Fiscal consolidations: comments

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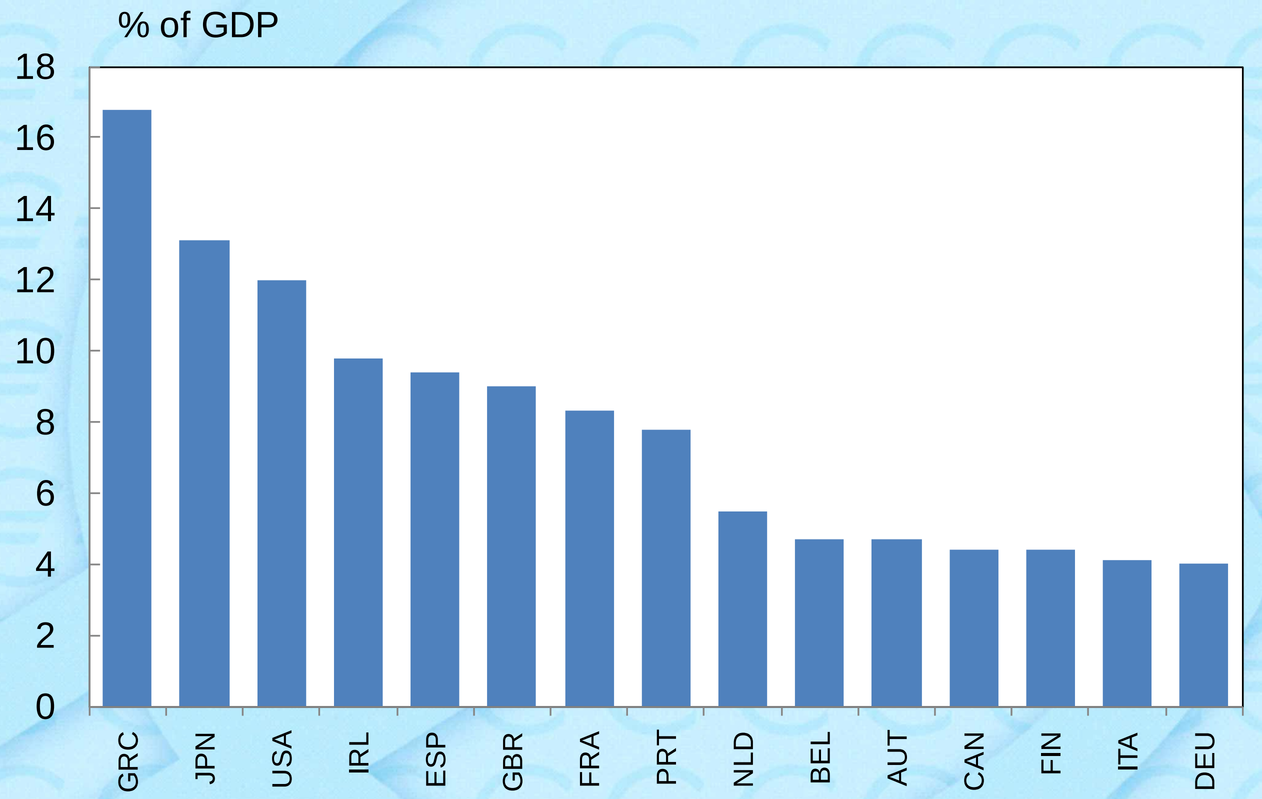
Introduction

- ♦ Current public debt concerns are a third stage in the global financial crisis.
  - banking crisis,
  - recession and
  - public debt crisis.
- ♦ Public debt crises require two main corrections.
  - – Improvement in primary public balances.
  - – Resumption of economic growth.
- ♦ Current estimates of required corrections to public balances are large.

Required fiscal adjustment between 2010 and 2020*



* The adjustment needed to stabilize debt at the end-2012 level by 2030 if the respective debt-to-GDP ratio is less than 60 percent or to bring the debt ratio to 60 percent in 2030.
Source: IMF.

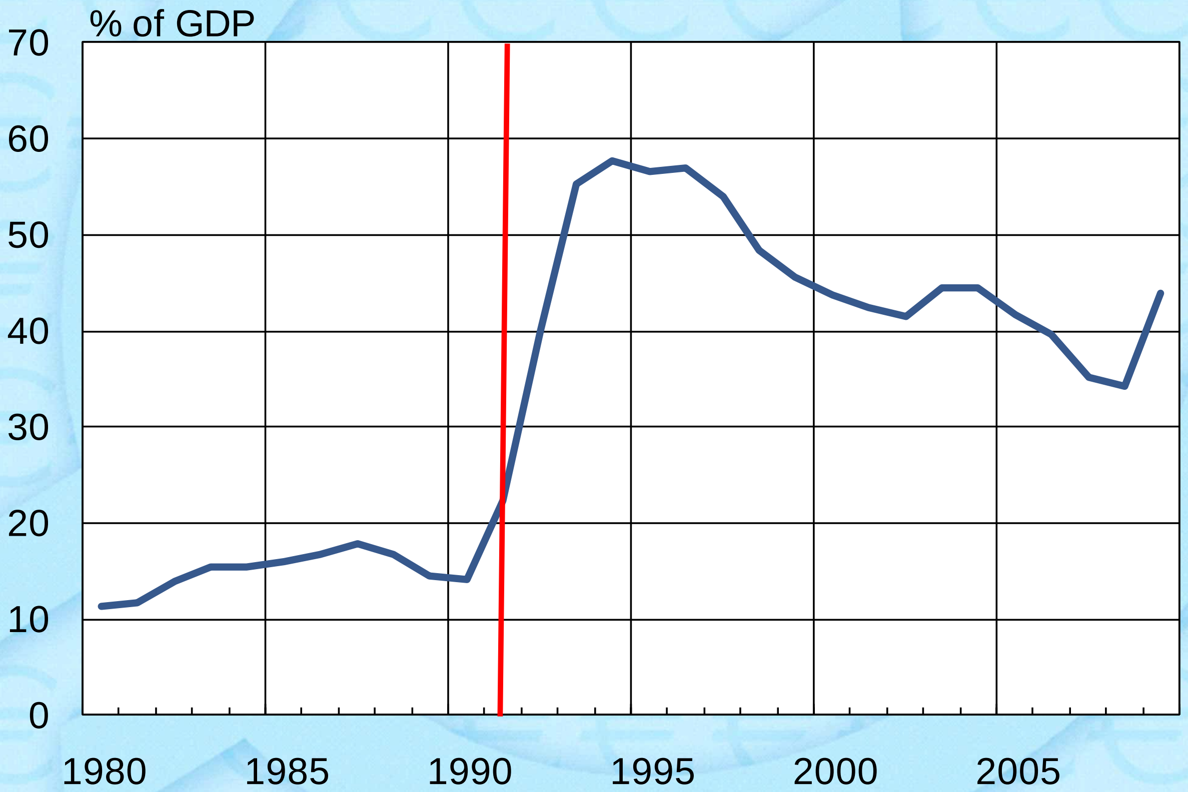
Effects of fiscal consolidations

- ♦ Usually reduced economic growth in the short run; smaller costs e.g. when
  - – Consolidation is large and persistent
  - – Fiscal multipliers are small
- ♦ Usually positive long-run effects; better success if
  - – Main focus on expenditures, with no cuts on productive spending
  - – Initial conditions
    - • Large government
    - • Unsustainable debt-to-GDP ratio
- ♦ Possible Non-Keynesian effects
  - – Key mechanism: improved perceptions about future
  - – Lower probability of a ”mess” in an unsustainable situation

Public debt dynamics after a financial crisis

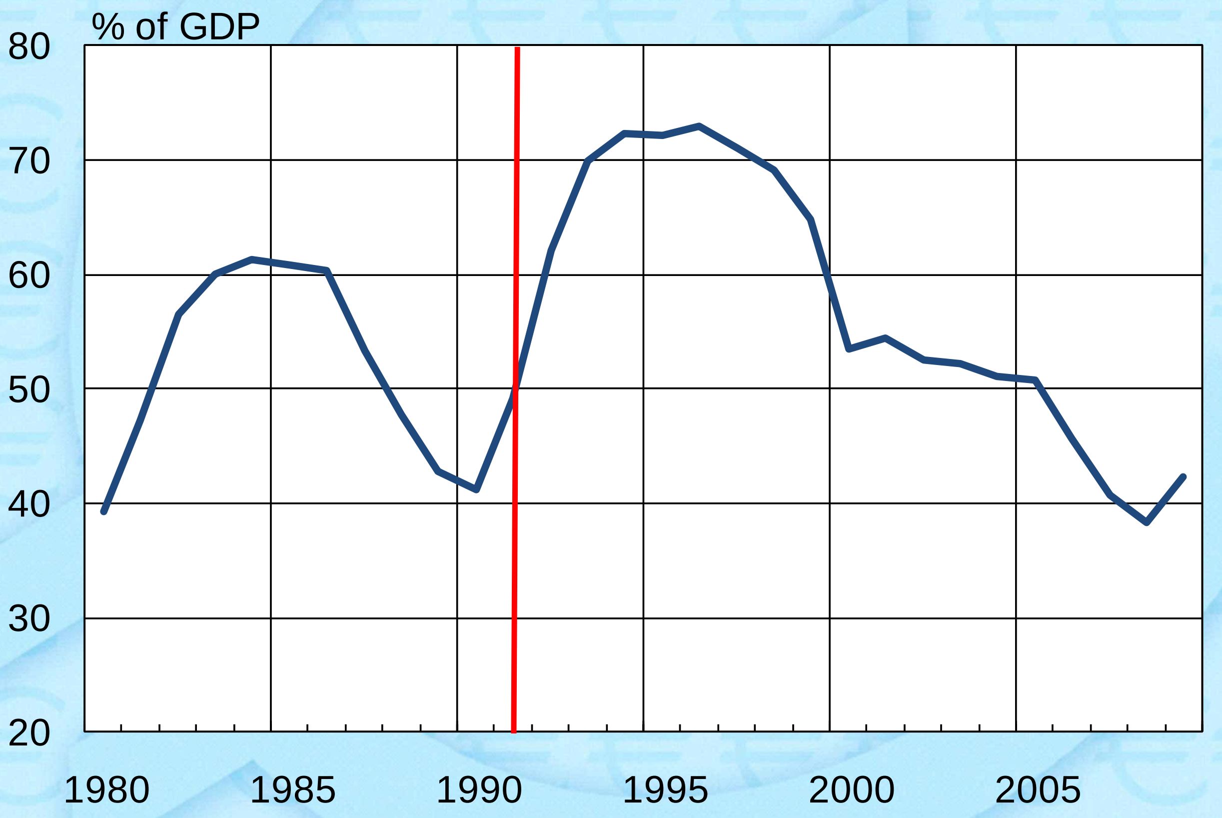
- Consolidation takes several years.
  - Examples: Finland 1991, Sweden 1991, Mexico 1994
- Not all countries reduced debt after a financial crises
  - Examples: Korea 1997, Spain 1977
- Public debt crisis is necessarily a part of financial crisis.
  - Example: Malesia 1997

General government gross debt of Finland 1980–2009



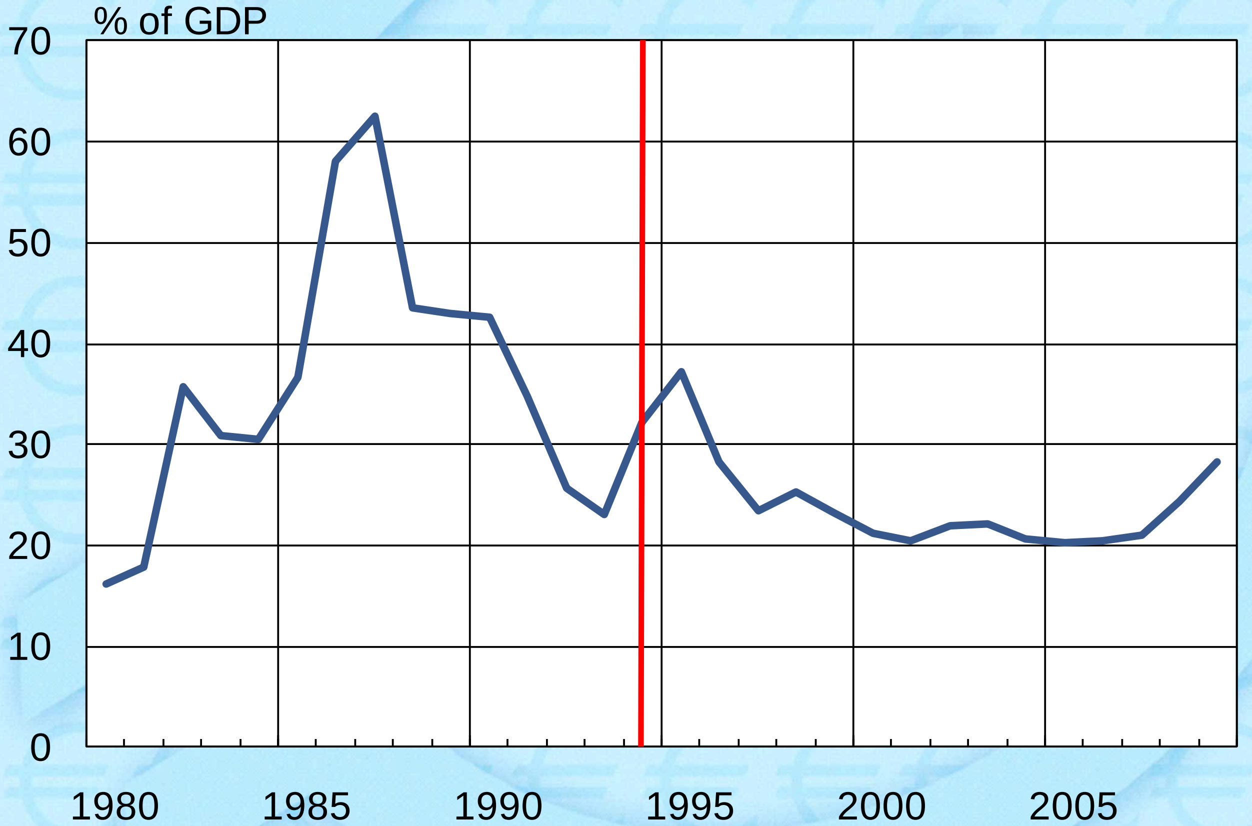
Source: Statistics Finland.

General government gross debt of Sweden 1980–2009



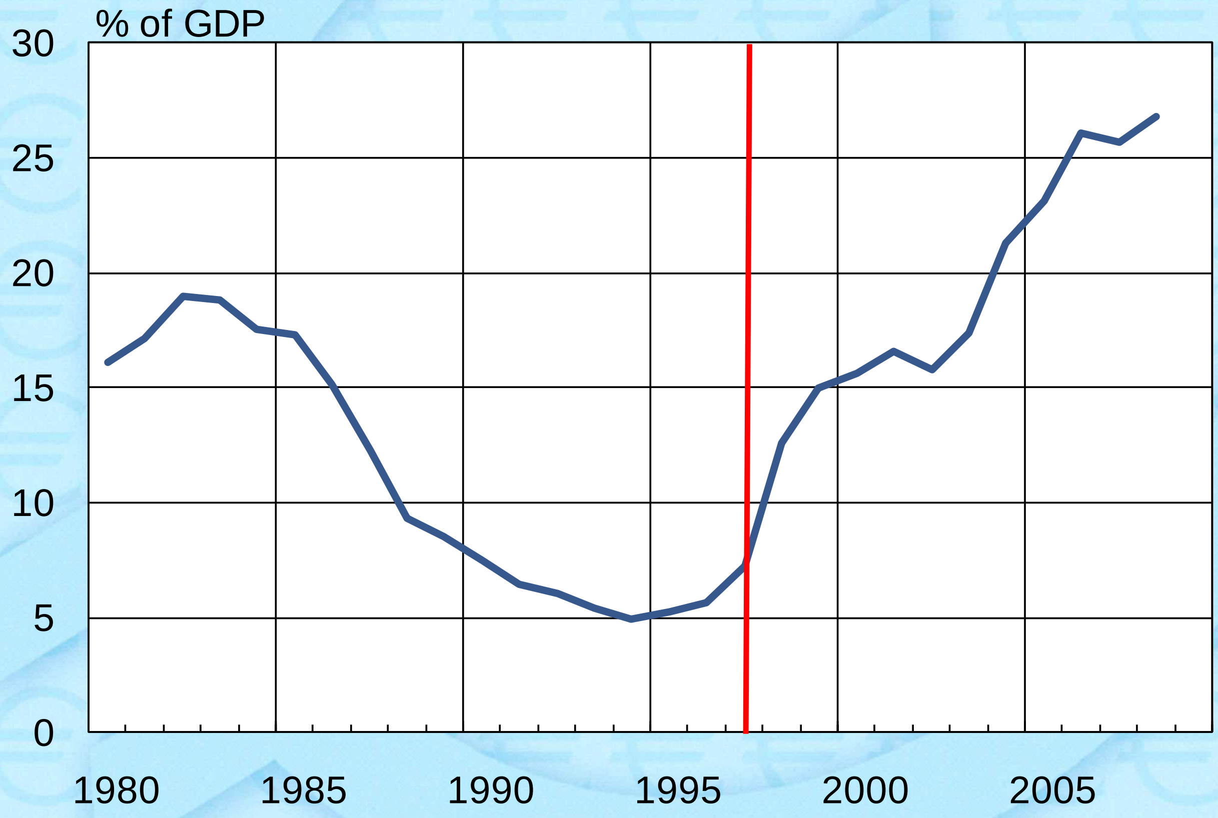
Source: European Commission.

Total central government debt of Mexico 1980–2009



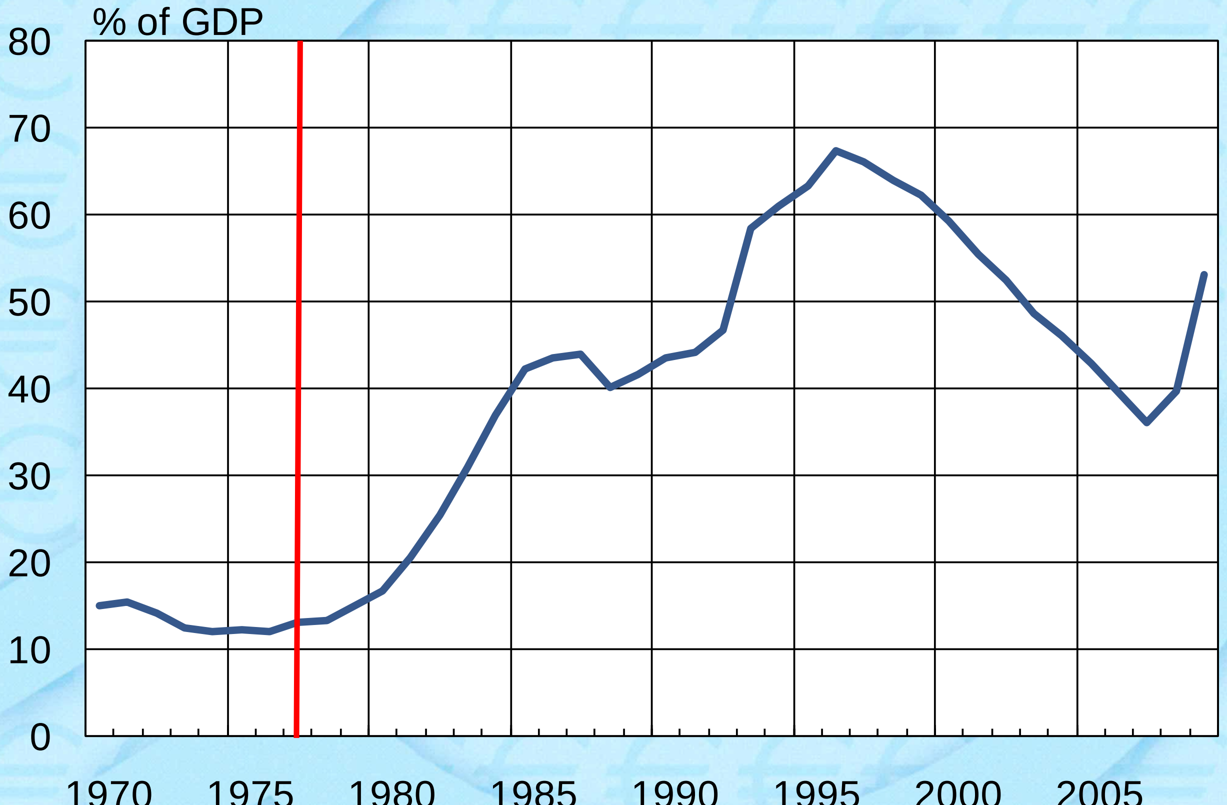
Source: OECD.

General government gross financial liabilities of Korea 1980–2008



Source: OECD.

General government gross debt of Spain 1970–2009



Source: European Commission.

Challenges

- Carrying out a fiscal consolidation is **inherently slow** and full of **uncertainties** that trouble the markets.
  - Uncertainty about future fiscal and monetary policy.
  - Uncertainty about future economic growth.
- Anchor expectations about future fiscal developments
  - Clear multi-year program to improve credibility
  - Substantial consolidation, possibly front-loaded
- Avoid disappointments during the consolidation
  - set somewhat conservative goals

- Develop better fiscal institutions
  - Centralized key policy-making
  - Multi-year expenditure ceilings
  - This is the current challenge for EU and Euro area

- Structure of consolidation
  - Focus on items with small or even negative fiscal multipliers (briefly noted earlier)

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Thank you