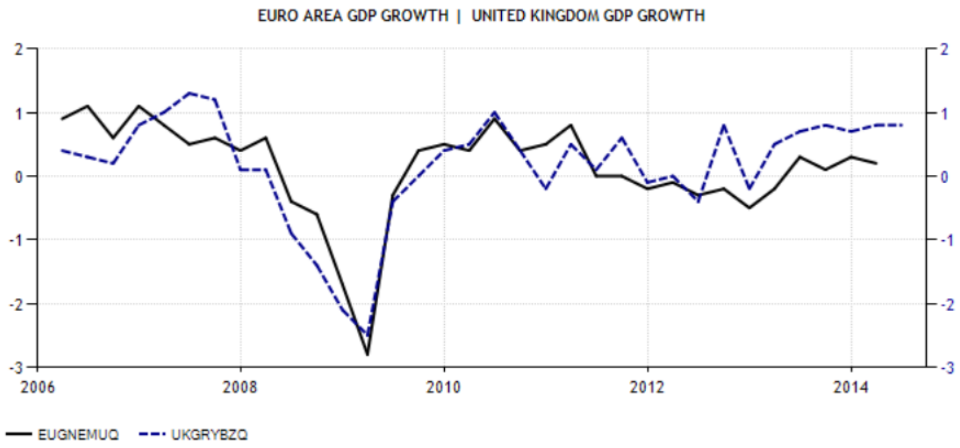
Postscript 2014: When You Find Yourself Going Through Hell, Look for an Exit[1]

Austerity Revisited

Just as one swallow does not make a summer, so a year and a half of more data doesn't change my assessment of austerity. It's still a dangerous idea and it still doesn't work. Yet the past 18 months has been hailed, especially in Europe, as a vindication of austerity policies because Europe is supposedly now in recovery. As can be seen in the chart below, it is true that the Eurozone economies as a whole stopped contracting in the last two quarters of 2013, while the UK has gone from laggard to leader in the growth stakes. Yet some issues need to stand scrutiny for the claim that austerity is producing what little growth we see in Europe to bear weight even if we discount the most recent figures, which augur a triple dip recession.[2]

Figure one: Eurozone and UK GDP growth 2006-2014



Source: tradingeconomics.com

[1] With all due apologies to Winston Churchill. Original quote: "when you find yourself going through hell, keep going." Nice line, but very bad policy advice if the policy one persists with is fundamentally flawed.
[2] See Richard Portes, "Drahgi has to do, as well as say, whatever it takes." Financial Times, August 21st 2014. http://www.ft.com/intl/cms/s/0/9f01f282-285e-11e4-9ea9-00144feabdc0.html#axzz3B3Usbmbx.

The first is the claim to recovery itself as a result of austerity policies, which once again deliberately confuses cause and correlation. To use an analogy to illustrate, imagine someone has a form of stomach cancer that leads doctors to have different diagnoses of what to do. The patient is encouraged not to undergo chemotherapy and try an alternative therapy of acidic enemas and a crash diet of 800 calories a day. The doctors and the patient persist with this therapy and the condition worsens. Eventually the same doctors intervene and apply chemotherapy. The patient recovers, but she is now so much weaker than she should be from the experience that her prognosis is now much more uncertain. Nonetheless, the doctors proclaim that while the chemotherapy was important, it was the enemas and the crash diet that really saved her. This is precisely what has happened in the eurozone, with austerity as the alternative treatment and ECB liquidity provision in 2011 and 2012 as chemo. It's quack medicine being hailed as a wonder drug despite the evidence.

But even if we accept that growth has returned despite austerity, it's hard to see the emergence of a sustained rate of growth in the recent figures sufficient to reduce the huge pile of debt that austerity has generated. Remember, government debts got bigger, not smaller, under austerity. Countries saw their underlying GDP shrink - and their debts get reciprocally bigger - the more that they cut – the so-called 'denominator' effect. In fact, if one looks at gross debt figures, Portugal has doubled, Spain has nearly tripled, and Ireland has nearly quintupled their respective debts. Second, if as *Austerity* maintains, what is at the heart of all this is a banking crisis nested within a set of dysfunctional institutions and not a public spending crisis, then one must ask how austerity, fiscal tightening, budget cuts, and all the rest can possibly restore growth? The wrong diagnosis, and the wrong medicine, is still unlikely to lead to lead to a satisfactory recovery.

Budget Cuts Still Can't Solve a Banking Crisis - But a New Central Bank Chief Can Buy You Time

This book was published in April 2013, nearly one and a half years ago at the time of writing this postscript. I finished the actual writing of *Austerity* in October 2012, just as the full effects of 'the Draghi put' were beginning to be felt in European bond markets. The 'Draghi put' was the Long Term Refinancing Operations (LTRO) of the European Central Bank (ECB) of December 2011 and February 2012, combined with new ECB President Mario Drahgi's promise of July 26th 2012 that he would do "whatever it takes" to save the Euro. That is, if he had to, he would buy sovereign bonds directly to keep yields down through a program called Outright Monetary Transactions (OMT).

Never has so much effect been gained by doing so little. Words alone, it seemed, calmed the markets because OMT was not actually used. Its promise, plus a trillion and more in liquidity, sufficed. From January 2012 through August 2014 Italian ten-year yields fell from 7.1 to 2.73 percent. Spanish ten-year bonds went from a peak of 7.36 percent in July 2012 to 2.4 percent today. Meanwhile, Greece's ten-year bond went from a post-bondholder haircut of 29.89 percent in May 2012 to a comparatively mild 6.2 percent today despite enduring a collapse of a nearly a third of GDP and seventeen straight months of deflation.[3] So the yields went down which is good. But what does a central bank liquidity-put designed to back-stop financial markets that are running out of funding (the purpose of the LTROs and OMT) have to do with cutting the state's budget? Recall that austerity is defined is this book as:

[3] All figures in this postscript are taken from either Bloomberg.com or tradingeconomics.com unless otherwise indicated.

"A form of voluntary deflation where the economy adjusts through the reduction of wages, prices, and public spending to restore competitiveness, which is (supposedly) best achieved by cutting the state's budget, debts, and deficits. Doing so, its advocates believe, will inspire 'business confidence' since the government will neither be 'crowding-out' the market for investment by sucking up all the available capital through the issuance of debt, nor adding to the nation's already 'too big' debt."[4]

Given such a definition, the answer is, nothing at all. Budget cuts can't triage a banking problem, but that hasn't stopped its advocates pretending that it can. To see why this is the case, let's recap what's actually still going on in Europe.

The crisis in Europe had two phases. The first phase we can call 'the break-up that never happened,' which began in May 2009 when then ECB president Jean Claude Trichet told the markets that "we are not at all embarking on quantitative easing."[5] In saying this Trichet effectively told the markets that the ECB was not going to backstop the system such that holders of Euro denominated sovereign debt could not swap bonds for cash on demand.[6] The diverse set of national bonds whose yields had tracked German bunds for seven years started to move rapidly apart from them. This was amplified by a change in government in Germany from a left to a right coalition, which led to damaging equivocation over the backstopping of Greece. Greece's own admission of dodgy deficit numbers plus the dozen or more 'Merkozy' summits that followed, where Germany and the ECB played 'pass the parcel' over who was going to stop the rot, added still more uncertainty to the mix. The end result was that that by mid-2011 periphery bond yields had split apart from German bunds and yields rose to unprecedented levels.

These yield spikes were not however driven by market concerns over the ability of the Spanish, or any other state, with the possible exception of Greece, to pay its pensions to

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[4] Mark Blyth, *Austerity: The History of a Dangerous Idea* (New York: Oxford University Press 2013) p. 2

[5] Jean Claude Trichet, "Introductory Comments with Q and A," European Central Bank, Press Conference, May 7th 2009. http://www.ecb.europa.eu/press/pressconf/2009/html/is090507.en.html

[6] See Eric Lonergan, *Money* (2nd Edition) (London: Acumen Publishers 2014), pp. 165-166.

retired teachers. The markets were instead pricing in the risk that the Eurozone would break up. Specifically, they were pricing in the possibility that the Euro denominated assets that market agents held lots of would rapidly devalue in the event of a break-up of the Euro since neither the central bank (the ECB) nor the most solvent state (Germany) seemed prepared to backstop them. Dithering for nearly two years over the meaning of treaty articles and inconclusive policy responses from multiple summits made the situation worse.[7] The state of the public purse was simply not driving events.[8] The perception of assets going to zero without insurance was.

The second phase of the eurozone crisis might be called 'the US crisis redux.' It ran from April to November 2011 and it made an already bad situation critical. In this latter phase of the crisis large European banks saw their funding sources dry-up in an almost perfect re-run of the US crisis of 2007-8.[9] As chapter three of *Austerity* details, both London based Repo markets and US money market funds stopped lending to European banks when the collateral they pledged in such transactions, European sovereign debt, lost value.[10] As liquidity drained from the system yields spiked across the board from already high levels as markets began to worry about default-risk among European banks ricocheting back to their sovereign hosts. Even Germany's famously dull Bunds spiked in the first half of 2011 as break-up risk and default risk combined to compel the ECB into action, the result of which was an initial trillion and a half Euros of basically free money being funneled into European

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[7] As the Brussels based think tank Brugel put it recently in a report that they prepared for the European Parliament, "European policy indecision…[and]…the unclear stance on debt restructuring in general…left many investors in a high state of uncertainty. This uncertainty weighed on sentiment and investment decisions." Directorate General for Internal Policies, Economic Governance Support Unit (EGOV), Committee Study on "The Troika and Financial Assistance in the Euro Area: Successes and Failures." February 2014, p. 26. Available at http://www.bruegel.org/publications/publication-detail/publication/815-the-troika-and-financial-assistance-in-the-euro-area-successes-and-failures/

[8] See Paul DeGrauwe and Yuemei Ji, "Panic Driven Austerity in the Eurozone." Available at http://www.voxeu.org/article/panic-driven-austerity-eurozone-and-its-implications

[9] Note the timing of this phase relative to Mario Drahgi's decisive intervention one month later.

[10] Blyth, *Austerity*… pp. 84-87.

banks under the guise of the LTRO and ELA (Emergency Liquidity Assistance) programs. But the public bailout of the European banking sector did not stop there.

As Oliver Wyman, the banking industry's key consultant group noted in October 2013, of the €700 billion that European banks have raised since 2007, "€350 billion has come from the public sector…In fact, total state support approved for the EU financial sector totals more than €5 trillion, equivalent to 40 percent of [Eurozone] GDP."[11] Of capital injected into banks to keep them afloat, "only about 10 percent of the original capital injected has been repaid."[12] Returns on equity have collapsed to around 4 percent while cost bases have risen, all of which implies without official support these banks would be bankrupt. Again, as Oliver Wyman put it bluntly, "otherwise insolvent banks have been recapitalized and the monetary policies of the ECB and national central banks have allowed banks to fund themselves at low cost."[13]

So to return to the first point, what does any of this – Draghi and friends dumping five trillion Euros into the banking system to save it - have to do with cutting state budgets? The answer is still nothing. Central bank policy, not public sector cuts, brought down yields and stabilized European sovereign debt markets. And so long as the markets believe that Draghi's promise to use Outright Monetary Transactions (OMT) – direct bond buying by the ECB if yields spike again - is credible, then those yields will stay down. Bad central bank policy, intergovernmental fudging, incomplete institutions, and a slow motion bank-run through the wholesale markets for interbank funding in Europe caused the crisis.[14] Five trillion Euros of

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[11] Oliver Wyman, "The Shape of Things to Come: What Recent History Tells US About the Future of European Banking." Oliver Wyman Consulting Group, August 2013, p. 14. Available at: http://www.oliverwyman.com/insights/publications/2013/oct/the-shape-of-things-to-come.html#.Uztu_K1dUxM

[12] Ibid.

[13] Ibid. p. 3

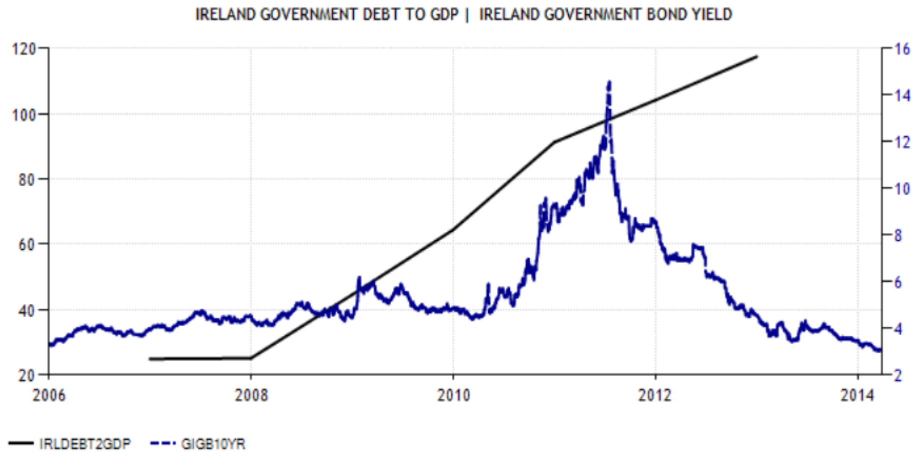
[14] See Matthias Matthijs and Mark Blyth (eds.) *The Future of the Euro* (New York: Oxford University Press 2015)

taxpayer-backed money, better central bank policy, and a move towards completing the institutions of a proper banking union to compliment the monetary union have stabilized the crisis. But it has not solved the crisis, despite appearances. This is a critical issue that we return to below.

Debts, Yields and Austerity

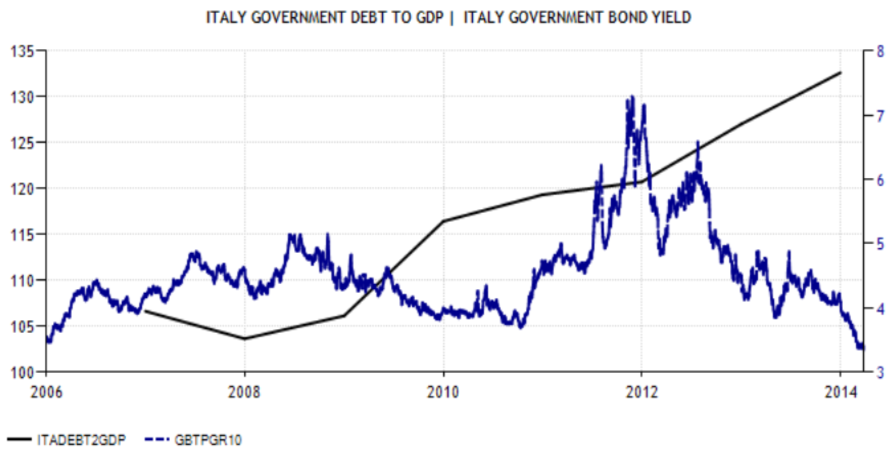
This ‘liquidity-not-austerity’ effect is seen most clearly in the relationship between government debt and bond yields. The pro-austerity camp argues that yields were spiking because the markets cared about the ‘out of control government spending and debt’ rather than break-up or liquidity risk, and so spending had to be cut. If so, central bank policy should have been ineffective since yields and debts should be *positively* correlated. As the debt goes up so should the yield as default risk is priced in. No amount of central bank liquidity should reduce yields on government debt if the markets care about the absolute volume and/or the rate of growth of the debt. In fact, backstops to bond markets should make austerity-hungry markets more nervous rather than less since it would imply official support for supposedly unsupportable debt loads. Yet if this is true, then to take two examples, Ireland and Italy’s numbers on debt loads relative to their ten-year bond yield since 2012 look really odd.

Figure Two: Ireland Debt to GDP and Ten-Year Bond Yields 2006-2014



Source: tradingeconomics.com

Italy: Government Debt to GDP and Ten-Year Bond Yields 2006-2014



Source: tradingeconomics.com

You don't have to estimate a fancy statistical model here to note that since the Draghi-put yields and debt-loads have been *negatively* correlated in a rather large and obvious way, and this is true of every bond issuer in Europe. Government debts have continued to go up as austerity bites while the yields have continued to go down, the exact opposite of the austerity case, which strongly suggests that central bank policy was what counted, and liquidity, not austerity, calmed the markets. And if the lower yields now enjoyed by sovereigns means that the affected governments have a bit less interest to repay, then they can then have a less restrictive fiscal stance, and yes, Europe can then grow, a little. But let's be clear that growth is coming from central bank policy pulling down yields, not austerity. Austerity continues to harm, not help.

The comparison with the US, which triaged and delevered its banks 2008-09 could not be clearer. The US, despite its historically slow recovery, has much lower unemployment rates while the Eurozone as a whole hovers around 12 percent. Europe's periphery sits in near perma-depression conditions, with Greece and Spain bearing 27 and 24 percent unemployment respectively. Even the success cases, according to the European Commission at least, of Portugal and Ireland have 15 and 11.5 percent unemployment respectively, and that factors out the depressing effects (in both senses of the word) of immigration on these numbers. But even the brute averages across these two areas tell a simple story.

Figure Three: US and Eurozone Unemployment Rates 2006-2014

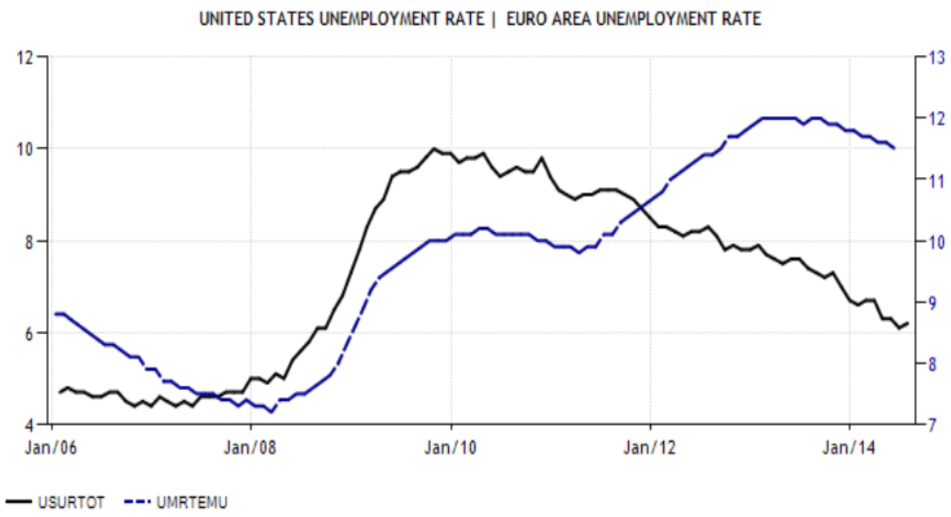
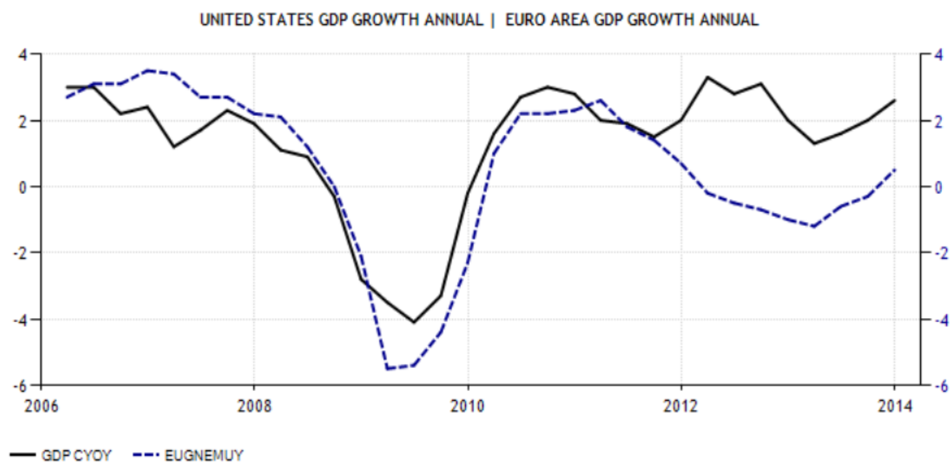


Figure Four: US and Eurozone Annualized GDP Growth



Source: tradingeconomics.com

At least as far as Europe is concerned, if this is a recovery, then its some definition of the word recovery I have hitherto been unaware of. Unemployment is stuck at level once deemed not just politically unacceptable but economically impossible. Similarly, when annualized, European GDP growth is barely positive and yet the eurozone recovery is being heralded from the rooftops at every possible opportunity. Sadly, it seems that facts still don't get in the way of a good ideology, which means harmful policies are still the only game in town.

Austerity after 2013 – Performing Recovery Despite the Evidence

When one digs into the country cases the story does not get any better for those still arguing for austerity. The UK has seen a dramatic return to growth despite its cuts. But does this vindicate austerity policies as Chancellor George Osborne and his 'booster-in-chief' Chris Giles at the *Financial Times* seem to argue? The answer is once again no. To see why one must first recall the rather mild telling-off the IMF gave the UK for excessive austerity when they did their country report in May 2013.[15] The IMF advocated that infrastructure spending be brought forward to offset the contractionary effects of austerity policies. Little did they know that the UK had already done just that.

As Simon Wren Lewis and Jonathan Portes both noted, UK austerity was effectively put on hold in late 2011 and the beginning of 2012 when the UK government began to notice that a contractionary policy was not expansionary after all.[16] Specifically, real government consumption went from -0.1 percent in 2011 to +2.6 percent in 2012. This boost to consumption, right where it matters in terms of consumptive bang-for-the-pound, effectively put austerity 'on-hold' in the UK before the IMF even issued its warnings. The rhetoric of austerity continued nonetheless, and the reality of budget cuts on social services, one third of which targets disabled workers, continued.[17] But with the choke hold off the economy could breathe. What let the UK economy spring from the trap however was the same thing that landed the UK in such trouble in the first place.

While housing is not single-handedly driving the UK recovery, it is integral to it. The boost to growth that easing up on austerity provided in 2012 was given a further boost by an unexpected fall in the UK savings rate later that same year.[18] This fall in savings, plus the UK governments decision to put the UK financial sector back together again with bigger airbags, combined with the ease-off on austerity to pump up a new housing bubble, centered once

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[15] See Ainsley Thompson and Paul Hannon, "IMF Sounds Warning on UK Austerity," available at http://online.wsj.com/news/articles/SB10001424127887324659404578498573982221716
[16] See Jonathan Portes, **"**What Osborne won't admit: growth has increased because of slower cuts," *New Statesman*, September 10th 2013, available at: http://www.newstatesman.com/politics/2013/09/what-osborne-wont-admit-growth-has-increased-because-slower-cuts, and Simon Wren Lewis, "Osborne's Plan B," available at: http://mainlymacro.blogspot.co.uk/2013/12/osbornes-plan-b.html.
[17] For an excellent analysis of the disproportionate effect of UK budget cuts on low-income and disabled persons see Mary O'Hara, *Austerity Bites: A Journey to the Sharp End of the Cuts* (Policy Press: Bristol 2014)
[18] See Simon Wren-Lewis "Some Notes on the UK Recovery." Available at: http://mainlymacro.blogspot.co.uk/2013/12/some-notes-on-uk-recovery.html

again in London.[19] The result has been the restart of mortgage lending via a scheme that gets 80 percent loan to value (LTV) loans to 95 percent at the expense of the public purse, basically giving everyone who qualifies their own Fannie and Freddie guarantee. The result has been a dramatic surge in house prices in London and a new consumption spurt due to this wealth effect.[20] In other words, it's the same old growth model put back together again, and this time around even the Bank of England is growing concerned.[21]

Indeed, it is a remarkable commentary on the state of the hollowed-out finance-monocrop that is the UK economy that even such modest growth is met with a massive flood of imports, with the UK posting the worst balance of payments figures since 1955.[22] Growth may be there, but its primarily benefitting Chinese and other exporters - not the British worker. It also tells a sorry story about who is buying all that property when British real wages have fallen eight percent since the crisis, with increasing evidence of international money laundering on a massive scale increasingly coming to light.[23]

Finally, if the UK really were still being as austere as the government pretends, then the confidence effects of the cuts would be seen in UK business confidence surveys as early as 2010 when the cuts were announced, as per the 'expansionary-contraction' thesis detailed in chapter five. Instead, we see UK business confidence plummeting from April 2010, reaching its nadir in January 2012, before bouncing off bottom just when the aforementioned

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[19] For typical reports see http://www.standard.co.uk/news/london/london-living-through-biggest-house-price-bubble-ever-9221297.html and http://www.ft.com/intl/cms/s/0/1f02ede2-8a8f-11e3-ba54-00144feab7de.html?siteedition=intl#axzz2xHDgYfaC

[20] https://www.gov.uk/affordable-home-ownership-schemes/help-to-buy-equity-loans

[21] http://www.theguardian.com/business/2014/mar/27/bank-of-england-house-prices

[22] See http://www.tradingeconomics.com/united-kingdom/current-account

[23] See Cynthia O'Murchu, "Tax Haven Buyers Set off Property Alarms in England and Wales," *Financial Times*, July 31st 2014. Available at: http://www.ft.com/intl/cms/s/0/6cb11114-18aa-11e4-a51a-00144feabdc0.html#axzz39YIQrTm0 and Mark Blyth and Jonathan Hopkin "Londongrad Calling," *Foreign Affairs*, April 21st 2014. Available at: http://www.foreignaffairs.com/articles/141350/jonathan-hopkin-and-mark-blyth/londongrad-calling

factors all came into play.[24] We should have also seen a pick up in business borrowing levels earlier if such confidence effects were in play. Yet the Bank of England's 'Trends in Lending' series saw consistent falls in business lending from January 2010 through to January 2013, which only began to creep up once these stimulus factors came into play.[25]

This is perhaps of little surprise when one considers that the government's own 2013 review of its 'ward of state' bank - the Royal Bank of Scotland Group - concluded that RBS had significantly overshot in its reduction of lending to business such that "a perception has risen among some small and medium sized enterprises (SMEs) that RBS is unwilling to lend. A recent customer survey showed that 30% of SMEs disagreed with the statement that RBS was 'open for lending'."[26] This result was typical of UK bank financing of SME's with three out of four applications being rejected in 2013. After all, if the bank that is 81 percent owned by the state will not lend to business, why should anyone else?[27]

That the UK's opposition Labour party has now embraced the need to continue the cuts even if they win the next election speaks to the sorry state of the revenue side of the UK budget more than it does to any logic of expansionary fiscal contraction.[28] Put simply, UK public spending was made possible by over-reliance on a financial sector that is now under pressure to lend more while building capital and reducing risk, so tax revenues have slumped. That, plus a politically unsustainable tax-put on the middle of the income distribution for revenue that neither the government nor the opposition wants to take the blame for, means cuts rather than revenue increases are on the cards for both parties if they want to win the

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[24] See http://www.tradingeconomics.com/united-kingdom/business-confidence
[25] See http://www.bankofengland.co.uk/publications/Pages/other/monetary/trendsinlending.aspx
[26] See http://www.independentlendingreview.co.uk/index.htm
[27] See James Quinn, "Osborne to Tell Banks: Increase SME lending," The Daily Telegraph, 24th May 2014. Available at: http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/10854724/Osborne-to-tell-banks-increase-SME-lending.html.
[28] See Blyth, *Austerity*… chapters five and six, for a discussion of this idea.

next election.[29] As such, continuing cuts in the UK make sense more as political insurance for both parties to stay in power than as any sensible economic strategy.[30]

Ireland exited its bailouts to great applause in December 2013 and is now able to float ten-year bonds at a little over three percent. That they are able to do so has once again everything to do with the 'Draghi put' lowering bond yields and bank funding costs and very little to do with Ireland's extraordinary austere budgetary stance over the past several years where it "consolidated almost 20 percent of GDP over an 8 year period, with no significant industrial or social upheaval."[31]

Although a recent European Parliament sponsored account of austerity programs in the periphery conducted by the think-tank Brugel argued that, in the Irish case, "fiscal consolidation was done in a balanced way…which contributed to restored trust in Irish public finances,"[32] its hard to square this with the fact that Ireland's gross debt to GDP now stands at 123 percent and may rise to 140 before stabilizing, while its budget deficits are still in the range of 6 to 8 percent, even if they are projected to come down further. So the key point remains – was it budgetary consolidation that restored trust or was it the knowledge that Irish and other Euro denominated bonds could be swapped for cash that lowered the yields? The evidence for the former position seems to be more asserted than demonstrated.

Consider that in Ireland, while all that ECB liquidity has lowered yields, it has also allowed Irish banks to play an indefinite game of 'extend and pretend' with the non-performing loans (NPLs) that constitute, according to the IMF, nearly a quarter of all loans

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[29] On the UK's tax put see "Higher Rate Tax Payers Pay Heaviest Burden" Financial Times, March 12th 2014. Available at: http://www.ft.com/intl/cms/s/0/2c5553b8-aa10-11e3-8497-00144feab7de.html#axzz2xHDgYfaC

[30] For an analysis of this dynamic see Mark Blyth and Richard Katz, "From Catch all Politics to Cartelization: The Political Economy of the Cartel Party" *Western European Politics* Vol. 28 (1) January 2005, pp. 34-61, available at http://www.markblyth.com/wp-content/uploads/2013/08/Blythkatz.pdf

[31] Stephen Kinsella, "Post-Bailout Ireland as the Poster Child for Austerity," forthcoming in *Ireland's Recovery from Crisis*, forthcoming in 2014. p. 2. The eight-year figure includes austerity budgets through 2016.

[32] "The Troika and Financial Assistance in the Euro Area…" p. 36.

on their books.[33] One way or another those losses will have to be recognized, and when they do there is, according to Morgan Kelly, a very high probability of a very large knock on effect to the small and medium sized enterprise sector as the banks call in whatever loans they can to cover these losses, which will have a major and deleterious effect on employment.[34]

But even if one allows for all this, the lessons of the Irish experience are simply not applicable to other states. Again as the Brugel report notes, Ireland's "tremendous success in the export sector…substantially reduced the impact of the fiscal adjustment on the economy."[35] However, that trick is not available to anyone else since "much of the [Irish] export base can be considered exogenous to the economy," such that Ireland was able to "engineer a deflation…while leaving exports untouched."[36]

As *Austerity* details, the majority of Ireland's exports are 'boxes in boxes out' tax arbitrage and transfer pricing games that are possible only because of its unique role as a gateway to Europe for foreign multinationals due to its super-low corporation tax rate. This export story is neither sustainable if growth falters in third country markets, nor is it repeatable elsewhere since, by definition, not everyone can be a tax-arbitrage hub.[37] And none of the relatively rosy projections for post-bailout Ireland that ignore these facts bother to factor in that Ireland has lost 50,000 graduates a year to immigration for the past five years. They are Ireland's future tax base that the government needs to pay back that massive pile of

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[33] IMF financial soundness indicators cited in *Ibid*. p. 38. See also https://www.centralbank.ie/publications/Documents/Macro-Financial%20Review%202013.2.pdf
[34] See lecture "Whatever Happened to Ireland?" by Professor Kelley available at https://www.youtube.com/watch?v=8LCofepdUzE&list=PLHKVjBSDqMB7OF1pdtOW6eRR5DUgBzuUU
[35] "The Troika and Financial Assistance in the Euro Area…" p. 36
[36] Kinsella, "Post-Bailout Ireland…" p. 5
[37] Although it doesn't stop everyone trying. David Cameron's support of the Loch Earn declaration on the need to tax global corporations being swiftly followed with a cut in UK corporation tax being a classic example.

debt they accumulated by bailing their banks and then applying austerity. Sadly, they don't seem to be coming home any time soon.

The other periphery states of the Eurozone, even the larger and less peripheral ones, have fared little better one year on. Portugal may be next to exit its bailout programs, but unemployment stands at 15.3 percent and it is estimated to rise again to 17.7 percent in 2014.[38] Public debt has risen to 124 percent of GDP and while its growth profile picked up in 2013, there is no evidence that this is due to the confidence effects of austerity finally kicking-in. After all, their debt is still rising due to the severity of the cuts. Rather, like France in mid-2013, Portugal's recent growth spurt is down to the fact that both countries missed their deficit targets in 2013 such that when their deficits increased the economy's automatic stabilizers (taxes down - transfers up) actually kicked in and provided a fiscal boost.

Portugal grew fastest in the second quarter of 2013 and growth slowed the more it tightened in later that year. France grew most rapidly that same quarter to great applause - and then growth fell to zero the next quarter as they tightened again. Growth happened because both countries *stopped doing austerity*, briefly, not because they were doing it. And while Portugal has across many indices been one of the best pupils in the austerity class, but despite all their efforts, and the effect of the 'Draghi put' on bond yields, investment has fallen by sharply over the past two and a half years. This hardly bodes well for future growth to pay back all that debt, debt built up because of the austere crisis response, and not prior to the crisis.[39]

[38] See www.tradingeconomics.com/Portugal and "The Troika and Financial Assistance in the Euro Area…" p. 40.
[39] "The Troika and Financial Assistance in the Euro Area…" p. 42.

Spain and Italy have hobbled along with insolvent banks and insolvent governments respectively, with 'extend and pretend' being the name of the game in both politics and economics in both countries. Spain recorded marginal positive growth in the latter half of 2013 but its annualized growth rate remained negative while unemployment remained stuck at 26 percent. Italian unemployment performance in 2013 was much better than Spain, coming in at half the Spanish rate, but annualized growth remained negative throughout 2013 as its debt to GDP ballooned to 132 percent. Meanwhile, continued political instability in Italy suggests that the road forward for more austerity and technocratic structural reform is limited at best.

Greece, the poster child for both profligacy and austerity, suffered the harshest austerity regime and has fared worse of all. Even the European Parliament-sponsored Brugel review admits as much with a wry degree of understatement. As they put it in their assessment of how Greece has responded to austerity, "the first and most striking finding is that reality proved the initial program assumptions largely wrong."[40] Those initial assumptions, concerning projected paths of GDP, domestic demand, and unemployment under austerity that structured both Greek programs' outcome expectations were off by twenty, twenty-four, and seventeen percentage points respectively versus that reality.[41]

In fact, Greece lost nearly a third of GDP in a five-year period while generating unemployment of over 25 percent. And while their debt load fell to 157.2 in 2013, it has risen again to 175.1 by August 2014. The notion that this debt load is ever going to be repaid is pure fantasy. But it is fantasy with a cost since it is in Greece where the human cost of austerity comes to the fore. To take just one set of public health examples, since the beginning of the crisis austerity cuts in Greece have resulted in a 25 percent cut in hospital

[40] "The Troika and Financial Assistance in the Euro Area…" p. 23
[41] Ibid. from IMF data, figures 14 and 15, p. 24.

and primary care funding, which in turn resulted in a *32-fold increase* in HIV infections between 2009 and 2013. Suicides have increased by 45 percent and infant mortality has increased by 43 percent over the same period. And in 2013, Greece had its first domestic cases of malaria since 1974.[42]

So Why Does it Continue? Welcome to the Class-Specific Put Option

So if its still not working, another year on, why does it continue? In *Austerity* the answer I gave was that it was part of the "Greatest Bait and Switch in Human History," where the private debts of the banking systems of the developed world were bailed and recapitalized via the public sector balance sheet. The result was that private debt was turned into public debt such that the benefits went to the insiders and the costs went to taxpayers. After another 12 months of thinking about this I came to a more pointed description of this process in a column I wrote for *The Guardian* newspaper in 2013.[43] That is, while austerity is still the "Greatest Bait and Switch in Human History," it is perhaps more appropriately thought of as a 'class specific put option' written on the majority of asset-poor OECD citizens. To see why this is the case we have to remember what a put-option is and how banks actually work.

A put-option is a contract where the writer of the contract has the obligation to pay for X asset at Y time, the right to which the buyer can exercise as 'the option.' On this definition the so-called "Greenspan put" in global markets prior to the crisis was a put option in the sense that once US asset values fell to a specific level, the US Federal Reserve (the writer of

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[42] See "Greek Austerity Tragedy Shows Where not to Make Cuts," *New Scientist*, 26th February 2014. Available at: http://www.newscientist.com/article/dn25125-greek-austerity-tragedy-shows-where-not-to-make-cuts.html#.UztWtq1dWOx
[43] Mark Blyth, "Eternal Austerity Makes Sense: If You are Rich," available at: http://www.theguardian.com/commentisfree/2013/nov/15/eternal-austerity-makes-sense-if-rich-david-cameron

the contract) cut interest rates to compensate for those losses. The more recent 'Draghi put' was a put-option insofar as the ECB wrote an option to cover the risk of break-up and liquidity risk in the eurozone via the LTRO programs. Austerity is then a 'class specific put option' in the following sense.

We hear a lot today about the increasing concentration of wealth and income in countries across the OECD, especially concerning the increasing share of income held by the top one percent, which peaked at 24 percent in the US just before the crisis and may have surpassed that figure in 2013.[44] But if one expands that set a little to include the top ten percent of the income distribution, one finds that they take home over fifty percent of all income. Although the figures are not as easily available, its probably then reasonable to say then that the top thirty percent of the income distribution of these societies earns the vast majority of income and owns most of the assets of these countries.

Now, given that assumption, let's think about how banks actually work, since things are seldom what they seem. When you 'save' you don't actually save anything. When you deposit money in a bank in an act of saving you are actually giving – at least in many European countries – an un-secured loan to a highly levered derivatives trading firm on the hope that you will get it back with interest later on.[45] Similarly, when a bank gives you a loan to buy an asset, a house for example, that asset is the bank's liability. Their asset is instead the loan, which is your liability, aka the mortgage. So like exports and imports in the global economy, bank/borrower assets and liabilities are symmetrical and sum to zero.

Given this, when you bail out a bank or a banking system, you are not just bailing the bankers. You are bailing the savers, the pensions, the mortgages, the derivatives written on

[44] For the definitive work, and numbers, on this topic see Thomas Piketty, *Capital in the 21st Century* (Cambridge: Harvard Belknap Press 2014).
[45] I thank Eric Lonergan for this formulation.

these loans and annuities, and all the rest that constitute the bank's assets, which are your liabilities and vice versa. So when governments bail banks they are simultaneously bailing the assets and incomes of the top thirty percent of the income distribution.

So think of bailouts as a put option exercisable by the top thirty percent on the bottom seventy percent of the income distribution. When the top thirty percent, people like me and (possibly) you, get our assets bailed and public debt balloons as a consequence, the cost of exercising the put-option is paid for by people who don't have many such assets and rely on government spending and public goods, but that's what gets cut. The poorest segment of society is forced to pay out on an insurance policy that they never agreed to guarantee, and for which they never received a single insurance premium from the holders of the bailed (i.e. insured) assets. This is why austerity is best thought of as a class-specific put option. It's free asset insurance for the top end of the income distribution, those who also just happen to be the people that vote most and fund elections. That in the long run this individually rational action will prove collectively disastrous for the top end too is a cost not internalized in the option's price. But it is one that we all have to pay the longer austerity continues. One can only help but wonder if the May 2014 elections to the European parliament, which saw large gains for nationalists, populists and non-mainstream left parties is the first sign of the seventy percent waking up to the reality of the put?[46]

The New Institutions of Austerity: The Good, the Bad, and the Pointless

Despite all this, some interesting institutional engineering has occurred in the Eurozone over the past 12 months. Some of it is good, some of it is pointless, and some of it is downright dangerous. In the first category we can put the EU banking union proposal that

[46] See http://www.results-elections2014.eu/en/election-results-2014.html

found its final form in March 2014. The banking union is a critical part of the institutions that should have been built at the time of the monetary union but were not.[47] That is, when you have a bunch of national level banks all borrowing in a foreign currency, which is what the Euro is to each of them *de facto*, and many of them have become bigger than the sovereign underwriting their risks, then you had better have some pan-European institutions for bank supervision, bank regulation, and common deposit insurance. Sadly, since the EU seemed to think, and still thinks, that the only institutions worth building were those that restricted the actions of sovereigns rather than banks, that didn't happen, the result of which is the banking mess described above. Yet as of early 2014 the banking union finally found its feet, which is good. But once again a closer inspection suggests that it's not quite the set of institutions it pretends to be.

First of all, while any banking union is better than no banking union, this one still has several key pieces missing.[48] To be credible, the banking union needs, as Paul De Grauwe put it, "an authority with financial clout. They don't have it so we don't have a banking union.[49] De Grauwe's problem is that while the agreed-upon single supervisory mechanism that places the ECB in charge of the solvency of banks above national regulators is a good idea, and a common resolution mechanism that gives those regulators the power and money to shut down failing institutions is better still, the entire set-up is cash limited at $55 billion Euros. That's not a lot of cash when one considers that Hypo Real Estate, a German mortgager that got into trouble in 2008, needed over 100 billion Euro in state guarantees to stay afloat.[50]

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[47] Erik Jones, "The Forgotten Financial Union," in Matthijs and Blyth (eds.) *The Future of the Euro*…forthcoming in 2015.
[48] For a good overview of the banking union see http://europa.eu/rapid/press-release_MEMO-14-57_en.htm?locale=en
[49] Paul De Grauwe, quoted in "Europe Strikes Deal to Complete Banking Union." Reuters, March 20th 2014. Available at: http://www.reuters.com/article/2014/03/20/us-eu-bankingunion-idUSBREA2J0ZJ20140320
[50] See Thomas Huertas and María J Nieto, "How much is enough? The case of the Resolution Fund in Europe." Available at: http://www.voxeu.org/article/ensuring-european-resolution-fund-large-enough

Second, the fund itself will be built up over an eight-year period, which is a bit of a prayer than nothing much happens between now and 2022, while it's recapitalization if its ever used will be limited by the fact that there is no mutualization behind it.[51] And perhaps most crucially, even if we get eight years down the line without a hiccup, this set up does nothing for what are euphemistically known as 'legacy assets' – the between 1.2 - 1.5 trillion Euro in NPLs cluttering up the balance sheets of European banks right now.[52] As Wolfgang Munchau has repeatedly argued, this set up may work for the next crisis, but it does nothing for the current one.[53]

Third, while the Single Supervisory Mechanism (SSM) and Single Resolution Mechanism (SRM) are much needed new institutions, banking unions are stabilized by deposit insurance more than any other factor. And while the banking union agreement guarantees normal deposits of up to 100,000 Euros across the union, there is no central fund to back this up. It all falls on the national authorities, which is the problem that banking union was supposed to solve in the first instance. The other 'big-bag-o'-Euros' out there, the European Stability Mechanism (ESM), the successor to the European Financial Stability Fund (EFSF) that bails out states cannot be used to either refund the SRM, nor can it pay out over deposit insurance shortfalls. In short, the banking union that Europe needs, one that would allow today's legacy assets, mainly the bad loans stuck in the Spanish and related banking sectors to either be asset-swapped out or recorded as losses without triggering a systemic implosion, needs something more than this to be effective. It needs some form of

[51] That is, sovereigns could pool risk to raise capital for it more cheaply, but that would be debt mutualization and is thus beyond the pale.
[52] The most comprehensive publically available estimate of outstanding European NPLs comes from the consultancy Price Waterhouse Cooper. They estimate the total at 1.22 Trillion Euros. See Price Waterhouse Cooper "European Portfolio Advisory Group: Market Update," July 2014. Table one p. 3. Available at https://www.pwc.com/et_EE/EE/publications/assets/pub/euro_npls.pdf
[53] See for one example of why, Wolfgang Munchau, "This is not the Banking Union Europe is Looking for," Available at: http://www.ft.com/intl/cms/s/0/92bbb0a6-6330-11e3-886f-00144feabdc0.html#axzz2xZpym4NP

common deposit insurance fund, an ECB special purpose financing vehicle to act to take the NPL's off the banks' books, or an extension of the ESM to work properly, none of which seems to be on the cards.

It does however signal the winding down of official support for the European banking sector, which may have several unintended consequences. One, the possible future implosion of the Irish SME sector, was noted already. The other is the further downgrading of European banks rather than their stabilization, which is what the ratings agency Fitch did to eighteen EU banks right after the banking union deal was signed.[54] As Fitch put it, "the likelihood of a downgrade or downward revision is based on further progress being made in implementing the legislative and practical aspects of enabling effective bank resolution frameworks, which is likely to reduce implicit sovereign support for banks in the EU."[55] For some banks then at least, the banking union may be more bad news that good, which is bad news for Europe as a whole.

While the new institutions of the banking union might be a qualified good, some others such as the ESM and its policy arm, Outright Monetary Transactions (OMT), might be considered a tad pointless.[56] After all, these institutions are a bit like the old doctrine of Mutually Assured Destruction (MAD) from the cold war. It works only because it isn't used. If the doctrine were ever tested the results would be disastrous for both sides.[57] If Spain, for example, applied to the ESM for a loan and OMT is activated to relieve its bond yield strains, it would be tantamount to a full admission of sovereign insolvency, which would start the very bank run through the bond markets that these institutions are designed to avoid. At that

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[54] See http://www.reuters.com/article/2014/03/26/fitch-revises-outlooks-on-18-eu-state-sp-idUSFit69388220140326
[55] Ibid.
[56] For an overview see: http://www.ecb.europa.eu/press/pr/date/2012/html/pr120906_1.en.html
[57] I thank Bill Blain for this analogy

point, as bond dealer Bill Blain put it, these new institutions would be "enough to cover the first 20 seconds of the next European financial crisis when the NPL's are in the region of 1.5 trillion."[58]

Some of the other new institutions, such as the Treaty on Stability, Coordination and Governance (renamed the intergovernmental Fiscal Compact) that came into effect in March 2012 are however downright dangerous.[59] This new treaty calls for national budgets to be "balanced or in surplus" in the medium term with enforcement of this rule guaranteed by stricter monitoring and "preferably constitutional" provisions in national legal frameworks. Countries that have "significant observed deviations" from the new fiscal limits enshrined in the treaty will have automatic sanctions placed upon them. In addition, signatory states agree that, "all major policy reforms that they plan to undertake will be discussed *ex ante* and, if appropriate, coordinated among themselves" (Article 11).[60] As if the limits on actions by states to compensate for exogenous economic shocks were not already binding enough, the EU just set them tighter - but to what end?

The specifics of this treaty strain basic logic. For example, the macroeconomic imbalances procedure (MIP) at the heart of the treaty, which sets the 'scorecard' for how well countries are doing, allows countries to have a maximum current account deficit of four percent or a surplus of six percent.[61] Given that imports and exports sum to zero, that surplus of +2 percent must be offset somehow. But as *Austerity* and a host of other analyses have pointed out, we can't all run a surplus at once. Someone has to buy the exports, and if the

[58] Bill Blain, Personal Communication, December 11th 2013.
[59] Available at http://european-council.europa.eu/media/639235/st00tscg26_en12.pdf
[60] Fiscal Compact quoted in, Nicolas Jabko, "The Crisis of EU Institutions and the Weakness of Economic Governance," in Matthijs and Blyth (eds.) *The Future of the Euro*…forthcoming in 2015, manuscript version, pp. 16-17
[61] See http://ec.europa.eu/economy_finance/economic_governance/macroeconomic_imbalance_procedure/mip_scoreboard/

treaty disallows corresponding deficits inside the Eurozone then they must be dumped outside. But with the US consumer cash-strapped and the Asian economies also running on exports, it's far from clear who that can be. Deficits and surpluses may sum to zero, but in the EU only one side of the equation is up for punishment. When it was reported that Germany actually ran a 7.3 percent current account surplus in early 2014 and the European Commission referred to this as a structural imbalance, Germany publically refused to take the criticism.[62]

The treaty is also riddled with such distributional and power imbalances. The MIP set unemployment as 'excessive' at only ten percent or above, while public debt is 'excessive' once it gets over 60 percent. Sustained high unemployment is then tolerable, moderately high public debt is not, and budget deficits above 3 percent are still deemed quite unacceptable. Add this all together, and then recall the Treaty article where that all major policy reforms must be discussed *ex ante* among signatories, and you might just get the feeling that the EU is trying to make fiscal policy illegal.

Regardless of whether one is a Keynesian or not, such a fiscal stance is building fragility into the system since even the most liberal OECD states still tax and spend at least 30 percent of GDP. Tying the state's hands *ex ante* to this extent while completely ignoring the level of internal demand or the possibility of serious external shocks shows that Eurozone governance hasn't moved very far in its thinking over the few years. The project is still all about trying to make the entire Eurozone into a giant Germany via wage reductions that will result, in theory, in a perma-surplus against the rest of the world. That can never work on it's

[62] See: http://mobile.reuters.com/article/idUSBREA0D0MU20140114?irpc=932 and http://europa.eu/rapid/press-release_IP-14-216_en.htm and http://www.bloomberg.com/news/2014-01-15/germany-snubs-export-critics-as-surplus-outstrips-that-of-china.html

own terms, and it certainly cannot work if the underlying problem is still a banking crisis that is being at best half-addressed by a set of incomplete institutions.

In short, Europe is not and still cannot be made into a single economy. It is constituted by different varieties of capitalism that work on orthogonal principles.[63] The current path of recovery via structural reform (more on this shortly) and new treaty commitments ignores this fact, trying to make very different sets of national institutional complementarities into one set of complimentary trans-national institutions. Economies are historically specific complexes of institutions and ideas. The current attempt to turn the whole of Europe into a net exporter in the German image cannot work once one recognizes this. Just as designing one set of flawed banking institutions to cover the continent risks ending badly, we risk doubling-down on our downside odds with a flawed one-size fits all fiscal reform agenda. There have indeed been some positive institutional reforms in the past year, but as is usually the case they are nested in some severe accidents-waiting-to-happen. We have a whole new set of stringent rules to stop the public sector doing things while the new rules on the private sector, where the problems still lie, are at best half-hearted measures.

Between the ECB's Stealth Bailout and the Goldilocks' Dilemma

Partial, positive, and pathological institutional reforms apart, what we are left with on a day to day basis is the ECB's on-going stealth bail-out of the European banking system. What is keeping the proverbial wheels on the wagon is still central bank liquidity support, but that may be running into its own limits. What the LTRO program incentivized periphery banks to do is best summarized in a ditty told to me by a Spanish bond trader.[64] 'You borrow

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[63] Peter Hall, "Varieties of Capitalism and the Euro Crisis." Paper presented at the International Conference of Europeanists, Washington DC, March 15th 2014.
[64] Read the bits outside of the brackets first and then re-read the whole thing.

at one (percent) and buy (a local bond) at ten (percent). You use the spread to bury the dead (non-performing loans (NPL's) on your balance sheet). You bank it at four (the bond) and Repo more (use the lower yielding and higher rated bond to borrow more money – again), then you hit-up the Germans (the ECB) for more (*pace* – five trillion Euros in total support).'

In other words the LTRO program is not just backdoor quantitative easing that uses local bank balance sheets as a surrogate for the ECB's balance sheet. It is a stealth resolution mechanism for all of the NPL's that clutter up the balance sheets of European banks and that continue to block the credit channels to the real economy. This is why European growth is so sclerotic. Not because public debts are too high. US debt is higher and yet growth is faster there because the US delevered and recapitalized its banking system. The Eurozone has not yet done that.[65] What Draghi has done to date is to flush the system with liquidity. More needs to be done.

Partly because of the fear of what a fundamental restructuring of the banking system will do to the real economy, and partly because in the Eurozone eighty percent of intermediation activities are done by banks and not by capital markets, there is no where else to park the dodgy assets that need to come off these banks' balance sheets except the ECB, and they don't want the job. The LTRO and related programs have bought time - but they have not brought solvency to the sector. The ECB recently announced a set of targeted LTROs and negative deposit rates to encourage more lending to the real economy and bring down the Euro to boost exports.[66] The results to date have been weak. Deflation seems to be

[65] See Wolfgang Münchau, "Don't Kid Yourself that the Eurozone is Recovering," *Financial Times*, September 29th 2013. Available at http://www.ft.com/intl/cms/s/0/99394460-26aa-11e3-bbeb-00144feab7de.html#axzz2xZpym4NP

[66] See http://www.businessinsider.com/june-ecb-decision-2014-6

taking hold throughout the Eurozone and growth remains sclerotic.[67] Moreover, the 'success' of the LTRO program in bringing down yields may built a kind of 'Goldilock's Dilemma' into Eurozone policy that makes this situation all the tougher.

As I argued in a piece in *Foreign Policy* magazine in July 2014, imagine that the Eurozone abandons austerity tomorrow and growth accelerates.[68] As a result interest rates will have to rise. At that moment the periphery banks holding all the local bonds that they bought with free LTRO cash will see their asset base shrink in value as yields go up, bond prices go down, and their balance sheets implode. Given this, growth can't get 'too hot.' The ECB needs an environment of slow but positive growth for this stealth resolution mechanism to work itself out. However, not only is such a process painfully slow, if growth is 'too cold' these policies can't work since only higher rates of growth will allow the banks to repair their balance sheets as new loans replace their NPLs. Given this constraint, where growth can't be either too hot or too cold, any loosening up on austerity risks undermining the policies that have brought yields down and re-liquidated the banks.

The ECB seems to be pinning its hopes on negotiating this dilemma on a new set of stress tests called the Asset Quality Review (AQR).[69] The AQR potentially provides the ECB with a way to triage the worst offenders of the banking system without setting off a general panic. By admitting a few bad apples without suggesting that the whole barrel is rotten, 'bad bank' solutions, such as Ireland's National Asset Management Agency (NAMA) and the proposed (at the time of writing) triaging of Portugal's Banco Espirito Santo (BES), may become the preferred model for other states' financial sector restructuring, which could have

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[67] See Claire Jones, "Eurozone Inflation Falls to a Fresh Low of 0.4 percent."
http://www.ft.com/intl/cms/s/0/e8eabd1a-1892-11e4-a51a-00144feabdc0.html?siteedition=intl#axzz394degk4M
[68] Mark Blyth, "Europe's Goldilocks Dilemma," available at:
http://www.foreignpolicy.com/articles/2014/07/14/europe_goldilocks_dilemma_austerity_growth
[69] See Claire Jones and Sam Fleming, "EU Regulators Unveil Stress Tests for Banks"
http://www.ft.com/intl/cms/s/0/bcc23a90-cf74-11e3-bec6-00144feabdc0.html#axzz36nXwwv6s

a positive effect on the needed downsizing and recapitalization of the European financial sector, despite the Goldilocks constraint.

Yet even here the problems are much larger than are commonly acknowledged. Price Waterhouse Cooper's European Portfolio Advisory Group calculated in July 2014 that outstanding European NPLs stand at 1.22 trillion Euros, which means NPLs have increased 2.5 times since 2008. So despite raising 350 billion Euro in new capital and getting 350 billion more from public sources - and around 50 from the issuance of complex securities called 'contingent capital (co-co's)' - the entire sector still needs a capital raise of around 300 billion. Doing this in the context of a 'one NPL at a time' bail-out via backdoor QE in a Goldilock's constraint is hard enough. But doing it in the context of self-harming, and ultimately pointless austerity policies and attendant growth destroying institutions makes it much harder still.[70]

The Persistence of - and Resistance to - Austere Ideas

Ideas move at a different speed from policy. Having an idea is costless while admitting one's ideas are wrong is costly. Implementing new ideas into policy is therefore both costly and slow. This is why governing ideas change more slowly than policy. And yet the past year has seen more than a few dramatic shifts in the topography of ideas on austerity, but not where it matters most.

The first place to look for any change in ideas is the least likely place to find it. That would be in the policy stances and research documents of the Troika (the European Commission, the ECB, and the IMF) whose analyses framed austerity policy in Europe.

[70] This is the reason why Oli Rhen, EU Commissioner for Economic and Monetary Affairs, said in an interview in El Pais 23rd January 2014 that "it will take another ten years to fix the Spanish crisis." http://elpais.com/elpais/2014/01/23/inenglish/1390468961_868224.html

Given how large the forecast errors were in the policy estimates of the Troika, as noted above, one would think that some new thinking might have occurred in response to these errors, and indeed, as we shall see that has indeed happened with one third of the troika, the IMF. With the other two thirds however, we see a shift in emphasis, but the underlying ideas remain the same, despite the evidence.

The Brugel report on austerity commissioned by the European Parliament highlighted earlier usefully analyses the language of Troika documents over time and notes the shift from the use of terms such as 'fiscal,' 'consolidation,' and 'reform,' which dominated the initial reform documents to a greater emphasis on terms such as 'growth' and 'employment.'[71] This is perhaps unsurprising given the lack of growth and high unemployment produced by the implementation of these policies.[72] Alongside this shift however is another shift, associated with terms such as 'structural reform' and 'privatization,' which increase in use over this same period. This perhaps suggests that in highly stressed economies where confidence effects failed to show up, other revenue and growth strategies had to be found. But most tellingly, as far as admitting error is concerned, acknowledgement is in short supply. As the Brugel report notes, "since greater economic and social cohesion is a major EU objective…we study how often issues such as poverty, fairness and inequality are discussed in the documents," and they note that "except for Greece, the issue received practically no attention in the Commission program documents."[73] Taken together, such inter-temporal shifts hardly suggest a paradigm shift in thinking among two thirds of the relevant policymakers.

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[71] "The Troika and Financial Assistance in the Euro Area…" pp. 17-23.
[72] "The Troika and Financial Assistance in the Euro Area…" pp. 19-21
[73] Ibid. p. 22

The False Promise of Structural Reform

One could cite this shift from austerity to structural reform and privatization as evidence of new thinking in terms of a renewed emphasis on growth over austerity via structural reform. But its really part of the same old set of ideas. First you consolidate, then you do structural reform, then you grow, in theory. This is a massive topic and I would be the last person to argue that the countries of Southern Europe do not need their share of reforms. Indeed, as I argued in *Austerity*, two of them in particular, Greece and Portugal, may need entirely new business models. But as the recent history of European and other structural reform efforts have shown, getting substantial economic reform in these countries is not going to happen if the method employed is top-down technocratic command and control. Moreover, if the reforms are based upon errant assumptions in the first place then the chances of success diminish further.

First of all, attempting to reform labor and product markets in the middle of a depression is akin to repairing the roof when it's on fire. The oft-heard argument that this has to be done now because the Southern economies didn't do any reforms previously when the 'good times' where here does not stand empirical scrutiny. As Peter Hall showed recently, on the OECD index for product market regulation, a reasonable index of flexibility, from 1998-2003 Italy and Spain outperformed Germany and the Netherlands.[74] Similarly, as Hall also notes, "measured in terms independent of wage costs, labor productivity increased in countries such as Portugal and Greece (although not in Spain and Italy) at rates commensurate with those in Northern Europe over the decade up to 2009."[75] Along these metrics at least, the notion that these countries haven't reformed at all is simply not true.

[74] Hall, "Varieties of Capitalism and the Eurocrisis" p. 9 Table 1.
[75] Ibid. p. 10

Take Italy and Spain, for example. Much is made of how so-called 'insiders' (unionized workers) benefitted from the Euro as wage costs soared and competitiveness slumped. As a consequence, the Troika argues that wages for these workers, as a necessary part of the adjustment, need to fall to restore competitiveness. Yet as Jonathan Hopkin has demonstrated, Italian unionized industrial wages were pretty much flat throughout the 2000s.[76] Ironically, the folks that made out the best were those in the protected non-tradable sectors that formed part of the Berlusconi 'pro-business' coalition. Given this, labor market reform in Italy has the wrong target in its sights.

In Spain, the sections of the labor market bearing most of the downward costs of adjustment and unemployment are young workers on temporary contracts. That is, those already working in the most flexible part of the labor market.[77] How making Spanish labor markets more flexible at this juncture will restore growth in Spain, or anywhere else, is therefore unclear. Ireland, for comparison, already has some of the most flexible labor markets in the world. It's not clear how abolishing Ireland's already low minimum wage will restore the balance sheet of Anglo-Irish Bank, or how, to take another comparative example, getting rid of the Greek taxi driver's monopoly in Athens will lead to a faster recovery in the Greek export sector.

Finally, as Pepper Culpepper's analysis of the Monti government's inability to get reforms through in Italy without the support of social partners spells out clearly, and the World Bank's 2004 report on a decade of structural adjustment programs (structural reform in the third world) previously admitted, countries need to own reforms for them to work.[78]

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[76] Jonathan Hopkin, "The Troubled South: The Euro Crisis in Italy and Spain," in Matthijs and Blyth (eds.) *The Future of the Euro*…forthcoming in 2015, manuscript version, p. 6

[77] Ibid. pp. 6-7

[78] Pepper Culpepper "The Political Economy of Unmediated Democracy: Italian Austerity Under Mario Monti," Paper prepared for the International Conference of Europeanists, Washington DC, March 15th 2014, and Dani

Brussels can insist on reforms, but that doesn't mean states will persist with them, especially if the logic behind them is so flawed to begin with. Democracy is not a moral hazard problem to be overcome: it is the key to reform.

Indeed, the entire fascination with structural reform of labor markets as the key to growth is at best dubious since its based upon a rather stunning misreading of Germany's economic turnaround in the mid-2000s.[79] Germany's 2000's turnaround is often attributed to the so-called Hartz reforms of that decade, which reduced welfare protections and increased labor market participation. Germany 'took the bitter medicine,' so the story goes, and so should everyone else. The problem is that the medicine can't work for two reasons. The first we have encountered already. The whole of the EU can't run a surplus against the rest of the world. Germany is only Germany because everyone else isn't Germany. An entire continent can't play the same trick when they are each other's major export markets.

Second, and more importantly from the point of view of structural reform, the idea that the Hartz reforms led to Germany's recent growth spurt turns out to be empirically false. Dustmann et al., have shown, using German data, that the reason wages fell in Germany was the reunification of the country a decade earlier plus the expansion of the German auto-sector abroad, both of which limited wage increases for a decade before the Hartz reforms. This plus lower input costs from Eastern European suppliers over that same period led to even more price-inelastic export goods that benefitted from the boom of the 2000s and continuing demand from outside the EU post crisis.[80] All the Hartz reforms actually did was to create a

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Rodrik, "Goodbye Washington Consensus, Hello Washington Confusion," *Journal of Economic Literature*, 44 (4) December (2006).

[79] Ironically, just as the risk of inflation in a recession that haunts the eurozone today is based upon a prior misreading of German history of the 1920s. See Blyth, *Austerity…* pp. 56-57.

[80] Christian Dustmann, Bernd Fitzenberger, Uta Schoenberg, and Alexandra Spitz-Oener, "From Sick Man of Europe to Economic Superstar: Germany's Resurgent Economy, *Journal of Economic Perspectives*, 28, (1) Winter 2014, pp. 167–188.

very low-paid sheltered low-productivity service sector in Germany that has increased German inequality quite dramatically, to the point that Germany has just brought in a minimum wage for the first time.[81] If Dustmann et al are correct, then the ability of anyone else to pull this trick off is zero.

Given all this, why then do we see this shift in focus from the expansionary wonders of austerity to the necessity of structural reform? We see it because 'structural reform' is where you move the goalposts to once the first set of goals turns out to be a mirage, as expansionary fiscal consolidation and debt reduction via austerity turned out to be. The only problem is that structural reform's proponents are going to have to move the goalposts again once these strategies also fail to produce positive results, as they have done so many times before, if they are not embedded in the societies that undertake them.

The IMF and Tensions in the Troika

The one part of the Troika that has substantially shifted their ideas is the IMF. As *Austerity* details, starting in 2008 under then Managing Director Dominique Strauss-Kahn, the IMF hewed to a much more expansionary line than it had done in previous crisis episodes. Cynics, like me, initially thought this was a case of 'now that core country assets are at risk, we bail rather than fail,' but the transformation has proven to be more than opportunism. As Cornel Ban details, the IMF's policy ideas have shifted substantially over the course of the crisis across multiple positions.[82]

The most well known shift is the so-called "Battle of the Boxes" where the IMF estimated negative fiscal multipliers greater than one for the periphery countries of Europe, which meant that a one Euro cut in public expenditure led to a greater than one Euro cut in

[81] See http://inequalitywatch.eu/spip.php?article114
[82] Cornel Ban, "Austerity versus Stimulus? Understanding Fiscal Policy Change at the International Monetary Fund Since the Great Recession," forthcoming in *Governance*, 2014.

final consumption and GDP, with no offsetting confidence effects.[83] Negative multipliers also imply positive ones, as the reciprocal demands, and as such this challenge was not limited to the technical boxes of IMF reports. In putting this out there the entire neoclassical edifice of the ECB and EC approach to the crisis was challenged from within the Troika itself.

Unsurprisingly, the EC hit back at the end of 2012 with its own version of multiplier estimates to counter the IMF's, arguing that, in essence, Troika policies were fine, and the multipliers would have been less than one such that contraction would have had a positive effect after all, had it not been for lot of people talking about the break-up of the Euro, which made things worse.[84] The IMF continued with this new line despite this attempted refutation by the EC, and also the ECB.[85] Indeed, the IMF's research thrust over the past five years has moved quite far from being the advocates of consolidation that they once were. Inequality as a constraint on growth, the need for higher taxes on top earners, the positive effects of public investment, environmental, and even wealth taxes now litter the IMF's research landscape.[86] And most recently the IMF just put the final nail in the coffin on Reinhardt and Rogoff's pro-austerity "Growth in the Time of Debt" paper.[87] Indeed, the IMF has gone so far as to make the *Washington Post* publish under the headline that "Communists Have Seized the IMF!"[88] Perhaps hyperbolic, but when *this* IMF is in the same policy bed as the EC and the ECB, continued frictions are bound to result.

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[83] For a summary see OECD http://www.oecd.org/eco/outlook/OECD-Forecast-post-mortem-policy-note.pdf
[84] See http://ec.europa.eu/economy_finance/eu/forecasts/2012_autumn_forecast_en.htm#documents
[85] See http://www.ecb.europa.eu/pub/pdf/mobu/mb201212en.pdf box 6 pp. 82-85
[86] Ban provides a useful mapping exercise of this shift in ideas in the fund. See Ban, "Austerity versus Stimulus?"
[87] Andrea Pescatori, Damiano Sandri, and John Simon, "Debt and Growth: Is There a Magic Threshold?" IMF Working Paper, February 2014.
[88] http://www.washingtonpost.com/blogs/wonkblog/wp/2014/02/26/communists-have-seized-the-imf/

From Excelgate to the End of Austerity?

Speaking of Reinhardt and Rogoff, perhaps the most dramatic turnaround in thinking in the past year has come from these two economists. Famous for their paper "growth in a Time of Debt" that predicted a rapid fall in future growth rates if debt to GDP ratios went past 90 percent, a University of Massachusetts at Amherst economics graduate student asked Professor Reinhardt for the excel file that their paper was based upon, got it, and picked it apart until nothing was left, all to great public *strum und drang* in what became known a 'Excelgate.'[89] The robustness of the results notwithstanding, I have a degree of sympathy for Reinhardt and Rogoff's position. As I argued in *Austerity*, given a choice between having more or less than 90 percent debt, and holding the method of debt reduction apart, who wouldn't want less rather than more? Not paying back lots of interest is probably a better thing than doing so, on balance.

What got these two economists into trouble was less what they said than the manner in which it was picked up by those Aditya Chakrabortty at *The Guardian* calls "Austerity Jihadists," who used the 90 percent meme to beat the drum for cuts everywhere regardless of the qualification and caveats of the original paper. Taking the authors down was therefore more about taking the wielders of the 90 percent meme down more than anything else. Battered and bruised from this affair, one might expect a doubling-down by Reinhardt and Rogoff after these attacks. But they simply carried on with their work, letting the data take them where it will, and where it took them to today is quite remarkable.

In January 2014 Reinhardt and Rogoff authored a new piece NBER working paper called "Recovery from Financial Crises: Evidence from 100 Episodes."[90] As well as

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[89] For an overview see http://en.wikipedia.org/wiki/Growth_in_a_Time_of_Debt

[90] Carmen Reinhardt and Kenneth Rogoff, "Recovery from Financial Crises: Evidence from 100 Episodes." NBER Working Paper 19823, January 2014.

extending prior work on the costs and duration of crises, this paper is remarkable for it's core claim that the current downturn, especially in the Eurozone, has no comparison. This time, apparently, it really is different. Indeed, their conclusion is worth quoting at length:

> "The current phase of the official policy approach is predicated on the assumption that growth, financial stability and debt sustainability can be achieved through a mix of austerity and forbearance (and some reform). The claim is that advanced countries do not need to resort to the more eclectic policies of emerging markets, including debt restructurings and conversions, higher inflation, capital controls and other forms of financial repression. Now entering the sixth or seventh year (depending on the country) of crisis, output remains well below its pre-crisis peak in ten of the twelve crisis countries. The gap with potential output is even greater. Delays in accepting that desperate times call for desperate measures keep raising the odds that, as documented here, this crisis may in the end surpass in severity the depression of the 1930s in a large number of countries."[91]

When the two intellectual figures perhaps most synonymous with arguments *for* austerity, in the public mind at least, have come this far, it shows us how in some quarters there really has been a shift away from austerity thinking in a very short period, which is most welcome. Sadly, those quarters do not write policy for the eurozone. That's done by the Troika and implemented by governments keenly aware that they are exercising the class specific put option as described above, which is why despite such ideational shifts, policy continues.

In closing this postscript a special mention must be reserved for the pre-ideological thinking of François Hollande, President of France, for actually justifying French budget cutbacks in January 2014 by invoking Jean Baptiste Say's truism that supply creates its own demand.[92] I've talked long and hard about the bankruptcy of both European banks and European ideas, but it takes a lot to beat this as an example of the bankruptcy of a political class. When the putative socialist alternative to austerity thinking goes one better than the opposition citing naive supply-side ideas that are 211 years old for support, you know that

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[91] Ibid. pp. 10-11
[92] See Wolfgang Munchau, "The Real Scandal is France's Stagnant Economic Thinking." Available at: http://www.ft.com/intl/cms/s/0/0a469808-7f6e-11e3-b6a7-00144feabdc0.html#axzz2xZpym4NP

austerity is going to keep going despite any and all evidence, because most of all, it remains, a dangerous, but seductive, idea.

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