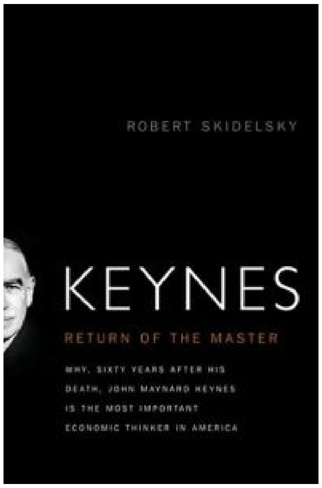

Book Keynes

Return of the Master

Robert Skidelsky
Public Affairs, 2009
Listen now

- play
- pause

00:00
00:00

Recommendation

The modern recession casts doubt on many long-held economic beliefs, in particular, the validity of free markets. Unable to agree on causes or remedies, economists look on as politicians try various kinds of stimulus spending and corporate bailouts. Pundits call forth the ghost of John Maynard Keynes, often incorrectly labeled as a has-been socialist and tax-and-spend liberal. But Robert Skidelsky, Keynes' biographer and a noted expert on the economist and his work, reveals how Keynes' pre-World War II experiences shaped an economic worldview that still holds lessons for the 21st century. This scholarly book assumes that the reader has more than a nodding acquaintance with modern economic theory and philosophy, yet Skidelsky also injects literary references and sparks of wit that enliven the sometimes-challenging text. *BooksInShort* suggests this abbreviated, but solid, look at Keynes to students of economic and political history, and to anyone who is trying to make sense of how the 2008 crisis happened and how to move forward.

Take-Aways

- John Maynard Keynes is one of the 20th century's great economic philosophers.
- He gained practical experience working in government, managing clients' money, and making and losing several fortunes.
- The modern global economic crisis raises questions about what role the state should play in economic life, with "saltwater" and "freshwater" economists on opposite sides.
- Saltwaters, or "New Keynesians," support some government role in regulation and stimulus spending.
- Freshwaters, or "New Classicals," accept 1980s Reagan-Thatcher free market theories.
- Two world wars and the Depression led Keynes to believe government should get involved in the markets to maintain employment and avoid economic shocks.
- Keynesian economics underscored many nations' post-World War II fiscal planning.
- Keynes' understanding of human psychology permeates his economic theory.
- Keynes believed that uncertainty about the future governs all market transactions.
- He said prosperity's purpose is not to create wealth for its own sake, but to improve human existence by providing daily security and tranquility.

Summary

How Do We Get Out of Here?

Most economists have explanations for how the 2008 world economic crisis happened, but opinions differ on the cause and the remedy. Many are looking to the past and to the ideas of economist John Maynard Keynes (1883-1946), who is known widely but superficially as a proponent of stimulus funding and government involvement in business. However, that explanation glosses over the complexities of his philosophy. Indeed, his experiences during the seminal economic events of his lifetime – World War I, the Great Depression and World War II – inspired him to create a new way of economic thinking. The harmonious functioning of capitalism became his goal, which included calling upon the state's tempering hand to tame the system's excesses. Some arguments as to how free markets around the world broke down beginning in 2007 and continuing into 2008 include:

- **"The collapse of the housing bubble"** – By 2005 the rise in U.S. home prices accounted for 50% of U.S. gross domestic product (GDP) growth. Government entities expanded lending, and commercial lenders gave mortgages to subprime debtors. As housing prices grew, people borrowed against equity. Rising interest deflated the balloon, and defaulted subprime loans became "a bullet that fatally wounded the banks."
- **"Financial innovation"** – The securitization boom resulted from deregulation. Rolling back the Glass-Steagall Act let commercial banks function like investment banks. The government chose not to legislate to control the vagaries of credit-default swaps, and the Securities and Exchange Commission (SEC) tripled bank leverage ratios. In 2002 Warren Buffett forecast that derivatives would become "financial weapons of mass destruction."
- **"The banking crisis"** – With bank assets under siege and liquidity scarce, a global banking panic ensued. In 2007, Northern Rock bank suffered the first run on a British bank in more than 100 years. Bear Stearns' and Lehman Brothers' collapse, along with AIG's trauma, called for a fast response. The $700 billion Troubled Asset Relief Program bailout was only one of many huge spending programs in Europe and the U.S.
- **The "collapse of commodity prices"** – Speculation and growing demand in developing nations raised commodity prices to new highs. But the economic crisis suddenly washed away demand, dropping prices dramatically and endangering export-led countries.
- **The "collapse of the stock markets"** – The banking and commodities crashes combined to sink the stock markets worldwide. Most severely affected were Russia's RTS Index, which dropped by 80%, and Japan's Nikkei, which fell by 42%.
- **The "collapse of the real economy"** – Before the subprime crisis, people held wealth largely on paper – in their property deeds and stock certificates. When perceived wealth dropped, consumption slowed, businesses laid off staffers and recession became a reality.

> "The economic hurricane now raging gives us an immense opportunity to reorient economic life toward what is sensible, just and good."

The underlying cause of these breakdowns is the failure of free market thinking, stemming from the 1980s era of President Ronald Reagan and Prime Minister Margaret Thatcher, which fueled a return to the belief in the "invisible hand" that theoretically guides free markets. Economic thinking now follows two predominant schools: "saltwater" and freshwater," which diverge on the need for government involvement in solving economic problems:

1. **Saltwater** – This contingent comes from the East and West Coasts. Its members consider themselves "New Keynesians." They say that market adaptations are not instantaneous, that time delays prevent stability and that the future is uncertain and, thus, not reliable for measurement or forecasting. They believe government fiscal policy has a role in the markets when shocks to the system don't immediately correct themselves. They pose their familial dispute with the freshwater school as a matter of the short term versus the long term. Keynes never entirely bought this distinction. "In the long run," he said famously, "we are all dead."
2. **Freshwater** – These University of Chicago-based free market or "New Classical" economists maintain that the markets provide the best outcomes, and that government interference is unnecessary and impedes the markets' smooth functioning. They believe they can discern the future by extrapolation and study of past events, based on mathematical models and quantitative analysis. Their models assume that everyone in the market always has access to complete, symmetric data, that markets instantly clear their own imbalances and that all market participants are rational.

> "The New Keynesians put common sense ahead of their logic, while the freshwaters put their logic ahead of common sense."

Three theories freshwater economists hold dear set the economic landscape for the past 30 years:

1. **"The rational expectations hypothesis"** – If the costs of items and salaries are free to move with changes in supply and demand, and if everyone has perfect, instant knowledge of these changes, including information about future events, then market factors (labor, capital, prices, wages) will adjust immediately. Since the markets know best, government intervention, regulation or stimulus spending will make matters worse. On average, events will follow models, given a percentage of "random error."
2. **"The real business cycle theory"** – Markets always adjust, but some forces may adapt more slowly than others. This accounts for boom-and-bust cycles.
3. **"The efficient financial markets theory"** – Because all data is available to all participants, the price of a financial instrument includes full information and thus accounts for the instrument's risk. Quantitative analysis can identify the correct risk profile and enable predictions about the future by showing the right price for any asset.

> "This so-called 'efficient market theory' should have been blown sky-high by last [2008] autumn's financial breakdown."

These theories say that investors can measure and price any risk or asset much as insurance companies insure against loss of life and property. The flaw is that actuarial data about life expectancies and property claims are old and straightforward, unlike data about newer derivatives or asset-backed securities, which are valued based on underlying assets. Unheard-of fluctuations when the markets went into tailspins in 2007 demonstrated again that the future really is unknowable – so was Keynes right?

John Maynard Keynes

Keynes might not have foreseen the market meltdown, but it wouldn't have surprised him, given the laissez-faire policies of the past 30 years. He experienced the waning of the Victorian era and the dawning of Edwardian England's philosophical and political changes. He socialized with Virginia Woolf and Bertrand Russell and joined the arty Bloomsbury Group. His wife, ballerina Lydia Lopokova, saw him as "more than an economist." He brought a strong affinity for psychology, aesthetics and morality to his work in economics.

> "The failure of the models...is not only a matter of limited data: Ultimately, it is a matter of limited applicability."

Keynes saw wealth as more than the pursuit of money for its own sake; rather, he felt that riches provide a way to live "wisely, agreeably and well." He worked as a civil servant but also managed money for himself and his investors through two world wars and the Great Depression. His government career, including a stint as a Bank of England director, informed his thinking on policy issues. In his investment business, he resembled an early 20th century George Soros or Warren Buffett. His practical work life inspired his scholarly books and papers; his academic writings carry the credibility of his market and political experience. He distrusted overreliance on mathematics and econometrics in describing monetary events, because he believed that the future is uncertain, and any attempt to quantify future prices, wages or events is flawed.

> "[Keynes'] ethics pointed him toward the ideal; his politics toward moderation."

In 1919, Keynes began a sort of "hedge fund," investing in "floating currencies" for his Bloomsbury friends. He made millions before his death in 1946 but was almost wiped out three times. He speculated in currencies and commodities, and he traded equities and bonds. Losing almost all his money in the panic that followed WWI and in the Great Depression taught him the futility of trying to beat market cycles. He became a buy-and-hold investor and observed that mob reactions to plunging markets are self-defeating: Everyone sells to try to preserve assets, but prices fall further. "The fact of falling prices injures entrepreneurs," he wrote, "consequently the fear of falling prices causes them to protect themselves by curtailing their operations." In 1931, he advised the insurance firm he directed not to sell its stocks. Like Buffett, he believed in buying in a bear market, being contrarian and feeling a sense of responsibility to the public good.

Keynesian Economics

To understand Keynes' theories, you must understand these tenets of his economic ideas:

- **"Uncertainty"** – Central to Keynes' thinking, uncertainty is why people keep cash on hand, why investments change in value and why interest rates don't always affect savings. Money is not just for spending; it's used to store future value. But since the future is unknowable, savings and investments are subject to indeterminable volatility and risk.
- **"The limits of econometrics"** – Keynes disagreed with relying on statistics to plot economic events, because such events change too rapidly, modeling relies on variables no one can prove, economic problems often have nonquantifiable causes and abstract notions do not lend themselves to quantitative analysis. Statistics can be useful in understanding "simpler, less abstract relations."
- **"Effective demand"** – People consume ("stable" demand) and invest for the future ("unstable" demand). The more they save, the less they buy, which affects business and leads to job loss. "Spending, not saving...creates output and employment."
- **"The inducement to invest"** – Investing is betting on an unknowable future. A stock market lessens that uncertainty by providing liquidity at a known price and furnishing companies with capital. People invest in a market for the protection of their liquidity at an earned return, but the market itself is prone to speculators and volatility.
- **"The rate of interest"** – Keynes believed interest rates derived from a desire for liquidity, not from supply and demand. The higher the liquidity, the higher the interest rate. Thus, a market meltdown leads to higher rates just when people need lower rates.
- **"The outcome"** – Keynes' policy prescription was "cheap money, wise spending." He said the government should spend to keep the economic engine going to maintain stability in private investments and to supply businesses with capital to provide jobs. His "big idea was to use macroeconomic policy to maintain full employment."

> "Ideas, knowledge, art, hospitality, travel – these are things which should in their nature be international. But let goods be homespun whenever it is reasonably and conveniently possible and above all let finance be primarily national." (Keynes)

Keynesian thinking dominated post-WWII economic policy, as nations sought to avoid the mistakes that led to the Great Depression. The Bretton Woods system was based on Keynes' approach that national stability depends on strong state support. The Washington Consensus, which replaced Bretton Woods in the '80s, advocated free markets, with little or no government intervention. Comparing the two, under Bretton Woods, national growth rates were higher, unemployment was lower, volatility was less, and the gap between rich and poor was smaller.

What Would Keynes Do?

Contemporary culture's morality came under scrutiny in the soul-searching that followed the 2007-2009 market crashes, which were marked by "institutional, intellectual and moral" failure. Keynes believed that economic life's purpose was to improve human existence, not in the material sense, but in giving people daily security and tranquility. If capitalism's single goal is to make everyone richer, jarring collapses create the perception that capitalism may not be the best way forward. Environmental destruction, weakened democracies, inhuman corporate cultures and a growing income gap are the social costs of capitalism.

> "Keynes is not just for the foxhole, but for the emerging world order."

Keynes was a capitalist, not a socialist; he saw capitalism as the best system for eradicating poverty and assuring wealth. He believed in private property, but justified morality-based curbs on excessive growth. He advocated public-private partnerships to advance human progress while tamping down the emphasis on profit for its own sake. This leaves a "role for state policy to reduce uncertainty arising from finance." Looking ahead, recall Keynes' distinction between "recovery and reform." Immediate recovery means more national spending to address the global slump in demand. Reform takes more time and requires considering new concepts to avoid repeating old mistakes.

About the Author

Robert Skidelsky, emeritus professor of Political Economy at the University of Warwick, is the award-winning author of a three-volume biography of John Maynard Keynes.