

History suggests that austerity and growth just do not mix

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Falling interest rates and rising domestic demand may be a route to growth amid austerity

Rising domestic confidence is not the only route to growth amid austerity. Foreign demand is typically more important. From 1987 to 1989 Ireland's fiscal balances improved and debt declined even as growth accelerated. Once again, falling interest rates mattered: long-term rates stood at around 13% when cuts kicked in. But exchange rates mattered more. In the year immediately before Ireland tightened its belt, its currency appreciated by 20% against that of Britain, its largest trading partner. The trend reversed in early 1987 and sterling subsequently rose by 17% against the punt. Irish exports surged by 10% a year from 1987 to 1990, accounting for most of the economy's impressive growth.

Italy's 1990s austerity programme, often cited by European policymakers as proof that a country like Greece can wrestle down its huge debt burden, tells a similar story. From 1991 to 1998 Italy moved its budget to surplus and stabilised its debt, only briefly dipping into recession in 1993. Here, too, a plunging currency proved essential. In September 1992 Italy was forced out of the European Exchange Rate Mechanism, a pre-euro system of semi-pegged currencies. Over the next few years the lira fell by roughly 40% against the D-mark. Italy's [current-account balance](#) swung to surplus and growth leapt. There is a lesson in this for Greece, but not the one [euro-zone](#) leaders wish to impart.

America will struggle to duplicate these successes. The scope for increasing exports is limited by the process of debt reduction in other rich economies. Exports account for a relatively small share of activity in America's economy in any case, leaving less room for a trade-led boom. Its second-largest trading partner, China, manages its currency against the dollar and would resist a dollar depreciation. Whenever investors seek shelter, even from an American slowdown, they choose Treasuries, and thus the dollar. In an economy constrained by low interest rates, a stubborn [trade deficit](#) and natural demand for the world's [reserve currency](#), there is little to cushion the blow of austerity.

Spending down, Fed up

A last lifeline for the president is the hope of support from the Federal Reserve. Central banks can partially offset the negative effect of budget cuts with looser monetary policy. The IMF economists find that spending cuts are more expansionary than tax increases precisely because central banks are more willing to compensate for the former. A Fed that is less concerned about [public](#)

[debt](#) may more be prepared to act. But with interest rates near zero, the Fed's choices are limited to unconventional policy options, where the threshold for action seems to be higher. External factors, like high commodity prices, may also tie the Fed's hands. The ECB is already tightening policy because of the effect of high commodity prices on [euro-zone](#) inflation.

America cannot wait for ever to rein in its debt. It needs to lay out credible plans for medium-term deficit reduction. But it has more leeway to delay cuts than most other countries, thanks to continued demand for its debt. Another year of recovery would help confidence more than a premature swing of the fiscal axe.

[“Identifying the effects of government spending shocks with and without expected reversal: An approach based on U.S. real time data”](#), Jacopo Cimadomo, Sebastian Hauptmeier and Sergio Sola, ECB Working Paper 1361, July 2011

[“Expansionary austerity: New international evidence”](#), Jaime Guajardo, Daniel Leigh and Andrea Pescatori, IMF Working Paper 11/158, July 2011

[“The 'austerity myth': Gain without pain?”](#), Roberto Perotti, June 2011 (presented at [this](#) June BIS conference)