Leithner Letter No. 171-174
26 February-26 May 2014

For my own part, I am deeply convinced that all excess in public expenditure beyond the legitimate wants of the country is not only a pecuniary waste … but a great political and, above all, a great moral evil.

William Ewart Gladstone
Chancellor of the Exchequer
Budget Speech (15 April 1861)

Britain has lived for too long on borrowed time, borrowed money and even borrowed ideas. … We used to think that you could spend your way out of a recession … that option no longer exists, and … in so far as it ever did exist, it only worked on each occasion since the war by injecting a bigger dose of inflation into the economy, followed by a higher level of unemployment as the next step.

James Callaghan
Prime Minister
Speech to the Labour Party Conference (1976)

In [1776], Adam Smith observed that "What is prudence in the conduct of every private family, can scarce be folly in that of a great kingdom." Until the advent of the "Keynesian revolution" in the middle years of this century, the fiscal conduct of the American Republic was informed by this Smithian principle of fiscal responsibility … Keynesianism stood the Smithian analogy on its head. The stress was placed on the differences rather than the similarities between a family and the state, and notably with respect to principles of prudent fiscal conduct. The state was no longer to be conceived in the image of the family, and the rules of prudent fiscal conduct differed dramatically as between the two institutions. The message of Keynesianism might be summarized as: What is folly in the conduct of a private family may be prudence in the conduct of the affairs of a great nation.

James Buchanan and Richard Wagner
Democracy in Deficit: The Political Legacy of Lord Keynes (1977)

In the comments section, I got a priceless gem from a big government fan, who relates that government spending has risen at an annual rate of 7% since 1965. Hence, austerity is defined as growth of government spending at a rate less than "normal." The 7% rate is instructive because, according to the rule of 72, you get a doubling every ten years. If the [U.S.] federal government continues to grow at its "normal" (non-austerity) rate, it will spend $32 trillion in 2043. Maybe then we'll finally have "enough" government spending to solve all of our problems.

Paul Roderick Gregory
"Austerity" To Blame? But Where's the Austerity?
Forbes (26 May 2013)

Austerity, What Austerity?

Europe and the U.S. Desperately Need Genuine Austerity: Not the "Faux Austerity" of the Past Several Years

In early January, when I typed "austerity" into Google, I received this response: "(1) sternness or severity of manner or attitude ('he was noted for his austerity and his authoritarianism'); (2) difficult economic conditions created by government measures to reduce public expenditure ('the country was subjected to acute economic austerity')." It's probably not coincidental: today's Oxford Dictionary uses almost exactly the same words to define austerity. Equally interestingly, this current definition differs significantly from one that was commonly used decades ago. *The Webster's Collegiate Dictionary* (5th ed., 1948), for example, defines austerity as "the quality or state of being austere." Austere, in turn, means "(1) sour and astringent; rough to the taste; harsh; bitter ('austere wine'); (2) rigorous; stern; (3) severe or strict; ascetic ('austere mode of life'); (4) unadorned, severely simple ('austere religion'); (5) grave, sombre ('austere mood')."

Notice how the definition has changed: *the earlier conception possesses no strand that's equivalent to the contemporary definition's second strand.* Behind this later addition I detect the evil hand of Keynesian economics (see in particular Hans-Hermann Hoppe, The Misesian Case Against Keynes). Specifically, Keynesians, who've long influenced bureaucrats, journalists and politicians, who in turn have influenced the public at large, have (a) conflated a particular trait (austerity) and a cardinal virtue (prudence); (b) confused cause and effect (as we'll see, austerity today doesn't, as Keynesians assert, create difficult economic conditions tomorrow; quite the contrary, profligacy today necessitates austerity tomorrow); and (c) rebadged austerity-prudence as a vice. Consequently, "austerity" has become a favourite term of abuse hurled by people (or their masters) who indignantly refuse to stand on their own two feet. But if you refuse to live within your own means then you must necessarily live within somebody else's means – whether that "somebody" likes it (or even knows it) or not. That's not courageous, just, prudent or temperate (i.e., virtuous).

In the past, prudence and frugality were clearly honourable – and thus obviously good. "There is no dignity quite so impressive, and no one independence quite so important," U.S. President Calvin Coolidge reportedly said, "as living within your means." If this dignity necessitated austerity, traditionalists rightly observed, then so be it: if you want it now, pay cash; if you haven't sufficient cash, defer your gratification and save; and if you can't save enough, then you'll just have to do without. Although he never (at least in *Self-Help*, the book for which he's best known) used the term, Samuel Smiles also extolled the morality and utility of the traditional conception of austerity. "The battle of life," he averred, "is, in most cases, fought uphill; and to win it without a struggle [is] perhaps to win it without honour. If there were no difficulties there would be no success; if there were nothing to struggle for, there would be nothing to be achieved." For this reason, Smiles concluded, "the very greatest things – great thoughts, discoveries, inventions – have usually been nurtured in hardship, often pondered over in sorrow, and at length established with difficulty."

For two reasons, then – the traditional conception of austerity, as exemplified by Coolidge and Smiles, but also as a matter of elementary logic – the able-bodied and sound-of-mind that don't stand on their own two feet are burdensome. Clearly, because sloth is a classical vice (i.e., one of the "seven deadly sins"), freeloading and slacking are immoral. Yet John Maynard Keynes couldn't abide the virtuous basis of industry and austerity and the immoral foundations of idleness and profligacy.[1] As a result, and thanks to Keynesianism's baleful influence, living within one's means is today – and perversely – regarded at best as unnecessary and at worst as intolerable. Why is independence superfluous? The state, insist its partisans, will cater to everybody's needs far better than capitalism among consenting adults possibly can. Indeed, its agents smugly assert, the state knows what a man wants better than does the man himself. Why, from the state's point of view, is autonomy unacceptable? Because if you don't depend upon it for employment, security, "healthcare," etc., then you explode the myth that it and only it can provide these things.

These days, it's apparently everybody's right to live at someone else's expense.[2] We "know" this because our rulers stridently tell us so. Exactly who is this "somebody else" to whose means each of us allegedly possesses the right to help ourselves? Our supposed betters coyly decline to identify him explicitly.[3] But on one point the anointed are crystal clear: any of the benighted who queries this "right" – and thereby affirms the virtue of living within your own means and the merit of traditional austerity – is not just clearly wrong: he's also obviously immoral.

The Mainstream Allege That Austerity Is Dumb and Even Dangerous

It's important to emphasise: today's politicians denigrate austerity. And their sock puppets, who call themselves "journalists," have obligingly given it a relentlessly bad press. Since 2009-2010, heads of government, finance ministers, etc., particularly in the European Union and seconded by their mascots, who call themselves "academics," have whined that "austerity has gone too far" and that it is "preventing a recovery" (see, for example, Thomas Catan and Ian Talley, IMF Renews Push Against Austerity, *The Wall Street Journal*, 16 April 2013 and Why Australia Must Avoid Austerity, *Business Spectator*, 29 December 2013). Apparently, austerity isn't just extreme: it's hazardous:

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1 See, for example, Letter 127-130, particularly pp. 14-18. "The 'virtue' of Keynes's teaching," writes Henry Hazlitt on p. 56 of *The Failure of the "New Economics:" An Analysis of the Keynesian Fallacies* (Nostrand, 1959), "is that it praised thriftlessness, reckless spending and unbalanced budgets … That it reached conclusions quite different from what the normal uninstructed person would expect – for instance, that saving is a sin and squandering a virtue – added, I suppose, to its intellectual prestige."

2 "The State," Frédéric Bastiat famously said in *The Law* (1848), "is the great fiction through which everyone endeavours to live at the expense of everyone else." Bastiat continued: "But how is this legal plunder to be identified? Quite simply: see if the law takes from some persons what belongs to them, and gives it to other persons to whom it does not belong. See if the law benefits one citizen at the expense of another by doing what the citizen himself cannot do without committing a crime."

3 They hint, however, that *you* are the meritorious Paul who receives the proceeds from the taxation of the other bloke, i.e., the Peter who doesn't deserve to keep all of the fruit of his labour. "Every election," as H.L. Mencken put it, "is a sort of advance auction sale of stolen goods." Following Mencken's logic to a conclusion that he overlooked: today's politicians loot the unborn in order to subsidise the already-living. Alas, the rallying cry "no taxation without gestation!" is utterly alien to the Anglo-American democratic tradition.

> In their new book, *The Body Economic: Why Austerity Kills – Recessions, Budget Battles, and the Politics of Life and Death* [Basic Books, 2013], economist David Stuckler and physician Sanjay Basu examine the health impacts of austerity across the globe. The authors estimate there have been more than 10,000 additional suicides and up to a million extra cases of depression across Europe and the United States since governments started introducing austerity programs in the aftermath of the economic crisis. For example, in Greece, where spending on public health has been slashed by 40%, HIV rates have jumped 200%, and the country has seen its first malaria outbreak since the 1970s.
>
> An economist and public health specialist, Stuckler is a senior research leader at Oxford University. Dr Basu is a physician and epidemiologist who teaches at Stanford University. "Had austerity been organized like a clinical trial, it would've been discontinued given evidence of its deadly side effects," Stuckler says (Why Austerity Kills: From Greece to U.S., Crippling Economic Policies Causing Global Health Crisis *Democracy Now!* 21 May 2013; see also Mark Blyth, *Austerity: The History of a Dangerous Idea*, Oxford University Press, 2013).

During the September 2013 election in Australia, Kevin Rudd hinted that stimulus (which he and the ALP champion) is right and righteous, and strongly implied that austerity (which the Liberal-National coalition allegedly advocates) is wrong and immoral. "When Australians vote today," he wrote on the day of the election in Choice Between Smart Nation or Austere One (*The Australian*, 7 September 2013),

> They will be making a choice between fundamentally different visions for the future of our country. Labor's vision is for a country where every Australian has the right to a decent job … an Australia where all our kids get the education they need. … It's an Australia with one of the world's best health and hospital systems, which looks after its elderly people and cares for those with disabilities.
>
> By contrast, Tony Abbott's policies all boil down to one thing: cuts. My opponent is planning to cut billions of dollars in spending: cuts to services; cuts to education; cuts to family payments; and cuts to public-sector jobs. And he continues to hide the details. Cuts are the last thing Australia needs as our economy faces a transition with the mining-investment boom winding down. Labor has a $15bn Better Schools plan to ensure our children get more one-on-one attention in the classroom. Mr Abbott will cut school funding – and then he will cut the Schoolkids Bonus, making it harder for hundreds of thousands of families to make ends meet. Labor is building the National Broadband Network to provide affordable, superfast broadband for families and businesses. … Mr Abbott will scrap the NBN. Labor will continue investing in our health and hospital system. Mr Abbott's track record as health minister was to slash $1 billion from hospitals.

Rudd concluded: "the choice is between smart policy" – that is, hands-on, interventionist and "stimulatory" policy – or hands-off, non-interventionist "austerity."

FIRST Came the Beneficial Stimulus, Asserts the Mainstream, THEN Followed the Harmful Austerity

Rudd sings devoutly from the mainstream's hymnbook. Echoing Keynes ("The boom, not the slump, is the right time for austerity at the Treasury," JMK asserted in 1937), Keynesians insist that times of bust are the right time for the government to indulge in extravagance – and the wrong time to submit to sobriety. Indeed, Paul Krugman and his followers go well beyond Keynes: *any* time is the right time for profligacy – the more egregious the better – and the wrong time for frugality (see also Paul Krugman, Keynes Was Right, *The New York Times*, 29 December 2011). Krugman and others also allege that, particularly in Europe, (1) the bailouts and other "stimulus" which panic-stricken policymakers "injected" into the structure of production in 2007-2008 has subsequently been replaced by "austerity"[4] and (2) this austerity has scuttled recovery. The exemplar of austerity-as-poor-policy, they say, is Greece. In that country, pressured by the EU in general and Germany in particular, the budget's deficit fell from 10.4% of GDP in 2010 to 9.6% in 2011; other countries, such as Iceland, Italy, Ireland, Portugal, France and Spain, also decreased their deficits relative to GDP from 2010 to 2012.[5] As a consequence of this austerity, Keynesians insist, economic conditions and prospects have worsened.

He's no fan of Keynesians, yet Paul Roderick Gregory ("Austerity" To Blame? But Where's the Austerity? *Forbes*, 26 May 2013) accurately summarises their position:

> Die-hard Keynesians bemoan [the fact] that, with a few exceptions, the world's economies are drowning in the quicksand of austerity. They preach we need more government spending and stimulus, not less. Northern Europe should bail out its less-fortunate neighbours to the South so they can pay their teachers, public employees and continue generous transfers to the poor and

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4 "Since 2008," said Giancarlo Corsetti in Has Austerity Gone Too Far? (*Vox*, 2 April 2012), "the fiscal policy debate has gone through several phases." Specifically,

- "The first phase was dominated by a call for fiscal stimulus to avoid another Great Depression. Thinking about deficit corrections in the future was seen as irrelevant, when not counterproductive, as it was feared that prospective consolidation plans would create additional uncertainty about the terms of the recovery.
- The second phase, from 2010 onward, saw the focus shift to fiscal consolidation as high public debt started to loom large. This policy shift occurred despite a global economy that was not yet on a firm recovery path and monetary policy at or near the zero lower bound in many countries.
- The third phase may have begun; with weak growth, calls for austerity appear to have fallen out of fashion again."

5 In "Italy Joins Europe's Austerity Club with Deep Cuts," for example, *Reuters* (25 May 2010) reported:

"Italy joined Europe's austerity club on Tuesday with 24 billion Euros of deficit-reducing cuts that target public workers and local government … 'This will be tough, with heavy sacrifices,' said Gianni Letta, cabinet undersecretary and [Prime Minister Silvio] Berlusconi's right-hand man, before the measures were approved. … Rome joins Greece, Spain and Portugal in enacting programmes to slash budget deficits with the aim of restoring investors' confidence following approval of a $1 trillion EU safety net aimed at stopping contagion from Greece's debt crisis. … Union leader says cuts are 'unfair' [and will] hit the poor." Similarly, according to Peter Wilkinson ("Clashes as Austerity Anger Drives Europe Strikes," *CNN*, 15 November 2012), "A wave of anger over austerity is sweeping across Europe as workers fed up with government spending cuts and tax increases took to the streets in a coordinated day of action Wednesday …"

unemployed. If not, Europe's South will remain mired in recession. In America, Keynesians entreat the skinflint Republicans to loosen the purse strings so we can escape sub-par growth. They advise Japan to spend itself out of permanent stagnation and welcome recent steps in this direction.

The stimulationists complain that they have been overwhelmed by the defeatist austerity crowd, [led] by the un-neighbourly Germans and the obstructionist Republicans. If only Germany would shift its economy into high gear while transferring its tax revenues to ailing Southern Europe, and the rascally Republicans drop the sequester cuts, we would be sailing along to a healthy worldwide recovery. We don't need spending restraint. Instead, we need stimulus, stimulus, and more stimulus to revive economic growth. We'll deal with the growing deficits later, the stimulation crowd tells us, but we must first get our economies growing again.

The official Keynesian story is that the PIIGS of Europe (Portugal, Italy, Ireland, Greece and Spain) have been devastated by cutbacks in public spending. Austerity has made things worse rather than better – clear proof that Keynesian stimulus is the answer. Keynesians claim the lack of stimulus (of course paid for by someone else) has spawned costly recessions which threaten to spread. In other words, watch out Germany and Scandinavia: If you don't pony up, you'll be next.

According to the Austrian School, Stimulus Is the Disease and Austerity Is a Necessary Condition of Recovery

Keynesians see financial crises and economic busts as largely unpredictable events that governments must prevent at all cost – and, when they nonetheless occur, must move heaven and earth to alleviate. Adherents to the Austrian School, on the other hand, explain them as the inevitable result of the unsustainable artificial boom provoked by government intervention in general and central and fractional reserve banks' excessive expansion of credit in particular. Bankers grant the worst loans during the superficially best times. For Austrians, the boom isn't a blessing; it's a curse. Moreover, recession isn't a curse: it's a cure. The bigger is the preceding unsustainable boom, the more severe will be the consequent genuine bust. The recession is the hang-over that follows the blinder; it's the cold-turkey that's necessary in order to kick the addiction to artificial credit.[6]

Like the big bushfire that eliminates the underbrush that the government forbade landowners to use small fires to remove, the recession is an inevitable and necessary phase of the modern business cycle. The bust rids the economy of the detritus, distortions and mal-investments that accumulated during the boom. Resources that have been put to un-

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[6] See in particular Murray Rothbard, Economic Depressions: Their Cause and Cure. Followers of Keynes seldom anticipate recessions, never mind crises, and so these things always surprise them. Followers of Ludwig von Mises, Murray Rothbard and Hans-Hermann Hoppe, on the other hand, usually anticipate downturns, crashes and crises – and are surprised when they (usually) don't occur. To Keynesians, in other words, the glass isn't just full: it's overflowing. Austrians, on the other hand, see a crack in a brittle and mostly-empty vessel. As a result, Keynesians are normally complacent and Austrians fretful.

productive uses (not least by governments' perverse incentives, regulations, decrees, etc.) must either be shifted to sectors where genuine demand exists – or be liquidated. Clearly, this clean-up and reorganisation can't occur overnight; accordingly, some resources must remain idle until entrepreneurs can find a sensible way to deploy them. This means that unemployment will temporarily rise, that plant and equipment will lie partly or fully idle until it can be retooled or scrapped, and that financial resources will be used to repay debt and "parked" in short-term assets instead of invested in long-term projects.

To Austrians, then, recession, unemployment and the like aren't consequences of austerity; they're results of the stimulus that kindled the artificial boom. Accordingly, governments mustn't try to retard, delay or prevent this process of retrenchment, reallocation and recuperation. During the recession caused by stimulus, in other words, they should avoid further "stimulus" like the plague. Keynesian "pump-priming," "automatic stabilisers," bailouts and so on vainly sustain the artificial boom, corrupt the necessary and salutary bust and thus weaken and abort any genuine recovery. Stimulus is akin to giving a drunk another bottle of whiskey and an addict another "hit" of heroin. It doesn't just delay recovery; in sufficiently large doses it kills the patient.[7] For bad measure, stimulus also creates a climate of uncertainty (Robert Higgs calls it "regime uncertainty") which deters private investment.

In short, Keynesians and Austrians recommend diametrically opposite policies to combat financial and economic crisis. Keynesians demand that governments redouble their profligate expenditure and frenzied intervention; Austrians recommend that governments slash their spending, taxes, legislation and regulation. Their interpretation of causes and effects is also irreconcilable. First came the beneficial stimulus, says the mainstream, and then followed the harmful austerity. First came the wild party, retort the Austrians, and then ensued the inevitable hangover – which more booze and drugs will only worsen.

So What, Exactly, Is Austerity?

Given these diametrically opposite diagnoses and prescriptions, how should we view the current situations in Europe, the U.S. and elsewhere? Has austerity prolonged the crisis, as Keynesians believe? Or, as Austrians maintain, is austerity a necessary condition of recovery? In order to answer these questions, we must define this key term more precisely. "Austerity measures," says The Financial Times Lexicon, "refer to official actions taken

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7 On 4 December 2008, I wrote a letter-to-the-editor:

"*The Weekend Australian* ("After the Binge," 29-30 November) correctly noted the long-term harm that awaits binge drinkers. This harm is physical (liver disease and various forms of cancer), cognitive (memory loss and depression) and social (unemployment, financial strain and damage to family and other relationships). Unfortunately, your economics and finance correspondents are utterly oblivious to the long-term harm of binge economic policy. Babbling incessantly about "stimulus," they cheer to the rafters the RBA's sudden and drastic reduction of the Overnight Cash Rate and the Rudd government's belated determination to "do whatever it takes" (except, of course, repeal its myriad stupid laws and regulations, slash its bloated budget and cut its onerous taxes). Like a crazed chemist who has only one drug to prescribe, whatever the ailment, the effect of the RBA's policy is to reward debtors and punish savers; and like a pusher on the street corner, the Rudd government (like the Howard government before it) peddles an addictive substance – dependence upon the state – that inevitably harms those who consume it."

Hardly surprisingly, *The Australian* declined to publish the letter.

by the government, during a period of adverse economic conditions, to reduce its budget deficit using a combination of spending cuts or tax rises." It adds: "various austerity measures have been announced since the global recession in 2008 and the Eurozone crisis in 2009."[8] Given the FT's conception, a sufficient condition of austerity is the joint occurrence of four things (the first and last of which are necessary conditions). Specifically, austerity is (a) a decrease of the government's budget deficit which has been caused by either (b) a decrease of government spending or (c) an increase of tax revenues (or both b and c) and which (d) occurs during a period when GDP is stagnant or falling. Most descriptions of and disputes about austerity follow the FT's conception. They have focussed upon two macroeconomic indicators, both expressed as a percentage of GDP: (1) the government's budget deficit and (2) its debt. The lower the deficit (that is, the higher the surplus) and the more the debt shrinks, the more austere is the policy.

More generally, austerity means not just that the government "taper" but that it abandon its profligacy. It doesn't merely tug the fiscal belt slightly: it yanks as hard as necessary in order to live within its means. Austerity means that when a government figuratively stands in the doctor's surgery and receives an unvarnished diagnosis – namely that it's woefully unfit and morbidly obese – it doesn't choose the slack option. It doesn't borrow in order to buy even bigger trousers: instead, it immediately adopts a strict diet and commences rigorous training, and before long it fits into smaller clothes. At a minimum, austerity worthy of the name means that the government quickly eliminates its budget's deficit; more ambitiously, it means that both its spending and its revenues fall significantly, even drastically, that its expenditures rapidly become smaller than its shrunken revenues, and that it uses the resultant budget surplus to repay a significant portion of its debt.

Are governments and households, in one vital respect, comparable? "What is prudence in the conduct of every private family," Adam Smith famously wrote in *The Wealth of Nations* (1776), "can scarce be folly in that of a great Kingdom." Here, too, Keynesians and Austrians differ diametrically. Austrians reason from two premises. Firstly, households and businesses cannot live indefinitely beyond their means; secondly, the government confiscates from households and businesses. *Accordingly, only if the private sector runs a surplus can the coercive sector run a deficit.* Even Keynes agreed: the government, like the households and businesses that it bleeds, cannot indefinitely live beyond its means. Because nobody's spending can forever exceed his income, everybody (including the government) must ultimately restrain his ends within his means. If he refuses, then as a matter of elementary logic he must live within somebody else's means – whether that somebody else is aware of it or not, and whether that somebody likes it or not. From the point of view of the Austrian School, then, the Keynesian mainstream is not just logically and empirically incorrect: it's morally wrong. Austerity is ethical and sensible, and profligacy is immoral and irrational.

Keynesians reject these premises and reasoning, as well as the morality that underlies it. In the words of James K. Galbraith (In Defense of Deficits, *The Nation*, 4 March 2010):

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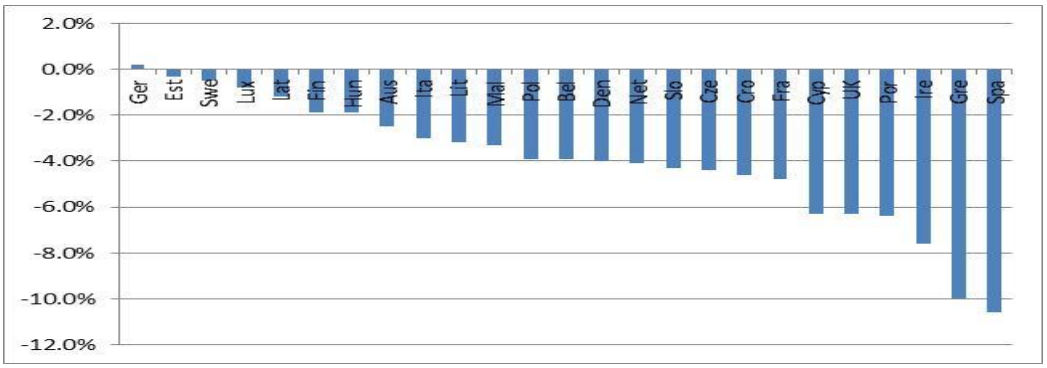
8 See also Austerity Europe: Who Faces the Cuts, *The Guardian*, 12 June 2010; Brian Wesbury and Robert Stein, Government Austerity: The Good, Bad and Ugly, *Forbes*, 27 July 2010; and Paul Krugman, The Austerity Agenda, *The New York Times*, 31 May 2012.

> It may seem like homely wisdom to say that "just like the family, the government can't live beyond its means." But it's not. In these matters the public and private sectors differ on a very basic point. Your family needs income in order to pay its debts. Your government does not … With government, the risk of non-payment does not exist. Government spends money (and pays interest) simply by typing numbers into a computer. Unlike private debtors, government does not need to have cash on hand … No government can ever be forced to default on debts in a currency it controls. Public defaults happen only when governments don't control the currency in which they owe debts – as Argentina owed dollars or as Greece now (it hasn't defaulted yet) owes Euros. But for true sovereigns, bankruptcy is an irrelevant concept. When Obama says, even offhand, that the United States is "out of money," he's talking nonsense – dangerous nonsense. One wonders if he believes it. Nor is public debt a burden on future generations. It does not have to be repaid, and in practice it will never be repaid.

A question to Galbraith: if so, then why does any government ever bother to levy taxes? Why doesn't it simply borrow whatever it likes, without limit, every year? In the U.S., why doesn't Caesar simply bypass Congress – and ignore its power over the purse and the borrowing limit – and issue as many trillion-dollar coins as he pleases?[9]

Figure 1: Ratio of Government Budget Surplus or Deficit to GDP (%), EU Members, 2013



Keeping in mind our conception of austerity (i.e., living within one's means) and its morality, it's worth mentioning that, for members of the EU, austerity or some rough facsimile thereof is not just a promise: it's a treaty obligation. How so? The Maastricht Treaty of 1992 stipulates that the budget deficit of a country joining the EU must be no greater than 3% of its GDP, and that its level of debt must be no higher than 60% of GDP. Few people, however, take "Maastricht criteria" seriously. Figure 1 shows that the budget deficit of the average EU member state is presently (the data were current in mid-2013) 4.0% of GDP, and Figure 2 shows the government debt of the average member of the

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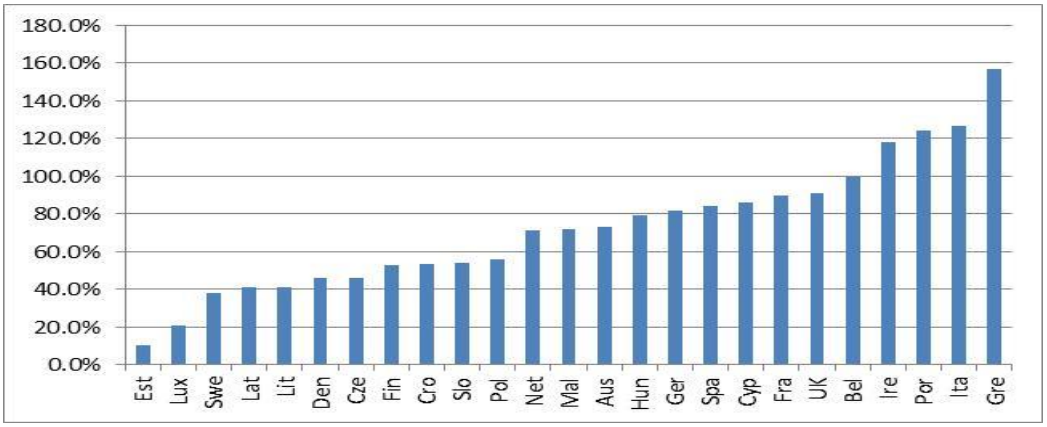
9 According to Paul Krugman: "So minting the coin would be undignified, but so what? At the same time, it would be economically harmless – and would both avoid catastrophic economic developments and help head off government by blackmail." Krugman hailed the dispute about this coin as "the most important fiscal policy debate of our lifetimes" (see Rage Against the Coin, *The New York Times*, 8 January 2013).

EU is 72.5% of GDP (www.tradingeconomics.com is the source of these and all subsequent presentations of data from EU countries).

It's rather comical: by these criteria the average EU country doesn't qualify (according to Maastricht criteria) for admission into the EU! Indeed, all major EU nations except Germany fail the budget deficit test: Britain, France, Italy and Spain all do. And all of the EU major member states, including Germany, fail the debt-to-GDP criterion.

Figure 2: Ratio of Government Debt to GDP (%), EU Members, 2013



By these two criteria, in other words – which are not mine but are rather part of the EU's "architecture" – there is simply no "austerity" in Europe. Virtually without exception, member states of the EU aren't honouring their obligations under the Maastricht Treaty. They're not living within their means; as a result, according to criteria solemnly agreed by treaty more than 20 years ago, they're not practicing austerity.

Three Varieties of Austerity

Recall from *The Financial Times Lexicon* that austerity reduces the government's budget deficit. If the deficit is rising, then there's no austerity. How to trim a deficit? The government must cut its spending, increase its revenue or adopt some combination of these two things. Generally speaking and regardless of their rhetoric, politicians of all partisan stripes love to increase expenditure and reduce taxes (which rewards their mascots), and they hate to reduce expenditure and to increase taxation (which punishes their followers). Three varieties of austerity, one legitimate and the others bogus, thus follow:

Variety #1: Genuine Austerity

Politicians' and bureaucrats' least favoured way to reduce the deficit is to implement genuine austerity, i.e., to cut spending drastically (both in absolute terms and as a percentage of GDP) and to slash taxes considerably. If they do these things (such that the government's revenues decrease and its expenditures fall even more, thereby turning the budget suddenly and sharply into surplus), and if they use this surplus to trim the debt, they shrink the size of the state; and if they do these things whilst GDP is stagnant or falling, then they're implementing "genuine" austerity.

Variety #2: Not Genuine But Not Completely Fraudulent Austerity

The intermediate (but still relatively unappealing, if you're a politician or bureaucrat) way to reduce the government's budget deficit is to (1) halt the growth of spending for a short period of time and (2) greatly increase its revenues (by either increasing the rate of existing taxes, or introducing new taxes, or both) for a long time. These two measures, plus (3) the hope that the growth of GDP resumes quickly enough to remove the pressure to take further unpalatable decisions, may reduce the deficit somewhat as a percentage of GDP, but probably won't decrease it in absolute terms. And it'll do nothing to reduce debt; indeed, borrowings (in absolute terms, if not as a percentage of GDP) may rise; for this reason, the state continues inexorably to grow. This approach, broadly speaking, describes short periods in the 1980s in Britain and the U.S.

Variety #3: Faux-Austerity

"Faux" (false or fake) austerity entails higher government expenditure, albeit perhaps at a slower pace than during the era before "austerity" commenced. A deceleration of the rate of increase of the government's expenditure, in other words, underpins faux austerity (in mathematical terms, the second derivative becomes negative, but the first derivative remains positive). So too do either increases of existing taxes or the introduction of new taxes, which increase the government's revenues more quickly than its expenditure, and thereby reduce its deficit. Unlike genuine austerity, which shrinks the state's income statement and balance sheet, faux-austerity, which is typically financed by borrowing (often at an accelerating pace) produces an ever-bigger state. This, or something roughly like it, occurred in Britain during most of the Thatcher years, most of the Reagan years in the U.S. and during the early Howard years in Australia. That's right, Virginia: except in very specific areas and for very limited periods of time (see Variety #2 above), Margaret Thatcher simply didn't "cut spending:" under her watch, education, "healthcare," welfare – in short, the welfare-warfare state – expanded inexorably. Ditto under the Reagan Administration. As we'll see, faux-austerity also characterises today's EU and U.S.

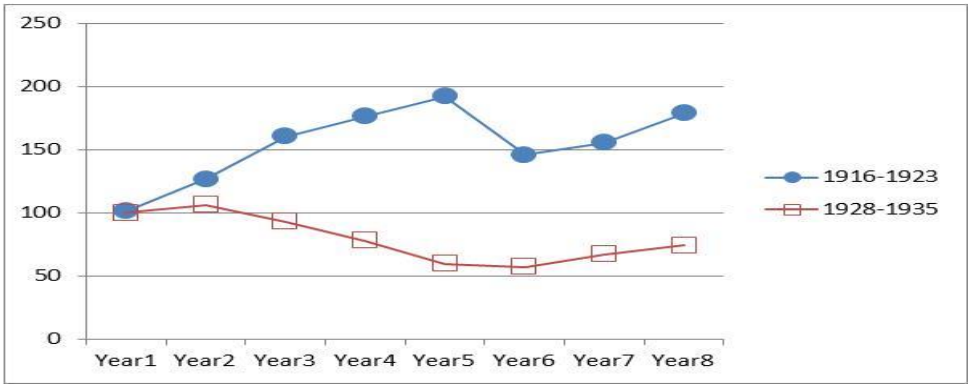
In principle, then, "austerity" of one or another of these guises can cover many different and otherwise incommensurate situations. Specifically, it can apply just as well to (a) the common situation where the size of the state increases rapidly, (b) the almost ubiquitous situation where the size of the state rises at a relatively steady pace and (c) the very rare situations where the state suddenly shrinks meaningfully.

A Textbook Example of Genuine Austerity That the Mainstream Mostly Ignores

Have you heard of the Depression of 1920-1921? In the U.S., it was an extremely sharp but relatively short (according to the National Bureau of Economic Research, it began in January 1920 and ended in July 1921) "deflationary depression." Why have so few people heard of it? Probably because it ended much more quickly than did the Great Depression of the 1930s and 1940s. Why did the Depression of 1920-1921 disappear so fast? The U.S. Government quickly and resolutely implemented genuine austerity.[10]

Figure 3 plots U.S. GNP during two eight-year periods: 1916-1923 and 1928-1935. To aid comparison of these two intervals, it standardises GNP in the first year of each at 100 (*Historical Statistics of the United States*, series F1, "Gross National Product at Current Prices," is the source of these data). It shows that the decrease of GNP between 1920 and 1921 (a whopping 24%) was far greater than in any single year of the Great Depression. From the peak in 1929 to the trough in 1933, GNP in the U.S. fell by a cumulatively greater amount (46%); but during the first three years of the Great Depression, GNP fell only slightly more (26%) than it did in the single year from 1920 to 1921. Not only was 1920-1921 (to use the phrase of the FT Lexicon) a "period of adverse economic conditions": it was, economically speaking, America's single worst interval of the 20th century. Notice, however, that after 1921 GNP rose sharply: from 1921 to 1922 it rose 6.5%; from 1922 to 1923 it soared almost 15%; and thereafter (not shown) it continued to rise strongly. *The Depression of 1920-1921 was the severest in America's 20th century history; it was also the shortest in America's 20th century history.* That latter attribute is perhaps why few Americans remember it.

Figure 3: U.S. GNP (Year 1=100), 1916-1923 and 1928-1935



How did the U.S. Government respond to the Depression of 1920-1921? By drastically slashing both expenditures and revenues, in absolute terms and also as a percentage of GNP; *in other words, it did the diametric opposite of what Keynes recommended in 1937 and what Krugman and others demand today.* Indeed, slashing its taxing and spending, which the First World War had bloated massively, likely triggered – as opposed to caused – the Depression. The preceding "stimulus," in the form of the massive growth of government during the First World War, and the aggressive interventionism of the Federal Reserve, which was formed in 1913, caused the Depression.

Figure 4 shows that the U.S. Government's expenditure skyrocketed from $713 million in 1916 to $18.5 billion in 1919; spending then plummeted to $6.4 billion in 1920, $5.1 billion in 1921, $3.7 billion in 1922 and $3.5 billion in 1923. *That's no typographical error: from the crest of the wave of spending in 1919 to its trough in 1923, the U.S. Government's expenditure plunged 81%.* Revenue followed a similar but less extreme path: it rose from $761 million in 1916 to $6.6 billion in 1920, and then fell steadily to $3.9 billion in 1923. *Also note that from 1920 to 1921, which we saw in Figure 3 was the single worst year in the 20th century, the U.S.*

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10 For a good overview, see Thomas Woods, The Forgotten Depression of 1920 (Mises Daily Article, 27 November 2009).

Government's revenue fell 20% (from $6.4 billion in 1920 to $5.6 billion in 1921); from 1920 to 1923, revenue fell 42%.

Figure 4: Expenditure and Revenue, U.S. Government ($m), 1916-1923

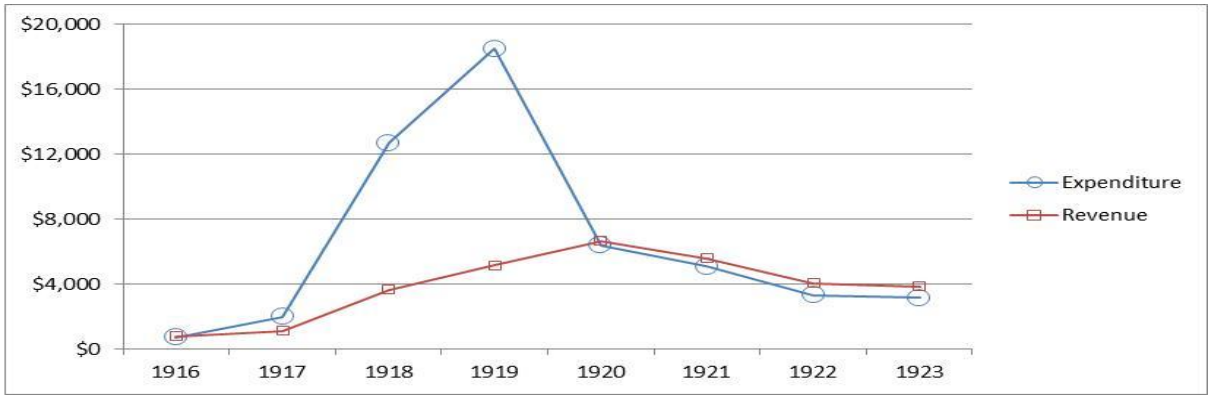
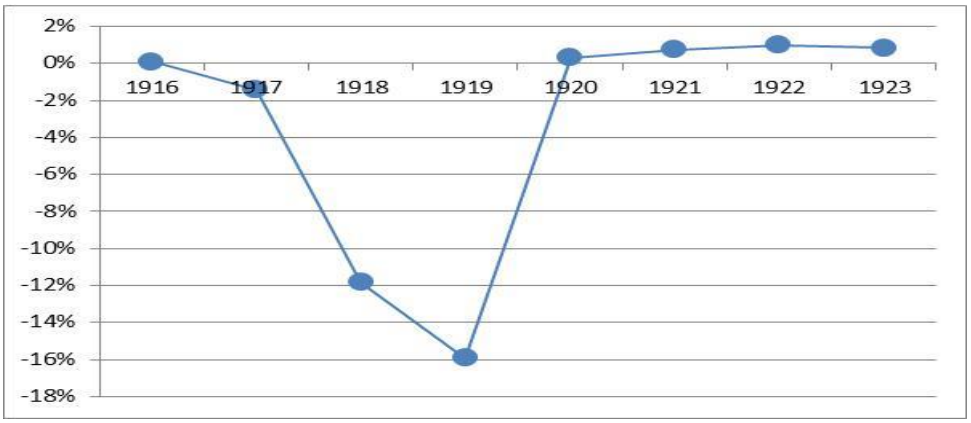


Figure 5 expresses the U.S. Government's surplus/deficit in each of these years as a percentage of GNP during the relevant year. In 1916, the government roughly balanced its budget; in 1917, as America entered the First World War, it ran a huge deficit (ca. 12% of GNP); and in 1919 (the war ended in November 1918, but the spigot took a bit of time to seal), its deficit was even bigger (ca. 16% of GNP). Notice, however, that within a year the government's budget returned to surplus (ca. 0.5% of GNP in 1920), and that for the next three years it remained in surplus. *Notice, too, that during the Depression of 1920-1921 the U.S. Government's budget surplus increased. During the worst year of the 20th century, in other words, the government's pending plunged even more rapidly than its revenue.* This, I think, is why Keynesians utterly ignore the Depression of 1920-1921 and attempt to rationalise it when reprobates bring it to their attention: Keynesians simply cannot explain how the drastic shrinkage of the government's taxing and spending immediately preceded the strongest recovery of the 20th century. What they cannot explain, they ignore or deny.

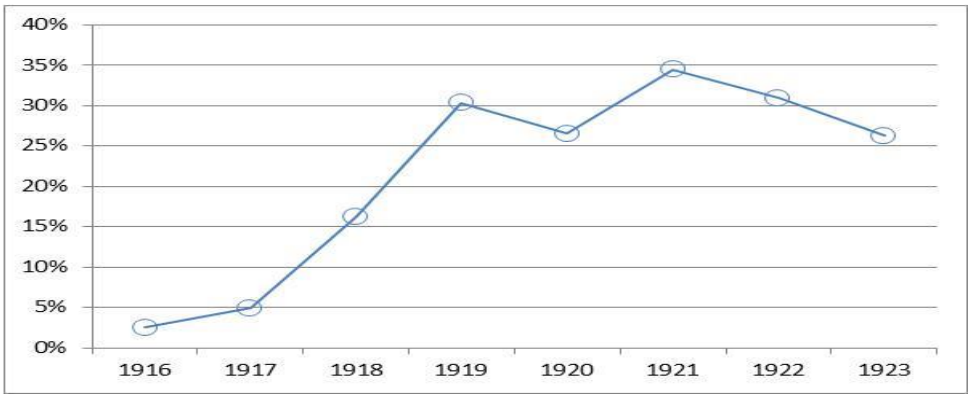
Figure 5: the U.S. Government's Budget Surplus/Deficit, Percentage of GNP, 1916-1923



What did the U.S. Government do with the surpluses it generated after 1920? *It used them to repay some of the debt which had exploded during the First World War.* Figure 6 expresses the U.S. Government's debt during a given year as a percentage of GNP during that year. Admittedly, debt rose between 1920 and 1921. This, presumably, was the final installment

of a longer series: the First World War caused America's debt to balloon from ca. 3% of GNP in 1916 to 35% in 1921. By 1923, however, debt was closer to 25% of GNP – a far cry from the level in 1916, to be sure; equally certainly, it was significantly less in 1923 than it was in 1921.

Figure 6: Ratio of Debt to GNP, U.S. 1916-1923



Let's recapitulate. The Depression of 1920-1921 was, by one key criterion, the severest in modern American history. Yet the recovery in 1921-1923 was the most robust in that country's modern history. How do we explain these facts? *The Austrian School tells us that the genuine austerity of the U.S. Government, which quickly and thoroughly removed many of the distortions, malinvestments, etc., introduced during the war, had much to do with it. The implication is vital: genuine austerity doesn't cause misery: it resolves it. Genuine austerity purges the rottenness of the false boom and thereby sets the stage for genuine recovery. Faux-austerity and Keynesian-style stimulus, on the other hand, cause misery and indefinitely postpone recovery.*

Did a Depression Really Occur in the U.S. in 1920-1921?

Some people reject – emphatically and vociferously – this conclusion. A blog post entitled The U.S. Recession of 1920–1921: Some Austrian Myths (23 October 2010), for example, states: "the U.S. recession of 1920-1921 is endlessly cited by Austrians as proof that Keynesian economic policies are not needed to stimulate an economy out of recession or depression. Unfortunately, Austrians are deeply ignorant about the recession of 1920-1921. This recession was atypical, occurred shortly after the WWI, and recent research shows that the GDP contraction was not especially severe."[11] In particular,

> … recent economic research has shown that the downturn of 1920-1921 was not as severe as previously thought. The widely accepted [by the mainstream, but not by Austrians] definition of a depression is a fall of 10% in output or GDP. In past estimates of the fall in national output, official Commerce Department data suggested that GNP fell 8% between 1919 and 1920 and 7% percent between 1920 and 1921. But Christina Romer has argued that actual

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[11] See also The Depression of 1920–1921: An Austrian Myth (9 December 2011), There Was No U.S. Recovery in 1921 Under Austrian Trade Cycle Theory! (25 June 2011) and Daniel Kuehn, "A Critique of Powell, Woods, and Murphy on the 1920-1921 Depression," *The Review of Austrian Economics*, vol. 24, no. 3, 2011, pp. 273-291.

> decline in real GNP was only about 1% between 1919 and 1920 and 2% between 1920 and 1921 … So in fact real output moved very little, and this was not a depression on the scale of 1929-1933 or previous 19th century depressions. Libertarians cannot claim that 1920-1921 was an example of the free market quickly ending a downturn where output collapsed by 10% or more (a real depression). In reality, GNP contraction was relatively small, and the growth path of output was hardly impeded by the recession.

Two important points comprise this criticism. First, compared to subsequent recessions-depressions in the U.S. (including the Great Depression), the Depression of 1920-1921 was indeed atypical. Second, estimates of the decline of output during these years do indeed vary. In particular, the U.S. Department of Commerce estimates that from 1920 to 1921 it declined 6.9%; Nathan Balke and Robert J. Gordon calculate that it fell 3.5%, and Christina Romer estimates that output decreased 2.4%.

How was this depression atypical? Most notably, severe deflation (in the mainstream sense of the term) – whose cause and consequence *The Evil Princes of Martin Place* devotes an entire chapter to describe and analyse it – occurred very suddenly: in 1920-1921, the Department of Commerce estimates deflation of 18%; Balke and Gordon's estimate is 13% and Romer's is almost 15%. Hence the data in and the interpretation of Figure 3: if between 1920 and 1921 output fell 6.9% and prices fell 18%, then GDP at current prices decreased by 0.931 • 0.82 = 0.763 or 24%. The collapse of wholesale prices was even more severe. These prices, estimates the Department of Commerce, plunged 37% – the most severe decrease in the U.S. since the late 1700s, and worse than any year during the Great Depression (as we've already noted, however, adding together all the years of the Depression yields more severe deflation). The deflation of 1920-1921 was extreme in absolute terms; its extent was also very great relative to the decline of output.[12]

This very feature of the Depression of 1920-1921 should disconcert Keynesians. *For if deflation is so horrible, as they insist, and if there's really such a nasty correlation between deflation and depression, then how on earth do they explain the relatively small decline of output that occurred in 1920-1921?*[13] Recall (see pp. 6-7) that Austrians don't define the depression *mechanistically*, i.e., as a contraction of 10% or more of some aggregate statistic such as GNP or GDP. Instead, they do so *logically*, i.e., as a valid deduction from true premises. As Bettina Bien Greaves wrote in *Mises Made Easier: A Glossary for Ludwig von Mises' Human Action* (Free Market Books; 2nd ed., 1990):

> Depression. In the trade cycle (q.v.), the period of economic readjustment which inevitably follows a boom created by inflation or credit expansion. The

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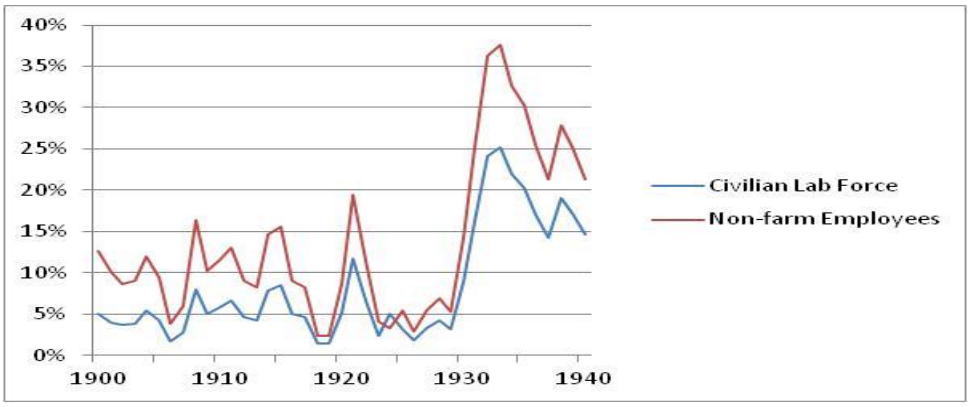
12 See N.S. Balke and R. J. Gordon, "The Estimation of Prewar Gross National Product: Methodology and New Evidence," *Journal of Political Economy*, vol. 97, no. 1, 1989, pp. 38–92; Christina Duckworth Romer, "World War I and the Post-war Depression; A Reinterpretation Based on Alternative Estimates of GNP," *Journal of Monetary Economics*, vol. 22, no. 1, 1988, pp. 91-115; and J.R. Vernon, "The 1920-21 Deflation: The Role of Aggregate Supply," *Economic Inquiry,* Vol. 29, No. 3, 1991, pp. 572-580.

13 "The whole Keynesian policy," writes Henry Hazlitt on p. 229 of *The Failure of the "New Economics:" An Analysis of the Keynesian Fallacies* (Nostrand, 1959), "is a policy of averting, at any cost, deflation of any amount, and courting almost any risk of perpetual inflation in order to maintain perpetual 'full employment.'"

> characteristics of a depression period are greatly reduced business activity, mass unemployment and much human misery. These characteristics continue until the illusions of the boom have been dispelled and economic activity has readjusted to the realities of the existing conditions. Attempts to interfere with free and flexible prices, wage and interest rates prevent recovery and prolong the depression period.

In Misesian terms, did the Depression of 1920-1921 qualify as a depression? Did "greatly reduced business activity, mass unemployment and much human misery" characterise these years? As Russell Napier describes in great detail in *Anatomy of the Bear* (Harriman, 2nd rev. ed., 2009), one of the severest bear markets in U.S. financial history occurred in 1920-1921. Indeed, by one widely-accepted criterion (the so-called Cyclically-Adjusted Price-to-Earnings ratio or CAPE, see also Letter 159-162) in these years the prices of stocks in the U.S. fell to the lowest level in the 20th century. Figure 7, which uses data (series D1) from *Historical Statistics of the United States*, plots the rate of unemployment from 1900 to 1940. It shows that in no two-year period – including the Great Depression – between 1900 and 1940 did unemployment rise more quickly and to a higher level than it did in the Depression of 1920-1921. In 1919-1921, unemployment rose 712%; in 1929-1931, 375%; in 1918-1920, 321%; in 1930-1932, it rose 155%, and so on.

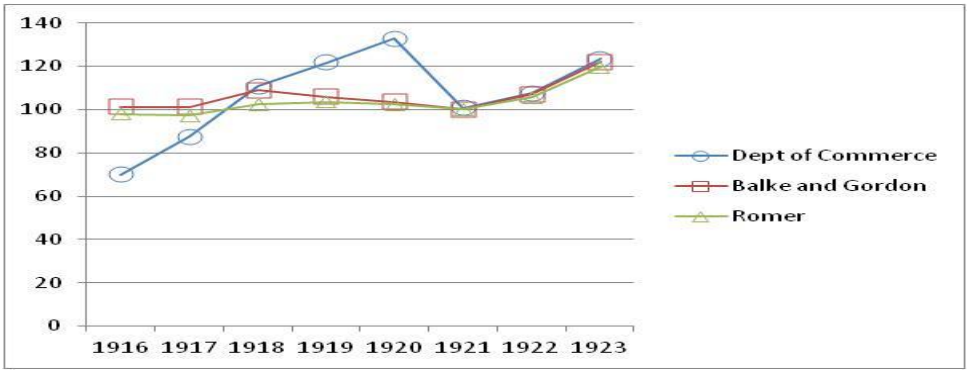
Figure 7: Rate of Unemployment, U.S., 1900-1940



Keynesians may, if they so choose, downplay the severity of the Depression of 1920-1921. But to say, in effect, "there was no depression because our definition of depression is …" overlooks much evidence and ignores uncomfortable questions. Call the events whatever you please; but also acknowledge them – and that Austrians explain them.

Two other undisputed facts should trouble the Keynesians. *First, although some question the extent of the downturn in 1920-1921, nobody gainsays the robustness of the upturn of 1921-1923.* Figure 8 plots GNP data from three sources: (1) the U.S. Department of Commerce (the source of the data in from *Historical Statistics of the United States*), (2) N.S. Balke and R. J. Gordon and (3) Christina Romer. To aid comparison, it standardises each series at the nadir of the Depression (i.e., 1921=100). Each series tells us effectively the same thing: between 1921 and 1923, GDP zoomed by 23% (Department of Commerce), 22% (Balke and Gordon) and 20% (Romer). Regardless of the source of data, that's a compound rate of growth of slightly more than 10% per annum.

Figure 8: Three Estimates of GNP, U.S., 1916-1923 (1921=100)

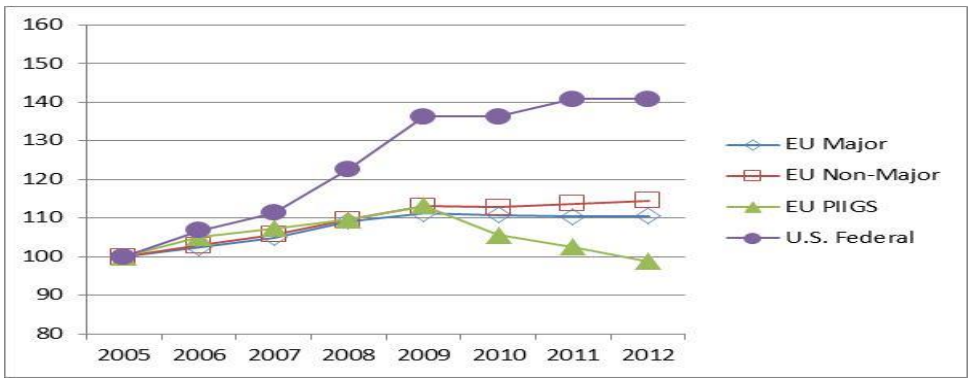


The final point is perhaps most damning. *Not only does nobody contest the robustness of the subsequent upturn: nobody disputes the severity of the antecedent austerity.* Nobody, in other words, has recomputed (or even criticised) the reliability and validity of the budget and debt data summarized in Figures 4-6. Keynesians must thus ponder two critical questions which – for them – admit no answer. First, why did such modest decreases of output – to which they themselves draw our attention – accompany such severe austerity? Secondly, why did such a robust recovery and expansion of output immediately follow such severe austerity? Austrians answer these questions coherently, but Keynesians flounder (see, for example, Blowing Bubbles and the Stagnation Puzzle, *Business Spectator*, 9 January 2014).

The EU and U.S. Since 2005: No Genuine Austerity But Faux Austerity Aplenty

Today, the critics of austerity take it for granted that governments in the EU (particularly the PIIGS) have drastically cut their expenditure. It's also an article of faith among critics that this alleged austerity (which, they maintain, has also occurred in the U.S.) has shrunk if not eviscerated the state. Do the facts support these assumptions? Figure 9 sorts EU member states into three slightly-overlapping categories: (a) major members (Britain, France, Germany, Italy and Spain), PIIGS (Portugal, Ireland, Italy, Greece and Spain) and non-major members (i.e., all others), and expresses overall government expenditure in each category relative to 2005 (=100).

Figure 9: Government Expenditure, EU and U.S., 2005-2013 (2005=100)

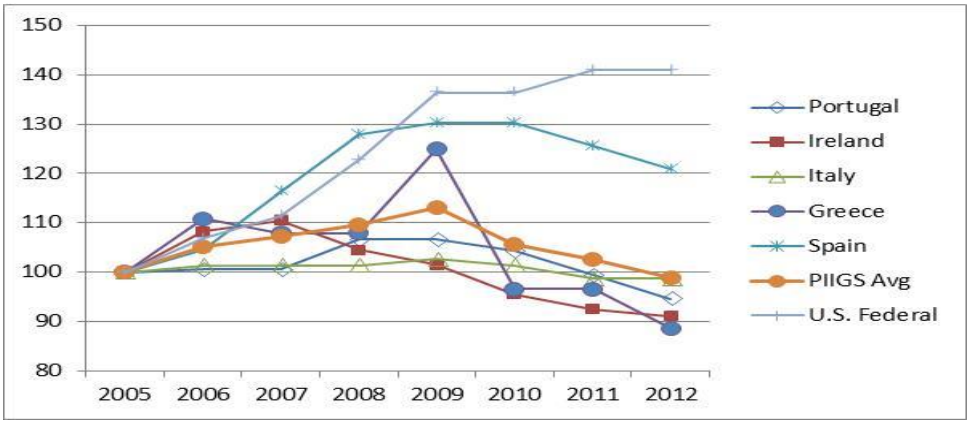


In the U.S., expenditure increased by 40% – that is, at a compound rate of 4.9% per year – between 2005 and 2012. Government expenditure also increased, albeit more slowly,

across the EU from 2005 to 2009. It increased by 12-14% and at a compound rate of 2.8-3.3% per year. In 2009-2012, on the other hand, spending changed little in major member states, increased slightly (by a total of ca. 3% and at a compound rate of 0.6% per year) in non-major states, and fell (by a total of 12% and at a compound rate of 4.4% per year) in the PIIGS.

Figure 10 plots total government expenditure (2005=100) between 2005 and 2012 in Portugal, Ireland, Italy, Greece and Spain. Expenditure rose in 2005-2008. On average in these countries, it rose 10% (i.e., at a compound rate of 3.2% per year) during this interval. It rose 28% in Spain (compound rate of 8.9% per year), between 5-10% in Portugal, Ireland and Greece (compound rate of ca. 2.3-2.5% per year) and changed little in Italy. Conversely, in 2008-2012 expenditure fell. It fell 11% in Portugal (at a compound rate of 3.9% per year), 13% in Ireland (4.4% per year) and 17% in Greece (6.3% per year). Does this more recent shrinkage of government expenditure confirm that these three PIIGS, at least, have endured austerity?

Figure 10: Government Expenditure, PIIGS and U.S., 2005-2012 (2005=100)



No. Figure 11 plots average annual budget deficits (expressed as a percentage of each country's GDP) in the U.S. these three categories of EU member states. Recall *The Financial Times Lexicon*: "… various austerity measures have been *announced* since the global recession in 2008 and the Eurozone crisis in 2009" (italics added). Clearly, however, by and large they haven't been *implemented*. A decrease of the government's budget deficit is one necessary condition of austerity. But it's not a sufficient condition. *Without exception, budget deficits across the EU have been considerably greater since 2009 than they were before 2009. But nobody called these deficits "austere" then; so how can Keynesians do so now?*

It's true that deficits were smaller in 2012 than they were in 2010 and 2011. Specifically, the average deficit in major EU countries was smaller in 2012 (-5.4% of GDP) than it was in 2010 (-7.7%); the average deficit in non-major countries was also less in 2012 (-3.6%) than in 2010 (-6.0%); finally, the deficit in the average deficit in PIIGS nation was smaller in 2012 (-8%) than in 2010 (-11%) and 2011 (-13%). The trouble, of course, is that "stimulus" rules: across the EU, as well as in the U.S., budget deficits remain very large – smaller than at their nadir, but nonetheless far greater than before 2009. Whereas Keynesians decry "austerity" in 2012 vis-à-vis 2010, Austrians see "stimulus" after 2009 vis-à-vis the boom until 2007.

Figure 11: Budget Deficits as a Percentage of GDP, EU and U.S., 2005-2012

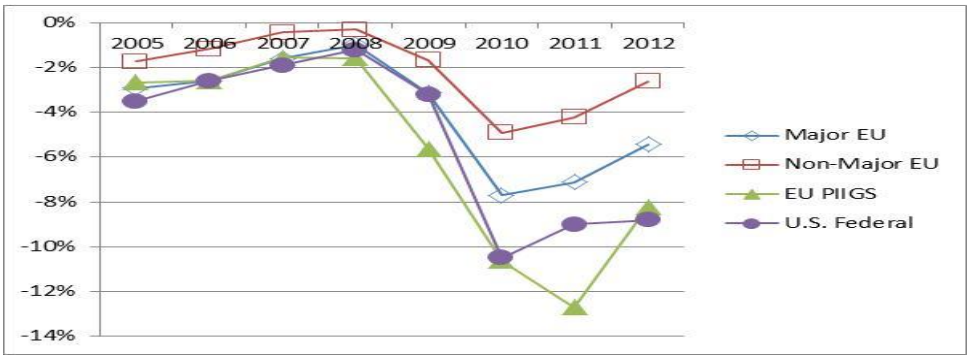
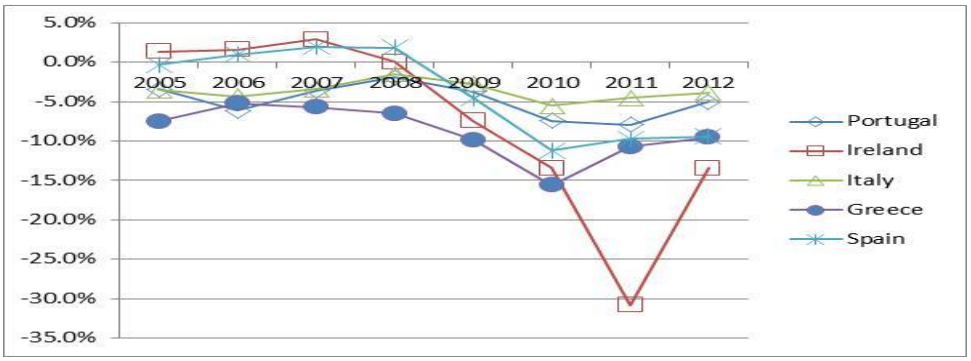
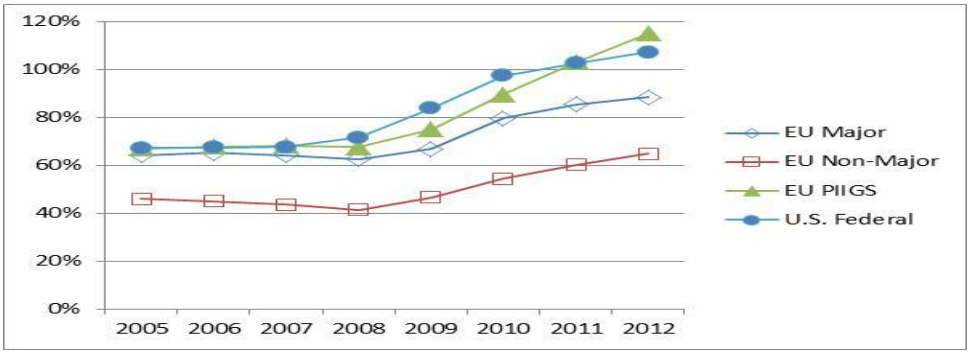


Figure 12: Budget Deficits as a Percentage of GDP, PIIGS Nations, 2005-2012



Not only do Figures 7-12 show no compelling evidence of genuine austerity; they also demonstrate that faux austerity is most prevalent in the U.S. and PIIGS. Although government expenditure in the PIIGS nations fell in 2009-2012 (Figures 9-10), it remains far too high relative to revenues. Accordingly, as their budget deficits have ballooned (Figures 11-12), these governments have been obliged to borrow increasingly heavily – and the PIIGS and U.S. have borrowed most heavily of all (Figure 13). As a result, since 2009 the average PIIGS government's debt as a percentage of GDP has risen from ca. 75% to almost 120%, which is only slightly greater than America's. That's clearly evidence of faux-austerity, i.e., profligacy and an even more bloated state; it's certainly not evidence of genuine austerity and a leaner and fitter state.

Figure 13: Government Debt to GDP (%), EU and U.S., 2005-2012



Why "Recovery," Particularly Among the PIIGS, Has Been So Anaemic

Keynesians in general and Paul Krugman in particular insist that the recovery in the EU and U.S. has been so anaemic because the stimulus and bailouts, etc., in 2007-2009 were too feeble, and because "austerity" (as we've seen, faux austerity is a more accurate description) allegedly replaced Keynesian stimulus. *They're demonstrably and diametrically wrong: recovery has been so feeble not because austerity has been much too severe; it's been so weak because "austerity" has been far too timid.*

Figure 14 combines data from the U.S. in 1916-1923 (Figure 5) and the EU and U.S. in 2005-2012 (Figure 11). *It shows that today's faux-austerity that Krugman and others decry bears no comparison to the genuine austerity that the U.S. Government implemented in the early 1920s. In effect, the welfare-warfare state today weighs almost as heavily today upon the EU and U.S. as the First World War once did upon the U.S. Government.* Whereas the Americans' genuine austerity of the early 1920s quickly and thoroughly returned the U.S. Government's house into some semblance of order, today America's and the PIIGS' finances remain in disarray. Then, genuine austerity created the conditions under which genuine recovery could occur; today, in sharp contrast, faux austerity in the EU and U.S. has begotten a faux-recovery.

Figure 14: Budget Surpluses/Deficits (% of GNP/GDP), 1916-1923 and 2005-2012

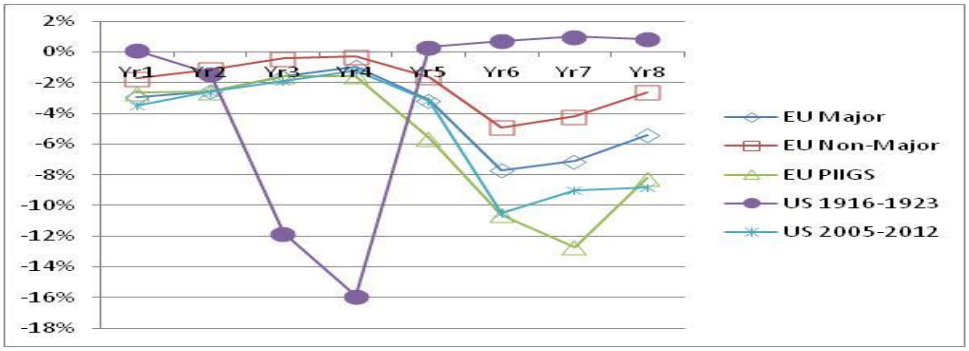


Figure 15: Ratio of Debt to GNP/GDP, 1916-1923 and 2005-2012

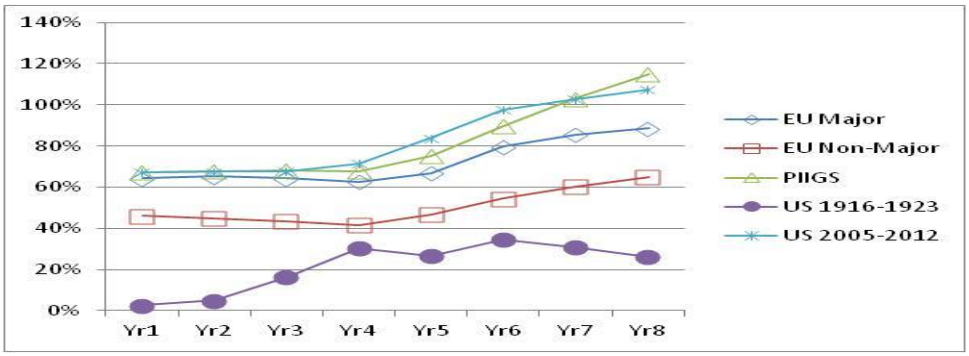


Figure 15 combines data from the U.S. in 1916-1923 (Figure 6) and from the EU and U.S. in 2005-2012 (Figure 12). In the early 1920s, the U.S. Government implemented genuine austerity; as a result, its debt (expressed as a percentage of GNP) fell significant-

ly. By today's lax standards, in the 1920s the U.S. Government was astonishingly trim; accordingly, it didn't block the road to economic recovery. In sharp contrast, today in the EU and U.S., debt continues to gallop relentlessly upwards; as a result, bloated governments' profligacy has "crowded out" private recovery.

It "Simply Can't Happen" in Australia – Or Can It?

During the past several years, I've heard it and read it countless times: what's occurred in the EU and in the U.S. in 2007-2009 "simply can't happen" in Australia. Why not? Several reasons, the mainstream confidently asserts. One of the major ones is that banking and prudential regulation has allegedly long been better in Australia than it was in the EU and U.S. Proponents of this view can't specify how and why the Australian Prudential Regulation Authority knows more or does its job better than (say) the Financial Services Authority in Britain; they simply insist that it does. Another reason why it can't happen here, say the Oz-boosters, is that Australian banks have allegedly been much more prudent lenders than their counterparts in the EU and U.S. Most notably, they repeatedly insisted in 2007-2009 that Australian banks eschewed "low-doc" mortgages (since then it's emerged that this claim, by and large, wasn't true). Hence Australian prudential regulators and the Big Four banks, their boosters come close to boasting, are world-beaters. What's more, the Commonwealth's debt-to-GDP ratio – a key measure of its allegedly prudent stewardship of the country's finances – gives it the "firepower" to combat and counteract any inclement financial and economic conditions that might arise.

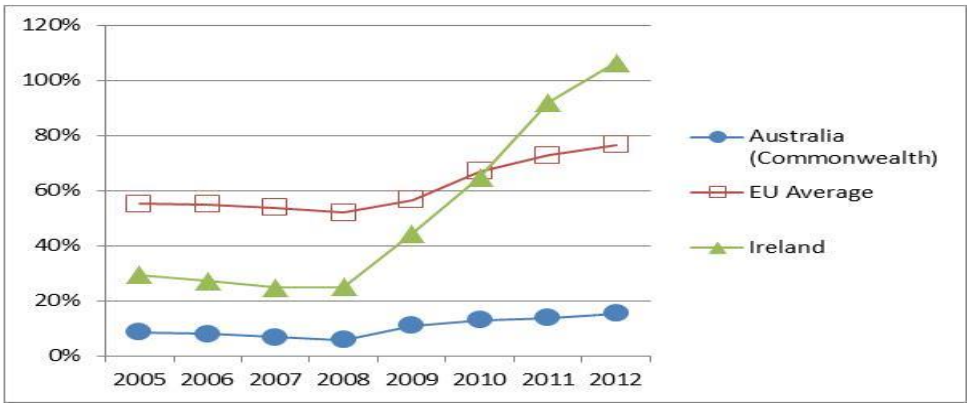
I'm not nearly so sanguine. Why not? Several reasons. One of the major ones is that if you carefully peruse the Irish mainstream media of the period 2003-2007 then – as in Oz today – you'll find very few negative references to and assessments of that country's prudential regulator. You'll also encounter next to no criticism of Ireland's banks: in particular, you'll uncover no concern that they were lending themselves and the country into misery. More generally, the press and "expert" opinion – not just in Ireland, but outside the country, too – praised its banks not least because they had become so big. How big? Big enough to feed the increasingly voracious "Celtic Tiger." Accordingly, you'll encounter plenty of denial in and after 2007. Patrick Neary, chief executive of the Financial Regulator, for example, famously told *The Irish Times* (14 October 2008): "Ireland's banks are solvent and will be able to offset potential losses on property loans with their better-performing loans." On 16 January 2009, the Taoiseach (Prime Minister), Brian Cowen, proclaimed "business as usual" at Anglo Irish Bank, and that people "should be reassured that the bank is solvent." And on 24 March 2010, Willie McAteer, the executive director of AIB, told the Finance Committee of the Irish Parliament:

> … We have a strong belief that we have significant and sufficient capital to meet even worse scenarios than we envisage. If bad debts and the economy get worse, we believe we are sufficiently capitalised. … I reject the suggestion that banks have been foolhardy in recklessly lending and driving up values. We are in competition right across the board and I cannot think of a bank that has been reckless. … Every loan goes through a central credit committee and is properly underwritten.

As I detailed in *The Evil Princes of Marin Place*, fractional-reserve banks are the Achilles Heel of any economy and financial system. What happens when the inherent bankruptcy of fractional-reserve banks finally becomes apparent? The government rescues them. What's a major consequence of a government's rescue of its major banks? The government's debt as a percentage of GDP skyrockets.

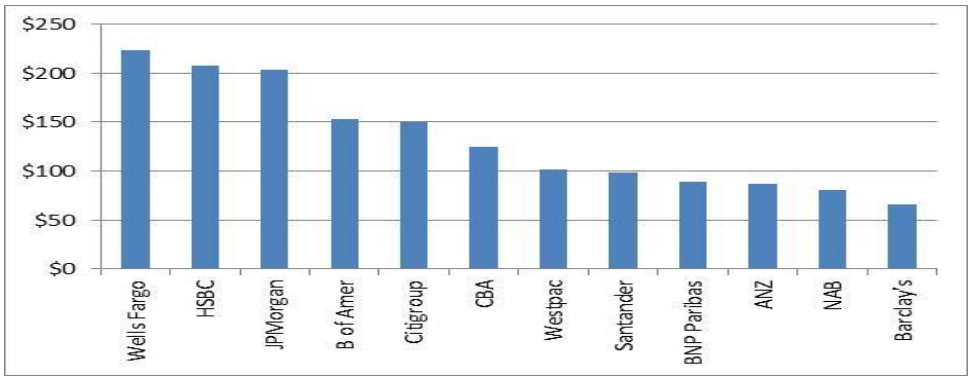
Figure 16 compares the Commonwealth Government's to the Irish government's ratio of debt to GDP. In 2005-2008, although it wasn't as low as Australia's (this measure excludes state governments' debts), Ireland's ratio was considerably lower than the EU average. Since 2008, however, Ireland's ratio has ballooned. By 2010 it equalled the EU average and thereafter exceeded it by a wide margin. Why has Ireland's ratio of government debt to GDP increased so enormously? More than anything, it (and the EU) financed massive bail-outs of the country's banks.

Figure 16: Government Debt (% of GDP), Australia and Ireland, 2005-2012



Relative to the size of the Irish economy before 2007, Irish banks became very large (ca. 10% of GDP). How big are Australia's banks today? Figure 17 plots the market capitalisations of the four biggest banks in Australia (i.e., Australia and New Zealand Banking Group, Commonwealth Bank of Australia, National Australia Banking and Westpac Banking Group), the EU (i.e., HSBC, Santander, BNP Paribas and Barclay's) and the U.S. (i.e., Wells Fargo, JPMorgan Chase, Bank of America and Citigroup).

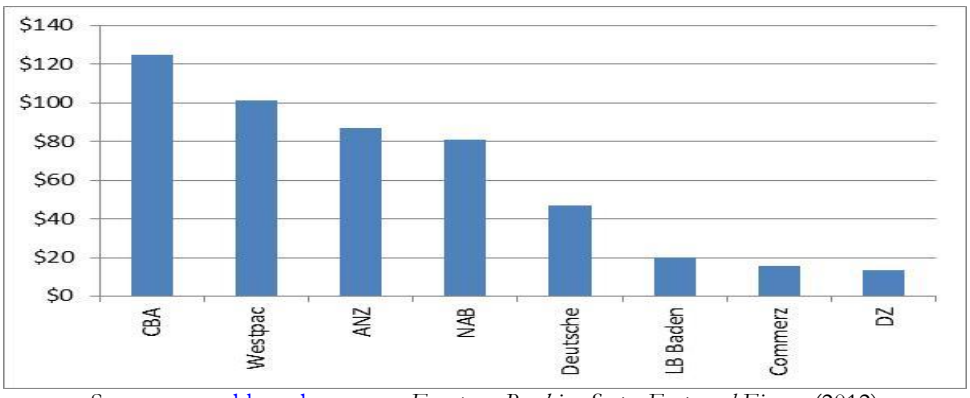
Figure 17: Market Capitalisation (Billions of $US) of the Four Biggest Banks in Australia, the EU and the U.S. (15 November 2013)



Source: www.bloomberg.com

How big are Australian banks? On average, their market capitalisation on 15 November 2013 was $US99 billion; the four biggest banks in the EU averaged $US115 billion and the four biggest banks in the U.S. averaged $US182 billion. *Australia's "Big Four" are among the world's biggest:* ranked according to market capitalisation, CBA is the world's tenth largest; Westpac ranks 11th, ANZ 13th and NAB 15th. Only one other country with a population less than 100 million (Canada) "boasts" banks in the world's top 20. Moreover, Canada's population is ca. 32 million versus Australia's ca. 23 million; and only two Canadian banks (Royal Bank of Canada, market cap of $US 87.2 billion; and Toronto-Dominion Bank, $US 75.7 billion) rank within the world's top-twenty (see also Morbidly Obese Australian Banks, 18 November 2013).[14]

Figure 18: Market Capitalisation (Billions of $US) of the Four Biggest Banks in Australia and Germany (15 November 2013)



Source: www.bloomberg.com, *European Banking Sector Facts and Figures* (2012)

How big are Australia's banks? Figure 18 compares the market cap of Australia's "Big Four" to the market caps of the four biggest banks in Germany (it applies the average ratio of share price to equity of Deutsche Bank and Commerzbank to the unlisted Landesbank Baden-Württemberg and DZ). By Australian standards, Germany's banks are very small. Germany's biggest bank, Deutsche Bank, has a market capitalisation of $US 47 billion. That's only 40% of the Commonwealth Bank of Australia. *The total imputed capitalisation of Germany's four biggest banks is ca. $US 90 billion – which is less than one-quarter of the combined market cap of Australia's Big Four. Indeed, the market cap of the Commonwealth Bank alone is bigger than the imputed market cap of Germany's ten largest banks.*

Oz-boosters might well object: today, the market capitalisation of the German banking system is much smaller than that of its Australian counterpart because it shrunk drastically during the GFC. From its peak in 2007 until 15 November 2013, for example, the price of Commerzbank's stock plummeted more than 95%. That's precisely my point: fractional-reserve banks seemingly prosper massively until they suddenly collapse (or the state rescues them from collapse). *Hence the uncomfortable question: is it appropriate – and safe – that a country of ca. 23 million should have a much bigger banking system than a country of ca. 80 million?*

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14 Three other big Canadian banks lurk in the world's top 50 by market cap: Bank of Nova Scotia ($US 73.9 billion on 15 November 2013), Bank of Montreal ($US 44.7 billion) and Canadian Imperial Bank of Commerce ($US 34.4 billion).

"The performance of Australia's banking sector," reported *The Australian* (BIS Warns Australia's Finance Sector Is too Big for Our Economy, 20 August 2012), "is seen by world investors and our own authorities as one of the great sources of our economic strength since the global financial crisis. However, research by the Bank for International Settlements suggests the dominance of Australia's finance industry contains the seeds of economic vulnerability." It continued:

> … according to BIS chief economist Stephen Cecchetti, "experience shows that a growing financial system is great for a while – until it isn't," he told the BIS annual conference in Switzerland, arguing there is an optimal size beyond which the financial industry drags down the rest of the economy.
>
> Australia's finance sector is larger than BIS recommends on the metrics it has developed. Its studies, based on analysis of the banking systems of 22 countries, including Australia, over a 30-year period, show *the finance sector starts subtracting from growth when it accounts for more than 6.5% of value added and more than 3.2% of employment. In Australia, the finance sector accounts for 11.5 % of all industry value added, having doubled its share of the economy since the mid-1980s. This compares with the 2008 peak of 7.7% in the US and 10.4% in Ireland* [italics added].
>
> Cecchetti contends that excessive growth in the finance sector leads to disruptive indebtedness, delivering poor economic returns … Rapid growth in the finance sector is associated with lower levels of national productivity. "Instead of supplying the oxygen that the real economy needs for healthy growth, it sucks the air out of the system and starts to slowly suffocate it," he says. "Households and firms end up with too much debt and valuable resources are wasted." The extraordinary dimensions of Australia's banking sector were highlighted by Bank of America Merrill Lynch research … showing that Australia has the second-largest banking system in the world by market capitalisation, surpassing those of the Eurozone, Japan, Britain and China.

The article's author, David Uren, concluded: "It is absurd for a nation of 22 million to have a banking sector that represents more than 8% of the world banking industry by market value. Banking now represents just under half Australia's listed market."

A banking crisis *did* afflict Australia in September-October 2008.[15] *When* – and not if – another one returns, the resultant bailout of the country's massive (relative to the size of

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[15] Professor Ross Garnaut is a respected academic economist, policymaker and company director. He's not just mainstream: he's a pillar of the establishment On 12 October 2009, during an interview on ABC TV's *The 7:30 Report*, came this revealing exchange:

> Kerry O'Brien: "You have said [*The Great Crash of 2008*, Melbourne University Press, 2009, p. 140] that, in fact, the big Australian banks were essentially insolvent at the time of the crash – in what way?"
>
> Professor Ross Garnaut: "They were starting to have great difficulty in rolling over their huge external debt, and without the Government guarantee on wholesale borrowing, they may not have been able to fund their liabilities, and you can go – you can be insolvent for two types of reasons, one: you get yourself into trouble with the way you've managed your debt and you can't roll over your debt as it becomes due, or

its economy) banking system will cause Australia's debt-to-GDP ratio to soar. It will thereby, I believe – as it did in Ireland – render some form of austerity a necessity.

Three Conclusions

Never mind Paul Krugman and other Keynesians: at no time since 2005 have governments in the EU or U.S. implemented genuine austerity. Instead, they've championed faux austerity. Accordingly, their "recoveries" from the economic and financial crisis are feeble and artificial; moreover, and for this very reason, like Australia they remain vulnerable to renewed economic and financial crisis.

Today, "Austerity" Is Everywhere Except in the Statistics

A researcher at the German Institute for Economic Research, Georg Erber (The Austerity Paradox: I See Austerity Everywhere, But Not in the Statistics, 28 February 2013), has examined in much greater detail than I have the EU's official statistics. Erber writes:

> … taking a close look at the actual statistics available from Eurostat on the PIIGS-countries plus Cyprus, one finds little empirical evidence that the governments there [or in the EU more generally] have *de facto* reduced their total public expenditures. This is in stark contrast to the current austerity debate, which seemingly implicitly assumes that austerity has occurred over the past couple of years since the global Great Economic Crisis broke out in 2008.
>
> The PIIGS remind me of the patient whose doctor orders him to lose weight by eating less. The patient responds by doubling his calorie intake. He later cuts back by ten percent and wonders why he is not losing weight. The PIIGS went on a spending binge from which they do not want to retreat. They then blame their problems on austerity and the lack of charity of others.
>
> So much for the scourge of austerity in … Europe. The facts show it simply does not exist. Instead of "where's the beef?" we should ask "where's the austerity?" Perhaps economist [Paul] Krugman can find it. But first I would advise him and others like him to consult some facts before they pontificate.

Adam Creighton agrees. In Nothing Austere about Europe's Fiscal Policies (*The Weekend Australian*, 11-12 May 2013), he writes:

> If thought corrupts language, language can also corrupt thought. A bad usage can spread by tradition and imitation even among people who should and do know better. In 1946 George Orwell famously pointed out how politics degraded and abused the English language for the sake of political ends. The same is true in economics. The word austerity, used to describe European and

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you run into trouble with the value of your assets. The rest of the world's problems, Europe and American's [sic] problems were problems with their bad assets, our problems were the problems of excessive reliance on a source of debt that turned out not to be reliable …"

> even U.S. fiscal policy, has been a clever ruse by opponents of measures that may cause any reduction in the size of government.
>
> No objective, sane person could describe, in a relative or absolute sense, fiscal policy in Europe or the U.S. as austere, a word stemming from the Greek meaning harsh or severe. … Government budget deficits in Europe are still up to twice as large as they were before the GFC … and are contributing to already vast public debt burdens. Far from the "savage cuts" of [former Treasurer] Wayne Swan's imagination, European governments have reduced only the rate of growth of public spending. … Yet "mindless austerity" has become a favourite phrase [since former Treasurer Wayne Swan] dumped his promise to restore the budget to surplus … [Swan] is trying to convince Australians that cutting public spending would undermine "jobs and growth." Whatever is undermining jobs and growth in Europe, it is likelier to be a bizarre fondness for bad economics than spending cuts.

Creighton quotes Alberto Alesina, a professor of economics at Harvard University:

> [There is] vast evidence showing spending cuts are much less economically costly than tax increases to restore budgets to surplus … Lower spending reduces the expectation of higher taxes in the future, with positive effects on … investors. … Most countries in Europe are actually raising taxes and not cutting expenses; what happens in practice is typically quite different from what is announced (see also Adam Creighton, Economists Attack Wayne Swan on Austerity, *The Weekend Australian*, 11-12 May 2013).

Keynes Was and Krugman Is Wrong – and the Austrians Have Been Correct All Along

"The boom, not the slump, is the right time for austerity at the Treasury," John Maynard Keynes asserted in 1937. That's not just demonstrably incorrect: it's diametrically wrong. One of the greatest slumps of the 20th century occurred in 1920-1921. The Depression of 1920-1921 was the shortest in America's 20th century history – and the recovery from that depression was the most robust in its modern history – precisely because the U.S. Government followed the polar opposite – and correct – path. It demonstrated that the bust is a correct time for genuine austerity. Krugman, too, is utterly wrong. The truth is that *any* time, boom or bust, is the right time for the state to adopt frugality and the wrong time to embrace extravagance.

Martin Masse (Is "Austerity" Responsible for the Crisis in Europe? Mises Daily Article, 11 June 2013) adds two important points. The U.S. Government, as well as governments in almost all member nations of the EU, are now much larger than they were in 2007. First, then, if (like *The Financial Times Lexicon*) we define austerity as measures undertaken which reduce the government's budget deficit, then faux austerity has clearly deepened the crisis. And second, if we define genuine austerity as policies which reduce the size of government, then Krugman and other Keynesians – if they are honest – must exonerate genuine austerity from all blame. *Genuine austerity hasn't deepened the crisis because since 2007 it has never been applied.* "Unfortunately," Masse concludes, "confusion over the meaning of

austerity impedes a better understanding of the situation and precludes a more relevant debate over the causes of and solution to the crisis." He continues:

> Keynesians … regret that even larger increases of government borrowing and deficit spending [haven't] occurred. These things, which certainly have marked the state's finances during the past few years, have been implemented in order to "stimulate" the economy. But, from an Austrian perspective, bloated governments and higher taxes help to explain why, several years after the financial crisis, American and European economies are still in the doldrums.

Genuine Austerity Quickly Heals – But Faux Austerity Extends – Misery

How to respond to claims such as Why Austerity Kills: From Greece to U.S., Crippling Economic Policies Causing Global Health Crisis (*Democracy Now!* 21 May 2013)? The Depression of 1920-1921 demonstrates conclusively that genuine austerity doesn't cause extended misery. Quite the contrary: it rapidly removes it. Genuine austerity sets the stage for genuine recovery. Faux-austerity, on the other hand, bastardises and corrupts recovery and thereby broadens, deepens and lengthens misery. "I favour the policy of economy," Calvin Coolidge sagely declared in his Inaugural Address,

> not because I wish to save money, but because I wish to save people. The men and women of this country who toil are the ones who bear the cost of government. Every dollar we carelessly waste means that their life will be so much the more meagre. Every dollar that we prudently save means that their life will be so much the more abundant. Economy is idealism in its most practical form.

According to the 2014 Index of Economic Freedom, the U.S. no longer ranks among the world's top 10 economically free countries. Hong Kong and Singapore continue to dominate the list, followed (at some distance) by Australia, Switzerland, New Zealand and Canada. These six – and no others – earn the index's "economically free" designation. In recent years Britain (#14) and the U.S. (#12) have – as a result, says the Index's compiler, of large reductions of property rights and increases of corruption and government spending – lost the most ground. Indeed, the U.S.'s ranking has fallen continuously for the past seven years. *Britain and the U.S. have descended into the "mostly free" category: as a result, they're neither "leading" nor "free" nations.* Not just for material reasons, but more importantly on moral grounds, they – and virtually all other countries, not least in the EU, some of whose members are becoming less unfree but none are properly free – desperately need drastically smaller governments and dramatically freer people. Rulers around the world must not just slash taxing, spending and borrowing, but also abolish shelves of legislation and entire departments, and resolutely deregulate capital and labour. These austere measures will encourage diligent saving, prudent investment and bold entrepreneurship. These actions – and not more reckless taxing, spending, borrowing, legislating and regulating – will set a sound foundation for genuine prosperity.

Chris Leithner