

From Keynes to Gordon Brown

Keynes:

Keynes published the *General Theory of Employment, Interest and Money* in 1936 and became arguably the most important economist of the 20th Century. It is to Keynes we owe the very concept of macroeconomics. He wrote in the middle of the Great Depression when in much of Europe and the United States, output either stagnated or fell and millions were unemployed. His central idea was that Depression (and recession) was caused by insufficient demand for output (aggregate demand). The 'market' would not automatically kick-start the economy and cure unemployment. Rather, Government must intervene by increasing the level of aggregate demand. Chiefly, Government should undertake to spend more on investment through undertaking public investment in economic and social infrastructure. This could be financed if necessary by printing money since, during a depression, inflation is not a problem.

In summary:

- Stagnant National Income and high unemployment caused by inadequate aggregate demand;
- In particular, as output stagnates, private investors become ever more reluctant to invest; such expectations serve to deepen the crisis;
- 'Balancing the budget' makes the problem worse, not better;
- The economy cannot be kick-started through easing monetary policy (ie, lowering interest rates) since investment is largely unresponsive to interest-rate changes;
- Nor can the economy be kick-started by lowering real wages; even if achievable, this would only reduce aggregate demand;
- Government must 'prime the pump' or act as investor of the last resort using fiscal policy;
- Progressive taxation helps stabilise the business cycle since people pay less tax during a slump and more during boom years.

Post-war period: 1945-70

Despite the adoption of Keynesian policy in some countries (eg, the USA under Roosevelt), the worldwide Depression lasted until the Second World War---war led to an enormous investment in armaments that kick-started all the main economies. By the 1950s, the large-scale investment in reconstructing Europe plus growing international trade had brought high growth to the West. Growth took place not merely in the USA but throughout Western Europe (eg, 'wirtschaftwunder' in West Germany and 'les trente glorieuses' in France).

The collapse of Fixed Exchange Rates and the first Oil Crisis

By 1970 growth in the West was slowing down. In particular, President Johnson's attempt to fund the 'Great Society' programme and the Vietnam War without raising taxes led to a permanent trade deficit, and gold reserves drained from the US Treasury. The US was forced to float the dollar value of gold in 1970, in turn leading to a collapse of the 'fixed exchange rate' system, which had been in effect since Bretton Woods in 1944.

This was followed in 1973 by a huge hike in the price of oil by the OPEC countries, in turn triggering a combination of inflation and stagnation. A second oil shock in 1979 further fuelled inflation.

Monetarism, Reagan & Thatcher

Under a floating exchange rate regime, monetary policy is generally more effective than fiscal policy. However, the move to monetary policy witnessed in the 1970s and 1980s went well beyond a 'change in monetary/fiscal balance'. In the inflationary climate of the mid-1970s, even the Labour government of Jim Callaghan was forced to go to the IMF and adopt monetarist policies. With the arrival of Thatcher in the UK (1979) and Reagan in the USA (1980), an ideological revolution was unleashed against 'big Government'. Keynesian policies were denounced, as was 'welfarism'--- the new Anglo-American consensus was based on 'rolling back the State' as well as reducing the influence of trade unions.

Other factors were at work in changing the economic climate. Reagan, although an anti-Keynesian, boosted the high-tech end of US industry by embarking on a large programme of military spending, raising the Government and external deficit in the process. In both the US and Britain, traditional industry suffered a marked decline. By the mid-1980s in the UK, coal, steel and manufacturing industries such as motor-car production were shutting down. Between 1970 and 2000, the share of the industrial sector in GDP fell from about 40% to less than 20%. Today, the financial services sector accounts for a larger share of income and employment than does manufacturing.

What is Monetarism?

The doctrine of 'monetarism' developed in the late 1960s and 1970s. Its best known advocate was Milton Friedman at the University of Chicago. In most simplified form, Monetarism says that 'rules-based' monetary policy should be the key mechanism used to control the macro-economy. Several points about Monetarism should be emphasised:

- All monetarists agree that inflation is caused by 'loose' monetary policy; ie, in the words of Friedman, that 'inflation is always and everywhere a monetary phenomenon'; similarly, that 'deflation/depression' is caused by excessively tight monetary policy;
- Friedman argues for 'rules based' (as opposed to discretionary) monetary policy; eg, only increase the money supply in line with the real rate of growth. The problem with 'discretionary' monetary policy is that its effects are subject to 'long and uncertain lags'.
- What is 'loose money': it comes about when Government attempts to finance expansion by 'printing money' (not literally, but by borrowing from Central Bank).
- IMF orthodoxy is based on monetarist ideas; eg, the cure for inflation in Third World countries is for Governments to cut back on spending. This notion is a cornerstone of the 'Washington consensus'.

Thatcherism:

After 1979, Mrs Thatcher attempted to 'set monetary targets' in order to reign in Government spending. This policy failed: by 1982 inflation had risen to 25% and unemployment to nearly 3 million. Targets were quietly dropped, but Thatcher continued to speak of 'rolling back the State', dismantling welfare and so on.

Meanwhile, in the USA, Reagan was no more successful than Thatcher in the early years. But while (like Thatcher) he continued to speak of rolling back 'big government' and of 'supply side economics', in reality he used Keynesian methods to boost economy---he cut taxes for the rich and greatly boosted military spending (star wars').

Supply side economics:

According to 'supply siders' such as Arthur Laffer in the US, reducing taxes on the rich will cause them to become more productive, hence boosting economic growth (and tax revenue). By contrast, supply siders believe that the poor will work harder only if their income is reduced. George Bush Sr dubbed this 'voodoo economics'.

Bill Clinton famously used the high-growth period of the 1990s to establish a budgetary surplus. Arguably he should have tightened monetary policy more to control the stock market bubble, but he preferred to leave this matter in the hands of Alan Greenspan.

George W Bush came to power just as the US entered recession. He has followed a policy termed 'military Keynesianism' by Larry Elliot (see Reading); ie, he has countered the downturn by putting far more money in the pockets of the rich, and by spending huge amounts on armaments. The huge budget deficit is financed by capital inflows to the USA mainly from the EU, China and East Asia.

Gordon Brown:

Brown is generally described as 'Britain's best Chancellor', largely because since 1997 (and since the early 90s), the UK has experienced steady growth, lower unemployment and very low inflation---the 'stop-go' cycle has disappeared. Because Brown concentrated on 'fiscal caution' in 1997-2001, he has also been termed Brian's most prudent Chancellor.

He is not a 'monetarist' although he believes in prudent, rules-based policy (hence the Treasury's 'golden rule');

He recognised that the good years (1997-2001) of (bubble-economy) prosperity & growth, he could build a surplus; during the downswing since 2001, he has (rightly) engaged in deficit spending---a good thing. But Brown has remained cautious---with the deficit never exceeding 3% of GDP in the downswing---and the budget balanced over the cycle as a whole.

Critics would argue that Britain continues to have some of the worse poverty in Europe---and certainly one of the least egalitarian economies.

- The gap between 'haves' and 'have-nots' has until recently been growing.

- In public services such as education, health & transport, Britain has done far worse than core Eurozone countries.
- UK manufacturing has continued to decline while financial services have prospered. The gap between the regions has widened.
- That continued prosperity has been fuelled in large part by the consumer spending bubble---as the housing market cools, Britain may enter recession.

In Summary:

Keynes was the most influential economist of the 20th century. He taught us that the market is a good servant but a poor master---that Government must act to maintain full employment.

The post-war Keynesian consensus was only challenged when the twin effects of the oil crisis and the demise of fixed exchange rates caused inflation to explode. The Monetarists thought they had the answer---but crude monetarism proved a poor answer.

As inflation slowed (and virtually stopped) in the 1990s, the period was used to restore 'sound' public finance. Brown---although he is a Keynesian---has been an eminently cautious Chancellor. If the UK economy falters, he may need to 'spend his way out of recession'. Anti-recessionary policy in the core Eurozone (Germany, France, Italy) has been weak because both monetary policy (the ECB) and fiscal policy (the Stability & Growth Pact) have acted as a brake on growth for nearly a decade.

Questions for Discussion

1. 'The job of a good Chancellor is always to balance the government budget'. Discuss.
2. Contrast what happens to Government spending and tax revenues when the economy is growing and when it is in recession.
3. Can cutting wages always ensure near-full employment? Give some examples.
4. What do you understand by the phrase 'Keynesian revolution'? Is Keynes relevant to day? Give examples of why/why not.
5. Did a revolution in economic thinking and policy making occur under Thatcher in the UK and Reagan in the USA? In what way is Gordon Brown a 'conservative' Chancellor?
6. Could one call George W Bush a 'Keynesian'? Explain your answer citing examples.