Keynes, 'love of money' and the current crisis

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Outline

Premise

- *I also want to emphasise strongly the point about economics being a moral science. [A science that]…deals with introspection and with values […] with motives, expectations, psychological uncertainties* (Keynes 1938, CW 14, p. 400)
- *Whereas modern theory serves as a simulacrum of the economy – stylised and abstract to be sure – Keynes theory is a diagnostic instrument in the service of Doctor Keynes, consulting economic physician* (Hoover 2006, p. 78)
- *"The love of money is the root of all evils"* (1 Timothy 6:10)

Motivation

- *As the world economy spirals into a deep recession, Keynesian economics has once more become fashionable* (Farmer 2009a).
- The debate on Keynes and the crisis has been largely focused on anti-cyclical policies, their short and long-run consequences, exit strategies and international transmission mechanisms (e.g. Krugman 2008, Ferguson 2009, Steil 2009, Farmer 2009b).
- Considerably less attention has been paid to diagnosis with some recent notable exceptions (Leijonhufvud 2009a, Bateman *et al.* 2010).
- **This paper investigates the origins of the present crisis, with the aim of contributing to the literature reasserting the relevance of Keynesian ideas for the present time.**

Focus of the paper

- Smithian view: *Financial crises and deep depressions arise from one of the following: non-essential institutional flaws which prevent the market from working its wonders, the system of intervention contains openings which allow some dirty rotten scoundrels to operate or external shocks dislodge the economy".* (Minsky 1991, p. 5)
- Similar interpretations leave little room for psychological factors and for the idea that
- *The natural laws of development of capitalist economies lead to the emergence of conditions conducive to financial instability. Law and policymakers need to be aware of institutional evolution and to develop instruments to contain the potential for both inflationary surges and deflationary disruptions. Potential instability is a basic system characteristic.* (Minsky 1991, p.6).
- **This paper focuses on the Keynesian concept of 'love of money' and on its connections with the current crisis.**

Keynes on love of money

- *It seems clearer every day that the moral problem of our age is concerned with the love of money.* (Keynes, 1925)
- *Capitalism depends upon an intense appeal to the money-making and money-loving instincts of individuals as the main motive force of the economic machine' and 'love of money' ,'one of the most powerful of human motives'* (Keynes 1926).
- *The love of money as a possession - as distinguished from the love of money as a means to the enjoyments and realities of life - will be recognised for what it is, a somewhat disgusting morbidity.* (Keynes 1930).
- *Dangerous human proclivities can be canalised into comparatively harmless channels by the existence of opportunities for money-making and private wealth.* (Keynes 1936)

Love of money and capitalism

- *Keynes came to believe that the irrational love of money was the very motor of capitalism. The majority of human beings desire money for itself, and some prove themselves willing to transgress all moral boundaries to acquire it. […] To enrich oneself becomes to accumulate without end. There is no limit to the amount of money one can possess. The mark of success, of power, of notoriety, becomes a sum of money. We are "worth" the sum".* (Dostaler 2009)

- Love of money is love for the unlimited accumulation of liquidity *per se* as mark of personal success and shield against uncertainty and risk. It is a specific form of greed, greed for liquidity, for security and for social recognition in a competitive and uncertain world. It is one of those psychological forces which Akerlof and Shiller (2009), *possibly perpetrating a solecism*, would label *animal spirits*.

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The facts of the crisis

- 2000 A monetary policy for a time of war (De Cecco 2007)
- Lending spree and boom
- MBS, ABS, CDS, rating agencies … Casino runs
- 2004 Monetary restriction … the end begins
- August 2007: the day the crisis hit
- September 2008: Lehman, AIG and the others …
- Financial innovation, tight coupling and complexity
- Laissez-faire and finance: a dangerous mix
- Collapse and emergency
- Lending of last resort and nationalisation of private debts.
- Recovery?

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Love of money and the current crisis

- *When leverage is rising all around with everyone buying on credit, everyone is also merrily making money. The profits thus made reinforce the process. Meanwhile, securitisation of loans and credit default swaps serve to obscure rising risk. Competition forces even those firms and individuals who realise that risk is rising to follow along or else be pushed out of the game altogether. A loan officer who does not lend, a risk manager who does not go along, a manager whose bank branch does not grow will all be under threat to lose their positions. The pressure to run with the herd becomes hard to resist.* (Leijonhufvud 2009, p. 5)

- The huge **bonuses** paid in recent years in the financial industry, with their potential to create distorted incentives in favour of excessive risk-taking short –termism and aggressive competition, provide the **first most evident connection** between 'love of money' , as mark of social recognition, and the current crisis.

- At a **deeper level** 'love of money, love for the endless accumulation of liquidity to be multiplied by leverage with all risks shifted off to someone else by using derivative, appears to be essentially connected to **securitisation**.

- **Hedge funds as epitomes of love of money.**

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Bonuses

- **Sinclair *et al.* (2008)**, finds that bonuses can be particularly harmful especially when they are related to noisy indicators of performance over brief periods.
- **Burtless (2009)** confirms that, in the current crisis, many of the decisions about asset purchases and extensions of credit were made by senior managers who had financial interests that differed substantially from the long-term interests of the shareholders for whom they supposedly worked.
- **Kirkpatrick (2009)** confirms that remuneration and incentive systems have played a key role, causing the development of unsustainable balance sheet positions and that remuneration problems also exist at the sales and trading function level.
- **Friedman and Friedman (2009)**, in their analysis of the consequences of unethical behaviour in the context of the present crisis, conclude that conflicts of interest and the way CEOs are compensated are at the heart of this financial catastrophe.
- **Erkens *et al.* (2009)** find that firms that used CEO compensation contracts with a heavier emphasis on annual bonuses (as opposed to equity-based compensation) experienced larger losses during the crisis and took more risks before the crisis.
- **Taleb (2009)** argues the mismatch between the bonus payment frequency (typically, one year) and the time of financial crises (about five to 20 years) is the cause of the accumulation of positions that hide risk by betting massively against small odds.

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Securitisation and hedge funds

- At a deeper level 'love of money appears to characterise the recent process of financial innovation and in particular that form of (apparently) **riskless securitisation**. Securitisation responds to the desire for liquidity as a shield against uncertainty and as potential source of more liquidity and more security to be obtained through leverage and complicated insurance and re-insurance mechanisms.

- *In many cases banks provided the loans that were used to buy the ABS collateral that contained the mortgages the banks were trying to move off their balance-sheets! The hedge funds in turn could leverage by factors of 20, 30 or more to hold the ABSs. […] Banks would live on origination and servicing feed, while at higher leverage ratios, hedge funds could be profitable at low interest rate spreads. These low spreads, in turn, required extremely low default rates as well as layers of insurance and backup lines of credit. Ironically, much of the risk returned to banks in the form of loans made to buyers of securities, promises to buy back bad securities, and the relation with monoline insurers.* (Wray 2008, p. 18)

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Mainstream blindness

- *In mainstream economics Keynes is dead. Standard macroeconomics is now classical economics, even though it may appear to be constructed from Keynesian components.* (Chick and Tily 2004)

- Leijonhufvud (2008) explains the theoretical blindness of the economic profession *vis à vis* Keynesian interpretations of the current crisis to mainstream reliance on the market efficiency hypothesis, rational expectations and the representative agents

- Pecchi and Piga (2009): **Boldrin and Levine** attack Keynes for confusing real and monetary factors. **Phelps** sees Keynes disdainful attitude towards the quest for wealth as *unusual for an economist,* emblematic of anti-materialism and blind to the intellectual satisfactions in business life. **Ohanian** describes Keynes' attitude as that of a *judgemental and critical social commentator who uses his economist's pulpit to make a rather puritan-based vision of the future.* **Fitoussi** recognises that Keynes' rejection of capitalism, with its greediness and egoistic behaviour, is not *so badly founded* but labels Keynes' attitude *Elite Communism* and pities Keynes' contempt for the wealthy classes.

- **Absence of monetary illusion, money is no one's real object, no room for morals in a deductive science judgement neutral, love of money as motor of the invisible hand**.

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Conclusions

- Expansionary measures in response to the crisis may be useful in the short run but are unlikely to provide definitive to the problems posed by 'love of money' . Actually they will make it worse.

- In the medium run, regulation of compensation practices in the banking and financial industry and of financial innovation (take the bets away).

- **Persuasion and a new economic philosophy**

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