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The ICEG European Center issues its monthly publication, which includes 2-4 brief analyses on macroeconomic and microeconomic issues. The publication focuses on two groups of countries: *Commonwealth of Independent States - CIS* (Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Moldova, Russia, Tajikistan, Turkmenistan, Ukraine and Uzbekistan) and the ten post-soviet *New Member States of the European Union – EU-10* (Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia).

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About us

ICEG European Center is an independent economic research institute based in Budapest, Hungary. The Center was founded by Dr. Pál Gáspár in 2001.

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Fiscal Consolidation in a Leaderless Global Economy[1]

Olivér Kovács

Introduction

The issue whether the austerity-driven crisis management can be regarded as an instructive way forward or not has been long discussed without reaching a broad consensus. Albeit there is a common view over the fact that injected and coordinated fiscal and monetary stimulus did nothing but limited and merely postponed the downturn, there is no *'unitas in necessariis'* with regard to austeritarian policies.

In this regard, there has been much discussed whether the highly globalised world economy would need globalised governance at the same time. Some argue that the historical experience serves as a guide in this respect by calling the attention to the key importance of a hegemonic power to harmonise the interest among core players and to govern towards common goals and principles. It is sensitively illustrated by Temin and Vines (2013) who reminded us to the British hegemony in the XIX. century which was mostly determined by the facts that in the century long peace after the end of Napoleonic wars, Britain became the first industrialised country to prosper through an export-led orientation, and what is more, London proved to be an efficient conductor of the international orchestra.[2] Let us add immediately, as Kindleberger (1986) emphasised in his classic book, between 1914 and 1945, no longer London, not yet New York was responsible for more harmonised governance. After this type of intermittent development of global governance, as the processes culminated in Bretton Woods, the United States was going the distance and became the powerful hegemony of the developed world. However, as always, nothing holds forever, and when the period of Great Moderation (1992-2007) was replaced by the Great Recession in the aftermath of the 2008 financial turmoil and its ensuing sovereign debt crisis, the American beacon seemingly went out.

It is instructive to mention that there were signs of coordinated actions in crisis management both in the US and in Europe. Still, the question whether we can have an efficient global governance remains open. In other words, can we imagine a hegemony on the basis of the state-of-the-art knowledge on a highly globalised world? At first blush, a well coordinated crisis management would be of paramount importance in bringing down deficits without jeopardising growth prospects by utilising spillover effects of fiscal consolidations as well.

[1] This research was realized in the frames of TÁMOP 4.2.4. A/2-11-1-2012-0001 „National Excellence Program – Elaborating and operating an inland student and researcher personal support system". The project was subsidized by the European Union and co-financed by the European Social Fund.

[2] See more on the issue of hegemons by Temin and Vines (2013) and for a summary of the book see Kovács (2013).

From coordinated stimulus to pro-growth coordinated austerity?

On the one hand, due to the panic and daunting Knightian uncertainty (Knight, 1921|2006) over the debt overhangs (De Grauwe – Ji, 2013) as a result of the anti-cyclical fiscal and monetary stimuli invoked to fend off the dramatic impact of the financial and economic crisis, prominent scholars and pundits have emphasized that governments should duly and credibly signal their commitment to severing the prevailed anti-cyclical fiscal behaviour (i.e. fiscal stimuli in recession) with large fiscal consolidations in favouring sustainable public finances (i.e. fiscal austerity in recession).

On the other hand, with due diligence of a cautious economist – being sceptical enough to look at the same problem from various aspects before forming an expert opinion on it – austerity is essential, but the question is always its extent and composition determined by country-specific context.

At this point, at least two interrelated considerations emerge from the empirical and theoretical literature. *First*, for a long time, the *traditional view regarding fiscal consolidation asserts that it is just a short term governmental intervention to decrease the excessive deficit and debt-to-GDP ratios in numerical terms merely*, and the best way to reach this outcome is to concentrate primarily on the expenditure side by resorting to large adjustments (i.e. reduction in unproductive expenditures like social transfers, public sector wages and salaries etc.).

Second, empirical evidence suggests that such large consolidations are more likely to cause fewer damages in economic growth (i.e. triggering recessionary effect more moderately) in the short term over the revenue-based adjustments (Alesina – Ardagna, 2010; Devries et al. 2011). *Importantly, empirical evidence also suggests that fiscal consolidations eventually have adverse effect on GDP growth already in the medium run*. As Guajardo et al. (2011) sensitively illustrated, after two years of consolidation, the real GDP growth tends to be lower and worse by leading to increase in public debt expressed in percentage of GDP.

By keeping in mind that after almost two years of austerity, the real GDP growth of the EU27 does not show any rehabilitation, moreover, according to Eurostat, the entire European Union is in recession and the dept-to-GDP ratio is at record height (the real GDP growth was -0.3%, and debt-to-GDP ratio is over 90% in 2012); it is more than welcome that the European Commission is getting more and more engaged in considering that *fiscal consolidations should pursue not only deficit-reduction in a mechanistic way, but should also address how to dampen the negative growth-consequence*, what is more, how to strengthen the growth-potential without confronting financial markets and investors' requirement to bring deficits down and thus put debt-to-GDP ratios on a downward trend. This reasoning is expressed in the recent paper of the European Commission by Buti and Carnot (2013) entitled "*The Debate on Fiscal Policy in Europe: Beyond the Austerity Myth*".

After mature deliberation, one can raise at least three insights with regard to how to address "growth-friendly" fiscal consolidation, as it is called in the literature: non-Keynesian, expansionary fiscal contraction. These are as follows: (*i*) Deficits and public debts are just symptoms; (*ii*) Differential diagnosis is needed to tackle global imbalances; (*iii*) Incorporating the characteristics of globalised world is crucial.

Deficits and public debts are just symptoms not the main problems themselves

In recession like today, deficits are in rise because of at least two phenomenons. First, in response to the recession which entails job-losses and therefore wreaks havoc on the revenue side, automatic stabilizers are in to dampen the decline in aggregate demand and to mitigate social consequences. Second, as John Maynard Keynes believed, economic policy has to be featured with anti-cyclical measures in favouring aggregate demand (i.e. surpluses in good times, while deficits through fiscal stimuli in bad times) which created further burden on the budgetary balance engendering additional expenditures. Let us underscore that these mechanisms are to tackle predominantly conjunctural downturns not structural ones. These were the main constituents of the soaring deficits and debts throughout the EU.

The turnaround – shifting to austerity – was a logical tail effect because of the malignant debt overhangs that triggered even more dramatic concerns over the solvency of national states. Since monetary policy is near to its capacity limit (i.e. near-zero interest rates), fiscal policy should act as a main conductor of recovery-targeting policies. Financial markets requires solid signals about the intention towards prudent public finances on the one hand; but fiscal consolidation should not deteriorate further the employment-unemployment situation, instead, it should consider the crucial role of rehabilitating employment to nourish demand in a more sustained way (i.e. consolidations should bear the stamp of addressing structural problems related to the national competitiveness).

Differential diagnosis in tackling global imbalances

Policymakers should acknowledge that fiscal consolidation has non-linear effect and each country has specific characteristics to be reckoned with. Some countries are facing more conjunctural problems, others have to cope with structural anomalies. It implies that certain countries should use fiscal consolidation as means of reducing deficit and public debt mainly in algebraic sum (traditional view); while those of having structural weaknesses require fiscal consolidations that bear the torch of economic dynamisation in parallel in a more vigorous way (e.g. addressing powers that are of paramount importance in the new techno-economic paradigm like R&D, innovation, education through fiscal impulse to resuscitate private sectors' similar activities to propel sustained growth).

The rationale behind the latter one is the fact that in severe and gloomy circumstances, firms – that are operating already in the markets – resist to investing in these fields because of the great uncertainty; the government should therefore dampen that kind of risk-aversion through dedicated fiscal support.

Let us recall to the fact that innovations were born even during crises (e.g. plastic, pocket calculator are those products that were invented during the Great Depression and the crisis of the 1970s). Additionally, young leading innovators are fewer in Europe *vis-á-vis* the US (Veugelers – Cincera (2010), thus fostering new start-ups may also be constructive if for no other reason than they have nothing to lose.

Incorporating the globalised world characteristics

Now we are living in a highly globalised world with extensive web of economic and societal linkages among national states. Accordingly, policies can easily have cross-country spill over effects to be taken into account. Consequently, fiscal stimulus in countries with relatively high global competitiveness can bring new élan into the aggregate demand of others – structurally weaker countries (peripheral ones) – through the additional demand for their exported goods and services. Importantly, sacrificing developmental function of the government during fiscal consolidations on the altar of targeting relentlessly and only the numerical levels of deficit and debt-to-GDP ratio can also have negative effect on other countries' – primarily on small, opened and export-oriented ones – aggregate demand and thus growth potential.

Concluding remarks

It would be naïveté to think that these insights are directing us towards the recognition that a more dedicated and effective global governance is needed to carry out these holistic considerations. For sure, a systemic approach seems to be a *sine qua non* of an effective crisis management. However, desiring an effective and efficient global governance can be deliciously tempting, this would be the wrong inference pervading by a good deal of abstract thinking and forgetting the real world nuances and complexities (i.e. it should be built upon wide political consensus to be as much democratic institutional framework as it would be required from national citizens and governments).

Furthermore, as the Nobel-laureate Daniel Kahneman pointed out, the predictive power of our knowledge reaches its diminishing marginal returns relatively fast (Kahneman, 2011).[3] There is no gainsaying the fact that this psychological finding holds especially in case of predicting non-linear processes evolving in the complex global system interspersed with growing interconnectedness and interdependency and the current dominance of uncertainties (e.g. estimating *ex ante* the value of fiscal multiplier precisely is particularly cumbersome as it was admittedly the case documented by Blanchard and Leigh (2013) as well as Barrell et al. (2012)).[4] As a corollary, even if the national state can be seen as the antiquated heritage of the French revolution, it still remains responsible for conducting pro-growth fiscal consolidations efficiently geared towards short term stabilization as well as medium and longer term sustained recovery alike.

In spite of the history which tells us that international cooperation could emerge, once the world economy has become ever deeply integrated with non-linear effects of weaving economic phenomenon like governmental policies, *the issue of "how" remains opaquely addressed and elaborated* even by Temin and Vines (2013). The idea of creating a prudent global governance might be ranked with the category of bucolic wishes. In our context, in the era of public debt, *fiscal consolidations should be pervaded by both pro- and anti-cyclical features conducted in a contextualised way* by European national governments being accompanied with longer term structural reforms.

[3] Even the most renowned economists fell short in predicting crises (e.g. the collapse of the Soviet Union; the East Asian financial crisis; the dot com crisis). Forecasting is rather problematic; what is more, we have no scientific evidence that such changes can be ever predicted credibly. Philip E. Tetlock, a well-known professor of psychology, revealed that experts are not proving to be more precise in forecasting than those of having significantly less or no expertise (Tetlock, 2006)! As Csaba (2008:286) rightly noted in his inaugural lecture to the Hungarian Academy of Sciences: „Our models are elegant, our theories do live in their closed systems; but they are incapable of understanding and shaping the societal reality in its entirety".

[4] The world's complexity and the fundamental uncertainty are also reflected by the emergence of the so-called 'imperfect knowledge economics' coined and articulated by Roman Frydman and Michael D. Goldberg right before the eruption of recent crisis (Frydman – Goldberg, 2007). Of course, some kind of truly global solutions would by all means required due to the financial globalisation (Obstfeld, 2013:55).

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Democratic Deficits in Europe – On Spirits and States

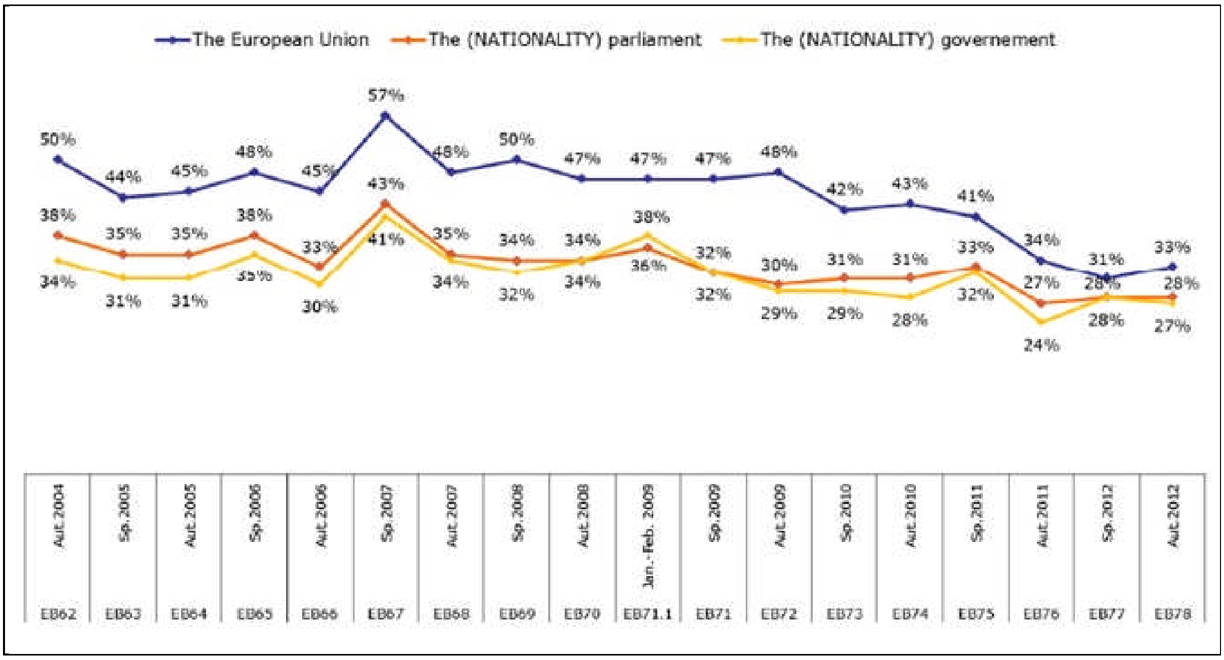
Olivér Kovács

In April 2013, Croatia had elections with a relatively low level of voter's participation by summoning the prevailing trend of deteriorating trust in government and its sates' institutions throughout Europe. The perceptible downward trend across Europe is more than obvious and can be confirmed in many ways. For instance, in the last 2009 elections, the participation of voters was particularly low even among newer member states (Poland showed 25%, Lithuania 21% and Slovakia 20% voter turnout). It reflects the pessimism over whether governments have the necessary ability to cope with the crisis successfully and to resuscitate growth.

As the Nobel-laureate George Akerlof together with his co-author Robert J. Shiller emphasised in the book Animal Spirits, the societal and economic development relies heavily on the trust infrastructure of the given country (Akerlof – Shiller, 2009).

As the economic „perfect storm" approached Europe in the aftermath of its eruption in the end of 2007 in the US, the crisis and its long-lasting management providing temporary refreshments merely have affected negatively the trust and confidence base of citizens exuded towards state and governmental institutions (*Chart 1*).

Chart 1. Trust in National Governments and Parliaments and in the European Union: Trend

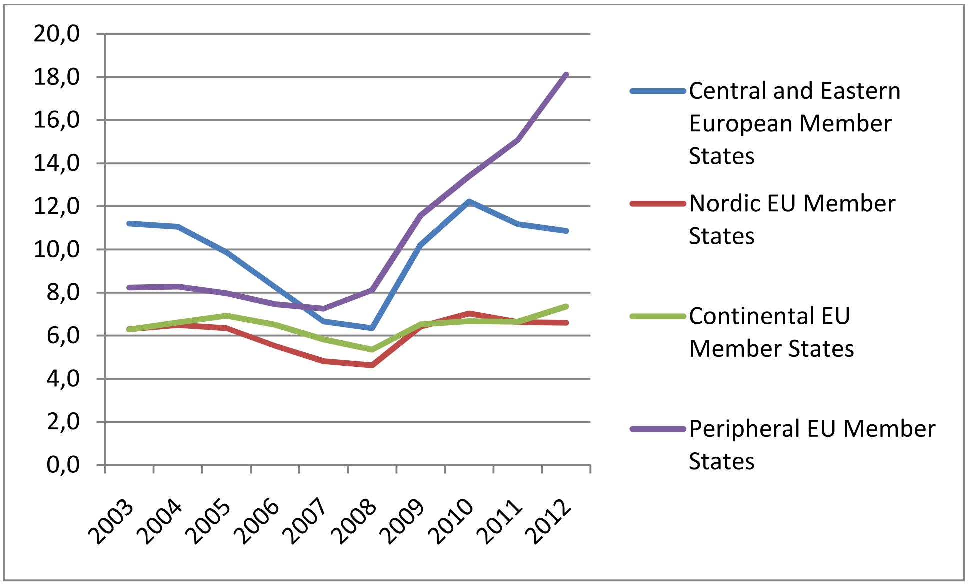


Source: Standard Eurobarometer 78, p. 14

This calls for pro-active states tailored towards two objectives during their battle when the concomitant weakening of economic growth in the era of austerity has also become much clearer: (i) dampening the sovereign risk through fiscal consolidations; (ii) while supporting as well as reinvigorating growth and not triggering soaring unemployment.

As Stevenson and Wolfers (2011) pointed out, every time when unemployment was in rise in economic history, the trust level declined, that is to say, the democratic deficit just deteriorated. This time is not different in this regard (*Chart 2*).

Chart 2. Trajectories of unemployment rate (%, 2003-2012)



Source: Eurostat

The question of how to stabilise and give impetus at the same time remains a central issue of contemporary European studies. For sure, the role of the state is appreciating. The question of „how to make the state to be a trust builder channel in a more dedicated way" can be linked to the issue of public sector innovation (See: European Commission, 2012) that may help to maintain the quality of service provision, to reduce excessive expenditures while not imposing additional burdens on labour and the economy as a whole. This may need new EU-level institutions to be engaged in disseminating the lessons learned in fields of public sector innovation and institutions that are respectfully signalling the commitment to democratic legitimacy and accountability.

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