THOUGHTS FROM THE FRONTLINE

That Time Keynes Had a Point

By John Mauldin | September 20, 2019

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> *"Practical men, who believe themselves to be quite exempt from any intellectual influence, are usually the slaves of some defunct economist. Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler of a few years back."*

-John Maynard Keynes

I begin with this Keynes quote because, while true, it doesn't go far enough. The problem isn't simply defunct economists or "scribblers of a few years back." We are in the grip of economists who, far from being defunct, hold great power. Whether they hear voices in the air (or Twitter), I can't say, but they are indeed madmen in authority.

Not all economists are in that category. Many provide valuable insight or are at worst harmless. They don't pretend they can change human nature or prevent the inevitable. Unfortunately, some economists do believe those things. Worse, they are in places from which they can wreak havoc, and they are.

Last weekend I received two emails referring me to articles about the economics profession. They came within minutes of each other, from two different associates who don't know each other. That seemed like an odd coincidence but it stirred my writing juices.

Please note, I don't agree with everything in the articles I'll describe today. They are nonetheless important because they try, at least, to describe and possibly fix the problem Keynes identified. We have to address them, not just economically but politically. We can't just put our heads in the sand and think this will go away.

The whole debt bubble, the income and wealth inequality angst, a growing deficit which will get worse after the next recession, and lack of economic understanding among voters is all coming home to roost. Better to think about that now, while we can still act and maybe even change things.

False Assumptions

The first item is a July 2019 TED talk by Nick Hanauer, a self-described Seattle "plutocrat" who founded and sold several companies. He is now a venture capital investor. Hanauer is far to my left politically, but his thinking reminds me a bit of Ray Dalio, and as we will see, some of the proponents of neo-Keynesian "new economics."

Hanauer's latest TED talk is titled "The dirty secret of capitalism—and a new way forward." You can either watch a video or read the transcript. He begins by describing the widening inequality problem we have discussed before, then quickly zeroes in on what he thinks is the problem: neoliberal economics.

> *Economics has been described as the dismal science, and for good reason, because as much as it is taught today, it isn't a science at all, in spite of all of the dazzling mathematics. In fact, a growing number of academics and practitioners have concluded that neoliberal economic theory is dangerously wrong and that today's growing crises of rising inequality and growing political instability are the direct result of decades of bad economic theory.*
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> *What we now know is that the economics that made me so rich isn't just wrong, it's backwards, because it turns out it isn't capital that creates economic growth, it's people; and it isn't self-interest that promotes the public good, it's reciprocity; and it isn't competition that produces our prosperity, it's cooperation.*
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> *What we can now see is that an economics that is neither just nor inclusive can never sustain the high levels of social cooperation necessary to enable a modern society to thrive.*

I know, those are fighting words to most free-market defenders, but hear this out. Hanauer blames the sad state of modern economics on three false assumptions.

First, it isn't true the market is an efficient equilibrium system. You may have read my "sandpile" letter that is one of my most popular ever. I reprint it every so often, most recently here. It describes how our astronomically complex modern economy is anything but an equilibrium. It is a growing sandpile whose collapse is certain. As Hyman Minsky wrote, stability breeds instability.

If, as too many economists believe, you think you can manage an economy toward equilibrium, you simply help the sandpile grow bigger so its eventual collapse is even more violent. That's how we get crises like 2008, and the one we will have again in due course.

The second false assumption is that price always equals value. That's the heart of the efficient market hypothesis, that stock prices always reflect all available information. Clearly, they don't, since we have all seen both overvalued and undervalued markets.

In fact, we have economist-run institutions like the Federal Reserve working to make sure prices *don't* equal value. They intentionally distort prices, starting with the most important one: the price of money, what we call "interest rates," with all kinds of harmful effects (and often benefits to those who already own assets).

The third false assumption is that humans are rational, utility-maximizing machines who look out for our own interests first. It's just not true. Humans are social animals, and we will, in the right conditions, sacrifice our own interests for others. Soldiers don't heroically jump on grenades because they're selfish. Parents and friends often sacrifice for their children and their friends. People accept lower returns to invest in ways they think improve the world, or pursue behaviors they feel are in the common and general interest but not their own individual interests. Happens all the time.

If we were all so naturally self-maximizing, there would be no such thing as love, which is a *choice* to place someone else's good ahead of your own. If you have some hidden selfish motive, it's not really love, is it? Not in the way any religion I know describes it.

Yet many economists persist in believing we are all competitive, all the time, and this somehow leads to equilibrium and prosperity. That is false and if it is your base assumption, all your other answers are going to be wrong. This is not an embrace of human nature, but a *denial* of it.

Meanwhile, another Seattle billionaire had some words on the same subject recently. Bill Gates didn't say exactly "economists know nothing," but that's clearly what he meant in this Quartz interview.

> *"Too bad economists don't actually understand macroeconomics," the Microsoft co-founder said. Asked what he meant by that, Gates continued:*
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> *"It's not like physics where you take certain inputs and you predict certain outputs. Will interest rates ever return to normal, and why aren't they returning to normal? You won't get a consensus between economists quite the way that if you dropped a ball out your window and called up physicists and asked, 'What the hell happened?' There's so many factors including what [economist John Maynard] Keynes called 'animal spirits' in the economic equation that we don't have predictability.*

> *Even today, people are still arguing about what happened in 2008. So it's even harder to look forward. [Look at] the role of the bond rating agencies in 2008, which is completely unreformed. Why would that be? Well, there must be a lack of consensus."*

Both Hanauer and Gates make a point. Economists began assuming equilibrium must exist early in the 20th century. General equilibrium was wonderful because it let them model the economy on paper (and later, computers). Economists have physics envy. In essence, they assume away whatever doesn't fit the model. Unsurprisingly, the models don't work when put to the test, because the assumptions are not anchored in reality.

The entire premise of equilibrium economics is false. The world is a complex system. To model it requires complexity mathematics and theory. Sadly, but not unsurprisingly, we are decades away (if ever) from actually being able to model the economy as long as one continues to assume equilibrium at some point.

Of course we can make observations and theories and propose policies. But we shouldn't do so under the illusion that some mathematical model allows us to know what we're doing. "Lies, damn lies and models" should have been the quote. So when Gates and Hanauer and others, including me, say that economists don't understand economics, our real point is that they rely on incorrect models and assumptions.

It gets worse when the politicians get economists to create models for them. These economists are every bit as trained as any circus animal and they don't even need a whip. The economists' assumptions inevitably lead to the conclusions the politician wants. Of course, they all have "neutral data and facts." What would a model be without facts and data?

Necessary Debate

The second article came to me from a person who thought it ridiculous. He sent it along with a lengthy preface warning about its (in his view, false) claims. I appreciated the thought but I am also trying very hard to break out of the tribal box. I now often say that I'm neither Republican nor Democrat, but American. I don't automatically reject ideas simply because of their origin. If I reject them, it's because I have *studied* them and concluded they are wrong.

That said, this one has a lot of problems but is still worth reading. The author is Jared Bernstein, an economist who once advised Vice President Joe Biden. (I've quoted him before.) In this piece he describes what he calls a "new economics" that will create a more "just" America.

Like Dalio and Hanauer, I think Bernstein correctly identifies many of our problems. It is not the case that everything would be peachy if government just got out of the way; we have deeper issues. I completely endorse Bernstein's first sentence: "The American economy has some serious, structural problems—and the economists are partly to blame." He goes on:

> *It is not a coincidence that the new economics is in ascendency at this moment. Though by some measures, inequality has not grown much in recent years, it remains at levels as high as the late 1920s, which, for the record, didn't end well. In one of the most disturbing developments emerging from recent research, the inequality of income and wealth is increasingly associated with the inequality of life expectancy.*
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> *The assumption that self-interested firms would self-regulate gave rise to repeated rounds of deregulation that gave us what I call the "shampoo economy": bubble, bust, repeat. The old economics wrongly claimed we couldn't have persistently low unemployment without spiraling inflation, yet that's precisely what we've enjoyed in recent years.*
>
> *In other words, the new economics isn't arising just because we want "better" outcomes from our markets. It's also arising because a lot of the old stuff has turned out to be just plain wrong.*

That is mostly true but I think it's because deregulation hasn't gone far *enough*. Large companies use political influence to have government protect them from competition. The result is a bunch of "zombies" engaged in counterproductive activities that market discipline would quickly send to the graveyard, were it allowed to work.

The solution, in my opinion, is not for government to further regulate private business, but for it to stop picking winners and losers. Consumers could then decide what works. Of course, there's room for reasonable regulation; we all want safe vehicles, clean food, etc. But regulations should promote competition, not suppress it.

I think many of Bernstein's policy ideas won't have the desired results, and some would be disastrous, but these are debates *we need to have*. We will achieve better results if we engage in them civilly and sincerely. That is hard in today's polarized environment… but avoiding it will be even harder.

Keynesian Sense?

That brings us back to Lord Keynes. Many now regard him as one of the "defunct economists" he himself blamed for the problems of his time. In certain quarters, "Keynesianism" is as unpalatable as socialism. In fact, while Keynes was a leftist by today's standards, he wasn't against capitalism.

Recently I ran across a 2009 article by Bruce Bartlett with the provocative headline, Keynes Was Really a Conservative. That overstates it, but Keynes was more conservative than you might think. Here's Bartlett.

Keynes completely understood the central role of profit in the capitalist system. This is one reason why he was so strongly opposed to deflation and why, at the end of the day, his cure for unemployment was to restore profits to employers. He also appreciated the importance of entrepreneurship: "If the animal spirits are dimmed and the spontaneous optimism falters… enterprise will fade and die." And he knew that the general business environment was critical for growth; hence business confidence was an important economic factor. As Keynes acknowledged, "Economic prosperity is… dependent on a political and social atmosphere which is congenial to the average businessman."

Indeed, the whole point of The General Theory was about preserving what was good and necessary in capitalism, as well as protecting it against authoritarian attacks, by separating microeconomics, the economics of prices and the firm, from macroeconomics, the economics of the economy as a whole. In order to preserve economic freedom in the former, which Keynes thought was critical for efficiency, increased government intervention in the latter was unavoidable [at least to him]. While pure free marketers lament this development, the alternative, as Keynes saw it, was the complete destruction of capitalism and its replacement by some form of socialism.

"It is certain," Keynes wrote, "that the world will not much longer tolerate the unemployment which… is associated—and, in my opinion, inevitably associated—with present-day capitalistic individualism. But it may be possible by a right analysis of the problem to cure the disease whilst preserving efficiency and freedom."

In Keynes' view, it was sufficient for government intervention to be limited to the macroeconomy—that is, to use monetary and fiscal policy to maintain total spending (effective demand), which would both sustain growth and eliminate political pressure for radical actions to reduce unemployment. "It is not the ownership of the instruments of production which is important for the State to assume," Keynes wrote. "If the State is able to determine the aggregate amount of resources devoted to augmenting the instruments and the basic rate of reward to those who own them, it will have accomplished all that is necessary."

One of Keynes' students, Arthur Plumptre, explained Keynes' philosophy this way. In his view, Hayek's "road to serfdom" could as easily come from a lack of government as from too much. If high unemployment was allowed to continue for too long, Keynes thought the inevitable result would be socialism—total government control—and the destruction of political freedom. This highly undesirable result had to be resisted and could only be held at bay if rigid adherence to laissez-faire gave way, but not too much. As Plumptre put it, Keynes "tried to devise the minimum government controls that would allow free enterprise to work."

There's actually a lot to like here. A government that focuses on keeping the "macro" playing field level while letting producers and consumers control the "micro" economy would be a vast improvement over what we have now.

That last quote from Plumptre is well said. Keynes wanted "the minimum government controls that would allow free enterprise to work." He sought a balance between central planning and anarchy. He saw a lot of room between the extremes.

Likewise, by establishing conditions in which market forces could work, Keynes sought to prevent the kind of radical policies some of his modern followers want. The crazy ideas we now fear—negative rates, MMT and the rest—didn't appear spontaneously. Their proponents see them as solutions to real problems. These ideas would go nowhere if the economy functioned better.

Today we're still seeking the balance Keynes wanted. We need an economics profession with clear thinkers. They're out there. We have to amplify their voices.

The Bond Master Class

I want to call your attention to a very important announcement made by our own Jared Dillian this week. He has launched a wonderful creation called *The Bond Masterclass*, an entire education on bonds and bond investing. It covers all types of bonds, how they actually work, how to invest in them, and a lot more.

Jared's mission here is to educate people about bonds. He is bringing a wealth of expertise and experience to the table, and one that he has the training and most importantly the ability to clearly and simply write about.

Bonds and fixed income alternatives are essential parts of a portfolio. You need to understand bonds. Knowledge is power and bond knowledge is added dexterity—and added ammunition in your investing arsenal.

The Bond Masterclass is an astonishing toolkit to have at your disposal. There's a large discount for our loyal readers, too, which I heartily encourage you to access right here.

Houston and Home Again

I will be in Houston next week with my partners at SMH, going over new offerings and meeting potential investors. I'm really quite excited about it, plus Texas barbecue too.

Monday and Tuesday were busy and exhausting. Tuesday evening found me in a room with 11 other people celebrating Danielle DiMartino Booth's birthday. I have a reputation for arranging good dinner parties with interesting people (well-deserved, I humbly point out). I knew a few people there, but many were new to me. Unsurprisingly for Danielle, Federal Reserve watchers and aficionados dominated the room. Some were well out of my league, and obviously on a first name basis with current Fed officials.

Randall Forsyth of Barron’s was on my side of the table, and it became almost humorous as they would simply say “Chatham House Rules,” looking at Randall and I specifically, then going on to offer some juicy tidbit. My great friend Lakshman Achuthan, head of the Economic Cycle Research Institute, sat between us and I kept leaning over and asking, “Did you understand that?” If he said no, I didn’t feel too bad about asking for clarification.

It was like a master class and I was grateful to be at the table. As we walked out, Lak and I both remarked about how much we learned. But then he turned to me and said, “But I don’t think I feel any better.” I just laughed and agreed.

I have often written that the Fed is making it up as they go along. It was never more evident than during that evening. Be afraid, be very afraid…

And with that I will hit the send button. Enjoy the week and find a few reasons to take some friends out for great conversation. It just gives everyone more energy.

Your wondering which path we will choose analyst,

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