Keynes' relationship to the current Global Financial Crisis

Gerard Jackson

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The global economic crisis that the reckless monetary policies of the world's central banks visited upon us has led to many mislabelling the situation as on of "classic Keynesianism". That vulgar Keynesian thinking contributed mightily to the crisis never enters the heads of these economic commentators — but then very little ever does.

There is nothing new about the current situation. David Ricardo and his contemporaries had a far greater understanding of this phenomenon than nearly all of the current economic commentariat, including those with Nobel Prizes. Paul Krugman, for instance, argues that recessions "happens when, for whatever reason, a large part of the private sector tries to increase its cash reserves". (Paul Krugman, *The Hangover Theory*, *Slate*, 4 December 1998).

This is simply not true. Recessions begin in the higher stages of production because the savings-consumption ratio has been distorted. This led to excess investment in the capital goods industries and construction. And nineteenth century economists — including Marx — recognised this problem as one of disproportionality. The recession does not begin because businessmen suddenly desire to accumulate cash balances: it begins when these businessmen find themselves in a profits squeeze as costs rise faster than revenues. (One only has to look at the profits and cash situation of firms in 1929 to see that Krugman's assertion is completely baseless).

Now let us look at the situation that confronted the early nineteenth century British economists. Once the Napoleonic War was over the economic distortions that it had caused, mainly through inflation, were revealed as malinvestments, i.e., unemployed capital and labour. Evidently, this was not lost on Ricardo. To him this was an interval during which unsound investments were liquidated, some specific capital abandoned and labour was redirected so that proportionality was restored (the Austrians call it the readjustment period). As he put it during this interval:

> The commencement of war after a long peace, or of peace after a long war, generally produces considerable distress in trade. It changes in a great degree the nature of the employments to which the respective capitals of countries were before devoted; and during the interval while they are settling in the situations which new circumstances have made the most beneficial, much fixed capital is unemployed, perhaps wholly lost, and labourers are without full employment. The duration of this distress will be longer or shorter according to the strength of that disinclination which most men feel to abandon that employment of their capital to which they have long been accustomed. (David Ricardo, *On The Principles of Political Economy and Taxation* , Penguin Bookes, 1971, p. 270-71)

What is striking about Ricardo's analysis is its microeconomic aspect. The realisation that capital is not, in reality, homogeneous and thus malinvestments will occur. Further, inflations create malinvestments that will eventually have to be liquidated, perhaps with considerable loss of capital. Now wonder Hayek was moved to comment that since Ricardo the classical economists have been more "'Austrian' than their successors". (F. A. Hayek, *The Pure Theory of Capital*, The University of Chicago Press, 2007). It's important to bear Hayek's observation in mind because the Austrian view of capital as a heterogeneous structure with a time dimension is a vitally important part of Austrian trade cycle theory.

Ricardo and his contemporaries clearly understood (including Malthus who quietly dropped his stagnation thesis) that unless prices and costs are allowed to adjust to the new monetary conditions persistent unemployment would emerge. Therefore it is fair to state that the classical contention is that if wage rates (the total hourly cost of labour) are maintained above their market clearing levels unemployment will persist.

This brings us to Keynes *General Theory of Employment, Interest and Money*. His disciples tell us that he showed that the classical view that cutting wage rates to restore employment worsens the situation because it reduces purchasing power thus keeping the economy depressed. Ergo, "only the government can rectify this through fiscal policy." (This means printing money). But there was nothing new in Keynes' treatment of wages.

I think the best way of dealing with his views on wages is to first deal with his views on savings and investment. Keynes' disciples assert that he showed that savings can exceed investment and so cause aggregate demand to fall. But Keynes did nothing of the kind. The truth be told, he was hopelessly contradictory and confused on savings and investment, something that should be obvious to anyone who managed to conjure up the necessary fortitude to plough through the *General Theory*. Keynesians make much ado about savings exceeding investment which will send the economy into recession. Now this is how Keynes defined savings and investment:

> ... saving is equal to the excess of income over consumption — all of which is conformable both to common sense and to the traditional usage of the great majority of economists — the equality of saving and investment necessarily follows. In short-
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> Income = value of output = consumption + investment.
> Saving = income − consumption.
> Therefore saving = investment..
>
> Thus any set of definitions which satisfy the above conditions leads to the same conclusion. It is only by denying the validity of one or other of them that the conclusion can be avoided. The equivalence between the quantity of saving and the quantity of investment emerges from the bilateral character of the transactions between the producer on the one hand and, on the other hand, the consumer or the purchaser of capital equipment. (*The General Theory of Employment Interest and Money*, Macmillan-St. Martin's Press, p. 63).

At the very beginning of chapter 7 he freely admits that

> In the previous chapter *saving and investment* [his italics] have been so defined they are necessarily equal in amount, being, for the community as a whole, merely different aspects of the same thing.... So far as I know, everyone agrees in meaning by saving the excess of income over what is spent on consumption. It would certainly be very inconvenient and misleading not to mean this. (Ibid. P. 74).

Keynes then writes on p. 81 :

> The prevalence of the idea that saving and investment, taken in their straightforward sense, can differ from one another, is to be explained, I think by an optical illusion...

Yet Keynes also argues that

> ... it is unlikely that full employment can be maintained, whatever we may do about investment, with the existing propensity to consume. There is room, therefore, for both policies to operate together;— to promote investment and, at the same time, to promote consumption, not merely to the level which with the existing propensity to consume would correspond to the increased investment, but to a higher level still. (Ibid. 325).

How can this be? He defines savings as equal to investment and admits that investment raises the demand for labour: yet he followed this with the argument that increased savings would lower aggregate demand and raise the level of unemployment. Hence the solution was more consumption and investment. But according to his own definition of saving and investment this is not possible. So he went from treating savings and investment as "merely different aspects of the same thing" (Ibid. 74) to being independent variables. He makes this shift very clear on page 210 where he writes:

> An act of individual saving means — so to speak — a decision not to have dinner to-day. But it does not necessitate a decision to have dinner or to buy a pair of boots a week hence or a year hence or to consume any specified thing at any specified date. Thus it depresses the business of preparing to-day's dinner without stimulating the business of making ready for some future act of consumption. It is not a substitution of future consumption-demand.

Irrespective of any protestations to the country Keynes was merely ploughing old ground here. He had written in 1930:

> For in certain cases a tendency for the rate of investment to lag behind the rate of savings might come about as the result of a reaction from over-investment. . . : inasmuch as, on my theory, it is a large volume of savings which does *not* lead to a correspondingly large volume of investment (not one which *does*) which is the root of the trouble. (John Maynard Keynes, *A Treatise on Money*, Vol. I, Macmillan and Co. Limited, 1953, pp. 178-79)

I think that what makes all of this so confusing is the absence of any consistent explanation of what savings really are. To define savings as income minus consumption is inaccurate and dangerously misleading. Savings are the process by which we transform present goods into future goods. That is, we use money to divert resources from current consumption into greater future consumption. It is this process that raises the marginal productivity of labour.

It follows that in this sense saving and investment will always be equal. (Note: cash balances are not savings. An increase in the demand to hold money is not an increase in savings. Cash balances and savings perform different functions.) Keynesians make no distinction between savings and cash balances; therefore they can, and do, assume that savings are not spent. But as the classical economists stressed: "To save is to spend."

The 'problem' of equality between savings and investment arises when we define savings in purely monetary terms (which we usually do) and investment at given prices. When investment exceeds savings we have inflation. The excess investment means that the banking system has created new credit. (This has led some economists to jump to the absurd conclusion that we can have investment without savings. They obviously have not heard of 'forced savings').

Deflation reverses the situation. A crisis has occurred and credit and money have contracted, banks have foreclosed, investment has halted, pessimism is rife, cash holdings have increased and prices are falling. (Note: a demand for cash balances does not precipitate the crisis). Savings now exceed investment. In short, it is monetary disturbances that cause discrepancies between savings and investment. These are fundamental facts, among many others, that Keynes' disciples have never been able to grasp. Their devotion to Keynesian scripture has given them a Pharisaic approach that leaves little room for genuine economic debate.

Given this argument how do we explain widespread unemployment if it is not caused by a fall in aggregate demand? So long as real wage rates (gross rates) are held above their market clearing rates unemployment will remain a problem. It's real money wage rates and real prices that count. And that's why Keynes wrote:

> Whilst workers will usually resist a reduction of money-wages, it is not their practice to withdraw their labour whenever there is a rise in the price of wage-goods [consumption goods] (*General Theroy*, p. 9).

That let the cat well and truly out of the bag. Let's use inflation to con the workers into thinking they are getting wage increase when in fact we are using inflation to cut their wages. Keynes evidently did not have a high regard for the intelligence of the average worker.

Some Keynesians argue that "the ability to hold money creates economic uncertainty". This is plain silly. What creates uncertainty is lack of foresight. We have economic uncertainty because we do not know the future, not because people can hold cash. If people suddenly act to accumulate cash holdings it is because current events have changed their expectations. This is something that the likes of Krugman never take into account. No doubt this is why they cannot fathom the markets' continuing negative responses to Obama's reckless economic policy and his incessant doomsaying.

Once it is realised that what is being discussed is not savings but an increased demand for cash balances the economic picture should immediately become clear. Hoarding is the other name for cash balances. To Keynesians hoarding is the economic equivalent of leprosy and has to be treated before it infects (depresses) the economy. Far from being a barren or anti-social action hoarding, however, is a highly productive economic activity that yields a return.

This is another economic fact that Keynesians have never come to grips with. Individuals hold money only to the extent that it yields a return that exceeds the expected return from expenditure. At the root of the demand to hold money is uncertainty, and from this we get speculation. Hence money balances are speculative in nature. The great Keynesian fear is that a large, if not sudden, increase in the demand to hold money will send the economy into a depression.

Now it is true that a sudden and significant demand for cash balances would have a deflationary effect. But it needs to be remembered that a sudden and motiveless demand to increase cash balances is unheard of. Significant increases in the demand for cash balances are a secondary feature of deflations: large-scale liquidations create pessimism in the business community and depress investment and borrowing, borrowers try to acquire cash to pay off their debts, banks accumulate reserves and falling prices induce consumers and business to hold more money.

These are the conditions that prevailed in the US from 1930-1932 when prices fell and production collapsed. Yet the phenomenon of increased hoarding during a deflation and the reasons for it was well-known to the classical economists. So what we have regarding hoarding and depressions is another Keynesian case of putting the cart in front of the horse.

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Gerard Jackson is Brookesnews' economics editor