Adjusting to a credit cycle bust: The role of fiscal policy

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One hears everywhere these days the accusation that “austerity is killing growth in Europe”! What austerity? Deficits have been reduced on average by about 1% of GDP in the euro area over the last three years (bringing the deficit from 6% of GDP in 2009 to 3% of GDP this year). The pace of deficit reduction has actually been equally gradual in the UK (which is often cited as a prime example of ‘savage budget cuts’) and the US. In both countries the deficit was reduced over the same time period from 11 to 8% of GDP. The image of a German-imposed austerity in Europe is thus plain false.

Of course, even a (de facto gradual) reduction in deficits could be killing growth ‘softly’. But this does not seem to have been the case so far, especially if one sets today’s austerity in the context of the huge fiscal expansion that preceded it. One cannot talk about the costs of cutting deficits without taking into account the entire cycle.

If one looks at the entire budget cycle, the picture of austerity killing growth does not hold up. Since the bursting of the bubble in 2007, the economic performance of the US has been very similar to that of the euro area: GDP per capita is today about 2% below the 2007 level on both sides of the Atlantic; and the unemployment rate has increased by about the same amount as well: it increased by 3% both in the US and the euro area.

Over a five-year period, the US has thus not done any better than the euro area although it has used a much larger dose of fiscal expansion. In the US (and the UK), the general government deficit is today still around 8%, compared to a little over 3% of GDP in the euro area.

Ironically, the economy with the strongest dose of expansionary policy (both monetary and fiscal) is also the one where growth (measured by GDP per capita) has been the weakest since GDP per capita in the UK is today 6% below the 2007 level. Of course, one could argue that the UK was particularly exposed to the bust because financial services make up a large part of its GDP. However, it still remains true that its economy, which is supposed to be the most flexible in Europe, has not recovered from the shock five years later despite massive doses of expansionary fiscal and monetary policy coupled with a devaluation.

Given the massive negative shock coming from the tensions in the sovereign debt markets, it is likely that the relative performance of the euro area will deteriorate this year. So far, however, it does not seem that austerity had a strong negative impact on growth in Europe.

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One can of course point to particular countries in Europe where austerity has led to a depression. But the US has also pockets of very depressed areas. For Ireland and Spain, read Nevada and California (and for Greece, read Puerto Rico). The proper comparison is thus between two continental-sized economies, both of which harbour considerable diversity. Moreover, the shock from the financial crisis should have been comparable for the US and the euro area since housing prices had increased (on average) by about the same amount and the expansion of leverage in the financial system had also been similar.

Prominent economists such as Paul Krugman and Richard Layard have recently pleaded: “Stop this austerity now.” But “this austerity” consists of a rather gradual reduction in deficits, which, at its present pace, would get the US and the UK only by 2017 back to the point where they started in 2007 (still a deficit of close to 3% of GDP).

It is certainly true that the evidence shows that austerity is not expansionary. And Krugman and Layard are also correct in pointing out that when private demand started to collapse in 2008, public demand had to be stepped up to prevent the Great Recession from becoming a second Depression. But four years later, some retrenchment of the public sector is unavoidable as public debt ratios become unsustainable – even if “this austerity” implies a temporary loss of employment and output. The fact that austerity does have costs does not imply it should never be undertaken. Rather, the results from the ‘Great Response’ to the Great Recession, which involved first considerable fiscal expansion and then gradual retrenchment, suggest that the benefits from deficit spending were smaller than expected, and possibly smaller than the cost of the austerity needed to bring deficits back under control.