Public Deficits – A Stick Shift to Revive Economic Activity

The explosion of public deficits, a spectrum of default payments of one or several countries or restructuring of their sovereign debt, are in no way specific to the crisis that has been sweeping through our western nations since 2007. Since the French Revolution, it has been possible to count four major phases marked by an uncontrollable escalade in national debts. The first period goes back to the Napoleonic wars in 1848 in which half of the countries, States and kingdoms at the time were successively declared bankrupt. The second period really got going after the foundation of the German Empire in 1870 and lasted about twenty or so years. The Great Depression, of course, clearly originated in the stock market crash in 1929 and lasted until the end of the 1940s. Finally, a fourth crisis, limited to the emerging markets, had devastating effects throughout the 1980s and 1990s. Japan, an industrialized country with an integrated economy, was also affected by this crisis, having suffered the implosion of several bubbles since the start of the nineties. Modern day is thus marked out by crises linked to debts which last on average two decades… or indeed longer, Japan for example still hasn’t escaped its “lost decade” which has been going on now for more than twenty years! The monstrous deficits preceding and accompanying the Great Depression were decreased in due form by the bankruptcies of certain States, while hyperinflation vehemently took on the role of eradicating the debts of several others (Weimar’s Germany naturally comes to mind). We also call to mind the fact that all of the countries allied with the United States during the First World War defaulted against this company – with the sole and well-known exception of Finland. None of the nations that defeated Germany at the time were in a position to repay the United States for their engagements, which worsened the declining economic conditions disguising the Great Depression. The colossal deficits of the First World War and the Great Depression – never paid back – ended up in default payments or restructurings consisting in partial repayments or in sudden rises in inflations. A bit closer to home, the crisis in the emerging countries was also regulated by a combination of restructurings topped with hyperinflation. This also allowed the cleaning up of debts and speculative bubbles to come to an end. Debts
also form an integral part of a State’s operation and its way of life. They likewise form the pattern of our own daily life.

The current crisis has nevertheless highlighted the deficiencies of our economic models where the debts’ variable is strangely absent despite the controlling and active role it plays in them. Our current economic system naturally includes salary and price variables. It is further determined by the central bank that, through its traditional inflation control instrument – namely, interest rates – has a fantastic lever to measure out our prosperity. It is because of all this that the essential ingredient of debt seems painfully to be to default on our current economic models to which nobody has had the guts to incorporate the credit variable. The body of economists, and with the credit rating agencies that parasite the system, are in this way late in globalization and seem stuck at the previous stage of closed economies in which all debts must be necessarily offset by debts of equal amounts. If we find ourselves today in a world where the credit rating agencies can dictate their law and where the debts of a country (or a region) are susceptible to collapsing an amazing human venture (the European Union), it is purely because of the deficiencies in our economic models, which do not include the debt and which, perhaps more importantly, overlook its effects. Our financial stability and prosperity depends nevertheless just as much on monetary policy (that is on interest rate setting) as on non-conventional tools and levers (such as injections of cash, and thus debts). And yet, our political leaders and our economists confine themselves to academic ponderings in which deficits are completely forgotten about. The balance of measures and approaches is at once slanted and the imbalances are systematically accentuated by decisions and positions that brush aside the (often beneficial) effects of the debt. The central banks, the ministries for Treasury and Budgets, the regulating bodies such as universities and academic research departments must therefore understand and include the active (and often “straightening”) role of debt in the economic grid. With economic framework no longer being able to be defined as a circuit (and a closed one at that), a great rethinking must occur based around these questions: What is the nature of our debts and how are they shared out between private debts, company debts and public debts? When does debt become excessive? When does investment make the economic growth of a country indebted to foreign funds? Are loans and bond issues the only mechanisms allowing the redistribution of funds? Why aren’t the risks fairly divided out between the various stakeholders? Is it not logical for the credit providers to assume a certain degree of non-repayment risk for their loans given the interest charged?
Furthermore, the responses to these questions must include a certain amount of evidence too often denied by economists and leaders. Indeed, resorting to loans allows households and individuals to stabilize their consumption and their daily life when their income fluctuates or is actually uncertain in times of crisis. In the same way, it allows businesses facing erratic turnovers to regulate their investments and their production. Credit allows the state to continue on with its public spending without taxing its citizens too much all the while providing it with important levers to revive entire sections of its economy. All in all, public debt offers liquidity to economic agents by greasing up the wheels with inevitably positive consequences on private and company investments. The citizen’s lifestyle and the improvement of economic conditions are thus tightly correlated to the debts of its state, because the volatility and macroeconomic uncertainties are exacerbated by the refusal to seek sufficient credit. In short: no public debts, no growth! This is because it is the debt that will allow our societies to become more modern, to build themselves, to enrich themselves and be confident that better days will come. Our material comfort, the development of our mentalities and even the blossoming of our democracies are indeed due to this capacity of becoming indebted, and this willingness and ability to live on credit, at least in part. Without debts and without this transmission belt of financial tools, we would still be poor, our Western world would not have been able to play its role as an engine of global growth and modernism, the average citizen would certainly not have been able to consume, to become owner of his home, or even just buy his cell phone, and companies would not have been able to invest and develop.

A country’s economy, like an individual’s budget, is condemned to restrict itself as soon as the credit tap dries because of, for example, a financial crisis. A painful deleveraging process is thus implemented consisting in repaying, at least in part, these debts, combined with default payments from debtors unable to fulfill the requirements of their creditors. Consequently, the States logically employ drastic reductions in their spending while the affected households stop any unnecessary consumption. The creditors, whoever they may be, are in no way tempted to take the helm by increasing their spending because of the inactive general climate and their losses for those that haven’t been repaid. Such a convergence is liable to paralyze an economy, or indeed global activity, within a general self-feeding deflationary spiral framework. The decrease in consumption and public spending translates therefore into stagnation, or indeed cuts, in salaries having in turn a negative impact on prices. The latter are indeed restricted for trying to conform to a half-mast request, with a disastrous cascading effect on revenues for all the stakeholders. Put otherwise, these essential debts do not impoverish the
world because the commitments of a household, of a business, or of a state evidently constitute assets for their creditors. In fact, the never-ending arguments created by the neoliberals in which our States can no longer get themselves into more debt and in which this crisis would have been worsened by the excessive debt, are truncated. This is because a quick and easy answer justifies the debt reflation in times of crisis. The size and extent of global debt has no effect on the level of world wealth, because the debt of an individual or a state is the debt of another, or indeed, several others. Moreover, it is essential to introduce a decisive qualitative distinction in this approach and in this analysis of the debt because all debts are not valued. Indeed, the profit of the debtor is crucial because one may remain solvent while another becomes liable to default in their payments. In addition, it is what explains the size of our current crisis and it is what allows us to come to the conclusion that the new debts taken out nowadays by solvent economic agents or by States (who may freely print the money) contribute to considerably relieving the excess of debts of the others. Spending and investment made by a state will have a necessarily positive impact on the employment and unemployment of unexploited resources. Companies and individual liable for debts will be in a position to progressively pay back. The growth will thus be the meeting point... if only the private sector – at least partially relieved of its debts and having new-found confidence – took the reins. The private sector would most certainly get into debt again, which would allow the state to take a breather in reducing its deficits, but the debtors’ profile will have changed and cleaned up. Indeed, these are solvent and strong debtors, in the sense that they fulfill their obligations, who will have taken the place of weak links who had a devastating effect on the economy. The global debt level will not have decreased, but the confidence and investment will be re-established by this simple debt-transfer to credible operators. Debt, thus, may well remedy debt, whilst conversely, breaking the chain of debt leading fatally to economic depression.

Excessive debt creates certain weaknesses, none of which highlight the fateful landing of 90% deficits (decreasing the GDP of the country in question), above and beyond which national debt strongly damages growth. Its excessive accumulation is obviously not devoid of risks. Common sense and intuition tells us that the ability of the States (much like the ability of households and companies) to pay their interest and their debts is seriously put into question by the sharp drop in their revenue. These situations, in the extreme, lead to a default payment for the state, or in individual bankruptcy for the debtors whose debts are becoming progressively more vulnerable to bumps. It is at this moment that consumption stagnates, that investment takes a step back, that unemployment gets worse, that creditors stop giving out loans – in short,
when confidence collapses. Indeed, the causal link is shown between excessive debts, the collapse of economic environment, the volatility of the situation and the bankruptcy of financial stakeholders. Because of all this, confidence is vital and its revival must be the absolute priority of the States, especially in stormy climates. In times of crisis, the State’s duty is to fill the gaps left by the collapse of the private sector. Furthermore, only the force of a public kick is able to get a growth, dangerously hypothecated by the increase in deficits (whatever their nature or their origin may be) and by the aging of populations, back on track. Let us remember by counterexample the USA, which upon the election of Franklin D. Roosevelt in 1936 and while it (and the whole world) was still in a depression, reduced public spending so as to stop its debts. These austerity measures decreed at the time by the Roosevelt Administration to please the financial sector caused unemployment to jump to 19% of the working population and forced the aim of the American public power to create jobs in order to compensate for the massive layoffs in the private sector. Indeed, it is close in this context to the big uncertainties that Keynes suggested to the state to pay people in order to dig holes to bury bank notes in. Boutade however highlighted the crucial role of the state Regulator, revealing the pressing necessity to maintain employment at a level permitting consumption and keeping confidence. For that matter, hasn’t the British Empire’s public debt, throughout the course of its history (more exactly, since the start of the 18\textsuperscript{th} century) reached unbelievable levels, at times exceeding 250% of its GDP? In effect, it is the gradual but irreparable decline that would have had to strike this country, in any case according to the standards wanting the landing of 90% debts in relation to the GDP trigger a restricting and volatile poverty cycle. However it is not its massive debt level that prevented the British Empire from taking down Napoleon and from jettisoning it in the Industrial Revolution taking place in the world. It is probably thanks to this lever of its debt that this empire prospered and got a relatively stable growth throughout the 19\textsuperscript{th} century until the First World War.

To put it another way, if our political and economics leaders wish to avoid the return of the “Great Depression”, they shouldn’t deceive themselves about its reasons, at the risk of having to suffer a new one in the near future. Because the both dramatic and long period from the 1930s was not so much provoked by the financial collapse (which was no doubt striking and memorable) than by the irreparable increase in unemployment. So when it was of course inconvenient to let the banks go bankrupt one after the other, the main tragedy was taking being played out elsewhere – that is, in the employment market, which was unfortunately threatened by the American Federal Government’s inability to react forcefully. This was reduced thanks to an economic adjust-
ment due entirely to the preparation of the Second World War. Waiting
for this impressive revival initiated by the war industry, a Keynesian
showcase, the USA nonetheless suffered (worse than the Depression)
combined deficits reaching 25% of their GDP at the time, equivalent to
$4000 billion in today’s money. Why did the Federal Government
manage to get into such advantageous spending at the end of the 1930s
and going into the 1940, given that they could have done it in 1931 and
thus avoid a decade of superfluous suffering for a country? Put simply,
for similar reasons to those that nowadays create tension between be-
lievers of growth and believers in austerity – that is for reasons of
principle and ideology. In fact, the obsession with deficits – as prevalent
in politicians then as it is now – was leading to counterproductive
decisions. Indeed, public spending and other New Deal stimuli was
substantially restrained in 1937 with the already known harmful effects,
taking place while the economy was giving encouraging signs and
unemployment was decreasing to 10%. Nowadays, rigor leads inevita-
ably and in the same way to a similar debacle to that of the second half of
the thirties in the general context of a stagnant employment market.
Because the obsession with deficits eclipses the fight against unem-
ployment which must be the priority. It goes without saying that it is not
the decrease in deficits – as important as it is – that presides over the
affected confidence of the general public. In this respect, the politicians
have proved time and time again that they are bad economists given that
the deficits in no way constitute a source to revive consumption, which
takes the lion’s share in aggregate demand. In addition, it is the very
anemic employment market that is at the same time responsible for a
consumption that remains at levels that are unable to have a domino
effect on the economy and salaries that are reaching their limits. An evil
combination that translates into a decrease in demand. Current perspec-
tives, which are hardly brilliant, risk therefore of being worsened by the
return of a new “Great Depression”, due entirely to rigor.

Why was this austerity policy imposed on peripheral European na-
tions? Has the deterioration of economics 101 been inevitable? Or is
austerity the result of the panic that seized hold of the markets which, in
turn, has paralyzed political leaders? In this respect, the correlation
between the soaring cost of financing the sovereign debt of these coun-
tries and the increase in austerity implemented is eloquent. Effectively it
is the countries which have suffered the highest “spreads” – i.e., those
which the markets were gradually squeezing for more and costly financ-
ring – which also implemented austerity measures and the most drastic
hardships. The intuition according to which it is the financial markets
and their threats of excesses which applied intense pressure on the
European Union and on its leaders with respect to intense budgetary
economies is therefore? Knowing that, conversely, austerity was not
implemented among the countries where the spreads remained stable. Since then, where does that leave us? That markets are “simply” in the end messengers, bearers of bad news? Namely that the deterioration of the public debt and the competitiveness of nations mechanically translated into a surge in their financing costs, which could only be controlled through all-round savings? Or that it is fear and collective panic which had a disastrous impact on the hollowing out of these spreads which are irrevocably far away from the fundamentals… a little like the surge in stock markets is regularly totally incompatible with the state of the real economy? Since the response to this dilemma is not obvious, you may doubt and opt for a second hypothesis Nevertheless, it is crucial that a central bank be involved in this type of situation. Indeed, it is only its determination and action to provide liquidity is able to calm things down. It means accepting the verdict of the markets and leaving the overwhelming majority of our citizens defenseless. The ultimate objective of its intervention is to appease the markets and other stakeholders in order that the fundamentals are analyzed for those they are, and not through the prism of collective panic. And, indeed, the decision of the European Central Bank in 2012 and its governor, Mario Draghi to support the Euro “whatever happens” was spectacularly decisive. By agreeing to assume its role as lender of last resort, the ECB has calmed markets and eased the affected countries that have gradually seen a significant improvement of these spreads. Rather than consolidate public accounts of peripheral European nations, the ECB confined itself to having its presence felt, with a resulting collapse of financing costs in these countries. Thus, it is the countries where these spreads were the most degraded (Greece and Portugal) which benefited from the sharpest decline. As economic data did not naturally improve with the wave of a magic wand, it is thus easy to deduce that the financing costs fell at the same time as the “fear” factor. Moreover, it is in the countries where this fear had been the most intense that ECB intervention proved to be the most effective, since it is there that the spreads had fallen the most. It is even possible to push this reasoning even further. And to assert that the soaring cost of financing sovereign debt of these peripheral countries had no correlation whatsoever with economic fundamentals! Otherwise: how do you explain that these spreads are at reasonable levels today – far from their records in mid-2012 – whereas the debt ratios/GDP likely worsened in all the countries in the spotlight? Should the erosion in these statistics relative to their public accounts and their growth not have been “mechanically” translated by new records on the financing of their debt? Yes, but in the meantime the ECB had appeared suddenly confirming the intuition that it is the market panic – not economic fundamentals! – which had initiated the surge in these spreads. Austerity is therefore only the result of intense panic which seized our politicians,
themselves, under pressure by the financial markets, in the absence of lender of last resort. Let us push this reasoning one last time, since it is now very easy to make this statement: it is countries which implemented the most extreme measures of austerity which today have suffered the biggest decline in their growth. In short, there are nations which suffered an unprecedented austerity by panicked markets and European leaders, knowing that these sacrifices did not in any way produce the expected results. Indeed, they deteriorated more the foundations of these countries, including their ability to pay their debt. As such, the cash crisis degenerated into an insolvent crisis! This is the cost of listening religiously to financial markets which, far from being the messengers, are confined to sending bad signals all the time. Signs very wrongly interpreted by European leaders who are woefully ignorant in matters of finance and who embarked lightheartedly into a crossfire against public deficits. Meanwhile, for its part, the ECB was complacent in its splendid isolation until the situation became truly untenable, whereas its more precocious intervention would have avoided so much human suffering. To paraphrase Paul Krugman who uses the significant metaphor of “ducks”, the determination of our politicians and the economic and financial elite to impose austerity won’t get rid of the vermin or the bad taste in our mouths! It always returns despite all possible treatments, like the rigorous madness that persists to reduce public deficits that it is on the contrary essential to use wisely during a recession.

The paying back of debts is thus practically inefficient as soon as it takes place in a general situation of stagnant revenues. We will never repeat it as much: growth will only be brought back with public policies aimed at promoting full employment and improving revenues. Once returned, this growth will only be maintained under cover of a legal and equitable redistribution, crucial to re-establish the link between a growing productivity and increasing salaries. Without the progression of revenue, no long-term growth will take place. That is unless our politicians and economists have deliberately made the choice to transform our nation into one of leisure… Only “reflation”, a term borrowed from Fisher – will break the current infernal spiral.