

Marketplace



Tim Congdon

‘So, who’s been proved right: the crass American Keynesians or the boneheaded German monetarists?’

In December 2008, the then German Finance Minister, Peer Steinbrück, injected a new phrase into macroeconomic debate—“crass Keynesianism”. In a *Newsweek* interview, he warned of the risk of “burning money without significant effects and in the end having a budget weighed down with even more debt”.

Steinbrück’s most egregious target was Gordon Brown, who was in the final phase of an almost decade-long public-spending binge. But his wider assault was on an idea devoutly held in nearly all US and British university economics departments. This was the notion, first propounded by Keynes in his 1936 *General Theory*, that increases in government expenditure and the resulting budget deficits stimulate economic activity.

The American Keynesians retaliated. In the *New York Times*, Paul Krugman invoked Keynes’s claim that a so-called “injection” of public expenditure raises aggregate demand by a multiple of itself. The Nobel laureate thought that “a huge multiplier effect” was indeed at work, but “unfortunately what it’s doing is multiplying the impact of the current German government’s boneheadedness”.

Krugman had, and retains, much influence over Barack Obama. Within a few weeks of Steinbrück’s verbal offensive, the newly-elected President Obama signed the American Recovery and Reinvestment Act. According to the latest *Economic Report to the President*, this was “the signature element in the Administration’s policy response to the crisis”. The “cost” was estimated at \$787 billion and described as “the largest countercyclical fiscal action in American history”.

It is now more than 18 months since the Steinbrück-Krugman exchange, a period usually regarded as long enough for fiscal measures to have an impact. So who’s been right? The critical variable is the unemployment rate. The *Economic Report* is right that the current burst of additional public expenditure is unprecedented. The increase in the structural budget deficit between 2007 and 2010 was six per cent of gross domestic product, far in excess of anything seen in the 1930s or in the early 1980s, which saw the previous big post-1945 recession. If a fiscal boost of six per cent of GDP, along with the alleged “multiplier” effects, has been unable to cut American unemployment, something is wrong with Keynesian theory.

The data are reasonably clear-cut. The US economy has not returned to sustained above-trend growth. The unemployment rate has been at or above 9.5 per cent for more than a year, the longest period of such high unemployment since records began. The verdict must be that this fiscal boost has made little difference to the unemployment rate. In that sense, Keynesianism has failed.

No doubt counter-arguments and excuses will be put forward by the Keynesians. They may say that underlying demand in the US economy has been weaker than they or anyone else expected and that the fiscal boost has at any rate stopped unemployment from rising further. But: “Why has underlying demand been so disappointing?”

The explanation could turn on the stagnation in the quantity of money since early 2009, which is the kind of evidence that non-Keynesian, monetarist economists would emphasise. But that has a devastating message for Krugman and his Keynesian associates. By implication, the correct policy move at the start of the Obama Presidency was to increase the quantity of money, not to expand the budget deficit. If the persistence of high unemployment is to be attributed to monetary forces, monetary policy—not fiscal—should be the focus of policy action.

Meanwhile, Steinbrück has every reason to chuckle. Germany has allowed some increase in its budget deficit, but not on the US scale. Its public finances, unlike the US’s, are fully sustainable. But the absence of an immense fiscal stimulus package and a large budget deficit has not been accompanied by disappointing outcomes on demand, output and employment. On the contrary, Germany’s unemployment rate is *lower* now than it was in mid-2007, when the crisis began.

In the second quarter, Germany’s GDP rose by over two per cent. If that pace were to continue for a year, output would be up by almost 10 per cent. Again a special influence was at work, the rebound in construction activity after a very cold winter. Nevertheless, Germany’s economy has clearly not been handicapped by its government’s refusal to embark on large-scale “fiscal expansionism”. I propose that in 2011 the Nobel Prize in economics should be awarded to Peer Steinbrück. Given the emerging evidence, he has a better understanding of the determinants of macroeconomic success than Paul Krugman, the 2008 laureate.