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Special Issue
**Economic policies in times of financial instability
and rising public debt**

Editorial to the Special Issue

*Torsten Niechoj**, *Özlem Onaran***, and *Sabine Reiner****

In 2012, public debt is still at the centre of attention and economic policies – globally, but especially in Europe. For most of the mainstream commentators the main source of public debt can be traced back to loose public spending behaviour and a lack of fiscal discipline. However, story and facts do not coincide perfectly, to say the least (see also the contributions by Ederer in the forum section of this issue and Niechoj and van Treeck 2011 in the last issue of this journal). To give only one example taken from the European case: In Spain the level of public debt is still below the German level although Germany is the main proponent and an example of presumably sound fiscal policy and a successful recovery after the financial market crisis from the point of view of both the public and mainstream academia. Additionally, the debt-to-GDP ratio of Spain had been falling until 2007, down to only 36 per cent, which is quite low in international comparison and far below the debt criterion of the European Stability and Growth Pact.

What is often neglected is the nexus between the current European crisis and the preceding financial crisis. The increase in public debt was a direct response to the turmoil within the financial system and essential to dampen the negative economic consequences of the financial crisis. Public spending stepped in when private consumption and investment dropped. Without it the recession would have been more pronounced and longer lasting. Both financial support for the banking system and stabilisation policies were costly but necessary. It was, however, not accompanied by an effective restructuring of the regulation of the financial markets and by a sufficient refinancing of the states, making accountable those who were responsible for the crisis: investors, funds, and banks in search of high profits. The states are still looking for a new type of banking regulation and are yet to depart from the efficient market hypothesis.

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Moreover, the financial crisis revealed the dangerous effects of imbalances at the European level. Since the establishment of the European Monetary Union and the loss of the exchange rate mechanism, current accounts have diverged drastically and non-sustainable growth patterns emerged, which holds for both current account deficit as well as surplus countries. High levels of foremost private and sometimes public debt is only one example of such unsustainable patterns; excessive dependence on exports is equally unsustainable.

Currently, we are facing an era of fiscal austerity in the euro area. Theoretical efforts are still necessary to get a grip on the effects of the current fiscal policies. This is, however, not an academic finger exercise. If fiscal multipliers are higher than expected by conventional wisdom, fiscal restraint may lead to a severe recession in the forthcoming years and has already dampened economic activity in the euro area to a large extent. Furthermore, especially in times of fiscal austerity the question of how to spend public money in order to generate the highest contribution to growth and welfare becomes crucial. In other words, the question is whether there exists an optimal composition of public expenditure and revenues and a best practice all European countries should follow. And surely, the overarching question whether the austerity approach, which all member states of the euro area are following right now, makes sense or not also has to be discussed.

This is the area of research this special issue on financial instability and public debt contributes to. We hope that the readers will find the thoughts and approaches in this special issue helpful.

The first article addresses how different views shape the reform of banking regulation. In »What are banks and bank regulation for? A consideration of the foundations for reform« *Sheila C. Dow* doubts that the belief of the mainstream in efficient markets based on rational expectations and calculations can guide a reform of the banking sector. According to this view, avoidance of moral hazard becomes the dominant policy recommendation although the moral hazard approach is a vague and misleading concept, as Dow shows. If, however, full information and smooth calculation is not at hand, uncertainty becomes an issue. Banking regulation has to deal with this and it becomes important to establish institutions that reduce uncertainty and foster confidence by, mainly, restoring the lender of last resort facility of the central bank. This gives rise to a more positive, supportive role of banking regulation making lesser use of negative incentives.

Jörg Bibow approaches the issue of financial instability and regulation in the context of capital flows in the second article titled »The case for capital account management in emerging market economies: The experiences of the BRICs«. As opposed to the conventional wisdom that advocates reserve accumulation as a form of »self-insurance« in the emerging markets with excessive private capital inflows, he argues that capital account management represents a less costly alternative policy in particular in the absence of a fundamental reform in the global financial order. Bibow shows that the presumable benefits of short-term speculative financial inflows do not outweigh the benefits of avoiding such inflows based on the policies regarding capital flows in Brazil, Russia, India and China during the global crisis and subsequent recovery.

In his contribution »The simple macroeconomics of fiscal austerity: Public debt, deficits and deficit caps«, *Thomas I. Palley* constructs a concise model in the tradition of Keynes and Kalecki to cover the macroeconomic effects of fiscal austerity. He emphasises the important role public debt can play in a recession and argues that public spending stabilises the economy by maintaining aggregate demand in view of low inflation. If policy makers refrain from using this tool to stabilise the economy and establish a deficit cap – like the German debt brake or similar fiscal rules currently planned or introduced in the euro area – then a negative balanced budget multiplier may occur when the positive wealth effect due to low inflation is overcompensated by the reduction of spending. As a result, budget deficit caps do not help to recover, they aggravate the recession.

The third article »Composition of public expenditures and macroeconomic performance in the European Union« by *Jesus Ferreiro, Maribel García del Valle, and Carmen Gómez* explores the relationship between the composition of public expenditures and the macroeconomic outcomes like growth, unemployment and inflation in the EU member states during the period 1995–2007. Their results show that there is no evidence of a robust relationship between the structures of the public expenditure and the macroeconomic performances. They conclude that there is no single optimum model of public spending that warrants the best macroeconomic performance. The effects should depend crucially on the macro and micro environment, incentive structures, and industrial policy components embedded in public spending decisions.

Toralf Pusch emphasises fiscal austerity providing a substantial threat of recessionary effects in the European Union. His article »Fiscal spending multiplier calculations based on input-output tables – an application to EU member states« finds that fiscal spending multipliers are underestimated in current model-based and empirical literature. The main difference of Pusch's approach is the calculation of import shares resulting from different domestic expenditure categories using input-output tables. Using domestic absorption as the major driving force for imports clearly increases, as it is shown, fiscal spending multipliers for EU member states. So the stimulus effect of fiscal spending is in the same way underestimated as the downwards risk of budget consolidation is in times of crises.

This special issue comprises a selection of papers of the 14th conference of the Research Network Macroeconomics and Macroeconomic Policies (FMM) on »Stabilising an unequal economy? Public debt, financial regulation, and income distribution«, held in Berlin, 29th to 30th October 2010. We would like to refer the readers, who are interested in a broader selection of papers covering the full spectrum of the conference, to the conference proceedings which have been made available as Volume 14 of the Series of the Research Network Macroeconomics and Macroeconomic Policies conference proceedings (Niechoj et al. 2011).

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