Utah FOUNDATION RESEARCH BRIEF

Thoughts on the Current Recession: Keynesian Economics

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This brief is part of a series of research briefs Utah Foundation is publishing on the economy. The series examines the current economic recession from a variety of schools of economic thought. These schools of thought represent different approaches to understanding how the economy works and what actions to take when the economy falters. We begin the series with a discussion of Keynesian economics, which is receiving much attention in recent months because of the debate over the large federal stimulus bill passed in February. Other briefs will outline the theories and observations of the Austrian, Post-Keynesian, and Chicago schools of thought. Understanding these different schools of thought will help readers further understand the roots of the economic crisis and potential solutions.

Keynesian Thoughts on the Current Recession

Keynesian theory is a school of economic thought which regards changes in aggregate demand (total spending in the economy) as the driving force of economic growth. It is argued by Keynesians that changes in aggregate demand have strong, short-run effects on real output and employment. This is because prices are rigid, or slow to respond to changes in supply and demand. Because prices do not adjust instantaneously, both monetary policy (changes in the money supply and interest rates) and fiscal policy (changes in government spending and taxes) can cause output and employment to fluctuate in the short run.[1]

In basic economic models, aggregate demand is defined as being comprised of four separate components of spending: consumption, investment, government spending, and net exports (total exports minus total imports). Fluctuations in any of these components cause output to either increase or decrease.

$Yd = C + I + G + (X – M)$
Yd = Aggregate Demand (sum of individual demand curves for different sectors of the economy)
C = Consumption G = Government Spending
I = Investment (X – M) = Net Exports

According to Keynesian theory, recessions are caused by disturbances to the economy that lead to contractions in the components of aggregate demand, particularly investment.[2] Some examples of such disturbances include changes in the price of oil, natural disasters, and wars. The disturbance may initially only affect one component of aggregate demand, but the resulting contraction is often compounded by the reactions of government, investors, and consumers. For instance, households often increase saving during recessions because of economic instability and the possibility of future job loss. Normally, increased saving is good for the economy, but when households save during economic downturns, less money is being circulated, meaning businesses face further losses from declines in sales.[3] This increases unemployment, creating a negative feed-back loop in the economy; a phenomenon which is known as the paradox of thrift. At the firm level, a decline in investment leads to a decline in production, causing firms to produce below capacity. As a result, firms need fewer workers and unemployment increases. This reduces consumption, further fueling the economic downturn.

Causes of the Current Recession

Paul Krugman, an advocate of Keynesian policy, indentifies the 2007 fall in China's stock market, and the subsequent 416-point slide in the Dow Jones Industrial Average, as the events which started the decline in investment ultimately leading to the current recession. Investors were shaken by the 2007 drop and began to panic over the number of risky mortgage-loan defaults that emerged with the collapse of the housing boom. Despite the best efforts of financial leaders to quell this panic, investors rightfully weren't convinced that the housing collapse was an isolated problem. Krugman argues that by late spring 2007 it was clear stock markets were being driven by a self-reinforcing downward spiral of anxiety. This led to falling prices in the market, which set off a chain reaction of defaults and bankruptcies by large market players who had taken on too much leverage by borrowing to buy risky assets.[4] While the recession was in large part caused by housing boom and instability of financial institutions, Krugman believes falling investment is what triggered the momentum behind the current downturn.

Even though investment contracted in late 2007, Krugman argues the effects weren't realized for several more months because of strong U.S. exports and consumer spending which stabilized aggregate demand.[5] Unfortunately, as banks such as Bear Stearns and Lehman Brothers failed, consumer confidence began to fail as well. Demand for manufactured goods collapsed as households realized their own financial security was at risk. Households had accumulated large amounts of debt during the last two decades when asset prices were rising. However, when these appreciation bubbles burst, households were faced with a double burden of decreasing asset values and high levels of debt. With both consumption and investments staggering, compounded by an eventual decline in net exports, the economic contraction was unavoidable.

Keynesian Solutions to Recessions

Keynesian policy prescriptions tend to focus on achieving full employment and stabilization of the business cycle.[6] This is because Keynesians view recessions as economic maladies, not as efficient market responses to periods of unsustainable growth marked by risky investments or the accumulation of debt (as viewed by the Austrian and Post-Keynesian schools). While the idea of using monetary or fiscal policy to "fine tune" the economy (adjusting government spending, taxes, and the money supply every few months to keep the economy at full employment) has largely been abandoned by Keynesians, many feel stabilization policies are sensible when the unemployment rate is high or when the economy is in recession.[7]

> Because Keynesians believe recessions are caused by disturbances to the economy that lead to contractions in the components of aggregate demand, they feel the best way to end a recession or move the economy back to full employment is for the government to actively engage in fiscal or monetary stimulus.

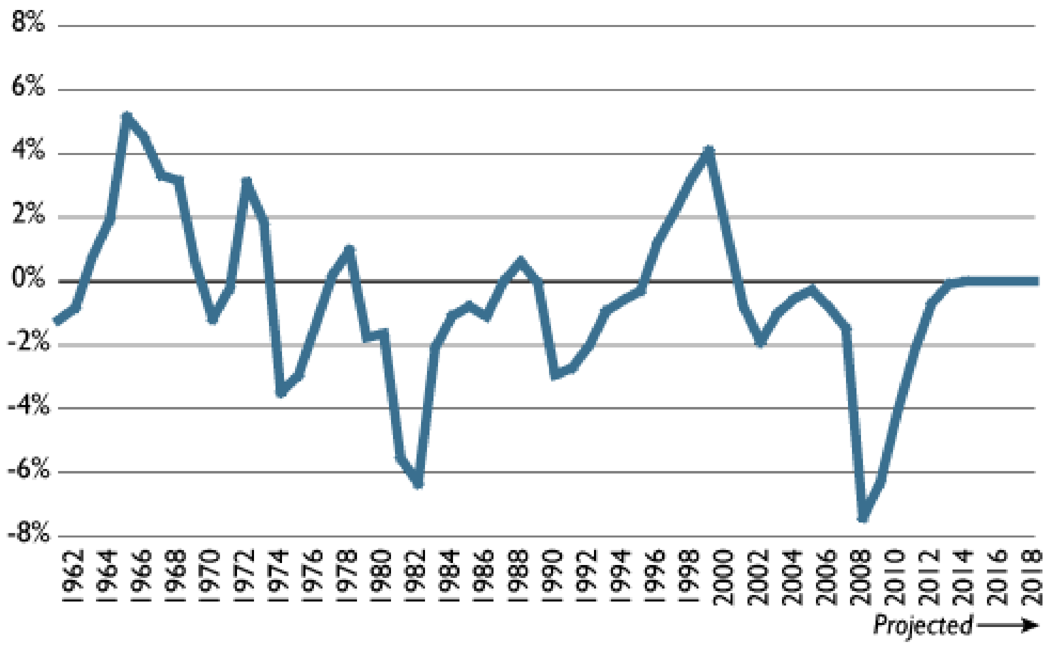
Government stimulus increases the flow of money in the economy and allows businesses to return to higher levels of output as demand for goods and services increase. Some examples of Keynesian fiscal stimulus include: 1) increasing government spending, which increases the number of jobs and amount of money flowing into the economy; 2) increasing government transfer payments (like unemployment checks), which puts more money directly into the hands of consumers; and 3) decreasing taxes, which increases the disposable income of workers.[8] An example of Keynesian monetary stimulus is decreasing interest rates, which increases the amount of money available to the economy and allows for more investment.

Keynesian Solutions to the Current Recession

As the recession continues to worsen, Krugman believes government spending is the only tool left available to stimulate the economy. Both consumer and investment confidence are down, the global effects of the economic downturn have lowered net exports, and monetary policy is not an option because interest rates are essentially already at 0%. This leaves government spending, which largely came in the form of the 2009 stimulus package. The 2009 stimulus package increases federal funds for numerous programs, some of which include emergency food assistance, state and local law enforcement, renewable energy development, homeland security, small business loans, infrastructure, prevention and wellness programs, improvement of medical facilities, and support for elementary, secondary, and postsecondary education. The package also provides funds to bolster unemployment compensation and Medicaid coverage, as well as enacts several tax cuts and other tax provisions.[9]

The 2009 stimulus package increased government spending by $787 billion. However, Krugman does not feel this is enough to pull the economy out of the recession; "It's helpful, but it does not cover even one third of the gap…" Krugman argues that out of the total amount approved, about $600 billion adds real stimulus. This is compared to the $2.9 trillion of spending lost from declines in the housing market, exports, business investment, and consumption expenditures. These declines have caused Gross Domestic Product (GDP, the most popular measure of economic output) to run well below its potential level (Figure 1).[10] Krugman also argues the $350 billion in the form of tax cuts will not provide a significant boon to the economy because households are likely to save, rather than spend the money.[11] Krugman feels a second stimulus is needed to cover the shortfall of the first. He warns that inadequate economic policies in the United States could lead to a long and protracted recession, similar to the "lost decade" of economic growth Japan experienced in the 1990s and early 2000s.[12]

Figure 1: The GDP Gap, 1962-2019 (as as percent of potential GDP)



The GDP gap is the difference between inflation adjusted GDP and its estimated potential level (which assumes a high level of labor and capital use).

Sources: Congressional Budget Office (CBO), Department of Commerce, Bureau of Economic Analysis. Data available from CBO.

Krugman is not the only well-known economist in favor of Keynesian solutions. Nouriel Roubini, chairman of RGE Monitor, warned as early as 2005 that America's speculative housing boom could trigger an economic crisis. He argues that more front-loaded fiscal stimulus, coupled with monetary easing, is the solution to avoiding a depression. He states that only $200 billion of the current stimulus package is front loaded (has an effect this year), meaning the stimulus does little to correct the problem now. Because this is a global crisis, Roubini also argues that in order to be successful, consistent and coordinated efforts must be made by the United States, Europe, Japan, China, and every other country that can afford to engage in fiscal and monetary stimulus.[13] Roubini favors bank nationalization as well, in which the federal government temporarily takes over failed banks, restructures them, and sells them back to the private sector. He believes this action would quicken the necessary restructuring of the financial market.[14]

David Harvey, a professor at the City University of New York, believes massive and prolonged deficit financing is necessary to reverse the current economic downturn; an action that is limited by both political barriers and the fact that the United States is already in a position of chronic indebtedness to the rest of the world.[15] It is often argued by historical economists that Roosevelt's attempt to return to a balanced budget in 1937-1938 pushed the nation back into a recession. It was therefore the massive stimulus of World War II spending, not the New Deal, which successfully resolved the economic crisis. Harvey feels the current stimulus is neither large enough nor sustained enough to stimulate the economy; he feels it may take $2 trillion in government spending, and a stronger focus on funding social programs for true stabilization. Like Krugman, Harvey argues that in order for the stimulus to work, the relief must be directed to those who will spend it on goods and services. This means low-income classes, as even middle classes are more likely to spend it on bidding up asset values (through the purchase of foreclosed homes and low-priced stocks).

Historical Notes on Keynesian Thought

Keynes' ideas were first presented in his book, The General Theory of Employment, Interest and Money, in 1936. They gained momentum during the Great Depression and World War II when the United States implemented the use of public works projects.[16] Keynesian policy was prevalent in the post-war period as well, during which most western capitalist countries experienced low unemployment and inflation. However, with the onset of stagflation in the 1970s and the emergence of New Classical economics, Keynesian theory was widely criticized in academic circles from the mid 1970s until the mid 1980s.[17] Since then, Keynesian theory regained recognition by influencing the development of New Keynesian economics and econometrics.[18] Keynesian theory has also seen resurgence during the current economic recession as many policy makers have turned to the use of fiscal stimulus and other Keynesian solutions.

Endnotes

[1] Alan Blinder, "Keynesian Economics," in *The Concise Encyclopedia of Economics*, 2nd ed., ed. David Henderson (Indianapolis: Liberty Fund Inc., 2007), http://www.econlib.org/library/Enc1/KeynesianEconomics.html (accessed 3 March 2009).

[2] Christina Romer, "Business Cycles," in *The Concise Encyclopedia of Economics*, 2nd ed., ed. David Henderson (Indianapolis: Liberty Fund Inc., 2007), http://www.econlib.org/library/Enc/BusinessCycles.html (accessed 29 April 2009).

[3] Paul Krugman, "Too Little Stimulus in Stimulus Plan," Presentation at the University of Pennsylvania, 18 February 2009, http://.wharknowledgeton.upenn.edu/article.cfm?articleid=2167 (accessed 26 February 2009).

[4] Paul Krugman, "The Big Meltdown," *The New York Times*, 27 February 2008, http://select.nytimes.com/2007/03/02/opinion/02krugman.html?_r=1&hp (accessed 24 February 2009).

[5] Paul Krugman, "Why We Haven't Had a Recession (So Far)," *The New York Times*, 29 December 2007, http://krugman.blogs.nytimes.com/2007/12/29/why-we-havent-had-a-recession-so-far/ (accessed 2 March 2009).

[6] Blinder.

[7] Blinder.

[8] David Weil, "Fiscal Policy," in *The Concise Encyclopedia of Economics*, 2nd ed., ed. David Henderson (Indianapolis: Liberty Fund Inc., 2007), http://www.econlib.org/library/Enc/FiscalPolicy.html (accessed 29 April 2009).

[9] Congress, House, *American Recovery and Reinvestment Act of 2009*, 111th Cong., 1st sess., 2009, H.R. 1, http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h1enr.pdf (accessed 4 March 2009).

[10] Figure 1 shows the expected GDP gap as estimated by the Congressional Budget Office (CBO). Even though Krugman believes CBO's estimates for future GDP are too optimistic, this graph is a good illustration of the "hole" the stimulus fails to fill. Paul Krugman, "More Stimulus Notes," *The New York Times*, 7 January 2009, http://krugman.blogs.nytimes.com/2009/01/07/more-stimulus-notes/ (accessed 23 April 2009).

[11] Krugman, "Too Little Stimulus in Stimulus Plan."

[12] Krugman, "Too Little Stimulus in Stimulus Plan."

[13] Michael Schuman, "Roubini Sees More Economic Gloom Ahead," *Time Magazine*, 3 March 2009, http://www.time.com/time/business/article/0,8599,1882729,00.html (accessed 5 March 2009).

[14] Tunku Varadarajan, "Nationalize the Banks," *The Wall Street Journal*, 21 February 2009, http://online.wsj.com/article/SB123517380343437079.html (accessed 6 March 2009).

[15] David Harvey, "Why the U.S. Stimulus Package is Bound to Fail," http://davidharvey.org/2009/02/why-the-us-stimulus-package-is-bound-to-fail/ (accessed 4 March 2009).

[16] "John Maynard Keynes," in *The Concise Encyclopedia of Economics*, 2nd ed., ed. David Henderson (Indianapolis: Liberty Fund Inc., 2007), http://www.econlib.org/library/Enc1/bios/Keynes.html (accessed 29 April 2009).

[17] Blinder.

[18] "John Maynard Keynes."

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