

DEFICIT REDUCTION, THE AGE OF AUSTERITY AND THE “PARADOX OF INSOLVENCY”

Yiannis Kitromilides
University of Westminster

During the recent general election campaign in the UK, the conservative party argued that if the election failed to produce a decisive outcome in the form of a government with an overall majority and with a credible plan for deficit reduction, this could have dire consequences for the economy and the country. The fate of Greece was -and still is- offered as a stark warning to what could happen to a heavily indebted country when the markets lose confidence in its ability to repay its debts. Indeed, after the election, the need for a stable coalition government, with an overall majority, capable of producing a credible programme of deficit reduction was one of the main justifications given as to why a coalition between conservative and liberal democratic parties, as opposed to the more fragile coalition between Labour and the Liberal Democrats, was in the national interests.

According to the new coalition government in the UK, deficit reduction is the top policy priority. The official document setting out the coalition agreement between the conservative and liberal democratic parties attempts to address directly the two central questions concerning the issue of deficit reduction: First, what is the relationship between deficit reduction and the continuation of the economic recovery? Second, what constitutes a “credible” deficit reduction plan? With regard to the first question the agreement states that “deficit reduction and continuing to ensure economic recovery is the most urgent issue facing Britain”. With regard to the second question the coalition partners agreed that “the credibility of a plan on deficit reduction depends on its long-term deliverability, not the depth of immediate cuts”. Since these statements can be subject to alternative interpretations it appeared initially that there was scope for compromise in formulating the actual deficit reduction plan.

The paramount objective of reducing the deficit **and** ensuring the continuation of the recovery can mean different things. It could be interpreted that deficit reduction is a *precondition* for the continuation of the

recovery (which was the conservative argument before the election): Not implementing immediate and additional cuts to reduce the deficit might “upset” the markets to such an extent that a “Greek-style tragedy” in Britain would follow, which will certainly put an end to the recovery. Alternatively, it can be interpreted that immediate deficit reduction and continuation of the recovery are *conflicting* objectives, requiring some kind of trade-off. (which was the labour and liberal democratic position before the election): Deficit reduction that is “too much, too soon” might also abort the recovery and cause a double-dip recession. In either case an aborted recovery and a double-dip recession does not help at all the cause of rapid deficit reduction.

The dangers to economic recovery of cutting “too much, too soon” are real, especially if all indebted countries adopt the same deflationary measures simultaneously. The dangers of not implementing immediate and additional cuts are only real if the inevitability of adverse market reaction is assumed. The case for deep and immediate cuts is, therefore, based on the need to appease the markets. It is, indeed, the financial markets, particularly the bond markets and the credit-rating agencies, who need convincing and who will ultimately determine whether the deficit reduction plan of a democratically elected government is credible or not. Leaving on one side issues of democratic accountability and national sovereignty what the markets demand is quite simply security. Borrowers need to reassure lenders that they will be able to repay their debts. What is the best way of providing this reassurance?

Despite what is stated in the coalition agreement, that the credibility of a deficit reduction plan does not necessarily depend on the “depth of immediate cuts”, it is now abundantly clear that the coalition government is fully committed to a programme of accelerated deficit reduction beginning with immediate cuts of six billion pounds. The Liberal Democratic party's position on deficit reduction has changed radically since the election. They now seem to have been converted to the view that the credibility of the deficit reduction plan *does* depend on the implementation of unpalatable immediate cuts and that without these cuts the country will face a Greek-style economic disaster presumably from a similar adverse reaction of the financial markets. In fact Mr David Laws, the Liberal Democrat Chief Secretary to the Treasury, in his first newspaper interview in the *Financial Times* (May 22/23. 2010) has gone as far as to warn the nation to prepare for an “age of austerity” and to accept the “unpalatable” in order to avoid the

“disastrous”.

Will the public at large be converted as easily and quickly as the Liberal Democrats to the view that the choice facing the country lies between the “unpalatable and the disastrous”? Most citizens are, of course, alarmed and concerned when told that their country has gigantic debts that need urgent refinancing and that unless a credible plan for deficit reduction is put in place the country might face bankruptcy. Their anxiety would to a large extent be based on a comparison between the experience of individual indebtedness and national indebtedness. Such comparison is of course natural and in many respects valid. The problems and challenges faced by an individual with massive debts are the same as those faced by a country. The debts must be repaid. The experience of repaying the debts can be painful and unpalatable. Loss of credibility can lead to insolvency and possible bankruptcy. The *solution* to the problem, however, is not the same in the two cases.

It was of course Keynes who warned us about the pitfalls of the logical fallacy of composition in formulating macroeconomic policy: What is true for the part is not necessarily true for the whole. For instance, while it is sensible to counsel an individual household faced with economic difficulties-such as unemployment- to “balance” its budget by cutting down spending and living within its means, it is not a sensible advice when the economy as a whole faces unemployment. In fact the solution to the country's unemployment problem is the opposite to that of an individual household's. What is needed in a recession is not a balanced but an unbalanced public budget. This simple Keynesian message-largely ignored by policymakers in the 1930s- was, thankfully, accepted by the G-20 governments in 2008 who agreed on a coordinated programme of deficit spending and global fiscal expansion. A similar lesson, based on the same basic principle, was learned with regard to global protectionism and the futility of beggar-thy-neighbour policies: One country can protect its domestic industries but not if all countries try to protect their domestic industries at the same time.

However, two years later, in dealing with the problem of public deficit reduction - whether in Greece and other countries of the euro zone or in the UK and the USA- the simple Keynesian warning appears to have been forgotten : It is undoubtedly true that an individual faced with mounting personal debts and pressures from lenders to repay the loans can avoid

bankruptcy by putting in place a personal “austerity” plan of savage and unpleasant cuts and, ideally, a plan of increasing individual income through increased work effort. In principle such a plan, however unpalatable and painful, can eventually achieve its objective of reducing or even eliminating the deficit in due course thus avoiding personal bankruptcy. It is true that the choice facing a single individual attempting to avoid bankruptcy is between the “unpalatable and the disastrous”. The same is not true for the economy as a whole. Enduring the “unpalatable” does not necessarily prevent the “disastrous”. The reason is quite simple. In the case of a single individual, the mere fact of cutting down spending in order to repay debts does not affect an indebted individual's ability to maintain or seek an increase in his or her income thereby facilitating the repayment of the debt. The ability of the economy as a whole, however, to increase its income will be affected by the very act of trying to deal with the problem of public indebtedness through “savage” cuts in public spending. The plan for preventing an individual from becoming bankrupt is by itself, in principle, tenable. The same plan imposed on an indebted economy is in principle untenable *if it is the only plan*.

Policymakers who in dealing with the global financial crisis have embraced the Keynesian concept known in economics textbooks as the “paradox of thrift” (saving may be good for an individual and bad for the economy, especially in a recession) thus helping to prevent a 1930s-style depression must now, in dealing with the problem of public deficit reduction, show the same appreciation of a very similar concept, which may be termed the “paradox of insolvency”: Deficit reduction measures that can achieve deficit reduction in the case of an indebted individual may not necessarily achieve the same result in the case of national indebtedness. A global deflationary spiral is not going to help improve public finances anywhere.

The age of austerity in the UK, therefore, which will come about as a result of the coalition's plan of accelerated deficit reductions, must be avoided not because it is “unpalatable” but simply because it will be ineffective. Deficit reduction cannot be achieved if the fragile recovery is destroyed and the economy is pushed back into recession. Even the financial markets might eventually realize this. Indeed, the markets who have been clamoring for savage austerity in Greece are now waking up to the fact that with projected negative economic growth rates, these plans could not prevent Greek default. Damned if you do and damned if you don't! Let that be a warning to the coalition partners in the Treasury as they prepare the emergency budget and

the age of austerity in order to appease the financial markets.