KEYNES AND THE ECONOMIC CRISIS

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I am not going to say too much about Obama's first hundred days because little enough has happened in them. When the title of this talk was mooted, it looked as though we would be comparing him to Roosevelt and *his* first hundred days, which saw a barrage of legislation laying the foundations of the New Deal. The economic situation today is not as desperate, and practically all the reforms to the financial system are still in the future. What we have had so far is a series of rescue operations, most of them started under the previous Administration—bank bailouts, stimulus packages. Whether they will be enough to bring about a complete recovery and over what period, time will tell. What I want to do instead is to outline some of the ideas that I have developed in my forthcoming book, *Keynes—The Return of the Master*, because I do think Keynes is a master and that his theory offers the most profound understanding of the causes of the present economic crisis, what is needed to overcome it, and how to prevent similar breakdowns in the future.

What Went Wrong?

The story of the present meltdown starts with the American subprime mortgage crisis and the role of financial engineering in bringing it about. Its contours are familiar enough. Banks lent to borrowers who were not credit-worthy. They turned the housing boom into a housing bubble, as house prices and home ownership rocketed between 2001 and 2006. This was due to a surge in the supply of credit. The credit explosion was partly the result of cheap money, but also of predatory lending. The banks scooped up the ninjas—borrowers with no incomes, no jobs, no prospects. They teased them with virtually free money for the first years of the loan. Securitization—the general name given to the financial innovations of the period—enabled this to happen. Credit default swaps are particularly important because they gave the banks the illusion that their lending was virtually risk-free. Credit default swaps were the means by which mortgage-backed securities entered the world banking system.

We all know the sorry outcome of the speculative frenzy: collapsing house prices, rising default rates, the increasing toxicity of bank assets, the freezing of inter-bank lending, the fear and actual occurrence of bank insolvency. Once the banks stopped lending to each other and to their customers, you got a credit freeze, and everything else followed with astonishing speed in the autumn of 2008. The collapse of commodity prices started in July, accelerating with the bankruptcy of Lehman Brothers in September. Stock markets collapsed, and then the real economy started shrinking. Up to the middle of 2008 it was still possible to make growth forecasts which assumed only a very slight fall in the rate of growth for the following 12 months. Then they all had to be revised downwards as the real economy went into a nose dive. One of the difficulties of discovering where we are today are these projections from bodies such as the IMF and the OECD that are all backward-looking. Is the present stock market bounce just a blip or the start of a durable recovery? No one knows.

The question is, why did a situation which seemed reasonably healthy in 2007 and even in the first half of 2008 suddenly turn out to be so diseased? The earliest explanations blamed greedy bankers, incompetent regulators, misaligned incentives and so on. But none of these touched on fundamental economic theory. That came later. The chief ones currently being canvassed may be grouped under two headings: government failure and market failure. The first is associated with the New Classical economics and the second with the New Keynesian economics. But neither, it seems to me, gets to the root of the matter. For that we need to return to Keynes himself.

Current Explanations of the Crisis

The New Classical economists find themselves in an uncomfortable position. According to the doctrines chiefly associated with them—rational expectations theory, real business cycle theory and efficient market theory—the present crisis should not have happened, because assets are always correctly priced. This is roughly what New Classical economists mean when they say that agents have rational expectations. Rational expectations are correct expectations. If this is true, a decentralized market system would never be subject to breakdown except in circumstances which had never happened before. Individual mistakes are randomly distributed and cancel each other out.

This being the case, New Classical economists are committed to the view that business breakdowns must be due to exogenous "shocks," events which cannot be fitted into models which assume normal distributions of contingencies. The main candidate for the shock which generated the present crisis is "excessive credit creation" and its main author is Alan Greenspan, till recently the hero of all conservative Americans, an all-wise master of the financial universe. Greenspan, it is alleged, kept money too cheap for too long. By the time he tried to remove the punch bowl, the party had gotten out of hand. By the time interest rates did finally go up, it was too late to do anything except bring about the collapse of the housing bubble and by doing that involve the whole of the banking system in the ensuing ruin. Surprisingly, there has been little criticism by the New Classical economists of the loose fiscal policy of the Bush administration. This is because Bush was a conservative hero and, after all, he spent those deficits wisely—didn't he?—by invading Iraq and Afghanistan and on other such noble enterprises on behalf of freedom.

The story is that "excessive credit creation," promoted by a one-percent Fed funds rate between 2003 and 2005, produced asset price inflation. Greenspan, in other words, produced a "money glut" from which a reaction in the form of credit restriction was inevitable. This is really a rerun of the conservative explanation for the Great Depression of 1929-1932. So you are getting a very old record dressed up in new math. The basic idea is always that the boom has to end in a slump because the boom is the sin and the slump is the wages of sin.

In blaming the crisis on Greenspan's cheap money policy, the New Classical theorists are forced to sacrifice one of their favorite intellectual propositions: the neutrality of money. This states that if the money stock is growing faster than productivity, as it certainly was in the early 2000s, the only effect will be to increase the rate of inflation; it will have no effect on relative prices. This is simply another way of stating the equally well-known "policy ineffectiveness proposition," which says that monetary expansion (or contraction) has no effects on the real economy. But what the New Classical economists now have to admit is that Greenspan's policy threw the economy out of equilibrium. Money, apparently, is not neutral, and policy is not ineffective. The New Classicals might reply that lenders were "surprised" by the cheapness of money into making loans which could not be repaid. But it had been the main object of Milton Friedman and, following him, the New Classical economists, to show that this type of "fooling" was no longer possible. Very cheap money by the Fed should not have led to "excessive credit creation" by the banking system if lenders were correctly anticipating inflation. The yield spread between the Fed funds rate and the banks' loan rate would simply have increased, choking off any housing bubble. This of course did happen after the banking crisis had occurred, not because the banks were expecting inflation, but because they were trying to rebuild their balance sheets.

The New Keynesians blame the crisis not on government failure but on market failure. Markets can fail, they argue, because they are plagued by all kinds of information problems. As a result, trading at wrong prices is possible and frequent. The main source of information failure investigated by the New Keynesians is "asymmetric information": insiders have an informational advantage over outsiders. The credit customer knows more about his risk of default than the bank does; the insurance buyer knows more about his health

than the insurance company does. Achieving efficient exchange under these conditions is difficult. Suspecting that the insider will use his superior information to cheat, the outsider will pay only a low price and therefore the insider will want to sell only bad goods. In the secondhand car market, all that will be left is a "market for lemons." New Keynesians also explain the stickiness of wages and prices in response to a shock by "menu costs," the cost of adjusting prices quickly to every change in conditions.

The New Keynesian models seem to fit some current facts rather well, such as banks giving out loans to borrowers who could never pay them back. The flaw in these models is that they assume that someone–the credit customer, the insurance buyer—possesses perfect, or at least superior, information. However, the present crisis shows that we are in a world of uncertainty, with the blind leading the blind. This is a crisis of symmetric ignorance, not asymmetric information. Bankers were not only greedy, but, as Taleb says, "phenomenally skilled at self-deception." Robert Merton and Myron Scholes, who in 1997 received a Nobel Prize for their work on derivatives' pricing methods, believed in models which led to the collapse in 1998 of their hedge fund Long Term Capital Management. The only people who were not really ignorant were the traders, who never bought the efficient market hypothesis. Their aim was to get in and out of trades as quickly as possible to make sure that they were not left holding the baby when the music stopped. They knew it was bound to stop, but meanwhile they might have retired with $50,000,000.

"Menu costs" might explain why individual firms faced with falling margins lay off workers rather than adjust their wage contracts. But a firm's profit expectations reflect not just its own cost curves, but its expectations of future demand in the economy. Like the New Classicals, the New Keynesians try to derive macroeconomic outcomes from decisions at the micro-level, differing from the former only in their assumption that knowledge of outcomes is asymmetrically rather than symmetrically distributed. Symmetric ignorance, or what Keynes called uncertainty, is ruled out by assumption.

Keynes's Explanation: Uncertain Expectations and Money

The heart of Keynes's explanation of why market economies are not automatically self-adjusting to full employment is that economic actors have *uncertain* expectations about the future. Those economists like Paul Davidson are right, therefore, when they place uncertainty at the center of Keynes's picture of economic life. Holding cash provides a way of dealing with uncertainty. But it also causes a collapse of aggregate demand, or spending, which sets the economy on its downward slide.

Recession in Keynes's economy is usually triggered by a fall in investment demand relative to intended saving due to more pessimistic expectations about the future. The ratio of saving intended for new investment falls; the ratio of saving to be held as money rises. The importance of money, Keynes wrote, "essentially flows from it being a link between the present and the future." As a consequence "a monetary economy… is essentially one in which changing views about the future are capable of influencing the quantity of employment and not merely its direction." Shifts in attitude to investment are key to the dynamics of the economic system. When fear of the future grows, there is a flight from investment into cash—from illiquid to liquid assets—and the economic machine runs down.

The existence of uncertainty explains why investment is heavily dependent on the "animal spirits" of businessmen; the role of money as a store of value explains why a key price in the system—the rate of interest—is "sticky" just when it needs to be at its most "flexible."

The classical belief that the economy was self-correcting rested on the view that the rate of interest was the equilibrating or balancing element in the economic system. It was the instantaneous adjustment of this price to shifts in the supply of saving and the demand for investment which was supposed to maintain the balance between the two. When the desire to save ran ahead of the inducement to invest, the rate of interest would fall. (This was the basis of the classical prescription that people should save more and spend less in a slump). By contrast, Keynes argued that the rate of interest has little effect on saving (which

depended on the level of income), but a big effect on investment. For any given state of profit expectations, the continued expansion of investment depends on a corresponding reduction in the cost of borrowing.

But here was the snag. "The rate of interest," Keynes writes, "is the price which equilibrates the desire to hold wealth in the form of cash with the available quantity of cash. The greater people's 'liquidity' or 'cash' preference, the higher the rate of interest they will charge for parting with money." A collapse in the expected profitability of investment tends to lead to an increase in liquidity preference, thus pushing interest rates up, when they need to come down. The logic of Keynes's *General Theory* is completed by this demonstration that the rate of interest can remain above the rate of profit necessary to secure full employment.

Why, Keynes asks, should anyone outside a lunatic asylum want to hold money? The answer was:

> Partly on reasonable and partly on instinctive grounds, our desire to hold money as a store of wealth is a barometer of our distrust of our own calculations and conventions concerning the future.... It operates, so to speak, at a deeper level of our motivation. It takes charge at the moments when the higher, more precarious conventions have weakened. The possession of actual money lulls our disquietude; and the premium which we require to make us part with money is the measure of the degree of our disquietude.

In short, Keynes distinguished between the *risk premium*, which is expected to be rewarded by greater wealth, and the *liquidity premium*, which is compensation for a decreased sense of comfort.

This is a completely recognizable picture of the recent credit crunch. Keynes did not deal explicitly with the behavior of banks. But his liquidity preference analysis applies to them. Because of their bad loans, all the major lending institutions are now trying to increase their cash balances, so they are raising the rates at which they are willing to lend to customers.

Keynes recognized that the increase in liquidity preference might make monetary policy ineffective, especially at the bottom of a slump:

> Cheap money means that the riskless, or supposedly riskless, rate of interest will be low. But actual enterprise always involves some degree of risk. It may still be the case that the lender, with his confidence shattered by his experience, will continue to ask for new enterprise rates of interest which the borrower cannot expect to earn.... If this proves to be so, there will be no means of escape from prolonged and perhaps interminable depression except by state intervention to promote and subsidize new investment.

Keynes's emphasis on uncertainty, and on the role of money as a way of dealing with it, has been virtually obliterated from modern mainstream economics.

Saving and Investment

In the Keynesian analysis you get a downturn when the propensity to save rises or the inducement to invest falls. Now it is true that investment in the U.S. never recovered from the collapse of the dot.com boom in 2001. At the same time, America was enjoying a huge consumption boom. Surely, one could say, this increase in consumption offset the stagnation in investment. And of course it did. Investment fell, consumption rose. Why was this position unsustainable? The short answer is that an increasing share of the consumption was being financed by borrowed money, i.e., the borrowing was not producing the means to repay the debt by creating new assets. As in the war, it was creating deadweight debt. This is the basis of

the view that the crisis and downturn were the result of a "saving glut" or, as Martin Wolf more accurately put it, an "investment dearth."

One can identify two sources of saving which were not finding an outlet in new investment. The first was the build-up of corporate profits, which were being returned to shareholders in the form of dividends or used to buy back shares or for mergers and acquisitions or in increased depreciation allowances. In other words, much of it was being hoarded or applied to what Keynes called the "financial circulation" rather than the "industrial circulation," that is, not in buying new assets but in swapping titles to existing assets, which simply increases the prices of those assets. The other source was Chinese, and more generally East Asian, saving.

The historian Niall Ferguson has described the Chinese-American symbiosis as "Chimerica," which he says seemed "like a marriage made in heaven…. East Chimericans did the saving. The West Chimericans did the spending…. The more China was being willing to lend to the United States, the more Americans were willing to borrow." The trouble with Chimerica is that the Americans didn't invest East Asian savings: they *consumed* them. In short, Chinese savings enabled the Americans to consume beyond their means. Chinese investment in U.S. Treasury bills failed to correspond to the development of new American assets producing a flow of income from which to service the debt. What it did do was to enable Alan Greenspan to run an exceptionally cheap monetary policy in the first five years of the new millennium. Yet, as he acknowledges, cheap money had only a "modest effect on recorded developed country investment," despite the fall in the long-term rate of interest. Instead it financed a big rise in house prices and the cheap refinancing of mortgages to buy consumer durables.

As a result of the investment dearth, the saving glut created from these two sources was not eliminated in the run-up to the 2008 collapse. Indeed, with East Asia growing faster than the U.S. and Europe, the gap between intended saving and intended investment grew. The U.S. consumption boom was at best a short-term answer to the growing gap between the two. It offset the deflationary effect of the saving glut without eliminating it. It was essentially a race between whether the housing bubble or the dollar collapsed first. As it was, the collapse of asset prices, first housing, then other securities, drastically diminished the wealth of most Americans and thus caused them to rein in their spending in order to rebuild their balance sheets.

How then to explain the investment dearth? Keynes expected that as societies got richer the returns to investment would fall and spending would switch increasingly to consumption. But he thought this would need to be brought about by a conscious policy of redistributing income from higher saving to lower saving groups. However, the redistribution of income in the last 20 years or so has gone in the opposite direction. The fact is that America was suffering from *under-consumption* masked by borrowing. Profits were gaining at the expense of wages. People were borrowing more, and working harder, to keep up accustomed living standards, but their actual wages were stagnant. Why were they stagnant? Because the things they had produced before were being produced much more cheaply in Mexico and East Asia. This was the major cause of the profit inflation in the American economy. In other words, the investment dearth in the American economy was partly the result of a depression of wages relative to profits. Since it is consumption demand that drives investment, the tendency to under-consumption by a large swathe of working-class and even middle-class America was bound to put a damper on new investment.

The Debate over the Stimulus

The New Classical economists have been unanimously against a fiscal stimulus, just as the Old Classical economists were in 1929-1932. This follows logically from their premise: if the economy is already at full employment a fiscal stimulus cannot improve matters; indeed, since government spending is likely to be less efficient than private spending, it will lower the medium-term growth prospects of the economy. Here is John Cochrane of Chicago University:

> If the government borrows a dollar from you, that is a dollar that you do not spend, or that you do not lend to a company to spend on new investment. Every dollar of increased government spending must correspond to one less dollar of private spending. We can build roads instead of factories, but a fiscal stimulus can't help us to build more of both.

Paul Krugman was enraged by this statement, pointing out that the conservative argument against fiscal stimulus was a rerun of the "Treasury View" of the 1920s:

> If there was one essential element in the work of John Maynard Keynes it was the demolition of Say's Law–the assertion that supply necessarily creates demand. Keynes showed that the fact that spending equals income…does not imply that there's always enough spending to fully employ the economy's resources.

It followed that, in situations in which there were underemployed resources, extra spending by government did not have to be at the expense of private spending.

How is it possible for New Classical economists to claim that economies remain fully employed with unemployment rates shooting up to 10 percent and businesses closing down for lack of orders? The answer given by the New Classical economists is that the unemployment of the unemployed is voluntary and therefore should not count as unemployment at all, but rather as a voluntary choice for leisure. If they are excluded from the workforce, it does of course follow as a matter of logic that government borrowing from the public to build roads will be at the expense of private borrowing to build factories and will not therefore increase total employment.

Few economists put the case against a fiscal stimulus as crudely as John Cochrane does. Most of those against a stimulus rely on some version or other of psychological "crowding out." If confidence in government policy is impaired—say, because its deficit is seen as expanding beyond limit—the government may well have to pay an increasing price for its debt. Although government deficits have been rising to 10 percent or more of GDP, few expect western governments to default on their debts. However, a more subtle form of default is inflation. If the public expects the government to inflate away its debt, the rate of interest it will demand for lending to the government will rise in line with the anticipated rate of inflation. This may be starting to happen in the U.S. and U.K., with markets pushing up yields on long-dated Treasury bonds even as base rates fall towards zero. Since the rate at which the government can borrow determines the whole structure of interest rates, this will force up the cost of borrowing for the private sector as well.

Conservative economists are much less frightened of "quantitative easing" or what is popularly called "printing money." A government can do this by selling securities to the central bank in exchange for cash, which it then uses to meet its excess of spending over revenue. Or the central bank can inject cash into the economy by buying long-term government bonds from the banks. The banks swap their securities for cash and then expand their lending against their higher cash reserves. Here is New Classical economist Robert Lucas in support of Fed Chairman Bob Bernanke's policy of boosting the money supply:

> It is fast and flexible. There is no other way that so much cash could have been put into the system as fast as this $600bn. was, and if necessary it can be taken out just as quickly. The cash comes in the form of loans. It entails no new government enterprises, no government equity positions in private enterprises, no price fixing or other controls on the operations of individual businesses, and no government role in the allocation of capital across different activities. These seem to me important virtues.

The virtue of quantitative easing as opposed to bond-issues is that it may lower the cost at which a government has to borrow money from the public to finance its own spending.

It's not clear to me at any rate how support for any kind of stimulus, whether fiscal or monetary, can be reconciled with the assumption that the economy is always at full employment. If the latter is true the only effect of increasing the quantity of money will be to increase the rate of inflation. On this assumption, the psychological effect of quantitative easing would be to raise rather than lower the long-term interest rates.

Printing money may not be an effective antirecession remedy for another reason. As Keynes pointed out, "If money is the drink which stimulates the system to activity…there may be several slips between the cup and lip." If the banks' desired ratio of cash reserves to deposits is increasing, as may well be the case if they hold a lot of toxic assets, they will not lower the interest which they charge for loans; if profit expectations are falling more quickly than the rate of interest, lowering the rate of interest will not increase the amount of loans; and, even if some people are stimulated to invest more, economic activity may not increase if other people are simultaneously increasing their saving to pay off debt. In technical terms, the money multiplier—the change in the total money stock for any change in the quantity of injected cash–may be quite small, or even negative. Between January and June, 2009, M2 in the U.S. collapsed even as the Fed was pumping money (M1) into the banks. For Keynesians it is the spending of the money, not its creation, which provides the "stimulus." The virtue of quantitative easing is that it may lower the cost at which a government has to borrow money from the public to finance its own spending. But this effect, like that of the fiscal stimulus, depends on the expectations the public holds about government policy.

Thus the stimulating effects of either fiscal or monetary expansion may be disappointingly small. The truth is that there is no easy way of digging yourself out of a hole. It is far more important to take precautions against falling into one.

The Keynesian Economy

Keynes's chief domestic prophylactic against uncertainty was what he called "cheap money, wise spending." To offset fluctuations in private investment demand, money should be kept permanently cheap, and the state's capital budget, which consisted of all public, or publicly influenced, investment programs, should be used to keep total spending at a full-employment level. By contrast, the government's "ordinary" budget for current spending should normally be in surplus. Keynes was just as keen to keep global demand continually high. He believed that a principal cause of the Great Depression had been a global "saving glut" originating in the United States. The U.S.'s, and to a lesser extent France's, accumulation of gold through its current-account surplus had forced all other countries on the gold standard to deflate their economies. It was to avoid a repetition of this deflationary pressure that Keynes worked out his plan for an international clearing union in 1941 which was designed to prevent countries from accumulating or hoarding reserves.

In time, as the returns from investment fell, the domestic aim of policy should switch to reducing income inequalities (thus raising the "propensity to consume") and increasing leisure time, with shorter working hours and more frequent holidays. In the golden age of capital abundance, with the economic problem solved, people would learn to live "wisely, agreeably and well." This was Keynes's answer to the question, "What is economic growth for?"

Conclusion

As we come out of the present economic crisis, Keynes's analysis of why an unmanaged, unregulated market economy is liable to collapse, how to escape from a slump, what policy and institutions a stable full-employment economy would require, and what economic growth was for, should again command attention. A highly desirable consequence of the reemergence of Keynes's analysis would be a second dethronement of the classical school which has led bankers, regulators and governments so grievously astray.