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A general theory of austerity

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Abstract

Austerity is defined as a fiscal contraction that causes a significant increase in aggregate unemployment. For the global economy, or an economy with a flexible exchange rate, or a monetary union as a whole, an increase in unemployment following a fiscal consolidation can and should be avoided because monetary policy can normally offset the demand impact of the consolidation. The tragedy of global austerity after 2010 was that fiscal consolidation was not delayed until monetary policy was able to do this.

An individual member of a currency union that requires a greater fiscal contraction than the union as a whole cannot use its own monetary policy to offset the impact of fiscal consolidation. Even in this case, however, a sharp and deep fiscal contraction is unlikely to be optimal. Providing this economy is in a union where the central bank acts as a sovereign lender of last resort, a more gradual fiscal adjustment is likely to minimise the unemployment cost.

As the theory behind these propositions is simple and widely accepted, the interesting question is why global austerity happened. Was austerity an unfortunate accident, or is there a more general political economy explanation for why it occurred? Answering this question is vital to avoid the next global recession being followed by yet more austerity.

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Section 1. Introduction

This paper 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 easily been 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. As section 2 shows, the macroeconomics needed to establish these propositions is standard: the allusion in the title to the General Theory of Keynes is deliberate. Section 3 looks at whether beneficial delays to fiscal consolidation were impossible because of financial market pressures. Both theory and evidence suggest not.

This prompts an obvious question. If austerity was unnecessary, why did it happen? On the one hand it is possible to tell (in section 4) a story about why austerity occurred that depends on a combination of historical accidents: the Greek debt funding crisis, the peculiarly diminished role that Keynesian economics plays in German policy discussion, and Germany's central role in reacting to the Greek crisis. I will argue that for various reasons a story along these lines is seriously incomplete, and cannot play more than a walk on role, particularly regarding developments in the US and UK. Section 5 provides a general, political economy theory of austerity, involving political opportunism on the right. I will suggest that this opportunism is made possible partly by the delegation of monetary policy to independent central banks. Section 6 summarises the argument, and asks whether austerity is therefore an inevitable consequence of any major recession.

We would have to go back to the Great Depression to find anything similar to the global adoption of austerity that we have seen following the financial crisis. Among the many differences between that period and this is that we now have, as a result of The General Theory, a well-established and widely accepted body of knowledge about why austerity can be easily avoided. Our recent experience is therefore unique. While there have been a number of discussions that have looked at this experience (such as Blyth, 2013), there remains no comprehensive but brief account of both why it was a mistake and whether it might happen again. This is what this paper aims to provide.

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. I will try and be more specific and precise 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.

Fiscal consolidation is there a policy action, and austerity is an outcome. The key idea discussed in Section 2 is that when we have a choice about when to undertake fiscal consolidation, then austerity does not need to follow any

fiscal consolidation, because the impact of fiscal consolidation on demand can be offset by monetary policy. The tragedy of undertaking fiscal consolidation from 2010 is that this has been a fairly unique period where monetary policy could not offset the impact of that consolidation, and therefore austerity as I define it was the result.

Section 2. Why delaying fiscal consolidation can avoid austerity

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 they would actually lose money by saving. 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 (zero lower bound) 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 longer term interest rates more directly, by buying substantial amounts of long duration financial 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. Central banks do not know how much QE they need to do to achieve any particular result, and there are lags in the economy which make this instrument very inefficient. As a result, it is far from being a solution to the ZLB problem. It was for these reasons that governments in the US, 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 are not difficult 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 austerity, and crucially had only undertaken fiscal consolidation when interest rates were no longer at their ZLB, that consolidation need not have led to austerity (as I define it here). Delaying fiscal consolidation would have allowed interest rate cuts to offset the negative demand effects of lower public spending or higher taxes. Postponing fiscal consolidation would not just delay austerity, but avoid it all together.

How long would we have had to delay fiscal consolidation to avoid austerity? In a back of the envelope calculation (Wren-Lewis, 2015a), I looked at the impact of a counterfactual which assumed that government consumption and investment in the US, UK and Eurozone had grown at trend rates from 2010 onwards. If governments 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. I calculated that 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. (For more details, see Wren-Lewis, 2015b.)

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 from the ZLB are the key to having fiscal consolidation without austerity, this suggests 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, Eurozone and UK could have avoided austerity altogether, can the same be said for individual economies that had unusually large fiscal problems? The obvious example is Ireland, which had not only bailed out a large financial sector, but had also allowed a housing boom which flattered tax receipts to increase public spending beyond a sustainable level. 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. As a result, 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 to have been higher relative to its 'natural' level.¹ 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 again.

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.

Note that 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 that there was 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 because it 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 5 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%. In the second year inflation would be reduced by 2%; 1% because of higher unemployment and 1% because inflation expectations had fallen

1 The natural level, sometimes called the NAIRU, is the level at which inflation is constant.

by 1%. In the third year 3% and the fourth by 4%. 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.² 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 large 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.

2 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 4 years to bring inflation back up to the average Eurozone level.

Section 3. Financial markets

The previous section showed two things. 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, but it would have been far more efficient to spread the unemployment required to achieve this over a longer period of time. Supporters of austerity would normally argue that this approach was impossible in both cases 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 in the past, 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. As a result, those arguing that markets made austerity inevitable need to consider why this did not happen in earlier recessions.

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, and the last recession was no exception. In the US the savings rate for households rose from below 4% to over 6%, in the UK from around 6% to over 11%, and in the Eurozone from about 13% to around 14.5%. 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 the scale and global nature of this recession. As we discussed in the previous section, the depth of the recession was a key reason why we encountered 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 affect how the financial markets regard the need for governments to sell more debt? The answer is probably that they should make the markets more keen to buy 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 deeper largely because consumers and firms saved more than in previous downturn. 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 also 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, there is now a large literature, associated with the work of Ricardo Caballero, which argues that there remains a shortage of safe assets in the economy as a whole. He writes

“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, 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 following the Great Recession.

This observation may appear to be at variance with evidence from those people who work in financial institutions, who typically say that we should worry about what the market will do, and that there is therefore a need for austerity. Unfortunately this source of information lacks authority and is biased. To say it lacks authority may seem surprising, given that financial institutions are closely involved in the markets concerned. 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. 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 in Section 5.

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 which showed no signs of cutting back on spending were vulnerable. Investors could easily move from one government's debt to another. Again the empirical evidence suggests this

argument is wrong. Canada and Japan were two notable major economies that did not switch to austerity in 2010. 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. Suppose a government has no wish to default on its existing debt, and suppose also that the stock of debt is not increasing. So 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 panics. 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.³

This will not happen if the government can create its own currency. If the market does 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. What this does is remove the need for an investor to worry about other investors in making a decision about whether 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, the existence of a sovereign lender of last resort 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. (I will discuss Greece below.) The crisis was never going to spread to those countries outside of 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

³ 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%.

unconditional, but it was enough to bring the Eurozone crisis to an end. This provides a clear test of the theory, and the test was passed (see Fuertes et al, 2015).

This raises an obvious question which 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 in Section 2, 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 of 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 not clear whether 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 still would have been 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 that restructuring of its debt should occur. The Eurozone refused to do either. The ECB restricted the supply of Euros to Greek banks, forcing 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.

Section 4. Was austerity an unfortunate accident?

In Section 2 we 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. In Section 3 we showed that there was 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. As earlier global economic downturns have not been met with austerity (see Kose et al, 2013) even though deficits and debt increased as a result, it seems natural to look for special factors that led to this mistake during the Great Recession.

The accident story might 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's situation occurred 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 austerity throughout the Eurozone through a modified set of fiscal rules.

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 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, in Germany the Keynesian position is 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 US, someone with anti-Keynesian views would be the exception.

The dangers to demand and output of reacting to primary deficits by imposing fiscal consolidation would have been recognised using a Keynesian perspective. The need to provide central bank support rather than impose draconian austerity on countries having difficulty with market access would also have been 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 to explain. Some have argued that it reflects a desire never to repeat the hyperinflation of the Weimar Republic, but this neglects the fact 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 also 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, it might be expected to make German policy makers 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 which 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 and its imposition was opposed by the majority of economists during the public debate, whereas views about the minimum wage among economists in the UK and 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 (Bofinger, 2015). Germany gained a substantial competitive advantage over its Eurozone neighbours, which together with the impact of the Hartz reforms 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 9% of GDP in 2015.

This combination of circumstances 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 both German attitudes and events in Greece clearly had some influence in the US and UK, it seems incredibly unlikely that this could fully explain the turn to austerity in these countries. Finally, the damage done by austerity, and the special nature of the debt funding crisis in the Eurozone, were quite clear to most economists by 2014 at the latest. A report published by the IMF's evaluation office (IMF, 2014) came to 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 longstanding 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%.

In 2009 every single Republican in the US Congress opposed President Obama's plan to use fiscal policy to stimulate the US economy. In that same year the Conservative Shadow Chancellor George Osborne opposed 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, that lower debt would boost confidence which would then stimulate demand ('expansionary fiscal contraction'), and that 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). It was also clear 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, the UK Conservative party won an election outright on a programme involving substantial additional fiscal consolidation.

In the UK in early 2010, 20 eminent economists and policy makers wrote a letter essentially endorsing the austerity plans of the Conservatives. 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 George Osborne in the following terms⁴:

"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 has been difficult to find any economists who support it.

4 Sources: (1) backtracking: George Eaton in *New Statesman* 15/08/12 (2) Turnbull quote: House of Lords select committee's questioning of George Osborne, available [here](http://parliamentlive.tv/Event/Index/7407feb6-9b7b-4f41-8fc8-00768eab2869):
<http://parliamentlive.tv/Event/Index/7407feb6-9b7b-4f41-8fc8-00768eab2869>

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 want a smaller state, but popular support for such a programme is, 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, saying⁵ "Budgetary discipline must come from a reduction in public spending and not from new taxes". 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 at a time of recession to focus on tax increases, unless deficit reduction was being used as a pretext.

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 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.

Although politicians on the right repeatedly use household analogies 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 its spending, that has a direct and noticeable impact on aggregate demand, and 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, it 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 in detail in Wren-Lewis (2015b), so I will only summarise the key points here. I noted in section 3 the tendency of economists from the financial sector to favour fiscal consolidation. 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 views of financial economists matter all the more because of the contacts they have with the media. The tendency in the media to talk 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.

Perhaps the most interesting argument in Wren-Lewis (2015b) is that the creation of independent central banks, coupled with a growing consensus that monetary policy and not fiscal policy should deal with macroeconomic stabilisation (Kirsanova et al, 2009), has helped reduce the extent to which policy makers and the media hear about the costs of fiscal consolidation in a liquidity trap. There could 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 once remarked (King, 1995): "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 in section 2 (delayed fiscal consolidation avoids austerity).

The deficit deceit hypothesis is therefore a general theory of why austerity happens when we are at the ZLB. It reflects opportunism on the political right, using widespread popular concern about rising government debt caused by a recession in order to achieve the underlying goal of a smaller state. This opportunism will only work under certain conditions. First, popular concern about government deficits must be strong, coupled with a generalised fear about the behaviour of financial markets. Second, knowledge about the harmful effects of fiscal consolidation at the ZLB must be weak within political parties, the apparatus of government and the public at large.

This conditionality can help explain why austerity has only emerged during this recession, and not during previous global economic downturns. 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', which was the tendency of government debt to rise over time (Calmfors and Wren-Lewis, 2011). This seems to cast doubt on the generality of the deficit deceit idea, unless we also note that deficit deceit is only likely to be employed if it will be successful.

Popular concern about government deficits will be much greater if these deficits are at 'record levels', which they inevitably were following the deepest global recession since WWII. A recession initiated by a financial crisis is also likely to see consumers reducing their own borrowing, and so (erroneous) analogies between governments and households become more persuasive. A recession initiated by a financial crisis also makes the public receptive to the potential power of these markets. Arguments that rational markets would not be concerned about government default when the central bank can create money are met with a widespread belief that the recent crisis means that markets 'are not rational'.

While all these factors point to the unusual conditions created by the global financial crisis, there are also some trends that have helped create the conditions for deficit deceit to work. The most obvious is the growing power of a neoliberal ideology that puts such stress on the desirability of a small state. Deficit deceit also requires less awareness among politicians, civil servants and the public at large of the harmful effects of fiscal consolidation when interest rates are at their ZLB. In the case of the Great Recession, the growing belief that central banks rather than governments should stabilise the economy has played a critical role, by concentrating knowledge about the harmful effects of fiscal consolidation in an institution that for its own reasons failed to disseminate that knowledge. Germany's anti-Keynesian approach may in part reflect the fact that they have had an independent central bank for some time.

The importance of deficit deceit in explaining recent (and in some countries, continuing) austerity means that it could easily happen again following another major recession. (This possibility is amplified by the apparent downward secular trend in real interest rates, often called secular stagnation, which means that ZLB episodes may occur quite frequently as long as monetary policy continues with current inflation targets). Efforts to prevent this happening can take a number of approaches, one of which has to be to ensure that knowledge about the harmful effects of fiscal consolidation at the ZLB does not stay locked up within central banks.

Section 6 Summary and Implications

This paper has argued that there was no good macroeconomic reason for austerity at the global level over the last five years, and austerity seen in periphery Eurozone countries could most probably have been significantly milder. As austerity could have been so easily avoided by delaying global fiscal consolidation by only a few years, a critical question becomes why this knowledge was not applied. While the unfortunate timing of the Greek debt crisis undoubtedly played a small part, it alone cannot explain austerity in the US and UK, and the weakness of the European left in failing to oppose austerity.

Instead, this paper argues that austerity was the result of right-wing opportunism, exploiting instinctive popular concern about rising government debt in order to reduce the size of the state. This opportunism, and the fact that it was successful (in its own terms), reflects a failure to follow both economic theory and evidence. This failure was made possible in part because the task of macroeconomic stabilisation has increasingly been delegated to independent central banks, but these institutions did not actively warn of the costs of premature fiscal consolidation, and in some cases encouraged it.

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