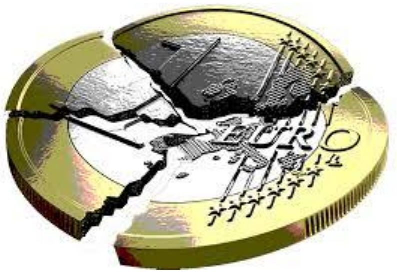

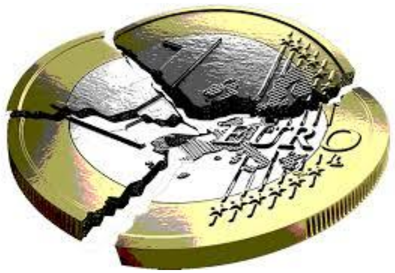

Fiscal Austerity and Wage Reduction Policies

A Fatal and Irresponsible Cocktail Imposed upon the Euro Crisis Countries as “Adjustment Programs”

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Main Message of Study & Overview

- Main message:
  - Euro crisis country “adjustment programs” – combining austerity and wage reduction policies – are a recipe for disaster & impoverishment
  - *Based on flawed mainstream theory & wishful (neoliberal) thinking*

1. Introduction: The unresolved euro crisis
2. Theoretical analysis: fiscal multipliers and “internal devaluation”
3. Empirical analysis: connection between employee compensation and private consumption expenditures
4. Proposals for alternative policies: focus on balanced growth and symmetric adjustment
5. Conclusion & outlook

1. The Unresolved Euro Crisis

- Eurozone performance unimpressive before crisis, dismally poor since
- A first class economic policy failure! Extraordinarily costly!

1. Euro regime failed to prevent intra-area divergences and buildup of imbalances; systemic fragility, accident waiting to happen …
2. When crisis hit regime was found ill-equipped to deal with it
3. Improvised policy responses – austerity and wage reductions – further magnified wreckage
4. Authorities remain in denial, generally call for more of the same

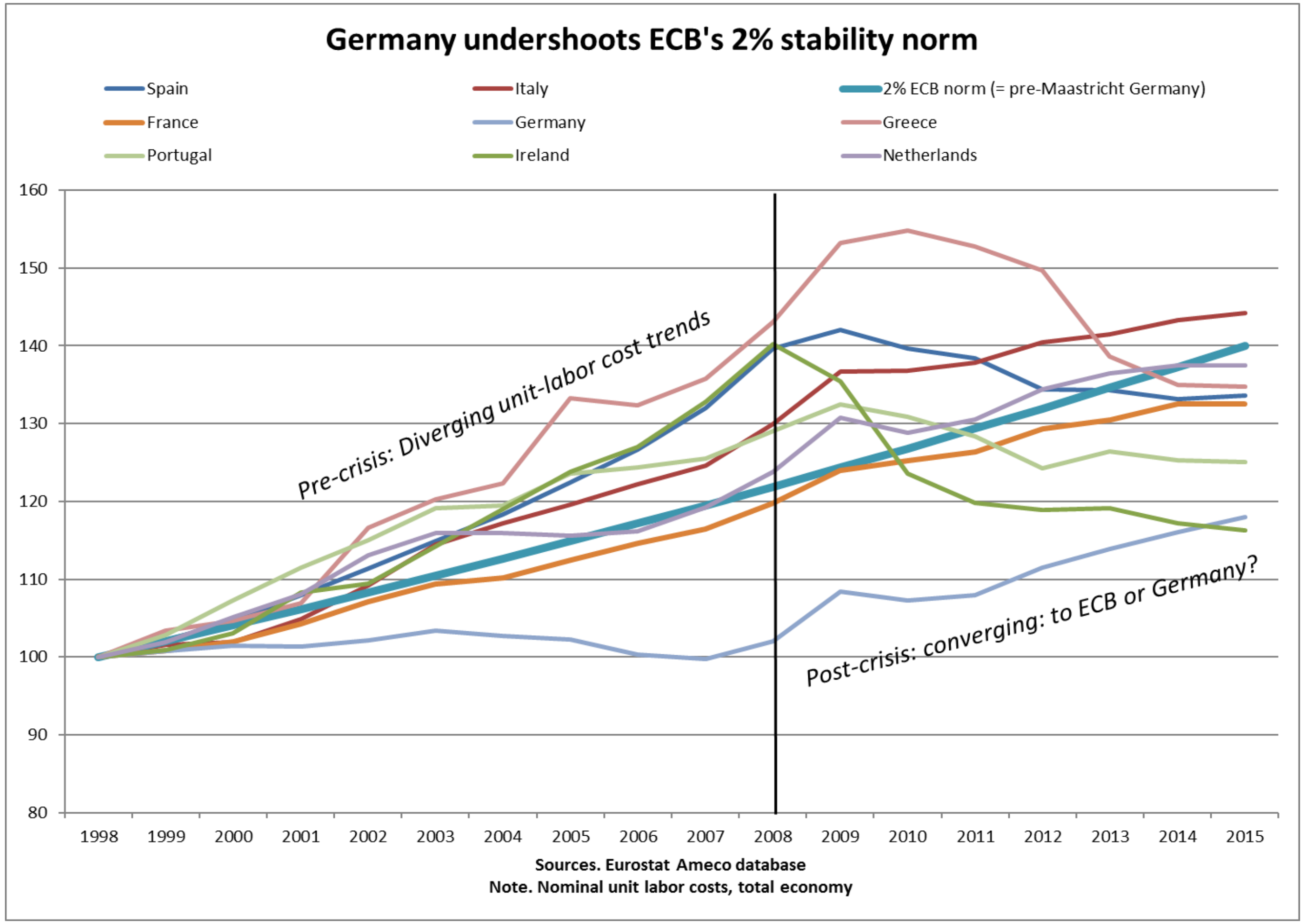
Who to blame?

1. Financial/banking crisis: blame Wall Street; *but EZ bankers & supervisors!*
2. Sovereign debt crisis: blame Greece and other profligates
3. Crisis of competitiveness: blame those who *lost* their competitiveness
4. *Today*: Lack of structural reform: blame the latecomers (Italy, France)

❖ NONSENSE!!!

1. Who designed flawed Maastricht regime?
2. Who caused intra-area divergences and imbalances?
3. Who ordered ill-guided crisis policies?
4. Who remains still in denial today?

A crisis “made in Germany”



- Maastricht regime design
- Pre-crisis policy
  - Germany reneges on euro commitment, setting EZ on collision course
- Post-crisis policy
  - Germany resists ‘internal revaluation’, forces partners into deflation
- ECB
  - Belatedly turned active since 2014, but in vain
  - Attacked in Germany!
- Who is master of denial?

2. Theory: Misled by Mainstream Follies

- Folly no. 1: Austerity does not really hurt, multipliers are small or even negative; have faith in confidence tricks
  - So imagine that austerity will bolster rather than harm growth
- Folly no. 2: Internal devaluations are largely equivalent to exchange rate devaluations
  - So imagine that wage reductions will be growth friendly (too)
- Folly no. 3: Combining austerity and wage reductions would seem to offer painless adjustment route to salvation & eternal bliss

Re Folly #1: Austerity and the Multiplier

- Multiplier idea: initial impact of austerity gets magnified
- Multiplier “optimists” look for factors that limit/compensate damage

❖BUT:

- Notion of zero/negative multiplier based on extreme assumptions
- Individually Eurozone countries may be small, but in case of jointly pursued austerity Eurozone represents large country
- Dysfunctional financial system and private sector balance sheet challenges limit compensation
- Unresponsive monetary policy denies compensation

Re Folly #2: Competitiveness and Internal Devaluation

- As inside currency union exchange rate devaluation not an option
- Wage reductions seen as substitute (“internal devaluation”)
  - “Structural reform” quickens adjustment euphemism for wage cuts/pressures

❖ BUT:

- Labor-capital substitution very slow
- Impact on **net trade** limited *if jointly pursued*
- While impact on **domestic demand** *immediate and strong*
- Wage cut is similar to tax hike on workers’ income!
  - While “structural reform” really a euphemism for wage cuts/pressures

Re Folly #3: Austerity *cum* Wage Reductions

#1: Expect **austerity** in large economy with dysfunctional financial system and unresponsive monetary policy to have sizeable impact

#2: Expect **wage cuts** to undermine private consumption as well as investment spending

#3: **Combining austerity and wage reductions** will not contain but augment the damage done to domestic demand

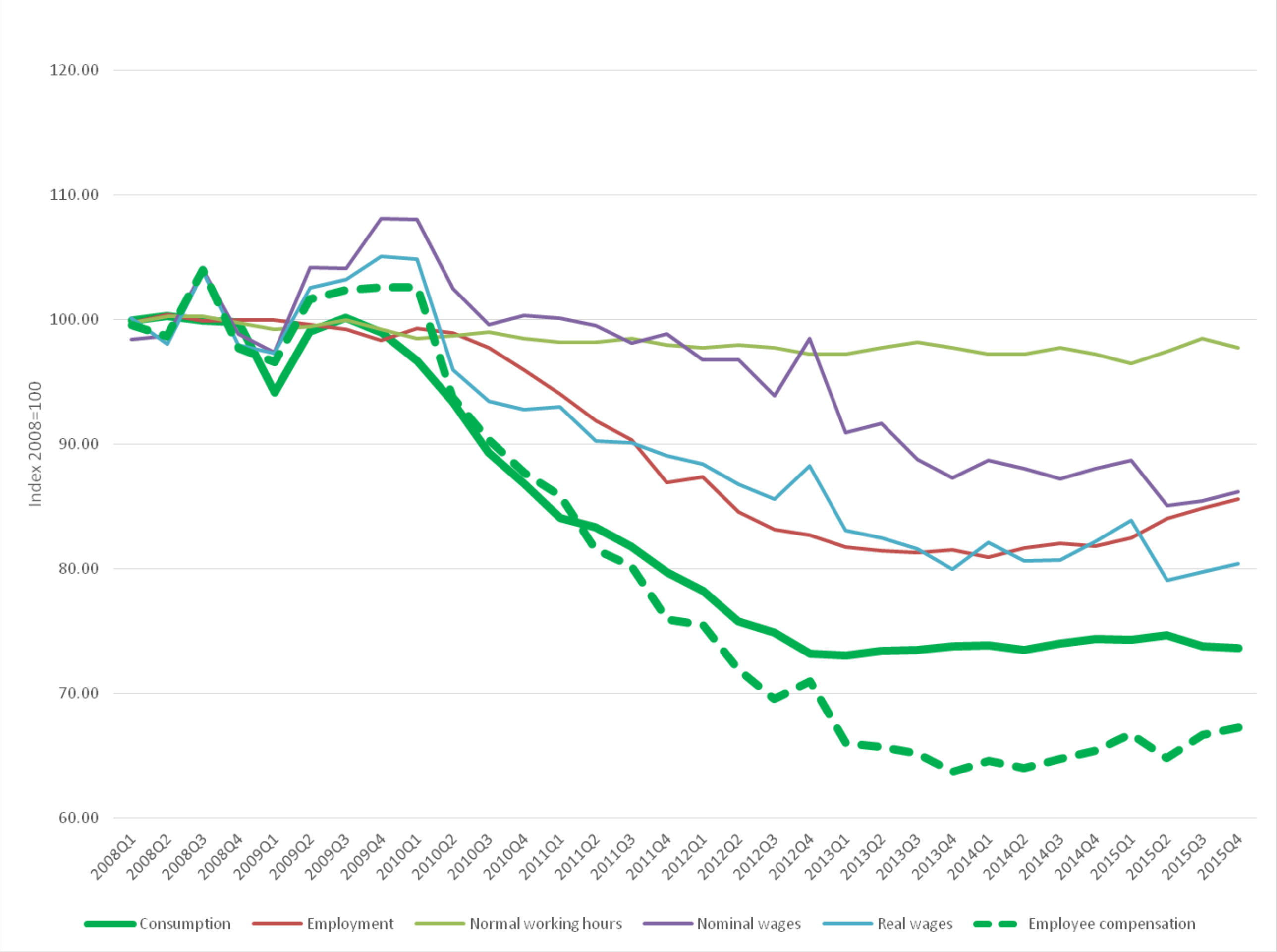
+ Disinflation/deflation worsens situation of debtors & banks
+ Intra-EZ trade little compensation excl. Germany (as jointly pursued)
+ For extra-EZ trade euro exchange rate dominates wages

3. Empirical Results

- **Hypothesis**: We expect to see a *strong relationship between employee compensation and private consumption expenditures*
  - Wage cuts reduce employee compensation, which we expect to undermine private consumption (as well as investment)

- Combination of austerity and wage cuts reduces employee compensation when:
  1. Number of salaried workers decreases
  2. Working hours of employees declines
  3. And/or those still or newly employed receive lower wages

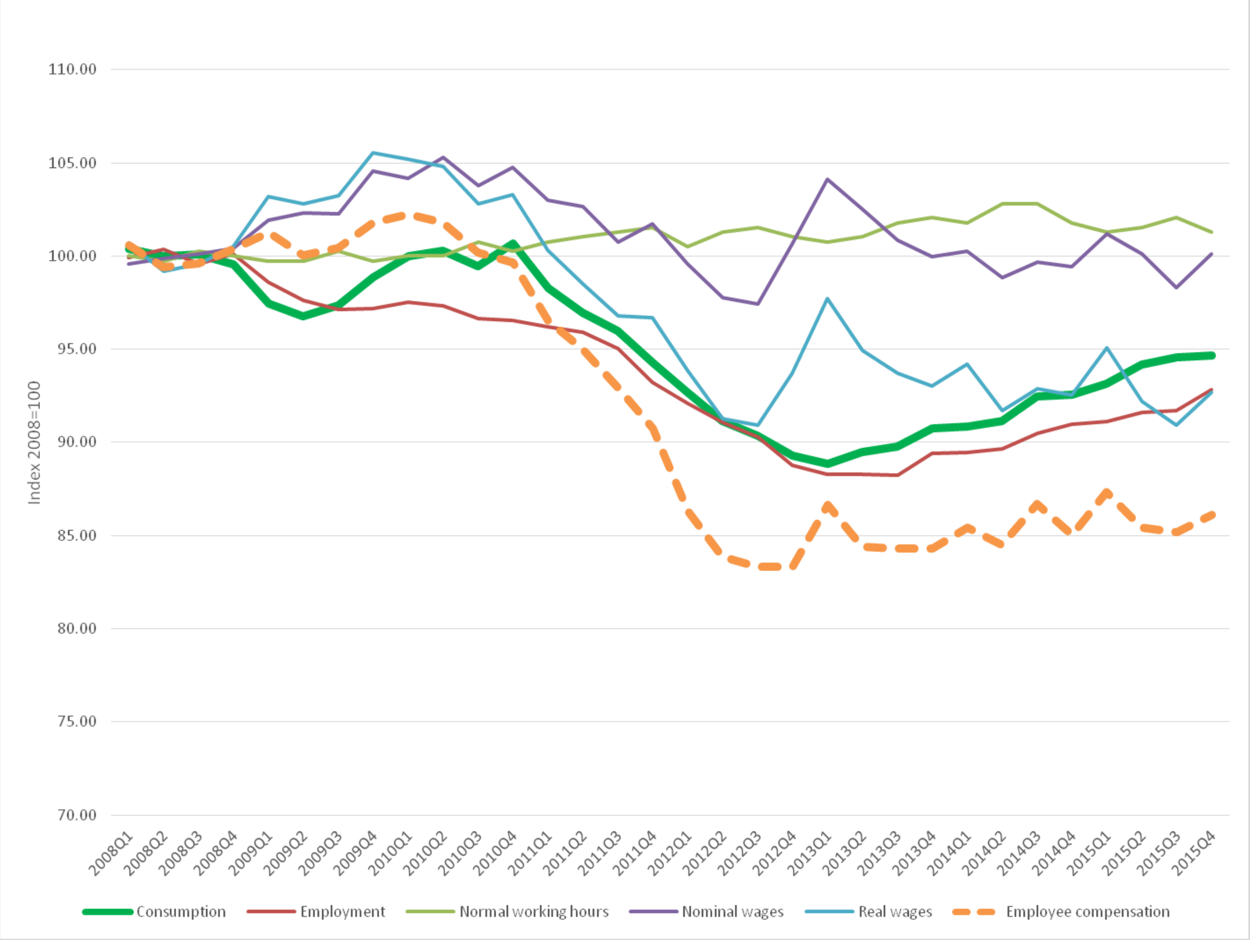
Greece



- Small decline in hours
- Big drop in employees
- Absolute decline in wages
- **Parallel decline in employee compensation and private consumption**
- At some point households dig into savings

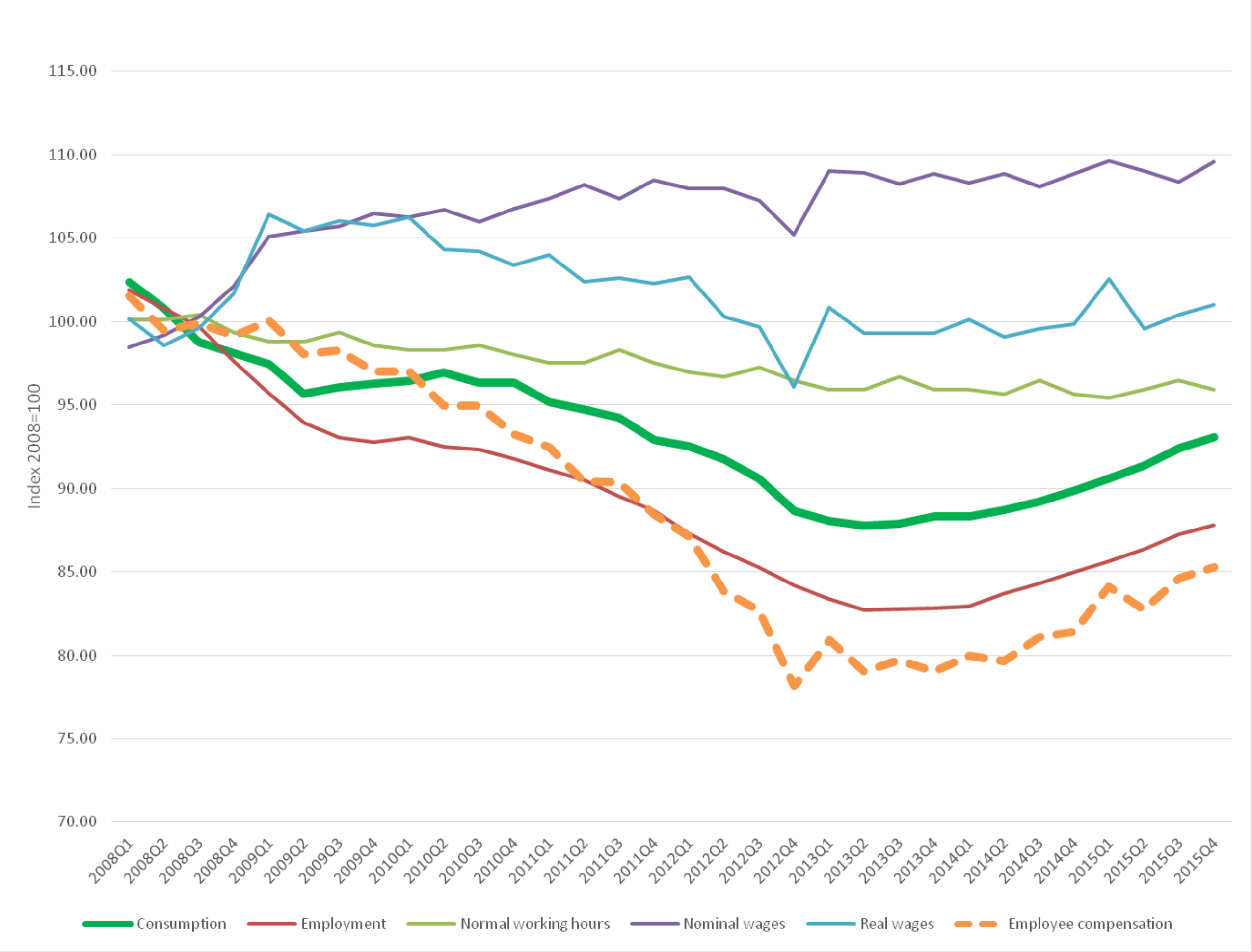
- Austerity & wage cuts (& reform) closely connected!
- Consumption decline also hit investment (accelerator)
- Fiscal consolidation backfired!

Portugal



- Small rise in hours
- Big drop in employment
- Nominal wage moderation, but real wage declines
- **Parallel decline in employee compensation and private consumption**
- At some point households dig into savings
- Ditto general macro picture

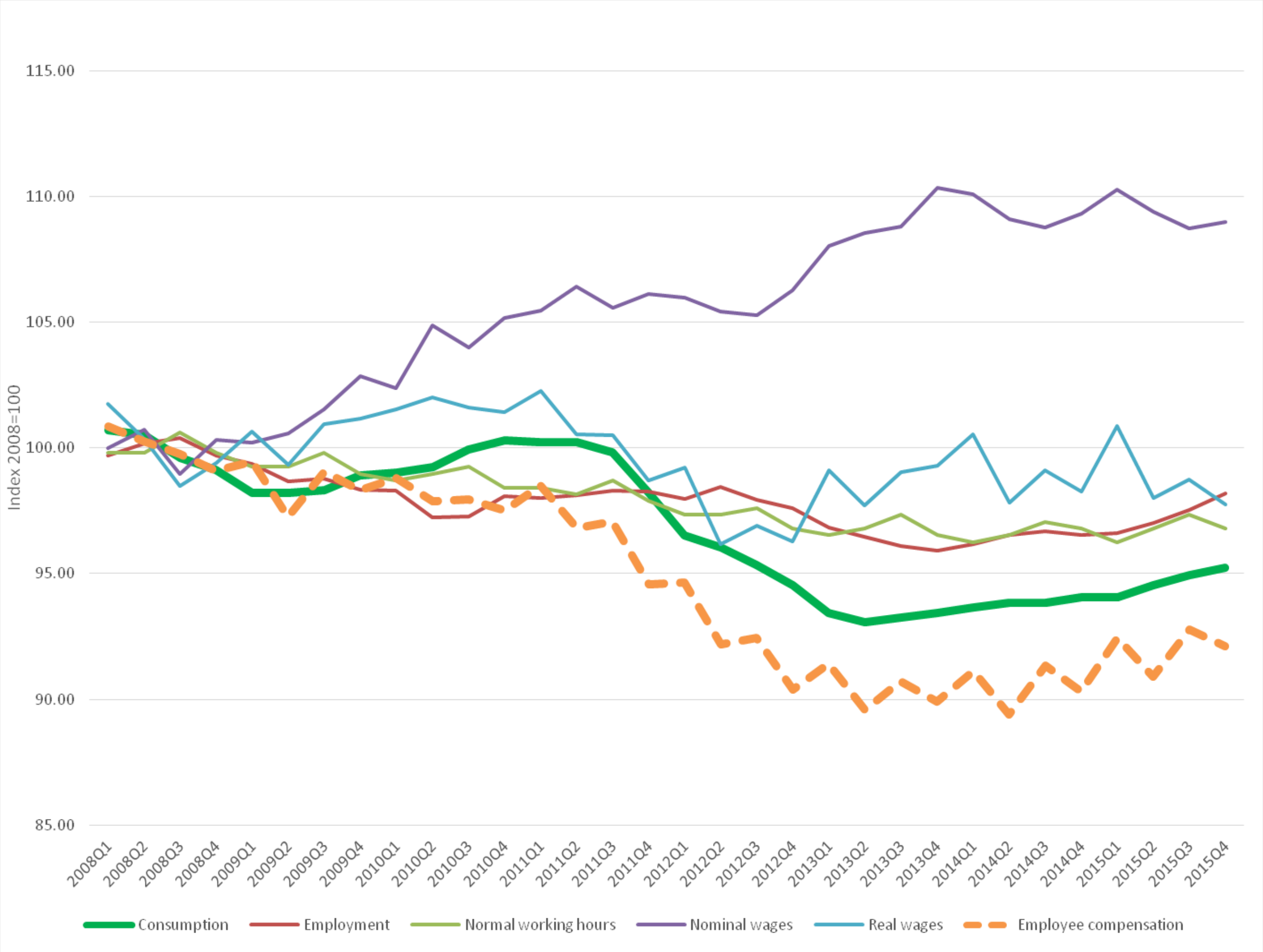
Spain



- Some decline in hours
- Huge decline in employment
- Delayed nominal wage moderation, and real wage decline
- **Parallel decline in employee compensation and private consumption**
- At some point households dig into savings

- Ditto general macro picture
- Beware: Spain's "recovery" largely driven by tourism boom; political instability/war in competing vacation destinations

Italy



- Some decline in hours
- Gradual decline in employment
- Delayed nominal wage moderation, real wage declines
- **Parallel decline in employee compensation and private consumption**
- At some point households dig into savings

- Ditto general macro picture
- Today, Italy (with France) blamed for being “latecomer” re structural reform

4. Proposals for Alternative Policies

❖**No doubt chosen policies have failed dismally! EU in "existential crisis"**

- Stop deflationary adjustment
- Stop asymmetric adjustment (of deficit/debtor countries only)
- Stop general wage moderation ("competitiveness" mantra)

❖Instead:

- Boost growth and inflation (toward 2% target) and require surplus/creditor countries to adjust as well ("internal revaluation")
- Continuation of ECB's easy money, but ***plus fiscal expansion***
- Really a "return to normal" re: public investment and wage raises

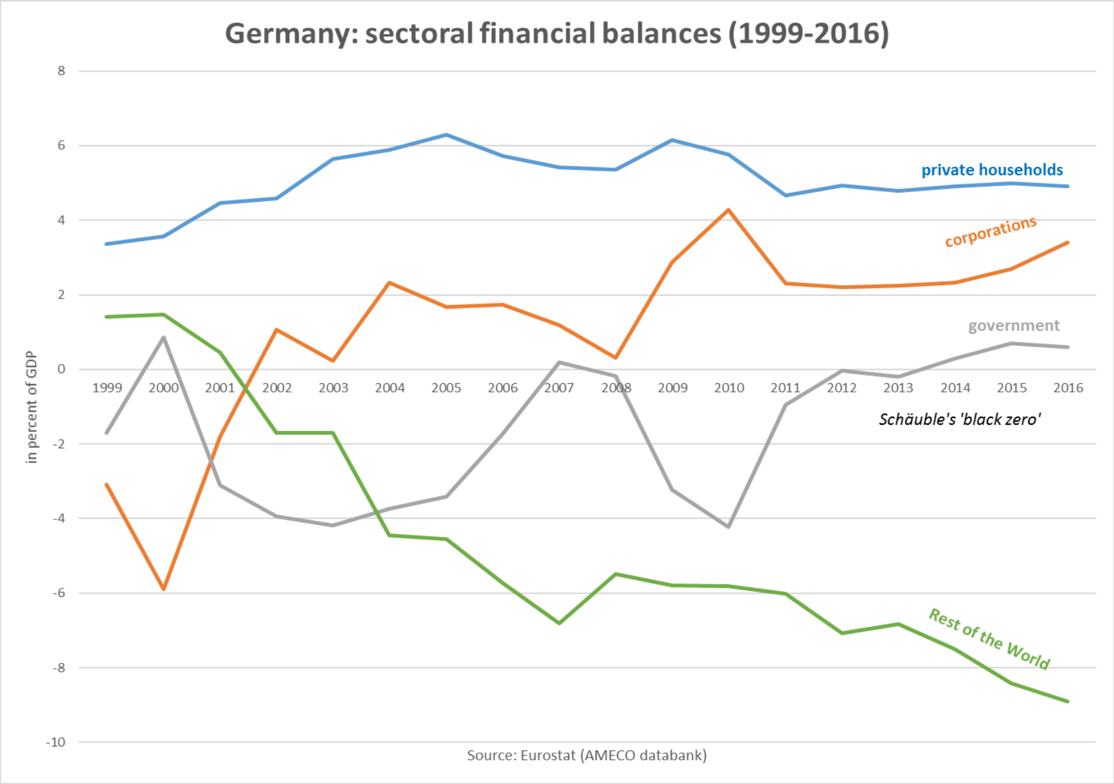
Euro Treasury Plan

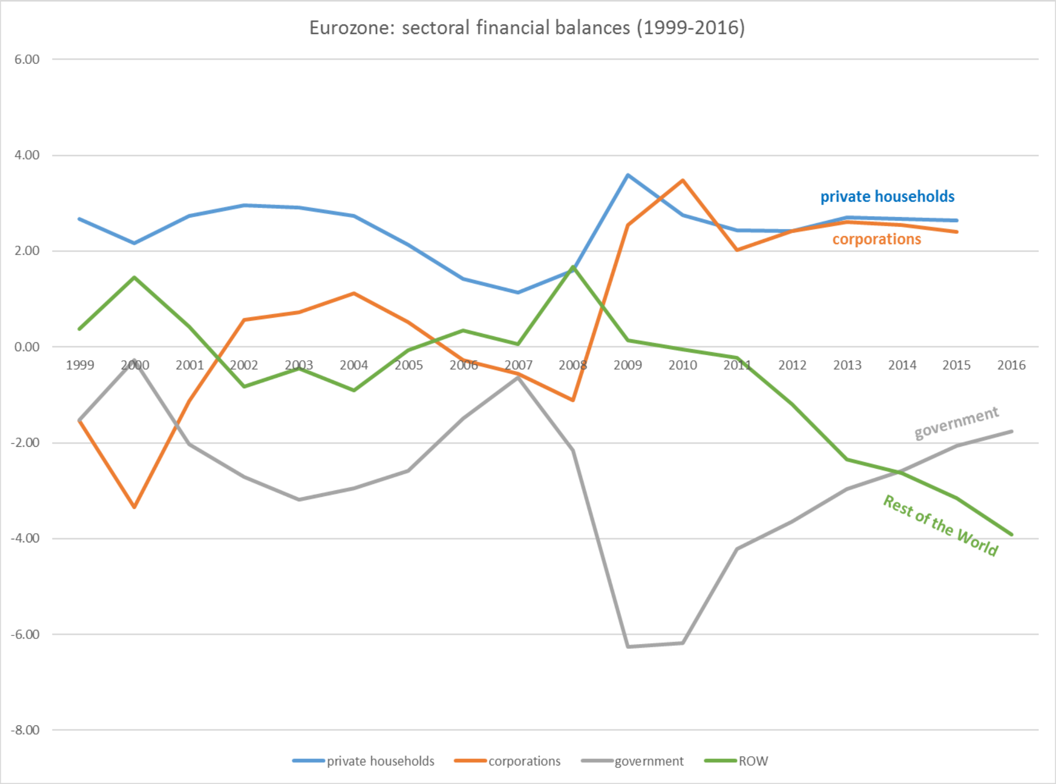
- ECB activism helpful but not enough by itself (Mario Draghi)
- “Juncker plan” too timid; Germany’s “black zero” fetish destructive

❖**Proposal**: Boost public infrastructure investment (“back to normal”, or temporarily more) and then let it grow at steady rate forever

- Issue common Euro Treasury bonds to provide investment grants to countries in line with their GDP shares
- Countries also pay interest on common debt in line with their GDP shares
- Countries henceforth balance national *current* budgets (SGP), i.e. excluding investment spending (which is centrally pooled)
- **Area-wide, balanced boost to public investment as anchor of prosperity**

Footnote: German model (mercantilism) not an option!





- Germany balances its budget as others take on extra debt and overspend
- EZ seems to more and more resemble Germany. *Can't continue!*

Conclusion & Outlook

Study shows that:

- Unresolved euro crisis consequence of failed policies & design flaws
- Crisis country "adjustment programs" based on flawed theory
- Empirical analysis confirms hypothesis of close connection between employee compensation and private consumption expenditures
- Continuation of current policies destined to blow up euro/EU
- Alternative policies proposed here focus on balanced growth and symmetric adjustment; *easy monetary policy needs fiscal support*
- For example, "Euro Treasury Plan" offers neat strategy for revival