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The Dangerous Return to Keynesian Economics

ECONOMICS

The Great Depression, in most places, began with the share market crash in 1929 and by the end of 1933 was already receding into history. In 1936, well after the Great Depression had reached its lowest point and recovery had begun, a book was published that remains to this day the most influential economics treatise of the twentieth century. The book was *The General Theory of Employment, Interest and Money*. The author was John Maynard Keynes. And his book overturned a tradition in economic thought that had already by then stretched back for more than a hundred years.

The importance of these dates is important. The economics which Keynes's writings had overturned is today called "classical theory", yet it was the application of this self-same classical theory that had brought the Great Depression to its end everywhere but in the United States, where something else was tried instead. And at the centre of classical thought was a proposition that Keynes made it his ambition to see disappear absolutely from economics. It was an ambition in which he was wildly successful.

Following a lead set by Keynes, this proposition is now almost invariably referred to as Say's Law. It is a proposition that since 1936 every economist has been explicitly taught to reject as the most certain obstacle to clear thinking and sound policy. Economists have thus been taught to ignore the one principle most necessary for understanding the causes of recessions and their cures. Worse still, they have been taught to apply the very measures to remedy downturns that are most likely, from the classical perspective, to push them into an even steeper downward spiral.

Keynes wrote, and economists have almost universally accepted, that Say's Law meant full employment was guaranteed by the operation of the market. To accept this principle therefore meant that the models then used by economists could not be used to analyse recessions and unemployment because within these models was buried the tacit assumption of full employment.

After 150 years of capitalist development, with the business cycle having been the clearest aspect of the operation of economies everywhere, Keynes in 1936 could still write that economists in accepting Say's Law had accepted "the proposition that there was no obstacle to full employment".

Keynes wrote that Say's Law meant that "supply creates its own demand". In his interpretation of this supposedly classical proposition, everything produced would automatically find a buyer. Aggregate demand would always equal aggregate supply. Recessions would therefore never occur and full employment was always a certainty. That economists have accepted as fact the proposition that the entire mainstream of the profession prior to 1936 had believed recessions could never occur when in fact they regularly did shows the power of authority in allowing people to believe three impossible things before breakfast.

But what was important were the policy implications of Keynes's message. These may be reduced to two. First, the problem of recessions is due to a deficiency of aggregate demand. The symptoms of recession were its actual cause. Second, 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.

The missing ingredient in classical economic theory, Keynes wrote, had been the absence of any discussion of aggregate demand. It was this missing ingredient that Keynes made it his mission to put in place.

And how successful he was. 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, no mainstream theory of recession had so much as glanced at the notion of demand deficiency as a cause of recession. It was specifically to deny the relevance of demand deficiency as a cause of recession that Say's Law had been formulated in the first place. Accepting the possibility of demand deficiency as a cause of recession was then seen as the realm of cranks. How the world does change.

This, it cannot be emphasised enough, did not mean that the possibility of recessions was denied. There were, and are, no end of potential causes of recession that have nothing to do with demand failure.

Indeed, no one explains the present economic downturn, the global meltdown we are in the midst of, in terms of deficient aggregate demand. It would be an absurdity to suggest the problems now being experienced have been caused by consumers no longer wishing to buy more than they have or savings going to waste because investors have run out of new forms of capital into which to invest their funds.

THE CLASSICAL THEORY OF RECESSION

CLASSICAL THEORY had taught that whatever might cause a recession to occur, it would never be a deficiency of aggregate demand. Production could never exceed the willingness to buy, and therefore treating the symptoms of a recession by trying to raise demand through increased public spending was in policy terms utterly mistaken.

Governments could create value but their income was derived from taxation. Taking money from those who were productively employed and directing production towards a government's own purposes remained acceptable so long as the level of such spending was limited and, most importantly, the government's budget remained in surplus.

These were the self-imposed restraints that Keynesian theory overturned. Public spending in combination with budget deficits, he argued, would propel an economy out of recession. This belief is now accepted by a very large proportion of the economics community.

Yet for all that, no recession has been brought to an end through increased levels of public spending, but many recessions have been ended by a return to sound finance and fiscal discipline.

THE GREAT DEPRESSION

THE HISTORY of public policy during recessionary periods has a number of lessons to teach, assuming we are capable of learning from them. In Britain, economic policy during the Great Depression saw the application of a full-scale classical approach. A policy was adopted of balancing the budget and containing expenditure. By 1933, the budget had been balanced and it was from 1933 onwards that Britain emerged from the downturn of the previous four years.

It is worth noting that it was balancing the budget that was seen to have made the all-important difference. In rejecting deficit financing during his budget speech of 1933, the British Chancellor of the Exchequer, Neville Chamberlain, made this explicit statement:

> 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.

The same story could be told about Australia, where the Scullin Labor government made the decision in adopting the "Premiers' Plan" which sought a cut in public spending, a return to budget surplus and cuts to wages. In the light of later Keynesian theory, nothing would have been seen as less likely to have achieved a return to prosperity, but a return to prosperity was most assuredly the result. All this is perfectly captured by Edna Carew (*The Language of Money*, 1996):

> A strategy was 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.

Certainly it was "later" criticised as overly deflationary after the depression had passed and Keynesian economics had become the vogue, but at the time, while the Great Depression was an actual fact of life, rather than it having been criticised, this was the consensus view of the economics profession of Australia. And it worked. Australia was amongst the first countries to recover from the Great Depression. The trough was reached in 1932 and from then on there was continuous improvement year by year.

Contrast the English and Australian experience with the United States. Roosevelt's New Deal applied a "Keynesian" prescription before Keynes had so much as published a word. From 1933 onwards, public works, increased public spending and deficit financing were the essence of economic policy. And with what results?

The data in the table below show the unemployment rates in the United States, the UK and Australia between 1929, the last pre-depression year, through to 1938, the last year before England and Australia went into the war.

Unemployment Rates
1929 to 1938

	USA	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%

None of these figures should be taken as anything more than indicative since there were no official unemployment statistics at the time. All are reconstructions based on incomplete data. But what these figures do provide is an accurate reflection of the reality experienced on the ground at the time. Although major pockets of unemployment remained, Australia and England had by the mid-1930s left the depression behind while the United States did not do so until the war finally brought recessionary conditions to an end.

THE POSTWAR RECOVERY

BY THE TIME the war came to an end, much of the economics profession had been converted to Keynesian theory. Although there was no evidence that the theory would actually work in a peacetime economy, a high proportion of economists advocated a continuation of the deficits and high levels of public spending that had prevailed during the war.

The major debate took place in the United States. Only four years before, it was pointed out, the American economy had been in deep recession. Millions of its men and women, who had served overseas or in war-related industries, were returning to the civilian economy in which the resumption of recession seemed a genuine possibility.

Yet Harry Truman resisted the pressure to provide a fiscal stimulus to the American economy. In his State of the Union address in January 1946, the American President made his policy direction clear: "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."

Truman, in refusing to apply a Keynesian stimulus, touched off the most sustained period of economic growth in American and world history.

STAGFLATION

IT HAS BEEN ARGUED that the slow development of the welfare state in the postwar period was the actual meaning of Keynesian policy. The "fine tuning" of the economy, as it was called, had in the eyes of some demonstrated the value of Keynesian policies. Whatever such fine tuning did or did not involve, at no stage in the twenty-five years after 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 1970s. Some have argued that President Kennedy had applied a Keynesian approach to end the mild recession of the early 1960s, but he had used tax cuts to stimulate growth. As with the Reagan tax cuts two decades later, this too was not a Keynesian approach. Keynesian economics is about increased levels of public spending.

Tax cuts are entirely classical in nature. They leave funds in the hands of those who have earned the income in the first place. Public spending diverts expenditure into directions of the government's own choosing. The first is market oriented, the second is not. The first would be expected to succeed under classical principles, the second would not.

The 1970s are in many ways a special case. It was a period which combined rapid growth in wages with huge increases in the cost of oil. But it also included an attempt to manufacture growth through a deficit-financed stimulus package on top of the expenditure related to the Vietnam War.

The result was what has gone down in history as the "stagflation" of the 1970s. It was a period that pulled economies into a downward spiral, combining high inflation with low growth, the very outcome any classical economist would have foretold. It took well over a decade to return the world's economies to high and sustained rates of non-inflationary growth.

THE JAPANESE RECOVERY PROGRAM

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. The end of the 1980s had seen brief recessions across the world from which most economies rapidly recovered.

Only Japan attempted to hasten recovery with a series of very large spending packages. Far from achieving recovery, this expenditure drove the Japanese economy into such deep recession that even today its economy, at one time the envy of the world, remains subdued. Yet, oddly, because economic theory continues to insist that the spending could only have been a positive, the example of the Japanese disaster is a lesson no one has been prepared to absorb.

Listen, however, to the following advice offered to the Japanese during the 1990s. It is the same advice offered to governments today, with the difference being that we at least now know the outcome in Japan.

Stanley Fischer, who in 1998 was the First Deputy Managing Director of the IMF, was very clear on the need for the massive increases in spending. Addressing a symposium in Tokyo in April that year, he said:

> Japan's economic performance is of course a matter of grave domestic concern. But given the prominent role of Japan in the world economy, and especially in Asia, it is also a legitimate matter for concern by Japan's neighbors and by the international community. There is little disagreement about what needs to be done. There is an immediate need for a substantial fiscal expansion …
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> On fiscal policy, the recent suggestion of a package of 16 trillion yen, about 3 per cent of GDP, would be a good starting point. But, unlike on previous occasions, the program that is implemented should be close to the starting point. 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. Anyone who doubts the effectiveness of tax measures need only consider the effectiveness of last year's tax increases in curbing demand.
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> The IMF is not famous for supporting fiscal expansions. And 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.

Another example of the same kind of advice is found in a February 28, 1998, editorial in the *Economist* under the heading, "Japan's feeble economy needs a boost":

> The [Japanese] government says it cannot afford a big stimulus because its finances are perilous. It is true that Japan's gross public debt has risen to 87% of GDP, but net debt amounts to only 18% of GDP, the smallest among the G7 economies. The general-government budget deficit, 2.5% of GDP, is smaller than its European counterparts'. 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.

Both took the view that Japan should immediately increase its spending and only afterwards clean up whatever problems were created. In Fischer's view, "there will be time to deal with the longer-term fiscal problem later". The *Economist* wrote that "now is not the time to sort the problem out. Far better to cut the budget later, when the economy has recovered its strength." These are conclusions that come directly from a Keynesian model that concerns itself with deficient demand as the cause of recession and looks to increased spending as its cure.

The *Economist* even added that "just now, in fact, Japan is a textbook case of a country in need of fiscal stimulus". Whatever may have been the case then, it ought to be the textbook case now for why all such forms of economic stimulus should be avoided at all costs. Because, say what you will about the causes of the Japanese downturn and the failure to recover, all major economies experienced the same deep recession at the start of the 1990s, but only the Japanese economy has never fully recovered its previous strength.

THE LEVEL OF DEMAND VERSUS THE STRUCTURE OF DEMAND

RECESSIONS OCCUR because goods and services are produced that cannot be sold for prices that cover their costs. There are reams of possible reasons why and how such mistaken production decisions occur. But when all is said and done, 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.

This cannot be emphasised enough. 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. The difference could not be more profound. To policy-makers today, the basic issue in analysing recessions is whether there is enough demand in total. To economists prior to Keynes, the central issue was to explain why markets had become unbalanced.

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 are seen as an intrinsic part of the solution, not as the additional problem such spending actually is.

Missing in modern economic debates is an understanding of the importance of structure, that the parts of the economy must fit together. What's missing is an understanding that if the entire economic apparatus goes out of alignment, recession is the result and recession will persist until all of the parts once again begin to mesh.

Think of what has caused this downturn in the first place. None of it is related to demand having suddenly evaporated for no good reason. All of the most visible causes can be brought back to distortions in decision making that led to the production of goods and services whose full costs of production cannot now be met. Look at the list:

• the meltdown in the housing sector in the United States after financial institutions were encouraged to lend to borrowers who would not in normal circumstances even remotely be considered financially sound

• the bundling of mortgages into financial derivatives whose value crashed with the crash in the value of housing and which has left the banking industry in a shambles

• the massive American budget deficits that were allowed to continue for years on end largely because the Chinese chose to recycle the dollars received in the American money market without either allowing the value of the yuan to rise, as it most assuredly ought to have done, or using the funds received to purchase American goods and services

• the phenomenal rise and subsequent fall in the price of oil which radically changed production costs in one industry after another

• the instability still being created across the world's economies over the actions that might or might not be taken to limit carbon emissions and reduce the level of greenhouse gases

• the arbitrary and erratic use of monetary policy to target inflation, the results of which have been to raise interest rate settings at one moment and lower them at another depending on assessments made by central banks

• the plunge in share market prices across the world, with savage effects on the value of personal savings.

There have been few periods in which so many forms of financial and economic uncertainty would have confronted the average business at one and the same moment. That business confidence has evaporated and an economic downturn has gained momentum is a matter of no surprise to anyone. The fact of recession is a certainty; only the depth to which it will descend remains in question.

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.

What is potentially catastrophic would be to try to spend our way to recovery. The recession that will follow will be deep, prolonged and potentially take years to overcome.

KEYNES'S FINAL THOUGHTS

IN AN ARTICLE ("The Balance of Payments of the United States") on the balance of payments published posthumously in the *Economic Journal* in 1946, Keynes wrote on one last occasion about the classical economics he had done so much to undermine. The Keynesian revolution had ripped through the economics world and had by then displaced almost all previous thought on the nature and origins of the business cycle. In looking out on the monster he had created, Keynes wrote in some dismay about the importance and value of classical economics and its modes of thought. The specific issue he was addressing was international trade. The actual underlying issue was the need for free markets and decentralised decision making. Here is what Keynes wrote:

> 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.

In looking at the anti-market policies then finding their way into public discussion, he noted just how damaging they would be in practice. He had been advocating free market solutions, the "classical medicine" of his description, but which others were reluctant to apply. Keynes wrote:

> We have here sincere and thoroughgoing proposals, advanced on behalf of the United States, 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.

It is this "modernist stuff, gone wrong and turned sour and silly", these "age-old poisons" that are the economics of the present day. We are on the precipice of adopting economic policies that will drag us into a deep and ongoing recession and which will diminish our economic prospects possibly for years to come. We may, just as Keynes said, drift on from expedient to expedient and never get really fit again.

These are issues of immense importance. To get them wrong may well leave our market economies in the wilderness for a generation. The question before us really 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.

This is not a mere matter of regulation but of actual direction and expenditure. No one disputes the importance of regulating the operation of markets. There is also a minor role that increased public sector spending might play in allowing some additional infrastructure projects to go forward while economic conditions are slack. But to believe it is possible for governments to spend our way to prosperity would be a major error. There is no previous occasion in which such spending has been shown to work, while there are plenty of instances in which it has not. On every occasion that such spending has been used, the result has been a worsening of economic conditions, not an improvement.

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.

Certainly there are actions that governments can take to relieve some of the problems of recession, but they are limited. Sure, this is a better time than most to build infrastructure. Absolutely, there need to be measures taken to assist the unemployed. Yes, the central bank should be lowering interest rates and ensuring the viability of the banking sector. All such steps are mandatory and largely non-controversial.

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. To expect and depend on anything else will take this economy down deflationary pathways that will require years to reverse.

The Keynesian model makes the engine of growth appear to be expenditure, irrespective of what that spending is on. And 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. Here is a passage from page 129 of the *General Theory* that will give you 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.

This is the earlier Keynes, the Keynes of the *General Theory*, the one who created and established the mindset in which policy is now devised. Productive government spending is rare and difficult to achieve. Wasteful profligate spending is easy and common as clay. There are now no end of projects coming forward, with hardly a one having been tested with any kind of rigour to ensure funds are not being drained away into unproductive fiscal swamps.

The standard macroeconomic model, the model that the proposed fiscal expansion will be based upon, is a model that will endanger our future economic prospects for years on end. 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.

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