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La ciencia económica después de la crisis mundial

Ensayos de Política Económica Nº 5, 2011

LA CIENCIA ECONÓMICA DESPUÉS DE LA CRISIS MUNDIAL

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Conferencia dictada el lunes 29 de agosto en el auditorio Santa Cecilia de la UCA. Organizada por el Departamento de Economía Facultad de Ciencias Económicas de la Universidad de Buenos Aires (UBA), la Escuela de Gobierno de la Universidad Torcuato Di Tella (UTDT) y la Facultad de Ciencias Económicas de la Universidad Católica Argentina (UCA)

"I am delighted to be here this evening. This is my first visit to Argentina and I am honored to be invited by the Catholic University of Argentina. I will talk about the world crisis from a Keynesian point of view, and my lecture will be divided into three parts: why did it start?; what should we be doing about it?; and what steps can we take to prevent something like this from happening again. So I will deal with "origin", "recovery" and "reform".

Because of the speed of the recovery in this part of the world my diagnosis and prescriptions might at first glance seem less relevant to Argentina and Latin America than to Europe and the United States. But Latin America's recovery is mainly based on rising commodity prices and commodity prices are, partly determined by what happens to the rest of the world. In a globalized world each country fate is bound up with the fate of its neighbors. Bringing about a global recovery, therefore, is in the interest of all, whether in South America or Southern Europe.

I. Diagnosis of the Crisis

Let me turn to the first topic: why did it happen? There is no an agreed view. Economists never agree about these sorts of things, and neither do historians, but the explanations coalesce in two competing views: I call them "too much money" and "too much saving".

The "too much money" view blames America's excessive expansionary fiscal and monetary policy which caused the Americans to live beyond their means for too long. In contrast, the "too much saving" view is that China's excessive saving created deflationary pressure in the world economy. According to the first view the crisis was endogenously generated within the United States; according to the second view it was the result of the working of the world monetary system.

The "too much money" interpretation builds on ideas associated with Austrian economist Friedrich Hayek. According to Hayek, business cycles were monetary disturbances caused by too loose monetary policy. Excessive money creation by the Central Bank makes it possible for banks to lend more than the public wants to save. Hayek called such a credit-financed investment "mal-investment". The "malinvestment" prior to the crisis in 2008 manifested itself in an asset bubble, based on residential housing. The housing boom was unsustainable debt-equity ratios were too high, with the effect that default rates went up which eventually brought banks down.

According to this interpretation, recovery requires a liquidation of the "mal investments" and an increase in saving. Joseph Schumpeter, another famous Austrian economist, wrote about the Great Depression of the 1930s that, "…any revival which is partly due to artificial stimulus leaves part of the work of

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depressions undone…" In other words, depressions have a part to play in the recovery – unless you have a depression, you won't have a 'sustainable' recovery, only a build-up to the next bubble. In the longer run, reform should be directed to preventing excessive bank lending. In fact, fanatical Hayekians want to abolish central banks all together since this would ensure that interest rates are directly dictated by the credit market without policy intervention.

The alternative view, the "too much saving" perspective, is the spiritual descendant of John Maynard Keynes. Keynesians give at least two cheers to those American pre-recession policymakers who combined a cheap money policy and fiscal deficits. That these policies, which mopped up excessive East Asian savings, produced asset bubbles was not inherent in the policies but due to the fact that the money was channeled into speculation rather than investment.

Considering that the money was flowing the wrong way, this outcome was hardly surprising. As Mervin King, the Governor of our Central Bank put it: "Capital flowed uphill, from capital scarce to capital abundant countries". It was flowing away from East Asia with its investment opportunities to America which offered much lower returns on capital. This is a consequence of Valery Giscard D'Estaing, former president of France, called the "exorbitant privilege of the dollar". Inflows of capital from across the Pacific simply blew speculative bubbles in the United States which then spread to other developed countries via the international banking system. In the absence of an increase in American investment, the global saving glut resulted in an ever larger American domestic and foreign debt. It took a collapse in housing prices to prick the bubble.

Now, I am a Keynesian and not a Hayekian so I need to say a word about the saving-investment analysis which underlies the Keynesian theory of crisis. In the Keynesian model, there is no nexus which automatically equilibrates decisions to save with decisions to invest. For Hayekians the rate of interest automatically balances investment and saving. For Keynes, however, saving is a mechanical function of income; investment is jointly governed by the rate of interest and expectation of profit. The rate of interest is the price for giving up liquidity. The typical Keynesian tipping point to crisis is an increase in liquidity preference which pushes interest rates up just when you want them to be coming down. Thus market determined interest rates alone cannot bring investment into equality with saving.

If you ask how Keynes would have explained this crisis, the answer is that he did not believe that all crises had the same proximate causes. In a world with a mechanical consumption function and unstable investment functions desired saving can diverge from desired investment for any number of reasons. But his main point is that the reconciliation between these diversions takes place ex-post through changes, not in relative prices, but in output and income. This is the Keynesian view of what happened in 2008 and 2009. When it became apparent that the risk taken on by the banks in their mortgage and lending activities had been under-priced, confidence in the soundness of the financial system was shattered and uncertainty spread from one bank to another and from one economy to another.

A Keynesian recovery program from the slump involves increasing, not reducing, aggregate demand; saving less, not saving more as Hayekians would argue. A longer term reform would involve reviving the state's role in the management of saving and investment, nationally as well as globally.

Getting the diagnosis right, in other words, is important in order to provide the appropriate prescriptions. If you accept the Keynesian story, the primary requirement for global recovery is to raise the level of global aggregate demand. As I shall argue later, this requires rebalancing for world economy to eliminate current account imbalances. If, on the other hand, you support the Hayekian story, pumping more demand into an already over-borrowed economy, will only accelerate the progress to the next crisis. This sets the stage for the political debate now going on between “stimulus” and “austerity”. In the absence of effective global coordination this is a national debate, rather than an international one.

II. Stimulus versus Austerity

The earliest response of the banking collapse of 2008 and 2009 was instinctively Keynesian. This was not based on much theory; there was just an understanding that the banking collapse was dangerous. The overriding priority was to avoid another Great Depression. It is sometimes forgotten how steep the slide was in the first year of contraction, starting in fourth quarter 2008. The downward slide in the first five quarters was equal to that of the first fifteen months of the Great Depression itself. However, unlike in the Great Depression, after the first five quarters the international economy bounce back. The crucial difference between 1930 and 2009 was the policy response.

Between 1929 and 1931 there was no discretionary fiscal expansion and interest rates were kept high because of the need to defend the gold standard. The gold standard did not give way until two years after the start of the Great Depression. In 2008, the response was quite different. Starting in the autumn of 2008, governments injected massive amounts of stimulus money into their failing banks and economies. All together 2.5 trillion dollars were injected into the global economy in the first year of the crisis in attempt to plug the gap in private demand and boost falling prices.

The stimulus worked. Global recovery began in the winter 2009 and continued into mid 2010. Trade revived, stock markets started booming, growth picked up. But that was the end of the good news. As recovery gathered pace, the large support system breathing life into the economy was gradually switched off. The monetary stimulus programs were discontinued and the fiscal stimulus programs were not renewed. In June 2010, the finance ministers and central banks governors of the G20 announced that they could not wait for the world economy to recover before removing the policies that made recovery possible.

Not all governments followed this line. Not the Chinese, and the Americans only partially, and by this time most of Latin America no longer needed the stimulus. But in Europe everyone clamored for a fiscal halt. Why this sudden change of direction? The proximate reason for this is clear: the cost to Central Banks and Governments of removing insolvent banks and sustaining collapsing economies brought into question the soundness of public finances and the risk of default on the National Debt the situation was particularly grave in countries which had entered the crisis with weak fiscal positions. In these countries, sovereign debt replaced private debt as the problem of the hour. In fact, the overall change in market sentiment can be dated quite precisely to the start of the Greek, Irish and Portuguese crises early in 2010.

It is worth noting German Chancellor Angela Merkel’s decision that individual states rather than the European Union should shoulder the responsibility of providing guarantees against further bank defaults after Lehman Brothers’ collapse. Herein lies at least part of the origin of the European crisis. German procrastination then aggravated the position further.

The story of the European financial problems is illustrated by the widening spread between bond yields of distressed country governments and those of the German government, and by the downgrading of sovereign debt to junk bond status in a number of Euro zone countries. The Euro zone emergency led the creation of the European financial stability facility of 750 billion euros in April 2010, and a series of subsidized loans to Greece and Portugal on conditions of austerity measures.

In addition to the proximate cause for austerity – the concern about the sustainability of government debt – I think there was a deeper cause which limited the revival of Keynesian economics. Robert Lucas – the high priest of "rational expectations" in Chicago – remarked early in the slump that "we are all Keynesians in the fox-hole". But once economies were out of the fox-hole, Keynes was put back into the cupboard, and the "too much money" view gained ascendance again. It was increasingly accepted that the crisis of 2008 and 2009 was a crisis of "excess", not a crisis of "insufficiency" and the only cure for "excess" was to eliminate it. Banks would be forced to de-leverage; governments to do the same. You do not pour alcohol down the throat of a drunk.

Behind the move towards austerity lies a piece of economic theory known as "crowding out". Chicago economist John Cochrane summarized it as follows: "every dollar in increased government expenditure must correspond to one less dollar for the private sector. Jobs created by stimulus spending are offset by jobs lost from the declined private sector. We can build roads instead of factories but fiscal stimulus can't help us build both roads and factories." So stimulus expenditure, according to this simplified "crowding out" theory, is doubly detrimental: not only does it fail to stimulate the economy but it actually makes things worse by making the economy less efficient. This, in turn, reduces the potential for recovery; there is a negative multiplier.

I have argued, from a Keynesian standpoint that "crowding out" only holds when the economy is at or near the limit of its capacity. As long as there is an output gap an increase in government expenditure does not steal resources from the private sector. On the contrary, it "crowds-in" resources which otherwise would be unused. Conversely, if the government reduces its spending when the private sector increases it's saving the result will be a further drop in aggregate demand which will continue until the community's saving is automatically reduced by growing poverty. The Keynesian prediction of the consequences of the move into austerity in Europe and the United States is that unless the policy is changed, or there is a new source of demand – such as an increase in net exports – there will be no recovery. Instead, the developed world will run a large risk of a double-dip recession. Naturally, this will have a large impact on the recovery of developing countries too.

Does empirical data bear out any part of this Keynesian story? Since the large support systems initiated in 2008 and 2009 were withdrawn, recovery in the developed world has stalled. The large output losses suffered in 2008-2009 have not being replaced; growth slowed down again in 2011, and in the EU is forecast to be flat or negative in 2012. As a result there are still sizeable output gaps in all major developed countries. OECD estimates that the output gap in the United States, the United Kingdom and the European Union is in the order of 3 per cent of potential output. Countries like Greece have an output gap of 11 per cent, and that is the country in which austerity is being pushed harder than anywhere else. There has been almost no growth in the United Kingdom for a year. With Germany slowing down, euro zone economic activity is falling. Similarly, growth is slack in the United States. East Asia, the Middle East and Latin-America are almost alone in propping up the global recovery.

So what would a Keynesian do? Given the psychology of the bond market, the scale of the fiscal problems currently faced by many governments, and the current freedom enjoyed by capital flows around the world, the straight policy of further fiscal stimulus seems to be ruled out – and this despite the fact that the alternative, austerity, is even less convincing. But all is not lost. I suggest two Keynesian remedies which could accommodate our economic as well as our political circumstances. I call the first "monetary Keynesianism" and the second "investment Keynesianism". The first is widely known as "quantitative easing" or "printing money". The second requires setting upt or utilizing investment institutions whose operations can be segregated from the fiscal position of governments.

I will not spend much time on quantitative easing (QE) but I do want to mention a couple of things. QE is supposed to work through two channels. The first is known as the 'portfolio balance' effect. By buying government bonds, Central Banks reduce the bond supply which pushes up their price and pushes down their yield. Lower yields on treasury bonds push down the whole structure of interest rates, enabling households and companies to borrow more cheaply. Thus stimulating investment by lowering interest rates is the first channel through which QE is stimulates the economy.

A second channel is the so called "wealth effect". Holders of the extra cash injected by the Central Bank will use some of it to buy assets – e.g. equity or houses – which pushes up asset prices which, in turn, increases the net worth of the business and housing sectors. This prompts them to increase their spending too. A variant popularized by the chairman of the Federal Reserve, Ben Bernanke, emphasizes how an increase in the value of households' assets allows them to borrow to invest and/or expand their consumption. Either way an increase in base money will expand real aggregate demand whenever there are extra resources to be brought into production, otherwise, of course, it will just raise the price level. To the extent that QE raises the rate of inflation, it will allow households and businesses to borrow at a negative real interest rate. Moreover, QE reduces the real interest rate that the government has to pay when servicing its own debt.

QE might, however, have negative effects on the global macroeconomic system. By lowering interest rates domestically, quantitative easing weakens a country's currency compared to its trade partners, thus stimulating aggregate demand by increasing net exports. This is of course good for the country practicing QE, but trade partners may view this as a declaration of 'trade war'. This is of course what China accuses the United States of doing right now.

I call this policy "monetary Keynesianism". Why? Well, first of all Keynes, too, believed in monetary policy as a stimulant. But more specifically, in his early days as an economist he was a monetarist in almost exactly the same way that Milton Friedman. His recipe for central bank action in the event of a downturn was to offset any actual or anticipated tendency for the velocity of money to fall. In fact, this idea pre-dated Keynes and was regarded as orthodox central bank policy. However, by the time Keynes wrote his General Theory in 1936, he had become skeptical of the ability of monetary policy to counter any severe collapse of confidence alone.

Famously, in the General Theory, Keynes wrote: "If, however, we are tempted to assert that money is the drink which stimulates the system to activity, we must remind ourselves that there may be several slips between the cup and the lip. For whilst an increase in the quantity of money may be expected, ceteris paribus, to reduce the rate of interest, this will not happen if the liquidity-preferences of the public are increasing more than the quantity of money; and whilst a decline in the rate of interest may be expected, ceteris paribus, to increase the volume of investment, this will not happen if the schedule of the marginal efficiency of capital is falling more rapidly than the rate of interest."

Keynes argued that it is not the printing of money but the spending of money which stimulates the economy. Printing money in the form of QE is not enough; you would have to send out checks to households with an expiration date on their validity to ensure that the printed money translated into a direct increase in consumption; alternatively you would need to use the money to write off debt. If you use it just to increase the cash reserves of the banks, it is not clear what happens afterwards.

What is the recent evidence on the impact of quantitative easing? Since 2008 it has been implemented in a number of countries. Over a period of eight months Ben Bernanke poured $600 billion into the US economy by buying long-dated government securities. As predicted, the injection of additional cash had an immediate effect on financial markets. The Dow Jones rose by 220 points right after the announcement. The boom in equity markets continued relatively uninterrupted until the end of the program. Turmoil in July 2011, however, wiped out the boost so that today, ten months and $600 billion later, the Dow Jones is below the pre-QE level.

More importantly, the $600 billion failed to lower the yield on ten-year government bonds. At the end of QE, ten-year bond yields were higher than at the beginning of the program. Whether QE caused inflation is difficult to tell. The rising price level is much more likely to be the result of a rise in commodity prices than an effect of quantitative easing. And, of course, commodity price rises were aided by bad harvests in Russia, Mexico, Argentina and other important food-stuff producers. Similarly, QE's effect on the dollar is unclear. Analysts say that QE weakened the dollar by between 3 and 10 percentage points. Finally, there is the effect on the money supply. Here the most recent experiment with quantitative easing is something of a special case since it did not actually aim to boost the money supply but to bring down the long-term interest rate. But experience of previous quantitative easing initiatives shows that M2 responds extremely sluggishly to increases in M1. To summarize, because of the rise in liquidity preference, 'monetary activism' is an uncertain agent of recovery

Again it is helpful to turn to Keynes. He wrote: "it may still be the case that the lender with his confidence shattered by his experience will continue to ask for new enterprise rates of interest which the borrower cannot be expected to earn. If this proves to be the case, there would be no means of escape from prolonged and perhaps interminable depression, except by direct state intervention to promote and subsidize new investment."

The uncertainty surrounding quantitative easing as a stimulus measure is the strongest argument for the second Keynesian alternative which I call "investment policy". As you know, Keynes advocated digging holes in the ground and filling them up again if the government could not think of anything better to do. While many governments can't think of anything better to do some governments can and we should aim to invest in the best alternatives. In Britain, I have been a leading advocate of setting up a National Investment Bank which would leverage a small pot of public money in the private markets to invest in much needed infrastructure projects. One could arrange the finance to have minimal impact on the fiscal deficit and the national debt. President Obama has called for a National Infrastructure Bank. There are many examples all over the world of such banks – I don't know much about experiences in Argentina or in Brazil – but we know that such investment banks in, for instance, Germany and the Scandinavian countries have been successful.

It is simply not true that all the government banks are going to make losses and that all government investments schemes are bound to be corrupt. Public investments are just as likely to be successful as private ones; and private investments are just as likely to be failures as public ones. At present, private investments markets are frozen and the cost of capital and labor is exceptionally low; this is the ideal time to try an initiative which not only stimulates demand, but which could modernize key infrastructure and possibly prepare us for a "greener" future. With his advocacy t of a US National Infrastructure Bank President Obama has taken the first step. Now it has to be put into practice. This is a decision which will have far-reaching consequences for the US post-election period.

III. Reform

My last topic is reform. The mindset leading up to the crisis was well summarized by Larry Elliot who, writing in The Guardian on December 8th 2008, observed that "It was assumed that prosperity could be built on a mountain of debt because asset prices would continue to rise. It was assumed that countries such as Britain, the US and Spain could consume vastly more than they produced year after year, while the big exporting countries such as China could amass ever bigger current account surpluses. And it was assumed that the resulting grotesque imbalances in the global economy could be smoothed out by financial markets, provided they were allowed to get on with the job of allocating capital free from the dead hand of meddling governments. All three proved to be utterly - and ruinously - misguided, and it is for that reason that the sky has fallen in."

Let me focus on the last one of these propositions: the proposition that the banks could be trusted to allocate capital efficiently because they will always price risk correctly. This is the exact opposite of what Keynes wrote in Chapter 12 of his General Theory: banks do not price risk correctly. They have neither the incentive nor the information to do so. Even so, this proposition dominated the pre-recession regulatory policy all over the world. Financial regulators believed that securitized credits improved allocative efficiency and therefore financial stability; they believed that mathematical forecasting models could deliver robust quantitative measures of trading risk; they believed that financial markets were self-correcting, with market discipline being a much better tool to regulate and control than regulatory supervision.

These assumptions have all been dismissed by recent events in one way or the other, making reform of financial regulation an urgent necessity. Increasing banks' capital requirements, limiting the debt they can take on, changing the accounting system, stress tests, and so on are just some of the measures being discussed. Some people even talk about separating retail banks from investment banks.

I support the idea of better and cleverer regulation but a Keynesian would say that this does not get to the roots of the crisis. The crisis was caused by investment failure, not by failure in financial intermediation. For Keynesians, therefore, the problem lies in the failure of the unmanaged market economy to coordinate saving and investment globally.

In this context, the biggest failure of reform so far is the failure to address the problem of current account imbalances between developed and developing countries. On paper, the G20 framework for strong, sustainable and balanced growth provides the ideal forum for developing internationally coordinated policy. But we are a long way from this. What we must do is reconsider Keynes' clearing union proposal of 1941. Keynes pointed out the asymmetric nature of the adjustment process under the gold standard. His words are worth quoting because I think they get to the heart of the matter even today: "To begin with, he said, 'the process of adjustment downwards is much greater than an adjustment upwards. And besides this, the process of adjustment is compulsory for the debtor and voluntary for the creditor. If the creditor does not choose to make or allow for his share of the adjustment, he suffers no inconvenience. For, whilst a country's reserve cannot fall below zero, there is no ceiling which sets an upper limit. The same is true if international loans are to be the means of adjustment. The debtor must borrow; the creditor is under no such compulsion."

So a Keynesian remedy, expressed in his proposal for an international clearing bank, was to set penalties for persisting creditors as well as debtors. In other words: surplus accounts in credit for more than a certain period of time and above a certain value in the clearing accounts of the Clearing Bank would be taxed at an escalating rate. In this way he hoped that the balances at the end of the accounting period would sum to zero. The clearing union, however, was never adopted and one creditor, the United States, was allowed to escape fate of debtors since international reserves were mostly be held in dollars. Over time, the unique reserve status of the dollar set the stage for the unsustainable asset and consumption boom of which I spoke earlier.

There are two further disquieting consequences of our present lack of a global monetary regime: the first is that it gives rise to the accumulation of reserves as an insurance policy against capital flight. Between 2003 and 2009 measurable global reserves increased from $2.6 trillion to $6.8 trillion – an average annual growth rate of about 15% at a time when global GDP grew at 4%. Reserve accumulation is what Keynes called "hoarding"; it represents a big increase in deflationary pressure, and our current non-system encourages that.

Secondly, the inflow of foreign reserves puts upwards pressure on the receiving countries' currencies, especially for commodity producers which are experiencing the fastest growth. This is of course the well known "resource curse". Despite enjoying one of the highest growth rates in the world, Latin America economies have seen their non-commodities exports crippled and imports rise over the recent period as the result of local currency appreciation. As I speak, steps are being taken to repel currency inflows and the Brazilian Finance Minister Guido Mantegna has phrased his measures in terms of a new currency war. Unless international monetary system is reformed, I fear that warfare will not be limited to currencies; I we will see trade wars which proved to be so destructive in the 1930s.

I advocate two reforms. The first goes back to Keynes' plans to tax persistent current account surpluses.

The second proposal is to move towards creating an international reserve currency. The advantages of this are twofold: to enable an increase of the volume of SDRs and to reduce the quantity of foreign currency reserves. More importantly, I believe that this proposal would make a bargain possible with China: China could be given an incentive to use its dollar reserves to buy SDRs. A cooperative solution to prevent a recurrence of our present unsustainable imbalances and reserve build up can only be reached as a bargain between leading surplus and leading deficit countries.

With the European and American recovery running out of steam and China taking steps to slow down its bubble economy, Latin American prospects are not as rosy as they seemed a year ago. Surely Argentina's sustainable growth rate is no way near the 7% or 8 % recently experienced. Commodity prices are highly cyclical and cyclicality is usually dangerous in a context in which monetary and fiscal policies begin to loosen. We need to know if there an output gap in the economy or if the economy is running up against its capacity frontier.

Ultimately, reform is not just a matter of having good ideas and policies; it requires political will: the political will to challenge extremely powerful vested interests. Today, we live in a system dominated by a "predatory plutocracy": looting of money at the top of the system encourages looting of money at the bottom. We experienced something like this in Britain with the riots of 2011. The recent crisis was not just an accident; it was an outcome – an inevitable outcome I would argue – of the political economy created in the 1980s. This is a political economy which is inherently unstable and which has become unaffordable, economically as well as morally. That is why Keynes offers a good starting point for thinking about how to reform it.

Thank you."