Debt And Its Discontents

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The world economy is in tatters, but what's to blame - debt or the austerity solution? And are we really in our own debt spiral? Ian McAuley separates the facts from fiction.

Successful prophecy is a matter of timing. Who, for example, has heard of George Perkins Marsh, an American Congressman and diplomat who in 1847 warned about the risk of human activity resulting in destructive climate change? At the other end of the timeline are those whose prophesies appear too late: their work becomes just another case of the wisdom of hindsight.

Luck ran against Harvard academics Carmen Reinhart and Kenneth Rogoff when they completed a huge research project which accurately predicted the 2008 global financial crisis. But as any academic knows, publication takes time – publishers put their manuscripts in a queue, and then engage in a protracted process of nitpicking. Their work "This Time is Different – Eight Centuries of Financial Folly", didn't hit the bookshops until 2009.

Their timing was better when in early 2010 they published their National Bureau of Economic Research paper "Growth in a time of debt". It came just when policymakers were devising ways of pulling the world out of what had grown from a mere "financial crisis" to the "great recession".

In their usual style, this work was thorough. They examined debt and growth in 44 countries over 200 years, producing a data set with 3700 observations. From this data their analysis showed that if government debt in any country were to rise to 90 per cent of GDP, economic growth would fall away sharply.

That figure of 90 per cent became an article of faith among fiscal conservatives. It reinforced the idea that austerity was the only policy path for profligate governments to steer their economies back to prosperity. If debt had caused the crisis, fiscal stringency would be the solution.

The only trouble was that there was a huge error in the Excel spreadsheet which formed the basis of their calculations – an error only recently detected by University of Massachusetts Amherst graduate student Thomas Herndon. Having lived and studied in Boston, I can imagine the schadenfreude when a University of Massachusetts student showed up two Harvard professors, but all researchers make mistakes. The problem lies in the peer-review process, which rarely involves replication of analysis.

In any case, the well respected economist Paul Krugman has been taking especial delight in bringing Herndon's findings to the world's attention.

Krugman pointed out that there was indeed a negative correlation between debt and growth, but, as we all should know, correlation does not prove causation. Does high debt impair growth, does low growth result in high debt, or are there other factors causing both low growth and high debt? Once the data was processed properly, there was no evidence of a 90 per cent tipping point beyond which economies spiral into depression.

It doesn't take a high level of economic sophistication to know that the relationship between debt and growth is complex. Any categorical statement should be treated with suspicion and checked against reality. For example, Australia's Commonwealth Government debt peaked at 120 per cent of GDP in 1945, and the following 25 years were ones of extraordinary growth, which saw debt rapidly fall to below 20 per cent of GDP, where it has stayed since.

Far more important than the level of debt is the way debt is used. Debt has a perfectly legitimate role in counter-cyclical management: governments should run surplus budgets in times of booms and deficits when recessions loom. Debt is a perfectly reasonable means of financing productive infrastructure, which is why it's important to distinguish between gross debt and net debt, the latter bringing into account the value of assets financed by debt.

It is unsustainable, however, for debt to be used to finance current consumption. That's one reason why gross public debt at around 80 per cent of GDP is a problem for Spain but not for Germany. The relation between public debt, private debt and foreign debt is also important. Japan's government debt, for example, is well beyond the 90 per cent of GDP level, but it is all held by Japanese.

In Australia, our understanding of debt has been clouded by a partisan political debate. The Liberal Party's statements about "record debt" only make sense if we ignore inflation or economic growth – akin to saying that a child's $10 pocket-money allowance is 40 times higher than his grandfather's two shillings and sixpence allowance in 1945. And our focus on public debt has distracted us from the issue of private foreign debt, which rose from 34 per cent to 87 per cent of GDP on the Howard government's watch.

We have been fortunate that the debt obsession has so far had little by way of policy consequences. Both mainstream parties have sensibly dropped their promises of immediate moves to a balanced budget, but for Europeans, particularly those in Mediterranean countries, the debt obsession has far worse consequences than for us, for it has entrenched the idea of recovery through austerity.

No reasonable person would dispute the need for the Mediterranean countries and other European countries such as France and the UK with less extreme imbalances to get their public accounts back in order. Over the long term, apart from financing productive assets, taxes and spending have to balance. But there are huge costs in trying to repair public finances too quickly, and, in fact, the process is proving to be counter-productive.

To put it simply, when a large proportion of an economy's productive assets – its people and physical capital – is left idle, growth suffers. Public finances suffer: there is less income and consumption tax collected, and, even if countries make savage cuts to social welfare, the growth in unemployment still places a huge demand on public spending. That's why public debt and unemployment have both been rising in so many European countries. They are locked into a destructive process of positive feedback.

Particularly disturbing is the huge rise in youth unemployment – 39 per cent in Portugal and Italy, 56 per cent in Spain, and beyond measurement in Greece. Of the Eurozone countries, only Germany and the Netherlands, which have a strong commitment to keeping their human capital employed, have been able to keep youth unemployment down to levels which we might consider tolerable.

The reality behind these statistics is a generation of idle, impoverished young people, disconnected from society and its norms, cynical about mainstream politics, and lacking opportunities for meaningful work and education. To see its possible consequences we can look back to Germany in the 1920s and 1930s, when National Socialism gave a sense of belonging to the unemployed, and was able to discredit the processes of parliamentary democracy. Or we can look around at countries in the Middle East and South Asia where religious fanatics are offering Jihad and martyrdom as a path to a meaningful, if short, life.

There is no easy solution to Europe's problems, but anyone with a sense of history should know that the risks of austerity are so high that it is not a solution. Any solution has to be within a framework of shared commitment, with costs borne fairly throughout the community, rather than by young people.