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The four fallacies of contemporary austerity policies: the lost Keynesian legacy

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The contemporary wide-scale austerity measures are likely to fail in most countries. The first fallacy derives from the false diagnosis that the present crisis is the outcome of lax public spending policy, when it is actually the outcome of a private credit-led speculative boom. The second fallacy assumes the possibility or even the generality of the so-called 'expansionary fiscal contractions': this neglects the short-term negative effects on domestic demand and overestimates the generality of Ricardian equivalence, the importance of 'crowd in' effects related to lower interest rates and the positive impact on trade balances. The third fallacy 'one size fits all' is problematic since Greece and Portugal cannot replicate the hard-won German success. Their productive, institutional and political configurations differ drastically and, thus, they require different policies. The fourth fallacy states that the spill over from one country to another may resuscitate the inefficient and politically risky 'beggar my neighbour' policies from the interwar period.

Key words: Austerity policy, European union, Keynesian theory, New classical theory
JEL classifications: B22, E12, E44, E62, F34, F36, F42, H12, H63, O52

1. Introduction

The devastating consequences of the American authorities' refusal to bail out Lehman Brothers came as a surprise for most economists and policymakers. Conventional dynamic stochastic general equilibrium (DSGE) models had not taken into account financial markets, derivatives, and large and interconnected financial entities (Smets and Wouters, 2002). They had assumed that only exogenous shocks would affect a structurally stable market economy. Modern mathematical finance was highly confident in the risk evaluation models that assumed a major financial crash was extremely unlikely if there existed instantaneous access to deep and liquid financial markets operating within a stable macroeconomic regime. The independent conservative central banker was in charge of defending price stability and the orthodoxy forbade it to buy or to accept as collateral any

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low-quality financial asset. Paradoxically, a low-inflation regime enabled a long period of low interest rates, which triggered the diffusion of very large leverage ratios in order to sustain high rates of return, especially in the financial sector.

The inability to anticipate and then understand the brusque reversal of economic activity initially led to a puzzling silence from mainstream economists. It also signalled a return towards the previously neglected authors whose analyses could make intelligible the economic processes observed during the bubble and its bursting. This 'bursting' was called the Minsky moment, when financial experts rediscovered that bubbles were endogenous (Davis, 1992) and that, under some circumstances, they could trigger a systemic equivalent to the Great Depression of the 1930s (Minsky, 1975, 1982). Facing the risk of its repetition, Irving Fisher's debt deflation theory was also perceived as a relevant reference in order to understand the joint collapse of the prices of most financial assets (Fisher, 1933).

In the realm of economic policies, under the pressure of events and urgency, the central bankers and Ministers of Finance have been reminded not to repeat the errors of the 1930s: expand liquidity even to speculators, let the automatic stabilisers play their role and if these instruments are insufficient, do not hesitate to cut taxes and increase public spending, especially if the interest rate tends towards zero. Some analysts have even announced the comeback of John Maynard Keynes and, thus, the defeat of new classical macroeconomics. However, as soon as the output freefall had been reversed, and the financial panic stopped via extended and unprecedented guarantees given to commercial and investment banks, financial profits have been booming again. It even turned out to be profitable to buy the Treasury bonds granted to bail out the banks by the equivalent of a purely domestic 'carry trade'.

Although macroeconomists and international organisations had been discussing the optimal strategy for central bank balance sheets and public debt to return to normality, in the spring of 2010 the recognition by Greece that its public deficit was far larger than had previously been announced triggered a violent reappraisal by financiers of the sustainability of the public debt of many European Union member states. Via a brutal rise in the price of credit default swaps (CDS) over sovereign debt default and a necessary hike in the interest rate in order to refinance public debt, national authorities have been strongly induced and sometimes constrained to adopt rather drastic austerity plans. However, this has proven to be insufficient to appease the anxiety of the international finance community. Thus, both the European Union and the International Monetary Fund (IMF) have been called to support and monitor the adjustment process, first in Greece, then Ireland and Portugal.

The present article aims to assess the relevance of such austerity policies given the unfolding of the crisis and the present stage of European integration. The diagnosis upon which they are based refers to the first-generation crises, which were caused by an excessive public deficit that was incompatible with a fixed exchange rate regime (Krugman, 1979). In contrast, the present crisis is the outcome of a private credit-led boom linked either to the piling up of complex and dangerous financial innovations (the USA and the UK) or to the unintended consequence of the euro for previously weak currency countries (Greece, Portugal, Ireland and Spain). This is the first fallacy pointed out by this article (see Section 2). From a macroeconomic point of view, austerity-generated recovery neglects the notion that strong effective demand effects might trigger a vicious circle of the cumulative loss of output and tax revenue, propelling a further and unintended explosion of the stock of the public debt/Gross Domestic Product (GDP) ratio. Symmetrically, this second fallacy takes for granted that crowding in and competitive mechanisms can quickly stop the downwards adjustments and trigger a vigorous recovery (see Section 3). The third fallacy relates to the belief that macroeconomic configurations are roughly the same in all developed countries. Hence, the governments of ailing countries should not hesitate to follow the strategy, even if socially and politically costly, that finally benefited the German economy so much. The diversity of capitalisms (Aoki, 2002) and their regulation modes (Boyer and Saillard, 2001; Amable, 2003) invalidates the 'one size fits all' vision that is implicit in contemporary economic policies (see Section 4). Lastly, the growing interdependencies between the member states of the eurozone make problematic the combination of their austerity policies. These growing interdependencies may even reinforce the factors of depression in the absence of a privately engineered recovery that would be associated with the restoration of confidence in the viability and efficiency of the eurozone (see Section V). A paradoxical conclusion emerges: is not the international finance community undermining its own basis and legitimacy by pushing such extreme and inefficient austerity plans?

2. The origin of the crisis: a private credit boom, not lax public policy

With the progressive liberalisation of finance, first at the international level and then domestically, banking and exchange rate crises have become more frequent, initially in Latin America, e.g. in Mexico, then in Europe during the process of convergence towards the euro and, lastly, in East Asia (Reinhart and Rogoff, 2009). Macroeconomists have had to recognise that the processes leading to the crisis were different in each case. The early Mexican crisis expressed the incoherence between a large public deficit and a fixed exchange rate regime. The strategy out of the subsequent recession was logically to curb public spending, to raise taxes, to reduce welfare and to implement wage cuts. Is the Greek sovereign crisis a repetition of such a configuration? This is the common diagnosis that apparently justifies the implementation of austerity policies: a huge and increasing public deficit can no longer be financed and belonging to the eurozone prevents any devaluation. Nevertheless, when placed in a historical perspective, the Greek crisis appears to be much more complex: it is part of a sequence of events that originates back to global financial liberalisation, the constitution of the eurozone and the quasi-collapse of the American financial system in September 2008.

2.1 The overarching cause: financial innovations mixing securitisation and subprime

The rationale behind austerity policies cannot be understood without referencing the American crisis. Of course, the USA has shown a long period of trade and public deficits, but these are not the origin of the present turmoil. Actually, the present turmoil derives from the long-term consequences of a cluster of financial innovations that aimed to separate credit decisions from their subsequent risks by splitting them into various components (associated with default, variability of interest and exchange rates). This has generated an extreme elasticity of credit supply that has favoured high leverage within the financial system and access to mortgage credit for the less affluent proportion of the population. This dissolution of the intrinsic responsibility of the bank within the bilateral relation of credit triggered an explosion of credit that fed the dynamism of effective demand. However, the quality of creditors has simultaneously been deteriorating, and this worsening position was hidden by the complexity and creative nature of fair value accounting (Boyer, 2008).

In a sense, the securitisation of subprime loans and related financial innovations have converted the poorest fraction of the population into Ponzi speculators that were convinced to bet upon the endless rise of American housing prices. The financial system has thus experienced large and easy profits that remained unchallenged until the bubble burst. The boom was bound not only to end (Boyer, 2000A), but also to trigger a melting down of Wall Street investment banks that finally reverberated throughout the entire American economy and, subsequently, globally (Figure 1). The overarching cause of the 2008 crisis was thus a private credit-led speculative boom: it was not public deficit generated. Most countries have been affected by the direct and indirect repercussions of the diffusion of toxic derivatives and the collapse of international trade. Some of them even had public budget surpluses because the real-estate boom had been generating high taxes; Spain is a good example of such a pattern (see Figure 9C). Therefore, there remains some doubt about the relevance of typical austerity policies based upon the correction of previous public finance imbalances.

2.2 A compensating mechanism for the stagnating real incomes of less privileged groups

Beneath the foam of financial bubbles, how can we explain the wide diffusion of credit-led growth regimes outside the USA, the UK, Ireland, Iceland and the Baltic countries? Basically, this phenomenon can be interpreted as a way out of the long-lasting crisis of the post-World War II Fordist regime that was built upon the synchronisation of mass production and mass consumption, an extended welfare, and a reduction in inequality (Boyer and Saillard, 2001). When the increases in total factor productivity quasi-vanished in the USA, as did the median real incomes of households, the conflicts and tensions over income distribution were exacerbated to the detriment of the less skilled and to the benefit of those working in high-tech industries, professional services and the international economy. Simultaneously, slowing growth has complicated the financing of past entitlements, while innovators and the middle classes have demanded lower income taxes. The outcome has been the recurrence of public deficits and more public debt, which has been

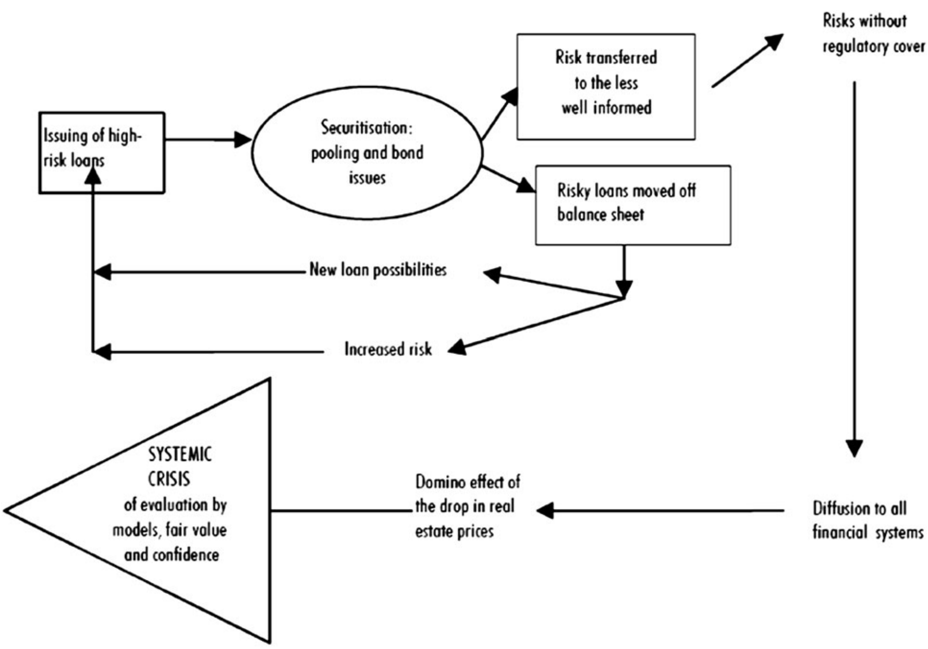


Fig. 1. *The erosion of credit contract responsibility leads to a systemic crisis.*

relatively easy to finance given the low real interest rate. This evolution of public finance can be interpreted as the socialisation by the state of the imbalance between the cost of the post-World War II social compromises and the resistance by affluent categories to continue to pay for social solidarity. Public and welfare deficits were especially acute in Europe, where welfare is much more extended and entrenched. Therefore, as early as the late 1990s, public deficits were already not the mere consequence of bad management, but rather the expression of an unsolved social issue.

So-called information and communication technology has contributed to a recovery of total factor productivity in the USA, but its benefits have been unevenly distributed: the more skilled have captured a share of these dividends, but at the bottom of the income distribution wage earners have experienced a moderate but persisting decline in their remunerations. During the 1980s, within each household, more members were forced to enter the labour market and work longer hours just to sustain the previous progression of standards of living, but these strategies encountered clear limits at the end of that decade. Since then, financial innovations have been providing another powerful but ultimately dangerous mechanism for reconciling a stagnating real income with the ongoing dynamism of consumption and a real-estate boom. The explosion of the remunerations of Chief Executive Officers and personnel linked to finance has also been closely linked to this new growth pattern (Figure 2).

In addition, the hike in financial profits and transactions has generated more taxes and this inflow has transitorily hidden the magnitude of the structural deficit of public budget and welfare, as observed at the end of the Internet bubble. When real-estate prices begin to decrease, not only do bad loans and toxic derivatives pile up, but also the tax basis dramatically shrinks in the financial sector as well in manufacturing. Hence, doubts about the sustainability of the American public debt is not the outcome of a transitory populist explosion of state expenditures—that would call for an IMF-type austerity programme—but evidence that actors have become aware that major imbalances have not been addressed over

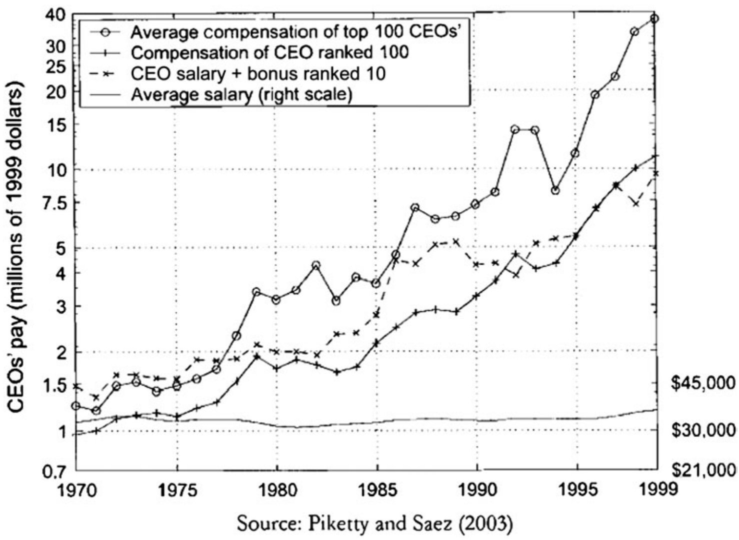


Fig. 2. *The widening of inequalities and financialisation in the USA. Source: Piketty and Saez (2003).*

the past two decades. In such a configuration, the adequate management of public finance is required, but this is not at all a substitute for long-awaited institutional reforms.

2.3 The excess of global savings and the cumulative imbalanced international economy

A third factor has to be brought into the picture in order to understand the American subprime crisis and its diffusion to the world economy: the abundant inflow of capital into the USA sustained long-term low interest rates and allowed domestic imbalances to persist over more than a decade. Japan and China reinvested a large part of their trade surpluses into dollar-denominated financial assets, including Treasury bonds (Figure 3). Consequently, the twin public and external American deficits persisted and deepened. Symmetrically, the unbalanced Chinese growth regime continued to compensate for the weakness of domestic consumption by the dynamism of exports.

Thus, the new configuration of the post-Bretton Woods system has significantly contributed to eroding the previous discipline in public finance, and it has relaxed the constraints on the intertemporal consistency of taxation and public spending at the national level. Low interest rates and fast growth have alleviated the burden of public debt interest payments and propagated the illusion that current economic policies are sustainable in the long run. When a more realistic assessment of risk manifested itself after September 2008, thereby pushing up interest rates for the weakest firms and banks, some countries experienced their first doubts about the quality of their sovereign debt levels. Afterwards, when the recovery engineered by large public interventions faltered in early 2011, the tightening of tax bases made the perils of sovereign debt more evident. The very viability of the current 'non-international system' is now at stake (Figure 4).

An important feature emerges from this analysis: the surge in sovereign debt concerns is not an autonomous or an exogenous phenomenon, but rather the consequence of a complex process involving financial innovations in the USA, a new polarisation of international relations and the strategies of governments facing strong public opinion for higher taxation.

2.4 How the subprime crisis has affected the rest of the world

Given the structural interdependencies operating at the global level (Palma, 2009), it is far from surprising that the quasi-melting down of the American financial system has heralded

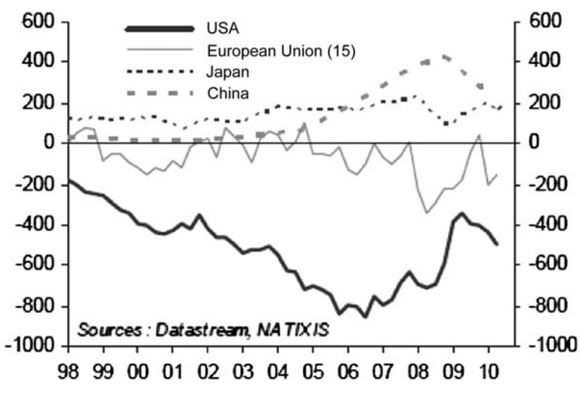


Fig. 3. *The polarisation of current balances and the new global savings/investment adjustments. Source: Artus (2010).*

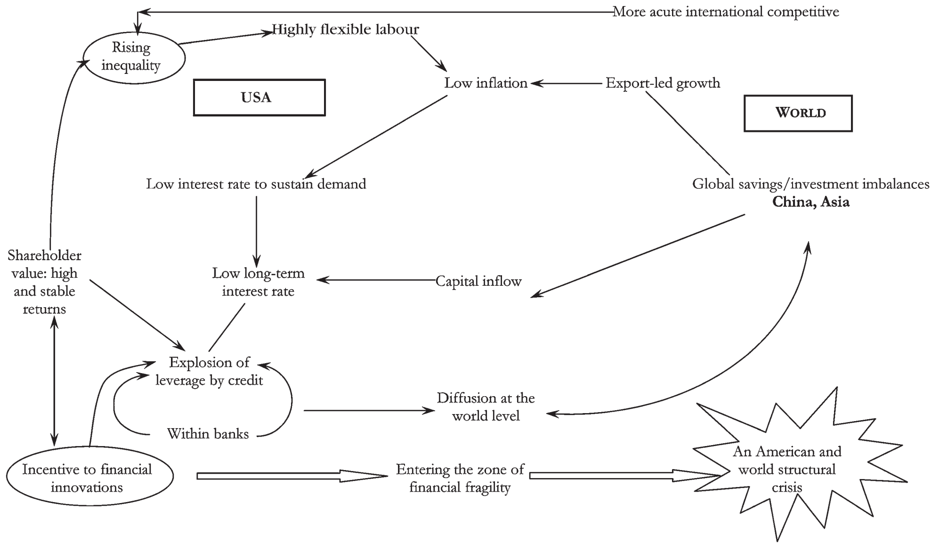


Fig. 4. *The involvement of international imbalances into the genesis of the subprime bubble.*

a major economic recession that has diffused to any economic entity or country open to globalisation. Nevertheless, the precise contagion mechanisms are diverse and they have different impacts according to the style of macroeconomic regime observed at the national level:

- The good pupils of financialisation, who had followed a light touch approach towards regulation (the UK, Ireland and Iceland), finally experienced a structural crisis led by their own finance-led growth. Of course, the related recession was exacerbated by the brusque rise in risk aversion transmitted by globalised financial markets.
- The present crisis displays a typical pattern: during the economic boom, fed by lax credit and monetary policy, all actors operating in the financial or productive sector tended to significantly underestimate the risk; conversely, when the speculative bubble burst, the very same actors shifted from naïve optimism to dark pessimism. The ratings agencies have reinforced this perverse mechanism by initially rating AAA dangerous and complex derivatives, which badly informed actors or incompetent entities bought in order to boost their wealth and/or their rates of return on equity.
- Consequently, the balance sheets of many private and public financial institutions have been incurring losses that they have been unable to value precisely. The related paralysis of interbank credit has been directly transmitted to the credit lines open to consumers and entrepreneurs. An initially limited real-estate crisis could have turned into a repetition of the Great Depression had public authorities not reacted quickly to limit it to the so-called ‘Great Recession’.
- Finally, international trade and financial flows diffuse the crisis to the world economy, including the most successful examples of innovation/exportation-led growth, such as Japan, Germany and Korea.

Facing the risk of a major depression, all governments have agreed to take seriously the risk if a repetition of the interwar dramatic period. Central bankers have allowed the ailing financial sector complete access to liquidity, and the Treasuries have accepted the hollowing of public deficit via the role of countercyclical mechanisms or explicit tax cuts and public spending. Furthermore, they have had to bail out their national financial systems via extended guaranties and the recapitalisation of major banks. These are the now neglected origin of the present concern about the risk of sovereign debt default.

2.5 Credit boom and public deficits were compensating mechanisms for the structural productive imbalances generated by the euro

This does not mean that the intrinsic institutional weaknesses of the European Union should be neglected. Actually, the same imbalances as those observed at the world level had been prevailing within the eurozone and they are the key to understanding the process that led to the generalisation of austerity policies in 2011. Before acceding to the euro, member states had to fulfil strict conditions: low inflation, exchange rate stability, low public deficit in proportion to Gross Domestic Product (GDP) and a limit for the stock of the public debt/GDP ratio. Of course, Europe was not an optimal monetary zone, but it was expected that the common objective of low inflation would stabilise long-term expectations and thus favour a form of convergence. However, this convergence has only been nominal because it has been associated with a deepening of the division of labour and the specialisation of national economies in sectors with contrasting opportunities to cope with international competition. The direct consequence has been the polarisation between Northern European economies that had trade surpluses and Southern European ones that have experienced a permanent deterioration in their degrees of competitiveness (Figure 5). On one side, once the threat of devaluation was removed the rate of interest strongly declined for weak currency countries and both firms and households have had easy access to credit, which has sustained their catching up. Thus, fast growth has sustained positive expectations about the viability of the related regimes. On the other side, given that interest rates and exchange rates were no longer available to governments, public spending and taxation have been the only instruments available to respond to domestic imbalances, such as unemployment.

It is thus not surprising to observe the fast growth of credit and/or persisting public deficits: they are the direct, but rarely anticipated, consequence of the absence of any significant redesign of European and domestic institutions after the launch of the euro. This explains the major difficulties facing governments since 2010. On the one hand, austerity policies do not address the underlying productive imbalances created by real-estate bubbles: public spending cuts exacerbate the gap between potential production and

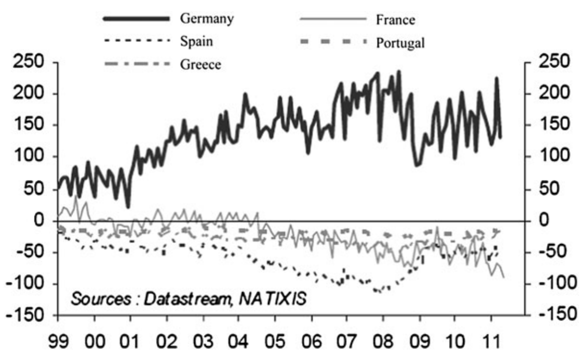


Fig. 5. *The cumulative polarisation of trade surpluses and deficits after the launching of the euro. Source: Artus (2010).*

effective demand, and salary and wage cuts only marginally restore the competitiveness of distressed sectors that have major overcapacities, e.g. the real-estate sector. On the other hand, governments face social and political opposition when they decide to reduce welfare and public services, and augment direct and indirect taxes. They are perceived as simultaneously socially unfair and inefficient at restoring the conditions for growth and providing better standards of living. Basically, they deal with the symptoms and not the origins of the doubts of the financial community about their sovereign debt levels.

3. An unjustified return to pre-Keynesian economic theory

The first fallacy relates to the misinterpretation of the origins of the subprime crisis and its repercussions over possible sovereign debt defaults, whereas the second concerns the implicit macroeconomic theorising that justifies the generalisation of austerity policies. Where public deficits come from matters, and new classical macroeconomics presents a caricature of the mechanisms that govern the level of economic activity and growth rates. Furthermore, only specific conditions warrant the possibility of an austerity-led recovery.

3.1 The concern for public finance sustainability derives from the consequences of successful antidepression policies

First-generation crisis models pointed out that a boom generated by excessive public deficits was bound to be stopped by accelerating inflation, a loss of competitiveness and a capital flight that makes the current fixed exchange rate regime unsustainable (Krugman, 1979). In such a configuration, the reduction of public deficit and devaluation of the domestic currency were logically grounded strategies in order to overcome the crisis. The American crisis is closer to the second-generation models (Krugman, 1999, 2001): large inflows of short-term capital provide the liquidity that triggers a real-estate bubble, which is left uncontrolled by public authorities, adept of light-touch financial regulations or of a pro-growth monetary policy based on low nominal interest rates. Of course, budgetary policy might also become pro-cyclical and exacerbate the emerging macroeconomic disequilibrium, but this is not the primary source of the speculative bubble.

Some data have suggested that most of the deterioration in the public debt levels of advanced countries after 2007 was a consequence of automatic stabilisers, namely the automatic contraction of public revenue owing to a decrease in asset prices and financial profits, and support to the ailing financial sector. Clearly, however, autonomous fiscal stimuli only accounts for a very small proportion of public debt augmentation (Figure 6).

This does not mean that a fiscal consolidation is not required in the future when an endogenous recovery is strong enough to absorb a tightening of monetary and/or budgetary policy. An early austerity policy might well annihilate the recovery and lead to a double dip in the economy. For instance, in 1997 the Japanese government introduced a new IVA tax in an attempt to reduce its public deficit, although this apparently rational move led to the opposite result: the ensuing recession reduced the tax basis and public debt continued to expand for a decade. This was especially problematic when highly indebted firms and households were saving more in order to reimburse their credit (Koo, 2009). Concerning the current situation in Europe, this danger was perceived by international organisations such as the IMF. Nevertheless, during autumn 2010, the international financial community declared that the time was ripe for imposing fiscal adjustment via the

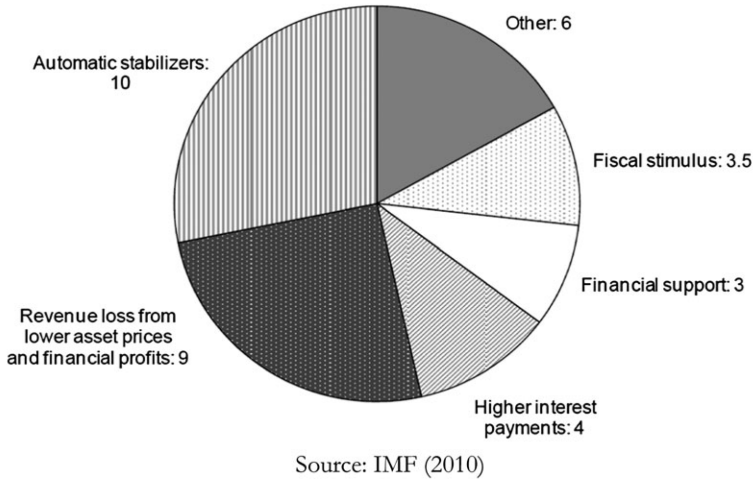


Fig. 6. *The various factors at the origin of governments' debt increases between 2007 and 2014 (percentage of GDP). Source: IMF (2010).*

explosion in the price of CDS, as soon as the Greek government admitted that the previous statement about its public deficit and debt had been grossly under-declared. Since then, doubts about the solvency of other eurozone economies have spread. Progressively, the structural origins of the financial turmoil have been forgotten.

3.2 Back to irrelevant pre-Keynesian macroeconomics

During the interwar Great Depression, recognised economists had already attributed the crisis to the public deficit and the blocking of pure market mechanisms for labour (nominal wage rigidity) and products (role of oligopolistic competition). Keynes's emerging theory explained the two anomalies that falsified classical theory: unemployment could persist for a long period in spite of a significant nominal flexibility and no automatic mechanism was able to propel a market economy towards full employment. The *General Theory* (Keynes, 1936) response and breakthrough proposed three alternative hypotheses. First, Keynes pointed out that conventional micro theory could not be extrapolated at the macro level since composition effects operate at the level of an economy analysed as a whole. Second, since uncertainty is crucial, the financial markets are the place where the expectations of various actors confront one another in such a way that a collective representation emerges, a convention that then shapes most decisions about production and investment. Third, and consequently, employment is the consequence of the level of effective demand, itself moved by investment decisions.

Thus, in Keynesian involuntary unemployment equilibrium, if households decide to save more, the decrease in effective demand implies lower employment and a higher fiscal deficit. The paradox of thrift also applies to austerity policies as soon as full employment does not prevail and if unemployment is not classical in the sense of disequilibrium theory, namely caused by the excess of real wages over marginal productivity (Benassy, 1982). This should be a warning against the diffusion of austerity policies without prior careful analysis showing that these Keynesian mechanisms are overwhelmed by classical ones. Why has this rather convincing argument been abandoned by contemporary economists (Figure 7)?

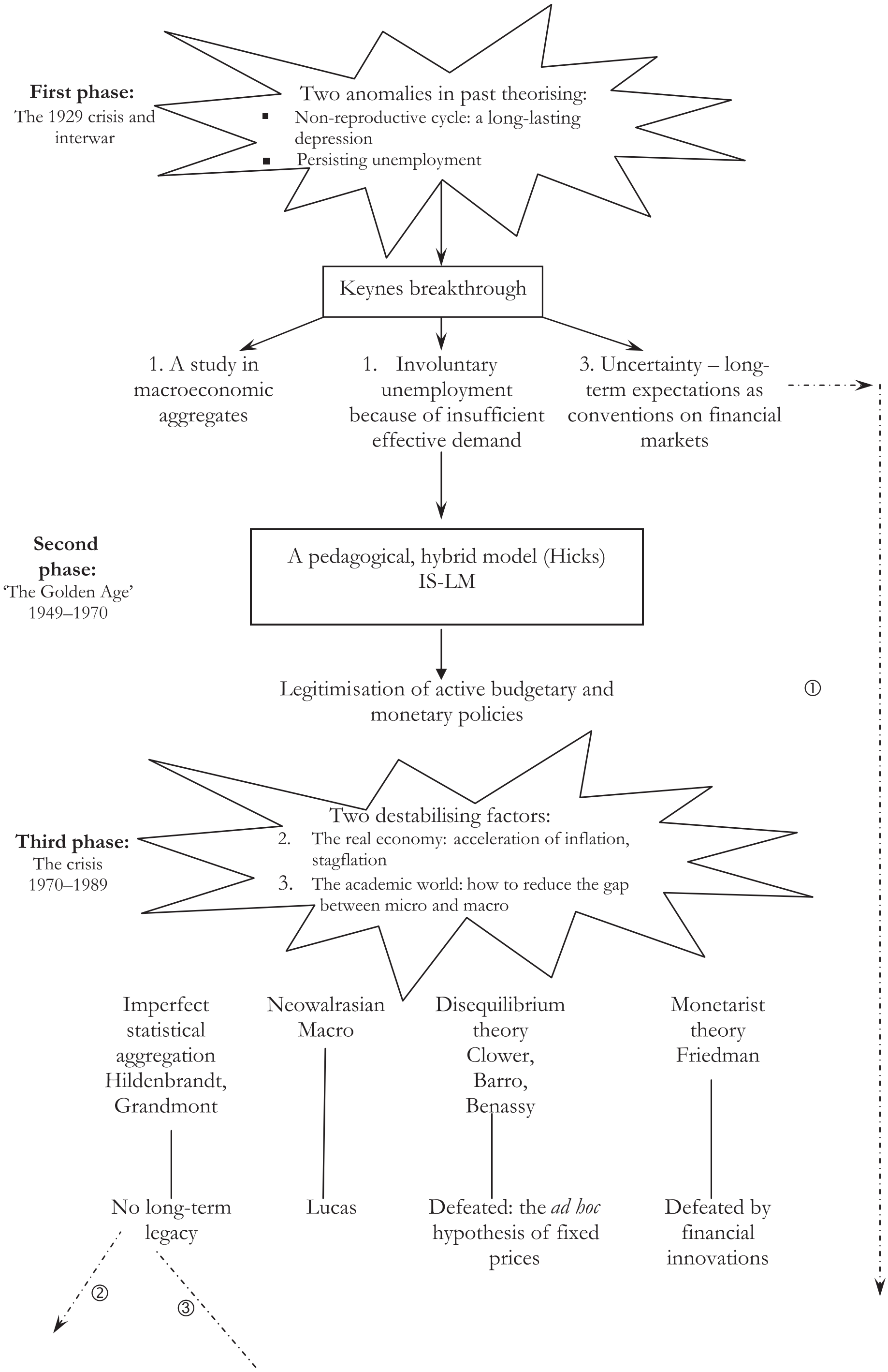


Fig. 7. *From Keynesian macroeconomics to the micro refoundation of classical theory.*

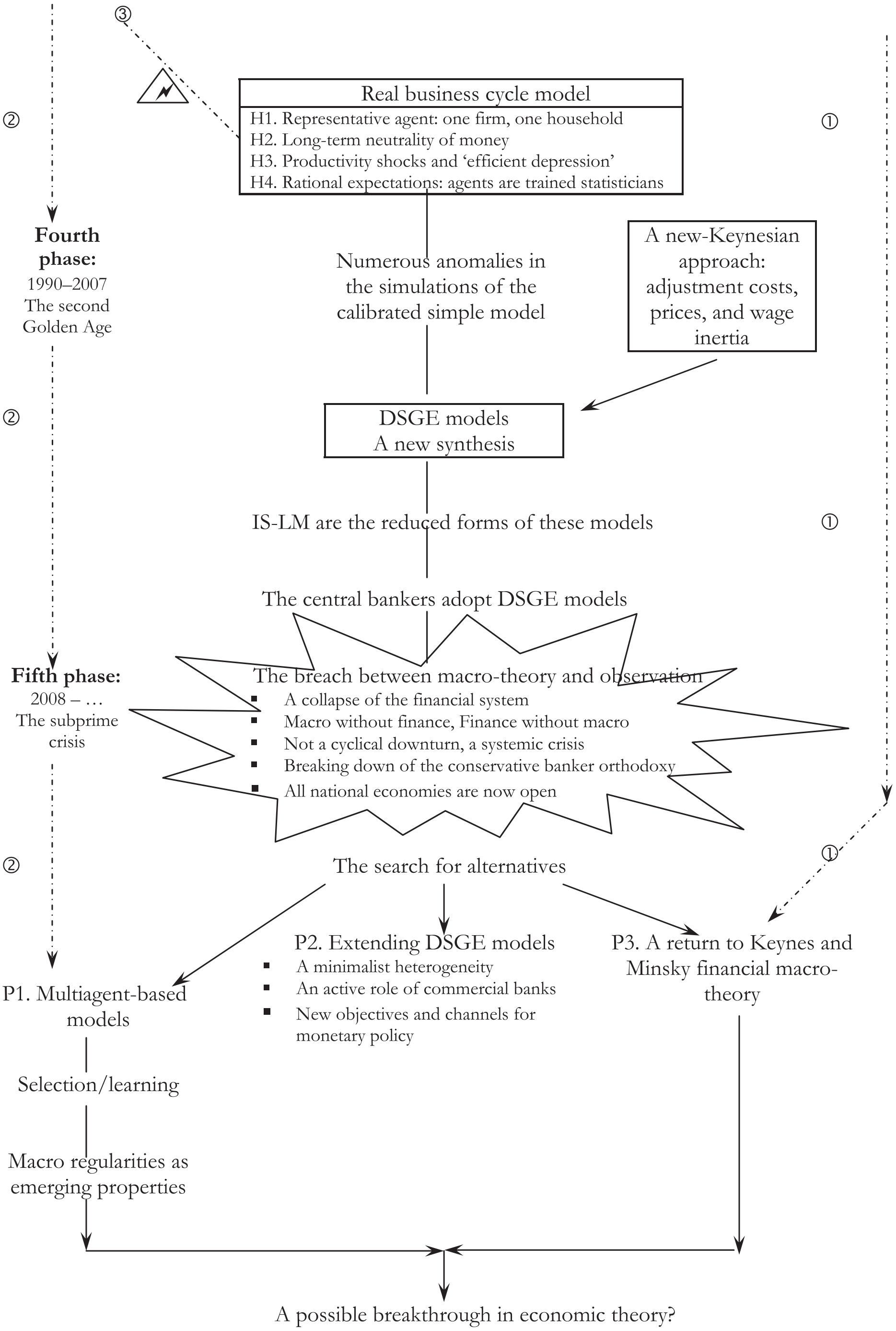


Fig. 7. Continued

The first step in the oblivion of Keynes's original message was the adoption of a rather specific and partial formalisation of the multifaceted proposals put forward by the *General Theory*: the IS-LM model that describes the adjustment respectively of Investment and Saving, Liquidity and Money supply introduces a form of continuity with respect to pre-Keynesian conceptions, e.g. the monetarist quantitative equation. In a second step, Milton Friedman cleverly used this path when the acceleration of inflation appeared to be a falsification of Keynesian analysis and a rehabilitation of his own conceptions. A priori, disequilibrium theory proposed a more general framework that was able to distinguish among various regimes, namely that Keynesian unemployment occurs because of insufficient effective demand, a classical regime is observed if wages are too high compared with productivity and inflation prevails when demand exceeds productive capacity (Benassy, 1982). However, at the epoch of the liberalisation of product and labour markets, it was difficult to resist the Chicago economist's arguing that this framework was only valid for administered or centrally planned economies and not for all advanced ones. Another promising research agenda aimed to develop a theory of imperfect statistical aggregation, but it was technical and difficult to follow. Its premise has only recently been rehabilitated, but no longer within the mathematical general equilibrium tradition: multi agent based models now belong to a neo-evolutionary paradigm (Dosi *et al.*, 2010). *De facto*, the winner of this third stage of macro theorising is Robert Lucas (1983). He reintroduced Walrasian hypotheses and combined them with rational expectations in stating that any unemployment is voluntary since it is the outcome of rational agents facing changes in real wages. By construction, under the rational expectations hypothesis, monetary expansion has only a transitory impact on real economic activity. Similarly, any budgetary policy is impotent because private agents anticipate the future tax increases required to reimburse the present public debt.

This breakthrough was refined by the next generation of models, termed real business cycles (RBC); namely, a representative agent solves an intertemporal optimisation problem that is only submitted to exogenous productivity shocks. What Keynesian models formalise as a typical endogenous productivity cycle led by the evolution of effective demand is thus taken as exogenous. Thus, RBC models invert the cause and the consequence and, therefore, provide an unlikely interpretation of the major crises of 1929 and 2008 assimilated to typical business cycles. For instance, against any common-sense understanding, the subprime crisis is analysed as the rational reaction of financiers to an unexpected fall in the productivity of the construction sector (Minford, 2009). The next step in the decay of Keynesian macroeconomics converges towards an extension of this paradigm to DSGE models. The commonality of all of these models is to assume that any market equilibrium is structurally stable and that perturbations are stochastic and exogenous or that the consequences of state interventions block the natural convergence towards a 'natural' equilibrium that should prevail by an 'invisible hand' mechanism.

Actually, the unexpected irruption of the crisis has falsified the theoretical hypotheses of most ruling macroeconomic models used by central banks as well as those produced by mathematical finance. Financial innovations have not hedged risks but instead created new systemic ones, while leading macroeconomic models had no bank or financial market. The simulations anticipated a rapid and spontaneous recovery (Wieland, 2010), but the models of closed economies were inadequate to forecast the huge repercussions of the collapse of the American financial system upon the world economy. Can one trust these models? Do they provide scientifically based evidence in favour of drastic austerity policies just when the government-engineered recovery is faltering? Previous developments call for two negative answers. Actually, public authorities are muddling through the opposite dangers of renewed inflation and debt deflation depression. Who would have imagined four years ago that conservative central bankers would buy massive amounts of toxic financial assets and Treasury bonds rated as quasi-junk?

3.3 The hypotheses that would justify austerity policies are rarely observed

Consequently, the arguments in favour of austerity have to be assessed not within an erroneous grand theory reconciling micro and macro, but by more modest and *ad hoc* analyses that are adequate and empirically grounded. The literature suggests that at least three major mechanisms coexist and interact and that their conjunction determines whether tax hikes and government spending cuts have a positive or negative impact upon economic activity (Figure 8).

- The direct reduction in effective demand is always present since, via the Keynesian multiplier, an austerity policy depresses output and employment. This is usually a short-run effect, but, in the absence of any other mechanism, adaptive expectations prevail and firms extrapolate the current level of activity from period to period. The related reduction in investment implies less productive capacity and this could trigger, in the medium term, a cumulative contraction of the tax basis and thus an unintended rise in

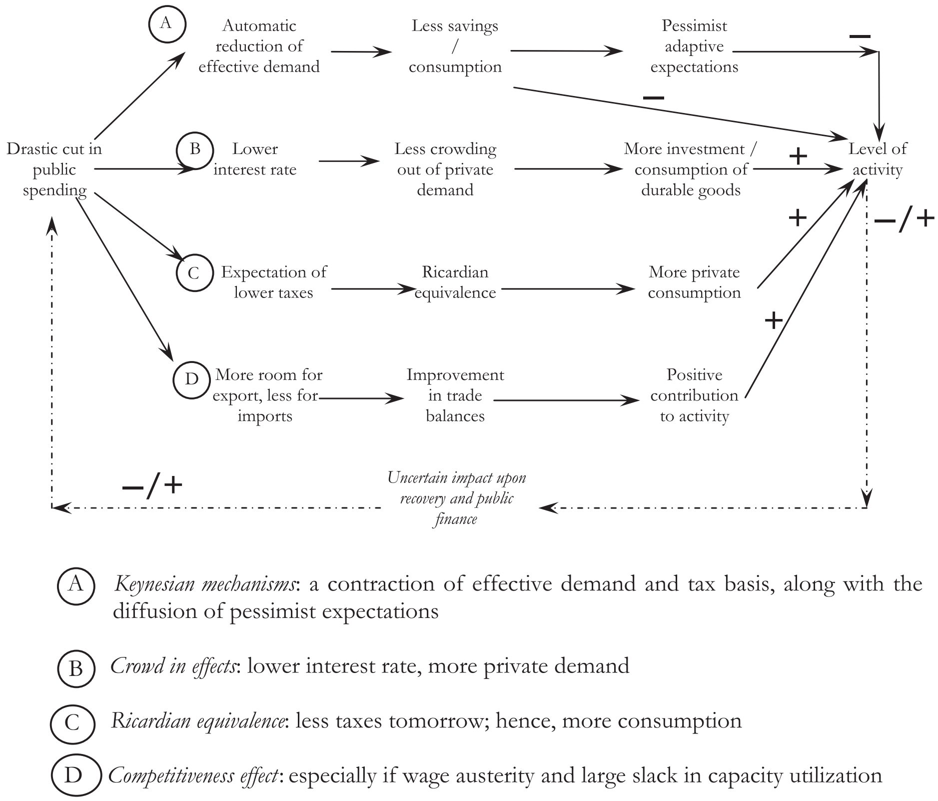


Fig. 8. *How classical and Keynesian mechanisms interact.*

the public debt/GDP ratio. Lower production and a persisting public deficit might enter into a vicious circle, as observed in Japan during the 1990s and recently in Greece.

- The first compensating channel relies upon the reaction of financial markets to the government programme: if they consider that there exists competition between private and public financing, a reduction in state borrowing induces a lower interest rate according to a reduction in the *crowding out effect* of public deficits. In addition, this implies that all public spending, even investment, is less productive than is private spending. Thus, the recovery of the private component of effective demand might progressively overcome the negative impact of public spending cuts and/or tax hikes. Nevertheless, it has to be pointed out that this classical effect is far from automatic compared with the Keynesian multiplier. Everything relies on how the international financial community reacts to the viability of each national austerity plan. Generally, large uncertainty prevails given the multiplicity and interconnectedness of the economic and social processes that condition the success or failure of the strategies of public authorities.
- The second countervailing mechanism relates to taxation. If a public deficit is lowered through a reduction in public spending, rational actors should anticipate that less taxation will be required in the future and this determines their levels of consumption and savings. This *Ricardian equivalence principle* assumes that all agents have access to credit in order to intertemporally optimise their consumption patterns in a fundamentally stationary world. This forward-looking decision-making is not necessarily available for agents that are constrained by involuntary unemployment or a lack of access to credit. Thus, according to the distribution of agents between the two groups, either new classical or typically Keynesian effects prevail (Wieland, 2010).
- The third classical channel relates to the role of public austerity measures on *domestic competitiveness* and external trade balances. Facing a depressed domestic market, firms may redirect their sales towards the international market, whereas a high income elasticity of import implies their contraction, which will be faster compared with domestic supply during a recession. The impact is still strong when the government reduces civil servants' remunerations and/or welfare benefits, because this is interpreted as a signal of wage austerity or private sector wage reduction. An improvement in the trade balance may thus progressively compensate for the negative impact of the contraction of the public sector. Of course, this impact is higher for largely open small economies and when the exchange rate reacts to the lower domestic interest rate to make domestic producers more competitive. However, the negative retroaction of the devaluation of the domestic currency upon public debt, when denominated in a foreign currency, introduces a countervailing mechanism.

A major conclusion emerges from this simple survey: there is no general theoretical reason to guarantee the success of any austerity policy. Everything depends on how all these opposite effects interact. In some configurations, they may even succeed in restoring public finance credibility, whereas in others they may fail.

4. Austerity policies: 'the one size fits all' fallacy

The previous developments suggest a potential diversity of macroeconomic configurations according to the degree of opening, the intensity of the impact of financial variables upon domestic aggregate demand and the nature of the prevailing growth regime. Actually, retrospective comparative analyses of fiscal consolidation episodes confirm the low likelihood of their expansionary impact. The third fallacy precisely relates to the diffusion of the vision that all national economies belong to the same variety that warrants the success of a fast return to budgetary balance.

4.1 Successful expansionary consolidations are the exception, not the rule

In contemporary economic history, are there examples of drastic austerity measures that have actually promoted rapid economic recovery? Recently, various researchers have agreed upon the list of these successful stories: Denmark 1983–86, Ireland 1987–89, Finland 1992–98 and, lastly, Sweden 1993–98 (IMF, 2010; Perotti, 2011). The success of such anticonventional policy seems to rely upon the variable mix of three main mechanisms (Table 1):

- A form of *credibility effect* is operating because all four cases show significant declines in their nominal interest rates. However, this is not only the consequence of the restoration of the credibility of public finance but also the outcome of successful anti-inflationary policies. In the Danish case this mechanism is powerful enough to propel an increase in consumption in spite of public spending cuts and wage austerity: the deceleration of inflation was such that real income was maintained and the consumption of durable goods boomed in response to lower interest rates.
- Actually, another form of *income policy* can be observed in order to ascertain the equivalent of an 'internal devaluation' via the moderation of unit production costs. Frequently, wage concessions are traded against personal income tax reductions or lower social contributions paid by firms: it is not simply a market mechanism but the consequence of a social pact promoting national competitiveness. This social democratic brand of capitalism, which is typical of three of these four countries, is thus crucial in explaining their abilities to implement such policies.
- In the case of Finland and Sweden, a *large devaluation* promoted a boom in exports that compensated for the contraction of domestic demand. Contrary to the Danish case, slower initial growth was the cost to be paid in order to reap the benefits of a higher growth rate in the medium term. It is clear that this mechanism is available for small economies that may adopt competitive devaluation without fearing retaliation from trade partners. Such an option is not available for medium-sized or large economies and, of course, it cannot be used simultaneously by all these countries. This route is also closed for the member states of the eurozone, which have accepted the irreversibility of their adoption of the common currency.

Consequently, austerity without pain largely belongs to a rare or mythical configuration. In all other cases, short-run costs have to be paid under the form of lower domestic demand. Actually, the specific conditions of the Danish expansionary fiscal contractions are difficult to reproduce:

- Firstly, given the legacy of the so-called Great Moderation, nominal interest rates are far lower than they were during the 1980s and early 1990s, and the management of the 2008 crisis has still contributed to very low nominal and even negative real interest rates in some countries, such as the USA and the UK. The only exception concerns countries that are suspected to default, but their macroeconomic configurations today are far from reproducing the virtuous circle of social democratic economies.

Table 1. *Four episodes of large fiscal consolidation: what are the conditions for success?*

	Nature and size of discretionary measures (% GDP)	Exchange rate regime/ monetary policy	Mechanisms involved			Impact		
			Credibility	Wage austerity	Real exchange rate	Domestic demand	Export	Time profile of GDP
Denmark 1983–86	4% less spending 4.9% more taxes	Exchange rate used as a nominal anchor	Interest rate falls from 21% to 11.3%	Complete plan of wage restraint and disinflation	Appreciation	Increase in consumption and investment	Moderate growth	Faster growth in the short term and then deceleration
Ireland 1987–89	3% less spending 0.1% less taxes	Exchange rate used as a nominal anchor	Interest rate falls from 11.3% to 9.2%	Tripartite wage bargaining and disinflation	Moderate depreciation	Stability of consumption, initial decline of investment	High growth	Slower growth and then acceleration
Finland 1992–98	0.4% less spending 3.5% more taxes	Floating exchange rate Inflation targeting	Interest rate falls from 12% to 4.8%	Income policy agreement (wage moderation against lower income tax)	Large depreciation	Deceleration of consumption and investment	Very large boom	First deceleration and then acceleration
Sweden 1993–98	3.6% less spending 4.8% more taxes	Floating exchange rate Inflation targeting	Moderate decline in interest rate from 8.6% to 5%	Low contractual wage increase and social contribution increase	Large devaluation	Strong contraction	Large expansion	First deceleration and then acceleration

Source: Synthesis elaborated from Perotti (2011).

- Secondly, with the decentralisation of industrial relations and the wave of deregulation, it is difficult to imagine the repetition of the social pacts that were instrumental in the acceptance by wage earners and citizens of income policies implying wage moderation. Therefore, a rise in unemployment is frequently the only instrument left to induce wage moderation.
- Thirdly, when countries have institutionalised the use of a fixed exchange rate as a nominal anchor, the only path available is internal devaluation, i.e. stronger wage and salary austerity policies than in the past when they could devalue. It is easy to imagine the social and political costs of such a strategy. Instead of the virtuous circle observed in Denmark from 1983 to 1986, a cumulative downward adjustment has been operating since 2008 in Greece, for example.

4.2 The German pathway: a difficult benchmark to emulate

Nowadays, these past episodes are only referred to by scholars, whereas the main reference among policymakers for a successful long-term austerity policy is Germany. *De facto*, a permanent preoccupation of German public authorities has been to keep public finances under control and their policies have delivered impressive results (Figure 9). These are the outcome of an original mix:

- Contrary to many other member states of the eurozone, the Ministry of Finance in Germany decided to reduce the public deficit by augmenting Value Added Tax during the booming years from 2004 to 2007, according to a rare countercyclical fiscal policy. Of course, fiscal consolidation is much easier during booms that it is within recessions or depressions (Figure 9C).
- But this decision was only part of a long-term strategy to restore public finances and the competitiveness of the German manufacturing sector that had deteriorated because of the large costs of reunification. As in the Scandinavian expansionary austerity policies, a wage austerity, pursued for more than a decade, has been crucial for implementing an internal devaluation (Figure 9A).
- Consequently, the trade balance has experienced a cumulative trade surplus during the whole period (see Figure 5) and, in spite of the net outflow of capital, the external balance has been positive. Thus, the international finance community—in search of high-quality financial instruments—has massively bought German Treasury bonds. Nevertheless, the related low real interest rate has not triggered a consumption boom contrary to that observed in the rest of the eurozone (Figure 9B).

Many analysts have inferred from this new 'German miracle' that any other country should emulate the same strategy: long-term wage moderation, welfare reforms including lower compensation for unemployment and countercyclical tax policy should sustain an export-led growth model, based not only on price competition but also on a permanent adaptation to the changing demand of the world economy. This repeats the pre-Keynesian fallacy that ignores that the surpluses of some countries are the strict counterparts of the deficits of others. Clearly, the German strategy has been sustainable only because the European Union and the rest of the world had dynamic domestic demands that created space for German exports (see Figures 5 and 9B). If all European countries were to simultaneously adopt similarly drastic austerity policies, they would only succeed in keeping the level of activity by gaining trade shares at the world level, for example with respect to the USA or Asia . . . a difficult task indeed.

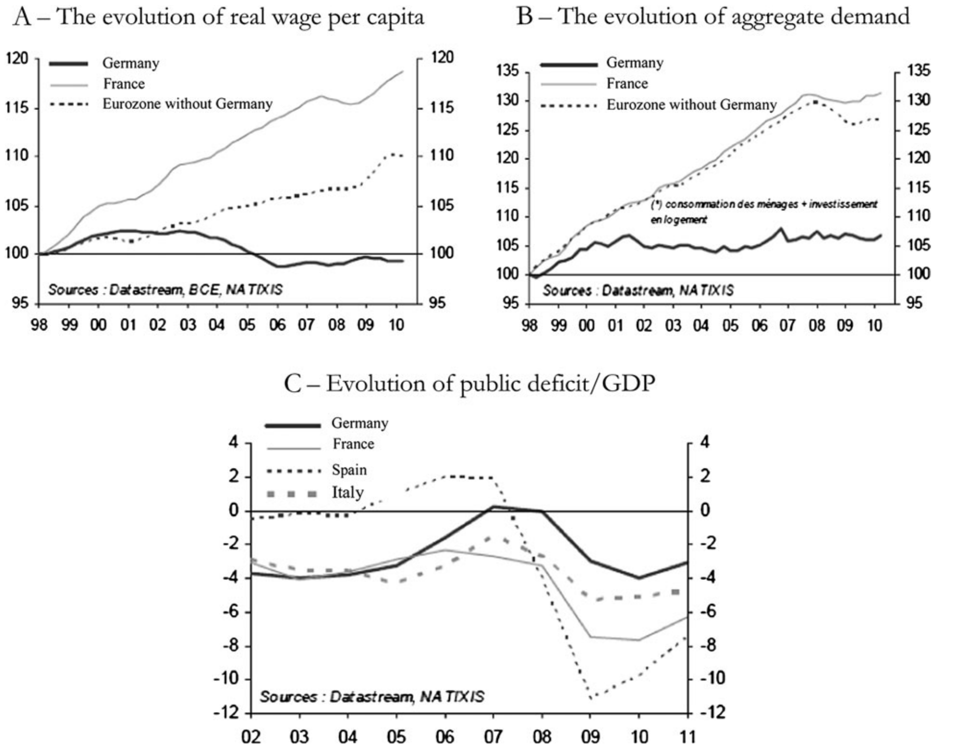


Fig. 9. *The success of German wage austerity measures relies on the dynamism of demand in other countries. (A) The evolution of real wage per capita. (B) The evolution of aggregate demand. (C) The evolution of public deficit/GDP. Source: Artus (2010).*

Given the deepening of labour division at the international level, the stronger and stronger linkages by trade, investment and finance and the generalisation of drastic fiscal adjustments would be detrimental to the viability of international relations. The European Union as a whole is not a marginal player in the world economy in contrast to Denmark, Ireland, Finland or Sweden, which could easily use competitive external or internal devaluation to consolidate their public finances. At this level, a benchmarking approach that would adopt the ‘one size fits all’ principle would be self-contradictory.

4.3 If the sources of the crisis differ, so should the economic policies

As mentioned, although the deterioration of public finances can sometimes cause an economic crisis, in other circumstances it might simply be a consequence and a symptom of another illness incorrectly diagnosed. The conventional analysis of contemporary European configuration is a good example of such confusion. The reading of the financial press gives the impression that sudden Latin American-type populism has invaded Europe and devastated its public finances. Elementary statistical analyses falsify this diagnosis and oppose at least two types of crises in public finances (Figure 10).

- In *Spain and Ireland*, the dynamism of the economic boom of the early 2000s, fuelled by easy access to credit, has induced a permanent improvement in public finances, as measured by the total public debt/GDP ratio. Why has public debt skyrocketed since

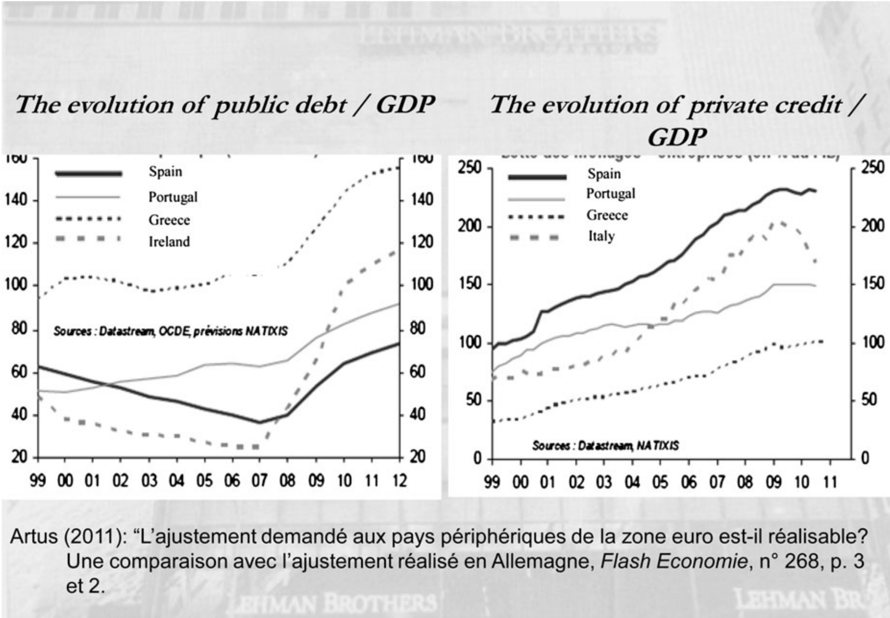


Fig. 10. *Two crises: a public finance issue for Greece and Portugal and excessive private credit for Ireland and Spain.*

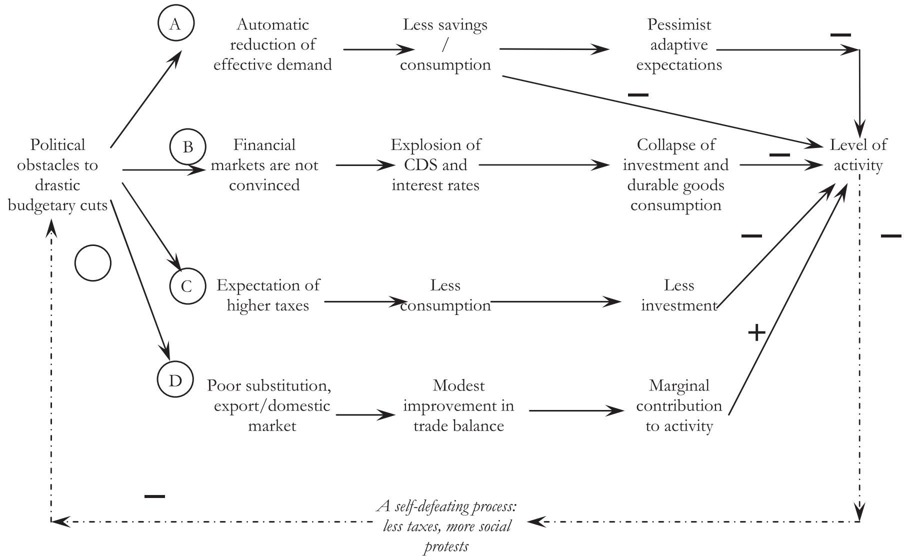
2008? Not only have automatic stabilisers played a role, but also the complete guarantee provided by governments to quasi-bankrupted financial systems has converted toxic credits into national public debt. The reduction in this public debt increase is a matter of decades and not a question of a single-year adjustment programme in the flow of public spending and taxation. Large balance sheet disequilibria (Adam and Vines, 2009) cannot be cured by the conventional tools that have proven so efficient in the case of a minor transitory negative shock upon public deficits. The Japanese lost decade is a good example of a long period of stagnation that was necessary in order to restore the financial positions of firms and banks. The crises would have been still more severe had the government not accepted large and persisting public deficits (Koo, 2009).

- The situation is quite different in *Greece and Portugal*: before the world crisis, their governments had maintained very large public debt levels and, of course, the situation has worsened with the countercyclical policy followed afterwards. In this configuration the state and not only private agents have extended their exposure to financial fragility in response to the very low real costs of public debt servicing after their accession to the euro. In terms of economic policy, Greece and Portugal face a public finance crisis, including for Greece the poor organisation of the collection of taxes, inaccurate accounting of public spending and lack of the legitimacy of governments alternatively led by strongly opposed parties. Should and could they repeat the equivalent of the Danish 1987 austerity plan (see Section 4.4 below)?

Clearly, the European Union is facing a dangerous period. On one side even countries suffering from a credit-led financial bubble are constrained by the pressures of financial markets and the European directives that ask for reducing their public deficits quickly. Unfortunately, this cannot cure the huge overhang in the real-estate sector and the bad mortgage debts that are piling up on the balance sheets of banks. On the other side, these structural public finance imbalances are so entrenched in other countries that it is economically and socially difficult to stop the only source of effective demand growth since the adhesion to the euro, namely public spending.

4.4 The Greek configuration does not fit with the requisites for an expansionary consolidation policy

The European debt crisis began in the autumn of 2010 with a surge in the price of CDS for the Greek debt. Since then it has diffused to Portugal and Ireland, and even Spain and Italy were under the scrutiny of anxious financial markets in the summer of 2011. Dealing efficiently and diligently with the Greek crisis was therefore crucial. The idea that an immediate and strong austerity policy was required was imposed by the conjunction of financial markets, the European Union and the IMF. Unfortunately, the productive structure and institutional configuration of Greece make the success of this strategy highly unlikely (Figure 11):



(A) *Keynesian direct and indirect effects*: less activity and thereby lower tax revenue and adverse expectations governing productive investment

(B) Impact of expectations *against crowding in*: absence of credibility for financiers and explosion in interest rates; hence, the non-sustainability and increasing probability of default

(C) *Anti-Ricardian effects*: public opinion expects more austerity; hence, less consumption and investment

(D) Reduction in costs is not sufficient to compensate for the structural *lack of competitiveness* and weakness of the exporting sector

Fig. 11. *The four obstacles to Greek recovery.*

- The *negative Keynesian impact* of public spending cuts and tax hikes has been strong and rapid: since the end of 2008, households have experienced a cumulative decline in their real incomes. This is the major cause of a long recession that dries out the basis for taxation and increases the public debt/GDP ratio (Artus, 2011A, 2011B, 2011C). A highly pessimistic mood within Greek society drastically limits investment and thus the capacity to improve the competitiveness of the economy that is necessary to reduce the need for external borrowing.
- Observing this adverse evolution, the international finance community is not convinced by the ability of the Greek government to pay back the debt: the immediate consequence of this is a dramatic rise in the related CDS. Given these expectations, the automatic *crowding in effect is not operating*: the credit to the private sector decreases drastically. What was initially considered a *liquidity* problem is now interpreted as a typical *solvency* crisis. There is thus a major difference compared with the past social democratic virtuous circle: on one side, the rapid decline in interest rate payments on the public debt and, on the other side, the dramatic augmentation of interest rates and insurance premiums. A form of self-fulfilling prophecy about the ineluctable Greek default cannot be stopped by the lagging and unconvincing measures decided by the European and international authorities.
- Given the continuous deterioration of public finances because of a cumulative reduction in production and tax basis, there are few reasons for Greek citizens to think that the austerity measures of today will precede a higher real income after tax in the future. On the contrary, the new demands expressed by the European commission, European Central Bank (ECB) and IMF induce the feeling that these austerity measures will be strengthened from period to period. Workers cannot gain employment and banks refuse to grant them credit, according to a typically pro-cyclical pattern of finance. Consequently, the *Ricardian equivalence plays no positive role* in promoting the stabilisation of macroeconomic activity.
- A third missing mechanism relates to the weak repercussion of the Greek austerity programme upon the restoration of the competitiveness of the economy. In spite of wage, salary and welfare cuts, the repercussion of the export performance is moderate and it cannot compensate for the decline in domestic demand. This is rather preoccupying because the constant deepening of the trade deficit is the cause of the cumulative debt of both private and public Greek agents. Because firms have cut their investments and innovation expenditures during this long recession, the structural weakness in the Greek economy has been exacerbated. Even the contribution of tourism to the reduction of the external deficit is declining because of the domestic social unrest. In turn, this adverse evolution induces the financial community to consider the default of Greece to be evermore probable.

It is important to mention that the Greek collapse proves the institutional incompleteness and incoherence of the eurozone. First, the adhesion to the euro is assumed by the Lisbon Treaty to be irreversible and this implies stronger ‘internal devaluation’, namely a greater degree of wage austerity than was previously necessary. Indeed, domestic public opinion might consider that the costs are excessive, the longer the depression period lasts. Second, the members of the eurozone have benefited from the euro via the stabilisation of exchange rates and a convergence of interest rates towards the German ones, but they have lost two policy instruments: monetary policy and the choice of the exchange rate regime to follow (Boyer, 2000B). The Southern European countries that had weak competitiveness and small exporting sectors have been induced to compensate for this deficiency through active public spending policies facilitated by low real interest rates. Unfortunately, the causality cannot be reversed: a long and painful austerity policy is quite adverse to the restoration of a strong productive sector, which would contribute to faster growth and a larger ability to pay back the public debt.

To sum up, the austerity policy will not function for the more severely hit countries and, conversely, it is not at all a solution for countries that have to experience a long period of the deleveraging of the private sector, especially in real estate.

4.5 Does the euro make austerity policies more difficult? UK versus Ireland

Many analysts address a strong criticism to the present organisation of the eurozone: by making devaluation impossible it implies quite drastic and unpopular internal deflation by wage and salary reductions for highly indebted countries. Does the UK fare better than the continental economies of the eurozone?

- First of all the British economy is a typical example of a *finance-led regime*, the imbalances of which are still more important that those observed for the USA. A priori, *public austerity is not the solution* since, quite the contrary, the government should counterbalance the long-lasting deleveraging of households and non-financial firms by an active public policy. The enlarged public deficit is more the consequence than the origin of the British crisis.
- Nevertheless, the bank of England has finally reacted to the risk of financial collapse by a very *lax monetary policy* and the easy refinancing of private financial institutions. Consequently, the very low short-term interest rate has triggered significant *devaluation* of the pound against other main currencies. This has been a stimulus to external trade deficit reduction and it has contributed to alleviate the fall in domestic demand, automatically associated with public spending reduction and tax increases. Under this respect, belonging or not to the eurozone makes a difference.
- This positive factor has not totally counterbalanced the fact that the UK has been constantly des-industrialising for decades: the present limited size of the sector producing tradable goods makes quite problematic the emergence of an export-led growth regime that would replace the one built upon a major role in global financial intermediations. Therefore, the nature of the new regulations that will be imposed on the financial sector is a key issue for the long-term recovery of the British economy. Would stricter rules of the game restore the competitiveness of the City in contrast with lighter financial regulations in the USA (Financial Services Agency, 2009)?
- In contrast, *Ireland* has also experienced a real-estate bubble fuelled by an easy access to credit, but its industrial basis remains quite strong. Even if the euro removes the possibility of regaining competitiveness via devaluation, a drastic adjustment programme may promote its progressive recovery and the resurgence of an export-led growth regime, whereby the credit-led boom would be a parenthesis in the Irish growth path.

This brief comparison shows how diverse might be the mix of classical, financial, Keynesian and competitiveness mechanisms, when one tries assessing the probability of success of an austerity policy in the context of a very uncertain prospect for world trade and growth. However, it is precisely a major issue at stake.

5. Inefficient 'beggar my neighbour' policies—again

The inappropriate diagnosis of the sources of public debt increases, absence of theoretical justifications and danger of a 'one size fits all' economic policy are not the only fallacies that impair the viability of a fast reduction of public deficits. The idea that if all economies repeat the strategy that has proven to be efficient for an individual country the world economy will recover is actually a fourth fallacy. This notion is an extension at the international level of the fallacy of composition that is at the core of Keynesian macroeconomics.

5.1 The context of a systemic international crisis is at odds with the permissive conditions that used to prevail

None of the conditions that explain the social democratic virtuous circle was absent in early 2010 (Table 2):

- It is difficult to anticipate the large decline in interest rates necessary to trigger a recovery of consumption and investment. For countries with strong currencies and/or high public finance credibility (e.g. the USA and Germany), the medium-term real interest rate is already very low and cannot be expected to continue to decrease. For national economies that have been more severely hit by the threat of public debt default, the more likely source of drastic interest rate decreases would result from successful restructuring or partial or complete default. The rapid recovery observed in Argentina after 2003 should be carefully analysed by these countries.
- Because real exchange depreciations have played a major role in previous large austerity policies, the member states of the eurozone no longer have this degree of freedom, and this calls for still more drastic income moderation, which is socially difficult to accept.

Table 2. *The factors that make contemporary large-scale austerity policies problematic*

	1990s	After the subprime crisis
1. World economy		
• Trade	Very dynamic and relatively steady	Large swings and uncertainty
• Finance	Growth enhancing via credit	Avoidance of risk and restrictive credit
2. European Union		
• Exchange rate regimes	Soft coordination allowing adjustments if necessary	The euro removes any internal adjustments
• Coherence of rules of the game	In the process of elaboration, optimism about European integration	An unfinished institutional construction, pessimism about the euro
• Sense of solidarity	Present via structural funds	National interest first, minimalist solidarity
3. Domestic economies		
• Growth	Unequal but a facilitation of taxation	Problematic, contraction of the tax basis
• Ability to work out compromises	Possible even if difficult	More and more difficult

- The epoch of income policy and ambitious social pacts, which played such a role in the stabilisation policies in Scandinavian countries during the 1980s, seemed to be over well before 2008. Could the urgency of the situation call them back? Can medium-sized or large countries that do not have a previous tradition of non-market coordination set up such income policies? A positive answer is problematic.
- The deepening international division of labour has produced a specialisation whereby some countries systematically focus on the production of internationally traded goods and others rely upon credit and capital inflows in order to compensate for their specialisation in the production of non-tradable goods. If the international financial system reassesses the prospect of the latter, in the short to medium term their productive systems will be unable to shift from domestic to international markets. The price elasticity of imports and exports has probably decreased and, conversely, the related income elasticity has risen. Thus, the classical price mechanism has become less important than have the Keynesian ones and, consequently, adjustments must now be made at the level of economic activity more than via the relative prices.
- If international trade evolutions become more and more difficult to predict, the country that adopts a large-scale austerity programme is not at all sure of benefiting from the dynamism of a stable international economy. On the contrary, all public and private agents may fear a brutal reversal of the current perspectives. This uncertainty hinders the recovery of investment, reduces productive capacity formation and, in the long run, slows the potential growth of each national economy, making it even more difficult to reimburse public and private debt.
- The advocates of expansionary fiscal consolidations postulate that less public intervention would trigger the dynamism of private entrepreneurs and the confidence of households. This mechanism is far from evident in the context of the early 2010, however. Most actors—non-financial firms, banks and households—are in the long-term process of deleveraging, namely using their cash flows and incomes to reimburse their debts (Geanakopolos, 2010). Therefore, the dynamism of investment, consumption and credit is hampered. It seems difficult to repeat the Danish success story in such a context.

This does not mean that many countries do not need to consolidate their public finances; however, such a strategy has to be planned over a sufficiently long time horizon. Governments could promise that as soon as an endogenous recovery led by the private sector starts, the Ministry of Finance would implement a programme of debt reduction, facilitated by higher growth rates. This would be much more credible than would the repetition of failed austerity plans or emergency bailing out operations by the European Union or IMF.

5.2 Will the lessons of the interwar period be forgotten?

The 2008 crisis is frequently compared to the 1929–32 Great Depression. Initially, central bankers and Ministries of Finance were warned by economists and historians not to repeat the economic policy mistakes that had deepened the interwar crisis. Consequently, they relaxed access to liquidity, accepted transitory public deficits and decided on discretionary measures in order to overcome the quasi-bankruptcy of financial systems. With the recovery initiated in the first quarter of 2009, a form of optimism about the self-regulating nature of market economies returned and the major preoccupation was redirected towards the dangers of excessive public debt. Progressively, the tribute to Keynesian economic policy principles has been abandoned in favour of a typical classical microeconomic approach to current unbalances. Therefore, it might be useful to recall some of the major lessons that economic historians have drawn from the interwar episode:

- A private accounting-type approach to public deficit and debt is misleading precisely because the state is not an individual private actor: it is in charge of stabilising the whole economic system. If firms and households no longer ask for credit and prefer to save, another actor has to go into debt just to fulfil the adjustments of savings and investments (Koo, 2009). If not, the level of activity will contract and exacerbate unemployment problems and deteriorate the fiscal balance.
- It is costly to defend unrealistic exchange rates because the trade balance deteriorates, the productive system loses its competitiveness and surging unemployment places strong pressure upon governments to extend public spending in order to sustain the level of activity. In recent financial history, the collapse of the Argentinean currency board offers a new warning about the dangers of an overvalued currency. This applies to the relation between the dollar and the yuan, but also to the eurozone.
- Nevertheless, if major countries decide to opt for competitive devaluation and/or implement tariff barriers to imports, they may start a 'beggar my neighbour' process, namely the defence of domestic employment reduces international trade and, in turn, this is an incentive for other countries to retaliate and erect their own barriers. The outcome might be devastating for the stability of international relations, a condition for any national growth strategy. Furthermore, major uncertainty about the future of international relations may trigger the adoption of autarky strategies by some governments under social pressure from public opinion.
- After World War I, the reparation plan between defeated Germany and the victorious countries failed because it imposed unrealistic income transfers out of a weak country that was unable economically to generate the sufficiently rapid growth to fund these reparations and maintain social and political order at home. The emergence of a xenophobic and nationalist government in Germany put at risk the whole international order. One may wonder if some European countries are not facing an equivalent danger in the 2010s.

From a theoretical point of view, this fourth fallacy relates to the confusion between an isolated entity and its interdependence among a series of other entities. The revival of pre-Keynesian conceptions is not immune from this basic criticism.

5.3 The impatience of finance against an orderly way out of public finance imbalances

How can we explain that all this learning from history, which has been studied by leading policymakers and academic economists, has gradually been forgotten? It can be argued that the international finance community has played a decisive role in the return to the obsession of the equilibrium of public accounts. Via external and then internal financial deregulation, most governments have abandoned a significant number of economic policy instruments (Boyer, 2011). Exchange rates are decided on foreign exchange markets, the degree of risk aversion varies according to the mood of a limited number of large investment firms, and the quasi-permanent quotation of stocks, bonds, options, swaps and derivatives constrains the degree of manoeuvre of each national government.

The irony but also the danger of the present unbalanced power between financiers and governments is that even though the latter have rescued the former, financiers now blame the states for their excessive debts, largely caused by the attempt to overcome the depression associated with the collapse of the world financial markets. They might become so impatient to recover their debts from insolvent nations that they cause their own bankruptcies as well as the collapse of national and international regimes. The role of ratings agencies is pernicious indeed. They have been lagging behind in diagnosing the imbalances in the public finances of Southern European member states, but their late downgrade has provoked a brutal overreaction of the interest rates and CDS pricing levels of Greek and Portuguese Treasury bonds, and this implies a self-fulfilling prophecy about their necessary defaults. Similarly, the international financial community has been asking for more austerity measures, but in October 2011 they complained that slow growth was an obstacle to the repayment of public debts, which is partially the outcome of the first wave of austerity policy. Did Keynes not conclude his *General Theory* with a call for the socialisation of investment, which he deemed too serious to be left to the vagaries of financial markets?

5.4 The present institutional configuration of the European Union does not provide an alternative and coordinated strategy

The current sovereign debt problems were not supposed to happen within existing European Treaties, such as Maastricht and Lisbon. On one side, the Stability and Growth Pact clause limiting the public deficit/GDP ratio to 3% has been violated by major economies such as France and Germany, and systematically by Greece since its adhesion to the euro. On the other side, the interdiction of any bailing out of an insolvent member state should have induced reforms in order to promote the productive structural adjustments required to sustain growth and sound public finance in less competitive economies.

Thus, Europeans are exploring unchartered territory both theoretically and politically. Should and could the ECB alleviate the emerging liquidity crisis affecting the banks by systematically buying the Treasury bonds of Greece, Portugal, Spain and Italy? From a technical point of view, is an economic government of Europe necessary to coordinate national budgetary policy? The constraints placed on the weakest economies could be alleviated by the dynamism of the more competitive ones, such as Germany, which would require no new austerity policy. But will politicians accept this limitation of national and democratic sovereignty?

Basically, major solvency crises—as opposed to mere liquidity crises—can only be overcome by an intra-European solidarity organised via the emergence of a central fiscal authority that would be entitled to decide on transfers among member states and to issue euro bonds under the condition that the strict supervision of national budgetary policy is accepted and implemented. Finally, the short-termism of contemporary unregulated financial markets could be reduced by the equivalent of a Tobin tax and progressively compensated for, or replaced by, a form of medium- to long-term planning about the key issues for European growth and welfare. Europe needs an alternative mechanism for the more efficient allocation of capital and competence, a prerequisite for easing public finance constraints.

6. Conclusion

The emerging consensus in 2011 about the absolute necessity of a rapid curbing of public debt should be challenged, because it has very weak foundations and rests upon four dangerous macroeconomic fallacies that were fought against by Keynes's *General Theory*:

1. The first fallacy concerns the origin of present public finance imbalances. The advocates of vigorous austerity policies assume that a wave of budgetary populism has destabilised previously self-regulated and stable market economies. Actually, this configuration is no longer observed in Latin America and it is very rare across the rest of the world. Basically, the present worries are the direct or indirect consequences, on public finance, of the bursting of a series of bubbles and the failure of credit-led growth.
2. A related misunderstanding comes from the assimilation of the public debt crisis to a simple transitory deviation from economic orthodoxy. A closer look at the evolutions of the public finances of OECD countries since the end of the Golden Age suggests a more convincing structural explanation. Since the 1970s successive governments of developed economies have used permanent budget deficits as a method of compensating for unsolved institutional imbalances. These deficits derive from the contradiction between the entitlements associated with post-World War II compromises and the growth slowdown associated with the end of Fordism. In a sense, a stock of debts represents the cumulated costs of the absence of reforms. *Per se*, a large-scale austerity policy does not necessarily overcome this contradiction.
3. The idea that large fiscal consolidation should be expansionary both in the short- and medium-term is more of a myth than is a firm result derived from a convincing general theory. This second fallacy derives from the implicit vision of modern classical macroeconomists, namely that a pure market economy is structurally stable and that only inappropriate public interventions trigger public finance crises. For instance, the typical DSGE models used by central banks are unable to sustain the generality of an austerity policy-generated recovery.
4. Intermediate-level models are required in order to assess rigorously how the various channels of public policy affect the level of activity. Crowding-in effects, credibility restoration and the enhancement of competitiveness via the reduction of unit production costs have a positive impact, but conversely budgetary cuts negatively affect the level of activity via Keynesian multiplier effects and adverse expectations about production and investment decisions. The efficacy of large-scale austerity measures is thus a matter of empirical analysis in order to determine how these contradictory mechanisms interact at the macroeconomic level.
5. Applying austerity policies whatever the causes of the public deficits and regardless of the structural and institutional configurations of each national economy—without any distinction—repeats the error of the Washington consensus, namely the 'one size fits all' approach. A retrospective and comparative analysis of the few successful examples of such a strategy (Denmark, Ireland, Finland and Sweden in the 1980s and 1990s, and contemporary Germany) shows that the various conditions that deliver these results are restrictive.
6. Recent transformations of the world economy have featured an unprecedented deepening labour division, a stronger interdependency, an increasing specialisation among national economies and a reduction in the price elasticity of external trade in favour of higher income elasticity. This makes the competitiveness argument of austerity policies problematic. Similarly, the unfolding of the subprime crisis has been stopped by low interest rates and this is inhibiting one of the mechanisms at the heart of expansionary fiscal contractions. Furthermore, the abandonment of income policies, the development of non-traded goods and major uncertainty about the future of

international relations have eroded the very conditions that made previous austerity measures-led expansions successful.

7. The diffusion of vigorous austerity policies rests upon a fourth fallacy, namely that a pertinent and efficient strategy for an individual country is also good for the international economy as a whole. Again, this is a dramatic oblivion of another key message of Keynesian theory: the fallacy of beggar-my-neighbour policies.

How can we explain such a paradoxical evolution of macroeconomic theorising and economic policy conceptions? This task might not be the exclusive responsibility of economists, because the rising power of the international finance community is definitely playing a major role in this surprising return of pre-Keynesian theories. The next major financial crisis might be the cost to be paid for this capture of economic theorising. It is also a challenge addressed to contemporary democracies.

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