THE DANA VIEWPOINT

KEYNESIAN ECONOMICS: RIP

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John Maynard Keynes was a British economist. He identified causes of business cycles and advocated the use of fiscal and monetary measures to mitigate the adverse effects of economic recessions and depressions. In the 1930s, Keynes led a revolution in economic thinking overturning older ideas that held free markets would automatically provide full employment as long as workers were flexible in their wage demands. Keynes' argued that aggregate demand determined the overall level of activity. After World War II Keynes' economic ideas were adopted by leading Western economies. Keynes' policies worked well in the 1950s and 1960s but ran into a stone wall in the 1970s. Milton Friedman and other economists began to doubt the ability of governments to regulate the business cycle with fiscal policy. By the late 1970s we were experiencing high interest rates (21% prime rate), high inflation (15%) and high unemployment (10%). It was a period of stagflation (high unemployment and slow economic growth). It wasn't a lack of money that was holding us back. It was uncertainty over government policies. We have written many times about the importance of the money supply. However, there is an addendum to the amount of money and the velocity of money - the speed at which the money circulates. We have seen estimates (*Wall Street Journal and Investors Business Daily*) that there is currently up to $1.5 trillion in money sitting idle, awaiting the removal of the uncertainties facing this recovery. Once the uncertainties of the late 1970s were removed, money flowed freely into the economy and we saw an unprecedented economic boom that lasted 25 years (1982-2007). Jobs were created, new businesses were started, and we witnessed staggering technological advances. Even though taxes were cut, we saw increased government revenues and even had a government budget surplus in the 1990s. This had nothing to do with Keynesian economics. It was simply a matter of a favorable climate for investing in America. The velocity of money was high (some may say too high), and returns on investments were above historic averages.

Not all countries participated fully in this growth. The European nations in general adopted Keynesian economic policies with high government spending and vast entitlement programs that have boiled over into the current financial crisis in Europe. Now European nations seem to have seen the error of their ways and understand that their governments cannot spend their way out of this financial crisis. First, it was Greece and now Spain that have instituted austerity programs. Both nations have debt that exceeds their GDP. Italy and Portugal are probably not far behind. Even Great Britain is cutting entitlement programs and other government spending programs. Britain announced an austerity budget to cut real spending at some government agencies by 25% over four years. France has announced a freeze on government spending from 2011 to 2013. They have also cancelled

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their annual Bastille Day celebration at Elysees Palace. German Chancellor Angela Merkel said spending cuts were "urgently necessary" and that such cuts "won't put a brake on the world's economic growth (*Wall Street Journal*)."

In a cruel twist of irony we seem to be going in the opposite direction of Europe and embracing Keynesian economic policy. This policy believes that there is a multiplier effect from government of up to 1.50. That is, for every $1 the government spends, the economy would grow by as much as $1.50. The International Monetary Fund disagrees. According to Stanford economist John Taylor, the IMF study shows a multiplier of .70. For every dollar the government spends, the economy only sees 70 cents in activity.

Uncertainty: The multiplier effect works positively in the private sector, and it is the private sector that creates real jobs. However, the continued uncertainty over the extent of public spending plus the extent of new taxes (including a very possible VAT – value added tax) is preventing a full-fledged economic recovery. Employers are reluctant to add new employees. They are improving their earnings by cutting costs and increasing productivity. This is good for the bottom line, but it does little to create new job growth that would create a robust economy. We need to see monthly reports of 150,000 – 200,000 new private sector jobs being created to put this recovery on solid ground.

The good news is that the American public and many members in Congress are waking up to the fact that Keynesian economics (public spending) is not working. It did not work in the 1930s either, as we actually had a recession (1938) within the depression, and we suffered double digit unemployment throughout the decade. This time can be different if the public demands and Congress enacts legislation that will lift the veil of uncertainty that will indicate a more conducive environment for establishing new businesses and creating new jobs in existing businesses. If this were to happen, money would come out of hiding and get this economy moving again.

Random Thought for July 2010: "I predict future happiness for Americans if they can prevent the government from wasting the labors of the people under the pretense of taking care of them."

Thomas Jefferson

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