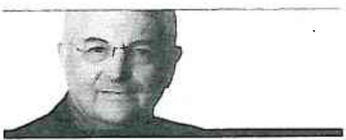
The austerity debate FT Series on the fierce argument between deficit-cutting and stimulus

Why the battle is joined over tightening



Martin Wolf

To tighten or not to tighten – that is the question. It is one to which policymakers have started changing their answers. Are they right to do so? That is the issue addressed in the Financial Times this week, echoing the fierce debates of the 1930s. If arguments for tightening are correct, failure to do so would bring fiscal and financial shocks in some of the world's most important countries. If arguments for tightening are false, decisions to do so threaten recovery and might trigger further financial shocks.

Where are the policymakers? The declaration after the Toronto summit of the Group of 20 leading nations, stated: "There is a risk that synchronised fiscal adjustment across several major economies could adversely impact the recovery. There is also a risk that the failure to implement consolidation where necessary would undermine confidence and hamper growth. Reflecting this balance, advanced economies have committed to fiscal plans that will at least halve deficits by 2013 and stabilise or reduce government debt-to-gross domestic product ratios by 2016."

This language is notably more cautious than that of the Pittsburgh summit of September 2009. That stated boldly: "We pledge today to sustain our strong policy response until a durable recovery is secured. We will act to ensure that when growth returns, jobs do too. We will avoid any premature withdrawal of stimulus. At the same time, we will prepare our exit strategies and, when the time is right, withdraw our extraordinary policy support in a co-operative and co-ordinated way, maintaining our commitment to fiscal responsibility."

So what has changed?

The first answer is that the world economy is recovering more strongly than expected. In April 2009, at the time of the London G20 summit, the consensus of forecasts for global economic growth this year was 1.9 per cent. By last September it had reached 2.6 per cent. By June 2010, it was 3.5 per cent. In the US, the consensus forecasts for 2010 were 1.8 per cent in April 2009, 2.4 per cent last September and 3.3 per cent in June 2010. Even for the eurozone, the consensus of forecasts has moved a little, from 0.3 per cent in April 2009, to 1 per cent last September and 1.1 per cent in June 2010.

The second answer lies with the fiscal crises in Greece and other peripheral members of the eurozone, reinforced by the election of the coalition government in the UK. The flight from risk was dramatic: in May, the yield on Greek 10-year bonds peaked at more than 12 per cent. This led to a rescue package by the International Monetary Fund and other eurozone governments, and the creation of a new €750bn joint IMF and eurozone stabilisation facility.

The extent of the tightening must also not be exaggerated. In its May Economic Outlook, the Organisation for Economic Co-operation and Development forecast a decline in cyclically adjusted fiscal deficits for the grouping as a whole from 6.4 per cent in 2010 to 5.8 per cent in 2011. Corresponding figures were 9 per cent and 7.9 per cent for the US, and 4.1 per cent and 3.6 per cent for the eurozone. But further tightening is now planned, particularly in the UK. Moreover, many think planned fiscal tightening does not go far enough.

What, then, are the arguments?

At the anti-deficit extreme are those who argue fiscal deficits have no impact on activity since they lead to offsetting behaviour by private people. Thus, if governments run deficits, private people save, since they understand that their taxes will ultimately rise. Another, very different, extreme position comes from those who believe a deep slump would purge past excesses, and so lead to healthier economies and societies. While people who think in these radical ways influence the broader politics, they have limited direct influence on policymakers. So what is the latter debate about?

The "cutters" argue that such huge fiscal deficits – never seen in peacetime in big developed countries, notably the US – threaten long-term fiscal credibility and depress private confidence and spending. While piling fiscal stimulus on top of the built-in stabilisers made sense in the panic of 2008 and early 2009, the time has come for swift consolidation. Otherwise, a spike in borrowing costs looms, with dire results. The permanent loss of output and revenue left behind by the crisis, along with ageing populations, make action inescapable and urgent.

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Finally, should economies weaken after a fiscal tightening, monetary loosening would be highly effective. The latter can work by encouraging investment and weakening exchange rates, so also encouraging exports. Many cutters also argue that the best response would be to reduce spending. That is the lesson, they say, from past fiscal retrenchment.

The "postponers" agree there must be decisive slowing of the growth of long-term spending. But they emphasise the fragility of recovery and, in particular, the huge private sector financial surpluses. This private frugality has caused the fiscal deficits, they insist, not the other way round. The sequence of events makes that evident.

Moreover, add postponers, we have seen a strong flight to safety: for the panickers, there is no alternative to bonds of highly rated governments, particularly the US, issuer of the world's safe-haven currency. Since the eurozone crisis, that role has become more entrenched. Moreover, the long-term interest rates of leading countries are falling, not rising: in the US, 10-year Treasury bond rates are 3 per cent. Where, then, is the threat to confidence?

Moreover, postponers would add, with interest rates close to zero, monetary policy is ineffective, except to the extent that it supports fiscal loosening. Fortunately, countries with their own central banks can finance fiscal deficits directly. This is untrue for members of the eurozone, which are, in effect, operating with a foreign currency. So long as excess capacity remains so large and normal bank lending so weak, such reliance on the central bank "printing press" creates no inflationary danger. On the contrary, the danger is rather that premature fiscal tightening would trigger a sharp economic slowdown, as in Japan in the 1990s, so pitching important economies into deflation.

The interaction of high indebtedness with deflation could, they argue, create a downward spiral. A Japanese-style "lost decade" threatens the developed world. That is particularly likely if everybody tightens together. If anything, further loosening is needed: in the first quarter of 2010, the GDP of every member of the Group of Seven leading countries was still below its pre-crisis peak.

Readers must make up their own minds on the merits of the arguments this week. My own strong sympathies are with the postponers. But on one thing everybody agrees: this debate matters. We cannot be sure who is right. But we can be sure that, if policymakers get it wrong, the results may well be dire. Physicians must prepare to respond swiftly to adverse reactions to their favoured course of treatment.

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