

Part II

The Two Sides of the Debate

As it was anticipated in the introduction, the Austerity vs Stimulus debate is not new to the world of political economy. The best known historical example of it, is the clash of ideas between John Maynard Keynes and the officials of the British Treasury in the 1920s, the former supporting a stimulus plan in opposition to the austerity policies pursued by the latter. Here we propose a less famous exchange, between two sets of economists: a letter by Keynes (and others) published on *The Times* and the reply by the Austrian economist Friedrich von Hayek (together with other LSE professors) in 1932. Keynes and Pigou argued that lack of confidence in the private sector was leading to be “pile[d] up in bank balances”. Only a fiscal stimulus could release the resources needed to revive the economy. Hayek and the other LSE academics replied that such policies would raise interest rates. The government should avoid any increases public expenditure (since it “imposes frictions and obstacles to readjustment”), and focus instead on supply-side reforms.