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A time to return to Keynes

Steven Pressman
Department of Economics & Finance, Monmouth University, West Long Branch, New Jersey, USA

Abstract

Purpose – This paper seeks compare the current financial and economic problems with the problems facing the world economy in the 1930s.

Design/methodology/approach – The paper argues that the Great Depression and the current problems have similar causes – excessive speculation, leading to a financial collapse that then results in an economic collapse. It then looks at the work of John Maynard Keynes to help solve the current problems.

Findings – The paper advocates a large public works program plus a number of policies to help US homeowners and thereby stabilize housing prices.

Originality/value – The paper provides a way out of the current economic and financial problems, and a way to avoid another Great Depression.

Keywords Economic depression, Keynesian economics, Fiscal policy, Debts, Housing

Paper type Conceptual paper

As the Great Depression swept across the world during the 1930s, John Maynard Keynes began a book he thought would transform economics. In a letter to George Bernard Shaw on January 1, 1935, Keynes wrote: "I believe myself to be writing a book on economic theory which will largely revolutionize not I suppose at once but in the course of the next ten years the way the world thinks about economic problems". The book came out in February 1936 with an extremely intimidating title, one alluding to the revolution in physics begun by Einstein. It was called *The General Theory of Employment, Interest and Money*. *The General Theory* (Keynes, 1936), as it has come to be called, provided an analysis of how economies worked as a whole, why things could go wrong and, most important of all, it told us what to do when facing economic problems.

Keynes was right. *The General Theory* did radically change economics. It established macroeconomics as a field within economics. In the years following the Second World War, it transformed how politicians thought about the economy and how they made policy decisions. Even President Nixon famously claimed "We are all Keynesians now", as he employed Keynesian policies to help the US economy grow and secure his re-election. Unfortunately, as a result of the work of Milton Friedman and Robert Lucas, a backlash began in the late 1970s. This backlash picked up steam in the 1980s and early 1990s. By the turn of the twenty-first century, Keynes was largely ignored. *Laissez-faire* or free market economics ruled the profession and the policy-making world. One result is that we now face the possibility of another depression, brought on by another stock market crash and another credit crisis.

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Keynes sought to explain why the world economy found itself mired in a Great Depression and what could be done about it. The main message of *The General Theory* was that spending drives economic activity. It did not matter who spent money; consumers, business firms, or the government could do it. When there is a great deal of

spending, jobs become plentiful and incomes rise sharply. In contrast, when firms and consumers are reluctant to spend, we face recession and depression with very high rates of unemployment.

A second message of *The General Theory* is that capitalism requires that people take chances. But problems arise when capitalism is more about gambling than producing goods and services. As Keynes (1936, p. 159) noted, "Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on a whirlpool of speculation. When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done". In the 1920s Wall Street did operate like a gambling casino. In the hope of becoming wealthy, people put little money down and borrowed a great deal of money to purchase stock. Stock shares served as collateral on these margin loans. People came out ahead as long as the returns on stocks exceeded the interest cost of borrowing. These gains could then be used to finance more speculation. But, like any Ponzi scheme, this required more and more money coming into the market and pushing up stock prices. The day of reckoning came in 1929 when the influx of new money slowed and some people decided to cash in their winnings.

Problems became serious in October 1929 when the stock market crashed. As Keynesian economist John Kenneth Galbraith documents in *The Great Crash – 1929* (Galbraith, 1954), once the market started its decline, there came the inevitable margin calls. Those who borrowed money to buy stock had to come up with more money because the value of their collateral had declined. This led to more selling, and as the market continued to fall, more margin calls went out and more selling took place, leading to even further rounds of margin calls and selling. Banks, which speculated heavily in stocks, were in a great deal of trouble. They were facing withdrawals by depositors to meet margin calls, and they too had to meet margin calls on their stock purchases. Making things worse, with the economy slowing down, people and firms began to default on their bank loans. Under normal circumstances, when loans are repaid, the money gets lent out again as soon as possible – this is how banks make money. But when defaults mount, it is harder for banks to make new loans. Moreover, as people became worried about the safety of their money in the bank, they started making withdrawals. This too was money that banks could not lend out. The result was a series of bank panics, bankruptcies, and a decade-long Great Depression. This is where Keynes comes in.

The conventional wisdom at the time was the need for "sound money" and "sound finance". Sound money meant that we could not just print up money and give it to banks to lend. Sound finance meant that the government had to keep its budget balanced. These shibboleths exacerbated the problem, as Keynes explained. Sound money meant that banks could no longer lend to businesses or to households wanting to spend but lacking ready cash. Sound finance meant that governments had to raise taxes and cut spending so that lost tax revenues due to joblessness would not result in budget deficits. All this made a bad situation worse.

Keynes pointed out that in difficult economic times, someone has to spend. However, households lacked jobs; those with jobs feared for them and were not likely to go on a spending spree. Similarly, business firms were reluctant to expand when the demand for goods was falling. Even if they wanted to expand, they would need to borrow money. Given the problems facing banks, and their unwillingness and inability

to lend, this was not likely. That leaves the government as the only possible spender. In one of the more famous passages in *The General Theory*, Keynes provided specific examples of what should be done. He called for more hospitals, more schools and more roads. But he noted that many people objected to such "wasteful" forms of spending. Another approach was therefore necessary. Keynes then provided such an approach. He called for the Treasury to print banknotes, bury them at suitable depths in abandoned coalmines, and then fill the mines to the surface with rubbish. With money clearly to be made, private enterprise would dig up the notes, hire workers to help in the endeavor, and unemployment would disappear.

We again face the problems of the 1930s, and we again need to heed Keynes's advice. The balance sheets of many financial institutions are currently a shambles due to excessive speculation in mortgage-backed securities. As individuals default on their mortgages, banks cannot make new loans. And as these mortgage packages decline in value, banks lose the capital that is necessary for them to function; they teeter on the brink of bankruptcy. With credit hard to obtain, borrowing and spending fall, and the economy heads into a severe recession. In the face of these problems, stock prices tumble. Another Great Depression becomes a distinct possibility. Many financial institutions have already gone under or have been bought out by other financial institutions with government assistance. After much delay and numerous mistakes, governments throughout the world have come to realize the need to buy up these bad loans and also to provide banks with the capital that is a perquisite to making new loans. The shibboleth of sound money appears to have been defeated.

But this is only half the job, as Keynes recognized. Just because banks can lend does not mean that they will lend. As we have seen, even after the US Congress passed a $700 billion bailout plan and even after developed countries decided to provide the capital banks that need, not much has changed – credit remains hard to get and stock prices have remained depressed. The problem is that lending also requires that there be someone willing to borrow and spend. As Keynes taught, if consumers and business firms are not willing to do this, the government must do it.

Printing money and burying it in abandoned coalmines is a rather silly way to create jobs. It would be much better to do those things that need to be done and that would make people's lives better. There is no shortage of what needs to be done in the USA today. Besides the crumbling roads, an insufficient supply of modern hospitals and the sad state of education, there is also a need to develop alternative energy sources to stop global warming. And as state and local budgets face massive deficits, with looming tax increases and spending cutbacks, the Federal government can provide money to lower levels of government and direct that it be spent on providing local services and maintaining public employment. Creating three million jobs at a cost of around $50,000-$60,000 apiece (pay and benefits), would cost the US government around $150 to $175 billion. This is less than one-third of the Wall Street bailout plan. But such action is necessary.

But we also need to deal with the causes of the problem – sinking home prices and massive consumer debt. This requires additional policy actions. First, we need to stabilize home prices. One way to do this is through tax relief to homeowners. A simple way to do this is to convert current tax deductions for mortgage interest and property taxes into refundable tax credits. At present, most middle-income homeowners get meager tax breaks on these payments because they are in relatively low tax brackets.

Low-income homeowners generally get back nothing because they generally do not itemize deductions and owe little in taxes. A refundable tax credit, set near the top marginal tax rate (essentially the rate of government housing subsidy for the wealthy), would assist all households with their housing expenses. To minimize the cost and to the keep large benefits from going to wealthy Americans, we just need to cap the maximum credit available. Making this change effective January 2008 would give many middle and lower income homeowners a large tax break immediately, thus also stimulating the economy.

Second, to aid homeowners we also need to do something about interest rates. Had this been 50 years ago people would have gone to their bank and negotiated a lower mortgage rate. Everyone would benefit – banks would get repaid rather than owning abandoned property, and families would be able to pay their mortgages. Today financial institutions sell individual mortgages and buy back a package containing parts of individual mortgages; unfortunately, banks cannot renegotiate the terms of what they do not own. This is where the government can step in. Even Adam Smith, the father of economics and a strong advocate of the free market, recognized that interest rate limits might be necessary. They are needed now!

Despite the media hype about subprime mortgages, the real villain is the variable rate mortgage. It is not hard to understand why. People with fixed rate mortgages accepted an interest rate that enabled them to make their monthly mortgage payments. Those with variable rate mortgages were enticed by low initial payments and refinancing promises. When mortgages reset, households faced rates they could not afford; and with no equity in their homes, they could not refinance. Capping rates makes it easier for households to make their monthly mortgage payments and keep their homes. Financial institutions holding mortgage-backed securities will benefit from fewer delinquencies and foreclosures. When 30-year fixed rate mortgages are going for around 6 percent, there is a good case for capping rates at 7 or 8 percent for several years. This is much quicker and much simpler than other proposed solutions that require someone renegotiating mortgages whose parts are held all over the world.

Third, credit card debt in the USA must be reduced. This is likely to be the next big credit crisis. Credit card debt has reached the highest level in US history, and exceeds the ability of many households to repay that debt. As lenders fear greater defaults and are less able to lend, they are making things worse by raising interest rates on credit cards. This makes it harder for consumers to spend money on new goods and services and to pay their mortgages. Part of the problem is that households can no longer eliminate their debts easily by declaring bankruptcy. Congress passed the Bankruptcy Abuse Prevention and Reform Act of 2005 after years of large financial contributions from the credit card companies. This law made it harder and more expensive for households to wipe out their debts under Chapter 7 bankruptcy. Many households must now use Chapter 13, under which they must pay back a good chunk of their debt.

Until the backlog of consumer debt is dealt with, there will be little hope for a resurgence of consumer spending and little hope of a sustained recovery. There are only two ways to deal with this debt – we can force consumers to tighten their belts and pay off this debt slowly, or we can eradicate the debt quickly and give consumers the ability to spend again. Returning to pre-2005 bankruptcy laws, until a new and better law can be enacted, is thus a priority.

Finally, we need to heed Keynes's advice about capitalism and make sure that these problems do not occur again. When we forget the lessons of history, and just think of the riches that can be made now if only the government would let the free market work, the result is that capitalism does come to resemble a gambling casino. This means that we need greater regulation of financial institutions. It also means severe penalties for those who promulgated the speculative frenzy – if for no other reason than to serve as a warning to those who might be inclined to take the money and run. Those pushing subprime mortgages on households because underwriting fees were greater must be prosecuted for fraud. CEOs and senior executives must also suffer great public humiliation. A strong message must go out that the gains from such activities will not be as great as the possible losses and that such behavior is not acceptable.

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About the author

Steven Pressman is Professor of Economics & Finance at Monmouth University, Co-Editor of *Review of Political Economy*, and Chief Financial Officer of the Eastern Economic Association. He is the author of more than 120 articles, and author or editor of more than a dozen books, including *Fifty Major Economists*, 2nd ed. (Routledge, 2006). He can be contacted at: pressman@monmouth.edu

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