Summary for non-specialists
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# Fiscal Multipliers and Public Debt Dynamics in Consolidations

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EU countries have seen large debt increases since the onset of the crisis. In most EU countries debt is now at an unprecedented level, which has put some Member States under close financial markets scrutiny. As a consequence, a number of countries have had to adopt sizeable consolidation packages to cut deficits with a view to prevent debt ratios from rising further.

In this context, a vast public debate is taking place on the effectiveness of consolidation in government finances in the current situation, centred on the question of whether "austerity can be self-defeating". In this context, "self-defeating" is understood as a reduction in government expenditure that leads to such a strong fall in activity that fiscal performance indicators actually get worse.

Given the renewed relevance of the debt, both in the financial markets, the public discussion has centred on the debt-to-GDP ratio as the key fiscal policy indicator. The present paper explores the possibility of self-defeating consolidations and aims to define precisely the conditions under which debt ratios can increase in response to fiscal consolidations. The main result in this respect is that such a possibility exists, but is mostly short lived and its occurrence depends on the effects on sovereign yields.

This paper finds a general condition that describes how the debt ratio reacts to consolidation measures as a function of the relevant parameters such the starting debt ratio, the cyclical budgetary semi-elasticities and fiscal multipliers. This basic condition shows that in presence of a high starting debt ratio and of a high cyclical semi-elasticity, relatively high fiscal multipliers more likely to be observed in crisis times are needed to have undesired effects of consolidations in the short term. In particular, the success of a consolidation in reducing the debt ratio depends crucially on the value of the multiplier, which measures the impact of consolidation on growth, and on the reaction of sovereign yields to such a consolidation. Hence, section 3 reviews the theoretical and empirical literature on the value of the multipliers.

We then show how such a conclusion changes when account is taken of the effect on yields, a particularly relevant condition in the current sovereign crisis. Section 3 shows that in the current context, when fiscal multipliers are deemed to be higher than in normal times, debt ratios may increase in the short term in response to fiscal tightening, but such an increase is mainly short-lived.

Section 4 analyses the conditions influencing the number of years that, in case of a short-term consolidation-induced debt-increase, are needed for a consolidation to show its effects on the debt ratio. It shows that the typical horizon for a consolidation to improve debt is two-three years – under the situation in which debt increases from the beginning. Intuitively, the main factors influencing the length of the reverse effect are the multipliers at the different years and the initial level of debt and deficit. Finally, Section 5 presents a set of policy conclusions.