

Turning the page? EU fiscal consolidation in the wake of the crisis

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Abstract

The fiscal cost of the financial and economic crisis in Europe is huge. The paper provides provisional estimates of this cost and looks at its implications for the sustainability of public finances, taking into account also the impact of aging populations. The historical experience suggests that economic growth is persistently lowered in the aftermath of financial crisis, making fiscal consolidation more difficult yet all the more essential. Meanwhile the timing of the exit from fiscal stimulus and subsequent fiscal consolidation must reconcile sustainability and stabilisation goals – a delicate balancing act. The paper will argue in favour of structural reform to boost the economic growth potential alongside fiscal consolidation. The fiscal coordination framework in the EU, together with the Europe 2020 strategy, is seen to underpin this approach.

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"There is no doubt that the crisis will leave us a heritage of severe macroeconomic imbalances. Dealing with them will represent one of the most daunting challenges for policymakers in modern history."

Jürgen Stark, Financial Times, 16 April 2010

1. Introduction

The financial crisis compelled many EU countries to rescue their financial institutions and the ensuing Great Recession prompted them to embark on major fiscal stimulus in addition to substantial fiscal shortfalls. Not surprisingly, the fiscal situation of EU countries has deteriorated dramatically. Action to design and implement "exits" from fiscal stimulus and accommodation is imperative, and this adds to the fiscal consolidation effort that is needed anyhow to finance the increases in ageing related public expenditure in the medium to long run. A major complication is that the crisis is found to weigh on potential growth in the decade ahead, which erodes the ability for government to raise revenues and halt the public debt snowball, unless decisive action to boost the output potential of EU economies is taken. Therefore, the EU's recent "Europe 2020" initiative to achieve "smart, sustainable and inclusive" growth¹ and the fiscal exit strategy should be seen as necessary complements.

This fiscal challenge is not unique to the EU, as the United States and other developed economies face similar ones. However, what is unique to the EU is that it comprises 27 sovereign states whose economies have strongly integrated over the past decade – not least since the majority of them share a single currency. A Member State that starts fiscal exit too early enjoys a first mover advantage in terms of better competitiveness and a lower risk premium, while the demand contraction spills over to other countries via the trade channel – which will thus face tougher conditions to tackle their own fiscal situation. Conversely, a country that consolidates too little or too late risks making its public finances unsustainable, and this may spill over to its peers via bond markets and the confidence channel – the recent Greek predicament serving as a strong reminder. Hence failure to deal with the fiscal challenge appropriately in any Member State can have pervasive cross-border spillover effects, which provides a strong rationale for a coordinated the fiscal exit.

¹ European Council Conclusions, Brussels, 26 March 2010.

Against this backdrop, the next section of this paper takes stock of the fiscal situation in the EU in the wake of the crisis. This is followed by a discussion of the medium- to long-term fiscal consolidation requirement as estimated in the Commission's Sustainability Report released in the autumn of 2009 (European Commission 2009a). Subsequently, the two are put together to gauge the size of the fiscal consolidation task at hand and compares this to the fiscal consolidation efforts enshrined in the ongoing Excessive Deficit Procedures agreed by the European Council for a major subset of EU Member States. The before-last section discusses some ongoing developments in the EU fiscal surveillance and coordination framework and the final section concludes.

2. The fiscal cost of the crisis

The financial crisis led to large increases in public debt and contingent liabilities related to financial rescues, which represents the direct fiscal cost of the crisis. Moreover, the improvement of fiscal positions prior to the crisis proved largely ephemeral, being associated with growth of tax rich activity in housing, construction markets and financial markets. The unwinding of these windfalls, along with the fiscal stimulus adopted by EU governments as part of the EU strategy for coordinated action, is the indirect fiscal cost of the crisis. This section provides estimates of both the direct and indirect fiscal costs.

2.1. The direct fiscal cost

After the demise of Lehman in September 2008 many EU countries scrambled to rescue their systemically important financial institutions. This had potentially large cross-border spillover effects, quickly revealing the need for a coordinated EU strategy. This prompted Member State governments, together with the Commission, to spell out the principles and objectives of financial rescues. Rescue packages for national banking sectors were rapidly set up in line with the guidance provided by the Commission on the design and implementation of State aid in favour of banks. The rationale of this guidance was to ensure that the rescue measures attained the objectives of financial stability and maintenance of credit flows, while minimising competition distortions and negative cross-border spillovers of public interventions.

By late 2009 the Commission had approved a total of over 3½ trillion (31.4% of GDP) of State aid measures to financial institutions. EUR 1½ trillion (12.7% of GDP) were effectively used under the four main headings of debt guarantees, recapitalisation, liquidity support, and

treatment of impaired assets (see Table 1). State guarantees on bank liabilities represent the largest budgetary commitment among the aid instruments, with EUR 2.9 trillion (24.7% of EU GDP) of approved measures, out of which EUR 1 trillion (7.9% of GDP) have been effectively granted. EUR 300 billion of state recapitalisations were approved (2.7 % of EU GDP), out of which EUR 170 billion (1.7 % of EU GDP) was effective. Provided either as part of a national scheme or through recapitalisation of individual banks on an ad-hoc basis, state capital took the form typically of ordinary or of preferential shares. In case of recapitalisation by preferential shares, the State aid rules determined the level of pricing, including step ups in order to incentivise the banks to redeem State capital when market conditions permit.

As Table 1 indicates there are considerable differences in terms of the size of the financial support programmes among Member States. At almost double its GDP, Ireland has committed by far the most resources to bank rescues. There is a second league of countries which includes the United Kingdom, Belgium and the Netherlands with effective support so far in the range of 20 to 30% of GDP, and a third group with effective support of around 10% of GDP (Austria, Germany and Sweden). These differences reflect the relative size of their banking sectors (United Kingdom, Ireland), the exposure to impaired assets originating in the United States (United Kingdom, Germany), the exposure to a collapse of local real estate markets (United Kingdom, Ireland, Spain, Denmark) and the exposure to emerging economies in Central and Eastern Europe (Sweden, Finland, Austria, Greece, Belgium, Netherlands).

(Table 1)

The overall figures of the committed funds can be used to gauge a range estimate for the total direct fiscal costs of the crisis. In a favourable scenario, a large part of the fiscal commitments may either be recovered or may not materialise (in the case of guarantees) (Table 2). In a more adverse scenario, however, these costs could easily add up to about 13 % of GDP. This estimated upper bound for the costs of the current crisis is derived by assuming that capital injections would double from the currently approved 2.7% GDP, while applying to other public bank interventions (including guarantees) the lower end of the range of recovery rates in past crises. This estimate of 13% is well in line with the average of past financial crisis and looks therefore realistic (see Table 3 for an overview of net and gross direct outlays of past financial crises). But in individual Member States the direct fiscal costs may of course be much higher than this average.

(Table 2)

(Table 3)

2.2. The indirect fiscal cost

Aside from this direct fiscal cost of the crisis, there is an indirect cost. This comprises the deterioration in the fiscal position induced by the decline in economic activity and increasing debt service cost, along with the impact of discretionary fiscal action in support of the real economy.

It is possible to track the current developments in budget deficits in the EU against previous banking and financial crisis episodes. According to Figure 1, the deterioration of fiscal positions in the EU is comparable to earlier financial crisis episodes, with the fiscal deficit on average estimated to have increased from less than -0.8% (0.6% in the euro area) of GDP in 2007 to 6.8 % (6.3% in the euro area) of GDP in 2009 and 7.2 % (6.6% in the euro area) of GDP by 2010. Indeed, the deterioration in the fiscal deficit as a share of GDP averaged about 7 percentage points for the major financial crises in the early-1990s in Finland, Norway, Sweden, Spain and Japan.

(Figure 1)

The distribution of the increases in fiscal deficits, however, is rather uneven, even though fiscal positions have deteriorated virtually everywhere in the EU (Figure 2). By far the sharpest (projected) deficit increases – rising to two-digit levels as a percent of GDP – occurred in Greece, Latvia, the United Kingdom, Ireland and Spain. It is no coincidence that these countries' fiscal positions have been disproportionately hit, given that some of the mechanisms that shaped the crisis were particularly prevalent there. The United Kingdom and Ireland are important financial centres and all five countries have seen major housing and consumption booms. Credit growth and soaring asset prices, in particular of housing, have tended to buoy government revenues during the boom with large shortfalls in the subsequent slump. Figures 3 and 4 illustrate the link between fiscal shortfalls and housing and suggest that countries which had comparatively large construction sectors and/or elevated real house prices in 2007 also registered the most rapid deterioration in their fiscal positions.²

² The mnemonics used in these and subsequent figures are: BE = Belgium, BG = Bulgaria, CZ = Czech Republic, DK = Denmark, DE = Germany, IE = Ireland, EE = Estonia, EL = Greece, ES = Spain, FR = France, IT = Italy, CY = Cyprus, LV = Latvia, LT = Lithuania, LU = Luxembourg, HU = Hungary, MT = Malta, , NL = Netherlands, AT = Austria, PL =

(Figures 2, 3 and 4)

A more formal analysis of the relationship between asset price and associated developments and fiscal outcomes is reported in European Commission (2009b). It distinguishes between a direct channel (transaction taxes and tax revenues stemming from construction activity) and an indirect channel that runs through the wealth and collateral effects on consumption and investment. It suggests that tax revenues grew strongly in response to the asset boom, although its impact on the fiscal position was muted since expenditure adjusted upward as well. In the downturn, revenues responded equally heftily, in the opposite direction, but this was not offset by adjustments in expenditure, which explains the sharp deterioration in fiscal positions. Regression analysis in the report shows that the main determinants of the revenue windfalls (or shortfalls) reside in growth surprises (i.e. errors in growth projections). But after controlling for growth surprises, house price developments explain a significant share of the temporary windfalls in Ireland, Spain and the United Kingdom. Deteriorating trade balances associated with rapid growth in imports and weak exports in the run up to the crisis were also found to have yielded temporary tax windfalls in several countries, reflecting that imports are part of the VAT tax base whereas exports are not. Both internal and external imbalances thus exacerbated the cyclical swings in the fiscal balance.³

It would be wrong to attribute the entire increase in fiscal deficits since the onset of the crisis to the shrinking demand for housing, higher cost of unemployment insurance or other 'automatic stabilisers'. Some of the run up in fiscal deficits has been the result of discretionary action. Specifically, governments adopted fiscal stimulus measures under the aegis of the European Economic Recovery Plan (EERP). The coordinated fiscal stimulus was motivated by the need to stabilise the economy. Monetary policy had been eased substantially, with official interest rates near the zero-rate bound. With the room for interest rate cuts thus practically exhausted, fiscal stimulus can be very effective as it will help prevent deflation and thus lower the real rate of interest. Fiscal policy is thus most effective when it is most needed, although the fiscal multipliers tend to be lower if the fiscal expansion is not perceived as temporary as private agents will respond adversely an expected increase in public debt (see Roeger and In 't Veld 2009).

Poland, PT = Portugal, RO = Romania, SI = Slovenia, SK = Slovak Republic, FI = Finland, SE = Sweden and UK = United Kingdom.

³ In fact, here is evidence that real estate bubbles and trade deficits are to some extent two sides of one coin, with the former absorbing labour and capital resources that would otherwise be available for export activities, see e.g. Balázs and Kierzenkowski (2010).

The fiscal stimulus under the EERP was initially estimated to amount to some 2% of GDP on average in the EU for the period 2009-2010, including EUR 20 billion (0.3 % of EU GDP) through loans funded by the European Investment Bank. More recent estimates point to an even stronger impulse. The packages rely both on revenue and expenditure measures (each contributing roughly half), including spending on public investment (about one quarter of the total stimulus), and were mostly temporary and targeted on the sectors most affected by the crisis (car scrapping schemes being a prominent example). The stimulus measures were estimated to contribute about $\frac{3}{4}$ of a percentage point to real GDP growth in 2009 and to contribute about $\frac{1}{3}$ of a percentage point in 2010. The dispersion of package sizes has been considerable though (Figure 5). For 2009 by far the largest fiscal stimulus package (in comparison to its GDP) was adopted by Spain, followed by Austria and the United Kingdom. For 2010 Germany and Poland stand out by their comparatively large fiscal stimulus packages.

(Figures 5, 6 and 7)

It is important that the distribution of package sizes is appropriately mapped onto the distribution of countries' needs and their 'fiscal space' (i.e. their ability to temporarily run fiscal deficits without jeopardising the sustainability of their public finances or their external positions). The analysis in Figure 6 suggests that, in most cases, Member States whose negative output gap (i.e. their degree of economic slack) was perceived to be largest, were also those that pursued the strongest fiscal stimulus – and vice versa. Figure 7 suggests that overall the amount of stimulus is also positively correlated with the fiscal space of Member States, although there are again exceptions.⁴ The exceptions include several emerging economies in Eastern Europe, some of which have seen their fiscal room for manoeuvre restrained due to EU balance of payments assistance provided together with the IMF and the World Bank (see below). This finding is important because it would be appropriate for Member States with a large 'fiscal space' to bear a larger share of the burden of fiscal stimulus

⁴ The fiscal space indicator used in Figure 7 comprises five elements: the initial public debt, the contingent liabilities vis-à-vis the financial sector, the expected revenue shortfalls stemming from the unwinding of the real estate and construction boom, the current account position and the share of discretionary (as opposed to entitlement) expenditure in the government budget (see for further explanation European Commission 2009b and 2009c). It should be underscored that the indicator is an imperfect gauge of fiscal space and for illustrative purposes only.

under the EERP and, conversely for countries with a more limited fiscal space to provide less fiscal stimulus.

2.3. Developments in public indebtedness

An issue of major concern is that public indebtedness is on an upward slope. This is the case not only because governments have implemented capital injections in distressed banks and granted guarantees that are debt financed (the latter only if and once guarantees are exercised) -- and yet do not show up in the budget balance since they do not entail public expenditure on goods and services in a national accounting sense -- but also because fiscal deficits are rapidly increasing. As indicated in Figure 8, the expected increase in public debt – about 20% of GDP from end 2007 to end 2010 – is typical for a financial crisis episode by historical standards. However, the jumping-off point is considerably higher (by up to 30 percentage points) this time than in previous financial crises. Moreover, the ongoing debt run-up coincides with the onset of the ageing bulge in public (health, pension) expenditure.

As depicted in Figure 9, the largest increases in public debt are indeed projected for those Member States which also record the sharpest increases in fiscal deficits, i.e. the United Kingdom, Spain, Ireland and Latvia. However, owing to their more favourable starting points, these are not the Member States that are projected to post the highest rate of public indebtedness, which remain the 'usual suspects' Italy, Belgium and Greece. Tentative projections point to a further increase of government indebtedness to a level of around 125% of GDP by 2020 on average in the EU under an unchanged-policy assumption. A sharp deterioration of the sustainability of public finances can thus be expected even before the budgetary cost of ageing is taken into account. These prospects thus call for a substantial adjustment in the years ahead.

(Figures 8 and 9)

3. Sustainability concerns

Financial market assessments of sovereign risk have been changing rapidly recently, which is partly a reflection of the concerns that exist over the sustainability of the public finances in the longer run alongside short-run liquidity concerns in some cases (Greece in particular). The most recent issue of the Commission's periodical Sustainability Report (European Commission 2009a) disentangles the various determinants of sustainability, in particular: (i) the impact of the starting position of public debt and deficits on the debt snowball; and (ii)

additional effects of ageing and the associated increase in age-related public expenditure and slower potential growth. This section will review its findings, preceded by a short discussion of the methodology.

3.1 Methodological issues

The European Commission (2006) has developed a fiscal indicator that has been used to assess the sustainability of public finances in the European Union, most recently in the 2009 Sustainability Report (European Commission 2009a). The maths is relatively straightforward, but inspecting it more closely is helpful for a deeper understanding of the indicator.

The methodology builds on the government's intertemporal budget constraint, which can be represented in a stylised form as follows:

$$(1) \quad -PB_t + i_t D_{t-1} = \Delta D_t$$

where t is the time index, PB is the primary balance (fiscal balance excluding debt-interest payments), D is public debt, i is the nominal interest rate and Δ is the difference operator. This can be reformulated in terms of ratios to GDP:

$$(2) \quad -pb_t + r_t d_{t-1} = \Delta d_t$$

where lower-case characters denote ratios to GDP while r is the real interest rate relative to the real growth rate of the economy (g) defined as:

$$(3) \quad 1 + r_t = \frac{1 + i_t}{(1 + g_t)(1 + \pi_t)}$$

where π_t is the inflation rate. Solving the difference equation (2), under the simplifying assumption that r is constant, yields a relationship between the initial debt ratio and the debt ratio at infinity, conditional on the future development of the primary balance and the interest-growth rate differential⁵:

$$(4) \quad d_{t-1} = \sum_{j=0}^{\infty} \left[\frac{1}{1+r} \right]^{j+1} pb_{t+j} + \lim_{j \rightarrow \infty} \left[\frac{1}{1+r} \right]^{j+1} d_{t+j}$$

⁵ Assuming a time-variant r does not change the results fundamentally, but makes the maths a lot more unpleasant. The actual indicator used by the European Commission (2006, 2009a) does assume a time-variant r to reflect variations in the growth rate of the economy g , whereas the interest rate i is held constant.

Sustainability requires that the present value of future debt approaches zero at infinity, *i.e.* debt cannot grow at a rate faster than the rate of interest – if it did debt would be explosive and no investors would be willing to buy government bonds at the going interest rate. This is the transversality condition to rule out a Ponzi game, and to satisfy it, the last term of equation (4) must be zero. This yields:

$$(5) \quad d_{t-1} = \sum_{j=0}^{\infty} \left[\frac{1}{1+r} \right]^{j+1} pb_{t+j}^*$$

where pb^* is the *sustainable* primary balance, which can differ from the *projected* primary balance under unchanged policies pb . We define the sustainability gap S as the difference between the two:

$$(6) \quad pb_{t+j}^* = pb_{t+j} + S_t$$

Substituting this identity in equation (5) and solving for the sustainability gap S yields the following expression:

$$(7) \quad S_t = \underbrace{rd_{t-1} - pb_{t-1}}_{IBP} - \underbrace{r \sum_{j=0}^{\infty} \left[\frac{1}{1+r} \right]^{j+1} (pb_{t+j} - pb_{t-1})}_{LTC}$$

This shows that the sustainability gap S can be thought of as consisting of two components. The first component, labelled *IBP* (initial budgetary position), corresponds to the necessary once-and-for-all increase in the structural primary balance to offset the debt build-up that would result if the initial structural primary balance was maintained in the future. The smaller, or the more negative, this initial structural primary position (or the higher the initial debt ratio), the larger will be the sustainability gap. The second component, labelled *LTC* (long-term change) corresponds to the necessary once-and-for-all increase in the structural primary balance to offset any debt build-up associated with a fall in the structural primary balance due to a future increase in age-related expenditure. The stronger this increase in age-related expenditure, the larger will be the sustainability gap. Putting the two together, one obtains the required increase in the structural primary balance on the account of, both, the initial budgetary position and its future deterioration due to ageing. The Commission's methodology also uses an additional measure, in which debt is constrained to be at most 60% of GDP at some pre-set point in time in line with the Maastricht criteria. This is called the S_1 indicator, as opposed to the S_2 indicator on which we focus here. The transversality condition on which the S_2 indicator is based is objective whereas the debt criterion on which the S_1 indicator is

based is normative. Numerically the differences between the two indicators can be significant, but they generally point in the same direction.

3.2 Measuring the sustainability gap

Figure 10 shows the initial structural balance as a per cent of potential GDP (in 2009) as reported in European Commission (2009a) along with the projected change in ageing-related expenditure between 2010 and 2060. Importantly, the structural balance positions shown in this table have been revised since the Sustainability Report was published and the possible implications of this are discussed in the next section. For now we stick to the 2009 Sustainability Report. The Report defines ageing-related expenditure to include public spending on pensions, healthcare and long-term care, netted against projected declines in education expenditure and unemployment benefit payments. The computations are based on the assumption that the old age dependency ratio will increase from 25% in 2007 to 54% in 2060 in the EU as a whole (with considerable variation across Member States). In addition, potential growth is projected, due to ageing, to fall from 2.4% in 2007-2020 to 1.3% over 2041-2060, with again considerable variation across Member States. Finally, the real interest rate is assumed to be fixed at 3%.

(Figures 10 and 11)

The S_2 indicator reported in Figure 11 shows a sustainability gap of 6.5% of GDP for the EU as a whole (5.8% for the euro area), meaning that for public finances to be sustainable, the structural primary surplus would need to be increased from its estimated 2009 level by an amount of 6.5% (5.8%) of GDP once and for all. This would be a consolidation which is not without historical precedent for some individual countries, but it clearly would be for the EU as a whole. The largest sustainability gaps, of more than 8% of GDP, are found for Ireland, Greece, Luxembourg, the United Kingdom, Slovenia, Spain, Latvia, Romania and Cyprus. An adjustment in the range of 4 to 8 percentage points would be required in Slovakia, Czech Republic, Malta, Lithuania, Netherlands, Portugal, France, Belgium, Austria, Germany and Finland. Smaller adjustments or no adjustment at all would be required in Poland, Sweden, Italy, Estonia, Bulgaria, Hungary and Denmark.

According to Figure 11, the composition of the S_2 indicator, in terms of the respective contributions of the initial budgetary position (*IBP*) and the impact of the long term change in ageing-related expenditure (*LTC*), appears to be rather diverse. Figure 12 looks more directly

at the distribution of this composition across countries. In the countries above the dashed diagonal line the sustainability gap is dominated by the projected increase in ageing-related expenditure whereas the initial budgetary position is the more predominant cause in countries below the dashed line. It turns out that the large sustainability gaps of Slovenia, Greece and Luxembourg are mostly due to the strong impact of growth in ageing-related expenditure. By contrast, the very large sustainability gaps of Ireland, the UK, Latvia and Spain are more dominated by their relatively poor initial budgetary positions. This reflects to some extent that these countries in 2009 were ahead of other countries in terms of the severe fiscal implications of the crisis.

(Figure 11)

A number of final observations are in order. First, as discussed in the previous section, many Member States have taken on contingent liabilities in the course of the financial crisis which are not incorporated in the above estimates. For countries with comparatively large financial rescue programmes, the sustainability gap may thus turn out larger than estimated here. Second, in some countries (Greece in particular), the initial budgetary position has been substantially revised since the 2009 Sustainability Report was published, and this affects countries' relative positions, as will be discussed in section 4. Third, the assumed potential growth rates may prove too optimistic, as discussed in more detail below.

3.3 The impact of lower potential growth and higher interest rates

It is difficult to imagine that the crisis would not have a long-lasting impact on the potential growth rate over and above the impact of ageing. Recent studies of past episodes of financial distress suggest sizeable output losses which are generally not recovered (Cerra and Saxena, 2008), especially if the crisis results in sharp increases in public indebtedness (Reinhart and Rogoff, 2010). Based on a country-panel regression analysis, Furceri and Mourougane (2009), estimate the impact on potential output to be in the range of 1.3 to 3.8%, with the upper estimate corresponding to deep and severe financial crisis. This estimate is in the ball park of estimates resulting from econometric work by the European Commission and simulations with its QUEST model, both putting the potential output loss roughly in the 2 to 4% range (European Commission 2009c,d). This estimated loss reflects a projected increase in structural unemployment and slower growth in the capital stock as investment is severely hit by the crisis. The loss in potential output may be even larger if total factor productivity were to fall to a lower trajectory as well, although the net impact is ambiguous. Innovation may

falter as R&D expenditure has been hit by the crisis, but, on the other hand, the least efficient suppliers are likely to disappear and this could have a favourable impact on productivity.

European Commission (2009a) reports the impact on the sustainability gap of a scenario in which the level of potential output is assumed to be persistently lower due to the financial crisis in line with these estimates, labelled as the "Lost decade" scenario.⁶ It suggests an increase in the sustainability gap by about 1.2 percentage point on average in the EU and the euro area. The dispersion of this impact across Member States is very wide, with particularly large increases in Ireland and Spain along with Malta (Figure 13). On the basis of this scenario exercise and the estimated contingent liabilities, European Commission (2009a) classifies Member States in three risk categories (high, medium and low). Member States in the high risk class in the euro area are Slovenia, Spain, Ireland, the Netherlands, Malta, Slovakia and Greece (the latter mostly because of its high initial debt level), and outside the euro area the United Kingdom, Romania, Latvia, Lithuania and the Czech Republic. Low risk Member States outside the euro area would be Denmark, Estonia, Sweden, Bulgaria and in the euro area Finland. All other Member States would be in the middle risk category.

(Figure 13)

As becomes clear from inspecting equation (7), an increase in the real interest rate has a (numerically) equivalent effect on fiscal sustainability as a fall in the growth rate of the economy. Such an increase in real interest rates may well materialise in certain cases if investors consider the risk of default of a government to have increased, e.g. because they fear that the political system of a particular country may not be able to produce the required increase in the primary structural balance to close the sustainability gap. For now, with a few notable exceptions, real interest rates are generally very low owing to the easy stance of monetary policy, the still weak economy and strong demand for sovereign bonds by banks (to reduce the risk profile of their portfolios and to benefit from the upward sloping yield curve). But this may well change as the economy and banks' balance sheets recover and monetary policy exits from its accommodative stance, thus further heightening the need for fiscal consolidation.

⁶ In fact, the report presents estimates for three scenarios labelled the "Rebound scenario" in which the loss in potential output would be fully recovered after ten years, the "Lost decade" scenario in which potential output would return to its pre-crisis growth rate after ten years (but not the level of potential output), and the "Permanent shock" scenario in which also the growth rate of potential output is permanently lower.

Some observers have pursued the idea that the adoption of higher inflation targets by central banks could help to reduce the differential between real interest and growth rates (see equation 3). However, such a strategy would be self-defeating. Since Fisher parity will normally hold, the increase in inflation expectations would simply push up nominal bond yields. The sovereign risk premium would simply be replaced with an inflation risk premium, without much affecting the real interest-growth rate differential. Worse still, potential output growth could falter further as the greater inflation uncertainty typically associated higher inflation would blur price signals and jeopardise the efficient allocation of resources.

4. The fiscal consolidation challenge

The timing of the exit from fiscal stimulus and subsequent fiscal consolidation to address the ageing issue should balance sustainability and stabilisation concerns. Even so, aside from the exact timing, the need for a decisive exit is pertinent. This backdrop this section first discusses the EU's exit strategy. This is followed by estimates of the size of the required consolidation effort and a tentative and stylised assessment of its likely economic impact based on the existing literature. Coordination issues are left for the final section of the paper.

4.1 The EU's fiscal exit strategy

In the acute stages of the crisis the focus was on fiscal stimulus and other crisis mitigation and control measures. However, that an exit from fiscal stimulus and subsequent fiscal consolidation would be inevitable was clear from the outset. As it became gradually clear that the recessionary tailspin had been arrested around the summer of 2009, more decisive steps towards the exit were taken. On 17 September 2009 EU leaders first agreed to formulate exit strategies to phase out stimulus measures, coupled with a call on Member States to implement them only when economic recovery was secured. This was echoed at the 24-25 September 2009 G-20 Summit, which pledged to sustain policy stimulus until durable recovery and renewed job creation were secured, while continuing to develop cooperative and coordinated exit strategies with policy measures to be implemented depending on varied national needs. On 19 - 20 October 2009 the ECOFIN Council adopted conclusions on a coordinated fiscal exit strategy across countries dependent on further economic recovery forecasts, although 2011 would be the latest start date for fiscal consolidation requiring efforts, above 0.5% of GDP per annum for most countries. On 1 - 2 December 2009 the ECOFIN Council agreed on principles for the coordinated exit strategy of public support schemes. Specifically, coordination among Member States should avoid negative spill-over effects and would

account for national specificities. The timing of the exit should take into account a broad range of elements, including macroeconomic and financial sector stability, the functioning of credit channels, systemic risk assessment and the pace of natural phasing out by banks.

Meanwhile the Council has opened a large number of Excessive Deficit Procedures (EDPs) under the Stability and Growth Pact (Table 4).⁷ While formally distinct from the exit strategy -- the EDPs would have been launched anyway under the corrective arm of the Stability and Growth Pact (see the final section) -- they are now effectively used to enforce the fiscal exit. The first country to enter an EDP since the onset of the crisis was the United Kingdom (July 2008), although at that point Hungary was also in EDP (since July 2004). In April 2009 EDPs were launched for Ireland, Greece and Spain, and in July 2009 for Poland, Romania, Lithuania, Malta and Latvia. This was followed in December 2009 with another batch of EDP's concerning Latvia, Austria, Belgium, the Czech Republic, Germany, France, Italy, the Netherlands, Portugal, Slovenia and Slovakia. All in all, a record 20 countries are now subject to an EDP, with only seven countries so far not involved in an EDP (Bulgaria, Denmark, Cyprus, Estonia, Finland, Luxembourg and Sweden).⁸ In some cases, the Council has issued revised recommendations for countries which either were found to backtrack on their correction commitments or that were hit by further bad surprises in their budgets.

(Table 4)

Since the start of 2010 the Greek fiscal crisis has been overshadowing the fiscal exit strategy for the EU as a whole. On 18 - 19 January 2010 the ECOFIN Council adopted conclusions on government deficit and debt statistics in Greece and urged the Greek government to tackle outstanding problems. On 15 - 16 February 2010 the ECOFIN Council accepted Greece's

⁷ The EDP sets out criteria, schedules and deadlines for the Council to reach a decision on the existence of an "excessive deficit" (meaning a deficit above the 3% of GDP threshold or that is inconsistent with convergence of public debt to the 60% of GDP threshold). No EDP procedure will be launched if the excess of the government deficit over the 3% threshold is considered temporary and exceptional and the deficit remains close to the threshold. When the Council decides that a deficit is excessive, it makes recommendations to the Member State concerned and establishes deadlines for effective corrective action to be taken. The Council monitors implementation of its recommendations and abrogates the EDP decision when the excessive deficit is corrected. If the Member State fails to comply, the Council can decide to move to the next step of the EDP, the ultimate possibility being to impose financial sanctions.

⁸ Moreover, on 12 May 2010 the Commission has launched EDPs for Bulgaria, Cyprus, Denmark, Finland and Luxembourg, but these were still to be confirmed by the Council at the time of writing.

updated Stability Programme which sets 2012 as the date for reducing the deficit below 3%. The Council also called on Greece to ensure a budgetary adjustment of at least 4% GDP in 2010. It set numerical limits to Greece's government deficits and to annual changes in its consolidated gross debt in 2010, 2011 and 2012. On 25 - 26 March 2010 the Spring European Council fully supported the efforts of the Greek government. And finally in the weekend of 1 -2 May 2010 a rescue package involving substantial International Monetary Fund and euro area Member States loans was finally agreed. However, the strong focus on the Greek predicament, while understandable, should not be allowed to eclipse the fiscal exit challenge affecting other EU Member States.

The 2009 Sustainability Report provides estimates of the required primary structural balance in the period 2011-2015 (based on the S_2 indicator and a projection of the structural primary balance for that period under unchanged policies). This required structural primary balance can be set against the currently estimated development of the structural primary balance to get an impression of the size of the correction required to achieve sustainability. This is done in Table 5. It shows that, relative to the 2009 estimates, by far the largest correction in the structural primary balance is indeed required in Greece, of the order of 20% of GDP, which is obviously not surprising in view of the size of its debt and deficit in 2009. However, sizeable corrections -- in the range of 10 to 20% of GDP -- would also be required in Ireland, Spain, Cyprus, Romania, the United Kingdom, Luxembourg, Slovenia and Lithuania. For the European Union as a whole the required correction now stands at 7% of GDP (6.7% for the euro area), an increase by $\frac{1}{2}$ a percentage point (1 percentage point for the euro area) relative to the estimate in the Sustainability Report.

(Table 5)

It is interesting to check if this sustainability requirement is reflected in the agreed "fiscal effort" (the required correction in the structural balance) as agreed by the Council for countries in EDP (see Table 4). As Figure 14 shows, this is indeed broadly the case: countries whose sustainability gap is highest are also those that have seen the largest correction requirements in their EDPs and vice versa.⁹ This is reassuring. The relationship between the two requirements is not one-to-one, but this should reflect the fact that the required fiscal efforts under the EDPs are, in most cases, lower limits: countries are expected to do more,

⁹ In Figure 14 Greece is not shown because its EDP has been overtaken by the programme for deficit reduction agreed by the euro area Member States, the European Commission, the ECB and the IMF, with the deficit required to reach 3% of GDP by 2014.

depending also on the pace of the economic recovery. The corollary is that respecting the fiscal effort countries have committed to under their EDPs is consistent with the need to secure fiscal sustainability.

(Figure 14)

4.3 The economic impact of fiscal consolidation

While fiscal consolidation is unavoidable, it obviously has repercussions for demand. How strong this effect will be, and perhaps even its sign, is uncertain. There is vast literature on the subject, so it is impossible to review it exhaustively here, and just a few highlights will be presented. Giavazzi and Pagano (1990) were among the first to argue that fiscal consolidations can in fact be expansionary, based on a number of case studies. In their seminal paper Alesina and Perotti (1995) found that economic growth fared better during large fiscal consolidations that relied on cuts in (current) government spending rather than higher taxes. Cuts in expenditure would: (i) reduce expectations of more disruptive tax increases in the future (Blanchard 1990); (ii) contribute to easing financial conditions such as real interest rates or a depreciation of the exchange rate (Alesina et al. 2002, Lane and Perotti 2003); and (iii) crowd in labour and improve competitiveness (Alesina and Ardegnà 1998, Lane and Perotti 2003). By contrast, tax-driven consolidations reduce labour supply (Barro 1981) and crowd out investment (Baxter and King 1993).

According to Perotti (1999) the odds of an expansionary effect of fiscal consolidation increase with the extent of the initial fiscal predicament, possibly because the private sector realises that the situation is unsustainable. This is particularly true for expenditure-based consolidations because they are more difficult and therefore signal the government's resolve in tackling the problem, and they are also less damaging for potential growth than (distorting) tax increases. Reinhart and Rogoff (2010) argue that when government debt rises above 90% of GDP, median growth falls by 1 percentage point. Consequently, cutting debt below that threshold would boost economic growth. The implications of these findings do not necessarily conflict with standard 'Keynesianism': the fiscal multiplier is likely to be positive in normal times, and certainly at times of financial crisis when households and business are credit constrained, but turns negative in the face of severe fiscal imbalances. Moreover, there is broad consensus that the odds of the multiplier becoming negative (i.e. of the adjustment being expansionary) increases when the fiscal consolidation is combined with structural reform to enhance potential output and the ability of the economy to absorb shocks smoothly.

Another important issue is the timing of fiscal exits. The timing of the exit from fiscal stimulus and subsequent fiscal consolidation should balance sustainability and stabilisation concerns. A too early and abrupt exit hampers the recovery process, increases unemployment and social hardship and may entail an unnecessary destruction of viable productive capacity.¹⁰ Too late exit leads to an unfavourable policy mix (monetary tightening kicks in when fiscal policy is still supportive, makes fiscal consolidation more difficult), delays essential restructuring of the economy, distorts competition, and threatens budgetary sustainability. In the strongly integrated EU economy there is also an issue of *relative* timing of Member States among each other. A Member State that starts fiscal exit too early could exploit a first mover advantage in terms of better competitiveness and a lower risk premium, while the contraction effect spills over to other countries via the trade channel. Conversely, a country that consolidates too late may render its public finances unsustainable, which may spill over other Member States via bond markets and the confidence channel.

The political economy of fiscal consolidations has been studied extensively. Alesina, Perotti and Tavares (1998) and Brender and Drazen (2008) find that, contrary to the conventional wisdom, governments which reduce budget deficits drastically and systematically do not face a loss in popularity in established democracies. Buti et al. (2009) confirm these results and also show that fear of electoral backlashes in the wake of structural reform is unfounded.¹¹ These findings seem at odds with the reluctance of governments to adopt severe adjustment policies (except under the worst circumstances), but this can be explained by the tendency of vocal interest groups to abuse 'Keynesian' views to protect their own interests. In fact, according to Buti *et al.* (2009) structural reform can even be electorally beneficial, provided

¹⁰ The 1937/38 recession in the United States is often quoted as a warning against premature exits from fiscal stimulus. However, the cutback in fiscal stimulus at the time was not an early but rather a late exit, in the wake of an unduly late and timid entry in the Great Depression in the first half of the early-1930s (Van den Noord 2010). Moreover, while the 1937/38 recession can be attributed to cut backs in fiscal stimulus to some extent, were predominant. Notably, geopolitical tensions played a major role, along with adverse business confidence effects of Roosevelt's New Deal policies. Concerning the latter, the strengthening of wage bargaining power amid mass unemployment and heightened uncertainty over property rights were prominent.

¹¹ Buti et al. (2010) suggest, moreover, the electoral impact of reform to be strongly dependent on which types of policies are considered. In particular, reform measures that are more likely to hit large groups of 'insiders', such as reform of employment protection legislation or pension reform, seem electorally damaging. In contrast, reform measures targeted at large groups of 'outsiders', such as the unemployed, would be electorally beneficial, while lowering taxes on labour would also find a positive reception with the electorate.

that financial markets work well, as they bring future yields of structural reform forward in time. This is important in this context, given that structural reform is inevitable in order to boost potential output and thereby facilitate the fiscal challenge (not least in the face of aging populations).

Are there really no downsides to fiscal consolidation? In fact there are some. First, with interest rates (at least at the short end) close to the zero-rate bound, the crowding-in effects of fiscal consolidation via lower interest rates may be small. This is why it is important that the pre-commitment of governments to fiscal consolidation is strong: it will keep bond yields low and facilitate the exit from monetary ease. But, second, to the extent sovereign bond yields fall, the associated flattening of the yield curve may in fact slow down the process of balance sheet restoration in the banking industry, as this owes much to the possibility to invest cheap base money in higher yielding bonds (unless capital gains on bonds offset this effect). Third, it is also not obvious that exchange rate depreciation could play its amplifying role of expansionary fiscal contraction. This is certainly the case inside the euro area, but even for the area as whole this is not obvious since other economies (including the United States) also face the need to consolidate their budgets. It is even less obvious that currencies of the developed economies will be able to depreciate against emerging Asian economies, unless emerging Asia changes its exchange rate policies. Finally, it is also not obvious that fiscal consolidation can rely solely on expenditure cuts. Tax increases may have to be accepted, especially on wealth and capital income.

In sum, the historical experience provides evidence of public debt thresholds above which economic growth is persistently lowered, suggesting that fiscal consolidation is essential for sustaining growth. The guiding principles for successful fiscal consolidations – also rooted in the historical experience – are that they should be based primarily on expenditure cuts complemented by structural reforms to increase work incentives and public sector efficiency. Tax based consolidation can probably not be avoided though, but tends to work better if gradual and starting from a lower initial tax burden. Improvements in the fiscal institutions can be important complements to consolidation. Difficult macroeconomic and public finance starting points appear to be catalysts for successful consolidations, which augurs well in the current situation, even if the transition to sustainable public finances will be very painful, yet unavoidable, in some cases.

5. Improving EU fiscal surveillance and coordination

It may be useful to recall that the rationale for EU fiscal surveillance is rooted in the creation of the euro in 1999.¹² The European Economic and Monetary Union (EMU) is unique in that it comprises a single currency in combination with fiscal policies conducted at national level – albeit within a common framework – by its participating Member States. The founders of EMU recognised that (especially 'peripheral') Member States would be tempted to "free ride" in the absence of the disciplining effect of exchange-rate risk or a national monetary policymaker, by running budget deficits while neglecting longer-term considerations of fiscal sustainability. The adverse effects of fiscal profligacy would be all the more damaging as they risked spilling over in financial conditions faced by other Member States, thus inflicting instability onto the area and squeezing productive capital formation in other participating countries. It would also hinder the European Central Bank (ECB) in doing its job of maintaining price (and by extension macroeconomic) stability.

These concerns led to the adoption of the Stability and Growth Pact in 1997 which fixes rules for fiscal policy and penalties if those rules are breached. Concretely, countries were required to move towards and sustain a fiscal position 'close to balance or in surplus' over the medium term and would be subject to corrective measures if the fiscal deficit exceeds 3% of GDP and/or if public debt fails to converge towards or below 60% of GDP, unless 'special circumstances' can be demonstrated. Participating countries submit annually a Stability Programme (Convergence Programme in the case of EU Member States outside the euro area) which contains a record of current and expected fiscal outcomes and on which the assessment of compliance by the competent authorities (the European Commission and the European Council) is based.

The fiscal provisions in the Treaty and Pact comprise a "preventive" and a "corrective" arm¹³:

¹² In that year eleven EU Member States – Belgium, Germany, Spain, France, Ireland, Italy, Luxembourg, the Netherlands, Austria, Portugal and Finland – adopted the European Union's single currency, the euro, establishing the second largest single currency area in the world (after the United States). Five other EU Member States have joined the euro area since its inception: Greece in 2001, Slovenia in 2007, Cyprus and Malta in 2008 and Slovakia in 2009. The area is set to expand further as most EU Member States currently outside the euro area are preparing to join at some point in the future. Only Denmark and the United Kingdom have formally opted out of the single currency.

¹³ For an early account of the rationales and features of the Stability and Growth Pact, see Brunila *et al.* (2001).

- The *preventive arm* stipulates that governments achieve and maintain budgetary positions close to balance or in surplus over the medium term. Sticking to this rule allows automatic stabilisers to play unfettered while respecting the 3% of GDP deficit ceiling stipulated in the Treaty. The annual updates of the "Stability Programmes" submitted by the governments to the European Commission take stock as to how far they have progressed in moving towards close to balance or in surplus and provide a policy trajectory in the pursuit of this goal over the medium term.¹⁴
- The *corrective arm* details the "Excessive Deficit Procedure" (EDP) embedded in the Treaty. It specifies when a waiver due to "exceptional circumstances" may be granted.¹⁵ It also details the timetable countries should respect towards ending the EDP, and the sanctions to be imposed when a country fails to respect the timetable.¹⁶

In 2005 the SGP was revised. It left the 3% of GDP deficit and 60% of GDP debt thresholds intact, but it introduced the following modifications:

- Regarding the *preventive arm*, rather than being uniformly set at close-to-balance or in surplus, the medium-term budgetary objectives (MTOs) were henceforth differentiated across countries. For countries which have not achieved their MTO the revised SGP requires an annual improvement of their structural balance by 0.5% of GDP as a benchmark. This adjustment can be modulated depending on economic conditions. As well, the implementation of major structural reforms that may positively affect the sustainability of public finances can be invoked to allow a temporary deviation from

¹⁴ EU Member States that have not yet adopted the single currency annually submit "Convergence Programmes" which essentially have the same coverage as the Stability Programmes.

¹⁵ Originally the SGP stipulated that as a rule a deficit above 3% is not excessive if real GDP has fallen by 2% or more. The Ecofin Council could also grant a waiver if GDP has fallen if the downturn is abrupt or large relative to past trends, but member states have committed not to invoke this possibility if the drop in GDP is less than ¾ %. These provisions have been modified in 2005.

¹⁶ The excessive deficit should be corrected in the year following its identification by Eurostat unless there are special circumstances. If, in the opinion of the ECOFIN Council, a member state fails to take sufficient measures to correct an excessive deficit, and after giving a further notice it may impose measures, including the obligation of a deposit with the Commission of initially 0.2% of GDP plus one tenth of the difference between the actual deficit and the reference value, with an upper limit of 0.5% of GDP. If the next year shows again an excessive deficit, another deposit according to the same formula for the variable amount can be required. If after two years the excessive deficit is still found to

the adjustment path or from the MTO itself provided that the deviation remains temporary and that an appropriate safety margin with respect to the 3% mark is preserved.

- Pertaining to the *corrective arm*, the annual fiscal effort of EDP countries should always be of at least 0.5% of GDP in structural terms. Revision of deadlines in the EDP can be granted if there are unexpected adverse economic events with major unfavourable consequences on government finances. Moreover, an economic downturn may be considered 'severe' (and hence the exceptionality clause invoked) in case of a negative growth rate or accumulated loss of output during a protracted period of very low growth relative to potential.¹⁷

The revised corrective arm proved flexible enough to allow fiscal stimulus under the EERP to be implemented in timeframes consistent with the recovery of the economy. This is because a severe economic downturn was called and deadlines in the EDP's could be extended in view of the overall economic situation. At the height of the crisis coordinated fiscal stimulus was successfully implemented, which proved particularly effective with interest rates approaching the zero bound and households and businesses severely credit constrained. But the implication is that once the exceptional circumstances are over the corrective arm should return to its restrictive mode.

While the safety valves in the SGP have served their purpose, recent developments confirmed a need for stronger EU surveillance and coordination as already highlighted before the crisis in European Commission (2008). A number of issues stand out. First, prior to the crisis deteriorations in underlying fiscal positions in some Member States were masked by buoyant tax receipts in the face of unsustainable asset booms. This was not always properly assessed or detected in time. Second, the dangers associated with unsustainable external positions, sagging competitiveness and the misallocation of resources associated with bubbles in real estate markets were not sufficiently appreciated. The possible unwinding of such imbalances can significantly affect the fiscal position and become a concern for the euro area as a whole.

exist, the deposit will "as a rule" be converted into a fine, to be distributed among the other member states according to their share in the area wide gross national product.

¹⁷ Other relevant factors may also be taken into account, but only if the general government deficit remains close to the reference value and its excess over the reference value is temporary.

Thirdly, structural reform, deemed essential for the rebalancing of divergences between euro area Member States, was not properly integrated in the euro area surveillance. Finally, gaps in the governance of the euro area were exposed, leaving room for a stronger coordinating role of the Eurogroup.

These concerns became particularly acute with the financial crisis, and accordingly the European Council has taken up a fresh commitment to tackle these issues. Against this backdrop the Council called on the Commission to issue proposals to strengthen the existing surveillance and coordination framework, building on Article 136 in the EU Treaty. Article 136 stipulates that "In order to ensure the proper functioning of economic and monetary union, (...), adopt measures specific to those Member States whose currency is the euro: (a) to strengthen the coordination and surveillance of their budgetary discipline; and (b) to set out economic guidelines for them, while ensuring that they are compatible with those adopted for the whole Union and are kept under surveillance." The Commission proposals to translate these principles into policy were enshrined in a Communication issued on 12 May 2010 and contain the following three building blocks:

- *More rigorous surveillance of fiscal sustainability and deeper ex ante coordination of fiscal policy.* Apparently comfortable fiscal buffers built up in good times evaporated with the crisis as they were mostly associated with tax-rich activities in housing, construction and financial markets. This calls for more ambitious fiscal targets in the face of emerging macroeconomic imbalances, while potentially disruptive high public debt also has to be tackled pre-emptively. Stability programmes would be frontloaded and peer-reviewed prior to their implementation. Penalties and incentives would be intensified, with Structural Funds suspended in case of non-compliance.
- *Broader surveillance of intra-euro area macroeconomic and competitiveness developments.* A preventive arm would be created for the regular monitoring of imbalances and competitiveness positions. This would be complemented by a corrective arm, in analogy with the sanctions foreseen under the Stability and Growth Pact, with the Eurogroup overseeing a detailed programme and time plan for the implementation of corrective measures. The Eurogroup and the Commission, when assessing the risk of excessive imbalance, would take into account relevant considerations of the EDRB.
- *A crisis resolution mechanism for euro-area Member States.* The euro area should equip itself with a robust crisis resolution mechanism, including a well-designed framework for

financial assistance that avoids moral hazard. Strong conditionality would be a prerequisite to secure strong incentives for the troubled Member State to take timely action and to gear this towards a more efficient economy. The Commission would conduct surveillance, design and monitor conditionality and arrange the loans to the Member State under assistance. There are several solutions regarding the way the assistance could be funded such borrowing by the EU, borrowing under an EU guarantee or the establishment of an EU fund.

6. Concluding remarks

The fiscal cost of the rescue packages for national banking sectors could cost up to 13% of GDP, which adds to the fiscal cost of the economic slump amounting to an increase in the EU aggregate budget deficit from less than 1% of GDP in 2007 to around 7% of GDP in 2010. As a result, public debt is on a strongly upward slope.

While the fiscal cost is comparable to earlier financial crisis episodes, its distribution across EU Members is uneven. The sharpest increases in public indebtedness are observed among those countries which are endowed with large financial centres or which have seen major credit-driven housing and consumption booms. Some of the run-ups in deficits and debt have been of a discretionary nature, owing to the coordinated fiscal stimulus motivated by the need to stabilise the economy. The dispersion of stimulus packages has been considerable, and largely reflects the variation in the degree of economic slack and the available "fiscal space". However, while necessary, the fiscal stimulus must be cut back in the years ahead so as not to complicate further the already sizeable consolidation requirement stemming from the ageing of populations..

Indeed, the size of the fiscal deterioration has given rise to concerns over the sustainability of public finances – though not exclusively in the EU. The "sustainability gap" – the required once and for all increase in the structural primary balance to respect the long-run solvency constraint – was estimated in 2009 to be of the order of 6% of GDP. This consolidation challenge is not without historical precedent for individual countries, but it certainly is for the EU as a whole. Moreover, the cross-country variation in the sustainability gap is large, with a host of countries requiring consolidations of more than 8 percentage points. Unfortunately, these estimates are even on the conservative side, because they do not take into account the impact of a possible slowdown in potential growth prompted by the crisis and a lasting increase in sovereign risk premiums on bond yields. Suggestions that higher inflation targets

could improve the sustainability of public finances are misguided since it would merely imply an exchange of sovereign risk for inflation risk without affecting real interest rates much.

While at the acute stages of the crisis the focus of EU policy coordination was mostly on crisis mitigation and control, its focus has now shifted to the exit from fiscal stimulus and the launch of major fiscal consolidation efforts. For example, the European Council has opened a large number of "Excessive Deficit Procedures" under the Stability and Growth Pact to enforce the fiscal exit and consolidation. Since late 2009 the Greek fiscal crisis has been overshadowing this overarching strategy, but this should not be allowed to eclipse the fiscal consolidation challenge for the EU as a whole.

While fiscal consolidation is unavoidable, it obviously has repercussions for demand and the short- to medium-run growth outlook. But how strong the demand shock will be, and perhaps even its sign, is uncertain. The odds of a fiscal consolidation turning out expansionary increase with the size of the initial fiscal predicament and with the extent to which the consolidation is supported by structural reform – e.g. in the framework of the Europe 2020 strategy for "smart, sustainable and inclusive growth" -- to enhance the growth potential for the economy and its ability to absorb shocks smoothly.

The recent developments clearly point in the direction of a need for stronger EU coordination and surveillance to orchestrate the fiscal exit and consolidation. The timing of fiscal exits must be coordinated, so as to avoid first mover competitiveness advantages spilling over to slower consolidators and, conversely, to avoid sustainability concerns of the latter to spillover via bond markets and the confidence channel. These concerns have become particularly acute and prompted the European Council to take up a fresh commitment to tackle them. Although the Stability and Growth Pact will remain the primary governance device for fiscal discipline, improvements will emerge from the current crisis, including the strengthening of the mechanism for prevention of fiscal profligacy, the creation of a mechanism to prevent the build-up of other macroeconomic imbalances and the creation of a resolution mechanism for fiscal emergencies.

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Table 1. Public interventions in the banking sector
% of GDP

	Capital injections		Guarantees on bank liabilities		Relief of impaired assets		Liquidity and bank funding support		Total	
	Approved	Effective	Approved	Effective	Approved	Effective	Approved	Effective	Approved	Effective
Ireland	6.7	6.6	167.5	167.5	-	-	-	-	174.2	174.1
Belgium	5.3	6.2	71.0	16.4	8.2	8.2	NA	NR	84.4	30.7
United Kingdom	3.5	2.6	21.6	11.2	-	-	16.3	14.6	41.4	28.4
Netherlands	6.9	7.9	34.8	7.8	4.0	4.0	8	1.6	52.8	20.3
Sweden	1.6	0.2	46.8	10.6	-	-	12.1	-	60.5	10.8
Austria	5.5	1.7	25.6	6.8	5.4	0.4	1.6	1.6	38.1	10.5
Germany	4.4	2.0	18.6	7.1	1.4	1.4	-	NR	24.3	10.5
France	1.2	1.2	16.5	5.4	0.2	0.2	-	-	17.9	6.8
Denmark	6.3	2.5	258.5	2.6	-	-	0.3	0.3	265.0	5.3
Italy	1.3	0.1	NA	-	-	-	-	-	1.3	0.1
European Union	2.7	1.7	24.6	7.9	0.9	0.8	3.2	2.3	31.4	12.7
Euro area	2.7	1.7	20.5	8.0	1.1	1.0	1.0	0.4	25.3	11.2

Note: Countries ranked by total effective support, NR = not reported by Member State, NA = not available. Source: Commission services 21 October 2009.

Table 2. Tentative estimates of the direct fiscal cost of the financial crisis
% of EU GDP

	Capital injections		Guarantees on bank liabilities		Liquidity and bank funding support		Total	
	Approved	Effective	Approved	Effective	Approved	Effective	Approved	Effective
Gross costs	2.7	1.7	24.6	7.9	3.2	2.3	31.4	12.7
Net costs								
Lower estimate	2.2	1.4	3.7	1.2	0.3	0.2	6.2	2.8
Upper estimate	4.3	2.7	7.4	2.4	1	0.7	12.7	5.8

Note: Capital injections lower estimate assumes a loss rate of 80% and higher estimate assumes a doubling of current gross costs and a loss rate of 80%; Guarantees lower estimate assumes a loss rate of 15% and higher estimate a loss rate of 30%; Liquidity and bank funding support lower estimate assumes a loss rate of 15% and higher estimate assumes a loss rate of 30% Source: Commission services 21 October 2009.

Table 3. Direct fiscal cost of past financial crises
% of GDP

	Net cost	Recovery	Total		Net cost	Recovery	Total
Argentina 1980	55.1	0.0	55.1	Latvia 1995	3.0	0.0	3.0
Argentina 1989	6.0	0.0	6.0	Lithuania 1995	2.9	0.2	3.1
Argentina 1995	2.0	0.0	2.0	Malaysia 1997	5.1	11.3	16.4
Argentina 2001	9.6	0.0	9.6	Mexico 1994	18.0	1.3	19.3
Bolivia 1994	2.7	3.4	6.0	Nicaragua 2000	12.6	1.0	13.6
Brazil 1990	0.0	0.0	0.0	Norway 1991	0.6	2.1	2.7
Brazil 1994	10.2	3.0	13.2	Paraguay 1995	10.0	2.9	12.9
Bulgaria 1996	13.9	0.1	14.0	Philippines 1997	13.2	0.0	13.2
Chile 1981	16.8	26.1	42.9	Poland 1992	NA	NA	3.5
Colombia 1982	5.0	0.0	5.0	Romania 1990	NA	NA	0.6
Colombia 1998	2.5	3.7	6.3	Russia 1998	6.0	0.0	6.0
Cote d'Ivoire 1988	25.0	0.0	25.0	Slovenia 1992	NA	NA	14.6
Croatia 1998	6.9	0.0	6.9	Spain 1977	NA	NA	5.6
Czech Rep. 1996	5.8	1.0	6.8	Sri Lanka 19889	5.0	0.0	5.0
Dom. Rep. 2003	20.8	1.2	22.0	Sweden 1991	0.2	3.4	3.6
Ecuador 1998	16.3	5.4	21.7	Thailand 1997	34.8	9.0	43.8
Estonia 1992	1.6	0.3	1.9	Turkey 1982	NA	NA	2.5
Finland 1991	11.1	1.7	12.8	Turkey 2000	30.7	1.3	32.0
Ghana 1982	6.0	0.0	6.0	Ukraine 1998	0.0	0.0	0.0
Hungary 1991	NA	NA	10.0	United States 1988	2.4	0.9	3.3
Israel 1997	NA	NA	30.0	Uruguay 2002	10.8	9.2	20.0
Indonesia 1997	52.3	4.6	56.9	Venezuela 1994	12.5	2.5	15.0
Jamaica 1996	39.0	5.0	43.9	Vietnam 1997	10.0	0.0	10.0
Japan 1997	13.9	0.1	14.0				
Korea 1997	23.2	8.0	31.2	<i>Average</i>	<i>12.6</i>	<i>2.6</i>	<i>14.6</i>

Note: Recovery is for the period to t+5. Source: Laeven and Valancia (2008) except for the US 1988 Spilimbergo et al (2008)

Table 4. Current Excessive Deficit Procedures
Situation in May 2010

	Date of Council Decision								Correction			
	5 Jul 2004	8 Mar 2005	10 Oct 2006	8 Jul 2008	27 Apr 2009	7 Jul 2009	2 Dec 2009	16 Feb 2010	Due by	Average fiscal effort ¹	Cumula- tive fiscal effort ²	Period
Hungary									2008	na	na	2005-08
									2008	na	na	2006-08
									2009	na	na	2007-09
									2011	≥ 0.5 %	≥ 1 %	2010-11
United Kingdom									2009/10	≥ 0.5 %	≥ 0.5 %	2009/10
									2014/15	1.75%	8.75%	10/11-14/15
Ireland									2013	≥ 1.5 %	≥ 6 %	2010-13
									2014	2%	10%	2010-14
Greece									2010	na	na	2010
Spain									2012	≥ 1.25 %	≥ 3.75 %	2010-12
									2013	≥ 1.5 %	≥ 6 %	2010-13
Poland									2012	≥ 1.75%	≥ 7 %	2010-13
Romania									2011	≥ 1.5 %	≥ 3%	2010-11
									2012	1.25%	3.75%	2010-12
Lithuania									2011	≥ 1.5 %	≥ 4.5 %	2009-11
									2012	≥ 2.25 %	≥ 6.75 %	2010-12
Malta									2010	na	na	2010
									2011	0.75%	0.75%	2011
Latvia									2012	≥ 2.75 %	≥ 8.25 %	2010-12
Austria									2013	≥ 0.75%	≥ 2.25 %	2011-13
Belgium									2012	≥ 0.75 %	≥ 2.25 %	2010-12
Czech Republic									2013	≥ 1%	≥ 4 %	2010-13
Germany									2013	≥ 0.5 %	≥ 1.5 %	2011-13
France									2012	≥ 0.5 %	≥ 1.5 %	2010-12
Italy									2013	> 1%	> 4%	2010-13
Netherlands									2013	0.75%	2.25%	2011-13
Portugal									2013	1.25%	6%	2010-13
Slovenia									2013	0.75%	3%	2010-13
Slovakia									2013	1%	4%	2010-13

1. Average over the period indicated in the 1st column

2. Total over the period indicated in the last column

Source: Council decisions

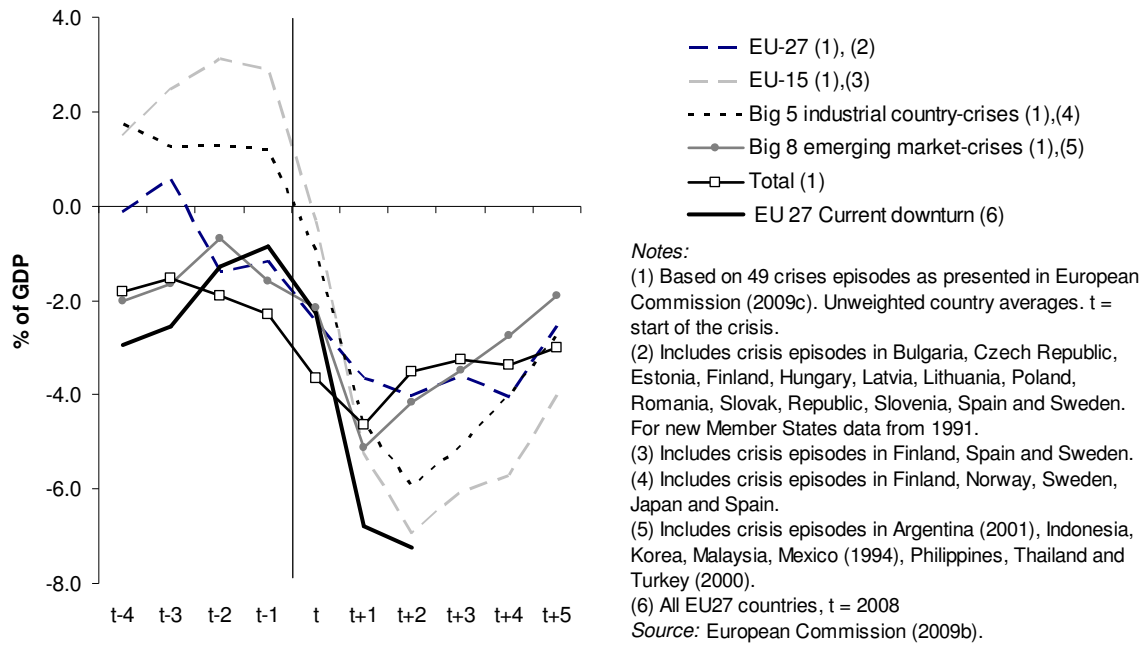
Table 5. Projected and required structural primary balance
% of GDP

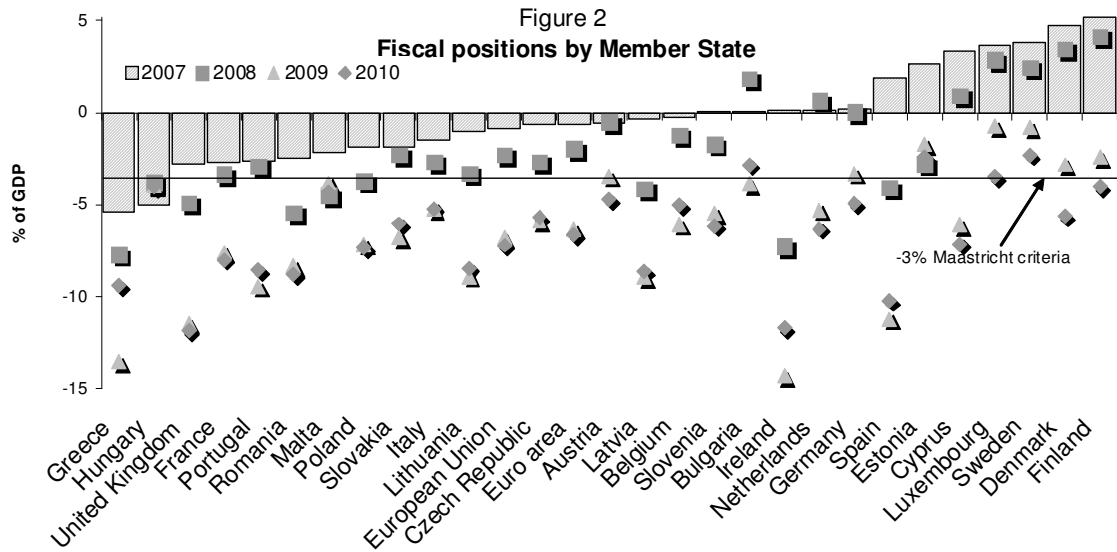
	2009		2010		2011		Required 2011-15		
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(7) - (2)	(7) - (6)
	Stability/ Converg. Program 2009/10	COM Spring 2010 forecast	Stability/ Converg. Program 2009/10	COM Spring 2010 forecast	Stability/ Converg. Program 2009/10	COM Spring 2010 forecast	2009 Sustaina- bility Report	Differ- ence against 2009	Differ- ence against 2010
Greece	-6.6	-7.9	-2.6	-3.2	0.5	-2.4	12.7	20.6	15.9
Ireland	-7.2	-7.3	-6.5	-6.5	-5.1	-6.7	7.2	14.5	13.7
Spain	-8.1	-7.1	-5.9	-6.1	-3.5	-4.7	6.4	13.5	12.5
Cyprus	-1.5	-3.3	-1.2	-3.6	0.8	-4.2	8.9	12.2	12.5
Romania	-5.9	-6.8	-3.7	-5.2	-2.0	-4.4	5.4	12.2	10.6
Un. Kingdom	6.8	-7.5	5.0	-7.6	2.4	-5.6	4.5	12.0	12.1
Luxembourg	1	1.7	-1.8	-1.0	-3.1	-1.3	13.6	11.9	14.6
Slovenia	-3.6	-2.3	-2.4	-2.5	-1	-1.8	8.4	10.7	10.9
Lithuania	-6.2	-6.1	-4.9	-5.2	-2.3	-4.9	4.2	10.3	9.4
Slovakia	-2.2	-5.1	-1.2	-3.9	-0.3	-3.2	4	9.1	7.9
Czech Rep.	-4.4	-4.1	-1.9	-3.2	-1.2	-2.8	4.6	8.7	7.8
Portugal	-5.2	-5.2	-4.1	-4.7	-1.8	-3.9	3	8.2	7.7
Netherlands	-1.1	-1.4	-2.3	-2.6	-1.4	-1.7	6.5	7.9	9.1
Latvia	-6.8	-5.3	-3.3	-4.3	-0.2	-6.1	2.2	7.5	6.5
Malta	0	-0.5	-0.3	-0.7	0.4	-0.2	6.3	6.8	7.0
France	-3.3	-3.9	-3.2	-3.6	-1.2	-3.3	2.8	6.7	6.4
Belgium	-0.1	-0.3	0.4	0.0	1	-0.2	5.9	6.2	5.9
Poland	-4.6	-4.6	-3.9	-3.5	-3	-2.6	1.1	5.7	4.6
Bulgaria	-0.2	-2.0	2.5	-0.3	2.5	0.1	2.3	4.3	2.6
Austria	0.1	0.3	-1.1	-0.8	-0.2	-0.7	4.5	4.2	5.3
Germany	1.2	0.9	-2	-1.0	-1.5	-0.8	5	4.1	6.0
Finland	1.7	1.6	0.3	-0.2	0.9	0.2	5.5	3.9	5.7
Italy	2.5	0.7	2.6	0.9	2.8	1.2	3.4	2.7	2.5
Hungary	1.8	2.6	2.1	2.3	2.3	1.1	3.5	0.9	1.2
Estonia	-0.5	-0.2	-0.8	-1.6	0	-1.4	0.3	0.5	1.9
Sweden	2.7	2.8	1.4	0.7	1.9	0.3	3.1	0.3	2.4
Denmark	0	2.6	-1.1	-0.6	-0.4	-1.0	1.9	-0.7	2.5
Eur. Union	-0.5	-2.5	-1.0	-2.8	-0.4	-2.2	4.5	7.0	7.3
Euro area	-1.5	-1.8	-2.0	-2.1	-0.8	-1.7	4.9	6.7	7.0

Note: Countries ranked according to difference between the required structural primary balance in the latest Sustainability Report (European Commission 2009c) and the actual 2009 structural primary balance in the European Commission Spring 2009 Forecast (European Commission 2010)

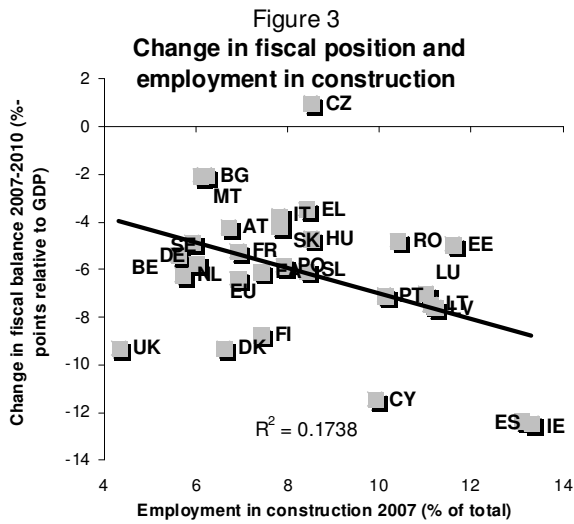
Sources: Stability and Convergence Programmes 2009/10, European Commission (2009c, 2010)

Figure 1 Tracking the fiscal position against previous financial crises

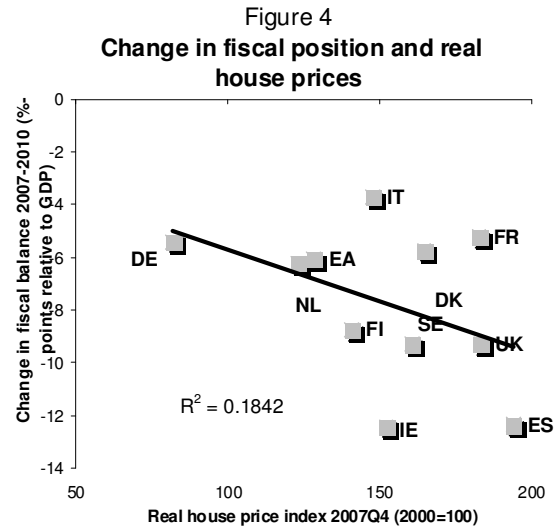




Source: Commission services

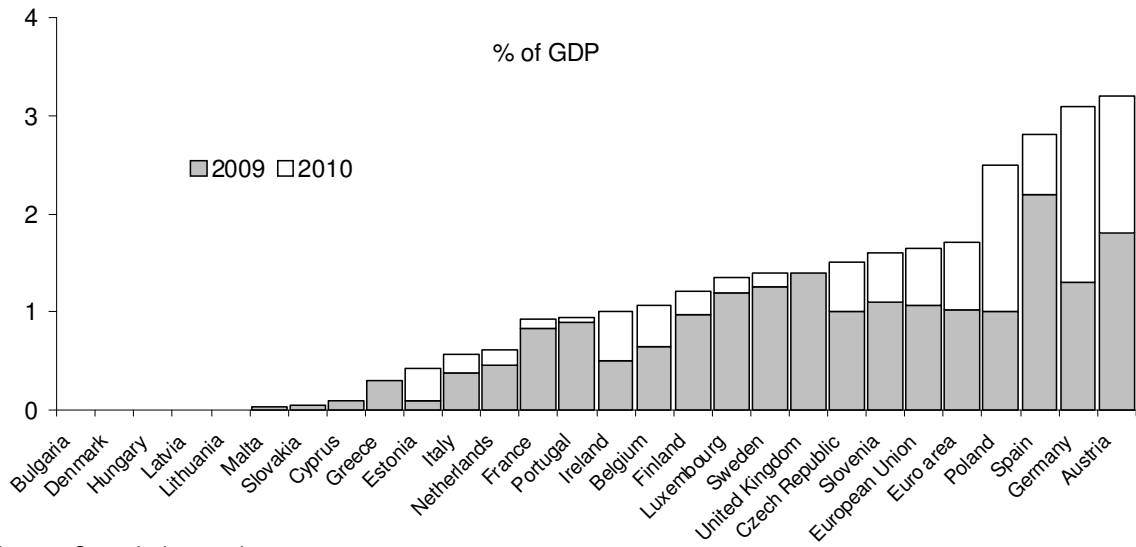


Sources: Commission services, OECD



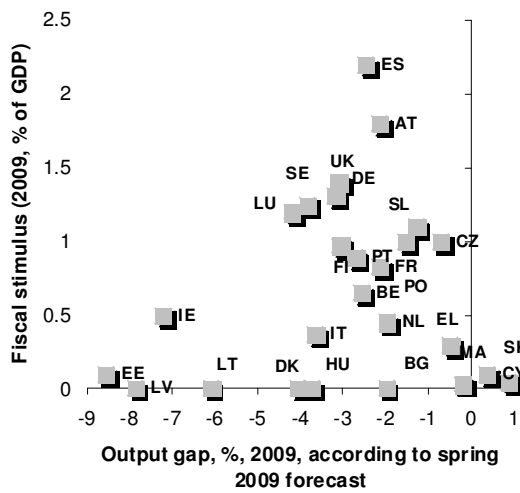
Sources: Commission services, OECD

Figure 5 Fiscal stimulus by EU Member State



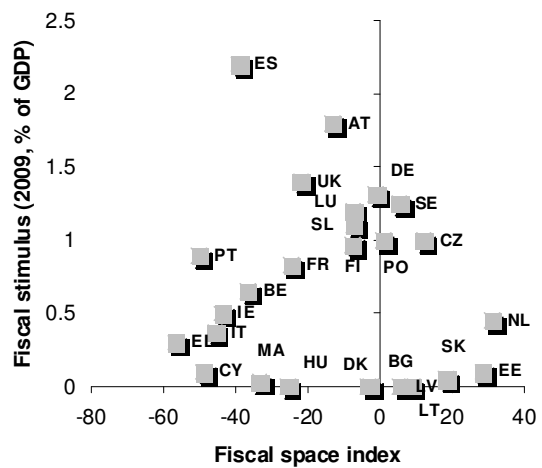
Source: Commission services

Figure 6 Output gap and fiscal stimulus



Source: European Commission (2009b)

Figure 7 Fiscal space and fiscal stimulus



Source: European Commission (2009b)

Figure 8 Tracking public debt against previous financial crises

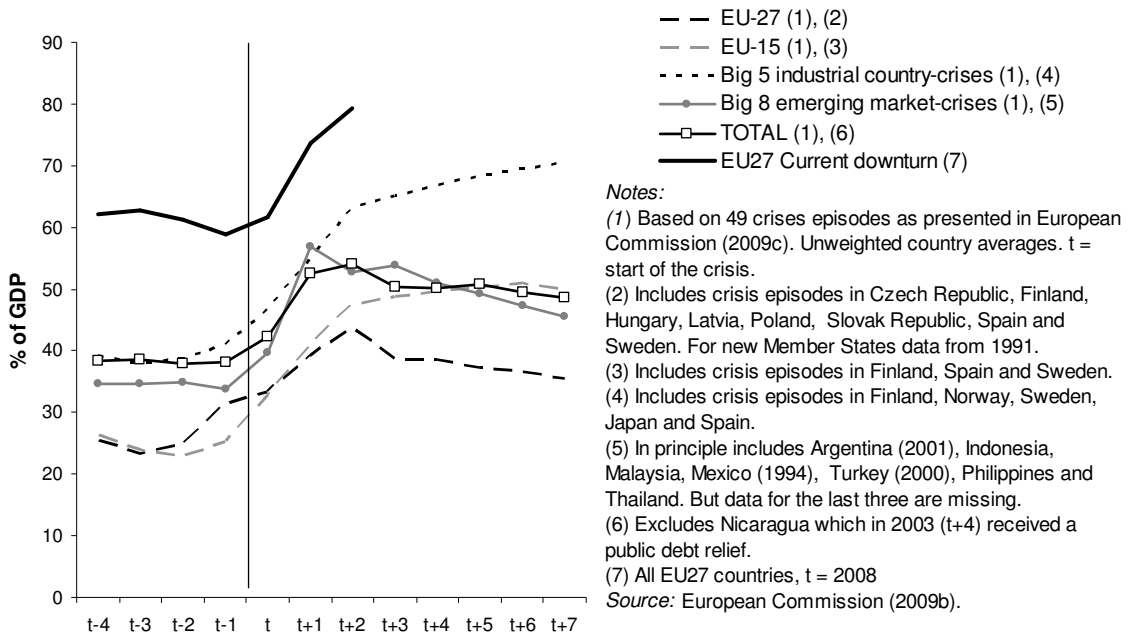


Figure 9 Gross public debt

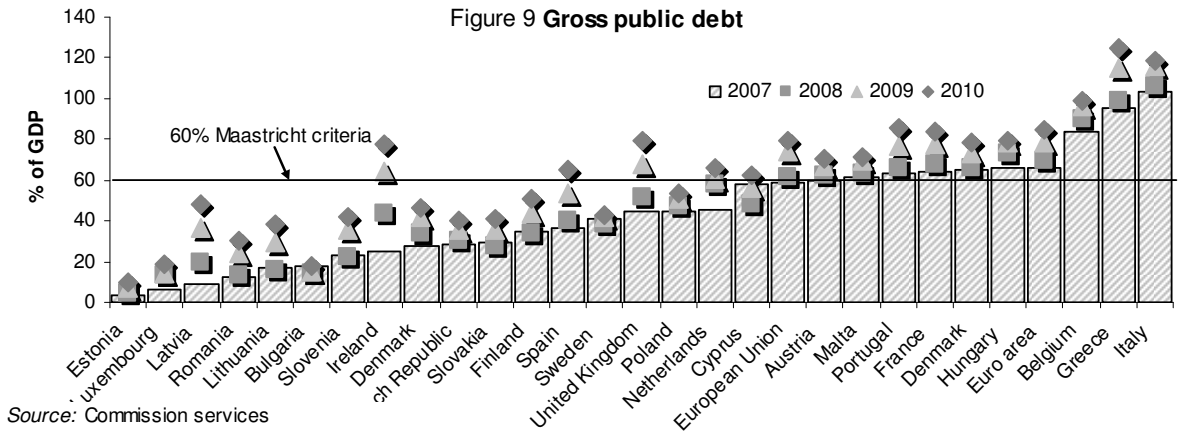
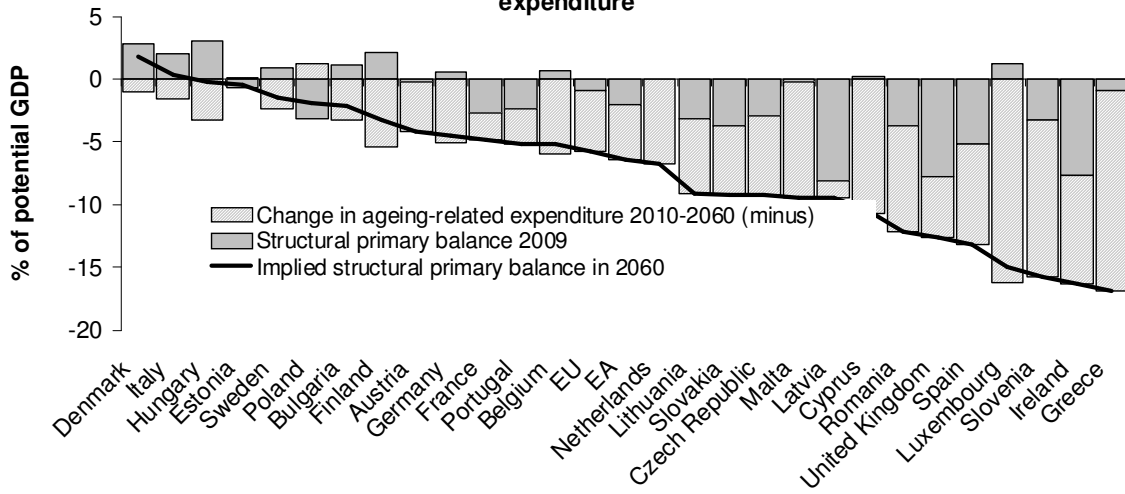
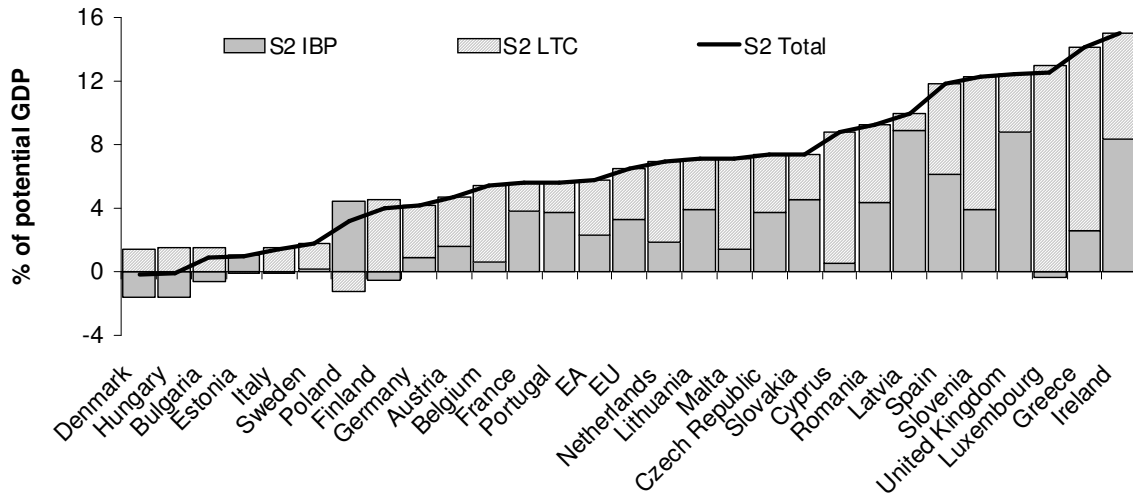


Figure 10 Initial structural primary balance and change in ageing-related expenditure



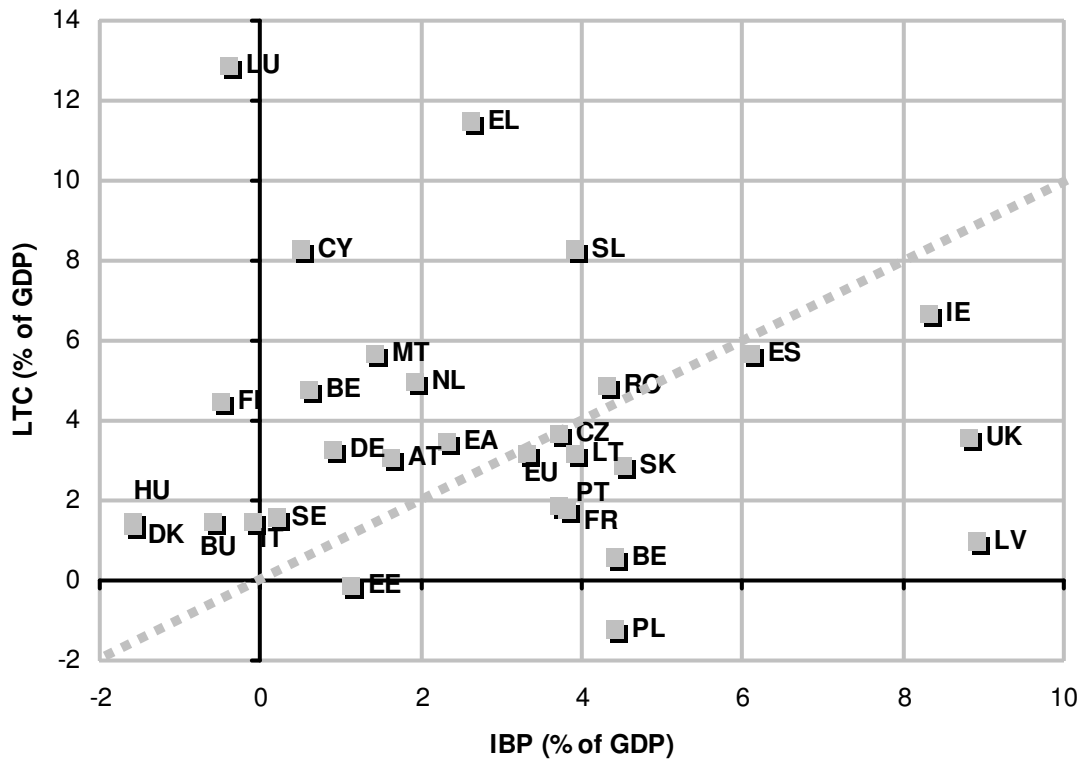
Source: European Commission (2009c)

Figure 11 Required adjustment of the structural primary balance



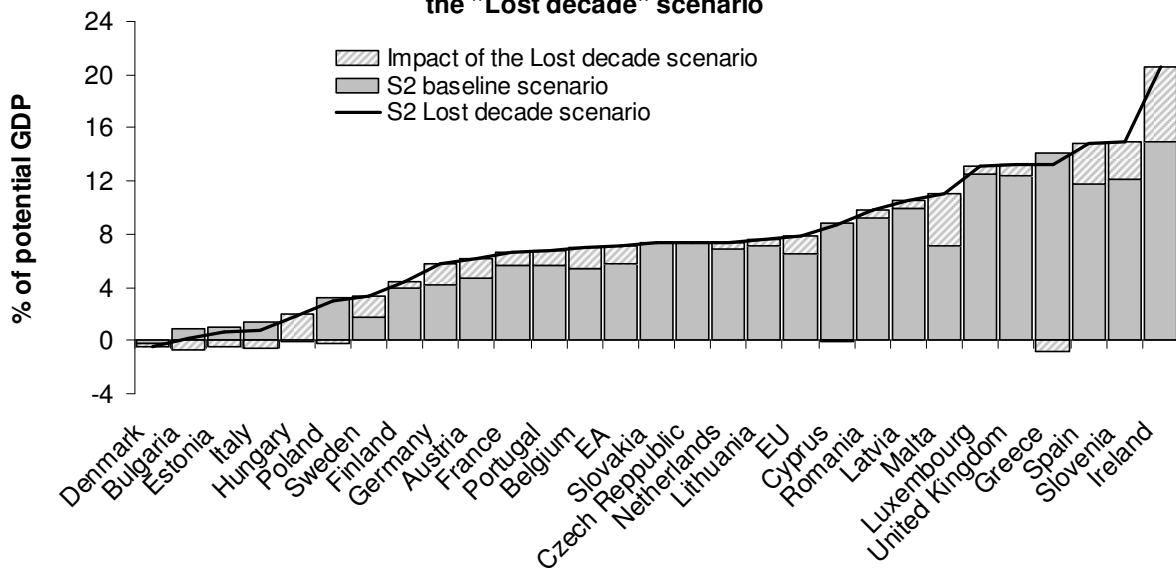
Source: European Commission (2009c)

Figure 12 Sustainability gap decomposition



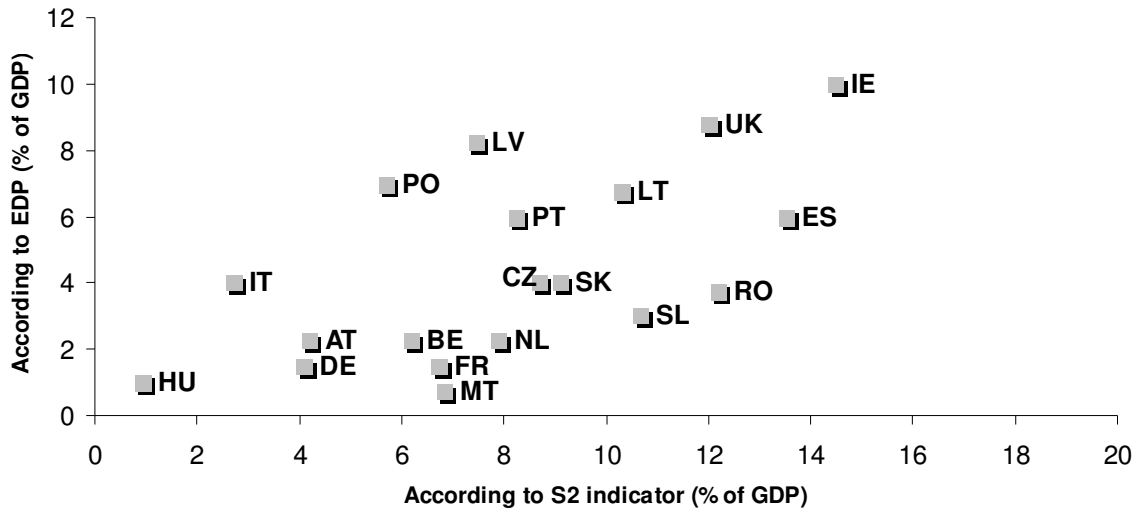
Source: European Commission (2009c)

Figure 13 Required adjustment of the structural primary balance: impact of the "Lost decade" scenario



Source: European Commission (2009c)

Figure 14 Required fiscal effort



Note: The required fiscal effort under the EDP is the minimum required cumulative change in the structural balance; the required fiscal effort according to the S2 indicator is the difference between the required structural primary balance over the period 2011-15 in the Sustainability Report (S2 indicator) and the actual structural primary balance in 2009. Greece is excluded since its fiscal effort is decided as part of the EU/IMF standby-arrangement. See Tables 4 and 5 for the sources.