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All Keynesians now? No; A frenzy of red ink is not the answer for our economy's future

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Recent announcements and commentary about next month's federal budget indicate that it's all over but the red ink. The ideas of self-styled followers of John Maynard Keynes about promoting fiscal boosts for economic growth are all the rage once more. It seems a "stimulus package" can and must rescue Canada's economy from crisis and recession.

Indeed, everywhere you look, it's bailouts and accelerated spending. Estimates of Washington's post-rescue deficit now run to \$1.5-trillion (U.S.). The European Commission has approved hundreds of billions of dollars worth of stimulus. China and Russia, too. Even though Finance Minister Jim Flaherty is still insisting that deficits will be temporary and targeted, pundits have been lining up to applaud what they anticipate to be a deeper plunge.

In the words attributed to U.S. president Richard Nixon in 1971: "We are all Keynesians now."

Such beliefs were plausible, once. Received wisdom after the Second World War was that the Depression of the 1930s occurred because governments ignorantly or willfully failed to support the economy with spending. In the 1950s and 1960s, so-called Keynesianism ruled: Government budgets could fine-tune output and counteract the depressing tendency of households and businesses to oversave.

Mr. Nixon's quote, however, soon acquired ironic tones. In the 1970s, rising state spending coincided with slower economic growth. In the 1980s, chronic deficits and swelling debt boosted interest payments and tax rates, while competition between government and private-sector borrowers forced interest rates up. The popularizers of Keynes sounded less convincing.

Many academic economists had already spotted a key flaw. Their objection was simple: People can see ahead. As consumers, investors and entrepreneurs, people know that government deficits now will mean lower spending, higher taxes and perhaps even debt default later. If that knowledge leads them to retrench, they can offset the government's impact on demand.

As for history, received wisdom was largely wrong. Countercyclical fiscal policies were not a radical new idea in the 1930s. American presidents Calvin Coolidge and Herbert Hoover - derided later as economically ineffective - advocated ramping public-works programs up in slack times. U.S. government spending did not fall during the Depression; it rose. It stood 7 per cent higher in real

terms at the trough in 1933 than it had in 1929, and its share of the economy in 1933 had grown by about 70 per cent.

The key policy failure of the 1930s was that of central banks. The U.S. money stock shrank by almost one-third from 1929 to 1933 - part of a worldwide contraction as the gold standard and belief in the benefits of purges inhibited aggressive action. After the imperative of war finance overruled central bank caution, rapid monetary expansion fuelled the recovery.

Recent experience has underlined the limits of Keynesian ideas. After the Japanese asset-price bubble burst, Tokyo tried massive infrastructure programs and huge budget deficits in the 1990s, yet the Bank of Japan's failure to get money and credit flowing meant stagnation. Meanwhile, countries where years of Keynesian misadventures had led to trouble trimmed spending and produced budget surpluses - and enjoyed rising living standards all the while.

Canada was a case in point: from fiscal deficits approaching 9 per cent of GDP in 1992 to surpluses of 3 per cent in 2000. Did this shift of nearly 12 percentage points hurt growth? Not at all. Supported by accommodative monetary policy, real GDP expanded by more than one-third. Lower taxes and less government intervention in the economy accompanied the shift, setting the fiscal stage for real output to grow by another fifth during the next eight years.

The abrupt end of that boom has prompted a desperate search for fixes. But the economy's most pressing need is for central bank cash, not big deficits. Demographic change will stress Canada's public programs and tax base in the years ahead. If additional threats of heavier taxes, slashed spending or unsustainable debt shake confidence, households and businesses will cut back.

Those now quoting the Richard Nixon of 1971 in support of stimulus should recall rather the John Maynard Keynes of 1936: "Practical men, who believe themselves to be quite exempt from any intellectual influence, are usually the slaves of some defunct economist. Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler of a few years back."

Manic government spending in January is no answer. Weaker revenues and higher employment insurance

payments will hurt Ottawa's bottom line, but rather than demanding more red ink, Canadians should be thinking about the next expansion and the economy they want in the future. Bailouts and a ballooning public sector will stifle innovation and the promising industries of tomorrow. A prudent fiscal framework - one that plays no regional or sectoral favourites, and evenhandedly rewards work, investment and innovation - will allow them to flourish. Ottawa should recall the things that brought Canada into 2008 in such good shape, and build on them.

The frenzy of red ink south of the border and around the world is driven by panic, not logic. Lack of fiscal stimulus does not herald economic collapse, and the widespread expectation that it will has become part of the problem.

Canadian policy-makers know better and, in next month's budget, they should show it.

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