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Growth friendly fiscal consolidation – the Austrian experience

Presentation

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The views expressed are those of the author.

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Financial Crisis/Great Recession led to fiscal deficit/debt explosion

- **In Euro area budget deficits increased from 0, 7 % of GDP in 2007 to over 6 % of GDP in 2009/2010.**
- **Public debt explodes between 2007 and 2011**
- **Euro area 66 % to 87 %, US 62 % to 97 %, UK 44 % to 85 % and Japan 167% to 212 % of GDP**
- **Economy stabilised by expansionary fiscal/monetary policies, Banking packages, but great recession led to fiscal deficit/debt explosion**

- **Euro area interaction sovereign debt with banking crises.**
- **Reduction of fiscal deficits necessary – but Euro area combined in better position than US, UK, Japan**

Financial crises – lessons from history

- **Since collapse of Bretton Woods System with its highly regulated financial sector 1971** – worldwide increase in the number of financial crises

- IMF data for the period 1971 – 2011:
  - 218 Currency crises
  - 147 Banking crises
  - 66 Sovereign debt crises

  - Associated with high fiscal and economic costs (especially when crises interact - double and triple crises)

Financial Crisis - Great Recession - Public debt and banking crisis

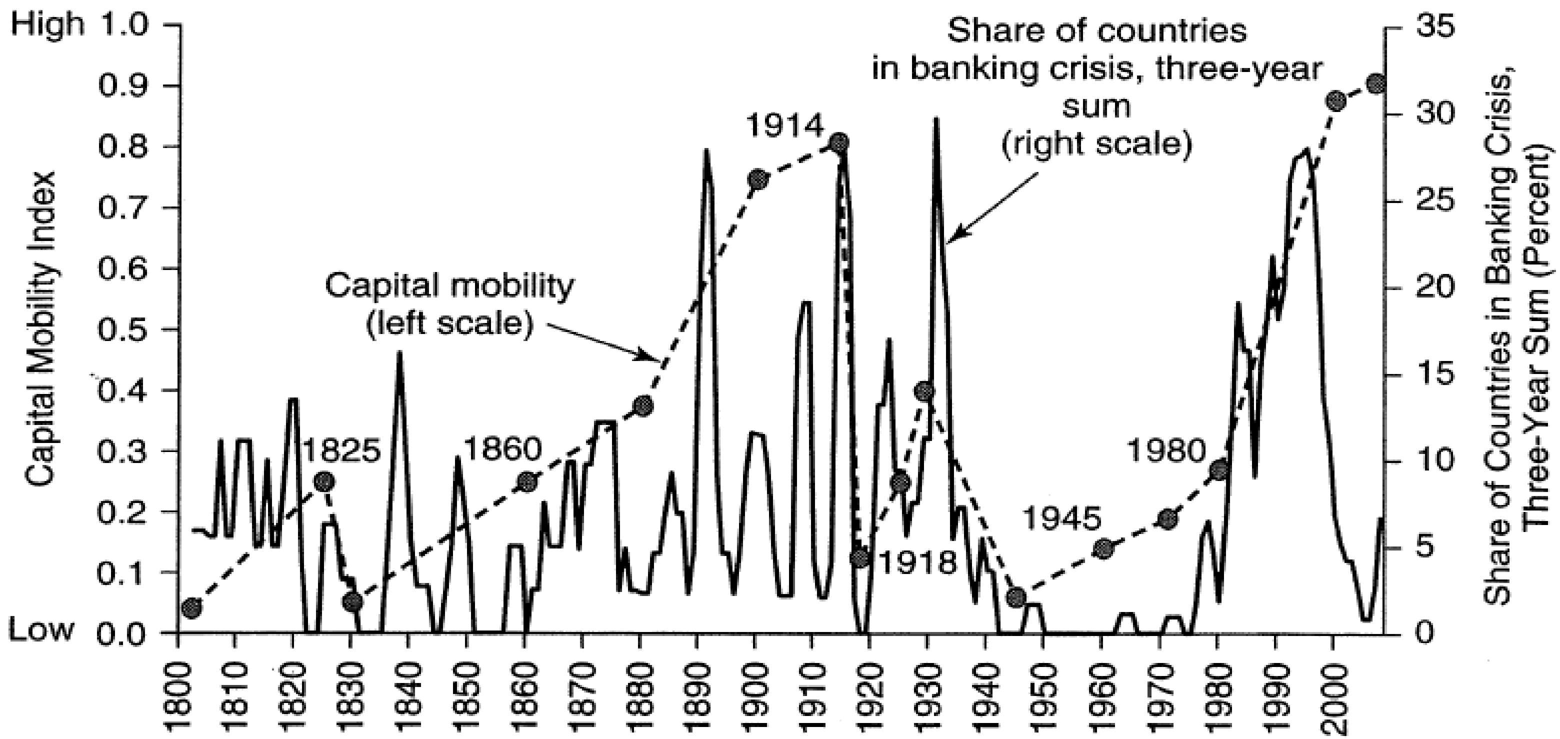
- **Current crisis 2007 - ? worst global crisis since the Great Depression in the 1930s**
- **Decisive economic policy action has been taken to address the current crisis, contrary to what happened in the Great Depression**
- **Especially expansionary monetary, fiscal policies and bank rescue packages**

Over time shift in focus of the current crisis:

1. **Financial crisis (beginning summer 2007, intensive as of autumn 2008)**
2. **Economic crisis - Great Recession (as of winter 2008/09)**
3. **Public debt and banking crisis (as of spring/summer 2010 in Euro area – Greece with contagion effects; Ireland, Spain)**

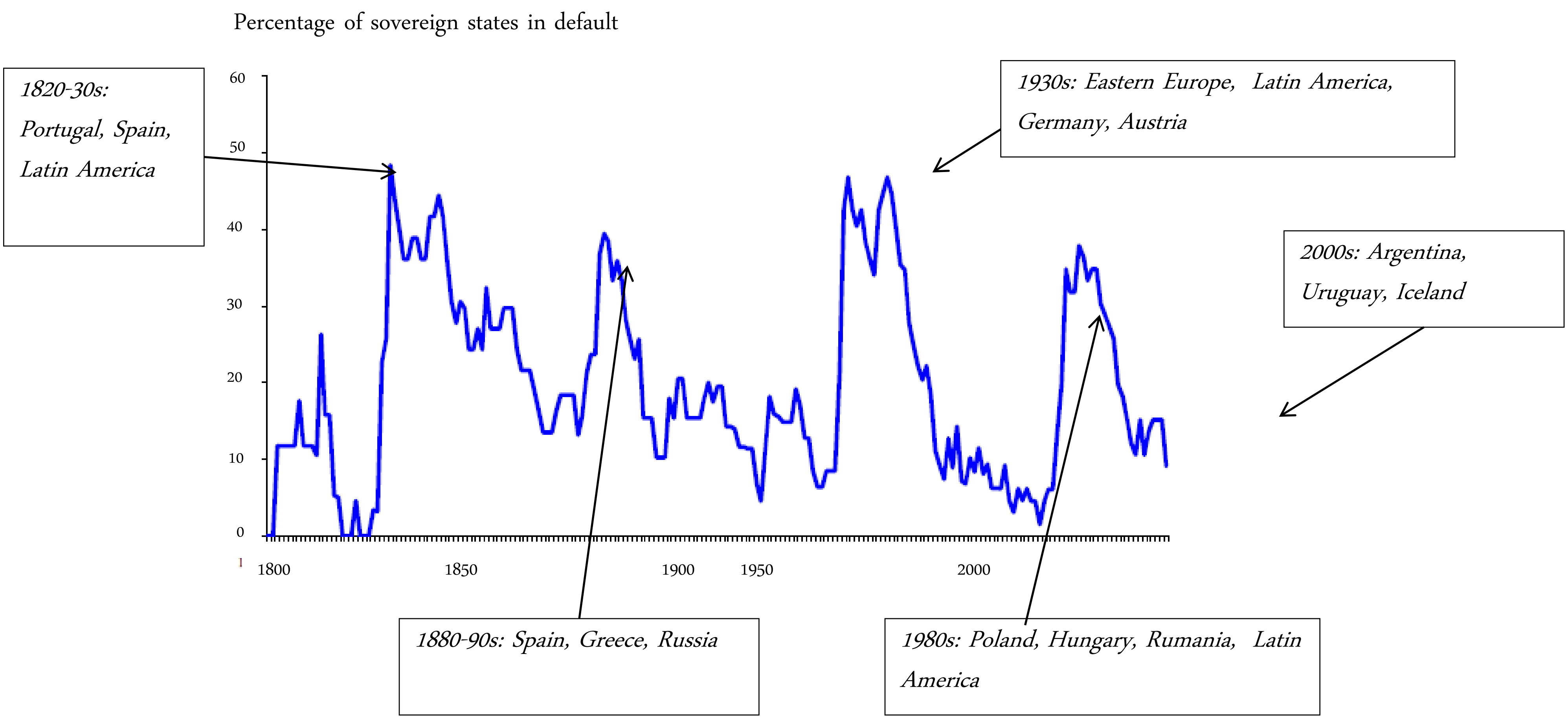
Financial Crises increase since End of Bretton Woods System 1971

- **"Reinhart, Rogoff This time is different" show that during Bretton Woods System hardly any banking crises**



Debt crises – historically a frequent event

- Debt crises most common in emerging markets
- Debt crises occur following strong international capital flows



Source: Reinhard/Rogoff (2008), Sturzenegger,/Zettelmayer (2006)

Growth friendly fiscal consolidation

- **How to consolidate budgets while avoiding negative growth consequences is a question currently subject to heated debate.**
- **Discussion fiscal multiplier - different views - negative due to non Keynesian effects, low 0,5 or high.**
- **IMF WEO 2011 – fiscal multiplier between 0,9 – 1,7,**
- **Eichengreen, O´Rourke in the 1930s multiplier 1,6**
- **Historical experience U.S. 1937 and Japan 1997 show that if after a deep crisis the fiscal stimulus is taken away, economies fall back into recession.**
- **Budget deficit cuts more painful if they occur simultaneously across many countries and monetary policy is not in a position to offset them.**
- **In the long term reducing debt beneficial for growth.**
- **IMF MD Strauss-Kahn said already in 2010 for Europe the growth problems are more serious than the deficit problems**

Growth friendly fiscal consolidation

- **Financing of the sectors of the economy - public, enterprises, private households, external - must match.**
- **If the public sector reduces its deficit the other sectors of the economy must decrease their surplus or increase their deficit.**
- **Only a growth friendly fiscal consolidation is successful in the long run**
- **Lower growth and the induced rise in unemployment - Hysteresis effect increases deficits again**

- **Austrian example after 1995 - lower public sector deficit with decreased private households savings ratio.**

Growth friendly fiscal consolidation - Austria 1995 - 1999

- **Growth friendly fiscal consolidation - Austria 1995 – 1999 under ’Austro-Keynesianisms**

- **Combining restrictive fiscal policy over 3% of GDP with supply and macro policies:**

  Increasing the tax rate on interest income

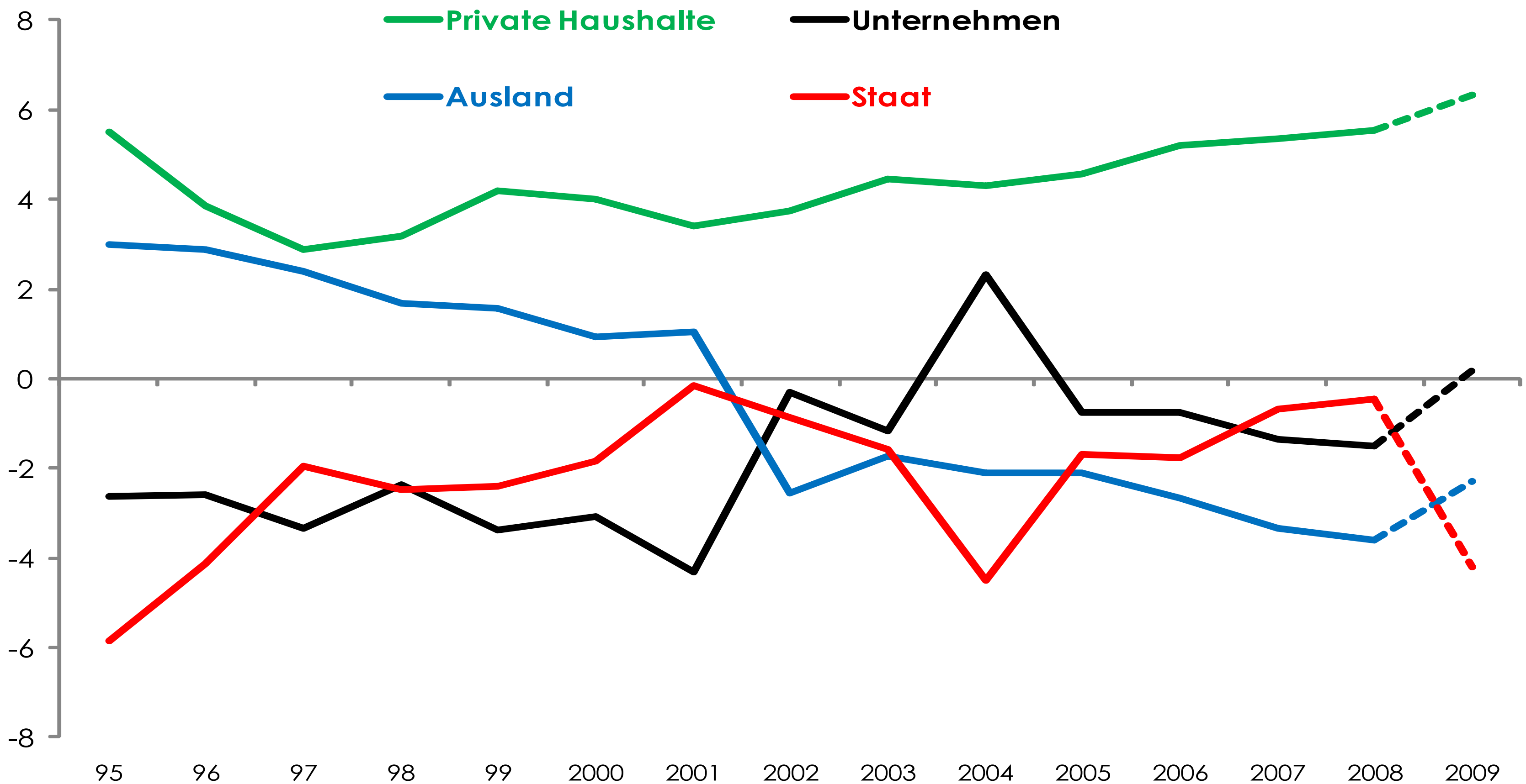
  Lowering subsidies for saving (Bausparen) and linking it to interest rates

  using tax exemptions in the housing sector to give incentives to private sector to spend existing reserves

- **Innovative expansionary package in 1996 nearly 3 % of GDP**
- **Shifting of public investment to the private sector**
- **A particular sort of public private partnership (PPPs)**

  - creating private entities owned by the state – motorways ASFINAG, Rail SCHIG, government buildings BIG

Growth friendly fiscal consolidation – Austria sectoral balances



Q: Statistik Austria, WIFO (Dezemberprognose 2009).

Growth friendly fiscal consolidation - Austria 1995 - 1999

Advantages of PPP demand management

- **Treating investment differently - depreciation over lifetime**
- **Gaining efficiency and flexibility**
- **No increase of the budget deficit**
- **Low financing costs**
- **combination of the strength of the private and public sector**

- **Shift in public demand from transfers to investments**

➢ **combination of fiscal consolidation and growth**

Growth friendly fiscal consolidation - Austria 1995 - 1999

- **Budget deficit from 5,8 % of GDP to around 2 % of GDP**
- **Private sector surplus from 6 % to around 3 % of GDP**
- **In parallel structural reforms due to EU accession 1995 – short term costs - longer term benefits – J curve effect**

- **Austria achieved higher growth during consolidation – on average 0,2 % annually - higher than EU 15.**
- **Also lower unemployment around 4 % than Germany, or the EU average**

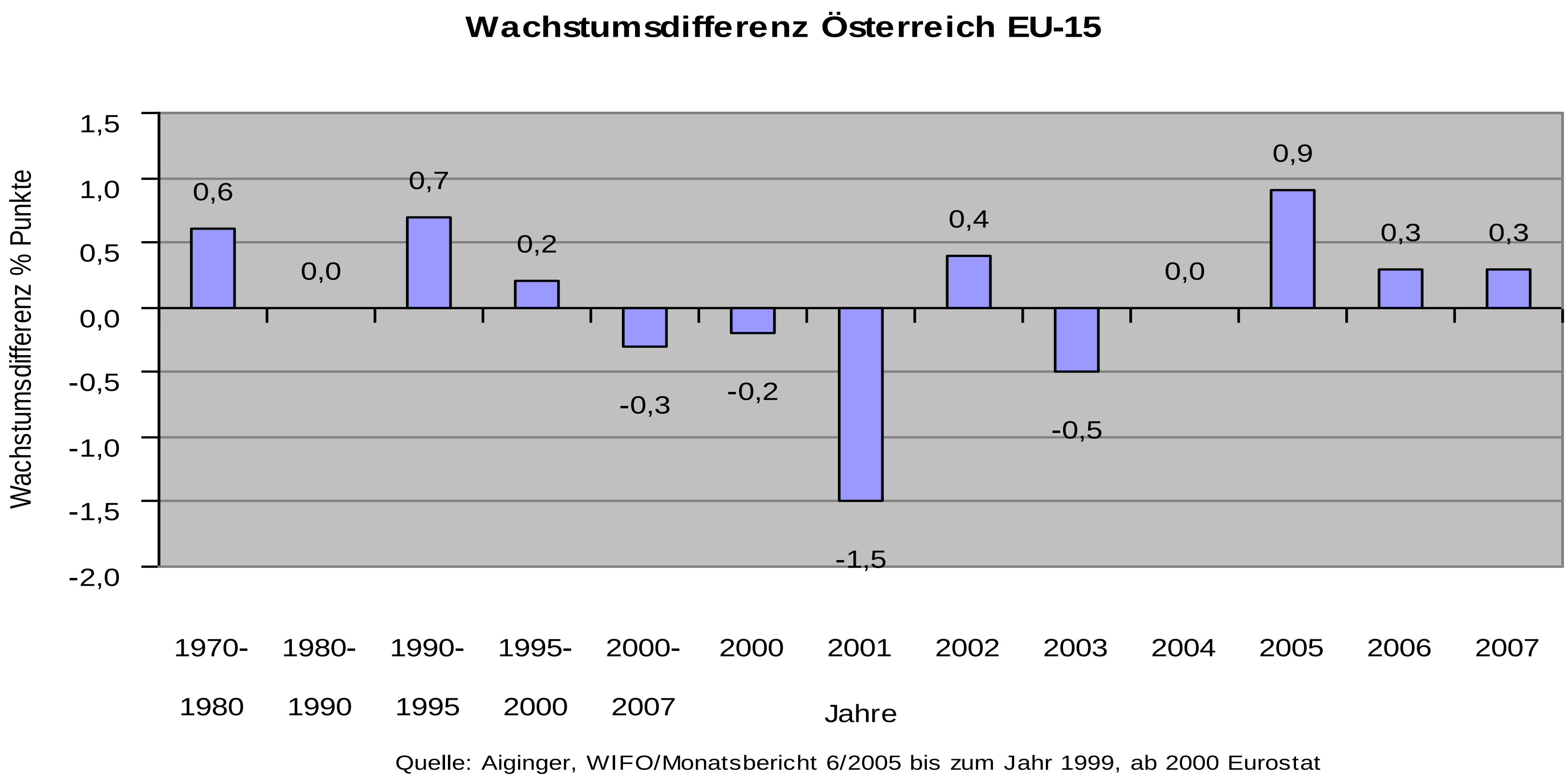
- **In terms of growth and unemployment Austria performed better under Austro-Keynesianism from 1970 to 1999 than under the Neoliberal regime from 2000 -2007.**

Growth damaging fiscal consolidation - Austria 2001

- In 2000 Austro-Keynesianism was abandoned and replaced by the neo liberal paradigm as conservative/right wing coalition was created.
- Goal of zero deficit let to pro cyclical fiscal tightening in 2001.
- damaged growth, increased unemployment, was not sustainable.
- Under the neoliberal paradigm from 2000 to 2007 Austrian growth and unemployment performance, was for the first time since 1970, worse than the average of the old EU members (EU 15).

Growth damaging fiscal consolidation - Austria 2001

Growth Differentials Austria – EU 15

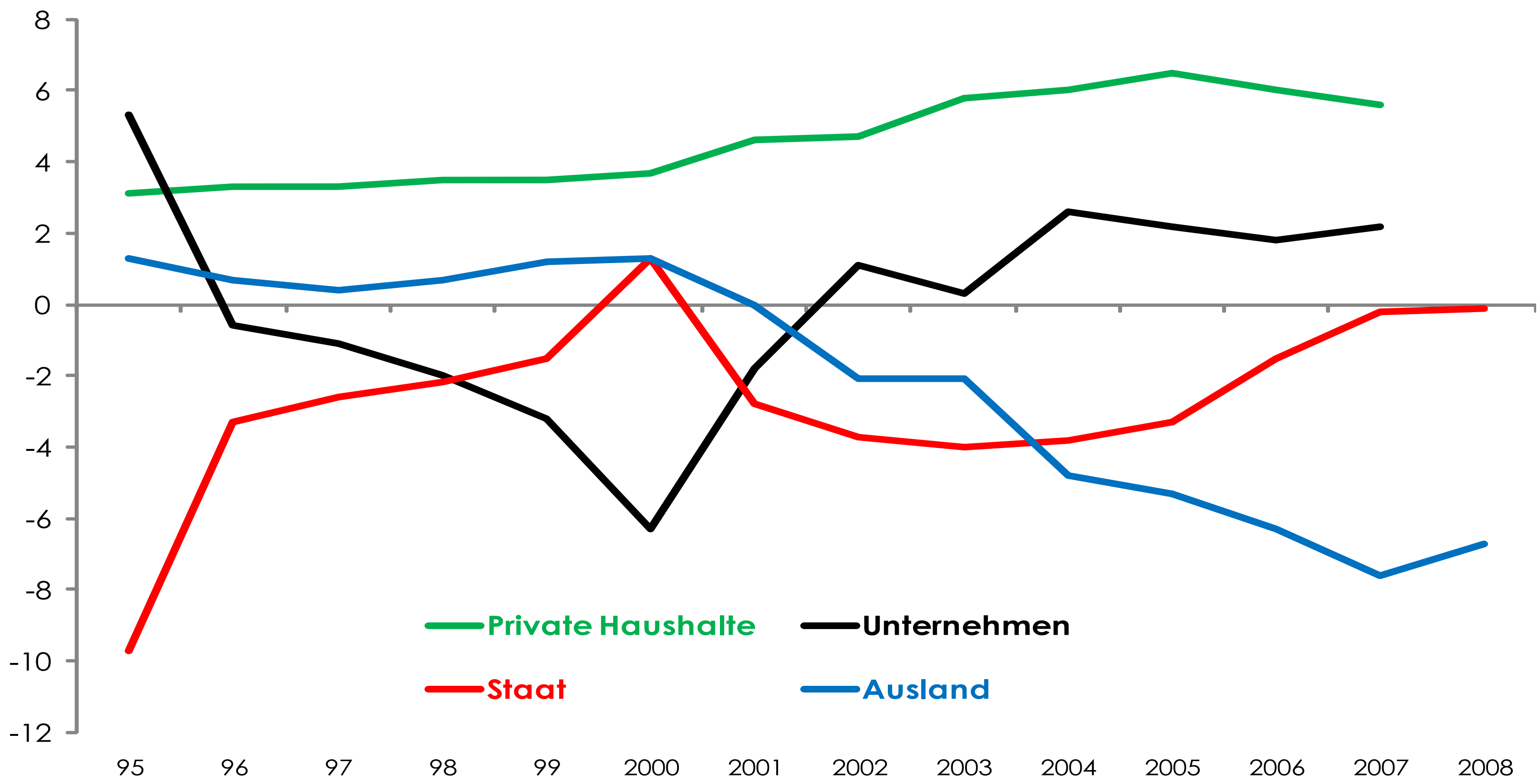


Fiscal consolidation - Germany

- German fiscal consolidation through external sector.

- Fiscal deficits decreased and the current account surplus increased.
- This cannot be a strategy for Europe as a whole, as it would then also contribute to global imbalances.
- But crises countries GR, IE, PT, IT, ES have huge current account deficits
- Their combined Trade and services balance deficit was 62 bn € in 2010.
- Deficit higher with ROW 40 bn €, China 33 bn €, than with Euro area - 22 bn €, GER 13 bn €.

Fiscal consolidation – Germany
sectoral balances



Q: Eurostat (Herbst 2009).

External Imbalances in selected Euro area countries

Goods and Services trade balances in billion EUR – cumulated GR, IT, IE, PT, ES

GR, IT, IE, PT, ES					
Jahr	**Welt**	**Euroraum**	**Deutschland**	**Rest der Welt**	**China**
2004	-40.789	-31.394	-22.830	-9.395	-13.644
2005	-69.984	-32.786	-24.479	-37.199	-17.961
2006	-103.934	-43.244	-28.995	-60.690	-23.797
2007	-104.101	-48.185	-38.331	-55.916	-30.923
2008	-116.466	-48.219	-31.600	-68.246	-33.840
2009	-42.104	-21.486	-15.384	-20.618	-23.134
2010	-62.834	-22.743	-17.873	-40.095	-33.065
2011	-38.520				-33.001

Quelle: Eurostat; für 2011 vorläufige Zahlen, es fehlen noch einzelne Länderdaten

Growth friendly fiscal consolidation - Austria 2012

- **In the fiscal consolidation of 2012 Austria has taken 2 measures to cut subsidies for saving**

Halving of the subsidy for

- savings for building Bausparen – from 3 % to 1,5 % and
- Third pillar of the pension system Zukunftsvorsorge from 8,5 % to 4,25 %.
- helps to cut the budget deficit and should lower the Austrian savings rate of 7,5 % of GDP

- **In Euro area –**
- **private sector surpluses and public sector deficits**
- **External Imbalances in countries most effected by the crisis**

Conclusions

- **Deficit reduction usually bring lower growth – potentially high fiscal multipliers**

- **Budget deficit reduction must be compensated by other sectors, otherwise GDP decreases.**

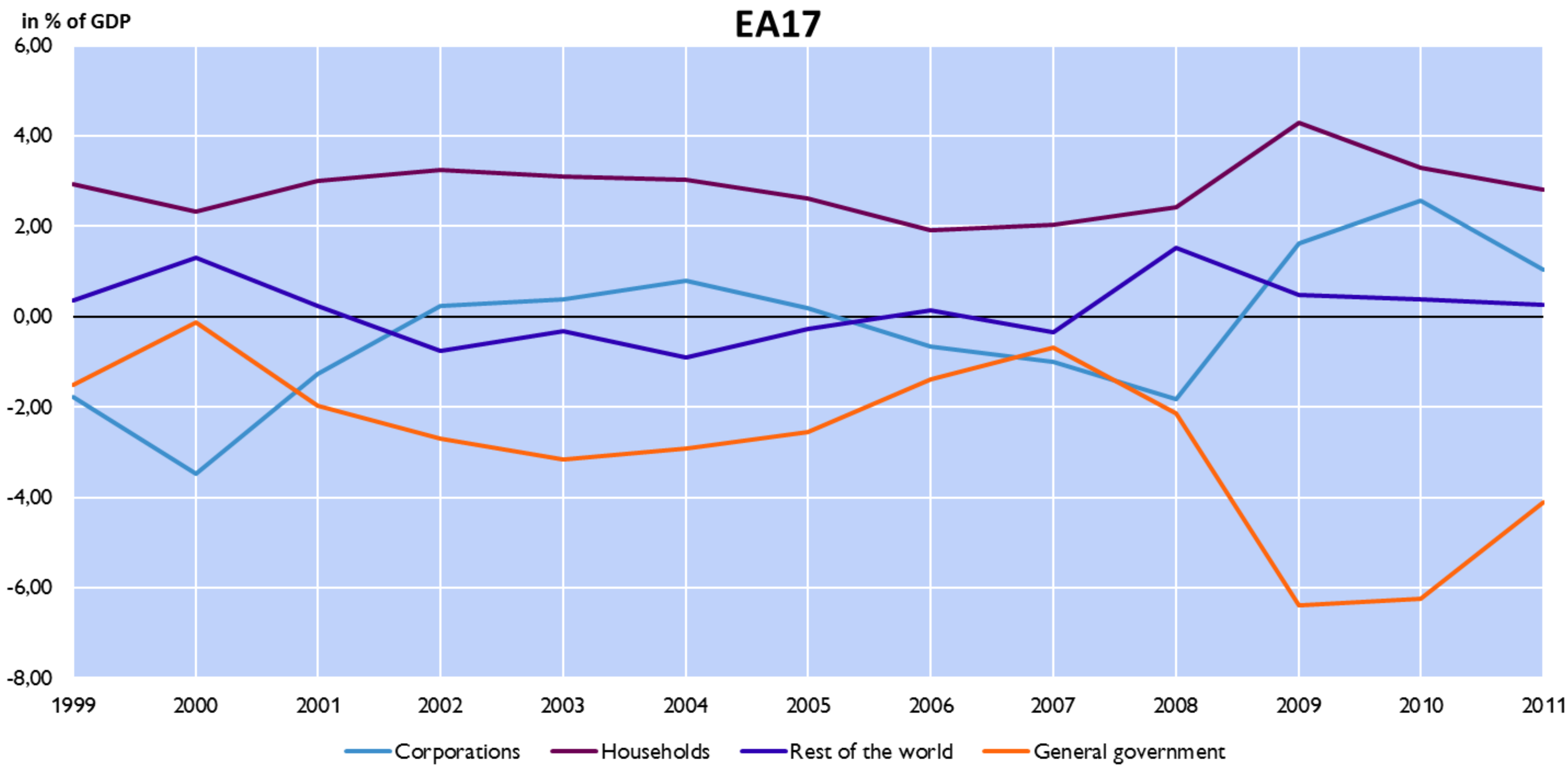
- **Lesson of the Austrian experience**
- Growth friendly fiscal consolidation can be achieved as the Austrian experience shows, but needs special policies to compensate falling public by private demand .
- Undifferentiated fiscal consolidation with pro cyclical fiscal policies, damages growth and is not sustainable.

Conclusions

Austrian model

- Economic impact of deficit cutting measures, especially on domestic demand and not just their budgetary consequences must be considered.
- Lowering savings rate in private sector – higher tax on interest income, less subsidies for saving,
- shifting public investment to the private sector
- Shift in public demand from transfers to investments helps – achieved through tax measures and public private partnerships (PPPs) in infrastructure.
- Using the low financing cost of state for investments e.g. housing stabilises economy, dampens increase in prices

Euro Area – sectoral balances



Source: Eurostat

Possible measures for Euro area growth friendly fiscal consolidation

Private sectors - measures to lower surplus e.g.

- Household sector - cut subsidies for third pillar pension systems to lower household savings or increase taxes on interest income
- Corporate sector - Increase corporate tax rates and compensate by increasing investment incentives for companies e.g. depreciation rates – goal more investment not higher tax income

External sector

- crises countries GR, IE, PT, IT, ES huge current account deficits.
- overvaluation especially against Asian currencies contributed to imbalances in crises countries - deficit with China 33 bn € 2011.
- fiscal consolidation through external sector like Germany - lower Euro exchange rate helps

Eurobonds, Eurobills could make financing cheaper thus lowering deficit levels

Literature:

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