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## Time for a midcourse correction on austerity



By Mark Zandi, April 28, 2013

Economists are normally a collegial bunch, so it is noteworthy when an intellectual food fight breaks out among us. We recently had a very public and important one involving questions about the economy's prospects and policymakers' response to our big budget deficits and government debt load.

The catalyst for the brouhaha was new research that challenged what many had believed to be seminal economic work coming out of the Great Recession: the book *This Time Is Different*, by Harvard economists Carmen Reinhart and Kenneth Rogoff. The book is no romance novel, but it is an engaging historical survey of economic disruptions around the globe going back to the 15th century. For example, the authors recount how King Henry VIII set off economic shock waves in the 16th century by systematically shaving his realm's silver coins to debase their value.

Reinhart and Rogoff conclude that economic downturns are especially hard when they begin with a banking collapse. Such recessions are deeper, and are followed by weaker, more halting recoveries, than those with nonfinancial roots.

Economies hit with finance-rooted slumps can take years, if not decades, to return to precrisis growth rates. A "new normal" often takes hold, leaving the economies permanently weaker. Think of Japan since its financial crisis in the early 1990s.

Reinhart and Rogoff also conclude that governments cannot stand by and watch their banks collapse. National financial systems really are too big to fail, and the public sector must use all its resources to ensure that they don't. Government budget deficits may thus balloon and debt loads rapidly increase.

If all these backstops are insufficient, governments, too, can fail. Think of Europe in recent years: As banks in Greece, Ireland, Spain, and Cyprus failed, they required so much capital that their governments were overwhelmed and needed bailouts themselves.

All this resonates ominously for the United States. The collapse of our financial system led to the Great Recession and a disappointing recovery. The economy has been growing for nearly four years, but too slowly, and unemployment remains painfully high.

Moreover, just as Reinhart and Rogoff predict, the U.S. government bailed out the financial system. The deficit soared to nearly 10 percent of gross domestic product at its peak, and federal debt ballooned to more than 100 percent of GDP. This was especially worrisome in the view of Reinhart and Rogoff, whose data showed that once government debt exceeds 90 percent of GDP, growth slows significantly.

Reinhart and Rogoff warned, about as clearly as economists can, that unless policymakers reduce the U.S. government's debt quickly, the economy is doomed to perpetually subpar growth. Their work provided an intellectual foundation for aggressive fiscal austerity, including the government spending cuts and tax increases we have seen recently.

This is where the new research comes in. Economists from the University of Massachusetts, Amherst, to whom Reinhart and Rogoff showed their data, found that their calculations contained significant flaws. It turned out that the relationship between government debt and economic growth was not as strong as Reinhart and Rogoff had suggested. The 90-percent-of-GDP threshold was not particularly meaningful. Questions were also raised about cause and effect: Does a large debt load produce slower growth, or does slow growth cause debt to rise?

The correct answer here is vital for policymakers trying to revive wobbly economies while addressing fiscal problems. Should they focus first on cutting government spending and raising taxes, or should they aim to jump-start growth - perhaps even by increasing spending and cutting taxes?

Reinhart and Rogoff's arguments were overstated, and the current austerity is overdone. We will need to cut budget deficits and reduce debt in the future, but we don't need to do so quickly. Congress' recent sequestration and other spending cuts and tax increases are now hitting with a vengeance, which means economic growth will be uncomfortably slow in coming months.

The recovery will thus be especially vulnerable to anything else that might go wrong. And it isn't difficult to imagine what that might be: a paralyzing political battle over the U.S. debt ceiling; a revival of the European debt crisis; a spike in oil prices due to tensions with Iran. Such scenarios become especially nerve-racking when you consider that the Federal Reserve is already making unprecedented efforts to support the economy. It's not clear how much more the Fed could do if things turned sharply worse.

That said, the odds are good that our economy will survive and even thrive by this time next year, once the fiscal headwinds fade. If so, Reinhart and Rogoff will have misjudged the lessons of financial history for the U.S. economy.

The United States cannot escape history: It has suffered just as other nations did after past financial crises. But it will make history by recovering from the latest such crisis in record time.

U.S. companies have rapidly improved their cost structures and are extraordinarily competitive. U.S. banks have raised record capital and are lending with increasing gusto. U.S. households have significantly reduced their debts, and net worth, the difference between what households own and what they owe, has never been higher.

This time is different.

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