April 18, 2011

Can Keynesians be anti-Keynesian?

Follow any policy debate, and you are sure to find a list of economists who support or inspire those on both sides of the issue. In **The Economist**, we find some of those on the roster for the new Republican leadership in the House of Representatives, and why:

> "When Republicans proposed slashing billions of dollars from federal spending this year, Democrats circulated predictions by economists that jobs and growth would be hit. John Boehner, the Republican speaker in the House of Representatives, countered with an economic expert of his own: John Taylor of Stanford University. 'Nothing could be more contrary to basic economics, experience and facts,' Mr. Taylor **asserted on his blog**, which Mr. Boehner cited. By cutting government spending, he said, the Republicans would 'crowd in' private investment and create jobs.
>
> "… if there is one ideology that unites today's Republicans, it is Keynesianism, whose nefarious influence they are determined to stamp out. 'Young Guns,' the book-sized manifesto of Eric Cantor, Kevin McCarthy and Paul Ryan, leading Republican House members, devotes several pages to the evils of Keynesian activism and its exponents in the administration."

One of the interesting things about the article is that among the economists cited as being among the critics of "Keynesianism," you find the names **John Taylor**, **Robert Mundell**, and **Kenneth Rogoff**. I find that list interesting because if you follow the links I attached to those names you will find work with models that are decidedly Keynesian in structure. Works by Taylor and Rogoff are, in fact, seminal contributions to **the "New Keynesian" paradigm** that dominates macroeconomics today.

As far as I know, none of these men have repudiated the basic worldview that motivates the referenced work. In fact, as recently as last year **John Taylor approvingly described**, as he has many times, a key characteristic of the paradigm for monetary policy that was in place the decades before the financial crisis:

> "… the central bank has a strategy, or rule, to adjust the interest rate depending on economic conditions: In general, the interest rate rises by a certain amount when inflation increases above its target and *the interest rate falls when by a certain amount when the economy goes into a recession*."

I added the emphasis to the last part of that passage as it is a feature of the so-called Taylor rule that is entirely built on the foundation of the New Keynesian model.

How, then, to explain the Keynesian predilections of the economists mentioned as presumed carriers of the anti-Keynesian mantle? The source of the confusion, I think, goes back to the historical, but somewhat obsolete, distinction between so-called Keynesianism and monetarism. The latter was, of course, personified in Milton Friedman and his dispute with what was the orthodoxy in the three decades following the Great Depression. Lost in the early-days labeling, however, was the fact that the disputes were more about the empirical details of theory rather than the theory itself.

In particular, Friedman did not deny the effectiveness of policy in principle but rather its wisdom or impact in practice. This sentiment is exactly the one he expressed in his prescient and transformative **1968 presidential address to the American Economics Association**:

> "In the United States the revival of belief in the potency of monetary policy was strengthened also by the increasing disillusionment with fiscal policy, not so much by its potential to increase aggregate demand as with the practical and political feasibility of so using it."

In **a recent essay on Friedman's views** about the ineffectiveness of fiscal policy, Tim Congdon notes Friedman's views on the issue:

> "Friedman offered two informal theoretical arguments for the virtual irrelevance of fiscal policy, as he saw it. The second was that fiscal policy is much harder to adjust in a sensitive short-term way than monetary policy. But the first was the more telling and deserves detailed discussion.… In Friedman's words, 'I believe it to be true… that the Keynesian view that a government deficit is stimulating is simply wrong.' The explanation was the wider effects of the way the budget deficit is financed. To quote again, 'A deficit is not stimulating because it has to be financed, and the negative effects of financing it counterbalance the positive effects, if there are any, on spending.' "

Though Congdon emphasizes different channels (associated with the mix of monetary and fiscal policy associated with deficit spending), those who follow such things may recognize in Friedman's remarks the notion of **Ricardian equivalence**:

> "This is the idea that increased government borrowing may have no impact on consumer spending because consumers predict tax cuts or higher spending will lead to future tax increases to pay back the debt.
>
> "If this theory is true, it would mean a tax cut financed by higher borrowing would have no impact on increasing aggregate demand because consumers would save the tax cut to pay the future tax increases."

My point is not to dispute or defend the truth of the Ricardian proposition. My point is that it has absolutely nothing to do with whether one believes (or does not believe) that the New Keynesian framework is the right way to view the world. The essential policy implications of the New Keynesian idea (like the old Keynesian idea) is that changes in gross domestic product can be driven by changes in desired spending by households, businesses, foreigners, and the government *in sum*. You can believe that and still believe in fiscal policy ineffectiveness, as long as you believe that total spending is unaltered by a particular policy intervention.

There are, of course, plenty of arguments against fiscal policy activism that do not require adherence to Ricardian equivalence, in total or in part. The most obvious would be the position that any short-term rush from stimulative policies is more than reversed in the long run by the negative consequences of higher tax rates on productive activity, or the redirection of private investment to lower return public spending. Again, the point is that a self-professed adherent to a Keynesian reality need suffer no doubts about the coherence of his or her intellectual framework if he or she objects to fiscal policies aimed at juicing the economy through greater government spending.

This whole discussion may seem like a bit of inside baseball, and perhaps it is. But the stakes in this debate are high, as clearly illustrated by **today's announcement** from rating agency Standard & Poor's that it reduced its outlook to negative on the triple-A credit rating of the United States. In my view, productive discussions about the truly pressing issues of our day are unlikely unless we understand where the disagreements lie—and where they do not.

*By **Dave Altig**, senior vice president and research director at the Atlanta Fed*

April 18, 2011 in Deficits, Federal Debt and Deficits, Fiscal Policy | Permalink