Short courses in economics carry an implicit warning: superficial analysis leads to simplistic conclusions. Where textbooks might be forgiven, a Nobel-Prize-winning economist who builds upon that superficiality deserves a reprimand.

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'A little learning is a dangerous thing; drink deep, or taste not the Pierian spring:'
(Alexander Pope)

**Superficial analysis; simplistic conclusions**

Where economics courses are short, context and relevance are neglected, which leaves many students with an aftertaste of 'unrealistic' assumptions (perfect foresight, zero transactions costs etc.); but greater harm arises from superficial exposure to Keynesianism. There the aftertaste is appealing: fiscal and monetary interventions alleviate recession and set the path to recovery. It is a matter for concern that a Nobel-Prize-winning economist should endorse such conclusions.

In contributing to a conference centred upon the 75th anniversary of *The General Theory*, Paul Krugman admits he is 'not a Keynes scholar, nor any kind of serious intellectual historian'. Although setting his exposition at the level of how 'I like to read' Keynes, he expects more from others: 'modern economists and economic commentators' are castigated for 'not knowing their Keynes' (Krugman, 2011, p. 5).

Krugman’s presentations begin with ‘the hoary old Samuelson cross’ (Figure 1): when aggregate expenditure is raised, output and employment are lifted to higher sustainable levels. The cross represents an uncomplicated remedy for unemployment:

‘If the Treasury were to fill old bottles with bank-notes, bury them at suitable depths in disused coal-mines... and leave it to private enterprise on the well tried principle of laissez-faire, to dig the notes up again... there need be no more unemployment’
(Keynes, 1936, p. 129).

The official reaction to Keynes’s remedy became known as ‘the Treasury view’: the means by which government expenditure is financed (taxation or borrowing) crowds out private expenditure. Krugman conjures his own response:

‘the argument that deficit spending by the government cannot raise income also implies that a decision by a private business to spend more must crowd out an equal amount of spending elsewhere in the economy’
(Krugman, 2011, p. 6).

Krugman is correct: resources are crowded out as much by business expenditure as by government deficit spending; but there is a crucial difference. With business expenditure, resources are redirected to better effect in creating desirable goods and services (with desirability signalled by market revenues sufficient to conserve value through capital amortisation). With fiscal deficit spending, there is no amortisation of capital: sovereign debt accumulates.

The point of departure between classical economics (particularly, the analysis of the Austrian School) and Keynesians turns on objectives. Keynesianism focuses upon labour activity – employment *per se* is desirable – whereas Austrian analysis focuses upon sustainable growth through the regeneration of capital. Though, to be fair, *The General Theory* was intended only as a ‘tract for the times’ (Hayek, 1966, p. 100); that is, for the conditions of the 1930s:
I consider that my suggestions for a cure...a reo na different plane from the diagnosis. They are not meant to be definitive; they are subject to all sorts of conditions of the time (Keynes, 1937, p. 142).

By its development after Keynes’s death, Keynesianism ignored that proviso; and there came a denial of any parallel between private and public sector borrowing. In raising tax revenues, economic growth would stabilise sovereign debt. Better still, after twenty-five years of so-called ‘Great Moderation’, Gordon Brown confidently announced the end of boom and bust. Gone was any recognition that, without running fiscal surpluses during good times, debt accumulates. In the USA, borrowing excesses were accompanied by a redistribution of resources to housing via government-orchestrated ‘sub-prime’ lending (see, Butler, 2009). Its consequences will long endure. For home-owners, as for many sovereign states, excessive borrowing produced levels of debt that challenge the feasibility of repayment.

Krugman, Keynes and the classics

As one set of ‘Keynes readers’ dwells upon long-term expectations, investor psychology and economic instability, a second set (where Krugman places himself) remains focused upon ‘demand failures’. Both sets argue that classical economics is riddled with fallacies, pre-eminent among which is the presentation of interest in terms of the market for loanable funds. And so, Krugman’s presentation moves from the Samuelson cross (with approval) to the credit-market cross (with disapproval). Bedded firmly within the classical paradigm, the credit-market cross (Figure 2) shows the price (interest rate) of credit. The alleged fallacy here is that:

‘[w]hen you think in those terms, it’s only natural to suppose that any increase in the demand for or fall in the supply of loanable funds must drive up interest rates; and it’s easy to imagine that this, in turn, would hurt prospects for economic recovery’ (Krugman, 2011, pp. 8–9).

By Keynesian analysis, economic recovery requires low interest rates; and Krugman endorses the notion that ‘as long as output is depressed, there is no reason government borrowing need drive rates up’. And it gets better: by making use of excess savings, fiscal deficit spending ‘helps the economy recover’ (Krugman, 2011, p. 12).

Krugman applauds Keynes’s innovation in regard to interest rate determination (The General Theory, chapters 12 and 13). By Keynes’s alternative theory, the interest rate is determined by asset portfolio adjustments. A highly liquid asset (money) bears zero (or low) yield and is held on the speculative expectation that the prices of bonds (and other securities) are more likely to fall than to rise. By this argument, the interest rate is set by the balance of sellers (anticipating a fall in bond prices) and buyers (anticipating a rise in bond prices) in readjusting the composition of their portfolios. The speculation that bond prices might rise (fall) is identical with the speculation that interest rates might fall (rise) and is the substance for Keynes’s musing that

‘[i]t is interesting that the stability of the system and its sensitiveness to changes in the quantity of money should be so dependent on the existence of a variety of opinion about what is uncertain. Best of all that we should know the future. But if not, then, if we are to control the activity of the economic system by changing the quantity of money, it is important that opinions should differ’ (Keynes, 1936, p. 172).

By manipulating the relative availability of money and bonds, a monetary authority determines the price (and yield) of bonds. Conventionally such operations were at the short end of credit markets. With ‘quantitative easing’ transactions were extended to longer-dated stock.

In setting such machinations as the primary determinant of interest rates, Keynes’s analysis fails to explain how interest rates would be determined in the absence (or uniformity) of speculation; except, that is, for the bizarre assertion that the theory does not apply in the USA, ‘where everyone tends to hold the same opinion at the same time’ (Keynes, 1936, p. 172).

That monetary expansion dissipates its force in financial markets rather than in markets generally is crucial to Keynes’s denial that price inflation is possible during a recession: ‘[t]he primary effect of a change in the quantity of money . . . is through its influence on the rate of interest’ (Keynes, 1936, p.
298). By that assertion, Keynes rejected both the credit-market cross and the quantity theory of money:

‘an increase in the quantity of money will have no effect whatever on prices, so long as there is any unemployment, and that employment will increase in exact proportion to any increase in effective demand brought about by an increase in the quantity of money’;

but Keynes made an important concession:

‘whilst as soon as full employment is reached, it will thenceforward be the wage-unit and prices which will increase in exact proportion to the increase in effective demand’

(Keynes, 1936, p. 295).

By that concession, Keynes exposed his (asset portfolio) theory of interest rate determination to the same criticism as that levelled against the credit-market cross: at full employment his theory has ‘nothing very useful or significant to contribute’ (Keynes, 1936, p. 243). This follows because, in raising prices generally, ‘an increase in the quantity of money’ must raise the (transactions) demand for money. At full employment, therefore, shifts in money supply cause shifts in money demand, leaving the interest rate indeterminate.

In embracing Keynes’s interest rate theory, Krugman rests his own conjectures upon possibly the weakest feature of Keynes’s General Theory; and he follows his master with great precision. Compare:

‘It is the policy of an autonomous rate of interest, unimpeded by international preoccupations, and of a national investment programme directed to an optimal level of domestic development . . . which is capable of restoring economic health and strength internationally’

(Keynes, 1936, p. 349):

with

‘What anyone who understood Keynes should realize is that as long as output is depressed, there is no reason increased government borrowing need drive rates up; it’s just making use of some of those excess potential savings – and it therefore helps the economy recover’

(Krugman, 2011, p. 12).

Keynes and Krugman alike would have us believe that interest rates can be manipulated willy-nilly by a monetary authority ‘unimpeded by international preoccupations’. If only that were true, highly-indebted nations could breathe a sigh of relief; but, for Krugman, the plight of western economies is not that borrowing has been too great, but that:

‘the interest rate required to achieve full employment is negative, in which case monetary policy is up against the zero lower bound, that is, we’re in a liquidity trap. That’s where America and Britain were in the 1930s – and we’re back there again’

(Krugman, 2011, p. 11).

(Krugman presents alternative graphical representations: either a credit-market cross with the intersection at a negative interest rate, or the Keynesian IS line, ‘showing full employment lying beyond ‘the zero lower bound.’)

The utter implausibility of these presentations is manifest, not simply in the narrow proposition for ‘a zero-lower-bound economy’, but in a key feature of Keynes’s General Theory. By its central precept (the income multiplier) every economy – past, present and future without exception and at whichever stage of development it happens to be – must achieve a unique level of consumption expenditure to have full employment; and if saving were to rise and consumption fall, the economy would plunge into recession. With Keynesian minds riveted to that belief, public sector deficits are the route to economic recovery.

**Interest rates, capital investments and debt**

It is in chapter 17 (seemingly ignored by Krugman) of The General Theory that Keynes’s engagement with microeconomics delivers crucial insights into interest as an inter-temporal price:

‘Let us suppose that the spot price of wheat is £100 per 100 quarters, that the price of the “future” contract for wheat for delivery a year hence is £107 per 100 quarters, and that the money rate of interest is 5 per cent; what is the wheat-rate of interest?’ £100 spot price will buy £305 for forward delivery, and £105 for forward delivery will buy 105/98 = 107 quarters for forward delivery. Alternatively £100 spot will buy 100 quarters of wheat for spot delivery. Thus 100 quarters of wheat for spot delivery will buy 98 quarters for forward delivery. It follows that the wheat-rate of interest is minus 2 per cent. per annum’

(Keynes, 1936, p. 223).

A forward discount on the wheat price indicates that too much was produced for the current period and not enough for the future. Consequential entrepreneurial readjustments are ubiquitous, occurring continuously across the widest spectrum of commodities. By Keynes’s presentation of commodity rates as inter-temporal prices, it follows that any manipulation of interest rates by a monetary authority chasing after macroeconomic ends must corrupt inter-temporal price signals. The inevitable consequence is that investments are allocated inefficiently: soaring US house prices driven by sub-prime lending were the most recent example.

While it is true that The General Theory lacks ‘any discussion of a banking crises’ and that ‘textbook macroeconomics’ gives money and banking ‘no central role in business cycle analysis’ (Krugman, 2011, p. 16), relevant analysis might have been found in Austrian business cycle theory. As with many Keynesians, Krugman guards his ignorance in preference to acknowledging the work of Keynes’s great rival, Friedrich Hayek.

Krugman feigns to understand so little about debt that he castigates ‘top officials and highly regarded economists’ for failing to understand that ‘inflows of capital from other nations simply add to the already excessive supply of U.S. savings relative to investment demand’. And he insists that these inflows ‘have as their counterpart a trade deficit that makes America worse off, not better off’ (Krugman, 2011, p. 15). Commentary so blatantly wrong is breathtaking. Seigniorage revenue is enjoyed by issuers of currency and other debt instruments that are demanded as ‘safe’ assets. The USA is predominant as the sovereign gaining most from
seigniorage. The use of dollars as an international currency allows the USA to import valuable goods and services for pieces of paper (currency and bonds) bearing either zero interest or interest below that paid on comparable sovereign securities.

Although there is recognition that ‘debt levels’ are ‘a key part of the story’ (Krugman, 2011, p. 18), by his analysis and judgements regarding the recent ‘freefall’, Krugman is wedded to the Keynesian perspective: government must ‘borrow for a while . . . to buy useful things like infrastructure’; this generates jobs making ‘it easier for highly indebted players to pay down their debt’ until a point is reached where ‘further deficit spending is no longer required to achieve full employment’ (Krugman, 2011, p. 20). These are dangerous instructions to journeymen economists. This nonsense was emphatically refuted by Hayek’s A Tiger by the Tail (1972). Yet, in the wake of the 2007 credit crunch, the 1930s have been invoked to press Keynesianism back into service. Krugman is not alone. Typical of Keynesian commentary is the following:

‘in a slump the rule of these copybook maxims is temporarily suspended. You can have more of A without sacrificing B. You can have environmental investment without sacrificing consumer satisfaction. Indeed the slump arises because not enough is being spent. We are in a kind of parallel universe familiar to cosmologists, when the normal rules are turned upside down and the traditional prudential warnings no longer apply.’

(Brittan, 2009)

The little that has been learned from twentieth-century history shows in exhortations to repeat past mistakes. The theoretical basis whereby aggregate demand management is purported to benefit the economy is riddled with dubious relational propositions. There are no panaceas by which an economy can duck the costs of past errors. On the contrary, Keynesian interventions only impair the entrepreneurial readjustments by which economic prosperity is achieved.

Conclusion

A recession presents no parallel universe. Instead, there is a unique continuum of historical time, where future events are driven by events that precede them. The raison d’être of the economics profession applies equally through good times and bad: its concerns are with scarcity and value, which implies that it is the classical paradigm which has general application:

‘[a]n analysis on the assumption of full employment, even if the assumption is only partially valid, at least helps us to understand the functioning of the price mechanism, the significance of the relations between different prices and of the factors which lead to changes in these relations. But the assumption that all goods and factors are available in excess makes the whole price system redundant, undermined and unintelligible’

(Hayek, 1975, p. 103).

In 2008 the Nobel Prize was awarded to Paul Krugman for research showing ‘the effects of economies of scale on trade patterns and on the location of economic activity’ (Royal Swedish Academy of Sciences, 2008). We might wish him a speedy return to his profession.

Notes

1. There are (at least) three accounts of a conversation between Hayek and Keynes, in 1946:
   (i) ‘I asked him whether he was not concerned about what some of his disciples were making of his theories. After a not very complementary remark about the persons concerned he preceded to reassure me that he would again quickly swing round public opinion – indicating by a quick movement of his hand how rapidly that would be done. But three months later he was dead’ (Hayek, 1952, p. 348);
   (ii) ‘I had asked him whether he was not getting alarmed about the use to which some of his disciples were putting his theories. His reply was that these theories had been greatly needed in the 1930s but if these theories should ever become harmful, I could be assured that he would quickly bring about a change in public opinion’ (Hayek, 1966, p. 103);
   (iii) ‘I asked him whether he wasn’t alarmed about what his pupils did with his ideas in a time when inflation was already the main danger. His answer was, “Oh, never mind, my ideas were frightfully important in the Depression of the 1930s, but you can trust me: if they ever become a danger, I’m going to turn public opinion around like this.” But six weeks later he was dead and couldn’t do it. I am convinced Keynes would have become one of the great fighters against inflation’ (Hayek, 1983, p. 115).

2. The IS line represents equilibrium in real sectors, with the interest rate generated by higher .

References


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