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DISCUSSION PAPER

THE CASE AGAINST AUSTERITY TODAY

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Immediately after the recession, it appeared as if policymakers had learnt the lessons of the 1930s, and of Japan in the 1990s. Not only were interest rates cut rapidly, but when they hit zero then expansionary fiscal policy packages were undertaken in a number of countries.

However, everything changed quite dramatically in 2010. The near-default of Greece, with contagion gradually spreading to other countries in the eurozone, led policymakers around the world to switch from fiscal stimulus to fiscal austerity. What finance minister can sleep easy when there is a chance that they too might be forced down the road being travelled by Greece, Ireland, Spain, Portugal and Italy? To all the world it looks like government debt is the overwhelming problem, dwarfing concerns about a weak recovery.

I suspect that the majority of macroeconomists, as well as policymakers and the general public, read the current situation this way. Yes, they might think, it would in principle be nice to undertake expansionary fiscal measures to boost the economy, but unfortunately high levels of debt just make this impossible. Fiscal support was appropriate in 2008–09 when the economy was in free fall. But now that the fear of cumulative deflation is passed, reducing debt must take priority, as the Greek crisis of 2010 showed.

I want to argue that this is a profound misreading of the situation. An alternative view, which appears more consistent with the facts, is that the crisis which started with Greece in fact tells us about some basic design flaws in the eurozone. Outside of the eurozone, the problem is that we have *too little* government debt, rather than too much.

Liquidity and solvency: the eurozone as a special case

There is a straightforward reason why the current debt crisis is largely confined to the euro area, which can be summed up in one short statement: these countries cannot print their own currency. There are two reasons why this matters. The first has been well understood for some time, but the second is only now becoming apparent.

The first decade of the euro saw markedly divergent trends in inflation between Germany and most other eurozone countries. Although buoyant housing markets masked the impact of this loss of competitiveness (and helped fuel it) in the short run, it is not sustainable in the longer term. When countries with their own currency experience this kind of loss of competitiveness, they can devalue; in the euro area, correction can only take place through inflation in uncompetitive countries staying below that of Germany for a sustained period. That, in turn, requires a period of low growth and sustained unemployment (on the realistic assumption that Germany is not willing to sustain high inflation). This makes bringing budget deficits under control much more difficult, for obvious economic and political reasons.

The second factor that makes the debt problem in the eurozone much more acute is that individual governments cannot resort to the printing press if they run out of money. The importance of this can most easily be explained by a simple analogy with a run on a bank.

A bank may go bust because it is **insolvent** – it has made loans that are too risky, such that in the long run it will never be able to fully repay its depositors. But it can also go bust because it runs out of **liquidity**, which in turn can be generated by a bank run. The bank may be perfectly solvent in the long run, but if enough depositors withdraw their money in the short term then it will run out of cash. The fear that this will happen generates a run, and bank runs are why central bankers act as lender of last resort for their domestic banks, providing unlimited liquidity when required.

As De Grauwe (2011) points out, eurozone governments can be subject to the equivalent of a bank run. If no one buys their debt, they will be forced to default. Lenders may decline to buy their debt because they believe that ultimately those governments do not have the political will to raise the taxes to cover their spending in a sustainable way: this is the equivalent of an insolvent bank. However, lenders may also forsake a country's debt if they believe no one else will buy that debt, even though that debt may be sustainable in the long run. A government may be subject to a self-fulfilling belief in the market that no one will lend to them.

With no lender of last resort, there is no backstop in place to curtail a run. If lenders do stop lending, default will result. In that situation, no one wants to lend.

By contrast, a country that can print its own currency is not so vulnerable because it can fund any shortfall by printing money. Its own central bank can be the lender of last resort, and existing lenders will get their money back. The European Central Bank (ECB) could be a lender of last resort for a eurozone country, but this is something the ECB is very reluctant to do.

This distinction between problems of liquidity and insolvency, while clean in theory, is more difficult to apply in practice, particularly in a crisis. When asset prices are falling, a once-solvent bank can quickly become insolvent at today's prices. Within the eurozone, a very similar problem arises for governments. How do we assess if a country can afford to sustain its debt in the long run? This depends on its long-run levels of spending and taxes, but it also depends on the interest rate it has to pay on its existing debt. At 'normal' interest rates debt may be quite sustainable, but if interest rates rise high enough then debt becomes unsustainable. As a result, in the absence of a lender of last resort, a government debt crisis can easily become self-fulfilling.

So, without a central bank of their own, eurozone countries are vulnerable to such self-fulfilling debt crises even if, at more normal interest rates, their debt levels are quite sustainable. Debt in Spain, for example, is considerably below debt in the UK as a share of GDP, but Spain is having to pay much more to finance its debt. Is this difference just because the markets have much more faith in the ability of the UK government to stabilise debt levels than in that of the Spanish government? A more likely explanation is that Spain can be forced to default as a result of a market panic, because the ECB might not buy its debt, whereas the Bank of England will in the last resort buy UK government debt.

Ironically, the architects of the eurozone did worry about the debt problem but for the wrong reasons. Their concern was that the market would not discipline individual profligate governments, who would free-ride on low eurozone interest rates. (As a result, they tried to set up mechanisms to control deficits, mechanisms that completely failed, for reasons discussed in Wren-Lewis 2003.) In practice, the critical problem has turned out to be almost the reverse – without a central bank that is prepared to be the lender of last resort, governments are too vulnerable to 'market discipline'.

So the lesson of 2010 is that the eurozone has design problems that could emerge even if all its governments were solvent in a long-run sense. Yet most policymakers in the euro area appear to be in denial about this, instead insisting that the problem lies with excessive debt levels in individual countries. This was a plausible line to take on Greece, and perhaps also on Ireland when it underwrote its insolvent banks. But as the contagion spreads to Italy and beyond, and leads France and Germany to undertake austerity measures despite an uncertain recovery, the mantra that excessive government debt is the only problem looks less and less credible. Nevertheless, the mantra goes on being repeated, for reasons I explore below.

The macroeconomic case for stimulus today and austerity tomorrow

Why is it important to see the debt crises in the eurozone as a special case? The reason is that the case for austerity today relies on a political argument that, because of what has happened in the eurozone, goes unchallenged. But before addressing that argument directly, we need to establish the macroeconomic case for the alternative: stimulus today and austerity tomorrow.

Debt sustainability is essentially a long-term problem. This is why the Office for Budget Responsibility (OBR) in the UK and the Congressional Budget Office in the US feel the need to undertake the heroic task of making macroeconomic projections 50 years ahead to assess fiscal sustainability. On the other hand, fiscal expansion to boost a recovery is essentially a short-term device. Indeed, it is plausible to argue that additional government spending *must be temporary* to be effective in stimulating the economy. And finally – but critically – the amount of extra debt generated by a short-term stimulus is likely to be relatively small compared to existing levels, so it does not significantly worsen the long-term problem of debt sustainability. In the case of the US, for example, the fiscal expansion undertaken after the recession contributes almost nothing to that country's long-term fiscal difficulties (CBO 2011).

Both Keynesian macroeconomics as taught to first-year undergraduates and the state of the art Keynesian macroeconomics used by central banks tell us that the optimal response to the twin problems of deficient demand in the short run and excessive debt in the long run is a fiscal stimulus today followed by austerity when the recovery is assured. But, you may ask, isn't this the same macroeconomics that has been discredited by the recession? And in any case are there not plenty of eminent macroeconomists who take a different view?

It is certainly the case that macroeconomics before the crisis tended to ignore how fragile the system was to financial shocks. There are interesting methodological debates about whether macroeconomics had become too skewed towards a belief in rational economic man. However, once the financial shock happened, I would argue that modern Keynesian economics has done pretty well in explaining how the recession unfolded. In three key respects it has successfully predicted outcomes that were far from obvious beforehand.

1. Many argued that interest rates on debt would have to rise if the amount governments needed to borrow increased. But this looked only at the supply side of the market and ignored demand. In a recession which has involved consumers switching in a massive way from spending to saving, and at the same time a 'flight to safety', the demand for government debt in the US, the UK and elsewhere has risen faster than the increased supply generated by larger deficits, with the result that interest rates have fallen, not risen. This 'paradoxical' result should be familiar to anyone who has done first-year undergraduate economics, or who understands the importance of general rather than partial equilibrium modelling.
2. The printing of money associated with quantitative easing, or QE, has not led to rampant domestically generated inflation. What inflation there has been has stemmed from commodity markets and reflected underlying supply problems clearly evident before the recession. Wage inflation in the US, the UK and elsewhere has remained very low. This is exactly what the Phillips curve, the bedrock of Keynesian analysis of inflation, tells us will happen in a recession.

3. Basic Keynesian macroeconomics also tells us that fiscal austerity will reduce demand, and in a demand-deficient recession this will mean lower output and higher unemployment. This is simply the reverse of why fiscal stimulus can help recovery. The events of 2011 show that this is exactly what has happened.

In macroeconomics, getting three quite fundamental predictions right is good going, and suggests that – whatever its deficiencies – the core of Keynesian macroeconomics is sound.

It is true that a minority of macroeconomists, particularly in the US, have argued against fiscal stimulus. Some are among the best of their generation. Yet what is striking in reading their comments (see, for example, Barro 2011) is the absence of any intellectual critique of Keynesian theory. Modern Keynesian analysis is either simply ignored or, at best, dismissed out of hand. The fundamental difficulty that many in this group have is that they fail to recognise that the recession reflects a lack of overall demand in the economy, and therefore represents a classic Keynesian problem. This is a little strange: pretty well all central bank economists use Keynesian theory in forecasting the economy and setting interest rates. As I suggest below, it may also be significant that most of these economists support the political right.

The political case for austerity today

So what prevents us following Keynesian theory and having stimulus today and austerity tomorrow? The political argument is both simple and, at first sight, powerful. Government promises of austerity tomorrow will not be trusted, and will not be credible, unless they are accompanied by austerity today. Governments that ignore the debt problem today will, it is argued, forget their promises on long-term austerity once the recovery has happened – they will go back to spending too much and taxing too little.

This argument makes a presumption that is probably correct, but then draws an inference that is not. The presumption is that governments are subject to 'deficit bias': the tendency for government debt as a share of GDP to drift up over time. Evidence over the last 40 years (but perhaps not over a much longer time frame) is consistent with deficit bias (Calmfors and Wren-Lewis 2011). There is a good economic case for arguing that, *over the long term*, government debt in relation to GDP should be a lot lower than levels seen before the start of the recession.

The incorrect inference is that this means that the process of reducing debt has to be unconditional and rapid. Once again, all the macroeconomic analysis (Keynesian or otherwise) suggests the opposite: debt should be allowed to respond to macroeconomic shocks, and debt correction should be gradual and context sensitive (Wren-Lewis 2011). The problem of deficit bias is that governments spend too much, or tax too little, in the good times. When economies grow rapidly, government deficits fall and may even become surpluses, so it *appears* as if government debt is not a problem. But this is an illusion, as becomes apparent when the boom comes to an end.

Just as the problem of deficit bias is long term, the solutions also need to apply over the long run. These solutions probably involve the combination of intelligent fiscal rules, which unpick the impact of the economic cycle on deficits, and institutional change that establishes independent fiscal watchdogs able to hold governments to account in the good times (like, hopefully, the OBR will do). The solution need not, and should not, involve austerity at all points in time.

But will a government that ignores the long-term debt problem in the short term have credibility in the long run? A simple analogy has some power here. If someone is overweight, what would you be more impressed by: a person who analyses why they are overweight, and embarks on a long-term plan (with suitable checks) to correct the problem, or someone who goes on a crash diet? Does the austerity shown right now by the current UK government, for example, clearly demonstrate that the same sense of austerity will continue to be applied once the recovery is established? It could just represent a politically convenient frontloading of deficit reduction, so that there is room for tax cuts just before the next general election. Plausible cases can be made for both interpretations, so why is one thought to be credible and the other not?

The political argument for austerity has gone unchallenged largely because of what has happened in the eurozone. At first sight, it appeared as if the markets were demanding austerity as a sign of credibility. The markets might be irrational in doing this, but who nowadays thinks financial markets are always rational – and in any case, governments are in no position to argue.

This is why it is so important to establish that the eurozone position is special. Not only are there logical reasons for believing this to be the case, but the evidence also points this way. Interest rates on government debt in most major economies outside the eurozone are very low. There is no sign of a crisis of credibility. This is particularly striking in the US, because it is happening despite political stalemate in dealing with that country's long-term fiscal problems. As I noted above, the reasons why the demand for government debt appears so high outside the eurozone are not hard to understand, once we know a bit of Keynesian theory. It means that the markets are saying borrow more, not borrow less.

Ideological agendas

Is basic macroeconomic theory being put to one side just because of a mistaken fear about excessive government debt? There is an important piece of evidence – the lack of discussion of 'balanced budget fiscal expansion' (BBFE) – that suggests another factor is at work here. BBFE describes the possibility that the *mix* of fiscal policy can be adjusted to stimulate activity without increasing debt at all. A clear example would be a temporary increase in government spending financed entirely by higher taxes. Obviously, this would leave the deficit unchanged. However, consumers would finance at least some (and possibly most) of the tax rise from saving, so consumer spending will fall less than government spending will rise, with a positive net effect on demand. There are many variations on this theme, and there is potential for extensive analysis to see which fiscal measures could be most effective in encouraging demand.

Yet the striking point about BBFE today is that it is hardly ever brought up. If the general view is that we would like to stimulate demand but high debt is a constraint, the obvious move is to explore possibilities of this kind. Yet the prevailing consensus is that fiscal actions of any kind have little or no impact on the recovery. The UK government argues, for example, not that a slower recovery is inevitable because of the need to reduce debt, but instead that austerity is a precondition for recovery.

So what else is behind the austerity consensus? The alternative agenda that I have in mind is ideological. Potentially it can be split into two parts, although they are obviously related. The first is simply a desire to reduce the size of the state. The second is a view that there should be as little state interference in the market as possible. Yet neither view can be brought out into the open when discussing countercyclical fiscal policy, for the following reasons.

At root, there is no necessary connection between temporary increases in government spending to boost activity and the long-run size of the state. A programme to modernise infrastructure could raise or reduce long-run maintenance costs, for example. Equally, debt can be reduced by raising taxes as well as by cutting spending. However, concerns about debt can be used as a pretext for permanently reducing the size of the state. As a result, an agenda of this sort must remain hidden.

The view that fiscal expansion should be rejected because it represents unwarranted state interference in a well-functioning market appears just bizarre, for three straightforward reasons. First, it is lack of regulation in freely functioning financial markets that got us into the current mess. Second, central banks 'interfere' in the macroeconomy all the time, and the case for fiscal expansion arises largely because central banks can no longer do this job when nominal rates are near zero. Third, can we seriously suggest current levels of unemployment do not represent market failure?

Put like this, it is obvious why this agenda has to be hidden, but can it be important at all in the current macroeconomic context? This is often the point about an ideology. It represents an underlying way of looking at the world that predisposes answers to questions which may be quite misplaced in particular contexts. How else do you make sense of arguments put by a few eminent macroeconomists – as well as many policymakers – that the current lack of recovery has little to do with austerity and lack of demand and instead represents a fear of excessive government regulation. Arguments like these cannot come from evidence, so they have to come from somewhere else.

I think there is a partial analogy with the issue of climate change here. The science of climate change, like Keynesian theory, is fairly unequivocal in its implications and has been largely consistent with recent evidence. However, climate change denial is clearly correlated with ideological position (Conway and Oreskes 2010). Furthermore, those who have a deep-rooted ideological problem with the implications of climate change find their most effective weapon of attack is to dispute the science. The analogy between the macroeconomic case for stimulus and the scientific case for the reality of climate change is unfortunately only partial, because it appears that climate change scientists are rather more immune to ideological influence than academic macroeconomists!

Will the policy consensus change again?

Immediately after the recession, expansionary fiscal policy packages were undertaken in countries such as the UK, US and China. However, this was always controversial, and the events of 2010 swung the policy consensus firmly to the other side. The dominant mantra became one of fiscal austerity.

The argument put forward by most governments today for fiscal austerity over stimulus seems to rest on two highly questionable propositions. The first is that events in the eurozone show the dangers to which any government could succumb if it does not embark on an immediate programme of austerity. I have suggested that there is a more persuasive alternative view, which is that a design fault in the eurozone means that it is peculiarly vulnerable to debt crises, and that as a result its lessons for those economies that *can* print their own currency are much more limited.

The second is that promises of austerity tomorrow will not be credible without austerity today. But who exactly requires this demonstration of credibility? Interest rates on government debt are exceptionally low. The time when governments need to show greater fiscal resolve is when the economy is strong and deficits are low, because it is then that the excuse to increase spending or cut taxes is strongest and also most inappropriate.

Standard macroeconomics suggested that the move to austerity in 2010 would slow the economic recovery, and events in 2011 support that standard view. Will this lead to the policy consensus shifting again? Perhaps – if policymakers outside the eurozone begin to see what is happening there as a particular problem of a common currency without a lender of last resort, that has little relevance elsewhere. Perhaps – if persistently low interest rates on government debt get the message across that markets are more concerned about a lack of growth than any show of fiscal self-flagellation. However, if there are also strong ideological pressures towards immediate austerity, then this change of direction may not occur. Even if it does, it will be too late for the many who have needlessly remained unemployed as a result of the policy switch of 2010.

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