CEPS COMMENTARY
Thinking ahead for Europe

The end of fiscal waterboarding?[1]

Daniel Gros

23 February 2015

The new government of Greece had to make a choice between staying in the eurozone and accepting the programme imposed by its creditors. Last Friday the choice was made. Greece chose to remain a member of the euro area and asked for a temporary extension on the existing programme with the aim of finding out what flexibility might be available to his country. There will certainly be flexibility to change some of the hundreds of detailed structural reform measures the previous government signed up to. But the one area where the new Finance Minister, Yanis Varoufakis, might be able to claim success is fiscal policy.

The Greek government had insisted all along that it would be unreasonable to demand a primary surplus of 4% of GDP from Greece (for 2015), and Mr Varoufakis had proposed an upper limit of 1.5% of GDP. His euro-area colleagues were visibly amused. Many of them already run larger primary surpluses today; and those European countries that did succeed in reducing their debt levels in the past, did so by running primary surpluses of 4% of GDP for over a decade (notably Belgium, Ireland and Sweden).

However, Greece's partners have understood that the raw numbers of the primary surplus have to be seen in the context of the very depressed state of the Greek economy. In terms of the budget adjusted for the state of the economy, Greece seems to be in a special situation. The statement of the Eurogroup of February 20th (http://www.consilium.europa.eu/en/press/press-releases/2015/02/150220-eurogroup-statement-greece/) acknowledges this by stating: "The institutions will, for the 2015 primary surplus target, take the economic circumstances in 2015 into account."

This makes sense, but adjusting the fiscal balance for the effects of the cycle is more of an art form than a science. Reasonable people can disagree on all the elements that go into estimates of the so-called 'cyclically-adjusted budget balance'. This was recognised a long time ago, which explains why the European Commission was appointed as the official referee for the cyclical adjustment of fiscal balances. Its latest estimates are summarised in the table below.

[1] The expression was coined by Yanis Varoufakis, the new Greek Finance Minister. It was intended to shock, but one needs to look beyond the headline numbers bandied about by the main protagonists to judge whether he was justified in using such provocative language.

Daniel Gros is Director of the Centre for European Policy Studies in Brussels.

Table 1. Cyclically adjusted budget balances as % of GDP (based on the Commission's potential GDP estimates)

	Cyclically Adjusted Primary Balance	
Country	**Change 2010-14**	**2014**
Euro area	3.9	1.6
Germany	3.6	2.7
Greece	**10.2**	**6.7**
Spain	6.1	1.0
Italy	2.8	4.0
Portugal	10.2	2.9

Data source: http://ec.europa.eu/economy_finance/eu/forecasts/2015_winter_forecast_en.htm

Looking at the entire programme period (2010-14), one could thus argue that Greece underwent a wrenching fiscal adjustment, worth over 10% of GDP in four years. However, as shown in the table, Portugal, which is even poorer than Greece, had the same fiscal adjustment, also over 10% of GDP in four years, and could thus also claim to have been 'fiscally waterboarded'.[2]

However, Greece can claim to be in a unique situation in terms of the primary balance achieved today. On a cyclically adjusted basis, it stood at 6.7% of GDP, in 2014 (preliminary data though) – four percentage points higher than in Germany and much higher than in the other peripheral countries.

In reading these numbers, one must keep in mind that in calculating the adjustment for the cycle, the Commission compares actual GDP to its own estimate of potential GDP. Here Greece's numbers are again unique. According to the estimates of the Commission, Greek potential GDP has fallen by about 18% since the crisis (and continues to fall by about 2% per annum), much more than in the other programme countries. This explains why the output gap is estimated to fall to 6% of GDP this year while unemployment remains stuck above 20%.

This astonishing estimate of the fall in potential is not due to a special methodology. The Commission applies a common methodology that has been agreed with national authorities. But this black box gives numbers that do not accord with common sense when fed with Greek numbers. One could thus argue that the black box might need some tinkering to make sense of Greece, but this would open a Pandora's box as many other member states would argue "why not me too?".

A reasoned analysis of the fiscal effort undertaken by the Greek authorities so far must come to the conclusion that, given the state of the economy, fiscal policy is indeed exceptionally tight; and that more attention should be given to the primary surplus relative to the state of the economy. It will remain impossible to pin down the exact size of the output gap and hence some judgment will have to be applied. Some relaxation of the near-term primary surplus targets, agreed when financial markets were in a state of crisis, seems appropriate given the depressed state of the Greek economy and the fact that the long-term cost of

[2] The improvement in Greece's overall budget balance amounts was larger than that of the primary balance because the debt-service burden went down by about 2.5% of GDP, thanks to the PSI operation and the generous interest rates on Greece's official loans. The opposite was the case for Portugal, whose interest costs went up, which implies that it will have to make a larger effort in terms of the primary balance to reach the same overall improvement in the fiscal balance.

refinancing public debt is now close to zero throughout the euro area. But the Greek government should also recognise that, once economic conditions normalise, primary surpluses on the order of +/-4% of GDP will be appropriate.

The cyclical adjustment of budget balances comes from the same basic idea as the GDP-linked payments proposed recently by Mr Varoufakis. Linking the fiscal effort to the state of the economy is a sound concept. But the devil is in the details, and the concept should be used to distribute the effort better over time, not to wriggle out of it.