

## No need for a panicked fiscal surge

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As it becomes increasingly evident that the recovery will remain subdued in Europe and the US, there is a growing chorus for indefinitely sustaining aggressive post-crisis fiscal stimulus. Governments that instead propose gradually reducing deficits and ultimately stabilising debt to income levels – such as both Germany and the [UK](#) – are accused of pig-headed fiscal conservatism. Had they only a better grasp of Keynesian truisms, we are told, these countries' leaders would realise that their penury risks throwing already weak economies into double-dip recessions, or even a sustained depression.

There is no question that huge uncertainty hangs over the global economy, but is the case against commonsense fiscal conservatism so compelling? I don't see it. Yes, output growth is likely to remain tepid compared with a normal post-recession recovery. As Carmen Reinhart and I have repeatedly emphasised in our research, anaemic growth with sustained high unemployment is par for the course in post-financial-crisis recoveries. Yes, [Europe's sovereign debt and banking problems](#) are unlikely to disappear soon. But sovereign debt problems are a typical aftershock of any wave of international financial crises. Worrisome as the current conjuncture may seem, the normality of the crisis trajectory to date hardly suggests the need for a panicked fiscal response.

Indeed, it is folly to ignore the long-term risks of already record peace-time debt accumulation. Even where [Greek-style debt crises](#) are unlikely, the burden of debt will ultimately weigh on growth due to inevitable fiscal adjustment. The fact that the markets seem nowhere near forcing adjustment on most advanced economies can hardly be construed as proof that rising debts are riskless. Indeed, the evidence generally suggests that the response of interest rates to debt is highly non-linear. Thus, an apparently benign market environment can darken quite suddenly as a country approaches its debt ceiling. Even the US is likely to face a relatively sudden fiscal adjustment at some point if it does not put its fiscal house in order.

Some portray Japan, with nearly a 200 per cent government debt to income ratio, as a poster child for extremely indebted countries with low interest rates. Japan's "success", of course, has a lot to do with its government's ability to sell debt domestically. How the country will handle its finances as saving by retirees shrinks and as its labour force rapidly shrinks, remains to be seen.

Similarly, the fact that postwar debts in the US and UK have exceeded 100 per cent of gross domestic product – a level that Ms Reinhart and I find to be above the threshold where growth might be affected – is hardly evidence not to worry about peace-time debt explosions. After a war, the natural phase-down in military expenditures combined with a surge of former soldiers into the workplace, makes it far easier to bring down debt-output ratios than after the kind of peace-time build-up

we are now seeing. The risks of rising debt, while apparently far off, cannot be lightly dismissed.

At the same time, the stimulus benefits of massive fiscal deficits are not nearly so certain as proponents of a new surge of spending maintain. The academic evidence on Keynesian growth effects of fiscal deficits is thoroughly inconclusive. Ironically, a lot of the newfound conviction comes from the casual empiricism on the growth effects of the Bush tax cuts, evidence that few academics consider sufficient to outweigh the mass of previous results. Indeed, it will take researchers many years, perhaps decades, to sort out the effects of the massive fiscal stimulus that many countries undertook during the crisis. My guess is that scholars will ultimately decide that fiscal policy was far less important than monetary policy and measures to stabilise the banking system.

Aggressive fiscal stimulus in the run-up to [the financial crisis](#) was reasonable as part of an all-out battle to avoid slipping into a depression. The risk of a second Great Depression was palpable, the huge cost of insurance arguably worth it. Today, the panic has abated, and a more sober cost-benefit analysis is required.

Importantly, governments that emphasise long-term fiscal sustainability are likely to have an easier time inducing their central banks to maintain highly supportive monetary conditions. Knowing that governments are serious about stabilising debt levels makes it easier for most central bankers to rationalise continued crisis measures, as some central bank governors (notably in the UK) have quite candidly stated. Otherwise, of course, they will rightly worry about being gamed into inflationary finance of runaway deficits. If a double-dip recession does threaten, then monetary policy, including aggressive measures to combat deflation, remains by far the most reliable first line of defence.

Unfortunately, much of the world is going to be facing huge macroeconomic uncertainty for years to come. There is uncertainty about regulation, sovereign debt, the state of our banking and healthcare systems as well as about political fallout from the financial crisis. In this environment, measures to gradually stabilise debt burdens – to restore normality – surely make sense. If things turn radically worse for a sustained period, then yes, absolutely, further action will be necessary. But until then, a panicked government fiscal surge is far more likely to destabilise [the nascent recovery](#) than to nurture it.

*The writer is professor of economics at Harvard University and co-author, with Carmen Reinhart, of [This Time is Different: Eight Centuries of Financial Folly](#)*