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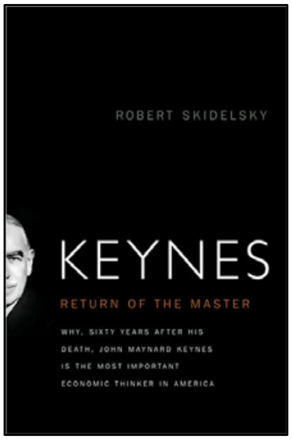

Keynes:

Return of the Master

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About the Author:
Robert Skidelsky is Emeritus Professor of Political Economy at the University of Warwick. His three-volume biography of John Maynard Keynes is considered the definitive account of the life and work of the influential British economist and has received numerous awards, including the Lionel Gelber Prize for International Relations and the Council on Foreign Relations Prize for International Relations. Skidelsky is also the author of *The World After Communism*. He lives in London.

General Overview:
The ideas of John Maynard Keynes have never been timelier and now Keynes's preeminent biographer, Robert Skidelsky, synthesizes from Keynes's career and life the aspects of his thinking that apply most directly to the world we currently live in. In so doing, Skidelsky shows that Keynes's mixture of pragmatism and realism – which distinguished his thinking from the neo-classical or Chicago school of economics that has been the dominant influence since the Thatcher-Reagan era and which made possible the raw market capitalism that created the current global financial crisis – is more pertinent and applicable than ever. Skidelsky asserts that Keynes offers nervous capitalists – and Keynes never wavered in his belief in the capitalist system – a positive answer to the question we now face: When unbridled capitalism falters, is there an alternative?

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Introduction

John Maynard Keynes is one of the most important economic thinkers of the 20th century. Perhaps his most significant contribution is his insight into the psychology of investors during a financial crisis. Today, with the world teetering on the brink of the greatest financial crisis since the Great Depression, the ideas of the Master are more relevant than ever.

Keynes' central insight is that the future is unknowable. He is careful to distinguish between risk and uncertainty. Risk can be quantified, but uncertainty cannot. For instance, actuarial data allows insurance companies to quantify risk quite precisely because information drawn from large population samples tends to be reliable over time. However, business ventures inherently involve uncertainties that cannot be quantified. Economists and financial wizards trying to use mathematical formulas to gauge and assign risk premiums to capitalistic enterprises extending well into the future are utilizing tools and methods that are inappropriate. In fact, the use of complex financial instruments designed to mitigate risk – i.e., derivatives and credit default swaps – actually increased the risk of a financial crisis because so many market participants mistakenly believed these instruments eliminated risk.

Keynes eschewed the application of arcane mathematical models and methods in favor of a psychological, philosophical, and historical approach to the subject of economics. Keynes's emphasis on pragmatism and realism stands in stark relief to the Neo-Classical school of economics, which insists that markets are self-correcting and susceptible to mathematical modeling. Of course, the recent market meltdown has exposed the flaws of the Neo-Classic school, which had been ascendant since the Reagan era.

The current financial crisis is not the result of an "external" shock, but rather the consequence of flaws within the financial system itself. More specifically, the current economic storm demonstrates conclusively that markets by themselves do not allocate resources optimally, nor do they recover by themselves if left to their own devices. Simply put, governments must provide fiscal stimulus in order to avert a prolonged economic depression.

Keynes believed that economics ought to have a moral aim. That is, abundance and prosperity are not ends in themselves, but rather means towards more important ends. More specifically, the value of wealth is that it enables a society in which individuals can pursue good lives (i.e., lives dedicated to worthy projects and noble aims). Therefore, Keynes's frowned on a culture that elevated the pursuit of money and economic efficiency above all else.

Keynes was critical of the assumptions that have guided most modern economists. He rejected the notion that human beings are rational economic agents. He also rejected supply-side economics and the idea that there is a natural unemployment rate. Indeed, in contrast to the Neo-Classical School, Keynes saw economic crises as resulting from insufficient demand. Therefore, he believed in full employment.

In addition, Keynes opposed vast disparities in wealth because they made economic systems unstable and unsustainable.

Keynes has a reputation as a socialist, but this is incorrect. He believed capitalism was the best system available, even with its defects. But Keynes did have a political objective. He believed that governments needed to ensure that market economies remained stable and at full-employment, otherwise, "the undoubted benefit of markets would be lost and political space would be opened up for extremists who would offer to solve the economic problem by abolishing markets, peace and liberty." In short, Keynes' thought is as relevant today as ever before.

The Crisis
What Went Wrong?

The world has just experienced one of the greatest financial meltdowns in history. However, most economists failed to predict or foresee the financial crisis coming. In fact, "according to mainstream economic theories, a downturn of this scale should not have happened." Clearly, the current economic collapse indicates that there are serious flaws in the mainstream economic paradigm. The economic philosophy of John Maynard Keynes is a valuable and necessary corrective to the flawed assumptions that have helped lead to the current financial crisis.

The conventional wisdom holds that the current economic debacle was caused by a failure of risk management. In fact, former Fed chairman Alan Greenspan insisted that the current crisis was brought on by "the under pricing of risk worldwide."

Debate over the current crisis also falls into two camps; those who believe the meltdown was precipitated by a "money glut" and those who believe it was precipitated by a "savings glut." In fact, this is a replay of the debate over the cause of the Great Depression.

The money glut explanation, of course, centers on Alan Greenspan's decision to keep interest rates too low for too long, thus allowing the real estate bubble to inflate until it burst. The savings glut explanation, on the other hand, focuses on the excessive savings rate in Asia and the Middle East in relation to America's excessive consumption rate, which led to cheap money and an economic imbalance that was unsustainable.

Essentially, the current financial crisis can be visualized as an inverted pyramid of debt that was built on the slender foundation of U.S. housing prices. More specifically, banks and other financial institutions held mountains of highly leveraged debt that was guaranteed by little more than the assumption that housing prices could only go up.

However, the banks had in fact made a high percentage of very risky loans – so called subprime loans – where borrowers quickly defaulted as soon as interests began to rise. Once housing prices began to fall, banks and other financial institutions soon found themselves holding "toxic securities," financial assets whose value was derived from plummeting real estate prices and bad loans. Consequently, banks were afraid to lend to one another and felt compelled to hoard cash. After all, no bank wanted to lend cash for collateral that might be composed of subprime mortgages. The result was a liquidity crisis.

The market meltdown was preceded by a number of financial landmarks:

- Housing prices in America soared roughly 124% in the decade before the collapse.
- Financial "innovation" exploded – i.e., financial instruments became ever more complex, abstract, and removed from reality.
- Deregulation and the dismantling of the Glass-Steagall Act – which had built a wall separating retail and investment banking – helped turn banks into casinos.
- The real economy (as opposed to the financial economy) collapsed – i.e., the selling and repackaging of debt replaced manufacturing.

The financial meltdown entailed a number of vicious cycles. For instance, decreased consumer demand in the advanced world has led to the collapse of commodity prices supplied largely by the developing world. Further, financial institutions forced to raise cash to meet capital requirements were forced to sell assets in a depressed market, which further diminished the value of such assets. As a result, the economic crisis was a downturn of global proportions, the biggest since the Great Depression.

During the Great Depression, however, governments reacted in self-defeating ways; they attempted to balance their budgets; they allowed banks to fail; and they stubbornly clung to the gold standard (which insured that interest rates remained high). In retrospect, such steps exacerbated the financial crisis. Today, most economists recognize the wisdom of adopting the Keynesian approach of increased government spending (i.e., fiscal stimulus) to prod the economy out of a recession.

During the Great Depression, and the current meltdown, a crisis in *lending* became a crisis in *spending.* This fact confirms Keynes's insight: a lack of demand breeds recessions. This contradicts the conventional wisdom that supply inevitably creates demand. In fact, according to the widely held monetarist school of thought, the way to ease a recession (and get institutions lending again) is simply to increase "the money supply in the economy, restoring the rate of money growth which had fallen during the downturn." However, Keynesians believe that while increasing the money supply is not sufficient to ignite a recovery, *spending* money is.

"The root of the financial crisis was not failures of character or competence, but a failure of ideas." Government officials, bankers, financial experts, and market participants all believed in the false assumptions that markets were self-correcting and that risk management techniques had rendered risk obsolete. In fact, this attitude fostered a climate of risk-taking that brought the economic system to the brink of catastrophe.

Hedge funds, credit agencies, central bankers, regulators, financial institutions, and the government have all received blame for the market meltdown. However, malfeasance and incompetence arguably played less of a role than the erroneous ideas and false assumptions that lay at the core of the Neo-Classical paradigm. Simply put, most politicians, economists, and financial players earnestly believed in ideas that were seriously flawed. More specifically, economic theories few understood were embraced on trust. As one observer noted, "Politicians only know what they need to know; this need not be much." In short, politicians and others believed the ideas economic experts sold them. Indeed, "the present crisis is, to a large extent, the fruits of the intellectual failure of the economics profession."

The Case for Keynes

In the United States, economic schools of thought fall into two general classes:

- Freshwater economists – (The Chicago School, Neo-Classical School, the political Right). These economists assume that free and unfettered markets are optimally efficient because they reflect the rational expectations of market participants. Practitioners of this school oppose government intervention and regulation.
- Saltwater economists – (New Keynesians, the political Left). These economists accept the assumption that markets are rational and efficient, but they allow some scope for government intervention in the economy.

These two schools, though they often appear diametrically opposed, share the same assumptions about markets and individuals being governed by rational expectations.

The Rational Expectations Hypothesis (REH) "represents a fusion of the rational-scientific aspirations of the Enlightenment with the belief in the 'wisdom of the crowd' characteristic of American democracy." More concretely, REH is the notion that millions of market participants have a collective wisdom no government or centralized authority could hope to posses. In short, adherents of REH believe that the distributed intelligence of countless rational actors operating through the free market leads to optimal asset prices and the most efficient allocation of resources possible.

"All bank risk-management models are based on the efficient financial market theory." However, Keynes was deeply critical of these kinds of assumptions. To begin with, contemporary risk management models are based on the probability distributions associated with the well-known Bell Curve. However, Keynes was adamant that it was inappropriate to use the Bell Curve to map or predict the uncertainties associated with the business cycle, political matters, and economic enterprises. While the Bell Curve is used appropriately by life insurers to calculate risk, talking in terms of the "probability of risk" is highly problematic when applied to a country's economic and political policies. Here, Keynes argued, we are talking about uncertainties, not risks.

Economic theories that rely on the Bell Curve fail to acknowledge or predict Black Swans, which are extremely rare but history-shaping events. Conventional risk managers believed their forecasting models eliminated uncertainty, but in fact their models cease to function in the face of Black Swans or dramatic uncertainties.

Classical economists insisted that markets were optimally efficient and therefore they could not fail. No wonder most economists failed to foresee the current crisis. Keynes, on the other hand, was convinced that economic life is inherently filled with uncertainties no one can possibly predict. Therefore, Keynes believed that assigning risk probabilistically to economic events was misguided. He did believe, however, that it was within the proper scope of government to reduce uncertainty. After all, reducing uncertainty makes possible financial collapses less likely.

John Maynard Keynes

John Maynard Keynes (1883-1946) was one of the most brilliant minds of the 20th century. A member of the famed Bloomsbury Group at Cambridge – whose members included Bertrand Russell and Virginia Woolf – Keynes took an unconventional and highly pragmatic approach to his subject matter. In fact, in contrast to most economists, Keynes was a highly successful investor. For the most part, he eschewed a mathematical and theoretical approach to economics in favor of a concrete realism.

Keynes believed "that the world constructed by classic economics happened not to be the world we actually live in." In other words, classical economics constructs an idealized world and then interprets events in ways that fit with their theories.

Keynes' economic outlook was shaped by his experience as a businessman, an investor, and government official. In particular, Keynes introduced the concept of 'expectations' into economic theory. Of course, Keynes' notion of expectations had little to do with the rational expectations posited by classical economists, but instead relied on down-to-earth expectations that include the "purely irrational waves of optimism and pessimism" experienced by shopkeepers, business owners, and investors.

In Keynes' view, the simple *fear* of falling prices was enough to create the *fact* of falling prices. Consequently, the economic system was not a self-regulating mechanism that automatically adjusted prices and wages, supply and demand. Rather, when downturns hit, vicious cycles invariably ensued. Therefore, an economic system that was out of kilter required a financial stimulus in order to restore confidence and get the economic engine running again.

Keynes experienced the Great Depression firsthand. He was troubled that savings were being used to finance speculation instead of being invested into productive assets. In fact, Keynes coined the term 'profit inflation' to refer to a rise in stock prices that benefited a narrow class of investors, but which was completely un-tethered to corporate health or productivity.

Keynes gleaned many lessons as an investor during the Great Depression. In particular, he believed a successful long-term investor needed to "anticipate mob psychology rather than the trend of real events." In other words, a wise investor was a contrarian.

However, Keynes also believed in being a buy-and-hold investor, an investor with a sense of social responsibility. Indeed, Keynes' investment philosophy seems remarkably similar to the approach of Warren Buffet; both believe in fidelity to a small number of well-chosen stocks and both believe that the best time to buy shares is in a falling market.

Keynes's Economics

Keynes believed that market participants often faced immeasurable risks. It follows from this, Keynes argued, that money is a 'store of value.' That is, money is a hedge against uncertainty. Classical economists, in contrast, saw money as a neutral medium of exchange. But for Keynes, money was a "subtle device for linking the present to the future."

Classical economists also viewed economics in Newtonian terms – i.e., human beings were like atoms in an economic universe that tended towards equilibrium. However, Keynes fundamentally rejected the idea that human beings behaved as predictably as billiard balls. Economics, Keynes insisted, was not a *natural science*, but a *moral science*.

Keynes believed that Classical economics went wrong by adopting unreal assumptions. The idea that human beings were rational agents, relentlessly pursuing self-interest, and forever seeking ways to maximize utility seemed to Keynes like over-idealized abstractions that bore little resemblance to the messy and complex world we inhabit. Economics, as much as possible, should appeal to common sense.

Classical economists believe that free-markets have a tendency to maintain optimum employment and productivity rates. Keynes, on the other hand, believed that unfettered free markets often functioned at less than optimum rates.

Uncertainty was a key idea in Keynes economic thought. He believed uncertainty was the reason people often prefer to keep their savings in liquid forms. War and weather are sources of uncertainty, but Keynes insisted that the capitalist system can also be a source of uncertainty. In particular, Keynes argued that when optimism is high, the economy thrives, but when uncertainty reigns, the economy sickens. Thus, governments have a responsibility to reduce uncertainty.

Keynes was deeply interested in probability theory. He distinguished between three forms of probability:

1. Cardinal probability – involves occurrences that can be quantified in absolute terms; i.e., there is a one chance in six the number “2” will come up in the role of the die. Insurance companies use actuarial data to compute risk of this sort.

2. Ordinal probability – involves rank ordering of probability; i.e., Venus Williams is more likely to win Wimbledon than Ana Ivanovic, but no precise numerical measure of that probability can be given.

3. Irreducible uncertainty – probability estimates are impossible.

Keynes believed that most of the probabilities we deal with in life fall into the latter two categories. For instance, we may be able to say that a bank in Mugabe is more likely to fail than a bank in Switzerland, but it would be erroneous to assign a specific probability to that risk. Further, many occurrences are simply unknowable. Will the stock market rally tomorrow? Who knows? There simply isn’t enough information available to help us foresee the future. Keynes would have said that it is ridiculous to rely on risk models based on past data; “there are influences which cannot be reduced to statistical form.”

The elaborate mathematical equations Wall Street developed to quantify risk were inappropriate for the task they were developed for. Therefore, Wall Street’s risk models provided false comfort and actually increased the risks they were designed to mitigate.

Keynes viewed the Great Depression as being caused by a collapse of demand. Excessive savings and cash hoarding subtracts from consumption and the decrease in demand leads to an increase in uncertainty. In Keynes’s view, “It is spending, not savings, which creates output and employment; and when spending falls short of earnings, unemployment results.” This is the ‘paradox of thrift’ – i.e., the natural inclination during a downturn is to save, but when everyone saves, then all are worse off.

Keynes believed the antidote to uncertainty was “cheap money, wise spending.” That is, interests rates should be low and domestic spending should be invested in policies that foster full employment, strong consumer demand, and public works. He also believed reducing income inequality would bolster consumer confidence. Such an approach, Keynes contended, would create a virtuous cycle of prosperity. Of course, Keynes thought the most important question in economics was: *What is economic growth for?*

Conclusion

The record is clear, Keynesian economics delivers better results than Neo-Classical macroeconomics. For instance, the period between 1951 and 2009 can be divided into two roughly equal periods where Keynesian and New Classical principles dominated. The Keynesian period (1951 – 1973) saw higher GDP growth, lower inequality, and less unemployment than the New Classical period (1980 – 2009). The inflation rate was slightly lower in the New Classical period, but most importantly there were five periods of economic contraction during the New Classic period versus none during the Keynesian period. In short, Keynesian principles have a better track record when it comes to economic performance.

Keynes was a critic of a money-obsessed culture. He believed that the purpose of economics was to make the world better ethically. Today, however, wealth generation is arguably one of the few values everyone can agree on in the West. Keynes viewed prosperity and material comfort as virtues, but only because they helped people live ethically better lives. In particular, Keynes saw wealth as a means that would help individuals enjoy the beauty in life, the arts, and fine culture.

Keynes believed a culture based on the love of money contained the seeds of its own dissatisfaction and dissolution. When wealth became the ultimate value, other goods – the environment, social bonds, and ethics – tended to be sacrificed on the altar of Mammon.

Keynes viewed uncertainty as an impediment to ethical growth. He believed a good government made efforts to reduce the scope of uncertainty and unhappiness. Unlike Friedrich Hayek, who viewed government intervention as a prelude to serfdom, Keynes insisted that prudent government policies and interventions could reduce uncertainty, a condition that demagogues often exploited for their totalitarian aims.

The current financial crisis has exposed the shortcomings of the Neo-Classical school of thought. Keynes's economic thought is skeptical of globalization, financialization, and laissez-faire economics – ideas that were at the heart of an economic philosophy that brought us to the brink of an economic catastrophe. Keynes's ideas show us how we arrived at our current predicament, and also how we might get out of it.

John Maynard Keynes, 1st Baron Keynes CB FBA (/keÉªnz/ KAYNZ; 5 June 1883 â€“ 21 April 1946), was a British economist, trained mathematician, whose ideas fundamentally changed the theory and practice of macroeconomics and the economic policies of governments. He built on and greatly refined earlier work on the causes of business cycles, and was one of the most influential economists of the 20th century. Widely considered the founder of modern macroeconomics, his ideas are the basis for the school of Keynes was a British economist (1883-1946), son of the economist and methodologist John Neville Keynes. J. M. Keynes first gained notoriety with his work during the Versailles Peace Conference, when he cleverly proposed in his book â€œThe Economic Consequences of the Peaceâ€, 1919, not to punish Germany to avoid future retaliation.Â Keynesâ€™ main thesis was that unemployment during the Great Depression was the result of the decrease in effective demand. So influential was John Maynard Keynes in the middle third of the twentieth century that an entire school of modern thought bears his name. Many of his ideas were revolutionary; almost all were controversial. Keynesian economics serves as a sort of yardstick that can define virtually all economists who came after him. Keynes was born in Cambridge and attended Kingâ€™s College, Cambridge, where he earned his degree in mathematics in 1905.