On European Austerity

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Since the outbreak of the sovereign debt crisis in winter 2009/10, eurozone governments have enacted a number of so-called rescue programmes. Most bail-outs pertained to Southern European countries like Greece, Portugal and Spain, on which this article concentrates; Cyprus as a small state is excluded. During the early stages of the crisis the bail-outs were seen as temporary measures was aimed at achieving orderly budgets, as well as reasonable growth and unemployment rates.

Since then disillusion has set in as the aforementioned countries have suffered from severe recessions and unprecedented levels of unemployment. According to a widely shared view, this adverse development is due to a brutal austerity course – a course aimed at balancing government budgets as soon as possible. Austerity measures, so the story goes, depress economic activity and induce a downward economic spiral.

The prevailing opinion, hopefully portrayed fairly, consists of two propositions. The first is the factual statement that Southern Europe practices austerity. The second is the economic hypothesis that balancing government budget deficits aggravates recessions. In this article I would like to challenge both propositions.

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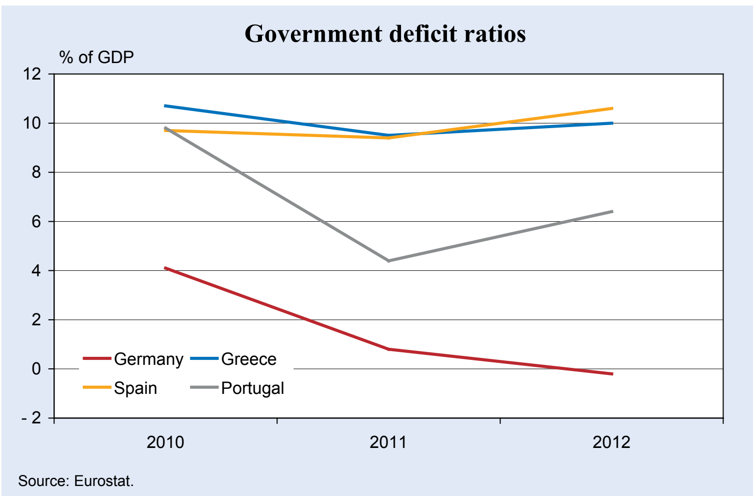
Is austerity real?

This is easy in the first case, i.e. the alleged austerity policies.[2] Let us first consider Spain. At the outset of the crisis in 2010 the country ran a budget deficit ratio of 9.7 percent of GDP, followed by 9.4 in 2011 and 10.6 percent in 2012. These figures are clearly unsustainable. In absolute terms the budget deficit rose from 101.4 million euros in 2010 to 111.5 million euros in 2012, flatly contradicting any sensible notion of austerity.

Greece's budget deficit ratios amounted to 10.7 percent in 2010, followed by 9.5 in 2011 and 10.0 percent in 2012, and the corresponding figures for Portugal reached 9.8, 4.4 and 6.4 percent, respectively. In all cases, deficit ratios obviously did not converge to zero. Portugal at least showed a deficit reduction in 2011, followed by an increase in 2012, whereas the deficit ratios of Spain and Greece remain almost steady at around 10 percent over the entire period. 'Austerity policy' in Southern Europe is simply a myth.

Figure 1



Source: Eurostat.

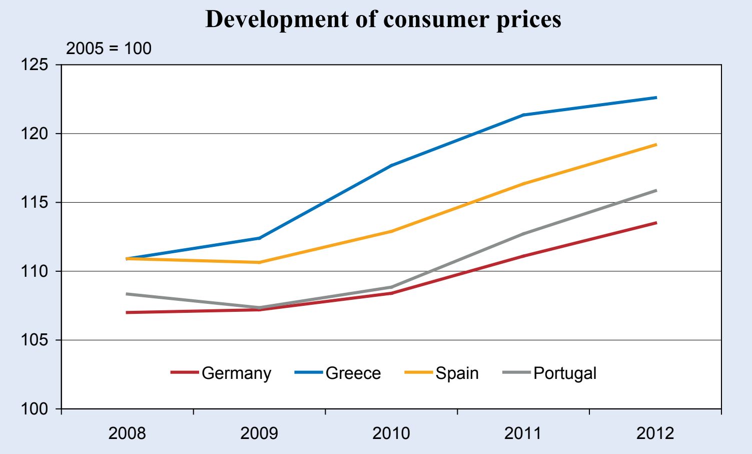
Government deficit ratios

This finding is remarkable for two reasons. Firstly, article 126 of the Treaty on the Functioning of the European Union obliges member states to avoid excessive deficits. The associated Stability and Growth Pact stipulates that budget defi-

[2] Data were retrieved from 'epp.eurostat.ec.europa.eu' on 25 April 2013 Government deficit is series 'EDP_89, sector S13, measured as PC_GDP'.

cits must not exceed 3 percent of GDP. The figures mentioned above exceed this reference value grossly. Yet sanctions are not discussed. What is more, Southern European countries obtain one bail-out after another, notwithstanding the evident fact that programme conditions do not work. Secondly, not only in the public press but also in the more technical literature on this topic there is an intensive debate about whether or not 'current austerity policies' are appropriate. Some authors agree (see e.g. Buti and Carnot 2013), others disagree (see De Grauwe and Ji 2013). However, from the viewpoint developed here, this debate is entirely beside the point since it disputes a myth. Discussing Spain's 'austerity policy' would only make senses if Spain had actually reduced its budget deficit in recent years, which has not been the case.

Figure 2



Source: Eurostat.

The complete failure of attempts to reach fiscal sustainability is nowadays disguised by references to 'primary', 'structural' or, preferably, primary structural deficits. These references neglect (rising) interest obligations and extrapolate former growth rates. By contrast, the original Stability and Growth Pact referred to plain budget deficits. It required member states to keep a close to balance or in surplus position, with a safety margin of 3 percent of GDP over the entire business cycle.[3]

Does austerity boost unemployment?

Meanwhile unemployment rates in Southern Europe have risen to frightening levels of 25.0 percent in Spain, 24.3 percent in Greece and 15.9 percent in Portugal.[4] This development challenges the prevailing opinion, which holds that extreme deficit spending spurs economic growth. The named challenge is reinforced by the fact that German unemployment rates fell from 7.1 in 2010 to 5.5 percent in 2012, while Germany actually reduced its budget deficit, from 4.1 percent in 2010 to 0.8 in 2011 and – 0.2 in 2012. In the German case a mild austerity policy was, in fact, accompanied by falling unemployment rates, an observation that is also totally at variance with the prevailing opinion.

Theoretical background

A remarkable shift has taken place in macroeconomic thinking since the inception of the Great Recession (see Farrell and Quiggin 2012). Until 2007 the majority of economists sustained the view that government expenditure crowds out private expenditure and hence does not change the level of GDP, but only its composition: if you buy government bonds you have to reduce other expenditure by a corresponding amount. On the basis of this accounting argument, myriads of articles demonstrated that deficit spending policies are (i) theoretically ill-conceived, (ii) empirically questionable, and (iii) politically impractical.

Some scholars added, however, that temporary budget deficits may help to cushion recessions because prices and wages do not react instantaneously. Even this sticky-price view, designed for a time span of some months, has been wiped out by now, as many economists sustain extreme deficit spending strategies intended for years (or decades?).

In Spain, Portugal and Greece, inflation rates were positive (repeat: positive!) until 2012. This contradicts the notion that current recessions are caused by downward price rigidities. With the single exception of Greece 2012, Southern European

[3] Council Regulation (EC) No. 1477/97 of 7 July 1997, revised by Council Regulation (EC) No. 1055/2005 of 27 June 2005 which introduced the 'cyclical adjustments'.
[4] Data were retrieved from 'epp.eurostat.ec.europa.eu' on 25 April 2013. Harmonized unemployment rates are series 'une_rt_a, total'.

inflation rates also exceeded German inflation rates.[5]

From a basic AD/AS diagram it follows that rising prices are incompatible with the leftward shifts of the AD curve, stemming from some unexplained 'lack of demand'. In the case of a leftward shift of aggregate demand, prices must fall rather than increase. Only a leftward shift of the AS curve, due to dwindling trust and increasing chaos would be compatible with present Southern European stagflation, where real incomes fall and prices rise.

Conclusion

The proposition that Southern European countries suffer from austerity policies contains two flaws. Firstly, there is no austerity policy; and secondly, deficit reductions are unlikely to prolong recessions. It remains to be seen why the latter view, dominating economics for centuries, has become a minority position in recent years. To explain this fully may be an interesting task for philosophers and historians. Personally I believe that pressure of the financial industry – which is eager to prolong the Ponzi games as long as possible – may be an explanation. In the public debate investors' opinions and governments' interests have largely crowded out received economic doctrine.

References

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De Grauwe, P. and Y. Ji (2013), "Panic-driven Austerity in the Eurozone and Its Implications", *VoxEU.org*, 21 February.

Farrell, J. and H. Quiggin (2012), *Consensus, Dissensus and Economic Ideas: The Rise and Fall of Keynesianism during the Economic Crisis,* http://www.henryfarrell.net/Keynes.pdf.

[5] Data were retrieved from 'epp.eurostat.ec.europa.eu' on 25 April 2013. Harmonized consumer price index is series 'CP00, average AVX'.