



Keynesian Psychology With Austrian Tails

*The following is a “thinking out loud” piece that more or less details why I no longer consider myself a devotee of Austrian economics. I have certainly not “gone Keynesian” by any means... but as determined with political labels long ago (dems vs repubs etc), I have now come to the conclusion that allegiance to any **economic** ideology is just as toxic (from a trading perspective) as allegiance to a political one.*

For as long as I have been a trader, I have considered myself a devotee of Austrian economics. This goes back to my earliest days of market involvement in the mid-1990s (and my immediate taste for the macro side).

Some of my first strong influences were Jim Rogers (whose views are still widely dispersed today), Doug Casey, and Victor Sperandeo, who explained Austrian economics in lucid detail in his excellent book [Methods of a Wall Street Master](#).

In addition to those influences, from the very beginning, most all the legendary global macro traders I came across — with the possible exception of George Soros — expressed themselves as either fiscal conservatives, flat-out Austrians, or some combination of the two.

There is a longstanding conversational thread and respected body of thought that subtly (or perhaps not so subtly) argues that the Austrian view — Hayek, Von Mises et al — represents reality, whereas Keynesian economics represents government-sponsored fantasy.

I still believe the charges are more or less true. **Keynesian economics IS unsustainable fantasy. It DOES always end in tears.** And Austrian economists were more or less CORRECT in envisioning the inevitable outcome of unchecked Keynesian activity (i.e. the global financial crisis as played out in 2008).

But here is the serious problem:

- While Keynesian economics fails in the long run, it does in fact work — or gives the appearance of working — in the short run.
- Like the man himself, devotees of the Keynesian school don't give a damn about ultimate consequence: *“In the long run we are all dead.”*

As far as the *predictive* track record of Austrian economics goes, the global financial crisis has been both the Austrians' glory and their shame:

- Glory because the Austrian view clearly **anticipated** the ponzi-fueled crisis, and
- Shame because the Austrian view got the aftermath completely — and I mean *completely!!!* — wrong. Dead wrong. The post-crisis Keynesian prescriptions “worked” to an astonishing degree.
- The Austrians can claim “the jury is still out,” of course. And they are technically 100% justified in claiming such. But this is *cold comfort to a trader...* and remember, too, that “in the long run we are all dead.”

As I write these words (on April 20th 2010), it is plain as day that mass injections of government stimulus **do in fact have ostensibly positive effect for significantly extended periods of time.**



Are we still going to wind up with hell to pay? The common sense observer in me — the Austrian economist in me — says “*Oh yes, most definitely.*”

There is no question that we are now doing all the things that are likely to make the next round of true crisis even WORSE than that experienced in 2008:

- Eating our seed corn
- Printing up mass amounts of money
- Papering over the true problems
- “Re” leveraging instead of de-leveraging
- Corrupting the ethical base of the system
- All in all, digging a deeper hole than before.

But WHEN IS THIS GOING TO HAPPEN? At this point, the answer remains unclear. It could be the third quarter of 2010. It could be the second half of 2011. It could be stretched out to 2014. Who knows?

Though the Austrians have strong logical evidence of being “right” in the ultimate scheme of things, the Keynesians can claim to be right RIGHT NOW — and for a meaningful stretch of the foreseeable future.

The JGB Example

Another example of Austrian failings (in a general sense) is the situation with Japanese Government Bonds (JGBs). Japan has been a country on the brink of fiscal failure for decades now. With its out of control construction projects, “bridges to nowhere,” and other boondoggles, Japan is a textbook example of Keynesian stimulus run amok. The country’s sovereign debt load, approaching 200% of GDP, is recognized by all and sundry (including the Japanese themselves) to be unsustainable, a huge disaster in the making. If you think Greece is bad, Japan will one day be Greece times a thousand.

At one point, real estate in Japan was so frothy, a patch of land in Tokyo was worth more than the state of California. **And yet still, twenty years after the great bubble’s bursting, the Keynesian-style spending program marches on.** For two decades, the Japanese government has embraced a stimulus-driven approach to staving off crisis. They haven’t exactly covered themselves in glory, but the country hasn’t imploded either.

And as the joke around Wall Street goes, many a trader has seen their career go up in smoke betting on the ‘inevitable’ Japanese implosion. It may indeed be ‘inevitable’... but it could also remain so for years more to come. **Waiting for the Austrian ax to fall on Japan’s mass Keynesian delusion is like waiting for Godot, on a scale measured in decades.**

This is why, in the light of all that has happened in the past 18 months, I have come to some new conclusions:

- The Austrian and Keynesian schools can BOTH claim to be “right” — just in **different time frames**.
- Though Keynesianism really does “end in tears,” as the historical record consistently shows, in the here and now, **NOBODY CARES**.
- Because the Austrian perspective is so timing-inept (timing nonexistent?), it is a **TOXIC IDEOLOGY** for traders, or any other market participants who can’t afford to just go sit by the lake and wait for doomsday (as Bob Prechter chose to do).



The Moralism Problem and Cassandra Syndrome

Another real problem with Austrian economics — speaking as a sworn-off devotee here — is the emotion-inducing moral aspect. It is well nigh impossible to embrace the full tenets of the Austrian school without getting angry. It is not realistic to be a full-fledged Austrian without recognizing, and criticizing,

- 1) the utter moral bankruptcy of the “spend now, pay later” Keynesian ethos, and
- 2) the inevitable pain, turmoil, and destruction that will come as a result of this shortsightedness.

In a way, being an Austrian is like being cursed with Cassandra syndrome. You can see the future, and you can see that it's disaster, but NOBODY ON WALL STREET GIVES A SHIT.

Consider this April 2010 commentary from permabull Bob Doll of Blackrock:

“Economic data continues to show that the recovery is proceeding stronger than most had expected, thanks in large part to the massive fiscal and monetary stimulus enacted around the world, which has sparked a recovery in growth even beyond some of the most optimistic projections. Demand among both consumers and companies around the world has been rising, and consumer spending has been stronger than expected (although spending has been coming from savings, rather than from growth in incomes). These trends imply that production levels have not yet caught up with demand, which augers well for the ongoing boom in production.”

Ladies and gentlemen, now there is a man who couldn't give a tinker's damn for the Austrian view.

Fiscal consequences to mass government spending? Who cares. Inevitable repeat of the 2008 crisis as consumers re-leverage and drink the kool-aid? Who cares. Threat of inflationary backlash and sovereign credit disaster as a result of out-of-control spending? Who cares. **ANY AND ALL DEBILITATING LONG TERM RESULTS OF MASS KEYNESIAN STIMULUS EFFORT THAT DO NOT FALL UNDER THE RIGHT NOW CATEGORY: WHO CARES.**

It's not just the pols who embrace “short-termism” — it's Mr. Market

The classic criticism of what's wrong with Washington (or Brussels, or Beijing, or wherever) is a focus on short-term results to the detriment of long-term consequences. Politicians are the ultimate champs at getting the love in today — and thus getting reelected — while screwing over the country tomorrow.

And, in fact, this epidemic of “short-termism” could also be highlighted as the central failing of Keynesian economic theory. The basic notion that Keynes proposed was one of countercyclical government spending as a buffer against business cycle volatility; i.e. spending in the hard times and saving in the good.

The problem is, the second half of the equation — saving during the good times — requires future-oriented self discipline and a willingness to endure discomfort. It requires politicians to rise above short-termism (i.e. to look beyond the next election cycle). And that vain hope was NEVER a realistic possibility.

But that's a rabbit trail. The key point here is, it isn't just the political class. THE ENTIRE MARKET IS A MASS EXERCISE IN SHORT-TERMISM. Consider:



- “Mr. Market” is, for all intents and purposes, a Keynesian.
- The market focuses almost exclusively on near to medium term results.
- The “right now” data points of earnings, indicators etc. outweigh concerns of future consequence.

And this is why the Austrian economic perspective can be so damn toxic from a trading perspective. Austrian-minded traders are forced to operate day-by-day in a predominantly Keynesian world.

Imagine being a Red Sox fan forced to sit in the Yankee section at baseball games. Now further imagine you happen to be a pensive and philosophical Red Sox fan, with all the Yankees fans in your vicinity seriously IQ-challenged. Then further imagine that your team (the Sox) only win a very small percentage of the time, while the Yankees appear to win game after game, for stretches that last years on end. How much fun would that be? What kind of effect would it have on your psyche?

The Market is a Lousy Prediction Mechanism

Some argue that the market is a high quality prediction mechanism — that market prices are effective leading indicators. The only problem is that this is 100% a theory of convenience. It works except when it doesn't.

And the times when it doesn't — i.e. periods like 2000-2002 and 2007-2008, when investors march themselves lemming-like right over a cliff — are disastrous. It is simpler to understand the following:

- Market activity doesn't predict much of anything, except by accident.
- The times when markets correct violently and dramatically — and this is a pattern that has repeated consistently for at least 100 years — can be considered to thoroughly discredit the data-mined examples of successful prediction episodes. In reality, Mr. Market's prediction record is a combination of myopia, outright coin flip, and disastrous whiffs on the cusp of meltdown.
- In reality, Mr. Market is almost always Keynesian and short-termist — focused on the “right now” — because this is the predominant mind set of the market's largest participants.
- During occasions of violent market dislocation (i.e. 2008 etc), Keynesian fantasies are temporarily upended by Austrian realities. The market does a lousy job of predicting these periods *precisely because* it takes an Austrian perspective to understand why they occur... and Mr. Market doesn't have that.

Humanity Sucks at Rationality... and It Always Will

Another weakness of the Austrian school is its inherent focus on rationality.

Now, one might assume that devotion to rationality is a good thing — that a rigorous focus on logic is a positive. Yet, while this is true in respect to physics and the motions of the heavenly bodies, it is NOT so true in respect to gaming the human element.

As Isaac Newton once lamented (having lost a bundle in the South Sea Bubble): “I can calculate the motions of the heavenly bodies, but not the madness of people.”

That inability to calculate the “madness of people” is precisely where Austrian economics FAILS... not in respect to the conditions LEADING UP to crisis, but in respect to human willingness to drink the Keynesian kool-aid POST-CRISIS... and to drink of it OVER and OVER and OVER again.



Or to get slightly Freudian, one might say the typical Austrian economics devotee harbors a secret wish. He wishes that his fellow man would cast off the chains of foolishness and embrace rationality... that the world would see the inherent logic and soundness of Austrian principles as a means of avoiding disaster in the first place.

But guess what? That AIN'T GONNA HAPPEN. Humans (i.e. fellow market participants) are basically pants-wearing monkeys, and as such, they will show no more resistance to the quick fix than a chimp offered a bag of bananas.

In other words, the post-crisis environment has shown us a psychological weakness of Austrian economics: A persistent tendency to grossly underestimate the ability of homo economicus to go back to the Keynesian “hopes and dreams” well again and again.

Monkeys, not Robots

In seeking to distance myself from Austrian weakness, I will find help in the form of deliberately cultivated guilt by association. The sin of reality distortion that the Austrian viewpoint implicitly commits here is similar to the recognized folly of “rational economic man.”

In other words:

- The neoclassical economic notion of “rational economic man” — i.e. man as robot — is silly.
- To the degree that the Austrians hope for, or secretly expect or anticipate, moral and logical adjustment toward greater awareness of future consequence — i.e. a general uptick in rationality — they fall prey to a sibling or first cousin of the “rational economic man” fallacy. **They assume too much in respect to the rational thinking capacity of their fellow men.**

The day mankind gives up the quick fix is the day that chimps walk away from bananas. To hope otherwise, or actively agitate in an effort to correct this short-sightedness on the part of the human race, is an emotionally expensive waste of time.

The embedded profit mechanisms of the Street are inherently Keynesian

There is yet another problem with the functional trading application of the Austrian mindset: the profit generating mechanisms of Wall Street are all Keynesian too (i.e. grossly short-termist with no sense of consequence).

And by that I mean the following:

- The way to make money on Wall Street is to make it RIGHT NOW.
- Bubbles and busts are inherently lucrative for the financier class.
- The financiers reap great fortunes in the bubbles, then mostly preserve those gains in the bust.
- **The costs of bust are seen as worthwhile in respect to bubble-era profit opportunities.**
- It is also easier to sell in a bubble — to appeal to full blown greed — than in any other environment.

As it turns out, the global financial crisis was inherently profitable for many of the biggest and most connected players. The government bailed out Wall Street without forcing a total disgorgement of profits or anything close to it. In fact, if anything, the survivors of the crisis were given the opportunity to rake in MORE taxpayer-sponsored profit than ever before.

In previous crises, **the same asymmetric profit-distribution dynamic applied: losses for the many, ample preserved gains for the few.** The dot com and telecom crises were marked by deep



enrichment, to the tune of hundreds of millions or billions, in respect to venture capitalists and capital formation entities and other wealthy insiders. The weakest hands at the table, i.e. the general public, were the ones who got fleeced. When the bubble burst, John Q. Public saw his retirement go up in smoke. Yet those who facilitated the bubble more or less saw a net reward for their efforts of substantial size, even after the “bust” cost was factored in.

And so, once again, the Austrian-oriented trader has a problem. **The profit mechanisms of global financial markets are inherently “right now,” inherently “short-termist,” and thus inherently Keynesian. And they always will be... because, logistically speaking, this is the most profitable orientation for the far-flung finance machine on the whole.**

The resolution — neither an Austrian nor a Keynesian be

The solution, as I see it, is to reject BOTH economic ideologies... to recognize that each one has its time and place, but each is also deeply flawed.

I have long been tired of Keynesianism, for all the obvious reasons. (When we get a new crisis that dwarfs 2008, with all the attendant misery that entails, Keynesian idiocy will be to blame.)

But I am now almost equally tired of the Austrian school, because of all the trouble and headache my Austrian beliefs have caused me as a trader.

If I could drop a postcard into a time machine, I would have the following mini-lecture delivered to my younger Austrian-oriented self:

You think the market should be a moral place? You think the markets should be more aware of the dangers of short-term thinking, more focused on long run future consequences? You think the financial system should be fair, instead of grossly tilted towards a small handful of connected players to the ultimate detriment of all? Well, good luck with all that. I used to think all those things too. But now I am recognizing that attaching any sort of emotion or moral outrage to such beliefs has all the utility of lamenting why man is an irrational animal, or fretting over the fact that the universe isn't “fair.”
From a trading perspective, the moral dynamic is an expensive waste of time — and always will be — because it is now, and always will be, a Keynesian world in simple pragmatic terms.

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Does this mean I reject the “truth” of Austrian economics? Do I deny the “reality” that short-sighted Keynesian policies run towards long-term disaster? No, of course not. I am in the business of rejecting ideologies in favor of objectivity here, not trying to craft some new one.

My new, label-free economic view might be summed up as follows:

- Markets are predominantly Keynesian in both *psychology* and *practice*.
- At the same time, this reality leads to inevitable *Austrian tails*.

To wit: When the government steps in to help out the market in some short-sighted, long-term destructive way, the average mutual fund manager will not ponder the ultimate consequence of such actions. He will just cheer, and find an excuse to buy more of his favorite names. (We can see this clearly, in fact, in the cheering response to authoritarian China, in which the heavy hand of Beijing is treated as an unalloyed good by Keynesian-minded investors, who have no time to ponder the long term consequences of central planning and / or hamfisted investment allocation as meted out by brutal regimes.)



At the same time, myopic Keynesian practice does in fact lead to the cyclical presence of “Austrian tails” — compressed periods of time, such as the year 2008, when the Austrians are proven massively right in their warnings as to long-term Keynesian folly.

So there you have it: **Keynesian psychology with Austrian tails.**

The Keynesians still disgust me in respect to their willingness to cheerfully wreck things, and in respect to the fact that myopia has a terrible long-term cost. But the Austrians no longer hold my favor in respect to the fact that, given the dominance of Keynesian perspective on Wall Street, attempting to trade from an Austrian point of view is more “morality based” than “reality based.”

I am no longer an Austrian. And I am certainly not a Keynesian. I’m just a trader.

JS

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