

Keynesianism Again

Interview with Lawrence Klein

Nobel laureate Lawrence Klein was a leading Keynesian in the 1960s. As the nation discusses tax cuts, few economists could provide a more insightful analysis of the evolution of Keynesianism over the past four decades. Professor Klein believes fiscal stimulus works, but we must balance monetary and fiscal policy for optimal results.

Q It strikes me as odd that, in the recent debate over whether we should have a tax cut, so many observers claim that only monetary policy matters. Why is that the case?

A. There are two reasons. People say monetary policy is easy and quick to implement. It can even be done overnight on the telephone, although it might take six months to feel its effect. By contrast, they say fiscal policy drags out in political and congressional debate in our country. It might take months to implement. But the point is that once fiscal policy is implemented, it might go to work much faster than monetary policy.

LAWRENCE KLEIN is Benjamin Franklin Professor of Economics Emeritus at the University of Pennsylvania.

Q. How rapidly would it go to work?

A. Because we have a withholding tax system—we put withholding in during World War II—it goes into effect almost immediately. If you reduce the withholding rates, the stimulus is immediate.

Q. In other words, if we reduce the withholding in a person's weekly paycheck?

A. Yes, once it is done, the effect comes very fast.

Q. And how quickly does it work its full effects through the economy?

A. Right now the American consumer has a marginal propensity to consume very close to one (in other words, on average, Americans spend almost all of what they make), and this has been true for some time. This is not new, it is a generational thing. So any tax cut would work its way quickly through the economy because people spend it. There would be a delay of only a few weeks.

Q. Obviously, the Keynesian revolution was at its height, at least in universities, in the 1960s. Has your view of its efficacy been changed to any degree by circumstances in the 1970s and 1980s?

A. I think the Kennedy-Johnson tax cut was a marvelous success in 1964. It was too bad it was not implemented a little sooner, and Kennedy died, of course. After that, Johnson dallied for a while about raising taxes to pay for the war in Vietnam. The stimulus did not get reversed until the tax increase and expenditure cap of 1969, and that had a quick effect once it was enacted. As you know, we had a recession in 1969–1970.

Q. But Keynesianism seemed to founder as inflation rose in the 1970s.

A. There are many reasons there was higher inflation in the 1970s. But that is a complicated story that deals with much more

than tax policies. The next big change, in terms of taxes, was Ronald Reagan's tax cut. He openly advocated duplicating what Kennedy had done. But he said lowering marginal rates on taxes will actually increase tax collection. Needless to say, that did not work out. Instead, he increased the deficit because he lowered tax rates and invested in Star Wars [the Strategic Defense Initiative] at the same time.

Q. Explain that a little further.

A. It was borrow and spend on a huge scale.

Q. In other words, it was too much fiscal stimulus.

A. Yes, it was too much. It was the most massive Keynesian stimulus ever in peacetime.

Q. Going back to the 1970s, Keynesian stimulus was widely regarded as one of the sources of inflation.

A. Balancing fiscal and monetary policies is a problem. If you do just one thing, it is not necessarily enough—neither monetary policy alone nor fiscal policy alone, and neither tax cuts nor expenditure increases alone. You need to mix policy. By having the right balance, you can get high employment and stable prices.

Q. But back in the 1960s Keynesians did not talk very much about monetary policy, or am I wrong?

A. Keynes himself was very much interested in monetary policy. He was a specialist all his life in the theory of money and interest rates. But this approach fell out of fashion and people concentrated on fiscal policy. Then, when monetary policy came back into fashion, people concentrated on the money supply and other monetary aggregates, such as M1 and M2, rather than interest rates, but that was not the way to go about it. Fortunately, I think interest rate policy is more effective now. Federal Reserve chairman Paul Volcker essentially eliminated M1 as a target in-

dicator. His successor, Alan Greenspan, eliminated M2. On the other hand, in the past year or two, Greenspan has said on various occasions that maybe we should reconsider using M2. The trouble is that all these measures of money cannot be relied on because the velocity of money changes. It is quite unstable.

Q. You mean the ratio nominal gross domestic product (GDP) divided by the amount of money is unstable over time?

A. Yes, that relationship is very unstable. Banking practice has undergone a fundamental technological revolution.

Q Why did fiscal policy lose so much credibility in the 1970s?

A. Because it became caught up in political arguments. In the first place, there was a movement toward less government. Politicians are saying that too much government is the cause of our problems, so the public-spending side of fiscal policy has become a no-no, except when you really need it.

Q. Let me again return to this issue. Do not some people say that fiscal policy tends to be undermined because it becomes inflationary?

A. As I mentioned, it does not have to be. When Kennedy and Johnson first had the tax cut, it worked very well. Then came the Vietnam War. We had instability of inflation, but that was because President Johnson did not want to pay for the war in Vietnam. He did so very reluctantly in 1969, when he said he would not run again. But it was too late.

Q. In sum, you believe that people are dubious about fiscal policy, first, because there is an anti-government attitude and, second, because they believe it just takes too long to implement? But there is a group of economists who argue that even when it is implemented, it will not have an effect. When the government borrows the money it spends, it is simply, in effect, a transfer from consumers to creditors.

A. Maybe, but it seems that ineffectiveness is hardly possible. When we have seen the tax cuts that President Reagan, for example, finally implemented, they had a huge effect.

Q. So you would argue that the real business cycle school and the expectations school people are wrong?

A. Oh, those guys. They do not understand how the economy works, that is all I have to say.

I believe that monetary policy has a chronic defect. It is asymmetric—it works better in restraining an economy than in stimulating an economy.

Q. Let us return to current conditions. You believe that we do need some fiscal stimulus right now.

A. Yes. And I argue that we would not have achieved the enormous goal of transforming the chronic deficits into balance and then into surplus in the 1990s if we had not had a mixture of both fiscal and monetary policies.

Q. Let us go through that.

A. After the Gulf War in the early 1990s, there was considerable euphoria, and the price of oil started coming down once we got the Kuwait reserves back into the system. But it turned out that the economy did not respond very well. We went to very high unemployment and stayed there. It was, in fact, a jobless recovery. Even though Greenspan tried to push rates down, it was a weak expansion. I believe that monetary policy has a chronic defect. It is asymmetric—it works better in restraining an economy than in stimulating an economy.

Q. Why is that?

A. You can lead a horse to water, but you cannot make him drink. Or monetary policy is pulling on a string when the economy is strong. That works. But when the economy is weak and you are cutting interest rates, it can be like pushing on a string. It does not work as well.

Q. Let us try to use an example to clarify that.

A. The example is 1992. The Federal Reserve kept using monetary policy. It got the federal funds rate down, and it kept pushing down short-term rates, but it did not get long-term rates down. In 1990 the thirty-year Treasury bond had an 8.6 percent yield. In 1991, it was 8.1. In 1992 it was 7.7, only a small decline. The big decline did not come until 1993, when the long rate fell to 6.6 percent.

Q. What happened then?

A. We had the combination of fiscal and monetary policy that was just the thing for the moment. We cut back on military spending. Other nondefense spending, excluding transfer payments such as social security, also fell.

Q. So what you are saying is that interest rates did not come down until there was a contraction in fiscal stimulus.

A. Until the suggestions of two successive chairmen of the Federal Reserve, Volcker and Greenspan. They said publicly: If you—meaning Congress—get the deficits down, we will do our part at the Federal Reserve by accommodating it.

Q. So what did the Fed do in this period when rates came down in 1993?

A. It just let the market-based long rates fall, although it was still worried about inflation, and did not cut the federal funds rate significantly.

Q You say that cutting rates is not necessarily stimulative, but it certainly worked in 1987 to keep us from collapsing.

A. It kept the stock market from falling apart.

Q. So in that sense it had a stimulative effect, did it not?

A. It had a stabilizing effect. Let me tell you about 1987. I went to the dinner meeting in which Greenspan was proposed and Volcker stepped down. That was in August 1987. Greenspan wanted to show that he was an inflation fighter, and he raised rates in August or September. Then the market crashed in October, and Alan really did the right thing. He went public and said legitimate borrowers can come to the discount window and be accommodated. They were invited. And short-term rates fell. Now, when the stock market collapsed in 1987 people said the wealth effect would kick in and consumption would fall apart. But they forgot to take into account that part of the wealth is in bonds as well as in equities, and the value of bonds went up. Greenspan then held the discount rate down and invited borrowers to the window. So there was an improvement in wealth from the side of debt securities and a deterioration in wealth from the equity side, and very little change in spending. And the economy did not go into recession. Monetary policy can be stabilizing at times. I am not saying that it isn't. What I am saying is that monetary policy cannot do everything. It cannot do the whole job.

Q Right now, are you concerned that we could slide into recession?

A. Yes, I am. I think that we need some insurance. I think it is unfortunate that fiscal stimulus now is tied up with fiscal reform in this huge \$1.6 trillion package. If we concentrated on stabilizing the economy and having the debate about tax reform later, it would be healthier for the economy.

Q. What kind of tax cut would work to stimulate . . . ?

A. Across-the-board cuts in marginal rates.

Q. Across-the-board reduction of rates? But that would be a long-term tax cut by definition, right?

A. That could be in the long term. But the estate tax should not be put in now, nor should the marriage penalty. You should not put other items in the package—just cut the rates and get the money in people's hands.

Q. Is there a way of cutting rates temporarily?

A. Sure, you could do that.

Q. How would that work?

A. Congress could legislate it.

Q. You mean we would have a one-year reduction in marginal rates?

A. Exactly. But that might not be as stimulative because it would affect expectations.

Q. Has that ever been done?

A. I think there have been some temporary cases. There have been some surcharges, for example.

Q. How much stimulus do you think we need on an annual basis?

A. I think around \$150 billion net injection. Then you could reverse that, or you could change interest rates after the economy got going. There are many options for policy combinations afterward.

Q. Would that have a multiplier effect on the economy as it works its way through on GDP?

A. I think the multiplier would start at about $1\frac{1}{4}$, $1\frac{1}{2}$, and work its way up to 2 in two or three years.

Q. In other words, a \$150 billion tax injection of money into consumers' hands, so to speak, would eventually add \$300 billion to GDP with a multiplier of 2?

A. Yes, in a year or two as it worked its way through the economy.

Q Are there people who believe there is no longer any multiplier effect?

A. Well, they often say that. I do not know if they mean there is no long-run multiplier. But I do not think they have any evidence that there is no immediate impact. There is some evidence that if you have a sustained change, say a sustained reduction in taxes, it would have a humped, parabolic-arc pattern. It would rise up to that value of 2 and then start declining. Now, where the debate arises is whether it declines toward zero or below zero. The crowding-out hypothesis would say it would eventually go below zero.

Q. The crowding-out hypothesis meaning that the government would have to borrow to finance it.

A. Yes, and it would crowd out private spending.

Q. And that is probably the main criticism of Keynesianism, is it not?

A. Yes. And that is why we need some monetary policy, too—if you want to soften the crowding-out effect.

Q. Is that your main reaction to the crowding-out criticism?

A. Sure.

Q Let me ask you one last thing about the tax cut debate. It seems that many people both inside and outside the Bush administration argue that the real benefit of cutting marginal rates is that they create incentives to work, save, and invest. What is your response to that?

A. There is no evidence on that. Those people do not do their empirical homework. We ran dozens and dozens of simulations with the data of the economy in the early 1980s with the Reagan tax proposals, and we found no evidence.

Q. You mean people did not work more due to tax cuts?

A. They did not work harder or with greater effort.

Q. Well, certainly to an economist, it would make sense that if you take home a little more money, you might work a little harder.

A. What brought the venture capitalists to Silicon Valley was not changes in the tax laws. We still have the capital gains taxes, we still have options, and people pay taxes on their options. One thing that probably did help was 401(k) plans. By having those kinds of retirement benefits in the tax system, we saw an enormous flow of funds into equity capital, and that financed a lot. They promote venture capital. I noticed that when the capital gains tax was reduced, activity in the small cap stocks increased.

Q. In the 1970s?

A. Yes.

Q. So you think that reductions in capital gains taxes can have some positive impact?

A. They can. But they also have a very big effect on income distribution. They have a lot of social consequences.

Q. Is this tax cut that Bush is proposing weighted too far toward the rich? If we want a stimulative tax cut, why should we weight it so far toward the wealthy, who tend to save their income?

A. It was not put forward as a stimulant. It was put forward as the kind of tax cut that his party likes and that he likes. But then economic growth slowed. He saw that he could make political progress by saying the economy needs it anyway. So he is arguing for the tax system as a stabilizing factor or as a jump-start factor, as well as a reform factor.

Q. What about Japan? Can Keynesianism save Japan?

A. Yes, the bubble burst in Japan in December 1989. If you

look at the statistics of the Japanese economy around 1995–1997, it had a couple of years of 2–3 percent growth. That was the Keynesian influence of the then-head of the Economic Planning Agency. He was a good Japanese exponent of Keynesianism. Japan built beautiful bridges and other infrastructure, but abandoned these sorts of projects because its debt is so big, and its deficit is so big, that it will not do them anymore.

Q. So what undermines Keynesianism, at least in Japan, is this high level of debt? Do you think this is correct?

A. No. I think Japan could stand a really good Keynesian sustained stimulus.

Q. With accommodative monetary policy?

A. Of course, at the beginning, and then it does not have to stay accommodative forever. To repeat, the main point is that we must find a balance of monetary and fiscal policies.

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