The Austerity Trap

& How to Exit It
Without Exiting the euro

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Five Key Perspectives

- The Ultimate Design Flaw of the Eurozone – The Fatal Conceit of Neoliberalism
- The (Calculated?) Misdiagnosis of the Crisis
- The Myth of Expansionary Fiscal Consolidations
- Using a Coherent Macroeconomics to Reveal the Austerity Trap
- Three Modest Proposals to Exit Austerity (w/o Exiting the Euro)

Many Design Flaws of the Eurozone

- Not an Optimal Currency Area: Different Responses to Shocks
- One Size Fits All Monetary Policy
- Economic Union Without Political Union
- Weak (& Contradictory) Mechanism to Adjust Trade Imbalances
- Competitive Depreciations Replaced by Competitive Deflations
- Constrained Fiscal Policy, User (Not Issuer) of Currency

The Ultimate Design Flaw of the Eurozone

- The Fatal Conceit of Neoliberal Economics (With Insincere Apologies to von Hayek)
- Changes in Relative Prices Will Always Guide Economies Back Toward Full Employment Growth Paths
- Hence, We Must Reduce or Restrict Available Policy Tools – No FX Control, Diluted Monetary Policy Influence, Restrict Fiscal Stimulus for Each Country – to Minimize Rel. Px Distortions

The Ultimate Design Flaw of the Eurozone

- Irving Fisher, JM Keynes, Hy Minsky Proved Theoretically Why Price Adjustments Can Lead Economies **AWAY** From Full Employment
- The Price Signals Leading to Full Employment Growth are Weak, Unreliable, and Bounded (Keynes' Uncertainty, Ch. 12 GT Asset Price Critique, Zero Nominal Yield & Prior Liquidity Preference Bound)
- Worse Yet, Downward Price Adjustments in Economies with High Private Debt Loads Can Lead to a Self Reinforcing Debt Deflation Vortex of Falling Asset Prices and Incomes, Thereby Threatening Social Disintegration
- History (Painfully, but Obviously and Repeatedly) Concurs

The Calculated Misdiagnosis of the Crisis

- Neoliberals Blamed GFC on Fiscal Deficits & Public Debt Profligacy
- In Fact, Prior to 2007-8, the Largest Deficit Spending was Evident in Eurozone Households & Firms: Also Highest Debt/Income Ratios, Largest Increase
- The Unusual Depth of the Economic Contraction had Everything to Do with the Private Sector Spending & Borrowing Retrenchment: Koo's BS Recession
- Large Fiscal Deficits Were Largely a Passive Response to Falling Private Spending and Failing Private Debt – An Outcome more than a Cause of the GFC
- Policy Makers and Investors Display Asymmetric Response to Private & Public Sector Deficit Spending – In Part Because of the Fatal Conceit of Neoliberalism

The Prevailing (Now Faded) Myth of Expansionary Fiscal Consolidations

- Economic Growth with Fiscal Consolidation is Indeed Possible
- But Only Under Very Special Conditions (Forgot to Mention That?)
- Interest Rates Must Fall Dramatically Enough to Drive Up Private Spending on Capital Goods, Housing, and Durable Consumer Goods
- Exchange Rate Must Fall Dramatically Enough to Drive Up Export Sales and Reduce Imports (Works Best for Small Open Economies)
- Yet Neither Interest Rates or Exchange Rate Decisions are Under Direct Influence of Individual Eurozone Nations: EFC Not Applicable to Eurozone

The Austerity Trap

- Increases in Taxes and Cuts in Government Spending Reduce Business & Household Income Flows
- Private Sector Less Able to Service Debt, Bank Loan Losses Rise (and Socialized)
- Private Sector Reduces Spending Out of Income Flows, Cuts Leverage
- GDP Growth Falls (or Worse Yet, GDP Levels Drop)
- Tax Revenues Come Up Short, Expenditures Cuts Come Up Light
- Fiscal Targets are Missed, as are Public Debt/GDP Targets, Debt is Downgraded
- Higher Taxes and More Government Spending Cuts are Required - Repeat

A Coherent Stock/Flow Macroeconomics

The Financial Balance Approach

Divide the economy into three sectors:
Government: (GFB)
Foreign: (FFB, or inverse of Current Account Balance, -CUB)
Domestic Private: (Household and Business or DPSFB)

Sector Financial Balance: SFB = Y – E for that sector
(or equivalently, S – I)

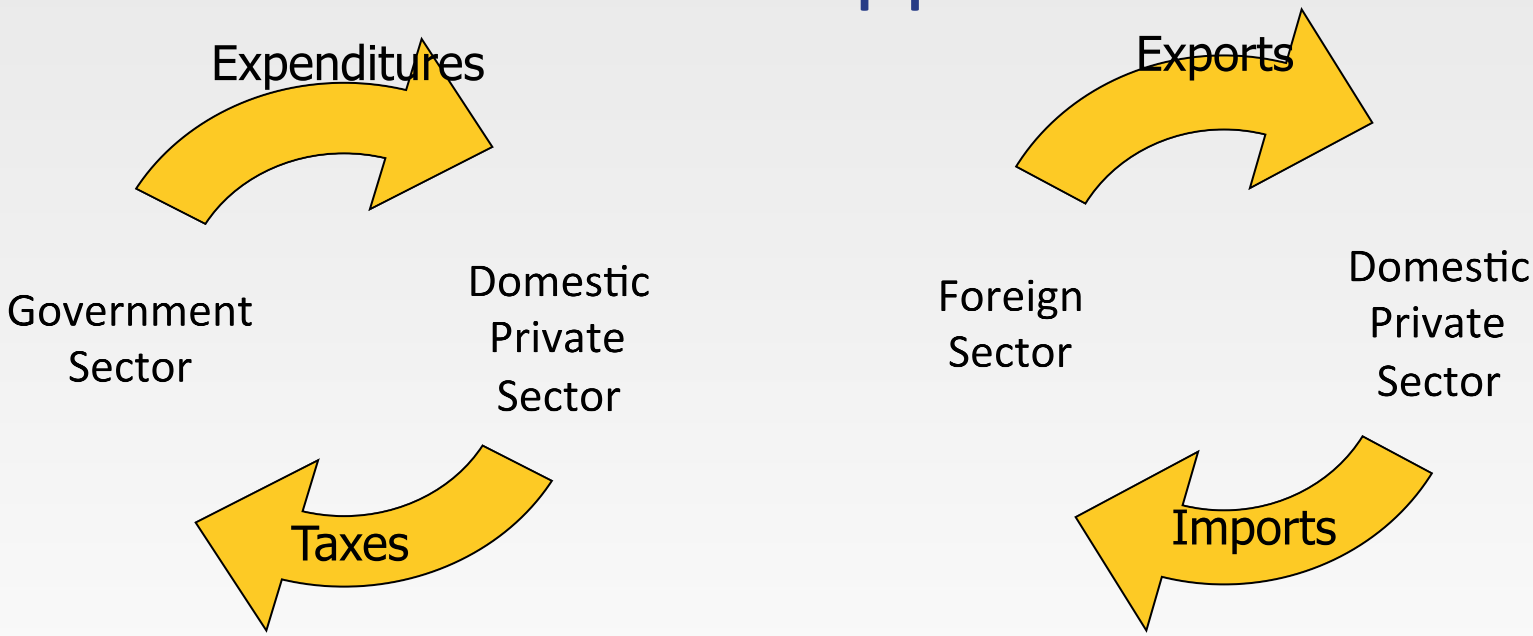
Any One Sector Financial Balance can be in:

Surplus:	$Y > E$, $S > I$	Accumulate financial assets, pay down debt
Neutral:	$Y = E$, $S = I$	No change in balance sheet positions
Deficit:	$Y < E$, $S < I$	Issue financial liabilities, sell assets

Using a Coherent Macroeconomics to Understand the Austerity Trap

- Neoliberals do not have a coherent stock/flow coherent macroeconomics: Godley, Minsky, & Keynes do; and Levy Scholars are developing SFC models
- Instead, Neolibs are monomaniacally obsessed with the government financial balance, and ignoring how that influences other sectoral balances
- In other words, ignoring 7 centuries of double entry book keeping
- Government cannot reduce its deficit unless other sectors are willing and able to reduce their net saving position
- An indebted private sector, and export led trade partners, won't comply

The Financial Balance Approach



Changing the FB for one sector has implications for the remaining ones

Sector balances <u>cannot</u> be analyzed in isolation – it all has to add up

The Financial Balance Approach

Domestic Private Sector Financial Balance is Positive when:
Government runs a deficit
Current account in surplus
CUB > GFB

DPSFB is Negative (and financial instability increases) when:
Government runs a surplus
Current account in deficit
CUB < GFB

DPSFB + GFB – CUB = 0
DPSFB = CUB – GFB

The Financial Balance Approach

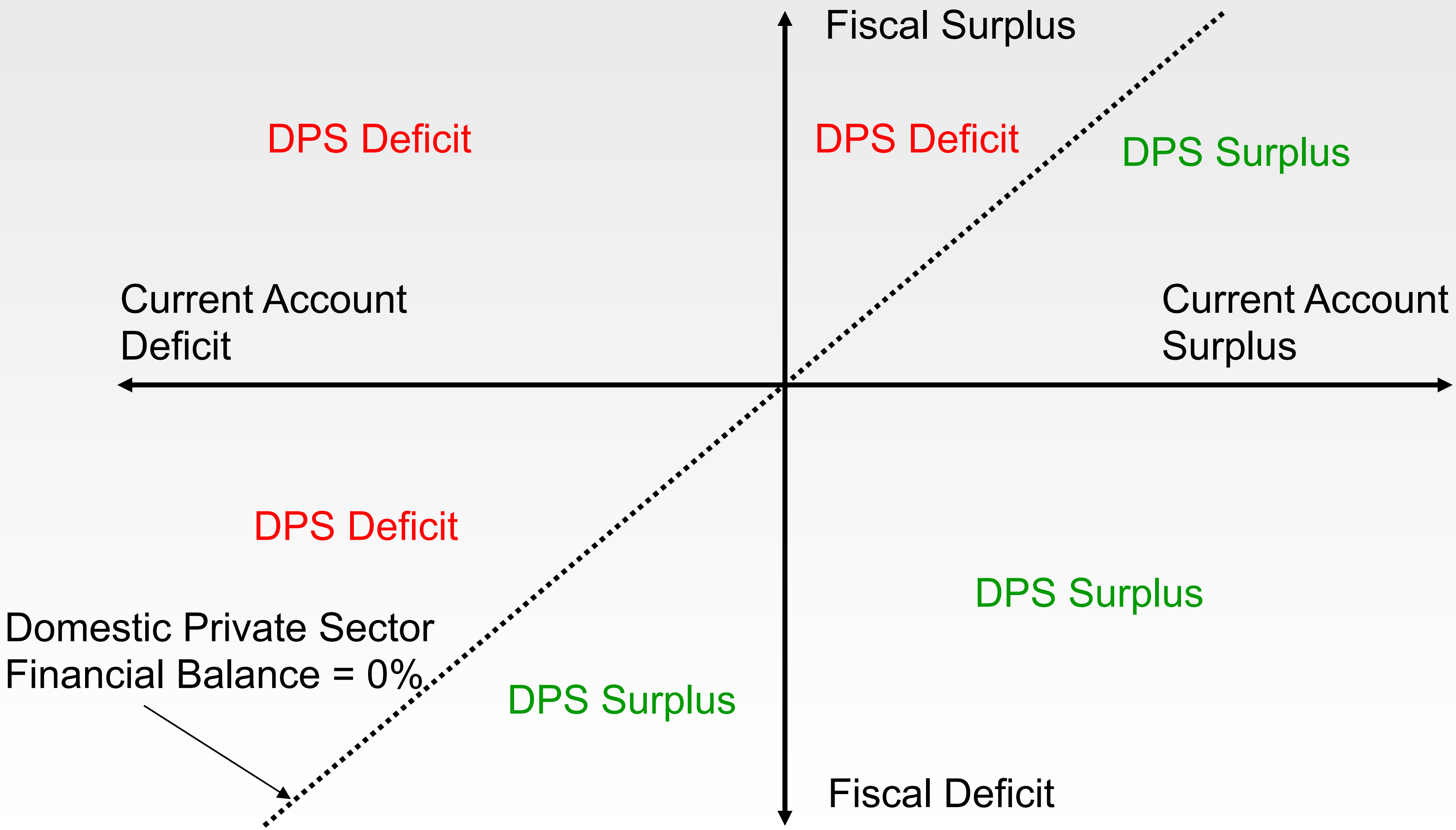
In order for a nation to run a Government surplus

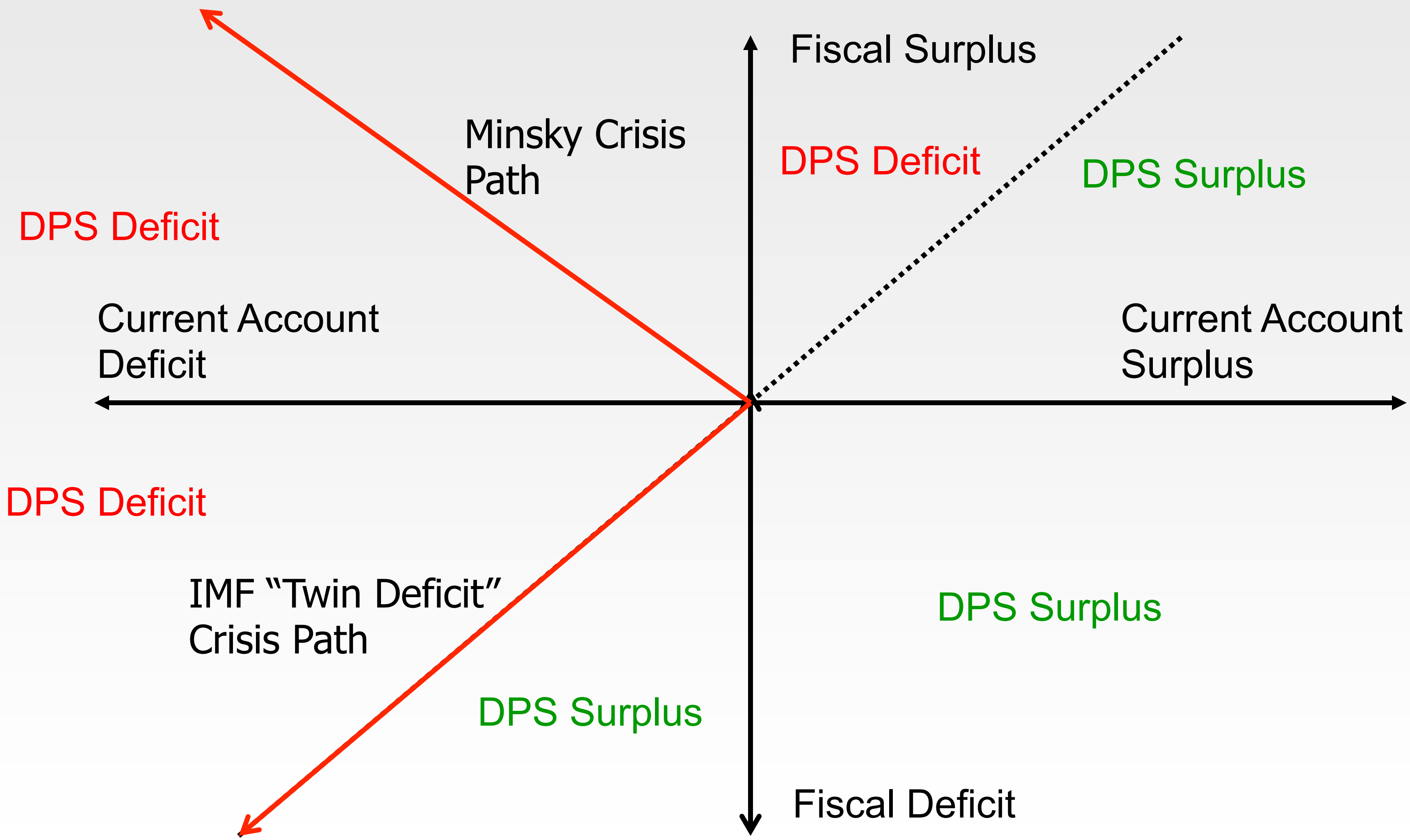
And a Domestic Private Sector financial surplus

So that both sectors can service and reduce debt (deleverage)

You need a current account surplus > government surplus

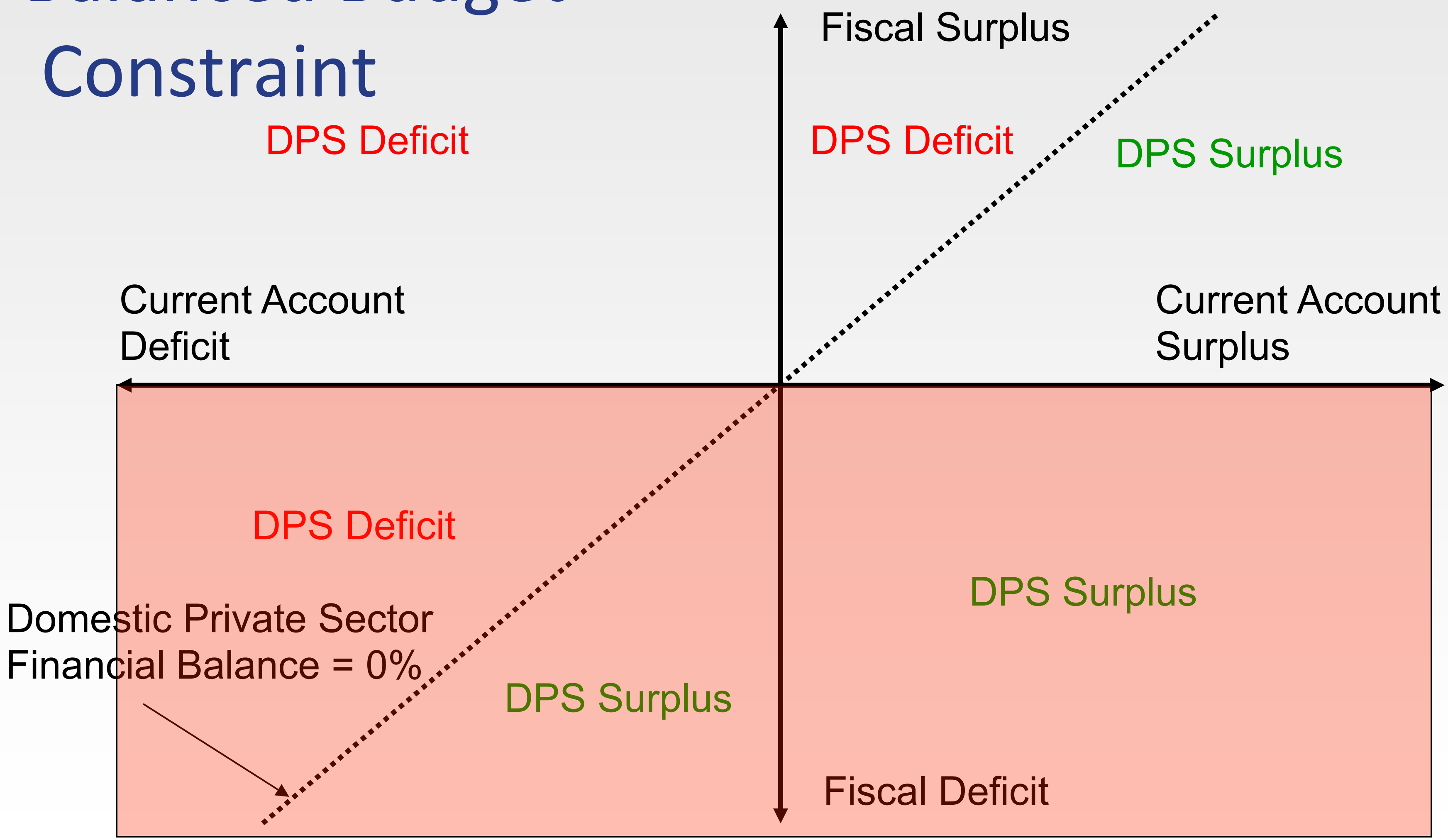
Reducing a fiscal deficit will erode the DPSFB
Unless the CUB increases in the same exact amount as the GFB


Fiscal Surplus
DPS Deficit
DPS Deficit
DPS Surplus
Current Account Deficit
Current Account Surplus
DPS Deficit
DPS Surplus
Domestic Private Sector Financial Balance = 0%
DPS Surplus
Fiscal Deficit

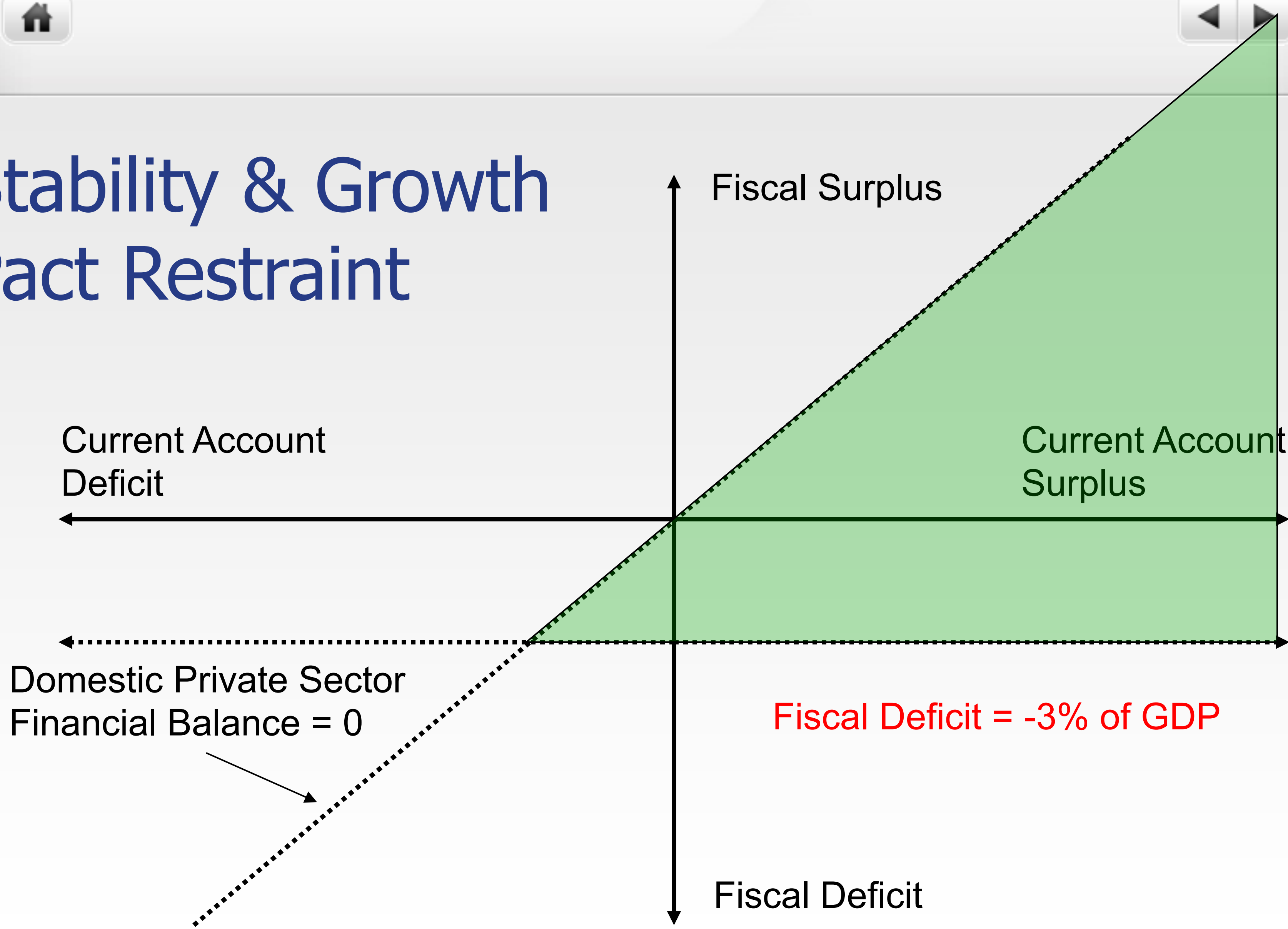


Fiscal Surplus
Minsky Crisis Path
DPS Deficit
DPS Surplus
DPS Deficit
Current Account Deficit
Current Account Surplus
DPS Deficit
IMF "Twin Deficit" Crisis Path
DPS Surplus
DPS Surplus
Fiscal Deficit

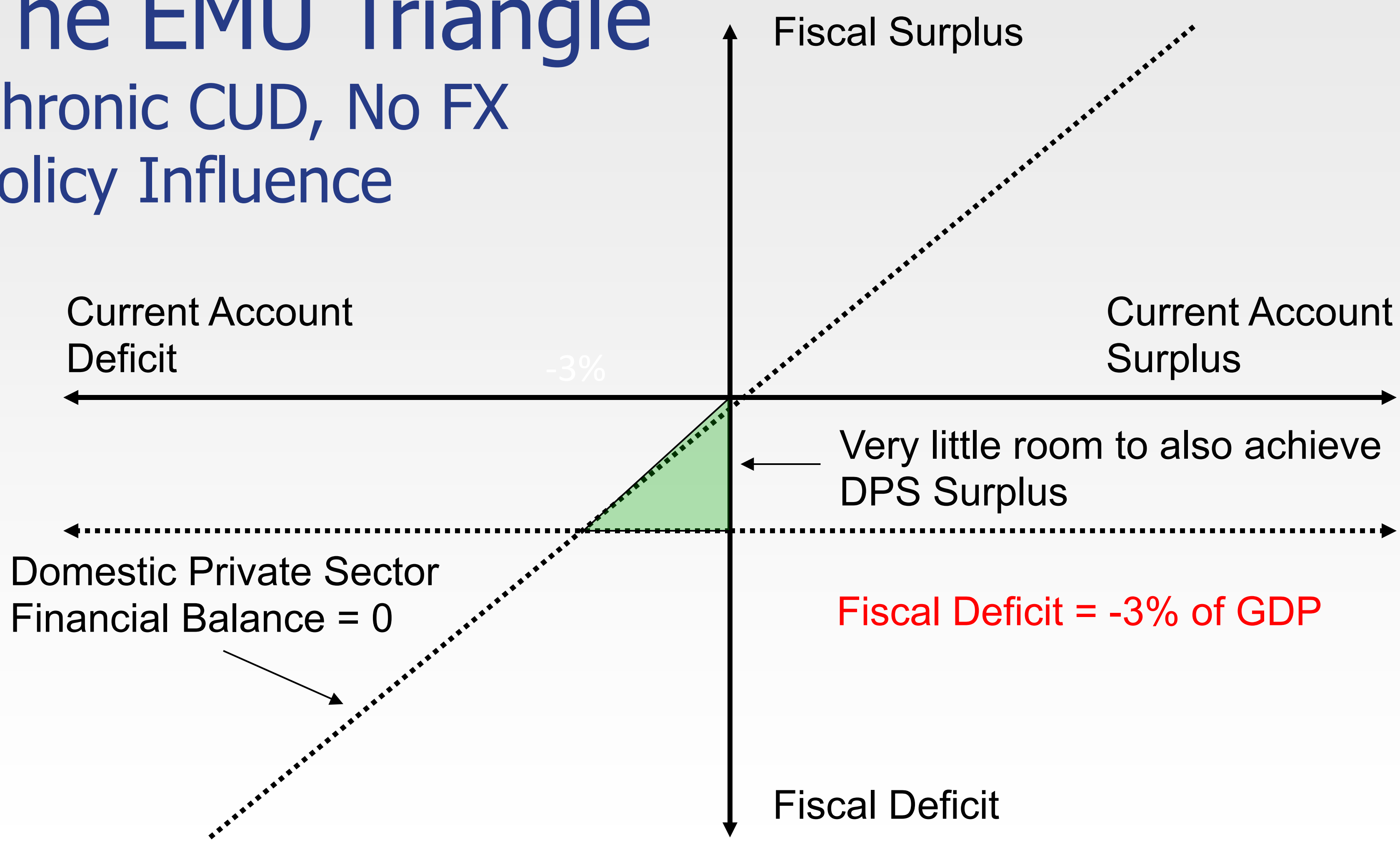
Balanced Budget Constraint



Stability & Growth Pact Restraint



The EMU Triangle
Chronic CUD, No FX Policy Influence



Three Proposals to Exit Austerity - Without Exiting the Euro

- The Key Challenge: How to Regain Some Control over Fiscal and Monetary Policy Tools Without Leaving the Euro System
- Alternative Public Financing I: Introduce the G Note
- Alternative Public Financing II: Reclaim the Banks
- Transition Nation & the Share Economy

The G Note

- Create a government liability that has the following properties
  - Zero interest coupon
  - Perpetual
  - Transferable
  - Denominated in euros
  - Available in 50 and 100 euro denominations, as both paper form and secured/encrypted electronic credit to bank accounts
- Use this G Note to Pay Government Employees, Suppliers to Government, and Beneficiaries of Transfer Payments, & Accept G Note at Par or Face Value as Payment for Taxes (Thereby Creating Demand for G Notes)

The G Note

- The G Note Allows Government to Say Nein Danke to Austerity
- Full Employment Fiscal Policy Can be Pursued
- Preferably through ELR & Import Competing Infrastructure Investments
- Euros are Freed Up to Pay for Imports, Service External Held Public Debt
- G Notes Acceptable as a Means of Payment/Settlement in Private Sector Transactions (Since Households and Firms Have Tax Liabilities to Pay)
- But Tax Enforcement Must Be Improved, Better Distribution of Tax Burden

Reclaim the Banks

- Austerity Reduces Private Income Flows, Raises Bank Loan Losses and Bailouts
- Instead of Recapitalizing Banks to Socialize Losses, Nationalize Them
- Just as Bank Loans Create Deposits, Bank Investments in Securities Create Deposits (Asset Seller's Bank Account is Credited with Money by Bank)
- Banks Do Not Require Deposits by Private Sector to Make Loans or Buy Securities – This Was Once Understood by Economists (Schumpeter, Keynes)
- Central Banks Setting an Interest Rate Target Must Provide All the Reserves Required to Maintain that Target Policy Rate (PX Fixer Loses Q Control)
- Hence, Banks Cannot Be Reserve Constrained Either

Reclaim the Banks

- Banks Become Captive Buyers of Government Debt
- Fiscal Policy Becomes Less Financially Constrained
- Zero Risk Weighting on Government Debt Means No Bank Capital Constraint
- Private Debt Write-offs Can Be Identified and Accomplished on Bank Books
- Bank Portfolio Increasingly Weighted Toward Less Risky Assets
- Bank Loans Can Support/Target Private Sector Investment Revival

Transition Nation, Not Just Transition Towns

- Neoliberal Economics in Part Depends Upon Depletion/Exhaustion of Both Natural and Social Capital
- Climate Disruption, Ocean Warming & Acidification, Bee Die-Off Suggest that Gaia is Not Very Pleased with Neoliberal Growth Strategy
- Transition Town Movement Now Spreading Globally
- Initially Designed to Prepare for Peak Oil, But Focus Shifting Toward Reviving Local Economies in a More Convivial and Sustainable Fashion

Transition Nation

- Local Currencies to Bypass Monetary Austerity
- TimeBanks to Exchange Productive Labor Without Money
- Barter Networks to Exchange Products Without Money
- Share Economy: Car share, AirBnB, Tool Libraries
- Local Food Production: Lawns & Rooftops to Food Forests, Cropmobster
- Credibles: Buy in Advance Financing for Small Food Purchasers

Conclusion: There is an Alternative, Lady Thatcher – Many of Them, in Fact

- We Can Choose a Life Affirming, Regenerative Economy over the Suicidal Economics of Neoliberal Austerity
- The Binding Constraint is Not Government Finance, But Rather Our Courage, Imagination, and Willingness to Collaborate
- Another World is Possible – But We are Going to Have to Recognize the Neoliberal Lies, Take Back Our Power, and Work Together to Build It

Zorba the Greek’s Advice for Dealing With the High Priests of Neoliberalism

“You want to build a monastery. That's it! Instead of monks you'd stick a few quill drivers like your honored self inside and they'd pass the time scribbling day and night...Well, I'm going to ask you a favor, holy abbot: I want you to appoint me doorkeeper to your monastery so that I can do some smuggling and, now and then, let some very strange things through into the holy precincts: women, mandolins, demijohns of raki, roast sucking pigs ... All so that you don't fritter away your life with a lot of nonsense!