

How Keynesian Economic Theory Contributed to the Financial Crisis

By Robert Genetski

It has been three years since the worst financial collapse in modern history. While much has been written about events surrounding the crisis, there is a deep sense of unease over what happened and why. Key policymakers dealt with the crisis through the application of the *Keynesian* economic theory. Understanding why the theory failed is crucial to avoid repeating the mistakes that produced such painful consequences.

US Treasury Secretary Hank Paulson's book, *On the Brink* (Business Plus, Grand Central Publishing, 2010) provides an insightful, first-hand account of how and why policymakers responded as they did at each stage of the developing crisis. Paulson's conclusion is shared by many. He believes his decisions, along with those of Fed Chairman Bernanke and Tim Geithner (then President of the New York Federal Reserve), saved the economy and the financial system from another Great Depression.

An alternative interpretation is the financial crisis resulted from a series of policy mistakes by each of these policymakers. A close look at the events and policy decisions during this period reinforces the alternative explanation. As the financial situation deteriorated in response to each policy mistake, the key players appeared oblivious to why things kept getting worse.

For example, on October 9th, after successive policy moves failed to contain the damage, White House Chief of Staff Joshua Bolten raises an important question: "I just wonder, Hank, why after all the steps we've taken to stabilize the market, are the markets not responding?"

Paulson's response: "Josh, I wonder exactly the same thing." (Paulson, p. 346).

The reason financial markets failed to respond as these policymakers expected is their decisions were based on a flawed economic theory. Each of the key US players—Paulson, Bernanke, Geithner and President Bush—view the economy from a *Keynesian* economic perspective. All were educated at Ivy League schools (mainly Harvard). All were instructed in *Keynesian* economic theory. Apparently, none of these key policymakers were aware of an alternative *classical* economic perspective, which provides a very different interpretation of economic events and how to deal with them.

Keynesian theory assumes when government increases its spending or provides credit to various entities, it adds to the total amount of spending or credit. The alternative *classical* economic theory assumes government spending and loans come at the expense of private spending and credit. From the *classical* perspective a government move to boost spending or credit to one area of the economy simultaneously weakens another area.

A second distinction between the two competing theories relates to monetary policy. The *Keynesian* view emphasizes the importance of interest rates as a guide to the amount of money or liquidity in the economy. The *classical* view downplays the importance of interest rates and focuses instead on the amount of money and liquidity in the banking system.

A final distinction between the two theories relates to the role of confidence. The *Keynesian* view assumes confidence plays a leading role in determining the economy's performance. In contrast, *classical* economic theory views confidence as a consequence of economic conditions. Constructive policies improve those conditions and boost confidence; destructive policies make conditions worse and undermine confidence.

Various accounts of financial crisis indicate policymakers consistently relied on a *Keynesian* perspective to formulate economic policies to deal with the financial crisis. In so doing, they contributed to the financial crisis.

The Gathering Storm

Some background on events leading up to 2008 is important to understand key policy decisions surrounding the crisis. From 2001-05 the Federal Reserve had adopted a highly expansive monetary policy. One key measure of money is bank reserves, which represent the raw ingredients of the money supply. (All references to bank reserves in this article refer to the St. Louis Federal Reserve series on adjusted bank reserves less excess reserves.)

Bank reserves are the first step in the Fed's money-creating process. They are the one measure of money completely under the control of the Federal Reserve. When the Fed creates bank reserves, the banking system transmits the newly-created reserves into more spending. When banking institutions are increasing their leverage, the pace of spending tends to increase at a faster rate than the increase in reserves. When leverage in the banking system is contracting, spending tends to increase at a slower pace than the increase in reserves.

From 2001-05 the Fed increased bank reserves at a 5% yearly rate. Typical lags combined with an increase in leverage in the banking system combined to produce a 6%-7% yearly increase in current dollar spending (GDP) from 2002-06. The increase in bank reserves provided the liquidity for a speculative boom in housing as well as institutional leveraging for the boom that preceded the financial collapse.

The Federal Reserve first began responding to this excessive stimulus in mid-2004 when it began raising its target interest rate from 1%. By the end of 2005, its target interest rate was increased to 4%. This fourfold increase in the Fed's targeted interest rate was sufficient to reign in the creation of new reserves. During 2005 bank reserves were essentially unchanged.

The lack of growth in bank reserves led to a slowdown in spending beginning in the spring of 2006. By the end of 2006, the pace of current dollar spending had slowed to 5%. In spite of the slowdown, the Fed continued to increase its target interest rate. The rate hit a peak of 5¼% in the late 2006. This increase in the Fed's target interest rate reduced the amount of bank reserves in both 2006 and 2007. By the end of 2007 bank reserves had were 3% less than they were in 2005. From a classical perspective, the Fed had shifted to a restrictive policy.

In late 2007 the spending pace continued to slow. In response to the slowdown, the Fed began to reduce the fed funds rate. By the summer of 2008, the Fed's target interest rate was down to 2%. From the *Keynesian* perspective, the decline in its targeted interest rate was consistent with an expansive monetary policy. From a *classical* perspective monetary policy was highly restrictive since the decline in interest rates failed to increase bank reserves. When economic conditions change rapidly, interest rates can be a very poor guide to monetary policy.

In the summer of 2008, bank reserves remained 3% lower than the level that existed 3½ years earlier. This lower level of bank reserves was consistent with a further slowdown, perhaps even a decline in current dollar spending. By the spring of 2009 year-over-year current dollar spending had fallen by 3%. A highly unusual multi-year decline in bank reserves was followed by the first year-over-year decline in current dollar spending in over half a century.

Critical Policy Decisions

Paulson's discussion of the deterioration in the US economy in 2007 and 2008 is insightful. Throughout he shows how policymakers never considered the slowdown in spending and developing lack of liquidity might be related to Fed policy.

In a speech he delivered in April, 2007 Paulson told audiences how the subprime mortgage problems were “largely contained” (Paulson, p. 66). Bernanke made similar comments in July, 2007. Paulson admits he and Bernanke were wrong. He says their problem was “We missed the dreadful quality of the most recent mortgages....” (Paulson, p. 66)

However, Paulson also notes, “We were in the midst of a general credit bubble. Banks and investment banks were financing record-size leveraged buyouts on increasingly more lenient terms.” (Paulson, p.69) Hence, Paulson clearly recognized the real problem extended far beyond the housing market.

Confusion with respect to the role of monetary policy continued throughout this period. Paulson relates how in mid-November of 2007 the Fed pumped \$47 billion in temporary reserves into the banking system, “...its biggest injection since 9/11.” (Paulson, p. 83) The next month the Fed lowered its targeted interest rate to 4¼%, a full percentage point below where it had been only three months earlier.

In spite of what was widely thought to be an expansive monetary policy, data on bank reserves reveal a different outcome. In November, 2007, reserves increased by only \$2 billion. In December they declined by \$4 billion. This pattern occurs throughout Bernanke’s tenure. The Fed announces major changes in monetary policy involving tens or even hundreds of billions of dollars in purchases or loans. Fed data then show changes in bank reserves for are often unrelated to the Fed’s announced policy.

Meanwhile, Paulson and Bernanke deal with the developing crisis by addressing specific individual problems. As the Fed was removing reserves from the economy in December, 2007 it announced a new program—Term Auction Facility (TAF)—designed to lend funds to depository institutions (Paulson, p. 84). This was a prelude to numerous unique attempts by both the Administration and the Fed to solve problems related to a specific company or industry. While policymakers were focusing on solving these specific problems, the Fed was removing reserves and contributing to a shortage of liquidity in the overall economy.

By January 2008 it became readily apparent the economy was getting worse. Instead of looking for the reason liquidity was drying up, Paulson and Bernanke perceive the problem as a lack of confidence. In an attempt to boost consumer confidence, Paulson recommends a \$150 billion “stimulus” program including one-time tax rebates and tax breaks to encourage business investment. The idea is to put money in the hands of people so they would spend it.

Keynesian economic theory assumes when government provides people with more money it raises their confidence and has a multiple effect on boosting spending throughout the economy. *Classical* economic theory assumes there is no increase in demand from government spending. Instead, government borrowing to fund the spending reduces the amount of credit available to others. The reduction in available credit produces less spending in other areas. This offsets the increase in demand from government spending.

During the spring of 2008, as consumers received and spent their tax rebates there was a brief one quarter increase in demand. Current dollar GDP, a measure of overall demand, increased by 1% in the spring quarter. This compares to no increase in both the preceding and subsequent quarters and is generally consistent with normal quarterly fluctuations. If they did anything, the impact of the tax rebates was merely to shift demand from one quarter into another.

From a *classical* perspective demand is primarily dictated by Fed policy. Any temporary boost from government spending would be offset by the reduction in credit from the increase in government borrowing. The overall impact of such fiscal manipulation is only positive if the benefits of the government’s spending outweigh the costs to those who are denied credit due to

the government's borrowing. Since the market tends to allocate credit to its most efficient uses, policymakers' decisions to reallocate it to other areas will tend to weaken, not strengthen the economy. The weakness in the economy throughout the spring and summer of 2008 is consistent with this *classical* view.

Paulson describes how the financial climate continued to deteriorate in spite of the fiscal stimulus. As each new problem emerges, Paulson and Bernanke focus on the need to boost confidence. Their focus on confidence as a causal factor seem to prevent them from identifying the role Fed policy was playing in restraining money and liquidity.

Paulson, Bernanke and Geithner address each new problem as it develops—from the failure of Bear-Sterns to the deterioration of Lehman and onto the government sponsored enterprises (GSEs) Fannie Mae and Freddie Mac. They attempt to devise a specific solution for each new emerging crisis. As the economy continued to deteriorate, not only did each specific problem become worse, new problems emerged.

The Liquidity Crunch

Fannie Mae and Freddie Mac were among the more serious of troubled financial institutions. They had hundreds of billions of dollars in debt and were losing billions of dollars each quarter. These agencies were created, sponsored and regulated by the US government, but were privately owned. Common stock was owned by the public, but its preferred stock was owned mostly by banks. Bank regulators had encouraged banks to buy preferred stock in these enterprises. In response, banks reportedly owned \$30-\$36 billion of preferred stock in Fannie and Freddie.

In July, 2008, amid massive losses at the GSEs, Paulson sought and received Congressional approval for Treasury to bail out the GSEs.

The legislation gave us broad discretion to provide financial support to the GSEs as we saw fit. ... The legislation did not impose any limitations on the amount of that support, except that it would not be exempt from the debt ceiling....it was perhaps the most expansive power to commit funds ever given to a Treasury secretary. (Paulson, p. 155)

Astute financial experts knew the US Treasury had a difficult problem resolving the GSEs' preferred stock problem. In late August, one analyst described the problem:

Now that Fannie and Freddie are in trouble, the government is in a bind. After encouraging banks to buy FNM/FRE preferred by loosening regulations, they cannot easily make the banking sector take \$36 billion of writedowns on securities that banks only invested in because of strong government incentives.

...

We are curious to see how the government will get out of that quagmire. Taking too steep a haircut on the preferred is out of the question due to the risk of further credit contraction. \$36 billion of writedowns decreases banks' lending capacity by at least \$450 billion. (Kirchner, Lawrence, *Seeking Alpha*, August 28, 2008)

With Treasury's unlimited authority to deal with this problem, Paulson (along with help from Bernanke, Geithner and others) did what Kirchner and others believed was out of the question.

On Friday, September 5th Treasury announced its solution to the "quagmire." Treasury would guarantee all the GSEs' hundreds of billions of dollars in debt. However, it would place Treasury in a senior position to preferred stockholders. This meant if any money were ever recovered from the GSEs it would go first to the US Treasury. Given huge cost of bailing out

the GSEs' debt, this meant the preferred stock would be essentially worthless. In effect, Treasury had overnight eliminated well over \$20 billion in bank equity, which supported well over \$200 billion in loans and investments.

Those following the Fannie-Freddie fiasco were stunned. They could not imagine a move that would trigger a major shortfall in liquidity in the midst of a financial crisis. In spite of highly-detailed descriptions surrounding many of his decisions, Paulson says nothing about this fateful one. It is a decision that produces an immediate collapse in financial markets. Within a week, a struggling Lehman declares bankruptcy, AIG follows and problems quickly spread not only to the entire banking system but also to money market funds.

Less than two weeks after this decision Paulson appears shocked to discover that "...all hell broke loose." (Paulson, p. 228) and "Liquidity was evaporating all over the place." (Paulson, p. 231)

Bernanke tells President Bush, "Mr. President, we are witnessing a financial panic." (Bush, George, *Decision Points*, Crown Publishing Group, 2010, p. 439)

With the financial system imploding, Paulson opts for a second bailout. Treasury had committed most of what at the time was an \$800 billion source of funds to bail out the GSEs. Since the situation was now worse, Paulson tells the President he will need another \$700 billion to shore up the financial system. When the President and Vice President press the Fed on what else it can do, Bernanke reportedly claims the Fed is impotent.

Ben insisted that, legally there was nothing more that the Fed could do. The central bank had already strained its resources and pushed the limits of its powers. The situation called for fiscal policy and Congress needed to make the judgment. President Bush pushed him, but he held firm.

"We are past the point of what the Fed and Treasury can do on their own," Ben said. (Paulson, p. 257)

This, of course, is wrong. The Fed has unlimited authority to create bank reserves and restore liquidity to the banking system. This was the reason the Fed was created. There is no limit on the amount of securities it can buy. The Fed can also reduce reserve requirements to restore liquidity. In fact, the Fed had spent the previous three years doing just the opposite, taking reserves out of the banking system and contributing to a lack of liquidity.

Bernanke had fallen into the *Keynesian* trap. He apparently assumed low interest rates meant the Fed had supplied sufficient liquidity to the banking system. He may also have relied on certain distorted measures of money that showed rapid growth. During periods of great stress bank deposits can increase dramatically as people seek the safety of government insurance for their money assets. Shifts in assets from one type of money asset to another can distort some of the more conventional money supply numbers. Whatever the excuse, Bernanke's advice was simply wrong. This would have been apparent to any policymaker familiar with the *classical* economic perspective. Unfortunately, all key policy positions were filled with those following the *Keynesian* perspective.

From a *Keynesian* economic perspective, all the government's bailout funds would add to total spending and therefore help stabilize the financial system. From a *classical* economic perspective, government assistance comes at the expense of taking funds from where market determines those funds are most needed. Hence, every dollar of funds intended to help the banks, auto companies or anyone else is at the expense of others who would no longer have access to that credit.

The temporary exception to this *classical* economic perspective of a closed system occurs when the Federal Reserve uses its tools to add or subtract money and liquidity. Unfortunately, instead of restoring liquidity the Fed inadvertently reduced it in the midst of the financial meltdown.

The reduction came in October, 2008 when the Fed began paying banks to keep their reserves with the Fed. Although the Fed offered to pay only ¼% for the funds, the rate was very attractive given existing financial conditions. So long as banks choose to keep reserves with the Fed instead of using them for loans and investments, the reserves cannot increase liquidity. It is similar to the Fed raising reserve requirements. The only distinction is that raising reserve requirements makes it mandatory to keep reserves out of the economy. Paying banks interest to keep reserves out of the economy makes the decision voluntary.

In October, 2008 the amount of bank reserves used for loans and investments dropped to \$79 billion from \$99 billion in September. Under the assumption of a ten to one leverage ratio, this \$20 billion bank reserve reduction was equivalent to removing \$200 billion in liquidity out of the banking system. Instead of flooding the system with liquidity, the Fed's policy removed 20% of the banking system's reserves in the face of the worst financial crisis since the 1930s. (The following month the Fed began restoring bank reserves. Within two months the worst of the crisis had passed.)

A month after the fateful decision regarding the GSEs preferred stock Paulson provides hints he may have, or at least should have, recognized the impact of destroying bank capital. In early October, he has this to say:

“From the start of the credit crisis, I had been focused on bank capital, encouraging CEOs to raise equity to strengthen their balance sheets....

...

Initially, when we sought legislative flexibility to inject capital, I thought we might need it to save a systemically important failing institution. ...now I realized two crucial things: the market was deteriorating so quickly that the asset-buying program could not get under way fast enough to help. ... We knew the money would stretch much further if it were injected as capital that the banks could leverage. To oversimplify: assuming banks had a ten-to-one leverage ratio, injecting \$70 billion in equity would give us as much impact as buying \$700 billion in assets.” (Paulson, pp. 336-337)

What Paulson's book gives keen insight to into is how Paulson, Bernanke and Geithner are belatedly concerned with restoring bank capital only after their decision a month earlier which had the effect of dramatically reducing bank capital.

According to Paulson, he Bernanke and Geithner continually assured President Bush and Vice President Cheney the Fed had done everything it could to increase liquidity. The Fed's data on bank reserves indicate this was not the case.

President Bush apparently relied on Paulson, Bernanke and Geithner to guide his decisions. According to Paulson, “the president said he had a simple test for making a decision on this: ‘If Hank Paulson and Ben Bernanke say it's going to work and help stabilize the financial system we are for it.’” (Paulson, p. 296)

Misdiagnosing the Crisis

The president, along with so many others, accepted the popular notion advanced by these three as to what caused the financial crisis. In his book, *Decision Points*, the President says,

“I was furious the situation had reached this point. A relatively small group of people—many on Wall Street, some not—had gambled that the housing market would boom forever. It didn’t.” (Bush, p. 440)

And, in an equally insightful look at both a lack of historical knowledge and his own *Keynesian* framework, the President concludes, “If we’re really looking at another Great Depression you can be damn sure I’m going to be Roosevelt, not Hoover.” (Bush, p. 440) President Bush is clearly unaware that under Roosevelt, after eight years of following *Keynesian* policies the unemployment rate in 1939 was more than 17%.

Paulson provides several hints certain foreign officials had a better grasp on events than US officials. For example, Chinese officials (who are familiar with the *classical* economic framework) are consistently more accurate in their assessment of US financial problems than our own officials. There is also a telling conversation in October, 2008 between President Bush and France’s President Sarkozy, who wants to discuss detailed financial reforms.

“That’s not for us,’ President Bush said. ‘We’re going to have our experts do that.’

The French leader came right back at him. ‘These experts are the ones that got us in trouble in the first place.’” (Paulson, p.375)

Looking back at the challenges and decisions surrounding the financial meltdown of 2008 several things are readily apparent.

1. Key policymakers all used the *Keynesian* economic perspective to assess what was wrong and to formulate policies to help promote financial stability.
2. Policymakers were continually surprised to find that after implementing their proposed solutions, the financial situation became progressively worse instead of better.
3. By relying on interest rates instead of assessing bank reserves and the existence of financial leverage the Federal Reserve often ended up with a monetary policy opposite to what it intended.

The recent financial crisis provides important lessons of how the *Keynesian* economic perspective produced a series of policy mistakes. These mistakes continued to the point where they created the worst financial collapse in modern time. So long as policymakers continue to use the *Keynesian* framework to develop economic policies, the potential for another financial crisis is uncomfortably high.

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