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Purists forced to retreat in global debate on fiscal policy

By Chris Giles Author alerts

A global fight over fiscal policy has raged since the International Monetary Fund shocked the world in 2008 by recommending governments stimulate their economies by cutting taxes and increasing spending.

Almost seven years later, the battle is stuck in a quagmire with questions still to be resolved. How far should governments attempt to offset economic weakness with fiscal activism?

Are attempts to reduce public borrowing in difficult economic times automatically counter-productive? And what constitutes prudent public finance management in an era of extreme uncertainty over sustainable levels of output?

Recently, the evidence has not been kind to anyone taking an extreme stance on these questions. Critics of austerity can certainly point to Japan, which raised its consumption tax in a move that appears to have backfired. By contrast, its supporters can once again point to the UK's ability to marry rapid economic growth with deficit reduction, leading Christine Lagarde, IMF managing director, to apologise for the fund's previous criticism of the UK's deficit reduction strategy.

The mood in Tokyo has soured since the spring. Abenomics, named after the radical economic policies of Shinzo Abe, the prime minister, has taken quite a knock after April's three percentage point increase in the consumption tax to 8 per cent hit the economy harder than expected. While everyone had forecast a weak second quarter as consumers spent in advance of higher prices, the severity of the crunch has been much deeper than expected.

Japan's economy contracted 1.7 per cent in the second quarter, worse than the hit caused by the 2011 earthquake and tsunami, and has raised questions over the second stage of the planned tax rise to 10 per cent next April. Even the bold Mr Abe is now more cautious, saying in September that he was "neutral" on the question of the second tax rise.

Within the eurozone, the picture is as mixed as it is on the global stage. For every country whose prospects appear to be damaged by fiscal austerity, there is a counter example of surprising strength amid the pain.

Apologetic: Christine Lagarde

Economists have been revising higher their forecasts for growth in 2014 in Spain, Ireland, Portugal and Greece, in a sign that the deficit reduction was no longer dragging their economies deeper into recession. In contrast to the better news from the crisis economies of 2011, France and Italy, two of the eurozone's three largest economies, remain in the doldrums, unable simultaneously to sustain expansion and deficit reduction.

In the summer, Matteo Renzi, Italy's prime minister, and François Hollande, the French president, joined forces to call for a fiscal compromise in which eurozone countries would be given more time to bring budget deficits under control in exchange for commitments to implement difficult reforms to their economies, battling deep-seated vested interests. France even declared a new budget, delaying its target to bring borrowing down to 3 per cent of national income by another two years to 2017.

Their call for flexibility on budget rules was met with a predictably outraged German, Finnish and Dutch response and predictions that backsliding on fiscal policy would destroy the hard-won improvement in confidence across the eurozone.

Amid the arguments, it is noteworthy therefore that the European Central Bank and the Organisation for Economic Cooperation and Development (OECD), both bodies renowned for their tough stance against government profligacy, have called for more flexibility "within EU fiscal rules".

The clear implication was that the bloc, as a whole, should spend more EU money on capital investment projects and Germany, which is running a budget surplus, should also open its purse strings to improve its infrastructure and boost growth rates across the EU.

Globally, the IMF, the organisation which started the global debate in 2008, has tried to advocate a “horses for courses” approach to fiscal policy.

Looser fiscal policy through tax cuts and spending increases is fine, it says, if a country has the scope and the strong public finances to underpin such a move. But if these do not exist, either because financial markets will not finance higher borrowing or the underlying fiscal position is very weak, countries must attempt to bring their budget back closer to balance, it says.

This more pragmatic approach is catching on. The OECD suggested in September that because Japan still had a long way to go to bring its public debt under control it needed to implement further tax rises, despite the pain of April’s move. The US, by contrast, could ease off for now so long as it worked on a medium-term plan.

Emerging economies, too, are subject to this emerging trend of more nuanced debate.

For India and Brazil, where slow growth has exposed weakness in the public finances, the OECD called for greater action to reduce borrowing by cutting state subsidies and eliminate distortions at the same time. In contrast, it said that fast growth in China implied its “broadly neutral fiscal stance is appropriate”.

The new tone in the fiscal debate around the world reflects the divergent fortunes of rich and poor economies alike. It has not settled the six-year war on fiscal policy, but suggests that the purists are no longer forcing policy makers into a false choice between austerity and growth.

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