The False Dilemma between Austerity and Growth

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Recently, the general discussion regarding the eurozone crisis is focused on the trade-off between adjustment and growth. The International Monetary Fund, for instance, argues that all countries with fiscal space should use it and should have flexibility in the short term to respond to the challenges of slackening global activity. Also, some policymakers claim that, due to the current recessionary context, a gradual but steady pace of adjustment is preferable to heavy front-loading. However, there are very few countries that have fiscal space; and economies in the middle of a financial crisis cannot afford to postpone adjustment. Particularly, in the current eurozone context this argument of a trade-off between adjustment and growth does not hold.

Peripheral European countries are under the market lens and need to regain credibility in the eyes of investors in order to recover sustained growth, just as many emerging markets did in the financial crises of the 1990s. As an example, over-adjustment in the fiscal front along with a renewed commitment to structural reforms were essential for Mexico to pull swiftly through the financial crisis in 1995-96. It is also true that the surge of exports to the U.S. at the onset of NAFTA, helped by a sharp currency depreciation, contributed significantly to this success. In the light of the Mexican experience (and that of other emerging markets), a more favorable international environment brought about by a much more assertive external rebalancing of surplus countries—especially, China and Germany —and a convincing commitment to adjustment and reform would be more conducive to restoring growth in non-German Europe than the illusionary lifting effects of budgetary relaxation.

Today, it seems that markets are taking a contradictory—even schizophrenic—view of current policy stances in the eurozone. On the one hand, any deviation from fiscal targets is punished in the bond market by an increase in the sovereign's risk premium. On the other, markets fear that fiscal austerity could trigger a recessionary spiral by damaging domestic demand, which would in turn harm government revenue. In market perceptions, this combination of higher interest rates and slow growth could ultimately turn into an ever-expanding public debt. Yet, if an economy has spent for an extended period more than what it can sustainably produce, there must eventually be a period of corrective consolidation—which means there will be a phase of weak growth and persistent high unemployment. This was true for emerging markets where governments did not hesitate (or had no option but) to apply harsh adjustment programs to recover investors' trust.

The trade-off between adjustment and growth only exists (and perhaps only for a limited period of time) for countries that are not in the middle of a financial crisis, like the U.S. and the U.K. For peripheral countries, this is clearly not the case. Several of these economies have been postponing adjustment for too long now; many European leaders have been in denial for too long. The truth is that the European debt crisis has been underestimated from the outset and localized problems have been allowed to metastasize. The financial crisis was initially misdiagnosed as Anglo-Saxon in nature, with limited ripple effects on continental Europe. The accumulated balance sheet disequilibria of both the public and the private sectors in most European countries were ignored. The need to deleverage was underestimated. Liquidity and solvency issues

were inadequately handled, creating perverse interactions between them. The spillovers between bank and sovereign risks were acknowledged only after the fact. The chimera that financing from the rest of the world (the IMF or the BRICs) would allow Europe to postpone solving its own problems was irresponsibly entertained by some. The current debate about the fictitious trade-off between adjustment and growth seems like another exercise in denial. With no institutional and political ability (nor willingness) to decisively implement the necessary policies, the crisis will remain unresolved and governments will be forced to endure the market's unrest and voters' revolt.

From the viewpoint of the markets, not even the "successful" Greek debt restructuring has been a solid step forward. After the agreement reached on February 21, a Greek default was averted, at least for the time being. Nonetheless, markets are still nervous, as the risk of the second Greek program going off track remains very high, particularly after the recent elections and the failure of Greek parties to form a coalition government. The yields on new Greek PSI bonds are quite steep and the yield curve remains inverted. Indeed, the Greek program failed to put an end to funding concerns; Greece will most likely need another round of debt restructuring and/or additional financing with continued fiscal consolidation. The prevailing uncertainty even raises the real possibility of a Greek exit from the euro.

Even if Greece's problem remains inconclusive, markets are now more concerned about Spain. The Spanish government has recently done most of what has been prescribed by the European Union. For instance, it launched new measures to cut public spending on health and education by up to €10 billion. Authorities also pushed through a labor market reform to make it easier and less costly to hire and fire workers. Additionally, the government requested banks to make provisions and raise capital buffers of €50 billion against property and construction loans, strengthening the banking sector.

However, despite these concrete policy measures, markets are uneasy. Given Spain's complex multilayer political organization, it appears to be arduous for the central government to control spending by the *Autonomías* or rule the powerful regional thrift institutions (*cajas*). Paradoxically, as it was previously stated, markets fear both the difficulty of achieving fiscal consolidation and the recessionary impact of austerity. Fiscal consolidation in the face of a recession is a testing exercise. Non-performing loans are growing and private sector indebtedness is high. Leaders need to find the right balance between market demands and mounting political difficulties without putting aside the urgent need of fiscal consolidation. They need also to carefully target budget cuts, so as to protect items that are conducive to growth in the medium term. Spain will have to experience a long period of painful corrective tightening. The IMF forecasts that the size of the Spanish economy will not recover to the level of 2008 until 2017 and that this and next years' Spanish budget deficits will exceed the targets and reach 6.0 and 5.7 percent of GDP respectively. In addition, revolts against austerity and structural reforms are further complicating the adjustment process.

Another concern is that a deeper recession and Spain's unprecedented unemployment rate of 24 percent will likely worsen the credit quality of private sector debt (currently at nearly 300 percent of GDP). The country experienced a huge construction boom and is now suffering the corresponding bust. Spanish house prices have fallen between 20 and 30 percent since their peaks in 2007. Moreover, the excess supply of housing is adding to downward pressures on house prices and further large drops are expected, judging by price declines in other countries that underwent similar property booms and busts. For example, in Ireland house prices have been declining since 2006 and by 2011 are estimated to have dropped by more than 45 percent.[1]

According to the central bank, Spanish banks have around €660 billion in mortgages on their books and loans at risk of default are rising rapidly.[2] Hence, with home prices expected to continue to fall and 80 percent of household wealth tied up in

real estate, the quality of the loan books will worsen and Spanish banks' non-performing loan ratio, already above 8 percent, will rise further. To a large extent banks have been postponing adjustment, mainly holding on to repossessed homes and buying back mortgage securities at high prices. Whenever banks and securities investors are required to acknowledge and absorb their losses, capital buffers won't suffice to stand the banking system "storm".

So what will happen next? Spain will probably try to avoid at all costs resorting to the European Union rescue mechanism. However, if the situation continues to follow the Irish path, Spain will have no option but to ask for help. And the eurozone, in turn, will have no alternative but to aid Spain. The equity support required by the Spanish banking system has been estimated above €100 billion[3], probably too high an amount to be either provided by the Spanish government or financed by the banks' disposal of non-Spanish assets, mostly in Latin America. To get around this painful track, the European Financial Stability Facility should be allowed to directly capitalize banks, which is not the case today. This way, Spain would escape a sharp increase in its sovereign debt—an upsurge that would certainly be punished in the bond market, setting off a vicious circle of higher debt and higher interest rates.

Social and political opposition to austerity has spread across Europe. Spain is by no means alone. Italy, like Spain, will not reach its deficit target this year. In the Netherlands, the government collapsed because of dissent on acceptable budget cuts. In France, François Hollande was elected on a platform that opposed the harsh German-enforced fiscal tightening. He plans to cut the budget deficit by raising taxes. However, Hollande promised to hire 60,000 new teachers, spending an extra €20 billion over five years and augmenting the size of the state.[4] Also, Greece's election on May 6 has revealed deep resentment over the severe recession that austerity has induced. Soon, Ireland will hold a referendum on the fiscal compact that intends to promote balanced-budget rules across the eurozone and the outlook remains uncertain.

In the late 1980s, austerity fatigue was also observed in Latin America, but only after years of continued macroeconomic adjustment and structural policies. Debt write-offs under the Brady Plan took place at the end, not at the beginning, of the adjustment process: this is why it triggered a full recovery of market confidence and a re-launching of growth. On the contrary, today's markets have lost faith in the European decision-making process and in the leaders' ability to solve the crisis. Thus, instead of explicitly relaxing fiscal consolidation to ease the pain for growth, eurozone countries need an overshooting in financing and adjustment to recover market credibility. Mexico's 1994 peso crisis is helpful to illustrate the importance of recovering the market's trust.

In the years leading up to the "tequila" crisis of 1994-95, Mexico received huge capital inflows, drawn mainly by a favorable economic outlook that followed several years of stabilization and rigorous structural reforms. For instance, thanks to these efforts, in 1993 inflation dropped to single-digit levels for the first time in over 20 years. The start of a comprehensive effort to liberalize the financial sector in 1988 gave an additional boost to foreign capital inflows. It is also relevant that, at the time, due to low domestic interest rates, investors from developed economies were looking for better returns abroad. As a result, net capital inflows reached a record high of $29.4 billion in 1993.

The Mexican economy was transformed by these developments: financial depth and bank financing to the private sector increased substantially, and domestic demand grew due to widely available resources stimulating massive current account deficits. In sum, financial institutions, firms and households all incurred in a strong leveraging process. At the same time, a number of vulnerabilities began to emerge. The current account deficit that was mostly financed by short-term flows in the context of a fixed exchange rate regime was very large. In addition, the strong growth in credit to the private sector occurred while financial supervision and regulation were inadequate. Eventually, the crisis was triggered by the sum of numerous

factors: rising international interest rates, federal elections, and criminal acts caused significant economic and political uncertainty. Suddenly, investors changed their risk perceptions. This led to bouts of panic and large capital outflows that, in turn, unleashed a profound crisis in the domestic financial system.

But, why was Mexico hit so hard during the tequila crisis? The crisis was so acute because, along with the vulnerabilities previously mentioned, there was a massive loss of confidence in the country and its institutions. Financing to Mexican banks was cut and trade financing became scarce. The new administration obtained financial aid from the U.S. government, the IMF and other international organizations that helped avoid a liquidity problem that would have resulted in a systemic financial debacle. President Clinton offered a loan from the Exchange Stabilization Fund of $20 billion that required no congressional approval. The IMF then agreed to lend another $17 billion, an unprecedented amount at the time.[5] Together with other funds from international organizations, the loans to Mexico were close to $50 billion.[6] There was an overshooting in financing.

At the same time, Mexican authorities undertook a harsh fiscal consolidation strategy, even more front-loaded than the programs implemented in the 1980s, which included higher taxes, steep increases in energy prices and deep expenditure cuts. There was an overshooting in adjustment: the primary surplus of the public sector was increased in just one year by 3 percent of GDP, from an already high level of 2 percent in 1994 to 5 percent in 1995. Still, at the time it was impossible to say whether the measures would work. Turning market sentiment around is by no means an easy task, but it is of the essence in resolving a crisis induced by economy-wide balance-sheet disequilibria.

Fortunately, the program did work in the end. The results of the efforts set in motion in Mexico as a response to the crisis of the early 1990s are a testament to the success of this strategy. By mid-1996, less than a year after the program was implemented, Mexico was able to enter the voluntary capital markets for financing once again. Also, it was in a position to repay both the U.S. government and the IMF years ahead of schedule. Nonetheless, the costs were high. In 1995, GDP declined 6.2 percent and the fiscal cost of the associated banking and financial crisis is estimated at around 18 percent of GDP. Yet, recovery was "V" shaped; by the end of 1997, output was substantially higher than before the crisis. Of course, this rapid recovery was also supported by a fast export growth associated with NAFTA and a favorable international context.[7]

This episode is an example that recovering market credibility is crucial in the resolution of a crisis. Decisive action was key for the positive outcome of the Mexican peso crisis. The program was designed to overshoot both in financing and adjustment, and to stay ahead of the curve. This is what allowed authorities to enhance credibility; and this is what the actions undertaken to deal with the euro crisis are missing.

Contrary to the Latin American experience, now some policymakers are suggesting that an "easy does it" approach to fiscal consolidation would be preferable to heavy front-loading even in countries with mild fiscal space. In general, very few advanced economies have enough fiscal room to even consider slowing the pace of near-term adjustment. These are countries that are not currently under market pressures, which is basically why they can postpone the inevitable fiscal retrenchment. One of these countries is the United States. The U.S. is a very particular case; first, because the dollar is the main reserve currency worldwide and, second, because its fiscal problem is not so difficult to solve. At least conceptually, it is easier to visualize fiscal consolidation in the U.S. than in most other developed economies that need to set government debt on a sustainable course. The U.S. government (measured by total spending) is smaller than those in the rest of the G-10 countries.[8] The real challenge for the U.S. is to stimulate economic growth and job creation in the short term while, at the same time, credibly addressing the issue of fiscal sustainability in the medium term.

The U.S. needs a mix of income and spending measures to achieve long-term fiscal sustainability. On the income side, a value-added tax (VAT) should be introduced. Although a VAT would be new to the U.S., this is a levy that exists in more than 150 countries worldwide and in every OECD country other than the U.S. On the spending side, for many, the central question regarding profligacy is about entitlement programs. Growth in entitlement spending associated with the aging population and its rising health care costs are the main factor in general federal spending dynamics. At 17.4 percent of GDP in 2009, health care spending in the U.S. exceeds that of any other developing nation.[9]

Economically, the U.S. fiscal problem is not so hard to solve. But there are of course huge political obstacles. Unlike peripheral countries in Europe where the austerity versus growth debate is nonsense, markets will probably allow the U.S. to implement a gradual but definite fiscal adjustment while maintaining growth support in the short run. Still, markets will not wait forever. The U.S. government needs to establish soon a credible medium-term plan that aims to regain sustainability otherwise markets will force this country to adjust.

More than fiscal relaxation in countries undergoing domestic adjustment, the relevant question for the world economy is how to exit the debacle of a continued aggregate-demand shortfall through the rebalancing of adjustment toward countries with large external surpluses. Almost four years after the Lehman Brothers bankruptcy, global economic growth remains feeble. Given the fiscal crisis in developed markets and the measures being taken to correct it, there has been a further fall of effective demand. Moreover, the prospects for growth in these countries look dim for the next few years. For countries in the middle of a financial crisis, there is no dilemma between austerity and growth. Eventually, they will have to adjust, hurting economic growth. A plausible strategy is to continue with austerity while accelerating structural reforms that will support growth in the medium term. Thus, in order to support aggregate demand, surplus countries need to stimulate much more domestic consumption. The asymmetry in adjustment between deficit and surplus countries—an issue that was conspicuously raised by Keynes in the Bretton Woods debates—has not been properly addressed since the outset of the current global financial crisis.

Fundamentally, China and Germany need to reduce their external surpluses because they stand against a sustainable adjustment path for deficit countries. It is true, as often claimed, that Chinese and German surpluses have already been reduced since the inception of the crisis, from 10.1 percent to 2.8 percent of GDP in the case of China and from 7.5 percent to 5.7 percent of GDP in the case of Germany since 2007 to 2011.[10] But, given the depth of prevailing disequilibria, this adjustment is clearly insufficient. The real growth of Chinese GDP has been 65 percent[11] and the Chinese renminbi appreciated by 20 percent against the U.S. dollar during the same period, which means that China's GDP has basically multiplied by two in nominal dollar terms. Thus, the current account surplus of China has been cut in dollar terms from $353 billion in 2007 to $201 billion in 2011, a significant but not overwhelming reduction. The problem is that the rebalancing of the world economy probably requires China to run a deficit, not a surplus. Certainly, the German surplus with the rest of Europe has shrunk because exports have fallen. The problem is that what is required is a sizable deficit induced by import growth. China and Germany still need to boost their domestic consumption, through wide transfers from the state to households in the first case and through significant increases in wages in the second.

International cooperation remains fundamental for achieving sustainable global growth. Last year, the G-20 agenda was dominated by discussions regarding the eurozone turmoil and long-term matters were set aside. However, the G-20 was created with a far-reaching purpose and its role is not only to respond to short-run issues, but also to lay the foundation and create the fundamental underpinnings for long-term global economic stability. Now, the need for action on the long-standing ar-

eas of concern—international imbalances and the adjustment mechanism—seems even more urgent as many industrialized economies will have to go through a painful period of corrective consolidation.

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Endnotes

[1] International Monetary Fund (2012).
[2] Banco de España (2012).
[3] BCA Research (2012) and Roubini and Greene (2012)
[4] The Economist (2012).
[5] The loan from the IMF represented 5.1 percent of Mexico's GDP. In contrast, IMF resources in the rescue package agreed for Portugal in May 2011 (over $38 billion, current prices) were equivalent to 15.1 percent of Portugal's GDP. The total loan packages approved were $50 billion (14.9 percent of GDP) for Mexico and $116 billion (45.4 percent of GDP) for Portugal. Source: International Monetary Fund (2012).
[6] Ortiz (2011).
[7] For a detailed study of the Mexican 1994-1995 crisis see Boughton (2012).
[8] U.S. average government expense between 2006 and 2008 was less than 22 percent of GDP, while in countries like Belgium, France, Italy and the U.K. it represented more than 40 percent of GDP. World Bank (2011).
[9] OECD (2011).
[10] International Monetary Fund (2012).
[11] Ibid; national currency, constant prices.