Is Austerity the Cure for Current Economic Problems?

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In 2008-2009 the United States and other advanced economies experienced the most severe financial crisis since the Great Depression of 1929 (Salvatore 2013: 39). The liquidity crisis on Wall Street morphed into a global economic contraction, and the subsequent bailing of banks deemed 'too big to fail' across the Global North, transmuted the disintegration of the financial sector into a crisis of sovereign debt (Blyth 2013: 5-6; Orr 2012: 1). It is thus the so-called sovereign debt crisis that has reignited the debate over austerity as the cure or the disease for contemporary economic problems (Konzelmann 2014: 701). There is undoubtedly a lot at stake in debates surrounding austerity and the term conjures up issues such as freedom, human rights, democracy and morality. In this essay however, I will focus on austerity as an economic policy predominantly in the context of the Global North. I will begin by defining the current economic problems that burden global capitalism. I will then construct the concept of austerity as an economic policy and present the arguments put forward by its proponents. I will argue that austerity is the mire for current economic problems because its results have been antithetical to its declared benefits due to its inherent contradictions; and will offer an alternative approach in the tradition of John Keynes.

In order to analyse whether austerity is the cure or the disease of current economic problems in a cogent way, it is first necessary to define the contemporary economic issues that plague global capitalism. According to McNally the statement made by the International Monetary Fund (IMF) in April 2008 – that we are currently experiencing 'the largest financial crisis in the United States since the Great Depression' – downplayed the extent of the plight facing the international capitalist economy for two reasons (2009: 35-36). Firstly, the financial crisis was no longer confined to the US. It had destabilising ripple effects at a global level and jolted the financial markets of the United Kingdom, the Eurozone, East Asia and many of the emerging economies. Secondly, the financial crisis was no longer simply financial. The collapse of the financial sector triggered a contraction of real economic growth on a global scale (McNally 2009: 36). This global economic slowdown is commonly referred to as the 'Great Recession' (Paeth 2012: 389), and its effects are still being felt in the form of: high levels of unemployment across the Global North, the most significant increase in the US savings rate since the 1940s, and sluggish growth (Orr 2012: 2).

The US and other developed states initially responded to the financial crisis and the ensuing recession through a combination of bank bailouts, and expansionary fiscal and monetary policy (the injection of liquidity into national economies and the reduction of interest rates) (Salvatore 2013: 40). The increase in government expenditure (required to resuscitate private sector financial institutions and directed towards stimulus spending) and pronounced declines in state revenues (Reinhart and Rogoff 2010: 574) resulted in sharp increases in the budget deficits of the major advanced economies particularly from 2008 to 2009; and as of 2012 all these states continued to be in deficit (Salvatore 2013: 41). The often-exorbitant deficits run by the advanced economies since 2008 lead to the accumulation of huge levels of national debt, this condition being referred to as the 'northern debt crisis.' Thus, what begun as a financial crisis due to unsustainable private debt morphed into a sovereign debt crisis as governments effectively inhaled the debt accrued by the private sector (McMichael 2012: 240). It is therefore the northern debt crisis and reverberations of the Great Recession that are the fundamental economic problems that frame today's global capitalist economy.

The current problems in the global economy therefore raise the question explored by Reinhart and Rogoff: how do we achieve economic growth in a time of debt (2010)? The promotion of austerity policies as the 'elixir' for stagnant growth and inordinate levels of state debt remains strong amongst economists and politicians who have trumpeted benefits to there implementation such as debt reduction and renewed growth and prosperity (Schui 2014: 1; Thornton 2013: 269). Keynesian economists on the other hand reject all forms of austerity and consider it a 'poison' for troubled economies (Thornton 2013: 269). So what is austerity? Austerity, derived from 'austere,' refers to a condition of severity and coalesces two strands of meaning, viz. self-restraint (rectitude, strictness and responsibility) and a reduction in living standards (Nicholson 2013: 26). Hence policymakers often justify austerity policies through appeals to ethics and morality (Konzelmann 2014: 701). In the context of economic policy however, the term generally refers to a reduction in spending by the state. Austerity programmes therefore endeavour to reduce public expenditure and increase tax revenues and other government receipts, in order to return state budgets to surplus to pay down sovereign debt (Konzelmann 2014: 703). Such programmes traditionally involve a combination of policies such as: cuts in government spending, tax increases, the privatisation of state owned companies and other assets, deregulation and interest rate hikes (Parguez 2013: 55; Schoenbaum 2012: 106).

Proponents of austerity such as Reinhart and Rogoff contend that states seldom "grow their way out of debts," and conclude that once debt to gross domestic product (GDP) ratios reach 90 percent and 60 percent for advanced and emerging economies respectively, public debt begins to depress economic growth (2010: 577-578). This leaves states vulnerable to financial crises due to a decline in confidence within the private sector (Reinhart and Rogoff 2010: 577-578). Ricardo elaborated on the causality of Reinhart and Rogoff's observations by asserting that high state debt will depress national economic growth because financing government expenditure and deficits, whether achieved through an increase in taxes or through loans, will ultimately have to be drawn from "the liquid resources of the community" (Roberts 1942: 257). In addition austerians argue that states with high levels of public debt face a decline in investor confidence and a subsequent reduction in foreign direct investment (Konzelmann 2014: 703). Thus heavily indebted states may raise interest rates in order to stimulate investor demand for government bonds. A rise in interest rates will increase the cost of borrowing for households and firms and is therefore likely to suppress consumption and investment by the private sector and drive down economic growth (Boccia 2013: 5). In addition higher interest rates increase demand for domestic assets and leads to appreciation of the domestic currency. This reduces net exports as domestic goods become more expensive, and thus less attractive to overseas consumers, further suppressing economic growth (Ball and Mankiw 1995: 6). Consequently austerians posit that a high public debt to GDP ratio potentiates a decline in economic growth and thereby trumpet austerity as the only route to growth for debt burdened economies (Blyth 2013: x).

In line with scholars such as Blyth and Krugman I disagree with the (somewhat waning) orthodoxy that "cuts lead to growth" and concur that austerity is indeed a dangerous concept (Blyth 2013: x), and the disease for current economic problems. The proclaimed benefits to austerity measures, viz. the reduction of public debt, an increase in economic growth (as confidence returns), and the provision of economic stability, have not manifested empirically (Blyth 2013: 3). A case in point is the tough austerity packages rolled out by Portugal, Ireland, Italy, Greece and Spain (PIIGS) once they were struck by the financial crisis in 2008. Budget cuts by PIIGS caused their economies to shrink and their debt loads (debt to GDP ratio) and interest payments to skyrocket (Blyth 2013: 4). The effects of such cuts on Greece, the poster child of austerity and the Eurozone crisis, was an increase of its debt to GDP ratio from 106 percent in 2007 to 170 percent in 2012, despite repeated rounds of austerity cuts (Blyth 2013: 4). Similar outcomes were witnessed in Portugal and Ireland, thus according to Blyth "austerity is clearly not working" (2013: 4). In fact its results are antithetical to its purported benefits, as GDP across PIIGS has declined resulting in an increase in the debt loads carried by these states.

So why is austerity failing? It is my contention that it is due to the flawed logic upon which it is couched, namely, the initiation of contractionary fiscal policy (austerity) during a recession. An engagement with Keynesian theory provides considerable insight into why austerity is the disease for current economic problems. Despite misinterpretations by his critics Keynes was not adverse to austerity. According to Keynes's analysis, austerity was the requisite complement to stimulus (expansionary fiscal and monetary policy) to be applied at the peak of the business cycle, to cool an overheated economy from inflation and financial collapse (Konzelmann 2014: 714). Thus for Keynes austerity was 'a policy for the boom not the slump' and therefore the implementation of austerity during the current economic recession is nonsensical (Konzelmann 2014: 714). In the case of debt reduction, Rowe asserts that the sustainability of public debt should be evaluated relative to GDP, i.e. the debt to GDP ratio; hence the "denominator matters" (2012: 33). As exemplified by PIIGS and the US (since 2011), budget-slashing austerity measures drive down GDP more than they curb debt therefore resulting in a condition of ever more unsustainable levels of debt (increased debt to GDP ratios) (Rowe 2012: 33). Hence for Rowe policymakers concerned with public debt would do well to adhere to Keynesian logic and stimulate the economy, rather than pursue self-defeating and illogical austerity programmes (2012: 33).

Holland and Portes have also taken up arms against 'self-defeating austerity' programmes in the context of the European Union (EU) (2012). As discussed above, the fundamental objective of austerity policies is to reduce government expenditure and increase government revenue, in order to pay down public debt. Somewhat paradoxically however austerity policies increase unemployment thus reducing tax revenues and may put upward pressure on social security spending such as unemployment benefits; therefore mitigating the effects of other austerity initiatives (Holland and Portes 2012: F4). In addition the authors argue that while austerity policies have reduced the stock of debt across the EU, the modest decrease in debt cannot keep pace with the substantial decreases in GDP; hence debt to GDP ratios have increased across the bloc. Furthermore a reduction in growth for individual EU states is particularly problematic due to the vast network of trade and capital linkages that traverse the region. This has allowed for spillover effects; a situation in which declining growth in state 'X' has reduced its demand for goods produced in state 'Y', thereby suppressing net exports and GDP in state 'Y', and potentiating a domino effect (Holland and Portes 2012: F5). Thus while austerity may transpire favourably for a state in isolation, coordinated austerity programmes across the EU has resulted in a rise in debt to GDP ratios for the majority of the EU members, and for the region as a whole (Holland and Portes 2012: F10).

Having argued that austerity is the disease for current economic problems it seems judicious to advance what I consider a cure. Krugman argues that the way debt is perceived by 'deficit-worriers' is erroneous and contends that a distinction between public debt and private debt should be made for two reasons (2012). Firstly, private debt differs from public debt in that private debt (a mortgage for example) must be repaid whereas government debt does not; governments need only ensure that their debt grows at a slower rate than their tax base. Secondly, private debt is money owed to someone else; US government debt on the other hand is largely money it owes to itself (Krugman 2012). Thus the solution to an economic problem caused by too much private debt is to take on more public debt for fiscal expansion (Krugman and Eggertsson 2012: 1490). As Krugman and Eggertsson assert the purpose of fiscal expansion is to sustain employment, output and incomes while private debts are abated (therefore maintaining tax receipts and averting an increase in unemployment benefits); allowing the government to focus on its debt once deleveraging within the private sector has come to an end (2012: 1490). Furthermore, an increase in fiscal expenditure is likely to be more effective when interest rates are at or close to the zero bound (as is the case across the Global North) due to a reduction in 'crowding out' of the private sector (Krugman and Eggertsson 2012: 1490). Hence low interest rates result in a larger multiplier effect, viz. an increase in government spending by one percent is likely to increase GDP by more than one percent, and thus the implementation of fiscal stimulus in the current economic climate is likely to provide a significant boost to GDP. It is important to note that the converse also holds. Therefore government cuts in the name of austerity have lead to a magnified decline in GDP (Holland and Portes 2012: F4-F5). The implication of Krugman and Eggertsson's thesis is that perhaps states can 'grow their way out of debt' after all.

Reinhart and Rogoff's seminal paper 'Growth in a Time of Debt' gained significant traction with policymakers and economists, and since its publication austerity has been conceived as the orthodox approach to addressing high levels of public debt for states across the Global North. In this essay I have illustrated that austerity has failed in achieving its trumpeted objectives in terms of reducing debt and restoring growth, by providing empirical evidence in the case of PIIGS. I have argued that its failure is due to a number of factors. Firstly, according to Keynes, austerity (fiscal contraction) is a policy for the boom not the slump. Therefore its implementation across states scourged by recession or slow economic growth, such as a number of the EU states, the US, and other advanced economies, is nonsensical. In addition austerity measures are often undertaken and justified by policymakers as a means to reduce debt. As I have demonstrated while austerity may have had some success in reducing absolute debt levels in some states, it has been unsuccessful in reducing the magnitude of debt to GDP. As exhibited this is the metric of importance as it provides information regarding the sustainability of a government's debt and hence its ability to repay it. Austerity has resulted in a significant decrease in GDP in states upon which it has been unleashed. This has been largely due to the large government expenditure multiplier that is characteristic of states when they have pushed down interest rates towards the zero bound. Thus a decrease in government spending in states subjected to austerity policies has lead to a magnified reduction in GDP. Therefore in line with Krugman, and in the tradition of Keynes, states should increase fiscal expenditure as a possible solution to current economic problems; as its effects will be significant due to a large multiplier, and governments can expect more 'bang for their buck.'

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