Consolidation causes little austerity

Ralph S. Musgrave

25. October 2011

Consolidation causes little austerity.

Abstract.

There is a widespread view that reducing national debts and deficits, or “consolidating” them, causes austerity or would hinder the recovery. The reality is that reducing structural debts and deficits and “stimulus debts” is easily done without any significant deflationary effects. In contrast, stimulus deficits cannot be reduced in that they are required to deal with recessions, thought they can perfectly well accumulate as extra monetary base rather than as extra debt.

Money for the above debt and deficit reduction can be obtained from raised taxes and/or public spending cuts, while making good the deflationary effect of the latter with quantitative easing. As long as the deflationary effect of the former equals the stimulatory effect of the latter, there is little net effect on GDP, aggregate employment and so on. Meanwhile debts or deficits are reduced.

Author: R.S.Musgrave, 24 Garden Avenue, Durham, DH1 5EQ, UK. 0191 3865821.

EconLit Subject Descriptors: H61, H62, H63.

There is a widespread view that reducing national debts and deficits, or “consolidating” them, causes austerity or would hinder the recovery. This view often takes the form of claims to the effect that deficits and debts must be reduced, but not before the recovery takes hold. Most readers will probably have seen innumerable examples of this sort of claim. But for the benefit those who have not, a few examples are: OECD (2010), Rivlin (2010:3), Harding (2011) or Ostry (2010A&B).

Some readers may be puzzled by the fact that three out of the above five works come from two reputable international organisations: the IMF and OECD. However this paper is nowhere near the first to suggest that these two organisations have a less than full grasp of debts and deficits, to put it politely. Prof. William Mitchell, for example, has been a constant critic of these two organisations (e.g. Mitchell (2011)).

The conventional “consolidation causes austerity” argument is usually to the effect that taxes must be collected (and/or public spending cut) in order to obtain the money with which to repay debts or reduce deficits. And tax increases or public spending cuts are deflationary, therefor, so the argument goes, consolidation is deflationary. The purpose of this paper is to show that the latter argument is badly flawed: that is, consolidation and a country’s stance on the “stimulus – deflation” scale are essentially independent of each other.

Various simplifying assumptions are made below, as follows.

1. The argument below is concerned only with countries which issue their own currencies. That is, while the arguments apply to the Eurozone as a whole, individual countries that are part of a common currency system, like the Eurozone, are not considered here.

2. Governments and central banks are considered as a single unit below, and are referred to simply as “government”.

3. The argument starts with the “closed economy” assumption. Open economies, that is economies which trade with the rest of the world, are considered towards the end.

Structural and stimulus debt.

A distinction is made below between debt arising for structural reasons and for stimulus reasons. Structural debt is taken here to mean debt which arises purely through failure to collect enough tax to fund government spending: there being no intention to impart stimulus. In practice this usage of the word “structural” amounts to the same as the definition given, for example, in the Reuters Financial Glossary definition, which is “The portion of a country's budget deficit that is not the result of changes in the economic cycle. The structural deficit will exist even when the economy is at the peak of the cycle."

This distinction between structural and stimulus debt is not in practice very important. The distinction is only made here so as to clarify the theory.

Structural debt.

The idea that structural deficits or debts cannot be reduced without deflationary consequences is on the face of it bizarre because as mentioned above, structural deficits and debts do not arise out of any intention to impart stimulus. Thus the removal of structural deficits and debts will not, by definition, have any "anti-stimulatory" effect.

This raises the question as to why there is a widespread belief that removal of structural deficits or debts will be deflationary. The answer is that those who make the latter claim make a simple mistake, which will now be explained.

Let us consider a government which raises spending by $X a year and fails to collect tax to cover this expenditure, and which has to borrow in consequence. The effects of consolidating the debt a few years later will then be considered.

The above failure to collect enough tax has a stimulatory or inflationary effect which must be countered by some sort of deflationary instrument, for example borrowing, assuming aggregate demand is to remain constant. Where government goes for the borrow option, the deflationary effect, is unlikely to be sufficient if government simply borrows $X. Reasons are as follows.

The latter “borrow and spend” scenario involves having government take $X from the private sector, give the private sector $X of bonds in return and spend the $X back into the private sector. The net result is that the private sector is $X up (in the form of $X worth of bonds).

That is different from extracting $X per year of tax from the private sector and spending the money. In the latter case, the private sector is no better off: at least the private sectors’ net financial assets (PSNFA) do not rise.

Thus under the borrow option, government will need to take some further deflationary measure. This additional deflationary measure could be to raise interest rates, or it could be to borrow an additional amount over and above the $X and doing nothing with the money concerned. Effectively, the “additional amount” is extinguished or “unprinted”.

Indeed, raising interest rates and borrowing the above “additional amount” come to much the same thing, since governments force through interest rate increases by borrowing, i.e. selling bonds. So let us assume that given a tax shortfall of $X, government has to borrow

$\$(X + X^1)$, where \$X represents money that is borrowed and spent, while the $\$X^1$ is money that is simply borrowed, period.

Consolidating the debt.

When government subsequently decides to consolidate the debt after let us say Y years, government will, all else equal, just need to reverse the above process: that is, it will need to raise taxes by enough to buy back \$XY of bonds, plus it will need to implement quantitative easing (QE) to the tune of $\$X^1Y$.

And this is where the big mistake comes by those who think that consolidating structural deficits or debt is deflationary. That is, in the case of debt for example, they think that the repayment of \$XY of debt involves simply raising taxes and/or cutting public spending by \$XY, and repaying creditors. And that certainly would be deflationary. In fact the latter mode of debt repayment is excessively deflationary and for no good reason: it is not a mirror image of the way in which the debt was incurred in the first place.

No doubt some adherents to the conventional view would claim that implementing QE while repaying debt is some sort of cheat. One answer is that the above process of incurring debt and then repaying it simply returns the relevant economy and its money supply to where it would have been if the above debt had not been incurred: that is, if the above extra government spending had been funded by increased tax right from the start.

Indeed, it is ironic that what are sometimes called “economic conservatives” or the political right (who tend to oppose governments running up large debts) are the very ones likely to object to paying off debt in the above manner, because debt repayment is “assisted” by printing money to the tune of $\$X^1Y$.

To repeat, the latter process simply returns the economy to where it would have been had structural debt never been incurred! Thus much of the West’s elite, economic conservatives in particular, are in the bizarre position of objecting to the very thing they want: the scenario that would obtain if no structural debt had been incurred.

Debt derived from stimulus.

In contrast to structural debt, there is debt incurred as a result of Keynsian stimulus: having government borrow and spend.

The conventional wisdom is that this Keynsian policy makes some sort of sense. However, it can well be argued that borrowing for stimulus purposes makes no sense at all. In particular, it is hard to see the point of government borrowing money and paying interest for the privilege when it can print as much money as it wants at no cost.

Keynes (1933), Friedman (1948: 250), Mosler (2010) and Hillinger (2010:3) pointed out that deficits can perfectly well accumulate as extra monetary base rather than extra debt. Of course having deficits accumulate as monetary base rather than debt is doubtless more stimulatory, dollar for dollar, than accumulation in the form of debt. But that just means that fewer dollars need be employed for given stimulatory effect under the “base” option than the debt option.

If incurring debt for stimulus purposes does indeed make little sense, it follows that if a government *has accumulated* debt for stimulus purposes, it should be possible to convert this debt to monetary base without any austerity. And indeed, this is easily done simply by “printing” or creating monetary base and buying back debt (or ceasing to roll it over). In short, debt can be converted to monetary base via QE.

That on its own would probably be too stimulatory because PSNFA becomes more liquid. And that in turn would necessitate some form of compensatory and deflationary measure, like increased taxes.

As long as the stimulatory effect of the QE equals the deflationary effect of the extra tax (and/or public spending cuts), the net effect is neutral. That is, there is no effect on GDP, aggregate employment and so on: in short, no austerity.

Apart from the above PSNFA effect, there are of course additional ways in which the Keynsian “borrow and spend” policy might work. For example, Keynsian borrow and spend involves taking cash from the relatively well off, and spending it in ways that channel money into the pockets of the population at large. Given that the less well-off spend a larger portion of additional income than the rich, there may well be an aggregate demand expanding effect.

However, the effects of Keynsian policy is much in dispute, plus quantifying the effect is not central to the argument here. The central point made here is that whatever the effect of Keynsian policy and the debt it gives rise to, the debt can be paid off without any “recovery hindering” effects.

To illustrate, if Keynsian type stimulus has an effect way beyond the PSNFA effect, that just means that consolidation will have a relatively deflationary effect, which in turn means that the tax increase accompanying the above mentioned QE would have to be relatively small.

To summarise so far, structural deficits and debts can be removed without any big deflationary effects. Stimulus debt is equally easy to remove. In contrast stimulus deficits clearly must stay in place as long as the recession continues. However, the latter can perfectly well accumulate as extra monetary base rather than as extra debt.

The combined structural and stimulus debt.

As most readers will have noticed, consolidating structural debt can be done in the same way as consolidating stimulus debt (extra tax or less public spending plus QE). Thus there is no real need to know how much of a country's debt has accumulated for structural rather than stimulus reasons. To repeat, the two were separated above just to clarify the theory.

Furthermore, the actual stimulus obtained from increasing stimulus debt years ago has nothing to do with how stimulatory or "unstimulatory" the consolidation of such debt this year or next ought to be. For example, if the private sector is currently in a fit of irrational exuberance, that would be an argument for consolidating debt in a relatively deflationary manner.

Indeed, to ignore both the size of the current debt and monetary base and the circumstances in which they arose is very much in keeping with Lerner (1983: 39), who said "government fiscal policy, its spending and taxing . . and its issue of new money . . . shall all be undertaken with an eye only to the results . . . and not to any established traditional doctrine about what is sound or unsound".

Incidentally, if taken to the extreme, the above QE policy, would involve buying back all debt which would result in a “zero debt” economy. And that is not as outlandish an idea as it might seem: Friedman (1948:250) and Mosler (2010) advocated zero debt economies.

Open economies.

As far as incurring and paying off debt goes, the basic difference between a closed and open economy is of course that foreigners can respectively buy and sell debt.

The word “foreigner” is not strictly accurate here in that as far as economic effects go, there is no difference between on the one hand a foreigner selling debt and reinvesting the proceeds abroad, and on the other hand, a native doing likewise. In other words it is the behaviour of those prepared to invest abroad rather than in just one country that is of relevance here. However, the word “foreigner” will be used below for the sake of brevity.

If foreigners sell debt during a debt consolidation phase and reinvest the proceeds abroad, the price of the currency of the country concerned falls relative to other currencies, that is devaluation takes place. And this of course involves a standard of living reduction for the country concerned, which certainly counts as “austerity”.

But there are several reasons for thinking the amount of austerity here will be or could be limited.

1. No austerity for the world as a whole is involved since in the absence of any evidence to the contrary, the best assumption that can be made is that the standard of living loss for the devaluing country will be matched by a standard of living rise for other countries.

2. Where foreigners hold a significant portion of a country's debt, there is a limit to how quickly they can withdraw their investment without causing a serious devaluation of the currency of the debtor country, which in turn devalues the worth of the rest of foreigners' investment in the country concerned. For example, China has been seriously concerned about the monetisation or threatened monetisation of US debt recently. But China has withdrawn very little of its investment in the US because of this. China, so to speak, has nowhere else to go.

3. As mentioned above, any austerity caused by the behaviour of foreigners can only occur via devaluation. If a significant number of countries coordinate their consolidation efforts, the foreign exchange effects are ameliorated, thus any austerity is also ameliorated.

Aggregate employment.

Some advocates of the idea that debt consolidation hinders the recovery presumably mean “recovery” in the sense of returning aggregate employment to pre-recession levels, rather than returning GDP growth to pre-recession levels. In fact there is little reason for consolidation to reduce aggregate demand and thus aggregate employment.

The only reason for such a reduction comes from the fact that debt consolidation changes the pattern of demand, which in turn requires people to change jobs, re-train and so on. And that would temporarily worsen the inflation / unemployment relationship. (The altered pattern of demand stems, amongst other reasons, from the devaluation of the currency of the debt repaying country, mentioned above.)

But this altered pattern of demand occurs just as much during the build-up of debt as during consolidation, which is yet another reason for governments not to incur debt! (Yet more arguments against governments incurring debt are given in Musgrave (2010)).

The solution to this altered pattern of demand problem is to consolidate debt slowly rather than quickly. If the resulting altered pattern of demand is small compared to the constantly changing patterns of demand that occur anyway, then the effect on aggregate employment will be small.

Is consolidation urgent or necessary?

Having argued that consolidation can be effected with little or no austerity, this is not to suggest that consolidation is urgent for every country.

Several governments are currently paying a rate of interest on their debt which, after adjusting for inflation, is around zero or even negative. Moreover the national debts of the US and UK at the time of writing are still only around half the level, relative to GDP, that obtained just after World War II.

Having said that, there is a particular sense in which debt reduction can be taken too far, which is as follows. As pointed out above, there is little point in a country which issues its own currency borrowing money, given that it can print any amount of such money as required. Thus reducing the stock of "interest paying" debt makes sense.

However, monetary base is at least nominally a debt (owed by the central bank to holders of monetary base). It is debatable as to whether this counts as debt, but if it does, then reducing this form of debt can go too far: if such a reduction were to reduce PSNFA to such an extent that the private sector did not spend enough to bring full employment, that would constitute "going too far".

Conclusion.

1. To the extent that an economy is closed, debt consolidation need not hinder the recovery or cause austerity. There may well be political problems relating to which income or social groups gain and lose from debt repayment, but overall, no austerity need be involved.

2. To the extent that an economy is open, debt repayment involves austerity for the country concerned only to the extent that debt holders invest the proceeds of debt repayment abroad. Even where proceeds are invested abroad, no austerity for the world as a whole is involved, since loses by debt repaying countries are matched by gains in countries which do not repay debt.

3. Austerity can be minimised in debt repaying countries if those countries coordinating their debt repayment efforts.

4. As distinct from austerity in the sense of hindering GDP growth, debt consolidation would reduce aggregate employment because the pattern of demand is altered. But this problem can be minimised by limiting the speed of consolidation.

References.

Friedman, M. (1948). A Monetary and Fiscal Framework for Economic Stability. *American Economic Review.* XXXVIII (3): 245-264, URL: http://nb.vse.cz/~BARTONP/mae911/friedman.pdf

Harding, R. (2011) Tackling the deficit is next fiscal battle. Financial Times. URL: http://www.ft.com/cms/s/0/af521dc4-63a9-11e0-bd7f-00144feab49a.html#axzz1ba97li8U

Hillinger, C. (2010). The Crisis and Beyond. Thinking Outside the Box. Economics. Discussion paper No. 2010-1. URL: http://www.economics-ejournal.org/economics/discussionpapers/2010-1

Keynes, M. (1933). An Open Letter to President Roosevelt. *New York Times*. December 31st. (See 2nd half of 5th paragraph). URL:

http://www.scribd.com/doc/33886843/Keynes-NYT-Dec-31-1933

Lerner, A.P. (1983). Functional Finance and the Federal Debt. In David C.Colander (Ed.), *Selected economic writings of Abba P. Lerner.* New York University Press. URL: http://k.web.umkc.edu/keltons/Papers/501/functional%20finance.pdf

Mosler, W. (2010). Proposals for the Banking System. *Huffington Post*, January 21st. (See 2nd last paragraph).

URL: http://www.huffingtonpost.com/warren-mosler/proposals-for-the-banking_b_432105.html

Musgrave, R. (2010). Government Borrowing is Near Pointless. Munich Personal RePEc Archive Paper No. 23785. URL: http://mpra.ub.uni-muenchen.de/23785/

Mitchell, W. (2011). The IMF – incompetent, biased and culpable. URL: http://bilbo.economicoutlook.net/blog/?p=13471

OECD (2010). Fiscal Consolidation: Requirements, Timing, Instruments and Institutional Arrangements. URL: http://www.oecd.org/dataoecd/63/57/46435606.pdf

Ostry, J.D. (2010A). Watch This (Fiscal) Space: Assessing Room for Fiscal Manoeuver in Advanced Countries. IMF Direct. http://blog-imfdirect.imf.org/2010/09/01/watch-this-fiscal-space-assessing-room-for-fiscal-maneuver-in-advanced-countries/

Ostry, J.D., Atish R. Ghosh, Jun I. Kim, and Mahvash S. Qureshi, (2010**B**) Fiscal Space. IMF Staff Position Note, SPN/10/11. URL: http://www.imf.org/external/pubs/ft/spn/2010/spn1011.pdf

Rivlin, A.M. (2010) Moving to a Fiscally Sustainable Budget. URL: http://www.brookings.edu/~/media/Files/rc/testimonies/2010/0211_budget_rivlin/0211_budget_rivlin.pdf