The coming revolt against austerity

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Mindless austerity is losing policy credibility in some Eurozone nations. This column suggests governments shouldn't mix long-term growth and fiscal discipline nor produce another Lisbon strategy. Instead, they should adopt a framework for fiscal policy cooperation, restructure debts, and remember that fiscal discipline is for the long run.

It is not just the election of François Hollande in France. Adopting contractionary fiscal policies in the teeth of a double-dip recession never made sense. And yet, public debts are high and markets in endemic panic. The solution must be based on a comprehensive analysis of the situation, not on arcane debates on the strength of the "confidence factor". It ought to combine debt restructuring, front-loaded collective fiscal expansion and long-run unbreakable commitments to fiscal discipline.

The next French president is mistaken when he mentions in the same breath the Fiscal Compact and the growth objective, but he has hit raw nerves.

- Under German pressure, his predecessor has endorsed the ideological view that governments under market pressure for their excessive debts ought to atone and close the deficit, even if this means procyclicality.

Strangely, the Commission, highly vocal against procyclicality in upswings, supports the German view.

- Under pressure from its friends, Greece has been forced to implement this policy for two years now and the results are plain to see. The debt ratio keeps growing.

Both the numerator (debt) and the denominator (GDP) display “surprising” outcomes, unemployment is soaring, economic and social pain is acute and political fermentation is ominous.

Next in line

Much the same applies, or will soon apply to Portugal, Spain, and Italy. Citizens rightly feel that sacrifices do not deliver the promised results. Even the IMF, long criticised for its stern advocacy of procyclical austerity, is now asking Eurozone nations that can to “go slow”. Among academics, paper after paper produces estimates of the multiplier that differ by huge amounts, even by signs, showing how little we know (see the Vox Debate ‘Has austerity gone too far?’). When the standard errors are bigger than the estimates, we are left to casual empiricism and lessons from history, both of which show that procyclical fiscal policies are bad, especially when monetary policy is not available any more.

For all these reasons, it was only a matter of time until the budget consolidation strategy adopted in Europe would come under intense criticism. Unfortunately, the situation is complicated.

- The sovereign debt crisis implies that highly indebted countries cannot simply borrow their way out of their predicament.
- The financial markets are clamouring that growth is a necessary condition for deficit reduction but, at the same time, they are unwilling to lend to governments at reasonable interest rates.

They are right on both counts. They want to see both immediate growth and a commitment to fiscal discipline. This is the challenge that governments have not been able to meet so far. What is to be done? The way out has to be based on five principles.

Principle 1: Don't mix long-term growth and fiscal discipline

There is zero empirical evidence to support the view that fiscal discipline hurts long-term growth.

- The only evidence, which is not robust, is that very high debt levels stunt growth.[1]
- A reasonable policy conclusion is that fiscal discipline and long-term growth are independent objectives.

The adoption of a Fiscal Compact – however clumsy in its current formulation – represents a major conceptual change. The Stability and Growth Pact failed over and again because it rested on the misleading view that sovereign governments can be forced by the threat of sanctions to alter their fiscal policies. The breakthrough achieved by the new pact is to decentralise back to the national level, where authority lies, the implementation of workable fiscal rules (Wyplosz 2011).

The Compact badly needs to be refined – it should require that national rules be effective and implemented. But the Compact is far too important to be jeopardised with a "growth clause" – a loophole that could undermine any gains. We have seen how governments summarily ditched the no-bailout clause, so we cannot allow a loophole to sneak in the new Treaty.

The Compact is about fiscal discipline, period. Growth is another important, but separate issue.

Principle 2: Don't produce another Lisbon Strategy

Calls for growth are now being morphed into proposals to adopt supply-side policies. Such policies are badly needed everywhere. The defining characteristic of much of the EU is the existence of myriad anti-competition arrangements that cater to special

1 The existence of a threshold famously established by Reinhart and Rogoff (2010) and Cecchetti et al. (2011) is challenged by Panizza and Presbitero (2012).

interests and stifle growth. Yet, this cannot be a collective undertaking. The Lisbon Strategy to make Europe “the most competitive and dynamic knowledge-based economy in the world” failed miserably – and predictably so. Such failure did not prevent the EU from rolling it over into Agenda 2020, a plan which is doomed to share the Lisbon Strategy’s fate.

Adding a new layer of requirements will create only a few jobs in national and European bureaucracies. More importantly, by pretending that they are doing something useful, once again our leaders will be able to avoid hard decisions.

Principle 3: We need a framework for fiscal policy cooperation

Fiscal policy is a matter of national sovereignty. The only efforts at reducing national sovereignty have focused on discipline and the result, the Stability and Growth Pact, has been a failure. There has been zero effort at coordination.

- The aggregate fiscal policy stance of the Eurozone is the invisible hand of national preferences.
- With externalities aplenty and no market mechanism, the outcome has to be sub-optimal.

Most of the time, it does not matter. This time, it does.

It was not by chance that the second G20 Summit called upon nations to adopt expansionary policies in countries that have enough room thanks to solid debt credibility.

- What is true in the world is even truer in the Eurozone.

Such an assignment of tasks is not even a topic for discussion.

- The Six Pack agreement does not shy from attempts at deep intrusion into national policy issues but it is terribly asymmetric.

There is no hint that countries could expand to make up for demand shortfalls elsewhere.

Yet, it has always been known that a critical shortcoming of the monetary union is that we do not have a federal budget that can carry out counter-cyclical policies. This has prompted calls for the creation of a fiscal union, but we must admit that such a step is not reachable for a long time, a matter of one generation or two.

The Fiscal Compact allows for national countercyclical policies, but an increasing number of countries have lost market access. One possibility is for countries with continuing market access to quickly use this possibility to adopt expansionary policies. Another possibility is to tap the EFSF-ESM to provide resources to countries in recession to expand, while these funds are currently used to force countries to contract. This does not require any treaty, only common sense.

Principle 4: Restructure debts

Market access is closing down on an ever-increasing number of countries because of expectations that their debts will be restructured. From the start, the notion of debt restructuring has been seen as foreign to Europe (Wyplosz 2010) and yet it has started to happen, and it will happen again but too little and too late.

- Instead of allowing the noose to tighten until a country suffocates, policymakers should run ahead of the curve and ratify the markets' judgement.
- Instead of paying juicy interest rates, governments should tax the markets rather than choking their citizens.
- Instead of fearing contagion, we should preventively restructure debts in countries that will never be able to resume growth under their existing (Greece, Portugal, Italy) or predictable (Spain, France, quite possibly Germany) burdens.

This assessment is based on the need to recapitalise banks that hold large amount of soon-toxic public debts.

Principle 5: Fiscal discipline is for the long run

A large number of public debts are above or close to 90-100% of GDP. Unless they are restructured in a way that sharply reduces their values, primary surpluses will be needed to bring debts down to more comfortable levels, clearly below 60%. This will take decades, not years.

- The current emphasis on achieving some nominal deficit targets in 2013 and 2014 may have some legal or symbolic justification.
- From an economic viewpoint, it is simplistic nonsense.

One virtue of the Fiscal Compact is that it shifts the emphasis to cyclically adjusted budget balances. One weakness is that it reasserts the Stability and Growth Pact's obsession with annual outcomes and objectives.

Official comments that the model should be the Swiss-German debt-brake arrangement are encouraging. This arrangement allows for quite some short-run flexibility (thanks to a "control account" where overruns can be temporarily parked). All that remains to be done is to ditch the infamous Stability and Growth Pact and insist that the debt-brake arrangement be the model in countries that have not yet adopted solutions that have proved their mettle in achieving fiscal discipline.

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