Schumpeter *and* Keynes

By Joachim Starbatty and Jürgen Stark

Secular stagnation as seen by the Austrian school.

Economists and politicians have long discussed the danger of a prolonged period of very weak economic growth. They see this kind of "secular stagnation" as a particular threat in Europe and Japan due to their rapidly aging and shrinking populations.

The fact is that growth of the world economy, and above all economic growth in Western countries, is lagging behind pre-crisis growth rates. The same applies to the U.S. economy, which was averaging 3–3.5 percent annual growth until 2007, but which has seen much lower rates since then. Growth in the euro area is also weaker than before the crisis at slightly over 1.5 percent, and Japan's economy has been stagnant for many years now.

This may be surprising given the extremely expansionary macroeconomic policy. Eight years after the Western financial system crisis broke out and more than six years after the escalation of the sovereign debt crisis in the euro area, central bank interest rates are at a historically low level of around zero percent—or even in negative territory. At the same time, public budget deficits are still considerably high in Western countries, and public debt levels the highest seen in peacetime.

The majority of the economic establishment, supported by international institutions such as the International Monetary Fund and the OECD, sees the cause of weaker growth rates as insufficient aggregate demand. For instance, the International Monetary Fund's October 2016 *World Economic Outlook* was entitled "Subdued Demand: Symptoms and Remedies." The central banks' ultra-loose monetary policy is set to continue, supplemented by additional fiscal stimulus. The European Commission

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is supporting this by calling for the use of the fiscal space it sees in certain EU member states.

American economists Lawrence Summers and Paul Krugman are particular proponents of this "new" theory of secular stagnation. The theory originates from the doyen of American Keynesianism, Alvin Hansen, who diagnosed the threat of an enduring period of economic stagnation, or secular stagnation, in the United States following the Great Depression at the end of the 1930s. He argued that the solution was to stimulate demand by way of government investment through higher public budget deficits and increased debt.

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Summers and Krugman are currently calling for the ultra-loose monetary policy to be continued even after economic recovery begins, in order to stimulate inflationary expectations and thereby reach a higher rate of inflation. This should also serve to reduce real interest rates further. They say that the equilibrium real interest rate has already been negative for some time, but because of low inflation, not yet negative enough to generate higher aggregate demand. In a situation like the present one, the central bank needs to "credibly promise to be irresponsible," as Krugman put it back in 1988.

"CREATIVE DESTRUCTION"—A REQUIREMENT FOR SUSTAINABLE GROWTH

It is precisely this irresponsibility of the central banks and constant bolstering of aggregate demand via government debt that caused the ongoing stagnation in the eyes of Joseph Schumpeter, the polar opposite economist to John Maynard Keynes in the twentieth century. In his "Theory of Economic Development" (1912), Schumpeter first of all established the principles underlying bubble formation: many things float on the wave of a prolonged period of prosperity without a driving force of their own, and if speculative anticipation acquires a causal significance, the symptoms of prosperity themselves finally become, in the well-known manner, a factor of prosperity. In other words, the whole world invests or buys companies or shares in companies without checking closely whether it is worth it in the long term, according to his theory.

What Schumpeter means is that these exaggerations cause undesirable developments in the macroeconomic production structure. In the event of an unavoidable economic demise, such misinvestments would have to be eliminated from the production process. He says that the unharnessed production factors are raw materials for subsequent periods of prosperity, which are primarily driven by product and process innovations. This selection process is of course perceived as painful, because values and wealth are destroyed and unemployment created, but it would be wrong to overlook the positive effects associated with it, according to Schumpeter. He later described this period as "creative destruction."

A policy aimed at hampering this process with "the cheapest money" and government demand stimulus in the hope of such weakness being eliminated in an economic upturn assumes that the existing production structure can also meet future needs. However, this is the main misconception—a policy that aims to rescue the viable as well as preserve the unviable prevents a national economy from moving towards a sustainable growth path.

This is exactly what has happened following the bursting of various bubbles since the beginning of this century. In the short term, the necessary national economic adjustments have been prevented by ever-lower interest rates, more liquidity, and increasing public debt.

KEYNES' RICARDIAN VICE

It is easy to imagine from the outlined interpretation of boom and bust how Schumpeter reacted to the publication of John Maynard Keynes' "The General Theory of Employment, Interest and Money" (1936). It is not widely known that Schumpeter initially (in 1936) considered Keynes' "General Theory" to be an intelligent effort but not a work that could free the world from the scourge of unemployment. He wrote that Keynes aimed to challenge his contemporaries to discussion, but that it wasn't easy to

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accept this invitation because he pleads everywhere for a definite policy, and on every page the ghost of that policy looks over the shoulder of the analyst, frames his assumptions, and guides his pen. In other words, Schumpeter said that Keynes' policy recommendations were not based on his theory, but that he had sought a fitting theory for his policy recommendations. He said that Keynes' recommendations may be suitable for England, but that this was no "general theory."

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We would like to take a close look at Keynes' methodological approach, as this point is the focus of current discussion and policy. Schumpeter accused Keynes of Ricardian vice, that is, retreating into a hypothetical structure, accumulating assumptions, constructing constant relationships between them, and then drawing political conclusions from them. It is remarkable that Keynes accused Ricardo of the same, of creating a hypothetical world void of experience, as if it were the real world, in order to permanently live in it. In so doing, Keynes reverted to his criticism of the Ricardian method in his 1933 essay on Robert Malthus, stating that it was Ricardo's more fascinating intellectual construction rather than that of Malthus that "constrained the subject for a full hundred years in an artificial groove" by turning its back on Malthus' idea of "effective demand." And Keynes considered himself the economist who would push the train back onto the right track. Schumpeter in turn said of Keynes that he set the course in the wrong direction, as the method of his "General Theory" was just as Ricardian in spirit and intention. "The same method is used of skirting problems by means of artificial definitions which, tied up with highly specialized assumptions, produce paradoxical-looking tautologies." He said that Keynes' central assumptions, "marginal propensity to consume," "liquidity preference," and "marginal efficiency of capital" would inevitably lead to the assumption of long-term unemployment. Schumpeter wrote in 1936 that this discovery has no greater practical importance "than a proof that motor cars cannot run in the absence of fuel."

In particular, Keynes' determination of lacking profitability of future investments went against the grain for Schumpeter, as there was not a single line of reasoning for this in "General Theory." Monetary and financial policy based on Keynes clearly assumes that there are now and will be in the future too few profitable investments. This kind of assumption would have appeared absurd to Schumpeter. His response to contemporary economists would be that precisely because they are halting the recovery process, they are preventing a process of creative destruction which forms the basis for any sustainable economic growth.

The Japanese economy is a prime example of this. The Bank of Japan's cheap money policy has enabled banks to keep zombie companies alive through liquidity injections until lacking profits cause them to become zombie banks themselves, reliant on the central bank's drip feed. Moreover, government debt has risen from around 60 percent of GDP in 1989 to a current 250 percent, without the Japanese economy being able to return to a sustainable growth path.

IRRESPONSIBLE MONETARY POLICY

This example shows that the Summers-Krugman formula is a cause for concern. Interest rates the world over are already too low according to the Bank for International Settlements—the central bank of central banks—in Basel.

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But even so, European central banks and the Bank of Japan introduced negative interest rates on bank deposits. This happened at the same time as the creation of ever more liquidity, quantitative easing of monetary policy via purchases of government and corporate bonds, and in the case of Japan, the purchase of shares. Deposits with central banks are intended to become unattractive. Banks are to be pushed to grant loans and assume higher risks. However, if banks were to follow the intentions of the central banks, this behavior could not be guaranteed and would also be highly risky. Because negative interest rates affect the banks' earning power, they can react by granting fewer loans. So the whole thing would be rather counterproductive. At the same time, negative interest rates are gradually becoming interwoven and are affecting customers. It is increasingly evident that the traditional saver is sustaining considerable real losses.

A further market intervention by the central bank or governments may be impending to prevent evasion attempts such as hoarding cash, and to aid the supposed effectiveness of monetary policy: limiting cash transactions or even eliminating cash altogether, as American economists declare. Or we remember the option of "helicopter money," whereby the central bank distributes money to individuals in order to boost consumption. Economist Milton Friedman's thought experiment aimed at demonstrating the effect of money highlights the extent to which the central bank should get involved, and takes monetary policy to the absurd.

Interventions of this kind gradually undermine the credibility of the central bank. Trust is lost because the effectiveness of measures is questioned, and the "unintended consequences" of this policy—to which the Bank for International Settlements has been referring for several years now—are increasingly recognizable. The central bank policy causes financial instabilities and new market excesses, as the interest rate has lost its steering and signal function. Central bank policy is no longer part of the solution but is becoming part of the problem. The economy is at threat of zombification. Necessary corrections to bank and company balance sheets are being delayed, unproductive companies are remaining on the market, and banks without sufficient capital or sustainable business models continue to exist. All of this means a considerable economic burden and causes a significant decline in productivity.

REFORM AGENDA

The macroeconomic production structure needs to be corrected to enable sustainable growth. Overcapacities stemming from before the crisis and excessive debt need to be decreased in order to release productive forces.

The euro area countries and Japan have long reform agendas, and little on them has been implemented thus far. This is also because central bank intervention has lifted the pressure to reform from the governments.

The reforms needed naturally differ from country to country. The priority in many European countries is restructuring of the banking sector. The familiar problems have been allowed to slide for too long. The banking systems now need to be quickly consolidated and restructured. Bad loans need to be outsourced, and banks—where necessary—recapitalized. National economies need to gain flexibility in order to reduce structural imbalances and increase production potential. Investment in education and vocational training, in research and development, and in infrastructure are key policy areas. Budget policy is in need of credible consolidation strategies to guarantee the long-term sustainability of public finances and regain trust in the solidity of government finances. This is not least necessary in order to confront impending sovereign insolvencies in a more normal interest rate environment.

Secular trends are clear, particularly demographic change with an aging and shrinking population. However, these do not in themselves pose the risk of secular stagnation. These trends have blended together with the consequences of the systemic financial and debt crises, and it only makes sense to tackle this matter via the supply side.

NO MORE KEYNES

The Keynesian formula is not part of the solution to the problems; it is only aimed at short-term effects. In the medium term, it leads to new excesses and exacerbates crises developing in public finance and the negative consequences of the currently excessively loose monetary policy. It is time for economists to emancipate themselves from Keynes and his disciples and turn their gaze towards the Austrian School and reflect on the insights of its most important representatives: Carl Menger, Eugen von Böhm-Bawerk, Joseph Schumpeter, Ludwig von Mises, and Friedrich August von Hayek.

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We will therefore leave the last word to Ludwig von Mises: "The task of economics is to foretell the remoter effects, and so to allow us to avoid such acts as attempt to remedy a present ill by sowing the seeds of a much greater ill for the future." ◆