

Austerity and growth: Dispelling confusion with some facts¹

Author: Roberto Tamborini, October 24th, 2013

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A lot of confusion surrounds the quarrel about austerity and growth in and among the Euro-countries. Confusion helps neither the assessment of the current policies nor the choice of the correct ones. Critics of austerity argue that it is mainly responsible for the extent and persistence of low or negative growth rates *after the Great Recession of 2008-09*. The orthodox pro-austerity pedagogy revolves around the following arguments: 1) poor growth of Euro-countries is a long-lived structural problem and it is not due to recent austerity measures; 2) stronger fiscal stimuli are either useless or harmful; 3) austerity is not enemy of growth, rather it is a means to foster sustainable growth; 4) austerity may depress growth (in the short run) if it is badly implemented, i.e. too little, too late, too much taxation rather than expenditure cuts, and no structural reforms².

The first confusion is between long-run and short-run analysis. Let us accept that the growth performance of major Euro-countries (Germany included) has been rather poor relative to the rest of the world for more than a decade, which cannot be due to recent austerity but to other structural factors. Agreement on this point still begs the following questions: *given the Great Recession shock*, has austerity been the best possible response? Has austerity amplified or absorbed the shock? How far are the Euro-countries from growth recovery?

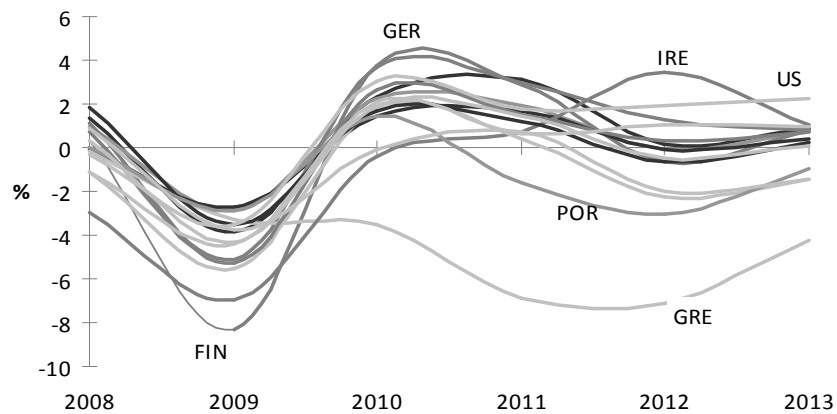
In order to address these questions, a second confusion should be dispelled concerning the nature of the Great Recession. To be consistent with the orthodox pro-austerity narrative, one should show that the Great Recession is just a large episode *along the long-run trend* of decline of potential growth of the Euro-countries, that actual GDP has closely followed available estimates of potential GDP, and that austerity is a means to restore potential capacity (at least). To the best of my knowledge, austerity advocates have never produced robust evidence in support of this view. One main reason being that such evidence does not exist. Available data tell a different story of a big Transatlantic shock emanating from the private financial sector and investing the engines of the real economy both on the supply and the demand side. Questionable as they may be, official estimates (e.g. Eurostat and OECD) indicate that since 2007 1) potential growth has been revised downwards, and 2) almost all countries have been operating with demand below capacity.

The crisis has indeed prompted a new wave of "structural" studies, both theoretical and empirical, revolving around the "macroeconomics and finance" nexus (e.g. Borio 2102, Hall, 2010). One important thread running through this buoyant literature is that there are different types of crises, and that the crises which originate in the (private) financial sector have special, thorny, characteristics that we still fail to understand fully. The main focus of these models is on the fact that financial shocks may disrupt growth potential as well as determine wide swings of GDP from its potential track. When this happens, the private sector's expenditure falls to an inefficiently low level, but not because the public sector's expenditure is too high. This phenomenon has also been popularized by Koo (2011) with his now famous notion of deleveraging or "balance-sheet crises". Contrary to the traditional neoclassical "loanable-funds" motivation for austerity, in a deleveraging process the non-financial private sector is not constrained in its ability to borrow but it is (it wants to be) a net saver in the first place. Things are even worse when the financial sector is deleveraging as well, because the consolidation of

private balance-sheets is not translated into new supply of loans either. Under these conditions, forcing the government into deleveraging to foster "crowding in" is pointless; the result is just additional excess saving. Flow-of-funds data provide abundant evidence (Koo, 2011; ECB, 2011). That is why, in a crisis of this type, fiscal multipliers turn out to be "surprisingly" larger with respect to those observed under ordinary fluctuations. Hence, none of these studies supports simple austerity recipes aimed to restrict the public sector's share of GDP in the hope that the private sector's one will be enlarged.

As preliminary evidence, the post-shock GDP growth rates for Euro-countries, UK and US (see figure 1), have largely followed a common "double dip" pattern with high cross-correlation (only Ireland and Greece seem on a track of their own). There are also some quantitative differences across countries highlighted on the graph. Hence, data suggest the presence of common Transatlantic driving factors together with country-specific factors.

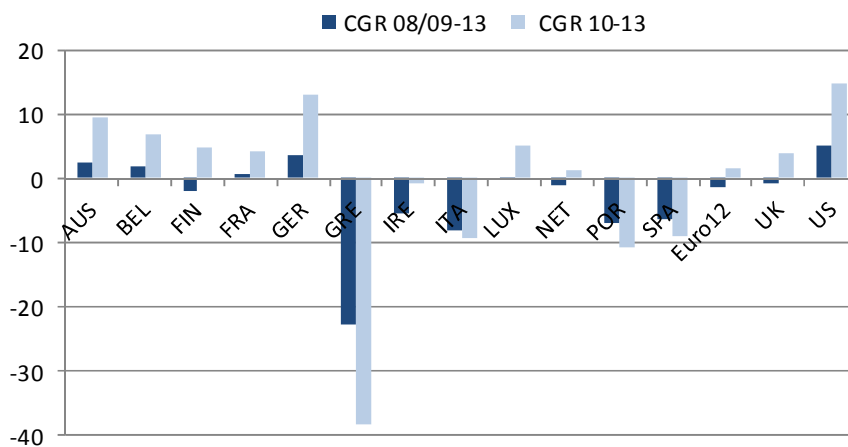
Figure 1. Year growth rates, 2008-13



Source: Eurostat, online database AMECO

The data indicate that after the second dip, growth rates are improving. Is this the true start of catching up with the pre-crisis ordinary state of affairs? "For Europe, recovery is within sight" President Barroso said in his State of the Union Address (September 11, 2013). As a matter of fact, in 2013 four Euro-countries are still dwelling in negative territory or almost zero growth (Greece, Italy, Portugal, Spain). The others are on the track of very weak growth (Germany included) with respect to, say, the US. A better gauge of the overall recovery process is provided by the compound growth rate (CGR) from the first year of recession (2008 or 2009) to 2013: if negative, it indicates a net output loss, if positive a net output gain.

Figure 2. Compound growth rates 2008/09-2013

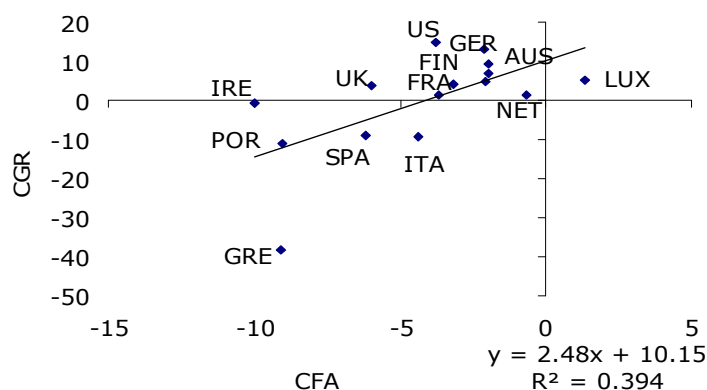


Source: Personal elaborations on Eurostat, online database AMECO

The Euro12 group as a whole is still lagging behind the pre-crisis GDP level by 1.4%. In fact, only three countries have gained a (small) additional output in five years (Austria, Belgium, Germany), and only three have barely caught up with their initial level (France and Luxembourg). The others, at foreseeable growth paces, will take *years* just to regain the pre-crisis level of GDP. All in all, there is not much ground for optimism or for declaring the end of the Recession war in Europe. How are fiscal policies related to *these* facts?

In the first place we need some measure of austerity. The ratio of the cyclically adjusted primary budget over GDP has become common use. This (net of thorny technical problems) may be a good measure of the government *intended fiscal stance*. However, a better measure of the actual impact of fiscal variables on the economy is the year change of the primary deficit over the current GDP³. Hence I measure fiscal austerity in year t as $FA_t = (F_t - F_{t-1})/Y_t < 0$, where F is the primary deficit and Y is GDP, both in current euros⁴. In a medium-term perspective after the 2009 shock, Figure 3 provides the correlation graph of the cumulated FA s (CFA s) with the CGR s of the Euro-countries. United States and United Kingdom have been added for comparison. There are a few interesting facts to consider.

Figure 3. Cumulated austerity and compound growth rates 2010-13



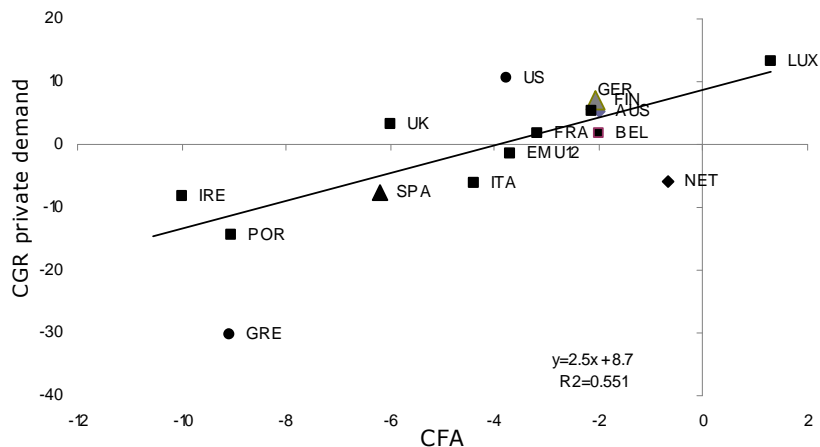
Source: Personal elaborations on Eurostat, online database AMECO

First, as of 2013 all countries (except Luxembourg) have built up a negative CFA as a result of a sequence of austerity doses. The five most financially distressed countries (Euro5: Greece, Ireland, Italy, Portugal, Spain) stand out for the strongest treatment, ranging from 4.4% of Italy to about 10% of Ireland, Portugal and Greece (the three under Troika treatment). Second, statistically there exists a significant *positive* relationship between the two variables. Hence the countries with the largest net output losses (the Euro5 countries) are also those with more cumulated austerity. Contrary to the orthodox narrative, these differences in fiscal policies matter: they account for about 40% of the cross-country variance in growth performances. The interpolation line indicates that the critical dosage of CFA that has triggered net output losses has been 4%, with 1% of additional CFA associated with 2.5% net output loss. This figure may provide a first quantitative hint for the notion of *excess austerity* (e.g. De Grauwe and Ji, 2013). It may be argued that severe austerity was a necessity for countries under sovereign debt attack; however, this does not justify the imposition of austerity as a global uncoordinated policy.

As recalled above, the pillar of growth-friendly austerity policies is "crowding in", that is, the substitution of more private expenditure (especially durable and capital goods) for less public expenditure. A simple and direct test, though seldom pursued, is provided by data on the GDP components. Following the same medium-term approach as above, figure 4 shows the compound growth rate of total private domestic expenditure *vis-à-vis* CFA s. The "crowding in" area (the north-west quadrant) contains 7 of the 15 cases, 4 of which display a "crowding in" effect (the ratio with CFA) smaller than 1. These are also countries with relatively low net fiscal restrictions (except perhaps the UK). The other 8 cases fall in the Keynesian area of "general crowding out" (south-west). Overall, a *positive* correlation prevails across all countries. Along the interpolation line, the CFA beyond which "crowding in" has vanished is about 4%. Notably, this is the same value that in figure 2 marks the point where CFA s have triggered net output losses. Then, on average, 1% of additional public sector's restriction has been associated with

2.5% of net loss of private expenditure. Again, differences in *CFAs* account for 55% of the observed differences in the compound growth of private expenditure⁵.

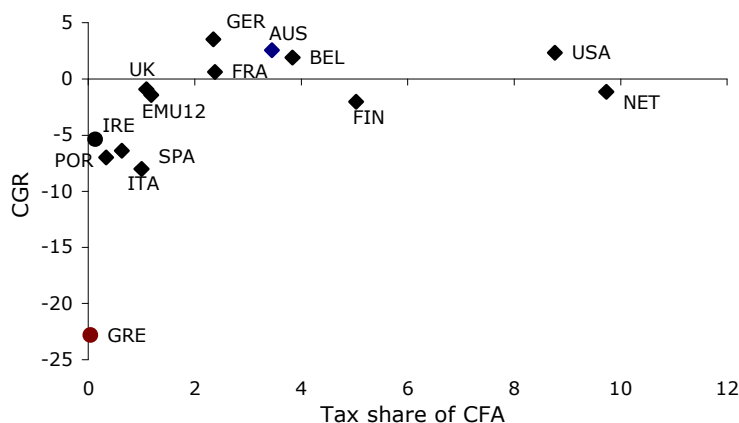
Figure 4. Correlation between *CFA* indicators and the compound growth rates of private expenditure, 2010-13



Source: Personal elaborations on Eurostat, online database AMECO

As recalled above, in the pro-austerity literature "composition matters". Accordingly, the recessionary effects of austerity are attributed to a composition unbalanced towards higher taxation instead of lower expenditure. However, inspection of the relevant data on the composition of *CFAs* does not lend support to this view. See figure 5. A virtuous austerity policy wants a tax share of *CFA* smaller than 1 (or negative); a tax share larger than 1 indicates that the *CFA* has been obtained by *increasing taxation more than expenditure*. Contrary to widespread beliefs, the countries with more virtuous composition of *CFAs* are those in the Euro5 group (for Ireland, Portugal and Greece this may actually be the effect of the Troika therapy). Nonetheless they are suffering the worst net output losses. All the other better performing countries have let expenditure grow and have increased taxation more than proportionally.

Figure 5. Correlation between the tax share of *CFAs* and compound growth rates



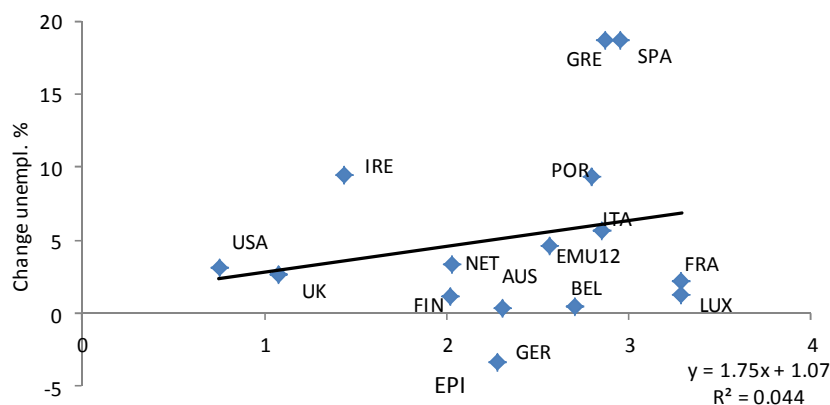
Source: Personal elaborations on Eurostat, online database AMECO

Finally, the other standard disclaimer in the pro-austerity narrative is that undesirable effects on unemployment may arise owing to labour market rigidity; if large losses of employment are observed, these are more the result of rigidities than of austerity *per se*. cursory inspection of standard labour market statistics does not lend much support to these argument in two respects. The first is that there is not much evidence that labour markets have remained rigid in

the face of falling output and rising unemployment. Wage deflation has been substantial in the most austere countries. The second is that differences in rigidity across countries amount to a thin explanation of differences in unemployment performances. Rigidity is a difficult concept to render operational. It combines institutional factors with other factors that condition the functioning of the labour market in specific economic circumstances. From the former point of view, OECD offers a well-known set of indicators, the Employment Protection Indicators (EPI)⁶, which are widely used by labour researchers for comparative analyses. A high value of the indicator provides a measure of rigidity in terms of legislations and regulations that may hamper wage changes and/or workers mobility across jobs and sectors.

To gauge how this dimension of labour market rigidity may relate to differences in unemployment performance across countries during the crisis, I have elaborated a synthetic index for each country based on two EPI: "Strictness of employment protection; Individual and collective dismissal (regular contracts)" (version 3), and "Temporary employment" (version 3).⁷ My index is the average of the average value of the two EPI from 2008 to 2013 (actually, EPI have remained constant or have changed very little in this period of time). The relationship between this rigidity index and the change of unemployment is shown in figure 6.

Figure 6. Labour market rigidity index and change of unemployment rate 2007-13



Source: elaborations on OECD Employment Protection Indicators

If *some* countries with higher index display a greater increase in unemployment than do *some* countries with lower index, this pattern is far from providing an exhaustive explanation of the differences in unemployment performance. True, the more flexible economies of US and UK have obtained relatively smaller increases in unemployment, but the majority of the Euro-economies, with much higher indices, have done no worse, or even better. The amazing performance of Germany is not associated with a lower than average EPI. The much worse unemployment performance of the Euro5 countries seems unrelated to significant differences in rigidity with respect to the other Euro-partners.

To conclude, there is persistent confusion around the crucial issue of austerity and growth standing in the way of policymaking in the Monetary Union. Critics and defenders of austerity have in mind different problems and different perspectives. Critics may have too a short-term perspective, but the orthodox pro-austerity arguments fail to address, and are inconsistent with, the available evidence about austerity and growth in the Euro-countries five years after the Great Recession. How long is the long run?

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¹ The complete working paper "Transatlantic austerity, 2010-..." can be downloaded from my homepage (<http://www-ceel.economia.unitn.it/corsomittone/tamborini/wp.php>).

² For a detailed and well articulated rendition of the arguments by institutional economists see e.g. Buti and Carnot (2013), Buti and Pench (2012), Buti and Padoan (2012).

³ In fact, the cyclical components of the budget do affect the budgets of their recipients in the private economy.

⁴ Note that *FA* is likely to *underestimate* the intended fiscal stance of government because low growth or recession tend to create larger primary deficits.

⁵ The sole support to GDP growth for all countries has come from exports. Yet this, rather than being evidence of "crowding in", indicates a typical Alexander's "absorption" mechanism whereby the enlargement of the export component is obtained by way of compression of the domestic components

⁶ <http://www.oecd.org/employment/emp/oecdindicatorsofemploymentprotection.htm>

⁷ Considering both segments of the labour market is important since temporary jobs are becoming increasingly common and typically less regulated than open-ended contracts. Both versions 3 encompass a larger number of indicators, and are available from 2008 to 2013.