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Austerity: Past and Modern History

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Introduction

In recent years austerity has once again become the subject of attention for economists, politicians, and scholars. By austerity we mean a set of restrictive economic policies aimed at controlling if not reducing public debt. Some believe that austerity brought about the cyclical destruction of many world economies at different times in history, while others sustain that contractionary policies have been and still are the only way that leads to growth. The level of contention surrounding this ideology has motivated the writer to provide pro and counter arguments on the matter while still leaving the reader some freedom in deciding how to tackle the various issues.

This paper will attempt to shed light on the concept of austerity in order to weave a thread through the various school of thoughts and paint a coherent picture of what this theory has created. The essay will analyze the origins, facts, and critics of austerity, but mainly why it has been/is such a controversial subject. The reason is because there has been a lot of contrasting evidence during the years. The subject has regained popularity after the Greek crisis of 2009, which induced the EU and the IMF to approve on a 110-billion-euro rescue plan in favor of Athens in 2010. Greece in exchange agreed to a program of strict restrictive policies to square the public debt. Six years have gone by since the beginning of the crisis and it is still difficult to identify a unanimous opinion within economic or political environments with regards to said policies. Evidence seems to suggest a rather negative scenario but a powerful ideology is sometimes stronger than a reality brought forward by facts.

Anyway, although ideologies, theories, and well-crafted socio-political argumentations may give insightful contributions to the well-functioning of society, people’s main concern in cases of economic distress is whether their money is safe and whether it is safe to spend it considering future uncertainty. It is for this reason that this paper is built on an underlying premise; that banks are at the center of the economy.

Cycles of economic contractions and liquidity crises can be harmful to banks by exposing them to the risk of insolvency and suppressing their ability to extend credit. Being banks the main source of loans to private individuals, depletions of such kind may contribute to the reduction of domestic consumption and overall to a greater contraction of the
economy. Having stated that, I will move through different stages in order to give a precise structure to this essay.

Firstly, I will give a general definition of austerity. Then, I will present the arguments put forth by its precursors and their successors and scrutinize how their theories influenced the economic and political orientations of several countries from the XVIII to the XXI century. Furthermore, I will discuss the effects that the implementation of austerity has had in said countries by analyzing a number of cases. I will move on by presenting some major critics of austerity and discuss about the recent European crisis with a slight deviation into the Greek situation.

Austerity is an economic policy, and/or ideology, that originated in the seventeenth century with the revolutionary ideas of John Locke and ramified throughout modern history up until today. It has been both praised and criticized, revalued and discarded, vigorously supported and strongly discredited, but despite being constantly disproved by illustrious economists in different eras, it does not cease to exist. As John Quiggin would refer to it, austerity is “zombie economics”, as it just keeps coming back time after time.¹

According to the supporters of austerity, the key concept is the so-called expectations channel, through which people’s expectations of the future are positively enhanced because of policies aimed at cutting the state’s budget, debt, and deficit while forcing a deflation. The boost in business confidence is supposedly given by the fact that the government will not be “crowding-out” the market and its available capital (taking it away from private sector investments) through excessive debt issuance, nor it will be supplementing the nation’s debt. In other words, the general concept is that austerity reduces the role of the state and redefines it as an un-interventionist organ of the market. The market can then regulate itself through those rational participants that we call banks, people, and financial institutions. However, the concept of austerity has not always been the same. It has evolved in several ways during its journey through our economic and political history.
Chapter 1
Austerity: A Long-Lived Idea

1.1 Supporters and Positive Evidence

1.1.1 John Locke
John Locke (1632-1704) was an English philosopher and physician, father of classical liberalism and influential predecessor of Enlightenment. He was a supporter of economic liberalism who pushed for the separation of the market from the state, and based his views of the society on individual property rights. Under the assumption of infinite land abundance, the philosopher and economist believed that the mere act of working on something, such as land, was sufficient for the person who worked on it to claim it as his own property. The only issue with his theory was the issue of spoilage.* As a religious individual, he believed God would certainly not have approved of such matter. He partially solved the problem by focusing the attention on money, as money could be stored and swapped for goods at any given time. What derived from this was Locke’s acceptance of a short-sighted God and an explanation of the inevitability of the creation of land, labor, and capital markets on one side and the worry of a tyrant state on the other. In Locke’s world, the state had no right to interfere with private property - let alone apply taxes - without the consent of its owners, as it invaded the essential criteria of owning property.** In short, the state’s sole role was to protect property.

Since this protection required the state to raise money, Locke faced a dilemma, which ended up being the foundation of future studies on liberalism: “The state: can’t live with it, can’t live without it, don’t want to pay for it”.

* It refers to the concept that an individual claim too many resources for his own that some of them might blemish before he has a chance to utilize them.
** In the “Two Treatises of Government”, Locke argued that governments are chosen by the people and thus exist to protect their rights. Governments that are unable to fulfill their role as protectors should be substituted by new governments.
1.1.2 David Hume

Building on Locke’s legacy, David Hume paved the road to the modern concept of austerity by advancing the concept of public debt. He was one of the first thinkers to argue, in “Oh Money”, that a monetary stimulus can be positively effective in the short run but might result in inflation or neutrality on real economic variables in the long run. With regards to state debt, he made no confusion in explaining his adversity to public debt and why it was undoubtedly harmful for a state to load up on it. As Locke had done before him, Hume saw the necessity of money (as an instrument), but as a catalyst for trade rather than a solution to the problem of spoilage or God’s short-sightedness. He believed that the merchant classes were the fulcrum of society, not the state. Hume praised the merchant classes because according to him they promoted efficient markets, increased industry, and ensured right allocation of capital. Thus, he acknowledged that a significant portion of the total goods and commodities should belong to the merchants. Once again, the enemy was the state. In fact, Hume condemned any state claim related to remuneration, especially in the form of debt as it potentially had no limits.*

Because issuing debt is much easier than raising taxes, Hume argued that the practice would be eventually abused by government. Overdoing such practice would lead governments to guarantee ever higher interest rates. As a consequence all private capital would flow to the state in the form of securities, leaving no space for other economic activities. The economist’s major concern, perhaps fear, was the idea of a loss of liberty, which could occur through an excessive borrowing of foreign capital when the issuance of domestic debt would eventually hit a ceiling. Furthermore, he argued that with taxes at their limits to pay interests on debts, the economy had no way of responding to a financial shock, thus forcing the nation into default. In conclusion, Hume’s vision was pessimistic in nature, as it provided no solution to the problems it identified and was further darkened by the prospect of an inevitable death of the nation.³

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www.econlib.org/library/LFBooks/Hume/hmMPL32.html
1.1.3 Adam Smith

Hume’s theories were taken a step further by his colleague and compatriot Adam Smith, who analyzed the issue of public debt and elaborated a solution based on a rather common stereotype known as the parsimony of the Scots. Smith believed that it was savings that drove investment, not consumption. He also sustained that investment caused consumption and not the other way around. The proverbial parsimony of the Scots (and of all humans in general), according to Smith, is something that is intrinsic to all people. In other words, we are all hardwired to save and invest. In Smith’s world, prodigality is overwhelmed by the sentiment of frugality, and because parsimony leads to investment and economic growth, there are no leakages of income and hoarding is inconceivable.

Although Smith acknowledged the necessity of the state for external protection, justice, and instruction of its citizens, he condemned the perversion of private savings channeled into government lending in the form of public debt. The state is a problem once again as it lacks the proverbial parsimony and impoverishes the nation through lavishness. However, since the state was necessary, Smith sought the best way to fund it. First, he thought about taxes in the form of progressivity, then about taxing only the luxuries, and finally about taxing everything that was considered nonessential. Eventually he realized that taxes would not be sufficient and he unwillingly accepted the need for debt, concept which he found unbearable. Following Hume’s line of thought, Smith condemned public debt for most of the same reasons. He believed that the rich merchant classes would be tempted by the possibility of easy money and would lend all their money to the state, which in turn would undermine the need for taxes. Eventually, when the issuance of debt would hit a ceiling and taxes would be at their limit in order to pay interest on the debt, merchants would depart and the nation would fall into bankruptcy. Yet, Smith went a step further than Hume. He believed that to avoid default, the state would pay the creditors (the rich merchants) in devalued currency (inflation), thus destroying their savings and inhibiting investment. In conclusion, this was the
reason for which, according to Smith, public debt was harmful and parsimony was the way to go.

Although Locke, Hume, and Smith never made a direct argument for austerity, it is evident that the fear of government debt, the diffidence towards the state, and the praise of frugality and morality in the form of parsimony were the foundations of economic liberalism.*

The ground on which Locke, Hume, and Smith developed their theories served as the foundation for “New” and “Neo” liberalism. These two schools of thought emerged from a notorious dispute on economic policy between David Ricardo and John Stuart Mill.** Ricardo argued that there was no role for the state within the market and that it should resist any temptation to interfere with its adjustments as it would only lead to unnecessary disruptions. Mill instead called for a more interventionist state. He argued that although taxes would be preferable to government debt, the latter was acceptable if it did not compete for capital by increasing interest rates.5

Mill’s campaign partly bore its fruits in twentieth century Britain where the British accepted the idea of a state as a tool for social reform and opened their doors to New Liberalism. Neo Liberalism instead found its home in Austria, the land of Schumpeter, Hayek, and Mises. Neoliberals argued that government interference in the market caused credit booms and busts and harmful malinvestments. They also asserted that if the state would be allowed to intervene, then it would always recur to printing money in troubled times. Overall, for the New Liberals, the cure to a recession was government spending, for the Austrians it was austerity.

1.1.4 North American Austerity

Austerity beliefs did not stop in Europe and reached the United States between the late 1920’s and the early 1930’s under the Hoover administration. Specifically, the Austrian school of thought promoted by Schumpeter was the ideology that prevailed under the name of “modern business cycle theory”. According to this theory, at any given point in

* Interpretation based on what written in the previous paragraphs.
time capitalism has a distinct capital structure, and when there are investment booms (inevitable in capitalism) both “too much” and “too much of the wrong type” of capital is invested in the economy. This leads to crashes. Schumpeter built upon this idea by introducing “liquidationism”, which emphasized that the “slump must happen” in order to progress with the business cycle and that any intervention would only make the crisis last longer. In other words, Schumpeter asserted that capitalism progressed because of entrepreneurs’ malinvestments that lead to failures, which were necessary for capitalism to evolve. Theoretically, evolution occurred because failures freed the necessary capital and raw material for the next round of innovation and investment. As a result, any intervention from the state such as inflation would only postpone the inevitable end of the business cycle.\textsuperscript{6} It is evident that this process of purging the system and cutting public spending, often referred to as emetism, is a veiled form of austerity. The effect of such policy, which will be discussed further on in the critics section, was enhanced at that time by the American principle of “sound finance”. The Hoover administration believed that growth could be boosted by increasing business confidence, which could only be renewed if the government signaled a credible turn in the direction of the emetic process while focusing on the balancing of the budget and raising taxes (even during a recession).

\textbf{1.1.5 British Austerity}

Although Britain had chosen to opt for Mill’s approach and to have a more interventionist state, the principles with which the British faced the crisis of the 1920’s and 1930’s were still very austere. Britain, in fact, was the world’s first economic power and the anchor of the gold standard, which allowed it to influence exchange rates and balances of other countries. It was obvious then that Britain was a firm believer of the “laissez-faire” ideology, where free trade, balanced budgets, and a limited liberal state was all that mattered. When the post-war crisis of the mid-1920’s hit, the UK Treasury and prime minister Winston Churchill strengthened austerity by repeating Hume’s and Smith’s arguments. Once again, increasing public debt for government spending by increasing interest rates would crowd-out private spending and take capital away from
trade. As a matter of fact, in 1929, the British Treasury asserted exactly the following: “increased government borrowing for public works would result in higher interest rates, if savings were to be attracted to gilt-edged stock so that borrowing would not be inflationary, and that this would tend to divert money that would have otherwise gone to home industry, or to overseas investment”.

Churchill’s secretary at the Economic Advisory Council, Hubert Henderson, went even deeper in accepting the teachings of austerity by recalling the concept of confidence. He claimed that government spending would always have a negative impact on people’s confidence. Moreover, the Treasury paraphrased Schumpeter by asserting that spending would worsen the balance of trade by increasing imports, and in the long run it would worsen the situation by reducing the competitiveness of British firms.

While Britain and the United States applied austerity in the more traditional sense of the word, Germany did not. It was there that a variety of peculiar events lead to the growth of a distinct but similar branch of liberalism.

1.1.6 German Ordoliberalism

Schumpeter’s theories about the inevitability of the business cycle and the “purging” of the system found no foothold in post-World War I Germany. The German scenery could not have been more distant from his visions. In fact, there was much innovation and very little destruction, especially with regards to the big, historical German firms. German austerity took a different direction from traditional austerity thanks to the beliefs of a group of economic thinkers called ordoliberals, whose idea of market and state was very different from that of typical liberals. According to ordoliberals, the state set the economic framework for the markets to be efficient from the start, by encouraging competition and aiding market adjustments through specific mechanisms and institutions. Ordoliberalism was developed in the Freiburg school of economics in the 1930’s by Eucken, Böhm, and Grossman-Doerth. They were mainly preoccupied with the misuse of private economic power and cartels. Eucken asserted that the role

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* Walter Eucken (1891-1950), also known as the father of Ordoliberalism, was a German economist at the Freiburg school of economics.
of the state was to focus on dissipating economic power groups by limiting their functioning and “focus on the regulation of the economy, not on the guidance of the economic process”. In German, the word “ordo” stands for order; many orders formed the economic constitution. Ordoliberals believed that for the constitution to work, all its members must play by the terms laid out by it, and they will do just so once they see the benefits it entails. Following Eucken’s instructions, Germany developed two independent institutions, one for the regulation of competition and the discouragement of monopolies and another for the maintenance of price stability: a central bank. The role of the central bank was to prevent the misuse of capital, which according to ordoliberals equaled spending. Thus, it eliminated any prospect of expansionary policies. The new German model focused on competition to promote supply-side economic growth, by stimulating the manufacturing of quality products to increase foreign demand and obtain budget surpluses.

The reasons why traditional liberalism did not apply to Germany were several, but one particular reason that shifted the attention away from liberalism was the stock market bust of 1873, also known as the founders’ crisis. The conditions for Ordoliberalism to drive were ideal. Germany compared to Britain was a late-developer. This meant that Britain was already a scale producer (cost advantage) and that no individual German entrepreneur had the economic power to compete against British industries. The key to the solution was the austere core of the German economic thought that anticipated Ordoliberalism - the proverbial parsimony. In other words, suppressing consumption and increasing savings through government directives would provide enough capital for large-scale industrial investments. In post-World War II Germany, Ordoliberalism found its definite place in time. As a matter of fact, government authorities needed growth because they feared political instability due to the people’s malcontent, but at the same time they were skeptical about expensive state projects. The Freiburg school gave a major push to Ordoliberalism. At the same time, ordoliberals found the support of big sponsors, such as “Frankfurter Allgemeine Zeitung”, the leading newspaper of the time. In addition, when Germany’s economic minister Erhard threw the economy off the cliff by freeing prices in 1948, it became clear that anything else than Ordoliberalism would
be pure nonsense. Moreover, when the Korean crisis hit, unemployment rose and the allies called for a better integration of welfare and economic policy, which resulted into the creation of a “social market economy” under the Christian Democratic Union. The results were an increase in real wages, reduced inflation, and stable prices between the 1950’s and 1960’s, the so called “German economic miracle”. Overall, the fact that Germany was coming out from an unstable and difficult historical context, combined with the fact of being a late developer catching up with Britain, made it possible for ordoliberal ideas to succeed. Perhaps Germany’s situation was unique.*

1.1.7 Hayek, Mises, and the Austrian Business Cycle
The 1920’s and 1930’s saw the Austrians attempt to promote their ideas of austerity throughout Europe. They rejected the idea of a state having a role in the economy and discarded the use of mathematical instruments, such as differential calculus, in favor of mere historical analysis. They believed that the economy was an unpredictable and ever-evolving organism. Specifically, Mises argued the impossibility of planning, which being a strictly ideological affirmation, was difficult for him to defend in economic circles of society. Thus, he slid in the background of his field, ignored by the other economists. A similar fate hit Hayek, who in a 1931 speech at Cambridge was asked by a member of the audience whether purchasing a new overcoat would be a cause for inflation, and his answer was: “Yes, but it would take a very long mathematical argument to explain why”, thus discrediting his own beliefs. As Mises did before him, Hayek was relegated to the background until 1970, when he was awarded the Nobel prize in economics. In fact, Hayek’s and Mises’ ideas survived the test of time and reemerged in the current crisis thanks to their thoughts on banks and business cycles. They claimed that banks made money by extending credit, and that they would do so to gain market shares against other more aggressive and less prudential banks. As a result, banks would borrow way beyond their reserve assets, knowing that the central bank would intervene by providing fresh liquidity in times of need. Entrepreneurs would then be able to borrow cheap credit to invest and would become reckless, while total borrowing would increase and

overall savings would diminish. As a consequence, they would hire more workers, reduce the unemployment rate, and purchase more raw material. The effects would be higher wages and prices and therefore more borrowing. More borrowing meant more money in circulation to spend on fewer goods, which is the basic definition of inflation. Once banks would understand their mistake, they would lower interest rates further in order to extend more credit and try to stay in business as long as possible. At this point, inflation would spike, the value of money would fall, and the banks would be obliged to raise interest rates even though they would be already struggling to find new credit. Once people would see the bubble, panic would breakout and the system would collapse. Moreover, Mises’ greatest fear was that intervention in a bust would lead to a capital strike from investors who would sit on their money waiting for better times. Overall, the Austrians (in particular Hayek and Mises) believed that in the aforementioned hypothetical slump, the solution would be to rebuild savings (less consumption) and therefore apply a policy of austerity. Equivalently, the last thing to do would be to bail out the banks and consumers, as intervention was the cause of the recession in the first place. Once again, the solution would have been to let the banks fail and restart the system (just as Schumpeter argued). In other words “do nothing and let the economy self-heal”.¹²

1.1.8 Friedman’s Monetarism

Further contributions to the argument of austerity came later in the XX century with Milton Friedman’s monetarism. He argued that attempts by the government to stimulate employment would only lead to inflation. More specifically, Friedman asserted that with an increase in the money supply by the government, employers would increase output in response to rising prices. Consequently, the unemployment rate would decline and wages would increase (Keynesian belief).¹³ However, this new equilibrium could not last forever because, according to Friedman, “unemployment was voluntary and was not due to a deficiency of demand”. Overall, if workers understood that their wages had increased while their real wages had not because prices had gone up as well, then they might have chosen to withdraw their labor, bringing
unemployment to its “natural rate”. In other words, monetarism argues that with inflation rising and unemployment stagnating, Keynesianism reaches a point where it basically “eats itself”.

If austerity was/is against government intervention, public choice supporter such as James Buchannan and Richard Wagner saw democracy as problematic. They argued that politicians cyclically engaged in public spending in order to maximize votes to ensure their reelection. Considering Friedman’s idea that inflation is a temporary solution, with unemployment returning to its natural rate, the result of this political activity is a “boom and bust” cycle that creates ever-higher inflation. Theoretically, the fact that politicians cannot be trusted causes economic and political instability. The solution is to create an independent central bank based on the German ordoliberal model of the Bundesbank. The apolitical nature of the Bundesbank would force it to focus on maintaining price stability alone.

As Ordoliberalism was not bound to stay in Germany, it spread throughout countries as well as influenced or caught the attention of foreign illustrious intellectuals.

1.1.9 Einaudi’s Views on Ordoliberalism and The Italian Students

The common belief in the late 1980’s and early 1990’s was that it was possible to grow and to reduce public debt through cuts in government spending. This school of thought began in the late 1940’s with the teachings of Luigi Einaudi, who was an economist, governor of the Bank of Italy, and President of the Italian Republic. He was a firm believer of the German ordoliberal economic system and argued, already in the 1940’s, for a European monetary union. More importantly, having taught at the University of Turin, he oriented an entire generation of young economists towards the idea of a European Union. Einaudi wanted the Eurozone to share a single currency controlled by an independent central bank, and to have a single market to discourage the formation of monopolies and to encourage competition. Again, like the Germans had done before him, he wanted a state that provided rules for the well-functioning of the market and did not intervene with supplies of liquidity in troubled times.
Straight out of Bocconi and University of Turin, students Alberto Alesina and Guido Tabellini published a paper that tackled the issue of escalation of public debt in democracies. In “A Positive Theory of Fiscal Deficits and Government Debt in a Democracy”, they claimed that when a governing party is about to lose an incoming reelection, it will create a deficit by providing public goods and leave the bill to the next administration; thus tying its successor’s hands. Consequently, the new party will return the favor. The result is an ever-higher level of debt.14 Once again, as the state could not be trusted with the economy, it was the old liberal ideas’ time to shine. At the same time, another batch of Einaudi’s students was seeking recognition in the field of economics. Giavazzi and Pagano returned to the Schumpeterian idea of business confidence by claiming that cutting spending could increase growth by positively influencing expectations. More specifically, they asserted that if people could understand that the spending cuts were part of a sound program of consolidation, then they would expect that a permanent reduction in public debt would lead to a future reduction in taxation as well. Basing their works on this concept, they argued that positive expectations would lead to a growth bigger than the contraction caused by the cuts in spending. To reinforce their theories, the students brought forward a case on Denmark, showing that Denmark had experienced substantial growth from 1983 to 1986 after major budget cut policies. However, since the budget cuts and tax increases were accompanied by changes in political power and new monetary and exchange rate policies, Giavazzi and Pagano relied on a series of econometric elaborations to show that growth was in fact mostly due to a response to shifting expectations. Quoting directly from the source, “the unexplained component of the boom is related to cuts in public spending. This is consistent with the view that cuts in current government consumption were seen as a signal of lower taxes further in the future”.15

In 1995, Alesina and fellow colleague Perotti examined twenty countries spanning thirty-two years in order to find successful cases of fiscal adjustments. Basing their findings once again on econometric proof, they recorded fourteen successful cases against thirty-eight failed maneuvers. Arguing that the unsuccessful cases were the result of too much taxation while the successful ones derived from favoring expenditure cuts to
higher taxation, they demonstrated that states that cut grew on average one percent faster than the G7 countries. It now seemed that all theories promoting spending and consumption as demand-side economics were suffering from a strong lack of legitimacy. It looked like Einaudi’s legacy was just beginning to affect the economic world through the production of pro-austerity arguments.

In 1998, Alesina teamed up with colleague Silvia Ardagna to further elaborate on the concept of expansionary austerity. Their academic work, “Tales of Fiscal Adjustment”, was based on the same principle of expectations-lead growth. More specifically, they argued that if people perceived budget cuts as permanent, they would tend to spend, consume, and invest more today because they would understand that taxes in the future would be lower. Thus they would be able to enjoy a permanent increase in their disposable incomes. They also asserted that cuts in spending during a fiscally stressful time had a greater positive effect because people would perceive an even stronger signal. Overall, they claimed that the right time to cut was not the boom but the slump.

To apply their theories, the two Italians looked at the economic situations of several European countries during the 1980’s and 1990’s. After partially disproving Giavazzi’s and Pagano’s observations on Denmark, they resolved that only two of the analyzed cases seemed to be expansionary, causing them to admit a weakness in the effect of expectations. By that time, it seemed that their convictions regarding combinations of “spending cuts in transfers, welfare programs and the government bill, some form of...wage moderation, and a devaluation immediately before the fiscal tightening” for a successful, long-term expansionary fiscal adjustment were fading. Nevertheless, eleven years later, during the crisis of 2009-2010, Alesina and Ardagna updated their work by creating an adjourned version of “Tales”, known as “Large Changes in Fiscal Policy: Taxes Versus Spending”, which provided no more supporting evidence to the argument than the original version. This was the paper that was cited by ECOFIN in 2010 and made the case for Jean Claude Trichet’s emergency budget program aimed at facing the crisis. In “Large Changes”, as in Tales, Alesina and Ardagna claim that cutting spending is preferable to raising taxes. Yet they also write a few lines about how ever-higher deficits are largely the result of bailing out various constituents in the financial sector. In this
paper, they add that the signal provided by the government by cutting spending not only foreshadows a reduction in taxation, but also warns people about bond-yield premium reductions, meaning cheaper loans. Thus, with better times lying ahead, people will decide to spend today. Overall, in the scenery imagined by the two economists (and many before them), the right solution is to cut (even in the slump) while spending is always to be avoided. At the same time, reductions in spending, such as cuts to wages of government employees, don’t lead to a recession but create growth in the form of “higher profits, investment, and competitiveness”. They claim that government spending leads to a reduction in growth. In fact, recurring to their beloved econometric calculations, Alesina and Ardagna demonstrated that “a one percentage point higher increase in the current spending to GDP ratio is associated with a 0.75 percentage point lower growth”\textsuperscript{17}. To further reinforce their belief in expectations-driven expansions, in “Large Changes” they analyzed twenty-one OECD countries from 1970 to 2007. Although the results were not more encouraging than those found in their previous academic work, the scholars identified a rather peculiar fact. They observed that the cases of unsuccessful adjustments were the ones that saw welfare transfers rise. In other words, they were condemning the welfare state by saying that “it is very difficult if not impossible to fix public finances when in trouble without solving the question of automatic increases in entitlements”.

In conclusion, even though the results were not brilliant and had not changed much since 1998, the theories and suggestions that began with Einaudi and carried forward by his students, were not mere ideas anymore. In fact, they were taken, as Alesina would say, as the only alternative to face the crisis by the EU president in 2010. They became the basis for the austerity maneuvers that still affect us today.
1.2 Opponents and Negative Evidence

1.2.1 John Maynard Keynes

John Keynes (England, 1883-1946), was one of the most influential economists of the XX century. He was advisory to the British Treasury under the government of Winston Churchill and revolutionized the idea behind macroeconomics. His beliefs were strongly anti-austerity. He argued that saving didn’t drive investment if “investment is free to fluctuate under the influence of expectations”, which is the core of austerity beliefs. Moreover, he argued that to get out of a recession it was necessary for the government to “prime the pump” to encourage investors to spend their money when there is uncertainty about the future. Keynes flipped austerity theories upside down in one of his most notorious works, known as “General Theory of Employment, Interest and Money”, in which, among many assertions, he argued that in times of uncertainty about the future, if rational investors wait for signals from other investors to invest, then all investors will refrain from investing while sitting on their cash, thus causing a depression. Turning away from Smith’s teachings, Keynes did not believe that all people are hardwired to save and invest. He claimed instead that savings did not necessarily devolve into investment, as savings and investments float free from one another. Overall, he concluded that savings could just as well lead to more saving and thus less consumption. The solution to a recession, according to Keynes, was in the hands of the state, as it was its responsibility to influence people’s expectations through raising the level of prices. Higher prices would increase the possibility of making profits, and thus make it reasonable again to higher workers. Summing up, Keynes’s believed in growth through consumption, also known as demand-side economics, where investment is the result of “consumption via workers’ paychecks”. Through this vision of the economic world, it is evident that business confidence is no longer a cause but an effect of growth. Keynes’s “General Theory” had a strong impact on the economic society at that time because it came out after two decades of austerity in which recovery was “just around the corner”. In addition, it reached its audience at the end of the 1930’s, just a few years before countries started programs of intensive wartime spending. Pro-austerity
doctrines were no longer considered plausible and Schumpeter was forced into retreat. However, it is significant to notice that in the same years of Keynes’s “General Theory”, countries that abandoned the gold standard and that were able to concentrate on boosting domestically generated demand recovered further and faster than those nations that stayed on it and looked to austerity via deflation as the way to “right the ship”.

Keynes’s contributions to society were more than economic technicalities. They affected society at a more ethical level. In 1933 he wrote about society though the perspective of a timorous accountant’ life. Referring to men of the XVIII century, he criticized the fact that instead of using their abundant material and techniques to build the “city of wonders” they built quarters of shacks. This because shacks would yield returns while the city of wonders would be an excessive extravagance that would “hypothecate the future”. He wrote about how his compatriots could not see that their nation would be richer if unemployed men and machines were used to build the much-needed houses. Quoting: “we have to remain poor because being rich does not ‘yield returns’. We have to live in shacks, not because we cannot build buildings, but because we cannot ‘afford them’”. He continued by saying: “we destroy the wonders of the countryside because the splendor of nature, accessible to all, does not pay dividends... London is one of the richest cities in the history of civilizations, but it cannot ‘afford’ the highest levels of civilization of which its citizens are capable, because they do not ‘yield returns’”.

Basically, what Keynes said was that people were so worried about complex formulas of financial accountability regarding whether something “yielded” or not that they failed to see conclusions that should have been otherwise obvious.

1.2.2 The United States Tries Austerity

Having discussed and explained the origins of austerity and its supporters, it might be useful to report the effects that this ideology has had in the different time periods mentioned above and explain why it has resisted until today. Starting from the 1920’s in the United States and the United Kingdom, this paper will analyze the consequences of austerity until today and look at the European Union’s economic policy.
As previously stated, the United States of the 1920’s and early 1930’s was the stage for emetism and Schumpeter’s liquidationist arguments. The Hoover administration, acknowledging the fact that letting the emetic process unfold via austerity was the only way to restore the proverbial loss in business confidence, surrendered to Schumpeter’s economic theories. In other words, in 1931 Hoover focused on balancing the budget and raising taxes despite the recession. The result was the worst economic depression Americans have ever experienced in the entire history of their country.

1.2.3 Facing the Great Depression
The 1920’s and 1930’s were peculiar times for the world. It was a time of ever-elusive equilibrium. The reason for these unstable times was a combination of complex loans, austerity, and the return to the gold standard. After World War I, the United States were stronger than ever, but France, Germany, and Britain suffered from the wounds of war and craved a return to the gold standard to restore the prosperity that was lost. France and the United Kingdom owed money to the United States while Germany owed billions to the Allied powers. The solution was found in the shape of loans and repayments that were issued from the United States, passed from Germany to France and Britain, and returned to the US. However, the stock market boom of 1928 pressured the Federal Reserve to cool domestic demand by raising interest rates. The unexpected result of this policy was a further push to the market boom, as US capital returned in the country to take advantage of the higher interest rates.\(^{20}\) However, when the Wall Street boom and crash of 1928-1929 hit, loans dried up in Europe and the Great Depression took its place in history. It is worthwhile to analyze each situation individually to see what happened to the aforementioned countries and whether their economic policies functioned as they were supposed to.
1.2.4 The United States in the Moment of Truth

The roaring twenties were possible in the United States because the country was off gold, as were most of the European nations, causing them to adapt to floating exchange rates by deflating externally. Although the early 1920’s were a time of prosperity for the United States, there were growing signals of trouble. In particular, agricultural prices were falling and the banking sector was showing symptoms of volatility. This was reflected into a slow rise of the unemployment rate under the Hoover administration, which tried to solve the problem by implementing public expenditure maneuvers during the biennium of 1924 and 1926. However, these proved to be insufficient as they only affected a very small percentage of the national product. Nevertheless, such measures seemed useless when the stock market boom hit 1928 and unemployment plummeted. The consequent stock market crash inspired Hoover to increase federal spending by one-and-a-half billion dollars, which was still an insufficient portion of the GDP to face the crisis. The result was that private spending continued to decline bringing tax receipts down as well, while “expenditure rose by almost 60 percent”. It was at this point that Hoover saw no alternative but austerity to restore business confidence and balance the budget in the sake of sound finance. The road taken by Hoover became steeper in 1931. When Britain abandoned the gold standard, investors began to fear that the US government would do the same. Consequently, confidence in the dollar diminished, capital flights soared, and unsustainable interest rates rose causing the insolvency of many banks. Hoover argued that “we cannot squander ourselves into prosperity” and raised a huge amount of taxes to compensate for the deficit. This resulted in a rise in unemployment up to twenty three percent of the labor force in 1932 compared to the fifteen percent of 1930. In 1933, the United States abandoned the gold standard, leading to a quick reflation via devaluation and to a path of recovery. However, in 1936, a new round of ideas supporting the notions of sound finance and budget balancing lead to a new biennium of austere tightening through fiscal contraction. Once again, the result was a recession that lasted from 1937 to 1938. In 1937, president Roosevelt definitely put austerity aside and famously claimed that “Let us unanimously recognize the fact that the Federal debt, whether it be twenty-five billions or forty billions, can
only be paid if the Nation obtains a vastly increased citizen income”.23 As a result, he gave order for a $3.5 billion increase in public expenditure which improved the economy that fully recovered in 1944 thanks to massive wartime spending.

1.2.5 The UK Goes Deep

Shifting the attention to the same period in the United Kingdom, one may recall that although the state was acquiring a more interventionist position, the predominant economic philosophy was still austerity.

Britain, as well as other European nations, aspired to a return to the gold standard. In particular, Britain wanted its currency to return to its anchor status of the gold standard by restoring the pre-war parity of the sterling. This meant strong deflation. Despite Britain’s relative financial weakness and low public morale, the Treasury believed it essential to pursue such strategy. After five years of austerity and pain (from 1920 to 1925), Britain finally returned to the gold standard and remained there until 1931. The Treasury’s austere policies, combined with being on gold (which required ever-more austerity), had the effect of rising unemployment from 10.4 percent in 1929 to 22.1 percent in 1932.24 What prevented Britain from defaulting altogether were the earnings on the capital account that came from the country’s offshore foreign holdings of sterling-denominated assets. Exports and domestic consumption were being annihilated by austerity. Moreover, when US capital stopped flowing into Europe in 1929 because it was being repatriated, Britain (as well as others) was no longer able to import capital to cover its deficit. Furthermore, general discontent about the level of unemployment caused many employees to transfer abroad further distressing the budget and increasing the deficit. Overall the British situation had taken the resemblance of a rather vicious cycle. More specifically, in order to be eligible for borrowing, Britain had to reduce its deficit, which was caused by austerity, with even more rounds of austerity. When the National Government replaced the Labour government, it put forth spending reduction and tax increase programs that were overwhelmingly aggressive. Gold reserves almost depleted and unemployment reached record levels. Austerity eventually lead Britain to leave the gold standard in 1931. The
resulting devaluation of the sterling was slightly beneficial to the city of London in terms of unemployment, but the general situation did not call for optimistic predictions. In fact, debt to GDP increased by 170 percent in 1930 and kept rising to 190 percent in 1933. Real output in 1938 was at 1918 levels. Finally, despite the increase in exports brought by the abandonment of the gold standard, high unemployment caused by the Treasury’s implementation of austerity policies did not decrease until the 1940’s. In fact, massive wartime spending set the country on the tracks of recovery with no sign of inflation.

**1.2.6 Waves of Swedish Liberty**

The effects of World War I could be seen in Sweden as well. Having liberal ideas, the governing Swedish Social Democrats did nothing to offset the postwar consequences that reflected into a fall in output and real wages, and unemployment got even worse as the liberal expectations of austerity failed to become reality. Following a very Schumpeterian direction, many Swedish economists argued that austerity was the only way to get through the crisis. Specifically, Gustav Cassel claimed that deflation and unemployment, as well as a fall in prices and wages were necessary to get out of the depression. As if fiscal contractions were not sufficiently austere measures, Sweden returned to the gold standard in 1924, which lead to further deflation. Moreover, the American capital flight and consequent European liquidity crunch of the late 1920’s, combined with Britain’s renunciation of the gold standard, contributed to further aggravate the Swedish situation. The results of continued austerity were rather tragic because despite the spike in exports brought by the deflationary policy in the 1920’s, unemployment reached twenty-five percent in 1932 from about twelve percent of the previous decade. It was only when the Swedish Social Democrats were reelected in 1932 that Sweden rejected austerity and embraced a more expansionary instruction sheet on economic policy. Major public spending programs were implemented to benefit the labor market. In addition, the government took the role of maintaining price stability while keeping national frontiers open for trade. But the Swedish government did even more to ensure the conditions for this new economic course. In fact, in 1933, the
government gave businesses greater flexibility of account by requiring them to balance the budget not over a given financial year but over a whole cycle. In addition, a budget-balancing fund was established in 1936 in order to make sure that accumulated surpluses were spent to reduce the nation’s deficit. All this, combined with a more pro-investment taxation strategy, created the conditions for a “total” expansionary policy that impelled both the supply side and the demand side of the economy. The results of this policy were “full employment, economic growth, fair division of national income, and social security”.

1.2.7 Germany’s Winning Model
In 1923, Germany did not experience hyperinflation due to a sharp turn towards Keynesianism but because there was a need to make war reparations to France less costly as possible. The Germans played the French by inflating the German economy, and exploited their remaining foreign creditors by depreciating the mark. The major side effect of these operations was that producers began looking at the exchange rate when calculating prices. As the exchange rate plummeted, these producers started dumping the mark in mass thus worsening the deficit. To attract capital, instead of raising interest rates, the government started printing more money (monetization). Overall, the famous German hyperinflation was what caused by “passive resistance plus devaluation plus deficit monetization”. The immediate response to this situation was rather effective, as it contemplated the introduction of a new currency (the rentenmark) that was pegged to real estate assets. However, when the streams of capital from the Unites States stopped flowing in 1929, the Reichsbank, despite having raised interest rates, was unable to attract capital inflows due to the general shortage of liquidity in Europe. As a consequence, the economy tanked as the deficit increased and official reserves and the gold cover fell rapidly. In 1928, the Social Democratic Party detached from the government that had ruled up until then, and in 1930 chancellor Brüning (center party leader) was appointed. It was then that Germany took a turn into austerity policies by undertaking major budget cuts to adjust for the deficit. Once again, the Social Democrats gave austerity a very emetic imprint. In fact, they argued that during a
recession the only solution was to let the system fail so that socialism would suddenly takeover. These beliefs were essentially summed up by then vice president of the SPD Wilhelm Dittmann, who when referring to the crisis claimed that “we want the current situation to develop further, and can only follow in the general direction that these tendencies show us”. Brüning insisted with further rounds of austerity despite strong pressures from the trade unions, which called for a more Keynesian intervention by presenting the so called WTB plan - a reflationary policy program. Discarding the SPD austere theory that government intervention would only delay the inevitable collapse of the economic system, the Nazis asserted themselves in the 1932 elections with the presentation of an anti-austerity plan that was in many ways similar to the WTB plan: the “Wirtschaftliches Sofortprogramm”. The paper could be resumed in three striking points:

1. unemployment causes poverty, employment creates prosperity;
2. capital does not create jobs, jobs create capital;
3. unemployment benefits burden the economy but job creation stimulates the economy.

In addition, the manifest included the proposal for leaving the gold standard. In other words, the Nazis took advantage of the bad economic situation and of the malcontent of the people to win the elections with 37.3 percent of the votes in 1932 and 43.9 percent in 1933. Although real wages did not increase, by 1936 full employment was restored in Germany, while unemployment affected thirty percent of the total workforce in 1932. However, unlike Sweden, most of the economic improvements were due to the fiscal stimulus caused by armaments. In fact, Germany did not experience the full economic boom until it was ready for war. In conclusion, the particular lesson that German history of the time in question taught the world was that when the Nazis ended austerity and left the gold standard growth returned. In general, it can be observed up to this point that austerity policies were rather controversial in the analyzed cases. Perhaps, observing a few more countries can be useful to obtain a clearer idea on the matter.
1.2.8 Tensions in Japan

Like many other powers after World War I Japan aspired to restoring the gold standard. Although the Nippon island was among those countries that was least affected by war damages, the economic system was not as solid as it might have appeared, as the banking system was brittle and inflation was high. As Japan was highly dependent on imports, the devaluation of the currency that resulted from being off the gold standard ended up fostering inflation through imports. The government tried to stall the issue by adopting strict austerity measures, especially through high interest rates. The results were not very encouraging, in fact, growth in Japan was negative in 1922, 1923, and 1925 with respective growth rates of -2.7%, -4.6%, and -2.9%.30 What came after 1925 were several years of strong political debates on whether to return to the gold standard (obviously through austerity). Despite the absence of real growth in the last four years and some complaints coming from domestically focused labor, farming, and business interests, the Seiyukai and the Kenseikai agreed to the necessity of going back to the gold standard. Yet they did not agree on the conditions for getting there. Politicians spread propaganda to the Japanese people through a strong program of pro-austerity advertising campaigns. One of the leading newspapers of the time, Osaka Mainiki, referred to the French case by saying that “France realized the repeal of the gold embargo: Japan should shame itself”. In 1929, Junnosuke Inoue was appointed as the new finance minister. Taking advantage of the situation, he gave orders for an even wider propaganda campaign aimed at convincing the people (successfully) about the advantages of a more contractionary economic policy. Reportedly, in one of his short books, he expressed the following concept: “We cannot avoid fiscal tightening and liquidation at least once in the process...the surest way is to go straight towards the repeal of the gold embargo...since we cannot avoid some pain...and sacrifice anyway”.31 Japan returned to gold at the worst possible moment. They did so in 1930, when all the other economies were contracting. As a result, demand for Japanese manufacturing declined drastically and the yen appreciated against the dollar by seven percent circa. Trade collapsed and the growth rate experienced dramatic reductions in 1930 and 1931, with respective figures of -9.7% and 9.5%. To complete the package, the reduction in
average income for Japanese households amounted to 676 yen, and it happened in just two years.\textsuperscript{32} Despite these less than acceptable signals, the Japanese government continued to pursue the path taken further worsening the situation. Austerity continued in the form of balancing the budget through cutting spending. The cuts affected especially the military, as Inoue, in 1930, promoted a campaign of disarmament as well as of removal of the gold embargo and a “purification of politics”. Inoue continued undaunted with spending cuts so that public expenditure lost another twenty percent of the budget. Furthermore, the finance minister ordered an even higher raise of the interest rates. The situation imploded in 1930 with the assassination of prime minister Hamaguchi by a military supporter. This came after the London Naval Treaty declassed the Nippon navy to permanent inferiority status. In 1931, Inoue ordered a further cut for the war department. Unsurprisingly, he resigned the same year after uncovering a plan by the army to overthrow the government. Inoue’s successor, Takahashi Korekiyo, representative of the opposition, revolutionized the economic policy. His first insights were to leave the gold standard and to halve the interest rates on commercial bills. He then increased government spending, which made up for an extra ten percent of the GDP. His maneuver was more extensive, as he also increased the money supply and ordered the Bank of Japan to issue long term “riskless” bonds on behalf of the government. In addition, to avoid capital flight of the new money in circulation, he instituted capital controls.\textsuperscript{33} The results were brilliant in every aspect. Prices decreased and debt decreased, while growth spurted between 1932 and 1936 by four percent each year. The economic upturn was further favored by the fact that the rest of the world was deflating while Japan was heavily reliant on trade.

\textbf{1.2.9 France Makes a Choice}

To complete the European landscape of the 1920’s and 1930’s, one cannot avoid mentioning France. France was on the winning side after World War I but it was the country that suffered the most damages from the conflict. As Germany paid “nothing” to France in war reparations via the 1923 hyperinflation, the French economy struggled to get back on its feet. The main obstacle to recovery was the distribution of political
power and the close relationship between the political right and the Bank of France. The conflict between the political left and the right derived from the fact that the latter wanted to tax and raise excises on everything and everyone, while the left wanted taxation on the income and wealth of the wealthy alone. Because of its ties to the political right, the supposedly democratic Bank of France stopped issuing short-term bonds that funded the government whenever it looked like the left would win the next elections. This meant that the left’s only instrument was to print more money, which done repeatedly fostered inflation. In fact, the Conservatives won the elections in 1924 and raised taxes on the constituencies of the left. When the left took back control later in the same year, it was unable to return the favor and deficits bloated. In 1926, the left resigned and a new government of the right was able to balance the budget by raising enough taxes. The squaring of the accounts combined with the reduction of inflation convinced investors to buy francs and allowed France to get back on the gold standard with full gold reserves in 1926. The period between 1926 and 1930 was one of stabilization and slight growth, especially thanks to the high interest rates that increased gold inflows. The aforementioned US capital flight, the stock market bust, and the consequent European liquidity crunch of the late 1920’s hit France heavily. By 1932, national production had fallen by seven percent. Moreover, by that time most countries were abandoning the gold standard and attempting reflation. This meant that choosing to stay on gold was France’s only option. In order to do so it had to deflate. However, since France was a democracy, the government knew that the people could only tolerate contractionary policies for a limited period of time before signaling dissent. The government knew that reflating the economy while being on gold was bound to lead to capital flight, but the Bank of France had no intention to cooperate. This happened because, as previously mentioned, the Bank of France was a highly undemocratic institution that favored the interests of its shareholders. These shareholders paid the governor’s salary in exchange for gold, cuts, and balancing of the budget, at the expense of the common people and for the benefit of the rentier class. Finally, the Bank of France reinforced ties with the conservative party to pinion the left and promote the advancement of austerity policies. Overall, the Bank of France nullified
all expansionary attempts from the left. This extremely contractionary political stance resulted in major spending cuts, a fall in industrial production, an increase in the real exchange rate, and a collapse of the money supply between 1932 and 1936. There was a turnaround at the beginning of 1936, when the people revolted against the government and the leftist Popular Front took control. It increased wages and reduced working times, which proved once again to be useless as it prompted another round of capital flight that unsurprisingly the Bank of France did nothing to stop. The usual consequences were higher interest rates and additional deflation. In 1936, France left the gold standard but doing so did not change much for the nation’s economy. The problem in France was that, unlike other countries of the time, devaluation was not accompanied by spending because the central bank was unwilling to support anything but austerity. The cause of such neglect was simply a higher import bill and an even deeper slump. In conclusion, by vetoing every budget increase the Bank of France made it so that French military spending between 1934 and 1938 was one tenth that of Germany. Also, alarmingly, French central bankers “called for defense cuts as late as 1940”, perhaps favoring Hitler’s plans for Europe.

1.2.10 Major Critics on Previous Evidence

Apparently, the cases that have been analyzed up to this point do not seem to strengthen the claims brought about the supporters of austerity. Recalling what was said about Denmark, the Danish represented Giavazzi’s and Pagano’s best argument in support of expansionary austerity. Later on, Alesina and Ardagna pointed out that the consolidation was followed by two years of recession, highlighting the fact that the results were mixed. Nonetheless, they did confirm that the consolidation that lasted from 1982 to 1986 was mainly the result of positive expectations. It was up to Bergman and Hutchinson to dismantle their work. They analyzed the causes of the 1988-1989 slump (which Alesina and Ardagna did not acknowledge). Specifically, “if expectations were altered when a major regime shift was signaled in 1982-1986...why then did those same expectations end up producing a slump
in 1988”?

In other words: did people change their expectations due to some unknown external factor (no), or was the signal not credible in the first place (but it worked for four years)? Moreover, none of the supporters of the case mentioned that when the consolidation was imposed the Danish economy was experiencing overheating. Thus, the cuts were done in a boom, not a slump.

Other cases brought by Einaudi’s followers were those of Ireland and Australia in the 1980’s. In “Tales of Fiscal Adjustment”, Alesina and Ardagna claimed that Ireland’s debt amounted to 116 percent of GDP in 1986, and that from 1987 through 1989 the nation experienced prosperity thanks to a new government that cut transfers, wages, and taxes. Apparently, devaluation combined with lower wages to decrease the cost of labor and cause growth and foreign investment to take off. Overall, according to the Italian economists, this economic success was due to a program of devaluation, budget cuts, and wage moderation.

In direct opposition with Alesina’s and Ardagna’s argument, American economist Stephan Kinsella claimed that Ireland’s expansion was not the result of consolidation but that it rather “coincided with a period of growth in the international economy, with the presence of fiscal transfers from the European Union, the opening up of the single market and a well-timed devaluation in August 1986”. Considine and Duffy used this last factor to explain that the big difference for what regards growth was given by the said devaluation and the “Lawson boom” of British exports. If all this was not sufficient to undermine Alesina’s and Ardagna’s evidence, Kinsella added another counterargument to the discussion by stating that “the average industrial wage rose by over 14 percent in the period 1986-1989 (which) boosted government revenue and increased...private consumption”. In conclusion, it appears as if the much-praised expectations channel made up for a mere insignificant part of the Irish expansion equation.

With regards to Australia, another champion of the “Tales” campaign, according to Quiggin the discussion is mute, as the argument for changing expectations does not exist because the cuts in unemployment benefits and capital taxes that Alesina and Ardagna claimed did not actually occur. Furthermore, contrary to what the two economists
asserted, Quiggin demonstrated that no contraction occurred but that rather “a major expansion in the role of government” did.\textsuperscript{38} Sweden in the 1920’s was supposedly another point in favor of expansionary contraction. In 1995, Giavazzi and Pagano wrote a paper on the Swedish economic situation between 1990 and 1994, a period of renown distress for the Scandinavian economy.\textsuperscript{39} They took a different approach to explain why Sweden’s consumption stayed flat rather than expanded despite budget expansions and tax cuts. They explained the case by stating that tax cuts in a slump warn consumers about bad times ahead and refrain them from consuming more despite the higher availability of cash. In other words, Giavazzi and Pagano reversed the usual concept that spending cuts lead to higher consumption by claiming that higher spending can be the cause for lower consumption (bad expectations). The variable they used to support their case was growth in the debt to GDP ratio that rose from 24.9 percent in 1990 to 67.8 percent in 1994. They argued that variations were mostly caused by tax cuts, bank bailouts, and other similar policies that supposedly warned consumers about bad times ahead and thus weakened private consumption. In addition, they claimed that the fall in private consumption lead to the creation of a one percent bond spread between a thirty-year Swedish government bond and an equivalent World Bank note of the same currency and duration in 1993 (nothing to get worried about). Allegedly, this episode combined with the Swedish government’ propensity to accumulate public debt to bring expectations to a level so low that when the state gave away free money in the form of tax cuts it had no effect on consumption. However, although Giavazzi and Pagano did mention a slight recession, they completely omitted the fact that between 1989 and 1993 Sweden underwent a “triple meltdown of real estate markets” (bubble), “stock markets and the exchange rate”.\textsuperscript{40} In other words, a real estate market bubble, combined with a currency crisis in the ERM system, caused massive deflation and devastated the labor market bringing the economy to its knees. It was only then that interest rates went through the roof; nothing to do with public debt.
Finally, it is rather obvious that consumers who had spent money in the real estate market might not have been inclined to spend much. Actually, the only reason for which consumption between 1990 and 1994 stayed flat rather than collapse was due to the fact that tax cuts had been effective.

Chapter 2
What about Europe and the Recent Crisis?

2.1 The EU Model and Its Results
Having looked at many individual cases, it is time to have a glance at the bigger picture. The EU model is based on the German ordoliberal model of the 1970’s, as it is founded on the same principles. The ECB constitution is, in effect, a concentrate of ordoliberal notions, while the EU Commission’s main objective is to regulate competition. The approach used to govern the Euro is essentially rules-based. The “new” fiscal treaty, enforced by the Maastricht Treaty of 1992 and the Stability and Growth Pact, is centered around rules and competition as the catalysts for economic growth. The rules are to be respected and, if broken, they must be supplemented with austerity and sanctions to those who break them. In addition, according to ordoliberal Europe, the essential factor for the return of growth is an independent monetary institution that ensures the enforcement of said rules - the European Central Bank. The problem with the German model is that, as previously mentioned, Germany’s situation was unique. The so-called German economic miracle was perhaps only possible because no other country was following the same model at the time. Specifically, what gave Germany an advantage was the fact of being a late developer that was attempting to catch up with Britain through an export-led ordoliberal system.

The reason why all the Eurozone countries cannot follow the same ordoliberal policy is simply reported by Martin Wolf in “Fixing Global Finance”: “Is everybody supposed to run current account surpluses? If so, with whom – Martians? And if everybody does
indeed try to run a savings surplus, what else can be the outcome but a permanent global depression?” In equivalent terms, for one country to run a surplus the others must be running deficits. In conclusion, the Euro system sees no place for compensation through the printing of money, as the only concern is the regulation of competition for the sake of economic growth and budget surpluses.

Furthermore, as the European Central Bank is not wired to act as lender of last resort, and as troubled member countries cannot mutualize their sovereign debts, countries in difficulty are bound to suffer and succumb. This is because without a national central bank and with the “single currency” a country is unable to manage the exchange rate, neither through open market operations nor through devaluations/revaluations.

Therefore, when investors began speculating on the stability of weaker member countries such as Greece, there was nothing that the Greek government could do to stop the fall. In these cases, “the crisis is deepened, as the danger of a State’s default depresses its bonds, widens the spread, and depreciates the assets of the banks that hold them.” Then, if the government does not intervene because it lacks the instruments to do so, the system will experience a bank run (as in Greece) and capital will flee to “sounder” countries such as Germany. Inevitably, poorer countries will get weaker and richer countries will get richer.

Critics on expansionary austerity came from the IMF as well, which analyzed Alesina’s and Ardagna’s paper of 2009 through alternative measures to demonstrate that fiscal contractions were actually contractions with no offsetting gains. In addition, it asserted that while it is true that tax increases contract the economy more than spending cuts, it has nothing to do with expectations but with the fact that the central bank can counterbalance the contraction by cutting interest rates. Finally, it claimed that in a system like the EU devaluation is not enough to promote growth. This is because it would be unlikely for all countries to increase their exports at once. Thus, a fiscal contraction is going to be more harmful to these countries if they all try to adjust at the same time.

Contrasting Reinhart’s and Rogoff’s belief that debt and growth were negatively correlated, researchers at the University of Massachusetts discovered that actually
there is no nexus between the two. What the IMF did find was counterproof to the
effects of the expectations channel. It demonstrated that expansionary austerity was in
reality recessionary. In fact, the fiscal multipliers have been higher in the recent
recession than before: 1.5 rather than 0.5. Equivalently, a fiscal contraction of €1.00
results in a €1.50 recession of the economy rather than €0.50 as the advocates of
expansionary austerity would sustain. In 2012 an IMF paper written by Nicoletta Batini gave expansionary austerity the final
blow, by arguing that: “while it is plausible to conjecture that confidence effects have
been at play in our sample of consolidations, during downturns they do not seem to have ever been strong enough to make the consolidations expansionary”. Surprisingly, another critic to austerity came from Roberto Perotti, who undermined the expectations channel by arguing that, unless supplemented with a mix of other policies such as devaluation and wage bargaining, contractionary policies lead to fiscal contractions. In 2010, Jayadev and Konczal argued that in none of the expansionary cases brought forward by Alesina and Ardagna in 2009 did a country increase growth and reduce debt contemporarily. Furthermore, none of those cases showed a reduction of deficit while in a slump. The CRS supported their claim in 2011 by asserting that “successful fiscal adjustments occurred when the economy was at or near potential output”. In conclusion, it might be necessary to return to the realities of recent history and look at some more contemporary data.

By 2011, the austerity cure advocated by Trichet in 2009 was yielding its results. Figures showed that debts got bigger rather than smaller and that GDPs decreased, while more cuts created even bigger deficits. In fact, the debts of Portugal, Spain, and Ireland respectively doubled, tripled, and almost quintupled with austerity. In December 2011 and then again two months later, Mario Draghi gave orders to implement the so-called ECB’s Long-Term Refinancing Operations (LTRO). Consequently, one trillion euros flowed into the troubled European economy. The results were revealing. By august 2014, interest rates on Italian ten–year bonds fell from 7.1 percent in January 2012 to 2.73 percent. Similar consequences were seen in both Spain and Greece.
2.2 The Greek Crisis and Austerity

The Greek crisis came into the spotlight in 2009 when newly-elected Prime Minister Papandreou revealed to the public the real values of Greece’s financial health. Public debt amounted to 110% of GDP while the deficit to GDP ratio was 12.7% instead of 3.7% as previously claimed. In 2010 the IMF, BCE, and the Greek government agreed on a rescue plan that required Greece to square its public debt account in exchange for 110 billion dollars. In 2011 another 50 billion euros were lent to Greece. Papandreou called for a referendum regarding the second package of austerity measures but was forced to resign. His successor Papademos continued with austerity despite strong protests from the people, until he was replaced by Samaras in 2012. The latter claimed that Greece had no more money and that without an intervention from the EU the nation would default. As a result, the Greek parliament approved a new program of austerity revolving around 13.5 billion euros. However, the situation was not getting better in 2013, thus motivating the Parliament into approving a maneuver that would cut thousands of jobs in the public sector.47 Fast-forwarding four years it is now 2017 and Prime Minister Alexis Tsipras declared in May as follows: “we are at the end of the tunnel and in 2018 we will abandon the memorandum”. The response to this rather optimistic assertion came from Nea Demokratia’s leader Mistotakis: “you let us sign another agreement of sacrifices after having promised that the cuts were over”. In fact, the Greek parliament approved another round of austerity - the fourth memorandum - that will cut pensions further in 2018 and reduce the threshold of non-taxable income in 2019. The maneuver is demanded by the IMF and BCE and will supposedly generate 4.5 billion euros to devolve in debt repayments and increases in instruction and health funds as well as to reduce taxes on lower incomes.48 The problem with this umpteenth maneuver - let alone negative data – has probably something to do with what was said in the previous chapters about democracy. That is, governments can only protract restrictive policies for so long until people start manifesting dissent. Greece has experienced numerous protests in the past six/seven years but 2017 seems to be the year in which people say enough.
Despite five years of austerity and cuts to pensions and wages public debt increases, purchasing power decreases, and the number of poor grows month after month. The first trimester of 2017 showed a reduction in growth of 0.5 percent and the lower class is not the only one to complain anymore. Doctors and professionals are struggling too. On May 17 thousands of people protested in Klaforhos and Patission Squares against the parliament. Similar strikes took place in Syntagma Square against the fourth memorandum.49

It’s since 2013 that the IMF claims that figures regarding Greece’s public debt do not add up. Backing this statement is not that hard a mission. One must only think that the new 8.5-billion-euro rescue plan approved on June 15 by the Euro group will barely be sufficient to honor the debt Greece has with the IMF and the Bce.50

What is even sadder about Greece however is the fact that 14 national airports are owned by German company Fraport while the great ports of Cosco and Salonico belong respectively to the Chinese and the French. Furthermore, people cannot afford to pay taxes, thus students and professionals are leaving in mass to emigrate to wealthier countries such as Sweden and Australia.

Conclusion

In this essay, I have tried to shed light on the notion of austerity. I have illustrated the main theories of its most renowned advocates and how they have influenced entire generations of economic thinkers. In addition, I have analyzed the ideological and factual effects it has had on different countries at various times. Finally, I have attempted to explain the main claims of austerity, such as the fear of debt and the concept of the expectations channel.

In this conclusion I will try to express another crucial observation, that is the reason for which I have decided to write on this subject and why austerity is such a common words these days. It has something to do with cause and correlation. More specifically with why there is the need for cutting. The initially introduced concept that contractionary policies have negative effects on banks is indeed true but perhaps there is more to the story. While it is true that it can
be beneficial for an overheating economy to slow down, it is also important to identify the cause of an entanglement of such kind and/or eventual crisis. Especially, it is fundamental not to confuse cause with correlation. The recent crisis that started with the real estate market bubble in the US and consequently expanded throughout Europe was not caused by an excessive accumulation of public debt (except possibly Greece) by irresponsible governments – the old liberal nightmare – but by a reckless and outrageous leverage of the banks. In 2008, the top three French banks owned assets accounting for 316 percent of French GDP. The two biggest German banks made up for 114 percent of Germany’s GDP and were running with leverage levels of up to forty-to-one. By 2012, the three biggest Italian banks owned assets for 115 percent of GDP. Even worse was the situation in the UK, where the combined assets of the top four national banks accounted for 394 percent of GDP. One can see that at such levels of leverage even the smallest turn against their assets can impair the banks’ balance sheets and even endanger the sovereign. Therefore, when the wind started to change direction, US banks were “too big to fail”, while the European banking sector was “too big to bail”. This was because European bankers, assuming that the ECB would bail them out in case of need, went too deep into leveraging. It was for this reason that contractionary policies were adopted – in order to save to bail the banks and get the system back on track. However, recalling what Roosevelt and Keynes said, it does not matter how big the public debt is, the only way to growth is through spending and consumption. Also, as history has taught us, it is never a good idea to cut in a slump.

Now, having said that the battle cry of austerity supporters is the need to cut spending because foolish accumulations of public debt create instability in the market by upsetting investors (who worry about the risk of sovereign default), increases in debt should be accompanied by spikes in government bond yields. However, data shows a rather different picture. It shows that investors could not care less about the level of government debt (the ancient liberal obsession).

Overall, it appeared as if the first refinancing maneuvers put forth by the supporters of austerity in the EU were only partially successful. Debt continued to be pulled up by austerity, while yields kept going down due to the ECB’s expansionary policy. A calmer
market driven by lower interest rates means that the government has less interests to repay, ergo a new path for growth. In conclusion, as the evidence suggests, there appears to be no case in which austerity has done good on its claims, not in the past, not in the present, and especially not in a slump.

For what regards the Greek situation, it appears as if Greece is drowning in debt it will never be able to repay. Although, more importantly, it seems like if history cyclically repeats itself. After years of austerity and restrictive policies public debt struggles to decrease, while unemployment remains high and poverty increases. It is like if the cases of Japan, the United States, and France, above the others that were described, are nothing but irrelevant pages in old history books.

It is 2017 and Mario Draghi says: “the crisis is over”. Alexis Tsipras affirms: “we are at the end of the tunnel and in 2018 we will abandon the memorandum”.

Perhaps it is true that powerful ideologies are sometimes stronger than facts.
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