Austerity: John Maynard Keynes versus the dries, an unfinished argument (Review, AFR, 29 May 2015

by Robert Skidelsky and Niall Ferguson

Ever since Britain's Conservative government took office in 2010, Keynesian advocates of government stimulus have heaped scorn on Chancellor of the Exchequer George Osborne's strategy of fiscal consolidation. As economist Robert Skidelsky and historian Niall Ferguson reveal, the argument over whether Osborne's policies have succeeded remains heated.

Niall Ferguson argues the UK economy has prospered on the wake of Conservative belt tightening after the 2010 election.

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Niall Ferguson

"If the facts change," John Maynard Keynes is supposed to have said, "I change my opinion. What do you do, sir?" It is a question his latter-day disciples should be asking themselves now.

Long before the United Kingdom's recent general election, which the Conservatives won by a margin that stunned their critics, the facts about the country's economic performance had indeed changed. Yet there is no sign of today's Keynesians changing their minds.

Did the Scottish independence issue distort the broader vote for or against management of the UK economy? First Minister and leader of the Scottish National Party Nicola Sturgeon is welcomed by activists and members of the public during the UK election campaign. Jeff J Mitchell

Because I admire him as an historian, not least for his Keynes biography, I omitted Lord Robert Skidelsky's name from my post-election commentary critiquing the contemporary Keynesian take on the UK economy.

Opprobrium was best heaped, I believed, on Paul Krugman, as he makes such a virtue of heaping it on others. Unwisely, Skidelsky has leapt to Krugman's defense.

Let me restate why the Keynesians were wrong. In the wake of the 2010 British election, Skidelsky, like Krugman, predicted that Chancellor of the Exchequer George Osborne was gravely wrong in seeking to reduce the budget deficit. In November 2010, he described Osborne as "a menace to the future of the economy" whose policies "doomed [the UK] to years of interminable recession." In July 2011, he told the Financial Times that Osborne was "making a wasteland," warning that financial markets might soon lose confidence in his policies.

In June 2012, Skidelsky argued that "since May 2010, when US and British fiscal policy diverged, the US economy has grown – albeit slowly. The British economy is currently contracting. For Keynesians, this is not surprising: By cutting its spending, the government is also cutting its income.

Austerity policies have plunged most European economies (including Britain's) into double-dip recessions." And, in May 2013, he reported that "The results of austerity had been "what any Keynesian would have expected: hardly any growth in the UK … in the last two and a half years … little reduction in public deficits, despite large spending cuts;…higher national debts… [and] prolonged unemployment."

By this time, groupthink had taken hold.

Skidelsky approvingly quoted Krugman's claim that Britain was "doing worse this time than it did during the Great Depression." More than once he echoed Krugman's assertion that Osborne had been motivated by an erroneous belief that if he did not reduce the deficit, he might forfeit investor confidence (the "confidence fairy").

Robert Skidelsky mounts the alternative view. That Conservative austerity reduced UK GDP by 2 per cent from 2010 to 2012. Bloomberg

Just a week before the UK voted this month, Skidelsky speculated that voters, "still wobbly from Osborne's medicine," might "decide that they should have stayed in bed." Instead, the Tories won an outright majority, confounding pollsters and Keynesians alike. What could possibly have gone wrong – or, rather, right?

The last-ditch argument now put forward by Krugman is that the UK electorate was fooled into voting Conservative by a one-year pre-election boom, cynically generated by a covert Keynesian stimulus. It cannot have been easy for him to abandon his cherished macroeconomic model in favour of a conspiracy theory, especially one that two decades ago lost whatever explanatory power it ever had for UK elections.

But there is an alternative explanation: the Keynesians were wrong. "Austerity" was not nearly as harmful as they predicted. Fiscal stabilisation may have contributed to a revival of confidence. In any case, nothing in modern British economic history told Osborne that he could risk running larger deficits with impunity.

There has been some sleight of hand in assessing Britain's recent economic performance. For example, Dean Baker took International Monetary Fund data for the G-7 countries' GDPs and made 2007 his base year. But a more appropriate benchmark is 2010, in the middle of which Cameron and Osborne took office. It is also worth including the latest IMF projections. And per capita GDP must surely be preferable to aggregate GDP.

No doubt, recovery in the UK began more slowly than in other G7 economies, except Italy. But there is also no doubt that the UK recovery picked up speed after 2012. Last year, its growth rate was the highest in the G7. According to the IMF, only the US economy will grow faster over the next four years, with the UK then regaining the lead.

It is wrong to assume that the UK could somehow have replicated the German or American recovery, if only Keynesian policies had been followed. The UK's position in 2010 was exceptionally bad in at least four respects, and certainly much worse than that of the US.

First, public finances were extremely weak, as a 2010 Bank for International Settlements study of trends in debt-to-GDP ratios clearly showed. The baseline scenario for the UK at that time was that, in the absence of fiscal reform, public debt would rise from 50 per cent of GDP to above 500 per cent by 2040. Only Japan was forecast to have a higher debt ratio by 2040 in the absence of reform.

Second, including financial-sector debt, non-financial business debt, and household debt the pre-crisis UK had become, under Labour governments, one of the world's most leveraged economies. In 1997, Labour's first year in power, aggregate UK debt stood at around 250 per cent of GDP. By 2007, the figure exceeded 450 per cent, compared with 290 per cent for the United States and 274 per cent for Germany. Government debt was in fact the smallest component; banks, businesses, and households each had twice as much.

Third, inflation was above the Bank of England's target. From 2000 until 2008, the inflation rate had crept upward, from below 1 per cent to 3.6 per cent. Among G7 countries, only the US rate was higher in 2008; but, whereas US inflation cratered when the crisis erupted, the UK rate remained stubbornly elevated, peaking at 4.5 per cent in 2011.

Finally, the UK was much more exposed than the US to the eurozone crisis of 2012-2013, as its principal trading partner suffered two years of negative growth.

So the real question is this: Did Osborne successfully stabilise the UK's public finances? If the Keynesians had been correct, he would undoubtedly have failed; growth would have turned negative and the fiscal/debt position would have worsened.

That is not what happened. Net government debt as a percentage of GDP had soared from 38 per cent to 69 per cent from 2007 to 2010. It rose under Osborne, too, but at a far slower pace, and is forecast to peak at 83 per cent this year, after which it will decline. By 2020, according to the IMF, only Canada and Germany will be in better fiscal health.

Stabilisation of the public debt has been achieved by a drastic reduction of the government's deficit from a peak of just under 11 per cent of GDP in 2009 to 6 per cent last year. By 2018, according to the IMF, the deficit will have all but vanished. The same story can be told of the government's structural balance, which fell from 10 per cent of GDP in 2009 to 4 per cent in 2014 and should be just 0.5 per cent in 2018.

This is an impressive performance in comparative terms. The US, for example, will still have a 4 per cent-of-GDP deficit by 2020 on either of the above measures.

To be sure, the UK did not "deleverage"; but, under Osborne, the debt explosion was contained. Among advanced economies, only Germany, Norway, and the US achieved smaller increases in aggregate public and private debt/GDP ratios from 2007 to 2014.

UK inflation was also brought under control, without the overshoot into deflation experienced by some developed countries. Osborne cannot claim direct credit for this, of course; but the choice of Mark Carney to serve as Governor of the Bank of England was unquestionably his.

Most important, no prolonged or double-dip depression occurred. Far from being worse than in the Great Depression, the economy's performance after 2010 was better than it had been in the recessions of the early 1980s and early 1990s. Indeed, the UK outstripped the other G7 economies in terms of growth last year, and its unemployment rate, which never rose as high as the rates in the US and Canada in the teeth of the crisis, currently stands at roughly half those of Italy and France.

Measured by job creation, too, UK performance was as good as the best, with employment increasing by roughly 5 per cent between 2010 and 2014. As Jeffrey Sachs has noted, the UK employment rate, now at a record-high 73 per cent, exceeds by far the US rate of 59 per cent.

The fact is that the more Keynesians like Skidelsky and Krugman talked about the "confidence fairy," the more confidence returned to UK business. One can argue about why that was, but it seems unlikely that Osborne's successful fiscal consolidation was irrelevant. There is certainly no evidence to support Krugman's repeated assertion that a country in the UK's situation – with its own currency and with debt denominated in that currency – could borrow without constraint in the aftermath of a major banking crisis. (Perhaps the Keynesians prefer to efface from their memories the mid-1970s, when Labour politicians, encouraged by Keynesian advisers, attempted to do just that.)

And the Keynesians' comparisons with the Great Depression were plainly risible from the outset. In terms of unemployment, even the recessions of the 1980s and 1990s were twice as painful.Without question, the UK has endured some real pain. From 2010 to 2015, average inflation-adjusted weekly earnings fell more than under any postwar government. But the electorate has decided that the right time to draw a conclusion about the performance of Cameron's team (now only at its likely half-way point) will be in 2020, not 2015. The good news is that since September 2014, earnings have been growing in real terms. The plunge that began under Labour took time to stop, but it is finally over.

Like Krugman (though his tone has been much less obnoxious), Lord Skidelsky has made the un-Keynesian mistake of sticking to an erroneous view in the face of changing facts. I look forward to the time when both have the intellectual honesty to admit that they were wrong – horribly wrong – about the economic consequences of Osborne's strategy.

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Robert Skidelsky

The economic historian Niall Ferguson reminds me of the late Oxford historian A.J.P. Taylor. Though Taylor maintained that he tried to tell the truth in his historical writing, he was quite ready to spin the facts for a good cause. Ferguson, too, is a wonderful historian – but equally ready to spin when he shifts into political gear.

Ferguson's cause is American neo-conservatism, coupled with a relentless aversion to Keynes and Keynesians. His latest defense of fiscal austerity came immediately after the United Kingdom's recent election, when he wrote in the Financial Times that, "Labour should blame Keynes for their defeat."

Ferguson's argument amounts to that of a brutal disciplinarian who claims vindication for his methods by pointing out that the victim is still alive. In pleading on behalf of British Chancellor of the Exchequer George Osborne, he points out that the UK economy grew by 2.6 per cent last year (the "best performing of the G7 economies"), but ignores the damage that Osborne inflicted on the economy en route to this recovery.

There is now much agreement about this damage. The Office of Budget Responsibility, the independent agency set up by Osborne to assess the government's macroeconomic performance, has just concluded that austerity reduced GDP growth by 2 per cent from 2010 to 2012, bringing the cumulative cost of austerity since 2010 to 5 per cent of GDP. Simon Wren-Lewis of Oxford University estimates that the damage might be as high as 15 per cent of GDP. In a recent poll of British economists by the Centre for Macroeconomics, two-thirds agreed that austerity had harmed the UK economy.

Moreover, Britain is not alone. In its October 2012 World Economic Outlook, the IMF admitted that, "fiscal multipliers were underestimated across the world." In plain English: the forecasters underestimated the extent of spare capacity and hence the scope for fiscal expansion to raise output.

Was it an honest mistake? Or was it because the forecasters were in thrall to economic models that implied that economies were at full employment, in which case the only result of fiscal expansion would be inflation? They now know better, and Ferguson should now know better as well.

A depressing aspect of Ferguson's interpretation is his failure to acknowledge the impact of the Great Recession on government performance and business expectations. Thus, he compares 2.6 per cent growth in 2014 with the 4.3 per cent contraction in 2009, which he describes as "the last full year of Labour government" – as though Labour policy produced the collapse in growth. Similarly, "At no point after May 2010 did [confidence] sink back to where it had been throughout the last two years of Gordon Brown's catastrophic premiership" – as though the Brown government's performance caused business confidence to collapse.

The claim that "Keynes is to blame" for Labour's election defeat is peculiarly odd. After all, the one thing Labour's leadership tried hardest to do in the campaign was to distance the party from any "taint" of Keynesianism. Perhaps Ferguson meant that it was Labour's past association with Keynes that had damned them – "their disastrous stewardship before and during the financial crisis," as he puts it.

In fact, Labour's most recent governments were determinedly non-Keynesian; monetary policy was geared to hitting a 2 per cent inflation target, and fiscal policy aimed at balancing the budget over the business cycle: standard macro-economic fare before the recession struck. The most damning charge against their stewardship is that they embraced the idea that financial markets are optimally self-regulating – a view that Keynes rejected.

Keynes was not to blame for Labour's defeat; in large part, Scotland was. The Scottish National Party's crushing victory left Labour with only one seat in the country. There are no doubt many reasons for the SNP's overwhelming triumph, but support for austerity is not one of them. (The Conservatives did as badly as Labour.)

Nicola Sturgeon, First Minister of Scotland and leader of the SNP, attacked the "cozy consensus" around fiscal consolidation in Westminster. The deficit, she rightly said, was "a symptom of economic difficulties, not just the cause of them." The SNP manifesto promised "at least an additional £140 billion ($220 billion) across the UK to invest in skills and infrastructure."

So if the SNP did so well with a "Keynesian" program of fiscal expansion, is it not arguable that Labour would have done better had it mounted a more vigorous defense of its own record in office and a more aggressive attack on Osborne's austerity policy? This is what leaders of the Labour party like Alistair Darling, Gordon Brown's Chancellor of the Exchequer, are now saying. But they seem to have had no influence on the two architects of Labour's election strategy, Ed Miliband and Ed Balls, both now removed from front-line politics.

What the Conservatives did succeed in doing, and doing brilliantly, was to persuade English people that they were only "cleaning up Labour's mess," and that, but for austerity, Britain would have "gone the way of Greece" – exactly Ferguson's view.

One might conclude that all of this is history: the voters have spoken. But it would be a mistake to accept the Conservative narrative as the last word. It is basically a tissue of propaganda, with little support in theory and destructive effects in practice.

This might not matter so much had there been a change of government. But Osborne is back as Chancellor, promising even tougher cuts over the next five years. And fiscal austerity is still the reigning doctrine in the eurozone, thanks to Germany. So the damage is set to continue. In the absence of a compelling counter-narrative, we may be fated to find out just how much pain the victims can withstand.

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