What can public austerity achieve, if anything?

by Keith Rankin, 9 May 2012

Public austerity, under different names, has commonly been extolled as a prudent fiscal policy that remediates alleged past excesses of governments.

Austerity essentially means, attempting to run a financial surplus. Thus private austerity means saving more than usual, and repaying debt. Austere businesses repay debt, and save, just as households do. Under conditions of global private austerity, banks find it extremely difficult to lend the money that flows into their coffers from savers and debt-repayers.

Austerity, as a public policy, can only be a successful route out of economic crisis in the event of the willing unausterity of others. Thus many governments today look to spending in China, India, South-East Asia, South America and Australia to balance their austerity policies. They seek export-led growth. When South-East Asian nations had their crises in 1998, it was spending in the west that facilitated the success of their austerity programmes.

In an extended crisis, the risk is that everyone wants to be austere at the same time. The major event in the post-2008 economy is worldwide private-sector austerity. In a global economy with just two sectors - private and public - an austere private sector can only succeed in its debt-reduction aims if governments spend those private sector surpluses.

If, in the event of global private austerity, governments refuse to borrow sufficiently from households and firms (albeit through banks), then an economic depression ensures. That's exactly what happened in the early 1930s. It is impossible for both the private and public sectors to succeed simultaneously in being austere. It is impossible for every sector on earth to spend less than it earns; to buy less than it sells.

Before the word austerity became fashionable in 2010, the euphemism "fiscal consolidation" was used in many countries. Austerity is simply the word journalists came to prefer, once political forces in favour of fiscal consolidation gained ground over political forces in favour of fiscal stimulus.

Pointedly, we have not adopted the language of policy-making in the Great Depression era. In New Zealand in the early 1930s, the natural inclination of the then conservative governments was "retrenchment". It meant exactly the same thing as austerity does today.

We should note that, in the early 1930s, even centre-left governments were generally austere. In 1931 the New Zealand Labour Party offered little more than its own version of retrenchment. The 1929-31 British Labour Government also was fiscally conservative.

In Australia, the federal Labor government in 1930-31, and the New South Wales government that lasted a little longer, were proponents of public stimulus. But both were unable to stay in office, given the conservative - indeed fearful - sentiment of too many voters, most of whom were not unemployed. Other state Labor governments

were at least as fiscally conservative as right-wing governments were, sometimes more so.

Recovery came about in all three countries when pragmatic centre-right governments quietly abandoned retrenchment policies. In New Zealand a popular Labour government, from 1935, was able to build on and extend its predecessor's policy, through fiscal and monetary stimulus.

The other term for austerity, used widely in the 1920s and early 1930s, was "deflation". In the 1920s the big problem was the system of fixed exchange rates known as the "gold standard". The problems of the gold standard are closely reflected in the problem of the Eurozone today.

Under a system where a number of countries agree to fix their exchange rates to a common standard, or where a number of fiscally sovereign countries share a single currency, there are set rules of adjustment when imbalances occur.

Thus in the late 1920s, insufficiently competitive countries such as Britain and Germany were required to deflate their economies, while countries running trade surpluses such as France and the USA were required to inflate theirs. To deflate an economy meant a programme of public sector austerity with the aim of reducing all prices and wages within that economy. This is exactly what is being imposed upon Greece in 2012.

There were several problems, with the most obvious one being that the deflation policies required of Britain and Germany were not matched by pro-inflation policies in France and the USA. (The Brüning government in Germany eagerly deflated during the Depression, paving the way for National Socialism.) The main fear in the surplus countries was that, if they experienced inflation, then French and American jobs would relocate to Britain and Germany.

Thus, in the 1920s, France and the USA required Britain and Germany to reduce their indebtedness while actively preventing them from doing so. Protectionism itself was not the main problem in the 1920s, but import tariffs imposed by the surplus countries (France and the USA) certainly were a substantial part of the problem.

The present-day austerity programmes in Greece, Spain, Ireland and Portugal can work. But only if Germany and the other European economies with current account surpluses actively pursue its opposite, stimulus.

At present, the austerity in Europe's south is being defeated by the austerity of Europe's north. In the absence of a shift to fiscal pragmatism, Europe is destined for a substantial economic depression and a return to 1930s' style political extremism.