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Euro zone and Austerity

As recently as last January, European Commission President Barroso declared that the threat to the euro zone is now over. In response, the Swiss franc fell against the euro, and sovereign bond yields in peripheral economies dropped. Developments since then make one wonder whether the comment has been premature and overoptimistic. For one thing, the economy is likely to go into recession as per the latest International Monetary Fund forecast. For another, unemployment is at 12% and there is an increasing lack of trust between North and South. Is the euro zone facing the prospects of a lost decade in terms of growth and employment, thanks to fiscal austerity? The IMF has recently argued that the fiscal policies in the US, UK and Germany are unduly restrictive; the austerity debate has also been reignited by some recent research.

For a couple of months the big news of course was the crisis in Cyprus, which represents just 0.2% of the zone's GDP. Hitherto, my knowledge of Cyprus was limited to two things – the Archbishop Makarios Marg in New Delhi (God knows for what services he rendered to the cause of non-alignment or world peace for a major road to be named after the first Cyprus president!); and the board of an India-dedicated fund, of which I was a member, had debated in the 1990s whether to locate the fund in Cyprus or Mauritius (Mauritius won). Cyprus has for long been a tax haven, and lately a particular favourite of Russian oligarchs, salting their money in the euro. The result was a bloated banking sector, reminiscent of Iceland, with total bank deposits amounting to eight times GDP! Since the domestic economy could obviously not use the resources, much of the money had been invested in Greek sovereign bonds, given the historical linkages between Greece and Cyprus. When Greece could no longer service its sovereign debt and forced a massive "hair cut" on bond holders, two large Cypriot banks came into trouble, and the government had to run to Brussels for a rescue. After the usual number of long meetings extending up to early mornings, a package was finally agreed.

While the rescue amount is not large, the conditions, for the first time, involve significant losses to the depositors in the troubled banks. In the 2008-09 financial crisis, it was principally the equity and subordinate bond holders who suffered. Subsequent bank and sovereign debt restructuring has involved senior bond holders also losing money. However, hitherto the depositors were not forced to take losses; the Cyprus package has now crossed that bridge. The initial conditions required a hair cut for all depositors; this has been slightly watered down to exclude insured deposits, i.e. those below € 100,000. The larger depositors would suffer losses of an estimated 60% of the amount on deposit – partly through compulsory conversion of up to 45% of the amounts into equity of the "bad bank" being carved out of the insolvent one, and a portion of the remaining amount ceasing to bear any interest. Perhaps one need not feel too sorry for the oligarchs, but an important precedent has been set. Cyprus has also imposed capital controls restricting transfer of money outside the country: this too is a "first" for the euro zone.

The efficacy of fiscal austerity to reduce the debt to nominal GDP ratio came into question last year when the IMF revised its estimate of the fiscal multiplier from 0.6 to anywhere between 0.9 to 1.9 (see The Other Side, November 22, 2012). The implication was that fiscal austerity may lead to a bigger drop in the nominal GDP, thus worsening the debt to GDP ratio. The logic of fiscal austerity itself was based on a 2010 paper by Carmen M. Reinhart & Kenneth S. Rogoff. "Growth in a Time of Debt", evidencing that public debt to GDP ratios beyond 90% lead to a fall in GDP. (This same research paper has been used by Republicans in the US calling for a sharp reduction in the fiscal deficit.) A paper published by the Political Economy Research Institute earlier this month has identified "*coding errors, selective exclusion of available data, unconventional weighting of summary statistics in the RR research.*" This paper comes to an entirely different and positive number for GDP growth even when public debt amounted to more than 90% of GDP, after correcting the data. This incident once again points to the weaknesses of regression based econometric analysis. Apart from the errors, RR has assumed that public debt is the independent variable and GDP growth the dependent variable: arguably the causation could well be reverse with low growth leading to high ratio of public debt! Again, surely the quantity of public debt is not the only variable affecting growth: its “quality” also matters, i.e. whether it has been used for investment or revenue expenditure Moreover, there are many other factors like competitiveness of the exchange rate; the “animal spirits” of the entrepreneurs; trust in societal institutions; etc., which affect growth. Elegant mathematics should not make us overlook the qualitative, non-quantifiable issues.

Meanwhile, the problems in the euro zone continue to gather momentum. France needs more time to achieve the fiscal target; a Portuguese court has ruled that parts of the austerity package are unconstitutional; there is still no elected government in Italy, even while problems in Spain (26% unemployment), Greece and Ireland continue.

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