1. A general theory of austerity

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Introduction

This chapter is highly ambitious in scope. It will first look at whether, from a strictly macroeconomic point of view, fiscal austerity was necessary. The conclusions are stark: for the world as a whole austerity could have been easily avoided. In a few Eurozone countries some austerity was inevitable, but unemployment at the levels we have actually seen could almost certainly have been avoided. The macroeconomics needed to establish this proposition are standard and discussed in a later section: the allusion in the title to the General Theory of Keynes is deliberate. The next section of the chapter looks at whether financial market pressures meant that beneficial delays to fiscal consolidation could not have been implemented.

This prompts an obvious question. If austerity was unnecessary, why did it happen? On the one hand it is possible to tell a story about why austerity occurred that depends on two historical accidents: the Greek debt funding crisis and the peculiar diminished role that Keynesian economics plays in German policy discussion, coupled with Germany's central role in reacting to the Greek crisis. For various reasons a story along these lines is seriously incomplete, and in particular cannot play more than a walk-on role in developments in the

US and UK. A general, political economy theory of austerity, involving political opportunism on the right, will be introduced. I will suggest that this opportunism is made possible partly by the delegation of monetary policy to independent central banks. The conclusion summarises the argument, and asks whether austerity is therefore an inevitable consequence of any major recession.

'Austerity' is a widely used word, and is often applied in a way that makes it equivalent to fiscal consolidation—any attempt to reduce the government's deficit by cuts to public spending or higher taxes. In this discussion, I will reserve the term 'fiscal consolidation' to refer to any package to cut spending or raise taxes. Austerity is when that fiscal consolidation leads to significant increases in involuntary unemployment. A more technical definition would be that austerity is fiscal consolidation that leads to a noticeably larger negative output gap. This definition implies that while austerity will always involve fiscal consolidation, fiscal consolidation could occur without austerity.

Why delaying fiscal consolidation can avoid austerity

In 2010, the Eurozone and the United Kingdom switched from fiscal stimulus to fiscal consolidation. A year later the United States followed. It therefore makes sense to first consider what the impact of fiscal consolidation at a global level might be. As nearly all textbooks at undergraduate and graduate level show, for a given stance of monetary policy (and in particular, for a given level of interest rates), fiscal consolidation reduces the total amount of demand in the economy. If the economy is already suffering from a lack of demand, as was the case in 2010, this will make any recession worse. The assumption that monetary policy does not change is critical. Central banks routinely change interest rates to stabilise aggregate demand. Deficient aggregate demand should lead to below-target inflation, and if central banks respond to this by reducing nominal interest rates this will encourage people to save less and spend more, which raises demand, which in turn increases inflation. So when fiscal consolidation reduces aggregate demand, interest rates could be cut to offset this impact. As a result, a policy of fiscal consolidation accompanied by an easing of monetary policy could avoid any need for total output to fall and unemployment to rise. As long as monetary policy is working well, fiscal consolidation does not lead to austerity.

A study of fiscal consolidation in individual economies supports this idea. When some people point to particular periods in individual

countries where fiscal consolidation did not lead to austerity, this period also featured an expansionary monetary policy (and/or, in countries with their own exchange rate, a large depreciation). This does not imply, of course, that in these cases fiscal consolidation becomes painless. Raising taxes, cutting transfers or cutting public sector jobs is difficult and can lead to hardship. But if incomes are growing, and for every public sector job lost a private sector job is created, then the hardship brought about by fiscal consolidation can be greatly reduced.

This brings us to the heart of why fiscal consolidation in 2010 had such negative effects on economies as a whole. A distinguishing feature of the recession caused by the financial crisis, often called the Great Recession, is that short-term interest rates were cut very rapidly, and quickly ended up becoming stuck close to zero. Economists often call this the zero lower bound (ZLB) problem, and it is also called a liquidity trap (any subtle differences between the two need not concern us here). Central banks cut interest rates to encourage more spending and less saving. The less you get for saving money, the less saving you will want to do. If interest rates became negative, people would find that by saving they actually lose money. That would be a very strong incentive not to save, but the problem is that most people could avoid these negative interest rates by saving in the form of cash. As a result, central banks are reluctant to push rates much below zero: it would have no impact except to make people hoard cash. That is the ZLB problem.

As an alternative to cutting short-term interest rates, central banks have tried the unconventional form of monetary policy known as quantitative easing (QE). Central banks are in the position of having a large influence on most short interest rates (interest rates on financial assets that are paid back in a matter of months), but normally their impact on longer-term interest rates (on assets that are paid back after a number of years) is only indirect. QE is an attempt to influence these rates more directly, by buying substantial amounts of these assets. To be able to do this, central banks have to create huge amounts of money. Although QE appears to have had some impact in reducing long-term interest rates, and therefore in increasing output, it remains a highly unreliable instrument. As a result, it is far from being a complete solution to the ZLB problem. It was for these reasons that governments in the US, the UK and Germany embarked on fiscal stimulus in 2009. With interest rates stuck at the ZLB, and huge uncertainty about the effectiveness of QE, governments needed to use fiscal policy to help increase demand and reduce unemployment.

For exactly the same reason, when governments turned to fiscal consolidation in 2010, monetary policy was unable to offset the negative impact that this had on demand and unemployment. What this negative impact actually meant depended on the economy. In the US it led to an unusually slow recovery, and unusually persistent unemployment. In the UK a recovery that had just begun in 2010 stalled, and did not resume until 2013. In the Eurozone we had a second recession shortly after the Great Recession. These differences may be easy to explain: in the US fiscal consolidation was delayed until 2011, and in the Eurozone interest rates were mistakenly raised in 2011. But the common feature is that fiscal consolidation increased unemployment substantially compared to what it might have been otherwise. This is the tragedy of austerity. If governments had waited before embarking on fiscal consolidation and, crucially, had undertaken fiscal consolidation when interest rates were no longer at their ZLB, that consolidation need not have led to austerity. Instead interest rates could have been used to offset the negative demand effects of lower public spending or higher taxes. Postponing fiscal consolidation would not just have delayed austerity, but avoided it altogether.

How long would we have had to delay fiscal consolidation to avoid austerity? In a back-of-the-envelope calculation, I looked at the impact of a counterfactual which assumed that government consumption and investment in the US, the UK and the Eurozone had grown at trend rates from 2010 onwards.[1] If government had followed this trend path, by 2013 this spending would have been around 15% higher in the US, a bit less than this in the UK, and about 10% higher in the Eurozone. This indicates the extent of austerity that occurred from 2010 onwards. This would have raised the level of GDP in 2013 by over 4% in the US, over 4.5% in the UK, and nearly 4% in the Eurozone. For the Eurozone these numbers accord with some more elaborate model-based exercises (which include the impact of higher taxes or lower transfers), although others suggest a still greater impact from austerity. This analysis also suggests that without the turn to fiscal consolidation in 2010, it seems highly likely that interest rates would have begun to rise by 2013. As interest rates departing the ZLB are the key to having fiscal consolidation without austerity, this suggests that fiscal consolidation need only have been delayed by around three years to avoid austerity.

The most common argument put forward against delaying fiscal consolidation is that the markets would not have allowed this. I will

discuss this in detail in the next section, but the conclusion is that there is no evidence to support this idea, and plenty of reasons to think it is wrong. (The issue is more complex for the periphery Eurozone countries, but here we are talking about the Eurozone as a whole.) Another argument is more political. It suggests that fiscal consolidation is only possible at a time of crisis. If it had been delayed until the recovery had been more complete, it would not have happened at all. This seems very difficult to believe. As a result of the Great Recession, debt levels in all economies rose substantially. Although the recovery itself may have reduced debt-to-GDP ratios compared to their peak following the recession, it still seems probable that they would have been substantially higher by 2013 than before the recession if no consolidation had occurred between 2010 and 2013. It is difficult to imagine that policy makers would have simply ignored this.

If the US, the Eurozone and the UK could have avoided austerity altogether, can the same be said for individual Eurozone economies that had unusually large fiscal problems? The obvious example is Ireland, which had not only bailed out a large financial sector, but also allowed a housing boom which expanded tax receipts to increase public spending beyond a sustainable level. This is discussed in much more detail in Chapter 2. Without prejudice, let us assume that the fiscal consolidation required for Ireland was greater than for the Eurozone as a whole. Could Ireland have also avoided any austerity?

The short answer is no, but the reasons are rather different from those normally put forward, and they in turn imply that the amount of austerity required might have been much less than we actually observed. Interest rates in Ireland are set at the Eurozone level, therefore if Ireland required a period of greater fiscal consolidation than for the Eurozone as a whole, it could not have offset the impact of this on demand in Ireland by reducing interest rates. As a result, for a time unemployment would have had to be higher relative to its 'natural' level.[2] However, higher unemployment relative to its Eurozone partners would have in time reduced inflation in Ireland (again relative to other Eurozone economies), increasing the competitiveness of its traded sector. This in turn would have added to demand, offsetting the negative impact of fiscal consolidation and bringing unemployment back down.

In macroeconomic terms, it is the real exchange rate (competitiveness) rather than real interest rates that adjust to ensure that any austerity is temporary, even if the demand impact of fiscal

consolidation is more long-lived. We can think of this in terms of financial balances. The government needs to run a large primary surplus for some time to service a higher level of debt and also to bring debt down. In the medium term this can be matched by a larger current account surplus, generated by increased competitiveness. If Ireland had its own exchange rate, and the foreign exchange markets had behaved as they should, then this adjustment in competitiveness could have happened immediately through a depreciation in the nominal exchange rate. That in turn would have meant no need for additional unemployment to bring this improvement in competitiveness about. In other words, the only reason that austerity is required in Ireland (in the absence of austerity in the Eurozone as a whole) is that Ireland is part of a monetary union.

How much austerity is required to get inflation down and bring about an improvement in competitiveness in a monetary union? That depends on how sensitive domestic inflation is to increases in unemployment, or, as an economist would say, it depends on the slope of the Phillips curve. However we can use basic macroeconomic theory to say something rather important about the speed at which inflation has to fall. Suppose, for the sake of argument, that prices needed to fall by 10% in Ireland relative to its Eurozone neighbours to offset the impact of fiscal consolidation. Suppose the slope of the Phillips curve implied that each 1% increase in unemployment above its natural level would reduce inflation in that year by 1%. At first sight that might suggest you could get prices down by 10% either by raising unemployment by 10% in one year, or (say) by raising unemployment by 2% for five years. That would be wrong, because it ignores a key feature of the Phillips curves commonly used in macroeconomics: inflation this year depends on expected inflation next year as well as unemployment this year.

This means that a more modest increase in unemployment spread over time could achieve the 10% cut in prices. Suppose unemployment increased by just 1% for four years, and assume also that expectations about inflation depended on past inflation. In the first year inflation would be reduced by just 1%. It would be reduced by 2% in the second year (1% because of higher unemployment and 1% because inflation expectations had fallen by 1%), by 3% in the third year and by 4% in the fourth. That produces the required total cut in prices of 10%, but at a substantially smaller total unemployment cost than if everything was done in one year.

Nowadays macroeconomists believe that expectations are formed in a more sophisticated manner than just looking at last year's data. However, if we move to the opposite extreme, where agents' expectations about inflation turn out to be completely correct, we get a very similar result.[3] The point is robust as long as inflation depends on expected inflation. A small increase in unemployment spread over a number of years is much more efficient at bringing about an improvement in competitiveness than a more short lived but larger increase in unemployment.

Without additional assumptions and a great deal of analysis it is difficult to say by how much the path of adjustment followed in Ireland, Portugal and Spain departed from this efficient, gradualist approach, and whether fiscal consolidation should have been delayed to achieve this gradualist path. As with thinking about the Eurozone as a whole, any discussion along these lines is normally pre-empted by claims that any more gradual fiscal consolidation was impossible because of the financial markets. It is to this issue that I now turn.

Financial markets

For the major economies including the Eurozone as a whole, austerity could have been avoided completely by delaying fiscal consolidation by a few years. For individual economies in the Eurozone periphery some austerity was necessary, because a period of below-average inflation was required to improve competitiveness relative to other Eurozone members. It would have been far more efficient to spread the unemployment required to achieve this over time. In each case supporters of austerity would normally argue that neither was possible because of pressure from financial markets. Once again, I will consider each type of economy in turn.

An initial point worth making is that the austerity that followed the Great Recession was unusual compared to previous economic downturns, as Kose *et al.* (2013) show. In the past economic downturns have led to large government budget deficits and rising government debt, but governments have not felt the need to embark on fiscal consolidation the moment the recovery has begun. Markets in the past have not forced such an outcome.

One reason often given for why markets might be unwilling to buy government debt in a recession is that large deficits mean there is more debt that needs to be bought. Yet this argument ignores a basic Keynesian

insight. Typically, recessions are caused by people saving more. This increase in saving needs somewhere to go. So although the supply of new government debt might increase in an economic downturn, the number of people wanting to buy financial assets also increases.

There are two key differences between the Great Recession and previous recessions. The first is scale and its global nature. As discussed in the previous section, the depth of the recession was a key reason for the ZLB problem. The second is that the recession was the result of a crisis within the financial sector. Since WWII downturns in most countries have typically reflected the need by governments or central banks to reduce inflation. The main impact of this difference has been that financial institutions have been less willing to lend to consumers or firms after the Great Recession, and those with financial assets have been reluctant to invest in risky assets.

Should these differences make a difference to how the financial markets regard the need for governments to sell more debt? The answer is probably that they should make the markets more interested in buying these assets compared to earlier downturns. Although government deficits have increased by more in the Great Recession compared to earlier downturns because the Great Recession was much deeper, the recession was larger because consumers and firms saved more than in previous downturns. Once again an increased supply of government debt was met by an increase in the amount people wanted to hold. In addition, the flight from risky assets increased the demand for government debt compared to more risky alternatives such as debt issued by firms. So there is no *a priori* reason to believe that governments would not be able to sell the extra debt that arose as a result of the Great Recession.

Indeed, a large literature, associated with the work of Ricardo Caballero, now argues that there remains a shortage of safe assets in the economy as a whole. Caballero writes:[4]

> This shortage of safe assets existed before the crisis, but it is even worse today. The demand for these assets has expanded as a result of the fear triggered by the crisis—as it did for emerging markets after the 1997–1998 crisis. But this time the private sector industry created to supply these safe assets—the securitisation and complex-assets production industry—is severely damaged.

In this context, any additional safe assets in the form of more government debt from the UK, the US or non-periphery Euro countries would be welcomed

How would we be able to tell if the markets were in danger of failing to buy government debt? The first symptom would be a rise in interest rates on government debt, as governments were forced to raise the return from these assets to attract buyers. That is exactly what happened in the case of Eurozone periphery governments. However, everywhere else has seen a steady fall in the interest rate paid on government debt. There is no evidence from the markets themselves that we were close to a global panic in the market for government debt.

This observation may appear to be at variance with evidence from people who work in financial institutions, who typically say that we should worry about what the market will do, and that there is a need for austerity. Unfortunately this source of information lacks authority and has a biased view. To say it lacks authority may seem surprising, given that financial institutions are closely involved in these markets. But where these institutions make money is by predicting day-to-day movements in the market and not from forecasting longer-run trends. Many in the US markets were convinced that interest rates on US government debt were bound to rise substantially after 2010, but they have not risen. They are biased for two reasons. One is simply institutional: a well-known saying is that a bond economist never saw a fiscal contraction they did not like. Another is more subtle, and is discussed later.

A slightly more nuanced version of the argument that austerity was required to prevent a market panic is the idea that, although at a global level the supply of savings had risen to match the additional supply of government debt, this still meant that individual economies that showed no signs of cutting back on spending were vulnerable. Investors could easily move from one government's debt to another's. Again the empirical evidence suggests this argument is wrong. There were two notable major economies that did not switch to austerity in 2010: Canada and Japan. Neither appeared to suffer any adverse market reaction.

In contrast, we have a compelling theory about why the Eurozone periphery countries did suffer at the hands of the markets from 2010 to 2012. That theory was put to the test at the end of 2012 and was vindicated. Unlike normal countries, members of the Eurozone do not have their own central bank. Instead they have the European Central

Bank (ECB). Why does this matter when it comes to how the markets regard government debt? It has to do with the risk of a country being forced to default because it cannot roll over that debt. Most governments have to roll over a substantial proportion of their debt each year. Assuming that a government has no wish to default on its existing debt and that the stock of debt is not increasing, as long as people buy the debt that it needs to roll over each year, it will not default. That debt remains potentially risky for any investor, because the investor has to be sure that there are enough other investors in the market to ensure the government can roll over its debt. Even if an investor is totally confident that the government has no wish to default, they also need to think about what other investors in the market believe. This can quickly lead to self-fulfilling panic. If every investor is worried that other investors will not buy the debt to be rolled over, they themselves will not invest, and the government may be forced to default: particularly if its debt-to-GDP ratio is already high.[5]

This will not happen if the government can create its own currency. If the market did panic in this way, the central bank would simply buy the debt that needed to be rolled over by creating money. Economists call this the central bank acting as a sovereign lender of last resort. This removes the need for an investor to worry about other investors in making a decision to invest. It removes a key source of risk, and makes government debt much safer. This in turn means that in practice the central bank never has to actually intervene in this way. Simply its existence means that self-fulfilling panics are much less likely to occur.

What this analysis suggests is that the debt-funding crisis that began in Greece only spread to other periphery countries because the ECB was not prepared to act as a sovereign lender of last resort. The crisis was never going to spread to countries outside the Eurozone whose governments borrowed mainly in their own currency, because they had their own central banks. This theory was put to the test in September 2012, when the ECB changed its policy. With the Outright Monetary Transactions (OMT) programme, it agreed to act as a sovereign lender of last resort. This support was not unconditional, but it was enough to bring the Eurozone crisis to an end. This provided a clear test of the theory, and the test was passed.[6]

This raises an obvious question that should be of great interest to those in the Eurozone. If the ECB had brought in OMT in 2010 rather than 2012, would the Eurozone crisis have spread beyond

Greece, and would Ireland and Portugal backed by the ECB have retained market access? The only logical reason why market access should not have been retained is if the markets doubted the ECB's resolve to sustain OMT support. Without that doubt, we can then ask whether this market access could have also been retained even if Ireland and Portugal had enacted a more gradual programme of fiscal consolidation, consistent with the analysis outlined earlier, resulting in less austerity? The answer is the same. The only barrier to a more sensible path for fiscal consolidation is the ECB's willingness to support it

A clear example where austerity has gone way beyond what was required for a Eurozone economy is Greece. Even if OMT had been available in 2010, Greece should not have been allowed to participate in this programme for two reasons. First, it had built up such a large amount of government debt and such a large deficit that it was far from clear that it could avoid default. Second, it had deliberately deceived its Eurozone neighbours about the extent of its debts. Without OMT support, Greece would have and should have been forced to completely default on all or most of its debt. Even if this had happened, Greece was still running a large primary deficit (spending was greater than taxes). Without any assistance, Greece would have suffered immediate and acute austerity. The IMF was established to provide conditional funding in cases like this, and this would have allowed Greece to avoid acute austerity. Nevertheless the fiscal adjustment it would have needed to make would have been large.

What actually happened was much worse than this. The rest of the Eurozone initially tried to avoid a Greek default, and then restricted the size of that default, by lending money directly to Greece, assisted by the IMF. It is often said that the Eurozone lent Greece money to give it time to adjust, but this appears false. The amount of money Greece needed to fund its adjustment towards primary surplus is of the same order of magnitude as the amount it received from the IMF. Most of the money lent by the Eurozone went to bailing out those who had lent to the Greek government. The reason for this may be very straightforward: many of those creditors were Eurozone banks, and a Greek default in 2010 might have sparked a Eurozone banking crisis.

In an attempt to allow Greece to repay these loans to the rest of the Eurozone, the Eurozone (with the IMF's unenthusiastic support) imposed an amount of fiscal contraction that went far beyond what any economy could cope with. As a result, Greek GDP declined by a massive 25%. Nevertheless by 2015 Greece had achieved primary

surplus, and asked that either further fiscal consolidation should be delayed to allow the economy to recover or restructuring of its debt should occur. The Eurozone refused to do either. The ECB restricted the supply of euros to Greek banks, and forced Greece to either embark on yet more fiscal consolidation or leave the Eurozone. It was an incredible exercise in raw political and economic power at the expense of the Greek people. The immorality of first encouraging Greece to keep its debt for the sake of the Eurozone banking system, and then failing to allow default once that banking system had become healthier, seems lost on those that wielded this power.

Was austerity an unfortunate accident?

Earlier in the chapter, I showed that for the major economies including the Eurozone as a whole, austerity could have been avoided completely by delaying fiscal consolidation by a few years. There was also no evidence that the financial markets had demanded the switch to austerity in 2010. Instead the Eurozone crisis went beyond a crisis for the Greek government because of the ECB's unwillingness until 2012 to act as a sovereign lender of last resort. In other words, austerity at the global level was a huge and avoidable mistake. This naturally leads to the question of why that mistake was made. Is there a general theory of austerity, which might lead us to think that it would occur again following a future global recession, or is it specific to the particular circumstances that occurred in 2010? In this section I will explore the second possibility.

The accident story would run as follows. The first unfortunate accident was Greece, where it became clear to everyone except Eurozone policy makers in 2010 that default was necessary. The second accident was that Greece happened to be inside a Eurozone that was dominated by Germany. The negative influence of Germany was felt in two ways. First, German policy makers were strongly opposed to OMT, which helped delay it until 2012. Second, Germany interpreted the crisis of 2010 as a generalised debt-funding crisis, and so reacted by imposing a modified set of fiscal rules that led to austerity throughout the Eurozone.

There does appear to be something special about macroeconomic beliefs among German policy makers. Elsewhere Keynesian theory is mainstream. Few policy makers in the UK or the US would ever try to argue that Keynesian theory was incorrect, or that a fiscal

consolidation would not lead—for a given monetary policy—to a fall in aggregate demand and output. In contrast, the Keynesian position in Germany is clearly a minority view. Among the five members of Germany's Council of Economic Experts, Peter Bofinger is described as 'the Keynesian'. Among any similar group in the UK or the US, someone with anti-Keynesian views would be the exception. From a Keynesian perspective, the dangers to demand and output of reacting to primary deficits by imposing fiscal consolidation would have been recognised. The need to provide central bank support rather than impose draconian austerity on countries having difficulty with market access would also be more easily recognised. Perhaps most importantly, the folly of imposing austerity across the Eurozone when it could not be counteracted by monetary policy would have been understood.

While the unusual position of Keynesian ideas in German policy discourse has been widely recognised, understanding where this comes from is more difficult. Some have argued that it reflects a desire never to repeat the hyperinflation of the Weimar Republic, but this neglects that the recession of the 1930s played a major role in bringing Hitler to power. Some have pointed to language, noting that the German word for debt (*schuld*) is the same as for guilt. But if there was a deep and unusual cultural aversion to debt, you might expect the German government to have a low level of debt by international standards, yet it does not. The economics taught in German universities appears very similar to that taught elsewhere.

A number of authors have focused on the economic doctrine of ordoliberalism. However, you could equally point to the influence of neoliberalism in the UK and USA, which I will discuss further in the next section. To the extent that ordoliberalism differs from neoliberalism in recognising the dangers of market imperfections, this might make it more open to New Keynesian ideas that see demand deficient recessions as also reflecting market imperfections.

One of the distinctive features of institutional arrangements in Germany is that trade union integration within many firms is strong, and unions remain important in setting wages. Another feature of Germany that is absent in many other countries is that Germany has for many years been part of a fixed or quasi-fixed exchange rate system. These two features combine to give Germany an alternative way to stimulate the economy besides fiscal policy, which is through downward pressure on German wages and undercutting Germany's competitors within the fixed exchange rate system. It is a mechanism

that employers naturally prefer, but to make it operate they need to dominate the policy debate and sideline Keynesian ideas. It is noticeable, for example, that Germany only recently imposed a national minimum wage; its imposition was opposed by the majority of economists during the public debate, whereas economists' views about the minimum wage in the UK and the US are more evenly divided.

This mechanism can be seen in how wages developed in the Eurozone before the Great Recession. While the overheating and above-average inflation in the periphery countries are well known, the opposite process happened in Germany, with wage increases well below nearly all the other Eurozone countries. This was, at least to some extent, a deliberate strategy by German firms and unions.[7] Germany gained a substantial competitive advantage over its Eurozone neighbours, which together with the impact of the Hartz reforms—a set of reforms of the German labour market named after the head of a commission, Peter Hartz, that proposed them in 2002—has meant that while unemployment has increased substantially in the rest of the Eurozone, it remains very low in Germany. The German current account surplus has ballooned to nearly 8% of GDP.

This position has in turn made Germany less sympathetic to calls for the easing of austerity across the Eurozone. If Germany joined the Eurozone at something close to its equilibrium exchange rate (competitiveness), and if this has not changed significantly over the subsequent 15 years (both suggested by large current account surpluses), then undercutting the rest of the Eurozone before the recession would imply a subsequent period where German inflation would have to exceed the rest of the Eurozone to restore equilibrium. However, above 2% inflation in Germany could be avoided if inflation in the Eurozone as a whole fell well below the ECB's 2% target. As a result, general Eurozone austerity and a resistance to unconventional monetary policy could be seen as simply pursuing Germany's own national interest.

While there is undoubtedly an important element of truth in both the unfortunate timing of the Greek debt crisis and the role of Germany in interpreting and reacting to it, there are three reasons why it cannot explain the dominance of austerity since 2010. First, within the Eurozone it would seem odd that there has been so little resistance to German views. If Germany is so unusual in its attitudes to Keynesian ideas, why did other countries where Keynesian theory is standard not attempt to challenge Germany? Second, while events in Greece and German attitudes clearly had some influence in the US

and the UK, it seems incredibly unlikely that this could fully explain the turn to austerity in these countries. Finally, by 2014 the damage done by austerity, and the special nature of the debt funding crisis in the Eurozone, were quite clear to most economists. A report published by the IMF Independent Evaluation Office (2014) came to the following conclusions:

> IMF advocacy of fiscal consolidation proved to be premature for major advanced economies, as growth projections turned out to be optimistic. Moreover, the policy mix of fiscal consolidation coupled with monetary expansion that the IMF advocated for advanced economies since 2010 appears to be at odds with long-standing assessments of the relative effectiveness of these policies in the conditions prevailing after a financial crisis characterized by private debt overhang … Many analysts and policymakers have argued that expansionary monetary and fiscal policies working together would have been a more effective way to stimulate demand and reduce unemployment—which in turn could have reduced adverse spillovers … In articulating its concerns [in 2010], the IMF was influenced by the fiscal crises in the euro area periphery economies … although their experiences were of limited relevance given their inability to conduct independent monetary policy or borrow in their own currencies.

In other words the move to austerity in 2010, although advocated by the IMF, had been a mistake, and a key cause of this mistake had been an incorrect interpretation of the Eurozone crisis. Yet while the IMF's own economists were prepared to make this admission, politicians (including those running the IMF) were not. In 2015 in the UK the Conservatives won an election on a platform promising more austerity, even though UK interest rates remained at 0.5%.

A general theory of austerity

In 2009 every single Republican in the US Congress opposed Obama's plan to use fiscal policy to stimulate the US economy. In that same year the Conservative opposition in the UK opposed similar stimulus

measures in the UK. In both cases the political right argued that deficits needed to be brought down more rapidly than the government was planning. On both sides of the Atlantic similar arguments were used: debt needed to be brought down to protect future generations, lower debt would boost confidence which would then stimulate demand ('expansionary fiscal contraction'), and rising debt would lead to higher interest rates because of market concern.

At first this last argument appeared to be vindicated as the Eurozone crisis developed. After the May 2010 election in the UK, this may have been important in persuading the minority party in the coalition government to agree to Conservative plans for more fiscal consolidation. However, by 2012 it was clear that fiscal consolidation was hurting the economy (the Office for Budget Responsibility (OBR) calculated that it had reduced growth by 1% in each of the financial years 2010/11 and 2011/12), that the debt funding crisis in the Eurozone was a purely Eurozone phenomenon, and that there was no evidence of any potential UK or US debt funding crisis. However, the austerity rhetoric continued. Republicans in Congress shut down the government in 2013 to force greater public spending cuts. In 2015 in the UK the Conservatives won an election outright on a programme involving substantial additional fiscal consolidation.

By this time, a growing number of people began to view austerity as a means to use fears about debt as a pretext to reduce the size of the state. In the UK in early 2010, 20 eminent economists and policy makers wrote a letter essentially endorsing the Conservatives' austerity plans. One of those was Lord Turnbull, head of the UK civil service from 2002 to 2005. By 2012, as the damage caused by UK austerity became clear, half those signatories had to varying extents backtracked. In 2015, Lord Turnbull questioned the British Chancellor, George Osborne, in the following terms:[8]

> I think what you are doing actually, is, the real argument is you want a smaller state and there are good arguments for that and some people don't agree but you don't tell people you are doing that. What you tell people is this story about the impoverishment of debt which is a smokescreen. The urgency of reducing debt, the extent, I just can't see the justification for it.

When George Osborne published his fiscal charter in 2015, proposing a new fiscal rule that would require budget surpluses as long as real

growth exceeded 1% (and requiring substantial further austerity to achieve that), nearly 80 economists signed a letter stating that this plan had no basis in economics, and it was difficult to find even one economist who would support it. The idea that deficit concern was being used as a pretext to reduce the size of the state, which I will call the deficit deceit hypothesis, is based on two propositions:

1. Political parties on the right wanted a smaller state, but popular support for such a programme was at best mixed.
2. From 2010 there was strong popular support for reducing government deficits.

Political parties of the right repeatedly used simple analogies between household and government budgets to reinforce this second point. The UK, for example, was described as 'maxing out its credit card'. One strong piece of evidence in favour of deficit deceit is the form of austerity imposed. Republicans in the US called for spending cuts to reduce the deficit, while at the same time arguing elsewhere that taxes should be cut. In the UK, over 80% of deficit reduction between 2010 and 2015 came from spending cuts. The further cuts proposed between 2015 and 2020 were entirely on the spending side, in part to pay for income and inheritance tax cuts. At first, France appeared to be an exception, proposing to focus on tax increases to reduce deficits. European Commissioner Olli Rehn was not pleased, saying that 'Budgetary discipline must come from a reduction in public spending and not from new taxes'.[9] Because some of any tax increase is likely to come out of savings, at a time of unemployment *a priori* you might expect fiscal consolidation to focus on tax increases.

An indication of the strength of popular support for cutting budget deficits came from the lack of opposition to these policies from the centre left. In the UK the Labour party has been extremely reluctant to adopt an anti-austerity platform, and centre-left parties in Europe have often helped to enact fiscal consolidation following European fiscal rules even when unemployment has been rising. Opposition to austerity has tended to come from parties outside the political mainstream.

One question the deficit deceit hypothesis has to answer is why we have not seen similar tactics from the political right in earlier recessions. It is true that what economists call 'pro-cyclical fiscal policy' is not a new

problem, but before the Great Recession economists were also focused on a problem they called 'deficit bias'—the tendency of government debt to rise over time (Calmfors and Wren-Lewis 2011)—which seems to cast doubt on the generality of the deficit deceit idea. There are two clear answers. First, the size of this recession meant that government debt increased substantially in a relatively short period of time. Second, to the extent that the financial crisis generated what economists call a balance sheet recession, most individuals were in the process of increasing their savings and cutting back on borrowing, so it seemed only right (to them) that the government should be doing the same.

Although politicians on the right repeatedly use analogies with households when discussing government debt, anyone who has completed just one year of undergraduate economics knows that such analogies are false. When an individual cuts back on their spending, the impact on the economy-wide level of aggregate demand is small. When a government cuts back on spending, that either has a direct and noticeable impact on aggregate demand or it influences a large number of other people's incomes, which leads them to cut back on their spending. As this point is both standard among economists and not that difficult to explain, this raises the question as to why the kind of macroeconomic logic outlined in the first two sections has been ineffective as an antidote to deficit deceit.

This issue is addressed elsewhere in detail (Wren-Lewis 2015), but the key points are summarised here. The tendency of economists from the financial sector to favour fiscal consolidation is clear. Perhaps even more important is the interest they have in exaggerating the unpredictability of financial markets, so that they become like high priests to the god of an unpredictable financial market. The bias that financial economists have in favour of austerity, plus this perceived 'high priest' role, matters all the more because of the contacts they have with the media. The bias that the media has in favour of talking to financial sector economists rather than academics about day-to-day market movements is perfectly understandable, but unfortunately too many in the media tend to also rely on financial market economists to talk about longer-term issues like austerity, and here academics have greater expertise. Chapter 4 of this volume, by Mercille, discusses the role of the media in the Irish bubble and bust in more detail.

Perhaps the most interesting argument is that the creation of independent central banks has helped reduce the extent to which policy makers and the media hear about the costs of fiscal consolidation in

a liquidity trap (Wren-Lewis 2015). There appear to be two reasons for this. One concerns the expertise in finance ministries. If governments have in effect contracted out the business of macroeconomic stabilisation to central banks, there is less need to retain macroeconomic expertise in these ministries. The second concerns the attitudes of senior figures in central banks to budget deficits.

Mervyn King (1995) once remarked: 'Central banks are often accused of being obsessed with inflation. This is untrue. If they are obsessed with anything, it is with fiscal policy.' This follows from a historic concern that governments will force central banks to monetise debt, which outside of a recession could lead to large increases in inflation. As a result, when policy makers and the media ask central bank governors about the impact of fiscal consolidation, the information they give is likely to be distorted by this primitive fear. They are likely to overplay the financial market risks of high debt, and be over-optimistic about the ability of unconventional monetary policy to overcome the ZLB problem. This is despite the fact that the models the central banks themselves use are Keynesian, and would produce analysis that accords with the logic outlined earlier.

This role of central banks may also help explain two other puzzles discussed earlier. Germany's anti-Keynesian approach may in part reflect the fact that they have had an independent central bank for some time. It may also help explain why deficit deceit has not been so evident in the UK at least in previous recessions.

Conclusion and implications

This chapter has argued that there was no good macroeconomic reason for any austerity at the global level over the past five years, and austerity seen in periphery Eurozone countries could most probably have been significantly milder. Instead, austerity was the result of right-wing opportunism, using voters' instinctive feeling that government should follow them in reducing borrowing to reduce the size of the state. The depressing implication is that the same process might occur in a future liquidity trap recession where consumers are reducing their borrowing. One way to avoid this would be to strengthen the influence of academic economists in policy discussions so that false analogies between consumer and government could be exposed. Another would be to give independent central banks the power to issue 'helicopter money'.

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Notes

[1] Published here: http://www.voxeu.org/article/fiscal-policy-explains-weak-recovery
[2] The natural level, sometimes called the NAIRU, is the level at which inflation is constant.
[3] In the previous example inflation would fall by 4% in the first year, 3% in the second, etc. The big difference between the two cases is that with a backward-looking Phillips curve, we would need unemployment to be below its natural rate after four years to bring inflation back up to the average Eurozone level.
[4] Ricardo Caballero, *VoxEU* post, 21 May 2010.
[5] Suppose a fifth of debt has to be rolled over each year, and total debt is equal to the size of GDP. If taxes are around a third of GDP, then to avoid default if the markets refuse to roll over debt would require increasing taxes by 60%.
[6] See, for example, Ana-Maria Fuertes, Elena Kalotychou, Orkun Saka, *VoxEU* post, 26 March 2015.
[7] Peter Bofinger, *VoxEU* post, 30 November 2015.
[8] House of Lords select committee's questioning of George Osborne available here: http://parliamentlive.tv/Event/Index/7407feb6-9b7b-4f41-8fc8-00768eab2869
[9] Quoted by Benjamin Fox in the *EUobserver*, 26 August 2013.