Back in the good old days of the 19th century when market economies oscillated between boom and prolonged recession, economists believed that nations were like households. They had to balance their budgets. If they spent more in one year they would have to save more the next to pay off the debt. Sound advice for a household. But not so for an economy as a whole.

Welcome to the Keynesian revolution

Keynes proved this in 1936, and subsequently governments followed this theory to get their economies out of depression and onto the long economic boom that lasted until the mid-1970s.

What essentially did Keynes, and his doppelgänger Kalecki, argue? Let's use a very simplified model to illustrate the point. Say there are two types of people who are active in the market economy: employees and investors. The investors own the assets of the business in which the employees work.

Altogether the businesses in a country produce $100 of goods and services in a year. If they could sell these goods and services, then say for illustrative reasons, that $70 would go to the employees as wages and salaries and $30 goes to the investors as a profit (return on their capital).

Now the businesses can only sell their goods and services if people with incomes (the same employees and investors) spend $100 buying these goods and services. No business keeps producing things that are not bought. The employees may be happy to spend their $70 on goods and services. But the investors will only spend their $30 if they can feel confident that they will get their $30 back plus a return for risk. This return may be 5% or more depending on the economic climate. Suppose the optimistic investors, in the first year, spend their $30 of dividends (or profits) on the goods and services. But at the end of the year, the business only makes $100 of sales and the investors only get back $30 (as $70 goes to employees). Not a good investment. Rate of return = zero.

So what do investors do? In the next year, they only spend $20 on investment goods and services. But then the combined purchasing power of employees and investors is $70+$20 =

$90. The business cannot sell all their product ($100). With only $90 in income they pay wages of $70, leaving $20 for the return to investors, but in addition, they cut back on production and retrench staff in the following year. Investors also cut back on spending as they also got a rate of return below what they feel reasonable given the risk of investing. It is safer to leave the money as cash in the bank or under the bed. And so the economy enters a downward spiral. Investors cut back, businesses sack staff and unemployment rises.

Downward spiral

What stops this downward spiral? There needs to be an external injection of spending into the system. This is the essential Keynesian message. By external, we mean something that does not originate from employees (householders) or the investment community. It has to come from either the government in the form of *perpetual* budget deficits or perpetual exports.

Clearly from the point of view of the world as a whole, exports cannot be the source. Some countries, for some of the time, can get income stimulus from exports (i.e. China for the last 30 years) but this is at the expense of other economies. At the end of the day, the stimulus to incomes has to come from governments who control the money supply and can thus spend without having to borrow. Essentially, they can monetise the debt. They do not have to pay this debt back – it is spending financed by central banks. The point is that if the government adds to spending (and production) without extracting an income for itself, it allows investors to realise the minimum rate of profit necessary for them to invest again.

This is what occurred for the 25 years following WWII. So what stopped it?

Inflation

Inflation. Inflation instigated by a series of oil price shocks but then prolonged by excessive government spending in the US to finance the Vietnam war. Governments in the late 1970s and 1980s reacted to inflation by drastically cutting spending. But the rate of inflation did not fall until the price of oil fell in the 1990s and China flooded the world with cheap manufactured goods. Certainly, if an expansion of the money supply is excessive we will get inflation. But taken to an extreme in the other direction, we get low growth and unemployment.

Where do you think we are in 2016? With 700,000 official unemployed, close to another 700,000 under-employed, and an inflation rate below 2%, I would say we are swung too far to the parsimonious side. It is all about balance. It should not be about blind and mechanical fear mongering about government budget deficits. The current political debate is on level with a Tony-Abbott-climate-change debate. Misguided, low brow and damaging to the well-being of many people.

Productivity growth

And incidentally, for those wondering, productivity growth will not break the deficient-demand impasse described above. Productivity growth would have to achieve a consistent rate of over 5% per annum to fill the void in spending. Given the historic rate has been about 1%, I would not count on it.

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