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Assessment of tomorrow

By: Kenneth Rogoff

The anti-austerity movement has lost both momentum and intellectual credibility

To understand the populist revolt against free trade and other pillars of mainstream economics – a revolt that US President Donald Trump harnessed to his political ambitions with remarkable skill – one must look back to the anti-austerity movement that followed the 2008-09 global financial crisis.

In the aftermath of the crisis, anti-austerity advocates began arguing that the so-called “government budget constraint” is less of an economic necessity than a malign intellectual construct that cruelly restricts social spending and transfers.

In their view, governments – at least in advanced economies – could almost always issue more debt at minimal long-term cost.

During the 2010s, as interest rates – especially on long-term government debt – fell to historic lows, the anti-austerity case seemed not only politically convenient but also, to many, intellectually compelling.

Even after the US government’s debt-to-GDP ratio rose by nearly 40% in the years following the 2008 crisis, many economists asked: Why not borrow more?

The answer was that much of the debt was relatively short term, leaving the United States highly exposed to rising interest rates.

After the COVID-19 pandemic, as interest rates returned to more normal levels, US debt-service costs more than doubled, and they continue to climb as older bonds mature and must be refinanced at higher rates.

While many politicians have yet to grasp the implications, the adverse effects of elevated debt and higher interest rates are already materializing.

The welfare state is no longer affordable

In Europe, the shift is just as striking. German Chancellor Friedrich Merz has openly declared that the welfare state, at least in its current form, is no longer affordable.

European countries already face sluggish growth and aging populations, and now they must also boost defense spending – an expense anti-austerity advocates may have little patience for, yet one that is increasingly unavoidable.

Historically, most debt and inflation crises have occurred when governments that could have met their obligations in full instead chose inflation or default.

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Once investors and the public sense a government’s willingness to resort to such heterodox measures, confidence can evaporate long before debt appears excessive, leaving policymakers with few options.

Thus, while the theoretical ceiling for government debt may be very high, the practical limits are often much lower.

This does not suggest that there is a precise threshold at which debt becomes unsustainable – there are simply too many variables and uncertainties at play.

As Carmen Reinhart and I noted in a 2010 paper, debt dynamics are akin to speed limits: driving too fast does not guarantee a crash, but it does increase the risk of one.

The loss of fiscal flexibility

For advanced economies, the real danger posed by high debt is not imminent collapse but the loss of fiscal flexibility.

Heavy debt burdens can limit governments’ willingness to deploy stimulus in response to financial crises, pandemics, or deep recessions.

Moreover, history shows that all else being equal – currency dominance, wealth, and institutional strength – countries with high debt-to-income ratios tend to grow more slowly over the long run than otherwise similar economies with low debt.

Even so, Reinhart and I were harshly criticized for an informal 2010 conference paper that examined the well-documented link between high public debt and slower growth using newly compiled historical data from our 2009 book This Time Is Different.

> Recognizing that governments must be mindful of debt does not automatically imply a need for austerity

The attacks escalated in 2013, when three anti-austerity economists claimed the paper was riddled with errors and argued that, once corrected, the data showed little evidence that high debt constrained economic growth.

In reality, their critique relied heavily on selective citation and polemic misrepresentation.

Our paper did contain a single error – not unusual in early, informal work that is not peer-reviewed – but nothing beyond that.

Crucially, recognizing that governments must be mindful of debt does not automatically imply a need for austerity.

Raising taxes or a moderate burst of inflation, as I argued in 2008, can sometimes be the lesser evil.

A dangerous illusion

The full, published version of our paper, published in 2012 and based on a larger dataset, contained no errors and reached nearly identical conclusions – a fact that the anti-austerity camp continues to ignore.

Since then, dozens of rigorous studies have consistently linked high debt levels to slower growth.

The free-lunch logic underlying anti-austerity economics has been exposed for what it always was: a dangerous illusion

The precise causal channels are still the subject of debate among economists, but the evidence is overwhelming.

Much of the confusion seems to stem from the common mistake of conflating debt with deficits.

While deficits are an effective tool and are absolutely necessary during crises, large legacy debts almost always act as a drag on growth and leave governments with less room to maneuver.

The anti-austerity movement has lost both momentum and intellectual credibility in recent years, partly owing to post-pandemic inflation but more fundamentally because real interest rates appear to have normalized.

As a result, the free-lunch logic underlying anti-austerity economics has been exposed for what it always was: a dangerous illusion.

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