Effects of fiscal consolidation envisaged in the 2013 Stability and Convergence Programmes on public debt dynamics in EU Member States

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The paper presents a simple analysis of the public debt-to-GDP ratio responses to fiscal consolidation efforts envisaged in the latest (2013) Stability and Convergence Programmes (SCPs) presented by EU Member States. In particular, the paper focusses on the impact that different assumptions on fiscal multipliers have on the projected dynamics of the public debt ratio.

By incorporating multipliers' effects in the standard debt evolution equation, the analysis presented in the paper has the advantage of providing, in a rather simple way, debt projection results accounting for the operation of the fiscal multipliers. A counterfactual (baseline) no-consolidation scenario is defined, to which results for the SCP scenario are compared. A set of low, medium and high multipliers' values is chosen and countries are allocated to the low- and high-multiplier groups based on reasonable criteria taken from the relevant literature.

In the current juncture characterised by deep and prolonged recessions in some Euro Area economies, experiencing high and growing unemployment rates, malfunctioning of traditional credit channels, financial constraints and pressure in sovereign debt markets, fiscal multipliers are deemed to be higher than in normal times (unless, with no fiscal consolidation, a country was perceived to substantially increase the probability of default on its sovereign debt). It is therefore the more important that feedback effects of fiscal consolidation on growth are taken into due account, when drawing conclusions on projected debt ratio dynamics.

Our analysis shows that, in the short run, "self-defeating" fiscal consolidation (i.e. fiscal consolidation leading to a *temporary* increase in the debt-to-GDP ratio) arises as *one of the possible outcomes* in our simple simulation model. Key determinants behind such an outcome are the parameters governing the size of the fiscal multiplier (its initial value, as well as its persistence over time) and the type of reaction held by financial markets (requiring lower or higher yields in the wake of fiscal consolidation).

When a high multiplier is used in the projections, this, together with currently high debt levels, would indeed entail short-term increases in the public debt-to-GDP ratio in response to fiscal consolidation, also if financial markets react "normally" (i.e. yields decrease when fiscal consolidation takes place). No significant short-term increases in the debt ratio would, on the contrary, be obtained for consolidating countries with an assumed low multiplier. On the other hand, if financial markets reacted "myopically" to consolidation (i.e. yields increased, based on financial markets' expectations of a higher debt ratio brought about by fiscal consolidation in the short run), an intermediate value of the multiplier would already be sufficient to generate a temporary increase in the debt ratio. Our analysis also highlights that, for high but plausible values of the multipliers, this counter-intuitive effect of a debt ratio increase following consolidation would be short-lived, unless financial markets react myopically to fiscal consolidation. Based on the observation that multipliers are expected to be higher in the current crisis context, short-term increases in the debt ratio following consolidation (relative to a baseline scenario of no consolidation) are likely for Belgium, Cyprus, France, Greece, Ireland, Italy, Portugal, Slovenia and Spain. However, these debt increases are expected to fade within maximum three years from the beginning of the consolidation programme, when financial markets behave normally. Based on planned consolidation efforts, the projected debt dynamics in some EU Member States implies it will in any case take many years for the debt ratio to get below its 2012 value, also in case of normal financial markets.

The final part of the paper presents a comparison of results obtained under the two assumptions of frontloaded versus back-loaded consolidation. The analysis shows that postponing fiscal consolidation with the argument that low multipliers are expected to prevail in the future would not improve the debt ratio dynamics. On the contrary, if postponing consolidation implies that the debt increases up to around 2020, a more adverse reaction by financial markets, and consequently worse economic and fiscal prospects, can be expected.