Despite the UK government's following of Keynesian policy prescriptions, Bloomberg columnist Matthew Lynn laments the results, wondering whether the UK will be the deathbed of Keynesian economics. Lynn argues instead that "what's needed is a total change of direction."

(No doubt many have seen it already but if you haven't there was a fantastic Keynes vs. Hayek rap video featured on YouTube that's a must see!)
http://www.youtube.com/watch?v=d0nERTFo-Sk

Introductory Comments by Luke McGrath, Mannkal Fellow

The Deathbed of Keynesian Economics

Matthew Lynn
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The UK has produced notable economists over the years, but John Maynard Keynes, the guru of government intervention, was one of truly global significance.

So it may be fitting that the UK will also become the deathbed of Keynesian economics.

Britain has been following the mainstream prescriptions of his followers more than any developed nation. It has cut interest rates, pumped up government spending, printed money like crazy, and nationalised almost half the banking industry.

Short of digging Karl Marx out of his London grave, and putting him in charge, it is hard to see how the state could get more involved in the economy.

The results will be dire. The economy is flat on its back, unemployment is rising, the pound is sinking, and the bond markets are bracketing the country with Greece and Portugal in the category marked “bankruptcy imminent.” At some point soon, even the most loyal disciples of Keynes will have to admit defeat, and accept that a radical change of direction is needed.

The public debate about the state of the British economy was enlivened last week by a brawl between economists.

On February 14, a group that included the former Bank of England policy makers Tim Besley, Howard Davies, Charles Goodhart and John Vickers published a letter to the Sunday Times calling on the government of Prime Minister Gordon Brown to control the ballooning deficit.

If it didn’t, the stability of the economic recovery would be threatened, and there would be a run on the pound, they warned.

Keynesian backlash

That brought a stinging response from the Keynesians, who are urging the UK to spend its way out of recession. Nobel laureates Joseph Stiglitz and Robert Solow were among the signatories to letters written by a group of 67 economists insisting that deficit spending was the only way to salvage the economy. The letters, published in the Financial Times, argued that a "a sharp shock" now "would be positively dangerous".

So who is right, and who is wrong? It's a debate that matters to the rest of the world. After all, if demand management doesn't work here, it won't work anywhere.

The UK has some experience of mass letter writing from Keynes's devotees. In 1981, a group of 364 economists wrote an open letter ripping into the policies of then Prime Minister Margaret Thatcher. They turned out to be totally wrong, of course. With hindsight, no one can now dispute that her policies led to a long and durable economic revival.

Budget blowout

And just as the Keynesians were wrong three decades ago, they are wrong now.

The UK has been in Keynes overdrive for the past 18 months. The budget deficit is already more than 12 per cent of gross domestic product, on a par with Greece. And while the Greeks are cutting spending, the British deficit is widening.

Figures for January showed another fiscal blowout. At the same time, interest rates have been slashed to 0.5 per cent. And the pound has slumped in value, which is supposed to boost demand for British goods, and help close the trade gap.

Just about everything possible has been done to encourage consumption. The results have been miserable.

Retail sales excluding gasoline in January fell 1.2 per cent from the previous month, twice as much as economists forecast. The number of people receiving unemployment benefits jumped to 1.64 million in January, the highest level since April 1997. The yield on UK government debt is now higher than on Spanish or Italian bonds, a sure sign that investors are losing faith in the country's ability to pay its debts. The inflation rate has also accelerated to 3.5 per cent.

Triple whammy

In reality, Britain has the worst of all possible worlds: a stagnant economy, a crippling budget deficit and rising prices.

The Keynesian consensus is that things would have been far worse without the stimulus provided by government. And if the economy isn't pumped up with inflated demand, it will collapse back into recession. If it's not working, that just proves the stimulus should be even larger.

It is the argument quacks always push: if the medicine isn't working, increase the dosage.

And yet, reality has to intrude into this debate at some point. The deficit can't get much bigger, interest rates can't be cut much lower, and sterling can't lose much more value.

Stimulating the economy isn't working.

In fact, it's only making it worse. Consumers and businesses don't want rising taxes. A falling currency pushes up the cost of everything the UK imports, stoking inflation. Savers get decimated, and yet the banks remain reluctant to lend because they rightly believe the economy is in the doldrums.

Recipe for recovery

What's needed is a total change of direction. Get the deficit under control. Raise interest rates to restore confidence in the pound, and reward saving. Cut taxes to stimulate enterprise and investment.
And yet the real lesson of the UK in 2010 will be of wider significance. A country can't spend its way out of a recession. And it can't fix what was at root a problem of too much debt by just borrowing more and more.

In the country of its birth, Keynesian economics is being tested. If the economy isn't growing at a healthy clip again by the end of 2010, its failure will be obvious to everyone.

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http://www.watoday.com.au/business/the-deathbed-of-keynesian-economics-20100223-p00z.html?posted=sucessful