# Austerity, A Threat to Democracy?

Lorenzo Bini Smaghi

Policymakers in advanced economies tend to postpone reforms and budgetary adjustment, which are politically costly, until the deterioration of financial market sentiment makes these measures unavoidable. Such a strategy is economically costly and politically dangerous. It is costly because once market sentiment deteriorates confidence can be restored only through drastic and much more painful measures. Austerity can be avoided only with a credible reform agenda. The strategy is also dangerous because the argument that "there is no other alternative" cannot be repeated indefinitely by governments that fail to act earlier. The risk that citizens may be attracted to populist solutions increases.

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Austerity measures are painful. This is why they are unpopular. It is also the reason why governments tend to postpone them until they become unavoidable. They become unavoidable when financial markets raise doubts about the solvency of the country and interest rates on the public debt rise sharply, calling into question the government's ability to refinance its debt. At that point, citizens understand that unless tough austerity measures are adopted the situation might get much worse. They are ultimately willing to accept austerity as the least worse solution.

Acting in this way may make life easier for elected politicians because they do not have to explain in detail why harsh measures have to be implemented. The responsibility is shifted to the external environment. The argument is simply that there is no alternative.

However, this is not a very efficient way to govern modern societies. It does not even pay off electorally. Even if the austerity measures avoid the worst scenario, after a while voters forget the original reason why they were adopted. They remember only the pain that the measures produced and blame the government, voting it out of office at the next election.[1]

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[1]These arguments are further elaborated in Bini Smaghi, *Austerity, European Democracies against the Wall*.

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## A vicious circle

By postponing unpopular decisions and acting only under extreme circumstances, when the danger is visible to all, policymakers enter into a vicious circle. The later they act, the more recessionary the measures are, and thus the more unpopular, which induces the policymakers to postpone them even further.

The eurozone crisis provides many examples of how this vicious circle operates. In Ireland, for instance, the government considered adopting new budgetary measures to face the mounting crisis only in November 2010, after interest rates had reached new highs. The same happened in Portugal, in the spring of 2011. In Italy, the government of technocrat Mario Monti was able to implement tough budgetary measures only in December 2011, after the spread between Italian and German government bonds had reached record levels. In all these countries, the government that implemented austerity measures lost the following elections. By the time of the vote, citizens reacted mainly to the recessionary impact of the austerity measures, forgetting that these measures were adopted in order to avoid a catastrophic event. This confirms that delaying action does not really pay off.

The perverse relationship between the way in which markets work and the political incentive to act only at the last minute is not present only in Europe. In the United States, the fiscal cliff was also only avoided at the last minute, at the end of 2012, avoiding a default on the debt.

The strategy of waiting for market pressure to convince citizens that harsh measures are unavoidable is dangerous. Indeed, it should not be taken for granted that under extreme circumstances policymakers are always able to take rational decisions, based on a thorough assessment of the pros and cons of the different scenarios. It is not clear that voters will always be willing to endorse these last minute decisions and may not be tempted, instead, to follow ‘new policies’, which are however untested. In fact, the alternatives to austerity measures are not clear cut.

## More gradualism

In theory, the budgetary adjustment needed to restore debt sustainability should be implemented in a gradual way, so as to avoid producing excessively negative effects on economic growth. However, while gradualism is desirable, governments do not have full control over the time horizon over which the adjustment measures can be spread. It ultimately depends on the financial markets’ willingness to finance the public debt and, in case of crisis, on the financial support provided by the international community.

This is one of the known unknowns. The markets’ assessment of a country’s debt sustainability is very difficult to forecast *ex ante*. Financial markets typically behave in a non-linear fashion. They may finance imbalances for a long time, until some ‘news’ related to some underlying fundamentals leads them to rapidly change their view.[2] What seems sustainable for a long time suddenly becomes risky and unsustainable. It is during these changes in sentiment that markets tend to behave erratically, each participants' behaviour being influenced by that of the others. The change in direction is unpredictable and can be very abrupt. Multiple equilibria can arise, with sudden shifts from one equilibrium to another. Markets can become severely stressed. A liquidity crisis, or a crisis of confidence, which may arise if market participants fear that they cannot rapidly liquidate their positions without experiencing major losses, can turn into a solvency crisis. At that point, the situation can rapidly precipitate and lead to financial instability. Only a very drastic reaction can avoid a crisis.

Given the above risks of market instability, one should expect governments to act in a timely way. The problem is that governments tend to look at financial markets through the rearview mirror. They consider that past and current financial conditions are likely to continue in the future as well. Governments generally do not consider the possibility of sharp reversals in market sentiment. They tend to consider that they have a lot of time at their disposal to take the measures needed in order to correct budget or external imbalances. However, it is precisely such unwarranted confidence that generates doubts in the markets about a government's ability to act, and creates the conditions for a change in sentiment and a rapid worsening of financing conditions.

For instance, in autumn 2009, when the newly elected Greek government found out that the budget deficit was much larger than expected, the market reaction was initially subdued. The government interpreted this reaction as a signal that it had a lot of time to intervene. Instead, this complacency started to raise doubts in the markets about the Greek government's understanding of the gravity of the situation and about its ability to react. Interest rates started rising sharply. The slow reaction by the Greek policymakers pushed interest rates even higher.

With the benefit of hindsight, had the Greek government immediately recognised the gravity of the situation towards the end of 2009, and acted decisively, it might have been able to avoid the sharp deterioration of market conditions. The crisis would probably have been less severe.

The responsibility for acting too late was not confined to the Greek government. The hesitations of the European authorities in supporting an adjustment program for Greece in the spring of 2010, induced market participants to believe that the gravity of the situation was underestimated. In fact, both the Greek Prime Minister and the German Chancellor, as late as March 2010, were stating in public that "Greece does not need an adjustment program".[3]

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[2]Even Alan Greenspan, former Chairman of the Federal Reserve and long believer in market efficiency, changed his mind in his recent book, *The Map and the Territory*.

[3]Press conference after the 5 March meeting in Berlin between Angela Merkel and George Papandreou.

The same assessment could be made of the events that took place in Italy and Spain between March and August 2011. As the recovery was faltering and the budgetary situation deteriorated, the two countries' governments appeared excessively confident that favourable market conditions would continue (spreads with German bonds were still below 100 basis points) and that the tough decisions could be further postponed. Spain called for early elections in the fall of 2011. Italy presented a three-year budget plan in June 2011 which however backloaded the main fiscal measures to 2013, after the next electoral deadline.[4]

As market sentiment further deteriorated in the spring of 2011, policymakers did not try to react by adopting new measures. Interest rate spreads continued to widen and reached new highs in early August. Only after the intervention by the European Central Bank (ECB), conditional on the countries' commitment to implement specific actions, did interest rates fall back to sustainable levels.

This experience shows that governments are generally inclined to believe that they have much more time than they actually have and tend to postpone adjustment measures. They initially try to adopt a gradual approach to fiscal adjustment and backload the tough measures. But if the adjustment is excessively delayed, markets have doubts about the government's determination to tackle the problem. At that point, the gradual approach becomes unsustainable and the backloading has to be replaced with frontloading in order to regain credibility.

To sum up, gradual budgetary adjustment is an alternative to austerity only to the extent that it is based on a credible strategy in the eyes of the markets. For gradualism to work, the government has to start adjustment earlier, in times of benign market conditions. However, as mentioned earlier, it is precisely the benign market conditions that deprive policymakers of the incentives to act early enough.

The ability to refinance the debt at low interest rates is seen as an indication that there is no need for immediate action.[5] This incentive is reinforced if the central bank implements extraordinary monetary policy measures that keep interest rates at very low levels, over the entire maturity horizon, in particular by purchasing long-term bonds as the Federal Reserve of the Bank of Japan does.

Without the pressure from the markets, governments tend to postpone the adjustment until it becomes unavoidable. One way to force governments to adjust in a timely way is to adopt fiscal rules, such as those foreseen in the European Stability and Growth Pact, which imposes numerical ceilings on budget deficits. However, these rules have proven to be relatively ineffective in fostering early adjustment. For instance, before the crisis, Spain and Ireland recorded apparently sound public finances, systematically below the 3 percent ceiling foreseen in the Maastricht rules. But these rules do not take into account the sustainability of

[4]For a detailed account of the crisis, see Bastasin, *Saving Europe*.

[5]This argument is often made by P. Krugman in his op-eds to suggest that there is still ample room for expansionary fiscal policy in the US.

underlying economic conditions and the possible accumulation of imbalances which may temporarily lead to a better than expected – but unsustainable – budgetary position. The new procedures on macroeconomic surveillance adopted with the 'six-pack reform' in 2012[6] should provide a better framework to induce countries to implement corrective measures in a timely way, without waiting for pressure from the markets.

Once financial markets start raising doubts about a country's debt sustainability, the room for following a gradual adjustment strategy decreases because markets are increasingly reluctant to provide more financing for a longer period of time.

## Debt restructuring

An alternative to austerity is to reduce the value of the outstanding debt through extraordinary financial measures. This solution was advocated in particular by the International Monetary Fund (IMF) to address the Greek crisis.[7] If a country cannot sustain the political costs of the necessary budgetary adjustment, debt restructuring might have to be considered at an early stage. A reduction of the stock of debt decreases the amount of budgetary adjustment required to service the debt and the size of the financial package provided by the IMF and other countries. A country's debt sustainability can be more rapidly restored if part of the debt is reduced, either through a haircut, which reduces the nominal value of the asset, or through a lengthening of maturities and a reduction in the interest rate.

This strategy seems quite appealing. It was followed in the past in some highly indebted developing countries, in particular in Latin America. In some cases, like Uruguay, the restructuring was conducted in a relatively orderly way and did not impair the country's ability to access international markets.

Actually, this solution is much more complicated and fraught with risks than would appear at first sight. There is no experience of orderly debt restructuring in advanced economies. The debt restructuring that has taken place in emerging markets cannot really be considered an example, given the different situation with respect to advanced economies.

The first difference is that the restructuring in emerging economies has mainly regarded external debt, that is debt held by foreigners. The burden of adjustment was largely borne by external subjects, typically banks. The scope of the restructuring has primarily been to avoid major disruptions in the international financial system, while allowing the country to not lose market access for too long. In the case of Uruguay, in 2002, the haircut was limited to slightly above 10 percent, which facilitated the agreement with the creditors. The restructuring was conducted in a

[6] http://ec.europa.eu/economy_finance/articles/governance/2012-03-14_six_pack_en.htm.

[7] IMF, "Greece: Ex Post Evaluation of Exceptional Access", http://www.imf.org/external/pubs/ft/scr/2013/cr13156.pdf.

relatively orderly way. Haircuts of larger size – such as the one required in the Greek case to restore debt sustainability – are much more difficult to achieve without disrupting the markets.[8]

In the specific case of Greece, a substantial part of the debt – about half – was held by domestic residents, in particular banks. A haircut reducing the value of the debt instruments, which were posted as assets by creditors, undermined the solidity of the domestic banking system, leading to a sharp contraction in banking activity, which in turn contracted credit to the domestic economy. The banking system thus needed to be recapitalised, and this could be done only with additional foreign aid provided by the international community. As a result, part of the money saved from the debt restructuring was compensated through new debt to recapitalise the banking system.

Another effect of debt restructuring is the increase in domestic savings that results from the creditors' attempt to gradually restore the value of their net wealth to pre-restructuring levels. This effect is bound to generate additional recessionary effects. The holders of government bonds, who tend to be among the poorest strata in society would be the hardest hit from the restructuring. Insurance companies would also be affected, possibly impairing the ability of pensioners to cash in their entitlements. The consequences of these redistributive effects could be quite difficult for a political system to absorb.

Another difference with emerging market debt restructuring is the contagion effect through the international financial markets. The first impact is on the other members of the monetary union. In May 2010, after the agreement on the Greek program was reached, financial markets did not calm down. They considered that Europe did not have an adequate safety net to prevent or absorb new crises. Market participants started selling Irish and Portuguese assets in the expectation that not enough funds would be made available by the euro area to avoid the default of these countries. Like the salvaging of Bear Sterns in the US, that of Greece was considered a last stand before a Lehman case.

Restructuring the Greek debt as early as May 2010, as some commentators now suggest, could have created a major financial crisis, which would have caught the euro area unprepared and without ammunition to counter the next wave of the crisis.

It took time and effort for European governments to decide and implement the European Financial Stability Facility as a temporary solution to be transformed later into the European Stability Mechanism. In fact, the discussions which led to the creation of the permanent mechanism added to the financial market instability, as the possibility of automatic debt restructuring for countries applying for the Mechanism – the so-called Deauville agreement of October 2010 – scared investors away from European debt instruments. The start of the public debate on the

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[8]See L. Bini Smaghi, "Private Sector Involvement", http://www.lorenzobinismaghi.com.

Greek debt restructuring, in April 2011, further contributed to a generalised rise in spreads in peripheral countries, and fuelled increasing tensions in the euro area until the summer of 2011, when the ECB's interventions brought back some calm.

To sum up, the mere discussion of debt restructuring in the euro area and its implementation in Greece generated widespread contagion to other countries and even threatened the survival of the single currency. It may be argued that the issue could have been tackled more effectively. Had the restructuring been engineered in early 2010, when the euro area safety net was not yet in place, it would have fuelled even greater instability, with potentially very disruptive consequences for the real economy.

Contrary to what some commentators have suggested, it is not at all easy to engineer an orderly debt restructuring in advanced economies. Such a concept – an orderly restructuring – may exist in theory, but not in practice.

## Debt sustainability

On balance, it is difficult to assess *ex ante* whether a program based on austerity measures, which can have sharp recessionary effects, is preferable to a debt restructuring, which reduces the level of the debt but may also create sharp repercussions on the domestic financial system and on domestic savings, with potentially disruptive contagion effects on the other countries.

The choice should depend on a rigorous debt sustainability analysis. If the debt is not sustainable, there is no point in implementing an austerity program which may over time make things even worse. If the debt is instead sustainable, based on a credible adjustment program, it is worth financing the adjustment, even if this requires external support.

The problem is that such an analysis is very difficult to make and is surrounded by uncertainty because it is based on assumptions about the way in which the economy will react to fiscal adjustment or debt restructuring, which can be invalidated *ex-post*, especially in the midst of a financial crisis. Furthermore, the contagion effects of a major financial disruption that can result from debt restructuring are very difficult to forecast. The Lehman Brothers' bankruptcy case shows that these effects can be hugely underestimated.

Debt sustainability is also difficult to assess because it depends on assumptions regarding the willingness and ability of the political authorities to implement the agreed measures, not only with respect to the fiscal adjustment, but also the structural reforms and privatisations included in the program.

In the case of Greece, several assumptions that were initially made in the debt sustainability analysis turned out to be wrong. First, the impact of the fiscal adjustment proved to be more recessionary. This was partly due to the rigidity of the Greek economy and partly to the excessive concentration of the adjustment on tax measures. Second, the weakness of the Greek administration impaired the effectiveness of some measures. The government's ability to implement structural reforms was overstated, as a result of the resistance exerted by political parties and various interest groups. The same lobbies opposed the implementation of privatisations. The burden of adjustment thus fell on very recessionary measures. Third, the loss of competitiveness accumulated since the entry into the euro was underestimated, which made the adjustment more painful. Finally, the measures were systematically adopted by the Greek authorities close to the deadline, rather than being frontloaded. Thus, the recessionary impact has been greater than expected, with the debt-to-GDP ratio continuing to rise.

The debt restructuring of the Greek debt was also based on wrong assumptions. Its impact on the banking system and the credit crunch were underestimated. The illusion that an orderly restructuring could be achieved initially led to a limited haircut, which proved to be insufficient. The contagion to the rest of the euro area was ignored, but fuelled a new bout of crisis in 2011-12 and brought the European economy back into recession.

As a result of this mismanagement, the Greek elections held in the spring of 2012 led to a deadlock and needed to be repeated. Only when Greek citizens saw clearly that the prolonged crisis could provoke their exit from the euro did they finally vote for the traditional pro-euro parties. The new government started implementing the program with a new spirit in the summer of 2012, slowly regaining the confidence of the markets and of its partners.

Although the Greek case is a very special one, some lessons can be drawn. First, there is no easy way out of a debt overhang. Both the austerity and the debt restructuring scenarios can be very disruptive. They should thus be avoided. However, this requires more time and more money to implement the adjustment. The key question is: who can provide the time and the money?

More time and more money to finance a gradual adjustment can be provided either by financial markets or by the international community. For this to occur, however, the adjustment program has to be credible, and ultimately successful, so that markets can be convinced that the debt is indeed sustainable.

Experience suggests that if the adjustment is based only on austerity measures, it will ultimately fail. Markets are thus going to be less and less convinced by adjustment programs based only on austerity measures, which can be self-defeating. The adjustment cannot happen only on the side of the numerator, that is the budget deficit; it has to happen on the side of the denominator as well, that is the economy's growth potential. In fact, in most cases the debt problem arises as a consequence of unbalanced or insufficient growth. It is not surprising that the crisis has affected mainly those countries whose growth potential was seriously affected by a loss of competitiveness, which led to an over accumulation of external debt.

### Structural reforms

Adjustment is credible if it seriously tackles the loss of competitiveness accumulated over time. This requires measures that strengthen growth potential. Countries whose competitiveness has been dampened either through a prolonged period of faster unit labour cost growth or more rigid labour and product markets need to implement corrective measures. This implies both a reduction in labour costs and measures to improve the functioning of the labour markets, and the liberalisation of product markets and the removal of judicial and bureaucratic barriers to investment. Only a credible reform agenda can convince investors that a gradual fiscal adjustment can be sustainable over time. This means that there is a trade-off between the gradualism of fiscal adjustment and the structural reform process, which can benefit from a favourable financial market environment and may thus be less costly for the economy.

This is consistent with experience. Germany, for instance, was able to achieve a lasting consolidation of its public finances through a delayed fiscal adjustment in 2003-04, also thanks to a flexible interpretation of the Stability and Growth Pact, in parallel with the implementation of its 20/10 reform agenda. This is also consistent with the Irish experience, as the reforms improved the resilience of its economy during the fiscal adjustment.

However, neither governments nor European authorities tend to be in favour of exploiting the trade-off between fiscal consolidation and structural reform to achieve a smoother adjustment process.

On the European side, there is no commitment instrument available yet to force member states to implement structural reforms. While it is relatively easy to assess the impact of fiscal measures, although there are sometimes wide margins of uncertainty, as seen in the Greek case, structural reforms are much more difficult to evaluate and to impose on member states. European institutions are thus reluctant to allow greater margins for manoeuvre on the fiscal side in exchange for a reform agenda. In addition, since reforms require time for implementation, an uncertain political horizon makes this type of commitment less credible. Only in countries that adhere to multiannual adjustment programs undersigned by all political parties can such a trade-off be implemented and monitored in an efficient manner.

At the country level, the trade-off is not appreciated because reforms are often unpopular. Reforming the labour or product market, liberalising professions or privatising public companies sometimes requires engaging harshly with lobbies and interest groups, which can be politically very costly. The Monti government's experience in Italy shows that it can be easier to push tax increases through parliament than structural reforms, for instance of the labour market. That is why structural reforms tend to be delayed, especially by governments that do not have a long horizon in front of them.

The typical argumentation against structural reforms is that they take time to produce their effects, and are sometimes pro-cyclical, that is they tend to worsen the cyclical situation. In dire economic conditions, the priority tends to be given to short-term relief to the economy, rather than to structural reforms. There is no understanding of the fact that, even though structural reforms produce their effects in the longer term, they have an immediate effect on confidence, especially of investors. Such confidence is needed in order to gain time and be able to implement a gradual adjustment.

Without a convincing reform agenda, markets will not provide the necessary room for gradual fiscal adjustment. As a result, governments that do not want to or cannot implement structural reforms are left with a strategy based on austerity. In other words, austerity is the result of the inability of governments, and more generally of society, to reform their economies and make them more competitive. The adjustment is thus bound to be extremely recessionary and self-defeating.[9]

Yet, a strategy of prolonged austerity, with only the alternative of debt restructuring, may put the democratic bases of society at risk. The elections which took place in Greece in 2012, after two years of austerity and debt restructuring, are a clear example of the risks of such a strategy. The rise of extreme parties, which try to exploit the desperate conditions of a large part of the population through populist promises, is hard to stop. The more the government insists on austerity, the more these extreme parties rise in popularity. Only by changing strategy towards more fundamental reform of the economy can a populist wave be countered.

## The (political) powers of central banks

The crisis has shown that one actor can play an important role in breaking the vicious circle of political paralysis and market instability. It is the central bank. The intervention by the central bank can help political authorities gain time by providing relief to the markets. But the central bank cannot solve the fundamental problems of growth potential and debt sustainability of countries that have lost competitiveness and need to undergo a profound reform process. Even without the so-called redenomination risk, that is the threat of exiting from the euro, a country that has lost competitiveness can only regain it through a painful period of wage and price moderation. But the adjustment can be made easier by a flexible and resilient economy, and well-functioning markets.

The Outright Monetary Transaction (OMT) announced in the summer of 2012 by the ECB has reduced financial market tensions and interest rate differentials. However, it has not eliminated the need to restore competitiveness in those countries that still have to put their public finances on a sustainable path. The longer

[9] L. Bini Smaghi, "Austerity and Stupidity", *Voxeu.org*, 6 Nov 2013, http://www.voxeu.org/article/austerity-and-stupidity.

the period of adjustment, the longer austerity will last, and the greater the risk of fatigue, with the inevitable political consequences.

The greatest risk is that these dangers are not fully perceived by policymakers, especially if their political horizon is relatively short. A reduction in interest rate spreads may give the false impression that the worst is over – and dilute the pressure for reforming.

This may create a new vicious circle. While governments look at the markets through a rearview mirror, markets are instead forward looking. Complacency is bound to generate new risks, sooner or later. If governments wait for these risks to materialise in order to act, they are likely to end up taking new austerity measures again, which will be self-defeating. Waiting for pressure from the markets is a dangerous political strategy. Citizens would be entitled to ask why a strategy that failed to solve the problem in the past should succeed this time round. The risk of a leap into the unknown increases.

## Conclusions

A political system that is not capable of escaping the vicious circle of delaying policy action until market pressure rises, which ultimately leads to more austerity, should agree to bind itself to a long-term commitment strategy, such as those that are made available by the international community. Adjustment programs of international institutions should increasingly be designed with a view to promoting a multi-year reform agenda, so as to allow for more gradual budgetary adjustments. The reluctance of advanced economies to request the support of international institutions is justified by the fear of losing national sovereignty. That, however, is an illusion. Countries that have lost the confidence of the markets have already lost part of their sovereignty. Linking their policies to international adjustment programs is actually a way to regain some sovereignty, and to reduce the risk of major disaster.

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