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# Strange Defeat

## How the New Consensus in Macroeconomics Let Austerity Lose All the Intellectual Battles and Still Win the War

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Macroeconomics in the United States today appears to be a site of intense controversy between supporters of more aggressive stimulus measures and supporters of austerity. These policy debates, while important, tend to obscure the strong methodological and theoretical consensus in the economics profession today. All major schools of mainstream macroeconomics are committed to a vision of the economy in which rational agents choose the optimal path over time, and in which any sources of instability are fully offset by a benevolent central bank, at least in normal times. These core intellectual commitments of modern economics have contributed to the weakness of efforts to reduce unemployment in the US and Europe. This paper first describes the intellectual failure of the most prominent arguments for austerity, and then argues that the deeper consensus in macroeconomics has nonetheless made it difficult to make consistent arguments for sustained deficit spending or for making lower unemployment a high priority relative to other macroeconomic goals.

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In 2010, policymakers in the advanced industrialised world pivoted sharply away from the Keynesian policies they had briefly espoused in the wake of the financial crisis of 2008-09. A confluence of economic and political events meant that the fragile consensus in favour of expanding government expenditure broke apart. Contributing factors included the sharp rise in public debt in much of Europe, largely due to government assumption of the liabilities of failing banks; the rise of "Tea Party" conservatives in the US following the November 2010 congressional elections; and the lack of a convincing political narrative about government expenditure. The Keynesian position was replaced, at least among elite policymakers, with a commitment towards fiscal consolidation and "austerity".

With the hindsight of three years it is clear that this historical recapitulation of the Keynesian versus "Treasury view" debate, 80 years after the original, and the consequent implementation of orthodox policies, was both tragic and farcical. Tragic, because fiscal retrenchment and rectitude prolonged depression conditions in the advanced economies and sentenced millions to the misery of unemployment. Farcical, because the empirical and theoretical foundations of wholesale austerity policies were almost comically weak. A few implausible and empirically questionable papers were used to provide the intellectual cover for the pivot, despite the fact that each, in turn, was quickly discredited both on their own terms and by real life events. As Mark Blyth (2013) put it, "Austerity didn't just fail – it helped blow up the world."

In the first part of this paper, we review some of the most influential academic arguments for austerity, and describe how they collapsed under scrutiny. In the second, we broaden the focus and consider the "new consensus" in macroeconomics, shared by most pro-stimulus economists as well as the "austerians". We argue that this consensus – with its methodological commitment to optimisation by rational agents, its uncritical faith in central banks, and its support for the norms of "sound finance" – has offered a favourable environment for arguments for austerity. Even the resounding defeat of particular arguments for austerity is unlikely to have much lasting effect, as long as the economics profession remains committed to a view of the world in which lower government debt is always desirable, booms and downturns are just temporary deviations from a stable long-term growth path, and in which – in "normal times" at least – central banks







can and do correct all short-run deviations from that optimal path. Many liberal, New Keynesian, and "saltwater" economists have tenaciously opposed austerity in the intellectual and policy arenas. But they are fighting a monster of their own creation.

### Introduction

In April 2013, an influential paper ("Growth in a Time of Debt") by Carmen Reinhart and Kenneth Rogoff (2010) that purported to show hard limits to government debt before causing sharp decreases in growth was the subject of an enormous amount of attention for the second time. Whereas in its first airing, the paper became a touchstone for the austerity movement across the advanced industrialised world, this time it was for less august reasons. Papers by Herndon, Ash and Pollin (2013) and by Dube (2013) showed the Reinhart-Rogoff study to have had serious mistakes in both construction and interpretation. This was not the first time that the academic case for austerity had been shown to be invalid or overstated. Two years earlier the major source of intellectual, support for immediate fiscal retrenchment was provided by another paper ("Large Changes in Fiscal Policy: Taxes Versus Spending"), again by two Harvard economists – Alberto Alesina and Silvia Ardagna (2009). This too was shown almost immediately to be deeply flawed, misapplying lessons from boom periods to periods of recession, wrongly attributing fiscal consolidation to countries undergoing fiscal expansion, wrongly applying the special conditions of small open economies to the world at large, and other egregious errors (IMF 2010; Jayadev and Konczal 2010).

Below, we examine the claims of these key papers and their logical and empirical failings. But the weakness of these papers invites a broader question: How could the wholesale shift to austerity have been built on such shaky foundations? While some of the blame must go to opportunism by policymakers and confirmation bias by politically motivated researchers, a large share of the blame rests with what is often called the "new consensus" in macroeconomic theory, a consensus shared as much by austerity's ostensible opponents as by its declared supporters.

The extent of the consensus in mainstream macroeconomic theory is often obscured by the intensity of the disagreements over policy, and by a certain confusion over labels. From the outside, the fact that macroeconomists can be classified as "New Keynesians" and "New Classicals" suggests that the fundamental philosophical debates of the 1930s continue to divide the profession. For those sympathetic to John Maynard Keynes' vision, the New Keynesians would logically seem to be on "their" side. In fact, however, the contending schools and their often heated debates obscure the more fundamental consensus among mainstream macroeconomists. Despite the label, "New Keynesians" share the core commitment of their New Classical opponents to analyse the economy only in terms of the choices of a representative agent optimising over time. For New Keynesians as much as New Classicals, the only legitimate way to answer the question of why the economy is in the state it is in, is to ask under what circumstances a rational planner, knowing the true probabilities of all possible future events, would have chosen exactly this outcome as the optimal one. Methodologically, Keynes' vision of psychologically complex agents making irreversible decisions under conditions of fundamental uncertainty has been as completely repudiated by the "New Keynesians" as by their conservative opponents.

In this piece, we refer to New Keynesian, "saltwater", and "liberal" (in the American sense) economists. While the first of these is a definite body of theory, the second is a broader world view, and the third is a political orientation, in practice they overlap heavily.[1] Whenever we use these terms, we are describing the left edge of the economic mainstream in the US currently, we are emphatically not describing the limits of potentially possible policy for the US currently, or of directions for legitimate economic inquiry. We are, however, describing a set of commitments shared by the vast majority of working macroeconomists and advanced students. There is a much wider field of economics beyond this consensus, from the postwar economics of Samuelson, Solow and Tobin, to the radical (or "heterodox") Keynesian economics kept alive at places like UMass-Amherst, The New School, and the University of Missouri-Kansas City, to the various traditions of Marxism. But since these schools currently have little or no influence on policy in the US or in Europe, they are outside the scope of this article.

One striking illustration of the consensus in modern macroeconomics is that the most effective theoretical counterpoint to the austerity position is provided not by cutting edge scholarship, but by a straightforward application of models that college students learn in their second year. Paul Krugman, for instance, most often makes his claims that "economic theory" has well-established answers to the problem of deep recessions, by referring to the investment saving-liquidity model (IS-LM). This was first written down by John Hicks in 1936. That it is being trotted out now as the public face of a professional economics to which it bears no resemblance, is remarkable. But it is perhaps less of a surprise when one recalls that the essential insights of Keynesian economics have long been banished from mainstream economics, to linger on only in "the Hades of undergraduate instruction" (Leijonhufvud 1981).

Modern macroeconomic theory is organised around intertemporal optimisation and rational expectations, while policy discussions are dominated by a commitment to the doctrines of "sound finance" and a preference for "technocratic" monetary policy conducted by "independent" central banks. The historical processes that led to these commitments are complex. For present purposes, what is important to note is that they severely limit the scope of economic debate. The need for "structural reform" and for long-term budget balance is agreed across the admissible political spectrum, from pro-austerity European conservatives to American liberals who savour the memory of Clinton era debt reduction. Even someone like Paul Krugman, who has been the foremost critic of austerity policies, treats the idea that governments do not face financing constraints, and that macroeconomic policy cannot be fully trusted to central banks, as special features of the current period of "Depression Economics", which must sooner or later come to an end. Mainstream Keynesians then become modern day Augustines: "Give me chastity and continence, but not yet".

### The Rise and Fall of Austerity Economics

In 2010, Alberto Alesina from Harvard University was celebrated by *Business Week* for his series of papers on fiscal consolidation. This was "his hour", the article proclaimed (Coy 2010). His surprising argument that the best way forward for countries facing high unemployment was to undertake "Large, credible and decisive spending cuts" was, for a while, on everyone's lips. Such cuts, he reasoned, would change the expectations of market participants and bring forward investment that was held back by the uncertainty surrounding policy in the recession. Specifically, Alesina and Ardagna (2009) purported to show that across a large sample of countries, governments had successfully cut deficits, reduced debts and seen higher growth as a result. The mechanism by which this occurs, enhancing the confidence of investors in countries with "credible" governments, thereby raising investment – has been derisively labelled "the confidence fairy" by Paul Krugman.

This idea of "expansionary austerity" – the notion that cutting spending would increase growth – is both an attack on traditional notions of demand management and also extraordinarily convenient for conservative macroeconomic policymakers. Not only would reducing the deficit and debt burdens of countries advance their long-term goal of reducing the size of the state, it would raise spending even in the short term, since the confidence effects of fiscal surpluses on private expenditure would more than offset any drag from the public sector contraction. Even better, consolidation was better according to Alesina and Ardagna (2009) if it was weighted towards spending cuts, rather than tax increases. As Coy (2010) notes "The bottom line: Alesina has provided the theoretical ammunition fiscal conservatives want."

As Blyth (2013) documents, this idea obtained immediate traction among policymaking elites and by mid-2010 the idea of deficit reduction in a period of weak demand (which might otherwise have been deemed nonsensical) was receiving support from high-level policymakers who spoke knowingly about the immediate need to restore "confidence" in the markets. Thus, for example Jean Claude Trichet, the president of the European Central Bank, observed:

> It is an error to think that fiscal austerity is a threat to growth and job creation. At present, a major problem is the lack of confidence on the part of households, firms, savers and investors who feel that fiscal policies are not sound and sustainable.[2]

As Blyth notes, while the argument for expansionary austerity was enthusiastically endorsed by policymakers (especially but not only in Europe), the intellectual case collapsed almost immediately. The paper was... "dissected, augmented, tested, refuted and generally hauled over the coals" (Blyth 2013). First, Jayadev and Konczal (2010) noted that none of the alleged cases of expansionary austerity occurred during recessions. They also noted that in some cases Alesina-Ardagna had misclassified periods of fiscal expansion as periods of fiscal consolidation. Immediately following this, the International Monetary Fund (IMF 2010) noted that the way in which Alesina-Ardagna had classified fiscal policy as being expansionary or contractionary seemed to have very little connection with actual fiscal policy changes. In terms of both effects and causes, the empirical work turned out to be valueless for policy.

Faced with mounting challenges to his work, Alesina appeared undeterred and defended his ideas while prognosticating on the future of Europe:

> In addition, what is unfolding currently in Europe directly contradicts Jayadev and Konczal. Several European countries have started drastic plans of fiscal adjustment in the middle of a fragile recovery. At the time of this writing, it appears that European speed of recovery is sustained, faster than that of the US and the ECB has recently significantly raised growth forecasts for the Euro area (Alesina 2010).

Three years on, this confident prognostication is an embarassment. *The Washington Post*, taking stock of the argument, concluded "No advanced economy has proved Alesina correct in the wake of the Great Recession" (Tankersley 2013). Not only did austerity not deliver higher growth: in the countries that tried it, output contracted more or less exactly in line with the degree of austerity they managed to impose (Degrauwe and Ji 2013).

But just as the case for short-term fiscal consolidation was disintegrating in the eyes of all but a few diehard believers, a new set of arguments became the intellectual bulwark of the austerity movement. As the Greek debt crisis spun out of control and interest rates on sovereign debt rose elsewhere in the European periphery, concern with public debt rose even in countries like the US, where bond markets were untroubled and yields on government debt remained at record lows. For respectable opinion, the question was when, and not if, government debt needed to be cut, if we don't want to "turn into Greece".[3]

It was at this point that the paper by Reinhart and Rogoff struck its mark. Using a panel of data on growth and government debt over many decades, Reinhart and Rogoff came up with a magic number – a 90% government debt to gross domestic product (GDP) ratio – beyond which economies faced a sharp drop-off in growth rates.

As with expansionary austerity, this argument caught on very quickly with policymakers. It was cited by David Cameron, Olli Rehn and Paul Ryan, among others, to justify a push for deep, immediate debt reduction. Unlike the Alesina-Ardagna paper, this one was not easily refuted. For one thing, the construction of the paper made it difficult for other researchers to try to replicate the results. But despite some early warnings about interpretations of the data (Bivens and Irons 2010; Ferguson and Johnson 2010), this difficulty was generally interpreted as a reason to defer to its findings rather than as a basis for scepticism. Second, and more insidiously, there is widespread agreement among mainstream economists that high government debt *must* eventually reduce growth, and so Reinhart and Rogoff's work was received without much critical scrutiny. The 90% threshold seemed to simply confirm a widely-accepted principle.







It is not surprising therefore that the errors in Reinhart and Rogoff's work were discovered by researchers decidedly out of the mainstream. Thomas Herndon, Michael Ash and Robert Pollin, all from the University of Massachusetts Amherst – a department that has been called the "single most important heterodox department in the country" – published a paper in April 2013 which showed that the Reinhart-Rogoff results were the consequence of coding errors and omissions and non-standard weighting of data. The 90% drop-off in growth disappeared when these errors were corrected.

Even more devastatingly, Arindrajit Dube (2013) (also from the University of Massachusetts) showed that if at all there was a correlation between debt and growth, it was more likely that episodes of low growth led to higher levels of debt rather than the other way around. Again, this counter argument had been made by opponents of austerity and could have easily been verified by supporters of austerity or Reinhart and Rogoff themselves, but simply had not been taken seriously.

With the key intellectual arguments for the austerity consensus falling apart before their eyes, the commentariat went into overdrive, speculating on the reasons why such policies could be adopted with such little vetting.

The media proposed various relatively benign reasons: confirmation bias, opportunism by politicians, etc. But while these were surely factors, they surely do not explain the catastrophic failure of the Economics profession to offer a rational basis for policy discussion.

James Crotty has provided a larger political economy framing of the austerity wars (2012). He suggests that austerian policies should be seen as class conflict – protecting the interests of the wealthy and attacking those of the poor, and that these battles should be seen as the latest skirmish in a longer war of ideas and priorities. Austerity, from this viewpoint, is less an intellectual failure than a deliberate choice reflecting the political dominance of finance capital and capital in general.[4]

Our purpose in this paper is to more deeply explore the battle of ideas and the extent to which the "macroeconomic consensus", shared by mainstream economists across the political spectrum, must take a large part of the blame. Many liberal "New Keynesian" economists have done yeoman work in making the political case for stimulus and against austerity. But they have not yet come to terms with the role their own theoretical and policy frameworks played in the turn to austerity – and continue to impede realistic discussion of the crisis and effective responses to it.

### The Hegemony of Consensus Macroeconomics

While there is much to admire in the doggedness of the UMass-Amherst team (and the alacrity with which a network of left-leaning bloggers and media figures publicised their results) the truth is that knocking down Alesina and Ardagna, and Reinhart and Rogoff's results was not difficult. The real question is, how was such crude work so successful in the first place?

The easy answer is that it was telling policymakers what they wanted to hear. But that lets the Economics profession off too easily. For the past 30 years the dominant macroeconomic models that have been in use by central banks and leading macroeconomists have had very little time and space for discussions of fiscal policy. In particular, the spectrum of models really ranged only from what have been termed real business cycle theory approaches on the one end to New Keynesian approaches on the other: perspectives that are considerably closer in flavour and methodological commitments to each other than to the "old Keynesian" approaches embodied in such models as the IS-LM framework of undergraduate economics. In particular, while demand matters in the short run in New Keynesian models, it can have no effect in the long run; no matter what, the economy always eventually returns to its full-employment growth path.

And while conventional economic theory saw the economy as self-equilibrating, economic policy discussion was dominated by faith in the stabilising powers of central banks and in the wisdom of "sound finance". Perhaps the major reason Reinhart and Rogoff's work went unscrutinised for so long is that it was only putting numbers on the prevailing consensus.

This is clearly seen when one observes that some of the same economists, who today are leading the charge against austerity, were arguing just as forcefully a few years ago that the most important macroeconomic challenge was reducing the size of public debt. More broadly, work like Alesina-Ardagna and Reinhart-Rogoff has been so influential because the New Keynesians in the Economics profession do not provide a compelling argument in favour of stimulus. New Keynesians follow Keynes in name only; they have certainly given better policy advice than the austerians in recent years, but such advice does not always flow naturally from their models.

There are two distinct failures here, one in economic theory and the other in discussions of economic policy.

### The Limited Support for Fiscal Expansion in 'Frontier' Theory

On a theoretical level, professional economists today are committed to thinking of the economy in terms of intertemporal optimisation by rational agents. In effect, the first question to ask about any economic outcome is, why does this leave people better off than any alternative? In such a framework, agents know their endowments and tastes (and everyone else,) and the available production technology in all future periods. So they know all possible mixes of consumption and leisure available to them over the entire future and the utility each provides. Based on this knowledge they pick, for all periods simultaneously ("on the 8th day of creation"), the optimal path of labour, output and consumption (Leijonhufvud 1981).

Given a framework in which an explanation in terms of optimisation is always the default, it is natural to think that unemployment is just workers making an optimal choice to take their leisure now, in the knowledge that they will be more productive in the future. In this view – mockingly termed the "Great Vacation" theory of recessions – stimulus is not only ineffective but unneeded, since the "problem" of high unemployment is actually what is best for everyone. Most economists would not accept this claim in its bald form. Yet they continue to teach their graduate students that the best way to explain changes in investment and employment is in terms of the optimal allocation of consumption and leisure over time. New Keynesians have spent a generation trying to show why the economy can move (temporarily) off the optimal path. The solution to these deviations is almost always found in monetary policy and only in very special circumstances can fiscal policy play a (limited) role.

De Grauwe (2010) distinguishes "Old Keynesian", "New Keynesian" and "Real Business Cycle (Ricardian)" models. He notes that the latter two "state of the art" frameworks are similar in their framing and methodological commitments. As he puts it:

> In the (Old) Keynesian model there is no automatic return to the long run output equilibrium. As a result, policy can have a permanent effect on output. The New Keynesian model, like the Ricardian model, contains a very different view of the economy. In this model fiscal policy shocks lead to adjustments in interest rate, prices and wages that tend to crowd out private investment and consumption. As a result, output is brought back to its initial level. In the Ricardian model this occurs very rapidly; in the New Keynesian models this adjustment takes time because of rigidities in wages and prices. But fundamentally, the structure of these two models is the same.

Moreover, in most cases, the "rigidities in wages and prices" in New Keynesian models are best handled by monetary policy. While these class of models are extremely large and varied, for the most part, in the New Keynesian approach, the key problem arises because periodically the interest rate generated by imperfect competition and pricing rigidities lead to a "wrong" real interest rate. As Simon Wren-Lewis argues:

> Once we have the 'wrong' real interest rate, then (using imperfect competition as a justification) New Keynesian analysis determines output and perhaps employment only from the demand side, and the determination of effective demand becomes critical to the model. Perhaps a better way of saying this is that if real interest rates are at their natural level, we do not need to think about demand when calculating output. In most cases, it is the job of monetary policy to try and get the economy back to this natural real interest rate. This gives you the key insight into why, ZLB problems apart, it is monetary rather than fiscal policy that is the primary stabilising policy (Wren Lewis 2012).

### New Keynesian Fiscal Policy

Indeed, the New Keynesian models that provide any support for fiscal policy only do so at the zero lower bound, where monetary policy has stopped being effective (And even here, the models can provide some tremendously counter-intuitive predictions that militate against common sense. For example, in the canonical model of policy at the ZLB, a payroll tax cut is contractionary, by the same logic that government expenditure is expansionary (Eggertson 2010). Since nobody actually believes this odd result – liberal economists universally supported payroll tax cuts as part of the Obama stimulus package in 2009, and bemoaned the demand-reducing effects of the cuts' expiration at the beginning of 2013 – it appears that even New Keynesians do not really believe their own models are useful guides to questions of stimulus and austerity.

Even if one does believe them, the truth is that New Keynesian models provide very little support for stimulus. With Ricardian equivalence built in, this is always going to be the case, but as Cogan et al (2010) show, the majority of these models provide very little empirical support for fiscal policy. Instead, the estimates of effectiveness of fiscal expansion coming from the wide array of these models were very small indeed.

Taken as a whole then, neither the New Classical nor New Keynesian theoretical approaches – those that dominate modern macroeconomics – afford a robust case for fiscal expansion. It is not surprising therefore that Keynesians seeking support for stimulus have "retreated" to older Keynesian frameworks like IS-LM. But this embrace of IS-LM is only for purposes of advocacy; in the journals and the graduate classrooms, New Keynesian models are as dominant as ever.[5]

On the specific question of government finances and the sustainability of debt, the analysis in any modern macroeconomics textbook is in terms of the intertemporal budget constraint. The core idea is that the present value of government spending across all future time must be less than or equal to the present value of taxation across all future time, minus the current value of government debt. This assumes that government must balance the budget eventually: After infinite time (this is how economists think), debt must go to zero. And it assumes that interest rates and growth rates cannot be changed by policy, and that inflation makes no difference – any change in inflation is fully anticipated by financial markets and passed through one-for-one to interest rates. At the same time, the budget constraint assumes that governments face no limit on borrowing in any given period. This is the starting point for all discussions of government budgets in economics teaching and research. In many graduate macroeconomics courses, the entire discussion of government budgets is just the working-out of that one equation.

But this kind of budget constraint has nothing to do with the kind of financial constraint the austerity debates are about. The textbook constraint is based on the idea that government is setting tax and spending levels for all periods once and for all. There is no difference between past and future – the equation is unchanged if you reverse the direction of time and simultaneously reverse the sign of the interest rate. This approach is not specific to government budget constraints, it is the way most matters are approached in contemporary macroeconomics. The starting point for most macroeconomic textbooks is the model of a "representative agent" allocating known production and consumption possibilities across an infinite time horizon.[6] Economic growth simply means that the parameters are such that the household, or planner, chooses a path of output with higher values in later periods than in earlier ones. Financial markets and aggregate demand are not completely ignored, of course, but they are treated as details to be added later, not part of the main structure.

One important feature of these models is that the interest rate is not the cost of credit or finance; rather, it is the rate of substitution, set by tastes and technology, of spending or taxing between different periods. The idea that interest is the cost of money, not the cost of substitution between the future and the present, was arguably one of the most important innovations in Keynes' General Theory. But it has disappeared from contemporary textbooks, and without it there is not even







the possibility of bond markets limiting government budget options. As soon as we begin talking about the state of confidence in the bond market, we are talking about a financial constraint, not a budget constraint. But the whole logic of contemporary macroeconomics excludes the possibility of government financial constraints. At no point in either of the two most widely-used macro textbooks in the US – Paul Romer's *Advanced Macroeconomics* and Blanchard and Fischer's *Lectures on Macroeconomics* – are they seriously discussed.

This framework at once overstates and understates the limits on government finances. On the one hand, it ignores the positive possibilities of financial repression to hold down the interest rate, and of growing or inflating out of debt,[7] and also the possibility – in fact certainty – that government debt can be held by the public permanently rather than being eventually paid off. But on the other hand, it also ignores reasons why governments might not be able to borrow unlimited amounts in any given period. (This goes for private budget constraints too.) The theory simply does not have any place for questions about government borrowing.

A faulty Excel spreadsheet was able to carry the field on stimulus and austerity because the economics profession had already limited itself to conceiving of the main problems of fluctuations as either desirable or easily solved by monetary policy. But the limits of modern macroeconomic theory are only half the problem. The other half is the policy implications promoted by consensus macroeconomics – specifically, the consensus that all the hard policy questions can be delegated to the central bank.

### The Preference for Technical Monetary Policy

In the view of consensus macroeconomics, Keynes was right that markets alone cannot ensure the full use of society's resources. But that is only because of a single wrong price, the interest rate. Let a wise planner set that correctly, and everything else will fall into place. Historically, this view owes more to Wicksell than to Keynes (Leijonhufvud 1987). But Wicksell was deeply worried by the idea that the market rate of interest, determined by the financial system, could depart from the "natural" rate of interest required to balance demands for present versus future goods. For him, this was a grave source of instability in any fully developed system of credit money. For modern economists, there is no need to worry: the problem is solved by the central bank, which ensures that the rate of interest is always at the natural rate. Lost in this updating of Wicksell is his focus on the specific features of the banking system that allow the market rate to diverge from the natural rate in the first place. But without any discussion of the specific failures that can cause the banking system to set the interest rate at the "wrong" level, it is not clear why we should have faith that the central bank can overcome those failures.

Nonetheless, faith in monetary-policy "Maestros" became nearly universal in the 1990s as the cult of Greenspan reached full flower in the US, the European Central Bank came into being as the commanding institution of the European Union, and central banks replaced government ministries as the main locus of economic policy in many countries. Respectable mainstream economists flirted with fatuity in their paeans to the wisdom of central bankers. In a somewhat ill-timed issue of the *Journal of Economic Perspectives*, Goodfriend (2007) argued that

> The worldwide progress in monetary policy is a great achievement that, especially when viewed from the perspective of 30 years ago, is a remarkable success story. Today, academics, central bank economists, and policymakers around the world work together on monetary policy as never before ... The worldwide working consensus provides a foundation for future work because it was forged out of hard practical lessons from diverse national experiences over decades, and because it provides common ground upon which academics and central bankers can work to improve monetary policy in the future.

Christina Romer (2007), a leading American New Keynesian who was soon to lead Barack Obama's Council of Economic Advisors, was even more obsequious in her praise for the wisdom of central bankers:

> The most striking fact about macropolicy is that we have progressed amazingly. ...The Federal Reserve is directly responsible for the low inflation and the virtual disappearance of the business cycle in the last 25 years. ...The story of stabilisation policy of the last quarter century is one of amazing success. We have seen the triumph of sensible ideas and have reaped the rewards...Real short-run macroeconomic performance has been splendid. ...We have seen a glorious counterrevolution in the ideas and conduct of short-run stabilisation policy.

This was, to put it mildly, an overstatement.

As far as the capabilities of central banks go, there is reason to doubt that they have the decisive influence on real economic outcomes that the conventional wisdom of the 2000s attributed to them. Short-term interest rates appear to have ceased having much effect on longer rates and on economic activity well before they reached zero. And if central banks could always guarantee full employment assuming positive interest rates, there would undoubtedly be ways to work around the problem of zero rates – committing to more expansionary policy in the future, intervening at longer maturities through quantitative easing, and so on. But while the US Federal Reserve and other central banks – such as the Bank of Japan – have tried many of these unconventional approaches, they have had little impact. This failure should raise serious questions about whether the effectiveness of conventional policy was also exaggerated. The relative stability of output and employment prior to 2008 may not have been, as widely believed, due to the skillful hand of central bankers on the economy's tiller, but to favourable conditions that were largely outside their control. And in any case, that stability is easy to exaggerate. In the US and Europe, the so-called "Great Moderation" featured asset bubbles and long "jobless recoveries," while in much of the developing world it witnessed a series of devastating financial crises and repeated collapses in employment and output.

For economists who received their training under the monetarist consensus that has dominated policy discussions since the 1980s, the terms "effective demand failure" and "monetary policy error" were practically synonyms. This notion that the central bank can achieve any level of money expenditure that it wishes has always been a matter of faith rather than reason or evidence. But it was a very convenient faith, since it allowed the consensus to remove the most contentious questions of macroeconomic policy from the democratic process, and vest them in a committee of "apolitical" experts.

And that is the other problem with the cult of the central bankers: They have never really been apolitical. Mainstream economists have made the disinterestedness of central banks into an axiom – in standard macro models, the "reaction function" of monetary policy has the same status as an objective fact about the world as, say, the relationship between unemployment and inflation. It is taken for granted that while elected officials may be corrupt or captured by particular interests, central bankers are disinterested technicians who only want what is best for everyone, or at least always follow their stated rules. For prominent liberal economists like Alan Blinder (who served on the Fed board under President Clinton), the performance of "apolitical" central banks is so exemplary that it becomes an argument against political democracy in general:

> We have drawn the line in the wrong place, leaving too many policy decisions in the realm of politics and too few in the realm of technocracy. ...the argument for the Fed's independence applies just as forcefully to many other areas of government policy. Many policy decisions require complex technical judgments and have consequences that stretch into the distant future. ...Yet in such cases, elected politicians make the key decisions. Why should monetary policy be different? ... The justification for central bank independence is valid. Perhaps the model should be extended to other arenas. ...The tax system would surely be simpler, fairer, and more efficient if...left to an independent technical body like the Federal Reserve rather than to congressional committees (Blinder 1987).

The idea of leaving hard questions to "independent technical bodies" is seductive. But in practice, "independent" often means independent from democratic accountability, not from the interests of finance. Private banks have always had an outsize influence on monetary policy. In the early 1930s, according to economic historians Gerald Epstein and Thomas Ferguson, expansionary monetary policy was blocked by pressure from private banks, whose interests the Fed put ahead of stabilising the economy as a whole (Epstein and Ferguson 1984). More recently, in the 1970s and 1980s, for the Fed of this era, holding down wages was job number one, and they were quite aware that this meant taking the side of business against labour in acute political conflicts. And when a few hi-profile union victories, like the 1997 successful strike of UPS drivers, briefly made it appear that organised labour might be reviving, Fed officials made no effort to hide their displeasure:

> I suspect we will find that the [UPS] strike has done a good deal of damage in the past couple of weeks. The settlement may go a long way toward undermining the wage flexibility that we started to get in labor markets with the air traffic controllers' strike back in the early 1980s. Even before this strike, it appeared that the secular decline in real wages was over (quoted in Mitchell and Erickson 2005).

Europe today offers the clearest case of "independent" central banks taking on an overtly political role. The ECB has repeatedly refused to support the markets for European sovereign debt, not because such intervention might fail, but precisely because it might work. As Deutsche Bundesbank president Jens Weidmann put it last year, "Relieving stress in the sovereign bond markets eases imminent funding pain but blurs the signal to sovereigns about the precarious state of public finances and the urgent need to act" (*Financial Times*, 7 May 2012). In a letter to the *Financial Times* (1 June 2012), one European bank executive made the same point even more bluntly: "In addition to price stability, [the ECB] has a mandate to impose structural reform. To this extent, cyclical pain is part of its agenda." In other words, it is the job of the ECB not simply to maintain price stability or keep Europe's financial system from collapsing, but to inflict "pain" on democratically elected governments in order to compel them to adopt "reforms" of its own choosing.

What the ECB means by "reforms" was made very clear in a 2011 memo to the Italian government, setting out the conditions under which it would support the market in Italian debt. The ECB's demands included "full liberalisation of local public services…particularly…the provision of local services through large scale privatizations"; "reform [of] the collective wage bargaining system...to tailor wages and working conditions to firms' specific needs..."; "thorough review of the rules regulating the hiring and dismissal of employees"; and cuts to private as well as public pensions, "making more stringent the eligibility criteria for seniority pensions" and raising the retirement age of women in the private sector[8] (quoted in *Corriere della Serra*, 29 September 2011).

Privatisation, weaker unions, more employer control over hiring and firing, skimpier pensions. This goes well beyond the textbook remit of a central bank. But it makes perfect sense if one thinks that central banks are not the disinterested experts but representatives of a specific political interest, one that stands to gain from privatisation of public goods and weakened protections for workers.

Certainly many economists do not support the kind of slash-and-burn "reform" being promoted by the ECB. But for the most part, consensus macroeconomics endorsed the delegation of all macroeconomic policymaking to central banks, insisted that monetary policy was a matter for technical expertise and not democratic accountability, and downplayed the real conflicting interests involved. This opened the way to a power grab by the central banks, on behalf of the owners of financial wealth who are their natural constituents.

The theoretical commitment to an economy where markets optimally arrange work, consumption and investment across all time, and the practical commitment to central banks as sole custodians of macroeconomic policy: These were undoubtedly the two most important ways in which the New Keynesian mainstream of economics prepared the way for the success of the austerian Right. A third contribution, less fundamental but more direct, was the commitment of economists to the tenets of "sound finance".

### Commitment to 'Sound Finance'

The term "sound finance" was adopted in the 1940s by the pioneering American Keynesian Abba Lerner, to describe the view that governments are subject to the same kind of budget constraints as businesses and households, and should therefore guide their fiscal choices by the dangers of excessive debt.





He contrasted this view with his own preferred approach, "functional finance", which held that government budget decisions should be taken with an eye only on the state of the macroeconomy. High unemployment means higher spending and lower taxes are needed, high inflation the opposite; the government's financial position is irrelevant.

Consensus macroeconomics has a strong commitment to the idea of sound finance. But this commitment is more reflexive, emotional or psychological than based on any coherent vision of the economy. As a resut, liberal, "saltwater" economists waver between incompatible views depending on the rhetorical needs of the moment. On the one hand, when stimulus is required, they dismiss the idea of financial constraints, and reject the idea of some threshold above which the costs of pubic debt rise precipitously. This was the heart of the Reinhart and Rogoff dispute, and the 90% threshold was the (disproven) cliff. But on the other hand, they invoke the very same cliffs when arguing for surpluses in good times that they dismiss when arguing for stimulus in bad ones.

This idea that the inflationary constraint on government spending is logically the primary constraint on government spending is rarely promoted. Instead appeals to unobservable "cliffs", nonlinearities and future collapses in confidence dominate the conversation about government spending. The then ECB President Jean-Claude Trichet was roundly attacked by the pro-stimulus economists for arguing, in 2010, in the depths of Europe's recession, that it was time to cut deficits and raise interest rates, on the grounds that:

> the economy may be close to non-linear phenomena such as a rapid deterioration of confidence among broad constituencies of households, enterprises, savers and investors. My understanding is that an overwhelming majority of industrial countries are now in t hose uncharted waters, where confidence is potentially at stake. Consolidation is a must in such circumstances (Trichet 2010).

As the critics rightly pointed out, there is no evidence or systematic argument for these "nonlinear responses". The Reinhart-Rogoff paper was intended to provide exactly such evidence; its usefulness to conservative policymakers like Trichet was undoubtedly part of the reason for its success. The problem is the collapse of Reinhart-Rogoff has hardly touched the larger vision of even the richest countries' governments as perpetually teetering on the edge of a financial cliff. And one reason for the persistence of this vision is that it is shared by many of Reinhart-Rogoff's liberal critics.

Here again is Christina Romer – one of the country's leading "Keynesian" economists – arguing in 2007 that the biggest macroeconomic problem facing the country is that policymakers are not sufficiently worried about holding down government debt. True, she admits, there is no direct evidence that high public debt has caused any problems so far. But

> It is possible that the effects of persistent deficits are highly nonlinear. Perhaps over a wide range, deficits and the cumulative public debt really do have little impact on the economy. But, at some point, the debt burden reaches a level that threatens the confidence of investors. Such a meltdown and a sudden stop of lending would unquestionably have enormous real consequences (Romer 2007).

Soon after giving this speech, Romer would be one of the leading advocates within the Obama administration for a larger stimulus bill. Lined up against her were economists such as Larry Summers and Peter Orszag. The conservatives' arguments in that debate recapitulated the language Romer herself had been using less than two years before. Summers, in a contemporary account, "believed that filling the output gap through deficit spending was important, but that a package that was too large could potentially shift fears from the current crisis to the long-term budget deficit, which would have an unwelcome effect on the bond market" (Lizza 2009).

Mainstream New Keynesian economists want to argue that lack of fiscal space is never a constraint on stimulus in bad times, but that gaining fiscal space is a reason to run surpluses in good times. Logically, these two views are contradictory. After all, "With low debt, fiscal policy is less costly" and "With high debt, fiscal policy is more costly" are just two ways of saying the same thing. But the mainstream of the economics profession has so far failed to face up to this contradiction. Liberal American economists seem unable to accept that if they give up the idea of a threshold past which the costs of public debt rise steeply, they must also give up the main macroeconomic argument in favour of the Clinton surpluses of the 1990s. Most critics of austerity are reluctant to admit that if high debt is not a constraint on stimulus in bad times, then it is not sensible to talk about "paying for" stimulus with surpluses in good times. Instead, they remain committed to the idea that government surpluses are definitely, absolutely needed – not now, but at some point in the future, they say. But that only cedes the moral high ground to the principled austerians who insist that surpluses are needed today.

### The Problem Is in the Economics Profession

In the stimulus vs austerity wars of the past four years, the New Keynesians who make up the left wing of the mainstream consensus have undoubtedly been on the right side of many big policy questions. Case by case, they certainly have the better arguments. But they have no vision. And so their victories over Alesina-Ardagna or Reinhart-Rogoff, count for much less than you might expect, since in the end, the vision of the economy, of the economics profession, and of economic policy hardly differs between the two camps. Alternative views of the macroeconomy exist, but they are simply ignored.

In this light, it is interesting to compare Krugman's 2009 *New York Times* magazine piece with his 2013 *New York Review of Books* piece. In the earlier article, while he has plenty of criticism of politicians, he makes it clear that the insidious problem is in economics profession. Even the best economists, he writes, prefer mathematical elegance to historical realism, make a fetish of optimisation and rational expectations, and ignore the main sources of instability in real economies. In 2009, Krugman was scathing about "the profession's blindness to the very possibility of catastrophic failures in a market economy", and made it clear that better policy would require better economics. He was unsparing – and insightful – about his own school as well as his opponents. The New Keynesian models used by "saltwater" economists like himself, he wrote, still "assume that people are perfectly rational and financial markets are perfectly efficient." He was scornful of the all-purpose excuse that "no one could have predicted", insisting that the world faced "disasters that could have been predicted, should have been predicted".

In the 2013 piece, this self-critical tone is gone. Now, the economics profession as a whole is almost completely exonerated. Their "failure to anticipate the crisis", he writes, "was a relatively minor sin. Economies are complicated, ever-changing entities; it was understandable that few economists realised" the fragility of the system before the crisis. Instead, his fire is all aimed at politicians, who "turned their back on practically everything economists had learned". The economists who have given intellectual support for austerity are reduced in this telling to a few outliers, a marginal clique. As a whole, he now says, the profession understands the problem properly; the lack of a proper solution is a sign of "just how little good comes from understanding". Building a better economics seemed both urgent and promising in 2009; four years later, that project has been abandoned.

**Conclusions**

It is too easy to dismiss the idea of the pivot to austerity as being the failure of flawed papers or as political opportunism alone. Such an analysis misses the fact that, for the majority of the economics profession, the ideas of stimulus and especially fiscal policy have always been intellectually uncomfortable while the arguments for austerity and sound finance come naturally. A conception of macroeconomic dynamics in which the economy was by its nature unstable and central banks could not be relied on to stabilise it was difficult even to describe in the language of the mainstream. This state of affairs is what Gramsci would identify as hegemony.

The 2008 financial crisis and the multiple subsequent crises it engendered did seem to shake that hegemony. For a brief period, it became obvious that writers such as Keynes, Bagehot, Minsky and even Marx had much more to provide in terms of explanation and solutions than were available from the kind of macroeconomic taught in graduate classes and published in the top journals. But as time has gone on and memories of the crisis have faded, the consensus has reasserted itself. Nowhere, perhaps, has this been more evident, and more consequential, than in the austerity wars.

If Krugman got it right the first time and macroeconomists have no answers to today's urgent questions, and not just that politicians will not listen to them – the question, then, is what is to be done? There are those who argue that there is nothing intrinsically wrong with the ways in which macroeconomics is studied, that it is just a matter of adding a few more frictions. But this is simply the traditional cherished belief of intellectual endeavours that the discipline always improves on itself. As any historian of ideas might suggest, this narrative of continuously closer approximation to the truth is often a myth, and intellectual "progress" is often down a blind alley or wrong turn.

In Axel Leijonhufvud's eloquent essay on the value of studying the history of economic thought (Leijonhufvud 2002), he offers the metaphor of a traveller who finds himself at a dead end in the road. If he is very bold, he might try to scale the walls (or bushwhack through the forest) blocking the path. But often, it is better to backtrack, to see if there was a turnoff somewhere earlier on the road that looked less promising at the time but in retrospect might have been a better choice. This, he suggests, is the situation of economics today. In this case, further progress means, first of all, looking back to earlier points in the discipline's evolution to see what of value might have been overlooked.

How far back we need to go – how long ago did economics take the wrong turn that led us to the current impasse? Was it 40 years ago, when the rational expectations revolution overturned Gordon's "Economics of 1978", which had less faith in central banks and was perhaps better suited to describing economies as systems evolving in time? Or was it 75 years ago, when Keynes' radical insights about fundamental uncertainty and the inherent instability of the capitalist investment process were domesticated by writers like Hicks and Samuelson in the neoclassical synthesis? Or was it 150 years ago, when the classical tradition of Ricardo and Marx – with its attention to dynamics, and central concern with distributional conflict – was displaced by the marginalist approach that made economics primarily about the static problem of efficient allocation? We do not here suggest that there is nothing worth keeping in the current macroeconomic canon, but we think these earlier traditions suggest important routes forward that have been abandoned. Indeed, those economists who worked in alternative traditions (Minskyan, Post-Keynesian, Marxist, and even Austrian) had a much more robust vocabulary for making sense of the crisis and the responses to it.

The industrialised world has gone through a prolonged period of stagnation and misery and may have worse ahead of it. Probably no policy can completely tame the booms and busts that capitalist economies are subject to. And even those steps that can be taken will not be taken without the pressure of strong popular movements challenging governments from the outside. The ability of economists to shape the world, for good or for ill is strictly circumscribed. Still, it is undeniable that the case for austerity – so weak on purely intellectual grounds – would never have conquered the commanding heights of policy so easily if the way had not been prepared for it by the past 30 years of consensus macroeconomics. Where the possibility and political will for stimulus did exist, modern economics – the stuff of current scholarship and graduate education – tended to hinder rather than help. While when the turn to austerity came, even shoddy work could have an outsize impact, because it had the whole weight of conventional opinion behind it. For this the mainstream of the economics profession – the liberals as much as the conservatives – must take some share of the blame.

**NOTES**

1 For the purposes of this article, "liberal" refers to the left side of mainstream US politics, as opposed to conservative. "New Keynesian" refers to a particular methodology in macroeconomics, which combines the Walrasian general-equilibrium framework of neoclassical economics with a specific set of "frictions" that allow for superficially Keynesian results in the short run, including some form of aggregate demand. This is opposed by "New Classical" economists, who believe that the long-run models they and the New Keynesians share should be used for the short run as well. "Saltwater" refers to one side of a sociological divide within the economics profession, with saltwater economists more eclectic, more willing to modify their models as needed to describe particular events or support particular policies, while "freshwater" economists are more committed to logically consistent reasoning from first principles.





2 See European Central Bank, Interview with Jean-Claude Trichet, President of the ECB, and *Liberation*, 8 July 2010.

3 For example, Laurence Kotlikoff (2011) – a respected financial economist – argued, "The financial sharks are circling Greece because Greece is small and defenceless, but they'll soon be swimming our way."

4 It is interesting in this regard that a recent paper by the IMF addresses the distributional effects of austerity (Ball et al 2013). The abstract alone confirms the Crotty viewpoint: "This paper examines the distributional effects of fiscal consolidation. Using episodes of fiscal consolidation for a sample of 17 OECD countries over the period 1978-2009, we find that fiscal consolidation has typically had significant distributional effects by raising inequality, decreasing wage income shares and increasing long-term unemployment. The evidence also suggests that spending-based adjustments have had, on average, larger distributional effects than tax-based adjustments".

5 For a sense of what a serious academic development of "IS-LM-style" models could look like, the best starting point is probably the work of Lance Taylor, particularly *Reconstructing Macroeconomics* (Taylor 2004).

6 It is somewhat ironic that the specific growth model that is most often used is the version developed by Robert Solow, since Solow himself is quite critical of the turn towards intertemporal optimisation as the core methodology of macroeconomics. http://www.nobelprize.org/nobel_prizes/economics/laureates/1987/solow-lecture.html

7 This is also ironic because Reinhart and Rogoff have both argued (albeit unenthusiastically) for financial repression or inflation.

8 See also the discussion on the Triple Crisis blog: http://triplecrisis.com/from-technocrats-to-autocrats/

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