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EUROZONE

Public finances: Stick to the path of reform!

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The figures published today on budget deficits and government debt in the EU show that substantial progress has been made on consolidating public finances. But at the same time they also reveal that many eurozone countries still have a long way to go before the overhaul of public finances can be concluded. A change of course would not only be premature but would also harbor major risks.

The acute financial market crisis in the eurozone is over, but the European debt crisis has left deep scars. Many eurozone member states are still sitting on huge piles of debt and, despite favorable conditions such as falling interest burdens and a pickup in growth, the descent from the debt mountain has barely begun. In 2015 government debt in the eurozone fell for the first time since 2007, but the debt ratio is still high at 90.7% of GDP. The headway made on consolidation since the crisis erupted is clearer when we look at the budget balance: in 2015 this stood at -2.1% of economic output, well below the crisis peak of -6.3% seen in 2009. This means that the eurozone as a whole met the 3% deficit criterion for the second year running. However, there are still substantial differences at country level.

Germany remains the model pupil, recording a budget surplus of 0.7% in 2015. Fulfilment of the 60% debt criterion is thus getting closer (debt ratio 2015: 71.2%).

Ireland's debt mountain is melting away thanks to resolute austerity measures and sizzling growth rates. However, the temptation to ratchet up spending and lower taxes should nevertheless be resisted – at 93.9% in 2015, the debt ratio is still close to the 100% mark.

In 2015 France bettered the budget deficit target agreed with the EU and recorded a small drop in government spending, but at 95.8% the debt ratio reached a new high. Moderate growth prospects, plans to increase security spending in the wake of the terror attacks in Paris and the upcoming presidential elections in 2017 all cast question marks over the budget targets for 2016/17.

Italy continues to insist on exploiting the flexibility contained in the fiscal rules, with the result that the balanced budget has been postponed until 2018. However, for this to happen, the Italian economy needs to get back into gear at long last. In 2015 the debt ratio edged up again slightly. For 2016 the government is penciling in a minimal decline to 132.4%, but this assumes that privatization revenues to the tune of 0.5% of GDP are realized.

Spain, Portugal and Greece remain a cause for concern. All three countries recorded a decline in the debt ratio in 2015, but at the same time they all missed the deficit targets agreed with the EU Commission, in some cases substantially. Additional savings to the tune of billions are still needed if the budget targets for 2016 are to be met. Elevated political uncertainty –gridlock in Spain, the shift to the left in Portugal and the wafer-thin three-vote parliamentary majority of the Greek government – is likely to make it more difficult to stick to the path of reform and consolidation.

As the sense of crisis in the eurozone increasingly subsides – doubtless thanks largely to the monetary policy measures enacted by the ECB – and the economic recovery continues, the eurozone risks becoming complacent. But the need for reform tends to be underestimated and the medium to long-term growth outlook overestimated. Last year the fiscal belt was surreptitiously loosened in a number of eurozone countries. Hardly any are still pursuing an ambitious reform program. In addition, heightened political uncertainty in several eurozone countries is likely to bolster moves to veer from the path of reform. The tough cuts of recent years have fueled popular disgruntlement with the established parties and boosted the popularity of political protest parties calling for an end to austerity.

However, abandoning the reform and consolidation course now would not only be premature, it would also entail major risks. The competitiveness of the eurozone economy needs to be improved further and the cleanup of public finances driven forward. Although it will be a while yet, national governments need to prepare for a turnaround in interest rates to avoid a renewed wave of uncertainty about the sustainability of government debt in a number of countries.

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