EUROPEAN POLICY CENTRE

POLICY BRIEF

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Achieving sustainable austerity

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BACKGROUND

After last week's summit, most of Europe is now on the road to a deepened Economic and Monetary Union, having agreed to draw up a 'Fiscal Compact'. If successfully implemented, this will limit the ability of countries to run deficits and prevent some of the unsustainable fiscal behaviour witnessed before the crisis. But will this rules-based approach address the fundamental underlying economic challenges? In other words, can it lead Europe onto a path of 'sustainable austerity', stopping the downward spiral of more austerity leading to lower growth and consequently high deficits?

The evidence suggests that it is unlikely to do so unless some of the key challenges to long-term economic performance are addressed at the same time. Many parts of Europe are still struggling to emerge from the economic crisis: growth is sluggish and the situation in many labour markets remains critical. While the relationship between austerity and growth is complex, evidence is mounting that austerity programmes are dampening economic activity and reducing investment in future growth performance, for example in education, training and infrastructure.

Many argue that this is the necessary price of appeasing the markets. But the long-term economic sustainability of eurozone economies is considered by the markets to be equally crucial. Why else would Ireland not be under even more pressure given its high deficit? Or why does Italy have such problems despite its relatively low deficit?

Without focusing on long-term economic performance, it is unlikely that improved economic governance will work. Countries must not only be willing but also able to repay their debt, which must come from renewed growth and prosperity. And without such an improvement the social cost and political acceptability of austerity programmes will rapidly diminish.

The European Economic Sustainability Index (EESI)

To examine economic sustainability in more detail, the European Policy Centre developed the European Economic Sustainability Index (EESI) in 2010. This Policy Brief updates the EESI with the most recent data. Not only does it take into account deficits (average 2011-2012) and debt levels (2011), but also considers growth forecasts (average 2011-2012)[i].

Furthermore, the EESI is oriented towards the long term: it incorporates the Global Competitiveness Index (2011)[ii], the Corruption Perceptions Index (2011)[iii] and the Labour Market Adjusted Dependency Ratio (2011)[iv]. These provide indications of how an economy is likely to perform in future. All these different factors are combined in the EESI to produce a relative ranking for all EU-27 countries[v].

Of course, no index can fully capture how a country's economy is likely to perform. There are always issues linked to each component of such an index: what are the appropriate indicators? For example, should the index also include private debt/savings, exposure to external creditors, current account positions or the cost of financing public debt (which is still generally lower as a percentage of GDP than in the pre-euro era)? What weight should be granted to each domain/indicator? How up-to-date, available and reliable is the data?

There are no definitive answers to these questions. But any analysis that fails to take into account indicators of long-term performance is both incomplete and misleading. The trajectory of the crisis will also depend on these long-term factors. Yes, the immediate financing crisis faced by eurozone countries must be addressed, but what will need to come afterwards? Can the crisis truly be resolved without a return to growth in the countries in the eye of the storm?

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Here the index can offer policymakers valuable pointers. A poor performance in the index doesn't mean that there is no chance of economic sustainability in the long term. Rather, the index suggests that those countries at the bottom of the ranking need to focus more on implementing the kind of reform that boosts efficiency and growth. It also suggests that these countries will need to do more to invest in future growth, and some of this investment will need to come from their stronger European partners.

STATE OF PLAY: THE EESI RESULTS FOR 2011

The results of the 2011 EESI show that there is some constancy at both the bottom and the top of the index. The Scandinavian countries perform best, managing to address both short and long-term challenges. The Netherlands is also in the top category – a slight improvement on the 2010 index[vi].

Estonia remains the best-performing country among the EU's Central and Eastern European member states (CEE-MS), although it is no longer quite in the highest category. Germany, Austria and Luxembourg also perform well, followed by the UK, which performs relatively well on long-term indicators. Cyprus[vii] and Lithuania have managed to move out of the danger zone, while Slovakia has slipped from the middle of the field into danger. Compared with the 2010 EESI, the rankings of Latvia, Lithuania and Cyprus have shown the most impressive improvement, while Bulgaria and particularly Slovakia have declined most.

Of the euro-crisis countries, Portugal has improved significantly by moving out of the unsustainable category[viii], joining Spain, which has remained in danger. At the bottom of the index, Italy and Greece remain a long way behind the other countries. The situation in both countries is clearly unsustainable.

But even between Greece and Italy there are clear differences: Greece is in a category of its own. This clearly justifies exceptional action, as it is unlikely that Greece will be able to move out of its current position without further support. But even the proposed 'haircut' is not the solution. With market distrust growing it is unlikely to be enough: applying a (hypothetical) radical haircut (a 50% cut in debt), as well as reducing the deficit by 50% and improving growth performance by 50% (i.e. halving the average contraction in 2011-2012), would still not be sufficient to lift Greece off the bottom of the index. At the very least, this suggests that much more attention needs to be paid to the long-term performance of Greece in order to overcome the crisis: there are no quick fixes.

How robust is the index?

One of the key questions surrounding any index is its sensitivity to any changes in the weight of its various domains[ix]. If more emphasis is put on short-term indicators (deficits and growth) and less on long-term indicators (Corruption Perceptions Index and Global Competitiveness Index)[x], it tends to improve the position of the CEE-MS: for example, Latvia and Bulgaria's rankings would improve significantly. At the same time, Ireland, France and the UK would all fall significantly in the rankings.

Applying the opposite (putting more emphasis on long-term indicators rather than short-term ones) would disadvantage the CEE-MS mentioned above as well as Estonia and Poland, while Spain, Ireland and Portugal would improve significantly.

PROSPECTS

Arresting the short-term crisis must be the current priority. The European Central Bank must step in, acting as a (temporary) lender of last resort to beleaguered eurozone governments. Eventually, some form of Euro- or Stability Bonds is likely to be necessary, with some proportion of debt being jointly guaranteed by all eurozone countries. Germany is still resisting such moves, both on moral ('rewarding unsustainable behaviour') and on economic ('how can discipline be imposed after Eurobonds?') grounds. It is also wary of being forced to potentially pay more for its own borrowing. But the choices are increasingly stark, with few credible options on the table.

Even if all this were to be put into place successfully together with a strict Fiscal Compact – and there would have to be a very tricky transition period – the big question is whether that would be enough to safeguard the stability of the euro in the long term.

The EESI clearly implies that both short- and long-term factors are important, so addressing the crisis must move beyond a singular focus on public finances if we want to achieve sustainable austerity. So what can be done beyond the current focus on the sustainability of public finances? In essence, the EU needs to concentrate on addressing growth divergence via a range of measures:

- Structural reforms must focus much more on actions which can enhance growth and create jobs. Yet, the just-published Annual Growth Survey 2012 concludes that while steps have been taken on fiscal consolidation, little progress has been made on labour market reforms or growth-enhancing measures;

- There needs to be a 'New Deal for Growth', based on investment rather than transfers[xi], with investment in future economic capacity treated differently in the emerging European economic governance system;

	Score	**2011**	2010	2007	**2010-2011**	2007-2010	**2011**	2010	Euro?
Sweden	0.76	**1**	1	8	**0**	7	**TOP**	TOP	
Finland	0.51	**2**	4	4	**2**	0	**TOP**	TOP	EURO
Denmark	0.51	**2**	2	4	**0**	2	**TOP**	TOP	
Netherlands	0.46	**4**	5	9	**1**	4	**TOP**	HIGH	EURO
Luxembourg	0.37	**5**	6	7	**1**	1	**HIGH**	HIGH	EURO
Estonia	0.36	**6**	2	1	**-4**	-1	**HIGH**	TOP	EURO
Germany	0.32	**7**	6	15	**-1**	9	**HIGH**	HIGH	EURO
Austria	0.26	**8**	8	13	**0**	5	**HIGH**	HIGH	EURO
United Kingdom	0.16	**9**	9	11	**0**	2	**HIGH-MIDFIELD**	MIDFIELD	
Belgium	0.05	**10**	13	22	**3**	9	**MIDFIELD**	MIDFIELD	EURO
France	0.00	**11**	15	20	**4**	5	**MIDFIELD**	MIDFIELD	EURO
Cyprus	-0.01	**12**	18	23	**6**	5	**MIDFIELD**	IN DANGER	EURO
Lithuania	-0.04	**13**	19	6	**6**	-13	**MIDFIELD**	IN DANGER	
Czech Republic	-0.10	**14**	20	17	**-4**	7	**MIDFIELD- IN DANGER**	MIDFIELD	
Latvia	-0.14	**15**	23	2	**8**	-21	**MIDFIELD- IN DANGER**	IN DANGER	
Poland	-0.14	**15**	12	15	**-3**	3	**MIDFIELD- IN DANGER**	MIDFIELD	
Ireland	-0.15	**17**	16	3	**-1**	-13	**MIDFIELD- IN DANGER**	IN DANGER	EURO
Slovenia	-0.15	**17**	17	19	**0**	2	**MIDFIELD- IN DANGER**	IN DANGER	EURO
Bulgaria	-0.17	**19**	14	12	**-5**	-2	**MIDFIELD- IN DANGER**	MIDFIELD	
Hungary	-0.21	**20**	21	24	**1**	3	**IN DANGER**	IN DANGER	
Portugal	-0.23	**21**	25	25	**4**	0	**IN DANGER**	UNSUSTAINABLE	EURO
Malta	-0.24	**22**	20	21	**-2**	1	**IN DANGER**	IN DANGER	EURO
Romania	-0.26	**23**	22	18	**-1**	-4	**IN DANGER**	IN DANGER	
Spain	-0.27	**24**	24	14	**0**	-10	**IN DANGER**	IN DANGER	EURO
Slovakia	-0.31	**25**	11	10	**-14**	-1	**IN DANGER**	MIDFIELD	EURO
Italy	-0.47	**26**	26	27	**0**	1	**UNSUSTAINABLE**	UNSUSTAINABLE	EURO
Greece	-0.88	**27**	27	26	**0**	-1	**UNSUSTAINABLE**	UNSUSTAINABLE	EURO

- Implementing the 'Europe 2020' strategy is crucial, especially for weaker economies;

- The internal market needs to be deepened, especially to help the crisis-hit countries to access investment capital;

- More balanced trade patterns are needed in the euro zone. This implies a shift from relying on exports to greater domestic consumption, especially in Germany;

- Monetary policy needs to favour growth – this is more important than a relatively modest increase in inflation:

- Finally, in the crisis countries political governance must be improved, including by giving technocratic governments the time they need to implement reforms.

But there is a Catch 22: markets are not fully rational. They want to see growth but they also demand austerity. Can this be reconciled? The EESI suggests that there is no alternative: there must be a credible mid-term trajectory which involves both growth and sustainable public finances. While an immediate return to healthy growth is unlikely, the foundations have to be put into place for future growth. For those countries in the most trouble, this will mean further support, potentially including a 'respite' period from the markets during which time they can put their public finances in order while maintaining the pace of reform and investment in future growth.

Despite all these difficulties, there are positive signs: Portugal and Ireland are receiving good progress reports and politically there are new starts in Spain, Italy and Greece, as well as new momentum at European level. The euro zone still has many assets it can bring to bear, including an aggregate performance which is by no means the worst among developed economies.

But much more will need to be done to address Europe's growth crises, especially if the recovery now starts to falter. This means that all of Europe is facing a long-term struggle to improve not just fiscal sustainability but also economic sustainability. If we want to sustain the euro zone, we have no other choice but to jointly encourage more growth to achieve a level of sustainable austerity.

Endnotes

i Source: Autumn forecast of the European Commission.

ii Source: World Economic Forum.

iii Source: Transparency International.

iv Source: European Policy Centre. The LMADR combines demographic projections with current labour market performance. For the EESI, the average result for 2030 and 2050 has been used. It replaces the cost of ageing in the EESI both for pragmatic(no new data is available, as the last cost of ageing report of the European Commission dates from 2009) and theoretical reasons (employment participation combined with demographics is a better indicator as it indicates growth as well as pressures on public services).

v N.B. The index neither offers an assessment of the absolute economic health of the EU or euro zone, nor an international comparison, but instead simply shows their position in relation to one another.

vi http://www.epc.eu/pub_details.php?cat_id=2&pub_id =1127

vii With Cyprus benefitting especially from its relatively favourable LMADR.

viii Portugal also benefits from a relatively favourable LMADR but also does relatively better on the longer-term indicators.

ix Using the LMADR instead of the cost of ageing does impact on the ranking for a number of countries. However, the LMADR is arguably a more appropriate indicator as it has implications for long-term growth as well as public finances.

x With both debt and the LMADR kept constant as they have both short and long-term implications: the debt will have short-term financing cost implications while the LMADR incorporates short-term labour market performance with long-term demographic projections.

xi For further details please see http://www.epc.eu/documents/uploads/pub_1277_a_new _deal_to_help_save_the_euro.pdf

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