A double dip is a price worth paying

By MARTIN FELDSTEIN

Critics of the *European countries' decisions to front-load their deficit reductions* miss the importance of seizing the current moment of crisis to take politically difficult budget actions.

If the timing of the fiscal consolidation were just a technical economic problem, the right policy would be to enact a multi-year budget that starts with little or no deficit reduction for the first two years, followed by a rapid return to budget balance. The slow start would be particularly appropriate in those countries where aggregate demand is now very weak.

But such a gradual adjustment strategy cannot work politically in countries where voters are sceptical about government promises of future deficit reductions. Immediate action is necessary to make future deficit cuts credible. And painful cuts in government pensions and in public payrolls as well as increases in personal taxes may only be possible while there is a sense of crisis throughout Europe.

Unfortunately, the front-loaded deficit reductions may push economically weak countries into recession for the next year or two. That is the cost of achieving the needed long-term deficit reduction in the current economic and political environment. The countries are nevertheless right to accept that bitter medicine in order to get on the right longer term path.

However, government officials are not warning the public that this is the choice that they have made. Instead they are claiming that the front-loaded fiscal deficit reductions will not weaken the economy in the short run. They argue that the increased confidence that will result from the prospect of lower deficits will lead to enough increased spending by consumers and businesses to actually raise the short-term pace of economic activity.

I think that is unlikely to occur. Although the increased confidence may eventually lead to increased spending, it will not be strong enough in the short run to outweigh the immediate contractionary effects of reduced government spending and higher taxes. It is even possible that the resulting economic slowdown will cause the cyclical component of the budget deficits to rise temporarily, offsetting part or all of the legislated reductions in the structural part of the fiscal deficits.

Although a country like Germany may avoid the downturn because the recent fall in the value of the euro will boost its exports to the rest of the world, other eurozone countries that trade mainly within the eurozone will not see a boost in exports from the lower value of the euro. The result will be double dip downturns that raise unemployment.

How will voters react in 2011 and 2012 if they see an economic downturn and relatively little deficit reduction after being promised that the cuts in government programs and increases in taxes would have immediate favourable effects? There is a danger that they will pressure governments to cut back on the future fiscal consolidation. It would be better for European

officials to warn voters that fiscal consolidation will bring with it the risk of a temporary decline in economic activity and a rise in unemployment.

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