Summary for non-specialists
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EU fiscal consolidation after the financial crisis. Lessons from past experiences

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Before 2007 systemic financial crises were mainly the fate of emerging economies. EU countries had been relatively immune, the most notable exceptions being Finland and Sweden during the 1990s and, earlier, Spain at the end of the 1970s. For instance, Laeven and Valencia (2008) report 122 systemic financial crises episodes between 1970 and 2007. Of these, only 22 crises occurred in today's EU27 (that is, including the countries that acceded to the EU in 2004) and the OECD. The crises have usually been very costly: the same authors estimate that net fiscal outlays to rehabilitate the banking system averaged 13% of GDP and increases in the public debt ratios averaged 20% of GDP. Owing to their relatively immunity from crises in the past, the EU countries were caught by surprise by the deterioration in public finances consequent to the financial crisis although developments in the run-up to it suggested that some countries, especially those that had experienced the fastest credit growth, were particularly vulnerable to the economic downturn to come. Following the crisis, rising government deficits, low economic growth and support to the financial sector are leaving a legacy of rapidly growing government debt ratios, which EU countries are currently tackling at different speeds according to their fiscal consolidation programmes.

The very large increase in public debt in the wake of the financial crisis can be considered as a transfer of liabilities from the private sector (where private indebtedness to GDP ratio has in some case more than doubled over less than a decade) to the public sector. At the same time, questions remain on the extent to which undisclosed losses continue to weigh on the banking sector. Europe appeared initially less exposed than other developed economies to the global financial crisis as banks were considered to have sufficient capital cushions and to be little exposed to the US subprime crisis. However, with hindsight, several European countries banking systems appear to face especially difficult situations either as a result of fragmented banking sector, rising borrowing costs, deteriorated capital ratios and growing exposure to non-performing loan especially in countries where house prices are experiencing the steepest reversal since the onset of the crisis. Serious concerns about European countries debt sustainability has only added to these difficulties most notably in countries most under close scrutiny by financial markets.

While the distressing effects of the global financial crisis are still unfolding policy actions must be taken on two fronts: on the one hand to restore public finances sustainability, including through adaptation of the EU fiscal and economic surveillance framework and, on the other hand, to restructure the financial sector, including through regulatory reform, not least to facilitate effective and growth-enhancing fiscal consolidation. While these goals are clearly challenging, past experience suggests that they are not out of reach. However, the evidence provided by Reinhart and Rogoff (2010) cautions that financial crises often end up in debt crises while Laeven and Valencia (2008) strongly suggest that durable fiscal consolidation is exceedingly difficult while the financial sector is still ailing. These facts should help drawing lessons to tackle the current European policy challenges, paying due attention to the EU-specific context and, more specifically, to the case of the euro area countries, where the absence of the nominal exchange rate adjustment could make it more difficult for certain countries to achieve their fiscal targets. To date, however, there has been no systematic investigation of the link between fiscal consolidations and financial crises and, a fortiori, of the specific feature of EU and euro area economies. The objective of this paper is to begin to fill this gap by considering European countries together with other non-EU OECD economies, where financial crises had also happened during the period 1970-2008. More specifically, we conduct an econometric analysis of the determinants of successful fiscal consolidation during or in the aftermath of systemic financial crises, where the criterion used to define fiscal consolidations as "successful" depends on the size of the reduction in the level of public debt in the medium-run. We pay specific attention to one specific feature of the current situation of most EU economies, which relates to the high level of public debt these countries entered the global financial turmoil in 2007. Our findings can be summarised as follows.

We find evidence suggesting that resolute policy action to restore the functioning of the financial sector is a pre-condition for achieving successful fiscal consolidations despite the fact that fiscal consolidations conducted in the aftermath of financial crises tend to be significantly less successful. Interpreting these results in the current context and giving due attention to country-specific issues suggest that a swift restructuring of the EU banking sector including regulatory changes and appropriate management and disclosure of exposure to impaired assets, are key conditions to support fiscal consolidation in the coming years. Put differently, to some extent the solution to the current EU fiscal problems might be of a non-fiscal nature.

Our results also suggest that fiscal consolidations need to be tailored to country-specific situations suggesting that a proper coordination of national fiscal plans is much needed. While the starting debt level (and related-risk of rising debt servicing burden) play a significant role, these elements become less important economically once due account is taken of the fact that countries with high debt have also comparatively more incentives to undertake fiscal consolidations, which may in part also explain their success or failure. More specifically we show that countries facing high debt level and high interest rates and/or at risk of experiencing low GDP growth in the coming years would have better chances of achieving successful fiscal consolidations if these were sharp and sustained while other countries were such constraints are less binding would be better off by undertaking more gradual fiscal consolidations. Generally speaking, public expenditure-cuts based consolidations tend to be more effective in part because these send convincing signals regarding the political will of the fiscal retrenchment as well as its medium-run viability.

Finally, we also find evidence suggesting that while exchange rate devaluation/depreciation may help to complement fiscal consolidation effort, these devaluation/depreciation are no guarantee to achieving successful fiscal consolidations. A number of possible factors can explain this result. First, the contribution of devaluation/depreciation depends on the degree of exchange-rate pass-through and the degree of trade-openness, which are to a larger extent out of governments' control. Furthermore, past experiences of successful fiscal consolidations conducted following large exchange rate devaluations were made possible through the anchoring of inflation expectations by pegging national currency to an inflation-proof currency, a role which was typically played by the Deutsche Mark in the EU before the advent of the euro. Overall, ongoing discussions on the difficulty to undertake fiscal consolidations in the absence of exchange rate devaluation in the euro area tend to disregard the fact that past successful devaluations have often come together with wide-ranging macroeconomic reform packages, which were arguably the most important factor of adjustment and did not depend on devaluation in order to be implemented.