IT'S THE ECONOMY, STUPID

Keynesian economics is very popular—
but it doesn't work, argues **Patrick Hannaford.**

It's The Economy, Stupid

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This article from the May 2013 edition of the IPA Review is written by student at La Trobe University, Patrick Hannaford.

In 1971, Richard Nixon announced the final end of the gold standard with the line 'we are all Keynesians now'. Whilst there is some dispute to the exact wording of Nixon's statement, the sentiment expressed by him highlights the problem at the core of the current global debt crisis. That problem is the prevalence of what Peter Smith calls 'Bad Economics'.

More specifically, the problem is the dominant role Keynesian economics has had in influencing governments and policy makers since the Second World War. This has resulted in Western societies that are 'far less prosperous than they would otherwise have been and more deeply mired in the misery of debt and dependency'.

In *Bad Economics,* Peter Smith uses logic and common sense to target and expose the foundational flaws in Keynesian economics, before calling for a return to the classical economic theories that preceded it.

There have been some recent economic theories that have challenged, and to some degree, moderated Keynesianism—such as monetarism and supply-side theory. However, these theories have been unable to surpass Keynesianism in prominence, which often experiences a resurgence in popularity when the economy goes into recession. One such resurgence occurred in the immediate response to the onset of the global financial crisis. In both the USA and Australia the federal governments' primary response to the crisis was to enact large scale economic stimulus plans that were straight out of the Keynesian playbook. In Australia this stimulus was enacted by a Prime Minister who had proclaimed his credentials as an economic conservative only a year prior, and the first stage of stimulus received bipartisan political support.

The reason Keynesianism is capable of such resurgences is partly because of the dominance Keynesianism has over how macroeconomics is taught. But there are also a number of distinct advantages that Keynesianism possesses, as Peter Smith argues, which have enabled it to be so long lasting.

The first of these advantages is simplicity.

Keynes cut through the complexity of economics by describing everything in aggregates, and reducing economics down to a simple mathematical equation that can be easily understood. The problem with this simplicity is that it obscures the true dynamic and complex nature of modern economies, and adds to the illusion that they can be controlled. It has also led to Keynesian ideas becoming part of a 'conventional wisdom' of how an economy operates, which has little relation to the real world.

The advantage of simplicity is only outweighed by the appeal Keynesian theory has to governments and the public sector economists who advise them.

By placing government spending at the heart of how to deal with a recession, Keynesian economics makes itself especially appealing to democratic governments that want to be seen to be 'fixing the problem'.

As a result, policies of economic stimulus are frequently the first port of call for governments. This is partly due to the hubris of those who seek election to parliament, but voters in democratic countries are undoubtedly also to blame.

Unless there is widespread understanding of sound classical economic principles, a politician who claims to have the ability to fix the economy is far more likely to find support than a politician who makes the argument that the economy must be allowed to correct itself. This is due to the fact that people have a natural predisposition to prefer someone who claims to have a solution, over someone who doesn't, even if the solution is quackery.

The above advantages would not be a problem if economic stimulus were the panacea that its proponents claim. But according to the classical economic theory that Peter Smith calls for, economic stimulus disrupts important market signals, propping up unproductive businesses at the expense of productive businesses and preventing needed economic readjustments. In other words Keynesianism offers false hope, whilst prolonging recessions and hamstringing recovery.

Unsurprisingly, the advocates of Keynesian stimulus disagree with this analysis. They frequently trumpet the success stimulus has had saving economies in recession, as well as preventing economic depressions. On the surface these claims seem plausible.

An example of this can be seen when comparing the USA and Australian post GFC stimulus packages. In the USA, President Obama claimed the stimulus was necessary to prevent the unemployment rate going above 8 per cent, yet following the stimulus it quickly went to 10 per cent. In Australia the economy, which was far less exposed than many of its competitors, quickly recovered from a relatively brief slowdown.

And yet both stimulus packages were hailed as success stories. One for saving the Australian economy from recession, and the other for preventing an economic depression in the USA.

What this highlights is that the claimed success of Keynesian stimulus is completely devoid of any objective measure of success. As stated by Peter Smith ‘if unemployment goes up Keynesian policy has worked. If unemployment goes down Keynesian policy has worked’. It is no surprise that such policies are preferred by activist governments. If a stimulus package does not produce the results promised, it is either because it wasn’t big enough, or economic downturn was worse than expected.

Smith’s answer to the prevalence of this ‘Bad Economics’ is to call for a return to classical (pre-Keynesian) economics, which appreciates the complex and dynamic nature of market economies. Economics that encourages price flexibility, and which does not advocate policies that are both harmful and in conflict with basic common sense.

Such a change in the zeitgeist is not an easy task. But Smith does see some hope in the current global debt crisis, as nations suffering from extreme debt burdens may be forced to abandon Keynesian prescriptions out of necessity. In such a circumstance the failure of Keynesianism must be aggressively highlighted to ensure that it does not once again rise from the ashes.