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MACROECONOMIC EFFECTS OF FISCAL CONSOLIDATION POLICY IN THE EU

Under pressure to meet the Maastricht criteria, the member states of the European Union reduced their general government deficits by half between 1995 and 1997. Nevertheless, a recession did not occur. Given the importance of the diminished burden of interest on government debt as well as one-off budgetary effects and outsourcing measures for the development of public households, together with the declining rate of inflation, disposable income of households was cut less than expected. The satisfactory development of the world economy provided a favourable framework for fiscal consolidation; for the countries which managed to cut their budget deficits most strongly (e.g., Sweden, Italy and Austria), the marked drop of the savings ratio and/or major currency devaluations constituted essential prerequisites for a successful fiscal consolidation at the macroeconomic level.

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In 1996 and 1997, the consolidation of government budgets became the most important economic policy goal pursued by the EU member states. In view of this "economic policy experiment", it is of considerable interest to analyse the supply- and demand-side effects of restrictive budget policies and to subject the theoretical expectations of various economic schools to an empirical test.

COMPREHENSIVE CONSOLIDATION OF GOVERNMENT BUDGETS IN THE EU

Under pressure to comply with the Maastricht criteria, the member states of the European Union succeeded in reducing government deficit by an average of 2¼ percent of GDP. The consolidation efforts differed in intensity, as did the success achieved. The group of countries reporting the most substantial improvement in the general government financial balance includes Sweden (+6¾ percentage points of

Table 1: Budget consolidation and interest payments

As a percentage of GDP

	General government financial balance	General government debt	General government debt interest payments
	Change 1995-1997 in percentage points		
Sweden	+ 6.7	− 3.0	+ 0.4
Greece	+ 6.6	− 0.6	− 3.3
Italy	+ 5.0	− 2.5	− 1.9
Spain	+ 4.7	+ 2.6	− 1.0
Finland	+ 3.8	− 3.0	+ 0.6
U.K.	+ 3.8	+ 0.1	− 0.1
Ireland	+ 3.6	−17.4	− 0.6
Portugal	+ 3.3	− 4.3	− 2.1
Austria	+ 3.2	− 5.0	− 0.1
Netherlands	+ 2.8	− 7.7	− 0.4
Denmark	+ 2.4	− 9.6	− 0.4
Belgium	+ 2.0	− 9.0	− 0.9
France	+ 1.9	+ 5.2	− 0.2
Germany	+ 0.7	+ 3.1	+ 0.1
Euro area	+ 2.3	+ 2.3	− 0.4
EU	+ 3.0	+ 0.3	− 0.6

Source: OECD, Austrian Central Statistical Office, own calculations

GDP), Greece (+6½), Italy (+5), Spain (+4¾), and Austria (+3¼). At the other end of the scale, Germany reduced its public deficit by no more than ¾ percentage point. Measured by the development of receipts and disbursements (as a percentage of GDP), about one third of the consolidation achieved was attributable to revenue-side measures and two thirds to expenditure cuts. However, the reduction of government deficits, the increased ratio of general government receipts and the lower expenditure ratio are a reflection of not only discretionary consolidation measures, but also cyclical effects.

During the 1996 and 1997 period of consolidation, economic growth in the euro zone averaged 2 percent, i.e., ½ percentage point less than in the two-year period before. Besides the policy of consolidation, the slow-down of growth can also be attributed to the negative effects of major exchange-rate changes within the European monetary system in 1995. A comparison with the USA shows the weakening of economic activity more clearly: while the rate of growth in the euro zone fell short of the U.S. rate by ¾ percentage point in 1993-1995, the gap widened to –1¾ percentage points during the consolidation phase of 1995-1997. In terms of domestic demand, the growth shortfall was more pronounced: 1 percentage point p.a. in 1990-1995, and 2½ percentage points in the 1995-1997 period.

DIFFERENT THEORETICAL EXPECTATIONS

Different schools of economic thought take greatly divergent positions on the effects of restrictive budget policies on economic growth. According to Keynesian doctrine, a policy of consolidation reduces demand, at least on a short-term basis: public consumption and public investment activities are directly affected by spending cuts; tax increases and lower transfer payments diminish the disposable income of private households and slow down the growth of public consumption, while the savings ratio remains unchanged. Given the low rate of aggregate demand growth, the business community expects lower sales and, consequently, shows a reduced propensity to invest – unless the domestic demand shortfall can be made up for by higher net exports. However, a simultaneous effort of fiscal consolidation in all EU member states also reduces the volume of foreign trade between the member states.

Table 2: Production and demand in the euro area

Volume

	1994	1995	1996	1997
	Percentage changes from previous year			
Gross domestic product	+ 2.7	+ 2.2	+ 1.6	+ 2.5
Total domestic demand	+ 2.3	+ 2.0	+ 1.1	+ 2.0
Private consumption	+ 1.3	+ 1.7	+ 1.8	+ 1.5
Public consumption	+ 1.0	+ 0.8	+ 1.9	+ 0.1
Gross fixed investment	+ 2.3	+ 3.4	+ 0.4	+ 2.0
Private residential investment	+ 5.8	+ 1.7	± 0.0	+ 0.2
Other private investment	+ 2.0	+ 5.4	+ 2.0	+ 3.4
Exports of goods and services	+ 8.7	+ 8.0	+ 4.6	+10.2
Imports of goods and services	+ 7.8	+ 7.4	+ 3.3	+ 9.0
Net exports[1]	*+ 0.4*	*+ 0.3*	*+ 0.5*	*+ 0.6*

Source: OECD. – [1] Contribution to changes in real GDP (as a percentage of real GDP in the previous year).

From the Keynesian point of view, public spending cuts and tax increases slow down economic growth at least on a short-term basis – either directly through their effects on public consumption and public investment, or indirectly through a cut in the disposable income of households and expectations of deteriorating sales by the business community.

Moreover, according to the Keynesian multiplier theory, discretionary spending cuts are assumed to have a more restrictive effect than tax increases, since the level of government disbursements fully impacts on demand, while tax increases also reduce private savings. Given the higher marginal and average private consumption ratio, cuts of social transfers to low-income households have a stronger effect on demand than measures affecting higher income groups (tax increases or lower interest payments). Many Keynesians therefore expected a steep drop in demand and, consequently, declining growth and job losses in the wake of the consolidation policies pursued to meet the "Maastricht criteria" (*Barrell – Morgan – Pain*, 1995, *Eichengreen – von Hagen*, 1996).

Table 3: Economic performance of the euro area vis-à-vis the USA

	Relative growth performance 1990-1995	1995-1997
	In percentage points p.a.	
Gross domestic product	–0.7	–1.8
Total domestic demand	–1.1	–2.5
Private consumption	–0.9	–1.5
Public consumption	+1.7	+0.2
Gross fixed investment	–3.6	–7.5
Exports of goods and services	–3.1	–5.1
Imports of goods and services	–3.7	–7.0

Source: OECD.

Neo-classical theory focuses on two possible growth inducing effects of a restrictive budget policy, which – on the assumption of rational expectations – are likely to come into effect even in the short run:

- Expectation effects: In view of reduced public and social expenditure, consumers expect their tax burden to decline in the future. Hence, they tend to save less (Ricardian equivalence theorem), i.e., total demand does not decline (*Barro,* 1974). Moreover, positive expectations may induce higher private investment. It has also been argued that trade unions, expecting a future tax relief, show moderation in their wage demands already during the consolidation phase, which in turn has a positive effect on economic growth.

According to neo-classical theory, fiscal consolidation stimulates economic growth through rising expectations on the part of consumers and investors and a declining level of interest rates.

- Interest rate effects: If Ricardian equivalence theorem does not apply, a decline of the financing needs of the public sector results in a reduction of demand in the capital markets, with interest rates falling in view of diminished risk premiums (increasing "credibility"; *Blanchard,* 1985).

In recent years, numerous publications by representatives of neo-classical economic theory maintained that fiscal consolidation measures are likely to have expansionary effects already on a short-term basis. *Giavazzi – Pagano* (1990) refer to the examples of successful fiscal consolidation in Ireland and Denmark in the 1980s in their attempt to show that private consumption increases as a result of a restrictive fiscal policy. *Alesina – Perotti* (1997) as well as *Alesina – Perotti – Tavares* (1998) distinguish between a "successful", i.e,. growth-stimulating consolidation policy, which aims at reducing social transfers and compensation of employees in the public sector, and an "unsuccessful" consolidation policy, which increases taxes or puts a brake on public investment. Overall, they conclude that fiscal consolidation generates economic expansion, whereas rising government deficits have restrictive effects.

NEGATIVE EFFECTS OF CONSOLIDATION ON DEMAND LESS PRONOUNCED THAN EXPECTED

FINANCIAL BALANCES AS AN IMPORTANT ANALYTICAL INSTRUMENT

Whereas budget policy may have a discretionary impact on tax rates and certain elements of public spending, the general government financial balance is also determined by the volume of GDP, which in turn is a function of the interaction of the borrowing and savings patterns of the different sectors of the economy (*Steindl*, 1982). The financial balances of the macroeconomic agents constitute an important factor, as they provide the overall framework for budget policy, especially during phases of fiscal consolidation. In purely tautological terms, the general government financial deficit can only be reduced through increased borrowing by the business sector, private households or abroad. This is accounted for by the mechanical identity of credit and debit balances, i.e., the fact that in an economy changes in financial liabilities are always balanced by changes in financial assets by the same amount and that the sum total of the financial balances of all the sectors always equals zero:

$$\underbrace{(G-T)}_{\text{General government net borrowing}} = \underbrace{(S_H-H)}_{\text{Household saving}} + \underbrace{(I-S_B)}_{\text{Corporate borrowing}} + \underbrace{(X-M)}_{\text{Balance on current account}},$$

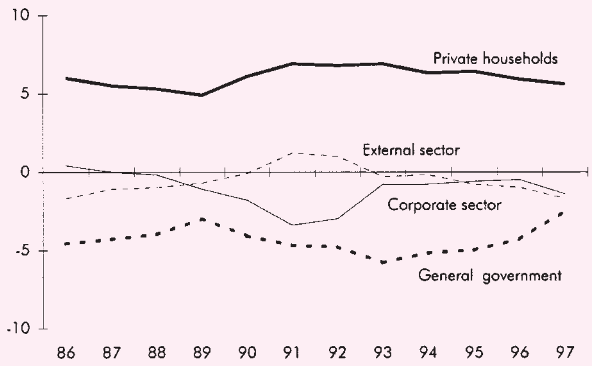
G . . . government spending, T . . . government revenues, S_H . . . private household savings, H . . . credit demand of private households, I . . . corporate investment, S_B . . . corporate savings, X . . . exports, M . . . imports.

The idea of financial balances is a simple tautology, but it may provide a useful framework for an empirical analysis of macroeconomic performance (*Rothschild,* 1966). An analysis of the development of financial balances will not permit the establishment of cause-and-effect relationships, unless additional assumptions regarding the behaviour of economic agents and the general government as well as exogenous factors are made.

It is an empirical fact that the financial surplus of private households tends to be relatively stable in the long run in many industrialised countries. The financial deficit of the

Figure 1: Financial balances by sectors in the euro area

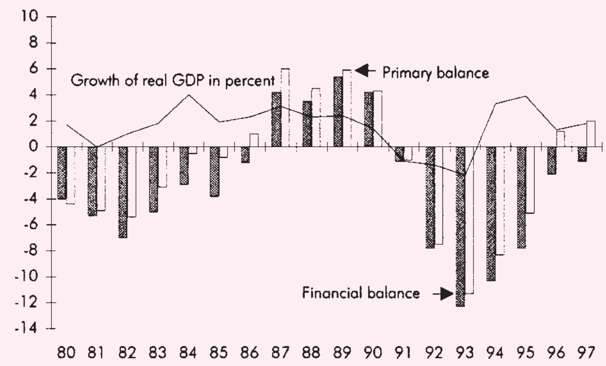
As a percentage of GDP



Source: OECD, excluding Luxembourg, Ireland, Portugal.

Figure 2: Growth and general government financial balance in Sweden

As a percentage of GDP



Source: OECD.

corporate sector fluctuates pro-cyclically in the course of the economic cycle: if profit and sales prospects are good, companies invest more and are willing to rely on borrowed capital. The financing position of the rest of the world is determined, above all, by the balance on current account, which is the result of growth differentials, the development of exchange rates, and divergences in monetary and fiscal policy.

An improvement in the balance on current account, a declining saving ratio, and a debt-financed expansion of corporate investment activities constitute a favourable macroeconomic framework for successful fiscal consolidation.

Employed as an analytical instrument, financial balances permit the identification of framework conditions under which a restrictive fiscal policy can be pursued without a substantial slow-down of economic growth:

- improvement in the balance on current account, i.e., increasing financial deficit of the rest of the world as a result of the improved price competitiveness or dynamic economic growth abroad;
- declining household saving ratio, i.e., expansion of domestic demand and increase of private borrowing;
- debt-financed expansion of corporate investment activities.

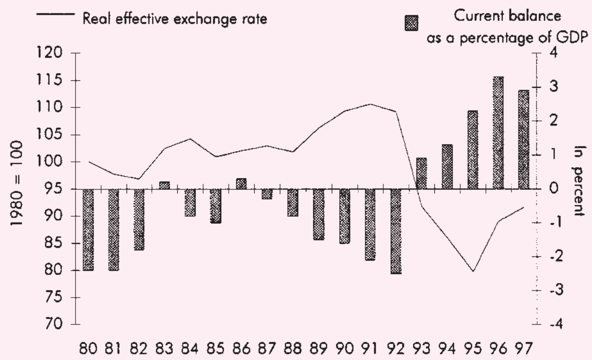
In the countries of the European Union, the financing position of each of the three private sectors deteriorated in 1996 and 1997, thus contributing towards the consolidation of public households. In Sweden, the financial balance of general government improved strongly (by 11¼ percentage points between 1993 and 1997, by 6¾ percentage points between 1995 and 1997). Economic growth slowed down noticeably from 1995 to 1997 in comparison with the period before; it fell below the EU average, but did not come to a complete standstill (on average +1½ percent p.a., compared with 3½ percent in 1993-1995). After substantial surpluses in previous years, the external sector marked up a deficit, the most important cause being the strong devaluation of the Swedish kronor. The financial surplus of private households, which had always been subject to major pro-cyclical fluctuations in the past, fell markedly during the consolidation phase. The corporate sector, which had reported a substantial credit balance during the first half of the 1990s, also saw its financial balance deteriorate considerably.

Since the mid 1980s, Italy has been pursuing a restrictive fiscal policy; in recent years, the level of net government borrowing was reduced at a particularly fast pace. The primary balance (receipts minus disbursements excluding interest payments) has been positive since 1992. Even during the phase of the most consistent budgetary restraint in 1996-97, the economy showed no signs of recession. However, the growth of real GDP slowed down considerably (+1 percent p.a. in 1995-1997, down from +2½ percent in 1993-1995) and remained far below the EU average. In macroeconomic terms, fiscal consolidation was supported, in particular, by the high exchange rate related financial deficit of the external sector. The financial balances of private households and the corporate sector also deteriorated.

Austria was able to consolidate the budget of the public sector within a short period in 1996-97 on both the reve-

Figure 3: Growth and general government financial balance in Italy

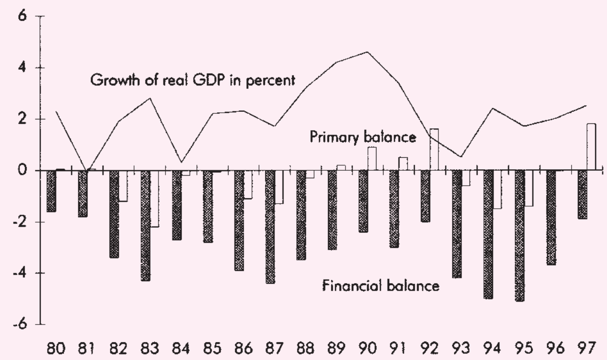
As a percentage of GDP



Source: OECD.

Figure 4: Growth and general government financial balance in Austria

As a percentage of GDP



Source: OECD.

nue and expenditure sides. Economic growth remained more or less at the level of the period before. The reduction of the financial deficit of general government was accompanied by a substantial reduction of private household surpluses; in 1997, the financial balance of the corporate sector also deteriorated considerably. Regarding the external sector, conditions continued to be unfavourable for fiscal consolidation and the surplus increased strongly – mainly as a result of the appreciation of the Austrian schilling. While the development of the balance on current account created excellent conditions for fiscal consolidation in other countries, Austria suffered from the improvement in the balance on current account of important trading partners (Italy, Sweden).

STRONG EXPORT DEMAND PREVENTS NOTICEABLE SLOW-DOWN OF GROWTH

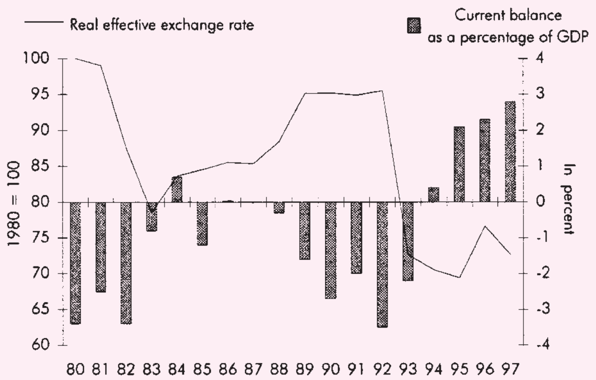
The decisive factor underlying the relatively favourable development of the EU economies – above all in 1997, the main year of fiscal consolidation – was the satisfactory performance of the world economy and, hence, the dynamic development of exports. Exports from the euro area increased by 10¼ percent, i.e., twice as fast as the year before. A successful export performance is not directly related to budget policy, but rather depends on the international economic cycle, which picked up noticeably – with U.S. demand for imports of goods increasing by 14¾ percent in real terms in 1997, after +10 percent in 1996. At the same time, the price competitiveness of the EU improved as a result of the appreciation of the U.S. dollar – with relative unit labour costs in the euro area in 1997 falling by 10.5 percent from the year before on account of changing exchange rate parities.

In 1997, net exports accounted for a quarter of total economic growth in the EU. If the import content of domestic demand and of exports is included in the calculation, more than half of the economic growth is attributable to the expansion of exports (with economic growth in Germany and Austria almost entirely due to exports).

In some countries with particularly stringent consolidation policies foreign demand made an above-average contribution to the success of fiscal consolidation. In Sweden, the turn-around in the balance on current account (i.e., the financial balance of the rest of the world) accounted for a major part of economic growth: while 1993 had closed with a deficit of 2¼ percent of GDP, 1997 reported a surplus of 2¾ percent. This was due to weak domestic demand, the satisfactory economic development of a number of important trading partners, and – above all –

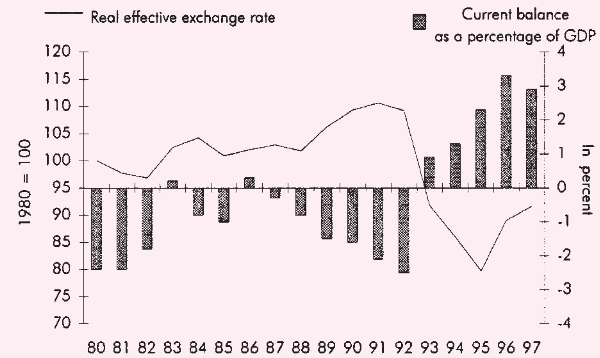
The favourable development of the world economy – above all strong import demand from the USA – was the engine of economic growth in the EU during the phase of budgetary consolidation. About 50 percent of economic growth in the EU members on average was accounted for by exports. For some countries, which were pursuing particularly restrictive fiscal policies, such as Italy and Sweden, the devaluation of their currencies, combined with a strengthening of exports and high current account surpluses, was another major factor of economic growth.

Figure 5: Competitiveness in Sweden



Source: OECD.

Figure 6: Competitiveness in Italy



Source: OECD.

the pronounced improvement in price competitiveness of Swedish goods on account of the devaluation of the Swedish currency. After the floating of the exchange rate, the real effective exchange rate dropped by 34 percent between August 1992 and April 1995. Exports increased by 20 percent p.a. in nominal terms.

In Italy, the balance on current account turned around after devaluations of the effective exchange rate of the lira by 35 percent between 1992 and 1995 from a deficit of 2½ percent of GDP in 1992 to a surplus of 3 percent of GDP in 1997. The improvement in competitiveness, the strong growth of exports and the high current account surpluses vigorously supported the process of fiscal consolidation in terms of financial balances.

DECLINING SAVING RATIO DIMINISHES SLOW-DOWN OF DOMESTIC DEMAND

Private consumption in the EU was growing at a very moderate pace – but more quickly still than would have been expected in view of the slackening in disposable income under the impact of fiscal consolidation. The household saving ratio fell by ¾ percentage point in the euro area and by 2½ percentage points in Austria. In a medium-term perspective, it is, however, expected to return to its long-term average; thus, the retarding effects of fiscal consolidation on economic growth may only take effect after a certain delay.

The dynamic development of exports not only contributed directly to economic growth in the European Union, but – through its income effects – also had an impact on investments and consumption. Nevertheless, growth of real domestic demand in Europe remained weak between 1995 and 1997, compared with both the period before and the USA. Sluggish demand for domestic and imported products is the most important reason for the improvement in the balance on current account of the EU – the surplus on current account of the euro area amounting to 1½ percent of GDP in 1997.

In real terms, private consumption grew by no more than 1.5 percent p.a. – more slowly than during the period before and much more slowly than in the USA. Nevertheless, the development of private consumption does not reflect that of disposable income: in some countries of the EU, the declining household saving ratio constituted an important factor in maintaining the level of consumption and mitigating the dampening effects of fiscal consolidation. In the euro area the saving ratio fell by ¾ percentage point during the consolidation phase. It remains to be seen, however, if this development is to be interpreted as a short-term deviation from the long-term trend (as sug-

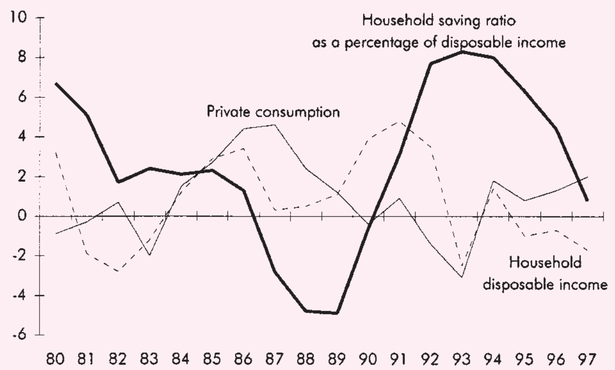
Table 4: Budget consolidation, income and consumption in the euro area

	1994	1995	1996	1997
General government financial balance as a percentage of GDP	– 5.0	– 4.8	– 4.1	– 2.5
Percentage points over previous year		+ 0.2	+ 0.7	+ 1.6
Household disposable income (volume)				
Percentage changes from previous year	+ 0.3	+ 2.1	+ 1.4	+ 1.2
Difference of 2nd order		+ 1.8	– 0.7	– 0.2
Household saving ratio (as a percentage of disposable income)	12.1	12.3	11.8	11.5
Percentage points over previous year		+ 0.2	– 0.5	– 0.3
Private consumption				
Percentage changes from previous year	+ 1.3	+ 1.7	+ 1.8	+ 1.5

Source: OECD.

Figure 7: Income and private consumption in Sweden

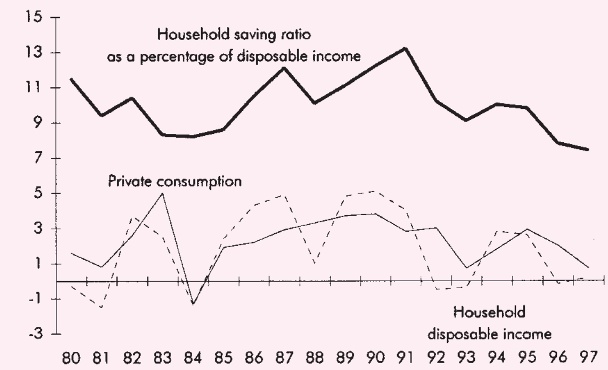
Percentage changes from previous year, volume



Source: OECD.

Figure 8: Income and private consumption in Austria

Percentage changes from previous year, volume



Source: OECD.

gested by error correction models) or as a reaction to lower interest rates or anticipated future tax reductions. If the former turns out to be correct (with past experience supporting the assumption), the growth-retarding effect of consolidation, though markedly mitigated in the initial phase, would remain noticeable over several years.

In Sweden, the drastic drop of the saving ratio from 8¼ percent (1993) to ¾ percent (1997) of household disposable income was instrumental in preventing a recession, caused by fiscal consolidation. Despite declining disposable income, the contribution of private consumption to real GDP growth, was perceptibly positive. The sharp decline of household saving as a percentage of disposable income was due to a number of causes: during the 1990-1993 recession, Sweden experienced its first phase of mass unemployment since the 1930s, which gave rise to considerable uncertainty with regard to future income levels and resulted in "anxiety-driven" savings (*Agell*, 1996). After the 1994 government reshuffle, Swedes regained confidence and reduced their excessive saving ratio. Social policy tended to cut transfer payments (income substitutes in the form of sickness, unemployment and old-age pension benefits) rather than the public offer of social services (e.g., child-care facilities). Thus, employment and the standard of living, particularly of women, remained relatively unaffected. Cuts in transfer payments were of a temporary nature and did not lead to a departure from the fundamental principles of the comprehensive welfare state (*Marterbauer,* 1998).

In Italy, household saving as a percentage of disposable income fell by another 1½ percentage points between 1995 and 1997, compared with the period before. It should be noted, however, that a substantial part of this development was due to the tax incentives provided for the purchase of new passenger cars ("scrap premium"), which contributed more than 1 percentage point to the 1997 growth of private consumption (+2½ percent in real terms).

Household disposable income in Austria was curtailed by over 2 percentage points in real terms per year as a result of fiscal consolidation in 1996 and 1997. Growth of private consumption slowed down, but did not come to a standstill, as the saving ratio dropped by 2½ percentage points to its lowest level in years. Private households had already shown a similar behaviour in the past: assuming the phases of slow income development (due, among other things, to fiscal consolidation) to be of a temporary nature, they have always given preference to consumption over "precautious saving". In 1998 – in a favourable economic environment and during a "consolidation break" – household saving as a percentage of disposable income rose by nearly 1 percentage point.

ESSENTIAL CONTRIBUTION FROM ONE-OFF BUDGETARY EFFECTS AND OUTSOURCING

To some extent, fiscal consolidation was achieved through measures which had a transient effect or were merely of an accounting nature and did not result in an immediate slow-down of economic growth. Among the best known examples of temporary deficit-reducing measures were the "Europe tax" in Italy – which yielded revenues equivalent to 1 percent of GDP and is to be paid back in subsequent years – or the postponement of public investment in Austria. Both measures led to a reduction of aggregate demand. Other measures, such as the extraordinary contributions by public telecommunications enterprises to public

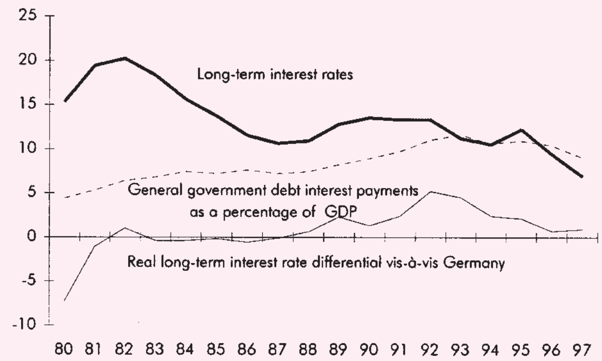
Table 5: Interest rates

	Short-term interest rate 1991-1995	Short-term interest rate 1996-97	Long-term interest rate 1991-1995	Long-term interest rate 1996-97
	In percent p. a.			
Euro area	8.7	4.8	9.0	6.5
Italy	11.1	7.8	12.0	8.1
Germany	7.2	3.3	7.3	5.9
USA	4.6	5.5	7.3	6.7
	Interest rate differential in percentage points p.a.			
Germany vis-à-vis the USA	+2.6	–2.2	±0.0	–0.8

Source: OECD, own calculations.

Figure 9: Interest rates in Italy

In percent



Source: OECD.

budgets in connection with the "insourcing" of pension payments for former PTT employees in France, Denmark and Austria, or the numerous cases of outsourcing of investment activities from the public sector, diminished the deficit without reducing demand. Throughout the European Union, such one-off budgetary effects amounted to a total of approximately ¼ percent of GDP in 1996 and ½ percent in 1997.

FALLING INTEREST RATES ACCOUNTED FOR ONE FIFTH OF OVERALL CONSOLIDATION EFFECT

The reduction of interest payments on general government debt meant a considerable relief for public households. It was due to the change-over to monetary union, a more restrictive fiscal policy, and a more expansionary monetary policy. In Greece and Italy, the interest rate effect accounted for almost half of the consolidation success achieved.

Interest rates have been declining noticeably in recent years in parallel with the process of fiscal consolidation. In Germany, for example, short-term interest rates fell by more than 1 percentage point between 1995 and 1997. Long-term rates were also brought down by 1 percentage point, whereas in Italy they dropped by almost 5 percentage points.

Whether or not changes in government demand for capital have a direct effect on the level of interest rates is a highly controversial issue – in both theoretical and empirical terms. In a survey of papers published on this subject, *Elmendorf – Mankiw* (1998) conclude that convincing evidence to support the effects of general government deficits or debt on interest rates (lower debt risk premium) is not available.

However, a relationship between fiscal consolidation and interest rates can be built on another causal chain. In Germany (and, hence, large parts of Europe), monetary policy obviously reacted to the efforts of fiscal consolidation and the curbing of inflation by adopting a noticeably less restrictive course. Whereas in the past the German Bundesbank had responded to substantial increases of wages and the budget deficit through a restrictive monetary policy, it permitted a softening of interest rates in view of fiscal policy restrictions. Interest rate policy also contributed towards fiscal consolidation via the exchange rate: during 1997, the main year of consolidation, the exchange rate of the DEM and the ECU against the U.S. dollar fell sharply.

Another important factor also needs to be considered in the countries with high interest rates: in the process of fiscal consolidation, expectations regarding participation in the Monetary Union were rising, which in turn resulted in a drastic decline of devaluation risk premiums. Thus, the interest burden to be borne by enterprises and the public sector was relieved by a substantial amount. The lowering of interest payments on general government debt accounted for almost half of the consolidation success achieved in Italy and Greece, and about one fifth throughout the EU. In Italy, interest expenses fell by 2 percent of GDP between 1995 and 1997.

To some extent, the effects of consolidation and interest rate reductions on investment activities offset each other within the European Union. Between 1995 and 1997, investment in construction slowed down noticeably despite lower interest rates, with the decelerating effects of falling public demand clearly dominating – growth of investment in machinery and equipment was almost cut to half compared with the 1993-1995 period. At the same time, countries with fast-growing exports – after currency devaluations – and a steep fall of interest rates reported above-average growth.

ECONOMIC POLICY CONCLUSIONS

Future fiscal consolidation measures – within the framework of the "Stability Pact" – may result in a more significant slow-down of economic growth than that experienced during the 1995-1997 period. One-off effects and outsourcing measures are limited in scope, further interest rate effects are not to be expected, least of all in the former soft-currency countries, devaluation has become impossible within the Monetary Union, and the saving ratio of households is expected to stabilise on a medium-term basis. Hence, an anti-cyclical budget policy is called for from the macroeconomic point of view.

The financial deficit of general government in the European Union was substantially reduced between 1995 and 1997. Except for a few particularly ambitious countries, such as Italy, Sweden and Austria, EU members hardly resorted to structural measures of consolidation (not counting lower interest payments, outsourcing measures and one-off effects).

With regard to its effects on economic growth, the consolidation process confirmed neither the concerns voiced by Keynesians nor the hopes expressed by neo-classical theory. It is true that economic growth slowed down noticeably over the previous period and vis-à-vis the USA, but the recession feared by many did not occur. Nor have any expansionary effects of consolidation on private consumption or investment activities become perceptible.

However, experience gained from the 1996-97 phase of fiscal consolidation does not permit the conclusion that further consolidation measures within the framework of the "Stability and Growth Pact", which provides for a reduction of general government deficits to zero, will again have no more than a moderate impact on economic growth.

The favourable performance of the world economy constituted an important factor underlying the success of the 1996-97 consolidation effort. Economic growth in the European Union was largely export driven. In some countries, the restriction on government borrowing was made up for in terms of net financial balances through devaluations and improvements in the balance on current account, i.e., higher net borrowing by the rest of the world. Thus, the negative effects of consolidation were shifted to the trading partners. Within the framework of Monetary Union, this instrument is available to a limited extent only, although the foreign trade relations with the USA (including the exchange rate development between the euro and the dollar) continue to be an important factor determining the development of the European economy.

In many countries the drop in savings as a percentage of household disposable income facilitated the process of consolidation. If the saving ratio again approaches the long-term average in a medium-term perspective, the retarding effects of consolidation on economic growth were postponed to subsequent years.

Fiscal consolidation was clearly supported by falling short-term and long-term interest rates. The reduction of interest payments on government debt contributed about one fifth to the total consolidation effect in the European Union. Capital spending and exports benefited from the lower level of interest rates, which was due to the reactions of monetary policy and the elimination of devaluation-risk premiums in the phase of transition to Monetary Union; the latter factor no longer applies under the conditions of Monetary Union.

A quarter of the consolidation effect is attributable to one-off effects and outsourcing measures, some of which had no impact on incomes and demand. Presumably, these instruments will be used to a limited extent in the future.

An analysis of some successful examples of consolidation illustrates the importance of favourable macroeconomic conditions for the success of fiscal consolidation. Lively private consumption, corporate demand for capital goods, and dynamic export activities – in brief, an environment of dynamic economic growth – greatly facilitate fiscal consolidation. Hence, measures of fiscal consolidation should be taken during a period of cyclical upswing so as to create enough room for an anti-cyclical fiscal policy in the phase of recession. An expansionary monetary policy may be essential to support fiscal consolidation. Thus, the well-balanced use of macroeconomic policy instruments is becoming a matter of crucial importance under the conditions of Monetary Union.

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Macroeconomic Effects of Fiscal Consolidation Policy in the EU

Future fiscal consolidation measures – within the framework of the "Stability Pact" – may result in a more significant slow-down of economic growth than that experienced during the 1995-1997 period. One-off effects and outsourcing measures are limited in scope, further interest rate effects are not to be expected, least of all in the former soft-currency countries, devaluation has become impossible within the Monetary Union, and the saving ratio of households is expected to stabilise on a medium-term basis. Hence, an anti-cyclical budget policy is called for from the macroeconomic point of view.