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Pace of austerity and fiscal fundamentals

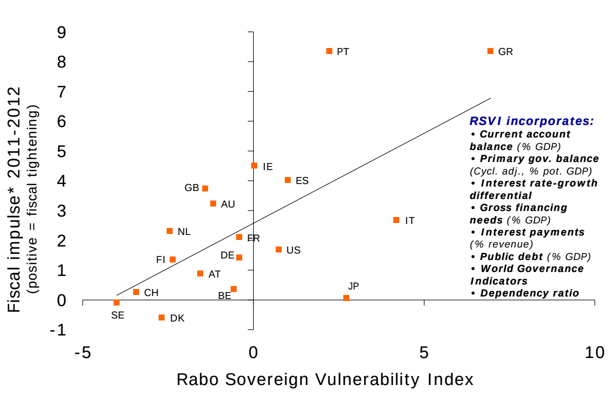
The fear of a rating downgrade or losing market access has caused many advanced countries to embark on a very aggressive fiscal consolidation plan. This can potentially be harmful for output and employment growth. At the same time, some countries may benefit from a quicker pace of austerity measures given their relatively poorer fiscal fundamentals. Getting the balance right is a highly intricate task.

The inception of the debt crisis forced many countries to throw away their fiscal stimulus rule books and tie themselves to the mast of fiscal prudence to ward off the bond vigilantes and the rating agencies. The question we need to ask is whether the pace of fiscal consolidation is optimal across countries? Put differently, is fiscal adjustment occurring at such a fast pace in some countries that it hurts adequate growth while being slow enough in some others to potentially raise the risk of a debt crisis? A simple way to address this question is to look at the pace of fiscal consolidation with respect to the country's fiscal fundamentals. In theory, the relationship between the two must be positive. In other words, the worse a country's public finances, the more fiscal austerity is necessary to attain debt sustainability.

Thankfully, this is also what we see in practice. But figure 1 shows that the relationship is much weaker than one would hope for. For example, the pace of consolidation seems somewhat slow for some countries given the state of their public finances (e.g. Japan, Italy, the US and Belgium). On the other side of the spectrum, one can argue that the pace of fiscal adjustment is too severe in some countries that have relatively strong fiscal positions (e.g. Australia, the Netherlands and the UK). The figure also suggests that the fiscal squeeze in the periphery countries of the Eurozone (Greece, Ireland, Portugal and Spain) is very severe given their fiscal fundamentals. Lack of market trust (see figure 2) impedes them from slowing down the pace fiscal adjustment.

Overall, we can claim that the pace of near-term fiscal adjustment should be such that long-run debt sustainability is attained. A very front-loaded fiscal consolidation plan can hurt output and employment and at the very extreme can even prove self-defeating as public debt ratios spiral out of control. Meanwhile, postponing the needed fiscal adjustment can make the country more susceptible to a debt crisis down the road. Admittedly, getting the balance right is an extremely difficult task.

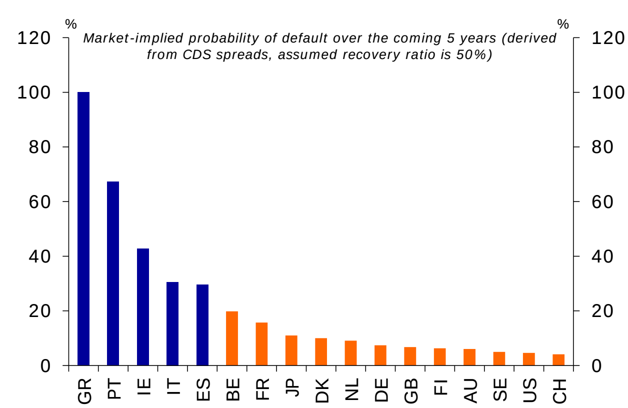
Figure 1: Pace of austerity is not always optimal



*Defined as the change in the cyclically adjusted primary balance (% of potential GDP)

Source: IMF, Rabobank

Figure 2: Markets have lost trust in the periphery



Source: Reuters EcoWin, Rabobank

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