Richard Layard explains the Manifesto for Economic Sense

Thousands of economists disagree with the austerity policies being followed in so many countries. Yet few speak out and I am one of the guilty ones. That is why Paul Krugman and I have now written a 'Manifesto for Economic Sense' which is reprinted below. We hope this will be signed by thousands of economists. More importantly, we hope that they will use the arguments in the Manifesto to engage in vigorous debate worldwide about how to emerge from the current stagnation.

As the Manifesto explains, the stagnation is not due to fiscal deficits. It's the other way round: the deficits are due to the stagnation. Fiscal contraction to reduce those deficits can only slow down the recovery. The view that it will 'restore confidence' was never plausible in the light of history and its emptiness once again stares us in the face.

So we hope that as many LSE graduates as possible will sign our Manifesto at www.manifestoforeconomicsense.org and please proclaim its arguments from the housetops.

A Manifesto for Economic Sense

More than four years after the financial crisis began, the world's major advanced economies remain deeply depressed, in a scene all too reminiscent of the 1930s. And the reason is simple: we are relying on the same ideas that governed policy in the 1930s. These ideas, long since disproved, involve profound errors both about the causes of the crisis, its nature, and the appropriate response.

These errors have taken deep root in public consciousness and provide the public support for the excessive austerity of current fiscal policies in many countries. So the time is ripe for a Manifesto in which mainstream economists offer the public a more evidence-based analysis of our problems.

- **The causes.** Many policy makers insist that the crisis was caused by irresponsible public borrowing. With very few exceptions – other than Greece – this is false. Instead, the conditions for crisis were created by excessive private sector borrowing and lending, including by over-leveraged banks. The collapse of this bubble led to massive falls in output and thus in tax revenue. So the large government deficits we see today are a consequence of the crisis, not its cause.
- **The nature of the crisis.** When real estate bubbles on both sides of the Atlantic burst, many parts of the private sector slashed spending in an attempt to pay down past debts. This was a rational response on the part of individuals, but – just like the similar response of debtors in the 1930s – it has proved collectively self-defeating, because one person's spending is another person's income. The result of the spending collapse has been an economic depression that has worsened the public debt.
- **The appropriate response.** At a time when the private sector is engaged in a collective effort to spend less, public policy should act as a stabilizing force, attempting to sustain spending. At the very least we should not be making things worse by big cuts in government spending or big increases in tax rates on ordinary people. Unfortunately, that's exactly what many governments are now doing.
- **The big mistake.** After responding well in the first, acute phase of the economic crisis, conventional policy wisdom took a wrong turn – focusing on government deficits, which are mainly the result of a crisis-induced plunge in revenue, and arguing that the public sector should attempt to reduce its debts in tandem with the private sector. As a result, instead of playing a stabilizing role, fiscal policy has ended up reinforcing the dampening effects of private-sector spending cuts.

In the face of a less severe shock, monetary policy could take up the slack. But with interest rates close to zero, monetary policy – while it should do all it can – cannot do the whole job. There must of course be a medium-term plan for reducing the government deficit. But if this is too front-loaded it can easily be self-defeating by aborting the recovery. A key priority now is to reduce unemployment, before it becomes endemic, making recovery and future deficit reduction even more difficult.

How do those who support present policies answer the argument we have just made? They use two quite different arguments in support of their case.

The confidence argument. Their first argument is that government deficits will raise interest rates and thus prevent recovery. By contrast, they argue, austerity will increase confidence and thus encourage recovery.

But there is no evidence at all in favour of this argument. First, despite exceptionally high deficits, interest rates today are unprecedentedly low in all major countries where there is a normally functioning central bank. This is true even in Japan where the government debt now exceeds 200% of annual GDP; and past downgrades by the rating agencies here have had no effect on Japanese interest rates. Interest rates are only high in some Euro countries, because the ECB is not allowed to act as lender of last resort to the government. Elsewhere the central bank can always, if needed, fund the deficit, leaving the bond market unaffected.

Moreover past experience includes no relevant case where budget cuts have actually generated increased economic activity. The IMF has studied 173 cases of budget cuts in individual countries and found that the consistent result is economic contraction. In the handful of cases in which fiscal consolidation was followed by growth, the main channels were a currency depreciation against a strong world market, not a current possibility. The lesson of the IMF's study is clear – budget cuts retard recovery. And that is what is happening now – the countries with the biggest budget cuts have experienced the biggest falls in output.

For the truth is, as we can now see, that budget cuts do not inspire business confidence. Companies will only invest when they can foresee enough customers with enough income to spend. Austerity discourages investment.

So there is massive evidence against the confidence argument; all the alleged evidence in favor of the doctrine has evaporated on closer examination.

The structural argument. A second argument against expanding demand is that output is in fact constrained on the supply side – by structural imbalances. If this theory were right, however, at least some parts of our economies ought to be at full stretch, and so should some occupations. But in most countries that is just not the case. Every major sector of our economies is struggling, and every occupation has higher unemployment than usual. So the problem must be a general lack of spending and demand.

In the 1930s the same structural argument was used against proactive spending policies in the U.S. But as spending rose between 1940 and 1942, output rose by 20%. So the problem in the 1930s, as now, was a shortage of demand not of supply.

As a result of their mistaken ideas, many Western policy-makers are inflicting massive suffering on their peoples. But the ideas they espouse about how to handle recessions were rejected by nearly all economists after the disasters of the 1930s, and for the following forty years or so the West enjoyed an unparalleled period of economic stability and low unemployment. It is tragic that in recent years the old ideas have again taken root. But we can no longer accept a situation where mistaken fears of higher interest rates weigh more highly with policy-makers than the horrors of mass unemployment.

Better policies will differ between countries and need detailed debate. But they must be based on a correct analysis of the problem. We therefore urge all economists and others who agree with the broad thrust of this Manifesto to register their agreement at www.manifestoforeconomicsense.org, and to publically argue the case for a sounder approach. The whole world suffers when men and women are silent about what they know is wrong.

Note: This article gives the views of the author, and not the position of the British Politics and Policy blog, nor of the London School of Economics. Please read our comments policy before posting.

About the author

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