Why Do People Hate John Maynard Keynes?

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Anyone who spends time on the economics blogs knows that Keynes is blamed for everything from the Wall Street bailouts to quantitative easing. But, why? There's nothing in Keynes "The General Theory of Employment, Interest and Money" that suggests that he would have supported the bailouts or QE2. Yes, he would have made sure the financial system didn't collapse, but that doesn't mean he would have issued blank checks to insolvent financial institutions run by crooked bankers. He wasn't a moron nor was he a tool of big finance. He simply believed that when the economy was in freefall, it's crazy to worry about deficits. Put the economy back on a solid growth-path first, he thought, then rising revenues would lower the deficits automatically. It's a reasonable solution that's worked many times before. Only, now, the austerity zealots have grabbed the policy levers in Washington and shut off the fiscal stimulus spigot, so tried-and-true economic theory has been jettisoned to placate the nutballs. It's a real mess.

Still, that doesn't answer our question: Why do so many people hate John Maynard Keynes?

Is it because they don't believe the government should ever meddle in the "free market" or is it because Keynes remedies usually involve a lot of red ink? Or is there a different reason altogether, a political objective that disguises itself as "principled Libertarianism" but, in fact, is an effort to crush the middle class and transfer more wealth to the uber-rich? Keep in mind, the GOP-led congress never had any problem running up deficits and doubling the national debt when G.W. Bush was in office. Only recently have they found religion. There's good reason to be skeptical.

Do Keynes critics know that he believed that budget deficits should be balanced during the good times? Of course not, because his most ferocious critics have never read anything he's ever written. They'd rather base their judgments on blog-blabber than give the man a chance and thumb through the original text. That's why they dismiss his many insights with a wave of the hand as if he was some big spending Democrat who didn't give a whit about the red ink he was generating. But that's baloney. Keynes is the best friend capitalism ever had. He put a human face on a system which–stripped of its niceties– is little more than a bloody scrimmage for survival. His emphasis on full employment helped to strengthen the middle class and create the most prosperous and productive economy the world has ever seen. "The General Theory" was a path-breaking work that revolutionized economics. It wasn't an attack on capitalism or free markets, quite the contrary, it was an in-depth study of how the system could be made to operate more efficiently. The central idea was that the system works best at full employment because additional incomes generate greater demand which leads to more investment and a virtuous circle. Here's an excerpt from an article in the The Library of Economics and Liberty:

"Contrary to some of his critics' assertions, Keynes was a relatively strong advocate of free markets. It was Keynes, not Adam Smith, who said, “There is no objection to be raised against the classical analysis of the manner in which private self-interest will determine what in particular is produced, in what proportions the factors of production will be combined to produce it, and how the value of the final product will be distributed between them.” Keynes believed that once full employment had been achieved by fiscal policy measures, the market mechanism could then operate freely. “Thus,” continued Keynes, “apart from the necessity of central controls to bring about an adjustment between the propensity to consume and the inducement to invest, there is no more reason to socialize economic life than there was before” (“John Maynard Keynes”, The Library of Economics and Liberty)

There’s a lot in Keynes with which even the most ardent “hard money” tub-thumper would agree, but since his views have been reduced to “Keynesian this” and “Keynesian that”, it’s hard to convince people otherwise. But Keynes wasn’t the spendthrift that many seem to think. In fact, he was quite conservative. And it’s doubtful that he would have thrown his support behind “too big to fail” or the Fed’s policy of shunting the losses of speculators onto the public’s balance sheet. Neither of these are consistent with his views of a free market. Calling the bailouts “Keynesian” is not just unfair, it’s ridiculous.

Obama’s American Recovery and Reinvestment Act (ARRA), on the other hand, was clearly Keynesian. It provided fiscal relief directly to the economy and–according to the CBO—it substantially lowered unemployment, narrowed the output gap, and increased growth. The ARRA stopped the financial crisis from turning into another Great Depression, which proves that Keynesian stimulus works.

But there’s more to Keynes than just fiscal stimulus. The man had a keen grasp of investor psychology, human nature and the workings of markets. Here’s a clip from The General Theory that gives a sample of his thinking:

“Our desire to hold money as a store of wealth is a barometer of the degree of our distrust of our own calculations and conventions concerning the future….The possession of actual money lulls our disquietude; and the premium we require to make us part with money is the measure of the degree of our disquietude.”

That’s brilliant, and it explains why a sudden downturn in the market can quickly turn into a full-blown crash. Investors get scared, withdraw their money and hunker down. Pretty soon, the equity share supporting the markets vanishes and a bank run ensues thrusting the economy into a protracted swoon. And it’s all because people lose confidence in their ability to anticipate what will happen in the future. Investment is all about anticipation; anticipation and confidence. Here’s how Keynes summed it up:

“It would be foolish, in forming our expectations, to attach great weight to matters which are very uncertain. It is reasonable, therefore, to be guided to a considerable degree by the facts about which we feel somewhat confident, even though they may be less decisively relevant to the issue than other facts about which our knowledge is vague and scanty. For this reason the facts of the existing situation enter, in a sense disproportionately, into the formation of our long-term expectations; our usual practice being to take the existing situation and to project it into the future, modified only to the extent that we have more or less definite reasons for expecting a change.

The state of long-term expectation, upon which our decisions are based, does not solely depend, therefore, on the most probable forecast we can make. It also depends on the confidence with which we make this forecast — on how highly we rate the likelihood of our best forecast turning out quite wrong. If we expect large changes but are very uncertain as to what precise form these changes will take, then our confidence will be weak.

The state of confidence, as they term it, is a matter to which practical men always pay the closest and most anxious attention."

If Keynes is right, then what does that tell us about Bernanke's QE2, unquestionably the most misunderstood and contentious policy in the Fed's history? Has Bernanke fulfilled his role as steward of the system by reducing uncertainty and building confidence in long-term expectations, or has he merely added to investor anxiety by implementing programs that no one really understands? And, if confidence is not restored soon, then what will happen when the Fed ends its bond purchasing program (QE2) at the end of June. Here's what Keynes said on the topic:

"…. a large proportion of our positive activities depend on spontaneous optimism rather than on a mathematical expectation,…. Most, probably, of our decisions to do something positive, the full consequences of which will be drawn out over many days to come, can only be taken as a result of animal spirits — of a spontaneous urge to action rather than inaction, and not as the outcome of a weighted average of quantitative benefits multiplied by quantitative probabilities…. Thus if the animal spirits are dimmed and the spontaneous optimism falters, leaving us to depend on nothing but a mathematical expectation, enterprise will fade and die…"

This quote illustrates the difference between Keynes "the psychologist" and Bernanke "the technician". Fixing the economy is not merely a matter of moving the right lever at the central bank. Lowering interest rates and adding to the money supply can be helpful in effecting a rebound, but, by themselves, won't do the trick. "Animal spirits" need to be revived by reducing uncertainty as much as possible. Here's how Keynes summed it up:

"The other set of fallacies, of which I fear the influence, arises out of a crude economic doctrine commonly known as the quantity theory of money. Rising output and rising incomes will suffer a set-back sooner or later if the quantity of money is rigidly fixed. Some people seem to infer from this that output and income can be raised by increasing the quantity of money. But this is like trying to get fat by buying a larger belt. In the United States to-day your belt is plenty big enough for your belly. It is a most misleading thing to stress the quantity of money, which is only a limiting factor, rather than the volume of expenditure, which is the operative factor."

This is really great stuff. The money supply alarmists have been pointing to the spike in base money as an indication that the country is quickly morphing into Zimbabwe, which is absurd because the transmission mechanism which the Fed traditionally counts on (the banks) is still on the Fritz. Yes, the banks are loaded with reserves, but households and consumers don't have access to those reserves and they're still deleveraging. Piles of money don't create inflation by themselves. Spending those piles does. At present, lending is flat and bank reserves are out of circulation. The danger of inflation is minimal.

Keynes could see that monetary policy alone could not restore confidence or put the economy back on track. He also knew that interest rates and credit easing did not provide an effective transmission mechanism for increasing demand, which is why the government needs to provide fiscal support when businesses slash investment and consumers are forced to increase their savings. Here's Keynes again from Chapter 12 of The General Theory:

"For my own part I am now somewhat skeptical of the success of a merely monetary policy….. I expect to see the State, which is in a position to calculate the marginal efficiency of capital-goods on long views and on the basis of the general social advantage, taking an ever greater responsibility for directly organizing investment."

This is what fiscal stimulus is all about; helping the economy to recover by generating activity (eg. government spending) when consumers are on the ropes and businesses refuse to invest. The alternative is higher unemployment, lower revenues, falling prices, soaring defaults, slower growth and a reinforcing downward spiral. That said, we could see deflationary pressures reemerge as early as next month when Bernanke's QE2 ends and the flaws in the Fed's strategy become more apparent. Here's Keynes on the topic:

"The way to keep economies booming was by maintaining a high volume of investment and increasing the propensity to consume 'by the redistribution of incomes…so that a level of employment would require a smaller volume of current investment to support it." (Robert Skidelsky, "Keynes; The Return of the Master", page 68, Public Affairs, New York)

So Keynes supported redistribution? You bet. He had the foresight to realize that gross inequality leads to flagging demand. When workers no longer have sufficient wherewithal to keep the economy growing via consumption, then the system has to be rejiggered to shore up demand. It's not a question of Big Government "soaking the rich" to create a socialist Utopia. That's bunkum. It's a matter of recognizing the inherent shortcomings of the system and finding ways to make it operate more efficiently. And, that was Keynes strong-suit, transforming an unstable, crisis-prone system into a vehicle for widespread prosperity and wealth creation. That's why he devoted so much time to unemployment, because he knew that unemployment was symptomatic of a deeper problem, an unwillingness of the private sector to invest. When businesses withhold investment–because they see no growing demand for their products–then joblessness rises, spending falls and the economy slips into a deep funk. Keynes realized that this state of affairs (Depression) can last indefinitely unless the government steps in and fills the gap created by the absence of private sector spending. Thus, when consumers have to trim their spending and patch their balance sheets, and businesses cannot find profitable outlets for investment, it's up to the government to run deficits for as long as it takes to rev up the economy and create a self-sustaining recovery.

Keynes remedies will work if the right polices are implemented. Unfortunately, today's politics don't support the policies. So, when the Fed's bond buying program ends, economic contraction will likely resume and the country will face the prospect of another excruciating slump

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