John Maynard Keynes: Has He Been Dethroned?

Michael Mussa assesses why the great 20th century economist was hailed in 2008 but is now less influential as countries head toward fiscal consolidation.

Steve Weisman: Has John Maynard Keynes been dethroned by the global financial downturn and crisis? This is Steve Weisman at the Peterson Institute for International Economics, happy again to have Michael Mussa, senior fellow here, and former economics professor at the University of Chicago. Thanks Mike.

Michael Mussa: My pleasure.

Steve Weisman: When this crisis began in 2007–08, everybody agreed on the need for deficit spending and stimulus. John Maynard Keynes was the man of the hour, coming back from the 1930s to remind us of his importance and the importance of his ideas. But now, he's back on the back burner at least in some countries. What's going on?

Michael Mussa: I think that the usual nonsense that we see in the circumstance of virtually any major economic downturn. The importance of Keynes' contributions—which are very important in the history of economics—tends to be a bit overemphasized at one point and then to be overdisparaged somewhat later on.

Steve Weisman: What did Keynes teach us that we need to remember?

Michael Mussa: Of course Keynes wrote on a broad array of subjects. The work that is most referred to in this context is his *General Theory of Employment, Interest and Money*, in which he seeks to describe how an economy could be in a fairly persistent state of less than full employment. And he contrasts this with what he said was the classical doctrine that the economy would, because of natural forces, tend to gravitate back to full employment relatively quickly following cyclical disturbances.

Steve Weisman: In 2008, at a time of crisis Keynes was cited as a reason for the need for a lot of stimulus and deficit spending. That was the right call, I think, in your judgment. But was it the right interpretation of what Keynes said?

Michael Mussa: Yes, I think in that respect it was. It needs to be remembered that most of the move towards much larger government deficits was the consequence of what we call the automatic stabilizers.

That is to say, the tendency for tax revenues to fall off quite significantly as the economy goes into recession, and the tendency for various transfer payments on employment insurance and so forth, to go up. So the government budget, particularly the federal government budget in the United States, tends naturally to move into deficit even if no additional policy action is taken to amplify that development.

Steve Weisman: In the 19th century, the common reaction to an economic downturn was to cut spending, cut the budget to defend currency. We're not returning to that, I presume?

Michael Mussa: No, though keep in mind in the United States, say in the 50 years after the Civil War, the total federal budget was somewhere between 3 and 4 percent of GDP. We're now up to 25 to 26 percent of the GDP. And the necessity to cut back and the recession came because the revenues fell, and the government didn't have any easy means to borrow lots of money in those days. So by force majeure, the government cut back as its revenues declined.

Steve Weisman: Now we're in a recovery that is precarious or anemic in some parts of the world. Britain is channeling Margaret Thatcher and they're cutting spending, laying off public employees, and basically saying that, whether or not Keynes was right, they are carrying too much debt to think about more deficit spending right now. Do you think that Keynes would advocate deficit spending if he saw the amount of debt in Europe and the United States being incurred?

Michael Mussa: I think he probably would, in present circumstances, still be an advocate of significant deficit spending. Though it needs to be remembered that the level of debt was not as high in the 1930s, even as it is now, certainly not coming into the Great Depression.

But it's also important to keep in mind that even the quite aggressive fiscal consolidation efforts that the British government has just announced, and I'm sure they will implement, do not involve moving the budget into surplus anytime soon. They are quite aggressive, but they're still going to have significant deficits for years to come; the idea is, over a period of five years, to get those deficits down to a level much closer to zero.

Steve Weisman: Are people exaggerating what's going on in the new British government?

Michael Mussa: I think there are two legitimate concerns. One is that the fiscal cuts, which have been announced, are quite substantial and very likely to slow the pace of economic recovery. I don't think they will stop the recovery in the United Kingdom, despite the magnitude of what is involved. But they are very likely to slow it.

Steve Weisman: But they're not so big as to stop it. Why do you think that?

Michael Mussa: Because there are other factors which are operating on the side of supporting the recovery: the natural tendency of the economy to recover, the foreign exchange values. Sterling has depreciated very substantially over the past year to 18 months against particularly the euro, but also the dollar.

So I think there's enough there to keep a recovery going. But having the government cut back significantly over a period of years is going to tend to slow the growth of demand for British output, and probably therefore slow the growth of the economy and to a nontrivial extent.

So one would argue from a Keynesian perspective: Well, since we already have high level of unemployment, it would be desirable to avoid that type of additional burden on the pace of recovery. The other concern, of course, is the more traditional public policy concern.

Keynes was effectively a socialist in his political orientation and would certainly have favored, and probably would still favor, a high level of government activity to support those who are less well off in society, and would oppose the types of cutbacks that the UK coalition government has recommended, from the standpoint of his political views separate from his view as an economist.

Steve Weisman: You often hear these terms like "bond vigilantes," and I think Paul Krugman in the *New York Times* used the term "Confidence Fairy" [to make fun of those who advocate] balanced budgets in order to impress the markets. What did Keynes make of that?

Michael Mussa: I think Keynes [understood] that in the circumstances of a deep economic downturn, where interest rates tend to be very low because private investment demand for loanable funds is very much depressed, the bond vigilantes cannot be very active.

That is not an environment where interest rates are being pushed up. It's an environment where interest rates are likely to remain quite low. Now when doubts begin to rise about whether a government will be willing and able to service its obligation in the medium to longer term, then that could push interest rates upward. That's what happened to Greece.

Early this year, they [with reference to Greece] looked at the deficit debt to GDP ratio of 120 percent and the deficits that looked like they were going to continue at enormous levels, and they said, "Well, we're not going to be able to pay this back." And the market then rapidly took up the government borrowing cost.

When you get into that situation, you don't really have the option of pursuing an expansionary fiscal policy. You've got to move towards consolidation, and the Greeks had been effectively forced to do that in their own interest. There is concern in the United Kingdom that they could get themselves into that situation. But the developments recently have not suggested that they are on the brink of it.

The government's fiscal policy and strong fiscal consolidation efforts are based upon two notions: that they could get into that type of situation if they aren't careful; and that, in any event, the policy of the previous government of spending much more than the government was prepared to raise in taxes, and much more than the level of taxes could plausibly support, is simply bad public policy and needed to be reversed, even if the economic conditions were not exactly ideal for doing that immediately.

Steve Weisman: What about quantitative easing, which might have the effect of depreciating US currency values? A number of finance ministries around the world think that might be the consequence. What would Keynes say about that? Certainly, defending currency and the gold standard was the idea that prevailed.

Michael Mussa: Issues with the gold standard were very important at the time of the Great Depression. We entered the Great Depression with most of the world operating on the gold standard. The concern that the resort to expansionary policies would lead to a drain of gold and force you off of the standard was a major constraint on expansionary fiscal—but also expansionary monetary—policy. And Keynes had complained earlier in his essay on the economic consequences of Mr. Churchill.

[Keynes complained] that after the first World War was over, the decision to put Britain back on the gold standard at the prewar parity was a substantial mistake—that it would result in persistent need for an excessively tight monetary policy in order to preserve the exchange rate at its prewar parity. So he certainly saw that the necessity [of expansion] for Britain, where the Depression really started earlier, and Britain had a very difficult period in the 1920s in contrast to the United States, perhaps, in part, because of the return to what was then a substantially overvalued exchange rate. He saw the necessity of depreciating sterling against gold as a key means for avoiding a deepening recession in the United Kingdom. Then, as now, when Britain left gold and it depreciated substantially against the dollar and the French franc and others, other countries were not necessarily too happy. They said it was a quote, "beggar-thy-neighbor" policy. And we hear some of that again.

Steve Weisman: Summing up, is Mike Keynes is as relevant as ever or not?

Michael Mussa: Not as relevant as ever, because circumstances in the world have changed considerably from his day. But there certainly are important elements of his thinking that remain as part of the corpus of economic analysis even today.

In my view, of course I was trained at the University of Chicago—[you spoke in your introduction] about dethroning Keynes. Well, he was dethroned at Chicago many, many years ago. So some skepticism about some of his ideas [has] been part of the view, at least of many economists, at least for a considerable period of time.

Steve Weisman: But for you, not so much?

Michael Mussa: I think Keynes was a very important figure in the history of economic analysis, particularly macroeconomic analysis. I think, as with any economist, as the discipline advances, you learn that they didn't get everything exactly right and they got some things quite wrong. And that's true for Keynes as it is true for most of the major figures in the history of economics.

Steve Weisman: Thanks Mike.

Michael Mussa: You're welcome.