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Transcript

Austerity: Virtue or Vice?

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Chris Giles:

Good evening, everybody. My name is Chris Giles; I'm the economics editor of the *Financial Times*. I'm very excited tonight to be chairing this debate on austerity. If there was a signature policy of the post-crisis period, it is this, and it is a policy which people have great passion about and also disagree vehemently with each other. I think we're going to see some of that tonight – or I hope so, at least.

On my left, on your right, is Holger Schmieding, who is chief economist at Berenberg Bank in London. On my right, your left, is Mark Blyth, who is the faculty fellow and director of International Relations at the Watson Institute for International Studies at Brown University, and has just published a new book, which is over there on the table: *Austerity: The History of a Dangerous Idea*.

The way we're going to do this today is that I will have each one giving about six or seven minutes of presentation, or at least outlining their case: Mark, anti-austerity; Holger, in favour. Then we'll have a little bit of a discussion between the three of us, and then with at least half an hour to go I'll open it up for questions.

Mark?

Mark Blyth:

Thank you very much. Thank you all for coming. I'm going to open the case as to why austerity is, to use the wonderful phrase of a friend of mine, 'pants'. So let's see, how is it pants?

For the past three or four years, we've been running a giant natural experiment. That natural experiment involves the United States, the European Union and the United Kingdom in the middle. If it wasn't for the sequester that's going on in the United States at the moment, the IMF and the CBO in the United States estimates US growth would be between 2.8 and 3.1 per cent. Now, they haven't managed a cut except for the sequester procedure, so 'first, do no harm': de-lever your banking system, recapitalize, growth starts to return. Economies actually do have wonderful self-healing properties on some occasions.

Britain has all those advantages, including its own currency, but it decided to tighten the screws itself. Its deficit, rather than the 3 per cent that the Americans are heading for – and a stabilization of growth – is actually now leading to more debt and a deficit of around 5.6 per cent for the end of the year. Periphery Europe, where they've tightened most of all, have managed to lose 20 per cent of GDP throughout the periphery, have generally a 22 million above-term unemployment, altered their entire long-term GDP track in the process – have basically dug themselves a hole it will take them 10 years to get out of, and they have more debt right across the board rather than less. Their deficits are in double figures. Every Commission target for the deficits gets kicked down the road like everything else, and the screws continue to tighten.

Point number one: it simply doesn't work. Now, why doesn't it work? Because there's a deep fallacy of composition at work here. When everybody who's everyone else's trading partners, who all share a currency none of them can print, all simultaneously contract, the denominator shrinks and the numerator increases. So a constant stock of debt on a shrinking economy, particularly in the zero bound, hurts. As the IMF reports from 2012 onward show, there's an extreme negative convexity in the negative multipliers, whereby in the periphery, between 1.5 and 1.7 dollars is lost for every dollar that's cut. That's why Greece and Spain and Italy all have more debt rather than less, and the ones who have cut the most have the largest negative convexities and the largest increases in growth – because of austerity.

What's really annoying about all of this is the fact that we forget why it started, which is what I like to call the class-specific put option on the global taxpayer. Because back in 2008, I don't remember too many American senators jumping up and down and screaming about the crazy amount of debt in the United States, which at that time was 61 per cent. We managed to get there because of two wars of choice without raising taxes, and a bunch of tax cuts that there were no corresponding offsetting spending cuts. So basically, 61 per cent. Then suddenly it's up to 90 – what happened in 2008, do you remember that? Yeah, that was that thing called the bailout of the global financial system, whereby through recapitalization, needed stimulus programmes across the board, and most of all lost tax revenue from these behemothic [*sic*] banks blowing up, all of the public balance sheets that we see became much, much more contaminated with debt. Yes, it ended up as public debt, but it was really the socialization of private debt, working through the credit channels, that ended up in the public's balance sheet, saving the banks.

So those people who made out basically with most of the income growth over the past 25 years, who have the most assets and the most income, got their assets and income bailed and reinsured. The cost of doing so was then passed down the income distribution to everybody else for them to pay, and the restriction of government and other public services. It is, in terms of politics, invidious, to say the least.

What was meant to solve all this was a wonderful thing called the confidence fairy. The basic idea behind this one, when you follow it through in the technical papers, is the following. Despite the economy falling around your ears, not knowing if you'll have a house next week or whether your spouse will still have a job, you lie awake at night worrying about public debt. It's the number one thing you care about. So you monitor this closely, because it's really quite terrifying, and you watch those spreads, you think they're terrible things. What you really want to see is firm action by the government to cut public spending, because using your rational expectations – and a wonderful trick called Ricardian equivalence – you then channel out 20 years ahead, calculating and recalculating your lifetime income, and you now know that because the welfare state will be smaller 20 years out, you'll have less taxes to pay right now. That inspires confidence – I'll run out to Ikea, buy a new couch and end the recession. That sounds ludicrous but I can assure you, that is exactly what the argument is. There are no confidence fairies.

The other thing I found doing the book: there are no positive cases of this ever working. None. I got pulled up in the *FT* about this and this is why I'm called a polemicist. But it's not true that there are any positive cases. All cases of fiscal consolidation happened when the economy is growing. Of the cases in the 1980s most highlighted – Canada, Denmark, Sweden, Australia – all of them happened to be small, open economies, where most of the heavy lifting was done by a devaluation of their own currency, and then import inflation not appearing in the economy because of wage control agreements. There are zero cases of countries in recessions, particularly who are each other's trading partners, sharing a currency none of them actually control, managing to pull off a simultaneous contraction and grow at the same time. The evidence for this is now in.

Why did we do this? Because it simply wasn't needed, let alone the fact that it wasn't working. So the idea of course, the markets were craving these huge yields because of the risk – well, risks come in different flavours, and one of the things actually pricing them was breakup risk. There's a big difference between the United States and the EU: one of them's a country, the other one isn't. What that means is one of them has citizens, which is a fiat money economy's credible commitment to tax inter-generationally – I know that my kids in the US will be paying off federal debt accumulated today – but the EU has two big problems. Number one, it has a fake central bank. It's basically a currency board with a liquidity pump. It can't socialize, it can't asset-swap, it can't mutualize. It can't even direct the bailout of banks, despite what the banking union is mooted to do the next time this happens. So given all this, the markets are pricing in breakup risk, because they know that ultimately David Cameron is not going to hand over the British taxpayer to bail out the French banking system.

Now, how do we know that this is actually true? We know this is true because the yields go all the way up until there's a programme announced called the LTRO 1. Then there's the LTRO 2. Then there's ELA – emergency liquidity assistance. And then there's the – oh my god – the OMT. So what actually cures the yield spread problem and brings this down isn't austerity, because austerity has destroyed 20 per cent of eurozone GDP in the periphery and created 22 million unemployed. That's not a good thing, even for people who buy sovereign debt. What they were counting on was a credible central bank policy for dealing with breakup risk. They got it, almost. Mario is trying to give us the rest of it. Whether he gets there or not depends on people who live in northern Europe.

Which brings me to Germany, because Germany occupies an interesting place in this one. Germany is not the United States. Germany isn't big enough to liquidate the problem. So you have a banking system which is three times the size in terms of asset footprint and twice as levered as the US. You don't have a central bank like the Fed that can reach in, pull out all the toxic assets, add liquidity, force a recapitalization and get growth started, because Germany isn't big enough to flush the system. So I understand completely why they want austerity for everyone else, because neither their own business model – which is predicated on cost control in wages and exports – nor their banking system is big enough and strong enough to pull the rest of them out of the mess that they've dug for themselves.

So if we remember this, in closing, I think the case for austerity falls apart. Number one, it doesn't work. Number two, it cannot work. Number three, it hasn't worked. And number four, it's not going to work.

Chris Giles:

Thank you very much, Mark, that's beautifully clear. I will just add a point of information: I presume that when you said you were picked up in the *FT*, you were picked up in a book review by Larry Summers, who is absolutely no fan of austerity himself, I think. It was actually a rather positive book review. Holger?

Holger Schmieding:

Thank you. I think there are so many points in what you said, we could debate five hours about that already. So I'm afraid I will have to let quite a few of these things stand, with one exception: let me say on breakup risk, I 90 per cent agree with you on what you said on that, and we may come to that further in the discussion.

Austerity, virtue or vice? I'm not sure which position I would actually take. I think it's neither virtue nor vice, but it can be necessary. It's like a good diet: you need to live within your means. If you haven't lived within your means but go beyond your means, there is no way around it. Eventually you have to get back to live within your means. If you call that austerity, it's not a virtue, it's just you have to get back to be sustainable. The being sustainable is the virtue, not the diet that makes you get back to live within your means. And if you're living beyond your means, what's the alternative? Live beyond your means forever, like Japan is trying to do? Look at them. They've tried to postpone seriously addressing their problems for 20 years and what have they got to show for it? A really, really big public debt problem. Over here in the UK, well, yes, this country has lived beyond its means for quite a while, from about 1998 to 2010. What does it have to show for it? A major rise in public debt.

Talking about austerity, if I look at the numbers, what is austerity actually? It's trying to cut the underlying budget deficit. If I look at where the budget deficits stand today in the Western world, I find that in the UK, in the US and Japan, the deficits are still – adjusted for the business cycle – far higher than they were in 2007. So to some extent what you can say, the austerity that we've recently seen in the UK and a few other places was just taking back the stimulus that countries granted themselves in 2008 and 2009 in response to a big recession. This unfortunately isn't yet quite austerity. All these countries – the US, the UK and Japan – are still living well beyond their means, a state to which they got accustomed in the years of the credit-fuelled boom of the previous decade.

The one region where the underlying fiscal position is roughly comparable to what it was in 2007 is the eurozone. There has not been any serious austerity in the eurozone as a whole. What there has been is a fiscal stimulus, a very modest one, post-Lehman, that has been taken back afterwards. If I look at individual places, it is true, Greece has had savage austerity. In my view, Greece has had too much austerity. Like a diet, if you overdo the diet, you're in trouble, and Greece has been asked to overdo the diet. It doesn't mean you should never go on a diet – no, you should live healthier, eat healthier.

But you should not simply stop almost all eating, even if you had a serious problem. Austerity, to use a slightly different metaphor, is the medicine. Sometimes you have to take it, but of course taking an overdose of it doesn't help. So there is indeed a clear case against overdoing austerity, which isn't the same as saying you should be living beyond your means forever.

Much more important, however, than the austerity, which is simply getting back to living with what you can afford in the long run, is the taking exercise, changing your lifestyle. As economists, we call that structural reform. A lot of that is happening across the eurozone. The OECD – that's the club of the developed countries in Paris – has a list of countries, it checks every year who is actually doing structural reforms. Number one for the last two years has been Greece; number two, Ireland; then come Estonia, Portugal and Spain. All the four countries in the eurozone that have received some external assistance so far – Greece, Ireland, Portugal and Spain – are leaders in structural reforms. Beyond austerity – which in Greece is overdone, in other places less overdone – they are actually doing a lot to get fit.

Now, let me take a somewhat broader historical perspective. I had the pleasure of living in this country as a student in 1980–81. What did I see? Major pain in the country, because Maggie Thatcher was getting serious about slashing inflation and reforming the labour market. The initial results of Margaret Thatcher were record unemployment, mass protests on the street, and howls by almost all economists at the LSE and a few other places that, please, she should change course. History has proven her right. It was painful but it worked.

If I remember my own country 10 years ago, Germany was the sick man of Europe, by far the worst economic performance, jointly with Switzerland, of all major developed countries. It had lived beyond its means with unification. Then Germany did labour market reforms and some modest austerity. The initial results were record unemployment, mass protests on the street for years. History has proven Germany right. Contrary to the advice dished out by most international economists that Germany should spend its way out of its disastrous performance in growth, Germany did not spend its way out of it – it went on a better diet and did a lot of exercise. The results are there by now to see for everybody: Germany and Switzerland are now among the strongest economies in Europe. They do show that reforms, structural reforms and if need be some cutting back of the state, do show spectacular results, but unfortunately with a lag.

But at the moment we have record unemployment in the eurozone periphery and protests. It's just what we had in this country in the early 1980s and what we had in Germany from 2004 to 2006. It is painful, I know. It is a painful medicine. But it doesn't mean that the medicine doesn't work. Again, the medicine has been overdone in the case of Greece, and I think the programme ought to be adjusted and is being adjusted. But it does not mean that the medicine as a whole is wrong. The alternative to correcting living beyond your means is not to go on living beyond your means and wait for somebody else to pay for it. That is not going to work anywhere.

Ultimately – talk coming to the eurozone again – as much as we talk about the eurozone debt crisis, the place in the Western world with by far the smallest increase in public debt since the start of the euro is the eurozone: 20 per cent increase in public debt-to-GDP over the last 13–14 years. In the UK and the US, this increase is 45 per cent of GDP; in Japan, it's triple digits. So all in all, whatever you want to say about the eurozone, the region is not that bad. The underlying fiscal position in the eurozone is largely sustainable now. The small countries are in a painful adjustment process. Political will is being strained, as it was in the UK ahead of the Falklands War, but it doesn't mean it's going to end in tears – it might.

The recent indicators are that Greece, if we leave it in peace – that is, if we don't ask it to swallow more of the medicine of which it has swallowed enough – the recent indicators are that the Greek economy will start to grow from the middle of this year onwards, helped by a rebound in business confidence, which in Greece is now above the eurozone average, coming out from very deep, and of course a strong tourist season as well. The rain over here, I must say, does help tourists moving to Greece a lot. Chances are if we leave Greece in peace – that is, the troika doesn't get overactive – and the government in Greece holds up, that a year from now Greece will be added to the list of countries which have, like the Baltics, like many others, like Britain under Thatcher and Germany under Schröder, come through hard times and have the results to show for it: namely, better results.

Chris Giles:

Thank you very much. Clearly we don't have a huge amount of agreement on either side of me, so I'm going to try and do a novel thing of trying to see if I can get some bits of agreement, or at least to quantify exactly where differences between the two sides exactly are. Seeing whether we can get a little bit of agreement on certain areas.

First of all, for Mark, I suppose one question which Holger raised – you talked about going on moderate diets and having exercise, essentially so that countries have to get back to live within their means. Do you accept that in the medium term at least, countries with deficits do have to get back to live within their means?

Mark Blyth:

So long as they're not all trying to do it at the same time, on the zero bound.

Chris Giles:

And if countries all have deficits at the same time, what does that therefore mean?

Mark Blyth:

If they're each others' trading partners and they share a common currency that none of them can control, devaluation is no longer an option. Neither is inflation, because you don't control your own printing press. Given this, the only way you can reduce your deficit is by basically having an internal deflation, which is austerity. If you do this at the same time as all your other trading partners, then there's a simple logic at work. You're not generating any income from which you could produce the savings you need to reduce your deficit. So what we see in the eurozone isn't someone going on a diet. We are seeing a kind of mutual suicide pact through bloodletting.

Chris Giles:

So just to be clear, you do think there is a need for countries to reduce their deficits – it's not just going to disappear on its own. So you think that policy action is needed.

Mark Blyth:

Hold on, let's not box me into, like, 'no, I think they should offer a million per cent deficit'.

Chris Giles:

No, I was just asking whether policy action is needed.

Mark Blyth:

Policy action is needed to stabilize the deleveraging of the private sector through the maintenance of the public sector's balance sheet. Cutting the two of them at the same time when everybody's doing the same thing is zero-sum against itself. We have the evidence of this. There is no need to debate it, it's a logical point.

Chris Giles:

There's an issue about how you do it, which you keep on answering saying you shouldn't do it now, but there's a question of whether it does need to be done. I just want a sort of yes-or-no answer, whether you think deficits are going to go away automatically or something needs to be done.

Mark Blyth:

Growth cures debt and deficits. Cutting does not actually reduce debts; it worsens them when everyone is doing it at the same time. QED, my answer is: any project which restores growth faster rather than slower, even if it's nominal, in the interim period is going to have a positive effect. That is precisely where we differ on this one. Structural reform sounds good but when you examine what it is, it is basically the same bag of reforms that the IMF ran around the world dumping on everyone via structural adjustment programmes in the 1990s. It didn't work. Getting rid of the Greek taxi driver's pricing monopoly is not going to lead to a giant rebound in GDP. Making Irish labour markets, which are amongst the most flexible in the world, a little bit more flexible by getting rid of the minimum wage is not going to do the same thing. And citing the Baltics, who basically robbed their pensioners of 30 per cent of their income to guarantee the senior bondholders of German and Swedish banks in 2009 through the Vienna agreement, I think is nothing short of – what's the word I'm looking for? Distasteful.

Chris Giles:

Criminal, you could have said. Hold on a second, because I think the answer is probably yes, there is some policy, but inflation would be something, so the denominator rises, and you'd be more comfortable with that than trying to cut the numerator.

Mark Blyth:

What's going to happen if we manage to get positive growth back is financial repression. That's really bad for the financial sector and they're going to fight it tooth and nail. So that's how you get rid of debt. After World War II, the United States and the United Kingdom liquidated 30 and 40 per cent of GDP respectively through a policy of financial repression. That is, you take the bonds, you stuff them in the banks, you make them hold them, you lower the coupon, you lengthen the maturity, and you run a positive inflation rate, with a debt with inflation. It's terrible for banks, terrible, but they've made all the money for the past 30 years, I think they should pay some back.

Chris Giles:

Holger, one of the things you said which made my eyebrows raise quite a long way up was that you said there had been no austerity essentially in the UK, and the US had just been taking back the stimulus that had been offered in 2008. Which essentially counters Mark's point he made, which is the opposite point, where he said it is essentially a massive reduction in tax revenues due to the financial crisis. This is one of these things that you should be able to have data and just be able to answer that question. Unfortunately the data which I'm holding in my hand, which everyone tends to go to, which is the IMF's cyclically adjusted primary balance data, is a really rubbish piece of data, because the cyclical adjustment of that is anyone's guess. So I would challenge you, Holger, that what you said is actually not necessarily true. There has been deep austerity in Britain and the US, because you can't rely on this sort of evidence to say that nothing has changed since 2007.

Holger Schmieding:

Well, that gets us into very deep economic water. I'm just relying of course on the standard available estimates for cyclical adjustment.

Chris Giles:

So you're not curious at all that these might actually be –

Holger Schmieding:

I know that these are very difficult –

Chris Giles:

And highly revised already, since 2008.

Holger Schmieding:

Yes. Having said that, when I see a reputable source like the OECD, this deficit for the UK being 2.8 per cent in 2007, and 5.1 per cent in 2012 – I have a lot of room for revision and a lot of room for disagreeing with how precisely you calculate that, and still come up with a conclusion that the underlying situation isn't really tighter than it was in 2007. It is definitely correct, and that's indeed part of the misunderstanding or part of the debate on that. That 2007, or that period, was of course a very interesting period, because you had all this credit boom. In a way, you had an artificial rise in tax revenues which never was sustainable. Just of course adjusting to the artificial going away may seem like pain – that is, if you drink four glasses of wine in the evening and then go back to two glasses of wine in the evening, that of course is possibly a bit of pain. But you're then still having two glasses of wine in the evening.

The point is, whichever way I cut and slice the data – the data are subject to a lot of comments – I come up with a conclusion that much of what we've seen in the US and the UK and Japan is taking back the post-Lehman stimulus rather than the real pain. The bad news in that is that unlike in the eurozone, I'm afraid in this country there is no way around: the real pain is yet to come.

But now give me the chance to reply to at least a few things that have been said. Very briefly, mutual suicide pact – well, let me remind you that Germany is not having any austerity at all. France isn't having very much of it. Much of the rest of the world is not having all that much austerity at the moment. So the mutual suicide pact between Greece and Ireland is unfortunate, and if you add Portugal to that it's really unfortunate, but those together are 6 per cent of eurozone GDP.

And the structural reforms of course, which 'never work', are the ones which cured Britain, Germany and many other countries.

Chris Giles:

Actually I wanted to ask Mark about structural reform, because there is a real case, particularly in parts of the periphery of Europe – and maybe Ireland is an exception to this, but for southern Europe in particular, these economies almost certainly weren't working well. The current account deficit in Spain before the crisis of nearly 10 per cent of GDP suggested it was living beyond its means. Something had to happen, and structural reform is one way of trying to make it live within its means, which has nothing to do with austerity but just making the economy work better. That's surely pretty clear and okay, isn't it?

Mark Blyth:

It is. Let me say yes, I think it's a great idea. But I've just come back from Italy, I was in Florence. If you look up at the Florentine hills, you find the same five families who have been growing wine there and own 80 per cent of the wine for 500 years. Despite war, revolution, social conflict, Mussolini, the whole lot – the same five families. The same, I believe, five families own the banks in Spain that did under Franco. The thing about the periphery is what the EU did was come in with the best of intentions and basically create a series of public and private capital flows which allowed a huge credit bubble to form. Remember, for every over-borrower, there has to be someone over-lending. The over-lending was coming from the surpluses generated by countries such as Germany, who weren't consuming enough because they basically haven't given their workers a wage increase in real terms in 12 years. It's not structural reform, it's a consumption squeeze. The German government's own office of exports admits this. I just came back from a conference that talked about this precisely. So I'm not sure you can pull that trick off twice, but it's not structural reform, it's a consumption squeeze where you happen to have a good export sector.

And what did the rest of Europe do? They papered over the cracks of class conflicts and social conflicts such as the Spanish civil war and they built roads and they gave everybody money to go play and so on and so forth. They effectively de-industrialized. Spain became banking, beaches and business services. The problem is that it's relied upon external capital flows to make the whole thing work. When those capital flows blew up in the financial crisis and stopped, their business model died with it.

Clearly these countries need deep structural reform. But that's something for the Italians to take charge of. Imposing this from outside is what the IMF tried to do all around the world and it simply doesn't work. We call this ownership of the programme, but if you're telling someone they need to own a programme and in the long run you'll be fine but in the meantime you've got to basically make an entire generation workless, but you'll be fine after – well, what precisely am I going to get? I don't know, but trust me, it will work.

The politics of this mean that even if it's true in principle, it will never happen in practice, particularly in countries who have terrible politics to start with. That's what the periphery suffers from, and structural reform is not going to solve that.

Chris Giles:

You raised structural reform, and Mark has actually called for the thing I was going to ask you about – the structural reform in the German economy as well. Clearly, if you've got current account deficits, you've got surpluses, and within a currency union, just as within the world itself, these can get pretty problematic. To what extent do you see the case for the surplus countries taking a bit of structural reform, and actually going out and partying a bit so that other countries can ease their transitions?

Holger Schmieding:

If I see where the partying in Britain has led the country, I'm not sure I really want to recommend that to anybody else. As I mentioned initially, the one country in the Western world besides Japan which has a serious fiscal problem, a really serious one, is this country. So I would never recommend anything like the credit-fuelled real estate boom which this country – and 'small Ireland' – had until 2007 to anybody in the world.

Germany, of course, could do with a lot of structural reforms, yes, but it had serious reforms. The reason for the German revival is not a consumption squeeze. The reason for the German revival is largely labour market reforms and some entitlement cuts. If you look at the German labour market, there is a very clear break in trend. Until 2005, it went dramatically downhill, the number of people with a job, as German companies were fleeing the country. From 2006 onwards, German companies added a lot of jobs at home, to the extent that now the number of people with a decent job is 12 per cent higher than it was in 2006, with a stagnant population. The first reward which German workers got from the reforms was two years later, after the initial pain started. The first reward was there are now plenty of jobs. There was a shortage of jobs in Germany. That's a big reward for workers. The second reward is, have a guess where in the last few years wages are actually rising quite nicely in real terms – it's, of course, Germany. The right way around is you first do the reforms to secure your job or get a job, and once you have a job then you ask for your wage rise – not when your job is at risk. The periphery will recover some of its wage losses a number of years after the start of economic recovery.

Chris Giles:

Okay, so more attempts at building consensus on the podium here have largely failed, so I think it's time to open it up to the audience as a whole.