

The Affordable Mortgage Depression

Government policies were designed to increase homeownership. Affordable Mortgages, created to realize this goal, were responsible for the Housing Bubble and distorted the economy. The unwinding of these distortions will result in a Global Depression.

Why Keynes is Irrelevant

Two consecutive Presidents and Congresses have relied upon expansionary monetary policy, aggressive interest rate reductions and stimulus payments to counteract the economic downturn. The Government has undertaken direct intervention in the private sector and has endorsed record deficit-financed spending for the same purpose.

Many politicians and policy makers have recently and enthusiastically gravitated towards Keynesian Economics as justification for the Government initiatives. It appears that most of these politicians have no idea what Keynes actually proposed and how Keynesian Economics works.

An Introduction to Keynesian Economics

John Maynard Keynes was a smart man who developed an interesting and intuitively attractive school of economic thought. Mr. Keynes advocated government intervention within the economy to mitigate the naturally occurring highs and lows. By using fiscal and monetary policy Keynes believed a Government could mitigate the adverse effects of economic recessions, depressions and bubbles.

Why the Government Doesn't Have a Clue About John Maynard Keynes

Keynesian Economics recommends counter-cyclical policies to smooth the normal fluctuations in the business cycle. Keynes recommended expansionary fiscal and monetary policy during recessions and depressions. But he called for the reverse during boom-times.

If the self-serving politicians extolling the virtues of Keynes today actually subscribed to his policies, they would have advocated shrinking the Government, tightening credit and paying down debt during the Housing Bubble. Additionally, they would consciously be planning to reduce spending and pay back today's deficit spending after the recovery.

Current proposed spending calls for a massive, debt-financed increase in Federal spending for at least the next eight years. There is no effort to meaningfully reduce spending, balance the budget or repay this debt. Nor is there any record of such reductions in Government expenditures during the recent Internet, Housing and Consumer Spending Bubbles.

Debt-financed Government spending is by definition stimulus. Yet deficit spending is not by definition Keynesian. The President and Congress are inappropriately pursuing stimulus spending into perpetuity, rain or shine, boom or bust, in the name of Keynes. One is not actually practicing Keynesian Economics when only relying upon its directives during the downside of the business cycle.

Those newly-minted Keynesians in D.C. might also find it interesting that Maynard would have advocated cutting taxes during this downturn. He would also not have been as progressive as our politicians with respect to defining "tax cuts". Sending a check to someone who doesn't pay taxes is stimulus or welfare. Keynes would have been fine with such an initiative. But he would also have endorsed cutting the taxes of people who actually pay them.

Why Keynes is Largely Irrelevant to the Current Economic Downturn

In order for Keynesian Economics to be appropriate or have a chance to be successful a certain set of assumptions must present. Given the conditions that exist today, I believe that John Maynard Keynes would reject our Government's policies as an inappropriate response to the Affordable Mortgage Depression.

I am not arguing against Keynesian Economics. I am advocating that:

- Our politicians don't understand the theory
- Policy makers are not applying it correctly
- The conditions required for its successful application do not presently exist
- Asymmetrically applying Keynesian policies only during recessions is a formula for disaster

Keynes' theory revolves around the concept of an economy having a Full Employment Equilibrium. Each economy supports an optimal level of employment and utilization of resources. When unemployment goes above this level the country's labor and capital is being underutilized. The Government should step in and spend some money to get employment back to optimum and restore the equilibrium. When unemployment falls below the optimal the economy is getting overheated and the Government should reduce monetary expansion, raise interest rates and cut spending.

With respect to a recession, in order for Keynesian policies to work the downturn must be of a "normal" variety and responsive to such intervention.

Run-of-the-mill, business cycle recessions are driven by triggers including but not restricted to:

- Interest rates are too high and restrain growth
- Manufacturers build too many capital goods and inventories accumulate. In response, producers reduce production and employment
- Consumer confidence falls for some reason leading to decreased demand

In such circumstances the Government is responsive to the cause of the slowdown and fills the temporary gap created by reduced employment/production/wages/consumption with Federal spending. The government might lower interest rates, increase credit availability, increase monetary supply, spend more money or hire more employees.

In fact, the Government has already undertaken each of these solutions as a response to the current downturn.

But our present calamity does not resemble a "normal" downturn. Interest rates weren't too high, manufacturers didn't produce too much (of non-housing assets) and consumer confidence didn't fall of its own accord.

The Affordable Mortgage Depression is the inevitable collapse of a dozen-year long economic distortion. This pervasive bubble was created and perpetuated by disastrous institutional changes to how the economy operated which profoundly effected the decisions of companies and individuals.

The Housing Bubble collapsed under its own weight as overvalued prices supported by excessive debt were not sustainable. The Consumer Spending Bubble was driven by rising asset values, increasing leverage, unsustainably low savings rates and the widespread abuse of liquidity options. When housing went bust so did the source of much of the excessive consumption. When debt applied to overvalued assets stopped performing, the long-lived Credit Bubble collapsed as the risk premium returned to the market.

Despite the Government's best efforts, Keynesian policies have little effect on these deflating bubbles. The Government reflexively responded to the economic malaise without fully understanding its cause. Policy makers continue their attempt to fill a short-term gap in the economy with Keynesian stimulus. The problem is that the downturn is not short-term nor is it possible to bridge the recession and return the economy to its previous, unsustainable state.

An Illustration of How Keynesian Policies Have Not Worked

The housing collapse clearly demonstrates the limitations of Keynesian Economics. Interest rate policy does not matter in an environment where the price of overvalued assets is rapidly declining. The Federal Reserve has reduced overnight interest rates to zero. Mortgage rates have never been lower in U.S. history. Yet home prices continue to collapse and foreclosures are setting new volume records. The most dramatic Keynesian interest rate policy ever implemented has had no meaningful impact.

The futility of relying on Keynes to curtail the housing implosion is further undermined by the fact that mortgage rates remain well above the marginal rates once available through adjustable-rate and other affordable loans.

Keynes Can Not Be Arbitrarily and Rigidly Applied to Dynamic Situations

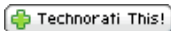
One can not arbitrarily apply Keynes' school of thought regardless of existing economic conditions. Keynes might happily have endorsed deficit spending, even massive deficit spending, if a Government had no existing debt or was maintaining a surplus.


He would certainly not have advocated perpetual deficits though. Keynes would not have blindly endorsed the idea of increasing spending irrespective of the resulting debt burden.

I have no idea where the appropriate cut off is for a healthy country's financial liabilities, but reasonable people are presently concerned about the viability of the Dollar and our solvency given the proposed levels of future debt.

Conclusion

To Keynes' credit, if he had been calling the shots over the last decade none of our current economic troubles would have occurred. He would not have allowed the creation of a Housing Bubble through Government intervention. Maynard would have aggressively restrained monetary policy, raised interest rates, reduced Government spending and potentially elevated taxes had any portion of the Housing Bubble mania manifest itself. I am not advocating Mr. Keynes' perspective, only lamenting that the newly converted Keynesians on Capital Hill didn't find religion before we inflicted this economic mess on ourselves.



Posted by Whitney Ross at [4/9/2009 9:26 PM](#) 

Categories: [Government Action is Counter Productive](#), [Housing Market Analysis](#), [Blind Leading the Blind](#)