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The Treasury View Failed in the 1930s. Why Should It Work Now?

Roberto Tamborini | Jul 1, 2010 4:55PM

The Toronto G8+12 summit, under the pressure of financial markets and of the LCFE[1] lobby, declared the end of the World Keynesian Games. For the United States, it was an easier task to put together the "army of the willing" to go to the Iraq war than to obtain a coordinated set of policies to support the world recovery, correct the global imbalances, regulate LCFE and reform the financial system. The meagre joint declaration that the governments are "committed to halving fiscal deficits by 2012 while sustaining recovery" means that everyone will look after its own domestic businesses. For Deutscheuroland the priority will be fiscal consolidation, possibly with some kind contribution of LCFE. Mr. Trichet says that this is the right choice because it will re-create confidence and sustain recovery (*La Repubblica*, June 16; Engl. here). On the other hand, critics argue that this policy will make of Deutscheuroland a world deflationary area seeking for net export outlets in a highly congested traffic area engulfed by China, Brazil, India and other emergent countries. The only country willing to sustain domestic aggregate demand is the US, but its twin fiscal-external deficits are hardly sustainable in the medium-long run. Tenuous hopes lie in China's proverbial secular wisdom, where the government seems willing to let wages grow, work conditions improve, and the renmimbi appreciate.

Exactly 77 years ago, in June 1933, an international conference of all major industrialized countries and political powers (including the Soviet Union and China) was held in London. The aim of the conference was to find a coordinated and orderly solution to the endless world depression followed by the 1929 US stock market crash. The thorny issues on the table were the world vicious spirals triggered by uncoordinated policies of competitive deflation and beggar-thy-neighbour exchange-rate devaluations, tariffs and trade barriers (Kindleberger, 1973, ch. 8). The doctrinal framework of the time was marked by the Gold Standard as an anchor of monetary stability, and the Treasury View as the golden rule for fiscal policy. In practice, almost zero anti-cyclical policies.

The Treasury View was, in the 1920s and 1930s, the British name of the doctrine of the government balanced budget. The idea was that the government should constantly keep its overall expenditures in line with total tax revenue regardless of the cyclical state of the economy. Besides being regarded as a practical golden rule for liberal, free-market governments, the Treasury View had a connection with a cornerstone of neoclassical (macro) economics known as Say's Law, or "supply creates its own demand" - the predecessor of modern "supply side economics". With aggregate demand constantly in line with (full-employment) aggregate supply thanks to spontaneous market forces, there is no need for government deficit spending. Indeed, any additional penny of public expenditure is a *subtraction from*, not an addition to, the given gross domestic output available for private uses.

The way in which the private economy reacts to deficit spending was later known as "crowding out", that is, the idea that both consumption (via higher prices and other substitution effects) and investment (via higher interest rates) are displaced exactly by the same amount as the additional public expenditure. Even in a downturn, the mechanical application of Say's Law would induce to believe that, if the private sector was absorbing less resources, further displacement of resources by way of the public sector would have made things worse. Hence, the mantra of government advisors was the same as that of Mr. Trichet: rebalancing public accounts in a recession

helps recovery by freeing resources and fostering confidence in the private sector (Kindleberger, 1973)

The Treasury View was practiced in the aftermath of the 1929 crash, especially in the United States, Great Britain and Germany (Arndt, 1949). Challenged by that unprecedented fall in economic activity, and hence in tax revenues, governments were strongly recommended, and felt compelled, to rebalance their accounts by cutting back on expenditure. Subsequently, public expenditures begun to rise again, but taxes were raised in parallel. The US President Hoover had stuck to the Treasury View until 1932, when the Federal budget went into red territory for $616 million after a *surplus* of $745 million in 1931. As to Great Britain, it is well known that in those years Keynes was struggling against the Treasury View (Keynes, 1931), elaborating much of the arguments he would later deploy in his *General Theory*, first of all the demise of Say's Law. Yet some relief to the British depression came, not from a change in fiscal orthodoxy, but from delinking the pound from the Gold Standard in the summer of 1931, thereby adding further instability to the international monetary system. Likewise, the debut of the neo-President Roosevelt (not present at the conference in person) was his clear statement that domestic recovery was his top priority, and hence he refused to re-peg the dollar to a target parity of 4:1 with the pound. This hit the London conference "like a bomb" (Kindleberger), and turned it into a failure.

Yet, viewed from today's standpoint, the most interesting case on the table of the London conference was Germany. The great defeated of World War I, after the devastating hyperinflation of the 1920s, was still plagued by the problem of the war reparations, that is, *public debt*. It will be recalled that Keynes, during the Peace Conference of Versailles, had raised strong arguments against imposing such a heavy burden on the German economy (Keynes, 1919, 1929). Keynes viewed Germany as a key element in the trade network of the industrialized world. The necessity of a large and persistent twin fiscal-trade surplus to pay for the war would have forced the continental giant into a deflationary competitive stance destabilizing the European (including Britain) international equilibrium. That had in fact happened, and, according to Kindleberger (1973), Germany went to the London conference after Chancellor Brünning had adopted severely restrictive fiscal policies that one year earlier had eventually induced the war reparation recipients to lift their yoke. Germany was represented by her central banker Hjalmar Schacht; since January, the new Chancellor was Adolf Hitler.

The majority view of scholars is that a chain of economic policy mistakes was integral part of the phenomena that turned a localized stock market crash into a devastating, almost ten-year long world depression. The doctrinal faith in the Gold Standard and the Treasury View, that stifled any policy action, epitomizes such mistakes. When, in October 2008, the world faced the threat that "It could happen again", we were reassured that now we have learned how not to repeat the same mistakes. Financial markets plunged until it was clear that governments would coordinate worldwide aggressive monetary expansions and fiscal stimuli (including LCFE bailouts). According to an IMF paper of December 2008: "*the optimal fiscal package should be timely, large, lasting, diversified, contingent, collective and sustainable*" (p. 2). After only 20 months, the Treasury View seems to have been reincarnated in Deutscheuroland. What has changed in these 20 months that now makes those welcomed fiscal plans unsustainable, and a *fiscal restriction* both *necessary* and *good for recovery*?

Among the things economists have learned in the past eighty years is a clearer picture of the conditions whereby the Treasury View works or it does not. For instance, according to the brilliant summary offered by W. Buiter (2009), the Treasury View does not apply, or else deficit spending is effective to sustain recovery, when

- there are idle resources due to a failure of effective demand
- there are no alternative policy instruments (including monetary policy) for boosting demand
- complete crowding out does not occur, either through higher interest rates, through Ricardian equivalence, or through a high degree of substitutability between private and public expenditure
- cross-border externalities from national fiscal stimuli (or their lack) are substantial (which also makes

international coordination desirable)

Going through Buiter's list, neo-supporters of the Treasury View should be ready to go on TV and tell people more or less the following:

The large worldwide displacement of aggregate demand that was caused by the financial crisis is behind us. We have largely succeeded in bridging the gap between aggregate demand and potential capacity of our economies. Inventories are thinner, plants are approaching full capacity, job creation is brisk, prices are soaring, credit lines are plentiful. We can now return the main control leverage of the economy to the hands of the central bank; nominal interest rates are sufficiently far from the zero-lower bound, interbank markets are calm, and the transmission mechanisms of ordinary monetary policy ensure prompt effects on credit supply and economic activity.

On the other hand, since demand for private investment is increasing faster, while households feel close to their normal permanent income, and would be eager to save more in view of future taxes, prolonged deficit spending would crowd out private spending thereby hurting economic recovery.

Looking at the international scene, recovery led by private investors and consumers is widespread so that cross-border spillovers of fiscal restrictions will be negligible, exchange rates are near equilibrium values, and we no longer see major imbalance problems that would call for coordinated policies.

Any volunteers? No? Let's then try with some honest truths.

It is evident beyond any reasonable doubt that none of the conditions that called for large and coordinated fiscal stimuli in 2008, and that would make them effective, has been totally removed. To say the least, official data still report large output gaps (economies operating below capacity) throughout Europe (*European Economy*, Spring 2010). Whether or not the new negative mood of the financial markets against euro-sovereign debts is justified, the point remains that borrowers cannot afford to argue with lenders, and prudent governments cannot but bend themselves to the rhetoric of the Treasury View if so lenders like. As an old leader of the former Italian Communist Party once said, “finance rules, governments talk, and politicians go on TV.”

There is actually a short-circuit that may be triggered by a flight from sovereign debts. Deficit spending may drive the interest rate on debt up not because the government is exhausting available resources as in the Treasury View, but because lenders demand an increasing default risk premium. A higher interest rate indeed curbs recovery while rendering default more probable. Typically, the key to this mechanism, in reality as well as in the mind of the lenders, is the evolution of the debt/GDP ratio. Starting from a given debt/GDP ratio, its movement will (roughly) be the result of the algebraic difference between the rate of change of debt (i.e. the additional deficit/GDP ratio) and that of nominal GDP. Unless a government jumps from deficit to surplus, as deficits are reduced debt growth will only slow down. Hence success in reducing the debt/GDP ratio depends on nominal GDP growth: this must be faster than debt growth. Cleary, the crux of fiscal restrictions in this context is their relationship with GDP nominal growth. Theory and experience provide much less rosy certainties than the Treasury View.

On the optimist side we can reckon on the so-called "Non-Keynesian effects" of fiscal policy. That is to say, fiscal restrictions that have positive growth effects (negative fiscal multipliers). Unfortunately, these models, like the older Treasury View, assume the economy to be near full employment so that the fiscal retreat shifts resources back to the private sector. We should instead consider that fiscal restriction will occur at the bottom of a recession (to be optimist), that is, with large unused resources, high unemployment, and close to zero real growth. Nominal inflation will not help, especially in the Deutscheuroland area.

The idea of the "Non-Keynesian effects" of fiscal policy has prompted a large amount of empirical literature with mixed and inconclusive results. Modern supporters of the Treasury View maintain that fiscal multipliers are much

smaller than the Keynesians like to believe, if not negative. In the above-quoted IMF paper one can read that "existing studies provide a range of fiscal multipliers from less than zero to larger than four" (p. 17). Even if one buys the idea that fiscal multipliers are small or negligible, the conservative implication is that fiscal imbalances are mostly ineffective, not that a fiscal restriction on top of a demand gap will sustain recovery.

When "Non-Keynesian effects" have been observed in reality, they could be traced back to a mix of particular conditions. One is a typical small-open-economy effect (the ideal case study was Ireland in her good old days!) whereby the lack of aggregate demand created by the fiscal surplus is swiftly replaced by a current account surplus. The other is a composition effect: cuts of unproductive expenses with no tax increases are more likely to produce these desired effects.

Can we reckon on the small-open-economy effect for the Deutscheuroland area as a whole? Reasonably, not very much. First, there is the problem that Deutscheuroland is not a single country. It is a nexus of interconnected countries competing on the total of their own aggregate demands. If all these countries enagage in fiscal restrictions at the same time, the open-economy effect is likely to be negative, not positive. Second, the additional problem exists that Deutscheuroland as a whole is not a small open economy in the world, it is the second economy after China, and in the next few years it is unlikely that the world will be an easy playground for neo-mercantilist countries. Exchange-rate depreciation may come to the rescue; but this was anathema to true believers in the Treasury View, and may also be contrary to the ECB ideal of monetary stability (though this may be adapted to changing times).

Virtuous composition effects are easier on paper than in practice: what are unproductive expenses? Unemployment benefits, public transports, health care services, public employees, bank bailouts? If the problem is a lack of aggregate demand, a large array of public expenses may have direct or indirect impact on private demand, and it may be hard to find former recipients of public funds eager to switch to their own purses in substitution.

In order to have a rough quantitative idea of alternative scenarios, let us consider some data from today's most fervent follower of the Treasury View, namely Germany. Table 1 provides the baseline figures elaborated by the EU Commission (*European Economy*, Spring 2010).

Table 1

	Deficit/GDP	Nominal GDP growth	Debt/GDP
2009	-3.3%	-3.5%	73.2%
2010	-5.0%	1.4%	78.8%
2011	-4.7%	2.5%	81.6%

Now let us consider the G20 plan, that is, the deficit/GDP ratio is halved by 2013 (i.e. a cut of about 16% of the previous deficit/GDP ratio each year, starting from -5% foreseen for 2010). This is reported in the second column in Table 2. The third column portrays different scenarios according to GDP nominal growth. Scenario A) is "neutral" in the sense that the small recovery foreseen in table 1 for 2011 will persist with no effects from the fiscal restrictions. Scenario B) represents the Treasury View, with a negative fiscal multiplier equal to -1 (1% cut in the deficit/GDP ratio, say from 5.0% to 4.95%, creates 1% additional nominal growth, say from 1.4% to 1.42%). Scenario C) is the Keynesian View where the multiplier is equal to 1. Then, by means of the simple accounting relations recalled above, the fourth column yields the debt/GDP level for each year.

Table 2

	Deficit/GDP	Nominal GDP growth	Debt/GDP
		Scenario A) Neutral	
2010	-4.2%	1.4%	76.4%
2011	-3.5%	2.5%	78.1%
2012	-3.0%	2.5%	79.1%
2013	-2.5%	2.5%	79.7%
		Scenario B) Treasury View	
2010	-4.2%	1.6%	76.2%
2011	-3.5%	2.9%	77.6%
2012	-3.0%	3.4%	78.1%
2013	-2.5%	3.9%	77.6%
		Scenario C) Keynesian View	
2010	-4.2%	1.2%	76.6%
2011	-3.5%	1.0%	79.3%
2012	-3.0%	0.8%	81.7%
2013	-2.5%	0.7%	83.6%

As can be seen, in the neutral and the Keynesian scenarios, debt/GDP growth will slow down relative to its baseline trend thanks to the deficit cuts, but it will not be stopped. The Keynesian scenario (based on a rather small fiscal multiplier) generates the typical self-defeating policy with GDP growth falling faster than deficit cuts. Interestingly, the exercise suggests that the "Non-Keynesian effects" may not produce a turning point in the debt/GDP growth until the cumulated impulse of defict cuts on growth is substantial. How large and persistent should the "Non-Keynesian effects" be? Will financial market makers be patient and far-sighted enough?

Far from being the polar star towards recovery, the Treasury View is a foggy road with many dangerous pitfalls. It is clear that the G8 governments should elaborate a credible exit strategy from extra-ordinary deficit spending in the medium-long run, but what is happening in Deutscheuroland is most probably too much and too early. If this is "imposed" by financial markets and LCFE, it only means that they have not stopped destabilizing the world economy, and we all are in serious trouble.

Readings

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[1] Large and Complex Financial Entities, according to the ECB official definition.

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