

Stimulus v austerity

Sovereign doubts

The fourth in our series of articles on the financial crisis looks at the surge in public debt it prompted, and the debate about how quickly governments should cut back

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ECONOMISTS are an argumentative bunch. Yet before the crisis most found common ground in the notion that fiscal stimulus was an obsolete relic. Monetary policy seemed wholly capable of taming the business cycle. Government efforts to increase spending or cut taxes to battle unemployment would only muck things up. When crisis struck in 2008, however, that consensus evaporated.

The frightening speed of the economic collapse spurred governments to action, in spite of economists' doctrinal misgivings. In 2009 many countries rolled out big packages of tax cuts and extra spending in the hope of buoying growth. This stimulus amounted to 2% of GDP on average among the members of the G20 club of big economies. Among Barack Obama's first steps as president in 2009 was to sign the American Recovery and Reinvestment Act, a stimulus plan worth \$831 billion, or almost 6% of that year's GDP, most of it to be spent over the next three years.

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Keynes to the rescue

Supporters of stimulus looked to the ideas of John Maynard Keynes, a British economist. Depression, his acolytes reasoned, occurs when there is too much saving. When too many people want to save and too few to invest, then resources (including workers) fall idle. Firms and families might save too much because of financial uncertainty or because they are rushing to “deleverage”—to reduce the ratio of their debts to their assets.

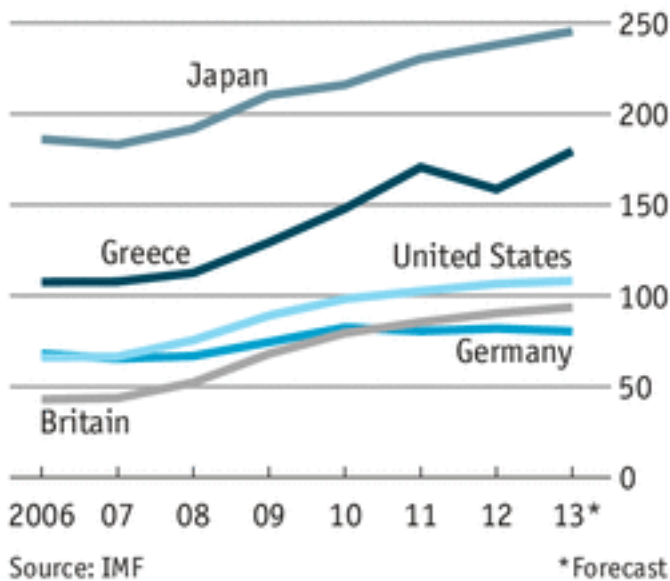
In normal times central banks would try to spur growth by adjusting interest rates to discourage saving and encourage borrowing. Yet by early 2009 most central banks had reduced their main interest rates almost to zero, without the desired result. Overindebtedness, some surmised, might have been preventing people from borrowing as much as they would like, whatever the interest rate. Governments, Keynesians reckoned, needed to make up for hamstrung firms and families, by borrowing and spending more (or taxing less) to put excess savings to work.

When there is slack in the economy, fiscal stimulus can be particularly powerful thanks to a “multiplier” effect. A dollar spent building a railway, for example, might go to the wages of a construction worker. He then spends the extra income on groceries, enriching a shopkeeper, who in turn goes shopping himself and so on. Every dollar of stimulus could thus result in two dollars of output—a multiplier of two. (Multipliers also apply to government cutbacks, amplifying the reduction in GDP.) That allows governments to deliver a hefty economic bang at moderate fiscal cost.

Borrowed climb

1

General government debt, % of GDP



Yet fiscal stimulus is needed most when governments already have extra costs to bear. From 2007 to 2010 rich countries saw the ratio of their gross sovereign debt to GDP spike from 74% to 101% on average. British public debt jumped from just 44% of GDP to 79%, while America's leapt from 66% of GDP to 98%. Greece's soared by 40 percentage points, to 148% of GDP (see chart 1). Greece's deficit was so high that when the government revealed it, the admission set off a crisis of confidence in public finances in southern Europe, and thus in the viability of the euro itself.

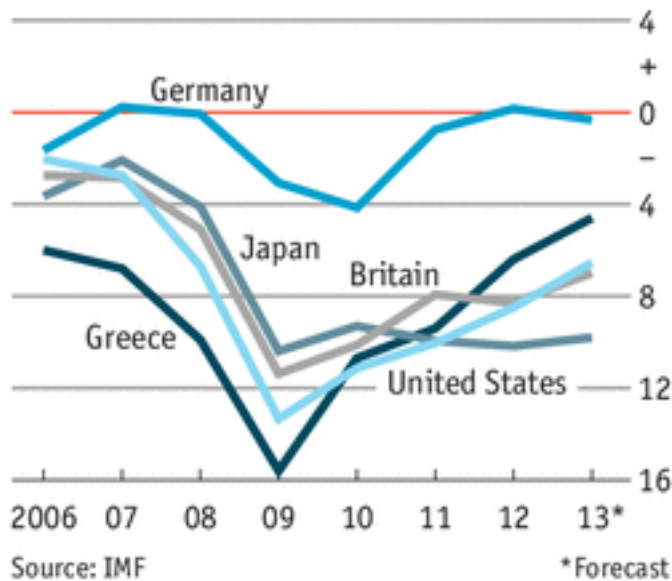
Stimulus was not the main reason debt piled up: the biggest drag on public finances came from lower tax receipts, thanks to weak profits and high unemployment. Financial bail-outs added to the fiscal toll, as did "automatic stabilisers"—measures like unemployment benefits that automatically raise spending and support demand when recession strikes. The International Monetary Fund (IMF) estimates that almost 60% of the rise in government debt since 2008 stems from collapsing revenues, more than twice the cost of stimulus and bail-outs combined.

As growth returned in 2010 some leaders argued that it was time to trim public spending. Others worried that the recovery was too fragile to permit any hint of austerity. There was no question that "fiscal consolidation" would eventually be necessary, but much dispute about when it should start.

Extended gap year

2

Government budget balances, % of GDP



Britain moved quickly towards sobriety, ending its stimulus in 2010 and planning future cuts. From 2010 to 2011 the government pared its “structural” budget deficit (ie, adjusted to account for cyclical costs such as automatic stabilisers) by two percentage points, with further drops of a percentage point in 2012 and 2013. Several southern European countries had to make even deeper cuts as the crisis spread. But America kept spending, adding new tax breaks to the previous stimulus. As a result, its structural deficit declined more slowly (see chart 2).

The debate about these policies hinged on two crucial uncertainties. One was the size of the multiplier. Sceptics reckoned that it would be low, and that neither stimulus nor austerity would have much effect on output or jobs. Stimulus simply absorbs resources that would otherwise have been used by private firms, they argued. Moreover, firms and households would probably save their share of the proceeds, rather than bolster the economy by spending them, since they would assume that the government’s largesse was only temporary and that tax bills would soon be going back up.

Those of a Keynesian bent downplayed these concerns. With unemployment high and private demand for loans low, there was little risk that the government would “crowd out” private activity. Indeed, in a “balance-sheet recession”, with indebted households forced by falling asset prices to pay off loans quickly, a boost to incomes from a fiscal stimulus would speed the financial adjustment, and thus generate a faster recovery.

The other question was how much debt rich governments could take on without harming the economy. Typically, lenders will demand ever higher rates of interest from spendthrift governments as public debts grow. That leads to higher rates for everyone else, crimping economic growth. But supporters of stimulus argued that a slumping economy with rock-bottom interest rates had no reason to fear the vigilantes of the bond market.

The academic evidence, inevitably, was also disputed. Carmen Reinhart and Kenneth Rogoff of Harvard University published a much-cited paper claiming that economic growth rates slow sharply when government debt tops 90% of GDP. Follow-on studies also turned up a negative relationship between growth and debt, although not always at the same threshold. Research by Alberto Alesina of Harvard and Silvia Ardagna of Goldman Sachs, an investment bank, showed that fiscal rectitude—especially in the form of spending cuts rather than tax rises—could actually boost growth.

Keynesians questioned Mrs Reinhart's and Mr Rogoff's conclusions, noting that slow growth might be a cause of high debt rather than a symptom of it. They also thought Mr Alesina's "expansionary austerity" was a pipe dream. In the past, they observed, it had occurred only under quite different conditions. Had government borrowing been gobbling up scarce credit, pushing interest rates for private firms upwards, then lower deficits could reduce rates and trigger an investment boom. But in most of the rich world interest rates were already low; excessive saving was the problem.

What is more, the Keynesians asserted, multipliers are much higher during nasty downturns than at other times. Research by Lawrence Christiano, Martin Eichenbaum and Sergio Rebelo of Northwestern University suggests that when interest rates are near zero the multiplier could be higher than two, since people have a greater incentive than usual to spend rather than save. A financial crisis also elevates multipliers, other studies found. Work by Larry Summers, the architect of Mr Obama's stimulus, and Brad DeLong of the University of California, Berkeley argues that given the cost of prolonged unemployment, stimulus during a long recession might pay for itself.

Time has begun rendering verdicts. Early last year a McKinsey study noted that financial deleveraging in America proceeded more quickly than in Britain and Europe. Also last year the IMF published an analysis of its economic forecasts which found that austerity crimped growth much more than it had expected. The larger the cuts a government planned, the IMF concluded, the farther below its forecast growth fell. The multiplier on spending cuts was perhaps twice what researchers had originally assumed. Spanish austerity reduced the government's structural deficit by more than two percentage points from 2011 to 2012. But cuts helped push the economy into recession. Net government borrowing actually rose.

In April this year research from the University of Massachusetts undermined the Reinhart-Rogoff finding that growth slows sharply when debt tops 90% of GDP. An analytical error and questionable data choices, it turns out, had underpinned the result. There is no consensus among economists as to what level of debt harms growth, or whether it is even possible to establish such a rule of thumb.

That does not mean that ballooning public debt is nothing to worry about, however. New research suggests that less-indebted governments are much more likely to resort to stimulus to foster economic growth, presumably because they feel they can afford to do so. It may be a long time coming (Japan's government debt now totals 245% of GDP), but at some point too much red ink will yield a debt crisis. Worries about a country's solvency will lead creditors to demand higher interest rates, which will then compound its fiscal woes.

Just when the bond market will turn depends on a number of factors. Economies seen as havens, such as America and Switzerland, have more latitude: economic upheaval tends to reduce their borrowing costs rather than raise them. It helps if most creditors are locals, too, as in Japan, since payments to them help boost the domestic economy.

Panic is more likely when debt is owed in a currency the government does not control, since the central bank cannot then act as a lender of last resort. Uncertainty over whether the European Central Bank would play this role fanned the euro-zone crisis, for example. Carried to extremes government-bond purchases may fuel worries about inflation. That in turn can lead to higher borrowing costs as creditors demand an inflation-risk premium. Yet during the crisis economies were so weak that central banks' purchases of government bonds proved reassuring to investors rather than worrisome, partly due to the reduced risk of panic and default.

The day of reckoning may nonetheless be closer than it appears. Failing banks can swiftly transform debt loads from moderate to crushing. Before the crisis the assets of Ireland's commercial banks swelled to over 600% of GDP. Ireland's debts duly exploded from 25% of GDP in 2007 to 117% in 2012, thanks mostly to the government's assumption of the banks' debts after the crisis struck.

Every cut has its day

Austerity, in short, still has its place. But what sort? Whereas some economists recommend spending cuts, other research indicates that higher taxes can also work. Both approaches have costs. Taxing pay

can distort labour markets; consumption taxes can lead to inflation, prompting contractionary monetary policy. Yet cutting spending is more unpopular and can exacerbate inequality.

The experience of the past few years has left little debate about timing, however. The moment to turn to austerity, ideally, is when the economy can bear it. Not all governments have that luxury, of course: Greece's, for one, could not delay fierce cuts since it could no longer borrow enough to finance its deficits. Those with more breathing space should aim to stabilise their debts in the long run, the IMF suggests, by laying out plans to reduce their deficits. The more credible their plans, the more leeway they will have to depart from them should conditions warrant it. As Keynes insisted, the time for austerity is the boom not the bust.