Keynesian principles: Statements

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Opening statements

Defending the proposition

Prof. Brad DeLong

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I regret that I cannot deliver on my promise: to make the case that "We are all Keynesians now." I cannot because it is not true: we are not all Keynesians now.

Against the proposition

Prof. Luigi Zingales

Robert C. McCormack Prof, Entrepreneurship & Finance, University of Chicago Booth School of Business

What does "being Keynesian" mean? Simply believing in the role of demand-side factors in the determination of aggregate output is an insufficient characterisation.

The moderator's opening remarks

Mar 10th 2009 | Mr Patrick Lane

On December 31st 1965 *Time* described the triumph, in American economic policy, of the ideas of John Maynard Keynes. The headline quoted Milton Friedman (of all people): "We are all Keynesians now." Friedman later wrote to *Time* to say that his words had been taken out of context, but the phrase was already destined for dictionaries of quotations.

"If the nation has economic problems," wrote the magazine 43 years ago, "they are the problems of high employment, high growth and high hopes." Keynesianism—meaning monetary and fiscal policies aimed at maintaining full employment—seemed to have all the answers. Within a few years, that faith looked badly misplaced.

Now Keynes is back. Arguably, this time his ideas are being discussed in their proper context: slump not plenty. From America to Japan, economies are shrinking. Central banks have slashed official interest rates, some of them to zero or close to it. Conventional monetary policy has been all but exhausted, and economies are still stuck. The fiscal pumps are primed, and nowhere more so in America, where a $787 billion bill of public spending and tax cuts has just been passed.

Are we all Keynesians again? If not, should we be? The proposer of the motion in *The Economist*'s latest online debate, Brad DeLong of the University of California, Berkeley, has been an uncompromising champion of Keynesian ideas, notably on his widely read blog. Economists

who deny that deficit-funded government spending can stimulate a stricken economy are, he says, the ones clinging to outdated ideas.

His opponent, Luigi Zingales, of the Booth School of Business at the University of Chicago, admits that the public and politicians are steeped in Keynesian ideas. That, he argues, does not make them right.

In recent months fierce words have been exchanged, both online and in print, over the ideas at issue. Leading economists plainly disagree. This is not some arcane academic dispute. Important questions of policy are at stake and I hope that this debate will shed more light on them. When conventional monetary policy runs out of road, what can be done? If fiscal policy can help, do tax cuts trump public spending, or vice versa? What, if anything, is to be gained by looking back to Keynes?

I'm delighted that economists of Mr DeLong's and Mr Zingales's calibre have agreed to make the case on either side of the motion. I hope that you, the readers of *The Economist*, will scrutinise the arguments of our protagonists and our guest "speakers"—and that you too will pitch in from the floor of our online debating chamber.

The proposition's opening remarks

Mar 10th 2009 |
Prof. Brad DeLong

I regret that I cannot deliver on my promise: to make the case that "We are all Keynesians now." I cannot because it is not true: we are not all Keynesians now. For example, I read in Sunday's *New York Times* that William Poole, former president of the Federal Reserve Bank of St Louis, believes that: "Government spending can't lead the way to sustained recovery, because its stimulating effect will be offset by anticipated higher taxes and the need to finance the deficit."

This is quite a shock, for back in 1970 William Poole was a Keynesian, who took for granted that deficit-spending fiscal policy had a proper and effective role in fighting recessions. And, indeed, the shock is amplified by the number of fellow travellers alongside Poole:

Robert Barro, Harvard University, said of the Obama fiscal stimulus proposal: "This is probably the worst bill that has been put forward since the 1930s. I don't know what to say. I mean it's wasting a tremendous amount of money. It has some simplistic theory that I don't think will work ... I don't think it will expand the economy ... It's more along the lines of throwing money at people ... I think it's garbage." (Barro seems to be talking about any and all stimulus bills).

John Cochrane, University of Chicago, said: "It's not part of what anybody has taught graduate students since the 1960s … They are fairy tales that have been proved false. It is very comforting in times of stress to go back to the fairy tales we heard as children but it doesn't make them less false." To borrow money to pay for the spending, the government will issue bonds, which means investors will be buying US Treasuries instead of investing in equities or products, negating the stimulative effect, Cochrane added.

Edward Prescott, Arizona State University, who won a Nobel prize for economics in 2004 for his study on business cycles, made this contribution: "Massive government spending likely lengthened the economic struggles each time. Economists in the field are deeply divided on the issue of federal stimulus … I don't know why Obama said all economists agree on this. They don't. If you go down to the third-tier schools, yes, but they're not the people advancing the science."

Eugene Fama, University of Chicago, stated: "Bail-outs and stimulus plans are funded by issuing more government debt. (The money must come from somewhere!) The added debt absorbs savings that would otherwise go to private investment. In the end, despite the existence of idle resources, bail-outs and stimulus plans do not add to current resources in use. They just move resources from one use to another."

The argument that Messrs Fama, Prescott, Cochrane, Barro, Poole and company are making is what economists call Say's law. It is the claim that decisions to increase spending—whether they come from the government or anybody else—cannot spur the economy and raise employment and production because demand must be created by supply. If the government spends, somebody else must cut back on their spending.

Anyone who uses his or her eyes can determine that Say's law is in general false. Recall 2003-06, when capital inflows from Asia, easy money provided by the Federal Reserve and promises that financial engineering would cheaply diversify risk spurred homebuilders to spend money building houses. The American unemployment rate fell from 6.0% to 4.8%. Recall 1996-2000, when the assembled investors of America

discovered the internet and in response businesses spent money like water on computers and telephones. The American unemployment rate fell 5.6% to 4.3%. In general, spending works to spur the economy, and the government's money when spent is as good as anybody else's.

Even though Say's law is not true in general, could it possibly be true in this particular case? Could it happen that as the government starts its spending that the spending is, in Fama's words, "funded by issuing more government debt ... The added debt absorbs savings that would otherwise go to private investment ... and just moves resources from one use [private investment] to another [government purchases]"? Yes, it can happen. When government deficit spending triggers a sharp rise in interest rates, that rise in interest rates will discourage and crowd out private investment spending. But you have to have that rise in interest rates, and we don't: the ten-year Treasury rate last Friday was 3.02% per year, down from 4.01% back before Obama's election victory.

Milton Friedman had some very harsh things to say about the Great Depression predecessors of Fama, Prescott, Cochrane, Barro, Poole and company when he contrasted his vision of Chicago-school monetary economics with theirs: "Chicago was one of the few academic centers at which the quantity theory continued to be ... central and vigorous ... throughout the 1930s and 1940s, where students continued to study monetary theory and to write theses on monetary problems. The quantity theory that retained this role differed sharply from the atrophied and rigid caricature that is so frequently described by the proponents of the new Keynesian income-expenditure approach—and with some justice, to judge by much of the literature on policy that was spawned by old quantity theorists."

So now, I cannot say we are all Keynesians now. The most I can say is that we should all be Keynesians now—and we should be.

The opposition's opening remarks

Mar 10th
2009 |
Prof. Luigi Zingales

What does "being Keynesian" mean? Simply believing in the role of demand-side factors in the determination of aggregate output is an insufficient characterisation. A true Keynesian differs, in so much as he also believes that: 1) monetary policy is not the most effective tool for stabilising the economy and it may be completely ineffective in some circumstances (liquidity trap); 2) fiscal policy is effective and government spending is the preferred tool; 3) government intervention works and short-run consequences are more important than long-run ones.

With this definition in mind, there could be four ways in which the statement "we are all Keynesians now" can be interpreted. I propose that the statement is false in three out of four of these interpretations.

The first interpretation is that the economic profession has reached a consensus on Keynesian positions. This statement is definitely false. If you browse through the articles published in the leading journal of the American Economic Association in 2008, you would find that only one of the 12 articles that deal with macroeconomic issues (JEL Code E) supports (albeit very indirectly) the idea of a fiscal policy expansion as a policy tool. An even stronger imbalance is present at the pinnacle of our profession. Among the 37 Economics Nobel prize winners in the last 20 years, four received the prize for their contributions to macroeconomics. None of these could be considered Keynesian. In fact, it is hard to find academic papers supporting the idea of a fiscal stimulus.

The second possible interpretation is that there exists a consensus among economists that the causes of the current crisis are Keynesian. Even under this interpretation the statement is patently false. I do not think that any economist would dare to say that the current US economic crisis has been caused by underconsumption. With zero personal saving and a large budget deficit the Bush administration has run one of the most aggressive Keynesian policies in history. Not only has adherence to Keynes's principles not averted the current economic disaster, it has greatly contributed to causing it. The Keynesian desire to manage aggregate demand, ignoring the long-run costs, pushed Alan Greenspan and Ben Bernanke to keep interest rates extremely low in 2002, fuelling excessive consumption by the household sector and excessive risk-taking by the financial sector. Most importantly, it has been the Keynesian training of our policy-makers that has led them to ignore the role that incentives play in economic decisions. The main difference between Keynes and modern economics is the focus on incentives. Keynes studied the relation between macroeconomic aggregates, without any consideration for the underlying incentives that lead to the formation of these aggregates. By contrast, modern economics base all their analysis on incentives. In 1998, when the Fed co-ordinated the bail-out of Long Term Capital Management, it did not care about the impact this decision would have on the incentives to take risk and price liquidity appropriately. When Mr Bernanke engineered the bail-out of Bear Stearns, he did not care about the impact this decision would have on the other investment banks' incentives to raise equity capital at rock-bottom prices. When he changed his position twice in the space of two days, letting Lehman fail, but bailing out AIG, he did not care about the impact it would have on investors' confidence and incentives to invest. It is this erratic behaviour that has spooked the market and created the current economic crisis: in a recent survey 80% of Americans declare that they are less confident of investing in the market as a result of the way the government has intervened.

If Keynesian principles and education are the cause of the current depression, it is hard to imagine they can be the solution. Thus, even the third interpretation of the house statement—that we should follow Keynesian prescriptions to combat the current economic crisis—is false. I am not disputing the idea that some government intervention can alleviate the current economic conditions, I am disputing that a Keynesian economic policy can do it. With a current-account deficit that in 2008 was $614 billion, a budget deficit that was $455 billion and military expenditures of $731 billion, it is hard to argue that the government is not stimulating demand sufficiently. The current crisis is not a demand crisis, it is a trust crisis. Bad corporate governance coupled with bad government policies has destroyed the financial sector, scaring investors and freezing lending. It is as if a nuclear bomb had destroyed all roads in America and we claimed that to alleviate the economic impact of such an event we should invest in banks. It is possible that eventually the effect will trickle down. But if the problem is the roads, you want to rebuild roads, not subsidise the financial sector. And if the problem is the financial sector, you want to fix this and not build roads.

The only interpretation under which the house statement is true is that "we"—the English/American people and their elective representatives—are all Keynesians now. Keynesianism has conquered the hearts and minds of politicians and ordinary people alike because it provides a theoretical justification for irresponsible behaviour. Medical science has established that one or two glasses of wine per day are good for your long-term health, but no doctor would recommend a recovering alcoholic to follow this prescription. Unfortunately, Keynesian economists do exactly this. They tell politicians, who are addicted to spending our money, that government expenditures are good. And they tell consumers, who are affected by severe spending problems, that consuming is good, while saving is bad. In medicine, such behaviour would get you expelled from the medical profession; in economics, it gives you a job in Washington.