

THE SDA (SELF-DEFEATING AUSTERITY) SYNDROME: ECONOMIC PERSPECTIVES FOR THE EURO AREA AND EURO AREA COUNTRIES IN 2012 AND 2013

1. The euro area is still in crisis

Four years after the start of the Great Recession, the GDP in the euro area is still below its pre-crisis level. The recovery has been short-lived. It started towards the end of 2009 following the implementation of expansionary fiscal policies, which first managed to dampen the economic consequences of the financial crisis and then contributed to the renewed growth. But, preoccupied by a rising public debt, worried by the risk of a surge in interest rates and constrained by the Stability and Growth Pact rule according to which the public deficits should be brought back to 3% of GDP, some governments engaged in austerity early, starting in 2010, believing that exceptional circumstances could not be invoked anymore. Thus, although the issue of public debt sustainability should have been seen as a long run issue whereas unemployment and growth are the main concern in the short run, the institutional and the financial contexts as well as dogmatic views have led national governments and the European Commission to reverse the priorities. While at that time exceptional circumstances had vanished, paradoxically, they came back under the pressure of tough negative fiscal stances that went in many cases far beyond the requirements of EU fiscal rules (see Part 4 of this report for an interpretation of the EU fiscal framework).

Since 2011, austerity has been generalised to all euro area members, though with variable intensity, and it was reinforced in 2012. Despite the multiplication of consolidation plans, the sovereign debt crisis did not fade away as persistent risk premiums on interest rates illustrate¹. As a consequence, economic activity rapidly weakened, and, according to the CEPR Business Cycle Dating Committee², the euro area entered a new recession in the third quarter of 2011. In the second quarter of 2012, GDP per capita in the euro area was 3.6% lower than at the beginning of 2008. Divergence is important across countries, however, with a fall of 17.4% in

1. For Ireland, Portugal and Greece market rates are not indicative of governments' cost of financing since these countries benefit from EFSF. But it remains that the market interest rates show clearly that the crisis and the tensions are still acute.

2. See http://www.cepr.org/press/20121115-Euro_Area_in_Recession_since_third_quarter_2011.htm.

Greece or 7.3% in Spain, whereas GDP per capita has increased by 2.3% in Germany (Table 2).

Besides, since the beginning of the crisis, labour market conditions have seriously worsened in the euro area, despite a modest improvement in 2010. In the second quarter of 2012, the number of unemployed was 6.5 million higher than at the end of 2007 (see Part 2 of this report for a more detailed analysis of the social consequences of the crisis). The unemployment rate reached a record level of 11.6% in September 2012. Spain is the country where the adjustment has been the largest, with the unemployment rate reaching 25% of labour force, while in Germany the number of unemployed has decreased steadily since 2009 and the unemployment rate is below 6%.

Table 2. Gains (+) or losses (-) of production and changes in unemployment rate

Percentage change									
2008q1 / 2012q3	DEU	FRA	ITA	ESP	PRT	GRC	IRL	Euro area	
GDP	+2.0	-0.7	-6.8	-5.7	-6.4	-16.7	-6.9	-2.4	
Per capita GDP	+2.5	-2.7	-8.6	-7.5	-5.9	-17.4	-10.5	-3.7	
Increase in unemployment (in %-points)	-2.5	+3.1	+4.1	+16.4	+7.9	+17.5	+9.7	+4.2	

* Except for Portugal, Ireland and Greece where GDP was not available for 2012Q3.

Sources: Eurostat.

Based on the fallacious diagnosis that fiscal profligacy was the original sin, the European Commission recommended and national governments applied the wrong medicine: generalised austerity for fragile economies. The current economic outlook of the euro area clearly shows that the cure is a failure. On a quarterly basis, GDP in the euro area contracted by 0.2% q-o-q in the second quarter of 2012 and still by 0.1% in the third quarter according to the Eurostat's first estimate. We now expect a fall in GDP of 0.4 % in 2012 as a whole. The bulk of this new recession comes from internal demand contributing -1.1 percentage point to GDP growth (Table 3), whereas the contribution of net exports is +1.3. Households' consumption and investment suffer from fiscal consolidation plans and are decreasing. Although this strategy of fiscal consolidation will lead to deficit close to the 3 % threshold for the euro area as a whole in 2012, the path of reduction will be disappointing given the negative fiscal stance estimated at 1.7 point of GDP.

Thus, from 2007 onwards, the euro area has remained in a protracted state of crisis. The economic and social situation has deteriorated to a point which is now worrying. Divergences are widening. Germany will be the country with the highest growth rate in 2012 (with a mere 0.8%) whereas the economic slump will worsen in Southern Europe with GDP decreasing by 6.2% in Greece, 2.8% in Portugal, 2.1% in Italy and 1.3% in Spain (Table 3). In the long run, this situation will inevitably question the ability of EMU to promote growth and social cohesion.

Table 3. Growth outlook in the euro area

Annual percentage change				
%	2010	2011	2012	2013
GDP	2.0	1.5	-0.4	-0.3
Private consumption	1.0	0.1	-1.0	-0.7
Investment	-0.3	1.6	-3.2	-1.5
Public consumption	0.8	-0.1	0.0	-0.1
Exports	10.9	6.3	2.5	2.4
Imports	9.3	4.1	-0.5	1.6
Contribution to growth				
Internal demand	0.7	0.3	-1.1	-0.7
External trade	0.7	1.0	1.3	0.4
Inventories	0.6	0.1	-0.6	0.0
Unemployment rate (%)	10.1	10.2	11.3	12.1
Inflation	1.6	2.7	2.5	1.9
Public deficit (% GDP)	-6.2	-4.1	-3.1	-2.6
Fiscal impulse (% GDP)	-0.3	-1.3	-1.7	-1.4

Sources: Eurostat, OFCE, ECLM, IMK forecasts.

Table 4. GDP growth rate in the euro area

Annual percentage change			
	2011	2012	2013
DEU	3.1	0.8	0.6
FRA	1.7	0.1	0.1
ITA	0.6	-2.1	-1.5
ESP	0.4	-1.3	-1.3
NLD	1.1	-0.9	-0.4
BEL	1.8	-0.2	-0.2
PRT	-1.7	-2.8	-2.2
IRL	1.4	-0.4	-0.4
GRC	-6.2	-6.2	-3.7
FIN	2.7	0.4	0.4
AUT	2.7	0.5	0.1
EA	1.5	-0.4	-0.3

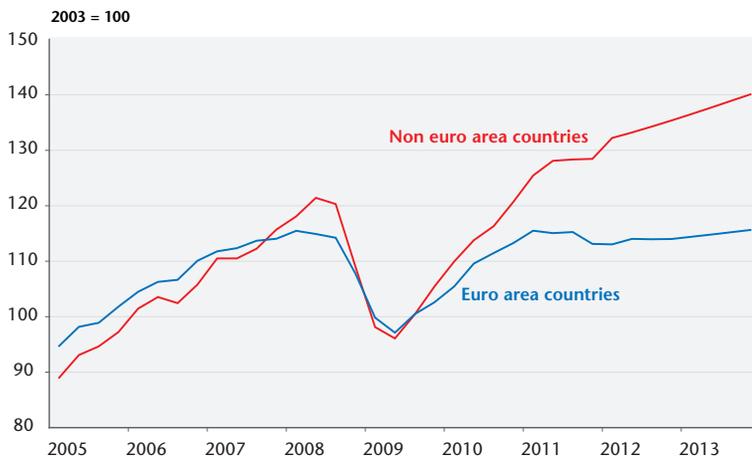
Sources: Eurostat, OFCE, ECLM, IMK forecasts.

The deterioration of the labour market situation, in conjunction with austerity policies, has led to a slowdown in households' incomes. Compensation of employees in the private sector contracted due to both a volume effect (employment decline) and a price effect: high unemployment reduced the scope for wage increases through the Phillips-curve. Moreover, civil servants' purchasing power has been hampered by the freeze or even the decrease of their wages (Greece, Spain,

Italy and Portugal) and bonuses (Spain). The increases in direct and indirect taxes (Italy, Spain, Portugal and France) as well as decreases in social benefits (Spain, Portugal) have also contributed to the deterioration of households' incomes. It has therefore adversely affected private consumption, which has been contracting by 0.9% since the last quarter of 2011. These developments have been amplified by the fact that consumer confidence went down leading to an increase in households' precautionary savings.

Net exports have been the single engine of growth over the latest quarters, due to the external demand from countries outside the euro area. Right from the beginning of the upturn in world trade in 2010, imports were less dynamic in the euro area than in the rest of the world. Besides, since the third quarter of 2011, the external demand among Member States has slowed down strongly, contrasting with a still buoyant external demand from other countries (Figure 2). Due to generalised fiscal consolidation, the expected positive effects of internal adjustment of competitiveness in many countries, such as Spain, Ireland, Portugal or Greece, are delayed. On the one hand, the decreases in wages contribute to a slackening internal demand. On the other hand, the external demand is restrained by the synchronised consolidation in the euro area. Consequently, the ongoing improvement in current accounts deficits in many countries of the euro area is mostly due to the contraction of imports and not much to exports. The Irish current account is nearly balanced and deficits of Spain and Portugal have fallen sharply, contributing to a reduction of macroeconomic imbalances, but one that has been one-sided; the surplus countries have adjusted far too little (see Part 3 of this report for a more detailed analysis).

Figure 2. External demand for euro area countries



Sources: IMF, National Accounts, OFCE, ECLM, IMK calculations.

Besides, it must also be taken into account that non financial firms have not completely recovered from the financial shock that hit euro area countries in 2008-2009. Their productivity has been reduced in reaction to the slump of economic activity. The new slow-down that started by late 2011 will postpone the adjustment of productivity so that profits remain at historically low levels. Similarly, the recovery of the rates of capacity utilization from the trough observed in the first semester of 2009 has receded as firms faced lower demand. After a temporary rebound in 2010-2011, the rate of capacity utilisation in the euro area has strongly declined, from 81.3% in the second quarter of 2011 to 77.8% in the third quarter of 2012. During the autumn of 2012, it has come close to its lowest level of the 1993 recession. This induced backlog of production will still drive labour and capital productivity away from their initial pre-crisis paths. Consequently, the investment rate is still largely below its level of 2008 and has been declining again since the end of 2011. Productive investment has decreased in Germany during the first half of year 2012. The situation is similar in Italy, with a fall of 7% over the last year. Finally, in Spain, housing investment and productive investment have adjusted, with a total drop of 8% since the last quarter of 2011. Comparatively, the adjustment of total investment in France is weaker.

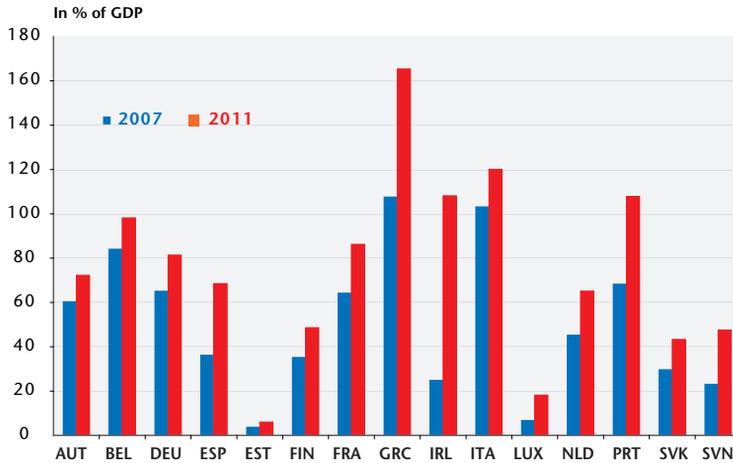
2. Why such a long-lasting crisis?

In 2008-2009, the euro area countries experienced the worst recession since the Great Depression. Consequently, the output gaps widened and public deficits increased sharply. This increase was a consequence both of the automatic stabilisers, as the recession decreased tax revenues and pushed up social and public expenditures, and of stimulating fiscal policies implemented in 2008 and 2009 in order to dampen the economic consequences of the crisis. Thirdly, public debt has also increased due to the measures taken to support the financial sector. Undoubtedly, the fiscal response has been successful as regards its objectives, which were to stop the recession process, to allow for a return to growth and to contain the financial crisis. However it also led, quite inevitably, to a sharp rise of public debt in all euro area countries except Estonia, Finland and Luxembourg (Figure 3). In the euro area, the public deficit has been above the 3% threshold since 2009.

This surge in public deficits and debts was rapidly seen as the most pressing issue in the euro area, although the output gap was still negative for all euro area countries³. Unfortunately, though unsurprisingly, the recovery has not been strong enough to lower the cyclical component of public deficits, i.e. the deficit which is due to the gap between actual and potential GDP, in most of European countries.

3. According to the EC estimates, the output gaps were negative for all countries in 2010. In 2011, the output gaps turned positive in Germany, Estonia and Malta.

Figure 3. Public debt



Sources: OECD.

Then, despite this fragile situation, countries started to tighten fiscal policies in 2010 or in 2011 (Table 5). While countries are facing substantial financing needs, financial markets can play a central role by urging governments to pursue fiscal virtue. Investors look for the most secure investment which is, to their eyes German public bonds. Hence, long run interest rates on German public bonds fall. On the opposite, other countries are threatened by a shortage of financing unless long run interest rates rise; then, this rise worsens their fiscal situation and their economic outlook, implying self-fulfilling expectations. To change expectations and reassure lenders, governments felt obliged to shift their strategy and prove their ability to lower deficits. It is possible to commit to longer-term consolidation without immediate cuts in deficits, but it is not easy. This line of reasoning sheds light on why austerity has been strengthened in the euro area in 2011 and 2012. Nonetheless, the consequence of this intensified fiscal adjustment has been to choke activity once again after the 2008-2009 shock. The return in recession in late 2011 in the euro area is clearly visible (Figure 4).

The perverse effect of fiscal restrictions implemented in the current cyclical trough is that, by stifling a spontaneous recovery, they postpone the reduction of public deficits because of the action of automatic stabilisers. Tax shortfalls and social expenditures widen the cyclical component of the public deficit and, in the case where multipliers are high and/or automatic stabilizers are highly sensitive to activity, they may even completely offset the initial budget cut. The outcome of fiscal restrictions during a cyclical trough is to foster recession, drive the level of unemployment upwards, and, in the best case, have a marginal effect on budget balance. As a consequence, the distrust from financial markets participants does not

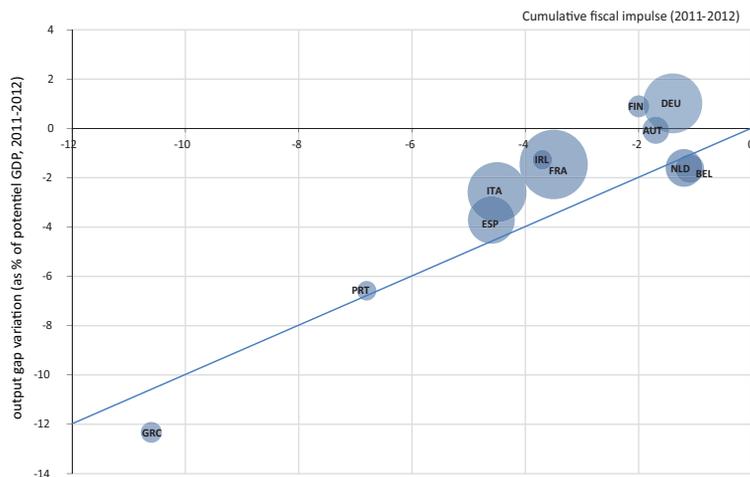
dissipate and governments tighten policy further. New measures strengthen recession, delaying even further the prospect for an improvement in public finance ratio. A vicious circle is under way.

Table 5. Fiscal stance

In % of GDP	2009	2010	2011	2012	2013
DEU	0.7	1.5	-0.9	-0.5	0.0
FRA	2.3	-0.5	-2.0	-1.6	-1.8
ITA	0.8	-0.4	-1.2	-3.2	-2.1
ESP	3.8	-2.5	-1.1	-3.4	-2.4
NLD	4.0	-1.1	-0.2	-1.0	-1.2
BEL	1.9	-0.3	-0.1	-1.1	-0.8
PRT	5.0	-1.7	-3.7	-3.7	-1.8
IRL	2.2	-4.4	-1.5	-2.4	-1.8
GRC	3.2	-8.0	-5.3	-5.0	-3.9
FIN	0.4	1.5	-1.6	-0.4	-1.3
AUT	0.4	0.6	-1.6	-0.1	-0.9
EA	1.8	-0.3	-1.3	-1.7	-1.4

Sources: Eurostat, OFCE, ECLM, IMK calculations.

Figure 4. Fiscal stance and output gap in the euro area countries



Sources: Eurostat, OFCE, ECLM, IMK calculations.

The failure of this strategy for reducing public imbalances by fiscal consolidation is due to a misconception about the functioning of economies, especially the underestimation of the multiplier effect. It is a fact, not a conjecture, that governments and European institutions have neglected the negative impact on activity of fiscal tightening and thought that they could reduce deficits quickly with only marginal effects on growth.

One mistake has been to conduct simultaneous consolidation in all euro area countries, thus increasing the size of the fiscal multiplier in the euro zone considered as a whole. The fiscal tightening conducted in one country is passed on to its foreign trade partners: the slump in its internal demand results in a contraction of its imports which lowers its partners' exports. As a consequence, in addition to its own restriction, each country suffers from the consequences of the fiscal tightening conducted outside. The overall multiplier of the euro area is then much higher than the average of national multipliers simply because the euro area as a whole is a much more closed economy than the countries composing it. Moreover, the argument according to which the fiscal multiplier of synchronised consolidations would be reduced by a cut in short-run interest rates was untenable in the euro area context of a liquidity trap: before consolidation began, the short-run interest rate set by the ECB had already reached its floor.

The second reason for the underestimation of the size of fiscal multipliers comes from a failure to take on board recent empirical evidence, which is consistent with theoretical intuition, that the fiscal multiplier is sensitive to cyclical conditions, *i.e.* it may be higher during economic slumps than during good times (see Box 1 for a discussion of recent literature that point to a consensus on this question).

Synchronised fiscal consolidations have been implemented during bad times, hence at the very moment when the negative impact of contractionary fiscal policy on activity is at its maximum. The increase in taxes and the reduction in social spending reduce disposable income and consumption. Moreover, due to the persistence of a high level of unemployment, a large number of households face a situation where their unemployment benefits are reduced or even cut completely. Consequently, they face higher constraints on their disposable income, which makes fiscal consolidation more detrimental to the activity level. This further effect is unlikely to be dampened by a decrease in the savings rate, which is probably already low or nil for long-term unemployed. Therefore, liquidity-constrained households cannot escape cutting consumption further to respond to the negative income shock. And for those who are still employed and may not face a direct liquidity constraint, the fear of being unemployed leads them to increase precautionary saving.

Similarly, the impact of consolidations is further amplified by the situation of firms. In bad times, there are more and more firms facing overcapacities. They have then no incentives to invest. And even for others, the investment may be limited by constraints on external financing, which are magnified through balance-sheet

effects. As uncertainty rises with the fragile situation of the economy, credit institutions are reluctant to engage in risky and less liquid investment projects. Similarly, market financing may be restrained as investors are afraid of poor performances of the stock exchange.

The situation of banks also helps understand the reasons for a higher sensitivity of activity to fiscal consolidation in recessions. Banks have been severely hit by the series of financial shocks over the last five years, *i.e.* subprime and then sovereign debt crisis. In a context where fiscal tightening worsens the financial situation of private agents, banks will be more reluctant to grant new credits; it thus magnifies the impact of austerity.

Box 1. A review of recent literature on fiscal multipliers: size matters!

Are the short-term fiscal multipliers being underestimated? Is there any justification for the belief that fiscal restraint can be used in an attempt to drastically reduce deficits without undermining business prospects or even while improving the medium-term situation? This is the question that the IMF tries to answer in the Spring 2012 World Economic Outlook. The Fund devotes a box to the underestimation of fiscal multipliers during the 2008 crisis. While until 2009 the IMF had estimated that in the developed countries they averaged about 0.5, it now calculates that they have ranged from 0.9 to 1.7 since the Great Recession

This reassessment of the value of the multiplier, which is discussed on the basis of a “corrected apparent” multiplier (see in Box 2), builds on the numerous studies carried out by IMF researchers on the issue and especially that of Batini, Callegari and Melina (2012). In this article, the authors draw three lessons about the size of the fiscal multipliers in the euro zone, the U.S. and Japan:

The first is that gradual and smooth fiscal consolidation is preferable to a strategy of reducing public imbalances too rapidly and abruptly.

The second lesson is that the economic impact of fiscal consolidation will be more violent when the economy is in recession: depending on the countries surveyed, the difference is at least 0.5 and may be more than 2 pp. This observation was also made in another study by the IMF (Corsetti, Meier and Müller, 2012) and is explained by the fact that in “times of crisis” more and more economic agents (households, firms) are subject to very short-term liquidity constraints, thus maintaining the recessionary spiral and preventing monetary policy from functioning.

Finally, the multipliers associated with public expenditure are much higher than those observed for taxes: in a recessionary situation, at 1 year they range from 1.6 to 2.6 in the case of a shock to public spending but between 0.2 and 0.4 in the case of a shock on taxes. For the euro zone, for example, the multiplier at 1 year was 2.6 if government spending was used as an instrument of fiscal consolidation and 0.4 if the instrument was taxation.

As the economic crisis continues, the IMF researchers are not the only ones raising questions about the merits of the fiscal consolidation strategy. In an *NBER working paper* in 2012, two researchers from Berkeley, Alan J. Auerbach and Yuriy Gorodnichenko, corroborate the idea that the multipliers are higher in recessions than in periods of expansion. In a second study, published in the *American*

Economic Journal, these same authors argue that the impact of a shock on public expenditure would be 4 times greater when implemented during an economic downturn (2.5) than in an upturn (0.6). This result has been confirmed for the US data by three researchers from the University of Washington in St. Louis (Fazzari *et al.*, 2011) and by two economists at the University of Munich (Mittnik and Semmler, 2012). This asymmetry was also found for the data on Germany in a study by a Cambridge University academic and a Deutsche Bundesbank researcher, Baum and Koester (2011).

In other work, a researcher at Stanford, Hall (2009), affirms that the size of the multiplier doubles and is around 1.7 when the real interest rate is close to zero, which is characteristic of an economy in a downturn, as is the case today in many developed countries. This view is shared by a number of other researchers, including two at Berkeley and Harvard, DeLong and Summers (2012), two from the Federal Reserve, Erceg and Lindé (2012), those of the OECD (2009), those of the European Commission (2012) and in some recent theoretical work (Christiano, Eichenbaum and Rebelo, 2011; Woodford, 2010). When nominal interest rates are blocked by the zero lower bound, anticipated real interest rates rise. Monetary policy can no longer offset budgetary restrictions and can even become restrictive, especially when price expectations are anchored on deflation.

As already noted by J. Creel⁴ (2012) with respect to the instrument to be used, *i.e.* public spending or taxation, other IMF economists together with colleagues from the European Central Bank (ECB) the US Federal Reserve (FED), the Bank of Canada, the European Commission (EC) and the Organization for Economic Cooperation and Development (OECD) compared their assessments in an article published in January 2012 in the *American Economic Journal: Macroeconomics* (Coenen G. *et al.*, 2012). According to these 17 economists, on the basis of eight different macroeconomic models (mainly DSGE models) for the United States, and four models for the euro zone, the size of many multipliers is large, particularly for public expenditure and targeted transfers. The multiplier effects exceed unity if the strategy focuses on public consumption or transfers targeted to specific agents and are larger than 1.5 for public investment. For the other instruments, the effects are still positive but range from 0.2 for corporation tax to 0.7 for consumer taxes. This finding is also shared by the European Commission (2012), which indicates that the fiscal multiplier is larger if the fiscal consolidation is based on public expenditure, and in particular on public investment. These results confirm those published three years ago by the OECD (2009) as well as those of economists from the Bank of Spain for the euro zone (Burriel *et al.*, 2010) and from the Deutsche Bundesbank using data for Germany (Baum and Koester, 2011). Without invalidating this result, a study by Fazzari *et al.* (2011) nevertheless introduced a nuance: according to their work, the multiplier associated with public spending is much higher than that observed for taxes but only when the economy is at the bottom of the cycle. This result would be reversed in a more favourable situation of growth.

Furthermore, in their assessment of the US economy, researchers at the London School of Economics (LSE) and the University of Maryland, Ilzetki, Mendoza and Vegh (2009), highlight a high value for the fiscal multiplier for public investment (1.7), *i.e.* higher than that found for public consumption. This is similar to the results of other IMF researchers (Freedman, Kumhof, Laxton and Lee, 2009).

In the recent literature, only the work of Alesina, a Harvard economist, seems to contradict this last point: after examining 107 fiscal consolidation plans,

4. See <http://www.ofce.sciences-po.fr/blog/?p=1372>.

conducted in 21 OECD countries over the period 1970-2007, Alesina and his co-authors (Ardagna in 2009 and Favero and Giavazzi in 2012) conclude first that the multipliers can be negative and second that fiscal consolidations based on expenditure are associated with minor, short-lived recessions, while consolidations based on taxation are associated with deeper, more protracted recessions. In addition to the emphasis on the particular experiences of fiscal restraint (Scandinavian countries, Canada), which are not found when including all experiences with fiscal restriction (or expansion), the empirical work of Alesina *et al.* suffers from an endogeneity problem in the measurement of fiscal restraint.

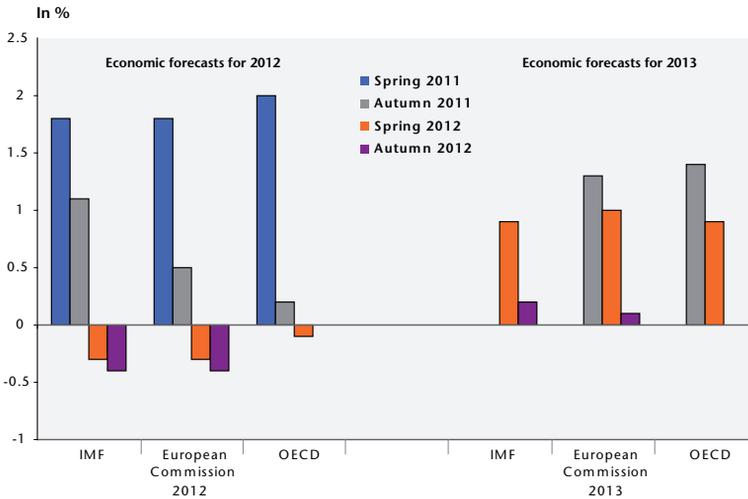
For example, in the case of a real estate bubble (and more generally in cases of large capital gains), the additional tax revenues from the real estate transactions results in a reduction in the structural deficit, as these revenues are not cyclically based (the elasticity of revenues to GDP becomes much higher than 1). So these are associated with an expansionary phase (in conjunction with the housing bubble) and a reduction in the structural deficit, which artificially strengthens the argument that reducing the public deficit may lead to an increase in activity, whereas the causality is actually the reverse.

With the exception of the work of Alesina, a broad consensus emerges from the recent theoretical and empirical work in the existing economic literature: a policy of fiscal consolidation is preferable in periods of an upturn in activity, but is ineffective and even pernicious when the economy is at a standstill; if such a policy is to be enacted in a downturn, then tax increases would be less harmful to the activity than cuts in public spending... all recommendations contained in Creel, Heyer and Plane (2011).

Drawing on facts, empirical evidence and theoretical insights (see Eggertson, 2011, Parker, 2011, and Michailat, 2012), it has to be stated that the size of fiscal multipliers has been underestimated until recently. In its last report on world economic outlook (October 2012), the International Monetary Fund (IMF) revised upward the estimation of the size of fiscal multipliers from 0.5 on average in developed countries to a range between 0.9 and 1.7 until 2009.

The revision of forecasts conducted by major international institutions also emphasize the underestimation of multipliers. The mean forecast for 2012 released in April 2011 by the OECD, the IMF and the EC was 1.9 percent with a mean fiscal impulse equal to -0.7 percent of GDP (Figure 5). According to the Autumn 2012 forecasts, the average forecast regarding 2012 amounts to -0.3 percent while the fiscal impulse has been revised downward to -1.5 percent of GDP. It can be seen that the growth forecast revision, -2.2 percentage points, exceeds the revision of the fiscal impulse, -0.8 percentage point, which suggests that everything else equal, the size of the implicit fiscal multipliers has been revised strongly upward in one year and a half.

Figure 5. Economic forecasts



Sources: IMF, European Commission.

3. The impossible recovery

Despite a growing consensus on the negative impact of a generalised consolidation in time of crisis, the European strategy has been maintained. There is consequently no reason to believe in a recovery of the euro area from the end of 2012 to 2013. The same causes will indeed produce the same consequences. Firstly, the infernal race to reach as soon as possible the 3 % threshold for governments' deficits will continue. Then, bad macroeconomic performances for the euro area countries in 2012 have led to further deteriorations in their output gaps. Consequently, the fiscal multipliers will remain at high values (see Box 2) so that the consolidation will continue to severely hamper GDP growth.

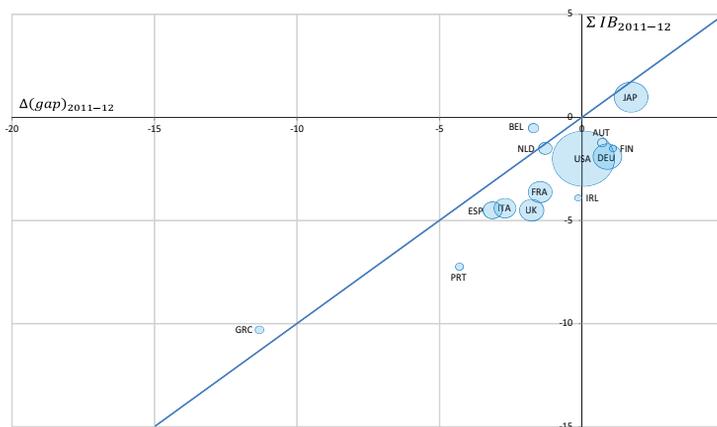
Box 2. What is the value of fiscal multiplier today?

Econometric estimates (based on past experience of "times of crisis") suggest a fiscal multiplier of around 1.5 (for an average mix of spending and compulsory levies).

Taking together 2011 and 2012, years in which a very strong fiscal impulse was carried out, confirms this econometric evaluation. By comparing on the one hand changes in the output gap from end 2010 to 2012 and on the other hand the cumulative fiscal impulse for 2011 and 2012, we obtain the short-term impact of

the fiscal consolidation. Figure 6 depicts this relationship, showing a close link between fiscal restraint and economic slowdown.

Figure 6. Change in the output gap and the impulse 2011-2012



Source: OECD, Economic Outlook no. 91, June 2012. The year 2012 is a projection (OFCE forecast October 2012). The area of the bubbles is proportional to real GDP in 2011 (\$ PPP).

For most countries, the “apparent” multiplier is less than 1 (the lines connecting each of the bubbles are below the bisector, the “apparent” multiplier is the inverse of the slope of these lines). Figure 7 refines the evaluation. The changes in the output gap are in effect corrected for the “autonomous” dynamic of the closing of the output gap (if there had been no impulse, there would have been a closing of the output gap, which is estimated as taking place at the same rate as in the past) and for the impact of each country’s budget cutbacks on the others through the channel of foreign trade. The bubbles in orange replace the blue bubbles, integrating these two opposing effects, which are evaluated here in a conservative way. In particular, because the output gaps have never been so large, it is possible that the gaps would autonomously close faster than what has been observed in the last 30 or 40 years, which would justify a more dynamic counterfactual and therefore higher fiscal multipliers.

Austria and Germany are exceptions. As these two countries enjoy a more favourable economic situation (lower unemployment, better business conditions), it is not surprising that the multiplier is lower there. Despite this, the “corrected apparent” multiplier is negative. This follows either from the paradoxical effects of the incentives, or more likely from the fact that monetary policy is more effective and that these two countries may have escaped the liquidity trap. But the correction provided here does not take into account any stimulus from monetary policy.

In the United States, the “2011-2012 corrected apparent” multiplier comes to 1. This “corrected apparent” multiplier is very high in Greece (~ 2), Spain (~ 1.3) and Portugal (~ 1.2), which is consistent with the hierarchy set out in point 1. This also suggests that if the economic situation deteriorates further, the value of the multipliers may increase, exacerbating the vicious circle of austerity.

Greece will still be the country implementing the most severe austerity; new voted measures will lead for example to a further reduction in pensions and to a reduction in wages in the public sector. In Portugal and Spain, the consolidation is forecast to be close to -2.9 and -2.5 points of GDP, respectively in 2013, slightly lower than what has been implemented in 2012. Germany would then stand as the main exception in this landscape of austerity. The fiscal position is already nearly balanced so that domestic fiscal policy would not drag down the economic activity. It may even be slightly expansionary if some legislative changes, which are currently being discussed, are implemented. For the whole euro area, the negative fiscal stance is expected to reach 1.4 % of GDP. This will maintain the euro area in recession. On a quarterly basis, GDP is not expected to grow at a substantially positive rate before the end of 2013. It is forecast to decrease by 0.3 % on the whole year after a recession of 0.4% in 2012.

Drawing on our analysis of fiscal consolidation viewed as a vicious circle, we forecast consumption to decrease by 0.7% in 2013, a marginal improvement from -1.0% in 2012. This lack of demand will add to the overcapacities of non-financial corporations and limit private investment. A new fall of investment is then expected for 2013 (-1.5%).

This domestic effect will then be amplified through European trade integration as the fall in domestic demand will trigger a slow-down of imports in all the euro area countries, which will have a negative feedback effect on exports. For Germany, it will be the main cause of the moderate growth in 2013 (Table 6). This will also be the case for the Netherlands, Belgium, Finland, Austria and Ireland. The external negative impact of the fiscal consolidation does not only stem from the austerity measures taken by the members of the euro area. We also expect a negative fiscal stance in the United Kingdom, though to a lower extent than the consolidation implemented for 2012, and in the United States. This would notably strongly contribute to the negative external impact in Ireland since the UK and the US account for more than 40% of Irish exports. For the other countries, the bulk of the negative impact of fiscal consolidation would stem from their own fiscal consolidation. These negative impacts will be particularly strong for the countries of Southern Europe which have already suffered from a substantial fall of GDP. Their situation will deteriorate further in 2013 with recessions going from -1.4% in Spain to -3.7% for Greece. The countries which expected to avoid a recession are Germany, Austria, Finland and France. But it must be stressed that the GDP growth rates in these countries will be below the potential growth rate, meaning that unemployment will increase further.

Besides, euro area will not manage to find substantial external sources of growth. Firstly, the euro area is much more a closed economy than are the small open economies composing it. Then, as has been stressed, the UK and the US will also strive to reduce their deficit. The so called "fiscal cliff" in the US will reduce the margin for manoeuvre of the second Obama's administration. Even in case of a

rapid agreement with Congress, the US won't avoid a stronger tightening of fiscal policy in 2013. Due to specific conditions, Japan and other Asian countries have a different fiscal stance but, given their present share in European countries' exports, it would not change the outlook for Europe. Moreover, the euro exchange rate is expected to stabilize at 1.25 dollar in 2013 and will then offer no stimulus to exports. The contribution of external trade to the GDP growth would however be positive (+0.5 point) but this would be mainly due to the slow growth rate of imports (+1.2%) compared to exports (+2.2%).

Table 6. Impact of consolidations in 2013 through...

In points			
	Fiscal stance	... domestic demand	... external demand
DEU	0.0	0.0	-1.7
FRA	-1.8	-1.8	-1.2
ITA	-2.1	-2.1	-1.2
ESP	-2.5	-3.3	-1.3
NLD	-1.2	-0.9	-1.5
BEL	-0.8	-0.8	-1.2
PRT	-2.9	-4.4	-1.6
IRL	-1.8	-1.4	-2.1
GRC	-3.9	-7.7	-1.1
FIN	-1.3	-0.7	-1.0
AUT	-1.0	-0.5	-1.0

Source: National accounts, Eurostat, OFCE, ECLM, IMK calculations.

This negative outlook might be mitigated if there were a significant return of confidence, as posited by the European Commission in its autumn forecasts. Ratification of the TSCG (Treaty on Stability, Coordination and Governance) might help to restore the belief that fiscal sustainability will be improved and that the coercive arm of the Stability and Growth Pact has been reinforced. Were this new Treaty credible, it would trigger a reduction of interest rates. Thus, the expectations of financial markets are crucial. But this conclusion rests on the hypothesis that interest rates have increased mainly because of fear of insolvency of some euro area countries. The fiscal strategy implemented presently is consistent with this view according to which the only way to exit the crisis is to restore the confidence of financial markets through the consolidation of public finances. However, this view completely overlooks the liquidity dimension of the crisis and the self-fulfilling prophecies which have driven interest rates upward. As P. de Grauwe (2011) stated, *the financial crisis has made clear that financial markets are driven by extreme sentiments of either euphoria or panic*. They may then easily switch from one equilibrium to another and there is no guarantee that the consolidation and the new developments in the euro area governance will have the desired effect on interest rates.

There is an alternative view to the fiscal profligacy hypothesis. Public interest rates have increased because of a misconception of EMU since it has made possible a situation where each national government becomes indebted in what amounts to a foreign currency and where investors may, without taking any exchange rate risk, switch from a security issued by a euro area government to a security issued by another euro area government. Consequently, when a government is considered as riskier for any reason, it may face difficulties in raising funds. This can quickly degenerate into a liquidity crisis and a brutal surge in interest rates. Starting from the situation of Greece in 2010, financial markets realized that the national governments of the euro area could be forced to default, which triggered a global loss of confidence and a rise of contagion effects. In such a situation, generalized austerity is not the right answer especially if fiscal multipliers are high. And, despite the SMP (Securities Market Programme), the ECB was until recently unable to lower interest rate premiums significantly. Financial markets were consequently not convinced that default was unlikely and perceived that governments would not be able to guarantee the sustainability of public debt as long as growth would remain sluggish or even negative.

In this respect, the announcement of the launch of the OMT by the ECB in September was an important step. The central bank signaled that it would stand ready to intervene on the secondary market for Treasury bills and bonds to lower public interest rates. These interventions would be conditional to the application of an adjustment or a precautionary programme supervised by the European Financial Stability Fund or the European Stability Mechanism. Even if the aim is to lower risk premiums, the success of the OMT is not guaranteed however. It first depends on a signaling effect, as illustrated by the sharp decline in the Spanish and Italian interest rates that followed the announcement made by the ECB in July and in September 2012. Then, the effectiveness of the operation depends on the effective purchases realized by the ECB. It can be stressed that the signaling effect would be magnified if the first operations carried out by the ECB are substantial. It is then essential for the ECB to fully play a role of lender of last resort. This is indeed a necessary condition for risk premiums on interest rates to recede. But this role can be fulfilled if, and only if, the ECB and the EU institutions have ruled out a break-up of the euro area and default on public debt. This is the idea behind the imposed EFSF/ESM conditionality. However the nature of such programmes is such that the ECB interventions are being made subject to the application of a consolidation programme, which will not allow euro area countries to get out of the trap where austerity, subdued growth, loss of confidence and a liquidity squeeze are mutually reinforcing.

The confidence of financial markets is necessary but not sufficient to balance the negative impact of fiscal consolidation. Recession might be mitigated, but it would not be avoided, notably in Spain, Italy, Portugal and Greece. When the multiplier (in the short term) is greater than approximately 2 (actually $1/\alpha$, α being the sensitivity of the public deficit to the economic cycle and valued at about 0.5 in

the developed countries), then fiscal cutbacks produce such a decrease in activity that the short-term deficit increases with the cuts. When the multiplier is greater than approximately 0.7 (in fact, $1/(\alpha+d)$, d being the ratio of debt to GDP), then fiscal restraint increases the ratio of debt to GDP in the short term. In the longer term, things get complicated, and only a detailed modelling can help to understand in what circumstances fiscal restraint would lead to a sustained reduction in the debt-to-GDP ratio. As long as a fully consistent strategy is not implemented, most European countries will not regain a sufficient pace of growth and they will miss the targets for public deficits. In 2013, we forecast indeed that Germany, Austria and Finland would be the only countries to meet their objectives (Table 7). For the other countries, the fear of a default will re-emerge, especially if interventions by the ECB remain modest. As long as the European Commission and national governments do not realise that austerity is self-defeating, they will still follow the second-worst strategy; that is, better only than a disorderly break-up of the euro area.

Table 7. Net governments lending in 2013

In %

	Forecasts	Target
DEU	-0.3	-0.5
FRA	-3.6	-3.0
ITA	-1.3	-0.5
ESP	-6.6	-4.5
NLD	-4.0	-3.0
BEL	-3.5	-2.2
PRT	-5.0	-4.5
IRL	-8.6	-7.5
GRC	-4.8	-4.6
FIN	-0.6	-0.5
AUT	-2.1	-2.1

Source: National accounts, Eurostat, European Commission, OFCE, ECLM, IMK calculations.