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Austerity's Internal Contradictions

Despite German complaints about the large size of government budget deficits in Greece, Spain, Portugal, Ireland and Italy, the fact is that German exports to these countries have risen over the past decade roughly in keeping with these deficits. Running deficits is how governments pump income and spending power into the private sector, after all. This poses a problem for Germany: now that these countries are being told to conform to the long-broken eurozone rule limiting such deficits to just three per cent of GDP, how will this affect their ability to buy German exports? For example, Germany's exports jumped sharply in April 2012, but nearly all of this went to countries outside the EU (up over 6% from last year), while sales to eurozone countries shrank 3.6% on the year.

The situation is much like what happened to Third World countries forced to adopt the International Monetary Fund's austerity plans from the 1960s onward. Austerity "improves" the balance of payments by cutting back the ability to import. For much of deficit-plagued Europe, cutting public spending will add fiscal shrinkage on top of the debt deflation plaguing these countries from their financial and real estate bubbles. For Germany, the demand that its customers impose budget "discipline" contradicts its own interest in maintaining exports. If these taper off to Greece and other Mediterranean countries, how is Germany to maintain its own domestic income and employment growth? Can it replace shrinking EU markets by selling to the BRICS or other countries?

Austerity programmes have two serious internal contradictions. First, even if tax rates are raised, tax revenue falls as the economy shrinks. This widens budget deficits – but not the kind of Keynesian deficit that pumps purchasing power *into* the economy. Matters are aggravated in today's situation by the fact that debt payments owed on past obligations divert spending away from current goods and services. Sales decline and employment falls off – and shrinking markets make debts harder to pay. This leads to more defaults, foreclosures, distress sales and a downward spiral. Thus fiscal austerity and debt deflation create the opposite effect from what has been promised – surely not a favourable prospect for German exporters! A further asymmetry in austerity policy is the belief that banks must be kept afloat rather than taken over under better-grounded lending and investment rules. If governments are indeed to spend, it should be on saving the real economy rather than on financial investors.

Chancellor Merkel intuitively opposed bailouts and showed reluctance at increasing the EU's bailout fund to €1 trillion. Helping countries "borrow their way out of debt" by subsidising a basically insolvent financial structure certainly has been a losing proposition for half a century. In the 1960s and 1970s, the IMF and the United States lent money to Latin American governments to support their currencies on the condition that they impose austerity programmes which ended up crippling their economies. The result was to widen their balance-of-payments and budget deficits – while currency support subsidised an enormous capital flight at favourable artificial exchange rates (for the flight capitalists). The charade finally ended in 1982 when Mexico announced it could not pay. The continent-wide wreckage had to be cleaned up by Brady Bond writedowns in the late 1980s.

Ultimately at issue is economic ideology. I am tempted to say "religion", but every religion in history has been opposed to supporting creditors and the 1% against the indebted 99%. Throughout history, the great religions have cancelled debts to prevent impoverishing large swaths of society. So rather than a bona fide religion, we have a bankers' sectarian cult – alas, one sufficiently backed to dominate many schools and popular media. From the IMF's austerity programmes to the neoliberal free hand in the Soviet Union after 1991, pro-creditor orthodoxy serves bankers. Its mentality has been likened to medieval doctrines of bloodletting to cure sick patients. The analogous financial doctrine is that austerity will improve government budgets, not push them

deeper into deficit. Austerity is supposed to make countries more competitive, not shrink the domestic market, slow investment and spur emigration, particularly of the most highly skilled labour.

Yet the last serious discussion of austerity's inability to enable countries to pay their debts was in the 1920s over German reparations. This was a great debate that pitted John Maynard Keynes and others against pro-creditor hard liners, headed by Jacques Rueff of France and Bertil Ohlin in the United States. Keynes pointed out that if the Allies demanded hard-currency reparations from Germany far beyond its ability to pay, they should spell out exactly how much German export production they would purchase. Instead, the United States raised its tariffs against German exports in 1921. New York bond buyers lent dollars to German cities, which turned the hard currency over to the *Reichsbank* to pay the Allies, who turned around and paid their inter-ally war debts to the US government. Thus Germany paid for reparations by shifting government debt onto local and private-sector balance sheets – until the dubious scheme collapsed in 1931.

Nearly a century earlier, a similar financial debate occurred in Britain between the Bullionists – bank lobbyists headed by David Ricardo – and the more realistic Banking School. Two centuries of experience have controverted pro-creditor austerity theories again and again, from 19th-century England to Germany in the 1920s to the more recent failures of hard-line IMF policy and Baltic austerity. Yet one finds no acknowledgement of this historical experience and neoliberal failure in today's economics curriculum or in the popular press. Instead, one gets rhetoric and a remarkable shortsightedness, as euphemisms are used in an attempt to rationalise austerity as if it will promote "price stability". The European Central Bank's website proclaims: "We in the Eurosystem have as our primary objective the maintenance of price stability for the common good. Acting also as a leading financial authority, we aim to safeguard financial stability and promote European financial integration."

So the ECB's first obligation is price stability – not growth, raising living standards or capital investment. The ECB demands bailouts for banks, thereby subsidising the debt overhead rather than writing down the debts (and hence, obliging creditors to take a loss). From the real economy's vantage point, the ECB is on the wrong side. When debts cannot be paid, some party must lose – either creditors or debtors. The 99% are debtors, and ECB doctrine (backed by the IMF and the Washington Consensus) says that it is preferable to plunge them into depression and unemployment than to expect the 1% to give up the remarkably giant gains they have made during the Bubble Decade.

The cover story for this pro-bank policy is the myth that central bank financing of government spending causes serious price instability. But there is little evidence for this. However, what *has* created enormous inflation is reckless credit creation by commercial banks in Europe and North America. If little attention has been paid to this fact, it is because of what has actually been inflated: asset prices for real estate, bonds and stocks. In contrast to commodity price inflation (typically accompanied by rising real wages), this usually is deemed a good thing. People like to see the price of their house rise, as well as the savings they invest in stocks and bonds. But rising home prices oblige families to take on what turns out to be a lifetime of debt to gain access to housing. Moreover, rising bond and stock prices make it much more expensive to purchase a retirement income. Most seriously, bidding up asset prices on credit leaves the economy debt-ridden. This is what is happening today. It is forcing debt-ridden economies to choose between saving the real economy or bailing out creditors for loans and investments gone bad. The ECB follows the 1% in saying: We do not want to lose; so taxpayers will have to absorb the loss. And it seems German exporters may be swept along in the austerity wave.

So we come to a third internal contradiction in demands for austerity: Instead of promoting European financial integration, ECB policy is forcing debtor countries to choose between imposing depression on a Lost Generation of unemployed young adults or withdrawing from the eurozone.

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