The Austerity Era and Its Effect on Major Economies

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In 2008 when the financial crisis hit the USA and sent shock waves around the world, most major countries began implementing stimulus packages to resuscitate their economies. To many economists, this seemed like a logical and rational thing, given the crisis environment. However, in 2010 the economic consensus of what policies to implement to counter such a financial shock switched from fiscal stimulus to fiscal austerity. In 2010 the OECD (Organization for Economic Cooperation and Development) advised the USA, in particular, to cut its budget deficit immediately and urged the Federal Reserve to increase short term interest rates. Such advice seemed somewhat mystifying, given high unemployment levels, low inflation, and low government borrowing costs. Luckily, the USA didn’t choose to pursue such extreme policies and began purchasing bonds to boost the economy’s weak demand. The situation in Britain and Europe was the polar opposite, where fiscal austerity became the latest trend. The Bank of England and the European Central Bank began increasing interest rates when the Eurozone and the British economies were deeply depressed and with no sign of rising inflation. The austerity consensus seemed to be rife; it wasn’t just the OECD advocating fiscal tightening, but also other renowned international organizations such as the Bank for International Settlements (BIS) and prominent economists like Raghuram Rajan and large swaths of the Republican party in the US. But what is the magnetic appeal of austerity? Well, there are many caveats, but the most prominent is ‘fear.’ The narrative was that if countries pursued fiscal stimulus and didn’t implement austerity policies, even considering the high levels of unemployment, countries would face the same fate as Greece, high and unsustainable levels of debt.

The Fear Element

In the immediate aftermath of the 2008 financial crisis, the austerity hawks were circling. By the end of 2009, the world economy and financial markets had stabilized, so the call for austerity slightly faded. However, shortly after the Eurozone was hit with the Greek crisis, the advocates of austerity began to amplify their message and get a foothold on economic policymakers around the globe. The austerians used the Greek crisis as an example of what would happen if fiscal tightening wasn't adopted. But the Greek crisis was *sui generis* in Europe; the other crisis countries in Europe suffered debt crises due to the financial crisis, not the other way around. The narrative was portrayed that the debt crisis in other Eurozone crisis countries was brought on by fiscal profligacy when, in reality, it was caused by the financial crisis. Countries like the US and Britain who have their national currency have not seen anything like a Greek-style run on their government debt. Both the US and Britain have had substantial debt and deficits; however, unlike Greece, they can print their currency or devalue their currency, limiting the chance of default. However, Greece was held up as a precedent for the risks of fiscal profligacy, and such behavior could result in plummeting market confidence, ultimately leading to a country's destruction. The resounding message was clear, deficits needed to be cut, or face disaster; many countries around the world bought into this fear and implemented austerity. There was a growing concern, especially in the US, in 2011. What would happen if the deficit and debt weren't cut substantially? Investors would lose confidence in the USA's ability to meet its obligations. Additionally, the austerity advocates posed two fundamental questions – what would happen if investors stopped buying US debt, and what would happen to interest rates? The fear was firmly embedded, and the only solution to prevent such economic oblivion was to implement austerity to bring down the deficit and debt.

The assertions of austerity advocates that low interest rates would deter investors didn’t come to fruition. Interest rates on long-term US bonds fell to a record low in 2011; investors didn’t seem worried. However, the austerity hawks further claimed that the Federal Reserve kept interest rates artificially low by buying government debt through its quantitative easing program. They claimed that when this program came to an end, interest rates would rise again, and to no surprise, they didn’t. The scaremongering of economic oblivion didn’t stop there; the austerity hawks jumped on Standard and Poor’s downgrading of the US government’s AAA rating. Many believed the market was signaling an imminent debt crisis, but in reality, Standard and Poor’s is just a rating agency, nothing more. Again, the false predictions of market reactions to the US’s downgrading didn’t come to fruition. There was a sense of irony, as credit rating agencies like Standard and Poor’s gave a plethora of AAA ratings to many financial instruments that eventually became toxic assets in the lead up to the financial crisis. Even if the dystopian notion of an oncoming debt crisis was real, the proposed remedy to counter it seemed illogical and counterproductive, to say the least.

It seemed pertinent to ask why fiscal austerity such as increased taxes and reduced government spending would help maneuver economies out of a depressed state? Surely such measures are necessary when the economy is close to full employment, and central banks begin to raise interest rates to fight off inflationary pressure. In this particular scenario, spending cuts need not have such a depressive effect on the economy because central banks can cut interest rates to offset the depressive impact of spending cuts. However, if the economy is profoundly depressed to the point where interest rates are zero-level bound, spending cuts can’t be offset, subsequently deepening the depression further. When an economy is deeply depressed, implementing such a policy reduces revenues and doesn’t have the desired effect of deficit reduction. Therefore, if a government's objective is to restore confidence and improve the long-term budget outlook, surely the logical thing to do would be to delay the spending cuts and tax increases. Such policies should be left until the economy is in a stronger position for such fiscal austerity to have its desired effect.

The Reasoning for Austerity

The consensus among most crisis countries in 2010 was that fiscal austerity was needed to prevent a deep-rooted and prolonged debt crisis. Even when economists highlighted the limitations of the confidence theory, the austerity advocates presented studies of countries that had brought down their deficits and experienced economic expansion through expansionary austerity measures. Austerians like to use examples of countries like the USA in the late 1990s and Canada in the mid-1990s, who were able to reduce their deficits and experienced economic booms shortly after. In the USA, it is undoubtedly true they were able to reduce their deficit and debt and move into a budget surplus, but not through expansionary austerity. Austerians fail to mention that at this particular time, there was another critical factor at play causing the booming economy –s the technology boom, which boosted economic growth and led to rocketing share prices, which in turn led to soaring tax receipts. Therefore, the notion that expansionary austerity led to this particular economic expansion is disingenuous.

Another proponent of austerity during the aftermath of the financial crisis was Britain, who had the firm belief that austerity wouldn't lead to an economic decline. The UK Government used the example of '1990s Canada'" to advocate austerity; during this period, Canada managed to cut its deficit and experience economic expansion. However, Canada's situation was slightly different because interest rates in Canada fell significantly, something Britain would have found difficult to implement. After the financial crisis, the UK interest rates were close to zero, making it difficult to offset spending cuts. Moreover, the Canadian economy in the 1990s was weak; therefore, they were able to boost their exports to their closest neighbor, the USA, as the weak Canadian dollar made their exports competitive relative to the strong US dollar. However, the UK was unable to use its weak currency (pound) to boost its exports with its EU neighbor. The Eurozone economies were weak, too, mainly due to the Eurozone's poor performance, which weakened the Euro currency's value, so the UK failed to boost its exports to the Eurozone.

There has been a lot of research from a wide array of organizations, including the IMF, who found that implementing austerity when an economy is depressed contracts the economy rather than expanding it. But why? In an economic downturn or recession, governments can usually offset budget austerity; they can use monetary tools to lower interest rates or devalue their currency. However, in the immediate aftermath of the financial crisis, most of the crisis countries weren't able to utilize such monetary tools. The core reasons were that interest rates were zero-level bound, and countries like Greece and Spain, who are in the Eurozone, couldn't devalue their currency as they shared a common currency. Likewise, they couldn't lower interest rates as the European Central Bank set the base rate.

Clearly, in such environments where economies are depressed, austerity seems to offer no remedial effect. Taking demand out of the economy at the exact time it needs it most is counterproductive, especially when interest rates are zero-level bound, and thus ineffective in offsetting spending cuts. A fiscal policy that focuses on cutting deficits instead of creating real jobs and a monetary policy that responds irrationally to any slight increase in inflation by increasing interest rates even when unemployment levels are incredibly high just further depress the economy.

Eurozone crisis countries, on the other hand, would need a different approach, primarily fiscal stimulus, and the ECB would have to relax their criteria on deficit and debt to GDP requirements. Eurozone countries don’t have the luxury of controlling their monetary policy, and are restricted in fiscal aspects, too. When an economy is depressed, implementing austerity only benefits a select few, the interests of creditors, rather than borrowers and the masses of working people. Creditors become concerned when governments can’t meet their financial obligations; they also take a dim view of any monetary policy that affects their returns. Creditors don’t particularly like when central banks keep interest rates too low; this is perceived to be inflationary, further affecting returns. The narrative among most developed economies is to protect the interests of financial institutions, rather than boost aggregate demand which allows countries to move out of a recessionary gap,

Alternative Monetary Tools When Interest Rates Are Zero-Level Bound

The neoliberal narrative of austerity in economic slumps needs to be revised, especially when interest rates are zero-level bound; fiscal policy should be aimed at creating jobs, not solely reducing deficits in economic slumps. Stronger economies’ monetary authorities, like the Federal Reserve and the Bank of England, need to look at more unconventional monetary measures such as quantitative easing to buy less traditional financial assets such as private debts and long-term bonds. Quantitative easing increases the money supply in the economy, which increases aggregate demand in the economy when the traditional monetary policy reaches its lower bounds. If central banks create new money to buy financial assets and government bonds from financial institutions, this drives up the price of bonds and reduces yields. Institutions that now have large amounts of cash reserves buy up other assets with better yields, once more driving up those prices and lowering yields. As yields (long term interest rates) across the economy fall, the coupon rates that financial institutions offer on their corporate bonds can also fall. This reduces borrowing costs for them, allowing them to offer lower interest rates on general loans and mortgages for households and businesses wanting to consume or invest, subsequently encouraging more borrowing for consumption and investment, boosting aggregate demand and stimulating the economy.

Additionally, the same QE mechanism could be used to fund temporary tax cuts to offset the budgetary effect; this would counter the impact on aggregate demand. Another variant could be intervening in FOREX markets to drive down the value of a country's currency, boosting the competitiveness of a nation's exports and thereby increasing aggregate demand and stimulating growth. Alternatively, moving to a more flexible inflation mandate, such as setting a higher inflation target of around 4%, e.g. for a five to ten-year period, would help depressed economies weather economic storms and stimulate the aggregate demand desperately needed. All of the tools mentioned above should be implemented when interest rates are close to zero, opting for austerity in such instances exacerbates the depression.

It is abundantly clear that countries that have implemented harsh austerity measures, such as the EU and the UK, have suffered prolonged periods of weak economic growth, reduced tax revenues, and liquidity traps over the last ten years. The consensus on economic policy to deal with depressed economies needs to change. But while the lobbying powers of financial institutions and their overwhelming influence on governments and legislation remain, policies of austerity will be the preferred tool of dealing with depressed economies.