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Austerity, the depression, high unemployment, devastated economies within Europe. The way forward!

The clear evidence is that Fiscal policy matters, Fiscal Stimulus helps, adds jobs to economies, and that's not the same as Quantitative Easing (QE). On the contrary, reducing budgets, reducing government expenditure, higher taxation during times of extreme recession [sometimes called a liquidity trap] simply lowers growth, lowers demand and causes further unemployment.

If the above statement is true and there is clear and present irrefutable evidence that it is, why on earth are governments in Europe following this path to misery? i.e. extreme austerity!

Many leading economists, not least the 2008 Nobel Economics prize winner, from who many of these comments are cribbed, have been expounding explanations concerning this since the 2008 crises.

To start at the beginning

There is little or no point in discussing how we got in the mess in Europe we have. Neither is this article intended to be a detailed overview, I merely intend to cover some main details regarding Europe's problems and point the way to recovery. However, it's reasonable to look briefly at how our banks got into the problems that very nearly caused the largest financial crash the world has seen.

It's often said Lehman's collapse in 2008 was the start of the crises, it was not. A full year earlier there were queues outside Northern Rock in the UK. The UK Government stepped in and guaranteed investors' deposits. Had they not the ripple effect would have devastated financial markets across the world. The same thing later applied to Fanny Mae and Freddy Mac in the USA, this followed by Lehman's which, un-like the previous three was allowed to fail. The fallout from Lehman's caused the US government to fund a $700 billion (Tarp) bailout but the crises started in Europe, not the US.

Both European and US governments let the banks off extremely lightly; they should have instigated receivership procedures. They didn't. Perhaps because of a shared guilt complex; either way the general public lost out, and are still now, four years later, picking up the pieces.

Looking Forward from 2008

Four years later, Europe is no nearer solving the depression than they were in late 2009. Following the initial printing of money (Quantitative Easing or QE) which most Euro countries decided upon. With trillions of Euros spent in Europe as a whole, the political mood changed to austerity, in no small measure due to Angela Merkel, although others are certainly also to blame.

It was decided the big spending economies were to blame and must be punished. Ireland, Greece, Portugal, Italy and Spain in particular. Sadly these five countries were all part of the Euro experiment and could not devalue their own currencies to alleviate their problems. They were stuck with the punishment Europe was to deal them.

Markets too, punished these European countries with high interest rates demanded on their Sovereign bonds. It would appear these same markets took a completely different view of countries that could devalue their currency. For example, UK & USA, both of which had huge deficits.

Now the huge QE and public spending programs of 2009 did help but not nearly as much as they could have. The QE was largely given to Banks. The expectation was that the banks would inject this into industry and the private sector would take up the slack in employment, causing growth in the economies. These banks however could not lend to higher risk projects as they had restrictions placed on them; they could lend on low risk low return projects but they had no appetite for these. Interest rates being far too low for them. Therefore too much of this QE was left on the respective reserve bank's balance sheets, hardly what was needed to boost Europe's economies.

From 2010, Austerity

The European single currency has been dominated by Germany and to a lesser degree France, but now France has a new president preferring expansion to austerity, this really only leaves Germany. It's totally in Germany's interest to keep a common currency for all members of the Union. This means that all countries and production has to keep to the same currency as Germany. The same labour rate expressed in Euros, the same interest rate competing for the market's cash as Germany. Clearly this is completely unworkable. In other circumstances, countries like Spain with 25% unemployed could have devalued

and their labour costs would have reduced at a stroke. Making them more competitive, with more jobs!
Even worse the Germans are obsessed with inflation. They remember the past when inflation proved to be a huge enemy but they forget. In this depression there is almost no inflation. Interest rates are near zero, the enemy the Germans now see is a figment of their imagination. That has also become a necessity.
Inflation could help rebuild our economies, create jobs at least until positive growth had increased and unemployment decreased. Inflation devalues debt, and that is exactly what is required in today's markets.

Public spending

Should we borrow more in the current European market conditions to solve our already far too high borrowing or debt problems? Obvious answer is "of course not", but no points for that.
It would of course be insanity to follow the above plan in normal markets or say, a household budget, these are not however normal markets. The very dangers we fear in normal markets, namely inflation, loss of credibility, withdrawal of market funds from investors causing higher interest rates, are just not relevant in this depression and liquidity trap.

Inflation is reducing within Europe, interest rates are at all time lows, and the credibility argument was blasted wide open when the USA was downgraded from their AAA rating. After their extraordinary money printing, there was no shortfall of investors or higher interest rates for their Sovereign debt or Treasuries. Their stock markets actually benefited and have continued to do so.

If we assume we should borrow more or in reality just print more, what should we do with it? Well certainly not give it to the banks, unless we can enforce lending to private enterprise which despite their protestations, they are certainly not doing now. We may even have to set up a state lending bank as an alternative.
Much better to invest in public projects, being careful to find worthy recipients, projects that encourage employment, that encourage growth of the economy. Health might be a good start but make no mistake these types of projects need very careful selection, but still this is exactly what we must do and do it quickly.

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(Thanks to Paul Krugman, Economics Nobel prize winner, for much of the above research).