Austerity and Competitiveness in the Eurozone: a misleading linkage

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Abstract

After focusing on fiscal indiscipline, the debate on the Eurozone crisis switched over persistent external imbalances among the European Monetary Union countries. Current account differentials were almost exclusively ascribed to the weak price competitiveness of deficit countries – neglecting demand-side factors – and consequently austerity measures have been imposed to peripheral countries in order to foster their competitiveness with the purpose of adjusting external imbalances through export growth.

In this context, the contribution of this paper is twofold. Firstly, we identify this view as *competitive austerity* (in parallel with the *expansionary austerity* narrative), as the set of measures which, according to policy makers, would stimulate trade balance, output and employment. Secondly, we criticize this approach since fiscal restraints were proved to be counterproductive. We conclude by disproving the austerity-competitiveness linkage from a Keynesian perspective as well as by means of some macroeconomic evidence, and we provide an alternative recipe to the Eurozone issues.

Keywords austerity, competitiveness, European imbalances, current account, fiscal policy, aggregate demand

JEL classification E630, F320, F450

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1 Introduction

Recently, the debate on the Eurozone crisis, i.e., the widening of government bond spreads, has switched from "fiscal indiscipline" (increasing public debts, or debt-to-GDP ratios) to external imbalances among the EMU members, particularly due to the fact that intra-Euro trade imbalances have increased after the onset of the Euro. Endorsing a pure *neoclassical* view, current account (henceforth, CA) imbalances have been almost referred to a lack of price competitiveness of deficit countries (*supply-side* factors), while little attention has been paid to real growth differentials (*demand-side* factors) which can positively affect import.

According to *mainstream* arguments, policy makers decided to tackle the Eurozone crisis by imposing fiscal austerity to deficit countries. These policies were firstly declared to contain debt-to-GDP ratios, and this view has been identified as *expansionary austerity* inasmuch fiscal consolidation was considered also able to stimulate income. In this paper, we argue that once austerity measures did not have delivered the expected results in terms of growth, restrictive fiscal policies have been still imposed albeit in something what different guise from their usual one. Specifically, still on the basis of *mainstream* underpinnings austerity was considered able to affect trade balances by fostering export: growing competitiveness would be achievable through wage deflation joined with "structural reforms" (i.e., labour market deregulation) aiming at enhancing productivity. In parallel with *expansionary austerity*, we innovatively identify this view as *competitive austerity*, that is a sort of causal connection, supposed by policy makers, between fiscal restraints and external competitiveness.

Following Keynesian arguments, we critically assess the austerity-competitiveness linkage from different perspectives. From a theoretical standpoint, we analyse the *mainstream* approach underlying restrictive fiscal policies aiming at promoting external competitiveness, we highlight its weaknesses and we suggest an alternative view. Besides, by means of some macroeconomic evidence we discuss *competitive austerity*, in both its impact on trade balances and its side-effects on real economy (output, domestic demand, unemployment and income distribution). More specifically, we claim that CA deficits did not decreased due to increasing export, but rather as austerity often confined the endogenous component of import by containing aggregate demand, and consequently income.

The paper goes as follows. In Section 2, we present the state of the art: after an overview on the new EMU context, we report arguments provided by literature about the Eurozone crisis genesis, as well as we examine policies adopted to face the sovereign debt crisis – at the beginning *expansionary austerity*, while at a later time *competitive austerity*. In Section 3 we focus on the theoretical framework underlying this dual interpretation of austerity, even if we proceed setting aside *expansionary austerity* (even the original proponents have now called into question its validity) and focusing on *competitive austerity* – the specific topic of this paper. Thence, on the basis of a wide economic literature which suggested that CA imbalances may matter even within a monetary union, in

Section 4 we advance a two-pronged explanation of CA misalignments: in detail, price competitiveness and growth differentials played a key role in trade imbalances. After analysing the impact of competitive austerity on external balances, in Section 5, based on Keynesian arguments, we examine the negative effects of austerity on output, employment and public debt-to-GDP ratios: we provide both theoretical arguments and empirical evidence in order to refute the tie between austerity and competitiveness. In Section 6 we finally disprove this linkage, and we conclude by suggesting an alternative recipe to austerity for the Eurozone.

2 Austerity and Competitiveness within the Eurozone: state of the art

As is common knowledge, in 1999 several European countries decided to join the EMU. As one key tool of adjustment was removed by waiving exchange rate flexibility, from the beginning the ability of the Eurozone (henceforth, EZ) countries to face negative shocks was considered the main challenge for the success of the single currency.[1] Moreover, as EMU treaties were not joined to banking and fiscal union, financial regulation and budget policies were kept under governments responsibility, despite the fact that both *Maastricht Treaty* (1992) and *Stability and Growth Pact* (1997) committed to rigorous convergence criteria as well as to strict public budget constraints. In a nutshell, the onset of the Euro has led to a greater market openness, combined with a stricter room for manoeuvre in using policy tools (e.g., confined public expenditure, no exchange rate adjustments, *one-size-fits-all* monetary policy).

The outbreak of the global crisis (2007) represented the first test for the EZ. Although the ECB opted for loose monetary policies to dampen financial shocks, it is well known that such crisis has had a dramatic impact, especially for countries which experienced a greater deficit-to-GDP ratio[2] than allowed by treaties – although this depended on tax revenue reductions greater than national income losses.[3] However, there was little concern about sovereign debts until speculative attacks on countries experiencing macroeconomic imbalances have fostered increasing fear about a debt crisis. This in turn led to troubles in refinancing public debts on markets, and Greece, Ireland, Italy, Portugal and Spain (GIIPS) experienced a rise in government bonds yields[4] compared to other EZ members: despite the monetary union, a single interest rate was no longer available. However, in this regard we must

[1] An institutional research [European Communities 1990] stated that *(t)he main potential cost of EMU is that represented by the loss of monetary and exchange rate policy as an instrument of economic adjustment at the national level*. This loss was not considered to be *exaggerated* since *relative real labour costs will still be able to change,* and *budgetary policies at national and Community levels will also absorb shocks*. However, the same paper asserted that *fiscal policy should not be used to delay market adjustments (e.g. real wage adjustments) when those adjustments are required*, and *wage discipline will also be more effective in a credible EMU*. Briefly, in case of trade deficits EMU original project clearly provided for the burden of the adjustment was passed on wages, with a negligible role for fiscal policy.

[2] General government deficit (2009, % of potential GDP): GRE 19.11; IRE 9.89; ITA 4.13; POR 9.17; SPA 9.28 (data: *IMF*).

[3] However, we shall consider that economic recessions can generate increasing public deficits owing to automatic stabilizers. Moreover, some countries faced banking crisis by government rescues (this was not the case of ITA and POR).

[4] GIIPS spreads relative to Germany peaked at different times (base points): IRE on Jul-11 (1323); ITA on Nov-11 (542); SPA on Nov-11 (543); POR on Jan-12 (1576); GRE on Feb-12 (3399).

emphasize the institutional framework of the EZ, since the ECB Treaty did not allow for direct purchase of sovereign bonds.[5] Policy makers decided to face the EZ crisis by means of fiscal austerity, which was considered the proper tool to reduce credit spreads: according to this view, austerity would have brought down debt-to-GDP ratios by reducing debt and by fostering income growth (*expansionary austerity*), hence it would lower the risk of peripheral countries leaving the monetary union. By contrast, from a Keynesian perspective it can be argued that austerity measures may actually foster market uncertainty, since debt-to-GDP ratio could boost given the size of fiscal multipliers [Ciccone 2002; Nuti 2013; Leão 2013].

Nevertheless, the wisdom that the sovereign debt crisis was mainly led by fiscal indiscipline [Attinasi et al. 2009; Sinn 2012; Wyplosz 2013] appeared questionable because several members showed a healthy fiscal position before the beginning of the global financial crisis (when low credit spreads indicated that markets did not consider a default risk), as well as some members reduced their debt-to-GDP ratio with respect to 1999.[6] Besides, a comparison among EZ countries with other non-EMU economies is useful to understand that fiscal policy itself is not sufficient to explain sovereign debt unsustainability fears (e.g., the Japanese case). To be fair, a clear difference emerges between EMU members and other advanced countries, where proper tools to sustain the economy and to avoid fiscal crisis (especially, monetary sovereignty combined with the sustain of central banks to the demand of sovereign bonds) are available.

Nevertheless, while the sudden rise of spreads led policy makers to focus on public debts, some scholars was paying the attention on persistent external disequilibria – in both trade and net foreign assets – among EZ members. In this regard, both *mainstream* and *non-mainstream*[7] literature highlighted that CA imbalances appeared able to cause a sovereign debt crisis [Brancaccio 2008; Cesaratto 2010; 2012; Giavazzi and Spaventa 2010; Wolf 2012; Alessandrini et al. 2012; Hallet and Oliva 2015], since deficit countries might have considered the opportunity to quit the monetary union to recover exchange rate adjustments, and consequently external debts would experience a devaluation. This alternative view on the EZ crisis represented a significant turnabout for the economic debate since it brought out the controversial issue of competitiveness. This topic has not emerged before since intra-EZ external imbalances were negligible before the onset of the Euro, while at a later time (especially after 2003) Portugal, Greece and Spain experienced large external deficits, Germany run large external surpluses, while the overall Euro area CA balance was close to zero.

[5] Only after the outbreak of the EZ crisis, purchases on the secondary market (at market prices) have been allowed.

[6] De Grauwe [2011] surveyed the pre-crisis dynamics of public and external debts in peripheral countries: Ireland, Italy and Spain reduced their debt-to-GDP ratio, Greece kept it stable and only Portugal experienced a raise. However, all these countries increased their private foreign debts. Then, spreads widening was not fuelled by high public debt-to-GDP ratios.

[7] In this paper we consider *non-mainstream* authors those who recognize the role that aggregate demand plays in determining output and consequently unemployment, even in the long run. Particularly with respect to the Eurozone issues, the so-called *non-mainstream* scholars take into account the dangers of an asymmetric adjustment by means of internal devaluation (i.e., the negative effects on output of decreasing real wages) and consider increasing external competitiveness relevant only insofar as it can stimulate export and then aggregate demand.

To be fair, the first interpretation of intra-Eurozone CA imbalances maintained they were not problematic [Blanchard and Giavazzi 2002], while at a later time economic literature considered external deficits as able to create a sovereign debt crisis even within a monetary union by three different channels. The former two are related to productivity [Blanchard 2007a] and liquidity [Merler and Pisani-Ferry 2012] issues,[8] while the third one is more linked to this paper: according to this view, an external deficit might affect the interest rates structure as it might be seen as a signal of weak competitiveness. In detail, external debts could suggest deficit countries to leave the monetary union in order to restore exchange rate flexibility (e.g., employers' federations could require a competitive devaluation to foster export). Then, foreign creditors would react by claiming a risk premium, i.e., by asking for higher interest rates to protect from feasible capital losses caused by currency devaluation [Brancaccio 2011].[9] In this context, yield spreads could have been merely caused by speculative attacks on countries exhibiting macroeconomic imbalances (markets might just bet on public debts), since investors were fully aware about the institutional framework of the EZ, that is ECB would not intervene in supporting government bonds demand in case of troubles in refinancing.[10] However, it is widely recognized that intra-EZ imbalances posed the problem of EMU stability, because of the lack of a fiscal union (able to absorb transitory shocks),[11] and owing to speculative attacks[12] against individual member countries.

In this respect, single currency inception has boosted trade imbalances. CA differentials among EZ members increased significantly, leading to the creation of two different areas (see Graph 1): countries with large CA surpluses – the *core countries* (Germany, Austria, Belgium, Netherlands and Finland) – and symmetrically countries that have seen worsening their CA deficits – the *peripheral countries* (Spain, Portugal, Ireland, Greece and Italy). Nevertheless, it is useful to highlight that the EMU represented a sort of turnabout for Germany, which had been experiencing a CA deficit before 1999, while actually is achieving huge external surpluses.

According to this alternative view, external imbalances emerge as a key factor to explain credit spreads, with a nil role for public debts. Consequently, while policy makers argued that austerity was the proper recipe to the EZ crisis since spreads lowered because *irresponsible* countries adjusted their

[8] We drew criticisms to these views since productivity dynamics was significant in GIIPS country before the global crisis, while the liquidity risk within the EZ has been mitigate by policy makers through TARGET-2 system.

[9] Furthermore, in case a persistent external imbalance is likely to bring about actual industrial decline, a kind of social fear related to a de-industrialization process could rise in deficit countries, and this would have a backlash on markets confidence.

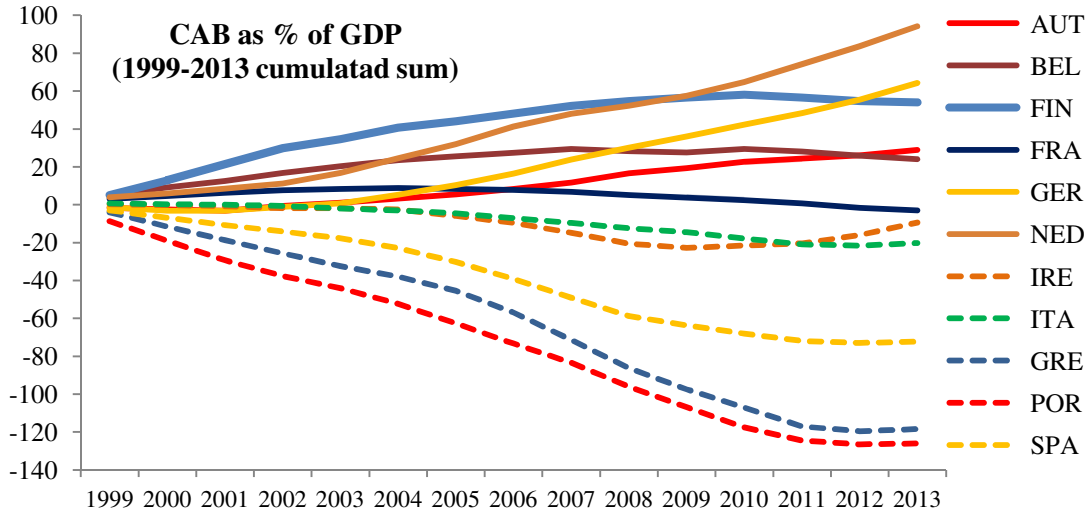
[10] Cesaratto [2017], Zezza [2012] and Benigno [2012] have seemed to consider this alternative reading of the EZ crisis.

[11] Within a fiscal union, in case an area shows a trade surplus its income will increase, leading to a greater fiscal revenue. In the meanwhile, a deficit area will experience low growth and increasing unemployment: welfare expenditure, here available exploiting the greater fiscal revenue of surplus areas, can thus balance the negative effects of a trade deficit. Obviously, a fiscal system makes imbalances sustainable, but it does not eliminate them: development policies in deficit areas are required to reabsorb imbalances. In this respect, within the EZ framework has been implemented the TARGET-2 system: however, it can solve only the liquidity troubles, without redistributive effects among surplus and deficit areas.

[12] Owing to the monetary union, speculation could be shifted from exchange rates to government bonds: while interest rates on GIIPS sovereign debt were climbing, German yields declined, as well as US, UK and Japan ones [Alessandrini et al. 2012]. This could be a signal of speculative attacks.

budget balance, it can be claimed that credit spreads lowered due to ECB refinancing operations,[13] conditionally to fiscal austerity.[14]

Graph 1 - Source: author's elaboration on OECD



Notwithstanding restrictive measures worsened debt-to-GDP ratios (also by depressing output, in contrast with the *expansionary austerity* view), austerity has been pursued even if its focus has been switched over external imbalances: briefly, austerity was even based on the assumption that GIIPS countries were unable to implement *supply-side* policies to increase their competitiveness.[15] So, peripheral countries were forced to austerity for two reasons. Firstly, to re-establish government debt sustainability, i.e., to reduce debt-to-GDP ratios by mitigating market losses of trust and by lowering risk premiums (*expansionary austerity*). Secondly, to restore external competitiveness through internal devaluation, wage reduction and structural reforms (*competitive austerity*). However, from a theoretical standpoint such adjustment was suddenly considered counterproductive and self-defeating by *non-mainstream* economists as austerity can foster depression and unemployment,[16] and in addition the whole EMU sustainability would become crucial, challenged by rejections against excessive fiscal

[13] Especially, we refer to LTROs (2011 and 2012), as well as to OMT, EFSF and ESM. Although these operations were considered as bypassing of the "no bailout clause" provided for Maastricht Treaty, they are consistent with ECB purpose to preserve Euro area financial stability, as restated by the *"whatever it takes"* announcement (Mario Draghi, 26 July 2012).

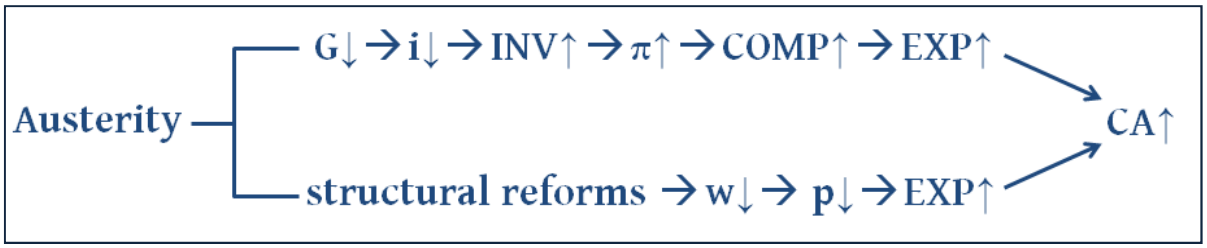
[14] This mechanism is usually identified as *structural adjustment*, a combination of free market policies (privatisation, fiscal austerity, free trade, deregulation). Notice that the EFSF's mandate is *to safeguard financial stability in Europe by providing financial assistance to Euro area Member States within the framework of a macroeconomic adjustment programme*.

[15] Alesina and Perotti [2010] stated that *a monomaniacal focus on aggregate demand is based on slightly outdated and oversimplified Keynesianism; the real constraint on European growth is not Germany's fiscal policy: it is the supply side rigidities that plague all European nations – especially those at the heart of this crisis*. Moreover, they argued that Germany competitiveness stems from *limited and timid labour market reforms*.

[16] We mainly refer to the "*Lettera degli Economisti*" (14.06.2010): "*(r)estrictive policies deepen crisis, feed speculation and can lead to the deflagration of Euro area. An alternative economic policy is required to prevent a further fall in income and employment"* (our translation, full text on http://www.letteradeglieconomisti.it/).

disciplines and nationalist tendencies.[17] Nevertheless, policy makers argued that austerity would *restore investors confidence*[18] by lowering debt-to-GDP ratios[19] even by stimulating income. Although the *Maastricht Treaty* already provided for a strict fiscal discipline, austerity was implemented in 2009 as a counterpart to ECB rescues on government debt. Then, fiscal restrictions continued with the *Euro Plus Pact* (2011) and the *European Fiscal Compact* (2012). According to the consensus view austerity would enhance external competitiveness (*competitive austerity*) and reduce CA imbalances through two distinct channels: i) increasing price competitiveness by fostering investment and productivity (π); ii) stimulating export by reducing nominal wages (w) and prices (p) through *structural reforms* (see Box 1). These measures focus on the *supply-side* in order to foster price competitiveness based on unit labour cost (ULC) and real effective exchange rate (REER): increasing exports would consequently reduce CA deficits.[20]

Box 1 - From austerity to current account: declared transmission channels



With regard to the *productivity channel*, since interest rate is determined on the investments/savings market (as assumed by the *neoclassical* theory), public expenditure would increase the market clearing interest rate, and this in turn would negatively affect investment. Therefore, government spending results in a lower private spending (public expenditure crowds out investments, even an equal amount in full employment). Conversely, austerity would enhance output since it would leave resources to the more efficient private sector (because of the profit purpose), and lower interest rates would stimulate investment,[21] which in turn would foster productivity, enhance competitiveness and increase export.

[17] A feasible negative scenario had already been predicted by Kaldor [1971]: "*Some day the nations of Europe may be ready to merge their national identities and create a new European Union (…). This will involve the creation of a full economic and monetary union. But it is a dangerous error to believe that monetary and economic union can precede a political union or that it will act (…) as a leaven for the evolvement of a political union which in the long run it will in any case be unable to do without. For if the creation of a monetary union and Community control over national budgets generates pressures which lead to a breakdown of the whole system it will prevent the development of a political union, not promote it*".

[18] We refer to the ECB recommendation letter to the Italy government (Frankfurt, August 5, 2011).

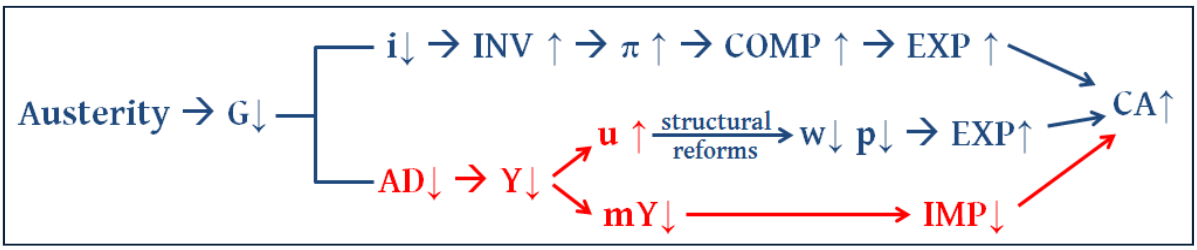
[19] A well-known study indicated that government's debts exceeding 90% of GDP are often correlated with low growth [Reinhart and Rogoff 2010]. This survey has exercised an important influence on fiscal policy debate, providing significant support for the *austerity agenda* that has been popular in Europe.

[20] As argued in the following, these channels appear consistent with our explanations of imbalances drivers.

[21] By contrast, from a *Keynesian* perspective investment decisions are taken based on expected demand and only secondly based on interest rate, hence it is improper to link the investment-saving market and the interest rate. Furthermore, saving depends on disposable income, then there is no assurance that the interest rate will actually be a price balancing investments and savings. Finally, in the EZ framework interest rate is an exogenous variable, managed by ECB: consequently, the argument that increasing government spending would rise the interest rate appears not grounded.

With regard to the *wage channel*, structural reforms mainly refer to the labour market deregulation: in this view, increasing price competitiveness would be achievable through lower wages, then a disinflation process would be realised through proper reforms which eliminate wage indexations, decentralise the bargaining process and make job agreements more flexible.

Box 2 - From austerity to current account: effectual transmission channels



Along with *supply-side* policies, from a *demand-side* standpoint we argue that austerity actually contains income growth[22] since it reduces aggregate demand: according to our view, restrictive fiscal policies have rebalanced CAs by containing import, especially by reducing its endogenous component. Moreover, by reducing aggregate demand (and thus output according to the traditional Keynesian view), austerity may cause unemployment (see Box 2). This in turn would justify structural reforms (especially in the labour market), since according to the *mainstream* view wage flexibility would eliminate (or at least reduce) unemployment. However, we aim to clarify that the *demand-side* channel were not stated in the EZ austerity agenda,[23] while it actually worked in deficit countries.

3 Expansionary and Competitive austerity: a puzzling theoretical framework

As argued, austerity has not yet produced positive effects on debt-to-GDP ratios (neither expansionary effect on output). Nevertheless, policy makers had been continuing to enforce restrictive fiscal plans to GIIPS countries in order to achieve public debt consolidation and to reduce external imbalances. For these reasons, we argue that a proper focus on the theoretical underpinnings of this twofold interpretation of austerity – *expansionary* (see 3.1) and *competitive* (see 3.2) – appears crucial.

3.1 Expansionary austerity

Fiscal restrictions are based on the *mainstream* literature which refers to the so-called *expansionary fiscal contraction*, grounded on the following hypothesis: since reductions in government spending positively affect representative agent's expectations (due to decreasing future taxes), a fiscal

[22] Theodoropoulou and Watt [2011] quantified the impact of austerity on income: fiscal adjustment programmes in 2010/2011 were estimated in (% of GDP) 0.5/0.9 for SPA; GRE 5.6/6.3 for GRE; 2.1/2.6 for IRE; 1.2/4.9 for POR.

[23] We refer to *Euro Plus Pact* (*Competitiveness Pact*), *European Fiscal Compact* and several ECB recommendations which are consistent with our dual characterization of *expansionary* and *competitive* austerity.

contraction would expand private spending, then it would boost income. The concept that fiscal restraints can result in real growth is commonly known as *expansionary austerity*.[24] The theoretical framework underlying this argument is the *Ricardian equivalence proposition* in its modern refining,[25] which states that deficit spending has no real effects since forward looking consumers internalise government's budget constraint in making their intertemporal expenditure decisions. Then, how to finance a given fiscal expenditure (taxes or bonds) will not affect agents' consumption – thus, it will not modify aggregate demand. This approach is often used as an argument against tax cuts aimed at fostering aggregate demand, since a budget deficit simply postpones taxes: if government financed spending through deficits, taxpayers would anticipate they would have to pay higher future taxes, hence they would increase savings (i.e., they reduce current consumption). Similarly, no effects on aggregate demand would occur in case government had chosen to tax now. However, Barro [1979] stated that Ricardo itself was quite unconvinced about the empirical relevance of the equivalence [Ricardo 1820] as it requires hard assumptions.[26] Moreover, we argue that the theoretical link between *Ricardian equivalence* and *expansionary austerity* is, at best, not clear: according to the former view, deficit spending has no real effects on the economy, while according to the latter restrictive fiscal policies could even increase real output.

An additional statement is usually included in this strand of literature: decreasing government expenditure will reduce the *crowding-out*, making *room for the private sector to expand* [Giavazzi and Pagano 1990], while fiscal consolidation could restore business confidence by lowering interest rates, and then stimulate further investment (*crowding-in*). Hence, fiscal consolidation was considered to be related with economic growth when realised by reducing public expenditure [Alesina 2010; Alesina and Perotti 1995]. To be fair, empirical surveys do not provide for a clear evidence in support of *expansionary austerity* – even the *World Economic Outlook* [IMF 2010] argued that austerity measures are repressive in the short run, even though they remain expansionary in the long run.

3.2 Competitive austerity

According to *mainstream* underpinnings, decreasing government expenditure will increase private spending since the public sector would crowd out the private one in two ways: i) by directly subtracting market share to private agents, which are regarded as more efficient and competitive than public operators due to the profit motive; ii) by raising the interest rate, as private investment are considered to be negatively related on it.

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[24] This well-known expression has been coined by Alesina and Ardagna [2009].

[25] Specifically, the original *Ricardian equivalence* did not assume full employment equilibrium, while it is supposed in its modern restatement [Barro 1979].

[26] Firstly, the hypothesis of perfect capital market is worthy of criticism since liquidity constraints can invalidate the lifetime income assumption, as well as international capital mobility can make the framework more complex. Secondly, uncertainty about future income levels would increase liquidity preference (e.g., for precautionary purposes), reducing present consumption. Finally, actual unemployment can aggravate the scenario by worsening expectations.

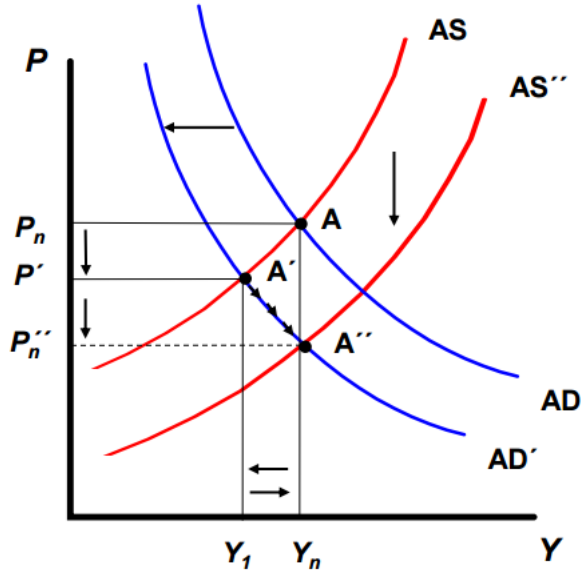
Furthermore, government wage bill accounts for a sizable share of public expense: in case austerity was implemented by reducing public employees (or by cutting their wages), this would have a direct impact on the whole frame of employment and compensations. Consequently, fears over job losses and could reduce consumers confidence, leading to save rather than spend: this can be inconsistent with *expansionary austerity*.

Moreover, deflationary effects might be achieved by means of a *fiscal devaluation*, a budget-neutral reduction of payroll taxes matched by changes in other taxes or in government expenditures [Calmfors 1998]. The typical example consists of a reduction of employers' social security contributions combined with a rise of the VAT rate: this would allow for the reduction of ULCs and improve export competitiveness, while a higher VAT rate would reduce consumption and import without penalising export. This might stimulate real economy as output should expand and trade balance improve. Furthermore, increasing social contributions are widely considered able to drive the prices of non-*tradeables* upwards, hence to cause a loss of competitiveness and consequently a of employment [Alesina and Perotti 1994]. On this basis, fiscal austerity is generally supposed to improve price competitiveness,[27] and all these mechanisms would operate as long as combined with a set of free market policies aimed at promoting efficiency and market openness (privatisation and deregulation). Accordingly, GDP growth is often related to the external sector, then policy makers should consider trade competitiveness as a key driver for economic growth even if within an integrated economic area as the EZ, where net export is virtually zero.

More generally, external trade can be influenced by austerity since this latter has an outright impact on prices and wages insofar as it affects aggregate demand: in a simple AD-AS model (see Figure 1), a fiscal contraction (for instance, a decrease in government spending, taxes being equal) will shift the aggregate demand schedule leftwards – from AD to AD'. The new equilibrium would involve a fall in prices (P' is lower than P_n) while it would imply a decrease in the equilibrium output (Y_1 is below its natural level Y_n) and employment. In this regard, we can immediately observe a basic inconsistency with *expansionary austerity* view, which implies growing output. However, *mainstream* economics consider output contraction as confined to the short run: in the medium run aggregate supply would move down (from AS to AS'') and the new equilibrium output (Y_n) would be reached with lower prices (P_n''). Fiscal restrictions are thus considered able to decrease prices without depressing real output and to enhance export by decreasing the real exchange rate. Finally, this mechanism is considered as symmetric, and expansionary fiscal policies would increase prices (without fostering real output, which would return at its natural level) and penalise export by the increasing real exchange rate.

[27] Perotti [2011] analysed four countries debt-consolidation experiences (DEN; IRE; FIN; SWE) and claimed: "*All four episodes were associated with an expansion; but only in Denmark the driver of growth was internal demand… In all cases interest rate fell fast, and wage moderation played a key role in generating a gain in competitiveness and a decline in interest rates… Wage moderation was facilitated by the direct intervention of the government in the wage negotiation process*".

Figure 1 - The dynamic effects of a decrease in the budget deficit [Blanchard and Johnson, 2013]



4 Imbalances explained: competitiveness, demand booms or something else?

Turning to the imbalances issue, the empirical evidence seems to suggest a twofold explanation of CA misalignments in the EZ context: specifically, both price competitiveness (driving exports) and growth differentials (affecting imports) were relevant for their genesis. Moreover, the actual debate appears quite weird since Euro inception increased external gaps between member states, while CA is almost on balance with respect to the whole EZ. To this regard, a single cause for external imbalances has not been traced so far, and different surveys are not consistent with each other in assessing the main drivers of such differentials. The European Commission provided a significant contribution in estimating the impact of each channel on CAs, by arguing that *changes in domestic demand could account for as much as 40-50% of the differences in current accounts observed in the Euro area since the launch of the Euro* [EC 2009]. Among scholars, Belke and Dreger [2013] argued that price competitiveness was highly relevant, hence ULC's realignment is required. Contrariwise, Comunale and Hessel [2013] stated that demand booms in peripheral countries may have been more relevant than price competitiveness, while Gaulier and Vicard [2012] did not consider losses in competitiveness as the main cause of deficits, but a symptom of demand shocks since the increase in ULC could be determined by rising prices in non-*tradeables*. Finally, Gabrisch and Staehr [2012] maintained that CA deficits would have caused relative ULC growth, but not *vice versa*. Summarily, it is possible to classify the determinants of external imbalances in two distinct groups: the first one refers to *supply-side* factors (see 4.1), while the second one is related to *demand-side* factors (see 4.2).[28] Furthermore, it should borne in mind that some Northern countries, especially Germany (see 4.3), experienced a

[28] Certainly, these channels have a different weight across deficit countries. Probably, the demand channel is more relevant for countries which experienced a sustained GDP growth during pre-crisis period (e.g., SPA and GRE), while in countries showing weak income dynamics (such as ITA) the supply channel (i.e., price competitiveness) played a key role.

peculiar growth model based on export growth and consumption restraints, which has been able to affect aggregate demand dynamics and composition.

4.1 Supply-side factors: price competitiveness, wages and productivity

Supply-side factors mainly refer to the competitiveness channel, according to which external imbalances are driven by price differentials: essentially, a real appreciation lead to a trade deficit. In this view, since a loss of competitiveness of surplus countries cannot occur in terms of technological regress (even if it might take place through increasing prices and wages), decreasing production costs are required to restore price competitiveness in deficit countries: in other words, an asymmetric adjustment (i.e., lower prices in the South) is regarded as necessary to shrink imbalances. However, we should observe that inflation in surplus countries is currently very low, and consequently price competitiveness gains in deficit countries are feasible only by deflation.

Table 1 - Source: IMF, WEO; OECD, Main Economic Indicators

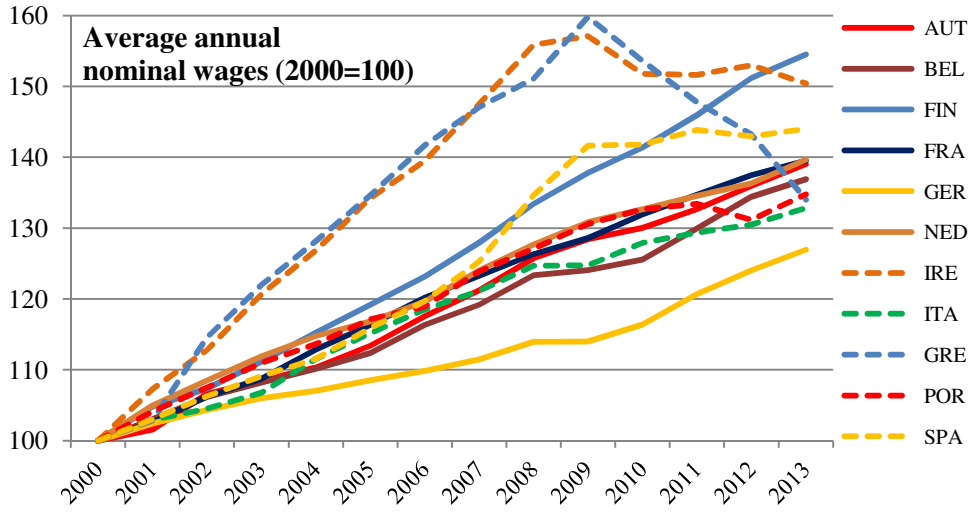
Country	CAB as % of GDP 1999-2010 (cumulated sum)	ULC annual average growth rate		CPI - annual average growth rate (1999/2010)
		Total Economy (1999/2008)	Manufacturing (1999/2008)	
Austria	22.76	0.71	-0.75	1.76
Belgium	29.40	1.82	-0.32	2.03
Finland	58.03	1.37	-2.42	1.77
France	2.39	1.74	-0.17	1.75
Germany	42.21	-0.06	-0.74	1.55
Netherlands	64.82	2.07	-0.02	2.26
Ireland	-21.66	4.76	0.50	2.91
Italy	-17.94	2.55	1.91	2.27
Greece	-107.05	3.37	1.68	3.12
Portugal	-117.60	2.57	0.99	2.56
Spain	-68.13	3.28	2.99	2.91

As a matter of fact, Northern countries – especially Germany – exploited low ULC growth and below median inflation rates after Euro inception (see Table 1). Then, due to the common currency, core countries experienced a real depreciation compared to the periphery: in this perspective, external imbalances may have been driven by wages and labour productivity differentials,[29] not compensated by exchange rate adjustments. Accordingly. EU policy makers attributed trade imbalances almost exclusively to a lack of price competitiveness of deficit countries assessed by means of REER dynamics [EC 2010], whereby core countries experienced significant depreciations, while in peripheral countries price competitiveness declined (see Graph 6). Also the dynamics of wage differentials should be considered as a root cause of imbalances. In this regard, some authors argued

[29] As argued in the following, CA balances are also influenced by different domestic demand patterns. However, Italy and Portugal seems to be peculiar cases: changes in their domestic demand are not strongly related to worsening current account positions. Conversely, this relation is stronger for Ireland, Greece and Spain (see Graph 4).

that Germany *pursued a policy of aggressive wage restraint (as a means of competitive real devaluation) resulting in large current account surpluses* [Stockhammer 2011], with export growth enhanced by wage moderation (see Graph 2) and poor ULC dynamics [Brancaccio 2011]. According to this view, wages would actually grow more than productivity in surplus countries to correct imbalances: however, this could imply a revision of the ECB inflation target to allow core countries to outpace periphery inflation rates without engendering deflation in the periphery. Nevertheless, the burden of the adjustment actually fell to deficit countries, as the EMU rule book provides for low inflation: this means that deficit countries were forced to restore competitiveness through disinflation, hence by lowering wages.[30] Consequently, this asymmetry[31] creates a deflationary bias: unless pushing periphery into deflation, core countries should achieve higher inflation rates than ECB target – obviously, this implies changing EMU rules, as well as a wage coordination to avoid a deflationary resolution of imbalances.

Graph 2 - Source: elaboration on OECD



Conversely, policy makers stated that competitiveness differentials are almost totally due to the low productivity growth in peripheral countries (compared to the central ones), as monetary wages seem to have converged [Draghi 2013].[32] However, we emphasize that labour productivity growth was higher in Greece and Ireland than in Germany before the global crisis, while in Spain it was in line with the

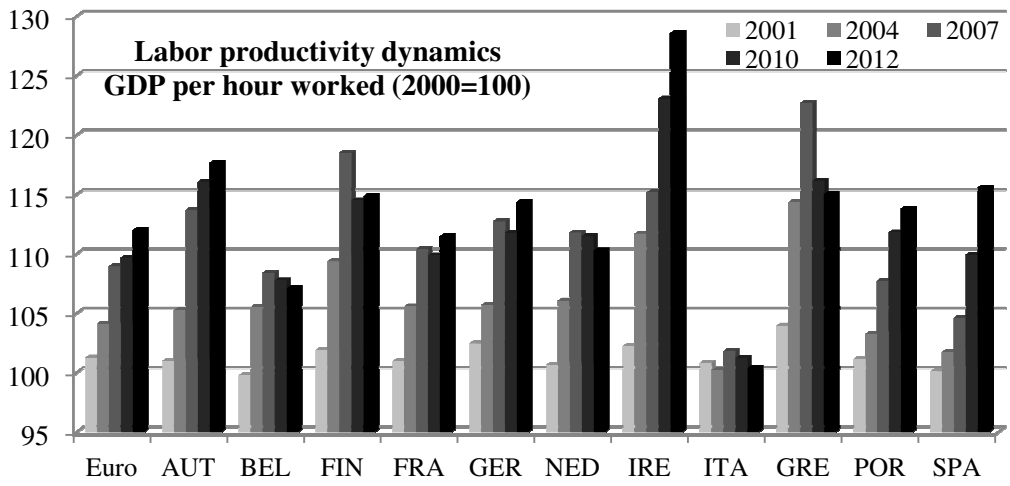
[30] Traditional policy instruments, namely exchange rate and discretionary fiscal policy, have been confined in the EMU. Hence, labour mobility is supposed to be the only adjustment tool. Nevertheless, Stockhammer [2011] stated that *wage flexibility has proven incapable of preventing long-lasting divergences in the levels of competitiveness and of current account positions across Europe*.

[31] Bagnai [2012a] claimed that ECB inflation target is biased because of the absence of a floor. This allows keeping inflation systematically below competitors, practicing a real competitive devaluation (a sort of *beggar-thy-neighbour* strategy).

[32] While wages and productivity dynamics may probably explain competitiveness losses in peripheral countries, also a comparison of ULC levels among members should be ascertained. Moreover, in this paper we mainly refer to the whole economy, not to the specific export sectors: it should bear in mind that also low productivity dynamics in non-export sectors might have increased production costs in those sectors which are exposed to the international competition. This issues definitely leave space for future research.

EZ average (see Graph 3): this dynamics was probably linked to the sustained income growth experienced in peripheral countries until 2007. In contrast with this evidence, *mainstream* economists usually state that deficit countries show *a large scope for* (labour) *productivity increases* (to be achieved through labour market deregulation), and that *a decrease in nominal wages sounds exotic, but is the same in essence as a successful devaluation; if it can be achieved, it can substantially reduce the unemployment cost of the adjustment* [Blanchard 2007b]. Such argument may be criticized by since wage deflation appears very different from a currency devaluation [Artus 2011]: the former can be a very painful process as it can take a long time to restore competitiveness, due to both wage cuts resistance and temporary lags between wage restraints and price decreases. Finally, countries which would need internal devaluation show high debt levels: in case lower inflation means deflation, this will increase the real value of debts. As a result, increasing public debt-to-GDP ratios could jeopardize sovereign bonds market, while increasing private debts may hinder consumption and investment, as well as compromise the banking system.

Graph 3 - Source: elaboration on Eurostat

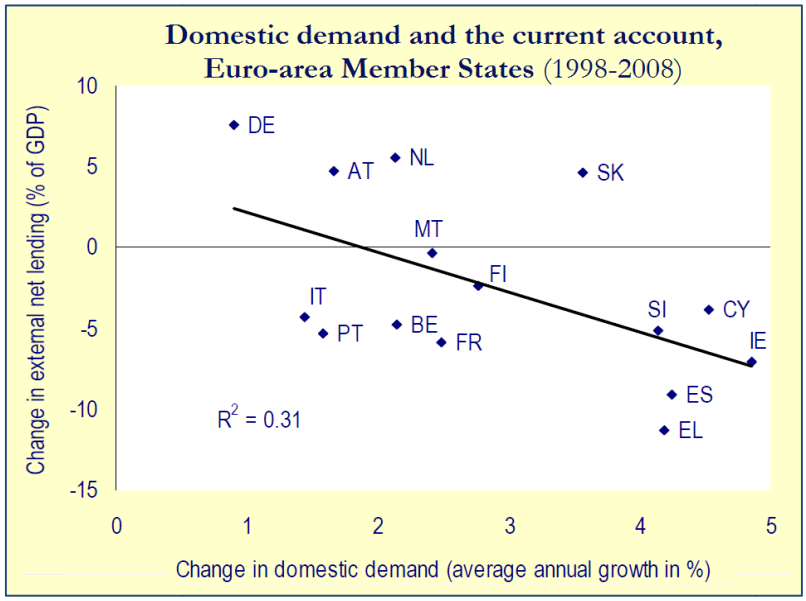


4.2 Demand-side factors: two different growth models

We basically relate demand-side factors to the existence of two different growth models, and to the fact that surplus countries export appeared able to meet deficit countries increasing demand. Specifically, two distinct growth models emerged within the EZ: i) core countries, which experienced an *export-led* model by pursing restrictive wage and fiscal policies since the onset of the Euro, partially *compensated by a relatively loose policy by the European Central Bank, tailored to the core countries, whose expansionary effects were predominantly felt in the EZ periphery* [Cesaratto and Stirati 2011]; ii) peripheral countries, where a *credit-led* model is reflected by both increasing domestic demand and growing income due to the cheaper access to financial markets (as a result of the interest rates downward convergence), combined with wage and price dynamics above the EMU average. Rather than a slack productivity growth, this wage trend led some Southern economies to a

loss of price competitiveness,[33] while core countries benefited from peripheral demand expansion [Uxó et al. 2011]. In the meantime, core countries have been experiencing low domestic demands (related to wage moderation) combined with weak real growth – probably, some core countries (as Germany) might have fallen in stagnation without export towards the South. These different models highlighted significant divergences across countries as far as concerns the determinants of economic expansion: while in *credit-led* countries agents financed consumption and housing through debt, they have been providing for great demand to *export-led* countries. This mutual action has brought about an "imbalanced" frame,[34] in both real and financial terms.

Graph 4 - Source: European Commission [EC 2009]



Also European Commission recognised demand factors as a determinant of CA imbalances (see Graph 4), although official reports emphasize the competitiveness channel.[35] Anyway, both domestic demand (which drives import) and external demand (which affects export) matter for CAs. In this framework, Cesaratto [2010] advanced an interpretation of imbalances within the EZ which refers to bilateral trade: in 2007 Spain export towards Germany was only 14.4% of its total export, while Spain imported from Germany 23% of its total import. As a result, Spanish deficit *vis-à-vis* Germany accounts for 49.3% of its external deficit: accordingly, Spain export is targeted towards different markets from Germany, while Spain represented an important outlet for Germany. In this perspective, other economists identified two different areas, but they conversely argued that the EZ suffers from an internal competitiveness problem rather than a lack of demand: for these reasons, expansionary fiscal

[33] Notice that competitiveness losses appear not related to sustained wage dynamics in Italy, but to stagnating productivity.

[34] We mainly refer to intra-European floes. For a snapshot, in 2006 Germany net export was for 57% towards the EZ, while 54% of Greece negative current account balance resulted from trade with Euro members (data: *Eurostat*).

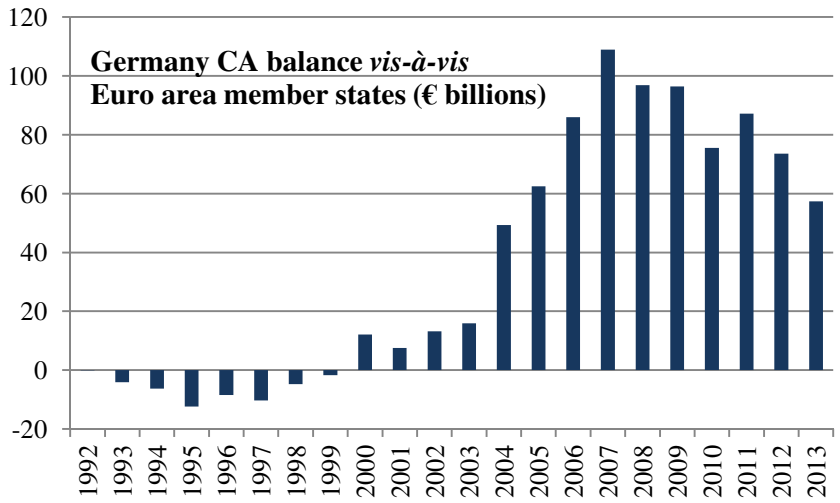
[35] "*(F)oreign demand was the main driver of exports but price competitiveness was key for explaining differences in export performance across Euro-area countries*" [EC 2010].

policies would provide for *temporary stimulus and relief, but at the expense of postponing the long-term adjustment that are needed to improve the competitiveness of the crisis-stricken countries*. Accordingly, deficit countries would need austerity to pursue a necessary devaluation: this *mainstream* view, which seems to be endorsed by policy makers, usually states that the solution for imbalances would be *more tolerance towards market forces that are already working in this direction* [Sinn 2014]. Conversely, it is possible to claim that strong domestic demand, in addition to positively affects productivity, can normally have side-impacts on CA since it can lead to growing import, as well as it can stimulate prices and wages, and consequently hinder competitiveness. According to the European Commission, this could have been actually occurred in Spain and Greece [EC 2009].

4.3 A focus on Germany growth model

As argued, core countries benefited from periphery *credit-led* growth and achieved high external surpluses. The main character of this tale was Germany, which after the Euro inception moved its CA *vis-à-vis* the EZ from a deficit to a surplus (see Graph 5). In parallel, growing peripheral demand combined with an easier access to international capital markets led Southern countries to further indebtedness, while Northern countries were willing to finance them due to the fact that the common currency eliminated the exchange risk.

Graph 5 - Source: elaboration on Deutsche Bundesbank

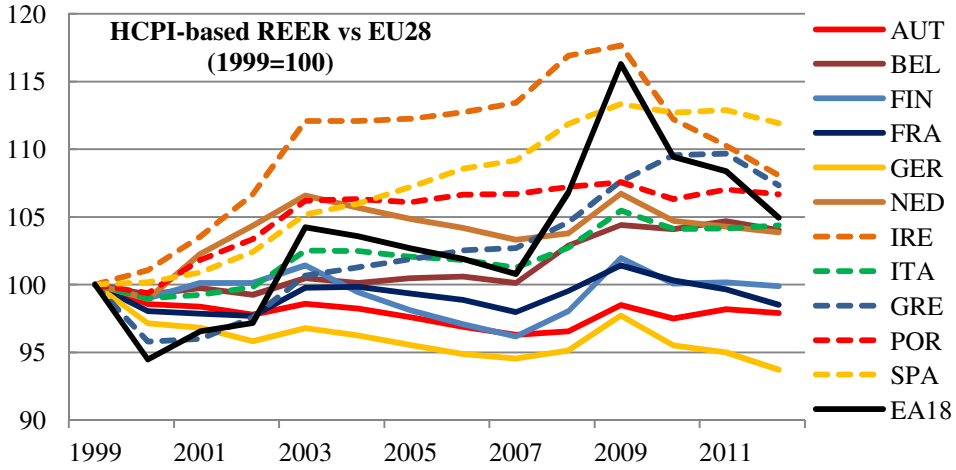


On this basis, external competitiveness appears linked to low domestic demand: in this respect, we provide some evidence on the Germany growth model to detect how it contributed to the widening of imbalances. According to data, since Euro inception Germany wage moderation has been relevant.[36]

[36] "*There is not only one way to restore competitiveness: I can only point out the success of Germany reforms, started in 2003 with labour market liberalization, and an increase in real wages lower than productivity growth; this was followed by cutting the social system costs, by raising the retirement age to 67 years, by creating a low wages segment… In order to implement this growth model in Italy, workers must give their consensus – similar to that obtained in Germany in last decade – accompanied by sacrifices, to regain competitiveness at world level. For example, between 2000 and 2010 labour costs per*

Nominal wage growth has systematically undershoot productivity dynamics, then ULC fell significantly between 2001 and 2007.[37] Accordingly, a marked decline in REER has been central for the rise of Germany export share, and this can be interpreted as a competitive devaluation. Two key factors determined Germany external competitiveness: off-shoring and structural reforms. Particularly, Marin [2010] claimed that *German firms' offshored part of production to the new member states in Eastern Europe, Russia and Ukraine*. Moreover, between 2003 and 2005 Germany implemented a strong labour market reform based on *Hartz* measures (both wage restraints and social contributions reductions were central in the *Schroeder Agenda*).[38] These factors led Germany to experience decreasing internal demand and increasing price competitiveness within a fixed exchange rate system.

Graph 6 - Source: elaboration on European Commission



Based on external performances, Germany is actually considered as a super-competitive economy.[39] However, the argument that its competitiveness has been fostered by income policies uncoordinated with other EZ countries is relevant. In fact, intra-EZ imbalances can be proved not to be solely driven by efficiency gaps: the empirical evidence indicates that Germany labour productivity is in line with the EU average (see Graph 3), while wage dynamics is not. Accordingly, Fritsche and Erber [2008] argued that *German competitiveness was mainly driven by massive wage restraints but is not due to productivity gains*.

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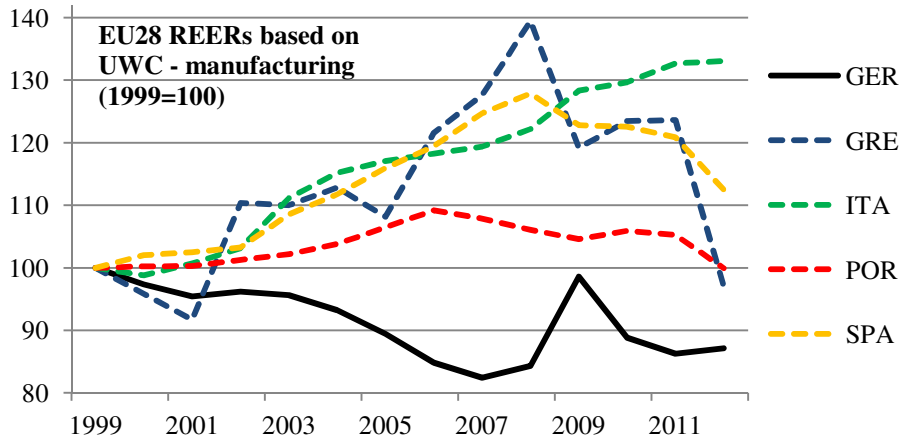
unit of output in Germany rose by 3.9% instead of 32.5% in Italy, and the cost of German products decreased by 18.2% as compared to the other EZ countries" (Roland Berger, consultant of Merkel's government, Corriere della Sera, 04.12.2011).

[37] "*Under the impression of high and sticky unemployment, the Schroeder Government initiated a series of labour market reforms starting in 2003, effectively reducing entry wages at the lower end of the labour market. Already starting in 2000, several tripartite negotiations had been undertaken in an attempt to lower wage growth and to restore price competitiveness... Most of the reforms essentially led to wage deflation... Little was done to restore competitiveness through increases in productivity... Indeed, productivity developments remained in line with other euro area countries*" [ILO 2012a].

[38] In 2012 Germany showed the highest proportion of low income workers in Western Europe (22.2%, *Eurostat*). Moreover, Brancaccio [2011] considered the slow wage dynamics as the result of deep changes in industrial relationships.

[39] Krugman [1996] suggested that competitiveness should be *a notoriously slippery term when applied to a country, rather than a firm*. In spite of this, Germany is defeating its international competitors and gaining an sort of dispute for market shares – it has been running a significant trade surplus also outside the EZ (its whole CA balance was 7.5% of GDP in 2013).

Graph 7 - Source: elaboration on European Commission



As a result, Germany experienced a strong decrease in REER with respect to the manufacturing sector[40] (see Graph 7), while on the contrary labour costs have drastically grown in other EZ countries: competitiveness differentials *vis-à-vis* peripheral countries were, on average, 20 base points,[41] and specifically a 40 base points gap with Italy emerged in 2012. However, it should be noted that before 2009 Italy ULC-based REER[42] was in line with the EU average, and HCPI-based REER was under the EZ median. Put it simply, while Italy price competitiveness traces the EU average, a sharp gap with Germany occurs.[43] Also the European Commission recognized this issue, and claimed that *if Italy's real exchange rates had evolved in a similar way to Germany's since the beginning of 1999, Italy's export growth would have almost matched that of Germany's, while in reality it was less than one third its size* [EC 2010].

These aspects notwithstanding, the *mainstream* argument goes as follows: I) CA surpluses reflect price competitiveness, while deficits mean lack of competitiveness; II) the fall in interest rates caused by the EMU led to unsustainable booms in borrowing and domestic demand in Southern countries, fuelling inflation and raising relative prices [Turunen et al. 2011]; III) deficit countries should adjust through internal devaluation. By contrast, in this paper we consider this view as disputable since it ignores the contribution that peripheral countries provided to core countries' export. Moreover, net export growth in Northern countries is partially due to a significant stagnation of domestic demand, caused by wage restraints and high saving [Simonazzi et al. 2013]. Then, Germany has been able to run an economy with *chronically weak demand* and persistent external surpluses since foreign countries have been the

[40] With regard to the manufacturing, Nocella [2015] observed a negative relationship between Germany labour share and export contribution to GDP (wage share deviations from average explain 68% export share variability). Moreover, wage share is more variable (1991/2007) in Germany than in Italy, USA and France.

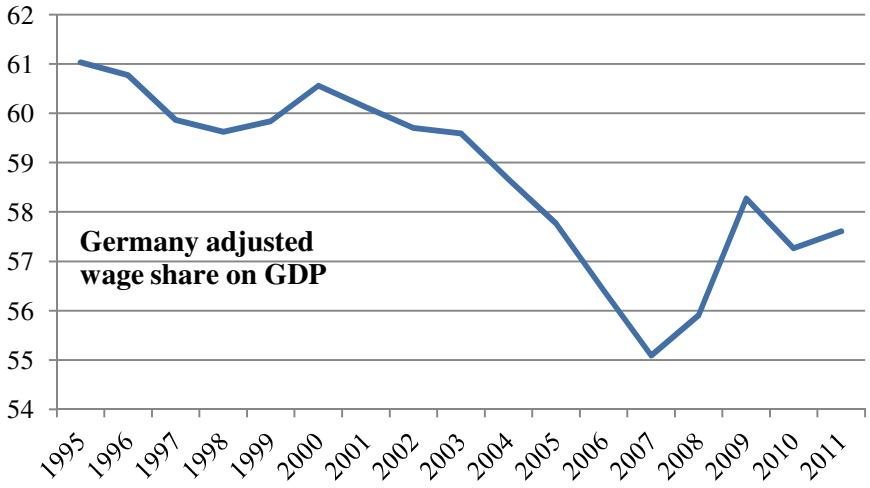
[41] Notice that from 2001 to 2007 (pre-crisis period), German nominal wages in the manufacturing sector grew at 1.8% average annual rate, far below Italy (3%), France (3.5%), Spain and Portugal (5.3%) (data: *OECD*).

[42] To be fair, recent ULC data are affected by a decreasing productivity, due to under-utilisation of output capacity.

[43] Italy competitiveness seems to be not compromised. To this purpose, we report trade balances distinguishing in total and European trade. With respect to intra-EU27 trade balance, from 1999 to 2012 Italy was essentially breakeven. However, in 1999 Italy exported to extra-EU27 countries 7.02% of its GDP, while 11.52% in 2012. Nevertheless, in the early 2000s Italy ran modest CA surpluses, while after 2005 import was greater than export, except for 2012 (data: *Ameco*).

opposite [Whyte 2010; Cesaratto and Stirati 2011]. In this regard, even the European Commission stated that *weakness in domestic demand has been the central driver of the downshift in imports and increasing current account surpluses*, also related to *the share of wages in GDP has been falling significantly in the Euro area as a whole; however, the fall has been significantly more marked in Germany and Austria than in the Euro area as a whole* [EC 2010] (see Graph 8). This is consistent with high propensity to save, which in Germany has been systematically 3% above the EZ average.

Graph 8 - Source: International Labour Organization



To prove weak internal demand, Table 2 provides evidence about different contributions to Germany real GDP growth. With reference to 1980/2013 (see 2.1) data show a 2.1% average growth rate, which is more than half (54%) due to consumption dynamics (C), and only 12% due to net export growth (NX). However, if we split the analysis in two sub-periods sharp changes in real growth contributions emerge. Before the onset of the Euro (see 2.2) average real growth was 2.7%, largely supported by consumption with a modest contribution of net export. After 1999 (see 2.3), Germany experienced lower growth rates (1.48% on average), with GDP dynamics depending on consumption for about 35%, while net export contribution was over 43%. Basically, weak domestic demand matches CA surpluses. Moreover, the clear change in net export contribution to growth indicates that Germany external competitiveness benefited from the Euro. Finally, investment-to-GDP ratios are quite constant overtime (about 18%),[44] then external competitiveness did not originate from a string investment dynamics, while it has been achieved through low labour costs.[45]

[44] To be fair, this can also reflect the high FDIs dynamics required by off-shoring.

[45] Lestrade [2010] referred to *wage dumping*: partially due to the widening of temporary job contracts, Germany became a two-tier society, with a dual labour market. In fact, apart from export-oriented employees, several workers have no minimum wage and no health insurance. Moreover, Murer [2012] estimated a 15% German unemployment rate (twice as much as the official data) by making revisions based on temporary workers and cumulative jobs: in this context, labour market deregulation provided for the implementation of *mini-jobs* (400 Euros per month) and *1 Euro-jobs*, usually for services, paid one Euro per hour.

Table 2 - Source: elaboration on Ameco (constant 2005 prices)

2.1) Average '80-13	C	G	I	X	M	NX	GDP
Growth rate	0.0194	0.0184	0.0186	0.0510	0.0482		
Share on GDP	0.5859	0.1941	0.1825	0.3183	0.2808		
Growth contribution	0.0113	0.0036	0.0034	0.0162	- 0.0135		2.10%
% growth contribution	54.00%	17.03%	16.15%	77.33%	-64.50%	12.82%	100%

2.2) Average '80-98	C	G	I	X	M	NX	GDP
Growth rate	0.0277	0.0243	0.0282	0.0446	0.0473		
Share on GDP	0.5895	0.1976	0.1841	0.2366	0.2078		
Growth contribution	0.0163	0.0048	0.0052	0.0106	- 0.0098		2.70%
% growth contribution	60.32%	17.74%	19.22%	39.05%	-36.33%	2.72%	100%

2.3) Average '99-13	C	G	I	X	M	NX	GDP
Growth rate	0.0088	0.0110	0.0063	0.0591	0.0494		
Share on GDP	0.5813	0.1897	0.1805	0.4218	0.3733		
Growth contribution	0.0051	0.0021	0.0011	0.0249	- 0.0185		1.48%
% growth contribution	34.57%	14.10%	7.71%	168.1%	-124.5%	43.62%	100%

In addition to wage moderation, also fiscal policy was relevant. In the early 2000s Germany experienced low income growth and high unemployment (10%), combined with growing public debt-to-GDP ratios, which were caused by expansionary budget policies aimed at subsiding workers damaged by *Hartz* reforms: these policies had contributed to put down real wages by about 6% [Bagnai 2012b]. Indeed, public deficits didn't depend on lower tax revenues, rather on higher expenditure on firms subsidies and on labour market active policies.[46] Moreover, low household consumption (due to wage restraints) contributed to the *export-led* growth. In the meanwhile, other peripheral countries were achieving fiscal consolidation (from 2000 to 2007), while only in 2006 Germany opted for restrictive fiscal measures: this is in contrast with *Maastricht Treaty*, which imposes budget policy coordination.

4.4 The adjustment of imbalances

As evidence suggests, the EZ crisis has not been caused by peripheral countries fiscal indiscipline, while persistent external imbalances (caused by price differentials and demand dynamics) not offset by real exchange rate adjustments might have played a key role. This turmoil exposed the structural fragility of the EZ, which does not allow for redistributive fiscal policies between surplus and deficit countries: combined with a peculiar institutional framework (especially, the belated ECB intervention), this makes the EZ not immune from speculative attacks on countries experiencing external imbalances. To adjust them, some economists suggested internal revaluation measures in surplus countries, as *a nice little inflation in Germany (...) and an expansion of its domestic demand* [Cesaratto and Stirati 2011], i.e., higher prices and wages in Northern countries [Brancaccio 2011]:

[46] Germany general government revenue/expenditure (billion): 2000, 946.64/923.36; 2001, 936.13/1000.78; 2002, 940.32/1022.33; 2003, 951.58/1040.72 (data: *IMF*). According to Bagnai [2012b], about two-thirds of additional (2000/2003) government expenditure represented direct or indirect subsidies to the industrial system.

accordingly, increasing wages in the North would reduce imbalances both lowering price competitiveness and changing income distribution (i.e., lowering profits would, in a Kaleckian fashion, increase aggregate demand and consequently import). In parallel, other authors claimed that an intermediate solution could be accomplished given peripheral countries troubles in achieving internal devaluation [Mayer 2011]: in so doing, the adjustment burden would be shared, especially during slowdowns, with surplus countries – the Keynesian view of stronger demand in surplus countries instead of weaker demand in deficit countries [Keynes 1943]. Contrariwise, Northern countries are not willing to endorse shared strategies, while they are imposing fiscal austerity to the South.[47] However, internal devaluation can stimulate competitiveness only in case wage restraints would cause an equivalent fall in prices – otherwise, it would only affect income distribution. In this regard, several surveys were sceptical about restrictive policies [Artus 2011; Levrero 2012; Papadimitriou et al. 2013]: even if they would correct CA misalignments, the cost of the adjustment would be vast in terms income loss and debt burden unless such adjustment was combined with surplus countries expansionary policies.[48] According to these arguments, we consider misleading the causal connection between austerity and competitiveness insofar as highly painful for deficit countries.

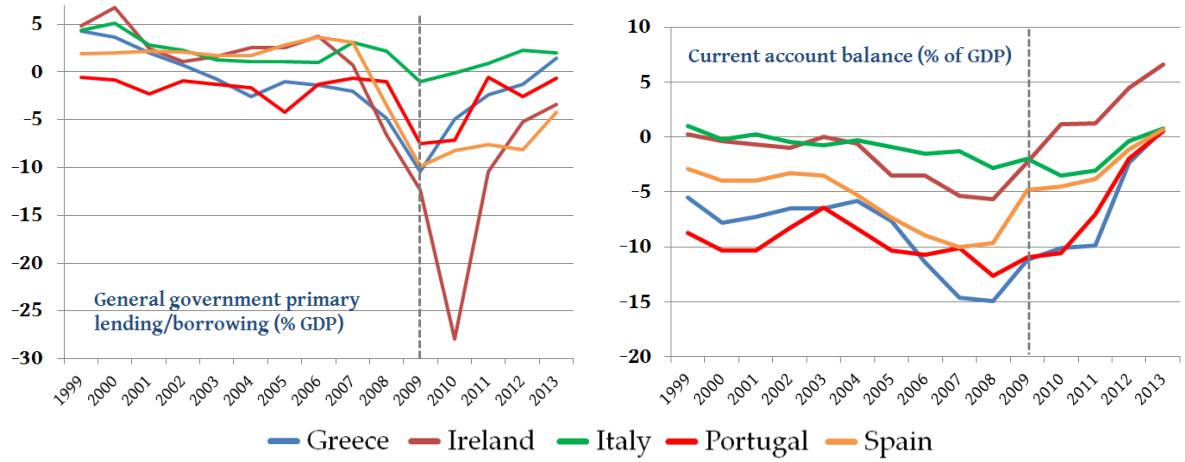
5 Austerity side-effects from a Keynesian perspective

As argued, *competitive austerity* has been a policy guideline so far, with GIIPS countries required to deflate in order to restore price competitiveness. Basically, it can be argued that restrictive policies has actually affected CA imbalances in the desired direction: if these measures were aimed to reduce external imbalances, macroeconomic evidence clearly show that, since 2009, in GIIPS decreasing deficit ratios (see Graph 9) – proxies for fiscal restraints – were combined with a progressive upward trends in CA balances (see Graph 10). Specifically, peripheral countries achieved positive CAs in 2013. Anyway, we consider this achievement as insufficient to endorse the *competitive austerity* perspective, especially due to the fact that restrictive policies dramatically contributed to lower income. On this basis, in this section we critically discuss austerity measures by means of additional evidence which refers to several macroeconomic outcomes (see Table 3).

[47] Specifically, *mainstream* arguments do not consider the idea of a substantial sharing of the adjustment burden. Alesina and Perotti [2010] argued: "*The constraint on European growth is not Germany's fiscal policy. It is the supply side rigidities that riddle all European national economies – especially those of southern European countries. To obsess about the demand side is simply misplaced – a slightly outdated, and oversimplified Keynesianism. Perhaps supply side reforms are unfeasible, but that should not lead us to fool each other that a German budget deficit of 5% instead of 3% of GDP will take Europe out of its predicament"*. Moreover, Dadush and Stancil [2011] stated: "*an extended period of austerity (fiscal consolidation, increased household savings, corporate and bank deleveraging) could lower prices and wages in the periphery, thereby re-establishing competitiveness*". Finally, J.P. Morgan [2013] referred to fiscal and competitiveness adjustments with a clear focus on sovereign deleveraging, real exchange rate adjustment, household and bank deleveraging, structural and political reforms: according to this report, *structural adjustment* would be feasible with political and constitutional reforms, and peripheral countries Constitutions are considered as constraining for governments' reform agendas.

[48] With reference to the costs of austerity, Kaldor [1971] claimed: "*Monetary union and Community control over budgets will prevent a member country from pursuing full employment policies on its own – from taking steps to offset any sharp decline in the level of its production and employment, but without the benefit of a strong Community government which would shield its inhabitants from its worst consequences*".

Graph 9 *Source: IMF, WEO* *Graph 10*



Particularly, wage moderation in GIIPS countries did not have an immediate effect on prices, and likely neither on export: in other words, austerity led to decreasing real wages without improving price competitiveness. In parallel, we observe growing unemployment rates combined with a progressive labour market *flexibilisation*, as proved by decreasing EPL: accordingly, employment dynamics was not related to the ongoing process of labour market deregulation.[49]

Table 3 - Source: elaboration on OECD

Nominal wages (growth)	2009	2010	2011	2012	2013	2014	2015
GREECE	5.81	-4.15	-2.49	-3.21	-6.74	-0.78	-0.42
IRELAND	0.86	-3.40	1.32	0.85	1.32	2.87	0.75
ITALY	0.10	2.38	1.33	-0.38	1.17	1.19	0.85
PORTUGAL	2.76	1.74	-1.40	-2.45	3.07	-1.32	-0.37
SPAIN	5.35	-0.50	0.70	-0.33	1.44	-0.31	0.25

Consumer Price Index	2009	2010	2011	2012	2013	2014	2015
GREECE	1.2	4.7	3.3	1.5	-0.9	-1.3	-1.7
IRELAND	-4.5	-0.9	2.6	1.7	0.5	0.2	-0.3
ITALY	0.8	1.5	2.8	3	1.2	0.2	0.0
PORTUGAL	0.8	1.4	3.7	2.8	0.3	-0.3	0.5
SPAIN	0.3	1.8	3.2	2.4	1.4	-0.2	-0.5

Unemployment rate 15-64	2009	2010	2011	2012	2013	2014	2015
GREECE	9.8	12.9	18.1	24.7	27.7	26.7	25.1
IRELAND	12.5	14.1	14.9	15.3	14.1	12.1	10.0
ITALY	7.9	8.5	8.5	10.8	12.3	12.9	12.1
PORTUGAL	10.0	11.4	13.3	16.3	17.0	14.5	12.9
SPAIN	18.0	20.0	21.5	24.9	26.2	24.6	22.2

EPL index	1999	2008	2009	2010	2011	2012	2013
GREECE	2.80	2.80	2.80	2.80	2.17	2.17	2.12
IRELAND	1.44	1.27	1.27	1.27	1.27	1.40	1.40
ITALY	2.76	2.76	2.76	2.76	2.76	2.76	2.51
PORTUGAL	4.58	4.42	4.42	4.13	4.13	3.56	3.18
SPAIN	2.36	2.36	2.36	2.36	2.21	2.21	2.05

[49] In Table 3 we provide *Employment Protection Legislation index* (data: *OECD*) for regular contracts.

To be fair, *competitive austerity* has not just involved internal devaluation in deficit countries to foster export (which had partially worked only for Spain and Portugal): restrictive policies have negatively influenced peripheral countries income and consequently lowered their import (especially for Greece and Italy). In this perspective, *competitive austerity* – consistent with an asymmetric-deflationary adjustment based on fiscal strictness and wage flexibility – led to dramatic effects on deficit countries domestic demand and productive systems, with a negative impact on employment. In addition to hinder internal demand, these measures had also poor substitution effects – which are typical in case of currency devaluation – between domestic and foreign goods. Finally, austerity did not lead to fiscal consolidation (in terms of debt-to-GDP ratio) so far.

However, both *expansionary* and *competitive* austerity appear questionable if analysed from an alternative theoretical perspective. For these reasons, following Keynesian underpinnings in this section we examine restrictive policies side-effects on output, employment and debt ratios in order to disprove the link between austerity and competitiveness.

5.1 The relationship between austerity and investment

Basically, the idea that fiscal consolidation may stimulate private expenditure (by lowering interest rate and boosting investors confidence) contradicts the usual Keynesian view that higher taxes and/or lower public expenditure have contractionary effects – amplified by the multiplier effect – on aggregate demand and then on output. In addition, the crowding-out thesis can be subject to a twofold critique. Firstly, investment decisions do not depend solely on interest rate, as they are deeply influenced by entrepreneurs' expected demand: in this regard, the inverse relationship between investment and interest rate, central to the *mainstream* view, was theoretically criticized from by Garegnani [1979] and empirically proved not to hold at firm level[50] [Chirinko 1993] – hence, some authors argued that *the empirical evidence on the sensitivity of investment to interest rates is, at best, equivocal* [Blinder 1997]. Secondly, public and private spending can be treated as interconnected: on the one hand, investment can grow due to the fact that public expense stimulates expected demand; on the other hand, government expenditure can provide for a more favourable economic environment (e.g., improving infrastructures). In this perspective, fiscal restraints can also reduce private investment, with the paradoxical effect to worsen efficiency and competitiveness.

5.2 Wage deflation effects on aggregate demand

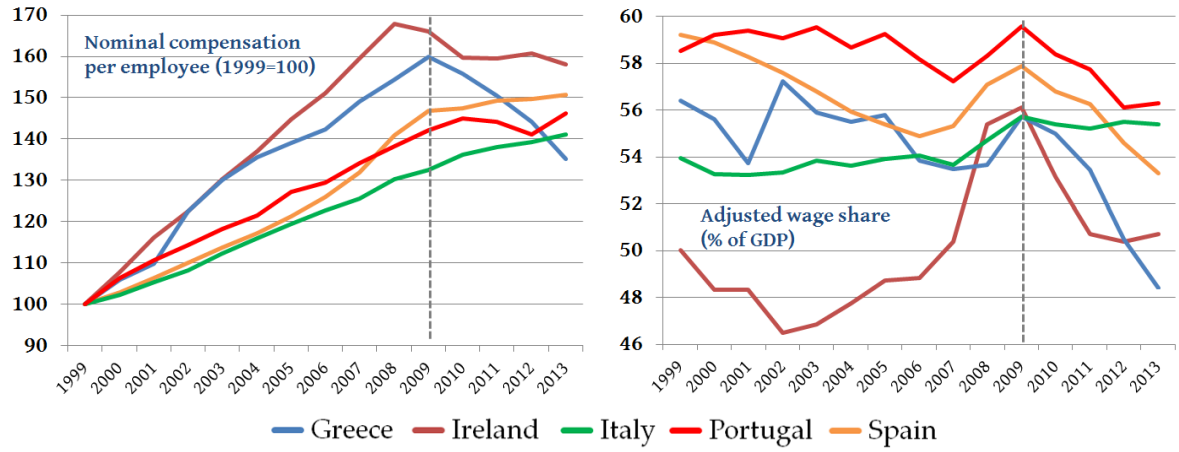
With respect to deflationary policies to foster competitiveness by means of wage deflation, two cases can be distinguished: i) wage decreases would be followed by an immediate and equivalent reduction in prices; ii) the just mentioned mechanism would not be straightway as prices are sticky, and

[50] A recent Krugman [2014] proposition reinforced this view: "*one of the dirty little secrets of monetary policy is that it normally works through housing, with little direct impact on business investment*".

consequently they would not promptly react to wage falls. Accordingly, while in the first case real wages would not change, in the second one income distribution would be modified.

Let us start from the case of constant real wages (i). In the actual EZ framework, where very low inflation is dominant, nominal wage moderation might lead to deflation: this latter would increase debt burden and induce agents to postpone consumption. Then, *competitive austerity* can reduce household spending even without changing income distribution: consequently, lower private expenditure combined with restrictive fiscal policies will dramatically affect aggregate demand and then total output – what is more, this in turn would negatively affect investment (since it is largely endogenous). Furthermore, even in case of perfect transmission, decrease of internal demand can outweigh export growth in *wage-led* economies [Stockhammer and Onaran 2012].

Graph 11 *Source: Ameco* *Graph 12*



However, the case of decreasing real wages (ii) appears more realistic: as suggested by Table 3, nominal wage moderation in peripheral countries (see Graph 11) affected prices only after a certain delay.[51] Consistently, the competitiveness effect has been confined, while income distribution has changed in favour of profits (see Graph 12). From an alternative theoretical perspective, such redistribution is able to depress the economy owing to the different propensities to consume of profit and wage earners [Kalecki 1954; Kaldor 1966]. Summing up, we can argue that the competitiveness effect – linked to wage moderation – can partially fail: this scenario is consistent with real wage reduction, and the subsequent redistribution in favour or profits would cause a fall in aggregate demand [Brancaccio 2011]. Moreover, wage deflation would have no effect in case this strategy was pursued by all member countries: in this case, this sort of wage dispute would lead to a generalised contraction of the EZ. Finally, as a large share of trade flows of member countries involves EZ partners, the *export-led* model cannot generally be applied.

[51] In Italy, nominal wages grew more than in other peripheral countries from 2002 to 2009: however, real wages seem not to show an upward trend due to high inflation in the *non-tradable* sectors (services and utilities).

To this regard, current wage moderation policies in the periphery to fill the competitiveness gap with core countries were previously pursued in core countries, with the consequence of higher employment abroad.[52] For instance, after a decade of low growth and high unemployment (9.7% in 1997) Germany opted for a the *export-led* growth model [Brancaccio 2011]: compared to other EZ countries, wage dynamics became significantly lower, and this allowed German firms to be more competitive.[53] On this basis, wage strictness in a fixed exchange rate regime means transferring on workers the burden on external adjustment. However, the EZ cannot be considered an *optimal currency area*,[54] and austerity become competitive since employment gains through mercantilist policies are reached at the expense of higher unemployment in other countries. Then, *competitive austerity* in a flawed currency area [Barba and De Vivo 2013] is essentially *beggar-thy-neighbour*. On these bases, this paper considers questionable the policy consensus view of "temporary" and "good" imbalances – suggested by *mainstream* economics [Blanchard and Giavazzi 2002] – which should be adjusted by means of austerity. Furthermore, austerity led to higher unemployment and lower economic growth, while governments have cut welfare programs which benefit the weakest members of society, deeply redesigning, *in a regressive sense* [Stirati 2012], income distribution and welfare.[55] Finally, deficit countries are experiencing a huge slowdown of economic activities which lead national firms to international processes of merger and acquisition, or even to became international sub-suppliers.[56]

For all these reasons, we claim that such painful process of wage devaluation has been dangerous and counterproductive. To this regard, ILO [2012b] recently argued that any recovery strategy should be *wage-led*, since wage shares have been dramatically decreased during last decades, while supply-side policies based on labour market deregulation are proved to reduce real wages, especially during slowdowns.[57] Consequently, the *competitive austerity* approach will not solve the EZ issues (mainly, low growth and unemployment), even though it has been considered a proper tool to correct trade imbalances. In our opinion, as long as deficit countries cannot pursue independent fiscal and monetary

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[52] "*…if nations can learn to provide themselves with full employment by their domestic policy (…), there need be no important economic forces calculated to set the interest of one country against that of its neighbours. There would still be room for the international division of labour and for international lending in appropriate conditions. But there would no longer be a pressing motive why one country need force its wares on another or repulse the offerings of its neighbour, not because this was necessary to enable it to pay for what it wished to purchase, but with the express object of upsetting the equilibrium of payments so as to develop a balance of trade in its own favour. International trade would cease to be what it is, namely, a desperate expedient to maintain employment at home by forcing sales on foreign markets and restricting purchases, which, if successful, will merely shift the problem of unemployment to the neighbour which is worsted in the struggle.*" [Keynes 1936].

[53] Germany CA balance (% of GDP): 1999, -1.35; 2000, -1.83; 2007, +7.48; 2012, +7.10 (data: *OECD*).

[54] As argued by Mundell [1968], *an essential ingredient of a common currency area is a high degree of factor mobility*. We claim that within the EZ labour market is not totally integrated in terms of laws, languages and cultures; by contrast, capital market is fully integrated, and its integration benefited also to the absence of exchange rate risk.

[55] Consistently, Busch et al. [2013] argued that *the EU's anti-crisis policies are accompanied – especially in Southern Europe – by harsh austerity policies, bringing in their wake growing unemployment, falling real wages, cuts in the social security system and privatization of public property*.

[56] Krugman [2000] identified these international operations as *Fire-Sale FDI*.

[57] Recently, this seems to be shared by policy makers: "*reforms to employment protection arrangements and unemployment benefit systems have positive effects in good times, but can become contractionary in periods of slack*" [IMF 2016].

policies they will not address the root cause of unemployment, which partially reflects restrictive fiscal measures taken abroad.

5.3 Internal vs. currency devaluation

As argued, *competitive austerity* was able to directly reduce aggregate demand through lower public expense (or higher taxes), and indirectly since, from a Keynesian perspective, it negatively influenced consumption and investment. Consistently, the only component of aggregate demand which might have increased was export, likely due to decreasing prices. In this regard, exchange rate regime is however crucial.

In the EZ case, where fixed exchange rates apply, lower prices generally allow for trade balance growth. Nevertheless, this means that other EZ countries will lose market shares, and the external adjustment is to be considered *compulsory for the debtor and voluntary for the creditor* [Keynes 1980] since core countries should increase their demand in order to reduce external surplus,[58] while deficit countries can restore their competitiveness only by means of internal devaluation.

In contrast, in case of flexible exchange rates the persistence of external deficits usually leads to currency depreciation: this would likely allow for the adjustment of relative prices and, generally, stimulate export and engender import substitution processes,[59] with a positive impact on income and employment.[60] Anyhow, this mechanism is not feasible within the EMU, and price competitiveness can be recovered only by means of internal deflation, hence by reducing labour costs.[61] However, in contrast with Blanchard [2007a], we argue that a wage deflation adjustment is significantly different from a currency depreciation: only in case prices of non-traded goods were perfectly flexible, as well

[58] This seems not to be the case of Eurozone, where surplus countries are financing external deficits of periphery through international capital flows. However, this not implies external adjustment, since core countries would keep their surplus. To this regard, it can be argued that external debt could be unsustainable in the long run even within a monetary union for three reasons: 1) in case peripheral countries would finance external deficits by means of international loans, they could face a debt crisis; 2) in case imbalances would persist, deficit countries would suffer the burden of adjustment in terms of growing unemployment and, according to the *competitive austerity* view, worsening welfare; 3) increasing trade deficits would be related to huge capital outflows, hence deficit countries could be induced to quit the currency union.

[59] Generally, this is the case of an economy which exhibits an advanced production system. To this regard, some authors argued that increasing price competitiveness would not be able to correct EZ imbalances since price differentials would not be the main driver of trade flows: according to Danninger and Joutz [2007] Germany surplus depended on its productive structure (quality, technological content and diversification), while Simonazzi et al. [2013] argued that *differences in price competitiveness (…) are only part of the explanation of the disequilibria, with a much greater role being played by the composition (and direction) of exports and the underlying organisation of production: it is the quality of exports that needs to be improved*. However, also this position regards *competitive austerity* as a wrong recipe for the EZ imbalances, since it would further damage the industrial system of deficit countries, while lower wages would not restore their external competitiveness because of the complexity of Germany export. Nevertheless, we consider flexible exchange rates as a feasible instrument to solve the imbalances issue, especially for deficit countries with a developed industrial base (as Italy), while they could not work for countries with narrow productive systems.

[60] Nevertheless, increasing relative prices of import would improve trade balance only in case the *Marshall-Lerner* condition was verified. Formally, this indicates that a currency devaluation would have a positive impact on trade balance only in case the sum of import and export price elasticities (in absolute terms) is greater than one.

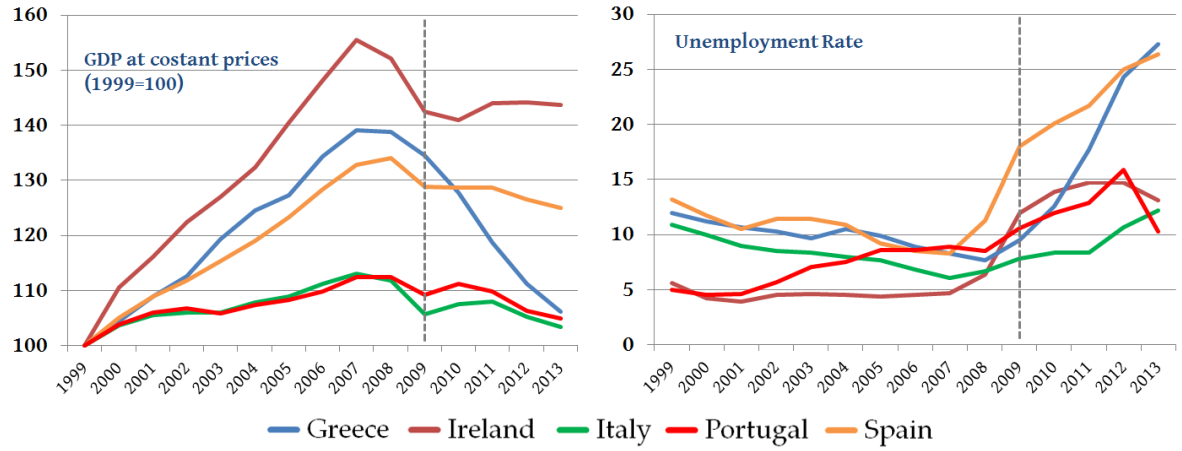
[61] In this respect, Dadush and Stancil [2011] claimed that peripheral countries workers appear too expensive compared to their more efficient German competitors: this is consistent with the argument that deficit countries could restore their external competitiveness only through wage adjustments.

as all prices immediately adjusted to wage cuts, the competitiveness effect would be similar.[62] However, this appears unrealistic since prices are usually sticky – to this regard, Artus [2011] claimed that wage reductions can lead to a *far more pronounced loss of purchasing power than an exchange rate depreciation*. Then, it is not certain that restrictive policies would improve price competitiveness through wage reductions since the profitability effect can confine the competitiveness one.

5.4 Output, domestic demand and unemployment

While austerity has been contributing to reduce intra-EZ external imbalances, it is negatively affecting deficit countries real growth (see Graph 13) and consequently employment (see Graph 14), which were already harmed by the 2007 financial crisis. As macroeconomic evidence is itself sufficient to refute the *expansionary austerity* view, we claim that policy makers shifted their focus on external competitiveness to pursue with restrictive policies. In our opinion, the EZ has been facing a signal lack of domestic demand (see Graph 15), and this is not solvable through export policies or wage competitiveness. In addition, *competitive austerity* could actually lead to deflation: if core countries inflation systematically settles below 2%,[63] competitiveness gains in peripheral countries are feasible only with zero or negative inflation, with the typical risks of deflation. Summing up, we argue that the EZ troubles rely on core countries economy (especially Germany), where the external demand is more central than the internal one: while German growth is mainly determined by price competitiveness, an *export-led* recovery based on restrictive policy cannot be adopted by all EZ countries.

Graph 13 *Source: Ameco* *Graph 14*



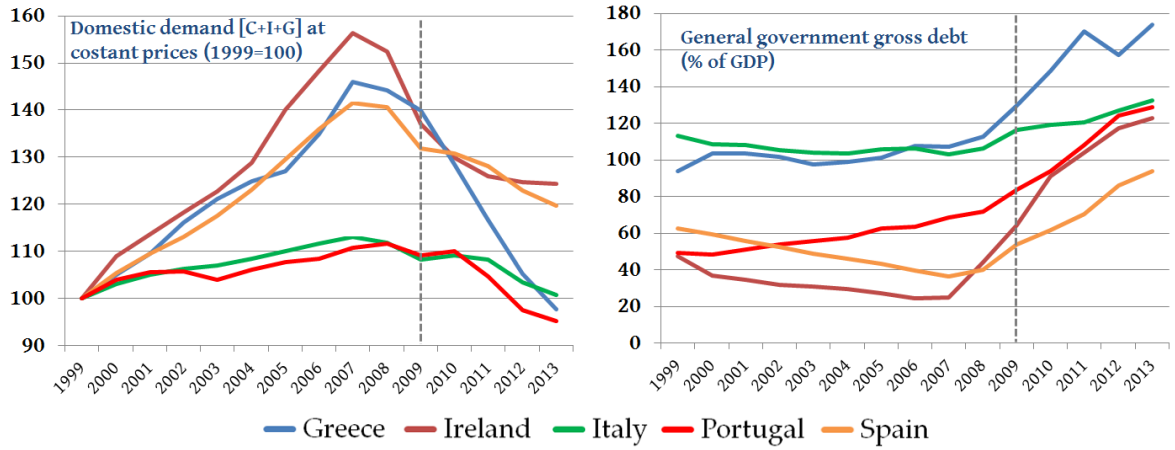
Conversely, in a Keynesian perspective both monetary and fiscal expansionary policies are able to sustain growth and employment. Within this approach, inflation (which would erode price competitiveness) should not be regarded as the automatic result of stimuli, but rather as depending on

[62] We remind that wage deflation would result quite different from currency devaluation with respect to the debt burden: falling wages would make credit market more nervous, especially in case loans are intermediated by the banking system.

[63] For instance, Germany CPI growth rate: 2010, 1.12; 2011, 2.31; 2012, 1.98 (data*: Ameco*).

other factors (e.g., the distribution conflict, which becomes more fervent when the economy approaches full employment): actually, inflationary pressures are unlikely in light of high unemployment and spare output capacity. Notwithstanding this alternative strategy, EZ policy makers have been attempting to enhance competitiveness through disinflation, although their policies produced huge costs in terms of growth and unemployment: austerity pushed peripheral countries into recession, and income in GIIPS countries is still significantly below the pre-crisis level, combined with high unemployment rates.

Graph 15 *Source: Ameco* *Graph 16*



Furthermore, it could be argued that output capacity does not just remain idle after long recessions, while it could be actually destroyed: net investment could fall below zero as unutilised capital would not be replaced. To this regard, Vianello [2013] argued that *an insufficient demand protracted over time unavoidably generates a slowdown in the formation of new productive capacity and therefore of potential income*. As a matter of fact, until 2008 both GDP and potential GDP was growing, while at a later time collapsing demand led GDP down: although until 2012 potential GDP did not decline, actual lack of demand is destroying output capacity.[64] Then, austerity is able to depress real economy (by hampering aggregate demand dynamics) even in the long-term, while its declared aim is to deflate the economy in the short-run to enhance external competitiveness.

5.5 A failed fiscal consolidation

While *competitive austerity* was implemented by means of cuts in public spending, it has not led to fiscal consolidation in terms of lower debt-to-GDP ratios. These policies should have restored investors confidence by overwhelming credit spreads, and then reduced unsustainability fears. However, from an alternative standpoint we consider fiscal austerity as inefficient to mitigate yield

[64] In the case of Italy, IMF estimates of potential GDP damage are ranged between 7% and 12%. In this framework, if decreasing potential GDP had been caused by austerity policies, a kind of paradox would be realized: a decrease in potential growth (caused by restrictive fiscal policies) would cause an increase in deficit-to-GDP ratio – since this ratio is calculated on potential GDP – and this in turn should lead to further austerity measures.

differentials, as well as an inadequate tool for solving the EZ crisis since its architecture does not involve proper adjustment instruments (e.g., common fiscal policy). Consequently, we consider ECB intervention on secondary markets – through the Securities Markets Programme and other institutional mechanisms (e.g., the ESM) – as the main cause of spread lowering, but such support for sovereign bonds demand was substantially conditional to austerity policies. This argument is supported by the empirical evidence, which indicates that since 2009 debt-to-GDP ratios have been rising steeply (see Graph 16): while fiscal restrictions have not achieved the expected results in terms of consolidation, credit spreads are actually lower than in 2010/2011, as a result of ECB bonds' purchases rather than due to austerity.[65]

Following Keynesian underpinnings, the fact that restrictive fiscal policies led to growing debt-to-GDP ratios can be explained by the role of fiscal multiplier: budget surplus may reduce total income, and then debt-to-GDP ratio would increase despite the reduction in public debt.[66] The consensus wisdom (i.e., austerity makes public debts sustainable) can thus be criticised since increasing government spending (especially, when the economy is below full employment) may reduce debt-to-GDP ratio due to the multiplier effect [Ciccone 2002; Leão 2013]. In this framework, even an IMF research revised upwards the estimates of fiscal multipliers [Blanchard and Leigh 2013], which were previously assumed to be, on average, about 0.5 in advanced countries. Briefly, fiscal consolidations are more expensive – in terms of output losses – than previously believed: the higher are fiscal multipliers, the higher is the probability that fiscal consolidation will have a counterproductive effects,[67] especially since fiscal multipliers are likely to be time-depending (i.e., higher in a downturn than during expansions).

Furthermore, since Euro inception the spending attitudes of GIIPS governments GIIPS varied significantly. Spain and Ireland ran primary surpluses until 2008, then bailouts and stabilizers led to fiscal deficits. Italy was the most striking case, as primary fiscal deficits were experienced only in 2009 and 2010, while Portugal and Greece have been running primary deficits since 1999 and 2003, respectively. Besides, the picture changes dramatically when net public lending/borrowing instead of primary balance are considered, i.e., including debt service,[68] since net public deficits often reflect interest expenditure: from 1999 to 2012, debt service has represented, on average, 5% of GDP for Italy and Greece, while about 3% of GDP for Spain, Portugal and Ireland. This means that a lower debt

[65] In this regard, Levrero [2014] asserted that ECB interventions were strong enough to control sovereign bonds' yields, with a scarce or nil influence for fiscal policy.

[66] A decreasing stock of public debt can actually be experienced only in case interest expenditure is greater than primary surplus. Otherwise, debt stock will increase despite restrictive fiscal policies.

[67] In this regard, Nuti [2013] argued that in case of fiscal multiplier was greater than the ratio between GDP and public debt, a *perverse* effect would emerge, i.e., fiscal consolidation would led to a higher debt-to-GDP ratio.

[68] The breakneck growth of spreads (occurred before ECB intervention) dramatically increased interest expenditure. To this regard, Barba and Pivetti [2009] argued that public debt, instead of the private one, can be *checked by interest rate control*.

service would have greater stances than austerity. Finally, fiscal consolidation can be considered as failed as public debts have increased even in absolute terms (except for Greece due to a haircut).

5.6 Current account: not only trade balance

As within actual debates a country is roughly defined as competitive in case it shows an external surplus,[69] we claim that a narrow link between competitiveness and CA balance should be considered as misleading since CA includes – apart from real trade (X – M = TB, i.e., export less import of goods and services) – also net factor incomes from abroad (NY) and net cash transfers (NCT). While this latter's contribution to CA is negligible within the EZ, this is not with respect to net factor incomes (both labour and capital) from abroad. Put it simply, a negative NY means that a country is paying to external factors more than its employed factors abroad are receiving.

As within the EZ trade deficits are often financed by international loans, and surplus countries finance deficit ones, this can basically lead to negative net factor incomes in countries which experience high external liabilities – hence, a debt spiral can be a consistent consequence.[70]

Table 4 - Germany CAB (billion) vis-à-vis the EZ - Source: elaboration on Bundesbank

Year	CA	TB	Y +	Y -	NY	NCT	TB/CA	NY/CA	NCT/CA
1992	-122.98	1585.51	23683.37	22232.65	1450.72	-3159.21	-	-	-
1993	-4062.30	-769.35	24724.31	25306.38	-582.07	-2710.88	-	-	-
1994	-6329.27	-649.92	23841.93	26525.89	-2683.96	-2995.39	-	-	-
1995	-12336.02	-1648.43	21710.40	29643.27	-7932.87	-2754.72	-	-	-
1996	-8447.12	546.16	25084.69	31336.48	-6251.79	-2741.49	-	-	-
1997	-10336.60	-1667.31	29462.93	35210.83	-5747.90	-2921.39	-	-	-
1998	-4735.29	4216.36	32926.20	38900.82	-5974.62	-2977.03	-	-	-
1999	-1747.50	7696.08	40845.36	47644.99	-6799.63	-2643.95	-	-	-
2000	12155.84	14359.03	56331.62	55250.20	1081.42	-3284.61	118.1%	8.9%	-27.0%
2001	7505.01	22543.81	51328.49	62830.08	-11501.59	-3537.21	300.4%	-153.3%	-47.1%
2002	13165.29	33656.62	51581.15	68629.61	-17048.46	-3442.87	255.6%	-129.5%	-26.2%
2003	15949.86	38388.42	51791.89	70583.99	-18792.10	-3646.46	240.7%	-117.8%	-22.9%
2004	49350.42	56143.30	67308.99	70115.10	-2806.11	-3986.77	113.8%	-5.7%	-8.1%
2005	62423.70	69511.06	73801.39	77166.86	-3365.47	-3721.89	111.4%	-5.4%	-6.0%
2006	85944.60	72397.30	96674.61	79774.77	16899.84	-3352.54	84.2%	19.7%	-3.9%
2007	108973.28	95118.55	121875.94	103007.12	18868.82	-5014.09	87.3%	17.3%	-4.6%
2008	96816.52	84323.34	104769.37	88356.40	16412.97	-3919.79	87.1%	17.0%	-4.0%
2009	96376.27	63744.04	101839.21	64488.99	37350.22	-4717.99	66.1%	38.8%	-4.9%
2010	75534.22	64246.33	99786.81	82434.62	17352.19	-6064.30	85.1%	23.0%	-8.0%
2011	87120.39	59394.48	114269.05	81940.59	32328.46	-4602.55	68.2%	37.1%	-5.3%
2012	73571.06	43062.14	110381.91	75027.57	35354.34	-4845.42	58.5%	48.1%	-6.6%
2013	57404.71	28971.07	104804.64	72745.94	32058.70	-3625.06	50.5%	55.8%	-6.3%

[69] The *Scoreboard of* EU *Macroeconomic Imbalance Procedure* states that the *alert mechanism* will get activated in case of *3 year backward moving average of the CA balance as percent of GDP, with thresholds of +6% and -4%.*

[70] Actually, debt spirals could have been verified in the EZ. For instance, SPA net incomes were -7.7 billion in 1998, -17.1 in 2005 and -35.5 in 2008; GRE net incomes were -1.4 billion in 1998, -5.6 in 2005 and -10.6 in 2008; IRE net incomes were -9.4 billion in 1998, -24.9 in 2005 and -25.2 in 2008 (data: *Eurostat*). Accordingly, CA worsening can be attributed to a large extent to negative net incomes. This latter were, especially for Ireland, capital incomes.

Besides, further consideration can be advanced with respect to the CA composition in surplus countries. To this regard, Germany CA *vis-à-vis* the EZ became positive in 2000 (see Table 4), and it largely depended on increasing trade balance – doubled if compared to 1999 – which experienced a steady growth up to 2008. Besides, net incomes share on CA was negative up to 2006, when it suddenly became positive (19.7%). Since 2006, NY share has been persistently increasing, and it has overtaken the TB share in 2013: it means that Germany CA is experiencing a shift from trade balance to factor incomes earned from abroad. Accordingly, we claim that CA balance is a highly misleading metric for external competitiveness since it does not consider solely real trade. To this regard, due to the fact that surplus countries are international creditor within the EZ, factor incomes usually involve capital incomes.

6 Final remarks

The main innovation of this paper was to examine the linkage between austerity and competitiveness which lies beyond restrictive policies implemented in the EZ periphery to cope with external imbalances, considered as the root cause of credit spreads crisis. For this purpose, we discussed both crisis genesis and policies: specifically, the central issue of this paper was the role of austerity as a tool for enhancing price competitiveness in deficit countries. To this regard, different remarks have emerged from this research. As argued, since fiscal indiscipline of peripheral countries was not the root cause of the EZ crisis (while a key role has been played by intra-EZ trade imbalances), austerity could not contribute to the reduction of credit spreads – which have been essentially lowered as a result of ECB purchases, with such support conditional on austerity programmes. Although restrictive fiscal policies actually worsened debt-to-GDP ratios, their focus has been switched over trade imbalances, and consequently on competitiveness: briefly, EZ policy makers may have moved from *expansionary* to *competitive austerity*, which would restore competitiveness (and then reduce CA imbalances) through *supply* channels, i.e., fostering export by reducing wages and prices and by means of structural reforms. However, we argued that *demand* channels have been prominent in determining the adjustment of trade imbalances, since income losses in the EZ periphery contributed to curb import.

In light of this paper, austerity may nevertheless be considered as misleading since it contradicts usual Keynesian arguments, i.e., it may have contractionary effects on aggregate demand and then on output. Furthermore, we claimed that internal devaluation processes exhibit several criticism (among others, concerns on internal demand with uncertain effectiveness on export growth, increasing debt burden in case of deflation, shifts in functional income distribution). This overall picture becomes more puzzling since austerity didn't lead to fiscal consolidation in terms of debt-to-GDP ratios, which conversely have been rising steeply (this can reflect the role of the fiscal multiplier).

Summing up, we argue that the EZ needs different policies to sustain aggregate demand and to promote a more balanced growth model, while *competitive austerity* has just transferred the burden of the adjustment to deficit countries. As a result, unemployment reached dramatic levels in the EZ periphery: to face this outcome, *mainstream* economics basically suggest labour market deregulation, while on the contrary we consider unemployment depending on low aggregate demand, exacerbated by restrictive policies. We claimed that the burden of the adjustment should be shared with a significant contribution of surplus countries: briefly, policy makers should lead core countries to foster their demand, and this would contribute to export growth in the South – otherwise, peripheral countries would be induced to restore their export competitiveness by means of exchange rate adjustments. To put it simply, if the burden of adjustment was shared, competitiveness realignments would be suitable through higher inflation in surplus countries, and to that end a coordinated wage policy should be necessarily pursued.

To conclude, we consider the austerity-competitiveness link as highly questionable since based on pure *mainstream* arguments: although *competitive austerity* has had a direct impact on peripheral countries' external balances, negative effects on their income and employment emerged. By contrast, we suggested Keynesian expansionary policies as an alternative recipe to the EZ issues.

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