Austerity – Pros and Cons

By Tejvan Pettinger on June 7, 2012 in economics

Readers Question: Following the austerity debate, what are the economic arguments for retrenchment? I know there are many against, i.e. the horizontal LM curve results in no interest rate crowding out with fiscal expansion, but I want to get a balanced perspective. What are the main arguments against retrenchment in economic terms?

Retrenchment means a cut in government spending. Retrenchment often refers to bringing down the size of government spending as a % of GDP.

Arguments for Retrenchment (For Austerity)

- Budget Deficits are too high and need to be reduced.
- If budget deficits are not cut, it will lead to higher bond yields (e.g. in case of Greece, Spain and Ireland).
  - Higher bond yields increase cost of financing the deficit. (An argument is that future generations will be paying interest on current levels of debt)
  - Higher bond yields and interest rates on other bonds can reduce private investment.
- Cutting budget deficits will give investors greater confidence about the long term performance of the economy. Lower debt levels will encourage the private sector to invest.
- The EU commission recently produced a report saying that austerity measures are working to reduce budget deficits. José Manuel Barroso, the commission president said: ‘I can say the medicine is beginning to work’ (Economist). The EU point to falling deficits in countries such as Estonia, Finland, Luxembourg and Sweden. Hungary has also improved its fiscal position.
- Government spending as a % of GDP has grown too high crowding out (the more efficient) private sector. Many claim that governments with lower share of GDP tend to be more successful, though evidence is very mixed. (is large government bad for growth?)
- Examples of countries who have pursued austerity and later showed strong economic growth. For example, Canada in 1993-96, cut fiscal deficit but maintained strong growth. More recently, supporters of austerity argue that the rebound in economic growth in Latvia and Estonia show that countries who pursue fiscal austerity can overcome their problems. (e.g. Latvia showed fastest growth of 5.1% in past 12 months at Q1 2012 link)
- Morality that the government shouldn’t be spending money they don’t have.

Arguments against Retrenchment (Against Austerity)

- In a recession and liquidity trap, there is a rise in private sector saving and therefore strong demand for government bonds. Despite rise in UK and US government deficits, bond yields have continued to fall – suggesting that there is no immediate need to cut spending in a recession. The fear over rising bond yields in UK and US is misplaced.
- In a recession, you have the private sector paying off debt (leading to lower private sector consumption and investment) This leads to a fall in aggregate demand. If the government also cuts spending then there will be an even bigger fall in demand. Keynesian economics suggests in a liquidity trap, we should increase government spending to offset the fall in private sector spending.
• Higher bond yields in Greece, Spain and Ireland are due to the problems inherent in the Eurozone – i.e. no lender of last resort. A better way of dealing with rising bond yields would be through common Euro bond and full fiscal union – cutting spending doesn’t help.

• Austerity measures in Greece, Spain and Ireland have not stopped rising bond yields. In fact austerity measures have led to higher bond yields. This is because markets see that austerity has caused lower growth and lower tax revenues, therefore, with a shrinking economy markets can’t see how governments can repay.

• **Austerity is self-defeating.** In a recession, governments who cut spending hard, have seen a large fall in nominal GDP. E.g. in 2011, Greece had a fall of 6% in GDP. This has led to a shrinking of tax revenues. Debt to GDP has continued to rise. In other words, austerity has reduced economic growth so much that the budget deficit has failed to improve.

• Recession is not the time for austerity. Austerity should be pursued when there is strong economic growth.

• Canada’s deficit reduction was successful because it could loosen monetary policy, devalue exchange rate and benefit from strong export demand to US and rest of world. Many Eurozone economies can’t do this. They can’t devalue, they can’t pursue expansionary monetary policy – they can’t rely on exports to recover – because the whole Eurozone is weak.

• The problems of the Eurozone is not just about deficits, it is about a lack of competitiveness, and misaligned exchange rates. In 2011, Greece had a current account deficit of 10% of GDP – It is fundamentally uncompetitive. Germany, by contrast has a current account surplus of 6% of GDP.

• Internal devaluation takes too long. Some argue that Spain and Greece can regain competitiveness through internal devaluation – cutting wages and prices. But, this takes several years of low growth and high unemployment. It is a painful

• There is no evidence that cutting spending creates increased confidence. In the UK, confidence collapsed after the coalition came into power and this contributed to double dip recession.

• Success stories like Ireland, Estonia and Latvia are dubious. After a 20% fall in GDP, Estonia has seen a rebound, but GDP is still 10% below 2007 peak. Unemployment has been in double figures for the past 4 years. This is not a success story. It didn’t have to be so painful. It is a similar story with Latvia – often praises as a success, but still with unemployment of 15% and GDP below 2007 peak.