

KEYNES, HAYEK AND THE GREAT RECESSION

The writings of Keynes and Hayek are rich with lessons on the causes of the current crisis and ways out of it, says **Robert Carling**. This essay is based on an address to the University of Queensland alumni meeting in Canberra on 26 September 2012

Economic history has unfolded before our eyes over the past five years as the worst financial crisis, the deepest recession (now dubbed the Great Recession), and the weakest recovery (the Feeble Recovery?) combined to deliver the biggest global economic shock since the 1930s. The shock was unevenly distributed, but its epicentre in the major advanced economies ensured the whole world suffered the fallout. Future generations will look back upon this era with fear and loathing just as we look back upon the Great Depression.

Similar to the turmoil of the 1930s revolutionising economic thinking then, the shocks of the last few years have breathed new life into old controversies about how economies work, why crises happen, and how to recover from them. These controversies were never resolved, but went into hibernation during the Great Moderation—the era of almost continual economic expansion, low inflation, falling interest rates, and booming stock markets from the early 1990s to 2007. Now, the arguments between Keynesians, Austrians and neo-classicists have returned with as much vigour as ever before.

John Maynard Keynes and Friedrich von Hayek were key protagonists in the economic debates of the 1930s. Their theories, policy prescriptions and teachings cover much of the ground occupied by opposing camps in the contemporary debate. For this reason, the writings of Keynes and Hayek are rich with lessons on the causes of the current crisis and ways out of it.

The rise and fall and rise of Keynes

Keynes' name long ago became synonymous with fiscal stimulus ('pump-priming') and deficits in times of recession. The world quickly embraced Keynesian pump-priming solutions when economies went into free fall in late 2008, and even today there are voices in favour of more of the same, or at least a tolerance for large fiscal deficits as long as economic activity remains subdued. However, we need only take a little detour through the history of economic thought to appreciate that the wisdom of this rush to embrace Keynesian solutions is open to challenge.

The early 1970s were the heyday of post-World War II Keynesianism, in Australia as much as elsewhere. The Australian government and its key economic advisory body, the Treasury, accepted the Keynesian consensus in that they believed in the management of aggregate demand through fiscal policy to dampen the business cycle. It is true that the Treasury was also a strong advocate of what are today called supply-side policies to strengthen the economy's productive capacity. Moreover, the Keynesianism that it



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believed in was of the symmetrical kind, which sought to tighten fiscal policy in an inflationary upswing as well as loosen it in a downturn, not the one-sided expansionary Keynesianism more popular with politicians. Despite these qualifications, it is correct to say that the Treasury at the time advised the government within a Keynesian framework.

Not long into the 1970s, however, Keynesianism began a retreat that continued up to the 1980s, initially because it had no answer to the stagflation of that era. This revision of Keynesian thinking strongly influenced the Commonwealth Treasury, which had a major falling-out with the Whitlam government in 1974 over the latter's refusal to countenance fiscal tightening in the midst of rampant inflation and an economic downturn. The Treasury eventually won that argument. Keynesian fiscal policy, if not exactly dead and buried, went into cold storage just like in other countries. But then it made a spectacular comeback with the onset of the global financial crisis in 2008, and was embraced once again by the Commonwealth Treasury as well as economic managers all around the world.

Keynes and the Keynesians

Strange though it may seem, there is an essential distinction between Keynes and the Keynesians. Many of the things that have been said and done in the name of Keynes since World War II are nowhere to be found in his writings and statements. They are actually interpretations and embellishments of what he wrote and said. This process started even before Keynes died. He is reported to have said after some discussions with Keynesian economists in the United States that he was the only non-Keynesian in the room. We can only imagine what he would have made of some of the policy views attributed to him since his death in 1946.

We cannot know how his thinking would have evolved in the modern world, but the essence of his *General Theory*¹ in the 1930s was that fiscal pump-priming should be used in the context of a deep and lingering slump and deflation. (In that sense, the *General Theory* was actually a theory tailored to the specific

circumstances of the 1930s.) He did not believe that an easy monetary policy would be effective in sparking a recovery in those circumstances, and therefore, advocated two key changes in fiscal policy: first, that the government should not struggle to balance its budget in the face of falling revenue; and second, that it should borrow to fund a large-scale public works program. The first is not at all controversial today. Only the terminology has changed to something like 'let the automatic fiscal stabilisers work.' But it was quite a radical thought in the 1930s. It is the second prescription that remains controversial.

After the war, the reinterpretation of Keynes continued in earnest and led to notions such as using fiscal policy to fine-tune the economy and influence the level of consumer spending. But Keynes never advocated fine tuning. His context was that of a deep slump, not an ordinary business cycle, and his version of pump-priming was a blunt instrument, not a scalpel. He is also reported to have rejected the idea of using fiscal policy to boost consumer spending through temporary cash payments or tax cuts for households. His response to that idea was similar to Milton Friedman's later permanent income hypothesis.² Keynes' name has become associated with big government and deficit financing as a normal state of affairs, but he never advocated them. In fact, he is on record saying there was no need for the size of government to exceed 25% of the economy—a figure that has been far exceeded in all developed countries.

When the counter-Keynesian revolution came in the 1970s, it jettisoned what the Keynesians had advocated, and to a lesser extent, undermined the crux of Keynes' own theory. Fine tuning was discredited. The failure of fiscal stimulus in conditions of stagflation came to be widely accepted. The 'rational expectations' school undermined Keynes' theoretical foundations.³ The fiscal multiplier was thought to be much smaller than previously believed. Activist fiscal policy was thought more likely to be destabilising than stabilising. These revisionist thoughts culminated in the view that fiscal policy should focus on medium- and long-term goals, such as strengthening the supply side of

the economy, while short-term management should be left to monetary policy. The budget would fluctuate symmetrically between deficit and surplus, but mainly on account of automatic responses of revenue and expenditure to the business cycle, not activist stabilisation policies.

The extent to which that message was internalised in policy circles has been overstated. Keynes and Keynesians came to be viewed with much reservation, but were not totally rejected. In Australia, for example, we still had some discretionary fiscal stimulus in the early 1990s recession. By and large, the political temptation to tinker with fiscal policy for short-term economic management went untested for an unusually long time during the Great Moderation, until the global financial crisis and the Great Recession, when the Keynesians came in from the cold.

Most countries applied large doses of fiscal stimulus in 2008 and 2009, with Australia's being among the largest even though the recessionary forces here were not as strong as elsewhere. Three years on, the discretionary stimulus has been withdrawn here and elsewhere, even though large fiscal deficits remain in most countries. However, the cessation of discretionary stimulus is not universally accepted. There are many prominent and vocal advocates of further rounds of stimulus—not in Australia but in the countries experiencing feeble recoveries or renewed recessions. At the same time, most of these countries are also under pressure to curb their deficits and debts—hence, the debate over 'austerity versus growth.'

Does fiscal stimulus work?

Was the world right to go back to Keynes? The economic conditions of 2008–09 were more like the 1930s than at any other time since then, and governments could have been excused for thinking that if ever there was a time for Keynesian pump-priming, that was it. Even so, there is a strong case that policymakers expected too much from fiscal stimulus in 2008–09. So rushed were they to do something as their economies collapsed around them that the measures taken were of poor quality. (Indeed, that is an inherent problem with an emergency stimulus.) Certainly, the type of stimulus applied

did not follow the Keynesian formula. There were few 'shovel-ready' public works projects, and much of the stimulus was aimed at consumer spending. In addition, they were too eager to ignore the lessons of the counter-Keynesian revolution of the 1970s and 1980s. Had they heeded those lessons, they would have known that stimulus was subject to various endogenous offsets such as leakage into imports. Because of these offsets, stimulus can end up being quite weak per dollar of stimulus applied, especially in an open economy. The fiscal multiplier is thus small and tends to shrink to zero the more time passes after the stimulus is applied.⁴ At best, fiscal stimulus in 2008–09 acted as a circuit-breaker to soften the downward economic spiral. It did not kick-start a sustained, robust recovery, nor should it have been expected to. And in many countries, it ratcheted up already uncomfortably high or unsustainable levels of public debt, thereby adding to the risk of future instability.

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Australia was at least starting from a position of fiscal strength, with no net public debt at the Commonwealth level. The Commonwealth budget would have gone substantially into deficit even if there had been no discretionary fiscal stimulus, simply through the loss of revenue from lower taxable profits and other incomes and higher expenses on items such as unemployment benefits—the operation of the automatic stabilisers. But was the additional widening of the deficit through a large discretionary stimulus necessary, and was it the key factor in avoiding an economic slump? The conventional wisdom believes so, but it attributes too much of our good fortune to fiscal stimulus and not enough to other advantages such as the strength of our banking system, the swift loosening of monetary policy, the large depreciation of the Australian dollar, and the policy measures taken to ensure

the banking system was not starved of funds. The expansionary effect of fiscal stimulus in 2008–09 softened the brief downturn that Australia experienced, but the fact that Australia did not have a deep slump had more to do with the other strengths listed above than with the fiscal stimulus. Meanwhile, the enduring legacy of the stimulus is an addition of tens of billions of dollars to the public debt.

Another question is whether the countries still experiencing weak recoveries or a relapse of recession would be correct to apply more stimulus or delay deficit-cutting measures until their economies are stronger. Here the answer almost certainly is ‘no.’ In addition to all the general reasons cited above to question the effectiveness of stimulus, these countries’ public debt burdens are now such a prominent part of their problems that it is difficult to see how adding to those burdens (which is what fiscal stimulus would do) can be part of the solution. For example, public debt in the United States has already risen to 80% to 100% of GDP (depending on how it is measured), and the long-term projections of its growth under current policies are quite horrendous. There is great uncertainty about how and when fiscal sustainability will be restored. Businesses are hoarding mountains of cash rather than investing. Any additional fiscal stimulus now would be neutralised by an adverse response from the private sector, which would attempt to save more in the face of even greater uncertainty. The deficit does not need to be eliminated overnight to resolve this uncertainty, but a credible plan to put the public finances on a sustainable footing over the next several years, backed up by concrete actions and commitments, would do wonders for confidence and investment.

Hayek’s world view

Hayek never published a critique of Keynes’ *General Theory*, but it is clear from his writings that he had a very different view of the world. This view has been subject to a great deal of misunderstanding because Hayek’s name, like Keynes, has been taken and attached to all manner of proposals and ideas that he never

actually put forward. His detractors even blame him for helping cause the global financial crisis by promoting a culture of greed and laissez faire. This is nonsense. It is possible, however, to piece together a Hayekian explanation of the Great Recession. In fact, Hayek is much better at explaining how the Great Recession came about than explaining how to make a fast exit from it.

Hayek and the Austrian school of economists, to which he belonged, believed that the supply side of the economy was the key, not as Keynes thought the demand side. Focusing on how economies got into crises in the first place, they pointed the finger at easy money policies, excessive credit growth, and what are today called ‘bubbles’ or ‘mal-investments.’ These were supply-side distortions that would eventually lead to a crisis and a slump of the worst kind, namely, one grounded in crippled balance sheets—be they of financial institutions, households, businesses or governments. The 2008–09 slump and the feeble recovery since are balance sheet phenomena that can be traced back to a long series of episodes of easy money policy and rapid credit expansions in the major countries.

Clearly, the behaviour of banks exacerbated the crisis and regulation was deficient, but this does not invalidate Hayek’s explanation. Hayek would never have said the banks should have gone unregulated. He would have said, ‘Get the regulation right and apply it in a consistent and predictable way.’ This was not done in the United States before or during the crisis. The regulators responded erratically and arguably made the crisis worse.

Hayek’s answer

Hayek could not offer a quick escape route from the current malaise. He certainly would not have agreed with Keynesian pump-priming. Hayek is associated more than anything else with the principle of economic freedom, and he always argued that the best thing governments could do to promote freedom and prosperity was to provide a stable, predictable framework of policy and regulation under the rule of law, with limited government, low and stable tax

rates, and sustainable public finances. Discretionary fiscal stimulus is the antithesis of predictability and stability. It is a manifestation of the arbitrary government intervention that Hayek loathed. Whatever positive effect it might have on aggregate demand would be offset by the harm it does to aggregate supply. This does not mean that Hayek-land is free of the business cycle. Hayek accepted the inevitability of the business cycle in a free-market system but saw it as a small price to pay for the benefits of the free market. He argued against policies that he believed would make the cycle worse.

Hayek would be in favour of fiscal consolidation (so-called austerity) in the current environment, combined with tax and expenditure reform and other structural policies to strengthen the long-run growth potential of the economy. Even the Hayekian true believers would not offer that as the fast road out of trouble, but there probably isn't a fast road.

Ultra-easy monetary policy

Economic managers in the major countries are now resting their hopes on unprecedented monetary policy interventions in the form of policy interest rates held at or near zero for extended periods, and massive doses of quantitative easing (or 'printing money') administered by the monetary authorities of the United States, Japan, the Eurozone and Britain. This ultra-easy monetary policy, as one writer has named it, constitutes one of the boldest economic policy experiments ever undertaken.⁵ Keynes would have said this will be ineffective, like pushing on a string. Hayek would have said it may be effective in stimulating something the longer it continues, but that it will stimulate the bad with the good, create new misallocations of resources, new bubbles, and therefore, store up big problems for the future.

To Hayek and the Austrians, it is just more of the easy money policies that ultimately led to the current mess. Ultra-easy money is providing short-term support to economic activity and helping keep deflation at bay, but it cannot produce a robust, balanced, sustainable recovery. It runs the risk of stoking inflation and producing more bubbles and

mal-investments. It also threatens to undermine the hard-won independence and credibility of central banks. Central bankers understand this but are haunted by the ghosts of the 1930s, when the conduct of monetary policy made the Great Depression worse. They are determined to ensure that monetary policy is doing everything possible this time to support economic activity, while buying time for governments to implement structural policies that can provide the foundations for a sustained recovery. Whether governments rise to the challenge remains to be seen. If they don't, then ultra-easy monetary policy cannot be a substitute and will ultimately end in tears.

Conclusion

These arguments will go on. The Great Recession brought a revival of Keynes, and to a lesser extent the Keynesians, but already there is renewed understanding of the limitations of fiscal stimulus and the urgency of fiscal consolidation. With the passage of time and dispassionate analysis, the balance may once again shift from Keynes towards Hayek. Hayek lost the argument with Keynes in the 1930s. But he may yet have the last laugh.

Endnotes

- 1 *The General Theory of Employment, Interest and Money* (London: Palgrave Macmillan, 1936).
- 2 Friedman hypothesised that households' spending decisions were based mainly on their expected sustainable income rather than short-term fluctuations.
- 3 Thomas Sargent and Neil Wallace, 'Rational Expectations and the Theory of Economic Policy,' *Journal of Monetary Economics* 2:2 (1976), provides an example of the rational expectations challenge to Keynes.
- 4 The International Monetary Fund recently reignited this debate by arguing that the fiscal multiplier can be quite large, but the IMF has in turn been criticised for the quality of its data.
- 5 William White, 'Ultra Easy Monetary Policy and the Law of Unintended Consequences' (Federal Reserve Bank of Dallas, 2012).