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Fiscal Austerity and the Euro Crisis:

Where Will Demand Come From?

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Fiscal austerity has emerged from the debate on the euro crisis as the main strategy to restore growth and employment. Stripped to its bones, the argument is this: reducing public debts reduces interest rates and injects confidence in the private sector, freeing the basic instincts to invest and consume. Why, in a depressed economy, businesses would expand their productive capacity is not clear, leaving free market enthusiasm the only apparent basis for such expectation. Clearly any policy response to the euro crisis deserves more solid foundations.

Many economists have pointed out that widespread austerity is likely to depress economic activity further without improving public finances. Yet, after the European Commission cut its growth forecast for 2014, austerity is likely to remain in place for at least another year. Indeed, with slower growth of gross domestic products, planned cuts in fiscal expenditures will not be sufficient to bring down deficit-GDP ratios and fiscal belts will have to be tightened further. Governments should reverse this course or expect forecasts to be cut again next year amid persistent unemployment.

If policies need to be sustainable both financially and socially, the current, general effort to reduce government deficits is lacking on both accounts. In this policy brief the fiscal deficit is presented alongside the private and external deficits, in order to emphasize that austerity requires finding alternative sources of demand besides fiscal expenditure. However, in today's Eurozone, no other source appears viable.

The fact that the Eurozone is still largely in the grip of the recession, and that growth is slowing in its stronger members too, should be no surprise. While government deficits have been cut across the monetary union (and beyond), no private actor, domestic or foreign, has picked up the foregone demand. Governments (and voters) considering further cuts to fiscal deficits should

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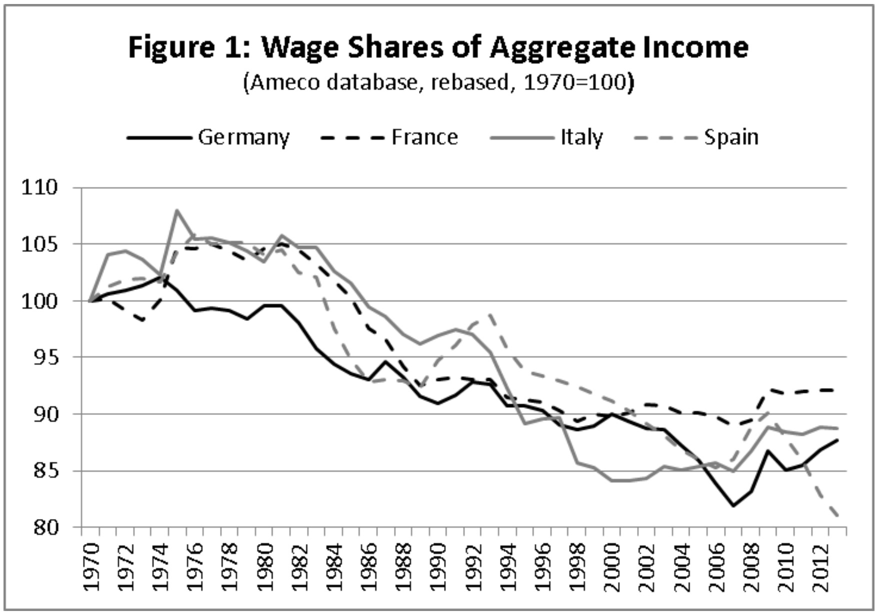
ask themselves an important question: where will demand come from? There are only three possible answers: households, businesses and the rest of the world.

As economic activity across Europe stagnates or contracts, government deficits are the only viable source of demand expansion. Household expenditure is largely curbed by record-high unemployment and policies that have made labor, and labor income, more "flexible"[1], making private spending more pro-cyclical. Data on the wage shares of aggregate income don't leave much hope: in the four largest European economies labor receives a smaller share than in the early 1980s.[2] Labor shares increased for a time after the financial crisis wiped out profits but, without increases in wages and employment, these gains are likely to be short lived (Figure 1).



Exports cannot to be relied on in the short term because competitiveness does not change rapidly and, in the long term, because a strategy of export-led growth would likely harm other Eurozone members (as has been the case with Germany's growth since 1999[3]) or trigger currency devaluations by external countries. Faced with weak domestic demand and uncertain prospects for export growth, Eurozone businesses cannot be expected to increase investment even if borrowing costs are at historical lows.

Countercyclical fiscal policy is the only option currently available to sustain aggregate demand. When the latter is stabilized and its private component is growing again, governments will have the opportunity to cut deficits and reduce debts without dramatic social costs.

Most frustrating to Europeans struggling with high unemployment and stagnating incomes must be the reluctance of government deficits and debts to come down despite the harsh austerity measures. This points to a fundamental constraint that is often overlooked in the austerity debate: any given level of output requires adequate demand by households, businesses, government and the rest of the world[4]. When one of these actors reduces its claims, output will decrease unless other actors pick up the slack. Put

[1] On the risks involved in pursuing higher labor flexibility and fiscal austerity at the same time, see Capaldo and Izurieta (2013).

[2] This long-term fall of the labor share follows a political economy shift common to other industrialized countries such as the United States and Japan.

[3] Flassbeck and Lapavitsas (2013) analyze in detail the relationship between Germany's export-led growth and current account imbalances in the Eurozone.

[4] This is the principle of effective demand introduced by Kalecki and Keynes. It always applies unless economic activity is subject to a supply-side constraint, typically foreign exchange scarcity in many developing countries.

differently, net claims (a sector's expenditure minus its income) on domestic output sum to zero.

Summarizing expenditures and incomes as net claims brings out the economy's resource constraint clarifying why deficit-GDP ratios have been stubbornly high in Europe (Figures 2-5). When a government cuts the deficit (its net claim on output) during a period of buoyant private demand, households or businesses may pick up the slack. Output may not change at all and the deficit-GDP ratio may decline. On the other hand, in the current recessionary environment households and businesses have proven unable to increase their net claims and government deficits have brought down output. In many cases ratios barely changed, predictably frustrating all efforts toward fiscal consolidation in the Eurozone.

Figure 2: Germany, Net Claims of Institutional Sectors on Output
(Shares of GDP at current prices, Ameco database)

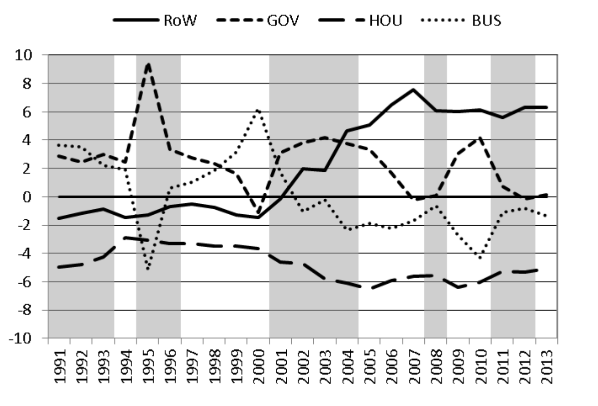


Figure 3: France, Net Claims of Institutional Sectors on Output
(Shares of GDP at current prices, Ameco database)

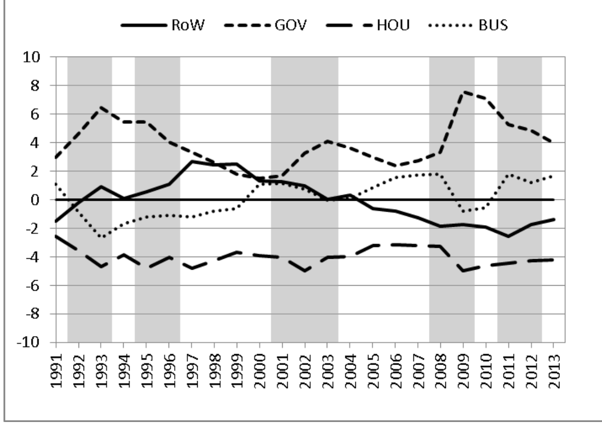


Figure 4: Italy, Net Claims of Institutional Sectors on Output
(Shares of GDP at current prices, Ameco database)

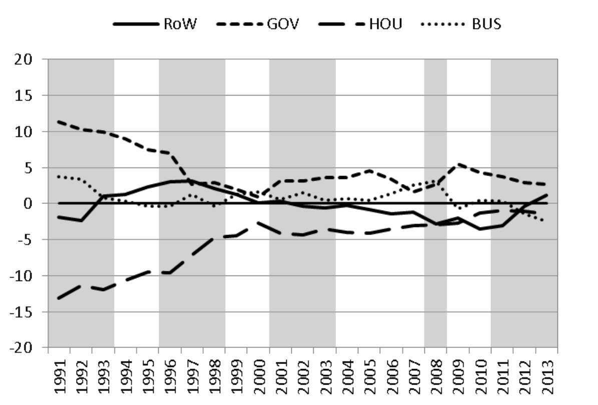
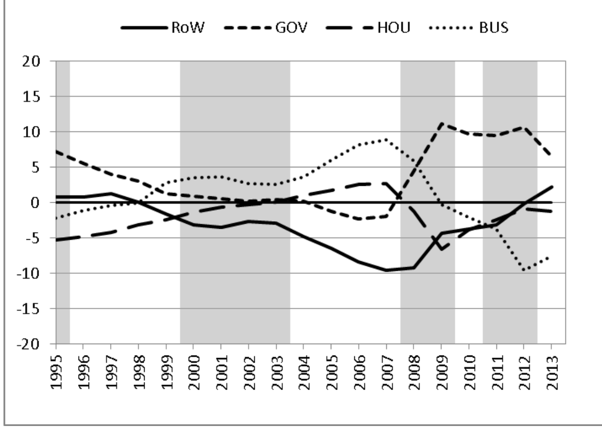


Figure 5: Spain, Net Claims of Institutional Sectors on Output
(Shares of GDP at current prices, Ameco database)



Note: RoW indicates Rest of the World, GOV General Government, HOU Households and Non-Profit Institutions Serving Households, BUS business. Shaded areas indicate recessions (OECD, 2012).

In Figures 2-5 net claims by every sector, as shares of GDP, sum to zero at any time and through any swings, reflecting macroeconomic equilibrium. This is due to the fact that equilibrium is built into the system of national accounts, the statistical basis for these data[5]. From this derives the famously misleading equality of saving and investment: although saving and investment always appear equal in the data, saving cannot be increased exogenously. In modern economies, where output adjustments are frequent, attempts to increase saving lead to lower output, lower investment and, paradoxically, lower saving. Fiscal austerity, which attempts at increasing aggregate saving by reducing government dis-saving, is a typical example. It follows that the timing of each swing in figures 2-5 is critical in ushering in a period of high growth or triggering a recession. When a sector cuts its net claims and no other sector increases them (aggregate saving increases), output falls. Net claims still balance out (saving still equals investment) but economic activity has declined, as indicated by the shaded areas[6].

In all countries net claims have interesting stories to tell. In Germany, after the post-unification effort, the government deficit was reduced when businesses became net borrowers in order to pay for investment. Yet the increase in business net borrowing was not fast enough to avoid a recession. A similar scenario played out in the early 2000s, when business net borrowing declined and turned negative thanks to tax cuts and a national policy of wage moderation. At that time, both the government deficit and net exports began to increase. When the government deficit was cut again, net exports were increasing quickly enough to avoid another recession.

In France the external surplus has been declining since the late 1990s but the economy has avoided long recessions thanks to the stabilizing role of the fiscal deficit. In Italy the decline of the external surplus and government deficit since the 1990s has been partially outweighed by falling household net saving. In Spain, high growth in the 2000s was supported by dynamic business net borrowing that spilled over onto the current account deficit. When investment dropped at the onset of the financial crisis, government had to pick up the slack. In all these cases it is clear, with the benefit of hindsight, where aggregate demand did or did not come from.

Is it possible that governments and political institutions supporting austerity did not ask themselves in advance where demand would come from? They probably did but they must have found reassurance in the long standing view that demand would come from the business sector. According to this view, reducing government borrowing leads to lower interest rates, thereby stimulating business investment. However, data have clearly refuted the validity of this mechanism, especially during recessions, in both developing and developed economies. Not only did interest rates decline in the 2000s in all Eurozone countries, including those with highly indebted governments, but during the financial turmoil of 2011, when bond yields did briefly go up, they increased in Spain too despite the country's low sovereign debt. At the same time, even with record-low borrowing costs, businesses did not increase investment and, in fact, continued on average to shed jobs.

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[5] As explained in Taylor (2010), the system of national accounts is built on Keynes's postulate that domestic output equals domestic income. Accordingly, every flow involved in production is also seen as contributing to someone's income. However, spending – effective demand – may exceed or fall short of domestic income triggering output adjustments. Neoclassical macroeconomics excludes this possibility by postulating that price adjustments always ensure equality of output and demand.

[6] The figures do not show the levels of income and sectors' demands, only the shares of net claims relative to gross domestic product. Nonetheless the figures are useful in pointing out the co-movements of different components of demand.

The correlation between fiscal austerity, declining interest rates and increasing investment is an economic myth. However, unlike classical myths, it has led to countless economic tragedies while offering little or no pedagogical value.

Despite all contrary evidence, many institutions still recommend relying on fiscal austerity to stimulate growth. The fact that austerity still features in policy recommendations while forecasts are repeatedly cut clearly testifies to this belief. The practical problem here rests with econometric models, particularly with estimates of output responses to reductions in government net claims (fiscal multipliers). Most models that have fuelled unrealistic growth expectations have underestimated fiscal multipliers and overlooked their relationship with the business cycle.

Indeed, fiscal stimulus has proven more effective and austerity more disastrous during recessions than during output upswings. The IMF recently acknowledged the importance of this correlation[7] but decades of persuasive efforts are hard to undo. Policymakers interested in forming sensible expectations about the effects of fiscal austerity and fiscal stimuli in the current European and global context should look at models where fiscal multipliers are endogenous. Work done at the United Nations (2010) is a promising step in this direction.

Concluding, the choices faced by policymakers, voters and modelers who consider fiscal austerity all boil down to answering the same fundamental question: where will demand come from?

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[7] See Baum et al. (2012)

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