Austerity is hurting – but is it working?
By Chris Giles and Robin Harding

Chris Giles and Robin Harding debate the case for and against, looking at the experiences of six countries

The Yes camp: spending less when times are lean is prudent, says Chris Giles

For evidence of the folly of allowing government deficits to remain high indefinitely, look no further than Japan. For almost two decades, the country has promised deficit reduction and reform in the future with a palliative of borrowing today. The result has been low growth, no reform and rising net debt from 12 per cent of national income in 1991 to 143 per cent today.

Austerity is not a policy designed to punish moral failings, nor an expression of outrage over high levels of taxation and public spending. It is, as Gordon Brown, the former British prime minister, put it, being “prudent for a purpose”. The purpose is to have sufficient ammunition in the public finances to fight crises or wars. Advanced economies had leeway in 2008; they do not now.

The purpose is also to spend hard-earned taxpayers’ money on the things that matter to society – health, education, alleviating domestic poverty – not shovelling tax dollars out of the country to foreign bondholders.

Why is austerity necessary? That is simple. The big lesson every advanced economy has learnt following the crisis is that it is poorer than it hoped to be. When you are poorer, you have to cut your coat according to your cloth.

The only question is the speed with which countries get deficits down. This is a nuanced area in which there are no easy answers because it is just as wrong to say deficit reduction does not hurt (it does) as it is to imagine stimulus generates so much additional economic activity that profligacy pays for itself.

If it were true that profligacy pays for itself and austerity is self-defeating then Greece, which has suffered extreme budget cutting and a horrible recession, would have a higher primary deficit today than in 2009. International Monetary Fund data show this to be nonsense, as it is in the UK, Spain, Italy, Portugal, Ireland and any other country accused of counter-productive deficit reduction.

Even with interest rates stuck close to zero, the borrowing costs faced by households and companies are not at this level, so scope for monetary expansion to offset deficit reduction still exists.
In parts of the eurozone, austerity has almost certainly been too fast, but a little less action should not be thought of as a panacea, as fiscal fine-tuning experiments have shown over many decades.

There is no magic number for the safe level of public debt as a share of national income. But it is reasonable to think that when debt is high, such as in the case of Japan, more government borrowing will give rise to some concern in companies and households that they will have to pay back the additional debt and tighten their belts accordingly. A reluctance to invest in these circumstances is natural.

No one should say austerity is nice, nor sufficient. But it is necessary.

The No camp: spending more will heal ailing economies, says Robin Harding

The case for running an easy fiscal policy today is simple: every dollar spent will add more than a dollar to economic output; every dollar hoarded will mean more than a dollar of lost production. At a time when millions are unemployed in the US, the UK and Europe, more activity is desperately needed.

This is not true in normal times. Then, if the government spends more, the central bank will have to raise interest rates to keep inflation under control. That “crowds out” the private sector. But at the moment interest rates are stuck at zero in most advanced countries.

Studies show that fiscal policy gives the economy a big boost when interest rates are trapped at zero. In such circumstances, Brad DeLong of Berkeley and Larry Summers of Harvard find that government deficits can quite easily pay for themselves through higher economic growth.

There are costs to loose fiscal policy. Debt and deficits are a problem in the long term and avoiding austerity does not mean ignoring them – it just means a response that is cleverer than immediate cuts.

The most obvious move is to tackle pension and healthcare reform. That lowers spending in the future. Another is to switch today's spending into capital projects. Invest now in roads or education, and they will pay you back with tax revenue in years to come, which you can use to pay debt.

That would not be the case if failure to cut spending would mean an immediate debt crisis. But the experience of the past few years – plus the weakening of Kenneth Rogoff and Carmen Reinhart’s case that debt greater than 90 per cent of gross domestic product leads to weaker growth – suggests that instant debt Armageddon is unlikely for big countries with their own currency.

The costs of profligacy must be set against the costs of austerity. Most obviously, if austerity leads to a prolonged period of high unemployment, people will drop out of the labour force and may never return. The price of saving money today could be a permanent loss of economic output and tax revenues – a high price indeed.

Japan can be held up as an example of profligacy’s folly. But it is a better example of what happens if you do not do enough right after a financial crisis and thus get trapped in an equilibrium of deflation and weak growth.

It all leads to a simple test for the timing of austerity. The time has come when any failure to cut the deficit would mean the central bank has to raise interest rates instead. For the US, Europe and Japan that date is still some way off.

Even better, with 10-year US Treasury yields at 1.7 per cent versus a long-term inflation target of 2 per cent, that investment is basically free. Failure to spend on public capital would be a missed opportunity.

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