Austerity backlash

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The heated discussion of recent economic research that challenges evidence of a clear link between high levels of public debt and slow economic growth has served as a focus for growing hostility to the "austerity first" approach that has been one of the principal elements of euro zone economic policy since the start of the Greek crisis. Some observers see a change in tone of recent statements from the European Commission as a signal that euro zone policy is about to shift decisively to a more pro-growth stance, playing down the need for budget consolidation. In practice, the extent of any change is likely to be limited.

Research from 2010 by Carmen Reinhart and Kenneth Rogoff, two leading US economists, which purported to show that economic growth was much lower in countries that allowed public debt to rise above 90% of GDP, had been widely cited over the last couple of years by advocates of the view that early action to bring down budget deficits in the euro zone was a necessary condition for a return to healthy (and sustainable) economic growth. The recent finding by three economists from the University of Massachusetts, Thomas Herndon, Michael Ash and Robert Pollin, that this claim of a "cliff-edge" relationship between debt and growth was not robust has led to a high-profile debate over the extent and direction of any links between debt levels and growth rates. The emerging consensus seems to be that the relationship is much weaker than Reinhart and Rogoff claimed but, even more importantly, it is unclear whether this weaker relationship is because high debt causes slower growth or because periods of weak growth lead to high levels of debt.

This debate has given further ammunition to opponents of the euro zone's current emphasis on rapid action to bring down budget deficits. Late last year, the IMF acknowledged that the damaging effects of fiscal consolidation on economic growth were, in the current conditions, significantly greater than it had previously thought. Last month, the president of the European Commission, José Manuel Barroso, expressed worries that the current focus on austerity was in danger of becoming politically unsustainable. Against this backdrop, some have predicted that the policy stance in Europe will now shift away from budgetary consolidation towards supporting economic growth.

No change in course

In our view, those hoping for a big shift in policy are likely to be disappointed, although there may be some adjustments at the margin. For example, France, Spain and Poland are likely to be given more time by the Commission to reduce their budget deficits below the 3% of GDP limit, on the basis that the current recession in the euro zone has made the original plans to meet the target this year unrealistic. This represents a slight relaxation in fiscal policy, which should give some support to economic activity in the euro zone during 2013 and 2014.

However, the crisis-hit countries of southern Europe are much less likely to have the opportunity to ease up on budgetary consolidation. Setting significantly higher limits for permitted future budget deficits in Cyprus, Greece or Portugal would require those funding the deficits (the IMF and the governments of other members of the euro zone) to commit themselves to provide additional funds. Although such funds may still have to be found *ex post* if economic growth in the crisis countries continues to disappoint, there is huge political resistance in Germany and the other "creditor" countries to providing additional funds in advance. In particular, many German policymakers are worried that lending additional funds would merely allow the governments

concerned to ease up on structural measures, such as the liberalisation of labour and product markets, which are seen in the north as necessary conditions for any renewal of economic growth in the south.

Even more importantly, Germany and the other countries of the northern core, which do have the freedom to relax budgetary policy, are highly unlikely to do so. There is long-standing scepticism among policymakers in Germany about the ability of fiscal policy to stimulate economic growth and this has been reinforced in recent years by worries among both policymakers and the general population about the country's poor demographic prospects. As a result, there is broad opposition to any measures that could be seen as weakening the state's long-term budget position and so reducing the ability of future governments to meet public pension commitments. Concerns over long-term fiscal pressures are shared by policymakers in several other euro zone member states.

In this situation, a "grand bargain" whereby Germany relaxed budgetary policy in the short term to support euro zone growth, in return for a solid commitment to structural reform in the weaker members of the euro zone and budgetary consolidation over the medium term across the whole single currency area, appears politically infeasible. Instead, something very like the euro zone's established approach looks set to continue. Without any significant relaxation in the German position, any change in policy is likely to be restricted to extending the timescales for bringing down budget deficits in countries such as France and Spain, giving only a limited boost to economic activity. This increases the danger that policy for the region as a whole will be overly restrictive, prolonging the present period of economic weakness in the euro zone and further ratcheting up political tension in southern Europe.