Keynes's big mistake

The one thing most people think they know about economics is wrong

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Some things are universally accepted as true. Water finds its own level; crumpets are best eaten in winter; and the England football team will not win the World Cup again, ever.

On a par with these things, the most accepted part of economics is Keynesianism. Of course, John Maynard Keynes said lots of things about economics in between his many and varied sexual encounters. But, as is the way of the world, one of the things he said turned out to be particularly influential. It is so influential that it has gone around the world. It is repeated and relied upon by Japanese finance ministers, *New York Times* columnists, Nobel prize winners and anti-austerity demonstrators. It is in textbooks around the globe. It is on page 262 of the Edexcel Economics A-level text book. In fact, it crops up several times in the book in various forms. Keynes, personally, is mentioned more frequently than any other economist living or dead. The idea guides government policy around the world and certainly here in Britain.

There is just one little problem: the idea is wrong. And as China — a devout follower of Keynes these days as much as of Marx — falters, it is becoming more and more apparent just how wrong it is.

The key idea is that if the economy is in the doldrums, the government should pep things up by borrowing and spending. If the public is reluctant to spend for one reason or another, the government should gallop along like the cavalry to rescue the day. The government should build roads, giving employment to builders who will then spend their wages on nights out, giving employment to waiters who will then buy new clothes, giving employment to shop assistants — and so on. The economy is thus given a boost by the good old government and all is well again.

In the Edexcel textbook this is referred to in capital letters because it is so central to how things work. It is called 'DEMAND MANAGEMENT'. And, to take one example, in 2008 Gordon Brown decided the government should do some extra borrowing and spending to resist the downward force of the crisis. I remember appearing on Radio 5 Live at the time, and when I resisted the idea, I was firmly told by the BBC economics correspondent that the vast majority of economists thought it was the right thing to do. And after all, if everybody believes it, it must be true.

In fact, during the past 50 years, there have been a number of times when the validity of this central part of Keynesianism has been put in doubt. But the idea has been like Tom, the cat in *Tom and Jerry*. However many times it is squashed under a ten-ton weight or falls from a great height on to rocks, it comes up smiling and unrepentant.

Gradually, however, reasons to think it is not true have grown in number and received a heavier weight of support from academics. The most significant work has come

However many times it is squashed, the idea of deficit spending comes up smiling and unrepentant

from a group of Italian economists. A landmark paper was written by Francesco Giavazzi and Marco Pagano in 1990. This has been followed up by more work by Alberto Alesina, Silvia Ardagna and others. They have been dubbed 'the Bocconi boys', which makes them sound like a mafia gang but is in fact a reference to the university in Milan where many of them have been professors or students.

The 1990 paper looked at the performance of Ireland and Denmark in the 1980s. It noted how these countries had reduced their government budget deficits, which according to Keynesian theory should have depressed the economy. But on the contrary, the economies did particularly well. From that beginning, the Bocconi boys have gained territory and influence, spreading representatives into the Bank of England, the European Union and Harvard.

Most recently, our own Professor Tim Congdon has written a couple of papers with a thorough summary of how the Keynesian theory has not worked since 1980 in Britain and America. He compares the changes in the budget deficit after adjustment for the business cycle with changes in the 'output gap' — how much the economy is performing below its non-inflationary potential. All the figures come from the International Monetary Fund.

The results do not fit Keynesian theory one little bit. Take the period from 1981 to 1988. It started with a budget produced by Geoffrey Howe in which he set out how he was going to cut the budget deficit, year after year. Appalled and disgusted, 364 economists representing the overwhelming Keynesian consensus wrote to the *Times* saying this would be disastrous. As it turned out, the following seven years of deficit reduction saw a reduction in the output gap and above-trend growth. Another period of reducing deficits, from 1994 to 2000, saw another period of above-average performance. In contrast, there were two periods when the government did more borrowing and spending — 1989–93 and 2001–09. In theory the expanding deficits should have boosted demand. In fact, they were times when the economy underperformed.

Most recently, the government has been cutting the budget deficit again. As in 1981, we know that the Keynesian consensus expected this to go badly. In 2011, Martin Wolf, for the *Financial Times*, said that the planned deficit reductions were 'a huge gamble'. He repeated with approval the view of Larry Summers, a former US treasury secretary no less, that the UK plans were 'not going to work out well'. But as it has turned out, the output gap has been narrowed.

In America, too, Keynesian theory has kept on being wrong-footed. During the Clinton presidency, spending was being cut on both defence and welfare. According to the Keynesians, the cutting of the structural budget deficit should have depressed the economy. But the very opposite happened. It boomed. Output moved from being 3 per cent below trend to 1.5 per cent above. And in late 2012, Keynesians got very distressed about the 'fiscal cliff'. This was the moment when taxes were increased and government spending reduced. Keynesians foresaw doom and gloom. Instead, growth accelerated in the following year.

We can also make some comparisons between countries. President Hollande was elected to power in 2012 explicitly on an 'anti-austerity' platform. In contrast to Britain, France did not attack its spending level. So, according to Keynesian theory, he was bravely fending off an economic downturn. But France's economy, with its Keynesian cavalry, has done worse than Britain's. France, the country that 'rejected' austerity, got it in full measure. Britain, the country that tried to be prudent, was the one that came out of the crisis better.

You might possibly be thinking: 'OK. So it seems that there are lots of reasons to think that Keynesian deficit spending is not the clever thing we were brought up to accept as an obvious truth. But what's wrong with it? It sounds so logical!'

Now this is embarrassing. I am afraid we are not quite sure why. There are several ideas knocking about. There is Milton Friedman's idea that the financing of the government borrowing counterbalances the positive effects. The Bocconi boys have suggested that prudent deficit reduction increases confidence and so increases spending. Then there is the 'Ricardian equivalence theorem' — a name crying out to be used in a pub quiz — according to which rising deficits make people nervous, so they save instead of spending. Tim Congdon provides evidence that the big flaw is in the neo-Keynesian assumption that the money people spend consists of income after tax after allowing for a consistent level of saving. In fact, he suggests, changes in their net worth are the most powerful influence on changes in how people spend.

Let's stop for a minute and, for the time being at least, accept the proposition that the textbooks are wrong and all the deficit spending around the world to avoid recessions has been misguided. What has been the result? Does it matter? I would like to suggest that the result has been a long-term tendency for governments to run deficits for too long and thus to create massive national debts. Japan is a prime case. I was a correspondent there in the early 1980s and remember being told repeatedly that recent growth was rather disappointing but not to worry because the government would do a lot more spending which would boost demand. More than 30 years later, Japan's debt has gradually increased to a massive 230 per cent of GDP and ever since the early 1990s its growth rate has been dismal.

And so it is now around the world. Most advanced countries now carry huge national debts by past standards. In the USA it is 103 per cent of GDP, in France 95 per cent and in Britain 89 per cent. It seems very possible that these heavy debt levels are part of the cause of the chronically low growth in the modern world. It seems likely that what has led us to this high-debt, low-growth world is the dominance of the Keynesian fallacy.

'Honestly, some of the nonsense they expect you to fall for!'

FROM THE ARCHIVE

Compelling evidence

From 'The Position of the Government', The Spectator, 15 January 1916: Any man who knew the nature of Englishmen, or rather, let us say, of the English-speaking race, during war, would have been able to foretell that an enactment to compel shirkers to do their duty would be certain of something like universal acceptance... Our people is a brave people in deeds, if not in words. It is, however, the disconcerting way of Englishmen to be perfectly illogical at times of crisis. For example, they feel not the slightest difficulty in telling you that they are dead against 'conscription' and will never agree to it, but that they are quite determined to compel men by law to serve their country in arms if they show any signs of shirking their duty in that respect.