Introduction: The Return to Keynes

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Our original intent

When we undertook the work on this volume, we believed that it was time to point out a quiet revolution in economic policymaking that had gone largely unnoticed: the return of a more active use of economic policy for purposes of stabilizing the economy. Now, after collecting all the essays from those economists we invited to contribute to the volume, the world has shifted beneath our feet. This introduction was originally written in October and November of 2008, while the world was slipping into an economic crisis; the final revision was written in February 2009, as governments around the world wrestled with how best to fashion their fiscal and monetary responses to the crisis. Suddenly our argument has more force and more urgency than we could have imagined.

The story we originally set out to tell is no less important and remains the backbone of this volume. That story explains how a strong counter-revolution against Keynesian ideas of stabilizing the economy that had taken place during the last three decades of the twentieth century had itself been overturned. We intended to show that politicians and policymakers had found their way back to the idea that monetary and fiscal policy had a role to play in stabilizing the economy.

During the last three decades of the twentieth century, a dedicated and brilliant cadre of “free market” economists were successful in propagating an argument that the active use of economic policy was not only not helpful but actually hurt the economy. This anti-Keynesian counterrevolution involved many people and worked on many levels. Some of those
involved denigrated Keynes and his character; others chose to ignore Keynes and simply built brilliant and sophisticated models demonstrating economic policy’s detrimental nature.

By the 1990s, these economists defined a new mainstream in economic theory and exercised a strong influence over policymakers around the world. This movement influenced the climate of opinion not only about macroeconomic policy but about any government intervention in the economy; not only should governments resist the temptation to try to stabilize the economy, they should also resist the temptation to regulate individual markets. By the end of the century, there was even a spate of articles in the popular press asking whether Friedrich von Hayek or Joseph Schumpeter was the greatest economist of the twentieth century; the foil in these arguments was always John Maynard Keynes, whose ideas had held sway at midcentury but were now argued to have been eclipsed by the facts of history.

Yet despite the many assertions at the end of the twentieth century that Keynes was no longer relevant, as we entered the twenty-first century the broad sweep of Keynes’s argument that stabilization was necessary began to overtake the new conventional wisdom of the “free marketers”; one of the most consistent facts about macroeconomic policymaking after 2000 was its focus on effective stabilization of the economy.

Following the collapse of the dot-com boom at the beginning of the decade, finance ministers and central bankers across the industrial democracies began to actively use government budgets and interest rates to attempt to steer their economies away from the shoals of trouble. And to a large extent, they were successful. Through 2007, the economies of North America, Western Europe, and Japan experienced extended growth with only moderate price increases.

The fall and rise of Keynes

This change to more active and explicit use of macroeconomic policy is the “revolution” that we originally set out to discuss in this volume. As we have noted, only a decade earlier this result would have seemed highly improbable, for during the 1990s the idea that macroeconomic policy was doomed to be ineffective had reached its apex. Perhaps it would be more correct to say that it seemed in the 1990s that a long battle had been fought over the usefulness of macroeconomic policy and that the advocates of “policy ineffectiveness” or “policy irrelevance” had finally won.

The stylized version of this story begins with the collapse of the Keynesian consensus in the early 1970s, when the combination of high unemployment and high inflation combined to discredit the tools of Keynesian economics. Keynesian economics was said to have been based on the idea that by using monetary and fiscal policy, the government could steer the economy away from the extremes of recession and inflation. However, the appearance of inflation and recession together (stagnation) in the 1970s marked a combination that not only was out of the reach of traditional Keynesian policies but was argued to actually be caused by Keynesian policies.

The response against Keynesian economics took many forms: monetarism, supply-side economics, rational expectations, and new classical macroeconomics. What all these responses had in common was that they explicitly took Keynesianism as their foil and made their mark by showing how to get past the “errors” of Keynesianism. Monetarists argued that Keynesians had erred by focusing on interest rates and federal budgets, rather than on the money supply; supply-siders argued that Keynesians had erred by focusing on the short-run stimulation to demand, rather than on the long-run incentives to growth; rational expectationists argued that Keynesians had erred by not understanding how the expectations of economic agents would undercut governments’ efforts to stabilize the economy; new classical economists built on the rational expectations revolution to construct yet more sophisticated models proving the ineffectiveness of macroeconomic policy in the face of well-informed and forward-looking economic agents. By the 1990s, this anti-Keynesian counterrevolution seemed to have achieved complete victory with the award of several Nobel Memorial Prizes in economics to the movement’s architects at the University of Chicago.

On the policy front, many had trumpeted the importance of the idea that traditional macroeconomic policy was more harmful than helpful. In 1979, Paul Volcker used the rhetoric of monetarism in initiating the monetary-tightening approach that he undertook to battle double-digit inflation in the United States; in the same year, Margaret Thatcher was elected prime minister after running on an explicit platform of monetarist ideas. In 1992, the European Union adopted the Maastricht treaty, which required budget discipline of its members, and by the end of that decade, President Bill Clinton had produced the first back-to-back budget surpluses in the United States in several decades.

But with the collapse of the dot-com boom in 2000 and the attacks of September 11, 2001, the nature of macroeconomic policy debate took a large, and largely unremarked upon, turn. The collapse of the dot-com boom was a severe blow to the arguments of the rational expectationists. In the world they so elegantly described, the stock market would never
have formed a bubble, much less have collapsed. In a quick stroke, an idea that had only recently won a Nobel Prize was no longer an idea in good currency. In the corridors of power, no one seemed to take the time to wait for word that the policy ineffectiveness revolution had collapsed. Policymakers did what they are wont to do and looked for pragmatic solutions to their problems. Within the European Union, Germany, France, and Italy all spent the next several years violating the budget deficit limits written into the stability pact that had underpinned the formation of the common European currency, the euro; governments of both the right and left argued that they needed to run deficits larger than those allowed in the stability pact to keep their economies operating well. At the same time in the United States, George W. Bush undertook such mass spending that the resultant budget deficit would be the largest in American history. (As Yoshiyasu Ono explains in chapter 2, Japan was somewhat of an exception to this trend in fiscal policy in that the Murayama [1994–1996] and Obuchi [1998–2000] cabinets in the 1990s tried using fiscal stimulus, while the Koizumi cabinet [2001–2006] attempted to run a neoliberal course after 2000.) Across the world, central banks had already abandoned monetarism’s goal of monetary aggregate targeting by the end of the millennium. In the new millennium, they became increasingly comfortable with the use of interest rate targets to ensure stable prices and employment.

Thus, in the first decade of the new millennium, macroeconomic policy shifted far back toward the open and unapologetic use of monetary and fiscal policy to stabilize the economy. This largely unannounced shift marked both the end of the influence of the “policy ineffectiveness” school and the return of a moderate form of Keynesian ideas. To be sure, no one was arguing for a simple return to the economic policymaking of the 1950s and 1960s; but in the battle between the advocates of macroeconomic management and policy ineffectiveness, the argument for active management has never seemed more persuasive than at the end of the first decade of the new millennium.

Keynes in spades

This change in the outlook of central bankers and ministers of finance is perhaps best illustrated by the initial responses to the global financial crisis that took place in autumn 2008. Beginning in September 2008, central banks pumped hundreds of billions of dollars of liquidity into the world’s financial system to address the crises of confidence and illiquidity that had resulted from the subprime lending crisis, and the finance ministers of the G8 countries simultaneously agreed to take equity stakes in private sector banks to help recapitalize them and so avoid the crisis of insolvency. These interventions violate every tenet of the advocates of “policy ineffectiveness,” and yet few serious voices rose to speak out at the time to say that these interventions were unnecessary or harmful. In fact, Alan Greenspan, who had been one of the most prominent and effective advocates of the free market philosophy as the chair of the Federal Reserve, admitted that “there was a flaw in my model.”

It is no exaggeration to say that the world’s economies were in crisis as this volume came to press. And while no one can have been happy with this state of affairs, it is more than amply demonstrated here that we originally set to note: economic stabilization had returned to the mainstream. Were this not true, it would not have been so easy to form the consensus that was necessary to address the crisis. The gradual, largely unannounced return to the Keynesian outlook had opened the door for making the kind of decisive moves that have been taken to address the crisis that began to unfold in 2008.

In fact, it is an important part of Keynes’s legacy that governments were able to act relatively quickly in the face of the crisis. During the Great Depression, the ideology of free markets prevented effective policy responses for many years. Keynes often played the part of an unwanted Cassandra in offering his economic policy recommendations in response to the Great Depression. The same might have been true in 2008 and 2009, had we not been able to see in retrospect that those wasted years after 1929 had not been necessary. Of course, if the ideology of the 1930s had not already fallen out of favor, it might have taken longer to effect the necessary policy changes. Fortunately, the anti-Keynesian counterrevolution had already come to an end.

The structure of this book

The purpose of this collection is to take stock of this new moment in economic policymaking. We hope to illustrate the changing policy landscape of the last decade and to provide a short introduction to some recent scholarship on Keynes and Keynesian ideas. As seems fitting at a moment when the global nature of the economy is at the forefront of our thinking, we have invited contributors from around the world. We have included essays from economists in Asia, Europe, South America, and North America to help explain the return to Keynes.

The opening section of the book consists of three essays that focus on the reemergence of macroeconomic policy as a tool for stabilization in the United States, Japan, and Europe. Starting the volume with these
essays establishes the recent return to stabilization policies and helps to delineate the quiet revolution that took place prior to 2008.

The three essays in the second section of the volume each address how contemporary economic theory deals with (or fails to deal with) themes in Keynes’s own work. The purpose of this section is to turn the reader toward recent work in the field and to examine how the themes and methods of contemporary work address (or fail to address) themes that Keynes argued to be central to understanding how the economy works.

In the third section, five historians of economic thought consider the state of the art of scholarship on different aspects of Keynes’s life and work. This section considers what we have learned in recent years about Keynes and the context from which his ideas emerged. During the last thirty years, the literature on Keynes has been very thin as the economics profession saw itself turning away from the idea that there is a role for effective stabilization policies. This section offers a chance to consider Keynes as a full historical figure and to appreciate the richness of his thought and his influences upon economic thinking.

The final section of the volume includes three essays that offer interpretations of Keynes’s work relative to the current global crisis. These three essays focus on the international dimension of Keynes’s thinking and how it relates to issues in international finance. In considering how Keynes viewed the nature of economic decision-making and how he addressed the global imbalances that would emerge in the postwar era, we see another area where his ideas continue to have contemporary relevance. Keynes explained very clearly the kind of panicked behavior that has characterized the recent crisis and thus was able to make policy recommendations that seem relevant again in the face of the failure of free market ideas to effectively steer the economy away from the shoals of disaster. As this volume went to press, many leaders were, for instance, calling for a return to a common, global framework for financial regulation, with the International Monetary Fund (IMF) returned to the role that Keynes had envisioned for it in the original Bretton Woods agreements.

A new age of Keynes

While making the final revisions to this introduction in February 2009, we were faced with an unusual demonstration of the extent to which macroeconomic stabilization policy has come to the fore. As we wrote, a second round of policy responses to the financial crisis was being formulated by governments around the world.

In the United States, President Barack Obama’s plan for a massive fiscal stimulus of nearly $800 billion was being signed into law; likewise, his treasury secretary, Tim Geithner, had just announced the administration’s plan for a new effort to deal with the toxic subprime assets that were crippling the banking system. In Japan, Prime Minister Taro Aso had announced plans for further fiscal stimulus, and the Bank of Japan was starting to implement new plans to increase liquidity. In the European Union, Germany, France, and Britain were each in the midst of rolling out new plans for fiscal stimulus, and the European Central Bank was examining new, supplemental measures for creating liquidity.

All of these responses served to further mark the degree to which the "policy ineffectiveness" arguments of the 1980s and 1990s have been replaced by the pragmatic demands of economic policymakers. In this sense, we undoubtedly live in a new Age of Keynes. Just as during the Great Depression, the reality of widespread unemployment is front and center in the minds of politicians and economists, who are looking for responses to mitigate the human suffering that comes with it.

Keynes himself was not dogmatic about the form that fiscal stimulus should take. Thus, it is not possible to find in his writings detailed treatment of the best way(s) to shape the response to a crisis such as we face. He did argue for large stimulus packages more than once during the interwar period, but the exact nature of his arguments was always shaped by the parameters of contemporary policy debate. While no one can know what Keynes would say about any particular policy on offer today, it is difficult to imagine him disagreeing with the need for a large fiscal stimulus under the conditions that prevail as we write this introduction.

However, during the Second World War, while Keynes worked within the Treasury, he developed nuanced versions of his ideas to help with postwar economic planning. Thus, at the same time that he was helping to develop the framework for Bretton Woods, he was also refining his ideas about fiscal policy. Much of what he wrote during this period was never incorporated into the body of ideas that became known as Keynesian after the war. For instance, it is impossible to find in his work during the Second World War any warrant for the kind of fiscal fine-tuning that was advocated in the postwar years by most mainstream Keynesians (Bateman 1996, 2006).

But our purpose here is not to pick and choose between the various policy proposals under consideration as we write this introduction and to give the imprimatur to those that are "most" Keynesian or "true" Keynesian. Our broad point, from a historical perspective, is that the need for macroeconomic management to stabilize the economy has been
reestablished in the first decade of the twenty-first century after a hiatus of several decades, when many of the leading names in mainstream economics made the opposite argument. It is in this broad sense that the arguments for “policy ineffectiveness,” laissez-faire, and neoliberalism have been displaced that we mean to claim that we are in a new Age of Keynes.

Nor are we interested in the kind of triumphalism that characterized the arguments of neoliberals immediately after the fall of the Berlin Wall. Just as they were wrong then to proclaim that it was the “end of history,” it would be wrong now to believe that the kind of massive macroeconomic interventions we are experiencing in 2009 will be the norm in the future. Perhaps the best way to understand the current moment would be in Keynes’s own terms. From early in his career, with the publication of *The Economic Consequences of the Peace*, Keynes began to consistently articulate a belief that capitalism was prone to instability. He did not, however, conclude that capitalism was always unstable—quite the contrary. What Keynes insisted on throughout all his work was that when the system got jammed, good macroeconomic policy was necessary to correct it. Keynes was not opposed to the market, only to the fetish that the market always functions well and always self-corrects when it experiences instability. Thus, while Keynes would almost certainly agree for the need for macroeconomic policy to help combat the growing unemployment we are experiencing in early 2009, there is no evidence that he would have seen such massive intervention as necessary into an infinite future. Once “animal spirits” return, he would not be surprised to see the government become less involved in managing the economy. What he would never cede, however, is the belief that the system could once again fall into a serious recession (or a raging inflation). And he would expect that when that happened, well-trained economists would step forward to explain the necessary interventions to mitigate unnecessary human suffering. Thus, if the future is truly Keynesian, it will be in this pragmatic sense that we will live with an understanding that despite the benefits of the market in good times, it also has the potential to cause great harm; and that we have the ability, and the responsibility, to mitigate that harm when it occurs.