



# Economics in Context

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Designed for use with the Global Development And Environment Institute's *In Context* textbooks

## The Impact of Austerity Policies in Europe

As discussed in the text, in response to the global financial crisis several European countries were pressured into pursuing austerity policies. Through government spending cuts and/or tax increases, austerity policies seek to reduce national debts. While a reduction in national debt from unsustainable levels can restore market stability, such contractionary fiscal policies during a recession may prolong and deepen the downturn.

The International Monetary Fund (IMF) was among the organizations promoting austerity policies in Europe, on the basis of economic analysis estimating the impact of changes in government expenditures on real output. This analysis hinges on something called the fiscal multiplier, which the IMF assumed was around 0.5. This means that a 1% reduction in government spending will reduce real GDP by 0.5%. Based on the situation in several European countries in the wake of the financial crisis, the IMF

concluded that the benefits of lower government spending, and thus reduced budget deficits, outweighed the costs of a reduction in GDP. In Greece, for example, the IMF predicted that the proposed austerity policies would reduce GDP by 5.5%

By 2013 the Greek economy had contracted by 17%, and the negative impacts of austerity on GDP in other European countries were also higher than expected. A January 2013 paper co-written by the chief economist of the IMF, Oliver Blanchard, reassessed the IMF's estimates of the fiscal multiplier, concluding that the actual value was somewhere between 0.9 and 1.7. Not only does this imply that austerity reduces GDP more than expected, but it also means that austerity policies are less effective in reducing government debts. When austerity significantly reduces GDP, that leads to lower overall tax revenues, thus offsetting the deficit-reducing benefits of lower government spending.

Blanchard's paper notes that fiscal multipliers change over time, and may tend to be higher during recessions. If this is true, that would imply that expansionary policies, rather than austerity, might be the more desirable policy prescription. If the multiplier during a recession is, say, 1.5, that would indicate that a 1% increase in government spending will lead to a 1.5% increase in GDP, along with a concurrent increase in tax revenues. Other economic analysis by the IMF suggests that austerity policies may be advisable when an economy is expanding, but are harmful both in the short- and long-run when an economy is in recession.

Nobel Prize-winning economist Joseph Stiglitz wrote in September 2013:

The wave of economic austerity that has swept Europe in the wake of the Great Recession is at risk of doing serious and permanent damage to the continent's long-cherished social model. As economists,

Note: This update specifically relates to *Macroeconomics in Context* Chapters 15 and 16, and *Principles of Economics in Context* Chapters 30 and 31.

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including myself, have long predicted, austerity has only crippled Europe's growth, with improvements in fiscal positions that are always disappointing. Worse, it is contributing to inequality that will make economic weakness longer-lived, and needlessly contributes to the suffering of the jobless and the poor for many years. (Oxfam, 2013, p. 2)

However, not all economists agree that austerity has failed, at least not in all countries. Latvia pursued rather severe austerity measures after the financial crisis, and by 2012 it was the fastest-growing of the 27 European Union economies, with a significant reduction in its budget deficit. A 2014 paper by the IMF analyzed 91 instances of austerity policies and found that in most cases the policies were successful in reducing budget deficits.

Finally, in November 2014 the IMF's Independent Evaluation Office published a report evaluating the IMF's recommendations during the financial crisis. The report concludes that:

the call for fiscal consolidation [austerity] proved to be premature, as the recovery turned out to be modest in most advanced economies and short-lived in many European countries.

... The policy mix pursued by advanced economies had destabilizing spillover effects on emerging markets, exacerbating volatility in capital flows and exchange rates. Also, the IMF did not sufficiently tailor its advice to countries based on their individual circumstances and access to financing when recommending either expansion or consolidation. (IEO, 2014, p. Ch. 5, p. 26)

Sources:

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