Austerity: the History of a Dangerous Idea

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Before we get to the Theory

Its useful to know why I’m interested in this question...
Europe is not in Great Fiscal Health

(Central government debt as percent of GDP, 2012)

Source: Standard & Poor’s from national sources
So What Brought About this “Fine Mess?”
ECB ‘Credibility’ or the Greatest Moral Hazard Trade in Human History?
This is what happens when you stuff your boots with periphery debts-gone-bad

Foreign banks combined consolidated claims on Greece, Ireland, Italy, Portugal, Spain (% GDP 2011)
The result is...
Assets held by banks in Germany, France, and the UK are about double the annual GDP of the entire EU

- Gross contribution to GDP and Bank Assets in the EU (millions of EUR)
For Comparison – The “too Big to Fail” USA

Bank Assets (millions of USD)

Bank Assets (% of GDP)

[Graphs showing bank assets compared to GDP, with categories for GDP, Other, Wells Fargo, Citigroup, Bank of America, Morgan Stanley, JP Morgan, and Goldman.]
At least the Brits have their own currency

Bank Assets (millions of GBP)

Bank Assets (% of GDP)

Bank Assets

- GDP
- Other
- HSBC
- Lloyds
- RBS
- Barclays

GDP

Top 4 Bank Assets

Total Bank Assets
France is the exemplar of the ‘too Big to BAIL’ problem

Bank Assets (millions of EUR)

Bank Assets (% of GDP)
If that goes bad, its game over for the Euro and the core banks
...which is why we have Austerity policies...

Keeping the periphery in at all costs

- Stopping the Bank run round the bond market...

But...

You Can’t Solve a Banking Problem with Budget Cuts
You Can’t run a Gold Standard in a Democracy
You Can’t Solve a Solvency Problem with a Liquidity Instrument
You can’t all cut at once ands expect to grow
So why did Anyone ever think that Austerity was a good idea?
The “can’t live with it, can’t live without it, don’t want to pay for it” problem of the state

- John Locke’s fifth chapter
- Appropriation, Markets and Money
- Alienation and wages
- Don’t trust the state since it will rob you blind
- But you need it to create the markets you want
“Public Credit will Destroy the Nation”

- David Hume
- Money and Merchants
- The Ease of Debt Issuance
- Crowding Out and Easy Money
“The Practice of Funding has gradually enfeebled every state that has adopted it”

- Adam Smith
- Parsimony, Savings, Investment and Growth
- Inequality and the Necessity of the State
- Taxation to the Rescue?
- Debt and the perversion of parsimony
Locke, Smith and Hume: Producing Austerity by Default

• The “can’t live with/without it and don’t want to pay for it” problem

• The state as the antithesis and catalyst of the market

• Austerity as an absence (state not yet big enough to cut) but also an inevitability that it needs to be cut

• Result: *Liberalism’s Neuralgia and the Aspirin of Austerity*
Two Tracks through 19\textsuperscript{th} Century Liberal Economics

- Can’t live with it and don’t want to pay for it
- Learning to live with it and Accepting the need to pay for it
Track 1A: Liquidationism

- Modern Business Cycle Theory
- Long Run Capital Structure (too much and wrong type)
- Misallocation of capital
- Austerity via Binge and Purge
Track 1B: The Treasury View

- Laissez Faire and crowding out
- “Can Lloyd George Do It?”
- The “Memoranda on Certain Proposals”
- Ricardian Equivalence and Investment
- Lack of Suitable Public Works
Track 2A: The Keynesian Moment (or Teaching Birds how to Fly?)

- The Critical Cases
- Simultaneous contractions in the 1930s
- USA, UK, Germany, France and Japan

- And the result is...
Keynes (and events) Overturn Austerity

• Fallacies of composition and scalability in labor and money markets
• Investment expectations as a social multi-person PD
• “Consumption, repeat the obvious, is the sole end of economic activity”

• Lessons Learned:
• Democracy is asset insurance for the Rich
• Redistribution and Debt is reinsurance for Democracy
Schumpeter Retreats

- Creative destruction over “many centuries”
- Lord Keynes’ Ideas “laughable”
- Bureaucratization and Socialism as the same

**Results:**
- The End of the Entrepreneur
- The End of Bourgeois Virtue
- The End of the Bourgeois Family
Austerity’s Long Winter
A European Home for Austerity

- Late Development and Export Led Growth
- Iron and Rye
- Freiburg and the State
- The economic constitution
- Competition not consumption
- Sound Money and CBI

**Result:** Crowding out Keynes Locally
And an American Pied-a-Terre

- Banks, leverage and credit extension
- Beguiling the entrepreneur
- The allure of debt
- Binge and purge (again)

**Result**: Do not intervene...ever!
Austerity’s Enablers

“It seems to be nothing more than simple and obvious wisdom to compare social institutions as they might be expected actually to operate rather than to compare romantic models of how such institutions might be hoped to operate.”

-James M. Buchanan
Politics Without Romance
The Neoliberal Shift

• Monetarism, Inflation, and the Natural Rate
• Public Choice and Political Business Cycles
• Democracy as a Problem - CBI as the solution
• Ratex, EMH and Ricardian Equivalence

• Result: *Crowding out Keynes Globally*
Road Testing Austerity

- Washington’s Consensus “Stabilize, Privatize, liberalize…and cut the state”
Austerity Enabled

• There is a free Pranzo if you skip your Cena

• Einaudi and the Bocconi School

• Europe as a disciplinary device on states

• Bocconi school as Austerity’s aircraft carrier

• From Milan to Harvard
The Expansionary Austerity Hypothesis

- Debt and time inconsistency
- Credibility and income shocks
- Spending and future taxes

**The New Cases:** Ireland, Sweden, Canada, Denmark, Australia
Austerity as a Policy Paradigm

• Alesina’s Ecofin Brief
• ECB June 2010 Report
• Troika conditionality
• Structure of periphery bailouts (cuts not taxes)

• **Result:** The Greatest Bait and Switch in Human History
But Reality Bites?

• Bocconi School defections
• IMF challenges to EFA hypothesis
• October 2012 WEO and 1.5-1.7 negative multipliers

• The New Cases Aren’t so New
• More debt not less
• The REBLL Alliance and the Debt Star?

• And yet it continues...