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UK austerity v US stimulus: divide deepens as eurozone cuts continue

The emphasis in Europe is on fiscal rigour and slashed budgets, but there is a growing awareness such policies are not working.

- Phillip Inman, Ian Traynor in Brussels and Dominic Rushe in New York

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As George Osborne digests the warning shot across his bows from Moody's and prepares to make his third budget speech, debate is intensifying over whether austerity measures in Britain and Europe are working.

In the US and across Europe, academic economists and policymakers are dividing as the improving American economy – unemployment is falling – suggests that the Obama administration's policy of trying to delay cuts is preferable to the brutal shrinking of the state being pursued on the other side of the Atlantic, where more and more people losing their jobs.

Osborne has sold his plan for the UK as the only way to avoid becoming another Greece. In the US, rightwing academic economists have raised the prospect of Washington becoming another Athens without a concerted attack on public services. Daniel Mitchell, of the libertarian-minded Cato Institute, argues that Europe has not been austere enough and that much more is needed. "European countries talk about austerity but they don't mean cuts," he says.

In Brussels, right-of-centre German economists, who until recently dominated the European Central Bank's main decision-making board, lobbied for a "can't-pay, won't-pay" stance towards southern European countries seen as profligate spenders who need to understand the moral hazard of raising their living standards on a mountain of debt. These economists, with many sympathisers inside the Brussels bubble of officials and advisers, argue that no amount of rock-throwing by protesters should dissuade politicians from cutting the size of state borrowing by reducing the size of welfare provision.

Osborne is bang on message with the Austerians. His budget speech on 21 March will have the same emphasis as his first two. Government spending will rise over time, but much more slowly than was planned before 2008. The rising costs of running a government means extensive cuts will continue to be necessary.

The Institute for Fiscal Studies warned in its most recent assessment of the government's finances that more than 80% of Osborne's spending cuts had yet to take effect. Housing benefit, tax credits and child benefit all face severe cuts over the next year and beyond.

Labour has criticised the government for going too far too fast. It argues that the aggressive nature of the coalition's cuts has given the public sector little time to implement reforms that would improve services as well as deliver lower spending. There is a wider point, supported by Keynesian economists such as Lord Skidelsky and David Blanchflower, a former member of the Bank of England's rate-setting committee, that governments need to keep supporting the economy through spending.

Businesses as much as households want to know that the state is willing to step in, not just to rescue banks but to invest in infrastructure and maintain the fabric of public services, otherwise they will stop investing or invest abroad. With the threat of a downgrade by the ratings agencies hovering over the UK, Labour says Osborne should have lobbied hard in Brussels for a co-ordinated spending plan that would leave the ratings agencies gasping but unable to act.

He might have been pushing at an open door. While the emphasis in Europe is overwhelmingly on fiscal rigour, slashed budgets and longer-term structural reforms, there is also a growing awareness that policies are not working, that something has to give as the sovereign debt crisis impacts ever more directly on the real economy in the form of soaring unemployment and a new credit squeeze.

"More people are openly questioning the economic logic of fiscal austerity at a time of pronounced private-sector weakness. The spectre of Greece and Portugal is putting advocates of the current strategy on the defensive," says Simon Tilford, chief economist at the Centre for European Reform thinktank. "But there is scant acknowledgement that growth will require expansionary macro-economic policies or the dismantling of huge trade surpluses in places like Germany."

There has also been a hint of a rethink at the International Monetary Fund and some of the ratings agencies. Officials at Standard & Poor's and the IMF have issued statements warning of the perils of quick and severe cuts. Like Labour, they argue that a bit more time for reforms could prove beneficial, albeit that these are hardline, supply-side reformers that principally want the burden of flexibility to fall on workers.

Reflecting a partial shift in policymakers' thinking, an EU summit two weeks ago formally focused on "growth and jobs". Another Brussels summit in two weeks' time is to have the same emphasis.

Germany's Angela Merkel, austerity's cheerleader, has dominated the debate for the past two years and faced few formidable challengers. But François Hollande, the Socialist frontrunner for the French presidency in May, as well as Mario Monti, the new Italian prime minister, are both calling for a recalibration, the better to balance discipline with stimulus.

"We need to talk not only about fiscal discipline, but also about growth. But we need to find more substance to it," says a government minister from a eurozone country

That effort is hampered, however, by the acute differences in perception on the crisis – its roots, causes, and cures. In Germany, the key to the euro's fate, there is no crisis. That makes it very difficult to mobilise resources to fix other people's problems. While youth unemployment in Spain or Greece is at 50%, the German jobless rate is at its lowest in 20 years.

A senior European diplomat says it is almost impossible to forge an effective consensus on what to do when the predicaments of national economies across the eurozone are so varied. "The problem with this crisis is the Germans don't feel it. That makes it more difficult for Merkel. It's something happening somewhere else. In that sense, I've never seen a crisis like this before."

Guntram Wolff, deputy director of the Bruegel economics thinktank in Brussels, says: "Some say the Germans should do more fiscal stimulus. But there's no need for that given the situation in the German economy. It's booming. The eurozone needs fiscal stimulus, but Germany can't deliver it because the only reason is to support others. German decision-takers are accountable to German voters."

The conflict about austerity versus stimulus may be seen as a clash of cultures fundamentally between the US and Germany. "US policy is always directed towards ensuring robust growth in domestic demand," says Tilford. "By postponing austerity, the Democrats enabled the necessary private-sector deleveraging to take place without forcing the US economy into a slump. In Europe, too many countries are attempting public and private deleveraging at the same time. Underpinning European thinking is essentially a small country mentality – exports will somehow offset the contractionary impact of all this. Of course, this is largely a fallacy. Not all European economies can rely on exports."

The US is home to some of the most prominent anti-austerity voices. Paul Krugman, the New York Times columnist and Nobel laureate, has railed against Europe's approach. "Britain, in particular, was supposed to be a showcase for 'expansionary austerity', the notion that instead of increasing government spending to fight recessions, you should slash spending instead – and that this would lead to faster economic growth," Krugman wrote recently.

But the policy has been a total failure, he argues. "It turns out that by one important measure – changes in real GDP since the recession began – Britain is doing worse this time than it did during the Great Depression."

Europe is also stymied by the fact that, unlike the US, it does not have the policy levers or instruments available for concerted fiscal stimulus. The EU budget is not up to the task. There is no eurozone lender of last resort. The European Central Bank's role is not to prime the eurozone economy, although its three-year banking liquidity operations are widely seen as the single most important response of the past year in containing the crisis.

As a result of the debt shock, the eurozone may be acquiring some of the instruments it needs, but very slowly – for example a permanent bailout fund, effectively an embryonic European Monetary Fund. But its current resources are too meagre to supply a robust firewall against, for example, an Italian emergency.

"In Europe we don't have an appropriate instrument to do anti-cyclical fiscal policy," says Wolff. "In the US you have the federal level running anti-cyclical fiscal policy."

With policymakers increasingly resigned to the likelihood of a Greek default and an exit from the euro, despite the current machinations over a second €130bn bailout, the eurozone may be heading for an even bigger debacle. The culprits can be easily identified in a dysfunctional Greece as well as among the dogmatists dominating the country's eurozone creditors. There's enough blame to go round.

And it may be too late to change track. "The Austerians have won the argument in the eurozone, at least for the time being," says Tilford. "As their medicine proves counter-productive in Spain and Italy as it has in Greece, Ireland and Portugal, opposition will mount, of course, but the risk is that much more damage will have been done by then."

And as unemployment soars in southern Europe, it may become paradoxically more difficult to implement the structural reforms – such as labour market changes – generally viewed as essential.

"As the social dimension gets more toxic, the political will for change dissipates," says Wolff. "The more the growth agenda is absent, the more of a backlash you're going to get against the whole European project."