Keynes, Marx and the effect of QE

One of the interesting sessions at last weekend's Historical Materialism conference (apart from my session, of course) was one on the work of Suzanne de Brunhoff. Brunhoff was a Marxist economist from the 1970s onwards who specialised in Marx's theory of money and applying it to the conditions of modern capitalism. She died this year. There is no space to deal with her contributions here. What I want to take up from the session was a presentation by Maria Ivanova of Goldsmiths University, London. Ivanova made some key observations about Marx's theory of money, but also of Keynes. She pointed out that, in his Treatise on Money written in 1930 at the start of the Great Depression, Keynes argued that central banks would have to intervene with what we now call 'unconventional monetary policies' designed to lower the cost of borrowing and raise sufficient liquidity for investment. Just trying to get the official interest rate down would not be enough.

As a recent paper from the Levy Institute put it: *"In the penultimate chapter of volume 2 of the Treatise, Keynes raises the question of the ability of the monetary authority to influence the price level…despite his doubts, Keynes nonetheless answers his own question in the affirmative, urging central bankers to adopt extraordinary, unorthodox measures in an attempt to counter the deepening recession."* Keynes proposed: *"My remedy in the event of the obstinate persistence of the slump would consist, therefore, in the purchase of securities by the central bank until the long-term market rate of interest has been brought down to the limiting point, which we shall have to admit a few paragraphs further on. It should not be beyond the power of a central bank (international complications apart) to bring down the long-term market-rate of interest to any figure at which it is itself prepared to buy long-term securities."* So here we have it in 1930: it's quantitative easing (QE) as advocated and implemented by the self-proclaimed saviour of the financial crisis, Ben Bernanke at the US Fed and later adopted by other central bankers.

In the Treatise, Keynes was convinced that such measures of buying government bonds and boosting fiat money quantity rather than just trying to lower the price of short term money would be effective *"Thus I see small reason to doubt that the central bank can produce a large effect on the cost of raising new resources for long-term investment, if it is prepared to persist with its open market policy far enough."* This would work because it would increase 'liquidity' in the banking system and it would also raise 'confidence' (that 'fairy dust' of modern economics) by convincing investors that the low cost of borrowing was here to stay. The latter point presaged the theory of modern monetary economist, Michael Woodford, who was a big influence on Bernanke, who claimed back in 2010 that QE would work in the same way. As Keynes puts in the Treatise: *"The remedy should come, I suggest, from a general recognition that the rate of investment need not be beyond our control, if we are prepared to use our banking systems to effect a proper adjustment of the market rate of interest. <u>It might be sufficient merely to produce a general belief in the long continuance of a very low rate of short-term interest rate</u>".*

Well, was Keynes (followed by quantity of money theorist Milton Friedman and the modern monetarists like Bernanke and Woodford) right? Did QE restore investment and economic growth through increased 'liquidity' in the banking system and by raising 'confidence and expectations'? Clearly not. The Bank of Japan adopted such measures through the 1990s with little success in restoring investment and economic growth. The QE adopted by the Fed, the BoE, the BoJ and, more recently, the ECB, may have put huge amounts of cash into the banks and inspired speculation into 'higher-yielding' assets like bonds and stocks, and even boosted the cash hoards on large non-financial firms, but it has not restored business investment and economic growth to pre-crash levels.

As Brunhoff explained, Marx's theory of money argues that there are three functions of money: as a means of payment or circulation; as a measure of value; and as a store of value. A monetary economy provides the possibility of hoarding, taking money out of circulation to preserve its value. In a slump or crash, capitalists try to hoard and avoid investment. If profitability stays low, then even a low rate of interest or mountains of 'liquidity' will not release that hoard, or the 'liquidity trap', as Keynes called it. You can lead a horse to water, but you cannot make it drink. So no matter how much cash the central bank pumps in by buying government or even corporate securities, investment does not recover. It's like pushing on a string. Such was the argument of Marx against the quantity on money theorists during the banking crisis of the 1840s.

But nothing changes. It is ironic that at the same time the huddled groups of Marxists were debating these issues at the HM conference in London, the IMF was holding an extravaganza debate on the 'success' of unconventional monetary policy at its much more august venue in Washington DC. Over two days, all the illustrious from Ben Bernanke, Claudio Borio, Adair Turner and Paul Krugman were present to hear papers by top monetarist economists.

And what did they conclude? Here is a flavour: One economist from the LSE commenting on QE found that: "*Yet, there is little evidence that the program led to an increase in credit.*" Some Fed economists considered the macroeconomic effect of QE. They concluded that *"our analysis suggests that the net stimulus to real activity and inflation was limited by the gradual nature of the changes in policy expectations and term premium effects, as well as by a persistent belief on the part of the public that the pace of recovery would be much faster than proved to be the case."* Then some European economists looked at the impact of the ECB's QE. They found that QE *"significantly reduced bank risk and allowed banks to access market based financing again. The increase in bank health translated into an increased loan supply to the corporate sector, especially to low-quality borrowers. These firms use the cash inflow from new bank loans to build up cash reserves, but show no significant increase in real activity, that is, no increase in employment or investment".*

So it seems that Keynes' original belief was wrong that QE could get a capitalist economy out of a slump by pumping banks and companies with cash or keeping bond rates permanently low. Indeed, let us return to Keynes. By 1936 after five more years of depression (similar to the time post the Great Recession now), Keynes became less convinced that 'unconventional monetary policies' would work. In his famous General Theory of Employment, Interest and Money (GT), Keynes moved on.

As the Levy Institute paper notes: *"What has not been borne out is the expected impact on the rate of investment. Businesses have indeed increased their borrowing, and the spread between corporate junk bonds has fallen to near-historic lows as companies seek to borrow at historically low interest rates. However, these funds are not being used to finance new investment. Similarly, banks have accumulated record levels of reserves in their deposit accounts at the Fed, earning the short-term interest rate, which is nearly zero. Thus, the policy has been successful in influencing the interest rate in the way Keynes predicted, but it has not had the impact on investment that he outlined in the Treatise."*

Why did the policy of QE fail, according to Keynes? The problem was that *"The state of confidence . . . is a matter to which practical men always pay the closest and most anxious attention… because of its important influence on the schedule of the marginal efficiency of capital. There are not two separate factors affecting the rate of investment, namely, the schedule of the marginal efficiency of capital and the state of confidence. The state of confidence is relevant because it is one of the major factors determining the former"* (p148–49). Thus, *"there is no clear evidence from experience that the investment policy which is socially advantageous coincides with that which is most profitable. "*

So low interest rates and extra liquidity cannot get things going again, if the profitability of investment (what Keynes calls the 'marginal efficiency of capital') remains too low. Keynes concluded in the GT: *"I am now somewhat sceptical of the success of a merely monetary policy directed towards influencing the rate of interest. I expect to see the State, which is in a position to calculate the marginal efficiency of capital-goods on long views and on the basis of the genera social advantage, taking an ever greater responsibility for directly organising investment; since it seems likely that the fluctuations in the market estimation of the marginal efficiency of different types of capital, calculated on the principles I have described above, will be too great to be offset by any practicable changes in the rate of interest".* And so Keynes moved on to advocating fiscal spending and state intervention to complement or pump-prime failing business investment.

Many Keynesians are still wedded to QE, however. It is just that not enough QE has been done. We need to consider negative interest rates and 'helicopter money', named after the idea that the central bank should just drop cash from helicopters to people below to spend – the modern version would be to credit every household bank account with a few thousand dollars. The People's QE, advocated by some advising the new left-wing leaders of the British Labour party, is a variant of this approach. You might think these measures would work. But if you got $1000 suddenly in your bank account, would you spend it or instead save it for a rainy day or pay down some outstanding debt? It's not clear that 'helicopter money' would do the trick in boosting 'demand' and thus growth.

As Stephen Cecchetti has pointed out, these 'extreme' QE measures are really forms of fiscal spending as the government must be prepared to bail out the central bank if the helicopter money is not spent and never seen again. Funding banks to invest in the productive sector has gained some traction with the new EU infrastructure fund or the proposed National Investment Bank by the British Labour leaders.

The Keynes of the GT was classic or 'old Keynesianism' that was dominant in the post-war period. But with the failure of 'old Keynesian' macro-management in the 1970s (with stagflation), there was a morphing into 'new Keynesianism' and back to the efficacy of monetary policy, as in the Treatise. The 'old Keynesian' style fiscal spending is now mainly ignored or dismissed by mainstream economists as lacking credibility. But some 'old-style' Keynesians continue to press for running budget deficits and borrowing more to do the trick.

There is no space to show why Keynes's view in the GT for more government spending cannot deliver economic recovery in a long depression. I have dealt with it in several previous posts. Suffice it to say that Keynesianism ignores the barrier between fiscal spending and growth created by low profitability. The Keynesian multiplier (more government spending accelerates economic growth) is not decisive. The Marxist multiplier (higher profitability leads to higher growth) is.

Anyway, the days of QE have come to an end, at least in the US. The US Federal Reserve, after the recent strong employment figures, is preparing to raise its policy rate for the first time in nearly ten years! Some argue that the Fed's QE programme has done its job by counteracting the slump and fiscal austerity sufficiently and now monetary policy can return to normal. Other mainstream economists like Krugman, Summers, Stiglitz etc are worried that a Fed hike could push the economy back into recession. As we enter 2016, we shall find out.

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