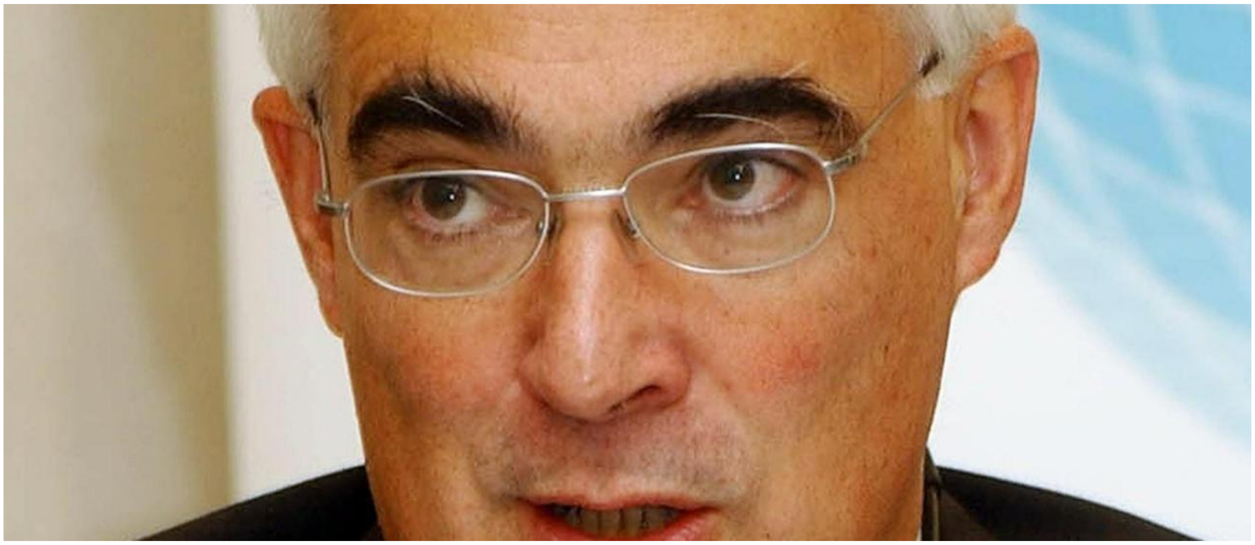
Austerity Hurts. But Does It Work?



By Nigel Roberts

A former British Chancellor of the Exchequer fears we may be confusing pain with gain.

In 2008, former U.K. Chancellor of the Exchequer, **Alistair Darling**, described the state of the economy as “arguably the worst it has been for fifty years.” Of course he made headlines. Then, in a bout of uncharacteristic political honesty, he further deepened the sense of staring into an economic abyss by adding, “I think it is going to be more profound and long lasting than people thought.”

Four years on and Alistair Darling thinks that his predictions were not gloomy enough. “I’m far more pessimistic now than I was in 2008,” he told INSEAD Knowledge in an exclusive interview in London recently. “If you’d asked me then, would the economy be growing four years later, I would have said yes. But it’s not - because the wrong calls are being made.”

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Commentary

The European Central Bank’s announcement that it would continue to intervene indefinitely in currency markets to support the Euro gave the markets a positive boost recently. But was it too little? Too late? And is it sustainable? From the blog of INSEAD Economics Professor Antonio Fatas.

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The ECB is now finally sending a strong message that they will do whatever it takes to defend the Euro. In many ways this is a game changer and it is difficult to understand why this was not done earlier. When we think about monetary or fiscal policy as stabilizing tools we see them as forces that can make recessions shorter and recoveries stronger. Clearly what we have seen in the last years is a slow moving process towards the inevitable solution, the only way this crisis could be resolved. **Read more**.

Now out of the political limelight, the former Labour Party politician reflects on the current state of affairs in the global economy from his office high under the eaves of the House of Commons. He still isn't happy about what he sees.

Darling believes that the action that his Labour government took in October 2008, with its massive bailout of the banking system and quantitative easing, was audacious enough to restore confidence and stimulate economic growth. "It wasn't perfect – but we did do more than people expected, more quickly than people expected," he says. "And it worked. It got us the time that we needed."

Return to Keynes

Not surprisingly Alistair Darling is an advocate of Keynesian pump priming and claims that the bold actions his Labour government took in 2008 succeeded in kick-starting growth by 2010 - just in time for the incoming Conservative-led coalition to reap the benefit. Darling charges that in the last two years his successor at the U.K. Treasury, George Osborne, has squandered that benefit with a single-minded pursuit of deficit reduction. "The problem in this country is we haven't got growth and the Chancellor is having to borrow £150 billion more than he announced when he presented his first budget after the general election. You will not get growth by pursuing a policy that is wholly dependent on squeezing the public sector. Without growth you are not going to get the tax revenues to pay down your borrowing and pay down your debt. It's not rocket science. It's the same arguments we had in the 1930s, it just seems people have forgotten the lessons."

Be bold and decisive

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He believes that present governments in Europe and the U.K. are ignoring the lesson that when you are on the brink of an economic abyss, you should confound expectations and be bold and decisive. “If you’re going to do something to prevent panic and a bad situation getting worse, you’ve got to do far more than markets and people expect and do it sooner. If you look at what happened in the last couple of years especially in Europe, precisely the opposite is being done. Far from learning from 2008, in the Eurozone in particular, every time they meet, they delay taking action. And when they do anything it’s too little and it’s far too late.”

The former U.K. finance chief gives qualified approval to the recent plan by the European Central Bank (ECB) to buy bonds from distressed Eurozone countries such as Spain in unlimited quantities [Ed note: see INSEAD Professor Antonio Fatas’ Blog comment, adjacent]. He believes that in contrast to the Eurozone governments, the ECB is going in the right direction with “outright monetary transactions” or OMTs. “Like so many initiatives in the Eurozone area, it is far from clear whether it will achieve everything that was claimed. Countries can only access this help by submitting themselves to possibly draconian undertakings in relation to their spending. There is, therefore, a disincentive for them to apply. Even if they do apply and get help, then what happens if they default? Does the ECB stop and therefore undermine the very confidence it sought to establish or does it carry on, in which case its credibility is undermined?”

From his view in the non-Eurozone U.K., Darling advocates a three-pronged strategy to kick-start a stagnant continental European economy. “Sort out Greece. Sort out your banks and rethink this austerity package. There are a growing number of voices saying this isn’t working. I wonder sometimes whether in her heart of hearts Chancellor Merkel is beginning to wonder that too.” The notion that Greece could leave the Eurozone is a nonsense for him. “The contagion risk is too great.”

A lost decade of growth?

Though Alistair Darling enthusiastically introduced quantitative easing in 2009 as one means of stabilising the financial system, he is less convinced that subsequent rounds of QE in the U.K. are succeeding in their stated aim of getting money out of bank vaults and onto the High Streets of Britain. But he points out that weak demand also plays a part in the failure of QE to percolate into the wider economy and that is largely down to weak growth.

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“The demand is always going to be suppressed if businesses think the economy isn’t going to recover. Why would you expand production or hire more people if you thought you weren’t going to be able to sell your goods and services. So the two things need to go together.”

“There’s been a lot of talk about a lost decade, but that’s where we’re heading at the moment. Because at best I see [the economy] just bumping along the bottom. Some people think that bumping along the bottom compared with worse things may seem OK. Well it’s not because other parts of the world are moving on.”

It’s never too late to repent

So if Darling’s dire warnings fell on deaf ears four years ago, does that mean that it’s now too late and that continental Europe and the U.K. could be facing a “lost decade” at best or an even steeper decline in growth? “It’s never too late. You can always repent. There needs to be a bit of repenting in a number of policy areas. What’s lacking at the moment is leadership at every level. In 2009 there was a glimmer of hope at the G20 meeting when countries across the world agreed to do the same thing. That’s gone at the moment and that needs to be rediscovered.”

But the longer this goes on, the more we delay the recovery, claims Darling. “And remember when recovery comes, we’re not going back to the world as it was. If you look at the rest of the economy and the new middle class in the emerging economies there is a huge opportunity there for the more established economies. But we’re never going to exploit those things unless we sort out the problems on our doorstep at the moment.”

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