Fiscal policy in the euro area: in the current juncture, don't apply sanctions

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Tomorrow the European Commission will assess again the fiscal situation of Portugal and Spain, and decide whether to recommend to the Council that the Excessive Deficit Procedure be stepped up for those countries, exposing them to various sanctions. This momentous decision can have major consequences for the countries concerned, but also wider implications. It sets a landmark in the application of the Stability and Growth Pact rules, and therefore begs the question of how best those rules should be applied, especially in the current juncture of weak growth in Europe. In turn, this question hinges on what fiscal policies should do to support the recovery more. The recent OECD Survey of the Euro Area provides analysis on what should be done.

Growth has picked up gradually over the past two years, but demand is still weak and unemployment remains very high in several countries, including Portugal and Spain. In the euro area as a whole, support to the recovery has essentially come from monetary policy, with little or no fiscal help. After three years (2011-13) of strong and widespread fiscal consolidation, fiscal policy has turned broadly neutral (Figure 1), but it needs to go further in supporting demand as monetary policy alone cannot do everything. Budget support should mainly come from countries with fiscal space. Those without, like Portugal and Spain, should nonetheless avoid a return to austerity.

Figure 1. Euro area fiscal stance[1]

Change in the underlying balance as a share of potential GDP, percentage points

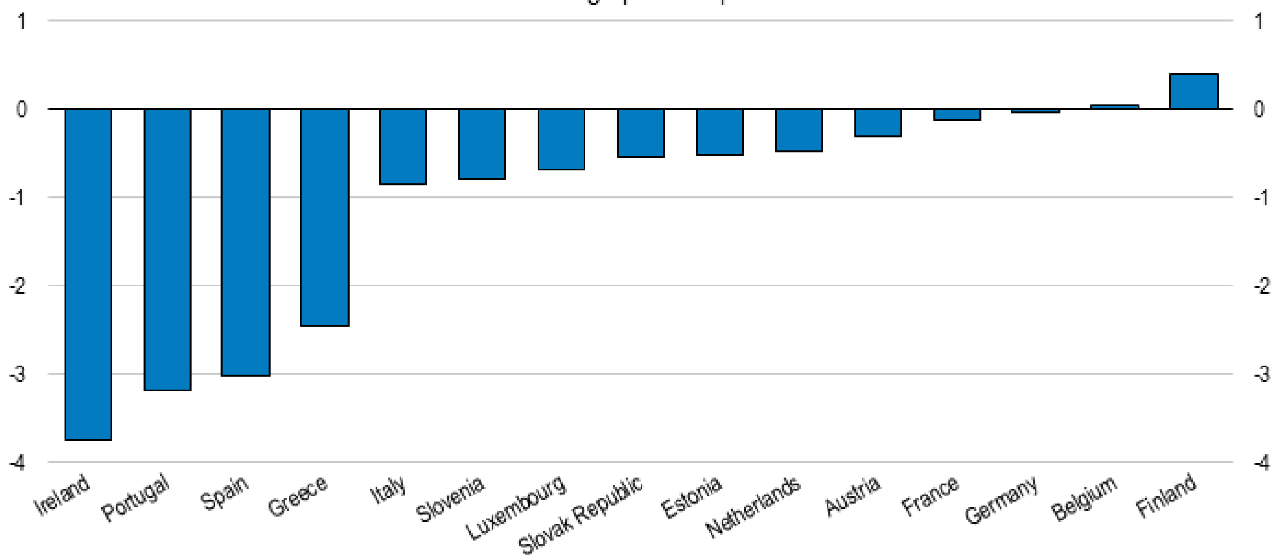
1. Euro area member countries that are also members of the OECD (15 countries).

Source: OECD (2016), "OECD Economic Outlook No. 99", *OECD Economic Outlook: Statistics and Projections* (database), June.

To maximise growth impacts and make them lasting, budget support should be targeted. Post-crisis consolidation often led to increases in labour taxes and large reductions in public investment (Figure 2), making public finances less growth-friendly. Policy levers to improve the composition and efficiency of public spending and taxes remain largely at national level, and progress on this front across the euro area has been insufficient. But European sanctions could make matters worse. For instance, they would likely imply a suspension (even if only temporary) of structural funds to the countries concerned, putting further downward pressure on public investment.

Figure 2. Change in public investment over recent fiscal consolidation episodes[1]

Percentage points of potential GDP



1. Consolidation episodes considered are those starting in 2009 or later.

Source: See Figure 21 of OECD (2016), *OECD Economic Surveys: Euro Area 2016* for futher details and source information.

In the current juncture, sanctions would be an economic mistake. In the absence of temporary fiscal expansion by countries with enough space, sanctions will somewhat tilt the euro area fiscal stance towards austerity, the opposite of what is needed. Further, they risk inducing further cuts to investment, thus hampering potential growth. Not to mention rekindling political tensions and animosities, again the opposite of what is needed. In a word: don’t.

See also:

OECD (2016), OECD Economic Surveys: Euro Area 2016, OECD Publishing, Paris.