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ECONOMIC VIEW

What Would Keynes Have Done?

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IF you were going to turn to only one economist to understand the problems facing the economy, there is little doubt that the economist would be John Maynard Keynes. Although Keynes died more than a half-century ago, his diagnosis of recessions and depressions remains the foundation of modern macroeconomics. His insights go a long way toward explaining the challenges we now confront.

According to Keynes, the root cause of economic downturns is insufficient aggregate demand. When the total demand for goods and services declines, businesses throughout the economy see their sales fall off. Lower sales induce firms to cut back production and to lay off workers. Rising unemployment and declining profits further depress demand, leading to a feedback loop with a very unhappy ending.

The situation reverses, Keynesian theory says, only when some event or policy increases aggregate demand. The problem right now is that it is hard to see where that demand might come from.

The economy's output of goods and services is traditionally divided into four components: consumption, investment, net exports and government purchases. Any expansion in demand has to come from one of these four. But in each case, strong forces are working to keep spending down.

CONSUMPTION The Conference Board reports that consumer confidence is near its record low. It is easy to understand why consumers are so scared. House values have declined, 401(k) balances have shrunk and unemployment is up. For many people, the sense of economic uncertainty is greater than they've ever experienced. When it comes to discretionary purchases, like a new home, a car, or a washing machine, wait-and-see is the most rational course.

A bit more saving is not entirely unwelcome. Many economists have long lamented the United States saving rate, which is low by international and historical standards.

For the overall economy, however, a recession is not the best time for households to start saving. Keynesian theory suggests a “paradox of thrift.” If all households try to save more, a short-run result could be lower aggregate demand and thus lower national income. Reduced incomes, in turn, could prevent households from reaching their new saving goals.

INVESTMENT In normal times, a fall in consumption could be met by an increase in investment, which includes spending by businesses on plant and equipment and by households on new homes. But several factors are keeping investment spending at bay.

The most obvious is the state of the housing market. Over the past three years, residential investment has fallen 42 percent. With house prices continuing to decline, increased building of new homes is not likely to be a source of robust demand over the next few years.

Business investment has lately been stronger than residential investment, but it is unlikely to pick up the slack in the near future. With the stock market down, interest rates on corporate bonds up and the banking system teetering on the edge, financing new business projects will not be easy.

NET EXPORTS Not long ago, it looked as if the rest of the world would save the United States economy from a deep downturn. From March 2004 to March 2008, the dollar fell 19 percent against an average of other major currencies. By increasing the price of foreign goods in the United States and reducing the price of American goods abroad, this depreciation discouraged imports and bolstered exports. Over the last three years, real net exports have increased by about $250 billion.

In the coming months, however, the situation may well go into reverse. As the United States financial crisis has spread to the rest of the world, fast-moving international capital has been looking for a safe haven. Ironically, that haven is the United States. Since March, the dollar has appreciated 19 percent, a move that will put a crimp in the export boom.

GOVERNMENT PURCHASES That leaves the government as the demander of last resort. Calls for increased infrastructure spending fit well with Keynesian theory. In principle, every dollar spent by the government could cause national income to increase by more than a dollar if it leads to a more vibrant economy and stimulates spending by consumers and companies. By all reports, that is precisely the plan that the incoming Obama administration has in mind.

The fly in the ointment — or perhaps it is more an elephant — is the long-term fiscal picture. Increased government spending may be a good short-run fix, but it would add to the budget deficit. The baby boomers are now starting to retire and claim Social Security and Medicare benefits. Any increase in the national debt will make fulfilling those unfunded promises harder in coming years.

Keynesian economists often dismiss these long-run concerns when the economy has short-run problems. “In the long run we are all dead,” Keynes famously quipped.

The longer-term problem we now face, however, may be more serious than any that Keynes ever envisioned. Passing a larger national debt to the next generation may look attractive to those without children. (Keynes himself was childless.) But the rest of us cannot feel much comfort knowing that, in the long run, when we are dead, our children and grandchildren will be dealing with our fiscal legacy.

So what is to be done? Many economists still hope the Federal Reserve will save the day.

In normal times, the Fed can bolster aggregate demand by reducing interest rates. Lower interest rates encourage households and companies to borrow and spend. They also bolster equity values and, by encouraging international capital to look elsewhere, reduce the value of the dollar in foreign-exchange markets. Spending on consumption, investment and net exports all increase.

But these are not normal times. The Fed has already cut the federal funds rate to 1 percent, close to its lower bound of zero. Some fear that our central bank is almost out of ammunition.

Fortunately, the Fed has a few secret weapons. It can set a target for longer-term interest rates. It can commit itself to keeping interest rates low for a sustained period. Most important, it can try to manage expectations and assure markets that it will do whatever it takes to avoid prolonged deflation. The Fed's decision last week to start buying mortgage debt shows its willingness to act creatively.

It is hard to say how successful monetary and fiscal policy will be in avoiding a deep downturn. But as events unfold, you can be sure that policymakers in the Fed and Treasury will be looking at them through a Keynesian lens.

In 1936, Keynes wrote, "Practical men, who believe themselves to be quite exempt from any intellectual influence, are usually the slave of some defunct economist." In 2008, no defunct economist is more prominent than Keynes himself.