Economic Commentary

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Keynesianism on Trial: Why the Obama Fiscal Stimulus Package May Not Work

Since the global financial crisis broke out in 2008 confidence in markets and unfettered capitalism has collapsed while there has been a resurgence in Keynesianism, the idea that the steady hand of government is always needed to maintain balance in the economy. Governments around the world starting with the administration of George W. Bush and followed by that of President Barak Obama responded by introducing measures to increase government spending and cut taxes in order to stabilize the economy. This is exactly what John Maynard Keynes recommended governments should do when there is a drop in aggregate demand, raise the level of government expenditures and lower taxes in order to boost demand and stabilize economic activity. This is exactly what the $787 billion Obama stimulus plan is aimed to do.

Under normal circumstances, Keynesian fiscal policy intervention in an economy works. However, are the circumstances underlying the present crisis normal? There is reason to believe that they are not, and if so, Keynesian-style policies may fail to achieve their desired objective and despite the effort, the economy may descend further into a depression.

Although Keynes' policy prescriptions are widely believed of having been largely responsible for getting our economy out of the Great Depression, the truth is that the breakout of the Second World War is what in fact finally put an end to the Great Depression. The common thinking is that the surge in the level of government spending brought about by the war was proof that Keynesianism does work. But circumstances then and now are not the same. Here are four reasons why they are not and why one should be concerned that the Obama stimulus package and others like it around the world may fail to deliver the same results this time.

1. By the time the US government embarked on its wartime spending, most of the financial bubble had already burst, debt levels and leverage had fallen and the financial system had been cleansed of its excesses. This time, the cleansing and de-leveraging process has not been completed and as long as this is the case, Keynesian policies will fail to work.

2. The level of government spending unleashed on the economy at the start of the war was much higher than the level of government expenditure being injected in the economy right now. In 1941 federal expenditures rose 177% compared to

1940, and they rose again by 200% in 1942 and again by 60% in 1943. As a percent of GDP federal government spending rose from 6.4% of GDP in 1940 to 14.2% in 1941 to 33.4% in 1942 until peaking at 44.1% of GDP in 1944. To do the same trick today, the US government should inject at least $2 trillion in 2009, and between $2-3 trillion annually over the following two years. This is far more stimulus than the government is doing right now or could possibly contemplate to do.

3. The gross federal debt to GDP ratio in 1939 was 55% and it rose during the war peaking at 121.5% of GDP in 1945. This time around it is around 75% of GDP in 2008 of which close to 30% is held by foreign and international investors compared to almost nothing in 1939. Today the US is a net debtor nation with foreign debt amounting to over 22% of GDP whereas back then the US was a net creditor nation. Today total financial debt, both private and public amounts to around 350% of GDP whereas in 1939 private debt was considerably lower. Clearly, the US government is not in the same position to increase debt levels unless something else gives like price stability, economic freedom, civil liberties or world peace.

3. In 1940-45, it was a wartime environment. The government took full control of the economy including wage and price controls, while the public a) welcomed the spending after a desperate decade of depression and high unemployment and b) was fully mobilized and supportive because there was a higher and single-minded purpose to the war mobilization. This time, in a peacetime environment, the general public and the financial markets are not willing or ready to see such a huge surge in government spending or debt increases.

If Keynesian deficit spending worked wonders in a wartime environment where prices were controlled and production was rationed and managed by the state, it does not necessarily follow that it should work in the present peacetime free market environment. Consequently, we should not put too much faith in what the government is doing for we are more likely to be disappointed. And if it fails it should neither be seen as a verdict that Keynesianism doesn't work. Rather, as long as there continues to be such a huge debt overhang, as long as the financial system has not been rid of its excesses and rationalized and as long as people's expectations and perceptions have not returned to reality, I am afraid that there is nothing more to expect than further contraction, further write-downs, further defaults, further unemployment and further pain. Once the de-leveraging process has run its course and swept away the old mentality and reckless financial practices the conditions for a sustained period of growth and prosperity will emerge. But it won't be any time soon.

Keynesianism only works in normal conditions. It is not a cure all for madness.

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