The Economist

Fiscal multipliers

Where does the buck stop?

Fiscal stimulus, an idea championed by John Maynard Keynes, has gone in and out of fashion

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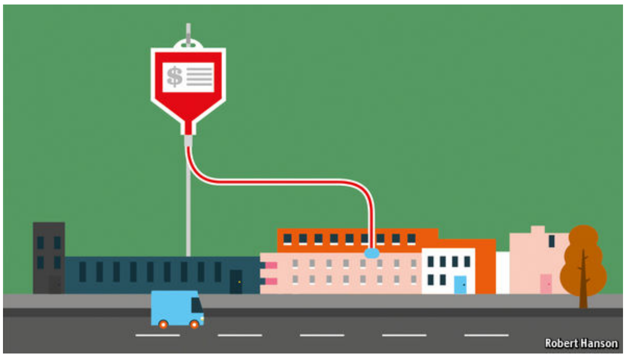

AT THE height of the euro crisis, with government-bond yields soaring in several southern European countries and defaults looming, the European Central Bank and the healthier members of the currency club fended off disaster by offering bail-outs. But these came with conditions, most notably strict fiscal discipline, intended to put government finances back on a sustainable footing. Some economists argued that painful budget cuts were an unfortunate necessity. Others said that the cuts might well prove counterproductive, by lowering growth and therefore government revenues, leaving the affected countries even poorer and more indebted.

In 2013 economists at the IMF rendered their verdict on these austerity programmes: they had done far more economic damage than had been initially predicted, including by the fund itself.

What had the IMF got wrong when it made its earlier, more sanguine forecasts? It had dramatically underestimated the fiscal multiplier.

The multiplier is a simple, powerful and hotly debated idea. It is a critical element of Keynesian macroeconomics. Over the past 80 years the significance it has been accorded has fluctuated wildly. It was once seen as a matter of fundamental importance, then as a discredited notion. It is now back in vogue again.

The idea of the multiplier emerged from the intense argument over how to respond to the Depression. In the 1920s Britain had sunk into an economic slump. The first world war had left prices higher and the pound weaker. The government was nonetheless determined to restore the pound to its pre-war value. In doing so, it kept monetary policy too tight, initiating a spell of prolonged deflation and economic weakness. The economists of the day debated what might be done to improve conditions for suffering workers. Among the suggestions was a programme of public investment which, some thought, would put unemployed Britons to work.

The British government would countenance no such thing. It espoused the conventional wisdom of the day—what is often called the "Treasury view". It believed that public spending, financed through borrowing, would not boost overall economic activity, because the supply of savings in the economy available for borrowing is fixed. If the government commandeered capital to build new roads, for instance, it would simply be depriving private firms of the same amount of money. Higher spending and employment in one part of the economy would come at the expense of lower spending and employment in another.

As the world slipped into depression, however, and Britain's economic crisis deepened, the voices questioning this view grew louder. In 1931 Baron Kahn, a British economist, published a paper espousing an alternative theory: that public spending would yield both the primary boost from the direct spending, but also "beneficial repercussions". If road-building, for instance, took workers off the dole and led them to increase their own spending, he argued, then there might be a sustained rise in total employment as a result.

Kahn's paper was in line with the thinking of John Maynard Keynes, the leading British economist of the day, who was working on what would become his masterpiece, "The General Theory of Employment, Interest and Money". In it, Keynes gave a much more complete account of how the multiplier might work, and how it might enable a government to drag a slumping economy back to health.

Keynes was a singular character, and one of the great thinkers of the 20th century. He looked every inch a patrician figure, with his tweed suits and walrus moustache. Yet he was also a free spirit by the standards of the day, associating with the artists and writers of the Bloomsbury

Group, whose members included Virginia Woolf and E.M. Forster. Keynes advised the government during the first world war and participated in the Versailles peace conference, which ended up extracting punitive reparations from Germany. The experience was dispiriting for Keynes, who wrote a number of scathing essays in the 1920s, pointing out the risks of the agreement and of the post-war economic system more generally.

Frustrated by his inability to change the minds of those in power, and by a deepening global recession, Keynes set out to write a *magnum opus* criticising the economic consensus and laying out an alternative. He positioned the “General Theory” as a revolutionary text—and so it proved.

The book is filled with economic insights. Yet its most important contribution is the reasoning behind the proposition that when an economy is operating below full employment, demand rather than supply determines the level of investment and national income. Keynes supposed there was a “multiplier effect” from changes in investment spending. A bit of additional money spent by the government, for instance, would add directly to a nation’s output (and income). In the first instance, this money would go to contractors, suppliers, civil servants or welfare recipients. They would in turn spend some of the extra income. The beneficiaries of that spending would also splash out a bit, adding still more to economic activity, and so on. Should the government cut back, the ill effects would multiply in the same way.

Keynes thought this insight was especially important because of what he called “liquidity preference”. He reckoned that people like to have some liquid assets on hand if possible, in case of emergency. In times of financial worry, demand for cash or similarly liquid assets rises; investors begin to worry more about the return *of* capital rather than the return *on* capital. Keynes posited that this might lead to a “general glut”: a world in which everyone tries to hold more money, depressing spending, which in turn depresses production and income, leaving people still worse off.

In this world, lowering interest rates to stimulate growth does not help very much. Nor are rates very sensitive to increases in government borrowing, given the glut of saving. Government spending to boost the economy could therefore generate a big rise in employment for only a negligible increase in interest rates. Classical economists thought public-works spending would “crowd out” private investment; Keynes saw that during periods of weak demand it might “crowd in” private spending, through the multiplier effect.

Keynes’s reasoning was affirmed by the economic impact of increased government expenditure during the second world war. Massive military spending in Britain and America contributed to soaring economic growth. This, combined with the determination to prevent a recurrence of the Depression, prompted policymakers to adopt Keynesian economics, and the multiplier, as the centrepiece of the post-war economic order.

Other economists picked up where Keynes left off. Alvin Hansen and Paul Samuelson constructed equations to predict how a rise or fall in spending in one part of the economy would propagate across the whole of it. Governments took it for granted that managing economic demand was their responsibility. By the 1960s Keynes's intellectual victory seemed complete. In a story in *Time* magazine, published in 1965, Milton Friedman declared (in a quote often attributed to Richard Nixon), "We are all Keynesians now."

But the Keynesian consensus fractured in the 1970s. Its dominance was eroded by the ideas of Friedman himself, who linked variations in the business cycle to growth (or decline) in the money supply. Fancy Keynesian multipliers were not needed to keep an economy on track, he reckoned. Instead, governments simply needed to pursue a policy of stable money growth.

An even greater challenge came from the emergence of the "rational expectations" school of economics, led by Robert Lucas. Rational-expectations economists supposed that fiscal policy would be undermined by forward-looking taxpayers. They should understand that government borrowing would eventually need to be repaid, and that stimulus today would necessitate higher taxes tomorrow. They should therefore save income earned as a result of stimulus in order to have it on hand for when the bill came due. The multiplier on government spending might in fact be close to zero, as each extra dollar is almost entirely offset by increased private saving.

Rubbing salt in

The economists behind many of these criticisms clustered in colleges in the Midwest of America, most notably the University of Chicago. Because of their proximity to America's Great Lakes, their approach to macroeconomics came to be known as the "freshwater" school. They argued that macroeconomic models had to begin with equations that described how rational individuals made decisions. The economic experience of the 1970s seemed to bear out their criticisms of Keynes: governments sought to boost slow-growing economies with fiscal and monetary stimulus, only to find that inflation and interest rates rose even as unemployment remained high.

Freshwater economists declared victory. In an article published in 1979 and entitled "After Keynesian Economics", Robert Lucas and Tom Sargent, both eventual Nobel-prize winners, wrote that the flaws in Keynesian economic models were "fatal". Keynesian macroeconomic models were "of no value in guiding policy".

These attacks, in turn, prompted the emergence of "New Keynesian" economists, who borrowed elements of the freshwater approach while retaining the belief that recessions were market failures that could be fixed through government intervention. Because most of them were based at universities on America's coasts, they were dubbed "saltwater" economists. The most

prominent included Stanley Fischer, now the vice-chairman of the Federal Reserve; Larry Summers, a former treasury secretary; and Greg Mankiw, head of George W. Bush's Council of Economic Advisers. In their models fiscal policy was all but neutered. Instead, they argued that central banks could and should do the heavy lifting of economic management: exercising a deft control that ought to cancel out the effects of government spending—and squash the multiplier.

Yet in Japan since the 1990s, and in most of the rich world since the recession that followed the global financial crisis, cutting interest rates to zero has proved inadequate to revive flagging economies. Many governments turned instead to fiscal stimulus to get their economies going. In America the administration of Barack Obama succeeded in securing a stimulus package worth over $800 billion.

As a new debate over multipliers flared, freshwater types stood their ground. John Cochrane of the University of Chicago said of Keynesian ideas in 2009: "It's not part of what anybody has taught graduate students since the 1960s. They are fairy tales that have been proved false. It is very comforting in times of stress to go back to the fairy tales we heard as children, but it doesn't make them less false."

The practical experience of the recession gave economists plenty to study, however. Scores of papers have been published since 2008 attempting to estimate fiscal multipliers. Most suggest that, with interest rates close to zero, fiscal stimulus carries a multiplier of at least one. The IMF, for instance, concluded that the (harmful) multiplier for fiscal contractions was often 1.5 or more.

Even as many policymakers remain committed to fiscal consolidation, plenty of economists now argue that insufficient fiscal stimulus has been among the biggest failures of the post-crisis era. Mr Summers and Antonio Fatas suggest, for example, that austerity has substantially reduced growth, leading to levels of public debt that are higher than they would have been had enthusiastic stimulus been used to revive growth. Decades after its conception, Keynes's multiplier remains as relevant, and as controversial, as ever.

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