The Keynesian House Of Denial

By David Stockman, 19 April 2016

We use the term "Keynesian" loosely to stand for economic interventionists of all schools. The followers of JM Keynes and Milton Friedman alike fit that category. So do some of the more rabid supply siders who claim the power to stimulate ultra-high economic growth with the tools of tax policy alone.

The common denominator is economic statism

The common denominator is economic statism. That is, the assumption that the state, including its central banking branch, is indispensable to economic progress and prosperity.

As the various denominations of the Keynesian economic church have it, capitalism is always veering toward the ditch of under-performance and recession when left to its own devices and natural tendencies; and, if neglected by the wise policy-makers of the central state too long, it lapses toward outright depression and collapse.

Our purpose here is not to correct the particular philosophical and analytic errors associated with each of these Keynesian or statist variants. On any given day we make it pretty clear the central banking based mutation of modern Keynesianism is predicated on two cardinal errors. Namely, the myth of demand deficiency and the false presumption that central bank pegging of interest rates, yield curves and other financial prices will enhance macro-economic performance while not harming the efficiency, stability and efficacy of money and capital markets.

The very worst thing the state can do

That's completely wrong. The very worst thing the state can do is meddle with and falsify financial market prices. Sooner or later cheap debt, repressed volatility, stock market "puts" and artificially inflated asset prices drain the genius of markets out of capitalism. What remains in the financial system is raw speculation for the purpose of rent gathering and leverage for the purpose of supercharged gambling.

On the other hand, what gets lost is true capital formation, honest price discovery and allocative efficiency. These are the building blocks of true macroeconomic expansion and rising wealth.

The irony is that the theories of Keynes and Friedman were designed to enable exactly that. Yet after having been morphed and melded into the cult of central banking in recent decades they have become a generator of main street stagnation and impoverishment.

In that regard, we have frequently pointed out that behind all the pretentious jargon and faux economic science of the likes of Yellen, Bernanke, Dudley and Fischer is little more than the "D" word. They believe that an economy can never have enough Debt.

At the end of the day there is no other purpose for the lunacy of 87 straight months of ZIRP and the fraud of $3.5 trillion worth of QE/bond-buying with digital credits conjured from nothing. It's all designed to get the primary economic agents-households, business and governments--to borrow and spend.

The old Keynesian and Friedmanite fallacies

The contemporary central bank based mutation of the old Keynesian and Friedmanite fallacies is rooted in this debt-centric economics but is far more dangerous. Owing to his anti-gold standard worldview, Friedman failed to realize that fiat money was nothing more than debt, but at least he swore an oath of restraint in the form of a fixed rule (such as 3% per annum) for the growth of credit money.

Even Keynes was not completely beguiled by the elixir of debt. His fiscalist angle had more to do with the class snobbery of the early 20th century English literati than an open-ended embrace of debt.

He simply felt that businessmen where less enlightened then high-minded civil servants as he had been at the British Treasury. When the former episodically lost their animal spirits, they left the economy awash in excess savings and the working class bereft of jobs. The function of the state, therefore, was to borrow the excess during periods of macroeconomic slack and put it to good use in public works--even digging holes (with or without spoons) and refilling them.

This got popularized in the notion of "pump priming" as originally articulated by New Deal activists such as Mariner Eccles. But the primitive counter-cyclical policy of the 1930s and the far more sophisticated Keynesian New Economics of the 1960s did not embrace the never too much debt predicate of Bernanke and Yellen.

After all, it was LBJs Keynesian advisors who campaigned aggressively for a anti-inflationary tax hike and fiscal retrenchment in the white hot "guns and butter" economy of 1968. The Democrat's Walter Heller and the Republican's Herb Stein differed as to when and how much pump-priming was warranted, but they agreed that it was only an occasional tonic and that the ***budget should be balanced over the cycle.***

This long forgotten catechism of fiscal balance over the business cycle is crucially important; adherence to it would not have led to an endless rise in the public leverage ratio.

When President Kennedy's New Economics team took over in the early 1960s, they argued for stimulative tax-cuts and temporary deficits. But none claimed that the American economy was drastically impaired because the permanent public debt was only 40% of GDP, not today's 103%. And they further believed that even the incremental public debt from stimulative deficits would be soon paid back by the resulting gains in GDP and tax collections.

For that matter, total credit outstanding in the public and private sectors combined was only 150% of GDP, not today's 340%. And that does make a difference. At the century-old historic debt-to-GDP ratio of 150%, the US economy would be dragging around $27 trillion of debt today, not its actual albatross of $62 trillion.

The fact is, the Keynesian fiscalist of the New Economics could not even have imagined today's leverage ratios on the business and household sectors, either.

The doctrine and practice of plenary central banking

Needless to say, the transformation of the ideas of Keynes and Friedman into the doctrine and practice of plenary central banking has resulted in a hybrid mutant. Counter-cyclical pump-priming has now become the practice of permanent stimulus and the presumption that capitalism is always defaulting into underperformance and worse.

Likewise, the temporary allocation of "excess savings" from the private to the public sector has become the permanent expansion of fiat credit money. And this massive growth of central bank balance sheets, in turn, has resulted in a monumental and fraudulent inflation of government bond prices.

Most destructive of all, the Friedmanite 3% rule of money supply growth has become forgotten, inoperative and irrelevant. In a fractional reserve banking system where Greenspan essentially abolished via sweep accounts the need for reserves on deposit money, Bernanke/Yellen nevertheless flooded the system with $2.4 trillion of excess reserves where virtually none were needed at all.

What this means is that policy makers and the main stream media that xerox their proclamations, prognostications and pettifoggery have become myopic. To wit, so long as the central bank is in full-on stimulus mode--and by any historical standard a 38 bps money market rate is exactly that--the economy can not fail or lapse into recession. Economic growth and expansion are definitional.

Wall Street camp followers never see recession coming

That's why central bankers and their Wall Street camp followers never see recession coming. It can't happen on their watch!

So this week we got another flashing yellow light. The core data from the business economy warns that the current tepid and long-in-the-tooth business expansion is coming to an end and that the next recession is lurking just around the corner, if it has not already arrived.

With the March decline, industrial production has now dropped during 13 out of the last 16 months. As Mish demonstrates in the charts below, this has never happened when the US economy was in an actual "escape velocity" mode.