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CURRENT AFFAIRS

ANALYSIS

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MASON: **Good evening and welcome to the Old Theatre of the London School of Economics. I am Paul Mason here with a packed audience. In this week's addition of Analysis I will be speaking to Steve Keen about his claim that if we keep the parasitic banking sector alive the economy dies. Steve Keen is professor of economics and finance at the University of Western Sydney in Australia and has a cult following among critics of mainstream economics. He was one of a small number of economists who put their reputations on the line before the collapse of Lehman Brothers and predicted that there would be a major financial crisis. In his recently updated book Debunking Economics; The Naked Emperor Dethroned, he argues much of what is taught here at the LSE and other major intuitions is, to put it politely, flawed and not only flawed, but helped cause and accentuate the impact of the crash. Neo-classical economics, he says with its naïve moneyless equilibrium theory of capitalism provided the unwitting cover for the greatest Ponzi schemes in human history. Before we start, before we hear more about Mr Ponzi, let's get an idea where the audience stands. If you agree with Steve Keen that the emperor really does have no clothes shout stark naked.**

AUDIENCE: Stark naked.

MASON: **If you disagree with him and defend the current consensus shout fully clothed.**

AUDIENCE: Fully clothed!

MASON: **Thank you. So there is clearly the Steve Keen fan club here tonight. Steve, welcome.**

KEEN: Thank you

MASON: **We will get onto your views about the banking sector in a bit. But first explain to us what you mean by neo classical economics?**

KEEN: Ok it is a theory of the economy which argues that it consists of utility maximising individuals and profit maximising firms.

MASON: **People who pursue there own interests**.

KEEN: Who work together in a system of that reaches ultimate harmony where that harmony means all prices in all markets reach equilibrium or tend toward equilibrium and they model the economy as if it has no money, no banks and no debt and for that reason you had no idea that a crisis caused by banks lending too much money and creating too much debt was about to hit the world.

MASON: **To be clear it is not that they know the existence of banks they just think bank and debt and money are neutral to the workings of the system.**

KEEN: They think you can model a macro economy without modelling without money or banks.

MASON: And when you have a go at mainstream economics that is the bit you are having a go at.

KEEN: Exactly, where we can't model the economy without the trio of banks, money and debt. If we have a model of the macro economy that excludes any of those we don't have a model of capitalism.

MASON: Just explain to us why this huge swathe of professional economists ended up not realising the importance of banking and debt. How did we get there?

KEEN: It starts from a vision that really comes to-, persuades the students, when they don't have enough exposure to money and debt, that money and debt don't matter.

MASON: They have a lot exposure in reality to money and debt.

KEEN: They do now.

MASON: Particularly the latter.

KEEN: They do. When they arrive as naïve students at the university, they are given this little exercise to say let's see what your preferences are and to work out what your income is and what relatives prices are. Work out what you therefore consume given that information. Now let's double prices and double your income. And what happens? The answer is nothing. I still buy the same amount. Let's say well therefore money is just a veil over barter. We can ignore the role of money in modelling capitalism and on we go. That is only true in a world without credit and a world without debt and a world without banks. We don't live on that planet.

MASON: What is wrong with tools that have worked even if they only work outside of a major once in 100 year depression? What is wrong with tools that work only 99% of the time?

KEEN: Well if that was true which it is not, the one time you need them is in a depression. We need them to stop it happening and not cause it. Then say it was ok and not our fault. We worked out the good times. That was Bernanke's ridiculous excuse after the crisis because they gave us the good times. Totally delusional. Sorry totally delusional. You don't need economists to have an economy. You do need engineers to have a bridge. Ok now. If engineers built bridges the same way economists built the economy there would be so many crashes we would reform the industry straight away. Economists can get away with it in and bask in the glory of a false boom and congratulate themselves for causing it.

MASON: **Now it is true that in 2005 I think you did predict a coming debt induced financial catastrophe. What was the moment that you realised that this was going to happen?**

KEEN: The time that I really consciously remember it was I was with my then wife in Perth. She was involved in the stage show of Dirty Dancing and I was doing an expert witness report on predatory lending and I wrote a throw away line saying that debt to GDP ratios had been rising exponentially and I knew as an expert witness rather than a barrister that I couldn't get away with it hyperbole, so I thought that I had better check this up. It won't quite be exponentially. I need to modify the words blah blah. I had to download the quarterly data, quarterly data for GPD monthly credit at two o'clock in the morning. I plot it and there was a pure expediential function. I went holy hell.

MASON: **So for the uninitiated this is a graph that starts fairly flat. Starts rising and then rises then up towards vertical.**

KEEN: Yeah and

MASON: **Of debt to GDP.**

KEEN: The ratio. Not the level of debt but the ratio to income and I though holy hell this has to stop at some point when it does the simple slow down of growth will cause the recession. Somebody has to raise the alarm at least in Australia and I am probably that somebody. Two o'clock in the morning, December 12th Perth 2005.

MASON: **When Lehman Brothers went bust-**

KEEN: I didn't predict that, by the way please.

MASON: **-you would have had to seen certain facts.**

KEEN: It is inevitable to see a credit crunch like one that hit England this year but wouldn't be able to say which firms would be affected.

MASON: **Let's talk about that one later. The question is when Lehman Brothers went bust did you then see scale of the collapse that would happen?**

KEEN: I was imagining probably a worse collapse than in fact occurred, because what I was really working on was a sheer, to me, macro economic-essential macro economic indicator of the ratio of debt to GDP. That had hit levels that I realised as time went on that I got more and more data that the level of debt to GDP in America as the crisis began to break was about one entire year's worth of GDP, greater than it had been at the start of the Great Depression. So looking at that I focused on the private level sector. I knew the government sector was bigger, I knew the government could emulate the downturn by deficit spending, but I focused on the sheer scale of the private thing and I though that this is gonna be the biggest crunch in history. In fact it ended up being smaller because of the sheer scale of the reaction in

the opposite direction but what I always thought what it would be and turning out to be is turning Japanese. Rather than being over in 5 or 10 years. The Great Depression courtesy of the second world war as well on for 20 years worth unless we do something about it.

MASON: **Just briefly summarise for us the causes of the crisis.**

KEEN: The fundamental cause of the crisis is the banking sector's profits are limited when they can only finance investment. Or consumption like buying a house over time is a consumption item. They only make huge amounts of money when by fooling us into Ponzi schemes which they themselves don't really like…

MASON: **Ponzi schemes are like pyramid selling.**

KEEN: Gambling on rising prices. You borrow money and they play flip that house and you think you can get wealthy by doing it. That's ok for an individual. But for an entire society to believe you can get rich by playing flip that house and all you are doing is accumulating debt, driving up house prices getting more income for bankers, more income for real estate agents. Then ultimately the debt level reaches so high that society can't substance it and we crash.

MASON: **What draws us down that route though? We know that bankers individually behaviour can lead to that. What is the objective, and in the system-, why it causes that?**

KEEN: Well first of all this is the one thing I have been trying to explain to Paul Krugman, money is endogenous money is created by the financial system– I am going to give up on it obviously – is that-

MASON: **Money is part of the financial system.**

KEEN: Money is not controlled by the central bank. Money is something which is generated by the private banking sector and there are really no effective constraints on the rate at which they can increase that. There are constraints how fast they can do it, but they can't be stopped from creating money. What it requires of course is a willing borrower on the other side. Of course when you get to the point where the willing borrowers disappear then that capacity to create can be constrained and we are seeing now, it's falling down. But when they could persuade us that it is really smart to be in debt, then as that bubble goes that actually causes the rising asset prices which encourages more people in. It sets off the entire bubble. That is what gets us in.

MASON: **This is a financial business cycle. So why should it cause depressions?**

KEEN: Because when you can't pay your debts you can't eat. Everybody loves the guy that walks down Main Street with a credit card that is buying everything until he can't afford to get the credit card out any more. And you built your own businesses based on this incredible demand brought by a person with a credit card and suddenly he can't get another credit card and he is not there anymore and all the economic capacity you've built up to service that demand is suddenly excess and you go bankrupt.

MASON: What was wrong with the policy once the crash had happened?

KEEN: Well the policy once the crash had happened and involved throwing everything over board including Paul Samuelson. I mean talk about ditching everything.

MASON: Samuelson is the doyen of Keynesian economics.

KEEN: No please. Of post war Raisian economics. They call it Keynesian. I'm not going to let them get away with that anymore.

MASON: Let me correct both of us then: he is the father of modern academic economics.

KEEN: Exactly.

MASON: So they throw everything out of the window? Why?

KEEN: Because they really saw total collapse staring them in the face and of course in this case, they were people who actually worked in the banking sector. I read Hank Paulson's "On the Brink" and he actually spoke about the point at which he realised that if he didn't get a huge amount of money to inject into the financial sector then all these corporations were bankrupt. He says at one stage that I knew I had to say a large amount of money; I didn't dare say a trillion, because that would have caused total mayhem. But he said a really big number and people said what will happen if we don't get the money and he said may… something in the nature of may God have mercy upon our souls. That's the level of panic that existed inside the of Politburo of America at that time.

MASON: We've got a coherent vision here that is of excessive lending, excessive borrowing, a policy framework designed to encourage it, speculation at the top, on the froth as it were, on the top of it, and then a political elite that throws aside the theory and goes for numerous rescue plans.

KEEN: Yes.

MASON: And it's still going wrong. It is still out of control as far as you're concerned.

KEEN: Oh yes, and at the same time neoclassical have come out of the foxholes and now and they're back putting their theories forward. I had my first exposure to this at a commercial seminar at Sydney where one of the other speakers had been flown out from the States and he started taking about reverse Ricardian-equivalence. You want to explain that one?

MASON: I don't want to explain it.

(Laughter)

MASON: I would rather have a stiff gin than explain that.

(Laughter)

KEEN: Again they're abusing Ricardo rather than Keynes in this way and claiming that some how out of Ricardo they can drive the argument that if the government goes into austerity that will stimulate the economy.

MASON: Yep. This is, this is in fact a theory that we in Britain are quite…

(Laughter)

MASON: … we are quite familiar with, because although it has not been publicly espoused by the government, it is publicly espoused by some of their supporters in economics. I will take that as another moment to allow anybody in the audience who might want to chip in and make a point contrary to what Professor Keen is making. Does anybody disagree with either his analysis of why it went wrong or, or the policy problems? Sir up there in a black polo-neck jumper.

SOFA: Er yeah, Dan Sofa. The danger with listening to you is it is sounding a little bit like an echo chamber. Why have you not had more success in engaging in dialogue here?

MASON: Why has the doom-sayer before the crisis not had more effect and not had more take-up since the crisis proved you at least partially right?

KEEN: Well that's a very good question. It's the, there isn't a dialogue in economics. There's a dialogue of the deaf. And 'cause people like myself who are critics within academic economics have been screaming at these guys for ages saying you know, go back, you're going the wrong way, if I can take a road, you know, a highway analogy. And they just completely ignore us. They, we're the learnies down the back of the corridor – the ones they can't get out of their department but they just ignore them – it'll be Austrians, Marxists, Post Keynesians, you name it, there's always one... about one in 10, one in 15, 20 or so of each

departments like that. So they ignored us all the way through. Now when actually, when the crisis has come along that they said couldn't happen, they are still trying to ignore us, but they simply dismiss us as, I think one of my friends explained to me this thing they call the air, what, the air of.. Paul you'd better remind me here, the air of um…

MASON: **Effortless superiority.**

KEEN: Effortless superiority.

MASON: **It's Balliol College you're talking about**

KEEN: "Keen doesn't really understand all this stuff as well as the rest of us do." They don't even bother engaging – it's a tactic. That's how they're engaging - by using effortless superiority. The trouble is what's happened they said couldn't happen and that's why I came out so loudly and say you prove, you say I don't know your theories, your theories say the situation we're in now can't happen, I think reality's on my side.

MASON: **Sir in the middle.**

MAN: It's slightly fashionable to accuse banks of being the bad-guys when in actual fact the kind of philosophical core of the modern capitalistic economy - it's individuals acting in their own best interests which is not equal to the best interests of society.

KEEN: Well there's the real danger, the reason bankers, I identify bankers as a problem is that the rest of us when we act in our own interests, we face what János Kornai, the great Hungarian economist called a hard budget constraint. Generally speaking we can borrow a bit, but we can't borrow indefinitely to finance what we do. Whereas banks are the ultimate generators of the soft budget constraint in capitalism – they can expand the money supply, they, it's a double-entry bookkeeping exercise to expand the money supply. The way they make money is by persuading us to take on that debt – that's what bankers do – they persuade us that if we borrow money, which is bad, we can lever up the gains we make in asset prices which is good, and make more money so we take on more debt than we should. That's the leverage that actually generates the rising asset prices to begin with. That's why they're dangerous – because they can succumb to that. They're not bad people but they've got an absolutely incredible temptation there and they fall for it and we get backed into it as well because we also as individuals make a gain out of that leverage. We have to remove that one massive flaw in capitalism to avoid perennial financial crises.

MAN: But I mean, banks have rigid capital ratios right, they have ceilings in terms of the amount of debt they can create – it's not a limitless …

KEEN: (Over) Most of those… I think it's more effective to model banks as if they are like a money lender in a peasant economy, who says he's got a couple of big eunuchs protecting a huge box of gold and therefore you can trust what he writes on a piece of paper and nobody ever dares go towards the eunuchs to find there's no gold behind them. Fundamentally banks manage to evade most of those controls. Even the whole idea of using reserve controls, people talk about it still, they don't realise that America's reserve ratios only applies to household deposits, not corporate deposits, and less than 10% of the American money supplies is subject to reserve controls and the reserve controls themselves have about a 50-day lag after the loans and deposits are created. We see what is a control mechanism but actually is a response to what is happening in the private sector.

MASON: Sir here – at the front.

BAXTER: Hello. My name is David Baxter and I'm a banker…

(Soft laughter)

BAXTER: … and ah, I move money around. Early in my career I actually did financial models for derivatives and all of that stuff so I guess I would be one of the bad guys in your theory. One question – you were saying that you predicted the crash in April 2005. Did you short any assets, did you recommend shorting any assets back then or…?

(Laughter)

MASON: So the question is Steve, did you use your advance knowledge to speculate on the downward price of any assets?

KEEN: No. I did once, bit of a gamble when I thought it might happen in October of 2009 I think. My attitude was I put a bit of money that I could afford to lose it and I got the timing wrong, the bubble continued. Timing is everything in a bubble.

MASON: (Over) So, so the…

KEEN: But I certainly warned a lot of people to get out of the, out of the industry, I said get out of stock market before 2007. Lots of people did and quite a few of them are very useful supporters of the work I'm doing now.

(Laughter)

MASON: So to the Steve Keen fan club, who are clearly here, he is fallible. You're listening to Analysis with me, Paul Mason, at the London School of Economics, interviewing the economist, Professor Steve Keen. Now Steve, what should we do to get ourselves out of this mess? What would you do?

KEEN: What I would do is what I call a modern debt jubilee and that is we have to reduce the level of debt and reduce the wealth of the financial sector, without penalising people who've purchased the goods that the financial sector's spun off to them that they called assets, all the loans they've, they securitised. So what I would argue in favour of is what could be called quantitative easing for the public. So rather than Ben Bernanke giving the money to the banks and saying please lend, you give the money to the public and say if you are in debt you must pay your debt down. If you're not in debt, here's cash. What that would mean is the banks would then find themselves getting a lot of their loans paid off, their cash reserves would rise, their income-earning components would fall, so they might be illiquid rather than insolvent – so there'd be challenges there. People who had debt would have less debt – they could then spend more easily. People who had no debt would otherwise be penalised, would have a stack of cash out of which they could spend. The income earning capacity of the bonds they'd bought would fall drastically so they would have less income to spend out of but much more cash. That would minimise the damage of making the transition and it would reduce the power of the finance sector overnight. Now that would also cause a lot of financial people to be unemployed – tough.

(Laughter)

MASON: Would it not also bankrupt the middle-classes of the western world? Because their pensions above all are linked to these financial assets.

KEEN: That's why I talk about giving a cash injection - that if you give cash to the public and if you're not in debt you have cash you can spend out of.

MASON: (over) And where does this cash come from?

KEEN: Fiat money.

MASON: (over) Fiat money – so you print money?

KEEN: Well, yeah – Ben Bernanke has…

MASON: (Over) You create money.

KEEN: You create money.

MASON: Wouldn't it be less extreme to say let's just go back to a system where banking serves industry?

KEEN: Oh yes. That's exactly, yes…

MASON: (Over) … Is that, but if you demolish banking, if you socialise it as you would inevitably have to do, you're not going to get the Krups, you're not going to get the Samsungs of this world.

KEEN: (Over) … No you don't . You don't socialise when you put something into receivership. We need people who know that what they've got to do is look at good ideas from capitalists, distinguish them from the bad ones as best they can and finance those, that's where the real growth comes from. We'd have more Samsungs

MASON: (Over) To be..

KEEN: (Over) … We'd have more Samsungs, more Apple iPods I imagine if we stopped bankers being able to make money by financing Ponzi schemes and said if you want to make money finance decent investment.

MASON: Concrete policy. OK. Suppose David Cameron rings you up, or George Osborne, they might…

(Laughter)

MASON: They like heterodox economists. What do you tell them - to do?

KEEN: Well I'd go for the modern debt jubilee – I'd certainly..

MASON: (Over) To write the debts down.

KEEN: I wouldn't go for austerity. I'd say you, when you have the private sector deleveraging and reducing the level of money in the economy, you don't want the government doing the same thing at the same time. It's applying this household analogy – which actually leads us into crisis because in a capitalist system there are two sources of money – the private sector can create it by creating debt, the government can create it by running a deficit. If you have the private sector deleveraging, so it's taking money out of the system…

MASON: And if states teeter on the edge of bankruptcy- I mean Britain was worried about its sovereign credit rating – what should they do, go on spending?

KEEN: Yeah. Fundamentally a country with its own sovereign currency can't go bankrupt when its debts are in that currency. The dilemmas in Greece are all because- er, in Europe – because there's actually no country that owns the Euro. And therefore they can run out of it in that sense.

MASON: What would you do for Greece then? They're in a different position. Suppose a Greek government comes to power that wants to

do something different than what the Commission is telling them. What would you advise them- This could be the prime candidate for your debt jubilee. They might have to actually have to write everything off.

KEEN: I think that's likely to happen. I think the weaker will leave. The situation in Europe and in particular in Greece, Spain is dire. And I'm saying so dire that little blokes with moustaches can start popping up everywhere.

MASON: You mean extremist politicians.

KEEN: Hitler arose out of the crisis in Germany in the 1930s and a large part of why he got the worship of the German people was because he went against conventional economic advice and ran a gigantic deficit and funded the world's largest war machine at the time and pushed it to full employment in the process. That demagoguery can rise in a situation like now. So to believe that we're every going to have political stability in the middle of the austerity being forced upon people I think is naïve. So at some point they're going to come out and the debts are over. I think that will probably happen.

MASON: And you way we're in the middle of the crisis.

KEEN: Oh no I think we're about 30% through.

MASON: 30% through? So there is more chaos on the way?

KEEN: Because the levels of private debt caused the crisis and are only slowly being reduced. The American data I know best and the American level peaked at 300% of GDP – that's private debt.

MASON: So when we see Detroit recovering, so when we see the housing market hovering on the bottom of the curve, you don't think it's the beginning of the end of the crisis?

KEEN: No, you only get the crisis over when you get rid of the debt accumulated in the previous bubble. And we have so far to go on the process that it could take 10-15 years before that's worked out of the system.

MASON: Questions! Sir.

AUDIENCE MEMBER: Kirk Economa, former student. Do you think there's an inconsistency in what you're saying. Pouring money at it will just re-inflate the bad investments and the bad ratings. So don't you think the focus should be on actually getting more timely and accurate information so that the market can function properly? Something like that.

KEEN: There's certainly a role for the market in giving accurate valuations. The trouble is that 99% of the activity on markets is speculative bubbles rather than actual information. I've got other proposals for the long term rather than just the current period now to reduce the extent to which that speculative overlay just distorts the financial sector. And part of this comes from the fact that it's

acceleration in debt that causes rising asset prices. So I'm arguing in favour of redefining financial assets in such a way that acceleration of debt won't drive the prices. And you'll get a more realistic valuation.

MASON: How would you redefine the financial assets?

KEEN: I'm talking about what I call jubilee shares. And the pill in the property market. And jubilee shares are the suggestion that shares continue to exist as they do now-

MASON: Shares in corporations?

KEEN: Shares in corporations. If you bought a share off a company or in an IPO – er, an issue of shares by the company – no change, the same as they are now. You could sell those shares a set number of times so you get some price discovery. Say seven times. I'm using biblical numbers here. Once the 7th sale had taken place, the share would last 50 years and expire. So you would cut out a large part of the secondary market. You'd still allow primary price discovery.

MASON: You're repressing the stock market as it exists today as a potential vehicle for speculation.

KEEN: Because what actually drives the price up is people borrowing money to take advantage of that and that's what actually gives the price bubbles. Now if you make it absolute lunancy to buy a share which is going to expire in 50 years, you'll get less leverage in the asset markets.

MASON: Steve the critics will say this is not a very dynamic model of capitalism – we have dynamism because we have speculation, because we have animal spirits.

KEEN: We have dynamism because engineers speculate, not because financiers do. Capitalism was far more dynamic when engineers dominated back in the 1950s. We need to get back to that world where the financiers are the servants of the engineers not the masters.

MASON: Sir at the back!

AUDIENCE MEMBER: Carl Gombridge. Related to the idea of dynamism, I want to just focus on this country and the analogy with Japan. And so I just want to question firstly whether we could be like Japan in say 10, 15 years. And secondly would it really be that bad particularly if we redistributed some of the wealth to some of the people who are suffering in the current situation. Why can't we just go on with 0.1% growth or indeed 0.1% recession for 10 years? Why would that be a problem?

KEEN: Well Japan continued developing industry until 1990 and it still has it. There has been far more industrial development in Japan than there's been in Britain. You guys have specialised in the biggest Ponzi scheme on the planet.

KEEN: If you have the private sector deleverging, so it's taking money out of the system and therefore reducing economic activity, if the government does it as well you'll amplify the downturn. So I'd say your austerity programme right now is the wrong way to go.

MASON: And if states teeter on the edge of bankruptcy- I mean Britain was worried about its sovereign credit rating – what should they do, go on spending?

KEEN: Yeah. Fundamentally a country with its own sovereign currency can't go bankrupt when its debts are in that currency. The dilemmas in Greece are all because- er, in Europe – because there's actually no country that owns the Euro. And therefore they can run out of it in that sense.

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AUDIENCE MEMBER: Carl Gombridge. Related to the idea of dynamism, I want to just focus on this country and the analogy with Japan. And so I just want to question firstly whether we could be like Japan in say 10, 15 years. And secondly would it really be that bad particularly if we redistributed some of the wealth to some of the people who are suffering in the current situation. Why can't we just go on with 0.1% growth or indeed 0.1% recession for 10 years? Why would that be a problem?

KEEN: Well Japan continued developing industry until 1990 and it still has it. There has been far more industrial development in Japan than there's been in Britain. You guys have specialised in the biggest Ponzi scheme on the planet.

MASON: You did say, and we did say you might address this issue of a debt bubble in Britain.

KEEN: Yeah.

MASON: This might be a good time for you to address that.

KEEN: The level of debt England's taken on is breathtaking. I thought America was bad when it had a total private debt ratio of 300% of GDP. Even the Treasury's figures here have you at 450% of GDP. And whereas America's financial sector debt peaked at 120% of GDP, yours is 250%. And at various times in the past 3 or 4 years something like 60% of aggregate demand in the economy has come from rising debt. Now turning that around is going to be painful and I really believe-, I can't see you avoiding a credit crunch at some stage that probably will be of the scale of Lehman Brothers.

MASON: Again? In Britain?

KEEN: Yeah. I hope I'm wrong but looking at those numbers, the only reason you've managed not to go down as fast as the Americans have is you've bounced up and down in changing debt levels. It's really quite intriguing to look at a graph of adding the change in debt to GDP in America. Where it went from really high-, positive to-, increasing demand to cutting it. Looking at England it bounces away all along the top. But it's one and a half times as high and twice and three times as volatile. When it starts to go negative, all the hot money that gave you what looks like a prosperous economy for so many years will be out the exits to Kuwait and wherever else the mafia lives and I think you'll find a bit of a credit crunch coming your way.

MASON: There is no suggestion of course that the mafia live in Kuwait!

[LAUGHTER.]

We will be sleeping with the fishes of the Persian Gulf if we suggest that. All that remains for me Paul Mason to say is thank you to Steve Keen and the audience at the London School of Economics.

[APPLAUSE.]