By Jonathan Davis
Published: June 13 2010 11:16 | Last updated: June 13 2010 11:16

Paul Krugman, the Nobel Prize winning economist, was in top thundering form in his comments on the recent meeting of G20 finance ministers, which produced a noticeable change in political rhetoric by welcoming the plans by several countries to tackle their hefty budget deficits.

“It’s basically incredible that this is happening with unemployment in the euro area still rising, and only slight labour market progress in the US,” he fulminates. Bowing to demands from the financial markets for fiscal austerity is “utter folly posing as wisdom”.

“Don’t we need to worry about government debt?” he goes on, “Yes – but slashing spending while the economy is still deeply depressed is both an extremely costly and quite ineffective way to reduce future debt.” The right thing would be to wait until after the economy is strong enough to allow monetary policy to offset fiscal austerity. “But no: the deficit hawks want their cuts while unemployment rates are still at near-record highs and monetary policy is still hard up against the zero bound.”

The intellectual credentials of Prof Krugman are not in question. But is he right to warn that even starting to tackle the fiscal imbalances today dooms us to another recession, or even depression? The alternative view, more popular in the circles I frequent, is that tackling debt with yet more debt is a far surer way to long-term ruin. Postponing the evil day, after all, was at the heart of the Federal Reserve’s failings in the later years of Alan Greenspan’s tenure and helped to land us where we are today.

Not even to begin laying the ground for reductions in public spending today, let alone to confront the huge unfunded liabilities that lie beyond budget planning horizons, makes little sense. On past form it will take years for any cuts announced today to be fully implemented, if indeed they can be achieved at all. Just as 364 economists turned out to be wrong when they denounced Sir Geoffrey Howe’s infamous 1981 UK budget, it is not axiomatic to me that Prof Krugman and co are right this time.

In any event it is surely debatable to blame the imminence of spending cuts mainly on pressure from the financial markets. It is not, after all, as if the “bond market vigilantes” have been much in evidence recently. Long-term bond yields have been falling, not rising. Pointing out the inconvenient fact that Greece and other countries have unsustainable fiscal problems is hardly an insight confined to a few hedge fund managers.

What really seems to affront the liberal academic mind is the idea that financial markets – irrational, greedy and capricious as they indubitably can be at times – should be seen to be driving public policy in any way. Unfortunately, a good deal of the argument about fiscal consolidation is about the timing of economic recovery, the appetite for risk in the private sector and the second and third order effects of fiscal tightening. This kind of judgment in my experience has never been the forte of economists.

I take more comfort from Paul Volcker, who as a former chairman of the Federal Reserve has a gold-plated track record in dealing with the consequences of past financial excess (and was rightly lauded by Prof Krugman, among others, for that achievement). In a recent article in the New York Review of Books, after discussing his plans for banking reform, Mr Volcker observes: “The critical policy issues we face go way beyond the technicalities of law and regulation of financial markets.

“There is growing awareness of historically large and persistent fiscal deficits in a number of well-developed economies. The risks associated with the virtually unprecedented levels of public debts as we emerge from recessions are evident. In California, as in my own state of New York, it’s not a matter of intellectual awareness but of practical confrontation.”

He goes on, for the benefit of US readers, to make a comparison with the tribulations of the Eurozone in its “struggle to maintain the common European currency, to rebalance the European economy and to sustain the political cohesion of Europe. Amounts approaching a trillion dollars have been marshalled from national and international resources to deal with those challenges. Financing can buy time, but not indefinite time. The underlying hard fiscal and economic adjustments are necessary”. That sentiment is surely unquestionable. There is no doubt that the hand of history is sitting heavily on the shoulders of the current generation of political leaders. They have critical judgments to make, and insufficient evidence to be sure that their decisions will turn out right. Mistakes are inevitable. The markets certainly have no monopoly on wisdom either – just look at their apparent readiness to lump in Hungary, a paragon of virtue in fiscal terms, with Greece.

But the time for procrastination, as Mr Volcker is right to observe, is passing.

www.independent-investor.com