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Remedying The Misprescription Of Austerity

At the yearly gathering of the world's top economic officials in early October here in Washington DC— the Annual Meeting of the IMF and World Bank—there was little optimism about the growth of the world economy. Indeed, the forecast unveiled by the International Monetary Fund (IMF) at the Annual Meeting punctuated the already downbeat mood: the Fund revealed they actually have downgraded the growth prospects for the globe's and U.S. growth.

For the world, growth was 3.2% in 2015; the IMF forecasts global growth in 2016 will turn out to be 3.1%. U.S. GDP advanced 2.6% in 2015. But the Fund believes U.S. growth in 2016 will be only 1.6%, and for 2017 it will be 2.2%; these projections are lower than what the IMF forecast just three months earlier by o.6%and 0.3%, respectively. What's going on here?

For one, growth of the advanced economies is projected to be half that of the emerging economies—a trend that has been underway for two decades but has attracted little attention. In fact, emerging markets now account for 60 percent of the world's economic growth, whereas a decade ago they accounted for 50 percent. To illustrate this, think of the world economy as a pie. Today the slice belonging to the advanced economies is 40 percent of the pie, while the emerging markets' slice accounts for 60 percent of the pie. (A decade ago their slices were of equal size). That change is significant in and of itself.

But there's more. As the overall size of the pie has grown—representing growth of the global economy—emerging markets contributed 80 percent to the increase in the size of the pie, and the advanced economies' contribution was only 20 percent. This cannot be chalked up to a one-time cyclical phenomenon; rather it is a long running structural transformation of the world economy. The realization of 'who is actually in the driver's seat' hung over the Annual Meeting. The clout of the advanced economies in global economic governance has shrunk considerably.

Another realization at the Annual Meeting was that the theological prescription of 'growth through austerity' as a remedy for the 2008 crisis actually worsened the economic prospects of many countries— especially the advanced economies. Any economist worth his or her salt saw austerity as a recipe for constraining not propelling growth. And many of us voiced our concern at the time. Simply put, you cannot make a flower bloom more brilliantly by cutting back on watering. Worse still—driven by the austerity distortion—fiscal policy was made to be put on hold. Although the executive branch of several governments pressed for fiscal expansion, their legislative branches wanted none of that.

So, what was the result? Undue reliance on monetary policy to drive economic growth. This meant that Central Banks were forced to rely on extraordinary means for stimulation. Frankly, some of the policies executed were downright innovative. 'Quantitative easing', once thought of as a policy of last resort, has now been mainstreamed.

The time for fiscal expansion is long overdue. Even Central Bankers—who are independent from other branches of government—have been increasingly and explicitly vocalizing this.

Let me give one example that is literally 'close to home': poor, dilapidated and outdated infrastructure—especially in transport but it is also characteristic of the underground pipe networks for water, gas and other substances--is the US economy's Achilles Heel. The resiliency and competitiveness of the large US economy derives from our ability to operate as an integrated market. This year the nation's capital has had to shut down large portions of its subway—a system that is only 40 years old-- after several subway car accidents as well as underground fires—including a few that resulted in fatalities.

The Washington DC authorities brought in a new manager for the system, and he revealed that not only has there been an appalling lack of maintenance but there were also fundamental defects, heretofore not made public. His only choice was to shut down portions of the system on a roving basis to make the needed corrections and renovations. To this day, this process is continuing. As you can imagine he is not popular with the public; but he is surely doing the 'right' thing.

The fact is that an increasing number of emerging markets have infrastructure systems that are state of the art and are ahead of the US. And, not just the Chinas and Indias of the world, but even countries in sub-Saharan Africa. It is obvious that fiscal policy that drives fundamental national investment is long overdue, especially programs where overall productivity will be enhanced and jobs will be created.

The lack of growth in the advanced countries is much of our own making. This no doubt dawned on the economic leaders at the Annual Meeting, and was at the root of their malaise.