

The austerity debate is beside the point for Europe

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Among the most visible symptoms of the 'euro' crisis are the high and variable risk premia that peripheral countries have to pay on their public debt. Moreover, an influential paper by Carmen Reinhart and Kenneth Rogoff suggested that a public debt level above 90% of GDP leads to a very high cost in terms of lower growth. The policy prescription for solving the crisis thus seemed simple: austerity. Fiscal deficits must be cut to reduce debt levels.

However, this debate about austerity and the cost of high public debt misses a key point: Public debt owed to foreigners is different from debt owed to residents. Foreigners cannot vote for the higher taxes or lower expenditure needed to service the debt. Moreover, a higher interest rate or risk premium just leads to more redistribution within the country (from taxpayers to bond holders) in the case of domestic debt. But in the case of debt owed to foreigners, higher interest rates lead to a welfare loss for the country as a whole because the government has to transfer resources abroad. A larger transfer to foreigners in turn usually requires a combination of a depreciation of the exchange rate and a reduction in domestic expenditure.

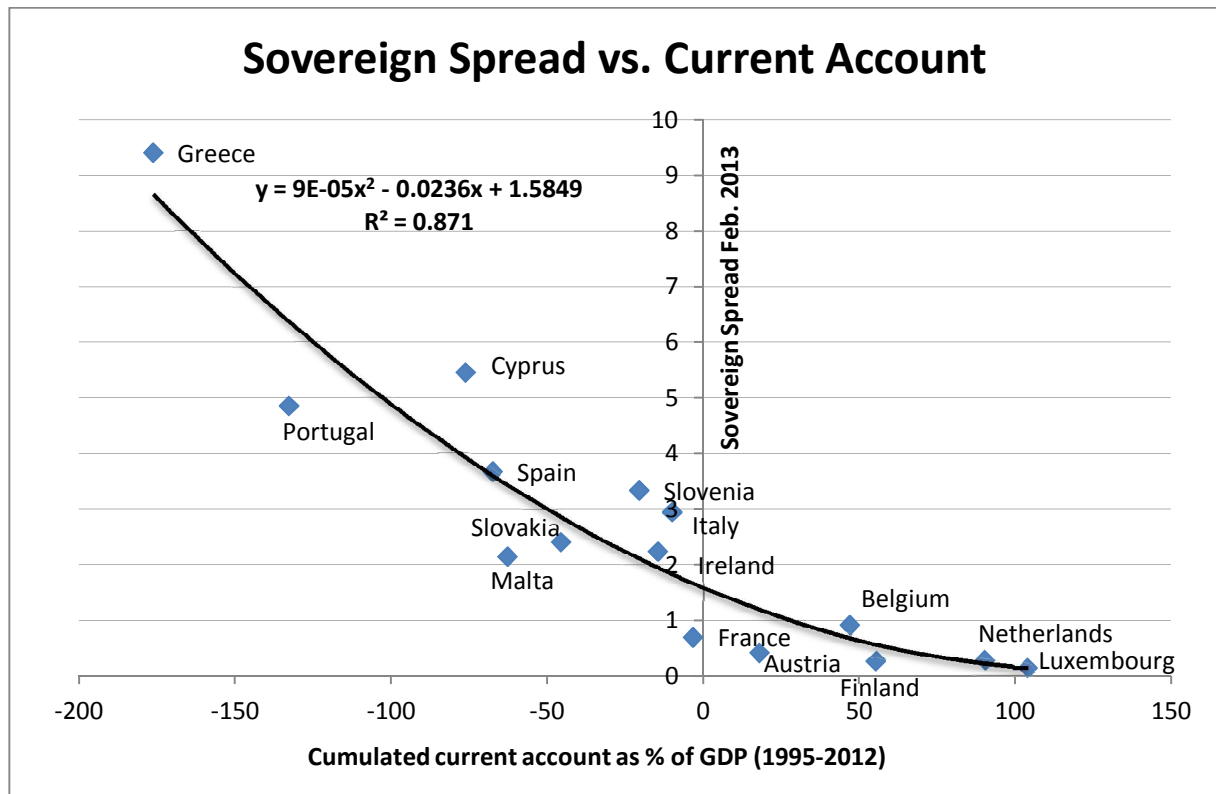
This distinction between foreign and domestic debt is particularly important in the context of the euro crisis, because euro area countries cannot devalue to increase exports if this is required to service foreign debt.

The evidence confirms that the 'euro' crisis is not really about sovereign debt, but about foreign debt. Only those countries that were running large current account deficits were affected by the crisis. The figure below shows the strong relationship between the risk spread and the foreign debt of euro area countries that had large current account deficits. The case of Belgium is particularly interesting because the risk premium on Belgian government debt has remained modest throughout most of the euro crisis period, although the debt ratio of the country is above the euro area average (around 100% of GDP) – and it managed to function without a government for over a year.

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An even starker example of the crucial difference between foreign and domestic debt is provided by Japan, which has by far the highest debt-to-GDP ratio among OECD countries, but (at least so far) the country has not experienced a debt crisis and interest rates remain, at around 1%, exceptionally low. The reason is clearly that the country has run sizeable current account surpluses for decades; and has thus more than sufficient domestic savings to absorb all this debt at home.

What does this imply for the austerity debate in Europe? If foreign debt matters more than public debt, the key adjustment variable is the external, current account deficit, not the fiscal deficit. A country that has a balanced current account does not need any additional foreign capital.

The reason that risk premia are continuing to fall in the euro area despite very high political uncertainty in Italy and continuing large deficits elsewhere is the same: the current account deficits of the countries in the periphery are falling rapidly, thus diminishing the need for foreign capital.

The debate about austerity and the high cost of public debt is thus misleading on two accounts.

First, it has often been pointed out that austerity can be self-defeating in the sense that a reduction in the fiscal deficit can actually lead in the short run to an increase in the debt-to-GDP ratio if both the debt level and the multiplier are large. However, austerity can never be self-defeating for the external, the current account, adjustment. On the contrary, the larger the fall in domestic demand in response to a cut in government expenditure, the more imports will fall and the stronger will be the improvement in the current account (and thus ultimately the reduction in the risk premium).

The experience of Italy is again instructive: the large tax increases implemented by the Monti government in 2012 had a stronger than expected impact on demand. GDP is falling so much that the debt-to-GDP ratio is actually increasing, and the actual deficit is improving only marginally because government revenues are falling along with GDP. But a side effect of the fall in GDP is a strong fall in imports and thus a strong improvement in the current account – which is the reason why the risk premium continues to fall despite the political turmoil created by the recent inconclusive election.

Second, if foreign debt is the real problem, the debate about the Reinhart and Rogoff results is irrelevant for the euro crisis. Countries that have their own currency (like the UK) or even more the US, which have the privilege of indebting themselves to foreigners in their own currency, do not face a direct financing constraint. For these countries it matters whether history suggests that there is a strong threshold effect once public debt exceeds 90% of GDP. But the peripheral countries in the euro area simply did not have a choice: They had to reduce their deficits because the foreign capital on which their economies were so dependent was no longer available.

But the reverse is also true: as soon as the current account turns into a surplus, the pressure from financial markets abates. This is likely to happen soon. At this point peripheral countries will regain their fiscal sovereignty – and will be able to ignore Reinhart and Rogoff's warning at their own risk.