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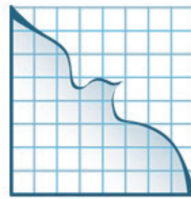

ECONOMISTS for PEACE & SECURITY

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War and famine. Peace and milk. —Somali proverb

## "Crisis of Austerity" Issue

The general conclusion I draw is that almost none of the conditions that determined what happened to Greece over the course of the first half of 2015 were related to economic conditions in Greece or to any understanding of the particular circumstances of the Greek economy.

~James Galbraith, page 11

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# Austerity in Ireland

## Patrick Honohan

Debt and austerity are really the story in the Irish economy the last seven, eight years. Could things have been handled better once the crisis emerged?

By late 2008, it was inevitable that there was going to be a devastating economic downturn in Ireland with massive job losses and acute indebtedness. The task of the Irish authorities from then on was to limit the damage and to navigate through the coming years to maximize the chances of a strong recovery. That would entail choices about how the looming debt burden was to be distributed.

Currently, recovery is underway; I don't want to say anything stronger than *underway*. At the start of the crisis, unemployment leapt from about 4 percent to 15 percent. It's now back down to single digits. The decline is partly attributable to emigration; but job growth has clearly returned.

As opposed to the weak employment recovery in the United States and the Euro area, Ireland has had an employment recovery as well as an unemployment recovery; so it's not just a migration story. Employment grew by a cumulative 7 percent from 2012 to 2015. But employment is still way way below the peak; so it's a solid recovery, but we are not there yet, whatever *there* means.

Personal disposable income is also well away from the peak, but showing a strong enough recovery. People talk about 6 percent, maybe 7 percent growth; but it's really 2.5 percent growth in employment with a little bit of productivity on top of that.

So where did the crisis come from? It was a result of a housing boom and bust and the damage done by the housing boom and bust to the stability of the public finances. Qualitatively similar features to the Irish boom were also in evidence in other countries in the run-up to the crisis. What made Ireland distinctive was the scale of credit expansion and the fact that the credit-fueled property price bubble was accompanied, and yet not noticeably moderated, by a construction boom; so quantity and price were moving in the same direction and there was a big increase in property prices. You had three-and-a-half times the level of debt, while real incomes only increased by about 40 percent. Housing prices peaked in the first half of 2007 and then started falling quite sharply.

Public finances had been very much supported by the tax revenue from the construction boom and the purchase of houses, building of houses, and so forth; but the fiscal position suddenly started to deteriorate with the downturn in house prices, People stopped wanting to buy houses because they were afraid. Suddenly there was a collapse in demand.

In the decade previous to the crisis there had been a general government surplus, and gross government debt had shrunk to below 25 percent of GDP; but in 2008-2009, boom-time revenue sources were evaporating. A sizable debt was (cont. on pg. 3)

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# Program

This issue is comprised of edited transcripts from a panel session held during the Allied Social Sciences Associations meetings in San Francisco, CA, January 3, 2016. Visit our website, epsusa.org, and click on "Past Events" for links to video and complete transcripts of the panel.

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**Patrick Honohan** joined the Peterson Institute for International Economics in March 2016 as a nonresident senior fellow. Honohan was governor of the Central Bank of Ireland and a member of the governing council of the European Central Bank from September 2009 to November 2015. He came to that position from Trinity College Dublin where he was professor of international financial economics and development and where he has since become an honorary professor of economics. Previously he spent 12 years on the staff of the World Bank as a senior advisor on financial sector issues. During the 1990s he was a research professor at Ireland's Economic and Social Research Institute. He also spent earlier spells at the Central Bank of Ireland and at the International Monetary Fund. A graduate of University College Dublin, he received his PhD in economics from the London School of Economics in 1978.

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**James K. Galbraith** holds the Lloyd M. Bentsen Jr. Chair in Government/Business Relations and Professor of Government and the outgoing chair of EPS. He holds degrees from Harvard and Yale (Ph.D. in Economics, 1981). He studied economics as a Marshall Scholar at King's College, Cambridge, and later served on the staff of the U.S. Congress, including as Executive Director of the Joint Economic Committee, before joining the faculty of the University of Texas. He held a Fulbright Distinguished Visiting Lectureship in China 2001, and was named a Carnegie Scholar in 2003. His recent research has focused on the measurement and understanding of inequality in the world economy, while his policy writing ranges from monetary policy to the economics of warfare, with forays into politics and history. Visit the web-site of the University of Texas Inequality Project (UTIP) for current research and an archive of published writings. Galbraith is the author of several books, including The End of Normal: The Great Crisis and the Future of Growth, (Simon & Schuster, 2014), Inequality and Instability: A Study of the World Economy Just Before the Crisis (Oxford University Press, 2012), The Predator State: How Conservatives Abandoned the Free Market and Why Liberals Should Too (The Free Press, 2008) and his latest, Welcome to the Poisoned Chalice: The Destruction of Greece and the Future of Europe (Yale University Press, 2016).

emerging augmented by the increased cost of increased social protection spending. Nobody wanted to buy houses, nobody wanted to build houses. The 14 percent of the population who were working in construction suddenly collapsed to the normal level of 6 percent or lower. Deficit grew both in absolute terms and especially as a percentage of GDP, and GDP was shrinking alarmingly.

Total government spending jumped from 39 percent of GDP in 2007 to 58 percent two years later. Tax revenues fell by 30 percent in the same period. It would have been 11.5 percent in the absence of bank rescue spending. This situation would not be sustainable for long. Something was going to have to be done—a lot of somethings.

The government had already begun a program of fiscal adjustment in 2008 that might be considered pro-cyclical. The economy was down and the government was trying to get control over its budget, although a deficit of 14 or even 11 percent of GDP could hardly be considered austere. Taxation of income in particular was increased, and a four-year plan of tax and spending changes designed to restore stability to the public finances was underway.

The banking system added to the fiscal pressure. Just a few days after the bankruptcy of Lehman Brothers and with the collapse of the third largest bank imminent, the government, wholly unaware of the scale of embedded losses in the bank balance sheets, stepped in with a blanket guarantee for the liabilities of all the overly controlled banks. The guarantee,was copperfastened [reinforced, strengthened; made permanent, embedded.—*Ed.*] in legislation. It wasn't expected that it would entail a significant budgetary outlay; but then they hadn't thought about whether short-term debt or new debt would be covered. They had said the guarantee was to cover more or less everything. There was no safety-first mechanism to limit the state's exposure to this pig-in-a-poke that they had acquired. Supervisory awareness of the vulnerability of the banks was very limited.

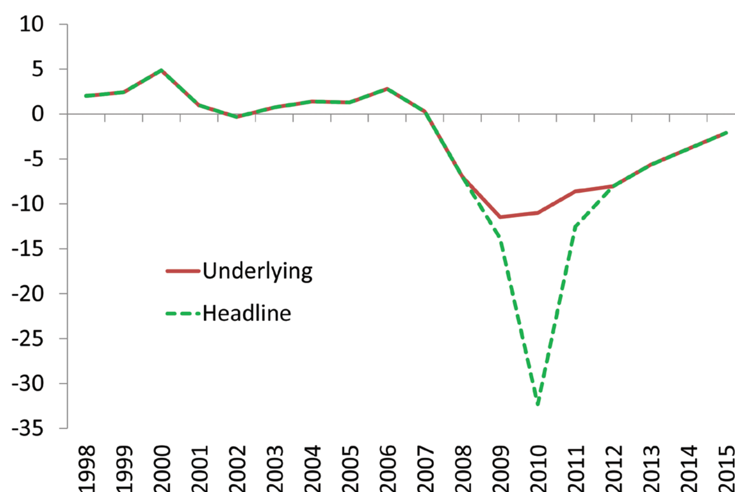
The combination of the loss of tax revenue and the increased spending on social transfers, coupled with the crystallization of the huge contingent liability from the bank guarantee, created a vulnerability in the Irish sovereign that resulted in a sudden stop in its access to international lending. The government still had a buffer of cash, but it could see that running out. The spreads on Irish government debt were rising, and bank depositors were fleeing because they could see this was not going to solve itself in the private economic system. Private markets were not going to finance Ireland, and therefore there was going to be some kind of massive collapse unless the IMF stepped in, which they did.

The EU/IMF program negotiated in November 2010 fully recognized the deterioration in the economic and fiscal conditions that had occurred since the government's own four-year adjustment program had been launched almost two years earlier. The deterioration of conditions at home and abroad meant that further belt-tightening would be needed; though in fact most of the heavy lifting had already been done in 2008-10. The new plan envisaged reaching a 3 percent deficit by 2015. That could have seemed a stretch to a naïve observer noting that the recorded deficit for the government in 2010 was 31 percent of GDP, about two-thirds of which lay in the bank recapitalization;but that 3 percent deficit target was achieved in 2015.

So why did it work? Unlike Greece and, to a lesser extent, other stressed countries making fiscal adjustments at the time, the Irish program employed a realistic sense of macroeconomic spending multipliers from the outset. They understood that if they were going to cut government spending and raise taxes, the economy was going to shrink. That was realistically modeled into the program. The program initially started with a very high penalty interest rate.Working with the model, the initial situation looked very marginal, as if it might not work; but it could be fixed by lowering interest rates.

Now I want to answer four frequently asked questions: First of all, could or should the pace and extent of fiscal adjustment have been different? Secondly, on the question of bail-in and the assumption of bank debts, is that the whole story? Thirdly, how was the distributional aspect handled given that austerity programs are not just a question of how much, but of who? Then finally, could the support from the EU partners have been different or better?

Question one: Should the fiscal plan built into the Irish program have involved larger deficits? That's austerity, if you like. With Ireland's gross government debt soaring to 120 percent of GDP by 2012, and with much punditry at first about the apparent attractions of a sovereign default or debt restructuring, Ireland's unilateral ability to run a more relaxed fiscal stance was extremely limited. Maybe they could have organized something with somebody; but nobody, public or private, was going to lend



to a government in a default situation.

Indeed, it wasn't altogether clear at the time of the program that Ireland's emerging debt situation was sustainable. The deficit went down to 31 percent of GDP. Without the costs of bank recapitalization, it was about 10 percent. The debt needed to be adjusted quickly if Ireland wanted to return to the markets and have a credible debt position.

Now, we do not have very good ways of measuring sustainability. In addition to debt ratios, there are problems in interpreting what the GDP means and in counting the profits of multinational corporations.

On the other hand, servicing costs are important. If you're borrowing a large sum of money from the IMF, you've got to pay more for the loan. If it's a big multiple of your quota, there's a big surcharge. The initial borrowing rate was 5.8 percent. At that rate, with debt at 120 percent of GDP, sustainability was very problematic. The IMF's rules are not designed for countries with such high levels of indebtedness.

Initially, EU lenders took the same interest rate of 5.8 percent; but their borrowing policy improved dramatically in 2011, when European official creditors greatly reduced the surcharges on the cost of funds. The IMF kept their rules, but European borrowings were serviced at rates very little above the cost of funds. This allowed repayment of higher-cost IMF loans and replacing them with market loans, now available at rates comparable to those of official lenders. Debt servicing costs were greatly eased.

Without these reductions in interest rates, Ireland probably wouldn't have made it. The reductions made the difference between a sustainable program and one that would have likely had to have been prolonged or renegotiated.

Could fiscal adjustment have been slowed sufficiently to reduce the employment loss? The employment loss had already happened when the IMF program began; you cannot blame the IMF for the employment loss. You can blame them for the slower recovery. The bounce-back could have been faster had the program been better designed.

I've promised to discuss whether bank guarantee created the need for fiscal contraction. The guarantee was too wide and too unconditional; but it's often correctly emphasized that the government socialized private bank losses. The long-term fiscal costs of making good on the guaranty are somewhere between 35 and 43 billion, between 22 and 27 percent of the starting GNP. Spread that out over a number of years and it's not anything like the determining factor in the contraction.

The larger policy errors were made long before the bank guarantee. The bank lending excess of 2004 to 2007 could have been eliminated by much more aggressive bank regulation at the time. If so, the post-crisis period of fiscal contraction could have been wholly avoided.

**It's one thing to suggest that aggregate economic activity was protected after the crash by the Irish government; but it's another to say that income and capital losses were distributed in an equitable manner. By its very nature, the crisis hit some people harder than others.**

Consumption per head peaked in 2008, then dropped sharply. Without the housing boom consumption per head of course would not have grown as much, but it would have been able to continue through the late period of the international boom. Ireland would have had a good 2008 instead of a bad 2008, and the decline subsequently would not have been so severe.

It's one thing to suggest that aggregate economic activity was protected after the crash by the Irish government; but it's another to say that income and capital losses were distributed in an equitable manner. By its very nature, the crisis hit some people harder than others, for example, those hit by unemployment in the downturn, or by having bought property or borrowed money to buy property at the top of the market.

How did aggregate inequality change? Inequality of market income jumped up between 2008 and 2009, and by 2012 it was still notably higher than it had been during the boom; but disposable income after taxes and social benefits were pretty stable. The Irish social and tax systems acted as a safety net and automatic stabilizer at the micro level. In fact, inequality after 2012 was lower than it had been eight years earlier.

Relative poverty actually improved by 2012 because the government from 2008-10 was more progressive; whereas the government now in place is less progressive. So income inequality is not the whole situation; there are a lot of horizontal inequities involved.

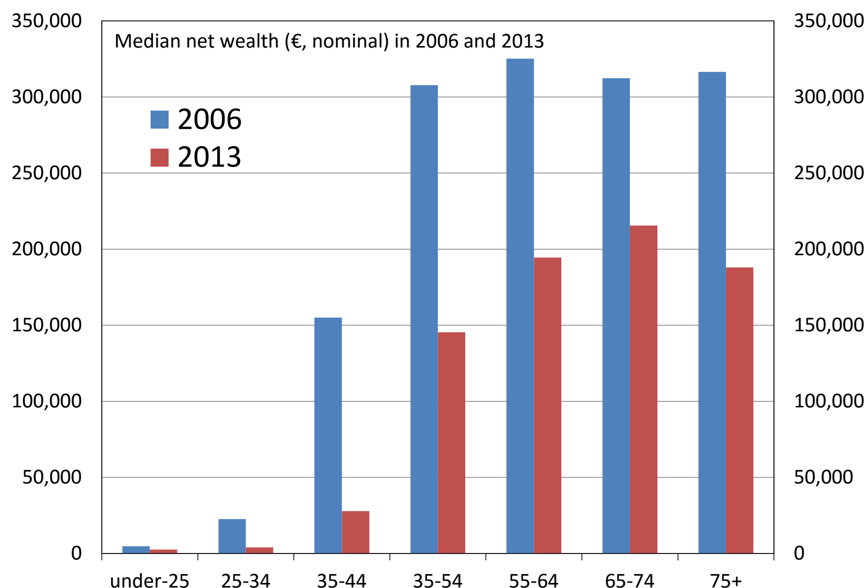
Figures on wealth inequality indicate people who were 35 to 44 years old in 2006 had a median net wealth of 115,000 Euros. Seven years later, the median net wealth for the same age group was down to 30,000. Other age groups didn't fare so badly. This disproportional fall for one group hints at a number of the complicated inequalities that had their effects on the political environment.

Finally, could international solidarity have done more? I think it could have. There are four things that could have been done better:

First of all, financial engineering, bank recapitalization: A significant block of money was injected by the government to recapitalize the banks and keep them going at the standard, higher-rate standards now prevailing. The government was slated to borrow about 35 billion, one-fifth of annual GNP, for the recapitalization. After stress testing proved that things were not quite as bad as that, they ended up needing only 16 or 17 billion.

But the Irish government had to borrow money to inject into the banks. The European official bodies could have devised something better. They could have simply injected European capital directly into the banks. They would have owned the banks, yes; but the Irish government would not have been burdened by the excessive debt, and the debt overhang period would

## *Net* wealth by age group 2006 and 2013




have been shorter.

We assumed that this would be part of the deal, but the European official bodies said they didn't have any mechanisms or legal authority to do it. And anyway, there was no political backing for it. They would have made more money by investing in the banks than they're going to get in return on the lending to the government. It was a no-brainer.

Less no-brainish, but also worth considering: Instead of a simple loan, they could have made a GDP growth-linked loan. This also would have enabled a faster growth response . Okay, we're going to put this money in, and while your GDP is so low, don't worry, you don't have to pay anything. But as your GDP comes back and starts to exceed a specified threshold, you're going to have to pay more, more than you would on a straight loan. Would that have been a good deal for Ireland? Yes! Because their growth recovery would have happened faster, they could have easily afforded to pay more. And depending on how it was calibrated it could have been a very good deal for the lenders.

Could the ECB have calmed the markets? Actually it probably could have. It could have said, We know you're running away from Irish banks. We know you're not prepared to lend to the Irish government. But we're not worried about the Irish banks. We're going to look after that situation, and you're not going to have any problems; so stop worrying.

I'm not quite sure that that actually would have been a good idea. I would have welcomed it at the time, but afterwards, the government still could have been faced with the challenge of limping on with its market access damaged and ultimately unaffordable refinancing costs. They would have had to borrow more and more from the market at high interest rates. It's not so easy to say to the market six months later, Look here, this package you put together doesn't make sense. Please lower the interest rates. That's what they did with the official lenders. They couldn't have done that with the market.

At the time I wish the ECB would have been more forthcoming with statements designed to calm the markets. I went as far as I could with my own statements, but a little man in Dublin saying it's alright, is not the same as somebody else saying, we'll do whatever it takes.

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# Austerity in the Baltics

## Jeffrey Sommers

The Baltic states can't be understood by just macroeconomic data alone. The greater context of the political economy is really essential to understanding what transpired there during the crash, the medicine that was applied to restore macroeconomic stability, and what has ensued since.

In my book on the contradictions of austerity in the Baltic States, James Galbraith wrote in the forward, "It is the fate of small countries to serve as pilot projects, as battlegrounds, and as points-of-origin for myths. In the wake of the great financial crisis, the three Baltic republics of Latvia, Lithuania, and Estonia have played these roles."

Latvia has been presented as a model austerity state, an exemplar of prudent policy for others to follow. However, most countries cannot follow their model because of the specific conditions and the way that the economy is structured in Latvia and the other Baltic states.

The story is a familiar one: Latvia suffered the worst decline in GDP from the 2008 shock of any state, roughly 25 percent. A tough program of internal devaluation was implemented. Macroeconomic stability was restored and unemployment is now just under 10 percent after being well over 20 percent. So Latvia has had some successes.

What did internal devaluation mean on the ground? More regressive taxation with increases in the VAT affected the poor disproportionately. We saw a lowering of the non-taxable minimum on income that, again, hit the poor with increased taxation. There were extensive cuts in the public sector, in welfare, education, and social benefits. There was mass unemployment following an increase in 'envelope wages' to avoid taxation in the increasingly 'flexible' private sector. Additionally, there were reductions in salaries; redundancy rights and employment protections were gotten rid of; long-term and youth unemployment increased, as did part-time employment; while full-time employment decreased.

As the Soviet Union was collapsing, many people saw the handwriting on the wall and took action to prepare a better situation for themselves once the Soviet system was defunct. Among those were Chekists, who were engaged in offshore banking/money laundering in support of all sorts of Soviet operations abroad, such as, for instance, giving aid to friendly political forces or to revolutionary regimes.

Latvia played a really big role in this privatization movement. Because of its proximity to West Europe it was also the transit point for much of the oil coming out of the Soviet Union. Some huge fortunes were made. Grigori Louchansky figured out that he could start selling oil at world prices while acquiring it at state prices and make a huge windfall on the arbitrage. He became a billionaire. A lot of other guys followed his lead.

The offshore financial structures to facilitate the outflow of raw materials from post-Soviet Russia and the CIS generally were all set up in Latvia. They still handle a lot of this traffic. So you have all these correspondent banks, essentially, where you go to launder your money from the CIS.

Correspondent banking is really really big business in Latvia. In the early 1990s there were over 100 banks for a country that then had a little over two million people. Now there's a little under two million, but they still have twenty-five banks. This is where organizations like Shorex, which is one of the main professional associations for people who are in the correspondent banking industry, go for their meetings because the business runs through here. Wealth management, tax optimization, or what my friends in the bar like to call stealing, is very very big business in Latvia. It is an economic structure that exists parallel to the structure of the real economy.

In 1991, George Viksnins from Georgetown University saw that, as Jamie said, Latvia could be a zone of experimentation. And it was small enough that he and his friends could control the puppet show.

George identified the young talent in the country and launched a really impressive organizational effort to create Latvia in the image that he wanted to see. The so-called "Georgetown Gang" convened in a series of meetings and came up with a plan for the country. They brought together people who essentially would control the country's financial policy for the next 25 years, people who would be prime ministers, finance ministers, central bank managers. Many are still players. The guy that's in charge of the central bank now is one of them. In their report, *Latvia 2000,* they clearly stated that the reform had to continue despite any changes in government; it had to be made public-proof. The reform program is the usual stuff—tight monetary policy, peg currency at a high exchange rate, progressive taxation, very high labor tax, no capital gains tax.

When the bubble burst in 2008, the prescription was to take the austerity medicine. In 2010 and 2011, no successes could be found among any of those who'd received this treatment. But by 2012, as there was an increasingly desperate search for a success story, they finally found one. Latvia was a kind of tabula rasa: a small place that people didn't know much about it; a frictionless opportunity for people to impose whatever narratives they wanted. The narrative was that this was a success case, this was the one that we had to follow.

Anders Aslund was one of the architects of Latvia's austerity model. He swept in right after the crisis, got cozy with the country's prime minister, and declared immediately that he knew what to do to insure a successful transition to macroeconomic stability and a return to prosperity in Latvia. (It's worth noting that his previous pupil was Boris Yeltsin.)

Let's move back a little bit in time to understand how the banking and housing bubble got inflated. NATO and EU accession in 2004 gained some confidence for the Baltic states. At the same time, there was a period of global liquidity. The Japanese carrying trade injected lots of cheap money to flow around. Alan Greenspan threw more in there with his credit Keynesian turn. Commodity prices increased, due in part to George Bush's war in Iraq. A huge 25 percent balance of payments imbalance emerged by 2006 because of massive import-based consumption paid for by all of the cash washing through.

Sweden once ruled Latvia. In fact, in the 17th century, Riga was the largest and wealthiest city in the Swedish empire. During the boom years just before the crash, Swedish banks stormed the country as conquistadors of sorts. Between 2005 and 2008, SEB and Swedbank in particular made their largest profits in the Baltic States rather than in Scandinavia itself. Eventually, the Swedish banks started to get out of Russian oil and move into real estate.

When the Soviets left, there was no real estate debt in Latvia. Bankers couldn't imagine a more beautiful situation than taking a debt-free economy and turning it into a debt-burdened one. Latvia's public debt-to-GDP ratios were negligible, which is one of the reasons they were able to impose an internal devaluation strategy. At the peak of the real estate bubble of 2007, private real estate debt consumed over 70 percent of the credit extended to the country. This wasn't for new construction for the most part; rather the sale prices of existing, beautiful, art nouveau buildings were greatly inflated, necessitating big mortgages. And the capital gains made on the sale of these properties fueled the growth of consumer-led consumption, etc.

My colleague Michael Hudson and I began to notice as early as February of 2005 that something was seriously amiss. We began publishing on this in Latvia, trying to warn of an impending real estate bubble burst. We met with the prime minister, the finance minister, and various people in the central bank. We quickly discovered that nobody cared. Well, they feigned to care, but they were all in the property markets, so they had a direct interest in seeing that the game continued.

Then we saw the development of a kind of Sartrean no-exit situation for Latvia's borrowers. In much of Europe, you are not allowed to walk away from a mortgage; you can't just send the title and keys back to the bank. A lot of Latvians lost their properties because they could no longer make their mortgage payments. The Swedish banks had made borrowers get cosigners—usually older aunts, uncles, grandfathers who had country farms, etc., and got daisy-chained into these debts. And so not only did people lose, say, their apartment in Riga, but they had to keep paying the mortgage on it, even though the bank had maybe already turned around and sold it again; because if they didn't do that, then the bank would go after the aunt's place in the countryside. I've been working with the Latvian parliament trying to get this overturned, but we haven't had much success yet, unfortunately.

By the fall of 2008, the money had stopped coming in from the Swedes. People panicked and there was a run on deposits at Parex Bank, the biggest bank in the country at the time. The Latvian taxpayer would come to the rescue. Was it the Latvian depositor that was being bailed out? No. It was really the Swedish banks. SEB was the chief correspondent bank of Parex. And so the Latvian banks were bailed out to insure that the correspondent banking sector, the offshore banking sector, would not be damaged. The government wanted to insure that there was not an exit of Swedish capital. The Latvian taxpayer got stuck with that chore, although in 2009 the European Commission sent a letter to the Latvians stating that they were going to get a bailout to help pay off the bailout for Parex Bank.

Because of the Latvia 2000 austerity project, Latvia really existed on the far right margins of neoliberal philosophy. Whereas there was some rethinking of some of those ideas at the IMF and the World Bank after the East Asian crisis in 1997-1998, in Latvia they still adhered to a hard austerity doctrine. In 2010, Einars Repse, then at the head of the finance ministry, previously prime minister and head of the central bank, advanced a very harsh austerity budget, so harsh the IMF, the United States, and the Swedes tried to restrain him. I found a Wikileaks cable from the State Department reporting on a conversation with Repse that said, "The telephone conference call did not go very well. According to the assistant secretary of state, with the IMF and the EU expressing serious concerns about the income distribution profile and proposed budget cuts, the EU and IMF urge the Latvian government to reconsider the measures. But Repse defended the harsh kind of austerity program"—and also of course used the old quote about never letting a crisis go to waste.

Street protest in Riga, January 13, 2009

There was some macroeconomic success in terms of returning the country to stability, although the price paid was quite high. But by 2012, we see this branding of Latvia as a success story. Anders Aslund and the Latvian government's public relations line, which was adopted by the IMF, was that the harsh Latvian plan worked because the whole country was committed to it. But I was there. I can tell you this was absolutely not the case.

The usual argument is that in a democracy you cannot impose austerity as harsh as was imposed in Latvia because the people will throw you out. In Latvia they didn't, and that's what seemed to be so compelling and exciting to, for lack of a better term, the austerians. Here was a country where the imposers of austerity were not thrown out. But it was not acceptance, but ethnic division and the fear of any kind of return to Russian control that prevented people from voting against austerity—a typical divide-and-conquer situation.

There were huge protests. I was at one on January 13th of 2009. There were 10,000 protestors on the streets of Riga. The Balts are a rather taciturn lot.When they get together in big numbers, if they're going to make any noise, they're going to sing in unison;it's very beautiful. Students, doctors, teachers, farmers, and pensioners all came out in the thousands over the next few months.

But rather than those protests continuing after the end of the spring of 2009, people just gave up. They understood that the government was not going to budge. So they just started leaving, and they left in huge numbers, like an Old Testament exodus.

Even as Greece was being told to follow the Latvian model, comparative poverty rates were absolutely horrific. In 2010 and 2011, nearly half the population was at risk of poverty—extreme poverty, a third of the population. far worse than Greece at that time, although Greece now is catching up. People started to self-deport, as Mitt Romney would say. Some have cynically said that this is how they dealt with the unemployment problem, by just getting rid of the unemployed. I don't think that was the intended outcome, although it certainly was an outcome of the crisis.

Some argued that people began leaving Latvia because of the EU accession in 2004. Actually the opposite occurred. Because of the real estate bubble that had created lots of employment, emigration actually started to decrease; but it did increase dramatically with the 2008 shock, and then again following the two worst years of 2009 and 2010. It continues at a fairly significant rate. Most discouragingly for Latvia's demographic future—and the situation is fairly closely reflected in Lithuania, not so much in Estonia. Live births in Soviet Latvia peaked in 1987 at 42,000, and in 2010 there were only 18,000. After the early 1990s, fertility rates dropped significantly. The country is becoming a retirement home and a nature preserve, a bunch of pensioners and a bunch of land without people.

So you can create macroeconomic stability, but there's a price for it.

As early as the second half of 2009, commodity prices started to come back, and so offshore business came back. There's also been a sale of resident permits, so you have a lot of people coming from China, Ukraine, Kazakhstan, etc.

Forestry is another present source of growth. The Soviets decided for a number of reasons that Latvia shouldn't have as many farmers as they had during Soviet rule. They thought that Lithuania should be the place producing more food, so they let a lot of Latvian agricultural land revert back to forests. Consequently there's a big reserve of forests now. It's like a bank account that you can draw down. Half of the country is forested, and half of that is publicly owned; so a big response to the crisis was to just begin clear-cutting forests. Now that is not necessarily a bad thing; it just depends upon how long you're going to do it and at what level it becomes unsustainable.

There have been some new financial innovations, including SMS loans [loans obtained by text message –*Ed.*] at usurious rates. People have returned to employment, but many of them are making a lot less than they did previously, and so they're forced to get loans.

There's been an increase in the inclusion of Latvian products in global production chains. Latvia's industrial sector is only about 10 percent of GDP, but it's starting to become a little bit more industrialized—a good thing. Grain sales were really up for a while, but they're starting to abate with declining prices.

One final point: My book, *The Contradictions of Austerity*, was published by Rutledge in 2014, and I thought this was rather curious: In addition to its classification under economics, it was also listed in their mental health section, which seemed to be a somehow appropriate cataloging of the book.

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# Austerity in Greece

## James Galbraith

The standard narrative of the Greek experience holds that Greece is a country with weak institutions, uncompetitive industry, and a culture of dependency and corruption; a country that is in need of market reforms and fiscal discipline that, if applied diligently, would yield economic recovery and ultimately a return of confidence in credit markets.

Not half of that is true. The descriptive elements have a certain validity that lends weight to the prescriptive elements, but without providing a logical support.

The question requires a view informed by political economy not merely of Greece, but also of the European and international dimensions. Here, then, are some generally accepted facts about the situation:

The Greek state never had strong institutions or competitive industry; has been in default for about half of its existence as an independent republic since the 1830s; and did over-borrow before 2010 for purposes that had no possibility of economic return, including military recruitment, the 2004 Olympics, and to cover hidden deficits in the health care system. The debt-to-GDP ratio had risen to about 100 percent of GDP by the time of the crisis.

At the same time, European banks, German arms dealers, and German construction companies all booked profits on those loans, while fully understanding that they were taking a degree of risk.

Furthermore, Greece was admitted to the Euro under false premises, in part disguised by derivative instruments designed for the Greek government by the helpful offices of Goldman Sachs. Greece was on the short end of the chronic European trade imbalances that basically pitted Germany against every other European state due to a combination of German industrial superiority and wage austerity in Germany that was destined inevitably to cause problems throughout the Eurozone system.

At the level of the world economy, the Greek credit position collapsed in a general flight to safety in 2009-2010. The financial crisis had its origins in the mortgage debacle in the United States, exported to Europe through asset-backed securities. The investment community sought to strengthen its portfolio by dumping those assets that were at risk, including the sovereign debts of a whole raft of countries. This would have happened even if Greek policy had been much better than it was.

The result in Greece was a further collapse of GDP and a rise in the country's indebtedness, so that the ratios were on the order of 170 percent of GDP at the start of 2015. Today [January 2016], they're closer to 200 percent.

Austerity in Greece came in abruptly following the election of George Papandreou at the end of 2009. The main purpose of the austerity program was to rescue the banking systems in the rest of Europe, especially those of France and Germany. Two of the four Greek banks were owned by French banks, which had thoughtfully placed a lot of sovereign debt on the balance sheet of their Greek subsidiaries. The bailout transferred the Greek debt to European taxpayers creating a political obligation problem of admitting the whole thing was going to be unpayable. It became, instead of a commercial consideration, a consideration entailing the reputations of the governments that had agreed to the deal.

The IMF came into the program in 2010 for several reasons. The first was that otherwise the IMF was largely out of business. Its programs had been paid off in Latin America and elsewhere, so it was not only out of work; it was running out of revenue. Secondly, the managing director of the IMF, Dominic Strauss-Kahn, had a very good chance of becoming president of France, particularly if he was able to deploy the resources of an international institution that he happened to control in order to serve the interests and promote the salvation of the French banking classes.

Thirdly, Angela Merkel needed the authority of the IMF in order to design a new post. Austerity was a political necessity, not designed by the Greek government, but rather a complement to its financial bailout package. It was also done with the very strong support of the United States Treasury, at that time concerned about the credit default swaps exposure of American banks, and therefore not wanting to entertain a massive write-down of the Greek debt.

The austerity implemented from 2010 through the end of 2014 included very large cuts to the Greek civil service - around 300,000 employees. Pensions were cut about 49 percent. There were pay cuts in teaching, universities, and health care. There was a cut in the minimum wage. Public investment basically came to an end, as did investment supported by European institutions, because the Greek government couldn't meet the copayment requirements. Unions, which had never been very strong in Greece, lost whatever collective bargaining power they had had. The forced privatization of Greek public assets did not bring anything remotely close to the revenue targets, because when you put everything on the auction block at once, there's a tendency for prices to fall.

Over all, the austerity imposed on Greece was two to three times greater than that in any other of the European crisis countries. Imagine about 10 percent of GDP disappearing very quickly in the US, as would have happened had there been no automatic stabilizers or stimulus package after 2008. That gives a rough comparison to what actually did happen in Greece because there was no inter-European automatic stabilization. None of this was under the control of the Greek government. Austerity was a policy that was entirely designed "from the outside" under a memorandum of understanding.

Overarching this at the macro level was a target for a primary surplus of 4.5 percent. This target was not going to be reached, although Greece did come to primary balance by the end of 2014. The mechanism

that was supposed to work was the same one that was advertised for Latvia: efficiency gains through privatization and management reforms; elimination of (allegedly) inefficient public servants; improved fiscal stance through increased taxation; and an internal devaluation through reduction of what had admittedly been an overly rapid gain in unit labor costs. According to the IMF forecast, that was supposed to produce a drop in GDP of about 5 percent in 2010-2011, followed by a full recovery by 2013.

The reality was a total collapse of both public and private investment and a drop in GDP of 25 percent from the peak, which was not recovered at all. Unemployment rose to an excess of 25 percent, well over 50 percent for young people. The labor market went to a high degree of informalization, which undercut funding of the pension system. Privatization brought essentially no efficiency gains. There's no real reason to believe that an electric utility, for example, is going to become more efficient simply because you transfer it to private ownership. The primary surplus target was a fraud, pure and simple, whose alleged severity was intended to obscure the fact that a great many other things in the memorandum of understanding were simply not going to be enacted even under the conservative government coalition in power at the time.

In 2012, there was a partial restructuring of the Greek debt that had the effect of destroying the funding basis of Greek pensions while not affecting those bonds that had been bought at a deep discount by the European Central Bank under the Securities Market Program in 2010. In 2014, when people started saying that there was a Greek recovery, what was in fact happening was a debt deflation. The price level was falling more rapidly than the nominal GDP; but both were in negative territory.

What happened in Greece in that context was a little bit of a political miracle: Instead of yielding to the temptations of the Greek Nazi party, Greeks instead coalesced behind a progressive coalition--a rather ragtag group of expatriate professors, union activists, ecological activists, and political militants--under the title of the Coalition of the Parties of the Radical Left, SYRIZA, that was elected on January 25, 2015. My friend Yanis Varoufakis, who had been teaching with me at the University of Texas, became finance minister the following day.

This new government did not seek to open a clearly necessary discussion about pan-European reform because there was no chance of being entertained in the prospect. We did have a modest proposal, coauthored by Yanis, myself, and former Labour MP, Stuart Holland, that had a number of elements for creating a viable resolution of not just the Greek, but the wider European country debt crisis, through the European Central Bank. But there was no avenue for the Greek government to get a new item on the agenda.

What the government had to do was to try to negotiate with its European partners and the IMF programmatic changes that would at least attempt to mitigate some of the most dysfunctional features of the program imposed during the previous four years. The basic hope was for a realistic primary surplus target in line with what had already been achieved, around one percent of GDP; labor relations that would meet the minimum standards of the International Labor Organization; protection of pensions at the lowest end of the spectrum for hundreds of thousands of pensioners; and a rational privatization program that would involve some continuing participation of the Greek government so that, if the assets did prove to have an up side, there would ultimately be some benefit to the national fisc.

l to r: Jeffrey Sommers, Patrick Hohohan, and Marshall Auerback

What was required to make the economy viable, or at least to prevent further collapse, was continued support through the European Central Bank and eventually a restructuring of the Greek debt. Immediately urgent were a number of deadlines for repayments to be made to the IMF and to the European Central Bank. After those were done, there was a grace period through 2022 in which there was plenty of time to negotiate the debt. It was the programmatic issues and the stabilization of the underlying economy that were central. The government, although it was a government of the radical left, was by no means a government of enthusiastic Keynesians or modern monetary theorists. Perhaps unfortunately, it was also not a government that was the least bit interested in breaking out of Europe or the Eurozone. So it did not propose an end to austerity, but rather tried to achieve stabilization, which would have been followed, if they'd been successful, by a kind of gradual balanced budget expansion.

What were the reactions? At the technical or institutional level, discussions were with representatives from the IMF, the European Central Bank, and the European Commission. Although those officials were not up front about their remit, it's clear now that they were never actually authorized to negotiate the terms of the program. Their job was to conduct a review of the previous financial assistance program, the memorandum of understanding. Their reporting requirement was to say how close to the initial agreement the Greeks were willing to come.

So the Greeks would make a concession, and then their concession would be pocketed, and the answer would come back, And now you must make another concession. At the political level the rhetoric was, The Greeks must work harder. There wasn't a serious discussion about the validity of the program, only the extent to which the SYRIZA government would hold out against complying fully with what the previous government had already agreed to. Meanwhile the European Central Bank, while stabilizing every other part of the Eurozone, worked to destabilize the Greek

financial system and to promote a slow run on Greek bank deposits. We were talking to the wall for four solid months.

At a higher level, the finance ministers were meeting periodically as the Euro Group. As a former member of the US congressional staff, I found it appalling; I normally think that governmental entities work together better when there are actual rules of procedure and records of what they're doing. The Euro Group was entirely ad hoc and unrecorded. The Euro Group was governed by the local considerations in the countries that were members.

The Balts and Finns were driven by their ideological commitment to austerity as a universal policy; therefore no deviation from that policy could be tolerated.

The Spaniards, Portuguese, and Irish were motivated by the fear of giving aid and comfort to SYRIZA-like movements in their own countries. Making concessions to Greece was a risk that they were not prepared to take.

The French and Italians were more sympathetic; but they were motivated, at least in part, by a sense that they could gain some policy flexibility themselves if they were not acting in solidarity with an obstreperous government on the periphery of Europe.

The Germans had a complex combination of internal and external politics. Herr Schäuble, the German finance minister, was the most direct and candid interlocutor of the Greek finance ministry, someone with whom it had cordial and direct discussions. He was never evasive about what he would or would not do. The only question was whether a higher authority might constrain him from holding to his positions. That pushed the Greek government to deal at the political level, directly with Angela Merkel.

The decision ultimately turned on whether the German government was prepared to tolerate the government of the left in Europe. Ultimately, Chancellor Merkel decided that she would not. From her point of view, the best thing to do was to create conditions under which the Tsipras government would fall. That led to the stalemate at the end of June and the referendum in which the Greek people rather bravely said, No, we do not wish to accept the terms that are being imposed upon us. But the government of Greece had already made its decision that it had no viable alternative except to capitulate.

The general conclusion I draw is that almost none of the conditions that determined what happened to Greece over the course of the first half of 2015 were related to economic conditions in Greece or to any understanding of the particular circumstances of the Greek economy. Those were simply not a relevant consideration for the creditors, all of whom were motivated by their exterior ideological and political commitments; while none of them pretended to have any particular belief in the efficacy of an austerity program.

A good many economists concluded that there was no option for Greece inside the Euro and that exit would be the better choice. By exiting the Euro, Greece would retain flexibility over the exchange rate and exit from the strictures of the memorandum. Neither Prime Minister Tsipras nor Chancellor Merkel would permit their finance ministers to engage in that discussion. At a meeting on the 8th of June, it became clear that there could be no negotiated exit. If Greece did exit from the Eurozone, it would have to do so under conditions that were within the capacity of the Greek government to manage alone. I was charged to lead a small team to list the problems that the government would face; and the list was long and daunting. While we in the Finance Ministry might possibly have made the choice for exit given the decision of the Greek people in the referendum on the 5th of July, it is understandable that the Greek government made the opposite call. They did capitulate, and the memorandum is now back in full force.

What are the effects of the memorandum today? The tax rate is up to 23 percent; there's much lower spending; capital controls are still in place. Privatization is going forward. Bankruptcy and foreclosure reforms to accelerate privatization are part of the prior conditions that were imposed on Greece in order to begin to get some of the refinancing that was promised under the program. In addition, the banks were recapitalized, and American hedge funds got a major share of the equity in the Greek banking system at a very low price.

It is clear this is not a program of economic recovery nor reform nor restructuring; it has nothing to do with the consequences for the Greek people. It is a program of clearance. It's a dispossession and liquidation carried out under a colonial administration. The issue is very simple: Do the Greek people, Greek enterprises, and the Greek state have any prior claim on the physical capital assets of the country?

In the context of the United States, the answer would be obviously not. Just because I live in Texas doesn't give me a presumptive right to own property there. But the European situation is different. Countries in the European Union and the Eurozone have a general presumption that they will continue to function as quasi-autonomous entities. That presumption that does not entail the complete abolition of the right of ownership of the poorer countries to their own assets in their own territory.

The question therefore is still politically unresolved. Although the direction of European policy is clear and the Greek government for the moment is entirely subordinate to that policy, I do not imagine that it will be free of resistance as foreclosures and evictions begin to take hold. The government is trying to protect householders in their primary residences, but the many people who have secondary residences on the islands are not protected. Houses which are perhaps more precious to people than their primary residences are going to be taken away in great numbers. I think you're going to see a deepening public resistance.

If there was a larger political purpose in crushing the Greek government, namely to intimidate the voters of Portugal and Spain and elsewhere, it's clear that the voters of those countries were not effectively intimidated. At least two of the finance ministers who were adversaries to Yanis Varoufakis over the January-to-June period are no longer in office because their right-wing governments have lost their majorities.

The future of austerity in the South of Europe is by no means a settled question, despite the rather depressing experience of the first half of this year.

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John Paul Dunne—University of Cape Town
Raymond Gilpin—National Defense University
Shikha Silwal—Washington and Lee University

### The Future of Growth

Sunday, Jan. 8, 2017 8:00 AM–10:00am
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Robert Gordon—Northwestern University
Anwar Shaikh—New School for Social Research
Gerald Friedman—University of Massachusetts Amherst

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