Monday, March 10, 2014

Global Macro Themes – Keynesian Failure

The financial crisis that started in 2008[1] and resulted in the worst global economic slump since the Great Depression provided the world's policymakers with a golden opportunity to display the effectiveness of Keynesian macroeconomic policies. Under the stewardship of the then UK Prime Minister Gordon Brown, world leaders at The London Summit 2009 announced a huge monetary and fiscal stimulus package in a desperate bid to reinvigorate the global economy. The classic mix of Keynesian demand-side stimulus measures – deficit-financed fiscal spending and ultra-easy monetary policy – removed the immediate downside tail risk, prompting some very premature self-congratulatory comments[2]. Four years on, though, and it is clear to many that these policies have failed to deliver. Not only that, but in many respects the global economy is in even worse shape now than it was then. It is definitely time for a major macroeconomic policy rethink.

2009 Revisited

After acknowledging the seriousness of the economic crisis enveloping the globe, at The London Summit 2009 held in April world leaders promised a rescue package to reinvigorate the slumping global economy. According to the official statement such policy action would "*constitute the largest fiscal and monetary stimulus and the most comprehensive support programme for the financial sector in modern times*"[3].

Turning words into actions governments in all the major economies adopted aggressive deficit-financed fiscal expansions which central banks reinforced via further monetary stimulus, either in the form of additional interest rate cuts (where the binding constraint of the zero bound on nominal interest rates had not been reached) or by balance sheet expanding asset purchase programmes (QE in other words).

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[1] We prefer to reference the start date of the crisis rather than the end date as many financial market participants do because, in our view, this crisis is far from over.

[2] The following news clip perfectly illustrates the self-delusional arrogance of policymakers at the time. In this case Gordon Brown's classic foot-in-mouth Freudian slip occurred during Prime Minister's Question Time in December 2008. See: http://www.youtube.com/watch?v=7iPaiylUYW0

[3] The statement also contained the following promise: *"We will conduct all our economic policies cooperatively and responsibly with regard to the impact on other countries and will refrain from competitive devaluation of our currencies and promote a stable and well-functioning international monetary system."* We strongly doubt whether such ideals are being adhered to now given the deliberate debasing of the JPY under Abenomics and the RBI governor's recent comments.

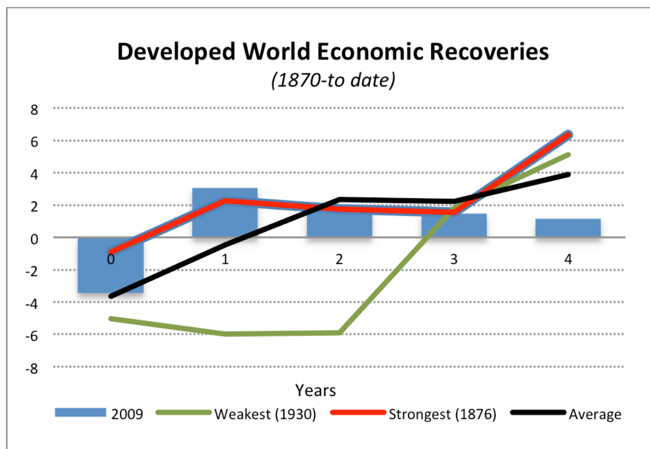
Unsurprisingly, given the degree of demand-side stimulus thrown at the global economy over such a relatively small period of time, economic activity picked up markedly in the second half of 2009 with investors, policymakers and economists all celebrating the so-called "green shoots"[4].

The Zarnowitz Bounce

However, following this initial bounce - one consistent with the famous Zarnowitz[5] rule - the global economic recovery faltered during 2010 leading many financial market participants to wonder whether the hoped-for "V-shaped" recovery was in fact transforming into the much less desirable "W-shaped recovery"; one characterised by a double-dip recession.

In response to the apparent emergence of downside risks to global economic growth central banks in the major economies provided yet more monetary stimulus; a process that continues to the present time[6].

Despite such policy action, as can be seen in the chart below, the recovery since the Great Recession has been lacklustre; a very generous description in our view. Indeed, when the present recovery in the developed economies is benchmarked against the seven economic recoveries witnessed since 1870, we find that it is one of the weakest. Even the recovery following the Great Depression was stronger by its fourth year.



That the greatest economic stimulus package *"in modern times"* has failed to generate a more robust economic upswing is not the only reason for concluding that the Keynesian policies have failed. Another tell-tale sign of this failure comes from the composition of economic growth, specifically, the investment component.

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[4] To illustrate how desperate the sell-side was to see evidence of improvement numerous economists resorted to showing that the second differential of economic growth was positive, which simply meant that the pace of economic contraction was easing. Personally, we have never understood how something becoming worse, albeit at a slower pace, can in any way be viewed as outright improvement.

[5] Victor Zarnowitz was an economist who specialized in analyzing business cycles the rule that bares his name simply states, "Deep recessions are usually followed by steep recoveries".

[6] Our previously stated view is that tapering of asset purchases by the Fed constitutes less monetary accommodation as we outlined in our research note "*GMT – Tapering Is Wrong!",* 1 October 2013. However, this is not a view shared by the Fed or other leading central banks.

Animal Spirits

In his General Theory, written in 1936, Keynes posited that economies do not automatically adjust to full-employment; a theory conditioned by the recent experience of the Great Depression. This notion ran contrary to the prevailing "classical" school theory one that utilised Say's Law[7]. His argument was that it was indeed possible for an economy to be locked into a "bad equilibrium"; one characterised by insufficient aggregate demand.

Furthermore, Keynes argued that in a situation of insufficient aggregate demand an economy would not only fail to self-correct, and in doing so fail to return to full employment, but that it was likely to continue deteriorating. The basic outline of the argument is as follows: the business sector, given insufficient demand for the goods and services produced, would seek to maintain profitability by cutting input costs, the most important of which is labour, and curtailing investment. Faced with falling aggregate income, consumers would pullback on spending even further, leading to yet another leg-down in aggregate demand. The result: a vicious deflationary downward cycle in economic activity and rising levels of unemployment.

Keynes's policy prescription to the problem of insufficient demand was for governments to employ a combination of lower interest rates (monetary stimulus) and increased government spending (fiscal stimulus). In addition to the direct GDP boost from deficit-financed government spending[8], Keynes argued such policies would boost flagging private sector "animal spirits", which he assumed was an important determinant on business sector decisions to invest. Given business investment is also a component of GDP encouraging additional business investment would serve to boost further economic growth. In summary, Keynes judged that implementing this combination of demand-side stimulus would, aided by the accelerator theory of investment, not only short circuit a private sector-induced "vicious cycle" but would establish a public sector-induced "virtuous circle".

Investment – The Facts

Unfortunately for Keynesian economists the accelerator theory of investment has not been validated in the latest economic recovery. Business investment has singularly failed to pickup markedly over recent years despite the aggressive fiscal and monetary stimulus that has been injected. As can be seen in the chart below, as a share of GDP, outside of China[9], business investment remains very

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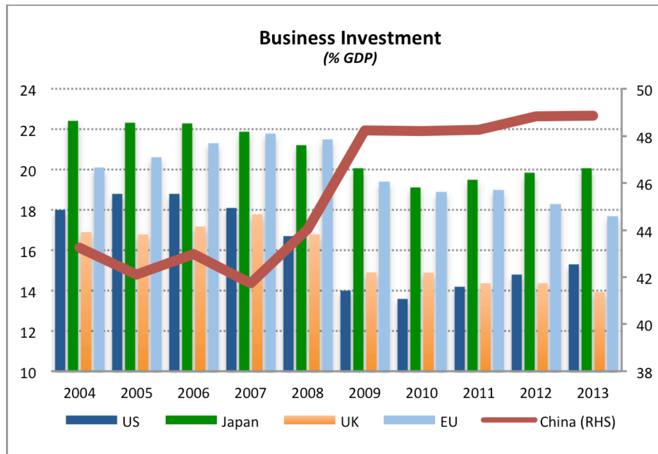
[7] According to Say's law "supply creates its own demand". Hence, the possibility of excess aggregate supply or unemployment – beyond normal, frictional, unemployment – is ruled out.
[8] The increase in government spending must be deficit financed and not come from taxes to be stimulative, as otherwise it is a case of robbing Peter to pay Paul, ignoring - for simplicity - the possibility of differing marginal propensities to consume.
[9] China's strong investment growth has nothing to do with resurgence in animal spirits but rather a lot to do with the very visible hand of state planners.

weak, indicative of the fact that the Keynesian policies adopted have failed to rekindle private sector "animal spirits". Explaining away the absence of a meaningful pick-up in business investment is a serious problem for Keynesian economists.



Die-hard followers of this branch of economics no doubt argue that the failure of business investment to pick-up in the recovery phase is not because such policies are ineffective, but because that there has not been enough demand-side policy stimulus.

However, given the sharp rise in government indebtedness since the Great Recession (an on-going trend we might add); the bloated balance sheets of central banks driven to QE because of the zero bound constraint on nominal interest rates; and their simultaneous commitment to maintaining low inflation targets (effectively removing the possibility of driving real interest rates strongly negative) we find such arguments baseless.

More than that, it is our contention that the Keynesian demand-side stimulus measures implemented were, in fact, doomed to failure right from the very beginning. This reflects our judgement that the underlying source of the Great Recession has been, and continues to be, widely misdiagnosed[10].

Indeed, in many respects the global economy is in even worse shape after such policies than it was in 2009 as fiscal and monetary policy settings are so far away from the norm. Until this error of perception is corrected, and more appropriate macroeconomic policies introduced, the prospect of a strong sustainable economic recovery in the developed world is slim[11].

It is definitely time for a major macroeconomic policy rethink.

[10] In the interests of brevity we will outline in more detail our argument as to why such Keynesian policies were flawed from a theoretical perspective in a separate research note.
[11] We do not rule out this optimistic scenario entirely. In part, because it is always wise "never to say never" but also because there are, at least theoretically, other possible escape routes although these have nothing whatsoever to do with Keynesian demand-side stimulus.

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