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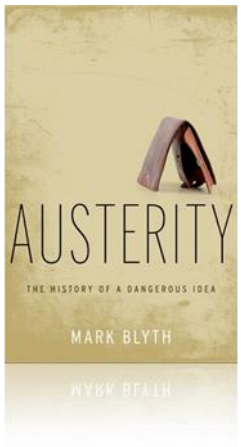
Austerity:
The History of a Dangerous Idea



Blyth, Mark, (2013), Oxford University Press, New York.

"Austerity is a zombie economic idea because it has been disproven time and again, but it just keeps coming. Partly because the common sense notion that "more debt doesn't cure debt" remains seductive in its simplicity, and partly because it enables conservatives to try (once again) to run the detested welfare state out of town, it never seems to die."

"Austerity is not just the price of saving the banks. It's the price that the banks want someone else to pay."

Summary

In *Austerity*, Mark Blyth argues that politicians in both Europe and The United States have hoodwinked us into believing that irresponsible public expenditure has made the economic crisis worse. Austerity is their cure-all for dealing with the financial crisis, giving them the pretext to make draconian cuts to public spending. The author stresses how these politicians tell us we have been living beyond our means and that it is time to tighten our belts.

Blyth considers that this argument conveniently forgets that the debt sprang not from wild public spending, but that it is rather is the direct result of the bail-out, recapitalisation and liquidity injections into a banking system on the brink of bankruptcy. The bail-out resulted in private debt being re-labelled public debt, while those responsible for the financial crisis got off scot-free. The state took the blame and taxpayers footed the bill.

The problem, argues Blyth, is that austerity is a very dangerous idea. First of all, it does not work — something he argues by showing the results of austerity policies over the last few years and by giving 20th century examples. For Mark Blyth (a political economist), austerity makes sense when a given nation wants to find a path to growth but cannot possibly work if all nations adopt austerity policies at the same time. At best, the latter will result in a shrinkage of the economy, and at worst it will plunge a country into even more dire situations — as the austerity policies pursued by Hoover in the United States during the Great Depression so clearly show.

That is why Blyth reminds his readers that the arguments for austerity are largely ideological, weak and based on flimsy evidence. In making his case, Blyth brilliantly reveals the flaws in the theory and practice of austerity policies.

The author

Mark Blyth is professor of political economy at the Watson Institute for International Studies at Brown University. Blyth's research focuses on analysing the impact of uncertainty and randomness on complex systems (especially economic ones) and why people continue to believe in certain economic ideas despite overwhelming evidence that they are false. He was a member of the Warwick Commission on international financial reform, which urged macro-prudential regulation. Blyth has also written several books, including *Great Transformations: Economic Ideas and Institutional Change in the Twentieth Century*, which questions the return of financial orthodoxy in the wake of the world-wide financial crisis. More recently, he published *Austerity: The History of a Dangerous Idea* — chosen by *The Financial Times* as one of the best books of 2013.

Key ideas and opinion

Austerity is split into three parts. The first part gives an overview of what is at stake in the austerity debate. The second part looks at how subprime mortgages in The United States dealt a body blow to the European economy and the reasons for adopting austerity. The third section explores the intellectual origins of the concept of austerity, how it was put into practice in the 20th century, and why it is such a dangerous idea.

Austerity, debt and the blame game

Mark Blyth **defines austerity** as **a form of voluntary deflation in which the economy adjusts by cutting wages, prices and public spending to restore competitiveness** — something that is supposedly best attained by slashing budgets, public debt and deficits. The defenders of such measures believe that this will 'inspire business confidence', given that the government will neither be 'excluding' investors from the market by absorbing all the capital available by issuing bonds, or be adding to a national debt 'that has grown too big'. However, Blyth considers that the yearning to apply austerity policies is not only rooted in ideology. He also sees **vested interests in blaming states so that the real culprits of the economic crisis can get off scot-free**.

Before 2008, nobody — apart from a few conservative mavericks in the United States — was worried about 'excessive national debts and deficits'. Italy's public debt in 2002 stood at 105.7% of GDP and nobody cared a fig about it. In 2009, the figure was almost the same and every one was worried sick about it. According to Mark Blyth, the world financial crisis of 2007-2008 explains the change in attitude. The cost of the bail-

out, recapitalisation and cleaning up the banking system has been estimated at between 3 and 13 billion dollars, depending on who is doing the counting. Therefore **it is a mistake to talk about a sovereign debt crisis when it is really a banking crisis that has been dressed up as something else**. Thus, Portugal's public debt as a proportion of GDP rose from 62% in 2006 to 108% in 2012. In Ireland, net debt as a percentage of GDP soared from 24.8% in 2007 to 106.4% in 2012.

Blyth considers public debt important but for different reasons. The author is worried that most of this debate on sovereign debt and the measures needed to reduce it are based on misinterpretation and confusion of cause and effect. Furthermore, the debate has taken on a moral tone, in which austerity is seen as 'good' and 'spending' evil — something that can all too easily lead to self-destructive budget-slashing. Blyth stresses that **although austerity intuitively seems to be the best way of reducing debt, it ignores two key issues**. The first is that **the economy will shrink if we all try to pay our debts at the same time**. The second is that **austerity policies have a bigger impact on those on the lower and middle parts of the income scale**. There are two reasons for this: (1) those on low and middle incomes are forced to tighten their belts more while those at the top reroute the blame for their mistakes to the state and get off scot-free; (2) people on lower incomes are more dependent on government services — both direct ones (transfers, public transport, education, health) and indirect ones (tax benefits and subsidies). Austerity thus polarises society even more between 'haves' and 'have-nots', making it much harder to achieve sustainable policies for tackling greater public debt in a context of lower economic growth.

Why should we all adopt austerity?

The author of *Austerity* notes that **the crisis began in the United States** because the system became "too big to fail". **Disintermediation, securitisation and the surge in repo markets made borrowing cheaper and fuelled higher-risk lending.** Blyth stresses **the illusion that these risks were controlled through financial derivatives and models employing self-regressive vectors**. Such models simply saw the future as a re-run of the past and a reflection of normal behaviour patterns, thus ruling out major, random, game-changing events (which are impossible to predict, and yet occur more often than we like to think). As a result, the **use of these models spread and amplified risk in the financial system instead of reducing and controlling it**. It was believed that little risk was being taken and that it was spread, when in fact risks were rising in an exponential fashion, like magma making its way to the surface before a catastrophic eruption.

Nevertheless, the author argues that **the deepest cause of the crisis was the blind support of these models lent by the economic theories of the so-called 'neo-classical' or 'neo-liberal' school**. These theories were based on two basic premises: (1) that individuals have their own interests and they pursue strategies that best serve those interests; (2) markets continually reset. **According to this theory, although we can expect mistakes by isolated individuals, it is impossible for markets to make systematic errors given that they simply**

reflect optimal choices by individuals who, taken as a whole, produce "the optimal price". Thus government action is only a hindrance, since with precise, shared information; the expectations of individuals regarding possible future states of the economy will converge and automatically produce a stable, sustained equilibrium.

Both regulators and those who were regulated swallowed this logic on market efficiency and rational expectations. Blyth considers that this theory — far from providing an accurate description of the present system — is little more than a stylized theory in which economic cycles, boom and bust, unemployment and financial regulation are given scant consideration. Furthermore, **according to this theory, equilibrium and efficiency stem from the business decisions taken by informed, intelligent players. It thus ignored the risk of a crisis stemming from factors other than moral hazard — which it considered the only one needing monitoring.** This is was why Lehman Brothers was allowed to go bust. **The idea was that if individual institutions taking disastrous decisions were bailed out, others would surmise they could also act recklessly in the knowledge that the government would come to their rescue.**

To sum up, in the United States, risk was seen as something that concerned the individual. American politicians happily subscribed to the idea that banks were best left to regulate themselves. Everything would be fine so long as they did not need bailing out. The private sector and not the public sector — so went the theory — always tended to equilibrium. **The theoretical approach was incapable of conceiving that instruments supposedly designed to make the world a safer place —** mortgage bonds and derivatives, default insurance, the banks' risk models — **could actually make it a much more dangerous one.** As a result, great swathes of the system were hidden but highly interdependent, forming parts of a complex whole. This, combined with over-confidence in our ability to manage risk, led to a disaster aided and abetted by the state. **Blyth believes that the $13 trillion bail-out would have been worth it had the costs been shared out on the basis of blame and ability to pay. But this was not the case.**

The financial crisis that began in the United States in 2007 **reached Europe in 2008**. As in America, **institutions' private debt was highly levered and was turned into sovereign debt.** One of the strangest aspects of the way the crisis spread from the US to Europe was the **sudden way Keynesianism was embraced by almost everyone except the European Central Bank (ECB) and the German government.** One of the main reasons for this, according to Blyth, was the neo-liberal beliefs dominating political economy, which denied that such a crisis could arise in the first place. When the crisis did hit, there was space for Keynesian ideas once again. **Even international economic institutions advocating austerity in developing countries, such as the IMF, began to argue that monetary tools were not enough to solve the crisis and that an active, co-ordinated fiscal policy was needed.** Countries as diverse as Brazil, China and the United States worked together to stimulate their economies. China made the biggest effort, with a stimulus plan that was the equivalent of 13% of its GDP. Spain promised 7%, and the United States 5.5% of their respective GDPs.

Nevertheless, **the return of Keynesian stimulation measures was short-lived, lasting roughly a year. Blyth stresses that Germany played a key role here**. Two factors played a role in the return to neo-liberalist economic policies. **The first was Germany's memory of hyperinflation in the early 1920s.** The second was its rise from the ashes after World War II to become Europe's biggest economy by the early 1960s. **German politicians and citizens were convinced that political decisions rather than financial markets lay at the root of the crisis**. They believed in the need for order and stability, especially in financial stability supervised by a strong, independent central bank — an idea that was enshrined in the project for the Euro. Blyth considers that given this historical baggage, it is hardly surprising that Germany joined forces with the ECB shortly after the beginning of the crisis to both put an end to the stimulus package and start a fiscal squeeze. **The argument was that fiscal contraction, instead of leading to a fall in production, would stimulate it, given that consumers and investors would anticipate the tax cuts arising from budget cuts and boost their spending, thus making up for shrinking government expenditure.** The final communiqué at the end of the G20 meeting in Toronto in 2010 echoed the message of "fiscal consolidation favouring growth" that had been espoused by Trichet and expanded on by Schäuble. It gained the support of the Canadians and British, leaving the US to pursue a different policy.

While Germany's anti-Keynesian stance is understandable, Blyth asks why the rest of Europe suddenly turned against stimulus spending. **It was particularly surprising given that Europe (with the exception of Greece) and the US could hardly be accused of reckless public spending.** According to the author, the answer to this conundrum lies in the fact that **no state could cover the risks created by its own banks, which were simply 'too big to bail'**. In 2008, the three largest French banks had assets valued at 316% of France's GDP. The two biggest German banks had assets equivalent to 114% of Germany's GDP. IN 2011, these figures were 245% and 117%, respectively. Deutsche Bank's assets alone were equivalent to over 80% of Germany's GDP. Meanwhile, the comparative figure for ING was 211% of Holland's GDP. The four main UK Banks held assets equalling 394% of GEP, while the three biggest Italian banks totalled 115% of Italy's GDP. In this context, **no country in the Eurozone could rescue its banks without resorting to inflation to deal with the crisis — a measure that was impossible given a shared currency. The Euro also meant that no country could devalue its currency.** Accordingly, **the only way was to bail out the banks, choosing the path of austerity**.

Blyth thinks that **the awful state of affairs in Europe does not stem from a few gaps in its institutional design or the greed and immorality of its banks but rather in the 'epistemic hubris' that underlay the project for a common currency**. Plans for the Euro were rooted in a set of economic ideas that blinded us to the consequences of institutional design — something that was starkly revealed by events in the US. **By concentrating on inflation rates, budget deficits and public debt, the EU planners could not or would not see that the fast-growing banking system had become 'too big to bail'.** The price of this arrogance is the belief among Europe's elites that a decade or so of unremitting austerity will be enough to underpin the banking system — even though it could bury the EU in the process**.**

The intellectual history of austerity

Bearing in mind our present problems and the austerity policies being used to tackle them, **Blyth explores the intellectual and empirical origins of austerity** to discover how the concept stands up. He begins with three classic liberal writers: Locke, Hume and Smith. Blyth stresses that **liberal economic ideas were a reaction to the state**. However, it was not the state we know today (usually a representative democracy bent on big government spending) but rather one run by **monarchs whose vices and caprices made them utterly untrustworthy**. Accordingly, the state was best avoided and if it could not be overcome, at least it could be cut down to size. Liberals viewed the state with the deepest distrust. In establishing markets as an antidote to the state, they found it hard to admit that states were in fact needed to create and preserve markets. **Locke and Hume adopted a line of liberal thought that systematically denied the state anything but a minimal economic role.** Another school of liberal thought, subscribed to by **Adam Smith, admitted the need for the state** but worried about how it should be paid for**.**

As time went by, the tension between these two points of view on the state (can't live with it, can't live without it) sparked a debate on how states should be funded. This created the conditions for **austerity as an economic doctrine for curbing state spending, at a time when government expenditure had become large enough to justify such a policy**. Blyth reminds readers that in the 1920s and 1930s, **the United States, Japan, Sweden, Germany, the United Kingdom and France all tried to reduce fiscal deficits by adopting austerity measures.** The policy had disastrous results, not only preventing economic recovery but also helping to spur the outbreak of the Second World War.

In the United States, **following the Wall Street Crash of 1929, President Hoover began to raise taxes and cut public spending at the same time.** In two years, **unemployment soared from 8% to 23% and the economy collapsed**. **America did not fully recover until 1944**, when unemployment fell to just 1.2%, thanks to war spending. Great Britain — the world's greatest financial power at the time — set a high fixed exchange rate after World War I in order to boost growth. This policy was meant to give investors confidence. A Sterling devaluation was avoided because it was thought this would lead to a stock-market crash. However, it contributed to a decline in British exports and dashed hopes of a post-war recovery. The country suffered high unemployment until the 1920s. Unable to revalue or devalue its currency, the British government was left with few options and **the United Kingdom chose austerity**. Blyth stresses the self-destructive nature of this policy — **public debt rose to 170% of GDP in 1930 and to 190% in 1933**.

Japan was the country that took the strongest austerity policies following the stock exchange crash of 1920. **In 1930, Japan's economy shrank by 9.7%**. In 1932, Junnosuke Inoue — Japan's Finance Minister and the architect of the country's austerity policies — was assassinated. His successor in the new government, **Takahashi Korekiyo, abandoned austerity and the economy began to grow again by an average of 4% per annum between 1932 and 1936**. Despite this, Korekiyo was assassinated in 1936, bringing Japan's dalliance

with both democracy and austerity to an end. The following period was one of expansion in every sense.

Blyth notes that the emphasis is usually placed on Germany's hyperinflation. Yet, as he points out, Germany suffered from the flight of American investments following renegotiation of Germany's debt. This led the Reichsbank to raise interest rates to stem capital flight, pushing the economy into recession. It was against this background that the Central Party gained the Chancellorship and tried to put the economy back on course by making drastic budget cuts. **Public support for the Nazis rose as the cuts bit deeper.** Indeed, the Nazi Party was the only one that argued against austerity — something that turned it into the country's second biggest party in 1930 with 18.3% of the votes. Its share of the vote rose to 49.3% in 1933. This is why **Blyth argues that it was austerity, not inflation, that swept the Nazis to power.**

Blyth notes that after these catastrophic events, the world seemed to lose its taste for austerity. Nevertheless, **in the 1990s, various new studies argued that fiscal consolidation in Australia, Canada, Denmark, and the Irish Republic had boosted the economy.** This sparked renewed interest in tax and budget cuts as a growth mechanism. **Yet, as Blyth notes, the results were disappointing in terms of economic growth and greater investor confidence. As Keynes pointed out, the right moment to choke public spending is not when the economy is stalling but when it is rising.** Authors defending austerity measures argued that these were isolated examples of economic contraction. **The cuts would work in countries that could export to bigger economies that were still growing.** Accordingly, **interrelated economies could not all plump for austerity at the same time and hope to increase their exports.** Lastly, the author notes that the main mechanisms used were currency devaluation and social compacts with trade unions to control prices, prevent the erosion of wage purchasing power, and stave off social unrest. Blyth therefore argues that there is little evidence to show that austerity spurs growth and fosters confidence.

This is why the author is worried by the popular support for austerity policies, especially in the Eurozone. **Some have hailed the measures taken by Eastern EU States (specifically, Rumania, Estonia, Bulgaria, Latvia and Lithuania) as evidence that austerity policies work.** These nations made deeper cuts (in proportional terms) than any other EU country in 2009 and 2010 yet grew faster than the rest in 2011 and 2012. However, one can interpret these facts differently. **Blyth notes that all of these nations, with the sole exception of Estonia, now have a bigger public debt than when the cuts began. Furthermore, these policies have done nothing to reduce unemployment,** which will soon be into double figures in these nations. Moreover, confidence has nose-dived. For example, although Latvia was the EU country that grew most in 2011, 91% of Latvians saw the economic outlook as bleak and 58% thought that things would only get worse.

Blyth is convinced that austerity does not work. As he shows throughout the book, it is an idea that has been tried time and time again and has been discarded just as often because it fails to deliver the goods, while raising the debt burden. **Debt is concentrated in nations for which no write-off will be forthcoming and high inflation and default can be ruled out. This means the only reasonable solution is to raise taxes on top earners over the**

next few years. According to Blyth, taxation, not austerity, is the best way of tackling debt. This is not because austerity is unjust (which it surely is), nor because there are more debtors than creditors (which is also true), nor even because democracy may have an inflationary bias (it does not). It is simply because austerity does not work.