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Austerity and Debt Realism

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Kenneth Rogoff, Professor of Economics at Harvard University and recipient of the 2011 Deutsche Bank Prize in Financial Economics, was the chief economist at the International Monetary Fund from 2001 to 2003. He is one of the world's premier international economists, with influential publications spanning the fields of global finance, monetary and fiscal policy, and economic development.

CAMBRIDGE – Many, if not all, of the world's most pressing macroeconomic problems relate to the massive overhang of all forms of debt. In Europe, a toxic combination of public, bank, and external debt in the periphery threatens to unhinge the eurozone. Across the Atlantic, a standoff between the Democrats, the Tea Party, and old-school Republicans has produced extraordinary uncertainty about how the United States will close its 8%-of-GDP government deficit over the long term. Japan, meanwhile is running a 10%-of-GDP budget deficit, even as growing cohorts of new retirees turn from buying Japanese bonds to selling them.

Aside from wringing their hands, what should governments be doing? One extreme is the simplistic Keynesian remedy that assumes that government deficits don't matter when the economy is in deep recession; indeed, the bigger the better. At the opposite extreme are the debt-ceiling absolutists who want governments to start balancing their budgets tomorrow (if not yesterday). Both are dangerously facile.

The debt-ceiling absolutists grossly underestimate the massive adjustment costs of a self-imposed "sudden stop" in debt finance. Such costs are precisely why impecunious countries such as Greece face massive social and economic displacement when financial markets lose confidence and capital flows suddenly dry up.

Of course, there is an appealing logic to saying that governments should have to balance their budgets just like the rest of us; unfortunately, it is not so simple. Governments typically have myriad ongoing expenditure commitments related to basic services such as national defense, infrastructure projects, education, and health care, not to mention to retirees. No government can just walk away from these responsibilities overnight.

When US President Ronald Reagan took office on January 20, 1981, he retroactively rescinded all civil-service job offers extended by the government during the two and a half months between his election and the inauguration. The signal that he intended to slow down government spending was a powerful one, but the immediate effect on the budget was negligible. Of course, a government can also close a budget gap by raising taxes, but any sudden shift can significantly magnify the distortions that taxes cause.

If the debt-ceiling absolutists are naïve, so, too, are simplistic Keynesians. They see lingering post-financial-crisis unemployment as a compelling justification for much more aggressive fiscal expansion, even in countries already running massive deficits, such as the US and the United Kingdom. People who disagree with them are said to favor "austerity" at a time when hyper-low interest rates mean that governments can borrow for almost nothing.

But who is being naïve? It is quite right to argue that governments should aim only to balance their budgets over the business cycle, running surpluses during booms and deficits when economic activity is weak. But it is wrong to think that massive accumulation of debt is a free lunch.

In a series of academic papers with Carmen Reinhart – including, most recently, joint work with Vincent Reinhart ("Debt Overhangs: Past and Present") – we find that very high debt levels of 90% of GDP are a long-term secular drag on economic growth that often lasts for two decades or more. The cumulative costs can be stunning. The average high-debt episodes since 1800 last 23 years and are associated with a growth rate more than one percentage point below the rate typical for periods of lower debt levels. That is, after a quarter-century of high debt, income can be 25% lower than it would have been at normal growth rates.

Of course, there is two-way feedback between debt and growth, but normal recessions last only a year and cannot explain a two-decade period of malaise. The drag on growth is more likely to come from the eventual need for the government to raise taxes, as well as from lower investment spending. So, yes, government spending provides a short-term boost, but there is a trade-off with long-run secular decline.

It is sobering to note that almost half of high-debt episodes since 1800 are associated with low or normal real (inflation-adjusted) interest rates. Japan's slow growth and low interest rates over the past two decades are emblematic. Moreover, carrying a huge debt burden runs the risk that global interest rates will rise in the future, even absent a Greek-style meltdown. This is particularly the case today, when, after sustained massive "quantitative easing" by major central banks, many governments have exceptionally short maturity structures for their debt. Thus, they run the risk that a spike in interest rates would feed back relatively quickly into higher borrowing costs.

With many of today's advanced economies near or approaching the 90%-of-GDP level that loosely marks high-debt periods, expanding today's already large deficits is a risky proposition, not the cost-free strategy that simplistic Keynesians advocate. I will focus in the coming months on the related problems of high private debt and external debts, and I will also return to the theme of why this is a time when elevated inflation is not so naïve. Above all, voters and politicians must beware of seductively simple approaches to today's debt problems.

Read more from our "Austerity and its Discontents" Focal Point.

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