Austerity Won't Win the War

By Antonio Fatas , INSEAD Professor of Economics

It is surprising that some still hold on to their economic theories even if the facts keep proving them wrong.

Ideology seems to dominate much of the macroeconomic analysis we see these days. But what is more surprising is how broad this phenomenon is and how the general economic commentary that one reads in the press cannot move away from the merits of austerity.

Fears of hyperinflation are compounded by the constant reference to "printing money" in relation to central bank actions to spur growth by increasing the money supply. This is not only incorrect from a factual point of view (most of the increase in the monetary base corresponds to reserves, not to bank notes being printed) but is also misleading when it comes to the understanding of the role of central banks. Even those who support central bank actions during the crisis have to add a sentence at the end to warn us about the danger of so much liquidity.

And austerity, as much as the data has disproven the claim that it would be through reduction in government spending and increased confidence that advanced economies will return to healthy growth rates, it does not seem to lose its appeal either. As an example, here is a **CNBC article** that provides a long list of arguments of why austerity is winning the war. The arguments: the UK is finally growing, Spain's GDP is not falling anymore and even in Greece we now start seeing the possibility of positive growth. And where is this coming from? From the austerity that these wise governments have implemented over the last year. This is, of course, a misleading analysis of the data.

It is still the case that countries where austerity was the strongest have seen the lowest growth rates (and the largest increase in debt). The only reason why these three countries are either returning to growth or not collapsing anymore is that after such a deep crisis, growth must return at some point. Yes, even without any policy actions to support growth, economies recover. But they do so slowly and they will never return to where they should have been. And just to get the facts straight, in these three countries, governments have stopped being a large drag in the economy. When you reduce government spending growth suffers. Once government has stabilised at a low level it does not become a drag on growth.

The last five years have provided an incredible array of macroeconomic experiments for us to learn about the effects of monetary and fiscal policy to stabilise cycles. But it seems that this crisis will be wasted, not so much in terms of implementing reforms but in terms of our ability to use data to improve our understanding of macroeconomics.

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