

## Brown needs to apply reverse thrust to Reagan theories

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America has said goodbye to one of the last great deficit spenders. Many eulogies have been paid to Ronald Reagan: victor in the cold war, the man who made America smile again. Most glossed over the unsavoury parts of his record - the Iran contra scandal, the attacks on labour, the pro-rich bias of policy - and were generous to a fault when it came to what George Bush Sr called the Gipper's voodoo economics.

In this respect, Reagan was firmly in the camp of rightwing politicians who acted like the most extreme Keynesian, amassing huge deficits as a way of pump-priming growth and remaining confident that the budget would eventually come good. Surprise, surprise, the deficit ballooned, not least because the tax cuts were accompanied by the big increase in defence spending - military Keynesianism - that the Kremlin could not hope to match.

It's tempting to say that Ronnie was the last of a breed that included our own dear Ted Heath, but that would be incorrect. George Bush Jr is a fully paid up disciple of Reaganomics, and the cost of the war on terror together with the tax handouts to the better off have had the predictable outcome of turning an inherited budget surplus into a \$500bn deficit within four years.

All this turns received political wisdom on its head. Traditionally, the Republicans were the party of sound money, the Democrats the deficit spenders. In the recent past, however, it has been Reagan and the current occupant of the White House who have been the spendthrifts, Bill Clinton - under the tutelage of Fed chairman Alan Greenspan - the deficit hawk.

The American experience is a useful antidote to the view that fiscal policy no longer matters. In both the Reagan and Bush Jr years, deficit spending has dovetailed with easier monetary policy to support growth. There is nothing wrong with running deficits when activity is weak, provided that policy-makers are prepared to accept the inevitable corollary: that surpluses should be run in good times. This part of Keynes's thinking is harder to swallow and Jacques Chirac pointedly noted at last week's G8 summit that the size of the US trade and budget deficits posed a potential threat to the stability of the global economy.

Doubtless this was said with tongue firmly in cheek, given France's flagrant flouting of Europe's stability and growth pact and its determination not to bow to fiscal orthodoxy.

Good for Chirac, who can boast of stronger growth than his neighbour Gerhard Schröder. Neither France nor Germany took advantage of the late 1990s boom to tighten policy, which was a mistake. Whereas Berlin responded to the global recession of 2001 by tightening policy, Paris let the budget deficit take the strain. The Germans held their structural deficit steady at 2.8% of GDP between 2001 and 2002, then cut it to 2.3% in 2003. The French allowed the deficit to increase from 1.9% of GDP in 2001 to 3.2% in 2002 and 3.3% in 2003.

Given that the eurozone's problem has been a lack of domestic demand, the Gallic approach makes more sense, and it is not at all surprising that - as Charles Dumas of Lombard Street Research puts it - the French hare has been outpacing the German tortoise. "With the euro still strong enough to inhibit export growth," Dumas says, "France's pragmatism over government deficits contrasts with Germany's doctrinaire pursuit of balance."

Both, of course, have performed less strongly than the US, and two recent studies from the Organisation for Economic Cooperation and Development and the European commission provide a possible explanation. The papers suggest that monetary policy in the euro area is less effective than in the US, and one obvious consequence is that fiscal policy may need to become a more important tool of demand management. The Europeans have always been wary of this route, expressing concern that it is hard to judge the right policy response and that the effectiveness of fiscal easing is limited by import leakage. But, as Anthony Thomas of Dresdner Kleinwort puts it, calibrating the fiscal policy response means governments should err on the side of caution "but that doesn't mean they should do nothing at all. Import leakage may be a problem for an individual member of the euro area adopting a counter-cyclical fiscal policy, but less so for the euro area as a whole."

France seems to recognise the sense of this. The stability and growth pact - too much stability, too little growth, according to the former French finance minister Francis Mer - is effectively dead, but Europe's economy is still growing far more slowly than the US's.

The bog-standard explanation for this is that Europe is riddled with too many structural rigidities in its labour and product markets, but the OECD makes clear that macro-economics has played a big part as well. In particular, the monetary policy transmission mechanism in the eurozone is weaker and slower than in the US. The result is that it takes longer to adjust to a shock and requires a stronger policy response.

There are two points here. One is that the European Central Bank has been more cautious than the Federal Reserve: the ECB has cut rates from 4.75% to 2% but the Fed slashed US rates from 6% to 1%. Given the transmission problems identified by the OECD, the ECB should have been ahead of the curve, but has tended to be behind it.

The second point is that even if monetary policy is effective in a common currency area there needs to be a greater role for fiscal policy in smoothing out differences in performance between parts of the zone that are booming and those that are struggling. If monetary policy is not as effective as it should be, there is an even stronger case for fiscal policy playing a more active role.

The good news for the eurozone is that the economy does at last seem to be on the mend. The less good news is that the recovery is still over-reliant on exports as the main engine of growth, and this makes it vulnerable to a downturn in the US and China. The bad news is that fiscal policy is still a total mess, which is one reason for Gordon Brown's cautious approach towards monetary union.

It is hard to dispute that Britain would be exchanging a sound fiscal regime for a far inferior model in the event of having to sign up to the stability pact. Unpopular though the decision was to run a tight fiscal policy in the first two years of Labour rule, from a macro-economic standpoint it was the right thing to do. The economy was growing strongly in the boom of the late 1990s, and it was an appropriate time to put money in the bank.

As a result, when the downturn came following the dotcom meltdown, there was scope to turn on the public spending tap. The resilience of the economy was in no small measure due to the extra jobs created in the public sector, with a multiplier effect as the newly employed spent their wages as consumers.

The challenge for the government now is to get its current account back into surplus as growth strengthens. Effective use of fiscal policy for demand management requires enough firepower to make discretionary policy effective, and that is the point of Brown's golden rule. Balancing current spending over the economic cycle avoids the indiscipline of Reaganomics, but it does give him the scope for a structured activism that the eurozone sadly lacks.