

US FISCAL STIMULUS HAS FAILED

Tim Congdon

Modern macroeconomics – the subject that is supposed to have originated in Keynes's 1936 *General Theory* – has received excellent intellectual marketing over the last 60 or 70 years. According to the advertising agencies for Keynesianism in the economics departments of the leading Anglo-American universities (Cambridge in the UK, Harvard, Columbia and Princeton in the USA) the defeat of unemployment resulted from Keynes's key policy insight. This was – or at any rate was alleged to be – that fiscal policy should be used to steer aggregate demand, positively when unemployment was high and negatively when inflation threatened. The net result should be a steady path for growth, with more or less 'full' employment on average.

The last few years have been a massive disappointment for the Keynesians, particularly in the USA. A plunge in demand and output so severe as to be labelled 'the Great Recession' caused the US unemployment rate to soar from about 5.5% in spring 2008 to over 9% in May 2009. Newly-elected President Obama was told by his Keynesian advisers – notably Jo Stiglitz of Columbia, Paul Krugman of Princeton and Larry Summers of Harvard – that the correct antidote was a burst of government spending and a widening of the budget deficit.

The Federal deficit soared from \$160 billion in 2007 to \$1,400 billion in 2009, with a discretionary so-called 'fiscal boost' of about \$700 billion accounting for the bulk of the change. Indeed, this \$700 billion stimulus was the largest ever policy-driven adjustment to the USA's budget balance. Further, the Keynesians were explicit about the beneficial effects they expected soon to be visible. In the words of Jo Stiglitz in his 2010 book *Freefall*, 'On average the *short-run* multiplier for the US economy is around 1.5. If the government spends a billion now, GDP *this year* will go up by \$1.5 billion.'

I have italicised 'short-run' and 'this year' in the above quote, because – although *Freefall* was published in 2010 – much of it was in fact written in 2009. At the time of writing (June 2011), almost two years have passed since Stiglitz's assertion, while Obama's fiscal boost has had ample time to work. Bluntly, the fiscal

boost has failed. In the two years since mid-2009 the US economy has not returned convincingly to above-trend growth. In fact, unemployment in May 2011 (9.1%) was identical to the figure two years earlier.

Indeed, the current spell of high unemployment may soon have to be judged the most prolonged since the 1930s. The worst previous post-1930s example came in the early 1980s, when unemployment exceeded 9% in March/April 1982, climbed above 10% in September 1982 and fell back to under 9% in September 1983. So an unemployment rate above 9% lasted about 18 months. By contrast, in the latest episode unemployment has already been above 9% for two years and fears are now being expressed of another phase of beneath-trend growth in late 2011.

What can American policy-makers do? The fashionable interpretation of the Great Recession is that it was caused by the banking industry, which had extended too much credit in the upturn and must now be punished for its sins. An alternative view takes its cue from Friedman and Schwartz in their 1963 classic *Monetary History of the USA*, which argued that a fall of over a third in the quantity of money between 1929 and 1933 was the dominant cause of the Great Depression.

The point is that in the Great Recession monetary trends have once more exhibited great instability. As Friedman and Schwartz argued, the most important measure of money in determining expenditure and output is one which is broadly defined to include all bank deposits. Nowadays that is best approximated by the so-called 'M3' aggregate. In the two years to April 2008 the average annual growth rate of M3 was just over 12%; in the two years to April 2011 the corresponding figure was minus 1%. It is the collapse in the growth of the quantity of money that explains the stubborn refusal of the US economy to achieve above-trend growth, despite a massive so-called 'fiscal injection' and virtually zero interest rates. The American Keynesians must stop parroting on about the supposed virtues of 'Keynesian reflation' in combating depressed conditions.

Tim Congdon is Chief Executive of International Monetary Research Ltd (www.imr-ltd.com).