THOUGHTS FROM THE FRONTLINE

Ray Dalio-John Mauldin Discussion, Part 5

By John Mauldin | July 5, 2019


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The Problem with Keynesianism
Without Savings, Nothing Happens
Maine and Montana

> "The belief that wealth subsists not in ideas, attitudes, moral codes, and mental disciplines but in identifiable and static things that can be seized and redistributed is the materialist superstition. It stultified the works of Marx and other prophets of violence and envy. It frustrates every socialist revolutionary who imagines that by seizing the so-called means of production he can capture the crucial capital of an economy. It is the undoing of nearly every conglomerateur who believes he can safely enter new industries by buying rather than by learning them. It confounds every bureaucrat who imagines he can buy the fruits of research and development.
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> The cost of capturing technology is mastery of the knowledge embodied in the underlying science. The means of entrepreneurs' production are not land, labor, or capital but minds and hearts."

"Whatever the inequality of incomes, it is dwarfed by the inequality of contributions to human advancement. As the science fiction writer Robert Heinlein wrote, 'Throughout history, poverty is the normal condition of man. Advances that permit this norm to be exceeded—here and there, now and then—are the work of an extremely small minority, frequently despised, often condemned, and almost always opposed by all right-thinking people. Whenever this tiny minority is kept from creating, or (as sometimes happens) is driven out of society, the people slip back into abject poverty. This is known as bad luck.'

President Obama unconsciously confirmed Heinlein's sardonic view of human nature in a campaign speech in Iowa: 'We had reversed the recession, avoided depression, got the economy moving again, but over the last six months we've had a run of bad luck.' All progress comes from the creative minority. Even government-financed research and development, outside the results-oriented military, is mostly wasted. Only the contributions of mind, will, and morality are enduring. The most important question for the future of America is how we treat our entrepreneurs. If our government continues to smear, harass, overtax, and oppressively regulate them, we will be dismayed by how swiftly the engines of American prosperity deteriorate. We will be amazed at how quickly American wealth flees to other countries."

"Those most acutely threatened by the abuse of American entrepreneurs are the poor. If the rich are stultified by socialism and crony capitalism, the lower economic classes will suffer the most as the horizons of opportunity close. High tax rates and oppressive regulations do not keep anyone from being rich. They prevent poor people from becoming rich. High tax rates do not redistribute incomes or wealth; they redistribute taxpayers—out of productive investment into overseas tax havens and out of offices and factories into beach resorts and municipal bonds. But if the 1 percent and the 0.1 percent are respected and allowed to risk their wealth—and new rebels are allowed to rise up and challenge them—America will continue to be the land where the last regularly become the first by serving others."

—George Gilder, *Knowledge and Power: The Information Theory of Capitalism*

"The ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else. Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist."

—John Maynard Keynes, *The General Theory of Employment, Interest and Money*

"Nothing is more dangerous than a dogmatic worldview – nothing more constraining, more blinding to innovation, more destructive of openness to novelty."

– Stephen Jay Gould, *Dinosaur in a Haystack: Reflections in Natural History*

I think Lord Keynes himself would appreciate the irony that he has become the defunct economist under whose influence the academic and bureaucratic classes now toil, slaves to what has become as much a religious belief system as an economic theory. Men and women who display appropriate skepticism on other topics indiscriminately funnel facts and data through a Keynesian filter without ever questioning the basic assumptions. Some go on to prescribe government policies that have profound effects upon the citizens of their nations.

And when those policies create the conditions that engender the income inequality they so righteously oppose, they often prescribe more of the same bad medicine. Like 18th-century physicians applying leeches to their patients, they take comfort that all right-minded people will concur with their recommended treatments.

This is part of an ongoing series of a discussion between Ray Dalio and myself. Today's installment, adapted from a letter I wrote several years ago, addresses the philosophical problem he is trying to address: income and wealth inequality.

Last week I dealt with the equally significant problem of growing debt in the United States and the rest of the world. The Keynesian tools much of the economic establishment wants to use are exacerbating the problems. Ray would like to solve it with a blend of monetary and fiscal policy, what he calls Monetary Policy 3.

The Problem with Keynesianism

Let's start with a classic definition of Keynesianism from Wikipedia, so that we can all be comfortable that I'm not coloring the definition with my own bias (and, yes, I admit I have a bias). (Emphasis mine.)

> Keynesian economics (or Keynesianism) is the view that in the short run, especially during recessions, economic output is strongly influenced by aggregate demand (total spending in the economy). In the Keynesian view, aggregate demand does not necessarily equal the productive capacity of the economy; instead, it is influenced by a host of factors and sometimes behaves erratically, affecting production, employment, and inflation.
>
> The theories forming the basis of Keynesian economics were first presented by the British economist John Maynard Keynes in his book *The General Theory of Employment, Interest and Money*, published in 1936 during the Great Depression. Keynes contrasted his approach to the aggregate supply-focused "classical" economics that preceded his book. The interpretations of Keynes that followed are contentious, and several schools of economic thought claim his legacy.

> **Keynesian economists often argue that private sector decisions sometimes lead to inefficient macroeconomic outcomes which require active policy responses by the public sector, in particular, monetary policy actions by the central bank and fiscal policy actions by the government, in order to stabilize output over the business cycle.** Keynesian economics advocates a mixed economy—predominantly private sector, but with a role for government intervention during recessions.

(Before I launch into a critique of Keynesianism, let me point out that I find much to admire in the thinking of John Maynard Keynes. He was a great economist and taught us a great deal. Further, *and this is important*, my critique is simplistic. A proper examination of the problems with Keynesianism would require a lengthy paper or a book. We are just skimming along the surface and don't have time for a deep dive.)

Central banks around the world and much of academia have been totally captured by Keynesian thinking. In the current avant-garde world of neo-Keynesianism, consumer demand—consumption—is everything. Federal Reserve policy is clearly driven by the desire to stimulate demand through lower interest rates and easy money.

And Keynesian economists (of all stripes) want fiscal policy (essentially, government budgets) to increase consumer demand. If the consumer can't do it, the reasoning goes, then the government should step into the breach. This of course requires deficit spending and borrowed money (including from your local central bank).

Essentially, when a central bank lowers interest rates, it is encouraging banks to lend money to businesses and telling consumers to borrow money to spend. Economists like to see fiscal stimulus at the same time, as well. They point to the numerous recessions that have ended after fiscal stimulus and lower rates were applied. They see the ending of recessions as proof that Keynesian doctrine works.

This thinking has several problems. First, using leverage (borrowed money) to stimulate spending today must by definition reduce consumption in the future. ***Debt is future consumption denied or future consumption brought forward.*** Keynesian economists argue that bringing just enough future consumption into the present to stimulate positive growth outweighs the future drag on consumption, as long as there is still positive growth. Leverage just equalizes the ups and downs. This has a certain logic, of course, which is why it is such a widespread belief.

Keynes argued, however, that money borrowed to alleviate recession should be repaid when growth resumes. My reading of Keynes does not suggest he believed in the unending fiscal stimulus his disciples encourage today.

Secondly, as has been well documented by Ken Rogoff and Carmen Reinhart, there comes a point at which too much leverage becomes destructive. There is no exact way to know that point. It arrives when lenders, typically in the private sector, decide that borrowers (whether private or government) might have some difficulty repaying and begin asking for more interest to compensate for their risks. An overleveraged economy can't afford the higher rates, and economic contraction ensues. Sometimes the contraction is severe, sometimes it can be absorbed. When accompanied by the popping of an economic bubble, it is particularly disastrous and can take a decade or longer to work itself out, as the developed world is finding out now.

Every major "economic miracle" since the end of World War II has been a result of leverage. Often this leverage has been accompanied by stimulative fiscal and monetary policies. Every single "miracle" has ended in tears, with the exception of the current recent runaway expansion in China, which is still in its early stages. (And this is why so many eyes in the investment world are laser-focused on China. Forget about a hard landing or a recession, a simple slowdown in China has profound effects on the rest of the world.)

I would argue (along, I think, with the "Austrian" economist Hayek and other economic schools) that recessions are not the result of insufficient consumption but rather ***insufficient income***. Fiscal and monetary policy should aim to grow incomes over the entire range of the economy. That is best accomplished by making it easier for entrepreneurs and businesspeople to provide goods and services. When businesses increase production, they hire more workers and incomes go up.

Without income, there are no tax revenues to redistribute. Without income and production, nothing of any economic significance happens. Keynes was correct when he observed that recessions are periods of reduced consumption, but that is a result and not a cause.

Entrepreneurs must be willing to create a product or offer a service in the hope there will be sufficient demand for their work. There are no guarantees, and they risk economic peril with their ventures, whether we're talking about the local bakery or hairdressing shop or Elon Musk trying to compete with the world's largest automakers. If government or central bank policies hamper their efforts, the economy stagnates.

Many politicians and academics favor Keynesianism because it offers a theory by which government actions can become decisive in the economy. It lets governments and central banks meddle in the economy and feel *justified*. It allows 12 people sitting in a board room in Washington DC to feel they are in charge of setting the most important price in the world, the price of money (interest rates) of the US dollar and that they know more than the entrepreneurs and businesspeople who are actually in the market risking their own capital every day.

This is essentially the Platonic philosopher king conceit: the hubristic notion that a small group of wise elites is capable of directing the economic actions of a country, no matter how educated or successful the populace has been on its own. And never mind that the world has multiple clear examples of how central controls eventually slow growth and make things worse over time. It is only when free people are allowed to set their own prices of goods and services and, yes, even interest rates, that valid market-clearing prices can be determined. Trying to control them results in one group being favored over another.

In today's world, savers and entrepreneurs are left to eat the crumbs that fall from the plates of the well-connected crony capitalists and live off the income from repressed interest rates. The irony of using "cheap money" to drive consumer demand is that retirees and savers get less money to spend, and that clearly drives their consumption down.

Why is the consumption produced by ballooning debt better than the consumption produced by hard work and savings? This is trickle-down monetary policy, which ironically favors the very large banks and institutions. If you ask Keynesian central bankers if they want to be seen as helping the rich and connected, they will stand back and forcefully tell you "NO!" But that is what happens when you start down the road of financial repression. Someone benefits. So far it has not been Main Street. As George Gilder said,

> **Those most acutely threatened by the abuse of American entrepreneurs are the poor. If the rich are stultified by socialism and crony capitalism, the lower economic classes will suffer the most as the horizons of opportunity close. High tax rates and oppressive regulations do not keep anyone from being rich. They prevent poor people from becoming rich. High tax rates do not redistribute incomes or wealth; they redistribute taxpayers—out of productive investment into overseas tax havens and out of offices and factories into beach resorts and municipal bonds.**

Without Savings, Nothing Happens

Those who were forced to endure Economics 101 may remember that Savings = Investment. In any real-world economic system, you must have savings in order to have investment in order for the economy to grow. Generally, savings are actually leveraged to produce *more* investments (and thus eventual production and consumption) than if the "profit recipients" had simply spent the money themselves. This will become critically important next week.

This idea that consumption is better than savings is the heart of the Keynesian conceit. Yes, I know, I've written many a time about Keynes's Paradox of Thrift: "It is a good thing for individuals to save, but if everybody saves then there is less consumption." That seems true on the surface and makes a great sound bite, but it has an inherent flaw. It assumes that savings don't become investments that increase productivity, which in turn leads to the production of more goods and services, which ultimately creates income, which then creates more demand.

Without savings, nothing happens. Nothing. There has to be capital of some kind from somewhere in order for economic activity to happen. Productivity growth is ultimately a product of savings, and it is productivity growth that will generate an increase in income for the country as a whole. There are consequences to the fact that savings are close to an all-time low.

And when those limited savings go to purchase government bonds, it takes money away from more productive and income-producing endeavors.

A static economy does not raise overall income or wealth. Only an economy that is growing as a result of a healthy level of savings and investment can produce the results Keynesian economists want: increased incomes for everyone.

Your typical Keynesian economist isn't willing to wait for savings to become investment. They and the politicians they serve want results today. And the only way to get results today is to get people to spend today, while the process of saving and investing takes time.

Neo-Keynesian economists are ultimately teenage children who want the pleasure of consuming today rather than thinking about the future. And I won't even go into the burden we are placing on future generations by borrowing money to goose our current economy and expecting them to pay that money back. We are building toward a future intergenerational war that is going to be very intense once our children learn how we misspent their future. But that's yet another letter.

Maine and Montana

Early August sees me in New York for a few days before the annual economic fishing event, Camp Kotok. Then maybe another day in New York before I meet Shane in Montana and spend a few days with my close friend Darrell Cain on Flathead Lake.

After a long day spent in airports, I arrived at my home in Puerto Rico (Shane is in California) in the early evening with the full intent of writing and finishing a much different letter than the one above. Then I realized I did not have the key to the house. Shane and I had talked about dealing with such a contingency, but we never actually did it. That will shortly change. And while the key did materialize some six hours later, the new time constraints forced me to go back to previous material to address what is a serious obstacle to resolving the problems Ray and I see.

Next week, we will look at policies that not only increase savings and investment, but will restart economic growth and put us back on track to more equitable distribution of the economic pie.

And with that I will hit the send button and wish you a great week!

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