Box 8

PAST EXPERIENCE OF EU COUNTRIES WITH SUSTAINING LARGE PRIMARY BUDGET SURPLUSES

Public debt sustainability requires a country to generate sufficiently large primary surpluses (i.e. budget balance net of interest payments) over an extended period of time so that the ratio of public debt to GDP will not grow without bound.[1]

In the framework of EU/IMF adjustment programmes, the euro area countries with very large fiscal imbalances are undertaking ambitious corrective action to stabilise and then reduce their government debt-to-GDP ratios. To put these efforts into perspective, this box looks at past episodes of large primary budget surpluses in EU countries, which were maintained over an extended period of time during the period 1980-2010. Such fiscal strategies were key to reducing government debt ratios.[2]

To identify improvements in the fiscal position which were driven by discretionary fiscal policy actions, the focus is on the cyclically adjusted primary balance (i.e. a measure of the primary budget balance adjusted for the effects of the business cycle). In particular, the analysis considers those episodes during which an average cyclically adjusted primary surplus of at least 4.5% of GDP was achieved for a minimum of five years. According to this criterion, a total of six episodes of large cyclically adjusted primary surpluses are selected spanning the period from 1988 to 2004 (see table).

As shown in the table, all six countries achieved average cyclically adjusted primary surpluses between 4.5% of GDP (Greece) and 5.6% of GDP (Finland), with considerably higher peaks during the period. The large cyclically adjusted primary surpluses were maintained for long periods ranging from a minimum of six years in Italy, Greece and Sweden, to 12, 13 and even 14 years in Belgium, Ireland and Finland, respectively. The long time

1 Under the conventional assumption that the (effective) nominal interest rate on the stock of debt is higher than the nominal growth rate of the economy. For details, see the box entitled "Factors driving government debt-to-GDP ratios", *Monthly Bulletin*, ECB, April 2011.
2 See the box entitled "Experience with government debt reductions in euro area countries", *Monthly Bulletin*, ECB, September 2009 and the box entitled "Government debt dynamics and primary budget balance developments in the EU Member States", *Monthly Bulletin*, ECB, March 2011.

Selected episodes of large and sustained cyclically adjusted primary budget surpluses in EU countries

Country (period over which large CAPSs were maintained)	Belgium (1993-2004)	Italy (1995-2000)	Ireland (1988-2000)	Finland (1998-2003)	Greece (1994-1999)	Sweden (1996-2001)
Average CAPS (percentage of GDP)	5.4	5.5	5.3	5.6	4.5	4.7
CAPS at peak (percentage of GDP)	6.8	7.0	7.1	8.0	5.1	5.8
(year(s) in which it was achieved)	(1998)	(1997)	(1994)	(2000)	(1998, 1999)	(1998, 2000)
Average debt ratio in the previous five years (percentage of GDP)	125.7	107.1	103.3	56.1	77.1	65.2
Change in debt ratio (percentage points of GDP):						
in the previous five years	4.0	28.8	29.2	13.8	37.2	31.0
over the period of large CAPSs	-34.5	-12.7	-75.2	-9.5	-4.3	-18.3
in the following five years	2.0	-3.3	-10.4	-10.4	4.9	-9.0

Source: ECB calculation based on European Commission data.
Note: CAPS = cyclically adjusted primary surplus.

periods over which large cyclically adjusted primary surpluses were sustained suggest that this achievement is not a reflection of particular favourable cyclical economic conditions. The cumulative fiscal adjustment[3] to achieve the high and sustained levels of primary surpluses was also considerable: for example, in Greece a cyclically adjusted primary surplus of 4.8% of GDP was achieved in 1994 following a cumulative adjustment of 10.1 percentage points of GDP over a four-year period (1991-1994). Likewise, Sweden achieved a cyclically adjusted primary surplus of 3.5% of GDP in 1996 following a cumulative adjustment of 6.0 percentage points of GDP over a three-year period (1994-1996).

Two observations (that are not mutually exclusive) on debt developments before the start of the adjustment period characterise the countries in this sample: i) debt-to-GDP ratios were very high before the improvement in the cyclically adjusted primary balance (Belgium, Italy and Ireland had debt ratios in excess of 100% of GDP); ii) the debt ratio had increased considerably prior to the fiscal adjustment (Greece, Sweden and Finland), also as a consequence of a banking crisis (Finland and Sweden).

The sustaining of large cyclically adjusted primary surpluses for an extended period of time puts government debt ratios on a downward path. The countries under consideration reduced their debt-to-GDP ratios during the adjustment period, in some cases substantially. In the case of Greece and Finland, however, deficit-debt adjustments with an upward impact on the government debt ratio partly offset the effect of the primary surpluses.[4] Moreover, for all countries, except Greece and Belgium, the debt ratio also continued its downward trajectory after the end of the period of high primary surpluses. The reduction in debt ratios was supported by declining interest rate/growth rate differentials. Here, the beneficial effect of sound fiscal policy on reducing (market) interest rates and supporting sound and sustainable output growth played an important role.[5]

Overall, past evidence shows how countries that are confronted with a large and rising government debt-to-GDP ratio may succeed in stabilising and reducing it. This requires a sustained upfront consolidation effort that allows the achievement of large primary surpluses, which have to be maintained over an extended period of time.

3 The cumulative fiscal adjustment is measured as the sum of annual changes in the cyclically adjusted primary budget balance over the reference period.
4 In the case of Greece, the deficit-debt adjustments over the period in which large cyclically adjusted primary surpluses were maintained, were mainly related to the revaluation of debt denominated in foreign currency following the devaluation of the drachma and to transactions in financial assets. In the case of Finland, the deficit-debt adjustments were mainly related to transactions in financial assets.
5 See also the article "The effectiveness of euro area fiscal policies", *Monthly Bulletin*, ECB, July 2010.