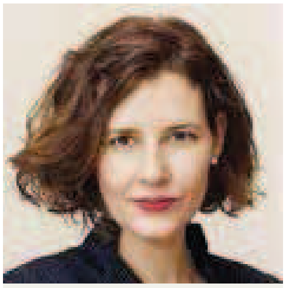
Welcome to Austerity 2.0

The financial impact of Brexit has led to fears of prolonged or intensified austerity across Europe. Dana Reizniece-Ozola examines the economic pitfalls ahead

"Brexit" and "austerity" are two of the most controversial subjects of recent times. Brexit is a political challenge stemming from an EU membership referendum; austerity is an economic challenge stemming from the political short-sightedness of pro-cyclical policies. But both phenomena have a direct effect on businesses and households across the European Union.

The Brexit vote, and Euroscepticism more generally, have come together with lengthy and hotly-disputed austerity policies in some countries to burden Europe's economic revival by limiting the influx of private money into the economy. The uncertainty caused by both Brexit and austerity is a key reason for the ineffectiveness of the European Central Bank's quantitative easing policies. But how do Brexit and austerity interrelate? And what economic challenges can be expected from the referendum result?

One major impact relates to the EU's multiannual financial framework (MFF) – for both the current (2014-2020) and next planning period. When Article 50 is invoked, the negotiations around and adoption of the 2021-2027 MFF will become more stressful and challenging than before. The withdrawal of Britain's contribution will give greater power to net contributors and reduce the opportunities for net recipients. The decades of success stories that arise from EU funding is the primary argument for Structural Funds and the Cohesion Fund. The fundamental importance of an influx of capital into smaller, peripheral economies is visible in the Baltic states, and elsewhere too. Ireland may, yet again, be one of the best examples. Small newcomers to the EU rely on financial assistance – help that would otherwise have to be found in national budgets or on international bond markets. This alternative would invariably create new pressures and calls for austerity, meaning spending cuts to long-term projects such as preventive healthcare or fixing structural unemployment.



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Should the Brexit negotiations result in a swift removal of contributions from the UK, we may even see austerity pressures and a sudden need to redistribute fiscal capacity away from projects financed under the 2014-2020 MFF. The current British input to the EU budget is substantial. With the European project on a less-than-stable footing at the moment and the economic recovery not as fast as had been hoped, expecting ad hoc contributions from other member states to make up the missing funds resulting from Brexit appears to be wishful thinking.

Two other aspects are trade relations and financial market interdependence. Both could lead to prolonged or re-introduced austerity policies in EU countries. The operations of British financial service providers in other EU members (and vice-versa) will need to be addressed during the renegotiation process. The relocation of financial services and workers will bring shifts in tax revenue streams, and some countries could lose out. The high degree of mutual exposure to financial services, along with the economic uncertainty and currency fluctuations that the Brexit referendum has brought about, are set to cause damage to national budgets and limit the room for fiscal manoeuvring.

This is most evident for trade in goods and services. Austerity measures will have to be undertaken because of falling trade – not only real, but projected. The UK's economy is closely tied to those of other EU member states. Many of these countries – including my own – could suffer or are already suffering losses due to the result of the referendum and the depreciating pound sterling. Falling export values and smaller tax revenues from exposed industries are already affecting planning for 2017 national budgets.

These are the current and most immediate consequences of Brexit for the macroeconomic situation and budgetary planning. Additional costs could come from possible infringements of the free movement of labour and the resulting social expenses required for repatriated families.

So does Brexit mean a stricter and more prolonged period of austerity is necessary for Europe? The uncertainty of Brexit has already reduced private and public spending. But this won't turn into a fully-fledged austerity in all EU member states if the situation is politically managed and economic uncertainty contained. The EU's leadership may well need to find a way to implement, not only talk about, policies that will push Europe's economy towards much stronger growth. ■

Commentary

Austerity experience shows we need EMU-sized democracy

Many reasons have been cited for the Brexit vote. Austerity and immigration policies are among the most prominent. But democracy (or the lack of it) is just as important a factor.

Austerity is justified when demand exceeds potential supply, causing prices to rise. However, when productive capacities are underused, austerity causes harm. Firms reduce their supply capacities, investment and employment. After the financial crisis, the world experienced a major demand shock; many countries sought to stimulate their economies through public spending programmes.

The United States was successful in stimulating its economy, but Europe took another route. After learning of the policy fraud regarding budget limits that helped Greece enter the euro, the EU decided to ensure rigid application of the Stability and Growth Pact – a move that caused a double-dip recession. Productive capacities shrunk and unemployment and poverty shot up, especially in the south of Europe. Germany was exempt from this dynamic because it was deemed "safe", attracting capital from the rest of the eurozone.

Opposition to austerity was widespread, but as the Greeks quickly learned, national elections could not change the eurozone's macroeconomic policy mix. National governments are constrained by consensus in the European Council, which prevents radical policy changes. Whether the European policy consensus is good or not is irrelevant for democracy. In a democracy, citizens (not governments) make choices about policy orientations, but in Europe this is never the case. Citizens cannot "own" intergovernmental deals that are imposed on them.

The problem is sharpened in the eurozone because money is the hard budget constraint. The system produces winners and losers. In the traditional nation state, winners can compensate losers, and the welfare state has been the foundation of political and social stability since the Second World War. The EU compensates poorer regions, which helps governments to favour their own constituencies. The paradox is that the poor in rich countries support the rich in poor countries. This injustice fuels dissatisfaction with Europe.

In a global economy, large markets generate productivity gains that allow higher wages in the long run. So the solution to Europe's problem is not reducing the economy to the size of the political nation, but increasing European democracy. A European government is the solution. ■

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