Re-embracing Keynes

Scholars, Admirers, and Sceptics in the Aftermath of the Crisis

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Today we have involved ourselves in a colossal muddle, having blundered in the control of a delicate machine, the working of which we do not understand. The result is that our possibilities of wealth may run to waste for a time perhaps for a long time.

—Keynes, The Great Slump of 1930 (CWK IX: 126)

We cannot, as a community, provide for future consumption by financial expedients but only by current physical output.

—Keynes, The General Theory (CWK VII: 104)

PREMISE

While there has never been a real halt in the flow of scholarly literature, undoubtedly the 2008–9 crisis has seen an upsurge in the wave of references to Keynes, in the media, the economic press, and political discourse.

The number of admirers has gone up and for the first time in a very long time those who look back to Keynes have outnumbered the sceptics. On the other hand, the Keynes revival has brought back to
the fore doubts and objections to the relevance of Keynes's arguments to contemporary problems and issues.

In this chapter I investigate which aspects of Keynes's analysis and recommendations economists wish once again to see accepted and implemented and which are still rejected and misunderstood. I am also concerned to find out whether the 'return to Keynes' plea is matched by original research into his work and how much is sheer rhetoric or relies on second-hand knowledge.

In this chapter I will not attempt a systematic review of material published on this matter in the last couple of years; my more modest purpose is to illustrate a few cases and some issues. My point is that in the face of unqualified admirers and sceptics alike, scholarly investigation into Keynes's writings more than ever is called for in order to take stock of his work and teaching.

GOVERNMENT DEFICIT

The standard 'return to Keynes' argument is the need for fiscal stimulus to boost the economy from the depths of recession. The burden of the deficit is not seen as the main drawback of government intervention, but a necessary measure to address a failure in aggregate demand.

There are still many economists who oppose this view, as witnessed by the manifesto sponsored by the Cato Institute and signed by 237 American economists (the most renowned among them being M. Bordo, J. Buchanan, J. Cochrane, E. Fama, S. Horwitz, D. McCloskey, A. Meltzer, E. Prescott, V. Smith, R. Whaples, and L. White) who refused to endorse the statement made by President Obama in January 2009 that 'we need action by our government, a recovery plan that will help to jumpstart the economy'.

The signatories declared:

Notwithstanding reports that all economists are now Keynesians and that we all support a big increase in the burden of government, we the undersigned do not believe that more government spending is a way to improve economic performance. More government spending by Hoover and Roosevelt did not pull the United States economy out of the Great Depression in the 1930s. More government spending did not solve Japan's 'lost decade' in the 1990s. As such, it is a triumph of hope over experience to believe that more government spending will help the US today. To improve the economy, policymakers should focus on reforms that remove impediments to work, saving, investment and production. Lower tax rates and a reduction in the burden of government are the best ways of using fiscal policy to boost growth.1

Similarly, in the UK, an open letter, signed by 20 economists, was sent to the Sunday Times (14 February 2010) advocating a more rapid reduction of Britain's budget deficit than currently planned, 'to support a sustainable recovery'.2

This pronouncement provoked a reaction in the form of two letters sent to the Financial Times (18 February), signed by R. Skidelsky and others 57 economists, and by R. Layard and eight more economists.3

In the first it is argued that the signatories of the Sunday Times letter 'seek to frighten us with the present level of the deficit' but 'they omit to say that the contraction in UK output since September 2008 has been more than 6 per cent, that unemployment has risen by almost 2 percentage points'.4

The second letter points out that 'it would be dangerous to reduce the government's contribution to aggregate demand' since it 'would not produce an offsetting increase in private sector aggregate demand, and could easily reduce it'.5

Concern about the size of the government deficit is not in itself a sign of opposition to the Keynesian argument;6 it is, rather, acceptance of the classical presupposition that supply creates its own demand, or of the 'Treasury view' according to which public expenditure 'crowds out' a corresponding amount of private expenditure.

Samuel Brittan (2010) has pointed out that the fiscal debate recently has been impoverished by lack of understanding that logically there are in fact not two (pro or against the reduction of public deficit through curbing public expenditure) but four positions: there are also the options of reducing the level of public expenditure, matched by lower takes, or leaving it at the same level, but in any case not urging the cuts in the deficit.

The dividing issue between Keynesian and anti-Keynesian positions is in fact the relationship which is established between the size of the deficit and the level of income and unemployment.7 (For comparison of world unemployment in October 2009, see Figure 1.1). Since there is no theory to justify the 'right' size of deficit nor the amount of government spending, the issue at stake is the scale of priorities: in times of recession and high unemployment—so the Keynesian
argument goes—the priority is to sustain the level of aggregate demand, to increase the level of income and employment; this is the only way to reduce the size of the deficit and to prevent the vicious circle of lower income—lower government revenue.

Economists of Keynesian orientation have argued that the Stability and Growth Pact is at the root of the problem in Europe, since the European monetary system imposes a deflationary bias by restricting fiscal space. Others have argued that in the US the crisis originated from a distribution of income problem, that is, a private debt which has increased to offset the fall in wages and salaries. So the remedy is to substitute public for private debt, increasing expenditure on health, education, and housing, so as to restore an adequate and sustainable level of aggregate demand (Barba and Pivetti 2009).

Moreover, Krugman has argued that, contrary to the widespread view that Germany which chose austerity did better than the US which went for Keynesian policy, as far as real gross domestic product (GDP) is concerned, data for 2008–10 show quite the opposite: during the last two years, actual government purchases of goods and services (excluding transfer payments from the federal government to states) have been higher in Germany than in the US (Krugman 2010; see Figures 1.2a and 1.2b).

So the effectiveness of fiscal policies is back at the core of the disagreement between economists who favour or do not favour a ‘return to Keynes’, as it was in the 1970s between Keynesians and Monetarists. I rather doubt whether econometric exercises designed to measure the impact of the current fiscal stimulus engineered by the countries of the Organisation for Economic Co-operation and Development (OECD) in recent months (see Table 1.1) will prove conclusive and persuasive. As in the 1970s testing the values of the elasticity of the LM-IS curves helped neither contending party to win its case, estimates of the value of the multiplier associated with each fiscal measure are not going to regroup economists between the two camps.

However, since Keynes’s original argument has seldom been reappraised, it is worth considering it more carefully.

Commenting on the Report of Steering Committee on Employment (1944), Keynes objected that ‘it would be a failure to adopt a remedy for severe cyclical unemployment which may have [the] effect’ to destabilize the national budget since ‘measures to stabilise the national
income are *ipso facto* measures to stabilize the national budget' (CWK XXVII: 366). And he continued:

The Committee give the impression that, whilst the measures they propose to avoid unemployment are admittedly necessary and advisable, a price has to be paid for them in the shape of budgetary deficits and perhaps a consequent weakening in international confidence in our position. Exactly the opposite is the truth. It would be a failure to take such measures which would inevitably un stabilise the budget and weaken confidence. Is it supposed that slumps increase the national wealth? (Ibid.)
Thus, Keynes's first tenet against traditional thinking was based on the reversal of the causality relation between deficit budgeting, level of income, and international confidence in a country.

The second tenet is that public expenditure as a means to reduce unemployment should be interpreted as a means to increase aggregate demand rather than to adjust supply to the existing level of demand.

In the so-called 'pro free market' literature, Keynes's position is ridiculed as being based on the 'digging holes in the ground' argument: it does not matter how public money is spent, as long as it is spent, since it will generate income and through the multiplier the savings necessary to finance the initial expenditure.

Keynes's 'digging holes' suggestion is meant to illustrate the principle, not to provide a blueprint of 'useful' public work schemes. He illustrates the point with reference to expenditures on goods which have no useful purposes from the point of view of consumption, but which nevertheless produce the desired effects.

Gold mining, which is just another form of unearthing bottles dug in the ground, or pyramid building had positive effects on income and employment because they yielded fruits that 'could not serve the needs of man by being consumed' and therefore do not 'stale with abundance' (CWK VII: 131). Keynes then writes:

Just as wars have been the only form of large-scale loan expenditure which statesmen have thought justifiable, so gold mining is the only pretext for digging holes in the ground which has recommended itself to bankers as sound finance; and each of these activities has played its part in progress—falling something better. (Ibid.: 130) [emphasis added]

There are two points here. The first is that 'it would, indeed, be more sensible to build houses and the like; but if there are political and practical difficulties in the way of this, the above would be better that nothing' (Ibid.: 129). The political difficulties arise mainly from 'the education of our statesman on the principles of the classical economics' (Ibid.). The second point is that expenditure on 'useful things' may not be as effective: 'Two pyramids, two masses for the dead, are twice as good as one; but not two railways from London to York' (Ibid.). The argument is that the decreasing marginal efficiency of investment, 'unless the rate of interest is falling pari passu', sets a limit to the possibility of increasing the stock of wealth by means of 'useful'
forms of loan expenditure. Waste results not when expenditure is directed to objects which are not 'useful', but when they are not 'economically' viable.

The purpose of increasing aggregate expenditure is to generate income and employment, and this may not be sufficient to increase the stock of useful wealth. In Keynes's argument, financial availability is not the constraining factor in the augmentation of objects which 'could serve the needs of man', as are the constraints of their diminishing of marginal utility and the provisions for user and supplementary costs to maintain them.

**UNCERTAINTY AND PROBABILITY**

Many have argued that among the failures that contributed to the financial crisis it is pre-eminently the failure of ideas as originating in the new macroeconomic paradigm that developed during the 1970s and 1980s, where 'consumers and firms...know the statistical distributions of all the shocks that can hit the economy. As a result, they can make scientifically founded probabilistic statements about all future shocks. In this world of God-like creatures, there is no uncertainty, there is only risk' (De Grauwe 2010: 157).

This is the main point in Skidelsky's latest book: 'underlying the escalating succession of financial crises we have recently experienced is the failure of economics to take uncertainty seriously' (Skidelsky 2009: 188).

The 'return to Keynes' is interpreted here as the need to take on board his division of economics (CWK VII: 293–4) between 'the study of those economic activities in which "our views of the future are... reliable in all respects" and the study of those in which "our previous expectations are liable to disappointment and expectations concerning the future affect what we do today"' (Ibid.). The former allows for probability calculation, while the latter is dominated by the notion of uncertainty.

Keynes reached this conclusion on the basis of his theory of probability. While it cannot be fully analysed here, the main point can be outlined following Lawson (1985) and Roncaglia (2009).

Keynes's definition of probability (P) is that of a logical relationship between a proposition h (premise) and a proposition a (conclusion). If knowledge of h (premise) allows for a rational belief in a (conclusion), there is a probability relation of degree a (CWK VIII: 4). This description is supplemented by another concept, the 'weight of the argument', which is positively correlated with the 'magnitude' of the evidence of h. It is an indicator of confidence, providing a broader base for the rational belief. So, while probability establishes the degree of rational belief in the conclusion, the weight expresses the confidence in that probability.

How does uncertainty get into the story? To answer the question, we need to distinguish between two types of knowledge, that is, 'that part of our rational belief which we know directly and that part we know by argument' (Ibid.: 2). Knowledge is thus obtained either as the result of contemplating the objects of acquaintance' (Ibid.: 18) or through the probability relation.

If, in the probability relation:

\[ a \mid h = P \tag{A} \]

we define a as the primary proposition and the probability relation (A) as the secondary proposition, uncertainty can be defined as the absence of a secondary proposition, or the lack of a probability relationship. It refers to an immeasurable relationship between premise and conclusion in the absence of a secondary proposition. In the absence of a secondary proposition, no comparison between magnitudes of probabilities of different contingent outcomes is possible, and uncertainty prevails.

'Thus uncertainty, is not merely a situation in which the probability relation is known and the primary proposition, a say, relative to the evidence, gives rise to a numerical probability that is less than unity' (Lawson 1985: 914).

It refers to all those cases, Keynes writes, in which no rational basis has been discovered for numerical comparison. It is not the case here that the method of calculation, prescribed by theory, is beyond our powers or too laborious for actual application' (CWK VIII: 30).

It follows that we cannot hope to remove uncertainty by becoming more skilful in calculation or by collecting more information. It is uncertainty which we cannot cope with by means of probability (Svetlova and Fiedler 2011).

Why does Keynes's distinction matter? First, it rejects the presupposition that risk can be measured and allocated in such a way as to
prevent uncertainty of the outcomes. This is at the root of the current crisis and financial instability, as pointed out by Minsky (1982) long ago and recently repeated by several commentators of Keynesian orientation.

‘Not distinguishing uncertainty, which is not calculable, from risk, which is, banks, embracing the assumptions of neoclassical or efficient markets finance with mathematical algorithms, believed that they were able to calculate risk with a “high probability of being right”’ (Bresser-Pereira 2009: 12).15

The consequence of embracing the assumption that all risks can be calculated, following the ‘efficient market economics’ rather than a type of economics inspired by Keynes, has been to increase rather than reduce the frequency of financial crisis, as many studies have demonstrated.16

A number of studies comparing the 1930 crisis with the present meltdown have almost unanimously shown how in the recent crisis the behaviour of the monetary authorities that adopted Keynesian policies of reducing interest rates and increasing liquidity, rather than relying on the allegedly self-adjusting market forces, has drastically curbed the fall in income and employment.

Second, reliance on the risk calculation of financial assets has loosened the connection between the monetary and real sides of the economy. ‘The increasing instability of the financial system is a consequence of a process of the increasing autonomy of credit and of financial instruments from the real side of the economy: from production and trade’ (Bresser-Pereira 2009: 19).

THE STATE OF ECONOMICS

The remark made in Blanchard (2008) that ‘the state of macro is good’ is often quoted in a derogatory sense. What is the good of an approach that failed to accommodate the facts of the current crisis?

Blanchard (2008: 13) openly admits that in the basic New Keynesian model there is no unemployment, but he believes that the problem can be ‘fixed’ by introducing a more sophisticated explanation of the real and nominal wage rigidity assumption as prevailing in the labour markets.

Blanchard is also adamant that the model ‘falls short of the mark’ in assuming an ‘arbitrage approach’ to the determination of the term structure of interest rates and asset prices, leaving no room to the role that financial institutions play in the economy. However, his optimism—‘one can be confident that progress will happen rapidly’—is simply anchored to the ‘urgency of understanding the current financial crisis’ (Blanchard 2008: 18; emphasis added).

On the other hand, Colander et al. (2009) the Dahlem Report, 2008,19 while denouncing the ‘systemic failure of the economics profession’, before in predicting and now in understanding the crisis, invoke the legacy of economists of alternative traditions,19 failing to mention Keynes as a source of inspiration. In their critique of the prevailing approach, they focus, rather, on the study of interactions and connections between actors as the missing feature of current macro analysis.

Their research agenda includes items such as study of the interconnectivity of the economic system (mainly through network analysis), the informational role of financial prices and financial contracts, and the construction of indicators ‘warning’ of bubble formation.

Likewise, the pitiless jaccuse of the ‘complete markets macroeconomics’20 by W. Buitier is accompanied by the belief that the future ‘belongs to behavioural approaches relying on empirical studies on how market participants learn, form views about the future and change these views in response to changes in their environment, peer group effects etc.’ (Buitier 2009).

The profession and many of its leading journals still remain in the thrall of free-market thinking while other economists get very little hearing, their work largely ignored and marginalized. Very few cases of recantation are on record. A notable case is Richard Posner, who in September 2009 made a public endorsement of Keynes:

Until last September, when the banking industry came crashing down and depression loomed for the first time in my lifetime, I had never thought to read The General Theory... Baffled by the profession’s disarray, I decided I had better read [it]. Having done so, I have concluded that, despite its antiquity, it is the best guide we have to the crisis.21

Another case is Gregory Mankiw, who in November 2008 repudiated the judgement he had made in 1992 that The General Theory was an ‘out dated book’, saying: ‘If you were going to turn to only one economist to understand the problems facing the economy, there is little doubt that the economist would be John Maynard Keynes.’22


Thus, while welcoming the wind of ‘return to Keynes’, we must not be oblivious to the fact that there has been very little change in the positions held in the professions. For instance, in response to Posner, Gary Becker reiterates the usual ‘sticky wage’ fallacy in interpreting Keynes:

Keynes and many earlier economists emphasized that unemployment arises during recessions because nominal wage rates tend to be inflexible in the downward direction. The natural way that markets usually eliminate insufficient demand for a good or service, such as labor, is for the price of this good or service to fall. A fall in price stimulates demand and reduces supply until they are brought back to rough equality. Downward inflexible wages prevents that from happening quickly when there is insufficient demand for workers.23

Moreover, the ‘return to Keynes’ in many cases turns out to be lip service with very little original work done on those aspects of Keynes which are relevant to the present recession and crisis of economics. P. Krugman and J. Stiglitz have been very vociferous in the media in propounding and defending Keynesian ideas. While Stiglitz has built his academic reputation by introducing rigidities, market imperfections, and asymmetrical information into the ‘classical synthesis’ model, Krugman has remained critical of the New Keynesian approach and seems, therefore, closer to Keynes’s main message in The General Theory.24

The strand of literature which has remained faithful to Keynes and is accused of ‘preaching to the converted’ relies, with few exceptions, on scholarly work done in the 1980s and 1990s. I believe that there are areas in which we can expand the scope of the ‘return to Keynes’ agenda and which should be taken up in the current debate.

A RESEARCH AGENDA

The economics of Keynes is not just about government spending and injection of liquidity in times of crisis, but also about international cooperation on matters of finance, primary commodities, and international payments to provide the appropriate framework to a market economy. It is the conviction that markets and economic behaviour are to be guided by a logic of coordination and rules, rather than left to the pursuit of individual interests and to the freedom resulting from the lack of public intervention and regulation by the institutions.

It incorporates a view of rational behaviour under uncertainty, where reasonableness as opposed to rationality is praised (see Marcuzzo 2011). While irrationality (‘animal spirits’ and ‘herd behaviour’) may at times dominate investment decisions or financial markets, ample room is left to rationality bounded by knowledge, judgement, and experience.

In their recent book, Akerlof and Shiller (2009) explicitly draw from Keynes the notion of ‘animal spirits’ as opposed to ‘rationality’ to explain behaviour in the economy. Driving human actions are confidence, fairness, corruption, money illusion, and stories, which are the ‘real motivations for real people’ (Ibid.: 174). While I have some doubts that their ‘animal spirits’ are what Keynes meant by them, I agree that they capture the distrust in the Benthamite calculus which underlies the economic theorizing that Keynes was firmly opposed to.

A distinguishing feature of Keynes’s approach is also to be seen in a conception of economics as extension of possibilities, as opposed to the logic of scarcity; it is an appeal to judgement on the basis of the circumstances and a plea to the exercise of the imagination and creativity in seeking solutions, rather an appeal to the timeless ‘iron laws’ of a physical science. Keynes’s economics is a ‘moral’ science which ‘deals with introspection and with values... it deals with motives, expectations, psychological uncertainties’ (CWK XIV: 300).

I would like to give a couple of examples of the directions in which today’s favourable wind of ‘return to Keynes’ could drive the research agenda.

The first is appraisal of Keynes’s contribution to finance theory, which has been overshadowed by almost exclusive attention to the effects on economic aggregates expressed in real terms of expenditure policy measures.

Keynes was led from his early belief that rational agents stabilized financial markets through arbitrage and speculation to the realization that markets can remain unsettled, which explains why he claimed that institutions are needed to maintain order in those markets.

De Cecco (2010) and Kregel (2010) have made important contributions towards an understanding of the development of Keynes’s thoughts on finance from the Tract to The General Theory, providing further theoretical grounds to explain why he mistrusted markets. The basic idea is: unarbitraged margins preventing the law of one price from prevailing in financial markets may be widespread occurrence;
the 'beauty contest'—picking what one thinks others are most likely to think that others think are the best choices—is the framework within which decisions are made and actions carried out in stock markets.29 'noise trading'—when uninformed agents derail the operations of rational agents—sends the market in unstable directions. In conclusion, much of what is 'new' in contemporary behavioural finance can be found in Keynes's 'old' bottles.

The second line of research is in the area of reform of the institutions in charge of overseeing the international system of payments and taking action to smooth prices and output of those commodities which play a crucial role in international trade.

Two issues preoccupied Keynes throughout the whole of his theoretical and practical activity: monetary reform and the stabilization of commodity prices. This can be appreciated if we take into account the unpublished material, at the level not only of theoretical reflection but also of Keynes's concrete experience as a speculator, mainly on the futures markets for raw materials and money.26

Keynes's conviction was that there are strong links between fluctuations in prices of primary commodities and agricultural products on the one hand, and financial crisis and structural trade imbalances on the other. He held that in the absence of buffer stocks for commodities, and with insurance against price volatility based only on market mechanisms, the system is doomed to instability and any policies aiming at stabilizing commodity and currency prices must go hand in hand with reform of the international monetary system.

While it appears that some of the ideas prevailing before the crisis, namely that financial markets should be deregulated, that private ownership yields more efficient results, that governments should balance their budgets, and that central banks should only aim at price stability, are losing ground, the demand for a new set of rules to govern international trade, currency, and financial markets is not satisfactorily catered for. The suggestion here is to take a fresh look at Keynes's wide range of proposals (searching through his less known writings) and not to make do with simple-minded so-called Keynesian policy. The risk is that 'hydraulic' Keynesianism—'stop and go' policies—may again take the lead, losing track of the theoretical basis that supports them, and again squandering the opportunity to exploit to the full the richness of Keynes's thought.

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According to Wolf (2008), there are 'three broad' lessons to be derived from Keynes's teaching. The first is to discard the notion of 'efficient markets' and to endorse the notion of uncertainty; the second is to accept that the economy cannot be analysed or managed in the same way as an individual business; the third is to disown the belief that individual self-seeking behaviour guarantees a stable economic order.

Will these lessons find their way back into the corpus of economic teaching and research agenda?

The boost to aggregate demand through government expenditure and injection of liquidity into the system to fight depressions and offset credit crunches are policy recipes also invoked by people of non-Keynesian persuasion, whose searches for alternatives to mainstream economics look in different directions. Thus, a new research agenda is needed to provide food for thought to those sceptics who doubt the utility of Keynes's ideas in rebuilding an alternative paradigm, and also to admirers who have little and narrow acquaintance with Keynes's writings.

While 'the return to Keynes' wind is certainly to be welcomed, it may not outlive the present crisis. Scholars and admirers of Keynes may fail to persuade sceptics and opponents, and there is no telling whether a new generation of economists will take today's lesson to heart. The hope is that Max Planck's dictum (1950: 33) quoted in Kirman (2009) applies not only to a 'new' but also to an 'old' theory: 'a new scientific truth does not triumph by convincing its opponents and making them see the light, but rather because its opponents eventually die, and a new generation grows up that is familiar with it'.

NOTES
1. See the manifesto available at http://www.cato.org/special/stimulus09/cato_stimulus.pdf. This url was last accessed on 21 September 2012.
5. Among them D. Hendry, A. Blinder, R. Solow, D. Vines.
6. A copy of the letter is available at http://www.ft.com/intl/cms/s/0/75b2481e-1cb5-11df-8d8e-00144feadb49a.html. This url was last accessed on 21 September 2012


20. 'Both the New Classical and New Keynesian complete markets macroeconomic theories not only did not allow questions about insolvency and illiquidity to be answered. They did not allow such questions to be asked.' in Buitter (2009). Available at http://blogs.ft.com/maverecon/2009/03/the-unfortunate-uselessness-of-most-state-of-the-art-academic-monetary-economics/.


24. See Wray's nice description of the 'message':

"Entrepreneurs produce what they expect to sell, and there is no reason to presume that the sum of these production decisions is consistent with the full employment level of output, either in the short run or in the long run. Moreover, this proposition holds regardless of market structure—even where competition is perfect and wages are flexible. It holds even if expectations are always fulfilled, and in a stable economic environment. In other words, Keynes did not rely on sticky wages, monopoly power, disappointed expectations, or economic instability to explain unemployment. While each of these conditions could certainly make matters worse, he wanted to explain the possibility of equilibrium with unemployment. (Wray 2007: 3)"

25. 'In the short run one does not win by picking the company most likely to succeed in the long run, but by picking the company most likely to have high market value in the short run' (Akerlof and Shiller 2009: 133).

26. A preliminary inquiry can be found in Fantacci et al. (2012) and in Fantacci et al. (2010).

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