DISCUSSION PAPER

Back to the Future: A New Keynesian Age

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Introduction

In developed economies, we are witnessing a return of the 'old' Keynesian economic doctrine that had long been declared dead. In the context of the Covid-19 crisis, governments are once again turning to aggregate demand policies of Keynesian nature. They are assuming responsibility to revive growth and improve employment and income outcomes, and weaponising the state's massive spending powers to that end. The British economist's policy prescriptions, which he developed in the aftermath of 1929 Great Depression, seem quite relevant to the current situation in most developed economies. Keynes suggested that in an economy where unemployment is persistent and growth is sluggish, governments should step in to boost aggregate demand. Only through this, he suggested, can an economy function at its full capacity and provide employment for the population.

Governments in the US, the UK and the Eurozone, are currently preparing to enact massive spending programmes. Although they have not materialised yet, various governments seem determined to use the full power of state budgets, often at the expense of rising public debt, in order to revive growth and increase employment. In the UK, Prime Minister Boris Johnson has declared an impressive 'Rooseveltian' spending package (Rayner, 2020). The EU is preparing to rebuild the Union's infrastructure and increase investment in green technologies across the continent. In the US, there seems to be a bipartisan consensus about the need for a sizable infrastructure programme, however, the political quarrel about its content continues. This is a truly transformative moment, because since the neoliberal revolution of the 1980s, governments in developed economies have refrained from economic interventions of this sort and scale. The idea that unfettered markets are best suited for organising the economy remained dominant throughout this period. With Covid-19, governments have realised that leaving all things to free markets is not the most optimal option. It is therefore appropriate to understand this change as the revival of the Keynesian policy framework.

However, at the same time, it is false to assume that this major transformation in policy approach is caused by the Covid-19 crisis alone. The current crisis represents the culmination of long-simmering tensions in the system. Problems that have remained unresolved since the 2008 global financial crises have reached their climax in the atmosphere created by Covid-19. It has been realised that traditional policy channels are not working, and despite near-zero interest rates, growth rates remain low. As pointed out by several notable economists, problems afflicting developed economies run deeper than Covid-19 (Summers, 2020; Krugman, 2020). Low population growth and a dearth of investments due to capital saturation causes what economists call secular stagnation. Unless supported by the government, market forces are incapable of driving the economy to full capacity. In other words, there are structural problems which require a radically different approach from the government. This is why economic discussions are once again taking place on the high table of grand theories.

This paper argues that the Covid-19 crisis will accelerate the major policy transformation already underway in developed economies towards a Keynesian framework. First, it summarises the long-hold discussion between those who supported unregulated free markets and those who believe in the necessity of government intervention and regulation. Second, it introduces the theoretical bases for the argument that governments in developed economies should intervene in their economies to keep them healthy in the current situation. Third, it discusses the spending packages proposed in the US, the UK and Eurozone based on what we know about them so far. It concludes that the new Keynesianism is likely to live on and bring about what it promises.

Government vs. Markets

One of oldest battles in the field of economics is the one between those who support unfettered markets and those who support government intervention. Obviously, there is a whole spectrum of ideas which combine government intervention and market forces in an economy. However, those who support free markets in a radical way argue that government interventions create only waste and inefficiency. Free markets, according to this approach, have the intrinsic capacity to bring about optimal results; market forces of supply and demand determine the prices, inclusive of wages and interest rates, which make sure that all the resources of an economy, inclusive of labour and money, are allocated to their best use. Private businesses, acting on sheer profit motive, are naturally inclined to follow market forces and prices; they compete, innovate, and create value, which ultimately contribute to the overall well-being of the society. Therefore, governments should simply provide the institutional and legal basis for the markets to operate and let the 'invisible hand' of the economy operate.

Writing in 1930s, J. M. Keynes thought that there was something fundamentally wrong with the above reasoning. After the Great Depression of 1929, millions of workers were unemployed whereas enormous productive capacity, including machinery, equipment, factories, were standing idle. 'Market forces' were clearly incapable of connecting unemployed workers and idle productive capital, and organising the economy to bring about the best results. He thought, in such an environment, that government intervention was not only preferred but also required. According to Keynes, governments had to intervene to boost effective demand, which would in turn increase investment and employment. He proposed massive fiscal spending by the government to energise the economy until it gets on its feet again, and to put an end to the misery of millions of unemployed workers, and channel idle capital into investment (Keynes, 1936/1978). This is clearly in contrast to the fundamentalist free market ideology described above.

Keynes' ideas were followed by the governments of his time. In fact, even before Keynes formulated his ideas into a theoretical model, various governments were following 'Keynesian' reasoning. In the US, under the so-called 'New Deal', President Roosevelt enacted a series of public spending programmes on infrastructure, housing etc., as well as transfers to the unemployed and the poor. Roosevelt's spending programme was critical for reviving the economy throughout the 1930s. After the Second World War, both in the US and the UK, and to a lesser extent in other developed economies of the West, governments continued to assume the responsibility to fine-tune the aggregate economy via fiscal policies. When the economy was down, they increased spending to boost employment and investment, and when things were fine, they reduced spending to cool the economy and avoid inflation. In Keynesian reasoning, governments' role in the economy was essential for avoiding recessions such as the one experienced in 1930s, and to maximise social welfare. Unless government intervenes, unemployment for prolonged periods should be expected.

Economic historians often refer to the period between the Second World War and 1970s the 'Golden Age of Capitalism'. Keynesians can surely take some pride in this periodisation. Throughout this period, unemployment was low, inequality was limited, and growth was high. The middle class of rich economies enjoyed vast improvements in their living standards (Boratav, 2020). However, in the 1970s, Keynesian reasoning started to fall apart. In the context of the oil crisis, both inflation and unemployment were rising (i.e. stagflation), defying Keynesian policy prescriptions. Those who supported government interventions found themselves on the defence, while pro-market liberals took centre stage. The oil crisis was essentially a supply-side shock for which governments could not find a solution to with demand-side policies. Increased spending made inflation worse. Keynesianism was in decline. As policy makers turned their faces to pro-market liberal thinkers, Keynesianism lost its theoretical influence.

In 1979, Margaret Thatcher came to office in the UK, and in 1981, Ronald Reagan in the US. Policymaking in developed economies has since been dominated by the pro-market neo-liberal approach. Governments in developed economies dismantled Keynesian fiscal policies and have made it their prime objective to minimise government interventions in the economy. Rooted in a strong faith of efficient functioning of markets and private businesses, they accelerated privatisation, and deregulated trade, finance, and labour markets as much as possible. Financial sectors had free rein while labour market protections for workers were gradually dismantled. 30 years later, however, the 2008 global financial crisis led to another confrontation between two major lines of thinking.

'Secular Stagnation'

After the 2008 global financial crisis, it became apparent that without government involvement, the American economy, and thus the entire global economic order, could easily collapse. As expected, the US government bailed out big American businesses, putting an end to 30 years of neoliberal legacy. The American Federal Reserve lowered interest rates to historic lows and flooded the economy with almost unlimited liquidity. At the time, the government's strong intervention was expected to be temporary, paving the way back to 'normalcy'. However, more than 10 years since the crisis, economies are still struggling with low growth and lower than full employment. Despite unprecedented monetary loosening and negative interest rates, investments are not picking up and recovery remains weak. In this environment, discussions have gradually changed their focus from how and when the economy will turn back to the previous order, to whether we need a fundamentally different approach (Başbay, 2019a).

In his address to the IMF in 2013, former US Treasury Secretary Larry Summers put forth the argument that developed economies may be facing 'secular stagnation'. Secular stagnation is a term that was first coined by American Keynesian economist Alvin Hansen in the 1930s. Hansen claimed that when rich economies arrive at a mature state of economic development, where the population is ageing and technological advancements are slowing, economic growth falls and stagnation becomes the normal state of the economy. In such an environment, Hansen said, capitalists' inducement to invest is very limited because profits in real businesses are low. This creates a contradiction and a recipe for economic stagnation: in rich capitalist economies with an enormous capacity to raise funds, investments remain very low. The solution is to be found in Keynesian fiscal policies (Hansen, 1938).

According to Summers, the economic situation since the 2008 global financial crisis is quite similar to the one described by Alvin Hansen in 1930s. Economic growth is not picking up despite persistently low interest rates and almost unlimited liquidity. Businesses simply reject to undertake large business investments, which are paramount for creating sufficient levels of employment and income. Rich capitalists, instead of investing in employment-generating productive investments, accumulate their money in unproductive assets, such as real estate (houses, land) or financial assets (stocks, bonds), and wait for the next speculative bubble in the financial markets. In this environment, traditional policy channels remain ineffective. In particular, Summers claimed, there is nothing that can be accomplished via central banks anymore. Interest rates have been near negative zone for quite some in almost all the major developed economies. More liquidity simply does not seem to incentivise more spending. According to Summers, instead governments should consider 'old' Keynesian policies (Summers & Stansbury, 2019).

Furthermore, Summers makes the case that the Covid-19 crisis only makes secular stagnation worse. Aggregate demand has dropped even further because the propensity to save, in place of consumption, has increased; out of precaution against further blows to the global economy. Profitability has also declined, which has made businesses even less inclined to invest. In other words, people save even more while businesses keep even higher reserves in their accounts. This is Alvin Hansen's description of how secular stagnation comes into being, except all happens at a higher intensity. How much of this is temporary is open to question, of course, but the structural reasons for secular stagnation (population growth and capital saturation) will remain. In such an environment, government intervention only becomes more important (Summer, 2020).

Another notable economist and Nobel laurate, Paul Krugman, has suggested that the government should adopt a stable spending programme which would last for years. According to Krugman, the US government should spend 2% of GDP in deficit in order to boost the American economy. Increased government spending can be spent on infrastructure, R&D, or child development, but the ultimate aim is to increase aggregate demand and pull the American economy out of slump. This would lead to a 200% public debt to GDP ratio, which has never been reached in American history, but according to Krugman, this is the only way out "because everything we see now says that bad times will be a very frequent occurrence" (Krugman, 2020). If realised, which Krugman admits is unlikely, this would truly be a Keynesian revolution. Even if a radical plan like Krugman's is not put into action, it seems ever more likely that governments in the developed world, first and foremost the US, will use their fiscal powers.

Keynesian Policies are Back

In the US, the House of Representatives has recently passed a $1.5 trillion infrastructure bill for building country's roads, bridges, railways, schools as well as renewable clean energy sources. Transportation Committee Chairman Peter A. DeFazio said that the fact that bill has passed "is proof that finally, there is a majority of us in Congress who won't accept the status quo and instead are willing to fight for a new vision", and that the bill puts "millions of people to work in jobs that cannot be exported, while harnessing American-made materials, ingenuity, and innovation" (Laris, 2020). However, the bill was passed by Democrats without bipartisan support, and so is expected to be turned down by the Republicans in the Senate. Though Republicans do not oppose an infrastructure bill per se, they are critical of the content of the bill, especially spending on items related to 'green energy' (Laris, 2020).

Another $1 trillion bill is known to have been prepared by President Trump's office for building infrastructure across the country and stimulating the economy. The bill is said to include spending on roads and bridges as well as 5G wireless and broadband internet networks over a 10 years period. It is reported that President Trump wants an 'ambitious' bill which would help recovery by putting people to work across the country (Leonard & Wingrove, 2020). There seems to be growing consensus in American politics about the need for a fiscal stimulus and preparations for a sizable spending package in both sides of the US politics. For Republican fiscal hawks, this surely is a serious break from the past as they have historically rejected such spending packages.

In the EU, discussions regarding a sizable spending package continues. The Union is trying to accomplish what they could not after the Eurozone debt crisis. The European Commission has passed a $2 trillion spending bill to build the EU's infrastructure. If approved, the programme will build the Union's infrastructure, especially in renewable energy, over the next 7 years beginning from 2021 (Bock, 2020). European Commission President Ursula von der Leyen said: "the recovery plan turns the immense challenge we face into an opportunity, not only by supporting the recovery but also by investing in our future" (EC, 27 May 2020). Note that such radical action was not taken even in the aftermath of Eurozone debt crisis which wreaked havoc over the economies of southern Europe.

A similar policy package is expected in the UK, the birthplace of Keynesianism. Most recently, Prime Minister Boris Johnson pledged hundreds of billions of pounds to building the country's infrastructure, including roads, railways, communication, as well as main public services, including hospitals, schools, public houses, and railways, in order to bring the country back to a stable growth path. Prime Minister Johnson promised a 'New Deal', referring to the US President Roosevelt's famous spending programme of the 1930s, which was celebrated as the 'Rooseveltian' moment of Johnson. (Rayner, 2020). Moreover, the spending programme is unlikely to be temporary and is certainly about more than the Covid-19.

In fact, already in March, before the Covid-19 crisis, Chancellor Rishi Sunak announced that the government would be spending an extra £175 billion on infrastructure across the country over the next 5 years. This was was quite unexpected from the Conservative government of the UK, which came to office in 2010 and has been an exemplar of how neoliberalism works (or not). The budget proposal was perceived as a surrendering of the long prevailing austerity approach and celebrated as 'Keynesianism reborn'. As Will Hutton put it, with the latest budget, "a rubicon has been crossed. Keynesianism has been restored to its proper place in British public life" (Hutton, 2020).

Governments are now trying to repeat what they accomplished after the Second World War. During and after the war, Keynesian fiscal policies were followed, intentionally or otherwise, to their fullest extent. Massive government spending on the war effort and rebuilding the economy afterwards created the boost in aggregate demand, which was critical for pulling the economy from the swamp of Great Depression. In the 1950s' high growth environment, Hansen said, "how inventive, productive and dynamic the American private enterprise economy can be, when operating under the pull of adequate aggregate demand, has been demonstrated in a remarkable laboratory experiment during the last fifteen years" (Hansen, 1954, p. 412). It remains to be seen if Keynesian policies will be able to accomplish the same after the crisis brought on by Covid-19.

Conclusion

It has become a truism that crises lead to major transformations. The Covid-19 pandemic seems to be no different. Analysts of diverse subjects are discussing how this once-in-a-lifetime crisis will change the world in their respective fields, and agree that most things will be quite different when the pandemic is over. In the field of economics, there seems to be revival of old Keynesian economic policies. Aggressive fiscal policies, which dominated economic orthodoxy of the post-World War II era, are making a comeback. The reasons for this radical move are not difficult to see. After more than 10 years of near-zero interest rates since the 2008 global financial crisis, developed economies are still struggling to revive growth rates and reduce unemployment. While the failure of traditional policies was already calling for a substantial re-evaluation of the dominant policy framework, the Covid-19 crisis has become the final straw.

Developed economies are arguably facing secular stagnation. As Alvin Hansen discussed years ago, low population growth and capital saturation leads to a dearth of investments, which leads to anaemic growth and unemployment. Wealthy investors in mature economies, do not undertake investments but instead accumulate their capital in unproductive assets, which does not contribute to economic growth and employment but rather creates speculative bubbles prone to crisis. The solution Hansen proposed was more government intervention of a Keynesian nature, similar to what governments did between the Second World War and the neoliberal revolution of early 1980s.

Keynesian prescriptions are straightforward: governments should step in to boost aggregate demand (and thus profits) through public spending. They should realise public investments in infrastructure, education, healthcare, housing etc. or increase public services, so that business can reap the benefits of higher profits created by higher demand. Only in this way, it is argued, can economic growth pick up in developed economies to provide adequate employment and income to the vast majority of society. Otherwise, mature economies are unlikely to escape the growth slumps they are in.

In the context of Covid-19, governments of developed economies seem like they have finally surrendered to interventionist policies. In the US, both Republicans and Democrats agree that there is need for fiscal stimulus. In the UK, even before the Covid-19 crisis, the announced budget was more in line with the Keynesian understanding rather than the austerity mentality that the Conservative government has been known for. In the EU, there are talks over a massive spending programme which is expected to build the infrastructure across the continent and spur economic growth. What remains to be seen is if the second Keynesian age will be as successful as the first one.

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