

The Effects of Fiscal Consolidation on Macroeconomic Indicators in Cyprus: A FAVAR Approach

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Abstract

This paper implements a recently developed econometric model, the Factor-Augmented Vector Autoregression (FAVAR), to estimate the dynamic effects of fiscal consolidation policies on key macroeconomic variables such as aggregate output, price level, employment, private consumption, investment and interest rate. The results of our analysis show that fiscal retrenchment efforts in the form of either a government expenditure reduction or a government revenue increase, lead to a fall in GDP driven by the negative responses of investment, private consumption and employment. As a result of the contractionary effects of consolidation on economic activity, inflation decelerates. Fiscal tightening based on expenditure reduction results in a larger contraction in output than consolidation through an equivalent revenue rise, especially in the medium term. Thus, the policy mix between expenditure cutbacks and tax increases matters as it influences the cost of fiscal consolidation in terms of lost output. Within two years, GDP falls cumulatively by 1.0% and 0.6% as a response to fiscal consolidation (amounting to 1.0% of GDP) associated with spending cuts and equivalent revenue increases respectively.