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Ryan Bourne: Beware these new Keynesians who claim more spending is always the answer – whatever the state of the economy

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Are British Keynesians wedded to a macroeconomic theory, or just engaged in motivated reasoning to justify ever more government stimulus?

I ask, because last week the *New Statesman's* George Eaton tweeted:

"The UK is on the brink of recession – entirely predictable given benefit cuts, tax rises and rate rises piled on top of falling real wages. Do we really have to do Keynesianism 101 again?"

As this line of thinking takes off, it's worth exploring the merits of such claims.

Economists around the world recognize that supply-shocks resulting from the pandemic and Ukraine war have created inflationary pressures by constraining the output of our economies. That means that for any given growth in overall spending, we are seeing less real output growth and more inflation.

It takes pure denial, though, to ignore how genuine excess demand has added fuel to the fire of these problems. Overly expansionary macroeconomic policies have clearly driven up the price level further, exhibited by overall spending growth rising sharply above its pre-Covid trend.

For the decade prior to the pandemic, the UK's nominal GDP (NGDP) – i.e. total spending in money terms, or aggregate demand – grew at an average rate of 3.7 per cent per year. When the pandemic hit, NGDP fell sharply as households hunkered down and were prevented from spending on things they'd usually enjoy.

The Government spent and transferred vast amounts in relief, borrowing £450 billion, to try to counteract the downturn. Combined with the enforced depression in spending from business closures, households have since scurried away £200 billion more than expected in savings.

Crucially, the Bank of England also cut its base rate to 0.1 percent and ploughed in £200 billion in quantitative easing. All fiscal and monetary levers were yanked to try to ensure a robust demand-side recovery when things reopened.

It's now clear that there was too much stimulus for too long. Not only does the latest year's worth of data show British NGDP 1.8 percent above the level we'd have seen if a pre-Covid trend had been maintained, but NGDP growth accelerated towards the back end of last year.

In 2022 Q2 it grew at an annualised rate of 10.5 percent, three times its pre-crisis trend. That sort of aggregate spending growth guarantees significantly above-target inflation.

Ultimately, the buck for this stops with the Bank of England. They have the mandate and tools to curb demand-driven inflationary pressure.

Andrew Bailey and co. can certainly throw their hands up and claim they are powerless to have prevented the oil price hikes or supply-chain disruption, but they are culpable for not having kept aggregate spending growth on an even keel (remember, monetary policy operates with a lag).

Contra Eaton, it's therefore entirely appropriate to be hitting the macroeconomic brakes with rate hikes or, yes, spending cuts.

Monetary policy is king, and you can argue that certain tax hikes may worsen supply conditions in the economy or that providing certain targeted relief is worthy given the difficulties people face.

But given the macroeconomic conditions, it's bizarre to be endorsing more fiscal and monetary stimulus as a general idea, at a time of very low unemployment and very high inflation.

Indeed, "falling real wages" are not a phenomenon that arises from nowhere. They are the result of a macroeconomic policy error that caused too much money chasing too little output, driving up the price level and short-changing people's nominal pay.

More top-down government spending risks exacerbating these pressures, forcing the Bank into the choice of sharper rate rises or letting inflation embed itself in people's expectations, making future policy tightening more damaging.

Self-declared advocates of "Keynesianism 101" should understand this. Their case for macroeconomic stabilisation policies was largely based on the concept of sticky wages.

When aggregate demand fell, they said, people's unwillingness to take cash pay cuts would prevent wages falling to price people back into work. This would create unemployment, as more people would be supplying their labour at the old wages than what firms demand.

In the Keynesian view, printing and spending money to drive up inflation is therefore a feature of stimulus, not a bug, as it allows falling real wages to do the job of ensuring a faster return to full employment.

Yet, weirdly, a lot of today's Neo-Keynesians want to simultaneously credit macroeconomic policy for us returning to very low unemployment levels, but overlook that real wages are falling partly because of the overexuberance of the policies they celebrate.

This doublethink is especially egregious in the US, where the Democratic left are dreaming up ever-more elaborate theories to explain away inflation as a distinct phenomenon.

The latest brainwave is that companies with monopoly power are responsible for rising prices.

How companies suddenly became more greedy or powerful in the past year is left unexplained, but this misdiagnosis has now entered the realm of policy. Just last week, progressives in Congress introduced new anti-price gouging laws that would empower the federal government to fine firms who significantly raise prices during emergencies.

No British politicos go that far, at least yet. But Eaton's talk of a recession risk from policy tightening and the zombie idea of a clear trade-off between inflation and unemployment could soon turn into a political argument for keeping the macroeconomic taps on.

It's important to be clear then that the aim of policy in trying to curb excess inflation should not be to reduce the overall level of aggregate demand. It should be to slow its growth to eliminate any demand-side pressures pushing inflation above two percent.

If the Bank of England slams the brakes way too hard, or tries to counteract any war-induced price pressures to get inflation right on target, we'd see wilder swings in output and employment.

The point is, there's no iron law where monetary and fiscal tightening must result in recession or more unemployment. In the US the rate of demand growth has significantly decreased, but businesses continue to add plenty of jobs. Here, the number of vacancies exceeds the number of people unemployed for the first time since records began.

Even if one was convinced that macroeconomic tightening hampers hiring, it's therefore not obvious it would cause much more unemployment, particularly if it helps quell worker's inflation expectations before they manifest into higher pay demands.

For many, though, macroeconomic stimulus is simply "good" and so the opposite must be "bad." When unemployment is high, more government spending is the answer. When inflation is eroding wage slips and unemployment is low, more government spending is the answer.

As Keynes famously did not say: "When the facts change, I find new reasons to advocate for stimulus packages."

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