Public finances: consolidation following crisis of confidence

Following the onset of the financial and economic crisis, public finances in the states of European monetary union deteriorated dramatically, and for 2009, almost all member states ran an excessive deficit. The about-turn was particularly pronounced in countries that had previously experienced macroeconomic or financial exaggerations. While these imbalances had a positive impact on public finances before the crisis hit, their inevitable correction drove government deficits and debt up sharply. Tax revenues fell, while labour market spending rose. In many countries, economic stimulus programmes were a further drain on the public coffers. In addition, large amounts of public funds were used to support the financial markets in some instances, which equates to a transfer of losses and debt from the private to the government sector.

The radically changed economic and fiscal prospects as well as the insight that considerable imbalances had built up previously, together with heightened political uncertainty in some countries, resulted in a reassessment of the risk associated with lending to individual sovereigns. In several countries, doubts about the government's ability and willingness to pay, and concomitantly risk premiums on government bond yields, grew so much that these states resorted to assistance under fiscal and macroeconomic adjustment programmes or took steps to support banks.

From 2010 onwards, most of the countries hit hardest by the crisis took measures to bring down soaring government deficit ratios. However, the improvement was frequently less than originally targeted, and the agreed plans and requirements were loosened – in some cases repeatedly. One problem was that the underlying macroeconomic structural problems, and thus the extent of the adjustments needed, were obviously underestimated. Overall, government debt ratios have continued to rise noticeably up until recently and have reached very high levels in most instances. Further consolidation is needed, and public finances remain vulnerable to negative shocks. In addition, the ongoing fiscal uncertainty threatens to depress overall development.

Sound public finances in the member states are a prerequisite for smooth economic growth in the monetary union. They ensure fiscal manoeuvrability, promote sustained economic growth and high employment, and help stabilise the financial market. They thus make it easier for monetary policy to ensure price stability in the medium and long term. Those countries whose public finances are still highly vulnerable to negative shocks especially must continue to press ahead with consolidation, even as the macroeconomic adjustment process continues.

Divergent developments in the countries worst hit by the crisis

Before the crisis, some of the worst hit countries had sound fiscal metrics but macroeconomic imbalances …

Public finances have developed very differently in the individual member states. However, there are some similarities. For instance, one group of the countries particularly badly affected by the crisis discussed in this article (Spain, Ireland and Cyprus) exhibited relatively sound public finances before the onset of the financial and economic crisis as measured by conventional indicators (general government balance, structural balance[1] and debt ratio). This was mainly because macroeconomic and financial imbalances, some of them connected to an overheated property market, had temporarily caused a sharp expansion in domestic demand and consequently boosted public finances. Rapid wage growth and strong private consumption were reflected in income and consumption tax revenues. Unexpected and exceptional income was, moreover, generated in connection with large-scale real estate transactions and rising asset prices. In some instances, government revenues grew much stronger than would have been expected given developments in nominal gross domestic product (GDP) and in view of legislative changes. General government spending was also expanded sharply. However, expenditure ratios initially changed very little given the rapidly rising GDP (in the denominator). Overall, budget surpluses were generated, and the debt ratio was usually well below the 60% reference value.

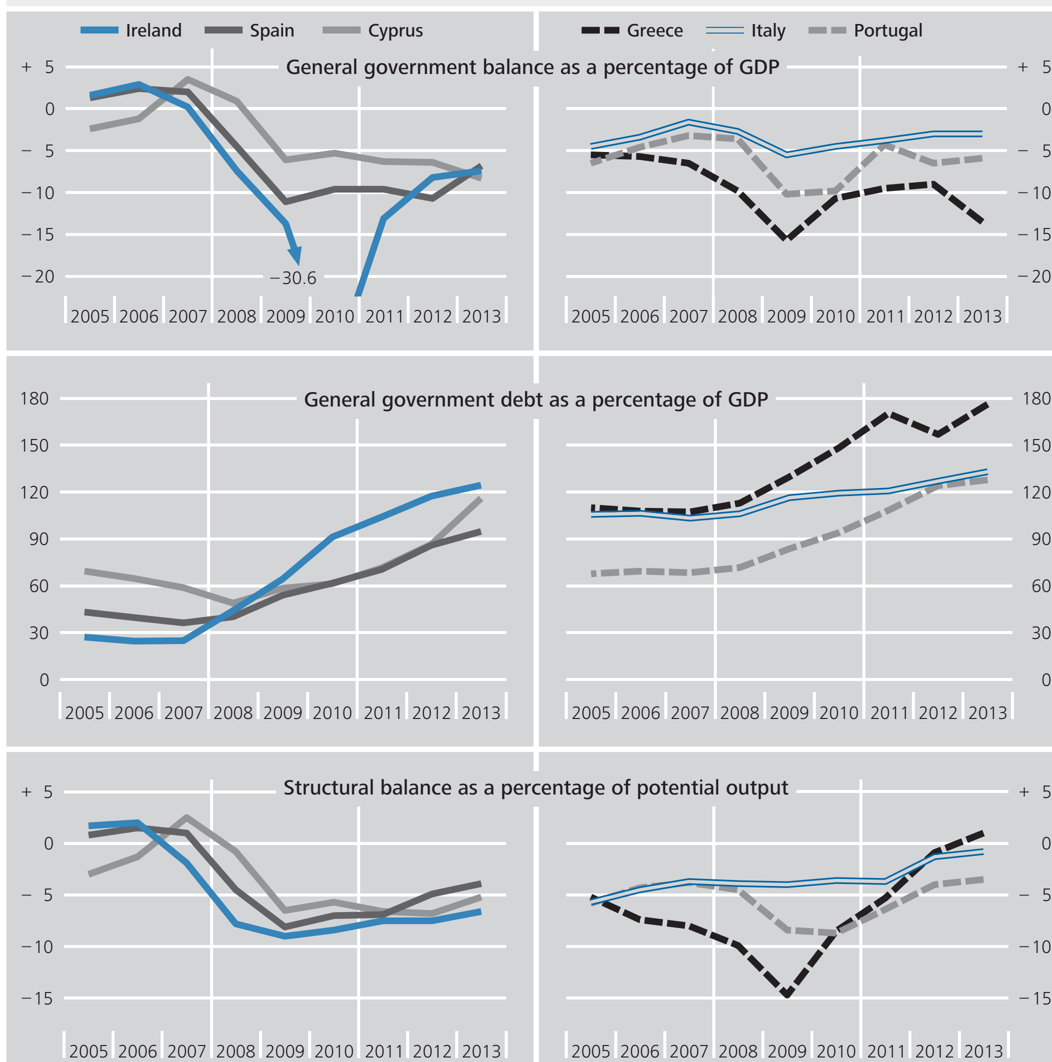
… with public finances undergoing a fundamental reassessment during the financial and economic crisis

With the onset of the financial and economic crisis, public finances in these countries deteriorated abruptly, however. The exceptional additional revenue evaporated, and the economic correction meant that the "regular" tax base was also much more unfavourable than before. In addition, the estimated level of structurally neutral expenditure growth had to be corrected downwards as potential growth proved lower than originally predicted. With the onset of the crisis, several countries launched economic stimulus programmes, and the structural expenditure ratio continued to rise, in part because expenditure growth remained high, in some instances – not least because structural factors drove up spending on social benefits. The banking sector, which was also affected by the real estate crisis, suffered large-scale losses. Consequently, governments mobilised considerable funds to support banks. With hindsight, it was evident that the macroeconomic imbalances had created considerable risks for public finances. As the correction started, the situation of, and outlook for, public finances were fundamentally reassessed, and government debt rose very rapidly. Nonetheless, the previous budget surpluses and low debt levels meant that there was initially considerable fiscal leeway, and these countries were able to absorb at least a large part of the burden arising from the shock themselves.

Another group of countries had unfavourable fiscal metrics even before the crisis

By contrast, public finances in a second group of countries (Greece, Portugal, Italy) were far more difficult even before the onset of the financial and economic crisis, with Portugal and Italy experiencing weaker overall economic growth before 2008 than the first group (see the chart on page 25). Conditions for public finances were relatively favourable in these countries after they joined the monetary union, which was reflected, in particular, in a clear drop in the average interest paid on government debt and, in some instances, in relatively strong wage and consumption growth. However, the authorities did not take advantage of these good conditions to rapidly bring about structurally balanced budgets and push ahead

1 The structural balance is the general government balance adjusted for the impact of cyclical factors on government revenues and expenditure and adjusted for temporary measures. We use the structural balances reported by the European Commission here. These are, however, observed in relation to potential output as calculated by the Commission – not in relation to GDP as in the Commission's calculations – in order to eliminate cyclical influences from the denominator of the ratios observed. For more on how adjusted revenue and expenditure ratios are calculated, see the chart on p 44. The structural and cyclically adjusted budgetary figures are frequently subject to revisions, particularly in relation to the recent past, as the output gap is often difficult to estimate in real time. See also p 43.



with reducing the in some cases very high debt ratios. Greece is a case apart, particularly as the desolate public finances were long masked by flawed statistics. Once the crisis hit, it became evident that public finances in Greece were out of control, and markets lost confidence. As in the other group of countries, spending momentum initially remained high in most countries in this group. In Portugal and Italy, public finances deteriorated less during the crisis than in the countries of the first group, mainly because the previous exaggerations – particularly on the real estate market – were far less pronounced, and the unexpected revenue shortfall was consequently lower. Moreover, because the situation before the crisis was unfavourable, economic stimulus programmes had been employed fairly sparingly especially in Italy.

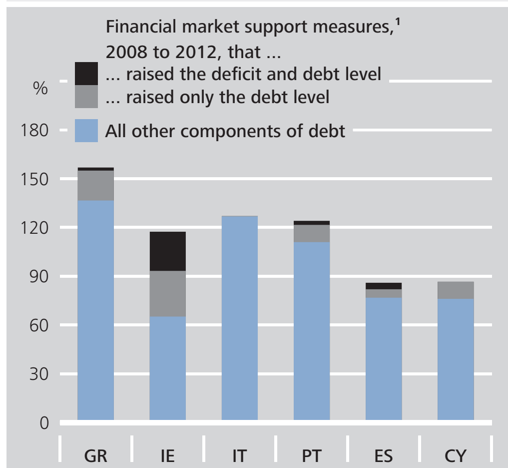
Loss of confidence and start of consolidation

Consolidation started in 2010

It quickly became clear that the rapid and sharp expansion of deficit and debt levels in several countries threatened, if unchecked, to result in a serious loss of confidence in the sustainability of public finances, with considerable negative consequences. Accordingly, most member states started fiscal consolidation from 2010

Government debt in 2012

As a percentage of GDP



Source: European Commission and Bundesbank calculations. **1** In connection with measures to support financial institutions, various factors can influence the deficit and/or debt ratio. Guarantee fees or dividends on shares may create revenues, whilst expenditure may increase, for instance, as a result of interest expenses for additional debt taken out for the support measures or of called guarantees. This affects the deficit and consequently also the debt levels. A recapitalisation of banks by the government has an impact on the deficit ratio only if the government cannot expect an adequate return. Otherwise, it is a financial transaction (acquisition of a recoverable financial asset) which has no influence on the government deficit ratio, but raises government debt and government assets. By contrast, covering losses or transfers raise both the deficit and the debt level.

Deutsche Bundesbank

onwards. Nonetheless, there were growing doubts as to the ability and willingness of the countries hit hardest by the crisis to meet their obligations, and risk premiums on the interest rates payable on their government debt rose sharply. Greece was the first euro-area member state to be forced to resort to financial assistance in May 2010. The low-interest assistance loans alleviated the adjustment process. At the same time, far-reaching consolidation and economic reforms were agreed for the following years in order nonetheless to make progress on tackling the imbalance. At the end of 2010, a similar programme was agreed for Ireland, with Portugal following in the spring of 2011 and Cyprus in the spring of 2013. A financial assistance programme was agreed with Spain in mid-2012, albeit only for the financial sector. The EU and euro area created tailor-made aid funds to finance these programmes: the European Financial Stability Facility (EFSF), the European Financial Stabilisation Mechanism (EFSM) and the European Stability Mechanism (ESM).[2] Italy also experienced significantly higher market pressure and high risk premiums. The Eurosystem’s outright monetary transactions (OMTs) reduced this market pressure, especially for the programme countries and Italy.

Average improvement in structural balance not very ambitious in some cases

The amount of consolidation achieved since 2010 varies considerably among the countries under observation. In the period from 2010 to 2013, it was particularly large in Greece (4 percentage points) according to European Commission data (as measured by the average annual improvement in the structural deficit ratio), with some of it (½ percentage point) the result of declining interest expenditure thanks to subsidised assistance loans and the debt restructuring for private creditors in 2012. However, the preceding deterioration and difficulties were particularly severe there, and the situation remains fragile. Portugal, Spain and, to a lesser extent, Italy achieved a much smaller, but nonetheless perceptible, consolidation, with an average annual improvement of about 1 percentage point. In Ireland and especially Cyprus, the average annual adjustment was only around ½ percentage point in structural terms, the minimum improvement specified in the European fiscal rules for countries in excessive deficit procedures. The timeline for consolidation varies from country to country, with most of it having been achieved in 2012.

Higher interest spending due to sharp rise in debt

Overall, rising interest expenditure has been a drain on the public coffers of the countries hit especially hard by the crisis. Here, the decisive factor is not the average interest payable on government debt, which is at a historic low. The increase in the volume of debt is key. All countries have seen their debt levels soar since

2 For more on the various new rescue mechanisms, see for instance, Deutsche Bundesbank, European Council decisions on the prevention and resolution of future sovereign debt crises, Monthly Report, April 2011, pp 53-58 and Deutsche Bundesbank, Towards a European Stability Mechanism, Monthly Report, February 2011, pp 64-65. Reforms to the fiscal rules for the monetary union will not be dealt with in further detail here. For more on the topic, see European Central Bank, Stronger EU economic governance framework comes into force, Monthly Bulletin, December 2011, pp 98-100.

the onset of the crisis. Although consolidation has started, debt ratios have continued to rise, reaching figures far in excess of 100% – except in Spain. In some countries, expenditure on supporting banks has also been an important factor.[3]

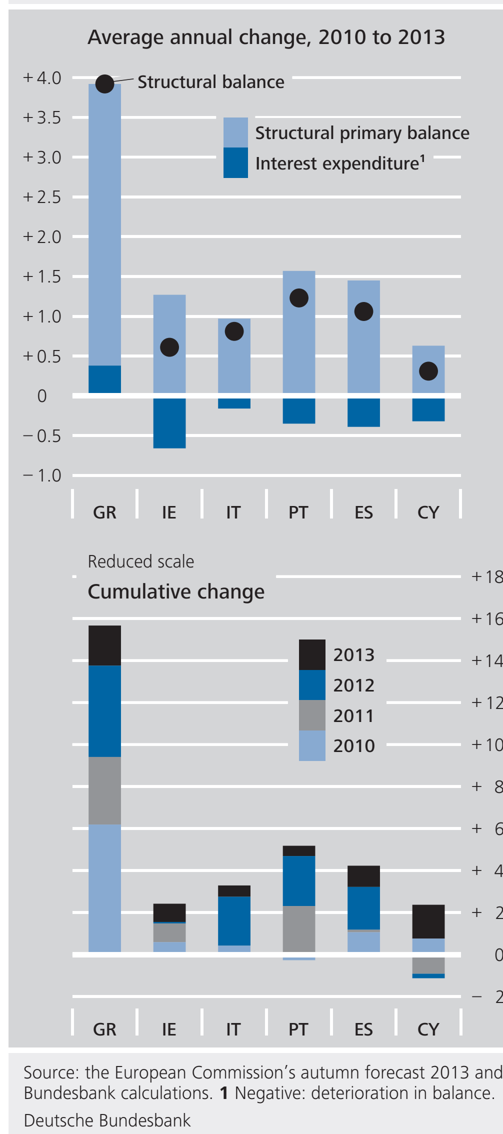
Consolidation less successful in terms of revenues …

The revenue ratios corrected for cyclical factors and bank support measures[4] have changed only moderately overall in all countries since 2009. They are, however, lower in Spain, Ireland, Greece and Cyprus than in Portugal and Italy, and also perceptibly lower than the euro-area average. Yet the moderate overall change in the ratios masks considerable increases in taxes and levies in all countries except Italy. However, these are offset by revenue-dampening factors in other areas. These include the incipient correction of macroeconomic imbalances and changes in the economic structure with the necessary move away from the construction industry and domestic private consumption and towards fiscally less profitable areas such as exports. Adjusted primary expenditure (total expenditure less interest expenditure) made a larger contribution to consolidation than the revenue side in almost all countries. This is a welcome development, as studies suggest that consolidation strategies that focus on expenditure are probably more promising in the medium and long term than those that target revenues.[5]

… than in terms of primary expenditure

Change in the structural balance

In relation to potential output; change in percentage points



Source: the European Commission's autumn forecast 2013 and Bundesbank calculations. **1** Negative: deterioration in balance.
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Individual countries still face considerable challenges

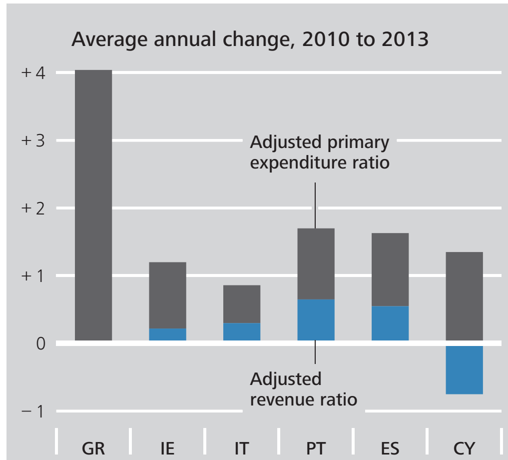
Caution necessary when assessing levels of structural balances

Remarkable progress has already been made in many of the countries under observation. However, deficits remain high, and considerable further adjustments are still required. Moreover, caution is necessary when assessing the remaining structural deficits. Determining overall potential output involves some uncertainty – especially in an environment characterised by major economic upheaval (see pages 19 to 37). That is relevant also for estimating structural government deficits, although this applies less to the structural changes previously in the spotlight than to the levels. The European Commission is currently reporting perceptibly negative aggregate output gaps for most of the countries hit hardest by the crisis; this means that the levels of the structural deficits are thought to be considerably lower than the unadjusted deficits. In the past, it has, however, often

3 See Deutsche Bundesbank, The development of government interest expenditure in the European monetary union, Monthly Report, September 2013, pp 59-64.
4 For more on how adjusted revenue and expenditure ratios are calculated, see the legend to the chart on p 44.
5 See, for instance, A Alesina and S Ardagna (2013), The design of fiscal adjustments, Tax Policy and the Economy 27(1), pp 19-68.

Contribution of adjusted revenue and expenditure ratios* to change in structural balance

In percentage points, in relation to potential output



Source: the European Commission's autumn forecast 2013 and Bundesbank calculations. * To obtain the adjusted revenue and expenditure ratios as a proxy for the structural ratios, which the European Commission does not report, the cyclically adjusted variables are placed in relation to potential output and the effects of supporting financial institutions are excluded. For the latter, Eurostat has data up until 2012. For 2013, the Commission mostly reports the influence on the deficit ratio as a whole. Here, it is assumed that revenues from the support of financial institutions in relation to potential output were of the same magnitude in 2013 as the average for the period 2009 to 2012. The remainder is assigned to the expenditure side.
Deutsche Bundesbank

proved a mistake to diagnose in real time purely cyclical weakness, as this weakness often subsequently proved to be at least partly structural. As a consequence, the economic normalisation did not bring about the anticipated automatic reduction in the deficit, and deficits proved persistent. With hindsight, it is clear that real-time cyclical deficits and surpluses have not balanced over time.[6] The fact that growth forecasts have frequently been revised down recently also suggests that a conservative approach is warranted.

Greece a case apart in many respects

Among the countries particularly badly affected by the crisis, Greece is a case apart in many respects. Although it has achieved by far the greatest consolidation, it remains to be seen whether the second adjustment programme will be implemented as planned. The programme has already been repeatedly revised or even completely replaced. For one thing, expectations about economic and fiscal developments proved too optimistic, and structural problems were underestimated. For another, some of the originally agreed measures were not implemented in full or on time. Although private creditors' claims were restructured in 2012, question marks remain regarding the sustainability of Greek's government debt. The debt ratio will be significantly reduced as planned only if macroeconomic and fiscal assumptions are, in fact, realised. In this, short-term cyclical developments will be less decisive than potential growth, which is driven mainly by structural reforms. Future developments in Greece will depend, not least, on whether there is confidence that the country will steer a reliable political course.

Considerable progress already achieved in Portugal and Italy

In improving their structural fiscal position, Portugal and Italy have already made considerable headway on the road to sound public finances. Portugal started out in more unfavourable circumstances, and its financial assistance programme has also been adjusted several times. However, the Troika (the International Monetary Fund and the European Commission in liaison with the European Central Bank) has deemed implementation in Portugal to be satisfactory overall. That said, if the country is to exit the programme on schedule in mid-2014 and regain access to the capital markets, it will need to persevere with structural reforms and consolidation. There is uncertainty not least as to whether elements of the measures decided upon in order to implement the agreed course of consolidation might once again be declared unconstitutional. In Italy, the main priority is not to jeopardise the consolidation success already achieved but rather to be rigorous in pursuing the steps which remain to be taken to achieve a structural budget surplus, enabling rapid reduction in the elevated debt ratio despite weak potential growth. The course of fiscal consolidation announced by the previous government at the height of the crisis has recently been watered down significantly. If

6 See G Kempkes (2014), Cyclical adjustment in fiscal rules: some evidence on real-time bias for EU-15 countries, Finanzarchiv, forthcoming.

efforts were limited to keeping the deficit ratio consistently just below the 3% threshold, the country would remain very vulnerable to further negative shocks.

Though other countries have also made progress on consolidation …

In Ireland, improvement in the structural fiscal position so far has not been particularly pronounced compared with that of other countries heavily affected by the crisis, and the structural deficit remains very high. However, the fiscal conditions attached to the financial assistance programme were all satisfactorily met, according to the Troika's assessment, and the programme was completed in December 2013. Now, the main priority is continuing to be rigorous in staying the course towards sound public finances, even without a programme to comply with. Cyprus, too, has received positive initial reviews of the assistance programme agreed in spring 2013, but the process of consolidation is only just beginning here. In Spain, the assistance programme for the financial sector ended in January 2014; a significant portion of the credit line was not drawn down. Despite notable progress on consolidation, the fiscal deficit remains high, and the details of further measures to achieve the 3% threshold and a balanced structural budget need to be elaborated. The large degree of fiscal autonomy enjoyed by the regional governments presents a particular challenge with respect to planning and implementing deficit reduction. It remains to be seen whether enhanced monitoring by the central government within the framework of the new debt brake will actually prevent the regions from missing their targets, as was observed in the past.

… the banking sector continues to present a particularly high risk to public finances

Some countries' banking sectors continue to harbour risks for public finances which are difficult to gauge – particularly but not only those countries in which the banking industry has large total assets on aggregate relative to GDP. Banks' assets have been scaled back, of course, in some cases extensively. The aggregated total assets of Irish banks, for example, have shrunk by around 40% since the onset of the crisis. In addition, major cleansing of bank balance sheets has been assisted by shifting distressed assets to resolution agencies, and banks have been recapitalised, sometimes using funds from assistance programmes. Nonetheless, the need for additional government support cannot be ruled out, for instance in response to the comprehensive balance sheet assessment in the run-up to European banking union. (On deleveraging in the banking sector, see pages 59 ff.)

Further swift consolidation needed

Broad consensus on fiscal consolidation, but debate about speed

Despite a considerable consolidation drive in recent years, public finances in the countries hardest hit by the crisis are not yet in sound health, and confidence in their sustainability remains shaky. It is therefore largely undisputed that government deficit and debt ratios need to be brought down. However, a lively debate continues to be had, both by politicians and economists, about the right speed at which to consolidate.

Though lost growth is to be expected in the short term …

Proponents of a halt to consolidation or of slower consolidation point to the short-term loss of growth which is generally associated with deficit-reduction measures. With many of those countries most severely affected by the crisis presently in recession, those measures have had a procyclical effect, all the more so as the fall in real GDP associated with deficit-reduction measures – the fiscal multiplier – is, they argue, particularly marked during a recession.

… the extent is unclear

However, despite a range of academic research on the matter, there is a great deal of uncertainty as to the magnitude of the fiscal multipliers, with the results of individual studies varying widely (see the box on pages 46 and 47). Their magnitude depends on many factors, such as the nature of the consolidation measures, the size of government debt, the degree of interconnectedness with the international economy, the response by monetary policy-

Short-term effect of fiscal measures on economic growth

Most of the euro-area countries hit especially hard by the crisis are not only faced with the task of repairing their public finances, but are also suffering from a pronounced economic downturn, which is associated with high unemployment. If and to what extent fiscal consolidation dampens the growth of gross domestic product (GDP) in the short term is therefore an important and controversial question. There is little dispute that fiscal consolidation – particularly if carried out via spending cuts when expenditure ratios are high initially – promotes economic development in the long term.

The impact of consolidation on economic output is measured using fiscal multipliers, with studies showing a fairly broad spread of values. For consolidation measures amounting to 1% of GDP, most studies establish a short-term negative impact on the GDP growth rate of between 0 and 1 percentage point. Very high multiplier values of above two are reported just as rarely as a positive impact.[1] A number of factors evidently influence the size of the multiplier. Cuts in either government consumption or investment directly impacting aggregate demand tend to involve higher short-term growth losses than increases in taxes and social contributions.[2] Sclerotic labour and product markets with comparatively rigid nominal wages and prices have higher multipliers as a result, because the necessary adjustments are then carried out via quantitative reactions, which means losses in output and employment. For similar reasons, the multiplier tends to be higher in the case of fixed exchange rates. The multiplier also generally increases if an economy is not very open, because if international trade links are weak the withdrawal of demand will make itself felt domestically to a greater extent.

Particularly relevant for the economic policy debate about consolidation in the peripheral countries are influences which can cause the fiscal multipliers in these countries to be higher or lower than normal at the current time. Results of recent empirical studies suggest that multipliers are particularly high during an economic downturn.[3] One reason for this could be that in a downturn with high unemployment a particularly large number of households use their remaining income entirely for consumption purposes. If the fiscal consolidation causes further reductions in income, these can no longer be cushioned with a temporary decrease in savings or temporary borrowing and the fall in aggregate demand is correspondingly greater. Such effects can be amplified further through a financial crisis which entails a credit squeeze and through high private sector debt. A financial crisis also harbours the danger that difficult access to loan financing will discourage enterprises from making investments. It should be noted, however, that if public finances are unsound, forgoing consolidation may exacerbate the credit

1 For an overview see, for example, A Spilimbergo, S Symansky and M Schindler (2009), Fiscal Multipliers, IMF Staff Position Note 09/11; S Gechert and H Will (2012), Fiscal Multipliers: A Meta Regression Analysis, IMK Working Paper 97-2012, IMK at the Hans Boeckler Foundation, Macroeconomic Policy Institute.
2 See, for example, O J Blanchard and R Perotti (2002), An Empirical Characterisation of the Dynamic Effects of Changes in Government Spending and Taxes on Output, Quarterly Journal of Economics 117, pp 1,329-1,368 whilst, for example, A Mountford and H Uhlig (2009) come to the opposite conclusion in What Are the Effects of Fiscal Policy Shocks?, Journal of Applied Econometrics, pp 960-992.
3 See for example A Baum and G Koester, The impact of fiscal policy on economic activity over the business cycle – evidence from a threshold VAR analysis, Deutsche Bundesbank Discussion Paper No 03/2011; A Auerbach and Y Gorodnichenko (2012), Fiscal Multipliers in Recession and Expansion, in: A Alesina and F Giavazzi (eds), Fiscal Policy after the Financial Crisis, University of Chicago Press, pp 63-98; O Blanchard and D Leigh (2013), Growth Forecast Errors and Fiscal Multipliers, American Economic Review, 103(3), pp 117-120.

crunch because the further losses in the value of government bonds which could then be expected would place additional strain on banks.[4]

One of the arguments sometimes cited in favour of currently elevated multipliers in the countries particularly hard hit by the crisis is that monetary policy can no longer cushion the effects of fiscal consolidation on the real economy if the interest rates set by the central bank are in any case already close to zero. Various simulation studies indeed yield higher fiscal multipliers if the monetary policy response to declining price pressure is eliminated.[5] However, monetary policy has other (unconventional) instruments in addition to interest rate policy and has used these in recent years. The argument is only important for the euro-area countries most severely affected by the crisis because many of them are currently consolidating their budgets at the same time, thus also influencing price development in the euro area overall (the relevant reference point for single monetary policy). Otherwise, monetary policy geared towards the euro-area aggregate does not respond to consolidation in individual countries.

The fact that many countries are currently repairing their public finances simultaneously reduces the fiscal multiplier to the extent that this prompts a monetary policy response. On the other hand, fiscal consolidation also leads to losses in demand in trading partner countries via fewer imports. However, the interaction created by simultaneous consolidation is not likely to be very significant in quantitative terms.[6]

There are, nevertheless, also a number of factors which suggest lower multipliers currently in the countries hit especially hard by the crisis. The multiplier tends to be smaller the higher the debt ratio of the country in question.[7] Furthermore, positive confidence effects may cause a marked reduction in short-term growth losses. A credible, swift consolidation policy may lessen uncertainty about the government's ability and willingness to pay, as well as about expected medium to long-term fiscal burdens, thereby reviving economic activity. In particular, risk premiums – quite considerable in some cases – which many of the countries severely affected by the crisis have to pay when borrowing on the capital market may be cut.[8] Insofar as this also decreases the interest rates for consumer and corporate loans, domestic demand may be boosted and the multiplier thus reduced.

The overall conclusion is that the size of fiscal multipliers depends on the country under review, the time, the macroeconomic and fiscal environment as well as a series of further factors and is subject to high uncertainty. As explained on pages 45 ff, as well as the size of the multipliers other factors also play an important role in the question of the appropriate speed of consolidation, and rapid fiscal consolidation is called for in vulnerable countries.

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4 Empirical studies do not deliver a consistent picture with regard to the influence of financial crises but tend to point towards higher multipliers. See, for example, A Afonso, J Baxa and M Slavik (2011), Fiscal developments and financial stress: A threshold VAR analysis, ECB Working Paper No 1,319; G Corsetti, A Meier and G Muller (2012), What Determines Government Spending Multipliers?, Economic Policy 27, pp 521-565.
5 For example, see L Christiano, M Eichenbaum and S Rebelo (2011), When Is the Government Spending Multiplier Large?, Journal of Political Economy 119 (1), pp 78-121.
6 For example, see T Cwik and V Wieland (2011), Keynesian government spending multipliers and spillovers in the euro area, Economic Policy, pp 493-549.
7 See E Ilzetzki, E Mendoza and C A Vegh (2013), How Big (Small?) Are Fiscal Multipliers?, Journal of Monetary Economics 60(2), pp 239-254; C Nickel and A Tudyka (2013), Fiscal stimulus in times of high debt: reconsidering multipliers and twin deficits, ECB Working Paper No 1513.
8 Evidence of an influence of fiscal indicators on the risk premium is provided, for example, by D Haugh, P Ollivaud and D Turner (2009), What drives sovereign risk premiums? An analysis of recent evidence from the euro area, OECD Economic Working Paper 59; L Schuknecht, J von Hagen and G Wolswijk (2010), Government bond risk premiums in the EU revisited: The impact of the financial crisis, ECBW Paper No 1152.

makers, the actual business cycle position, and, not least, capital market confidence in the soundness of public finances and the associated danger of risk premiums.

Debt ratio may be increased temporarily by consolidation in unfavourable circumstances, but can be expected to fall in the future

Gauging the magnitude of the multipliers is particularly crucial if a very high value would mean consolidation causing a short-term or even long-term worsening in public finances rather than any improvement ("self-defeating consolidation").[7] However, under realistic assumptions, a rise in the deficit ratio resulting from consolidation measures is very unlikely even in the short term. On the other hand, if high but quite plausible multiplier values are assumed, the debt ratio may well initially show a more unfavourable pattern than it would have done without the deficit reduction measures.[8] Though the absolute level of debt will be lower than it would be without consolidation, owing to the smaller deficit, the debt ratio may nonetheless rise because of the effect of consolidation on GDP, which is the denominator in the ratio. This is more likely the higher the multiplier and the debt ratio. However, in the medium and long term, the debt ratio will fall even in this scenario, as the dampening effect of consolidation on GDP growth – not considering any weakening in potential growth – is only temporary. In the crisis, the financial markets have, in any case, responded mostly positively to consolidation measures and negatively to political uncertainty about these measures.

Lasting effect on potential growth of greater importance

Therefore, when gauging the right speed of consolidation, its influence on potential growth – as well as the credibility of any announcement of later consolidation – is more important than its short-term effect. A lasting impact may result from impaired potential growth, which is ultimately crucial to the sustainability of public finances. Exacerbated underutilisation of productive potential brought on by fiscal consolidation can impede growth in potential output. Then, reduced growth would not be fully recovered in the subsequent upturn. Such might be the case, for instance, if what started as cyclical unemployment hardened into long-term unemployment owing to a depletion of human capital (eg in the form of lost skills), the labour force were less productive after a period of unemployment (hysteresis), or if workers, particularly skilled ones, emigrated.

On the other hand, amidst all this uncertainty, proponents of swift consolidation can point to the fact that a considerable part of the economic collapse in the countries most severely affected by the crisis cannot be regarded as cyclically induced weakness (see pages 19 to 37). From this perspective, there is a danger that inefficient economic structures will be kept in place for too long and the requisite adjustment process and reforms will be put off. Furthermore, consolidation may actually strengthen potential growth if it creates confidence in the long-term sustainability of public finances, and, as a result, risk premiums on interest rates fall, and if the yields on government bonds and interest payments on corporate borrowing are closely correlated. A loss of confidence in public finances and rapidly rising yields would, in any case, be highly destabilising even in the short term, and would probably more than outweigh any other, positive effects attained by deferring consolidation. In addition, high debt ratios may impair potential growth because government borrowing crowds out private borrowing and investment, and high interest payments have to be financed through distortionary taxation which also tends to hamper growth.[9]

In the medium and long term at least, structural reforms which boost potential growth can lend support to fiscal consolidation. For in-

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7 For example, B DeLong and L Summers (2012), Fiscal Policy in a Depressed Economy, Brookings Papers on Economic Activity, Spring, pp 233-274, and P Krugman (2012), Blunder of Blunders, The New York Times blog, 22 March, see the possibility of consolidation measures exacerbating the crisis.

8 For example, see European Commission (2012), Report on Public Finances, European Economy 4/2012, and G Corsetti, K Kuester, A Meier and G J Mueller (2013), Sovereign Risk, Fiscal Policy, and Macroeconomic Stability, The Economic Journal, 123(566), pp F99-F132.

9 See S Cecchetti, M S Mohanty and F Zampolli (2011), The real effects of debt, BIS Working Paper No 352.

A one-off capital levy: a suitable instrument for solving national solvency crises within the current EMU framework?

In the course of the current sovereign debt crisis, strong doubts have occasionally arisen as to whether individual euro-area member states are capable of servicing their government debt or whether they are implementing the necessary measures at the political level. At times, risk premiums on the respective government bonds rose sharply and the credit assessments of the major rating agencies were downgraded considerably. This situation prompted the euro area to agree various assistance measures. While such measures were generally subject to consolidation requirements, they nevertheless imply a substantial mutualisation of sovereign solvency risks without being counterbalanced by a corresponding transfer of sovereign powers to the central level.

However, the EMU governance framework set up with the European Union treaties essentially remains in place. Under this framework, the member states themselves are primarily responsible for their own national fiscal and economic policies, the assumption of liability for the debts of other member states is largely excluded, and the monetary financing of governments through the single monetary policy is prohibited. This should ensure that liability and control are interconnected inasmuch as, in the first instance, it is the taxpayers of the respective member states who bear responsibility for their national sovereign debt. If solvency problems still cannot be resolved, sovereign debt creditors should next be called on to bear the financial risks of their investment decisions themselves in line with market economy principles. Economic adjustment programmes financed by taxpayers from other member states should only be employed as an exception and a last line of defence in cases where the financial stability of the euro area as a whole would otherwise be in grave danger. Moreover, such programmes presuppose that the state in question "merely" has a liquidity problem and that its public finances are either sustainable or that sustainability has meanwhile been re-established by suitable measures. Given the Eurosystem's stability mandate, granting (real) debt relief via higher inflation should be out of the question. Thus, a crucial principle of the current EMU governance framework is that a member state experiencing a crisis must fully utilise its own resources and capabilities available in order to restore confidence in the sustainability of its public finances and thus avert the otherwise likely scenario of a sovereign default that would surely amount to a national emergency.

The current crisis has shown that confidence in the ability of a number of states to service their own debts has been eroded even though high government liabilities are, in some cases, backed by considerable public and private assets. In fact, these assets sometimes form a greater fraction of GDP than in the countries providing assistance.[1] This being so, it would appear sensible to first lower government debt by mobilising government assets through privatisation measures. But beyond that, one may also ask whether, in the exceptional situation of a national emergency, privatisations and conventional consolidation measures aimed at the long-term generation of sizeable primary surpluses should be supplemented by a contribution from existing private assets towards averting the threat of a sovereign default.[2]

1 This can be inferred from the ECB's "Household Finance and Consumption Survey" (http://www.ecb.europa.eu/home/html/researcher_hfcn.en.html), the financial accounts and the national accounts.
2 The option of introducing a capital levy has recently been discussed from various angles: see S Bach (2012), Capital Levies – A Step Towards Improving Public Finances in Europe, DIW Economic Bulletin 8; or IMF, Fiscal Monitor, "Taxing times", October 2013, p 49. The arguments presented here expressly refer to the special case of countries experiencing a fiscal emergency where a capital levy constitutes an alternative to sovereign default.

With this special context in mind, this box outlines the various aspects of a one-off levy on domestic private net wealth, in other words, a levy on assets after liabilities have been deducted. From a macroeconomic perspective, a capital levy – and even more so a permanent tax on wealth – is, in principle, beset with considerable problems, and the necessary administrative outlay involved as well as the associated risks for an economy's growth path are high. In the exceptional situation of a looming sovereign default, however, a one-off capital levy could prove more favourable than the other available alternatives. Placing an additional but, compared to the capital levy, more protracted burden on the private sector through ongoing charges, primarily in the form of consumption or income-related taxes, or making more drastic cuts to government spending might no longer be sufficient or might be considered impossible to enforce. Ultimately this concerns scenarios in which potential creditors have massive doubts about the country's debt sustainability, such that a one-off capital levy is considered as an alternative to a sovereign default.

Under favourable conditions, a net wealth levy could bring about a one-off redistribution of wealth between the private and the public sector within the country in question, thereby facilitating a relatively rapid and significant fall in the sovereign debt level and the faster restoration of confidence in the sustainability of public debt (and the country's debt servicing). If the levy is referenced to wealth accumulated in the past[3] and it is believed that it will never be repeated again, it is difficult for taxpayers to evade it in the short term, and its detrimental impact on employment and saving incentives will be limited – unlike that of a permanent tax on wealth. A rapid fall in sovereign debt could, in particular, have a positive effect on the risk premiums of government bonds for the country in question, and employment and saving incentives would be strengthened as a result of lower uncertainty concerning future tax burdens. The public acceptance and political enforceability of a one-off capital levy could be enhanced by deploying it as an instrument of income redistribution, complementing the retrenchment efforts, which ensures that wealthy individuals shoulder a larger share of the adjustment burden, especially as the specific redistributional effects for a given levy volume can be steered by granting tax-free allowances and tapering the tax schedule.

As a result, the general economic outlook and public acceptance of the necessary fiscal measures in the country concerned may fare better than under the alternative scenario of a sovereign default. Not least, it would be in keeping with the principle of individual national responsibility for fiscal policy in the member states if all consolidation options were rigorously utilised, and it would simultaneously bolster the credibility of the prevailing European governance framework. The incentives for pursuing a sound fiscal policy in the future could be considerably strengthened if it were clear that, in the event of a crisis, the cost of pursuing unsound policies could not be shifted onto taxpayers in other countries.

However, in practice the collection even of a one-off net wealth levy entails considerable difficulties. One of the broad set of conditions necessary to ensure successful implementation is the credibility that the levy will indeed be imposed as a once-only measure in an extraordinary national crisis situation – which is the only way to limit the negative impact on investment and the potential for capital flight. Although the government cannot guarantee in general that the levy will be a one-off measure, it would enjoy greater credibility if, first, the requisite structural reforms were put in place, second, a verifiable outlook of sustainable public finances including safety margins were given, and, third, the political costs of a repeat levy were high. In addition, the decision to raise a levy should be made swiftly. Otherwise, those affected would be more likely to seek to evade the tax, and, with a rising level of tax evasion, the public

3 This means measuring private net wealth on a specified date in the past.

acceptance of the levy could be expected to diminish. Other problems are that the valuation of non-financial assets, in particular, is likely to be relatively time-consuming and often contested, and that, in the case of illiquid assets, it would probably be necessary to spread payment of the levy over a period of time, which means that the reduction in government debt would not take place in its entirety straightaway.

In addition, once a levy had been raised, this would send a signal to other countries with very high public debt levels, and may trigger evasive responses. It would probably be a considerable challenge to limit these effects by pointing to a euro-area-wide outlook for sound public finances. The rigorous implementation of the current fiscal framework may certainly help in this respect.

Overall, a one-off net wealth levy entails considerable risks, and the conditions for successful implementation are not easy to fulfil. Therefore, a capital levy should be considered only in absolutely exceptional circumstances, such as that of a looming sovereign default. However, in comparison to a sovereign default, the imposition of a capital levy could probably take place in a more structured and orderly way. It would conform to the principle of individual national responsibility, according to which domestic taxpayers should be first in line to cover their government's liabilities, before any appeal is made to the solidarity of other countries.

Structural reforms a key complement to fiscal consolidation

stance, the government deficit ratio will fall if higher government tax receipts generated by growth are not fully matched by higher expenditure. Even the debt ratio will then fall more quickly, aided by a larger denominator supplied by higher GDP growth. Government expenditure can also be reduced directly: for instance, through labour market reforms which reduce structural unemployment. Reforming an inefficient, growth-inhibiting public sector may also both support short-term deficit reduction and improve a country's growth prospects. In addition, structural reforms may reduce risk premiums on yields, as these are not only caused by fiscal difficulties but may also reflect trade imbalances and implicit risks to public finances.[10] For these reasons, it makes sense not to limit conditions for programme countries to fiscal consolidation but to strive for a comprehensive adjustment in the overall economy and the financial sector through changes in the economic policy framework.

Credibility of consolidation process crucial …

The appropriate speed for consolidation also hinges crucially on the credibility of the consolidation process. Particular attention needs to be paid to this consideration if a sovereign is facing the threat of default because capital investors' trust has been severely dented and private funds are therefore being withdrawn. External payments crises of this nature arose in many of the countries most affected by the crisis. If the impression is created that little more than lip service is being paid to consolidation, while the necessary cuts are actually being pushed further and further back, there is a danger that risk premiums will not continue to fall but instead the sovereign debt crisis will flare up again. In this scenario, slower consolidation

10 See N Dötz and C Fischer (2010), What can EMU countries' sovereign bond spreads tell us about market perceptions of default probabilities during the recent financial crisis?, Deutsche Bundesbank Discussion Paper No 11/2010; J Aizenman, M Hutchison and Y Jinjarak (2013), What is the risk of European sovereign debt defaults? Fiscal space, CDS spreads and market pricing of risk, Journal of International Money and Finance 34, pp 37-59.

or postponement to a later date may incur heavy macroeconomic costs. The credibility of a consolidation path can be bolstered by binding rules, provided these rules are generally regarded as effective and are expected to be obeyed. The European fiscal rules should make a significant contribution to building trust in sound public finances in the euro area. These rules were reformed over the course of the crisis, with some loopholes eliminated, and in principle they furnish a suitable framework for the necessary fiscal consolidation. However, some recent decisions in European forums raise doubts as to whether they will actually be rigorously applied.[11] At the same time, reform and consolidation fatigue seems to be on the increase at present in many of the countries most affected by the crisis.

… but doubts about rigorous application of the fiscal rule book

Putting off political costs not a solution

With regard to political acceptance and feasibility, there can be no doubt that consolidation measures are not popular in the short term, one of the reasons ultimately for policymakers' general propensity to borrow. However, swift, thorough-going measures which level off relatively quickly may meet with greater acceptance than smaller rounds of consolidation repeated over a number of years with visible results taking longer to come through and additional measures being needed time and again.

Consolidation painful but necessary

All in all, the current financial and debt crisis presents fiscal policymakers in the countries hit hardest by the crisis with a major challenge. Their public finances, with very high and still rising debt ratios, remain vulnerable to negative shocks. Although these countries are engaged in a difficult process of general economic adjustment, and deleveraging is also required in the private sector, the course of fiscal consolidation is unavoidable. Otherwise, there will be an increased risk of an even more far-reaching loss of confidence in the sustainability of public finances, which would have significantly more negative effects still. In addition, consolidation creates room for any future calls on government resources, such as contributions to a recapitalisation of banking systems if shortfalls in cover come to light and investors cannot be bailed in to a sufficient extent. Ensuring sustainable government finances will thus make a significant contribution to ensuring the crisis can be dealt with in an orderly fashion and, under the current EU framework, remains essentially a task for national governments. If there is a threat of government over-indebtedness such that severe consequences may result, then far-reaching emergency measures such as private net wealth contributions must not be ruled out *ex ante* (see the box about capital levies on pages 49 to 51). The newly created assistance funds are to provide liquidity support to member states in difficulties – with conditionalities attached – only if the financial stability of the euro area as a whole is endangered, and as a last resort.

Drastic fiscal adjustment measures required upon the prospect of default, if not beforehand

Reliable and rapid fiscal consolidation also needed to protect monetary policy

Sound public finances are a central requirement for a single monetary policy in the monetary union if price stability at low interest rates is to be safeguarded in the medium and long term. It has become apparent from the debt crisis that the makers of the single monetary policy may otherwise feel pressured into taking measures which are in a grey area of their mandate in order to prevent acute escalation. Even measures like these can only buy time for the requisite reform and consolidation measures, and they come at the cost of harmful incentives in the long term. It is crucial that this time be used effectively. Thus, for this reason too, countries at risk need to implement reliable and swift fiscal consolidation.

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11 See Deutsche Bundesbank, Recent decisions of the Ecofin Council regarding the excessive deficit procedures for euro-area countries, Monthly Report, August 2013, pp 70-72. Some of the decisions made in autumn 2013 with regard to fiscal surveillance also add to these doubts.