The Big Read Coronavirus economic impact

Global economy: the week that austerity was officially buried

The IMF and World Bank are urging richer countries to spend their way out of the pandemic, although some developing nations face cuts

Chris Giles in London OCTOBER 16 2020

This was the week we witnessed the funeral of austerity. Those who used to worship at its altar now urge countries to throw caution to the wind. Fiscal orthodoxy, practised over decades since the debt crises and inflation of the 1970s and 1980s, has been replaced with fiscal activism.

As the IMF and World Bank annual meetings wrap up in virtual form in Washington this weekend, many of the most senior figures at the top — and in the research departments — of these institutions have been singing a new tune on fiscal policy this week.

Carmen Reinhart, the eminent economic historian who is now chief economist at the World Bank, recommended countries should borrow heavily during the pandemic. “While the disease is raging, what else are you going to do?” she asks. “First you worry about fighting the war, then you figure out how to pay for it.”

Ms Reinhart was a leading advocate of austerity a decade ago after publishing a research paper which concluded that at a similar stage in the 2008-09 financial crisis — to where we are now — high levels of public debt undermined economic performance. It concluded that, “traditional debt management issues should be at the forefront of public policy concerns”.

Carmen Reinhart, pictured at the World Economic Forum in 2011, was a leading advocate of austerity after the 2008-09 financial crisis © Tomohiro Ohsumi/Bloomberg

The IMF itself warned after that global financial crisis that “many countries face large retrenchment needs going forward”, but now it tells all countries that have access to financial markets to issue debt and to spend without the prospect of austerity later. As she reached for inspiration from the Russian novelist Fyodor Dostoyevsky, Kristalina Georgieva, head of the IMF, said, “Only one thing matters — to be able to dare”.

Both advanced economies and many emerging ones have keenly taken the advice to heart as they have battled coronavirus. The IMF estimates that countries have increased spending or cut taxes by $11.7tn so far — 12 per cent of global gross domestic product in 2020. To put this in perspective, just over a decade ago and after months of bickering, the G20 nations finally agreed a stimulus worth 2 per cent of global GDP for two years after the financial crisis.

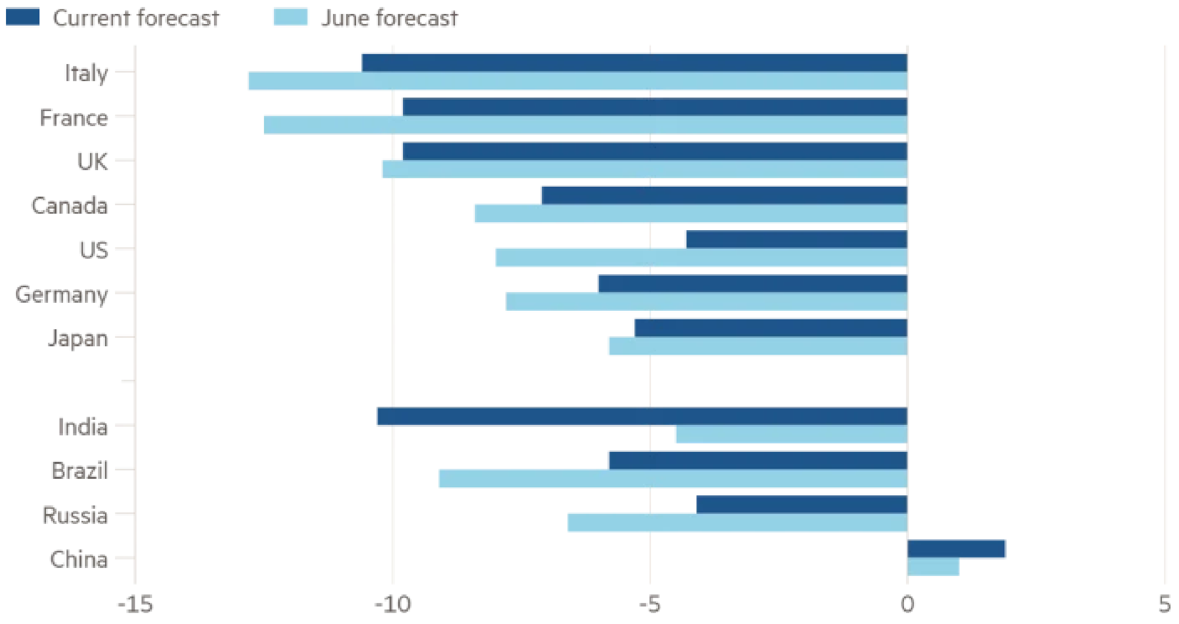
In terms of fiscal policy, this time really is different.

The fiscal consensus that prevailed until the past few years was built on the lessons learnt internationally after the boom decades of the 1950s and 1960s. The experience was that raising or lowering taxes and changing public expenditure was too slow in most political systems to be effective in taming the economic cycle and, instead, tended to amplify it. Monetary policy — set ideally by independent policymakers in central banks — took on that role.

The second part of this fiscal consensus accepted that the best policy would target longer-term stability in public finances, ensuring debt and deficits met broad rules of thumb that would almost always ensure that compliant countries would face no difficulties in financing themselves. This would allow them to concentrate on improving the efficiency of their tax systems and public spending.

The world's leading economies will see historic contractions in 2020

Change in GDP (%)



Source: IMF
© FT

That consensus was still dominant at the time of the 2008-09 financial crisis, culminating in the Toronto G20 summit declaration in 2010 that highlighted "the importance of sustainable public finances" and warned that "countries with serious fiscal challenges need to accelerate the pace of consolidation". Greece, for example, had already lost the confidence of its lenders.

Fiscal over monetary policy

The question now is why has the thinking changed so radically. Answers cover three distinct categories: bitter experience of the past decade, changed circumstances and raw politics.

There is little doubt that the 2010s was a difficult decade for almost all economies around the world, with underlying growth considerably lower than hoped at the time of the Toronto summit. Most of this had more to do with a global fall in underlying productivity performance than with tax and public spending strategies, but even with the potential for growth lowered, economic performance disappointed, largely because monetary policy did not have the ammunition to stimulate economies sufficiently.

The world's big economic blocs never achieved the conditions that would have induced rapidly rising wages and inflation, so interest rates could rise towards more normal levels, despite the drama of officials such as Mario Draghi at the European Central Bank doing "whatever it takes". Monetary policy simply could not have provided the $11.7tn boost that fiscal policy managed this year.

An anti-austerity protester interrupts then European Central Bank president Mario Draghi at a 2015 press conference. Monetary policy then simply could not have provided the $11.7tn boost that fiscal policy managed this year © Ralph Orlowski/Reuters

After the past decade, instead of jealously guarding their independence, leasing central bankers now talk of the need for fiscal policy to help keep inflation from falling. In recent weeks, Jay Powell, the Federal Reserve chairman, said "the recovery will go faster if we have both tools [fiscal and monetary] working together", while Andrew Bailey, Bank of England governor, called for "a very close and sensible co-ordination" of the two economic policies.

Long gone is the notion, supported by former UK chancellor George Osborne, that it was imperative to have a credible plan to reduce deficits in the public finances because that would give households the confidence to spend rather than save.

There are also economic circumstances that did not apply until recently. The main change, most notably highlighted by Olivier Blanchard, former IMF chief economist, is that with government borrowing costs in advanced economies below or close to zero — at almost all durations — and likely to remain so, countries could afford to service considerably higher levels of debt without posing a greater long-term burden on their finances because economies were likely to grow faster than the interest on debt. "The issuance of debt without a later increase in taxes may well be feasible," Prof Blanchard said in January 2019.

The example he gave was for a one-off increase in debt, which at the time was seen as an otherworldly scenario because few countries ever borrow a huge chunk of money for a strictly limited period in peacetime. But in 2020, the pandemic has arguably provided just this situation and the one-off nature of deficits has been used by the IMF as the justification for supporting the large-scale borrowing that countries are undertaking.

Jay Powell, the Federal Reserve chairman, said recently that 'the recovery will go faster if we have both tools [fiscal and monetary] working together' © Kevin Dietsch/Pppl/AFP via Getty

Finally, there is no longer any desire for austerity after the difficult 2010s, so the political and public mood fits with the new economics. Arguably, austerity sowed the seeds of its own destruction by raising support for populist politicians like Donald Trump and Boris Johnson who had no truck with difficult budgetary issues and rarely saw any problem with public spending largesse.

After the financial crisis, President Barack Obama and Democratic politicians joined forces with Republican fiscal hawks in the difficult process of reducing the US deficit only to watch Donald Trump gain popularity with enormous tax cuts in 2017. There is no mood around Joe Biden, the Democratic presidential nominee, to play that game again if he wins on November 3.

Prominent economists and former Democratic party officials, Jason Furman and Larry Summers, have provided the intellectual underpinning of the shift in the party's stance. They argued last year that there were still costs and benefits of lowering government borrowing, but "the benefits of a reduced probability of a fiscal crisis do not outweigh the costs of deficit reduction".

In the UK, Boris Johnson's Conservative government has ruled out austerity as the way to resolve the nation's public finance difficulties and, even in Germany, the bastion of fiscal probity, politicians such as economy minister Peter Altmaier now boast about introducing "the biggest stimulus programme of all time" in response to coronavirus.

Kristalina Georgieva is head of the IMF, which is now telling all countries that have access to financial markets to issue debt and to spend without the prospect of austerity later © Eric Baradat/AFP

Too early to bury austerity

It would be wrong, however, to say that everyone has signed up to the new consensus that deficits and public debt do not matter any more. Even within the IMF, there are tensions. While its managing director urges countries to dare to do new things, officials still insist on austerity for countries that are forced to borrow from the fund.

Oxfam, the anti-poverty charity, complains that the IMF has pushed austerity measures on 80 per cent of countries forced into its lending programmes during the coronavirus pandemic. "This austerity drive will hurt the countries it claims to help and flies in the face of the fund's own research findings, showing it worsens poverty and inequality," says Ana Arendar, Oxfam's head of inequality policy.

But it is not just lenders who worry that countries might in time need a more conservative approach to fiscal policy.

"Much will depend on whether the fiscal legacy of the virus is simply a step increase in the debt-to-GDP ratio — because of a huge but temporary burst of additional borrowing," says Robert Chote, who has just stepped down as the head of the UK's Office for Budget Responsibility. "Or whether we find ourselves confronting a big increase in the structural budget deficit as well.

Former UK chancellor George Osborne maintained it was imperative to have a credible plan to reduce deficits in the public finances because that would give households the confidence to spend rather than save © Charlie Bibby/FT

"A rise in the structural deficit would strengthen the case for consolidation [austerity] measures, but you still wouldn't want to go at it too quickly," he adds.

In the UK, the Institute for Fiscal Studies warns that the crisis is likely to require higher health and social care spending in future, far in excess of any benefit from lower borrowing costs. It said this week the UK would ultimately need to find tax rises of probably around 2 per cent of GDP to limit a likely persistent rise in public debt.

With ageing populations across advanced economies, this is likely to become an ever more pressing issue in the decade ahead. Austerity might have been buried for now, but if governments' luck does not hold on borrowing costs and when ageing hits, there is no guarantee it will not be resurrected.