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What Keynes Could Tell Paulson

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By David Ignatius
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In times like these, when even the most sober analysts are wondering if we're heading for another Great Depression, it's wise to take a deep breath, head to the basement and dust off a copy of John Maynard Keynes's modestly titled 1936 treatise, "The General Theory of Employment, Interest and Money."

Most of us remember Keynes from our college economics courses as the guy who advocated deficit spending to "prime the pump" during downturns. And that was certainly part of his argument. But revisiting "The General Theory," what's striking is that it's a book about economic panics and the market psychology that produces them -- and the consequent need for government intervention. Parts of it could have been written this week to describe the cascading defaults of Bear Stearns, Lehman Brothers and AIG.

The problem with financial markets, Keynes argued, was that investors were periodically seized by an extreme form of what he called "liquidity preference," which made them wary of putting their money into anything but the safest investments. "It is of the nature of organized investment markets . . . that, when disillusion falls upon an over-optimistic and over-bought market, it should fall with sudden and even catastrophic force," he wrote. "Once doubt begins it spreads rapidly."

That's a pretty good description of what has been happening on Wall Street over the past few months. We've gone from a bubble of overenthusiasm, in which interest-rate spreads took little account of risk, to a state of panic in which financial institutions are so risk-averse that they don't want to lend to anyone. As Keynes observed, "the actual, private object of the most skilled investment today is . . . to outwit the crowd, and to pass the bad, or depreciating, half-crown to the other fellow."

Keynes's revolutionary idea was that financial markets were not inherently self-correcting, as classical economics had argued. Left to itself, Wall Street might remain in a liquidity trap in which the markets would stay frozen and productive investment would cease. So it fell to the government to take actions that would restore confidence and stimulate investment. "I conclude that the duty of ordering the current volume of investment cannot safely be left in private hands," he wrote.

Which brings us to Treasury Secretary Henry Paulson and the present financial crisis. Since he intervened to rescue Bear Stearns in March, Paulson has been trying to pump cash into markets that are locking up because of the extreme liquidity preference of investors. But each rescue measure only sets up the next disaster -- so that Paulson lurches from Bear Stearns to Fannie and Freddie to AIG, and now to a government pledge to buy up $700 billion or more of mortgage-backed securities.

What advice would Keynes offer Paulson and Fed Chairman Ben Bernanke? His first instinct, I think, would be to reiterate that markets, left to themselves, will not solve this sort of crisis. They need government help -- in this case, on a scale that would have daunted even Keynes -- including

underwriting mortgage loans, backstopping the market for credit swaps and other steps. But if these measures are taken piecemeal, without broad political support, they may only add to the public's anxiety. Indeed, that's a real worry now: A Wall Street panic may become a Main Street panic.

Keynes's biographer, Robert Skidelsky, makes clear that at every stage of Keynes's career, he tried to think broadly about the social and political consequences of economic policy. That was true in his famous denunciation of onerous German reparations payments after World War I, which he correctly warned would lead to a future war; it was true in the magnanimity of the post-World War II international financial system he helped create at Bretton Woods.

A truly Keynesian rescue plan should do more than bail out foolish investors. How might the pieces fit into a larger design? Well, if the taxpayers are going to acquire a stake in the nation's largest insurance company, perhaps that company can be the cornerstone of a new system of universal private health coverage. If the taxpayers are going to acquire $700 billion in real estate assets, perhaps the eventual profits can fund new investments in infrastructure or energy technology.

Keynes spoke in the finicky English of a Cambridge don, but listen to what he said: "When the capital development of a country becomes a byproduct of the activities of a casino, the job is likely to be ill-done." Keynes wouldn't have wanted to nationalize that casino; he was an active investor himself. But he reminds us that public purposes are best served by public institutions.

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