The Remedist

By ROBERT SKIDELSKY

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Among the most astonishing statements to be made by any policymaker in recent years was [Alan Greenspan](http://topics.nytimes.com/top/reference/timestopics/people/g/alan_greenspan/index.html?inline=nyt-per)’s admission this autumn that the regime of deregulation he oversaw as chairman of the [Federal Reserve](http://topics.nytimes.com/top/reference/timestopics/organizations/f/federal_reserve_system/index.html?inline=nyt-org) was based on a “flaw”: he had overestimated the ability of a free market to self-correct and had missed the self-destructive power of deregulated mortgage lending. The “whole intellectual edifice,” he said, “collapsed in the summer of last year.”

What was this “intellectual edifice”? As so often with policymakers, you need to tease out their beliefs from their policies. Greenspan must have believed something like the “efficient-market hypothesis,” which holds that financial markets always price assets correctly. Given that markets are efficient, they would need only the lightest regulation. Government officials who control the money supply have only one task — to keep prices roughly stable.

I don’t suppose that Greenspan actually bought this story literally, since experience of repeated financial crises too obviously contradicted it. It was, after all, only a model. But he must have believed something sufficiently like it to have supported extensive financial deregulation and to have kept interest rates low in the period when the housing bubble was growing. This was the intellectual edifice, of both theory and policy, which has just been blown sky high. As [George Soros](http://topics.nytimes.com/top/reference/timestopics/people/s/george_soros/index.html?inline=nyt-per) rightly pointed out, “The salient feature of the current [financial crisis](http://topics.nytimes.com/top/reference/timestopics/subjects/c/credit_crisis/index.html?inline=nyt-classifier) is that it was not caused by some external shock like [OPEC](http://topics.nytimes.com/top/reference/timestopics/organizations/o/organization_of_petroleum_exporting_countries/index.html?inline=nyt-org) raising the price of oil. . . . The crisis was generated by the financial system itself.”

This is where the great economist [John Maynard Keynes](http://topics.nytimes.com/top/reference/timestopics/people/k/john_maynard_keynes/index.html?inline=nyt-per) (1883-1946) comes in. Today, Keynes is justly enjoying a comeback. For the same “intellectual edifice” that Greenspan said has now collapsed was what supported the laissez-faire policies Keynes quarreled with in his times. Then, as now, economists believed that all uncertainty could be reduced to measurable risk. So asset prices always reflected fundamentals, and unregulated markets would in general be very stable.

By contrast, Keynes created an economics whose starting point was that not all future events could be reduced to measurable risk. There was a residue of genuine uncertainty, and this made disaster an ever-present possibility, not a once-in-a-lifetime “shock.” Investment was more an act of faith than a scientific calculation of probabilities. And in this fact lay the possibility of huge systemic mistakes.

The basic question Keynes asked was: How do rational people behave under conditions of uncertainty? The answer he gave was profound and extends far beyond economics. People fall back on “conventions,” which give them the assurance that they are doing the right thing. The chief of these are the assumptions that the future will be like the past (witness all the financial models that assumed housing prices wouldn’t fall) and that current prices correctly sum up “future prospects.” Above all, we run with the crowd. A master of aphorism, Keynes wrote that a “sound banker” is one who, “when he is ruined, is ruined in a conventional and orthodox way.” (Today, you might add a further convention — the belief that mathematics can conjure certainty out of uncertainty.)

But any view of the future based on what Keynes called “so flimsy a foundation” is liable to “sudden and violent changes” when the news changes. Investors do not process new information efficiently because they don’t know which information is relevant. Conventional behavior easily turns into herd behavior. Financial markets are punctuated by alternating currents of euphoria and panic.

Keynes’s prescriptions were guided by his conception of money, which plays a disturbing role in his economics. Most economists have seen money simply as a means of payment, an improvement on barter. Keynes emphasized its role as a “store of value.” Why, he asked, should anyone outside a lunatic asylum wish to “hold” money? The answer he gave was that “holding” money was a way of postponing transactions. The “desire to hold money as a store of wealth is a barometer of the degree of our distrust of our own calculations and conventions concerning the future. . . . The possession of actual money lulls our disquietude; and the premium we require to make us part with money is a measure of the degree of our disquietude.” The same reliance on “conventional” thinking that leads investors to spend profligately at certain times leads them to be highly cautious at others. Even a relatively weak dollar may, at moments of high uncertainty, seem more “secure” than any other asset, as we are currently seeing.

It is this flight into cash that makes interest-rate policy such an uncertain agent of recovery. If the managers of banks and companies hold pessimistic views about the future, they will raise the price they charge for “giving up liquidity,” even though the central bank might be flooding the economy with cash. That is why Keynes did not think that cutting the central bank’s interest rate would necessarily — and certainly not quickly — lower the interest rates charged on different types of loans. This was his main argument for the use of government stimulus to fight a depression. There was only one sure way to get an increase in spending in the face of an extreme private-sector reluctance to spend, and that was for the government to spend the money itself. Spend on pyramids, spend on hospitals, but spend it must.

This, in a nutshell, was Keynes’s economics. His purpose, as he saw it, was not to destroy capitalism but to save it from itself. He thought that the work of rescue had to start with economic theory itself. Now that Greenspan’s intellectual edifice has collapsed, the moment has come to build a new structure on the foundations that Keynes laid.

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