Q & A with Hunter Lewis, author of *Where Keynes Went Wrong*

November 8, 2010

<u>WHY SHOULD WE CARE ABOUT JOHN MAYNARD KEYNES?</u>

He died in 1946—it might seem long ago. But he remains immensely influential. I would argue that he is the most influential person of the last century, with Winston Churchill, another Englishman, perhaps a close second.

Virtually all world governments today may be described as Keynesian—in their approach to managing economies. In particular, almost all the responses to the Crash of 2008 came out of Keynes's playbook. One person's ideas have never before so thoroughly dominated the world.

My book offers a heretical view, but this might not altogether have displeased Keynes. He described himself as a "rebel and heretic." He spoke in his *General Theory* of the brave army of rebels and heretics down through the ages, and certainly included himself. I think Keynes was quite surprised when he and his ideas were so thoroughly embraced by the establishment.

Keynes was also someone who lived in the moment. He developed policy recommendations and then theory to back them up. All his friends agreed about this. It was policy first and then theory. Keynes's last book was written during the Great Depression and reflected the conditions of that time. Would Keynes be a Keynesian today? I have my doubts. But there is no way to know for sure.

It is not easy even to be sure of what Keynes thought while living. I have read just about everything Keynes wrote, read it carefully, and any assertions I make are based on what Keynes himself said.

This is important. Much of what Keynes wrote was obscure. It takes some labor to follow it and most people don't try. They rely on what others tell them. Particularly today, when we are betting trillions of dollars and the future of our country on Keynesian remedies, this cannot be acceptable. We need to read Keynes carefully and be very clear about what he said and did not say, and then argue from there.

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<u>WHAT WAS KEYNES THE MAN LIKE</u>?

He was not only the immensely influential figure I have described. He was also an electrifying personality. He always seemed to be "on." The art historian Kenneth Clark said that "He never dimmed his headlights." He could out-talk and out-debate anyone. And he knew it.

This annoyed some people. US secretary of the Treasury Henry Morgenthau described Keynes as "one the fellows that just knows all the answers." Even friends were wary. Here's what Bertrand Russell, philosopher and mathematician, one of the smartest people of the 20th century, said about Keynes: “When I disagreed with him, I felt I took my life into my hands…. I seldom emerged without feeling something of a fool.”

Keynes could be utterly charming. He could also be extremely rude. Kingsley Martin, editor of the *New Statesman*, which Keynes partly owned, put it this way, in of all places an obituary notice: “His wit was shattering and his capacity for rudeness unequalled.”

On one occasion, Keynes reduced a (later) Nobel Prize winning economist and treasury colleague to tears. During a “high table” dinner at Cambridge, he turned to Isaiah Berlin, not yet famous, and asked him what he was doing. On hearing, he replied “rubbish” or words to that effect. He then turned away to the companion on his other side and said not another word. Pity for Keynes. Berlin was not only brilliant. He was witty and fun.

Keynes was full of personal contradictions. He railed at the love of money. He called it “the worm…gnawing at the insides of modern civilization.” But he also very much wanted to be rich. He railed against investment speculation, but avidly speculated himself. At one point, he was completely wiped out, and had to turn to his father, a teacher, for rescue. Two more times, he could have been wiped out, one of them 1929, which he did not expect, the other 1937, which he did not expect either.

In the early years, Keynes held few investment positions, loaded on the leverage, and also market timed. After 1937, he gave up on the market timing. But he always kept the high concentration and especially the leverage. Very oddly, the man who called gold the “barbarous relic” often recommended buying gold as a diversifier. He ended up a millionaire in pounds, but not especially rich by today’s jaundiced standards.

Keynes also liked to subvert and poke fun at what he called Victorian morals. He called himself an “immoralist.” But he worked as hard and saved as diligently as any Victorian.

As I mentioned, Keynes thought of himself as a rebel and heretic. But he loved being lionized and listened to by the establishment. He may be said to have invented the role of the public policy entrepreneur. He also invented the role of the mass media intellectual and seemed to enjoy every minute of his celebrity. The media especially loved it when the Cambridge intellectual married a ballerina.

November 22, 2010

WHERE DID KEYNES GO WRONG AS YOU SEE IT?

As brilliant as he was, there is something initially troubling about his ideas. They have a formulaic quality. In so many cases, he delighted in taking some piece of conventional wisdom or even of common sense and turning it on its head. So—you think that prudent saving and investing is the way to wealth. On the contrary, spending is the way to wealth. But surely one must invest in order to get rich? And how can one invest without first putting aside some savings? No, no, said Keynes. Don’t be a dunderhead. Where do you get the savings if not from income? And where do you get the income if not from someone's spending? So it's really spending that drives everything.

This is something like a parlor game. Take a circular flow and interrupt it wherever you like, giving the old folks apoplexy in the process. More fun than Monopoly. But it's a parlor game that led directly to China's 15% of GDP stimulus program. Meanwhile, never mind that Keynes personally was not a spender, but rather a diligent saver and investor.

Let's continue a little further with Keynes's logical inversions. Perhaps you think that too much debt is imprudent, will lead to bubbles, and thence to ruin. Not at all. There is actually no such thing as too much debt. So long as humans still have needs, there should be more, not less debt. In order to afford the debt, all we have to do is keep reducing interest rates. By continually reducing interest rates, we can sustain a permanent condition of boom. Viewed this way, there is no such thing as a bubble. Or—a bubble is a boom with interest rates too high. Not too low, too high.

The eventual goal should be to reduce nominal interest rates to zero. Then keep them there. In other words, credit should be completely free. For reference, see especially pages 220-221 and 336 of *The General Theory*. Keynes did say that it would take some time to abolish interest rates. Perhaps a generation. On that schedule, we should have reached a regime of free credit by about 1966.

Free credit is not a new idea. The French socialist Proudhon proposed it in the 19th century. This does not necessarily make Keynes a socialist. But Keynes embraced free credit for the long term (without, incidentally, mentioning Proudhon). Of course today we have respected Keynesians like Gregory Mankiw and Kenneth Rogoff calling for negative interest rates, achieved by ramping up inflation. But even they haven't endorsed keeping nominal interest rates at zero forever.

When you read Keynes right through all his many volumes, this habit of taking the conventional wisdom and turning it on its head begins to seem a little too predictable. You think that high interest rates will persuade more people to save and thus increase savings? Nonsense. Low interest rates, not high rates, will increase savings.

On the other hand, you don't really want more savings. There is usually a glut of it. There is a glut of it even before you reduce interest rates. And as we have seen, reducing interest rates is a good thing to do. The way to deal with this perennial savings glut is for the government to print new money. Keynes says that this new money is also "savings." It is just as "genuine" as traditional savings. But by adding this new savings to the old savings, you can cure the problem of a savings glut. Got it?

Please note that Alan Greenspan, Ben Bernanke, and Paul Krugman have each echoed this recently. They also say that there is a global savings glut. The correct response has been to print more of what Keynes called "genuine savings." Of course we don't call it "genuine savings" anymore. We now call it liquidity or quantitative easing or some other handy euphemism. It still seems highly paradoxical to try to solve an alleged savings glut problem by printing more money to add to the available cash.

November 29, 2010

ARE YOU MORE CRITICAL OF GEORGE W. BUSH OR BARRACK OBAMA?

Both. We are focusing on Keynes at this moment because the world is applying his ideas on such a giant scale. In this country, Democrats are Keynesians, but so are Republicans. Same in the UK for Labor and the Tories. As previously noted, few actually read Keynes, but nevertheless it seems that everyone is a Keynesian. Why not—everyone else seems to be a Keynesian. This might be said to define an intellectual bubble, a bubble supporting all the other bubbles. But intellectual bubbles, like others, may become largest just before they pop.

The policies of George W. Bush and Barrack Obama have come directly out of Keynes's playbook. Consequently they have that paradoxical, stand-commonsense-on-its-head, flavor. For example, we are told that:

The Crash of 2008 was caused by too much debt. We will therefore solve it by adding more debt.

Yes we do derive economic growth from debt. But the more you borrow the less growth you get. For the decade ending 1959, we got 73 cents in new GDP growth for every dollar we borrowed. That has steadily declined as the debt has grown. For the seven years ending with the Crash of 2008, it was only 19 cents. At some point, we will find that the return on debt is totally negative. And the US may meanwhile lose its credit in the wider world.

It is true that the US does not seem in imminent danger of losing its credit. It is an ironic fact that the International Monetary Fund relies on the two great borrowing countries, the US and Japan, for most of the money that it then lends to countries in distress. In other words, the US borrows and then re-lends this money to the IMF which in turn lends it further, often with no realistic hope of repayment.

Much of the borrowing the US does is from world central banks. Where does this money come from? It is printed. Of course the US itself currently prints some of the money used to buy its own treasury bonds. In other words, it sells to itself. The US also prints money and uses it to buy US mortgages back from foreign central banks that want to sell them. The foreign central banks then by prior agreement re-channel this money into US treasury bonds. So directly or indirectly the US is printing quite a bit of the money currently needed to support the US's credit—not, it would seem, a sustainable situation.

This idea of borrowing our way out of debt isn't the only the only paradox that is currently guiding our affairs. To take another example, our government concludes that some firms are "too big to fail." We therefore insist on merging them and making them bigger. Result: we get more and more "too big to fail" firms. Sheila Bair, the head of our FDIC, which stands behind bank deposits, thinks that we need to abandon "too big to fail" before it devours us. But nobody else in government seems to agree with her.

Paradoxicalism is an entirely bi-partisan affair.

George W. Bush got right into the swing of it. He told us that "I have abandoned free market principles to save the free market system."

Barrack Obama has his own paradoxes. For example, he said that his first budget was taking us from "an era of borrow and spend" to an era of "save and invest." Never mind that it is all deficits into the future. Similarly, to reduce medical expenses, we must increase medical expenses. I thought it particularly interesting that he saw spending as a good way to increase demand generally. But it wouldn't increase demand and therefore prices in healthcare.
We have become so accustomed to this paradoxical language we just take it for granted. If the Keynesian paradox of thrift and all the other Keynesian paradoxes are so widely accepted, they must surely be right. After all, Keynes explained why all this is true. If anyone doubts, just read Keynes.

December 6, 2010

WILL WE FIND THE RATIONALE FOR RECENT POLICIES IN KEYNES'S OWN WRITING?

No. You will find the policies but you will not find a real rationale. There is a basic problem here. Keynes did not prove his propositions. He did not even try to prove them. He claimed in a letter to the governor of the Bank of England, Montague Norman, that his ideas were a "mathematical certainty." But that was just a crude bluff. There are very few chains of closely reasoned logic in Keynes, mathematical or verbal. There is almost no interest in evidence. In the whole of *The General Theory*, there are only two pages devoted to empirical evidence. And one of the two studies cited is dismissed as "improbable."

Keynes was more of an intuitionist than a logician or empiricist. He threw out intuitions, really hunches, and expected people to grasp their truth directly, without the need for tedious step-by-step argument or evidence. He explicitly said that economics consisted of one person's intuitive brain speaking to another's.

There is nothing wrong with hunches. But can we really bet the future of the world on them? And it is a bit disconcerting how vague Keynesians are, even today. Respected Keynesian economists, people like Christina Romer in the White House, Robert Shiller, and Paul Krugman, when asked how much stimulus is needed, say things like "More than you think" or "It must be done on a big enough scale." And how long should stimulus be applied? "For a year or two." Or even "For a long time in the future." Why so non-specific? Because we are betting our chips on hunches.

December 13, 2010

IS IT TRUE THAT KEYNESIAN REMEDIES WERE PROVEN BY THEIR SUCCESS IN GETTING US OUT OF THE DEPRESSION? THAT'S WHAT WE WERE TAUGHT IN SCHOOL AND OUR CHILDREN ARE STILL BEING TAUGHT.

My own view is that the US printed too much money in the 1920s. This blew up a bubble which popped, precipitating the stock market Crash. Prices began to fall precipitously. President Hoover then made the error of getting commitments from businessmen not to lower wages. It was not that Hoover was "hands off" as is often alleged. He was very active and his interventions were misguided.

Holding up wages while prices were falling was a crucial error. It is a formula for massive business bankruptcy. If a business's revenues are falling, costs must fall or bankruptcy must follow. Since businesses were told that they should not reduce wages, under threat of federal action against them, they had no choice but to adopt the next best way to get costs down: a strategy of massive layoffs. The ironic result was that those lucky enough not to be fired enjoyed the equivalent of a raise: their wages could buy more and more as prices fell. Meanwhile those laid off lost everything. If prices and wages had fallen together, no one would have suffered; no one would have had to be laid off, because real purchasing power of wages would have remained the same. It would have still involved some pain, because the number of hours worked would have fallen too. But there would have been no bread lines and mass suffering.

When Roosevelt became president, he continued many of Hoover's policies. Including an explicit policy of keeping wages up. Indeed he incorporated it into law through the National Recovery Act. Keynes was not a fan of the NRA in general, but he did say that he favored the policy of keeping wages at pre-Depression levels.

Keynes was also not exactly the Keynesian that we assume he was during the Depression. A close reading of his writings and speeches reveals that he did not favor stimulus after the 1929 Crash. He thought that lower interest rates would fix everything. He also recommended an end to stimulus in Britain in 1937. Keynesianism in the 1930s was not the fully developed formula of print, lower rates, bail out, and stimulate that we saw in 2008.

Was President Roosevelt a Keynesian? Yes and no. Raymond Moley told us that Roosevelt was never known to read anything "serious." We can be pretty sure he never read Keynes. The two did meet once for less than an hour. Accounts of the meeting differ. The President told Felix Frankfurter, a friend of Keynes, that he was impressed. He seems to have told others the opposite. So we don't know.

Roosevelt's policies may be described as broadly Keynesian. But we also need to remember that these policies did not pull us out of the Depression. Only World War II did that. Some Keynesians respond that World War II provided the massive stimulus that was needed all along. But comparing peacetime and wartime economies is apples and oranges. It is generally agreed that this amount of stimulus in peacetime would have blown prices through the roof. Wartime price controls worked fairly well precisely because we were at war. Also because the economy had a few clear and simple goals, not true in peacetime.

December 20, 2010

HAVE KEYNESIAN POLICIES WORKED SINCE?

Most agree that they did not work in the late 1960s and 1970s and instead contributed to the Great Inflation of that era. Nor did they work for Japan after its Crash. Twenty years later, Japan is still struggling. As is often remarked, the Japanese did not liquidate the mistakes of the past. The zombie loans, banks, and companies lived on and on. By contrast, the avoidance of Keynesian policies in East Asia in the late 1990s seemed to work very well. The East Asians did liquidate and recovery was fairly swift. This was like the US Depression of 1920 when we also liquidated and the economy recovered in only a year and a half. Today in America we have relatively little liquidation and lots of zombie loans, banks, and companies. We seem to be definitely on the Japanese path.

January 3, 2011

WHAT WERE SOME OF KEYNES'S OTHER MAIN IDEAS?

Some of his most celebrated ideas have clearly been disproven. He said that stimulus spending would produce a gusher of new taxes. It would pay for itself and not increase the debt to GDP ratio. Tell that to Japan, which kept trying one stimulus after another, only to see its government debt soar. Paul Krugman now says that stimulus should pay for 40% of itself, but there is not a sign that it did recently in the US or anywhere else.

Keynes also said that his multiplier, the ratio of stimulus to employment or economic growth, would be as much as twelve times and no less than three or four. Since then no one has been able to demonstrate a multiplier higher than one. It may often be closer to zero. I don't think that money borrowed from abroad should give us a multiplier today of zero, but the results remain to be seen.

Keynes's most famous idea, that economic slumps are not self-correcting, was disproven by a Keynesian disciple, Franco Modigliani, even before Keynes's death. Yet President Obama still echoed it in 2009. He told us that without stimulus the economy might fall past the point of return.

Another well-known Keynesian idea, that you can't have inflation when the economy has excess capacity, has had its ups and downs. During the 1970s stagflation, it fell out of favor. But it has come back and is guiding Fed policy today. The trouble is that we can't really measure capacity. In any case, average capacity isn't what matters. What matters is the capacity of each sector and how these sectors interact with each other. History does make clear that inflation can coexist with excess average capacity.

January 10, 2011

YOU HAVE ALSO POINTED OUT SOME ODD MISTAKES ON KEYNES'S PART.

Some of Keynes's mistakes are very odd. For example, he stated that an investment in the stock market was "sterile" because the cash did not go into new plant and equipment and the like. He evidently forgot that the seller of the stock gets cash and that cash doesn't disappear. To me the oddest slip of all is his argument that long-term investing on Wall Street is impossible because everyone is a short-term speculator. That's backward. The potential return on long-term investing should go up, not down, if everyone else is doing the reverse.

Keynes famously said that the private economy was run on "animal spirits." By contrast, government makes decisions based "on long views and collective wisdom." In an unguarded moment, Keynes also said that politicians were "utter boobies." But leaving that aside, why are public officials immune from animal spirits themselves? There is a further paradox. If Wall Street is a death star of financial and political corruption, why will a marriage of Wall Street and Washington not corrupt Washington? Surely it is no coincidence that the flow of campaign contributions from Wall Street to Washington increased throughout the bubble eras and spiked after the Crash.

January 18, 2011

YOU SOUND LIKE A POPULIST.

I plead guilty so long as populism means thinking that an economy should be run for the benefit of the average people and especially disadvantaged people, not for the benefit of government and wealthy people and other special interests. The marriage of government and Wall Street in today's economy worries me a great deal. I think that Keynes himself would have been appalled by the kind of crony capitalism that his ideas have helped spawn. When he said the politicians should lead the economy, I think he was thinking of the politicians listening to him and doing what he said. Not that there should be this torrent of campaign money flowing to Washington because Washington is making so many crucial economic decisions. People do worry that the Treasury Secretary, according to his own logs, is talking to Goldman Sachs almost daily. But has anyone noticed that Goldman in the fall of 2008 acquired the right to borrow at virtually zero interest unlimited dollars from the Federal Reserve, dollars that have been conjured out of thin air? Goldman repaid the TARP loans with much fanfare. But why is it still allowed to borrow newly printed money from the Fed at giveaway rates?

Crony capitalism is still in its infancy in the US. In China the government simply tells the banks to get the loans out the door and they do. Chinese loans have grown almost 40% this year and this has contributed to the new bubble which is forming there by deliberate government policy. The Russian government has adopted a similar approach. Prime Minister Putin told his bankers this summer that they would get more loans out the door, hang the quality of the loans, or they would get no summer vacations. So far as I know, they did get the vacations. And of course if one of the reckless borrowers gets in trouble, he or she can just go to the government which will instruct the bank to forego repayment. Is this the kind of world that we are creating for ourselves in the US as well?

January 24, 2011

IF YOU HAD TO CITE ONE THING, WHAT IS THE WORST FEATURE OF KEYNESIANISM?

The threat of crony capitalism is bad enough. But if one were to try to pinpoint a single problem with Keynesianism, it is what it does to prices. The Soviet Union collapsed because it wouldn't allow prices to tell the truth about the economy. But the essence of Keynesianism is price manipulation. Especially the big prices like interest rates and currencies. We keep making the same mistake. Secretary Paulson's original TARP plan didn't work because real mortgage prices had been obliterated. Geithner's follow-up plan just tried to manipulate mortgage prices further. At a minimum we need real price discovery in interest rates, mortgages, and currencies; and we also need to reverse the steady government reduction in required bank reserves, and instead make them much bigger.

The bottom line I am offering here is that Keynes is the emperor without any clothes. His ideas may be helping the elite get richer. They are first in line to borrow the cheap money. But these ideas are impoverishing the masses, including the people clinging to life on a dollar a day.

January 31, 2011

WHAT DO YOU SEE AHEAD?

For the moment, world governments are congratulating themselves on having weathered the Crisis of 2008. They enjoy what passes for financial calm, but an eerie calm. None of the imbalances and distortions which precipitated the crisis have actually been addressed. The government's printing presses are still furiously running off American, European, Japanese, and Chinese currency, the cheap currency that got Wall Street "drunk" in the first place. Borrowing and spending are up, not down. Total debt continues to grow faster than income. Speculation thrives. Patient, "good citizen" savers are, as usual, granted the merest pittance of interest. Global vendor finance still prevails, with China still the dominant seller/lender, the same role that the US played in the 1920s. The same group of people who created the dot-com and housing bubbles by and large remain in charge.

Much debate currently swirls around whether the Federal Reserve's massive rescue effort will ignite inflation or whether the real risk is not inflation at all, but deflation. Very few commentators entertain the possibility that what lies immediately ahead is neither inflation nor deflation but more bubbles. But we would miss the lesson of the last fifteen years if we fail to understand that excess credit creation and controlled low interest rates can lead to inflation of assets, i.e. bubbles, just as easily as inflation of consumer prices.

February 7, 2011

YOU ALSO SEE THIS IN MORAL TERMS?

Keynes saw himself, along with Lytton Strachey and other Bloomsbury friends, as a great debunker of Victorian values. If you reread the great Victorian novels, there are many morality tales, not least about debt. In these pages, easy credit and debt are described as addictive and dangerous, the seducer and un-doer of vulnerable human beings, especially young people.

Is it possible that the Victorians were right? That Keynes, for all his brilliance, was morally blind? Are we living through a Victorian novel with ourselves as the heedless victims of greed and folly? If so, there may still be time for a Victorian happy ending, but only if we, as a society, are willing to give up our illusions and stop borrowing faster than we earn.

If this is right, it will not be enough to say, paraphrasing St. Augustine, give me virtue, but not yet. If I understand them correctly, it is this Augustinian stance that Warren Buffet and George Soros seem to be recommending. I do not personally think it is realistic. I believe instead that if we are to start saving and investing, rather than borrowing and spending, we must start now, without further delay. This is the what the Victorians told us and I think it is time to heed them.