The debacle of austerity

By Xavier Timbeau

This text summarizes the OFCE's October 2012 forecasts.

The year 2012 is ending, with hopes for an end to the crisis disappointed. After a year marked by recession, the euro zone will go through another catastrophic year in 2013 (a -0.1% decline in GDP in 2013, after -0.5% in 2012, according to our forecasts – see the table). The UK is no exception to this trend, as it plunges deeper into crisis (-0.4% in 2012, 0.3% in 2013). In addition to the figures for economic growth, unemployment trends are another reminder of the gravity of the situation. With the exception of Germany and a few other developed countries, the Western economies have been hit by high unemployment that is persisting or, in the euro zone, even rising (the unemployment rate will reach 12% in the euro zone in 2013, up from 11.2% in the second quarter of 2012). This persistent unemployment is leading to a worsening situation for those who have lost their jobs, as some fall into the ranks of the long-term unemployed and face the exhaustion of their rights to compensation. Although the United States is experiencing more favourable economic growth than in the euro zone, its labour market clearly illustrates that the US economy is mired in the Great Recession.

Was this disaster, with the euro zone at its epicentre, an unforeseeable event? Is it some fatality that we have no choice but to accept, with no alternative but to bear the consequences? No – the return to recession in fact stems from a misdiagnosis and the inability of Europe's institutions to respond quickly to the dynamics of the crisis. This new downturn is the result of massive, exaggerated austerity policies whose impacts have been underestimated. The determination to urgently rebalance the public finances and restore the credibility of the euro zone's economic management, regardless of the cost, has led to its opposite. To get out of this rut will require reversing Europe’s economic policy.

The difficulty posed by the current situation originates in widening public deficits and swelling public debts, which reached record levels in 2012. Keep in mind, however, that the deficits and public debts were not the cause of the crisis of 2008-2009, but its consequence. To stop the recessionary spiral of 2008-2009, governments allowed the automatic stabilizers to work; they implemented stimulus plans, took steps to rescue the financial sector and socialized part of the private debt that threatened to destabilize the entire global financial system. This is what caused the deficits. The decision to socialize the problem reflected an effort to put a stop to the freefall.

The return to recession thus grew out of the difficulty of dealing with the socialization of private debt. Indeed, in the euro zone, each country is forced to deal with financing its deficit without control of its currency. The result is immediate: a beauty contest based on who has the most rigorous public finances is taking place between the euro zone countries. Each European economic agent is, with reason, seeking the most reliable support for its assets and is finding Germany’s public debt to hold the greatest attraction. Other countries are therefore threatened in the long-term or even immediately by the drying up of their market financing. To attract capital, they must accept higher interest rates and urgently purge their public finances. But they are chasing after a sustainability that is disappearing with the recession when they seek to obtain this by means of austerity.

For countries that have control of their monetary policy, such as the United States or the United Kingdom, the situation is different. There the national savings is exposed to a currency risk if it attempts to flee to other countries. In addition, the central bank acts as the lender of last resort. Inflation could ensue, but default on the debt is unthinkable. In contrast, in the euro zone default becomes a real possibility, and the only short-term shelter is Germany, because it will be the last country to collapse. But it too will inevitably collapse if all its partners collapse.

The solution to the crisis of 2008-2009 was therefore to socialize the private debts that had become unsustainable after the speculative bubbles burst. As for what follows, the solution is then to absorb these now public debts without causing the kind of panic that we were able to contain in the summer of 2009. Two conditions are necessary. The first condition is to provide a guarantee that there will be no default on any public debt, neither partial nor complete. This guarantee can be given in the euro zone only by some form of pooling the public debt. The mechanism announced by the ECB in September 2012, the Outright Monetary Transaction (OMT), makes it possible to envisage this kind of pooling. There is, however, a possible contradiction. In effect this mechanism conditions the purchase of debt securities (and thus pooling them through the balance sheet of the ECB) on acceptance of a fiscal consolidation plan. But Spain, which needs this mechanism in order to escape the pressure of the markets, does not want to enter the OMT on just any conditions. Relief from the pressure of the markets is only worthwhile if it makes it possible to break out of the vicious circle of austerity.

The lack of preparation of Europe’s institutions for a financial crisis has been compounded by an error in understanding the way its economies function. At the heart of this error is an incorrect assessment of the value of the multipliers used to measure the impact of fiscal consolidation policies on economic activity. By underestimating the fiscal multipliers, Europe’s governments thought they could rapidly and safely re-balance their public finances through quick, violent austerity measures. Influenced by an extensive economic literature that even suggests that austerity could be a source of economic growth, they engaged in a program of unprecedented fiscal restraint.

Today, however, as is illustrated by the dramatic revisions by the IMF and the European Commission, the fiscal multipliers are much larger, since the economies are experiencing situations of prolonged involuntary unemployment. A variety of empirical evidence is converging to show this, from an analysis of the forecast errors to the calculation of the multipliers from the performances recorded in 2011 and estimated for 2012 (see the full text of our October 2012 forecast). We therefore believe that the multiplier for the euro zone as a whole in 2012 is 1.6, which is comparable to the assessments for the United States and the United Kingdom.

Thus, the second condition for the recovery of the public finances is a realistic estimate of the multiplier effect. Higher multipliers mean a greater impact of fiscal restraint on the public finances and, consequently, a lower impact on deficit reduction. It is this bad combination that is the source of the austerity-fuelled debacle that is undermining any prospect of re-balancing the public finances. Spain once again perfectly illustrates where taking this relentless logic to absurd lengths leads: an economy where a quarter of the population is unemployed, and which is now risking political and social disintegration.

But the existence of this high multiplier also shows how to break austerity’s vicious circle. Instead of trying to reduce the public deficit quickly and at any cost, what is needed is to let the economy get back to a state where the multipliers are lower and have regained their usual configuration. The point therefore is to postpone the fiscal adjustment to a time when unemployment has fallen significantly so that fiscal restraint can have the impact that it should.

Delaying the adjustment assumes that the market pressure has been contained by a central bank that provides the necessary guarantees for the public debt. It also assumes that the interest rate on the debt is as low as possible so as to ensure the participation of the stakeholders who ultimately will benefit from sustainable public finances. It also implies that in the euro zone the pooling of the sovereign debt is associated with some form of control over the long-term sustainability of the public finances of each Member State, *i.e.* a partial abandonment of national sovereignty that in any case has become inoperative, in favour of a supranational sovereignty which alone is able to generate the new manoeuvring room that will make it possible to end the crisis.

OFCE growth forecasts, October 12

Annual growth in GDP, %

	2011	2012	2013
Euro zone	1,5	-0,5	-0,1
Germany	3,1	0,8	0,6
France	1,7	0,1	0,0
Italy	0,5	-2,4	-1,1
Spain	0,4	-1,4	-1,2
Netherlands	1,1	-0,2	0,3
Belgium	1,8	-0,1	0,9
Finland	2,8	0,8	1,1
Austria	2,7	1,0	0,5
Portugal	-1,7	-2,8	-1,2
Greece	-6,2	-6,2	-3,7
Ireland	0,8	-0,4	-0,1
United Kingdom	0,9	-0,4	0,3
United States	1,8	2,2	0,9
Japan	-0,7	2,4	1,3

Sources : National calculations, OFCE forecasts October 2012.

Fiscal policy honoured

By Jérôme Creel

"The size of many multipliers is large, particularly for spending and targeted transfers." Who today would dare to write such a thing?

The answer is: 17 economists from the European Central Bank, the US Federal Reserve, the Bank of Canada, the European Commission, the International Monetary Fund, and the Organization for Economic Cooperation and Development, in an article published in January 2012 in the American Economic Journal: Macroeconomics.

They continue in the abstract: “Fiscal policy is most effective if it has moderate persistence and if monetary policy is accommodative. Permanently higher spending or deficits imply significantly lower initial multipliers.”

What are the values of these multiplier effects, and what about the significant reduction in such effects if fiscal policy is expansionary over the long term? According to these 17 economists, based on eight different macroeconometric models for the US and four different models for the euro zone, the conclusion is clear: a fiscal stimulus that is in effect for 2 years, accompanied by an accommodative monetary policy (the interest rate is kept low by the central bank) produces multiplier effects that are well above one both in the United States and in the euro zone (between 1.12 and 1.59) if the stimulus plan targets public consumption, public investment or targeted transfers. For other instruments available to government, such as VAT, the effects are smaller, on the order of 0.6, but still decidedly positive.

What if the stimulus is continued? The multiplier effects of a permanent increase in public consumption dwindles, of course, but they remain positive in the euro zone, regardless of the model used and regardless of the assumption made about the monetary policy pursued. Rare cases of negative multiplier effects are reported for the United States, but these depend on the model used or on assumptions about monetary policy.

Finally, a comment and a question raised by this recent article.

The comment: the choice of an optimal fiscal policy in the euro zone is well worth a few moments of reflection, reading and analysis of current work, rather than a truncated and distorted vision of fiscal policy that is judged without fair consideration as harmful to economic activity.

The question: an expansionary fiscal policy has … expansionary effects on gross domestic product; must we really deprive ourselves of an instrument that is, after all, effective?

Regaining confidence in the euro: Three pressing issues

By [Jérôme Creel]

In a communication on European economic governance before the European Parliament’s ECON Committee on Monday, 17 October 2011, three pressing issues were identified in order to save the euro and improve its management.

Saving the euro without further delay is the priority. To do this, it is necessary to provide the EFSF with sufficient funds and to require the ECB to continue intervening in the market for government bonds, so as to resolve the difference between the long-term rates of the peripheral countries and those in the countries in the heart of the euro zone (Germany, France, Netherlands), where these rates are falling and thus benefiting these countries, whereas the rise in the periphery is placing a heavy burden on the public finances of Greece, of course, but also of Portugal and Spain.

Second, the new legislation amending the Stability and Growth Pact and setting up a symmetrical device for monitoring macroeconomic imbalances needs to be implemented as soon as possible. This second priority is urgent, too: it should in the future allow the euro zone to avoid a new crisis, or at least to protect itself with proper instruments and surveillance. In this context, the European Parliament is being asked to “check the checkers” so as to give a real boost to Europeans’ trust in their institutions.

Finally, it is necessary to ensure the proper functioning of European governance. Nothing has been lost, intelligent rules do exist: they must be applied after consultation. Inflation targeting on the monetary side and a genuine golden rule of public finances on the budget side both need to emerge.

Communication to the European Parliament ECON Committee, 17 October 2011

Dear Honorable Members,

After almost two years of European turmoil related to the bad management of public finances in a few Eurozone countries, and more than four years after a deep worldwide crisis, time is certainly ripe for reaching European solutions to cure the crisis. Two emergencies are at stake: first, stopping distrust’s contagion vis-à-vis Eurozone members; second, stopping misbehaviors’ contagion among Eurozone members in the future. By the way, this second emergency certainly necessitates a separation between two periods: the short run and the longer run.

1. Short run emergency 1: improving trust in the Euro

In order to cope with the first emergency, Eurozone countries need a more automatic solidarity mechanism. There have been different options discussed and implemented so far at the Eurozone level, from the EFSF (then future ESM) to Eurobonds, or the intervention of the ECB on secondary markets. They all need to be enforced and implemented as soon as possible without limitations, otherwise discrepancies in long-term yields on public bonds will continue to grow across Eurozone members, at the expense of countries with twin deficits and at the benefit of countries which are closer to twin balance. Without strong automatic interventions, Eurozone countries take the risk of feeding distrust in their ability to support the Euro. The consequence might be distrust in the future of the Euro, distrust in the future of the EU project.

2. Short run emergency 2: enforcing the “6-pack” with improvement in its democratic content

In order to cope with the second emergency, the European Commission, the President H. van Rompuy and the European Parliament have dealt with the EU governance of the near future through a “6-pack” of legislative amendments which were adopted on 25 September 2011.

A major step has been made in the good direction: macro imbalances are no longer automatically related to deficits as they may also refer to surpluses; and a macro imbalance can be considered “excessive” only to the extent that it “jeopardizes or risks jeopardizing the proper functioning of the EMU”. This is clear understanding that provided Eurozone countries are primarily partners rather than competitors, their trade links shall not be automatically confounded with risky imbalances for they do not impinge on the common currency, the Euro.

The “6-pack” also deals with the better enforcement of the Stability and Growth Pact, introducing earlier sanctions, and a more comprehensive fiscal surveillance framework. This is certainly necessary to make sure that the risk of moral hazard in the Eurozone is reduced to a minimum. However, the overall ‘6-pack’ must pass beforehand criteria for the effectiveness of a fiscal rule.

There have been different ways to assess reform proposals for economic policies. A well-known and convenient one is a set of criteria first developed by George Kopits and Steven Symansky at a time when both were working at the IMF. According to them, a fiscal rule is effective if it is well-defined, transparent, simple, flexible, adequate relative to goal, enforceable, consistent and efficient. In an amendment by the European Parliament related to macro imbalances, one can read that the indicators in the scoreboard must be relevant, practical, simple, measurable and available; moreover, flexibility is advocated in the assessment of macro imbalances. The Kopits-Symansky criteria are thus still relevant, and only their seventh criterion, consistency, seems to have been forgotten from the list. Does it reveal that through the current reform proposals, no one wishes to deal with monetary policy, which consistency with fiscal policies might well be assessed, and the other way round?

I have written elsewhere my own views on Kopits and Symansky's set of criteria (Creel, 2003; Creel and Saraceno, 2010), but I think I need to insist on the simplicity one. I fear the existence of a so-called "simplicity" criterion when complex problems are arising. For instance, a strong public deficit may be due to 'bad times' (recession, slow GDP growth), interest rates hikes, wrong policies, a non-existing tax system, etc. A simple rule cannot handle the multiplicity of the causes for a deficit. I also fear that such a criterion is simply disrespectful towards the people: well-informed people can certainly approve complex rules if they believe that those who implement them target the common interest.

It leads me to propose that the "simplicity" criterion is changed into a "democratic" criterion. That change would not be substantial as regards Kopits and Symansky's justification of their criterion: simplicity is required, they say, to enhance the appeal of the rule to the legislature and to the public. Changing “simplicity” into “democratic” would thus be consistent with their view. It would add two advantages. First, there would be no need to target simple or simplistic rules, if more complex ones are required. Second, to enhance their appeal to the public, these rules should be endorsed and monitored by a Parliament: as their members are the representatives of the public, the latter would be fully informed of the nature and properties of the rule.

What would be the main consequences of assessing reform proposals through the lens of democratic content in the current context? First, the now-complex setting of fiscal rules in the EU, under the amendments of 25 September 2011, is well-defined but it is no longer simple. That should not lead us to assume that these rules will not be efficient. Second, if all European authorities, including the European Parliament, approved a stricter surveillance mechanism for fiscal policies, macro imbalances, and employment guidelines, control over the misbehaving countries should be shared with all these authorities, hence also including the European Parliament. The implication of the latter, with that of the European Council, would enhance the appropriation of rules by the public, and the trust of the public in their institutions. Third, another consequence would be that automaticity in sanctions should not be an option for automaticity is contradictory with the essence of a democracy: contradictory debates.

Are the current reform proposals respecting the “democratic” criterion? The implication of the EP in these reforms already calls for a positive answer. Nevertheless, the implication of the EP in “checking the checkers” is necessary to achieve a definite positive answer. This implication might be very productive in reassessing the effectiveness of the policies which are undertaken in a country where suspicion of misbehavior is developing. The implication of the Economic Dialogue and the European Semester should also be used to improve trust in the EU institutions and the Eurozone governments, with due respect to the subsidiarity principle. Sharing information, analyses, data should be viewed by all partners as a way to achieve cooperation, keeping in mind that John Nash showed through his solutions that cooperative equilibria always lead to a win-win situation.

“Checking the checkers”, as I mentioned above, involves an informed assessment of the effectiveness of fiscal policies. Such an assessment is not dealt with in the current Stability and Growth Pact. During the procedure of fiscal surveillance, and before sanctioning a country, it is of the highest priority to gauge the effectiveness of a fiscal policy which has led to higher deficits and debts.

Discussions about fiscal policies are usually very pessimistic nowadays, as far as their effectiveness is concerned, but those endorsing these discussions take the risk that the people have finally no trust in their governments, for they are said to follow the wrong policies, and in the European institutions that are not able to stop these policies.

It may be useful to recall (once again?) that a consensus exists in the economic literature about the sign of the fiscal multiplier: it is positive. And because of that, the Chinese, US, German, French, etc. governments decided to increase their deficits through discretionary policies during the worldwide crisis: these governments were conscious that their policies were helpful. Why shouldn’t they during other ‘bad times’? Why should we all think that a contagion of fiscal restrictions in the EU will help us thrust again? Good policymaking requires that policies are contingent to the economic situation (GDP growth, inflation rate, level of unemployment, etc.).

In my view, at this stage, there are two important prerequisites to a rapid improvement in the EU governance, and I do not think they require a new Treaty. We all know that at the ECB and beyond, some argue that political pressures led this institution to buy public bonds, in contrast, they add, with the EU Treaty. Its independence would have been at stake. For this reason, the first prerequisite is in recalling the independence and mission of the ECB. The ECB is a young institution and it needs confidence in itself, as a teenager does. Once definitely adult, after full confidence is reached, the ECB will not fear coordination or cooperation with governments and the EP that fully respect its independence but may wish to improve the consistency of their policies with its.

The second prerequisite is in recalling the objectives of the EU, growth and stability, and in admitting that there is not a single way to achieve these objectives, for countries are still so different within the EU, even within the Eurozone. The 'one size fits all' is no longer an option, hence the necessity to complement fiscal rules with an assessment of macro imbalances and with regular, transparent, and democratically-controlled assessments of the relevance of the underlying analyses by governments on the one hand, and controllers on the other. There is a strong role for the EP in acknowledging and managing this no 'one size fits all' way of dealing with fiscal rules.

3. Longer run emergency 2: more intelligent rules?

In the longer run, if improvements by the ECB in cooperating with governments have not materialized, a binding commitment to follow a cooperative behavior could be included in the statutes of the ECB. A change in its statutes might also be considered, with a view to adopting, for instance, a dual mandate similar to that of the Fed. That way, it would be clear that "if 5% inflation would have (Central bankers') hair on fire, so should 9% unemployment" (Ch. Evans, 2011). Another possibility would be to urge the ECB to implement full inflation targeting. That would require the ECB to make public its forecasts and minutes of decisions, thus enhancing information and potentially influencing the private sector.

Lastly, the most important debate on fiscal policymaking is in wondering what governments are doing with tax and spending, and how they finance them. The European Semester and the monitoring of indicators of macro imbalances certainly go in the good direction, but rather than a global view on the evolution of deficits and debts, Eurozone countries should think about circumscribing the good and bad parts of taxes and spending and make sure they all target the good policy, at their benefit and at the benefit of others. Of course, this is not an easy task, but it is a task that would make the EU fiscal rules ever more "intelligent".

Having common objectives within Europe 2020, it could be thought of having common tools to reach them: a higher EU budget? Or an authentic but modified golden rule of public finance where some expenditures proved to be productive, with the agreement of all EU member states, would be left out of the scope of binding rules? That is not the hot topic of the day, but had it been before the SGP reform of 2005 that the stability of the Eurozone might not have been at stake the way it has been since the worldwide crisis.

I thank you for your attention.