EUROPEAN ECONOMICS UPDATE

25th Feb. 2013

CAPITAL ECONOMICS

Has the EC softened its stance on austerity?

- **Recent hints that the European Commission could grant further extensions to governments that are missing their deficit targets provide hope that the Commission will not force austerity regardless of the economic damage. But even without additional measures to rein in borrowing, the fiscal squeeze that is already planned will act as a very heavy drag on activity in the coming months.**
- Forecasts published by the European Commission (EC) last week revealed that many countries are set to far overshoot the public borrowing targets set out in their *Stability and Convergence Programmes* (SCPs) last May. Cyprus will probably be the worst offender this year, with a borrowing overshoot equivalent to 4% of GDP related to the costs of the Greek debt restructuring. **But Spain, Portugal, Italy and France all look set to miss their targets by some distance too.** (See Chart 1.)
- Admittedly, the EC forecasts are based on current policies, meaning that these governments could announce new measures in the coming months to bring them closer to their targets. But there are few concrete signs that they will do so. Indeed, French President François Hollande stated at the weekend that "There is no need to add more austerity in 2013. A lot has already been asked of the taxpayer."
- **Yet despite all of this, the EC seems to be taking a relatively lenient stance, suggesting that it might overlook budget shortfalls related to weaker than expected economic performance.** Vice-President Olli Rehn stated on Friday that "In the case of Spain, it seems that the structural fiscal effort [net of one-off and cyclical factors] has been undertaken and that there has been also an unexpected shortfall of growth". He hinted that similar reasoning might be applied to other countries and that they might therefore be granted more time to reduce their borrowing – the final decision will be made this May.
- But calls for more austerity might yet build again. The EC's forecasts reveal that all of the major euro-zone countries apart from Germany, the Netherlands and Ireland are set to miss their *structural* deficit targets by a wide margin too. **If the EC is unwilling to turn a blind eye to slippage that cannot be explained by economic weakness, it might still push for more discretionary tightening.**
- And while only the EC has the power to impose sanctions on non-conforming governments, pressure for consolidation could come from other angles too. The fact that Germany and the Netherlands are meeting their own SCP targets might make them call louder for fiscal tightening elsewhere. Countries wishing to apply for OMTs will need to pass an independent ECB review of their fiscal progress before they become eligible. (Note that the Bank is already calling for France to do more.) The IMF will have a say in the requirements for those countries receiving bail-out funds. And of course, financial markets might be less sympathetic about indebted countries' economic woes than the EC currently sounds.
- **Importantly, even in the unlikely event that *no* additional measures are required, the austerity that is already planned will seriously damage most euro-zone economies' performance this year.** (See Chart 2.) The squeeze is set to be worth more than 1% of annual GDP in France, Spain, Italy, Portugal, Greece and Cyprus. For this and many other reasons, we think that the consensus forecast of a 0.2% fall in euro-zone GDP this year is much too optimistic.

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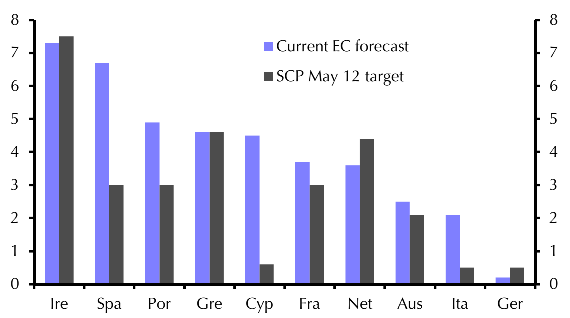
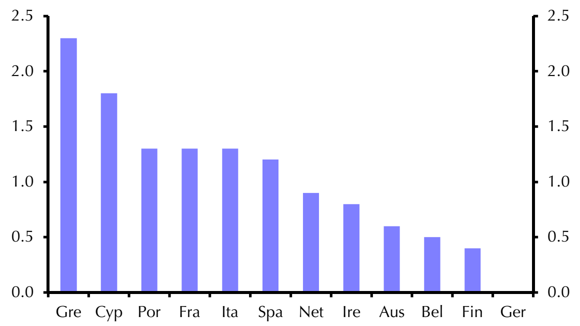
Chart 1: EC Deficit Forecasts Vs. Target, 2013



Source – European Commission

Chart 2: Forecast Narrowing of Struct. Deficit (% GDP, 2013)



Source – European Commission's Winter 2013 Forecast