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# Fiscal and Monetary Policy in optimal and non-optimal currency areas: The discussion between austerity and countercyclical policy.

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**Abstract**

From 2010 there is a wide debate in the academic field on the topic of economic policy. Supporters of contractionary policies have had the political power to apply them absolutely in Europe. According to supporters of this current the problem is not the current deficiency in demand but on trust referring to the confidence of financial investors, confidence that will be regain through fiscal responsibility, which means, cut in public spending and punctual payment of the public debt. It doesn´t matter that the investors represent less than 5% of total population and austerity affects more than 95% of people. The results that we will see in this paper clearly show the failure of austerity measures and, therefore, surprises the persistence of its promoters defending them and even worse, keeping them operating.


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***Keywords: Fiscal policy, monetary policyt, currency areas, austerity, countercyclical policy***

## Introduction

***"The boom, not the slump, is the right time for austerity at the Treasury"***

**John Maynard Keynes (1937)**

Following the crisis of the euro in 2011, the European Commission on Economic and Monetary Affairs in Brussels, chaired by Olli Rehn, established rigid austerity policies on public debt supported by the International Monetary Fund (IMF) and the European Central Bank (ECB), the so called *"troika"*. It was

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decided to establish tightening measures on economic policy that, according to economists of the stature of Joseph Stiglitz and Paul Krugman, both Nobel laureates in economics, among many others, would aggravate the recession and not allow a prompt recovery of the *"South"* Eurozone.

In this paper I will try to show whether the results obtained in these almost five years of austerity give reason to its supporters or to those who are in favor of a countercyclical fiscal policy.

It is clear to many of us that behind this false scientific controversy are political interests. Ideology has always overshadowed scientific thinking on economics to the extent that, as pointed out repeatedly by Paul Krugman, some economists have refused for decades demonstrated macroeconomic knowledge and their forecasts have been made unsubstantiated but after several years of not met, its promoters continue holding them, fastened without acknowledging the failure of its projections. Something like the constant denial of climate change by the massive issue that humanity is making of $CO^2$.

The polemic between austerity and expansion is part of the controversy between neoliberalism and those economists close to the thinking of John Maynard Keynes, polemic that revolves around whether austerity must be given in the expanding of the economic cycle and expansion of its recessionary phase.

Austerity in the recessive phase reduces drastically inflation thus favoring creditors -the financial capital- and harming debtors. Furthermore, if inflation goes to zero or becomes deflation, lenders benefit even more while debtors see their debt increased in real terms.

Contractionary monetary policy has not been applied only in Europe; we also see it in the fiscal policy proposals of the Republican Party in USA.

Despite this conservative dominance in economic policy in Europe, the European Central Bank (ECB) is taking steps closer to countercyclical thinking, injecting liquidity into the European financial system since 2014 which has helped in the weak recovery of the last months.

## Objective

For several years it has been my purpose to collaborate in the development of a broader theory of optimal and non-optimal currency areas than the one which was used in the establishment of the Euro Zone (Encinas 2009). The experience that the European crisis is giving us, especially in the euro zone, and the impact that the regional debt has had over the monetary and fiscal system of nations with single currency has shown the importance of this issue.

In the 9th International Conference on Developments in Economic Theory and Policy, Bilbao, June 2012, I introduced the term "Stockholm Syndrome in Economics" referring to what happens when governments (the abductees) convert the debt of banks (the abductors) in public debt, transferring liabilities from private companies (those are the banks) to public debt, freeing owners of such private enterprises (those are the bankers) from their irresponsible bad financial decisions "... bailed out through ad hoc arrangements that understandably had many people furious about putting taxpayers on the hook for private irresponsibility". (Krugman, 2015).

We have seen that in innumerable cases and very sharply in the *"southern"* part of Europe following 2011. In doing so, governments ignored a fundamental principle in business, no matter whatever type they are: the responsibility of both, debtors and creditors, in their bad financial decisions. By this principle governments do not help many entrepreneurs who daily go bankrupt around the World, transferring those debts so that residents pay them through taxes. Of course those companies are not protected by the IMF alone or the troika.

The link between global economic performance and income concentration in the hands of financial capital introduces new paths on which we must go deeper. We should understand that markets in order to work more efficiently require greater competitiveness both on supply and demand. Monopolies and oligopolies affect the assigning resource capacity of the market in equal way as monopsonies and oligopsonies do (Encinas 2010 and 2014a).

The issue is critical to understand which path or paths will deprive in economic policy in the following decades. The lack of economic growth that we have seen in the world in the last 30 years, with the exception of China and a few countries that have coincidentally shown positive balances in foreign trade, necessarily leads to a rethinking of economic policies as population pressures in the absence of economic growth.

What the World needs to break with nearly three decades of very low growth? The model followed has shown its failure and that model is now introduced fully in Europe. Mexico and many other countries have become exporters of imports and the low proportion that their domestic markets have in GDP plus the permanent fall in the purchasing power of wages has perpetuated this lack of development and has spread into many countries in the Eurozone since 2008.

**Some history**

"In 1947, after World War II, the Austrian economist Friedrich Hayek convenes in Mont Pelerin (Switzerland) a group of thinkers and conservative economists contrary to Keynes, among them Milton Friedman, Ludwig von Misses, Walter Lippmann, Charles Popper, Karl Polanyi and Carlos Salvador de Madariaga, the purpose of the call: establish an ideological platform with liberal economic fundamentals that opposed both Marxist thought and social democrats and Keynesian currents which enacted the welfare state "(Encinas 2014b, p. . 98).

For these theorists, whose interests coincide with the major financial capitals, the "market" is an automatic and magical regulator of the entire economy and government intervention only distorts and prevents it from fulfilling his duties. For them imperfect competition disappears of its economic analysis as well as concentration and poor income distribution. None of this has negative effects on the balance of economic system. Whenever something goes differently to the way predicted by them, government intervention appears to be the culprit.

In 1982, the world economic crisis triggered by the external debt opens doors to this stream of economic thought to displace Keynesian thinkers in positions of power and indoctrinate new generations who have been quietly prepared in American and European universities to take control of economic policy both in industrialized and underdeveloped countries. Thus begins a slow dismantling of the welfare state.

Interestingly, neither the great industrial powers nor the successful Asian economies, strictly applied the dogmas of Neoliberalism within their economies. In the first we saw constant state regulation in the economy, while in the latter a rigid investment planning and strict protectionism to their basic industry and national capital have played a key role in economic growth.

In the last 30 years we have witnessed various economic crisis whose origins and results have shown how wrong the recipe of neoliberal economic policy is. The low global economic growth, with a few exceptions that occur in countries with positive results in their trade balance, is perhaps the clearest failure of the model.

The euro crisis in 2011 gives, contrary to expectations, the long-awaited opportunity to apply in the industrialized Eurozone more broadly neoliberal principles, something that also occurs in the USA but not to the extent that in Europe.

We have observed in the last five years significant pressure from the Republican Party and its extreme right wing, the so called *Tea Party*, trying to force the implementation of contractionary policies in the form of measures to further limit the welfare state or trying to prevent its application as is the case of the popular named *Obamacare*, which seeks to ensure a safe medical care net to the majority of the US population and which is developing with great success despite a very bad start due to programmatic issues that have been fixed.

However, Keynesian macroeconomic theory of the past 60 years has given sufficient evidence of his scientific reason. Our hypothesis is that the distribution of income through mechanisms like the *welfare state* is essential to keep running the market as allocator of scarce resources, an allocator rather inefficient, incidentally, which operates not through an invisible hand and requires, therefore, a constant regulatory intervention by public policy. Juan Tugores (2010) notes rightly that *"markets are a 'public good' too important to be left in the hands of their most interested apologists …"*

**Procyclical policies in Europe: austerity in the recession**

We read in the Bible, the Book of Genesis, the story of Joseph who interpreted a dream of the Pharaoh and said:

> *"The seven good cows and the seven good heads of grain are seven good years. And the seven thin, sick-looking cows and the seven thin heads of grain mean that there will be seven years of hunger in this area. These seven bad years will come after the seven good years. God has shown you what will happen soon. He will make these things happen just as I told you. For seven years there will be plenty of food in Egypt. But then there will be seven years of hunger. The people will forget how much food there had been in Egypt before. This famine will ruin the country. It will be so bad that people will forget what it was like to have plenty of food… So, Pharaoh, you should choose a wise, intelligent man and put him in charge of Egypt. Then you should choose other men to collect food from the people. During the seven good years, the people must give them one-fifth of all the food they grow. In this way these men will collect all the food during the seven good years and store it in the cities until it is needed. Pharaoh, this food will be under your control. Then during the seven years of hunger, there will be food for the country of Egypt. And Egypt will not be destroyed by the famine."*

It is very clear from this famous story that the "wise, intelligent man" will be the one that applies austerity in the era of abundance and distributes at the time of recession. Definitely austerity politicians would not have fullfilled that profile.

Joseph always seemed to me very Keynesian, much more than most of the followers of Keynes. To apply austerity in the boom and expansionary policy in recession is the logical recipe that gave us the English economist. Unfortunately expansionary policy has always been applied in both, the recession and the rise, and governments have borrowed at any time accumulating financial liabilities that have been manageable only in the medium term, provided they were accompanied by inflation which reduces their percentage in relation to GDP.

The statistical analysis of trends and economic results of the variables related to economic growth allow carrying out important findings that support our hypotheses and conclusions to which I arrived.

The variables to be studied are GDP (at current prices, constant prices and in international dollars according to data from the Penn World Table (PWT, version 8.0); data on exports and imports and the balance of trade surplus; GDP per capita in all three versions: at current prices, constant prices and PPP international dollars according to the PWT; and the evolution of public and private debt of the countries chosen.

The austerity policy has been based on the reduction of public spending and fiscal surpluses to lower debt at the expense of maintaining high unemployment, low or negative growth rates and low inflation or just plain deflation that harms debtors but favors creditors.

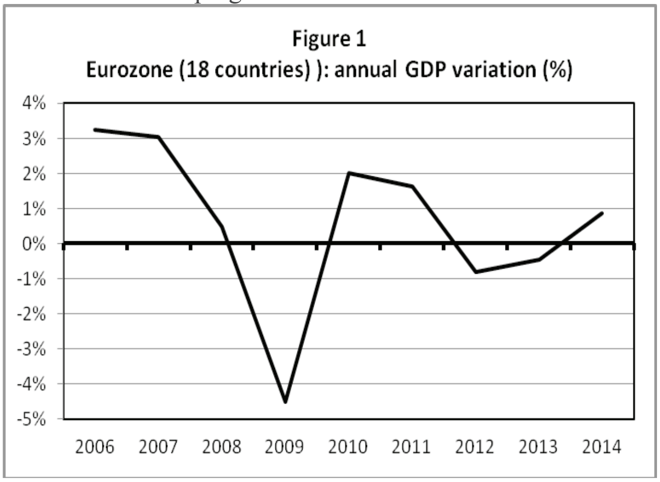
As regards monetary policy, the European Central Bank (ECB) kept for several years too high interest rates which aggravated the lack of investment and consumption, typical of the low cycle.

It was not until recently that the ECB has started a policy of cheap money and purchase of government liabilities in order to inject liquidity into the region. I do not think this is enough and I think it comes three years later. The ECB is loaded with a failure in its structure that is the lack of been lender of last resort, which has prevented the Euro Zone to be a fully optimal monetary area, among other lags.

**Gross Domestic Product**

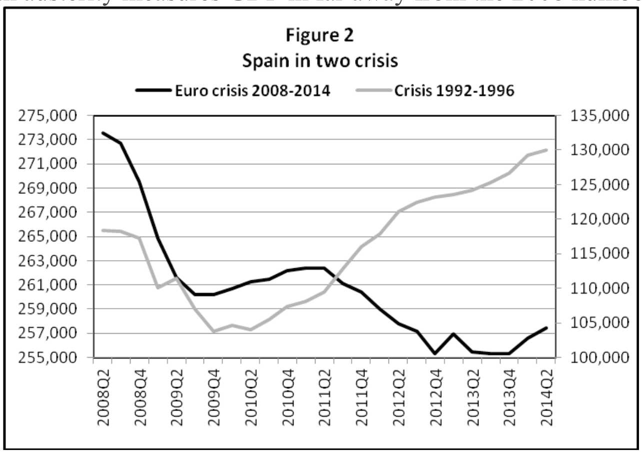
Let us see the results of the austerity policy applied in the Eurozone. We begin with the evolution of GDP. It is obvious that if the measures to cut public spending were right, we would be seeing after 4 years a strong recovery of this variable.

Figure 1 shows clearly the failure of austerity policies that were implemented in the European Union since 2011: a fall in GDP showing negative numbers for 2012 and 2013. In 2014 there was a small increase of 0.88% in GDP far away from the numbers pregreat recession.




Source: Own elaboration with data from Eurostat

Figure 2 shows us the diferent responsal of Spain GDP in two diferent crisis: 1992-1996 when GDP at current prices fell 12.34% and the recent Euro crisis when the downfall was 6.68%. As you can see in 1992 with a deeper fall in GDP but without austerity the recovery last only two and a half years. In the euro crisis, with a smaller fall but with austerity measures GDP in far away from the 2008 numbers six years latter.

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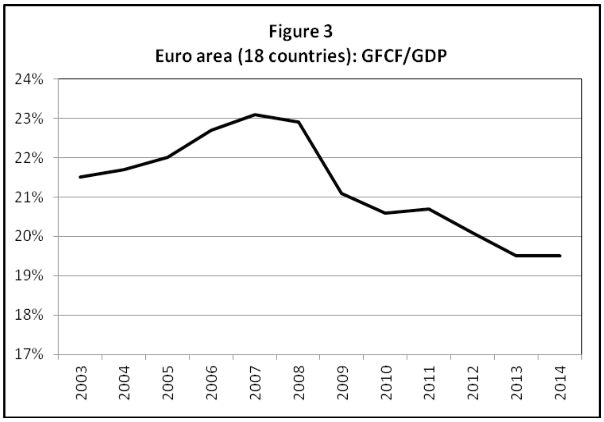
Is important to notice that from 2011 to 2014 the Eurozone GDP (18 countries) has grow only 1.23%, an annual average oncrease of 0.3%.

**Investment**

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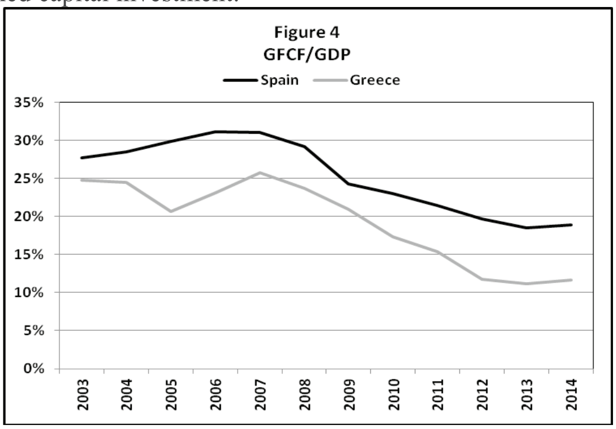
The investment behavior is a very important element to determine the evolution of an economy. In Figure 3 we see the gross fixed capital formation (GFCF) as percentage of GDP in the 18 original countries of the euro area, after reaching a 23% average prior the 2008 crisis, investment declines down to 19.5% in 2013 and 2014 and we don´t see signs of recovery. EU investors are indecisive and do not initiate a clear investment campaign.

GFCI is part of GDP in conjunction with Consumption, Public Expenditure and Trade Balance. In the World Bank statistics does not include changes in inventories; it was formerly classified as gross capital investment and as gross fixed capital investment.




Source: Own elaboration with data from Eurostat

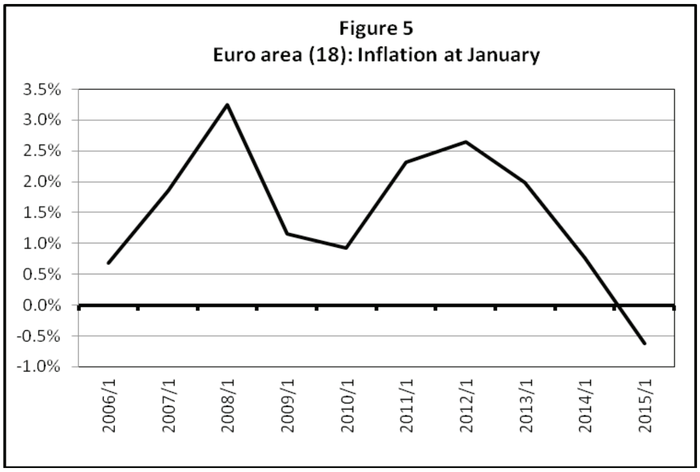
In Figure 4 we see that the GCFC in Spain reduced 39.2% and has not recovered. In the case of Greece the reduction has been 54.9%.

**Inflation**

In Figure 5, the inflation measure for the month of January each year, appears the dreaded deflation which implies lack of recovery in demandand is related to the liquidity trap in which despite zero nominal or real negative interest rates, consumers do not accept increase their consumption through credit and, therefore, investors do not undertake new investments. What is the main cause of the fall in inflation to negative levels in the lump? Producers inventories of finished products have to be sell below their price, even below their cost, in order to regain liquidity.

In recent months, however, the negative inflation in Europe is due more to the drastic reduction in the price of oil and its derivatives.

Deflation in the case of Greece and Spain has been higher in the last months of 2014 and early 2015 than the European average

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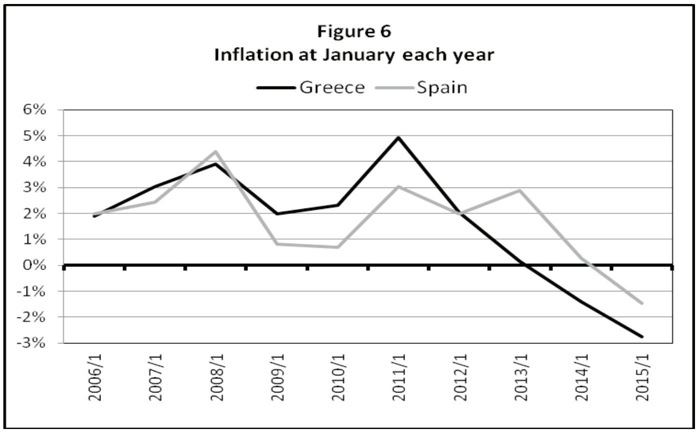
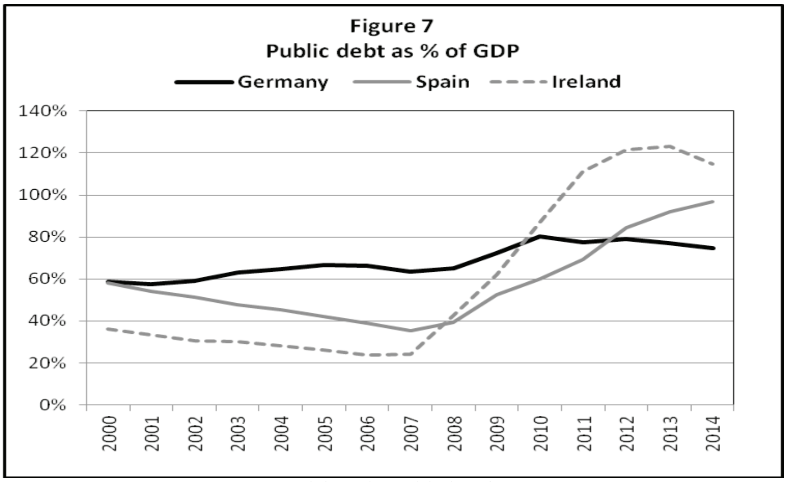
Deflation in the case of Greece and Spain (Figure 6) has been higher in the last months of 2014 and early 2015 than the European average which is another symptom of their bad economic situation.




Source: Own elaboration with data from Eurostat

**Public Debt**

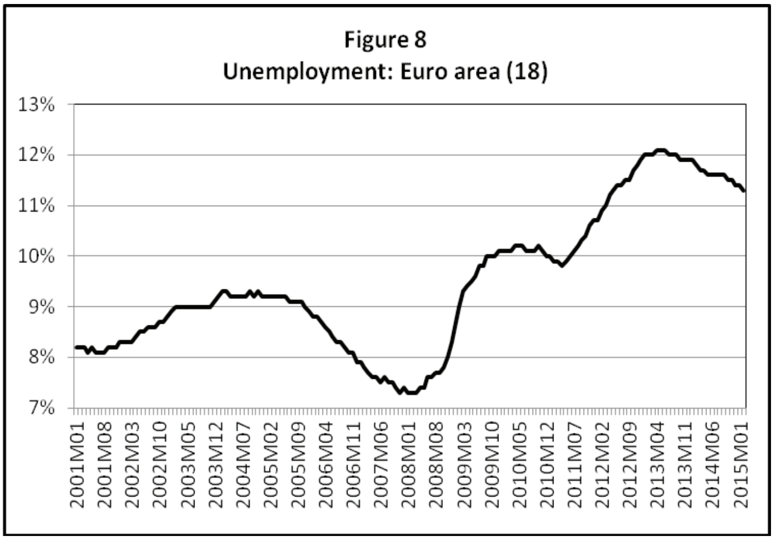
Nothing shows us better that debt as a percentage of GDP is not the problem, but the consequence of other factors, than Figure 7. In 2000 both, Germany and Spain, had a 58% of public debt over GDP and Ireland less than 36.3%. While Germany porcentage permanently grew Spain and Ireland diminished this ratio to 35% the first and 24% the second. Due to the Great Recession both countries stopped their growth. Since 2010 Ireland surpased Germany's porcentage and Spain did it in 2012.




Source: Own elaboration with data from Eurostat

The problem is not the size of the debt, the problem lies in the size of a negative trade balance. Since the outbreak of the Great Recession, countries with trade deficits have had to borrow at high interest rates in order to pay they debt, activate its economy and fight unemployment.

**Unemployment**

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Although unemployment rate has been diminishing for a year it is still too high and it is above the 8 or 9% average prior to the crisis.

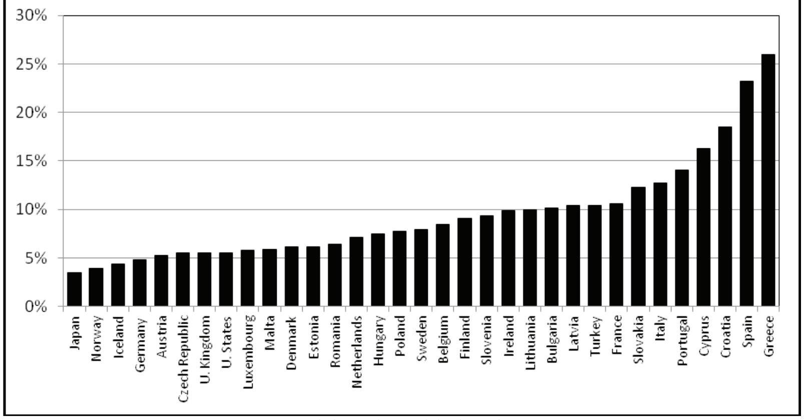

Figure 9
Unemployment at February 2015

Source: Own elaboration with data from Eurostat

In Figure 9 I present unemployment rates in different countries. Spain and Greece show in their unemployment rate the magnitude of the problem they face.

Statistical analysis shows clearly the reason why the opposition to austerity policies has spread in all European countries. Germany still clings to them, probably because it is the largest creditor of the European Union. From the ideology of politicians and economists of austerity reducing public debt was going to allow automatic recovery of investor confidence and with it investment and consumer will return to spend more. This is obviously a biased view of class showing be mistaken. When will regain their faith the millions of unemployed and the millions of families who have seen their income reduced? Can a market consume the entire capacity of its production plant when most of its inhabitants have seen decrease the proportion of income they had while national income has been concentrated in too few hands?

It is clear that neoliberalism has led to the current crisis and far from recognizing its political failures cling to their dogmatic and preconceived ideas. We need other economists and politicians with scientific objectivity and willing to think in the majority and not on the minority.

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