LECTURE 19: AUSTERITY AND THE NEW POLITICS OF PUBLIC DEBT

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Before we start….

- Break into groups of 4-5 and discuss the following question:

- *What is the sovereign crisis in the Eurozone?*

Introduction

- Public debt is a question of the distribution of wealth, between public and private actors.

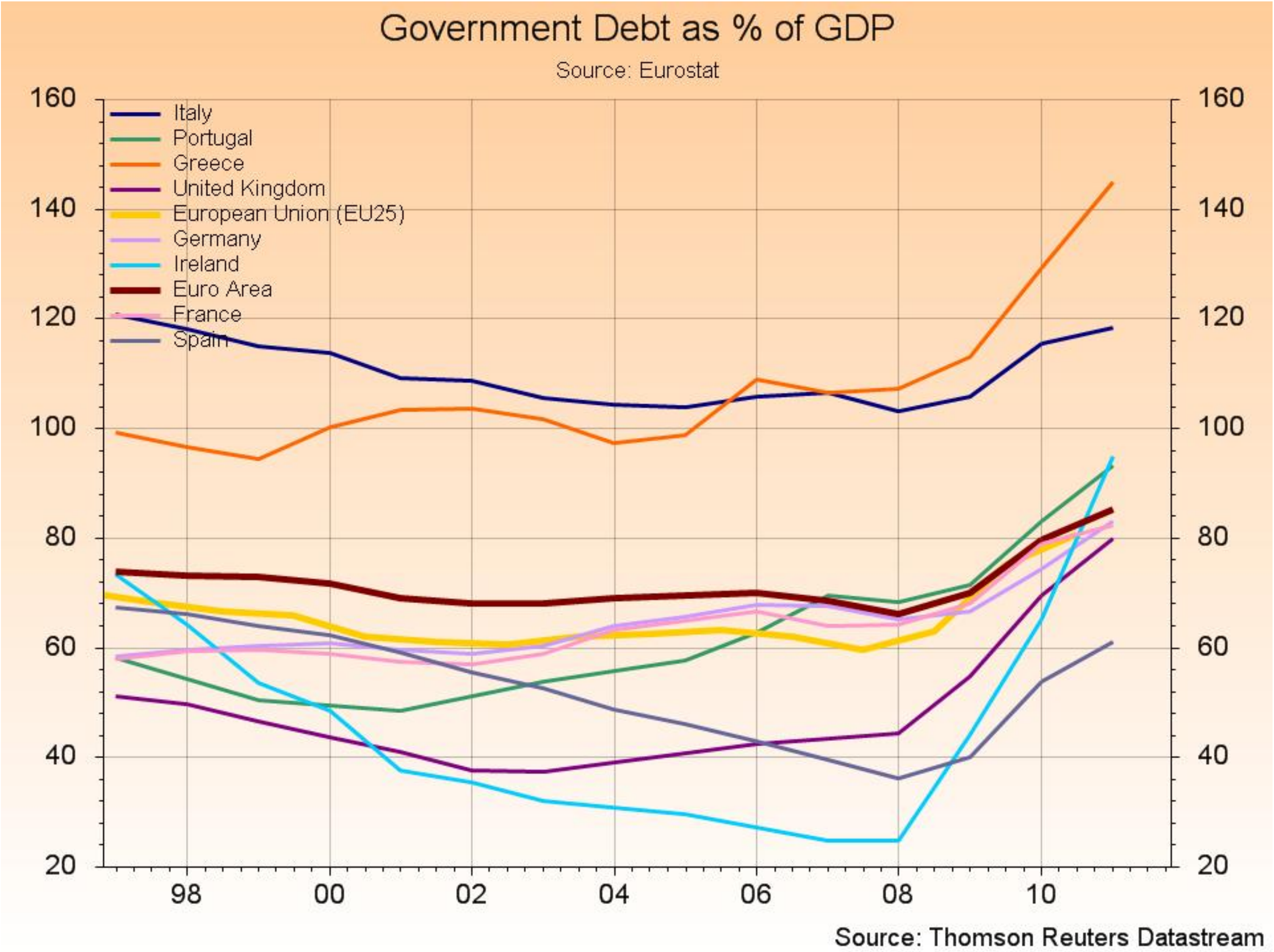
- Europe has the highest amount of private wealth in the world and the greatest difficulty in resolving its public debt crisis.
  - What explains this strange paradox?

- The world is rich but the governments of the world are poor. In this lecture, we will discuss the new politics of public debt and austerity as a distributional problem.

The Eurozone

- In 2008, the Eurozone experienced a 'sovereign debt' crisis when the interest rate charged on government debt increased in Greece, Ireland, Portugal, Spain and Italy.
- Public debt now averages around one year of national income in most member-states (approximately 90 per cent of GDP).
- But this varies significantly between member-states of the Eurozone.
- Most of the increase in sovereign public debt since the great recession in 2008 was an outcome of the public sector 'bailing out' the private sector and the collapsed revenues associated with declining economic growth.
- The EMU is a radical experiment in trying to manage a single currency without a state.

Public debt as a % of GDP



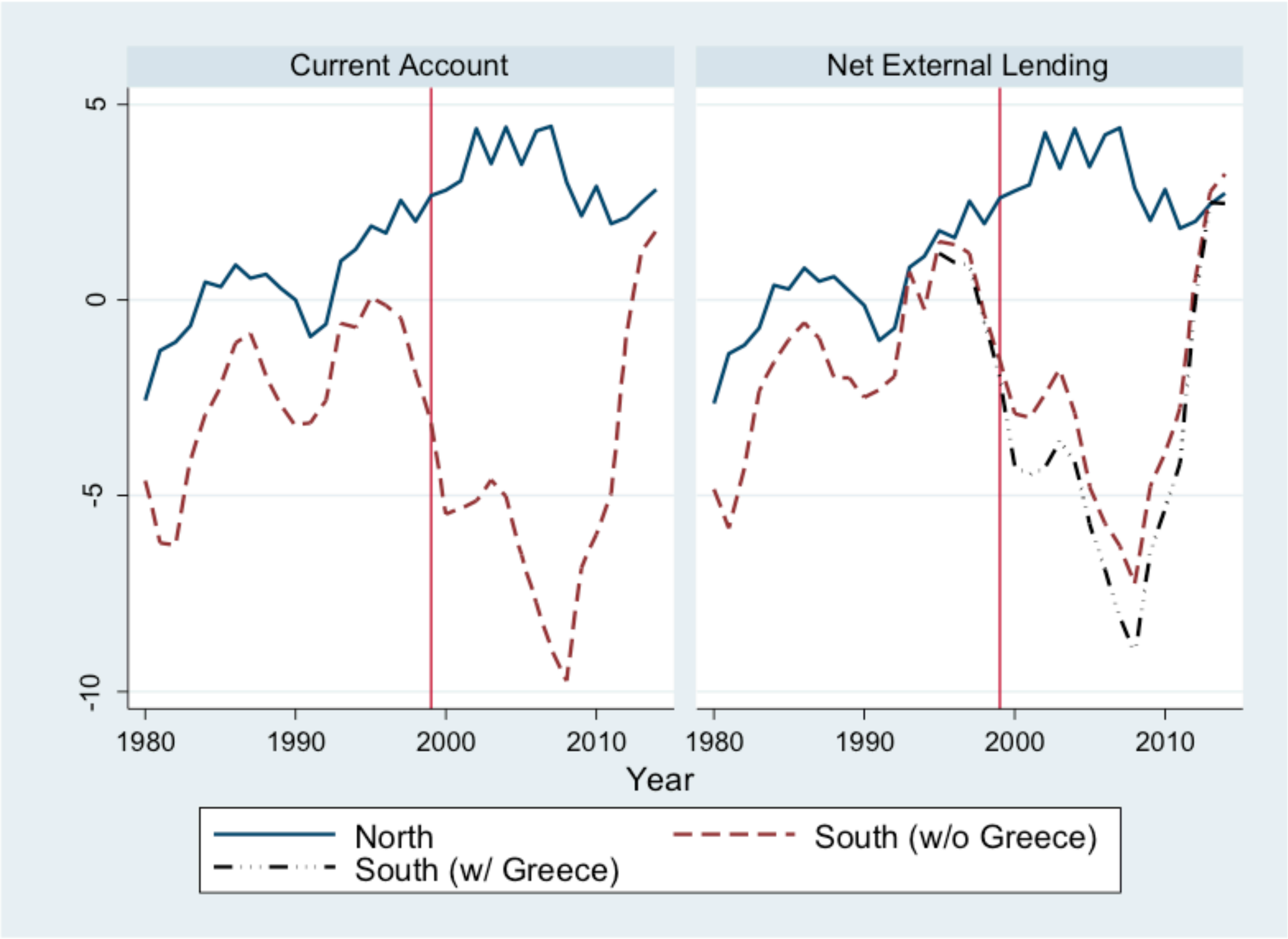
A stateless currency

- The EMU does not have federal fiscal or budgetary union capable of absorbing asymmetric shocks.
- This absence of shock absorption at the European level was radically exposed during the crisis. Banking and fiscal policy were *nationalized* whilst monetary policy was *Europeanized*.
- The cost of the collapse in the banking sector in Ireland is paid by national taxpayers not the federal currency union.
  - Banks are global in life but national in death.
- In the absence of a functioning central bank, capable of acting as a lender of last resort, financial markets panicked.
- The interest rate charged on ten year bond yields skyrocketed and some countries were priced out of international markets, with the implication that they had to seek a loan from the 'Troika'.
- It is the interest rate rather than the size of the public debt that matters!!

The origins of the crisis

- The origins of the sovereign debt crisis in Europe are both domestic and international.
- From 1999, all EMU member-states transferred monetary sovereignty to the European Central Bank (ECB). This was created as the most independent central bank in the world and modeled in the tradition of the German Bundesbank.
- The European treaties specify that the ECB's primary mandate is price stability, not economic growth, maximizing employment or financial market stability.
- Up until 2008, everything seemed fine in the stateless currency. Interest rates converged. Households, firms and governments could borrow cheaply.
- This convergence in financial markets was assumed to equal economic and political convergence.
- But the political foundations of national economies continued to diverge. Portugal did not become Austria. Germany did not become Italy.

Macroeconomic imbalances



Divergent growth regimes

- This difference between member-states would not be a problem in a political federal union i.e. between California and Delaware in the USA. But it is a problem in the EMU.

- Capital flowed from richer core member-states (Germany) to poorer peripheral member-states (Greece) fueling asset price bubbles in Spain and Ireland, and public debt in Greece.

- One way to observe this divergence or 'macroeconomic imbalance' is to examine the current and capital account of member-states. Up until 2008, most trade was internal to the Euro area, which became, in effect, a semi-closed trading bloc.

Internal devaluation

- Prior to the monetary union, these different political economies could co-exist, without producing imbalances between each other, because each member-state had macroeconomic tools to adjust their economies when confronted with an economic shock.

- This is no longer the case.

- In the absence of exchange rate adjustments (improving competitiveness by changing the price of currency), member-states must implement '**internal devaluations**' i.e. austerity.

Eurozone rules

- In agreeing to join the European monetary union ,all member-states agreed that they cannot have a public-debt to GDP ratio of more than 60 per cent or budget-fiscal deficits that exceed 3 per cent.
- These rules were first broken by Germany, then France, Italy and Greece.
- Other than these rules, the EMU did not generate the capacity at European level to deal with asymmetric economic shocks. It was an unprecedented experiment in international regional cooperation: creating a currency union without a state.

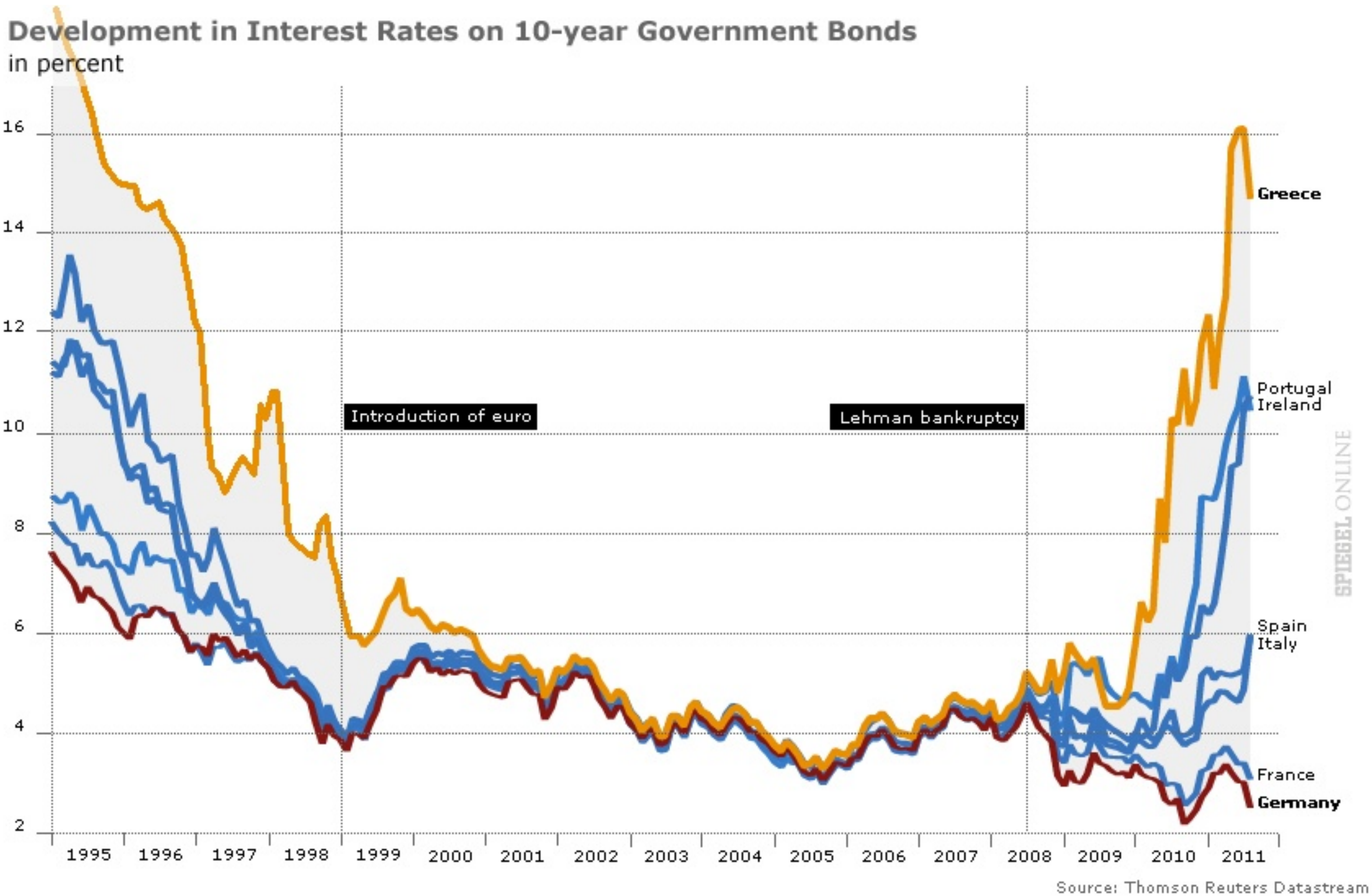
Fragile monetary union

- The fragility of the EMU was radically exposed in 2008. When the US subprime mortgage crisis spread to Europe, regional banks in some countries collapsed, economic growth declined, property bubbles burst and government revenue declined.

- In the absence of a central banking capable of acting as a lender of last resort financial markets panicked.

- Government bond yields shot up. Interest rates diverged. Peripheral member-states of the Euro area were priced out of the markets and had to resort to a Troika loan, with strict conditionalities.

Divergent interest rates



No lender of last resort

- The important point to note is that the fiscal and sovereign debt crisis in the euro area was a **consequence** not a cause of the financial crisis.
- The sovereign debt crisis could have been avoided if the ECB had the capacity to act as a lender of last resort.
  - But the ECB does not have this mandate.
- The ECB eventually resolved the sovereign debt debt crisis when Mario Draghi issued a press release in 2012 signaling that he would "do all that is necessary to save the Euro".
- But the damage had already been done. Investment in peripheral member-states collapsed, unemployment skyrocketed, and trust in the EU evaporated.

Who pays?

- The question of who pays for this financial-banking collapse in the EMU reveals the tense relationship between capitalism and democracy; markets and citizens; investors and taxpayers.
- It also reveals the limitations of the nation-state in governing global markets.
- Rather than tax wealth and capital, governments borrow from those who hold wealth and capital in the form of government issued bonds. A marginal increase in the interest rate can effectively make sovereign states insolvent.

Back to Piketty….

- For Thomas Piketty there are three ways to tackle sovereign debt in Europe:

- Taxes on capital
- Inflation
- Austerity

- Inflation was the main strategy, historically, in how nation-states dealt with public debt.

  - In Europe today, the strategy is austerity, or internal devaluation. But what exactly does this mean?

Austerity

- It means reducing public expenditure and increasing taxes, whilst trying to reduce wage and labour costs, as a mechanism to reduce public debt and budget deficits.

- In theory, European governments could reduce all public debt by privatizing all public assets.

- This means the government would pay rent to private actors who own schools, hospitals and police stations rather than pay interest on public debt to fund these public services.

- This is not likely to happen. But it underpins a lot of the criticism of the introduction of water charges in Ireland.

Capital taxes

- Piketty suggests that a progressive tax on capital-wealth (not just bank deposits but all assets including shares) is the optimal strategy to deal with public debt.
- He propose a capital-wealth tax at a rate of 0 per cent on up to 1 million, 10 percent between 1 and 5 million, and 20 percent above 5 million. In one swoop this would reduce public debt by 20 percent of GDP.
- Alternatively, the same rates of 0, 1, and 2 percent over 10 years would yield the same result.

Inflation

- What about inflation as a strategy to reduce public debt?
- An inflation rate of 5 percent per annum would allow governments to reduce their debt by more than 15 percent.
- It was this type of inflation that allowed Germany to embark on its post-war reconstruction without creating a sovereign debt crisis (in addition to massive financial assistance from the USA).
- If there is no inflation, and no tax on capital, and a growth rate of 2 percent per annum, then the only choice is to cut spending and wages.
- But this austere strategy will take countries such as Greece over 20 years to reduce their debt to GDP ratio by 20 percentage points. It is questionable whether this adjustment is possible within a democracy.

Conclusion

- Public debt and fiscal policy are **distributional dilemmas** not technical problems.
- For example, the Irish government spends more on debt interest re-payment as a percent of it's GDP than it does on its universities.
- Public debt is another persons private wealth. It is a form of redistribution between the public and private.
- Net private wealth in Europe is equal to 600 percent of GDP. The public sector (government) is in net debt. They must tax workers and borrow from those who own capital-wealth to fund public services and provide social rights to their citizens.
- There is no 'technical' solution to these distributive dilemmas. It is a political economy problem that reflects an in-built tension between competitive markets and social rights.

Discussion

- In distributing the burden of adjustment for the banking collapse governments have decided to not tax capital-wealth.
  - *Why do European governments not tax capital to deal with the public debt crisis, as suggested by Piketty?*
- This would require nation-states giving up more fiscal sovereignty to European policymakers.
- Neither the nation-state nor Europe has the problem solving capacity to implement such a strategy.