

EURO-ZONE: AUSTERITY AHEAD? – STATE OF FISCAL DEFICITS AND SCENARIOS FOR MAJOR COUNTRIES

VIII. New Paradigm Workshop

May 26, 2021

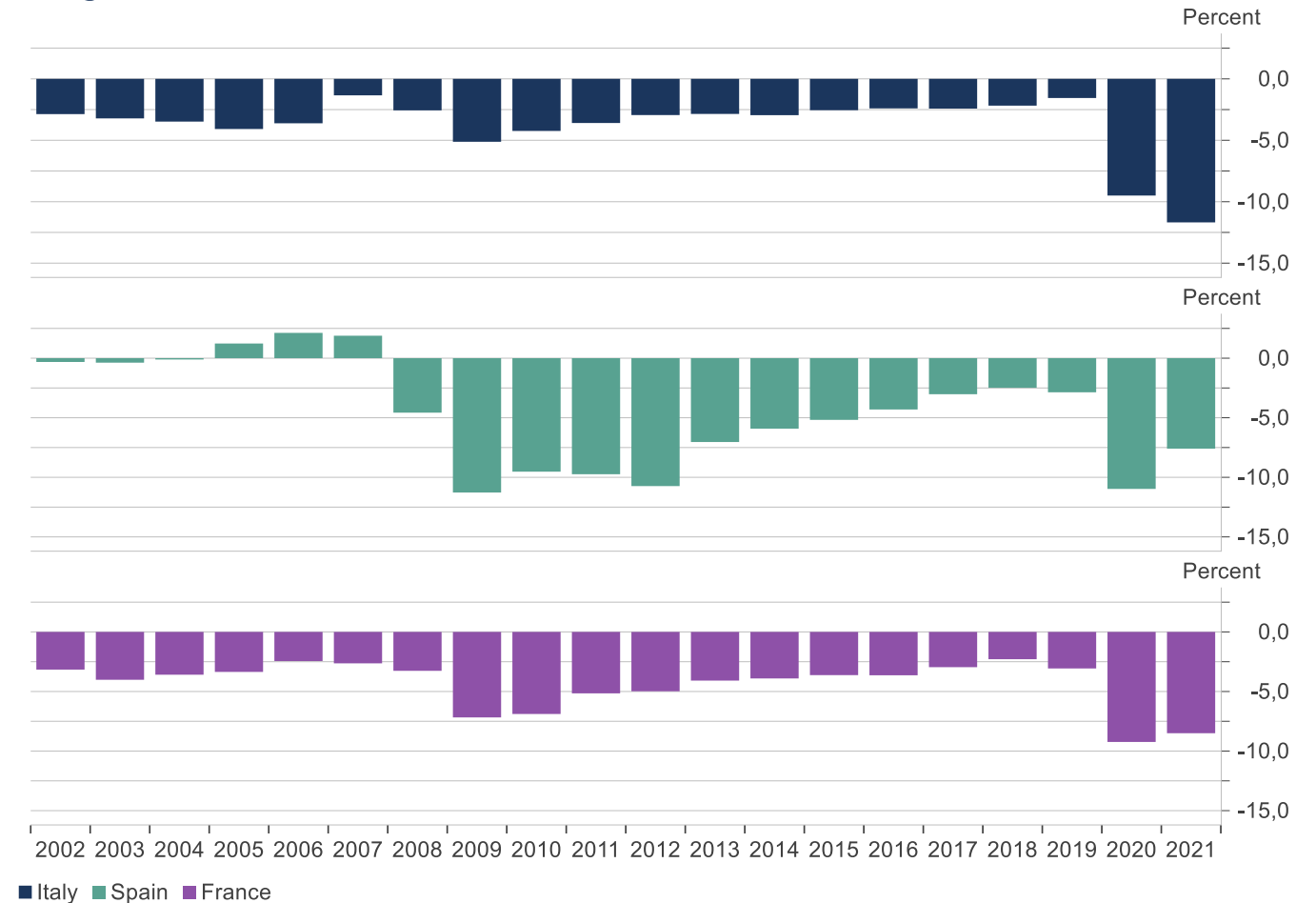
Prof. Dr. Sebastian Dullien

(joint work with Christoph Paetz and Dr. Sebastian Watzka)

Challenge: Large deficits

- The Covid19 pandemic has left EU member states with large fiscal deficits
- For many countries, deficits are now significantly higher than at the beginning of the euro crisis
- EU fiscal targets are far away from actual outcomes
 - Reminder Maastricht
 - Deficit < 3 % of GDP
 - Debt < 60 % of GDP

Budget balance, % of GDP



EU fiscal rules: Vade Mecum

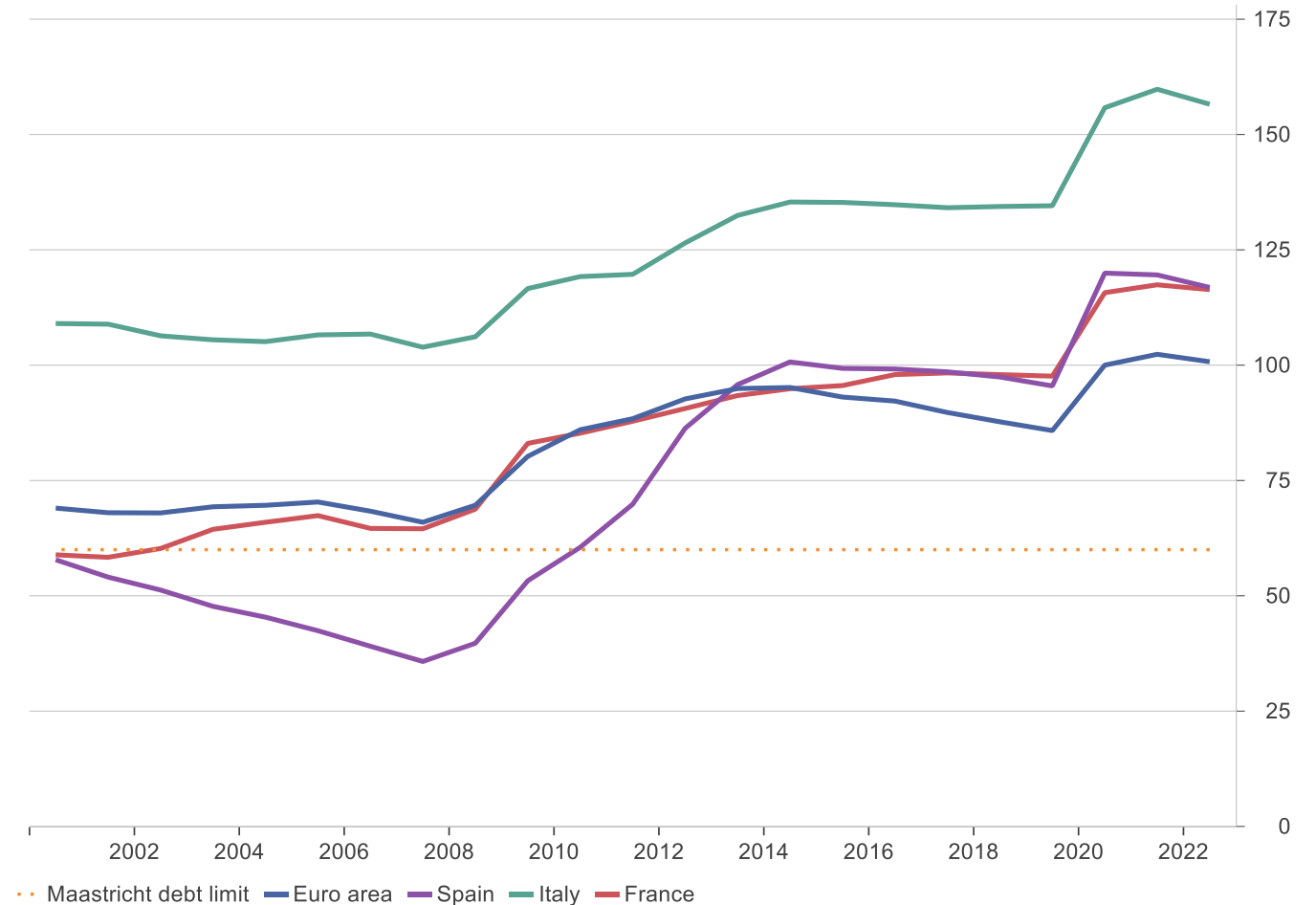
- Fiscal rules require (quick) adjustment to target
 - Structural adjustment towards medium-term budget objective (MTO)
 - Annual 1/20 reduction in difference between 60 % and current debt-to-GDP ratio
- Details are described in the Vade Mecum
 - (Definition: „a handbook or guide that is kept constantly at hand for consultation”)



EU fiscal rules

- Reduction of deficits towards the MTO might be the smaller problem
- The 1/20 rule seems much more challenging
 - For Italy: 5 percentage point reduction in debt-to-GDP ratio *per year*

Gross Government Debt in % of GDP



Simulation: Complications & our solution

– Our approach: Simulation with NiGEM

– Conceptual Problem:

- What degree of austerity is really needed to meet EU rules?
- To a certain extent, deficits will fall by themselves without *contractionary effects* (i.e. support payments for closed business)
- Large uncertainties about deficits in 2021
- NiGEM base line includes already a certain degree of austerity

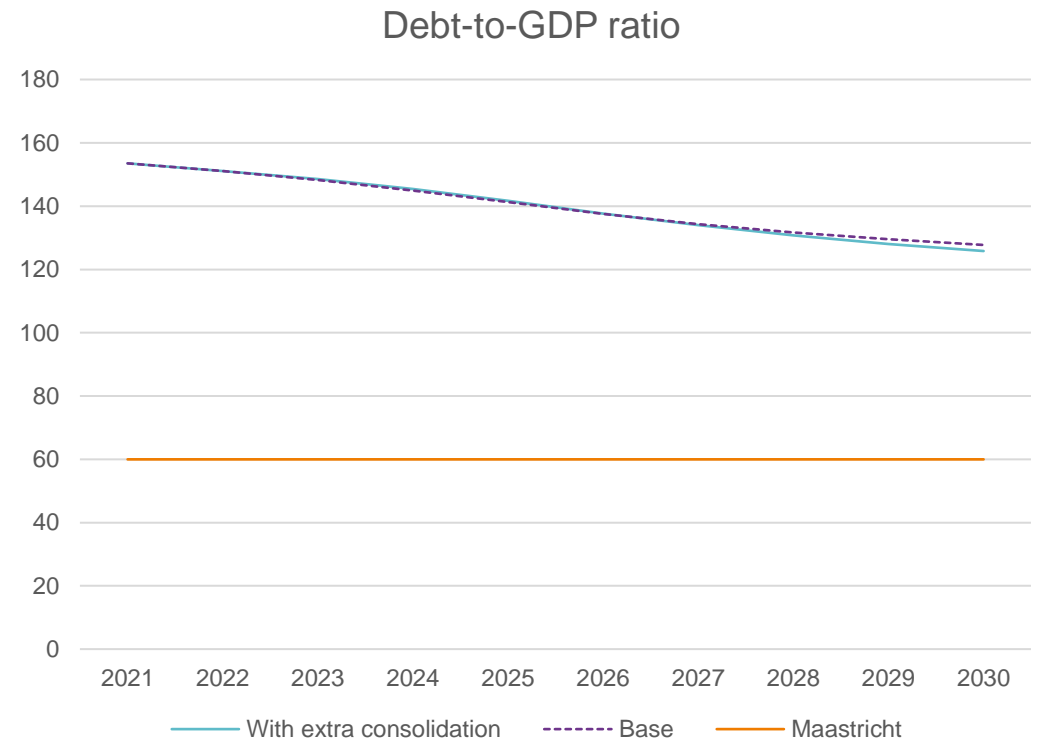
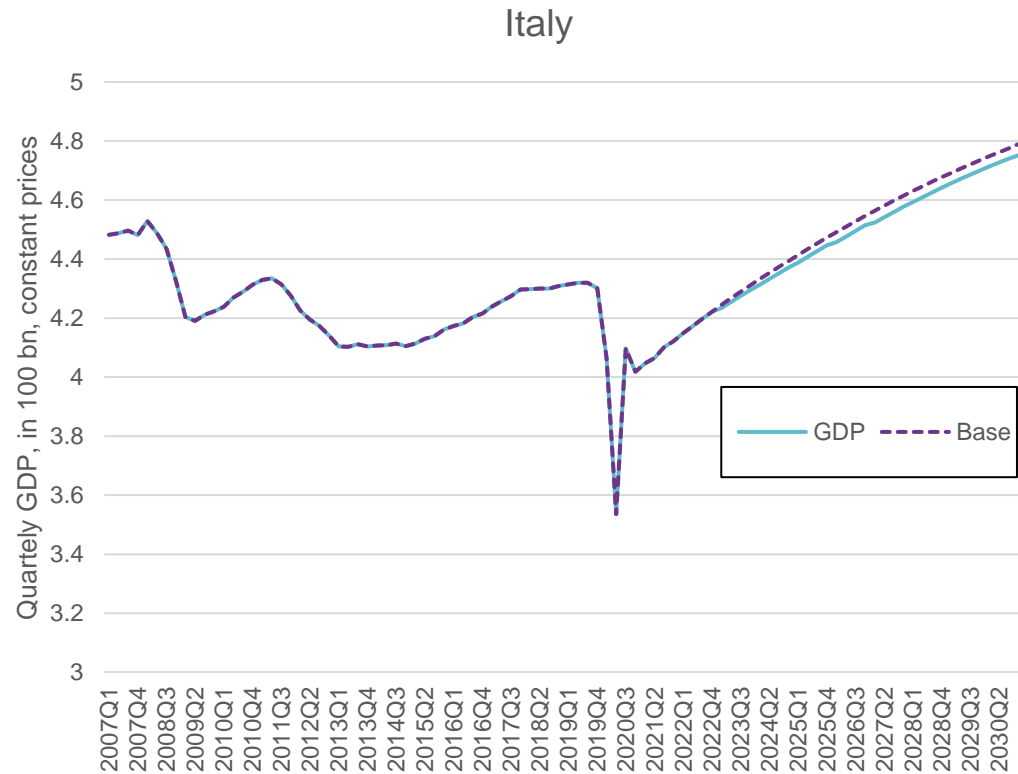
– Our solution:

- We have made sure that 1/20 rule is met
 - Consolidation by 0.75 percent of GDP until 1/20 path is met
 - Consolidation by at least 0.5 percent of GDP if deficit larger than medium-term budget-objective
 - Cuts 50 % in public consumption and 50 % in public investment

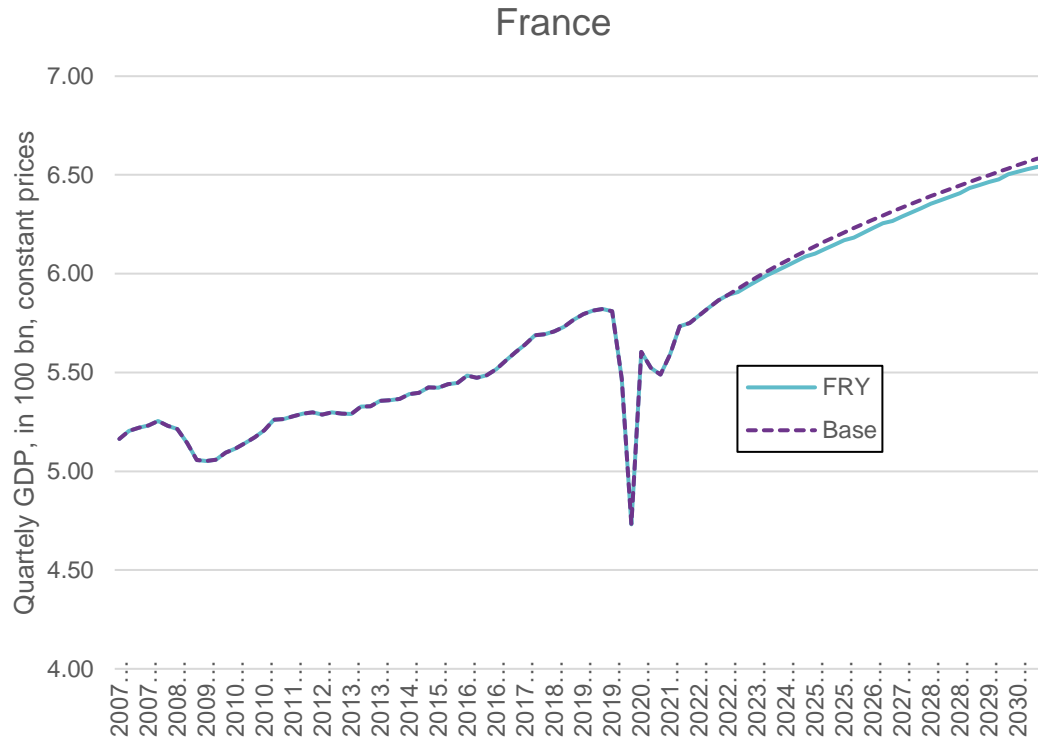
Results: Italy

- Pre-crisis GDP will only be reached at the end of 2023; 2007 level only in 2027 (two „lost decades“!)
- Permanent negative effect: In 2030, GDP is about 0,75 % below base line

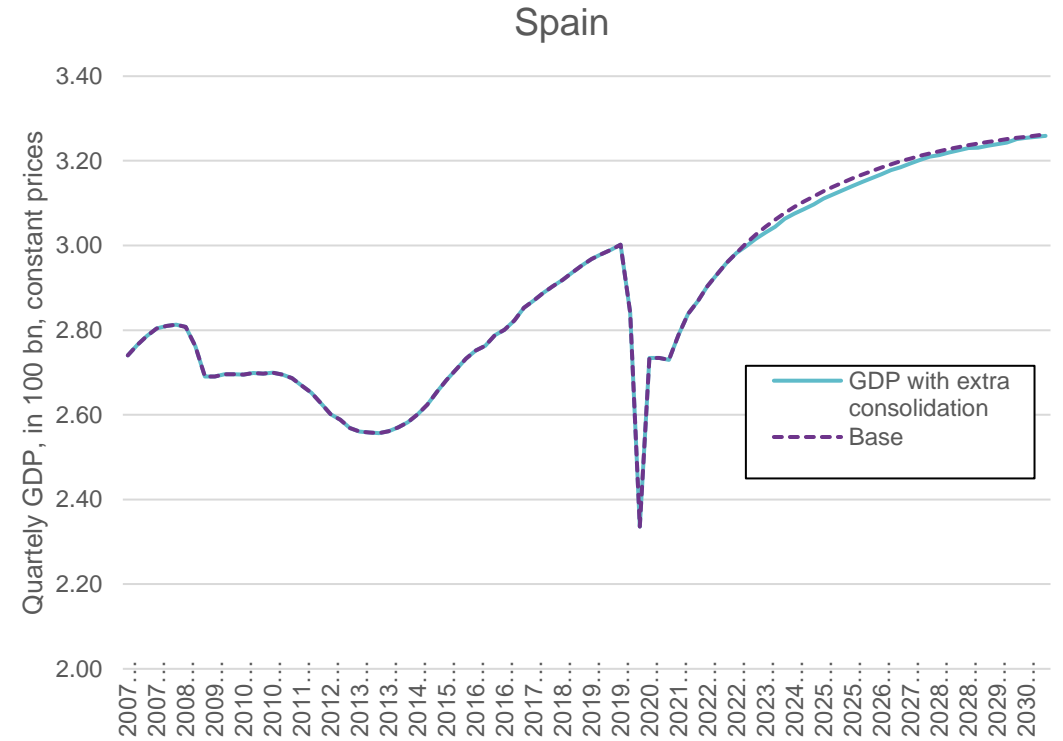
- Positive effect on debt-to-GDP ratio until 2030 is highly limited



Results: France & Spain



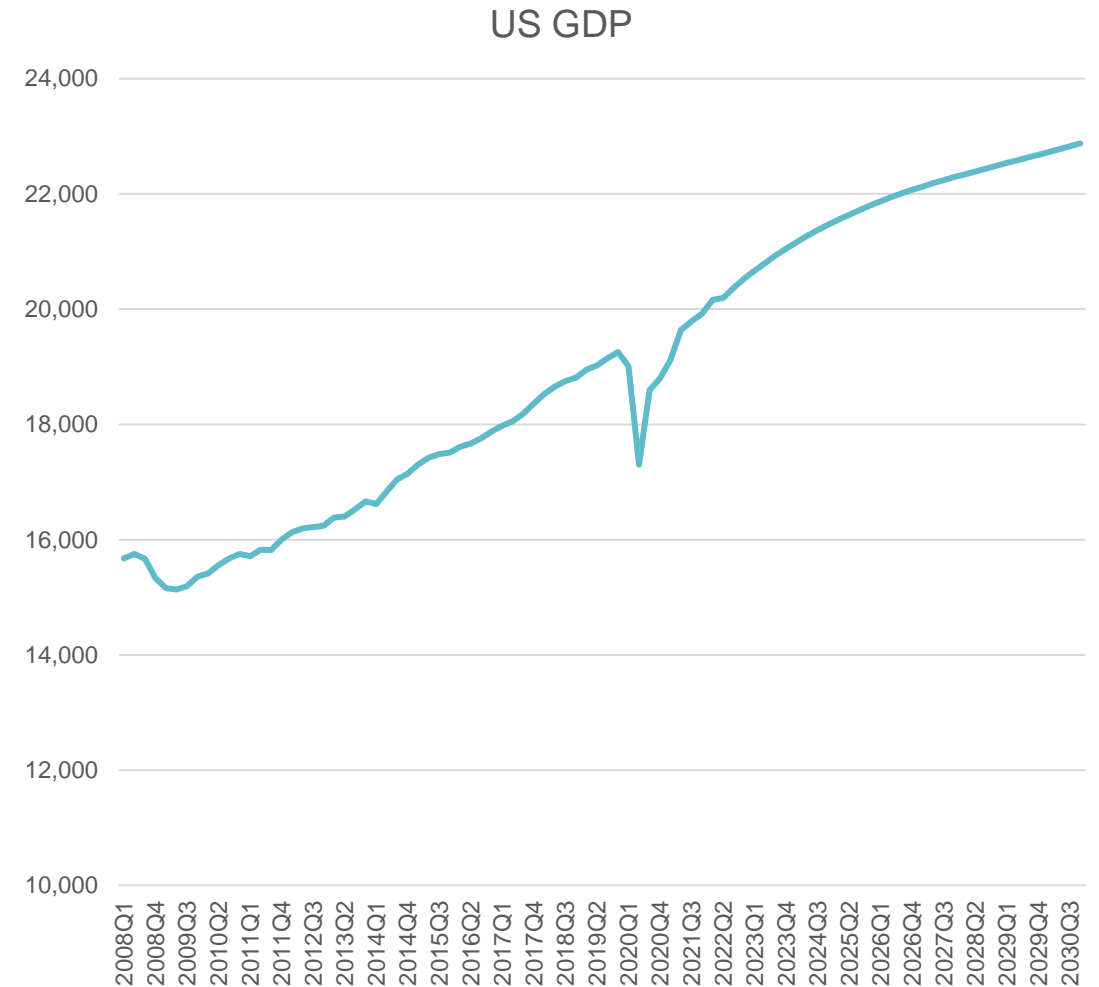
- Pre-crisis GDP will only be reached in mid-2022
- Permanent negative effect: In 2030, GDP is about 0.6 % below base line



- Pre-crisis GDP will only be reached in mid-2023
- GDP remains significantly below pre-crisis trend

Alternative policy approach: The US

- US president Biden has passed a large stimulus
- With this stimulus, pre-crisis GDP will be reached in late 2021
- Trend GDP is quickly gained back
- Blanchard/Pisani-Ferry (2021): This is right approach in order to prevent negative impact on potential GDP



Conclusions

- EU fiscal rules put a significant consolidation burden on major euro-area's public budgets
- GDP might remain below pre-crisis trend
- Danger of negative feedback from underutilized capacities to lower GDP potential

THANK YOU VERY MUCH FOR YOUR ATTENTION!

