Martyrs by Mistake:

Keynes Vs Hayek in 1932,
& Krugman Vs Ferguson in 2010

A recently rediscovered exchange between, among others, Keynes and Hayek from 1932 shows how closely today's policy debate mirrors that which occurred in the Great Depression. Sadly the exchange also highlights just how little progress has been made in understanding how and when to use what we now refer to as Keynesian policy[1].

On October 17th 1932 Keynes et al. wrote: *"when a man economizes in consumption, and lets the fruit of his economy pile up in bank balances or even in the purchases of existing securities the released real resources do not find a new home waiting for them. In present conditions their entry into investment is blocked by lack of confidence.*

…

If the citizens of a town wish to build a swimming-bath, or a library, or a museum, they will not, by refraining from doing this, promote a wider national interest. They will be "martyrs by mistake," and, in their martyrdom, will be injuring others as well as themselves. Through their misdirected good will the mounting wave of unemployment will [sic] be lifted still higher."

In reply, two days later, Hayek et al. wrote: *"Under modern conditions the security markets are an indispensable part of the mechanism of investment. A rise in the value of old securities is an indispensible preliminary to the flotation of new issues. The existence of a lag between the revival in old securities and revival elsewhere is not questioned.*

…

It is perilous in the extreme to say anything which may still further weaken the habit of private saving.

…

We are of the opinion that many of the troubles of the world at the present time are due to imprudent borrowing and spending on the part of public authorities. We do not desire to see a renewal of such practices. At best they mortgage the Budgets of the future, and they tend to drive up the rate of interest – a process which is surely particularly undesirable at this juncture when the revival of the supply of capital to private industry an admittedly urgent necessity.

…

Hence we cannot agree with the signatories of the letter that this is a time for new municipal swimming baths…"

In the seventy eight years since these letters were written the global economy has moved from Great Depression to Great Recession with numerous boom bust cycles in between but the Keynes-Hayek debate remains unresolved, a fact exemplified by the public spat between the Nobel Laureate Paul Krugman and Harvard Historian Niall Ferguson:

Krugman: *"Right now, we have a severely depressed economy — and that depressed economy is inflicting long-run damage. Every year that goes by with extremely high unemployment increases the chance that many of the long-term unemployed will never come back to the work force, and become a permanent underclass. Every year that there are five times as many people seeking work as there are job openings means that hundreds of thousands of Americans graduating from school are denied the chance to get started on their working lives. And with each passing month we drift closer to a Japanese-style deflationary trap.*

Penny-pinching at a time like this isn't just cruel; it endangers the nation's future. And it doesn't even do much to reduce our future debt burden, because stinting on spending now threatens the economic recovery, and with it the hope for rising revenues.

[1] The 1932 letters were written to The Times of London and were rediscovered by Richard Ebeling.

So now is not the time for fiscal austerity."

Ferguson: "*If you have a non credible fiscal strategy of borrowing a trillion dollars a year for the rest of time, never ever again running a balanced budget, and remember that is US fiscal policy right now, at some point the markets are going to get spooked. And I think that point is nearer than Paul Krugman believes.*

Indeed I think nothing would spook the markets more than for Paul Krugman's advice to be accepted by the Obama administration and for you and I to be reading in tomorrows papers or on Bloomberg headlines 'massive new fiscal stimulus promised by the US Government' that may well be the trigger."

More importantly the Keynes/Krugman Vs Hayek/Ferguson argument has been played out by policy makers on the grandest scale.

In the immediate aftermath of the crisis governments around the world engaged in the biggest coordinated monetary and fiscal stimulus program in history. The statement of the G20 group in April 2009 shows how the Keynesian prescription dominated thinking at that time:

We are undertaking an unprecedented and concerted fiscal expansion, which will save or create millions of jobs which would otherwise have been destroyed, and that will, by the end of next year, amount to $5 trillion, raise output by 4 percent and accelerate the transition to a green economy. We are committed to deliver the scale of sustained fiscal effort necessary to restore growth. …Taken together, these actions will constitute the largest fiscal and monetary stimulus and the most comprehensive support programme for the financial sector in modern times."

The mood changed abruptly with the onset of the Greek sovereign debt crisis in January 2010. By the time the G20 had reconvened in Toronto in June 2010 fiscal austerity was very much the order of the day:

"…recent events highlight the importance of sustainable public finances and the need for our countries to put in place credible, properly phased and growth-friendly plans to deliver fiscal sustainability…Those countries with serious fiscal challenges need to accelerate the pace of consolidation. …advanced economies have committed to fiscal plans that will at least halve deficits by 2013 and stabilize or reduce government debt-to-GDP ratios by 2016."

The Toronto declaration tried hard to present the policy volte-face as a natural result of the previous stimulus having done its job. But with the US unemployment rate still close to 10%, core consumer price inflation at just 0.9% and heading lower, and with cyclical indicators showing a slowdown, the G20's optimism rings hollow. More likely the policy shift is nothing more than a pragmatic response to recent events: Keynesianism has been tried and seemingly found wanting, while austerity looks like the best way to head off a global version of the Greek sovereign debt crisis.

Just as the Great Depression failed to resolve the Keynes Vs. Hayek debate so we suspect the Great Recession will fail to resolve the Krugman Vs Ferguson debate. If, as appears likely, the economic recovery falters the Krugman camp will likely conclude that inadequate stimulus was withdrawn too early. While at the same time the Ferguson camp will ascribe the problem to previous excessive deficit spending. Equally if the recovery remains in place one side will conclude the stimulus was big enough after all. While the other will claim fiscal austerity arrived just in the nick of time. Either way it is a very safe bet to expect both camps to claim victory regardless of how the economy turns out.

In the absence of a clear paradigm it is understandable that policymakers are flip-flopping between spend and save policies. However, dramatic policy shifts such as enacted by the G20 may produce the worst of all worlds where deficits are ratcheted ever higher without engendering sufficient confidence in the private sector to foster a sustainable recovery.

In the opinion of this author the Keynes Vs. Hayek debate has raged unresolved for nearly eight decades because the two sides continue to talk past one another. Having failed to agree on the causes of financial crises they have never been able to coherently discuss their resolution. Hopefully the following parable will help explain how such obviously intelligent, informed and articulate men as Keynes, Krugman, Hayek and Ferguson can fail to understand one another's positions for so long.

Fighting Fire with Fire

Schumpeter was a charming tourist town enjoying a sunny sub-tropical climate in the heart of a beautiful densely forested valley. The only thing blighting the otherwise perfect lives of the townsfolk were the sporadic forest fires which occasionally happened during the warm dry summers. Usually the fires were small short lived affairs but they did frighten the tourists and thereby damaged the livelihood of the residents.

After one unusually fierce fire, now known as The Great Fire, the tourists stayed away for several years causing much hardship for the townsfolk. Such was the economic hardship caused by The Great Fire that the good people of Schumpeter came together to organize the town's first central fire department. The townsfolk willingly paid the small levy needed to pay for the fire trucks and the wages of the fire fighters. A grand new fire department was built in the centre of town in the Art Deco style.

Over time the fire department became a vital part of the town's economy and its chairman was considered an important civic leader. In one notably prosperous period the Chairmanship of the fire department fell to the renowned Mr Bluebridge.

Chairman Bluebridge developed many new and creative methods of anticipating forest fires. Under his guidance the fire department became adept at spotting and quickly extinguishing forest fires before they took hold. Such were Chairman Bluebridge's talents that he gained an almost mythical reputation, some saying he could see fires that had not even started.

As the years of Chairman Bluebridge's tenure passed the memories of the forest fires faded. Tourists began flocking to the town of Schumpeter in ever greater numbers. The town prospered and the townsfolk became steadily wealthier.

Mr Bluebridge explained to the grateful townsfolk that this new prosperous regime was due to his department's new policy of preemptive fire fighting. The Chairman explained that the fire department no longer waited for fires to start, rather he sent his fire fighters out into the forest to beat out the fires even while they were barely smouldering. The Chairman proudly referred to this preemptive fire fighting as his 'risk management paradigm'. One of his trusty lieutenants generously described the result of this policy as 'the great moderation'.

The great moderation continued year after year. The tourists continued to flock to the town and the forest continued to grow. Over time the trees in the forest grew taller and taller while casting off an ever thicker layer of dead leaves and branches.

In the summer months this growing stock of tinder made the job of the fire department progressively more difficult. The fire fighters found the fires were starting more frequently and, once started, were more difficult to extinguish. The Chairman was alive to this problem and responded by recruiting more fire fighters and equipping his men with bigger more powerful fire engines. In response to the higher incidence of fires he sent his larger teams of firefighters into the forest more frequently.

With each passing season the Chairman found his ever growing fire department required an ever larger levy on the townsfolk.

As the levy rose some of the townsfolk began complaining that the costs of the fire department were growing faster than the income from the tourists. Some talked ominously of what may happen when there were no more fire fighters to hire. They talked in dark tones about reaching the 'zero hiring bound' after which would come another uncontrollable Great Fire.

The charismatic Chairman dismissed such fears explaining that the lessons of the Great Fire had been learned and his modern fire department would never let it happen again. Once again the Chairman's trusty deputy leapt to his master's defense telling the townsfolk of all of the newly developed fire fighting techniques at their disposal, including his radical new idea of fighting fires with helicopters.

The relentlessly rising burden of funding the fire department gradually split the townsfolk into two viscerally opposing camps.

On one side were the Krugmanites. The Krugmanites argued the townsfolk must provide the fire department with all the resources needed regardless of cost. Such was their enthusiasm they occasionally criticized the Chairman for not demanding an even larger fire department.

The opposing camp were known as the Fergusonians a group of perennial pessimists who complained the fire department would bankrupt the townsfolk.

Having won the debate for years eventually the fire department became simply too expensive. Chairman Bluebridge and his Krugmanite followers were pushed aside and the fire department was taken over by the Fergusonians.

The Fergusonians immediately set about reducing the number of fire fighters. The horrified Krugmanites complained that it was folly to shrink the fire department while the forest was so overgrown and thick with combustible dead wood.

The forest continued growing until, one particularly hot dry summer, a new Great Fire took hold. The fire was fuelled both by the overgrown trees and the thick layer of dead wood. The diminished fire department had no hope of controlling the new Great Fire which eventually engulfed the town.

The townsfolk gathered on the smouldering remains of their burnt down fire department to work out what to do next. The Krugmanites, who had correctly predicted the fire, claimed intellectual victory. The Fergusonians who also knew the Great Fire had become inevitable also claimed victory.

Understandably the townsfolk could not tell who was right and who was wrong and therefore took the only reasonable step of blaming the trees. After a quick vote legislation was passed limiting the size of trees.

The fire department was rebuilt. Chairman Bluebrige's deputy was promoted and the fire department was given the new responsibility of tree pruning.

After fifty years had passed the townsfolk complained that the tree pruning was spoiling the forest and deterring the tourists - tree pruning was halted. After another thirty years the town burnt down once more.

The Krugmanites and Fergusonians are still arguing, and the townsfolk have a new tree pruning law.

Hopefully the analogy to our current economic predicament is clear. Whenever the fictitious Mr Bluebridge successfully prevented a forest fire he inadvertently created the conditions for an even bigger fire in the future. Similarly each time our policymakers and central bankers successfully counteract a debt-driven recession, they do so with even more debt and in so doing create the conditions for an even bigger future recession.

In a sense the conflicting positions of Paul Krugman and Niall Ferguson are both correct, but on different time horizons. We suspect Paul Krugman's concerns that the economy will slip back into recession without more stimulus will prove valid. Equally we share Niall Ferguson's concerns over fiscal sustainability. Additional stimulus today may achieve nothing more than delaying and amplifying the subsequent downturn.

Those arguing for more fiscal stimulus today invariably misuse analysis of Keynes to support their case. At the risk of stretching the parable beyond breaking point, the Keynesian analysis suggests governments should help replant the forest after the fire, to hasten its recovery. It does not suggest preventing fires from occurring in the first place.

Today foresters use controlled burns to prevent future uncontrolled burns. Our policy makers would be wise to allow controlled recessions in order to prevent future uncontrolled depressions.

George Cooper

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