The "Austerity Myth" and Economic Development in the Modern Macroeconomic Debates

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Abstract

The paper focuses the consequences of the implementation of austerity measures on macroeconomic performances and economic development in the modern macroeconomic debates. After taking austerity measures as a necessity, but also as a solution to economic problems which contributed to the creation of the "austerity myth", today criticism of these measures indicate that the macroeconomic mainstream in the future will not be based only on a radical anti-Keynesianism and neoliberal paradigm. Since the positive effects of fiscal consolidation in the form of economic growth and employment in most economies were absent, the long ago opened debate in macroeconomics between the two research programs: classical and Keynesian, which was temporarily abandoned during the domination of the new neoclassical synthesis, was reopened. Supporters of the austerity measures theoretically followed the concept of the Ricardo–Barro equivalence theorem and the crowding out effect, but on the broader base it is the part of rational expectations macroeconomic framework and dynamic stochastic general equilibrium (DSGE) models which provide microeconomic foundations of macroeconomics. On the other hand, due to the fact that positive effects were absent the Keynesian approach reaffirmed the doctrinal problem of macroeconomic fluctuations, which are again, became important macroeconomic problem, putting into question the development of the microeconomic foundations of macroeconomics. Therefore not only that pragmatic Keynesianism returned in economic policy, but also the austerity measures are indicated as the key reason for deepening recessionary trends and opening wider social conflicts.

Keywords: austerity measures, macroeconomic debates, economic development
JEL Classification: B22, E32, E62

1. Introduction

The global economic crisis has had an impact on the change in economic policy, albeit a temporary one, but also on the macroeconomic debates that have been an ongoing issue between

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representatives of the two research programs – the Classical one and the Keynesian one. Neither of these is unusual, it could even be qualified as expected taking into account the milestones in the development of modern macroeconomics so far. However, the severity of the crisis, the length of its duration, as well as its global character, has led to consequences more significant for macroeconomic theory than the impacts of previous economic recessions. It should, however, be noted that, in the past, the changes in the dominant macroeconomic theory were related to cyclical fluctuations in economic activity. The sources and character of the recent global crisis, and the measures of economic policy designed to overcome it, but also the post-crisis course of the macroeconomic trends, have raised the issue of austerity measures as the key topic in current macroeconomic debates on the choice of appropriate economic policies, but also on the appropriate model of economic development.

The paper first discusses basic postulates of the macroeconomic model developed within the framework of the "new neoclassical synthesis", which dominated until the crisis, and its elements that the crisis has challenged. It discusses the place and role of fiscal policy in it, as well as the changes that the global economic crisis has brought in terms of economic policy making and especially fiscal policy making. Then, it discusses the factors in the post-crisis period that have caused the return to the classical concept of glorifying savings (in public finances) and the possible effects of this approach on macroeconomic developments. It discusses the reasons that have led to the creation of the "austerity myth" that would be a solution to almost all macroeconomic problems in the post-crisis period of weak economic growth. The paper insists on a comparative analysis of the advantages and disadvantages of the concepts which adopt and reject austerity measures as a backbone of macroeconomic policy, as well as on a comparative analysis of the doctrine differences between these two macroeconomic approaches (the classical one and the Keynesian one).

2. The New Neoclassical Synthesis – The Evolution of Misleading Macroeconomic Consensus

While in the first decades after the Second World War, macroeconomic theory and policy was marked by the legacy of the British economist John Maynard Keynes – through the Keynesian economic system and the Keynesian economic policy, though they were far from the original Keynes' ideas. Instead, a type of synthesis (the "neoclassical synthesis"[2]) evolved within

[2] The term was formulated by the American Keynesian economist Paul Samuelson.

the Keynesian macroeconomic schools (it was called the "Old Keynesianism", Davidson, 1994, p. 4), which was, perhaps, the most successful attempt to establish a consensus in macroeconomics. However, since it was not possible to synthesize Keynes' revolutionary approach to economics with the old neoclassical approach, it ended in excluding all Keynes' revolutionary elements from the synthesis (Barbera, 2008, p. xii), so that the macroeconomic mainstream included an updated version of the pre-Keynes' classical system complemented by Keynes' recommendations for economic policy making in order to overcome the unemployment problems (Davidson, 1994, p. 4) by using fiscal policy, which is why Keynesianism was wrongly equalised with fiscalism. In doctrinal terms, the deviation from Keynes, within the framework of Keynesianism, was made by the framework of the most famous interpretation of the *General Theory* – Hicks' IS-LM model (1937), which was crucial for modern macroeconomics to become "infected" by Walrasianism (Taylor, 2010, p. 222) and which was used by Alvin Hansen for "an American version of standard Keynesianism" (Mynski, 2008, p. 32). However it did not provide the opportunity for an adequate analysis of a growing economy characterized by an imbalance, as a consequence of aggregate demand due to the trends in the financial markets in which borrowing increases as a result of an increase in income, as indicated by the post-Keynesian author Mynski (Keen, 2010, p. 130).

The "new neoclassical synthesis" can be seen as the consensus that was established in macroeconomics between the New classical macroeconomics and new Keynesian economics, which was essentially based on "microeconomic foundations of macroeconomics" and rational expectations. Restricting macroeconomics to the aggregation of behaviour of representative entities that optimize their behaviour in an environment of perfect competition and availability of perfect information (the neoclassical environment) or in the environment of market rigidities and asymmetries in information (the new Keynesians environment) did not happen as a random effect. This macroeconomic consensus was the result of decades-long development of macroeconomics, especially of the monetarist and classical counter-revolution during the 1970s, when the Keynesian approach collapsed. Instead of this, the neoliberal concept of economic policy, based on the recommendations of monetarism and neoclassical theory, through the introduction of rules in economic policy making, particularly in the field of monetary policy and the transition from full employment goal to the aim of low and stable inflation rate, as the responsibility of the central bank, secured stable economic growth with low inflation rates (Prascevic, 2014).

The "new neoclassical synthesis", or macroeconomic mainstream, according to Akerlof, can be equated with the five important macroeconomic neutralities – "misleading illusions" which contributed to "radical anti-Keynesian conclusions" (Akerlof, 2007, pp. 6-7): 1) The life cycle hypotheses; 2) The Modigliani - Miller Theorem; 3) The natural-rate hypothesis; 4) The rational expectations hypothesis; 5) The Ricardo-Barro equivalence theorem. During the time monetary policy was based on nine principles according to these neutralities (Mishkin, 2010): 1) Inflation is always and everywhere a monetary phenomenon; 2) Price stability has significant advantages; 3) There is no long-term trade-off between unemployment and inflation; 4) Expectations are crucial to macroeconomics; 5) The Taylor Rule is necessary for price stability; 6) The problem of time inconsistency is relevant for monetary policy; 7) The independence of the Central Bank improves macroeconomic performances; 8) A credible commitment to a nominal anchor encourages price and income stability; 9) Financial shocks play an important role in generating business cycles.

In the period before the onset of the crisis, all the above mentioned neutralities were important, especially the Ricardo–Barro equivalence theorem, which fully contested the possibility of effective influence of growth of government expenditure on the level of aggregate demand and economic activity. Coupled with the permanent income hypothesis, these neutralities explained rational behaviour of a representative entity (i.e. a representative household), which saw financing of increased government expenditures by issuing bonds as future liabilities (as opposed to the conduct of the so-called "Keynesian household"). Therefore, the households with the growth of government expenditures, which are financed by government bonds, would reduce their spending, which would nullify the effect of increased government expenditures on aggregate demand. The basis of Ricardo–Barro theorem is causality:

$$\textit{growth of budget deficit} \rightarrow \textit{growth of private savings}$$

By including the permanent income hypotheses, or that of consumption life cycle, real interest rates will have to rise in a closed economy which leads to crowding out investment. National debt thus becomes an intergenerational burden which leads to reduced capital stock of future generations. The effect of substituting tax by issuing bonds in open economies will primarily lead to increased borrowing from abroad. The balance of payments deficit that has occurred in this manner will mean a reduction in the national wealth stock in the long term. Therefore, it will have negative impact on economic growth.

3. The Impact of Global Recession on Macroeconomic Consensus

The global recession, characterized an exceptional decline in global aggregate demand since the Great Depression (1929-33), has led to changes in the macroeconomics in the sense of accepting pro-Keynesian ideas and economic policies. At the beginning of 2008, the "pragmatic Keynesians" from the IMF, Dominique Strauss-Kahn and Olivier Blanchard, stressed the need for changes in the conduct of economic policy. After 25 years of commitment to a "strong" economic policy, relying on monetary rules and fiscal conservatism, as well as the liberal ideology of free market capitalism embodied in the Washington Consensus, the IMF proclaimed active fiscal policy through fiscal stimulus. With the transition of recession into crisis, in autumn 2008, there was an almost complete domination of Keynesians in the next two years. However, while Keynesians blamed the Washington Consensus for the crisis, using similar logics, their opponents saw it as an insufficiently liberal concept, which, to a certain extent, didn't follow Friedman's recommendations, but to a much extent was in accordance with activism of John Kenneth Galbraith (Boettke & Luther, 2010, p. 16).

The recession challenged the following important postulates which the mainstream macroeconomic thought relied on (Romer, 2011, pp. 1-2):

1. Macroeconomic fluctuations that had been considered to have successfully been brought under control, became a significant macroeconomic problem.
2. The liquidity trap was gaining in importance because it became obvious that the problem of low nominal interest rates (almost zero) was not uncommon.
3. Insufficient attention given to the problem of financial regulation, given that the problems in the functioning of the financial system emerged as quite important.
4. The acceptance of high unemployment rates for a longer period, which had been almost unimaginable in previous years.
5. Small value of the new Keynesian dynamic stochastic general equilibrium models (DSGE) in explaining the origin and methods of overcoming the crisis.

Table 1. Lessons for fiscal policy from financial crisis

Lessons for fiscal policy from global crisis	Meaning of lessons in the field of fiscal policy
Short-term stabilization requires fiscal policy measures	Due to the fact that low nominal interest rates reduce the effectiveness of monetary policy (the "liquidity trap"), coupled with the traditional approach of central banks to the unemployment problem. In contrast to the period before the recession in which the short-term stabilization was ceded to monetary policy as being more flexible and resistant to political pressures than fiscal policy
Fiscal policy is effective in the fight against recession	Conventional measures of fiscal stimulation proved to be very effective. This led to the famous anti-Keynesian "neutrality": it was shown that changes in the amount of current income affect the amount of spending, and that cash flow has an impact on investment
Fiscal area is valuable for the conduct of macroeconomic policy	Healthy public finances enable more powerful use of fiscal expansion in the situation when it is necessary, or in cases of a deep recession. Therefore, the real limitations in the form of lack of strong public finances in the period when economic trends did not require this were the reason why fiscal expansion could not be significant enough
The political economy of fiscal policy is very important	Political economy is crucial for understanding the undertaken fiscal responses to the recession. In periods of economic recession, its primary focus is shifted to political macroeconomics topics related to the political motives of economic policy makers, as well as the motives of voters who, faced with limited personal income, become fiscally conservative, not understanding the reasons for fiscal expansion

Source: (Romer, 2011).

The economic policy measures that were applied were Keynesian measures of encouraging aggregate demand, coupled with measures for increasing financial stability and providing more general help for the financial sector (Table 1). With the abandonment of fiscal conservatism, fiscal policy underwent significant changes, compared to the period before the crisis. Fiscal stimulus packages were significant in most countries, and as it would later prove, were applied even in places where they were not sustainable in the medium term, creating large fiscal deficits and high share of public debt. This was especially true in underdeveloped economies and those with emerging markets that were "innocent observers" and that the crisis spilt over to, leaving them confronted the withdrawal of capital investors, even in cases where there was no increased risk, as well as with falling global aggregate demand.

4. The "Austerity Myth" and Classical Comeback in Macroeconomics

The shift towards abandonment of pro-Keynesian economic policy measures occurred already in mid-2010, when economies faced significant problems of public finances as the cost of saving banks, insurance companies and the overall financial sector, together with expenditures for stimulating economic activity, became extremely high. Countries were beginning to face a sovereign debt crisis. It was to be expected because the analyses show that in the period of three years after an economy is hit by a financial crisis, there is an increase in central government debt. Therefore, they had to start with the implementation of austerity measures which had recessionary effects on economic trends. This contributed to the intensification of the debate between the supporters and the opponents of fiscal austerity measures, as well as the general return to classics – anti-Keynesian (neo-liberal) approach to macroeconomics.

After relatively easy acceptance of Keynesian fiscal stimulus at the onset of the crisis, it was not hard to accept the idea that fiscal expansion had to be completed, but there was no agreement as to a suitable moment to begin with that. The economists who supported anti-Keynesian approach considered that fiscal austerity measures should be undertaken immediately, contributing to the creation of the "austerity myth" according to which fiscal consolidation would eliminate most of the economic problems that economies were facing – the high public debt, government deficit, and unemployment. Namely, macroeconomic policy, and fiscal policy in particular, should be conducted in order to increase investor confidence in sound foundations of public finances and economy in general. Thus, budgetary consolidation would not be harmful to the economic recovery, but rather the opposite – it would be positive for GDP growth (Alesina & Perotti, 1995; Alesina & Ardagna, 2009).

Advocacy of austerity measures is comparable to the concept of "expansionary fiscal contraction" or of the "German view" of fiscal policy that was developed in the 1990s and whose effects were discussed in detail by many important economists Giavazzi & Pagano (1990), Bertola & Drazen (1993), Barry & Devereux (1995). According to this intertemporal model, expectations and rational behaviour of individuals play the decisive role in explaining why the strong fiscal contraction has expansionary effects on economy. Starting from two opposite views on the effects of a restrictive fiscal policy: the Keynesian one, which highlights the consequences of recession and the so-called "German view", which highlights the consequences in the form of encouraging economic activity (economic expansion)[3], an attempt was made to reconcile them and provide explanations for why both approaches are correct, of course, in different circumstances.

The Keynesian approach is based on the direct impact of austerity measures on reducing aggregate demand (through the reduction of private consumption), which has immediate effects in slowing down economic activity, which is especially evident in the circumstances of post-recessional slow recovery of economies after 2010. German or anti-Keynesian approach assumes that fiscal consolidation will have an indirect positive effect on expectations, especially if it is conducted through the reduction of government expenditure. This positive effect will mean that, due to the reduction in the share of government in GDP, there is an expectation of lower tax burden in the future, which will stimulate private consumption and investment (crowding-in effects on private sector consumption and investment) – contrary to the Keynesian vision. It will be more significant if fiscal austerity is expected to last longer, because it will provide a significant reduction in the tax burden in the future and the results, i.e. the positive impact on consumption and investment depend on the expected fiscal policy in the future. Theoretical and empirical analysis of the effects of fiscal austerity implies that they are considered through three channels of impact: 1) through the reduction in disposable income due to an increase in the current tax burden; 2) through the effect of wealth due to the reduction of nominal and real interest rates; 3) through the effect of reducing the volume of public goods that are available to consumers (Giavazzi & Pagano, 1990, pp. 80-82).

The classical approach of those advocating austerity measures means that a policy of fiscal consolidation should be the result of social consensus, as well as appropriate political decisions, i.e. not to be challenged in the long run, considering the fact that its impact will depend on changes in expectations with respect to fiscal policy to be conducted in the future (a reduction in expected future tax). Therefore, changes in fiscal policy must be credible, they must be trusted; otherwise, the positive effects, according to advocates of applying austerity measures, will fail. If we apply this requirement to the fiscal consolidation policy implemented in the European post-crisis economies faced with the problem of public finances, coupled with recession pressures (rising unemployment), it is evident that they could not fulfil it, partly because of the

[3] Examples are implemented economic policy of the “expansionary stabilization” in Denmark (1982-84) and Ireland (1987-89), when the fiscal consolidation led to economic expansion, not the economic recession; it is in accordance with the “German vision”.

recessionary effects that the applied austerity measures had, and partly because of the deteriorating social status of the majority of the population. Thus, in most economies, the positive effects of fiscal consolidation did not materialise, and negative impact on economic growth, employment and income distribution in the form of increased poverty, led to political consequences in the form of choices of economic policy makers (the government) who reject austerity measures, regardless of necessity their application in some form. This, of course, entitled the Keynesian approach, which promotes postponement of fiscal consolidation until a recovery in economic activity is achieved, particularly in economies where there is no threat of rising inflation rate.

The Keynesian theoretical approach suggests just the opposite, demanding that fiscal restriction is time-limited, because only in this case it will not have long-term detrimental effects on economic activity and slow economic growth. In either case, however, it can be expected that the effects of the trends in the unemployment rate will be a negative one, or that they will increase, although in certain circumstances, fiscal contraction can stimulate consumption and investment (Barry & Devereux, pp. 250-251).

The main differences between those who are supporters and those who are against the austerity measures could be summarized in the following table (Table 2).

Table 2. “Pros” and “Cons” of the austerity measures

	PROS of the austerity measures	CONS of the austerity measures
WHO?	Classicalists – mainstream macroeconomists	Keynesians (New Keynesians, Post Keynesians, “pragmatic” Keynesians)
WHEN AND HOW LONG?	Immediately and long lasting	Postponement and time-limited (until an economic recovery particularly when there is no threat of rising inflation rate)
WHY?	To eliminate most of the economic problems – high public debt, government deficit and indirectly unemployment (“austerity myth”)	Strong recessionary effects on the economy (increasing unemployment)
HOW?	To increase investors and households confidence in sound public finances and economy in general (positive for GDP growth) – especially expenditure based fiscal consolidation	By reducing aggregate demand (fall in government expenditures will not be eliminated by the rise of private consumption and investments due to recessionary pressures and psychological factors)
PREVIOUS EXPERIENCE	“Expansionary fiscal contraction” concept or the “German view” of fiscal policy (developed in the 1990s)	Aggregate demand management – Keynesian fiscalism

MODEL – THEORETICAL BASE	Intertemporal model with rational expectations (decisive role) (R-B theorem)	Aggregate demand model and fiscal multipliers, “Keynesian household”, bounded rationality of the economic agents, psychological factors
TRANSMISSION MECHANISM	Encouraging economic activity through an indirect positive effect on expectations – due to an expectation of lower tax burden in the future and fall in interest rate, which will stimulate private consumption and investment (crowding-in effects on private sector consumption and investment), otherwise it could be expected to have further crowding out effects (with recessionary consequences) and risinig inflation	Revenue and expenditures based consolidation decrease aggregate demand (due to fall in disposable income and wealth; government expenditures), missing the rise in private investment due to psychological factors (animal spirit of investors) and rise in interest rates (due to premium risk)
CONSTRAINTS	Lack of political support and social consensus – positive consequences on consumption and investment depend on the expected fiscal policy in the future	Economic recession as a result of the austerity measures will have to be overcome by fiscal expansion in the future

The debate on the implementation of austerity measures in the post-crisis period also included an analysis of the impact of high public debt (public debt/GDP ratio) and the deficit on the realized rate of economic growth. It was, of course, based on empirical analysis, but there are no unambiguous conclusions in this case either. Empirical analysis made during the global economic crisis (2007-09), which considered a longer period of time, or trends during several financial crises, point to different conclusions – from a slight decrease by only 1 percent of the average real GDP growth rate in the periods where the economies were facing problems with public finances (for economies in which the debt/GDP level was equal to or greater than 90 percent, Reinhart & Rogoff, 2010, p. 25), to a significant decrease by 2.2 percent (Herndon, Ash & Pollin, 2013, p. 2). In emerging market economies, the problem of high public debt had a significant impact on the rate of inflation, as opposed to advanced economies (Reinhart & Rogoff, 2010). This suggests a level of debt that creates the so called “debt intolerance” in which there is a significant increase in risk premiums that further stifles economic activity and forces governments into implementing very severe austerity measures in order to maintain the credibility of public finances and thus reducing the risk premium. The increase in risk premiums, coupled with the implementation of austerity measures, has significant recessionary impacts that are particularly evident in the European economies in the post-crisis period after 2010.

There is yet another important aspect related to episodes of high public debt, which refers to its duration and the long-term impact on economic growth – reducing the growth rate by 1 percent per year has significant cumulative effects if the problem of high public debt lasts for a decade or two (Reinhart, Rogoff & Reinhart, 2012, p. 84). Out of the 26 episodes of high public debt in advanced economies in the period since 1800, even 20 of them lasted for longer than a decade (Reinhart et al., 2012, pp. 69-70).

5. Conclusion

During and after the global economic crisis (2007-09), fiscal policy was the backbone of economic policy in most countries, both in the developed ones and those with emerging markets, providing the necessary stimulus to the slowed down economic activity. It was an element of the return of "pragmatic" Keynesianism to the macroeconomic scene, which, in the theoretical domain, challenged decades-long domination of the classical theory through the "new neoclassical synthesis" based on dynamic stochastic general equilibrium models (DSGE) of the New Classical and New Keynesian macroeconomics. The implementation of counter-cyclical fiscal policy, however, did not go without costs, which, in the years after the crisis, proved to be extremely high for whole society. This relates primarily to the deterioration of public finances in many countries – the growth of debt-to-GDP ratio. This led to demands for severe austerity measures. Initially, they were presented as a solution to the overall economic problems. However, the initial enthusiasm in the implementation of these measures was soon lost because these measures turned into the austerity myth, so that, in most countries, they had very negative impact on economic activity, economic growth and employment as well as the overall social trends due to increased poverty and other social consequences (income redistribution). This resulted in political consequences in the countries where fiscal consolidation was implemented, which involved increased support for political opponents to fiscal austerity. However, although the commitment to austerity measures is considered to be the strategy of banks, lenders and other financial institutions through which they are trying to keep their financial and political position, it is possible to found a theoretical debate behind it. This debate relates to the acceptance or rejection of the classical concept based on the Ricardo-Barro theorem and radical anti-Keynesianism. Actual trends show that in many economies, instead of improvements, public finances have experienced deterioration, along with economic and social collapse. This also contributed to the conclusion that the commitment to austerity measures is actually an austerity myth that will not yield results unless accompanied by the implementation of the structural reforms that would provide a stimulus to economic growth.

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