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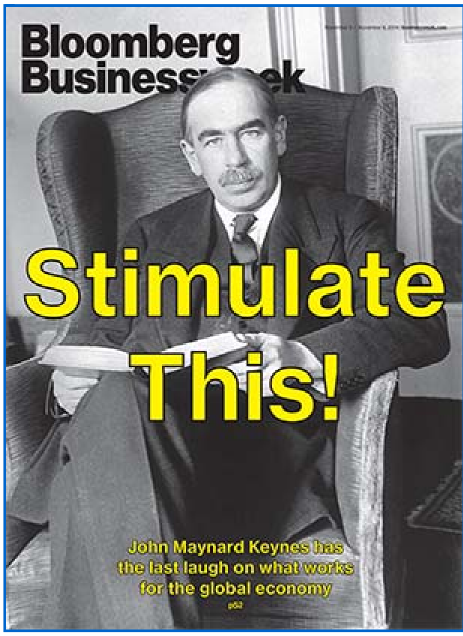
John Maynard Keynes Is the Economist the World Needs Now

By Peter CoyOctober 30, 2014

Is there a doctor in the house? The global economy is failing to thrive, and its caretakers are fumbling. Greece took its medicine as instructed and was rewarded with an unemployment rate of 26 percent. Portugal obeyed the budget rules; its citizens are looking for jobs in Angola and Mozambique because there are so few at home. Germans are feeling anemic despite their massive trade surplus. In the U.S., the income of a median household adjusted for inflation is 3 percent lower than at the worst point of the 2007-09 recession, according to Sentier Research. Whatever medicine is being doled out isn't working. Citigroup (C) Chief Economist Willem Buiter recently described the Bank of England's policy as "an intellectual potpourri of factoids, partial theories, empirical regularities without firm theoretical foundations, hunches, intuitions, and half-developed insights." And that, he said, is better than things countries are trying elsewhere.

There is a doctor in the house, and his prescriptions are more relevant than ever. True, he's been dead since 1946. But even in the past tense, the British economist, investor, and civil servant John Maynard Keynes has more to teach us about how to save the global economy than an army of modern Ph.D.s equipped with models of dynamic stochastic general equilibrium. The symptoms of the Great Depression that he correctly diagnosed are back, though fortunately on a smaller scale: chronic unemployment, deflation, currency wars, and beggar-thy-neighbor economic policies.

An essential and enduring insight of Keynes is that what works for a single family in hard times will not work for the global economy. One family whose breadwinner loses a job can and should cut back on spending to make ends meet. But everyone can't do it at once when there's generalized weakness because one person's spending is another's income. The more people cut back spending to increase their savings, the more the people they used to pay are forced to cut back their own spending, and so on in a downward spiral known as the Paradox of Thrift. Income shrinks so fast that savings fall instead of rise. The result: mass unemployment.



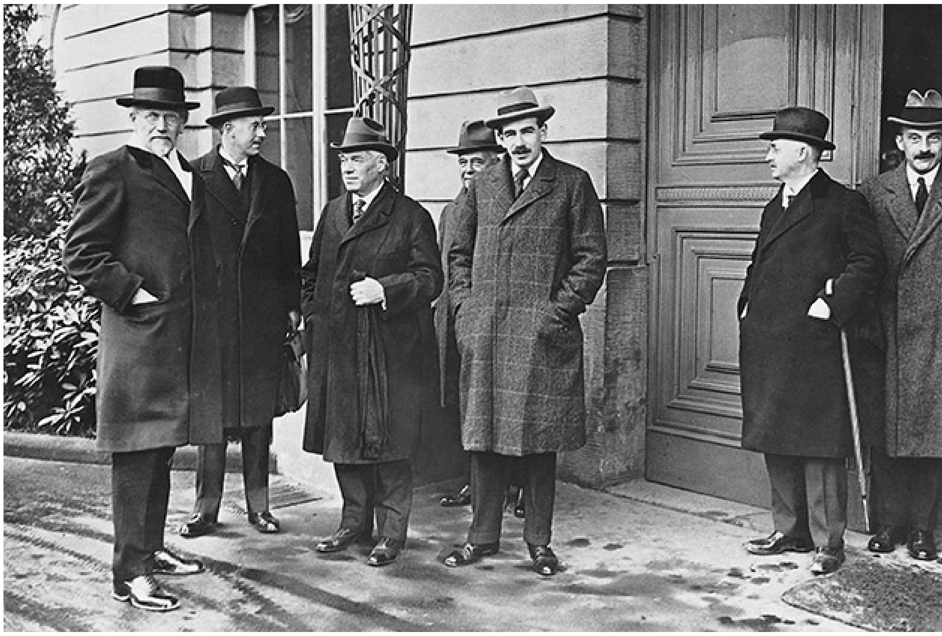
Photograph by Bettmann/CorbisBehind this week's cover

Keynes said that when companies don't want to invest and consumers don't want to spend, government must break the dangerous cycle by stepping up its own spending or cutting taxes, either of which will put more money in people's pockets. That is not, contrary to some of his critics, a recipe for ever-expanding government: Keynes said governments should run surpluses during boom times to pay off their debts and soak up excessive private demand. (The U.S. ran small surpluses in two boom years of the Clinton administration.) Far from a wild-eyed radical, he said economists should aspire to the humble competence of dentists. He wanted to repair economies, not overthrow them.

"There are still many people in America who regard depressions as acts of God. I think Keynes proved that the responsibility for these occurrences does not rest with Providence," Bertrand Russell, the philosopher, wrote in his autobiography in 1969.

Enthusiasm for Keynes waxes and wanes. The last time the gawky Brit made a splash was 2008-09, during the global financial crisis. People who had borrowed extravagantly, using their houses as ATMs, turned overnight into financial Calvinists, cutting spending to pay down debt. Nervous chief executive officers simultaneously cut back on corporate investing. That led to a lack of demand for goods and services. Unemployment shot up, reaching 10 percent in the U.S. in 2009. Even conservative economists who generally eschewed Keynes knew a Paradox of Thrift when it punched them in the nose. "When things collapse, everybody becomes a Keynesian," says Peter Temin, a professor emeritus of economics at Massachusetts Institute of Technology and co-author with University of Oxford economist David Vines of a new book, *Keynes: Useful Economics for the World Economy*.

Richard Posner, the free-market federal appellate judge, wrote a 2009 article for the *New Republic* titled "How I Became a Keynesian." Harvard University economist Martin Feldstein, a longtime deficit hawk who was President Reagan's chief economic adviser, wrote an op-ed in the *Washington Post* in October 2008 saying, "The only way to prevent a deepening recession will be a temporary program of increased government spending." The following February, Congress passed a $787 billion stimulus, albeit smaller than Keynesian economists advocated and with no Republican votes in the House. Even Germany, that bastion of austerity, put aside its misgivings and approved its biggest stimulus package ever.


Photograph by Sueddeutsche Zeitung Photo/AlamyKeynes at a 1922 meeting to stabilize the German mark

The crisis-induced embrace of Keynes infuriated the likes of German Finance Minister Peer Steinbrück, who complained in 2008, “The same people who would never touch deficit spending are now tossing around billions. The switch from decades of supply-side politics all the way to a crass Keynesianism is breathtaking.” Wrote John Cochrane of the University of Chicago Booth School of Business on his website: “If you believe the Keynesian argument for stimulus, you should think Bernie Madoff is a hero. Seriously. He took money from people who were saving it, and gave it to people who most assuredly were going to spend it.”

The Keynesian jolt didn’t last long. European governments pivoted to austerity on the theory that doing so would reassure investors and induce a wave of investment, creating growth and jobs. It didn’t happen. The U.S. was marginally less austere and grew a bit faster. But even in the U.S., stimulus faded quickly despite continuing high unemployment. Far from priming the pump, changes in government outlays actually subtracted from the growth of the U.S. economy in 2011, 2012, and 2013. The Japanese government has been running big deficits to compensate for chronic hoarding by households and businesses, but in April it faltered, chilling the nation’s halting recovery by raising the value-added tax to 8 percent from 5 percent.

With fiscal policy missing in action, the world’s biggest central banks tried heroically to plug the gap. The U.S. Federal Reserve cut interest rates to near zero, and when even that failed it tried some new tricks: buying bonds to bring down long-term interest rates (“quantitative easing”) and signaling the market that rates would stay low even after the economy was on the path to recovery (“forward guidance”). The limited effectiveness of those measures is sometimes chalked up as a failure of Keynesianism, but it’s just the opposite. Keynes was the economist who demonstrated that monetary policy ceases to be effective once interest rates hit zero and whose recommended policy in those circumstances was tax cuts and spending hikes.


Courtesy Harvard Theatre Collection/Harvard UniversityAngelica Garnett, Vanessa Bell, Clive Bell, Virginia Woolf, and Keynes at Woolf's house in England in 1935

Whatever the economic facts, the slowness of the global recovery soured people on governments' ability to intervene for the good. Stimulus is a toxic word in the U.S. midterm elections; Obama got nowhere with his $302 billion bridges-and-potholes bill this year. Germany, far from using its economic power to become an engine of growth for Europe as requested by its trading partners, is expanding at the expense of other countries. It's keeping its workers busy by producing goods and services for export, while not buying the goods and services produced by other countries. That explains why the surplus on its current account, the broad measure of trade and investment income, equals 7 percent of its gross domestic product, the highest among major economies.

This isn't a stable status quo. The mid-October shock in global stock markets betrayed grave concerns about a relapse. While the U.S. economy is growing adequately for now despite the drag from fiscal policy, China's pace is slowing, Japan is suffering from the self-inflicted wound of its consumption tax hike, and the 18-nation euro zone had zero growth in the second quarter. That simply isn't good enough, Treasury Secretary Jacob Lew said in an October visit to Bloomberg. "You need all four wheels to be moving," he said, "or it isn't going to be a good ride."


Courtesy Wiedenfeld & NicolsonWith his wife, ballerina Lydia Lopokova

Enter Lord Keynes. Cutting interest rates is fine for raising growth in ordinary times, he said, because lower rates induce consumers to spend rather than save while stimulating businesses to invest. But where rates sink to the "lower bound" of zero, he showed, central banks become nearly powerless, while fiscal policy (taxes and spending) becomes highly effective as a fix for inadequate demand. Governments can raise spending to stimulate demand without having to worry about crowding out private investment—because there's plenty of unused capacity, and their spending won't lift interest rates.

It's the closest thing economists have found to a free lunch. Keynes, ever the provocateur, argued that in a deep recession anything the government did to induce economic activity was better than nothing—even burying bottles stuffed with bank notes in coal mines for people to dig up.

Of course, it's far better if the money is spent well. Considering the crying need for better roads, bridges, tunnels, schools, and the like, it's a no-brainer for governments to build them now, when there are willing hands and cheap loans. Harvard economist Lawrence Summers, a former Treasury secretary, and Brad DeLong of the University of California at Berkeley argued in 2012 that infrastructure investment might even pay for itself, in part by keeping people employed so their skills don't atrophy.

If instead governments of rich nations do nothing more, hoping their economies heal on their own, they'll all risk getting stuck in the same rut that's trapped Japan for most of the years since its postwar economic miracle abruptly ended in 1990. Inflation is a fixable problem, as former Federal Reserve Chairman Paul Volcker showed: You just jack up interest rates high enough to break the fever, with a deep recession an unfortunate but temporary side effect. Japanese-style deflation, the spawn of chronic slow growth, is harder to break. Even fiscal stimulus may not work if households and businesses fall into a funk. As with fighting an epidemic or an insurgency, it's crucial to act fast before the enemy gains strength. "This is going to be a bad analogy, but it's like the fight against ISIS," says David Joy, chief market strategist at Ameriprise Financial (AMP).

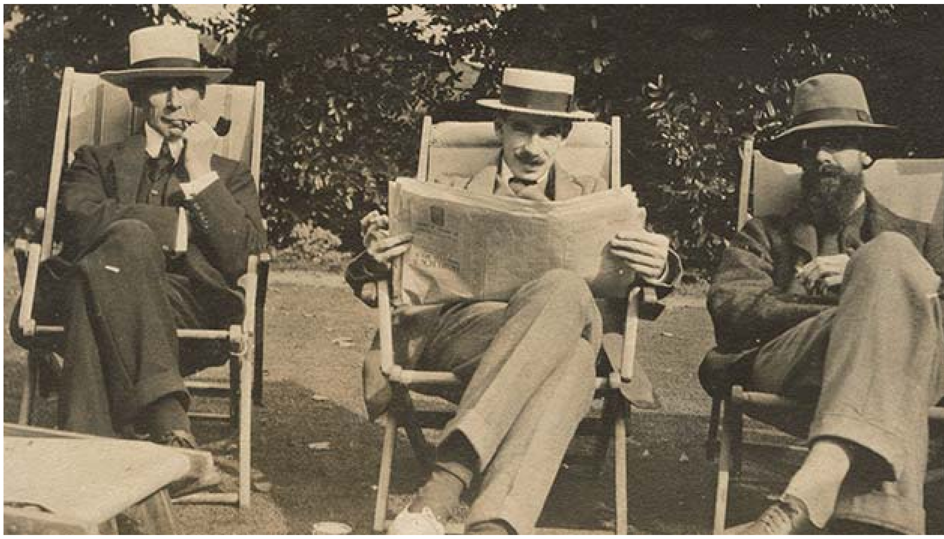
Keynes could be difficult and inconsistent. Paul Samuelson, the late Nobel laureate economist, described his book *The General Theory of Employment, Interest and Money* as "badly written, poorly organized … arrogant, bad-tempered, polemical, and not overly generous in its acknowledgments," before summing it up as "in short, a work of genius."

The mid-October shock in global stock markets betrayed grave concerns about a relapse

Love him or hate him, there's no one like Keynes on the world stage today. He was a statesman, a philosopher, a bohemian lover of ballet, and a member along with Virginia Woolf in the artsy, intellectual Bloomsbury Group. He made and lost fortunes as an investor and died rich. In 1919, in a prescient book called *The Economic Consequences of the Peace*, he condemned harsh reparations imposed on Germany after World War I, which were so punitive that they helped create the conditions for Adolf Hitler's Third Reich. In 1936 he essentially invented the field of macroeconomics in his masterwork, *The General Theory*. From 1944 until close to his death at age 62 two years later, he led Britain's delegation in negotiations that resulted in the founding of the International Monetary Fund and the World Bank.

In the 1950s and 1960s, Keynesian thinking ruled. President Kennedy's chief economic adviser, Walter Heller, persuaded the president in 1963 to propose a tax cut to stimulate demand. (It passed in 1964, after his assassination.) "That was the first time in history that a president specifically endorsed and adopted the Keynesian approach," Heller told the *New York Times* in 1987.

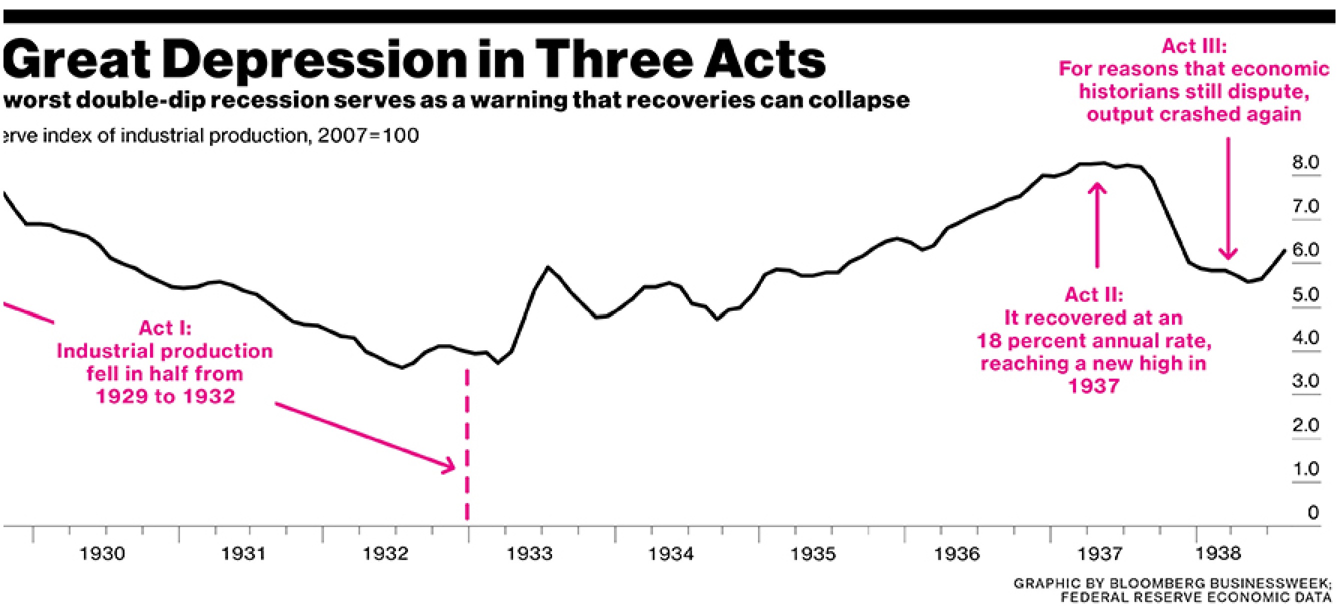
Keynes came under a cloud starting in the 1970s because his theories couldn't readily account for stagflation—the coexistence of high unemployment and high inflation. Academic economists were drawn to the new theory of "rational expectations," which said that government couldn't possibly stimulate the economy through deficit spending because foresighted consumers would rationally expect that the stimulus would have to be paid for eventually and so would save for future tax hikes, offsetting the initiative. Supply-side economists said Keynes missed how low taxes could stimulate long-term growth by inducing work and investment. "Unsuccessful policies and confused debates have left Keynesian economics in disarray," the Swedish economist Axel Leijonhufvud wrote in 1983 for a conference celebrating Keynes's centennial. A successor theory that evolved in the 1980s and 1990s, New Keynesianism, attempted to inject rational expectations theory into Keynes's worldview while preserving his observation that prices and wages are "sticky"—i.e., they don't fall enough in a slump to equalize supply and demand. New Keynesians range from conservatives such as John Taylor of the Hoover Institution to liberals like Berkeley's DeLong.



Photograph by National Portrait Gallery LondonWilliam Russell, Keynes, and Lytton Strachey in 1915

On Wall Street, Keynesianism never really died, because its theories did a good job of explaining the short-term fluctuations bank economists are paid to predict. “We approach forecasting more from a Keynesian perspective whether we like him or not,” says Joseph LaVorgna, chief U.S. economist at Deutsche Bank Securities (DB).

If Keynes were alive today, he might be warning of a repeat of 1937, when policy mistakes turned a promising recovery into history’s worst double dip. This time, Europe is the danger zone; then it was the U.S. What’s called the Great Depression was really two steep downturns in the U.S. The first ended in 1933. It was followed by four years of output growth averaging more than 9 percent a year, one of the strongest recoveries ever. What aborted the comeback is still debated. Some economists blame President Franklin Roosevelt for signing tax hikes and cuts in New Deal jobs programs. Others blame the Federal Reserve. Dartmouth College economist Douglas Irwin argues that the Roosevelt administration triggered the relapse by buying up gold, removing it from the U.S. monetary base. The move to prevent inflation succeeded all too well, causing deflation. Whatever the cause, Britain and other trading partners were dragged down, and U.S. output plunged and didn’t fully recover until America’s entry into World War II. “We are really at a kind of 1937 moment now,” says MIT’s Temin. “It’s a cautionary history for us.”



Now as then, getting out of the doldrums will take concerted international action. Any country that tries to stimulate growth alone is vulnerable to leakage; a lot of the buying power that it gins up gets spent on imports, so it doesn’t help domestic production or employment. Likewise, a country that wants to free-ride on its trading partners can cheapen its currency, allowing it to export more (and create jobs) while importing less (hurting employment abroad). That’s the very definition of beggar-thy-neighbor economic policies.

Keynes devised a solution for such behavior that he pressed for in his last years, but he was defeated at a conference in Bretton Woods, N.H., in 1944 by his American counterpart, Harry Dexter White, a senior official at the Department of the Treasury. Keynes called for an "international clearing union" that would strive to keep trade and investment in rough balance.

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The problem then, as now, is that creditor countries had all the power. They could demand that debtor nations pay interest on old loans instead of, say, feeding their children. Debts must be honored, of course. But Keynes understood that creditor countries have a part to play. They should give debtor countries some breathing room by buying more of their products and services. Today that would mean Germans vacationing more in Mykonos and buying more port wine, giving the Greeks and Portuguese the euros they need to service their loans from German banks. The concept was unarguable. But the U.S., running a trade surplus in 1944, had no interest in an international body that would tie its hands. (Today it's Germany, sitting on a massive trade surplus, that doesn't want to be told what to do.) The outcome was a less powerful organization, the International Monetary Fund, for aid to countries with balance-of-payments problems, and the World Bank, for promoting development in the poorest countries.

The big question is whether today's international financial architecture is up to the challenge of restoring balance to global trade and investment. The IMF, to its credit, has pivoted away from the austere prescriptions of the "Washington Consensus" that it championed through the 1990s and toward a more Keynesian perspective. "His thinking is more relevant at the current juncture than it had been in previous troughs of the global economy," says Gian Maria Milesi-Ferretti, deputy director of the IMF's research department.

But the IMF lacks the authority that Keynes's stillborn international clearing union would have had, and it's perceived in some quarters to be beholden to U.S. interests. Brazil, China, India, Russia, and South Africa are trying to set up an alternative. Germany isn't heeding the IMF much either as it presses France and Italy to take the same austerity medicine as Greece, Ireland, Portugal, and Spain. "Flash-in-the-pan, short-term stimulus programs" aren't the way to boost growth, German Economics Minister Sigmar Gabriel said on Oct. 20 in advance of a joint ministerial meeting in Berlin. At loggerheads, the Germans and French punted a joint proposal to Dec. 1. Eswar Prasad, a Cornell University economist and author of *The Dollar Trap: How the U.S. Dollar Tightened Its Grip on Global Finance*, writes in an e-mail that Keynes's proposed system "requires good domestic policies and a heavy dose of international cooperation," both of which are in short supply.

So goes the fighting among the physicians as the patient ails. Keynes saw the same kind of flailing at the start of the Depression. "We have involved ourselves in a colossal muddle, having blundered in the control of a delicate machine, the working of which we do not understand," he wrote in 1930. "The result is that our possibilities of wealth may run to waste for a time—perhaps for a long time." Keynes himself has shown us the way out.

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