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The Return of the Keynesians

by Christopher Lingle

The Keynesians are back. After laying low in recent years, they are promoting their interventionist plans once again.

Take Joseph Stiglitz, for example. He apparently waited until he gained the credibility of sharing the Nobel Prize in Economics in 2001 to become an unabashed cheerleader for Keynesian economics. Such a universally recognized accolade allowed him openly to support a body of economic thought that had recently been thoroughly discredited by its notable failures. His new book, *Globalization and Its Discontents,* is his most recent exercise in expressing contempt for free markets.

True to form, promoters of Keynesian economic theories are encouraging governments to engage in active policies to manage demand and consumption. Their selective memory contains a gap that overlooks the stagflation of the 1970s, soaring public-sector deficits of the 1980s and 1990s, and relentless growth in government control over private lives during most of the post-World War II period.

It would be wise for the rest of us to resist their belief that governments can fine-tune an economy by making adjustments in taxes or government spending or manipulating interest rates. This caution is offered since there is a dearth of evidence to support their views.

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As it is, Keynesian policies are based on a widely accepted fallacy that economic growth is driven by demand, especially consumption spending. Perhaps unwittingly, those who support this view see savings as a nonessential and even counterproductive activity that undermines the health of the economy.

Nothing could be further from the truth, since economic growth requires the fuel provided by savings. When households decide to boost their savings, the pool of investment capital is increased. In turn, interest rates are pushed down naturally and a larger number of investment projects can be undertaken.

The negative view of savings is painfully familiar in Japan. However, attempts at demand management by Japan's government over the past decade have failed. Now that interest rates are virtually at zero and fiscal spending has become constrained by high debt levels, Tokyo has exhausted conventional policy tools to offset its economic malaise. The truth is that these traditional tools do not work.

Instead of the Keynesian presumption that demand drives economic growth, the reverse is true. Demand is the result of economic growth. Paraphrasing an economic law named after the nineteenth-century French economist J.B. Say, market economies work on the basis of the supply of one good creating the demand for one or more other goods. In other words, you must first produce to be able to consume.

Reviving the neglected verities of Say's Law requires debunking a belief system that is subconscious and seldom subjected to introspection. One problem in exorcising Keynesian policy influences is that the demystification requires understanding some basic economic theory that is hard to grasp. Further, many implicit assumptions behind much of Keynesian analysis will seem obscure in their effect or validity to lay persons.

Understanding Say's Law begins with the commonsense observations that purchasing power as the basis for consumption necessarily arises out of the act of production. Moreover, just as goods cannot be purchased unless people earn income from producing, so goods cannot be consumed if they are not produced. Hence, the driving force of a market economy is supply and not demand.

This logic shows that economic growth depends on how much is saved (and how well it is invested) instead of how much is consumed. Savings and investment can lead to increases in the per capita quota of invested capital so that increases in productivity lead to higher real wages and increased prosperity. Spending on consumption leaves fewer resources for production.

Policies to force interest rates artificially lower to boost consumption are actually counterproductive since they discourage savings. Such policies also have the undesirable effect of encouraging long-term investment although consumers have not changed their preference for future goods over present goods.

The Grasshopper and the Ant

If all goods were consumed and none were set aside to invest in time-consuming production, we would be in the situation faced in the fable of the grasshopper and the ant. While the ant toiled away, the grasshopper derided him for not playing in the sun. When winter came, the grasshopper faced starvation for not laboring in the present to prepare for the future. Keynes, being childless, perhaps saw no merit in the wisdom of nursery tales.

Attempting to increase aggregate demand by increasing government spending also will not restore growth. There is little evidence to suggest that fiscal or monetary policies have a systematic effect on real economic variables.

In fact, government's printing money and spending more cannot induce stable long-term growth because those activities do not generate new wealth, capital, or savings. Sustainable economic growth requires an expansion of the capital base, and that requires savings.

When central banks push down interest rates to put more money into the economy or when governments run deficits, funds are diverted from wealth generators to wealth consumers. A better move would be to cut government spending so that resources are released for productive use.

It is astonishing that the failed principles of central planning are readily applied in government attempts to manipulate market economies. Nevertheless, policymakers are as incapable of acquiring the knowledge needed to control markets as planners are. Even though macroeconomic meddling to "correct" market conditions involves the same presumptions that (mis)guided central planners, supporters of Keynesian policy willfully ignore evidence from the failures of communism and socialism.

Although market economies experience fluctuations, extreme booms and busts are caused by the sort of meddling that is supported by Keynesian prescriptions. These interventions also interfere with the innate self-adjustment mechanisms that would generate stability in capitalist economies.

Alas, Keynes's teachings remain very much alive and just as wrong now as they always have been. Apparently the discovery that centralized economic decision-making through political mechanisms is inferior to decentralized market mechanisms has already been lost on some. □