NO PLAN B: BUT IS THERE A 'THIRD WAY'?

Kent Matthews*

Abstract
This paper reviews the argument for a slowdown in the fiscal consolidation policy of the UK government. It reviews the existing literature and the evidence of the interwar period in the UK where a recovery occurred without a relaxation of the tight fiscal regime of the period. It argues that even in a zero-lower-bound, the evidence for a plan B is weak. Given that there may have been significant capacity destruction, the paper suggests a third way that calls for a supply-side framework that sets the condition for an improvement in long-term growth and productivity.

1. Introduction

'It's the economy, stupid' was the campaign slogan of the Bill Clinton presidency in the USA. The same message, if it is not part of a re-election campaign, could turn out to be the epitaph of the Conservative–Liberal Democrat coalition administration in the UK that assumed office in 2010. The flatlining of the economy and the continued message of no alternative to the economics of austerity have raised questions as to whether there is a more promising alternative to the Plan B that is usually mooted in policy circles, that is, slowing the policy of deficit reduction and using fiscal policy to offset weak and fragile household spending and corporate investment. However, the fiscal stimulus package of the Obama administration, often held up as a model for those seeking an alternative, has yet to generate the kind of multiplier effects expected by its supporters.

The technical double-dip recession in the UK economy has resurrected the call for a Plan B. Matthews (2011) examined the case for a Plan B and concluded that there was no such case if it meant a softening of the policy of fiscal austerity. This conclusion was based both on the lack of clear current evidence for a large fiscal multiplier and on the experience of the 1930s, which was one of fiscal conservatism and loose monetary policy.

This paper revisits the case for an alternative policy by reviewing the efficacy of a fiscal expansion under a zero lower bound (ZLB) for interest rates, with the 1930s used as a reference period. It questions whether a fiscal expansion at a ZLB would have worked as costlessly as its supporters suggest for the interwar period and even in the current period. Empirical evidence suggests that a Keynesian-style fiscal policy would have been ineffective in the interwar period; neither would it work today. A money-financed fiscal expansion could have had temporary expansionary effects at a cost of higher inflation. This may be perceived to have been less of a problem in the 1930s than it would be today, but from an historical perspective it was not feasible as it would have been accompanied by a further depreciation of sterling.

This paper also brings to bear new evidence to suggest that, unlike in the interwar period, automatic stabilisers cannot operate in the way expected by some theoretical paradigms because of strong supply-side shocks that may have reduced potential GDP. Recent research shows that in some countries output never returns to its former trend rate following a financial crisis. The UK may be one such country. The paper suggests, however, that there may be a 'Third Way' that places an emphasis on supply-side policy to encourage investment and risk-taking through appropriate tax policy and greater access to bank credit.

The paper is structured in the following way. The next section examines the 1930s recession/depression and highlights some resemblances to and differences from the recession beginning in 2008, sometimes now called the 'Great Recession'. Section 3 reviews the evidence on fiscal policy multipliers and the scope for the use of expansionary fiscal policy in the recovery of the 1930s. The fourth section examines the recession and recovery in the 1930s, compares it with similar post-war recessions and recoveries in the UK, and reviews the issue of capacity destruction and the possibility of a permanent supply-side shock. The final section concludes with an examination of the arguments for capacity rebuilding and supply-side policies.

2. All our yesterdays

The inter-war years throw up both similarities to and differences from the present which make the exercise of learning from history an imprecise one. Obvious similarities are the fall from gold in September 1931 and the 25 per cent depreciation of sterling between mid-2007 and end-2008. Another similarity with today's monetary conditions is the period of low interest rates in the recovery period of the 1930s. While Bank Rate fell to a constant 2 per cent from 1933 till 1939, Treasury Bill rates fell to around 0.5–0.75 per cent and long-dated gilts between 2.5 and 3.5 per cent. Government debt resulting from the First World War was around 175 per cent of GDP over the whole period – well above current levels – and a cause for concern and constrained fiscal policy in terms of maintaining credibility with foreign investors, just as current debt levels constrain fiscal policy.

In other respects there are big differences between the two periods. The most obvious is the level of inflation. Inflation was negative (minus 3–3.5 per cent) in the 1921–33 period and a low positive 1.3 per cent in 1934–38, compared with consistently high and above-target inflation for nearly 60 months in the recent period. The public sector deficit was another striking difference. Although there were instances when public sector borrowing was higher than expected, particularly in the recession period of 1929–31 (Middleton 2010), by and large the period was one of fiscal orthodoxy.

However, one striking similarity is the way the economy behaved in the aftermath of the downturn in the world economy and the fall from gold. With 1929(4) and 2008(1)[1] as base points, Figure 1 shows the output loss relative to the base point from 1929(4) to 1934(1) and 2008(1) to 2012(2). What is particularly striking is the depth of output loss relative to its peak in today's Great Recession and the closeness of the match with the Great Depression of the interwar years. This pattern is not matched by any other recession since the Second World War. What is also notable is the difference in the pattern of the recovery. In the 1930s, the economy had returned to its level prior to the downturn within 16 quarters, whereas after 17 quarters the current economy remained 4.3 per cent below its peak.
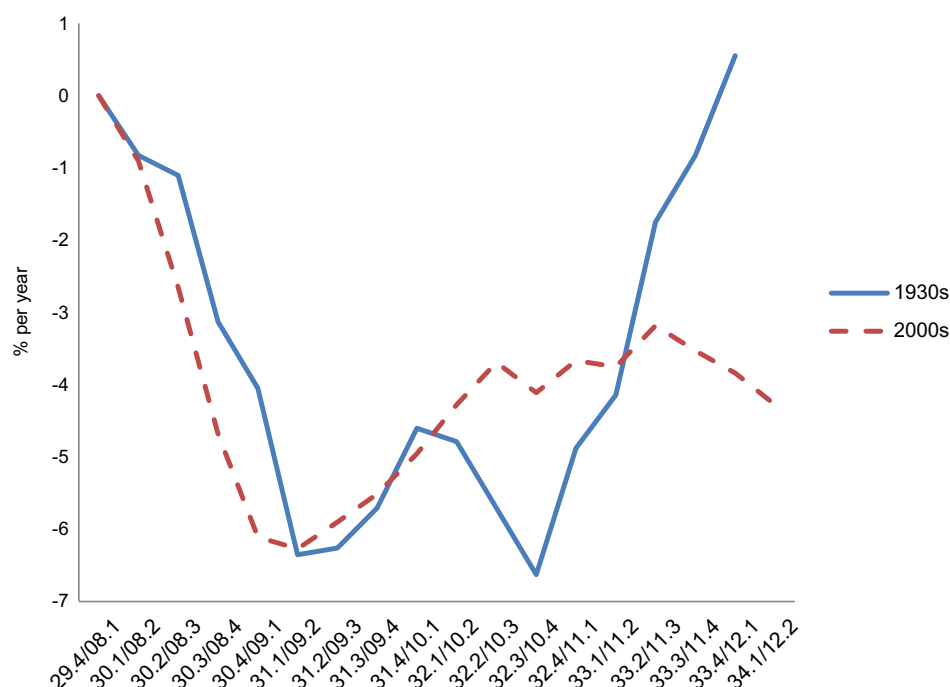
Figure 1: Output loss and recovery, 1929(4)–1934(1) and 2008(1)–2012(2).
Sources: Hayes and Turner (2007), Office for National Statistics (ONS).

Recovery from the current recession is clearly taking longer than was the case with the economy of the 1930s, and that is the puzzle that needs explaining. Table 1 shows that, despite some similarity in the pattern of the downturn, there were as many differences as similarities in the two periods covered in Figure 1.

First, fiscal austerity was very much the order of the day in the 1930s. The UK economy in the 1930s was very different from that of today. As a percentage of GDP, the government sector was less than half of its current size. The return to the gold standard in 1925 created a different environment for expectations from the post-Second World War history of stop–go and periodic devaluation. It is arguable that the economy was at capacity until 1931 and scope for discretionary policy was minimal until later in the 1930s. The Treasury view dominated thinking on economic policy, although the attempt to override the automatic stabilisers was not always successful. The public sector deficit averaged 1.1 per cent of GDP in the depth of the recession period of 1930–33 – small by current standards but widely viewed as damaging to confidence at

Table 1: Summary statistics 1929–34 and 2007–2012 (yearly averages, %)

Years	Public sector deficit/GDP	Annual inflation	Quarterly growth rate	Treasury Bill rate	Bank rate
1929–1934	0.5	–2.1	0.1	2.4	3.3
2007–2012	5.5	3.4	–0.2	1.4	2.0

Sources: Feinstein (1972), Capie and Collins (1983), Hayes and Turner (2007), ONS, Bank of England.

the time (Middleton 2010). The position of Britain in the world economy, the use of sterling as a global vehicle currency, and heavy government indebtedness weighed heavily on the thinking of the policymakers.

While average growth showed a basically flat economy for both periods, inflation was negative in the first half of the 1930s but remains a problem in the current period. Policy also differed in that the 1930s was one of tight fiscal policy and loose monetary policy, but the current period can be described as loose but tightening fiscal policy and seemingly loose but actually tight monetary conditions.

The next section reviews the literature on the Keynesian multiplier, in particular the case of the ZLB. It poses the question: would a fiscal expansion have aided recovery in the 1930s? Would it aid recovery now?

3. The Keynesian multiplier and the zero lower bound

The simple Keynesian multiplier of first-year undergraduate textbooks has long been seen as a special case of the neoclassical/Keynesian synthesis with a 'liquidity trap'. Once the government financing constraint, wealth effects and the supply side are brought into consideration, the short-run multiplier is less than unity even without having to invoke rational expectations. In a recent review of macroeconomic models, Ramey (2011) concluded that the fiscal multiplier was in the range 0.8 to 1.5. However, he found no consensus in the literature on the means by which an increase in government spending increases GDP. The typical New Keynesian model of Smets and Wouters (2007, 2003) – hereafter S-W model – shows a low multiplier. This is because it builds a sticky-price framework on to a neo(new)-classical foundation. The current generation of New Keynesian models allows for forward rational expectations and, with inter-temporal government financing constraints, these models exhibit accelerated Ricardian equivalence effects. Higher multipliers are produced only if consumers are assumed to behave suboptimally or are liquidity constrained, or workers are willing to supply as many hours as firms are willing to demand. Simulations with the S-W model for the euro area by Cwik and Wieland (2011) reveal short-run multipliers of around 0.5.

Yet it can be argued that the multipliers produced by the typical New Keynesian model understate the impact of fiscal policy in the context of ZLB interest rates. This aspect is examined in Christiano, Eichenbaum and Rebelo (2011) (CER). Monetary policy in the CER model follows a conventional Taylor rule. The government budget is balanced and fiscal expenditures are financed by equivalent lump-sum taxes. As a result of tax-financed fiscal expansion, households feel poorer and consume less; but because they are poorer they choose to work more (wealth effect)[2]. In the face of an increase in demand, because of the assumption of sticky prices, not all firms can raise prices. Hence those firms that are price sticky face a fall in relative prices for their goods and experience a disproportionately higher demand. To meet demand they increase their demand for labour, bidding up money wages. Mark-ups fall, real wages rise and households supply more labour willingly. Thus output rises in response to a fiscal expansion by more than in the simple S-W model. Based on a calibrated model CER argue that the multiplier is 1.05. However, if the ZLB is binding, the multiplier rises to 3.7. This is because as demand rises expected inflation rises and depresses the real interest rate. Actual inflation lags behind because of the assumption of sticky prices. The fall in the real interest rate augments the increase in demand by stimulating private spending.

It would seem that the ZLB provides a framework for the efficacy of fiscal policy and support for a Plan B. However, other considerations suggest that the multiplier is smaller in practice. Fiscal policy takes time to come into effect because of Friedman's famous 'inside lags' while inflation expectations can move faster. Indeed, CER show that with a one-period lag the multiplier falls to 1.5 and with a two-period lag it falls to 1.44. Most studies using the S-W framework calibrate the model to US data, although Braun and Körber (2011) calibrate a New Keynesian model to Japanese data for the 1990s and 2000s. They show that expectations loosen the ZLB constraint, which is therefore no longer binding and reduces the multiplier to 0.9.

Other studies suggest that the fiscal multiplier is state-dependent. The basic Dynamic Stochastic General Equilibrium (DSGE) model solves on a local linearised path of a system of non-linear equations; thus, the effects of fiscal expansion on consumption or output are the same whether the economy is in a roaring boom or a deep recession. Parker (2011) argues that the multiplier should be state-dependent and calls for research into non-linear systems. However, the problem with this argument is that researchers will have to use many more recessions in their sample than the world has hitherto generated in order to produce reliable results; and a policy prescription based on unknown outcomes is a risky proposition[3].

In contrast to the mainstream finding the International Monetary Fund (2012, Box 1.1) has argued that fiscal consolidation should be slowed because fiscal multipliers have been underestimated. The IMF regresses its forecast error of GDP growth (made in early 2010 for 28 countries for the period 2010–11) on its forecast of fiscal consolidation. If we assume that the forecasting model is true and the forecast of fiscal consolidation is correct, then the coefficient on the fiscal consolidation variable (defined as the forecast of the change in the structural fiscal balance as a percentage of GDP), should be zero[4]. However, the main finding (even if we allow for missing variables) is negative and statistically significant, which is interpreted as an underestimation of the multiplier[5].

It is difficult to interpret this result without knowing something about the properties of the IMF's assumptions of fiscal consolidation. The IMF assumes rational expectations and that the forecast of the contraction of the structural fiscal balance (an unobservable) is optimal. It can be argued that in many countries the high level of debt has led them to override the automatic stabilisers and increase fiscal consolidation, creating an even worse downturn than expected. In this case the unexpected downturn would be caused by a worse than expected fiscal consolidation rather than a higher multiplier[6]. It is clear that the IMF finding cannot be accepted without qualifications about the need for further research on the dependence of fiscal multipliers on time and economic conditions. For example, Ilzetzki, Mendoza and Végh (2010) study fiscal policy in 44 countries and show that the multiplier is conditional on a number of contingencies. They find that the multiplier is low to zero in open, flexible exchange rate economies that are highly indebted – like the current UK economy.

With respect to the interwar period, while the 1930s in the UK represent a period of recovery without fiscal expansion, it is difficult to evaluate the counterfactual that a fiscal expansion could have been beneficial. Macroeconomic models of the interwar period have been few. But two studies deserve mention because of their attempt to model the supply side. Dimsdale and Horsewood (1995) estimated a demand-dominated model (D-H model) with a supply side of the Layard–Nickell–Jackman[7] variety (D-H model) and static expectations, while Matthews (1989, 1986) estimated a New Classical rational expectations model with a strong supply side.

In their pamphlet *Can Lloyd George Do It?* (1929), Keynes and Henderson argued that a £100m a year fiscal boost for three years would have reduced unemployment by 500,000 (Matthews 1989). The New Classical model of Matthews (1986) simulated a bond-financed fiscal expansion of £100m a year for three years, and this produced a multiplier impact of just 0.55–0.65 (in line with the mainstream finding of recent research). This was because crowding-out was caused by a rise in the real rate of interest and a rise in the real exchange rate, although there was no change in the price level.

A similar exercise with the D-H model produces output effects consistent with a multiplier of 1.6–1.75 and a rise in the price level by 3.6 per cent by Year Three. Crowding-out is negligible in the D-H model because the bond expansion has only a moderate effect on interest rates and the exchange rate, and bonds do not appear as a wealth effect in any of the expenditure functions. However, what is critical in the D-H model is that expectations are static. Even with the crowding-out channel closed through a fixed interest rate (which can be interpreted as the equivalent of the ZLB), the multiplier in Year Three is only 1.95 and employment rises by 300,000, which is insufficient to reduce unemployment by the 500,000 claimed by Keynes and Henderson (1929). In contrast, Matthews (1989) simulates the same fiscal policy package proposed by Keynes and Henderson as a purely money-financed expansion and shows that an extra 370,000 jobs could be created by Year Three but at the cost of a 13.5 per cent rise in the price level and a 14.5 per cent devaluation of sterling[8].

Both models suggest significant multiplier effects in a ZLB situation, although the second model has a substantial inflation cost attached to it. So would a judicious use of fiscal policy have aided recovery in the Great Depression? In other words, are we, as some would suggest, repeating the mistakes of the 1930s by not pursuing fiscal expansion?

It is generally accepted that a policy of cheap money aided the recovery by stimulating consumer spending and creating a housing boom (Crafts and Fearon 2010). Contrast this with the current situation where quantitative easing (QE) has not had similar effects because of the heavy indebtedness of the household sector and the desire to save (or repay debt). After Britain left the gold standard in 1931, it was possible to change monetary policy. After an initial period of shock and a vacuum in policy, a looser monetary regime was ushered in six months after gold was abandoned. In this situation, fiscal orthodoxy was seen as the necessary condition for buying policy credibility and stabilising expectations. The combination of loose money and tight fiscal policy worked to create the conditions of recovery. According to Middleton (2010), a fiscal expansion may not have been feasible given the policy objective of buying credibility and underpinning expectations. But one important difference between the 1930s recovery and the current economic situation is that in the interwar period there is the suggestion that there was sufficient capacity in the system to accommodate a loose monetary policy. As we shall see in the next section, this assumption may not be appropriate for the current recovery.

4. Capacity destruction and the output gap

The need to assuage the fears of international investors may have constrained the Treasury mandarins in the 1930s, but in principle there was sufficient capacity to use fiscal policy to move out of the recession faster. A closer examination of the path of GDP in the interwar period shows the economy moving along trend until 1929–30, when the economy was engulfed by a wave of deflation following the Great Crash in the USA and the downturn in world trade
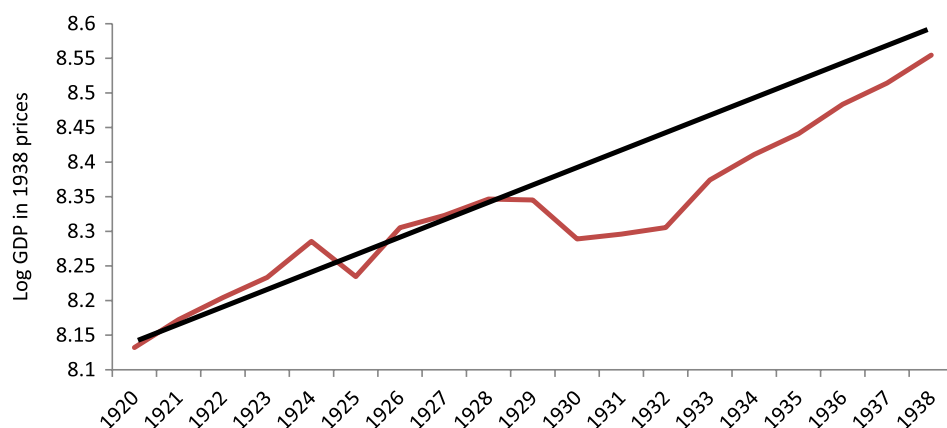
Figure 2: Real GDP, 1920–1938.
Source: Feinstein (1972).

(see Figure 2). Recovery was long-drawn-out but the economy was close to trend capacity by the time of the Second World War.

Recovery in the 1930s occurred without the assistance of fiscal policy. Based on mainstream estimates of the fiscal multiplier and research done on the interwar period, there must be some doubt that a government expenditure boost that involved more government borrowing could have aided the recovery without significant inflationary and devaluation cost.

Figure 3 shows the long view of real GDP between 1955 and 2012. The post-2008 recession is of a deeper magnitude than the recessions of 1980–81 and 1991–92. However, those previous recessions saw output returning to a trend rate of growth of about 2.5 per cent a year. This is not happening in the Great Recession.
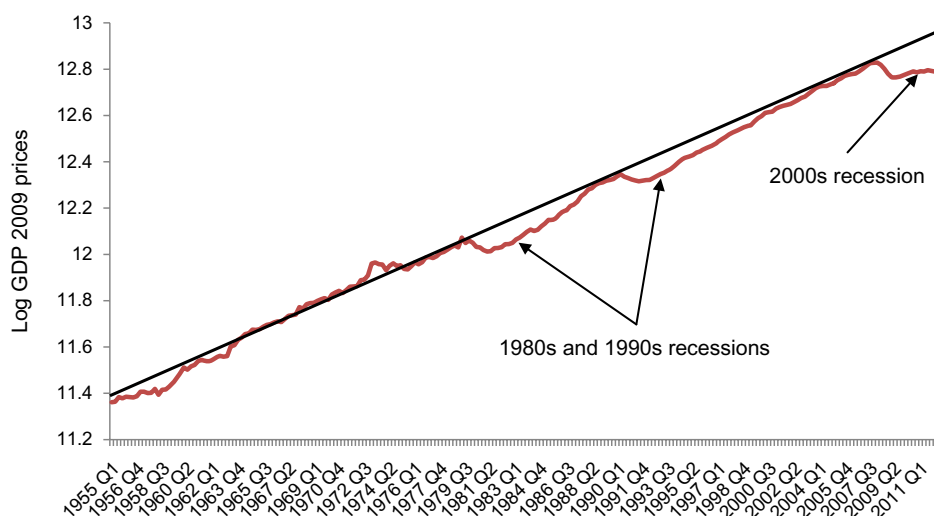

Figure 3: Real GDP, 1950–2012.
Source: ONS, 2012 (estimated).

(a) Malaysia

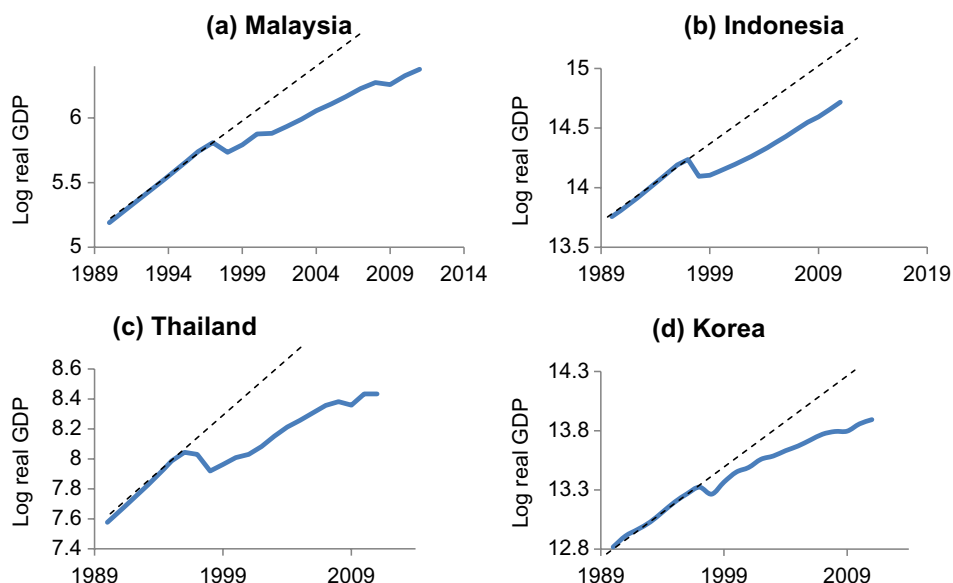**(b) Indonesia**

(c) Thailand

(d) Korea

Figure 4a–4d: Asian financial crisis, 1997–1998.
Source: IMF statistics.

Research by Cerra and Saxena (2008) suggests that some economies never recover the output loss from a financial crisis. For example, Figures 4a–d shows the permanent output loss for the affected economies of the Asian financial crisis of 1997–98. Such events are part of the 'creative destruction' process of capitalism (Schumpeter 1942). Capacity that is destroyed is not always replaced at the same rate and potential output is lowered.

There may be a number of reasons why a similar result may have occurred following the 2008 recession in the UK. Investments in low-value-added consumer products may have led to overcapacity, falling investment returns and stock market corrections. Investment in real estate has diverted resources from productive processes and fuelled a housing bubble, which has had negative wealth effects in the crash. Alternatively, as Minford (2010) suggests, an oil price of $100 plus has necessitated a switch in the choice of techniques, which can cause a disruption of permanent dimensions. His explanation for the current banking crisis is that it is the outcome of a negative 'non-stationary productivity shock'[9]. Such shocks are not new to the UK. A similar shock occurred after the return to peacetime in 1920 after Britain found that it had lost most of its traditional pre-war markets (Solomou 1996). But whatever the reasons, the possibility of capacity destruction and permanent output loss is recognised by the government and international agencies as a factor reducing the official estimate of the output gap (Pybus 2011).

5. Capacity building and the supply side

Capacity destruction requires a supply-side policy response to encourage capacity rebuilding. Two policy responses can be considered. First, an easing up of the drive to regulate the banking system, at least until the economy recovers. During the 1930s recovery, bank credit played its
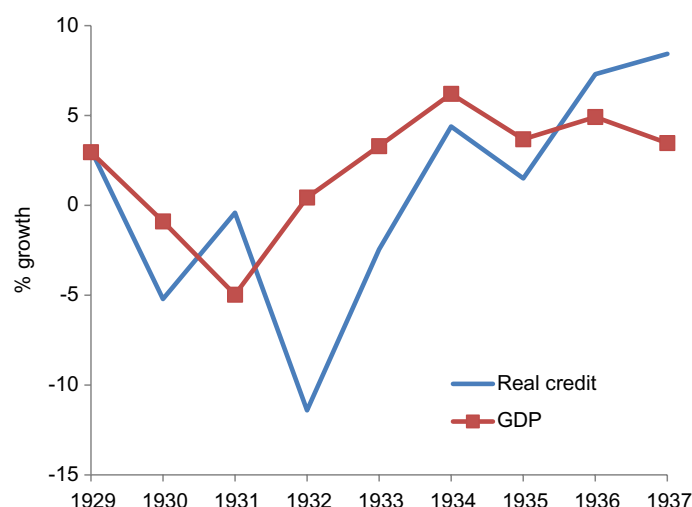
Figure 5: Real bank credit growth and GDP growth, 1929–1937.
Sources: Feinstein (1972), Sheppard (1971).

part through the policy process of 'cheap money'. Figure 5 shows the correspondence between real bank credit growth and real GDP growth. Naturally, the issue of endogeneity remains and no causation can be attributed to the relationship. Also, bank credit played less of a part in the financing of small and medium-size enterprises (SMEs) in the 1930s than it does today. However, Figure 5 indicates a correspondence or at the very least a joint determination.

While bank rate at 0.5 per cent and QE gives the impression that money is cheap in the current recession, so far the main beneficiaries have been large companies that have used the outcome of QE to restructure company debt by issuing corporate bonds and repaying bank loans. In contrast, lending to SMEs has been contracting as banks have widened spreads to rebuild capital and increase liquidity in response to greater regulation. The wider spreads also reflect the increased risk in the lending portfolio. The consequence of wider spreads and possible credit rationing is that SMEs have been unable or unwilling to use bank credit to rebuild capital. Figure 6 shows the annual rate of growth of bank and building society lending to the non-financial private sector against the annual real GDP growth rate by quarter. Again, the correspondence cannot be used to argue for causation, but clearly negative bank and building society credit growth is not healthy for an economy struggling to escape flat growth. An atmosphere of 'banker bashing', tightening regulation on higher capital and liquidity requirements have contributed to weak bank lending. The 'funding for lending' policy launched by the UK Treasury and the Bank of England in July 2012 may be a step in the right direction, but a more a coherent policy would be to halt the perceived over-regulation of banks at least until the economy is in better health.

The second response worth considering is a wholesale policy of supply-side improvement, which starts with greater access to investment funding by SMEs; reduction in the regulatory burdens on businesses; flexible immigration of skilled labour (including overseas students) so as to attract and retain talent; the creation of an environment that increases productivity, investment and risk-taking in the business sector as a whole (through greater certainty of corporation tax and regulation); and tax cuts.
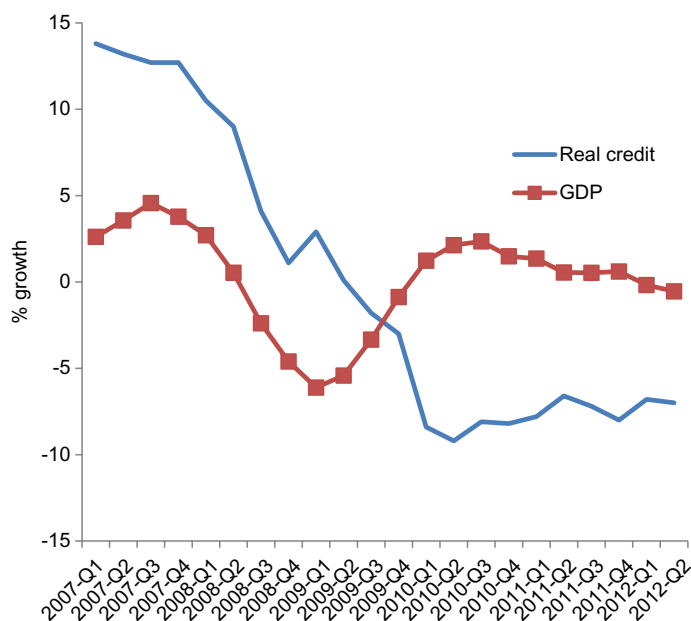
Figure 6: Real bank and building society lending (year-on-year growth) and GDP growth, 2007(3)–2012(2). *Sources*: Bank of England, ONS.

Tax cuts would work in two ways: a productivity effect and a wealth effect. Tax cuts on high-income earners would restore the tax competitiveness of the UK for the location of multinationals. McKinsey & Company (2010) identifies multinationals as strong productivity drivers of the UK economy and argues that high labour and business taxes have led to relocation in Switzerland and Ireland, reducing the UK tax base by £1 billion[10]. The wealth effect works through the labour market in general by increasing the returns to labour and risk-taking. For example, Fernández-Villaverde, Guerrón-Quintana and Rubio-Ramierez (2011) show that revenue-neutral supply-side policies in a New Keynesian model at the ZLB would generate an increase in current consumption, through a wealth effect from increased future productivity. Shifting tax policies away from income will increase future income and, through the expectations mechanism, encourage higher current consumption. An increase in current consumption can be expected to raise the real rate of interest, which will dampen some of the effect; but at a ZLB the initial output effect will be larger.

It is fair to say that unconventional monetary policy has not yielded the results expected by its proponents; but there remains a debate to be had about when it should be reversed. Similarly, however, the efficacy of fiscal policy of the conventional Keynesian variety is questionable even at the ZLB. A rise in government borrowing and debt at the current time – especially given the sovereign debt crisis elsewhere in the world – would affect expectations and confidence quite apart from any crowding out and Ricardian equivalence effects.

In the face of ineffective monetary policy and inappropriate fiscal policy, a Third Way is the adoption of supply-side policies. The lesson from the 1930s is that, if the drop in trend output is not permanent, then the appropriate course of action is loose monetary policy, fiscal austerity and supply-side reform. However, if the UK is in a situation where the drop in trend output is

permanent, as is feared, then the appropriate policy is to maintain fiscal austerity, but combined with a tightening of monetary policy from the current position and the loosening of the supply side through balanced-budget tax cuts and a softer approach to bank regulation.

Notes

1. 1929(4) means fourth quarter of 1929, and so on.
2. Consumption and leisure are normal goods.
3. In an empirical analysis of the effects of fiscal stimulus packages on household spending in the 2000s, Taylor (2011) concludes by doubting the efficacy of the 2009 American Recovery and Reinvestment Act stimulus package.
4. In econometric jargon, the forecast of the fiscal consolidation variable and the forecast error of GDP growth should be orthogonal.
5. This can be seen in the following way. Let y be GDP growth and X be fiscal consolidation, and the relationship between y and X be given by $y = -\beta X + \varepsilon$, where ε is a random error and β represents the multiplier impact on growth of the fiscal consolidation. Let X^f be the IMF forecast of fiscal consolidation and this is done perfectly, so $X = X^f$, but let the model the IMF uses to forecast growth be described by $y^f = -\hat{\beta} X^f$ and $\beta > \hat{\beta}$. Then the forecast error of growth is described by $y - y^f = -(\beta - \hat{\beta}) X^f + \varepsilon$ and the regression coefficient of the forecast of fiscal consolidation on the forecast error of growth is negative $-(\beta - \hat{\beta})$ only if $\beta > \hat{\beta}$, meaning that the multiplier is underestimated.
6. Let us say that the actual fiscal consolidation is systematically greater than the forecast so that $X = (1 + \rho) X^f$. So actual growth is given by $y = -\hat{\beta} X^f (1 + \rho) + \varepsilon$. Then $y - y^f = -\hat{\beta} \rho X^f + \varepsilon$, and the regression coefficient of the forecast error on the forecast of fiscal consolidation is $-\hat{\beta}\rho$ which is also negative.
7. See, for example, Layard, Nickell and Jackman (1991).
8. This was simulated as an unexpected monetary loosening to support expansionary fiscal policy. An expected monetary loosening would have produced minimal effects on output and employment and higher inflation.
9. Another view is that government policy responses may have inhibited the recovery (Taylor 2009). A similar argument is made by Benjamin and Matthews (1992) about the US Great Depression.
10. The same study identifies other tax restructuring policies including a reduction of corporation tax to 20%, the removal of tax shields such as interest deduction (thereby equalising the incentives for equity and debt financing), the removal of the tax bias against intangibles and the reformulation of tax incentives on R&D.

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