“Animal Spirits” and Fast Economic Recovery: Reading the Lessons Correctly

by Lloyd S. Etheredge <1>

Keynes believed that economic growth occurs when a free society permits its natural “animal spirits” to flourish and create the economic future. This insight can guide us to better policies for fast economic recovery if we connect the idea to the reality it described and read the lessons correctly.

Keynes' phrase was commonly used of British students in boarding schools in late Victorian and Edwardian England. Their “animal spirits” and inherent optimism (not derived from cold, rational calculations) found natural expression in the competitive freedom of the playing field and, sometimes, in an irreverent, youthful independence and instinct for challenging the rules that enjoined vigilance by headmasters. The energy of freedom and team competition carried forward to free, competitive markets to build the wealth of Britain and a global empire.

Next, academic economists began to craft their science by turning the observation of animal spirits and the passion to win at cricket into their own mathematical equations that modeled human beings as rational, profit-maximizing robots. Today, they recommend public policies that are based on these equations. The equations captured important truths - cricket players want to win and rationality helps to create winning strategies. However, in current circumstances, economic health requires that we reconnect, directly, to the touchstone psychology of the playing fields.

What are the correct lessons? Current political rhetoric reminds us that there are different diagnoses that we can draw about these animal spirits and remedies to restore economic health. Yes, it is easy to see how totalitarian dictators, regulators, and bureaucrats could intrude and take control of youthful athletic competitions and suppress natural enthusiasm. And it also would weaken competitive games if - as Mitt Romney believes about America - teams somehow can use political influence to be awarded easy “welfare state” bonuses to their scores, and become dependent on these political strategies for winning. But I think that today's psychological challenge of economic recovery is larger, and it requires that we restore confidence by repairing a catastrophic moral breakdown and failure of institutions.

Returning to the playing fields of Eton: “Animal spirits” actually thrive in a larger moral context, a background of rules and values that Keynes and his British readers took for granted. Current rhetoric aside, "regulation" does not always destroy sporting contests: The games are *defined* by rules and social norms, the presence of honest umpires who enforce the rules, a shared understanding of game-enhancing zones for strategy and deception, the boundaries for cheating, and sanctions against cheaters. The contests are shaped by the code of sportsmanship and respect. They honor a basic human equality and fairness: Traditionally, each player takes a turn at bat and teams compete only with their own skill and the same equipment as everyone else. [We should observe, too, that the motivating scores in athletic games are made-up numbers. It is an insight worth remembering: players and teams may have "profit maximizing" motives about scoring, but they were not paid in money.]

By this diagnosis, the missing agenda to restore economic confidence is to restore a moral order, confidence and trust in government and other major institutions. Some of the world's most trusted institutions - banks and financial institutions, government regulators, and even Presidents - unexpectedly and catastrophically betrayed or failed a public trust. The "risk shifting" players gained fabulous wealth, damaged the lives of billions of people worldwide, and added public debts that will limit other expenditures in almost every country for at least a generation. They have not gone to jail, paid reparations to the victims, apologized to the victims, or agreed to play by the rules in the future. Today, the wealthy are becoming wealthier while the mass of the public already has paid a fierce price, is being left to repay the huge burdens of public debt for recovery, and with limited ways to play by the rules of the market system and win.

Thus, the Federal Reserve wastes hundreds of billions of dollars by using its equations and believing that the way to restore confidence is by low interest rates and easy money to buy cricket bats and balls. Catastrophic institutional failure and betrayal are only partly corrected by monetary policies or by fiscal policies. [Today, governments have been throwing trillions of dollars at the problem of economic recovery. Earlier, it worked. Now, it doesn't: in the EU, next year's growth rate is expected to be about zero.]

Confidence has not been restored because major institutions and leaders have not restored confidence in themselves.

- Across all G-20 countries, the hostility to government is likely to grow and the moral credibility and authority of governments may weaken. As interest rates rise, the carrying charges on huge, cumulated national debts will force additional cuts in government budgets and the public will see services, promised benefits, and performance erode while taxes on wages and earnings also will rise. [Even now, in America, the public is beginning to discover effects of budget deals and cuts: multi-year backlogs in trusted government agencies that have been covered up.] Any elected government in the G-20 is more likely to be voted out of office by growing economic anger and frustration, for ineffective policies, lackluster performance, and allowing unjust outcomes. Their fate is to be paralyzed by growing anger and division and to have economic policy equations with missing variables. <2>

Happily, a rapid solution may be possible. I see three steps that would be part of a strong package.

I.) <u>An (Assigned) Wealth Tax</u>. The G-20 nations (at their summit next month in Australia) can agree to an annual tax of 2% - 3%/year on wealth, for individuals worth more than $5 million, that will continue until the full debt incurred as part of the recovery process has been amortized. Any further sums needed for recovery will be added to the total for repayment. This restores moral order and it pays for the recovery. It assures that debts incurred for recovery will be paid without being a further burden on the vast majority of the world's people who have paid enough, as victims. The wealthy will continue to earn a positive return (everything on their first $5 million and above 2% - 3% on the rest) - they just will become wealthier more slowly. Imposing the tax in all countries will limit opportunities for cheating. The earmarked wealth tax sends important deterrent and incentive-creating messages to the wealthiest members of society that they will share in the responsibility for rapid recovery and future accountability of banks and financial managers who they control.

Also: the wealth tax is a political test. Passing the wealth tax will help to restore confidence in governments and elected politicians who are (rightly) suspected to be dependent on campaign contributions by the wealthy. To pass the tax, political parties must shake free from this dependency, rethink their priorities and, with their own confidence, reassert control.

A. <u>Rebalancing the Scales of Justice</u>

A proposal for a wealth tax can raise moral arguments. Is it fair, or just, to impose a 2% - 3% annual tax, earmarked for recovery, on a class of wealthy people? In part, this is a question of whether it is fair to impose *any* tax and it is not unique to this proposal. More specifically, the question is whether there should be detailed moral calculations, like the immediate BP cleanup settlement process imposed by the Obama Administration, linking specific payers and their acts of wrongdoing or negligence and payees who could be fully compensated for damages to their lives and livelihoods and to the public treasury to amortize recovery debts?

The first answer to these objections is that I am making an argument about *justice* in paying the costs incurred for *economic recovery*, and a public process to establish a sense of moral order for the future, not also attempting a full moral and economic rebalancing of historical acts of negligence or calculation leaded to the economic crisis, like the BP settlement. It might be an even better moral solution to secure a larger BP-like settlement, but it strikes me as complex, although worth considering if somebody proposes a way to do it.

A second answer to these objections is that there also may be a case, based on the historical record, for other steps - for example, to extend a wealth tax beyond individuals to include all of the many institutional holders of wealth (e.g., retirement and endowment funds) whose hired agents speculated, or who were directly negligent in failing to self-police the financial sector and who may have benefitted from the generous profits of investing in what they knew, or should have known, to be asset bubbles. This extension of the G-20 wealth tax can be considered, but institutional investors can be agents for many smaller holders (e.g., in retirement accounts). It is more straightforward and fairer to tax wealth as it is owned, ultimately, by individuals with assets more than $5 million.

When they consider public policies, all G-20 governments face a scale of justice with weights and considerations on both sides. Given that the costs of recovery must be repaid, I am suggesting: 1.) a way to pay them that is *more* just than the current mechanism of shifting the burdens of repaying debts to mass publics who have been disproportionate victims and who are less able to pay; 2.) a *practical* way to pay them that speeds economic recovery by also using a simple, assigned wealth tax to restore a sense of moral order. (And 3.) when it does speed recovery, the wealthiest, too, may come out even further ahead than if nothing is done.)

B. The Politics of a Just Solution

The reader might, at this point, believe that I am living in a political fantasy even to suggest a 2%-3%/year tax on the world's wealth Establishment. Yet in democracies the vast majority of the victims, and the beneficiaries of using the wealth tax, have a vote! Any political candidate or party in G-20 democracies that supports the wealth tax initiative should win the next election with an overwhelming majority. In America, Mitt Romney knows that there has been a breakdown in the moral order, that trust must be restored, and he may realize that - if he will deliver a wealth tax - that Republicans can sweep to victory. Democrats, too, know that a wealth tax is a good political solution.

II. Improving the Moral Gamesmanship of Wall Street

To achieve a vibrant global capitalist system a second set of direct steps can improve the moral gamesmanship of Wall Street. For example: 1.) End the tax benefits for the wealthy unless they produce honest game scores in the real economy. We give capital gains tax benefits for "investing" in the stock market but only a fraction of this money actually invests in new plant and equipment and economic growth. Large fractions of so-called "investments" are buying and selling to play the market or outsmart other players. As Clayton Christensen recommends, only venture capital and "buy and hold" investment, that is used for business growth in the real economy and held for several years, should be publicly rewarded with tax benefits. A further step? 2.) Recognize moral priorities by a new 10% luxury tax on financial gambling, including the profits secured by hedge funds for their clients.

III. Messages for Young People

Another lesson from reading Keynes correctly is that society should send stronger messages to young people that we do want youthful "animal spirits" to migrate directly from sports competition into the economy. Too many students, in America and elsewhere, imagine a future of being hired by somebody else and today's large numbers of unemployed youth have few options. The current economic theory and societal message is that they should focus on their STEM education. The new (US) Common Core for public education can be quickly expanded to rebalance imaginations and add skills so that young people, naturally, also think about the option to join with friends to start and build their own companies. The traditional curriculums in other G-20 countries can be rebalanced to encourage self-starting motivation rather than authority-oriented instruction. (A visionary organization, the World Academy of Art and Science, has recommended such international rebalancing to support personal growth and goal-setting, project planning and management, leadership, and related psychological shifts and skills.) We give loans for college education: What about, in the G-20 countries, experimenting with $10,000 seed money loans to graduates to join with others to start their own businesses?

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An overview of other missing variables in economic equations that also might be creatively combined to give useful policy guidance for faster recovery is Lloyd S. Etheredge, "A Rapid Learning System for G-20 Macroeconomics: From Greenspan to Shiller and Big Data," online at www.policyscience.net at I. A.

<2> Next, without economic recovery, the forecasts of the intelligence community warn of eroding Establishment control, hostility toward governments, and the open class warfare and other expressions of anger and even violence of the 1930s, beginning in Europe where the rate of prolonged employment of young males often is greater than 40%. [The failures of economic recovery, government credibility, and high levels of prolonged unemployment, especially of male youth, are already seen by intelligence agencies as contributing recruits to terrorism and to the rise of nationalist, ethnic, extremist and messianic movements in the Arab Middle East, the Ukraine, and the scary rise of angry, Right-wing politics in France and other European countries.] The upbeat reporting of Establishment news media may begin to shift and new political movements and escalating ethnic conflict can be accelerated by social media.

October 20, 2014

Attachments:

- Liz Alderman and Alison Smale, "Divisions Grow as Downturn Rocks Europe," The New York Times, August 29, 2014.
- Historical graph, "Young and Jobless Across Europe," The New York Times, November 15, 2013.

INTERNATIONAL BUSINESS

Divisions Grow as a Downturn Rocks Europe

By LIZ ALDERMAN and ALISON SMALE AUG. 29, 2014 . NYTimes

German Chancellor Angela Merkel, with Spanish Prime Minister Mariano Rajoy, in Spain. Miguel Riopa/Agence France-Presse — Getty Images

PARIS — Six years after being struck by economic crisis, Europe is facing a fresh downturn, with few new ideas on the table for reigniting growth and deepening political divisions over the austerity policies that many blame for worsening the malaise.

Even as the United States

economy rebounds from its worst recession since the 1930s, Europe is heading in the opposite direction. A halting recovery that took hold in the 18-nation euro currency bloc in the last year has now gone into reverse as Germany, France and Italy, its three largest economies, stumble anew. Some analysts say the region could be headed for another full-scale recession — a slowdown that could have ramifications in the United States, Europe’s biggest trading partner. For American companies that do business in Europe, profits would suffer.

Germany, the Continent’s economic engine, contracted in the second three months of the year, while the bloc of 18 European Union nations that use the euro failed to grow at all. Political and financial instability related to Russia’s confrontation with Ukraine and the effects of escalating economic sanctions between Europe and Russia have further clouded the economic outlook.

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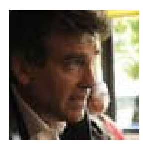

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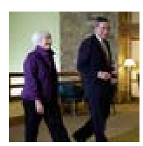

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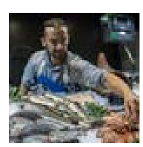

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AUG. 20, 2014

Diverging Paths

The eurozone and the United States both rebounded from the worst of the economic crisis, but while the United States economy has consolidated much of those gains, the eurozone has continued to struggle.

GROSS DOMESTIC PRODUCT

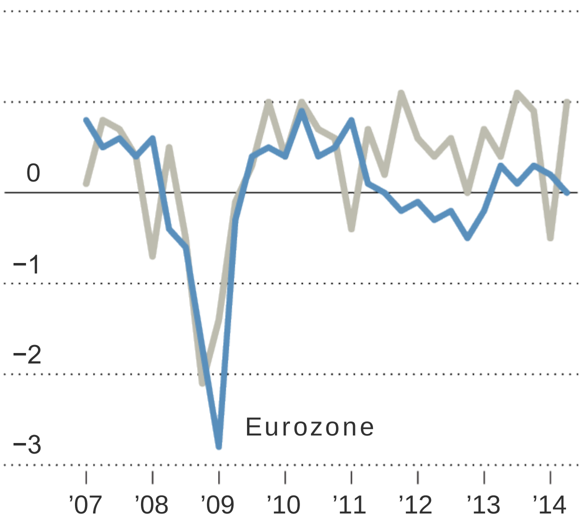
Annual rate of change, quarterly

+2%

United States

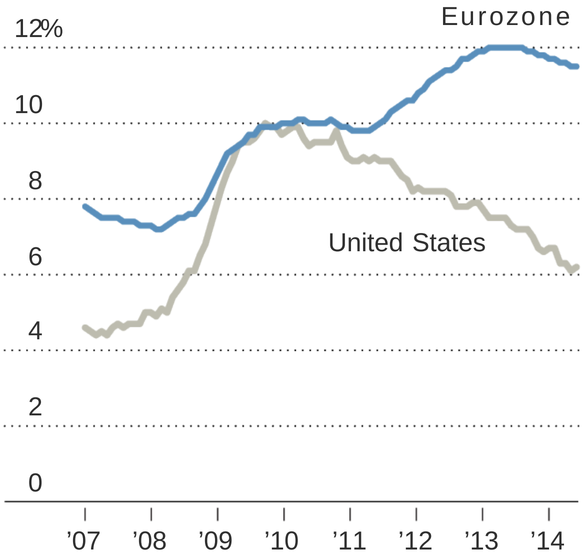
+1

Unemployment, which in the United States has fallen to 6.2 percent from a peak of 10 percent in 2009, has fallen only marginally in Europe, to 11.5 percent in July from a peak of 12 percent last year, according to figures released on



UNEMPLOYMENT RATE

Monthly



Source: Eurostat

Note: Figures are seasonally adjusted. G.D.P. figures are also adjusted

Friday.

"Europe is at risk of secular stagnation," said Lawrence H. Summers, a former United States Treasury secretary and former economic adviser to President Obama, referring to a situation in which very sluggish economic growth becomes the new norm. Unless governments find a solution, he added, "there is little chance that reasonable and rapid growth is going to return to the eurozone."

The fresh downturn has worsened tensions between European leaders and Chancellor Angela Merkel of Germany. Ms. Merkel continues to stand by an austerity program that she considers essential to financial stability, but that many critics now say is only deepening Europe's woes and leaving it at risk of losing a generation of growth.

The situation has placed additional pressure on Mario Draghi, president of the European Central Bank, to act more aggressively, much as the Federal Reserve has in the United States, to stimulate the economy through bond purchases. In a speech last week at a Federal Reserve conference in Jackson Hole, Wyo., Mr. Draghi for the first time challenged the austerity consensus, suggesting that European governments might need to relax their budgets in the short run to give their economies a kick.

Action by the European Central Bank, which meets in Frankfurt next week, has become more urgent in the face of signs of another potential menace: deflation, a downward spiral in prices and wages that could further crimp Europe's recovery prospects. On Friday, Europe's statistical agency reported that inflation declined again in August to its lowest level since 2009.

"This is a major red light" for Europe, said Jean-Paul Fitoussi, a professor of economics at the Institut d'Études Politiques de Paris. "We need to change the direction of policy to avoid a situation with potentially worrisome consequences for society and politics.”

It is not clear that a shift in monetary policy alone can reinvigorate the European economies. President François Hollande of France, whose government has been in turmoil after a failed effort by a left-leaning minister to challenge Germany’s economic prescriptions, on Thursday called for a “eurozone summit” to restore growth and investment in the euro area “as soon as possible.”

A new approach is needed, Mr. Hollande told a conference of French ambassadors in Paris, because “the recovery is too weak, because inflation is too low, because the euro is too strong, and because Europe is menaced by long and possibly interminable stagnation if we don’t act.”

Mr. Hollande, a Socialist who as a candidate promised a new economic approach, has shown little willingness to break decisively with Germany over Ms. Merkel’s insistence that keeping government debt under control is the precondition for long-term prosperity.

Still, France, Italy and a number of other countries are likely to press within the European Union in coming months for a loosening of deficit-reduction targets for the next several years.

The austerity program has helped Spain, Ireland and other troubled economies regain their ability to borrow money in the bond markets. But critics say that forcing countries to cut spending and raise taxes to meet fiscal targets while in recession also delayed and weakened the economic recovery, impeding job creation and income growth.

Ms. Merkel, while agreeing that growth is important, continues to rebuff calls for a change in German policy.

“We can talk about whether you make 2 or 3 percent more debt, or 1 percent, or, like us, a balanced budget,” Ms. Merkel said this week. “But one really must question whether we can go on receiving less than we spend, so that our debts keep on growing. Indeed, a whole crisis of confidence has grown out of that.”

Still, she hinted she could be more flexible if countries undertook reforms to revive competitiveness. Spain, which adopted more business-friendly labor laws and other structural changes to its economy, is one of the few eurozone countries to show signs of recovery. In a visit this week with Prime Minister Mariano Rajoy, Ms. Merkel praised Spain as a model for how to rebound from the crisis.

Ms. Merkel has remained unmoved by her critics, even as Germany’s economy has slowed and been challenged by new pressures like the confrontation with Russia over Ukraine. To some degree, the slowdown in Germany is being driven by a lack of demand for its exports from neighbors like France and Italy, which, lacking the ability to use government spending to spur growth, have struggled to gain economic traction. Italy, the third-largest eurozone economy, has returned to recession and remains saddled with a debt equal to 136 percent of gross domestic product, the highest ratio in the eurozone after Greece. Analysts said a new crisis in Italy could reignite fears that the eurozone will come apart.

Germany is further vulnerable to the strife in Ukraine. Sales of machinery to Russia, the industry's fifth-largest export market, fell 19 percent in the first six months of the year. On Thursday, Ms. Merkel said the European Union would discuss tougher sanctions this weekend, hours after Kiev accused Moscow of a fresh incursion.

Germany is also grappling with its strained relationship with France, where Mr. Hollande is having trouble holding his party together as calls increase to challenge the supremacy of German economic policy leadership. While the two recessions that have hit France in the last five years have not been as deep as those in other countries, growth has failed to revive meaningfully.

Germans worry about the imbalance between the Continent's two essential powers, while French leaders feel belittled by Ms. Merkel, who "wants to give us lessons," said Jean-Christophe Cambadélis, a prominent French Socialist. "We are a great nation trying to pull ourselves together. We are not one of the German länder," he added, using the German word for its 16 states.

"Germany is a strong country, but it is too weak to lead the Continent alone," said Guntram Wolff, a German who runs the Bruegel organization in Brussels. While trade with France is important, their common projects — monetary union, the European Union itself, centuries of shared history — count for much more, he said.

A prolonged downturn in Europe, should it happen, could weigh on the American recovery and have far-reaching consequences for European society and politics at a time when far-right forces have emerged as challengers in France, the Netherlands, Greece and elsewhere, analysts said.

And as American imperatives point toward more multilateralism, Mr. Summers said, “a greatly diminished and stagnating Europe will mean that the United States will increasingly lack its best partners.”

Liz Alderman reported from Paris and Alison Smale from Berlin. Jack Ewing contributed reporting from Frankfurt.

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Young and Jobless Across Europe , NYTimes 11/15/13

Change in youth unemployment from the year ended June 2008 to the year ended June 2013.