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FRESH-UP
ECONOMICS

Economic strategies to manage the crisis: austerity or government investment programmes?

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1. Overview

What is a crisis? A crisis is a concept that in general terms refers to a severe disturbance, and in economics, it is no different. Economic crises are those moments in which, for a wide variety of reasons, the economic variables become destabilized.

How to identify a crisis? The most common indicators of a crisis are the economic imbalances that manifest as increasing levels of unemployment, inflation, business inactivity, poverty, etc. In this sense, crises may occur as a natural moment in the economic cycle; or they may be the consequence of specific shocks, most commonly in the last decades as a product of globalised economic dynamics.

How to manage an economic crisis?
In these situations, when the imbalances come to produce a crisis in an economy, public policies have the responsibility to stabilize the countries' economic growth. How to do it in the best way is the question that economists and policymakers ask themselves, and, as it is easy to imagine, the formulas for action are not always consistent with one another. Each school of economic theory formulates different hypotheses, and therefore different conclusions and practical recommendations.

The two models of general reference in economics are the **Neoclassical** school on the one hand and **Keynesian** on the other. To face economic imbalances the recommendations of the two models and the economic policy suggested would be different due to the fact that they depart from different assumptions of how the economy works[1].

The economic policy of the Neoclassical school rejects employing incentives to increase public spending - or in economic terms, 'the incentive on the aggregate demand that is managed mainly by the fiscal policy' . This is because this school believes that public spending would produce price increases as it assumes the economy is always at its full employment level -and therefore supply could not increase-. According to neoclassical theory, situations of imbalance are rectified by the flexibility of prices and by the automatic mechanisms of the market.

On the contrary, for the Keynesians, the main instrument with which to intervene in the economy is indeed the fiscal policy. This is because it is the most effective instrument for counter-cyclical measures, directly impacting the aggregate demand. The variations in public spending (by granting subsidies, lowering taxes, etc.) lead to an increase in people's income which is considered to surely lead to an increase in consumption. Increased expectations leads to a further increase in investment. These series of chain reactions take place in a way that, in the end, the increases in income and GDP are greater than those initially generated by the public spending, due to what Keynesians call the 'multiplier effect'. Therefore, managing the fiscal policy and with it, the aggregate demand, is how this model

[1] For more details on the different economic schools, check the chapter "Economic schools of thought: Labour perspective".

suggests generating the necessary changes that an imbalanced economic situation might require.

Are those the only schools/lines of action?

Economic science does not constitute a homogeneous and generally accepted body of knowledge. The concerns and the answers to economic problems differ according to the schools of thought and, naturally, according to the position or the interest that explicitly or implicitly is assumed by the researchers. The two lines presented above (Neoclassical and Keynesian) and under which we will erect this dossier, constitute the opposite points of a wide spectrum that includes other economic schools that are distributed closer to one or the other.

For example, the monetarist school (also known as the Chicago school) is an important current that strongly criticized the weight of the State in the economy, as well as the use of fiscal mechanisms as the main instrument for dealing with economic imbalances. Led by Milton Friedman, this anti-interventionist current supported the autonomous logic of the market and an economic policy centred on monetary policy instruments. Therefore it is clearly situated on the spectrum next to the neoclassical current.

On the other end of the spectrum, the post-Keynesian economy has given more strength to four elements in Keynes' initial analysis: income distribution, financial institutions, and trade unions and multinational companies. According to this school, which is logically closer to Keynesian theories, in times of crisis fiscal policy should be used to ensure that the level of aggregate demand is such as to ensure full employment. So far this aligns with Keynes' original position, but differs in that it advocates designing an economic policy mix that combines wage policy with a robust redistribution mechanism, and adds a recognition of the need for a downsizing and restructuring of the financial system.

Apart from these two schools, and without forgetting the classical and Marxist roots, alternative currents have not ceased to proliferate, calling for a different reading of economic problems. Among them we can find the structuralist school, the institutionalist school, the ecological economy and the feminist perspective. All these pathways are located closer to or further from the Neoclassical or Keynesian political choices of crisis management depending on their similarity to the aforementioned, and will be the subject of our chapter on economic theories.

Why is it important to understand how crises are managed?

1) ***To understand different interests.*** It is important to bear in mind that these two opposing models (the Neoclassical and the Keynesian together with the other many in the middle) respond to a debate that is not only regarding different economic theories, but also ideologies and political options. Neither ideologies nor political options are tethered to specific economic interests. Rather, ideologies and political options are directly framed by the interests of different groups and their power capacity. This means that the real battle is one of redistribution: who bears the burden of loss in a crisis?

   The impacts on the different social sectors might be quite different if, for example public policies chose to stabilize the countries' economic growth by means of counter-cyclical measures while using instruments to protect the most vulnerable sectors; or if instead governments decide to let the market arrange the imbalances by its own while bailing out the bankrupted banks and financial creditors. Understanding this will be useful to anyone who is concerned about who is harmed and who benefits from the different possible strategies. In the end, all economic policy measures are conditioned by value judgments and ideological assumptions and, above all, by the dominance of one or the other interests in the social system.

cartoonistgroup.com/ Washington Post Writers Group/ Nick Anderson

2) ***To recap what we have not learnt so far***. In general, the overall approach of formal education (mainly via textbooks) bases its response to the economic concept of crisis on the neo-liberal economic paradigm. The market is seen as the basic self-balancing instrument which contains rational agents seeking to maximize profits and income, encouraging individualistic, utilitarian behaviour.

   In this context, crises always tend to be explained in a mechanical way, framed within various thematic concepts linked to growth and economic cycles, macroeconomics and public sector intervention, without explaining the causes of the crises or the point of contact with reality. That is, without exploring the direct effects that one or another crisis management strategy may have on our daily lives, nor questioning who benefits and who suffers in each situation. Therefore, this dossier aims to challenge that pattern of learning, hoping to awaken the student's critical view of the different ways of dealing with economic problems that exist in today's world.

3) ***To understand the past.*** All throughout the 20th century, the empirical evidence portrays a highly unstable evolution of capitalist economies over time, where economic crises have occurred consistently and with increased frequency. The Great Depression after the crash of 1929, the oil crisis of the beginning of the 1970s and the 2008 financial crisis are some examples of global economic crises, albeit with different triggers (interest rate movements, changes in the costs of production, the explosion of speculative financial bubbles). What's more, each lasted for a different period of time.
   A conservative policy response was what came to dominate political economy management of economic crises since the 1970s. Policies focused on reducing public deficits, cutting public spending, controlling wages and devaluing the national currency

have constituted the basis of austerity plans implemented in many European countries after the 2008 crisis.

Austerity means the cessation or reduction of public spending. Ultimately it means the retreat of the State as a social benefactor that injects resources into the economy. The problem is that these austerity policies have not been able to guarantee enduring stability and well-being, nor have they avoided major economic problems, such as mass unemployment, the waste of resources, poverty and inequality. Therefore, it is worth questioning to what extent austerity is the correct strategy to use in a crisis.

4) ***To understand the future.*** Currently, while this dossier is being produced, an unexpected and abrupt change in the role of the State is taking place as a result of the exceptional crisis generated by the COVID-19 virus. Governments in almost every country of the world have been and continue to be faced with difficult trade-offs between the health, economic and social challenges that arise as result of the pandemic. Many national and subnational governments have reacted quickly to address the economic and fiscal consequences of the crisis, and countries are spending significantly more than they did in 2008-2009. Two-thirds of OECD countries have, for example, adopted measures in support of subnational government finance (OECD, 2020).

   The use of public investment across all levels of government to support a COVID-19 recovery over time represents a completely different scenario to the one promulgated by advocates of austerity that supported a reduction in public spending and a targeting of inflation above all else. Although it is still too early to deeply understand how this crisis was managed and whether the increased presence of the State as an investor in the economy is here to stay, it is encouraging to witness how in some countries, the objectives of economic recovery are being tied to social and climate goals.

KEYWORDS

- Crisis
- Economic Policy
- Regulation
- Aggregate Demand
- Welfare State
- Public investment
- Neoliberalism
- Austerity

2. Background information

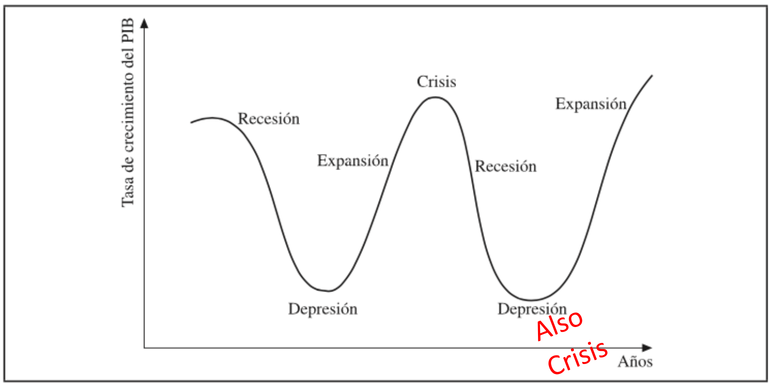
Introduction

What is a crisis? A crisis is a concept that in general terms refers to a situation of disturbance, and in economics it is no different. Economic crises are those moments in which, for a wide variety of reasons, the economic variables destabilize.

The most common indicators of a crisis are the imbalances that manifest in increasing levels of unemployment, inflation, business inactivity, poverty, etc. In this sense, crises may occur as a natural moment in the economic cycle, or they may be the consequence of specific shocks, most commonly in recent decades as a product of globalised economic dynamics.

What is the difference between a crisis and a recession?

The capitalist dynamic has been qualified as the cyclical process of fluctuations of diverse signals of different magnitudes. It is normal to find phases of expansion and accelerated growth following phases of depression and stagnation, as shown in Figure 1.



An economic cycle is that period of time in which expansion of the economy (GDP growth) is followed by a crisis in the rate of accumulation which then becomes a recession, which bottoms out at a given moment reaching the trough or depression, from which economic expansion begins again.[2]

A recession is the phase of slowdown in economic activity in which consumption is reduced, leading to a decline in production, real income and employment. This recessionary phase can be more or less extended in time, but is generally considered to be of shorter duration than the depression.

While the graph shows that the crisis is a disruption that changes the trend of the expansionary phase as commonly explained in textbooks, in our daily understanding, the crisis is often associated with the depression phase.

The depression is the moment when the recession bottoms out or in other words when the recession is sustained over time and becomes more severe. What follows a trough is

[2] It is important to emphasize that the idea of economic crisis as a phase of a cycle is one of the ways to approach its concept, but not the only one. In general, the concept of crisis is framed within various thematic blocks linked to growth and economic cycles, macroeconomics, current crises and/or public sector intervention.

necessarily an upturn phase where the economic variables start to recover. In these situations, when the imbalances come to produce a crisis in an economy, it is necessary to try to reverse the situation to regain the equilibrium. Precisely, the chosen strategy and beneficiaries of that recovery depend on political economical decisions, and these aspects are the ones we will try to illustrate in this dossier.
How to do it in the best way is the question that economists and policymakers ask themselves, and, as it is easy to imagine, the formulas for action do not always agree. Each school of economic theory formulates different behavioural hypotheses, and different conclusions and practical recommendations. To understand the different positions, the two models of general reference in economics are posed, mainly the Neoclassical school on the one hand and the Keynesian analysis on the other, and the different propositions that each one of them follows.

The theory: two opposed models

All the macroeconomic relations have a quantitative dimension that must be closely followed and recorded in order to manage or intervene in them. The potential policy responses available represented by the myriad economic theories present discrepancies, as will be shown.

The neoclassical model

The neoclassical model assumes that, at a given moment, there is a productive capacity (which we will call total or aggregate supply) determined by the number of factories, machines, equipment, etc. (physical capital) and workers (human capital). Further, it assumes that prices are always flexible. This flexibility is what would allow supply and demand to always return the economy to equilibrium at full employment. When there is an oversupply of a resource that results in its surplus, its price would drop (the wages would drop) and then its demand would increase, thus automatically correcting the existing unemployment.

The main idea of this so-called *liberal* model is that to achieve equilibrium with full employment it will be enough to make prices completely flexible and allow markets to function freely. Exogenous interventions of any kind would be useless to correct imbalances, since imbalances are supposed to resolve on their own as a function of the freedom of markets and flexibility of price. According to this model, iInterventions will only lead to economic inefficiencies by causing either price increases (inflation) or displacement of individual spending. The latter might happen as rational private agents, who realize the State's increasing deficit, foresee that taxes will be higher in the future and therefore would rather save than consume.

The Keynesian model

The starting hypotheses of the Keynesian model present a different vision of the operation of the economy and reach very different conclusions. The main difference is that for Keynes, prices are rather rigid, that is, that they would not respond to changes in demand. And he thought that this rigidity especially affected wages because workers are usually not willing to accept lower wages than they receive at any given time.

If we are standing on a level of production that does not have the capacity for full employment, it means that the demand of employment is lower than the supply. The capacity to achieve full employment could be propelled by increasing the aggregate demand which would result in the creation of more employment opportunities. Therefore, according to this model, the State's interventions aimed at increasing aggregate demand would be very useful and necessary in order to increase production when the economy is below full employment. Only when the economy has reached its full employment level could any further intervention increasing the demand cause an increase in prices.

Instruments to respond to economic imbalances: fiscal and monetary policies

The final aim of economic policymaking is to intervene in the general imbalance. To try to achieve this objective, the State's two main instruments are its fiscal and monetary policies.

Fiscal policy: this is the most relevant State intervention when trying to influence the aggregate demand. It can be defined as the policies employed to balance public income and spending. Public spending is defined by the sum of:

- The current expenses: those destined to the remuneration of the personnel working to service the public sector, the acquisition of goods and services, and current transfers.
- Public investment: those with which the public sector contributes to gross capital formation in the economy or capital transfer resources to other sectors.
- Financial expenses: those destined to meet the interests and the burden of public debt.

Naturally, public expenditures must be financed. Public income can be gathered in three ways:

- With the income from the sale of goods and services produced by public companies,
- Through coercive measures (mainly through taxes),
- Raising public debt.

By managing the variations in the two components of the fiscal policy (income and spending), Governments generate changes in economic activity in different ways:

- Aggregate demand can be expanded by increasing public spending.
- Personal disposable income can be increased —and with it, consumption and aggregate demand— by lowering taxes.
- Investment can be incentivized through tax credits or by reducing the tax pressure on profits.

Monetary policy: this is the set of interventions carried out by the Central Bank of a country to influence the existing amount of money creation and thus contribute to the achievement of the general objectives that have been set. Governments control the monetary policy by determining the key interest rates to stimulate or slow down the deposit money creation of banks and thus the investment and consumption enabled by loans.

The starting point of monetary policy is to influence the amount of money in circulation by making changes in interest rates in the money market: when the money supply increases, the interest rate decreases and vice versa. The interest rate fluctuations influence, on the one hand, the money creation of the banks (with low interest rates banks have more incentives to give loans) stimulating the real economy by increasing investment or consumption; and on the other hand, rates influence individual behaviour (as low interest rates discourage saving already existing deposit money) also with the purpose of impacting the real economy once more by stimulating consumption.

In both ways (directly influencing consumption, saving and investment, or facilitating credit), changes in interest rates can affect aggregate demand and, consequently, the level of production and income and employment. However, the fiscal policy is considered to be the most direct option as it intervenes directly in the real economy while monetary policy intervenes initially in the money market and only afterwards in the real economy, resulting in a less direct and therefore less effective impact on the economy. Furthermore, monetary policy is considered as a less direct instrument since the intention to stimulate the economy by lowering the interest rate in order to stimulate the private sector to ask their banks for loans (that would – for sure – be used for investment and consumption), leaves the decision on the somewhat recalcitrant private sector. For companies and households the interest rate is only one factor among others which determines spending choices – and not even the most important one.

The fiscal policy in contrast is directly creating new money to be spent into the economy. It's transferred directly from the government to the bank accounts of the private sector, ready to create demand. No other decisions are needed from the private sector. And above all, it works when the key interest rate is no longer able to help the situation (for example when they can't be lower than zero) and the whole private sector acts pro-cyclical.

How do the two models suggest responding to economic imbalances with the policy instruments?

To face economic imbalances the recommendations of the policy avenues aforementioned would be different essentially because they are departing from different assumptions regarding how the economy works. Therefore, the economic policy of the Neoclassical school rejects the use of incentives to increase the aggregate demand because doing so would produce price increases as they believe the economy is always at its full employment level. As a consequence, this line of analysis would avoid using fiscal policy, as the main objective of this policy is to affect the aggregate demand. For neoclassical theory, the imbalance situations are rectified by the flexibility of prices and the automatic mechanisms of the market. These are the adjustment mechanisms in this neoclassical model that results in the rejection of any other public intervention.

Regarding monetary policy, although in the long term the variations in the money supply do not have much effect on income (since once the level of full employment is reached, it then cannot be exceeded), in the short term they are an adequate means to expand or contract the aggregate demand as the variation of the interest rate control consumption, investment and credit. In sum, the neoclassical model predicts that expansionary fiscal policy will only procure price increases, so the defenders of this model suggest monetary policy as the main instrument to intervene on the imbalances of the macroeconomic variables.

On the contrary, for Keynesians, the main instrument to intervene in the economy is fiscal policy due to its direct impact on aggregate demand. The variations in public spending lead to an increase in aggregate demand and income. Surely, this increase leads to a new increase in consumption opening up better expectations that, once again, lead to a further increase in investment. Thus, a series of chain reactions take place that, in the end, increases in income and gross domestic product (GDP) are greater than those initially generated by original expectations, due to what Keynesians call the multiplier effect. Therefore, managing the fiscal policy and with it, the aggregate demand is how this model suggests generating the necessary changes that an imbalanced economic situation might require.

For Keynesians, the mechanisms of monetary policy do not differ from the neoclassical model. In other words, if the interest rate is high the agents have more incentives to save, and if the interest rate is low, they have more incentives to invest and consume. The difference lies, however, in the effectiveness of the monetary policy. First, Keynesians question the actual effect of for instance lowering the interest rate as an instrument for stimulating the economy, considering that investment is such a volatile variable that depends rather on other circumstances: on the expected benefits, on the general conditions of the economy and of the expectations of the entrepreneurs. Secondly, Keynesians question the impact of monetary policy in times of recession. If the economy is on an expansive trajectory, many loans are requested and granted, stimulating the creation of bank money. In contrast, in a recessionary economy, the supply of bank money will even be reduced as more loans are repaid than taken out. Here, the private sector acts pro-cyclically and therefore makes the crisis bigger. In this situation, only the creation of money by deficit spending can help. The chain by which variations in the quantity of money transmit monetary impulses to the economy would be broken. For this reason, Keynesians argue that monetary policy is not effective in achieving increases in production, income, and employment.

Based on the main ideas in which each model bases their theories and their assumptions, we could simplify the suggestion of each theory as follows:

Assumptions\Model	**Neoclassic**	**Keynesian**
Prices	Flexible	Rigid
Employment	Full employment	Underemployment
Adjustment mechanism	Prices	Interest rate, Income
Public intervention	No, markets can regulate themselves automatically	Yes, the economy needs regulation
Fiscal Policy	No, it will only produce price increments because the economy is already at full employment levels	Yes, it will help the economy to recalibrate, affecting the aggregate demand thanks to the multiplier effect
Monetary Policy	Only efficient in the short term – mechanism used to intervene in imbalances	No, it is not efficient to affect growth, income or employment

Consequences of each economic policy choice

The models we have just analysed involve different points of view when making decisions about economic problems. Those issues are complicated and constitute for the economic authorities a decision regarding what measures to take when imbalances occur. Nonetheless, macroeconomic problems can be approached with sufficiently good knowledge thanks to theoretical proposals and empirical research. However the final decisions inevitably respond not only to scientific data but also to the preferences and ideologies of those who adopt them.

And this shows that the question of the effectiveness of the different economic policies depends not only on the framework of theoretical models as on the objectives that they want to achieve as a priority. If the fiscal policy and monetary policy were equally effective, models can predict that the same effect will be achieved by increasing the money supply or public spending. However, there is an obvious distributional effect that is not taken into account: although an increase in production and global income can finally be achieved, it is not the same if it is enjoyed by, for example, the holders of profitable assets or by the unemployed or pensioners.

The different institutional framework within which these two policies are implemented must be considered. While the fiscal policy is subject - or at least should be - to the direct control of Parliaments, which are the seat of popular sovereignty, monetary policies are designed by central banks, institutions that are much less influenced by democratic control, especially since they have become independent. In short, it turns out that all economic policy measures are conditioned by value judgments and ideological assumptions and, above all, by the pre-eminence of one or the other interests in the social system.

Crisis: The World Economic Disorder and opposing responses

After having studied the theoretical problems of economic imbalance and the analytical instruments that allow economists to understand and respond to them, in this section concrete crisis examples are explored which place in the foreground the reality in which they occur, and the political measures adopted to face them.

Throughout the 20th century, the world economy was subject to great instabilities in the growth process. Three major global crises shocked the world economy while the models that planned their recovery varied throughout time.

The Big Depression and the Keynesian model

At the break of the century, after a phase of expansion favoured by the appearance of new technology and global markets, the First World War gave origin to a new phase of economic depression. The war mobilized millions of people, who were subtracted from production; but when the war ended and all the economies recovered, a major crisis of overproduction originated, aggravated by insufficient demand. Temporarily, the economy flourished during the roaring Twenties, but the short-term affluence could not hide the deeper structural problems in the most important developed countries. The disorder created by the disappearance of the gold standard and the lack of monetary regulation of subsequent international exchanges caused a new crisis in 1929, known as the Big Depression.

Until then, the ideas of the liberal model reigned in the economic policy of the industrialized countries. Following this theory, liberal ideas recommended that governments should not intervene to try to correct economic imbalances. However, markets showed an inability to resolve mass unemployment and crisis on their own. It was precisely in this moment that seeing that the market did not guarantee equilibrium by itself, Keynes proposed that the State would take a new active role with an economic policy model that corrects the imbalances and compensates for the insufficiencies of private spending. During the 1930s, several governments started spending on public works or any type of activity to create jobs. This increase on public spending and the consequent expansion of the aggregate demand (expansive fiscal policy) was what allowed families to increase their consumption, which, in turn, made it possible for companies to sell their goods. Therefore, thanks to State intervention and the multiplier effect, it was possible to create employment and make productive activity recover. In fact, during World War II governments' intervention in the economy increased tremendously all over the world.

After the war the Keynesian economic model became more and more popular as it fitted well in the new reality. The combination of post-war long term and unpreceded economic growth and the consolidation of what was called the Welfare State (characterized by the wide range of social needs covered by public spending), sealed the Keynesian school victory. Challenging the neoclassical model by pointing to its imperfections and the necessary new intervention mechanisms, Keynes became the guide for the execution of economic policy for more than thirty years in most developed economies.

The oil crisis and the end of the Welfare State

The end of World War II opened a new period of growth, practically uninterrupted from the late 1940s until the mid-1970s. World exports went from 60,000 million dollars in 1948 to two trillion in 1980, which is a good indicator of the magnitude of the accumulation process and the internationalization of the economy of those years. The consolidation of the Welfare State and with it the rise in the standard of living in Western economies and the expansion of international investments was seen as such a permanent phenomenon that the world economy was considered to be on a stable and definitive path of economic growth.

However, throughout these years new economic disturbances appeared and the general growth, as well as the Welfare State model, were severely weakened. The stable upward trend in consumption (expansion of the aggregate demand) put pressure on prices and companies continued to rely on the cheap credit (low interest rates) to ensure that the increase in their productive capacity compensated for the wage increases that workers consistently claimed. The growth in public spending (fiscal policy) and money supply (monetary policy) added to the overheated economy in the West. All these factors led to a crisis in 1973 when the oil prices skyrocketed and the world economy entered a phase of disorder and acute crisis that lasted well into the 1990s.

As a consequence of a decision by the oil-exporting countries (OPEC) to, in an unprecedented manner, increase the price per barrel, the Western economies who were net oil importers, saw their trade balances deteriorate almost instantaneously. At the same time, governments continued to face enormous expenses. The first responses were to continue to carry out Keynesian policies to increase public investment: increasing social benefits as unemployment grew and helping companies in crisis. However as the crisis provided less and less public revenue, it turned out that the public deficits were getting higher, increasing public debt incessantly. All this brought with it the economic recession in Western countries, combined with a large drop in production and employment, a rise in prices, and the expansion of the money supply that attracted financial speculation and the financialization of the economy as a whole.

The neoliberal model and the 2008 financial crisis

All the above gave rise, in short, to a world economic panorama dominated by unemployment, inflation, public and foreign deficits and the increase of social unrest that came with it. A general crisis of these dimensions required very forceful responses that began to occur, as early as the 1970s, in the military dictatorships of Latin America, which were the first regimes to apply liberal measures that would later spread throughout the world. The fall of the Berlin Wall in 1989 and that of the entire former socialist bloc together with the generalization of unemployment that greatly weakened the working classes, created the political conditions for a recovery aimed primarily at benefiting the regain of business profit. The theoretical support would come from the hand of neoclassical principles that were now reformulated in what has been renamed as neoliberalism.

The incorporation of new information technologies and the establishment of regimes of full mobility for movements of goods and capital made it possible to globalize a large part of productive activity. This was the new economic stage of planetary interconnection and predominance of neoliberal ideas that gave a response to the great crisis of the 1970s and opened the door to a new era of practically unencumbered financial disturbances. There were117 systemic banking crises in 93 countries and 113 episodes of financial stress in 17 countries from 1970 to 2003, shortly before the last major crisis in 2007.

In this context, a deregulatory process that had been established since the end of World War II allowed banks to spread low-quality, high-risk financial products that ended up contaminating the entire international financial system. With very low interest rates, banks in the United States granted hundreds of thousands of mortgage loans to people in very precarious financial situations. They were the so-called *subprime* mortgages, also called junk mortgages or NINJA loans, because they were granted to people "No Income, No Job and No Asset". Such *subprime* mortgages were transformed and combined into new assets that the banks called Residential Mortgage Backed Securities (RMBS), that is, obligations guaranteed by residential mortgages, or Commercial Mortgage Backed Securities (CMBS) if they were commercial mortgages. They were acquired by investment funds (often owned by the banks themselves), which in turn derived them into new products, thus generating a perverse chain, because if the initial mortgage stopped paying, all subsequent products would immediately lose value.

When these mortgages stopped being paid, as it was easily foreseeable that sooner or later, some banks would begin to record losses or even declare bankruptcy, already at the beginning of 2007. Little by little the contamination was spreading all over the world, the credit tap was closing and with that investment stopped, unemployment multiplied and governments were all facing another global crisis in 2008. What started as a financial crisis became a crisis in the real economy. Without clear recipes to deal with it, everything indicated that massive state intervention would be necessary, but that clashed with the dominant neoliberal thinking.

The conservative response: austerity

The response to the crisis since the 1970s, including the latest one of 2008, have been inspired by the economic policy launched by the conservative revolution that started almost at the same time that Margaret Thatcher in the United Kingdom and Ronald Reagan in the United States won the elections in 1979 and 1980, respectively: a conservative, neoliberal, market-driven response to economic, social and political problems. Both leaders started their terms by formulating two new economic policy objectives: the reduction of inflation and the reduction of the public deficit while placing confidence in the market as a mechanism for providing maximum efficiency in automatic balances and individualism instead of cooperation.

The implementation of this conservative response involved the application of a series of structural adjustment policies that removed the blockages that affected private initiative, enabling companies to recover profits and change the balance of social power. These adjustment policies focused on reducing aggregate demand, and specifically aimed to reduce the external deficit by using the traditional instruments of demand now in a restrictive sense: control of the money supply and credit, cuts in public spending, control of wages and devaluation of the national currency. Simultaneously, this model was accompanied by measures that relaxed the labour market rules, liberalized the financial markets and limited state intervention.

These structural adjustment measures have been applied with more or less intensity in almost all the countries of the world as the macroeconomic correction mechanisms. Especially after the great crisis of 2008, the European Union responded with an intensification of the so-called austerity policy with the implementation of the Troika. The Troika was a programme imposed together by the European Commission, the International Monetary Fund and the European Central Bank to certain countries (Greece, Ireland, Portugal, Cyprus, Spain, Hungary, Latvia and Romania) establishing austerity instruments in exchange for financial assistance. To deal with the debt that the crisis had left as the states took over the huge invoice that resulted from the rescue of the banking sector, very large cuts were imposed in public and especially social spending, thus trying to ensure that governments did not have to face such a large bill. However, these cuts in public spending entailed a negative multiplier effect much greater than expected, which instead of improving it produced a re-emergence of the recession in almost all of Europe, with the inevitable aftermath of more unemployment and more debt. At the same time and paradoxically, Germany, the country that made the strongest enforcements of these austerity measures in the above-mentioned countries, countered the crisis by setting up stimulus packages to incentive its domestic demand.

Austerity measures were applied in less developed countries as well. As analysed before, economic crisis problems were followed by external debt problems. Following the conservative response, the main target of which has been the reduction of public deficits, international organisations 'came to the rescue' by granting loans establishing strict conditionality clauses. In this way, the agencies that granted them ‘aid’, the World Bank and the International Monetary Fund (IMF), ensured that emerging countries' governments responded to the principles and interests of the great creditor powers. To respond to the payments, governments were forced to reduce consumption and imports, as well as public spending, which, according to the prevailing liberal beliefs, was always understood to be harmful.

The consequences were dire everywhere but even more severe in the poorer countries where the reduction of the welfare state meant a huge increase in poverty, unemployment and social unrest with record levels never before reached. In short, so far, austerity policies have enabled companies to recover profits and change the balance of social power, but they have not been able to guarantee lasting stages of stability and well-being, nor have they avoided major economic problems, such as mass unemployment, the waste of resources, poverty and inequality.

Counter-cyclical response: what government investment could look like

The primary economic policy applied in several countries to manage the crisis has followed the austerity policies described above. However, there are some examples of countries who decided to make a daring stand in casting aside the harshest austerity measures its European creditors had imposed. In this context, the recent experience of Portugal seems to be one of the first examples of this kind of counter-cyclical economic policies.

The aftermath of the 2008 crisis found Portugal at its worst recession in 40 years. Between 2011 and 2014 tens of thousands of businesses went bankrupt, unemployment soared above 17 per cent and hundreds of thousands of young skilled people emigrated, generating a loss of over 4% of the working population. In 2011 the government of Passos Coelho negotiated with the IMF a bailout following the typical austerity plan of cutbacks to welfare state services, cutting labour costs and pensions and privatising public assets, all measures leading to an aggregate demand collapse. Antonio Costa, by then the Lisbon mayor, signalled these measures as a submission to the neoliberal agenda which was exploiting the nation and expelling capital, rather than attracting it.

After being elected Portugal's prime minister in 2015, Anotonio Costa went against the norm by reverting the austerity measures that had affected working hours, holidays and taxes, as at the same time increasing the minimum wage by 20 per cent in two years. Interestingly, this policy was managed while keeping at balance the public spending and even reducing the fiscal deficit. Costa's policy raised people's income by lowering taxes, especially for those with lower wages, helping to revive the domestic economy and with it lifting public investment and reducing unemployment , while still not overstretching the fiscal capacities. In short, he combined fiscal discipline and income distribution.

Nevertheless, whereas for many this counter-cyclical response showed that crisis can be overcome without destroying jobs and living standards; for others, Costa merely introduced a few changes in the economy and has had the good fortune of being lifted by the European general recovery, falling oil prices, an increase in exports and the tourism boom. Therefore, critics argue that the expansion of the domestic demand was small and overcompensated by the amelioration of the balance of payments which allowed for catering to the economy without increasing the external financing need. Further, the lack of a long term investment plan for the country aiming at increasing productivity and the fragility of the banking sector have raised some concerns about the future path of the country.

It is still too soon to understand if these sorts of comebacks of counter-cyclical instruments are successful measures in the face of a crisis. In the case of Portugal, the country might, in the end, have simply benefited from the improvement of its macroeconomic situation thanks to the recovery of Europe. However, the underlying belief of Costas' government, namely that by reducing unemployment and increasing people's income confidence is strengthened, may be the beginning of a new change in the global political economy, as according to his ideas, confidence is a great driver of economic recovery.

The role of Political Economy: further advice

In recent years, globalization inspired by neoliberal adjustment policies has resulted in a consistenttransfer of wealth from labour to capital, from the peripheries to the centre and from the poorest population groups to the most favoured, according to reliable reports on the distribution of income and wealth.[3]

Given all the considerations, it is surprising that the economic policies applied in recent years, sometimes imposed without excuse by international organizations, have been based on measures (mainly the radical control of inflation and budget deficits) that do not have sufficient theoretical or empirical support in the literature when presented outside of simple rhetoric.

All this makes it possible to suspect that economic policy is not carried out based on objective criteria or neutral interests, but rather from a very significant social conflict and in a context of great inequality, so that only the most powerful subjects and institutions can influence governments to adopt the policies that interest them most. These actors do so to ensure that the applied economic policies are those that best safeguard their economic, financial and political interests.

Therefore, we must understand the functioning of this most conservative economic science, the one which has the approval of the status quo, powerful means of dissemination and which reduces societies to the field of individuality and rational behaviour is in fact exclusively in the interests of profit. It is urgent for everyone to understand that behind every economic policy decision there is an interest in making the choice.

[3] According to the World Inequality Report 2018: in recent decades, income inequality has increased in nearly all countries, but at different speeds, suggesting that institutions and policies matter in shaping inequality. Since 1980, income inequality has increased rapidly in North America, China, India, and Russia. Since 1980 up to 2018 the global top 1% earners have captured twice as much of that wealth as the 50% poorest individuals.

Glossary

- **Macroeconomy:** Macroeconomy is the line of the economic theory which instead of approaching the problems from the individual point of view it contemplates them by considering the economy as a set of economic relations, or in other words, the aggregations of the parts. Therefore, when we talk about the economy of a nation-state and the most important issues that can be managed concerning the aggregate functioning of the economy we are talking about: full employment, economic growth, price stability and equitable rent distribution.

- **Neoclassical model:** The neoclassical model is based on the hypothesis that the economy automatically reaches full employment and for this reason, the aggregate supply is fixed at a certain quantity completely inelastic to prices. Furthermore, it establishes that prices are completely flexible so that they can go up or down as necessary to automatically correct the inequality that may occur between aggregate supply and demand. Under these conditions, intervention through demand is rejected because it would only lead to price increases.

- **Keynesian model:** The Keynesian model is based on the consideration that prices are very rigid, so they cannot guarantee equilibrium by themselves. Therefore, a situation of equilibrium with unemployment can occur. When the latter happens, it is useful to resort to increases in demand to achieve more income and employment.

- **Aggregate demand:** The aggregate demand is a macroeconomic measurement of the total amount of demand for all finished goods and services produced in an economy. Aggregate demand is expressed as the total amount of money exchanged for those goods and services at a specific price level and point in time. In other words, it is the sum of the aggregate consumption, the aggregate investment and the public expenditure.

- **Aggregate supply:** The aggregate supply is the amount of production of goods and services that companies in an economy as a whole are willing to bring to the market at different levels of existing prices. Many factors influence the aggregate supply: the availability of an economically active population, the capital in stock, and the technology. All of these factors, once aggregated, determine the level of production of an economy.

- **Inflation:** Inflation, or in other words the instability of prices, is one of the causes of very negative disturbance in the economy of a nation. Combating inflation and not affecting growth and employment is an unresolved challenge. Traditionally, there have been three main explanations for inflation: push of demand-side which occurs due to an excessive pressure on spending; push of costs, a pressure that comes from costs, mainly from wages; and structural inflation, which explains the increase in prices which is part of the general nature of the economic system.

- **Pro-cyclical and counter-cyclical policies:** they refer to a strategy applied by the government that is positively (procyclical) or negatively (countercyclical) correlated with business cycle fluctuations in the gross domestic product (GDP). A pro-cyclical fiscal policy occurs when governments choose to increase public spending and reduce taxes during an economic expansion, but reduce spending and increase taxes during a recession. A counter-cyclical fiscal policy on the other hand, operates by reducing spending and raising taxes during a boom period to control inflation and debt, and increasing spending and cutting taxes during a recession to create a demand that can drive an economic boom.

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3. Training material

Activity 1.1: Quiz THE MODEL

Overview
The activity is designed for students to internalise the differences between the two models regarding the type of intervention they suggest. It is accompanied by a follow-up activity to continue at home or in the next class.

Aims
• To stimulate thinking about the theoretical concepts explained
• To explore the main mechanisms of the fiscal and monetary policies
• To provide some basic facts about the Neoclassical and Keynesian Model

Materials and time
No materials are needed. Time is adjustable from 30 minutes to an hour.

Group size
10 minimum

Instructions for trainers
1. Break up the class into small groups.

2. The teacher reads out the questions for each round (see Quiz Questions below) - there are 3 rounds with 3 questions in each round.

3. According to the level of understanding of the audience, the teacher could decide to proceed with the activity as a quiz or to share the answers in cards that students should pick to 'fill in the blanks' of each question. See below the answers in the two different formats.

4. After each round, the teacher gives the answers to the questions and encourages discussion. In total, this part of the activity should take between 20 to 30 minutes.

5. The activity could be complemented with the follow-up segment described above to fill one hour of activity.

Questions

1. Indicate at least two differences between the starting hypotheses of the neoclassical and Keynesian models.

2. For the…..model the State should intervene in trying to offset the economic imbalances.

3. Fiscal policy affects the .... and monetary policy affects the ...

4. The neoclassical model understands that the best policy to use in the face of economic imbalances is the ...

5. The Keynesian model understands that the best policy to use in the face of economic imbalances is the ...

6. What is the multiplier effect?

7. Is tax reduction an element that defines fiscal or monetary policy?

8. Who determines the money supply?

9. Could monetary policy influence consumption?

Answers

1.

	Neoclassic	Keynesian
Prices	Flexible	Rigid
Employment	Full employment	Underemployment
Public intervention	No, markets can regulate by themselves automatically	Yes, the economy needs regulation

2. Keynesian

3. Fiscal policy affects the **aggregate demand** and monetary policy affects the **money supply**

4. Monetary

5. Fiscal

6. A series of chain reactions that happen after the aggregate demand is expanded by the public spending (fiscal policy) and that in the end increases private income and product growth in a greater way than that initially generated by the original stimulus.

7. Fiscal

8. Government/Central Bank

9. Yes, in a secondary effect. When the money supply increases, the interest rate decreases and real variables such as consumption and investment expand as people have fewer incentives to save on the one hand, and more incentives to get bank credit as their cost is low (the low rates) on the other hand, therefore generating incentives for financing consumption or investment with credits.

Quiz cards (to print)

Flexible prices	Fixed prices
Full employment	Underemployment
Markets can regulate by themselves automatically	Markets can't regulate by themselves automatically, they need regulation
Keynesian	Aggregate demand
Money supply	Monetary
Fiscal	A series of chain reactions that happen after the aggregate demand is expanded by the public spending (fiscal policy) and that in the end increases private income and product growth in a greater way than the initially generated by an original stimulus.
Fiscal	Government/Central Bank
Yes, in a secondary effect. When the money supply increases, the interest rate decreases and real variables such as consumption and investment expand as people have fewer incentives to save on the one hand, and more incentives to get bank credit as their cost is low (the low rates) on the other hand, therefore, generating incentives for financing consumption or investment with credits.	

Activity 1.2: Quiz Follow up.

This activity may be used as a follow- up to the quiz activity as an in-class activity or given as homework.

Aims

• To extend the learning from the quiz activity

• To help students to understand how macroeconomic variables operate in the real economy.

Steps

1. During the answers review, the teacher records the correct ones on the board.

2. Each quiz group chooses a model and a policy to defend as the best one to solve economic imbalances. Students may be allowed to have the learning material (the table) with them for orientation.

3. Invite students to discuss them in their groups, including discussion of assumptions and impacts.

4. Invite each group to present their argument to the wider group. Departing from an overview of each model, they should explain how they understand how the fiscal and monetary policies of that model affect the real economy and how each model predicts their impact.

Activity 2: Media exploration

Overview

A media exploration on economic topics that intends to help students make these publications more reachable. It is suggested that students search for media examples from different countries and find those with different perspectives, in order to make it clearer to the students how the news could be biased.

Aims

• To familiarise students with reading about economic news and to develop their skills in media literacy
• To teach students that the way we receive information about economy is biased
• To try to identify austerity or public stimulus measures applied by countries

Materials and time

Newspaper articles that discuss economic crises. The teacher decides if this could be a global or a local crisis; any of the crises above explained or a different one. Ideally, the articles would be based on the same crisis but from different sources. The material should be provided by the teacher.
The activity should take between 45 minutes to one hour.

Group size

Any

Instructions for trainers

1. Ask the students to divide into groups. Photocopies of the media reports are placed facedown on the tables and numbered. In turns, each group chooses an article.
2. Each group should read and discuss the piece, trying to identify any possible bias. For example, they should identify facts, opinions, speculations and so on.
3. Some questions that could guide the analysis of the article might be (the teacher could decide to modify this):

    a. Are the students familiar with the source?
    b. Can the students identify where the article could be written?
    c. Is it providing facts or opinion?
    d. Is the article discussing only the economic perspective or also the political and social spheres?
    e. Does this material help them better understand the crisis it discusses, or was it making it more confusing?
    f. Were there different perspectives from the different sources?
    g. Are the students able to spot some of the keywords studied?
        - Economic Policy
        - Regulation
        - Welfare State
        - Public investment
        - Neoliberalism
        - Austerity
    h. Is the article defending any position about government intervention?

4. After some time each group reports back, explaining their answers to the questions, and anything else that they discussed. They can be respectfully questioned by the other students. Record the findings of this activity on the board.

Suggested sources:

- Financial Times
- The Economist
- The Wall Street Journal
- International newspapers as well (El País, The Guardian, etc)
- Local economic/political economic media is strongly encouraged
-

Examples:

Chris Giles for Financial Times : *Global economy: the week that austerity was officially buried.* Link

The Economist: *Beyond crisis management, Bold ideas for solving America's financial mess.* Link

Activity 3: Role Play

Overview

An interactive activity that sets the classroom floor for debate.

The two different models (austerity vs. stimulus) should be used in their 'pure' representation, however explain that in reality governments decisions are more nuanced and not black or white.

Aims

• To enable students to become knowledgeable in the different political economy theories
• To promote skills of debate and analysis
•To generate interest and discussion around different ways to manage a crisis

Materials and time

Photocopies of the cards (below) with the different situations of economic imbalance. Explanation and group activity is estimated between 20 and 30 mins. The final discussion should take 30 min approximately according to the number of groups.

Group size

16 minimum

Instructions for trainers

1. Divide the students into pair groups that later will be divided again in half.

2. Number the cards below and ask the students groups to each pick a card. Each card contains different economic imbalances.

3. Ask the groups to read and discuss each problematic situation and think about which recommendations would be taken by each model (neoclassical or Keynesian). For this, each group should be divided in half and take the role-play of representing one of each of the two economic schools.

4. After the discussion in their groups, each group in turn takes to the stand and presents their argument. For this, arrange the room to allow the speaking contestants to get a central position in the classroom, arranging the seats for the rest of the students around to listen and observe.

5. Following each group discussion the teacher should ask the audience (the rest of the students) to vote for which solution they would support and why.

6. To guide the students into what role each should take, they should clarify their positions by trying to answer WHAT, HOW and WHOM. Here there are some questions to guide the analysis:

    a. Should the State intervene or not?

    b. If yes, how?

   i. Fiscal policy: expanding public spending (granting subsidies, reducing taxes, etc); or reducing it (rising taxes, privatising public assets, etc)

   ii. Monetary policy: expanding money supply and with it lowering interest rates encouraging consumption and investment; or reducing the money supply and with it raising the interest rate, therefore encouraging saving and the removal of money from the economy.

c. If not, how?

   i. Leaving the market to regulate by itself, allowing prices to increase if there is a demand excess, or reduce if there is an oversupply.

   ii. By automatic mechanisms: depletion of the existing capital stock that requires its replacement and therefore rising the labour demand

d. Are the actions taken more similar to an austerity plan or to a public investment one?

e. What might the social impacts be? / Which sector of the society will benefit the most?

Problem cards

Inflation: prices rise faster than wages and nominal interest rates. As prices rise faster than wages, consumption decreases; investment also decreases due to the high process volatility and uncertainty.

Recession: a period of negative economic growth or in other words a decline in the size of the economy. As the economic activity is slowing down, consumption is reduced and companies' inventories increase.

Debt crisis: government increases their expenses while at the same time incomes fall

Unemployment: an imbalance between demand and supply of workers. It is due to swings in the business cycle, as costs have increased and companies need to reduce the number of employees in order to not lose benefits.

Inequality: enlargement of inequality as a result of the increasing concentration of wealth at the already high levels of the wealthy population, resulting in the deterioration in the living standards of the majority.

Activity 4: Choose your crisis

Overview
An activity to learn about crisis and economic history.

Aims
• To provide a historical perspective on the contemporary crisis.
• To equip students with the tools to investigate issues of economic crisis and the events that led to them.
• To encourage students to think critically about the commonalities and differences between the crises.

Materials and time
Photocopy of the crisis timeline. This activity should be planned to happen over two days. On the first day, the teacher presents the activity (15 minutes); on the next session students give their presentations (time depends on the number of students and the group arrangements but it could take from one hour to two hours).

Instructions for trainers
1. After reading through the contemporary crisis timeline, according to the crisis of interest, arrange students into small groups (no less than two, no more than four if possible).
2. Each group is asked to do in-depth research on the crisis they choose. Try to avoid two groups doubling up on the same event.
3. After researching at home, each group makes a presentation about the crisis event they chose. The presentation should be around 15 minutes. Supporting material as power points or posters are welcome.
4. Students should bear in mind the following items to take into account in their presentations:
    a. What were the causes of the crisis?
    b. Which sector was affected the most?
    c. Did the government take any action? If yes, which one(s)?
    d. Was there intervention from international organisations?
    e. What were the economic policy decisions applied? Austerity or Public support?
    f. Did the country better its situation? / Was a solution found?
    g. Is it possible to identify if any income redistribution occurred?

Crisis timeline
The late 1970s, early 1980s Latin America Debt Crisis: known as the 'lost decade', Latin American countries borrowed huge amounts of money from international institutions accumulating a foreign debt that later they were not able to repay.

1997 Asian financial crisis: the crisis started in Thailand, as after acquiring the burden of a huge foreign debt, bankruptcy produced a contagion effect which spread to their closest neighbours.

1998 Russian financial crisis: the Russian government's devaluation of the ruble fell into an impediment to repay their debt. The crisis had severe impacts on the economies of many neighbouring countries.

2001 Argentinian great depression: The impact of Russian and other regional depressions combined with the economic instability caused by the unstable pegged from the peso to the dollar caused a terrible economic crisis of high unemployment, riots, the fall of the government, and a default on the country's foreign debt.

The early 2000s the dot-come bubble: stock market collapse caused by excessive speculation in Internet-related companies in the late 1990s.

2009 Greek government-debt crisis: sovereign debt crisis faced by Greece in the aftermath of the financial crisis of 2007–08.

2008-2014 Great Recession in Spain: took place in the aftermath of the 2008 financial crisis. The main cause of Spain's crisis was the housing bubble and the accompanying unsustainably high GDP growth rate.

2020. Global health crisis due to Covid-19.

Potential sources

- Britannica Encyclopaedia
- IMF
- UNCTAD
- The World Bank

4. Interactive learning

Quiz: THE MODEL

Overview

The activity is designed for students to internalise the differences between the two models regarding the type of intervention they suggest. It is accompanied by a follow-up activity to continue at home or in the next class.

Questions

1. **Indicate which of these starting hypotheses of the neoclassical and Keynesian models are true:**
    a. Prices: the neoclassical model assumes they are flexible, Keynesian assumes they are rigid
    b. Prices: the neoclassical model assumes they are rigid, Keynesian assumes they are flexible
    c. The Keynesian model assumes that markets can regulate themselves automatically
    d. The Neoclassical model assumes that the economy is at a level of full employment
    e. The Keynesian model assumes that the economy is at a level of full employment

Correct answers: a) and d)

2. **For the________model the State should intervene in trying to offset the economic imbalances.**
    a) Keynesian
    b) Neoclassical

Correct answer: a)

3. **Fiscal policy affects the _____ and monetary policy affects the _____**
    a) Money Supply / Aggregate demand
    b) Interest rates / Aggregate demand
    c) Aggregate demand / Money Supply
    d) None of the above mentioned

Correct answer: c)

4. **The neoclassical model understands that the best policy to use in the face of economic imbalances is the ______**
    a) Fiscal
    b) Monetary

Correct answer: b)

5. **The Keynesian model understands that the best policy to use in the face of economic imbalances is the ______**

    a) Fiscal
    b) Monetary

Correct answer: a)

6. **The multiplier effect refers to a series of chain reactions that happen after aggregate demand is expanded by public spending (fiscal policy) and that in the end increases private income and GDP growth in a greater way than that initially generated by the original stimulus.**

    a) True
    b) False

Correct answer: a)

7. **Is tax reduction an element that defines fiscal or monetary policy?**

    a) Fiscal
    b) Monetary

Correct answer: a)

8. **Who determines the money supply?**

    a) Consumers
    b) Private Banks
    c) Government/Central Bank

Correct answer: c)

9. **Could monetary policy influence consumption?**

    a. No, consumption is not influenced by monetary policy, as it does not influence prices

    b. Yes, although via a secondary effect. When the money supply increases, the interest rate decreases and real variables such as consumption and investment expand. This is because people have fewer incentives to save on the one hand, and more incentives to get bank credit as their cost is low (the low rates) on the other hand, therefore generating incentives for financing consumption or investment with credit.

Correct answer: b)