THE OLD ECONOMICS FOR TODAY'S CRISIS

Posted on December 28, 2008 by Keghart

Category: Opinions

By Robert Skidelsky, member of the British House of Lords and the author of the biography, John Maynard Keynes: Economist, Philosopher, Statesman.

What is in even shorter supply today than credit is an economic theory to explain why the current financial tsunami occurred, and what its consequences might be. Over the past 30 years, economists have devoted their intellectual energy to proving that such disasters cannot happen. The market system accurately prices all trades at each moment in time. Greed, ignorance, euphoria, panic, herd behaviour, predation, financial skullduggery and politics – the forces that drive boom-bust cycles – only exist off the balance sheet of their models.

By Robert Skidelsky, member of the British House of Lords and the author of the biography, John Maynard Keynes: Economist, Philosopher, Statesman.

What is in even shorter supply today than credit is an economic theory to explain why the current financial tsunami occurred, and what its consequences might be. Over the past 30 years, economists have devoted their intellectual energy to proving that such disasters cannot happen. The market system accurately prices all trades at each moment in time. Greed, ignorance, euphoria, panic, herd behaviour, predation, financial skullduggery and politics – the forces that drive boom-bust cycles – only exist off the balance sheet of their models.

So mainstream theory has no explanation of why things have gone so horribly wrong. To understand how markets can generate their own hurricanes we need to return to John Maynard Keynes.

The Great Financial Meltdown would not have surprised the British economist, who died in 1946, for he thought that this was exactly how unregulated markets would behave. The New Economics, as Keynesian economics was known in the United States until it became the Obsolete Economics, was designed to prevent such collapses. It held that governments should vary taxes and spending to offset any tendency for inflation to rise or productivity to fall. And for roughly 25 years – from 1950 to 1975 – they did. The developed world grew at an average annual rate of 3.2 per cent without a business cycle, with very moderate inflation, and without the benefit of the huge rewards now deemed necessary to keep executives properly incentivized. Then the free-market deregulators and globalizers seized control of the engine room, and boom-bust cycles returned with a vengeance.

Keynes first became convinced of the instability of unregulated economies in the boom years of the 1920s – the "Roaring '20s," as they were called. In many ways, the 1920s were like the last 15 years in their technological dynamism, the extravagant lifestyles of the very rich and in their "irrational exuberance." But they were especially like the recent past in their belief that prosperity would continue without interruption.

The magical formula for success was supposed to be the new "science" of monetary management. From the fact that depressions were associated with falling prices and booms with rising prices, the economist Irving Fisher concluded that economic cycles could be eliminated by policies of price stability. If governments could keep prices steady, the economy could safely be left to look after itself. Under his influence, the U.S. Federal Reserve Board set itself the goal of price stability. And the price level did stay remarkably stable for most of the 1920s.

Fisher's views were discredited by the stock market crash of 1929, but his doctrines were revived by Milton Friedman in the 1970s. Plagued by inflation, governments around the world took up Friedman's monetarism, which maintained that inflation was due to governments' printing too much money. Central banks were made independent (the Fed already was) and were given the single task of keeping prices stable. Moreover, financial innovation in increasingly deregulated markets was said to make investment less and less risky. The formula seemed to work. Not only did inflation stay low – not once did it exceed 4 per cent between 1991 and 2006 – with very little price volatility from the 1990s onward, but the U.S. economy showed strong, though not particularly steady, growth of 3.22 per cent on average, with a low of 0.8 per cent in 2001 and a high of 4.5 per cent in 1997. Once again perpetual prosperity beckoned.

So what went wrong?

What was wrong was the theory. The price level is not a leading, but a lagging, indicator. Asset bubbles can coexist with a stable price level, even while the rest of the economy is starting to slide into depression. And this, in essence, is what Keynes believed was happening in the late 1920s. Money, he argued, was being switched from production to speculation. The rich were getting very much richer, while the incomes of the rest were stagnating. "Profit inflation," fuelled by collateralized debt, coexisted with an "income deflation." Share prices were being driven up to dizzying heights even as farmers were finding it harder to service agricultural mortgages.

Every financial crash is different in detail – today's started in the banking system, not the stock market – but the anatomy of all is surprisingly similar: A speculative frenzy, triggered by some technical innovation such as mortgage-backed securities, that collapses when reality – in the form of more sober valuations – kicks in.

No one has bettered Keynes in his understanding of the psychology of financial markets. "Most ... of our decisions to do something positive ... can only be taken as a result of animal spirits ... If animal spirits are dimmed ... enterprise will fade and die" is one famous remark. "Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on a whirlpool of speculation. When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done" is another. Professional investment, he wrote, is like "a game of Snap, of Old Maid, of Musical Chairs," whose object is to pass on the Old Maid – the toxic debt – to one's neighbour before the music stops. What makes the game toxic is not greed – which is universal – but uncertainty masquerading as certainty.

"The outstanding fact is the extreme precariousness of the basis of knowledge on which our estimates of prospective yield have to be made," Keynes wrote in his great book *The General Theory of Employment, Interest, and Money* in 1936. We disguise this uncertainty from ourselves by assuming that the future will be like the past, that existing opinion correctly sums up future prospects, and by copying what everyone else is doing. But any view of the future based on "so flimsy a foundation" is liable to "sudden and violent changes. The practice of calmness and immobility, of certainty and security suddenly breaks down. New fears and hopes will, without warning, take charge of human conduct ... the market will be subject to waves of optimistic and pessimistic sentiment, which are unreasoning yet in a sense legitimate where no solid basis exists for a reasonable calculation." Keynes accused economics of being itself "one of these pretty, polite techniques which tries to deal with the present by abstracting from the fact that we know very little about the future."

One must bear in mind that Keynes's aphorisms, which seem so apposite today, were for years dismissed with a pitying

smile as the product of a primitive state of economic thinking that had been rendered obsolete by powerful desktop computers and PhD math unavailable to economists of Keynes's generation.

The second strand of Keynes's economics was formed by the depressed 1930s, rather than the booming 1920s. His main insight was that a wounded economy would not simply bounce back but would take years to recover. In his own technical language, it might remain a long time in a state of "underemployment equilibrium," from which it could be rescued only by a massive external shock. As we know, this proved to be the case. It was not the New Deal that brought the U.S. economy back to full employment, but World War II and the huge increase in government spending it brought about.

The long Japanese stagnation of the 1990s is another example of how long it can take for toxic debt to work itself off the balance sheet of banks, and how relatively powerless governments are to produce recovery in the face of flight into cash.

Of course the problem of what a government can or should do to mitigate these financial storms is not disposed of by pointing out that economies don't behave in the way economists claim that they do. Keynesians want to create financial corridors to limit "the flight of the butterfly," in Paul Davidson's graphic phrase. Free-marketers argue that the cost of periodic crashes and massive rescue operations is worth paying to preserve freedom of capital movements and technological dynamism. Today, as the costs of the bailout mount up, this argument is heard much less.

We know now that we know very little. But Keynes's insights should not be tossed away as old garbage. At the very least we can say that we have no warrant for basing economics on assumptions that are so often discredited by events. Suitable perhaps for professors and students, such economics are likely to be especially toxic for policy-makers.