Summary for non-specialists
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Fiscal consolidations and spillovers in the Euro area periphery and core
Jan in 't Veld

This paper describes model simulations of fiscal consolidation measures undertaken in 2011-2013 in the EA periphery and core. It uses a variant of the Commission’s QUEST model, a multi-country DSGE model, which includes Germany, France, Italy, Spain, Portugal, Ireland and Greece separately, and models the rest of the EA as one block. The simulations assume ‘crisis’ conditions prevailing (high share of constrained households, ZLB) and uncertainty about the nature of fiscal consolidations with gradual learning.

The GDP effects depend crucially on the composition of the consolidation and on how quickly expectations are affected. Under uncertainty and gradual learning negative GDP effects are largest. Expenditure-based consolidations have larger impact multipliers than revenue-based consolidations (for Spain 1.1 vs. 0.5 resp., on average 0.8).

While average impact multipliers are in the range between ½ and 1, depending on the degree of openness, negative spillovers can add between 1½ and 2½ % to the negative GDP effects. The GDP impact could be considerably smaller if credibility is achieved earlier, as opposed to the assumed gradual learning in these scenarios, but the effects could be larger still if consolidations had been more biased towards expenditure measures.

Based on observed changes in structural primary balances 2011-13, the simulated GDP losses after three years consolidations amount to between 3 and 8%: (DE:-3.9; REA:-3.2; FR:-4.8; IT:-4.9; ES:-5.4; IE:-4.5; PT:-6.9; EL:-8.1). Higher risk premia add further to the negative GDP effects (section 4), adding between 2 and 3% to the simulated output losses.

The finding of large negative output effects and significant negative spillovers does of course not imply that fiscal consolidations should have been avoided. Highly indebted countries faced pressure from financial markets, or in some cases had completely lost access to markets, and a slower pace of consolidation could have raised general fears of sovereign default. Such expectations of default could lead to worse growth outcomes than consolidations per se (Corsetti et al (2012), Roeger and in ‘t Veld (2013)).

As spillovers from consolidations in Germany and core EA have worsened the overall economic situation, the question is how a temporary stimulus now could support growth in the euro area. A simulation of such a temporary fiscal stimulus in surplus countries (Germany and other core EA) shows it can boost output and help reduce their current account surpluses. The improvement in current account deficits in the periphery is however small.