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Debt and Growth

Every event, just as every encounter, as the ancient Chinese saying goes is pre-destined. It has both bad and good aspects.

The effects of the last week tremor in the academic world are now spreading far beyond the corridors of universities.

The reputation of two economists of great standing now stands tarnished by the revelation that the procedures adopted by them in their research were questionable; and that their findings and the policy solution dished out were not acceptable. The after-effects of the tremor are assuming tsunami proportions and are spreading to the real world.

The good aspect is that it has emboldened many a critic to question the decisions taken by the policy makers to reconsider and change their directions.

The incorrect policy study

Two academics of repute, Carmen Reinhart, and the former chief economist of the International Monetary Fund (IMF), Kenneth Rogoff presented a research paper at the 2010 Annual Meeting of the American Economic Association held in New York. In their paper on “Growth in a Time of Debt”, they came out with the finding that there was a threshold of public debt beyond which growth of any country will be at peril. The threshold according to them was 90 percent of gross domestic product (GDP) and any budget deficit leading to rise in public debt beyond this level would lead to a sharp fall in growth.

Since the crisis ridden countries in the eurozone countries have had public debt far exceeding this figure, the only solution according to the study was to adopt measures of austerity. Fiscal deficits for fighting unemployment and falling output are a taboo.

The findings and the solution came very handy to European Commission and European Central Bank. Since the solution had the seal of approval of the two famous economists, austerity had also the aura of sanctity. Tightening measures were introduced in the debt-ridden eurozone countries, as conditionalities to the bail-out assistance.

The EU's Economics Commissioner, Olli Rehn hailed "the 90% rule".

In the United States, it was the Republican Senator Paul Ryan who emerged as the guru of austerity opposing the fiscal stimulus measures of President Obama.

All eurozone member countries have to fall in line. Portugal cut its fiscal deficit by a third between 2010 and 2012, only to see unemployment rise to 18 percent. More countries, Ireland, Greece, Italy, Spain and Cyprus are now in the grip of recession and they cannot adopt the Keynesian measures of fiscal expansion as they are bound by the euro zone rules.

Errors in the study

The errors in the paper by Reinhart and Rogoff were detected by a university student who wanted to test the reproducibility of the results. While doing so after obtaining the spreadsheet from the Harvard professors, it was found out that the two economists had left out data of five key countries in their list of 20 countries under their analysis. Further, there were some statistical procedural errors and a coding error in the spreadsheet analysis. So, the so-called threshold level of debt is of doubtful validity.

Indeed it is too much to hold Reinhart and Rogoff responsible for the current plight of Greece or Cyprus in the eurozone or any developed country which has rejected the Keynesian measures of fiscal remedies in favour of monetarism which lays stress on quantitative easing and reducing interest rate. The QE has not worked well. On the other hand, it is likely to lead to currency wars of depreciating the exchange rate for promoting exports at the expense of their competitors.

In fact, the time is now for raising domestic demand through fiscal remedies.

The latest forecasts by IMF are gloomy. The IMF observed that developed countries, embracing austerity did badly and developing countries which incurred fiscal deficits to fight recession did far better. In our own region, Fiji, PNG and Vanuatu did not embrace the austerity measures of the sort advocated in the eurozone, despite the rising debt levels. They still incurred fiscal deficits of small size, trying to push the growth upwards.

The debate between Keynesians and austerity advocates is increasingly becoming meaningless. It is now finally realized, as the European Commission President Barossa conceded: “While I think 'austerity' is fundamentally right, I think it has reached its limit."

Need for competency

Already the voters have responded. In Italy, the technocrat professor, the acting Prime Minister Mario Monti was rejected. In Greece, people threw out Papandreou. Austerity hawks cannot borrow or commission ideas to promote their ideology.

In the meanwhile, economists need not think they can and have the authority to dictate policies. Lord Keynes wrote in his ***Essays in Persuasion*** thus:

“If economists could manage to get themselves thought of as humble, competent people on a level with dentist, that would be splendid.”