11 "THE FAILURE OF MARKET FAILURE"

On either side of the Global Financial Crisis of 2008, two of Britain's leading economic commentators each published an article titled "The Failure of Market Failure." The economist John Kay went first, arguing in August 2007 that invocation of market failure to legitimize state intervention "concedes too much to market fundamentalists."[1] By accepting the notion that markets can be complete and efficient – that it is imaginable that markets succeed in delivering a social optimum on their own – center-left politicians implicitly accept the methodological individualism and narrow definition of rationality of neoclassical economics. In so doing, they ignore the fact that interventions at systemic scale, such as Britain's National Health Service, could only be established and maintained by collective action in response to motives (such as compassion and solidarity) not reducible to individual, material incentives.

Some fifteen months later, as the financial crisis paralyzed the market economy, the journalist Will Hutton and his collaborator Philippe Schneider published an article under the same title and began with a similar critique:

> The free-market fundamentalists have been so successful in creating an intellectual hegemony that they have managed to steer debate about the market's weak properties as a system into a debate about the scope of particular market failures. The presumption has been

[1] J. Kay, "The Failure of Market Failure," *Prospect* (137) (August 1, 2007).

> that the market paradigm works, even if they admit deviations from the general rule.[2]

Even while assaulting the pretensions of the market's advocates, Kay and Hutton and Schneider separately celebrate what Kay terms the "genius" of market economies: "their ability to innovate and adapt in an environment of uncertainty and change."[3] In their turn, Hutton and Schneider assert that despite their "significant shortcomings," markets "remain incredibly effective as 'open access' systems in creating conditions for innovation." They recognize that "market selection provides a way of evaluating and choosing between competing entrepreneurial judgments: successful ones draw resources and expand while ineffective ones free up theirs and are discarded."[4] This is the downstream phase of the Innovation Economy, where exploration of new economic space depends on processes of trial and error. Upstream, however, Kay correctly notes that "markets don't do the basic research, or the training that isn't job-specific, on which the innovative capacity of economic systems depends."[5]

Market Failure or Failure of Markets

These critiques of reliance on the identification of market failure – sound as they are – do not go far enough. I extend them to include the failure of market failure to motivate corrective state action. Hutton and Schneider correctly identify the Crisis of 2008 as "not a market failure but a systemic failure of markets."[6] Yet even such catastrophic events have failed to generate adequate responsive intervention by the state. During the Great Depression, the radically different policy stances of the governments in Britain, the United States and Germany shared one common factor: the refusal to recognize unused human and physical resources at massive scale as, *in and of themselves*, sufficient to justify

[2] W. Hutton and P. Schneider, "The Failure of Market Failure: Towards a 21st Century Keynesianism," National Endowment for Science, Technology and the Arts, Provocation 08 November (2008), p.5. Curiously, Hutton and his collaborator make no reference among their fifty-six footnotes to Kay's preceding article.
[3] Kay, "The Failure of Market Failure," p. 15.
[4] Hutton and Schneider, "The Failure of Market Failure," p. 18.
[5] Kay, "The Failure of Market Failure," p. 18.
[6] Hutton and Schneider, "The Failure of Market Failure," p. 18.

a correspondingly massive state response. Only mobilization for war – first by Germany, then by Britain, and finally by the United States – provided the political underwriting for state action at the scale required. More than eighty years later, even in the context of a higher level of economic activity and employment, it has been striking how the arguments that rationalize acceptance of the systemic failure of markets echo those of the 1930s.

From the Wall Street Crash of 1929 through the Global Financial Crisis of 1931 to the collapse of the international economic system into autarchic chaos in 1933, the onset of the Great Depression demonstrated the fragility of the Three-Player Game when all players simultaneously seek to protect themselves by unilateral pursuit of Cash and Control. In each of the leading industrial nations – Britain, the United States and Germany – governments were challenged to respond to mass unemployment of their constituents. The British experience is peculiarly instructive due to the clarity of the policy debate surrounding the government's consideration of an unprecedented initiative, debt-financed public works to address mass unemployment, not least because that debate was largely orchestrated by John Maynard Keynes. In very different ways, the American and German experiences confirm that, on its own, market failure had limited power to legitimize state intervention to allocate resources even when they would otherwise have been unemployed.

Examination of this most extreme of historical examples has obvious bearing on evaluation of the joint and several responses of governments to the Global Financial Crisis of 2007–2009 and the consequent Great Recession. For my own purposes, it can also inform consideration of the role of the state in the longer-term economics of innovation: the haphazard, stepwise invention, deployment and exploitation of technologies that have successively transformed economic possibilities over the past 250 years.

In 1931, Andrew Mellon famously confronted the third Republican US President whom he had served as Treasury Secretary over ten years. Enormously wealthy as a result of his capitalist ventures, Mellon urged Hoover to stand aside while "the market" performed its necessary, cleansing function:

> Liquidate labor, liquidate stocks, liquidate the farmers, liquidate real estate . . . It will purge the rottenness out of the system. High

> cost of living and high living will come down. People will work harder, live a more moral life . . . Enterprising people will pick up the wrecks from less competent people.[7]

To his credit, Hoover's response was to move "the greatest Secretary of the Treasury since Alexander Hamilton" from his position of authority in Washington to London as Ambassador to the Court of St. James's. Behind the anecdote lies the conflict that ever drives the formulation of economic policy in a capitalist democracy, a conflict made brutally explicit in Mellon's *laissez-faire* prescription.

The game played between the state and the market economy takes place on a field on which two systems for organizing power to allocate resources and to distribute the costs and benefits of their production and consumption coexist and co-evolve. A rough historical rhythm is discernible as the losers from one dispensation appeal to – or invent – the other in search of redress. So, in eighteenth-century Britain, Adam Smith legitimized the market as the alternative both to the restrictions on "natural liberty" imposed by traditional statutes and institutions and to corrupt and corrupting state power, whose economic extension was evident in the granting of monopolies and the provision of patronage. Two hundred years later, Deng Xiaoping followed in Smith's footsteps but with greater directorial authority. Contrariwise, protectionism predictably persists in emerging industrial economies (the United States in the late nineteenth century) and in declining ones (Britain in the mid twentieth century and, all too possibly, the USA tomorrow), as those unable to compete in open markets exercise their political option. As Dani Rodrik has comprehensively documented, deepened globalization of markets intensifies the conflict to the point of calling into question the simultaneous maintenance of both democracy and the autonomous nation-state.[8]

[7] H. Hoover, *The Memoirs of Herbert Hoover: The Great Depression, 1929–1941* (New York: Macmillan, 1952), p.30. In an unpublished paper, Brad DeLong has shown that the "liquidationist" theory of depression policy, which emphasized the necessity of freeing resources from uneconomic investments, had its own coherent rationale and some degree of historical evidence in its favor, most recently in the swift economic contraction and recovery of 1921, which – be it noted – was *not* driven and amplified by a financial crisis: J. B. DeLong, "'Liquidation' Cycles and the Great Depression" (1991). Available at http://econ161.berkeley.edu/pdf_files/Liquidation_Cycles.pdf.

[8] D. Rodrik, *The Globalization Paradox: Why Global Markets, States, and Democracy Can't Coexist* (New York: Norton, 2011), pp.184–206.

Each distribution of power invokes its own legitimizing ideology. The free market of Adam Smith and Milton Friedman is subject to challenge by the demands both of national security (especially in the United States) and social security (especially in Europe). Capitalism has thrived in epochs of complementary coexistence between politics and markets: for two short generations during the High Victorian age from roughly 1850 in Britain; for one long generation of "repressed capitalism" after World War II across the western world, including Japan. But the potential for conflict is always present, ready to emerge whenever the markets of the private sector fail to deliver or whenever the capture of the state by one interest generates outcomes deemed intolerably unfair by others.

From this perspective, the formulation of economic policy in time of crisis takes place in a space contested by competing ideas as well as competing interests. Conflicting definitions of the legitimate limits of state action generate confusion, first for the participants and then for those who retrospectively evaluate the policy process. True as this was of the formulation of economic policy during the Great Depression, it remains so in the confused and confusing aftermath of the Global Financial Crisis of 2008. Today, the coexistence of market capitalism and political democracy again appears fragile as the developed world struggles with the multiple consequences of digitalization – globalization internationally and industrial automation at home – in the face of China's rise.[9] How much more so was it eighty years ago, under the impact of the Great Depression and in the aftermath of the Great War and its political, financial and cultural disruptions.

Britain's Policy Paralysis

In Britain, the attempt to fashion political responses to the economic challenges of 1929–1931 was a study in paralysis. Two competing but not mutually exclusive explanations offer themselves. The first is that the political leaders and their principal advisors were victims of ignorance, along with their constituents. The revolution in economic analysis expressed in Keynes's *General Theory*, published only in 1936, would

[9] See D. Rodrik, "Populism and the Economics of Globalization," National Bureau of Economic Research Working Paper 23559 (July 2017).

have clarified the issues and liberated the Labour government to act. The second explanation is that the paralysis of policy reflected deep conflicts in the structure of power relationships that the government inherited and that it was powerless to change in peacetime: specifically, between the responsibility of the private sector to allocate resources and to distribute income and wealth, and the scope allowed for the state to redress market failure. Both explanations are correct. But from today's vantage point, when Keynes's work has been available for more than two generations in various guises, it is the latter explanation that must carry the most weight.

The politicians of 1931 were crippled not only by their own ignorance but by the unenlightened self-interest of others: the bankers, investors and businesspeople who controlled access to the cash needed to fund both the state and the investments of the market economy. Determined to restrict the scope of state action in peacetime, they entrenched the economic and financial losses of market failure. The rare exceptions, David Lloyd George and Keynes, stand out as imaginative opportunists, refusing to be constrained by consistency, and responsive to the radical transformation of the world around them. In the *General Theory*, Keynes wrote of the "long-term investor":

> It is . . . he who most promotes the public interest, who will in practice come in for most criticism . . . For it is in the essence of his behaviour that he should be eccentric, unconventional and rash in the eyes of average opinion. If he is successful, that will only confirm the general belief in his rashness; and if in the short run he is unsuccessful, he will not receive much mercy. Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally.[10]

In addition to writing a summary prospectus for the aspiring venture capitalist – this passage has hung on the wall of my office since I entered Wall Street – Keynes might also have been writing of his own standing in the world of 1929–1931.

Prior to 1929, and outside of wartime, the deployment of state authority (or quasi-state authority in the case of nominally private

[10] J. M. Keynes, *The General Theory of Employment, Interest and Money*, in E. Johnson and D. Moggridge (eds.), *The Collected Writings of John Maynard Keynes*, vol.7 (Cambridge University Press and Macmillan for the Royal Economic Society, 1976 [1936]), pp.158–159.

central banks, such as the Bank of England) had been limited to defense of the currency's link to gold and last-resort lending to the money market and through it to the banking system, since of all industrializing nations Britain's economic development was least underwritten by state initiatives. The modest beginnings of a social safety net were just discernible in the form of contributory state pensions and unemployment insurance, but intervention to offset contraction of the market economy was unknown to theory or to practice. As Keynes struggled to escape from a mode of thinking that implicitly assumed that all resources are always fully employed, he proposed an abstraction of the state's activities in terms of a generalized investment function: debt-financed expenditure that would fill the gap in aggregate demand when private-sector investment fails.

In the *General Theory*, he dramatized the point with characteristic panache:

> If the Treasury were to fill old bottles with bank-notes, bury them at suitable depths in disused coalmines which are then filled up to the surface with town rubbish, and leave it to private enterprise on well-tried principles of *laissez-faire* to dig the notes up again ... there need be no more unemployment and, with the help of the repercussions, the real income of the community, and its capital wealth also, would probably become a good deal greater than it actually is. It would, indeed, be more sensible to build houses and the like; but if there are political and practical difficulties in the way of this, the above would be better than nothing.[11]

What Keynes understood even before he could formulate a comprehensive theoretical explanation was that unemployed resources, human and capital, possess negative productivity. Skills atrophy and become obsolete; machines rust and likewise become obsolete. Putting them to work on whatever projects, even with zero economic return, will augment the flow of income and expenditure that, by definition, have been inadequate. And, incidentally, whatever goods and services those newly reemployed choose to spend their incomes on can be expected to be as economically "efficient" as what those still employed are spending money on. The positive effect will be all the greater if the new income and expenditure are funded by borrowing: as Richard Kahn demonstrated at the time, loan-financed expenditures

[11] *Ibid*. 129.

would finance themselves out of savings from the increased stream of income.[12]

Keynes's attempt to fashion an autonomous macroeconomic role for the state failed to drive economic policy in the Britain of the 1930s. In response to his advocacy of Lloyd George's program, however, the policy debate at the time explicitly addressed the role of the state relative to systemic failure in the markets of the private sector: its potential to deliver corrective action; the barriers such intervention would face; the unintended but countervailing consequences of such initiatives; and, indeed, the legitimacy of undertaking such an effort in the first place.

How deep this debate goes – to the foundations of democratic capitalism – is demonstrated by the extraordinary resonance that arguments three generations old have in today's debate over the proper role of the state in response to this generation's crisis. Even more, the terms on which Keynes's critics won the debate illuminates analysis of the state's role more generally. For those who exercised control over state expenditures required that they be evaluated and justified on a case-by-case basis – subject to strict scrutiny as to financial return, economic efficiency and administrative discipline. Only the clear danger of war for national survival would legitimize the state's mobilization of economic resources with the incidental effect of eliminating unemployment.

The circumstances that greeted the British Labour government that took office in June 1929 were daunting at best. Throughout its life to August 1931, it was a minority government. Although backed by the largest of the three parliamentary parties, it was dependent for survival on at least the abstention of Liberal members of Parliament. Four years before, in 1925, Winston Churchill – thoroughly miscast in the role of Chancellor of the Exchequer – had put Britain back on the gold standard at the now overvalued prewar parity. Although this was generally held to have completed the return to normality, it generated persistent

[12] R. F. Kahn, "The Relation of Home Investment to Unemployment," *Economic Journal*, 41(163) (1931), pp.173–198. As we shall see in the Coda to this second edition, estimating the size of the multiplier has become a useful focus of research in the academic literature. It is clear that its magnitude is context-dependent. It is also clear that it will be at a maximum when economic resources are grossly underemployed and when monetary policy is broadly accommodating, as was the case in Britain between the Wall Street crash in 1929 and the international crisis of the summer of 1931.

pressure on monetary policy to defend sterling, at the expense of domestic economic conditions. By the time the Labour government took office, reported unemployment had averaged 10 percent or more for the past seven years, concentrated in the staple export trades, all of which were affected by the overvalued currency: coal, textiles, iron and steel, and shipbuilding. When the government resigned twenty-six months later, reported unemployment had reached 25 percent. Cutting unemployment benefits as the keystone of a program of fiscal austerity, which "responsible" political and financial option required as part of a quixotic attempt to keep the country on the gold standard, had become the issue over which the cabinet divided and fell. It was replaced by a nominally National government, which was, in fact, dominated by the Conservatives.

During their time in office, members of the Labour cabinet enjoyed an opportunity, never before presented to political leaders of any state, to consider a deliberate and direct assault on mass unemployment. On taking office, the government had been confronted with a radical program of state intervention delivered by Lloyd George, who had launched the proposals in a dramatic attempt to regain the pivotal position he had occupied before, during and immediately following World War I.

Lloyd George was the most dynamic British politician of his age. Like Lyndon Johnson in the United States two generations later, he was an outsider who fought his way to the citadel of power by skill and cunning. Emerging from rural poverty in Wales, he moved the Liberal Party toward radical initiatives in the years before 1914, most dramatically through the "People's Budget," which he introduced as Chancellor of the Exchequer in 1909. The budget imposed taxes on land plus increased and more progressive income taxes to fund old-age pensions. For the first time since the seventeenth century, the House of Lords exercised its veto to challenge the House of Commons' power of the purse. Two general elections followed to confirm, albeit shakily, the Liberal government's legitimacy. With the king's pledge to ennoble as many new peers as needed to pass the budget, the supremacy of the House of Commons was confirmed and subsequently enshrined in the Parliament Act of 1911.

In contrast with Johnson, Lloyd George reached his political apotheosis as a war leader. As Chancellor in a Liberal cabinet deeply committed to nineteenth-century principles of limited government and individual freedom, Lloyd George seized on the need to mobilize the nation for total war. In 1916, a parliamentary coup made him Prime Minister with Conservative support and irrevocably divided the Liberals, who never again formed a government. Victory on the battlefield in 1918 was followed immediately by a general election in which the Coalition triumphed. However, when the Conservatives realized they no longer needed Lloyd George, the Coalition government dissolved, and the Conservatives took power on their own in 1922. The divided Liberals gave way to Labour (now no longer merely an interest group within the Liberal coalition) as the principal opposition.

Like Johnson's, Lloyd George's character was as controversial as his policies. Years afterward, Keynes remembered Lloyd George as he had appeared as a member of the Big Four at the Versailles Peace Conference of 1919:

> How can I convey to the reader, who does not know him, any just impression of this extraordinary figure of our time, this siren, this goat-footed bard, this half-human visitor to our age from the hag-ridden magic and enchanted woods of Celtic antiquity? One catches in his company that flavour of final purposelessness, inner irresponsibility, existence outside of or away from our Saxon good and evil, mixed with cunning, remorselessness, love of power, that lend fascination, enthrallment, and terror to the fair-seeming magicians of North European folklore ...
>
> Lloyd George is rooted in nothing; he is void and without content; he lives and feeds on his immediate surroundings; he is an instrument and a player at the same time which plays on the company and is played on by them too; he is a prism, as I have heard him described, which collects light and distorts it and is most brilliant if the light comes from many quarters, a vampire and medium in one.[13]

His character was also subject to question in more mundane terms. Truly a political entrepreneur, he created the Lloyd George Fund as his war chest for fighting electoral battles. It was funded with contributions on an explicitly reciprocal basis, with a set price for each level of "honour," from humble membership in the Order of the British Empire to peerages up to and including earldoms and marquisates.

[13] J. M. Keynes, *Essays in Biography*, in E. Johnson and D. Moggridge (eds.), *The Collected Writings of John Maynard Keynes*, vol.10 (Cambridge University Press and Macmillan for the Royal Economic Society, 1972 [1933]), pp.23–24.

Although Lloyd George was exiled from power after 1922, he remained a unique source of political energy. Much of the drama of interwar British politics was driven by the shared determination of "responsible" political leaders across the spectrum of ideology and interest to keep him in exile: the very creation of the National government in 1931 with its pro forma Labour leadership, Conservative base and irreconcilable anti-Lloyd George Liberal support, stands witness. In 1929, he made his last throw of the dice by offering a radical response to Britain's economic slump.

Lloyd George's assertion in the 1929 election campaign that "We can conquer unemployment" represented the first deliberate effort to design a countercyclical macroeconomic policy of fiscal stimulus, not only in Britain but anywhere in the world. The significance of this initiative is heightened by the support it received from Keynes, who had first gained public standing in 1920 through his exposition in book form of *The Economic Consequences of the Peace*[14] and, most particularly, his denunciation of Lloyd George for his role in constructing "the bad peace." When challenged for this turnabout, Keynes's characteristic retort was: "The difference between me and some other people is that I oppose Mr. Lloyd George when he is wrong and support him when he is right."[15] His pamphlet, "Can Lloyd George Do It?" provided an aggressively affirmative response to the question its title asked.[16]

The central thrust of Lloyd George's pledge to conquer unemployment was a two-year, £200 million debt-financed program of public works. National income was then on the order of £4 billion. A direct stimulus equal to 5 percent of national income would have been significant, although its economic weight would have been diluted by being spread over several years. Hobbled also by his deserved reputation for opportunistic recklessness, Lloyd George's initiative ran headlong into obstacles deployed from within the Treasury, then and still the core of Britain's permanent government, and from both major political parties.

[14] J. M. Keynes, *The Economic Consequences of the Peace* (New York: Harcourt, Brace and Howe, 1920).

[15] R. Harrod, *The Life of John Maynard Keynes* (New York: Harcourt Brace, 1951), p.396.

[16] J. M. Keynes and H. Henderson, "Can Lloyd George Do It?" in E. Johnson and D. Moggridge (eds.), *The Collected Writings of John Maynard Keynes*, vol.9 (Cambridge University Press and Macmillan for the Royal Economic Society, 1972 [1929]), pp.86–125.

In the debate that ensued over the next two years, three parameters of policy were invoked again and again:

(1) Economically, any works funded by the state must be "useful" and "remunerative."
(2) Administratively, centrally subsidized or funded projects must not circumvent the machinery of local government.
(3) Financially, state aid could only be funded out of current revenue.[17]

At the time and since, the financial criterion was the principal focus of theoretical debate. The original round of that argument, conducted in the context of 1929–1931, was the catalyst that triggered the process through which Keynes thought his way to the theoretical rationale for a stimulative fiscal policy and, indeed, to macroeconomic theory in its broadest sense. But the other parameters of policy have proved to be at least as significant in constraining state economic initiatives. Most critically, debate over the specification of what can constitute an economically legitimate object of state expenditure has persisted to this day, defining and limiting the role of the state in the market economy in good times as in bad – whether state expenditures are proposed in response to the market economy's failure to generate adequate aggregate demand in the short term or in order to increase the market economy's growth potential in the longer run.

As promulgated at the time, the financial parameter expressed two overlapping conceptual confusions. The first lay in the difficulty of comprehending the existence of persistent unemployment through a mode of analysis that assumed full employment. If all resources are fully employed, according to the hypothesis, then borrowing and spending money can only result in inflation. In fact, in Britain and around the world, mass unemployment prevailed and prices of all goods and services were *falling*, with disastrous consequences for all who had to service fixed amounts of debt from declining revenues and income. The second confusion was generated by the economic logic that defines the volume of employment as inversely related to the level of real wages. The existence of unemployment was considered evidence that real wages were too high. Any attempt to reduce unemployment could

[17] The evolution of public works policy is exhaustively documented in W. H. Janeway, "The Economic Policy of the Second Labour Government: 1929–1931," unpublished Ph.D. thesis, University of Cambridge (1971), pp.26–69.

only operate by reducing real wages through inflation: that is, by driving prices up relative to nominal wages. Either way, debt-financed spending by the state could be condemned as an inflationary threat both to Britain's already challenged competitive position in the international marketplace and also to the domestic standard of living.

The most extreme form of the financial parameter came to be known as the Treasury dogma. Winston Churchill, in his last budget speech as Chancellor of the Exchequer before the general election of June 1929, set it forth in absolute terms:

> It is the orthodox Treasury dogma, steadfastly held, that whatever might be the political or social advantages, very little additional employment and no permanent additional employment, can, in fact and as a general rule be created by State borrowing and State expenditure.[18]

The Treasury's formal response to Lloyd George and Keynes, in April 1929, was more nuanced:

> The large loans involved, if they are not to involve inflation, must draw on existing capital resources. These resources are on the whole utilized at present in varying degrees of active employment; and the great bulk is utilized for home industrial and commercial purposes. The extent to which any additional employment could be given by altering the direction of employment is therefore strictly limited.[19]

It was to this statement that Keynes was explicitly responding when, in the preface to the *General Theory*, he emphasized the core lesson of the book: to explain how "changing views about the future are capable of influencing the quantity of employment and not merely its direction."[20]

At the time, Keynes attacked the Treasury dogma head on, invoking common sense rather than high theory:

> There is nothing in the argument which limits its applicability to State-promoted undertakings ... It must apply equally to any new business enterprise entailing capital expenditure. If it were announced that some of our leading captains of industry had decided to launch out boldly, and were about to sink capital in new

[18] Quoted in Keynes and Henderson, "Can Lloyd George Do It?" p. 115.
[19] "We Can Conquer Unemployment," Memoranda by Ministers on Certain Proposals Relating to Unemployment, Cmd. 3331 (London: HMSO, 1929), p. 53.
[20] Keynes, *General Theory*, p. xxii.

> industrial plant to the tune, between them, of £100 millions, we should all expect to see a great improvement in employment. And we should be right. But, if the argument we are dealing with were sound, we should be wrong. We should have to conclude that these enterprising business men were merely diverting capital from other uses, and that no real gain to employment could result.[21]

Missing from Keynes's argument, however, was that business investment, as opposed to state investment, definitionally satisfies the first two parameters of policy: it is economically efficient and administratively legitimate.

The challenge Keynes failed to overcome in 1929 – and that has been evident in every debate over stimulative fiscal policy in peacetime from the Great Depression to the Great Recession – was to justify debt-financed expenditures abstracted and decoupled from the specific projects and programs through which cash is actually dispensed. Nonetheless, under pressure from Keynes, the senior officials of the Treasury – the "Treasury knights" – begged off from the extreme version of the dogma. In his draft notes for the evidence he gave to the Macmillan Committee on Finance and Industry, Sir Richard Hopkins referred to the statement in the April 1929 White Paper as "perhaps rather telescopic." In his direct confrontation with Keynes before the committee, Hopkins was "prepared to give [Keynes] that argument" – that in theory loan-financed public works would "pay for themselves." And Chancellor of the Exchequer Philip Snowden himself, in his parliamentary statement in response to a renewed Liberal plan for "national development," directly contradicted his predecessor, Churchill:

> It has sometimes been crudely said that a view obtains in the Treasury that any money borrowed by the State automatically cancels another loan of equal amount to enterprise . . . This is a misrepresentation. But it is necessary also to say that in the economics of Government borrowing there are regions which are disputed and only partially explored.[22]

Yet even as Keynes won the public debate over the Treasury dogma, an alternative barrier to action took the first rank. The fear that radical economic policy would undermine confidence in sterling and threaten

[21] Keynes, "Can Lloyd George Do It?" pp. 115–116.

[22] CP 329(30), para. 63, quoted in Janeway, "The Economic Policy of the Second Labour Government", pp. 176–177.

Britain's ability to remain on the gold standard had been explicit in official statements from the beginning of the debate. Now this concern was complemented by the line opened up by Hubert Henderson, who warned of the potential domestic economic consequences of any substantial program of public works.

Henderson was strategically placed as secretary to the government's Economic Advisory Council (EAC), a newly formed body whose existence reflected at least some sense that economic advice was needed. Henderson was a protégé of Keynes and had coauthored "Can Lloyd George Do It?" with him. But, as early as May 1930, his position had shifted. He wrote privately to Keynes, repudiating the view that Britain's unemployment problem was "a short-period, transitional problem":

> If you launch a . . . £200 million two year's programme . . . there are solid grounds at once for believing that that means that taxation is likely to be increased ever higher, year by year . . . I should say that the alarm might quite easily serve to counter-act finally the employment benefits of the programme, and you would then be in a vicious circle of requiring a still bigger programme, still more unremunerative in character, with an increasing hole in the Budget, and increasing apprehension, until you were faced with either abandoning the whole policy or facing a real panic-flight from the pound.[23]

Henderson here invoked "Ricardian equivalence," the idea that state borrowing is economically the equivalent of state taxation since the lenders and everyone else in the private sector "know" that the borrowings will have to be paid back out of future tax revenues. Of course, Ricardian equivalence exhibits exactly the same fallacy as the Treasury dogma, the assumption that all resources are already fully employed. If they are not, increased employment and income generated by government stimulus will increase the tax base from which to service the government's debt with no necessary increase in tax rates. Keynes could only assert that the increase of business profits would, "after the first blush, have more effect on them than anything else." Henderson won the debate due to his mobilization of the confidence argument to

[23] H. Henderson to J. M. Keynes, May 30, 1930, Keynes Papers EA/1, quoted in Janeway, "The Economic Policy of the Second Labour Government," p.280.

augment the economic parameter, as his subsequent contributions to the policy discussion would show.

Henderson repeated his position publicly to the EAC's Committee of Economists in October 1930, and he drafted the section of its report dealing with public works, despite the fact that Keynes had been the driving figure in the creation of the committee in the first place and that Kahn was its co-secretary. Explicitly rejecting the Treasury dogma and sketchily referring to the multiplier, the report justified only works that satisfied the economic parameter by being "useful and productive," that could be "put into production and carried out with speed" and that would "not . . . create later a difficult 'demobilisation' problem." "Finally," the report concluded,

> The scope and scale of the programme as a whole must be such as to commend itself as reasonable and sensible to public opinion . . . While . . . we do not believe that employment created by public works need involve a diminution of resources devoted to private investment, it might easily do so, if it took a form which aroused apprehension as to the stability of the public credit.[24]

No doubt, the controversial personalities of the political sponsors of such radical programs – Lloyd George, Keynes himself, and secondarily Sir Oswald Mosley, who had served as an activist member of the Labour cabinet before resigning to found the British Union of Fascists – contributed to the apprehension that Henderson invoked. But what emerges as of lasting importance from this episode is the requirement that the components of state programs of expenditure be evaluated by the same criteria – "useful and productive" – that financial capitalists would apply to the investment projects of the market economy.

Implicit in this argument from confidence that trumped Keynes's economic logic is the same presumption that animates the oxymoronic notion of expansionary fiscal austerity today. State initiatives to stimulate aggregate demand are deemed inherently wasteful and, therefore, destructive of private-sector confidence. Conversely, a reduction of aggregate demand resulting from the imposition of fiscal discipline on the state will be more than offset by the blossoming of private-sector investment, animated by what Paul Krugman has

[24] CP 363(30), para. 68, quoted in Janeway, "The Economic Policy of the Second Labour Government," p. 281.

memorably personified as "the confidence fairy." Henderson's arguments of eighty-five years ago could have been written yesterday.[25]

In September 1931, the National government, which succeeded Labour, had the political legitimacy to execute one of the great exercises in pragmatic opportunism: it abandoned the gold standard. Fearful that renewed liquidation of international assets could spill over to undermine confidence in the domestic banking system, the government jumped before it was pushed. Britain was thus freed from the market forces that drove deflation for eighteen more months in the United States and Germany and fully five more years in France. Currency depreciation of some 30 percent gave Britain access to the positive cash flow that confers autonomy of action at the national level as at the level of the individual bank or venture capitalist.

Yet the constraining power of ideas persisted: fear of loss of confidence still limited action by a government exempt from external financial and domestic political challenge. As the opponents of government stimulus in 1929–1931 abandoned their argument from first principles, they succeeded in keeping the Labour government and the National government from the path of experimentation that Franklin Delano Roosevelt pursued in the United States, however haphazardly and inadequately. And unemployment in Britain, while roughly halving from the 1932 peak, did not fall below 10 percent, even as the depreciated pound and the cheap money consequent on relief from adherence to gold combined to generate a slow recovery. Only mobilization for war at the end of the decade would finally drive the British economy to full employment.

The New Deal

In contrast with Britain, both the United States and Germany witnessed activist programs of public works financed by central government

[25] See, for example, R. Barro, "The Coming Crises of Governments," *Financial Times*, August 3, 2011, or the numerous self-justifying speeches of Britain's then Chancellor of the Exchequer available at www.hm-treasury.gov.uk/newsroom_ and_speeches .htm. For a thorough and balanced critique of "expansionary fiscal contractions," see International Monetary Fund, "Will it Hurt? Macroeconomic Effects of Fiscal Consolidation," in *World Economic Outlook* (Washington, DC: International Monetary Fund, 2010). Available at www.imf. org/external/pubs/ft/weo/2010/02/ pdf/c3.pdf.

deficits. The economic devastation in these countries was manifestly worse than in Britain, as the economic contraction was accelerated and amplified by domestic banking crises that liquidated savings as well as jobs. And, in each case, the failure of an incumbent conservative government to respond effectively to the Depression created the political opening for radical initiatives. Yet the history of civilian public works in the two hugely different regimes – the New Deal and the Third Reich – serves perversely to confirm the lessons to be drawn from the British experience of political paralysis.

The centerpiece of FDR's initial program of recovery and reform was the National Industrial Recovery Act, passed into law on June 16, 1933. Title II of the Act created the Public Works Administration (PWA), endowed with an enormous appropriation of $3.3 billion, more than $50 billion in current dollars, 165 percent of then total federal revenues and almost 6 percent of 1933 GDP.[26] The PWA drew on the distant history of US state and federal governments' funding of internal improvements: turnpikes, canals and railroads. More recently and relevantly, countercyclical public works had been advocated as an instrument of public policy to offset periodic waves of unemployment by the economists William Foster and Waddill Catchings in their 1928 book *The Road to Plenty*,[27] and embraced reluctantly, and to a limited and indirect extent, by Hoover through the Reconstruction Finance Corporation.[28] Characteristic of the first New Deal's incoherent experimentation, however, the PWA had been preceded by the Economy Act of 1933, which was intended to fulfill FDR's campaign pledge to balance the budget and mandated a $500 million reduction in federal spending, then running at only $3.6 billion.

The conflict between the orthodoxy of public finance and the demands of the economic emergency were duplicated in the operations of the PWA. Harold Ickes, administrator of the PWA as well as Secretary of the Interior, was a cantankerous, utterly honest progressive who served FDR loyally for the full thirteen years of his presidential tenure. He was "determined that no money under his jurisdiction

[26] J. S. Smith, *Building New Deal Liberalism: The Political Economy of Public Works, 1933–1956* (Cambridge University Press, 2006), p.2.

[27] W. Foster and W. Catchings, *The Road to Plenty* (Boston: Houghton Mifflin, 1928).

[28] Smith, *Building New Deal Liberalism*, pp. 27, 136.

should be wasted or corruptly spent."[29] Under Hoover's Reconstruction Finance Corporation, projects had been required to be self-liquidating: that is, revenues from tolls and fees were to offset the capital costs of construction. This limited both the volume of projects funded and any impact on unemployment or aggregate demand.

> Although Ickes and the PWA relaxed the Hoover-era requirement that projects be self-liquidating, the change was made only on paper. The PWA proclaimed that projects would be chosen based on their social and economic "desirability," their fit with pre-existing plans, their engineering and technical "soundness," the financial stability of the applicant, and the "legal enforceability" of any securities bought by the federal government in order to fund the project. In fact however, only the last three factors – engineering, legal and financial soundness – were formally measured and reviewed by the PWA.[30]

Criticism of Ickes's disciplined approach was widespread from the beginning, as exemplified by *Business Week*'s editorial comment: "Mr. Ickes is running a fire department on the principles of a good, sound bond house."[31] After the fact, John Kenneth Galbraith estimated in the official review conducted in 1940 that "total off-site and on-site employment" generated by the PWA and related federal construction projects averaged slightly less than 1.2 million during the years 1934–1938, at the start of which period unemployment was over 10 million. Many of the jobs ascribed to the PWA were indirect, the result of derived demand for construction materials; the count was not based on the mathematics of the multiplier.

FDR had no patience with such calculations, and he was not alone: frustration with the PWA's limited direct impact on unemployment led to the June 1935 creation by executive order of the Works Progress Administration (WPA) as the vehicle for providing direct "work relief." Although the WPA made a widespread contribution to the creation of public works of value, it was under continuous assault for funding uneconomic waste ("boondoggles") and for political patronage. Nonetheless, it managed to create some 1.6 million jobs on average, again as estimated by Galbraith.[32]

[29] A. J. Badger, *The New Deal: The Depression Years, 1933–1940* (New York: Hill & Wang, 1989), p.83.
[30] Smith, *Building New Deal Liberalism*, p. 86. [31] Quoted *ibid.* 99. [32] *Ibid.* 101.

The New Deal's accounting maintained the fiction of a balanced normal budget, from which such emergency programs as the PWA and the WPA were excluded. In fact, the aggregate federal deficit reached $3.2 billion in 1936, as the growth in GDP averaged some 10 percent per year from the Depression low of $56.4 billion, and unemployment declined from the peak count approaching 15 million at the time of FDR's inauguration to below 5 million in the summer of 1937 – still (as in Britain) about 10 percent of those working or looking for work.[33]

The administration then snatched defeat from the jaws of incipient victory by means of an aggressive shift back to fiscal orthodoxy. Spending cuts and tax increases – notably including the $1.4 billion, first-year impact of Social Security taxes with no offsetting benefits paid out until the following year – killed recovery and generated a recession that drove unemployment back above 11 million in 1938.[34] Only then did the "proto-Keynesians" of the second New Deal, led by Federal Reserve chair Marriner Eccles, convince FDR to commit explicitly to fiscal stimulus, embodied in a $3.75 billion spending package.[35] Two years later, when the war in Europe exploded from its "phony" stage into Hitler's blitzkrieg in France, the United States followed Britain into mobilization for total war, even though rearmament by stealth remained a political necessity in the United States through the 1940 presidential election.[36]

The Third Reich

In Germany's case, it was at the start of his regime that Hitler needed to exercise stealth while investment in armaments drove economic recovery. Still subject to the restrictions on ground, naval and air forces imposed by the Versailles Treaty, the Third Reich adopted the civilian "work creation" programs it inherited from the last administrations of

[33] See www.nber.org/databases/macrohistory/rectdata/08/m08084a.dat.

[34] Among my father's first career-making insights as an apprentice economic analyst was his anticipation of the "Roosevelt recession." See M. C. Janeway, *The Fall of the House of Roosevelt: Brokers of Ideas and Power from FDR to LBJ* (New York: Columbia University Press, 2004), p.93.

[35] Badger, *The New Deal*, pp. 111–113.

[36] See R. J. Gordon and R. Krenn, "The End of the Great Depression, 1939–1941: Policy Contributions and Fiscal Multipliers," National Bureau of Economic Research Working Paper 16380 (2010).

the Weimar Republic and aggressively propagandized their importance.[37] But, as the leading scholar of the Third Reich's economic history, Adam Tooze, writes: "the 'Keynesian' issues of work creation and unemployment were never as prominent in the agenda of Hitler's Government as commonly supposed."[38]

The monies appropriated confirm the relative magnitudes of investment in war-fighting capability versus civilian public works. The two "Reinhardt Programs" of work creation approved in 1933 amounted to some 1.5 billion Reichsmarks.[39] Even augmented by the much-heralded autobahn construction program, which was explicitly legitimized by its importance to national defense, the economic weight was marginal compared with the secret four-year, 35 billion Reichsmarks rearmament program to which Hitler committed in June 1933 at the same time as he eliminated formal international constraints by declaring a moratorium on foreign debts. "In every respect except propaganda," writes Tooze, "the civilian work creation measures of 1933 were dwarfed by the decisions taken in relation to rearmament and foreign debt. The military spending package vastly exceeded anything ever contemplated for work creation." Despite continuing promotion of the "Battle for Work," Tooze reports, "not a single Reichsmark was allocated to national work creation in 1934 or at any point thereafter."[40]

Creatively financed by off-budget credits laundered through a state-sponsored financing vehicle in which such major industrial companies as Krupp and Siemens participated, rearmament was the engine of German recovery. From 1 percent of national income in 1933, such expenditures reached 10 percent in 1935 and more than 20 percent in 1938, as national income itself doubled from the 43 billion Reichsmark level of 1933.[41] In no way subject to the tests applied to proposed civilian public works in Britain or the United States – or, indeed, in Germany itself – Hitler's Four Year Plan generated uncoordinated chaos as the armed forces competed for labor and materials: the first imposition of price controls and rationing on consumer foodstuffs came as early as 1937, and "by 1939, shortages of raw materials were leading to

[37] R. Evans, *The Third Reich in Power* (New York: Penguin, 2005), p.329.

[38] A. Tooze, *The Wages of Destruction: The Making and Breaking of the Nazi Economy* (London: Allen Lane, 2006), p.38.

[39] *Ibid*. 42–48. [40] *Ibid*. 55, 59. [41] *Ibid*. 53, 62–63.

grotesque consequences for the everyday life of ordinary Germans."[42] More relevant to the regime's priorities, aircraft production actually declined between 1937 and 1938.[43] But in response to headlong spending on armaments, and amplified by the manipulation of statistics, the reported number of people unemployed declined from the Depression peak of 6 million in the winter of 1932–1933 to fewer than 1 million in 1937.[44]

Parallel Stories

Considering the radically different paths of policy in Britain, the United States and Germany, one observes that Britain preempted its industrial rivals by leaving the gold standard early, and then, with appalling consequences, Germany trumped both Britain and the United States by seizing mobilization for war as its economic motive force. Less than ten years after the fall of the Labour government and Britain's departure from the gold standard, the potential for loan-financed government spending to stimulate final demand and eliminate unemployment was conclusively demonstrated country by country through the economic impact of rearmament. From 1937 to 1942, British "Public Authorities' Current Expenditures on Goods and Services" rose from £536 million, or 10.5 percent of gross national product, to £4,581 million, or 47.3 percent of GNP.[45] Over the same period, unemployment fell from 10.8 percent to 0.6 percent.[46]

Unsurprisingly, the story in the United States runs in parallel. In 1929, total expenditures by all levels of American government had amounted to a mere 9 percent of GDP; of this, only 1.7 percent was federal spending. The increase in the public-sector share to 15.4 percent in 1933 was entirely a function of the collapse in GDP by no less than 46 percent in then current prices, from $103.6 billion to $56.4 billion. The trivial increase in federal expenditures, from $1.7 billion to $2.3 billion, was more than offset by a decline in state and local spending. While total government savings did decline from $2.6 billion to

[42] Evans, *The Third Reich in Power*, pp. 363–364. [43] *Ibid.* 362. [44] *Ibid.* 333.

[45] B. R. Mitchell, *British Historical Statistics* (Cambridge University Press, 1988), p.834.

[46] "Labour Force 8: Adjusted Estimate of Overall Percentages Unemployed 1855–1965 and Percentages of Insured Unemployment 1913–1980," in *ibid.* 124.

a deficit of \$0.5 billion – of which two-thirds was at the federal level – the \$3.1 billion contribution to final demand amounted to only one-fifth of the catastrophic decline in private-sector gross fixed investment, which fell by no less than 90 percent, from \$16.5 billion to \$1.7 billion, and was the primary engine of economic contraction.[47]

During the summer of 1964, I served as a research assistant to Lester Chandler of Princeton, a doyen of old-school money-and-banking finance. Chandler was on the way to publishing *American Monetary Policy, 1929–1941*,[48] a useful, if underappreciated, corrective to Milton Friedman and Anna Jacobson Schwartz's much better-known *Monetary History of the United States*,[49] which attributed the Depression's dynamics to perverse monetary policy alone. At the time, the concept of the full-employment budget deficit was being promulgated by the Council of Economic Advisors as a useful rationale for the Kennedy–Johnson tax cuts of that year. Professor Chandler guided me through a back-of-the-envelope calculation to estimate the magnitude of the federal deficit in 1933 that would have been roughly consistent with a return to full employment. I recall the number we came up with was about three times the size of total federal expenditures in 1932.

The peacetime scale of the public sector in both the USA and the UK was simply incommensurate with the magnitude of the collapse in private-sector economic activity. In the United States as in the United Kingdom, mobilization for war demonstrated the economic potential of government stimulus. As total government spending rose from \$13.8 billion in 1938, or 16 percent of GDP (of which federal spending was less than half), to no less than \$62.7 billion in 1943, or 48 percent of a GDP that in aggregate had itself doubled, unemployment fell from 20 percent in June 1938 to 0.2 percent in June 1942.[50] In July 1940, Keynes took rueful note in an article published in the *New Republic*: "It is, it seems, politically impossible for a capitalist democracy to

[47] Bureau of Economic Analysis, US Department of Commerce, National Economic Accounts, tables 1.1.5, 1.1.10, 3.1 and 3.2. Available at www.bea.gov/national/nipaweb.

[48] L. V. Chandler, *American Monetary Policy, 1929–1941* (New York: Harper & Row, 1971). The published work does not refer to the back-of-the-envelope exercise Chandler conducted with me.

[49] M. Friedman and A. J. Schwartz, *A Monetary History of the United States, 1867–1960* (Princeton University Press, 1963).

[50] See www.nber.org/databases/macrohistory/data/08/m08292a.db.

organize expenditure on the scale necessary to make the grand experiment which would prove my case – except in war conditions."[51]

From the perspective of the post-2008 Great Recession, the authors of the most comprehensive analysis of the economic effect of transnational fiscal and monetary policies during the Great Depression broadly concur:

> Fiscal policy made little difference during the 1930s because it was not deployed on the requisite scale, not because it was ineffective . . . The real Keynesian stimulus, when it came, would be associated with military expenditure during World War II, producing very rapid growth in countries like the United States. In our view, peacetime stimulus packages, which could have halted the rise in unemployment that ultimately led to the election of Adolf Hitler . . . would have been preferable to the stimulus of war.[52]

This is precisely why scrutiny of the peacetime stimulus programs of the 1930s is so relevant. For if the state is blocked when it asserts the authority to allocate resources in pursuit of full employment when they are manifestly not scarce, how will it legitimize such interventions in the market economy under normal conditions? Echoing Keynes, Badger asks the right questions with specific reference to the United States in the 1930s, but with broader reach across time and space:

> Could policy-makers in the 1930s have devised ways of spending enough money to secure full economic recovery? Did the expertise and mechanisms exist for a larger public works programme than that operated by the PWA? How big did the deficit need to be to secure full employment? Would such a deficit have been politically feasible and economically successful in the face of intransigent business opposition? Do Keynesian economic policies work only in time of war?[53]

[51] J. M. Keynes, "The United States and the Keynes Plan," *New Republic* (July 29, 1940), in E. Johnson and D. Moggridge (eds.), *The Collected Writings of John Maynard Keynes*, vol.22 (Cambridge University Press and Macmillan for the Royal Economic Society, 1978), p.149.

[52] M. Almunia, A. S. Bénétrix, B. Eichengreen, K. S. O'Rourke and G. Rua, "From Great Depression to Great Credit Crisis: Similarities, Differences and Lessons," National Bureau of Economic Research Working Paper 15524 (2009), p.25.

[53] Badger, *The New Deal*, p. 117.

The Great Depression and the Great Recession

During the 1930s, the requirement that projects of civilian public works be useful and productive on their own terms limited the ability of the state to offset the failure of private investment. The prospect of wasteful boondoggles financed with borrowed money drove the "argument from confidence" that carried the day against Keynes's proposal for debt-financed fiscal stimulus and the New Deal's halting experiments along similar lines. For, indeed, an extended and diverse history of incompetent and mendacious disposition of state-controlled resources was available for all to observe. It was not for nothing that the pre-Victorian British political establishment had been known as "Old Corruption." In the United States of 1933, the theft of the Navy's petroleum reserves at Teapot Dome a decade earlier was living memory. But, in consequence, only when Britain and the United States were compelled to respond to Hitler's mobilization for war was unemployment finally conquered, by the ultimate engine of economic waste.

The Global Financial Crisis of 2007–2009 and the Great Recession that followed came in a world institutionally transformed from that of the 1930s. In 1936, Keynes had expressed his frustration over the inability of peacetime Britain to generate an adequate response to the Great Depression in his "Concluding Notes on the Social Philosophy Toward Which the General Theory Might Lead":

> I conceive, therefore, that a somewhat comprehensive socialization of investment will prove the only means of securing an approximation to full employment; though this need not exclude all manner of compromises and devices by which public authority will co-operate with private initiative.[54]

The term "socialization" sounds revolutionary. Yet, in historical fact, something not unlike what Keynes suggested has occurred: a revolution in the scale of the state relative to the private sector and, in particular, of government expenditures relative to private investment. I find it astonishing that the voluminous literature written to compare and contrast the Great Depression of the 1930s and the Great Recession that began in 2008 has paid so little attention to this most obviously significant fact.

[54] Keynes, *General Theory*, p. 378.

In today's Britain, general government expenditures exceed private-sector fixed capital formation, and they have done so for years.[55] In the United States, combined federal, state and local government expenditures exceed gross private domestic fixed investment.[56] Thus, as discussed in Chapter 8 through the lens of Minsky's big-state capitalism, the public sector is of a scale to cushion abrupt reductions in the most volatile element of private-sector spending. In both cases, this is without taking into account the macroeconomic role of social welfare transfer payments, which serve as automatic stabilizers when private-sector income and employment contract. Reflecting the impact of the Great Recession, combined US government spending rose from 31 percent of GDP in 2006, with the federal share at two-thirds, to more than 35 percent in 2009, with virtually all of the increase at the federal level (in this comparison, transfer payments are taken into account, as they should be because this source of private-sector income is stable regardless of macroeconomic conditions). And the public sector of the United States is smaller as a component of the national economy than that of any other developed or substantial emerging economy in the world.

Stimulus and Austerity after 2008

The universal turn toward fiscal stimulus by the major governments in the winter of 2008–2009 was informed by history – the culturally embedded experience of the 1930s as evaluated by such scholars as Ben Bernanke, Barry Eichengreen and Peter Temin. And big-state capitalism proved capable of putting a floor under the economic consequences of a financial crisis. In the institutional context of the early twenty-first century, the measure of that success was that unemployment rose to only about 8 percent to 10 percent in the developed nations, versus the 25 percent to 30 percent experienced during the Depression. It should not be surprising that the regulatory response has been muted to somewhat the same degree. One might say that with 25 percent unemployment, you get Glass–Steagall; with 10 percent unemployment, you only get Dodd–Frank.

55 *United Kingdom National Accounts* (The Blue Book) (2008), table C1.

56 United States Bureau of Economic Analysis, National Economic Accounts, table 1.1.5. Available at www.bea.gov/national/nipaweb.

Across the world, central banks reduced their policy rates (the short-term interest rates that they directly control) to the "lower bound" – that is, approximately zero. And the leading central banks – the Federal Reserve, the Bank of England, the European Central Bank, the Bank of Japan – augmented conventional monetary ease with "quantitative easing," the direct purchase of (generally) government debt of relatively long maturity. This phenomenon signaled, to use Paul Krugman's prescient phrase, "the return of Depression economics."[57] For the enormous increase in risk aversion and liquidity preference proved resistant to efforts to induce a generalized shift out of the liquidity trap and back into consumption and investment. To summon a traditional notion curiously absent from policy discussions, the central bankers of the world committed themselves to pushing on the strings at their disposal.

Initially, the activist response to the Global Financial Crisis was itself global. In particular, the emerging nations of East and South Asia, led by China, demonstrated the will and the ability to defend themselves by pursuing nakedly mercantilist trade and currency policies: the invocation of Cash and Control at the national level. They had experienced in the late 1990s the threatened or actual imposition from abroad of exactly the sort of deflationary discipline that the gold standard had existed to enforce – but it was this time asserted in the name of the Washington Consensus. Now those countries' accumulated reserves bought them time, and now they knew what to do with it: they deployed programs of fiscal stimulus and credit expansion on a scale unprecedented in peacetime. Unencumbered by fear that the capital markets would exercise an effective veto over political initiative, China most particularly demonstrated the relevance of Keynes's economics to today's crisis:

> According to Fitch Ratings, fiscal stimulus packages as a percentage of gross domestic product amounted to 6.9 percent for Vietnam, 7.7 percent for Thailand, 8 percent for Singapore, 13.5 percent for China, and a whopping 14.6 percent for Japan. Taiwan, with a relatively modest stimulus of 3.8 percent, gave $100 spending vouchers to each of its 23 million inhabitants, including convicts. The Singaporean government subsidised businesses that retained staff. In China, the mother of all stimulus packages funnelled

[57] P. Krugman, *The Return of Depression Economics* (New York: W. W. Norton & Company, 2009).

> $585bn of spending into the economy, and even more through directing state-controlled banks to increase credit.
>
> Unlike in the west, there is little debate in Asia about how well the stimulus worked. It has been spectacular.[58]

Indeed, Chicago's Robert Lucas reluctantly allowed, during the winter of 2008–2009, that "everyone is a Keynesian in a foxhole."[59] The existence proof represented by mobilization for World War II suggests that Lucas's metaphor is more apt than he intended.

Yet, in the West, scarcely had the world been saved from the threat of a second Great Depression than the menace of sovereign debt crises emerged to compromise the stumbling return to economic growth. First in Berlin and then in London, politicians called for fiscal consolidation and then, more explicitly, for fiscal austerity, preempting capital markets that remained content to fund unprecedented state borrowings at minimal rates of interest. However, except on the fundamentalist fringes of the debate, the assault on stimulative public policy did not express a retreat to a confused model of the world in which, by definition, all resources must always be fully employed.[60] Rather, it was Hubert Henderson's argument from confidence that was deployed: on the one hand, fiscal deficits on the scale necessary would invite the vigilantes of the bond and foreign exchange markets – James Carville's bullies – to punish spendthrift states. On the other, the imposition of fiscal discipline in the public sector would, against relevant experience, stimulate confidence in the private sector to the extent needed to generate recovery.[61]

Whether deployed by German disciplinarians distributed between Berlin and Frankfurt, by Oxonian blue bloods in the Palace

[58] D. Pilling, "Asia's Keynesians Take Pride in Prudence," *Financial Times* (July 21, 2010).

[59] Quoted in J. Fox, "Bob Lucas on the Comeback of Keynesianism," *Time* (blog) (October 28, 2008): http://business.time.com/2008/10/28/bob-lucas-on-the-comeback-of-Keynesianism.

[60] Attempts to summon the hard-core Treasury dogma back into battle in 2008, notably by Eugene Fama and John Cochrane of the University of Chicago, played no substantive role in the policy debate.

[61] For an acute, detailed analysis of the emergence of consensus among economic experts for stimulus, and its rapid evolution into the "dissensus" that accompanied the shift to austerity, see H. Farrell and J. Quiggen, "Consensus, Dissensus and Economic Ideas: The Rise and Fall of Keynesianism during the Economic Crisis," March 2012. Available at http://www.henryfarrell.net/Keynes.pdf.

of Westminster, or by America's home-grown Tea Party activists, this radical repudiation of the pragmatic policies that saved both financial capitalism and the market economy is best understood as a ploy in the ongoing contest over the legitimate scope of the state relative to the market economy. Of course, such argumentation is the substance of politics. And, of course, capture of the state by private interests and privileged expropriation of economic rents – as in contemporary Greece – are suitable targets. But in the United States and other apparently mature political economies, justifying austerity today in anticipation of excessive Social Security payouts a generation hence serves only to underline the political content of the ploy.

After all, only half a generation ago the looming fiscal crisis with which the American government was threatening its own and the world's financial markets was the potential repayment of the entire national debt and, thus, the elimination of the risk-free asset that has been the foundation of the financial system for more than half a century. It took inspired fiscal irresponsibility, delivered through two wars of choice *un*financed by massive tax reductions, to produce the threat of uncontrolled deficits spiraling toward default. It would, alternatively, have taken only a modest amount of the sort of collaboration evident as recently as the Reagan and Clinton presidencies to bring back fiscal balance in the longer term.

In the context of the Three-Player Game, the consequences of explicitly invoking the financial markets as the judges and disciplinarians of state behavior can be anticipated, and they are dangerous. The most general lesson to be learned from observing the centuries of financial history summarized by Carmen Reinhart and Kenneth Rogoff is that, given the opportunity, financial markets will go to extremes.[62] Some twenty years ago, my wife's doctor responded to her inquiry as to whether our cat could accompany her during an extended hospital stay by asking, "Can you guarantee his behavior?" "Yes," she responded, "it will be bad."

Thus, an economic orthodoxy that has manifestly failed and that is itself in process of reconstruction from the inside out was invoked to rationalize the tolerance of Keynesian waste, albeit on a materially smaller scale than the last time around. Policies that force economic

[62] C. M. Reinhart and K. S. Rogoff, *This Time is Different: Eight Centuries of Financial Folly* (Princeton University Press, 2009).

contraction through fiscal cutbacks in defense of national solvency are likely to be self-defeating. Evidence that fiscal austerity will generate expansion is limited to those few instances when a relatively small and open economy enjoyed the offsetting benefits of major reductions in both long-term interest rates and its effective exchange rate, usually while its principal trading partners were enjoying economic booms.[63] Canada in the early 1990s is a prime example.

As we shall explore in the Conclusion, the reversion to austerity was one aspect of a larger, longer and successful effort to reconfigure the Three-Player Game by delegitimizing the state as an economic actor. That this effort should reach fruition as the forces of excessive globalization and accelerating digitalization of the world economy generated intense demands for political response helps explain the rise of populism across much of the developed world. Trump and Brexit mark the extent of the retreat from responsible policy formulation to invocation of miraculous cures for the polity's illness. As Mario Monti, former Prime Minister of Italy and a respected economist, plaintively addressed a gathering at the Centre for Economic Policy Research in London in September 2017: "What has happened to the Anglo-Saxon countries? We grew up learning from their rationality."

Before confronting the reconfiguration of the Three-Player Game, we must first take account of the transformation being wrought on the market economy by the digital revolution, now generating its own momentum beyond any need for state sponsorship. In fact, on the contrary: the relationship between the state and the technological revolution it engendered has been inverted, even as was the case when the railway age and the age of electrification reached their respective maturities. The enterprises that are disrupting the established markets of the legacy economy are simultaneously challenging state authority across a broad and widening front.

[63] See the analysis by a chastened International Monetary Fund, "Will it Hurt? Macroeconomic Effects of Fiscal Consolidation," in *World Economic Outlook* (Washington, DC: International Monetary Fund, 2010). Available at www. imf.org /external/pubs/ft/weo/2010/02/pdf/c3.pdf. Also D. Baker, *The Myth of Expansionary Fiscal Austerity* (Washington, DC: Center for Economic and Policy Research, 2010).