Been There Done That:
The Political Economy of Déjà Vu, 1950 and 2010

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"In spite of the incredible reputation of the General Theory, I could not find in it a single important doctrine that was both true and original. What is original in the book is not true, and what is true is not original. In fact, even most of the major errors in the book are not original, but can be found in a score of previous writers."
-Henry Hazlitt (1995 [1960], 3)

"We have been going back and forth for a century. I want to steer markets (Keynes). I want them set free (Hayek)."
-John Papola & Russell Roberts (2010)

1 Introduction

On October 17, 1932 D.H. Macgregor, A.C. Pigou, J.M. Keynes, Walter Layton, Arthur Salter, and J.C. Stamp (Keynes et al.) posted a letter in the *Times of London* articulating what they believed was one of the primary causes for the continuation and severity of the Great Depression, private spending. They were deeply concerned by the fall in consumption at that time, and they believed government action was necessary to counteract this fall in aggregate demand, "[t]he public interest in present conditions does not point towards private economy; to spend less money than we should like to do is not patriotic" (Macgregor 1932, 13). They continued further,

> *Moreover, what is true of individuals acting singly is equally true of groups of individuals acting through local authorities. If the citizens of a town wish to build a swimming-bath, or a library, or a museum, they will not, by refraining from doing this, promote a wider national interest. They will be "martyrs by mistake" and, in their martyrdom, will be injuring others as well as themselves. Through their misdirected good will the mounting wave of unemployment will be lifted still higher.*

While they thought most of their fellow economists would agree with them, they did anticipate some dissent. T.E. Gregory, F.A. von Hayek, Arnold Plant, and Lionel Robbins (Hayek et al.) responded in the *Times of London* on October 19, 1932. Hayek et al. took issue with Keynes et al.'s lack of understanding of the difference between consumption and real investment. Instead, they argued that investment was crucial to lengthening the process of production. While increased consumption would fuel immediate consumption industries, it would not provide the incentive for productive long-term investments. Hayek et al.'s disagreed with Keynes et al.'s insistence that government had both the capacity and the incentive to use deficit spending to increase aggregate demand. Hayek et al. (Gregory 1932, 10) believed that "[i]f the Government wish [*sic*] to help revival, the

right way for them to proceed is, not expenditure, but to abolish those restrictions on trade and the free movement of capital (including restrictions on new issues) which are at present impeding even the beginning of recovery."

The exchange on the pages of the *Times of London* was just the start of what was to become one of the most important public policy debates of the century; one that would continue until even the present day.[1] While Keynes's ideas had a deep influence on the economics profession, it arguably even had a bigger impact on public policy. Keynes's deficit spending prescriptions effectively eliminated the budget constraint of public officials, engendering a dramatic jump in the growth of government deficit spending and the size of government in general (Buchanan and Wagner, 2000[1977]; Buchanan, Burton and Wagner, 1978; Hayek 1976, 90). As Cochrane (2009) explains "[f]iscal stimulus can be great politics, at least in the short run. The beneficiaries of government largesse know who wrote them a check. The businesses and consumers who end up getting less credit, and the businesses that can't sell them products, can only blame 'the crisis,' and call up their congressmen to get their own stimulus." The type of spending that grows under the broadly defined 'stimulus' is also an important factor. Looking at the stimulus measures being passed for the current financial crisis, Horwitz (2009) observes, "[w]hat we are seeing happen right now is that Congress sees this crisis as an

[1] While Hayek published *Prices and Production* in 1931, and Keynes published *Treatise on Money* in 1930 (some of the 'Keynesian' ideas can even be traced back further to 1927 in his *End of Laissez Faire: The Economic Consequences of the Peace*), both books that established their separate systems, they were not in contact during the publication of these books (Hicks 1967). In 1936 John Maynard Keynes published *The General Theory of Employment, Interest and Money (General Theory)*, a book that incorporated some of his ideas that really jump-started the 'Keynesian Revolution,' a revolution in macroeconomic thought that rejected the classical view that markets are inherently self-correcting, instead holding that markets are in a constant state of employment disequilibrium and that government intervention is necessary to allow free markets to work (Keynes 1934). Established economists at the time simply rejected any such notion of a revolution. As Frank Knight (1937) mentioned in his review, "I may as well state at the outset that the direct contention of the work seems to me quite unsubstantiated." The older economists mostly rejected Keynes's ideas but the young took it and ran with it, making sure the debate continued throughout the century.

opportunity to enact a whole variety of programs that they've wanted to pass for years, especially (but not only) the Democrats who no longer fear a veto, and now finally have the chance."

It is important to note, as Skidelsky (2009, 103) points out, that many of Keynes's followers bastardized his theory in order to justify policies that even Keynes did not approved of. Towards the end of his life, even Keynes questioned the desirability of having government take more than 25% of national income (Skidelsky 2009, xvi). Skidelsky (2009, 103) does admit though, that Keynes was partially at fault for this because, Keynes, in his hurry to get policies enacted, did not insist on close adherence to his theories (also see Leijonhufvud 1968). Hayek (1995[1966], 244) observed this as well,

> *...I have little doubt that we owe much of the post-war inflation to the great influence of such over-simplified Keynesianism. Not that Keynes himself would have approved of this. Indeed, I am fairly certain that if he had lived he would in that period have been one of the most determined fighters against inflation. About the last time I saw him a few weeks before his death, he more or less plainly told me so…I had asked him whether he was not getting alarmed by the use to which some of his disciplines were putting his theories. His reply was that these theories had been greatly needed in the 1930s; but if these theories should ever become harmful, I could be assured that he would quickly bring about a change in public opinion.*

A few economists saw through the alluring Keynesian promises of growth inducing profligacy and levied a decisive critique of Keynesian economics and its followers, which became known as the 'New Economics.' Henry Hazlitt was one of the most thorough critics of Keynes, publishing both a line by line refutation of Keyne's *General Theory* (1959) and an edited volume of the critics of Keynesianism (1995 [1960]). Despite the severe shortcomings found in the Keynesian model by its critics, revealing the fallacy of

the Keynesian system, Keynesian ideas have witnessed a surge in popularity in the wake of the current financial crisis, especially in the political arena. Looking over the debates that occurred in the past and comparing them to those occurring today, one cannot help but get a feeling of déjà vu that we are, once again, embarking down the economically dangerous road of deficits, debt and debasement. The same road that Adam Smith (1776) explained in the *Wealth of Nations.* As Beaulier and Boettke (2009) explain,

> *In the final chapter of The Wealth of Nations, Adam Smith argued that once national debts have accumulated to a certain degree, they are rarely paid. Government officials, he argues, are both unwilling and unable to get serious about debt. They don't want to lose popularity by raising taxes and they will never cut spending enough. Instead, they employ "juggling tricks" to push the debt problem into the future and hide the full costs.*

Boettke (2009a) goes on,

> *…fiscal irresponsibility leads to monetary irresponsibility to pay for it…And the consequence is inflation and the destruction of the social bonds of trust that sound monetary policy is supposed to provide…In short, when I read either Krugman or Sumner all I see is the endorsement of the 'juggling tricks' without any recognition of either the complexity of the 'trick' being attempted, or the consequences even if the 'trick' is pulled off.*

2 One More Time, With the Same Feeling

Nearly eight decades after the onset of these Keynesian ideas, the debate over the efficacy of public spending during economic downturns is once again in full swing. In the *Sunday Times* a debate broke out between economists lead by Tim Besley and Lord Robert Skidelsky respectively. Besley et al.'s letter on February 14, 2010 warns the UK against the problems that plague governmental fiscal policies. Along with 19 other co-signers, he states "[i]n order to restore trust in the fiscal framework, the government should also introduce more independence into the generation of fiscal forecasts and the scrutiny of the government's performance against its stated fiscal goals." Robert

Skidelsky, along with 56 co-signers (among them Brad DeLong and Nobel Laureate Joseph Stigliz), fired back on February 18, 2010,

> *They seek to frighten us with the present level of the deficit but mention neither the automatic reduction that will be achieved as and when growth is resumed nor the effects of growth on investor confidence. How do the letter's signatories imagine foreign creditors will react if implementing fierce spending cuts tips the economy back into recession? To ask – as they do – for independent appraisal of fiscal policy forecasts is sensible. But for the good of the British people – and for fiscal sustainability – the first priority must be to restore robust economic growth. The wealth of the nation lies in what its citizens can produce.*

Another example of the return of this debate came when economists Brad De Long and Luigi Zingales (Lane, Long & Zingales 2009) in a recent issue of *The Economist* debated the desirability of Keynesianism. De Long asserts that the issue comes down to Say's law, which he claims, "[a]nyone who uses his or her eyes can determine that Say's law is in general false." Much of the Keynesian refutation of Say's law is suspect, as Hazlitt (1995 [1960], 6) pointed out, "Keynes 'refuted' Say's Law only in a sense in which no serious economist ever maintained it." In reality, the Keynesians, even today, are adhering to the same distorted interpretation of Say's Law (see Horwitz 1997; Kates 1998). Mises (1952, 70) explained Keynes's 'rejection' of Say's Law, "Keynes did not refute Says Law. He rejected it emotionally, but he did not advance a single tenable argument to invalidate its rationale."

Zingales was more on the mark. He claims the only way "we are all Keynesians now" is in the sense that politicians and the general public are drawn into the Keynesian mentality. As he said,

> *Keynesianism has conquered the hearts and minds of politicians and ordinary people alike because it provides a theoretical justification for irresponsible behaviour. Medical science has established that one or two glasses of wine per day are good for your long-term health, but no doctor*

> *would recommend a recovering alcoholic to follow this prescription. Unfortunately, Keynesian economists do exactly this. They tell politicians, who are addicted to spending our money, that government expenditures are good. And they tell consumers, who are affected by severe spending problems, that consuming is good, while saving is bad. In medicine, such behaviour would get you expelled from the medical profession; in economics, it gives you a job in Washington.*

Despite the fact that these Keynesian ideas have once again gained prominence among even some notable economists, we would be reckless to discard the lessons from the past and re-embrace these ideas. Arguments made and the lessons learned have not been retained, and once again we are heading down the path of fiscal profligacy, and capricious government intervention. These misguided policy recommendations, which are all too quickly embraced by politicians eager to curry favor with special interest groups come at precisely the time when basic economics shows the need for fiscal austerity and political stability.

The remainder of this chapter will explain the evolution of the Keynesian ideas and show that some modern economists have adopted back the Keynesian tenants, almost wholesale, when the current financial crisis hit. We will examine the modern arguments advanced by Keynesians such as Paul Krugman and Brad DeLong, and demonstrate that they are essentially making the same arguments that were advanced in the past. We show that the critiques levied by Keynesian critics back in the 1950s are just as relevant and devastating to Keynesian propositions today as they were in the past but need to be more creatively presented in order to catch hold. We do not want to be making the same arguments again and again only to continually talk past one another.

3 Keynesian History

John Maynard Keynes published his *General Theory* in the midst of the Great Depression. In the *General Theory*, Keynes holds that the economy is primarily in a state of unemployment equilibrium, rejecting the classical model of full equilibrium. Many of these ideas directly called into question the common beliefs in economics, not just at the time but even today. As Frank Knight (1937) noted, "…Mr. Keynes's own doctrines are, as he would proudly admit, among the notorious fallacies to combat which has been considered a main function of the teaching of economics." The economy is mired in a chronic state of recession because of excess savings and thus, a lack of consumption and investment. According to Keynes, investment falls short of savings because of the decreasing Marginal Efficiency of Capital as more investment is made in the same homogenous capital, as well as the capriciousness of the determinates of the interest rates (Shackle 1973; Skidelsky 2010, 92) . The lack of consumption and investment in turn leads to unemployment and a slowdown in production, further decreasing income and consumption even further. The only way out of this "paradox of thrift" is for government to run budget deficits during times of economic recession to increase consumption and investment. Even if the public money is not channeled into productive investments it would still do its job in jumpstarting consumption and production by creating jobs. Keynes argued that budget deficits could be afforded because they would later be made up by budget surpluses in better economic times.

In the wake of the *General Theory* came many attempts at interpreting Keynes's ideas, engendering an extensive body of newly inspired macroeconomic work, as Paul Samuelson (1988) observed, "[t]he Keynesian revolution was the most significant event

in 20th-century economic science." In the first few decades after the General Theory was published, the followers of Keynes sought not only to clarify what Keynes had said but also to understand and account for the counter-arguments being made at that time.

Essentially the early Keynesians believed the economy was inherently unstable and subject to shocks due to their belief that investment was erratically influenced by 'animal spirits,' and thus subject to huge swings based upon artificial considerations. Once out of equilibrium, they believed, the economy would take a long time to recover on its own, if at all, as Keynes held that there was no inherent tendency back to full employment equilibrium in the free market. Thus, they argued that government intervention was required to restore effective aggregate demand in order to bring the economy back to full employment, and they believed that this was best achieved through fiscal, rather than monetary policy. As Keynes (1932, 60) wrote, "…there will be no means of escape from prolonged and perhaps interminable depression except by state intervention to promote and subsidise new investment."

By the 1950s many believed that Keynes and his followers had won the day. Samuelson (1955) showed that 90 percent of American economists accepted the 'neo-classical synthesis,' meaning they generally accepted the classical model for microeconomic issues and the Keynesian model for macroeconomic issues. In the neo-classical synthesis, macroeconomics takes precedence over microeconomics, especially during economic downturns because unless the economy is in macroeconomic balance, microeconomic market forces won't operate. While this last point is similar to the neo-classical perspective, it is important to note a point that Boettke (2009b) makes that distinguishes the two approaches,

> *...while there may be macroeconomic problems, there are only microeconomic explanations and solutions. Aggregate variables do not interact with one another independent of the choices of individuals. And those choices are guided by the incentives actors face, and the informational signals they receive. In short, economics is about exchange and the institutions within which exchanges take place. It is all about property rights, relative prices, the lure of profit and the penalty of loss.*

In the long run the classical model was correct but economists seemed to believe the Keynesian model was necessary for short run aggregate phenomena. In other words, though it was generally held that fiscal austerity and balanced budgets were economically desirable, these fundamentals should be abandoned in times of economic hardship.

Despite this dominance in macroeconomics from the 1950s to the 1970s there were a few lone voices making important criticisms of the Keynesian theory. On December 31, 1965 *Time* magazine quoted Milton Friedman as declaring "[w]e are all Keynesians now," but Friedman corrected the quote by providing the context in a letter to the editor on February 4, 1966 writing,

> *You quote me [Dec. 31] as saying: "We are all Keynesians now." The quotation is correct, but taken out of context. As best I can recall it, the context was: "In one sense, we are all Keynesians now; in another, nobody is any longer a Keynesian." The second half is at least as important as the first.*

Friedman was referring to the fact that even though Keynesian ideas were on the way out in the profession because they could not be grounded in microeconomic foundations, in times of economic turmoil, economists and politicians would still turn in desperation back to the empty, but alluring Keynesian promises. By the 1970s, Keynesian ideas were thought to have been relegated to the history of economics. Friedman's monetarist counter-revolution helped illustrate many of the flaws with the Keynesian models and helped pave the way for a revival of the classical approach which became known as the

'New Classical' school, led by Robert Lucas. Lucas & Sargent (1978) rejected the Keynesian model as well as attempts to modify it,

> *...existing Keynesian macroeconomic models cannot provide reliable guidance in the formulation of monetary, fiscal, or other types of policy. This conclusion is based in part on the spectacular recent failures of these models and in part on their lack of a sound theoretical or econometric basis. Second, on the latter found, there is no hope that minor or even major modification of these models will lead to significant improvement in their reliability.*

The massive inflation, and even stagflation, of the 1970s coupled with the theoretical contributions of the Monetarists and New Classical Economics led to a shift in macroeconomic thinking (Buchanan 2001[1986], 324). A renaissance of the market economy shifted the macroeconomic view of the role of government. They held that government intervention inhibited the self-correcting tendencies of the market. What was needed, especially in times of economic recession, was not more government intervention, but less government intervention. Keynesian theorists were forced back to their drawing boards because they had no way to incorporate these microeconomic foundations into their aggregated macroeconomic models while retaining the traditional Keynesian governmental panaceas they favored.

The New Keynesian theorists ended up adopting some key features of the New Classical school. Namely, they attempted to titivate the Keynesian models by incorporating microeconomic foundations. The New Keynesian literature has attempted to "search for rigorous and convincing models of wage and/or price stickness based on maximizing behaviour and rational expectations" (Gordon 1990). So while Keynes described the economy as inherently out of equilibrium, with no tendency towards it, New Keynesians view the market as always tending towards equilibrium, just that certain

rigidities prevent the market from equilibrating automatically, leaving some room for government intervention, but, as Cochrane (2009) explains "…not to rescuing the ancient view that fiscal stimulus is important…"

4 The Current Crisis and the Return of Basic Keynesian Ideas

There are still modern adherents of Keynesianism who attempt to defend the traditional Keynesian prescriptions despite the many theoretical shortcomings of the outmoded model. Additional layers of sophistication and technicality have been added, but they are still built upon the same debunked Keynesian foundations. As John Cochrane (2009) points out about the theories used to debunk Keynesiansim, "[t]his is not fancy economics. Most of my arguments come from simply asking where the money is going to come from, simple arithmetic." To their credit, some modern adherents of Keynesianism such as the above mentioned New Keynesians, have outright rejected Keynesian tenants and prescriptions that have failed to find support in basic microeconomic theory.

Modern Keynesians have also attempted to justify stimulus policies based upon modern government capabilities. Just as Mises (1952, 69) said of Keynes and his *General Theory,* "[w]hat he really did was to write an apology for the prevailing policies of governments," so too are ideas of modern Keynesians. These theories hold that with advances in oversight and accountability practices, political pitfalls that have plagued past stimulus attempts, such as stimulus funds being directed to politically motivated projects rather than towards productive investments, can be avoided. The internet, better accountability standards and refined management techniques, they argue, can ensure that stimulus funds are funneled only to those projects that are ensured to meet a minimum

requirement of productivity (Summers 2008). While certainly appealing, the blunders and earmarks that characterized the recent stimulus packages suggest that even the internet and advanced management techniques cannot ensure against political shenanigans and defalcations (Newton-Small & Scherer 2009). Furthermore, even if modern proponents of Keynesianism solve the public choice critiques, they still have failed to address the even more devastating critiques. Horwitz (2010a) stresses the importance of the epistemic problem faced by stimulus programs, "…the important question is not 'how many jobs?' *but 'which jobs?'* Jobs are easy to create; the right jobs are not and require the distributed intelligence of the marketplace."

Despite some of the valiant attempts to address and account for past critiques of Keynesian ideas, when a crisis hits, any progress is thrown out the window in favor of the politically popular Keynesian solutions. Despite the long history of unanswered critiques, and failed attempts that forced even the old proponents of Keynesianism to reject old Keynesian tenants, the promise of economic recovery through fiscal profligacy proves too enticing to resist. Modern Keynesians, when it comes to economically trying times, are making the very same mistakes as their predecessors. In response to the current crisis they have offered up essentially the same Keynesian nostrums. Just like the Keynesians of yesterday they seek the miracle of turning stone into bread (Mises 1948), but have failed to explain how this miracle is to happen. As many of the old critics of the Keynesian system have pointed out, they keep trying in vain. In this section we will demonstrate that the Keynesian framework failed to stand up to basic economic critiques in the past, and that modern manifestations of Keynesianism still fail this test, and thus are inappropriate and even pernicious, especially in a downturned economy.

4.1 The Framework

Little has been added to the traditional Keynesian framework since the 1950's. Despite its lackluster performance, and the inability of proponents to provide a microeconomic justification for it, stimulus is still the proffered solution for a downturned economy. Larry Summers (2010) directly makes the case for Keynesian remedies,

> *It is important to recognize that the ultimate consequences of stimulus for indebtedness depend critically on the macroeconomic conditions. When the economy is demand constrained, the impact of a dollar of tax cuts or expansionary investment will be at its highest and the impact on deficits at its lowest.*

As Keynes et al. (Macgregor 1932) argue, the solution for economic woes cannot be found in the private economy and government must step in to boost consumption in order to put the economy on the path to recovery. This same argument is once again being used to argue for Keynesian inspired stimulus. Paul Krugman (2010a) argues,

> *Penny-pinching at a time like this isn't just cruel; it endangers the nation's future. And it doesn't even do much to reduce our future debt burden, because stinting on spending now threatens the economic recovery, and with it the hope for rising revenues.*

Krugman's quote bears a close resemblance to Keynes (1932, 61),

> *The voices which – in such a conjecture – tell us that the path of escape is to be found in strict economy and in refraining, wherever possible, from utilizing the world's potential production, are the voices of fools and madmen.*

Larry Summers (2010) echoes this same sentiment, arguing that there is a strong case for temporary stimulus if there is excess capacity and rigid interest rates because the short-run multiplier is likely to be higher than average. Christina Romer (2009a) stresses the

inability of the private sector to recover from the current economic crisis without the assistance of government directed stimulus,

> *With the dramatic fall in household wealth and the rapid spread of the downturn to our key trading partners, there was no realistic prospect that the private sector would generate a turnaround in demand any time soon. Thus, although stabilizing the financial system and helping distressed homeowners was essential, it would not be enough. We needed to bring in the other main tool that a government has to counteract a cataclysmic decline in aggregate demand: fiscal stimulus.*

Robert Frank (2009) chimes in as well, defending the case for stimulus,

> *The only remaining major component of aggregate demand is government spending. Stimulus proponents, following John Maynard Keynes, believe that increased government spending — financed by borrowed funds or printing new money — is the only way to bolster aggregate demand and end the downturn quickly. Recent results suggest that this strategy is working.*

Despite all these prominent economists defending stimulus today, the Keynesian case for stimulus has been carefully refuted, both in the past and in modern times. John Cochrane (2009) lays out three of the most poignant arguments against Keynesian stimulus,

> *First, if money is not going to be printed, it has to come from somewhere. If the government borrows a dollar from you, that is a dollar that you do not spend, or that you do not lend to a company to spend on new investment. Every dollar of increased government spending must correspond to one less dollar of private spending. Jobs created by stimulus spending are offset by jobs lost from the decline in private spending.*
>
> *Second, investment is "spending" every bit as much as is consumption. Keynesian fiscal stimulus advocates want money spent on consumption, not saved. They evaluate past stimulus programs by whether people who got stimulus money spent it on consumption goods rather than save it. But the economy overall does not care if you buy a car, or if you lend money to a company that buys a forklift.*
>
> *Third, people must ignore the fact that the government will raise future taxes to pay back the debt. If you know your taxes will go up in the future, the right thing to do with a stimulus check is to buy government bonds so you can pay those higher taxes. Now the net effect of fiscal stimulus is*

> *exactly zero, except to raise future tax distortions. The classic arguments for fiscal stimulus presume that the government can systematically fool people.*

So, Keynesian proponents must assume that government has better incentives and a better capacity, than the private sector, to direct resources to their most productive use. Eugene Fama (2009) echoes this point,

> *Even when there are lots of idle workers, government bailouts and stimulus plans are not likely to add to employment. The reason is that bailouts and stimulus plans must be financed. The additional government debt means that existing current resources just move from one use to another, from private investment to government investment or from investment to consumption, with no effect on total current resources in the system or on total employment.*

Then Keynesians must assume that savings is an actual leakage from the economy, but that hardly is the case. Tyler Cowen (2010) argues, "[c]orporations with cash surpluses are not destroying real resources, nor are they stuffing cash in their mattresses. They are investing in financial assets." Rizzo (2010a) adds to this explanation,

> *…unemployment of resources, including labor, is not always pure idleness. We are living in conditions of real uncertainty. A bubble has burst, the domestic auto industry faces uncertain prospects, tax rates are on the way up – how far and in what respects in anyone's guess – we have just faced a possible healthcare transformation with its unique costs and taxes, European debt problems are becoming manifest, and more.*

Finally, Keynesian proponents must also assume that people do not take into consideration that the stimulus must be paid back eventually in the form of higher taxes. In attempting to measure the multiplier effect of stimulus dollars during peacetime, Robert Barro (2009) got a number that was insignificantly different than zero, due to the fact that people foresee the growth in taxes to pay for the stimulus.

Mario Rizzo (2010b) questions the Keynesian tendency to disband economic theory during downturns, asking "[w]hen does the Keynesian moment end — and the ordinary laws of economics retake the stage?" Rizzo (2010c) also questions the ability of government to actually cut government spending during good economic times to make up for financial profligacy during economic downturns due to entrenched special interest groups. If there are any reductions, they "…will be half-measures taken half-heartedly. *So over the long run the size and scope of government will expand permanently*" (Rizzo 2010d). Freedman et al. (2010) find that without a political regime that ensures that deficits do not continue to grow once the economy improves, the long-run costs of deficit spending during a recession can exceed the short-run benefits.

The Keynesian model, at its best is still an over-simplified and overly aggregated schematic that is built upon highly idealized assumptions of benevolence and omniscience. A severe problem for Keynes, whose main criticisms of the classical school, according to his biographer Robert Skidelsky (2009, 82), was that it "…used models which assumed certain things which did not occur in the real world…" As Hayek (1995[1966], 242) noted on the aggregation of Keynes's model,

> *His final conceptions rest entirely on the belief that there exist relatively simple and constant functional relationships between such 'measurable' aggregates as total demand, investment, or output, and that empirically established values of these presumed 'constants' would enable us to make valid predictions. There seems to me, however, not only to exist no reason whatever to assume that these 'functions' will remain constant, but I believe that microtheory had demonstrated long before Keynes that they cannot be constant but will change over time not only in quantity but even in direction.*

Keynes also did not foresee the public choice issues that emerge in contemporary democratic settings in which public policy is actually formed and implemented, instead

assuming that policy was crafted by a small group or relatively wise and enlightened people (Buchanan, Burton & Wagner 1978, 16). The case for Keynesianism was also grounded in a closed economy model, and as Niall Ferguson (2009) points out, we are in "…a globalized world, where uncoordinated profligacy by national governments is more likely to generate bond-market and currency-market volatility than a return to growth."

The Keynesian model also fails to account for how government intervention in the economy distorts the incentives to invest. Not only did Keynesian inspired stimulus during the Great Depression fail to help the economy improve (Romer 2009b), Keynesian policies adversely affected investment because businessmen were scared to undertake long-term projects with the uncertainty created by the constant political manipulation of the economy (Higgs, 1997). People make decisions based upon relative prices, and when government intervenes into the economy, distorting relative prices, it incentivizes people to behave in unpredictable ways, leading to what economists refer to as the problem of 'unintended consequences.' Keynesian models avoid taking into account these relatives price effects, and the toll they take on the economy. As Lee Ohanian (2009) argues,

> *…the old Keynesian model does not come anywhere close to meeting today's standards for economic analysis. Economics is about incentives: the incentives for households to work, consume and save, and the incentives for business to hire workers and invest in plants and equipment. These incentives are remarkably absent from the macroeconomics of yesteryear. And modern economic analysis shows that the impact of government spending on the economy depends on what it is being spent on and how it ultimately is paid for.*

4.2 The Causes of the Crisis

There is a wide range of explanations offered for the current financial crisis. Some of the competing narratives advanced are new, relying on modern conditions or innovations for

their explanation, while others echo explanations that have been advanced to explain past economic downturns. The traditional Keynesian explanation for the severity of the Great Depression, as outlined in Keynes et al.'s *Times of London* letter, that blames private sector spending, is once again being advanced, as Martin Wolf (2010) argues "[w]hat we are seeing, in short, is an epidemic of private sector frugality…"

Some of the most widely cited explanations include blaming complex and poorly understood financial instruments (Foster 2009) and private sector greed (Kotlikoff 2010, 31). While arguments for greed and stupidity are tempting, they fail to explain why these components of human nature, which are omnipresent, all of the sudden lead to a financial meltdown, and thus fail to adequately explain the root causes, leading to misguided policy recommendations. Similarly, some explanations focus on the deregulation of the financial sector, which in turn let loose private sector greed (Skidelsky 2009, 44). In an op-ed in the *New York Times*, Krugman (2009) blames the deregulation of the financial system for partially being at fault for the onset of the financial crisis,

> *America emerged from the Great Depression with a tightly regulated banking system. The regulations worked: the nation was spared major financial crises for almost four decades after World War II. But as the memory of the Depression faded, bankers began to chafe at the restrictions they faced. And politicians, increasingly under the influence of free-market ideology, showed a growing willingness to give bankers what they wanted…And the bankers — liberated both by legislation that removed traditional restrictions and by the hands-off attitude of regulators who didn't believe in regulation — responded by dramatically loosening lending standards. The result was a credit boom and a monstrous real estate bubble, followed by the worst economic slump since the Great Depression.*

Similarly, the lack, or insufficiency, of regulation is often advanced as an alternative, or contributing factor to the financial crisis as well (Bernanke 2010). Contrary to this claim, many economists have actually found contradictory, complex, and constantly changing

regulation lead to the financial industry troubles. Klein (2010) challenges this explanation by looking at some basic measures of the magnitude of financial regulation, such as the number of federal registry pages, the amount of federal spending on finance and banking regulation, as well as other metrics for the growth of government. Klein finds no trend to indicate that there actually was a period of decline, or even lack of growth, in government programs or financial regulation. The deregulation and free market sentiments were stronger in rhetoric than in actual practice.

Levine (2010a) stresses that innovation is a constant in all industries, and that yes, it does have risks and sometimes leads to product misuse, but that claiming financial innovation inhibits economic growth is like claiming that medical research does not advance human health because sometimes drugs are abused. Financial innovation, just like innovation in any other sector, is a necessary component of economic growth.

Another explanation offered for the current crisis is large capital inflows from foreign nations, due to a global savings glut, lowered interest rates and lead to a rise in mortgages and a decline in lending standards (Greenspan 2010). Taylor (2009) finds that there is no empirical evidence to support this argument, and that the evidence actually points to a saving shortage. The "savings glut," which is outside of the United States, was offset by the saving shortage in the United States.

A more comprehensive understanding of the financial crisis requires taking a broader perspective of the political economy of the events preceding the crisis. Only with this perspective can the role that government, and in particular Keynesian inspired policies, played in creating the regulatory and institutional conditions that set the stage for the real estate bubble and its subsequent collapse be seen. In this section we discuss

what we hold to be the primary causes of the start and continuation of the financial crisis; namely inflationary policies, policies that lead to the housing bubble, and the regulatory regime.

4.2.1 Inflationary Policies

In response to the recession of 2001, the Federal Reserve pushed down the federal funds rate, the primary target rate of the Federal Reserve, from 6% in January of 2001, where it had hovered in between 4.5 and 6.5% since the end of 1994, to hover around 1% by around July of 2003, it's lowest rate in 40 years (Roberts, 2010). It even reached negative rates when adjusted for inflation (FRED). The artificially low interest rates and inflation spurred investments for which the economy did not have real resources to complete. In other words, the cheap availability of loans encouraged entrepreneurs to collectively make investments that exceeded the resources of the economy, and the productive and technological capacities of the economy. While, an un-manipulated interest rate would have risen, operating as a brake on the economy to curtail malinvestment and overinvestment, and would have allocated loanable funds to only their most valuable projects (Hayek 1975 [1933], 94), the artificially low interest rates prevented this rationing device from operating to choke off superfluous investment.

Taylor (2009) finds that the excess monetary expansion was the main cause of the boom and the subsequent bust. Using the Taylor rule, a monetary policy rule that accounts for inflation and the interest rate, a rule that the Federal Reserve has followed for roughly the last 20 years, Taylor compares the actual federal funds rate with the federal funds rate that should have been targeted according to the rule. Taylor finds that

there was a significant deviation from the prescriptions of the Taylor rule, indicating that monetary policy was too easy according to what historical experience dictates it should be. Using a model, Taylor then estimates what housing starts would have been had the Taylor rule been followed, and then charts them against the actual housing starts, showing that the low interest rates were indeed a key factor in the housing bubble.

Mises (1948) alluded to this earlier when he said, "John Maynard Keynes, late economic adviser to the British Government, is the new prophet of inflationism." The arguments by modern Keynesians are similar to the original arguments Keynes himself made. Mises (1949, 787-793) had no respect for this either, "Keynes did not add any new idea to the body of inflationist fallacies, a thousand times refuted by economists… He merely knew how to cloak the plea for inflation and credit expansion in the sophisticated terminology of mathematical economics." Economists like Mises knew the true effects of inflation.

Inflation, as Hayek argued, is a lot more destructive than just a rise in the general price level. Inflation necessarily creates changes in relative prices, causing people to adjust their behavior, which in turn creates even more distortions that ripple through the economy, pushing the economy to a position that is inconsistent with the underlying preferences and technology. Much of the concerns of Keynesians, such as unemployment, are often caused by this inflationary distortion of relative prices. As Hayek (1974) noted in his noble lecture, "We have indeed good reason to believe that unemployment indicates that the structure of relative prices and wages has been distorted (usually by monopolistic or governmental price fixing), and that to restore equality

between the demand and the supply of labour in all sectors changes of relative prices and some transfers of labour will be necessary."

The problem with inflation, and why it adversely affects relative prices, is that it ripples through the economy distorting the information signals which prices represent. Hayek (1945) carefully detailed the important role that prices play in the economy by transmitting dispersed knowledge of time and place to the relevant economic actors. As Hayek (1941, 64) notes,

> *But general price changes are no essential feature of a monetary theory of the trade cycle; they are not only unessential, but they would be completely irrelevant if only they were completely "general"—that is, if they affected all prices at the same time and in the same proportion. The point of the real interest to trade cycle theory is the existence of certain deviations in individual price relations occurring because changes in the volume of money appear at certain individual points; deviations, that is, away from the position that is necessary to maintain the whole system in equilibrium.*

Inflation also bears additional costs, besides the relative price manipulations that undermine the epistemic function of prices. There are costs of avoiding inflation, which involve both the cost of tax lawyers and accounts, as well as the economic cost of investors refraining from particular investments, or altering their investment and consumption plans in order to obtain favorable tax treatment. There are 'Shoe leather costs,' which are the costs associated with people having to run to the bank more frequently during inflationary times. In addition, there are also 'Menu costs' which comprise the costs associated with price changes necessitated by inflation, such as having to reprint menus in order to reflect higher prices. Accountancy costs emerge because the relative price distortions don't equally effect all goods at the same time, so it undermines the accuracy of the information conveyed by financial statements. Accountancy costs are

exacerbated by the fact that these distorted financial statements are then used to make future plans, meaning that inflationary distortions are carried forward. Finally, bouts of inflation also undermine the reliability of contracts, making private actors more wary of engaging in long-term contracts, as well as raising the costs of contract negotiation and enforcement.

4.2.2 Housing Bubble

The easy money and artificially low interest rates spurred a bubble in the housing sector, where the ten-city composite index realized an average annualized rate of return of 13% from June 2001 to June 2006 (Murphy 2008). There were several factors that concentrated the excess currency, or overinvestment, into the housing sector. First, was Fannie Mae and Freddie Mac, both government sponsored enterprises that were chartered by Congress with the intent of providing liquidity, stability, and affordability to the mortgage market in order to promote access to mortgage credit (Fannie Mae Charter Act 1954; Federal Home Loan Mortgage Corporation Act 1970). In other words, the political purpose of these government sponsored enterprises was putting mortgages into the hands of people who would otherwise have been denied a mortgage in the free market due to insufficient income, an unstable job, or lack of assets (c.f. Block et. al 2008). In fact, these agencies were given a target requirement for the number of loans they made to borrowers with below median income for the area, which rose to 55% in 2007 (HUD). They accomplish this by participating in the secondary market for mortgages or by buying up bundled mortgages from banks, either through outright purchase or by swapping them for a mortgage-backed security that promises the originators a guaranteed

rate of return. Both of these courses of action shelter the originating bank from the risks of its mortgages as the risk is transferred to Fannie and Freddie.

Fannie and Freddie were equipped with several privileges, unavailable to market institutions in order to carry out this goal. One of the most favorable privileges was that Fannie and Freddie were implicitly backed by the U.S. taxpayers, meaning that while the stockholders maintained any gains, there was an implicit federal guarantee for any losses that resulted from the mortgages. Privatizing gains and socializing losses obviously in and of itself sets up the perverse incentives for excessive risk taking. Fannie and Freddie were also able to borrow funds at a rate that was only slightly above the federal funds rate, a rate that was significantly lower than the rate available to market institutions (Bernanke 2007). With these special provisions, Fannie and Freddie were in control of a combined $1.8 trillion in assets by 2003 (Frame and White, 2005). To put that in perspective, based purely upon assets, they were the 2nd and 3rd largest companies in the U.S., respectively, at that time. Between 1998 and 2003 when the housing market began to soar, they were the most frequent buyers of loans (Roberts, 2010). In return for these privileges, government ensured that they would have the ability to influence the policies of Fannie and Freddie through the presidential appointment of five members of both Fannie's and Freddie's board of directors and through the Department of Housing and Urban.

Another factor that channeled overinvestment into the housing industry was tax code manipulation. To encourage house ownership, the U.S. government has kept an extremely popular deduction for mortgages, while renting has not received similar treatment (Norberg, 2009). In 1997, home ownership was again encouraged through the

tax code through the abolition of the capital gains tax on real estate investments, while it was maintained for other types of investments (Roberts, 2010). Just this change in 1997 is estimated to have increased the number of home sold by 17% (Bajaj and Leonhardt, 2008). Nobel Laureate Vernon Smith (2007) wrote that the 1997 tax break was the cause that fueled the "mother of all housing bubbles…"

Of course, the view that government programs that distorted relative prices in order to influence private actors' decisions is not new, in fact, Henry Hazlitt in his famous *Economics in One Lesson* (1979 [1946]) warned that,

> *Government-guaranteed home mortgages, especially when a negligible down payment or no down payment whatever is required, inevitably mean more bad loans than otherwise. They force the general taxpayer to subsidize the bad risks and to defray the losses. They encourage people to "buy" houses that they cannot really afford. They tend eventually to bring about an oversupply of houses as compared with other things. They temporarily overstimulate building, raise the cost of building for everybody (including the buyers of the homes with the guaranteed mortgages), and may mislead the building industry into an eventually costly overexpansion. In brief in the long run they do not increase overall national production but encourage malinvestment.*

This goes beyond just the housing bubble. Any artificial changes to the rate of interest will have a similar, and often devastating, effect. Hazlitt (1959, 385) in his, almost point for point, book of refuting Keynesian fallacies, *The Failure of the "New Economics,"* notes,

> *It is hard to believe that Keynes is as niave as he pretends, and that he is not laughing up his sleeve. The rate of interest—the valuation of time and all investments—is to be taken out of the market and put completely in the hands of the state. But Keynes ignores the complete interconnectedness of all prices. This especially includes the price of capital loans, any State tinkering with which must necessarily affect and distort all prices and price relationships throughout the economy.*

It is important to remember that the downturn is the recovery, the boom is where the problems emerge. The recession that results in the popping of the bubble is the market correcting itself. Thus as Rothbard (1962, 860) notes,

> *It should be clear that any governmental interference with the depression process can only prolong it, thus making things worse from almost everyone's point of view. Since the depression process is the recovery process, any halting or slowing down of the process impedes the advent of recovery. The depression readjustments must work themselves out before recovery can be complete. The more these adjustments are delayed, the longer the depression will have to last, and the longer the recovery is postponed. For example, if the government keeps wages rates up, it brings about permanent unemployment. If it keeps prices up, it brings about unsold surplus. And if it spurs credit expansion again, then new malinvestment and later depressions are spawned.*

Thus, any attempts to use government to interfere with the market adjustments will make things worse. These are exactly the policies that the Keynesians prescribe to, and to which we now turn.

4.2.3 Regulatory Regime

During a recession, whenever laws and regulations become highly sensitive to political manipulation or popular opinion, oftentimes the first people blamed as the culprits are businessmen. When popular sentiments such as this are combined with a political administration that demonstrates a willingness to intervene in the economy in order to appease these sentiments, it creates a highly unpredictable business atmosphere. So precisely when political officials should be setting an environment in which entrepreneurs feel safe to undertake investments, they often create an atmosphere that discourages investment. Robert Higgs (1997) finds that this phenomena, known as 'regime uncertainty,' helps explain the magnitude and length of the Great Depression because of the constantly changing regulatory and legal framework in response to the

recession. Policies that have been pursued before and during the current financial crisis have lead to greater uncertainty for investors as well.

Ross Levine (2010b) finds that policymakers and regulators had a hand in creating conditions that lead to the financial crisis by maintaining policies that encouraged destabilizing policies. Capital requirement regulations required investors to use the SEC created National Recognized Statistical Rating Organizations (NRSRO) for security ratings. The NRSRO has limited competition in the credit rating industry to just a few key players, in 2000 there were only three recognized agencies and no justification or list of criteria for becoming recognized (White, 2009). By sheltering the credit ratings from competition, entry and innovation, these regulations reduced the reputational incentives of the protected rating agencies to accurately rate securities. Other policies such as the *Recourse Act,* which revised the *Basel* regulations, made it so banks had the incentive to hold mortgage-backed securities over individual mortgages and commercial loans by changing their relative capital reserve requirements (Friedman 2009; Roberts 2010). As Friedman (2009) stresses, regulation homogenizes, mandating what regulators believe to be prudent banking practices on the entire system, if the regulators are wrong, the whole system is at risk. One of those misguided policies that encouraged systematic risk was the de facto policy of the federal government to bailout large or politically connected firms over the past three decades (Roberts 2010). Following an implicit policy to bailout firms if they suffer extreme losses, but allowing them to enjoy all upside profits, mollifies the prudence inspired by the profit and loss system, encouraging more risky behavior.

In addition to regulations that played a role in leading to the financial crisis, there has been a flux of new regulations after the initial onset of the financial crisis that have created uncertainty for investors; including even the Obama administration's continuing lambasting of profit-seeking businessmen has created an atmosphere of uncertainty. Alan Meltzer (2010), points to several factors that increased economic uncertainty in the wake of the start of the financial crisis. The passage of the healthcare bill produced uncertainty for employers, especially those considering hiring new employees, as there was significant doubt about the CBO's estimates of the total cost that would be borne by employers. In addition, the estimates for the healthcare bill also depended upon cutting spending in politically popular areas in the future and other generous assumptions, creating uncertainty about future tax hikes or inflation in order to fund it, along with rising uncertainty about future Social Security and Medicare obligations (Holtz-Eakin 2010). The auto bailouts, which transgressed the rule of law in order to hand out political favors to politically powerful unions over bondholders, put further doubts into the minds of investors (King Jr. 2009). Amity Shales (2010), compares the adverse effects of government induced uncertainty in the Great Depression as well as following the onset of the financial crisis, concluding that,

> *Mr. Geithner is gradually discovering that to recover, the market needs a specific kind of confidence. It is not something Washington can hand down. It is not even demand confidence—the confidence of the consumer who wants to shop. The confidence relevant to recovery is the confidence of the investor and the saver. It comes only when an administration in Washington demonstrates reliability and restraint.*

These insights that government intervention into the economy can inhibit investors from investing and preventing recovery were stressed by past critics of Keynesianism. These flaws in the policy prescriptions stemming from the Keynesian ideas have long been

refuted. Economists have seen through the inconsistencies since Keynes's *General Theory* itself. As economist David McCord Wright (1958) noted,

> *If consistency is the bane of little minds, Lord Keynes had certainly a great one. No one who studies the work of John Maynard Keynes can fail to be impressed by the frequent brilliance of his insights and the usefulness of many of his tools of analysis. But he lacked that sober quality which causes a man to sit down and carefully consider the consistency of his various successive theories and pronouncements.*

Chicago economist Frank Knight (1937) in his review of the *General Theory* had little respect for Keynesian policy prescriptions from the view of economics when he said, "I can only comment that phrases like socialization of investment, with no indication of what procedure is in mind, sound (to me) more like the language of the soap-box reformer than that of an economist writing a theoretical tome for economists." This seems relevant for today with many of the modern proposals from modern Keynesians.

Economists F.A. Hayek and William Hutt had legitimate fears about the outcomes of government intervention inherent in the Keynesian policies. Hayek (1941) noted, "[a]re we not even told that, 'since in the long run we are all dead,' policy should be guided entirely by short-run considerations? I fear that these believers in the principle of *après nous le deluge* may get what they have bargained for sooner than they wish." And Hutt (1954) worried,

> *Actual policies have, for decades, been based precisely upon the politically attractive rule, justified by Keynesian teaching, that disharmony in the wage-rate structure must not be tackled but offset; whilst the current tendency is to assume dogmatically with no examination of the institutional and sociological factors involved, that to advocate wage and price adjustments is to recommend the conquest of the moon.*

These fears have often manifested themselves in reality when Keynesian policies were implemented. Henry Morgenthau, the treasury secretary under FDR, said in 1939, "[w]e

are spending more money than we have ever spent before, and it does not work...We have never made good on our promises...after eight years of this administration we have just as much unemployment as when we started...and an enormous debt, to boot" (Schram 2009). This lead Hazlitt (1995 [1960], 10) to wonder, "[b]ut whatever the full explanation of the Keynesian cult, its existence is one of the greatest intellectual scandals of our age."

5 Conclusion

In the progression of economic ideas, some ideas are discarded as theoretically unsound and empirically invalid. Keynesianism is one of those ideas that was found lacking, and appropriately, discarded. Yet, it has shown a bewildering tendency to reemerge during times of economic hardship, precisely when a return to basic economics is needed most. Its promises to turn stone into bread are too enticing to refrain from entertaining. As Peter Boettke (2010) stresses,

> *In extraordinary times, what we need most is ordinary economics. Crises such as the collapse of communism, the failure of development planning, the rise of tensions over globalization, the consequences of a major natural disaster, and financial collapse need to be met not by extraordinary theories designed to provide emergency room economics, but by a return to cool-headed and basic economic principles. Incentives matter even in the economic emergency room, and in fact, since we are dealing with an emergency to forget that basic point is perhaps even more costly than in normal time, perhaps so costly as to be deadly for the economy. Losing our heads as economists and violating the basic principles of the discipline is how we turn a market correction in to an economy wide crisis --- which in my view is what we have done over the last year and a half.*

Throughout history fiscal profligacy and government interventionism have caused the decline and the downfall of many societies. While the theories that promise abundance

out of scarcity are intoxicating, they are based upon false premises, premises that attempt to violate the fundamental lessons of basic economics. As Mises (1949, 885) warns,

> *The body of economic knowledge is an essential element in the structure of human civilization; it is the foundation upon which modern industrialism and all the moral, intellectual, technological, and therapeutical achievements of the last centuries have been built. It rests with men whether they will make the proper use of the rich treasure with which this knowledge provides them or whether they will leave it unused. But if they fail to take the best advantage of it and disregard its teachings and warnings, they will not annul economics; they will stamp out society and the human race.*

Heedless attempts to overturn the basic laws of economics with ungrounded Keynesian policies will only lead us down the dangerous path of deficits, debt and debasement. Perhaps Richard Ebeling (2010) sums it up best,

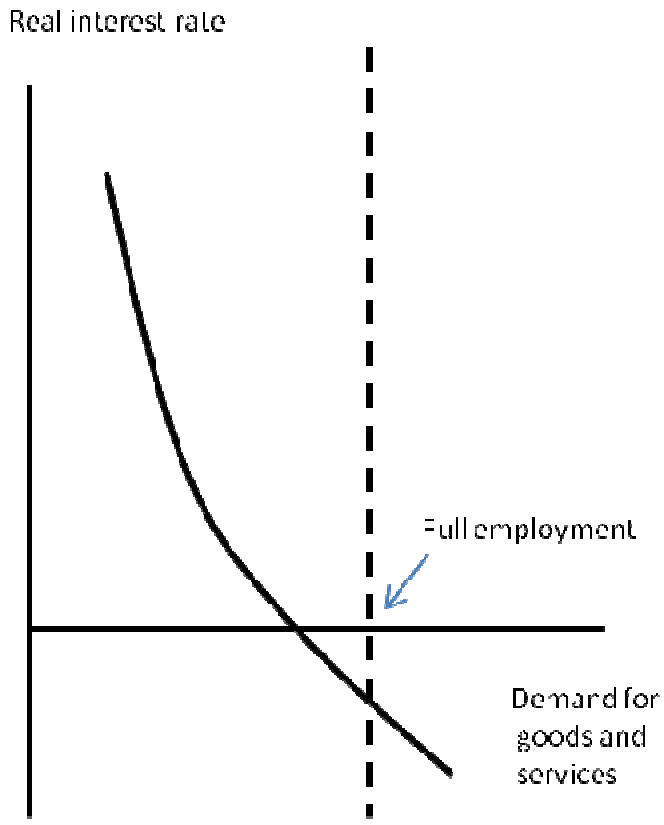
> *…it is unfortunate and a tragedy that this debate has to be fought once again. But the tragedy is that after the failures of Keynesian policies then and in the post-World War II period; after the reinforcement of anti-market rigidities that retarded and delayed a rebalancing of the economy in the 1930s; and after all the big government "experiments" and extensions of political power over the market place that only caused anti-investment and anti-recovery uncertainty in the private sector during those New Deal days; after the reintroduction of neo-mercantilist trade policies that undermined the global market; and after the huge fiscal irresponsibility that undermined financial confidence in the country in the 1930s business community…After all of these failures of interventionism and "activist" monetary and fiscal policy in the 1930s, the same public policy madness is still recommended as "wisdom" today.*

The déjà vu we are currently living through is dangerous. Fortunately, but perhaps even more unnerving, is that it is also unnecessary. The lessons of the past should be learned before the same mistakes are made yet again. Political economy has the answers, if anyone is willing to listen.

Appendix: Lack of Creativity on Both Sides

The return down the road of debts, deficits and debasements is not just a failure that can be pinned on new Keynesians who have failed to reject conclusions of Keynes's system that fail to pass basic microeconomic inspection. Economists who have failed to explicate the theoretical and historical failure of Keynesianism in a fashion that would be understood by the economic profession, politicians and the public are also to be blamed. The revival of recycled Keynesian ideas has imbued not a serious reformulation of the way in which sound economics is articulated and conveyed, but a simple duplication of arguments already rendered in the past. Both sides of the debate have suffered from a lack of intellectual creativity, as well as a failure to talk on the same terms.

Similar to the debate between Malthus and Ricardo (see Machlachlan 1999), the debate between Keynesian proponents and opponents have not reached resolution primarily due to the lack of realization that they are using two fundamentally different styles of economic argument. While Keynes criticized the mathematization of economics and warned against the excessive reliance on econometrics, his aggregative formulas which abstracted out of real essential elements in the economy were highly translatable into mathematics and econometrics. These formulations have been passed on, as exhibited by Paul Krugman's (2010b) recent macromodel,



Horwitz (2010b) critiques the Keynesian-based model,

> *There are so many problems with this from an Austrian perspective that it's hard to know where to begin. The biggest is that there's absolutely no notion of capital or the idea that production takes time here. There's no way to distinguish between consumption and investment - it's all part of AD or Y. Lowering the interest rate just gets us more demand for "stuff." The fact that it might skew the kind of stuff that gets produced toward the early stages of longer-term production processes in ways that are not sustainable never enters the picture. The fact that with heterogeneous capital goods, even given idle resources, one cannot assume that C and I will move directly together and not opposite each other never enters the picture.*
>
> *Nor does this enable us to see how the negative real interest rates of the boom of the last decade gave us tons of malinvested capital from which we are still trying to extract ourselves. Can this model, which he uses all of the time, explain the various features of the boom and how it turned to bust? The other sorts of distortions that inflation might create that are also damaging to economic growth and employment are never considered. It's a model with no price level, no time, and no capital. it's the worst of Keynesianism in one picture.*

What is needed is a radical rethinking of the monetary institutions in society, and the binding rules on fiscal policies. Some of the foremost economic scholars of the 20th century, Nobel Laureates F.A. Hayek, James M. Buchanan and Milton Friedman all tried to creatively seek ways to bind fiscal and monetary authorities, especially when these authorities act in concert, engendering fiscal profligacy and expansion of government. Each one, in their own way ended up rejecting the possibility of controlling government spending. Hayek (1976) proposed allowing competitive money issue,

> *We have always had bad money because private enterprise was not permitted to give us a better one. In a world governed by the pressure of organised interests, the important truth to keep in mind is that we cannon count on intelligence or understanding but only on sheer self-interest to give us the institutions we need.*

Friedman (2007) in an interview published posthumously, argues to hand the responsibilities of the Federal Reserve over to a computer,

> *In any event, the computer program would certainly prevent any major disasters either way, any major inflation or any major depressions. One of the great defects of our kind of monetary system is that its performance depends so much on the quality of the people who are put in charge. We have seen that in the history of our own Federal Reserve System. Surely a computer would have produced far better results during the 1930s and during both world wars.*
>
> *That raises a question about the desirability of our present monetary system. It is one in which a group of unelected people have enormous power, power which can lead to a great depression or which can lead to a great inflation. Is it wise to have that power in those hands?*

Buchanan (1999[1962]), goes so far as to propose a brick standard, which he defined as a monetary regime under which the a standard building brick, of a specified quality, would be exchangeable at the mint for a paper currency, and paper currency would be exchangeable for bricks. Market forces then would spontaneous work in order to adjust

the price level. As the general price level rises, people will exchange currency for bricks and as the general price level falls, people will exchange bricks for currency. Buchanan resorted to this monetary regime due to waning faith in the ability of monetary authorities to restrain themselves, as he explains,

> *When, however, we recognize that in all matters of economic policy specific action scan only be taken by individual human beings, and that these human beings are fallible and subject to mistakes and error, we begin to sense the merit of the second, alternative, approach, that which aims at securing the desired results spontaneously rather than instrumentally.*

This kind of creative thinking has been carried forward by monetary theorists George Selgin and Larry White (1994), who wrote a summary of the major advances in free banking scholarship for the *Journal of Economic Literature*. Laurence Kotlikoff (2010) takes a novel approach in his book *Jimmy Stewart is Dead* as well, recognizing that loose monetary policy helped lead up to the financial crisis, and that fiscal profligacy is not a viable long run remedy for it either.

Given the monetary mischief and fiscal irresponsibility that has characterized modern social democratic societies, the choice before us is how to get back on a policy path of sound money and fiscal responsibility. This is a choice over rules and institutional structures. We are confronted, as Gerald O'Driscoll has put it, with the choice of either free banking, narrow banking, or no banking. What we cannot do is continue down our current policy path. Creative thought among the best and brightest political economists of our age must be directed on finding that set of rules which effectively bind the hands of the fiscal authority, and finding the alternative institutional arrangements for money and finance which will eliminate the ability of the state to engage in monetary mischief. In this regard, as in some many others, we cannot simply

point backwards to the work of Hayek, Friedman and Buchanan, but we must begin with their work and push it forward in time to address our problems in our time.

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