

October 30, 2010

**“Are we all Keynesians? Yes and No!”**

**T. K. JAYARAMAN**

“No man is a prophet in his own country.”

We have heard it before.

But, have we ever heard that a prophet eventually recognized and accepted, was one day suddenly disowned by the land of his birth?



British Chancellor of Exchequer Osborne

That was what happened ten days ago, when George Osborne, Chancellor of the British Exchequer delivered a speech, as Andrew Testa wrote in New York Times of Oct 21, “that made Keynes — who himself worked in the British Treasury — blanch.”

Osborne rejected the Keynesian view that deficit spending by governments is crucial to fight a recession.

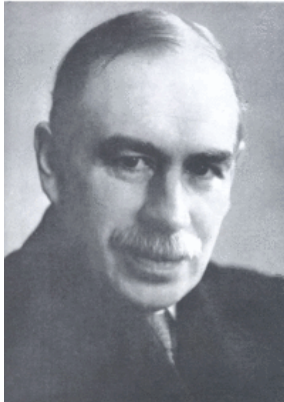
Thus, John Maynard Keynes, the world’s most influential British economist of the 20<sup>th</sup> century is no more relevant in Britain.

The British government announced budget cuts of about £83 billion (US\$130 billion) by 2015. The cuts are directed towards reducing the public deficit presently estimated at 11.5% of GDP. The corresponding deficits of US and Germany are 10.7% and 5.4%.

The highlights of Osborne’s speech are:

- All departments face average cuts of 19 per cent
- Half a million jobs out of a total of 6 million government jobs will go
- Civil servants pay more into their state pensions
- Cuts in child benefits
- Pension age raised from 65 to 66 would save £5 billion a year
- Foreign services will lose 24% of its budget
- Police spending will fall by 4%

- Home Office and Ministry of Justice spending will fall by 6% a year
- Queen Elizabeth II is not spared: cut in Royal household spending by 14%
- Armed forces budget will be cut by 8%
- BBC has to fund its World Service on its own
- 17,000 defence jobs would vanish



Lord Keynes

Britain's Institute for Fiscal Studies says that most of the pain would be inflicted on working families, the sick and the poor.

### **Worldwide Trend**

Britain's decision is influenced by the worldwide trend in cutting government expenditures. Ireland, which was a victim to property bubble and banking crisis, has already initiated spending cuts. Germany and Greece have also taken similar measures. France in recent weeks has been facing public protests against a rise in the retirement age and other reforms.

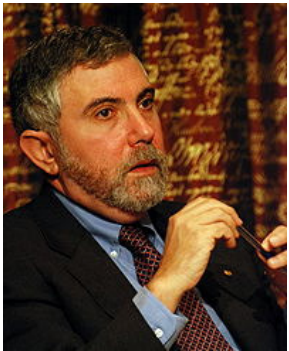
The only country, where the fiscal stimulus along Keynesian lines is still on is the United States. As the economy did not respond fast enough, President Obama is facing a disenchanted electorate, who will be going to polls for electing Senators and Congressmen in November. The ultra conservatives led by the unsuccessful Vice Presidential Republican candidate Sarah Palin have mounted an immensely popular campaign to reduce the size of government.

### **“A Gamble?”**

Staunch Keynesians led by two Nobel Laureates, Professors Joseph Stiglitz and Paul Krugman have already reacted the way one would expect.



Nobel Laureate Joseph Stiglitz



Nobel Laureate Paul Krugman

Writing in the *Guardian*, Stiglitz wrote: “Austerity is a gamble that Britain - and the world - can ill afford”.

His arguments were that Keynesian fiscal stimulus, including buying debts of the banks in distress, did work. While those countries, including China with their relatively large fiscal stimulus packages did better, “the US stimulus package was both too small and poorly designed.” Stiglitz lays the blame on US politics rather than economics, which drove the size and design to be small and ineffective.

Most of the increase in deficits and debts in the US and UK is not due to the stimulus but to the bank bailouts. Stiglitz argues that cutbacks in spending will weaken Britain, and even worsen its long-term fiscal position relative to government spending.

The reasoning is obvious. Fall in aggregate demand due to cutbacks, when private sector is weak, would mean lower output and higher unemployment, unless something else fills the gap.

Stiglitz also makes it clear that monetary policy will not work, as short-term interest rates are low; and any increase in money supply would not substantially reduce long-term interest rates and would not lead to increases either in consumption or investment.

Weakening the currency through rise in money supply for cheapening exports to foreigners, as a measure to fill the domestic demand gap has been described by Stiglitz as “hardly the road to recovery.”

Krugman in his New York Times column writes that fiscal austerity will depress the economy further, unless it can be offset by a fall in interest rates. Since interest rates in Britain, as in America, are already very low, there is no room for further fall. So, Krugman suggests the sensible thing is to “devise a plan for putting the nation’s fiscal house in order, while waiting until a solid economic recovery is under way before wielding the ax.”

### **A Long Standing debate**

The debate has been in the past was on the lines of monetarism *versus* fiscal policies. The monetarist school led by Nobel Laureate Milton Friedman argued that money alone mattered; and pumping in money with no government involvement would be sufficient to stimulate investment and growth.

The proponents of fiscal policies rejected that idea. They argued that when expansionary monetary policies could not work, government should increase public expenditures. The conservatives in Britain and the Republican Party in the USA stand for small government; and the Labour and Liberals in Britain and Democrats in USA largely support pro-active fiscal policies.

People against “big” government have naturally embraced monetarism, with no room for expansionary fiscal policies. It has become an ideology, which has been considered worth fighting for. The Tea Party movement symbolizes the new creed of less government.

Yet, the 2008 financial crisis brought to the fore the need for throwing out the ideological predilections.

The CNN last week released a video clip showing former President George W. Bush announcing his book, *Decision Points*, a revealing document. President Bush explains how he took “the decision to set ideology aside to prevent an economic collapse.”



Nobel Laureate Milton Friedman

It may be recalled that in late 2008, President Bush brought the two Presidential candidates Obama and McCain off the campaign trail to get their support for passing the big bailout program.

Thus, in reality, it was the Republican President Bush, who abandoned the ideology.

To look back, it was also another Republican President, Richard Nixon who publicly announced: "I am now a Keynesian in economics." That was in 1971, when President Nixon took the US off the gold standard.

In fact, the phrase is popularly associated with Nobel Laureate Friedman.

It only signifies the need for rationality in politics or pragmatism. The objective is to save economies from collapsing due to the impact of the inevitable business cycles.

Friedman in his letter to the editor of Time magazine, published in the February 4, 1966 edition, clarified his stand:

"In one sense, we are all Keynesians now; in another, nobody is any longer a Keynesian."

Friedman's oft-quoted words would perhaps sum up the British government position as well.

---

***Dr. T. K. Jayaraman ([jayaraman tk@usp.ac.fj](mailto:jayaraman_tk@usp.ac.fj)) teaches monetary economics at USP. The views expressed do not represent those of this newspaper or the USP.***