ECONOMICS: EUROPEAN PERSPECTIVES

IS THE ECB SENDING THE WRONG SIGNALS ON SPENDING?

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The euro area's budget deficit continues to narrow, but not quickly enough to prevent its debt ratio from rising. Stronger growth and ultra-low financing costs point to a lower deficit again this year. But after years of hardship, governments may be tempted to spend any fiscal dividend—especially with the ECB short-circuiting the discipline normally provided by bond markets.

Last year, the euro area recorded a budget deficit equal to 2.4% of gross domestic product (GDP), down from 2.9% in 2013. This was the smallest deficit since 2007—just before the onset of the global financial crisis—and compares with a peak of 6.2% in 2009. It's also significantly lower than in the US (5.3% of GDP), Japan (7.7%) or the UK (5.7%)*.

Special Factors Help

Last year's improvement was not the result of tighter fiscal policy or cyclical developments. The aggregate fiscal stance for the euro area as a whole was broadly neutral in 2014 and growth was too weak (in real and nominal terms) to provide much help.

Most of the deficit reduction was due to less financial assistance to the banking sector and lower debt-servicing costs—due, in part, to the efforts of the European Central Bank (ECB). Stripping these factors out, the fiscal position of the euro area as a whole was little changed in 2014.

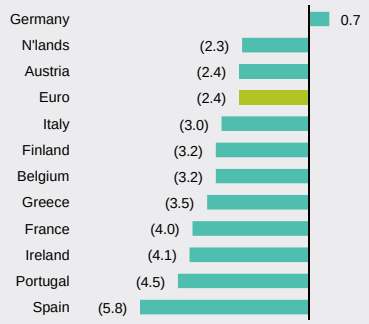
Beneath the Surface

Despite this static underlying position for the region as a whole, there were some interesting developments at the country level (*Displays 1 and 2*):

- The biggest improvement took place in Ireland, where the deficit narrowed to 5.8% of GDP from 4.1% in 2013 (the improvement was even bigger than this, excluding financial interventions). This was partly due to tighter fiscal policy but, more importantly, to a strong rebound in the economy, which grew by 4.8% last year (6.1% in nominal terms).
- Spain took second place. Helped by lower financial assistance, its deficit fell to 5.8% of GDP from 6.8% in 2013. As in the rest of the periphery, Spanish fiscal policy was tightened very aggressively between 2010 and 2013, but the government has clearly taken its foot off the brake. This has helped the economy recover, but leaves Spain with the highest deficit in the euro area and a debt-to-GDP ratio rapidly approaching 100%.
- Helped by lower debt-servicing costs, Germany recorded a budget surplus equal to 0.7% of GDP last year (2013 surplus 0.1%). Except for two much smaller countries (Luxembourg and Estonia), this makes Germany the only euro-area country currently running a budget surplus. Without this, the euro

Display 1
Only Germany in Surplus

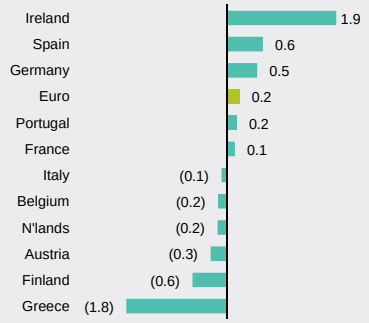
Government Budget Balances
(Percent of GDP; 2014)



As of December 31, 2014
Source: Eurostat and Haver Analytics

Display 2
Big Improvement in Ireland

Change in Government Budget Balances
(Percent of GDP, 2014)



As of December 31, 2014
Excluding financial interventions.
Source: Eurostat and Haver Analytics

*Latest estimates for 2014 general-government deficits from the International Monetary Fund.

area's overall fiscal position would look far less healthy (3.7% of GDP).

- Two countries stand out for a lack of progress. In France, the deficit moved from 4.1% to 4.0% of GDP, while in Italy it moved from 2.9% to 3.0%. In France, this represents a deliberate flaunting of the euro area's fiscal rules. The Italian government, meanwhile, seems to be content holding the deficit close to the 3.0% stability-pact ceiling (and allowing debt to march steadily higher).
- Only one country recorded a material deterioration in its fiscal position last year: Greece. Adjusted for financial interventions, Greece's deficit rose to 3.5% of GDP from 1.8% in 2013. It's important to note that this predates the change of government earlier this year which is likely to have pushed the deficit even further off course.

Debt Continues to Rise

Although budget deficits have been on a declining trend in recent years, debt-to-GDP ratios continue to rise—reaching a record 91.9% last year for the region as a whole. Only two countries (Germany and Ireland) managed to reduce their debt ratios last year; five currently have ratios above 100% (*Display 3*).

Even so, at 177% of GDP, Greece's huge debt ratio stands out. It's important to note, though, that much of this debt is subject to grace periods and preferential interest rates. As a result, debt-servicing costs were equal to just 3.9% of GDP last year, lower than in Portugal, Italy or Ireland (*Display 4*).

Moreover, Greece's effective debt-servicing costs are lower than this. That's because interest paid on bonds held by the ECB is remitted back to Greece (or would be, if the government was complying with its program). Adjusting for this would put effective debt-servicing costs close to the euro-area average. In time, Greece's debt burden will have to be addressed. But the current burden is not as onerous as the headline number—or the Greek government—suggests.

Looking Ahead

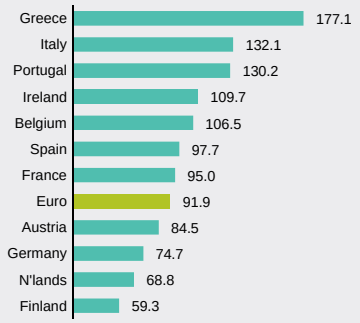
Three factors are likely to shape the outlook for government finances this year. First, with an easing of German fiscal policy likely to offset modest tightening elsewhere, the fiscal stance for the region as a whole is likely to be broadly neutral. Second, with growth accelerating, the cyclical backdrop is likely to favor lower deficits. Third, ultra-low bond yields mean debt-servicing costs are likely to fall again.

All three factors point to lower euro area deficits this year. We would not, though, expect big improvements. In part, that's because the recovery is unlikely to be strong enough to provide a significant boost to public finances. But it's also because governments may be tempted to spend any boon from faster growth or lower interest rates.

With public finances still far from sustainable in many countries, this would be a worrying development. However, after a period of considerable hardship—and with the ECB short-circuiting the discipline normally provided by bond markets—who could blame governments for trying? ■

Display 3
Elevated Debt Levels

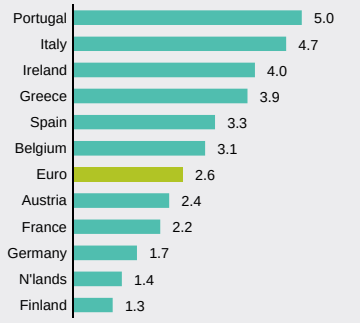
Gross Government Debt
(Percent of GDP, 2014)



As of December 31, 2014
Source: Eurostat and Haver Analytics

Display 4
Greek Debt Subsidy

Government Interest Payments
(Percent of GDP, 2014)



As of December 31, 2014
Source: Eurostat and Haver Analytics