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Fiscal Austerity and the IMF

As we begin Samvat 2069, I am wondering whether the IMF has started becoming more Keynesian on the issue of fiscal austerity. But before coming to this point, let us take an overview of the mounting problem of fiscal deficits and public debt in the rich countries; as a percentage of GDP, it is close to the level at the end of the Second World War.

The U.S. is fast approaching a "fiscal cliff" as the deadlock on fiscal policy between the President's insistence on tax increases on the rich to reduce the deficit, and the Republicans' demand for tax reduction to spur growth, continues. The latter is a rehash of the so-called, and now mostly forgotten, "Laffer Curve", drawn on a restaurant napkin showing how growth and hence revenues will pick up after tax cuts: it became the cornerstone of the Reagan tax policy. If the deadlock is not broken by 31st December, the Bush tax cuts would lapse, and public expenditure, particularly on defense, would be automatically cut: the economy could then face a recession in 2013. What is truly amazing to this columnist is the argument that the Republicans are fiscal conservatives. The last three decades of history evidences the exact opposite: Reagan left huge deficits to his successor, Bush Senior. The latter could not do much about them; his Democratic successor adopted polices which led to a fiscal surplus. This was frittered away by Bush Junior through tax cuts for the rich, and his unending "war on terror" in Afghanistan and invasion of Iraq. The Republican faith in the market also led to the financial crisis of 2008, and President Obama inherited the mess!

Across the Atlantic, the problems of the euro zone are too well known. Last week the Greek Parliament did pass the expenditure cuts demanded by the lenders as a condition precedent to releasing the next tranche of assistance. The big question of course is how long the people of Greece (or the Spaniards for that matter) would continue to accept "fiscal austerity". A messy breakup of the zone cannot be ruled out in the year ahead. And, a recession is on the cards even without it (also in the U.K.)

The once miracle economy of Japan has been going nowhere for the last 15 years. Public debt was above 100% in 1997 – and has since gone up to more than twice that percentage despite the near zero interest rates for much of the time. And, despite the ultra-loose monetary and fiscal policies, growth has been uneven – and the economy in deflation. Japanese GDP contracted 3.5% in July-September and is suffering external deficits thanks to an uncompetitive exchange rate -- and to the territorial dispute with China. Does the conventional wisdom of the relationship between money supply, inflation and exchange rate, not apply to Japan?

The rich countries have also been pumping monetary stimuli in the economy: Federal Reserve with its QE II and III; the ECB with its OMT (outright monetary transactions); the Bank of England's purchase of government bonds; etc. This can help in financing the public debt without yields shooting up: but what about reducing it as a percentage of nominal GDP? Mathematically, the answer is simple: reduce the growth in the numerator (public debt) below the growth in the denominator (nominal GDP). The former requires growth in revenue and cuts in expenditures (austerity); the latter, higher inflation and GDP growth and productive public investments: not the umpteen bridges to nowhere built in Japan. Actually global growth has been falling since its recovery in 2010, and is forecast to fall further in 2013.

With monetary stimuli and low interest rates not leading to growth, the answer to debt reduction depends on the assumption of what economists refer to as the "fiscal multiplier": the ratio between fiscal tightening to GDP fall. This was widely accepted to be around 0.5. In other words fiscal tightening of 1% of GDP would lead to a fall of 0.5 % in the economic output. In that case, in the debt to GDP ratio, the numerator will fall faster than the denominator; a corollary is that fiscal austerity is the right medicine for the problem of public debt.

The IMF's latest research (Global Economic Outlook, October 2012) suggests that the multiple has been between 0.9 to 1.7! (The latter figure is a revision of more than 300% in the earlier assumption!) Other analysts cited by The Economist (October 27) estimate the multiplier to be as high as 2.5 or 3 in recessionary economies. A multiple higher than unity means the ratio of debt to GDP will keep growing with fiscal austerity as the highly indebted counties in the euro zone are finding out: the human cost of austerity, mostly borne by the relatively worse off, is another issue!

Will the revision of the multiplier at last convince the proponents of econometric analysis and financial economics (and policy-makers) of the fragility of the conclusions their methodology leads to? Keynes seems once again right on macroeconomic policy issues, and in his disbelief in statistical models!

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