EUROPEAN POLICY CENTRE

POLICY BRIEF

September 2010

Austerity loves company?

Fabian Zuleeg and Hans Martens

BACKGROUND

The last three years have seen tumultuous changes in Europe's economies. The events triggered by a crisis in the US sub-prime housing market quickly exposed the imbalances in the world economy and precipitated the deepest global economic downturn since the European Union was founded.

While the impact varied, no EU Member State escaped the fall-out. Most governments responded by pumping large amounts of debt-financed public spending into their economies. This fiscal stimulus helped cushion the impact of the crisis, but had a devastating effect on public finances, with large deficits and rapidly increasing public debt-to-GDP ratios. This aggravated pre-crisis economic imbalances, triggering the euro crisis, starting with Greece but threatening most of the euro zone's weaker economies.

Europe is now coming full circle, with many governments introducing austerity plans to get their public finances under control. But while European economic policy coordination played a significant part in the response to the financial, economic and euro crises, there appears to be no real coordination of the austerity policies at European level.

The European Economic Recovery Plan: together at last?

After the collapse of Lehman Brothers in September 2008, many European governments followed the US example by providing a fiscal stimulus to their economies. The European Commission scrutinised these programmes and, where necessary, demanded changes to ensure they did not distort the Single Market (for example, if large subsidies were made available in one country but not in others).

In November 2008, it went further by proposing a joint response in the form of the European Economic Recovery Plan (EERP), calling for a European fiscal stimulus of €200 billion (1.5% of EU GDP), with €170 billion from national budgets and €30 billion from the EU budget and European Investment Bank.

A key aim of the plan was to "exploit synergies and avoid negative spill-over effects through co-ordinated action". Given Europe's close economic interdependence, the success of crisis-mitigation measures in one country inevitably depended on the actions of the others. The joint response was designed to maximise the effectiveness of public spending and help to avoid 'beggar-thy-neighbour' policies. Despite different starting positions, European governments agreed on the EERP in December 2008, leading to a better-coordinated response at EU level.

Although the fiscal stimulus measures merit critical examination (and mistakes were made in the heat of the crises), they undoubtedly prevented the world economy falling deeper into recession. But the return to Keynesian-style counter-cyclical spending has not been accompanied by a recovery strong enough to automatically re-balance public budgets.

A common debt

While public finances have come under severe pressure across Europe, the nature of these debt crises differs widely. In some Member States, such as Ireland, the UK and Spain, there is more of a 'deficit crisis': these countries had consolidated their fiscal position before the crises, but now have large deficits resulting from their stimulus programmes, and public debt is therefore rising quickly. In other countries, such as Italy, the deficit caused by stimulus measures is relatively limited but the debt has been a problem for years. Greece, of course, demonstrates the worst-case scenario, with a large debt stock *and* large deficits resulting from stimulus measures.

Given that growth levels are likely to remain weak for some time to come, such large public debt and deficit levels are clearly unsustainable. Not only must this debt be financed – and the Greek situation demonstrated how financial sector concerns (whether justified or not) can rapidly make financing of public deficits expensive – but high yields on government bonds can also have a 'crowding out' effect (i.e. reducing private sector investment) and could push up interest rates and inflation.

None of this is automatic. Much depends on who the government owes the debt to (domestic or international) and the level of private debt, as well as the overall economic situation. Speculation also plays an important role. But it is clear that the current increases in debt are creating a problem which current and future generations will have to deal with.

Fiscal consolidation also has negative effects on growth when money is taken out of the economy, usually through a combination of public expenditure cuts and increased taxes. EU governments thus face a real dilemma: how to find the right balance between fiscal discipline and keeping their economies growing at least at a moderate rate.

Together we stand or fall

The debt crisis also triggered a crisis in the euro zone. The unsustainability of public finances in some countries made it necessary to safeguard them from a sovereign default by providing large-scale funding from the economically stronger Member States and the International Monetary Fund. The euro crisis highlighted the need to find better instruments to deal with similar situations in future, with the Commission proposing, among other measures, more European scrutiny and greater coordination of national budgets.

This crisis has also demonstrated the need for a more homogenous approach to structural policies to enhance competitiveness across all euro economies. This will require Member States to take structural reform programmes at the EU level (i.e. the Lisbon Strategy and now its successor, Europe 2020) more seriously and incorporate them into euro-zone governance.

Improved competitiveness is crucial, given Europe's low growth prospects, the challenges posed by growing economies such as China, India, Brazil and Turkey and the EUs own demographic developments. This is especially important for the weakest economies – without healthy growth these countries will not be able to address their public finance imbalances.

The euro crisis provided some temporary relief: a more realistic exchange rate to the US dollar, addressing its previous over-valuation. This gave the German export sector a very good platform for growth, once again demonstrating the interdependence of Europe's economies.

STATE OF PLAY

The policy challenge in the months and years to come is reconciling the need for public finance consolidation in the not-too-distant future with maintaining economic recovery and 'managing' public spending cuts to minimise negative impacts on economic growth, public services and, indeed, citizens' quality of life.

In Europe, the tide is turning. The mood is shifting towards public finance consolidation and while some commentators such as *The Economist* have rightly pointed out that the planned measures in a number of EU countries are not as austere as politicians have made them sound, it is nevertheless clear that most of Europe is now moving down the long and painful road to better public finances.

This view is not echoed universally outside Europe: the Obama administration has made it clear that it does not share this approach (yet) and expects Europe to do more to stimulate demand. However, the EU and the US face very different futures: while the US has reason to hope that future economic and demographic growth will help erode the debt level, economic growth in the EU is likely to be more subdued.

Austerity in ascendancy

This new austerity is driven by several factors, which differ from country to country and have different political, economic and social consequences. While some introduced programmes from a position of strength, for others – under severe pressure from the markets – these measures are crucial to restore their credibility with international markets as well as complying with euro-zone rules and meeting IMF conditions. For them, the economic, social and political impacts of austerity are likely to be more severe, but are unavoidable in the circumstances.

Different countries are also at different stages of economic recovery: it seems to be more robust in

Germany than elsewhere, which should imply an earlier return to improved public finances. Germany also has a cultural bias towards fiscal consolidation, with stricter public finances popular with much of the population, resulting in a mechanism anchored in the German Constitution designed to severely limit public debt from 2016 onwards. In addition, the 2009 German election produced a coalition which committed itself to fiscal consolidation, as did this year's UK election.

Countries such as the UK and Ireland have also seen a very rapid deterioration in public finances, driven both by large increases in their current deficit and by measures to support their disproportionally large banking sectors. This necessitates a relatively rapid consolidation process.

Tightening belts

In some countries, the austerity programmes have prompted large-scale public protests and significant political opposition, with governments often accused of hitting more vulnerable groups in society far harder than richer individuals or companies. But there has also been widespread support for them: a recent Eurobarometer poll showed that three-quarters of Europeans believe that measures to reduce public debt and deficits cannot be delayed, suggesting a common European understanding of the need for fiscal consolidation.

However, the nature of the austerity programmes varies widely from country to country, with governments choosing a significantly different mix of spending cuts and tax increases, and in different time frames. While there have been some similarities – most countries are attempting to protect frontline services such as education and health while cutting back administration and public-sector pay and privileges – this has been driven more by similar political preferences than any attempt at cross-border coordination. There is also significant divergence in the extent of structural reform programmes accompanying the austerity programmes, with some countries demonstrating that they not only see a need to get their public finances under control but also to safeguard the long-term sustainability of their economic and social model.

All this points to a significant divergence in approaches to fiscal consolidation across Europe, in line with the general pre-crisis divergence in economic policies. Economic and Monetary Union does provide a framework for coordination, but the focus is predominantly on where to get to (deficits below 3% and debt below 60%) rather than how to get there. Better economic coordination is lacking, with Member States not even using existing mechanisms and the European level focusing only on existing, narrow EU competences in relation to public finances, with limited progress on a common approach towards competitiveness.

In this exceptional situation, where both deficits and debt levels require significant medium- to long- term correction, the EU must go beyond the limited macroeconomic coordination which prevails in less exceptional times.

While there are good reasons why one size would not fit all, there are many areas in which better coordination could be mutually beneficial for Europe's economies. At the very least, a broad consensus is needed on the way forward for the EU economy, on the best path out of the crisis and how each country can contribute. So far, austerity programmes have been purely national, dominated by domestic political and economic considerations.

PROSPECTS

Countries' return to a national focus contrasts with the moves towards economic coordination and even policy integration during the economic crisis and subsequent debt and euro-zone crises. So far, Member States' actions have run counter to the proposals for enhanced European economic governance.

Interdependence and spill-overs

The crises of recent months should have made it clear that Europe's economies are interdependent, so policy measures in one country inevitably have spill-over effects in others. This is clearly also true for the austerity programmes. If tighter public finances reduce growth and consumption in one country, this affects its European partners through trade. Increasing VAT or other consumption taxes unilaterally changes the price differential between countries, potentially shifting demand from one Member State to another. Corporation tax changes or levies on financial services can influence companies' decisions on where to locate. Cutting subsidies in one country might improve the fortunes of companies in others where subsidies are maintained.

This shows that austerity programmes might well have a distorting impact on the Single Market not dissimilar to the impact of differential fiscal stimulus programmes. Here, there is a clear role for the Commission as guardian of the Treaties.

All countries must recognise that they may put themselves at a competitive disadvantage if they introduce austerity measures unilaterally. But it goes further than this: the euro crisis has shown that euro-zone countries have a very direct stake in each others' economies. If any one is left behind – be it in terms of growth or of getting its public finances under control – all euro-zone economies will suffer, and Europe's weaker economies will not be able to manage on their own. But some politicians are in danger of forgetting these lessons.

There is also scope to learn from each other, to ensure that the right kind of austerity programmes are introduced, including structural reforms with long-term impacts and policy measures which aim to generate, or at least not impair, economic activity (for example, by avoiding further taxes on labour). Public-sector reform is a further significant challenge, given the need to increase productivity and abolish special provisions for civil servants such as earlier retirement ages.

At the same time, European governments must safeguard investments in their economic future, driving forward the transformation to a green, smart economy. At EU level, delivering Europe 2020 (the new European growth strategy) must be a priority, including giving the right legislative impetus for investment and growth, for example through the creation of a Digital Single Market.

All this points to the crises as a key driver for a more coordinated approach to austerity programmes rather than the return to a national focus noted earlier. So why has this not happened?

Economic disunity

There are a number of reasons, including the perception in many countries that the main problems lie elsewhere. The rapid pace of developments in recent months has also limited the opportunities for effective coordination, especially at European level, where decision-making tends to take longer.

Added to this is the large degree of uncertainty over the state of Europe's economy and the right policy response, further limiting the scope for coordination. But many of these reasons also applied earlier in the crisis, and arguably the time pressure and the degree of uncertainty were even higher then.

Despite strong economic arguments for a coordinated approach to austerity, Member States do not appear willing to heed them: their focus is still domestic, stressing that competences for public spending and taxation lie predominantly at Member-State level. This might also reflect public opposition in those countries with stronger economies to having their decisions influenced by the concerns of those which are struggling.

Sadly, the Commission has not shown the leadership it displayed when proposing the EERP, perhaps because spending cuts and tax increases are far less popular than increasing spending, especially given the current lack of international pressure and consensus to do so.

It is now time for the Commission to re-take the initiative, to ensure that economic interdependence and spill-overs are taken into account in any austerity programme. It should also help to find a European consensus on where we are now and how best to respond to the challenges we face. European Council President Herman Van Rompuy can help here, by pushing for a consensus on the need for coordinated action and far-reaching euro-zone governance reforms.

So far, however, it looks like this opportunity will be missed. Despite Europe's professed need and will to coordinate economic policies better, when it comes to the crunch we are a long way from working together effectively on our fiscal and structural policies, which is needed if we are to make Economic and Monetary Union work.

If we ignore the fact that European economies are inextricably linked, not only will the austerity programmes be harsher and less effective, but the lack of coordination is also likely to reduce Europe's ability to safeguard its economic and social model for future generations.

Fabian Zuleeg is Chief Economist and Hans Martens is Chief Executive of the European Policy Centre.

This paper is published under the auspices of the EPC's Well-being 2030 research project.

European Policy Centre ■ Résidence Palace, 155 rue de la Loi, 1040 Brussels, Belgium
Tel: +32 (0)2 231 03 40 ■ Fax: +32 (0)2 231 07 04 ■ Email: info@epc.eu ■ Website: www.epc.eu

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With financial support from
the European Commission