Popular Economic Theories

[Another chapter cut out by the editors because it was considered to be too technical. Unedited.]

In reading layman at economics you will frequently come across terms such as “Austrian School”, “Monetarist Economics” and “Keynesian Economics” without any explanation. This chapter is to provide a brief review of each of these three popular economic theories and to discuss interesting facts about seven of the most popular and influential economists of past and recent times.

JOHN MAYNARD KEYNES (1883 – 1946)

An English economist considered by some to be one of the founders of modern “macroeconomics” and by most to be one of the most prominent economists of the 20th century. He was a career civil servant, rising to prominence in the British Treasury; as well as a writer philosopher art collector and private investor. He moved in society, academia and bureaucratic circles with ease. Twice he made and lost fortunes speculating in foreign exchange markets.

In his influential book “The Economic Consequences of Peace” (1919) he warned that the dire consequences of the planned “astronomically high” war reparations imposed on post World War I Germany word impoverish the country and lead to a revolution. Keynes prediction proved true when only a fraction of the war reparations were paid, the German Weinmar Republic collapsed and from the ashes Adolph Hitler was elected to office. Keynes book “The Gen. Theory of Employment, Interest and Money” (1936) brought him worldwide acclaim and his economic theory was brought to the American universities by Paul Samuelson’s classic textbook “Economics” (1948).

The basis of Keynes management of economic cycles is countercyclical policies: tighten government fiscal spending during the boom times and step in with federal deficit spending to create demand during the recession. Unfortunately, most and government policies have only been brought into the deficit spending half of Keynes theory. This form to the basis of the US economic policy 2008 – 2014.

Keynes is being credited with the following are quotes:

“When the facts change, I change my mind. What do you do, sir?”

“This along one is a misleading guide to current affairs, in the long run, we’re all dead.”

KEYNESIAN ECONOMICS

Keynesian economics were first presented by the British economist John Maynard Keynes in his book “The General Theory of Employment, Interest and Money” published in 1936 during the Great Depression.

Keynes believed in capitalism but not laissez-faire capitalism. He believed capitalism is inherently volatile and needs macroeconomic management to avoid or tame the destabilizing business cycles. Without government intervention, the resultant instability would weaken the public's belief in capitalism and lead to downfall.

Keynesian economists often argue that private sector decisions and sometimes lead to inefficient macroeconomic outcomes which require active policy responses by the public sector, in particular, monetary policy actions by the central bank and fiscal policy actions by government, in order to stabilize output over the business cycle.

COMMENT BOX

Of these two tools he states are needed to modulate the economy – monetary policy and government fiscal policy – the lack of government congressional fiscal policy has necessitated a more drastic application of the monetary actions by the Federal Reserve.

"General Theory" is often viewed as the foundation of modern economics. Keynes argues that demand, not supply, is the key variable governing the overall level of economic activity. One can only enhance employment and total income by first increase in expenditures for either consumption or investment. Without government intervention to increase expenditure, economy will remain trapped in a low employment state.

Magneto theory

Keynes is stated that in a recession the economy suffers from a "magneto trouble" referring to a car's a battery and not the engine or drivetrain being the cause of the trouble. He stated this could be corrected by "jumpstarting" the economy. Keynesian economic theory advocates federal government spending to restart or stimulate the economy even if it takes deficit spending… spending money the government does not have but needs to borrow.

Keynesians believe it is the government's responsibility to improve the public welfare by offsetting fluctuations using countercyclical fiscal and monetary policy. Countercyclical policy means the following:

(1) High inflation in boom times is managed by decreasing government spending and/or increasing taxes to slow the money supply and the economy.

(2) Deflation and high unemployment during recessions is managed by increasing demand for services and goods with the government stepping in to replace the lack of demand by private business and individuals with the demand of the government for goods, services and labor intensive infrastructure spending to stimulate employment and to stabilize wages.

This is contrary to the prevailing classical economic theories that argued for tax cuts during budget surpluses, spending cuts during economic downturns and balance to government budgets.

True Keynesian economics has suffered from the misinterpretation and hijacking of his original theory by the successive Neo-Keynesian, New Keynesian and Post-Keynesian schools of economics; which is have only been successful in convincing the federal government to buy into this second part (deficit spending during recessions) but not into the first part (decreasing government spending and decreasing taxes in boom times). Knowing his name has been attached to the US government applying deficit spending throughout the entire business cycle would have John Maynard Keynes going over in his grave.

The Paradox of Thrift

Keynes often lectured about the “paradox of thrift.” As consumers save money someone else’s economy shrinks. It is the “you’re spending is my income and my spending is your income” philosophy. His solution for this is economically stifling high savings rate (e.g. Japan 1990s) is to increase consumption by social program spending and to decrease savings directly or indirectly by central bank policies keeping the interest earned on savings accounts to near zero. All the above were put into play 2008 – 2014.

Brian Riedl of the Heritage of Foundation in a 2009 interview with At National Review Said:

“The grand Keynesian myth is that you can spend money and thereby increase demand. And it’s myth because Congress does not have the vault of money to distribute to the economy. Every dollar Congress injects into the econ0omy must first be taxed or borrowed out of the economy. You’re not creating new demand, you’re just transferring it from one group of people to another.”[1].

Keynes ideas influenced Franklin D Roosevelt’s of you that is sufficient to buying power caused the depression. [It has since been concluded the tight Federal Reserve policy was actually the culprit]. Keynesian ideas became almost official in socially democratic Europe after World War II and in the US in the 1960s. The 1960s success of Keynesian economics resulted in almost all capitalist governments adopting its policy recommendations. In 1965 “Time” magazine ran a cover article with a title comment from Milton Friedman (later echoed by US Pres. Richard Nixon) that “we are all Keynesians now”.

Keynes influence waned in the 1970s. Milton Friedman and other monetarist economists suggested that sustained Keynesian policies would lead to both unemployment and inflation; a condition termed “stagflation.”

As Friedman had predicted, in the early 1970s stagflation appeared in both the US and Britain and Keynesian economics was officially discarded by the British government in 1979 as Milton Friedman and other monetarist economists from the Chicago school of economics emerged.

Nobel laureate Paul Krugman actively argued the case for vigorous Keynesian intervention in the economy in his columns for the New York Times 2008 – 2014.

COMMENT BOX

But government spending is just a redistribution game of robbing (that taxing) Peter to pay (welfare) Paul with a net gain of zero because government does not "earned" of money itself, it needs to either take it from someone who earned it and redistribute it to non-workers or the unemployed; purchase so-called "print" the fiat of the money with her the Federal Reserve actually just creating a bank deposits with computer keystrokes. Keynes never anticipated either the $700 billion 2008 Troubled Asset Relief Program (TARP) or the 2008-2014 Quantitative Easing (QE) #'s1,2,3,4 and 5.f he were alive today he would most certainly be suing those who have attached his name to these atrocities to promote and their own social and political agendas.

MILTON FRIEDMAN (1912 – 2006)

In American economist, graduated from Rutgers University with a degree in mathematics and received his advanced degree in economics at the University of Chicago where he met his future wife, economist and co-author, Rose.

He taught economics at the University of Chicago for 30 years, served as an economic adviser to Ronald Reagan, was affiliated with the Hoover Institute at Stanford University, worked with the Federal Reserve Bank of San Francisco and won the Nobel Peace Prize in economics in 1976. He is referred to as the father of the Monetarist School of Economics. He led the opposition to the then popular Keynesian government policies and correctly foresaw the 1970s "stagflation" that eventually led to Keynesian practices falling out of favor in the late 1970s.

Friedman argued that many of the services provided by the government could be performed better by the private sector. He considered the US Postal Service to be an unnecessary government monopoly; he supported gay rights and same-sex marriage; he supported the legalization of marijuana; and was instrumental in eliminating the federal conscription (military draft) during the Nixon administration.

Milton Friedman has written that misinformed and misguided central banks have caused the business cycles. In the classic of book "Monetary History of the United States 1867 – 1960" (– – –), Milton Friedman and Anna Schwartz attributed inflation to excessive money supply generated by the central bank; and deflationary spirals to failure of the central bank to increase money supply to solve a liquidity crisis. The authors concluded that the Great Depression of the 1930s was the refusal of the central bank to increase the money supply – pump money into the economy to create more liquidity. In response to the authors' long assertion, Federal Reserve Chairman Ben Bernanke agreed with the authors and in a 2002 tribute speech to Milton Friedman he stated:

"you're right, we did it. We're very sorry. But thanks to you, we want to do it again." This statement was an eerie foreshadowing of the 2008 commencement of the Federal Reserve's TARP and QE programs.

In their monumental work "A Monetary History of the United States 1867-1960" (1963) Milton Friedman and Anna Schwartz argued that to the Federal Reserve and not the stock market or free market was the basis of the Great Depression.

When Estonia was transformed from an impoverished Soviet Republic to the democratic and free market and referred to as the "Baltic Tiger", Prime Minister Mart Laar claimed the greatest influence driving his initiatives was Milton and Rose Friedman's "Free to Choose" (1980) and F.A. Hayek's "The Road to Serfdom."

Friedman's main contribution was convincing people of the importance of allowing free markets to operator. Three of his playing famous quotes are:

"If you put the federal government in charge of the Sahara Desert, in five days there would be a shortage of sand."

"Nothing is as permanent as a temporary government program".

He also famously and sarcastically quipped that price deflation can be corrected by "dropping money out of a helicopter." This "helicopter money" would re-emerge 40 years later when the Federal Reserve's easy money policy (QE 1 – 5) would be referred to as "helicopter money" and thus earn the Federal Reserve Chairman Ben Bernanke the title "Helicopter Ben."

MONETARISM

Monetarism is a theory of economics which emphasizes the role of government, central banks specifically, in modulating the economic or business cycles by controlling the amount of money in circulation. Monetarist accepted the "Debt – Deflation" a theory of cycles but they believe the loose and tight credit cycles are caused by the central bank's (Federal Reserve) control of the amount of money in circulation.

Monetarists also believe, like the Keynesians, that demand can control the business cycle; but they argue that the erratic monetary policies followed by central banks can cause business cycles. By raising and lowering interest rates, the Federal Reserve is able to intentionally or unintentionally generate recessions or booms much like the Great Depression was cause as detailed in Ben Bernanke's PhD thesis.

Fool in the Shower Analogy.

Friedman used his "fool in the shower" analogy when he criticized the Federal Reserve's misguided attempts to control economic cycles. He stated that when a bathroom shower is at first it turned on the cold pipes always make the water the first comes out of the shower cold. The initial reaction is to overreact and to turn the hot water faucet on full until the water comes out scalding hot.

Milton Friedman opposed the theory of central banks but acknowledge their existence was a fact of life. He developed what he called a "K percentage rule", much like the newer "Taylor Rule" (John M. Taylor) both of which propose setting strict guidelines to regulate the Federal Reserve Bank's handling of the money supply using predetermined inflation targets and executing with minimal human emotional influence, much like putting the central bank or Federal Reserve on an autopilot.

In 1979 Margaret Thatcher, the United Kingdom's Prime Minister, employed monetarism economic theory to bring Britain's inflation from a high of 27% to 4.6% by 1983; with the trade-off of having caused a recession with high unemployment.

in 1979 Pres. Carter appointed Paul Volker as Federal Reserve chairman with the goal of ending the stagflation which he did successfully using monetarist economics theory to rein in inflation the tight monetary supply, resulting in the 1981 recession.

In a 1997 then the Federal Reserve chairman Alan Greenspan employed at monetarism economic theory by flooding the world with dollars and creating liquidity in response to the Asian financial crisis.

Currently, the US Federal Reserve follows a basically monetary school of economic model to modulate economic cycles. Current Federal Reserve chairman, Ben Bernanke studied in the Great Depression of the 1930s extensively for his PhD dissertation so he is more likely to error on the side of too much rather than too little liquidity. His replacement, Janet Yellen is expected to continue the same ease monetary policy.

AUSTRIAN SCHOOL OF ECONOMICS

The Austrian School began in 1871 with the work of Carl Menger and his "Principles of Economics." Current day Austrian economists work in many different countries and few are actually Austrian.

Despite the efforts of luminaries as such as Ludwig von Mises and F. A. Hayek, it has come under withering criticism by monetarist Milton Friedman and most recently Keynesian Paul Krugman.

Austrian school economic conclusions are reached logically through deduction and often lack mathematical models, econometrics and statistical methods of the more mainstream economists. George Mason University in Virginia is the emerging modern day standard bearer for the Austrian school of economics that opposes government intervention in markets

Ludwig von Mises believed the misguided policies of government central banks enable commercial banks to fund loans at artificially low rates reason, resulting in an increase of the circulating money supply which fosters a reckless investments or a miss-allocation of resources he called "Mal investment". The Austrian theory believes the market is self-correcting unless the central bank interferes and recessions are controlled by fiscal tightening without easy credit or bailouts.

Austrian theorists are free market, non-government intervention economists who believe government intrusion ultimately sows the seeds of the next crisis and prevents what Austrian school theorist Joseph Schumpeter called "creative destruction".

Austrian school economists Ludwig von Mises, F. A. Hayek, Joseph Schumpeter and others laid the blame of booms and busts on government policies and not on the free markets.

They argued that overleveraged banks, corporations and households should not be bailed out but rather be allowed to perish as victims of “creative destruction” and leave the strong and financially viable to survive in the marketplace. They argued that economic slumps should be allowed to run their natural course and as Andrew Mellon famously quipped “purge the rottenness out of the system.”

Using public money, redistributed from successfully managed banks, corporations and households to keep these financial zombies on life support is not an efficient use of capital. They are not advocates of the privatizing of profits and socializing of losses that we have seen so much of during the 2008 – 2014 a recession.

F.A. HAYEK (1899 – 1992)

Hayek was Austrian and later a British economist who had academic affiliations with the London School of Economics, the University of Chicago and University of Friedberg. He shared the 1974 Nobel peace prize in economics. His book “The Road to Serfdom” (1944) warned of the dire consequences of allowing state control over production and the economy. The book was published by the University of Chicago and an abridged version was also published in the Readers Digest; allowing it to reach a far wider audience and to become popular among non-academics advocating for individualism and limited government. The book has seen a recent resurgence in popularity.

Hayek worked for Ludwig von Mises and in keeping with the Austrian school of economics at theory he believed in the central role of the state should be only to maintain the rule of law. He argued that socialism required central economic planning which in turn led to totalitarianism.

In “The Road to Serfdom”, Hayek contended that economic control becomes political control and he pointed out to that powerful bureaucracies do not attract Angels of – they attract people who enjoy running the lives of others and they tend to make an effort to increase their influence and power.

In “The Constitution of Liberty”, Hayek and his mentor Ludwig von Mises at the University of Vienna argued that government attempts to plan the economy would inevitably doomed to fail.

“Liberty not only means that the individual has both the opportunity and the burden of choice; it also means that he must bear the consequences of his actions and will receive praise or blame for them. Liberty and responsibility are inseparable. A free society will not function or maintain itself unless it’s members regarded as a right that each individual occupy the position that results from his action and accept it as due to his own action.… Responsibility has become an unpopular concept”. (1949 [3].

Hayek was Keyne's most prominent contemporary critic, with sharply opposing views on the economy. He regarded the Keynesian government redistribution of income or capital as an unacceptable intrusion upon in individual freedom. He did however acknowledge the need for a safety net for those threatened by the extremes of indigence or starvation.

In 1975 Great Britain's Prime Minister Margaret Thatcher famously took her own copy of F. A. Hayek's "The Constitution of Liberty" out of her briefcase, explaining "this is what we believe."

Pres. Ronald Reagan listed F. A. Hayek as one of three people who most influenced his philosophy and he invited him to the White House as a speaker. In 1991 Pres. George H Bush awarded Hayek the Presidential Medal of Freedom, one of the United States's highest civilian awards, for a "lifetime of looking beyond the horizon."

HYMAN MINSKY (1919 – 1996)

He received a BS in mathematics from the University of Chicago and his PhD in economics from Harvard University. He was an American economist and professor of economics at the University of Washington in St. Louis, Brown University and the University of California Berkeley.

Like a Keynes, he supported government intervention in financial markets and he stressed the importance of the Federal Reserve as the lender of last resort in an economic crisis. He wrote that many adding misinterpreted Keynes's famous work "General Theory" text and adopted only the government to deficit spending solution to recessions and largely ignored the government fiscal spending component during the boom times.

Minsky is best known for his "Financial Instability Hypothesis" which recognizes financial swings between booms and busts are integral part of business cycles. He claimed that in prosperous times a speculative euphoria develops, followed by excessive debt accumulation, debt default, a decrease in asset values and finally lender tightening of credit availability.

He characterized investors and consumers as "momentum investors" who, unlike value investors, take perceived intuitive action, but often in and in erroneous, herd mentality direction during the peaks and troughs of economic cycles. In the face of higher leverage and high debt levels, the economic event will force debtors to start deleveraging, selling assets and trigger a rush to the exits with their sudden, but too late, realization of the impending free fall; resulting in Irving Fisher's debt deflation downward spiral.

The Minsky Moment

In 1998 Paul McCulley a managing director of the huge bond fund manager PIMCO was discussing the Asian or Russian economic crisis, referred it to the sudden, but most often, too late recognition of the investors' dire situation and inevitable free fall as the "Minsky Moment".[4].

Wile E. Coyote Moment

Paul Krugman uses the analogy of the "Wile E Coyote Moment" referring to the popular 1948 Warner Bros. Looney Tunes made for t.v. cartoon character who would run off a cliff; realizing his predicament and inevitable free fall, only as he momentarily hung in a pre-fall suspended animation.[5].

Minsky stated his theories verbally and did not build mathematical models based on them. Consequently, his theories have not been incorporated into mainstream economic models, although his “Minsky Moment” will be resurrected with the advent of all future sudden economic down turns.

JOSEPH SCHUMPETER (1883 – 1950)

he was an Austrian American economist who was born in Austria and became a US citizen and later taught at economics Harvard University. His massive of volume “Business Cycles”(1939) received a little recognition, however his work “Capitalism, Socialism and Democracy” (1942) was widely read in many languages.

Schumpeter was the first scholar to develop a theory about entrepreneurship. He argued that the innovative and technological change of a nation came from the entrepreneurs. He taught that the best institution enabling the entrepreneurs to purchase the resources needed to realize his or her vision was a well-developed capitalistic financial system. The central theme of his work was that capitalism can only be understood as an evolutionary process of continued innovation and when he referred to as “creative destruction”.

He acknowledged that technological innovation could be expected to create temporary monopolies, with abnormally high profits that would soon be diminished by competitors and imitators. He said the temporary monopolies were necessary to provide the incentive necessary to justify the time effort and capital necessary to develop new products.

Schumpeter disputed the idea that democracy was a process by which the electorate identified the common good and politicians carry this out for them. He argued people were largely manipulated by politicians who set their own agendas. He went on to say that capitalism could collapse from within if Democratic majorities of 04 restrictions upon entrepreneurship that will burden and destroy the capitalist structure.

Joseph Schumpeter was the undisputed champion of the art of prayer. He popularized the term “creative destruction” which is still used today to describe a process in which old ways of doing things that are endogenously destroyed, allowing for the emergence of and replacement by better and more efficient new ways without the use of government subsidies or taxpayer bailouts to allow failed businesses to continue to exist on taxpayer-funded life support as zombie corporations or banks.

IRVING FISHER (1867 – 1947)

He was an American mathematical economist, inventor and personal health campaigner promoting vegetarianism and eugenics it. He received his PhD in economics from Yale University and returned there to teach economics.

His unfortunate claim to fame was his prolific and public confidence in the US stock market just a few days before the famous October 7, 1929 stock market crash. Fisher asserted “stocks have reached what looks like a permanently high plateau". [6] with the this sudden loss of the fortune he made as an inventor ($6 – $10 million), he dedicated his life of impoverishment to understanding and reporting on the underlying causes of business cycles. He was an early skeptic of fractional bank reserve policies.

Fisher's research lead to his "Debt – Deflation" theory of economic cycles. He attached a great importance to the behavior of the heavily indebted of borrowers whose motive was the profits from the increase in the prices of these assets which they expected would greatly exceed the interest payments on the borrowed money. [A common misconception during the 2000 – 2008 house flipping episode.].

Fisher argued that when dad is unable to pay the debt they will collectively liquidate assets causing asset prices to decrease into a deflationary spiral. Even though incomes and asset values decrease, the debt service remains unchanged been to default, foreclosure and bankruptcy. The important point he made was that debt contracts (mortgages and loans) are not indexed to the fluctuation of the asset of value, so any decrease in asset of value causes an increase in their relative value of the debt maybe even to the point where the debt exceeds the assets of value. The 2008 – 2011 housing the evaluation resulting in "upside down" homeowners is a recent example of how this theory plays out in reality.

In "Booms and Depressions" (1932) Fisher writes:

"Those debtors who have the burned their fingers by over indebtedness and those creditors who have burned their fingers by over lending, become overcautious; and restrict borrowing. Then the pendulum may gradually swing back, caution may be thrown to the winds, and over indebtedness again prevail. This swinging back and forth may go on indefinitely." [7]

Fishers "debt – deflation" theory of excessive debt accumulation has been used to explain the worst economic crisis in American history – 1837, 1857, 1893, 1929 and he might argue, post humorously, 2008.

Back in his day, Fisher is a theory was largely ignored in favor of Keynesian economics, due to the damage to his reputation caused by his very public and optimistic proclamation of the US stock market only days prior to the famous 1929 stock market crash.

Later, world renowned economist Milton Friedman would call Fisher "the greatest economist the US is ever produced."[8]. Fisher will remain famous for his "index visible filing system" invention patented in 1913, sold to Kardex Rand and mass marketed under the ubiquitous name "Rolodex".

Keens Debt-Reset Theory successfully predicted the 2008 recession by incorporating some of Fisher's work on debt-deflation theory.

KARL MARX (1818 – 1883)

He was a zealous intellectual advocate of communism. His work on political economy, Das Kapital (1867) was the foundation for later communist political leaders such as V. I. Lenin and Mao Tse-Tung.

Mark Blaug, economic historian, points out that Marx wrote “no more than a dozen pages on the concept of social class, the theory of the state, and the materialistic concept and of history; while he wrote literally 10,000 pages on economics pure and simple.” [9]

In the early 1800s, economic or business is cycles, referred to as “propensity to crisis”, were not yet recognized as an inherent feature of capitalism.

The Marxian school of economics concerns itself with the analysis of crisis in capitalism and in academia it is largely independent from Marxist own advocacy of socialism.

Karl Marx claimed that recurrent business cycle crises were an inevitable result of the operations of the capitalistic system. In his view, all that the government can do is to change the timing of economic crisis. By delaying a crisis, government policy could in fact make the inevitable crisis even worse.

According to Mark said, capitalism contains the seeds of its own destruction. Periodic crises in capitalism form to the basis of the theory of calm Marx, who further claimed that these crises were increasing in severity. He saw profit as the major engine of market economy and theorized profitability has a tendency to keep Klein, resulting in economic crises.

Marx argued the labor theory of value, which holds that the value of a commodity is the labor time invested in it. In his model, capitalists do not pay workers the full value of the commodities they produce, instead, they compensate the worker for the necessary labor only. The rest, called surplus labor, would be pocketed by the capitalist. Marx drew conclusions that actually do not follow from his theoretical premises. His conclusion that profit is equal to surplus value no longer holds true and calls into question his theory that the exploitation of workers is the sole source of profit.

The absence of economic crises in socialist systems can be explained by economic crises not rising in systems in which the means of production are never privately owned and all economic processes are controlled by public authorities. No crisis emerges because the subjects have no opportunity to voice their dissatisfaction. Wherever consumers lack the freedom to choose and the productive structure is imposed on them by government, business cycles cannot occur. In fact, such economies are continually and permanently in a situation of recession crisis.

The Diamond and the Water Paradox

Economist Adam Smith pondered it but was unable to solve the diamond – water paradox. He noted that “even though life cannot exist without water and can easily exist without diamonds, diamonds are, pound for pound, vastly more valuable than water… Water in total is much more valuable than diamonds… Because water is plentiful and diamonds are scarce, the marginal value of a pound of diamonds exceeds the marginal value of the pound of water. The idea that the value derives from utility contradicted call boxes labor theory of value, which tells her that in items of value derives from the labor used to produce it and not from its ability to satisfy human wants." [10].

Marx will always be remembered more for his advocacy of socialism.

COMMENT BOX

Marx spent his life in impoverished surroundings and for most of his adult life he relied on Friedrich Engels and other friends for his financial support… the irony of which, is not lost.

Karl Marx's famous quote:

"From those according to their ability to those of according to their needs," might well be paraphrased as "income inequality" for political purposes in the US 2014 midterm elections.

SUMMARY