have already reached 90 per cent in 2010 and further significant increases to levels well above those in the euro area are foreseeable in the years ahead.

With these debt levels and fiscal prospects, the IMF (2010) has identified the fiscal adjustment needed over the next decade to bring public finances back onto a sustainable footing. The results are staggering: for the average of the euro area the adjustment would have to be around 6 per cent of GDP, and for the average of the G7, the UK and the US around 10 per cent of GDP (see again Table 1). If the adjustment were to come mainly on the expenditure side (as discussed below and recommended by much of the literature), it would imply a decline in real spending by 10-20 per cent or more.

When talking about fiscal sustainability two additional fiscal risks must be taken into account, which, together with 'visible' debt and ageing-related liabilities, set the stage for considerable 'fiscal stress' in the future (Leeper, 2010). First, the financial crisis has shown that private sector debt can become a contingent liability for the public sector, for example via bank bail-out costs. The financial crisis has seen significant debt increases due to financial sector support, and not only in countries which featured a bloated banking sector. At this point, the global dimension of contingent liabilities comes into play: contingent liabilities can turn into 'real debt' across borders as well (e.g. global bank losses on US sub-prime mortgages which turned into contingent and real liabilities for many governments). Implicit contingent liabilities assumed by euro area governments to resolve the financial crisis amounted to an average of 20 per cent of GDP, and much more in some countries (van Riet, 2010).

Private debt can also seep into government accounts when, for example, for political or financial stability reasons, the public sector supports over-indebted households through mortgage relief or corporations through financial support. Private sector indebtedness is very high in many countries (Table 2). Aggregate private sector indebtedness in the euro area was around 170 per cent of GDP in 2009, the same order of magnitude as the G7 average and the US figure. Household and corporate debt exceeded 200 per cent of GDP in Ireland, Portugal, Spain, the Netherlands and the UK. Together with public sector debt, the total debt stock averaged about 250 per cent of GDP in the euro area. It was even higher in some member countries, and on average in the G7. Moreover, the deterioration in public balance sheets over the crisis period (which followed a strong increase in private debt) has not been accompanied by a commensurate repair of private balance sheets. This is consistent with the historical pattern of recent decades during which the overall debt stock in many advanced economies has continuously increased.

Second, governments may face contingent liabilities from third countries if they have directly or indirectly underwritten their liabilities. In the European context, such liabilities could arise from the Greek programme and the European Financial Support Facility (EFSF). The related total contingent liabilities exceed 5 per cent of euro area and individual country GDP and are therefore not negligible (Table 3).

Table 2: Debt ratios of non-financial corporations, households and the general government sector in selected countries (per cent of GDP)

	Private				General government		Total	
	Non-financial corporations		Households		1999	2009	1999	2009
	1999	2009	1999	2009				
Germany	58.3	71.1	72.2	63.4	60.9	73.1	191.5	207.7
Ireland	-	204.2	-	120.8	48.2	64.0		389.0
Spain	54.4	140.0	42.8	86.0	62.3	53.2	159.6	279.3
France	74.9	108.7	36.4	53.6	58.8	78.1	170.1	240.4
Italy	53.0	83.2	21.6	42.2	113.7	115.8	188.4	241.1
Netherlands	95.6	94.2	83.1	127.9	61.1	60.9	239.8	282.9
Portugal	107.1	164.7	54.9	97.0	49.6	75.1	211.5	336.8
Euro area	71.9	104.6	49.6	65.8	71.9	78.7	193.4	249.1
Canada	61.4	53.6	68.3	82.9	91.4	82.5	221.0	219.0
Japan	129.5	95.9	75.8	65.5	127.0	192.9	332.2	354.3
United Kingdom	73.1	116.3	66.6	103.1	43.7	68.1	183.4	287.5
United States	64.9	77.6	69.8	96.4	60.4	83.0	195.1	257.0
G7 average	78.4	84.6	65.9	80.2	77.3	100.8	221.6	265.7

Sources: private sector: OECD (National Accounts), ECB (Quarterly Euro Area Accounts) in the case of the euro area and ECB calculations; public sector; ECB (Government Statistics) in the case of EU countries and the euro area aggregate, OECD (Economic Outlook) for Canada, Japan and the United States and ECB calculations.

Note: The debt of non-financial corporations sector covers loans and securities other than shares of this sector. The debt of the household sector consists of loans. The G7 figures have been aggregated using GDP weights.

Table 3: Cross-border contingent liabilities in the euro area.

Country	EFSF		Greece		Total
	(EUR billions)		(percentage of GDP)		
Belgium	15.3	2.9	4.4	0.8	5.2
Germany	119.4	22.3	4.9	0.9	5.8
Ireland	7.0	1.3	4.4	0.8	5.2
Spain	52.4	9.8	5.0	0.9	5.9
France	89.7	16.8	4.6	0.9	5.4
Italy	78.8	14.7	5.1	0.9	6.0
Cyprus	0.9	0.2	5.0	0.9	5.9
Luxembourg	1.1	0.2	2.8	0.5	3.3
Malta	0.4	0.1	6.8	1.2	8.0
Netherlands	25.1	4.7	4.3	0.8	5.1
Austria	12.2	2.3	4.3	0.8	5.1
Portugal	11.0	2.1	6.6	1.2	7.9
Slovenia	2.1	0.4	5.9	1.1	7.0
Slovak Republic	4.4	0.0	6.6	0.0	6.6
Finland	7.9	1.5	4.5	0.8	5.3
Greece	12.4	0.0	5.2	0.0	5.2
Total euro area	440.0	79.2	4.8	0.9	5.7

Source: EFSF and European Commission.

Moreover, the nominal figures are likely to understate the marginal fiscal burden, as related liabilities are likely to fall due (if at all) during times of financial stress when national imbalances may already be costly and/or difficult to finance.

Two important implications arise from this discussion. First, while there are precedents for the magnitude of debt for individual countries, the same is not the case globally, where the level of overall indebtedness is unprecedented. The public liabilities of very few advanced countries today would be regarded as entirely 'safe' by the standards applied only a few years ago. Second, the magnitude of public liabilities itself is uncertain and, in reality, not fully under the control of governments, contrary to past beliefs. While budgetary balances and ageing costs reflect short- and long-term policy decisions and are broadly predictable and controllable by policy makers, the crisis has shown that this may not be the case for contingent liabilities from the private sector. Only theoretically could governments have refused to support banks, households, firms and other governments. Moreover, the magnitudes turned out to be much higher and more uncertain than anybody had predicted before the crisis.

Given these facts about the size and uncertainty of public liabilities, it is hardly surprising that no clear benchmark exists to determine when deficits or debt become unsustainable or when markets will start to perceive fiscal developments and dynamics to be unsustainable. During the crisis, the Italian Government did not have financing difficulties, in spite of public debt well in excess of 100 per cent of GDP, and the Japanese Government seems able to manage debt of 200 per cent of GDP without any significant interest penalty. However, there are reasons to believe that the threshold for safe debt ratios is 'normally' much lower, especially for small countries. These countries may not benefit from being considered 'safe-havens' by investors on whose confidence they depend. A few years ago the IMF broadly defined the benchmark for safe public debt ratios for countries with 'emerging market character' as below 40 per cent and for unsafe ratios as above 60 per cent (Hemming et al., 2003).

The experience of euro area countries suggests that a number of them became subject to increased market scrutiny with much higher risk premiums and limited market access as of the fiscal crisis of spring 2010. At that time, the Greek debt outlook was certainly far above the IMF thresholds. However, public debt in Spain, Portugal and Ireland was projected to be 65-85 per cent of GDP for 2010 and the European Commission (2010) projected debt to stabilise at between 75 per cent and 90 per cent of GDP in these countries. It was notably the expected magnitude of and uncertainty about contingent liabilities from the financial sector that contributed to fast and strong adverse market reactions despite 'moderate' visible public debt. The market reaction could have been much stronger and might have spread to other countries if the fiscal crisis had not been mitigated and kept 'local' by international 'insurance' measures. 'Safe' debt ratios may therefore be lower for all but the biggest and most credible developed countries and perhaps not far above the 60 per cent that the founding fathers of EMU had agreed on.³

³ See also Ostry et al. (2010) for a probabilistic approach to safe debt ratios.

III

Consolidation and its Benefits - Long and Short Term

Long-term effects on growth and demand

Fiscal consolidation has a range of positive effects on long-term growth. Fundamentally, it reduces the amount of savings used by the public sector, leaving more resources for private investment. Moreover, fiscal consolidation strengthens fiscal sustainability and contributes to an overall improvement in macroeconomic stability. A strengthened financial position allows governments to ensure stable long-term growth by smoothing out economic shocks. The evidence is that the growth-enhancing effects of fiscal consolidation are statistically significant and important in size: over very long-term economic developments in developed countries, several studies establish a pattern of significantly lower average growth occurring for countries with debt-to-GDP ratios above 90 per cent (Checherita and Rother, 2010; Kumar and Woo, 2010; Reinhart and Rogoff, 2010). However, in times of high actual levels of risk exposure and increased risk aversion, the growth-reducing effects of fiscal imbalances are likely to occur at lower levels of fiscal deficit and debt. The evidence also refers to the recent decades when only a few countries had very high debt above 90 per cent of GDP. Hence, the adverse effects on individual countries mentioned above did not have major repercussions for the global savings pool and for the potential stabilising role of governments at the global level. This is likely to be different when global debt levels are very high, crowding out effects across countries emerge and expectations of economic and financial stability deteriorate.

Table 4: Total expenditure
(per cent of GDP, unless otherwise specified)

	Total expenditure	change in expenditure ratio (percentage points of GDP)	
	2010	1999-2007	2007-2010
Belgium	53.1	-1.8	4.7
Germany	46.7	-4.5	3.2
Ireland	67.5	2.8	30.7
Greece	49.8	1.8	3.6
Spain	45.7	-0.7	6.5
France	56.5	-0.3	4.2
Italy	51.0	-0.2	3.1
Cyprus	46.1	5.4	4.0
Luxembourg	42.9	-3.0	6.8
Malta	44.6	-0.6	2.2
Netherlands	51.7	-0.8	6.5
Austria	52.7	-5.2	4.4
Portugal	49.3	2.7	5.6
Slovenia	49.7	-4.1	7.3
Slovakia	40.0	-13.8	5.7
Finland	55.8	-4.4	8.6
Euro area	50.8	-2.1	4.8
Canada	43.5	-3.3	4.1
Japan	40.6	-2.7	4.7
United Kingdom	51.1	5.1	7.1
United States	42.2	2.6	5.4
G7 average	44.8	1.0	4.5

Sources: Autumn 2010 European Commission Economic Forecasts (AMECO database) and OECD Economic Outlook (Dec 2010) in the case of Canada, Japan and the United States. The weights for the calculation of the G7 aggregate are based on GDP data from the OECD Economic Outlook (Dec 2010).

In addition, the composition of the fiscal adjustment can induce substantial long-term growth effects, e.g. by reducing distortive tax rates and improving the quality of public finances. Expenditure ratios in the euro area were generally already high before the crisis and have risen steeply over recent years to new or near historical peaks (Table 4). The euro area average and the UK expenditure ratio is projected to

exceed 50 per cent of GDP in 2010. The main reason for the unfavourable deficit and debt dynamics over the boom and bust cycle has in fact been lax expenditure policies (Holm-Hadulla et al., 2010; Hauptmeier et al., 2010).

Reducing public expenditure with a focus on non-productive items (e.g. social benefits, expenditure on non-core objectives) can add to the success and benefits of consolidation in several ways. The efficiency of such non-productive expenditure can be increased by improving the targeting of transfer payments and by reducing disincentives to work. This should allow major savings in tax benefit systems. Similarly, cross-country studies show that large improvements in efficiency in the areas of public health and education expenditure could be gained in many countries by bringing spending efficiency to the level of the best performers (Afonso et al., 2005). At a more general level, evidence suggests a negative relationship between government transfers and economic growth (Checherita et al., 2009). Finally, reforms of public pension systems and longer working lives are of particular importance. Over time, reducing public expenditure also helps to make room in the budget to reduce distortive taxes, thereby supporting private sector activity (see Tanzi and Schuknecht, 2000; European Central Bank, 2010; Alesina and Ardagna, 2009; Larch and Turrini, 2008, for more in-depth discussion).

The scale of such improvements in the quality of public finances and the scope of resulting fiscal savings can be significant (Barrios and Schächter, 2009; Afonso et al., 2005). Moreover, the evidence is that substantial debt reductions are possible over periods of ten years or more if appropriate policies are implemented consistently (Nickel et al., 2010). The benefits of ambitious fiscal consolidation can be gained at very limited economic cost when consolidation is conducted with a medium-term perspective and focuses on expenditure reforms (Schuknecht and Tanzi, 2005; Hauptmeier et al., 2007).

The benefits of consolidation in the short-term

Fiscal consolidation has, by definition, an adverse direct effect on domestic demand in the short run. However, these adverse effects may be compensated by positive effects on confidence and expectations. The overall effect may, as a result, be less damaging than the pure effect of the fiscal contraction, and it may even be positive (Giavazzi and Pagano, 1990; Alesina and Perotti, 1995).

The evidence is that such compensating positive effects on demand will be larger under the following conditions (ECB, 2010):

- i. the fiscal starting position is weak, so consolidation is expected to lead to a significant improvement in sustainability and overall stability;
- ii. the plan for fiscal consolidation is ambitious and credible, possibly part of an overall structural reform agenda, so that the expectations of lasting improvement in the fiscal situation rise;

- iii. the composition of the adjustment is focused on reducing disincentives to work and save, on enhancing expenditure efficiency and on protecting growth-friendly expenditure so that the supply conditions in the economy improve swiftly;
- iv. the share of households that can adjust their saving in response to the fiscal consolidation (i.e. Ricardian households) is high, and
- v. part of the impact of consolidation is offset by means of the exchange rate or low interest rates.

In the Eurozone countries, and other G7 countries, by late 2010, the first condition, a weak starting position existed. Substantial gains in sustainability are therefore to be expected from the implementation of consolidation strategies in some of these countries. In particular, it is clear that the cost of inaction would be huge: the consequences of not addressing the fiscal imbalances swiftly and decisively would be higher adjustment needs in the future. The choice of consolidation strategy is in the hands of governments. In practice, the implementation of consolidation plans either only just started in 2010 or is planned to start in 2011. A number of countries in the euro area, notably those with the largest imbalances, have set out important structural reforms as part of their medium-term strategies.

All in all, there are good reasons to believe that the short-term negative demand effects of well-conceived fiscal consolidation are likely to be small if, indeed, these effects are negative at all.

IV

Consolidation and Financial Stability

The most significant and positive effects of consolidation on the economy and demand relate to strengthening confidence and diminishing concerns about financial instability.

Concerns about fiscal sustainability can be exacerbated by obligations arising from or related to the financial sector (see Chapter 2 above). The resulting increase in interest rates and government bond spreads not only feeds back into public finances but also into the health of the financial sector. Changes in the nominal value of government bonds (lower value due to higher interest rates and spreads) or a downgrade in rating can affect the quality and eligibility of a bank's collateral pool. This would limit access to and raise the costs of external funding. Lower bond values can also affect the size of banks' balance sheets and erode their capital base. Funding and capital problems can, in turn, feed back to the government and worsen its fiscal problems.

Spillovers to the real economy can exacerbate the adverse impact of such feedback. Funding and capital problems can force banks to extend fewer loans to the private sector. A loss of public confidence in governments and banks can further worsen the funding problems for these sectors and the real economy. Cross-border links through international government bond ownership or bank deposits can exacerbate these problems. In particular, countries deemed to be in a similar situation and with net foreign funding needs may become subject to contagion from the problems in other countries and 'sudden stops' where market-based funding ceases. A vicious circle arising from bad fiscal positions is certainly conceivable: large fiscal imbalances can push up government bond spreads which, in turn, undermines financial stability and thus the real economy and again the fiscal outlook. Moreover, the speed at which market confidence can be lost and financial repercussions can emerge has turned out to be extremely fast. As a result, 'non-linearities' (or very abrupt economic and financial market reactions) and the risk of very drastic events can be significant.

One aspect of potential fiscal-financial transmission where there have been important changes over the past decades should be considered in greater detail – that of where public debt is held. If public debt is mainly in the hands of domestic economic agents, there may be less risk of volatility. Domestic debt holders may have better information about the true situation of public finances and may, thus, be less susceptible to 'mood swings'. The risk of 'runs' and 'sudden stops' is therefore smaller. Moreover, access to market financing can be increased if debt holders are induced to keep holding this debt (for instance via

regulation or capital controls) and/or to accept a low interest rate (financial repression). This is more likely to hold for domestic than for foreign debt holders.

Developments over the past decade illustrate the point as the data on the proportionate share of specific countries' outstanding debt held outside the issuing country shows (Table 5). They suggest greatly increased financial globalisation and a greater dependence of governments on foreign investor confidence. By 2009, for example, over half of euro area debt was held outside the issuing country. This compares to one third only a decade ago. The picture is similar for the United States where less than half of government debt is held by residents.

Amongst our sample countries, the share of foreign debt ownership is largest in France and the Netherlands. Domestic debt owners still hold a majority of their own government's debt in Spain, Italy and the UK. But only Japanese public debt remains almost entirely in domestic hands.

Table 5: Debt ownership (per cent of total debt)

	Domestic		Foreign	
	1999	2009	1999	2009
Germany	65.1	47.0	34.9	53.0
Spain	73.2	54.8	26.8	45.2
France	72.0	32.1	28.0	67.9
Italy	66.3	57.2	33.7	42.8
Netherlands	67.0	28.9	33.0	71.1
Euro area	67.5	46.5	32.5	53.5
Canada	-	-	-	-
Japan	93.2	94.0	6.8	6.0
United Kingdom	82.7	71.8	17.3	28.2
United States	60.8	47.5	39.2	52.5
G7 average	-	-	-	-

Sources: National sources (Germany – Deutsche Bundesbank; Spain – Tesoro Público; France – Agence Trésor; Italy – Banca d'Italia; Netherlands – Dutch State Treasury Agency; Japan – Bank of Japan; the UK – Debt Management Office; the US – Department of the Treasury) and the ESCB in the case of the euro area.

Notes: The numbers may not be fully comparable across the countries due to different definitions of debt. For some countries the data is based on a narrower concept of debt than general government debt (marketable debt; national, regional and local government debt).

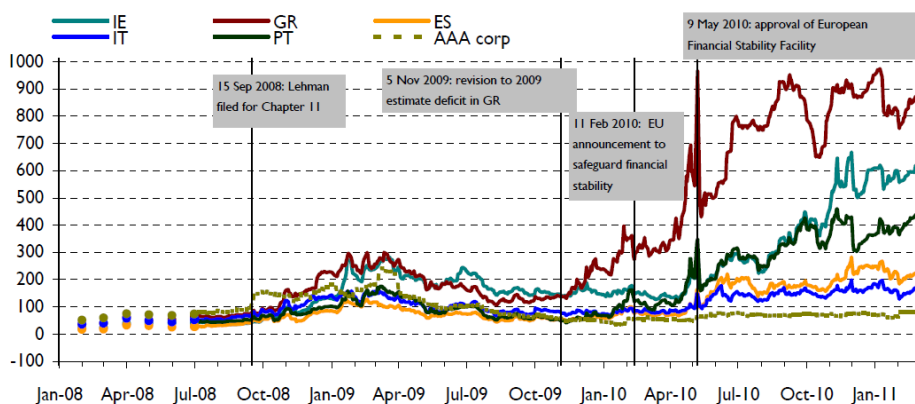
The relevance of strong and fast fiscal-financial links in the context of the financial crisis and the fiscal crisis as of spring/summer 2010 can be illustrated with a number of charts (see Chart II, panels a) to d)). Panel a) reports government bond spreads as compared to Germany for a set of euro area countries over the financial crisis. Spreads were rather limited until the autumn of 2008. They went up in the post-Lehman period clearly reflecting a sharper distinction between government borrowers. In fact, elasticities of spreads in relation to deficits and debt are estimated to have increased 8 to 12-fold in the post-Lehman period compared to before (Schuknecht et al., 2010). However, the reaction of spreads to imbalances appears to have increased further after the onset of the fiscal crisis. When Greece announced a deficit ratio of 12.5 per cent of GDP in October 2009, its government bond spreads started rising. In the following months and notably as of April 2010 a number of other countries' spreads started rising as well in tandem with those of Greece.

Not only did risk premiums in government bond markets increase considerably after Greece announced its huge fiscal imbalances, but trading in Greek debt also came to a virtual standstill rather suddenly in early May 2010 (Chart II, panel b)). While other countries avoided this type of 'sudden stop', some markets also became much more erratic and less liquid.

Chart II: Fiscal Financial Interlinkages

a) Spread of 10 year German government bond yield

(Jan 2008 – 28 Feb 2011, end-of-month until mid 2008, daily data thereafter; basis points)

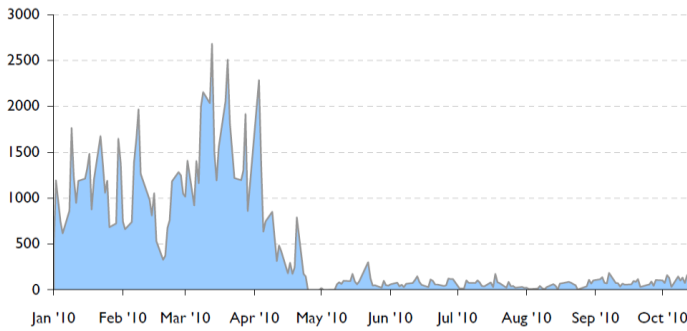


Sources: Bloomberg, Thomson Reuters Datastream and ECB calculations.

Notes: Bond yield spreads vis-à-vis the German 10 year government bond, end-of-the-month and end-of-day data (last value 28 Feb 2011) 17:00 CET; 28 Feb 2011, 19:00 CET for AAA corporate). Euro Area corporate AAA rated bond yields (maturity 7-10 years)

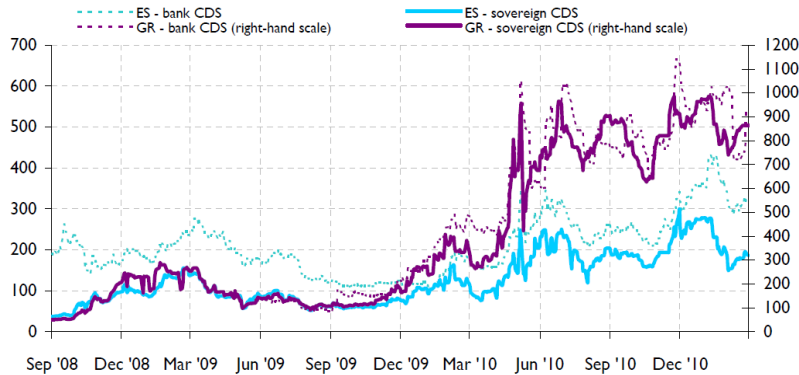
b) Trading volume in Greek government bonds

(1 Jan – 30 Nov 2010; daily data; EUR millions)



Source: Bank of Greece.
Note: Volumes traded on secondary market platform run by the Bank of Greece (HDAT).

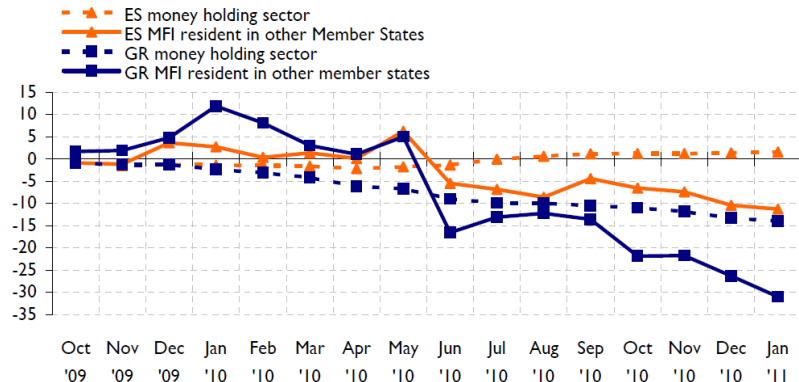
c) Sovereign and bank CDS spreads (1 Sept 2008 – 28 Feb 2011; basis points)



Sources: Bloomberg, Thomson Reuters Datastream and ECB calculations.
Notes: For each country the CDS spreads of the largest banks, for which CDS quotes were available, were used to calculate the average CDS spread of banks in that country.

d) MFI deposits held by money-holding sector and by MFI resident in other member states in Greece and Spain

(Oct 2009 – Jan 2011; cumulative percentage change; stock; seasonally adjusted)



Source: ECB (BSI statistics).
Notes: Growth rates at the end of the period; monthly data.

The severe adverse fiscal-financial linkages due to government solvency concerns and insufficiently ambitious fiscal policies can be illustrated further by the remaining two panels in Chart II. Panel c) shows credit default swap spreads in the Greek and Spanish banking systems. Before the end of 2009, Spanish credit default swaps (CDS) and government bond spreads were not particularly closely correlated (Greek data was not available). However, with the start of the fiscal crisis, bank CDS spreads moved very much in tandem with government CDS spreads. It is no secret that banks from these countries increasingly financed themselves through ECB operations as market access became more limited. Another risk from fiscal concerns is deposit outflows (panel d)) and tightening bank lending standards as customers withdraw support and banks have increasing funding difficulties.

Market behaviour might have been even more extreme than the picture which emerged had it not been for the combined efforts of European governments, the IMF and the ECB as well as the countries' own adjustment efforts. Although no certain conclusions can be drawn, it is likely that markets would have turned to the worse if international support had not been forthcoming and countries had not undertaken significant adjustment efforts. Inaction could well have resulted in damaging confidence in the real economy of the affected countries and, via contagion and contagion fears, also that of other countries.

All in all, fiscal-financial spillovers can be significant even in countries with seemingly less vulnerable positions that are willing to consolidate and that have the prospect of international financial support. Major pre-emptive fiscal adjustment can then become the best option if the alternative is bankruptcy or a very strong adjustment in the context of an international adjustment programme.⁴

It is also important that the 'core' countries that are able to serve as regional or global insurers maintain their safety margins and do not become a case for insurance themselves. Given that the transmission of a loss in confidence via fiscal-financial channels has been extremely strong and fast even for rather small countries, this argument is all the more important for 'core' countries so as to anchor expectations of stability at the country level and at the more systemic, international level. There is, therefore, a strong case for ambitious consolidation in all countries in a timely manner. At the same time, there is no doubt that a country with manageable imbalances can afford a more gradual adjustment path than a country with very large imbalances or even acute financing difficulties.

⁴ It would, however, be a misunderstanding of our argument to conclude that consolidation would quickly result in the resumption of strong growth. It is rather that the prospect of a gradual and moderate recovery is much better than the alternative of lower growth or even macroeconomic instability due to loss of confidence.

V What Principles Should Guide Consolidation?

The fiscal situation in the euro area and G7 countries with very high public debt levels, unsustainable debt trends and large and uncertain contingent liabilities is very serious. While, for most large countries so far, the overall financing of public debt has not been a problem, market participants have questioned the sustainability of debt in some countries. There is a strong case for significant consolidation in Europe and other advanced economies without delay. First, unsustainable public liabilities with their deleterious effects on long-term growth and confidence should be reduced. Even in the short term, the benefits of consolidation are likely to outweigh their costs, given the environment of strong, non-linear fiscal-financial interlinks. Consolidation is needed to underpin confidence in fiscal solvency at the country level and prevent adverse international externalities.

How to consolidate?

Two further important considerations for policy should be addressed. First, how should consolidation be undertaken, and how far should it go? To reap the full short-run and long-run benefits, consolidation should reflect a change of ‘regime’ away from discretionary and disjointed ad hoc policy decisions towards an ambitious, comprehensive and credible reform strategy based on a sound institutional framework.

In practice this means that both the plans announced and the immediate measures must convince economic agents that the (present and any future) government will succeed in improving fiscal sustainability, while strengthening the foundations for strong and balanced economic growth. This means that governments need to implement immediately plans to return to positive primary balances over the next few years. In the euro area and the EU, countries need to correct their excessive deficits above 3 per cent of GDP in accordance with their commitments and reach balanced budgets by 2016. This would imply high primary surpluses which would, in turn, help to achieve the necessary debt reduction.

The 60 per cent of GDP ratio set down as a ceiling for public debt by the Maastricht Treaty, remains a sensible figure for safe public debt ratios. Figures of 90 per cent now being floated are much too high given the vulnerability and sudden-stop-like experiences in the fiscal crisis. Moreover, contingent liabilities, including from the household and financial sectors, need to be accounted for and reduced immediately via ambitious social security and financial sector reform.

The evidence is that consolidation should generally be based on expenditure reduction. Reducing expenditure ratios at least to below the pre-crisis levels of about 45 per cent in the euro area economies is a first goal. Further expenditure

reductions could provide additional support to long-term growth via lower taxes and reduced distortions in the economy (Tanzi and Schuknecht, 2000).

The implementation of sizeable and well-targeted expenditure cuts early in the consolidation phase will have the effect of increasing confidence as they demonstrate the political resolve of governments. Medium-term reforms need to address future burdens, notably in the areas of pension and health care systems.

Moreover, fiscal reforms should be coupled with structural reforms in order to maximise the benefits for growth and sustainability. Both the labour and product market need to be flexible. Financial sector regulation should ensure sound incentives and early detection of emerging risks. The chances of successful and sustained consolidation can be increased by strengthening the institutional environment for fiscal policy-making at the national and the international level. In addition, central bank independence, the prohibition of monetary financing of government obligations and constraints on intergovernmental bailouts in Europe will play an important role: they are designed to reduce the incentives for profligate fiscal policies and should therefore be fully respected in order to prevent moral hazard.

The risks of ‘fiscal engineering’

The prevailing approach to macroeconomic policy-making by means of fiscal engineering is of questionable value. It seems to be based on the belief that economic recovery can be fine-tuned via fiscal policies.⁵ There is generally great uncertainty about the effect of fiscal policies on the economy and even the scale of public liabilities. The experiences of the fiscal crisis countries in 2010 show how little we know about sustainable debt ratios, and how strong and fast adverse market reactions can be. But while markets which ultimately punish unsustainable fiscal behaviour may not get it perfectly right, or react too late and too strongly, politicians may not get it right either. In such an environment of uncertainty and non-linearity similar to the environment for emerging markets in the past, fiscal engineering is a very risky approach.

The risks and costs of fiscal engineering with too little consolidation too late are exacerbated by two further factors. Policy makers may react to concerns about solvency and loss of confidence with macroeconomic stop-gap measures such as financial repression and interference with central banks (although for the euro area this possibility is excluded by law). This could, of course, mitigate risks to fiscal solvency in the short run, but at a high price in the long run. Moreover, there is a

⁵ In late 2010, for example, many expert and political opinions argued against fiscal consolidation and even advocated further stimulus in some countries in the belief that fiscal policies could engineer the recovery. There also appeared to be an unspoken belief that ‘a little’ inflation might help to eliminate the public (and private) debt overhang without any adverse fiscal-financial repercussions (even though investors would then take flight out of assets denominated in the inflationary currency).

serious risk of microeconomic policy errors such as trade protection, regulatory measures etc. It is now widely accepted that such policy errors further aggravated the great depression (e.g. Kindleberger, 1973; Smiley, 2002). Such errors, themselves likely to be consequences of fiscal-financial turmoil, would have major consequences for the financial sector and real economy, shift the supply curve inward and further undermine economic stability.

Finally, it is well known that fiscal policy is subject to a deficit bias. Politicians are all too willing to seize upon excuses that allow them to delay difficult decisions. In this environment, expert advice needs to be particularly prudent so as not to induce destabilising policies. If things go fundamentally wrong, the pressure on central banks to accommodate fiscal problems could increase enormously.

All in all, the uncertainty about a range of factors suggest a strong case for early and determined fiscal consolidation: the effects of fiscal policy on the economy; the strong and non-linear reaction of markets; the risk of a cascade of policy errors; and the incentives for short term-oriented fiscal policy making suggest a need for great caution in efforts to fine tune the economy via fiscal engineering.

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