Austerity Measures in the Current European Debt Crisis

What drives governments to choose these unpopular policies?

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1. Introduction

Austerity Measures in Europe

This paper tries to analyze what has driven several European countries of the so-called "periphery" to carry out very unpopular austerity measures that has proven to hurt the politicians in charge in following elections. In this sense, this paper does not try to determine whether fiscal consolidation is effective to solve the current European debt crisis. Besides, due to the extremely complicated nature of this crisis, this paper will not try to describe what are the causes and possible solutions to it either.

Currently there is an intense international debate on which solution suits best the recent European debt crisis that has affected so many countries of the Euro-zone. Actually the debate is whether austerity measures or fiscal consolidation (tax hikes and spending cuts) are better than expansionary measures to promote growth (such as Central Banks lending to banks, the purchase of bonds and stocks and throwing money into the market among others).

Despite all the controversy and popular opposition, the reality is that many European countries are following austerity measures during the debt crisis, so in relation to this topic, this paper tries to describe what is behind the decision taken by these democratically elected governments to carry out fiscal consolidation this way.

Apart from the most typical measures of fiscal consolidation, which consist on raising taxes and cutting public spending, other proposals have been suggested to solve the crisis, such as for example the creation of a European Financial Stability Facility or EFSF, a

Franco-German Pact on Fiscal Stability that was designed by former president Sarkozy and Merkel, etc.

In order to analyze the reasons that lead governments to choose austerity measures, it is important to first understand, at least in part, the causes of the debt crisis. In this sense, there are both economic and political causes.

As for economic reasons, according to a publication of the European Commission, the current European debt crisis can be considered at least in part as a result of transferring liabilities linked to the financial crisis "from private –banking- sector to the public sector" [BARRIOS et al., p. 4][1]. In another publication by The Economist[2] the following statement can be found: "virtue in the core was dependent on vice in the periphery" [The Economist 2011, p.6]. What it explains is basically that the periphery could enjoy booms fuelled by debt, while the core could still grow through exports, despite a weak domestic demand. So for example, while Germany had a current-account surplus of almost 7% of GDP, some countries in the periphery had current-account deficits larger than 10% of GDP (figures in 2008). Another economic cause of the crisis is the fact that although periphery countries have lost competitiveness in a way wages has grown faster than productivity, these countries cannot depreciate their currency against their trading partners. Currency devaluation would lead to an improved balance of trade, growth in GDP and growth in tax revenues. However, due to monetary policy inflexibility, indebted countries cannot print

[1] BARRIOS, et al. (2010). European Commission. Directorate-General for Economic and Financial Affairs, "EU fiscal consolidation after the financial crisis. Lessons from past experiences", European Union (Brussels: July).

[2] The Economist, (2011). "State of the Union: Can the euro zone survive its debt crisis?", Economist Intelligence Unit (London: March).

money to pay creditors and ease their risk of default, as it is also explained by The Economist.

As for political causes of the European debt crisis, one of the most remarkable ones is the financial markets' lack of confidence towards the indebted European economies. Another one can be the role of Rating Agencies as a huge influence in the previously mentioned lack of confidence. Finally, a third reason can be the disagreements between European leaders that defend their interests on how to solve the crisis. This third reason can lead to the lack of confidence by the markets as well.

Research methodology

The methodology used for this paper has been secondary research, so a large number of newspaper articles on the debt crisis, the bailing out of the banking sector, political situation in Germany and Spain and effects of fiscal consolidation published in Germany, Spain, the UK or the U.S. have been used for this purpose.

This paper has also used working papers on fiscal consolidation and its effects by IMF, the European Commission and Central Banks, in order to explain why there is such a rejection by the general public of austerity measures.

2. Argument

Literature Review

There are a large number of working papers and other kinds of literature on fiscal consolidations, studies that analyze whether these policies are beneficial in the short, medium and long-term, etc. As it was already mentioned in the introduction, although this paper does not try to find any answer to the question of fiscal consolidation as a good or bad measure during a debt crisis, it is important to review the literature on this topic, in order to be able to understand the reasons why the population rejects these austerity measures.

After reviewing some literature on austerity measures, it can be said that the basic definition of austerity measures, which are common in all papers, is that they are a combination of tax hikes and spending cuts. On the other hand, the term "austerity measures" can also be referred to as "fiscal consolidation". So in this paper both terms will be used alternatively, as the reader could already notice during the introductory part.

A working paper by the IMF[3] published in 2010 mentions that currently there is the highest average budget deficit of advanced economies in 50 years, so in 2007 it represented only 1%, while in 2009 it rose to 9% and in 2010 reached 100% [IMF 2010, p.93].

In this IMF paper on the macroeconomic effects of fiscal consolidation, the basic research questions were on which would be the short-term effects of fiscal retrenchment on economic activity, the role of monetary policy, composition of the package (taxes against

[3] IMF, (2010). "Will It Hurt? Macroeconomic Effects of Fiscal Consolidation," World Economic Outlook (Washington: October).

spending), the perceived risk of sovereign default and simultaneity of deficit cuts, etc. Other research questions in this working paper were the influence of interest rates and the long-term effects of austerity measures to the economy [IMF 2010, p.93].

One of the findings in the IMF paper were the "contractionary effect on output" (if fiscal consolidation with a value of 1% of GDP takes place, then GDP decreases 0.5% and unemployment rises 0.3% in a period of two years [IMF 2010, p.94].

Other findings are that the reduction of interest rates supports output, so "in case of near zero levels, fiscal consolidation is more costly", [IMF 2010, p. 94] the positive effect on exports of a decline of the value of currency in a country, the fact that "spending cuts have less contractionary effects than tax-based adjustments" and "monetary stimulus is weak following indirect hikes such as VAT" [IMF 2010, p. 95].

Finally, two other major findings by this IMF paper were that there is less contraction in the case of sovereign default crisis countries, and that there are positive long-term effects (that meaning less debt, more private investment and lower interest rates).

In another working paper by Barrios et al.[4] at the European Commission on the lessons learnt from fiscal consolidation being carried out after past financial crisis, the main questions are when is the appropriate timing for fiscal consolidation in relation to the economic recovery, the role played by the current financial crisis, the macroeconomic adjustment mechanisms (especially the exchange rate) and what are the similarities

[4] BARRIOS, et al. (2010). European Commission. Directorate-General for Economic and Financial Affairs, "EU fiscal consolidation after the financial crisis. Lessons from past experiences", European Union (Brussels: July).

between the current debt crisis and other debt increase episodes in the past, as well as trying to find the definition of a successful fiscal consolidation.

This paper describes the current economic context in Europe as a period in which government debt ratios are rapidly growing, as a result of the financial crisis, increasing government deficits, low economic growth and support to the financial sector [BARRIOS et al. 2011, p.3].

Among the most relevant findings in this paper, it can be found that "restoring the financial sector is a precondition for achieving successful fiscal consolidation", while in the aftermath of a crisis, it is less successful (gradual fiscal consolation against "cold shower") [BARRIOS et al. 2011, p. 29].

Then, high debt levels have an incidence on the success of fiscal consolidation, while the influence of exchange rate depreciation or devaluation is inconclusive due to the numerous exceptions reviewed in this European Commission paper.

After reviewing these two first papers on economic features of the current crisis and the fiscal consolidation, a more social approach to austerity measures effect is a paper on the distributional effects of fiscal consolidation by Callan et al.[5], at the Institute for Social and Economic Research. This research compares the distributional effects of austerity measures introduced in 6 EU countries (Estonia, Ireland, Spain, Portugal, UK and Greece) after the 2007-08 financial crisis. Then, the main research question is the impact on income poverty and inequality.

[5] CALLAN, et al. (2011). Institute for Social and Economic Research, "The distributional effects of austerity measures: a comparison of six EU countries," University of Essex (Colchester: December).

The findings show that "how the cost of the crisis is distributed has implications for the prospects for macroeconomic recovery, financial stability, as well as the political acceptability of pathways in this direction" [CALLAN, p. 16]. Then, "high income households contribute a larger proportion to public pay cuts" (except in the case of Portugal and Estonia), "VAT increases change the shape of the burden", "measures fall less heavily on older people" [CALLAN, p. 17] (except in Greece), "the risk of poverty increases especially in Ireland and Portugal" [CALLAN, p. 18], and "changes to benefits and pensions hit those on low income the hardest" [CALLAN, p. 26].

After some of the key points on this topic has been described through the review of these three working papers (by the IMF, Barrios et al., and Callan et al.), it is easier to understand that there is still room for debate on whether austerity measures are good or bad in the current situation for Spain, so the public opinion totally rejects them.

Dependent variable

The dependent variable is this paper is the fact that, although fiscal consolidation is unpopular and vastly opposed by the public, governments affected by the debt crisis in Europe still choose to take austerity measures. Of course, this is very risky for the governments themselves, because it can affect negatively in the next elections.

Independent variable

The independent variables the paper takes into account in order to explain the dependent variable are the IMF and central banks' recommendations, the pressure to periphery governments (in this case Spain) by some political leaders from core Euro-zone states like Germany, the differences between right and left wing political parties and their position towards fiscal consolidations and whether this is a factor that affects the decision to undertake fiscal consolidation, the views of rating agencies, and finally the public opinion in both not debt countries (Germany) and indebted countries (Spain) to see how differ to one another and whether this explains the dependent variable subject to analyze in this paper.

Controlled variable

The variables that are going to be controlled in this paper are basically monetary inflexibility in the Euro-zone, and other economic factors such as GDP levels in both Germany and Spain, etc. Besides, in the comparison between both countries, this paper will not include the case of Greece (involved in the crisis by mismanagement of public finances), since it is far different from the crisis in Spain, which was motivated by the banking sector and the housing bubble burst.

Hypothesis

In order to understand what makes governments such as the current one in Spain choose unpopular fiscal consolidation against the public opinion, it is important to think about it in an international and political context.

The hypothesis in this paper is that two different levels of Europe (core and periphery) which are represented by the examples of Germany and Spain, has made some countries with better economic conditions after the global financial crisis (Germany) impose too tough austerity measures that are mainly suffered by the periphery (Spain). In this sense, stronger countries can decide on policies of weaker countries.

However, since every hypothesis needs a counter-hypothesis, it is also interesting to see to what extent Spain has to accept imposed austerity measures without much resistance, or whether if there is any alternative for Spain to negotiate any kind of conditionality. At the same time, it is important to see to what extent Germany can concede to the Spanish demands. Since the role of Spain can oppose and actually balance decision-making between both countries, a further analysis on what way Spain can do that is also required in this paper.

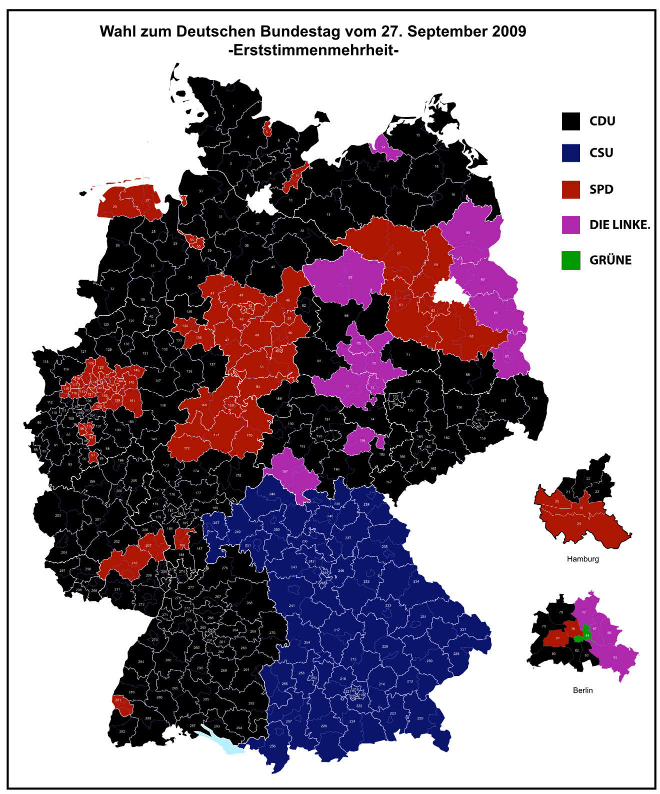
Main political reasons on why choosing austerity measures

This paper is only focusing on the political causes or reasons why the Spanish government is carrying out austerity measures, so a comparison between the situation in Germany and Spain is relevant in order to successfully develop the hypothesis of this paper.

The basic political reasons that will be analyzed in this report are the following: 1) politics in both core (Germany) and periphery (Spain) economies before and during the crisis, taking into account whether their leaders are from right or left wing political parties, 2) pressure to the Spanish government from core political leaders, 3) the role of Rating Agencies as a huge influence in the lack of markets' confidence, and 4) what are the major Central Banks and IMF saying about it.

Politics in Germany and Spain *before* the crisis

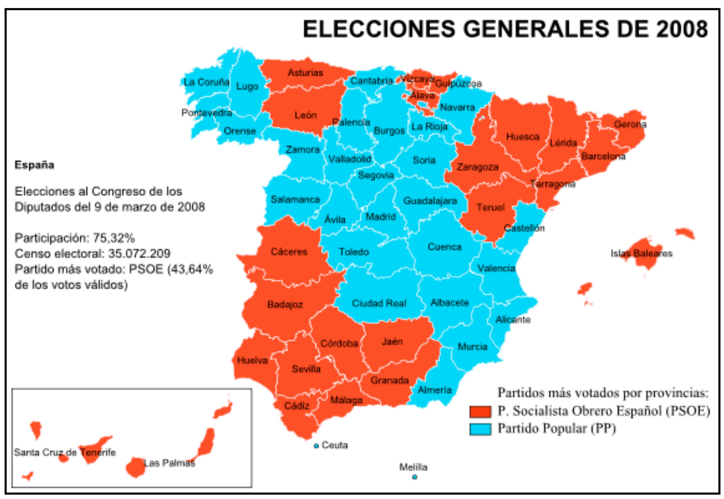
If we look at the politics in Germany and Spain before the crisis, the most remarkable difference is that while in Germany the ruling party was a right wing party, in the case of Spain it was a left wing party. In the latest German federal election in November 2009, the coalition between the CDU (*Christlich Demokratische Union Deutschlands*, or Christian Democratic Union), the CSU (*Christlick-Soziale Union in Bayern*, or Christian Social Union) and the FDP (*Freie Demokratische Partei*, or Free Democratic Party) won the election and formed a center-right government with Angela Merkel as the Chancellor.



Note: Parliamentary districts results in the German Federal Elections (2009)

Although at that time the coalition between CDU and CSU had the lowest share of votes in 60 years, their main political rival, the SDP (*Sozialdemokratische Partei Deutschlands* or Social Democratic Party) had its worst result in history. So these results can be understood as even though the center-right coalition had lost votes in this election, the fall of votes of the center-left SDP was even more significant.

The case of Spain is very different. The center-left wing PSOE (*Partido Socialista Obrero* Español, or Spanish Socialist Workers' Party) won the general elections in 2008 again, and almost achieved an overall majority of seats in the Congress, against the conservative PP (*Partido Popular*, or Popular Party). José Luís Zapatero was reelected as PM. These results reflect how the majority of the Spanish population preferred at that time liberal, left-wing policies rather than conservative, center-wing policies.

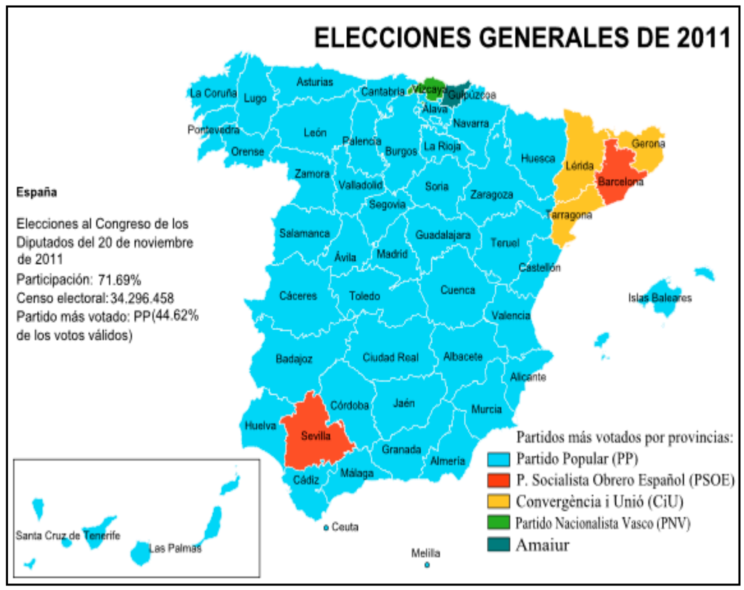


Note: Spanish General Election results (2008).

Politics in Germany and Spain *during* the crisis

Since both democratic elections results were known before the debt crisis in Europe became such a problem, it is easy to see what the trends in both countries were without taking into account the effects of the crisis. However, after the Spanish housing bubble burst effect and the start of the debt crisis, the government led by Zapatero began carrying out unsuccessful expansionary measures to improve worsening jobless rates (such as Plan E). This Plan E consisted on the government putting money to promote the construction of parks, roads, etc. However, this had the negative effect of even increasing more the fiscal deficit.

The next general elections took place in 2011. At this time, the image of the ruling party had worsened to such an extent PP vastly won in these elections. The new PM Mariano Rajoy promised during the election campaign not to increase any tax, a promise that could not be kept at all after the decision to carry out the so much unpopular austerity measures.



Note: Spanish General Election results (2011).

However, it is also important to take into account the fact that even when the PSOE was in power, the government increased the VAT tax from 16% to 18% (that is an austerity measure), while spending cuts were also taking place. That means that although the new ruling center-right party has taken a lot more austerity measures, that does not mean a center-left wing party such as the PSOE did not start fiscal consolidation.

As a conclusion to this data, it seems more or less obvious that although right wing parties feel more comfortable with austerity measures, liberal parties are also obliged to take them to some extent. Even if we see the case in Germany, where recent Länder or Regional Elections are showing how the opposition party SDP is winning against the CDU, the SDP leaders do not disagree with Merkel's vision of the necessity to stop fiscal deficit of the periphery countries in the Euro-zone as an ultimate solution for this crisis[6]. That is, both right and left parties in Germany agree on imposing austerity measures to Spain. So, left and right wing government are not a major, key reason on whether austerity measures take place or not.

Pressure to Spain from core countries' political leaders

During the recent debt crisis in Europe, it has become more obvious that foreign policies play a really big role in the negotiations between countries in the Euro-zone area. Furthermore, through these negotiations it is also easy to see which country leaders seem to be more powerful.

Since this paper tries to compare the cases between Germany and Spain, it is important to analyze the relations between the current Chancellor in Germany (Merkel) and the PM in Spain (Rajoy).

Both political leaders have supported each other during electoral campaigns in their countries, basically because both leaders are from conservative, center-right wing political parties that in many cases share the same values. In this sense, when Zapatero was still in power and was hugely criticized by the markets and international leaders for not doing

[6] GÓMEZ, J. Economía "El SPD alemán y Los Verdes se suman a Merkel en el rechazo a los eurobonos" (Germany's SPD and the Green Party support Merkel's rejection to the eurobonds), El País (May 24th, 2012).

enough to stop the fiscal deficit, Rajoy (still in the opposition at that time) and Merkel seemed to share the same opinion on what was necessary for Spain to recover from the crisis.

So when Rajoy gained power in Spain, it was not unexpected that Rajoy would try to firmly follow the strict measures recommended by Germany, first of all as a gesture of being a reliable partner in Europe, but also because Rajoy also had a similar opinion on what was good for Spain. The issue began when the harsh measures imposed to the Spanish population were not enough to recover confidence in the markets. While Rajoy tried to negotiate less hard austerity measures with Germany, Merkel avoided any kind of concession, undermining the popularity Rajoy had during the first weeks after being elected in the Spanish general elections.

Even some newspapers in Spain such as *El País* did not hesitate to state that in the loss of power of the PSOE and now the increasing loss of power of the PP, who were to blame were not the Spanish political leaders themselves but the international context and the foreign pressure represented by the markets but also by some foreign leaders.

In this regard, there is a feeling in Spain that the policies and economic measures that are now taking place in Spain are not chosen or proposed by Madrid or even by Brussels, but by Berlin. Of course, this is not the case only in Spain, but what seems clear is that fear of instability in the southern part of Europe is moving deposits and investment to the core economies such as Germany. Then, this is undermining years of efforts in Europe to achieve a credible union between countries.

Core economies see the periphery as lazy economies that have been enjoying bubbles and have been living above their possibilities[7], while in the periphery economies the image of core Europe has also worsened and it is starting to be depicted as a kind of despotic north[8].

The Franco-German Pact between Sarkozy and Merkel encouraging all debt Euro-zone countries to take fiscal consolidation is of course another way of pressure to the Spanish government to follow these rules proposed by their neighbor states' leaders.

Besides, although this is not a direct foreign pressure from a core economy, obviously seeing the example of Greece is not helping the Spaniards to stop feeling unrested. Of course the nature of the crisis in Greece is completely different from the nature of the crisis in Spain. However, the consequences of too harsh program on austerity measures in the Greek economy seem to be a reflection of what can actually happen to Spain in the near future if more expansionary measures are not carried out. Then, this is also a kind of pressure (at least a psychological pressure) to the government in Spain.

The role of Rating Agencies

There are many newspaper articles recently that try to find out how important is the role of credit agencies to motivate governments to choose austerity measures. If we look at to what extent downgrading by credit rating agencies has affected economies hurt by the debt

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[7] GÓMEZ, J. Economía "Angela Merkel advierte que nadie viva por encima de sus posibilidades" (Angela Merkel warns anybody cannot live above their possibilities), El País (June 15th, 2012).

[8] MENÉNDEZ DEL VALLE, E. Opinión "La incontenible ambición de Alemania" (Germany's uncontrollable ambition), El País (May 8th, 2012).

crisis (in this case the Spanish economy), we see that when Standard & Poor, Moody's or Fitch among other have lowered rating of sovereign debt, that has been after these rating agencies have considered that fiscal consolidation in Spain were not enough to deal with high debt levels.

Of course, this fact has made the ECB and many politicians in Spain such as the former PM Zapatero directly criticize these credit rating agencies[9]. Since this debt crisis is in part because of a lack of confidence by the markets to the Spanish economy, being downgraded by these rating agencies and being told by them austerity measures are not enough yet can definitely influence policy decision-making by the government to carry out even tougher measures so the markets can eventually rest.

It is a fact that the European leaders but also the European Central Bank are calling to investors to rely more on the moves and efforts in Europe (who seem to be not fully understood) and not to rely too much on ratings decided by the previously mentioned credit rating agencies.

That is why a lot of the criticism towards the current crisis management by the European leaders focuses on the fact that these leaders seem to make their decisions according to the rating agencies and the market as whole, rather than assisting the citizen who actually chose them to be in power of their nations.

What are the Central Banks and the IMF saying?

[9] WERDIGIER, J. Global Business, "European Central Bankers Criticize Role of Rating Agencies", The New York Times (January 12th, 2012).

In order to understand the whole context in which the Spanish government decided to take unpopular fiscal consolidation, it is important to bear in mind what are the Central Banks and the IMF saying about it.

In this sense, we see some working papers that do not necessarily share the official thinking of Central Banks, but are written by members of the Central Bank that defend fiscal consolidation as a way to solve the debt crisis at least in the long-term, as it can be read in Almeida's work by the Bank of Portugal.

On the other hand, it is remarkable that the opinion of the European Central Bank (the one that could have the most decisive role if it decided to carry out economic expansionary measures such as throwing money to the markets or lending to the CBs of the Euro-zone countries in need), is that although austerity measures and other structural changes in the banking sector, etc. in countries such as Spain or Italy are unavoidable in the current situation, a pact of growth is also necessary in Europe. Related to this recommendation by the ECB it is important to remember that the current president of France (Hollande) is actually proposing less austerity and more growth to solve the crisis. Hollande's idea seems to be rejected by not only Germany but also other leaders such as the case in Finland, who fear that sharing debt with the periphery will end up hurting their local economies as well.

The case of the IMF is also remarkable, since although the IMF considers that it is important to reach fiscal stability again, cutting government spending too fast will hurt income and make long-term unemployment worse.

Basic argument

Within the Euro-zone there are core economies and periphery economies. At the same time, we have countries with more power to decide and control rules than other. This is the case of Germany, which seems to be more powerful than Spain in decision-making within Europe. The basic difference between these two countries is that nowadays Spain is severely struggling with a debt crisis, a bubble burst, a banking sector, lack of confidence by the markets in the solvency of the economy and a huge problem with the jobless rate. However, the case of Germany is almost the opposite than Spain, and far better economically after this crisis.

In order to get out of the crisis, there is increasingly a call for expansionary measures. But in countries like Germany who are not suffering the fiscal deficits of the southern area, expansionary measures means spending more on the failures of their neighbors. In this sense, while the Spaniards demand more help from Europe, Germany demands Spain a guarantee that things will get done in a better way from now on. That means drastically cutting the fiscal deficit. The way suggested by Germany to do so is with fiscal consolidation. It is not difficult to understand why Germany tries to impose these measures to Spain. Since the debt is in Spain, further spending through the taxes paid by the German citizens to the bail out of the Spanish banking sector, etc. would definitely be extremely unpopular and very costly for the German government.

Then, Spain has little room to negotiate but accept carrying out austerity measures that will worsen the situation of the government and the leaders in power at the moment. So in the question on why the Spanish government chooses fiscal consolidation, it is obvious that the Spanish government cannot really avoid them due to the very nature of the crisis. This debt crisis is not something that can be solved only on a local level. It is also a lack of confidence from foreign investors, etc. In this sense, what is believed or thought outside Spain counts a lot. Then, Spain cannot ignore suggestions and proposals from other foreign leaders and organizations such as IMF.

Credit rating agencies do not help to improve this situation, but instead pressure even more the Spanish government to go further with the austerity measures. However, despite having all this in mind, the Spanish politicians cannot forget they have been actually elected democratically by citizen that watch what their government is doing. That means that if the government chooses to carry out unpopular austerity measures, there is a risk that at one level the population may end up rejecting them through popular unrest, riots and other episodes that could be seen in the Greek crisis.

In the press the following sentence "Spain is too big to fail" is usually used. That is the Spanish economy is too big within the Euro-zone so leaving the Euro as its currency would have terrible consequences for the rest of the Euro-zone countries. It will probably cause contagion to other countries (especially Italy but also maybe France) and perhaps it would mean the end of the common currency[10].

Although this is not a very likely scenario (Greece seemed more likely to leave the Euro but their citizen finally elected a government in favor of keeping the Euro but changing the conditionality terms established after their bail out), obviously Spain can certainly use it as a negotiation weapon with Germany. That means that in the event of Germany insisting on further austerity measures in Spain, the Spanish government can actually try to renegotiate or get concessions by the German government by arguing that the popular unrest caused by

[10] WARNER, M.B. (2012). The World from Berlin, "Europe Could Economize Istelf to Death", Spiegel Online International (Berlin: April).

the fiscal consolidation may developed into a rejection of the Euro, something that Germany clearly wants to avoid.

Then, the new political context in the neighboring France, where the left-wing party headed by Hollande won the latest elections can also help Spain find an ally or partner in the negotiations about the future banking bail out, etc. between Euro-zone countries.

Conclusion

Although this paper does not try to explain if fiscal consolidation is more positive or negative to the economies hit by the European debt crisis, it has analyzed the literature on the topic, in order to understand why these measures are so unpopular not only among the public but also about a large number of economists.

Then, it has analyzed some of the consequences of fiscal consolidation in the short-term for the economies that decide to carry them out. Finally, the paper tries to compare the cases of Spain (as a periphery economy) and Germany (as a core economy) in order to see what motivates the German government to propose austerity measures, and what motivates the Spanish government to apply this fiscal consolidation during a period of crisis.

To do this, the political context of both countries has been analyzed to see if the orientation of the political parties in power is relevant in the decision of carrying out fiscal consolidation. However, it is proved that both right and left-wing political parties take austerity measures or propose them to third countries. At the same time, left-wing parties seem to be more hesitant to these measures and usually prefer expansionary measures, such as the case of Hollande in France.

Finally, although the role of credit rating agencies, CBs and the IMF are very important and can be behind the motivation of the taking austerity measures, these do not seem to be crucial. But an unbalance of power within the European Union members seems to be the key. In this sense, Berlin is stronger than Madrid in decision-making through Brussels. Of course, this is not 100% true though, since Madrid can still negotiate through the help of strategic allies such as France or Italy, in order to get concession by Germany. At the same time, Spain can also use the example of Greece as something that has to be avoided from happening in Spain as well. That means can always argue that too harsh austerity imposed to its citizens can make Spain eventually choose to leave the Euro.

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