FAILED AUSTERITY IN EUROPE: THE WAY OUT

OFCE, ECLM, IMK

Executive summary

Four years after the start of the Great Recession, the euro area remains in crisis. GDP and GDP per head are below their pre-crisis level. The unemployment rate has reached a historical record level of 11.6% of the labour force in September 2012, the most dramatic reflection of the long lasting social despair that the Great Recession produced. The sustainability of public debt is a major concern for national governments, the European Commission and financial markets, but successive and unprecedented consolidation programmes have proven unsuccessful in tackling this issue. Up to now, asserting that austerity was the only possible strategy to get out of this dead end has been the cornerstone of policymakers' message to European citizens. But this assertion is based on a fallacious diagnosis according to which the crisis stems from the fiscal profligacy of member states. For the euro area as a whole, fiscal policy is not the origin of the problem. Higher deficits and debts were a necessary reaction by governments facing the worst recession since WWII. The fiscal response was successful in two respects: it stopped the recession process and dampened the financial crisis. As a consequence, it led to a sharp rise in the public debt of all euro area countries.

During normal times, sustainability of public debt is a long-term issue, whereas unemployment and growth are short-term ones. Yet, fearing an alleged imminent surge in interest rates and constrained by the Stability and Growth Pact, and although transition towards more normal times had not been completed, member states and the European Commission reversed priorities. This choice partly reflects well-known pitfalls in the institutional framework of EMU. But it is equally reflecting a dogmatic view in which fiscal policy is incapable of demand management and the scope of public administrations has to be fettered and limited. This ideology has led member states to implement massive fiscal austerity during bad times.

It is clear now that this strategy is deeply flawed. Euro aera countries and especially Southern European countries have undertaken ill-designed and precipitous consolidation. The austerity measures have reached a dimension never before observed in the history of fiscal policy. The cumulative change in the fiscal stance for Greece from 2010 to 2012 amounts to 18 points of GDP. For Portugal, Spain and Italy, it has reached respectively 7.5, 6.5 and 4.8 points of GDP. The consolidation has rapidly become synchronised, leading to negative spillovers over the whole euro area, amplifying its first-round effects. The reduction in economic growth in turn makes sustainability of public debt ever less likely (Table 1). Thus austerity has been clearly self-defeating as the path of reduction of public deficits has been highly disappointing regarding the initial targets defined by member states and the Commission.

Table 1.Forecast fiscal stance and GDP growth rate in euro area

	Fiscal stance in % of GDP		GDP growth in %	
	2012	2013	2012	2013
DEU	-0.5	0.0	0.8	0.6
FRA	-1.6	-1.8	0.1	0.1
ITA	-3.2	-2.1	-2.1	-1.5
ESP	-3.4	-2.4	-1.3	-1.3
NLD	-1.0	-1.2	-0.9	-0.4
BEL	-1.1	-0.8	-0.2	-0.2
PRT	-3.7	-1.8	-2.8	-2.2
IRL	-2.4	-1.8	-0.4	-0.4
GRC	-5.0	-3.9	-6.2	-3.7
FIN	-0.4	-1.3	0.4	0.4
AUT	-0.1	-0.9	0.5	0.1
EA	-1.7	-1.4	-0.4	-0.3

Source: OFCE, ECLM, IMK.

Since spring 2011 unemployment within the EU-27 and the euro area has begun to increase rapidly and in the past year alone unemployment has increased by 2 million people. Youth unemployment has increased particularly dramatically during the crisis. In the second quarter of 2012, 9.2 million young people aged 15-29 years were unemployed, which corresponds to 17.7 percent of the 15-29 year-olds in the workforce and accounts for 36.7 percent of all unemployed in the EU-27. The same tendencies are seen for low skilled workers. The hysteresis of the labour market will lead to the persistence of a high level of unemployment in the years to come. The first symptoms that unemployment will remain high in the coming years are already visible. In the second quarter of 2012 almost 11 million people in EU had been unemployed for a year or longer. Within the last year long term unemployment has increased by 1.4 million people in the EU-27 and by 1.2 million people within the euro area.

Long term unemployment results in the reduction of the workforce due to a flexion effect. This will make it more difficult to generate growth and healthy public finances within the EU in the medium term. Besides the effect of long term unemployment on potential growth and public finances, long term unemployment may cause increased poverty when unemployment benefits stop because sooner than expected. Given our forecast for unemployment in the EU and the euro area, we estimate that long term unemployment can reach 12 million in the EU and 9 million in the euro area at the end of 2013.

What is striking is that the consequences of ill-designed consolidation could and should have been expected. Instead, they have been largely underestimated. Growing theoretical and empirical evidence according to which the size of fiscal multipliers is magnified in a fragile economic situation has been seemingly willfully overlooked. Concretely, whereas in normal times, that is when the output gap is close to zero, a reduction of one point of GDP of the structural budget deficit reduces activity by a range of 0.5 to 1% (this is the fiscal multiplier), this effect exceeds 1.5% in bad times and may even reach 2% when the economy is severely depressed. All the features (recession, monetary policy at the zero bound, no offsetting devaluation, austerity amongst key trading partners) known to generate higher-than-normal multipliers were in place in the euro area.

The recovery that had been observed from the end of 2009 was brought to a halt. The euro area entered a new recession in the third quarter of 2011 and the situation is not expected to improve: GDP is forecast to decrease by 0.4 % in 2012 and again by 0.3 % in 2013. Italy, Spain, Portugal and Greece seem to sink in an endless depression. Unemployment has soared to a record level in the euro area and especially in Spain, Greece, Portugal and Ireland. Confidence of households, non financial companies and financial markets has collapsed again. Despite some recent improvements resulting from belated policy initiatives, interest rates remain elevated and governments of Southern countries still face unsustainable risk premium on their interest rates, while Germany, Austria or France benefit from historically low interest rates.

Rather than focus on public deficits the underlying cause of the crisis needs to be addressed. The euro area suffered primarily from a balance of payments crisis due to the build-up of current account imbalances between its members. When the financial flows needed to finance these imbalances dried up the crisis took hold in the form of a liquidity crisis. Attempts should have been made to adjust nominal wages and prices in a balanced way, with minimal harm to demand, output and employment. Instead salvation was sought in across-the-board austerity, forcing down demand, wages and prices by driving up unemployment.

Even if some fiscal consolidation was almost certainly a necessary part of a rebalancing strategy to curb past excesses in some countries, it was vital that those countries with large surpluses, especially Germany, took symmetrical action to stimulate demand and ensure faster growth of nominal wages and prices. Instead the adjustment burden was thrust on the deficit countries. Some progress has been made in addressing competitive imbalances, but the cost has been huge. Failure to ensure a balanced response from surplus countries is also increasing the overall trade surplus of the euro area. This is unlikely to be a sustainable solution as it shifts the adjustment on to non-euro countries and will provoke counteractions.

There is a pressing need for a public debate on such vital issues. Policymakers have largely ignored dissenting voices, even as they have grown louder. The decisions on the present macroeconomic strategy for the euro area need also to recognise that the new EU fiscal framework leaves euro area countries some leeway. Firstly, countries may invoke exceptional circumstances as they face "*an unusual event outside the control of the (MS) which has a major impact on the financial position of the general government or periods of severe economic downturn as set out in the revised SGP (…)".* Secondly, *the fiscal framework requires* "*a minimum annual improvement of at least 0.5 % of GDP as a benchmark, in its cyclically adjusted balance net of one-off and temporary measures, in order to ensure the correction of the excessive deficit within the deadline set in the recommendation"*. This is of course a minimum, but it would also be seen as a sufficient condition to bring back the deficit to GDP ratio towards 3 % and the debt ratio towards 60%. And it is far less severe than the massive austerity imposed on member states. Simulations by the iAGS consortium show how big a difference a softened austerity program, one that still respects treaty obligations, could make in terms of output and employment.

A four-fold alternative strategy is thus necessary:

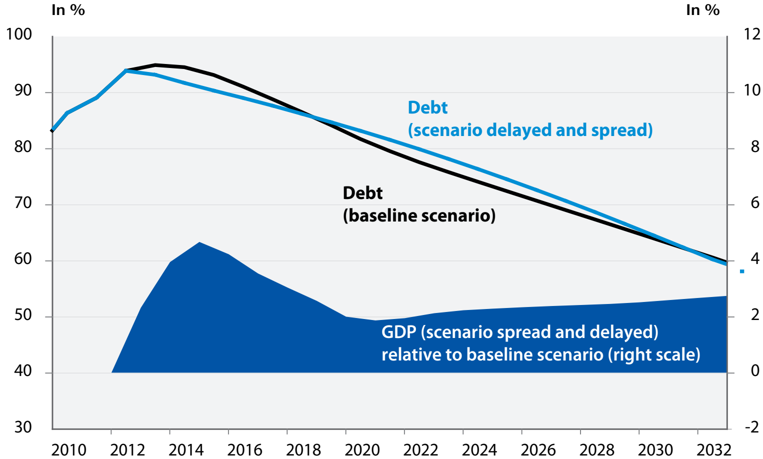
First, delaying and spreading the fiscal consolidation in due respect of current EU fiscal rules. Instead of austerity measures of nearly 130 billion euros for the whole euro area, a more balanced fiscal consolidation of 0.5 point of GDP, in accordance with treaties and fiscal compact, would in 2013 alone ease the austerity squeeze by more than 85 billion euros. By delaying and capping the path of consolidation, GDP would in average 3.7% higher 2013 and 2017 (Figure 1) resulting in substantially lower unemployment.

Second, the ECB must fully act as a lender of last resort for the Euro area countries in order to relieve MS from the panic stemming from financial markets. For panic to cease, the EU must have a credible plan made clear to its creditors.

Third, significantly increasing lending by the European Investment Bank as well as other measures (notably the use of structural funds and project bonds), so as to meaningfully advance the European Union growth agenda beyond the vague and unbudgeted promises made at the June and October European Councils. These promises need to be transformed into concrete investments.

Fourth, a close coordination of economic policies should aim at reducing current accounts imbalances in a balanced way. The adjustment should not only rely on deficit countries. Germany and the Netherlands should also take measures to reduce their surpluses by expanding domestic demand and encouraging faster wage and price growth.

Figure 1.Debt and GDP in baseline and alternative scenarios



Source: iAGS model.