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Keynes, Hayek and the Great Stimulus Debate

ARTICLE: KEYNES, HAYEK AND THE GREAT STIMULUS DEBATE 1-7

ABOUT FRIEDRICH HAYEK.....2

INTEREST RATES AND ECONOMIC INDICATORS 8

COBANK REPORTS SECOND QUARTER FINANCIAL RESULTS 9

ABOUT COBANK 9

About this article

Russ Roberts is an economics professor at George Mason University and research fellow at Stanford University's Hoover Institution. His most recent book is *The Price of Everything: A Parable of Possibility and Prosperity.*

The $862 billion federal stimulus package enacted last year marked a triumph for the Keynesian school of economics – those who believe that, at times of economic contraction, government can and should use fiscal policy and public spending to replace shrinking demand in the private sector.

Today, with the U.S. jobless rate still near 10 percent and GDP growing anemically, debate continues to rage about the wisdom and impact of the 2009 stimulus plan and the debts incurred to implement it. Opposing the Keynesian view are disciples of another dead economist, Friedrich Hayek, a contemporary of Keynes and frequent intellectual sparring partner. Hayek, who believed government intervention tends to distort markets, is credited with developing theories that highlighted the fundamental flaws behind the centrally planned economies of socialist and communist countries. Though he is far less well known than Keynes, the Austrian-born Hayek was nonetheless awarded a Nobel Prize in economics in 1974. He died in 1992.

Among Hayek's supporters is Russ Roberts, an economics professor at George Mason University and research fellow at Stanford University's Hoover Institution. OUTLOOK recently spoke with Roberts about Hayek's theories and their implications for public policy in the current political and economic environment.

OUTLOOK: Who was Friedrich Hayek and what is his background?

RR: Friedrich Hayek was an economist born in Austria in 1899, so he had a toe in the 19th Century but was influential all through the middle of the 20th Century.

He spent the 1930s mostly at the London School of Economics, where he was a frequent intellectual combatant with John Maynard Keynes. During that time, he worked on business cycle theory. In 1945, he wrote a very influential article, titled "The Use of Knowledge in Society," exploring the role that prices play in allowing knowledge, which is known by individuals, to almost magically be used in various economy-wide decisions about what to buy and what to produce.

Later in his life, he was interested in the philosophy of legislation, law and political economy. He wrote about the notion of getting government out of the provision of money, which he saw as a major cause of the business cycle

Friedrich Hayek

Born: May 8, 1899

Died: March 23, 1992

Nationality: Austrian

Field of Study: Economics & Philosophy

Education: University of Vienna
Doctorate in Law 1921
Doctorate in Political Science 1923

Academic Appointments:
1931 - 1950 London School for Economics
1950 - 1962 University of Chicago
1962 - 1968 University of Freiburg

Honors: Nobel Prize in Economics (1974)

and inflation. His last book, *The Fatal Conceit*, summed up a key part of his intellectual life: Be skeptical of the ability of experts to steer things from the top down in effective ways that are consistent with liberty.

OUTLOOK: What was Hayek's economic point of view and main theory?

RR: Probably his single most important idea was the notion of "emergent order." He believed that order often emerged through the decisions of individuals rather than being created. If you look around you see that the supply in America of almost every good is plentiful. You always expect when you go into a store to find the shelves stocked full. You don't go in to the grocery store and find they are out of meat. It never happens. Why is that? No one's in charge of the supply of meat or almost anything else.

One of the reasons our complex society works so smoothly, without our often appreciating it, is the fact that prices send information to consumers and to suppliers about how to make things and how to buy things in the most effective way. If you think about how complicated many products are, how many people cooperate in producing them, it is amazing. Take something as simple as a pencil. All the different pieces of it – graphite, cedar and rubber for the eraser – come from all over the world, yet the people who worked together to produce it rarely communicate. There's no one in charge of making sure there's enough cedar for pencils, cedar for grilling salmon and cedar for furniture, yet some how there is always plenty of cedar for everybody. Hayek called that a marvel. The price system creates an orderly process that no one created and no one is in charge of, yet it works very well.

His theories on the business cycle – why the economy has ups and downs – are coming into prominence now that the economy is struggling. People are starting to again question whether the Keynesian perspective is the right one. Hayek's influential book, *The Road to Serfdom*, was a warning at the end of World War II that if the government got too large, we were at risk of heading in the same direction as either the fascists or the communists. England went farther down that road than the United States, but both pulled back in the 1980s. Both [President Ronald] Reagan and [British Prime Minister Margaret] Thatcher invoked Hayek's ideas when they worked to reduce at least the growth of government, if not the size of government in absolute terms.

OUTLOOK: Hayek was well known in academic and political circles. How come Hayek never received the public renown of Keynes?

RR: He was very well known in the 1930s, but I think the narrative that triumphed about the Great Depression is that capitalism is inherently flawed. I don't think that's the right narrative, but that was the narrative that won the day. Hayek was associated with the notion that capitalism was self-regulating, and many people decided that the Great Depression disproved that theory.

Russ Roberts is an economics professor at George Mason University and research fellow at Stanford University's Hoover Institution.

> During the Great Depression, people just wanted an answer, even if it was wrong. The New Deal didn't work very well, but it sure sold politically. Hayek had a harder sell.

The other reason is that Hayek was willing, at various points in his career, to be totally hands off in times of economic decline. During the Great Depression, people just wanted an answer, even if it was wrong. The New Deal didn't work very well, but it sure sold politically. Hayek's ideas had a harder sell.

OUTLOOK: What would Hayek have said about the causes of the most recent economic downturn?

RR: Similar to the Great Depression, we're in the middle of a fight over what narrative is going to win to describe what we learned from this crisis. For example, a lot of people want to push the claim that the reason we had this crisis is because of a naïve belief in self-regulation. Obviously, the Hayekian world view is very open to the idea of self-regulation, emergent order is about a self-regulating system. But if Hayek were alive today, I think he would point out that the 1980s and 1990s were not exactly self-regulating with respect to financial markets. People like to claim that they were; they like to claim the reason the financial system went off the rails was because we allowed financial institutions to regulate themselves. It is a false claim for many reasons, including the fact the financial industry is one of the most highly regulated industries in the world. Even in 2005 that was true.

But the most important point I would make, and that I think Hayek would make, is that economic freedom and a self-regulating market requires a profit and loss system, where the profits encourage risk taking and the risk of loss encourages prudence. Government policy, going back to the 1980s, systematically removed most of the risk of loss from financial institutions who had lent money recklessly. If you tell a lender that if you make a bad loan, you are not going to have to pay the consequence and you are going to get your money back anyway, then it's highly likely they'll make more bad loans. I certainly wouldn't call that a self-regulating system. It may be that government turned a blind eye to a lot of what happened on Wall Street and in the housing market, but there was no incentive for the private investors in these large financial institutions to be prudent, even when they weren't being supervised, because they knew they had the backstop of the government.

OUTLOOK: What role would Hayek say monetary policy played in the recent recession?

RR: Hayek was fascinated and absorbed by the role that prices play in steering resources and decisions. One of the most important prices in the

economy is the price of patience and the reward for patience, which is the interest rate. If you give up consumption today, you get more tomorrow, the amount extra that you get depends on the interest rate. Similarly, if you are an investor and you have to pay back that money, the rate at which you have to pay back determines what risks you'd be willing to take and which ones you decide to pass on. If interest rates are very high and you have an investment that is not very productive, you are not going to be as interested in borrowing money and people aren't going to be interested in lending to you. So the interest rate plays a crucial role in allocating resources over time with regard to saving and investment decisions. If the government distorts that decision via its central bank, it's going to distort economic activity and economic decisions.

Hayek would argue that the historically low interest rates from 2002 to 2005 under [Fed Chairman] Alan Greenspan encouraged a lot of home building and other types of investments that turned out not to be productive when interest rates eventually went higher. Jerking around the investment decision like that is not a very healthy thing. Of course, we're doing it again now. We are artificially holding the short-term interest rate very, very low in hopes of stimulating the economy. It's not working so well, unfortunately, though it may be preventing a worse situation. Hayek's perspective would be that cheap money and cheap credit are a mistake.

OUTLOOK: The fiscal stimulus we've seen over the past year is straight out of the Keynesian playbook. What would Hayek have recommended in response to the recent recession?

RR: He espoused different ideas at various times. During the Depression in 1930s, he originally said, "Do nothing, leave it alone, let the economy heal. We have to bear the cost of our past bad decisions by policymakers." In earlier work before the Depression, however, he actually was more aggressive about monetary policy as a response to economic downturns. But I don't think he ever was supportive of what we now call stimulus fiscal policy. He worried a great deal about deficits, and he worried about inflation that might follow government spending that was excessive. There was a conversation he reported having with Keynes after World War II, where he worried about inflation. Keynes said he was worried, too, but said he'd just get his followers to get worked up about it at the appropriate time and stop it. Keynes had great confidence in his persuasive powers, perhaps correctly. Unfortunately, Keynes died shortly after that conversation, and we did eventually enter into a long inflationary spiral that was very destructive in the 1960s and 1970s.

Let's for a moment talk about the virtues of doing nothing in the current crisis. One of the reasons we're in the mess we're in is because we built way too many houses, houses that are right now sitting unoccupied. There is very little demand for new construction, so there's been massive unemployment

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in the construction industry. What do you do about that? One thing you don't do is spend $862 billion on a bunch of stuff that isn't related to housing. The second thing you don't do is keep interest rates really, really low, which keeps the price of houses high and keeps them unoccupied. When you build too many houses, you need to let home prices fall.

Hayek would argue that the housing market needs to heal itself, and you can't fix it by artificially injecting money into the economy or artificially lowering interest rates. That problem doesn't go away because you pretend it's not there. The fact is we made a mistake because we built too many houses, and we made that mistake because of government policies that encouraged homeownership and cheap credit. Why would you assume you get to make that mistake at zero cost? The virtue of Hayek's hands off approach is to force you to think about the fact you made a mistake and there's no free lunch – no painless way to solve the problem.

OUTLOOK: So Hayek would say we need to "take our medicine" and let the market find equilibrium and stability on its own without government intervention?

RR: Yes. Of course, people don't like medicine. They want to believe there's a pill you can take that tastes good and doesn't have any side effects. I don't know a lot of pills like that. Certainly in economics, we know even less about the economy than we do about the human body, and we are not so good at administering the medicine. Right now we are in a big debate about whether the medicine of the stimulus made things better or whether the side-effects – such as large budget deficits and government debt – are going to be more harmful than the proposed cure.

OUTLOOK: Is Hayek truly experiencing a revival now the way Keynes did a few years ago?

RR: Well, let me start by talking about Keynes. Among policymakers and academic economists, Keynes in the 1970s and 1980s fell out of fashion. Stagflation – the coexistence of high unemployment and high inflation – was impossible according to Keynesian models and the followers of Keynes who were writing in the '70s. Yet it happened and they found themselves on the defensive. There were various other intellectual trends that happened then which called into question the very idea of being able to steer the economy with the fiscal and monetary policy techniques that had been thought to be effective in the past. So Keynes went out of fashion. There wasn't any Keynesian stimulus in the recession of 1981; no one proposed a giant

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spending program. What Reagan proposed was a cut in taxes and painful monetary policy. It worked; the economy started to recover without taking Keynesian help. In the recessions of 1991 and 2001, which were relatively short, there was no Keynesian stimulus proposed and we recovered from both. But the size of this recession was so large and the unemployment was so worrisome that, all of a sudden, a bunch of economists said you've got to spend a lot of money. What was the justification for it? There wasn't any, other than the fact that there seemed little else to do. Interest rates were already very low so it seemed that all we had left was the Keynesian bullet so we fired it.

I think what is happening now is the whole idea of macro-economics and business cycle theory has been deeply called into question by the current crisis. It has encouraged people to look at theories that have been neglected or discarded, with many wondering whether there was more to them than we originally thought. In that sense, Hayek is having a bit of a comeback on the macro economic side. On the micro side, his understanding of prices has always been important and still has influence. People understand that price controls and distorting prices are not a good ideas.

OUTLOOK: A lot of Hayek's theories were a repudiation of centrally-run economies in communist and socialist countries. How should they be applied to generally open Western economies?

RR: A lot of people say, we are not going to go communist; we're talking about a mixed economy where government has to have a role and therefore Hayek is irrelevant because he just said communism or fascism is bad. It's a fair criticism, but it misses the point. The underlying insight of Hayek is to be skeptical of the ability of experts and individuals to steer complex systems. That is why he was skeptical of a controlled economy.

He was very involved in a debate in the 1930s and 1940s about whether a planned economy – forget whether it's run by benevolent people or evil people – can be successful. He didn't believe that a central authority could assign prices and quantities to the myriad products and services that people would buy in a way that would create some kind of semblance of order. He understood that order could be created without control from the top; it could be created by bottom-up decisions from individual consumers and producers. He won that argument, along with a bunch of other people, who said that centrally-planned economies would be inefficient. The point

that's crucial is that his critique of centrally planned economies applies to a lot of other things, too. If you are going to run the auto industry from Washington, D.C. – which is what we're trying to do right now – Hayek's insight is that the government's incentive to run it well is not very good. He'd say that you're going to make all kinds of mistakes that you don't anticipate, even with the best of intentions. I don't think we're sliding down the road to socialism, but that doesn't mean that Hayek's insights don't apply. A lot of the things the Obama Administration is trying to do attempt to steer economic markets from the top down rather than from the bottom up. Hayek's insights suggest they are going to fail or lead to consequences we are not going to like. Some of those consequences may be hard to see but are real, like encouraging businesses to turn to Washington for help rather than working harder to compete and serve their customers.

OUTLOOK: If Hayek were alive today, what advice would he give policymakers and political leaders?

RR: He'd be in favor of getting government out of things it's not very good at doing on the spending side. There's lot of stuff that the government spends money on that he'd say is wasted or worse than wasted. He wasn't an anarchist, he didn't believe in zero government or zero social welfare spending. But he would certainly be against current monetary policy and would suggest that the government should get out of the business of trying to steer the economy through interest rates. He'd want to get rid of all subsidies, such as subsidies for people making electric cars or wind energy. He would say, instead, let private investors take those risks, because they're better incentivized to understand and weigh the different costs and benefits of those technologies. He would certainly be against attempts to centrally plan our energy future.

In the end, Hayek was a man who wrote about fundamentals that are timeless – such as the challenges of complexity. The insights he saw in a complex economy in 1930 and 1940 are even more applicable today as our economy is getting even more complicated. The inability of experts to understand the consequences of their decisions with respect to the economy is even truer today than it was when Hayek was most influential. Also his skepticism about the ability to centrally plan an economy or even an individual industry is even more true today than before. His passion and belief in freedom is as relevant today as ever. He made the point that power is a very addictive drug. Hayek was passionate about decentralizing power. His insights into power and prosperity are immortal. ■

Interest Rates and Economic Indicators

The interest rate and economic data on this page were updated as of 7/31/10. They are intended to provide rate or cost indications only and are for notional amounts in excess of $5 million except for forward fixed rates.

KEY ECONOMIC INDICATORS

Gross Domestic Product (GDP) measures the change in total output of the U.S. economy. The Consumer Price Index (CPI) is a measure of consumer inflation. The federal funds rate is the rate charged by banks to one another on overnight funds. The target federal funds rate is set by the Federal Reserve as one of the tools of monetary policy. The interest rate on the 10-year U.S. Treasury Note is considered a reflection of the market's view of longer-term macroeconomic performance; the 2-year projection provides a view of more near-term economic performance.

ECONOMIC AND INTEREST RATE PROJECTIONS

Source: Insight Economics, LLC & Blue Chip Economic Indicators

				US Treasury Securities	
2010	**GDP**	**CPI**	**Fed Funds**	**2-year**	**10-year**
Q1	2.70%	1.50%	0.13%	0.90%	3.70%
Q2	**3.20%**	**-0.20%**	**0.19%**	**0.90%**	**3.50%**
Q3	2.70%	1.30%	0.19%	0.60%	3.00%
Q4	2.80%	1.50%	0.20%	0.70%	3.00%
2011	**GDP**	**CPI**	**Funds**	**2-year**	**10-year**
Q1	2.80%	1.70%	0.20%	0.70%	3.00%

PROJECTIONS OF FUTURE INTEREST RATES

The table below reflects current market expectations about interest rates at given points in the future. Implied forward rates are the most commonly used measure of the outlook for interest rates. The forward rates listed are derived from the current interest rate curve using a mathematical formula to project future interest rate levels.

IMPLIED FORWARD RATES

Years Forward	3-month LIBOR	1-year Swap	3-year Swap	5-year Swap	7-year Swap	10-year Swap
Today	0.46%	0.49%	1.07%	1.78%	2.37%	2.90%
0.25	0.39%	0.54%	1.21%	1.92%	2.48%	2.98%
0.50	0.47%	0.66%	1.37%	2.10%	2.61%	3.08%
0.75	0.58%	0.80%	1.57%	2.27%	2.77%	3.21%
1.00	0.70%	0.98%	1.73%	2.44%	2.89%	3.31%
1.50	1.05%	1.36%	2.14%	2.77%	3.16%	3.52%
2.00	1.47%	1.74%	2.49%	3.07%	3.38%	3.68%
2.50	1.83%	2.12%	2.84%	3.32%	3.58%	3.85%
3.00	2.20%	2.51%	3.19%	3.57%	3.79%	4.02%
4.00	2.94%	3.28%	3.73%	3.95%	4.09%	4.25%
5.00	3.50%	3.82%	4.03%	4.20%	4.30%	4.40%

HEDGING THE COST OF FUTURE LOANS

A forward fixed rate is a fixed loan rate on a specified balance that can be drawn on or before a predetermined future date. The table below lists the additional cost incurred today to fix a loan at a future date.

FORWARD FIXED RATES

Cost of Forward Funds

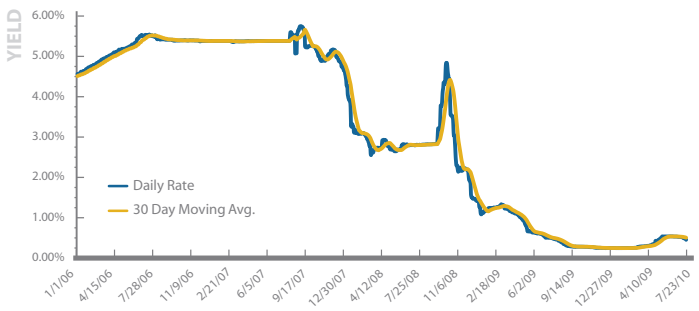
Forward Period (Days)	Average Life of Loan			
	2-yr	3-yr	5-yr	10-yr
30	5	6	8	6
90	10	19	20	15
180	13	33	35	26
365	32	57	64	47

Costs are stated in basis points per year.

SHORT-TERM INTEREST RATES

This graph depicts the recent history of the cost to fund floating rate loans. Three-month LIBOR is the most commonly used index for short-term financing.

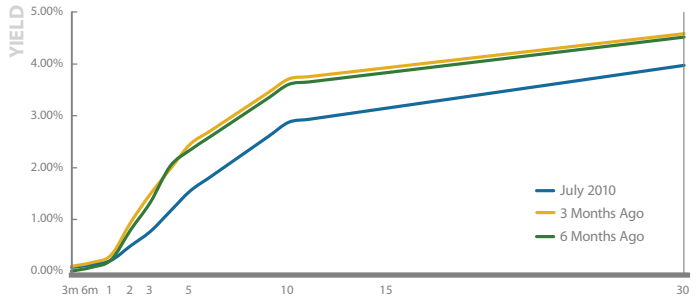
3-MONTH LIBOR



RELATION OF INTEREST RATE TO MATURITY

The yield curve is the relation between the cost of borrowing and the time to maturity of debt for a given borrower in a given currency. Typically, interest rates on long-term securities are higher than rates on short-term securities. Long-term securities generally require a risk premium for inflation uncertainty, for liquidity, and for potential default risk.

TREASURY YIELD CURVE



CoBank Reports Second Quarter Financial Results

In August, CoBank announced financial results for the second quarter of 2010.

Second-quarter net income was $150.4 million, compared with $156.1 million in the second quarter of 2009. Net interest income for the quarter was $217.9 million, compared with $239.7 million in the same period last year. Average loan volume for the second quarter of 2010 was $43.2 billion, compared to $45.9 billion for the same period in 2009. For the first six months of 2010, net income increased

1 percent, to $319.0 million and included the impact of refunds of insurance fund premiums paid in prior years. Net interest income for the first six months of 2010 was $448.6 million, compared to $492.9 million in the same period of 2009. Total loan volume for the bank at June 30, 2010 was $42.3 billion.

As in recent prior quarters, loan volume decreased primarily due to lower commodity prices and lower inventories at agricultural cooperatives, which resulted in a corresponding reduction in seasonal lending to agribusiness customers. Those declines were partially offset by growth in loans to rural energy customers and in wholesale loans to associations in the Farm Credit System.

"We're pleased that CoBank recorded another period of strong financial performance in the second quarter of 2010," said Robert B. Engel, president and chief executive officer. "Overall demand for loans in many of the industries we serve remains soft due to the uncertainty that persists about the direction of the global economy. However, the bank continues to generate robust earnings and to fulfill its mission as a reliable source of credit and other financial services for our customer-owners across rural America."

At quarter end, 1.74 percent of the bank's loans were classified as adverse assets, compared with 2.01 percent at March 31, 2010. Nonaccrual loans improved to $272.1 million, compared to $298.6 million at the end of the first quarter. During the second quarter, the bank recorded a $4.0 million provision for loan losses, in addition to the $12.5 million provision in the first quarter of this year. Provisions for loan losses in the first six months of last year were $30.0 million. The bank's reserve for credit exposure now totals $503.3 million, or 2.1 percent of non-guaranteed loans outstanding when loans to Farm Credit associations are excluded.

About CoBank

CoBank is a $58 billion cooperative bank serving vital industries across rural America. The bank provides loans, leases, export financing and other financial services to agribusinesses and rural power, water and communications providers in all 50 states.

CoBank is a member of the Farm Credit System, a nationwide network of banks and retail lending associations chartered to support the borrowing needs of U.S. agriculture and the nation's rural economy. In addition to serving its direct borrowers, the bank also provides wholesale loans and other financial services to affiliated Farm Credit associations and other partners across the country.

Headquartered outside Denver, Colorado, CoBank serves customers from regional banking centers across the U.S. and also maintains an international representative office in Singapore. For more information about CoBank, visit the bank's web site at www.cobank.com.

"We're pleased to see continued stabilization in overall credit quality and improvement in credit quality for certain sectors," Engel said. "Although it's possible we could see a decline in credit quality in certain areas of our loan portfolio as a result of ongoing challenges in the economy, our strong earnings and loss reserves continue to function as important safeguards for the bank and its capital foundation."

Capital and liquidity levels at the bank remain strong and well in excess of regulatory minimums. At quarter end, the bank held approximately $14.6 billion in cash and investments. The bank averaged 258 days of liquidity during the first six months of the year, compared with the 90-day minimum established by the Farm Credit Administration, the bank's regulator. "As global credit markets have continued to stabilize over the past several months, we expect to adjust our liquidity position closer to our management target of 180 days over the balance of 2010," Engel said.

Engel noted that, in the broader economy, conditions in the credit markets have improved markedly since the depths of the banking crisis in the latter half of 2008 and the first part of 2009. However, overall economic activity in the United States remains sluggish as evidenced by a stubbornly high jobless rate and low consumer confidence.

"At CoBank, these dynamics have clearly impacted the borrowing needs of our customers, along with the bank's loan volumes and net interest income," Engel said. "And it remains difficult to predict with any certainty when real confidence and vigor will return to the U.S. economy, bringing with it a substantial increase in consumption and investment. We are fortunate that our board – and our base of customer-owners – understand the importance of managing for the long term and protecting our bank's foundation of strength and stability. We continue to focus on serving as a trusted and dependable financial partner for our customers and delivering on a value proposition that has proven to be both powerful and enduring throughout an enormously challenging period in our nation's economic history." ■

Commentary in Outlook is for general information only and does not necessarily reflect the opinion of CoBank. The information was obtained from sources that CoBank believes to be reliable but is not intended to provide specific advice.