

# The Mirage of Austerity Economics

By not considering money dynamics, austerity economics is a false paradigm

By Dix Sandbeck. March 2016.

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At the ideological centre of North American austerity economics in the neoliberal sign is the von Mises institute in Alabama, named after the famous Austrian economist, Ludwig von Mises. Von Mises was a third generation economist of the Austrian school, having studied under Böhm-Bawerk, who in turn had studied under Menger, considered one of the three founders of neoclassical economics in the 1870s.<sup>1</sup> Austrian economics has from the start been linked to the economics of balanced budgets, small government and austerity responses to economic crises.

One of the economists attached to the von Mises Institute is Robert P. Murphy who, among other things, has written an introductory economics textbook based on the principles of Austrian economics. The Institute also publish other publications, both in paper formats and on the Internet. Among these are its flagship, "The Mises Daily". In this, Murphy in 2011 published a little paper "The Upside-Down World of MMT".<sup>2</sup> As the name suggests, it is a critique of MMT, or Modern Money Theory, an alternative theory of money closely related to post-Keynesian economics.

MMT's is built around the claim that a government with its own currency can never run out of money—i.e. it can never go bankrupt—and that deficits are not something that need to be feared if government spending can raise employment.

Let's return to Murphy and his attempt to refute MMT. We will not here get into the pro and cons of MMT, but only look at the argument of Murphy's refutation, which is interesting if only because it restates the standard arguments that are behind most austerity economic prescriptions. Its core argument refers to the national accounting identities found at the start of all neoclassical introductory macroeconomic textbooks. It thus shows that the tendency to favour austerity prescriptions to crises is directly derived from core neoclassical principles.

In the language of the textbooks, Murphy starts with restating the familiar national account identity, e.g.:

$$\text{GDP} = C + I + G + (X - \text{IM}).$$

It says that GDP is created by following inputs: private consumption (C) + private investment (I) + government spending (G) + net exports (X — IM).

Eliminating net exports (X — M) [exports minus imports] by assuming it to be 0, we get the national income that the GDP creates and distributes to domestic households, which use it in the following ways:

$$\text{GDP} = C + S + T$$

This says that households spend the incomes they receive on respectively consumption (C), savings (S) and taxes (T).

Noting that we have two equalities that both are equal to GDP, the neoclassical logic resolves that they must also be equal to each other, thus:

$$C + I + G = C + S + T$$

Seeing that C appears on both sides, basic arithmetic rules allow us to remove them and move the remainder aggregates around, which gives:

$$G - T = S - I$$

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<sup>1</sup> Together with Leon Walras from France and Stanley Jevons from England.

<sup>2</sup> <https://mises.org/library/upside-down-world-mmt>

This equality, which is often encountered in the economic literature, says that government spending minus revenue is an identity to private savings minus private investment. Said differently, we get that net government spending (deficits or surpluses) equals net private saving.

It should be noted that the  $G - T = S - I$  equation only says something about the two differentials, not about absolute sizes. Absolute sizes of the elements of the equation is a different discussion, albeit also a favourite topic of neoliberal economists, who advocate that government sizes should be as small as possible so that there is more room for the market sector in the total economy. We will return to this in another context.

Murphy sees this well-known national accounting identity as a death-knell for MMT (and presumably post-Keynesian economics, too). He sees it as validating the austerity claim that if government deficits grow, it must incur a negative balancing movement that reduces financing available to the private sector. In the jargon of neoclassical economics, government deficits “crowd out” private sector savings and investments, and therefore reduce valuable market-generated growth.

That his economics contains a heavy dose of ideology is revealed when he goes on to say “[if] government borrows and spends more, the equation tells us we might see lower private consumption, rising interest rates, and real resources being siphoned out of private investment into pork-barrel spending projects.”

There we have it: governments always do bad (lots of pork-barrel spending) and markets always do good (lots of value for the shareholders). But unfortunately for the austerity defenders, the world is not so simple. Certainly, there are many examples of bad government and lobby driven decisions that waste money on pork-barrel projects (recall the famous ‘bridge to nowhere’ in Alaska). And that indeed is a big problem that also needs to be addressed aggressively in a new economy. However, on the other hand the market economy led by multinational corporations has bigger problems: it creates growing inequality and is inexorably leading us toward climate change and environmental collapse, primarily because the beneficiaries at the top can’t let go the enormous profits that the current resource intensive system allows them to rake in. The real ‘growth model’ of the current economic elite is the utopia of an unending fossil-fuel driven consumption binge, which in the name of profit maximization endlessly devour products produced by the lowest common cost denominator—environmental and social consequences be damned.

The fact of the matter is that there is nothing in the purported austerity logic that forces us to condemn all government funded by money expansions. This is especially true for areas—such as climate change abatement—where only governments have the capacity and scope to lead.

If we return to the  $G - T = S - I$  identity and examine it closely, we find that it is an abstraction over abstractions with little reality content. It is an abstraction whose constituents themselves are abstract aggregates over sector components. In concrete cases, they are constructed over data sampling, with all the uncertainty that that entails.

Be as it may, much worse is that the whole conceptual set-up treats what are based on diffuse flows as static balances, i.e. it depicts the economy as a snapshot, or, perhaps more precisely, as a tautological still picture that by virtue of its tautological nature always will be true. However, the whole conceptual construct requires that the well-known, but nonsensical, core neoclassical assumptions hold, in particular its repertoire of perfect conditions (competition, information, foresight, etc.). These must be accepted as a relevant starting point for an economic analysis along the austerity methodology. But in the process, several critical aspects of economic reality are violated.

First, when consumption ‘C’ is eliminated from the two sides of the identity in order to simplify the equation, the input aggregates and the output aggregates *are separated by economic time* and can therefore in fact not be equalized. What does that mean? Consumption C in the input equation is occurring in different economic time than the output, or income-based C. Thus, even though the tautological snapshot considers all of its balances to occur simultaneously, they represent different steps in time-ordered economic sequences. This means that between input C and output C there stands an economic production cycle, and if the two Cs are identical, it can only happen by rare coincidence, and essentially only in a static economy where we also must ignore depreciation as a function of economic time. This implies that the output GDP that investment gives rise to must include the value of depreciation that is a function of the growth process.

Second, the conceptual framework behind the identity violates the eighteenth century French physiocrat, Quesnay's old insight: that in order to visualize an economy one needs to consider three things—factors of production, consumption goods for sale, and money.<sup>3</sup> This is an apparently quite obvious fact, but it was downplayed by the early neoclassical economists who talked about the 'veil of money', which indicated that money is like a veil cast over the real economy, and it is the real economy that matters. Much of modern mainstream economics has still not disentangled itself fully from this barren notion. In this vein, the logic adopted by Murphy is a prime example of arguments that don't consider money in a dynamic sense.

The fact is that there exist dynamic money balances in a circulating economy, which, with Quesnay's reminder in sight, is of utmost importance for understanding the changes that occur in an economy. Thus, if we want to describe the economy by identity equations we at least should add ' $\Delta M$ ', 'change in money balances', on both sides, e.g.  $G-T+\Delta M_g = S-I+\Delta M_p$ . That would indicate that changes in the real aggregates can be initiated by monetary changes, and that impacts on the other side of the equation can be both real and monetary. It also needs to be considered that when micro changes coalesce into macro flows, they exhibit a time sequential nature. In other words, the macro 'identities' are composites of fluctuating movements that in fact never can be fully identical due to dynamics in time-space.

One problem with the identity approach arises from confusion between the nature of microeconomic and macroeconomic structures. It is quite obvious that when someone at the microeconomic level buys something, what the buyer hands over of money is the same money as the seller receives. Thus, the aggregate, or combined, balance sheet of the seller and the buyer remain the same; however, their internal compositions change. Obviously, the buyer cannot use the same money to buy things twice. But he or she can replenish their money balances through credit.

At the macroeconomic level such simplicity doesn't hold. Individual actions merge into flows, and monetary changes and unused capacities must be considered. The main aim of macroeconomic analysis is to investigate how changes in the economic flows are absorbed by other elements in the overall economic structures. And at this level, money can be used twice, which is indicated by the fact that banks can make repeated loans from the same reserve/capital base if just their balance sheets move in some sort of tandem with other banks.

Consider the starting identity again: it is clear that ' $S$ ' must be derived from income-based GDP and cannot represent existing savings, which are wealth components. Therefore, the ' $S$ ' in the identity only represents changes (additions or reductions) to existing savings, and as such is a residual from current-period income. ' $M$ ' alone is not part of GDP created in a given time period, but  $\Delta M$  is. Changes in money balances, including those arising from creation of new money or perhaps drawing down existing holdings of bank account money (which adds to velocity in the  $M = Q \times V$  equation<sup>4</sup>) can lead to autonomous growth in some economic sectors during a given period, i.e. growth that not necessarily 'crowd out' resources for other sectors. The extent to which crowding out occurs, or more precisely, demand-pull inflation is ignited in factor markets, is mainly a function of the degree of utilization of existing capacity in the economy.

That means that if we want to describe the economy as functional balances, we must add the money balances. They are key constituents of the dynamics that at all times are latent within an economy. Note how we now can write a formula that resembles the Marxian formula for expanded reproduction:  $M \rightarrow C \rightarrow M'$  ( $C$  in Marx' usage stands for commodity production). In a similar vein, we can tentatively write  $M \rightarrow GDP+ \rightarrow \Delta M$ .

Henceforth, it becomes even more important to understand the above-mentioned capacity of the economy to convert idle money balances into active investments, but also, if these are not sufficient, to create new money for the investments. While better technology, improved organization and enhancing human resources can be dynamic growth factors without requiring investments of money, in most cases expanding existing production or setting up new businesses will require money investments.

In this regard, it is clear that money can be created on both sides of the identity, albeit in different ways: the private sector through credit expansion by commercial banks, and on the government's side through the money creating ability of central banks.

<sup>3</sup> Cited after Rosa Luxemburg, "The Accumulation of Capital" Ch.5.

<sup>4</sup> Effective money supply equals money quantity times velocity.

In practical terms, investments by businesses require access to bank accounts, which can be drawn upon when payment needs arise. Money on bank accounts can either be savings (retained earnings of the firm) or newly created bank credit, or of course both (in practice, the funds available can be held on several accounts, and savings can even be held as highly liquid financial paper that easily can be converted into cash (checking accounts) when payments are due.

It has been known for some time that private sector banks create money when they extend credit above their reserves or capital base (whichever is the main regulative constraint – in early banking there were no government regulative constraints and money expansion were left to banks own prudential assessments—often with the unhappy outcome of debilitating runs for specie withdrawals from banks which had overextended note issues). Even if modern banks are at their limits, modern central banks are accommodative and will extend the needed reserves, although at a cost. In Canada, the price is the rate in the interbank markets for reserves, or, if acquired from the central bank, the upper limit of its bank rate band.

Acknowledging the existence of the endogenous money circuit has in the last couple of decades been a mainstay of post-Keynesian economics (a major theoretical trend within which MMT can be placed). Seen in a wider perspective, the commercial bank system extends credit to governments, households, non-deposit taking financial institutions, and firms. Focusing on the firms' sector, the amount of credit extended is added to the firms' checking accounts. In most cases, firms use new credit to pay for expansion or start-up of new businesses, which is how the economy's productive capacity mainly expands.

The study of economic dynamics includes how changes that occur on the microeconomic level will be absorbed into macro and monetary trends. This is in particular the case when micro changes exhibit trend effects (mainly driven by human behavioural idiosyncrasies—for instance fashion fads or even investment fads—which often has considerable influence upon economic developments).

The basic problem of austerity economics is that it builds upon equilibrium principles that lead to static notions about dynamic processes. This has induced a lack of proper understanding of the role played in modern economies by money and quasi-money (assets that are highly liquid, i.e. easily and quickly can be converted to cash in markets).

In the same way as firms can create expanding economic activities financed through bank credit, governments can also finance expanded activities by borrowing from private banks and money markets (by issuing interest bearing bonds that these markets buy). But, as mentioned, they also have another option that is not open to the private sector: they can create money to fund their activities through central bank operations. This should, as much as prudently is possible, be preferred ahead of commercial credits, since the costs of central bank credits are of course negligible (basically some extra administration costs incurred by the central bank).

In the current system of mixed economies, it is clear that if there is any 'crowding out', it is rather a political motivated tendency to allow the private banks and financial institutions to 'crowd out' governments' abilities to properly finance their operations, either through progressive taxes or by injecting extra demand into the economy through public activities financed by central bank money creation. Instead, a political ideology underpinned by austerity economics has forced governments to pay for budgetary deficits by raising interest-bearing commercial debts—in good times and in bad times.

The aggregate volume of debts become interest-earning assets for the economic elite, whose accumulation of wealth has been growing at a rapid clip during the last couple of decades. The demand for new debts as wealth-storing objects (on the debt-financing side) is thus caused by the wealth accumulation that rising income inequalities are breeding. New income always starts in the money form and has to be converted to assets that can earn new incomes. Obviously, if governments started to use their own banks when in need for loans, the wealth-replicating machine of the current economy's debt structures would shift into lower gear, while on the other hand the lower interest payments charged to the public by the private sector means that there would be a bigger part of governments' revenues available to fund their social responsibilities.

Thus, in the end it is not just a question of economic theories or conjuring up identity equations. And the austerity logic is, due to its inconsistencies, not a compelling case for cutbacks and small government. It is claimed that austerity policies are necessary in order to balance the books when the economy is slow, but

oftentimes the malaise of deficient government funding really arises from having implemented top-heavy tax cuts, which create structural imbalances between expenditures and revenues.

The true political choice is between relying excessively on a private money-banking system that among other functions also serve to expedite accumulation of wealth at the top, due to its ability to leverage speculative bets made by holders of wealth (individuals as well as institutional). Or having a system where banking is community oriented and governments can utilize the resources at their disposal, including their ability to create money by central bank operations. This latter option should be an important tool when the economy needs a boost, or new socio-economic responsibilities require large-scale investments in new technologies; as we are facing now with the urgent need for investments in a palette of climate change abatement technologies.