FOREIGN AFFAIRS
Published by the Council on Foreign Relations

July 9, 2010
SNAPSHOT

The G-20's Dead Ideas

Why Fiscal Retrenchment is the Wrong Response to the Crisis

Mark Blyth and Neil K. Shenai
MARK BLYTH is Professor of International Political Economy at Brown University. NEIL K. SHEN Candidate at the Johns Hopkins University School of Advanced International Studies.

One of the most well-known lines in John Maynard Keynes' *General Theory* notes how politicians t themselves as reacting to "events" when they are in fact "usually the slaves of some defunct econom G-20 meeting, held last month in Toronto, proves Keynes' wisdom once again -- with a twist. The G ended with a collective endorsement of "growth-friendly fiscal consolidation," which assumes that i states tighten their fiscal belts, states will have to borrow less, pay less interest, and, therefore, will n private-sector growth. Such a strategy may sound sensible, but it relies on the same fallacy of compo brought on the banking crisis -- that by making individual banks safe, you make the system as a who reverse. That is, although it may make sense for any single state (or firm or household) to clean its b all the G-20 states embark on such a course at once, the results could be disastrous. The whole -- Ke insight -- is not equivalent to the sum of its parts. The finance ministers of the G-20 states seem to b retrenching in the middle of a recession, they will somehow improve their states' balance sheets and period of economic growth. Deflation, in other words, is now good for growth. How did we get here

Less than two years ago, the world's financial institutions pleaded for a taxpayer-funded bailout of t financial system, arguing that allowing the largest banks and most globalized firms to fail would lea depression. They got what they wanted: according to the IMF, the 34 states that it classifies as "adva spent approximately 55 percent of their respective GDPs on capital injections, liability guarantees, a purchases of bad assets from the major banks.

Although these dramatic measures may have been distasteful to some, they seem to have worked. T economy avoided a second Great Depression. Between March 2009, when markets began to reboun day, average global asset prices have rebounded and the appetite of institutional investors for econor steadily grown.

But even the most Herculean efforts of finance ministers and central bankers could not prevent the fi contagion from spilling over into the real economy. Credit tightened, investment fell, and unemploy the world. Here, too, policymakers had a response. Nearly every advanced industrialized country in embarked on a policy of Keynesian stimulus to buoy their national economies against prolonged rec deflation. As Robert Skidelsky, the British economic historian, has put it, "the Master" has returned, many of the fiscally conservative tenets of the Washington consensus, which drove IMF and World I economic crises for decades.

There was a cost to this Keynesian victory, however. Government finances suffered, with fiscal defic Europe and North America. As Carmen Reinhart and Kenneth Rogoff recently found, this should nc surprise, since banking crises are almost always followed by sovereign debt crises, or at least prolon fiscal stress and lost output. When the private-sector firms clean up their balance sheets by reducing stockpiling cash, the public sector takes on debt, partly through automatic stabilizers such as unemp and partly through discretionary spending, including fiscal-stimulus projects. Now, with the real eco the taxpayer is saving and reducing debt rather than spending, resulting in increasing deficits and fisca public side of the ledger.

The global financial crisis has thus taken an ironic turn. The same large multinational financial firm: government bailouts are now shocked and surprised by the spending of "profligate" governments. Ir actors are now speculating against the very governments who brought them back to life by shorting consequence, governments across Europe are adopting austerity measures to outflank the positions c speculators.

Academic commentators such as N. Gregory Mankiw [1] and Jeffrey Sachs [2] are championing the both have called for the G-20 to focus on balancing budgets and on "pro-growth" austerity. They po high unemployment and stagnant output as proof of the failure of current policies. Similarly, former Chair Alan Greenspan recently declared that the lack of a rise in the cost of servicing long-term U.S "regrettable," since "it is fostering a sense of complacency that can have dire consequences." But dc persistent unemployment and bloated government finances indeed lie with politicians who fell for K proscriptions? And, more fundamentally, are austerity policies the right course for the G-20 states?

First, in order to say that the global stimulus policy has failed, it is necessary to consider the counter fiscal stimulus at all. There is already a natural experiment of this case: the countries of Eastern Eurc not to inject large amounts of liquidity into their national economies. For example, in May 2009, as and Western European countries were consciously expanding public deficits, Latvian President Vald government on course for "severe budget stabilization measures" and several "structural reforms," n resemble what the G20 is wishing upon itself today. Yet Latvian GDP fell more than 17 percent in th of 2009, while unemployment grew to more than 16 percent, and government finances -- the theoret of all this belt-tightening -- collapsed because of falling tax revenue. These results were replicated fr Romania with even worse results, suggesting that the G-20 member states should perhaps be careful for.

Second, financial markets are social phenomena, which means that economic performance is as muc market participants' beliefs as it is by fundamental indicators or textbook policy. In the parlance of t prices can move on "momentum," whereby disequilibrating price movements compound one other, market prices away from their true worth -- a dynamic that is visible in sovereign debt markets toda

Imagine, for example, a case in which a number of creditors believe that a certain state is likely to b in the next few months. The state's creditors would demand more collateral, or yield, for holding the worsening the cash position of the state. Eventually, the pressure from speculators would cause the s cash, thereby creating the very situation that investors feared -- but from which they would also prof short selling of bonds. Such a scenario feels eerily like 1991, when George Soros famously made $1 by short selling the British pound. And just like in 1991, central banks are following the wrong lesso calling speculators on their positions, European governments appear to have caved to the pressure a over demand management.

It is likely that France, Germany, and the United Kingdom will move to cut their deficits dramaticall lead to a rise in eurozone unemployment, a decrease in the purchase of U.S. exports, and a faltering economic recovery. Falling economic growth in the G-20 states will further lower consumption and unemployment. Meanwhile, the financial sector will see its equity holdings shrink and its balance sh again. Such a scenario makes it quite possible that these same financial institutions will argue that th not big enough and should be tried again -- but now from a more leveraged position. To see a glimps future, look at Japan: seesawing between spending and retrenchment cost Japan 15 years of growth a between 1990 and 2005, when Japan's economic policymakers were swayed by exactly the same so that are ascendant in the G-20 today.

There is no silver bullet to avoid the macroeconomic fallout associated with financial crises. The qu where (and by whom) this pain will be felt. So far, it appears that although the financial sector was l responsible for creating the $2 trillion in losses since the crisis began, it is determined to avoid payi the taxpayers that paid to bail these firms out are now being doubly taxed as government services ar of "growth-friendly fiscal consolidation," in the words of the G-20. What lies ahead, then, is a harm allies U.S. Tea Party activists with Greek public-sector unions.

In sum, both of the following statements are true: countercyclical spending worsens government fina austerity compounds an already miserable unemployment situation. But cutting spending in the mid is no solution -- especially when market participants conflate stimulus spending with bailouts of the Refilling a $2 trillion hole in the global financial architecture does not have the same effect on dema trillion stimulus package spent on brick-and-mortar projects. Such a conflation damns fiscal stimulu ineffectiveness -- even though a large portion of the stimulus is yet to be spent in the United States a almost all of the debt accrued since the crisis comes from tax-revenue losses and bailout costs.

It is a shame that many of the most powerful ideas of dead economists are the most fallacious. The G proved that supply does not create its own demand. The mortgage debacle showed that good and bac co-exist quite happily. Although the idea of "austerity" may have the immediate ring of virtue, in the vice. Keynes was indeed right, but with a twist. It is not the ideas of dead economists we have to wo rather the dead ideas of very much alive ones.

Return to Article: http://www.foreignaffairs.com/articles/66490/mark-blyth-and-neil-k-shenai/the-g-20s-
Home > Snapshot > The G-20's Dead Ideas
Published on *Foreign Affairs* (http://www.foreignaffairs.com)

Links:
[1] http://gregmankiw.blogspot.com/2009/09/how-large-is-fiscal-policy-multliplier.html
[2] http://www.ft.com/cms/s/0/e7909286-726b-11df-9f82-00144feabdc0.html