Introduction

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More than three years ago, the collapse of Lehman Brothers marked the beginning of a global financial crisis which later came to be known as the 'Great Recession'. Today, the world economy is still out of balance. Yet, although the causes of the crisis are multifaceted, including a lack of financial market regulation, rising income inequality and global current account imbalances (Dullien et al. 2010; Niechoj et al. 2011), the current policy debates are dominated by a narrow focus on the so-called public debt crisis in many countries. Judging by the quality of these debates, it would even seem that many politicians see the high public debt levels as the main cause of the crisis, when in fact they are largely a consequence of it. By contrast, the deeper origins of the crisis are still not being properly addressed.

In the United States, there have been heated discussions about the appropriate level of the 'debt ceiling', accompanied by the rhetoric of a looming government default. And yet, even the gloomy macroeconomic prospects of the United States still look positive when compared to the situation in Europe, where the constant talk about the seeming fiscal profligacy in the 'periphery' reflects a lack of attention to the more pressing economic, social and political imbalances within Europe.

In Europe, the deficit and debt criteria of the Stability and Growth Pact have been tightened further, and a new 'fiscal compact', whose aim is to include balanced budget rules in the constitutions of all member states of the eurozone, is already under way. Clearly, this does not address the deeper origins of the crisis. Even if the fiscal compact had already been introduced with the start of the euro in 1999, it is very unlikely that it would have prevented the crisis starting in 2008. The main problem of the eurozone before the crisis were not excessive government deficits – in Ireland and Spain governments were even persistently running financial surpluses. Rather, the origin of the crisis was the macroeconomic imbalances, linked to two divergent growth models: a private debt-led growth model in the 'peripheral economies', in which financial asset and housing bubbles as well as nominal wage increases far above productivity increases contributed to strong domestic demand and a loss of external competitiveness; and an export-led growth model with very low increases of unit labour costs especially in Germany and the Netherlands and some smaller countries 'at the core'. Taking medium-term productivity developments plus target inflation rate of the European Central Bank as a guideline, German wage development was as much out of line as wage development in the peripheral economies. Ironically, the new European Union legislation does include the possibility of a so-called 'Macroeconomic Imbalance Procedure', aimed at preventing excessive private debt levels and current account imbalances. But the German government managed to impose an asymmetric interpretation of it, by which current account deficits of more than 4 per cent of GDP can be subject to sanctions, whereas current account surpluses will be considered problematic only if they exceed 6 per cent of GDP, while no sanctions are possible.

Over the past years, the alarming state of economic policy and economic policy advice in Germany has come to the forefront of global academic and political discussions. When the Euro crisis escalated last year, Wolfgang Münchau wrote in the Financial Times that the "sheer degree of incompetence at the top level of the German government is breathtaking". Unfortunately, it is difficult to disagree with him. In fact, German officials acted as if they deliberately wanted to worsen the crisis with their lethargy and their insistence on what, in their view, were sound economic principles when it was already clear that sticking to those principles would cause economic disaster.

Back in 1999, Paul Krugman wrote a succinct op-ed about the Germans in the New York Times.[1] There he addressed the problems to be expected in Germany and the newly created euro area. The title was "Why Germany kant compete." Krugman argued that in his view the main difference between Germany and the United States may not be political but philosophical:

[1] http://web.mit.edu/krugman/www/kompete.html.

> "The real divide … is not political but philosophical; it's not Karl Marx vs. Adam Smith, it's Immanuel Kant's categorical imperative vs. William James' pragmatism. What the Germans really want is a clear set of principles: rules that specify the nature of truth, the basis of morality, when shops will be open, and what a Deutsche mark is worth."

Speculating about the possible implications of such a mind-set for the economic prospects of the euro area, Krugman concluded that "[i]n an environment where deflation is more of a threat than inflation, an obsession with sound money can be a recipe for permanent recession". This is exactly what we are observing today: The obsession with those principles including neoclassical fiscal policy doctrines has devastating consequences in many European countries. However, it would be misleading to attribute the difficulties in overcoming the current crisis to a lack of pragmatism alone. Clearly, while self-imposed austerity measures have been less extreme in the Anglo-Saxon countries as compared to the euro area, the lack of attention to the deeper origins of the crisis characterises government policies in most countries around the globe.

The contributions collected in the present book are united by the attempt to analyse the issue of public debt in the larger context of macroeconomic and social imbalances. In part I, the structural causes of the crisis and perspectives for a new sustainable growth model are discussed. Part II asks the question of how to deal with economic imbalances in a broad sense, ranging from political and power imbalances to the global current account imbalances. The chapters in part III are concerned with the role of the emerging economies in the global current account imbalances. Part IV treats the problem of public debt more specifically. Finally, the chapters in part V discuss strategies for dealing with public debt and macroeconomic imbalances in Europe. In the remainder of the introduction, we provide a brief overview of the chapters to come.

I. From crisis to growth?

The paper by *Amitava Dutt*, "Growth, distribution and crises", presents four simple models of growth and income distribution which together explain the effects of increasing inequality on the rate of growth and the possibility of crises in advanced capitalist economies. The models give a central role to two features of capitalist economies, that is, uncertainty and power relations, which are arguably not adequately incorporated into neoclassical macroeconomic and growth models. Although the models are simple and do not examine fiscal policy and open economy considerations, they focus on some aspects of the recent crisis, and especially on the role of increasing inequality in bringing it about, and underscore the need for improving income distribution for more sustainable – as well as equitable – growth.

Mark Setterfield discusses "Real sector imbalances and the Great Recession". While much attention has been focused on the financial woes of the U.S. economy in the wake of the Great Recession, this chapter focuses on an important real sector imbalance: the failure of real wages to keep pace with productivity growth over the past three decades. This imbalance is shown to create a structural flaw in the aggregate demand generating process that threatens to undermine future macroeconomic performance. The chapter reflects on the policy responses necessary to remedy this situation, and the likelihood that the U.S. will succeed in avoiding a future of secular stagnation.

Sebastian Dullien, *Hansjörg Herr* and *Christian Kellermann*, in their contribution "Towards a social and sustainable growth model", remind us that in the early stages of the "Great Recession", the downward dynamic of many indicators mirrored that in the Great Depression. The authors argue that an important difference between the two big crises in the last hundred years is that governments during the Great Recession passed fiscal stimulus packages and measures to stabilise the financial systems. However, in contrast to the Great Recession, the Great Depression had a lasting structural impact on the economy. The New Deal in the U.S. under President Roosevelt with his aggressive policy to reduce power of the elites in the financial system and restructure finance, regulate labour markets and change income distribution brought fundamental changes which paved the way for the prosperous development after World War II. During the Great Recession, while short-run policies were much more sound and prevented a cumulative downturn spiral, at least until 2012 no systemic steps were taken to change the underlying factors of the crises as was done in the 1930s. As a result, there is now the danger of a "lost decade" of little or no economic growth.

Philip Arestis and *Elias Karakitsos* discuss the "Economic policy implications of the 'Great Recession'". In the authors' view, there are clear policy implications that emanate from the crisis. To begin with it is important to state that prior to the 'Great Recession' there had been clear acceptance of the Efficient Market Hypothesis (EMH), with the focus on 'light-touch regulation'. It is also the case that the International Monetary Fund praised these approaches and recommended them to other countries. All these policy initiatives have been discredited by the events that led to the 'Great Recession'. These and other policy implications are briefly discussed in this contribution to conclude that an important policy that has not been addressed properly is that of financial stability. In fact, the emergence of Central Bank independence, focusing exclusively on maintaining price stability, along with the use of the rate of interest as the main instrument of economic policy, that is inflation targeting, implied that the objective of financial stability was downgraded and responsibility over it became obscure. The authors discuss the latter policy at some length, emphasising the recent U.S. initiative that emerged as the Dodd-Frank Act of 2010, which is the focus of the discussion on this front.

II. How to deal with economic imbalances?

In the first chapter of this section, "Imbalances? What imbalances? A dissenting view" *Randall Wray* reflects on the notion of balance as an economic as well as a natural and ethical concept. He reminds us that regular debt cancellations were common practice in early societies. Why? Wray asks. The answer is not that these were bleeding heart liberals. No, debt cancellation was to restore balance. If all your subjects are in hock to creditors, you cannot rule them, Wray explains. Redemption allows time and debt to start over from balance. What, then, is the problem in Euroland today? Power, is Wray's answer. Private creditors in central Europe have too much of it; sovereigns on the periphery have too little. The creditors are starving the member states, aided and abetted by the euro, which usurped sovereign power and handed it over the banking elite. Wray concludes: Admonish the Mediterraneans all you like for their budget deficits, but they still will have them compounded by the German export surpluses.

Claus Thomasberger, in his contribution "Economic imbalances, capitalism and democracy" also relies on the view that the euro crisis today is not only – and not in the first instance – an economic crisis. He argues that the current crisis management in the European Monetary Union denies the most basic economic insights. It does not take into account

a) that not only the world, but the European Union, too, is a rather closed economy, b) that a reduction of sovereign deficits, if it is not accompanied by a parallel reduction of external imbalances, goes necessarily at the expense of the private sector, and c) that the reduction of external deficits in one country requires a reduction of surpluses in other countries. Hence, Thomasberger, placing himself in the tradition of Karl Polanyi, elaborates the thesis that the *relation* between the *political* and the *economic* sphere is a crucial dimension. In the end, he concludes that the eurozone can still be safeguarded. But as long as the destiny of Europe is influenced largely by the neoliberal credo we may arrive at a point where the conflict between the advantages of the euro and the losses in terms of policy space, democracy, and quality of life will erupt.

The contributions by Thomas Palley and Paul Davidson analyse the causes of and potential remedies for the global current account imbalances more specifically. The title of the chapter by *Thomas Palley* is "Explaining global financial imbalances: A critique of the saving glut and reserve accumulation hypotheses". The chapter examines three different explanations of the global financial imbalances. It begins with the neoliberal globalisation hypothesis that explains the imbalances as the product of the model of globalisation implemented over the past thirty years. It then examines the saving glut and reserve currency hypotheses. The paper concludes by arguing that both the saving glut and reserve currency hypotheses are inconsistent with the empirical record and both provide a misleading guide for policy.

Paul Davidson summarises "The Keynes solution for preventing global imbalances". The mainstream economic solution for curing persistent global imbalances in international payments is for the deficit nation(s) to become 'more competitive' to increase exports and reduce imports. Traditionally this has meant that the deficit nation should devalue its currency in terms of exchange rates and/or reduce money wage rates and fringe benefit costs thereby reducing production costs relative to the nation's trading partners. This is still the orthodox solution despite the experience of the 'competitive' exchange rate wars of the 1930s.These exchange rate devaluations were seen as a way of becoming more competitive and therefore 'exporting your unemployment' to your trading partners. The result was increased global depressionary forces. According to Davidson, most of today's central bankers and politicians are on track to repeating historical economic errors.

III. Emerging economies and global imbalances

Xinhua Liu, in his chapter, “FDI in China: A sovereign money perspective”, starts from the observation that since the financial crisis began, the levels of FDI in China have had large fluctuations. From the traditional view, decreasing FDI may lead to insufficient funding of domestic investment, and this then affects the strategy of ‘defending growth and adjusting structure’. Liu, by contrast, bases his analysis on modern money theory to argue that the FDI which has been brought into China is really to increase the foreign exchange reserves (FER) held at the central bank. Hence on one hand, the excessive growth of FER leads to the risk of foreign exchange assets falling in value should the RMB appreciate. On the other hand, excessive amounts of high-powered money issued by the central bank as it buys the foreign exchange will affect the implementation of monetary policy and will probably lead to financial fragility. For local governments, attracting FDI is essentially a means to obtain more financial support from the central government as foreign funds are ‘guarantee funds’ for local government. The Western part of China, a very much underdeveloped region, has less ability to attract FDI, which makes it hard to get central government funds. Liu suggests that the central government expand the transfer payments to the western part of China, and hence reduce the efforts to attract FDI blindly to achieve sustainable development.

André Moreira Cunha, *Fernando Ferrari-Filho* and *Daniela Magalhães Prates* ask: “Can the Brazilian countercyclical policies adopted in 2008 – 09 be considered Keynesian?” Their chapter analyses the economic policy responses of the Brazilian government to the international financial crisis. It concludes that, despite the fact the Brazilian economic policy response to the international financial crisis seems reminiscent of Keynesian economic policies, it is not possible to argue that the recovery of the Brazilian economy can be considered a Keynesian show-case. Nevertheless, the authors see some signs of a policy change since the beginning of the Dilma Rousseff government, such as: instead of fiscal surplus targeting, the Government has sought fiscal responsibility; monetary policy has become somewhat discretionary; the monetary authorities have adopted broader strategic capital controls to avoid the appreciation of the *real* – going in this direction, some mechanisms of control over operations with currency derivatives were introduced; and a new industrial policy – it aims at promoting strategic economic sectors and the country's investment on innovation, research and development – was launched.

Sunanda Sen, in her contribution, "Managing global financial flows at cost of national autonomy: China and India" argues that the narrative as well as the analysis of the global imbalances as exists in the literature remain incomplete unless they capture the part of the story which relates to the experiences of the emerging economies experiencing the surges in capital flows. In her view, in addition to disregarding the implications of the capital flows on their domestic economies, especially in terms of the 'impossibility' of following a monetary policy that suits growth in the domestic economy, such analysis fails to recognise the significance of uncertainty and changes in expectations as factors behind the build up of the large official reserves, often in a precautionary mode. She argues that experiences in China as well as India confirm this view. Financial integration and free capital mobility, which are supposed to generate growth with stability in terms of the efficient market hypothesis, have not only failed to achieve their promise, especially in the advanced economies, but have also pushed the high growth developing economies like India and China into a state of compliance, where domestic goals of stability and development are sacrificed to attain the globally sanctioned norms of free capital flows.

IV. How to deal with public debt?

Malcolm Sawyer reflects on "The impossibility of balanced structural budgets". His chapter points to the push for balanced budgets in many countries. It briefly reviews the rationale for balanced budgets and finds them wanting. It is argued that a balanced budget and economy operating at potential output are in general incompatible, and hence a balanced structural budget is not possible. It is argued that there are major issues in the estimation of potential output and of the size of structural budget positions, which create severe difficulties in using the structural budget position as an objective of fiscal policy.

Pedro Leão asks: "How to make fiscal policy counter-cyclical". He notes that in most countries, discretionary fiscal policy has often been pro-cyclical: instead of dampening the business cycle, actual discretionary policy has mostly magnified it. In his compact chapter, he proposes a mechanism that allows discretionary fiscal policy to be counter-cyclical.

This involves the creation of a Budget Agency which carries out expenditures that, in addition to increasing its debt, also raise its saleable assets – and, therefore, do not reduce the net value of its balance-sheet. One example is the construction, during a downswing, of housing and office buildings that will be sold in the subsequent upswing. Besides real estate investment, the Budget Agency may also undertake balance-sheet neutral expenditures in two other sectors responsible for the bulk of business cycle fluctuations: business investment and durable consumption.

Catherine Mathieu and *Henri Sterdyniak* ask: "Do we need fiscal rules?" They begin by arguing that the crisis is not due to the rise in public debts and deficits. However, the crisis led to a huge rise in government debts and deficits, first due to measures taken to support banks, later to the automatic fall in tax revenues, and finally to measures implemented to support output. Proposals aiming at imposing fiscal policy rules are back to the forefront. But according to the authors, there is no evidence that economically relevant rules can be set. This issue is especially acute in the euro area, where the Stability and Growth Pact (SGP) did not work, and where member states are directly under financial market pressure. The ECB and the Northern countries, having agreed to help Southern countries, wish, as a counterpart, to impose a 'New Fiscal Pact', which risks paralysing fiscal policies and preventing economic stabilisation.

V. Macroeconomic imbalances and public debt in Europe

Jan Priewe analyses "European imbalances and the crisis of the European Monetary Union". Priewe sets out to explore the driving forces for the current account imbalances within the eurozone, fathom their risks and their impact on the sovereign debt crisis of several member states. He develops the proposition that the sovereign debt crisis of the peripheral countries is mainly a reflection of European imbalances, and that the diagnosis of a sovereign debt crisis of the countries as the prime problem is misleading and respective policy conclusions do not address the fundamental issues. Although financial rescue efforts are urgently needed, they will be in vain as long as the underlying problems are not addressed, the author concludes. He contrasts various competing approaches to explaining the EMU crisis with his own interpretation, based on the diagnosis of neo-mercantilism (especially in Germany), which includes a digression on the role of diverging unit labour costs.

Gregor Semieniuk, *Achim Truger* and *Till van Treeck* also discuss the interrelatedness of current account imbalances and government debt, in their chapter, "Towards reducing economic imbalances in the euro area? Some remarks on the Stability Programmes 2011 – 2014". Their contribution evaluates whether the 2011 national Stability Programmes (SPs) of the euro area countries are instrumental in achieving economic stability in the monetary union. The authors analyse how the SPs address the double challenge of public deficits and external imbalances. Their analysis rests, first, on the accounting identities of the public, private and foreign financial balances and, second, on the consideration of all SPs at once rather than separately. They find that SP conclusions are optimistic regarding GDP growth and fiscal consolidation, while current account rebalancing is neglected. Hence, especially for current account surplus countries, a more expansionary fiscal policy will likely be required to maintain growth rates.

In the chapter, "Germany – best practice for the euro area? The Janus-faced character of current account surpluses", *Torsten Niechoj* focuses on the most important current account surplus country within the euro area, Germany, which in the current policy debates is often presented as a case of best practice other member states should follow. This would be a misjudgment though, as Niechoj argues. Increasing current account surpluses after the introduction of the euro did not lead to prosperity. On the contrary, they were accomplished by GDP growth rates below the European average, the establishment of a low-paid sector and poor and sometimes even negative real wage growth rates. Moreover, wage restraint in Germany contributed to a decline of price competitiveness of other member states and thus amplified European imbalances. During the crisis, a partly and temporary departure from this policy approach fostered a fast recovery and an increase in employment. It was brought about by an active stabilisation policy, demand from Asia and limits to external flexibility in the labour market.

The next three chapters are case studies for three countries currently facing a public debt financing crisis. The first of these chapters is by *Jesus Ferreiro* and *Felipe Serrano*: "When the solution is part of the problem: The fiscal policy in Spain". The authors remind us that the impact of the crisis since 2007 has been greater in Spain than in most European or euro economies. While the origin of the global and European crises was not in

Spain itself, and the Spanish economy is in part merely paying the costs of a crisis generated abroad, the authors attribute the strength and duration of the crisis to a set of elements that are distinctive to the Spanish economy. These include the structural problems of the Spanish labour market, the high dependence of the Spanish economy on the international financial markets, and, lastly, the wrong strategy of fiscal policy implemented before and during the first years of the crisis. The chapter argues in particular that the mismanagement of fiscal policy before the crisis, adopting a pro-cyclical stance during the expansion, exacerbated the existing imbalances before the crisis. Moreover, the authors explain how the fiscal measures implemented at the first stage of the crisis contributed to increasing the fiscal imbalances without having the expected positive economic impact.

The next chapter, by *Yannis Monogios*, is entitled: “The ‘Tax gap’ as an indicator of fiscal sustainability. Analysis and policy proposals for the case of Greece”. Monogios highlights the necessity of taking measures to address explosive debt dynamics in developed economies (particularly so in Europe) which requires frequent (re)assessment of whether current policies can generate sustainable fiscal outcomes if they continue to be implemented in the future. To this end, fiscal or debt sustainability assessments are customarily employed as a standard part of the fiscal policy evaluation toolkit. These assessments fall into various categories depending on the method of analysis and the criteria adopted in the sustainability exercise. Apart from the *traditional* sustainability analysis of public debt (based on the government’s inter-temporal budget constraint framework), a set of alternative criteria/indicators have often been employed in the relevant evaluations. Monogios presents an analysis of fiscal policy sustainability in the post-2008 crisis period in Greece, based on the concept of the ‘Tax-gap’ for the short and the medium term. On the basis of this criterion, the conclusions of the technical analysis for current fiscal (and tax) policy are accompanied by brief thoughts and policy proposals aimed at improving public finance perspectives at a critical juncture for the country’s fiscal and economic future.

In the final chapter, “The Portuguese economy at the crossroads of the euro and globalization”, *Júlio Mota*, *Luís Lopes* and *Margarida Antunes* argue that the present situation in Portugal, more than revealing the fragility of the budgetary situation, mainly reflects the weakness of its productive structure. This weakness results from an economic policy that has favoured the non-tradable sector, and from the new conditions of global trade that have undermined Portuguese industry. These realities have resulted from the global economic model that was adopted in Portugal when it joined the EU as the European Single Market (ESM) was being launched. The adoption of supply-side and anti-inflationary policies through currency appreciation has conditioned the industrial sector renewal and particularly the export sector. These political guidelines were reinforced when the government decided that Portugal should be in the founding group of the European Monetary Union (EMU). Beyond this, international specialisation has also been penalised by the presence of new players in international trade and by the global productive processes. The authors conclude that the current crisis is accompanied by a repositioning of the state in the economy, reducing and weakening its capacity for manoeuvre. According to them, it is this same ideological bias that was present when, in the European institutions, the condition of Portuguese public accounts was identified as a major problem.

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