The Role of Economists in Causing Economic Stagnation

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Introduction

There is a long history of governments with activist policy agendas and no shortage of economists having offered advice on this. But the economic approaches Keynes developed or amplified, inspired by a respect he and many other economists held for the Soviet and German planning systems, provided a major boost to legitimising government economic policy activism. As well as a belief in a greater role for planning, Keynesianism also reflected a popular belief that free enterprise entailed considerable waste and that the Great Depression was evidence that it could become chronically unstable.

From the 1920s at least until the 1980s, a greater faith in the abilities and selflessness of officials and politicians persuaded most people that wise government manipulations of interest rates/money supply and taxation/spending would squeeze more out of an economy's potential output. Such policies also entailed using preferential levels of taxes and credit supply to promote particular industries and to finance social programs.

While the failing Communist experiment brought a roll-back of government activism, the policy remained strongly embedded and was reinvigorated with unfortunate results as the 2007 Global Financial Crisis unfolded.

Keynesianism and Economic Growth

The Keynesianism that dominated economic policy advice in the modern era brought an abandonment of the understandings previously held about how prosperity arises and is maintained. The Keynesian revolution cut the previous link between savings, investment and economic growth. Its approach classified investment as an expenditure no different from consumption, saving as a residual of unspent income and capital expenditure as an automatic outcome of increased demand. This relegated the association of growth with investment (and innovation and skill formation) into some long run irrelevancy.

In fact, investment is a key determinant of growth and wealth even though the relationship is imprecise and depends on the efficiency with which the economy generates savings and allocates these between investment opportunities. Reserving some portion of production from immediate consumption so that investment in capital, skills and new techniques can be undertaken is the reason why the capitalist societies came to dominate the world.

Regulatory impediments can distort this - investment can offer a poor return to economic growth when market rewards funnel a large share of the expenditure into areas of poor productivity. Only rarely does this occur in situations other than where the investment is subject to government direction or incentive mechanisms.

The importance of investment for economic growth was always recognised by the socialistic economists and systematised in planning approaches normally associated with input-output modelling of the econometrician Wassily Leontief and the Harrod-Domar model but these addressed special cases of "development economics". Their use was in planned economies where they were formalistically applied and failed to produce the anticipated growth.

The importance of policies that encourage savings and market based investment in bringing about prosperity, without conscious plans specifying savings levels and their direction to pre-determined areas of investment, has been demonstrated by sequential waves of economic success stories. The "economic miracles" in defeated Germany and Japan came on the back of freeing up markets, and an associated massive hike in national savings and productive investment. However, these countries' successes were discounted because were said to be special cases - economies that already had the basic infrastructural characteristics of the developed world on which prosperity could be built. Indeed, establishment economists argued against liberalisation. John Kenneth Galbraith wrote,

".. there never has been the slightest possibility of getting German recovery by this wholesale repeal, and it is quite possible that its reiteration has delayed German recovery. The question is not whether there must be planning– the assignment of priorities for reconstruction and rehabilitation, the allocation of materials and manpower, the supplying of incentive goods and all the rest– but whether that planning has been forthright and effective."[1]

The rise of the Newly Industrialised Countries (NICs) of Hong Kong, Taiwan, Singapore and Korea following economic liberalisation brought forth a new set of rationalisations for their success. Some argued that, as relatively small countries, the NICs were able to exploit widening trade opportunities in the west that would only be available to small niche players. Others, especially socialists, argued that there were unique conditions associated with these countries, largely due to their positions on the frontier of the Chinese and Russian Communism. What is beyond dispute is that the four NICs, having been utterly devastated economically and having never had any of the basic industrial infrastructure of the defeated Axis powers, had by the turn of the current millennium achieved living standards comparable to those of the established developed world.

That their success has been followed by similar increasingly obvious achievement by China and India, the two most populous economies in the world, has required new explanatory theories. Some argue that these countries' growth cannot be sustained; others that India's is built on fragile service provision and that China's owes much to the central direction of the Communist Party. Both explanations are easily refuted by the enduring nature of the economies' growths, while the idea that China is a centrally directed economy enjoying success leaves a vast vacuum in attempting to explain the failures of pre Deng Xiaoping Communism.

Investment Cycles

Investment comprises domestic saving plus net capital inflow. It tends to decline when residents and foreigners consider its returns are falling. Cycles of falling and rising returns have been recognised ever since economies have been studied, indeed, a severe recession hit the Roman Empire in AD 33 when investment dried up probably as a result of a trade

[1] White, Lawrence H. (2012-03-22). The Clash of Economic Ideas (pp. 232-233). Cambridge University Press. Kindle Edition.

imbalance[2]. In that case, anticipating banking practices 1900 years later, the Emperor made interest free loans to eligible banks which could pledge real estate as collateral and confidence was restored.

Financial market management became far less passive after World War I. The US government's mismanagement of the world's dominant economy led to the unsustainable boom of the roaring twenties followed by the Great Recession. With international trade falling by two thirds and mass unemployment, this was probably the most severe contraction the world has seen.

But the reasons behind the causes of the Great Depression were never universally accepted. The Keynesian revolution and its successors thought that it could have been averted by increased government spending to reignite the cycle of demand and investment and sustained growth.

Economists contesting this for the most part preferred the less direct but still activist approach, fostered by Milton Friedman, involving steady money supply growth and, where necessary, interest rate manipulations. As David Stockman points out in *The Great Deformation*, the US implementation of this policy fomented the unsustainable 1920s Wall Street boom, followed by the 1929 Crash as the policy was unwound.

Few economists were prepared to argue that the solution to resolving the imbalances caused by the credit creation during World War I and the 1920s lay in allowing the overheated economic embers to cool. Doing nothing other than reducing spending and regulation was considered too passive and ineffective in a world where government economic management had been elevated to unwarranted perceived levels of success. Steady growth (punctuated largely by energy crises) up until 2007 persuaded most people that skilful economic management by governments had made the world safe from recessions.

The Legacy of Stagnation in the First World

Even though the Global Financial Crisis is now seemingly interminable, at least among the major OECD economies, undeserved confidence remains in active government management.

Prior to 2007, the steady increase in government spending and credit creation resulted in debt-stimulated growth among the wealthier countries. This has run its course. Debt growth, high levels of unproductive government expenditure and an increased complexity of business regulations have combined to undermine the previous seemingly effortless ever-increasing growth in prosperity.

The GFC has demonstrated that even the richest developed countries cannot increase their wealth in the face of their governments' increasing seizure of the output from market

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[2]The Financial Crisis of A.D. 33: A Keynesian Depression? M. K. THORNTON AND R. L. THORNTON
http://www.jstor.org/discover/10.2307/2122822?uid=3737536&uid=2129&uid=2&uid=70&uid=4&sid=21102416835111

transactions and making those same transactions increasingly expensive through regulations.

Since 2006, the developed countries of the world have shown negligible economic growth. According to IMF data, the Euro zone countries, Japan and the UK have all grown by less than 2 per cent in the six years to 2012; the US has grown by almost five per cent (though the growth rate appears to have been recently revised downwards).

By contrast, the NICs have shown real growth of 23 per cent, and India and China a colossal 54 and 78 per cent respectively.

Unsurprisingly, the rapidly growing developing countries have much higher levels of investment than the increasingly sclerotic First World economies. Investment, in terms of shares of GDP, in the established major economies (the Euro zone, the US, UK and Japan) is at 20 per cent and less. None of this group of countries has restored the share of investment to levels that approach those pre-GFC.

The NICs, China and India have shares of investment within their economies at 26 per cent, 48 per cent and 36 per cent respectively. And all three have restored their investment shares back to pre-GFC levels. Moreover, all three not only have increased their domestic investment but have become major lenders to the established developed nations, which even with this supplement to their own savings are unable to restore their previous levels of investment.

One reason for this economic failure on the part of the First World is the ceaseless growth in the size of government and regulation. Establishing a barometer for the latter is notoriously difficult but the government share in the major developed economies ranges between 38 per cent (Japan) and 49 per cent (Euro zone). By contrast, the NICs and China get by with government spending at little more than 20 per cent of GDP and India has 28 per cent.

This data is illustrated in the table below.

Key Economic Indicators in Selected Economies

	Per cent GDP growth 2007-12	Investment per cent share of GDP 2012	Investment share ratio 2012 minus 2006	2006-12 Av Govt per cent share of GDP
Euro Area	1.8	18.7	0.86	49
Japan	1.3	20.3	0.89	38
UK	0.7	14.7	0.85	44
US	4.9	16.2	0.79	40
NICs	23.3	25.8	0.98	21
China	77.8	47.8	1.11	22
India	53.6	36	1.02	28
Australia	17.6	28.4	1.04	36

Source: IMF, World Economic database

Government spending comprises largely health, education and welfare and administration and offers less in terms of productivity gains than private sector spending.

Moreover, the productivity of aggregate government spending has been diminished over recent decades because government expenditure has exited from capital investment. Although public sector capital expenditure usually offered poor productivity, a reason why governments have privatised and out-sourced such activities, it remained expenditure with some payoff. Government's own capital expenditure has been replaced by more of the income redistribution expenditures and more intensive regulatory appraisals that offer no – indeed even negative - productive increment.

Similarly, the potency of private investment is diminished by government actions. Most obviously, these are manifest in the energy sector, where low productivity wind and solar investments are mandated across the western world. Wind turbines may have a productivity of one third that of the fossil plant required to be displaced and solar even less than this. Such energy sources account for 20 per cent of electricity supply in Spain. For energy as a whole wind and solar have been growing at 20 per cent and 60 per cent a year respectively. They now account for seven per cent of total energy use in the euro area and 10 per cent of electricity in the EU[3]. Other green-stipulated wasteful investments would include hybrid cars and mandatory energy saving features of buildings.

How do First World nations rediscover the path to growing prosperity? The answer lies with emulating the successes of the rapidly growing developing nations and the NICs by reducing the size and role of government within their economies, and lowering taxation. This is clearly proving difficult even for those governments that accept it as the only path forward. The rise of social expenditure and the regulatory barriers to business innovation, once in place, are very difficult to remove, even to reduce. And the path is made infinitely more difficult by the many voices of influence domestically, and from agencies like the IMF, counselling against "austerity", a notion that has little logic in the case of spending restraint by governments which have persistent budget deficits.

Australia, as a resource supplier to the more successful economies has fared better than other First World economies in the post 2007 GFC but with mining growth faltering this seems unlikely to last.

To see on-going growth Australia must, like other economies, emulate the successes of the rapidly growing developing nations and the NICs by reducing the size and role of government within their economies, and lowering taxation. But the Australian Governments, like that of many other countries, has failed to realise that deficit spending and loose money supply not only offer no route to recovery but actually consign their economies to greater failure. Indeed, the Rudd Government in foreshadowing spending increases on education, health and disabilities is moving Australia in the opposite direction to that needed to restore economic resilience.

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[3] http://www.energies-renouvelables.org/observ-er/html/inventaire/pdf/14e-inventaire-Chap03-3.7-UnionEuro.pdf