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ABSTRACT

Further Austerity and Wage Cuts Will Worsen the Euro Crisis*

This note argues that the solutions to the euro-area crisis proposed by the EU governing institutions in cooperation with the IMF, based on further austerity and wage cuts, will worsen the crisis. They are unlikely to reduce both sovereign and external debt ratios of countries experiencing these problems. Quite in contrary, they are likely to further reduce the real GDP growth of these countries.

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Freedom of capital movements is an essential part of the old laissez-faire system and assumes that it is right and desirable to have an equalisation of interest rates in all parts of the world. It assumes, that is to say, that if the rate of interest which promotes full employment in Great Britain is lower than the appropriate rate in Australia, there is no reason why this should not lead to a situation in which the whole of British savings are invested in Australia, subject only to different estimations of risk, until the equilibrium rate in Australia has been brought down to the British rate. In my view the whole management of the domestic economy depends upon being free to have the appropriate rate of interest without reference to the rates prevailing elsewhere in the world. Capital control is corollary to this.

(Keynes, 1942)

The problems

Some euro-area countries presently face two major problems. The first is high and increasing sovereign debt to GDP ratios (Tab. 1). The second is high external debts (both private and public; see Tab. 2).

Economic theory suggests that a high and increasing sovereign debt ratio is a consequence of i) real interest rate higher than real GDP growth rate and ii) repeated primary budget deficits. Yet, the latter is less important than the former as the sovereign debt ratio can decrease over time if real GDP growth is higher than real interest rate, even in presence of repeated primary budget deficits[1]. Analogously, economic theory suggests that high external debt is typically a consequence of accumulated high current-account deficits (Tab. 3).

In this note, we will focus on Portugal, Italy, Greece and Spain in comparison with Germany. Sometimes we will refer to the former as "peripheral countries" in the light of their geographical position within the euro area.

The two major problems referred above seem to be the underlying causes of the "change of regime" in the dynamics of the nominal interest rates on government bonds that started in 2008 but manifested clearly in 2010-2011 (Fig. 1).

The recent interest-rate dynamics is likely to reflect the fact that financial markets have started to take into account not only the default risk (the risk that the sovereign debt of a country may not be paid back) but also the exchange-rate risk (the risk that the sovereign debt of a country is paid back in a currency other than the euro).

In 2009-2010, inflation rates have generally decreased when compared to 1999-2008 (Tab. 3). Since nominal interest rates have either increased or marginally decreased in peripheral countries, real interest rates in these countries have increased. Instead, in Germany, a one-percentage-point decrease in the nominal interest rate has been accompanied by a roughly equal decrease in the inflation rate, so that the real interest rate has remained stable (around 2.6 percentage points). Although inflation data are not yet available for 2011-2012, current real interest rates are likely to be particularly high in Greece and Portugal due to very high nominal interest rates.

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[1] The key condition is $d < b_0 \frac{g - r}{1 + g + \pi}$ where d is the primary budget deficit ratio, b_0 is the initial sovereign debt to GDP ratio, g is the real GDP growth rate, r is the real interest rate and π is the inflation rate. Besides b_0, all other variables are steady-state variables.

In addition, the average real growth rate in most of the euro-area countries, including Germany, has been negative in 2009-2010. Yet, the recession has been stronger in peripheral countries (Tab. 3).
Finally, while Germany was continuing to play the role of net exporter in 2009-2010, the current-account deficits of Greece, Portugal and Spain have remained large, and Italy's deficit has increased (Tab. 3).
In sum, the indicators in Tab. 1 and Tab. 2 suggest that Italy has a sovereign debt problem, Spain has an external debt problem while Greece and Portugal have both an external and a sovereign debt problem. Notably, Germany's sovereign debt ratio is well above Spain's. In addition, it has increased by almost 22 percentage points from 1999 to 2010 (Tab. 1). This has happened despite an average primary budget surplus of 0.6% of GDP in the same period (Tab. 1). Yet, this result can be explained by an average real interest rate that has been 2.6 percentage points higher than the average real GDP growth rate between 1999 and 2010 (Tab. 1), and alerts for the dangers of anaemic real GDP growth for sovereign-debt sustainability.

The issues
This situation poses three main questions:

i) Why are current nominal interest rates so high in Greece and Portugal?[2]

In our view, one reason is the existence of free capital mobility. It allows capitalists to allocate their capital where the return is higher and the risk is lower. This means that euro-area countries must compete against each other in order to raise funding in financial markets. Such a competition pushes interest rates up in countries where the default risk and/or the exchange-rate risk are higher. Another explanation is the absence of a Central Bank acting as a lender of last resort since this absence increases both default and exchange-rate risk in countries with high sovereign and/or external debts. A third reason is the lack of country-level monetary policies (such as systematic open-market operations by the ECB on specific government bonds) aimed at keeping the interest rate low in countries where GDP growth is low. A fourth reason is that speculative attacks are favoured in the environment created by free capital mobility, absence of a lender of last resort and lack of country-level monetary policies. Of course, there may be other reasons but we aim at keeping this note short.

ii) Why is recent real GDP growth particularly low in both peripheral countries and Germany?

Our view is that low real GDP growth is primarily a consequence of low real aggregate demand growth. Recent austerity policies have inevitably contributed to depress aggregate demand growth. What is mostly needed now is that these policies be abandoned. Instead, what we see is a discussion about how to strengthen austerity and stimulate growth at the same time. The latter seems to be a contradiction in terms but there are still some ideas that are worth discussing.

[2] This question particularly applies to Greece and Portugal as nominal interest rates in Italy and Spain are much lower although increasing.

Putting it differently, nowadays there seems to be a great emphasis on the need for liberalizations and privatizations as engines for growth, particularly in peripheral countries. For instance, Italy has recently approved a new liberalization program while Portugal privatized the remainder of the national electricity provider, EDP, and will shortly privatize the national water utilities, air carrier, and postal service.

In our view, these policies can stimulate GDP growth only if they can increase aggregate demand growth. Yet, it is still controversial whether these policies are actually able to increase aggregate demand.

Let us consider, for instance, privatizations. They may stimulate private investments but it is not a-priori clear if the private sector will maintain or increase the level of investment and expenditure that was previously assured by the public sector. Any net reduction would imply a fall in aggregate demand. Even the increase in efficiency, that is usually recognized as a potential effect of privatizations, does not necessarily lead to lower prices (which may boost exports) as privatizations usually happen in sectors producing non-transactional goods (such as public utilities) where competition is lower and operators have higher market power.

Analogously, regarding liberalizations, it is not clear if they actually lead to cost/price reductions and so to an increase in external competitiveness. The effects on the internal demand are also uncertain. In addition, even if we assume (as a matter of faith) that the effects on export growth and internal demand are positive in the long run, in the short run they are likely to be negligible. And, the crisis in the euro area requires short-run solutions to the problem of low aggregate demand growth, particularly in peripheral countries.

iii) Why are current-account deficits historically large in Greece, Portugal and Spain?[3]

Again, there can be several possible explanations. First, some countries are more dependent than others from GDP growth of commercial partners. If the latter is low, more-dependent countries will experience lower export growth than others. Second, free-market competition from low unit-cost countries, such as China and India, boosts import growth and lowers export growth in countries where the main manufacturing activities are based on traditional industries. Third, unit costs of labour are actually higher in some countries than in others. Fourth, free capital mobility has led to an increase of the share of sovereign debt held by non-residents in some net-borrowing countries, thus worsening the income balance of these countries. Further, taxes on unit costs of production and final prices are actually higher in some countries for many different reasons including policies resulting from the EU Stability and Growth Pact. In addition, some countries are characterized by lower competition in non-tradable sectors, increasing costs of tradable goods. Finally, the balance-of-payments constraint faced by some countries has become less binding with the introduction of the euro as the need to collect foreign currency through exports for the payment of imports has become less stringent, to some extent due to the collateral guidelines of the Eurosystem (Sibert, 2010). Again, the above reasons are not exclusive of others.

In summary, there are some euro-area countries that are historically unable to compete with Germany when currency devaluation is not a policy option (or even when it is).

[3] This question particularly refers to Greece, Portugal and Spain as Italy does not seem to have a serious external debt problem.

This was known at least to some (see, for instance, Graziani 2002; and Pivetti, 1998) when the euro was created but the issue (namely, the possibility of balance-of-payments problems within the euro area) did not receive enough attention.

The EU/IMF solutions

In the situation described above, EU governing institutions[4] in cooperation with the IMF consider further austerity and wage cuts as potential solutions to the two major problems mentioned at the beginning of this note. Indeed, on the one hand, the European Council has recently approved a new "fiscal compact" that strengthens the Stability and Growth Pact (SGP). It sets a new target for debt reduction (1/20 reduction of debt in excess of 60% of GDP every year). In addition, it sets a new much more stringent target for the structural budget deficit that must not exceed 0.5% of GDP (the SGP defined a 3% upper bound for the deficit). The Council further agreed to enshrine the new fiscal rule in the national legal systems of Member States at the constitutional level or equivalent[5]. On the other hand, the IMF has repeatedly advised national governments of countries implementing its adjustment programs to cut nominal wages[6]. For instance, in Portugal, for public-sector employees with salaries above a certain threshold, the cut was between 5 and 10% in 2011. And, there will be an additional cut of roughly 14.3% in 2012 including pensioners. Greece implemented similar wage cuts starting in 2010.

This EU/IMF strategy raises four additional questions:

i) Can further austerity (defined as primary budget surplus policies) help?

In our view, further austerity will lower the growth rate of internal aggregate demand and thus reduce GDP growth[7]. This may help the current account to improve because import growth lowers when GDP growth lowers. Yet, lower GDP growth is likely to push the sovereign debt to GDP ratio up. In addition, if austerity is applied everywhere in the euro area, including Germany, then export growth will also fall, and the current account will ultimately be unlikely to improve.

ii) Can wage cuts help?

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[4] We mean the European Council and the Ecofin/Eurogroup, but also, and in particular, the European Commission's Directorate-General ECFIN, the Economic and Financial Committee for the Council of the EU, and the ECB.

[5] This recent Council agreement can be interpreted as the continuation of the strategy of reinforcement of austerity measures seen in earlier Council meetings and, for example, in the reform of the SGP adopted in July 2010 by the European Commission.

[6] For the case of Portugal, the influential opinion of the IMF chief economist is summarized in Blanchard (2007, p. 15). Andini (2008) has provided an empirical evaluation of Blanchard's arguments, highlighting the dangers of nominal wage cuts for GDP growth.

[7] Recent estimates show that the fiscal multiplier is significantly larger than one (see Acconcia et al., 2011 among others). An interesting discussion on the effectiveness of fiscal policy in a stock-flow model is provided by Arestis and Sawyer (2011).

Wage cuts may improve competitiveness by reducing unit labour costs, thus increasing export growth. Yet, this increase in the growth rate of external demand is unlikely to happen if all countries are doing the same thing at the same time (cutting wages) and if commercial partners in the euro area experience low GDP growth (also because of austerity). By converse, wage cuts are likely to reduce growth in internal aggregate demand and so to reduce GDP growth. Lower GDP growth may reduce current-account deficits by lowering import growth. Yet, export growth may also fall because other countries are doing the same (i.e. reducing their import growth). So, in the end, the current account may not improve.

iii) Should we trust the EU/IMF strategy?

This strategy is not the result of God intervention. It has been designed and implemented by men and women. Some of them are very hard-working, bright and influential economists. Yet, and unfortunately, we cannot but highlight the fallacy of some ideas, put forward by EU/IMF policy-making circles, that have contributed to lead the euro area to the current misery. Indeed, many of the economists that are presently in charge of preserving the future of the euro area, in the recent past, have not shown resistance to the idea that, with the creation of the EMU, "intra-European balances of payments could become just a statistical curiosity" (De Cecco and Giovannini, 1989, p. 11). In contrast, some of them have even argued that "because of the symmetry between current account surpluses and deficits across countries in the euro area, the European Central Bank has no reason to respond by changing monetary policy" (Blanchard and Giavazzi, 2002, p. 185-186). Finally, while many of them were celebrating that "ten years after the entry into force of the Stability and Growth Pact, the aggregate euro-area deficit ratio, as estimated for 2007, stands at its lowest level in several decades" (Barrell et al., 2008, p. 64), the real GDP growth rate of the euro area also reached its lowest level in several decades (see Fig. 2).

iv) Where will further austerity and wage cuts lead to?

We believe that, by lowering internal aggregate demand growth, further austerity and wage cuts will lead to low GDP growth and recession[8]. The latter may lower import growth but, since export growth will also be anaemic in absence of a boost from countries with a current-account surplus, like Germany, it is likely that the current account of peripheral countries will not improve at all. Hence, the result of the reduction in primary public deficits (austerity) and wage cuts is likely to be an increase in private debt (note that the current-account deficit can be seen as the sum of private and public net borrowing requirements).

A further increase in private debt may increase the default risk of private-sector banks. Low GDP growth caused by further austerity and wage cuts may imply that the sovereign debt to GDP ratio increases rather than decreases. The latter may also increase the default risk of banks.

Announcements of austerity and wage cuts may have some positive short-run effects (sometimes limited to few days or weeks) because recent speculation in the euro area

[8] Another consequence is social unrest, which is likely to act as a crisis amplifier (see Ponticelli and Voth, 2011).

has been based on negative expectations (default and similar scenarios). Indeed, it is true that these announcements often generate positive expectations among financial-market participants. Nevertheless, these policies are likely to fail in the longer run for the reasons mentioned above.

In sum, in our view, markets will realize soon that indebted countries will not be able to reduce their external and sovereign debt ratios through further austerity and wage cuts. To some extent, in the case of Greece and Portugal, they have already realized. That is why these countries are presently unable to sell their sovereign debt in the financial markets[9]. It is also the reason why the ECB, in order to save the euro, has seen itself forced to act as lender of last resort, albeit indirectly and non-transparently, through large exceptional and ad-hoc operations providing liquidity to the European banking system. Instead, we argue it would be more effective for the ECB to intervene directly in the sovereign debt markets of peripheral countries (De Grauwe, 2011). The simple announcement of a last-resort lending will probably suffice to reduce the size of the intervention itself.

The same destiny of Greece and Portugal is likely to soon befall Italy and Spain if policies based on austerity and wage cuts[10] are not abandoned.

The alternatives

A deep recession in the euro area could be avoided if alternative policies are identified and implemented. The root of the crisis is not the peripheral countries' lack of fiscal discipline. Instead, it is a flawed Economic and Monetary Union design. The key macroeconomic policy framework of the EMU, namely the Stability and Growth Pact, was and is flawed (see Arestis et al. 2001).

The EU governing institutions' response to the crisis has been that peripheral countries did not follow the Stability and Growth Pact close enough in the past. So their recipe to address the crisis, i.e. the new "fiscal compact", is essentially "stay the course, just try harder". However, these policies will not solve the problem. Staying the course in the current context just means worsening the crisis. These policies have not worked in the past (since the EMU was created). Hence, it should be obvious that they will not work in the future. Paradoxically, and contrary to general belief, these policies have not worked even in the country widely seen today as promoting this strategy: indeed, in Germany, they have resulted in over a decade of anemic GDP growth accompanied by unsustainable sovereign debt dynamics.

The EU governing institutions should seek to identify what went wrong as well as policy alternatives. Only by identifying policy alternatives will the European Union be able to truly address the euro crisis. The problem, of course, is that it is hard for the institutions that made mistakes to acknowledge their authorship. It is always easier to blame responsibility on someone else.

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[9] There has been no primary-market issuance of medium and long-term sovereign debt by Portugal and Greece since the beginning of their respective EU/IMF adjustment programs. The only sovereign debt that has been sold or issued is either short-term bills or resulting from loans from the IMF and the EU (EFSF). Domestic banks are thought to be the largest buyers of short-term bills. Although not explicitly, they have been encouraged to do so by the ECB, with recourse to the emergency long-term refinancing operations set up by the ECB.

[10] Nominal wage cuts have not yet been implemented in Italy (at least not in large scale) but there are already rumours about the need to cut public-sector wages.

In our view, in the light of the actual causes of the current euro crisis discussed above, policy alternatives should be oriented towards: i) reducing nominal and real interest rates; ii) increasing the growth rate of aggregate demand; and iii) reducing current-account deficits.

In practice, the alternatives include: i) limitations to free capital mobility in the euro area (better if through administrative controls than through Tobin taxes); ii) a Central Bank acting as a lender of last resort; iii) country-level monetary policies operated by the ECB to keep the real interest rate of a country compatible with its specific real GDP growth; iv) policies stimulating internal demand growth in Germany[11] (i.e. the converse of the current austerity) to stimulate real GDP growth in Germany and exports of peripheral countries; v) country-level fiscal polices[12] to keep into account country specificities (i.e. the end of the "one budgetary rule for all" policy implemented so far); and vi) more focused trade and industrial policies to help European industries face Asiatic competition. These are just few proposals. There are many other options available to change the course of the "euro ship".

To conclude, there are many issues not covered in this note and some of our propositions, in absence of a more detailed analysis, may sound exotic. The hope is that at least the main message, summarized in the title of this note, is clear. Of course, we are not the first nor probably will be the last to send a "mayday". The final question is: will someone listen?

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[11] Of course, the argument applies to all the other surplus countries, such as the Netherlands.

[12] These policies should be coordinated and eventually defined at European level to avoid moral hazards of national governments in presence of a lender of last resort.

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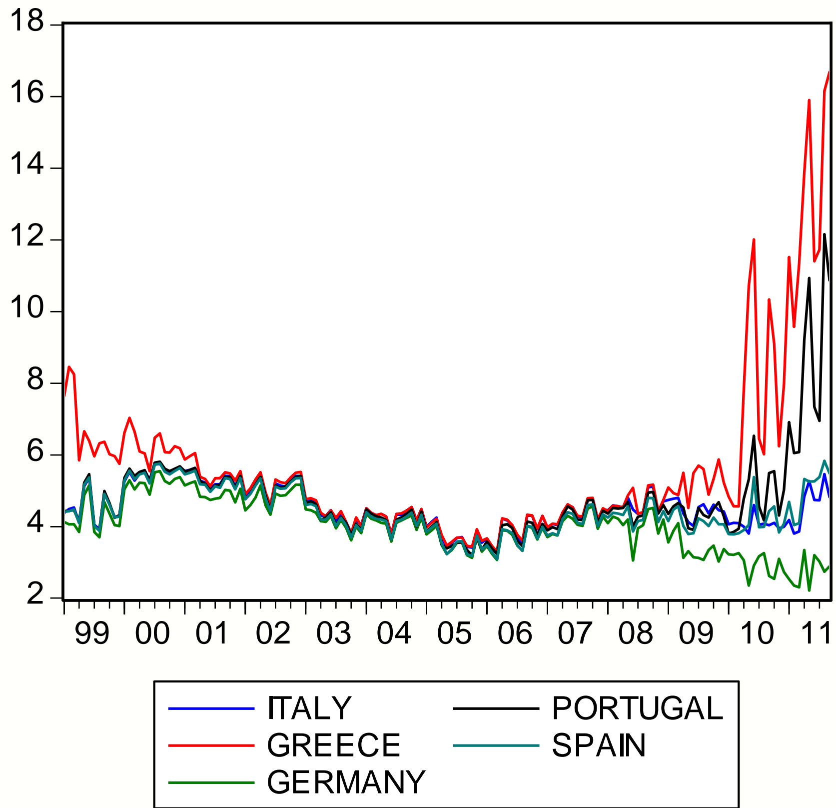
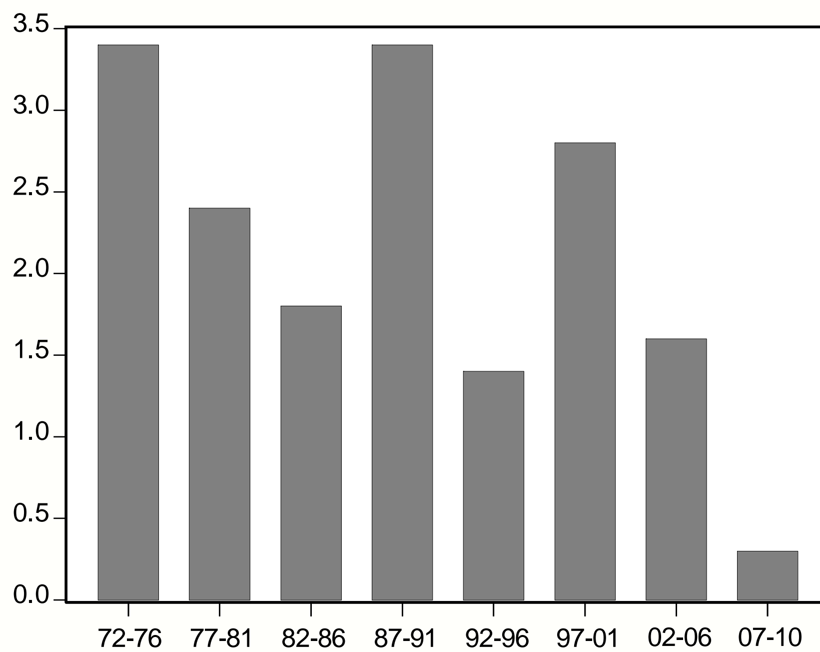
Fig. 1 − Nominal interest rates on 10-year government bonds



Source: European Central Bank

Fig. 2 − Real GDP growth in the euro area (EMU11, founding members)



Source: Barrell et al. (2008, p. 5) and authors' calculations from Eurostat data

Tab. 1 – Government finances (period averages)

	Sovereign debt (% of GDP)				g – r *	Primary budget surplus (% of GDP)		
	1999-2010	1999-2008	2009-2010	1999-2010 difference	1999-2010	1999-2010	1999-2008	2009-2010
Germany	66.5	64.1	78.8	21.9	-2.6	0.6	0.9	-1.2
Greece	108.3	102.5	137.1	50.9	-0.1	-2.0	-0.7	-7.8
Italy	108.0	106.3	117.0	5.4	-2.0	2.1	2.3	-0.5
Portugal	63.3	58.3	88.2	43.7	-1.2	-1.9	-0.9	-7.1
Spain	49.9	48.4	57.4	-1.4	1.1	0.4	2.1	-8.4

Source: Authors' calculations from Eurostat data. * Difference between average real GDP growth rate (g) and average real interest rate (r). This difference is calculated as nominal interest rate minus nominal GDP growth rate. The nominal interest rate in year t is calculated as interest payments in year t over nominal stock of sovereign debt in year t−1.

Tab. 2 – External debt positions (2010)

	Net external debt position (% of GDP)	Net external liabilities (% of GDP)
Germany	-22.7	-42.0
Greece	102.4	98.2
Italy	34.9	17.1
Portugal	85.3	107.9
Spain	82.9	87.1

Source: Cabral (2011)

Tab. 3 – Macroeconomic indicators (period averages)

	Inflation rate (HICP)			Real GDP growth rate			Current account deficit (% of GDP)		
	1999-2010	1999-2008	2009-2010	1999-2010	1999-2008	2009-2010	1999-2010	1999-2008	2009-2010
Germany	1.5	1.7	0.7	1.2	1.6	-0.7	3.5	3.1	5.7
Greece	3.3	3.3	3.0	2.4	3.5	-3.4	-8.9	-8.6	-10.6
Italy	2.2	2.4	1.2	0.8	1.3	-1.8	-1.0	-0.7	-2.7
Portugal	2.5	2.9	0.3	1.2	1.6	-0.8	-9.8	-9.6	-10.5
Spain	2.8	3.2	0.9	2.6	3.5	-1.9	-5.7	-5.9	-4.9

Source: Authors' calculations from Eurostat data.