

## Box 7

### FISCAL ANCHORING AMID UNCERTAINTY

Since the recent financial crisis and severe economic downturn, government debt-to-GDP ratios in many euro area countries have risen to very high levels. At the same time, risk aversion in financial markets has increased. As such a combination carries potentially large macroeconomic risks, this box reviews the benefits of fiscal consolidation, particularly in a high-debt environment.

#### Costs and benefits of fiscal consolidation

In the short term, fiscal consolidation reduces aggregate demand and thus has a negative impact on economic activity. At the same time, credible and ambitious consolidation raises expectations of future economic growth and induces economic reactions, which may offset the demand effect in the short term. The conditions under which these expectation effects are particularly large, as identified in the literature, are likely to apply to a considerable extent in the current economic environment. Notably, they include low confidence in the sustainability of public finances under unchanged policies, and the announcement of ambitious and credible consolidation plans based on a growth-friendly change in the overall fiscal strategy.<sup>1</sup>

<sup>1</sup> See the box entitled “Fiscal consolidation: past experience, costs and benefits”, *Monthly Bulletin*, ECB, June 2010, and the article entitled “The effectiveness of euro area fiscal policies”, *Monthly Bulletin*, ECB, July 2010, for an overview of the costs and benefits of fiscal consolidation.

These beneficial short-term expectation-based effects reflect the clear growth-enhancing benefits of fiscal structural reforms in the longer term. A reduction in governments' financing needs leads to lower long-term interest rates, owing to lower demand for savings and declining risk premia. This improves financing conditions in the private sector and stimulates productive investment. For the government, this frees up resources to reduce distortionary taxes and finance more productive expenditure. Moreover, with sound fiscal positions, households and enterprises can trust in the government's ability to smooth out economic fluctuations through the operation of automatic stabilisers. A safe macroeconomic environment is a prerequisite for long-term productive investment to take place, be it in physical capital or in the formation of human capital through education.

Empirical studies across a wide range of industrial countries and time periods provide important evidence on the growth-inhibiting effects of high government debt burdens. In particular, a number of recent studies find an adverse relationship between debt-to-GDP ratios above 90% and economic growth.<sup>2</sup> While the observed critical debt threshold of around 90% of GDP appears robust across different data samples and methodologies, it is most likely not invariant to changes in the economic environment. In the current economic environment of considerable uncertainty, the growth-inhibiting effects of debt may already start at lower levels.

### Consolidation in an uncertain environment

Aside from having positive effects on growth, fiscal consolidation efforts can reduce the risk of negative and mutually reinforcing links between government finances, the financial sector and the rest of the economy. The heightened degree of risk aversion that characterised the financial crisis has led investors to make sharper distinctions between government borrowers, as reflected in the increasing divergence of government bond spreads in the euro area. In the case of Greece, concerns over the sustainability of public finances impeded the ability of the Greek government to finance itself in the market, which has threatened to spill over to other euro area countries.

The risks of a loss of confidence in the sustainability of public finances in one country are not limited to contagion across sovereign bond markets. The effect of a fiscal crisis on the holders of government debt, such as banks, pension funds and individual investors, can undermine financial stability and the outlook for the real economy. In particular, as witnessed during the financial crisis, uncertainty can easily skip across different asset markets, so that volatility in government bond markets adversely affects activity in other financial market segments. A resulting slowdown in the extension of credit could be one consequence. The fact that government bonds are frequently used as collateral for financial transactions adds weight to such concerns.

The confidence of markets in the sustainability of public finances is determined by a number of country-specific and time-variant factors, such as the debt and deficit ratios, implicit public liabilities, the financing structure of its current debt, the growth outlook and the country's fiscal track record. It is therefore impossible to predict precisely the level of debt that will ensure confidence in the sustainability of public finances. Clearly, the benefit of pursuing sustainability-

<sup>2</sup> The correlation between high debt and lower growth is established for a very long time period by Reinhart, C.M. and Rogoff, K.S., "Growth in a time of debt", *NBER Working Paper Series*, No 15639, National Bureau of Economic Research, January 2010. Robust econometric evidence is presented by Checherita, C. and Rother, P., "The impact of high and growing government debt on economic growth: an empirical investigation for the euro area", *Working Paper Series*, No 1237, ECB, 2010. See also Kumar, M. and Woo, J., "Public debt and growth", *Working Paper Series*, No 10/174, IMF, 2010.

enhancing policies is large in the current risk-averse environment. In a global high-debt environment, this benefit of macroeconomic stability is magnified, since it reduces the risk of contagion to other countries.

To achieve large reductions in government debt and reap the benefits of consolidation, past experience<sup>3</sup> in euro area countries shows that countries will need to commit firmly to longer-term fiscal consolidation, a strong focus on spending reduction and parallel structural reforms to support potential growth. This will provide a fiscal anchor in the current uncertain environment and prevent fiscal burdens from weighing down on growth in the longer term.

<sup>3</sup> See Nickel, C., Rother, P. and Zimmermann, L., “Major public debt reductions – Lessons from the past, lessons for the future”, *Working Paper Series*, No 1241, ECB, 2010, the box entitled “Experience with government debt reduction in euro area countries”, *Monthly Bulletin*, ECB, September 2009, and the box entitled “The Greek economic and financial adjustment programme”, *Monthly Bulletin*, ECB, May 2010.