AllianceBernstein

Europe's Fiscal Progress Faces Complacency Risk

- **Dennis Shen**
  Economic Associate—Global Economic Research, + 44 (020) 7173 9270
- **Darren Williams**
  Senior European Economist—Global Economic Research, + 44 (020) 7959 4543

Euro-area governments have made significant progress towards their medium-term fiscal objectives. However, domestic opposition to austerity and increasing complacency by policymakers are jeopardizing the commitment to further adjustments, in our view. This may pose a longer-term risk to fiscal sustainability.

National governments in the euro area have made material progress on their budgetary objectives. Last year, the consolidated budget deficit for the euro area improved to 3.0% of gross domestic product (GDP), according to preliminary estimates. It was the first time since 2008 that the regional figure was within the Maastricht deficit threshold.

New medium-term projections for 2014–2017 point to continued improvements in fiscal positions, supported by a favorable growth outlook. At the regional level, the underlying budget balance (excluding one-offs) is projected to steadily improve from –3.0% of GDP in 2013 to –0.4% in 2017. While significant cross-country variation in fiscal positions still exists **(Display 1)**, convergence should also continue as the countries with the biggest deficits make the steepest reductions.

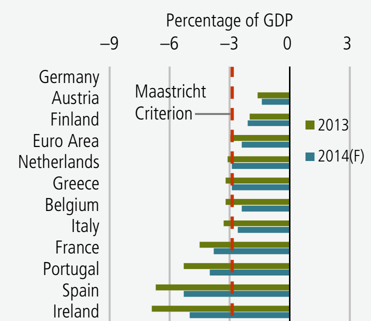
Continued Consolidation

Many countries still have hard work ahead. According to the Maastricht criteria, deficits of European Union (EU) member states must not exceed 3.0% of GDP and government debt must be below 60% of GDP. Countries with excessive deficits—like France, Spain, Ireland and Portugal—still need to take significant consolidation steps. And countries like Greece, Italy and Belgium, which have smaller deficits but high government debt stocks **(Display 2)**, need to ensure that debt is "sufficiently diminishing and approaching the reference value at a satisfactory pace."

And that's not all. The new EU fiscal framework in force since January 2013 (the "Fiscal Compact") strengthened previous rules by requiring member states—including those compliant with the Maastricht criteria—to continue tightening in order to reach a structural (cyclically-adjusted) deficit of not more than 0.5% of GDP. This is relevant for countries like the Netherlands and Finland. In fact, the only major euro-area country that is already compliant with this requirement—and therefore does not need to do anything more—is Germany.

Display 1
Variation in Fiscal Positions

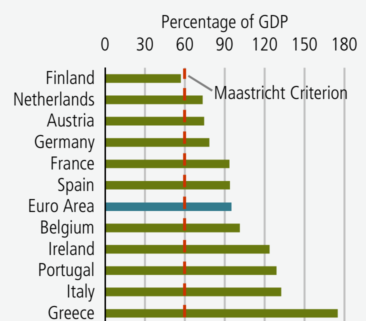
Underlying General Government Balance,* 2013 Results and 2014 Targets



As of June 2014
*Underlying general government balance excludes one-offs like bank recapitalization costs.
Source: European Commission

Display 2
Debt Still Elevated

General Government Debt, % of GDP



As of December 2013
Source: European Commission

Slower Pace of Tightening

While the region's fiscal rules require member states to maintain the medium-term adjustment, the scale of discretionary tightening has notably eased relative to years past. In 2014, the euro area's discretionary fiscal tightening will average about 0.4% of GDP*—as measured by the change in the structural primary balance. This is a little less than the 0.6% of GDP in 2013, and well below the peak of 1.4% implemented in 2012. According to current projections, this moderation will continue in 2015 and 2016, with incremental efforts of 0.2% of GDP and 0.3% respectively. This easing has caused some concern about the commitment of governments to longer-term fiscal health.

In our view, much of this reduction in the pace of fiscal consolidation is a natural development given the intense, front-loaded adjustment that has already taken place. These efforts have been particularly notable in the periphery. For example, Spain's underlying deficit was down to 6.7% of GDP last year from 11.1% in 2009 while Greece's deficit was cut to 3.2% from 15.7% over the same period. With structural positions now in a better place, some moderation in the pace of consolidation appears justified.

Moreover, as we've argued in the past,** fiscal policy was probably tightened too aggressively during the crisis, so the recent gradualization has been an important factor in supporting the current economic recovery. This recovery can be just as vital as discretionary tightening in helping governments reach their fiscal objectives.

But, that doesn't mean there's room for complacency. While some rebalancing between austerity and growth is warranted, the magnitude of this rebalancing is also important. As the structural adjustment is incomplete, fiscal discipline remains critical for longer-term debt sustainability. With strong domestic pushback against austerity and much more limited pressure now from financial markets, there has been an increasing willingness on the part of governments to adopt more populist, expansionary policies. These actions warrant some caution on the medium-term outlook.

Austerity Fatigue Sets In

After the deep economic crisis, and with unemployment still elevated, austerity fatigue has become a fixture across the region; this popular discontent was put on visible display in last month's European Parliament elections, which delivered a heavy blow to the political establishment. With a certain amount of complacency settling in across national governments, some backtracking on fiscal commitments has become a more present risk.

There have been several recent examples of this. In France, the government missed its fiscal objective last year (with an underlying deficit of 4.5% of GDP versus a 3.6% target). The European Commission noted that France was at risk of not being able to meet its 2014 and 2015 objectives either, amidst uncertainty on savings to make up for scheduled tax cuts.

Italy's resolve is also weakening. The government of prime minister Matteo Renzi requested fiscal breathing room this year for an expansionary budget. In Spain, the government announced a fiscal stimulus worth 0.3% of GDP last month-end and will finalize a major tax reform for 2015 that is unlikely to be fiscally neutral. And in Greece—where austerity fatigue is perhaps at its greatest—the government has pledged social relief and that "no more austerity measures will be needed." In our view, these actions will present challenges to fiscal objectives, particularly in 2015, when tax cuts take hold and pre-election expenditures pick up in countries like Spain, Portugal, Ireland and Greece.

The pan-European mood is also evolving. Later this month, the French and Italian governments will present a plan to reform the region's fiscal rules. The proposal seeks to grant flexibility in meeting budget objectives if a deviation results from public investment that supports growth and employment. This sounds very similar to the reforms of 2005, when rules were relaxed at the behest of France and Germany to accept an excessive deficit in certain exceptional cases, which ended up undermining fiscal commitments more broadly. After the huge progress made in recent years—at enormous cost—we think it is critical that medium-term debt sustainability is not undermined by premature complacency. As in 2005, Germany's position on fiscal governance will again be crucial. ■

*A weighted average of the change in the structural primary balance in Germany, France, Italy, Spain, the Netherlands, Belgium, Austria, Finland, Greece, Portugal and Ireland (weighted by nominal GDP).

**See "Dynamic Fiscal Multipliers: Why Austerity Has Failed in the Euro Area", *Economics: European Perspectives*, March 20, 2013.

The information contained herein reflects the views of AllianceBernstein L.P. or its affiliates and sources it believes are reliable as of the date of this publication. AllianceBernstein L.P. makes no representations or warranties concerning the accuracy of any data. There is no guarantee that any projection, forecast or opinion in this material will be realized. Past performance does not guarantee future results. The views expressed herein may change at any time after the date of this publication. This document is for informational purposes only and does not constitute investment advice. AllianceBernstein L.P. does not provide tax, legal or accounting advice. It does not take an investor's personal investment objectives or financial situation into account; investors should discuss their individual circumstances with appropriate professionals before making any decisions. This information should not be construed as sales or marketing material or an offer or solicitation for the purchase or sale of any financial instrument, product or service sponsored by AllianceBernstein or its affiliates.

Note to Canadian Readers: AllianceBernstein provides its investment management services in Canada through its affiliates Sanford C. Bernstein & Co., LLC and AllianceBernstein Canada, Inc.

Note to European Readers: European readers should note that this document has been issued by AllianceBernstein Limited, which is authorised and regulated in the UK by the Financial Conduct Authority. The registered office of the firm is: 50 Berkeley Street, London W1J 8HA.

Note to Australian Readers: This document has been issued by AllianceBernstein Australia Limited (ABN 53 095 022 718 and AFSL 230698). Information in this document is only intended for persons that qualify as "wholesale clients," as defined in the Corporations Act 2001 (Cth of Australia), and should not be construed as advice.

Note to New Zealand Readers: This document has been issued by AllianceBernstein New Zealand Limited (AK 980088, FSP17141). Information in this document is only intended for persons who qualify as "wholesale clients," as defined by the Financial Advisers Act 2008 (New Zealand), and should not be construed as advice.

Note to Readers in Vietnam, the Philippines, Brunei, Thailand, Indonesia, China, Taiwan and India: This document is provided solely for the informational purposes of institutional investors and is not investment advice, nor is it intended to be an offer or solicitation, and does not pertain to the specific investment objectives, financial situation or particular needs of any person to whom it is sent. This document is not an advertisement and is not intended for public use or additional distribution. AllianceBernstein is not licensed to, and does not purport to, conduct any business or offer any services in any of the above countries.

Note to Readers in Malaysia: Nothing in this document should be construed as an invitation or offer to subscribe to or purchase any securities, nor is it an offering of fund management services, advice, analysis or a report concerning securities. AllianceBernstein is not licensed to, and does not purport to, conduct any business or offer any services in Malaysia. Without prejudice to the generality of the foregoing, AllianceBernstein does not hold a capital markets services license under the Capital Markets & Services Act 2007 of Malaysia, and does not, nor does it purport to, deal in securities, trade in futures contracts, manage funds, offer corporate finance or investment advice, or provide financial planning services in Malaysia.

Note to Singapore Readers: This document has been issued by AllianceBernstein (Singapore) Ltd. (Company Registration No. 199703364C). The Company is a holder of a Capital Markets Services Licence issued by the Monetary Authority of Singapore to conduct regulated activity in fund management and dealing in securities.

Note to Taiwan Readers: AllianceBernstein L.P. does not provide investment advice or portfolio-management services or deal in securities in Taiwan. The products/services illustrated here may not be available to Taiwan residents. Before proceeding with your investment decision, please consult your investment advisor.

Note to Hong Kong Readers: This document is issued in Hong Kong by AllianceBernstein Hong Kong Limited (聯博香港有限公司), a licensed entity regulated by the Hong Kong Securities and Futures Commission. This document has not been reviewed by the Hong Kong Securities and Futures Commission.