

Modern European Austerity Policies and the Treasury View: What Has Changed? (draft for discussion with incomplete references, not to be quoted without permission)

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1. Introduction

When the subprime crisis erupted in the United States, in the first semester of 2007, a large number of analysts believed that it would be contained before it became a full-fledged financial crisis or, more certainly, before it turned into a deep recession. The reason for the widespread optimism was that not only economists, but policy-makers as well were supposed to have learned the lessons of 1930s. “It”, as Hyman Minsky used to refer to the Great Depression, would not happen again because now policy-makers knew how to prevent it. Subprime mortgages were a relatively small segment of a large financial market, so a financial crisis would require contagion to other segments, particularly to banks, which was judged unlikely given the healthy capital coefficients all the large banks exhibited in the United States at the time. Without contagion to the banking sector, the financial crisis would remain local, without meaningful systemic repercussions. But even if systemic repercussions did take place, governments in the affected countries were expected to rapidly adopt expansionary fiscal and monetary policies to prevent amplification mechanisms, such as debt deflations and income multipliers, to operate killing any significant contractionary forces on its tracks.

History did not unfold in the way it was expected to. The financial crisis was in effect contained, even if belatedly. Contagion, however, did take place and affected financial systems, not only in the United States but also in other countries, particularly in Western Europe. The near-collapse of financial systems paralyzed credit and capital markets which led to a fall of output and employment. Rising liquidity preference caused banks to hold idle reserves in increasing amounts as monetary authorities moved to increase liquidity and firms to pile cash raising interest rates for practically everyone who could think of demanding loans.

By the late 2008 (and particularly after the Lehman Brothers episode), it was clear that the crisis had in fact become much more threatening than initially expected, as it did affect productive activity and it was spreading worldwide. Accordingly, a meeting of G 20’s political leaders¹ was called to coordinate a common global anti-crisis initiative. Members of the G20 agreed that aggregate demand had to be supported by active demand management policies. The newly-inaugurated Obama administration followed up the recommendations passing in early 2009 an almost one-billion-dollar fiscal package consisting of new spending and tax reductions. Some measures were also taken in the same direction in Western Europe. It seemed that, in contrast with the 1930s, coordinated expansionary policies would take the place of beggar-thy-neighbor measures, global aggregate demand would be sustained and the world economy would sail out of the crisis scared but relatively unscathed.

¹ The G20 comprises the ten largest advanced and the ten largest emerging economies of the world.

These expectations were to be falsified not long afterwards. In the United States, the possibility of following up the first initiative with new programs of government spending was quickly buried by the remarkable hesitation of the Obama administration. After the loss of majority in the Congress for the republicans, in 2010, new initiatives in fiscal policy became all but impossible.

Developments in Europe were even more surprising. A few large banks, particularly in the United Kingdom, Switzerland and Germany, were affected directly by the subprime crisis, still in its early moments. But the worst was yet to come, after the failure of Lehman Brothers. Some countries, like Ireland and to some extent Spain, suffered contagion through their banking systems. Others, like Portugal for instance, were exposed to financial instability through their need for balance of payments financing. Still others had to finance fiscal budget deficits through the placement of bonds in international markets. Whatever the original reasons for contagion may have been, by 2010 some European countries were going through an open crisis, while others, like France or Italy, were judged to be in fragile condition, all of them hit by the deterioration in financial markets. Paradoxically, this was also the time when some countries, led by Germany, broke the apparent “Keynesian consensus” established in 2008. Concern with output and employment ceded their place to concerns with fiscal deficits and public debt. The language of the G20 communiqués became ambiguous, trying to balance the demands of the two groups of country leaders, those pressing for reflation and adoption of expansionary policies, and those pressing for budget consolidation and debt reduction, in a word *austerity*.

The opposition between *expansionists* and *austerity-ers* was not confined to debates within the G20. As peripheral Eurozone countries saw their financial position deteriorate dramatically, austerity was enshrined in the rescue packages designed by what became popularly known as the troika (a tri-partite group formed by representatives of the European Commission, the European Central Bank and the IMF).

At times, the current confrontation seems to have been transplanted directly from the 1930s dispute between “expansionists” (today generally referred as “Keynesians”) and the “Treasury View” (hereafter TV). The return of TV in the 2000s, and its strength, took most people in the Anglo-Saxon countries by surprise. Although orthodox economic theory has moved decisively towards the restoration of the prestige of Say’s Law among American academic economists in the last three to four decades², few people believed policy-makers would actually make decisions accordingly. In Continental Europe, however, it was a different matter, as we will see below: austerity is not a recent or an exotic belief and it did not have a “comeback” in the last four to five years. In fact, it seems it never left the scene, especially in Germany.

Skidelsky () has noted that economists, especially academic economists, tend to forget that the 1920s and 1930s debate around TV was not centered in universities or research centers. Rather, it involved civil servants, politicians and some economists. Theoretical arguments most of the time took a back seat to operational concerns of government action. It was a difficult task to accurately

² Say’s law has reappeared in economic theory in the theory of the natural rate of unemployment.

portray TV because civil servants in government did not care to produce doctrinal material of the kind one expects to examine in academic debates. Moreover, officials in function are not usually at freedom to engage in public debates as academic economists do. Most of what Treasury officials had to say was manifested in internal documents not meant to be seen by outsiders. A recently published collection of documents prepared by Treasury officials from 1925 to 1946, edited by G. C. Peden (Peden, 2004) is a major contribution to the knowledge of how TV was structured and how it developed in time. Among the most striking features of these documents one counts the relative freedom from economic dogma that most Treasury officials exhibited and the importance of operational concerns in shaping their policy recommendations.

In this paper we investigate how closely the austerity view reproduces the arguments of the “old” TV. To do it, in section 2 we present the points raised by Treasury officials against expansionist fiscal proposals in the 1920s and the 1930s. Section 3 is dedicated to presentation of the points raised by modern proponents of austerity. An evaluation of both sets of arguments is offered in section 4. Section 5 concludes with an outline of some of the empirical issues involved in this debate.

2. The Treasury View

The Treasury View was never articulated as a school of thought on policy choices. There is no founding document or text where its principles are listed, explained and justified. It was expressed mainly through memoranda prepared by Treasury officials to answer demands from higher authorities (most frequently the Chancellor of the Exchequer), presentations as expert witnesses in Royal Commissions or, rarely though, to counter proposals presented by people outside government in newspaper articles, speeches, open letters and manifestos. Most of the officials that formulated the core of TV were not professional economists but career civil servants (See Peden, 2004). Their perspective was mostly shaped by what they believed to be sound principles of public finance rather than macroeconomics, which in fact was being created as an independent discipline precisely during those years. Therefore, TV emerged as a semi-formed doctrine as a body of arguments raised *against* expansionary policies proposed during the period between the return to gold standard in Great Britain, by the mid-1920s, and 1931, when the country abandoned it.

Great Britain had returned to the gold standard at the same exchange rate to the US dollar used before World War I. The rate was consensually considered to overvalue the pound, but British authorities believed that price flexibility would guarantee that the required nominal adjustments would be made to remove the disequilibrium. While adjustments did not take place, however (or if they just did not take place at all), the economy would lose competitiveness and output and employment would fall. As the 1920s approached its end, pressures mounted on the government to rely less on automatic adjustments and to implement expansionary policies to fight the very high rate of unemployment observed at the time.

Under the gold standard, monetary policy was constrained to protect gold reserves. Monetary authorities, even if they wanted to, could not use interest rate policy to stimulate the economy. For many economists, *under these conditions*, the only policy tool left was to implement a public works program to counteract the deflationary forces of the overvalued currency. It was in this context that TV emerged and its main focus defined: opposition to activist fiscal policy. In modern times, TV is remembered only as an archaic argument against fiscally-induced macroeconomic expansion based on an almost superstitious attachment to Say's Law. Surprisingly, perhaps, theoretically-based arguments, however, were in fact rarely raised in this debate. There is little reason to suppose that TV defenders were trying to hide their colors by avoiding the issue. Internal documents of the Treasury published in Peden (2004) show the relatively little weight carried by theoretical arguments in general in memoranda that were not intended for publication of any sort.³

In any case, if one is concerned with theoretical issues, it was not Say's Law per se that inspired TV, but the loanable funds theory according to which investment activity depended on the supply of credit, which was itself dependent on the savings of the general public. In this context, public investment was believed to withdraw resources from the available savings fund, reducing the supply of credit for private endeavors. Crowding out could only be avoided if public investments were to be financed by the creation of new money, but then inflation would ensue, and private expenditures would be reduced because of the fall in real incomes of private agents. In other words, public investment would crowd out private expenditure, with no effects on the overall level of activity and employment in any case.

This is not the place to make a proper critique of the loanable funds theory.⁴ But one should keep in mind that the question of how to finance public expenditure while avoiding crowding out private expenditure was the *central* point of debate between Keynes and the Treasury in the late 1920s and early 1930s. It is only fair to acknowledge that Keynes himself took quite a long time to present a more forceful argument in this respect and even then his argument was not really absorbed either by civil servants or, in fact, by academic economists as the apparently interminable debate between liquidity preference and loanable fund theories seems to bear witness in the current debates around the same point.⁵

³ Some officials did believe in Say's Law, most notably perhaps Otto Niemeyer. Others were less orthodox, such as Ralph Hawtrey. In any case, contrary to the beliefs of some modern authors, a more abstract debate on the nature and role of the state opposing Keynes to the Austrians like Hayek had hardly any significant role.

⁴ A Keynesian critique of the loanable funds theory is presented in detail in Cardim de Carvalho (2012).

⁵ To this day this remains a point of contention among Keynesian economists as well as among economic historians. Middleton (1985), for instance, considers that by the end of his exchange with Bertil Ohlin in *The Economic Journal* around the determination of the interest rate, Keynes had accepted loanable funds theory. For an examination arriving at the exactly opposite conclusion see Cardim de Carvalho (2012).

Treasury officials often pointed out that positive effects of an increase in public expenditure would be rather limited, in any case, given the degree of openness of the British economy. Leakages would occur through two channels: an increase in incomes, if it could be achieved, would increase imports. Since it was safe to assume that British exports depended on incomes in the rest of the world, deficits in the trade balance would emerge that had to be financed. Financing the deficit could be difficult, however, because newly created financial resources could be used to increase external investment rather than internal expenditure, reducing gold reserves and threatening the value of the pound. This would be especially serious if an increase in public expenditure reduced confidence by private agents on the wisdom of political leaders, stimulating capital flight.

In fact, the impact of increasing government expenditures and deficits on private confidence was a central concern of Treasury officials and a central element of TV. Capital flight was not the only channel through which the loss of confidence would express itself. More immediately, interest rates on public securities issued to finance the expenditure would rise, increasing financing costs for private investors as well (quite independently of the more mechanical crowding out effect mentioned earlier). Maintaining fiscal discipline even in the face of adversity would signal virtuous intentions on the part of the authorities and would contribute to keeping interest rates low and financing conditions adequate for private and public borrowers, which Treasury officials believed would be more efficient in promoting recovery than increasing public spending.

Operational concerns also loomed large in the TV.⁶ Treasury officials insisted that Keynes, perhaps the most active proponent of increasing government expenditures at the time, underestimated the difficulties of using public expenditures as a management instrument by government authorities. Defining and implementing projects took longer than Keynes seemed to acknowledge, long enough, in the view of Treasury officials, to make it useless to smooth out fluctuations in unemployment. Officials also called attention for the fact that, in Great Britain, a large share of public investments were made by local administrations, which made difficult to coordinate an overall expenditure strategy by the central government.

Finally, TV also relied on the notion that most of British unemployment at the time was *structural*, rather than cyclical.⁷ Moreover, it was distributed throughout the country in very unequal ways. For both reasons, it could not be eliminated or significantly reduced by general measures to increase aggregate demand. Treasury officials took solace in the thought, often repeated in their memos, that FDR's New Deal had proved that public investment does not offer an efficacious way out of a large crisis.⁸

But arguments of a more political nature were also raised. Two points stood out. The first dealt with the question of *who* should decide on which investments governments would make. The

⁶ Middleton (1985), Peden (2004) and Clarke (1988) all agree on this point.

⁷ Middleton (1985) is particularly insistent on the structural and regional character of mass unemployment in Great Britain in the late 1920s and early 1930s.

⁸ One should note, anyway, that in the absence of macroeconomic theories that could explain what all the experiences of unemployment had in common it was necessarily the particularities of each situation that would attract attention.

argument was raised that it would increase the power of the state over society if government bureaucracies were charged with the choice of investment projects instead of private individuals exercising their freedom to select whatever they considered to be best. Besides, in the case of Great Britain, a centrally coordinated public investment plan would trip over local governments who were responsible, according to the Treasury, for a large share of such expenditures.

The second argument still has strong echoes in the modern debate, as we will see in the next section. Treasury officials were deeply concerned with the loss of control over public finances that allowing expenditures to be made without previous provision of revenues would entail. This is perhaps the most important of all TV features: the notion that the Treasury had conquered the right to manage public finances on behalf of the nation against the anarchy and squandering of resources that previous systems entailed. Breaching the discipline created an unacceptable risk: it could become a precedent, rather than an exception. Politicians could not be trusted (as kings before them) to contain their impulse to put their hands in the public purse. Balanced budgets were a guarantee that this victory for modernity over aristocratic abuses would be preserved.⁹

3. Modern Austerity Views

The mere recapitulation of TV's main points shows how much the approach is in fact still alive today. However, while one looked to Great Britain in the 1920s and 1930s to find the toughest resistance against expansionary fiscal policies, it is doubtless to Germany that we have to look now. The academic debate still has relatively little practical relevance. As in the 1920s and 1930s, influential "public" economists (the most notable example today is certainly Paul Krugman) count less because they are professors than because they have outlets in prestigious newspapers and write for the general public, as newspapermen, rather than as teachers. Those who prefer to keep what they seem to see as the high ground of an academic posture have very little impact on the debate even if they also frequent the pages of important newspapers.

⁹ The view that allowing fiscal deficits to emerge once, even if for good reasons, would open the door for fiscal irresponsibility of politicians is an old war horse of conservative criticism of Keynes's policy proposals. See, e.g., Buchanan (1987: 142): The Keynesian policy model seemed to offer an intellectual-moral argument for expanded public spending financed by debt (or money). But ordinary politics fails almost totally when the other side of the Keynesian policy norms are required for macroeconomic purpose. Political decision makers cannot increase taxes so as to generate compensatory budgetary surpluses. The bias toward deficits emerges directly from the most elementary application of public choice of principles. In this context, the net contribution of the whole Keynesian half century must be evaluated negatively. It is represented best by the regime of massive and continuing budgetary deficits that we observe, deficits that bear no relationship to any alleged macroeconomic purpose, and that are almost universally acknowledged to have adverse consequences for the economy as well as for the moral bases of modern society. These deficits emerged because the Keynesian impact was to dislodge almost totally the precept of budget balance from the effective fiscal constitution."

It remains difficult to present an articulated view of the Austerity View (hereafter AV), as it was the case with TV. AV proponents seem to believe that some principles are self-evident and dispense explanation (such as the temptations to which politicians are subjected). In any case, the main debate takes place among political leaders and opinion-makers mostly through speeches, articles and interviews, and consistency and completeness are not always a concern for those presenting the case for austerity or against it. If anything, AV is more frequently articulated as governments' rhetoric than TV was. As a consequence, appeal is often made to high moral principles and values, and to proper behavior of citizens and of whole countries rather than (or in parallel) to theoretical principles or economic theories.

Differently from TV, however, AV academic champions had a more direct line to government policy-making, at least from 1963 on, when the Committee of Economic Experts was created to give advice to government authorities. The Committee's advice was (and is) not binding. In a few times there seemed even to be some more or less open conflict between its members and members of the cabinet.¹⁰ Generally, however, there seemed to be a degree of consensus between academic economists and government officials in favor of austerity that would be surprising in Anglo-Saxon countries.

In part, the consensus is rooted in the history of the country in the Twentieth Century. The catastrophic experience with nazism followed by defeat, foreign occupation and division of Germany by the winning powers left, as it could not be otherwise, a deep imprint in the political culture of the country. Nazism was identified to closed economies, but also with administrative chaos and far too much state intervention in the way the economy operated. In reaction, both conservatives and center-leftists became deeply suspicious of political programs that promised to increase the powers of government to steer the economy toward any goal that has not been decided by private agents themselves. Keynesianism, except for two very short periods, seemed to have suffered this rejection by being related to a closed economy.¹¹

History is also important for the fact that post-war Germany is evidently a success story, even if not as polished as sometimes it is generally believed, and this success cannot be ascribed to the adoption of Keynesianism. On the contrary, as Dillard once noted, the social market economy, the guiding concept of economic management adopted in the country after the war, is "is quite un-Keynesian in its emphasis on the unregulated market as the focus of economic policy." (121)

¹⁰ Conflicts between the Committee and the cabinet are known to have happened under Chancellors Erhard and Brandt.

¹¹ The left had different reasons to reject Keynesianism. As a legacy of Marxism, the left tended to focus on production, rather than on aggregate demand. Be it as it may, left wing parties never had enough power to impose its own views. In Germany, social democrats only governed in coalition with liberals. See Allen (1988). See also Rosanvallon (1988) and Boyer (1985) for the case of France and De Cecco (1988) for the case of Italy.

But the theoretical framework adopted by economists and government officials was not orthodox Anglo-Saxon neoclassical theory either. Although the labels have to be taken with a grain of salt, influential economists, like Herbert Giersh, and influential political leaders, like current Finance Minister Wolfgang Schauble, see themselves as Schumpeterians in opposition to the Keynesianism they identify with some foreign governments and multilateral institutions.

These economists understand being a “Schumpeterian” as implying the opposition to appealing to demand management policies even as a relief during a crisis, let alone to lead a recovery. Business cycle theorists tend to think of downturns as the way the economic system gets rid of the excesses that mark the cyclical peak. To prevent a recession to run its course means keeping in operation firms that could not stand competition and misemployment of production factors impeding the system to work more efficiently. Letting government expenditure to lead a recovery is, however, the main target of Schumpeterian criticism.¹² Here the argument seems to be somewhat confused by the fact that austerity proponents most of the time seem to conflate two different problems. AV defenders argue that recovery from a crisis must be led by the private sector to be sustainable in the long term. Only by introducing innovations and increasing their competitiveness firms can generate recoveries that will be translated into sustainable growth. In other words, government expenditures may not lead a recovery wave because this does not lead per se to the increased competitiveness that ensures continued growth. From a Keynesian point of view this seems to be a *non sequitur*. At least Keynes himself never proposed that government expenditures should permanently *lead* capitalist development. What he did argue was that when an entrepreneurial economy finds itself in a situation of *unemployment equilibrium*, some “outsider” must break the impasse. This outsider must probably be the state for several reasons, such as (1) governments do not fear the future as private agents do since they cannot go bankrupt; (2) they do not need to “earn” money before they spend; (3) they are big enough to move the economy towards a desired direction; and so on. He believed that private investors would follow *once they began to make money* and take over. When “Schumpeterians” argue that government spending cannot be a permanent solution for capitalism’s woes they would probably get from Keynes an approving nod, but probably accompanied by the remark that this was right, but not the point.¹³

Of course, the AV argument is not that governments should not do anything, but the right policies are supposed to be those that are seen as helping private firms to recover investment in innovations and improved competitiveness. First and foremost comes fiscal budget discipline intended to show that governments will not put any pressure on financial markets, not now, not ever. This should increase the confidence of borrowers to seek credit but also of lenders, leading

¹² See, for instance Giersch (), although Schumpeter himself admitted the government intervention in the case of a depression in his 1939 opus Magnum.

¹³ There were some influential Keynesian economists, as most notably Alvin Hansen, who interpreted deficiencies of effective demand as permanent pointing to the possibility of a stagnant economy in the future. The fear that such ideas could induce governments to take more direct roles in private decision-making was an importante elemento to explain the hostility of business sectors to Keynesian policies. See Collins (1981).

to lower interest rates and a larger supply of finance. Confidence of lenders for the AV is as important as it was for TV, a key measure of success for both.

Another point of close identification between TV and AV is the notion that unemployment in the 2010s, as in the 1920s and 1930s, is *structural*, not cyclical, unemployment. Some of the AV champions prefer even to define it as *classical* unemployment, explained by the resistance of real wages to fall which forces firms into non-competitive positions and to suffer the loss of markets to competitors. Austerity is a way to force workers to accept lower wages so to lower labor costs and to recover firms' competitiveness.¹⁴

One novel argument in support of AV, frequently employed by German authorities, refers to demographic changes going on in Western Europe. It is alleged that Germany's aging population imposes the need to ensure fiscal surpluses impeding the government to implement expansionary policies that could create budgetary deficits and increase public debt. Other countries with similar demographics should follow its example.

4. Evaluation

Both TV and AV approach balanced budgets as a value in itself for political, rather than economic, reasons, in contrast with Keynesianism for which the fiscal budget is a policy tool. In Great Britain balanced budgets were the symbol of the modernization of the state achieved in the nineteenth century. Allowing fiscal deficits, or, worse, actively seeking fiscal deficits would open the door for the irresponsibility of politicians to roll back all the reforms that guaranteed that the state would maintain sound public finance. In Germany, if anything, the memory was even more dramatic, of nazis discretionarily intervening in the economy to promote warfare. Eliminating the power to effect discretionary spending is seen as key to safeguard rule-based modern societies if not modern civilization itself.

Views like these find echo in the general population (or among voters) that tend to instinctively oppose fiscal deficits and the accumulation of public debt based on the belief (shared by political leaders as well) that a country is like a big family, of which the government is the head. The head of family knows that he (or she) may have to appeal to credit eventually but he also knows that he cannot do it permanently because he will soon be broke.¹⁵ In politics the situation may actually be worse since the easiness with which it is possible to get into debt may transform it into an addiction until bankruptcy comes to punish the sin. The idea that a country (and governments) is subjected to the same constraint as a family is a fallacy of composition that Keynes and Keynesians were obviously unsuccessful so far to dispel. In any case, the focus of the debate should not be fiscal deficits but government spending. Deficits (or surpluses) are results not instruments. As Keynes himself noted, in a perfect world governments would signal through their spending policies

¹⁴ Of course, labor costs could be cut if productivity increased. However, meaningful productivity increases may take much longer time to materialize than a reduction in money wages.

¹⁵ Collins (1981: 3) quotes Franklin Roosevelt criticizing Herbert Hoover 's administration for deficit spending ignoring that governments were no different from households, which FDR took for a fact.

that they are prepared to support full employment and this should be enough for income and tax revenues to rise, possibly arriving at a balanced budget at the end.¹⁶

Another common misunderstanding shared by voters and political leaders, as well as some economists, is that to promote recovery through aggregate demand management is to create something out of nothing, an act of magic rather than of government. It is appealing to intuition the proposition that one has to save before one can invest (how could one invest something that was not yet created?). The complexity of Keynes's alternative argument prevents the clarification of the issue in the political debate.

AV, however, seems to be more muddled than TV when the issue is its own theoretical foundations. AV proponents seem to be fighting a strawman, when the argument is made that opposition to government spending is based on the notion that it cannot sustain long-term development. Although it is certainly true that there are a few critics of austerity who rely on a stagnationist view of modern capitalist economies (that some like to call *mature*) this by no means represents the mainstream of its opponents. On the contrary, the point raised by defenders of expansionary policies is that this is the way not only to generate the means to support private investment but also to generate the confidence entrepreneurs need to jump into the turbulent waters of innovative investment.

In fact, AV proponents seem to face difficulties to distinguish: (1) normal fluctuations when fine tuning may or may be efficacious to maintain the level of activity versus major crises; (2) expenditures planned as relief of social emergencies (as in the case of unemployment compensation) versus a policy of stimulus to recovery, especially through public investment; and (3) the policy of stimulus to recovery just mentioned versus the search for new patterns of growth dependent on state leadership. AV arguments are used as all the terms in the three dichotomies were freely interchangeable.

A central point to TV and AV is that it is never explained where the demand will come for the goods produced by the private firms. TV seemed to rely here on some form of Say's Law. Once wages were down and lenders' confidence restored, firms would be able to produce and in the process create the purchasing power required to absorb that additional production. If only prices and wages were flexible enough to allow the adjustment process to proceed more quickly!

In the case of AV, it seems to be implicit in the policy strategy the appeal to exports as outlet for increased production.¹⁷ It is by raising net exports that German authorities hope to recover the

¹⁶ See Cardim de Carvalho (1997) and Kregel (1983)

¹⁷ Helmstadter (1988: 416), himself a former member of the German Committee of Economic Advisors, arguing in support of Giersch's views offering a curious fusion of Schumpeterianism and classical Say's Law: The Council is concerned, not merely to utilize existing productive potential but that present production facilities should be continuously modernized which actually matters far more in the long term. The Council has often pointed to the lessons which can be learned from economic history which underscore the fact that 'the primary impetus for expansion often originates in supply, which automatically creates equivalent

economies of the European Union. There is, of course, another fallacy of composition involved in the notion that increasing net exports can be a *general* solution for the current crisis. Therefore, one may conclude that a rejuvenated beggar-thy-neighbor policy is implicit in AV programs.

AV in fact is presented by its proponents as a *supply strategy*, in contrast with the *demand strategy* of Keynesians. The core of AV supply strategy for recovery is not really balanced budgets (other than the expected effect on lenders' confidence and interest rates) but stimulating private investment. AV contrasts this goal with an alleged Keynesian goal of using government expenditure to stimulate consumption. It is really unclear where such characterization of Keynesian policies originates. Most Keynesians, now as before, actually defend raising public investments coupled with measures that could stimulate private investment. The point of contention is not that private investments should be stimulated but how it should be stimulated: Keynesians believe that nothing is more stimulating than the perspective of growing demand for the goods that will be produced by new plant and equipment, while AV seems to think that giving tax favors would be more efficacious (besides, of course, the expected confidence effect, already mentioned). AV proponents create another Keynesian strawman to establish a distinction without a difference between supply and demand side policies when both are centered on increasing investment.

AV is less insistent on the question of how to finance public expenditure than TV, perhaps because it already starts from a rejection of attempts to revive economies in crisis through government spending. True Schumpeterians, of course, would not rely on the same loanable funds view that informed the TV approach to finance.¹⁸ On other hand, the attachment of German government authorities, and in particular the monetary authorities, to the quantity theory of money seems to be much stronger than it was in the British Treasury in the 1920s and 1930s¹⁹, making the concern with inflationary effects of expansionary monetary policies much sharper.

In the same vein, AV proponents take as a given that one is dealing with open economies as TV did in the past. However, while TV treated the balance of payments as a constraint on policy choices, AV sees foreign trade as the key to the success of the strategy. Expanding the economy through rising exports not only solves the problem of where is the demand for the national output coming

demand'. This wording is reminiscent of Say's law, a principle which is often misunderstood. What is meant here is that the right kind of supply creates its own demand. Indeed many of the present day problems involving growth and employment can be illuminated by the simple formula of Say's law provided that this is interpreted qualitatively: 'The right kind of supply invariably creates its own demand'. If producer and consumer goods are supplied which incorporate modern developments in science and technology, which work reliably, and most crucially of all, which fulfill a need that is felt by populations somewhere in the world, then the supplier will be able to obtain a price which more than covers his costs. This kind of supply is created in efficient and well managed factories and workplaces, and these, by designing and producing such goods, create more employment. This is the crux of supply-oriented anti-unemployment therapy."

¹⁸ For Schumpeter's view of the role of savings and finance in capitalista development, see his *Theory of Capitalist Development*.

¹⁹ Perhaps because there were only a few economists in the Treasury.

from but it also removes the possibility that growth can be constrained by the need to increase imports. For them, in contrast, Keynesianism can only be applied to closed economies being therefore hopelessly inadequate for advanced economies.

5. Conclusion: But Does It Work?

At the end of the day, the essential test for any policy strategy must be whether it works or not. But answering questions like this is not so easy and cannot be tackled in the space left in this paper. A few remarks, though, may be in order.

Austerity is a policy recipe to fight crises. Did it lead to actual recoveries? Austerity policies were imposed on the so-called peripheral countries of the eurozone since 2010. They all present a similar picture: drastic expenditure cuts and rising taxes lead to a sharp fall in the level of activity and an increase in unemployment. This period is followed by a measure of stabilization where the downward spiral is contained and some weak and volatile expansion may be observed, although from very low levels, not enough to recover past peaks of production, let alone past growth trends. Political leaders committed to austerity tend to announce the latter as proof of its efficacy, but the real point to be clarified is whether the previous collapse was a result of austerity itself or was the result of previous accumulation of disequilibria, so that it would occur anyway, perhaps with even worse consequences. The fragility of recovery in the recent eurozone countries' experience has been associated with the dependence on external demand that is a central piece of AV. On the other hand, at least in part, growth of *net* exports has also been dependent on the fall of imports that tends to accompany the contraction of the economy and may not be sustained if the economy truly recovers. This has affected not only peripheral economies, but also at least some of the core economies of the area.

The claim that austerity may be related to innovation and productivity increases is much harder to evaluate. AV proponents are in fact very vague about the actual connections between them. It seems that austerity is seen as an important element in a context that *favors* innovation. Possibly, one is referring to the idea that austerity is associated with the notion of responsible government, one that remains in the wings, trying to be as neutral as possible with respect to actual economic activity. Another possibility is the idea that an austere government will not raise taxes on firms taking away their profits. But AV proponents mostly emphasize the negative aspect: Keynesianism is supposed to favor consumption, not investment, closed, not open, economies, government intervention, not entrepreneurial initiative, and therefore creates an anti-business climate that does not support productive investment. It is a *cultural*, rather than strictly economic, question.

Boyer (1985: 78) wisely noted, debating similar issues to those treated in this paper, that "(h)ence the revival of pre-Keynesian concepts is not simply a matter of propaganda or ideology. However debatable are the policies of monetarist, supply-side, or rational-expectations schools, they do point to the presence of real macroeconomic problems." The difficulties faced by Keynesians to sell their alternative policies to voters and political leaders are not entirely due to the difficulty to understand the complexities of modern capitalism and the role of the state. There are at least two

real problems to be faced by any Keynesian alternative, especially in peripheral countries, both related to the balance of payments.

The first has to do with net exports. A domestic growth expansion, based on public investment (or, less likely, on private expenditures) will face the problem of paying for imports, since there will be no reason for exports to grow *pari passu* with imports. President Mitterrand actually tried to grow by stimulating domestic demand in the first year of his first term, and the policy had to be abandoned.²⁰

The second problem is related to the first. Under the euro, it is even more difficult to promote recovery by domestic stimuli. The common currency imposes a hard liquidity constraint not only on external deficits but also on domestic deficits. The euro rules are, in fact, much tougher than those in force in the 1920s and 1930s, since a country could leave the gold standard when it was convenient while the adherence to the euro is sustained by a treaty. When fiscal and balance of payments deficits and public debt are already large the perception that a country really has no alternative but to submit to austerity becomes overwhelming.

One alternative is left, of course, in the form of what German Schumpeterians called “international Keynesianism”: that is, an institutional framework that favors internationally coordinated expansion instead of austerity. In fact, it was such a goal that inspired the Bancor Plan Keynes prepared for the Bretton Woods conference but that was rejected because of United States opposition. The perspectives for such initiatives remain, to say the least, very limited.

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²⁰ See Kalecki on “domestic exports”.

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