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Too tight

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MONEY IN A FREE SOCIETY

Keynes, Friedman, and the new crisis in capitalism

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When it comes to the lacklustre recovery from the financial crisis, the dominant left-wing narrative has been shaped by Paul Krugman and other Keynesians. The main villain in the piece is austerity. In this view, if only Western governments had the guts to borrow and spend more money, economic recovery would have been much quicker. Instead, the doctrines of the "Austerians" have ruled, and spending cuts have left much of the West in an economic torpor or even brought a downward spiral. It has become a common view - promoted by the University of California at Berkeley economist Brad DeLong - that more government borrowing and spending might have paid for itself through boosting economic growth, a kind of "Laffer Curve" for the Left.

On the Right, two narratives compete. The first focuses on big government and policy uncertainty as the problems. The Obama recovery failed to match up to the Reagan recovery because President Obama expanded the role of government and disdained business, thus discouraging private investment. The continuing economic problems of the United Kingdom are harder to explain in this manner, but perhaps the disruptions in the Eurozone are partly to blame.

This narrative has found favour with rightwing politicians, but it is not sticking with the intellectuals. If true, it is hard to explain why US corporate profits are now measured at record highs (the Keynesian emphasis on weak demand has this problem as well). And if any sector in the United States is doing well it is health care, which probably has been subject to more legal and regulatory uncertainty than any other.

An alternative account of what went wrong is sometimes called "neo-monetarism" or "market monetarism". In this view the American financial crisis and the Eurozone troubles have the common root of excessively tight monetary policy. It is argued that the Federal Reserve did not commit to stabilize the nominal flow of purchasing power in 2008 and that it has since sat on its hands, even when relatively low inflation and high unemployment should have justified a more active monetary policy. Similarly, the European Central Bank - or is it Germany? - has forced a disastrous tight money policy on a Eurozone that would have done better with a serious dose of inflation, both to wipe out the real value of some debts and to flood the system with liquidity. With its reliance on central banks, this isn't exactly a "free market" view, but it does suggest that with a few central bank adjustments the notion of a self-regulating market economy is very much alive and well.

The market monetarists draw on Milton Friedman for inspiration, but they modify Friedman in two regards. First, they emphasize the earlier Friedman, who stressed active central banks, liquidity flows, and money as a lubricant of trade, as opposed to the later inflation-fighting Friedman of the 1970s. Second, they do not adopt Friedman's focus on targeting narrow measures of the money supply, but rather they look for broader measures of whether the central bank is doing enough to maintain the flow of purchasing power.

Enter Tim Congdon. Congdon, a former Treasury adviser and now an economics consultant, offers the first serious book-length neo-monetarist take on the financial crisis. Spread out over its 486 pages are smart discussions of why the Keynesian revolution is overrated, why central banks have been focusing on the wrong monetary aggregates, why liquidity traps are not to be feared, and what UK fiscal policy has been about for the past few decades.

Congdon nails the major problem with the left-wing narrative of the sluggish recovery, namely that the efficacy of fiscal policy is far from demonstrated. Where is the evidence that more government borrowing and spending would have solved our problems? Even President Obama has admitted that "shovel ready" projects do not come in the trillions. A lot of the supposed employment boost of the 2009 fiscal stimulus in the United States came from reshuffling workers from one project to another, rather than creating jobs overall. Looking back towards history, the biggest burst of recovery during the 1930s came when Roosevelt severed the link of the dollar to gold, an act of monetary not fiscal policy. Arguably the Second World War deserves credit for the eventual recovery, but no comparably massive and popular project is on the horizon today, and wartime spending required significant restrictions on consumption for many years, hardly a model for an impatient electorate in 2012. The economist Scott Sumner stated the case against fiscal policy another way on his blog The Money Illusion. Sumner noted that no one believes fiscal policy (unlike monetary policy) could be used to target a price inflation rate of say 4 per cent a year. The implication is that fiscal policy is not very effective in managing overall demand in an economy, so why should we so trust it as a tool of crisis management? Along related lines, Congdon correctly emphasizes that changes in the quantity of money smother changes in fiscal policy. Furthermore, if you are worried about "liquidity traps" - low interest rates causing money and bonds to become near-equivalent financial instruments - central banks can always find a way to get the new money into circulation.

There are a variety of studies which ostensibly show that fiscal stimulus "works", but these studies typically either a) start with models assuming stimulus works, or b) show that stimulus creates some jobs in the short run, rather than sustainable long-run gains. As for the UK, it is well known that active fiscal policy can be self-defeating in an open economy with a flexible exchange rate. And for all the talk about self-defeating austerity, as of mid-2012 government spending in Britain was still growing, albeit more slowly than in some previous years. If all this scepticism about fiscal policy sounds radical, reset your expectations. It is what most of the economics profession - not just the Friedmanites - believed in pre-crisis times, only a few years ago. Recent events have not overturned these time-honoured truths. Even if spending cuts are self-defeating in a recession, as is arguably the case in the Eurozone, that does not mean spending boosts will set things right. If anything, Eurozone experience indicates that more fiscal policy is a sheer impossibility for some of the world's troubled governments, and some countries, such as Spain, have too much quality infrastructure, not too little.

Yet fiscal policy has become the new orthodoxy of the critics, the subject of unceasing calls to arms which all good and righteous people are supposed to heed. In fact what we have witnessed is a politicization of the debate, and the near-impossibility of finding consensus among popular writings on macroeconomics.

If we can't rely on fiscal policy, then what should we do? Congdon argues that the Fed in particular has neglected the basic truths of monetarism. He sees broader monetary aggregates, such as "M3", as more important than the monetary base (think of the base as "dollars" - what the Fed controls directly, and M3 as a broader superstructure of credit and financial assets built on that base). This critique is on the right track, but perhaps too backward-looking. More recently, the market monetarists have shifted their attention to forward-looking policy rules, whereby the central bank signals it will maintain a predictably increasing flow of nominal purchasing power for all periods to come. In this regard, Congdon's book is now a bit behind the curve.

Does the market monetarist movement hold all the answers? Not quite. It's worth trying to keep the broader monetary aggregates at robust levels of growth, but what happens when this is not possible? The danger is not so much Keynes's liquidity trap - considered a mythical beast by many, including this author - as the private sector's reluctance to lend, such as followed the partial collapse of financial intermediation in 2008. Those credit relationships are being repaired only slowly, and so private investment will lag until trust is repaired. In the meantime, the authorities could prop up the monetary aggregates by printing more currency, but that's not nearly as useful as trustbased expansions of bank lending and private investment. In other words, undoing the damage from a credit collapse is not always easy.

Furthermore, the economic ills of both the United States and Britain are rooted ultimately in the often unimpressive recent productivity of those economies. Much of the supposed economic growth between 2000 and 2008 was bubble-based and thus illusory, and median incomes and job growth showed abiding structural problems before the crisis struck. We were not as wealthy as we thought we were, and this has required some fall in living standards. In such an environment, just about any macroeconomic recipe will appear to under-perform, including a perfectly tuned monetary policy.

Money in a Free Society doesn't have all the answers, it is perhaps overlong, and it could have been more focused on remedies rather than devoting so much space to a long history of Keynesian thought in the United Kingdom. Nonetheless, it is a bracing and largely accurate take on what has gone wrong, a wake-up call for those who think they know all the right answers, and a medicine against the strands of political correctness that have been encircling and indeed strangling the macroeconomic debate.

Tyler Cowen is Professor of Economics at George Mason University. His books, as author, include The Great Stagnation: How America ate all the low-hanging fruit of modern history, got sick, and will (eventually) feel better, which appeared last year, and An Economist Gets Lunch: New rules for everyday foodies, which was published earlier this year.