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Naive Keynesianism and Other Fallacies

One of the most frequently cited statements in economics is John Maynard Keynes' observation that "Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist."

For decades after those words were written, and extending even to the present time, Keynes was that influential defunct economist.

A landmark event in economic history was the open letter signed by 364 British economists in March 1981 protesting against the Thatcher government's (non-Keynesian) economic policies.

Its most telling paragraph read: "Present policies will deepen the recession, erode the industrial base of our economy and threaten its social and political stability."

Ironically, the economy began to recover at that very time (March 1981), and the upturn extended to mid-1990.

But it is not true that history never repeats.

Responding to finance minister Ruth Richardson's May 1991 budget which cut government spending, 15 academic economists from the University of Auckland wrote a letter to the editor of the *New Zealand Herald* on 6 June 1991.

It read: "We wish to state in the strongest possible terms our view that in the present state of the economy, and in the midst of an international recession, the deficit-cutting strategy is fatally flawed. It can only depress the economy further and because of this it will be to a considerable extent self-defeating."

In fact, strong real GDP and employment growth commenced from the time the letter was written. A 1995 article by Victoria University economists Kunhong Kim, Bob Buckle and Viv Hall dates the June quarter of 1991 as a trough in New Zealand's business cycle for GDP. Real GDP in 1995 was 17% higher than in 1991. Unemployment fell from 11% of the labour force in September 1991 to 6.1% in September 1995.

Far from being self-defeating in fiscal terms, the outcome of the budget was to turn a deficit of 2.7% of GDP in the year to June 1991 into a surplus of 0.9% of GDP by the year ended June 1994.

But some commentators still labour under the misconception that the University of Auckland economists were right.

Thus Nick Smith, in an article in *The Independent* of 4 June 2009, wrote that after the May 1991 budget, "the economy went into freefall, unemployment nearly touched 11 percent and business and household activity fell away sharply."

This is nonsense. As Chart 1 confirms, real GDP hit its lowest point precisely in the June quarter of 1991. The naïve Keynesian analysis is simply wrong. The reductions in wasteful government spending in the budget and the freeing up of the labour market with the May 1991 Employment Contracts Act combined to make the reformed economic framework more coherent and promoted confidence in the government's economic directions. A strong recovery ensued.

The article is equally mistaken on productivity. It states that "productivity measures the cost of output for labour inputs". It then acknowledges that labour productivity "did jump following Richardson's fiscal cure but only at the expense of vast swathes of the workforce." It also argues that workers became cheaper to employ than their Australian counterparts, which largely explains "New Zealand's deteriorating performance relative to Australia", and suggests that "fewer people were cranking out the same output."

This is confusion on stilts.

First, productivity is a volume measure: labour productivity is a ratio of output to labour input, for instance trays of kiwifruit harvested per man-hour. Labour costs such as wages do not come into the picture.

Secondly, the claim that the fiscal cure was at the expense of workers presumably relates to trends in wages. But, as Chart 2 shows, real average weekly earnings did not fall significantly following the 1991 labour market reforms (although archaic penalty and overtime rates were cut) and they would probably have fallen anyway during the recession, given the real wage overhang from the unsustainable wage increases of the mid-1980s.

Thirdly, between 1992 and 2000 (years ended June) New Zealand outperformed Australia for labour productivity growth, as measured by Statistics New Zealand. But this was not at the expense of employment ("fewer workers cranking out the same output"). Between June 1991 and June 1996 full-time-equivalent employment grew from 993,100 to 1,041,600, a rise of 11.6%

What should we make of all this?

Few economists would argue that in times of recession, governments should act against the so-called 'automatic stabilisers' of lower tax revenues and higher welfare payments.

But fiscal consolidation can be expansionary, as the 1991 experience showed, and it is hard to argue against cutting expenditure that doesn't represent value for money, whatever the state of the economy.

And it is certainly not the case that more government spending automatically stimulates the economy. If that were true, the massive increase in government spending in New Zealand from 2005 (up by nearly 50% in the following 5 years) would not have led to the recession that began in early 2008 and continues today.

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Chart 1: Real GDP (P) Quarterly Seasonally Adjusted

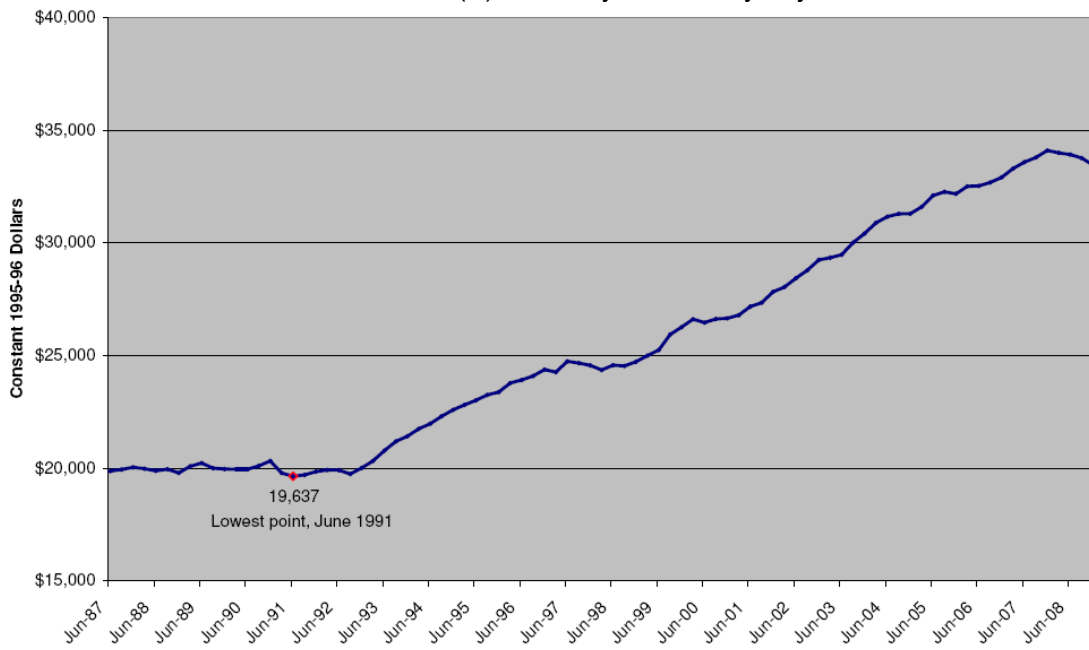


Chart 2: Real Average Weekly Earnings (full-time equivalent basis)

