Editorial

Scenarios for Government Debt in Europe: Growth versus Consolidation Debate

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The Keynesian moment in the aftermath of the financial and economic crisis in 2008/09 did not last very long. Soon, the policy discourse was that governments must now engage in fiscal consolidation to get public finances back on a sustainable footing. In the euro area, the call for fiscal consolidation measures implemented on the national level was accompanied by attempts to coordinate and monitor economic policy more closely and more effectively, embracing both crisis resolution mechanisms (e.g., rescue funds) and crisis prevention measures (e.g., reform of the Stability and Growth Pact, fiscal compact).

More than two years since the outbreak of the sovereign debt crisis, some member countries on the euro area's geographical periphery still face severe fiscal consolidation requirements and their long-term debt sustainability remains clouded by uncertainty.

The debt dynamics hinge crucially on fiscal policy discipline, future economic growth and the financing conditions prevailing on the financial markets. But a scenario-based analysis shows that reversing the debt momentum both in the EMU countries that have been hit particularly hard by the crisis (Greece, Ireland, Portugal, and Spain) and in the core monetary union states (Germany, France, and Italy) is not an insurmountable task.

Even in a macroeconomic environment that is not overly optimistic (real GDP growth of 1-2%), the member states that are currently plagued by debt could make a return to long-term debt sustainability. This will, however, require a resolute commitment to fiscal consolidation together with implementation of the envisaged economic reforms. It is also important that the EU provides the necessary support for the amount of time needed for these countries to prove that their consolidation efforts have been successful. By way of example: If Italy generates a 4% primary surplus (planned for 2013) and notches up only 1.0% annual growth, the debt ratio will go down to 90% in 2025 with interest expenditure around 4% of GDP.

However, at a time when the recovery is still fragile and monetary policy already loose, difficult trade-offs between short-term growth and consolidation might arise – typical estimates of short-run fiscal multipliers amount to 0.5-1.0%.

They imply that in the short run, the impact of consolidation on GDP growth is likely to be negative. But there may be permanent longer-term gains in the level of output. Over time, financial markets will reward fiscal probity with reduced borrowing costs in the sovereign debt market, stimulating private domestic investment as a source of employment and growth.

A well-considered choice of policy instruments helps to ease short-term trade-offs, with some measures strengthening the economy's long-run growth potential, while also helping to ensure fairness and political acceptance of the consequences of consolidation.

Economic analyses show that the chances of success are improved by giving priority to spending cuts rather than tax increases, and by outlining and sticking to credible fiscal roadmaps. Clearly, countries with credibility will have more freedom regarding the timing. Last but not least, a convincing policy response to the sovereign debt crisis needs to combine the consolidation of public finances with structural reforms aimed at substantially improving medium-term growth prospects in member states.

These arguments counter the recent political tide in Europe shifting away from austerity measures to calls for growth initiatives.

Growth initiatives definitely are needed in terms of structural reforms, improving the incentives for investment, innovation and labour input or opening up areas to more competition. On the other hand, retreating to debt-financed demand programmes is not a way towards higher, but rather lower medium-term growth. It would mean repeating the strategies that in many countries led into the present crisis.