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The Legacy of Austerity in the Eurozone

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The recent slight improvement in the GDP growth rates in the eurozone (which is actually of microscopic proportions) has led European policy-makers to proclaim victory and assert that the austerity programmes imposed within the eurozone are paying off. These same policy-makers clearly feel vindicated and take the small turnaround in growth rates as evidence that austerity, although painful, works by creating confidence in the future.[1]

But is this really the case? In this Commentary we argue, first, that the improvement in the eurozone business cycle is the result of the ECB's announcement of its Outright Monetary Transaction (OMT) programme, and second, that austerity has left a legacy of unsustainable debt levels that will test the political resilience of the debtor countries.

The Commission or the ECB?

Those who claim that the improvement of the business cycle in the eurozone is due to the austerity measures imposed by the European Commission have a lot of explaining to do. They need to demonstrate that the austerity measures have created confidence, which in turn has improved consumption and investment, and all this at a time of rising unemployment. The empirical evidence for this confidence effect is extremely poor (see Guardajo et al., 2011). A more plausible explanation for the (slight) recovery is the OMT-programme announced in July 2012 and implemented in September 2012. The effect of this announcement led to a dramatic fall in the long-term government bond rates in the troubled eurozone countries. In countries like Greece, Ireland, Spain and Portugal the spreads with the German bond rate more than halved in a short period of time. There is no evidence that this fall was related to improvements in fundamental economic variables (such as the debt-to-GDP ratios and the external debt). In fact, these fundamentals continued to deteriorate after September 2012. All this would suggest that it is the ECB-announcement alone that is responsible for the dramatic lowering of the spreads.

These lower spreads, in turn, had the effect of reducing the funding costs of troubled eurozone governments and helped to create a more positive environment around the eurozone and its future. It is therefore much more plausible to argue that if there was a

[1] See Schaüble, *Financial Times*, 16 September, 2013.

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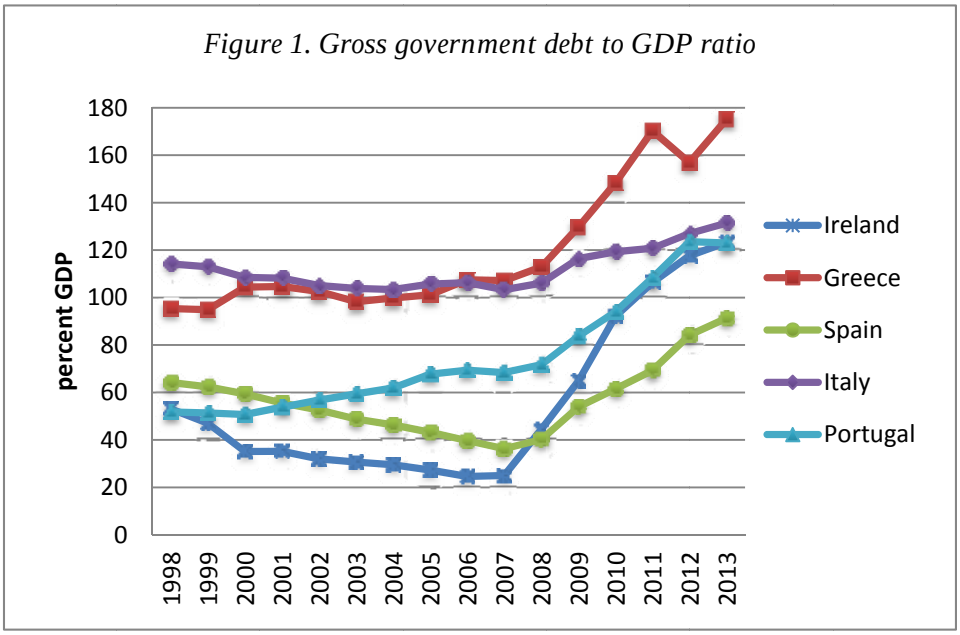
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positive confidence effect, this was induced by the ECB's OMT-programme.[2] The cries of victory from Berlin and Brussels are somewhat misplaced. They should have come from Frankfurt.

The legacy of austerity

The most striking feature of austerity and its legacy is that, despite the intensity of these programmes, there is no evidence that they have increased the capacity of the debtor countries' governments to continue to service their debt. In Figure 1 we show the government-debt ratios of the debtor countries. Note that while the debt ratios started to increase in 2008 as a result of the banking crisis, the austerity programmes that were set in motion after 2010 do not seem to have arrested the explosive growth of the government-debt ratios – (the possible exception is Ireland).

Figure 1. Gross government debt to GDP ratio

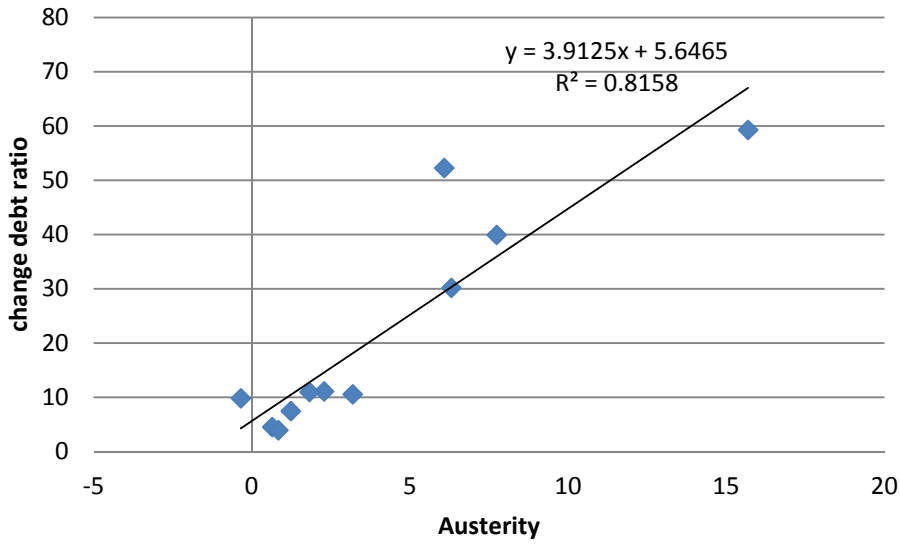


Source: European Commission, AMECO database.

We explore this issue further In Figure 2. We show the degree of austerity (measured by the change in the cyclically adjusted primary budget) on the horizontal axis and the increase in the debt-to-GDP ratio on the vertical axis, during 2009 and 2012. We observe a very strong positive correlation, i.e. more intense austerity programmes coincide with increasing government debt ratios. The underlying mechanism has been well recognised since the days of Irvin Fisher (Fisher, 1933). The recession that prevailed in the southern countries was a 'balance sheet recession' in which private agents desperately tried to reduce their debt levels (Koo, 2012; Krugman, 2010 and 2012). When, at the insistence of the European Commission and the creditor nations, the southern countries' governments were also forced to de-leverage, debt-deflation dynamics were set in motion, leading to deep recessions – in some countries even depressions reminiscent of the 1930s.

[2] De Grauwe & Ji (2013).

Figure 2. Change government debt/GDP ratio (%) and Austerity (% GDP) during 2009-12



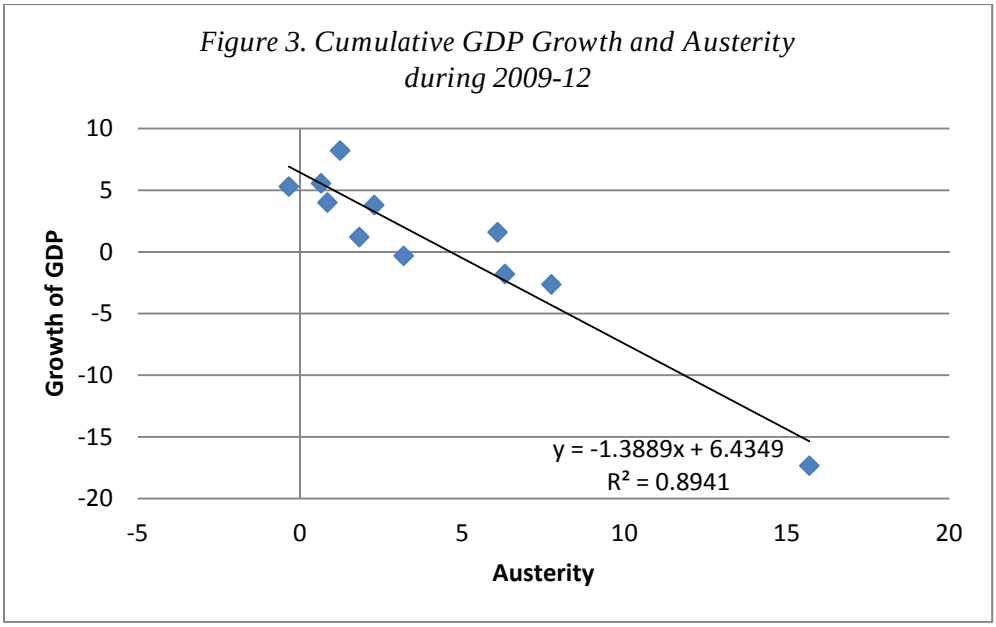
Source: IMF, Fiscal Monitor Database, April 2013.

Note: i) fiscal contraction (austerity) is defined as the change in the structurally adjusted primary government budget from 2009-12. ii) In the case of Greece, we do not take the debt restructuring of 2012 into account, which reduced the Greek debt ratio by 30%.

We show the nature of this deflationary process in Figure 3, where we present the same austerity measure on the horizontal axis and the decline in GDP during the same period (2009-12). We observe a strong negative relation, i.e. the stronger the austerity programme, the deeper the decline in GDP. The estimated equation suggests that on average for every 1% increase in austerity, output declines by 1.4%. This is in line with the results obtained by other researchers and the IMF, indicating that the fiscal multiplier exceeds 1 (see Auerbach & Gorodnichenko, 2011; Blanchard & Leigh, 2013).

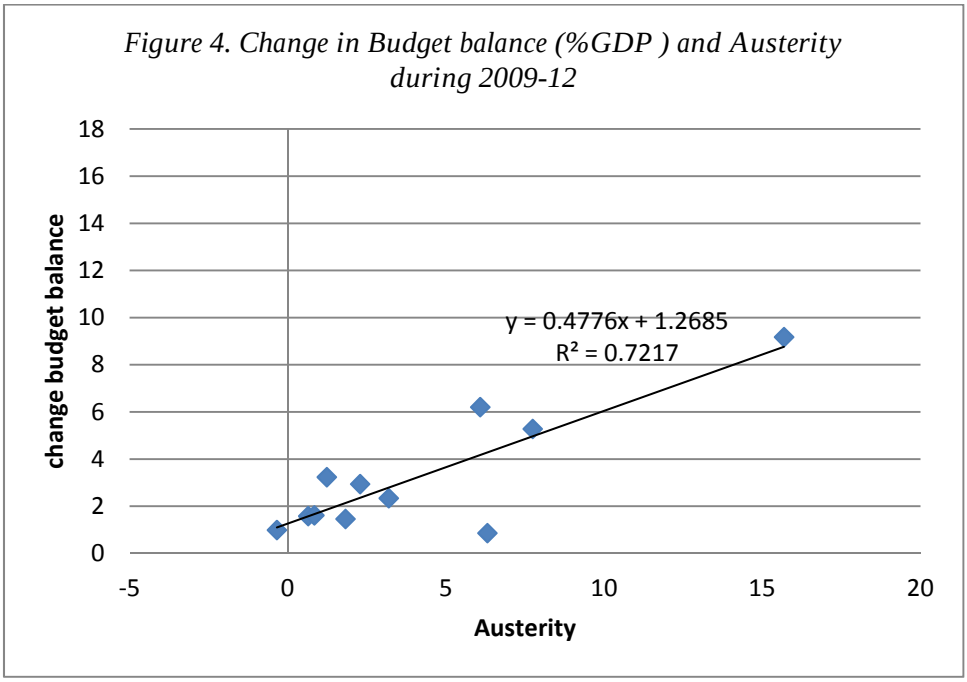
What is rarely emphasised is that the strongly negative output effects of the austerity programmes made them particularly ineffective at reducing overall budget deficits – see Figure 4. Again, this shows the austerity measure on the horizontal axis. We now have the change in the overall government budget balance on the vertical axis. The regression line shows that, on average, a 1% increase in austerity only leads to a 0.5% improvement in the budget balance. Put another way, in order to improve the budget balance by 1%, an austerity programme of at least 2% is necessary. Given our measure of the fiscal multiplier of 1.4, this also implies a drop in GDP of 2.8%. Thus, the eurozone austerity programmes imposed a very unfavourable trade-off for the periphery countries: in order to improve their government budget balances by 1% a sacrifice of 2.8% of GDP was necessary.

Figure 3. Cumulative GDP Growth and Austerity during 2009-12



Sources: IMF, Fiscal Monitor Database, April 2013 and European Commission, AMECO.

Figure 4. Change in Budget balance (%GDP) and Austerity during 2009-12



Source: IMF, Fiscal Monitor Database, April 2013.

Some observers have argued that this is a necessary price to pay to redress the disequilibria in the eurozone (see Gros, 2013). But is this so? The issue is not whether or not the periphery had to engage in austerity. They had no choice (although they should have been allowed more time). The issue is whether for the eurozone as a whole a more symmetrical adjustment might have improved the unfavourable trade-off between budget balance and economic growth in the periphery. It is our contention that a more symmetrical fiscal adjustment – whereby the creditor nations agreed to stimulate their economies – would have reduced the price the periphery had to pay (in terms of lost output) to achieve a given improvement in their government budget balances.

Another way to see the validity of this argument is as follows. The imposition of austerity programmes in the eurozone has fallen victim to the 'fallacy of composition'. What works for one nation fails to work when every nation applies the same policies. When one nation is forced to deleverage through austerity (i.e. is trying to save more) this may work when it is alone in doing so. In that case, its attempt to increase its savings and thereby create a current-account surplus is facilitated by the fact that the others continue to dissave, i.e. they accept running current-account deficits. When, however, all countries try to save more at the same time, i.e. they all attempt to create current-account surpluses each country's attempt to do so makes it harder for the others to achieve their objectives. As a result, they are forced to increase their austerity efforts. In the end, they are no more successful but GDP will be lower everywhere.

It is surprising that the European Commission, as the guardian of the interests of the eurozone as a whole, did not take the system-wide implications of generalised austerity programmes into account. This may have something to do with the fact that the Commission acted as an agent defending the interests of the creditor nations, and not the interests of the eurozone as a whole. It is high time that the Commission takes up its role of defending the interests of the debtor nations with the same vigour that it defends the interests of the creditors. It is also time that the Commission insists, and possibly sends Troikas, to the creditor nations to ensure that they fulfil their side of bargain in the adjustment process.

How temporary are the high debt levels?

The failure to impose symmetrical fiscal policies has left a legacy of unsustainable debt levels in the periphery. Some observers have argued that the strong increase in the debt-to-GDP ratios is something observed in all recessions and therefore temporary (see, for example, Schmieding, 2013). Of course, everything on earth is temporary in some sense. Given the size of the build-up of government debt ratios in the eurozone's periphery, the temporary nature of this build-up may become quite long drawn out.

In the following table we show what 'temporary' may mean. The table calculates the number of years it will take for the peripheral countries with high government debt levels to halve these debt levels. We show the results under relatively favourable macroeconomic circumstances, i.e. assuming that the nominal interest rate on the debt has dropped and equals the nominal growth of GDP (a condition that is not yet met in these countries). The table shows that even when these countries manage to maintain a high primary surplus of 4% for many years (which today they do not reach at all) it will still take between 12 to 22 years to halve the debt. In fact, with the exception of Ireland, these countries have not yet been able to stabilise their debt levels, so the numbers in the table underestimate the number of years that will be needed to halve their debt levels. The issue is whether their political systems will have enough resilience to maintain such 'temporary' austerity programmes in order to slowly and painfully draw down the levels of debt.

Table 1. Number of years required for peripheral countries to halve their debt levels

	Debt-to-GDP ratio (%) in 2013	**Number of years needed to halve the debt levels**		
		Primary surplus		
		2%	3%	4%
Spain	100	25	16	12
Ireland/Portugal	120	30	20	15
Italy	130	32	21	16
Greece	180	50	30	22

Conclusion

One effect of the intense austerity imposed on the debtor nations is a sharp increase in the government debt ratios in these countries. This increase is to a large extent due to the poor effectiveness of austerity programmes. The latter suffered from the well-known 'fallacy of composition' problem. Austerity programmes that can work in isolated cases fail to work well when every country imposes austerity at the same time. We have argued that this fallacy of composition made these austerity programmes both ineffective and costly for the periphery. Ineffective in that they required a lot of austerity to move the government budget only a little way; costly in that they led to large output losses for a given austerity programme. This could have been avoided by more enlightened and symmetrical budgetary policies, whereby the inevitable austerity of the debtor nations was compensated by fiscal stimulus in the creditor nations. Such symmetrical budgetary policies would not have put all the adjustment costs on the debtor nations, but would have spread it on both the debtors and the creditors (who bear equal responsibility for the crisis).

Consequently, southern debtor nations now face a legacy of unsustainable debt that will drag them down for years, if not decades to come. The failure of the creditor nations and the European Commission representing these nations to think in terms of the interests of the system as a whole will return with a vengeance when the creditors have to accept a restructuring of the debt of the periphery.

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