KEYNESIANISM

We Are All Keynesians Now

Several decades ago Richard Nixon declared 'I am a Keynesian'. That was it. Mr. Republican, the arch conservative, had embraced the heresy. From that moment on everyone was a Keynesian.

Keynes' The General Theory of Employment, Interest and Money is an economic classic. Its publication was a watershed event and the theory now defines economic orthodoxy. It is for economics what Einstein's Theory of Relativity is to physics. The book is pretty heavy sledding. Reading it in good times would be like taking Sartre's Being and Nothingness to the beach. In difficult times however, this bible for economists merits the effort. To understand this current orthodoxy we should first look at the one which preceded it.

Classical Economics

John Maynard Keynes wrote his General Theory in the midst of the Great Depression. The Depression's peculiar characteristic was that all the infrastructure of production was in place. The factories were standing, the roads laid out, a trained work force was there. But it was not producing much. Keynes felt that 'classical economics', essentially laissez-faire economics, which was the orthodox thinking of his time, was not explaining the Depression and was offering no real cure.

Classic theory says that an unfettered economy will by its nature make maximum use of productive resources like money, labor, machinery and materials. A series of simple, self-adjusting formulas ensures maximum efficiency. The first equation is that supply creates demand. A common rendition of this is: build it and the people will come (to buy it). Whatever it costs to produce something is immediately income to someone, so the money will be there to buy whatever is produced.

That part of income which does not go into immediate consumption will go into savings, which equals investment. Investment, which creates the means of production, translates into personal income, just as does production for consumption. Whatever investment is needed to keep the economic ball rolling will be reflected in the demand for savings. The price of savings is the interest rate.

Next, full employment is the natural economic condition. Unemployment only exists when people refuse to work for the wages offered, and the proffered wage is equal to the true value of the labor. 'True value' meaning what someone else is willing to pay for the thing produced by that labor.

The desire for profit and the discipline of competition drive this best of all possible worlds. Profit motive requires that resources will be used to create the things people are most willing to pay for; competition ensures the most efficient use of those resources and that translates into the lowest price.

Equilibrium, meaning maximum efficiency, is the natural state of this system. Any deviation in any of the elements is automatically corrected by adjustments in the others. If there is not enough machinery to produce for the existing demand the interest rate will go up to attract money away from consumption and into investment, which will then go toward producing the needed machinery. If employment falls so will wages, since the supply of workers is greater than the demand. When wages fall it is worth it for employers to hire more workers.

In this scheme the fundamental problem always comes from those forces which are powerful enough to intervene in the economy's free movement: government, monopolies and labor unions. Government's strong suit is misallocating resources. A billion dollar bridge which services fifty cars per year is not anyone's idea of efficiency. Business monopolies--combinations in restraint of trade is the term of art--restrict production of some things, raise prices and reduce penalties for inefficiency. Unions raise wages beyond labor's true worth, so prices have to go up, hence some workers must be unemployed because there are not enough sales at the higher price.

Demand Side

Keynes' reply is that all of this is fine as long as an economy is operating at its maximum potential. But, he objected, this happy circumstance is <u>not</u> the system's natural condition. His economy is much more complicated and far more dynamic. There is no equilibrium. He saw demand as the driving force in an economy. With "effective demand" he qualified the assumption that demand is always there as a kind of pervasive force that only needs supply to satisfy it. On the contrary, "effective demand", the only kind that counts because it is the only kind that results in actual spending, depends on some very special conditions. This demand depends upon employment (wages) and employment depends on investment.

Investment can mean machinery and equipment or it may mean working capital, the money a business needs to sustain its operation until sales are made. During the depression the long term and infrastructure type of investment was already there, but to get the economy rolling again there was as Keynes saw it a serious need for working capital. Orthodox economists looked at the existing plant and equipment and concluded that it must be trade barriers and the price of labor which were standing in the way of a fully functioning economy.

But for Keynes investment is the key and here he made his clearest break with classical economics. In the classical view the entrepreneur/investor is a cool calculator. He looks at the ordinary returns on capital then casts about for an investment that promises to make a similar return. Keynes' entrepreneur by contrast is the gonzo man of action. No rational guy, he is motivated by "animal spirits". Once he has a crude idea of what income he might get from an investment he measures it against what it will cost and he measures his cost against the current interest rate. The current interest rate is the safe bet, the other side of a loan, and if the estimated return on a new investment is higher then the new project is a go.

The entrepreneur's vision of the future is not so bound by the past but he is very much restrained by "expectation". Expectation is a big theme with Keynes. He thought prior economists did not give it nearly enough credit. This expectation is what we often see in the stock market, in other words it is the speculators' view of the future and as a consequence it can fluctuate wildly.

Just as the level of new investment can vary without much reference to any reasonable view of the economy, so too can interest rates. Keynes did not believe that interest was determined by the supply of savings and the demand for investment. On the contrary, interest depends on expectations, just like investment. People may save money but if they are pessimistic about the future they will put that money in their pockets, not into a CD, hence not into investment. Just having the money for an uncertain future is much more important than earning any interest. Keynes called this the 'liquidity preference'. Interest then is not the price for savings, it is the price for surrendering liquidity.

Money has a value above and beyond its simple utility as a medium of exchange. It is valuable because it is scarce and because as a practical matter there is nothing that can be substituted for it. This adds a premium to interest, the price of money, which translates into a lower level of investment.

Keynesianism breaks the automatic link between investment and the need for investment, between the interest rate and the demand for savings, between the desire to consume and a system's ability to satisfy that demand. In brief, the economy is too important to be left to irrational humans.

Keynesianism

If we recognize the term at all we know it means government intervention in the economy, and that is exactly what Keynes had in mind. Government must extract money and direct it to precisely those points where it will maximize demand. Usually this means taking it from those who can afford to save, 'the rich' variously defined, and giving it to those who are going to spend it immediately, the poor and working class. This can be done in a variety of ways from welfare to public works projects to 'stimulus programs'.

Similarly, government, via the central bank (our Federal Reserve) must create an adequate supply of money such that capital is readily available.

Only government can provide the long term policies that will allow for consistent business planning, free from the boom and bust emotions of a free economy.

These ideas are so much a part of our economic thought, so institutionalized in public programs, that even free-marketers may not realize how much they take them for granted. Social security and unemployment are transfer programs meant to prop up demand. Critics will argue about how best to fund them and at what level, but not about whether they should exist. The Federal Reserve will continue to create money, we are not going back on the gold standard, and the only argument will be about how much should be created. In other words, we live in a Keynesian world.

One final element of Keynes' thought is particularly relevant today. That is confidence. Keynes injected human emotion into the economic process. Government can deliver capital to the market, government can transfer money to those most in need. But it can't make entrepreneurs invest and it can't force people to spend. Only a sense of confidence can motivate those things and it takes time to revive that feeling.

If there is a lesson here for investors it is that we must be patient.