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Why the ‘bitter medicine’ of austerity isn’t working

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The same unpalatable cures were prescribed for countries suffering from very different ailments. **Stefan Collignon** sorts the right medicines from the wrong

WRITTEN BY

(http://europesworld.org/author/stefancollignon/)

Stefan Collignon (http://europesworld.org/author/stefancollignon/)

Professor of European Political Economy at the London School of Economics and at the Scuola Superiore Sant’Anna, Pisa

Other articles by Stefan Collignon (http://europesworld.org/author/stefancollignon/) ›

Europe is sick, and sick people take medicine. Europe's economic doctors recommend "bitter medicine" to restore the EU's competitiveness, but have we diagnosed the sickness correctly? Does the medicine have to be so bitter when some are arguing that to restore its economic health Europe should stop taking the medicine altogether. That's a recommendation that may not find many friends in policy-making circles, but that is increasingly being echoed by European voters.

Who is right, and what ought to be done to restore economic health to the European Union? There are three distinctly different explanations of the euro crisis. The first blames irresponsible fiscal policies for creating unsustainable government debt. But while this explanation may have been true for Greece, it proved to be false in Ireland and Spain. The second explained that the crisis stemmed from excessive borrowing by both public and private sectors. The large current account deficits in the southern eurozone states even before the onset of the crisis would seem to support this thesis; its argument is that those countries have sought to mask their declining competitiveness by accumulating more debt. The European Commission rallied to these ideas and conceived the new macroeconomic imbalance procedure (MIP) as a remedy.

The third way of looking at the crisis has been the European Central Bank's view of it as essentially a liquidity crisis to be dealt with by implementing unconventional monetary policies, and by itself rolling over the supervision of large banks that at national level has been protected by crony capitalism. The ECB's actions saved the euro from collapse, but structural problems persist. Hence all the calls prescribing bitter medicine.

In the U.S., economist Paul Krugman argued in a widely-read paper that "theorists of competitiveness … make seemingly sophisticated arguments, most of which are supported by careless arithmetic and sloppy research. Competitiveness is a seductive idea, promising easy answers to complex problems. But the result of this obsession is misallocated resources, trade frictions and bad domestic economic policies." Europe should have listened. For when the eurozone crisis broke in 2008 Greece, Portugal, Spain, Cyprus and Ireland were all running high current account deficits of well above

5% of GDP, and some economists concluded that these countries had been living above their means and now had to balance their current accounts. Little mention was made of the surplus countries.

Unpalatable medicine was administered in the form of harsh austerity policies as the antidote to excessive private and public spending. To avoid “excessive” deficits in the future, the European Commission set up its new macroeconomic imbalance procedure (MIP), with the result that all the high deficit countries reduced their imbalances in recent years.

Unfortunately, “sloppy” economists had overlooked the simple fact that high current account deficits within the eurozone correlated with rapid economic growth and high rates of investment. In other words, the peripheral eurozone countries had seized the opportunities inherent in the single currency to catch up with its core members. There was nothing wrong with macroeconomic imbalances within the euro area, and in fact, a good many economists had predicted that the imbalances would arise through the creation of the monetary union.

What was wrong, though, was importing the concept of external imbalances into the single currency area. Payment flows within the same currency area are not “external”, because payments are made in euros, regardless whether the payer is in Berlin, Athens or Madrid. In economic terms, the eurozone is a single country, even if politically it is not. And that is where the problem lies!

Economists who believe that the existence of separate governments and jurisdictions justifies textbook treatment of current account deficits are simply too lazy to think through the logic of monetary union to the end. In countries with their own national currency, current accounts are important because they represent the net flow of foreign currency and changes in foreign exchange reserves. If a country runs out of reserves, its currency will crash, but in a monetary union the logic is different. Net spenders borrow money from net savers. These payment flows are facilitated by the banking system which re-distributes the existing money stock, although the money comes from the European Central Bank acting as lender of last resort to banks, thereby ensuring that banks will not run out of money.

Debt needs to be repaid, of course. But in a monetary union this does not require current account surpluses. Money is borrowed in euros and must be repaid in euros. It is the task of banks to assess the creditworthiness of their clients and, although sometimes they get this wrong, they must get it right on average as otherwise they will collapse. Because bank failures can have dramatic effects, it is right that the ECB has now taken over responsibility for banking supervision, but that alone cannot prevent systemic crises. A necessary macroeconomic condition for ensuring the sustainability of private and public debt is that the local economy should grow at a rate higher than or equal to local interest rates. Yet by taking the “bitter medicine”, the eurozone’s southern economies have lost the capacity to satisfy these conditions.

A deficit country does not necessarily suffer from a lack of competitiveness. With the help of large net imports it may actually be in the process of improving its competitive position. But a country may also throw a party for consumers, borrow rather than save and then, without investment, the economy will stagnate – in which case the deficits become a problem. For example, before 2008, Greece significantly improved its productivity and global export market shares, but Portugal did not. By giving the same medicine to both countries, more damage was done than good.

Since 2009, the problem for the crisis countries has been that the austerity policies imposed on them have reduced growth and even shrunk the economy, while political brinkmanship and lack of solidarity among governments have pushed up interest rates in crisis countries to a point where financial markets feared the eurozone as a whole might break up. This has created a vicious cycle of recession, unemployment, rising poverty and social exclusion, which then feeds back into financial instability. The medicine has become a poison. The responsibility for this disaster must be equally shared by all governments, although some are clearly more equal than others. The right medicine would have been to set up an economic government for the eurozone armed with the powers to stimulate economic growth, stabilise financial markets and restore social welfare.

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