The quiet demise of austerity

By James McCormack
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It has been several years since policymakers seriously discussed the merits of fiscal austerity. Debates about the potential advantages of using stimulus to boost short-term economic growth, or about the threat of government debt reaching such a level as to inhibit medium-term growth, have gone silent.

There is no mistaking which side won, and why. Austerity is dead. And as conventional politicians continue to take rearguard action against populist upstarts, they will likely embrace more fiscal-policy easing – or at least avoid tightening – to reap near-certain short-term economic gains. At the same time, they are not likely to heed warnings of the medium-term consequences of higher debt levels, given widespread talk of interest rates remaining "lower for longer."

One way to confirm that an international fiscal-policy consensus has emerged is to review policymakers' joint statements. The last time the G7 issued a communiqué noting the importance of fiscal consolidation was at the Lough Erne Summit in 2013, when it was still the G8.

Since then, joint statements have contained amorphous proposals to implement "fiscal strategies flexibly to support growth" and ensure that debt-to-GDP ratios are sustainable. Putting debt on a sustainable path presumably means that it will not increase without interruption. But in the absence of a definite timeframe, debt levels can undergo lengthy deviations, the sustainability of which is open to interpretation.

Objections to austerity were understandable in the period following the 2008 financial crisis. Fiscal policy was being tightened when growth was languishing below 2% (after bouncing back in 2010), and sizeable negative output gaps suggested that overall employment would be slow to recover.

In late 2012, at the peak of the post-crisis austerity debate, advanced economies were in the midst of a multi-year tightening equivalent to more than one percentage point of GDP annually, according to cyclically-adjusted primary balance data from the International Monetary Fund.

But just as fiscal policy was being tightened when cyclical economic conditions seemed to call for easing, it is now being eased when conditions seem to call for tightening. The output gap in advanced economies has all but disappeared, inflation is picking up, and world economic growth is forecast to be its strongest since 2010.

In 2013, Japan was the only advanced economy to loosen fiscal policy. But this year, the United Kingdom appears to be the only one preparing to tighten its policy – and that is assuming recent political ruptures haven't altered its fiscal orientation, which will be reflected in the Chancellor of the Exchequer's Autumn Statement.

Most observers would agree that government debt levels are uncomfortably high in many advanced economies, so it would be prudent for policymakers to discuss strategies for bringing them down. Moreover, there are several options for doing this, some of which are easier or more effective than others.

In the end, government deleveraging is about the relationship between economic growth and interest rates. The higher the growth rate relative to interest rates, the lower the level of fiscal consolidation needed to stabilize or reduce debt as a share of GDP.

As economic growth continues to pick up while interest rates lag, at least outside the US, fiscal authorities will have further opportunities to reduce debt, and create fiscal space for stimulus measures when the next cyclical downturn inevitably arrives. But policymakers are not doing this, which suggests that they have prioritized largely political considerations over fiscal prudence.

After the recent elections in the Netherlands and France, a growing chorus is now proclaiming that "peak populism" has passed. But one could argue just as easily that populist ideals are being absorbed into more mainstream political and economic agendas. As a result, politicians, particularly in Europe, have no choice but to favor inclusive growth policies and scrutinize the potential impact that a given policy could have on the income distribution.

This political environment is hardly conducive to fiscal consolidation. Any tax increases or spending cuts will have to be designed exceptionally well – perhaps impossibly so – for leaders to avoid a populist backlash. Some people will always lose more than others from fiscal consolidation, and deciding who those people are is never a pleasant exercise.

So far, those decisions are being delayed on political grounds. But the economic implications of high government debt cannot be ignored forever. Monetary policy is already starting to change in the US, and it could be on the verge of changing globally. One way or another, fiscal authorities will have to confront challenging tradeoffs in the years ahead.

James McCormack is Managing Director and Global Head of the Sovereign and Supranational Group at Fitch Ratings.