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Eurozone countries must not be forced to meet deficit targets

Last year, 13 eurozone countries surpassed the deficit to gross domestic product ratio of three per cent. The latest forecasts by the European Commission suggest the region is slipping into a mild recession this year. As a consequence, in the absence of further policy measures, most of these countries risk missing their budgetary targets. This especially applies to Spain, where last year's deficit was eight per cent of GDP. The Commission expects its output to decline by one per cent this year (not a particularly pessimistic forecast) yet the country is still supposed to reach the three per cent deficit threshold by next year. Many other countries are in the same boat.

The dilemma for the EU – especially for the Commission whose surveillance role is being enhanced – is how to respond to this situation. Should Olli Rehn, the Commission's vice president, push countries to take further immediate actions? Or should he recognise that these targets are out of reach and put emphasis on efforts rather than outcomes? From a structural point of view, the preferred option is clearly the latter. However, the European fiscal framework has lost a lot of credibility. He may wish to use the opportunity to demonstrate his ability to enforce discipline.

Economic history teaches us that financial crises have long lasting, if not permanent, negative effects. Most European countries have already lost several percentage points of GDP and it seems wise to expect the second

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recession to do the same. Mr Rehn has good reasons to require action. However, demanding adherence to the 2013 targets has two major drawbacks.

First, immediate austerity measures would aggravate the recession. Recent research suggests that the short-run negative effects of austerity measures tend to be higher than we previously thought. Though most European governments have structural problems with their budgets, that does not call for impairing all automatic stabilisers in a recession year.

A second drawback of imposing immediate action is the form that this would almost certainly take. Closing a gap on short notice is not compatible with smart consolidation. The most effective way to achieve a dramatic result by next year would be to just raise existing taxes – with all the adverse consequences on potential output and no effects on the effectiveness of public spending.

A better path to sustainable public finances is to launch credible reforms today that ensure rebalancing of the government budget tomorrow. A typical example is the raising of the retirement age or reform of social benefits. However, it is hard for financial markets to monitor the implementation of such measures. The Commission is right to ask for them, and it should have an important role in the surveillance of policy actions and the evaluation of their effects.

Mr Rehn's involvement in the budgetary policies of individual member states is motivated by their effects on other members. Attention has recently been focused on the negative effects of excess borrowing. However, in this era of major private deleveraging, the positives should also be considered.

This means minimum additional austerity over and above what is already planned in countries under direct financial stress and for no additional austerity at all in countries that do not face an immediate threat of losing access to the financial markets. Provided credible structural measures are implemented, this stance would be consistent with the EU treaty and budgetary sustainability. And it would certainly be better for the economy of the eurozone.

This article was co-authored with Coen Teulings, director the CPB Netherlands Bureau for Economic Policy Analysis. Jean Pisani-Ferry is director of Bruegel, the European economic think-tank