

## Keynes and His Errors

Guest: G.P. Manish

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**WOODS:** Until recently, we actually thought Keynesianism was more or less dead. You can see the textbooks evolve away from it in the 1980s and 1990s. Now it’s back with a vengeance. Can you account for that?

**MANISH:** There are many reasons for that. I think one of the big reasons is that even though a lot of the conclusions or some of the policy prescriptions of Keynesians and Keynesian economics kind of went into the background, the conceptual framework of the Keynesian economics of the *General Theory* remained. When the crisis of 2008 hit, and lots of people were searching for answers, they unwittingly found themselves consulting an economic science whose fundamental concepts remained Keynesian. Some of the answers given also went back to what were given at the end of the Great Depression. I think that is one of the biggest reasons for the relapse.

**WOODS:** What was it exactly that Keynes was saying about the market economy? He wasn’t just saying that if there should by some strange fluke happen to be a depression, then you have to follow these policy prescriptions. He was talking more about the market economy in general. He was making broader claims. If you had to narrow it down to one or two claims, what it is that Keynes is saying about a market economy?

**MANISH:** He’s essentially saying that it’s inherently unstable, firstly. And because of the fact that it’s so affected by people’s psychological propensities—the consumption function, how much people are willing to expend on consumption or investment. These things are very unstable. Because these consumption/investment expenditures are both so unstable, the market economy is inherently unstable. It could reach full employment or high employment, or it could just completely spiral down into a chronic unemployment situation. Then there are no forces inherent in the market to get it out of that kind of funk of depression and low unemployment. So he wasn’t just making a claim about any one historical period. He was making a general claim about markets, and his claim is that markets can remain in a depressed state for a long period of time and can always lurch into it without any warning.

**WOODS:** Can you explain what the term “animal spirits” means? Keynesians feel like they’re being caricatured and not treated fairly, because people are not accurately explaining that concept. They’re saying animal spirits are just a psychological factor that we can’t really account for but which plays a substantial explanatory role in the Keynesian system. Are people being unfair to Keynes in the way they describe animal spirits, and what are animal spirits?

**MANISH:** Well, to some extent, maybe, and any economic term which becomes popular can get caricatured. Really Keynes’s whole discussion of animal spirits comes in his discussion of long-term expectations. So the way I understand the term, and the way he uses it, is essentially as a substitute for any kind of rational decision-making. Keynes’s essential point is that when you have a very capital-intensive economy, long-term expectations play a huge role in entrepreneurial decision-making. So, for example, if you’re going to invest in a steel mill or something like that, it has a lifespan of 15 to 20 years. How can you possibly form expectations about things which could affect the value of your investment over 15 to 20 years? For that reason, there is really no rational basis for making any entrepreneurial investments in these long-term projects, so people kind of just fall back onto these animal spirits, just these irrational kinds of random expectations, etc., of future possibilities. Then, of course, for Keynes there is also the question of the herd mentality in the market, in that if a few people do X then a lot of others are just going to follow like fish

swimming in the ocean, all doing the same thing, etc. And that again makes for an unstable investment environment. So it's going to be the same problems of instability in the market.

**WOODS:** What does he recommend as a way of coping with animal spirits? Is there any way to do that?

**MANISH:** He really doesn't recommend any way. One of his points is that the market is unstable, because investment expenditure or the amount that entrepreneurs will spend on various investment projects is because of these animal spirits, so it's just going to be completely unpredictable and totally random. Employment is going to fluctuate with that, because there's going to be no demand for employment in these investment industries. The only solution he provides is, of course, right at the end I think of chapter three, where he talks about the socialization of investment. There he says the government has to step in and essentially control the whole area of long-term investment. But then the question which arises is why aren't people who are in government also ruled by animal spirits? Just because you're in the government doesn't mean you become superhuman. In that sense, if you take Keynes seriously, there is really no solution. Though the market does have a solution in the form of the profit-loss mechanism, which Keynes of course didn't address.

**WOODS:** Do you want to address it?

**MANISH:** Sure. One of the big problems with the conclusions Keynes derives from what he says is that because of the fact that investors are ruled by animal spirits, the markets are going to be inherently unstable, and so we can conclude that the allocation of factors of production is not necessarily going to reflect any rationality. It's not going to be in line with consumer preferences. But what Keynes and even other people who use the concept of animal spirits I think seem to overlook is that of course there are certain entrepreneurs who are irrational, and there are certain entrepreneurs who make mistakes. But then there are others who succeed, so essentially the profit-loss mechanism allocates the pool of available capital to those entrepreneurs who succeed. And of course those who succeed and make profits are the ones who have guessed correctly.

So I think that even if you admit that, yes, investors could be irrational in their decision-making, you don't have to therefore conclude that the market is going to be irrational in allocating factors or even in the level of expenditure. As long as you admit the fact, which I think is a basic empirical observation, that different people are differently able to predict the future. So Warren Buffet, for example, is far better than I at being an entrepreneur, so that's why he has as much capital as he has, and I don't have much and nor will I try.

**WOODS:** Tell me if I'm wrong about this or if I've got the basic gist of it, and then I want you to elaborate on it. The title of Keynes's famous book begins with the words *The General Theory*.

**MANISH:** Right.

**WOODS:** So what he's saying here is that the classical economists had really, unbeknownst to themselves, been dealing with a special case. They had been dealing with the special case of full employment, where all resources and labor are gainfully employed. He says that's only a special case. As you were indicating before, there's no reason to expect that the market economy will settle on an equilibrium like that. It could just, as you say, continue to dwindle and move downward in a spiral of unemployment. Now if that's what he's saying, then why is he wrong to think that? Why is he wrong to think that the market is just as likely to be in that sort of unemployment or underemployment equilibrium, and why is he wrong to think that the market has no way of recovering from that?

**MANISH:** Okay, so let me take both points you mentioned in order. So first, Keynes was wrong in that he caricatured economists before him. Steven Gates has a book in which he talks about how Keynes completely caricatures the economists before him. Given some of the *General Theory*, you will get the idea that they never even thought about what could cause recessions and unemployment. Of course, that was

completely untrue. They did have a theory of recessions and unemployment.

Now, to come to the second point as to why we would not expect the economy to settle in that kind of recessionary spiral or recessionary equilibrium: the answer involves price flexibility on the market. That's how markets recover. As Austrian economists and even others have argued, when a boom turns into a bust you need price flexibility to reallocate resources back in line with consumer preferences, because what the boom represented was a misallocation of resources, which in turn was caused by meddling with the amount of money in the system and the creation of fiduciary media, as Mises would call it. Therefore, due to the mechanism of price flexibility, and especially the actions of entrepreneurs—who are always, of course, looking to make profits and therefore always trying to appraise the future, and always trying to move resources back to align in a way that is in line with consumer preferences—we would expect the market to use up resources in the best available way and to the best available level.

**WOODS:** Let's talk a little bit more about a common claim that we hear Keynesians make to this day about idle resources. They'll say that when you have an economy like we have now, and you have all these production facilities that are lying idle, and factories, not to mention individuals, laborers who are idle and not producing anything, then surely there can't be any reason not to favor some type of stimulus from the government side that would activate these idle resources into activity once again. In other words, you would have to be some type of free-market ideologue to think, "No, it's better not to kick start the idle resources into play. Let's just sit here and let everybody suffer." That's the way a lot of popular Keynesian renditions would put it. What do you say?

**MANISH:** Two points on this. Firstly, it's hard to even recognize what is idle in terms of economically idle. For example, if a manufacturer has a machine, and he chooses to not use it in certain times of the year when he thinks the demand for his product doesn't justify it, but nevertheless chooses to use it more intensively at other periods of time, economically speaking we cannot say that the machine was idle when he chose not to use it. Of course, physically it was idle. Similarly, if someone closes his hotel for let's say two months of the year you cannot say economically that that resource is idle. This point was made by William Hutt in his book *The Theory of Idle Resources*. Just by looking at a resource it's not really possible to conclude that it's economically idle, that it's not serving some purpose in the plans of some entrepreneur. That's the first point.

Now of course in the midst of a recession, one could argue that lots of these resources that are lying there unutilized are in fact economically idle in the sense that they are not really being utilized in any plan of any entrepreneur of any production process in any kind of economically rational manner. Just having concluded that they're idle doesn't necessarily mean that the cause of it is some market-led phenomenon. You could argue just the same that these resources are idle because of interferences into a market phenomenon or market processes. Like I said before, when a boom turns into a bust, if you do intervene in a large-scale manner into the market economy, then of course, you could argue that all of these idle resources are caused by such interferences into the price system. So just acknowledging that some resource is idle, however hard it might be to identify firstly—and Keynesians just use the term idle resources in a very unscientific manner sometimes—but even accepting the fact that they are idle, you don't have to conclude, therefore, that markets are to blame.

**WOODS:** Of course, you have to ask: why are the resources idle? What's the cause of this? Also, with regard to your first point about understanding the difference between "physically idle" and "economically idle," I don't know who it was who gave this example, but imagine a clothing store. There's a display of men's dress shirts and they're all priced at \$100 per shirt. They're not being purchased. At any time, the store could drop the price of those shirts to \$1 a shirt. They would clear away all of those shirts. Would it be right to say that those shirts are idle when they're set at \$100, or is it rather the case that the person selling them is waiting for an opportunity? He thinks that things will be better for him in the future if he keeps the price at \$100 and waits for a mutually advantageous transaction to take place. And that's what's going on, on a

large scale, in the wake of a bust following an artificial boom in the Austrian business cycle tradition. Am I right?

**MANISH:** Right. You are right. You could also use the same argument not only about clothes in a store but even the clothes in your own house. How many jackets do we all own, but how many do we wear every day? Do we rent the rest out? We don't, because we get utility just by having the jacket available to wear anytime we might expect it. Similarly, an entrepreneur like in the example that you gave is choosing to keep that dress shirt or whatever the product might be and reserve it and not sell it at any price below that \$100, because he expects people to be able to pay that \$100. Of course, like I mentioned before, because of the fact that entrepreneurs have different capabilities, you would expect some of these guys to get it right and some of them to get it wrong. And of course, you would expect the ones who get it right repeatedly to be the ones who are successful in the market, and that's how the market rationally allocates resources. So of course, entrepreneurs can make errors, right? So the guy who prices his clothes at \$100 might be wrong. He might be—Keynesians claim—acting on the basis of some irrational animal spirits. Then he'll be outcompeted on the market.

**WOODS:** G.P., you're originally from India, and you moved to the United States how many years ago?

**MANISH:** About five years ago.

**WOODS:** Okay, and how did that happen? You learned about Austrian economics in India, and you thought the best place to pursue it was the U.S.? Your wife also has a Ph.D. and is a professor of economics, so tell us: how does something like that happen?

**MANISH:** I was doing my master's in economics in India, and at that time the library of the institution I was in happened to have books by Mises, Rothbard, Hayek, and all the other Austrian economists. I was dissatisfied with the economics that I was learning, and I happened to stumble upon those books. Then I happened to stumble upon Mises.org on the web, so I got access to many more books. And then I decided to pursue my Ph.D. along with my wife, who was also interested in these ideas along with me. We happened to get scholarships to study at Suffolk University with Ben Powell who is a student of Peter Boettke from George Mason University. [TW note: Ben is now at Texas Tech University.] So in a sense, it's a lot of luck involved in being here right now.

**WOODS:** Well, I'm thrilled that you're here, and of course, I was on the panel that examined you when you were engaged in the oral exam at the end of the Mises University summer program. And of course, we were all thinking: this guy should be on the other side of the table administering the exam, not taking the exam. So I thought to myself, if you can't beat them, join them, and I thought: I want a course on Keynes for [LibertyClassroom.com](http://LibertyClassroom.com), because I think a lot of people, libertarians included, may know a little bit about Keynes. but a real Keynesian would just clean their clocks. I wanted somebody who's going to explain Keynesianism from the ground up, and follow that with a critique. I looked no further than you. In our closing minute, can you describe what somebody would learn by taking your [Liberty Classroom](http://LibertyClassroom.com) course on the economics of Keynes?

**MANISH:** Well like you mentioned, Tom, what they'd learn first and foremost is the basic structure of the Keynesian argument. In order to criticize somebody you have to understand what they said, first of all. That's what the first objective of the course is: to introduce everybody to Keynesian economic jargon, the basic concepts involved. How does Keynes define consumption expenditure? What is the consumption function? How does Keynes define what investment expenditure is? Then how do all of these concepts interact with each other, as presented by Keynes? Then explain this kind of recession, a permanent, chronic recession on the market. At the end, I attempt to make a few critical points, especially regarding Keynes's criticism of the necessity of savings, from an Austrian perspective. That's how I round off the course, so essentially what people would get would be a good grounding in solid Keynesian economics as well as a

critical look at it at the end.

**WOODS:** Well, I'm deeply grateful to you for doing that, and I think probably I should give you one more minute to say something about Troy University and the Johnson Center, because there are certain institutions people think of when they think about learning free-market economics—Grove City College and various other places. They don't think about Troy University, but maybe they should.

**MANISH:** Absolutely. It's because we're relatively new compared to places like Grove City, Loyola, and New Orleans and Hillsdale, but we have a center here called the Manuel Johnson Center. I'm a member of it. We have seven other free-market scholars along with me, so that's eight in total. We have a new economics major, and essentially we teach free-market economics or are all interested in free markets and all influenced by Austrian economists. There's a heavy dose of all of that stuff in our curriculum, and so young students should definitely look at Troy University to get their econ major to study free market economics, definitely. Hopefully, more and more bright young minds will choose Troy and our reputation will grow.

**WOODS:** Tell us where Troy is and also how far away it is from the Mises Institute.

**MANISH:** Yeah, Troy's of course in Troy, Alabama, which is in southeast Alabama, but it is just about an hour and half drive from Mises Institute in Auburn. So students can get an opportunity to drive down and meet everybody at the Institute as well whenever they like, attend all the summer events, etc. We also encourage students to go to all the other summer events, for example, organized by the Foundation for Economic Education, which is in Atlanta now, which is also not too far away. Just about two and a half, three hours away, and other organizations.

**WOODS:** It sounds great, and I'm thrilled that you and your wife both have the opportunity to teach there, and I'm equally thrilled that you had time today to talk to us about Keynes and give us the basic overview. But people who want to know the full thing, like the systematic overview, so they can smash all the bad guys they should take your course at [LibertyClassroom.com](https://libertyclassroom.com).

**MANISH:** Absolutely, Tom, yeah. Thanks for having me on the show.