Article

Public sector

Keynes versus Hayek, once again

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This Monthly Report's Dossier tackles one of the major debates in economic policy today. Eight years since the collapse of the Lehman Brothers and the start of the Great Recession the international economy is still ailing, afflicted by a harsh combination: high debt, weak growth, low inflation and fiscal and monetary policies which, after the interventions of the last few years, have now run out of leeway. The big questions are: how did we get into this situation and what can or should be done?

This Monthly Report compares the two main paradigms which, more or less implicitly, attempt to achieve intellectual supremacy and thereby influence public policy; a debate which appears to take us back to the last century's controversy

between John Maynard Keynes and Friedrich von Hayek.

The dominant paradigm, which we might summarise as Keynesian, fundamentally attributes the ills of the international economy to secular trends in non-financial phenomena such as demographic changes and technological stagnation, resulting in a chronic lack of aggregate demand in the economy. That's why this current of thought is identified with John Maynard Keynes although, at the time, the theories proposed by this great British economist were designed more for short-term situations than for phenomena that reflect an underlying trend.

The alternative paradigm, with fewer followers but growing influence, could be classified as Hayekian as, albeit with some small differences, it is in line with the ideas on economic cycles advocated years ago by economists such as Friedrich von Hayek, Irving Fisher and Hyman Minsky. From this perspective the root of the problem is financial as it is due to both monetary and fiscal policies that have led many countries to levels of public and private debt that are manifestly counterproductive.

These two schools of thought have opposing recipes for economic policy and the predominance of the Keynesian view can perhaps be put down to the political appeal of its proposals in many countries. The idea is to take advantage of low interest rates in an attempt to revive the economy via state investment in infrastructures, funding this by issuing more public debt. Some even propose this renewed expansion in public debt should not only be accompanied by accommodative monetary policy but also directly monetised by issuing currency. Not surprisingly the Hayekian view is less politically appealing as it recommends much more unpleasant tasting medicine consisting of deleveraging, restructuring debt, fiscal containment and supply reforms.

The complexity of this debate prevents us from drawing any simple conclusions and it is not easy to come down on one side or the other. Nevertheless the exceptional nature of our current economic and financial situation must serve as a benchmark for judging the two approaches in question.

Nominal interest rates for many low-risk financial assets with maturities of 10

years or longer have already been negative for a couple of quarters. This is a totally abnormal situation which had never happened before in the modern economy, let's say the last 200 years; not during the gold standard days or under the current paper currency system.

The aim of this Monthly Report is to analyse this crucial debate so that readers can judge for themselves whether this anomaly is more in line with the Keynesian paradigm and due to trends in the non-financial economy or, on the contrary, is a phenomenon more in line with the Hayekian explanation that emphasizes monetary causes and the accumulation of debt as the determining factors.

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