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# The Perils of Austerity

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## The Context

In the G8-G20 summits immediately following the 2008 financial crisis, the emphasis was on stimulus and growth. By 2010 two schools of thought emerged, the first advocating more stimulus (Obama in the early years of his administration) and the Europeans led by the Germans stressing fiscal consolidation.

In 2011, the new orthodoxy stemming from the Euro-Zone summit and the G20 summit in Cannes was fiscal consolidation through austerity, i.e. program cuts, laying off public servants, reducing wages and pensions, increasing work hours etc. Coming a week after the Euro Zone, EU and IMF imposition of yet harsher measures on Greece, shocked by the threat of a Greek Referendum and an Italian meltdown, the mainstream view went unchallenged. Even President Obama, preoccupied by his own re-election constraints, a paralyzed bipolar Congress and a Tea Party, breathing down his neck, had to mute his preference for stimulus and job creation and implicitly join the austerity chorus.

## A policy both unjust and, worse still ineffective

Evidence suggests that this strategy is proving to be both *unjust* and *completely ineffective*. The guinea pig is Greece which is proving to be Patient One in a global economic epidemic.

What is this epidemic all about: The growing social fracture between a small fraction of ‘winners’ (1% extremely rich and 10% very rich) at the expense of the large majority of new ‘losers’ (whose numbers are swelling as the middle class, previously the joy of Western civilization, is melting at an accelerated pace).

The main source of Public Sector Indebtedness engendered by the 2008 Crisis was the huge transfer of wealth to the financial sector after the Lehman Brothers default. To save the banks, Governments went into debt with little restraint. When they then found themselves with significant deficits and the Damocletian sword of a downgrade from the rating agencies, (who have now become the self-appointed arbiters of the world economy), they turned upon the common people to eliminate these deficits by ‘austerity’ measures.

Greece’s deficit was due to many causes but one of them was predatory lending where, as in the case of the subprimes, some of the major lenders knew that Greece’s capacity to repay was limited, but counted on credit default insurance to make money either way. Regardless of what the origin of the Greek indebtedness, the main point is that the Common People in Greece, are asked to pay for a debt that they did not incur.

Although the pre-austerity welfare state in Greece was generous to the average citizen, Greek salaries, whether divided by 14 payments or 12, remained among the lowest in Europe. The inefficiencies and bloated bureaucracies were real and were aggravating circumstances in the deficit. So were the tax avoidance and tax evasion schemes, well documented by the press.

But these by themselves, existed for years and in times of growth, were tolerated. . Corruption is morally reprehensible and must be controlled but, it is ubiquitous and exists in varying degrees in most countries including Russia, Italy, France, The United States, and even our own Canada. It is worth noting that the two most corrupt economies on earth the Chinese and the Indian also post the highest growth rates. Therefore abstracting from the ethical questions,

corruption, in itself should be seen as an aggravating circumstance for deficit creation, not its main cause.

This does not mean we have to justify or condone corruption. What it does mean is that the tax evasion by the Common People in Greece (the *hoi polloi*) was not the cause of the current meltdown which was due to a much higher level of corruption by the elite. The culprits are both the local borrowers but also the foreign lenders. As in the case of the subprimes, deliberate predatory lending with the insurance policy of credit defaults, means that a skilled investor can make a lot of money from other peoples' or countries' misfortune. In fact, with interest rates normally low, the ambitious investor stands to make more money repossessing a collateral than being paid back in full. This is true in the case of Greece, where Greek default will enrich many derivative savvy speculators,

At the human level, austerity has been very harsh. With suicide rates doubling, shops closing left, right and center, the Greek population is chafing under the pressure. According to the OECD, no other country has been subjected to such harsh austerity measures in peacetime. Greece sets a new record. The citizens are now resorting to civil disobedience (The I-will-not-pay... movement) because they see themselves, as being forced to pay for other people's extravagance - the Oligarchy of the now hated 300, not the 300 Spartans of old, but the 300 members of the Greek Parliament. They are perceived as observing an *omertà* or mafia-type tacit conspiracy of silence and mutual protection, independent of party affiliation.

### **Counterproductive Results**

Now if austerity were merely unjust but effective, a Machiavellian could conclude

that it is a necessary evil and that Life is unfair anyway. The common people could become cannon fodder to win the accounting battle of balancing the books. Waste not, want not. Be not profligate. Live within your means. Bite the bullet. Make sacrifices. The end would then justify the means to ensure the tranquility of the world economy and not to disturb day traders like myself, quite inconvenienced by the uncertainty that is Greece (... and Italy and Portugal etc.)

But is this what's happening? Taking the evidence of the last two years, as an example, austerity has had the opposite effect : In Greece, *it has worsened the public deficit and for a very simple reason*. The Deficit/GDP ratio cannot be reduced if the denominator, the GDP, falls even further than the numerator. Since public sector expenditures account for between 20 and 40% of the GDP in most countries, a drastic reduction of these expenditures needs to be compensated by a higher increase in private consumption and investment. Otherwise the net effect is counterproductive with a worsening of the ratio.

Under present conditions with an increasingly demoralized population, with less purchasing power, more uncertainty about job security, everyone ends up trying to save for a rainy day and rightly considers that it would be madness to consume.

The idea that diminished government expenditures will in themselves motivate consumers to spend, or businesses to invest, under conditions of frightening uncertainty - belongs to an Alice in Wonderland class of delusions. Whoever really thinks that recently unemployed or the potentially future unemployed will buy new flat screen television sets to stimulate the economy is ignorant of human psychology. In times of danger, we tend to hunker down and lie low. When everybody lies low, the result is

recession and ultimately depression.

The Greek economy is not at a standstill. It is sliding down the precipice to unknown depths, which may include (I sincerely hope not) civil war. Following the Second World War, Greece had a very bloody civil war, whose root cause was class warfare. A repeat is, unfortunately, not out of the question.

The facts are perhaps inconvenient but they are real. Greece went into recession in 2009 after 15 years of sustained positive growth. Since the austerity 'cure' was introduced the Greek economy contracted by 5% in 2011, unemployment rose from 9 to 16.6%, and the *principal metric*, the debt to GDP ratio has gone up from 106% to 152% instead of down.

To top it all, a full 28% of government expenditures go to the payment of interest on the accumulated debt, mainly to foreign creditors. This is clearly unsustainable.

### **Is this really a cure?**

Greece is in a death spiral. But it is not alone. The Indignation Movement in Europe and its sister movement in the US under the name Occupy XXX (Wall Street, banks, business school etc.) are gaining momentum all over the world and are now present in 76 countries.

In spite of all this, government after government is promising blood, sweat and tears to its population, in a completely unnecessary fashion. On November 7, France announced the most severe austerity package in 60 years; the UK, Spain, Ireland, etc. are all applying the same losing medicine and the US middle class must expect a very painful loss of standard of living after the next 2012 election, independently of who wins.

Why is it unnecessary? Because it is based on a wrong diagnosis giving rise to the losing strategy of austerity. From my 25 years of teaching economic history I have learned the following. *Austerity by itself has never rescued a country from depression.* This is certainly not what happened in the 1930s. The Great Depression ended, sadly, with the stimulus package of the Second World War an anti-austerity package par excellence where the production of tanks and guns systematically went up in smoke to produce demand for more guns and tanks whose destination was also to go up in smoke. In the meantime fifty million people died.

### **Positive Outcomes are possible**

To avoid a repetition of this nightmare positive public investment (infrastructure, education, etc.) is desirable to promote intelligent consumption and investment by the Private Sector. This public expenditure can be funded either by borrowing at low rates or by expansion of the money supply. The US Government can borrow at only 2% a year interest, for the next ten years, because this is what US Treasury bills yield. The Germans can also borrow at very low rates. Greece by itself cannot do it, but the Euro Zone can through a variety of proposed instruments such as euro-bonds. This would imply a form of active fiscal federalism such as the one in place in the US and in Canada.

This much is certain. If California defaults, it will not be expelled from the dollar zone. Some mechanism will be found to restructure the debt and start afresh. When GM went into bankruptcy a couple of years ago after the initial financial shock, many people lamented the passing of such a venerable institution, long a symbol of US capitalism. Did GM really die? Not at all. Like a phoenix it rose from bankruptcy and is posting a profit. All told, there is life after

defaults and the bankruptcy laws ensure that restructuring allows for resurrection.

Another way to push the reset button on the European economy would be through monetary federalism. The European Central Bank is hampered by a treaty written by the Germans and ensuring that its only goal is to prevent inflation and safeguard the value of the euro in international exchanges. Its mission statement is much more restrictive than that of the US Federal Reserve or, for that matter, the Bank of Canada. The mandate of the Federal Reserve is much wider and its goals include the promotion of fuller employment and economic growth.

The ECB could learn more from American economic history than from the Greek Crisis. If it were to act like a true central bank, it could resort to 'quantitative easing' which involves injecting liquidity into the Private Sector with new electronically created money. Will that cause prices to rise (i.e. provoke inflation)? Probably, but not that much given the fact that our starting point is high unemployment. With excess capacity the price rise can cause the economy to grow.

Economic History shows that growth is usually associated with rising prices (mild inflation) not falling prices (deflation). The present anti-inflation phobia is quite irrational as is the fundamental diagnosis of what a depression is really about. It is not a situation where there is not enough to go around.. On the contrary, it is one, where unused capacity (in the form of unemployment) and unsold goods, (because of mismanaged distribution systems) paralyze the economy. What is needed is to unlock the hidden potential of the economy, the dormant factors of production, and place the depressed countries and the world on the path of intelligent sustainable growth.

## **A World Economy that has never been richer**

But *even without further growth*, today's numbers show that the World has never been richer than in 2011. We produce a huge \$75 trillion GWP (Gross World Product) a bonanza of liquid assets held by banks and private corporations and all this without tapping into a reserve force of at least 30% of the world workers who are either unemployed or underemployed.

Where is the scarcity to justify austerity? Where is the global economic famine? It is non-existent. There is more than enough to go around between the real wealth of the world and the financial wealth sitting in the coffers of major corporations and some countries like China. Austerity will not unlock this wealth. What will is a better distribution of spending power and considerable reduction of the social fracture or growing income inequality between the 1% and the 99%.

Is this a minority position? Yes, it is. The current orthodoxy exhorts fiscal consolidation through spending cuts at any price. But this anti-austerity minority position is also held by two American Nobel prize winners Paul Krugman and Joseph Stiglitz among others and even former deficit hawks like Kenneth Rogoff of Harvard are now advocating mild inflation as a way out of global economic stagnation.

Minority positions of today can become mainstream positions of tomorrow when paradigm shifts occur. This may not happen overnight. If present trends continue, we will all be 'Greeks' within two years, whether we live in France, the US, Italy, or Spain and this will lead to major trouble. As Stiglitz recently put it in Toronto, *austerity is a suicide pact between governments*. Add to this the possibility of a new financial crash

triggered by a random world event and we have the recipe for the perfect storm.

One of the functions of the G8 and G20 should be to forecast and if possible prevent crises. I am a firm believer in both institutions as a step in the right direction towards better global governance. But so far, the forecasting function has been deficient and even more so the crisis prevention one. Both institutions tend to be reactive not proactive. The G8 meetings in 2007 did not see the Great Recession coming and the 2010 G8 G20 meetings did not see the Arab

Spring, the Indignation and the Occupy XXX movements.

Let's hope that by the time the G8 and G20 meet next year, in Chicago and Mexico, a paradigm shift will begin to occur in favor of revisiting the diagnostics of scarcity and the strategy of extreme austerity, and more attention paid to feeding an anemic, yet rich world economy instead of starving it to death.

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Short Bio November 2011

- Former Canadian ambassador to the OECD and former chairman of the board of its Development Center.
- Member of the G8 – G20 Research Group which acts as an unofficial secretariat of the G8 – G20. In operation for the last 15 years, the Research Group monitors the work of the G8 – G20, assesses member’s compliances with promises made in previous summit meetings and establishes a time line of progress or lack of progress
- President of the New School of Athens Global Governance Group (NSoA), a global think tank studying solutions to present and emerging world problems on the model of Plato’s Ancient Academy. *See below*
- Professor of Economics (EME) University of Montreal
- Strategic planning consultant and forecaster
- Author of 9 books and over 150 papers.

**THE NEW SCHOOL OF ATHENS**

*The Original School of Athens*

In 1510-1511, the famous Italian Renaissance artist Raphael was commissioned to decorate with frescoes the rooms now known as the Stanze di Raffaello, in the Apostolic Palace in the Vatican. The Stanza Della Signature was the first of the rooms to be decorated, and *The Scuola di Atena* (School of Athens) the second painting to be finished there.

Raphael’s painting depicts a mythical meeting of nearly all the ancient Greek philosophers, who lived over many centuries. At the center are Plato and Aristotle. Plato is depicted as pointing towards the sky, reflecting his idealism. Aristotle points to the ground reflecting, in turn, his pragmatism, more evident in the Lyceum than the Academy.

*The New School of Athens*

With the above as background, The New School of Athens (NSoA) is an international initiative taking the Raphael painting as a metaphor for the revival of the Platonic Academy in twenty-first century form. Platonic Idealism and Aristotelian pragmatism are combined, in modern form in an international think-tank focusing on rigorous analysis and a do-tank in action-oriented solutions seeking mode, inspired by Aristotle.

The NSoA focuses on the solutions of global problems and moves from Plato’s politics – the organization of the city state to cosmopolitics – the organization of Planet Earth itself. Its mission statement is exploring better ways of managing our world. For a detailed description of its activities, see [www.newschoolorfathens.org](http://www.newschoolorfathens.org)