Austerity has become one of the buzzwords of the decade. Governments the world over seem to have accepted it as a matter of course. It is held up proudly by some, embraced reluctantly by others.

Yet the debate surrounding austerity continues. In one corner are those who push for more deficit-cutting measures, while in the other sit those who believe that it is time for governments to suspend their efforts to reduce deficits now, given the weak global economy.

One way to enlighten this debate is to focus on the current state of the world economy, rather than on how economies operate in normal circumstances. With an eye on the present, it is clear that a pragmatic approach—a steady pace of adjustment within a clear medium-term framework—is the best course of action.

Picture the captain of a ship, whose cargo must be brought safely and quickly to its destination. The move to austerity, like the captain’s conduct, must be guided by a clear plan, and keep a steady course in sometimes stormy waters.

Steady as she goes

What is the current climate—the special circumstances that characterize the global economic picture right now—and what does it imply for fiscal policy management? I will focus on advanced economies, because this is where fiscal imbalances are larger and the debate is more heated.

Advanced economies are recovering from the largest economic shock since the Great Depression. Governments attempted to stimulate economic growth by increasing their fiscal deficits, which was for the most part successful, but now there is a need to scale back deficits to get their fiscal houses in order. Yet in most advanced economies, unemployment remains high and output far below potential. In these circumstances, the changes in economic output brought about by reducing the government deficit—the so-called fiscal multiplier—are larger than those traditionally discussed in economic literature. Traditional estimates of fiscal multipliers often ignore whether an economy is growing rapidly, faltering badly, or is somewhere in between. This is because when output is near or above capacity, a deficit reduction is more likely to lower inflation and less likely to lower output. So estimates of the fiscal multiplier that include periods when an economy is booming lead to underestimation of the magnitude of the multipliers. It is like trying to assess the effectiveness of an umbrella by looking at how much it protects you from rain even on days when the sun is shining. Umbrellas are helpful when it rains; when the sun is shining they are not very useful. And you really can’t assess their true effectiveness over an average of rainy and sunny days.

In addition, multipliers tend to be particularly high during the current phase because interest rates are already at record lows and so fiscal tightening cannot be offset by monetary relaxation.

Vagaries of the markets

Some might argue that a fiscal contraction that has an expansionary effect on the economy is at least a possibility in countries where spreads are high; that is, where governments now must borrow at high interest rates and where austerity measures could trigger a return to market confidence. The reasoning is that such action will inspire markets’ confidence in governments and in their ability to manage their deficit and debt. Easing markets’ concerns should lead to lower borrowing costs for governments, which may spread to the rest of the economy.

But a confidence-inspired decline in interest rates on government debt—something that very well might accompany fiscal tight-
ening in more normal times—could be impeded by markets’ current focus on short-term developments.

If the market sentiment is that fiscal tightening will slow growth in the short term, spreads will not decline because of the fear that sluggish growth will depress tax revenues and discourage governments from sustaining fiscal adjustment over time. This problem is exacerbated by the danger that—when a country’s public debt is high compared with its overall output—fiscal tightening might drive up the public debt-to-GDP ratio in the short run. This scenario, again, assumes that output slows when fiscal policy is tightened.

So two self-fulfilling prophecies are possible:

• If markets anticipate that tightening will not slow growth, spreads could fall and growth could indeed be sustained despite fiscal tightening.

• If markets anticipate that tightening will slow growth, spreads could rise and growth would suffer as deficits are cut.

The recent downgrade of some European countries’ credit rating by Standard & Poor’s, which cited the negative impact of fiscal tightening on growth, suggests that market behavior will lead to the latter, less appealing, outcome.

It’s safe to say that sizable fiscal tightening will have a contractionary effect on the economy, a problem that will be magnified by simultaneous fiscal policy tightening by most advanced economies. It would help to spread out the adjustment, postponing some of it until output has recovered and the credit channel is stronger.

Some argue that the fiscal multiplier would be small or even negative (a fiscal contraction leading to an output expansion) if fiscal tightening is implemented through cuts in government spending rather than by raising taxes. But I disagree. The factors that support the recovery of private sector demand—namely, monetary policy expansion, a lowering of the exchange rate, a decline in spreads—will suffer no less from spending cuts than from revenue increases. I would agree that, for most advanced economies, spending cuts are preferable to tax hikes. But this is for structural reasons—not because one approach costs significantly less over the short term. Potential growth in countries where tax rates are already high, as in most European countries, would suffer in the long run from further increases.

On the move

Altogether, one can conclude that fiscal tightening is likely to impact negatively on output in the short run. This implies that countries where economic activity is already weak would benefit from a more gradual pace of fiscal adjustment. It would help to spread out the adjustment, postponing some of it until output has recovered. So, if moving too quickly with fiscal adjustment involves output costs, why move at all? Why is it appropriate to start tightening fiscal policy now rather than just postponing it until times are better? The answer is obvious for countries that are already under market pressure. Given the difficulty of borrowing at sustainable interest rates, however, these countries’ fiscal adjustments will have to be front loaded: most of the deficit reduction must take place sooner rather than later.

What about other economies? They definitely have more room to maneuver fiscally and could have a more moderate pace of adjustment. But even for them, barring a major deceleration in economic activity, postponing the adjustment altogether—or even implementing an expansionary fiscal policy—would be too risky in the current circumstances for three reasons:

• Public debt hasn’t been this high since World War II. High public debt levels are hard to sustain, but—more important—when public debt is high even small increases in interest rates can derail public finances. Under these conditions, deferring austerity measures is riskier.

• Market preoccupation with short-term developments makes it more difficult to trade medium-term fiscal tightening for short-term fiscal expansion—for example, reforms in pension and health care spending that would reduce medium-term deficits and allow increased spending in the near term. Spreads do not seem to take into account differences in long-term social spending, which suggests that future reforms will buy little credit from markets today.

• The Greek debt restructuring has shattered the assumption widely held throughout the post–World War II period that debt restructuring does not happen in advanced economies. So markets are more nervous about fiscal developments than ever before.

Risk management

The relative importance of these three factors varies across countries. But the main message is that postponing fiscal adjustment until better times is now more difficult than in the past. Credibility seems to require a down payment in the form of some nontrivial fiscal tightening. A gradual approach would avoid the risk of having to tighten too rapidly later should markets start having doubts about credibility. Moreover, some of the costs related to fiscal adjustment discussed above—for example, a possible rise in spreads when fiscal policy is tightened as growth slows—are more likely to occur with large cuts to deficits than with moderate ones.

The last thing the world economy needs in this uncertain environment is a knee-jerk fiscal policy reaction. Thus, for countries that are not under market pressure, proceeding at a steady speed—with some consideration for cyclical developments, particularly by allowing fiscal multipliers to operate fully—with a clear sense of direction and with a mix of austerity measures that takes into account long-term efficiency goals is the right thing to do.