Austerity vs Stimulus

Robert Skidelsky · Nicolò Fraccaroli

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The Political Future of Economic Recovery

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Robert Skidelsky
University of Warwick
Coventry, Warwickshire
UK

Nicolò Fraccaroli
London School of Economics
and Political Science
London, UK

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Introduction

It is known that the financial crisis of 2008 started as a subprime crisis. It is less known how it soon turned into a sovereign debt crisis, moving the focus of media and policy-makers from banks' balance sheets to governments' public debt. The Austerity vs Stimulus debate became prominent in this later phase.

Before 2008, American banks were issuing mortgages so easily that even the so-called subprime mortgage borrowers—borrowers with poor prospects of repayment—were accommodated with a loan. Once issued, banks put the loans in the financial market in the form of securities. When house prices started to fall, banks' balance sheets, largely inflated by the securities generated on mortgages, shrank. This is how the so-called subprime crisis begun. Fearing insolvency, banks stopped lending to each other and to their customers, causing a 'credit crunch'. This phenomenon, emerging at first in the USA, was soon transmitted to the financial markets in the UK and continental Europe, whose banks were interconnected with their American peers through the purchase of securities and interbank lending.

The German sociologist Wolfgang Streeck, whose essay opens this collection, described how the public sector intervened in the market to deal with this huge private debt problem. In order to restore confidence, governments bailed out their banks. This resulted in the explosion of public debt. Nevertheless, as soon as the financial sector was successfully rescued, the narrative of the Great Recession changed drastically. The crisis turned into a sovereign debt crisis, and the focal point of the discussion in newspapers, talk shows and even in academic debates, became the public debt problem. It was at this point that the arguments for austerity begun to gain success. Austerity policies aimed to restore fiscal balances. The restoration of fiscal balance was seen as the necessary condition for restoration of private sector confidence, and hence investment and economic growth.

The Reason for this Book

But why was austerity needed? This question is somewhat puzzling if we consider that 'before 2008 no one… [was]concerned with "excessive" national debts or deficits' as Mark Blyth, author of one of the most compelling books on the history of austerity, wrote.[1] Nevertheless, the issue divides contemporary economists, as is shown by the recent exchange in Project Syndicate between the economic historian Niall Ferguson (Harvard University) and one of the authors of this book, Robert Skidelsky (Warwick University), which inspired the creation of this short book.

To understand the full ramifications of the debate, one would need to delve deep into fiscal theory and historical arguments about the role of the state in the economy. Our aim here is more modest: not to describe how the 'dangerous idea' of austerity gained success among academics and policy-makers in the recent past (for which Blyth offers a persuasive account), but to offer a non-technical guide to a topic which dominates much of today's political discussion, and which even politicians lack the ability to discuss properly. (It is sufficient to note how many times British politicians talk about debt and deficit interchangeably).

The Puzzle

The question we are trying to answer in this book is: Should the British government have opted for austerity after the collapse of 2008? Or should it have gone for economic stimulus? Since austerity is the consensus policy in the European Union, the question is of more general relevance.

First, a couple of definitions: *austerity* is the reduction of the public deficit. In the UK its purpose was to restore private sector confidence in government finance, reduce the cost of government borrowing and free up resources in the private sector. On the Continent (Greece, Spain, Italy, Portugal, etc.), austerity was demanded as a condition for external financing of the deficit, its object being to eliminate the risk of default. Its medium-term purpose was to bring about a decrease in consumption and wages (known as 'internal devaluation'), in order to restore competitiveness and bring back growth. *Stimulus* is, on the contrary, an increase in the public deficit, aimed at sustaining aggregate demand and hence aggregate output and employment. At the end of the day, the final object of both stimulus and austerity policies is the same: to bring back growth. They differ, though, in the way they think this can be achieved, this difference reflecting a divergence in their view of how the economy works.

This divergence is not new. The debate, starting in 1924,[2] between the economist John Maynard Keynes and the officials of the British Treasury, already provides most of the answers we need today. The two stories, whose roots lie in history, represent divergent interpretations of the common understanding.

The Arguments for Austerity

Moral arguments for austerity, of which Florian Schui[3] has offered a wide review, can be found in pre-modern thinkers like Aristotle and Aquinas; economic arguments for austerity also have a long history.

The most familiar economic argument has been 'crowding out'—the view that government spending, whether financed by taxes or borrowing, diverts resources from productive use by the private sector. This goes back to Adam Smith and Ricardo. It was supported by the then Chancellor of the Exchequer, Winston Churchill, when he said in 1929:

> when the Government borrow[s] in the money market it becomes a new competitor with industry and engrosses itself resources which would otherwise have been employed by private enterprise, and in the process it raises the rent of money to all who have need of it.[4]

This reasoning is identical to that of contemporary austerians, like the Chicago economist John Cochrane, who wrote that 'every dollar of increased government spending must correspond to one less dollar of private spending. Jobs created by stimulus spending are offset by jobs lost from the decline in private spending. We can build roads instead of factories, but fiscal stimulus can't help us to build more of both'.[5]

Today the crowding out argument has taken a renewed form, known as 'expansionary fiscal contraction', elaborated by a group of academics belonging to the Bocconi University in Milan. According to Sue Konzelmann,[6] this proposition comes in two different, but complementary, forms.

The *Ricardian* school derives from Robert J. Barro's (Harvard) revision[7] of the concept of 'Ricardian equivalence', first stated by David Ricardo in his *Essay on the Funding System* (1820). Ricardian equivalence claims that a stimulus policy will fail to revive private spending, since forward-looking taxpayers know that a deficit today means higher taxes in the future, and will therefore increase their saving in order to pay the 'deferred taxes'. The net effect of increased borrowing is therefore zero.

The second school of thought is the *New Classical*. The claim here is that an increase in the government's deficit will raise interest rates, by reducing the total of saving available to finance private investment, and therefore increase the cost, and thus reduce the volume, of such investment. This thesis was supported by famous mainstream economists like the Nobel prizewinner Eugene Fama who claimed that 'stimulus plans absorb savings that would otherwise go to private investment. […] Stimulus spending must be financed, which means it displaces other current uses of the same funds'.[8] Both arguments, it should be noted, assume an absence of spare productive capacity in the economy.

A refinement of the interest rate argument is so-called psychological crowding out, which introduces us to the main focus of this book: confidence. Those who believe in psychological crowding out concentrate on the psychological impact of deficits. The real effect of a bond-financed stimulus package remains the same: interest rates rise. Nevertheless, the cause is different. The reason for higher interest rates is not a shortage of savings, but a shortage of confidence of the business sector in the government's stimulus programme. John Maynard Keynes noticed this argument in the 1930s, when writing that a policy perceived by 'the average City man […] as crack-brained and queer […]' will 'upset the confidence of the business world and weaken its existing motives to action', without giving the government the time to 'put other motives in their place'.[9] This positive correlation between austerity and business confidence finds its origins in the Victorian theory of fiscal policy, in which a state's creditworthiness derives from a balanced budget (which included surpluses to repay the national debt). Accordingly, a reduction of public spending would have a positive effect on business' expectations, boosting private investment, while an increase in government spending, and especially borrowing, would shake the confidence of businessmen, who would reduce their spending. In the real world, though, it is extremely difficult to forecast business' reaction to fiscal policies. Helpless in face of the mismatch between economic theory and economic reality, Olivier Blanchard, the IMF's chief economist, called the business sector 'schizophrenic' for its reaction to austerity policies, which did not correspond to what mainstream theory suggested.

In 2011, an article by the Belgian economist Paul De Grauwe argued that confidence does not depend on the size of the national debt, by showing that the UK government, despite having a higher deficit and level of debt than Spain, was paying a lower interest rate on its debt.

A recent debate between Robert Skidelsky and Niall Ferguson also looked at the confidence question. Ferguson claimed that it is deficits which destroy confidence; Skidelsky replied that 'confidence closely tracks the performance of the economy. Austerity did not pull confidence up; it pushed it down, because it pushed the economy down'.[10] This intuition brings us directly to the main arguments of the Stimulus side.

The Arguments for Stimulus

The advocates of stimulus policies may loosely be called Keynesian. It is a myth that Keynes (or indeed post-war Keynesians) supported fiscal deficits at any time and under any circumstances. In the vulgarized view, Keynesian policies are associated with excessive and unbridled government spending to bribe the electorate. This incorrect interpretation of Keynes derives from one of his most quoted remarks that unemployment can be reduced 'if the Treasury were to fill old bottles with banknotes, bury them [...] and leave it to private enterprise [...] to dig the notes up again' (*General Theory*, p. 129): the continuation of the sentence 'if they can think of nothing better to do' is normally omitted. The tendency to frame the Austerity vs Stimulus debate as an endless contest between austerians and Keynesians is simply wrong.

Keynesians have never supported running budget deficits at all times. According to their view, the choice between expansive and restrictive fiscal policy depends entirely on the current economic conditions. In a phrase, less famous than the one above, Keynes wrote in 1937 that 'The boom, not the slump, is the right time for austerity at the Treasury'.

Keynes's reasoning was straightforward. During a boom, when the economy is at full employment, additional public expenditure would crowd out real resources. On the other hand, during a slump when the resources of an economy are under-employed, a deficit created through fiscal stimulus is not deferred taxation but a boost to economic activity. As such it creates its own means of repayment by increasing the aggregate income from which the government's revenue is drawn, and reducing the government's spending on unemployment. No question of 'crowding out' of real resources arises. Keynes did, however, recognize the possibility of psychological crowding out—that is adverse expectations by the business community concerning the effects of running deficits. He wrote the *General Theory*, in large part, to create expectations which would support what he believed to be the correct policy.

Relationship with Monetary Policy

Expansionary policy can take two forms, fiscal and monetary. In this book, we have concentrated on stimulus by fiscal measures. But the economy might also be stimulated by monetary policy. Indeed, both weapons were used in the immediate aftermath of the downturn. Attention then switched to the explosion of public sector deficits, and fiscal expansion to expand aggregate demand was ruled out on confidence grounds. But it was also recognized that austerity was hindering recovery. So, in both the UK and the Eurozone, the authorities sought to offset fiscal contraction by monetary expansion, through the 'unconventional' use of quantitative easing: the Bank of England purchased £350 billion in assets mainly government bonds, between February 2009 and October 2012. In March 2015, the European Central Bank (ECB) led by Mario Draghi started to buy €60 billion of assets every month. In this book, we will not pursue the debate concerning the efficacy of quantitative easing, or the interaction between monetary and fiscal policy, but reproduce an assessment by Thomas Fazi of the Draghi QE policy.

Austerity vs Stimulus: A Political Debate

As this introduction has already suggested, the revival of the debate was mainly driven by political factors. A recent letter on *The Guardian* signed by David Blanchflower, Mariana Mazzucato, Victoria Chick and others[11] argues that austerity has little to do with economic theory, the view also taken by Paul Krugman. Despite its origins in academia, the idea of austerity gained success mainly because of its political message. Austerity's political-economic prescription, in fact, matches the ideology of laissez-faire, a common ground for European and British centre-right parties that dominated the political scene before and during the recession (with the exception of the new labour). The idea that economic growth should come from the private sector and that government's fiscal policy should not interfere with the functioning of the market offered strong political support for policy-makers who wanted to reduce the size and influence of the state, an ideology for which Alesina and the other Bocconi scholars provided the needed (even if definitely scanty)[12] evidence.

Today stimulus ideas are spreading among new emerging left-wing forces in Europe, trying to break with the current narrative in which the state should act as an individual household, saving wisely and paying off its debt. While Keynesianism's original purpose was to 'save' the capitalist system (unable to adjust on its own), its prescriptions find a favourable response in left-wing parties, whose aim is to preserve the state's presence in the economy, and in particular to protect the social security system, the main target of austerity cuts. As Italian economist Giorgio La Malfa puts it in the conclusion of his most recent publication (*John Maynard Keynes*, 2015, Feltrinelli), Keynes's ideas could represent the next dividing line—what political scientists would call 'cleavage'—in the new European party-system emerging from the crisis. New forces such as Syriza in Greece, Podemos in Spain, the Bloco de Esquerda in Portugal today are headed in this direction. In the UK, the victory of Jeremy Corbyn as leader of the Labour party, being the only candidate who advocated deficit spending, suggests that this Keynesian trend is spreading to Westminster.

Politics aside, the outcome of the debate between Austerity and Stimulus will be settled (for the time being) by what is deemed to work. A quick return to a satisfactory 'normal' of growth and employment will seem to vindicate the Austerity school: indeed, Britain's chancellor, George Osborne, has already been claiming victory in the fiscal battle. Any undue prolongation of stagnation on the European continent, or a return to 'boom and bust' in Britain, will strengthen Austerity's challengers. The austerity story, though shaken, is today still the dominant one in Europe. As Robert Skidelsky put it, the 'Master' has yet to return.

Robert Skidelsky
Nicolò Fraccaroli

Notes

1. Mark Blyth (2013) *Austerity. The History of a Dangerous Idea*, Oxford: Oxford University Press.
2. With the publication on *Nation and Athenaeum* of Keynes's article 'Does Unemployment Need a Drastic Remedy?', in which the British economist argued that monetary policy was not enough to fight unemployment, but also fiscal stimulus was needed.
3. Florian Schui (2014) *Austerity. The Great Failure*, New Haven and London: Yale University Press.
4. Winston Churchill (1929) *Disposal of the Surplus*, Common Sitting of 15 April 1929, Series 5, vol. 227, Hansard.
5. Cochrane, J. (2009) *Fiscal Stimulus, Fiscal Inflation or Fiscal Fallacies?*, http://faculty.chicagobooth.edu/john.cochrane/research/Papers/fiscal2.htm.
6. Sue Konzelmann (2012) *The Economics of Austerity*, Centre for Business Research, University of Cambridge, WP No. 434.
7. Robert J. Barro (1979) *On the Determination of Public Debt*, Journal of Political Economy, 87 (5), 940–971.
8. Eugene Fama (2009) *Bailouts and Stimulus Plans*, Fama/French Forum, 13 January.https://www.dimensional.com/famafrench/essays/bailouts-and-stimulus-plans.aspx.
9. John Maynard Keynes, XXI, p. 290, quoted in Marcus Miller, Robert Skidelsky and Paul Weller (1990) *Fear of Deficit Financing: Is It Rational?*, in Roger Dornbusch and Mario Draghi (eds.) *Public Debt Management: Theory and History*, CEPR, Cambridge, UK: Cambridge University Press.
10. Robert Skidelsky (2015) *No Pain, No Gain for Britain?*, Project Syndicate, May 19. https://www.project-syndicate.org/debate/skidelsky-and-ferguson-debate-austerity#niall-ferguson-british-austerity-by-robert-skidelsky-2015-05.
11. David Blanchflower et al. (2015) Jeremy Corbyn's opposition to austerity is actually mainstream economics, The Guardian, 23 August 2015. http://www.theguardian.com/politics/2015/aug/23/jeremy-corbynsopposition-to-austerity-is-actually-mainstream-economics.
12. The title of one of the papers that inspired the theory of expansionary fiscal contraction is very eloquent in this regard: F. Giavazzi and M. Pagano (1990) *Can Severe Fiscal Contraction be Expansionary? Tales of Two Small European Countries*, NBER Working Paper n. 3372.