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# Fiscal Challenges and the Great Recession

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**Fiscal Challenges and the Great Recession***

by

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## I. Introduction

To some extent the consequences of the economic crisis, that accompanied and followed the 2008 financial crisis, are still being felt especially in the advanced countries: unemployment remains high in several countries, although it has been falling in most of them; growth is lower than desirable; fiscal imbalances remain high; and, according to the latest statistics from Eurostat and from the IMF, public debts are still rising in many countries as shares of GDPs. For the world as a whole, the share of public debt into the world's GDP has reached a historical record. These developments continue to generate debates among experts on the kind of policies the countries' governments should be promoting, now and in future years. As is often the case, in debates in economics, the difference in views is wide.

Just how wide that difference is can be appreciated by citing a blog, by Paul Krugman, from November 16, 2013. Strongly endorsing views that had been expressed a few days earlier by Larry Summers, at a research seminar at the IMF, he wrote that we are in a "liquidity trap" in which the "natural" rate of interest, the rate that in his view would equate saving and investment, presumably for the United States, has become "negative" and where "the normal rules of economic policy don't apply", because "the [US] economy remains deeply depressed ". Due to this *depressed* state of the economy, "more spending *of any kind* [productive or unproductive] is good for the economy". Italics added. He added that: "the panic over public debt looks … foolish … [because] servicing the debt … has no cost [in the United States] in fact [it has a] negative cost". His message for governments was to spend, the more the better. Some other commentators, including Martin Wolf, in a column in The Financial Times , endorsed Krugman's views.

The above statements must be related to the US fiscal situation. In 2013, the latest year for which final fiscal data for the *general* government are available, the US overall government balance (the fiscal deficit) was 7.3 percent of GDP and the gross debt had reached 104.5, well over that for the European Monetary Union, which was 95.2 percent of its GDP. The deficit has been coming down from the extraordinary peak level of 14,7 percent of GDP, reached in 2009, in part because of the expiration of the tax cuts, that had been introduced in earlier years by President Bush, the sequestration of some public spending in 2013, and the economic recovery underway. However, in 2014 the public debt of the *general* government of the United States would keep rising and the fiscal deficit is expected to be close to 6.4 percent of GDP. In the euro area, these variables are expected to be 95.6 and 2.6 of GDP respectively in 2014. The data are from the April 2014 Fiscal Monitor of the IMF.

The policymakers of various countries and many experts have continued to worry about the fiscal developments, both in the United States and elsewhere, including Europe, and about the medium and long run impact of the current fiscal and monetary policies. It is, thus, natural to ask what fiscal and monetary policies would be prudent for the countries to follow, now and over the medium run, to improve the economic *and* fiscal situation and to exit permanently from the crisis. Should they continue with (and even intensify) the current policies, that are still associated with large fiscal deficits and growing public debts and exceedingly low interest rates; or, even intensify those policies, as Krugman and Summers believe would not be helpful, given the "depressed state of the economy"? Or should the countries go back to more orthodox policies?

The terms that have been used, by some of the participants in this debate, to define the policies, are a bit unorthodox to say the least. For example, the "deeply depressed" US economy is in fact growing at better than 2 percent per year and the unemployment rate has been falling rapidly. As a matter of fact the so-called "austerity" policies, in the US and in several other countries, have little resemblance to how a dictionary would define that term. In 2013, the governments of most, though not all, countries were spending more, as shares of their GDPs, or even in absolute amounts, than they were in 2007, the year before the crisis. In some countries they were spending much more. See Table 1 for the shares of public spending into GDPs in selected recent years.

In 2007, the last year of a long and significant bubble, both public and private spending, had been inflated by the bubble which had been fed over several years by unusually low interest rates and by the large acquisition of sovereign bonds (especially by China). These developments had distorted, in an upward direction, both the growth rates of the economies of several countries and also their tax revenue. Therefore, when judging developments over the years, both the income levels of the countries and the fiscal accounts, should be adjusted, to correct them for the positive impact on them of the bubble in the years before the crisis, in order to allow realistic comparisons with later years. In some countries (Spain, Portugal, Ireland, Iceland and, to some extent, even in the US and the UK) the corrections needed could be significant. For some elaboration of this point, see Tanzi, 2012.

Table 1. Public Spending in Selected Years

(Percentages of GDP)

| | 2007 | 2009 | 2013 |
|---|---|---|---|
| Australia | 34.5 | 38.1 | 37.3 |
| Belgium | 48.2 | 53.7 | 54.4 |
| Canada | 38.6 | 43.4 | 44.5 |
| Denmark | 50.9 | 58.0 | 57.7 |
| Finland | 47.4 | 56.1 | 58.6 |
| France | 52.6 | 56.8 | 57.1 |
| Germany | 43.5 | 48.2 | 44.7 |
| Greece | 47.5 | 54.0 | 47.3 |
| Ireland | 36.7 | 48.3 | 43.1 |
| Italy | 47.6 | 51.9 | 50.8 |
| Japan | 33.3 | 40.0 | 40.0 |
| Netherlands | 45.3 | 50.8 | 50.7 |
| New Zealand | 34.1 | 37.3 | 35.7 |
| Portugal | 44.4 | 49.8 | 48.2 |
| Slovak Rep. | 30.5 | 41.6 | 36.6 |
| Slovenia | 40.2 | 46.2 | 55.9 |
| Spain | 39.1 | 46.3 | 45.1 |
| Sweden | 51.0 | 54.9 | 52.9 |
| Switzerland | 33.4 | 33.2 | 33.3 |
| United Kingdom | 39.8 | 46.8 | 43.5 |
| USA | 35.5 | 42.8 | 38.0 |
| Euro Area | 46.0 | 51.2 | 49.9 |

Source: IMF, Fiscal Monitor. April, 2014

## II. Links Between Public Spending and Wellbeing

It may be useful to provide some historical statistics to correct some perceptions of where many countries came from and where they are now, on the *historical and global fiscal map*. For details, see Tanzi, 2011. Without such a map there is the danger of believing, as it seems to have happened to Columbus when he reached America, that you have landed in India when, in fact, you have reached a new unknown land. The *fiscal* continent that had been reached in recent years was definitely an unknown land. How unknown it was can only be seen with the help of historical data.

Just before the Great Depression, in 1929, the level of public revenue and of public spending for the general government of the United States was around 11 percent of GDP. As late as 1940, in Sweden, the country that came to epitomize the welfare state, that level was still only around 15 percent of GDP. By the year 2013 public revenue in the USA had reached 31 percent and public spending was 38 percent of GDP, a significant part of it was financed by debt. In Sweden, both levels were higher than 50 percent of GDP in 2013.

For OECD countries, as a group, the average *tax* level increased from around 24 percent in 1965 to over 35 percent in recent years. However, in several European countries (Austria, Belgium, France, Italy, the Netherlands, and most of the Scandinavian countries) the tax burden was well over 40 percent of GDP and the spending level exceeded 50 percent of GDP. For the euro area, in 2013, general government revenue was 47 percent of GDP and the spending level was 50 percent. These statistics indicate how much the economic role of the state had grown over recent decades. They must be kept in mind when countries are advised or pushed to further increase their public spending. Short run developments should not blind us to long run dangers.

According to statistics provided by the OECD, the highest tax levels in the OECD countries were reached in the last decade of the 20$^{th}$ Century and not in the first decade of the 21$^{th}$ Century. In the latter decade, because of growing resistance by taxpayers to higher taxes and because of growing tax competition among countries, the tax levels had stopped growing before the financial crisis arrived. In several countries the tax levels had been reduced, in some significantly, and had been progressively replaced by public borrowing. However, as already mentioned, the economic bubble, that had characterized the years *before* the "Great Recession", had significantly (but temporarily) contributed to tax revenues, pushing them above the level they would have reached without the effects of the bubble, in the countries affected by the bubble. In other words, the bubble had created "revenue windfalls" giving the impression that the fiscal accounts of the affected countries were in better shape then they actually were. See also Tanzi, 2013. The "tax windfalls" were bound to disappear, once the bubble burst and the bubble could not go on forever. When the bubble burst, the revenue lost would be magnified by the impact of the "Great Recession" on the economy. These developments, by themselves and apart from the increases in public spending, contributed to the sharp increase in fiscal deficits when the crisis started.

Some observers might consider as normal the increase in taxes, in public spending, or even that in public debt that had occurred in recent decades. Some theories, as for example the ones that go under the names of the *Wagner's Law* and *the Baumol's Effect*, had predicted that, as countries developed and became richer, they would require an increasing role of the state in their economy, thus leading to higher public spending as a share of GDP. Therefore, a correlation should be expected to exist between the levels of public spending and per capita incomes among countries, at least up to some limit. However, it should be obvious that public spending, as a share of GDP, cannot be expected to keep growing forever, without at some point, eliminating completely private sector activities and destroying individuals' incentives. Therefore, while such a correlation exists when <u>all</u> countries (rich and poor) are taken together, it does not exist among the group of rich countries, when they are taken as a separate group. For these countries, policies play a major role. Among the rich countries there are some (Austria, Belgium, Denmark, Finland, France, Italy, Netherlands, Sweden, or even Greece) in which, in recent years, public spending exceeded 50 percent of the countries' GDPs and there are some other countries (Australia, New Zealand, Switzerland, Canada), which have been spending far less. There are also some (Korea, Singapore, Taiwan, Hong Kong) where the public spending is as little as 20 percent of their GDP. Surprisingly, the lower spending countries have also lower public debts and lower fiscal deficits than the high spending ones.

Some might argue that higher public spending is desirable, because it promotes wellbeing for the citizens, even if it might lead to occasional macroeconomic difficulties. Others might argue that higher public spending would be desirable in today's circumstances, because it would promote growth and prevent "secular stagnation". These arguments are at the center of the current debate, on what countries should do to exit from the crisis. We shall analyze these arguments in turn, starting with the welfare question. It ought to be stressed that, in discussing these arguments, economic theory is often less helpful than one would hope. For this reason, the arguments presented are based on intuition, experience, and available data, and not on theoretical considerations.

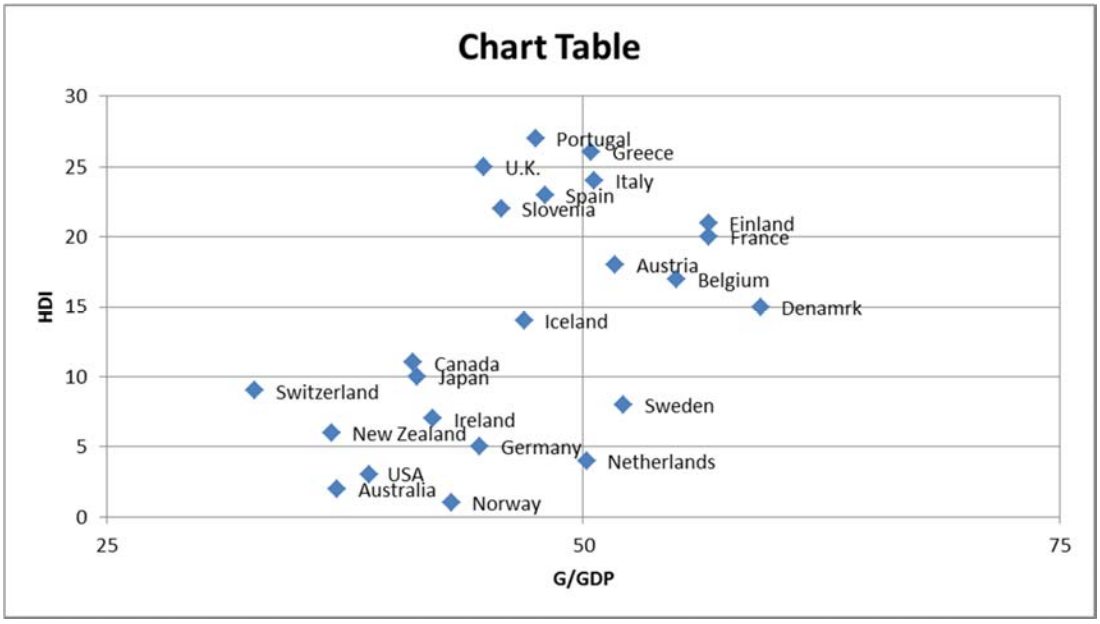
Let us consider first the "Human Development Index" (HDI) an indicator of *wellbeing* prepared annually by the UNDP. The HDI has had the input of some important economists, including the late Mahbub ul Haq and the Nobel Prize Winner Amartya Sen. The HDI "measures" some important aspects of countries' "human development". The index for 2012 that we use was published in 2013, in the UNDP Annual Report. The rankings of the countries by the HDI are reported in Table 2, together with the shares of the countries' public spending into their GDPs for the same year. The spending shares are shown in the table, in descending order, starting with the country with the highest share. For the HDI, the lower is the index the higher is estimated to be the country's "human development". The best score, (number 1), is that of Norway, followed by that of Australia (number 2) and so on. The shares of public spending into GDPs for 2012, shown in Table 2, were obtained from the IMF, Fiscal Monitor.

The table shows a broadly *negative* relationship between the HDI indexes and the levels of public spending for the richest countries. Spending more, after some given level is reached, does not seem to make countries achieve better HDI scores. In order not to raise questions about the relationship, South Korea, Hong Kong, Taiwan, and Singapore have been excluded from Table 2, and from the accompanying chart, because these countries achieve relatively good HDI rankings with unusually low shares of public spending into GDPs. Some might have argued that these economies have unusual features that might make them not good representative of the sample of developed countries.

The scatter diagram, shown in the chart, confirms visually the conclusion that, for rich countries, the relationship between the share of public spending into GDP and the level of “human development” achieved tends to be negative. The countries that have the best HDIs are largely countries with relatively lower shares of public spending. The countries with the highest levels of public spending do not do as well, in the indexes prepared by the UNDP.

Table 2. Public Spending (G) as Shares of GDP and Human Development Indexes (HDI) for 2012

| Countries | G/GDP | HDI |
|---|---|---|
| Denmark | 59.3 | 15 |
| Finland | 56.6 | 21 |
| France | 56.6 | 20 |
| Belgium | 54.9 | 17 |
| Sweden | 52.1 | 8 |
| Austria | 51.7 | 18 |
| Italy | 50.6 | 24 |
| Greece | 50.4 | 26 |
| Netherlands | 50.2 | 4 |
| Spain | 48.0 | 23 |
| Portugal | 47.5 | 27 |
| Iceland | 46.9 | 14 |
| Slovenia | 45.7 | 22 |
| United Kingdom | 44.8 | 25 |
| Germany | 44.6 | 5 |
| Norway | 43.1 | 1 |
| Ireland | 42.1 | 7 |
| Japan | 41.3 | 10 |
| Canada | 41.1 | 11 |
| United States | 38.8 | 3 |
| Australia | 37.1 | 2 |
| New Zealand | 36.8 | 6 |
| Switzerland | 32.8 | 9 |



An alternative way of addressing the question of whether higher public spending leads to higher well-being is by using a methodology originally suggested and applied in a paper by Tanzi and Schuknecht, 1997. This methodology was later used, in modified and more elaborated versions, in papers by Alonso, Schuknecht, and Tanzi, in 2005 and 2010 and has been used recently by other economists. The basic aim of this methodology is to try to connect the levels of public spending by countries with a large range of socio-economic indicators that, presumably, governments want to influence in desirable directions, through their actions and especially with their public spending programs. Examples of these indicators are: the unemployment rate, the income distribution, the poverty rate, literacy or human capital, the rate of growth of the economy, the rate of inflation, life expectancy or some other health indicators, the extent of "red tape", the quality of infrastructure, and some others. The methodology makes unavoidable assumptions; for example it gives equal weight to the indicators, an assumption that might be questioned, but that is hard to avoid, unless one replaces it by other assumptions, such as that of assigning arbitrary weights to the indicators.

Once again, the result, obtained for a large sample of advanced countries, is that at best there does not seem to exist a positive correlation between levels of public spending and the *desirable* levels reached by the socio-economic indicators. In fact, rich countries with relatively lower levels of public spending (Switzerland, Australia, Japan, the United States, Norway, Canada, and some others) seem to do better, in terms of these indicators, than countries in which governments spend much more. There is a parallel between the results achieved using this methodology and that using the HDI results. The cited articles should be consulted for the specific results. It should be stressed that this is a kind of performance related methodology for assessing the impact of public spending on wellbeing.

A further indirect evidence, that more public spending does not necessarily lead to more well-being, as the latter is defined by the HDIs or by the socio-economic indicators, is provided by countries that at some point in time reduced *significantly* the share of public spending, accompanying that reduction with well thought out, pro-market, structural reforms that did not require more public spending. For examples, see Chapter 13, in Tanzi, 2011. That chapter describes the reforms carried out by the European Nordic Countries and especially by Sweden in the 1990s, after four years of deep recession. In some of these countries, the reductions in spending were remarkably large, certainly much larger than those that the international organizations have been suggesting to some of their member countries facing fiscal difficulties. For example, between 1992 and 2007, the year before the arrival of the financial crisis, Sweden had reduced the share of its public spending into GDP by 16.7 percentage points; Norway by 14.7 points; Canada by 14.6 points; Ireland by 10.7 points; and Australia by 4.6 points. See Tanzi, 2011, p. 235. These countries' economies and their socio-economic indicators did not suffer from the spending reductions and these countries were still among those with some of the best HDI rankings in 2012 and (with the exception of Ireland) with some of the best economic performances during the financial crisis. The Irish recent difficulties had nothing to do with its reduction in public spending in the years before the crisis. Ireland has started growing again, after a remarkable fiscal adjustment of around 20 percent of GDP between spending cuts and revenue increases and so has Spain and some other countries.

Observing countries over almost half century of work with many of them, has convinced the author of this paper that, with few exceptions (perhaps that of the Scandinavian countries which seem to have more of a community spirit and absence of some other problems, such as corruption, than other countries and are thus able to have good governance, in spite of high public spending), a level of public spending of *around* 35 percent of GDP (a level close to that of Switzerland, Australia, New Zealand, Japan, Canada, Ireland and the USA before the crisis) should be sufficient to finance <u>all</u> the government programs that governments *can efficiently monitor*.

It is easy to increase public spending, in response to demands by interest groups that the government does something to alleviate social ills or to stimulate an economy. Unfortunately it is much more difficult to monitor efficiently the public spending to prevent it from creating complexity, inequities or poverty traps for individuals, families and enterprises. Perhaps, a *range* of public spending of between 30 and 40 percent of GDP would be wide enough to enclose in the range most countries, allowing them to have roles of governments, as expressed by levels of public spending, which are high enough and different enough to reflect the countries' societal preferences and their monitoring abilities. It should be stressed that this range is not suggested by theoretical considerations, or by political biases, but simply by experience and observations, acquired from many years of relevant work with the governments of many countries.

High spending levels often bring: (a) inefficiency in spending; (b) require higher tax rates and, often, inefficient and complex tax systems with high compliance and administrative costs; (c) bring "free riding" and "rent seeking" by citizens in the government programs; (d) bring complexity and governance problems, including, at times, serious problems of corruption in the expenditure programs; (e) contribute to high public debts, that may cause macroeconomic problems; (f) create *horizontal* inequity, between beneficiaries of government programs who are truly deserving (for example those who have *major* disabilities) and those who are not, or are less deserving (those with *minor* or *faked* disabilities) who still get similar disability benefits; and(g) create "poverty traps" for some individuals because the income from work, for some individuals with low incomes, may end up being taxed at very high tax rates, when they lose some public subsidies that they have been receiving.

Let me add a few words on a different theory of why public expenditure tends to grow over time. It is a theory significantly different from Wagner's or Baumol's. The theory has been described in some details, with examples, in, Tanzi, 2013. It stresses the fact, evident from observations in various countries, that government programs resemble many individuals in today's world: they are born thin but, as they age, they become progressively fat. Therefore, to contain the growth of spending, governments need to focus on and to prevent the fat from accumulating, trying to eliminate, or at least to reduce, it. Often, they do not need to eliminate the original programs, <u>but they need to eliminate the fat</u>. This implies that it is not necessary to eliminate the welfare states, as some have been asking. Without the fat, the slimmed down welfare states, which had been created in past decades, could survive, close to their original version. There are some examples of programs that have gone through this slimming down process. These reforms, of course, are not politically easy especially when there are vocal calls for fiscal expansion. These structural reforms require strong political determination and good technical work related to the needed policies. They would also benefit from the clear and unconditioned support from relevant and influential international organizations.

Egregious examples of fat can be found in disability insurance, in food stamp programs, in pensions rights, in health systems, and in other areas, including those associated with government subsidies (that in many cases go to those who do not need them, as in those for agriculture in the USA, the European Union, and other areas; or those to energy in many areas of the world). Some examples of fat in spending programs are described in Chapter 14 of Tanzi, 2013. In some of these programs *deserving* and *less deserving* individuals often end up receiving identical public benefits, thus creating significant horizontal inequity among citizens and excessive public spending.

Reading the daily newspapers and watching television programs during the recent crisis years one was struck by the frequent reports of how “austerity” was killing the countries’ economies and was dramatically reducing people’s welfare. It has been claimed that citizens would fare better if only their governments spent more. However, in spite of the talk about austerity, available data indicate that most (though not all) governments are now spending as much *in total* as they were ever spending, or that they should have spent. Please refer back to Table 1. Selective examples of hardship have contributed to send the message that “austerity kills” and that public spending should be increased. The examples have been amplified by the media, or by a few biased commentators with easy access to the media. This, of course, does not mean that attempts by governments at reducing public spending have always been fair and that they have not hurt some individuals; or that some particular groups have not suffered in recent years. But this shifts the focus from the *size* of the total spending reductions, which have been carried out, to the question of the distribution and the *fairness* of the cuts, when cuts have been made. The distribution of the cuts should have attracted much more attention than it has.

## III. The Impact of Monetary Expansion on Income Distribution

There is a perception, shared by many, including the author of this paper, that, in many countries, the cost of the fiscal adjustment and the benefits from the monetary expansion have not been distributed fairly and, especially, that those who had contributed to, or had created, the Great Recession with their actions did not suffer, or did not suffer enough. Simply the profits or the gains had been privatized while the costs of the crisis had been socialized. Where fiscal adjustment occurred, it was more focused on spending cuts than tax increases and the cuts hardly affected those with high incomes. The monetary expansion has also benefited individuals at the higher end of the income distribution. Many of these individuals, directly or often indirectly, were able to get the cheap loans from the banks that allowed them to benefit handsomely from newly developing bubbles in various markets and in other ways.

A November 2013 report issued by the McKinsey Global Institute has estimated that the *value* of sovereign and corporate bonds, in the US, the UK and the euro area, *increased* by $ 16 *trillion* between 2007 and 2012, mostly because of the fall in interest rates and the effect that that fall had on the value of bonds with longer maturity. Those who owned these bonds and also those who own stocks in corporations, that have sharply increased in value, have been gaining much from the monetary policies followed by the central banks in recent years. For example, corporations have been using cheap loans to buy back their own shares, thus benefiting shareholders and the managers of the corporations, whose compensation is often linked to the value of the shares. In the USA this has been happening on a large scale creating a very profitable money machine for corporate managers. A December 18, 2013 article in the Financial Times has shown the existence of a close correlation, since 2008, between the growth of the Federal Reserve balance sheet and that of S&P 500. On the other hand, those who in the past had owned interest –bearing assets of the kind that were non- tradable in secondary markets (such as saving deposits in banks and certificates of deposits and equivalent) and that had received interest incomes from them, have been the losers from the fall in interest incomes that they had been receiving from those assets, because of the sharp fall in interest rates.

The distributional impact of the recent *monetary policies* has attracted much less attention than it should have received, in spite of the fact that monetary policies may have been more important for income distribution than fiscal policy, the policy that attracts so much attention. The monetary policies that have been followed by central banks may, also, have had an undesirable impacts on consumption, thus delaying the recovery.

The relationship that may exist between the level of real interest rate and both the income distribution and the saving rate (and, thus, the propensity to consume of individuals) was discussed, three decades ago, in a paper by an IMF paper by Tanzi, 1984, on the United States. A more technical version of the paper was published later. See Tanzi and Sheshinski, 1989. However, while the first version of the paper attracted some attention by the financial media, including an article in Fortune magazine, the main point made by the paper was ignored afterword. The 1984 paper had tried to solve the puzzle that the sharp increase in real interest rate in those years--- brought about by the Fed's policies, to deal with high inflation, introduced under Paul Volcker--- had led to a fall, and not to the expected large increase, in the rate of saving.

The solution to that "puzzle", suggested by the Tanzi and Sheshinski's paper, supported by the result of a survey of financial assets provided by the Federal Reserve Bank, was that a large share of the interest bearing financial assets was owned by individuals who were close to, or over, the retirement age. These individuals depended significantly, for their consumption, on the interest incomes that they received from the financial assets and, because of their age, they also had a higher marginal propensity to consume. The large increase in real interest rates that had taken place at that time had raised their real incomes and had lead to higher consumption, higher economic activity and a lower saving rate.

The composition of financial assets is now different from what it was at that time. Saving accounts and certificate of deposits, with fixed interest rates and not traded in a secondary market, are now much less important than they were in the 1980s, before the liberalization of the financial market. Still, the recent McKinsey Report estimated that the loss in interest income, mostly by older individuals, due to the fall in real interest rates in recent years, amounted to $ 630 billion. Since the first half of the 1980s the importance of the secondary market and of tradable financial assets has increased significantly.

A consequence of the very low interest rates, promoted in recent years by the central banks, has been a large gain in the value of stocks and of longer-term *tradable* financial instruments and large losses in the interest incomes on the non tradable instruments held by older and less rich individuals. The latter are often not individuals who can get loans at zero or close to zero rates from the central banks or from commercial banks. Therefore, the impact on the income distribution of the monetary policy of recent years has not been beneficial to (and may even have hurt) those at the lower ends of the income distributions. It has clearly helped those at the upper end. That policy contributed to making the income distribution less even and may have even reduced aggregate demand. This has made the full recovery from the crisis more difficult to achieve.

During attempts at reducing public spending, counties' governments should give the utmost importance to the objective of ensuring that, when spending cuts are made, or occasionally when tax increases are introduced, they are borne by those who are more able to bear them, and not by those for whom, for administrative or political reasons, benefits can more easily be reduced. Unfortunately the expenditure reductions, or the tax increases, have not always followed principles of equity. Following these principles should be especially important when the fiscal adjustment is made during a wildly expansionary monetary policy that, by reducing the borrowing costs for easily accessible credit for some privileged groups, while reducing the interest incomes and reducing the access to credit for less privileged groups, make the distribution of income less even. Monetary policy is a blunt instrument that, unlike fiscal policy, cannot protect those in need but can easily favor, in not always transparent ways, those well positioned and better connected to take advantage of the low rates.

## IV. "Growth" versus "Austerity"

Let us now turn to the second argument against the, presumed, “austerity” that countries are being accused of pursuing. From some of the statements one would conclude that public spending is being slashed. These accusations have been made by many commentators including Paul Krugman, in his articles in the New York Times, Martin Wolf, in his articles in the Financial Times, and by various European and American economists, in addition to the less surprising statements by labor union leaders. Perhaps a bit more surprising, for the author of this paper, have been statements, naturally more nuanced, occasionally made by high -level representatives of the IMF. Those statements have reminded one of the famous invocation made by Saint Augustine to God, to give him chastity *but not yet*. The IMF has declared itself to be in favor of reducing the fiscal imbalances *but not as fast*, especially, but not only, in the USA and the UK. These countries have occasionally been criticized for pursuing, too much “austerity” in the short run.

The figures below provide the shares of public spending into GDP for selected, recent years, including the most recent figures available for 2013, for the USA and for the UK. The data are taken from the IMF latest Fiscal Monitor (April 2014).

| | 2007 | 2009 | 2013 |
|---|---|---|---|
| USA | 35.7 | 43.1 | 38.0 |
| UK | 39.8 | 46.8 | 43.5. |

Comparing the figures estimated for 2013 with those for 2009, there was a clear and significant reduction in the share of public spending in those years, a reduction that would seem to provide some support to the concerns expressed by the statements by the critics of fiscal adjustment. However, comparing 2013 not with 2009 but with 2007, the last “normal” year before the crisis, it is obvious that both of these countries, in 2013, were spending and borrowing more than they were in 2007, a non crisis year, when the two countries had fiscal deficits of 4.0 and 2.9 percent of their economies. In 2007 they had these deficits in spite of the windfall taxes that the countries were getting from the bubble, as mentioned earlier. See also Tanzi, 2012. It is, thus, difficult to understand how the recent spending figures could be defined as reflecting “austerity”.

It should be recalled that, after the crisis started, the US and the UK introduced *very* large “stimulus programs”, aimed at combating the recession and at stimulating the economy, relying on the expected effects of the Keynesian multiplier. These “stimulus programs” contributed to push their fiscal deficits in 2009 to the truly extraordinary levels of 14.7 and 11.3 percent of their respective (though falling) GDPs. Keynesian, countercyclical fiscal policy was always intended, or understood, to be a *temporary* policy. Large fiscal injections have usually been expected to end when the money allocated for them has been spent and when the multiplier has done its expected work. Fiscal expansions had never been intended to require *long- lasting* or *permanent* fiscal injections. An analogy can help convey the basic point being made here. If one night a person goes out and drinks too much and the next day he or she reduces his or her drinking closer to, but still well above, the normal level, that person cannot be described as engaging in “abstinence” on that day.

The stimulus programs introduced by various countries, in 2008 – 2009, sharply increased public spending and the public debts, during the period when the money allocated in the program was being spent and the GDPs were falling. Between 2007 and 2009, public spending as a percentage of GDP increased by: 7.4 in the USA 7.0 in the UK and 5,2 in the euro area; and public debt as a percentage of GDP increased by 22.1 in the USA, by 22.4 in the UK and by 13.7 in the euro area.These were extraordinary increases. The public spending was pushed to levels that many observers considered unsustainable –as most would consider fiscal deficits of the range of 11 to 15 percent of GDP.

These extraordinary deficits could not fail to create concerns about fiscal sustainability. They surely produced concerns in the mind of the author of this paper. It was, thus, inevitable that, after the money that had been allocated to the stimulus programs had been fully used, public spending would begin to be reduced. Even if the level of spending were adjusted to reflect the fall in GDP (the denominator), the spending levels in 2013 (and 2014) would still be larger than they were in 2007. It must be repeated that 2007 was a year in which the denominator (the GDPs) and tax revenue had been inflated by the bubble. These effects made the fiscal accounts in 2007 look better than they would have been without the bubble. It should also be noted that 2013 was a year when the expansionary monetary policy that the central banks had followed and the historic fall in the interest rates reduced significantly the public spending necessary to service the public debt. In conclusion it is difficult to understand how the recent levels of public spending could possibly be defined as reflecting "austerity".

Let us now address more directly the issue of the expansionary fiscal policies, the policy that the supporters of such policies call "growth policies" and contrast them with what they call "austerity policies" .

In a recent interview, published in The New York Times (Sunday Business, October 27, 2003, p. 6), Eugene Fama, one of last year's winners of the Nobel Prize in Economics, was asked: "Do you accept the basic teaching of John Maynard Keynes, which tells that government, should spend more to counter the effects of a recession" ?. His answer was: "No, I don't think there's a lot of empirical evidence that Keynesian spending really helps". Several other economists, including many of the recent winners of the Nobel Prize in Economics, would broadly agree with that answer. The list would include, Friedman, Lucas, Prescott, Kydland, Sargent, Sims, Phelps and some others. There are, of course, also economists, more numerous among earliest winners of the Nobel Prize, such as Samuelson, Solow, and Tobin, and, more recently, Krugman and, perhaps, Stiglitz, who would disagree with Fama's statement and would believe that Keynesian spending during recessions is helpful. With the passing of time, the economists who share the assessment of Fama have become more numerous and have become the majority. The majority of *academic* economists would now agree with Fama's answer, although a majority of policymakers would probably still believe in the traditional Keynesian policies. The view of the author of this paper is more nuanced. Namely that a Keynesian fiscal expansion can be helpful *provided that some conditions are present*.

A distinction should be made between the view that was probably held by Keynes himself, at the time when he wrote his seminal book, although we obviously cannot be certain, and that of some of his followers who, at times, became so enthusiastic about countercyclical and spending policies that, as Keynes himself was reported to have declared, they made him feel like a "non-Keynesian". In more recent times, so –called "new-Keynesian models", proposed to counter some of the criticism to the more traditional Keynesian interpretations, have been developed by some economists. To some extent these models have replaced, in academic work, the more traditional Keynesian models, that had relied on fiscal expansion and on the work of the multiplier, to fight recessions and that still guide current policies.

The "new-Keynesian models" have at times become so detached from the real world that they remind one of the debates, held among theologians, in the middle ages, which at times related to whether the human soul had a weight; or to how many angels could stand on the tip of a pin. The new models at times require a significant dose of almost religious faith. They have muddled the debate to the point where "the laws of economics no longer apply". It should be recalled that some of the laws of physics also do not apply in a zero gravity world, or when the temperature reaches the absolute zero. But those are not the situations that are experienced by mortals. The discussion that follows proceeds along the more traditional, and the more down -to -earth, Keynesian lines.

Keynes wrote his seminal book in the first half of the 1930s, a period of deep depression that had followed the "roaring 20s", which had been a decade that had seen high growth, low government borrowing, low public spending, low and falling public debts and much faith in the laws of classical economics, which assigned the dominant role to the supply side of the economy, the side that was believed to drive economic performance and that continues to be associated with the so-called "structural" policies. Because of the almost absence of modern social legislation in the 1920s, a decade that preceeded the introduction of modern welfare states, and because of the importance attached at that time to the supply side of the economy, much of the public spending, that was promoted by the Keynesian ideas, if enacted, would have been directed toward productive public works and to the creation of infrastructure. There is evidence that Keynes did not show much concerned with social legislation. See Tanzi, 2011, pp. 124-26. In the USA, for example, the spending that was carried out by the Roosevelt Administration, had been directed towards creating productive, physical infrastructures. These included the Hoover Dam, the projects of electrification promoted by the Tennessee Valley Authority, the Golden Gate Bridge in San Francisco, and other similar projects. This spending clearly contributed to increasing the growth potential of the US economy while also creating incomes that stimulated demand. At the same time Roosevelt was creating some social programs (the New Deal) that would become important in the future, but that were less important immediately, and even reduced aggregate demand in the short run because social securities contributions were paid immediately but, for several years, nobody would receive pension payments.

In today's world, Keynesian public spending, made to counter the impact of a recession, as in 2009, would, first, take place in countries in which many governments were already spending about half of their countries' GDPs; second, they typically spent little on essential and productive infrastructures; and, third, they already had high shares of public debts. In some cases they had debts levels close to, or over, 100 percent of their GDPs. In this situation, concerns about the impact of *additional* spending on public debt, on future taxes, on the sustainability of fiscal policy, and on the potential, future growth of the economies, become unavoidable. These concerns are bound to affect the psychological and actual responses, on the part of consumers and investors, to the ongoing policies. These responses can potentially reduce the expected, potential, short-run, positive impact of so-called expansionary policies.

There is another important difference, between the present and the time when Keynes wrote The General Theory, a difference that must be recognized, but that has not attracted attention. In today's world, a large number of people has government jobs, or works for fixed salaries (and not for daily wages) for large enterprises. An increasing number of people receive, public or other, pensions. Many or most of the incomes received from these sources are not suspended, or reduced, during recessions. When a stimulus program is enacted, a significant share of the *additional* public spending is likely to be received by individuals who have not been affected by the recession. These people have not lost their jobs, or other sources of income. Unlike some unfortunate workers who have become unemployed, or the smaller number of other individuals who have seen their incomes reduced by the economic slow-dawn, these individuals are not likely to change their spending habits, because of the extra incomes that they receive from the fiscal expansion. However, worries about *future* developments *may* reduce the consumption or the investing of some of these individuals. For many people, any, immediate and direct benefit received from the countercyclical spending is likely to be seen as a windfall to be saved.

For example, the US stimulus package of 2008-2009 gave salary increases to government employees who did not need, or had not expected, to receive them and increased the distribution of food stamps and other benefits, by relaxing the rules, to many individuals who had not, or not yet, been affected by the crisis. These people would not contribute much to the classic Keynesian multiplier. In conclusion, the *conditions* that exist at the time when a recession arrives, are likely to be important in determining the impact that a "stimulus package" will have on the economy. Some conditions that have become typical of modern countries are likely to have reduced the size of the fiscal multiplier. See on this, also chapter 9 of Tanzi, 2013.

There are other qualms or doubts about the effectiveness of the current countercyclical policies that may be worth mentioning. These policies were introduced, in 2008-2009, at a time when the initial conditions mentioned above were not ideal for promoting their effectiveness. Major obstacles were the already high fiscal deficits and high public debts, which existed in several countries, before the expansionary policies were enacted. These doubts are especially relevant with respect to the views, held by some vocal supporters of these policies, that the already highly "expansionary" policies, (both fiscal and monetary), that several countries have followed in the post 2007 period, should be further strengthened. Below, we discuss briefly some of these qualms or doubts.

**First Qualm**

As mentioned earlier, the estimates of GDP and the growth rates of the economy, for the years up to 2007, had been distorted and somewhat inflated by the "bubbles" that had characterized the years before the Great Recession. The bubbles did not distort only the allocation of resources within the countries, but, being externally financed, increased also the countries' growth rates during the bubble years. In several of the countries affected by the crisis, too much had been produced in particular sectors (especially in construction and related activities,) that would not attract buyers and would lose value; and too many workers had found, highly –paid, employment in some sectors (selling or financing houses). For example, in the United States, the share of sectors such as "Construction" and "Finance, insurance, real estate, rental, and leasing" into GDP rose by more than 3 percent. This increase impacted positively but temporarily the US growth rates. In some other countries the impact of these sectors on GDP and on the growth rates may have been even larger.

By generating what could be considered artificial growth, the bubbles inflated both personal incomes and wealth (through the growth in current incomes and in capital gains) and government revenue (through windfall taxes from the sectors affected by the "bubble"). This led to both higher *personal* consumption and higher *public* spending. As a consequence, the saving rate in several countries had collapsed and the current accounts deficits had reached the sky. The bursting of the bubble in 2007-2008 inevitably led to a reduction in the windfall tax revenue and in the potential economic growth rates.

If the above observations are correct, the currently estimated *General Government Cyclically Adjusted Balances* (reported on p. 69 of the IMF Fiscal Monitor of April 2014), that have been calculated assuming large gaps between current and *potential* output, are likely to be overestimated, because they have been estimated on the basis of the past trends in growth rates, trends that have been assumed to have been normal and that could continue in the future. Those growth rates had been inflated, because they had included the value of some goods and services (mainly houses and financial services produced), *as* they had been measured at the time they had been produced. Much of that value vanished when the bubble burst. The GDP figures for the pre-crisis period ought to be adjusted downward to reflect the fall in the value of the houses and of the financial incomes produced in that period. Some of the houses were abandoned or destroyed, because they found no buyers, and many individuals dealing with sub-prime mortgages lost their jobs because those jobs vanished.

The above discussion implies that there may be less genuine current slack in the economies than is assumed by the estimates of the capacity gaps. The current unemployment and growth rates may send wrong signal and may suggest wrong policies. Furthermore, labor is not as fungible as assumed by traditional Keynesian economics. The years of the bubbles created demands for individuals with skills that were less in demands for the jobs that the expansionary policies created. Expansionary policies cannot create jobs that match exactly those that had been held by those who became unemployed. An elaboration of this point is contained in Ch. 9, in Tanzi, 2013.

**Second Qualm**

The real fiscal situation of many countries is now significantly worse than it appears from the official statistics: (a) because the monetary policies followed by the central banks, have reduced the estimated fiscal deficits, by sharply and artificially reducing the costs of servicing the public debts. See Tanzi, 2013, chapter 3, for estimates. The McKinsey report cited earlier has estimated that the benefits, to the governments of the US, UK and of the countries of the European Monetary Union, derived from the expansionary monetary policies of the central banks, have been in the range of $ 1.6 trillion; (b) because of the aging of the populations and the impact that this trend will have, relatively soon, on pensions and health expenditures. This aging has created enormous implicit liabilities for governments; and (c) because of various maneuvers that governments had used in recent years to show better fiscal results. See Tanzi, 2013, chapter 6.

Some of these maneuvers have been: (a) making greater use of “public private partnerships”, to reduce public spending for infrastructure, that, in many cases, created future contingent liabilities for the government; (b) pushing private banks and other financial institutions to increase lending to politically favored sectors, thus creating “moral hazards” and the danger that private debt would become public debt, as happened in the USA, Ireland and several other counties; (c) underinvesting in necessary public infrastructures, thus increasing future spending for repairs and for expansion; (d) pushing in various ways the central banks to promote easier monetary policy, to reduce the cost of financing public debt, as reported earlier; (e) pushing some spending or some public debts to off-budget accounts; (f) selling public assets, to increase public revenue, thus reducing the “net worth” of the public sector; (g) raiding the assets of private pension funds; (h) exploiting the monopoly power of some public enterprises, especially those selling energy, for the revenue that they generated for the government; and so on. These and other maneuvers, while they always existed, for various reasons, became more common in the years before the crisis. In those years they had started attracting more attention, on the part of the OECD and the IMF. See Tanzi, 2007. More recently they have attracted more attention by the IMF. See, Irwin, 2012. Some of these skeletons were bound to come out of the proverbial closets, once the crisis came, as they did in Greece and Spain.

Lower growth rates, expected by some economists in future years, will have a negative impact on the countries’ public finance.

**Third Qualm**

As mentioned earlier, much of the additional spending, promoted by countercyclical fiscal policy (by stimulus programs), is not connected with the creation of productive infrastructures, which could be expected to increase the potential (the supply side) of the economy. Rather, it is connected with consumption, and especially with consumption by the aged; alternatively, at times it is directed toward politically attractive but unproductive investments (the famous “roads to nowhere”); or is directed toward individuals who have not been affected by the recession and who are not likely to change their spending behavior. It is difficult or impossible, for governments, in today's complex economies, to be able to direct the money from "stimulus packages" toward the specific individuals and the enterprises which would contribute most to a country's economic expansion. Governments simply do not have that kind information or the power to resist political pressures. Therefore, much of the spending in stimulus programs ends up having little positive effect on the economy, while it creates more public debt and more difficulties for the future.

## V. A Digression on Policy Uncertainty

The *psychological* impact of expansionary policies, especially of those that raise questions and concerns about their sustainability, must be given some attention. This aspect had attracted relatively little attention until recently. Traditional Keynesian economists had paid almost no attention to the psychological reactions of economic agents, assuming that all there was to countercyclical policy was the mechanical work of a timeless and psychologically neutral multiplier. The multiplier was assumed to respond, mechanically and presumably immediately, to changes in current income, and only to those changes. In that work the real rate of interest had played almost no role. New-Keynesian models have de-emphasized somewhat the effect of changes in current income and have given more importance to inter-temporal substitution effects on consumption. The lower is the real interest rate, the more important, for individuals, future consumption and future income become. With some governmental action and with the policy followed by central banks the government can attempt to affect the choice between the present and the future.

Unfortunately, governments do not have information about the rate of substitution between present and future and they cannot determine it. They also cannot eliminate the uncertainty and the risks from the actions of borrowers and lenders. True liquidity traps may exist mainly in the models of theoretical economists. These traps are for sure irrelevant for many individuals and small enterprises which desperately need liquidity and are not able to get it, because the banks, even when they have plenty of reserves, as they have had up to now, prefer to lend them to safe borrowers, such as governments, large enterprises, and favored customers and will not lend to risky individuals.

Drawing some conclusions from the earlier discussion, it seems reasonable to conclude that the positive, desirable impact of a fiscal expansion will be greater and more likely to occur when:

(a) a country's economy is relatively close so that the extra income is not spent abroad;

(b) the economic slowdown has been due to the weakening of "animal spirits", one that has led to the lowering of consumption and investment, in a country with reasonably good structural policies. The cause for the economic slowdown must not have been the bursting of a bubble, that had become unsustainable and that may have had little to do with weakening "animal spirits";

(c) before the slowdown occurred, the fiscal situation had been seen as broadly sustainable. Putting it differently, the *initial situation* must have been one of relatively low public debt and tax burdens and public spending that had been seen as sustainable;

(d) the monetary policy, followed by the central banks, must also have been seen as sustainable and thus not expected to be subjected to potential, sudden changes in the medium term, and ;

(e) the monetary policy must not have created distributional effects that negatively affected aggregate demand.

These were not the conditions that had prevailed before the recent financial and economic crises, in several of the countries that faced difficulties. Many of these countries entered the crisis with already high fiscal deficits, high and rising public debts, large, current account imbalances, and monetary policies that had been subjected to criticism for having been too relaxed for too long and that had contributed to the bubbles and to undesirable distributional effects. In several of the countries, there had already been questions raised, before the crisis, about the sustainability of their fiscal policies and their current accounts, in spite of the support that the policies were having from the windfall taxes (due to the bubble) and from the low interest rates. For these countries, a fiscal expansion was bound to raise questions, in the mind of many, about the sustainability of fiscal policy and realistic doubts about the size of the fiscal multipliers and these questions would affect their economic behavior during the crisis.

Add, to the above, the fact that, under the circumstances, the fiscal policy was likely to be accompanied by worries about possible, but not clearly defined, structural policy changes, and by changes in monetary policy. Examples of such changes were those related to reforms of the financial market, of the labor market, of the tax system, of the health sector, and in monetary policy. It is easy to appreciate the great uncertainty faced by economic operators. In such an environment, the future must seem more difficult to predict than is normally the case and this must encourage at least some investors to delay making real investments and, especially, investments that extend over a long period, the ones more conducive to growth.

Given the above, how would a normal economic operator (as a consumer or investor), in countries such as Italy, France, Greece or even the United States or the UK, react if, in spite of the already high fiscal deficit and the high and growing public debt, the government announced that it would promote a large public spending program that would immediately raise the fiscal deficit and the public debt? This is an important question that supporters of so-called " pro -growth" fiscal policies do not ask, while some of them have continued to assume the existence of large fiscal multipliers. This question leads directly to the issue of *uncertainty* and its impact on the outcomes of economic policies.

The impact of "policy uncertainty" and of "uncertainty about the future" is an area that, until recently, had attracted relatively little formal attention partly because of obvious difficulties to measure it. But, assume that you are a potential investor, or you are the decision maker for an enterprise, and you are considering whether to make a real investment that will tie your hands and your money for a long time in a specific activity; or that you are considering to hire additional workers that you would not be able to dismiss easily, if you discovered that, because of economic conditions, you no longer need them, as is the case in several European countries. You must worry about the future, about possible changes in monetary policy, that could make your future borrowing more expensive and access to credit more limited, and about the sustainability of fiscal policy or changes in that policy, that might be damaging to you. You would worry about change in “spreads” and in “ratings” for the country; you might even worry about the possibility of a default on the public debt. These will be frequent references in the media to uncertainty and to the impact of some, not yet clearly defined, policies on potential returns on your investment.

One who lived in the United States would worry about government shutdowns, about a possible government default on its debt, about the impact of the Obama-care law on insurance costs, about the impact of the still undefined Dodd-Frank law on the financial sector, and about what the Federal Reserve Bank was going to do about its QE policies and its interest rate policy.

If you lived in Italy you would have to worry about possible changes in government and about frequent changes in taxes, changes that have created so much uncertainty that some have defined the situation as a “fiscal Babel”. Italian citizens do not know what taxes they will be paying just a few months down the road. If you lived in France you would also have been facing the prospect of a major tax reform that might increase the already very high tax burden.

Of course, uncertainty always exists, but it becomes more felt, more significant, and more damaging during periods of fiscal crisis and when countercyclical policy is introduced in already questionable fiscal conditions. In these periods uncertainty is likely to capture the minds of many economic operators and make the “value of waiting” to make economic decisions increase for many of them. These psychological reactions are likely to encourage some corporations to buy their own shares, as they have been doing in the USA.

Uncertainty has also implications for the impact of monetary policy across the areas of a monetary union, be that the European Monetary Union or the monetary union that exists in the United

States. The banks that must lend money to especially small enterprises and to individuals must be influenced by differences in uncertainty and in risks between the borrowers from different areas. It should not have been a surprise that businesses in different countries of EMU were faced by different interest rates, when they asked for bank loans, even though in principle the monetary policy of the ECB has been a uniform policy. The interest rates that the companies located in the areas with the greatest uncertainty and risks inevitably faced the highest rates.

Three economists, at Stanford and the University of Chicago, have attempted to provide a measure of economic policy uncertainty by checking references to it found in 4,300 articles in leading newspapers from several countries and from other media sources, over many years. See Baker, Bloom and Davis, 2013. From the evidence that they have gathered, they have concluded: (a) that uncertainty played a major role in the Great Depression in the 1930s; (b) that it had increased since the 1960s, because of greater governmental interventions in the economies, and especially since the onset of the recession in 2008; and (c) that the growth of uncertainty has been impeding the full recovery from the recent recession. Thus, to some extent, Keynesian activism has come at the cost of an increase in "policy uncertainty", with obvious effects on the size of multipliers.

For Europe, uncertainty became particularly high in 2001, in 2003, in 2008, and in 2011-2012. In France, it became very high in 2008, and especially in 2011– 2012. In Germany it reached the highest levels in 2001, 2003, 2008, and 2011. In Italy it reached the highest level in 2001, 2011, and in later years. In the UK, it was high in 2003 and 2008 and in the following years, especially 2011-2012. In Spain, the highest levels were reached in 2009 and then again in 2012.

Uncertainty has negative effects at both firm and national levels. In the United States, in the post-2008 period, increases in uncertainty were driven mainly by tax, spending and healthcare policies. See Makin, 2012. Makin concluded that, until recently, uncertainty had been less pronounced for monetary policy, because the policies of the Fed had not changed much and had been promised not to change for the medium run, and more for fiscal policy, at least until 2012. However, in 2013 it became clear that uncertainty for both future fiscal and central bank policies was posing a risk for the recovery. Investors had reacted negatively to the news about the reduction of the asset-purchase program by the Fed. As Makin put it: "Uncertainty causes households and firms to delay decision until the uncertainty is resolved or at least substantially diminished. Symptoms of responses to elevated uncertainty include reduced levels of spending, on goods and services, by households, and reduced levels of investment and hiring, by firms. Firms and households may respond to higher uncertainty by accumulating larger precautionary cash balances…" ibid. p. 2. This explains the large cash balances and the low investments by corporations in the United States.

Countercyclical policy, both fiscal and monetary, had been conceived to be short run policies. For fiscal policy the assumption had always been that government would increase public spending (or cut taxes), at some point in an economic slow-down , and the multiplier would do the rest. A presumably large multiplier would expand the impact of the initial fiscal stimulus and help the economy come out of the recession. Multipliers as large as the ones that have been estimated by some economists (Blanchard, De Long and Summers, and others) would be expected to lead to very large increases in output following a fiscal expansion. If the reported size of these multipliers were right, the US stimulus package of 2008-2009, that exceeded $800 billion, would have provided an increase in income of several trillion dollars to the US economy! It thus seems strange that six years after that stimulus money was spent we are still waiting for the results of that stimulus and that some of the same economists, that had estimated the large multipliers, are calling for more fiscal expansion, in spite of the still high fiscal deficits and growing public debts and the concerns about the long run sustainability of that policy. If a medicine to cure a disease does not work, it might make sense to shift to another, rather than just increase the dosage.

## VI. **Concluding Remarks**

The counter-cyclical policy (high fiscal deficits and expansionary monetary policy) followed since the beginning of the Great Recession has reduced the unemployment rate by less than it had been expected that it would. However, the monetary policy has had a large impact on asset prices (the value of bonds and of stocks, and it has started to affect again housing prices). Personal wealth has been growing at a fast rate, making those who benefit from this increase capable of spending more. However, workers are benefiting much less from this increase. Enterprises are still not investing, or not investing enough, given the low interest rates, and individuals are still consuming less than needed for a full recovery. Is this the cost of uncertainty? Or is it the fact that the policies that are being pursued, and especially the monetary policy, are transferring large spending power to individuals who are less likely to rush to spend more especially to spend on the normal goods that the economies produce? For sure, the policy of reducing interest rates on normal savings and securities must have reduced the incomes of those who in the past had depended on the interest income they received from these sources. These are likely to be aged and retired people with high propensities to consume. Deteriorating income distributions, as a consequence of the current monetary policies, may be playing a role in the lack of increased personal demand, as was theorized three decades ago in some work by the author of the present paper.

If there were a realistic choice between “growth” and “austerity”, would any reasonable person choose austerity? But is there really such a choice? Those who push for what they call “growth policies” must truly believe in two kinds of free lunches: the one that comes from presumably costless fiscal expansion and the one that comes from the costless printing of money. The balance sheets of the major central banks have in recent years expanded by 2 to 4 times but the positive impact, on the economies, of that expansion, as distinguished from that on particular institutions or individuals, who can borrow at almost zero rates, are still hard to see.

Monetary policy has made it easier for governments to continue with their current fiscal policies. However, unemployment has remained higher than it should be; fiscal deficits have remained high, in spite of the large subsidies that the governments have been receiving on their budgets from the monetary policy; public debts have continued to grow, as shares of GDPs; and economic growth has remained low or modest, in most countries, although in some it has been improving recently. These results would not justify a clear vote of confidence for the actions of the major central banks and the governments. Those actions may have prevented immediate disasters in 2008, but might have contributed to less desirable results in later years. The main question that must be asked is whether the laws of economics have truly been suspended or changed by the ongoing situation, so that a kind of "new normal" has become "normal".

Consider the following. In several countries, interest rates are now at the lowest level that they have been for 200 years. Public debt, at least globally, is higher than it has ever been. Tax levels seem to have hit a ceiling in many countries, and should not be looked at for a solution to the current fiscal difficulties, with the possible but unlikely exceptions of the US and Japan, where taxes are lower but politics makes significant tax increases difficult. Interest rates cannot go down more than they have, unless the laws of economics are truly suspended. One must ask if this can be considered the "new normal." To believe that it is, one would have to suspend one's disbelief.

Some questions must be asked. Given the large increases in high-powered reserve money, that central banks have created with their policies, in time, and with uncertain lags, when these reserves begin to be used by the banks, for loans for real investments, they could lead to large increases in prices, as some economists, have been predicting. This happened in the past in several countries. How realistic are these fears? Also, how will the Fed (and other central banks) deal with the "brutal challenge" (Greenspan's term) in finding a smooth exit path from their current policies, including from "Quantitative Easing", as they must and as the Fed has started to do?

Greenspan, who was blamed for having kept interest rates too low for too long, before the financial crisis, has admitted that he has "preferences for rates which are significantly above where they are". See interview in the Financial Times, Life and Arts, October 26/27, 2013, p. 19. Greenspan has also expressed strong worries about the "swelling size of [debt combined] with rising complexity". What will happen when prices start going up and interest rates follow them (remember the "Fisher effect"?), leading to sharp falls in the value of asset prices and to huge losses for many investors and to much higher costs for governments in servicing their enormous public debts? Is this an event so unlikely that it should not worry us? Or does it reflect the worries of pessimists who have not forgotten some of the fundamental laws of economics and who do not believe that those laws have been permanently suspended?

Can the "law on the growth of public spending" provide some guidance to governments, giving them a difficult but realistic guide for getting out of their present difficulties? Following that law, governments would reduce their fiscal deficits by reducing, at a reasonable rate, non essential and less efficient public spending, of which there is a lot in most countries, and by combining that reduction with the introduction of growth-friendly, structural policies, as some countries did in the past. In these reforms the supply side of the economies ought to receive much more attention. It is the supply side and not the demand side that over the long run determines growth. This truth seems to have been often forgotten in the recent debates, in which growth has become a description of what can be achieved in the short run with a Keynesian stimulus, even one associated with totally unproductive spending.

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