The Stimulus/Austerity Debate

Why the battle is joined over tightening

By Martin Wolf
Published: July 18 2010 19:13 | Last updated: July 18 2010 19:13

To tighten or not to tighten – that is the question. It is one to which policymakers have started changing their answers. Are they right to do so? That is the issue addressed in the Financial Times this week, echoing the fierce debates of the 1930s. If arguments for tightening are correct, failure to do so would bring fiscal and financial shocks in some of the world’s most important countries. If arguments for tightening are false, decisions to do so threaten recovery and might trigger further financial shocks.

Where are the policymakers? The declaration after the Toronto summit of the Group of 20 leading nations, stated: “There is a risk that synchronized fiscal adjustment across several major economies could adversely impact the recovery. There is also a risk that the failure to implement consolidation where necessary would undermine confidence and hamper growth. Reflecting this balance, advanced economies have committed to fiscal plans that will at least halve deficits by 2013 and stabilize or reduce government debt-to-gross domestic product ratios by 2016.”

This language is notably more cautious than that of the Pittsburgh summit of September 2009. That stated boldly: “We pledge today to sustain our strong policy response until a durable recovery is secured. We will act to ensure that when growth returns, jobs do too. We will avoid any premature withdrawal of stimulus. At the same time, we will prepare our exit strategies and, when the time is right, withdraw our extraordinary policy support in a co-operative and co-ordinated way, maintaining our commitment to fiscal responsibility.”

So what has changed?

The first answer is that the world economy is recovering more strongly than expected. In April 2009, at the time of the London G20 summit, the consensus of forecasts for global economic growth this year was 1.9 per cent. By last September it had reached 2.6 per cent. By June 2010, it was 3.5 per cent. In the US, the consensus forecasts for 2010 were 1.8 per cent in April 2009, 2.4 per cent last September and 3.3 per cent in June 2010. Even for the eurozone, the consensus of forecasts has moved a little, from 0.3 per cent in April 2009, to 1 per cent last September and 1.1 per cent in June 2010.
The great austerity debate: Over this week some of the world’s leading policymakers and economists will be addressing in the FT the all-consuming contemporary economic debate: austerity versus stimulus. Will cutting now risk suffocating the fragile recovery of the global economy? Martin Wolf, Lawrence Summers, Niall Ferguson and others give their views.

The second answer lies with the fiscal crises in Greece and other peripheral members of the eurozone, reinforced by the election of the coalition government in the UK. The flight from risk was dramatic: in May, the yield on Greek 10-year bonds peaked at more than 12 per cent. This led to a rescue package by the International Monetary Fund and other eurozone governments, and the creation of a new €750bn joint IMF and eurozone stabilisation facility.

The extent of the tightening must also not be exaggerated. In its May Economic Outlook, the Organisation for Economic Co-operation and Development forecast a decline in cyclically adjusted fiscal deficits for the grouping as a whole from 6.4 per cent in 2010 to 5.8 per cent in 2011. Corresponding figures were 9 per cent and 7.9 per cent for the US, and 4.1 per cent and 3.6 per cent for the eurozone. But further tightening is now planned, particularly in the UK. Moreover, many think planned fiscal tightening does not go far enough.

What, then, are the arguments?

At the anti-deficit extreme are those who argue fiscal deficits have no impact on activity since they lead to offsetting behaviour by private people. Thus, if governments run deficits, private people save, since they understand that their taxes will ultimately rise. Another, very different, extreme position comes from those who believe a deep slump would purge past excesses, and so lead to healthier economies and societies. While people who think in these radical ways influence the broader politics, they have limited direct influence on policymakers. So what is the latter debate about?

The “cutters” argue that such huge fiscal deficits – never seen in peacetime in big developed countries, notably the US – threaten long-term fiscal credibility and depress private confidence and spending. While piling fiscal stimulus on top of the built-in stabilisers made sense in the panic of 2008 and early 2009, the time has come for swift consolidation. Otherwise, a spike in borrowing costs looms, with dire results. The permanent loss of output and revenue left behind by the crisis, along with ageing populations, make action inescapable and urgent.

Finally, should economies weaken after a fiscal tightening, monetary loosening would be highly effective. The latter can work by encouraging investment and weakening...
exchange rates, so also encouraging exports. Many cutters also argue that the best response would be to reduce spending. That is the lesson, they say, from past fiscal retrenchment.

The “postponers” agree there must be decisive slowing of the growth of long-term spending. But they emphasise the fragility of recovery and, in particular, the huge private sector financial surpluses. This private frugality has caused the fiscal deficits, they insist, not the other way round. The sequence of events makes that evident.

Moreover, add postponers, we have seen a strong flight to safety: for the panickers, there is no alternative to bonds of highly rated governments, particularly the US, issuer of the world’s safe-haven currency. Since the eurozone crisis, that role has become more entrenched. Moreover, the long-term interest rates of leading countries are falling, not rising: in the US, 10-year Treasury bond rates are 3 per cent. Where, then, is the threat to confidence?

Moreover, postponers would add, with interest rates close to zero, monetary policy is ineffective, except to the extent that it supports fiscal loosening. Fortunately, countries with their own central banks can finance fiscal deficits directly. This is untrue for members of the eurozone, which are, in effect, operating with a foreign currency. So long as excess capacity remains so large and normal bank lending so weak, such reliance on the central bank “printing press” creates no inflationary danger. On the contrary, the danger is rather that premature fiscal tightening would trigger a sharp economic slowdown, as in Japan in the 1990s, so pitching important economies into deflation.

The interaction of high indebtedness with deflation could, they argue, create a downward spiral. A Japanese-style “lost decade” threatens the developed world. That is particularly likely if everybody tightens together. If anything, further loosening is needed: in the first quarter of 2010, the GDP of every member of the Group of Seven leading countries was still below its pre-crisis peak.

Readers must make up their own minds on the merits of the arguments this week. My own strong sympathies are with the postponers. But on one thing everybody agrees: this debate matters. We cannot be sure who is right. But we can be sure that, if policymakers get it wrong, the results may well be dire. Physicians must prepare to respond swiftly to adverse reactions to their favoured course of treatment.
America’s sensible stance on recovery

By Lawrence Summers
Published: July 18 2010 19:53 | Last updated: July 18 2010 19:53

Economic commentators are mired in an unhelpful dialectic between “jobs” and “deficits” that, despite its apparent simplicity, has obscured rather than clarified the policy choices ahead in the US, Europe and elsewhere.

Critics have complained that the continued commitment by the administration of President Barack Obama to support recovery in the short term and also to reduce deficits in the medium and long term constitutes a “mixed message”. In fact, it is the only sensible course in an economy facing the twin challenges of an immediate shortage of demand and a fiscal path in need of correction to become sustainable.

The austerity debate

Most economists across a broad spectrum would likely agree to three basic propositions about fiscal policy.

First, in normal times, the scale of government budget deficits affects the composition but not the level of output. Increased deficits under these conditions will raise either public spending or private consumption. But because interest rates adjust upward to balance supply and demand at full employment or at the central bank’s desired level of output, any increases in these sources of demand will be offset by reduced investment and net exports. As a consequence, budget deficits will not stimulate output or employment.

A range of other considerations – including the crowding out of investment; reliance on foreign creditors; misallocation of resources into inefficient public projects; and reduced confidence in long-run profitability of investments – all make a case in normal times for fiscal prudence and reduced budget deficits.

And there are numerous examples, notably the US in the 1990s, where reducing budget deficits contributed to enhanced economic performance.

Second, where an economy’s level of output is constrained by demand and the central bank has at best a limited ability to relax that constraint because it cannot reduce interest rates to below zero, fiscal policy can have a significant impact on output and employment. Through either direct spending or tax cuts that promote private spending, hiring or investment, governments possess a range of tools to raise demand directly. As
increased demand boosts incomes, these measures raise output further. The result will be economic growth and reduced joblessness.

To the extent that expansionary fiscal policies affect growth, their impact on future indebtedness is attenuated as tax collections rise, transfer payments fall, and the ability of the economy to support debt increases.

Third, and finally, there is a very strong presumption that there are likely to be beneficial effects from the expectation that budget deficits will be reduced after an economy has recovered and is no longer demand-constrained. Not least of these are increased confidence and reduced capital costs that encourage investment, even before the deficit is reduced. Such impacts are likely to be particularly important when prospective deficits are large and raise substantial questions about sustainability or even creditworthiness.

In most of the industrialised world, given that economies are in or near liquidity trap conditions, it is the last two propositions that should control policy. Together they make a case for fiscal actions that maintain or increase demand in the short run while reassuring markets on sustainability over the medium term.

Mr Obama is building on the Recovery Act – passed early last year and now in its most intense phase of public investment – by fighting to extend unemployment and health benefits to those out of work, and to help struggling state and local governments prevent cutbacks in vital services and avoid job losses for teachers, police officers and firefighters. At the same time, he is pushing for additional measures to help create and protect jobs, and strengthen businesses. He has called on Congress to expand the clean energy manufacturing tax credit, to help small businesses through tax cuts and a lending fund, and to pass his proposal to create jobs while upgrading energy efficiency in homes.

While the first step in any sound fiscal strategy must be to do everything we can to promote recovery, Mr Obama has also made it a priority to take tough steps to bring down the deficit to sustainable levels as recovery is achieved.

Fiscal responsibility is not only about our children and grandchildren. Excessive budget deficits, left unattended, risk weakening our markets and sapping our economic vitality. They raise the question – as when Washington put off hard choices during much of the previous decade – of how long the world’s greatest borrower can remain its greatest power.
During the next five years, the US is expected to experience the fastest deficit reduction since the second world war. Much of that will stem from the return to growth and the phasing out of Recovery Act programmes.

But Mr Obama has made other commitments that further reduce the deficit by more than $1,000bn. They include a three-year freeze on discretionary spending outside national security and allowing the 2001-03 tax cuts to expire for the very richest. He has also put in place a framework that offers the potential to contain health costs, and convened a bipartisan commission that will make recommendations to cover the costs of all federal programmes by 2015 and improve the long-run fiscal outlook.

The combination of measures that prevent sharp declines in demand in the short run, and measures that add to confidence by controlling the factors that drive deficits, offers the best prospect for moving the economy forward in the next few years. Of course, US growth can come only in a global context. That is why Mr Obama welcomed the Group of 20 leading nations’ emphasis last month on the importance of global actions to ensure that sound fiscal policies are in place and also that economic recovery has sufficient momentum.

We will see clearly in the years ahead that pushing growth and reducing deficits are complementary, not competing, objectives. Reducing the spectre of prospective deficits will enhance near-term growth. And ensuring adequate growth in the near term will reduce long-term deficits.

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It is far too soon to end expansion

By Brad DeLong
Published: July 19 2010 22:21 | Last updated: July 19 2010 22:21

It was in 1829 that John Stuart Mill made the key intellectual leap in figuring out how to fight what he called “general gluts”: he saw that what had happened was an enormous excess demand for particular financial assets was driving an enormous excess supply of goods and services – and if you relieved the excess demand in finance you would cure the excess supply of labour. When the government relieves an excess demand for liquid money by printing up cash and swapping it out for government bonds, we call that expansionary monetary policy. When the government relieves an excess demand for bonds by printing up more Treasuries and selling them to finance its own purchases of goods and services, we call that expansionary fiscal policy. And when it prints up cash and bonds and swaps them for risky private financial assets, or when it guarantees private assets and so raises the supply of high-quality and reduces the supply of low-quality bonds, we call that banking policy.

But what happens should a government print more bonds than investors think it will dare to raise future taxes to pay off? What happens when a government’s debts are no longer regarded as safe? Then policies of monetary or fiscal expansion or of banking sector asset swaps and guarantees do not boost but reduce the supply of safe assets: they move government paper into the “risky” category. We saw this in Austria in 1931 and east Asia in 1997-98 and Greece right now. Then not expansion but rather austerity, to restore confidence in the safety of government liabilities, is the best a government can do – that and cry for help from outside.

Here we have the crux: Greece, Ireland, Spain, Portugal and Italy need to be austere. But Germany, Britain, America and Japan do not. With their debts valued by the market at heights I had never thought to see in my lifetime, the best thing they can do to relieve the global depression is to engage in co-ordinated global expansion. Expansionary fiscal, monetary and banking policy, are all called for on a titanic scale. But, the members of the pain caucus say, how will we know when we have reached the limits of expansion? How will we know when we need to stop because the next hundred billion tranche of debt will permanently and irreversibly crack market confidence in dollar or sterling or Deutschmark or yen assets? Will this shrink rather than increase the supply of high-quality financial assets the world market today so wants, and send us spiralling down? Economists had asserted before 1829 that what we call “depressions” were impossible because excess supply of one commodity could be matched by excess demand for another: that if there were unemployed cobbler then there were desperate consumers looking for more seamstresses, and thus that the economy’s problems were never of a shortage of demand but of structural adjustment. But once Mill had pointed out that these economists had forgotten about the financial sector, the way forward was clear – if you could cure the excess demand in the financial sector. Monetarist dogma says the key excess demand in that sector is always for money – and so you can always cure depression by bringing the money supply up. The doctrine of the British
economist Sir John Hicks says the key financial excess demand is for bonds, and you can cure the depression by either getting the government to borrow and spend or by raising business confidence so the private sector issues more bonds.

Followers of the US economist Hyman Minsky say the monetarists and the Hicksians (usually called Keynesians, much to the distress of many who actually knew Keynes) are sometimes right but definitely wrong when the chips are as down as they are now. Then the key financial excess demand is for high-quality assets: safe financial places in which you can park your wealth and still be confident it will be there when you return. After a panic, Minsky argued, boosting the money stock would fail. Cash is a high-quality asset, true, but even big proportional boosts to the economy’s cash supply are small potatoes in the total stock of assets and would not do much to satisfy the key financial excess demand. Trying to boost investment would not work either, for there was no excess demand for the risky claims to future wealth that are private bonds. The right cure, his followers argued, was the government as “lender of last resort”: increase the supply of safe assets that the private sector can hold by every means possible: printing cash, creating reserve deposits, printing up high-quality government bonds and then swapping them out into the private market in return for risky assets.

We don’t need one of expansionary monetary and fiscal and banking policy, we need all of them – until further government action begins to crack the status of the US Treasury bond as a safe asset, and further government bond issues reduce the supply of safe high-quality assets in the world economy. Has that day come? No. The US dollar is the world’s reserve currency, the US Treasury bond is the world’s reserve asset. The US has exorbitant privileges that give it freedom of action that others such as Argentina and Greece do not have. Will that day come soon? Probably not.

But trust me, we will know when the time comes to stop expansion. Financial markets will tell us. And not by whispering in a still, small voice.

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Today’s Keynesians have learnt nothing

By Niall Ferguson

Published: July 19 2010 13:52 | Last updated: July 19 2010 13:52

To those of us who first encountered the dismal science of economics in the late 1970s and early 1980s, the current debate on fiscal policy in the western world has been – no other word will do – depressing.

It was said of the Bourbons that they forgot nothing and learned nothing. The same could easily be said of some of today’s latter-day Keynesians. They cannot and never will forget the policy errors made in the US in the 1930s. But they appear to have learned nothing from all that has happened in economic theory since the publication of their bible, John Maynard Keynes’s *The General Theory of Employment, Interest and Money*, in 1936.

In its caricature form, the debate goes like this: The Keynesians, haunted by the spectre of Herbert Hoover, warn that the US in still teetering on the brink of another Depression. Nothing is more likely to bring this about, they argue, than a premature tightening of fiscal policy. This was the mistake Franklin Roosevelt made after the 1936 election. Instead, we need further fiscal stimulus.

The anti-Keynesians retort that US fiscal policy is already on an unsustainable path. With the deficit already running at above 10 per cent of gross domestic product, the Congressional Budget Office has warned that, under its Alternative Fiscal Scenario – the more likely of the two scenarios it publishes – the federal debt in public hands is set to rise from 62 per cent of GDP this year to above 90 per cent by 2021. In an influential paper published earlier this year, Carmen Reinhart and Kenneth Rogoff warned that debt burdens of more than 90 per cent of GDP tend to result in lower growth and higher inflation.

The Keynesians retort by pointing at 10-year bond yields of around 3 per cent: not much sign of inflation fears there! The anti-Keynesians point out that bond market sell-offs are seldom gradual. All it takes is one piece of bad news – a credit rating downgrade, for example – to trigger a sell-off. And it is not just inflation that bond investors fear. Foreign holders of US debt – and they account for 47 per cent of the federal debt in public hands – worry about some kind of future default.
The Keynesians say the bond vigilantes are mythical creatures. The anti-Keynesians (notably Harvard economics professor Robert Barro) say the real myth is the Keynesian multiplier, which is supposed to convert a fiscal stimulus into a significantly larger boost to aggregate demand. On the contrary, supersized deficits are denting business confidence, not least by implying higher future taxes.

And so the argument goes round and around, to the great delight of the financial media as the dog days of summer set in.

In some ways, of course, this is not an argument about economics at all. It is an argument about history.

When Franklin Roosevelt became president in 1933, the deficit was already running at 4.7 per cent of GDP. It rose to a peak of 5.6 per cent in 1934. The federal debt burden rose only slightly – from 40 to 45 per cent of GDP – prior to the outbreak of the second world war. It was the war that saw the US (and all the other combatants) embark on fiscal expansions of the sort we have seen since 2007. So what we are witnessing today has less to do with the 1930s than with the 1940s: it is world war finance without the war.

But the differences are immense. First, the US financed its huge wartime deficits from domestic savings, via the sale of war bonds. Second, wartime economies were essentially closed, so there was no leakage of fiscal stimulus. Third, war economies worked at maximum capacity; all kinds of controls had to be imposed on the private sector to prevent inflation.

Today’s war-like deficits are being run at a time when the US is heavily reliant on foreign lenders, not least its rising strategic rival China (which holds 11 per cent of US Treasuries in public hands); at a time when economies are open, so American stimulus can end up benefiting Chinese exporters; and at a time when there is much under-utilised capacity, so that deflation is a bigger threat than inflation.

Are there precedents for such a combination? Certainly. Long before Keynes was even born, weak governments in countries from Argentina to Venezuela used to experiment with large peace-time deficits to see if there were ways of avoiding hard choices. The experiments invariably ended in one of two ways. Either the foreign lenders got fleeced through default, or the domestic lenders got fleeced through inflation. When economies were growing sluggishly, that could be slow in coming. But there invariably came a point when money creation by the central bank triggered an upsurge in inflationary expectations.
In 1981 the US economist Thomas Sargent wrote a seminal paper on “The Ends of Four Big Inflations”. It was in many ways the epitaph for the Keynesian era. Western governments (not least the British) had discovered the hard way that deficits could not save them. With double-digit inflation and rising unemployment, drastic remedies were called for. Looking back to central Europe in the 1920s – another era of war-induced debt explosions – Professor Sargent demonstrated that only a quite decisive policy “regime-change” would bring stabilisation, because only that would suffice to alter inflationary expectations.

Those economists, like New York Times columnist Paul Krugman, who liken confidence to an imaginary “fairy” have failed to learn from decades of economic research on expectations. They also seem not to have noticed that the big academic winners of this crisis have been the proponents of behavioural finance, in which the ups and downs of human psychology are the key.

The evidence is very clear from surveys on both sides of the Atlantic. People are nervous of world war-sized deficits when there isn’t a war to justify them. According to a recent poll published in the FT, 45 per cent of Americans “think it likely that their government will be unable to meet its financial commitments within 10 years”. Surveys of business and consumer confidence paint a similar picture of mounting anxiety.

The remedy for such fears must be the kind of policy regime-change Prof Sargent identified 30 years ago, and which the Thatcher and Reagan governments successfully implemented. Then, as today, the choice was not between stimulus and austerity. It was between policies that boost private-sector confidence and those that kill it.

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Stimulate no more – it is now time for all to tighten

By Jean-Claude Trichet
Published: July 22 2010 20:47 | Last updated: July 22 2010 20:47

The acute fiscal challenges across all industrial economies are no surprise. Our economies are emerging from the worst economic crisis since the second world war, and without the swift and appropriate action of central banks and a very significant contribution from fiscal policies, we would have experienced a major depression. But now is the time to restore fiscal sustainability. The fiscal deterioration we are experiencing is unprecedented in magnitude and geographical scope. By the end of this year, government debt in the euro area will have grown by more than 20 percentage points over a period of only four years, from 2007-2011. The equivalent figures for the US and Japan are between 35 and 45 percentage points.

The growth of public debt has been driven by three phenomena: a dramatic diminishing of tax receipts due to the recession; an increase in spending, including a pro-active stimulus to combat the recession; and additional measures to prevent the collapse of the financial sector. Because we avoided the catastrophic scenario of a financial meltdown, the third element does not represent a very significant volume of spending for most countries. But calculations by the European Central Bank show the volume of taxpayer risks earmarked to support the financial sphere, including all options – recapitalisation, guarantees, toxic assets etc – was as high as 27 per cent of gross domestic product. It is, remarkably, the same gigantic proportion on both sides of the Atlantic.

Taking account of these facts, there is a strong unity of purpose among the world’s policymakers to address our fiscal fragilities. It is reassuring that the consensus on the need for credible fiscal exit strategies, along with profound financial sector reform, is very broad. But the timing remains disputed. In the waiting camp, some argue that it would be desirable to maintain or even increase the fiscal stimulus to avoid jeopardising the economic recovery. Others claim that fiscal consolidation will have a negative systemic impact on the global economy by damping the growth environment. I disagree with both these views. We have to avoid an asymmetry between bold, if justified, loosening and unduly hesitant retrenchment. There are three main reasons for starting well-designed fiscal consolidation strategies in the industrial countries now, precisely to consolidate the present recovery.

First, we have the experiences of fiscal consolidation episodes in less exceptional times, which make clear the long-term benefits of reducing sizeable fiscal imbalances. These experiences also suggest that, provided consolidation is pursued as part of a comprehensive reform strategy, the short-term costs for economic growth tend to be contained or very limited. The success of a fiscal consolidation strategy strongly depends on its design. Adjustment on the spending side, accompanied by structural reforms to promote long-term growth, has typically been the best strategy, especially when combined with a credible long-term commitment to fiscal consolidation.
Second, given the magnitude of annual budget deficits and the ballooning of outstanding public debt, the standard linear economic models used to project the impact of fiscal restraint or fiscal stimuli may no longer be reliable. In extraordinary times, the economy may be close to non-linear phenomena such as a rapid deterioration of confidence among broad constituencies of households, enterprises, savers and investors. My understanding is that an overwhelming majority of industrial countries are now in those uncharted waters, where confidence is potentially at stake. Consolidation is a must in such circumstances.

Third, systemic economic stability – and therefore sustainable growth – relies on the ultimate capacity of public finances to intervene in difficult circumstances. Fiscal buffers are essential when our economies are in a typical business cycle. They are even more necessary when our economies are coping with exceptional circumstances. Had our public finances not been credible when that 27 per cent of GDP of taxpayer risk was mobilised, we would not have avoided a financial meltdown and a second Great Depression. We are doing all that is possible to avoid a future economic catastrophe resulting from the extreme malfunctioning of the financial sector. And I am convinced that we will succeed. But even with the best G20 financial reform there may be many different triggers for economic and financial dislocation. Other unexpected events, including natural catastrophes, may need emergency fiscal support. Sound public finances are a decisive component of economic stability and sustainable global growth.

With hindsight, we see how unfortunate was the oversimplified message of fiscal stimulus given to all industrial economies under the motto: “stimulate”, “activate”, “spend”! A large number fortunately had room for manoeuvre; others had little room; and some had no room at all and should have already started to consolidate. Specific strategies should always be tailored to individual economies. But there is little doubt that the need to implement a credible medium-term fiscal consolidation strategy is valid for all countries now.

In the extraordinary circumstances we have experienced since 2007, central banks across the Atlantic, the Channel, the Pacific and all over the world have demonstrated a remarkable capacity to analyse unprecedented situations and take appropriate decisions. They have designed their monetary policy stance to preserve the credibility of price stability in the face of both inflationary and deflationary risks. They have implemented transitional non-standard measures aimed at improving the functioning of certain segments of financial markets that are essential for the transmission of monetary policy. And they have engaged in unprecedented international co-operation. The ECB, which acted at the very start of the financial turmoil on August 9 2007, will contribute to consolidate a confident economic environment by ensuring price stability in the euro area as we have done for more than a decade. We expect governments to confirm their determination to consolidate their public finances. That commitment is as important today for the G20 paradigm of “strong, sustainable and balanced” growth as yesterday were their exceptionally bold decisions to avoid a depression.

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Critics of the European countries’ decisions to front-load their deficit reductions miss the importance of seizing the current moment of crisis to take politically difficult budget actions.

If the timing of the fiscal consolidation were just a technical economic problem, the right policy would be to enact a multi-year budget that starts with little or no deficit reduction for the first two years, followed by a rapid return to budget balance. The slow start would be particularly appropriate in those countries where aggregate demand is now very weak.

But such a gradual adjustment strategy cannot work politically in countries where voters are sceptical about government promises of future deficit reductions. Immediate action is necessary to make future deficit cuts credible. And painful cuts in government pensions and in public payrolls as well as increases in personal taxes may only be possible while there is a sense of crisis throughout Europe.

Unfortunately, the front-loaded deficit reductions may push economically weak countries into recession for the next year or two. That is the cost of achieving the needed long-term deficit reduction in the current economic and political environment. The countries are nevertheless right to accept that bitter medicine in order to get on the right longer term path.

However, government officials are not warning the public that this is the choice that they have made. Instead they are claiming that the front-loaded fiscal deficit reductions will not weaken the economy in the short run. They argue that the increased confidence that will result from the prospect of lower deficits will lead to enough increased spending by consumers and businesses to actually raise the short-term pace of economic activity.

I think that is unlikely to occur. Although the increased confidence may eventually lead to increased spending, it will not be strong enough in the short run to outweigh the immediate contractionary effects of reduced government spending and higher taxes. It is even possible that the resulting economic slowdown will cause the cyclical
component of the budget deficits to rise temporarily, offsetting part or all of the legislated reductions in the structural part of the fiscal deficits.

Although a country like Germany may avoid the downturn because the recent fall in the value of the euro will boost its exports to the rest of the world, other eurozone countries that trade mainly within the eurozone will not see a boost in exports from the lower value of the euro. The result will be double dip downturns that raise unemployment.

How will voters react in 2011 and 2012 if they see an economic downturn and relatively little deficit reduction after being promised that the cuts in government programs and increases in taxes would have immediate favourable effects? There is a danger that they will pressure governments to cut back on the future fiscal consolidation. It would be better for European officials to warn voters that fiscal consolidation will bring with it the risk of a temporary decline in economic activity and a rise in unemployment.

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