Episode 476: Where Keynesianism Goes Wrong

Guest: Steven Kates

WOODS: I've just been telling people about your work and your book we're going to talk about today. I have a wide array of listeners of all different background in terms of knowledge of economics. Some of them I'm sure already know what Say's Law is, but some don't, and we could all use a refresher. So leaving out the Keynes question, just give me the explanation of Say's Law the way Say himself would have explained it.

KATES: Well the way it was explained — and I don't like using Say's version, because even though it's named after him — it was named in the 1920s after him — he didn't actually give it the best explanation. The best explanation you find is in John Stuart Mill and almost identically good as him is his father, James Mill. And the point about Say's Law was this, and it went through the entire classical school, right up to 1936, and it said whatever may cause a recession, it will never be a deficiency of demand.

And that of course is a complete anathema in a modern economic environment, where it's always assumed that the problem is a deficiency of demand. What Say's Law said, it never was, and the phrase they used was, “There's no such thing as a general glut,” which is very archaic, but the actual meaning they mean was, in our terms, you never ever have a recession because of demand deficiency. Thousands of other reasons, but never for that.

WOODS: Well, let's say something about that idea of the general glut, though, because I think people can at least understand the idea of general overproduction, because from time to time we hear economic journalists of various stripes attributing downturns either in the present or in the past to general overproduction. There was just too much production; there was a general glut, and that led to the problems.

The point that is made in Say's Law is that, although you could have a glut in some sector, there could be entrepreneurial error in some sector, there's no general problem that there's just too much stuff in general. There can be too much of one thing, and that was an error, and they should cut back on the production of that, but the too much of one thing simply means that there was corresponding underproduction of something else that was demanded more highly. But there's no such thing as a problem of everything.

But why? I can imagine people thinking that it sounds plausible that everybody just got too optimistic and everybody produced too much of everything. Why is that not a problem, at least according to the classical economists?

KATES: Well, you know, if you start with the first, the general glut debate, it takes place in 1820. Now, since the beginning of the Industrial Revolution, 1760, everybody was going wow, look at all this stuff we're pouring out. But if you think of 1820 by today's standards, the idea that they had so much that they could not possibly absorb anymore is obviously ridiculous. Same thing now. You go back to when Keynes published *The General Theory* in 1936. Now, by our standards, living standards of the 1930s were pretty minimal compared to what we now live through.

And so it's what always happens. People have always lived in the most abundant times ever, at least since the Industrial Revolution. We've always lived in a time when we have more than our predecessors had. And so it's always one of those arguments that you can't possibly argue plausibly that we've run out of things to buy because we are just all so flushed with everything. But the idea is palpably stupid. We all know that no individual you can hardly think of wouldn't have more if they could have it. But to think of the societies in that way is absurd. And the idea that we somehow have no more capacity to actually invest and to build more productive investment is even more ridiculous.

WOODS: It may be easier to see the point of Say's Law when we imagine a barter economy. I've got potatoes and you have baseball bats and somebody else has oranges or whatever. If the orange guy produces more oranges and I produce more potatoes and so on, this is not a disaster. It means that now there's more stuff for us to exchange, that maybe any one of my potatoes now exchanges for fewer oranges or something, because there's greater abundance, but it's not like we have to look at each other and scratch our heads and say, oh no, we're drowning in potatoes and oranges. It's a great thing, that now I can just exchange my potatoes for some more oranges and so on and so forth.

There's a problem that's introduced supposedly, though, when money comes into the picture. Was this part of Keynes' issue, that money somehow screws up the adjustment process?

KATES: Well, I only wish it were. The classical economists were well into that, understanding how important it was to understand the nature of the exchange economy. But what the classical economists were always at pains to do is to make sure people understood that it is production that creates the ability to demand. Unless we are all producing, you can't buy. Unless each individual is producing and earning an income, then each individual cannot buy, so that for the foreign exchange economy, you have to first understand it in terms of the actual products — I always think of it as a fruit bowl, with like oranges and potatoes, but it's the same idea. There is so much going into the fruit bowl and so much coming out, but it's what we have.

A classical economist would then say, but this exchange problem will be interrupted by the fact that there is money and credit, and this can crudely distort the way the economy actually unfolds and can cause individuals who are thinking, well, I think I can sell X, Y, and Z to get into an overproduction of particular items. And if you go back to the GFC, which of course the housing market in the United States, they were producing far more than the actual demand could carry in terms of what they would be actually willing to pay for. They couldn't afford what was being produced. So you had this distortion.

But the problem always understood in the classical terms was that it was the existence of money and credit that caused these things to happen, that would cause these distortions. There are other possibilities, like the oil shock back in the 1970s, that's the sort of thing that can also cause a recession. But generally speaking, it was something went wrong with money and credit, and the whole process of real production would be distorted and some things you would just find cannot be sold at prices that would cover their costs.

What Keynes did, and this is a terrible disaster for economics to this day I think, is he brought money in right at the beginning. He began with the idea of money, and so what we have lost sight of is the real production sits underneath the money exchange and because of that, we don't tend to see what is going on in the real economy. All we look at instead is the money side of it.

WOODS: All right, I do want to get to Keynes in a minute. I do want to say something about this popular rendering of Say's Law where you sometimes hear it expressed as supply creates its own demand, which is — you've written a whole article on where that formulation came from. But it's so misleading, because it makes it sound as if Say's Law is saying that all you need to do is produce something, and there will automatically be demand for it.

But what was actually being said was that if you're concerned about making sure that all the oranges get bought, the more you produce, the more wherewithal you bring to the marketplace to be able to buy those oranges. So the demand for oranges comes from my production of potatoes, so that my production, my supply creates the demand that I bring to the marketplace. So that's what that phrase should mean, but it creates a lot of confusion in people's minds, because supply creates its own demand sounds like a ridiculous, idiotic, moronic view that of course we are well rid of today in our modern society.

KATES: Well, the fact of the matter is, and it's one that again that I don't know if you want me to get into just yet, but the phrase itself — and this is one of the things I find so extraordinary — the phrase itself comes from a book written by an American economist in 1933. It's not like this classic tradition. It's written by a guy named Harlan McCracken, who was at the University of Minnesota at the time, ended up in Louisiana, and he wrote this phrase, but he was being critical of Say's Law. He was saying, well, economies don't really — and so the phrase has come into economics as the meaning of Say's Law was first stated by someone who didn't accept Say's Law and then taken up by the single most important person who was opposed to Say's Law, and that being Keynes.

The core point of Say's Law was that demand is caused by supply. You must supply to be able to demand, which is obvious, and then it says that whatever might happen, we are never going to end up in a recession because we've been supplying too much. We'll never ever be able to be in a position where we've just created so much wealth that nobody wants to buy anymore and we don't need people to work and produce it.

WOODS: All right, let's say something now about Keynes. First of all, do you think he misstated or misunderstood Say's Law, or was he just overturning what he truly understood to be the real Say's Law, or was there a misunderstanding — because like, I know in Henry Hazlitt's critique of Keynes, he's of the belief that Keynes is critiquing his own faulty understanding of Say's Law. Is that also your view?

KATES: My own view is that Keynes perfectly well understood it, perfectly well. He has this passage in *The General Theory*, in which he describes the classical view, and he says oh look, we've forgotten the effect of the man. We've forgotten all about that; we've just gone on this tradition of David Ricardo. And he perfectly states it. He doesn't call it Say's Law. That's not what he calls Say's Law. But he gets the point exactly right.

But he's a polemicist. Keynes does not intend to actually explain this to you so that you will say uh huh, let's debate the issue. He wants to actually cloud everyone's minds. Up until Keynes publishes his book, everybody accepts in some way that you can't have overproduction, demand deficiency does not cause recession. You then have the Great Depression and everybody sort of loses track of what's going on in the economy. They just lose it.

And so what you end up with is Keynes being able to, if you like, bamboozle people. It's the circumstances of the times that allow it to happen, and without that you could never have gotten something as ludicrous as people don't want to buy, because they just prefer to save instead. You could never have gotten that up past the economics community, who all understand what was wrong with that, except — and this was the big exception — those who were under 30. This was a kind of a revolution from below.

WOODS: What, though, is the best way to convey this to a general public that will find it at least superficially plausible that an economic downturn could occur because people, let's say, become skittish about spending and the demand for products is not what people anticipated that it would be, and that goes to show that deficient demand really is at the heart of an economic downturn? What's the flaw in that thinking?

KATES: Well you see, it's the difference between what causes it and what the superficial appearance is. We have never ever had a recession where you could say, ah, this has always been caused by people just not wanting to buy. The global financial crisis happened in a kind of quasi-boom where everything was going really fantastic, except the housing market. This is your partial glut. Your housing market in the U.S. went into a downturn; this led to repercussions in the financial markets, and it then transmitted across the globe. We had these international circumstances where economies were going into recessions because of a credit freeze. There was credit freeze across the world. Now, no one can describe that as a fall in demand in the sense that the problem was caused because all of a sudden everybody said oh, come to think of it, I'd rather save. What really happened was that businesses around the world found that they couldn't get credit to run their businesses, and there was this massive downturn that happened everywhere and is continuing because the very way we tried to fix it is actually making the problem worse.

WOODS: But is there a part of the business cycle in which we do see a curtailment of consumer spending?

KATES: Yeah, that is what — it was always understood. No one could miss it that, when you ended up in a recession, there was a fall in consumer spending, and there was an even larger fall in investment spending. That's what you see.

WOODS: But is this why people think that the downturn is caused by the fall in consumer spending?

KATES: Yes, it looks really plausible. That's the stupidity of it. It looks — yes, of course, that's so obvious. And if you go right back to the beginning of the literature, everybody is recognizing, here you are in recession and nobody's buying. All the stuff, all the goods we're producing is piling up in our warehouses and no one's buying it. And so you need an explanation for why weren't people buying. Because people do buy things. Why aren't they buying?

And so what developed was a theory to explain the fact that you have these mistakes made by businesses, like with the housing industry in the United States. You have mistakes, you have distortions that happen in the economy that have to be rectified. Certain things, like the housing industry had to contract, certain shifts in the underlying what we produce and how we produce it and where we produce it have to take place, and then the economy would resume.

Along comes Malthus in 1820, and he writes this book, and he says look, you know, the problem is that people are choosing to save. And so you have what's called the general glut debate, and it goes on between 1820 and 1848, and at the end of it, everybody just pounds the daylights out of Malthus. Everybody looks at this thing, and they say you know what, there's no such thing as a general glut. Whatever it was that might have caused people not to buy, it never was because people decided to save. And so the fact that it looks that way is a large part of the problem.

But there are two — if you're interested, I've got two particular ways to talk about this. People said, when I was being taught this stuff way back in the '60s, they would say, well you know, great proof of Keynesian economics came at the beginning of World War II. Everybody was still in recession, and particularly the Americans because they used the Roosevelt New Deal to try to get out of the Great Depression, and it never worked. But there they were. So we were in 1941, the governments start to spend, the economy picks up, no more unemployment. Okay, so that's the story.

But the real story, the one that I find fascinating, is the one at the end of World War II. So here you are, 1945, the same Keynesians are coming to President Truman in this case, and they say, look, what we have to do now is maintain spending, because we have these huge deficits existing now, these massive deficits existing already. Public spending has been huge, and that's why we've been able to wipe out unemployment. But look, if we cut out all this public spending at the same time as all these soldiers are coming back from overseas, we're going to end up straight back in the Great Depression. You must maintain public spending.

And so what does Truman do? He says well, you know, I'm this kind of simple soul, and I don't think we should maintain spending. And so what he did in 1945 was he balanced the budget. He just did it. He said okay, no more of the spending. Public spending just cascaded down, the budget was balanced, and, as we all know, it touched off the greatest period of economic prosperity and growth in history, went right through the 1970s. It wasn't the deficit that you needed; it was actually getting rid of it, and that starts things going.

The other one, of course, is right now, you know? I just saw the statistics yesterday, that the participation rate, the proportion of males in the labor force now is at the lowest level it has ever been, and we're going all the way back to 1948. It's the lowest it's been since 1948. And you know, sure there are people getting older, so that there are — people live longer, so there's a proportion there, but it's well beyond that. If you actually break the stats down, you can see that what is happening now is that you have this huge falling out of the labor force. People can't find jobs, and they just give up looking.

The supposed stimulus we put in in 2009 and was done by everyone, everybody has reversed it, because it did not work. The problems it has created are still with us, but no economy went into recovery because of this stimulus, and it was just as obvious as anything to a classical economist, and it's completely invisible to almost all macroeconomists today who follow Keynes.

WOODS: The episode you mentioned with Truman and World War II has been cited by a man I'm sure you're familiar with, Bob Higgs, who said that this is probably the best empirical example of Keynesianism in action that you could possibly ask for, given that so many Keynesians in the United States including Alvin Hansen predicted that there would be mass unemployment at the end of World War II. And they said you have to keep producing tanks, even though you don't need them anymore. They said this; they predicted it; the exact opposite happened. What more could you ask for than that? Now of course, they didn't fold up their tents and go home. They kept on going. That's the way people seem to be, unfortunately.

But in other words, the nature of this dispute here between the Keynesians and let's say the modern day heirs of the classical economists who have taken what they were saying and refined it, purged it, and built on it — people like the Austrian economists — is that the Austrians are looking at the kinds of spending, the channels that the spending is moving in, as opposed to simply raw numbers of overall spending, giant aggregates. Looking at a big number and try to push it upward, and instead looking at patterns: where's the money going? Which sectors have been artificially bloated and need to come back down to size, and which others need to expand correspondingly? I feel like I must be oversimplifying the nature of the debate, but am I?

KATES: Well you know, my problem all the way along is that I have found people impervious to seeing the point. Austrian economics carries on the classical tradition. The transitional text by Carl Menger — 1873 I think or something like that — it's a transitional text, and it is, for me to read it, just a classic. But the interesting thing — I don't know how interested you are in this part, but the interesting thing for me is the reason I got into reading Mill, I picked him up by accident and suddenly I realize I'm reading an 1848 book that is a refutation of Keynesian economics. And when I finally after many years unscrambled it, it turns out that Keynes gets the idea of demand deficiency from Malthus, so that Mill, for all practical purposes, is trying to explain what's wrong with Keynesian economics. But by the time you get to Menger, the interest that they have then, that had gone. The general glut debate had been resolved. No one was going to argue that demand deficiency caused recession.

But the new problem was the Marxist and socialist views that somehow — and in fact it's interesting, Marx is one who argued like Keynes that overproduction was the cause of recession. So here you have the Austrians who are dealing with a different kind of problem. They were trying to explain what was wrong with socialism, and so the same kinds of arguments that had existed when dealing with the general glut debates suddenly were reconfigured to explain what was wrong with socialism and why in particular the labor theory of value didn't work. So the marginal theory of productivity theory of wages and distribution gets crafted to explain a different kind of issue.

But the funny thing is that while they were doing that, to some extent the eye was taken off the ball of the original issue, which was the general glut issue, the Keynesian demand deficiency issue. So by the time you get to 1936, the original notions behind why the general glut had been argued out, why people had agreed that demand deficiency couldn't happen, all that is gone. And so it's only a weak read, and Keynes just blows it over. There isn't that kind of understanding, especially amongst the younger generation economists who were coming up.

And so you get this thing established, and to go a bit further, what establishes it? You have Keynes writes this really obscure — I mean, really obscure, very difficult to read, even today when you think you know what he's saying, it's difficult to read. In 1937, you get a paper put out by a guy named John Hicks, and this has become the staple textbook explanation of Keynesian economics. It's pretty good, but it's not what he called — it's not a proper explanation of classical economics. But he calls Mr. Keynes and the classics, and he pretends he's explaining both. Then you come to 1948 and

Paul Samuelson invents the 45 degree line and Y = C + I + G, the basic economic framework that every student of economics learns for the subsequent 35 years. And so it's just drilled into your head. Get an economist for the first seven years and you've got him for life.

And so to this day, it's impossible, in fact impossible, for people to see that demand cannot possibly create the supply that they're buying. Supply is created by business people who are trying to think what would those people out there buy. They produce and then they find out whether they're right or wrong, but it's never demand that pulls, it's supply that pushes.

WOODS: And of course, in order to demand anything, you can't just stomp your feet in the colloquial sense of the word "demand." You have to have something with which to demand. You have to have the fruits of some previous production yourself in order to demand anything in exchange. And so production is, of course, at the heart of it. And once you get that basic logical priority of production over consumption, it becomes so much easier to understand real economics. And yet, it's such a simple insight that I have to feel like maybe I'm just not sophisticated enough to understand what the Keynesians are saying, because surely they can see what I see.

KATES: Ah, but you see, everybody can see that if they had, whatever amount of money they have now, they had more, they'd be able to buy more. So it's true for any individual. In the same way, if a counterfeiter goes out and counterfeits some money and goes and spends it, well, they haven't produced anything, but they can spend. Same for an individual.

The point about all of this is that it's an aggregate issue. It's a national economy issue, it's the whole economy, so for any individual, we can be given money by the government, we can be paid welfare and that's great. We can say, well, fantastic; we have more money; I can spend. And it looks as if it just requires somebody giving me money. And behind, though, the actual structure of the economy and the whole lot of it and everything there that allows your money to be turned into goods and services is totally forgotten.

And this is part of the way that I think Keynesian economics is able to be sold, because it looks as if you give me more money, you give me an extra $1000, I can spend more, and I can buy more. But if you give everybody an extra $1000, nothing happens, because everybody would just go out with that extra $1000, spend the money, and there's still no more extra there in society from which to buy.

WOODS: Before I let you go — I probably should let you go now, but too darn bad; I've got one more question for you. What about the issue of hoarding? Even today you will sometimes hear Keynesians who have nothing good to say about the so-called hoarder, which is simply somebody who's added to his cash balance beyond a level that the Keynesian considers reasonable. What is the alleged crime of the hoarder, and why is it actually something that does not have, I assume in your view, bad economic consequences? You could imagine people thinking it does. This hoarder isn't contributing anything. He's not keeping the circular flow of money going, and so therefore he's leading to a slow down and a downturn, and that's bad. Why is it not bad?

KATES: Well, you see, it's one of those ideas that everybody thinks of saving in the sense of saving as putting money away. It's a non-active something you're doing, so if I personally save, if anybody saves, they say ah ha, I take my income, whatever it was, and I take part of that, and I put it in the bank, and therefore I just might as well take that money and put it in a strong box and bury it in the backyard. So saving for an individual is clearly someone not spending.

But if you say okay, that's great for you as an individual, how about we talk about national saving? How does a country save? How does the whole United States save? What does the United States do to save? We talk about national savings — what is that? And obviously it's not America going out and putting money in the bank. America doesn't put money in the bank. The government doesn't put money in the bank. That's not what causing national saving. What national saving is if you understood it properly, national saving is using your resources — forget about money — using your resources in a productive value-added way.

And you say, ah, maybe these people don't want to use their resources. Why aren't they using resources? The reality is, of course, that if you own capital, as in a machine — you actually have a shop front, say, and you are renting out your shop to somebody who comes by and wants to put up a store or a restaurant or whatever, and your previous tenant moves out, you don't go, oh, well, forget about that. Nobody hoards the actual physical assets that they can use to earn money. Money just turns over, no matter what you do. If person over here, A, has $1000 and he gives it to person over here, B, so A has $1000 less and B has $1000 more, well, we've still got the same $1000. The money still exists. The money doesn't disappear.

But the question really at the bottom of it is, what's happening to resources. National saving, if you think of savings in terms of the national economy and the relation to the money, you've completely lost the plot. You will not see what's going on, because national saving has to be understood as that proportion of your resources that you are using for investment purposes. That's how the classical economists thought about it.

And a Keynesian model only thinks about newly produced investment goods. They forget about the entire infrastructure that's been here from time immemorial. We have roads and electricity generation plants that have existed for years and years and years, and these are what constitutes your saving. When they are used to produce value-adding goods, when your electricity is driving factories and turning on lights in businesses, this is what saving actually is. We are using resources, part of the productive process.

But if you go and think with money, like I've heard so often, you have lost the idea of what's underneath it. You couldn't even begin to explain what saving consists of. Hoarding, of course, during a recession when things are really bad, everybody sort of becomes a bit more wary, and that has always been the case, but that is not the same thing as hoarding as a Keynesian describes it, which is hanging onto money, which is absolutely a ridiculous way to think about an economy, which is actually built on the underlying productivity, which is what drives our economic prosperity.

WOODS: So in other words, by saving, what I'm really doing is freeing up resources, making resources available for people who want to invest them in the expansion of some production process or the purchase of capital equipment or whatever. By my not expending the resources, I'm making them available for the productive expenditure by somebody else, that that's a better way to think about the act of saving.

KATES: That's right, it's a perfect way, it's the only way — I'm telling you, you said that exactly right, that's exactly right. If you think of it in terms of money, you're just going to lose it. If you think of it in terms of what are resources being used for — I mean, Solyndra is a perfect example. Say, oh look, we're pouring our money into this asset, which of course the cost of it is well beyond the end benefits you're ever going to get out of it. So it's not even just you're using resources. You have to be using them in a value-adding kind of way. But before you can use resources, there has to be, just like you said, that saving, and the saving actually exists in real terms, not money terms.

WOODS: Well, Stephen Kates, I appreciate your time and your willingness to figure out the time zone issue between us here on two sides of the world. Very kind of you. I'm going to direct people to your book, *Say's Law and the Keynesian Revolution: How Macroeconomic Theory Lost Its Way*. We'll link to that on today's show notes page. This is Episode 476, so it'll be TomWoods.com/476. I'll also link to your work on this, your articles that people can read, and to your — I suppose you have a professional page I must have here in my notes — I'll link to that as well. Thanks again for your time. We all appreciate it.

KATES: And thank you very much. I appreciate it myself.