The Crisis in Economic Thought: The Final Death (and Next Life) of John Maynard Keynes

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It's of course a great privilege for me to be here in this role and especially on the occasion of the 75th anniversary of the publication of the General Theory.

Two years ago, as you may recall, our profession enjoyed a moment of ferment. Economists who had built their careers on inflation targeting, rational expectations, representative agents, the efficient markets hypothesis, dynamic stochastic general equilibrium models, the virtues of deregulation and privatization and the Great Moderation were forced by events momentarily to shut up. The fact that they had been absurdly, conspicuously and even in some cases admittedly wrong imposed even a little humility on a few. One senior American legal policy intellectual, a fellow traveler of the Chicago School, announced his conversion to Keynesianism as though it were news.

The apogee of this moment was the publication in the New York Times Sunday Magazine of Paul Krugman's essay, How The Economists Got It So Wrong. And in it, I noticed, Krugman admitted, and I'll quote, that:

> … a few economists challenged the assumption of rational behavior, questioned the belief that financial markets can be trusted and pointed to the long history of financial crises that had devastating economic consequences. But they were swimming against the tide, unable to make much headway against a pervasive and, in retrospect, foolish complacency.

And I must say, looking out on this audience, it would be fair to say that there were more than just a few and it's a pleasure to be here among you.

In keeping with mainstream practice, Krugman named almost nobody. So, in a reply essay entitled, Who Were Those Economists, Anyway?, I described the neglected, ignored and denied second and third generation work largely, though not entirely, in the tradition of Keynes which did get it right. I could have named many more than I did including many in this room.

Let me begin therefore here by distinguishing between the three major lines of Keynesian thought that did in fact get it right-that had bearing and application on the events through which we have just passed. And I will honor the well remembered and beloved by identifying these lines with Wynne Godley, Hyman Minsky and Galbraith père.

Godley, of course, worked in the Keynes, Kuznets, Kalecki, Kaldor tradition of macroeconomic models attentive to national income accounting identities and to consistency between stocks and flows. The virtue of this approach is clarity and a comparative lack of overreaching ambition. Models of this type say nothing false which may not seem like much, but it's a huge advantage over the starting position in mainstream economics which consists of nothing which is true. And the models direct you to check whether factual claims make sense given everything that they may imply.

Thus, that the federal surpluses in the United States' budget in the late 1990s implied unsustainable private debts was clear to those working in this tradition at the time. Just as, the fact that household debt burdens were again unsustainable was clear in the 2000s. Again, perhaps it seems like not much, because it is simply an argument rooted in the national income accounts, until you remember that policy in a country like the United States is very strongly influenced by the macroeconomic forecasting of institutions like the Congressional Budget Office which impose no such consistency constraints on their models and do not check to see whether forecasts in one area imply reasonable and plausible outcomes in another. For this reason, much of that work is essentially nonsense.

Hyman Minsky developed an economics of financial instability, of instability bred by stability itself, the intrinsic consequence of overconfidence mixed with ambition and greed. Minsky's approach, very different from Godley's, is conceptual rather than statistical. A key virtue is that it puts finance at the center of economic analysis, analytically inseparable from what is sometimes called real economic activity, for the simple reason that capitalistic economies are run by banks. And, of course, his second great insight is into the dynamics of phase transitions: the famous movement from the hedge position to the speculative position to the intrinsically unsustainable, doomed to collapse ponzi position which arises from within the system and is subject actually to formalization in the endogenous instabilities of non-linear dynamical models.

To grasp what Minsky is about, it seems to me, is to go immediately beyond the coarse notion of the "Minsky moment," a concept which implies falsely that there are also non-Minsky moments. It is to recognize that the financial system is both necessary and dangerous, that strict financial regulation is both indispensable and imperfect. Right away the idiocy of a concept like the "Great Moderation" becomes apparent. Just as with any machinery from an automobile to a nuclear reactor, a long record of stable performance does not prove that the controls and the backup systems are perfect anymore than it can show that they are unnecessary. Argument otherwise, whether made by the head of the central bank or an applicant for a license extension before the Nuclear Regulatory Commission is the mark of a crank.

The Galbraithian line, is allied to and descended from Keynes in the same sense that my father's work was; accepting the central role of aggregate effective demand, the national income accounts, the credit circuit view of economic life and the financial instability hypothesis. But, it is also embedded in a legal institutionalist framework, rooted in pragmatism, framed by Thorstein Veblen and John Commons, forged in the political economy of the New Deal in the United States. This tradition emphasizes the role played in financial crisis by the breakdown of law and the failure of governance and regulation – and the role played by technology as a tool in the hands of finance for the purpose of breaking down and evading the law.

I want to stress this today, and not just for family reasons, because I think it remains the least familiar of the three, I would say, broadly Keynesian lines of analysis are most pertinent for an understanding of what we've been through and are still going through. When you engage the mainstream on the national income accounts, at least they know what the damn things are. And these days you can even get, though for who knows how much longer, a respectful mention of Minsky even from someone like Larry Summers, if not any sign that he has actually read him.

What you cannot get – not at a meeting sponsored by the International Monetary Fund, not from the participants at the Institute for New Economic Thinking – is any serious discussion of contract law and fraud. I've tried, repeatedly. No one will deny, in response to the question, the role that fraud played in the financial debacle. How could they? But they won't discuss it either. And it seems to me, this reflects a logic which bears pursuing.

Why not? Why is this one of the great taboo topics of our modern economic history? Well, personal complicity, frankly, plays a role among present and former government officials, regulators, consultants and the academics who advised them and those who either played the markets or took fees from those who did.

At the INET conference at Bretton Woods, a few weeks ago, Mr. Summers stated that he was – it was a wonderful phrase – that he was not among those who regard financial innovation as necessarily evil. I took a note as I heard him say that, I thought that really bears quoting.

There is a web of negligence and complicity here. Of culpability, abetted by the way universities are funded and by what they teach.

But it's more than that. Let me try to frame it in somewhat more abstract terms. I would say that the commodity is the foundation stone of conventional economics. That the theory of exchange requires the commodification of tradable artifacts. Without that, there is no supply and demand. A world of contracts, each backed by a separate and distinct set of promises each only as good as the commitments made specifically and the ability of the laws and courts to enforce them, is a different sort of world. Just because you can call a set of such contracts by a name, "collateralized debt obligation" or "credit default swap", and just because you can create something – you may even be able to create something called an exchange to trade them on – does not make them into commodities with a meaningful market price.

Complexity here is what is going to defeat the market with, in principle, infinite variability, and in practice, more distinct features than one can keep up with. In great volume, contracts of these kinds are per se hyper-vulnerable to fraud. Examples range from the New Jersey phone company that simply printed made-up fees on its bills hoping that no one would notice and for a long time nobody did, to the fact that almost no one at the insurance giant AIG realized that the CDS contracts they were selling contained a cash collateral clause, something that would cost them billions at a time when they didn't have access to the cash. They range from unnoticed provisions permitting CDO managers to substitute worse for better mortgages in previously sold packages without notifying the investors, to the Mortgage Electronic Registration System and the pervasive incentive to document fraud in the foreclosure process.

The concession that fraud was present in this process is like the phrase, “Minsky moment.” Although true and although it concedes something, it doesn’t begin to cover the case. Even to say that fraud overwhelmed the system doesn’t go far enough.

I highly recommend to you, if you haven’t done so, that you read the Financial Crisis Inquiry Commission Report just published in the United States, or the even more recent report of the Senate Permanent Committee on Investigations, the many reports of the Congressional Oversight Panel and the report of the Special Inspector General for the Troubled Asset Relief Fund, SIGTARP. These are, by the way, very, very good documents prepared by serious public servants and it’s plain as day. Fraud was not a bug in the system, it was a feature. The word itself, along with abusive, egregious, reckless and even criminogenic suffuses these accounts of what went on.

Godleyans teach that stocks can not be separated from flows. Minskyans teach that finance can not be separated from reality. And my father’s tradition is that the legal and the technological can not be separated. The financial world, as it exists, has nothing to do with the commodity world of real exchange economics with its delicate balance of interacting forces. It is the world of technology at play in the form of quasi mass produced legal instruments of uncontrolled complexity. It is the world of, in other words, of evolutionary specialization in the never ending dance of predator and prey. In nature, when predators achieve an overwhelming advantage, the prey suffer a population crash, from which the predators in turn suffer later on. In economics it’s a financial crash, but process and dynamics are essentially similar.

Corporate fraud is not new; financial fraud is not new. What was new here was the scale and complexity of debt obligations, backed by mortgages. Mortgages are not like, say, common stocks which although issued in the millions are each an identical claim on a company’s net worth. Mortgages are each a claim on the revenue stream of a different household, backed by homes of a diversity made irreducible by the simple fact that each one is in a different place. Long-term mortgages have existed since the New Deal, in the U.S., but they were rendered manageable for decades by their simple uniform structure, their substantial margin of safety and the fact that the secondary markets were public and imposed standards on what could be issued and on what could be passed on to the agencies created for refunding those markets. And what this meant was that supervision was possible. There could be a well understood code covering what was right and what was wrong along side practitioners who understood the ethics of the matter and enforcement officers who could work with them fairly smoothly for the most part and intervene when abuses became apparent.

In the computer age, on the other hand, we entered the world of private labeled securitization, of negative amortization payment optional, Adjustable Rate Mortgage with a piggyback to cover the down payment. Oh, and documentation optional.

There was a private vocabulary, well-known in the industry, covering these loans and related financial products: liars’ loans, NINJA loans (the borrowers had no income, no job or assets), neutron loans (loans that would explode destroying the people but leaving the buildings intact), toxic waste (the residue of the securitization process). I suggest that this tells you that those who sold these products knew or suspected that their line of work was not one hundred percent honest. Think of the restaurant where the wait staff refers to the food as scum, sludge and sewage.

To learn as we do from the excellent book by Bethany McLean and Joe Nocera, All the Devils are Here, that at the dominant mortgage originator in the United States, Ameriquest, the office chiefs fed their sales staff crystal methamphetamine to keep them going. It just adds a touch of telling detail, as does the fact that the founder of Ameriquest ended his career as the United States Ambassador to the Netherlands.

Rendering such complex and numberless debt instruments comparable requires a statistical approach based on indicators. And that launches into a world which was not imaginable in, say, 1927. The world of credit scores, ratings and algorithms, a world of derivative and super derivative instruments of sliced and diced residential mortgage backed securities, collateralized debt obligations, synthetic CDOs, synthetic CDOs squared, credit default swaps – all designed to secure that triple-A rating and to place the instruments which had been counterfeited to begin with – they looked like mortgages but were not really mortgages. Laundered, that is to say, transformed from the trash that they were into a triple-A security and fenced, which is to say, sold to the legitimate investment market by an intermediary called a commercial or an investment bank. To place these counterfeit, laundered and fenced instruments into the hands of of the mark. The mark. And who was the mark? Michael Lewis, in the The Big Short tells us who the mark was. The mark had a name in the industry, they would say, “who are we selling this stuff to?” And the answer would come back, “Düsseldorf.”

The Texas institutionalist, Clarence Ayres, to bring you a voice from my home territory in Austin, Texas, stressed most strongly the role of technology and the irreversible contribution of new tools to the production process. In finance, it’s the algorithm that is this tool, it seems to me. A radically cheap substitute for underwriting, a device for converting the financial gain into a computerized casino in the strict sense where one can never be sure by how much the house is bending the rules. We observed only, as I’ve already mentioned, that no one at AIG FP knew they had cash collateral clauses in those contracts, that the holders of synthetic CDOs did not know that they were getting a worse mortgage substituted for a better one, that the ratings model did not factor in the default risk when mortgages were issued with two-year teaser rates and so on and so forth.

Keynes, I think, understood these issues very well so far as they went in his time as an active player in the speculative markets. And this is what led him to argue that those markets should be small, expensive to access and restricted to those who could afford to play and lose. He did not think they should be repressed entirely, partly because he enjoyed them and partly because as he famously said, it is better for a man to tyrannize over his bank balance than over his fellow man. But in Keynesian terms, it seems to me, what we have seen since the financial crash should be no surprise at all. That is to say, the failure of the world economy and particularly of the financialized economies of Europe and North America, to recover from this debacle is a product of the character of the debacle itself. Absolute distrust, leading to absolute liquidity preference is the incurable consequence, it seems to me, of financial fraud.

I say incurable. This is the diagnosis of an irreversible disease. The corruption and collapse of the rule of law, in the financial sphere, is basically irreparable. It’s not just that restoring trust takes a long time. It’s that under the new technological order in this field, it can not be done. The technologies are designed to sow and foster distrust and that is the consequence of using them. The recent experience proves this, it seems to me. And therefore there can be no return to the way things were before. In other words, we are at the end of the illusion of a market place in the financial sphere. Let me take this analysis and bring it to bear momentarily on Europe. We speak in a common place way these days of the Greek crisis, the Irish crisis, the Portuguese crisis and so forth, as though these were distinct financial events. This fosters the impression that each can be resolved by appropriate agreement between the creditors, headquartered in Frankfurt, Brussels, Berlin, Paris, and the debtors taken one by one. Good behavior, taking the form of a suitable austerity will be rewarded by a return to normal credit conditions and market access. That, at least, is the official presumption. The financial market, in this imagery, is severe but fair, she cracks the whip on the profligate but praises and rewards the prim.

But that Greece has a weak tax system and a big civil service was hardly news. It's a fact that's been true for decades, overlooked in the good times and surfaced when convenient. That Ireland had a housing boom that was intrinsically unsustainable was surely hardly news. The initial shock to Europe didn't come from the discovery of these facts, it came from American mortgage markets. When European banks and other investors realized the extent of their losses, beginning in late 2008, they looked for ways to protect themselves and they did this as any sensible investor would, by selling the weak assets and buying strong ones: German, French bonds and above all United States treasuries. That is why yields rose on all the small peripheral countries and fell on the big ones despite the very different circumstances in the countries that were badly affected.

It's obvious that Greece cannot implement the programs demanded of it without crashing its GDP, and driving up its debt to GDP ratio on that account. But even if it could, any event, affecting any European country, or for that matter, some place else in the world, could sink Greece again irrespective of what Greece does. So, there is no national policy solution and no financial market solution. That is the meaning of the negotiations now underway in Luxembourg and elsewhere. There will be a restructuring or a default, and there must be an economic and not merely a financial rescue. And beyond that there obviously must be not only a new European architecture, but a new financial architecture that is not built around the banks as they exist today and the credit markets as they came to exist in the period before the crisis. Either that or the depression in Europe will simply go on and on. Until eventually the European Union falls apart.

That's what I mean when I say that practically speaking what we're dealing with here and what we need to recognize is not an interruption to a long process of economic growth, a recession or some shock to aggregate demand. It is an incurable disease at the heart of the system.

Our challenge as Keynesians, now, is to work out the practical implications of this reality and to spell out a course of action. And perhaps the first step that we should take, it seems to me, is clearly to condemn what I'll call the False Keynesianism that came briefly to power with the new Administration in America in 2009.

In January of that year, as you recall, the new Administration announced the need for stimulus or a recovery program. Without it they calculated unemployment might rise as high as 9% by 2010 before beginning to decline again. With it, they forecast unemployment would be held to 8%, recovery would begin in mid-2009 and by early 2011, that is to say now, unemployment would be down to 7% on its way back to 5% by 2013. It's 9% in the United States, as we speak.

The forecast was a political and an economic disaster, but in retrospect, it's most interesting for what it tells us about those who made it. Plainly they did not understand, perhaps they did not wish to understand, what was going on. They adopted the assumption of a glide path back to 5% unemployment, which meant that the natural rate of unemployment – the most un-Keynesian and anti-Keynesian concept ever devised in modern economics was built into the mentality and the computer models that they were using. The only issue was the speed of adjustment and whether a little boost would help us get there a little faster. The stimulus package was not meant to provide a substantive response to the crisis, but just to increase that speed of adjustment by a small amount.

Plainly, in short, there was no real crisis in the minds of those who took office in 2009. There was just an unusually deep recession, a Great Recession it came to be called, and the recession would end. Chairman Bernanke of the Federal Reserve Board said from the beginning, the recession will end, the economy will recover. He did not say how he knew, but when it did he was sure things would return to the normal prosperity of the mid-2000s. It was the mindlessness of output gaps the consensus business cycle forecasting and of Okun’s law. The Minsky moment would surely pass.

This is a bad movie and we have, of course, seen it before. You may recall that in 1960 the Uncle of, as it happens, of Larry Summers, co-invented a concept called the Phillips curve, stipulating on very weak empirical evidence and no clear theory the relationship between the unemployment rate and the rate of inflation. True Keynesians, including my teacher, Nicholas Kaldor, Joan Robinson, Robert Eisner, a great hero of mine, and my father were appalled. The construct was doomed to collapse and when it did, after 1970, the school that most people thought of as Keynesian was swept away in the backwash.

Today, the failure behind the recovery forecast is conflated with the failure of the stimulus itself and the same thing is happening again. Those who failed most miserably to forewarn against the financial crisis have, as a consequence, regained their voices as scourges of deficits and public debt. There is a chorus of doom as those who once thought the new paradigm could go on forever are now inveighed against living beyond our means and foretell federal bankruptcy and the collapse of the dollar and the world monetary system amongst other scary fairy tales. This includes such luminaries as the leadership of the International Monetary Fund and of all things, the analytical division of Standard and Poor’s – an enterprise on which one might hope at least a small amount of modesty might have developed or devolved in the wake of recent events. It would be pathetic if it were not so dangerous. But the fact is, these forces are moving down a highway which has been cleared of obstacles by the retreat, indeed the destruction of the False Keynesian position.

So it’s our task, it seems to me, against the odds, to build a new line of resistance. And I’ll wind up by saying that I think that line must have at least the following elements in it:

First, an understanding of the money accounting relationships, that pertain within societies and between them, so that we cannot be panicked by mere financial ratios into self-destructive social policies or condemn ourselves to lives of economic stagnation and human waste. And in particular I should add, since it’s important in Denmark at the moment, to the destruction of social welfare systems and pension systems which provided the foundation of a decent life for a large part of the population for decades.

Second, an effective analysis of the ongoing debt deflation, the banking debacle and the inadequate fiscal and illusory monetary policy responses so far. In America and in Europe, this is a crisis primarily of banks not of governments and it’s for us to call attention to this fact.

Third, a full analysis of the criminal activity that destroyed the banking sector, including its technological foundation, so as to quell the illusion that these markets can effectively be restored to anything like their form of 4 or 5 years ago. As part of this, obviously, it would be useful to have a renewed commitment to expose crime, to punish the guilty, and enforce the laws. Post Keynesian Economists for a More Effective FBI, I think is a splinter organization I would be happy to sponsor and solicit your membership in.

Fourth, an understanding of the way in which financial markets interact with the changing geophysics of energy, especially oil, with the commodity markets to choke off economic recovery unless the energy problem is addressed squarely. I think that's something that we're seeing happening now.

Fifth, a new strategic direction to redesign and rebuild our societies for the challenges of aging, infrastructure, energy, climate change and shared development which we all face. And to create the institutions required to make this happen. That requires, I think, from an intellectual point of view, a merger of the Keynesian, Post-Keynesian and the Institutionalists traditions which is, in fact, something that is already underway.

Sixth, to achieve these goals by mobilizing human brains and muscles to overcome unemployment and to assure a widely-shared, decent, and reasonably egalitarian society according to the most successful and enduring social models, by which I mean a commitment to the deepest policy principles that Keynes himself held and also an understanding that we should use history as a guide to what has worked and what does not.

And seventh, the reconstruction of the instruments of public power – the power to spend, the power to tax, the money power and the power to regulate – so as to effectively pursue these goals with democratic checks and balances to prevent the capture of new state institutions by predatory forces. I will not pretend, as Keynes did, that nothing stands in the way but a few old gentlemen in frock coats who require only to be bowled over like nine pins and might enjoy it if they were.

We should take on this challenge simply as a matter of conscience. We are not contestants for power. It is for us a matter of professional responsibility and civic duty. My friend Bill Black, who has some experience in this area, likes to say, in the words of William of Orange, that it is not necessary to hope in order persevere.

Thank you very much, for the pleasure and honor of making these remarks.

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