We need real Keynesian solutions now

COLUMN | Many people use the term 'Keynesian,' even though they have no idea what it means

BY ROGER BOOTLE

Are we all Keynesians now? Two weeks ago, I invoked the ghost of Keynes and there has recently been a flood of references to him. People are holding forth with much sound and fury — often signifying nothing. So what, if anything, does the teaching of this long-dead economist have to offer us today.

John Maynard Keynes, born in 1883, died in 1946; present at the Versailles negotiations in 1919; Britain's representative at the Bretton Woods conference in 1944; father of the two key institutions of the post-war monetary order, the International Monetary Fund and the World Bank; author of The General Theory of Employment, Interest and Money; and, most importantly, the origin of the adjective "Keynesian."

This word has all but lost its original meaning. Like fascist, it began describing a set of beliefs, but has become a term of abuse or approbation, wielded by those who mostly have not the faintest idea what it actually means. So I want to give my version of "Everything you wanted to know about Keynes and were afraid to ask." I think I can reduce his view to seven essential propositions.

■ 1. The economic system is naturally prone to periods of depression.

■ 2. When one occurs, the system is not necessarily self-correcting.

■ 3. Such depressions are not the result of individual choice. On the contrary, individuals en masse can become trapped in a depression which is in no one's interest but which, as individuals, no one can counter-act.

■ 4 This represents pure waste. Unemployed workers want to work and businesses want to use their productive capacity. If they did, then the things they produced would be available for all to buy, and the incomes they earned would let them buy the products of others.

■ 5 For individuals it may be appropriate to react to difficult times by saving more. Yet collectively this is a disaster. One man's saving is another man's reduced income. Extra borrowing by the government, if it encourages more output, can be self-financing.

■ 6. The key is aggregate demand. In normal circumstances it is possible to influence this by changes in interest rates. But there is a level below which interest rates cannot go and at that point conventional monetary policy is powerless. Moreover, even if interest rates can be lowered this may have no effect if people cannot or will not borrow.

■ 7. At this point, aggregate demand can only be boosted by the government borrowing more, either to spend directly or to give to others to spend via tax cuts or the like.

The Keynesian view first hit the world like a bombshell, then became commonplace and then was dismissed as irrelevant or dangerous. What went wrong? Two things. First, although the Keynesian framework is a useful way of thinking about all economic conditions, it is both valid and truly radical only in depression conditions.

Second, Keynesians went too far. His treatment of inflation was sketchy at best. Understandably. In the Depression, inflation was hardly public enemy number one. But the Keynesians took this a step further. Some said inflation didn't matter. Others felt that even though it did matter, they could control it through prices and incomes policies. And inflation was let loose.

They also underplayed the role of monetary factors, in stark contrast to the master himself. And they underplayed the adverse long-run consequences of public deficits. Advocacy of public borrowing to get an economy out of depression became a relaxed attitude to deficits in general.

They also overestimated the state's ability to manage demand, believing they could fine-tune the economy. But our poor ability to forecast and the unpredictability of policy changes meant actions designed to stabilize the economy often destabilized it.

Was Keynes "a lefty?" Yes and no. Yes, in that he identified how individuals left to their own devices, even in their collective guise as "the market," could not deliver the collective best interest. Thereby, he identified a key role for the state. No, in the sense of believing in a fully collectivist society. Indeed, he thought he was helping to preserve the capitalist system from disaster and halting the spread of socialism.

As a supporter of free markets, I see no problem in calling myself "Keynesian." I see this as no different from believing that, even though markets perform most roles better, there are some things, such as defence or public health, only the state can adequately provide.

We are now in Keynesian conditions and need Keynesian solutions. There is nothing anti-Keynesian about trying to get out of the current position through lower interest rates. For anyone who believes in markets and is wary of state action, this must be the first resort. But don't be surprised if it doesn't work.

In that instance, don't be shy about allowing huge increases in government borrowing to stave off depression. Finance must not be confused with economics. There are costs to debt, but idle men and machines are real costs which are never recoverable and hence are borne forever.

Roger Bootle is managing director of Capital Economics and a Daily Telegraph columnist.