ILLUSTRATION BY BINAY SINHA

### WERE UK FISCAL 'CONTRACTIONS' DEFLATIONARY AND 'EXPANSIONS' STIMULATORY?

'Contractions' would be deflationary, in line with the Keynesian textbooks, if 'pluses' in the second column were accompanied by 'minuses' in the third column. The evidence is totally at variance with the Keynesian position

| Years under consideration | Change in structural Budget balance from last year beforehand to end-year (%) | Change in output gap from last year beforehand to end-year (%) |
|---|---|---|
| 1981-88 | +8.2 | +1.8 |
| 1989-93 | -4.7 | -5.1 |
| 1994-2000 | +8.0 | +4.7 |
| 2001-09 | -12.9 | -3.5 |
| 2010-14 | +6.4 | +0.5 |

Data are from the International Monetary Fund

# Britain's 'austerity' election

## How the United Kingdom shows that fiscal consolidation is economically and politically beneficial

I was in London in early April and watched the televised debate of the political leaders contesting the national election. I watched in amazement as, apart from the Conservative and the UK Independence Party leaders, all the others laid into what were labelled the "austerity" policies followed by the Conservative-Liberal Democrat coalition to deal with the massive Budget deficit left by the preceding Labour government. The most strident was the leader of the Scottish National Party (SNP), Nicola Sturgeon, who was completely against any austerity — whilst the others, including Labour's Ed Miliband and Lib Dems' Nick Clegg seemed to be echoing variants of St Augustine's plea in his *Confessions*: "Give me chastity and continency — but not yet!"

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After this debate, despite the dead heat predicted by all the pollsters, I did not believe that when it came to the ballot box the majority of English voters would be able to cast their vote without choking in favour of Labour's Mr Miliband and his Shadow Chancellor Ed Balls — the architects of Labour's incontinence under Gordon Brown. When the prospect of a Labour government kept in office in a hung Parliament by the SNP, which promised a more extreme version of the last Labour government's fiscal excesses, even the waverers must have baulked. So I was not surprised when the BBC's exit poll predicted a Conservative victory.

But the election outcome also provides another lesson. Though many academics and much of the commentariat had argued against the speed, and some even on the need for the coalition's contractionary fiscal adjustment on traditional Keynesian grounds, their fears that these policies could lead to another slump were belied by the actual outcomes in terms of unemployment and even growth. This must have given credence to the Tory claim that they needed another five years to complete the task of fiscal consolidation and put Britain on a path of sustainable growth.

There are also lessons to be learnt about the crude Keynesianism propounded by much of the commentariat and many academics during the Great Recession. They have repeated the opprobrium hurled at the fiscal consolidation undertaken by the first Thatcher government, when 364 UK economists wrote a letter to *The Times* denouncing it, claiming it would lead to a slump. I refused to sign the letter. Thatcher's fiscal consolidation was followed by robust growth.

Furthermore, a group of Italian economists at Bocconi University have considered a number of other fiscal consolidation and questioned the standard Keynesian claim that they necessarily depress demand and output. Instead, they identify what they describe by the malapropism "expansionary fiscal contraction" (see Alberto Alesina and Silvia Ardagna's 2009 NBER working paper, titled "Large Changes in Fiscal policy: Taxes versus Spending").

The British monetarist Tim Congdon (in his article "In praise of expansionary fiscal contraction", which appeared in *Economic Affairs* this year) has provided some support. He examines the change in the cyclically adjusted public sector net borrowing (PSBR), with a reduction representing fiscal tightening, and sees if it is accompanied by below trend growth and a reduction in the "output gap" with more spare capacity and higher unemployment. The "output gap" is measured with reference to the level of potential output when unemployment is at the monetarist "natural rate" — that is, the non-accelerating inflation rate of unemployment (Nairu). The "output gap" is then given by the percentage difference between actual gross domestic product (GDP) in constant prices and estimated potential GDP. So above-potential output is associated with a positive value of the output gap and beneath-potential output with a negative value. (See OECD *Economic Outlook* 1995, page 74). Mr Congdon's estimates of the changes in the output gap and in the PSBR for 1981 to 2013 for the United Kingdom from the International Monetary Fund are in the table. If the Keynesian view is valid, one should see an inverse relationship between changes in the cyclically adjusted Budget balance (PSBR) and changes in the output gap.

There are five phases from 1980 in the table. During the first, 1981-88, the Thatcher government's fiscal policy was contractionary, but the output gap improved, refuting the claims of the 364 economists who had signed the letter to *The Times*. From 1989 to 1993, fiscal policy was expansionary, to counter the downturn associated with membership of the European Exchange Rate Mechanism, leading to a worsening of the output gap. From 1994 to 2000, which includes the early years of the Blair government, fiscal policy was contractionary with an improvement in the output gap. Thereafter from 2001 to 2009, in Mr Brown's fiscal expansion there was a worsening of the output gap. Under George Osborne in the Conservative-Lib Dem coalition, fiscal policy was again tightened and contrary to the academic and media Jeremiahs, there was an improvement in the output gap.

Three conclusions follow about macroeconomic policy. First, Keynesian counter-cyclical policies do not work, justifying the conventional policy prescriptions accepted till the Great Recession. Fiscal policies should be concerned with the microeconomy, the financing of public goods, and maintaining fiscal and debt sustainability. Second, business cycle fluctuations should be managed by monetary policy. Third, the fear of the ineffectiveness of monetary policy because of a purported Keynesian "liquidity trap" is unwarranted. As Ben Bernanke wearing his academic hat wrote, "The general argument that the monetary authorities can increase aggregate demand and prices, even if the nominal interest rate is zero, is as follows: Money, unlike other forms of government debt, pays zero interest and has infinite maturity. The monetary authorities can issue as much money as they like. Hence if the price level was truly independent of money issuance, then the monetary authorities could use the money they create to acquire indefinite quantities of goods and assets. This is manifestly impossible in equilibrium ... This is an elementary argument, but ... it is quite corrosive of claims of monetary impotence" ("Japanese Monetary Policy: A case of self-induced paralysis", A Posen and R Mikitani (editors), *Japan's Financial Crisis and its Parallels to US Experience*, 2009).

Finally, politically, the result of the UK election shows that a government undertaking austerity for credible fiscal and debt sustainability need not fear the electoral consequences.