Article #1 – Austerity

Will Austerity Solve the Financial Crises?

As a result of the financial crisis in the US and, later on, in Europe, the principle of austerity, as a cure for all, became a rallying point for many in central banks and in the economics profession. They believed that tough fiscal policy was the only treatment for excessive debt and any easing would spell disaster. As countries started to apply these ideas, many realized that such policies were self-defeating – indeed economies already weakened by the crisis would be condemned to perpetual stagnation and shoulder even greater debt burdens.

Recently, the IMF carried out a study revealing that the impact of the economic tightening forced on many European countries was rather dire. So is austerity good or bad? The answer is more nuanced. There is no doubt that a country wading in a sea of debt needs to tighten its expenditures. On the other hand, if austerity is applied too stringently, growth and, indeed, the hope of any economic recovery appear dim.

Thus a thoughtful understanding of the relation between austerity and growth is essential. If indiscriminate budget cuts do not automatically boost growth, austerity can be expansionary when it depresses interest rates sharply. However, interest rates have been very low for some time – near zero in some case and households are also trying to reduce their debt. In this case, budget cuts will have an adverse impact on demand.

On the other hand, for many European countries like Greece or Portugal a focus on fiscal consolidation was unavoidable: they had reached a point where investors were shunning their bonds and where financial rescue by the rest of Europe had ground to a halt. Other countries like the UK were also potentially susceptible to financial disaster. It is true that bond yields have now been stabilized, but this does not discredit the effort towards achieving sound budgets.

If austerity is necessary for the economic recovery of a country, it must be applied wisely along with other policies. In the case of Greece, the policy of imposing huge budget cuts and to continue tightening as the Greek economy was tumbling led to disaster. By choking the Greek economy, all hopes of recovery were dashed and the debt could not be reduced. It is now clear that deficits cannot be erased instantly. A medium-term approach combining deficit reduction overtime with monetary loosening to ease the pain and restart the economy is the only solution.

Source: Fiscal Austerity – A Deficit of Common Sense: the Debate About Budget Deficits Has Become Dangerously Theological.

ESSAY QUESTIONS - In your own words, address the following ideas in the context of this article: austerity and its potential impact on the economy; is there another way? Elaborate.

ESSAY EXAMPLE - score 6 or 5 – Very Strong

The financial crisis that started in the US revealed the existence of deep structural weaknesses in a number of countries with seemingly sound economies. These countries started to carry larger and larger debts and found that they could not borrow anymore on the financial markets. A country that is heavily indebted needs to implement more borrowing to pay back its lenders. Unfortunately, investors lose confidence in the financial soundness of such economies and become reluctant to buy more bonds.

At first, help was forthcoming from various international organizations, but there were ties and the buzzword was “austerity.” In the context of this article, the concept of austerity refers to the use of drastic fiscal policy to reduce a country’s excessive public debt, hoping that this will promote economic growth. The debt accumulated overtime as the country ran large budget deficits year after year. In order to reduce the debt, the government must replace these deficits with surpluses, allowing the country to pay back its debt. Yet budget surpluses can only arise if the country tightens its fiscal policy, i.e. increase tax and/or reduce public spending.

It is now clear that, unless the country implements radical austerity reforms, the hope of recovery from the crisis is dismal. However countries that are heavily indebted, like Greece, are also likely to exhibit weak and stagnant economies. In such case, the immediate imposition of restrictive fiscal policy can only worsen their plight. If the state of the economy worsens, the likelihood of paying back their debt is reduced: the policy of austerity is self-defeating.

A better approach would be to apply the austerity policy in a flexible manner and overtime in order to reduce the debt gradually. At the same time, to restore growth in the economy and consequently the ability to repay the debt, the country must adopt an expansionary monetary policy.

ESSAY EXAMPLE - score 6 or 5 – Very Strong

The financial crisis in Europe and U.S. brought many governments to the edge of bankruptcy. Governments were burdened by the enormous task of bailing out financial institutions at the time when tax revenues were falling due to depressed economic activity. The threat of unsustainable debt has led to calls for governments to tighten their belts. The question is whether this policy is successful in treating the economic malaise in the European countries.

The IMF report reveals that the belt tightening by the European governments have had a negative effect on the economies of these countries as unemployment in these countries has soared. The answer therefore is rather complicated and depends on how stringently austerity is applied.

In general, drastic cuts in government spending increase unemployment and may drag the economy down to a degree that government tax revenues fall. This outcome defeats the intention of lowering government debt.

A possible different outcome would be if government budget cuts reduce interest rate boosting investment demand. This would help the economic recovery. However, in Europe and the U.S., interest rates have been low for a while and business sending activity has not necessarily increased.

So what should the governments do? In countries such as Greece and Portugal governments do not have much choice other than reduce their expenditures. In these countries debt was reaching to levels where foreign lenders were refusing to extend loans to the governments, threatening them with bankruptcy. Therefore Portugal and Greece do need to apply some measure of austerity and reduce their government budget deficits. In other words these countries need to practice fiscal consolidation. However to prevent their economies from falling into abyss, they should undertake expansionary monetary policy to boost the overall economic activity.

ESSAY EXAMPLE – score 4 or 3 - acceptable

In the article, austerity is presented as a policy implemented to help countries reduce their excessive debt. Many economists thought that tough fiscal policy would help so these countries were forced to use austerity policy. However a new study by IMF has now shown that these policies had rather bad consequences in certain cases.

A country in debt must tighten its spending, but this could have adverse effects on the country's economy. So is austerity good or bad? We need to know relation between austerity and growth. With austerity, interest rate will increase and that helps economy, but budget cuts hurt demand. So we don't know what is the overall effect of austerity.

When countries like Greece and Portugal became heavily indebted, they had to pay back their debt. But investors would not buy their bonds and the rest of Europe would not help anymore. So they had to put up with huge budget cuts. Unfortunately these cuts had very bad effect on economy and things got worse rather than better.

The other way to solve problems of these economies is to try to pay back debt, but not all at once. At the same time, they must have monetary loosening to restart the economy. So there can be a solution in the medium run when countries are heavily indebdted.

ESSAY EXAMPLE – score 2 or 1 – not acceptable

Austerity is a cure for all. If a country has a lot of debt, it only has to use austerity policy to solve its problem and never ease. Many countries used austerity policy otherwise it would spell disaster and be self defeating.

IMF studied result of austerity and is not sure if it is good or bad. It might save country or it might mess up country badly. Growth and hope appear dim so relation between austerity and growth essential. Austerity expansionary because interest rates very low for some time so budget cuts are important.

Greece and Portugal need fiscal consolidation as investors are shunning their bonds, but bond yields are stabilized so UK have financial disaster. Europe does not help anymore.

Austerity must be wise. Countries with austerity are tumbling to disaster with no hope for recovery. Deficits cannot be erased so need monetary loosening to restart the economy.