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THE POLITICAL ECONOMICS OF AUSTERITY

Sue Konzelmann

'The first requirement for an understanding of contemporary economic and social life is a clear view of the relation between events and the ideas which interpret them. ... Ideas are inherently conservative. They yield not to the attack of other ideas but ... to the massive onslaught of circumstances with which they cannot contend'.

John Kenneth Galbraith (1999:6-17)

1. Introduction

Recent events constitute a 'massive onslaught of circumstances', calling into question existing ideas about the relationship between the public sector and the private sector – finance, in particular – and the state's management of the economy. The collapse of the American sub-prime real estate bubble in 2007 set off a chain of events, culminating in the failure in 2008 of Lehman Brothers Holdings Inc., the fourth largest investment bank in the United States. This triggered panic in international financial markets, the effects of which spilled-over into the real economy, creating a deflationary crisis of global proportions.

When a crisis occurs, there is a spectrum of possible responses. In this instance, the first was unparalleled, internationally coordinated monetary and fiscal stimulus, followed by governmental rescues of banks and financial institutions deemed 'too big to fail'. However, the resulting substantial increase in levels of public debt, exacerbated by policy responses to the onset of a major global recession, swiftly led to a revival of the Neoclassical economic orthodoxy epitomised by 1920s 'Treasury View' – that government deficits and public debt squeeze-out private sector expenditure and are therefore economically damaging (Barro 2009; Cochrane 2009, 2010; Fama 2009).

The Greek sovereign debt crisis served as the catalyst for austerity, the theoretical justification for which was seemingly high-quality academic research by Reinhart and Rogoff (2010) into the long-term historical relationship between public debt and economic growth. This purported to identify a level of public debt – 90 percent of GDP – at which an economy's growth stagnates, a threshold already crossed by Greece. The implication for policy was that the cumulative negative effect of high levels of fiscal debt on economic performance warranted immediate sharp cuts in government spending, conditions imposed on Greece by the terms of its bailout. Any caution relating to the already depressed state of the Greek economy was dispelled by Alesina and Ardagna's (2010) revival of the 'expansionary fiscal consolidation' hypothesis – which postulated the counter-intuitive notion that reducing government spending would generate increased growth.[1] Growing fears of a Greek default soon raised concerns about the ability of other peripheral Eurozone countries – notably Portugal, Ireland, Italy and Spain – to manage their mounting deficits. Thus, what had begun as a largely *private* debt crisis morphed into a Europe-wide *sovereign* debt crisis as investors refused to lend to governments they judged to be actually or potentially insolvent. In an effort to calm the bond markets, the European Central Bank (ECB) and the International Monetary Fund (IMF) imposed tough austerity measures as a condition for their financial support, effectively shifting the onus of the crisis from the financial sector to the state.[2]

[1] According to this logic, the announcement of spending cuts and plans to reduce the deficit can be expected to increase business confidence, with positive effects on private sector spending and output. From this perspective, business spending is seen to be depressed because of fears about the sustainability or future cost of government deficits, the need to increase future taxes and the government's ability to borrow for future needs.

[2] It is important to note that from an economic perspective it matters greatly whether a country has control over its currency because countries that do – like the US and UK – are not operationally constrained by their budget; if necessary, they can borrow from the Central Bank to assure bondholders that they will not default. By contrast, Eurozone members neither issue their own currency nor have a floating exchange rate; they are therefore vulnerable to speculative raids by financial exchange traders and they are subject to the conditionalities – i.e., austerity – imposed by lenders, including the European Central Bank and the International Monetary Fund (IMF).

With increasingly strident demands for austerity, it might be assumed that the nature of economic austerity, as well as its objectives and effects, are clearly understood. However, as Galbraith observed about the tendency for theory to follow events, ideas about austerity economics have evolved since the earliest theorizing some three hundred years ago – as have the economies within which they were developed. Yet this lengthy debate has failed to produce general agreement about *what* constitutes austerity, much less *why* and *when* it should be applied.

The term 'austerity' generally refers to forms of cutting-back on spending, notably (but not only) that of governments.[3] From an economic policy perspective, austerity measures are usually implemented to reduce a country's current fiscal deficit[4] – the difference between government spending and revenues– and to contain its mounting public debt. Austerity programmes therefore include some combination of measures to reduce public expenditure and to increase tax revenues and other government receipts (such as the selling-off of non-financial assets). However, this is not as straightforward as it might appear because the method of funding public deficits – borrowing and/or money creation – has to be decided; and this has economic, social and political consequences of its own. Further, by reducing an important component of effective demand, austerity has real-world macroeconomic effects that also need to be taken into account, not least because of the effect they might have on government income and expenditure.

An important objective of a policy of economic austerity is the maintenance of investor confidence in the government's ability to manage its finances. This determines not only its ability to borrow now and in the future, but also the terms and conditions upon which creditors are willing to lend. For bondholders, the two main risks are inflation (and the consequent reduction in the real value of bonds) and default, the latter of which is low for countries with their own currency when they are borrowing in that currency. However, if a government's debt rises to a level causing creditor concern about the security of their investment – or the risk of provoking speculative raids – a higher rate of interest will be demanded to compensate for this higher perceived risk (especially by foreign lenders, who also bear the risk of a possible depreciation of the debtor country's exchange rate). This adds to the government's cost of borrowing – and hence to its deficit and debt – and risks triggering a self-reinforcing vicious cycle. There are thus strong incentives for governments to keep national debt and borrowing levels within bounds deemed reasonable by investors and speculators.

Addressing the question, 'When do countries have too much debt?' Pettis (2013:122) concludes that 'they have too much debt when the market believes they have too much debt'. At such times, the pressure to reduce public debt propels austerity up the policy agenda. But as Kitromilides (2011:528) observes, the debate about austerity is much wider than 'simply a technical dispute about opposing schools of thought in macroeconomics ... [with] economists advocating diametrically opposite solutions to policy problems'. Austerity measures have wide economic, political and social motivations and consequences; and agreement about the particular measures chosen and the pace at which debts are to be retired is secured through a process of political negotiation.

As evident in Figure 1, which graphs the average public debt-to-GDP ratio for the G8 countries since 1880,[5] public sector debt levels have fluctuated widely. The two World Wars produced the sharpest spikes, with average public debt reaching 116.2 percent of GDP in 1922 and 144.6 percent in 1945. During the Interwar years, the debt-to-GDP ratio rose from 75.4 percent in 1929 to a peak of 94.7 percent

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[3] The Oxford Dictionary of English defines austerity as: 'difficult economic conditions created by government measures to reduce public expenditure'.

[4] A fiscal budget surplus or deficit is the difference between government revenues (i.e., tax returns and income from the selling-off of non-financial assets) and government expenditures (i.e., spending on goods and services, transfer payments, capital expenditures (on infrastructure and public works) and interest payments on outstanding public debt).

[5] The G8 countries include Canada, France, Germany, Italy, Japan, Russia, the United Kingdom and the United States.

during the Great Depression in 1932, before falling back to 72.8 percent in 1937. After the Second World War, when domestic and international financial markets were tightly regulated and governments assumed the role of macroeconomic managers, public debt fell steadily – to 70.7 percent of GDP in 1950, 46.4 percent in 1960, 36.5 percent in 1970 and 34.0 percent by 1974. However, from the mid 1970s, as markets (especially financial markets) were progressively liberalized and governments assumed responsibility for maintaining market freedom – and resolving recurring financial crises – public debt rose steadily, reaching a peak of 82.2 percent of GDP in 1999 before increasing sharply following the 2008 financial crisis, to reach 99.8 percent in 2011.

Insert Figure 1 About Here

The sections ahead trace the social, political and economic developments that have shaped the debate about austerity economics since the 17th century when the earliest theories about public debt were proposed. Section two describes the origin of the national debt and its evolution during the 17th, 18th and 19th centuries in response to changes wrought by British imperial expansion and the industrial revolution. These developments set the scene for the 'Classical' debates, when calls for austerity were associated with the perceived need for the government to balance its budget during peace-time in order to maintain the credibility required to borrow for future needs as they might arise. Here, much of the debate revolves around the effects of government spending, and whether it should be financed by borrowing or taxation. Section three examines the growing concerns about the problem of urban poverty accompanying the industrial revolution, and associated demands for political, economic and social reform. This served to politicise the question of austerity, since public indebtedness, which had previously been primarily a consequence of national emergencies, was now also associated with ongoing expenditure on public goods and social welfare provision.

Following World War One, the debate about austerity economics rose to the top of the policy agenda as a consequence of the high levels of public debt accumulated during the war, and the economic challenges of the inter-war years. This is the focus of Section four, which explores the British 'Treasury view' – that the paramount policy objectives were to return to the gold standard and to balance the budget – and the 'Keynesian' challenge that ultimately ushered in a 'paradigm shift' following World War Two. During this latter period, austerity was associated with the peak of the business cycle, when restraint was required to cool over-heating economies and prevent inflation, to create budgetary space to meet the costs of involuntary unemployment and, once exchange controls had been abolished, to ward-off speculative raids on currency values.

Section five examines the revival of pre-Keynesian, 'Neoliberal', ideas during the turbulent 1970s and the sea-change in economic thought and policy it produced during the decades leading up to the 2008 financial crisis. During this period, the need for austerity became increasingly associated with the *trough* of the business cycle, which followed the bursting of credit 'bubbles' that had driven the prior boom. The devastating effects of the resulting sharp and deep recession led to calls for remedial austerity on *moral* as well as economic grounds. Section six explores key dimensions of the debate about austerity economics following the 2008 financial crisis, when calls for governmental parsimony have been increasingly driven by international financial markets, demanding 'credible evidence' that governments are serious about managing their budgets and repaying their debts, so as to protect the interests of investors in sovereign debt.

Section seven draws together the main threads of the analysis and the conclusions that follow from it. Throughout the historical narrative, important analytical themes revolve around the arguments used to justify austerity – notably appeals to ethics and morality (reinforced by misleading analogies drawn between government budgets and the accounts of firms and households). These include: concerns about

inflation and the observed relationship between inflation and unemployment; 'Ricardian equivalence' and 'non-Keynesian' effects of austerity; and the correlation between public debt levels and economic growth. The class analytics of austerity – who bears the burden of austerity and who benefits – and the process by which alternative ideas penetrate the mainstream and reconstitute the conventional wisdom are also important analytical themes.

2. The Origins of National Debt – and the Classical Debate about Austerity

The national debt, in its modern form, is only about 300 hundred years old; and for much of its history it has been used to pay for wars, of one sort or another (Goodhart 2011; Graeber 2011). Great Britain was among the first of the European countries to use public borrowing to fund military expansion. The catalyst was a humiliating naval defeat by the French in the Battle of Beachy Head in 1690. This produced a determination to build a more powerful navy. However, since funds could not be easily secured through taxation, the Bank of England was established in 1694, as a private institution, to raise money and lend it to the government by purchasing its (sovereign) debt.

Although markets for sovereign debt had emerged in Florence and other Italian city republics during the 15th century – and they had spread throughout Europe, to Spain, France and Holland – it was Britain's 'Glorious Revolution' (1688-89) and the political dominance of its rich upper-class elite that ushered in a more orderly system of government borrowing. Under William of Orange, the stability of the British political system created such confidence in the government's debt that it was able to borrow large sums at lower rates than those paid by private borrowers and other governments (Clark 2001:403). The ability of the British government to borrow relatively cheaply gave it considerable advantage; and it fostered fiscal prudence to maintain the confidence of the money markets.

The industrial development that followed transformed the economy and spurred domestic and international growth (Hobsbawm 1999). In 1707, the Act of Union bought together England and Scotland, and the British Empire began to expand. By the end of the eighteenth century, Britain was the foremost colonial power in North America and India; and following the defeat of Napoleonic France in 1815, it enjoyed a century of virtually unchallenged global dominance (Parsons 1999). Other capitalist countries also embarked on imperial expansion to secure sources of raw materials and markets. Successful wars for this purpose, although initially incurring public debt, usually became self-funding since the gains in natural resources, markets and tax revenues far surpassed the costs of securing them.[6] However, once the new colonies had been acquired, they needed defending, maintaining and administering. These costs were less easy to recoup, especially when the colonies revolted against taxation, as the Americans did during the War of Independence (1775-1783). The unpopularity of taxation, its short-term nature and tendency to provoke unrest, thus encouraged exploration of alternative methods of public financing; and with these developments came new ideas and theories about government spending and debt.

One of the earliest contributions to the Classical austerity debate was made by Bernard de Mandeville's (1714) *The Fable of the Bees: Or, Private Vices, Publick Benefits.* The fable began with an indictment of the extravagance of the rich ruling class of the day and the hypocrisy of their making a 'virtue' out of austerity and thrift. However, when a prosperous society of bees decided to cut spending to be virtuous, the hive collapsed. Mandeville was making the point that the spending of the wealthy had the public benefit of supporting others' livelihoods. This sparked considerable controversy because not only did it suggest that individual virtue (austerity) could be a public vice; it also implied that excessive spending could be a public benefit. Mandeville was describing a fallacy of composition – that although *individual* austerity could be assumed to be good for society, *collective* austerity could have the opposite effect – a proposition Keynes would return to some 200 years later.

[6] It is important to note that during the early 20th century, the idea that wars for imperial expansion were self-funding was contested. See, for example, Veblen (1915) (especially Chapter Viii) and (1919) and Hobson (1902).

The Dutch economist, Isaac de Pinto was another early contributor to this debate. In his *Traite de la Circulation et du Credit* (1761), Pinto argued that national debt and stock market speculation in securities played a potentially positive role by fostering credit, increasing the circulation of money and promoting economic well-being. This contrasted sharply with the view of the 18th century British economists, David Hume (1752) and Adam Smith (1776), who were concerned about England's sovereign debt crisis (brought about by imperial expansion) and the 'degeneracy' associated with public borrowing. Fierce critics of mercantilism – and of Mandeville[7] – they argued that debt financing of mercantilist activities by government was not only evidence of profligacy, it also imposed fiscal burdens on future generations of taxpayers.

Following the American Revolution, the British financial system served as a model for the newly independent American colonies; and at the request of Congress in 1789, Alexander Hamilton, the first Treasury Secretary, prepared a report analyzing the state of the new country's finances and recommending a plan for retiring the national debt. With the aim of inspiring domestic and international investors' confidence in the new nation's solvency, Hamilton's *First Report on Public Credit* outlined a 'debt assessment plan' by which all debts would be repaid at face value, the Federal government would assume responsibility for the debts of the states, and the debt would be financed by issuing interest-bearing bonds that could be used as collateral for securing further loans. In contrast to Smith and Hume, Hamilton reasoned that by *funding* the debt (rather than paying-off the principal as quickly as possible) and by allowing creditors to secure further loans against their investments in government bonds, the plan would encourage investment in government securities, transform the debt into a source of capital and stimulate the economy (Staloff 2005).

During the 19th century, David Ricardo, writing at the end of the Napoleonic Wars during which Britain had accumulated an enormous amount of debt, referred to debt as '… one of the most terrible scourges ever invented to afflict a nation'. However, by this time industrialization was much further advanced than in the late 18th century when Hume and Smith were writing. The government, in league with the mercantilists, was no longer portrayed as necessarily threatening to economic progress by borrowing; and the national debt was more favourably regarded. Ricardo's interest focused on the relative merits of alternative ways of financing public expenditure. In his *Essay on the Funding System*, Ricardo (1820) examined the relative 'equivalence' of financing a war by means of taxation or by the issuing of government bonds. Although he concluded that there was no real difference, he doubted the practical significance of this logical conclusion because if people had 'rational expectations', they would be indifferent between the two funding systems. But since they were likely to oppose additional taxes to fund the war – and so to favour borrowing – their decisions must be distorted by this 'fiscal illusion'. He therefore concluded that 'during peace, our unceasing efforts should be directed towards paying off that part of the debt which has been contracted during war'.

Thomas Malthus took a different view. In his *Principles of Political Economy,* Malthus (1836) argued that those living on the interest from the national debt – Smith and Hume's 'idle rich' – 'contribute powerfully to distribution and demand … they ensure effective consumption, which is necessary to give the proper stimulus to production' (p. 400). Because he believed that employment and incomes for the many depend upon the powers of production, Malthus maintained that 'it would be the height of folly to determine, under all circumstances, that the sudden diminution of the national debt and the removal of taxation must necessarily tend to increase the national wealth, and provide employment for the working classes' (p. 411). Attributing the stagnation that followed the Napoleonic Wars to under-consumption resulting from the cessation of wartime activities, Malthus recommended a moderation in the pace at which war-time debts were retired, going so far as to suggest that, if all else failed, the government

[7] For a discussion of Mandeville, Hobson and others who regarded thrift as a vice, see Keynes (1936), Chapter 21, Section VII.

should impose taxes and spend the proceeds, thereby restoring the balance between demand and supply (Davis 2003: 133-134).

John Stuart Mill, whose father was a close friend of Ricardo, took a position between those of Malthus and Ricardo. Whilst a proponent of free markets, he argued that government intervention was justified in the interest of society as whole. In *Of National Debt*, Mill (1848) defended public debt in situations of under-consumption, when 'some amount of national debt is desirable, and almost indispensable, as an investment for the savings of the poorer or more inexperienced part of the community'. However, he believed that public borrowing was potentially harmful because it absorbed capital that would otherwise be used for production and employment. Thus, in answering the question of whether it is 'expedient to take steps for redeeming that debt,' Mill contended that 'in principle, it is impossible not to maintain the affirmative'.

After Mill, economists devoted less attention to the national debt, which for Britain and the other advanced economies remained relatively low and stable until 1914, with the outbreak of World War One. Although there were debates about the effects of government spending, the rate at which the national debt should be retired, and the means of financing it, from a policy perspective, there was general agreement that, except in extraordinary circumstances such as war – or to relieve poverty – every effort should be made to maintain a balance (if not a surplus) in the government budget.

Karl Marx, however, took a much different view. He argued that:

> '[t]he public debt becomes one of the most powerful levers of primitive accumulation. As with the stroke of an enchanter's wand, it endows unproductive money with the power of creation and thus turns it into capital, without forcing it to expose itself to the troubles and risks inseparable for its employment in industry, or even in usury. The state's creditors actually give nothing away, for the sum lent is transformed into public bonds, easily negotiable which go on functioning in their hands just as so much so much hard cash would' (Marx 1976: 919).

Marx went on to show how important the founding of the Bank of England and the trading in public debt had been for the establishment and growth of banks and other financial institutions 'in the capitalization of wealth and the expropriation of the masses' and hence the development of British capitalism (Marx 1976: 921).

During the second half of the 19th century, with the second industrial revolution well underway, economists shifted their attention to other issues. Largely in response to the direction in which Marxist analysis was taking Classical economics, the 'marginal revolution' produced the 'Neoclassical' School, [8] which discarded the social and political elements of Classical economics and divorced economic theorizing from its historical context, increasingly presenting economics as a 'science' that addressed universal principles. Neoclassical economists emphasised the primacy of markets in determining relative prices and income distribution; and they were sceptical about taxation and government spending, seeing them as misdirecting market forces.

3. From Warfare to Welfare – The Social Reform Movement and 'Politicisation' of Austerity

From the mid 18th century, the industrial revolution brought widespread social and economic change that further influenced the direction of theory and policy with respect to the economics of austerity. In addition to economic growth, industrialization gave rise to major social problems, especially mass urban poverty. According to Herrick (1944: 68), 'the social problem … was that created by the concentration of property-less people in the centres of industry'. However, the 18th and 19th century emphasis on *individual* freedom and responsibility meant that societal needs were not afforded much policy priority.

[8] The term, 'Neoclassical', was first used by Veblen (1899).

This slowly began to change as industrialization progressed and the political franchise widened. In Britain, the Great Reform Acts of 1832, 1867 and 1884-5 extended the male right to vote and hence the need for political parties to solicit working-class support at the polls. Efforts were made to encourage commercial and industrial expansion and to improve the economic lot of the poor by cheap food policy. Progress was also made in protecting women and children, and in legitimising trade unions and their activity. The Factory Act of 1834 and the Education Act of 1870 put collective interests above individual freedom and set precedents for the social reforms of the 20th century (Herrick 1944: 70).

Nineteenth century legislation also attempted, albeit without much success, to deal with urban poverty. The speed of the transition from an agrarian to an urban based industrial economy led to a sharp deterioration in living and working conditions – especially during the latter half of the 19th century. As what remained of the old social order disappeared, increasing numbers of people faced difficulties subsisting in what was becoming an exclusively cash-driven economy, where they faced the uncertainties of fluctuating prices, insecure employment, and poor prospects, especially for those who survived long enough to get too old to work.

This transformation of economic and social conditions produced both innovative thinking and forward-looking views on social policy. John Ruskin was a leader amongst those contributing ideas about how society might evolve and be managed as industrialization progressed. Studying both the history of public debt and the behaviour of successive governments, he concluded that governments had too much of a penchant for expensive warfare. But Ruskin had ideas about how government might be converted so as to benefit society more: 'If we were to set our governments to do useful things instead of mischievous, possibly even the apparatus might in time be less costly!' (Ruskin 1862-63:12) In his collection of essays, *Unto This Last*, Ruskin dissected the Classical economic theories of Mill, Ricardo and Malthus; and he set out a vision of society that outraged many conservatives. Ironically, whilst Ruskin considered himself to be a 'violent Tory', many of his ideas were eventually adopted by the nascent British Labour Party. His 'political creed' – spelled out in the Preface of *Unto This Last* – anticipated the social reform movement of the early 20th century and contained many of the central components of the post-war welfare state, especially its commitment to full employment.

The appalling living and working conditions suffered by the working classes during the industrial revolution generated significant social and industrial unrest – so much so that political parties evolved to accommodate, channel and ultimately represent the interests of the new urban proletariat, especially as the franchise extended. In Britain, the fledgling Labour Party emerged to challenge the established two party system. This increased political visibility of the working classes strengthened, and was strengthened by, the ideas of social reformers such as Ruskin; but it also ratcheted-up fears amongst the upper classes that social change might prove uncontrollable. This promoted a split within the British Liberal party. Whilst some felt that state intervention in markets remained the biggest threat to civil liberty, a significant group, including David Lloyd George and Winston Churchill, saw the concentration of capital and the possibility of socialist revolution as being the greater threats – a view that the Russian Revolution in 1905 did little to dispel.

According to Herrick (1944: 76), '[t]he idea of individual freedom metamorphosed into the idea of social justice, which finally emerged as a guiding light of 20th century Liberalism'. The result was a rapid growth in state involvement in social welfare provision. But rather than experiment with radical change, such as that envisioned by Ruskin, the British government instead took its inspiration from Germany's Otto Von Bismarck, who during the 1840s had responded to the challenges of rapid industrialization – and the rising strength of the industrial proletariat – by initiating a process of social reform. Following the German example, and empowered by a 1906 landslide election victory, between 1907 and 1913, the British Liberal Government enacted a programme of social legislation that included the Trade Disputes Bill, the Workman's Compensation Act, the Old Age Pensions Act, the Trade Boards and Labour Exchange Acts, the Children's Act, the Housing and Town Planning Act, the National Insurance Act, the

Coal Mines Act and the New Trade Disputes Act. The pressure for change was intensified by the 1909 *Minority Report of the Royal Commission of the Poor Law*, authored by Beatrice Webb, which emphasised the structural causes of poverty and argued that the solution was provision of public services to citizens who needed them; it also advocated a policy of public works to address the problem of unemployment. According to Herrick (1944: 74), 'the question of social reform dominated public discussion in the years before the First World War … The level of debate in parliament and in the press was extraordinarily high … it reveals a clear and significant Liberal philosophy, neither radical nor socialist, which helped to create what has been called the "welfare state"'. Thus, by 1914, the early foundations of the British Social Welfare State had been put in place.

In many respects, the social reform movement in Britain – which took place during a period of relative trade and financial stability – embodied developments that would be built upon after World War Two. For the social reformers, the focus was on the importance of improved social welfare for the effective functioning of the economy. Public spending on social welfare provision was regarded as having public benefit; and – in a departure from the Classical doctrine of 'laissez-faire' – the state was assigned a central role in reform. The progress of the social reform movement was, however, halted by war (1914-1918). A ruinously expensive industrial war, the First World War, whilst reinforcing Britain's commitment to collectivism, led to renewed debate about the vastly expanded public debt, which put 'austerity' centre stage.

4. The British 'Treasury View', the 'Keynesian' Challenge and the Politics of Austerity

Britain emerged from the First World War victorious, but economically weak; and after a brief but hectic boom, the economy fell into depression. In 1920, the Lloyd George Liberal government, assuming that the rise in unemployment would be temporary, as it had been before 1914, set up an Unemployment Grants Committee to encourage public works schemes. However, the cost to the public purse of persistent unemployment raised doubts about the government's ability to meet the interest charges on the 1917 War loan and thereby to retain the confidence of its creditors; and this served to reinforce the deflationary bias in government policy. In 1922, Stanley Baldwin, the Conservative Chancellor of the Exchequer, warned that 'money taken for government purposes is money taken away from trade, and borrowing will thus tend to depress trade and increase unemployment' (Middlemas and Barnes 1969:127). The theoretical justification for this view – labelled the 'Treasury View' – was provided by Ralph Hawtrey, the Treasury's economist, who argued that '[t]he original contention that the public works themselves give additional employment is radically fallacious. When employment is improved, this is the result of some reaction on credit, and the true remedy for unemployment is to be found in a direct regulation of credit on sound lines' (Hawtrey 1925:48).

The British Government thus reverted to pre-war Classical laissez faire economic and financial orthodoxy in its policy making. Public expenditure was reduced in an effort to balance the budget and return Britain to the Gold Standard; a concerted effort was made to re-pay large war-time loans; and monetary policy was targeted at defending sterling. Continued high unemployment and deficits in the balance of payments were attributed to the war, which had disrupted export markets and radically increased production costs. In these circumstances, the Treasury reasoned that a return to economic 'normality' required wage reductions to restore prices to their pre-war levels. However, efforts to cut wages were met with fierce resistance from the trade unions; and industrial militancy intensified, rekindling the fear of socialism that had been triggered by the 1917 Russian Revolution. The situation worsened when, in 1925, the Treasury, with Winston Churchill as Chancellor of Exchequer, restored the Gold Standard and re-valued sterling at its 1914 gold parity. The resulting price deflation squeezed British manufacturers, who tried to limit their losses by cutting wages to further reduce labour costs. This precipitated the 1926 General Strike and a six month walk-out by the coal miners. But despite the ensuing economic, social and political unrest, continued high unemployment and a persistent balance of

payments deficit, the Treasury single-mindedly pursued its restrictive economic policy, with very little success as far as reducing the national debt was concerned. [9]

The Treasury View rested on the belief – held by Keynes himself, when he wrote his *Treatise on Money,* published in 1930 – that savings determines the level of investment and that monetary policy is appropriate for countering economic fluctuations (Laidler 1999:148-9). Keynes later modified his position by arguing that the solution to Britain's economic problems lay in increasing home demand to compensate for shrinking export markets. In 1924, he had published 'Does Unemployment Need a Drastic Remedy?', arguing that the cure for unemployment was to be found not only in monetary reform but also in 'the diversion of national savings from relatively barren foreign investment into state encouraged constructive enterprises at home'. In 1928, in 'How to Organize a Wave of Prosperity', he again argued for public spending to combat unemployment; and in 1929, with Hubert Henderson, Keynes wrote the pamphlet, *Can Lloyd George Do It?*, in support of Lloyd George's campaign pledge to reduce unemployment by major public works expenditure, financed by borrowing.[10]

The British Treasury refuted this contention in its 1929 White Paper; and Winston Churchill, re-iterated the orthodox Treasury view in his 1929 budget speech:

> 'Let us, first of all, by way of preliminary digression, address ourselves to the burning question of whether national prosperity can be restored or enhanced by the Government borrowing money and spending it on making more work. The orthodox Treasury view … is that when the Government borrow[s] in the money market it becomes a new competitor with industry and engrosses to 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'. (Churchill 1929).

John Maynard Keynes remains a towering influence in economics. But he was not the only voice advocating government intervention to stabilize the economy – nor was he the first.

4.1. American Inter-war Economic Policy and Thought

The United States had emerged from World War One in much better shape than Britain. From 1922 to 1929, the economy grew rapidly and employment remained high,[11] supported by rapid organisational and technological change, high levels of investment in manufacturing and construction, and a sharp increase in consumer expenditure, especially on cars and consumer durables. However, this revolution was not confined to the level of expenditure and the way the economy was organised; it was also related to the way the economy was theorised. In economics, there had developed a 'vigorous, diverse and distinctly American literature dealing with monetary economics and the business cycle' (Laidler 1999:211). The analysis was essentially institutional; and there was little opposition amongst American economists to the idea of counter-cyclical fiscal and monetary policy. There was, however, considerable debate about the effectiveness of such intervention – and how it should be financed.[12] The main academic centres where these ideas developed were Harvard (where Lauchlin Currie, Paul Ellsworth and Harry Dexter White

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[9] As a percentage of GDP, public debt had risen from 25 percent in 1914 to 182 percent by 1923, as consequence of the cost of the post-war recession. By 1929, it was down to 160 percent; but it rose again to 178 percent by 1933 owing to the Great Depression. But as the economy recovered during the 1930s, the national debt steadily fell as a percentage of GDP, reaching 110 percent by 1940.

[10] Keynes favoured borrowing because in his view, during the 1920s and 1930s, potential savings exceeded domestic investment opportunities. The excess either went abroad or was used by some to consume more than they produce. The excess savings could thus be more productively employed to provide a source of funds for public works. He argued against money creation because, according to Moggridge (1992:464), 'in existing circumstance, the Bank of England could not increase the volume of credit because an expansion in credit would tend to reduce the rate of interest and lead to an increase in foreign lending with awkward consequences for the balance of payments'.

[11] The exception to this was agriculture, which was in recession throughout the 1920s.

[12] For an analysis of US policy during the inter-war years see, especially, Arndt (1944) and Laidler, (1999).

were important contributors) and Chicago (where contributors included Aaron Director, Paul Douglas, Frank Knight, Henry Simons and Jacob Viner).

Elements of American economic thinking during the 1920s in many ways anticipated Keynesian analysis and policy recommendations, particularly with respect to stabilizing the trade cycle. William Foster and Waddill Catchings were among the first to articulate a case for using public works expenditure to counter a slump.[13] Their work attracted the interest of Chicago economist, Paul Douglas, who argued that

> 'the best way [to counter a slump] would be for the government to expend purchasing power for the construction of public works which would thus give purchasing power to the workers and stabilize the price level. Since the services of these public works would later largely be offered gratuitously to the public, they would not enter into the volume of commodities offered for sale and hence would not cause a fall in the price'. (Douglas 1927:41)

Considering the alternatives for financing such expenditure, Douglas concluded that:

> 'if proper safeguards could be provided to prevent inflation, ... I would personally favour an issue of paper money on the part of the government to pay for the materials and the labor utilized. In this way, society could get needed public works constructed without any added cost to itself. Labor which would otherwise be largely unemployed would be used instead to construct needed roads, buildings, playgrounds, etc. … The issue should be so limited as (1) to prevent the index of unemployment … from rising above, let us say five per cent; (2) to prevent the general price level from rising by more than two or three per cent; (3) to prevent the foreign exchanges from being dislocated'. (Douglas 1927:42)

The onset of the Great Depression reinforced these theories and added urgency to the debate about policy. Developing their ideas further, Douglas and his research student, Aaron Director, made the case for public works expenditure financed by monetary expansion: 'It is possible for government to increase the demand for labor without a corresponding contraction of private demand and … this is particularly the case when fresh monetary purchasing power is created to finance the construction work' (Douglas and Director 1931:210-11). The Americans favoured money creation to finance government deficit spending because they took the view that it injected new liquidity into the system and did not incur an interest charge or have an adverse effect on the rate of interest. So long as inflation remained within acceptable limits, they believed that it would have a greater expansionary effect than debt financing (Chick 1983: 321; Wray 1983). Since bond sales to the public leave the public with less money to spend, Lerner (1943: 40), for example, argued that the government should borrow from the public 'only if it is desirable that the public should have *less* money and *more* government bonds' (emphasis added).

By 1932, however, Douglas believed that monetary policy had failed to deal with the depression, concluding that large-scale government spending was now required. The Harvard economists, Currie, Ellsworth and White – having also concluded that the economic situation was now sufficiently serious that monetary policy alone was not capable of dealing with it – prepared a Memorandum explaining their perspective and outlining their recommendations for policy:[14]

> '[This Memorandum] sketches out an explanation of the then developing Great Contraction, as well as a comprehensive and radical policy program for dealing with it … [T]he main domestic component of that program was to be vigorously expansionary open-market operations and substantial deficit spending that, particularly in its early stage, was to be financed by money creation; its international dimension involved a return to free trade and serious efforts to resolve the problems of international

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[13] Important contributions of Foster and Catchings to this emerging literature include *Profits* (1925) and *The Road to Plenty* (1928).

[14] Both Lauchlin Currie and Harry Dexter White became key policy advisors during the Roosevelt era. At the Federal Reserve Board and later at the Treasury and White House, Currie became a leading advocate of expansionary fiscal policy, and White was a co-architect with Keynes of the Bretton Woods system (Laidler 2002:515).

indebtedness that had originated in the Great War and in the Treaty of Versailles'. (Laidler and Sandilands 2002)

In 1933, when the Roosevelt administration came to office, the US was suffering 'from the most extreme prostration which any capitalist country had ever experienced in peace time' (Arndt 1944:34). Informed by the work of the American economists at Harvard and Chicago, the 'New Deal' reforms of 1933 through 1937 were enacted. According to Arndt (1944:34), the New Deal 'was the most spectacular attempt that was made after the Great Depression to promote recovery by means of a deliberate expansionist policy as the chief stimulus of economic activity, and without recourse to totalitarian control of the economic system'. From 1933 to the third quarter of 1937, the American economy recovered. However, fears of possible inflationary effects checked New Deal expansionism, slowing the recovery; and in 1937, under pressure to reduce the fiscal deficit, there was a brief reversal – *to austerity.* This produced a sharp recession late in 1937 that almost returned the economy to depression. However, rearmament took over as the driver for growth and with the massive stimulus provided by the Second World War, the American economy recovered fully.

4.2. 'Keynesian Austerity' in Britain – A Policy for the Boom, not the Slump

During the late 1920s and 1930s, Keynes was often accused of ignoring the need to maintain confidence in both the authorities' financial policies and Britain's position in the international community (Middleton 1982:55). However, Keynes was opposed to fiscal profligacy; and his critics misunderstood the fact that in Keynes's analysis, *austerity* was the necessary counterpart to stimulus – to be applied during the boom as a means of averting inflation or the risk of financial collapse. Thus, in the wake of the 1931 financial crisis, Keynes 'wrote to Prime Minister (MacDonald) to say that a crisis of confidence was 'very near' and that the budget must be balanced' (Middleton 1982:175).

The following year, as unemployment continued to climb, Keynes and colleagues at the University of Cambridge sparked a public debate about the economics of government stimulus and austerity. In response to the invitation from the Editor of *The Times,* soliciting economists' opinions about the problem of inadequate private spending, the Cambridge economists underlined the importance of *both* private *and public* spending to combat the unemployment caused by insufficient effective demand.[15] The idea behind proposing government spending in a slump was that it mobilises unused resources, especially human resources. This, in turn, expands aggregate demand, further mobilising resources. The result is a virtuous cycle with multiplier effects since the total increase in economic activity exceeds the initial increase in government spending that set it off. Hayek and colleagues at the London School of Economics (LSE) responded with the alternative position: Being 'of the opinion that many of the troubles of the world at the present time are due to imprudent borrowing and spending on the part of public authorities,' they argued that any public spending should take the form of investment in the securities of private businesses; and they set out their case for fiscal austerity and the freeing-up of markets.[16] By attributing the crisis to differing causes – insufficient effective demand as opposed to insufficient funds for private investment – the Cambridge and LSE economists advocated contrasting policies. The Cambridge economists argued for government borrowing from the public to spend on public works to close the gap between actual and potential demand. By contrast, the LSE economists argued for government austerity in order to make the space for private investors in the market for finance.

In *The Means to Prosperity*, Keynes (1933) continued to call for fiscal stimulus; and in 1935, Lloyd George again proposed government borrowing and public works to address the problem of persistent unemployment. By then, 'public support was sufficient to make ministers feel that they ought to be seen as doing something' (Peden 1984:176) and the Treasury relaxed its resistance. By 1935, however, recovery was well underway – but it had come *not* from fiscal policy but from monetary policy designed

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[15] Macgregor, et. al. (1932a and b)
[16] Gregory, et. al. (1932)

for an entirely different purpose. In 1931, speculation had forced sterling off the Gold Standard. The resulting depreciation allowed interest rates to be lowered, which reduced the cost of financing the 1917 War loan and triggered a house building boom which led the economy out of recession. However, the economic picture was not uniformly positive. Unemployment remained high in the north and the west, where Britain's traditional industries (cotton, coal, steel and ship building) were located. Keynes recognized this[17] – and the need to prevent other parts of the economy from over-heating. So in 1937, he wrote a series of articles: In 'The Problem of the Steady Level', he urged that any new productive capacity be located in Britain's distressed regions; and in 'The Right Time for Austerity', he argued that the time had come for austerity, 'to protect us from the excesses of the boom and, at the same time, put us in good trim to ward off the cumulative dangers of the slump when the reaction comes, as come it surely will'. Keynes thus made explicit the point that – whilst during the slump, the cure for unemployment is stimulus – once the recovery is established, austerity is required to prevent the economy from over-heating and triggering inflationary pressures.

4.3. World War Two and Commitment to 'Keynesian' Ideas about Deficit Spending

During the interwar years, Neoclassical economics – the then dominant orthodoxy – proved incapable of explaining the persistence of high levels of involuntary unemployment and the failure of markets to clear. This constituted a 'massive onslaught of circumstances' that cleared the way for new ideas to challenge the conventional wisdom. However, it was the economic recovery during World War Two (1939-1945), generated by the massive stimulus to aggregate demand, that seemed to justify Keynes's ideas about the role of the state in managing the economy. It also re-established confidence in the West that capitalism could be restored.

Whereas the Classical and Neoclassical economists had focused on the effects of government borrowing and spending on the *budget* – so-called 'sound finance'[18] – 'Keynesians' focused on their effects on the *economy* – the new fiscal theory of 'functional finance'. According to Abba Lerner (1943: 39):

> 'The central idea is that government fiscal policy, its spending and taxing, its borrowing and repayment of loans, its issue of new money and its withdrawal of money, shall all be undertaken with an eye only to the *results* of these actions on the economy and not to any established traditional doctrine about what is sound or unsound. … The principle of judging fiscal measures by the way they work or function in the economy we may call *Functional finance*'.

During the late 1930s and 1940s, although there was widespread agreement about the economic benefits of full employment – and the role of the state in achieving it – there was debate about the need for government expenditure to *maintain* full employment at a continuously high level. Even among those advocating government deficits to combat involuntary unemployment, there was disagreement about their use across the business cycle. Some – including Keynes – advocated balancing the budget across the cycle, with deficits in the slump offset by surpluses in the boom. Others, such as Kalecki, saw the need for *permanent* budget deficits to maintain full employment across the cycle. But he acknowledged the political limits to the use of government deficits for this purpose because 'industrial leaders' could be expected to oppose employment policy on the basis of its potential to strengthen the bargaining position of the working classes.

In Kalecki's view, whilst '[i]t is true that profits would be higher under a regime of full employment than they are on average under *laissez faire* ... "discipline in the factories" and "political stability" are more appreciated by the business leaders than profits. Their class instinct tells them that lasting full

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[17] Whereas *The General Theory,* published in 1936, had been concerned with nationwide macroeconomic aggregates, recognition of the uneven nature of the recovery had moved Keynes's thinking on.

[18] For the Classical economists, the government account was essentially the same as the account of an individual or private firm. The Keynesian logic rejected this analogy.

employment is unsound ... and that unemployment is an integral part of the normal capitalist system' (Kalecki 1971: 141). Owing to the considerable political influence of opponents of government spending designed to maintain full employment – and the fact that 'they would probably find more than one economist to declare that the situation was manifestly unsound' – Kalecki argued that '[t]he pressure of all these forces, in particular of big business, would most probably induce the Government to return to the orthodox policy of cutting down the budget deficit' (Kalecki 1971: 144). He therefore believed that 'full employment capitalism' would need 'to develop new social and political institutions ... reflect[ing] the increased power of the working class. If capitalism can adjust itself to full employment, a fundamental reform will have been incorporated in it. If not, it will show itself an outmoded system which must be scrapped' (Kalecki 1943:330).

During the decades following World War Two, with steady economic expansion, the public debts accumulated during the war were progressively paid off. Across the industrialized world, the state assumed a central role in managing the macro-economy; and there was widespread commitment to full employment and the welfare state.[19] Financial institutions were either brought into state ownership or more tightly regulated to ensure that they channelled capital to the productive side of the economy and to contain their disruptive potential. Domestically, there were quantitative and qualitative controls on credit to maintain price and employment stability; and the Bretton Woods system (1944-1971) was established to stabilize the international economic environment and to foster world trade – and in so doing, to create the conditions enabling national governments to more effectively manage their welfare states. International capital flows were controlled and foreign exchange rates were stabilised by pegging currencies to the dollar, which was backed by gold. All of this helped to lay the foundations for high wage, mass production industrial economies, in which prices were stabilized and greater accord was maintained between capital and labour. The result, especially from 1952 to 1960, was full-employment, low-inflationary growth, rapidly rising living standards and declining inequality (Marglin and Schor 2007); and there were virtually no financial crises.

4.4.'Bastard Keynesianism'

During the post-war period, starting in America and spreading rapidly to the rest of the world, 'Keynesian' economics was absorbed into mainstream economics as the *'Neoclassical Synthesis',* a term coined by Paul Samuelson, whose text book *Economics: An Introductory Analysis* came to dominate the teaching of economics. Branded 'Bastard Keynesianism' by Joan Robinson, the Neoclassical Synthesis watered-down Keynes's concern about economic equality and his advocacy of the use of public spending to support effective demand. The importance of time in Keynesian theory was also played-down by adoption of the more static Hicksian IS-LM representation of the *General Theory,* which reduced the Keynesian system to one of comparative statics and lost crucial elements of Keynes's analysis, including uncertainty, expectations, speculation and animal spirits (Kahn 1984; Robinson 1973, 1978 and 1979).

In macroeconomic policy, attention turned to fiscal 'fine tuning' to offset business fluctuations. This was in opposition to Keynes's view that government intervention should be used as a temporary and self-liquidating measure when the economy is 'stuck', generating persistent involuntary unemployment or inflationary pressures that risk precipitating financial crises. Under the 'Neo-Keynesian' regime, economic policy was characterized by a *'stop-go'* cycle – of inflation-busting austerity during the boom and employment-generating stimuli during the slump – whilst on the international trade and payment account, the ideal was a balance between outward and inward flows across the cycle. However, following the discovery of the Phillips Curve (1958)[20] – positing an inverse relationship between the level of

[19] No such commitment was made by the USA until the 1960s. However, as the dominant world economy whose economic infrastructure was undamaged by the war, and who became the major supplier of capital and resources for European and Japanese recovery, the American economy had little need of government intervention to secure full employment following the war.
[20] Phillips (1958).

unemployment and the rate of inflation of money wages – inflation was increasingly considered the price to be paid for maintaining a high level of employment. Pressures in the labour market were seen as generating wage increases in excess of productivity increases. As a result, the emphasis in anti-inflation policy shifted – away from moderating effective demand to counter 'demand-pull' inflation – to the imposition of incomes policy to control 'cost push' inflation.

Incomes policies were usually effective in the short period; but in the longer-term they broke down as the erosion of living standards fuelled industrial unrest and policy-busting wage demands (Jackson et. al 1975, Tarling and Wilkinson, 1977). Nevertheless, '[d]uring the post-war period, incomes policies became the standard anti-inflation policy. In the short run, they succeeded in slowing price inflation, but only at the expense of real wages, especially among public sector workers who disproportionately bore the brunt of wage restraint' (Wilkinson 2012:1513) . This led to rising tides of worker militancy and to large pay settlements during the later stages of incomes policies.[21]

Incomes policies – and their ultimate failure – played an important part in discrediting the policies of political parties in power, leading to their defeat at the polls[22] and, as predicted by Kalecki, ushering in austerity measures to curb wage demands.

5. 'Neo Liberalism', Deficit Spending and Exposure to International Financial Markets

During the late 1950s, the academic debate about austerity economics re-emerged with the publication in 1958 of James Buchanan's *Public Principles of Public Debt.* This reignited the 'burden of the debt' controversy about the long-term implications of the size of the national debt, and, in particular, the substitution of borrowing for fiscal financing.[23] Growing unease about the increasing size of the debt of many countries – in absolute money terms rather than relative to GDP[24] – led to the resurrection of pre-Keynesian ideas about public debt. However, there was no general re-affirmation of Classical principles. Instead, the '[academic] discussion of public debt ... remained confused by an admixture of the two contradictory models of analysis' – Neo-Keynesian and Neoclassical (Buchanan 2008: 730); and an important *political* dimension of this debate was playing out in the US. During the decades of economic and financial stability following World War Two, as memories of earlier financial crises and the 1929 Stock Market Crash faded, so, too, did concerns about the supposed risks – and consequences – of government profligacy. According to Buchanan (2008: 730),

> '[w]hile confusion and ambiguity characterised economists' ideas of public debt, the politicians had learned the Keynesian policy lessons – but with a roughly two-decade lag. By the early 1960s, the 'old time religion' … had lost its constraining influence. [In the US, p]olitical leaders of the 1960s and beyond had learned that demand enhancing deficits may be justified … Their natural proclivities to spend without taxing constituents caused them to look on economic settings in a biased fashion. The purist Keynesian policy set – deficits in depressions, surpluses in booms – proved unworkable in democratic politics … The regime of apparently permanent debt financed deficit spending was born'.

During the 1960s, especially in the United States, the focus of policy shifted, from maintaining stable full employment levels of demand, to a 'new economics' based on growth (Perry & Tobin 2000). In December 1965, *Time Magazine* reported that '[i]n Washington the men who formulate the nation's economic policies ... skilfully applied Keynes's ideas — together with a number of their own invention — to lift the nation through the fifth, and best, consecutive year of the most sizable, prolonged and widely distributed prosperity in history'. However, according to Gardner Ackley, President Johnson's chief

[21] For further discussion about the evolution of incomes policies, see Tarling and Wilkinson (1977).

[22] The Labour Party was voted out of office in 1951, the Conservative Party in 1974 and the Labour Party in 1979.

[23] See Ferguson (1964) for a representative set of contributions to this debate. Under the Bretton Woods System, governments were not allowed to create money – so monetizing government deficits was not an option. This is also the case for member states of the Eurozone.

[24] Debt-to-GDP ratios were falling as a consequence of strong growth.

economic strategist and author of *Macroeconomic Theory*, the standard text for graduate teaching in the US for many years, whilst Americans were 'learning to live with prosperity ... frankly, we don't know as much about managing prosperity as getting there' (*Time* 1965). By the mid 1960s, growing imbalances, at first masked by macroeconomic stimuli, were becoming apparent; and with production pressing against capacity limits, productivity slowed and by 1966, the US economy was in serious difficulty (Marglin & Schor 2007). Labour costs rose faster than productivity; price inflation accelerated and the federal budget deficit was stretched by the Viet Nam War (1955-75) (Clark, 1979).

The British economy, as the least war-damaged in Western Europe, had a relatively prosperous 1950s. But it failed to modernise and remained fundamentally uncompetitive. On top of all this, competition intensified with the re-emergence of Japan and the continental European countries as leading industrial competitors and with the rapid increase in low cost manufacturing in developing countries. Manufactured imports into the other industrialized economies surged, causing a sharp deterioration in trade balances. In Britain, speaking in the House of Commons on 17 November 1965, Shadow Chancellor Iain Macleod said: 'we now have the worst of both worlds—not just inflation on the one side or stagnation on the other, but both of them together. We have a sort of "stagflation" situation. And history, in modern terms, is indeed being made' (Hansard 1965: 1165).

In 1971, in response to the first US trade deficit since before World War One, and under pressure to devalue the dollar, President Nixon announced that the US would no longer provide gold backing for the American dollar.[25] This decoupled the other Bretton Woods currencies from gold, lifting exchange rate controls and allowing them to float. Another consequence was the removal of external constraints on governments issuing currencies. This lifted controls on government borrowing; and it increased their exposure to highly liquid – and potentially hostile –global financial markets, which determined the terms on which they could borrow. It also injected a powerful new influence into the debate about economic austerity.

5.1. 'Stagflationary' Crises, Financialization and the rise of 'Neoliberalism'

During the 1970s, a sequence of events challenged the conventional wisdom in economic theory and policy. After 1971, the demonetization of the dollar diverted speculative funds into commodity markets (Robinson and Wilkinson 1977: 11), driving up commodity prices, with an accelerating effect on industrial and consumer prices (Kaldor 1976); and the 1973 oil crisis precipitated a deep recession in 1974-5. The combination of increasing oil prices and deflationary policy to fight inflation, especially in the US, UK, Germany and Japan (with a lag), gave rise to 'stagflationary' crises that hastened sectoral and regional decline in many of the Western industrial economies. This resulted in the widespread destruction of jobs and rising unemployment. As a result, governments faced increasing budget deficits and debts as tax revenues fell sharply and the costs of mass redundancies and failing industries increased. Consequently, whereas in earlier periods, government borrowing had been used to finance capital account items, as Buchanan (1987: 1046) observed, '[d]uring the 1970s and 1980s, for the first time in modern fiscal history, governments explicitly used debt to finance ordinary consumption outlays, including transfers. Once debt financed deficit spending for public consumption came to be an element of the status quo, attempts to restore budgetary balance faced enormous political opposition'.

With the economy slowing, governments actively encouraged expansion of the financial services sector as a means of countering stagnation (Magdoff and Sweezy 1987). At the same time, the diminution of

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[25] Under the Bretton Woods system, most countries sought to maintain an overall balance of trade, settling international trade balances in US dollars, with the US's agreement to redeem other central banks' dollar holdings for gold at a fixed rate of thirty-five dollars per ounce. The US, however, had not been not overly concerned about maintaining a balance in trade since it could pay its export deficits in dollars. Nor had it taken action to prevent the steady loss of American gold. By 1971, under pressure to devalue its currency, due to the decline in US gold reserves, instead of devaluing the dollar, President Nixon removed gold backing from the dollar. (See Helleiner (1994:115-21) for a further discussion).

profitable industrial investment opportunities encouraged the liberalizing financial sector to intensify its search for new customers and markets. After 1973, using the influx of funds from the newly rich oil exporting countries, private banks (especially the large American ones) expanded their lending to developing countries, notably, Mexico, Argentina and Brazil, for investment in infrastructure projects to accelerate the pace of economic development. Between 1975 and 1982, Latin American debts rose dramatically – as did the cost of servicing them, particularly when the US and Europe increased interest rates to combat inflation. Growing difficulties with debt servicing and repayment were exacerbated by the deterioration in exchange rates against the US dollar; and, in August 1982, the Mexican government announced that it was no longer able to service its debts, precipitating the Latin American debt crisis. Effectively bankrupted, countries turned to the IMF for assistance, the condition for which was the 'Washington Consensus', imposing tight 'fiscal responsibility' conditions – *austerity* – and requiring the recipients to reduce deficits and debts by means of public spending cuts. Thus, faced with growing international pressures, governments were forced to adopt restrictive policies acceptable to their creditors, including the IMF. But these progressively undermined their competitive positions, increased indebtedness and limited opportunities for improvements in real wages. The resulting deterioration in growth rates and living standards not only caused debt-to-GDP ratios to rise (both by increasing the former and lowering the latter); it also created widespread social unrest – and resentment of the IMF – as Latin America entered its 'lost decade'.

The historical division within the Keynesian school of economics – in which the American Neo-Keynesian branch had become dominant – meant that the Keynesian response to the events of the 1970s was diverse. Whilst the Neo-Keynesians, with their flawed IS-LM models, were unable to explain stagflation, the Cambridge and Post-Keynesians were actively offering alternative explanations and cures.[26] In their view, the increase in prices during the 1960s and early 1970s was the result of increasing commodities prices, which had a knock-on effect on producer and consumer price inflation. This was made worse by the wage/price spiral, as workers sought to maintain living standards in the face of falling real incomes and as employers attempted to protect profits by raising prices. With incomes policies restraining wages, falling real incomes reduced purchasing power, which depressed demand and at the same time encouraged a shift in consumption, away from more expensive home-produced goods and towards cheaper imports. This further dampened home demand, output and employment, adding to the depressive effect of governmental counter-inflationary austerity programmes (Wilkinson 2012). Rising inflation and unemployment therefore interacted to produce stagflation.

However, increasingly, these problems were attributed to Keynesian fallacies. Amongst economists, this sparked a revival of traditional liberal beliefs in the monetary causes of inflation and the efficacy of unrestricted markets in maximising economic welfare – a revival labelled *Neoliberalism*[27]. Neoliberals claim that excesses in monetary expansion generate inflation and that unemployment stems not from an insufficiency of effective demand but from labour market imperfections resulting from state and trade union intervention; overly generous welfare benefits that discourage work; and the poor quality and low motivation of those without work, which makes them unemployable at the prevailing wage. Such factors, Neoliberals assert, determine the level of *natural* rate of unemployment; and attempts by government to increase employment above this level either increase inflation or squeeze-out employment elsewhere in the economy (Friedman, 1977). Alternatively, Neo- Keynesians attributed stagflation to the degree of trade union monopoly, which raises wages above their market clearing rate and sets the level of unemployment. According to this logic, attempts to increase employment beyond this level, labelled the

[26] See, for example, Kaldor (1976).

[27] 'Monetarism' is a school of economic thought that emphasizes the role that the government can play in controlling the money supply as a means of managing inflation. By contrast, 'Neoliberalism' is a doctrine that advocates free and unregulated markets, privatization and small government. Friedman famously embodied the two. But after the failure of experiments with monetary targets during the 1980s, governments have adopted inflation targets and given Central Banks independence in using short term interest rates as a monetary policy tool. Many such governments have, to varying degrees, adopted a Neoliberal approach to the organization of the economy.

non-accelerating inflation rate of unemployment (NAIRU), merely add to inflation (Meade, 1982). Thus, for both Neoliberals and Neo-Keynesians, there is a simple choice between higher real wages or more jobs.

During the 1970s, these alternative theories of unemployment supplanted Keynesianism as the conventional wisdom in macroeconomics, shifting responsibility for unemployment from an insufficiency of effective demand to labour market failure; and these notions were progressively incorporated into government thinking and policy. In the UK, this was at first rather tentatively by the 1974-79 *Old* Labour Government (Morgan, 1990, pp 382-386) but then more whole heartedly by Thatcher's Conservatives in 1979 and by the *New* Labour government when it came to power in 1997. Following monetarist logic, the focus of economic policy shifted away from a concern about maintaining a full employment level of effective demand, to the use of monetary policy, austerity and price controls to manage inflation, with employment being left to market forces.

The view that 'Government is the problem' discredited policies of state intervention; and there was an almost evangelical reliance on free markets – in both goods and finance. Governments actively encouraged expansion of the financial services sector, which grew at a much faster pace than the productive side of the economy. Accompanying these developments was a growing expectation on the part of large, international financial institutions that their governments would come to the rescue should they find their equity capital insufficient to cover the risks they were taking.[28] The main outcome, however, was the steady expansion of public deficits, as a consequence of reduced tax revenues and an inability to crystallise public sector savings, largely the result of the increased costs associated with social supports and government 'watch dogs' to police newly privatised public services. Exploring the question of what had happened to employment policy, Robinson and Wilkinson (1977:13) concluded

> 'It is ironic that after the great technical achievements brought by the age of growth, all we are offered is a return to large scale unemployment and poverty in the midst of plenty, in an age of frustration. Kalecki was right to be sceptical; the modern economies have failed to develop the political and social institutions, at either domestic or international level, that are needed to make permanent full employment compatible with capitalism'.

5.2. 'Expansionary Fiscal Contraction' – Reality or Alchemy?

By the end of the 1980s, high levels of public debt renewed interest in the economics of austerity. As Harvard political economist, Benjamin Friedman (1988) observed: 'We are living well by running up our debt and selling off our assets … The costs, which are only beginning to come due, will include a lower standard of living … and reduced … influence and importance in world affairs'. The resulting debate initially focused on the effect that high government deficits and debt might have on inflation and balance of payments problems. According to Giavazzi and Pagano (1990), 'the high real interest rates of the early 1980s combined with the large stock of public debt inherited from the 1970s to create a potentially explosive debt problem. As governments started to tackle the problem with contractionary fiscal policies, public officials and economists voiced different beliefs about the likely effects of these measures'. This coincided with preparations for the Eurozone, the centrepiece of which was the Maastricht Treaty, establishing strict limits on member countries' deficits and debt levels. This heightened concern about public debt sparked interest in the experience of countries – such as Denmark (1983-1986) and Ireland (1987-1989) – that had grown despite sharp fiscal consolidations during the 1980s. From this research, emerged the novel idea of 'expansionary fiscal contraction' – the hypothesis that an economy could, in the short term, actually grow as a consequence of a policy of austerity.

Reviving the 'Ricardian equivalence' hypothesis – which Ricardo, himself, had been sceptical about – Barro (1974) reasoned that in response to government borrowing, tax-payers, anticipating higher future

[28] See, for example, Cheng (1977); Cohen (1986); Dale (1984); and Sgard (2012).

taxes to repay the government debt, would reduce current consumption to accumulate the savings needed to cover the increase in taxation they expect. Their indifference between tax- and debt-financed government spending programmes meant not only that government spending could not be expected to stimulate the economy; it also meant that by competing with the private sector, public investment would drive interest rates up and crowd-out (more productive) private investment.

Exploring the cases of Denmark and Ireland, Giavazzi and Pagano (1990) took the argument further, by suggesting that a major reduction in government spending – or the announcement of a plan to reduce deficits and retire public debts – could be expected to have positive effects on business and investor confidence; and that reduced public investment would 'crowd-in' private sector spending. However, the economic context of the 1980s was the more important contributor to the Danish and Irish experiences. This was a period when the world was under-going rapid interest rate reductions and economic expansion. For Denmark and Ireland, adding to these favourable conditions was a significant currency devaluation prior to linking their currencies to a stable currency; sufficient liquidity to prevent any reduction in current disposable income from constraining consumption; and a considerable improvement in government budgets resulting from increased tax revenues and cuts in public spending.

Although the research positing expansionary effects of austerity had only a modest impact when it appeared – and it has since been largely discredited[29] – following the 2008 financial crisis, advocates of austerity are again attempting to make the argument that the policies they propose will have a positive effect on economic performance.

5.3. The 'Great Moderation'

Following the deep recession of the early 1990s, there was a prolonged expansion, described as the 'Great Moderation'.[30] This was a period of reduced macroeconomic volatility during which, according to Robert Lucas (2003:1), the 'central problem of depression prevention [had] been solved'. The Great Moderation was also a period of accelerated financialization. With the rapid development and application of communication technologies, the financial system became increasingly internationalized and competition between the major centres of finance intensified. Regulatory arbitrage encouraged progressively 'light touch' regulation in order to attract and retain highly mobile international capital. Major industrial corporations were also drawn in, shifting from equity to debt financing and developing their own financial subsidiaries.

From the early 1990s, enormous volumes of liquidity from the high saving economies of the East and from Saudi Arabia, Norway and other oil rich countries flooded into the world's financial markets, driving down interest rates. Correspondingly large amounts of cheap credit were made available to businesses, households and governments in the West, where low interest rates encouraged increased spending on credit, especially in the US and UK, which also experienced large and expanding trade deficits. Extensive credit also fuelled house price bubbles that increased housing equity, which could then be withdrawn as collateral to support additional consumption (Wilkinson, 2012).

Financial institutions also increased borrowing, much of which was *off balance sheet* by means of increasingly complex financial instruments. For investors, low rates of interest created incentives for financial 'innovation' and the creation of new financial instruments with higher yields than traditional ones. Important among these were securitized products, which bundle together financial assets, such as mortgages, credit card receivables and automobile loans – the riskier the assets, the higher the yield. From the early 1990s, this market was both spurred by and encouraged expansion of the 'originate to distribute' model of banking, by which financial institutions were able to create high yield securitized products and rapidly sell them on, continuously renewing their liquidity, before the riskier constituent

[29] See, for example, Perotti (2012); Guajardo, Leigh and Pescatori (2011); IMF (2010); Jayadev and Konczal (2010).
[30] See, for example, Stock and Watson (2002) and Bernanke (2004).

assets began to default (Bord and Santos 2012). According to Greenspan (2002), these developments were 'especial contributors to the development of a far more flexible, efficient and resilient financial system than existed just a quarter-century ago'.

Apparently successful responses to recurring financial crises during the 1980s, 1990s and 2000s reinforced the view that monetary policy was 'well equipped to deal with the financial consequences of asset price busts' (Blanchard et al 2010:7) and asset bubbles were legitimised as engines for growth (Bellofiore and Halevi 2011). Despite the havoc caused when they burst, the dominant view was that bubbles are difficult to identify, so policy makers need not concern themselves with detecting or preventing them. Rather, 'it is the job of economic policy makers to mitigate the fall out when it occurs and, hopefully, ease the transition to the next expansion' (Greenspan 1999). In this context, calls for austerity accompanied the collapse of successively more serious asset bubbles, on *moral* as well as economic grounds. Thus, austerity economics effectively shifted, from being a policy for the top of the business cycle, to prevent inflation and financial crisis, to being one for the bottom, when the excesses of debt-fuelled over-consumption reached critical proportions. From this perspective, the 2008 financial crisis is not a spectacular 'one off' incident but merely the most recent in a series of progressively more serious financial crises requiring public intervention.

Whilst monetary policy was in the ascendancy, discretionary fiscal policy all but vanished as a stabilization device. However, despite the Neoliberal view that state intervention is economically damaging, during the Great Moderation there was, in fact, *increased* intervention. But its aim was no longer full employment and economic prosperity. Instead, policy was intended to restrain price – if not asset price – inflation and to ameliorate financial crises. An important outcome was socialisation of the risks and costs of financial speculation; another was the accentuation of the moral hazard associated with confidence that the banking system – and financial institutions considered 'too big to fail' – would be rescued in the event of crisis. Thus, economic policy, which prior to the 1980s had generally served the broader political economy, increasingly favoured the narrow interests of the wealthy and financial elites.

6. The 2008 Financial Crisis – and the Post-Crisis Debate about Economic Austerity

Following the collapse of the 'dot com' bubble in 2000 and the 9/11 terror attacks in 2001, the American Federal Reserve (Fed) reduced interest rates and held them low (at around 2 percent), forcing other Central Banks to follow suit or lose business to New York. Low interest rates fuelled a US house building boom, which was beginning to slow in 2006, just as the Fed was raising interest rates to curb inflation. The resulting housing market collapse caused default rates on American sub-prime real estate mortgages to sharply increase, undermining the value of securitized products in which they were incorporated and seriously damaging the national and international financial institutions that held them.

In July 2007, two Bear Stern hedge funds that had invested heavily in the mortgage-backed securities market collapsed; and in September, the British bank Northern Rock sought a bail-out from the Bank of England, triggering the first bank run in fifty years. In response to the resulting credit crunch, the Fed and the UK Treasury flooded the financial markets with liquidity. But banks, swinging from unbridled optimism to unreasonable pessimism, refused to lend. In early 2008, Northern Rock was nationalized and Bear Stern was rescued from bankruptcy. However, in September 2008, Lehman Brothers, the fourth largest investment bank in the US, was allowed to fail. This created panic in the international financial markets – and the banks looked to their governments for support.

6.1. The Policy Response to the Crisis

Facing the burgeoning crisis, prominent economists and policy makers re-kindled Keynesian ideas about the stabilizing role of fiscal deficits. In his pre-budget report in October 2008, UK Chancellor Alistair Darling declared that '[m]uch of what Keynes wrote still makes sense. You will see us switching our

spending priorities to areas that make a difference ... we can allow borrowing to rise'; and in November, a communiqué issued by the G20 vowed 'to use fiscal measures to stimulate demand to rapid effect'. During the autumn of 2008, motivated by fear of the possible collapse of the international financial system, the US and Britain, followed by the G7,[31] announced that they would buy into in their major banks and inject capital directly to recapitalize them. Deposit insurance was extended to protect depositors and to prevent runs on banks; and – recognizing that although banking institutions maybe global in life, they are national in death[32] – governments bailed-out systemically important but failing banks. This not only increased fiscal deficits; it also transferred the banking sector's *toxic* assets to government balance sheets.

Although Deutschebank's Chief Executive Joseph Ackerman admitted 'I no longer believe in the market's self-healing power', Germany, alone among the advanced economies, remained sceptical about the effectiveness of fiscal stimuli to restore stability. In a 2008 interview with *Newsweek,* Germany's Finance Minister Peer Steinbruck attacked such policies as 'crass Keynesianism' that would simply refuel credit-financed growth. In his view, 'a swift return to the reduction of deficits which have been temporarily increased' was required. Nevertheless, in 2009, in response to its deepening recession, Germany implemented fiscal stimulus – and 'for a short period in 2009 and 2010, there was a "Keynesian moment" when all governments implemented fiscal stimulus packages' (Seccareccia 2012:64).[33]

As governments around the world ran significant budget deficits and set interest rates very low to encourage private sector spending, financial market collapse was averted and confidence returned. However, by early 2009, the consensus among economists began to crumble; and in 2010, with the imminent depression apparently averted, but with unemployment still high, policy was sharply reversed as concern about high levels of public debt led to calls for fiscal austerity – first in the Eurozone (due to the perceived risk of sovereign debt default by weaker members) and then world-wide.

6.2.'Academic Kerfuffle'

Reinhart and Rogoff's historical research on financial crises, which purported to show a significant positive correlation between high levels of public debt and economic stagnation, served as the justification for the generalized return to austerity. Examining the empirical data on eight centuries of financial crises, Reinhart and Rogoff (2009) found that following a financial crisis, output and employment recover very slowly and that the average duration of debt over-hang episodes is 23 years. This implies a substantial cumulative loss in output, raising concerns about the long-term negative consequences of high levels of public debt. From this, they conclude that in the current context, financial sector regulatory and organizational reforms will be necessary if stronger growth is to be encouraged; and since growth is slower when public debt is high, austerity is called for to reduce public debt-to-GDP ratios to growth-permitting levels.

Their (now infamous) 2010 study goes further, alleging to identify a public debt 'threshold' – 90 percent of GDP – at which economic growth contracts. On publication, these findings were seized upon by politicians who wanted to reverse course from stimulus to austerity, to hold individuals (rather than the system) responsible for their unemployment, poverty and disability and to reduce the size of the state. In his 2010 Mais Lecture, UK Chancellor of the Exchequer George Osborne contended that '[a]s Rogoff and Reinhart demonstrate convincingly, all financial crises ultimately have their origins in one thing' – high levels of public debt. In America, Chairman of the House Budget Committee, Congressman Paul

[31] The G7 consists of the finance ministers from the US, UK, France, Germany, Italy, Canada, and Japan.
[32] Quoting the Governor of the Bank of England, Mervyn King. (Financial Services Authority (2009:36).
[33] Although credited to Keynes, it is important to note that the stimulus packages – temporary tax cuts and one time payments designed to get consumers to spend – are not the kind that Keynes would have advocated. He would have called for governments to invest in programmes that would generate good quality jobs with the potential to generate multiplier effects within the economy.

Ryan, maintained that '[a] well known study completed by economists Ken Rogoff and Carmen Reinhart confirms a common-sense conclusion. The study found conclusive empirical evidence that gross debt ... exceeding 90 percent of the economy has a significant negative effect on economic growth' (Ryan 2013:78). And in his address to the ILO on 9 April 2013, Olli Rehn, EU Commissioner for Economic Affairs, used the paper to argue that 'public debt in Europe is expected to stabilize only by 2014 and to do so at above 90 percent of GDP. Serious empirical research has shown that at such high levels, public debt acts as a permanent drag on growth'.

Once published, the article faced substantial and growing criticism until its findings were ultimately discredited. The first criticism concerned the direction of causation. Since Reinhart and Rogoff (2009, 2010) fail to locate their analysis in any theoretical framework that provides causal links between public debt levels and GDP growth, the direction of causation – if indeed there is one – could equally go either way. Although their interpretation of the correlation is that high levels of government debt cause economic stagnation, this cannot be substantiated by mere statistical association. Moreover, it makes more sense to suppose that a slowdown in GDP growth will cause tax receipts to fall and unemployment-related expenditure to rise, requiring increased government borrowing.

Reinhart and Rogoff (2009, 2010) also make other misleading claims. For example, in considering the period leading up to the 2008 global financial crisis, they assert that 'the rise in asset prices was being fuelled by a relentless increase in the ratio of household debt to GDP, against a backdrop of record lows in the savings rate' (Reinhart and Rogoff 2009:212). A more likely explanation is that the increase in asset prices and the accumulation of household debt to finance additional purchases were fuelled by optimism about the future, shared by consumers and investors, and by the apparently limitless availability of bank lending (Wilkinson 2012). It is also reasonable to suppose that this shared confidence was destroyed by the 2008 financial crash, which not only deepened the resulting recession, accelerated the reduction in government tax revenues and increased government expenditure and unemployment-related transfers; it also increased the need for governments to borrow.[34]

Perhaps even more problematic is the questionable quality of the empirical evidence upon which politicians and international bureaucrats placed so much faith. Scholars checking Reinhart and Rogoff's results soon came to question their dataset, since no one was able to replicate their findings; and when Reinhart and Rogoff eventually allowed researchers at the University of Massachusetts Amherst access to it, they discovered omitted data, methodological problems and Excel coding errors, which when corrected caused the stagnation threshold to disappear (Herndon, Ash and Pollin 2013).

Despite the refutation of their findings – and the implications this has for the austerity programmes they were used to justify – Reinhart and Rogoff (2013) have shrugged them off as 'academic kerfuffle'. They concede that 'austerity seldom works without structural reforms – for example, changes in taxes, regulations and labour market reforms – and if poorly designed can disproportionately hit the poor and middle class. Our consistent advice has been to avoid withdrawing fiscal stimulus too quickly, a position identical to that of most mainstream economists' (Reinhart and Rogoff 2013). But they maintain that austerity is a sound policy in the current context since – although the stagnation threshold cannot be defended – when public debt levels are high, growth is slower than it would otherwise be.

6.3. The Growing Post-Crisis Consensus about the Effects of Economic Austerity

The catalyst for the sharp reversal in policy in 2010 – from economic stimulus to austerity – was fear of a Greek sovereign debt default and recognition that within the Eurozone the risk of default is a credible one. This is because member states are required to give-up control of their currency, ruling out money

[34] In more enlightened times, this process was regarded as an *automatic* stabiliser, limiting the scale of the economic downturn. It also suggests that the people in Greece and elsewhere in the streets protesting against government cuts are better economists than those advocating them.

creation and devaluation in response to trade deficits and/or speculative pressures on public borrowing. The absence of a Eurozone fiscal union means that weaker members are obliged to go cap-in-hand to stronger members, who have insisted that they adopt stringent austerity measures as the condition for financial assistance.[35] The justification for this austerity strategy was explained by Jean-Claude Trichet, then president of the ECB, who in a June 2010 interview with *La Repubblica,* cited with approval the 'confidence boosting effects' of the (soon to be discredited) 'expansionary fiscal consolidation' hypothesis. Dismissing concerns about the dampening effect of austerity on growth, Trichet argued: 'As regards the economy, the idea that austerity measures could trigger stagnation is incorrect ... In fact, in these circumstances, everything that helps to increase confidence ... in the sustainability of public finances is good for the consolidation of growth and job creation'. He went on to declare: 'I firmly believe that in the current circumstances, confidence-inspiring policies will foster and not hamper economic recovery, because confidence is the key factor today'. The important question here is, of course, *whose* confidence – consumers, industrial investors or financial speculators?

Outside of the Eurozone, although politicians – particularly in Britain and America – have yet to seriously consider the alternatives to austerity, international economic organisations have acknowledged its negative consequences. Considering the broader effects of fiscal austerity in the context of economic depression, as early as 2010, an ILO-IMF report argued that

> '[a] premature fiscal retrenchment could damage growth and lead to even larger deficits and debts. Abrupt shifts in fiscal policy stances, in many countries at the same time, could destabilize recovery and weaken future growth. A credible and gradual return to fiscal stability over several years is likely to be a more successful strategy, not only for recovery and growth but also for deficit and debt reduction … Social dialogue is essential to avoiding an explosion of social unrest'. (p. 8)

It concluded that 'high and long lasting unemployment … represents risks to the stability of existing democracies and hinders the development of new democracies in countries under-going political transitions'. (p. 22)

The importance of balancing the requirements for near-term economic recovery and longer-term fiscal balance has also been increasingly recognised at internationally influential levels. In a 2011 speech, US Fed Chairman, Ben Bernanke said that '[a]cting now to put in place a credible plan for reducing future deficits over the long term, while being attentive to the implications of fiscal choices for the recovery in the near term, can help serve both objectives' (Bernanke 2011). The importance of the these dual objectives was echoed by Christine Lagarde (2011), Managing Director of the IMF, in an article in the *Financial Times:* 'What is needed is a dual focus on medium term consolidation and short term support for growth ... Decisions on future consolidation ... create the space in the near term for policies that support growth'. In a speech at the Economic Club of New York on 10 April 2013, she again stressed the importance of policies aimed at employment and growth: 'job creation is an urgent priority. A high level of employment is the best guarantee of a vibrant economy and a healthy society.... The best way to create jobs is through growth' (Lagarde 2013).

As austerity programmes have progressed, their contractionary effects have been widely acknowledged. The Bank of England's Monetary Policy Committee (2011) reported that '[g]rowth has been weak throughout the year, reflecting a fall in household incomes, persistently tight credit conditions and the effects of continuing fiscal consolidation'; and the UK Office of Budget Responsibility reported that austerity measures had reduced GDP by 1.4 percent during 2011-12 (Office for Budget Responsibility 2013: 38). Olivier Blanchard (2012), chief economist at the IMF, also admitted that fiscal consolidation 'is clearly a drag on demand, it is a drag on growth'; and in 2013, he conceded that 'forecasters

[35] The stronger members are apparently blind to the fact that the negative multiplier effects of these spending cut backs will necessarily be Eurozone-wide.

significantly underestimated the increase in unemployment and the decline in private consumption and investment associated with fiscal consolidation' (Blanchard and Leigh 2013:5).

Even within the Eurozone, there is growing recognition that the sharp fiscal consolidation programmes are impeding recovery. With reference to Spain, Lagarde confessed that 'we do not see a need to do up front, heavy duty fiscal consolidation as was initially planned' (IMF 2013). And at a conference in Brussels, European Commission President Jose Manuel Barroso said that whilst he believed that austerity was 'fundamentally right', it had 'reached its limits in many aspects' and there was now a need for 'a stronger emphasis on growth and growth measures in the shorter term. We have been saying this, but we should say it louder and clearer'.[36]

In America, in his *Semi-annual Monetary Policy Report* on 26 February 2013, Bernanke warned Congress against the 'sharp, front loaded spending cuts' that would come into effect at midnight on 1 March, if no deal was reached to prevent it; and he urged that these be replaced 'with policies that reduce the federal deficit more gradually in the near term but more substantially in the longer run'. He went on to argue that:

> '[t]he size of deficits and debts matter, of course, but not all tax and spending programs are created equal with respect to their effects on the economy. To the extent possible, in their efforts to achieve sound public finances, fiscal policy makers should not lose sight of the need for federal tax and spending policies that increase incentives to work and save, encourage investments in workforce skills, advance private capital formation, promote research and development, and provide necessary and productive private infrastructure. Although economic growth alone cannot eliminate federal budget imbalances ... a more rapidly expanding economic pie will ease the difficult choices we face'.

However, on 1 March 2013, with no deal reached, President Obama signed an order putting the cuts into effect. The British Coalition Government, too, remains focused on reducing deficits above all else, despite the accumulating evidence that austerity is not only undermining economic recovery; it is also deepening the downturn.

Regardless of the actual or expected economic consequences of austerity, its effect on the financial markets' assessment of governments' capability to manage their economies cannot be ignored:

> 'In societies deeply permeated and reshaped by financialization, policy alternatives tend to oscillate between monetary and fiscal austerity and letting the (financial) markets rip. But this process is mediated by other factors, notably the relative economic and political weight of banks and other financial institutions in given societies and the location of particular states within the global political economy'. (Callinicos 2012:74)

In short, whilst the academic debate has focused primarily on the theorized economic effects of a policy of austerity rather than stimulus – supported by an observed inverse correlation between public debt-to-GDP ratios and GDP growth – policy-makers (although not all politicians) are beginning to accept that austerity is slowing growth and hindering recovery. But they also recognise that, despite having been rescued from melt-down (for which they, themselves, were largely responsible), the global financial markets are now demanding austerity – not because of its *economic* effects, but as 'credible' evidence that governments are serious about managing their budgets and re-paying their debts. Moreover, because indebted governments are heavily reliant on the financial markets for funding, they are vulnerable to pressure from speculative investors seeking short-term gains. The irony, however, is that in the current context of prolonged economic recession, further austerity can only depress GDP and increase public debt, prolonging the negative market responses and intensifying the crisis. The likely effect of this is a social and political backlash if governments continue to pander to the interests of the financial sector by

[36] Quoted in Mason 2013.

avoiding the re-regulation demanded by the current parlous state of both the financial system and the real economy.

7. Analytical Conclusions

As Galbraith (1999:6-17) observed, in order to make sense of contemporary social and economic developments, it is important to have a clear understanding of events, the ideas marshalled to interpret them, and how these are related. This he identified as 'conventional wisdom', the hallmark of which is acceptability. He went on to argue that conventional wisdom gives way not so much to the challenge of new ideas as to 'the massive onslaught of circumstances with which it cannot contend' (loc cit, p17). This clears the way for new ideas, which have been fermenting as the onslaught gathers pace, to become sufficiently acceptable to form the basis for the *new* conventional wisdom.

Since the early twentieth century, there have been two major periods during which cumulative events have given rise to a battle of ideas that shifted economic orthodoxy. The first was the turbulent interwar period, during which there was substantial involuntary unemployment in Britain, resulting from a loss of competitiveness that was made significantly worse by the Treasury's adherence to financial austerity targeted at returning Britain to the gold standard at pre-war parity. Opposition to this gave rise to the 'Keynesian revolution', which ultimately displaced the Neoclassical orthodoxy as the conventional wisdom in economics. The second was the stagflationary crisis of the late 1960s and 1970s, during which the apparently contradictory coexistence of high levels of unemployment and inflation produced the 'Monetarist counter-revolution'.

Somewhat surprisingly, we are not (yet) in the throes of a third 'Galbraithian episode', precipitated by the bursting of the bubble of debt-inflation, fuelled by unbridled monetarism and typified by austere macroeconomic policies and continuously high levels of unemployment. At present, the Neoliberal orthodoxy remains unshaken, buttressed by the new dogma that the *real* problem is too much debt and that austerity (especially on the part of government) is required to get it down – a view that is being reinforced by the considerable economic and political influence of globalized financial markets.

7.1. Concerns about Inflation – and the Relationship between Unemployment and Inflation

The fundamental difference between the Neoclassical and Keynesian conventional wisdoms is that the former is essentially laisser-faire – resting on the belief that economic efficiency requires governments to abstain from interfering with the working of free markets. The latter, whilst not denying the benefits of well functioning markets, insists that free markets do not *necessarily* guarantee the full utilization of available resources. It follows from this that in the interest of economic efficiency and social justice governments have a duty to intervene in the economy to eliminate the *involuntary* unemployment of productive resources, especially labour. The important change wrought by Keynesianism was thus in establishing that unemployment and poverty are *systemic* rather than individual problems.

After the Second World War, however, inflation displaced unemployment as the major macroeconomic policy problem. Concern about rising prices, exacerbated by an observed inverse relationship between the rate of inflation and the level of unemployment, became influential in the debate about Keynesianism; and the pace of wage and price inflation became causally important in the 'stop-go' rotation of macroeconomic policy. During the 1960s and 1970s, as restrictive incomes policies became standard anti-inflation policy tools, usually deployed in conjunction with demand-restricting macroeconomic policies, these measures – especially incomes policies – fuelled industrial unrest due to the greater constraint they imposed on wages than on prices. The consequential downward pressure on living standards led to increasing worker militancy and large pay settlements during the later stages of incomes policies, ultimately causing their collapse, which, in turn, played an important part in discrediting the political party in power.

This evolving inflationary crisis constituted the second Galbraithian episode that ushered in Neoliberalism (a revised version of pre-Keynesianism) as the new conventional wisdom.

This reversion played itself out against the backdrop of different interpretations of Phillips' (1958) analysis, which identified an inverse statistical association between levels of unemployment and rates of wage inflation. For Keynesians, the 'Phillips curve' reaffirmed the idea that inflation is the price to be paid for lower levels of unemployment; they therefore continued attempts to contain price inflation by means of austerity when the economy was overheating and stimuli to head-off excessive unemployment. From the 1960s, however, the nature of the macroeconomic problem changed as, instead of there being *either* too much inflation *or* too much unemployment, *both* unemployment and prices began to rise together – a phenomenon described as 'stagflation'. This tendency was accounted for by the Cambridge and Post-Keynesians as the wage-demand response to the effect of rising direct taxes and import prices on workers' real take-home pay, whatever the level of unemployment (Wilkinson and Turner. 1972). Alternatively, from rather different theoretical standpoints, both Neoliberals and Neo-Keynesians hypothesised that there is an inflationary barrier to reducing unemployment below a certain level due to imperfections in the labour market. Friedman (1977) labelled this the *natural* level of unemployment, whilst Meade (1982) called it the *non-accelerating inflation rate of unemployment (NAIRU).*

As the stagflationary crisis progressed, Neoliberal theory – that inflation is a monetary phenomenon and unemployment is explained by labour market imperfections – came to be regarded as the alternative to Keynesianism. From this perspective, austerity has a central role to play in maintaining price stability by directing the economy back towards the natural rate of unemployment. The Neoliberal challenge to the Keynesian orthodoxy was ultimately successful; and the focus of policy shifted away from attempting to maintain a full employment level of effective demand and stable prices. Since then, employment has been left to market forces, with joblessness being considered a *personal* – rather than a systemic – problem.

7.2. Misleading Analogies and Ideas

The historical record reveals that the ideas used to justify economic austerity have a long – and chequered – track record; and economics abounds with fanciful explanations about how systems have built-in stabilisers that make state intervention unnecessary, or even counter-productive.

One of the earliest and most abiding of these is the notion that governments' budgets are analogous to those of firms and households and that they therefore requiring balancing. This comparison is fundamentally flawed; and it is clearly misleading to promote the idea that when public deficits and debts are high – analogous to when households and firms have accumulated too much debt – it is necessary to suffer the 'pain' of austerity to eliminate them, with anything less being portrayed as fiscally irresponsible.[37] This is because, first, unlike a private household or firm, a sovereign government that issues its own currency and has a floating exchange rate is not operationally constrained by its budget because it can both issue and adjust the value of its currency to manage a deficit. Second, whilst a household or firm can balance its budget by reducing spending and repaying its debts, a government cannot. During a slump, government deficits rise as a consequence of falling tax revenues and rising unemployment-related social costs, putting upward pressure on public debt levels at the same time as GDP growth is slowing. In this context, cutting public spending will not only deepen the slump it will also add to public debt. As Keynes – and Mandeville more than two hundred years before him – explained, there is a fallacy of composition in this analogy because, whilst it may be true that over the long term individual firms and households cannot spend more than they earn, in the economy as a whole, people earn what they and others spend. If spending falls short, earnings are lost; and as a consequence, labour and other economic resources become unemployed. This has a negative multiplier effect, further reducing income, effective demand and employment. Moreover, because labour and capital are not

[37] Perhaps it is not completely coincidental that these ideas stemmed from an age when the medical professions believed that to save lives of the sick it might be necessary to remove their lifeblood (Greenstone 2010).

immediately mobile, such adjustments can be slow and painful, so that unemployed and under-employed labour and other productive resources can be wasted for extended periods of time. At times like the present, when the economy is deeply depressed, it is therefore fundamentally wrong on the part of government to advocate a policy of austerity, which can only deepen and lengthen the slump – and it is a travesty to appeal to peoples' sense of collective responsibility in order to trick them into supporting a policy that can only make their own individual *and* collective situation worse.

'Ricardian equivalence' is another misleading idea, invoked to justify the current programme of austerity. Although Ricardo, himself, was sceptical about the practical relevance of his notion of equivalence – doubting that consumers are 'rational' in the way economists suppose them to be – contemporary proponents of austerity are making the claim that if the government cuts spending and reduces borrowing, private sector spending will increase to fill the gap. This hypothesis rests on the assumption that consumer and business decisions are based on (rational) expectations about the future, however uncertain that might be. Consequently, when public deficits and indebtedness are high, private sector spending is assumed to be weak because households and firms are increasing savings to provide for anticipated future tax increases to fund the public sector deficit. Conversely, so the 'expansionary austerity' story goes, if governments promise to cut spending and reduce deficits, private sector future prospects will improve due to the anticipated reduction in the tax burden. The resulting positive expectations about the future are assumed to cause current savings to fall and private sector consumption and investment to increase, offsetting the fall in public spending, with a positive impact on growth. Whilst there may be a kernel of truth in this idea when the economy is at the top of the business cycle, cutting government spending during a recession, when business and consumer confidence is already low, is likely to depress it further – with predictable negative effects on private sector spending, economic recovery, fiscal deficits and public debt levels.

There is something reassuring to Neoliberals – given their fixation with the overarching efficiency of markets – in the assumption that public sector profligacy and private sector parsimony (and vice versa) are interactive. If this were the case, the economic system would indeed become self-stabilising, obviating the need for government intervention. However, there are few signs of any such tendency toward automatic stabilisation. A much more realistic explanation of why private spending is currently weak is that households and businesses are deleveraging as a consequence of their high levels of accumulated debt, their low levels of confidence (further undermined by the government's programme of austerity) and the increased risk of unemployment. In these circumstances, businesses can hardly be expected to increase investment and employment until there are real signs of a recovery, giving them confidence that the returns from doing so will be adequate. This, in turn, depends in part upon increased household expenditure and improvements in private sector balance sheets boosting consumer confidence. The point here is that it is the immediate past and current experiences – *not* long term rational expectations – which determine consumer and investor confidence and, by extension, their current action; and when this confidence is low (as it currently is), austerity can be expected to reinforce pessimism, adding further twists to the vicious cycle of falling demand, employment, incomes and investment.

7.3. The Relationship between Debt and Economic Growth

Since the 1980s, a consequence of adopting Neoliberal policies has been the slowing-down of GDP growth, with deep recessions during the early 1980s and 1990s that played an important part in decimating manufacturing and increasing import dependency. Slumps have been followed by unsustainable bubbles, inflated by increasing supplies of low cost credit from the progressively deregulated financial sector. The latest credit bubble burst in 2007, bringing bank lending virtually to a halt and precipitating a world-wide crash of monumental proportions. The initial response by governments was to rescue systemically important (but failing) financial institutions and to reflate their economies. But increasing the money supply – a policy termed 'quantitative easing' – has had little effect in stimulating the economy because the underlying problem is not a shortage of supply but rather a lack

of demand for credit, in no small part by pessimistic consumers whose debt-financed spending had supported earlier bubbles. Instead, quantitative easing has acted as a sort of 'blood transfusion' for struggling banks, boosting the prices of financial assets and stabilising the institutions that hold them.

In 2010, after bank bailouts and emergency stimulus measures had apparently averted financial collapse, there was a policy *volte-face* to one of austerity. This was partly due to a similar volte-face on the part of the financial markets: Having cried-out for a rescue in the wake of the financial crisis, they now felt emboldened – with the support of international institutions including the IMF – to challenge countries that were subsequently burdened with high levels of public debt. The theoretical justification was provided by the (discredited) theory of 'expansionary fiscal consolidation' – the notion that macroeconomic breakdowns result from excessive public borrowing and high levels of accumulated debt, which can only be reversed by reducing spending and running-down debt. In this context, the effectiveness of austerity in engendering recovery and economic growth rests on the belief that there is an inverse relationship between levels of public debt and economic growth, a proposition that has been debated since the 18th Century, and one that was seemingly laid to rest by Keynes. It has recently been resuscitated by supposedly high-quality academic research by Harvard economists Reinhart and Rogoff (2010) that was seized upon by politicians wanting to reverse course. Although this research has since been comprehensively discredited, political, ideological and class interests continue to rely upon it to justify adherence to a programme of austerity, despite mounting evidence of its damaging effects on both economic growth and the wellbeing of the most socially and economically vulnerable segments of society, who bear the overwhelming burden of austerity – and a notable change of heart by the IMF.

7.4. The Class Analytics of Austerity

Who benefits and who bears the cost is another important theme in the evolution of ideas about economic austerity. In Britain, before 1834, the poor were supported by the supplementation of wages from parish rates under the terms of the Old Poor Law. Its abolition due to spiralling cost left the poor to the scant mercy of the labour market.[38] However, as the industrial revolution progressed, the growing social and political strength of the working class led governments to accept an increasing duty to provide social welfare. Prior to the Keynesian era, such expenditure was limited more by fear that the relief of poverty would damage the work ethic and undermine parsimony in public spending (the hallmark of sound finance) than by any difficulty the government might have had in raising the money. On the contrary, before the First World War, Britain's industrial prominence, adherence to the gold standard, laissez-faire trade policies and tight control of public spending ensured that the government could borrow at exceptionally low rates of interest. But following World War One, as Britain's economic and financial position weakened, the burden of the government's austerity was increasingly borne by workers. As the economy became mired in depression – and involuntary joblessness became widespread – unemployment pay and other social provisions were cut and increasingly subjected to means testing.[39] The result was grinding poverty for large segments of the population.

After World War Two, when the welfare state was firmly in place – and its social and political popularity protected it from serious cut-backs – austerity took a more periodic macroeconomic form, designed to stabilise economic activity, protect employment, prevent inflation and avert financial crises. Steeply progressive tax regimes ensured that the cost of these measures was borne proportionately more by the better-off. As a result, during the decades that followed, egalitarianism and an extended period of economic growth delivered greater economic equality and unprecedented improvements in living standards. However, this social and economic progress was undermined, as Kalecki (1943) had predicted, by the failure to create social and political institutions capable of supporting continuously high levels of employment. State management of the economy was ultimately destabilized by the crisis-ridden 1970s, which also discredited worker-friendly legislation, trade union organisation and collective bargaining.

[38] See, for example, Wilkinson (2001).
[39] See, for example, Harris (2004).

The resulting counter-reaction to Keynesianism was led by Neoliberal theorists, who portrayed unemployment as a ‘natural’ phenomenon, made worse by trade union activity, legally enforceable labour market regulation and overly-generous welfare provisions, casting doubts on the wisdom of efforts to maintain full employment.

Between 1979 and 2008, governments of all political persuasions pursued Neoliberal economic policies with emphasis on labour and financial market deregulation and macroeconomic strategies emphasising monetary control. Economic policy has alternated between the unleashing of debt-fuelled consumer binges and excessive asset speculation, followed by the imposition of deep austerity measures when bubbles burst. Having abandoned control of international capital movements and the supply of money, governments have effectively discarded the levers that they previously relied upon to regulate the financial sector and to manage deficit-financing and debt reduction. However, without these means, economies are prey to hostile speculation in international financial markets and the risks to fiscal budgets of rising interest rates and debt servicing costs. In this respect, as Greece and other weaker members of the Eurozone are discovering, the *votes* of speculators in financial markets carry more weight in determining economic and employment policy and outcomes than do those of the electorate. In this context, the only clear beneficiaries of austerity are financial speculators, with their proven ability to hold governments to ransom.

Ultimately, however, austerity is a threat to the whole of society as it not only creates sharp societal divisions but also threatens the foundations of economic prosperity for all. For, whilst the burden of austerity is currently bearing hard upon the majority – especially workers in the public sector and those who rely on public services and welfare benefits – in the final analysis the only way an economy can pay-off its debts is by *growing* its economy and generating a surplus. This, in turn, means harnessing the productive capability of the majority to produce and add value – as well as to spend. Even a modicum of common sense reveals that debt repayment cannot be readily achieved, if at all, by savagely cutting expenditure, creating unemployment, slowing economic growth and impoverishing swathes of a country’s population. The only effective way forward is a re-balancing of the economy away from a reliance on financial services and the demotion of finance to its role as the servant of enterprise, rather than its master.

7.5. Reconstituting the Conventional Wisdom

A further theme in the analysis of ideas about economic austerity is the process by which alternative theories succeed or fail in penetrating the mainstream and reconstituting the conventional wisdom.

Today’s policy of generalised economic austerity – like the 1920s ‘Treasury View’ – has the primary objective of reducing government deficits (and indebtedness) in order to retain access to external finance at reasonable terms and conditions. Although its proponents claim that in so doing austerity will contribute positively to growth, it does not form part of any coherent policy aimed at fiscal and monetary sustainability or macroeconomic recovery. Rather, by confusing the consequences of our current economic difficulties with their root cause, austerity is addressing the symptoms rather than the disease that is afflicting the economy. In this regard, it has been likened to the economic equivalent to the pre-scientific Medieval practice of blood-letting, observing that the patient is getting sicker and then bleeding some more.[40] In *economic* terms, government deficits and increasing public debt-to-GDP ratios are the direct consequence of the 2008 global financial crisis – and the resulting government bank bailouts – and this has been made worse by the resulting economic depression, that has caused tax receipts to collapse and social costs to soar.

[40] See, for example, Krugman (2011) and Stiglitz, quoted in Lemoine (2012).

This raises the question of (1) why a government would pursue a policy of austerity in the context of economic recession – when there is no *economic* basis for such a policy and persistent macroeconomic imbalances threaten to further destabilize the global economy – and (2) why so little serious consideration is being given to the *alternatives* to austerity. The answer can be found in the considerable political and economic influence of liberalised global financial markets – and in the distribution of economic and political power within the neoliberalized global political economy.

During the era of Neoliberalism, economic policy has been largely driven by narrow private sector interests of industrial and financial elites – as it was during the period preceding the 1929 Stock Market Crash. However, unlike the earlier period – when financial institutions were allowed to fail and financial speculators lost vast sums of money – following Lehman Brothers' collapse in 2008, the wholesale rescue of systemically important private financial institutions convinced the markets that the risks of speculation would be socialized, effectively shifting the balance of power and influence away from the state. Thus, in the aftermath of the 2008 financial crisis, economic policy has been increasingly dictated by financial market traders, with their own interests at heart and very little loyalty to any national social or political economy. They are demanding austerity as evidence that governments are capable of managing their deficits – and are serious about repaying their debts. Austerity has thus become the *objective* of policy, rather than a policy whose objective is macroeconomic stabilization. However, if economic austerity further undermines macroeconomic performance – as it is everywhere it has been implemented – the financial markets are unlikely to prove sympathetic of those countries suffering the effects of the policies they are demanding.

Moreover, since the 1960s, the private sector – finance in particular – has steadily increased its power and legitimacy relative to the state. The distribution of financial resources has been increasingly skewed towards speculative activities, depriving the productive side of the economy of much needed capital and reinforcing the cumulative and self-reinforcing cycle of economic stagnation and involuntary unemployment. Government budgets have been strained by the growing costs of both socializing the risks of financial speculation and countering economic recession. In this context, growing inequality has been aggravated by austerity, which has a disproportionate effect those in lower segments of the income distribution, who rely on public services but have very little, if any, voice in their provision. By contrast, the interests of those with economic and political influence are being served by austerity and by the systematic assault on the state.

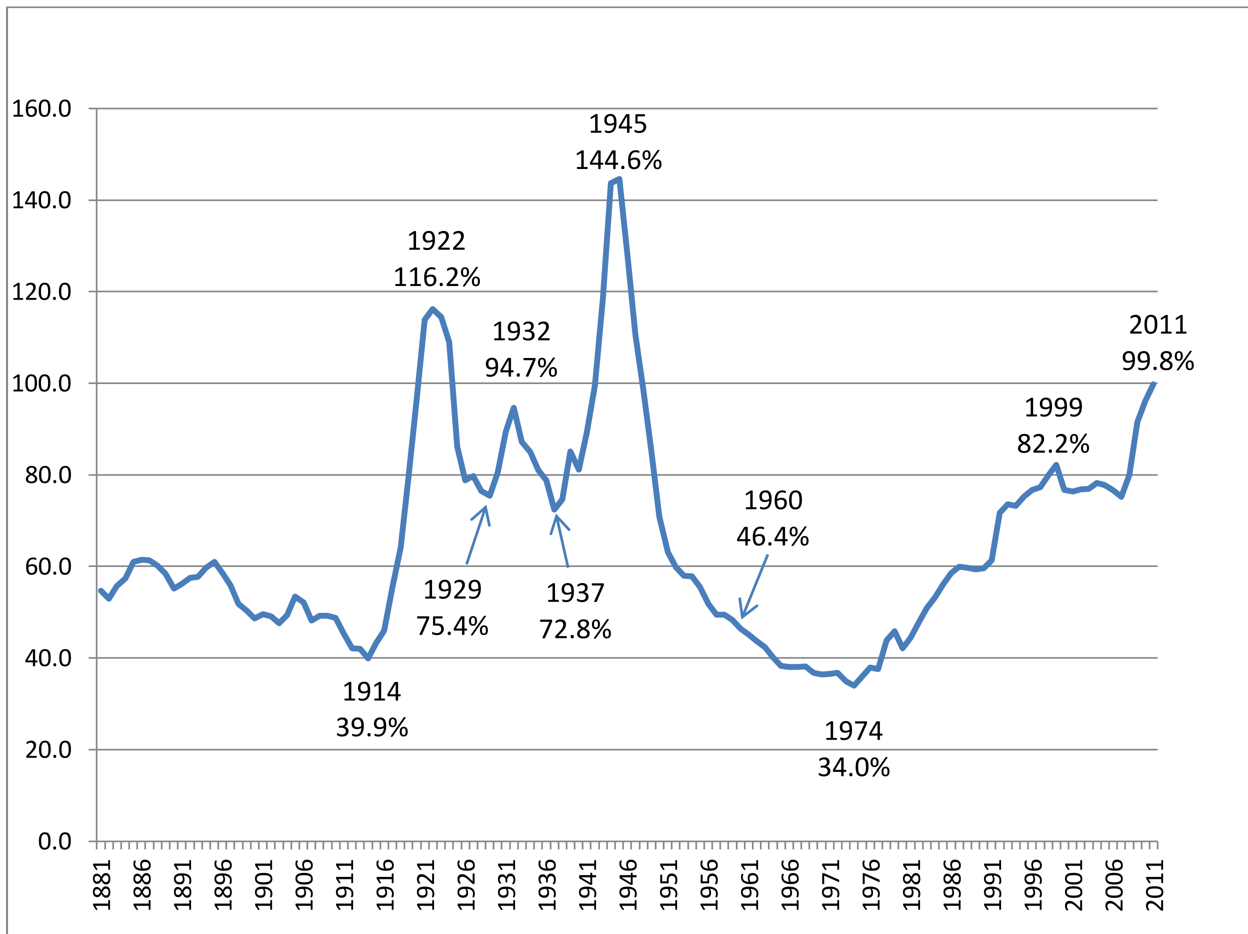
At present, nearly half a century of Neoliberal policy has returned the world economy to more or less where it was in the early 1930s – with austerity having the same effect now as it did then. However, despite invalidation of the theories used to justify it – and overwhelming evidence of the failure of austerity to deliver on its promises – there is currently little serious debate about the *alternatives* to economic austerity. Alternative ideas are indeed *fermenting* – and they have been since the brief return to Keynesian ideas and policies in the wake of the crisis. But with the turn to economic austerity in 2010, they have failed to penetrate the mainstream; and the Neoliberal conventional wisdom remains entrenched.

Perhaps the crisis has yet to affect enough of the world's population – or to last long enough or become serious enough – to mobilize a coordinated theoretical and policy response. After all, it took almost half a century, including two World Wars and the Great Depression to create the political and economic 'will' for the major institutional reforms of the 1940s and 1950s which played a central part in the post-war prosperity. What is more, the Second World War was chastening for those who had suffered the deprivations of the inter-war years; and there was a strong collective sense of 'we are not going back to that' about their post war attitudes.

The tragedy today is that, with the benefit of hindsight, we should know better. In this, the evolution of ideas about economic austerity casts significant doubt upon neutrality. Faced with Galbraith's massive

forces of consequence, the economic theories chosen to advise those charged with resolving the dilemmas facing society are less likely to reflect the proven predictive value of theory than the extent to which they serve the purposes of those with greatest influence. It is thus clear that the ability to effectively articulate alternative ideas to the dominant orthodoxy, to create a forum where they will be heard and seriously discussed, and to find the political means by which they can be translated into policy are of great consequence.

Figure 1: Public Debt as a Percentage of GDP, Average for the G8 Countries (1880-2011)



Source: IMF (2010) Historical Public Debt Database
http://www.imf.org/external/pubs/cat/longres.cfm?sk=24332.0 [accessed 12 March 2013]

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