America's Great Depression, Chapter Two

Keynesian Criticisms of the Theory

- Main criticism 1) Keynesians say savings ≠ investment
  - To Keynesians, savings and investment are done by two different groups of people, at two different "phases" of the circular flow
  - Cash "savings" leak out of consumption
  - Investments are made from a different phase
  - In depressions, gov'ts should increase investment and decrease saving
- Rothbard's Counter
  - Investment and Savings are inextricably linked
  - Investment must come from Savings because Savings is everything not consumed
    - Except bank credit expansion
  - Keynes's separation into "phases" is artificial and unnecessary
  - Time preference decides ratio of consumption to investment
  - Utility of money determines investment vs. cash savings
  - Time pref. and util. of money are different, unrelated phenomena
  - A person must save to invest
- Criticism 2) The Liquidity Trap
  - What if the demand for money is so persistently high that the rate of interest can't go low enough to get investment up and leave the depression?
  - Keynesians say the rate of interest is determined by "liquidity preference"
- Rothbard's counter
  - Interest rate is determined by time preference, not liquidity preference
  - Increased cash savings will come from consumption and investment in proportion to time pref.
    - It's worth noting this could break down at the margin where consumption is reduced to subsistence, but that's negligible in any first-world economy
  - Keynesians blame "speculative hoarding" of cash (instead of buying bonds) for depression's negative effects, but...
    - The rate of interest is not just the rate on loans
    - In depressions, people expect wages and producers' goods' prices to fall faster than consumers' goods' prices
    - This "hoarding" speeds the adjustment and end of the bust!
- Wage Rates and Unemployment
  - Keynesians assume downward wage rigidity
    - Rothbard notes they obfuscate this assumption with a bunch of equations, but it's an assumption
    - Therefore, the only way to lower wages is via inflation
    - However, price theory applies to wages just like anything else
    - Wage controls by gov't or unions move workers from most valuable applications to less valuable ones, and if the wage controls are really widespread, even this adjustment can be hindered!
    - Misconceptions can cause confusion and slow adjustment, too
      - The "mystique" of unions (see p. 44)
      - "High wages cause prosperity" (actually it's the other way around)
      - The bully pulpit (e.g. Hoover)
  - Does a fall in wage rates cut aggregate demand and therefore prolong the depression?
    - During the depression, real wage rates either hold steady or increase (due to deflation)

        - Keynesians confuse wage rates with wage incomes
        - Wage income = wage rate × hours worked
        - Even if wage rates are sticky, hours worked are not
        - The real dynamic is labor vs. land—if wage rates become cheaper vs. land, more hours of labor will be demanded
        - But what if the demand for labor is inelastic?
            - This can only be caused by businesses waiting for wage rates to stop dropping
            - Don’t interfere! Let the fall happen, then hiring will begin
- The role of speculation
    - Entrepreneurs only make clusters of errors in the face of distorted signals caused by gov’t or banks
    - Speculation speeds up adjustment
    - It is not self-perpetuating
- **Figure 1 Goes Here (see video for full description and additional animation)**
- Since the Keynesians implicitly assume wage rigidity, they cannot argue against policies that allow wages to fall—according to their theory, such policies are harmless because they cannot have an effect!
- Given a total money supply, the total flow of spending only declines if the social demand for money increases
    - I think Rothbard is being too glib here and it may be possible to think up other things that might cause total spending flow to fall
    - However, even if this does happen, it’s not a calamity! It’s a natural part of correction
- Above-market wages discourage investment and increase cash hoarding at the expense of investment! It makes the problem worse!
- Keynesians say: Wage earners consume a larger proportion of their income, therefore, falling wages means less consumption and worse depression!
    - This is not true. Plenty of wage earners (e.g. sports superstars) have huge incomes and may invest plenty
    - Even if this was true, it’s a very clumsy way to manipulate relations between the rich and poor
    - Also: we *want* less consumption and more savings! Keynesian suggestion is plain wrong!
- What about if artificially high wage rates are handled by reducing man-hours of employment?
    - Reduction in work time spread over many people underemploys many and the underemployed are less likely to press for reduced wage rates
    - Spreading out the work makes it less efficient and aggravates the problem!