Fiscal and monetary policy in crisis

Timothy P. Sharpe B.Com B.Ec(Hons)

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Newcastle Business School
Faculty of Business and Law
The University of Newcastle
Australia

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______________________________

Timothy Paul Sharpe

Date: _________________________
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Publications

This thesis comprises the following published and submitted research articles.

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Statement of contribution of others

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______________________________
Professor Martin John Watts
Date: _________________________

I, Dr James Juniper, attest that Research Higher Degree candidate Timothy Paul Sharpe made a significant and original contribution to the joint publications included as part of this thesis.

______________________________
Dr James Juniper
Date: _________________________

______________________________
Timothy Paul Sharpe
Date: _________________________

______________________________
Associate Professor Suzanne Ryan
Faculty Assistant Dean (Research Training)
Date: _________________________
Additional publications

The following conference papers have relevance to the thesis but are not explicitly included herein. In most instances, refereed conference papers have been revised and subsequently published.


Watts, M.J. and Sharpe, T.P. (2011) All you need to know about debt dynamics but were afraid to ask, presented at the *10th Australian Society of Heterodox Economists Conference*, December, Sydney: Australia.

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Summary

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Background

For many advanced economies, the early post-war period was characterised by full employment, modest inflation and economic prosperity. Under the guidance of the Keynesian model, fiscal and monetary policy was used for economic stabilisation and to achieve low levels of unemployment on a sustained basis.¹

During this time, newly available macroeconomic data and the development of applied econometric models, largely due to the work of Jan Tinbergen and Lawrence Klein, encouraged empirical analysis. Klein (1947) argued that the micro-foundations of Keynes’s aggregate relationships (e.g. the consumption function) should be established to underpin the large scale macro-models which were under construction. The search for micro-foundations combined with the Hicks-Hansen IS-LM representation of The General Theory defined the neoclassical synthesis which dominated post-war macroeconomic thought.²

Extensive empirical analysis of inflation and unemployment dynamics ensued. In particular, Phillips (1958) observed an inverse relationship between money wage growth and unemployment in the UK, known as the Phillips curve.³ Samuelson and Solow’s (1960) analysis of the Phillips curve as an exploitable trade-off between inflation and unemployment gave it credence for policymaking.⁴ During the 1960s it was believed that a stable trade-off existed, so policymakers had a clear set of choices. Unemployment could be reduced via expansionary Keynesian demand-side policy but would likely result in higher inflation. Contractionary fiscal policy was seen as a solution to a supply-side inflation shock since it could move the economy along the Phillips curve. The Keynesian model provided all the necessary levers for economic stabilisation.

Friedman (1948) however was critical of the short-run nature of Keynesian analysis which he argued eschewed the long-run objectives of economic stabilisation policy. Friedman (1948:263) began to outline a ‘stable framework of fiscal and monetary action, [which] largely eliminates the uncertainty and undesirable political implications of discretionary action by governmental authorities’. Here, Friedman was critical of the long and variable lag time associated with fiscal policy in particular but of discretionary

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¹ The Beveridge Report (1942) in the UK, Australia’s White Paper on Full Employment (1945) and the US Employment Act (1946) highlighted the strength of Keynesian principles in influencing policymakers. Policymakers also benefited from Lerner’s (1943) work on functional finance.
² Concerns raised by members of the Cambridge Circus (e.g. Kahn, Robinson, Sraffa) about the use of aggregate production functions in the modelling of growth and income distribution were ignored with the development of large-scale, though single-sector IS-LM models.
³ Another important empirical relationship was Okun’s (1962) ‘law’ which reports an inverse relationship between unemployment and output. Ball et al. (2013) suggests that the ‘law’ continues to offer a strong and stable heuristic for most countries.
⁴ The empirical work of Phillips, which focused on the long-run relationship between unemployment and inflation, was inappropriately interpreted as an expression of a short-run policy trade-off to compensate for the obliteration of Keynes’ own approach to price and wage dynamics. The latter was set out in Keynes’ Z and D curve analysis in The General Theory, but had been obscured by debates over the nature of respective elasticities in the IS-LM model.
policy in general. Friedman’s framework however only promised reasonable full employment and a reasonable degree of stability.

While fiscal policy was generally emphasised over monetary policy by post-war (neo-) Keynesians, Friedman’s (1956) restatement of the classical quantity theory of money challenged Keynesian policy prescriptions and re-asserted the role of money and monetary policy (i.e. Monetarism). While distinct from Fisher’s (1911) earlier transaction version, Friedman argued that controlling the money stock was the most effective means of controlling inflation, and rejected any role for macroeconomic policy in stabilising real variables, such as output and employment in the long-run. Tobin (1972) recalls that Friedman had set out his theoretical framework using the widely accepted Hicks-Hansen IS-LM model. In doing so, debate regarding the role of fiscal and monetary policy was largely reduced to an econometric debate about empirical magnitudes (see Friedman and Schwartz 1963, 1970, 1982).

In the 1970s, global supply shocks, notably the 1973 oil crisis and the 1979 energy crisis, resulted in many economies experiencing stagflation, characterised by high unemployment and high inflation, following contractionary macroeconomic policies designed to reduce inflation. Stagflation was inconsistent with the Phillips curve trade-off which was already under attack by economists, particularly Edmund Phelps and Milton Friedman.

Phelps (1967, 1968) and Friedman’s (1968, 1977) hypothesis distinguished between nominal and real wages, and the short- and long-run outcomes of an unanticipated change in nominal demand. The latter would lead to conflicting perceptions among employers and employees regarding real wage adjustments which would permit a temporary deviation in the unemployment rate from its so called natural rate. Once inflation expectations are fully incorporated, however, the initial employment effects disappear as the unemployment rate returns to its natural rate. Expectations were formed adaptively, a notion which had been revived by Friedman’s (1957) work on the consumption function.

The key implications of the Phelps-Friedman natural rate hypothesis were that unanticipated inflation, not inflation per se matters; there is no permanent or stable trade-off between inflation and unemployment; and, unemployment can be kept below the natural rate only by accelerating inflation or above it only by accelerating deflation (Friedman 1977). Hence, the long-run expectations-augmented Phillips curve was vertical and unemployment would tend towards its natural rate. The latter is consistent with real forces and accurate perceptions. Lowering the natural rate would require policies which increased the competitiveness and flexibility of labour markets, such as reducing the power of trade unions, enhancing labour mobility, and minimum wage reforms. Keynesian demand-side policy could neither temporarily nor permanently reduce the natural rate.

The natural rate of unemployment (NRU) was later replaced by the non-accelerating inflation rate of unemployment (NIRU/NAIRU, see Modigliani and Papademos 1975). Full employment is now largely associated with the unemployment rate consistent with the NAIRU. But, unlike the Beveridge (1944) full employment definition of the early
post-war period, the NAIRU does not imply equality between the number of job vacancies and the number of unemployed persons.

The anti-Keynesian revolution gained serious momentum following the stagflation episode. Monetarists had established monetary policy as the dominant instrument for economic stabilisation. According to Friedman and other Monetarists’, for example, Allan Meltzer and Karl Brunner, the conduct of monetary policy should be guided by simple, fixed rules. Targeting (narrow) monetary aggregates was recommended by Monetarists who were critical of targeting market interest rates as suggested by the Radcliffe Report (1959).

Friedman’s views had been gaining traction among policymakers since, at least, the late 1960s (see, for example, Francis 1968). The US Federal Reserve, under the guidance of Paul Volcker, implemented Monetarist theory in 1979 by targeting the growth in the money supply. The apparent correlations between the money stock and inflation however disappeared due to financial innovation and deregulation. The experiment was subsequently abandoned in 1982.

The theoretical foundations of Keynesian macroeconomics were also under attack by the New Classical economics of Lucas, Sargent and Wallace. Drawing on Muth’s (1961) rational expectations, Lucas (1976) argued that aggregate relationships would change with each policy initiative given adjustments to the decision problems of individual agents (i.e. the Lucas critique; see also Goodhart 1975). The Lucas critique had a profound effect on the direction of modern (mainstream) macroeconomics. In particular, the simulation of policy outcomes using large-scale macro-models was called into question; it encouraged the development of small formal macroeconomic models (e.g. the ‘econometrics without theory’ approach of Sims 1980); and, it strengthened the view that micro-foundations (e.g. tastes, technology) and forward-looking expectations were essential to dynamic economic modelling.

Meanwhile, policymakers became increasingly concerned with the rising budget deficits which followed the supply shocks. Academic debate largely echoed the political shift towards deficit and debt reduction or fiscal discipline. The efficacy and sustainability of government net spending came under intense scrutiny.

For Monetarists, restraint in government spending was considered important to avoid the need for central banks to finance the deficits and, in doing so, generate excessive money growth which would threaten price stability. Notwithstanding this, restraint in

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5 Monetarist views were particularly influential to the Carter and Reagan administrations in the US, and Thatcher’s conservative economic agenda in the UK.
6 While the Monetarist experiment failed, the theory offered the blueprints for modern day central banking. In particular, the argument that monetary policy can only target nominal quantities was the foundation to inflation-targeting, which first began in New Zealand in the late 1980s and is now widely practiced by central banks within advanced economies. In addition, the Monetarist argument that central banks should be independent and guided by transparent rules remains pervasive. The notion of central bank independence was reinforced by Kydland and Prescott’s work on time-inconsistency.
7 Keynes’ Z and D curve analysis was compatible with rational expectations regarding the short-run proceeds from the sale of output. However, Keynes questioned the applicability of rational expectations to long-run returns on financial and non-financial investments given fundamental uncertainty.
government spending had been necessary due to government commitments to the Bretton Woods exchange rate system (1944-1971).

While balanced budgets over the cycle were considered broadly appropriate, the government budget constraint, an accounting identity, was interpreted as set of \textit{ex ante} financing choices for government net spending (see Patinkin 1956; Christ 1968). That is, government could raise taxes, borrow or issue high-powered money (‘print money’). Monetarism had already warned against the latter, and the other financing options for government generated a revival of crowding-out theory and Ricardian equivalence.

Crowding-out could take various forms, yet Blinder and Solow (1972:3) asserted that financial crowding-out was ‘disputed by almost no one’. Drawing on classical \textit{loanable funds theory}, it was argued that government debt would compete with private debt in financial markets, put upward pressure on interest rates and therefore reduce interest-sensitive private expenditures.

Barro’s (1974, 1989) Ricardian equivalence maintained that under a certain set of (restrictive) assumptions an increase in government spending would be offset by an increase in current private savings as the private sector anticipated higher future taxes. Thus national savings, real interest rates, investment, and the current account balance would remain unchanged. This was a special case of Modigliani and Brumberg (1954) and Friedman’s (1957) earlier work on the \textit{life-cycle theory/permanent income hypothesis}.

The long-term consequences of budget deficits or fiscal sustainability was analysed in terms of the debt dynamics, which had already been presented by Domar (1944). While there was (is) no \textit{operational} definition of fiscal sustainability, numerous econometric investigations of the so called \textit{present value budget constraint} were developed to assess the sustainability of fiscal balances (see Hamilton and Flavin 1986; Trehan and Walsh 1988, 1991; Hakkio and Rush 1991). Most investigations focused on the US with mixed evidence in favour of fiscal sustainability. The policy implications however were limited since the estimates relied on historical data.

Instead, policymakers required forward-looking measures which motivated the development of fiscal indicators, such as primary gap, tax gap and net worth indicators. These methods, largely due to the work of Buiter (1985, 1995), Blanchard (1990) and Buiter et al. (1993), underpin the European Commission’s S1 and S2 fiscal indictors currently used to assess fiscal sustainability.

The 1981 tax cuts of the Reagan administration characterised the shift in political and economic opinion regarding fiscal policy. Drawing on the so called \textit{Laffer curve} and emerging \textit{supply-side economics}, the tax cuts were an attempt to increase tax revenue. The budget deficit, however, increased which precipitated the \textit{Gramm-Rudman-Hollings Deficit Reduction Act} (1985) to formally constrain government spending.

By the end of the 1980s, inflation, high interest rates, and currency and debt crisis were all (theoretically) tied to ‘excessive’ budget deficits (see Fischer 1989). The mainstream
political and economic discourse was now firmly geared to budget restraint or sound finance, which did not necessarily imply balanced budgets over the cycle.

At this time, Williamson (1990) outlined the prevailing development model of the IMF, World Bank and US Treasury, known as the Washington Consensus. While the term ‘neo-liberal’ had already infiltrated economic and social policy dialogue, there was no operational definition. The Consensus became synonymous with the neo-liberal policy orientation which emphasised market-based reform such as trade liberalisation, financialisation, deregulation, and privatisation and restrained fiscal policy.

High and persistent unemployment among OECD members during the late 1980s and early 1990s motivated the OECD Jobs Study (1994) and subsequent Jobs Strategy (1995). Influenced by the McCracken Report (1977) and the analytical framework set out by Layard et al. (1991), the labour market outcomes were attributed to an inability to adapt to economic and social changes in view of market deregulation, and rapid globalisation and technological change. Unemployment was interpreted as an individual problem arising from supply-side deficiencies such as insufficient skills, training and education, poor attitudes, and rigid labour markets. The IMF embraced this policy orientation (see, for example, IMF 1999).

The introduction of the Euro as legal currency in 1999 marked Stage Three of the European Monetary Union (EMU) formation set out in the Delors Report (1989).8 The Report which followed the Hannover Summit (1988) recommended that monetary policy be conducted by a new independent institution (European Central Bank) charged with the primary task of maintaining price stability; the European Currency Unit should become the single currency in Europe (later called the ‘Euro’); and, budgetary discipline was necessary among member states to strengthen economic convergence. The notion of ‘sound’ budgetary positions was formalised as specific government deficit and debt rules within the so called Maastricht criteria, and monitored and enforced by the Stability and Growth Pact which incorporated financial penalties for non-compliant members.

The 1990s through to the early 2000s were characterised by relatively less volatile economic times, the so called Great Moderation. The apparent economic stability was largely attributed to monetary policy geared to low inflation, passive fiscal policy, and deregulated labour and financial markets.

New Consensus Macroeconomics (NCM) dominated mainstream macroeconomic research. NCM models, such as dynamic stochastic general equilibrium (DSGE) models

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8 The Werner Report (1970) had previously offered blueprints to an economic and monetary union in Europe set out in three stages which included a plan for a fixed exchange rate and common currency among the European Economic Community (EEC) to be achieved within a decade. The EEC, a common market, was established by the Treaty of Rome (1957). However the proposal for lost momentum in the early 1970s as the supply shocks enveloped the global economy. Instead, EEC members implemented snake in the tunnel exchange rate management after the collapse of the Bretton Woods exchange rate system in 1971. This was replaced by the European Monetary System (EMS) in 1979 which established the European Currency Unit and the Exchange Rate Mechanism. The EMS was a further step towards an economic and monetary union as it attempted to improve monetary stability and achieve closer economic convergence among the EEC.
had been developed in response to the *Lucas critique* (see Woodford 2003). Drawing on the contributions of real business cycle theory (see Kydland and Prescott 1982) and New Keynesian principles (see Mankiw and Romer 1991), the models were driven by individual agents exhibiting optimising behaviour in the presence of market failures, such as incomplete markets, imperfect competition and asymmetric information. While monetary policy geared to price stability could ostensibly stabilise output and employment in NCM models (see Blanchard and Galí 2007), there was no distinct role for fiscal policy in economic stabilisation (see Fontana 2009).

Krugman (2001, quoted in Nevile and Kriesler 2001:1) asserted that ‘[a]lmost all economists agree that monetary policy, not fiscal policy, is the tool of choice for fighting recessions.’ Lucas (2003:1) declared that the business cycle had been solved, and that ‘the potential for welfare gains from better long-run, supply side policies exceeds by far the potential from further improvements in short-run demand management’ [emphasis in original]. Instead, government budgets were likened to that of a household which reinforced fiscal restraint. Buiter (2004:4) is clear:

> ‘The definition of (in)solvency of the state is, in principle, no different from that of the (in)solvency of any other economic agent … The capacity to tax and to issue legal tender makes the state an unusual borrower, but below the surface, it is subject to the same pains and joys of borrowing experienced by private sector borrowers.’

Despite the apparent success of New Consensus Macroeconomics, the pre-GFC period was characterised by rapid private debt accumulation and real wage repression particularly in the USA which, according to the earlier work of Minsky (1975, 1986), precipitates financial instability. Households became increasingly reliant on tentative lines of credit as underwriting standards were largely eliminated under the so called *originate-to-distribute* model of modern banking (Wray 2008, 2010). Speculative ‘bubbles’ however were invisible to the NCM models which had been informed by the *efficient market hypothesis*.\(^9\)

The Global Financial Crisis (GFC) largely emerged from the subprime mortgage crisis and subsequent liquidity crisis in the USA, following the housing market collapse. As lenders became increasingly risk adverse and tightened underwriting standards, the US short-term debt market practically disappeared (Wray 2010). A chain of events ensued, which in 2008 culminated in the US government takeover of Fannie Mae and Freddie Mac, the sale of Merrill Lynch, the collapse of Lehman Brothers and the bailout of AIG by the US Federal Reserve. However the financial crisis quickly became a *real* economic crisis, as consumer and business confidence diminished and the private sector began to net save to reduce burgeoning debt levels. The *Great Recession* enveloped the global economy.

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\(^9\) Macroeconomists have, for some time, acknowledged the possibility of speculative bubbles, that is, where asset prices deviate from their intrinsic values. While there are numerous theories of asset price deviations, such as rational growing bubbles, fads and information bubbles, there is no basis for determining when they might ‘burst’.
Low interest rate conditions, particularly in the Eurozone, and unscrupulous lending activities of poorly regulated financial institutions, particularly in the USA, ostensibly caused the GFC. A flawed theoretical framework however would severely compromise policymakers’ response to the crisis.
Abstract

The Global Financial Crisis and ongoing Eurozone crisis have posed a growing challenge to the implementation of mainstream macroeconomic stabilisation policies. This thesis develops an integrated and coherent theoretical and empirical framework for understanding the constraints on the post-crisis conduct of fiscal and monetary policy among Eurozone and advanced non-Eurozone economies. It is presented as a series of published and submitted research articles which are informed by the principles of Modern Monetary Theory.

The central contribution of the thesis is to highlight the policy freedoms of economies which enjoy full fiscal-monetary policy sovereignty. The implications are, first, government within sovereign economies are not adequately exploiting their inherent financial capacity to implement a full employment policy and advance the public purpose. Second, economies which do not enjoy policy sovereignty, such as Eurozone members, face a unique set of institutional constraints which have undermined not only policymakers’ attempts to address the deepening crisis, but the achievement of sustained full employment. The thesis is highly critical of these institutional arrangements and recommends that policy sovereignty is restored since it promotes flexibility in the design and implementation of fiscal and monetary policy, and eliminates the financial constraints vis-à-vis implementing a full employment policy, such as a Job Guarantee.
Overview

The Global Financial Crisis and ongoing Eurozone crisis have posed a growing challenge to the implementation of mainstream macroeconomic stabilisation policies.

With the displacement of active fiscal policy during the neo-classical counterrevolution of the 1970s, a policy preference for monetary stimulus was maintained despite many central banks lowering policy rates to (effectively) the zero nominal bound early in the crisis.

Temporary fiscal stimulus measures were then adopted, in part, due the limited capacity for further monetary stimulus as policymakers within advanced economies struggled to prevent a lasting recession. The use of fiscal measures for economic stabilisation however was guided by the medium-term pursuit of fiscal sustainability, which had underpinned a preference for sound rather than functional fiscal management.

Rising government deficit and debt to GDP ratios, largely due to the workings of automatic budget stabilisers, heightened the urgency of consolidation programs geared to fiscal sustainability. Fear of rising long-term interest rates and low economic growth via financial crowding-out effects and so called public debt threshold limits reinforced the policy directive.

Meanwhile, the largely reactive policy advice from major Inter-Governmental Organisations (e.g. IMF, OECD) made some important concessions but continued, for the most part, to espouse the neo-liberal model which had precipitated the crisis. The policy advice however has been severely compromised by the failure of these organisations to differentiate between those countries that can conduct independent fiscal and monetary policy, and those subject to institutional policy constraints, notably the Eurozone countries.

Amid the unfolding post-crisis events, this thesis develops an integrated and coherent theoretical and empirical framework for understanding the constraints on the conduct of fiscal and monetary policy among Eurozone and advanced non-Eurozone economies. It is presented as a series of published and submitted research articles which are informed by the principles of Modern Monetary Theory.

While the individual articles make a unique contribution to the extant literature (identified therein), the central contribution of the thesis is to highlight the policy freedoms of economies which enjoy full fiscal-monetary policy sovereignty. That is, where the consolidated government sector (Treasury and Central Bank) issues a fiat, non-convertible currency and operates with a flexible exchange rate (e.g. Australia, US, UK and Japan). A flexible exchange regime allows for discretion regarding foreign exchange interventions (i.e. monetary independence).

The implication is that government has a central policymaking role which no market-based rhetoric should undermine. Specifically, sovereign economies are not adequately exploiting their inherent financial capacity to implement a full employment policy and advance the public purpose. Economies which do not enjoy policy sovereignty, such as
Eurozone members, face a unique set of institutional constraints which have undermined not only policymakers’ attempts to address the deepening crisis, but also the achievement of sustained full employment. The thesis is highly critical of these institutional arrangements and recommends that policy sovereignty is restored since it promotes flexibility in the design and implementation of fiscal and monetary policy, and eliminates any financial constraints vis-à-vis implementing a full employment policy, such as a Job Guarantee.

The articles have been arranged into chapters and are presented chronologically to demonstrate a coherent progression of thought.

Chapter 1 critically assesses the evolution of policy advice from major Inter-Governmental Organisations during the crisis from a broad consensus about the need for modest fiscal stimulus measures in selected countries, to a general agreement that virtually all OECD countries must now adopt medium-term fiscal consolidation strategies in the pursuit of long-term fiscal sustainability.

Chapter 2 revisits the algebra of debt and deficit dynamics which underpins fiscal sustainability. The chapter is critical of the standard interpretation that neither the interest rate nor the growth rate is assumed to be affected by budgetary policy, per se. Given these ‘immutable laws’, debate has been confined to the timing of fiscal austerity measures, rather than their appropriateness for all countries, whether sovereign or operating within a monetary union.

Chapter 3 provides a theoretical and empirical investigation of the relationship between government deficit and debt ratios, interest rates and economic growth. It is presented in two parts. Part (a) investigates financial crowding-out which was claimed to reinforce the urgency for fiscal austerity measures among all advanced economies. An empirical approach is developed to examine financial crowding-out among advanced sovereign and non-sovereign (Eurozone) economies. Part (b) examines potential public debt threshold limits among Eurozone economies. In particular, a transmission mechanism linking high public debt ratios and low economic growth is unpacked.

Notwithstanding the so called expansionary fiscal contractions hypothesis, it was recommended that monetary easing accompany fiscal austerity to soften any contractionary effects. Yet conventional monetary policy channels became quickly exhausted as central banks reduced policy rates to (effectively) the zero nominal bound. Central bankers were charged with stimulating the economy which involved so called unconventional monetary measures such as quantitative easing and its variants.

Chapter 4 explores the origins of quantitative easing, its underlying objectives, how it has been implemented, and the ostensible theoretical and empirical arguments for its use. An evaluation of the available evidence and the policies of the Bank of England is undertaken to assess whether quantitative easing has fulfilled its stated objective(s).

With the Eurozone framework considered to be incompatible with policy sovereignty, Chapter 5 assesses the future of the European Monetary Union. It is presented in two parts. Part (a) critically assesses recent and proposed policy reforms within the
Eurozone. These are considered to be piecemeal and fail to restore policy sovereignty, which ultimately requires that member countries exit the Eurozone. Key issues associated with the latter are briefly discussed. Part (b) acknowledges that the modest policy proposals have been guided by what is feasible within the political and economic constraints of the Eurozone. Here a Job Guarantee is examined as a policy option for periphery Eurozone economies, specifically Spain, faced with high rates of joblessness and deteriorating debt dynamics.

The final chapter, Chapter 6, defends the critical stance of the thesis which is informed by the principles of Modern Monetary Theory (MMT). Reflecting upon its proximity with post-Keynesian theory, and its contributions and critics, it is argued that the incorporation of MMT principles enhances the post-Keynesian framework, principally with respect to understanding the distinction between sovereign and non-sovereign economies, the role of the payments system and the implications for the conduct of macroeconomic policy. The merits of a Job Guarantee (or Employer of Last Resort) as a desirable full employment policy is also critically assessed.
The boom, not the slump, is the right time for austerity at the Treasury.
J.M. Keynes 1937