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Debt and Austerity in Europe: Who Will Pay for Growth?

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OVERVIEW

Bottom Line: Eurozone countries that need to ease fiscal policy cannot afford to take on more debt, while those who have the capacity to stimulate their economies do not want to.

Advocates of austerity appear to be in retreat. The idea that economic growth drops precipitously after a government's debt reaches 90 percent—a much-cited reason for fiscal consolidation—has been discredited. Steep cuts in government spending aimed at reducing national debt are damaging growth prospects in both the United States and Europe, leading policymakers and academics alike to call for austerity measures to ease up until recoveries are more firmly entrenched. In the peripheral countries of Europe in particular, a vicious cycle of fiscal tightening resulting in lower economic growth, missed fiscal targets, and financing shortfalls—which in turn require more cuts—is becoming a major concern. Advocates of more government spending note that borrowing rates for the major industrial countries remain at extraordinarily low levels, hardly signaling an imminent crisis. Thus, the case for easing austerity seems compelling.

DEBT STILL MATTERS

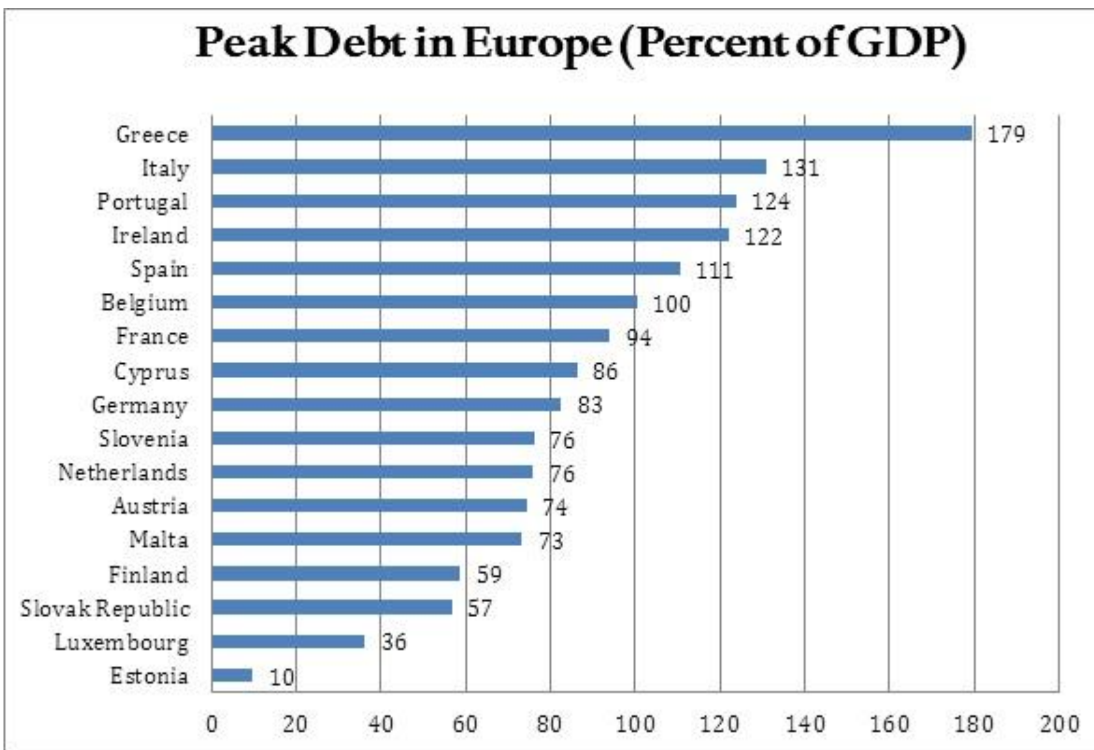
Much of the industrial world emerged from the crisis with high and rising levels of debt that limited sovereign nations' abilities to adopt countercyclical stimulus measures. Concerns about long-term fiscal and debt sustainability increased borrowing costs and limited market access, requiring several European countries to seek bailouts. Even where financing is readily available, such as in the United States, the difficult politics of fixing the long-term fiscal challenge rules out the ability to ease policy now. Across countries with vastly different debt policy situations, it may take many years before debt is reduced to manageable levels and growth returns to precrisis levels, if at all.

BUT HOW MUCH DEBT IS TOO MUCH?

The levels of public debt vary widely in Europe, and debt peaks at a manageable 90 percent of GDP for Europe as a whole. However, most peripheral European countries have surpassed the sustainable public-debt capacity they can manage on their own.

The chart below shows peak sovereign debt as a share of country GDP, using IMF data released in April 2013.

DATA IS FOR GROSS SOVEREIGN DEBT AS A SHARE OF GDP.



Source: IMF April 2013 World Economic Outlook.

Any of a number of shocks—such as a sudden rise in interest rates, a dip in growth, or an increase in government spending—would send the projected debt ratios to unsustainable levels. Last year's IMF review of Spain, for example, assumed that sovereign debt would peak at just over 100 percent of GDP in 2011 and decline gradually to below 90 percent by 2017. The IMF then looked at shocks to interest rates, growth, and fiscal policy in peripheral countries; shocks in each area sent the debt ratio soaring. Even in a rosy economic-growth scenario, markets are likely to demand a cost premium on debt due to these risks.

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Left unaddressed, the risks associated with high debt levels will have substantial costs for the economy and undermine the consensus in support of reform. Despite these concerns, the cost of borrowing in the periphery is at multiyear lows. Extraordinary ECB actions last fall—committing to "do whatever it takes" in the words of ECB governor Mario Draghi—and growing expectations of German concessions after September elections have stabilized markets. These promises and expectations are likely to be tested by future crises, underscoring both the fragility of market stability and its dependence on an implicit federalism that is, at best,

many years away. There is a delicate balance between taking advantage of low borrowing costs today and risking a loss of market confidence.

GROWTH IS ESSENTIAL

The IMF now forecasts a 0.3 percent decline in output in the euro area this year, followed by slow growth in 2014. Recent data point to a 1 percent to 2 percent decline in growth in the second quarter with little sign of a turnaround. The ECB's May 2 cut in interest rates will help, but with rates near zero and growing evidence that credit rationing is clogging the transmission of monetary easing to the periphery, an easing of fiscal austerity makes sense as the best remaining option to spur growth.

Yet, in spite of the need for growth-inducing policies, fiscal spending continues to be cut. Recent EU announcements that governments can delay meeting deficit targets will be postive for growth, but to a significant degree represents easing that was already anticipated. It still remains the case that Eurozone-wide government spending will decrease by one-half to three-quarters of a percentage point this year after adjusting for cyclical factors. From this perspective, recent announcements delaying fiscal adjustment may not reflect an easing from what was feasible earlier.

There lies the dilemma. Those countries that need to stimulate aggregate demand the most, and those where the politics would allow it are least able to take on additional debt to do so. A future fiscal union in Europe would address this dilemma by allowing borrowing costs to be spread across all EU countries rather than fall on struggling peripheral economies. For now, the IMF's solution is to call for Germany and other countries with the capacity to expand ("fiscal space") to loosen policy and allow sovereign debt levels to rise while the periphery pursues economic growth. Bailout fatigue and Germany's own confidence that its fiscal path is appropriate make this outcome unlikely.

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Absent these options, any easing of fiscal policy in the periphery requires that debt first be put on a sustainable trajectory and confidence be restored. Ultimately, comprehensive official debt relief will likely be required to reach that goal.

Looking Ahead: Kahn's take on the news on the horizon

Will Central Banks Deliver?
The Bank of Japan has promised "shock and awe," while the European Central Bank (ECB) has cut rates and hinted at more. Upcoming monetary policy meetings need to deliver.

Is Slovenia Next?
A government bond issue in Slovenia was successful, but the European Union is stepping up pressure on the government to clean up its financial sector.

Fiscal Exit Strategy
The U.S. deficit has fallen sharply, pushing back the debt limit until September/October. Hopes are fading for an extension linked to corporate tax reform. Is there a plan B?