Magellan
Planning Group, Inc.

Keynes Contra You

-J. Kevin Meaders, J.D, CFP®, ChFC, CLU

October, 2010 - John Maynard Keynes. You've heard the name. Was it Econ 101 in college? Isn't he associated with economics somehow? Keynesian Economics. Where have I heard that?

Well, no matter what you know of Keynes or don't know, he, more than any other person, affects your life in everyday ways. He affects your job, your investments, your savings, your pensions, your retirement benefits, your taxes, and your entire financial security—right down to the value of the pennies in your pocket. Considering all this, it might be prudent to learn a little more about Keynes, don't you think?

Keynesian Economics was borne out of the Industrial Revolution as a sort of defining relationship between industrialists and labor. The industrialist's motive is to maximize profitability by paying the lowest possible wage. According to Keynes, as a result of the refusal of workers to accept a lesser wage, unemployment ensues. Thus, unemployment is the direct result of the workers' refusal to accept a lower wage.

Keynes writes, "A classical economist may sympathize with labour in refusing to accept a cut in its money wage…; but scientific integrity forces him to declare that this refusal is, nevertheless, at the bottom of the trouble."[*]

So Keynes postulates another way to reduce the worker's wage: not by reducing the amount of dollars the worker receives, but by reducing the amount of "stuff" that each of his dollars will buy. The amount of dollars the worker actually receives Keynes calls "money-wage," but the amount of goods and services purchased for a dollar is the "real-wage."

It would not do you much good to earn $1 Million per year if every trip to the grocery store cost you $50,000. In real terms, the worker who earns $100 per year is wealthier if an identical trip to the grocery store cost only $1. The actual amount—the money-wage—is meaningless. The power to purchase—the real wage—is everything.

The answer, therefore, according to Keynes, is not a cut in money wages since workers would resist, but a cut in real wages, which is simply a loss in purchasing power due to a rise in the cost of living. If you reduce a worker's money-wage, he earns less money per hour. If you reduce his real-wage, the money that he earns will buy him less because prices are higher.

Keynes explains that "since there is, as a rule, no means of securing a simultaneous and equal reduction of money-wages in all industries, it is in the interest of all workers to resist a reduction in

[*] *The General Theory of Employment, Interest and Money*. John Maynard Keynes, 1935.

their own particular case. In fact, a movement by employers to revise money-wage bargains downward will be much more strongly resisted than a gradual and automatic lowering of real wages as a result of rising prices."[*]

There you have it. It is much easier to reduce the real-wage through inflation and loss of purchasing power than to reduce the money-wage because "it would be impracticable to resist every reduction of real wages, due to a change in the purchasing power of money which affects all workers alike; and in fact reductions of real wages arising in this way are not, as a rule, resisted unless they proceed to an extreme degree."[*]

"Every trade union will put up some resistance to a cut in money-wages, however small. But since no trade union would dream of striking on every occasion of a rise in the cost of living, they do not raise the obstacle…"[*]

"Thus it is fortunate that the workers, though unconsciously…do not resist reductions of real wages…"[*] Meaning they don't resist rising prices—inflation.

Perhaps one could argue his doctrine of intentional inflation was directed to the industrialists alone. One can imagine thousands of workers toiling away in the company factory, living on company land, renting a company flat, and buying all their essentials from the company store. In this way the industrialists might control the real-wage—the cost of living—as well as the money-wage.

But Keynes is speaking to the powers that be: the "governing and academic classes of this generation." And grateful governments latched on quickly and firmly. Finally they had an academic who defended—nay, promoted—the depreciation of purchasing power through inflation. And that means war!

See, there is an age-old saying: "To carry on a successful war three things are needed: money, money, and yet more money." When governments go to war they have almost unlimited conscripts, but not an unlimited supply of money. To get the required money, a government has only three options:

1. <u>Borrow it</u> from other countries and the population through the sale of bonds.
2. <u>Raise taxes</u> and tariffs and reduce benefits.
3. <u>Create money</u> and force everyone to accept it through legal tender laws.

In the United States, we utilize all three, but two of them have limits. One can only borrow what others are willing (and able) to loan, and large increases in taxes are politically unpopular. Thus, the remaining choice of money creation is the clear favorite, and as renowned economist Hans F. Sennholz eloquently points out in his 1979 book, *Age of Inflation,* the trend is worrisome at best:

> "In the past, the inflations were of relatively short durations, limited to periods of national emergency when the central government was called upon to finance extraordinary defense expenditures. After the end of hostilities monetary stability soon returned as the emergency financing was abandoned. Today, public demand for governmental services never abates, in wartime and in peacetime, but seems to

---

[*] *The General Theory of Employment, Interest and Money*. John Maynard Keynes, 1935.

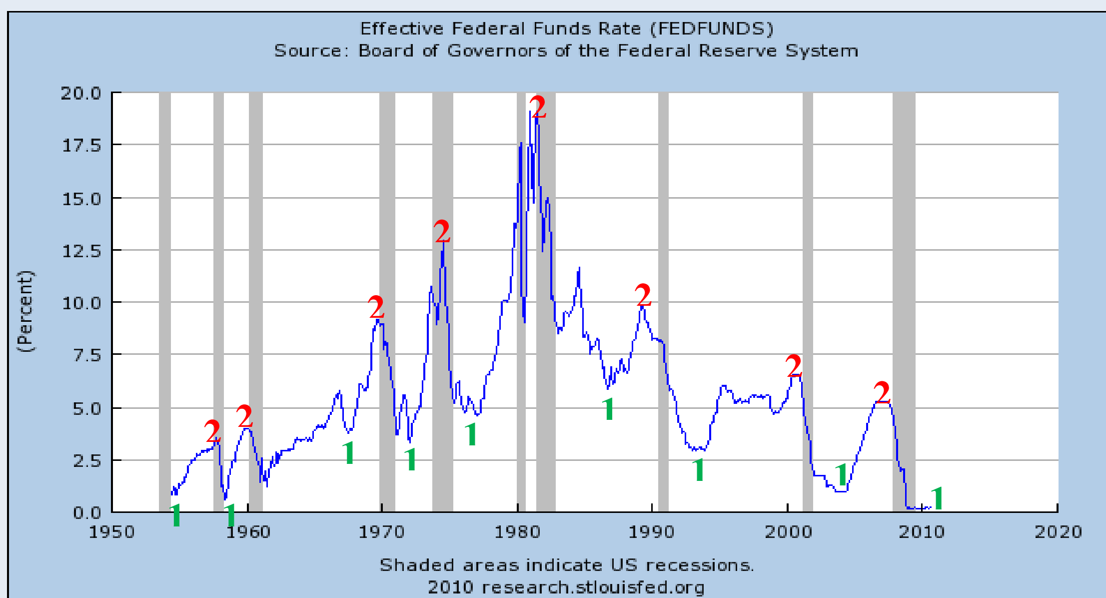
> accelerate year after year. In fact, the more government spends on economic and social objectives the louder the public clamor for more services seems to become.
>
> Thus, the temporary emergencies that in the past gave occasion for extraordinary defense expenditures and inflationary financing have given way to a permanent emergency of social service and inflationary financing. It is true that inflation can never be permanent, for it must come to an end with the total destruction of the currency."*

What Keynes and his followers either don't know or won't admit is that every period of monetary expansion is followed by a period of painful correction. Indeed, the initial flood of new, cheap money creates a boom—a tide that raises all boats, but in due course a crash inevitably ensues. As anti-Keynesian Ludwig von Mises explains:

> "The wavelike movement affecting the economic system, the recurrence of periods of boom which are followed by periods of depression, is the unavoidable outcome of the attempts, repeated again and again, to lower the gross market rate of interest by means of credit expansion. There is no means of avoiding the final collapse of a boom brought about by credit expansion. The alternative is only whether the crisis should come sooner as the result of voluntary abandonment of the further credit expansion, or later as a final and total catastrophe of the currency system involved."†

The total catastrophe of our currency system has not yet occurred because the more tenable alternative thus far has been the "abandonment of further credit expansion" though, indeed, as Mises foretold, recessions and depressions followed.

To prove Mises' point, take a close look at the chart of the Effective Fed Funds Rate below. Note that the shaded areas indicate a recession—a bust—but before every recession is the "abandonment" Mises spoke of, which I have labeled with a red "2." This is a raising of interest rates—an abandonment of easy credit.



---

* *Age of Inflation*, Hans F. Sennholz, 1979.
† *Human Action: A Treatise on Economics*, Ludwig von Mises, 1949.

Notice what happens just after every red 2: a bust, just as Mises says. And before the red 2 (which is a rise in rates), there is a lowering of rates which indicates the beginning of the "quantitative easing" (lower rates = cheap money), which I have likewise indicated with a green "1." Now take notice of what happens to the rates every time a recession occurs—more of the same—another artificial lowering of rates, creating yet again another boom-bust cycle.

Mises is right on. The Fed lowers rates to create a boom (**1**), a boom ensues. The Fed raises rates to control inflation (**2**), and then a bust comes (recession), and then the Fed lowers rates again to create a boom (**1**). Every time, just like clockwork. Every green 1 is followed by a red 2 is followed by a recession is followed by a green 1, *ad infinitum*.

Finally, I want you to note the ever increasing intensity of the monetary easing needed since 1980 (the downward trend of green **1**s). Each time the Fed is forced to drive down rates because of the previous rate hike, the lower the rate has been. Until finally, now, we are as low as we can go. In addition, the Fed has taken other measures over and beyond this—exasperating both the boom, and the bust. Both yet to come.

This chart was put together by the Fed, and you can see that the most recent recession, according to them, ended in 3rd quarter 2009. In our opinion, that's just wishful thinking. What has us worried is not the current recession—whether you agree it's over or not—but the next recession yet to come, which, unless there is a serious turn of events, could be even worse.

Fortunately for the powers that be—unfortunately for the rest of us—the population has not caught on. Indeed, most economists, politicians and business forecasters seem to have not caught on either. Many are clamoring for yet more quantitative easing, above and beyond the already low interest rates, the so-called "QE2." Will it take a complete collapse of the monetary system—as Mises warns—for us to finally take a sound money approach?

As American tax-payers and voters, it would seem we are quite out of luck. Both the Democrats and the Republicans support this type of ponzi-style shell game because they can make promises without raising taxes. And what politician doesn't want that? Moreover, when's the last time you didn't vote for either a Republican or a Democrat?

For us as investors, however, we have an edge. Knowing and understanding the boom-bust cycle is a real advantage that we can use to both make money in the boom and protect ourselves during the bust. We know a boom is coming, and we know that a bust will inevitably follow.

Now that we know what to look for and what to expect—as investors—we can position ourselves accordingly. As I outlined in my last letter, stocks will inflate along with everything else when inflation finally occurs. Inflation has not yet shown itself because the monetary easing—the newly created money—is tied up in the mortgage industry, the empty homes. As this unwinds, it is still not clear whether the Fed will buy more treasuries, which is tantamount to fiat money creation. We should know more after the Fed's meeting in early November.

This type of world macro insight has brought us double digit returns so far this year in silver, gold, agribusiness, and India—all of which are satellite holdings—while the broad markets are essentially flat.

The views and opinions are those of J. Kevin Meaders, J.D., CFP®, ChFC, CLU and should not be construed as investment advice. All information is believed to be from reliable sources; however, we make no representation as to its completeness or accuracy. Additional risks are associated with international investing such as, currency fluctuation, political and economic stability, and differences in accounting standards. Investors cannot directly invest in indices. Past performance does not guarantee future results.

About J. Kevin Meaders

kevin@magellanplanning.com

Kevin Meaders graduated from Oglethorpe University in Atlanta with a double B.A. in Philosophy and Political Science, and then obtained a law degree from Georgia State University College of Law, focusing on estate planning and trust law. He has earned the designations of Certified Financial Planner (CFP®), Chartered Financial Consultant (ChFC) and Chartered Life Underwriter (CLU). He holds a General Securities Principal and Registered Representative registration and Investment Advisor Representative registration through ING Financial Partners (member SIPC).

About Magellan Planning Group

www.magellanplanning.com

Magellan Planning Group was established in 2000 to provide a service uniquely tailored to the needs of our affluent Atlanta community. We concentrate on *personalized* retirement planning through tri-disciplinary coordination:

- Financial planning with our Certified Financial Planner™ to prepare a retirement plan that takes into account your needs and expectations. We are a fee only asset management firm with a $500,000 minimum relationship.

- Estate planning with our in-house Attorney-at-Law to determine and prepare the documents needed to minimize family liability and maximize privacy. (www.magellanlegal.com)

- Tax planning through a relationship with our in-house CPA to manage tax obligations throughout the year and prepare a tax return that takes into account current tax laws. (www.magellantax.com)

Our relationship doesn't begin and end with the preparation of a plan and the appropriate documents. We establish close personal relationships with our clients and their families and maintain those relationships through regular 'check-ups', market commentaries and educational Lunch & Learns.

4170 Ashford Dunwoody Rd. NE, Suite 480
Atlanta, GA 30319
404-257-8811

Securities and advisory services offered through ING Financial Partners, member SIPC.
Magellan Planning Group is neither a subsidiary of nor controlled by ING Financial Partners.

Neither ING Financial Partners nor its representatives provide tax or legal advice.
Please consult with your tax and legal professionals regarding your individual circumstances.