The Case Against Deficit Hawks

Absurd Austerity Policies in Europe

Philip Arestis and Theodore Pelagidis

Austerity policies again prevail in Europe as well as in the United States. These economists, based in England and continental Europe, focus on the poorly understood damage that the austerity mania will almost certainly do on their side of the Atlantic. Why is it happening? There is no rational answer.

The purpose of this short article is to investigate the wisdom of the fiscal austerity in Europe. This is important in that, before this recent hysteria at fiscal contraction, fiscal stimulus was thought to be the appropriate macroeconomic tool to save us from another Great Depression. Those attempts, by the United States, the UK (before May 2010), and a number of European and other countries in the world, managed to contain the seriousness of the situation so that only a "second Great Recession" rather than a Great Depression emerged. Continuing the same economic policies would give us faster growth even beyond what has materialized. By contrast, a dangerous austerity period has been initiated, following the election of a new government in the UK and, more important, the June 2010 meeting of the G20, the result of which, we very much regret, will be quite painful for all of us. We are just about to witness a worsening of the economic situation. It is this paradox that we wish to discuss in what follows.

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Austerity Policies in Europe

In tandem with most European governments, George Osborne, the UK chancellor of the exchequer, in June 2010 announced drastic cuts in the government budget in an ostensible effort to avoid the possibility of another Greek-style technical default. It coincided with the outcome of the June 2010 G20 meeting deliberations that dropped support for fiscal stimulus and emphasized again the risk of having sovereign debts get out of control, despite President Barack Obama's negative reaction. In the U.S. case, cuts are happening in an environment where the politicians seem to be incapable of directing the not-so-big stimulus in productive directions, while at the same time too much of the stimulus was in inefficient tax cuts.

The critical issue in terms of this short experience is whether we need more and cautiously directed stimulus to enable the global economy to retain the current economic activity or whether we need a fiscal solution. Keynesian measures have worked so far, as shown by a few examples. Witness the GDP growth rates in the second quarter of 2010 (on an annualized basis): a decent 4.8 percent in the UK, a healthy record level of 8.8 percent in Germany, and a rather disappointing but still acceptable 1.6 percent in the United States. However, Keynes never claimed either that his proposed policies could make a "one-night magical delivery" or that they could correct at once all past irrational exuberances that unregulated markets produced. In Keynes's way, delivery might become smoother and with the least possible negative repercussions, especially if appropriate monetary accommodation complemented systematic spending.

On the contrary, a coordinated fiscal retrenchment in the EU-3 (Germany, Britain, and France), as Osborne supports, will mean that the entire EU will suffer, in particular its weakest members. It will erode further their domestic competitiveness and decrease demand for their exports. The result will be a persistent current account deficit for the EU Mediterranean countries (Portugal, Italy, Greece, and Spain), which will require corresponding capital inflows. These inflows could not be in the form of foreign direct investment (FDI) in the context of a falling domestic competitiveness, in view of their inability to alter the exchange rate because they are members of the Economic and Monetary Union (EMU), and thus are subject to its restrictions, and the loss of confidence by the financial markets. These Mediterranean countries will therefore have to sell more bonds at a higher rate of interest to finance a persistently high deficit in their current account. Then, EU banks, keeping Mediterranean bonds on their balance sheets, will probably experience deterioration in their position again.

In sum, if a contractionary, Hooverite, "post–Great Recession"–era policy finally prevails globally and especially around Europe, the UK and similar countries might find it even harder to drive their economies through an export-led policy medication. It would then be easy to predict what will happen to those banks keeping toxic skeletons in their closets. Another bank crisis of the kind we had in August 2007 may very well ensue, with the banking sector simply freezing as a result of loss of confidence and quite possibly bank bankruptcies.

We argue in this short piece that the spectrum of austerity policies is haunting Europe. All the powers of old Europe have entered into an unholy alliance to form this spectrum, about which all of us should be depressed.

The Puzzling Nature of This Absurd Fiscal Austerity

This recent decision in support of austerity measures in most eurozone countries marks an unfortunate sudden turn in the mood regarding the prospects of the European economy, in particular its weakest

member-states. More concretely, it is puzzling why there has been a sudden drop in support of the fiscal stimulus and the emphasis on the risk of oversized sovereign debts and overstated fears of high inflation. Clearly, then, in the near future, the degree of puzzlement will be magnified. Along similar and equally theoretically puzzling lines, and over the recent past but definitely since the May 2010 Greek debacle, most European governments announced drastic cuts in government expenditure in a purported attempt to avoid the possibility of a Greek-style technical default. At the same time, new developments in the eurozone have emerged. Italy has to renew €120.85 billion in bond obligations and another dose of €104.22 billion in Treasury bills, with interest payments on debt totaling roughly €23.62 billion. The interest rate on the ten-year bond obligations of the Belgian government reached 3.5 of 7–7.5 years.

Similar developments are expected from other core eurozone countries, such as Austria, which has a banking system that closely depends on the ability of Hungary and other European countries (Iceland and Ireland are the obvious ones) to pay back debt obligations without any significant debt restructuring (haircuts). French banks are also thought to be heavily loaded with €75 billion worth of Greek toxic bonds; one can now understand French president Nicolas Sarkozy's furious campaign to bail out Greece. Greek default will cause many bank losses in France and in other European countries that hold such Greek debt.

Spain, Greece, and Portugal are expected to have added together €2.2 billion worth of toxic assets to EU banks' balance sheets. According to the 2010 annual report recently published by the Bank for International Settlements (BIS 2010), French and German banks are exposed no less than 61 percent to the debt of the above Mediterranean member states. In Spain alone, French exposure is about €184 billion ($248 billion) and that of Germany about €150 billion ($202 billion). The value of these assets hidden in banks' balance sheets has already plunged, threatening bank solvency, choking off lending, and leaving the taxpayers of such solvent countries as Germany with a Hobson's choice: foot the bill for the profligacy of Greece and other eurozone countries in similar positions or bear the expense of bailing out their own banks. Doing neither, for now at least, appears to be unthinkable.

One may very well wonder why this sudden emphasis on austerity has emerged even in countries with strong balance sheets, when one of the well-known lessons of history is that, in times of recession, fiscal stimulus is the best medicine. The answer, however, to the question of why the continentwide approach has turned toward austerity can easily be explained. If state budgets are restricted, so the magical thinking goes, wonderful things will happen. Sovereign bond prices will rise, rescuing imperiled banks. Moribund interbank lending will be resuscitated. Government borrowing costs will decline. Economies will be reinvigorated. The embrace of austerity is also easier to understand in a political context. It is clear that European politicians are incapable of directing stimulus toward productive public investment, and the public continues to reject tax increases to cover the future deficits that today's stimulus would create. But this belief of the politicians does not, surely, emanate from the writings of Keynes or Keynesian policies, as some authors wrongly ascertain (see, for example, Sachs 2010). It is clearly a belief that springs from the incapable politicians, who fail to direct stimulus to foster aggregate demand. But even this kind of "just spending Keynesianism" currently prevailing in the United States—that is, mixing consumer and investment budgetary expenses together with some tax credits—forgets that it saved the system from collapse in 2009 and subsequently retained, to a great extent, a certain satisfactory level of economic activity, stabilizing the economy (Tyson 2010).

It is actually the lack of more powerful and, mainly, more systematic stimuli, especially in surplus countries such as Germany or Japan, that threatens today to raise the risks of a double-dip recession, which may not have a 40–50 percent probability. In Europe in particular, the near-absence of a stimulus has indeed brought the eurozone close to dissolution. And to repeat the comment made above in an attempt to clarify the point, it is the deep and prolonged recession that finally revealed member-states' huge public debts and made borrowing very expensive for most of the member-states and unbearable for others

(Greece being the typical example). Banks are severely hit as they keep trillions of undervalued sovereign bonds hidden on their balance sheets; and nobody really knows which and how many banks are in this tragic situation. But would draconian cuts in the context of a very fragile growth rate solve the problem? Surely not.

The problem is that embarking on austerity increases the risk of dreaded outcomes in Europe, including negative growth of the gross domestic product, sovereign default, political instability, and shuttered capital markets. These outcomes make bank failures more likely, not less. The critical issue, however, is whether we need more and cautiously directed spending to offer more room to the global economy to retain the current economic activity or whether we need to draw the stimulus to an end. Nobody would disagree, for example, with safety nets or government support to postsecondary education, investment in clean energy, and new transport infrastructure, as some of the authors seem to be suggesting. After all, these are all Keynesian measures indeed. To be fair, some of the authors who are in a rush to denounce Keynesianism, such as Sachs (2010), also reject draconian cuts in spending. But the dilemma is still there.

As for the "overborrowing" of Greece, and that of other European countries in a similar position, this should be attributed neither to "naive Keynesianism" nor to the corrupted and rotten society, phenomena that surely exist but are usually overstated (Arestis and Pelagidis 2010a, 2010b; Reid-Henry 2010). The great culprit for the faltering economy lies with the macroeconomic prescription that has been implemented over the past decade. The absence of appropriate domestic economic policies, in view of the EMU arrangements in which the countries do not have interest-rate policies in their hands (the European Central Bank's [ECB's] interest-rate policy is what matters) and the Stability and Growth Pact that does not permit governments to run fiscal policies as a stabilization instrument, has produced an extremely hard euro policy that has eroded domestic competitiveness and increased demand for imports. The result was a ballooning current account deficit that reached 14 percent of GDP in Greece in 2008, a deficit that requires corresponding capital inflows.

As elaborated above, these flows could not be FDI in the context of a falling domestic competitiveness. Government thus had to take over and sell bonds to finance a fast-deteriorating current account as the hard currency was fueling domestic consumption by making imports cheaper and more competitive.

The question still remains, though, what should be the right policy to avoid a painful dissolution of the EMU, as the weakest Mediterranean countries seem not to have room to stabilize their economies. One may indeed raise the point that a country such as Greece, which has come so close to default, has no other option but to crack down on its deficit through austerity fiscal measures. Still, we should not forget the responsibilities of the EMU. It follows that what the EMU could and should have done at an early stage in the proceedings, and still should do now, is to protect the euro area and its weakest regions.

There are actually three options with regard to policy matters that are at odds with what the G20 have decided in the first week of June 2010. First and foremost, the ECB should continue to sterilize the market from toxic sovereign bonds; that is, use its balance sheet to buy as many toxic bonds as necessary to stabilize the market. It should also extend its intervention if necessary. As a number of commentators have suggested for the Fed, the ECB could also buy more long-term public debt, buy private-sector debt as well, and raise its long-term inflation target. Second, the ECB should lower its interest rates further, preferably near the Federal Reserve's level—that is, close to 0 percent. Third, countries with huge surpluses, such as Germany, should be convinced to spend more and tax less, which means smaller current-account deficits for the weaker EMU partners and possibly a little more inflation for Germany. In any case, it is completely absurd for any surplus country within a monetary union, like Germany in the case of the EMU, to implement austerity measures with a current-account surplus on the books. As De Long (2010) rightly suggests, Germany, the United States, Japan, and even Britain need not be austere, and the best they can do to relieve the global depression is to engage in coordinated global expansion, at least for now.

To those arguing that German chancellor Angela Merkel will definitely not change policies, the answer is that Germans have already taken to the streets, and in case the opposition takes power sometime in the future, one should not be surprised to see a U-turn in the macro policy prescription. It is also possible, in a double-dip recession scenario in the eurozone, that Germany may finally be obliged to change its current policy course to avoid possible eurozone dissolution.

Conclusion

In conclusion, if a contractionary policy era finally prevails globally—the United States included, especially in Europe—Greece and similar countries might find it even harder to drive their economies through an exports-led medication. It would then be easy to predict what will happen to those European banks—German, French, or British—that keep toxic skeletons in their closets. This austerity mania will then hit us all very hard.

For Further Reading

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