Worksheet 17.3

To Continue Stimulus or to Pursue Austerity?

In the seemingly endless debate over the role of the government in the macroeconomy, there are two main camps: those who think the governments of the developed economies have not done enough to get their economies out of recession, and those who think they have already done too much, and therefore need to start rolling back stimulus and reducing deficits.

At the heart of this debate are the two macroeconomic schools of thought, the Keynesian demand-side theories and the neo-classical, supply-side theories. Two intellectuals have emerged in the last several years representing the two sides of the macroeconomic debate. On the demand-side, representing the Keynesian school of thought, is 2008 Nobel Prize winning economist Paul Krugman. Representing the classical, supply-side school of thought is Harvard economic historian Niall Ferguson. These two have squared off in many forums over the last three years, Krugman arguing for more and continued fiscal stimulus to prop up and increase demand in the economy, Ferguson arguing for smaller deficits, lower taxes and less government spending to increase private sector confidence and thereby supply in the economy.

Recently these two squared off once again in the aftermath of a G20 meeting in which the governments of several major economies from Europe and North America announced plans to begin rolling back the stimulus spending they embarked on throughout 2008 and 2009. The reason for increased 'austerity measures' (policies that reduce the budget deficit and slow the growth of national debt), argue global leaders, is to reduce the chances of more countries experiencing debt crises like that experienced by Greece in 2010.

International investors realized in early 2010 that Greece's budget deficits were a much larger percentage of its GDP than previously thought, and very quickly decided that Greek government bonds were an unsafe investment. Almost overnight the cost of borrowing in Greece shot up above 20%, bringing investment in the economy to a halt and forcing the government to cut its budget, leading to higher unemployment and reduced social benefits for the people of Greece.

If investors were to look at the growing budget deficits in other developed countries and then suddenly lose faith in other government's ability to pay back their debts, then a similar crisis could occur in much larger economies, including the UK, Germany and the United States. Therefore, these countries have begun reducing deficits and rolling back stimulus spending: measures that may just plunge their economies into an even deeper recession than that of the last two years.

The videos below show the leading intellectuals on both sides of the stimulus/austerity debate presenting their arguments. Below each video are discussion questions to help guide your understanding of their views. Watch the videos and respond to the discussion questions in the comment section below.

Video 1: Krugman argues for continued stimulus

Discussion Questions:

1. What are the two 'profoundly different views of economics' that are being tested as governments begin rolling back the fiscal stimulus packages of the last two years?
2. What are three characteristics of an economy in a 'depression' according to Krugman?
3. What is 'budget austerity' and why does Krugman think this should not be the first priority of policymakers in the G20 nations?
4. Why is deflation dangerous according to Krugman?
5. What is the additional annual cost to the US government of borrowing and spending an additional trillion dollars now? What is the potential additional benefit of more stimulus?

Video 2: Ferguson argues for austerity and 'fiscal regime change'

Discussion Questions:

- Why might the US have to pass spending cuts and tax increases to maintain its 'credibility in international bond markets'?
- Why would fiscal tightening 'choke off the recovery'?
- How is the financial crisis in Europe a warning to the US?
- How could the 'costs' exceed the 'benefits' of deficit financed expansionary fiscal policy.
- Ferguson proposes a new type of policy that 'boosts confidence'. Why will expansionary fiscal and monetary policies fail if private sector confidence remains depressed?