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The Current Crisis Has a Silver Lining

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Abstract

Capitalism has had many crises and often they have led to improvements in the way it has operated. Two related improvements are predicted as a result of the current crisis. One is the hastening of the decisive defeat of market liberalism. The other is the rehabilitation of fiscal policy as part of the tool kit used to minimise the inherent instability of capitalist economies. After a brief exposition of the core aspects of market liberalism, this article considers the use of fiscal policy in each of the short run and the long run. Policies around the OECD in the last 16 months have already embodied both these improvements, but a similar achievement in the long run will be more difficult. The crowding-out thesis has more appeal when applied to the longer run. However, the empirical evidence does not support crowding out. More generally, economic orthodoxy relies on neo-classical growth theory to support a belief that longer run trends in real economic variables such as output and employment are determined solely by supply side factors. The article uses the authority of Solow and Swan to emphasise that this is an assumption, not the result of any analysis, and that neoclassical growth theory itself assumes that fluctuations in investment over the business cycle will necessarily affect the path of potential output. Moreover, not only is the NAIRU (Non-Accelerating Inflation Rate of Unemployment) determined by the path of investment in physical and human capital, but at a much lower level of unemployment than the conventional wisdom believes.

Introduction

Capitalism has had many crises in its centuries-long history and in many cases the crisis has led to improvements in the way capitalism has operated — for example, the improvement in central bank institutions and policies in a number of countries that resulted from the Depression of the 1930s. This article predicts that the cloud of the current crisis will have a silver lining with two interrelated aspects. One is the bringing forward in time of the decisive defeat of the view of the role of government held by Hayek and popularised by Milton Friedman. The other is the rehabilitation of fiscal policy as an important part of the tool kit used to minimise the inherent instability of capitalist societies — usually called the business cycle. Both of these outcomes can be considered in the short run or longer run contexts. Policies around the OECD since August 2007,

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and more particularly over 2008, have already embodied these two outcomes. A similar achievement in the long run will be more difficult and may require a public education campaign similar to that mounted by Hayek and his disciples, albeit in the opposite direction.

The next section of this article very briefly outlines the position held by Hayek and Milton Friedman, and their resort to a public education campaign to convince policy makers and voters to adopt their ideas. Then in the following two sections, the role of the government in managing a capitalist economy and the part to be played by fiscal policy are discussed in short run and long run contexts respectively. The final section replaces the conventional conclusion with one that suggests which of the issues discussed in the article are likely to cause problems in the future.

Market Liberalism

The essence of Hayek's position on the role of government was that there are very few exceptions to the rule that the market is the best way of deciding what is to be produced and how it is to be produced. Moreover, even when market failure exists (that is, when the market is not the best way of deciding what is to be produced and how it is to be produced), the consequences are usually of less importance than those of the government failing in this respect, and are easier to correct. This is the core of what is generally known as market liberalism but usually called economic rationalism in Australia.

Hayek's classic book in political philosophy, *Road to Serfdom*, was published in 1944. In the next few years, Hayek saw that post-second-world war society was indeed moving away from individualism, and lamented that:

> under the sign of "neither individualism or socialism" we are in fact rapidly moving from a society of free individuals towards one of a completely collectivist character (1949: 1).

Hayek acknowledged that this movement away from individualism was due to politicians implementing what the public desired, but argued that therefore public opinion should be changed through the writings of himself and like minded economists and political philosophers:

> ... what to the politicians are fixed limits of practicability imposed by public opinion need not be similar limits to us. Public opinion on these matters is the work of men like ourselves, the economists and political philosophers of the past few generations who have created the political climate in which the politicians of our time must move (1949: 108).

He therefore set up a club of like-minded individuals with the aim of changing public opinion. The most influential of these was Milton Friedman whose numerous magazine articles and TV appearances together with the famous book written with Rose Friedman, *Free to Choose* (1980), proved very effective in influencing public opinion, not least in Australia.

The market liberalism espoused by Hayek and Milton Friedman is clearly a descendant of classical liberalism as espoused, for example, by Locke. It too has primary emphasis on the freedom of the individual from constraints imposed by other individuals and the state. Friedman makes it clear that, for market liberals, freedom has nothing to do with freedom from hunger, the right to employment (freedom from unemployment) and similar freedoms that were stressed after the Second World War — for example, in Articles 23 and 25 of the Universal Declaration of Human Rights. Constraints imposed by lack of means do not constitute a lack of freedom. Robinson Crusoe could have no problem of freedom while he was alone on his island, even if he starved to death (Friedman 1962: 12).

For market liberals, the major function of government is to protect freedom from the actions by one's fellow citizens as well as from actions by those outside the country. This involves preserving law and order, enforcing contracts and encouraging competitive markets. Friedman also acknowledges that government can, on occasion, help to achieve goals that would be very difficult or expensive for individuals to achieve, even though to some extent they could be achieved through the working of the market. However, he argues that governments should be very cautious in this sphere. He is not as radical in this respect as Hayek. For example, Friedman believes that central banks, as statutory corporations, have an important role to play in implementing appropriate monetary policy. Hayek considers that an economy would be better off without a central bank.

Part of the Friedman gospel was to decry the use of fiscal policy, which involved government expenditure, and to urge tax cuts whenever possible. Taxes, he thought, both interfered with the working of the market as well as enabling bigger government. Friedman, at least in his popular writings, also argued that government should not be involved in income distribution:

> The ethical principle that would directly justify the distribution of income in a free market society is "To each according to what he, and the instruments he owns, produced" (1962: 162).

However, this principle was not widely accepted in Australia.

Economic Management and Fiscal Policy in the Short Run

The extent to which fiscal policy was used in many OECD economies in 2008 to stimulate the economy was unprecedented in recent decades but, despite Milton Friedman, it did not involve any break with current economic orthodoxy. For at least the last 20 years, economists from a wide spectrum of schools of thought have held that fiscal policy can be a helpful tool in increasing output and employment when there is unused capacity in an economy. In a symposium at the 1997 Annual Meeting of the American Economic Association, five eminent but diverse economists, who among them had considerable experience on bodies concerned with official policy making or advising, discussed whether there is a core of practical macroeconomics that could be confidently used, especially to underpin macroeconomic policy. Their articles were published as Blanchard (1997), Blinder (1997), Eichenbaum (1997), Solow (1997) and Taylor (1997). Given the diversity of the five, there is a remarkable degree of agreement between them.

They all agree that in the short run, due to wage and price rigidities, knowledge deficiencies and perhaps expectation factors, fiscal policy as well as monetary policy can influence output, employment and unemployment, though their detailed theoretical reasons for this differ. This belief in the ability of fiscal policy to have the traditional effect on macroeconomic variables in the short run is not confined to academics. It has been affirmed in an official publication of even such a conservative institution as the IMF, which stated that:

> Most economists argue that in the right circumstances, fiscal expansion can be an effective tool to stimulate aggregate demand and revive a stagnant economy (Gupta and Clements 2005: 10).

Back in 1997, Blinder questioned the idea that tight fiscal policy could stimulate the economy, presumably through its effect on expectations about interest rates. The events of 2008 have demolished any belief in this theory, but in the media and among politicians, there is still undue attention paid to whether expansionary fiscal policy will result in a budget deficit and what should be done if it does. For example, the Leader of the Opposition has stated that if there is a deficit, the government should outline its plans for repaying the money borrowed. In reality, in the current circumstances any deficit should be financed by a loan from the Reserve Bank, not by borrowing from the public at all. A loan from the Reserve Bank need never be repaid, and usually should not be repaid, though in some circumstances there may be political advantages in doing so. This is not a short run issue and will be taken up again in the section on the longer run context.

The five economists cited above were typical of academic orthodoxy in that they all thought that, except at fairly high levels of unemployment, there is a trade-off between inflation and unemployment in the short run. This is irrelevant in current circumstances, but unemployment can be much lower than orthodoxy suggests. Nevile and Kriesler (2008) set out the arguments supporting this position. In the situation at the beginning of 2009, a more worrying possibility is that even with relatively high unemployment, expansionary fiscal policy may need to be used in a sophisticated way and be supported by other policies if adverse side effects are to be avoided. Otherwise, it could lead financial markets to act in ways that lead to a rapid and large depreciation of a country's currency. The inflationary consequences of this could lead to an inflation-devaluation vicious circle.

The possibility that a large budget deficit may lead to a large fall in the value of a country's currency on foreign exchange markets has been stressed more by journalists than by academic economists. The most influential book arguing this is by Thomas Friedman (2000).[1] He coined the term 'golden straitjacket' for his argument (2000: 101–111) that, to have access to international financial markets, a country has to follow a set of rules which make up this straitjacket and if a country breaks these rules it is 'disciplined' (2000: 110) by financial markets either avoiding lending to, or withdrawing money from, that country. The golden straitjacket has in all 16 rules, one of which is maintaining as close to a balanced budget as possible. Thomas Friedman's position certainly became part of the orthodoxy among writers in the media, in Australia as well as overseas. But among academic economists there is no widely agreed position on this issue. However, if an inflation-devaluation vicious circle is feared, incomes policy and expanded labour market programs can reduce inflationary pressures and help prevent any vicious circle developing.

It is true that since the 1997 American Economic Review symposium, a so-called 'new consensus on monetary policy' received some prominence in the academic literature and even among central banks. The 'new consensus monetary policy' has rather dubious theoretic foundations (Kriesler and Lavoie 2007) and shows a remarkable ignorance of the history of economic thought and recent United States economic history (Galbraith 2008). However, all that matters in this context is its primary policy recommendation — inflation targeting as the major guide to implementing monetary policy — and its claim that targeting inflation 'makes actual output conform to potential output' (Goodfriend 2007: 61) where potential output is defined as the level of aggregate output determined by the real business cycle. Claims are made, not only that 'as an operational matter a central bank can make the economy conform to its underlying core', but also that 'monetary policy should not try to counteract fluctuations in employment and output due to real business cycles' (ibid). Goodfriend (2007) was published in the issue of a journal dated Fall, 2007. Whether one regards this as an example of hubris or merely irony, there is no doubt that the events in the US in (their) autumn of 2007 effectively ended any claims to real world relevance by the 'new monetary consensus'.

There is one more point to be made in the discussion of issues in the short run. Except for its importance, this would be a footnote. It does matter what government expenditure is spent on. In many countries, including Australia, spending on infrastructure is a very valuable way to increase government spending and, less obviously, this includes spending on human capital as well as physical capital. For humane, social and economic reasons, spending on human capital should include measures to help the most vulnerable such as the long-term unemployed and those who drift in and out of employment who, while not technically long-term unemployed, share many of the same characteristics and are just as vulnerable members of the labour force. It is also important to help those, who hitherto have had continuous but casual employment, so that they avoid joining the ranks of the long term unemployed or of those who drift in and out of employment.

If one gives a high weight to concern for the less well-off in our community, spending on human capital is clearly of prime importance. There are also strong arguments that it also may be at least as important in raising productivity as investment in physical infrastructure. Vocational training can help overcome skill bottlenecks. From a longer term point of view, Heckman and Kreuger (2003) have shown the importance of early intervention programs for disadvantaged children.

Economic Management and Fiscal Policy in the Long Run

Once the context shifts to longer run issues, the analysis in this article departs from what is generally considered economic orthodoxy, especially the dominant view among economists that trend movements in real variables such as output employment and unemployment are determined by the supply side. Current conventional wisdom holds that fiscal policy and other tools for managing aggregate demand have little place in long run analysis. As Solow put it, 'the appropriate vehicle for analysing the trend motion is some sort of growth model, preferably mine' (1997: 230).

In the case of fiscal policy, the argument that it cannot affect long run output and employment has been put at two levels. There is analysis that specifically relates to fiscal policy and argues that the stimulus it provides will, in the longer run, crowd out an equivalent amount of private sector economic activity. In addition, there is the more general belief that the longer run growth path of an economy is determined by supply side factors. Hence, fiscal policy, like any other policy instrument designed to influence aggregate demand, has no effect on real variables in the longer run, unless it has side effects which affect supply-side variables.

Crowding-out theory maintains that an increase in the deficit will cause a rise in interest rates, and this will reduce private investment expenditure. If increased public expenditure increases economic activity, more money will be demanded by persons and corporations in the private sector to carry out this increased economic activity. They will try to borrow this extra money, forcing up interest rates. This argument has been applied even in a short run context. In this context, it rests on an invalid assumption that the monetary authorities are successful in maintaining a constant rate of growth of the money supply. This operational rule for monetary policy is necessary if interest rates are to rise. Moreover, the analysis that shows increased government expenditure leading to higher interest also shows that any increase in private expenditure, for example, on investment or even foreign expenditure on Australian exports, will also lead to a rise in interest rates in Australia.

The underlying assumption is invalid because the monetary authorities, in Australia and elsewhere, have not maintained a constant rate of growth of the money supply. Even before widespread financial deregulation, targeting the volume of money was remarkably unsuccessful. Now, after financial deregulation, the volume adjusts endogenously to whatever size is desired by those with an effective demand for money. Monetary authorities operate directly on interest rates, and the rate of growth of the money supply is only one of many factors that they take into account when determining interest rates. In the case of Australia, this has been documented by Reserve Bank officers, for example in Macfarlane and Stevens (1989: 5–6). In effect, those supporting the crowding-out thesis in today's world of deregulated financial markets are arguing that, whenever government expenditure increases, the central bank actively tightens monetary policy to the extent necessary to reduce private investment by an amount equal to all, or most of, the increase in public expenditure.

Empirical evidence in Australia does not support the crowding-out thesis. If one examines changes in the size of the deficit and changes in short term interest rates in Australia, it is hard to find a relationship, but if anything the relationship is inverse (Nevile 1997: 101–103). This is also the case overseas. Heilbroner and Bernstein carried out a cross-sectional analysis of the G7 countries. Pressman summarised their findings as follows:

> [T]hose countries whose public debt increased most during the 1980s did **not** also experience the largest increases on real interest rates. In fact, if anything the actual relationship seemed to be the reverse. Canada, whose public debt increased the most among G7 countries between 1980 and 1986 experienced the smallest increase in real interest rates among the G7 countries over the same time period. Conversely, the United Kingdom experienced the smallest increase in government debt and the largest increase in real interest rates (1995: 215).

Once crowding-out theory is rejected, there is no reason not to return to something like Lerner's (1943) functional finance, in which government revenue and expenditure are determined so that economic activity is at the rate which produces full employment without inflation and without any concern about whether the resulting budget, or a series of budgets, are in surplus or deficit. However, the straightforward argument in favour of functional finance, for however long the period, should not be taken to dismiss any problems generated by a rising public debt, if this is necessary to maintain full employment without inflation. Also, maintaining full employment without inflation is a much more complex problem than is suggested by Lerner's 1943 article, and this issue will be taken up later in this section.

If a country's public debt is held by its own citizens, the liability (to taxpayers) is balanced by the assets of those citizens who hold the debt. Nevertheless, the consequences for income distribution of a continually growing public debt may be important. In theory, these could be overcome through taxation and other fiscal measures for redistribution, but if the interest bill is large, this may not be feasible for political reasons. Even so, the rule that the budget should be balanced, not over a year but over the business cycle, is too strict as it ignores the effects of inflation and economic growth. If nominal gross domestic product is growing, there can be a positive budget deficit on average over the business cycle without any upward trend in the ratio of public debt to gross domestic product. In the case of Australia, however, this discussion is purely academic since our public debt — net of debt between different levels of government — is close to zero.

However, most academics and even many bureaucrats probably have long run macro neoclassical theory (growth theory) in mind when asserting that in the long run output, employment and unemployment are determined by supply-side factors, not due to a deficiency in demand and cannot be reduced given the institutional structures of society. It is not possible to analyse the economic theory supporting this conclusion since there is not any. Neoclassical growth theory, based on the Solow/Swan model just assumes full capacity of physical capital and full employment. Swan (1956) made this clear from the start. Before a fixed factor of production — land — is introduced, Swan's model spells out what happens in Harrod's growth model if interest rate policy ensures that the warranted rate of growth is always equal to the natural rate of growth.

Solow is explicit in assuming full employment and tends to discuss what happens in an economy in which in the long run 'the real wage adjusts so that all available labour is employed' (1956: 68). Nevertheless, Solow is not completely happy with the unrealistic nature of this neoclassical assumption (see, for example, footnote 7) and even goes so far as to talk about 'the basic equation which determines the time path of capital accumulation that must be followed if all available labour is to be employed' (1956: 67).

In an article published 44 years later, Solow was forthright. Neoclassical growth theory, he says, supposes:

> the available supply of labour always to be fully employed and the existing stock of productive capital goods always to be fully utilized ... This assumption of full utilization could better be made explicit by introducing a government that makes (useless) expenditure and levies (lump-sum) taxes in order to preserve full utilization but this is rarely done ... Full employment/utilization is usually just assumed (2000: 350).

Moreover in the following paragraph, Solow makes an even more damaging statement as far as the conventional view of neoclassical growth theory is concerned:

> The neoclassical model allows in one important effect for the interaction between fluctuations and growth: fluctuations will surely perturb the rate of investment and that will necessarily affect the path of potential output (ibid).

As Solow discusses later in his article, this is true of investment in human capital as well as investment in physical capital. In other words, if there is such a thing as a NAIRU, or non-accelerating inflation rate of unemployment, it is path-determined and is smaller the greater amount of government expenditure on physical and human capital.

This raises the issue of the Phillips curve. This is based on a belief in the self-adjusting forces of a market economy, which will lead to market clearing in all markets — including the labour market — in the long run, though these forces may be impeded in the short run due to rigidities and stickiness. If this belief is correct, while the short run Phillips curve is upwards sloping, the long run Phillips curve is vertical at NAIRU. If unemployment is kept below NAIRU for any length of time, this will lead to accelerating inflation. Related to this is the belief in the neutrality of money, so monetary policy will have no long run effect on the level of employment.

The rationale for this is that at the macro level, employment and wages are determined in the labour market, where the wage rate is seen as the price which equates the demand and supply for labour. Assuming that demand and supply schedules behave in the conventional ways, a market clearing wage will be established so that there would be no involuntary unemployment at that wage. Unemployment can only be the result of an impediment to the market mechanism, which prevented the wage rate from adjusting to the equilibrium level. Such rigidities or wage stickiness are assumed to be only short run phenomena, so that the labour market will always clear in the long run.

There is little evidence to support a belief in the ability of markets to clear so that there is no under-utilisation of resources, particularly in the labour market. It is not the wage rate which determines employment, but rather the level of aggregate demand in the economy. There is nothing inherent in capitalist economies which pushes demand to the full employment level. The short-run trade-offs between unemployment and inflation which underlie the Phillips curve usually do not work for a number of reasons. In particular, if prices are set on a cost plus mark-up model and there are constant or decreasing costs, there is no need for increased output to be associated with increased prices up to the level of full employment or full capacity utilisation. Moreover, with appropriate policies in place, the level of full employment that can be reached without inflationary consequences is higher than that usually assumed.

In Australia, and many other counties, governments have defended a concentration on keeping inflation at a very low rate with the claim that high rates of inflation adversely affect longer run growth in output and employment. There is no doubt that this is true for very high rates of inflation, but there is substantial evidence that this is not the case when the rate of inflation is below, say, 10 per cent. Those who support fighting inflation as the over-riding goal of macroeconomic policy claim the support of the current dominant school of thought in economics. Professor Robert J. Barro is one of the most respected members of this school. In a study of the experience of more than a hundred countries over thirty years, Barro found that there was evidence of 'causation from higher long-term inflation to reduced growth and investment', but immediately commented that 'it should be stressed that the clear evidence for the adverse effects of inflation comes from the experience of high inflation' (1996: 168). The general tenor of Barro's article suggests that he had inflation rates above 20 per cent a year in mind when he used the term 'high', although anyone less sympathetic to the argument that inflation has adverse effects on growth might maintain that his empirical work shows that 'high' should be taken to mean more than 50 per cent a year. Barro's general result has been supported by numerous other studies.

Many media commentators and some academics have countered the argument for a reduction in the priority given to fighting inflation with the claim that such a reduction runs the risk of making inflation harder to contain, whereas pre-emptive interest rate rises add credibility to policy which lessens the risk of an increase in inflation. This is true, but the argument is completely symmetrical with respect to unemployment. Pre-emptive increases in spending policy to expand employment equally lessen the risk of an increase in unemployment. In the Australian case, this is illustrated by the experience of the 25 years following the Second World War. No one doubted the commitment of successive governments to maintain full employment. Both monetary and fiscal policy reacted quickly to the first signs of any looming decline in the rate of economic growth and minimised departures from full employment growth. The most spectacular example was the 1952 recession precipitated by the virtual halving of the price of wool that occurred as a result of the cessation of hostilities in the Korean war. The value of wool exports fell by about a half while that of all other exports increased slightly. Real gross national product declined by over 10 per cent in 1951/52, but both aggressive monetary and fiscal policy halted the fall after that one year. Unemployment rose in 1952/53 but by a relatively small amount and the rise did not last long.

Looking Ahead

The two aspects of the silver lining of the current crisis are inter-related, in that it is somewhat easier to use fiscal policy as a major part of a package of policies to minimise fluctuations in economic activity, if budget expenditures bear a greater ratio to gross national expenditure. While the Howard Government accepted the principles of market liberalism, in practice this did not have much effect on the level of government expenditure in Australia.[2] Since December 2007, this level has increased partly due to the recession-induced decline in government revenue and partly to increases in expenditure. Market liberalism is not a problem in an Australia in the grip of a severe recession. Moreover, the policies of the Rudd Government in Australia are the correct short-term policy response to a severe recession. Luckily for the rest of the world (including us), so are the Obama policies in the United States.

The problem is in the longer run and revolves around the emphasis by the Federal Opposition on the growing deficit and the obsession of the media with this issue. The Opposition claims that Government polices will mortgage our children's future. The truth is exactly the opposite. If we finance with current taxes things which will bring benefits for many years to come, we are being generous to our children who will reap benefits they have not paid for. Borrowing is the obvious way to finance such things. Using resources — many of which would otherwise be lying idle — to build roads, railways and other physical infrastructure, will add to the productivity of the economy our children will inherit and raise their standard of living. It will also increase their ability to pay taxes, and hence the ability to reduce the public debt if that is thought desirable.

In any case, the whole issue of paying off the public debt is misguided. As noted earlier in the article, a loan from the Reserve Bank need never be repaid. It only should be repaid when the economy is operating at more than full capacity with inflationary consequences. A large public debt can, in certain circumstances, limit government policy options, but in Australia public debt is currently close to zero, and even if pessimistic forecasts of how big it will become are accepted, it will still be among the lowest in the western world.

Earlier in the article, the importance of helping the long-term unemployed gain the skills to help them get a job was emphasised. If, or when, the economy starts to grow rapidly and the government puts priority on restoring a surplus and reducing the public debt, many of the long-term unemployed will miss out on gaining a job. In general, the long-term unemployed are the last that employers consider when hiring new staff. Often correctly, employers believe that these staff need to relearn skills and even basic habits required to be a productive employee. The best chance long-term unemployed have of getting a job is when rapid growth is restored, and every effort should be made to help them achieve this, rather than cutting expenditure to restore a budget surplus.

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Notes

1. Page references in this article are to the 2000 revised edition. The first edition was published in 1999.
2. There was a very slight upward trend in the ratio of Commonwealth Government taxes to Gross Domestic Product over the period from the December quarter 1996 and the same quarter in 2007 (the trend was calculated by the author from figures in Australian Bureau of Statistics (2009)).

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