The work of John Maynard Keynes shows us that counter-cyclical fiscal policy and an easing of austerity may offer a way out of Eurozone crisis

Debates between 'Hayekian' and 'Keynesian' perspectives constitute one of the main conceptual fault-lines of the Eurozone crisis. In the second of two EUROPP articles covering this debate, **Simon Wren-Lewis** *looks at how the current programme of austerity and the view that the private sector can do little wrong may be driving the continent further into recession. Policymakers must instead embrace the Keynesian response of counter-cyclical fiscal policies.*

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Let's begin by imagining that the Eurozone was a single country, like the United States. The US is currently undertaking significant austerity, even though there is no market pressure to do so. In fact, quite the opposite is the case – it is an excellent time to borrow to invest. So why are the US, and also the UK, undertaking austerity? The main argument is that government debt is too high.

The Keynesian response is that this is the wrong time to be worrying about government debt. In a recession which is due to an increase in private sector saving, the government needs to run matching deficits to prevent output falling. For the world as a whole, if government deficits come down, private sector surpluses must fall to match. Normally monetary policy would encourage the private sector to save less by lowering real interest rates. However in many countries the monetary authorities have already lowered nominal rates (almost) as far as they can. In addition these authorities, or their governments, seem unwilling to let real interest rates fall by encouraging above target inflation in the future.

Advocates of austerity argued that reducing government debt would encourage private spending by boosting confidence. This was always an argument of hope over both theory and evidence, as the last two years has shown. So the only way the private sector surplus can fall to match lower public sector deficits is for output and incomes to fall, which prolongs and intensifies the recession.

This argument against austerity now is quite compatible with a view that government debt is much too high from a longer term perspective. It is all about choosing the right time to deal with that problem. Fiscal policy should be countercyclical, not pro-cyclical. Political economy arguments that we should 'not waste a crisis' while there is political will to reduce debt seem logically flawed. Austerity should also not be surrogate for attempts to reduce the size of the state.

Following the Great Depression, Keynes taught us the need for countercyclical fiscal policy when monetary policy is absent or ineffective. Keynesian economics is hardly a school of thought, but mainstream macroeconomics, as contained in nearly every textbook, and as practiced in nearly every central bank. That does not prove it is right, but it increases the personal responsibility of policy makers who choose to ignore it.

With this perspective, fiscal policy in the Eurozone as a whole seems particularly misguided. Overall government deficits as a share of Eurozone GDP are much lower than in the US or UK, yet the speed of fiscal consolidation is more rapid in the Eurozone. The obvious question is whether this can be explained by the fact that the Eurozone is not one country.

Private or Public Sector Profligacy

The story told by many is that the Eurozone crisis is a result of fiscal profligacy in some countries, and the need to put that right quickly because of market pressure. This account misses two essential underlying causes of the crisis, which have to be recognised if a solution is to be found. The first missing element is competitiveness. In my view fiscal policy in many Eurozone countries outside Germany was insufficiently tight before 2008, but for most not because it implied a build up of government debt. The problem was that private sector demand was too strong, encouraged by large capital inflows from abroad and real estate bubbles.

Here again a classic Keynesian perspective is instructive. In a monetary union, fiscal policy has to take on a major countercyclical role in response to large idiosyncratic shocks. Yet this was hardly acknowledged in the original Stability and Growth Pact (SGP), and does only slightly better in the current set of Eurozone fiscal rules. I have argued that, by ignoring countercyclical fiscal policy, the SGP encouraged governments in periphery countries to allow a growing loss of competitiveness to persist. In that sense, ignoring basic Keynesian ideas helped cause the Eurozone crisis.

The second key feature of the current crisis is also a result of excess private sector demand in periphery countries, and that is a banking crisis. This, rather than fiscal profligacy, was the major cause of the crisis in Ireland, and likewise in Spain. Economic and political forces then led to governments bailing out their banks, and it is this which put into question the sustainability of government finances.

Recognising these two aspects of the crisis is critical in analysing solutions. Yet they do not provide a complete answer to why interest rates on the debt of so many Eurozone countries are so high. As French politicians have observed, their fiscal data looks better than in the UK, so why have they lost their triple AAA status while the UK retains theirs? The answer is that the UK has its own central bank, so that the worst form of default that lenders to the UK can suffer is inflation.

Helping or Harming Periphery Countries

Recognising this last fact means that there was, and still is, a very simple and effective solution to the immediate Eurozone crisis, and that is for the ECB to undertake a programme of Quantitative Easing (QE) focused on markets where interest rates were inappropriately high. There is a deep fear in all central bankers about fiscal dominance, but that has not prevented QE in the US and UK, because those programmes are designed to be reversible once they are no longer needed (or if inflation becomes a threat).

The main reason this has not been done by the ECB appears to be a concern about moral hazard: that without market pressure, governments would lose their incentive to undertake austerity and structural reforms. (There is also a concern about ECB balance sheets, but this just seems to misunderstand what a central bank is.) There are two quite reasonable responses to this concern. First, in a crisis, moral hazard concerns have to be put on one side, as central banks recognise in a financial crisis. The fire engine does not drive slowly to the fire to encourage others to be careful. Second, data on underlying primary balances clearly shows that all periphery governments have already undertaken a massive amount of austerity.

These moral hazard concerns are misguided for a more fundamental reason: they misdiagnose the key problem as public rather than private sector profligacy. Intervention by the ECB to lower interest rates on government debt today is unlikely to encourage excessive private sector spending and lending during the next boom.

The ECB should have recognised that QE directed at high interest rates on government debt was consistent with its mandate, because these interest rates were causing unnecessary deflationary pressure in the economies concerned. The route European policy makers instead took was to replace market funding of deficits by intra-governmental funding, with strict conditionality. This has been a disastrous policy for three reasons.

First, it does nothing to deal with the fundamental causes of the crisis. You do not encourage the countercyclical fiscal policy required to moderate private sector booms by making fiscal policy more pro-cyclical. In addition, creating major recessions in these countries makes it more, not less, likely that banks will be bailed out.

Second, governments have been forced to implement austerity programmes that have been much too draconian. While an appropriate austerity programme would eventually have reduced default risk (although only after a considerable period, once debt itself began falling), forcing excessive austerity has in some cases made the short term problem of default risk worse. Not only have domestic recessions created by austerity increased the size of bank bailouts, but in the case of Greece excessive austerity has generated political instability which also increases default risk.

Third, it has turned a crisis of market confidence into a distributional struggle between Eurozone countries, which could threaten the cohesion of the Eurozone itself. The 'you will have to leave' threats to Greece are just a particularly nasty manifestation of this.

The essential problem is lack of competitiveness outside Germany. Although this requires deflation, there are two simple reasons why it should be gradual rather than sharp. The first is the Phillips curve: gradual deflation to adjust the price level is much more efficient. The second is aversion to nominal wage cuts, which makes getting significant negative inflation very costly.

An Anti-Keynesian School

If the ECB had capped bond yields for Eurozone economies, might austerity in the Eurozone as a whole been less rather than more rapid than in the US or UK? Unfortunately there remains an underlying problem, which is a failure in Europe to acknowledge the macroeconomic impact and importance of fiscal policy in a monetary union. A good recent example is the Netherlands, where contractionary fiscal policy was implemented despite falling GDP, rising unemployment and no market pressure. As I argued above, the new fiscal rules continue to ignore the need for countercyclical fiscal policy, which helps explain pro-cyclical fiscal policy in countries like the Netherlands.

There is a second occasion when fiscal policy should be used in a countercyclical manner, besides preventing divergences in competitiveness. This is when aggregate monetary policy loses its power to stabilise the Eurozone as a whole, because interest rates hit a zero lower bound. Again, this is textbook stuff (thanks to Keynes). This is where the Eurozone currently finds itself, yet its fiscal rules are pushing countries in the wrong direction. The more countries like Germany apply austerity, the more difficult adjustment outside Germany becomes.

Why does this simple logic continue to be ignored by Eurozone policymakers? There was a fear when the Eurozone was set up that allowing countercyclical fiscal policy would lead to deficit bias, because governments would spend in recessions but not save in booms, and union would reduce market discipline. This last point now seems a little ironic, as we currently have too much market discipline. Yet the focus on government profligacy effectively meant that governments ignored the possibility of private sector profligacy, which turned out to be the greater problem.

This is not to deny that long term deficit bias is a serious issue, both in the Eurozone and outside. This is most effectively tackled in my view through a combination of appropriate long term fiscal rules and national fiscal councils that can police those rules. However fiscal rules within a monetary union should also encourage governments to set countercyclical rather than pro-cyclical fiscal policy.

There is an underlying pattern behind Eurozone policy errors. They reflect a view that macroeconomic difficulties are primary due to bad government decisions, while private sector decisions within a free market environment do not create problems. Whatever label we want to give this view (Ordoliberal orAnti-Keynesian), it is the fundamental cause of the current Eurozone crisis. Its persistence despite all the contrary evidence allows the crisis to continue and threatens the integrity of the Eurozone itself.

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About the author

Simon Wren-Lewis is a professor at Oxford University and a Fellow of Merton College. His current research focuses on the analysis of monetary and fiscal policy in small calibrated macromodels, and on equilibrium exchange rates.

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