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Policy vacuum

Politicians in the US and the EU remain bewildered by the phenomenon of slowing economic growth. Solutions have therefore simplistically polarised into opposing ideologies about the role of government spending. The split mirrors the conflict between Keynesian and neo-classical economists about (a) the re-balancing mechanisms that operate in an economy; and (b) the effectiveness of government in influencing those mechanisms. Underlying the debate are two theoretical issues: Can the future be quantified in terms of probabilities, or not? And, is the government exogenous to the system, or not? The Keynesian (fiscalist) view is that the future is so uncertain – and people so naturally cautious – that the economy will not spontaneously gravitate towards full employment equilibrium, and will also over-respond to negative exogenous shocks. This is the central case for government intervention. The neo-classical (monetarist) view is that risk can be quantified and priced, and that – providing that markets are efficient, information is perfect, and participants adhere to rational expectations – the economy will be drawn towards its ‘natural’ rate of unemployment. This is the central case for minimum levels of government intervention.

In terms of psychology, Keynes’s view is more realistic than that of neo-classical economists. Indeed, the neo-classical approach seems to confuse simplifying assumptions about reality with reality itself. There is, however, a fundamental flaw in both stances. This is the assumption that people ‘normally’ make their decisions independently of one another. They do not. Neuroscience confirms that we are ‘Janus-faced’: we are self-assertive, but we also integrate into larger wholes. We therefore (a) depend on the observed behaviour of others to provide information that we cannot access directly ourselves (which counters Keynes’s subjective uncertainty), and (b) absorb, and are stimulated by, the beliefs and emotions generated by others (which counters the neo-classical presumption of objective risk). The former allows ‘rational’ individual decisions; the latter ensures that these decisions are nevertheless formed within the ‘non-rational’ environment of collective beliefs and moods.

It follows from this that government spending can be a powerful influence on individual decisions and on collective beliefs. However, this is not the same as saying that government is truly an independent agency. Politicians are affected by the general mood: they buy votes by increasing spending during boom conditions ‘because it can be afforded’, and raise taxes during difficult times ‘to share the burden’. This ignores feedback into individual and collective psychology. Large changes in spending and taxes over short periods of time can be profoundly de-stabilising, whereas gradual changes over long periods can facilitate rational decision-taking without overtly exciting non-rational expectations.

The 2008 financial panic was not an exogenous event. It arose from the correlated decisions of people whose mood was influenced by rapidly-rising government spending and lax credit policies. It was an energy gap in the system (*Commentary*, No. 162), which reversed the system’s polarity from growth to contraction. The purpose of such a gap is to cleanse the system of excesses and, once it manifests, almost the only thing that government can do is ensure that the process does not get out of hand. This involves drawing a distinction between a misallocation of resources and the underutilisation of resources. Policy should certainly ensure that a 1930s-type financial implosion does not occur, but there is no presupposition that an extra fiscal stimulus is required. In 2008, left-leaning US and EU governments were unable to make the distinction: the banking system was supported (which ended the panic), but spending was increased (which generated fears of higher taxes, higher inflation, and debt insolvency). Increased public sector spending is being offset by higher private sector savings.

Collective behaviour and semi-dependent public sector spending are sources of systemic risk. Their potential for de-stabilising the economy and financial markets needs to be included properly both in economic theory and in policy-making. In the meantime, the global economy is reversing from an unsustainable extreme, and ‘normal’ policy tools are not working. We are in an era of change.

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