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Second Report

iAGS

2014

Executive summary

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FROM AUSTERITY TO STAGNATION
HOW TO AVOID THE DEFLATION TRAP

(…)
Yes, how many years can a mountain exist
Before it's washed to the sea?
Yes, how many years can some people exist
Before they're allowed to be free?
Yes, how many times can a man turn his head
Pretending he just doesn't see?
(…)
Blowing in the wind, 1962, Bob Dylan

Five years after the beginning of the financial crisis in 2008, the euro area is still in crisis. However, there are some positive signs which have emerged. Some say that the main imbalances are on their way toward resolution. Others claim that the euro's survival of what has proven to be a major crisis is a step forward in creating a prosperous and sound European Union. Some may rationalize that the European integration process has always progressed by desperate responses to critical situations. Some may even interpret migration flows from peripheral countries to the core, to escape the misery of the crisis, as showing that the optimality of the currency area has improved.

Our analysis of the state of the European Union and the euro area is strikingly different. We think that the policies conducted so far, in particular austerity, have failed and that such a failure has a cost. Imbalances have not been solved but only displaced, from current account to unemployment, from public deficit to inequalities. Despite tremendous efforts, private or public debt ratios are still high and deleveraging still stands as the only objective. A large majority of European citizens live in countries still stuck in the crisis and for whom recovery is an abstract concept (table and Figure 1). We think that alternative policies were possible. In addition, we believe that other policies can and should be implemented now to *really* exit the crisis.

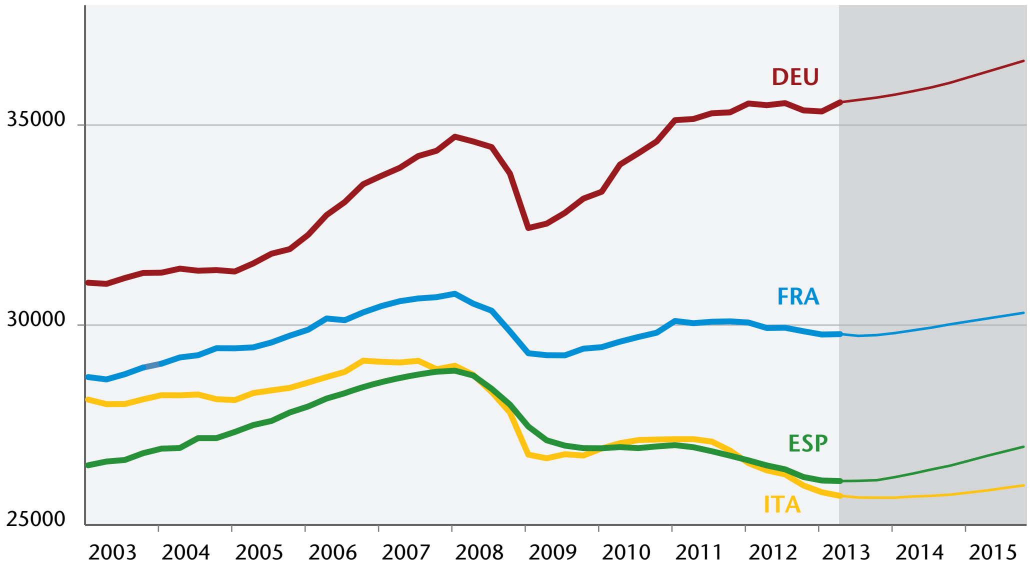
Table 1. Euro area iAGS forecast, GDP yoy growth

	2013	2014	2015
DEU	0.4	1.2	1.6
FRA	0.1	1.1	1.5
ITA	-1.8	0.3	1.0
ESP	-1.4	0.7	1.4
NLD	-1.1	1.0	1.6
BEL	0.0	1.2	1.6
PRT	-1.8	0.9	1.4
IRE	-0.5	1.4	1.9
GRC	-4.1	-0.4	2.4
FIN	-0.9	1.7	1.9
AUT	0.4	1.0	1.3
EA	-0.3	1.0	1.5

Source: iAGS 2014 forecast.

Figure 1. iAGS forecast 2014-2015 for main EA countries

GDP per head, World Bank ppp, 2005 prices



Sources: iAGS 2014 forecast. Eurostat, national accounts and World Bank.

1. The cost of failing

The cost paid to regain confidence from financial markets and from the business sector has been far too high. In a time when the fiscal multiplier was at an all-time high, a historically unprecedented consolidation was conducted. Apart from the nearly absurd demonstration that such an austerity can be conducted and accepted by the people, the economic disaster is huge. Unemployment has reached a record 12.2% in the euro area and is at a rarely matched level in some countries (Spain, Portugal, and Greece). A generation entering the job market will endure a long lasting spell of poor jobs if they are fortunate to gain employment at all.

Even more worryingly, high unemployment levels will pass on to increases in long-term unemployment which can turn into structural unemployment and lower growth potential in the future. Estimations imply that 64 percent of the increase in unemployment within the EU eventually turns into long-term unemployment [see details in chapter 2]. These calculations imply a long-term unemployment rate above 5.5 percent in the euro area in 2015. An increasing amount of young people are also facing long-term unemployment; some 2 million of the 5.5 million young unemployed are under 25. As a consequence inequalities are rising and poverty increasing in many countries, and as future prospects further deteriorate, the sword of Damocles of austerity requires plans for a further dismantling of social systems, although they are the last stand against an expansion of inequalities.

Whining about the past is of no use. But understanding "how much we had to pay for what" is a necessity in a democracy. Our simulations, in line with a recent Economic Paper from the European Commission, show that backloading rather than frontloading austerity would have avoided in most countries the recession of the years 2012 and 2013, while achieving the same debt to GDP ratios in

2032. Unemployment would be lower today than it is by 1.7 points in 2013 and 2014 [see details in chapter 1 of the iAGS 2014]. In some countries, the difference is even larger: backloading in Spain would have made a difference of unemployment of more than 3.7 points.

The iAGS 2013 was one of the few to take seriously early warnings that fiscal multipliers are high in a time of crisis and to make realistic proposals for alternative policies. The intense debate between economists has shed some light on the reason why so many persisted in calling for austerity while outcomes worsened, why such a high price was paid to avoid a problem of free-riding inside the euro area that we consider vastly exaggerated. Austerity was the consequence of letting financial markets judge the sustainability of European democracies and be the strong arm of public finance discipline. That also has been a failure, and in the end, it was only the resolute action from the ECB that solved the problem during the summer 2012. Stating definitively that the euro was not going to split, creating the instrument, OMT, with which, subject to certain conditions, limitless amounts of under-pressure sovereign bonds (up to 3-year maturity) could be purchased, and building the needed institutions (among them ESM and the still to come Banking Union) to deal with short term debt threats has bought time. Those steps were necessary. But they came too late to delay the austerity programs of the years 2011 and 2012. One may even fear that frontloading was the prerequisite for those institutional advances. And the conditionality and link to the fiscal compact question their effectiveness if "the markets" see fit to challenge the commitment of the central bank, explaining why austerity has continued through 2013.

The cost is not only economical but political as well. Six months now before the 2014 May European Parliament elections, the trust in European institutions is at rock bottom, showing that the failure has not remained unseen by the people. According to the latest Eurobarometer, "trust in European Union" and "trust in national parliaments or governments" are at the lowest level since 2004, the main concerns being unemployment (according to 51% of the EU population) and the economic situation (according to 33%).

2. The consequences of failing

The high level of unemployment resulting from the crisis and the remedies applied to solve it are exerting downward pressure on wages generally and actually pushing down wages in the crisis countries. This is a costly and dangerous way to adjust real exchange rates and rebalance the euro area. There is a real and present danger of it marking the beginning of an unstoppable deflation. ECB officials[1] may distinguish with subtlety disinflation from deflation, but we affirm that there is only a lag in time. Wage deflation has set in southern Europe: nominal real wages have been decreasing for the last two years in Spain, Portugal and Greece.

1. Like for instance Benoit Coeuré, stating in the French newspaper *Les Echos* on the 25/11/2013, that according to him, the disinflation phase should continue in Europe « *but without changing into deflation because of the start of an upswing* ». Translated by the authors [Selon lui, la phase de désinflation (c'est-à-dire un ralentissement de l'inflation) devrait se poursuivre en Europe « *sans pour autant se muer en déflation (une phase de diminution générale et durable des prix, NDLR) en raison d'un début de reprise de l'activité économique* »].

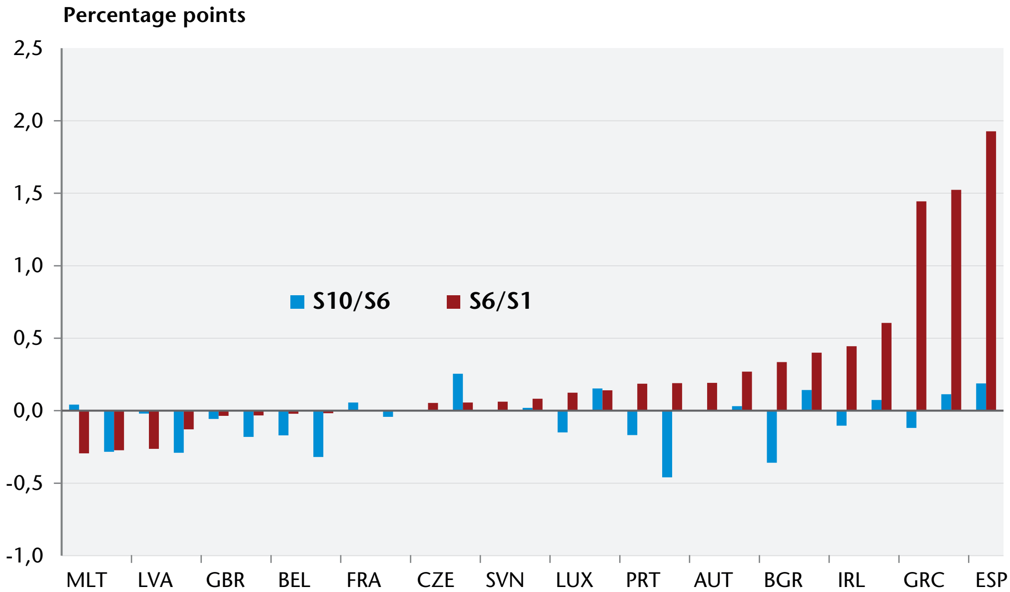
Competitiveness in Spain is thus "improving" by more than 5% per year relatively to other trade partners. That process will go on while unemployment is high, and given the current level and expected speed of reduction, it is easy to anticipate how long that pressure will continue [see chapter 3 of the iAGS 2014].

Frontloading the deficit reduction has fuelled this process. Continuing the fiscal squeeze will certainly not stop it. Moreover, what is happening in Spain will initiate the same in other countries. We need to remember that in the 20's and 30's, when the gold standard was preventing devaluation, wage deflation in Great Britain (Churchill), in Germany (Brüning) or in France (Laval) ended in generalized deflation, led to an increase of the real burden of the debt and ultimately to the collapse of the "peg". The reason is simple: devaluation can succeed only if you are the only one to conduct it and if national private and public debt is devaluated as well. Neither condition is met today.

If deflation is not prevented, more unsustainable private debt will emerge. This in turn will mean more public debt, for, in this crisis, the true name of public debt is socialized unsustainable private debt. This will lead to calls for more austerity and in this spiral, the euro will break down.

Moreover, if deflation is not prevented, European households will experience an unavoidable decline in their income which will lead to a widespread increase in poverty and inequality. Granted, inequalities so far have not exploded. High incomes have been hit and lower ones have suffered reduction. But in Southern European countries like Spain, Croatia, Cyprus, Italy and Greece we can observe a striking increase in income inequality during the crisis. In Spain, Greece and Italy, the increase in inequality is driven by an increase at the bottom of the income ladder. In contrast a group of European countries, such as Belgium, the Netherland and Germany have experienced decreasing inequality (Figure 2).

Figure 2. Change in interdecile ratios, 2008-2012 EU



Source: EU SILC, Eurostat. Interdecile ratios are ratio of average decile income after transfers.

Together with increasing inequality, many Europeans, especially in Southern Europe and the Baltic countries, have experienced deterioration in the living standards of low income groups and increasing poverty rates. Not all groups in society are hit equally. Children have experienced the largest decrease in living standards since 2008. This decrease may have large long-term consequences for the concerned individuals as well as for society as a whole. The low skilled also tend to be a vulnerable group, as the risk of being poor is three times as high if you have a low education compared to if you are highly educated. Compared to other educational groups on low skilled have also suffered the largest increase in unemployment by far. The improvement in the economic situation will certainly boost higher incomes, as wealth accounts are already suggesting [more on this in Chapter 2 of the full iAGS 2014]. Meanwhile wage deflation in many countries will feed the inequalities between capital owners and the workers.

3. The way out

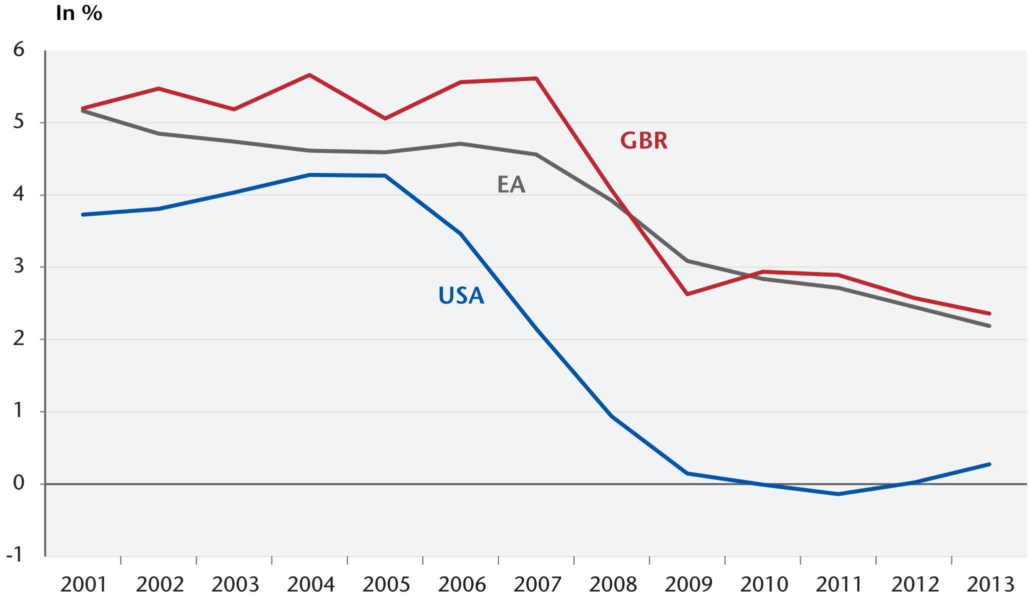
The iAGS 2013 proposed an effective alternative to the policies of austerity; the same can also be said for iAGS 2014. This is a necessity if we don't want Europe to be the "United States of Stagnation".

First, relying on institutional advances, monetary policy must substantially reduce the sovereign spreads that still exist inside the euro area. Our simulations show that such a policy can ease significantly the outcome in crisis countries. Ireland would benefit from a cumulated increase in activity of more than 3% from 2014 to 2032, while Greece and Spain would enjoy 8% higher GDP cumulated over the same period [Details of this in chapter 1]. As we argued in iAGS 2013, this aggressive monetary policy should be backed by a credible commitment of member states toward public finance stability. A well-designed debt redemption fund is one way of providing this commitment while ensuring that public investment is maintained and debt repayment is done in a way that burdens aggregate demand as little as possible.

Second, even if frontloading has been an unnecessary disaster, backloading is still an option. Public investment has been slashed throughout the crisis, accounting to a large extent for the overall consolidation (Figure 3). It is high time to stop destroying our common future and instead get back to investing in it. Simulations show that higher public investment would substantially boost GDP and reduce unemployment while improving the fiscal position, despite the higher public spending incurred.

But there is more. Climate change and the rising cost of our continent's energy dependence leave us no other option than to ensure a transition toward a low carbon economy. Chapter 4 of the iAGS 2014 presents a detailed investment plan for the EU, organized around existing energy and climate European commitments for 2020, and totalling close to 200 billion euros in annual investments for a better future. By developing alternatives to road transportation, capturing energy-saving potential through energy renovation, building up a renewable energy supply and modernizing the electrical grid throughout Europe, these infrastructure investments will help to build future wealth. As such, this Green New Deal should not be accounted for in the same way as current spending. A smart golden rule would let gross debt increase if net (of collective wealth increase) debt is steady. Moreover, it is also time to discuss the 60% limit for public debt and shift toward a new way to account for public capital. Our simulations show that our proposed investment plan, sustained to 2020, would result in an immediate boost to GDP reaching close to 2.5% in the EU. Moreover, this boost would not be only temporary, with lasting positive effects sustained long after the end of the investment plan. As a result, despite increased public spending, such an investment plan would achieve a sustained reduction of the debt-to-GDP ratio in the euro area and could contribute to more well-being.

Figure 3. Net Public Investment



Source: OECD Economic Outlook, eo93. Net public investment as a share of potential GDP.

Thirdly, poverty and inequality must be fought. Poverty and inequality is not only morally unacceptable, but is also shown to have a deep structural and socio-economic impact on the economy, in the form of leading to poor institutions, lower levels of education and, in the end, less economic prosperity. An alternative approach, consisting of a European investment plan, active labour market programs, an increase in the education level and a fairer tax system, will together reduce poverty, inequality and unemployment by creating jobs and wealth.

Finally, wage deflation has to be addressed directly. A minimum wage norm across the EU would be a brake to deflation. It would have to be implemented respecting national practices and economic situations, but it could be a powerful tool for re-balancing in the medium term the current account positions in a symmetrical way. Our simulations in chapter 3 of the iAGS 2014 show that it could in the mid- term solve the current account imbalances and ensure sustainability without risking deflation.