It's not austerity. Or is it? Assessing the effect of austerity on growth in Europe, 2010-15

**Date:** Thursday, 12 October 2017 – 2 pm  
**Venue:** Seminar Room, Department of Economics and Management  
**Speaker:** Matteo Fragetta – University of Salerno

**Abstract**

While the debate over the relationship between austerity and growth in Europe has been lively and intense, systematic and rigourous empirical analysis has remained underdeveloped. With this econometric study of a panel of European countries and the US from 2010 to 2015, we have sought to fill this gap. In particular, our study is organised as a "test" of the "it’s not austerity" hypothesis, i.e. that austerity cannot be regarded as the explanatory variable of the post-crisis poor growth in Europe. To this end, we have articulated this hypothesis in four control variables of the growth-austerity relationship accounting for external competitiveness, the sovereign debt crisis, the general efficiency of the economy, and the composition effect of austerity between (less) expenditure and (more) taxation. As further control variable we have also considered one-year official forecasts of austerity. Austerity has been identified as a year-to-year increase in the structural primary balance relative to potential GDP. Upon estimating a static relationship using year-to-year changes in the variables with two methods (two-way fixed effects and Pesaran’s PCCE (2006)), and a dynamic one, aimed at capturing longer-run effects, with the Arellano-Bond difference panel estimator, our main conclusion is that the "it’s not austerity" hypothesis does not pass our test. The austerity coefficient is significant in all estimated relationships (except one) with the "Keynesian" theoretical sign, i.e. a negative effect on GDP growth in a range between 0.7 and 0.9 in the static specification and slightly lower in the dynamic one. On the other hand, the evidence also indicates that austerity cannot be regarded as the single negative factor impinging on growth in the panel under examination. The general efficiency of the economy has also played a role, but what emerges as the more significant co-determinant is the increase in the debt/GDP ratio, with an effect on growth comparable to austerity (or larger in some specifications). However, this fact should be reconsidered carefully, because the "excess austerity" hypothesis may be corroborated, according to which it is growth-depressing austerity which causes the debt/GDP ratio to grow, hypothesis enhanced by the finding that the real value of debt and its real interest rate are both non-significant.