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Primer on the Great Debate

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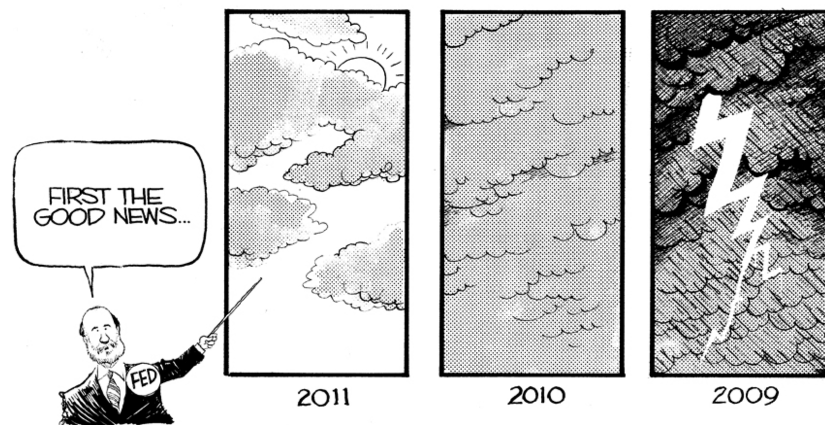

Do you understand why well-known economists, including Nobel Prize winners, are on opposite sides of the debate about the stimulus package and what should be done about the recession? Not only Americans, but people everywhere are confused, largely because the economists who are writing and speaking about what should be done have such fundamental disagreements.

There are two main schools of thought. One group is under the broad umbrella of the Chicago or Austrian school economists who are heavily influenced by the teachings of F.A. Hayek (1899-1992) and Milton Friedman (1903-2007). The members of the other group are commonly known as Keynesians, who accept many of the teachings of John Maynard Keynes (1883-1946) and his disciples.

Recessions/depressions are usually the result of excessive credit expansion and/or inflation, most often caused by central banks (i.e., the Federal Reserve in the U.S.). The main cause of the current global turndown was a "housing bubble" in the United States, the United Kingdom and many other countries, a bubble that developed because too much money was flowing into housing along with a loosening of credit standards.

The Chicago/Austrian school economists correctly note that once the central bank stops excessive money and credit creation, the free market will correct itself by allowing the price of overvalued assets (i.e., housing in the current recession) to fall to an equilibrium level where supply and demand meet, and the economy will begin growing again. Their prescriptions normally call for a relatively passive role for government. This may include the reduction of high marginal tax rates on labor and capital which have diminished the incentives to work, save and invest and some extension of the social safety net to provide emergency aid to the families of those who have lost their jobs, etc.

The Keynesian economists correctly argue that during a recession, individual and business spending and investment is below that required for full employment. Their solution is to increase government spending to make up for the shortfall in private spending.

The Chicago/Austrian economists will properly argue that any increase in government spending will ultimately have to be paid for by higher present or future taxes, or inflation (which reduces the value of the money). The Keynesians will reply that if there is unused labor and capital, and if government spending can utilize this labor and capital surplus, GDP and the tax base will be larger. Also, the gains from the increased employment and higher tax revenues may exceed the long run costs (and particularly the human costs from unemployment) of waiting until the business cycle naturally corrects itself.

In theory, if the increased government spending is only utilized on projects where the benefits of the venture exceed the costs of the additional inflation and net tax burden, the Keynesians' call for more spending could have merit. (In the 1930s, it was argued by many that even if the government only employed people to dig holes and then fill them in, the economy would be better off. Most modern Keynesians no longer advocate such wasted effort, which clearly did not work.)

The Keynesians have several problems translating their theory into practical policy, particularly in democratic countries. They need to determine the correct amount of additional spending (how much "stimulus") and then have it spent in the early stages of the recession. Experience has shown that most additional government spending arrives in the later parts of the recession, or even after the recession is over.

This merely adds to the inflationary pressures, which are often building as economic activity picks up. Another problem is what the economists consider desired increases in spending - those areas which meet a reasonable cost benefitstandard. These are often quite different from those projects on which the politicians often want to spend money (rebuilding soccer fields and increasing wages for unionized workers - both of which are in the new stimulus bill).

Many economists who accept the basic Keynesian argument of the utilization of labor and capital resources, nevertheless, were against the stimulus bill just passed by the U.S. Congress, because much of the spending would be wasteful or even destructive, by reducing the incentives for productive economic activity.

The financial world is now globalized. In recent years, the United States depended on China, Japan and the oil-rich nations to buy much of its debt caused by deficit spending. This helped keep interest rates down, and made it easier for the Fed to control inflation, while not impeding employment growth. The politicians had the best of all possible worlds: low inflation and full employment, while they were still able to increase government spending.

Now, with China, Japan and the major oil producers earning fewer dollars to reinvest in the United States, coupled with the fact that many governments around the world are engaged in "stimulus" and issuing much more debt, the question is, "Who is going to buy all of the new debt?" To the extent there is a shift of investment away from businesses and venture capital and toward buying government bonds, economic growth will be slowed. To the extent central banks become the buyers of last resort (of the government bonds), the additional money creation will result in more inflation.

Slower growth and higher inflation is known as "stagflation," which the United States experienced in the late 1970s. The Keynesians have no solution for this dilemma. The Chicago/Austrians do, but the adjustment is painful before the dawn. Margaret Thatcher and Ronald Reagan were up to the challenge a quarter-century ago. Are any of today's leaders?

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