The End of Austerity in Europe?

blogs.lse.ac.uk/eurocrisispress/2015/01/28/the-end-of-austerity-in-europe/

Eurocrisis in the Press 1/28/2015

By Max Hänska

After a spectacular swing to the left, away from a political establishment that ruled the country uninterrupted for decades, Greece's election signals the changed mood that is taking hold of Europe. Austerity has failed. What economists have been saying all along, has now been loudly affirmed by the electorate.

I take it as a given that Greek debt is unsustainable in the long run, and that austerity measures have precipitated a spiral of economic contractions that have aggravated economic woes—this much, at least, should be uncontroversial. But identifying the problem is the *easy* part. Finding a workable solution is the *hard problem*. In finding a solution Europe faces an economic and a political challenge.

The economic arithmetic

Greece rightly wants to get a reprieve from cuts that have battered the country for close to half a decade. The question is how to fund additional spending?

Greece is running a small primary surplus (before servicing debt), so in theory it could decide to default on its loans (though the government has declared it will not default), strengthen its tax base by fighting tax evasion and direct additional revenue towards spending, instead of servicing debt.

However, reneging on its obligations would probably also force the ECB to retract its liquidity line to Greek banks—which have been drawing heavily on the ECB to remain liquid as capital flight has remained high. Disrupt this liquidity line, and Greece will have a banking crisis on its hand. To raise the money to shore up its banks without external funds (it is not clear that this would even be possible), it would have to cut public spending even further than it has already done, in turn suffocating the economy and reducing its tax base. A banking crisis would probably precipitate more cash-in-hand transactions further decreasing declared income, and thus tax revenue.

Greece could exit the Euro (though the government has also declared it will not do so, and how an exit would work is anyone's guess). But, hypothetically, how much confidence would a new drachma enjoy? Presumably wherever possible Euros would be used in cash transactions, no matter what new currency the government decides to institute, reproducing the problem of a shrinking tax base. Either way, the state would soon find itself short of the necessary cash to pay wages, pensions, etc.

How could a negotiated debt-restructuring—a write-off, extended maturity, or interest rate reduction—look like? Roughly 16% of Greek debt is held by the IMF and ECB, the former has always insisted on full repayment. If Greece manages to get concessions beyond extended maturities from the IMF (i.e. a write-off) this would be unprecedented. The ECB cannot accept a write-off because it would be in outright breach of its mandate (monetary financing of states). If it did this would cause a constitutional crisis of the euro system. In any case, the ECB has played its last card. Interest rates are effectively at 0%, and it is now soaking up government debt to the tune of around 3000 euros per Eurozone citizen to counter deflation. Unfortunately, as is the case in a borderless world, most this additional liquidity will flow towards the strongest economies, instead of generating demand in the weakest ones.

60% of Greek debt are EU loans guaranteed by Eurozone member states. A reduction of debt would activate these guarantees and effectively require other members to repay Greek debt. With 56bn Germany is the larger guarantor, followed by France, Italy and Spain. Would all guarantors take a proportional hit? What about Portugal, which has a lower minimum wage than Greece? And how would the activation of these guarantees affect the budgets of Italy, for instance? Given these challenges, an outright write-off seems improbable, extended maturities and more

favourable conditions more likely.

The remainder of Greek debt is held by private creditors, but these are surely hold-outs who will insist on full repayment at some point down the line, as they did with Argentinian debt.

Furthermore, if we are talking about an end of Austerity (and thus extra cash for public spending) across Europe, the arithmetic changes. We would no longer be talking about guarantees, but debt-mutualisation, or Eurobonds.

The political challenge

This leads us to a set of political problems that some commentators prefer to overlook.

To be sustainable, and realistic, mutual debt, sufficient for a significant stimulus, would require a political vehicle, a European fiscal authority with some real capacities to effectively coordinate European economies. Such a capacity would need to include the ability to raise (at least some) taxes to fund itself independently. This would require the ability to create its own tax raising institutions where existing ones are inefficient. Without some bona fide capacities it is hard to see how Eurobonds would allow Europe to borrow at reasonable conditions (i.e. at rates much closer to current German than Greek borrowing costs). Such a political vehicle would also have to negotiate the best way to spend common funds to stimulate growth.

Without such a capacity Eurobonds would effectively allow Greece and Italy to vote that Germany should give them money, without Germany having any influence on how it is spent. The moral hazard created by such arrangements would hardly be conducive to wise fiscal policy.

The fears that debt-mutualisation without some coordinating capacity would remove any incentive to reform, are real. Syriza has already suggested that it will reverse the dismissal of civil servants. But unless it starts re-hiring on the basis of need (e.g. to strengthen the capacity and efficiency of greek tax authorities) and individual merit, instead of simply reinstating their supporters, thus continuing clientelistic practices that caused Greece's political morass, there will be no confidence that any additional public spending will be used to pursue meaningful reforms.

It is clear that austerity must end. The real problem for the Eurozone is finding a political vehicle to raise funds for, and effectively implement a stimulus.

Note: This article gives the views of the authors, and not the position of the Euro Crisis in the Press blog, nor of the London School of Economics.

Max Hänska is a postdoctoral fellow in the Multidisciplinary Opinion and Democracy Research Program at the University of Gothenburg, an associate at LSE IDEAS, and the lead investigator on the Euro Crisis in the Press project.

Related articles on LSE Euro Crisis in the Press:

Syriza's win and the Greek elections: many shades of grey

Greek elections 2015: a short overview

Crisis Discourses in Europe: Media EU-phemisms and Alternative Narratives