Mannkal Economics Foundation Economic Scholars Essay Competition

"The First Rule of a Hole"

Why Do We Expect Keynesian policies to save us now when they have failed in the past?

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During a dinner party in 1934, John Maynard Keynes having observed one guest carefully remove a towel from a stack to dry his hands proceeded to sweep the entire stack onto the ground, explaining that his injection of activity proceeded to stimulate employment amongst the restaurant workers. This very act succinctly summarised one of the central ideas within his book *The General Theory of Employment, Interest and Money.* Some 60 years after Keynes death, President Obama and his consortium of world leaders are loosely emulating this act through significant fiscal expansion. And like Keynes, these leaders are failing to acknowledge past lessons learnt. Keynes repackaged a theory that was discredited by Frédéric Bastiat some 80 years earlier in his 1850 essay *That Which Is Seen and That Which Is Unseen*, under what is referred to as the parable of the broken window. This allegory offers a story of the shopkeeper's son who breaks a pane of glass, and whom is praised for his actions given that he has provided employment for the glazier – money will be paid to the glazier, whom in turn will spend, and hence money will circulate throughout the economy and prosperity will flourish. This facet of the transaction is positive and is 'what is seen'. However, as Bastiat argues, 'what is not seen', is that the shopkeeper has sacrificed his money to replacing the window, rather than to replacing some equipment, which itself is more productive than the replacement window. Current governments are faced with the very same Bastiat parables, littered throughout the post World War 1 period, and like Keynes, are failing to acknowledge their existence by moving forwards with their Keynesian 'window breaking' policies.

Although blame has been firmly planted on liberalism, the fundamental cause of the current downturn is not too little government intervention, but too much. Starting on January 3 2001, the Federal Reserve Bank began to cut the federal funds rate from 6.0%, reaching a 45 year low of 1% between June 2003 and 2004, and beginning to increase thereafter. The central bank's actions were aimed at stimulating the slowing economy in early 2001 as well as boosting confidence in the face of the September 11 attacks. Such measures were appropriate at the beginning of the downturn, but as the economy began to expand, monetary policy was artificially held below the natural rate that would prevent overheating. As mentioned before, it took until June 2004 for Federal Funds rate to increase, while during that period the economy posted modest growth, with annual growth rates for 2002, 2003 and 2004 of 1.6%, 2.5% and 3.6% respectively. If not for leaner growth in the last quarter of 2002 and first quarter of 2003, these annual figures would be significantly higher, with 2003 experiencing second and third quarter growth rates of 3.5% and 7.5% respectively (U.S Bureau of Economic Analysis). It was argued that interest rates were kept low due to the presence of deflation. Productivity gains during the period offset increases in aggregate demand, hence putting downward pressure on prices. The Federal Reserve however, had failed to disentangle productivity information and interpreted these pressures as deflationary – preferring to leave the interest rates low under high aggregate demand conditions. This was coupled with the Clinton Administration pressuring home mortgage underwriters, including the previously government-sponsored enterprise Fannie Mae, to expand mortgage loans among low and moderate income individuals. The combination of the two distorted the market and directed malinvestement into real estate, pushing prices skyward, and creating an asset bubble. Furthermore, the Federal governments $124 billion bailout of saving and loan associations during the S & L crisis created a moral hazard that encouraged lenders to make similar high risk loans with the belief that they would be insulated through Government intervention. And now that the bubble has burst, and we are faced with a global recession, to suggest further government intervention in the form of Keynesian spending policies, is much like trying to dig your way out of a hole – they should instead, as former British Chancellor of the Exchequer Dennis Healy suggested, obey the 'first rule of a hole' – that is when you are in one, stop digging.

Keynes believed that there was a natural tendency of laissez-faire regime to generate levels of investment that result in an underemployment equilibria – that recessions were characterised by weakening aggregate demand due to declining investment, that spilled over into high unemployment. Hence, State intervention is prescribed to cover the shortfall and inject cash into the system through fiscal spending and tax rebates, that will in turn be amplified by recipients spending – a process known as the multiplier effect – and overall aggregate demand will increase, boosting growth and reducing unemployment.

Keynesian policies have a poor track record. They became widely accepted and enjoyed a place as Governments conventional macroeconomic management tool post WWII – accepted given their perceived success in bringing the U.S out of the 1930's Great Depression. Between 1933 and 1941 U.S President Franklin D. Roosevelt implemented the New Deal –a Keynesian approach that saw a budget deficit through public spending on 38 major public projects and readjusting taxation to fix the high unemployment, low growth and a deflationary environment. The problem lay in the fact that the public funds didn't represent any real increase in additional investment, with 43% being financed through increased taxes, and the other 57% borrowed from banks in the form of bank purchases of government bonds – money that would have otherwise been diverted to private investment. Although the unemployment rate was reduced between July 1933 and December 1936 from 23.3% to 15.3%, it proceeded to increase to 20.1% in May 1938, on the back of a reduction in the money supply coupled with increased labour costs due to higher taxes. It wasn't until rearmament began that unemployment began to decline, reduced to 1.9% in 1943. Fiscal spending was $148 billion in 1943 prices, equivalent to $1500 billion in 2002 dollars. The wider community at the time felt that FDR had implemented a master stroke, but as Noble Laureate Milton Friedman concluded, the New Deal "hampered recovery from the contraction, prolonged and added to unemployment and set the stage for ever more intrusive and costly government" (Powell 2004). Research suggests the New Deal prolonged the Depression for another seven years. While the Great Depression imposed itself upon all economies, Keynesian policies were not orthodoxy for all. Britain pursued a full-scale classical approach - a policy of balancing the budget and the containment of 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. In rejecting deficit financing during his budget speech of 1933, the British Chancellor of the Exchequer, Neville Chamberlain, stated, "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" (Clarke1988). Here we can see that even the reason for Keynesian policies inception into various governments' economic policy, like the policies themselves, was inherently incorrect.

Keynesianism fell out of favour with Governments during the 1970's and 1980's recessions. Sharp increases in the price on oil in 1973, inefficient taxes on investment and associated depreciation in the U.S dollar had lead to stagflation during the 1970's – low economic growth, high unemployment and high inflation. Simple Keynesian policies could not be prescribed to the situation, as it contradicts the Phillips curve – that inflation and unemployment are inversely related – of which is fundamental to the Keynesian approach. The appropriate economic stance was Reaganomics (named after U.S president Ronald Reagan). These policies explicitly rejected state intervention in favour of free market liberalism by reducing government spending and decreasing taxes. For the U.S, Real GDP growth recovered strongly after the 1982 recession, growing at an annual rate of 3.4% for Reagan's Presidency, while unemployment that peaked at 10.7% and in 1982 steadily declined to 5% when Reagan finished his second term in 1989 (United States Department of Labor). The U.K applied Thatcherism (after U.K Prime Minister Margaret Thatcher). Thatcher held a strong belief in effectiveness of the free-market system, enabling inflation to drop from an earlier high of 18% to 8.6% two years into her term, while GDP growth recovered from a low of -2% in 1981 in two years, reaching a high of 5% in 1988 (National Statistics Online)

Conversely, Japan prescribed 10 fiscal stimulus packages totalling more than 135 trillion yen (3 percent of GDP), in order to drag the economy from recession in the 1990's. Proponents of fiscal intervention in Japan believed that "there will be time to deal with the longer-term fiscal problem later" and 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" (The Economist 1998). None was able to cure the depression, instead creating what is known as the "Lost Decade". Between 1992 and 2003, real GDP grew only 1.17% a year, with an even lower growth rate of 0.75% since 1998. Japans official public debt is in excess of 150 percent of GDP, up from 40 percent before 1992 and currently higher than that of any other developed nation (Japan Statistics Bureau and Statistics Centre). What the government was able to achieve, like Obama's plan, was to keep these "zombie firms" on life support through bail-outs – allowing these inefficient, debt-ridden firms to continue to drain the economy instead of allowing appropriate free-market re-structuring that will reallocate resources away from these failed businesses to higher valued uses that will put the economy in greater economic and financial shape post recession. Keynesian policies promised recovery, but all they delivered were the shackles of public debt that impinges the economy today. Governments and the countries they manage, if they weren't already there, are about to join Japan on the chain gang.

President Obama, and global government officials alike, like Keynes, fail to see what is "not seen" in the global financial crisis version of Bastiat's parable. While it may be easy for these officials to explain the theory of their Keynesian approaches – that government spending will stimulate the economy by 'pumping the prime' – to the general public (who we will assume have limited knowledge of economic theory), they fail to address where this money is going to come from. This is what is 'not seen'. The government has three approaches to raising these funds – taxation, issuing government bonds and printing money. Each distorts the market more than any held belief on the benefits of the spending. Taxation is the equivalent of robbing one individual to pay a different. If Obama is going to offer tax reliefs to 95% of his citizens, a pillar of his Presidential platform, as well as provide a raft of tax rebates in line with Keynesian policy, then taxes are going to have to be raised elsewhere. Of particular worry is the plan to raise corporate taxes by $190 billion over the next ten years. He wants to place heavier taxes on commodities and option traders. Obama is favourably considering increasing taxes on intangible drilling, an important technique in oil and gas exploration - overall. While these measures put money back in the pocket of the average American, it is not this group that will drag the economy out of a recession. As Keynes highlighted it is deficient investment that results in weakened aggregate demand, not consumer spending – and hence placing more taxes on the business' that undertake investment will deter investment that is needed for a recovery. Governments can finance the fiscal expansion through borrowing by issuing Treasury bonds. When the government enters the market as a borrower, they both reduce funds available for the private sector while raising interest rates, making it harder for the private sector to gain access to capital – known as the crowding out affect. The bipartisan Congressional Budget Office estimated that each dollar of additional debt crowds out about a third of a dollars worth of private domestic capital. Private sector borrowing and investment is replaced by government investment that is characterised by lower economic returns. Furthermore, any additional public debt will add to the U.S's current 11.5 trillion dollar debt, which may begin to erode confidence in the U.S's ability to repay, in turn raising interest rates and deterring private investment. Higher interest repayments may be financed by increased taxes – reducing consumer and investment spending. Our economies become less productive and less prosperous. For a small open economy like Australia with a flexible exchange rate, there is consequently a real possibility that any increase in demand caused by fiscal easing will merely raise interest rates, induce capital inflow from abroad, appreciate the currency and reduce net exports. The third avenue includes increasing the money supply, but due to its highly inflationary effect, is seldom considered. Distortions in the market created the downturn, and hence adding more through these financing techniques again disobeys the 'first rule of a hole' – stop digging.

The Keynesian revival under the current crisis may not be due to what some feel is the superiority of Keynesian policies in combating recessions, but more to do with implementing policies that will distance governments from the free-market system and the opposition parties who advocate this system for whom they blame for the downturn, without a full transition to socialism. It may be that governments want to be seen to be acting, and acting fast, rather than to be seen to do nothing – a stance in which it is a lot harder to explain the underlying economic theory to the masses, of whom ultimately decide the government's fate.

Obama's $787 billion stimulus plan has been referred to by those on both sides of the political spectrum as the "New New Deal". If Obama has referenced FDR's plans as a solution to the current recession, then as history will show us that unless Obama plans to start a war on scale with WWII and re-introduce subscription, then employment and growth will not be stimulated. Keynes argued that Keynesian policies were much better suited to a totalitarian state than a market resembling laissez faire. "Nevertheless the theory of output as a whole, ...is much more easily adapted to the conditions of a totalitarian state, than is the theory of production and distribution of a given output produced under conditions of free competition and a large measure of laissez-faire." (Keynes 1936 pg xxvii). Unless libertarian governments are going to switch to totalitarianism, then these Keynes policies will prove inefficient. It can be argued that Keynesian policies of massive government spending will stimulate economic activity in the short run, but as the bipartisan Congressional Budget Office showed that long-run growth will be reduced. This is good for government that are constrained to short time frames. Perhaps it's time for politics to be eliminated from economic policy, and governments around the world do what's best for the economy and the community in the long-run, rather than what will be best in maintaining their short-term positions.

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