Macroeconomic developments, policies and inequality

Introduction

In 2011 we witnessed the spread of the public debt crisis within the euro area. The central principle of the policy response to this crisis has been the escalation of fiscal austerity programmes in those member states that received financial support from the EU and the IMF and in those that have been facing increasing difficulties in the financial markets – in other words, pretty much everywhere. These fiscal policies, in combination with the European Central Bank’s tightening of monetary policy, have aborted the recovery that had been forecast for the area. The prospect of a recession in the euro area in 2012 – and, given the close economic interdependence among member states, in the EU as a whole – is now highly realistic. The irony has been that the depressed demand conditions induced by fiscal austerity in the euro zone have been making the task of consolidating public debts and government deficits ever more difficult and costly.

This chapter, while reviewing these macroeconomic developments and policy responses, also investigates their implications for income inequality between EU member states. Is there any likelihood that the catching-up process – in terms of per capita output between poorer and richer EU member states – will, under the current and currently foreseeable macroeconomic conditions, continue?

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Economic developments — the crisis is not over

Recovery aborted — risk of double-dip recession

During 2010 and at the start of 2011, the European economy appeared to have bounced back — although considerably less strongly than the US — from the Great Recession (see Figure 1.1). In the course of 2011, however, the recovery virtually came to a standstill. For 2012, the current official forecasts are bleak. Growth at such rates is actually below the historical trend of the European economy, which means that no progress can be expected in closing the output gap that has been opened up by the crisis and in reducing the sharply increased unemployment. Growth forecasts were repeatedly revised downward during 2011, as the debt crisis escalated in the euro area. With employment and unemployment figures deteriorating (see Chapter 2) and credit stagnating or even shrinking, the risk of a double-dip recession has increased markedly. The most recent forecasts are more pessimistic still — with the Institut für Makroökonomie und Konjunkturforschung (IMK 2011), for instance, forecasting a second and substantial contraction (-0.6% for real GDP in the euro area in 2012). Moreover, all forecasts are subject to substantial downside risks; the prolonged sovereign debt crisis and a possible second banking crisis in Europe, with their potential for another credit crunch, pose a major threat to the European economy, with macroeconomic policy already so stretched (see below). This would almost inevitably have an adverse effect on the US economy and the global economy more generally, where there are already worrying signs of a slowdown in until recently resilient emerging economies.
Economic developments – the crisis is not over

A lost half-decade – at least

After three years of supposed recovery from the crisis, EU27 output still remains almost 2% below its high point in the summer of 2008. Even if a renewed recession is avoided – which looks unlikely – Europe will at best experience a lost half-decade – five years with no net increase in output. In this respect, the USA appears to have turned the corner, with output growth stabilising and employment expanding.

Behind the EU average figures we see substantial variation between member states. Output losses since the onset of the crisis in the second quarter of 2008 have yet to be reversed in all but six member states, most of these small ones (see Figure 1.2). As was documented in the last edition of Benchmarking Working Europe (ETUC and ETUI 2011), the losses have been greatest in the Baltic states, in countries which have been facing a debt crisis in the financial markets, such as Greece and Ireland, Italy and Spain, but also in member states such as Slovenia, Romania, Hungary and Denmark. Countries such as France, the Netherlands, Germany, Austria and Belgium have more or less clawed their way back to the pre-crisis output level, whereas Sweden, Slovakia and, spectacularly, Poland even grew over the period as a whole.
Economic developments – the crisis is not over

Recovery on the rocks?

The forecasts for the next two years and especially for 2012 are not positive, in particular for large European economies – several of which, such as France and Germany, have so far fared relatively well – Poland being an exception. Some of the member states which are projected to grow most robustly are those bouncing back from the biggest losses; this is especially the case of the Baltics (see ETUC and ETUI 2010 and Figure 1.3 above). At the same time, what can only be described as the economic nightmare in Greece and Portugal is set to continue next year: the Commission is forecasting, almost certainly over-optimistically, a further loss of output in the region of 3% for these two countries.

Normally economies can be expected to accelerate as they emerge from a long and deep recession. In much of Europe, however, there seems to be a serious risk that an initial recovery has been snuffed out before it has had a chance to significantly improve the labour market situation and enable the (public) debts accumulated during the crisis to be brought down. To some extent, this reflects the special difficulties of an economic and financial crisis in which both households and the government are trying to repair their balance sheets at the same time and the banking sector is fragile. The comparison with the US, though, suggests that policy mistakes have played an important role, an issue we examine further below.
Government debt-to-GDP ratios rose sharply – on the EU average by almost 25 percentage points of GDP – in the wake of the crisis, as output plunged and governments ran deficits, partly automatic, partly discretionary, to cushion the crisis (see Figure 1.4). What is, on the face of it, more surprising is that, in spite of the austerity programmes implemented across the EU, starting at the latest in 2011, in some cases earlier (see below and Theodoropoulou and Watt 2011), gross debt-to-GDP ratios, far from declining, are projected to increase slightly in the years 2011, 2012 and 2013, from their elevated post-crisis levels, in virtually all countries.

These figures are a stark reminder that success in reducing government debt depends on three variables. In addition to the primary government balance (the government’s surplus or deficit before interest payments), these are the nominal growth rate and the interest rate paid on the debt. As a result of the crisis, nominal growth has been depressed, and austerity policies, by reducing demand in a context where the private sector is also trying to rebuild its balance sheets, have worsened the situation. Meanwhile, the failure to resolve the government debt crisis has led to investors, concerned about possible losses (defaults and ‘voluntary’ haircuts, as imposed in the case of Greece), demanding ever higher interest rates on the debt of countries seen as vulnerable (see Figure 1.8).
The combination of these factors means that enforced fiscal consolidation is proving self-defeating in terms of reducing fiscal positions (as foreseen in Theodoropoulou and Watt 2011).

As can be seen in Figure 1.5, the discrepancy between total and primary (i.e. excluding interest payments) government budget deficits has been particularly pronounced in member states which received financial support from the EU and the IMF, because of the large interest payments. The primary budget deficit in countries such as Greece and Portugal has been spectacularly reduced, even in the face of deep recession in their economies, yet their total budget deficits remained high and off-target, while their public-debt-to-GDP ratio also increased.
In spite of the deteriorating macroeconomic conditions, apart from a brief upturn in early 2011, fiscal policies have been contractionary since 2011 at the latest in almost all countries. Figures 1.6 and 1.7 show the evolution of the structural government budget balance (excluding interest payments), an indicator of the stance of discretionary fiscal policy (as changes in government revenues and expenditures due to the business cycle are netted out) on the y-axis and that of the output gap (i.e. the difference between potential and actual output) in the EU member states on the x-axis. Figure 1.6 shows the situation in the years 2009 and 2010. We might refer to this as a Keynesian period. Figure 1.7 repeats the exercise for 2011 and 2012, the austerity period, on the basis of Commission forecasts. In both cases, there is an association between the two in that countries with higher negative output gaps (i.e. more severe recessions) are more likely to have experienced a discretionary tightening of fiscal policy. Overall, this means that governments in the EU have been pursuing a tightening in the discretionary part of their fiscal policies in spite of a deterioration in the demand for the output of their economies. Particularly crass examples are the Baltic States in 2009/10 and Greece and Portugal in 2011/2012.
More importantly, there are major differences between the two periods (2009-10 and 2011-12). In the first ‘Keynesian’ period most countries actively steered against the crisis with expansionary discretionary fiscal policy (as reflected in a negative movement in the primary structural balance). In the ‘austerity’ period (Figure 1.7), on the other hand, all but a few countries implemented discretionary contractionary policies. This is despite the fact that the negative output gaps had closed to only a limited extent in most cases. Portugal is a striking example of the change. In the first period it sought to stimulate its economy, but was forced first by the financial markets and then by the EU/IMF conditionality in 2011 to adopt a radical austerity package, deepening and prolonging its recession.

In terms of the effects of these austerity programmes on income distribution, the first indications are that they have in several cases been regressive, affecting those at the lower ends of the income distribution more adversely than those at the top (see Theodoropoulou and Watt 2011). Even when this has not been the case though, the recession is likely to reduce the intended progressivity in the structure of austerity packages (see for example Matsaganis and Leventi 2011 for the case of Greece). To the extent that austerity is likely to lead to prolonged unemployment spells and labour market marginalisation, increases in inequality would appear inevitable.

Figure 1.7  Procyclical fiscal policy 2011-2012

During 2011, the European Central Bank raised its main refinancing rate by 25 basis points (0.25 p.p.) twice, in April and July. It claimed that this policy tightening was justified by increases in headline inflation, despite the fact that core inflation (prices excluding volatile items such as energy and food) remained contained, and by its expectation that the economic recovery in early 2011 was set to continue and strengthen. On both occasions, the increase in the spreads in the 10-year bond yields of Greece, Portugal, Ireland, Spain and Italy increased sharply (see Figure 1.8). This reflected the market sentiment that the prospects for successful debt restructuring in these countries had declined because of the higher financing costs imposed by the ECB and/or that the interest-rate hikes were more generally premature and would hit the peripheral countries particularly hard. This monetary tightening was reversed in November and December, after Mario Draghi had replaced Trichet as ECB President, and as alarming figures over the growth prospects of the European economies emerged.

At the same time the ECB has continued half-heartedly to pursue its Securities Markets Programme, buying out Italian and Spanish government bonds in order to stabilise their markets, while the debate among its governing council members over whether it should intervene more dynamically in the markets continued publicly and as the calls for the ECB to step in and act as the governments’ lender of last resort in the euro area intensified. At the very end of 2011, it offered low-interest loans not to governments but to the banking sector. At the time of writing, it was not clear whether some of these funds would find their way into the sovereign debt market; in any case, this indirect approach raises serious normative issues (subsidising banks at the expense of taxpayers). The failure to undertake a full government banker role so far, along with other failures of economic governance, has led to a spreading of the debt crisis even to member states with fundamentally sound public finances whose governments then promptly planned and started implementing further fiscal austerity measures, further stifling economic growth (see previous section).
Output growth and cross-country inequality

The dismal output growth conditions that have prevailed in the European economy since the onset of the crisis in 2008 have not only dampened prospects for the European economy as a whole but also halted or reversed the previous relative output growth developments, under which poorer EU member states grew faster than richer ones. As can be seen in Figure 1.9, during the period 1999-2007, there was a relatively clear distinction between the new member states with relatively low GDP per capita and the old member states with relatively high GDP per capita. (We use purchasing power standards here to allow for price level differences and illustrate ‘real’ living standards.) The former grew faster, reducing East-West inequality in Europe in a process that would eventually, had it continued, have led to the convergence of real per capita incomes. Overall, there was a very strong negative correlation between income levels and rates of change, implying a strong convergence trend. Partial exceptions were Ireland, which grew rapidly in spite of its high initial level and Poland where, along with Hungary, per capita incomes grew rather slowly despite their relatively low starting point.
As Figure 1.10 illustrates, however, after 2008, the GDP per capita growth rates converged between rich and poorer member states, turning very negative for some of the poorest central and eastern European countries, such as Latvia and Estonia, while some wealthy countries (Belgium, Germany) performed comparatively well. Overall, for this period there is no relation whatsoever between income levels and their rate of growth. These figures clearly suggest that the convergence process in real per capita income — that is, a clear trend towards falling inequality between national populations across Europe — has come to a halt. What is unclear is whether the convergence process will continue once more if and when the European economy as a whole emerges from crisis. While this does not necessarily affect the issue of within-country inequality (see Leschke et al. 2012), the combination of sluggish growth, mass unemployment and cutbacks in welfare spending is unlikely to be conducive to the Europe2020 goals of reducing relative poverty within countries (see Leschke et al. 2012).
What is needed instead are policies that are consistent with the perception of the euro area and the EU as the large, integrated and relatively closed economy that it has become. Generalized fiscal austerity alone, and the insistence by Germany and other core economies that current account imbalances are corrected unilaterally by those member states in deficit, are bound to make recession deeper and more widespread. Policy changes are needed to, among other things, ensure that capital flows do not grind to a sudden halt in the presence of current account imbalances while the deficit countries commit to bringing their public finances on to a sustainable path; and, at the same time, there is a need for measures to protect member states from the sometimes irrational attacks of financial markets.

The analysis of the trends presented in this chapter leaves little doubt that the EU is currently at a very critical juncture in its history. Essential objectives, such as promoting economic progress, strengthening economic and social cohesion, and establishing and maintaining an economic and monetary union, are in jeopardy. The persistent misdiagnosis of the current crisis in the euro area as rooted in earlier ‘fiscal imprudence’, and the political unwillingness to put into place all the mechanisms necessary to secure its smooth functioning, have increased the risk that the euro area may break up with unpredictable, but almost certainly hugely damaging consequences for European integration. Meanwhile, the recession that these policy responses have generated has halted the process of convergence in per capita income between poorer and richer member states. For as long as the current account imbalances within the euro area are not resolved in a symmetric fashion, the divide between the core and the periphery will persist or even widen further.

However, growing inequality among member states is not just the outcome of this crisis and the way it has been handled. Just as in the run-up to the Great Depression of the 1930s, the rise in income inequality, especially at the top of the income distribution, had reached unprecedented levels immediately before the economic crisis broke out. While the underlying causalities are controversial and have yet to be fully understood, resolving the current crisis without taking care to reduce income inequality is likely to leave in place the seeds for another crisis in the not-so-distant future, and also to damage the legitimacy of the European integration project. Yet in many countries the austerity policies have served to exacerbate existing forms of inequality.

Crisis and inequality — inextricably linked

Conclusions