Fiscal Consolidation

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• **Introduction**
  - The financial crisis has led to a severe deterioration of public finances in many countries.
    - Sharp falls in tax revenues.
    - Support for banks in some countries.
  - Several lessons:
    - Potential for fiscal tensions also among euro area economies.
    - Adhering to the Maastricht rules offered little protection.
  - Fiscal consolidation is now essential.
Deficits and debts

General Government Deficit (% GDP)

General Government Debt (% GDP)

Source: April 2012 Stability Programme Updates for IRL, PT, ES, IT.
IMF March 2012 Staff Report for GR.
EA based on weighted average SPUs excluding GR for 2012-2015
Underlying IRL deficit -9.4% in 2010 & -9.4% in 2011 excluding bank recaps

Note: GR IMF figures take account of the portion of €198bn PSI which is debt improving. Further GR GGD reduction offset by bank recap (€50bn) and other outlays.
PT figures do not include impact of 3.9% GDP bank recap.
ES figures do not include impact of €100bn (9.4% GDP) bank recap.
Estimated using SPU inputs based on standardised EC structural balance methodology. No SB figures publicly available for GR. EA weighted average excluding GR.

Further Consolidation needed in 2015 to support these paths.
Revenue and expenditure ratios

**GG Revenue ratio as % GDP**

**GG Expenditure ratio as % GDP**

*Source: April 2012 SPU for IRL, PT, ES, IT. IMF March 2012 Staff Report for GR. EA average 2012-15 based on weighted average of SPU submissions and excludes GR.*
• **Effectiveness**
  – Monetary policy is important:
    • Is there room to cut interest rates?
  – Fiscal consolidation works by depreciating exchange rate and stimulating exports.
    • How open is the economy? Is the exchange rate fixed or floating? Are trading partner undergoing consolidation?
  – Might be captured by:
    • Whether fiscal targets are reached.
    • Improvements in the structural balance.
    • Evolution of debt-to-GDP ratio.
Consolidation and the achievement of fiscal targets

Structural Deficit as % GDP

- 2011
- 2012
- 2013
- 2014
- 2015

Medium Term Objective

Consolidation effort outlined to date 2011-14

- IE
- PT
- ES

Change in Structural Primary Balance 2011-14

• Consolidation measures outlined relative to structural improvement achieved over 2011-2014 high in IE and PT, but low in ES

Source: Stability Programme Updates (April 2012) approved by European Commission.
No data on structural balance publicly available for GR.
Debt-to-GDP ratio

- Debt/GDP ratio depends on:
  - Primary deficit, including bank support.
  - Other factors that change D/GDP (independently of deficit).
  - The wedge between the interest rate and GDP growth, \( r - g \).

- Essential to return to growth:
  - Domestic fiscal policy.
  - Uncertainty about future policy and economic conditions.
  - Economic activity abroad.
Sources of debt dynamics

IRELAND

PORTUGAL

Source: Calculated using inputs from respective April 2012 SPUs. GR figures use March 2012 IMF Staff Report assumptions. PT figures exclude 3.9% bank support announced June 6th.
Sources of debt dynamics

Source: Calculated using inputs from April 2012 SPU submission to European Commission
• **Expenditure vs. revenues**
  – Expenditure-focused consolidations appear more successful in reducing deficits (IMF 2010).
    • Associated with lower short- and long-term interest rates and weaker exchange rate.
    • Tax increases raise inflation, leading CBs to tighten policy.
    • These effects are temporary.

  – Current consolidation programs across the EU generally balanced slightly in favour of expenditures.
Expenditure vs. revenues

Planned consolidation 2012-2014 as % GDP

Expenditure-based measures 2011-2014 as % GDP

Revenue-based measures 2011-2014 as % GDP

Based on publically announced/formally legislated measures. Amounts lower than SPU in case of ES (by 1.5% GDP in 2012 and 1.6% GDP in 2013).
GR figures include MTFS measures, Budget 2012 and February 2012 Supplementary Budget. These amounts exclude the ~7% GDP in additional measures the IMF deem necessary for GR to meet its 2014 SB target of +4.5% GDP.
• **Timing**
  – All else equal, gradual structural adjustment desirable.
  – In practice, good reasons to front-load consolidation.
    • Markets worry about “consolidation fatigue” and that fiscal plans will not be implemented and demand a risk premium.
    • A delay means that public debts will rise more and for longer than otherwise, also raising the risk premium.
    • Lower interest rates reduces debt servicing costs, supports economic growth and makes success more likely.
Timing of Consolidation

Consolidation Efforts to end-2014 (% GDP) (Year commenced)

- ES (2010)
- PT (2009)
- GR (2010)
- IRL (2008)

Source: 2011-14 based on detailed/formally legislated measures as % SPU nominal GDP. Less consolidation assumed relative to SPU in case of ES (1.5% GDP in 2012 and 1.6% GDP in 2013). GR amounts based on measures in MTF, Budget 2012 and February 2012 Supplementary Budget. They exclude further measures expected to be announced in June 2012 to support primary balance target of +4.5% GDP by 2014. IMF (March 2012 Report) estimates this will require further 7% GDP in measures.
• **Summary**
  
  – Fiscal consolidation essential for restoring sound public finances.
  
  – To stabilise and reduce debt-to-GDP ratios, a return to growth is crucial.
    
    • Calibrate the timing and composition of consolidation efforts.
    
    • Efforts to raise confidence by removing uncertainty.