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From austerity and beyond

Position Paper by

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Introduction

The European project started as a purely economic endeavor but with a vision of growing into something much bigger such as a federation of all States. Recent events, however, have shaken this idea to the point that it now seems nearly impossible to implement. The financial crisis has revealed the vulnerability of inadequate and ill-designed integration and has put the continent at a crossroads paving the way for opportunistic political projects. The response of the EU has been to stifle spending and discipline the Member states mainly focusing on the profligate peripheral countries. It is increasingly questionable whether austerity policies provided a viable solution to the crisis as the consequences have been more unemployment, less welfare state and higher political instability caused by reactionary political projects.

This paper traces back the reasons for the current economic crisis in the first part and goes through the aftermath of the austerity regime in the EU in the second. The last part proposes several solutions to the current situation that challenge the structural reforms and the pro-cyclical economic decisions.

1. How did we get here

The story of austerity became salient only after the financial crisis hit the Eurozone and revealed the weaknesses of the European Monetary Union. Today the continent is still firmly in the grip of no-profligacy policies that are causing increasing social tensions and deepening inequalities that ultimately fuel far-right and populist movements. But why did the system show no visible signs of instability and why is it that the EU is still in recession while the US economy has already managed to surface and grow? Does the structural design of the euro area need adjustment and what kind?

These questions have dominated the economic and political debate of the continent for the past decade but the response to the crisis has failed to prove that it can propel the EU back to the pre-2008 growth wave. The crisis has exposed the discrepancies between the core and the periphery with the former blaming the latter for being too fiscally profligate and spending on “drinks and women”[1] thus obscuring the real cause for the economic shock. The narrative imposed by the creditor countries has failed to address the underlying reasons for the implosion of the Eurozone but it is nevertheless still the prevailing one.

When the Maastricht convergence criteria were drafted, it was at a time of general EU support and expectations for a quick transition into a political and fiscal union. This criteria, however, laid the foundations for the divergent patterns between the core and the periphery as they limited the scope for macroeconomic policy and promoted the idea that fiscal discipline was enough to boost growth. In 1998, Greece, Italy, Spain, Portugal and

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[1] http://www.telegraph.co.uk/news/2017/03/21/anger-head-eurozone-finance-ministers-says-southern-europe-blew/

Ireland all fulfilled the criteria, with just the first two having higher debt but moving towards the 60% threshold. Two economists, Stephanie Schmitt-Grohe and Martin Uribe, argue that the they were initially weakened by the prerequisites for the adoption of the euro- the sharp decrease in the interest rate led to an increase in demand and inflation and influenced a large financial flow to the countries with higher growth and hence a faster return on investment, which happened to be the periphery.[2] The core mature economies, on the other hand, were having big surpluses due to self-imposed austerity policies and were advocating for an export-led growth. Thus, the financial flows were going to the periphery and back to the core with the former accumulating vast foreign debt, very adeptly concealed by the overall positive growth level of the monetary union. It is very hard to imagine today that in 1999 Germany was considered the sick man of Europe[3] and Spain was the model to follow. What was happening was that while the core was compressing domestic demand and maintaining competitiveness by keeping inflation low, the periphery was borrowing heavily and having a negative current account balance. This divergent pattern, however, fuelled growth both in Germany and in Greece.

After the global financial crisis spilled over to Europe, the financial flows ceased and this hit the periphery the hardest due to its debt-induced vulnerability. Fiscal austerity became the new norm as the creditor countries told the debtors to limit the deficits and debts and turn to fiscal discipline by compressing demand and increasing competitiveness through export-led growth. After the adoption of the single currency countries could no longer rely on adjusting the exchange rate of their currencies to fight asymmetric shocks. The Maastricht criteria and the fiscal compact further limited states by imposing strict rules on discretionary policies and targeting monetary policy to an average, which due to the size of the German economy de facto coincided with rates appropriate to them. Since all that mattered was price stability, the mandate of the European Central Bank was also restricted to keeping inflation low unlike the US Federal Reserve, which also has a mandate to pursue full employment.

One possible way of dealing with the crisis could have been if the Eurozone was an optimal currency area as described by Robert Mundell in 1961. Alas, the single currency is far from being one. While the euro area does fulfil the trade integration criteria and has somewhat symmetry, there is almost no flexibility of the labour market and fiscal transfers between member states. The EU budget currently amounts to around 1% of the EU's GDP or 155 billion with roughly 80% of it returned to each country under the form of various allocated expenditures and only a small part actually redistributed among member states.[4] The closest mechanism to fiscal transfers are the Cohesion funds, which amount to around 40% of the total budget and aim at reducing disparities between regions mainly focusing on the periphery. Although well-intended, this policy has had little redistributive effect. A study conducted by Paolo Pasimeni and Stéphanie Riso shows that for every €1000 difference in levels of income per capita the EU budget offsets only €11, while in the US the equalizing

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[2] S. Schmitt-Grohé& M. Uribe (2013), "Downward Nominal Wage Rigidity and the Case for Temporary Inflation in the Eurozone", JOURNAL OF ECONOMIC PERSPECTIVES, VOL. 27, NO. 3, SUMMER 2013, (pp. 193-212).

[3] http://www.economist.com/node/209559

[4] http://voxeu.org/article/redistributive-function-eu-budget

effect of the federal budget is 40% or 35 times higher.[5] Paul Krugman has estimated that since 2007 Florida has received 5% of the USA's GDP in the form of welfare spending and tax reductions without a word of blame. The fact that 6 countries (France, the UK, Germany, the Netherlands, Italy and Spain) amount to 80% of the total EU GDP further illustrates the disparities within the union.

Neglecting macroeconomic policies as a possible way out, the Eurozone countries instead turned to austerity and structural reforms thus shifting the biggest burden on labour. The model pursued was Germany, which in 2003-2005 implemented harsh austerity reforms, which transformed it into the second largest exporter in the world. But while cutting wages and spending on public works, shrinking the public sector and turning to export to compensate for the compressed inner demand might be suitable for one country, it is greatly unsustainable for the entire EU as the world trade balance as a whole has to be zero. Austerity was also preferred because it required no adjustment from the core member states, who by being the creditors also had the upper hand in the negotiations. Although this pro-cyclical reaction to the crisis has led the Eurozone into a double dip recession, structural reforms still remain the course of action as evident from the recent European parliament report.[6] The result is that in 2015 in twelve euro area countries there has been an increase in wage inequality.[7] Even in Germany the bottom 90% had lower real income in 2008 than in 1992.

II. The downsides and consequences of austerity policies

Austerity policies did reduce the macroeconomic imbalances between the core and the periphery. However, the adjustment was mainly borne by countries of the periphery, which paid a heavy price to narrow the gap with core countries. As a result, the Eurozone now has a trade surplus whereas its trade balance was neutral prior to the crisis: in other terms, the core countries' model was implemented everywhere. But this unilateral adjustment has had heavy social consequences on European countries which had to undertake it, putting into question the legitimacy of these policies and of the EU as a body.

1. Economic consequences

Aside from the obvious short-term shrink in the economic output (reducing government spending mechanically reduces the economic activity), austerity policies also had a more long-term unintended effect. In some countries (such as Greece, but not only), the economic downturn was so disruptive (brutal reduction in public spending, high unemployment) that it triggered not only a reduction in current growth, but also a reduction in potential growth. From the perspective of industrial capital, lack of investment to maintain existing facilities and adapt them to future market trends reduced not only the competitiveness of the

[5] Ibid

[6] European Parliament resolution of 16 February 2017 on improving the functioning of the European Union building on the potential of the Lisbon Treaty (2014/2249(INI))

[7] http://www.europarl.europa.eu/RegData/etudes/BRIE/2015/565884/EPRS_BRI%282015%29565884_EN.pdf, p.5

countries but also their production capacities. The same applies for the "human capital": a too high unemployment rate jeopardizes the very possibility of economic recovery. When people are unemployed for too long, it becomes difficult for them to reenter the job market. Thus, the longer a situation of under-investment and high unemployment lasts, the costlier the economic recovery becomes: the same potential growth requires greater investments both in the productive capacities of a country and in the formation of its work force after a period of stagnation. Countries subjected to the austerity policies, especially in Southern Europe, are in this situation where the economic damage is extensive.

2. Social consequences

Austerity policies, because of the sharp, pro-cyclical adjustment they required, led to rising unemployment especially in periphery countries. Unemployment rates in Spain, Portugal, Italy and Greece are all higher than the Euro average, whichever subcategory of unemployment is considered. In February 2017[8], among the top six EU countries with the highest unemployment rate, four are Southern countries of the Eurozone, namely Greece (23,1%), Spain (18%), Italy (11,5%) and Portugal (10%). The same applies for the youth unemployment rate: 45,2% in Greece, 41,5% in Spain, 35,2% in Italy and 25,4% in Portugal. This comes with a handful of dire consequences: middle-aged people pushed out of the market experience a social downgrading while young people see their economic perspectives narrowing, if not disappearing. This economic slump led to a social disaster, which has political consequences.

3. Political consequences

The adjustment is not limited to the economic field: its social consequences fueled anti-EU ideas and anti-establishment parties. People excluded from the labor market sought someone to blame for their situation, while young people went looking for a future elsewhere. The EU came to be viewed as an institution enforcing a conservative agenda and always putting the economic interest of the market over the one of its citizens. Austerity policies have been economically and socially harmful, with heavy consequences in the political arena. In France, for example, there is only one presidential candidate who has a clear Europhile discourse: all the others want to "renegotiate" France's relationship with the EU, and sometimes, this "renegotiation" looks a lot like a Frexit. And France is not alone in that case: in nearly every country who had to implement austerity policies, anti-EU parties are on the rise. This raises many questions about the future of the EU as it currently stands.

In the French presidential election, for instance, two of the main contenders Marine Le Pen and Jean-Luc Mélenchon both find substantial support among the young population, which is unprecedented, especially for the National Front, which traditionally does not appeal much to youngsters. So why would they follow these parties instead of the traditional governing parties? Marine Le Pen and Jean-Luc Mélenchon both offer a different path for the future of France and they both take a very harsh stance against the EU and its austerity policies. After a decade of austerity, the discredited traditional parties are no longer seen as

[8] All these figures are from Eurostat: http://ec.europa.eu/eurostat/statistics-explained/index.php/Unemployment_statistics

capable of offering any tangible vision for a better life, which results in new-comers ranking high in the polls. Austerity policies, even though they were intended to be efficient from a macroeconomic perspective, have done heavy damage to the political capital of the EU in countries which had to implement them. The damage is so extensive that people are now looking for a possible solution for a better future and it is not necessarily one that includes the EU.

It is essential to understand why they don't want the EU any more to ask the right question: how can we make this right? How do we put the EU back in people's fantasies about their future?

III. What lies ahead: challenges and possible solutions

The EU is a project that has had its ups and downs but has nevertheless managed to resurface. In 2017, 60 years after the Rome treaty, the Union is yet again facing a time of change. The main challenge is structural transformation capable of giving people a viable vision for a common future. The following part offers several solutions to the aging political and economic system of Europe.

1. Building a more consistent monetary union

The second big challenge for policy makers is the state of the Eurozone. It has become clear that the Economic and Monetary Union has structural flaws which led to the macroeconomic imbalances at the root of the sovereign debt crisis and austerity policies. There is already a theoretical and even political backing in favor of a reform of the EMU: Emmanuel Macron, France's front-running presidential candidate, publicly supported this idea when he was minister of the Economy, and economists have been pointing for years the structural flaws of the EMU. There are two principals of an economic government: one in the form of a supranational body for the EMU to equilibrate and coordinate the economic policies, and a Eurozone Treasury to allow fiscal transfers between countries to deal with asymmetric shocks. The latter proposal would allow for more public investment in physical and immaterial infrastructure especially at a time when the private sector is still risk-averse. This will allow for expansionary policies to rekindle sustainable growth and job creation especially among crisis-hit Member States.

2. A new method of economic governance

At a time when leading economists suggest that secular stagnation has become the norm with monetary policy is insufficient to deal with economic shocks and boost growth and employment, it is imperative that the EU reacts properly in order to avoid falling into another recession. One of the possible solutions is to bring back the long neglected fiscal policy as a macroeconomic tool by implementing the so-called UK *Golden rule* and lifting the burden of fiscal consolidation from the current expenditure. This ca be achieved if public capital expenditure is removed from deficits thus allowing states more flexibility for

expansionary policies that even the Commission itself called for.[9] What expenditure is to be excluded can be decided on a periodic basis by the Council, the Commission and the Parliament while its financing can be done through the European Treasury as explained in point 1 above. This rule effectively challenges austerity by maintaining fiscal responsibility through the Stability and Growth Pact.

Conclusion

The EU is a project *sui generis* and as such has the difficult task of paving its way without using a manual. While this may seem daunting, it is also a possibility to set a world model to follow- one that is sustainable and inclusive. In this paper we tried to explain why the current crisis is not one of the “naughty” peripheral states but one that has structural imbalances behind it instead. The Maastricht criteria have led to more divergence than convergence of the economies thus resulting in austerity-driven resentment among the crisis hit countries. Austerity measures have made it normal to have more than 25% youth unemployment and structural reforms have led to jobs resembling a Russian roulette by putting people in constant precarity. While the initial response of the European political leaders has failed to deliver working solutions, there is still room for improvement. Although they might seem difficult to achieve politically, the European Treasury and the Golden rule of public investment may bring back the vision of a united and solidary Europe and fight off far-right political projects that exclude and divide. The challenges today are real. However, there also represent a real opportunity to build an EU 2.0.

[9] http://europa.eu/rapid/press-release_MEMO-16-3711_en.htm