Has austerity failed in Europe?

By Daniel Gros

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Although many European governments have announced expenditure cuts and tax hikes, their debt/GDP ratios continue to deteriorate. So, if the purpose of austerity was to reduce debt levels, its critics are right: fiscal belt-tightening has failed. But the goal of austerity was not just to stabilize debt ratios.

In fact, austerity has worked as advertised in some cases. Germany's fiscal deficit temporarily increased by about 2.5 percentage points of GDP during the global recession of 2009; subsequent rapid deficit reduction had no significant negative impact on growth. So it *is* possible to reduce deficits and keep the debt/GDP ratio in check – provided that the economy does not start out with large imbalances, and that the financial system is working properly. Obviously, the countries on the eurozone's periphery do not meet these conditions.

Countries whose governments have either lost access to normal market financing (like Greece, Ireland, and Portugal), or face very high risk premia (like Italy and Spain in 2011-2012) simply do not have a choice: they must reduce their expenditures or get financing from some official body like the International Monetary Fund or the European Stability Mechanism (ESM). But foreign official financing will always be subject to lenders' conditions – and lenders see no reason to finance ongoing spending at levels that previously led a country into trouble.

So, in the eurozone periphery, austerity is not a question of fine-tuning demand, but of ensuring governments' solvency. Economists like to point out that solvency has little to do with the ratio of public debt to today's GDP, and much to do with debt relative to expected future tax revenues. A government's solvency thus depends much more on long-term growth prospects than on the current debt/GDP ratio.

A reduction in the deficit today might lead in the short run to a fall in GDP that is larger than the cut in the deficit (if the so-called multiplier is larger than one), which would cause the debt/GDP ratio to rise. But almost all economic models imply that a cut in expenditures today should lead to higher GDP in the long run, because it allows for lower taxes (and thus reduces economic distortions).

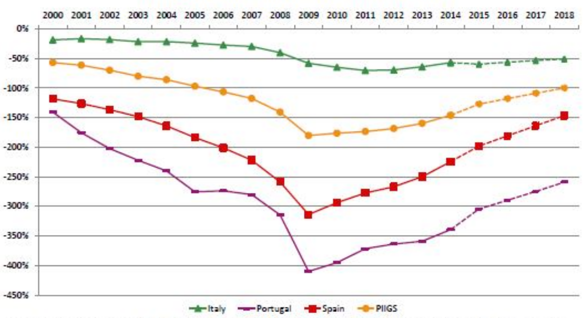
Austerity should thus always be beneficial for solvency in the long run, even if the debt/GDP ratio deteriorates in the short run. For this reason, the current increase in debt/GDP ratios in southern Europe should not be interpreted as proof that austerity does not work.

Moreover, austerity has been accompanied by structural reforms, which should increase countries' long-term growth potential, while pension reforms are set to reduce considerably the fiscal cost of aging populations. Such& reforms promise to strengthen the solvency of all governments that adopt them, including those on the eurozone's periphery.

More important, austerity has been very successful in restoring external balance to the eurozone's periphery. The current accounts of all southern eurozone countries are improving rapidly and, with the possible exception of Greece, will soon swing into surplus. This fundamental change has contributed to the reduction in risk premia over the last year, despite the political upheaval that continues in many countries (particularly Italy, Portugal, and Greece).

The external aspect is crucial. If public debt is owed to domestic investors, it can be serviced with the taxes levied on GDP. But debt owed to foreigners can be serviced only with goods and services sold abroad – that is, exports. Thus, the key variable for countries that had large current-account deficits, and thus are burdened today with high foreign-debt levels, is not the debt/GDP ratio, but the foreign debt/exports ratio (together with the growth prospects for exports).

Cumulated Current Account Balance as % of Exports of Goods and Services (excluding oil)



Source: calculations based on data from Eurostat and the IMF (WEO database). Oil is exluded from exports, because, for these countries, oil exports consist only of re-exports of refined crude oil, and the value-added margin of the refinery is a small fraction of the overall value of these countries' exports.

Here, developments are encouraging. During the boom years, when countries like Greece, Portugal, and Spain were running ever-larger external deficits, their exports did not grow quickly, so their foreign debt/exports ratios deteriorated steadily, reaching levels that are usually regarded as a warning signal. For example, for Spain and Portugal, the sum of past deficits relative to annual exports reached 300% and 400%, respectively, in 2009, whereas a 250% ratio is typically regarded as the threshold at which external-financing problems can arise.

With austerity, imports have crashed everywhere in the periphery, while exports – helped by falling labor costs – are increasing (except in Greece). As a result, these countries' current accounts are now moving into surplus, and their external solvency is improving rapidly.

Indeed, according to the IMF, Spain should record growing current-account surpluses over the next five years, as exports rise strongly, thus cutting the external debt/export ratio by half (to about 150% in 2018), while Portugal's ratio should fall to about 250%. Even Italy, whose external deficits have remained small, will soon record a current-account surplus.

Austerity always involves huge social costs; but it is unavoidable when a country has lived beyond its means and lost its foreign creditors' confidence. The external fundamentals of the eurozone's periphery are now improving rapidly. In this sense, austerity has done exactly what it was intended to do.

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