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MACROCOSM

Restructuring Austerity

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The "end to austerity" in Europe does not mean the end to structural reforms (or austerity).

In a radio interview last weekend, French Finance Minister Pierre Moscovici declared an "end to the dogma of austerity." His declaration was specifically in response to the European Commission agreeing to extend to 2016 the target for France to reach a budget deficit of 3%. But the idea that austerity in Europe is now over has recently become a widespread media meme.

Both Moscovici and the media are guilty of wishful thinking that overstates the case -- and upsets euro area conservatives, notably the Bundesbank's Jens Weidmann. As recently as last weekend -- as Moscovici was announcing the end of austerity -- Portugal raised the official retirement age from 65 to 66. And while the Commission has indeed allowed an extension of the deadline for France, it has not changed the target. France still has to reach the 3% target agreed to under the fiscal compact -- so while the speed of adjustment has been reduced, the total of the adjustment has not changed.

- France is not alone in being allowed such an extension. Spain too has been allowed an extra two years to reach the 3% target, but the target itself remains.

But as Olli Rehn -- the European Commissioner for Economic and Monetary Affairs and the Euro -- emphasized at the launch of the EU spring forecasts -- the reduction in the pace of budget correction *does not mean there should be a reduction in the pace of structural reforms.*

- In a recent blog post Rehn highlighted how perceptions of the euro area consolidation process wrongly frame the debate as between austerity or no austerity, "a political battle between the Austerians and Spendanigans."
- Quite rightly, he argues that this false dichotomy "misses the point that both pursuing structural reforms and easing credit conditions are at least as important" as fiscal policy.
- In fact, if growth is the question, then we would argue that they are *more* important (see "Europe's Supply-Side Revolution" February 17, 2012).

Update to strategic view

EUROPE MACRO: Declarations of the end of austerity in the euro area are, at best, premature. Improvements in market conditions mean that there is room to slow the pace of fiscal consolidation -- but not the direction of it. It is key that pressure to continue structural reforms remains, with their biggest champion being ECB President Mario Draghi. Their pace has not slowed, with supply-side reforms already taking root in peripheral nations.

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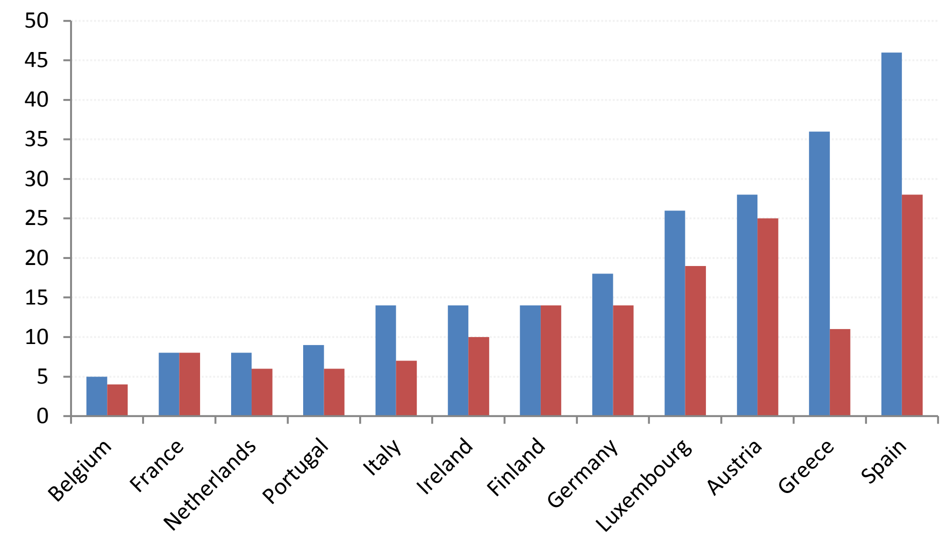
In *its new Monthly Bulletin* (which also includes an excellent explainer on TARGET2; see "Recommended Reading" May 2013) -- the European Central Bank looks at progress made so far on structural reform in the euro area, and also highlights areas that need more progress.

- Tax reforms -- particularly in countries that have received bail-outs -- to combat tax evasion and simplify collection have been implemented.
- But the ECB says that more emphasis must be put "on growth-friendly tax reforms that shift the tax burden away from the labour force and reduce the impediments to work and investment."
- Unemployment benefit rates and durations have been reduced, removing a disincentive to work.
- There has been a significant reduction in the time taken to start a new business (please see chart below).

Days required to start a new business **2008** **2013**



Source: ECB, TrendMacro calculations

- In peripheral nations -- Portugal, Ireland, Greece, Spain and Italy -- significant reforms to labor markets have already been implemented, with increased flexibility in wage-bargaining structures. This has been particularly clear in Spain with the move away from national level wage agreements to local bargaining.
- And downward flexibility in wages has been increasing in peripheral nations as unemployment remains high.

The structural reform theme was also pushed by ECB President Mario Draghi in a speech given on Monday, in which he called for a reduction in both current public spending *and* taxes -- also warning that vested interests in non-competitive sectors which limit individuals' opportunities to pursue their goals need to be eliminated.

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Recommended Reading

TARGET Balances and Monetary Policy Operations
ECB Monthly Bulletin
May, 2013

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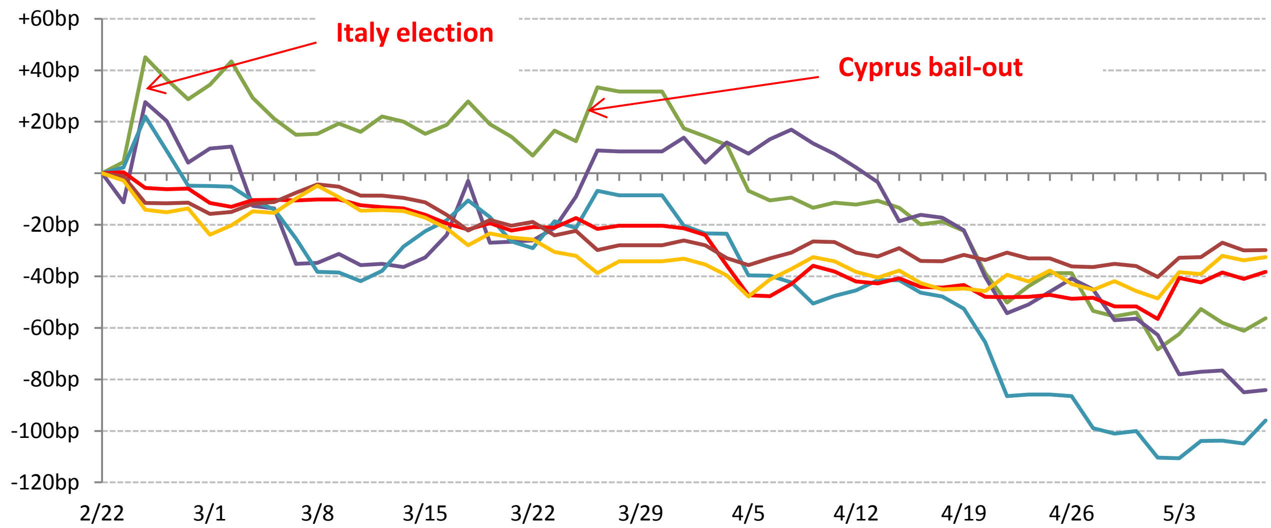
Overall, in assessing the recent media and political tone change on austerity, and in looking through the rhetoric to the facts on the ground, a few important points stand out.

- The *pace* of fiscal consolidation is slowing, but the *direction* certainly hasn't changed.
- The European Commission's relaxation of deficit target deadlines is a reflection of current market conditions for sovereigns which are quite permissive, with both yields and spreads continuing to compress (please see the chart below).

10-year sovereign yield, change from before Italy election
Italy — Portugal — Spain — France — Germany — UK



Source: Bloomberg, TrendMacro calculations

- But slower fiscal consolidation is not being allowed to derail the structural reform process. Draghi -- the closest thing the euro area has to a finance minister -- continues to push hard for structural reform, as do governments throughout Europe, with the notable exception of France.
- Even in Italy, newly elected Prime Minister Enrico Letta has on the one hand promised an end to the focus on austerity, while on the other hand promised to continue the labor market reforms begun by Mario Monti.

The euro area has gotten through the most difficult part of its crisis -- the truly existential part. Actions by the ECB have succeeded in removing major risks -- particularly "redenomination risk," that is, the risk that the euro currency will break up. But while these measures have been successful fire-fighting, they will not in themselves lead to growth. The reduction in the pace of fiscal consolidation is understandable considering the increasingly benign market conditions for sovereign debt. But the pace of structural reform needs to be maintained for there to be a reasonably rapid return to growth. Happily, it is on those structural reforms that euro area governments are continuing to focus.

Bottom line

Declarations of the end of austerity in the euro area are, at best, premature. Improvements in market conditions mean that there is room to slow the pace of fiscal consolidation -- but not the direction of it. It is key that pressure to continue structural reforms remains, with their biggest champion being ECB President Mario Draghi. Their pace has not slowed, with supply-side reforms already taking root in peripheral nations.