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EU Fiscal Consolidation after the Financial Crisis Lessons from Past Experiences

Bank of Italy Occasional Paper

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Abstract

The global financial crisis has led to a sharp deterioration of EU countries' public finances. Views are split regarding the most appropriate consolidation strategy to follow, in particular considering: the timing of fiscal consolidation in relation to the path of economic recovery reflecting (a) the trade-off between consolidation and stabilisation; (b) fiscal consolidation in the context of a distressed banking system where the credit channel is hampered and without which economic recovery can hardly take place, (c) the absence of exchange rate adjustment in the euro area which could make it more difficult for countries with competitiveness problems to achieve successful fiscal consolidation. The existing literature on fiscal consolidations provides only partial evidence on these issues. In this paper we set out to investigate these questions by drawing on EU (and non-EU OECD) experiences during the period 1970-2008. We estimate econometrically the determinants of successful fiscal consolidations and show that: (i) in the presence of a systemic financial crisis, the repair of the banking sector is a pre-condition for a fiscal consolidation to succeed in reducing debt levels, especially so when fiscal consolidations are sharp, (ii) even after the banking sector is repaired, fiscal consolidations are usually less successful than in absence of financial crises, although more vigorous fiscal consolidations (i.e., cold shower) tend to yield higher results, (iii) current debt dynamics in the EU are very unfavourable and in some cases, coupled with rising debt servicing costs and much deteriorated growth outlook warranting differentiated consolidation strategies across EU countries, (iv) we do not find conclusive evidence in support of exchange rates (including real exchange rate) depreciation/devaluation as enhancing the success of fiscal consolidation as their effect appear to be low and insignificant.

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