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Austerity versus Stimulating the Growth in EU

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Abstract *Financial crisis led to a sovereign debt crisis due to high deficits accumulated before the crisis and also due to large bail out programs for commercial banks. Besides the reform of EU economic governance, austerity policies were imposed at national level under Troika control, especially for the most affected peripheral countries, like Greece, Ireland and Portugal. A large number of Member States (23) entered into the excessive deficit procedure established under European Semester, adopting austerity and structural economic reforms programs. Fiscal consolidation had a very negative social and economic impact, affecting the demand and economic growth. EU and national governance must be quickly improved in many aspects in order to stimulate economic growth and increase the living standard in all Member States.*

Key words:
Austerity, deficit, debt, growth, crisis, fiscal consolidation, reform.

JEL Codes:
D92, F43

1. The context of austerity policies

After the financial crisis spread from USA to EU and turned into an economic crisis one may see the great mistakes of EU economic governance, national governance, especially in the Southern Europe, and corporate governance. Enormous speculative bubbles in the housing sector and in the finance sector both in USA and EU were caused by inflation targeting policy (cheap money), bankers greed and their risky activities (derivatives), financial deregulation and weak public supervision, but they were supported by the implementation of demand side policies, through accelerated expansion of credit, and also by liberalization policies under the strong influence of ultraliberal (monetarist) school of economics. The governments from developed countries (USA and EU) were forced to launch a large bail-out program for commercial banks and to offer a generous support to car industry and these measures led to an explosion of budget deficits and public debts in USA and Euro countries. Thus the financial crisis has transformed into a sovereign debts crisis within Eurozone revealing also the vulnerability of some states to external shocks due mainly to the lack of their own monetary policies, to internal fiscal and financial imbalances, to delays in deploying structural reforms both in public and private sectors, to low economic competitiveness on internal market and also on international markets.

The so-called EU economic governance, the supervision and coordination of macroeconomic policies at the supranational level, enforced under the Stability and Growth Pact (SGP), signed in Amsterdam in 1997, was not able to prevent or correct the great mistakes made at national level: tolerance of corruption, funds waste and high tax evasion, the persistence of weak policy making and poor governance, wrong policy decisions at corporate level, lack of vision in the field of industrial base and product market rigidities, weak attention given to private deficits and debts and to economic competitiveness. The response of EU level to sovereign debt crisis was based on two main approaches: one relying on European Semester, pacts, treaties, law packages, mechanisms concluded /adopted at European level with the aim to impose the market discipline on national fiscal policies, to increase the engagement of national fiscal policies to fiscal rules, to establish a strong commitment of Member States to reduce excessive macroeconomic imbalances, to create a new and permanent mechanism to address the financial crisis (European Stability Mechanism), to strengthen the surveillance of economic policies of Member States; the other one based on imposing harsh austerity measures at national level under the guidance, supervision and financial assistance of so-called Troika-European Commission, European Central Bank and International Monetary Fund. It was Angela Merkel, Germany's leader, backed by the former French president, Nicholas Sarkozy, who imposed the austerity policy at EU level with the help of European Commission and European Central Bank.

2. Austerity policies in Eurozone

One may debate on the systemic character of the crisis and on the fragility of Eurozone due to its economic heterogeneity, the banking sector situation and the threats of debt contagion as a result of pushing up the cost of investment or "spreads" on government bonds by the financial markets. The most affected by the Eurozone crisis were the so-called PIIGS countries-Portugal, Ireland, Italy, Greece and Spain-where deficits and debts (public and private) were very high, economic productivity and competitiveness were noticeably lower and where the banking sector was most exposed to housing sector bubble. It has been created a vicious circle of shocks transmitted from the governments to the banking sector and from the banks to the governments. Basically the crisis has started in Greece and has evolved rapidly in the other above mentioned countries and since spring 2010 three countries-Greece, Ireland and Portugal- have been driven into unprecedented EU-IMF programs of measures to provide aid in return for cutting high levels of public debt, to put their finances into a balance situation and to set their economies back on the path to growth. But the austerity policy is an EU-wide problem, because 23 out of 27 EU countries – including Germany– entered into the excessive deficit procedure established under European Semester, being forced to agree upon the austerity and structural economic reforms programs in order to cut the levels of deficits and debts in line with the targets set in the Stability and Growth Pact. Austerity was seen as an instrument for attaining two major objectives: a) to preserve a sound basis for maintaining the common currency, Euro, and also Economic and Monetary Union by counteracting financial contagion and moral hazard, providing financial stability and regaining market confidence; b) to foster economic reforms within EU with the aim to resume a sustainable economic growth and enhance the competitive potential of European economies in a globalised economy.

2.1. Austerity policy in Greece

When financial and economic crisis burst, Greece was a very heavy indebted country facing high budget deficits and was forced to ask Eurozone and IMF partners for an emergency loan (a bail-out program), receiving 110 billion Euro in May 2000. This loan and the subsequent ones came under strict conditionality on implementing economic reforms, especially a tight fiscal consolidation. Implementation of these reforms was much delayed and led to deep recession and created a vicious circle of austerity induced recession and recession induced fiscal derailment (Vassilis Monastiriotis, 2013). I do not think we can blame the European level for its delayed and somehow unconvinced reaction to Greece hopeless situation. Greece used false statistics for entering Eurozone in 2001 and maybe for presenting its economic evolution while the efficiency of its national governance was quite low, but there were also external factors like financial markets and institutions, among them the famous Goldman Sachs, that have contributed in full to the failures of domestic policies.

In the period 2010-2012 Greece implemented a fiscal adjustment of 20% of GDP (50 billion Euro), reduced the fiscal deficit by 9 p.p., but with a price of a GDP contraction by 20%. Austerity measures referred more to the increase of indirect taxation-VAT and excise duties (and less to direct taxation) and to taxes on properties, reduction of salaries, bonuses, social benefits, cutting of public employment, reform of labour market and pension system, structural reforms in the field of education and health, but poor results were obtained in the field of privatization, downsizing of public sector, control of tax evasion and money leakage abroad, mainly in fiscal heavens. On one hand the austerity measures and economic recession provoked a huge public discontent and a prolonged political instability while the delay in implementing fiscal consolidation and structural reforms have fuelled the uncertainties/rumors related to the possible exist of Greece from Eurozone. On the other hand Troika expectations and projections referring to Greece situation were repeatedly wrong and they influenced the markets position on Greece, on several occasions they expected an imminent default and Greece exist from Eurozone. Under these difficult circumstances there were made two substantial cuts on Greek sovereign debt, the first one amounting to 100 billion Euro in February 2012 on behalf of private creditors and the second one amounting to 40 billion Euro in December 2012 on behalf of institutional creditors.

Greece is maybe the best example for three main lessons of austerity policy. Firstly, how the decrease of demand as a result of austerity measures affects the economic growth, which on its turn badly affects budget revenues. Secondly, although fiscal consolidation through tax hikes and spending cuts is highly recessionary, any form of fiscal expansion for supporting the economic growth was almost impossible due to high imports, huge black economy and very high tax evasion. Thirdly, the management of the crisis revealed five failures of the Greek political system (Vassilis Monastiriotis, 2013) in the field of *communication*, how the public was inform on the critical situation and on the need of austerity, in the field of *coordination,* among and within the political parties, in the field of *negotiation* with foreign partners on more feasible and growth oriented programs, in the field of *implementation*, where there were many delays and an obvious lack of will, in the field of *strategy,* where an investment strategy, inspired by Marshall Plan, was proposed by the European Commission in July 2011 and where Greece did very few things.

Besides the important developments within Eurozone, like banking union and fiscal union, and financial support offered to more vulnerable countries, one needs consistent and credible efforts for fiscal consolidation at the national level, for implementing growth strategies and industrial policies, for modernizing and restructuring the economic base.

2.2. Austerity policy in Ireland

Ireland was after Maastricht the most successful story from cohesion countries but was heavily affected by financial crisis and speculative housing bubble. Irish sovereign debt crisis was caused by the wrong government decision taken in September 2008 to guarantee all the private liabilities of its major six banks which led to an increase of public debt from 40% of GDP to 100% of GDP. Due to the house-price inflation and to narrowing of tax base(50% of employees being exempted from income tax) the budget revenues fell during the crisis (2008 and 2009) by 18 billion Euro (20% of GNP) while budget expenditures increased by 9 billion Euro (10% of GNP). The loan program agreed with Troika in December 2010 imposed severe constraints on budget policy as all fiscal decisions were taken with its acceptance, fiscal performance was subject to its quarterly reviews and its representatives were included in the government departments. Ireland was able to attain the fiscal targets with low costs in social and political terms, but the fiscal consolidation produced an obviously economic and employment contraction, the last one being mitigated by the relatively high emigration. GDP decreased in real terms by 11.8% between 2008 and 2011 and it was forecasted another GDP reduction of 5% between 2012 and 2015.

The fiscal consolidation was based on expenditure cuts for two-thirds and tax increases for one-third, which reflects an orthodox liberal view about the appropriate fiscal adjustment policy mix (Sebastian Dellepiane and Niamh Hardman, 2012). The main actors-political parties, employers associations, trade unions- reached to some compromises on fiscal adjustment, the corporate tax rate was maintained at 12.5%, social insurance contributions for employers were not increased, no changes were made in marginal income tax rates, instead there were some significant increases in indirect taxation, like VAT, and in property taxes, also there were made cuts in pay and services, including social welfare payments where some tax breaks assigned for buying social services like education, health, pensions were removed or reduced. The unemployment rate increased from 6.4% in 2008 to 15% in 2012.

Ireland is a good example of peripheral country able to reduce its fiscal deficit and unit labour costs in order to regain markets confidence and to further borrow the needed funds. But investment was stagnant in the last years because demand was lacking and funding of new private investments proved to be very difficult due to the banks reduced lending capacity and due to the high level of household debts. We may see a close link between banks and sovereign debts which was not broken and is closer than ever (Niamh Hardiman, Aidan Regan, 2013). The bank rescue burden must be taken over from Irish government to the European Stability Mechanism in charge with bank recapitalisation process. Ireland needs the acceptance of European Central Bank for restructuring of its debt. Due to bad policy decisions taken in the early stages of crisis and to heavy burden put on the employers and employees the confidence in internal political institutions and also in European institutions is quite low now and it is required a radical change in economic policy orientation at both levels.

2.3. Austerity policy in Portugal

Portugal has encountered financial difficulties, mainly due to the current account deficit and foreign debt. Between 1995 and 2010 Portugal financial position deteriorated to a large extent, international investment position reaching -108% of GDP and its net external debt 85% of GDP due to large and persistent current account deficits. Before adopting the Euro the devaluation of national currency (escudo) led to the fall of the income and interest on Portuguese financial assets held by non-residents relative to the income and interest on foreign financial assets held by residents (Ricardo Cabral, 2013), which had been reflected by a good position of income account, a reasonable net external debt and favorable remittances from emigrants. All these positive effects disappeared once the Euro was introduced, because automatic stabilizers were removed and current account deficits accumulated leading to an increased external debt and affecting income balance.

Under Troika bail out program Portugal has to pass from a primary deficit (deficit derived after deducting the interest payments component from the total deficit of the budget) of -7.2% in 2009-2010 to a primary surplus of + 3.2% of GDP in 2016 and to improve the trade balance deficit from -8.5% in 2010 to +5.1% by 2017, the last goal being totally unrealistic having in mind the previous situation, the level of economic competitiveness and the great difficulties of importing partners (Ricardo Cabral, 2013).

Portugal received 78 billion Euro under the Memoranda of Understanding concluded with Troika in May 2011 based on very strict conditions concerning target actions (222) and austerity measures. Portuguese state should provide funds for bank capitalisation and guarantees on bank issued debt, amounting to 27.2% of GDP. From the total loan an amount of 12 billion Euro was allocated to a new bank recapitalisation program. The requirements set for banks capital have discouraged the credit activity, especially in the production field.

Austerity measures meant the increase of VAT rate, property taxes, personal income taxes, fees for public services, reduction of income tax deductions, freeze of public sector employment, cuts of nominal wages and employment in public sector, cuts of pensions and social expenditures. Public deficit and debt remained at high levels, domestic demand decreased by 12.2% in real terms between 2010 and 2012, unemployment rate reached 15.8% in the third quarter of 2012.

Ricardo Cabral(2013) questions the competence and efficiency of elite bureaucrats from European institutions, how the policies are prepared and decisions are made, how the human and financial resources are used, how the governance is badly affected by the lack of proper checks and balances, how the monetary policy of ECB is designed and implemented, how the EMU fiscal policy strategy based on Stability and Growth Pact focused on short term and limited objectives, how the EU governing institutions become a kind of modern tyrants within the EU. The implementation of Troika adjustment program in Portugal did not produce good results and damaged the country's output, competitiveness and development perspectives. It is clear that after several years of austerity the peripheral countries of EU have economically regressed and lost two decades of gains, so one needs a quick and major policy change on behalf of EU institutions.

3. Stimulating the growth

Paul Krugman (2012) considers the high unemployment as the main difficult matter to be addressed to and to be resolved in US and other countries, because the rate of unemployment is very high everywhere and the social impact of the crisis is very hard. For Krugman there is a true and huge human disaster and also the need to solve the economic difficulties on short term and to resume a robust economic growth. Consumer demand is seen as the engine of economic growth and its contraction, due to high private debts, loss of revenues and jobs, led to economic depression. Krugman had repeatedly blamed the austerity measures and revealed the strong vulnerabilities of less competitive countries from Eurozone and recommended a higher inflation rate and stimulating economic growth by increasing public expenditures and investments. On short term any quick economic recovery requires strong incentives and efforts on behalf of the government due the reluctance of private sector to invest or to increase the output in the context of reduced consumer demand. Paul Krugman is an opponent of supply side policies, like those suggested by Raghuram Rajan, from Chicago University and also by other supply-siders, like Robert Mundell and Robert Lucas jr. But an increase of government spending or fiscal expansion cannot be achieved otherwise than through tax increases and/or large domestic and external loans, which may affect the public deficit and debt and may create additional financial burdens for the countries that are already passing through terrible financial difficulties.

For **Joseph Stiglitz** (2012) there is an obvious requirement: restoring a sustainable and equitable growth by establishing some important objectives based on public investments. The main problem confronting USA and EU economies is the lack of demand and until the total demand will be sufficient to fully utilize the resources it would also count the supply side. Stiglitz would like a selective reduction of profit tax, but only for companies that invest and create jobs. State investments in infrastructure, education, technology, built the foundation of modern economic growth and this will be also true in the future, leading to economic expansion and the attracting private investments. He wants the steering of investment and innovation efforts for jobs and natural environment protection by promoting a rational consumption of resources, by penalizing pollution, by using the tax credit to encourage investments and the creation of new jobs. In Stiglitz opinion imposing a qualitative growth means also social equity (a fair income distribution), protection of the environment and resources, and a certain correction of the market forces.

4. Conclusions

Nowadays austerity policy is under a heavy fire due to its poor results. Jean-Claude Juncker believes "*that budgetary consolidation on its own cannot be the right response to the recession we're going through. We have to organize a virtuous circle between public finance and growth in Europe, and I'd like to target particularly the countries that are currently weakened.*" Jean-Claude Trichet points to lost confidence/trust of households, businesses, savers, consumers so much needed for creating growth and jobs, and also for adopting "*strategies and policies that will stay on track* *in the medium-to-long term"* and for changing "*an economy that continues to spend more than it earns."* Hannes Swoboda criticized the "*extreme austerity*" which badly affects people and leads to higher deficits and higher taxes. Peter Praet, the Belgian chief economist of the ECB, argued that "*the fiscal compact needed to put spending questions beyond politics, there are weaknesses due to ineffective public governance and market failures and the reforms have to be pushed faster than what was planned".* Sandro Gozi, Italian MP, Democratic Party demanded a new sense of vision for Europe and thinks that "*it is a crisis of democracy in Europe – because we have built up monetary union without a sufficient political dimension".* Martin Schulz, president of European Parliament thinks that "*the reduction of public expenses did not regain the investors trust and no national economy could recover without an economic revival through strategic investments"*. French minister Benoit Hamon has recently said "*the time has come to complete the austerity policy in Europe*", adding that "*only Angela Merkel, supported by Northern States, believes that austerity works, when it is clear that the unemployment rate will not drop".* On 22 April Jose Manuel Barroso, president of EC commented that "*while I think austerity is fundamentally right, I think it has reached its limits"* while European Council President Herman Van Rompuy conceded the economic crisis is "*lasting too long"* and we need "*to move faster on the reforms with the biggest immediate growth impact".*

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