Flash Economics

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Does a highly restrictive fiscal policy lead to a recession?

We take France's fiscal position as our starting point. Since long-term interest rates exceed potential growth in nominal terms, stabilizing the public debt ratio would require moving from a primary deficit (excluding interest on the debt) of 2.9% of GDP in 2025 to a primary surplus of around 1.8% of GDP in 2030. What would be the impact on activity of a 4.7 percentage point of GDP reduction in the primary deficit over five years?

The experience of the southern euro zone countries (Greece, Spain, Portugal) in the 2010s shows that the restrictive fiscal policy pursued there led to a sharp contraction in activity that lasted several years.

The experience of Sweden in the 1990s, by contrast, suggests caution: the move from a fiscal deficit of more than 11% of GDP in 1993 to a surplus of 0.8% of GDP in 1998 had no visible adverse effect on GDP growth, owing to a recovery in consumer confidence that allowed a sharp fall in the household saving ratio.

It is therefore not certain that a restrictive fiscal policy, based mainly on cuts in public spending, leads to a recession.

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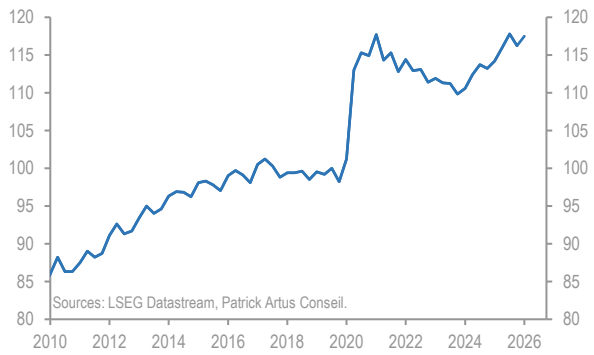
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What fiscal outlook for France?

France's public debt ratio is currently rising rapidly (**Chart 1**).

Chart 1
France: general government debt (% of GDP)



Stabilizing France's public debt ratio requires more than a return to primary balance (excluding interest on the public debt): since long-term interest rates exceed nominal GDP growth (**Chart 2**), **a primary surplus is needed**. The primary surplus required to stabilize public debt equals the product of the public debt ratio and the gap between long-term interest rates and nominal growth, i.e. around 1.8 percentage points of GDP (**Chart 3**).

Chart 2
France: real GDP (Y/Y, %)

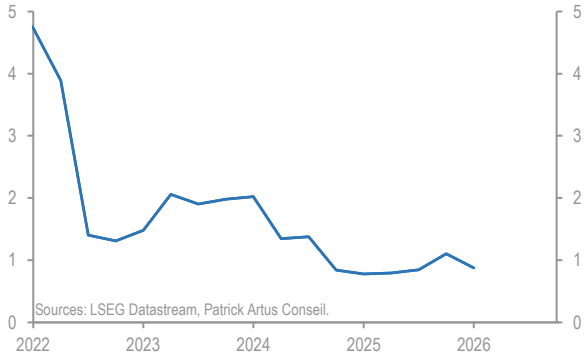
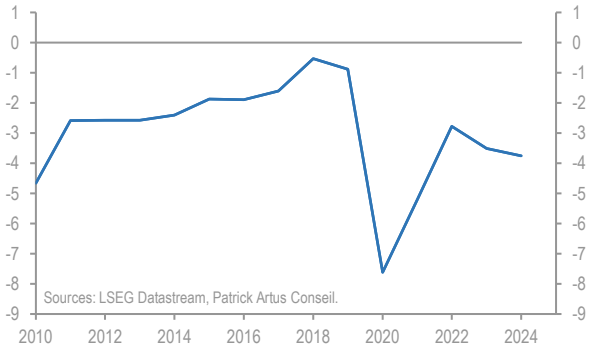


Chart 3
France: primary budget deficit (% of GDP)



This means that stabilizing France's public debt ratio requires reducing the primary deficit by 4.7 percentage points of GDP. If this is carried out from 2026 to 2030, it would imply **cutting the deficit by 0.9 percentage point of GDP per year** over the period. Is this achievable without tipping France into recession?

The experience of the southern euro zone countries in the 2010s

The sharply restrictive fiscal policies pursued from 2010 onwards in Spain, Portugal and Greece led to a severe contraction in activity, accompanied by a stabilization of public debt (**Charts 4a, 4b and 5**).

Chart 4A
Budget surplus or deficit (% of GDP)

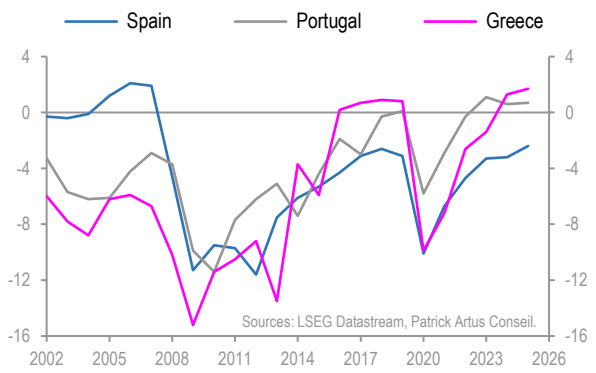


Chart 4B
General government debt (% of GDP)

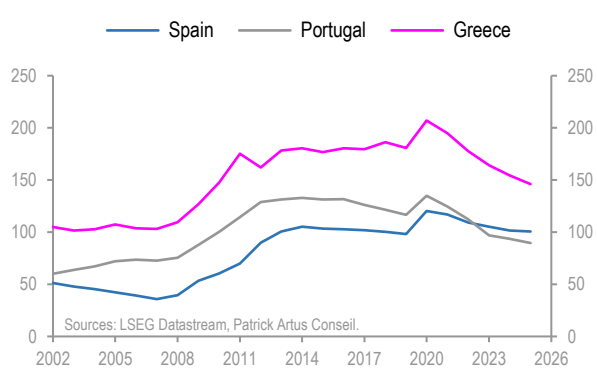
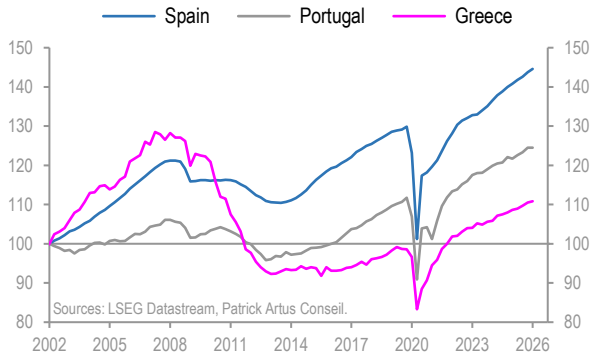


Chart 5
Real GDP (2002.Q1 = 100)



The level of GDP in volume terms recorded in 2007 was not regained until 2018 in Spain and 2019 in Portugal; in Greece it has still not been reached to date. Growth did, admittedly, pick up strongly from 2015 in Spain and from 2017 in Portugal and Greece, thanks to the low tax burden in Spain and Portugal (**Chart 6**) and to a fall in labour costs that made these economies more attractive. But **the initial cost of the fiscal adjustment, in terms of growth and unemployment, was considerable** (**Chart 7**).

Chart 6
Tax and social contributions (% of GDP)

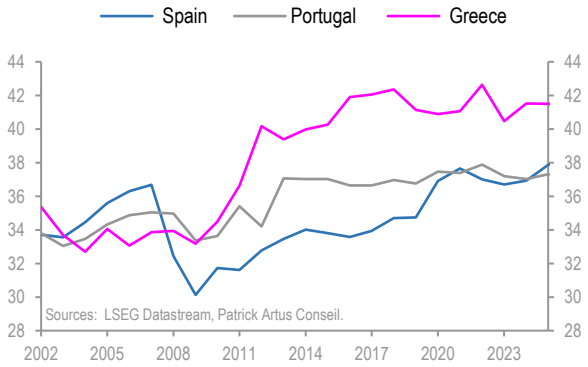
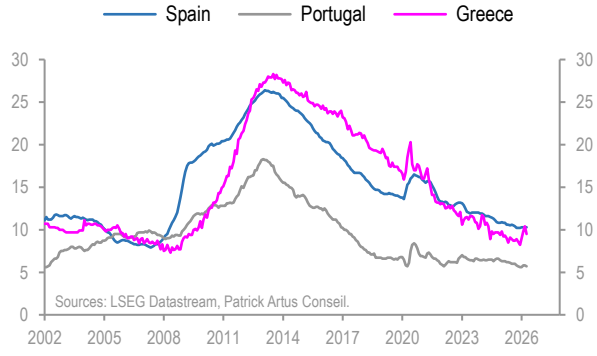


Chart 7
Unemployment rate (%)



The experience of Sweden in the 1990s

Sweden moved from a fiscal deficit of more than 11% of GDP in 1993 to a surplus in 1998 (Chart 8). The policy combined cuts in public transfers and sickness-related spending, a reform of the public sector (a shift to the agency model) and an increase in compulsory levies, in particular social contributions. As a result of this deficit-reduction effort, Sweden's public debt ratio stabilised from 1994 and fell sharply from 1998 **(Chart 9).**

Chart 8
Sweden: budget surplus or deficit (% of GDP)

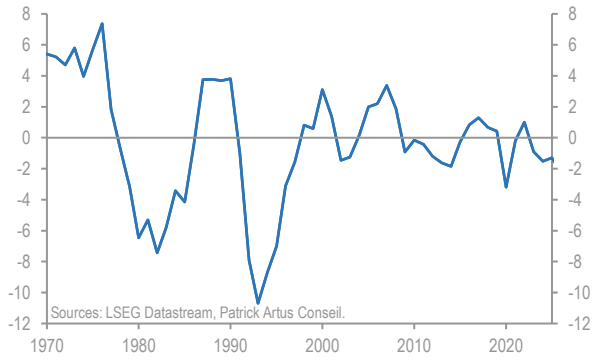
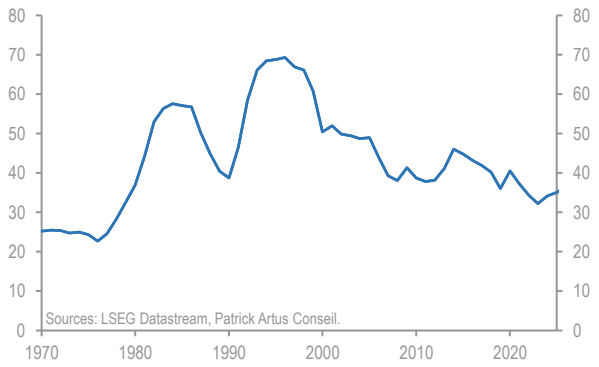


Chart 9
Sweden: general government debt (% of GDP)



Despite this very sharp fiscal consolidation, **Swedish growth remained strong from 1994 onwards** (**Chart 10**). One key explanation for the absence of any negative effects is **the improvement in consumer confidence**, reflected in **the fall in the household saving ratio from 1995 to 2008** (**Chart 11**).

Chart 10
Sweden: real GDP (%, Y/Y)

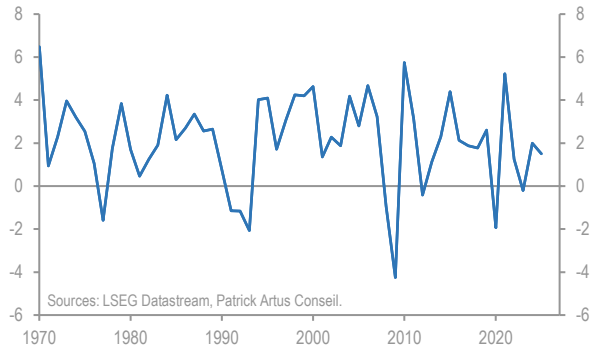
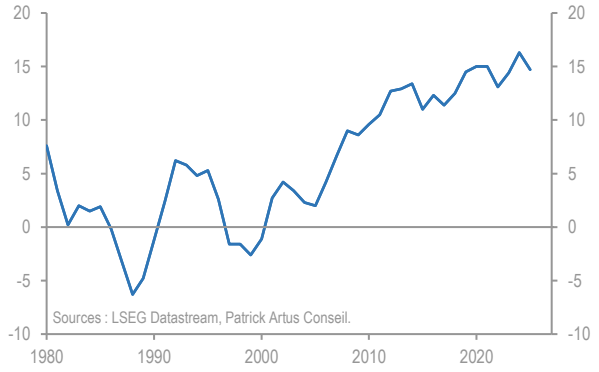


Chart 11
Sweden: household net saving rate (%)



Summary: the effects of a highly restrictive fiscal policy are hard to predict

If France is to stabilise its public debt ratio by 2030, the necessary reduction in the primary deficit will be considerable (4.7 percentage points of GDP). Past examples of fiscal consolidation show how difficult it is to gauge the effect of a rapid deficit reduction on growth. Indeed, the evidence shows:

- in the 2010s, in the southern European countries, a strongly adverse effect of deficit reduction on growth and employment;
- in the 1990s, in Sweden, the absence of any adverse effect of fiscal consolidation on growth, thanks to the recovery in consumer confidence.

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