

Deficit panic I

Budget austerity and the real cuts agenda

'The British government's austerity package is based entirely on ideology, not on any economic rationale'

Prof David Blanchflower, New Statesman

20 September 2010

1.1 Introduction – fear itself

*This is pre-eminently the time to speak the truth, the whole truth, frankly and boldly. Nor need we shrink from honestly facing conditions in our country today. This great Nation will endure as it has endured, will revive and will prosper. So, first of all, let me assert my firm belief that **the only thing we have to fear is fear itself, nameless, unreasoning, unjustified terror which paralyzes needed efforts to convert retreat into advance.***

Franklin Delano Roosevelt, Inaugural Address, March 1933

Here is the answer which I will give to President Roosevelt... We shall not fail or falter; we shall not weaken or tire. Neither the sudden shock of battle nor the long-drawn trials of vigilance and exertion will wear us down. Give us the tools and we will finish the job.

Sir Winston Churchill, 1941

Our problems are man-made, therefore they may be solved by man. No problem of human destiny is beyond human beings.

John F Kennedy

In the past, politicians promised to create a better world. They had different ways of achieving this. But their power and authority came from the optimistic visions they offered their people. Those dreams failed. And today, people have lost faith in ideologies. Increasingly, politicians are seen simply as managers of public life. But now, they have discovered a new role that restores their power and authority. Instead of delivering dreams, politicians now promise to protect us from nightmares. They say that they will rescue us from dreadful dangers that we cannot see and do not understand.

Adam Curtis, *The Power of Nightmares*, BBC, 2005

Democratic politicians, from Franklin Roosevelt in the Depression to Churchill in the Second World War, to JFK's, in Adam Curtis's words, optimistic vision, once sought to lead and mobilise populations on the assumption that social problems can be solved by collective action using the power of government. Now, politicians and the media use fear and hysteria over a range of social issues from public deficits to the environment, epidemics and terrorism,

and promote scepticism about the capacity of government to deal with those threats and challenges. The outcome is passivity and fatalism, a sense that these problems are beyond us and our capacity to act collectively in the public interest, the domain of government. Political scientist Sheldon Wolin calls this 'managed democracy'ⁱ; a process of manipulation and deception by ruling elites in which governing myths such as the magic of markets or imaginary or exaggerated external threats are deployed to conceal the reality of political power and the hollowing out of democratic institutions which pursue the priorities of the ruling elites behind façade of legitimacy. Differences between political parties are now so small that voters no longer have a genuine choice, breaking a fundamental democratic principle. This is mainly because all western political parties have been captured by what Michael Hudson calls 'junk economics'ⁱⁱ. Junk (or 'free market') economics is behind the hysteria over public deficits and public debt. The central argument in this paper is that irrational deficit panic is a pretext for pursuing an ideological programme and that effective action requires us to recognise that deficit panic is classic elite exercise in fear mongering.

1.2 Summary

The current hysteria over the UK's public spending deficit and the assumption that the deficit is a threat to prosperity to be reduced mainly by cuts in spending programmes ('budget austerity') is based upon a deeply flawed model of the economy which equates public finances simplistically with household finances. The reality is that so long as the private sector is spending less than it is earning and running a surplus the public finances must necessarily go into deficit. Cutting the deficit by reducing spending is misguided because there is plenty of evidence to show that cuts in spending will not succeed either in reducing the deficit or restoring growth. The deficit panic hides the real reason for the cuts planned by Britain's Coalition Government which is confirmed by the 'senior figure' quoted by one of the Prime Minister's close advisers (see below). The deficit is pretext for a further erosion of the social protection and redistributive functions of government under the banner of the almost 40 year neoliberal project. The governing mythsⁱⁱⁱ of 'free markets' or 'smaller government' conceal the true purpose of neoliberalism: the prioritising of the financial sector over social needs and production and the privileging of a small financial elite in an unprecedented concentration of economic and political power. The crisis of the public finances is a direct consequence of the failure of the global banking system which itself is a consequence of 40 years' financial deregulation (the transfer of the control of the public money supply to private banking interests) and debt overload. Only by vesting the power to issue money and credit (bank loans) with elected governments and the restoration of controls on exchange and capital movements across borders can we begin the process of reforming a dysfunctional economic system which left alone only brings chronic instability and insecurity.

1.3 The threat of the deficit

This is not a Greek crisis. It is not a Mediterranean crisis. It has nothing to do with the supposed fiscal irresponsibility of any particular country. It is a crisis of the world's banking system.....This is not about Greece. It is about avoiding the recognition of losses in the banking system and therefore about keeping the architects of a catastrophically unstable system in place for the time being. Meanwhile, the Greeks are asked to sacrifice. Not because sacrifices accomplish anything but because the political leaders in northern Europe require a cover story.

James K Galbraith, The Imperative of a Green New Deal, Germany, 4 June 2010

*Fiscal tightening, while conservative in intent, leads to lower and lower growth in the short run. Tougher sovereign budgets produce government worker layoffs, pay cuts, reduced pension benefits and a drag on consumption and the ability of the private sector to accept an attempted hand-off from fiscal authorities. Recession becomes the fait accompli, and the deficit/GDP ratio moves ever higher because of skyrocketing risk premiums and a plunging GDP denominator. **In many cases therefore it may not be possible for a country to escape a debt crisis by reducing deficits!***

Bill Gross, PIMCO, Investment Outlook, June 2010

The British government's austerity package is based entirely on ideology, not on any economic rationale.

Prof David Blanchflower, New Statesman 20 September 2010, quoted in Dealing with the deficit – there is a better way, Union the union, October 2010

The UK's public spending deficit is presented amidst an atmosphere of fear and panic created by politicians and media commentators as a mortal threat to future prosperity, if not our existence. The Coalition government has presented plans for aggressive reductions in spending^{iv} but its Labour predecessor also planned a similar albeit less severe programme and passed

a law to require the deficit to be halved in four years. The assumptions underlying deficit panic can be summarised as:

- unless the deficit is dealt with then an unsustainable burden of debt will be placed on future generations, public spending will crowd out the private sector investment upon which growth and prosperity depend;
- financial markets will only buy government bonds at high interest rates;
- reductions in public spending are the main means of reducing the deficit;

As Nick Clegg explained to his party conference:

We could have decided to go more slowly but it would have worsened not eased the pain. Because every day you ignore a deficit, it gets harder to fix. The debts mount up and you have to pay interest on them. Already we are spending £44 billion a year on interest alone. Under Labour's plans, that would have risen to nearly £70 billion. A criminal waste of money that shouldn't be lining the pockets of bond traders. It should be paying for police, care workers, hospitals and schools.

Nick Clegg, Deputy Prime Minister, Liberal Democrat conference, September 2010

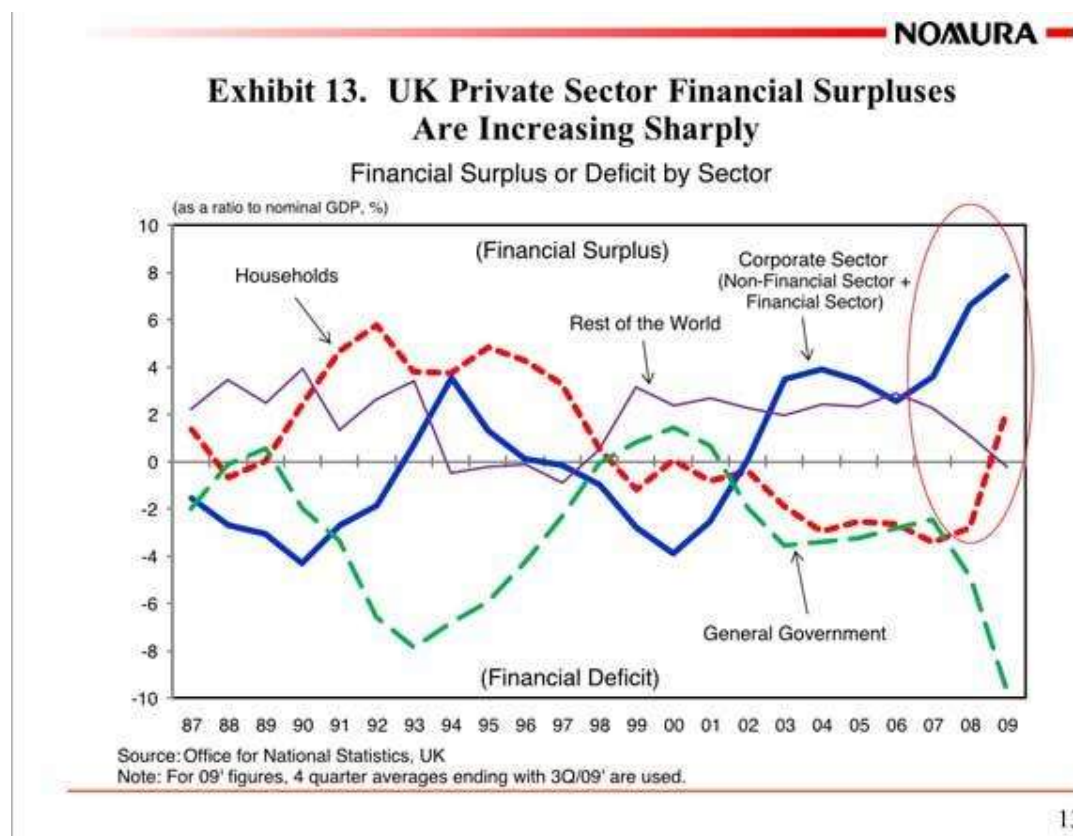
Several points need to be made about the Deputy Prime Minister's statement which confuses the deficit – the difference between revenue and outgoings – and debt, amounts owed by the government to its bondholders:

- Government debt represents the savings and pensions of millions of British people and interest payments on that debt help finance pensions. Without that debt, some other mechanism would need to be found or the Government would have to pay pensions directly.

- The principal on Government debt does not have to be repaid and indeed governments generally pay interest only and roll over debt by redeeming bonds through issuing new ones. Implying that public debt is the same as a mortgage is grossly misleading.
- The Bank of England actually holds about 30% of all British government bonds, bought as part of the strategy of quantitative easing where bonds were exchanged for new money issued to banks^v. When this is taken into account, the national debt is below 45% and not 64% of GDP.
- Governments generally do not have to borrow from private financial institutions^{vi} but could finance any shortfall over revenue by using their sovereign power to issue money and spending it directly into circulation or drawing credit at zero interest from their central banks such as the Bank of England. In terms of the economic impact, it is no different from what private banks do already and no different either from the Government issuing bonds.

It is not obvious that the spending deficit is such a catastrophic problem that it must be dealt with in an arbitrary period of 4 years. There is no evidence that the British government has any difficulty in raising finance by selling bonds. And even if the deficit were such a serious threat in the short term it is not obvious either that aggressive cuts in public spending will reduce it. There is no logic to the spending programme. A public spending deficit is not a consequence of fiscal profligacy or fecklessness but simply the outcome of basic arithmetic: if the private sector is running a surplus, spending less than it receives in income by saving and paying off debt, then it follows (assuming

that the country's external balance is not sufficient to offset the private sector surplus) that **the public sector must run a deficit** because all the three economic balances, public, private and external must always add up to zero. In other words, no government is in a position to determine whether or not it runs a surplus or deficit.^{vii} This is the macroeconomic equivalent of double entry book keeping where for every debit there is a credit and each cancels the other. Empirical support for this is found in Richard Koo's presentation^{viii} which demonstrates from official statistics that the UK's private and public sector balances since 1987 move exactly as the rule predicts.



Attempting to run a public sector surplus or balance the books in conditions where private sector is deleveraging^{ix} is not only impossible but damaging for economic activity because less demand means lower output and employment.

Where the banking sector is a net borrower because of the calamitous state of banking balance sheets, the public money supply shrinks. A government deficit is therefore an important source of liquidity in those circumstances. Just how disastrous budget austerity has been in the past is demonstrated in *The Economic Consequences of Mr Osborne*^x. Immediately after the First World War a Conservative – Liberal coalition cut spending from 1919 onwards. The UK's economic output collapsed by 21% and unemployment almost trebled in just a few years. Public debt increased to 150% of GDP, higher than at the end of the war^{xi}. The Lloyd George government introduced a 20 year period of economic stagnation and social conflict culminating in the Second World War as a result of the disastrous Versailles Treaty and the cynical policy of appeasement, only partially relieved by the application of Keynes's ideas in the 1930s when government spending increased. The popular radical historian Alan Taylor gives a flavour of the times.

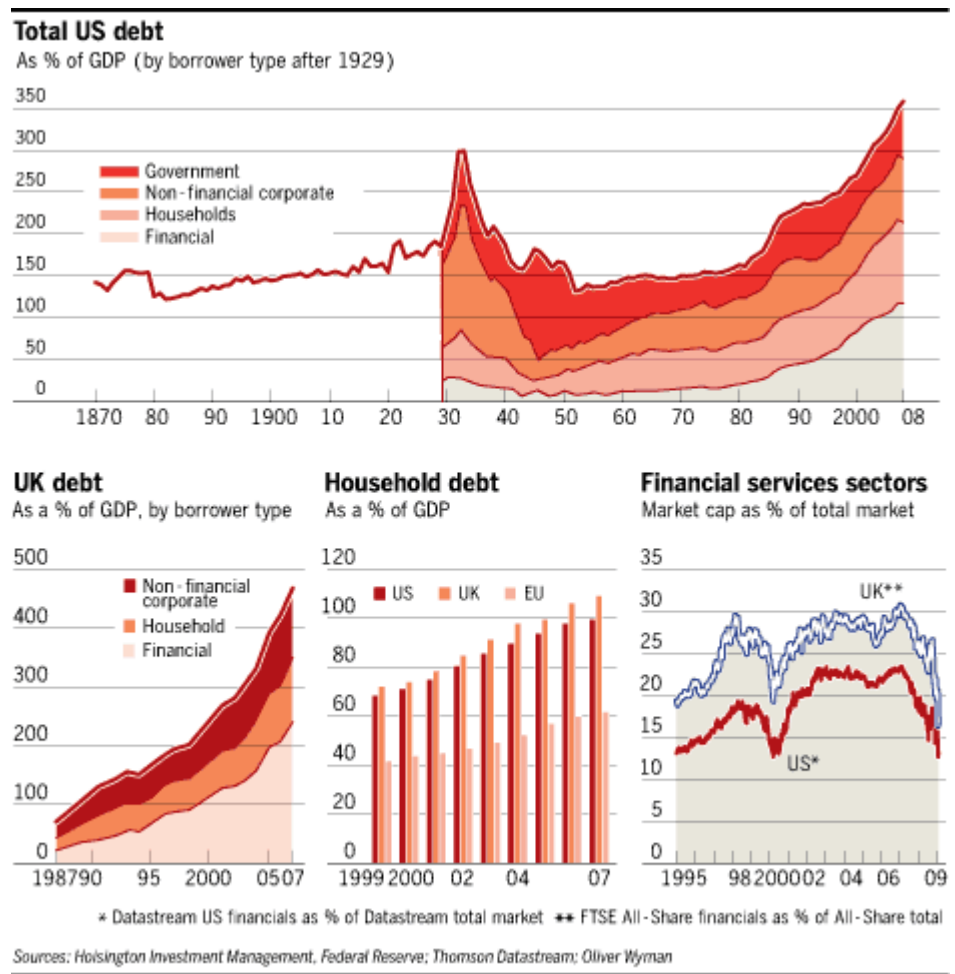
There was still an unmistakable upper class, despite the bleat about increasing economic equality. One per cent of the population owned two thirds of the national wealth; 0.1 per cent owned one third. Three quarters of the population owned less than £100. Territorial magnates, their wealth reinforced by mining royalties and urban rents, kept up great town and country houses with staffs of thirty or forty servants. The political governing class was largely drawn from a few hereditary families. Most of its members were educated at Eton and some others at Harrow. Nearly all went to Oxford or Cambridge.

A J P Taylor, English History 1914 - 1945

Contrast this dismal record with the post war Labour Government which despite a historically high public debt ratio in 1945 had the courage to spend, creating, as John Pilger says, 'some of our greatest public institutions such as

the National Health Service and the arts edifices of London's South Bank^{xii} and also sustained full employment and a recovery in manufacturing.

However, the social patterns of the Lloyd George coalition appear now to have reasserted themselves^{xiii}. And according to insurance company Legal and General, the Coalition is gambling on the biggest ever private sector boom^{xiv}. This means that private sector debt will need to rise beyond what are already the highest levels in history. (See below, the bottom left hand chart.)



Source: Financial Times, Jan 2009

It is hard to see how more household and consumer debt can be added to the £1.4 trn there is already when consumers are worried about job security, with the projected loss of up to a million jobs as a consequence of the planned cuts.

Britain's debt-laden society

Total UK personal debt including mortgages was £1,455bn (Sep 2010), an annual increase of 0.8% over the year. This is an average increase of 8% a year since 1993, doubling every 9 years on average.

The average amount owed by every adult is £57,737 or 127% of average earnings.

Citizens Advice Bureaux deal with 9,000 new cases of debt problems every day.

Average credit card interest is 18.86% affecting 70% of all credit card balances.

There were 64.4m credit and charge cards at the end of 2009, 2.4m more than the UK's population.

39,000 families have their homes repossessed each year because they cannot keep up their mortgage payments.

Four in ten adults are worried about their debt, 5.4m spend more than they earn while 39m break even or have less than £100 left each month.

The average student starting university in 2010 is expected to graduate with £24,702 of debt

Annual interest payments on personal debt are £65.6bn

Source: CreditAction, November 2010

Britons generally do not have savings sufficient to give a reasonable degree of financial security throughout life and into old age

53 % of single pensioners have annual incomes of less than £10,000 and 36% of pensioner couples have less than £15,000. Millions of pensioners report financial related stress including anxiety (43%), lack of concentration (22%), insomnia (24%) and feeling depressed (21%).

15 million people or 30% of adults could not survive until the weekend on savings as they have less than five days' average pay in savings.

Almost 3 million households can no longer afford to save and only 50% say they have money left over after paying bills and debts.

Source: CreditAction

Almost 80% of private pension wealth is owned by the top 20% of households and the bottom 50% has just 2%. Half of all Britons have less than £5,000.

Source: ONS Wealth in Great Britain 2006-08 (Dec2009)

Half of all single pensioners have a weekly occupational pension of £70 or less, and for couples it is £158.

Source: Pensions Policy Institute, Pension Facts, October 2010

The government is therefore relying on an investment and export led boom by private businesses. But again it is difficult to see how this can happen quickly. The EU countries which are the UK's main trading partners are pursuing their own destructive version of 'austerity' and depressing their own economies. Banks must expand their lending to businesses rapidly, something which would reverse the current status of the banking sector as a net borrower from the economy and its preference to lend against speculative investment in assets rather than in generating real wealth. But the main obstacle to an expansion of bank lending is not only weak balance sheets but the fact that debt in the UK economy has probably reached its limits and a prolonged period of debt reduction and stagnation is more probable than a resumption of 'normal' growth.

1.4 The real deficit agenda

“The scale of the deficit gives us the chance to do things that would have been unthinkable two years ago.”

A ‘senior figure’ quoted by Ian Birrell, speechwriter to David Cameron, The Guardian, 1 October 2010, confirming that the deficit panic is contrived.

The deficit panic conceals the real reason for the cuts planned by Britain’s Coalition Government, confirmed by the ‘senior figure’ quoted by one of the Prime Minister’s close advisers and which discloses the elite’s cynical use of the deficit as a pretext for a further erosion of the hard-won social protection and redistributive functions of government; this is the neoliberal or ‘free market’ revolution; a process begun almost 40 years ago in Chile with the US-sponsored overthrow of the Allende government and the implementation under the direction of economists trained at the University of Chicago, of an economic programme facilitated by state terror^{xv}. Chile served as a laboratory for policies introduced in Britain and the US notably under the Thatcher and Reagan administrations and maintained by the governments which succeeded them. Further progress and consolidation of what David Harvey calls the restoration and consolidation of class power^{xvi} depends upon creating a crisis and an atmosphere of panic in which rational debate can be drowned by scaremongering. As Harvey says:

Does this crisis signal the end of neoliberalism? My answer is that it depends what you mean by neoliberalism. My interpretation is that it’s a class project, now masked by a lot of rhetoric about individual freedom, liberty, personal responsibility, privatisation and the free market. That rhetoric was a means towards the restoration and consolidation of class power, and that neoliberal project has been fairly successful.

One of its basic principles that was set up in the 1970s was that state power should protect financial institutions at all costs. This is the principle that was worked out in the New York City

crisis in the mid-1970s, and was first defined internationally when Mexico threatened to go bankrupt in 1982^{xvii}

Free market and 'smaller government' rhetoric serve as a governing myth for the deregulation of, and the passing of the control of the public money supply and national currencies, to a financial elite. This is a myth in the religious sense and not the popular meaning of something which is untrue. A religious myth is a story or allegory not necessarily to be taken as literally true or historically accurate but is intended to convey a deeper unifying truth about a group of believers. This governing myth is used in a manipulative way because none of those who promote the free market cover story, the insiders, believe it or take it seriously^{xviii}.

The elites and the politicians who have been willing accomplices in emptying democratic institutions of any real content are rather like parents who tell their children stories about Father Christmas. In other words the story of democratic politics has been one of deception by junk economics. The woeful state of mainstream economics, its theoretical incoherence, phony 'laws' and lack of connection to any reality has been thoroughly analysed and exposed by Australian economist Steve Keen, who predicted the crisis.^{xix} What economics does however is to justify the appropriation of resources and the extraction economic rent (that part of output which does not have a cost of labour attached to it, such as the value of land or infrastructure laid down by past generations), by a financial elite principally by issuing debt (or credit) which costs nothing to produce. Privatisation of public services and public assets, widespread across the developed world and hailed as a great success, are no more than the principle of rent extraction applied to the public domain.

40 years' financial deregulation has led to a speculative global credit binge which has reached its limits; but instead of writing down unsupportable debts and liquidating the so-called toxic assets^{xx}, governments have effectively transferred these liabilities to public balance sheets. Nor has the huge public assistance and transfer of banking liabilities resolved the crisis. According to the Bank for International Settlements' annual report, *'banks on both sides of the Atlantic remain "highly leveraged and still appear to be on life support. The essential task of reducing leverage and repairing balance sheets is simply not finished. Losses on European bank balance sheets are expected to mount over the next few years. Some banks are rolling over existing loans rather than inducing foreclosures, delaying loss recognition.'*^{xxi}

A report^{xxii} from the New Economics Foundation estimates that public support for the UK banking system is **at least £1.2 trn** but complains that there is a *'shocking lack of information'* about where the money has gone or how it has been used. Indeed this staggering level of public support has produced very little return. Bank lending has stagnated and the sector is actually a net borrower. There are also indications that banks will require further public support in 2011 when banks will need to borrow £24bn each month, equal to a quarter of the annual expenditure on health^{xxiii}. There is the suspicion that public spending cuts are intended to clear the way for another round of bailouts. However this would be perverse.

What the last government should have done was to nationalise the insolvent banks, wipe out the shareholders and bondholders and clean up the balance sheets by isolating the so-called toxic debt and cancelling or writing them

down. It also means restructuring banks for their public purpose. Because banks provide the public money supply in the form of credit, they are indeed too important to be allowed to fail. But this does not mean that banks should be able to run up liabilities several times the size of the British economy, engage in speculation or manipulate tax and regulation through the use of 'offshore' financial centres or avoid reserve requirements by the use of derivatives. The failure of all parties to reform the banks in the public interest is surely as Martin Jacques said an example of '*abject political negligence and cowardice*'^{xxiv}.

The causes of the crises and how simple monetary and tax reform principles involving the restoration of the sovereign collective power of governments to issue currency can banish a fundamentally unstable and dysfunctional economic system for good, and the practical possibility of achieving financial security for all is explored in more detail in part II. It will also illustrate how the UK government can meet all its spending needs and more without the need to borrow by using its own sovereign power and using new sources of taxation.

Faced by a failure of credit, they have proposed only the lending of more money. Stripped of the lure of profit by which they induce our people to follow their false leadership, they have resorted to exhortation, pleading tearfully for restored confidence. They only know the rules of a generation of self-seekers. They have no vision, and when there is no vision, the people perish.

Yes, the money changers have fled from their high seats in the temple of our civilization. We may now restore that temple to the ancient truths. A measure of that restoration lies in the extent to which we apply social value, more noble than mere monetary profits.

Franklin Delano Roosevelt, Inaugural Address, March 1933

The great enemy of the truth is very often not the lie -- deliberate, contrived and dishonest, but the myth, persistent, persuasive, and unrealistic. Belief in myths allows the comfort of opinion without the discomfort of thought.

John F. Kennedy

You don't believe in something because you understand it. You believe in it because it's mysterious. It's like the peace of God that passeth all understanding. It certainly passeth my understanding. It hurteth my brain just to think about it!

John Bird as an investment banker, Bremner Bird & Fortune

End notes

ⁱ Democracy Inc "managed democracy and the spectre of inverted totalitarianism (2008)

ⁱⁱ See www.Michael-Hudson.com Professor Hudson is one of a tiny number of economists who predicted the financial crisis.

ⁱⁱⁱ See James Galbraith, *The Predator State*, 2008

^{iv} £81 bn reductions planned over 4 years. HM Treasury, *Comprehensive Spending Review*, October 2010

^v Lloyds TSB Corporate Markets, *gilt market outlook*, February 2010. 'As a result of these purchases the Bank of England has almost fully funded the central government's 2009/10 borrowing requirement.'

^{vi} Countries in the euro zone are forbidden by the European Central Bank to borrow from central banks or issue currency, but this is a self-imposed and unnecessary restriction on economic sovereignty which could be removed given the political will.

^{vii} See Victoria Chick, www.debttonation.org

^{viii} Richard Koo, video and presentation on <http://ineteconomics.org/people/participants/richard-koo>
Successive fiscal consolidations in Japan in the 1990s only made its fiscal deficit worse

^{ix} A technical term for repaying debt.

^x Ann Pettifor and Prof Victoria Chick, 2010, www.debttonation.org

^{xi} According to his biographer, when Aneurin Bevan returned to south Wales in 1921 after two years at the Central Labour College in London, output and employment in the south Wales coal field were half what they were in 1919.

^{xii} John Pilger, *Morning Star*, 8 November 2010.

^{xiii} 17 of the 29 members David Cameron's first cabinet were educated at private schools. 21 went to either Oxford or Cambridge. <http://www.guardian.co.uk/news/datablog/2010/may/12/new-cabinet-whos-who-list>

^{xiv} Legal & General Investment Management, *Fundamentals bulletin*, July/August 2010.

^{xv} See Naomi Klein, *The Shock Doctrine*, 2007.

^{xvi} See <http://www.redpepper.org.uk/Their-crisis-our-challenge>,

^{xvii} *Ibid.*

^{xviii} 'Any society driven by market incentives will fail catastrophically in economic as well as political terms.' Anatole Kaletsky, *Capitalism 4.0*, 2010, p7-8.

^{xix} *Debunking Economics: the naked emperor of the social sciences*, 2001. Soon to be updated.

^{xx} These refer to securitised mortgages, i.e. subprime or 'junk' loans converted into high quality bonds and unregulated derivatives such as credit default swaps whose value is unknown and for which no effective market exists.

^{xxi} *Daily Telegraph*, 28 June 2010.

^{xxii} *Where has all the money gone?* NEF, October 2010

^{xxiii} *Ibid.*

^{xxiv} Martin Jacques, *New Statesman*, August 2009

Sources

Ann Pettifor, editor of Real World Economic Outlook (2003) and The Coming First World Debt Crisis (2006). www.debtonation.org

James K Galbraith, The Predator State, 2008

Sheldon S Wolin, author of Politics & Vision, Democracy Inc. Managed Democracy and the Specter of Inverted Totalitarianism, 2008

Naomi Klein, The Shock Doctrine, 2007

Michael Hudson, www.Michael-Hudson.com

Steve Keen, www.debtdeflation.org

David Harvey, Marxist geographer, www.davidharvey.org and author of A Short History of Neoliberalism

Global Research, website of economist Michel Chossudovsky, www.globalresearch.org

Appendix 1

Some of the economists and commentators who oppose budget austerity:

Paul Krugman (Nobel Laureate)
Joseph Stiglitz (Nobel laureate)
David Blanchflower
Ann Pettifor
Victoria Chick
Michael Hudson
Steve Keen
Robert Skidelsky (Keynes's biographer)
James Galbraith
Robert Reich
Ha-Joon Hang
Chris Pissarides (Nobel Laureate)
Peter Diamond (Nobel Laureate)
Dale Morten (Nobel Laureate)
Anders Borg, Swedish finance minister

Appendix 2

Essential measures for monetary and financial reform

1. Public control of the money supply and credit creation
2. A financial transactions tax
3. Restoration of controls on all exchange and capital movements across national borders
4. An end to speculation by banks
5. Derivative contracts such as swaps to be properly regulated and restricted to the needs of the real economy.
6. Land value and natural resources taxes.
7. All traded shares to expire after a fixed period of time.
8. Loans on land and property to be limited to ten times the annual rental value.