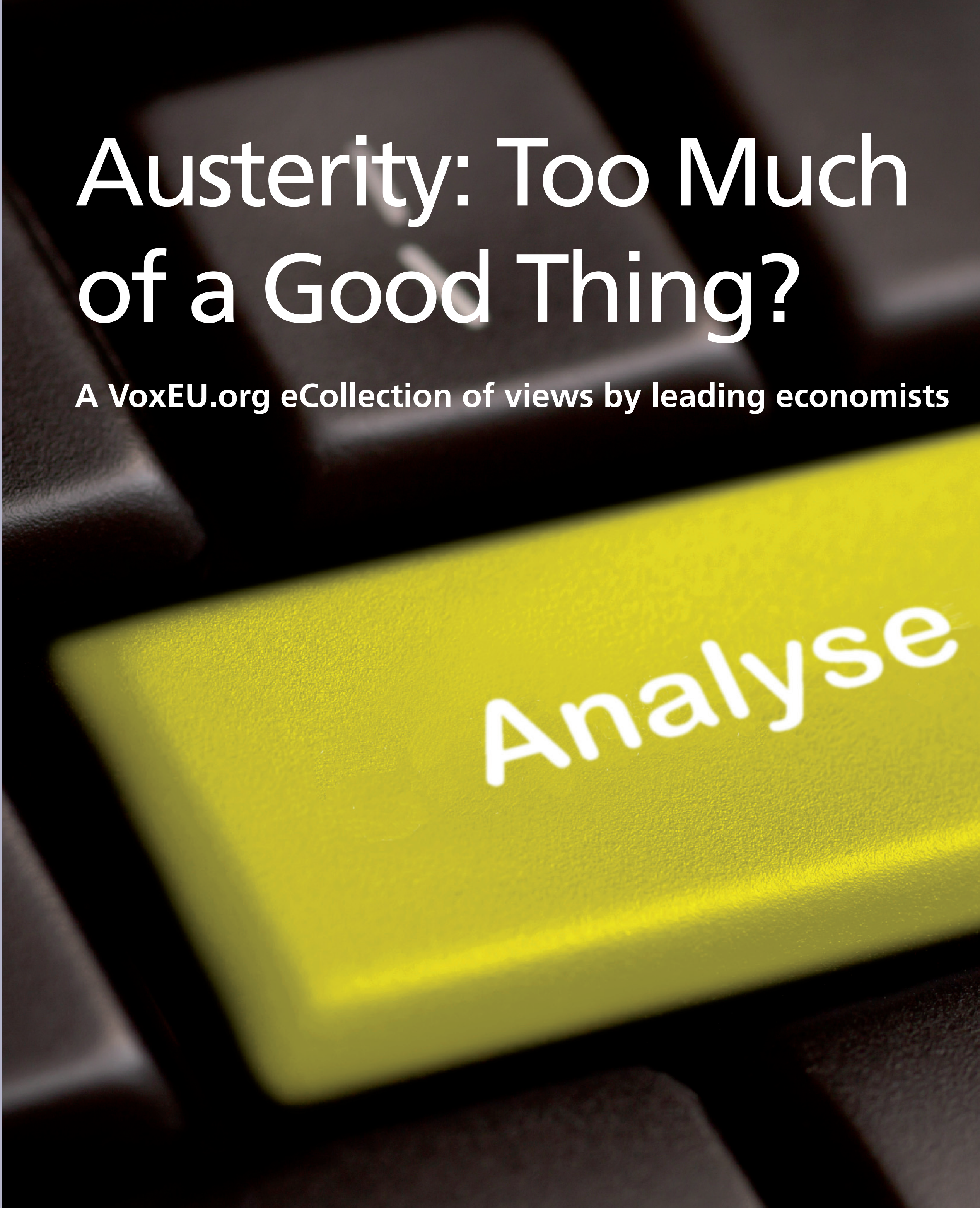
Austerity: Too Much of a Good Thing?

A VoxEU.org eCollection of views by leading economists



CEPR

Edited by Giancarlo Corsetti

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Foreword

Four and half years after the global crisis erupted, the world's mature economies – especially the Eurozone – find themselves with shockingly fragile macroeconomies and financial sectors.

The list of uncertainties which could shatter these fragile systems is worryingly long. It includes:

- A Greek EZ exit and likely contagion, an event whose probability is rising despite the June 2012 election.
- A Spanish bailout, and likely contagion to Italy and possibly France.
- Popular uprisings against austerity measures that, to many citizens, seem fruitless as well as endless.

The latter point has focused attention firmly on the question: Has austerity gone too far?

Have the consolidation programmes adopted by several EZ countries since 2011 been cutting too much and too soon? Has austerity triggered a self-defeating 'doom loop' whereby budget cuts and tax rises widen deficits by throwing economies into tailspins?

This eCollection of Vox columns – which first appeared in the Debates section of VoxEU.org – presents the research-based analyses of some of the world's most authoritative economists on fiscal matters. They consider these questions from a wide range of perspectives. Some argue strongly that austerity has been misapplied and is killing the patient it was intended to save. Others argue that, given high debt ratios, austerity is the least bad option.

While the authors differ sharply on whether austerity has gone too far too fast, none denies the need for medium-term adjustment. With ageing populations, rising healthcare costs, and global crisis-linked debt, the need for fiscal discipline is clear.

In closing, it is important to acknowledge the rapid and highly professional contribution made by "Team Vox" – notably Anil Shamdasani, Bob Denham, Pierre-Louis Vézina, and Charlie Anderson. This eCollection would not have been possible without their energy, enthusiasm and commitment.

Richard Baldwin

Policy Director of CEPR

Founder and Editor-in-Chief of VoxEU.org

Lausanne, 20 June 2012

Introduction

Giancarlo Corsetti
Cambridge University and CEPR

As Vox publishes this eCollection, the global economy is shaken by news and rumours of a possible exit of Greece from the Eurozone, of large capital flights from this country, and of bank runs in some countries in the Eurozone. Four years after the eruption of the global crisis, advanced countries, and especially the Eurozone, are still in a profound state of macroeconomic and financial fragility.

The crisis is not rooted in a lack of fiscal discipline. Yet the sharp increase in public (explicit and implicit) debt has progressively shifted policy priority from stimulus to fiscal consolidation. A high stock of public liabilities is feared to hamper investment and growth and make an economy excessively vulnerable to market sentiments. Within the Eurozone, fiscal adjustment is complicated by the additional constraint of a common monetary policy, and the lack of a common budget providing insurance across regions.

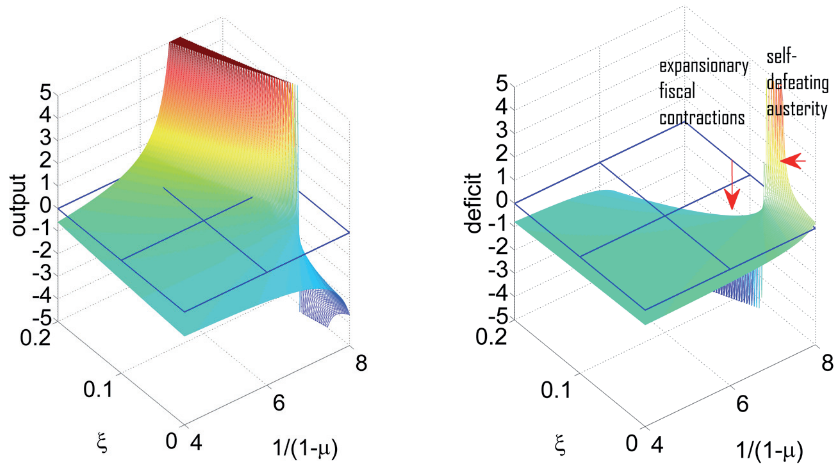
Are the consolidation programmes adopted by several countries since 2011 cutting too much and too soon, and thus creating unnecessary contraction and macroeconomic risk? This eCollection of VoxEU columns debates different aspects of this question. The stakes are high. In the Eurozone, the backlash from erring on the side of austerity could easily undermine social consensus towards the common currency and jeopardise progress towards integration. A crisis in the Eurozone, in turn, is bound to have (and is already having) deep negative repercussions at global level

It is important to clarify from the start that the debate is not about the need for fiscal discipline. In advanced countries, with an aging population and rising healthcare costs, the large expansion of debt due to the crisis is an unwelcome addition to the fiscal burden, and requires a convincing policy response. Rather, the debate is about the extent to which spending cuts and tax hikes in the short run are desirable and effective in containing the prospect of sovereign risk crises.

The question has many dimensions. The first dimension concerns the fiscal multiplier when markets charge a risk premium on government debt. This dimension can be illustrated by means of a figure that I borrow from joint work with Keith Kuester, André Meier and Gernot Müller. The figure is produced based on a standard new-Keynesian model, extended to encompass the possibility that (a) markets price sovereign risk based on expectations of future deficits and debt, and (b) rising risk premia on sovereign debt in turn create jurisdiction risk, affecting all residents in the economy, via a deterioration of the balance sheets of banks and corporates, increasing taxation risk, rising tariffs and costs of utilities, falling internal demand, and the like. Because of these reasons, fiscal stress translates into higher borrowing costs for private agents.

The figure is drawn assuming a large recessionary shock that causes the monetary authorities to bring (nominal) policy rates to zero, and studies the effect of an upfront cut in spending expected to last for the entire duration of the ongoing recession (see Corsetti et al. 2012 for details).

The figure plots the responses of output (left graph) and the deficit-to-GDP ratio (right graph) to a spending cut by 1% of GDP, against two key features of the crisis. On the right axis is the expected duration of the recession, in quarters, running from four to eight (that is, two to four years). On the left axis is the sensitivity of sovereign risk premium to expected deficits, which is rising in the initial stock of debt.



Source: Corsetti et al (2012)

The figure conveys a key message. If the recession is not expected to last very long (below four quarters), upfront spending cuts cause a moderate fall in output, and end up reducing the deficit. In this mild recession scenario, the direct contractionary impact of a cut in public demand is attenuated by the indirect effects on the interest rate on sovereign debt, de facto lowering private borrowing costs.

However, when the anticipated duration of the recession is longer (more than one year) the picture changes radically. For countries in relatively good (fiscal) shape, hence with a low sensitivity of the sovereign risk premium to future deficits, the direct effect dominates and becomes quite large – this is the case recently stressed by Christiano, Eichenbaum and Rebelo 2011. Because of the size of the multiplier, upfront cuts are self-defeating: the deficit-to-GDP ratio actually rises.

Conversely, for countries not in good shape, hence with a high initial public debt and/or a higher sensitivity of the risk premium to future deficits (moving up on the left-hand axis), the macroeconomic impact of spending cuts may even change sign: at some point, fiscal contractions become expansionary. It should be stressed that in the simulations underlying the graph, the conditions for expansionary fiscal contractions are actually strict – the debt-to-GDP ratio exceeds 110% – and quite sensitive to the assumptions regarding risk premia. But observe that the borderline between self-defeating and expansionary contractions is quite thin: small differences in the state of expectations and market attitudes may make a large difference regarding the impact of fiscal cuts. Moreover, although the graph does not depict this additional result, as the anticipated duration of the recession becomes longer, the economy becomes more and more vulnerable to self-fulfilling crises.

Despite the stylised nature of the exercise, there are concrete lessons to be learnt. At a minimum, the analysis confirms the sensible idea that the best strategy for debt consolidation is not the same across all countries.

- Early implementation of cuts to signal a government determination may work for countries with an already compromised fiscal stance, reflected in a high risk premium. But there is little need for rushing into cuts in countries with a relatively strong fiscal position (some of which are actually benefitting from a negative risk premium!). More complex is the situation of countries that have fared well so far (perhaps thanks to their monetary independence), but may still face the risk of deterioration of market sentiments because of underlying weaknesses in their economy and financial system.

There is also a deeper lesson, however.

- As expectations about output growth, and the sensitivity of risk premia to the future path of debt and deficits can vary significantly over time, it is quite difficult to assess the impact of fiscal reform. Plans that are well designed under a certain scenario may turn out to be counterproductive for a seemingly minor revision in market expectations. This consideration calls for a cautious approach to debt consolidation, preferring steady reforms with effect over time to cash-generating, immediate budget cuts.

Indeed, according to the model underlying the graph, adopting measures able to phase in cuts over time in a credible way, vastly improves the macroeconomic outcome.

It is also worth stressing that the theory and evidence on the effect of fiscal policy at times of financial crisis is scant. A global environment dominated by financial difficulties of banks struggling with chronic undercapitalisation, and financial markets never fully recovered from the paralyzing shocks in 2007-9, may cause fiscal policy to affect the economy in ways that are not sufficiently understood. Not only are we increasingly aware that multipliers may be significantly larger at time of economic slack. A paper presented at the *Economic Policy* panel this April suggests that, in the experience of OECD countries, fiscal policy has much larger effects in years of financial and banking crisis. While past crises may be different from the current one both in their size/geography and the policy response by the government, this is additional evidence calling for a cautious approach to fiscal retrenchment.

The second dimension of the question is the impact of fiscal reform on uncertainty. Namely, there is widespread consensus on the idea that at the root of the global crisis lies a significant increase in uncertainty that caused firms and households to increase precautionary saving and postpone investment plans. Successive rounds of budget plans of increasing severity may have, in some circumstances, created anxiety and confusion, adding to uncertainty.

- A key criterion for the success of fiscal consolidation is as simple as this: measures that reduce uncertainty are likely to be more effective; measures that raise uncertainty are likely to less effective, if not counterproductive.

The problem of uncertainty is especially acute in countries where tax hikes and deep cuts have so far not corresponded to any improvement in the macroeconomic conditions, thus generating expectations of either further austerity or unsettling reversals in the fiscal conduct.

This leads us the the last dimension of the question, which concerns what lies on top and above fiscal consolidation. While public solvency is a necessary condition for stabilizing markets, much of the crisis has global roots, and its stabilisation requires global action. Without a sense of direction, it would be next to impossible to keep a high level of consensus on contraction measures.

This sense of direction is what is currently missing in the euro zone. The low level of trust among governments has so far undermined progress in the cooperative design of an effective macroeconomic and financial framework. It is hard to see any crisis resolution without strong cooperation in banking, over recapitalisation or deposit insurance and public debt management, choosing among the various proposals, ranging from liquidity provision to reduce rollover risk, to a sinking fund or some form of Eurobond. The slow institutional and political response is at this point feeding the crisis, frustrating the effort exercised at country level.

- Fiscal consolidation is not sufficient to restore macroeconomic stability. Worse, consolidation itself may not be within the reach of governments without international policy cooperation providing a sense of direction out of the crisis.

The contributions of this eCollection shed light on all these different dimensions.

Alesina and Giavazzi rightly emphasise the content of the budget adjustment over the sheer size. The message is clear: adjustment operating on the spending side has a bigger chance of succeeding and being sustainable, than adjustment operating on the tax side.

The lesson applies to the composition and content of spending, and extends to the tax structure too. In many of the countries in a fiscal crisis, the provision of public services is poor, the productivity of the public sector is low, and the state often lacks the administrative capacity to spend on projects. By the same token, tax collection is inefficient, and the distribution of the tax burden unfair.

Fairness in sharing the burden of budget adjustment (both on the spending and the tax side), and the capacity of government to maintain a sufficient provision of public goods are crucial. Much of the success of budget consolidation will rest on widespread political consensus on the strategy.

The two contributions by DeLong and Rendahl call attention to a key problem, however. In a liquidity trap, the length and depth of the current recession is not exogenous, but is bound to depend on the extent to which current demand affects the level of economic activity. A sharp increase in unemployment and underemployment of capital activates adverse dynamics. As low employment today raises the probability of low employment tomorrow, job destruction today induces people to cut their consumption in anticipation of lower income *today and in the future*. This vicious spiral – destruction of jobs today generates expectations of persistently low employment tomorrow, thus causing even lower demand and more job destruction today – is a powerful, dangerous mechanism that can easily frustrate attempts to 'keep one's house in order' through immediate cuts.

Policy implications are well articulated in the contributions by Charles Wyplosz and Carlo Cottarelli. Charles Wyplosz draws attention on basic principles to design policies that stand a chance to keep the Eurozone alive. Namely, fiscal policy is for the long run, and should not be mixed with growth (for which the old or a new Lisbon Strategy is irrelevant). Europe needs a framework for policy cooperation, and for managing debt-restructuring.

Rather than a knee-jerk reaction of fiscal policy, Carlo Cottarelli writes, the current high level of uncertainty among firms and households makes it advisable to reconsider budget adjustment in relation to the ultimate policy goals of bringing our economies out of the doldrums and reducing the risk of financial instability. Fiscal adjustment should be steady, not rushed.

Of course there are differences in the conditions across countries, as stressed by Buti and Pench. Reaffirming the rationale for the fiscal compact, these authors warn about reliance on a gradual strategy of adjustment in countries where the stock of public liabilities is high, and which are coming out of a financial crisis. Under these circumstances, fiscal and financial stress requires immediate action. A clear instance of these measures is given by the Italian government, which has indeed shown resolve in reacting to deteriorating market confidence with stern measures.

Conversely, John Van Reenen makes a strong argument for the UK to slow down the pace of budget adjustment. In this country, borrowing in sterling has remained quite cheap. The government resolve and the action by the Bank of England had made a default relatively unlikely. The price of buying additional insurance against fiscal stress via further cuts may at this point be way too high.

An independent monetary policy (and a sharp depreciation of the pound) have arguably enabled the UK to fare well with the crisis, despite the magnitude of the shock the country had suffered via the crisis of its financial sector. Yet the conditions for slowing down adjustment may not be there for several countries in the Eurozone. This is the view expressed by Manfred Neumann, who forcefully argued that a relaxation of the fiscal stance could raise the prospect of a Eurozone break up. The pain from austerity is then to be assessed against the much worse option of a break up.

Ultimately, political consensus is the essential ingredient for any credible strategy of stabilisation. When from general principles one tries to move on to feasible policies, Wyplosz argues, the set of available measures to mitigate austerity is quite limited. The small steps government can credibly take may not be enough to prevent the political process to generate disruptive dynamics.

Francesco Daveri argues that, in fact, independently of slogan and headlines about renegotiating the terms of the fiscal compact, there is little alternative but to use the flexibility already built in the current agreements, and continue with bold implementation of economic reforms. Voters' reward for politicians who oppose austerity is bound to run into a hard constraint.

Yet, in his comment to Daveri's piece, Manasse warns against the often used argument that opposition to cuts come from countries that were most profligate in terms of spending growth. Indeed, in real terms, German spending grew much more rapidly than in Spain and Greece in the years before the crisis.

Panizza and Presbitera argue forcefully that high public debt is a drag for growth, proposing new evidence emphasizing the causal link between large stock of public liabilities, and the evolution of economic activity.

An insightful piece by Marco Annunziata makes it clear that youth unemployment in the Eurozone crisis countries has been exacerbated by the crisis, but it not a by-product of the crisis. The problem has deep roots in a policy that attempted to overcome rigidities in the labour market and the production structure by creating a deeply divided labour market, with 'ins' and 'outs'. The 'outs', mostly young people, provided the necessary flexibility to adjust in the years before the crisis, where domestic expansion coexisted with increasing competition from the Asian and Central European producers.

The collection ends with my leading commentary in the VoxEU debate "Has austerity gone too far?". Apart from revising some of the topics discussed above, this last contribution also points to the need for bold action – especially financial and monetary – to complement the fiscal adjustment effort.

The Eurozone cannot have it both ways. Crisis countries are rightly asked to take stern measures to correct their imbalances. This is a necessary component of a strategy for recovery. But individual countries' efforts, no matter how strong, cannot fix problems that are inherently systemic. An equally strong initiative at Eurozone level is what the survival of the single European currency, and perhaps much more, ultimately depends on.

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The austerity question: 'How?' is as important as 'how much?'

Alberto Alesina and Francesco Giavazzi
Harvard University and CEPR; Bocconi University and CEPR

Europe's embrace of austerity has sparked a debate among economists. This column argues that the debate has gone astray. Until the critical principle – 'how' is as important as 'how much' – is embraced, the austerity debate in Europe will continue to be completely out of line with the real economic trade-offs.

The European debate on fiscal austerity has gone astray – focusing exclusively on the *size* of deficit reductions. What policy makers should really be focusing on is the budget-tightening's *composition* (tax versus spending) and on the accompanying policies. Indeed, the title of this Vox debate – "Has austerity gone too far?" – reflects this inappropriate emphasis on size.

In our view, the essential question is not "how far" governments go but of "how" they go far enough.

Evidence on new taxes versus new spending cuts

Economists have engaged in some lively debates about how to measure and evaluate the effects of large fiscal adjustments episodes in OECD countries (Europe in particular). But a careful and fair reading of the evidence makes clear a few relatively uncontroversial points, despite the differences in approaches. The accumulated evidence from over 40 years of fiscal adjustments across the OECD speaks loud and clear:

- First, adjustments achieved through spending cuts are less recessionary than those achieved through tax increases.

- Second, spending-based consolidations accompanied by the right polices tend to be even less recessionary or even have a positive impact on growth.

These accompanying policies include easy money policy, liberalisation of goods and labour markets, and other structural reforms.

There remains a lot of work to be done on identifying the appropriate accompanying policies and understanding the channels through which they help spending-based stabilisations, but the fact is there, as shown for instance in a recent paper by Roberto Perotti (2011).

Third, only spending-based adjustments have eventually led to a permanent consolidation of the budget, as measured by the stabilisation (at least) if not the reduction of debts-to-GDP ratios.

IMF research on the austerity composition issue

Two recent IMF publications (IMF, 2010, Chapter 3, and Devries et al 2011) agree that spending-based adjustments are indeed those that work – but not because of their composition, rather because almost 'by chance' spending-based adjustments are accompanied by reductions in long-term interest rates, or a stabilisation of the exchange rate, the stock market, or all of the above.

This line of argument is flawed on purely logical grounds. Financial prices – interest rates, the exchange rate, the stock market – are not exogenous. They respond to fiscal policy announcements. For instance, if investors perceive, correctly, that only spending-based adjustments will lead to a permanent consolidation of the budget, this will increase 'confidence' and result in lower interest rates and higher stock prices.

A more convincing piece of evidence comes from a comparison of the effects of different 'types' of fiscal adjustment on confidence and on output. Tax-based stabilisations not only eventually fail, in the sense that they are unable to stop the growth of the debt-to-GDP ratio. When these fiscal packages are announced entrepreneurs' confidence falls sharply, and this is reflected in a fall in output. On the other hand, spending-based stabilisations (especially if accompanied by appropriate contemporaneous polices) do not negatively affect economic confidence contemporaneously. Moreover they are often accompanied by an increase in output within a year.

It stands to reasons that European countries where tax revenues over GDP or close to 50% do not have the room to increase revenues even more.

A paper by Harald Uhlig and Mathias Trabandt (2012) nicely shows how close many European countries are to the top of realistically measured Laffer curves. Thus any additional tax hikes would lead to relative low increases in tax revenues and could be very recessionary, through the usual supply- and demand-side channels.

Given all of the above we should stop focusing fiscal policy discussions on the size of austerity programmes. A relatively small tax-based adjustment could be more recessionary than a larger one based upon spending cuts. Likewise, a small spending-based adjustment could be more effective at stabilising debt over GDP ratios than a larger tax-based one.

Digging deeper into austerity's composition

One should go even further in disentangling the effects of composition.

- Which spending cuts are more likely to be effective?
- Which kind of tax reforms could achieve the same amount of tax revenue with fewer distortions?
- From where should market liberalisations start, and how fast should they proceed?

Some answers may be the same for all countries, others may differ.

For instance, in general moving taxation towards the VAT and away from income taxes is preferable.

In some countries there is no way out without a substantial raise in retirement age and cuts in government employment.

Incidentally this provides a clear link with labour-market reforms. Public-sector employment can only be reduced after firing constraints are moved and appropriate safety nets are put in place. Similarly the emphasis on the need and productivity of physical infrastructures is often misleading, at least in many countries.

Conclusion

Until this critical principle – 'how' is as important as 'how much' – is embraced, the austerity debate in Europe will continue to be completely out of whack with real economic consequences. .

We are in for a big disappointment on the centrepiece of Eurozone austerity – the Fiscal Compact. The Fiscal Compact bears the seeds of its failure:

- The new Fiscal Compact that Europe has decided to impose upon itself through a treaty change makes no mention of the composition of fiscal packages.
- European economies will remain stagnant – if not further fall into recession – if adjustments will be made mostly on the tax side and debt ratios will not come down.

And in the end, as was the case with the Growth and Stability Pact, the rules will be abandoned.

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Spending cuts to improve confidence? No, the arithmetic goes the wrong way

J Bradford DeLong
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The Vox debate on austerity rages on. Here Brad DeLong draws on his recent research with Larry Summers to argue that unless long-term real borrowing costs in the Eurozone exceed 5%, the short-term contractionary effects of spending cuts are likely to erode rather than bolster the overall fiscal situation.

In their recent Lead Commentary, Alesina and Giavazzi (2012) attack Corsetti (2012) for missing the point:

> *"The European debate on fiscal austerity has gone astray – focusing exclusively on the size of deficit reductions. What policy makers should really be focusing on is the budget tightening's composition (tax versus spending) and on the accompanying policies. Indeed, the title of this Vox debate – "Has austerity gone too far?" – reflects this inappropriate emphasis…"*

But as I read further, I feel that Alberto Alesina and Francesco Giavazzi immediately proceed to miss an even bigger point. They say:

> *"… spending-based consolidations accompanied by the right polices tend to be less recessionary or even have a positive impact on growth. These accompanying policies include easy money policy…"*

But right now in Europe we are not going to have easier monetary policies to offset the contractionary effect of fiscal policies, are we?

Indeed, it is not even clear what, in today's context, easier monetary policies would mean.

The ECB could induce banks to make more loans, and fund more investment and consumption spending by credibly promising to raise its permanent inflation target – but it will not so promise, and it would not be believed if it did. The ECB cannot induce banks to make more loans and fund more investment and consumption spending by swapping bonds for reserves as long as the value of pure liquidity is zero and reserves are as good as – nay, better than – short-term bonds. The ECB could induce banks to make more loans and fund more investment and consumption spending by taking risk onto its balance sheet and so freeing-up scarce private risk-bearing capacity – but is that monetary policy? No, that is fiscal policy, albeit non-standard fiscal policy.

Fiscal policy is the only game in town. If austerity is to boost recovery, it must do so because it in itself is good for recovery – not because it is accompanied by monetary policies that speed recovery.

It is certainly the case that a Europe with shaky credit could boost its economy by pursuing a spending-based reduction in its deficit that boosted confidence in public credit. As Karl Smith of UNC Chapel Hill noted in this blog post, one way of seeing this is to look at a neo-Wicksellian equilibrium flow-of-funds condition in financial markets. On the left-hand side place the net flow of private savings into a country's financial market: its domestic private savings which depends on the level of economic activity (i.e. Savings[Y]), minus net exports (NX). On the right hand side place the change in the desired bond holdings of banks and other investors, a function of the riskiness of bonds ρ and the real opportunity cost of money to banks, the difference between the nominal interest rate i and the expected inflation rate π, i.e. i.e. $\Delta B[i - \pi, \rho]$. The resulting neo-Wicksellian equilibrium condition is:

$$Savings[Y] - NX = \Delta\ Bond\_holdings[i - \pi, \rho]$$

This equation tells us that the warranted level of domestic private savings – and thus, via savings, the short-term equilibrium level of economic activity Y – can be boosted by: 1) a depreciation that raises NX, 2) monetary policy that reduces i, 3) a commitment to higher future inflation that raises expected inflation π, or 4) policies to reduce the riskiness ρ of the bond stock – by policies like loan guarantees, forced recapitalization of the financial sector, or adoption of a budget strategy that reduces the risk of holding private or public bonds that may be subject to default, less-than-fully-voluntary exchange, or unexpected inflation.

The only stimulus possible

In a situation where an economy is at the zero lower bound so that i cannot be lowered, a central bank that will not raise π, and a common currency that rules out depreciation to raise NX, reducing the riskiness ρ of the bond stock is the only game in town.

Now a credit-worthy government like the US would have no problem reducing the average riskiness ρ of the bond stock. It would simply issue more bonds and spend the money on projects of social utility. Because its credit is good, its bonds are automatically less risky than the average, and so the average riskiness of the bond stock falls.

And a government with shaky credit that adopts a credible fiscal plan also has no problem reducing the average riskiness ρ of its bond stock. It adopts its plan. Its plan is credible. And, voila, the average riskiness of the bond stock declines – and so the warranted flow of private domestic savings rises, and so the equilibrium level of economic activity rises as well.

What makes a fiscal plan credible?

But what is a credible fiscal plan? It certainly involves in the long-run balancing the funding requirements of the promised social insurance system with taxes. But what does a credible fiscal plan require in the short run? Does it require austerity now, and spending cuts now?

The point of Lawrence H. Summers's and my contribution to the spring 2012 Brookings Institution Panel on Economic Activity (DeLong and Summers 2012) was that, as a matter of basic arithmetic, if there is any short-term Keynesian multiplier at all – even one as low as 1/2 – and if there is any long-run shadow cast on potential output by a deeper economic downturn at all – even one as low as 1/10 – then for a country like those of western Europe with a marginal tax-and-transfer share 0.4 and an expected long-run growth rate of 2% per year, short-term spending cuts worsen the long-run fiscal picture as long as the government's real long-term borrowing cost is under 5%.[1]

Thus, unless we believe that the long-term real borrowing costs for western Europe as a whole will be more than 5% per year – that nominal borrowing costs will be more than 7% year – spending cuts now to reduce the deficit are likely to erode rather than bolster the overall fiscal situation. They damage rather than restore confidence. They raise rather than lower the riskiness of the outstanding bond stock. And so they reduce rather than raise employment and production in the economy.

Credible plans and programs for long-run fiscal balance, yes.

Structural reforms to free-up enterprise and increase opportunity, yes.

Reworking the social-insurance state to make it cheaper and less wasteful, yes.

But spending cuts now to lay sacrifices on the altar of credibility in the hope of improving confidence and reducing the riskiness of the outstanding bond stock? No. The arithmetic simply goes the wrong way – unless you believe that Eurozone nominal bond yields will soon normalize to levels above 7% per year.

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1 The formula is $r < g + \tau\eta\mu/(1\text{-}\mu\tau) = 5\%$, m is the short-term Keynesian multiplier (say, as low as ½), h is the long-run shadow cast on potential output by a deeper economic downturn (say as low as 1/10), t is the marginal tax-and-transfer share (say, 0.4), and g is the expected long-run growth rate (say 2%). Short-term spending cuts worsen the long-run fiscal picture as long as the government's real long-term borrowing rate r satisfies this formula. See DeLong and Summers (2012) for details.

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A time to spend: New insights into the multiplier effect

Pontus Rendahl
University of Cambridge

Many developed economies are in a liquidity trap with interest rates at or near zero. Many also have high unemployment that looks set to persist. This column argues that it is times like these when governments should be spending more, not less – they just have to be careful how they do it.

With debt-levels hitting record highs and growth running low on steam, European policymakers have found themselves facing a grim dilemma: should government spending be increased at the risk of reawakening the wrath of the sovereign bond markets? Or should austerity instead assume the political mantra with the hope of merely muddling through?

True, substantial theoretical and empirical evidence lend support to the idea that a deficit-financed expansion in public spending may raise output and speed up the recovery. And the most recent experience in Europe has shown with terrifying clarity that high levels of debt may provoke yet another round of sovereign debt crises. But there is little, if any, support in the current macroeconomic literature for the view that expansionary fiscal policy must come at the price of ramping up debt. In fact, contemporaneously tax-financed spending might do the trick equally well. And inasmuch as a 'balanced-budget stimulus' can set the economy on a steeper recovery path, the long-run sustainability of debt may well improve, and not deteriorate (DeLong and Summers 2012).

The reasoning underlying these ideas is known as Ricardian equivalence (Barro 1974). Yes, the same theorem that allegedly bears responsibility for putting a "nail in the coffin" of the Keynesian multiplier (Cochrane 2009) also suggests that spending will have the same effect independently of its source of financing. Ricardian equivalence states that, under certain conditions, financing a given level of spending through debt (ie future taxes), or through current taxes, is irrelevant.

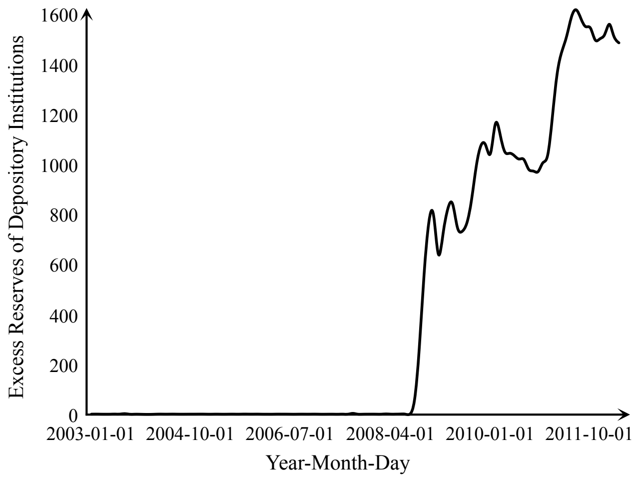
Yet while Ricardian equivalence might have put a nail in the coffin of the *Keynesian* multiplier, it has certainly not pre-empted the underlying idea: that an increase in government spending may provoke a kickback in output many times the amount initially spent. Indeed, a body of recent research suggests that the fiscal multiplier may be very large, independently of the foresightedness of consumers (Christiano et al 2011, Eggertson 2010). And in a recent study of mine (Rendahl 2012), I identify three crucial conditions under which the fiscal multiplier can easily exceed 1 irrespective of the mode of financing. These conditions, I argue, are met in the current economic situation.

Three conditions for a large balanced-budget multiplier

Condition 1. The economy is in a liquidity trap …

When interest rates are near, or at, zero, cash and bonds are considered perfect substitutes. As the intertemporal price of money fails to adjust further, a disequilibrium emerges in which the demand for assets exceeds the supply. A dollar lent is no longer a dollar borrowed, and cash is instead hoarded. Figure 1 illustrates the evolution of US banks' cash reserves held at the Federal Reserve from 2003 until today. While money, of course, is a very elusive concept, the skyrocketing rise of bank cash reserves suggests that liquid means are being pulled out of circulation.

Figure 1



Under these peculiar circumstances the laws of macroeconomics change. A dollar spent by the government is no longer a dollar less spent elsewhere. Instead, it's a dollar less kept in the mattress. And the logic underpinning Say's law – the idea that the supply of one commodity must add to the immediate demand for another – is broken. In a liquidity trap, the supply of one commodity (eg labour) may rather add to the immediate demand for cash, and not to any other real commodity per se (Mill 1874). From merely being a means of payment, cash turns into a means of storage.

Condition 2. … with high unemployment …

So while a dollar spent by the government is not a dollar less spent elsewhere, it is not immediate, nor obvious, whether this implies that government spending will raise output. The second criterion therefore concerns the degree of slack in the economy.

If unemployment is close to, or at, its natural rate, an increase in spending is unlikely to translate to a substantial rise in output. Labour is costly and firms may find it difficult to recruit the workforce needed to expand production. An increase in public demand may just raise prices and therefore offset any spending plans by the private sector.

But at a high rate of unemployment, the story is likely to be different. The large pool of idle workers facilitates recruitment, and firms may cheaply expand business. An increase in public demand may plausibly give rise to an immediate increase in production, with negligible effects on prices. Crowding-out is, under these circumstances, not an imminent threat.

Combining the ideas emerging from Conditions 1 and 2 implies that the fiscal multiplier – irrespective of the source of financing – may be close to 1 (cf Haavelmo 1945).

Condition 3. … which is persistent.

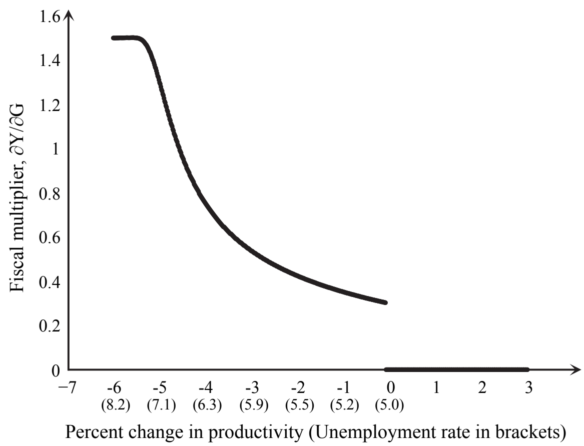
But if unemployment is persistent, these ideas take yet another turn. A tax-financed rise in government spending raises output, and lowers the unemployment rate both in the present and in the future. As a consequence, the increase in public demand steepens the entire path of recovery, and the future appears less disconcerting. With Ricardian or forward-looking consumers, a brighter outlook provokes a rise in contemporaneous private demand, and output takes yet another leap. Thus, with persistent unemployment, a tax-financed increase in government purchases sets off a snowballing motion in which spending begets spending.

Where does this process stop? In a stylised framework in which there are no capacity constraints and unemployment displays (pure) hysteresis, I show that the fiscal multiplier is equal to the inverse of the elasticity of intertemporal substitution, a parameter commonly estimated to be around 0.5 or lower. Under such conditions, the fiscal multiplier is therefore likely to lie around 2 or thereabout.

Collecting arguments

To provide more solid grounds to these arguments, I construct a simple DSGE model with a frictional labour market.[1] A crisis is triggered by an unanticipated (and pessimistic) news shock regarding future labour productivity. As forward-looking agents desire to smooth consumption over time, such a shock encourages agents to save rather than to spend, and the economy falls into a liquidity trap. In similarity to the aforementioned virtuous cycle, a vicious cycle emerges in which thrift reinforces thrift, and unemployment rates are sent soaring. Figure 2 illustrates the associated fiscal multiplier (y-axis) under a range of news shocks, stretching from a 7% decline in labour productivity to a 3% increase. The unemployment rate is given in brackets.

Figure 2



There are three important messages to take away from this graph.

- First, for positive or small negative values of the news shock, the multiplier is zero. The reason is straightforward: With only moderately pessimistic news, the nominal

1 DSGE model = Dynamic Stochastic General Equilibrium model.

interest rate aptly adjusts to avert a possible liquidity trap, and a dollar spent by the government is simply a dollar less spent by someone else.

- Second, however, once the news is ominous enough, the economy falls into a liquidity trap. The multiplier takes a discrete jump up, and public spending unambiguously raises output. Yet, in a moderate crisis with an unemployment rate of 7% or less, private consumption is at least partly crowded-out.
- Lastly, however, in a more severe recession with an unemployment rate of around 8% or more, the multiplier rises to, and plateaus at, around 1.5. Government spending now raises both output and private consumption, and unambiguously improves welfare.

Conclusions

Pessimism and uncertainty about the future fuels fear, and fear is, as we know, a powerful thing.

- A gruesome outlook can set the economy on a downward spiral in which fear reinforces fear; thrift reinforces thrift; and unemployment rates are sent soaring.

But the same mechanisms that may cause a vicious circle can also be turned to our advantage.

- A tax- or debt-financed expansion in government spending raises output and sets the economy on a steeper path to recovery.

Pessimism is replaced by optimism and spending begets spending.

But these times are also fragile. Without a credible plan for financing, an increase in government spending will come at the price of debt. And a rise in debt may contribute to further rounds of pessimistic expectations. To be successful, therefore, the tax and spending policy advocated in this column must not magnify people's insecurities.

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The coming revolt against austerity

Charles Wyplosz
The Graduate Institute, ICMB and CEPR

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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The austerity debate: Make haste slowly

Carlo Cottarelli
IMF

As with austerity itself, the austerity debate shows no sign of disappearing any time soon. This column argues that the last thing that the world economy needs at this uncertain moment is a knee-jerk reaction from fiscal policy. While the column agrees that governments need to make cuts, it stresses they should not lose sight of the bigger picture.

The austerity debate would not be as heated if commentators focused on the current state of the world economy, rather than on how economies work in normal times. If they did, they would see that a pragmatic approach – proceed with moderate adjustment, at a steady pace, if markets allow you to do so – is the best course of action. You may call it the Goldilocks principle: fiscal policy should be just right. Or, if you want to show off your classical studies, you may call it the *festina lente* principle, with the backing of two thousand years of history.[1]

So, what are the relevant facts – the special circumstances that characterise global economic conditions now – and what do they imply for fiscal policy? I will focus on advanced economies, because this is where the debate is most heated.

To start with, advanced economies are recovering from the largest economic shock since the Great Depression. In most of them, output is well below potential. In these circumstances fiscal multipliers are larger than those often found in the literature, which are estimated without considering the cyclical position of the economy: when output is

1 *Festina lente* ("make haste slowly") is a motto widely used at least since the early Roman Empire to underscore the importance of moving forward with resolve but with adequate preparation.

near or above capacity, deficit cuts are likely to result in reduced inflationary or current account pressures rather than lower output, biasing down estimates of multipliers that do not control for cyclical positions (see IMF 2012 for new evidence on this).

Two additional factors suggest that fiscal multipliers are relatively high at present.

- First, the monetary authorities have little scope to lower money market rates to offset some of the deflationary impact of fiscal tightening. Unconventional policies can be used further but their effect on private sector credit is far from certain. The financial crisis has left big scars and has weakened the propensity to lend of financial intermediaries, including because of insufficient own capital.
- Second, nominal exchange rate depreciation is not an option for the countries that would mostly benefit from it – ie the Eurozone countries with weak fiscal accounts (as a significant portion of their trade is with partners inside the currency bloc).

It could be argued that an expansionary fiscal contraction is at least a possibility in countries where spreads are high and where fiscal consolidation could trigger a return to confidence. Let me be clear about this. These countries will have to frontload fiscal adjustment, given their difficulty in borrowing at sustainable interest rates. But a confidence-inspired decline in spreads that might accompany fiscal tightening in more normal times could be impeded by the current focus of markets on short-term growth developments. If markets believe that fiscal tightening will lead to a decline in growth, spreads will not decline (a problem that seems particularly severe in case of large fiscal tightening, due to nonlinearities in the relationship between growth and spreads; see Cottarelli 2012). This may be a case of multiple equilibria: if markets anticipate that tightening will not slow growth, spreads could fall and growth could indeed be maintained despite a fiscal tightening, while, if markets anticipate that growth will slow, spreads could rise and growth would suffer. But the recent downgrade of some European countries by Standards & Poor's, citing the negative impact of fiscal tightening on growth, suggest that market behaviour will likely lead to the realisation of the bad equilibrium.

Altogether, we can conclude that a sizeable fiscal tightening would have contractionary effects on the economy (a problem that is magnified by the fact that most advanced economies are tightening at the same time). Spreading the adjustment over time, allocating part of it to periods when the output gap will be smaller and the credit channel will be stronger, would have advantages.

Does this conclusion hold also for expenditure-based consolidations? Probably yes, as the factors that would support the recovery of private sector demand (a monetary-policy expansion, an exchange-rate depreciation, a decline in spreads) are no less impaired at present for spending cuts as they are for revenue increases (as noted by DeLong 2012 on this site). I would argue that, for most advanced countries, an expenditure-based consolidation is preferable. But this is not because one is much less costly than the other in the near term. It is because potential growth in countries where tax rates are already high, as in most European countries, would suffer in the long run from further increases.

So, if moving too quickly with fiscal adjustment is risky, why move at all? I already answered for countries that are under severe market pressure. Markets are already concerned about fiscal credibility in those countries, and promising that the adjustment will come at a later time would just not be credible. What about other countries? They have more room and could slow the pace of adjustment depending on cyclical developments. But even for those, short of a major deceleration in economic activity, postponing the adjustment altogether would be risky for three reasons.

- First, public debt has never been so high since WWII. High debt may raise sustainability questions; but, more important, when debt is high even relatively small increases in interest rates can move public finances from a good to a bad equilibrium, derailing public finances. In these conditions, deferring fiscal adjustments involves higher risks.
- Second, market focus on short-term developments makes it more difficult to trade off long-term fiscal tightening (say, reforms in entitlement spending) for short-term

fiscal expansion. Spreads do not seem to reflect differences in long-term trends in entitlement spending (Cottarelli 2012), suggesting that long-term reforms may buy little credit from markets in current circumstances.

- Third, the Greek debt restructuring has broken a taboo that had persisted throughout the post WWII period, namely that debt restructuring does not happen in advanced economies.

Of course, the relative importance of these factors varies across countries. But the main idea is that postponing fiscal adjustment to better times is now more difficult than in the past: a gradual approach would avoid the risk of having to tighten too rapidly later, should markets start having doubts about your credibility. It is a matter of risk management. Note finally that some of the costs related to fiscal adjustment discussed above – for example a possible rise in spreads as growth decelerates – involve some nonlinearities, ie the costs are more likely to occur for large deficit cuts than for moderate adjustments.

The last thing that the world economy needs in this uncertain environment is a knee-jerk reaction from fiscal policy. Proceeding at a moderate speed – with some consideration for cyclical developments but with a clear sense of direction and with a mix of consolidation measures that takes into account long-term efficiency goals – seems the right thing to do. *Festina lente!*

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Fiscal austerity and policy credibility

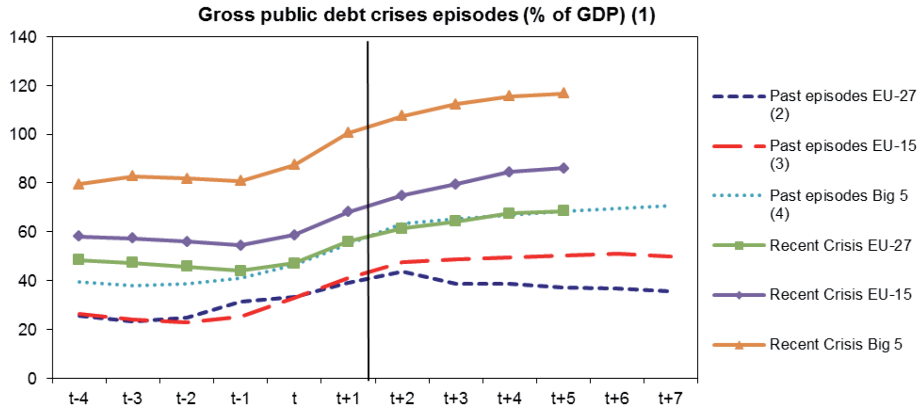
Marco Buti and **Lucio R Pench**
European Commission

Most economists agree that European economies share the need to reduce public deficits and debts. This column stresses that while gradual consolidations are in general more likely to succeed than cold-shower ones, the superiority of a gradual strategy tends to evaporate for high levels of debt and is also less pronounced for consolidation episodes following a financial crisis.

The renewed phase of tension in Europe and the Eurozone in particular since the second half of 2011, with the prospect of a double-dip recession alternating with that of a sovereign-debt crisis, has reignited the debate on fiscal austerity, to which European governments have been committed since the end of the most acute phase of the crisis in 2009.

Before entering the debate, it is important to stress that there should be little question that European economies share the need to reduce public deficits an debts from levels that, as confirmed by a growing strand of empirical literature (Reinhardt and Rogoff 2009, Kumar and Woo 2012), are likely to be harmful for growth in the medium term, and even more so if one factors in the large implicit government liabilities linked to ageing. In fact, a striking feature of the current financial crisis compared to previous comparable episodes in industrial economies is not so much the increase in public debt from the onset of the crisis, which appears to have followed a well-trodden path, but the (much) higher level from which the increase started (Figure 1). This heightens the concern for threshold effects.

Figure 1 Gross public-debt crises (% of GDP)



Notes: (1) Based on 49 crises episodes. Unweighted country averages. t = start of the crisis. (2) Includes crisis episodes in Czech Republic, Finland, Hungary, Latvia, Poland, Slovak Republic, Spain and Sweden. For new Member States data from 1991. (3) Includes crisis episodes in Finland, Spain and Sweden.(4) Includes crisis episodes in Finland, Norway, Sweden, Japan and Spain. Sources: Calculations based on IMF International Financial Statistics and AMECO.

The debate on fiscal austerity therefore is about the timing and speed of consolidation, not on its overall size.

The debate on fiscal austerity: A stylised representation

In economic terms, it can be seen as revolving around the size of the fiscal multipliers; the higher the multiplier, the more costly, in terms of growth, the austerity. The following stylised representation (borrowed from Roeger and in't Veld (2012)) may help to illustrate the matter.

For a given composition of the fiscal adjustment, the multiplier can be expressed as:

Multiplier = [1 – 'confidence'] / [1 + (monetary policy) + (competitiveness) - (financial constraint)]

The 'confidence' term refers to i) 'non-Keynesian' wealth effect on consumption and investment stemming from the expected reduction in future taxes and ii) the credibility effect on the real interest rate stemming from the reduction in risk premia (both effects are supposed to follow an adjustment that is, and perceived to be, permanent (and successful), hence the 'confidence' label); 'monetary policy' and 'competiveness' stand, respectively, for the accommodating reaction of monetary policy to and the gains in international competitiveness from the negative impact of adjustment on inflation, which partially offset its negative impact on private demand; finally, the proportion of households and firms that are liquidity or credit constrained will increase the multiplier, by making difficult or impossible for the private sector to compensate by borrowing the impact of adjustment on current income.

The composition of fiscal adjustment interacts with the multipliers determinants to produce different growth outcomes depending on the choice of the instrument, with the ranking however inverting when one moves from the short to the medium-to-long term. In particular, (exhaustive) expenditure cuts have more negative short-term output effects, but positive effects in the long term (through the non-Keynesian confidence channel), the short-term output loss of tax increases is smaller, but persistent over time (for a summary set of simulations of the effect of different instruments using the Commission QUEST III model, see European Commission 2010).

Last but not least, the effects of adjustment are likely to differ depending on whether the economy is in a recession or expansion phase. The response effect of output is likely to be larger in a recession, reflecting the presence of unused resources.

If one compares this stylised representation of the effects of fiscal adjustment with the current situation in the Eurozone, the following conclusions stand out:

- the state of the economy can be characterised as a balance-sheet recession, namely, a major financial-cycle bust following a boom against backdrop of low inflation (Borio et al 2011). This implies that the multipliers determinants are working in different directions;
- on the one hand, that the debt and capital overhang in the private sector and the corresponding impairing of the financial sector make further borrowing to offset the impact of fiscal adjustment on current income a difficult if not impossible proposi-

tion; the very low level of inflation and interest rates constrain the room for accommodating monetary policy and for achieving competitiveness gains (under fixed exchange rates);

- on the other hand, ballooning public deficits and debts, largely a consequence of the unrecognised unsustainable nature of revenues and build-up of contingent liabilities during the long boom phase preceding a balance-sheet recession, raise doubts on government solvency thereby increasing the ‘confidence’ term, working through the sovereign-risk channel linking public and private borrowing costs.
- moreover, conventional fiscal stimulus measures fail to address directly the debt overhang and balance-sheet repair problem. Addressing balance-sheet repair problems head on is instrumental to reducing the size of the multipliers in the adjustment process and ultimately unlocking a ‘virtuous cycle’ of self-sustained recovery (Buti and Padoan 2012);
- therefore, while economies share the need for reducing deficit and debts, the appropriate pace of consolidation should differ across countries. Countries with very high and/or rapidly rising debts may be well-advised to pursue a fast adjustment, in spite of an unfavourable economic environment, if the alternative of a sovereign-debt crisis is sufficiently plausible. While the composition of the adjustment should be tilted towards expenditure, which typically would have risen too much throughout the period when windfall revenues were flattering public accounts, a mix of expenditure cuts and tax rises is likely to be inevitable. Besides considerations of political economy, it may also produce a smoother response of output to consolidation.

These conclusions find support in an analysis of successful fiscal consolidations focusing on the probability of reducing the public-debt ratio relative to its pre-consolidation levels (European Commission 2010b). In particular, it shows that while gradual consolidations are in general more likely to succeed than cold-shower ones, the superiority of a gradual strategy tens to evaporate for high levels of debt and is also less pronounced for consolidation episodes following a financial crisis.

It has been recently argued that fiscal consolidation can be 'self-defeating', if for example risk premia respond positively to the debt-to-GDP ratio and the latter increases instead of diminishing as a result of consolidation. While this result is plausible in the short term for a range of values of the multiplier and the debt ratio, the reaction of risk premia presupposes myopia on the part of financial markets, since the initial increase in the debt ratio would be followed by a movement in the opposite direction, as the multiplier effect fades away and the primary balance is permanently improved by the adjustment (Gros 2011).

How the EU fiscal framework fits in the policy debate

The EU fiscal framework is sometimes characterised as imposing a 'one-size-fits-all' fiscal-consolidation model, which ignores the need for differentiation outlined above (Wolf 2012). This characterisation is less than accurate. Admittedly, the EU fiscal framework is rule-based, which implies a presumption of reaction on the part of the budgetary authorities when certain trigger indicators of unsound fiscal policies are activated. In turn, the rules to be workable, the triggers need to be easily readable , hence the choice of 'reference values' for the government deficit (level) and debt (level and change) for triggering the excessive deficit procedure (in fact considerations of simplicity led to privileging until recently the deficit indicator at the expense of debt dynamics). At the same time, the framework leaves considerable scope for modulating the fiscal-policy reaction, both in terms of the initial prescription of the adjustment path and its subsequent adaptation to economic shocks. These characteristics have been accentuated by the recent reform of the Stability and Growth Pact (European Commission 2011, 2012) and are borne out by the fiscal exit strategy that EU countries commonly agreed already in 2009 and subsequently confirmed with some modifications. The strategy revolves around three pillars:

- Countries are given a multi-year horizon, ranging from two to five years, to correct the excessive deficit position. Setting a deadline for the correction is a requirement of the excessive-deficit procedure but also serves the economic purpose of anchoring expectations of return to sound public finances;

- the speed of adjustment and the degree of frontloading broadly reflect the availability of fiscal space and economic conditions. Specifically, countries facing market pressures were recommended to start their, typically larger, adjustment, already in 2010, while for the others adjustment should effectively start from 2011. Consolidation is generally gradual, albeit substantial;
- countries are encouraged to pay attention to the quality of the adjustment, in terms of composition and accompanying structural reforms. Policy recommendations in these areas, which already figure prominently in adjustment programmes, are to be sharpened for all countries through the implementation of the macroeconomic imbalances procedure, which complements the recent reform of the Stability and Growth Pact.

Concerning the response to shocks, it needs stressing that the Stability and Growth Pact explicitly allows for the playing of automatic stabilisers around the adjustment path, that is, the adjustment is formulated in structural terms. Acknowledging the problems inherent in the measurement of structural balances, the framework calls for a 'in-depth analysis' of the reasons behind a country' s failure to meet the budgetary targets, including revisions in potential growth and endogenous changes in revenue elasticities. To these elements of flexibility the recent reform has added the possibility of extending deadlines for the correction of the excessive deficits irrespective of a country' individual predicament, if the situation of the euro area or the EU as a whole calls for a relaxation of fiscal policy.

It should also be noted that the operationalisation of the debt criterion of the excessive-deficit procedure through the '1/20' debt-reduction benchmark - possibly the most visible innovation of the reform - is accompanied by greater allowance for an economic reading of the debt trigger. Of particular interest in the current context is the provision whereby capital injections to preserve the stability of the banking sector are counted as mitigating factors when assessing a breach of the benchmark.

The greater-than-commonly-appreciated flexibility afforded by the Pact entails a considerable room for discretionary judgement when it comes to its application. In particular, while the occurrence of economic shocks allows for an extension of the deadline for the correction of the excessive deficit, on condition that the prescribed structural effort has been delivered, it is left to the discretion of the Commission and the Council whether an extension should be effectively granted. In this connection the second pillar of differentiated of the EU fiscal exit strategy, namely, differentiation according to fiscal space, comes into play. It may be warranted to ask an additional fiscal effort of a country facing the risk of a debt interest spiral, while longer correction deadlines certainly make sense for countries where sovereign risk is subdued.

The attention drawn by few problematic cases should not obscure the fact that most countries in the Eurozone and the EU are making steady progress towards the correction of the excessive deficit in line the multi-annual adjustment path defined by the Council in 2009. For these countries the EU framework has provided an anchor, in the absence of which adjustment might have less credible and hence even more costly, according to the stylised discussion presented above. Nor is it clear, including from the revealed preferences of national authorities, that even the minority of countries that are struggling to meet the deadlines would necessarily benefit from a generalised relaxation of the current targets.

A differentiated application of flexibility, trading the risk to stabilisation against those to financial stability, may in fact be the preferable approach. Nor should the quest for flexibility be concentrated on the relaxation of deficit targets. When balance-sheet repair is the pre-condition for the restoring of normal economic relationships, it may be preferable to concentrate the limited fiscal firepower on the recapitalisation of the banking sector rather than on conventional tax and expenditure programmes (for model simulation lending support to prioritising bank recapitalisation see Kollmann et al 2011).

To sum up, the EU fiscal framework can certainly be criticised. As every rule-based framework it represents an imperfect answer to the basic credibility problem of economic policy. Depending on their overall persuasion and their reading of the current situation critics may reproach a lack of flexibility or even an excess of it. The framework is not however disconnected from the economic debate on austerity. In fact, it can rationalised broadly consistent with the view that "weak growth in countries facing precarious fiscal positions is not sufficient evidence against fiscal austerity" (Corsetti 2012).

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Fiscal consolidation: Too much of a good thing?

John Van Reenen
London School of Economics and CEPR

Many policymakers in Europe seem to stick to the idea that fiscal consolidation might inspire confidence and help the economy to grow. This column argues these sentiments may be understandable but are basically wrong. For countries like the UK where borrowing is relatively cheap and sovereign default unlikely, slowing down the pace of fiscal consolidation would be a rational response. The obsession over the fiscal stance is a distraction from sustainable long-run growth.

This week's political events in the Netherlands and France which look likely to lead to government dissolution, have been interpreted as a set-back for the pace of fiscal consolidation in Europe with popular resentment punishing incumbent leaders ("Leaders in Austerity Backlash" was the headline of the *Financial Times* on 24 April 2012). The response of the European economic establishment has been to stay the course. In the words of the Bundesbank President, Jens Weidmann: "We can only win back confidence if we bring down excessive deficits and boost competitiveness….in such a situation, consolidation might inspire confidence and actually help the economy to grow" (*Financial Times* 2012).

These sentiments may be understandable, but I will argue that they are basically wrong. Germany is rightly concerned about past and future fiscal profligacy by countries like Greece undermining the euro. But the problems of Spain and Ireland, for example, stem not from public borrowing but rather high private debts due to the aftermath of the construction bubble. Forcing Spain down to a deficit of 3% of GDP by 2013 when the 2011 level is 8.5% is, as my colleague Luis Garicano describes it, "Mission Impossible". Or as *The Economist* (2012) puts it "The misguidedness of today's austerity obsession is clearest in Spain…Relying on austerity alone, in a shrinking economy after a huge private debt burst, is a recipe for deflation and depression that could easily end up worsening the underlying fiscal position"

Although it is sometimes possible for sharp fiscal consolidation to stimulate growth, this is very rare and nigh on impossible when your main trading partners are also embarked on similar austerity drives. The economic question is whether the current pace of fiscal consolidation should be slowed. Even if a slowdown is granted on pure economic grounds, austerity defenders would say that in some countries the risk of a sovereign bond crisis means the current path is justified (Corsetti 2012). Further, even if the markets are favourable, political credibility requires cutting fast now. In considering the case for slowing the pace of fiscal consolidation, I look at the straight economics first before examining the issue of bond-market psychology and political economy. All three aspects are linked, of course.

The economics case for slowing austerity

The IMF (2012) recently made the case for slowing the pace of fiscal consolidation in countries where borrowing costs are low. "Overdoing fiscal adjustment in the short term to countercyclical revenue losses will further undercut activity, diminish popular support for adjustment, and undermine market confidence."

The arguments for slowing the pace of fiscal austerity are relatively simple (eg Delong and Summers 2012). First, there is a sizeable gap between actual and potential output which monetary policy struggles to eliminate, even with quantitative easing, when interest rates are close to zero. Although the financial crisis is likely to have reduced the level of potential output the exact magnitude is much disputed. It is likely that depressed measured productivity in most of Europe is due to depressed demand as well as a negative supply shock (CEP 2011).

Second, the fiscal multiplier is likely to be much higher during the current deep downturn than in normal times (eg Auerbach and Gorodnichenko 2010). This implies that fiscal contraction has a much more damaging effect on economic output when activity is depressed as it is now than it would do during a stronger stage of the business cycle.

Third, the longer the recession lasts the more likely 'hysteresis' effects are likely to set in which prolong the period of slow growth. This may operate through the labour market as the numbers of long-term unemployed rise and these individuals lose their human capital; through capital scrapping or through credit constraints on innovative firms (Aghion et al 2009, Aghion et al 2012). This implies that short-run policies over demand may have long-run impacts on the productivity supply side of the economy. These hysteresis effects are typically ignored in the macro models of member states

These arguments imply that in the face of a slowdown in demand, adjusting the pace of a fiscal consolidation plan can be justified.

Some caveats on the question

Before discussing why political and psychological considerations might cause a revision of opinion, I want to first raise some caveats to the whole Vox austerity debate relating to the long run, the medium run, the composition of cuts, and other Eurozone challenges.

Long-run policies towards growth

In some sense the obsession over the fiscal stance is a distraction from the more fundamental question of how to establish sustainable long-run growth. Structural reforms to increase competition in labour and product markets are one way of helping here[1]. It would be a "waste of a good crisis" to fail to enact needed structural reform as

1 For some ideas see Van Reenen 2011, Garicano *et al* 2012, Bloom *et al* 2012.

Mario Monti is attempting to do in Italy by reducing barriers to entry and exit. More generally, attention needs to be refocused on these longer-run issues and this motivated setting up the LSE Growth Commission co-chaired by Tim Besley and me.

Medium-run policies towards fiscal consolidation

There is no dispute that the escalating public deficit and debt position following the financial crisis of 2008–09 required a credible medium-term fiscal consolidation plan. This was also an opportunity to tackle longer-run issues such as entitlement reform (eg pensions), which could help lock-in expectations about the credibility of debt reduction. Some countries like the US have notably failed on this score. But European countries have generally adopted such a programme. The issue is, now that growth is stalling should these plans be adjusted in the light of the new circumstances?

Consolidate: It ain't what you do, it's the way you do it

In an interesting contribution to the Vox debate Alesina and Giavazzi (2012) argue that achieving consolidation through spending cuts is much more effective that through tax hikes. I broadly agree that we should be as much concerned with the composition of consolidation as we are with the level. However I am unconvinced that the 'taxes rise bad, spending cuts good' mantra has sound theoretical or empirical basis. It seems likely that we need a combination of both, especially as they blend into each other when we think about tax deductions (eg overly generous employer-provided health insurance tax deductions). More important is the question of where spending cuts are made. Philippe Aghion (2012) has stressed the failure of both crude Keynesianism (it doesn't matter how you keep demand up) and fiscal neo-liberals (fiscal stimulus is always ineffective). He argues persuasively for directing countercyclical spending on areas where growth is enhanced such as innovation and education. A classic mistake by the UK is achieving consolidation through huge reductions in public investment, such as the cancellation of the 'shovel-ready' schools buildings programme.

Eurozone woes

Fiscal consolidation is one part of Europe's troubles, but there are larger problems to do with the urgent need to properly regulate, recapitalise, and restructure the banking system. This certainly requires strengthening of the European Financial Stability Fund. Some sort of Eurobond is probably the best way forward (for some ideas see the Economist and Euro-nomics), although this inevitably relies on 'northern Europe' taking on the more risky debt of its fellow Eurozone members. The price exacted by Germany has been tough (and unsustainable) budgetary rules. It is economically and politically impossible for countries like Spain to make all the adjustment through budgetary means without some greater protection. The solution requires a closer economic union for Eurozone countries, something which all politicians seem to baulk at. But without 'more Europe' it is hard to see a long-term future for the euro.

But this brings us back to the politics

The political dimension

A common response to the call for slowing down fiscal austerity is that retreat would fatally undermine a government's credibility. This concern cannot be lightly dismissed – it is often too easy to delay taking any tough medicine into the future, when another government will have to bear the electoral pain.

There must be limits to this argument, however. If the economic data clearly shows that growth is slowing much more than forecast and an economically rational plan would be to slow consolidation, it cannot be wise to tie oneself to the mast and go down with the sinking ship come what may.

What governments should do is to maintain a balance of spending over the cycle, holding down current public spending as a share of national income during an upswing. Do excessively tough fiscal consolidations during a downturn make it more likely that such governments will behave sensibly during the upswing? It is equally possible that they will have a boom in public spending at this point to make up for the degraded public services in the past, a procyclical fiscal policy that is the worst of both worlds (for example, see Wren-Lewis 2012).

Bond-market psychology

The most common defence of current austerity programmes is that even if the economic fundamentals suggest an adjustment and the government is credible, there is a risk that irrational bond markets might demand huge spreads for sovereign debt and possibly push a nation into default. Corsetti (2012) discusses the sovereign risk premium of highly indebted countries and how this may affect private sector lending. Models can be constructed where austerity in a recession is not so bad because fiscal multipliers are low and confidence can be restored.

Although other things equal, high public debt probably dampens fiscal multipliers (eg Ilzetzki et al 2010), there now seems abundant evidence that multipliers will be high in the deep recession we currently suffer through. This was certainly the experience of the Great Depression where underutilised resources and the low opportunity cost of public funds meant that the fiscal multiplier appeared large (eg Almunia et al 2009 and Crafts 2012).

Indeed, rather than excess austerity buying ‘insurance’ against a catastrophic event, it may feed into low growth causing the markets to doubt whether sovereigns can deliver on their pledges, thus forcing up bond yields. This is one part of the Spanish crisis. The relatively benign position for British gilts is mainly due to the fact that the UK is not in the Eurozone and can devalue its currency. Far from an insurance policy, excess austerity may make a catastrophic event more likely.

Conclusions

Every country must look to its own situation in framing a policy response and all countries need a medium-term credible fiscal consolidation plan. This requires some guesswork as economics is an inexact science, yet it requires less guesswork than punditry over psychology and politics. In my view, the current evidence suggests that for countries like the UK where borrowing is relatively cheap and sovereign default extraordinarily unlikely (so comparisons with Greece are fatuous), slowing down the pace of fiscal consolidation would be a rational response. This is also true for most of northern Europe. For southern Europe belt tightening is necessary, but not on the scale currently demanded in Brussels and Berlin. Of course the facts may change, and I keep the liberty to change my view when this happens.

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Too early to sound the alarm

Manfred J M Neumann
Deutsche Bundesbank

Debt finance of public consumption has clearly gone too far in several countries, reaching the borderline of sustainability. Have austerity measures now gone too far as well? This column argues it seems too early to sound the alarm. First, the global economy is likely to grow by 3.3% this year, and second, reversing the fiscal stance or exiting the euro are worse options than austerity.

Debt finance of public consumption has clearly gone too far in several countries. Too far in the sense that it has reached if not exceeded the borderline of sustainability. Have austerity measures meanwhile gone too far, too?

I don't think this is generally the case. Let's take GDP growth as a rough indicator. According to the IMF the global economy is likely to grow this year by 3.3%. The forecast is down by half a percentage point, hardly an alarming number. The Eurozone, by contrast, is at the borderline to a mild recession; output might shrink by half a percentage point this year.

But let's look behind the curtain of the average. The Eurozone weak forecast is dominated by the negative growth prospects of the south, where the two larger countries, Italy and Spain, needed cuts in public consumption. The outlook for Greece and Portugal is worse but they have small weight. In sum, if we take output growth as indicator, there is some evidence that austerity may have gone too far in one or the other member country of the Eurozone. On the other hand, if we look at public consumption and public deficits, it is not clear at all whether enough has been achieved.

And what do we mean by "gone too far"? Did anyone expect that short-run growth would go unaffected when countries switch from fiscal expansion to austerity? Even politicians know that there is this price to pay though they might have no idea how large the fiscal multiplier might become. Withdrawing from a drug 'in one stroke' can be a potentially dangerous venture. But trying to do it in many small doses makes it most likely to get no lasting results. Moreover, the longer the austerity process takes, the weaker public endorsement will become. A serious problem in this respect is that politicians are often tempted to minimise the austerity measures as well as delay and renege on promises of structural reform.

In sum, it seems too early to sound the alarm.

But let's assume that the authorities of a high-risk country believe that the country can no longer bear the price of austerity? What can they do? Three options spring to mind:

- A first option is simply to reverse the fiscal stance.

It seems to be futile to do so, however, as it is likely to immediately unleash a confidence crisis, pushing up the sovereign risk-premium. In brief, it would not only mean to forgo harvesting the fruits of the past austerity efforts but to fall deeper into debt unsustainability.

- A second option is to check the austerity composition.

As emphasised by Alesina and Giavazzi (2012) the type of fiscal adjustment chosen makes a tremendous difference. Spending-based adjustments are to be preferred to tax-based adjustments. Cutting into spending is able to generate the expectation of lasting budget consolidation and of lower future taxation, hence higher permanent income. Unfortunately, once an ill-designed adjustment programme is under way, attempts at restructuring may become politically very difficult if not impossible.

- A third option is to exit the euro.

To talk about this option is widely considered politically incorrect. I do understand this insofar as there are still some freaks around who are obsessed with the idea of fractionalising or undoing the euro. Extremism should be disregarded, yet economists must not shy away from doing the analysis of exit.

The exit option has many pros and cons that cannot be taken up here. The main reason to mention the exit option clearly is the problem of insufficient relative price adjustment. Does it make sense forcing Greece into a decade of austerity and slump in order to achieve a sufficiently low wage level? Wouldn't currency depreciation be a much more effective strategy to achieve price competitiveness in one stroke and turn the country to recovery?

The inflation option

Finally, there is the infamous option of inflation. It is tempting for any government to take recourse to monetary policy. Collecting the inflation tax is the unpleasant solution of the monetarist arithmetic of government finance (Sargent and Wallace 1976). Many governments have chosen this solution time and again when their budget policies got out of hand.

In the south of Europe the inflation tax was considered a normal source of government finance before the foundation of the Eurozone. To be sure a country like the UK that has kept its own currency may choose to inflate its sovereign debt away. But this is no admissible solution for the member states of the Eurozone. They have signed a Treaty that rules out using inflation for government finance. They have tied their hands and must honour the commitment, except if they are prepared to exit the Eurozone. The commitment must equally well be honoured by the jointly owned ECB. The Bank has been provided formally with the status of independence from governments to fulfil the mandate of maintaining price stability. The independence status loses justification should the ECB not deliver the product but concentrate on nursing careless investors and a few high-risk governments.

The ECB should not be lender of last resort to governments

The ECB's excessive swinging round to massive intervention in selected sovereign markets and the unprecedented blowing-up of long-term refinancing operations can be taken as signals that the ECB erroneously believes it must adopt the function of lender of last resort to governments (Wyplosz 2011). This makes little sense.

- Since the early 19th century central banks' last-resort lending serves to provide liquidity to solvent banks when market participants hold off temporarily for lack of sufficient information about solvency.
- The solvency of countries is much easier to monitor.

A country that is known to be fundamentally solvent will never become illiquid but always be able to borrow at short notice.

In conclusion, the notion that a solvent country needs the ECB to bridge a situation of illiquidity is a non-flyer. The notion serves to hide that the ECB's securities market programme can be misused to redistribute resources between member countries. That constitutes a serious problem. After all, redistribution is a matter for elected politicians, not for appointed central bankers.

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The impossible hope of an end to austerity

Charles Wyplosz
The Graduate Institute, ICMB and CEPR

With French and Greek voters rejecting austerity, politicians are once again taking the government spending debate seriously. This column argues that the voters are right – it is a bad idea to tighten fiscal policy when growth is so feeble. But the column adds that, wherever one looks, the road away from austerity looks desperately blocked.

Thanks to French and Greek voters, austerity is finally being debated seriously. Until now, the debate was circumscribed to economists, with the usual Keynesian and anti-Keynesian chapels trading theoretical and empirical arguments over the size and the sign of the multipliers.[1] As usual, any prejudice can be buttressed with some research.

It has now emerged that growth in Greece and elsewhere has been "disappointing" and that debt-to-GDP ratios do not decline much when growth is negative and deficits are "surprisingly resistant". The problem is that even enthusiastic pro-growth economists will find it hard to come up with policy suggestions that can turn the situation around reasonably soon. Structural reforms are what are badly needed, but their effects are too slow for prompt relief.

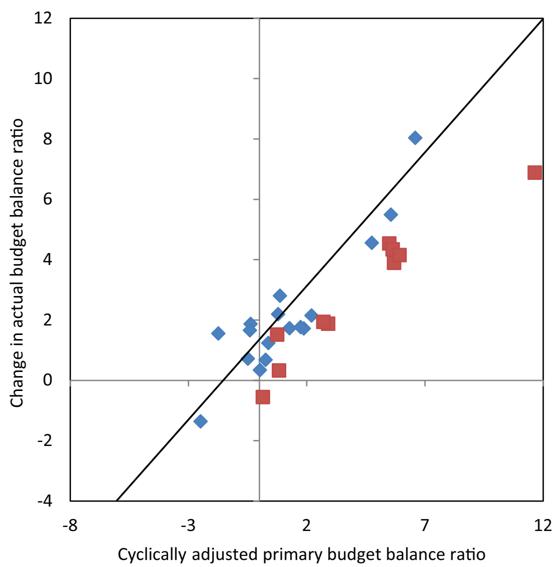
Figure 1 shows the relationship between budget stabilisation efforts, measured on the horizontal axis as the change in the cyclically adjusted primary balance ratio to GDP, and the change in the actual budget balance ratio. The 45-degree line is the effort-equals-effect threshold – i.e. the austerity efforts (horizontal axis) are matched by actual improvement in the primary deficit to GDP ratio (vertical axis).

1 For a recent balanced evaluation, see Perotti (2012).

- The squares correspond to those countries where real GDP overall growth over the period was less than 2.5%; in these countries, with one exception (Hungary, which stabilised earlier) the outcome is worse than the effort.
- The diamonds represents countries that grew faster; in these, the outcome was at least as good as the effort.

Plainly it is a bad idea to tighten fiscal policy where growth is feeble (or negative).

Figure 1 Budget balance effects of budget consolidation efforts

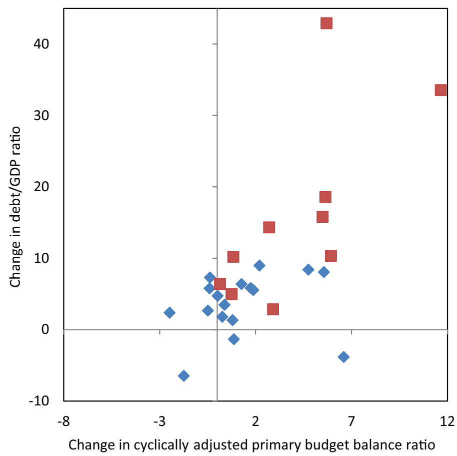


Notes: The sample includes all EU member countries. The period covered in 2009-2011.
Source: AMECO on line, European Commission.

The results from budget consolidation efforts are even more disappointing when looking at the evolution of the gross public debt. For the same countries and over the same period, Figure 2 displays on the vertical axis the change in the debt-to-GDP ratio while the horizontal axis measures the fiscal consolidation effort exactly as in Figure 1.

The message from this chart is damning: with three exceptions (Estonia, Hungary, and Sweden), debt-to-GDP ratios rose everywhere in the EU, even in countries that were reducing their cyclically-adjusted primary deficits. For those countries where GDP growth was less than 2.5% over the two years, the debt ratios often increased much more (even though in one case, Ireland, this was a one-off bank bailout). For these countries, it even seems that the debt increases faster where the effort is stronger.

Figure 2 Debt effects of budget consolidation efforts



Source: AMECO on line, European Commission.

Clear evidence in the eyes of voters

The evidence is informal but it is quite consistent with formal studies that report non-trivial positive multipliers. Importantly, it is what voters see. They cannot be blamed for concluding that the economic, social, and personal pain that they suffer – and that many of our colleagues in economics seem to ignore or belittle – is not delivering or is even backfiring. Even though the cases of Hungary and Estonia, which went through consolidation and wrenching recessions earlier, show that there is light at the end of the tunnel, the case for carrying out fiscal consolidation "no matter what" is very weak at best.

What could different policies look like?

The answer, unfortunately, is bound to be disappointing. Monetary policy is quasi-impotent as far countercyclical action is concerned.

- The interest rate can be lowered, but it is so close to zero that any effect would be largely symbolic.
- Quantitative easing has yet to prove its effectiveness.

Preliminary evidence from the long-term refinancing operations (LTROs), which have been instrumental in suspending the debt crisis as argued in Wyplosz (2012), is that banks stack up cash but do not lend, in part because they are busy deleveraging, in part because demand for credit is in hibernation.

- The only contribution that monetary policy could make would be a sizeable exchange-rate depreciation – but against which currency?

The dollar is weak because the markets expect some action to stop the US federal debt from spiralling away. East Asia, the new economic powerhouse, follows China in tracking the dollar. Latin America, the second economic powerhouse, is panicking as their exchange rates rise. Still, a weak euro is the best that can happen.

Turning to fiscal expansions, the situation is depressing. Several countries have lost market access and a few more are on the verge of losing it. While the financial markets clamour that they want to see growth and no austerity, they will not provide ample financing to countries like Italy, Spain, and France. Ideally, countries with an ability to borrow would play the locomotive role, but a locomotive must be powerful enough to pull the wagons up the hill. That leaves us with Germany, but Germany is now at full employment. Expanding its already sizeable debt to add heat to an already hot economy, which would bring up inflation – a highly unattractive option.

European Investment Bank saviour?

This is why people look at clever ideas. One of them is to allow the European Investment Bank (EIB) to borrow and finance spending. The attraction is that EIB borrowing is guaranteed by the member state but does not add to official public debts. But numbers matter. The annual spending budget of EIB is about 0.5% of GDP. Even a doubling would represent very little firing power, assuming that enough projects can be prepared for rapid disbursement, which is unlikely.

Another creative idea is to discover that the Commission has unspent money, again of a similar amount. How quickly this money may be made available remains to be seen – the Commission is, after all, a fairly heavy bureaucracy with rigid procedures. Furthermore, 'European money' from the EIB and the European Commission is unlikely to be entirely channelled to the Eurozone countries that need it most for macroeconomic reasons. More importantly, perhaps, is the reminder by Alesina and Giavazzi (2012) that the composition of fiscal policy actions matters. In countries with arguably excessive public spending, expansionary fiscal policies stand to be more logical and more effective if they take the form of tax cuts. That is not in the hands of the EIB and the Commission.

Another creative idea is to issue Eurobonds to finance emergency spending. By being collectively underwritten by all member countries, these bonds could be subscribed by the financial markets at low interest rates. Ultimately, however, they would be indirect debts of individual member countries, many of which are already over-indebted. This means that the more reputable countries would assume the risk that the most indebted ones are eventually unable to pay back.

A way around the problem would be to make these new bonds senior to existing ones, either formally as suggested by Delpla and von Weiszacker (2010), or informally by being short-run as proposed by Hellwig and Philippon (2011). In principle, even hard-pressed governments could borrow large amounts in this way. The problem is that the existing bonds would become junior, which could precipitate a market run and eventually lead to defaults. A safer way to finance hard-pressed governments is by the ECB but this is against the Treaty and anathema to Germany and many others, for good reasons.

Finally, the last possibility is default by governments that need to shift their policy stance but cannot do so because of high indebtedness. By eliminating a significant portion of their public debts, those governments would instantly cut a big spending item, debt service, and recover the breathing room that they need. The default would have to be deep enough to allow them to recapitalise their banks, which hold domestic public bonds, and still end up with a small enough debt. The problem is that defaults cut borrowers off from market access for a while. Defaulters would therefore need to secure support from the IMF and, quite possibly, from other Eurozone member countries, all of whom are unlikely to give their blessings, especially since many governments are concerned about losses suffered by their own banks. They may prefer squeezing defaulting countries out of the Eurozone, a process that could prove to be highly contagious and quite possibly lead to the premature death of the euro itself.

Monetary policy out of order, no policy space, the EIB and Commission too small, Eurobonds impractical, deep defaults unacceptable and possibly resulting into a Eurozone breakup; wherever one looks, the road away from austerity looks desperately blocked.

What is left? Small steps that add up to not enough of a stimulus

The madness of holding governments to infeasible debt reductions within a couple of years or so must be replaced by the realisation that this objective will take decades, not years, to be reached.

Some countries will have to default, partly at least, entirely for Greece. Inevitably, the costs will be borne by everyone – bondholders, banks and their governments, and the Eurosystem.

EIB and Commission money will help a little if they are promptly disbursed. Germany must also conclude that playing the locomotive is in its deep interest and that a little bit of inflation is much more preferable than letting the euro disappear. After all, average German inflation over the roughly 50 years before the euro (1950-98) was 2.7%.

Sticking to austerity is bound to lead to more Greek-style elections. This is after all the lesson from German history – voters who suffered and despaired and felt mistreated by foreign powers ended up voting for Hitler.

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Weekend elections: Democracy and the fiscal compact

Francesco Daveri
University of Parma and IGIEG

Voters in France, Greece, Italy, and Germany rewarded politicians who opposed austerity. This column argues that attempts to fulfill campaign promises will run up against a hard constraint. The countries whose voters are calling for looser fiscal policies are those where public spending rose fastest since the birth of the euro. The only way out of today's difficulties is to use the flexibility already in the fiscal compact and continue with bold implementation of the economic reforms that are under way.

Sunday 6 May 2012 was Europe's "Super Sunday" of elections:

- The French presidential election gave the victory to Francois Hollande.
- Parliamentary elections have left Greece without a coalition capable of governing.
- There were local elections in Germany and Italy.

All these showed similar results.

With Europe in recession, voters rewarded those who oppose budget cuts. But the turnaround of budgetary policies advocated by the majority of voters runs up against an important constraint. The nations where voters demand lower taxes are those in which public spending has risen more in the last ten years. The only way out of today's difficulties is the bold implementation of economic reforms. This has started in many countries, but it must continue.

The spectre of anti-austerity movements haunts Europe

In France, Nikolas Sarkozy started with a reformist bent but soon shelved the 316 proposals for reform and growth that had been produced by the Attali Commission (which, significantly, included the future Prime Minister of Italy, Mario Monti). After giving up his initial goal of rebuilding France from scratch, he narrowly lost the election, ending his race wooing Marine Le Pen's voters at the very last minute. The winner Hollande made very generous promises during the election campaign – €20 billion worth by some reckonings. This would raise the French budget deficit above 5%.

In Greece, the two main parties – the conservatives of Nea Democratìa and the socialist Pasok – failed to reach the hoped-for Grand Coalition majority. The Greek voters are uncertain of which way to jump – into the dark unknown of Eurozone exit or the continued pain of austerity. Voters judged the two big parties to be guilty of providing parliamentary support to the budget cuts brought about by the Government led by the former central banker Lucas Papademos, seen as the local representative of the loathed troika (the ECB, IMF and the European Commission).

In Italy, the massive success achieved by the Five-Star Movement which ran against the Italian political caste is not very different from the electoral success of radical leftist movement Syriza in Greece as well as that of the neo-communist Mélenchon in France.

All these parties are driven by the electorate's aversion to restrictive fiscal policies that are necessary to keep them inside the monetary union. These policies, however, are increasingly identified as the eventual reason of the persistence of the crisis and not as an umbrella of protection against it (see the Vox Debate on whether austerity has gone too far).

The same applies, inter alia, to the German Pirate Party which has gathered more than 8% of the vote in Schleswig-Holstein, a state in northern Germany with a strong Danish minority. Even in these elections, the resilience of Angela Merkel's CDU and the partial recovery of its current allies, the Liberal Democrats, were not sufficient to prevent a centre-left coalition from winning the local election.

Overall, the result of the European Super Sunday brings into question the fiscal compact and its logic. Though the agreement was signed by 25 EU countries only a few months ago, it has now become the hallmark of German-led fiscal rigour on the rest of Europe. The spectre of an international anti-austerity movement is haunting Europe, and nobody knows how to deal with it.

Reforming the fiscal compact is hard

The fiscal policy turnaround advocated by the majority of voters in Europe will encounter severe constraints which cannot be ignored, not even by the governments more seriously concerned by the social implications of the adoption of stringent fiscal policies. Taking a look at how public spending evolved in European countries over the past ten years, i.e. since the euro was introduced, provides a handful of examples of such constraints.

- Since the end of 2001, the 17 countries of the Eurozone saw government spending rise from €3.3 to €4.7 trillion billion (in current euros), hence by 39.6%.
- As a percentage of Eurozone GDP, spending has increased from 47% to 51% of GDP.

The post-2008 crisis was certainly a powerful factor in this increase. Yet if one looks at Germany alone, the picture looks quite different. On the one hand, the German economy suffered a major shortfall in 2009, with a real GDP decline in excess of five percentage points; and growth was not very fast even in the first part of the decade. This was when Germany was the sick man of Europe. But, between 2001 and 2010, government spending in Germany went up by a mere 18.5%, from just over €1 trillion to €1.2 trillion. As a result, the share of public expenditure to GDP has remained roughly constant in Germany, despite the crisis and bank bailouts, aid to automakers and, recently, generous wage increases to public employees. Government spending remains fairly high (48%

of GDP), but its size has remained the same share of GDP as in 2001. This is, more or less, what the Germans mean by “fiscal discipline”.

The numbers are obviously subject to interpretation, but as such they cannot be questioned. Irrespective of what one thinks of the ‘German’ fiscal rule, the data on Germany imply that, in the rest of the Eurozone without Germany, public spending has gone up at a much faster pace, by some 41.5% between 2001 and 2010. This is an increase of 23 percentage points higher than that in Germany. The country that has provided one fourth of the financial resources for the temporary EU bailout fund (EFSF) and will provide the same proportion of the future permanent bail-out fund (ESM) has witnessed a much smaller increase of its own public spending vis-a-vis that of the other EMU member states.

Union paradoxes

This, in a nutshell, explains the bulk of the current dissatisfaction of the German electorate with the euro and the current setting of the European institutions. It is this dissatisfaction that goes a long way towards explaining the seemingly erratic attitude of Chancellor Merkel in recent years. And Slovakia may also be appended to Germany as a case in point. As reported in the *Wall Street Journal*, it appears that Slovakia has committed, adding up disbursements and guarantees, a total of €13 billion to the EZ bailout funds. This figure is bigger than the annual tax revenue of the Slovak Government. Slovakia is giving its contribution to save a country like Greece which in 2010 had an income per capita of around €20,000, far greater than the €12,000 of the Slovaks. The discontent with the euro does not end in Germany but also extends to smaller Eastern and Northern states in Europe.

The list of big EZ spenders, however, shows some variability. For example, over this period, spending has increased by “only” 31% in Italy, while it has gone up by much more in other countries on the brink of default: +56% in Portugal, +72% in Greece and +89% in Spain. In France, the increase in expenditure reached +42%. As a result, the increases in expenditure as a proportion of GDP in the EuroMed countries have fluctuated between the +5 percentage points for France and Greece and the +9 in Portugal (with Spain in between with +7).

Confronted with the relatively less unfavourable data for Italy, one may question whether this can be ascribed to the ability of the guardians of the public purse (and especially of Giulio Tremonti, who was the minister of the Economy for most of the time between 2001 and 2010). Well, it might be. Most likely, however, the relatively smaller increase of spending in Italy had more to do with the very high initial level of public debt with which Italy entered in the euro. Italy's public debt stock was already 105% of GDP in 2001, slightly higher than in Greece.

In France, Spain, and Portugal, by contrast, public debt in 2001 was much lower. Endowed with low debt, these countries didn't think twice when, once in the euro, they enjoyed the bonanza of cheap credit brought about by German reputation. They kept spending habits that exceeded the long-run growth of their tax revenues. Now these other countries are footing more the bill for their past choices.

In Italy – with twice as much debt as the other Mediterranean countries – public spending should have fallen, at least as a proportion to GDP, rather than increasing. This was not to be. Regrettably, government spending (in current euros) went up by 31%, which led, given persisting low growth even from before the crisis, to increases that took spending from 47.9% to 50.6% of GDP.

The options ahead

The election outcomes of the European Super Sunday raise an important consistency issue for the current setting of European policies. Can democracy and the fiscal compact stay together?

The answer is unclear. Yet, it remains that, with the comparative data on public spending in hand, it is difficult and even unfair to ask Mrs Merkel to renegotiate the fiscal compact. That would put the spotlight on something – the importance of credibly implemented fiscal discipline – that has been largely overlooked for many years in Europe, even before the recent crisis.

Above all, asking Mrs Merkel to renegotiate it is like asking her to commit political suicide. It would also be unfair because Germany, under the same demographic and economic shocks as the other people of Europe, controlled public spending much more effectively than other European countries proved able to do. At least, they should not pay for this.

The right way forward is to use the flexibilities in the Treaty. Even in its current form, margins exist for less than automatic implementation of sanctions against lack of fiscal discipline in the face of proven success in the adoption of measures conducive to economic growth. This is the route to take if Europe is to gain further democratic legitimacy and return to growth at the same time. Moreover, leaving the structural reform road – even the half-hearted economic reforms under discussion -- would be a major, self-defeating, mistake. The monetary union as a whole would pay very dearly for such a mistake in the years to come.

Editor's note: This first appeared on our consortium partner's website LaVoce.info in Italian; http://www.lavoce.info/articoli/pagina1003057.html.

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Re: Weekend elections: Democracy and the fiscal compact

Paolo Manasse
University of Bologna

In his piece on EU elections in this eCollection, Francesco Daveri makes two points. The first is that the results across Europe share a common trait: the revolt of large sectors of the electorate, particularly in France and Greece, but also in the Italian and German administrative elections, against the (self-) imposed austerity of Mrs Merkel, enshrined in the "fiscal compact". The second is that there are few alternatives to the fiscal compact, given that most protests come from the very countries who, in terms of public expenditures, were more profligates. On the first point, to my reading, the true political 'surprises' in the Italian and French elections did not come from the winners, but from the 'outsiders', Ms LePen Jr and Mr Grillo. Their exceptional performances has arguably little to do with the austerity of the fiscal compact, and probably a lot to do with the protest against an arrogant, inept and often corrupt political establishment (the case of Greece is clearly different).

On the second point, the data commented in the article, government spending as a share of GDP and government spending in nominal terms should be interpreted with caution when discussing 'profligacy'. The empirical evidence (very controversial!) suggests that contractions in spending cause a more than proportional fall in GDP (a multiplier larger than unity), as recent cases of Greece and Italy indicate quite clearly. As a result, an increase in the ratio would occur when cuts in spending reduce output more than proportionately. Even greater caution should be used when interpreting changes in nominal terms. It's well known that the origin of the current imbalances within Europe is the loss of competitiveness of the peripheral countries against Germany. Figure 1 shows a familiar picture, consumer prices in Germany (blue line), Greece (red) and

Spain (yellow). In the last two countries, between 2000 and 2010 consumer prices increased by respectively 16 and 23 percentage points more than in Germany. In order to get an index of 'real expenditures' I simply correct the nominal data with inflation[1], obtaining Figure 2.

Figure 1

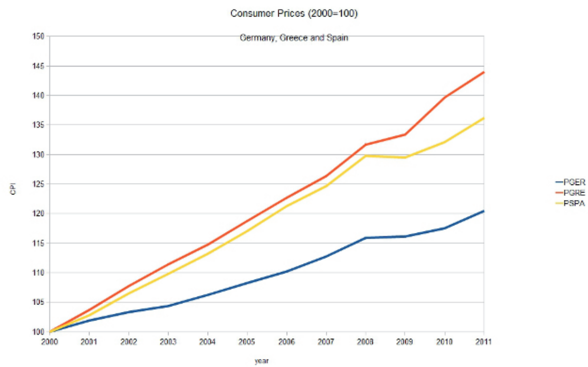
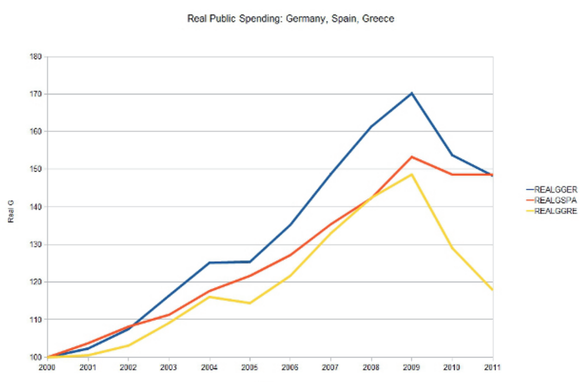


Figure 2



1 In figure 2, I subtract from nominal spending growth the rate on consumer price inflation. If the government spending deflator were available than that should be used. Note, however that since the consumer price index weights the price of tradables (which should be similar across countries) and of non-tradables, if consumer prices rise more rapidly in Greece and Span relatively to Germany, then it must be the case that the price of non tradables (such as public services) in Greece and Spain must rise even faster relatively to Germany's. Thus by using consumer prices to deflate nominal spending , I am actually over-estimating 'real spending' in Greece and Spain, and underestimating real spending in Germany.

The figure shows that, thanks to the moderation of prices, between 2000 and 2009 Germany was able to increase public spending much more rapidly than Spain and Greece (20 percentage points of real growth more). The figure also shows two other important aspects: after 2009, the cuts in Greece were very hard, about 30% in real terms. So the voters' answer is understandable. In addition, spending cuts above 20% in real terms have also been made in Germany since 2009. Here lies the stupidity of the fiscal compact: a recessive corset imposed to everyone, those who (possibly) need it and those who do not, that makes things worse for everyone.

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Paolo Manasse is Professor of Macroeconomics and International Economic Policy at the University of Bologna. He also taught at L. Bocconi (where he currently teaches Macro in the PhD program) , at Sorbonne (Paris I), Johns Hopkins (Bologna Center) and other Italian universities. He obtained his PhD from the LSE with Rick van der Ploeg and Charlie Bean. He worked as a Consultant for the OECD, the World Bank, the Inter-American Development Bank, and was a resident Consultant, Visiting Scholar and Technical Assistance Advisor for the IMF. He is a research fellow of IGIER-Bocconi in Milan, and of the Rimini Centre for Economic Analysis. His research interests are in international macroeconomics, including a wide range of issues such as monetary and fiscal policy in currency unions, fiscal federalism and asymmetric information, international trade and the labor market, international policy coordination, sovereign debt and banking crises.

Is high public debt harmful for economic growth? New evidence

Ugo Panizza and **Andrea F Presbitero**
UNCTAD; Università Politecnica delle Marche

Countries with high public debt tend to grow slowly – a correlation often used to justify austerity. This column presents new evidence challenging this view. The authors point out that correlation does not imply causality – it may be that slow growth causes high debt. They argue that policymakers should be wary – the case for cutting debt to boost growth still needs to be made.

> *It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so.* (Mark Twain)

Do high levels of public debt reduce economic growth? This is an important policy question. A positive answer would imply that, even if effective in the short-run, expansionary fiscal policies that increase the debt-to-GDP ratio may reduce long-run growth, and thus partly (or fully) negate the positive effects of the fiscal stimulus.

Most policymakers do seem to think that debt reduces growth. This view is in line with the results of a growing empirical literature which shows that there is a negative correlation between public debt and economic growth, and finds that this correlation becomes particularly strong when public debt approaches 100% of GDP (Reinhart and Rogoff 2010a, 2010b; Kumar and Woo 2010; Cecchetti et al. 2011).

Debt and growth, what causes what?

Correlation, however, does not imply causation. The link between debt and growth could be driven by the fact that it is low economic growth that leads to high levels of public debt (Krugman 2010).[1] Establishing the presence of a causal link going from debt to growth requires finding what economists call an 'instrumental variable'.[2]

In a new paper (Panizza and Presbitero 2012), we propose a novel instrument variable that allows us to reject the notion that debt causes slower growth in OECD countries. We do confirm the oft-noted negative correlation between debt and growth, but show that debt does not have a causal effect on growth (see Figures 8 and 9 in our paper). The discussion of the instrument is somewhat technical, so we omit it here; interested readers can find all the details in Section 2 of our paper.

To answer the question "Do high levels of public debt reduce economic growth?" we follow the econometric procedure of trying to reject the proposition that "debt has no growth effects". Our research shows that this proposition cannot be rejected, so it may well be that it is true. We cannot, however, be sure. Think of a murder trial where the jury finds the man has not been proven guilty "beyond a reasonable doubt". This certainly suggests that he is innocent, but establishing innocence is not what the trial was about, so technically, we cannot claim that the jury declared him innocent.

Indeed, none of the papers in the literature on debt-growth links can make a strong claim the debt has a causal effect on economic growth.

In this light, we refer readers back to Mark Twain's wisdom. There is a value in assessing the degree of our economic ignorance.

Policy implications: Responsible fiscal stance and lenders of last resort

We believe that our findings are important for the current debate on fiscal policy (see the Vox Debate started by Corsetti 2012). There might be many good (or bad) reasons

1 The observed correlation between debt and growth could also be due to a third factor that has a joint effect on these two variables.
2 This is something that is correlated with the debt, but uncorrelated with the random errors in the economic linkage between growth and debt.

for fiscal austerity, even during recessions. We do not want to enter that debate here. However, we do not find any evidence that high public debt hurts future growth in advanced economies. Therefore, given the state of our current knowledge, we believe that the debt-growth link should not be used as an argument in support of fiscal consolidation.

The fact that we do not find a negative effect of debt on growth does not mean that countries can sustain any level of debt. There is clearly a level of debt beyond which debt becomes unsustainable, and a debt-to-GDP ratio at which debt overhang, with all its distortionary effects, kicks in. What our results seem to indicate, however, is that the advanced economies in our sample are still below the country-specific threshold at which debt starts having a negative effect on growth.

We believe that there is a subtle channel through which high levels of public debt can have a negative effect on growth. In the presence of multiple equilibria, a fully solvent government with a high level of debt may decide to put in place restrictive fiscal policies aimed at reducing the probability that a change in investors' sentiments would push the country towards the bad equilibrium. These policies, in turn, may reduce growth (Perotti 2012), especially if implemented during a recession (such policies may even be self-defeating and increase the debt-to-GDP ratio, DeLong and Summers 2012, UNCTAD 2011).[3] In this case, it would be true that debt reduces growth, but only because high debt leads to panic and contractionary policies.

While such an interpretation justifies long-term policies aimed at reducing debt levels, it also implies that countries should not implement restrictive policies in the middle of a recession. These policies are the reason for the negative effect of debt on growth. Yet, policymakers under pressure from market participants might not have an alternative. This is why we need prudent fiscal policies *and* lenders of last resort that can rule out multiple equilibria (De Grauwe 2011).

3 We do not find evidence of such a channel because before the creation of the euro most OECD countries could rule out multiple equilibria by using their own central banks as lenders of last resort.

Conclusion

Our reading of the empirical evidence on the debt-growth link in advanced economies is:

- There are many papers that show that public debt is negatively correlated with economic growth.
- There is no paper that makes a convincing case for a causal link going from debt to growth.
- Our new paper suggests that such a causal link does not exist (more precisely, our paper does not reject the null hypothesis that there is no impact of debt on growth).

We realise that our results are controversial. While we are convinced of the soundness of our findings, we know that sceptical readers will find ways to challenge our identification strategy. However, the first two points are uncontroversial. The case that public debt has causal effect on economic growth still needs to be made.

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Wasted youth

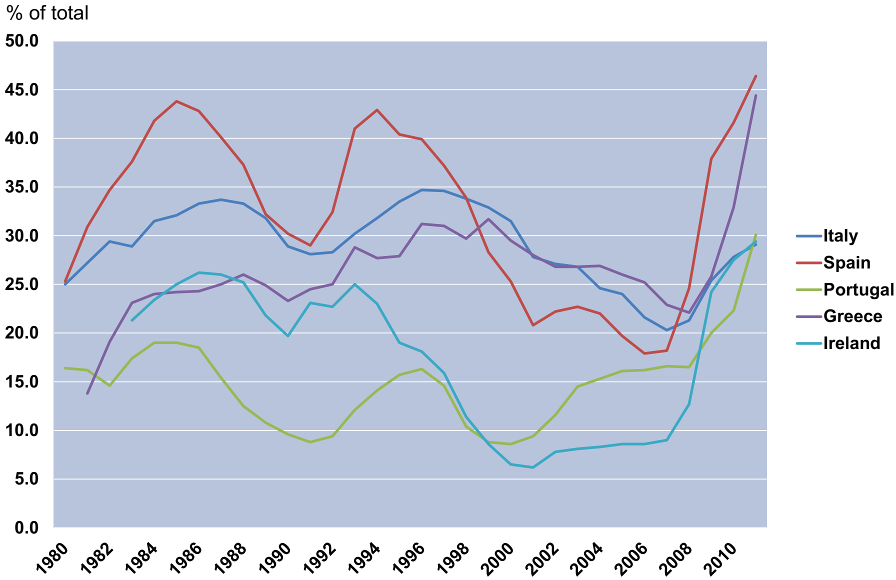
Marco Annunziata
General Electric Co.

In Greece and Spain, around half of all workers under 25 are now unemployed. In Italy, Ireland, and Portugal, the rate of youth unemployment is around one in three. But this column argues that we shouldn't go blaming austerity; even when these countries were booming, youth unemployment was still painfully high. The problem is far deeper.

Youth unemployment is one of Europe's most glaring problems. Opponents of austerity point to the swelling ranks of unemployed young (15-25 years of age) people in Europe's periphery as proof that fiscal tightening can no longer be tolerated. The *Financial Times* notes that youth unemployment rates have reached 51% in Greece and Spain, 36% in Italy and Portugal, and 30% in Ireland, and warns "is it plausible that people will put up with this indefinitely? No." (Wolf 2012).

The seriousness of the problem cannot be underestimated, and the speed at which young people have been thrown out of the labour market is frightening. But equally frightening is how long Europe has lived with high youth unemployment. Sadly, in several countries the rise in youth unemployment looks largely like a reversion to the mean after unsustainable credit growth spurred a bubble in fixed-term jobs.

Figure 1 Youth unemployment rates



Implausible as it sounds, Italian voters have put up with an average youth unemployment rate of 30% for the last 40 years; Spanish voters with a rate of 32%. Italy experienced "strong" economic growth during 1994-2000, with GDP rising at an annual average of 2%. During this boom period, the youth unemployment rate still averaged 33%. In other words, one young person in three was unemployed when the economy was at its strongest. The rate never dropped below 20%.

Spain's economy grew at an average of 3.6% between 1995 and 2007. During this impressive run, the youth unemployment rate averaged 28%; it was below 20% for just three years, with a "best performance" of 18% in 2006.

The IMF (Morsy 2011) has recently pointed out that the unemployment rate of young people in advanced countries has historically been higher than those of older age groups, partly because they have fewer contacts and less job-search experience. But it also noted that in some countries, structural problems clearly put young people at a much more significant disadvantage. Germany's youth also have a higher unemployment rate than older generations, but their rate is just over 8%.

Figure 2 Italy: Youth unemployment and GDP growth

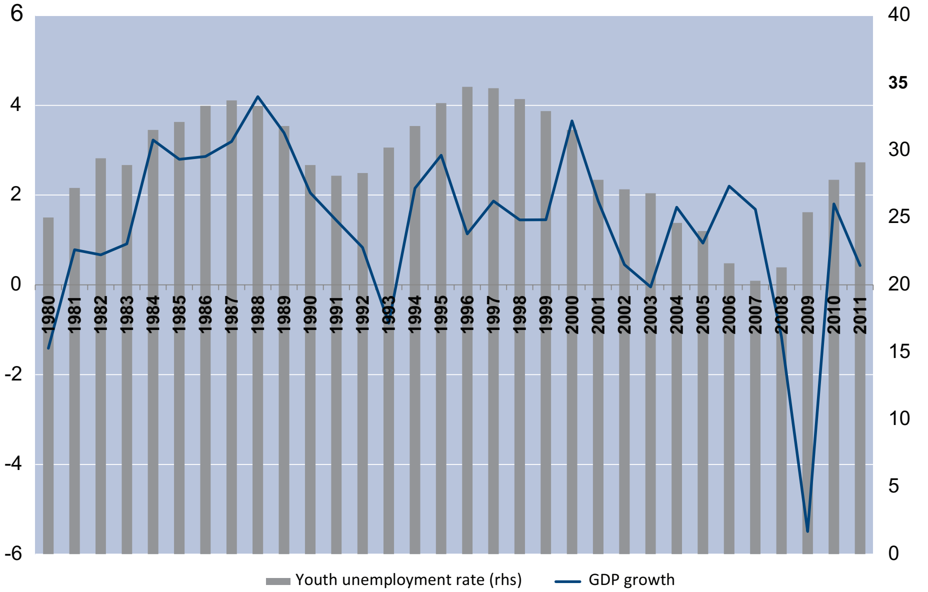
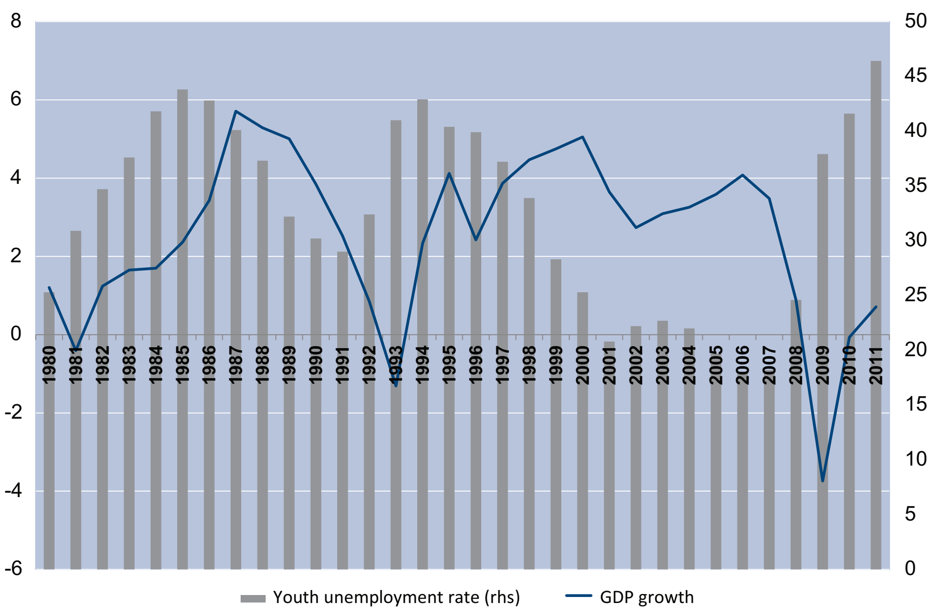


Figure 3 Spain: Youth unemployment and GDP growth



Austerity hurts, but it's the underlying structural problems that are the real issue – rigid and distorted labour markets and education systems plagued by falling standards and a growing misalignment with the demand for skills of a rapidly changing and very competitive global economy (Garcia 2011). Germany's better coordination between the school system and industry, including via its apprenticeship programmes, pays off.

Formal and informal social safety nets attenuate the extent of the problem. Family networks in Italy and Spain, for example, play an important role in providing accommodation and financial support to young unemployed people. Another question is how many of those who are registered as unemployed might be working in the informal sector. But the negative social and economic impact remains severe. Most depressingly, this 'wasted youth' problem translates into a deterioration of the human capital stock, depressing productivity and economic growth for years to come.

It is important to ensure that fiscal adjustment and structural reforms are socially sustainable; to the extent that there is room to mitigate the impact of austerity on growth and employment, this should of course be done – although in some countries the room is limited, or needs to be found by tackling wasteful public expenditures. But it is equally important to recognise where the key structural problems are and to address them. The ambition cannot be simply to go back to the good old days of 30% youth unemployment.

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Has austerity gone too far?

Giancarlo Corsetti
University of Cambridge and CEPR

Is austerity self-defeating? Is it keeping Europeans underemployed for years and destroying the very growth needed to pay off the debt? Or is it steering nations clear of Greek-like tragedies? So starts a new debate on Vox on austerity, introduced in this column.

Fiscal tightening is the watchword all across Europe. The measures adopted so far have not yet proved to be a cure-all for financial market concerns about debt sustainability. They have, however, coincided with renewed economic slowdown or even contraction. This brings into question the desirability of fiscal austerity.[1]

Two examples: Italy and Britain

How much of Italy's slowdown is due to austerity and how much is due to the near debt-meltdown last summer? There is little doubt that the credit crunch that followed the sudden loss of credibility of Italian fiscal policy (whether or not justified by fundamentals) has a lot to do with the severe slowdown that this country is experiencing. The current fiscal tightening is arguably contractionary, but the alternative of not reacting to the credibility loss would have produced much worse consequences.

Things are more complex for the UK; it hasn't lost credibility and it borrows at low interest rates. Does this mean UK policymakers are shooting themselves in the foot? Are they keeping the economy underemployed for years and thus destroying potential

1 This column draws on Corsetti and Müller (2012).

output with their austerity drive? Or, are they wisely forestalling a bond market rebellion like those seen on the continent that would prove much costlier?

Unfortunately we cannot know the answers definitively. Ten years from now some observers will deride the belief that the 'confidence fairy' would be summoned by belt-tightening; others will declare that their conservative fiscal attitude saved the countries from Greece's fate. With only one economic path visible to historians and firm evidence in scant supply, we may never know.

A new Vox debate

The solution is a vigorous debate – which this column hopes to contribute to by launching a new Vox debate on the issue of austerity. There is a lot at stake in addressing the austerity question in the right way; which of the competing views is right matters greatly for policymaking and economic and social outcomes.

The terms of the debate are clear.

- The debate is not about the desirability of restoring safer fiscal positions after the large increase in gross and net public debt in the last few years.

This can be safely taken for granted.

- The question is whether governments should relent in their efforts to reduce deficits now, when the global economy is still weak, and policy credibility is far from granted.

Under what circumstances would be wise to do so?

Budget policy vastly differs across countries.

- By and large, countries fall into three categories. At one extreme we have countries already facing a high and volatile risk premium in financial markets. At the other extreme we have countries with strong fiscal shoulders, actually enjoying a negative risk premium. A third category includes countries not facing a confidence crisis, yet with inherent vulnerabilities – a relatively high public debt, a fragile financial sector, and high unemployment.

The question of how to ensure debt sustainability is vastly different across these.

Moreover:

- Not only specific conditions at country-level, but also policies at regional and global level may cause a given fiscal measure in a country to have vastly different effects.
- International considerations will complicate the analysis; a policy which may be perfectly viable and desirable for a country conditional on an international context, may not work in another, say, depending on the degree of international cooperation, especially in providing liquidity assistance and 'firewalls' against contagion.

Issues in front-loading austerity measures

Since 2008, the fiscal policy debate has gone through several phases.

- The first phase was dominated by a call for fiscal stimulus to avoid another Great Depression.

Thinking about deficit corrections in the future was seen as irrelevant, when not counterproductive, as it was feared that prospective consolidation plans would create additional uncertainty about the terms of the recovery.

- The second phase, from 2010 onward, saw the focus shift to fiscal consolidation as high public debt started to loom large.

This policy shift occurred despite a global economy that was not yet on a firm recovery path and monetary policy at or near the zero lower bound in many countries.

- The third phase may have begun; with weak growth, calls for austerity appear to have fallen out of fashion again.

The ranks of commentators who view austerity as potentially self-defeating have swollen (Cafiso and Cellini 2012, Cottarelli 2012, Gros 2011, Krugman 2012). These authors argue that the weak output growth caused by fiscal austerity may itself fuel market doubts about government solvency. Higher funding costs, combined with lower activity, might thus worsen the fiscal position, defeating the very purpose of the initial tightening measures. As observed by Olivier Blanchard, the “damned if you do it, damned if you don’t” attitude on fiscal austerity by financial markets may appear quite schizophrenic (Blanchard 2011).

New thinking: Self-defeating tightening in a liquidity trap

Recent contributions on the mechanism through which fiscal contraction in a liquidity trap is counterproductive provide an important change in perspective, relative to the initial debate.

A key point here is the recognition that much of the advanced world is currently in an unemployment and underemployment crisis. Destruction of jobs and firms today may be expected to have persistent effects on potential output in the future. These effects in turn translate into a fall in permanent income, and hence demand, today (see DeLong and Summers 2012 and Rendahl 2012).

In a liquidity trap, this creates a vicious self-reinforcing circle. Today’s unemployment creates expectations of low prospective employment, which in turn causes an endogenous drop in demand, reducing activity and raising unemployment even further. This vicious cycle may have little to do with price stickiness and expectations of deflation at the zero lower bound, an alternative mechanism early on stressed by Eggertsson and Woodford (2003) and more recently by Christiano et al (2011). Independent of deflation, the vicious cycle can be set in motion by expectations of lower income when shocks create persistent high underemployment. Theory suggests that this effect can be sizeable. The question is its empirical relevance.

The empirical evidence indeed weighs towards large multipliers at times of recession (Auerbach and Gorodnichenko 2010) or at times of crisis (Corsetti et al 2012), as opposed to very small multipliers when the economy operates close to potential and monetary policy is 'unconstrained.' In light of these results, it can be safely anticipated that the current fiscal contractions will exert a pronounced negative effect on output.

This is why, with a constrained monetary policy, there is little doubt that governments with a full and solid credibility capital should abstain from immediate fiscal tightening, while committing to future deficit reduction (the virtues of this policy are discussed by Corsetti et al 2010 and Werning 2012).

The problem is that, in the current context, promising future austerity alone may not be seen as sufficiently effective. Keeping market confident in the solvency of the country has indeed provided the main motivation for governments to respond to nervous financial markets with upfront tightening.

Credibility, sovereign risk, and macroeconomic instability

In a recent paper (Corsetti et al 2012), my co-authors and I highlight issues in stabilisation policy when the government is charged a sovereign-risk premium. The root of the problem is the empirical observation that sovereign risk adversely affects borrowing conditions in the broader economy. The correlation between public and private borrowing costs actually tends to become stronger during crises. Perhaps in a crisis period high correlation is simply the by-product of common recessionary shocks, affecting simultaneously but independently the balance sheets of the government and private firms. Most likely, however, it results from two-way causation.

In the current circumstances, there are good reasons to view causality as mostly flowing from public to private. First, in a fiscal crisis associated with large fluctuation in sovereign risk, financial intermediaries that suffer losses on their holdings of government bonds may slow down lending. Second, both financial and non-financial firms face higher risk of loss of outputs and profits due to tax hikes, increase in tariffs, disruptive strikes, and social unrest, not to mention lower domestic demand.

There are at least two implications of this 'sovereign-risk channel of transmission', linking public to private borrowing costs, for macroeconomic stability.

- First, if sovereign risk is already high, fiscal multipliers may be expected to be lower than in normal times.

The presence of a sovereign-risk channel changes the transmission of fiscal policy, particularly so when monetary policy is constrained (because, for example, policy rates are at the zero lower bound, or because the economy operates under fixed exchange rates). When sovereign risk is high, the negative effect on demand of a given contraction in government spending is offset to some extent by its positive impact on the sovereign-risk premium.

Some exercises we carry out suggest that, typically, consolidations will be contractionary in the short run. Only under extreme conditions does the model predict either negative multipliers (in line with the view of 'expansionary fiscal austerity') or counterproductive consolidations (in line with the view of 'self-defeating austerity'). To the extent that budget cuts help reducing the risk premium, there is some loss in output, but not too large.

- Second, due to the sovereign-risk channel, highly indebted economies become vulnerable to self-fulfilling economic fluctuations.

In particular, an anticipated fall in output generates expectations of a deteriorating fiscal budget, causing markets to charge a higher risk premium on government debt. Through the sovereign-risk channel, this tends to raise private borrowing costs, depressing output and thus validating the initial pessimistic expectation.

Under such conditions, conventional wisdom about policymaking may not apply. In particular, systematic anticyclical public spending is arguably desirable when policy credibility is not an issue. In the presence of a volatile market for government bonds, however, anticipation of anticyclical fiscal policy may not be helpful in ensuring macroeconomic stability. A prospective increase in spending in a recession may feed confidence crises by amplifying the anticipated deterioration of the budget associated with output contractions.

Thorny issues for highly indebted countries

This possibility poses a dilemma for highly indebted countries. In light of the above considerations, countries with a large amount of debt may be well advised to tighten fiscal policies early, even if the beneficial effect of such action – prevention of a damaging crisis of confidence – will naturally be unobservable. From a probabilistic perspective, even a relatively unlikely negative outcome may be worth buying insurance against if its consequences are sufficiently momentous. In the current crisis, unfortunately, we know that such insurance does not come cheap.

Beyond austerity

The near-term costs of austerity mean we should keep thinking about alternatives, such as making commitments to future tightening more credible (eg entitlement-programme reforms).

However, the presence of a sovereign-risk channel also provides a strong argument for focusing on ways to limit the transmission of sovereign risk into private-sector borrowing conditions.

- Strongly capitalised banks are a key element here.

The ongoing efforts, coordinated by the European Banking Authority, to create extra capital buffers in European banks correspond to this logic.

- Another element is the attempt by monetary policymakers to offset high private borrowing costs (or a possible credit crunch) when sovereign-risk premium is high.

Normally, the scope to do this is exhausted when the policy rate hits the lower bound. Recent unconventional steps by the ECB, however, suggest that more is possible. The extension of three-year loans to banks, in particular, appears to have reduced funding strains, with positive knock-on effects for government bond markets.

- These arguments are especially strong for either countries already facing high interest rates in the market for their debt, or countries reasonably vulnerable to confidence crises.[2] These countries would be ill advised to relax their fiscal stance.
- The arguments apply less to governments facing low interest rates.

The main issue is where to draw the line. Under what circumstances is it safe to postpone implementation of fiscal corrections?

Conclusion

There is an increasing tide in favour of reconsidering fiscal austerity programmes, in recognition of the persistent effects of underemployment of labour and capital on potential output. At the same time, however, it should be recognised that weak growth in countries facing precarious fiscal positions is not sufficient evidence against fiscal austerity. Where sovereign risk is high, fiscal tightening remains an important avenue to bring down deficits at a limited cost to economic activity, as risk premiums recede over time. In addition, fiscal austerity may well have important unobserved benefits, by preventing greater macroeconomic instability which tends to arise in the presence of high sovereign risk.

In light of these considerations, it is perhaps useful to move beyond the headlines of 'expansionary contractions' and 'self-defeating fiscal austerity'. As a matter of fact, most governments face specific questions on how to reform their spending and taxation, rather than a general question of 'how much'. Not only the intensity, but also and especially the content of upfront budget cuts currently contemplated in countries may be expected to have a first-order impact on the current recession.

2 For example, because of a high stock of public debt, small fiscal shoulders, and financial fragility.

Moreover, budget considerations are sensible insofar as in addition policymakers actively explore other ways to contain sovereign-risk premiums, or at least reduce their impact on broader economic conditions. Indeed, the big burden for the crisis countries in the Eurozone may be uncertainty of the common institutional and policy framework, favouring a solution for the debt overhang problem (a stock, not a flow problem), joint support to stem confidence crises and contain the transmission to the private sector (see Whelan 2012 on the 'fiscal compact'). Fiscal and monetary interventions are sensible when directly targeted to these. They are counterproductive to the extent that they exacerbate the credibility problem and feed uncertainty. There is vast unexploited room for nonstandard and standard monetary interventions. But again, without a sense of direction, ie without a political and institutional development, the scope for the occasional action by existing institutions appears quite limited.

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Fiscal discipline, not austerity, is the right response to the large accumulation of public liabilities during the first years of the crisis. This eCollection summarises the view of leading economists about the path and content of budget adjustment that can help advance economies to move out of the crisis, and resolve the policy impasse that is unsettling the euro zone.

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