Iyanatul Islam and Anis Chowdhury[1]

The fallacy of austerity-based fiscal consolidation

Fiscal consolidation seems to be the cry of the day, at least in Europe and Japan. Fiscal consolidation in the US during the Clinton years, Denmark (1983-87) and Ireland (1987-89) and the relative prosperity that ensued, have led many to believe that it is possible to achieve fiscal consolidation without harming growth and employment prospects. Thus, the tide has turned against the very brief period when "we were all Keynesians" that helped prevent the world economy sliding into deep depression.

Many economists have highlighted the weaker theoretical rationale and doubtful empirical bases for the fear of government deficits and public debt. Here, we look at the oft cited example of successful fiscal consolidation with growth during the Clinton era in the US.

It is worth reiterating Evsey Domar's observation that fiscal sustainability crucially hinges on economic growth. Thus, we should distinguish between "growth-based consolidation", and "austerity" or "thrift-based consolidation".[2] In a situation of uncertainty about the global economy and as the private sector repairs balance-sheets after a long period of debt-financed over-consumption, thrift-based fiscal consolidation will most likely lead to an outcome similar to the "paradox of thrift", when people end up saving less as their incomes decline due to cuts in spending by all trying to save more.

How does austerity-based fiscal consolidation work?

The proponents of "expansionary fiscal contractions" argue that even the supposedly short-run damage of fiscal austerity would be limited or not arise at all; instead, recovery should follow very soon, if consolidations are credible, decisive, and of the right kind.

Some advocates of fiscal consolidation may acknowledge the countercyclical role of fiscal stimuli, but only in very exceptional situations. However, they instead insist that fiscal consolidation is necessary for economic recovery, and that fiscal stimulus measures must be switched off as soon as possible to minimize damage to "credibility". This is supposed to inspire the "confidence" of bond investors to offset any contractionary impact of public expenditure cuts or increased taxes, especially important for countries facing acute debt problems, with very high debt ratios. The prospect of soaring debt service burdens threatens crowding out and adverse confidence effects. The key link here is between debt burdens and bond market confidence, and thus differs from the 'Ricardian equivalence' hope for positive "supply-side effects" from reduced public spending.

Hence, fiscal consolidations are supposed to be expansionary because cuts in government spending should strengthen the expectation of permanently lower taxes and lower interest rates, which should, in turn, increase both current consumption and investment. In the most favourable austerity-based fiscal consolidation scenario, greater credibility and investor confidence effects exceed the contractionary effects of reduced public spending, resulting in higher growth.

Additionally, fiscal discipline is seen as a safeguard protecting monetary policy from political pressures. Besides central bank independence, a prudent fiscal framework is expected to help maintain price stability.

In sum, deliberate reversal of fiscal trends, brought about by changed macroeconomic policies and institutions, is expected to positively impact business expectations and investments to deliver economic employment and growth. Thus, crucial links -- involving fiscal consolidation, fiscal and monetary institutions, and economic growth and employment -- are believed to exist.

Clinton success

Fiscal consolidation during the Clinton era is the best recent example of growth-based fiscal consolidation. In fiscal 1992, the deficit was $290.4 billion, or 4.7% of GDP. The deficit in 1997 came down to $22.0 billion, or 0.3% of GDP. In 2000, the surplus peaked at $236.4 billion, or 2.4% of GDP.[3]

During the Clinton era, annual GDP growth rate averaged 3.6%. Job growth averaged 2.8 million per year and the median hourly wage rose at a 0.5% annual rate. In his second term, annual GDP growth averaged 3.9%, job creation averaged 2.8 million per year, and the real median wage grew at a 2.0% annual rate.

What contributed to this stellar growth performance - the best since the late sixties? The proponents of fiscal consolidation attribute this to deficit reduction. But a close examination of relevant data reveals a more credible explanation.

First, there was a sharp upturn in productivity growth from the fourth quarter of 1995, averaging 3.1% annually. The surge in productivity growth cannot be attributed to deficit reduction or the expectation of permanently lower taxes. Instead, the surge in productivity appears to have been an exogenous development, usually associated with much greater use of information technology.[4]

Second, contrary to the prediction of fiscal consolidation proponents, the dollar strengthened from mid-1995 after President Clinton announced on 19 April 1995 that the U.S. "wants a strong dollar" and "has an interest over the long run in a strong currency". This change in US exchange rate policy resulted in the US dollar's value rising against other major currencies from under 80 in January 1995 to over 100 by January 2000.[5]

There were two arguments in favour of this policy shift in favour of a strong dollar. First is the time lag for exports to rise and imports to decline in response to depreciation, worsening the current account deficit before improving it – the so-called J-curve effect. Second, in a world of increased capital mobility, the expectation of a falling dollar requires correspondingly higher interest rates due to the arbitrage condition known as 'interest parity'. Higher interest rates, associated with the weakening dollar, thus slowed output and export growth.

A strong US dollar also meant less imported inflation, allowing the Fed to maintain expansionary monetary policy. The Fed refrained from aborting the long boom of the 1990s by raising interest rates, even though unemployment fell markedly below any previous conventional measure of unemployment below which the rate of inflation would accelerate – the so-called NAIRU (non-accelerating inflation rate of unemployment). In addition to boosting growth, low interest rates helped keep bond yields close to the nominal GDP growth rate, and the interest burden under control.

The strong dollar policy and lower interest rates were crucial for the Clinton era expansion, which in turn increased revenue and reduced social security expenditure, thereby achieving a fiscal surplus. Expansionary monetary policy, in particular, triggered and sustained growth, with fiscal consolidation a consequence.

As documented by Stiglitz and others,[6] a downside of this expansionary monetary policy was increasing private sector debt and unrealistic expectations about future earnings. As a result, the saving rate plunged to historic lows and the private sector debt ratio attained new heights.

Concluding remarks

The world is a closed economy. When every other country is facing the prospect of a growth slowdown or outright recession, no major economy can depend on exports to compensate for cuts in domestic expenditure. Large economies are also closed enough, in the sense that much of their own growth depends on domestic demand, rather than external growth. Investor confidence works in a symmetric and pro-cyclical way – rising with a booming economy and falling when the economy is in a downturn.

Therefore, austerity-based fiscal consolidation is a risky bet. It is unlikely to yield investor confidence when unemployment continues to rise. Forcing the renminbi to appreciate should raise domestic demand in China and enable other low-cost suppliers to compete with Chinese exports, but US exports are unlikely to grow, ceteris paribus. Interest rates can only rise from here on and monetary policy will not be able to offset the contractionary effects of tighter fiscal policy. Fiscal consolidation is only possible when economic recovery gains tractions.

***Anis Chowdhury** is Senior Economic Affairs Officer, UN-DESA, New York and Professor of Economics, University of Western Sydney, Australia.*

***Iyanatul Islam** is Senior Employment Policy Specialist, ILO, Geneva and Professor of International Business, Griffith University, Brisbane, Australia.*

[1] The views expressed here are strictly personal and do not necessarily reflect the views of the United Nations or the ILO.

[2] Domar, E. D. (1944). "The 'Burden of the Debt' and the National Income." *American Economic Review* 34(4): 798-827; Domar, E. D. (1993). "On Deficits and Debt" *American Journal of Economics and Sociology*, 52(4): 475-478.

[3] President Clinton was also able to fend off pressure to increase spending when the surplus did emerge in 1998 by suggesting the need to "let's save the surpluses until we put social security on a firm footing" – no tax cuts, no big spending increases. For a political economy explanation, see Per Gunnar Berglund,and Matias Vernengo (2004). "A Debate on the Deficit". *Challenge* Nov–Dec.

[4] Dean Baker (2010). "Fiscal Policy". Center for Economic and Policy Research, Washington, DC.

[5] See Bradford DeLong and Barry Eichengreen (2001). "Between Meltdown and Moral Hazard: The International Monetary and Financial Policies of the Clinton Administration". Conference on the Economic Policies of the Clinton Administration, Kennedy School of Government, Cambridge, MA, 26-29 June.

[6] See, for example, Wynne Godley and Alex Izurieta (2003). "Coasting on the Lending Bubble: Both in the UK and in the US". Paper presented at the Annual Meeting of the Society of Business Economists, London, June 25. http://www.cerf.cam.ac.uk/publications/files/WA_LendingBb_Jun03.pdf; Wynne Godley and Bill Martin (1999). "How Negative Can U.S. Saving Get?" Policy Note 99/1, Levy Economics Institute; Wynne Godley and Randall Wray (1999). "Can Goldilocks Survive?" Policy Note 99/4, Levy Economics Institute.