

Keynesian Economics: How to Ruin Your Economy in One Easy Lesson

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Relevant Dates

The Great Depression 1929-1933

John Maynard Keynes: *The General Theory of Employment, Interest and Money*. Published: February 1936

Keynes's Message

- Firstly, the problem of recessions are due to a deficiency of aggregate demand. The symptoms of recession are its actual cause.
- Secondly, an economy in recession cannot be expected to recover on its own, and certainly not within a reasonable time, without the assistance of high levels of public spending and the liberal use of deficit finance.

Aggregate Demand

- Aggregate demand has since 1936 played the central role in the theory of recession.
- Recessions are attributed to an absence of demand, and even where they are not, overcoming recessions is seen as dependent on the restoration of demand which is the active responsibility of governments.
- Until 1936, accepting the possibility of demand deficiency as a cause of recession was seen as the realm of cranks.

Ending the Great Depression – The UK

- In Britain, economic policy during the Great Depression saw the application of a full scale classical approach.

- British budget speech of 1933:

“At any rate we are free from that fear which besets so many less fortunately placed, the fear that things are going to get worse. We owe our freedom from that fear largely to the fact that we have balanced our budget.”

Ending the Great Depression - Australia

Edna Carew (1996) on the Premiers' Plan:

“A strategy adopted in June 1931 by Australia’s Scullin government to reduce interest rates and cut expenditure by 20 per cent, partly through slashing public-sector wages.

“The objective was to reduce Australia’s huge budget deficit problems. Australia had to get its books in order if the country was to continue to get overseas finance.

“Devaluation had already been forced and increased tariffs tried.

“The rationale behind the Premiers’ Plan was to revive business confidence.

“The plan was welcomed as an example of creative economic planning; Douglas Copland claimed it was ‘a judicious mixture of inflation and deflation’.

“Later it was criticised as overly deflationary.”

Not Ending the Great Depression - The United States

From 1933 onwards, public works, increased public spending and deficit financing were the essence of economic policy. And with what results?

Roosevelt's Treasury Secretary in 1938

“We have tried spending money. We are spending more money than we have ever spent before, and it does not work. . . . I want to see the country prosperous. I want to see people get a job. I want to see people get enough to eat. We have never made good on our promises. I say, after eight [sic] years of this administration, we have just as much unemployment as when we started . . . and an enormous debt to boot.”

Henry Morgenthau

Unemployment Rates Australian and the United States 1929-1938

Year	US	UK	Australia
1929	3.2%	10.4%	8.0%
1930	8.7%	16.1%	12.7%
1931	15.9%	21.3%	20.1%
1932	23.6%	22.1%	23.0%
1933	24.9%	19.9%	21.0%
1934	21.7%	16.7%	17.9%
1935	20.1%	15.5%	15.5%
1936	16.9%	13.1%	12.6%
1937	14.3%	10.8%	10.9%
1938	19.0%	12.9%	8.9%

The Post War Recovery in the United States

Harry Truman's State of the Union
address delivered in January 1946:

“It is good to move toward a balanced budget and a start on the retirement of the debt at a time when demand for goods is strong and the business outlook is good. These conditions prevail today.”

Stagflation

- At no stage in the first 25 years following the War did Keynesian theory actually have to confront an economy in deep recession.
- The first serious attempt to use Keynesian theory to deal with a major downturn did not occur until the late 1960s and early 70s.
- The result was what has gone down in history as the “stagflation” of the 1970s.

The Japanese Recovery Programme of the 1990s

- The most recent large-scale example of an attempt to use a Keynesian deficit-financed spending program to restore growth to a depressed economy occurred in Japan during the 1990s.
- In the 1990s, Japan attempted to hasten recovery with a series of very large spending packages.
- This expenditure drove the Japanese economy into deep recession.
- The example of the Japanese disaster is a lesson no one has been prepared to absorb.

Advice to the Japanese – IMF

- “There is little disagreement about what needs to be done. There is an immediate need for a substantial fiscal expansion....
- “The well-known reservations about increases in wasteful public spending are correct: that is why much of the package, at least half, should take the form of tax cuts.
- “It is true that Japan faces a long-term demographic problem that has major fiscal implications. But after so many years of near-stagnation, fiscal policy must help get the economy moving again. There will be time to deal with the longer-term fiscal problem later.”

Advice to the Japanese – *The Economist*

“The [Japanese] government says it cannot afford a big stimulus because its finances are perilous.... Rightly, the Japanese are worried about the future pension liabilities implied by their rapidly ageing population. But now is not the time to sort the problem out. Far better to cut the budget later, when the economy has recovered its strength.”

Level of Demand versus Structure of Demand

- The causes of recession are structural. They are the consequence of structural imbalances that result from errors in production decisions, not the fall in output and demand that necessarily follows.
- Modern macroeconomics is built around the notion of the *level* of demand while prior to Keynes recessions were understood in terms of the *structure* of demand.
- In modern economic theory, rising and falling levels of spending are for all practical purposes what matters. That is why increasing public spending and adding to deficits is seen as an intrinsic part of the solution, not as the additional problem such spending actually is.

Missing is the Structure of Demand

Missing in modern economic debates is an understanding of the importance of structure, that the parts of the economy must fit together.

Missing is an understanding that if the entire economic apparatus goes out of sync, recession is the result and recession will persist until all of the parts once again begin to mesh.

Causes of the Present Downturn

- the meltdown in the housing sector in the United States
- the bundling of mortgages into financial derivatives
- the massive American budget deficits
- Chinese exchange rate policies
- the phenomenal rise and subsequent fall in the price of oil
- uncertainty over future actions on greenhouse gases
- the arbitrary and erratic use of monetary policy
- the plunge in share market prices

Keynesian Demand Management

- But just as the causes of this downturn cannot be charted through a Keynesian demand-deficiency model neither can the solution.
- The world's economies are not suffering from a lack of demand and the right policy response is not a demand stimulus.
- Increased public sector spending will only add to the market confusions that already exist.

Keynes's Final Thoughts (1946)

“I find myself moved, not for the first time, to remind contemporary economists that the classical teaching embodied some permanent truths of great significance, which we are liable to-day to overlook because we associate them with other doctrines which we cannot now accept without much qualification. There are in these matters deep undercurrents at work, natural forces, one can call them, or even the invisible hand, which are operating towards equilibrium. If it were not so, we could not have got on even so well as we have for many decades past.”

Keynes “Classical Medicine” (1946)

“We have here sincere and thoroughgoing proposals ... expressly directed towards creating a system which allows the classical medicine to do its work. **It shows how much modernist stuff, gone wrong and turned sour and silly, is circulating in our system, also incongruously mixed, it seems, with age-old poisons....**

“I must not be misunderstood. I do not suppose that the classical medicine will work by itself or that we can depend on it. We need quicker and less painful aids But in the long run these expedients will work better and we shall need them less, **if the classical medicine is also at work.** And if we reject the medicine from our systems altogether, we may just drift on from expedient to expedient and never get really fit again.”

The Central Policy Question

- The question before us is whether markets should be allowed to find their way with only minimal government direction, or whether the economic system should be directed from above by elected governments and the public service.

Lasting Solutions

The only lasting solution also consistent with restoring prosperity, growth and full employment is to rely on markets.

The repeated attack on the market economy, and the role of the private sector, is a mindset begging for trouble.

Recovery Means the Private Sector

- But what must be explicitly understood is that recovery means recovery of the private sector.
- It is business and business investment that must once again take up the load of moving our economy forward.
- It is the banking system that must be allowed to allocate funds.

The Essence of the Keynesian Model

- The Keynesian model makes the engine of growth appear to be expenditure irrespective of what that spending is on.
- The most important element in the recovery process, according to these same models, is an increase in the government's own level of expenditure, and again it appears to matter not much at all on what that money is actually spent.

Banknotes in Mineshafts

From the *General Theory* to give some idea of what's in store.

“If the Treasury were to fill old bottles with banknotes, bury them at suitable depths in disused coalmines which are then filled up to the surface with town rubbish, and leave it to private enterprise on well-tried principles of *laissez-faire* to dig the notes up again (the right to do so being obtained, of course, by tendering for leases of the note-bearing territory), there need be no more unemployment and, with the help of the repercussions, the real income of the community, and its capital wealth also, would probably become a good deal greater than it actually is. It would, indeed, be more sensible to build houses and the like; but if there are political and practical difficulties in the way of this, the above would be better than nothing.”

The Argentine Road to Recovery

If the Argentine economy is your idea of utopia, this is the way to bring it about faster and with more certainty than anything else that might conceivably be tried.