The power of defunct economists

Economists' concepts have informed much of the debate around fiscal policy, but the crisis in the eurozone goes well beyond basic text book theories, says ***David Rowe***

John Maynard Keynes famously said: "The ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed, the world is ruled by little else. Practical men, who believe themselves to be quite exempt from any intellectual influence, are usually the slaves of some defunct economist." The recent debate about fiscal policy bears witness to Keynes' insight in a way he little imagined.

Those who studied macro-economics in the 1960s, 1970s or 1980s very likely used Paul Samuelson's best-selling introductory textbook or one of its many look-alike imitators. The core framework presented in these texts is what can reasonably be called the simple hydraulic model. A core component of this is the secondary impact resulting from a deficit-financed increase in government spending. Such spending results in a dollar-for-dollar increase in income somewhere in the economy. Recipients of such spending would increase their own spending by a proportion of the income they received, equal to 1 minus the marginal propensity to consume (MPC). In the limit, subsequent rounds of this process would ultimately increase total demand by a multiple of the initial deficit spending, where this multiple was 1/(1-MPC).

This model clearly ignores many real-world realities. For example, there is no role for interest rates and financial markets – a shortcoming addressed by John Hicks in what has become known as the IS-LM model. In the late 1960s, Carl Christ of Johns Hopkins University introduced a further critique focused on the complete government budget restraint. His point was that deficit-financed government spending necessarily introduces an increase in outstanding public debt, and the future implications of this must be considered in any analysis of the long-term impact of such spending.

Macro-economic theorists have been debating this issue ever since. One critique of the traditional fiscal multiplier was mounted by Robert Barro and others, who came to be associated with the rational expectations school. One strand of this thinking was formulated in a paper entitled *Are government bonds net worth?* In it, Barro argued that, under certain assumptions, increased deficit spending would increase saving and bequests sufficient to pay for the servicing and eventual retirement of the associated debt.

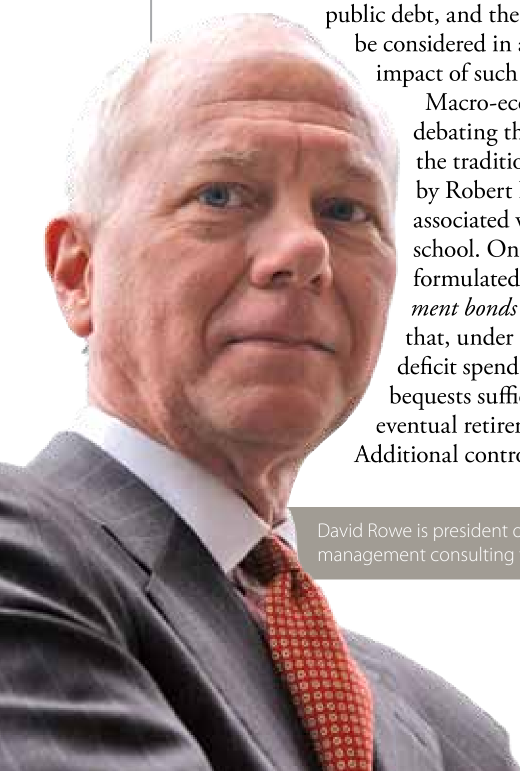
Additional controversy has surrounded the role of expected versus unexpected policy changes and differing reactions among economic actors, partly based on asymmetric information available to them.

Another missing component in the simple hydraulic model of introductory economics is the possibility of bankruptcy of either private or public entities. Introducing such a possibility clearly implies a constraint on the aggregate potential for debt-financed government spending. In effect, government debt levels can become unsustainable if the associated interest payments end up being a serious obstacle to continued economic growth. This is generally measured in terms of the ratio of interest payments on public debt to the GDP of the sovereign entity. Excessive interest relative to GDP can raise fears that the government entity in question will either stimulate inflation as a means of shrinking the real burden of the debt or possibly repudiate the debt outright. Such fears can result in sudden spikes in interest rates that magnify the already dangerous burden of interest payments, leading to a vicious circle that further reduces the potential for an orderly resolution of the problem.

So, what are the implications of all this for today's global economy? The crisis in the eurozone indicates the long-term limitations implied by the complete government budget constraint have begun to bind with a vengeance, for some countries at least. Greece was forced into restraints that triggered sometimes violent public protests. Despite heroic retrenchment efforts on the part of Ireland, the markets remained unconvinced it could resolve its fiscal problems alone. While the fiscal circumstances of the eurozone probably remain within a manageable range, the severe disparities among countries will continue to test the political will to sustain European Union (EU)-wide solidarity. An explicit insolvency of one or more EU countries, with the prolonged funding constraints this would imply, cannot be ruled out.

Meanwhile, the debate about the merits or dangers of fiscal stimulus in the US resembles nothing more than a dialogue of the deaf. Advocates of past and proposed future stimulus argue from a basis apparently grounded in the simple hydraulic model of Econ 101. Opponents simply dismiss the effectiveness of fiscal policy based on continued unemployment of between 9% and 10%, despite the huge debt-funded stimulus already undertaken.

One thing should be clear both in Europe and the US. The level of outstanding sovereign debt, and doubts about the political will to control its future growth, make the complete government budget constraint directly relevant to current circumstances. For better or worse, deficit-funded fiscal stimulus is proving less effective than it has in past cycles. In my view, a slow and prolonged recovery should be the baseline assumption, with significant surprises more likely to be on the downside than the upside. ■



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