



DIRECTORATE-GENERAL FOR INTERNAL POLICIES

POLICY DEPARTMENT
ECONOMIC AND SCIENTIFIC POLICY **A**



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**Is the Semester hard-wired for
Austerity or for Growth?**

**Interparliamentary Committee Meeting
January 2013**

COMPILATION OF NOTES



DIRECTORATE GENERAL FOR INTERNAL POLICIES
POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICY

Is the Semester hard-wired for Austerity or for Growth?

Interparliamentary Committee Meeting
Brussels, 29 January 2013

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Abstract

During the Interparliamentary Committee Meeting, a debate took place on two key policy issues: the relationship between effectiveness and political legitimacy of the new framework for European Governance and the difficult cohabitation between austerity and growth. The need for a more active role of the European Parliament in the central elements of the European Semester (recommendations) was emphasised, as both accountability and political legitimacy are insufficiently accounted for. Assessment and policy prescriptions differed more widely when the austerity-growth nexus was debated, e.g. between those warning about the harsh effects on welfare and long-term growth induced by the large slack in effective demand and those calling for more tolerance towards market forces to correct competitiveness differentials and unsustainable current account imbalances between euro area countries.

This document was requested by the European Parliament's Committee on Economic and Monetary Affairs.

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PROGRAMME



EUROPEAN PARLIAMENT

**European Parliamentary Week
on the European Semester for Economic Policy Coordination
Brussels**

**Interparliamentary Committee Meeting
organised by the Committee on Economic and Monetary Affairs (ECON)**

Tuesday 29 January, 15:00 - 18:30 - (Room PHS 3C50)

DRAFT PROGRAMME as of 24.01.2013

15.00 - 17.00 WHO GETS TO SET THE PATH FOR EUROPE'S RECOVERY? THE SEMESTER, DEMOCRACY AND SUBSIDIARITY.

- 15.00 - 15.05 Opening address by **Sharon Bowles**, Chair of the ECON Committee
- 15.05 - 15.15 Presentation by **Guntram Wolff**, Deputy-Director of the Brussels-based think-tank Bruegel
- 15.15 - 15.25 Presentation by **Stefan Collignon**, Professor of Political Economy at Sant'Anna School of Advanced Studies, Pisa
- 15.25 - 15.35 Introductory address by **Dominic Hannigan**, Chairman of the Joint Committee on European Affairs of the Irish Parliament (*Oireachtas*)
- 15.35 - 16.50 Exchange of views between Members of the European Parliament and National Parliaments with the invited speaker
- 16.50 - 17.00 Concluding remarks by **Elisa Ferreira**, Chair of the Working Group on the European Semester and rapporteur of the report on the "*The European Semester for Economic Policy Coordination: Annual Growth Survey 2013*"

17.00 - 18.30 IS THE SEMESTER HARD-WIRED FOR AUSTERITY OR FOR GROWTH?

- 17.00 - 17.05 Opening address by **Sharon Bowles**, Chair of the ECON Committee
- 17.05 - 17.15 Presentation by **Hans-Werner Sinn**, President of the Ifo Institute for Economic Research
- 17.15 - 17.25 Presentation by **Xavier Timbeau**, director of the analysis and forecasting department of the *Observatoire Français des Conjonctures Economiques* (OFCE)
- 17.25 - 18.30 Exchange of views between Members of the European Parliament and National Parliaments

EXECUTIVE SUMMARY

Who gets to set the path for Europe's recovery? The Semester, Democracy and Subsidiarity

Guntram Wolff (Deputy-Director of Bruegel, Brussels) and Stefan Collignon (Professor of Political Economy at Sant'Anna School of Advanced Studies, Pisa) elaborated on the critical nexus of the European Semester and Democracy.

According to Mr Wolff, EU countries are de-facto sub-sovereign States. Limited sovereignty largely stems from shared obligations in terms of monetary policy (for euro-area Member States) and fiscal policy as well as key non-fiscal policy areas (for all EU Members). Limits to sovereignty were present even before the financial and debt crisis erupted which emphasised not only the pros but also the cons of increased macro-financial integration and the potentially large adverse spill-over effects. It showed a need for reinforced economic governance with more efficient instruments and better coordination at the EU level if growth and political stability were to be preserved in Europe. Here Mr Wolff opines that the European Semester with its new legislation that overhauls the Stability and Growth Pact and the gradual building of crisis resolution institutions was the appropriate response. Following the transfer of greater powers of coordination and supervision from periphery to centre, the European Parliament has rightly led a strong battle for ownership and more political legitimacy. Progress has been slow and limited so far as the Council and the Commission are still running the show, but today's meeting and similar open debates (e.g. the Economic Dialogue) represent important positive developments. In order to further enhance the European Parliaments political accountability and legitimacy, Mr Wolff thinks that three options are possible: i) first, the creation of a dedicated Brussels-based space of discussion for EU and national Members of Parliaments on horizontal policy issues; ii) secondly, Members of the European Parliament ought to go to the 'capitals' making the exchange of information with national parliaments more systematic along the lines of the hearing of ECB President Draghi to the Bundestag; iii) and last but not least it would be an option to go beyond the built-in design of current treaties in terms of governance and start to think about a federal European Union.

Mr Collignon addressed the theme of political legitimacy in terms of decision theory. He claimed that the Euro-crisis is ultimately the consequence of incoherent policies decided by national governments in pursuit of partial interests for which they are legitimated in their national constituencies. While it is true that Member States seek to reap benefits from European integration, their autonomous and sovereign decisions generate externalities for European citizens anywhere in the Union. These unaccounted external effects violate the fundamental principles of democracy, which is *"government for the people, by the people, through the people"*. There is an inconsistency between Community and national decision-making levels: decisions are de-facto made by the Council and the Commission, while democratic control and legitimacy only comes from national parliaments. Without a coherent unified decision maker the EU will not be able to reap the full benefits of integration, but without the democratic consensus by all citizens concerned and affected by the decisions, the efficient implementation of European policies becomes an impossible goal. What is needed is a quantum-leap in Europe's governance. Instead of amalgamating European and national policies, the two decision levels need to be separated: national parliaments should be responsible for public goods that affect citizens only at the national level, while the European Parliament should represent all European citizens and control all decisions made at the European level. National parliaments can only supply democratic legitimacy indirectly, while the European Parliament is the only institution citizens can

control directly. A European democracy and the clear separation of national and European government competences does not require a European demos a priori, but by giving citizens the right to vote for European decision makers, the demos will ultimately emerge. Mr Collignon concluded that this transformation of Europe's governance is in line with the 2000 years old tradition of European republicanism.

In his introductory address, Dominic Hannigan (Chairman of the Joint Committee on European Affairs of the Irish Parliament) agreed on the need to reframe governance and legitimacy by re-addressing the current trend of intergovernmental governance and agreements. In this regard, the engagement of individual countries in EU policy through visits and hearings of national Members of Parliaments before the European Parliament was considered to be a step in the right direction. Symmetrically, presentations and speeches by European Institutions representatives before National Authorities to illustrate the design of EU policies are also very useful and important.

During the lively debate, led by Sharon Bowles (Chair of the ECON Committee), interventions focused on different policy aspects. While the debate was somewhat shaped by 'national' preferences, awareness of the need to reduce the gap between national priorities and common EU objectives was a 'Leitmotiv' of most interventions. Most delegates called for a stronger peer pressure of the European Parliament when discussing Commission recommendations. Some argued in favour of reinforcing formal dialogue and visit exchanges between EU and national Members of Parliaments. Several delegates stressed that the method of cooperation must be pursued with greater force even in the absence of unanimity on key governance issues (e.g. Fiscal Compact). A few delegates also warned about the risk for democracy of leaving key policy issues fully in the hands of market forces.

While the limited size of the EU budget and the Treaties does most likely not allow going beyond the current framework for economic policy coordination, the general perception was that further progress in terms of fiscal integration will not be possible without a parallel transfer of 'political' sovereignty from the periphery to the centre. After having been asked to clarify the option of a 'federal' EU, Mr Wolff argued that the new set of rules on strengthening budgetary and financial surveillance represents a positive development, but that it merely has to be considered a 'partial' adjustment - an intermediate process - towards an EU framework for economic governance. Concerning the too limited size of the EU budget for effective EU governance, Mr Collignon agreed that the EU would never have a system like the US where the Federal Budget represents about 50% of general government outlays but also pointed out that a fiscal capacity representing 2-3% of the EU GDP would already be very significant in terms of macro-economic stabilisation policy.

Is the Semester hard-wired for austerity or for Growth?

Hans-Werner Sinn (Ifo Institute for Economic Research) and Xavier Timbeau (Director of Observatoire Française des Conjonctures Economiques, Paris) brought two different assessments of the causes of the current crisis about and put different policy prescriptions forward.

According to Mr Sinn, the euro area suffers from an internal competitiveness problem rather than from a temporary lack of demand. The lack of competitiveness was provoked by the euro itself, which caused interest rates to converge and made cheap credit available to southern Europe and Ireland. This fuelled an inflationary boom. Between 1995 and 2008, the Greek price level increased by 67%, the Spanish one by 56%, the Irish one by 53% and the Portuguese one by 47%. By comparison, the average euro area price level increased by 26% while Germany's price level only increased by 9%. He argued that demand-led programmes for Europe's crisis-stricken countries – in fact meaning debt-financed expenditure programmes – advocated by many European leaders are not the right medicine, since they would provide temporary stimulus and relief, but at the expense of postponing the much-needed adjustments in competitiveness. Mr Sinn argues that they are no more than a painkiller that dampens the symptoms but does nothing to cure the underlying illness. What Europe in his opinion needs is austerity in the south and inflationary growth in the north to improve the competitiveness of the south and to structurally improve the current account imbalances. The financial crisis has calmed down somewhat thanks to the fact that the European Stability Mechanism (ESM) and the ECB stand ready to buy any troubled country's government bonds if bankruptcy looms, but at the cost of shifting the burden of potential write-off losses to the taxpayers of the euro area's still-solid economies. This has provided a respite, but it is not a contribution to a real solution of the euro area's problems. The real solution lies in a realignment of national price levels within the euro area that replaces the realignment by way of open revaluations and devaluations. Such a realignment, in his opinion, cannot be achieved by significant price cuts in the south, since that would require extreme austerity programmes that would undermine the stability of the southern countries. Mr Sinn pointed to the terrors that Germany faced under the Weimar republic after undergoing a 23% real depreciation in the period from 1929 to 1933, which drove the country to the brink of civil war. However, some degree of austerity that would keep prices constant for a decade, coupled with strong inflation in the core countries, is unavoidable if the euro is to survive. Mr Sinn warned that the path towards an equilibrium in the euro area will be painful for all parties involved. Based on calculations by Goldman Sachs, he showed that Spain, for example, would have to keep its prices constant for a decade while Germany inflates by 5.5%. The necessary inflation in the north, in his opinion, cannot be achieved by dictating wage increases, since they would imply a counterproductive stagflation, potentially exacerbating the current account imbalances. Instead, only demand-driven wage and price inflation could do the job. Such inflation would automatically take place if the ECB and the community of states abstained from making available excessive guarantees that have the effect of impelling capital flows from the north to the south.

Mr Timbeau agreed that excessive austerity is counterproductive to both economic and social stability. Short-term (demand) austerity measures, i.e. reduced spending for private and public consumption, have destroyed the incentives for further investment in Europe thus also negatively affecting the long-term (supply) potential. Presently, only exports are a source for economic growth. The ensuing slowdown of long run economic growth leads to rising unemployment and social problems and a worsening of public finances. Is there an alternative to austerity? The US has taken a different policy track, which seems more successful. Public spending has complemented the massive slack in private spending

(consumption and investment). The positive outlook has calmed financial markets. By contrast, the financial crisis in the EU is perpetuated by a rigid imposition of austerity on Member States which find their productive capacity seriously harmed. Like in the US, credit-financed public spending should remain a policy instrument for the EU as well in order to stimulate private economic activity. This would require suspending the rigid constraints of the Stability and Growth Pact and Fiscal Compact until the output gap has been closed again. Once the situation normalises, a tight fiscal control regime is of course necessary to prevent similar crises in the future. One may object that public debt ratios in Europe are already too high and do not provide any room for further public borrowing. However, debt ratios of 100% or more have occurred before in history without ruining a country's economy. Mr Collignon mentioned 4 cases: the UK (particularly during Napoleon Wars and World War II), the US (World War II), France (last part of XIX century and WW I) and Spain (early XX century). While wars have been the main reason for higher public debt, economic depression and the unification of countries have also been important factors for rising debt. Mr Timbeau concluded that what had always brought down public debt was economic growth. Therefore, the unification of Europe deserves a period of higher debt that leads to higher growth in the future.

A few delegates were puzzled by Mr Sinn's narrative of the current crisis, noting that growth was also looming in some northern EU countries not hampered by the competitiveness burden faced by southern EU countries. Other delegates wondered how come we did not notice the emergence of these imbalances before and whether our theoretical models were appropriate. Several delegates pointed out that demand shortfalls (a negative output gap) of 10 pps. or more observed in some EU countries must also affect the economy's future potential to the extent that the capital stock is growing slowly and unemployed lose their skills. Others, however, sharing Professor's Sinn analysis, reported examples of countries where market forces do seem to bring about the expected results in terms of adjusting macro-economic imbalances: In Spain, the trade balance (exports minus imports) has finally moved to positive territory, the estimated contraction of GDP in 2012 (1.3%) is lower than expected (1.5%) and public finance developments are on track. Mr Sinn's reaction to various objections raised in the debate can be summarised as follows: First, we have most likely reached the limits in terms of EU economic governance, whereby giving more power to the centre will require a change the EU treaties, which is a very difficult task at the current juncture. Second, the level of competitiveness in some southern EU countries is extremely bad. In those countries, prices must necessarily go down, either through a very costly (both economically and socially) internal devaluation (permanent wage-cuts) or through a temporary external devaluation (a temporary and orderly exit from the euro with re-entry once the largest imbalances have been cleared). According to Mr Sinn, and given the size of the adjustment needed, only the second option is technically and politically feasible for a country like Greece. He also considered such nonsensical economic notions as artificially increasing wages in northern EU countries, as advocated by IMF director Christine Lagarde. This, he pointed out, would lead to stagflation, which would reduce rather than increase the demand for southern exports. While agreeing on the importance of long-term macroeconomic sustainability, Mr Timbeau suggested the need for considerable caution regarding the pace of price-fiscal adjustment. According to recent IMF research, the size of fiscal multipliers can be well in excess of one during a deep financial crisis, implying that fiscal consolidation is self-defeating.

CURRICULA VITAE OF THE SPEAKERS

Stefan COLLIGNON

Stefan Collignon is ordinary professor of political economy at the Sant'Anna School of Advanced Studies in Pisa and International Chief Economist of the Centro Europa Ricerche (CER) in Roma. Besides that he is the founder of the Euro Asia Forum at the Sant'Anna school of advanced studies.

Previously, he was Centennial Professor of European Political Economy at the London School of Economics and Political Science (LSE) and Visiting Professor at Harvard University in the Faculty of Arts and Sciences (Government Department) as well as an associate of the Minda de Gunzburg Centre for European Studies at Harvard. He also taught at the University of Hamburg, the Institut d'Etudes Politiques in Paris and Lille and at the College of Europe in Bruges as well as at the Free University of Berlin. Furthermore, he served as Deputy Director General for Europe in the Federal Ministry of Finance in Berlin.

He received his Ph.D. from the Free University of Berlin. He also studied at the Institut d'Etudes Politiques (Paris), the University of Dar es Salaam, Queen Elizabeth House in Oxford and the London School of Economics.

Hans-Werner SINN

Hans-Werner Sinn is Professor of Economics and Public Finance at the University of Munich, President of the CESifo Group. He is a member of the Council of Economic Advisors to the German Ministry of Economics, and a past president of the German Economic Association (Verein für Sozialpolitik) and of the International Institute of Public Finance (IIPF). Mr Sinn holds honorary doctorates from the universities of Magdeburg and Helsinki and has been knighted with the Maximilians Order. He has received many awards and prizes, among them the Europe Prize of the University of Maastricht. He taught at the University of Western Ontario and was a research fellow at the universities of Stanford, Princeton, Jerusalem and Bergen, as well as at the LSE. His fields of interest include economics of transition, risk and insurance, natural resources, macroeconomics, trade and public finance. His publications in these areas include several monographs, scholarly and policy articles, which have been translated into six languages.

Xavier TIMBEAU

Currently Xavier Timbeau is head of the Forecast and Analysis Department at the OFCE. He has experience in macro economic analysis, economic forecasts, economic modelling and applied econometrics. Recent research interests have been NAIRU estimations and the prediction of inflation using different NAIRU concepts, the economic outlook for the euro area, the real estate market and housing channel for monetary policy, public accounts and intangible assets such as education embodied in people. Apart from that he has been working in the Stiglitz-Sen-Fitoussi commission as a rapporteur and he teaches macroeconomics and environmental economics at Supélec and Sciences-po.

Education: Ecole Polytechnique (1989), ENSAE (Ecole nationale de la statistique et de l'administration économique, 1991), DEA, Paris I Panthéon Sorbonne (1991).

SPEAKERS' NOTES



DIRECTORATE GENERAL FOR INTERNAL POLICIES
POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICY

Economic Growth versus Austerity

Stefan COLLIGNON

NOTE

Abstract

Optimal economic growth requires that there is enough effective demand to absorb the potential output the economy can generate. If demand is too high, it leads to inflation, which will be countered by restrictive monetary policies. If it is too low, investment will fall and lower actual GDP growth will also have detrimental effects on long run growth. It is shown that the Euro Area is presently compounding its economic woes by an excessively restrictive fiscal policy stance. A reform of the Stability and Growth Pact is proposed.

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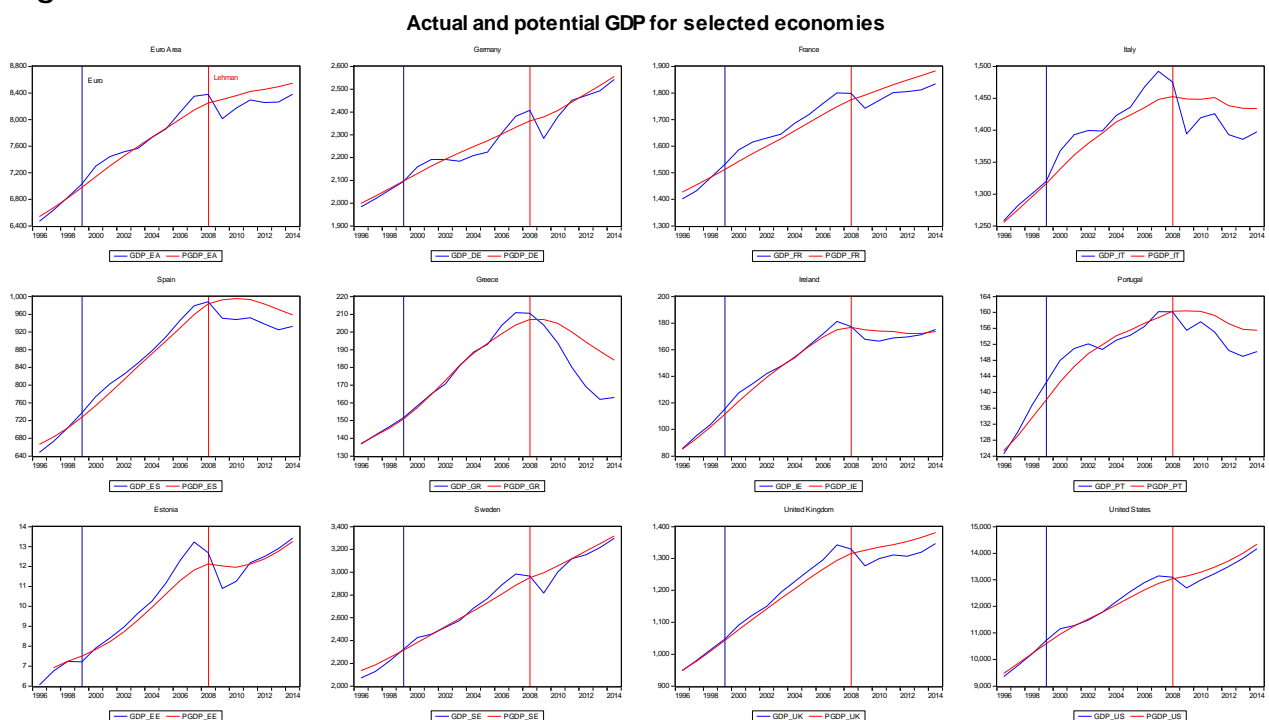
INTRODUCTION

As the Euro Area enters its fifth year of crisis, it is time to reflect on whether we are on the right track. The dominant policy consensus deserves re-examination: unemployment rates are at historic records, recession is back in most member states, the risk of poverty is shooting up, and public debt ratios are hardly coming down. In this context, the question must be asked whether austerity has helped to stabilise the economy or whether it has aggravated the crisis. In this note, I will present some evidence that excessive austerity is counterproductive to economic and social stability.

1. THE DEPTH OF THE CRISIS

Triggered by the Lehman bankruptcy in 2008, the global financial crisis has caused a major loss of output and income in most economies of the globe. Figure 1 gives evidence for the Euro Area, some Member States and the United States. Although the fall in income is significant everywhere, some economies, notably Germany and Sweden, have quickly pulled out of the recession and are producing output at their potential capacity again; Estonia, which is sometimes named a successful adjustment example has indeed returned to growth, although its productive capacity was also reduced during the crisis. The United States is also on track of fully absorbing its potential output capacity. In the Euro Area as a whole, however, and especially in the crisis economies in the South, actual GDP is lagging behind potential; but while the output gap¹ is closing in most Euro Area economies, this effect is often a consequence of lower or even negative *growth* of productive capacities. The crisis has therefore a detrimental long run impact on the economy, which translates in rising unemployment and public debt.

Figure 1:



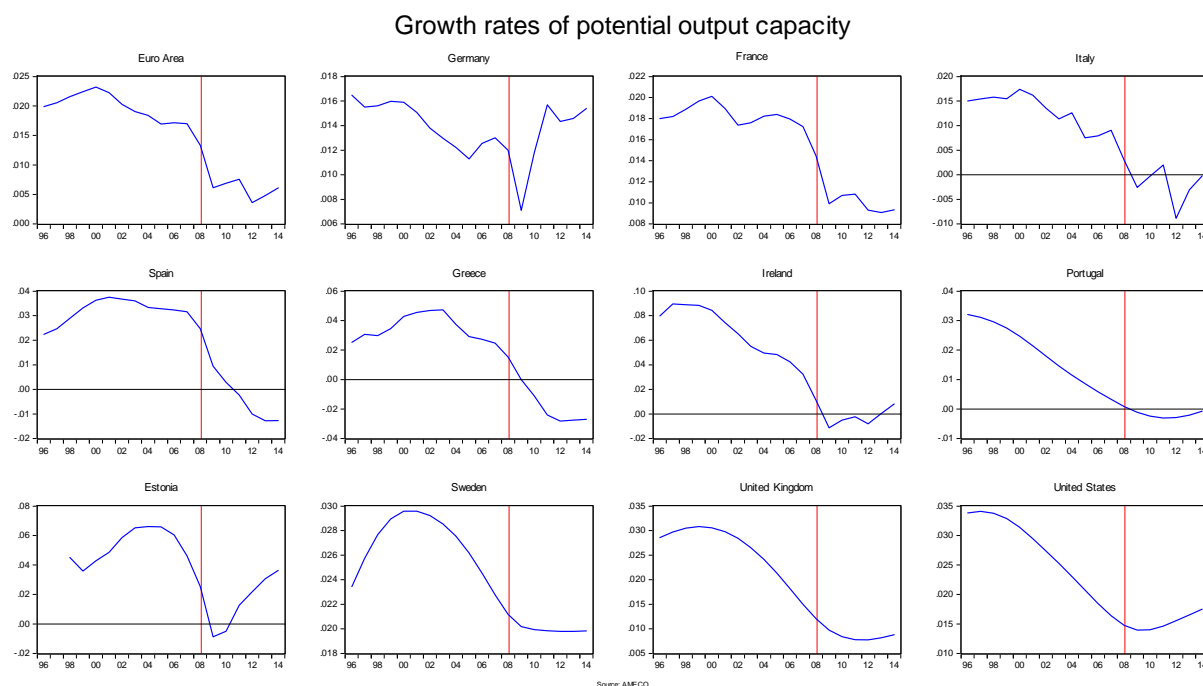
Source: AMECO.

Since it started in 1999, the Euro Area has experienced two booms with demand exceeding supply capacities; one in 1999-2000 and a second just before the global financial crisis (see Figure 1). Booms also occurred in other economies during those years, although in the United Kingdom, Sweden, or the USA they were longer and stronger and causing higher inflation. Yet, while previous booms were simply tuned down to meet potential supply, the crash after 2008 caused not only huge output losses everywhere, but it also lowered potential growth in many economies.

¹ The output gap is the difference between actual GDP and the potential output capacity of an economy, determined by the available labour force, the stock of capital and total factor productivity.

This is shown even clearer by Figure 2. While potential growth in the Euro Area was around 1.5% before the crisis, it dropped below 0.5% after 2009. Only Germany has returned to capacity growth rates similar to the pre-crisis period, although those rates were well below the Euro Area average and only half of the Anglo-Saxon performance. Thus, Germany's traditional characteristic of a slow-growth economy is presently masked by the troubles in competing economies². More seriously, in France, the UK, the USA, Sweden and Estonia, the crisis had slowed down potential growth, and in the south of Europe productive capacity is even shrinking.

Figure 2:



Source: AMECO.

These developments have very significant negative consequences for the labour market. Instead of absorbing a growing labour force, shrinking capacities generate unemployment and push a growing share of the labour force out of productive employment. Slower growth will also negatively affect the dynamics and sustainability of public debt. It must therefore be the primary objective of economic policy in Europe to reverse these developments.

² Some factors contributing to Germany's slow growth is the absence of domestic consumption as will be shown below.

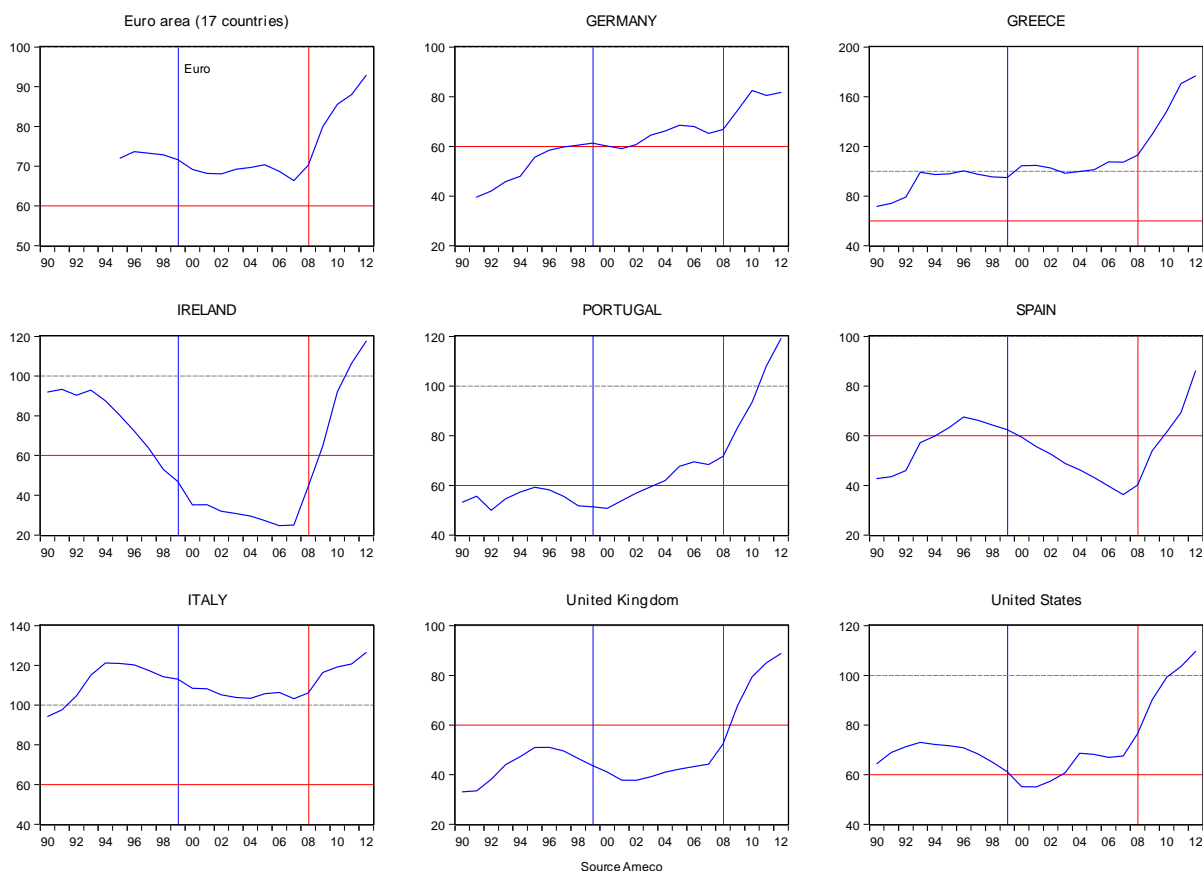
2. POLICY RESPONSES

In the immediate aftermath of the crisis, all G20 nations agreed that, given the climate of general uncertainty and dysfunctional financial markets, stimulating effective demand by public borrowing was necessary to avoid a severe depression. The United States, China, Japan and the UK announced large spending packages, although the Euro Area was more reluctant. Germany and France did undertake stimulative measures, Italy did not. The stimulus worked. A sustained depression was avoided and even Italy benefitted from the spillover for its exports. But while growth returned, it did so in most cases at lower rates than before.

As soon as the world seemed to pull out of the global financial crisis, Europe was shaken by the debt crisis, which turned into a full-fledged Euro crisis. When the newly elected Papandreou government in Greece revealed the misdemeanours of its predecessor, confidence in Europe's fiscal policy framework, and especially into the Stability and Growth Pact, collapsed. Investors rapidly dumped Greek government debt from their portfolio, yield spreads shot up, the Euro interbank market froze, and soon the crisis spilled over to Ireland, Portugal and the rest of Southern Europe.

At that point, Europe's policy consensus started to deviate from global wisdom. Given that excessive debt seemed to be the problem, fiscal consolidation became the dominant theme for policy makers. Sometimes extremely harsh austerity measures were imposed on Member States with rapidly rising debt ratios. It was argued that high deficits were a sign of fiscal irresponsibility and needed to be reined in by cutting expenditure and rising taxes. However, despite these measures, the situation got worse.

Figure 3 shows, that the rapid increase in public debt ratios was a direct consequence of the global financial crisis. Fiscal profligacy may have prevailed in Portugal and Germany, also in France (not shown), but the Euro Member States with the greatest debt problems, such as Ireland, Greece and Spain, have seen stable or falling debt ratios before 2008 and extremely rapid increases thereafter. In fact, if there is one factor that these countries share, it is not budget irresponsibility before the crisis, but large output gaps since 2008 (see Figure 1).

Figure 3:**Debt-GDP ratios for selected economies**

Source: AMECO.

The European policy response to rising debt ratios was fiscal tightening at a time, when most countries were still experiencing negative output gaps. By contrast, in the USA public borrowing was deliberately used to stimulate aggregate demand. These different policy orientations must have had important consequences for the two economies.

3. POLICY CHOICES: STIMULUS OR AUSTERITY?

Fiscal policy must be seen in its economic context and over time. There are times when the economy needs to be stimulated and others when austerity is justified. The overall policy purpose must be to keep the demand for goods and services in balance with the capacity of supply. Demand is determined by spending on investment goods, private and public consumption plus the demand from the rest of the world. Under normal conditions, private demand for investment and consumption responds to interest rates and monetary policy, but in a severe crisis where trust in banks has vanished and general uncertainty blocks spending by firms and households, the government must step in. Public spending financed by credit can then compensate for insufficient private demand. However, this is only justified as long as the output gap is negative for otherwise public spending would ignite inflation.

Austerity is generally understood as a policy of deficit reduction by cutting public expenditure or rising taxes. It implies less public service and often lower public wages and employment. However, in broader terms, it may include also the reduction in private consumption caused by lowering wages and increasing savings. When austerity is used to reduce current account deficits, it may imply lower public borrowing and a reduction in the investment-savings relation.

Thus, in order to assess whether austerity is a desirable policy or not, a benchmark is needed. This is the output gap. A positive output gap implies that aggregate spending (demand) in the economy exceeds the potential supply, so that there is pressure for prices to increase. In that case, austerity would be a policy recommendable to stabilize the economy. Alternatively, a negative output gap implies a lack of demand that may push prices down or, more likely, reduce entrepreneurs' willingness to invest, thereby decreasing potential output capacity and weakening employment. In that case, stimulating demand by increasing private and public spending is required to stabilize the economy. Thus, one has to distinguish clearly between the levels of aggregate spending relative to the value of potential output, and the changes in spending, which reflect stimulus and austerity. Whether austerity is good or bad depends on the specific position of the economy. See Table 1.

Table 1: Economic policy options

	Excess demand	Demand gap
Stimulus is:	bad	good
Austerity is:	good	bad

From Table 1 we can deduct the right fiscal policy stance for governments. Fiscal tightening, and therefore austerity, is necessary when aggregate demand exceeds supply capacities, for otherwise risks of inflation emerge. On the other hand, when demand is insufficient to absorb the output capacity, austerity is self-defeating, because the lack of demand for products pushes firms to reduce investment and staff.

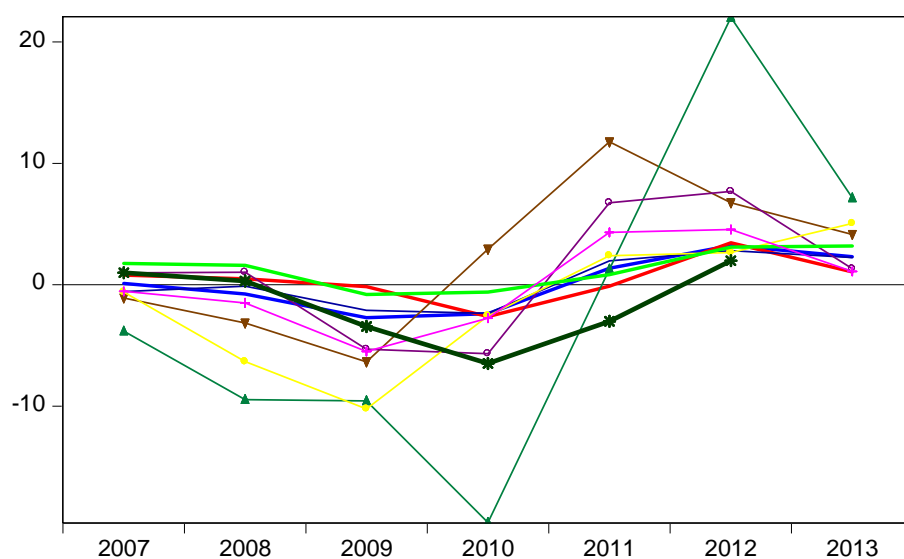
How important are the differences in fiscal policy stances in Europe? One commonly used variable to measure the policy stance is the change in the primary budget position, i.e. the deficit adjusted for cyclical variations and net of interest payments. The fiscal stance is tightening when the change in the primary position is positive and loosening when it is negative. Yet, the fiscal stance is not exactly identical with the stimulus packages of 2009,

for it shows only loosening or tightening over and above the cyclically adjusted budget position. Some of the huge stimulus packages in 2009, for example in Germany, have simply responded to the growing output gaps and thereby avoided a deep recession, but they did not necessarily generate additional growth impulses.

Furthermore, because investment decisions are made under long run considerations, it is not enough to stimulate demand only in the short run, say in one year alone. Fiscal policy has to be assessed in a multi-annual perspective. Thus, in order to measure the long run impact of fiscal policy in Europe, Figure 4 gives the cumulative effect of the fiscal stance since 2007 for several countries.

Figure 4:

Cumulative fiscal stance



Source: for Europe: Ameco and own calculations; for the USA: OECD and White House.



For the Euro Area as a whole, fiscal policy was mildly stimulative until 2011. Italy did hardly loosen in its fiscal stance, presumably because its debt ratio was already one of the highest in Europe, while Germany did become more accommodating, but only in 2010. The biggest loosening was observed in Ireland, Spain, Greece and France in 2009, while in 2010 most Euro Area members were already tightening their budget position again. In Ireland, the fiscal adjustment came with one year delay, but then it was all the more draconian.

The rapid return to fiscal tightening may be a fault of the Stability and Growth Pact (SGP), which stipulates³ that the excessive deficit procedure is suspended in case of a severe economic downturn "if the excess over the reference value results from a negative annual GDP volume growth rate or from an accumulated loss of output during a protracted period of very low annual GDP volume growth relative to its potential." However, when GDP growth bounces back into positive territory the suspension is revoked because the pact

³ Council Regulation (EC) No 1056/2005 of 27 June 2005 amending Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure, Article 1.

defines the exceptionality of the situation only in terms of growth rates and not in terms of output levels relative to potential. As a consequence, 12 Euro Area Member States have been declared to have "*excessive deficits*" already by the end of 2009,⁴ which need to be corrected by 2013. Thus, not only does the Stability and Growth Pact lead to a rapid and early fiscal consolidation, which is damaging long term growth as will be shown below; but in addition, it was applied in an overly restrictive way, which was probably in contradiction with the legal text.

The contrast is striking when one compares the Euro Area with the United States, which does not have such institutional constraints. Until 2012, the Obama administration has pursued anti-cyclical stimulating policies. This has, of course, given rise to higher debt ratios (Figure 3), but it has also helped to close the gap between productive capacity and effective demand (Figure 1) and it has even stimulated growth in potential GDP. By contrast, in the Euro Area debt ratios are also rising, but the restrictive fiscal stance prevents the closing of the output gap and lowers productive capacities. This worsens the debt ratio because of GDP in the denominator of the ratio, and because the reduced income yields less tax revenue.

⁴ http://ec.europa.eu/economy_finance/economic_governance/sgp/deficit/index_en.htm (accessed 21.1.2013).

4. THE IMPACT OF AUSTERITY ON ECONOMIC GROWTH

It is often thought that fiscal policy (or monetary policy in normal times) should aim at closing the output gap in the short run. This is the core of business cycle policies (Konjunkturpolitik). However, from a growth perspective, demand management is not just a matter of avoiding cyclical variations around the long run trend of a steadily growing economy. It is also about generating an environment, which sets incentives for productive investment and entrepreneurial initiative. Long run growth of productive capacity depends on a wide range of supply side factors. Improving these factors is the purpose of structural reforms, although it is clear that supply side policies will remain without effect if demand is insufficient to justify investment. This is why a more coherent and active macroeconomic policy for the Euro Area is so important.

The problem of demand management in the long run is more complex than simple Konjunkturpolitik, because potential output is not static. Usually potential output is calculated by a Cobb-Douglas production function, which assumes full employment of the labour force and capital stock and a given rate of technological progress (Total Factor Productivity - TFP, also called Solow residual). A long line of research has identified Research & Development (R&D) spending, human capital accumulation, public infrastructure, labour market flexibility and a number of efficiency variables as prominent explanations for the rate of technological progress, although the all deeper causes of economic growth are not yet fully understood (Helpman, 2004). However, given that these structural factors, and especially technology, will improve with economic growth, the growth of productivity is endogenous to the overall increase in output. A sustained slowdown of actual growth will therefore also reduce potential growth.

By definition, economic growth is a long run phenomenon. The complication for demand management derives from the fact that a negative output gap (i.e. a lack in demand relative to potential output capacities) will affect the rate of investment and therefore the level of the capital stock as well as the development and adaptation of technological innovation. By contrast, a positive output gap ignites inflationary pressures, which will be met by restrictive monetary policies, which may in the long run also reduce investment and growth.

There are two channels through which aggregate demand will affect future potential output: first, a negative output gap is a static indicator for insufficient market opportunities. A negative output gap will therefore lower investment and future output, especially when the lack of demand is persisting for a long time. Second, the dynamics of market opportunities can be measured by the difference between actual and potential GDP growth. If actual GDP grows faster than potential, a negative gap is closing; if it lags behind potential, the market dynamic worsens and this will accelerate the loss of investment and potential growth. Thus, a negative differential between actual and potential GDP growth leads to a negative feedback loop, which will cause the economy to stagnate or shrink.

To test whether this hypothesis of a long run reduction of the potential growth rate due to insufficient demand holds up, we have estimated a panel regression for Euro Area Member States, where the dependent variable in the first part is the potential growth rate and in the second the investment rate. As regressors we have taken the cumulative output gap between the moments when it switches from positive to negative or the other way round. Because a positive output gap is inflationary, we have also added the GDP deflator and separated periods with positive and negative cumulated gaps. Finally, we have also added the variable for investment, which catches all kinds of structural influences.

Table 2: Effect of cumulative output gap on potential GDP and investments

Dependent variable: log(PotGDP)							Dependent variable: log(Inv)		
	1981-2012	1990-2012	1999-2012	1981-2012	1990-2012	1999-2012	1981-2012	1990-2012	1999-2012
CumGap +	0.024 [0.072]	0.034 [0.049]	0.022 [0.018]	0.069 [0.065]	-0.062 [0.073]	-0.055* [0.032]	0.027** [0.012]	0.033** [0.012]	0.007 [0.009]
CumGap -	-0.206** [0.073]	-0.201*** [0.059]	-0.121** [0.056]	-0.023 [0.091]	0.011 [0.104]	-0.339* [0.182]	-0.057*** [0.015]	-0.072*** [0.021]	-0.106** [0.043]
GDP defl	19.632** [9.035]	-0.044 [7.569]	12.819 [9.550]	14.177** [7.182]	10.562 [10.550]	3.339 [22.713]	1.979** [0.683]	1.039 [0.901]	0.59 [2.859]
log(Inv)				3.104** [1.293]	2.848** [1.110]	1.907* [1.095]			
N	383	264	168	375	257	163	375	257	163

Standard errors in brackets. *significant at 10% level; **significant at 5% level; ***significant at 1% level. Cum Gap+ =Cumulative positive gap in % of GDP; Cum Gap- =cumulative negative gap in % of GDP; GDP defl= GDP deflator; log(Inv)=log of net investment (2005 prices). Estimator: Common Correlated Coefficients Mean Group Estimator (CCEMG). Data are from AMECO.

The results in Table 2 support our hypothesis. Prolonged negative output gaps in the Euro Area will reduce potential GDP, because the lack of demand will disincentivize investment (columns 1-3).⁵ This phenomenon is less clear for the periods of 1990-2012, which is dominated by many structural reforms due to the creation of the European internal market. This is supported by column 5, where the investment variable catching structural effects is strongly significant. However, for the monetary union era 1999-2012, our model is well supported by the data: a negative cumulated output gap lowers the potential growth rate, and structural reforms which increase capital accumulation raise the growth potential. The channel through which this effect is generated is the rate of investment, which falls the longer and larger the output gap remains negative. Inflation does not matter, presumably because the ECB has been successful in maintaining price stability. This may also be the reason, why positive output gaps do not generate higher growth: excess demand, which may generate inflation, will be countered by higher interest rates, which will reduce investment and potential growth.

Thus Table 2 presents supporting evidence that long lasting negative output gaps will reduce the growth rate of productive capacity. The question is then, which factors are affecting aggregate demand in the Euro Area.

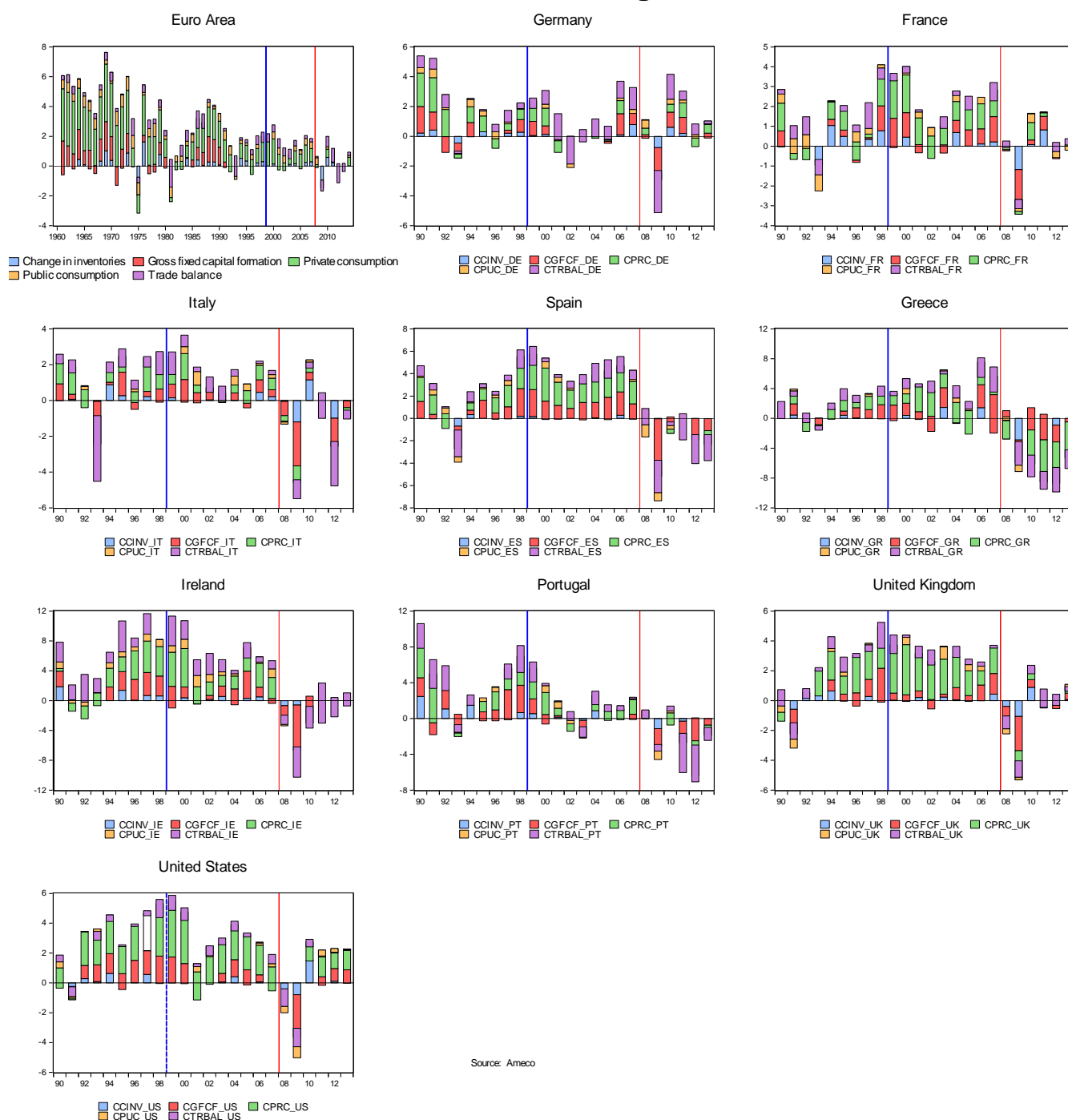
⁵ The negative gap is expressed in absolute terms so that a negative sign signals that an increasing negative gap will reduce potential GDP.

5. THE CONTRIBUTION OF EFFECTIVE DEMAND COMPONENTS TO ECONOMIC GROWTH

According to standard national income accounting practices, aggregate demand consists of changes in inventories, investment (Gross Fixed Capital Formation), private and public consumption and the trade balance. Figure 5 shows the contribution of these demand components to the GDP growth rates.

Figure 5:

Contributions to growth



This first panel gives a long term overview of demand component in the Euro Area for half a century. The important information is that growth was strongly driven by private investment and private consumption in the glorious 1960s and again in the growth period of the late 1980s. However, the absence of any significant investment since the 1990s is puzzling. The relatively positive growth performance of the first euro-decade was entirely driven by private and public consumption and net exports. Since the Euro-crisis even private consumption has shrunk, public consumption has nearly disappeared and the only significant driver of growth is net exports.

The performance of individual Member States is varied. Germany is dominated by exports, occasional investment and hardly any contribution from private or public consumption. In France, consumption has been important in the first decade of the euro, but it has been cut during the crisis. In Italy, public consumption was important in the first years of EMU, but since 2008 all components have been shrinking. High growth in Spain was dominated by investment and private consumption before the crisis, but now investment and exports have turned negative. Greece is characterized by a collapse of private consumption, investment and exports and an absence of public consumption. In Ireland, net exports have compensated the collapse of domestic demand, while in Portugal exports and investment are pulling the economy down. Outside the Euro Area, we find that the Blair-boom in the UK was mainly consumer driven, but in recent years the economy has become totally dependent on a weak foreign trade performance. Finally in the USA, and in contrast to Europe, private consumption is the single most important demand component, which also stimulates investment, although in recent years public consumption has compensated some of the private demand weakness.

6. CONCLUSION

The overall lesson from our considerations is clear. While the financial crisis has caused a credit crunch, with banks deleveraging their balance sheets and the corporate sector cutting costs, austerity, i.e. reduced spending for private and public consumption, has destroyed the incentives for further investment in Europe. Only exports are presently a source for economic growth. This means that the economic woes of the Euro Area are largely self-made: the collapse of domestic demand leads to a slowdown of long run economic growth, rising unemployment and social problems and a worsening of public finances.

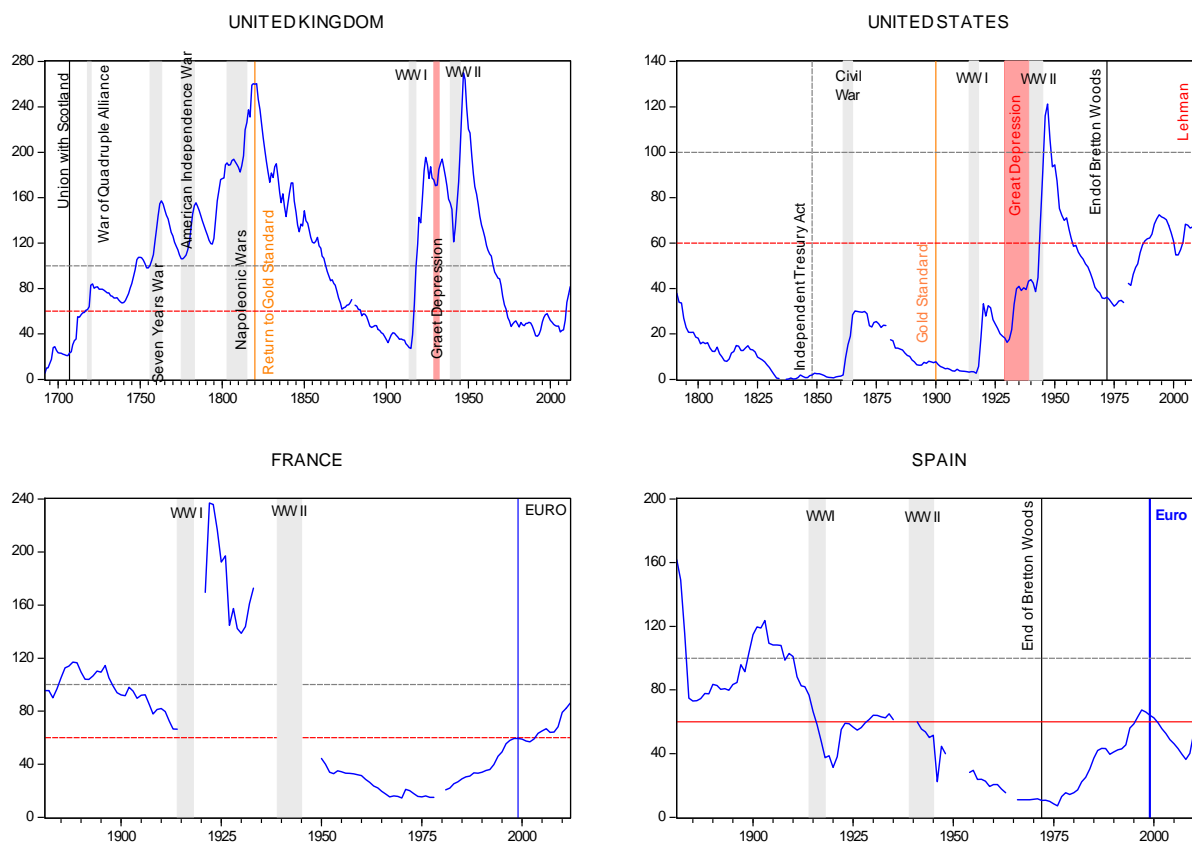
Is there an alternative to austerity? The United States have taken a different policy track, which seems more successful. Public spending has complemented private consumption and both are stimulating investment; the positive outlook has calmed financial markets. By contrast, in Europe the financial crisis is perpetuated by a rigid imposition of austerity on member states, which find their productive capacity seriously harmed.

Under these circumstances, credit-financed public spending should remain a policy instrument for the Euro Area in order to stimulate private economic activity. This would require suspending the rigid constraints of the Stability and Growth Pact and Fiscal Compact until the output gap has been closed again. Once the situation normalises, a tight fiscal control regime is of course necessary to prevent similar crises in the future. The amended Council Regulation (EC) No 1467/97 should therefore be amended to refer to the levels rather than the growth rates of actual and potential GDP.

One may object that public debt ratios in Europe are already too high and do not provide any room for further public borrowing. It might be useful to place this discussion in its historic context. Debt ratios of 100% or more have occurred before in history without ruining a country's economy (see Figure 6). While wars have been the main reason for higher public debt, economic depression and the unification of countries have also been important factors for rising debt. What has always brought down public debt has been economic growth. The unification of Europe would certainly deserve a period of higher debt that leads to higher growth in the future.

Figure 6:

Public Debt to GDP Ratios



Source: Abbas et al. (2010).

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NOTES



DIRECTORATE GENERAL FOR INTERNAL POLICIES
POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICY

Austerity, Growth and Inflation. Remarks on the Euro Area's Unresolved Competitiveness Problems¹

Hans-Werner SINN

NOTE

Abstract

While the financial protection measures enacted by the ECB and the community of euro area members have calmed financial markets, they have left the competitiveness problem of the euro area's southern countries and France unresolved. The paper compares price inflation before the crisis with the necessary and actual price cuts that have taken place since the outbreak of the crisis, predicting a decade of stagnation for the south and inflation for the north. Keynesian demand policy is counterproductive in the south and unnecessary in the north. The necessary realignment of relative goods prices and current account imbalances can be achieved if market forces are allowed to redirect capital flows to the north instead of being artificially steered to uses they are keen to avoid.

¹ This text is a summary and update of Sinn (2012), Chapters 1, 3 and 4.

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EXECUTIVE SUMMARY

Many European leaders have advocated growth programmes for Europe's crisis stricken countries, meaning in fact debt-financed expenditure programmes. In this note I will argue that such programmes are not the right medicine, since the euro area suffers from an internal competitiveness problem rather than a temporary lack of demand. They would provide temporary stimulus and relief, but at the expense of postponing the long-term adjustments that are needed to improve the competitiveness of the crisis-stricken countries. They are a painkiller that dampens the symptoms but does nothing to cure the underlying illness. What Europe needs is austerity in the south and inflationary growth in the north to improve the competitiveness of the south and to structurally improve the current account imbalances. However, instead of taking hectic policy actions, what this requires is simply more tolerance towards market forces that are already working in this direction.

The financial crisis has calmed down somewhat, thanks to the fact that the ESM and the ECB stand ready to buy any troubled country's government bonds if bankruptcy looms, hence shifting the burden of write-off losses, or of transfers aimed at preventing such losses, to the taxpayers of the euro area's still-solid economies. This has provided a respite, but it is not a contribution to a real solution of the euro area's problems. The real solution lies in a realignment of national price levels in the euro area that replaces the realignment by way of open appreciations and depreciations. The paper compares price inflation before the crisis with the necessary and actual price cuts that have taken place since the outbreak of the crisis.

1. THE COMPETITIVENESS PROBLEM

The unresolved problem underlying the financial crisis is the lack of competitiveness of the southern European countries and France. If anything, placating investors with taxpayer guarantees postpones the necessary painful adjustments through which competitiveness could be restored.

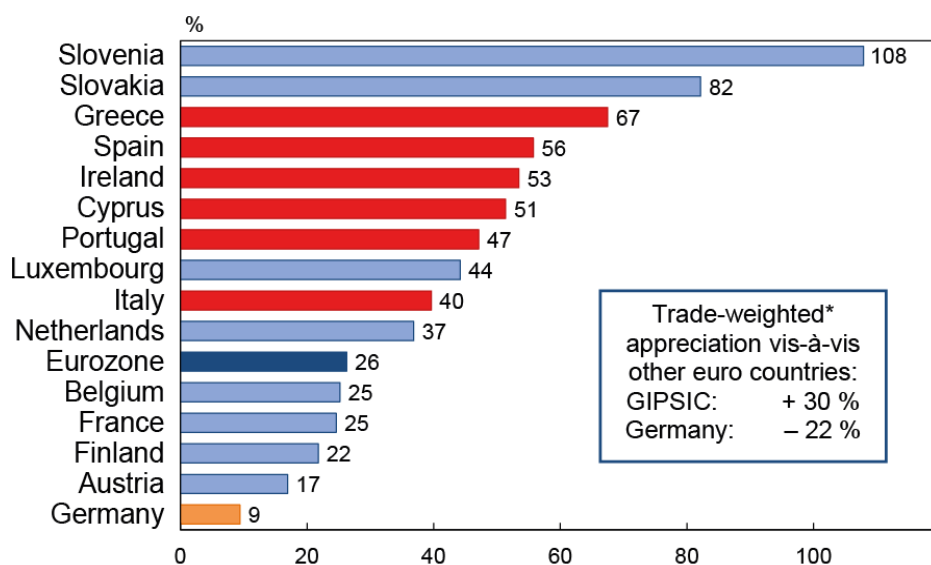
The lack of competitiveness was brought about by the euro itself. The announcement of irrevocable commitment to it at the Madrid Summit of December 1995, three years before its actual introduction in 1999, caused interest rates to converge, making cheap credit available to southern Europe and Ireland. The exchange rate risk that had hitherto caused huge interest spreads disappeared and the risk of state bankruptcy, which recently again caused huge interest spreads, was not yet on the radar. Both the political protection implicit in the Eurosystem, and the EU's interpretation of the Basel Accords that encouraged banks and insurance companies to gobble up southern European government bonds because no equity had to be held against such bonds, led to the risk of state bankruptcy being neglected. The upshot was an overabundance of cheap credit for southern Europe and Ireland, which fuelled an inflationary boom that initially helped the periphery to converge, but gained too much momentum and finally turned into a bubble that burst in 2007, when the American financial crisis swept over to Europe.²

In Greece and Portugal the government sectors used the credit to raise public-sector wages and hire more public employees, while in Spain and Ireland investors borrowed to buy real estate and build houses. In the end it made no difference how the credit entered the economy. In Greece government employees built homes with their credit-financed income and in Spain the construction workers paid taxes out of their credit financed wages to the state. In addition, the Spanish state collected a property tax, whose revenue increased enormously during the real estate bubble. The other sectors benefited as well in both cases.

As is shown in Figure 1, during the bubble, from the year of the Madrid Summit (1995) to the year of the Lehman crisis (2008), the Greek price level (GDP deflator) increased by 67%, the Spanish one by 56%, the Irish one by 53%, and the Portuguese one by 47%. By comparison, the average price increase of the countries now in the euro area was 26%, while Germany's price level increased only by 9%.

However, some currencies openly depreciated and others openly appreciated before the exchange rates were irrevocably fixed. Taking both the exchange rate adjustments and the price changes into account, it turns out that Greece appreciated by 18% relative to the rest of the euro area, Spain by 22%, Ireland by 30%, and Portugal by 14%. These numbers look relatively more moderate, since the respective rest of the euro area they relate to includes many other countries that also appreciated. If the GIPSIC countries are taken together, and if both price changes and exchange rate adjustments since 1995 are considered, the total rate of appreciation relative to the rest of the euro area from 1995 to 2008 was 30%. The countries in the southern and western periphery lost their competitiveness simply by becoming too expensive.

² See Sinn and Koll (2000) and Sinn (2010).

Figure 1: Development of the GDP deflator from 1995 to 2008

*Including exchange rate adjustments before the introduction of the euro.

Source: Eurostat, Database, Economy and Finance, National accounts, GDP and main components - Price indices; Ifo Institute calculations.

The Balassa-Samuelson effect, which is sometimes used as an explanation, namely that a productivity increase in the traded-goods sectors translates into a wage and price increase in the non-traded goods sectors, accounts for only a very small share of all this. The true explanation is the momentum of the bubble-building process, the speed of which implied a dangerous and huge overshooting of prices.

2. ITALY

Italy was an exception of sorts. Although Italian interest rates also came down after the Madrid Summit, a boom never ignited in Italy. True, the Italian state saved more in interest payments than its value-added tax revenue, but used it for additional public expenditure. Had Italy applied the interest saved to redeem its debt, its debt-to-GDP ratio today would be just 18%. Italy absorbed only modest amounts of foreign credit in the years before the crisis and never really prospered under the euro. Together with Germany, it posted the lowest growth rate of all European countries in the pre-crisis period. Nevertheless, and somewhat surprisingly, goods prices exploded, depriving Italy of its competitiveness. From 1995 to 2008, i.e. from the Madrid Summit to the Lehman collapse, Italian prices increased by 41%. If we add to this the open revaluation of the Lira in 1996, Italian prices in terms of deutschmarks or euros increased by 55%. Relative to the rising prices in the rest of the euro area, they increased by 27%; relative to German prices, by 48%.

3. THE NECESSARY DEPRECIATIONS

All this has to be changed by turning the price watch backwards. According to a study by Goldman Sachs Economics Research (2013), based on the price level in Q3/2010, Italy will have to cut its relative price level by 5 – 15% to achieve external debt sustainability,³ a rather modest depreciation thanks to the small size of its external debt position, which amounts to only 22% of GDP.

Steeper depreciations are needed for countries with higher external debt levels. According to the Goldman Sachs study, the relative prices of Spain, Greece and Portugal will have to come down by 25 – 35% to achieve external debt sustainability. France will have to cut its relative price level by 15 – 25%. Only Ireland would need no price adjustments to be able to service its debt. Germany, in contrast, will have to become 15 – 25% more expensive relative to the EU average to reduce its net foreign asset position to below 25% of GDP.

Table 1: Realignment needs in the euro area as of Q3/2010 relative to the euro area average*

Country	Depreciation	Average	Necessary price cut to come to par with Turkey
Portugal	25 – 35 %	30 % (20%**)	30 %
Greece	25 – 35 %	30 % (20%**)	38 %
Spain	25 – 35 %	30 % (27.5%**)	
France	15 – 25 %	20 %	
Italy	5 – 15 %	10 % (5%**)	
Country	Appreciation	Average	
Ireland	0 – 5 %	2.5 % (0%**)	
Germany	15 – 25 %	20 %	

* Based on the GDP deflator, assuming an external adjustment of the euro exchange rates so as to keep constant the overall terms of trade of the euro area vis-à-vis the rest of the world.

** As of Q3/2012, taking the rescue operations and interest-reducing policies into account.

Source: Goldman Sachs Economics Research (2013); OECD Database OECD.StatExtracts, National Accounts, PPPs and exchange rates; Ifo Institute calculations.

It should be emphasised that the Goldman Sachs figures can only be interpreted roughly as giving the depreciation necessary to achieve competitiveness. What they show is the necessary realignment to achieve external debt sustainability, in the sense that the net foreign asset or debt position, respectively, reduces to less than 25% of GDP in the long run. This obviously implies that the realignment need is smaller:

- (i) the larger the growth rate of the country considered,
- (ii) the lower the interest rate,
- (iii) and the larger the debt relief provided to the country in question.

³ Goldman Sachs Economics Research (2013). It is assumed in the Goldman Sachs calculations that the average price level of the euro area relative to the rest of the world stays constant, such that any deviation in the average euro area inflation rate is automatically compensated by a change in the external value of the euro.

Unfortunately, the new Goldman Sachs study does not inform the reader about its growth assumptions. In last year's report (Goldman Sachs Global Economics 2012), it assumed that nominal growth in Greece and Portugal was 2%; in Ireland, Spain and Italy 3%, and in Germany and France 4%. Given the realignment needs, which will be discussed further below, these figures seem overly optimistic, at least for France and Spain, if they were really used for the new Goldman Sachs study as well.

The role of interest rates is important inasmuch as they came down thanks to the interventions of the ECB and the insurance protection provided to investors by the community of euro area states. On the one hand, these interventions drove down the market rates; on the other, they took the form of public credit, which was offered at below-market conditions. Of particular importance was the Target credit provided to the crisis countries, on the order of 948 billion euros for the six crisis countries by September 2012, which is currently being made available for the private economy at an interest rate of only 0.75%.⁴ The open debt relief provided to Greece in Spring 2012, together with the indirect relief through postponing and reducing interest payments, have also significantly reduced the realignment needed.

Table 1 shows in brackets the realignment needs once these public interventions are taken into account: they fall from an average of 30% to just 20% for Greece and Portugal, and from 10% to 5% for Italy. Trivially, they would be zero for all countries involved if all received a sufficient amount of debt relief through low interest rates and haircuts.

The realignment needs for France and Germany, by contrast, stayed at 20%, albeit with opposite signs. The realignment need for Spain fell from 30% to 27.5%. Somewhat surprisingly, this figure is much higher than the estimate of 20% for Spain that Goldman Sachs had published just a year ago (see Goldman Sachs Global Economics 2012). Thus, the situation in Spain is obviously considered much more pessimistic than before.

Another approach to calculate realignment needs is based on OECD purchasing power parity (PPP) comparisons with other countries, as shown by the third column of Table 1. For Greece and, to a limited extent, Portugal, Turkey might be a suitable reference, given that that country has a flexible exchange rate determined by market forces and is on a similar development level with similar products. In 2011, Greece was 61% more expensive than neighbouring Turkey; it would thus have to depreciate by 38% to regain its competitiveness. The corresponding devaluation figure for Portugal is 30%, since Portugal is 43% more expensive than Turkey. These figures are, as the table shows, roughly in line with the Goldman Sachs estimates that do not consider the impact of the rescue operations.

The realignment is necessary to achieve debt sustainability and regain competitiveness, and competitiveness is the pre-requisite for new growth. Growth through artificial Keynesian demand stimuli is not sustainable. At best it is an improvement in capacity utilization. Sustainable growth, by contrast, will only result if a country is truly competitive in the sense of being inexpensive enough, given the nature and quality of its products, to enjoy high demand for its products from abroad be an attractive business location.

⁴ See Sinn and Wollmershäuser (2012a).

4. THE DEVALUATIONS ACHIEVED THUS FAR

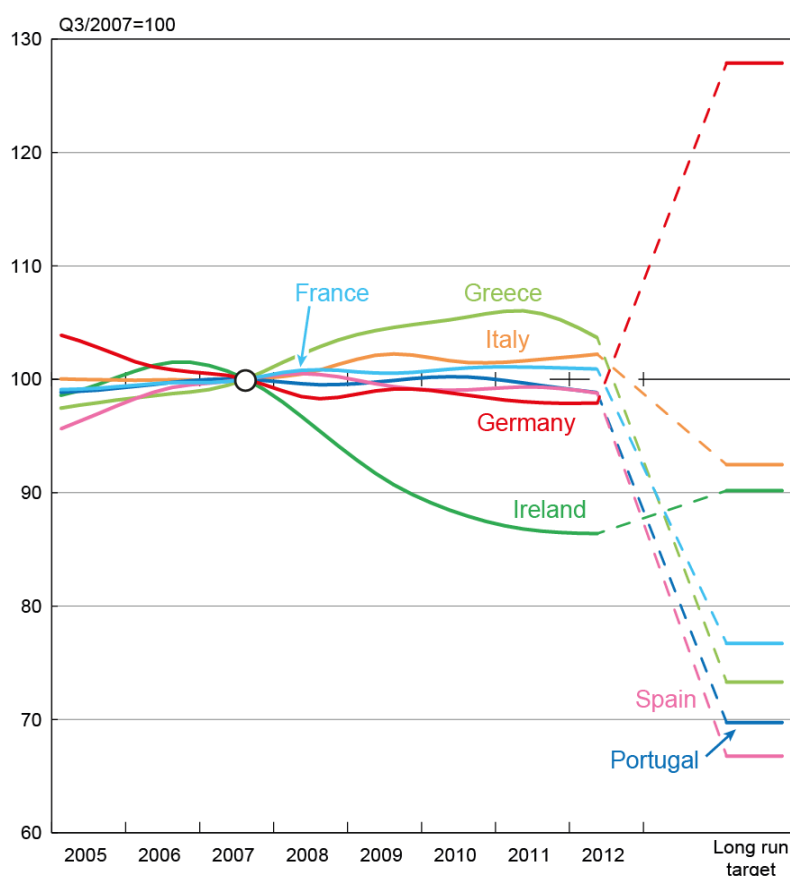
The question now is how much of the necessary realignment has already been achieved by the respective countries. The answer can be found in the Eurostat data on real exchange rates. These data basically give the GDP deflator of a country relative to a weighted average of the GDP deflator of other euro area countries. They are reported by the curves in Figure 2, where Q3/2007, the beginning of the crisis, is set equal to 100.

The chart shows that, unfortunately, not much has happened during the crisis. Most of the troubled countries either became even more expensive relative to their competitors than before, or stayed on the same relative price level. From Q3/2007 to Q2/2012, the relative Spanish and Portuguese prices fell by 1.2%. By contrast, the Greek relative price level increased by 3.7%; which is roughly the effect of indirect tax increases.

Germany's relative price level declined by 2.1%, while France's increased by 0.9%, both moving in the wrong direction.

Only the Irish relative price level changed to a significant degree. From Q3/2007, the first quarter after the interbank market first seized up, to Q2/2012, it declined by 14%. But the Irish prices had begun to come down even earlier, after the Irish real estate bubble burst in 2006. From the peak in Q3/2006 to Q2/2012, the Irish price level fell by 15% relative to the rest of the euro area. Together with the interest relief, the rescue funds and the low-interest policy of the ECB, this realignment has turned the Irish current account deficit from strongly negative to slightly positive.

Figure 2: Real exchange rates: development and necessary realignment



Source: European Commission, Economic and Financial Affairs, Economic databases and indicators, Price and Cost Competitiveness; Goldman Sachs Economics Research (2013); Ifo Institute calculations.

Why did Ireland succeed in cutting its relative prices, while the other crisis countries failed? The answer seems to be that Ireland's bubble burst already in 2006, while the other countries lurched into their respective crises after the Lehman debacle in autumn 2008. Whereas Ireland had to help itself by instituting wage and price cuts, the other crisis-stricken countries preferred to have their financial problems solved by collective rescue operations via the ECB, EFSF and ESM. Ireland later also benefited from these operations, but it remains the only country that has managed a sizeable real depreciation.

The chart also illustrates the difference between the depreciation already achieved and the average target price level according to the Goldman Sachs study. For this purpose, the Goldman Sachs figures were recalculated so that they fit the Eurostat definition of the reference price level against which the necessary revaluations and devaluations are to be seen ("rest of euro area" instead of "euro area average"). This is the reason why the realignment percentages shown in the figure exceed those in Table 1 for the bigger countries. Plainly, Greece, Spain and Portugal have a particularly long way to go to achieve debt sustainability, but practically none of the necessary adjustment has taken place yet, despite the fact that the crisis has lasted already more than five years. To a certain extent, this also applies to France and Germany, which have to devalue and revalue, respectively, by about 20% against the average which, translated into the Eurostat definition of a real exchange rate, implies devaluations and revaluations against the respective rest of the euro area of 24% (France) or 30% (Germany).

5. OTHER INDICATORS

Instead of looking at the GDP deflator, it may also be useful to look up the Eurostat figures for export prices. However, this does not improve the picture. With the exception of Spain, in all crisis countries export prices relative to the rest of the euro area declined by even less than the GDP deflator.⁵ The same was true for France, whereas in Germany export prices declined by even more than the GDP deflator. All this is bad news inasmuch as it dwarfs the hope that the true improvement in competitiveness is larger than suggested by the GDP deflator, since the Balassa-Samuelson effect may have hidden the true improvement in price competitiveness. For example, differential productivity increases in tradeables could have translated into wage increases and hence price increases of non-tradeables that compensated the reduction in the price of tradeables, hiding the true improvements in competitiveness. The fact that export prices fell by less than the GDP deflator rules this possibility out.

And although Spain is an exception, its export prices did not really come down all that much. While its GDP deflator declined by 1.2% relative to the rest of the euro area from Q3/2007 to Q2/2012, its export prices relative to the rest of the euro area declined by 2.0%, just 0.8 percentage points more than the GDP deflator.

The only thing that has improved in some crisis countries are relative unit labour costs. From Q3/2007 to Q2/2012, they came down by 8.6% in Greece, 6.2% in Portugal, and 9.9% in Spain, and increased by 1.6% in France and 1.9% in Italy. Some of these changes are larger than the respective reductions in the GDP deflators, but others even go in the wrong direction.

However, caution is called for. For one thing, unit labour cost reductions improve the competitiveness only if, and to the extent that, they reduce a country's goods prices. If they don't, they do not improve the country's competitiveness. They are instrumental variables at best, and by no means alternative measures of competitiveness as many seem to believe.

For another, unit labour costs tend to improve during a crisis simply because jobs and firms with high unit labour costs are wiped out first. The improvement of the average unit labour cost of the surviving jobs therefore may be little more than a statistical artefact.

When Germany suffered from its own euro crisis around 2003 and the Schröder government was forced to carry out painful social reforms, unit labour costs had improved due to the increasing mass unemployment that affected Germany. Some observers had regarded this as a sign of improvement, arguing that the painful wage reductions that the Schröder reforms implied would no longer be necessary. In fact, however, instead of an improvement in competitiveness, it was the destruction of low-skilled jobs with low labour productivity relative to wages that had improved the statistics.

A similar remark is appropriate for the improvements in the current accounts of the crisis countries. While everywhere exports and imports recovered after the Great Recession in 2009, in Q3/2012 exports were back on trend only in Ireland. In Spain and Portugal they were approaching the trend, but were still about 5% below it,⁶ while in Greece they were 26% below trend in Q1/2011. The reason for the current account deficit improvements is primarily a strong decline in imports, which did not signal an improvement in

⁵ European Commission, Economic and Financial Affairs, Price and Cost Competitiveness - Data Section, http://ec.europa.eu/economy_finance/db_indicators/competitiveness/data_section_en.html.

⁶ In Q3/2012, Irish exports had reached 99% of the trend value, Spanish ones 96% and Portuguese ones 95%, trends calculated as linear trend in the period 2002 – 2007.

competitiveness but was simply a result of the recession. Declining incomes and mass unemployment constituted an income effect that necessarily reduced imports.

What southern Europe needs is not an income effect, but a substitution effect resulting from lower relative prices, because only such a substitution effect can reduce the current accounts structurally, i.e. through improvements in competitiveness rather than an increase in unemployment. Alas, as the above analysis showed, there is no evidence of such a development yet.

6. TRAPPED IN THE EURO

Given the history of economic thought about downward price stickiness, this comes as little surprise for economists. After all, both Keynes⁷ and Friedman⁸ alike, the two great antagonists of the field, had agreed that a real devaluation through wage and price cuts is difficult if not impossible. And there is a large body of literature showing that this is the case, and why.⁹

In some countries there is a huge gap between the austerity programmes necessary to induce sufficient price cuts to make the country competitive, and those that a society can tolerate without sliding into social unrest, if not civil war. Greek President Antonis Samaras was right when he compared Greece with the Weimar Republic.¹⁰ When Germany was forced to cut its product prices by 23% from 1929 to 1933 by austerity programmes (Brüningsche Notverordnungen or Brüning's emergency measures), there were riots in German streets and leftwing and rightwing brigades engaged in pitched street battles. The country was indeed being driven to the brink of a civil war. What came instead in 1933 was much worse.

One of the reasons for the downward stickiness of prices and wages is the resistance of unions against unilateral wage cuts. If you start by cutting wages in one sector, the union representing that sector will object, since it fears to be the only one, so that not only the absolute but also the relative income position deteriorates. Only a coordinated wage cut in all sectors can overcome this problem, but that is hard to achieve.

Another reason for the downward stickiness is that the balance sheets of companies are distorted. When all prices fall, so do the prices of the real assets a firm owns. However, the bank debt of that firm remains unchanged. This exacerbates the risk of bankruptcy.

A similar argument applies to any private debtor who has to service his debt by using part of his income, e.g. a homeowner who is servicing his debt out of current income. An internal depreciation reduces his income in nominal terms and makes it more difficult, if not impossible, to continue servicing the debt. Thus not only firm bankruptcies but also private bankruptcies have to be expected after an internal depreciation by way of wage and price cuts.

True, the Irish example does show that some real depreciation is possible. However, in the Irish case a relative price cut of only 15% over a period of about 6 years (Q3/2006 to Q2/2012) was sufficient. It implied an absolute price reduction of just 8%.

By contrast, Greece and Portugal need a relative depreciation of 30% or more to become competitive again and be able to service their debt without foreign help. If the Turkey price comparison is used, Greece even needs a price cut of about 40%. That is quite a different order of magnitude. To achieve such cuts in relative prices one can try extreme austerity programmes to depress wages, but the result would in all likelihood be mass unemployment that tears at the very fabric of society.

In Greece, the labour market situation today is already hardly sustainable, with youth unemployment exceeding 50% and an official rate of unemployment moving towards 30%. This catastrophe results from the attempt to try the impossible.

⁷ Keynes (1960, p. 267).

⁸ Friedman (1976, pp. 214).

⁹ See for example Bewley (1999).

¹⁰ See Crawford (2012). The comparison was also made by other observers. See, e.g., Sinn (2011).

7. THE EXIT OPTION

The possibly fatal problems resulting from wage and price cuts of the order required to achieve competitiveness could be avoided by exiting the euro and devaluating the new currency formally, because that is in effect a coordinated wage and price cut relative to the prices of other countries. It would redirect demand away from imports to domestic products, increase demand for the country's exports and reduce the euro value of the country's internal debt along with the euro value of internal prices, thus avoiding the balance sheet distortion for firms and indebted private households.

True, there remains a problem with external debt denominated in euros, which would increase relative to domestic income after an open devaluation. However, an internal devaluation by cutting wages and prices brings about exactly the same problem. In both cases, the problem of unbearable foreign debt levels would have to be solved by haircuts on external debt. The advantage of an open devaluation over an internal depreciation through wage and price cuts is that it avoids the internal balance sheet distortion and circumvents union resistance.

As proposed in Sinn and Sell (2012), one could offer a country, while formally staying a euro area member, the possibility of temporarily exiting the euro to accomplish the necessary realignment via an open devaluation. If the existing euro banknotes are given to the country, and funds are provided to recapitalise its banking sector and subsidise sensible imports while some of the external debt is forgiven, this could be organised overnight with a minimal pain and prepare the ground for a quick economic recovery.

The exit option nevertheless involves some dangers. In particular, there could be contagion effects via the capital markets, of which any trained economist could paint dramatic pictures. However, in my judgment the dangers of an exit are minuscule compared to the horrors resulting from a non-exit.

Apart for the risk of social strife, I see these horrors in particular in the political contagion effect resulting from a membership guarantee. If a country can be sure that it will be kept in the euro with sufficient public support from other countries, there is an incentive for this country not to attempt the painful reforms that would be necessary for an internal depreciation. That is a sure way to perpetuate the problems.

Politicians may hope to be able to push through the necessary price and wage cuts directly by resorting to political tools. However, the history of broken treaties, rules and promises in the euro area does not bode well. There is no reason to believe that a legislated and rule-based approach will operate better in the future than in the past. The willingness to sign declarations and commitments necessary to receive the rescue funds will always be there, but once the money is in, the commitments entered into are not taken seriously any longer.

8. INFLATING THE CORE

The political problems foreseeable for a strategy of internal depreciation through price cuts, as well as the market uncertainty resulting from euro exits could be avoided if the south's real depreciation could be brought about by inflating the north.

However, inflation would have to be substantial and would create new problems for the northern countries. To illustrate this, let us assume that France succeeds in accomplishing the necessary realignment in a period of ten years of stagnation with an inflation rate of zero. Since France has to devalue by 20% against the euro area average price level, this implies that the average annual inflation rate of the euro area is 2.3%.¹¹ Since Germany in turn needs to appreciate by 20% against the average, it would have to inflate by 4.1% per year.¹² Spain in this case would have to deflate by 1.3% per year to realise a relative price cut by 30%. Even more demanding would be the 30% depreciation of Spain. If this is to be achieved with a decade of stagnation that keeps the Spanish price level constant, the average inflation rate in the euro area would have to be 3.6% per year, and Germany would have to inflate by 5.5% per year.

It is unclear though whether such a solution is politically feasible. There is a legal problem, given that the ECB's only mandate, according to the Maastricht Treaty, is to maintain price stability.¹³ If fluctuations in relative prices in the euro area are always realised without any country being driven to deflation, average inflation would necessarily violate the Treaty. From a legal perspective, a revision of the Maastricht Treaty would be necessary to choose this policy option.

Moreover, it is unclear whether the German population would accept being deprived of their savings. Given the devastating experiences Germany made with hyperinflation from 1914 to 1923, which in the end undermined the stability of its society, the resistance against an extended period of inflation in Germany could be as strong or even stronger than the resistance against deflation in southern Europe. After all, a rate of 4.1% for German inflation for 10 years, which would be necessary to allow the necessary realignment between France and Germany without France sliding into a deflation would mean that the German price level would increase by 50% and that, in terms of domestic goods, German savers would be deprived of 33% of their wealth. If the German inflation rate were even 5.5%, which would be necessary to accommodate the Spanish realignment without price cuts, its price level would increase by 71% over a decade and German savers would be deprived of 42% of their wealth.

And although the core countries would suffer, the solution would not be comfortable for the devaluating countries either. They will unavoidably face a long-lasting stagnation with rising mass unemployment and increasing hardship for the population at large. People will turn away from the European idea and voices opting for exiting the euro will gain strength.

¹¹ A French devaluation of 20% means that the euro area average price index grows by 25% while French prices stay constant (because $100/125=0.8$). Over a period of ten years this implies an annual average inflation rate of the euro area by 2.3%.

¹² When the European average price level increases from 100 to 125 as shown in the previous footnote and Germany revalues by 20% relative to the average, the German price level has to increase from 100 to 150, given that $150/125=1.2$. Over a period of ten years this implies an annual German inflation rate of 4.1%.

¹³ "Article 105: The primary objective of the ESCB shall be to maintain price stability. Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Community with a view to contributing to the achievement of the objectives of the Community as laid down in Article 2. The ESCB shall act in accordance with the principle of an open market economy with free competition, favouring an efficient allocation of resources, and in compliance with the principles set out in Article 3a." (Treaty on European Union, Official Journal C 191, 29 July 1992).

Thus, it might be politically impossible to induce the necessary differential inflation in the euro area.

Apart from that it is unclear whether the ECB would be technically able to bring about inflation in the core countries. After all, its main refinancing rate is already close to zero, indicating that the euro area is in a classical liquidity trap, where additional money creation is unable to stimulate additional demand. Japan, whose central bank had flooded the economy with money and kept the interest rate at a level of about zero since 1997, following the bursting of its own real estate bubble in 1990, shows that the risk of secular stagnation, to use a term that Alvin Hansen once coined, is all too real.¹⁴ Such a phase would be self-destabilizing, since deflation would induce even more money hoarding, less aggregate demand and further deflation.

¹⁴ See Hansen (1938).

9. STAGFLATION VS DEMAND INFLATION

Some politicians, such as Christine Lagarde, have argued that to bring about the required inflation in the core, the core countries should mandate higher wages through direct government actions or by encouraging unions to perform more aggressive negotiations.¹⁵ That, however, would be counterproductive as it would bring about a stagflation, i.e. a negative supply shock driving up prices through increases in the cost of production. Such a negative supply shock would not contribute to rebalancing Europe, because it would reduce the core countries' incomes and imports, which is the opposite of what the periphery countries need to improve their competitiveness and the sustainability of their debt. Theoretically, it is not even clear whether the current accounts of the core countries would really deteriorate after a dictated wage increase.

What the euro area needs for its internal realignment is a demand-driven boom in the core countries. Such a boom would also increase wages and prices, but it would do so because of demand rather than supply effects. Such demand-driven wage and price increases would come through real and nominal income increases in the core and increasing imports from other countries, and at the same time they would undermine the competitiveness of exports. Both effects would undoubtedly work to reduce the current account surpluses in the core and the deficits in the south.

The demand-driven boom could perhaps be artificially created in the core by extensive government borrowing, the Keynesian recipe. However, apart from doubts about the efficacy of such a policy, it would be problematic insofar as it shifts the burden of the debt to future generations. From a legal perspective, the government debt-to-GDP ratio is already large, far above the admissible 60% limit stipulated in the Maastricht Treaty. Deficits would moreover violate the Stability and Growth Pact as well as the new rules of the Fiscal Compact enacted in 2012.

An alternative way to generate the necessary boom in the core is to simply let the market forces work. After years of extensive and excessive capital exports to the southern countries, investors from the north now have realised their mistake and look more towards investment in the home harbour. This is the reason for the investment and property boom that Germany has experienced since the summer of 2009 and that has accorded it an above-average growth rate since then. After years of stagnation, mass unemployment and real depreciation which called for painful social reforms (Agenda 2010) and pushed Germany's GDP per capita from second to eighth position among the euro countries in the period from the Madrid Summit to 2008, the country has profited from a rebalancing of capital flows since the middle of 2009. Finland has profited from a similar effect.

The new boom generated in the northern countries because of the reluctance of capital exporters is exactly what Europe needs for a realignment of current account deficits. In fact, since the current account balances are by definition equal to international capital flows, a rebalancing of current accounts automatically entails a rebalancing of capital flows, implying and requiring it.

During the crisis, capital markets overreacted. This induced the ECB to shift its stock of refinancing credit from north to south, inducing the national central banks of the north to provide Target credit to the south. This led to Germany's current account surplus having been entirely absorbed by the Target credit drawn from the Bundesbank in the past few years, which is a purely public capital flow. In fact, while private capital was moving back home to Germany, public capital, primarily in the form of Target credit but also of

¹⁵ See Vinocur and Thomas (2012).

intergovernmental credit, was flowing abroad. The public credit compensated for the dearth of private capital flows from north to south, helping to finance the current account imbalances and compensating, in addition, for outright capital flight taking the form of credit stocks being called back home from south to north.¹⁶

It is time to end this policy. If the goal is to rebalance the current accounts, re-establish competitiveness as a prerequisite of new growth, reduce inter-country indebtedness within the euro area, a status quo that is likely to breed political tensions, public interventions that artificially reinstate capital flows from north to south should be reduced rather than expanded. It is a contradiction in terms if politicians argue that they want to reduce the current account imbalances in the euro area while, at the same time, they demand more public rescue measures that in effect replace private with public capital flows.

While public interventions into the allocative role of the capital market can be temporarily legitimated with the goal of stabilizing the economies of the south and preventing a looming crash, it is clear that, if carried out for a long period of time, they will undermine the goal of rebalancing the current accounts in the euro area and re-establishing competitiveness. This is an unavoidable policy conflict that policymakers should stop denying. They should instead acknowledge that the necessary rebalancing process of the Eurosystem will require a decade of austerity, stagnation and real devaluations in the deficit countries, coupled with an extended period of inflation in the surplus countries. It can only be hoped that the European idea will survive this strain.

¹⁶ See Sinn and Wollmershäuser (2012a and 2012b).

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NOTES

PRESENTATION XAVIER TIMBEAU

Interparliamentary Committee Meeting
29/1/2013

Austerity and Growth

Xavier Timbeau

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The Great Recession is going on

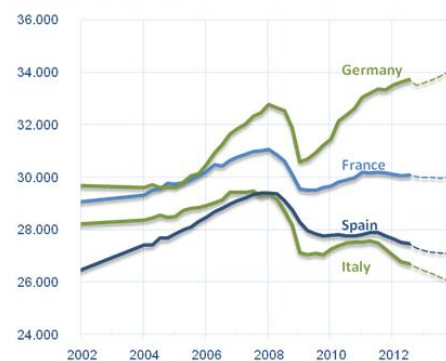
- Despite encouraging sign on financial ground, the crisis is going on
 - Euro banks stabilized; Spain and Italy near full financial markets access
- The light at the end of the tunnel may be the train coming the other way
 - No growth, unemployment, social crisis ahead, long term consequences of the slump in Europe

GDP growth forecast

GDP yearly growth	2011	2012	2013
Germany	3.1	0.8	0.6
France	1.7	0.1	0.1
Italy	0.6	-2.1	-1.5
Spain	0.4	-1.3	-1.3
Netherlands	1.1	-0.9	-0.4
Belgium	1.8	-0.2	-0.2
Ireland	1.4	-0.4	-0.4
Portugal	-1.7	-2.8	-2.2
Greece	-6.2	-6.2	-3.7
Austria	2.7	0.5	0.1
Finland	2.7	0.4	0.4
Eurozone	1.5	-0.4	-0.3

OFCE IMK ECLM joint forecast,
iAGS 2013, nov. 2012

Euro Area: GDP per head



Memo : Commission forecasts

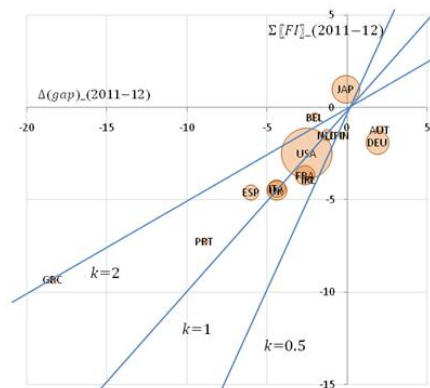
2012: -0.4%
2013: +0.1%

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Fiscal multipliers in time of recession

Fiscal impulsion 2010-2013

	2010	2011	2012	2013
Germany	1.5	-0.9	-0.5	0.0
France	-0.5	-2.0	-1.6	-1.8
Italy	-0.4	-1.2	-3.2	-2.1
Spain	-2.5	-1.1	-3.4	-2.4
Netherlands	-1.1	-0.2	-1.0	-1.2
Belgium	-0.3	-0.1	-1.1	-0.8
Ireland	-4.4	-1.5	-2.4	-1.8
Portugal	-1.7	-3.7	-3.7	-1.8
Greece	-8.0	-5.3	-5.0	-3.9
Austria	0.6	-1.6	-0.1	-0.9
Finland	1.5	-1.6	-0.4	-1.3
Euro area	-0.3	-1.3	-1.7	-1.4



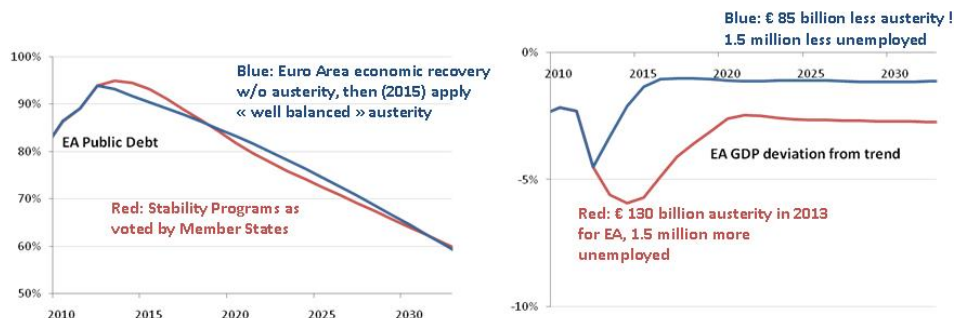
Fiscal impulsion is the opposite of the primary structural public deficit variation

- Strongest austerity plans ever, for 3 to 4 years
- Due to degraded outlook, fiscal multipliers are high
 - Low multipliers are met when economic agents are able to smooth over foreseeable future
 - Recession makes smoothing harder and costlier, future more gloomy and difficult to forecast
- Austerity is ill-designed: it causes recession instead of curing it

X. Timbeau

An other way is possible

- **“well balanced” austerity is the solution**
 - Waiting for better time to reduce public deficits
 - Delayed austerity would allow debt reduction to 60% GDP in most countries in 2032, with more growth and less unemployment
- **Addressing the “financial market pressure” needs a clear involvement of ECB**
 - OMT is a step, conditionality shall state delayed austerity and commitment to medium term
- **All that is compatible with existing treaties...**
- **... but in need of a strong commitment of countries to long term public finance stability**
 - Fiscal sovereignty transfer to democratic EU institutions



Have a look to iAGS 2013 report (www.iags-project.org) !

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NOTES

DIRECTORATE-GENERAL FOR INTERNAL POLICIES

POLICY DEPARTMENT ECONOMIC AND SCIENTIFIC POLICY **A**

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