Austerity: Hurting but Helping

Ana Conde
Diana de Mira
Mariana Bernarda

Agenda

European Economic Advisor Group Report 2014

Introduction
Brief introduction of the past events that lead to the situation discussed in the paper

Basic Concepts
Presentation of the concept austerity and the stylized facts

Trade-offs
Main trade-offs that need to be considered

Crisis Chronology
Description and analysis of different periods: 2002-2007; 2007-2009; and 2009-2012

Conclusion
Wrap-up of the work and discussion

Introduction

Main problem:

External imbalances between periphery and core countries

Solution:

Austerity

Main question:

Until what point can austerity help in a recession period?

Austerity - Concept

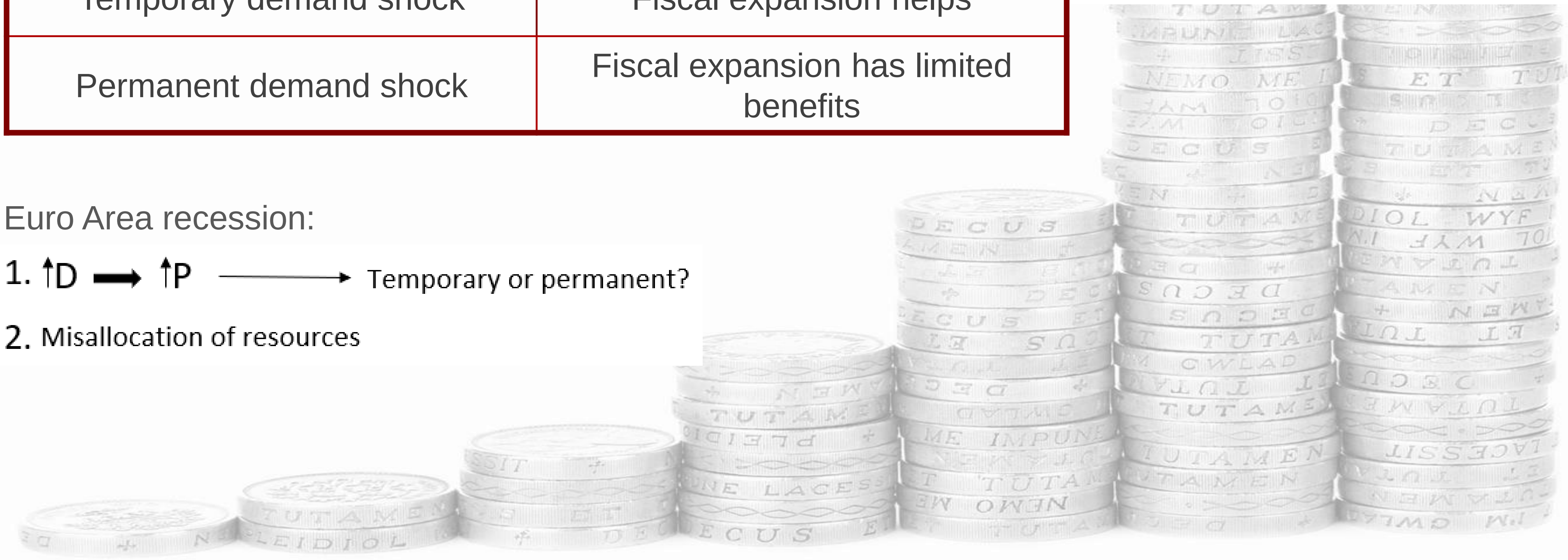
Set of economic policies implemented by the government to control public sector

Adjustment of fiscal policies depending on nature of recession:

Nature of recession	Effects of austerity measures
Temporary demand shock	Fiscal expansion helps
Permanent demand shock	Fiscal expansion has limited benefits

Euro Area recession:

1. ↑D ➡ ↑P ⟶ Temporary or permanent?
2. Misallocation of resources

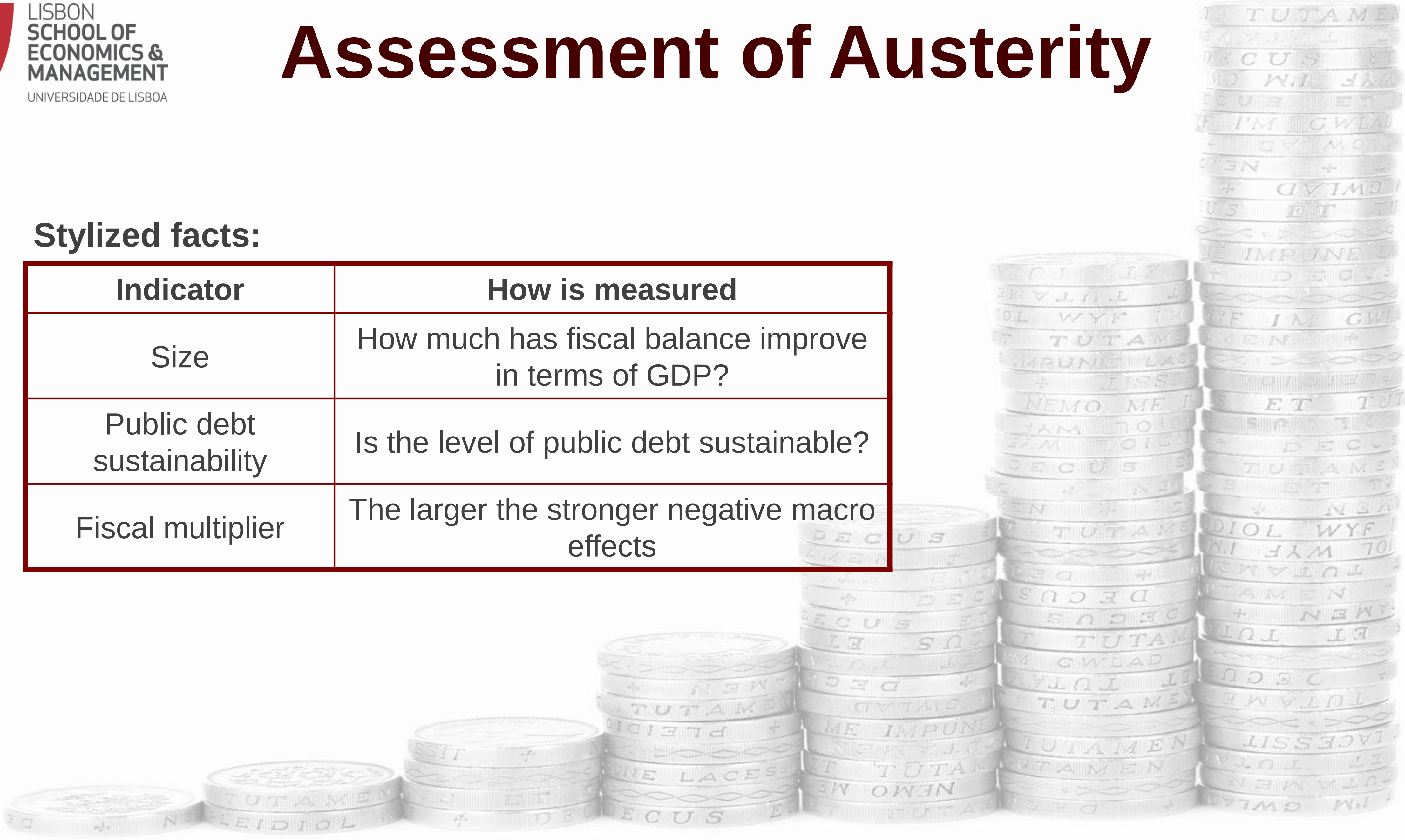


Primary Types

Revenue Generation	Increase taxes and public spending
Angela Merkel model	Increase taxes and decrease public spending
Public cuts	Decrease taxes and public spending

- Most economists and policy analysts agree that raising taxes will raise revenues - Tactic that most European countries took
- Austerity is successful if it makes public debt sustainable and if it contributes to decrease external imbalances in the periphery!

Assessment of Austerity



Stylized facts:

Indicator	How is measured
Size	How much has fiscal balance improve in terms of GDP?
Public debt sustainability	Is the level of public debt sustainable?
Fiscal multiplier	The larger the stronger negative macro effects

Trade-offs

Risk of Default
VS
Cost of Austerity

- Risk of not being able to make required payments - more fiscal adjustments
- Cost in terms of output and employment
- Incentive to carry the austerity measures because of the anticipation of its costs
- Recession as a necessity in this trade-off - use of austerity to make real devaluation
- Devaluation in a region within a currency union to achieve price adjustment

Trade-offs

Frontloading
VS
Backloading

- High short term costs vs credibility of the measures
- First one with less output and high debt to GDP ratio necessity of farther austerity - never ending cycle. (Extreme case of hysteresis)
- Second with lower costs and avoids hysteresis but too long and it can lose credibility

- Usually backloading means higher interest rates on government debt and therefore the need to front loading the fiscal adjustments

Trade-offs

Expenditures Cuts
VS
Tax Rises

- Tax-based fiscal corrections:
  - More costly in terms of output
  - Associated with large and long-lasting recessions
- Spending-based adjustments:
  - Less costly in terms of output
  - Associated with small downturns
  - Reduces expectation of higher taxes in future which might boost investors' confidence, increasing demand so these adjustments can be associated with economic growth
  - More likely to reduce debt-to GDP ratio and less likely to reduce recession
  - <u>But no consensus about size of multiplier</u>

- Both lower budget deficits and avoid a debt crises, phenomenon: expansionary austerity

ISEG LISBON SCHOOL OF ECONOMICS & MANAGEMENT
UNIVERSIDADE DE LISBOA

Timeline

2002 - 2007

2007 - 2009

2007 - 2009

Timeline

2002 - 2007

2007 - 2009

2007 - 2009

LISBON SCHOOL OF ECONOMICS & MANAGEMENT
UNIVERSIDADE DE LISBOA

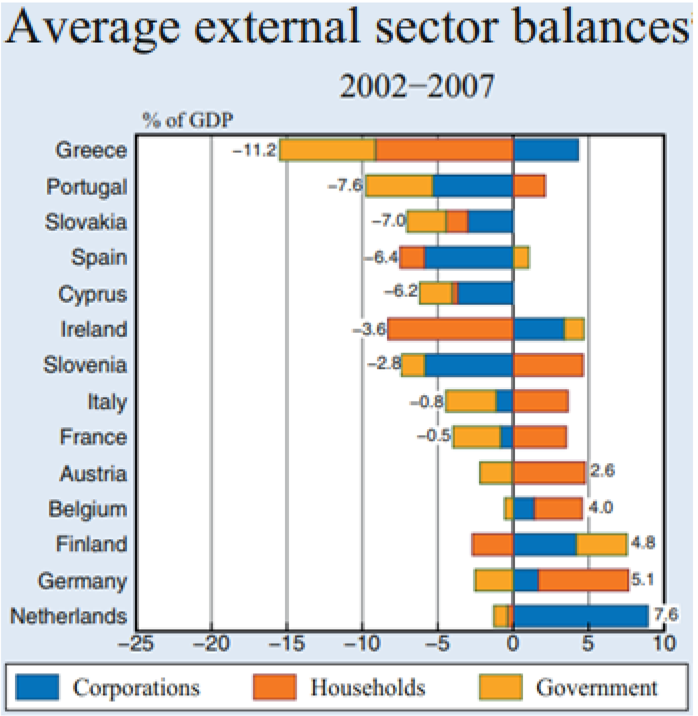
2002 - 2007

- Investment boom in periphery countries: outcome of expectations of income convergence accompanied by current account deficits financed by private capital inflows
- Lead to an expansion in demand, faster price rises in periphery but this destroyed their competitiveness and increased current account deficits
- Relative prices and allocation of resources were misaligned

Private capital flows stalled → Investment boom collapsed leading to recession

2002 - 2007

- Periphery countries of the euro area operated large current account deficits
- In general, private sector net borrowing contributed the most to this deficit which is consistent with the credit boom

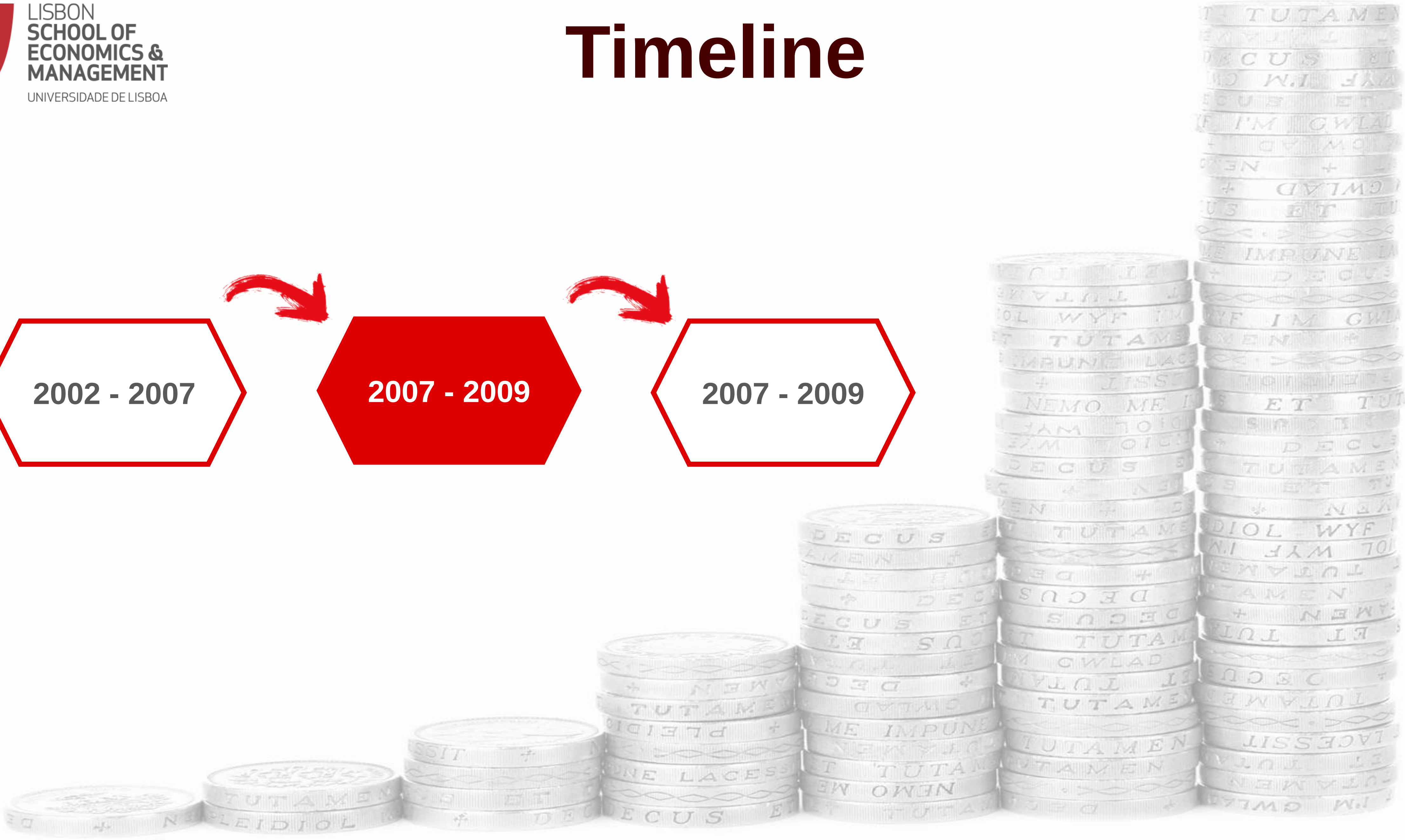


Timeline

2002 - 2007

2007 - 2009

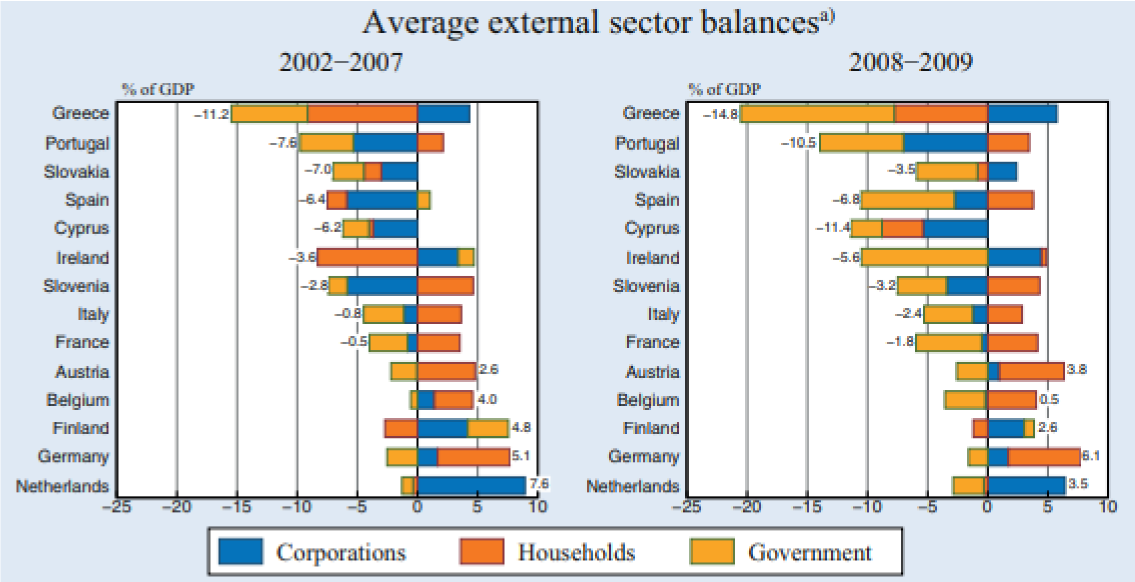
2007 - 2009



LISBON SCHOOL OF ECONOMICS & MANAGEMENT
UNIVERSIDADE DE LISBOA

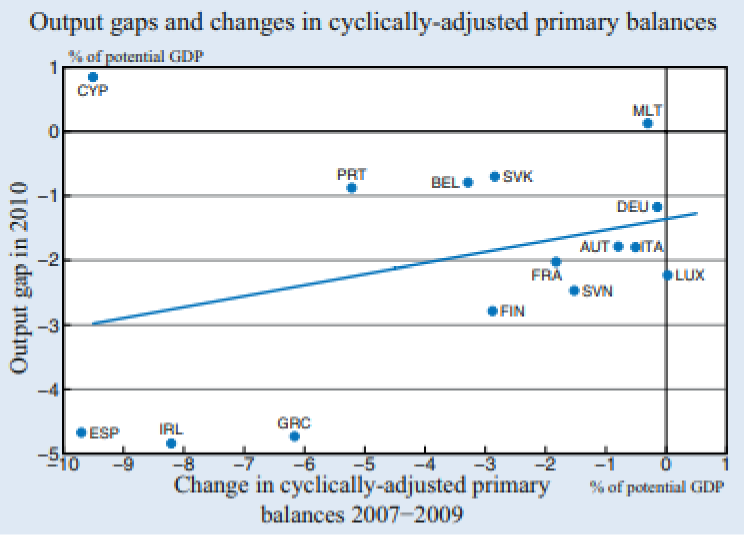
2007 - 2009

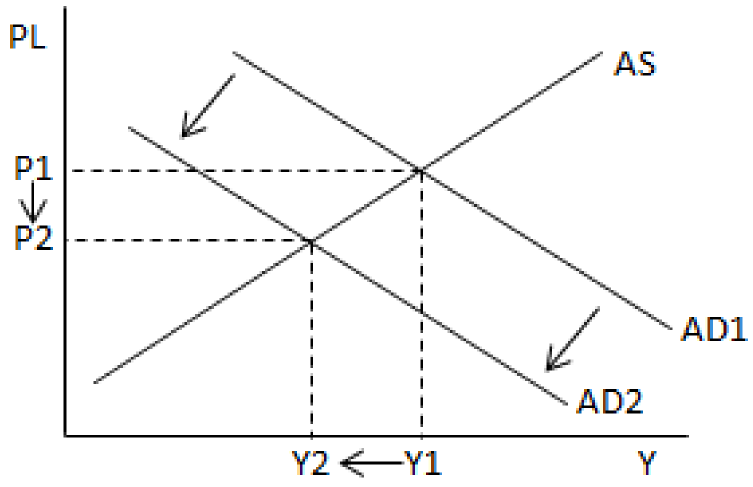
- Fiscal expansionary measures don’t have the desired effect
- Countries with high potential output are the ones that have large losses
- Adjustments in the private sector
- Worsening of the situation



2007 - 2009

- The measures implemented don’t have the desired outcome
- The temporary demand shock was a wrong assumption
- Fiscal measures would have been efficient in the case the previous assumption was correct
- There’s an increase of the debt that lead us to the following crisis period





Timeline

2002 - 2007

2007 - 2009

2007 - 2009

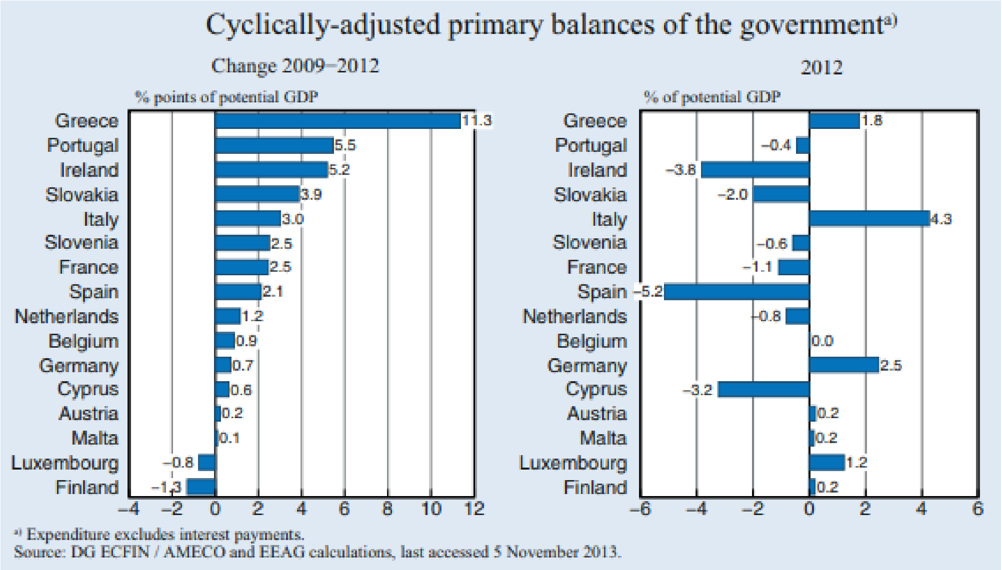
2009 - 2012

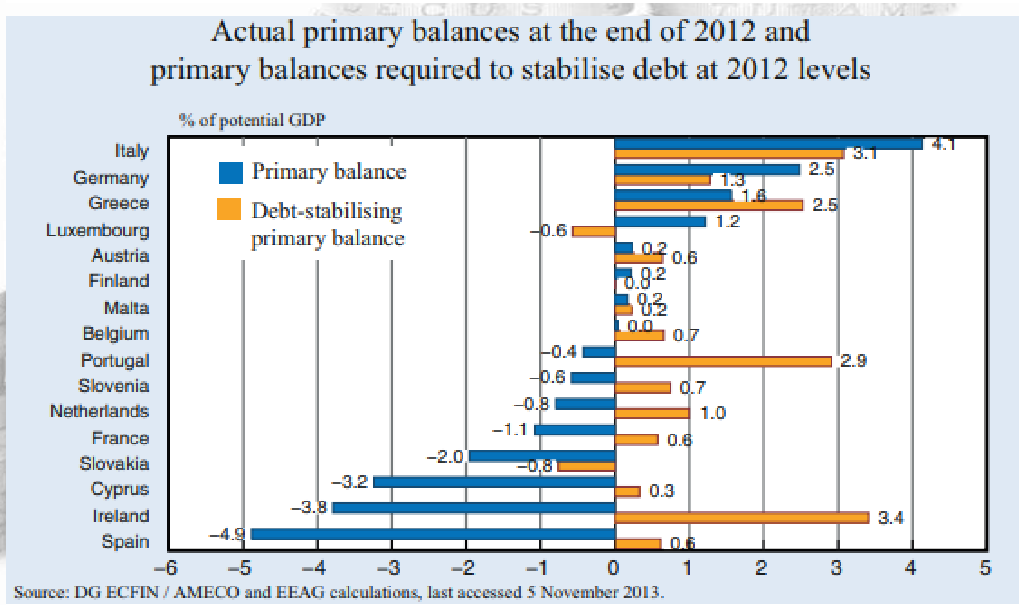
FISCAL EXPANSION ⟶ FISCAL AUSTERITY

- All countries except Finland and Luxembourg implemented austerity measures.
- Periphery countries seek external assistance – Troika
- Troika represents the states that offer better public credit.
- Enabled countries to:
  - 1. Backload fiscal adjustment
  - 2. Reduce costs of fiscal adjustment

2009 - 2012

- Overall improvement of cyclically adjusted primary balances - but was enough?
- Debt sustainability - only Luxembourg, Italy and Germany showed balances high enough to sustain level of debt
- External imbalances on peripheral area





2009 - 2012

Countries	Output vs. Employment	Labour productivity
Euro Area	ΔOutput > ΔEmployment	Pro-cyclical
Peripheral	ΔOutput < ΔEmployment	Counter-cyclical

Usual

Decrease expenditure → decrease output → automatic stabiliser worked

Conclusion

- Austerity made recession worse and may have anticipate it
- In the first period the crisis was a associated with a temporary demand sock and therefore fiscal expansionary policies were implemented
- The policies implemented don't have the expected effect
- Realisation that these crisis is a permanent one instead
- By the end of the studied period cyclical primary balances showed a overall improvement but it was not enough to make the debt sustainable

Austerity and recession are part of the ajustment process

2000

Investment Boom

Lead to expansion in demand and generated a faster rise in prices

2007

Financial Crisis

Due to the collapse of the construction boom

2008

Fiscal Expansion

To offset the recessionary effects of the Financial crisis which was interpreted as a temporary demand shock

2009

European Sovereign Crisis

Due to the financial expansion which was ineffective as they faced a longer-lasting demand and supply shock

2012

Debt Sustainable

Cyclically-adjusted primary balances levels were still not debt sustainable