The Return of Keynesianism

BY DONALD J. BOUDREAUX

In our Brave New World of Change We Can Believe In, I wonder about some recent changes—changes that I can't believe in.

For example, why are so many economists suddenly changing their minds about the economics of John Maynard Keynes (1883–1946)? Veritable stampedes of my fellow economists are rushing to take up again the banner of Keynesian economics, which most economists had abandoned by 1980.

Keynesian economics is an account of economywide employment that rather too simply alleges that economic health and growth—and, hence, the number of jobs—declines with decreases in "aggregate demand" and improves with increases in "aggregate demand." No need to bother with questions about how well individual markets are working; no need to worry that the money supply might be growing too fast and causing individual prices to be out of whack—no! The economy is really much simpler, said Keynes, than those silly classical economists, such as Adam Smith, made it out to be.

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All that really matters is the total demand for output ("aggregate demand"). If consumers cut back on their spending to save more, aggregate demand falls. As aggregate demand falls, firms scale back their operations. Workers are laid off. As workers are laid off, aggregate demand falls even further, causing even more layoffs. The economy spirals down into an "unemployment equilibrium."

Only higher spending can salvage the situation, and the only agency sufficiently immune to animal spirits to know what to do—and that has the wherewithal to spend with sufficient gusto—is government. If government spends, the resulting increase in aggregate demand will restore "confidence" to the economy. Business people will again be confident that they can sell what they produce, so they'll hire more workers. These newly hired workers will also spend. The economy will be saved.

The only trick is to make sure that the government doesn't spend *too* much. If it does, the result will be inflation.

Economists before Keynes (at least, those who were taken seriously) rejected such ideas. These economists—labeled disparagingly by Keynes as "classical economists"—pointed out that if people reduce their consumption expenditures and save more, the additional savings push down interest rates and prompt entrepreneurs to invest more. Rather than disappear from the spending stream, these savings are spent, but they're spent as demand for investment goods rather than as demand for consumer goods.

Classical economists argued, therefore, that higher savings were good, for they meant that the size of the economy's capital stock would increase. More saving meant more and better machinery, larger factories, more R&D, more worker training, more infrastructure. Over time this larger capital stock makes workers more productive and thus pushes real wage rates higher. Living standards increase.

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"Pshaw!" respond the Keynesians. "If consumers spend less on consumption goods, why would entrepreneurs increase the capacity of their operations? Moreover, even if people saved more today with the goal of consuming more tomorrow, investors' motives are so haunted by animal spirits that we can't rely on investors to read lower interest rates as a signal to invest more. Alas, only government can provide the rationality, stability, and spending necessary to keep the economy at full employment."

The "classical economists"—which include in this case not just scholars who preceded Keynes, but also the likes of Frank Knight, Ludwig von Mises, and F. A. Hayek, who were contemporary with Keynes or even younger than him—pointed out that an increase in savings doesn't mean a permanent desire to consume less in an absolute sense. It means a desire to spend a lower *portion* of income on consumption goods. As income increases, consumption will rise in an absolute sense.

A person saves more today, first, to increase his income and wealth over time so he can consume more in the future while still preserving or even growing his wealth, and, second, to be able to consume comfortably when illness or retirement makes further work impossible. The notion that people work to produce valuable output without any desire ultimately to consume the fruits of their labor is really rather bizarre, when you think about it, but it forms part of the foundation of Keynesian economics.

Short Memories

Another mysterious thing about economists' sudden renewed infatuation with Keynesianism is the flimsiness of the reason. It seems as if a year-long and (at least as of mid-April 2009) still-mild slowdown in economic activity has caused economists to forget an entire decade of experience. Are the 1970s *that* distant a memory?

Remember the disco decade? In addition to bad fashion, it featured high and rising unemployment along with high and rising inflation. Keynesian theory, unless it is contorted beyond recognition, doesn't allow both of these things to occur simultaneously. So the 1970s "stagflation" prompted economists to reassess Keynesian theory and the policies it suggested. Although no single macroeconomic consensus replaced the then-discarded economics of Keynes, economists finally recognized Keynesianism to be seriously flawed.

But here we are, a mere 30 years later, and it's as if the 1970s didn't happen. The lessons of an entire decade of harsh reality contradicting Keynesianism are cast from economists' memories by a burst housing bubble, a few months of economic slowdown, and an unemployment rate (again, as of April 2009) that hasn't been seen since way, way, way back in the 1980s.

What's going on? Why *this* change away from sounder macroeconomic reasoning by economists toward a once-discredited (and never really sound) Keynesianism?

I wish I knew the answer. But all I have are guesses. Part of the reason is that economists' memories are indeed shockingly short. Being experts at blackboard theorizing and computer simulations, too few economists familiarize themselves with economic reality. Another reason, at least for those economists who crave to be advisers to presidents and other government pooh-bahs, is that Keynesianism supplies ideal intellectual cover for the irresponsible spending that politicians long to do. Professor Smith or Dr. Jones stands a much better chance of being consulted by our leaders if the economists are prepared to tell them what they want to hear.

I hope against hope that matters will change. But I fear that my hope is too audacious. FEE

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The Great Depression and World War II

BY ART CARDEN

The current economic climate has a lot of people talking about the Great Depression. In particular, it has been said by people of divergent political views (George Will and Paul Krugman, for example) that World War II ended the decade-long economic nightmare. Examining this claim is worthwhile because it has implications for whether government intervention generally and in connection with war specifically are good for the economy. Further, this examination will help us understand how policy changes alter incentives. Finally, it will shed light on features of the New Deal era that have ominous parallels with what's happening today.

In *Depression, War, and Cold War*, Robert Higgs divides the Great Depression into three phases. The Great Contraction occurred during the Hoover years and went from 1929 to 1933. During this period private investment fell by about 84 percent. This set the stage for the Great Duration, 1933–1945. As Higgs shows, GDP and private investment increased during the early years of the New Deal, but as the 1930s wore on, President Franklin Roosevelt became ever bolder about undermining property rights. This delayed complete recovery. Finally, there was the Great Escape, which occurred after and in spite of World War II, not because of it. Higgs argues that the Great Escape occurred as a result of a partial dismantling of the regulatory infrastructure that had grown up during the Depression and the war; in effect, it was a rediscovery of the market and a new birth of freedom for entrepreneurs and workers.

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In discussing the Great Duration, Higgs introduces the term "regime uncertainty" to argue that the Roosevelt administration's aggressive interventions produced considerable uncertainty in the entrepreneurial environment. Investors did not know whether they would enjoy the fruits of their investments. One of my mentors in graduate school, a Keynesian, pointed out once that firms will not produce what they do not expect to sell. I would generalize this to say that they will not invest what they do not expect to control. The possibility of incurring the costs of an investment without enjoying any of the benefits made private investment much less attractive.

How do we know that regime uncertainty was responsible for the lack of recovery? Higgs brings several types of evidence to bear on the issue. First, business leaders who were polled expressed uncertainty about the entrepreneurial climate. Second and more convincingly, Higgs shows that the risk premiums on long-term corporate bonds were substantial, suggesting fear of expropriation. A firm that wanted to borrow long-term

Art Carden (art.carden@gmail.com) teaches in the department of economics and business at Rhodes College. This article is based on a talk entitled "Why World War II Did Not End the Great Depression," presented at a meeting of Libertarians for Peace and the Libertarian Liberty League in Monterey, California, on January 6, 2009. He thanks the audience, particularly David Henderson, for comments.