Austerity loses an article of faith

By Martin Wolf

The UK industrial revolution shows the Reinhart-Rogoff thesis on debt is not always right

In 1816, the net public debt of the UK reached 240 per cent of gross domestic product. This was the fiscal legacy of 125 years of war against France. What economic disaster followed this crushing burden of debt? The industrial revolution.

Yet Carmen Reinhart and Kenneth Rogoff of Harvard university argued, in a famous paper, that growth slows sharply when the ratio of public debt to GDP exceeds 90 per cent. The UK's experience in the 19th century is such a powerful exception, because it marked the beginning of the consistent rises in living standards that characterises the world we live in. The growth of that era is the parent of subsequent sustained growth everywhere.

As Mark Blyth of Brown University notes in a splendid new book, great economists of the 18th century, such as David Hume and Adam Smith warned against excessive public debt. Embroiled in frequent wars, the British state ignored them. Yet the warnings must have appeared all too credible. Between 1815 and 1855, for example, debt interest accounted for close to half of all UK public spending.

Nevertheless, the UK grew out of its debt. By the early 1860s, debt had already fallen below 90 per cent of GDP. According to the late Angus Maddison, the economic historian, the compound growth rate of the economy from 1820 to the early 1860s was 2 per cent a year. The rise in GDP per head was 1.2 per cent. By subsequent standards, this may not sound very much. Yet this occurred despite the colossal debt burden in a country with a very limited tax-raising capacity. Moreover, that debt was not accumulated for productive purposes. It was used to fund the most destructive of activities: war. Quite simply, there is no iron law that growth must collapse after debt exceeds 90 per cent of GDP.

The recent critique by Thomas Herndon, Michael Ash and Robert Pollin of the University of Massachusetts at Amherst makes three specific charges against the conclusions of professors Reinhart and Rogoff: a simple coding error; data omissions; and strange aggregation procedures. After correction, they argue, average annual growth since 1945 in advanced countries with debt above 90 per cent of GDP is 2.2 per cent. This contrasts with 4.2 per cent when debt is below 30 per cent, 3.1 per cent when debt stands between 30 per cent and 60 per cent, and 3.2 per cent if debt is between 60 per cent and 90 per cent. In their response, professors Reinhart and...
Rogoff accept the coding errors, but reject the critique of aggregation. I agree with the critics for reasons given by Gavyn Davies. The argument that data covering a long period of high debt should count for more than data covering a short one is persuasive.

Nevertheless, their work and that of others supports the proposition that slower growth is associated with higher debt. But an association is definitely not a cause. Slow growth could cause high debt, a hypothesis supported by Arindrajit Dube, also at Amherst. Consider Japan: is its high debt a cause of its slow growth or a consequence? My answer would be: the latter. Again, did high debt cause today’s low UK growth? No. Before the crisis, UK net public debt was close to its lowest ratio to GDP in the past 300 years. The UK’s rising debt is a result of slow growth or, more precisely, of the cause of that low growth -- a huge financial crisis.

Indeed, in their masterpiece, This Time is Different, professors Reinhart and Rogoff explained how soaring private debt can lead to financial crises that generate deep recessions, weak recoveries and rising public debt. This work is seminal. Its conclusion is clearly that rising public debt is the consequence of the low growth, itself explained by the crisis. This is not to rule out two-way causality. But the impulse goes from private financial excesses to crisis, slow growth and high public debt, not the other way round. Just ask the Irish or Spanish about their experience.

It follows that, in assessing the consequences of debt for growth, one must ask why the debt rose in the first place. Were wars being financed? Was there fiscal profligacy in boom times, which is almost certain to lower growth? Was the spending on high-quality public assets, conducive to growth. Finally, did the rise in public debt follow a private sector financial bust?

Different causes of high debt will have distinct results. Again, the reasons why deficits are high and debt rising will affect the costs of austerity. Usually, one can ignore the macroeconomic consequences of fiscal austerity: either private spending will be robust or monetary policy will be effective. But, after a financial crisis, a huge excess of desired private savings is likely to emerge, even when interest rates are very close to zero.

In that situation, immediate fiscal austerity will be counterproductive. It will drive the economy into a deep recession, while achieving only a limited reduction in deficits and debt. Moreover, as the International Monetary Fund’s Global Financial Stability Report also notes, extreme monetary stimulus, in these circumstances, creates substantial dangers of its own. Yet nobody who believes in maintaining fiscal support for the economy in these specific (and rare) circumstances thinks that “fiscal stimulus is always right”, as Anders Aslund of the Peterson Institute for International Economics, suggests. Far from it. Stimulus is merely not always wrong, as “austerians” seem to believe.

This is why I was – and remain – concerned about the intellectual influence in favour of austerity exercised by Reinhart and Rogoff, whom I greatly respect. The issue here is not even the direction of causality, but rather the costs of trying to avoid high public debt in the aftermath of a financial crisis. In its latest World Economic Outlook, the IMF notes that direct fiscal support for recovery has been exceptionally weak. Not surprisingly, the recovery itself has also been feeble. One of the reasons for this weak support for crisis-hit economies has been concern about the high level of public debt. Professors Reinhart and Rogoff’s paper justified that concern. True, countries in the eurozone that cannot borrow must tighten. But their partners could either support continued spending or offset their actions with their own policies. Others with room for manoeuvre, such as the US and even the UK, could – and should – have taken a different course. Because they did not, recovery has been even weaker and so the long-run costs of the recession far greater than was necessary. This was a huge blunder. It is still not too late to reconsider.