

A return to austerity in Europe: feasible or fictional?

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Theme

Inflationary pressure, rising levels of public debt and the fading post-pandemic recovery may suggest the premature adoption of policies for fiscal consolidation. However, the international economic outlook and the geopolitical situation created by the war in Ukraine rule out a return to the model of growth that emerged from the financial crisis in 2008-10.

Summary

The war in Ukraine has cast a dark shadow over the EU's economic recovery. Strong inflationary pressures, growing public debt, rising public deficits and increasing interest rates bode ill for the future, suggesting the expediency of a return to the austerity policies implemented after the crisis a decade ago. However, as this analysis shows, the international context may not favour this sort of fiscal adjustment in the eurozone. The new economic and geopolitical reality, characterised by deglobalisation and rivalries and clashes between major powers, means we must rethink the 'Germanised' model of wage devaluation and export-driven European growth that has come to dominate in Europe. The path forward for European fiscal policy will be defined by the debate between strategic and normative considerations. Germany's vision will play a fundamental role.

Analysis

There are many recipes for prosperity. One is a wealthy country with full employment, abundant opportunities, a predominantly export-oriented economy and a strict tradition of fiscal discipline, as is the case with Germany. Another is a less austere economy driven by internal demand, along the lines of the US. However, if there is one lesson to be learned from the academic literature on different types of capitalism, transitioning from one model to another is far from easy. Yet the eurozone as a whole –above all the countries of the south, such as Spain– emerged from the financial and euro crises of 2008-13 with 'Germanised' economies, characterised by internal wage devaluations and austerity. The measures brought a boom in exports and led to a structural current account surplus for the eurozone as a whole. Yet they also fuelled social discontent and inequality and the rise of anti-establishment parties. The period 2014-20 can be characterised by growth, 'austerity light', monetary expansion and low inflation, despite Brexit and Trump's neo-mercantilist presidency exposing export-reliant Europe to the risks of economic disintegration. Then came the pandemic, creating an interval in which European countries joined others around the world in an unprecedented but necessary exercise in fiscal and monetary expansion. In the EU, this was combined with a coordinated and cooperative response that resulted in the Next Generation EU funds.

However, the war in Ukraine, the slowdown in the Chinese economy and rising interest rates have cast a dark shadow over Europe's prospects for economic recovery. Strong inflationary pressures, together with high levels of debt and public deficits, mean there are real concerns about what the future holds. While European fiscal rules have been put on ice until the end of 2023 (while also pending reform), some voices are already calling for a return to austerity along the lines of 2010. However, the global economic landscape has changed, with geostrategic rivalries between major powers and risks of deglobalisation. Such a context means we must now ask ourselves whether fiscal restrictions and faith in the export-driven model are the best way forward for the EU as a whole. Reflections along these lines invariably lead to the debate on the role of the State in a post-COVID world, characterised by the decline of the international liberal order and the EU's need to build its strategic autonomy and find its place in the world.

There can be no doubt that countries with a structural public deficit, such as Spain, must balance their public accounts by boosting income and/or cutting spending, and that this must be accompanied by a credible long-term strategy for fiscal consolidation. However, the EU as a whole, and the eurozone in particular, must reflect on their model of growth to give more space to internal demand.

This analysis considers the extent to which the twin approach of austerity and exports that drove the recovery from the last crisis is appropriate given the current economic and geopolitical outlook. It also reflects on the position of Germany –historically the main proponent of austerity– by analysing the prevailing values, ideas and interests of the country's elites.

All stick and no carrot

The case for early fiscal consolidation is intuitive. It was easier to sustain higher levels of debt and public deficits at the end of 2021, when forecasts pointed to a strong economic recovery with moderate inflation, without risks of the financial fragmentation of the eurozone. However, the outbreak of war in Ukraine in February 2022 has slashed growth expectations, at the same time as surging inflation has led central banks throughout the world to raise interest rates. The question is thus to what extent we will see a hard landing after the boom that followed the post-pandemic rebound and what role fiscal policy should play in a context of tighter monetary policy.

In the 2010s, rising public debt and high risk premia in certain eurozone countries were the 'sticks' used to justify the austerity policies adopted across the continent. However, in this roadmap (occasionally referred to as 'austericide' in southern Europe), the 'sticks' were combined with significant 'carrots'. Under the most optimistic take on 'expansionary austerity', cuts in public spending should be amply compensated by the rise in foreign direct investment as a result of the confidence generated by the commitment to fiscal consolidation. This hypothesis failed to hold during the euro crisis, when foreign investors were spooked by the risk of redenomination, right through to Mario Draghi's famous 'whatever it takes' moment in 2012. Nonetheless, the idea of wage devaluation as a means to promote export competitiveness still holds sway. Therein lies –at least in part– the German strength in exports, held up as a shining example for European economies in need of structural reform. It was this process of imitation –again, in part– that allowed

countries like Spain to emerge from the 2008 crisis with a healthier balance of payments. Overall, the effect of the ‘Germanisation’ of Europe’s southern economies meant the eurozone as a whole went from a current account deficit of €200 billion in 2008 to a surplus of over €250 billion in 2014, around 3% of GDP.

Prioritising exports as a driver of growth means depending more on the rest of the world than on internal demand. It is precisely here that the prospects for recovery in 2020 differ from those of 2008. Three conditions are needed for internal devaluation policies to boost exports: (1) an interconnected global economy; (2) a context in which other big countries pursue policies of fiscal expansion; and (3) the presence of trade links that do not create dangerous dependencies.

The first of these conditions –perhaps counterintuitively– has actually held up the best over the years. The end of free trade has been announced many times since 2016: first came Trump and Brexit, then the pandemic and finally Russia’s invasion of Ukraine. However, globalisation, it would seem, is in bad form. Rebuilding global supply chains will come at a cost –in terms of trade frictions and inflation– that most states and societies are unwilling to accept. Recovery plans for the pandemic have included numerous measures on strategic supply chains (eg, microchips and health materials), with a tendency towards trade regionalisation and ‘friendshoring’, which involves moving parts of production chains to economies with less assertive governments than Moscow and Beijing. The upshot has been a qualitative reconfiguration and transformation of international trade and investment. Moreover, this trend appears to be here to stay.

The second condition (the need for trade partners to embrace fiscal expansion by increasing imports) is frequently overlooked. However, it is of fundamental importance. As Martin Wolf remarked in 2009, if all countries simultaneously pursued internal devaluation, Earth would need a trade surplus with Mars. Luckily for the EU, other countries chose to pursue expansive fiscal policies in the 2010s, alongside monetary expansion, which allowed higher internal demand to drive an increase in imports. As the work of Samuel Brazys and Aidan Regan and Palma Polyak shows, the recoveries of Ireland and Germany from the crisis –countries that theoretically benefited from internal devaluation– cannot be explained in isolation from the fiscal stimulus programmes of both the US (whose technology sector is closely linked to the Irish economy) and China (which became a key destination for German exports). Moreover, as Matthew Klein and Michael Pettis remind us, the conquest of export markets can sometimes be less a symptom of economic success and more a sign of weak internal demand. As these authors show, the export-driven growth strategies of China and Germany have ultimately come to transfer their internal imbalances to the global economy as a whole.

China has doubled down on its policy of confinement to tackle the new variants of COVID-19, while, at the same time, the US Federal Reserve has begun tightening monetary policy and Biden’s economic agenda is caught in a legislative logjam. All this suggests that neither Beijing nor Washington will play the same role as in the past. The same holds for the once promising BRICS countries, which now face deep economic challenges. In short, global demand for European exports will be lower than it was following the financial and euro crises of the last decade.

The third condition (the reliability of trade partners and countries that are relied on for key products) has collapsed as a result of the war in Ukraine. Among other things, Russia's invasion has clearly shown that deepening trade ties in the face of political tensions between states can be counter-productive. Not only has such a strategy been unable to mitigate disagreements between Brussels and Moscow –or, for that matter, between Washington and Beijing– it has exacerbated a major dependence on Russian hydrocarbons, above all by Germany. It is ultimately political considerations like these, rather than the imbalances of a highly interconnected global economy that stand in the way of a return to the paradigm of open markets, which facilitated the recovery in Europe after 2008. From now on, trade policy must form part of a broader approach to European foreign policy, which will limit the dividends of an export-driven growth strategy.

The future of the EU: ideas and interests

What can we expect from the EU, given this *impasse*? Its direction will largely depend on the stance of its dominant economic power, Germany, whose priorities were key both in setting the austerity agenda in 2010 and in enabling a more proactive and joint response to COVID-19. While other eurozone countries, such as France, also have a major role to play, it is reasonable to expect Germany's stance to be decisive, since France, Italy and Spain will probably back a more 'Keynesian' strategy of moderation to restore fiscal balances in the context of the reform of the Stability and Growth Pact. The key to understanding the position likely to be adopted by Berlin lies in the debate over whether it is normative considerations –ideas and values– or *realpolitik* –material and/or national interests– that will have the greatest influence on this decision. This apparently abstract debate has very real consequences.

The constructivist interpretation, which gives primacy to ideas, is defended by Mark Blyth and Matthias Matthijs. They argue that the type of austerity promoted by Germany in the past is a *dangerous idea*. First, because it is based on a false analogy that sees countries as families or companies, where the only option in times of economic crisis is to cut down on spending.

Moreover, relying on internal devaluation to drive exports may appear promising for an economy like Germany, where unions, large companies and public authorities are used to working together to achieve shared goals and where industry is equipped to export products with high added value. However, all this is the result of highly specific historical circumstances when it comes to the country's economy and institutions. Trying to emulate them in the short and medium term is a risky strategy for the EU. This is not to say that developing a more competitive export sector is a bad idea (it is not) but that this is not enough in its own right to transform Mediterranean countries into 'Prussias of the South'. This is particularly true if, as was the case from 2010 onwards, adjustment is focused on wage devaluation and ignores other factors, such as investment in R&D and active industrial policy.

The constructivist school of thought believes that normative considerations explain the choice of austerity policies at the European level, since the dominant ideas determine the spectrum of political possibilities. An emphasis on the expediency of exporting its 'ordoliberal' development model led the German authorities to support a less than

pragmatic series of economic decisions between 2010 and 2012. Angela Merkel's refusal to mutualise the European response to the Great Recession allowed a financial and sovereign debt crisis that began in Greece (which makes up just 2% of Europe's GDP) to grow to such a scale as to threaten the future of the euro itself (a currency whose main beneficiaries have been Germany and its northern-European partners). Framing the issues related to the single currency as a divide between the 'saints' of the north and the 'sinners' of the South ignores the financial vulnerabilities of both. Moreover, austerity undermined the cohesion of the EU and fuelled the rise of anti-establishment parties. It also failed to deliver the promised reductions in eurozone debt-to-GDP ratios (due to the lack of dynamism of GDP).

On the other hand, the realist school of thought, whose greatest proponent in Europe is Andrew Moravcsik, argues that it is not the dominant ideas but interests (material and other types) that dominate the foreign economic policy of states. A recent book by Julian Germann examining Germany's primacy in Europe argues that the country's decision to impose austerity on the rest of the eurozone should be understood in terms of pragmatic as opposed to ideological considerations. These factors reflect specific features of the German economy that are often overlooked by the most superficial of the realist narratives.

First, argues Germann, we should not even regard the German economic doctrine as 'ordoliberal'. The theories of the Freiburg school fail to give the unions and the welfare state the importance they acquired in the 'social market economy' of contemporary Rhine capitalism. What Germany actually developed was an export-driven economy. This orientation is less the product of reunification and monetary union –as is commonly thought– and instead can be explained by its origins in post-war Europe. It is also the cornerstone of the Rhenish model of growth.

The exchange rate crises and stagflation of the 1970s led German governments to support policies of wage moderation and monetary discipline policies both in Western Europe and the US. Germany played a key role in ending the Keynesian post-war consensus in favour of the hyper-connected liberal economic order that defined our world until 2020. However, perhaps the most interesting aspect of all this (as the title of Germann's book suggests) is that Germany was an 'involuntary architect'. Unlike Margaret Thatcher and Ronald Reagan, who led deep economic transformations of their respective countries, German leaders sought to hold on to the socio-economic commitments forged in post-war Germany. The problem was that the country's export orientation meant that maintaining this required a world open to trade and a stable monetary order. Austerity (and to a certain extent neoliberalism), which was promoted by Germany abroad, primarily served as a means to preserve the social market economy at home.

Germany continues to walk this tightrope, although the market for its exports has shifted from Europe to the global economy as a whole, expanding its production chains across the rest of the EU. As the parts of these production chains with the highest added value remain German, Berlin has promoted austerity policies in order to 'Easternise' the economies of southern Europe, transforming them into low-cost manufacturing centres for intermediary parts for German exports (eg, car components). From this standpoint,

the purpose of austerity is not to make a 'Prussia' of the south of the eurozone but rather something more akin to a Mediterranean Hungary, designed to capture German direct investment. In this respect, the post-2010 strategy was not the product of ideological short-sightedness but of a carefully considered assessment of the position of Germany –and thus the EU– in the world.

Conclusions

The economic slowdown and the inflationary surge created by the war in Ukraine have left the EU in a bind. On the one hand, they create additional pressure for the EU to turn its back on the large-scale fiscal –and above all monetary– stimuli implemented in response to the pandemic. On the other, rapid fiscal consolidation like in 2010 may not be the best way forward. The conditions needed for export-driven growth have deteriorated significantly over the last decade. The tendency towards trade regionalisation, the economic problems facing China and the US, geopolitical tensions and the internal tensions created by austerity policies all make it impossible to emulate the strategy adopted in the wake of the global financial crisis.

Unsurprisingly, countries like Spain, Italy and France favour a more 'Keynesian' strategy of moderation to restore fiscal balance. Germany's position will be key: whether its economic priorities reflect normative preferences (as suggested by constructivist explanations) or a more pragmatic calculus of interests (the neo-realist explanation). If Berlin turns out to be moved by an ideological roadmap, it may repeat the errors of the 2010s, embracing austerity and imposing it on the rest of the eurozone. If, however, its foreign policy is based on a calculated strategy for development, we are more likely to see a reassessment of the model of economic governance promoted by Germany in Europe. This would allow a change in approach for the eurozone as a whole, replacing its vision of a small and open economy without market power with another model more like the US, pivoting towards internal demand and capitalising on the political advantages inherent to issuing a reserve currency with greater fiscal margin. This second vision, which would be enthusiastically backed by France, would be in line with the desire to build the EU's economic strategic autonomy.

Germany's decisions between 2020 and 2022 suggest it has not yet decided on its response to this question. The COVID-19 crisis led Berlin to back a more shared European response. Decisions such as increasing military spending to 2% of GDP or increasing minimum wages will increase the weight of internal demand in Germany's economic orientation. The country's new coalition government, presided over by social democrats and in which the greens wield significant influence, would appear to favour national priorities. Nonetheless, and despite showing more openness to reform of Europe's fiscal rules, the Ministry of Finance is still strongly in favour of fiscal discipline.

There can be no doubt that certain European countries like Spain need to reduce structural public deficits and continue working to stabilise and reduce debt-to-GDP ratios over the medium to long term, preferably through increases in GDP derived from growth from investment and reforms. The eurozone as a whole has a debt-to-GDP ratio of around 100%, far below the US and Japan. This gives it significant room for manoeuvre for using fiscal policy as a tool to stabilise the economic cycle and to support vulnerable

sectors that are bearing the brunt of rising energy and food prices in a context of increasing interest rates. However, going from the German mentality of a small, open, 'price taker' economy to a US-style globalised economy with strong internal demand and the capacity to shape international microeconomic and financial balances requires progress to be made on banking and fiscal union, increasing the euro's international role and the EU's strategic autonomy.