

Talk to the Austin Robinson Society May 2nd 2012

Christopher Bliss christopher.bliss@nuffield.ox.ac.uk

Austin Robinson

Before embarking on the main topic of my talk I would like to say something about Austin Robinson, the dedicatee of this society. Austin was born by a few years a Victorian, and grew up an Edwardian. Several features of his vision reflect those times. Like many educated people of the period he found the dogmas of Christianity impossible to credit, while feeling Christian ethics to be an ideal. This view goes back to Mill. His young years were occluded by the horrors of the First World War, and his reading of Keynes' *Economic Consequences of the Peace* was what decided him to study Economics.

Austin Robinson was a Marshallian at a time when that species was becoming extinct. That means in particular that the firm and its organization was the subject of detailed study, where the new theories of the 1930s reduced the firm to a device for solving an elementary problem in the differential calculus. I remember being struck by Austin's detailed knowledge of industrial processes, the understanding of which one will never encounter in today's micro theorists. The largest influence on him was undoubtedly Keynes, who was his hero.

He was open and tolerant, always optimistic, and endlessly active. His work in establishing the new Economics Department in Sidgwick Avenue was invaluable, and his selfless efforts on behalf of the International Economic Association are reflected in a series of conference volumes that he edited. Yet his life was sad. The failure of his marriage to Joan was confirmed when she took up with Richard Kahn. Austin and Joan never divorced and continued to share the same house, and relations between Austin Robinson and Richard Kahn were on the surface amicable. One can only imagine the pain that Austin might have buried beneath the surface, perhaps losing himself in hard work for the sake of distraction.

Are the 1930s back?

It is evident that the British economy, and much of the world economy, is in a state of crisis worse than anything seen since the Second World War. Many recent developments evoke the 1930s. We have a high level of unemployment that refuses to submit to rapid cyclical recovery. A pattern that 1930s observers would recognize is replicated today: unemployment is higher in Scotland and Wales than in England. The depression of real incomes reduced effective demand in the 1930s, caused in that case particularly by wage cuts for civil servants and others. Today real incomes are again depressed, caused now by sluggish wage growth and high inflation. As with the 1930s, bank failures or shaky banks are to be seen in many countries. National indebtedness dominates policy. Inequality grows relentlessly. The Euro replicates some of the problems that the gold standard generated in the 1930s. The failure of the United Nations to agree on even a reprimand to Syria recalls the lack of response to the Italian invasion of Ethiopia that sank the League of Nations. The US shows signs of growing isolationism. Some commentators talk, apparently seriously, of an end to capitalism, and “anti-capitalist” demonstrators have erected their tents in several cities.

Notice however that the situation today is not the 1930s. In particular:

1. The contractions in output and employment seen so far are modest in comparison with the 1930s. Relative to 1929, real GDP in Britain fell by nearly 5% by 1931, after which it grew every year until 1938, when it was 18% higher than in 1929. Unemployment peaked at 17% in 1932, yet remained higher than its 1929 level until the war. Since 2007 the UK has seen sluggish growth and just a few quarters of contraction, with unemployment always below 10%. It should soon be confirmed that the current UK slowdown is smaller but more prolonged than the 1930s depression.
2. While regional differences in unemployment are evident both in the 1930s and today, the details are different. Scotland, Wales and the North-East suffered badly in both cases. In the 1930s London and the South-East were relatively prosperous and their labour forces relatively employed. Today, London with an

unemployment rate of 10.1%, has higher unemployment than any other UK region.

3. The depression in the US was far worse. Real GDP relative to 1929 fell every year until 1933 when it was nearly 26% lower. Not until 1936 did US GDP regain its 1929 level. Unemployment peaked in 1932 at 23%.
4. In the 1930s Britain's debt was not a great problem. Britain paid for the Great War by selling off overseas assets. This is in marked contrast to Germany whose debt, including reparations payments, was unsustainable.
5. Unlike the US, Britain in the 1930s did not experience a banking crisis, while a banking crisis is an important part of our recent troubles.
6. So far we have not seen the vigorous resort to protectionism that added greatly to the problems of the 1930s. Some protectionist sentiments, such as President Obama's unfortunate recent condemnations of outsourcing, give cause for concern. But for the time being the commitment to largely free trade remains viable.
7. In the 1930s the threat of war generated by Hitler's Nazi Party was real and powerful. Today there is no military threat to the sovereignty of Western nations.
8. Disenchantment with capitalism has revealed itself recently in street demos in London, New York, and other cities. These movements are marginal and inchoate. In so far as they reveal an ideological orientation they are left-leaning. In the 1930s the view that capitalism was finished was widespread, including articulate intellectuals, and embraced both the left and the right.

Pump Priming

A central and crucial question unites the two times, the 1930s and today. How did (will) the UK economy climb out of depression (recession)? One answer favoured by Paul Krugman among others, is that Keynesian policy is required; that is debt-financed public expenditure. A rather muddled version of this position is revealed by the UK Shadow Chancellor Ed Balls, who proposes a pump-priming push to the UK economy in the form of a temporary tax cut, say

to VAT, in order to get growth going. It is difficult to find any respectable economic theory that supports the pump priming idea.

I should add that Ed Balls does not refer to his proposal as pump priming, although as I see it no other term applies. I am sensitive to the distinction between true Keynesian policy and pump priming. As a young graduate student in the early 1960s I sat at the feet of the late great Paul Samuelson at MIT. In the US at that time there was much resistance to Keynesian ideas, and one way of sugaring the medicine for doubters was to argue that deficit-financed interventions were only a temporary pump-priming measure to get the economy going again. Samuelson, as a leading proponent of Keynesian ideas in the US, would have none of this. Government intervention was needed as long as effective demand was deficient.

A traditional 1960s-style Keynesian model says that a tax cut will expand the economy if there is spare capacity, and this means a temporary boost to growth. The old Keynesian models are far too mechanical. One does not need to be a Ricardian-equivalence nutter to conclude that temporary interventions have mainly temporary effects. If consumers know that the cut in VAT is temporary they are likely to respond in the rational manner, bringing forward expenditures, particularly on durables, into the low-VAT period, and cutting expenditures later.

This argument highlights the issue of what we should mean by *growth*. The simplest definition is the change in the logarithm of GDP from year to year. This is not a good objective of economic policy, as policies that raise it now may lower it later. A good example of this is the subsidies for scrapping old motor vehicles that were adopted in the UK and other countries. This policy surely encourages some people with old cars to bring forward their purchases of a new car. But that means more demand now and less demand later. Will that save an ailing motor vehicle industry? Probably not.

A better definition of growth is the long-term trend in the economy's productivity, when account is taken of persistent under-utilization of its factors. For most of the post-war years the real GDP of the UK economy grew at close to 2% on average, with of course substantial cyclical fluctuations. This rate of growth was lower after 1973 than before that year. The outcome under

New Labour 1997-2008 was in line with earlier post-1973 performance. Some have argued that following the 2008 banking crisis the UK has entered a period of substantially lower growth. When I mentioned this idea to a member of the Office for Budget Responsibility he said that we will know in 30 year's time.

What produces recovery?

We do not know at this time when and how the UK economy will recover and grow again. So let us look at the 1930s, where we do know what happened. British fiscal policy was strongly orthodox for most of the 1930s, with balancing the budget being the leading objective. Prior to 1931 monetary policy was driven by the commitment to the gold standard, until the link to gold was abandoned and sterling devalued. Keynes's great contribution to the policy debate, his *General Theory*, came too late to solve the problem of the depression. However the idea that the government should respond to a downturn with increased expenditure was proposed actively much earlier (*Can Lloyd George Do It?*). This was an argument that Keynes lost, at least where the British Treasury was concerned.

So the recovery was not the result of Keynesian policy. In 1931 Britain was forced to abandon the fixed gold/sterling exchange rate. This was accidentally a Keynesian policy in the sense that Keynes had strongly opposed the restoration of sterling convertibility at the pre-war exchange rate to the US dollar (*The Economic Consequences of Mr. Churchill*). The British economy was strongly export driven in the 1930s, for which reason sterling devaluation played an important role in the recovery. This contrasts with the present time, when UK exports are less important, and where the substantial devaluation of sterling after 2008 has had disappointing effects. Despite Treasury orthodoxy, Keynesian policy was eventually put to the test when rearmament was undertaken after 1936, at a cost to budget balance. This caused a small but significant fall in unemployment.

What did Keynes think about recovery from recession? He placed much emphasis on a loss of confidence that discouraged investment, a crucial driver of effective demand. His favoured fiscal policy was largely a stop-gap intervention, keeping the economy closer to full employment until confidence was restored and animal spirits took over. This approach saved Keynes from

having to worry about the long-run, when he remarked cynically “we are all dead”. In the final chapters of *The General Theory* he discusses long-run effects of high effective demand (those medieval cathedrals) as what seem to be balanced budget multiplier effects. The macroeconomics of the 1960s and 70s followed Keynes in treating fiscal policy as a counter-cyclical device. These ideas were eventually discredited when it was shown that macroeconomic fiscal policies were so frequently mistimed that they contributed little to stability.

Long-term recession and the government budget

Suppose that a recession is more than a standard transitory cyclical down-turn, but is something far more enduring. There is evidence that recessions following banking crises do last longer than other recessions. And there may be other reasons why the economy gets stuck in stagnation. How should policy respond? The ‘Keynesian’ answer is that the government should replace defective demand with higher expenditure and transfers. This type of deficit-financed intervention is additional to the built-in stabilizers that already push up the government deficit when recession arrives.

There can be little doubt that deficit-financed intervention expands the economy. By how much is uncertain and depends upon complicated issues neglected by traditional macroeconomics. These include inter-temporal planning by consumers with forward-looking expectations; the size of the multiplier in an open economy; negative feedback on investment if the interest rate is forced up; local capacity constraints in an otherwise under-employed economy; and more that you may be able to think up. A problem that I would like to bring to your attention concerns the structure of the government deficit. This takes the form:

$$\text{Net Public Sector Expenditure} + \text{Transfers} - \text{Tax Receipts} + \text{Debt Interest}$$

If the government is running a substantial deficit long-term the final term above (Debt Interest) grows over time. This means that to exert the same leverage on the economy the government must increase the deficit. The propensity to spend on UK product from interest payments is low, especially if the debt is owned by foreigners. For this reason the power of deficit-financed expenditure is constantly weakened over time. The UK is already spending

about 3% of national product on debt interest, and this number is projected to grow.

This last point is independent of the argument often repeated by the Prime Minister according to which the UK will have to borrow at higher rates unless the deficit is worked down. While this may be true, UK indebtedness compares favourably with other borrowers, notably Japan and Italy. UK debt in the form of gilts was 64% of GDP in 2011, a modest total in comparison with the immediate post-war years (when however much more of the debt was owned domestically). This calculation excludes the huge sums used to bail out banks, not counted as borrowing because the government hopes (unrealistically) to get most of this money back. If massive unfunded pension obligations are counted as debt the position is dire; but no government is honest in this regard.

One reason why 'Keynesian' policy might disappoint is that UK consumers with more pessimistic expectations are reducing debt. Private financial debt relative to financial assets is not extremely high, but expectations and confidence are what count. We have seen a marked swing from excessive confidence concerning the future to the evaporation of confidence. A notable feature of the boom years prior to the financial crisis is a gross failure of Ricardian equivalence. Seeing their government borrowing recklessly, notably in the US, consumers did not save to cover the future tax payments that would inevitably result. Instead they joined their governments at the drink today and forget tomorrow party, borrowing heavily.

Structure and the end of Macro

Why would the economy not recover rapidly from the recession? Capitalist economies are powerfully dynamic, and innovations and profit-seeking investments usually mop up unused resources. This is what happened in the 1930s. Then, while mining, fibres, and ship-building remained in the doldrums, the construction, electricity, and motor-vehicle sectors grew strongly. Today in the UK many firms are cash-rich. Their low confidence and high valuation of liquidity discourages them from investing.

Keynes in *The General Theory* gave us macroeconomics as we now know it. This sees the entire economy, its output, employment, and price level as a field on which policy operates. There are precursors of this in neoclassical monetary theory, but Keynes developed the concept. The macro view fits poorly with important features of reality. Full-employment in some regions is consistent with high unemployment elsewhere. The housing market inhibits the mobility of labour that might ameliorate this problem. This is an example of the distorted economy, one in which the various sectors that make up the national economy are unbalanced. Poorly located labour is one instance of factor supplies inappropriate to the needs of the total economy. Labour skills and experience are at least as important as location.

The UK economy faces a time when the need for recovery is evident, in a state of serious distortion. The financial sector was greatly over-expanded. There is a serious shortage of housing, especially in boom areas. Product innovation in manufacturing has been poor. Notwithstanding a 25% devaluation of sterling following the exit from the ERM, the pound is probably overvalued. Britain, which should have a comparative advantage in agriculture, runs a large trade deficit in food.

Of greatest importance is an educational system that has become dysfunctional. Schools are turning out tens of thousands of pupils lacking the most basic literacy, numeracy, and social skills essential for employment. Forever increasing examination achievements by school leavers owe too much to dumbing down of syllabuses. The massive expansion of higher education has seen too much imitation of traditional elite universities, and a grave lack of technical education that leads to employment. Graduate unemployment has increased while our plumbers are Polish.

A Policy for Growth

An endless refrain from the Shadow Chancellor Ed Balls has it that the coalition is cutting too hard too fast. It should instead have a policy for growth. No-one can dissent from the claim that more growth is needed, but how should this be achieved? Are the expenditures that the coalition is cutting (or will cut) conducive to long-run growth? It seems not. Welfare transfers, however desirable, add to demand for consumption. The retail sector has

improved its productivity faster than almost any other. Yet Britain cannot succeed by becoming a nation of shoppers. Improvements to hospitals, schools, or infrastructure are of doubtful value where growth is concerned. In recent decades billions have been shovelled into the health service and education. Health delivery has improved but higher salaries contribute little. There is no discernable improvement in educational performance, as the UK continues to slide down international comparative scales for literacy and numeracy.

What Ed Balls should be saying is that most of the present cuts are needed but that a program of growth-inducing expenditures should be substituted for some of the cuts. That would mean extra borrowing and who is to say that this would not be feasible? That is the easy part. Now comes the \$64 billion question. How can the UK government spend money to really boost long-run growth? Some possibilities will not work:

1. Picking winners never worked well
2. Reform of the banking system is essential, but some of it is antithetical to growth
3. Cutting taxes for high earners to boost growth has little empirical support
4. Reducing regulation and employment rules may be a good idea, but is it credible that this will be the gateway to higher growth?
5. Tax benefits for new employment will have limited effect while the demand for labour is depressed
6. Investment is already highly subsidised and it is mainly low confidence that holds it back

My list does not include Quantitative Easing, although it has not been as successful as some may have hoped. Its chief benefit has been the easing of balance-sheet problems at major Banks. It may also account in part for the extraordinary strength of the stock market with the economy in recession. However high company profitability plays a larger role, and given low PE ratios, the market would be higher were it not factoring in the risk of a major Eurozone disaster. While its benefits are questionable, Quantitative Easing has been horribly costly to savers. Other interventions are difficult and costly, and

have long-run consequences. The repair of the educational system will take decades, as will improvements in our disabled transport system.

Creative Destruction

The programme chosen by the Coalition is bold and its consequences uncertain. It will surely not deliver quick results. If it works it will be because it releases resources from an over-inflated public sector that the private sector will eventually pick up and put to better use. The same may happen with private employers who contract their business and release capital and labour. This is Schumpeter's creative destruction, where contraction is essential for eventual recovery. Anyone who believes that this will never work thinks that capitalism is a busted flush, a view for which there is little evidence. Capitalism has seen artificial booms and financial crises in the past, and has managed to get to its feet again. Distortion and a lack of balance have been features of the British economy for 100 years at least.

As recovery will not be rapid, there will be a General Election in 2015 with the economy seriously ill. A naïve view would say that Labour can hardly fail to return to power in those circumstances. Politics is never that simple, and Labour will need to convince the voters that it has a good strategy for curing the sick patient. I will leave the last words to Keynes – in this case from *The Economic Consequences of the Peace*:

“But who can say how much is endurable, or in what direction men will seek at last to escape from their misfortunes?”