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JAY'S ANATOMY OF

The GREAT KEYNSIAN COLLAPSE of 2008

The reputation of the British economist John Keynes, the seminal thinker whose theories later came to be known as "Keynsian economics" lost much of its value along with the stock market when the sub prime lending crisis poisoned the entire world credit system in the fall of 2008.

But the credit meltdown of 2008 represents the collapse of the flawed political implementation of a basically sound economic theory, the so-called Keynsian economics.

Many post WWII political leaders saw Keynes' economic theory as permission to write checks that would never have to be paid. Flash forward to the recent crisis. The great credit meltdown of 2008 is a failure of adult supervision – an unsurprising outcome, given the adolescent mindset of the congress and the infantile mindset of the Wall Street speculators. Keynes, himself, would not have been surprised at the collapse.

KEYNES' CHILDREN ARE MANY

John Maynard Keynes, 1883-1946, was probably the single most influential capitalist-friendly economist of the last 100 years. His principal contribution was the idea that government can and should manipulate the "money supply". This is done by increasing the money supply to reduce unemployment – the federal government lowers interest rates and runs fiscal deficits; or by reducing the money supply to curb inflation – the feds raise interest rates and run surpluses.

To characterize Keynes' primary contribution as the notion that governments can and should smooth out the business cycle by manipulating the money supply to stimulate employment is a simplification bordering on caricature. But this condensed version of the

Keynsian innovation in economic thinking – using monetary policy to manipulate (ie.e. boost) the private economy – was the core idea that has driven American economic policy for about 40 years.

One flavor or another of Keynesian economics has been championed by social democrats and fiscal conservatives alike. His theories have been credited with saving capitalism from itself and for helping finance liberalism 'without a tax increase". Of course, there is a always a cost – inflation is the hidden tax that follows excessive increases in the money supply. Naturally, many administrations and congresses of both partisan persuasions jumped on the Keynes bandwagon, except for that darned "budget surplus" part.

The quaint notion that the books must eventually be balanced still has not gained much traction among the political classes.

Here is a short description of Keynes' theory, excerpted from the "Concise Encyclopedia of Economics" -- available on the web "Library of Economics and Liberty":

> "Keynes's *General Theory* revolutionized the way economists think about economics. It… introduced the notion of aggregate demand as the sum of consumption, investment, and government spending; and … that full employment could be maintained only with the help of government spending…Why shouldn't government, thought Keynes, fill the shoes of business by investing in public works and hiring the unemployed? *The General Theory* advocated deficit spending during economic downturns to maintain full employment. … Keynes was a relatively strong advocate of free markets. … [He wrote], 'There is no objection to be raised against the classical analysis of the manner in which private self-interest will determine what in particular is produced, in what proportions the factors of production will be combined to produce it, and how the value of the final product will be distributed between them.'"
>
> [LINK: http://www.econlib.org/library/Enc/bios/Keynes.html]

These simplifications (mine and the above) omit the ideological window dressing. There are, after all, both liberal and fiscally conservative iterations of Keynes' doctrine. They tend to sort out into three camps that provide different answers to the including such not-unimportant questions such as -- "What are we supposed to do with all that newly created money?"

Camp liberal: Spend it directly on the disadvantaged individuals. Camp nationalist conservative: Spend it on employers – government and private-government cooperatives who carry out large projects. Camp libertarian conservative: Lend it freely to business and consumers to stimulate economic activity without picking winners and losers.

How "stimulus" deficits are actually spent has a critically important effect on real world outcomes – economic recovery can be delayed or even aborted if the spending piece isn't done right. Are the new deficit-financed moneys to be spent on large public projects or

on artificially low cost credit to stimulate large private projects? In the latter case, is there any public (i.e., government) control or are we to trust to free market forces? Is either set of projects likely to generate sustained growth? The most common recurring question is this: How much of the deficit moneys should be spent on less productive measures like welfare - in all its various forms? Neo-Keynsian economists use computer models to help answer such questions. Democracies use politics.

In the real world, deficits are spent both wisely and unwisely, both productively and for political expediency, both for future growth and for the alleviation of immediate pain.

And in the real world, Keynes' theory – especially the part that requires fiscal discipline - has mostly been honored in the breach. In addition to the inevitable political distortions of Keynsian theory, we have also to factor in the "greed innovations" of the finance community – the development of various financial "money gaming" schemes that is poorly understood by the political community, remaining under the radar until a malfunction takes place that is to big to ignore.

Let's look at the data about the "national debt" (the cumulative total of all prior net deficits, funded by federal borrowing in the form of treasury bills, bond and other credit instruments). The figures I quote below are set out in full in an appendix; they were not corrected by inflation.

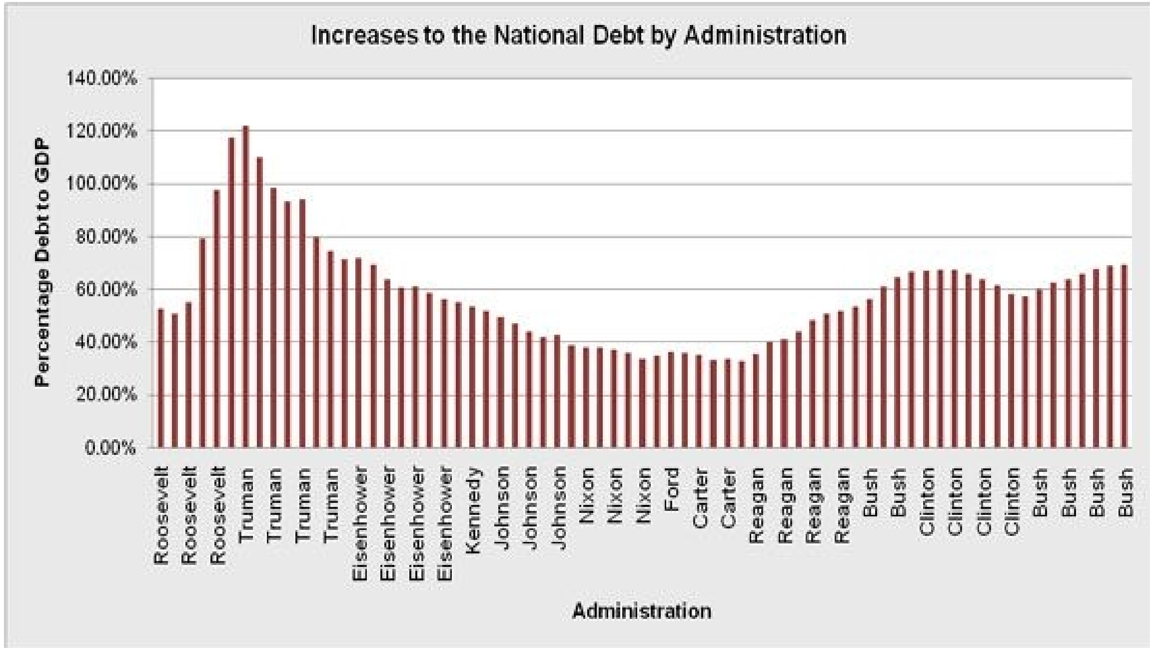
ROSS PEROT WAS MORE RIGHT THAN WRONG

In 1929, the national debt was about 17 billion dollars. By the end of WW II in 1946 that number had risen to about 269 billion. In 1950, the number was down to 256 billion, but in 1960 it was 286 billion, and by 1970, after the Vietnam War and Great Society had been deficit funded, it had grown to about 371 billion. When Reagan was inaugurated after the end of the Vietnam War, the Great Society deficits, and the Carter years of attempted fiscal restraint, the national debt had grown to about .9 trillion dollars.

By the end of the Reagan Cold War years, the debt (in 1989) was 2.8 trillion. During Bush I, the deficit increased to about 4 trillion. During the Clinton years from 1992-2000, the deficit increased from 4 trillion to 5.6 trillion.

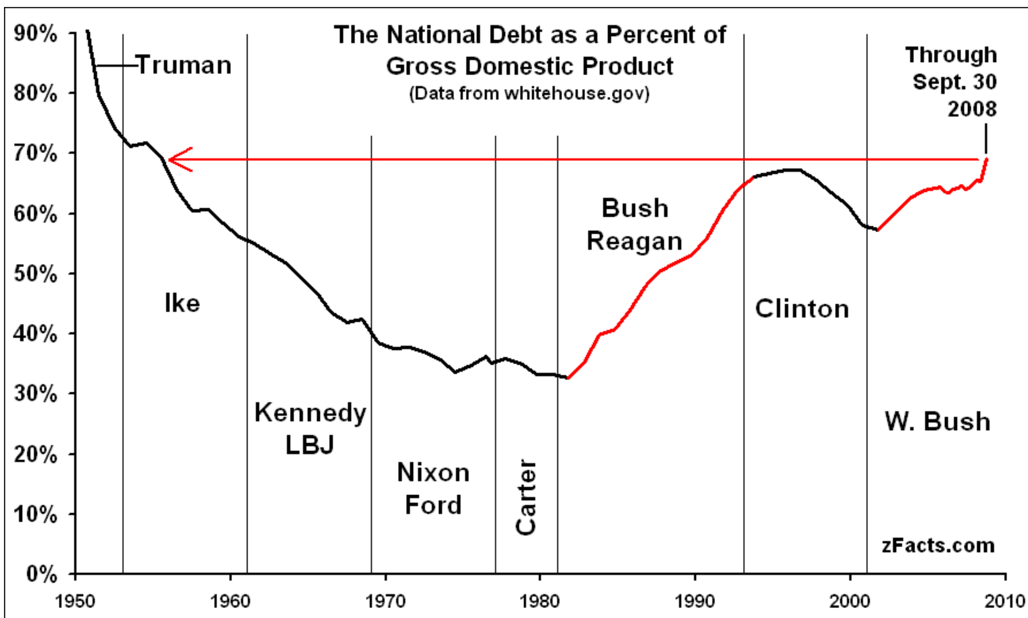
During the first two years of Bush II's administration (just before the 9-11 attacks), the deficit grew from 5.6 trillion on September 2000 to 5.8 trillion in September 2001. Then it exploded. From 2003 forward it grew at 1 trillion a year, reaching an estimated 10 trillion on September 30, 2008. The bailout costs will probably drive that number up as new data becomes available.

A chart is available showing the percentage increases in the national debt over the years since FDR. Here it is:



This chart fails to capture the debt explosion engendered by the recent bailout. But here's the takeaway point: **all** administrations since FDR have presided over an increase in the national debt. So much for Keynsian discipline!

The second thing to keep in mind is that our national debt is most meaningfully expressed, not in raw dollars (as the numbers I quoted above) or even in inflation adjusted dollars (a truly alarming exercise) but in terms of the percentage the debt represents of total spending, the current measure of which is GDP (gross domestic product). Here's that chart:



The national debt, at present, represents about 71% of the gross domestic product. For certain, we're not paying that down during a severe recession. I will not be surprised the learn, at the end of President Obama's first term, that the number has gone north, say, to 80 % of the GDP.

THERE AIN'T NO SUCH THING AS FREE MONEY

Now here's the dirty little secret of the credit meltdown. There is no such thing as "real" money. Even gold has primarily a psychological value. A simple thought experiment will suffice: You and you family are wandering in the desert far from help. What would you rather find: a pile of euros, dollars, gold bricks or an oasis with water, fruit, compass and a map?

Early Keynsian monetary theory talked about "controlling" something called "M 1" which meant the primary money supply. M1 was intended to capture all liquid funds. Here's the Federal Reserve Definition of M 1:

(1) currency outside the U.S. Treasury, Federal Reserve Banks, and the vaults of depository institutions;
(2) traveler's checks of nonbank issuers;
(3) demand deposits at commercial banks (excluding those amounts held by depository institutions, the U.S. government, and foreign banks and official institutions) less cash items in the process of collection and Federal Reserve float; and
(4) other checkable deposits (OCDs), consisting of negotiable order of withdrawal (NOW) and automatic transfer service (ATS) accounts at depository institutions, credit union share draft accounts, and demand deposits at thrift institutions. Seasonally adjusted M1 is constructed by summing currency, traveler's checks, demand deposits, and OCDs, each seasonally adjusted separately.

All you need to remember about this technical definition is this: All of M1 is "owned" by a person, company or institution and it is immediately spendable ("liquid").

The older generation of Keynsian economists naively assumed that "the economy' can be regulated by manipulating the M 1 part of the money supply. I emphasize <u>part</u> because it turns out that M 1 is a small fraction of the stuff we now actually use as money.

Credit in all its complicated and variegated forms is the new currency of the economy; credit is virtual money. The total amount of this "virtual money" is actually uncounted and, as a practical matter, is uncountable.

Here's the dirty little secret of the current economic crisis. The virtual money of the credit world hugely overwhelms the real money of the currency economy (as defined broadly by M 1).

How can this be? Money – whether virtual or real – is not a real asset. Real assets are like that oasis. The credit-engendered flood of virtual money represents a vast network of interlocking promises by individuals and institutions who lend virtual money, partly backed by real assets, and promise to repay these loans with virtual money partly backed by real assets. The whole game is leveraged. This means that a lender's or a borrower's assets are always potentially smaller than the money being risked in the transaction. Leveraging refers to the "faith ratio", if you will, between the small cache of assets and the large hoard of virtual money.

We've been playing a high stakes poker game for thirty years, and no one held the right cards. The credit meltdown was a perfect storm in the making. It was miraculous that we avoided an accounting as long as we did. But someone eventually called the bluff. And everybody at the table has been bluffing.

KEYNSIAN FISCAL DISCIPLINE: STAGES OF THE DECLINE

The decline from the noble heights of Keynes' theory to venal practice has played out in four stages.

Phase One: Predictably there was no working political consensus about how to spend deficits and absolutely no discipline about reversing them. Small deficits occurred in the late fifties and early sixties, but the deficit bam was broken when president Lyndon Johnson financed both the Vietnam War and the great society on credit. The Carter hyperinflation was a direct result.

Phase Two: Those ongoing and ever growing national deficits became the "national debt'; and that huge public indebtedness needed to be financed by some mechanism that would postpone any day of reckoning.

Enter the deficit enablers in the form of deficit debt financing instruments, 'I-O-U's" by another name, that were outsourced to rapidly growing underdeveloped economies like mainland China. Because these economies were in a "growth-not-consumption" pattern, this stratagem operated to postpone and reckoning. And as a side benefit the measure temporarily insulated the US economy from the huge inflationary pressures that otherwise would have resulted from too much money chasing too few goods and services. Our inflation was held at bay by the vast influx of under-priced goods from our underpaid creditors.

It was a devil's bargain that traded cheap WalMart goods for high paying American manufacturing jobs.

Phase Three: The US government lost control of the money supply but was unwilling to "fess up". People at the Fed have known for about 20 years that, in addition to currency in circulation and direct loans to financial institutions by the central bank, a new form of paper money emerged on center stage of the economic drama.

Sometime in the last twenty five years or so, heavily leveraged credit instruments became a new "virtual money" supply. New loans, leveraged at thirty to one against overvalued collateral, became the "new money".

Private "paper" has eclipsed the "real money".

THE GREAT RECKONING OF 08

In our current crisis, many major lending institutions – on Wall Street and Main Street – were leveraged 30 times value. Part of what is now happening is an attempt to force the leveraging in the virtual money sector back to more conservative levels, say, "only" 10 times value.

During the last 15 years, the scope and scale of the virtual money supply has swamped the real one. This is why outgoing Treasury Secretary Paulson is trying to leverage the bailout moneys entrusted to him. **He has no choice**. The U S government simply does not have the staggering amount needed to do much more. That larger figure remains a deep secret, but probably exceeds the current national debt by a large multiplier. So there will be failures and this really is a reckoning.

Let's assume that no major blunders take place – yes, this is a shaky assumption at best because we've already dodged at least one bullet. Thankfully Secretary Paulson came to his senses and abandoned the "let's buy up .6 trillion dollars worth of failed mortgages secured by overvalued property that no one will buy until the price drops another 45%. But go with that assumption for a moment. This recession will last about two years, starting now. At the end of that particular tunnel, the structural problems that led to this mess will probably not have been corrected.

At a minimum, this is what needs to happen:

<u>1. Compartmentalization of risk.</u> There is no risk-free financial utopia in the known universe. Any attempt to create one has the unintended consequence of spreading the consequences of risk so widely that the entire economy is made hostage. When we temper risk by intervening to rescue failing institutions we create a new risk environment. Any failure cascade affecting a particular industry or financial sector can be made a national failure if government commits to do whatever is necessary to stop it. In the lending and investment sector, the compartmentalization approach is fairly straightforward. Financial institutions need to be insulated from each other along function and risk vulnerability lines. Securitized home mortgages can never again be allowed to finance ordinary commercial business enterprises. High risk ventures, driven by the hope of high rewards, need to take place in financial blast shelters; the damage zone from their failures should affect only their investors and immediate employees. Investment banks should not have ordinary civilian depositors. And so on.

2. Privatization of failure. The immense size of the virtual money sector of the economy precludes bailouts of large private business enterprises. We can't allow banks to fail but we can't afford to prevent the failure of poorly run retailers and producers. That's what the bankruptcy laws are for. The bromide, "too big to fail" needs to be replaced with "too big to bail."

3. New mechanisms of fiscal discipline. I want to introduce the radical idea of enforced fiscal responsibility. For illustration purposes, only: Whether by constitutional amendment, a miraculous change in the beltway culture or some combination of the foregoing and new legislation, all federal programs that purport to create an "entitlement" must identify a revenue stream, then suffer a pro-rata reduction of the entitlement in any subsequent budget year where the revenue falls short. During non-recessionary years, the federal government must not only remain in balance, it must "tithe" (10% of gross federal revenue) to pay down the prior debt.

I remain reasonably optimistic about the future for the simple reason that we Americans do tend to learn from experience. In this sense, failure is the greatest teacher of all. I have no doubt that the great Meltdown of 2008 will be studied for years. The severity and duration of the Next Reckoning will depend on how much we learn and – more to the point – how well we apply those lessons…

JBG

APPENDIX

National Debt --- The Clock: http://www.brillig.com/debt_clock/

CBS – 9-29-08 by Mark Knoller

On the day President Bush took office, the national debt stood at $5.727 trillion. The latest number from the Treasury Department shows the national debt now stands at more than $9.849 trillion. That's a 71.9 percent increase on Mr. Bush's watch.

The bailout plan now pending in Congress could add hundreds of billions of dollars to the national debt – though President Bush said this morning he expects that over time, "much if not all" of the bailout money "will be paid back."

BELOW – NATIONAL DEBT BY YEAR

End of Fiscal Year	US Gross Debt USD billions	US Gross Debt as % of GDP
1910	2.6	
1920	25.9	
1930	16.2	
1940	43.0	52.4
1950	257.4	94.1
1960	290.2	56.1
1970	389.2	37.6
1980	930.2	33.3
1990	3,233	55.9
2000	5,674	58
2005	7,933	64.6
2007	9,008	65.5
2008	10,024.7	72.5 (EST)

NATIONAL DEBT BY YEAR [RAW NUMBERS]

09/30/2008	10,024,724,896,912.49
09/30/2007	9,007,653,372,262.48
09/30/2006	8,506,973,899,215.23
09/30/2005	7,932,709,661,723.50
09/30/2004	7,379,052,696,330.32
09/30/2003	6,783,231,062,743.62
09/30/2002	6,228,235,965,597.16
09/30/2001	5,807,463,412,200.06
09/30/2000	5,674,178,209,886.86
09/30/1999	5,656,270,901,615.43
09/30/1998	5,526,193,008,897.62
09/30/1997	5,413,146,011,397.34
09/30/1996	5,224,810,939,135.73
09/29/1995	4,973,982,900,709.39
09/30/1994	4,692,749,910,013.32
09/30/1993	4,411,488,883,139.38
09/30/1992	4,064,620,655,521.66
09/30/1991	3,665,303,351,697.03
09/28/1990	3,233,313,451,777.25
09/29/1989	2,857,430,960,187.32

09/30/1988	2,602,337,712,041.16
09/30/1987	2,350,276,890,953.00
09/30/1986	2,125,302,616,658.42
09/30/1985	1,823,103,000,000.00
09/30/1984	1,572,266,000,000.00
09/30/1983	1,377,210,000,000.00
09/30/1982	1,142,034,000,000.00
09/30/1981	997,855,000,000.00
09/30/1980	907,701,000,000.00
09/30/1979	826,519,000,000.00
09/30/1978	771,544,000,000.00
09/30/1977	698,840,000,000.00
06/30/1976	620,433,000,000.00
06/30/1975	533,189,000,000.00
06/30/1974	475,059,815,731.55
06/30/1973	458,141,605,312.09
06/30/1972	427,260,460,940.50
06/30/1971	398,129,744,455.54
06/30/1970	370,918,706,949.93
06/30/1969	353,720,253,841.41
06/30/1968	347,578,406,425.88
06/30/1967	326,220,937,794.54
06/30/1966	319,907,087,795.48
06/30/1965	317,273,898,983.64
06/30/1964	311,712,899,257.30
06/30/1963	305,859,632,996.41
06/30/1962	298,200,822,720.87
06/30/1961	288,970,938,610.05
06/30/1960	286,330,760,848.37
06/30/1959	284,705,907,078.22
06/30/1958	276,343,217,745.81
06/30/1957	270,527,171,896.43
06/30/1956	272,750,813,649.32
06/30/1955	274,374,222,802.62
06/30/1954	271,259,599,108.46
06/30/1953	266,071,061,638.57
06/30/1952	259,105,178,785.43
06/29/1951	255,221,976,814.93
06/30/1950	257,357,352,351.04

06/30/1949	252,770,359,860.33
06/30/1948	252,292,246,512.99
06/30/1947	258,286,383,108.67
06/28/1946	269,422,099,173.26
06/30/1945	258,682,187,409.93
06/30/1944	201,003,387,221.13
06/30/1943	136,696,090,329.90
06/30/1942	72,422,445,116.22
06/30/1941	48,961,443,535.71
06/29/1940	42,967,531,037.68
06/30/1939	40,439,532,411.11
06/30/1938	37,164,740,315.45
06/30/1937	36,424,613,732.29
06/30/1936	33,778,543,493.73
06/29/1935	28,700,892,624.53
06/30/1934	27,053,141,414.48
06/30/1933	22,538,672,560.15
06/30/1932	19,487,002,444.13
06/30/1931	16,801,281,491.71
06/30/1930	16,185,309,831.43
06/29/1929	16,931,088,484.10
06/30/1928	17,604,293,201.43
06/30/1927	18,511,906,931.85
06/30/1926	19,643,216,315.19
06/30/1925	20,516,193,887.90
06/30/1924	21,250,812,989.49
06/30/1923	22,349,707,365.36
06/30/1922	22,963,381,708.31
06/30/1921	23,977,450,552.54
07/01/1920	25,952,456,406.16
07/01/1919	27,390,970,113.12
07/01/1918	14,592,161,414.00
07/01/1917	5,717,770,279.52
07/01/1916	3,609,244,262.16
07/01/1915	3,058,136,873.16
07/01/1914	2,912,499,269.16
07/01/1913	2,916,204,913.66
07/01/1912	2,868,373,874.16

07/01/1911	2,765,600,606.69
07/01/1910	2,652,665,838.04
07/01/1909	2,639,546,241.04
07/01/1908	2,626,806,271.54
07/01/1907	2,457,188,061.54
07/01/1906	2,337,161,839.04
07/01/1905	2,274,615,063.84
07/01/1904	2,264,003,585.14
07/01/1903	2,202,464,781.89
07/01/1902	2,158,610,445.89
07/01/1901	2,143,326,933.89

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