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The debate on fiscal policy in Europe: beyond the austerity myth

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Summary

Several criticisms of the current fiscal strategy in the EU have recently been forcefully expressed. In this brief, we examine these criticisms, and provide some clarifications and responses. We recall that large adjustments are needed in most economies to restore sustainable fiscal positions, not because of the arbitrary will of the markets or of EU institutions. We then examine the debate over the precise speed of fiscal consolidation, which blends arguments over the short-run growth effects but also over the various possible costs and problems of no-consolidation. In practice, fiscal policy recommendations under the EU framework have struck a balance between the conflicting considerations.
Overall, we argue that the current EU fiscal strategy is essentially in line with the approach favoured by other international organisations. The EU fiscal recommendations are not an ideological call for austerity at all costs. In general, the flexibility embodied in the rules is being used within a "steady structural" strategy. Attention is also being paid to softening the consequences of fiscal adjustments, and fostering the return to sustainable growth and jobs, through a careful design of fiscal consolidation packages, structural reforms, and a restoration of functioning financial channels. Finally, a differentiated fiscal consolidation is part of the rebalancing process at work within the euro area, whereby the efforts of vulnerable euro area countries should be matched by rebalancing trends and appropriate policies in countries that feature large current account surpluses.

Introduction

The debate on the fiscal strategy in Europe seems at times like a war of religions. This is unfortunate because the objective disagreements in substance are in our view less pronounced than is sometimes depicted.

In this brief we lay out the main tenets of the EU approach to current fiscal adjustments. It is not a dogmatic call for austerity at all costs. Rather, it is a delicate balancing act between implementing credible adjustments, keeping flexibility against shocks, and factoring in institutional constraints. We constantly keep our approach under review.

We proceed by examining more closely some of the accusations levelled against fiscal policy recommendations adopted by the Council under the EU framework. Our claim is not that recommendations have always been "just right", nor that they could not be improved upon in any specific aspects. But we would say that more often than not, these recommendations have been and remain sensible and in line with those advocated by other institutional organisations such as the IMF or the OECD.

1. Allegation 1: There was irrational panic in the sovereign bond markets of vulnerable European countries, and this led to the imposition of unnecessary harsh consolidation.

This criticism is laid out in particular by de Grauwe and Ji (2013). There are two aspects: one is about the functioning of financial markets and the value of market signals; the other about the fiscal policy response.

There is agreement that markets are prone to excessive swings. This need not imply, however, that markets acted purely out of irrational fear in the sovereign bond crisis.

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First, some investors did lose money on Greek bonds after all. Second, although arguably excessive at times, sovereign spreads were and are at least loosely correlated with the underlying fundamentals. So even though they may not reflect *only* fundamentals, spreads are not unrelated to objective factors either.

It is clear that the announcement of the OMT programme by the ECB has had a critical effect on market expectations. By this move, which aimed at ensuring effective monetary policy transmission and preventing redenomination risks, the threat of a self-fulfilling liquidity crisis is being assuaged. Effectively, the possibility of ECB interventions in the secondary market helps coordinate market expectations: investors rightly believing in the sustainability of a country do not have to fear a liquidity crisis.

As is clear as well however, the OMT announcement *per se* does not address the underlying sustainability concerns. Vulnerable countries have sustainable positions under the condition that they adjust. The OMT itself is a programme of sovereign debt purchase under strict and effective conditionality. Fiscal adjustment and the possibility to activate the OMT are thus in strong complementarity. The fact that the reduction in spreads coincided with the announcement of the OMT is no sufficient evidence that the concomitant consolidation efforts were not necessary.

The growing perception that adjustments are underway likely also contributed to the improvement in markets. This is disputed, because public debt ratios have recently continued to rise. But debt ratios are a quite lagged indicator of progress in fiscal sustainability. Progress has been much more evident when looking at the reduction in fiscal deficits, especially in cyclically-adjusted terms, even though the growth picture has remained weak. On average the euro area structural balance has been cut from 4½% to 1¼% between 2009-2013, with much stronger adjustments in countries such as Greece or Portugal. There has also been visible progress in improving external and relative competitiveness positions.

To summarise on this point: we agree that markets are liable to multiple equilibria. But we would not infer that they have just been producing irrational signals in the sovereign crisis. Further, the effect of the OMT announcement, while undisputed, cannot be read as evidence that significant fiscal adjustment was unwarranted. Now, it may be argued that consolidation, while necessary, was not needed to the extent prescribed. This leads to the next point.

2. Allegation 2: The adjustment is too front-loaded.

There is widespread agreement that fiscal consolidation should be pursued in most European countries. This is the view of the IMF, the OECD and the Commission. Large improvements in fiscal positions are needed (and underway) to stabilise and reduce high levels of debt. Even vocal critics of the EU often admit that fiscal consolidation is unavoidable, in particular in countries where sustainability is at risk. It is important to underline this area of agreement. Once it is admitted that fiscal adjustment is due, the issue becomes not one of principle, but one of degree.

Many commentators say the problem is rather that adjustment is overly frontloaded, especially for the euro area periphery (e.g. Wolf, 2013). These criticisms rarely give details on their own prescribed course. Running fiscal policies requires operational annual budgetary targets consistent with a credible medium-term plan. Country-specific features are important as well to consider (Gros, 2013). A sweeping conclusion that fiscal retrenchment is excessive without specifying a detailed alternative is in a sense evacuating the hardest issues faced by policymakers.

The recent international consensus is that fiscal consolidation needs to continue at a gradual and sustained pace, and that fiscal adjustment in most advanced economies is broadly appropriate (IMF, 2013).

When setting the pace of fiscal adjustment, two considerations are critical from a technical standpoint. One is the economic outlook, including what we know of the short-term effects of consolidation (the multiplier). Another is the sustainability gap, understood as the scope of needed adjustment over the medium-run. The EU framework calls for paying attention to both.

It is agreed that there is no single fiscal multiplier across fiscal variables, countries and time. In particular, as compared with usual circumstances, there are reasons to expect higher multipliers in an environment of weak activity, lack of room for a supportive monetary policy, and tight financing constraints for private agents.

All else equal, non-linearity in the growth cost of fiscal adjustment does call for spreading out adjustments over time. A variant of this argument is to allow sequencing of public and private deleveraging for getting out of a balance-sheet recession. The Japanese fiscal retrenchment of the late 1990s is frequently invoked as a case of premature tightening (Koo, 2008).

The policy implications require treading a fine line however. The above arguments have to be weighed against several opposite considerations:

First, while consolidation may be now more costly than in normal times, no or limited consolidation may in some cases have even worse consequences, notably if it triggers market expectations of a sovereign default and a liquidity crisis (Corsetti, 2012). This risk might have been recently lowered with the ECB announcement of the OMT, but the latter does not remove the need to demonstrate early commitment to fiscal consolidation, as noted above.

The second point is simply basic arithmetic: when the scope of required adjustment is large on the medium-term, even a gradual consolidation strategy spreading out consolidation over several years in broadly equal instalments will translate in not-insignificant fiscal effort from the beginning. While measuring fiscal sustainability gaps is fraught with difficulties, the indicators compiled by the Commission for EU countries, which are widely acknowledged, suggest that in a number of cases sustainability gaps are at historic highs (European Commission, 2012a). The IMF considers a structural adjustment pace of 1% a year as a useful guideline, with needed differentiation according to the country situation (IMF, 2012). The SGP requires an annual structural adjustment of 0,5%, and more in the case of vulnerable countries. While fully back-loading consolidation to better times might still be theoretically envisaged, the risks of time-inconsistency and lack of credibility cannot be neglected. In addition, one cannot be sure by when and how much the multiplier could fall in the future (Wolff, 2013).

Finally, the room for trading off public against private deleveraging depends on the overall external position of the country. Contrarily to Japan in the 1990s, euro area countries under distress face a big overall external challenge that must be confronted by significant adjustments of the nation as a whole. This is bound to be painful, whatever the exact distribution between public and private deleveraging. Again, this does not fully remove the case for sequencing, but it limits the scope and benefits of such approach.

Policy prescriptions for fiscal policies under the E(M)U framework have struck a balance between these conflicting considerations. It should be recalled that the fiscal exit strategy originated in the early response to the crisis in the form of a fiscal stimulus in 2009/2010. Many initial recommendations under the excessive deficit procedure (EDP) were drafted in this period, where it was agreed that the initial fiscal relaxation should be followed by fiscal retrenchment to stabilise and reduce debts. Recommendations set out at the time, of which a number remain in place, charted a path of sustained but spread out adjustment over several years, and with more effort required when the sustainability challenge is bigger.

The adjustments underway are a reflection of accumulated imbalances and the massive effects of the crisis. These are the essential motivations for current consolidation efforts, not the arbitrary will of EU authorities or financial markets. As developed in the next point, the Commission has made use of the flexibility embodied in the EU rule-based framework (Buti and Pench, 2012). The precise pace of adjustment remains a delicate balance in each country specific cases, and may always be discussed. For example, future recommendations could better factor in the consequences of changes in growth models (such as rebalancing towards the tradable sector) in terms of lower tax elasticities.

3. Allegation 3: The Commission follows an inflexible approach.

This criticism comes at a paradoxical time. The Commission has taken the initiative by proposing to extend deadlines for correcting the excessive deficit in several countries. Besides, a key aspect of the flexible approach we have adopted has recently been to make more explicit the focus on structural targets, rather than just the overall deficit of a country. We expect this to remain important going forward.

A key characteristic of recommendations under the SGP is that the deadline for reducing the nominal deficit below 3% of GDP is conditional on the macroeconomic forecast at the time of issuing the recommendation. Missing the nominal targets does not expose the country concerned to an escalation of the excessive deficit procedure, including the possibility of financial sanctions, if the structural effort (specified in the recommendation in terms of changes in the cyclically-adjusted balance net of one-off and temporary measures) has been delivered. Rather in these cases the country would receive an extension of the deadline for correcting its excessive deficit. The absolutely key point here is that we have not, and will not, pursue dogmatic targets for the reduction of the headline fiscal deficit, irrespective of the circumstances a country finds itself in.

The reliance on structural targets provides both predictability and flexibility, and hence supports the credibility of the adjustment strategy. The predictability stems from the fact that countries can embark on a "steady structural approach". The flexibility lies in allowing the automatic stabilisers to play out around the (structural) path of adjustment. Unless warranted by an overwhelming financing constraint, there is no need to chase nominal targets when growth disappoints. Of course cyclically-adjusted balances are not without limitations either, based as they are on conventional assumptions about the working of the economy and the budget. But our surveillance framework is being developed to take into account these limitations when assessing the effective delivery of the structural fiscal effort (European Commission, 2012b).

This has been the approach followed in several occasions already, including for the three programme countries (Greece, Ireland and Portugal) as well as for Spain last year. Further extensions of deadline may be recommended in the near future, as the Commission has already made clear in presenting its winter forecasts.

The simple allegation that the Commission pursues austerity inflexibly does not hold. Nor obviously does the opposite accusation that the framework is being weakened by downplaying the role of headline balances. The size of the fiscal adjustment already produced in vulnerable countries and elsewhere is testimony against that.

4. Allegation 4: Fiscal consolidation is not politically or socially sustainable.

There is no denying that the adjustments undergone by several countries are severe and this may strain social cohesion. However, there is much to do in order to soften the consequences of adjustments, and accelerate the return of a sustainable recovery:

- The composition of fiscal adjustment should be carefully designed. That often means some emphasis on expenditure restraint, but needs to go beyond that in order to pick-up growth-friendly measures in an encompassing manner. Spreading the costs across the population and confronting vested interests which often protect less productive spending help generate a sense that everyone pays their fair share. Besides, implementing structural fiscal reforms, such as pension reforms, improve public sustainability (and medium-term growth) without weighing on aggregate demand in the short-run, although not all consolidation can go this route in practice.

- Another aspect is structural reforms promoting better functioning labour and product markets. In the present juncture, fiscal consolidation and 'reform responsiveness' go hand in hand (Buti and Padoan, 2012). Structural reforms can alter not only the efficiency with which economies respond to shocks, but also the distribution of the effects. For example, flexible work arrangements and lower nominal rigidities reduce the impact of downturns on outright layoffs. Reducing rents in product markets would help ensuring the pass-through of wage restraint on prices and distributing purchasing power to households. In other cases (such as changing employment protection legislation), reforms would not help cushioning the impact of negative shocks, although they may foster a stronger upturn. These issues are not just a matter of efficiency, but also of sharing the cost of adjustment in an equitable manner (Coeuré, 2013).

- The cost of total deleveraging may also be made lower by a number of other factors, such as efficient bankruptcy procedures or genuine financial repair that allows lending to dynamic parts of the economy to go unhindered. Besides, restoring effective monetary policy and credit channels throughout the zone is likely to soften the costs of consolidation. The primary objective should be to lay the basis for a sustainable recovery.

- In countries inside our outside the euro area under a EU-IMF programme, efforts have been taken by the governments concerned and the troïka (Commission, IMF, ECB) to embed equity considerations in fiscal adjustment plans. Tax measures have focused on higher income brackets, and cuts in government wages or social benefits have often spared the lowest income levels. In some of the countries, the internal and external imbalances were so large and deep-rooted that radical choices had to be considered to rebuild their economic and policy credibility.

5. Allegation 5: The Commission's approach is one-sided. It puts all the burden of adjustment on debtor countries.

Several observers have pointed to the spillover implications of fiscal policies, and possibly insufficient policy coordination in the EU (e.g. Holland and Portes, 2012).

We would agree that the symmetry of the adjustment is a legitimate concern. There are ways to favour a coordinated approach to rebalancing, but the currently available tools also present limitations.

For vulnerable countries of the euro area that face a large external sustainability gap, external growth is the only sustainable way to grow out of their debts. They must undergo rebalancing but their adjustment should indeed not be unduly hampered, and ideally should be fostered by concomitant changes elsewhere.

The improved current balances in the periphery thus have to be matched by rebalancing trends also in euro area countries that feature large current account surpluses. Policies and reforms supporting demand in these countries have a role to play. In Germany, the fiscal stance is now broadly neutral, hence consistent with the call for a differentiated fiscal stance according to the budgetary space. Reforms advocated by the Commission and the Council in labour and product markets or the tax system should contribute to raising domestic demand. There is also an increasing willingness to allow wages to reflect the higher productivity in surplus countries. And since fiscal consolidation *cum* deflation is likely to be self-defeating, re-establishing competitiveness across the area implies higher than average inflation in stronger countries, provided price stability in the euro area as a whole is ensured and expectations well anchored.

The discussion also has implications for the long-run improvement of EMU architecture. The current situation appears as a *cas d'école* for the potential attraction of a "fiscal capacity" at the central level, in the form of a stabilisation instrument, which the Commission has evoked in its Blueprint on the future of EMU (European Commission, 2012c). A dedicated stabilisation fund could improve the conduct of fiscal policies throughout the cycle by enforcing tighter policies in good times and providing additional leeway for cushioning downturns. Such a tool could strengthen the existing automatic stabilisers while maintaining a credible rule-based framework. It would be particularly useful in the current predicament characterised by large cyclical differentials across the zone as well as a not insignificant average output gap. However, according to the Commission blueprint such a tool should only be considered in the longer term in the context of full fiscal and economic union.

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