Keynes’ General Theory at 80 – lessons learned and lost

(Helsinki June 2016)
John Maynard Keynes (1883-1946)

Until the late 1920s Keynes was an (more or less ...) ordinary mainstream Cambridge economist

- *The Economic Consequences of the Peace* (1919)
- *Treatise on Probability* (1921)
- *Treatise on Money* (1932)
But then
THE GREAT DEPRESSION

Was a time before World War II where the economy was terribly stuck.
How could things go so terribly wrong -- and what could be done?

"The difficulty lies not so much in developing new ideas as in escaping from old ones."

John Maynard Keynes
To Keynes it was obvious that the old – (neo)classical -- theory was wrong and an active cause behind the disaster.
So he decided to break away from the then ‘received opinion’ among economists and write
I believe myself to be writing a book on economic theory which will largely revolutionize – not, I suppose, at once but in the course of the next ten years – the way the world thinks about economic problems.

Keynes in letter to George Bernard Shaw (1935)
What was Keynes breaking away from?

**Business cycle view**

More or less mechanistic, given by nature and nothing to do about
Say’s law

Supply creates its own demand.
All markets clear
No general overproduction or unemployment
Saving always become investment
(brought into equality via interest rate adjustments)
Equilibrium = full employment

By assumption the economy was thought to have a ‘natural’ tendency to reach an equilibrium with full employment via flexible prices (and wages)
Supply side economics

The economy is -- both in the short and long run – basically determined by supply, and demand only affects the economy in the short run.
Loanable funds theory

To invest, firms and households are assumed to first save, giving the basic causal direction

$S \rightarrow I$

Demand is downward sloping since higher interest rates make fewer investments profitable and hence smaller amounts of ‘loanable funds’ will be demanded.
Public works and expenditures

Society is basically a zero sum game. Budgets have to balance. Expanding the public sector will only ‘crowd out’ the private sector. Trying to expand the economy via under-balanced budgets therefore futile.
Laissez-faire and free-trade

Unregulated and free markets solve societies’ allocation problems perfectly.

Ricardo’s theory of comparative advantage and the Heckscher-Ohlin theorem show that free trade is to the benefit of all (win-win non-zero sum game)
Wage flexibility and unemployment

Unemployment is basically a pricing problem on the labour market caused by ‘sticky’ wages and labour unions.

Lowering wages would solve the problem and automatically establish equilibrium.

Unemployment therefore always ‘voluntary’
Monetary theory

Money is nothing but means of circulation and plays no essential role in theory (‘barter economies’)

Interest rates basically seen as a device to create equilibrium between savings and investments
Conclusion

Markets may perhaps temporarily get out of equilibrium, but in the long run they will always return to full employment equilibrium.

No basic need for public interventions beyond having central banks to set an equilibrating rate of interest.
What were Keynes’ alternative views?

**Business cycle view**

Keynes didn’t share the classics’ mechanistic view.

Recessions had to be counteracted since they were a waste of societies’ productive assets.

Basic problem: lack of investments and aggregate demand.

We can’t just wait for the long run to settle everything.

‘In the long run we are all dead’
Say’s law

Keynes firmly rejected – based on both theoretical and empirical considerations – the view that there were sufficiently strong and stable self-adjustments to equilibrium in real-world economies.
Equilibrium ≠ full employment

Keynes showed that the economy could settle at an equilibrium without full employment due to lacking aggregate demand.
Macroeconomics is about both supply and demand

Money is not neutral and matters in both the short and the long run

The fluttering veil

“It is well that the people of the nation do not understand our banking and monetary system, for if they did, I believe there would be a revolution by tomorrow morning.”

Henry Ford (1922)
Savings and investments

It is not $S \uparrow \not\Rightarrow I \uparrow$, but rather $Y \uparrow \Rightarrow I \uparrow$

"What is prudence in the conduct of every private family can scarce be folly in that of a great Kingdom."

Adam Smith

To classics $i \Rightarrow (S = I)$, but to Keynes the \textbf{liquidity trap} means lower interest rates do not always lead to higher savings
Contrary to the classics, to Keynes it was *investment* that was the real dog wagging the tail of *savings*.

**Paradox of saving** -- wanting to save more you end up saving less

”I think it makes a revolution in the mind when you think clearly of the distinction between saving and investment”
Public works and expenditures

Balanced budget not necessary
(budget deficits => output & employment ↑)

When ‘animal spirits’ low, government has to step in and increase investments

No necessary ‘crowding out’ or ‘Ricardian equivalence’
Laissez-faire and free-trade

Great in theory, but in reality we have to aim for ‘second best’ rather than wait for the long run equilibrium to settle everything
Wage flexibility and unemployment

The classic view was connected to the fallacy of composition (‘atomistic fallacy’)

How could dear money and credit restrictions bring down real wages?

‘In no other way than by the deliberate intensification of unemployment’
Liquidity preferences

Uncertainty as to the future -- especially i -- => hold money as a way of postponing decisions

Money not only a means of circulation but also used as a *store of value* and for *speculation*
Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on a whirlpool of speculation. When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done.
Liquidity preferences make monetary policies sometimes ineffective.

Argument for using fiscal policies.

When 'animal spirits' are lacking in the private sector, the state has to step in and promote growth and employment.
Conclusion

There are no sufficiently strong and stable forces always making economies return to full employment and equilibrium.

Especially in recessions monetary policies not enough and so fiscal policies are necessary.
Common themes in Keynes’ Economics

• Uncertainty vs. Risk

  Economic reality is not a ‘nomological machine’

  ‘Unknown unknowns’

  ‘Non-ergodicity’
  The past not projectible into the future
  ‘Sample’ taken from the past doesn’t necessarily say anything about a future ‘Population’
Fundamental uncertainty

=> producers keep to money and don’t know when consumers buy

=> problems

=> conventions (not true statements), adaptive expectations, heuristics
• Expectations

Because of genuine uncertainty – not risk – expectations become important in a non-market clearing on future markets.

In a GET world ‘rational’ expectations are always fulfilled and hence not analytically really that important.
• All economies are inherently monetary (non-barter)

• Historical vs. logical time (irreversibility of time, path dependency)
• Realism and relevance

Economics is a science of thinking in terms of models joined to the art of choosing models which are relevant to the contemporary world. It is compelled to be this, because, unlike the typical natural science, the material to which it is applied is, in too many respects, not homogeneous through time ... Good economists are scarce because the gift for using 'vigilant observation' to choose good models, although it does not require a highly specialised intellectual technique, appears to be a very rare one.
I'd rather be vaguely right than precisely wrong.

John Maynard Keynes
• Prices are not (only) determined by supply and demand

Mark-up rules
Flexible price often makes things worse because of income effects (> substitution effects)
• w ↓ => D ↓ => p ↓ => debt-deflation processes (Fisher-Keynes-Minsky)
• Wages are not (only) determined by supply and demand on the labour market

conventions, relative positions (cf. Robert Frank & Fred Hirsch and ‘positional goods’), power

Goods market => Labour market
• Unemployment is to a large extent involuntary

Obviously ... if the classical theory is only applicable to the case of full employment, it is fallacious to apply it to the problems of involuntary unemployment – if there be such a thing (and who will deny it?). We need to ... work out the behaviour of a system in which involuntary unemployment in the strict sense is possible.
• Income and wealth distribution have large effects on growth
  Inequality => slower growth and higher unemployment

• Economic growth does not follow an equilibrium trajectory – it is inherently a dynamic disequilibrium process
• Human choice is real -- not ”single exit” as in closed mainstream deductivist models

The gross substitution theorem does not hold, and choices often lexicographic (Maslow need hierarchy)

• Institutions, money, power, social conflicts play important roles in economic life

Institutions mediate social conflicts -- ’third party logic” -- e.g. inflation problematic/income policies)
• **Principle of effective demand**

Economies are to a high degree demand-led both in short and long run

Investment => Savings via ‘multiplier’ and ‘accelerator’

Investment not constrained by savings, but rather by **finance** (cf. MMT)
A Keynesian perspective on economic policies of today

We are still unambiguously in a post-crisis world

Low interest rate is probably the best indication we are not back in normality.

Potential growth has collapsed, recovery is sluggish, unemployment still high, demand still down 2-4 % since 2007
The whole system seems to have lost much of its resilience and capacity to rebound.

And the solutions that men in authority – political and economic – have come up with are in profound intellectual error as to the causes and cures of today’s problems.
• Fiscal policies are not irrelevant

- ’Helicopter money’ and QE are supposed to => i ↓ and attain FE
  But i is at ZLB and FE far away
  Money stay in the financial sector and does not find its way into real economy
  Balance sheet recession (Koo) –even when i low, consumers don’t want to borrow, so FISC POL => Investments ↑

Genuine uncertainty => firms and consumers not sure what will happen
=> ‘cheap money’ (i ↓) not enough when ’animal spirits’ low, you also need FISC POL
I am not confident that on this occasion the cheap-money phase will be sufficient by itself to bring about an adequate recovery of new investment. It may still be the case that the lender, with his confidence shattered by his experiences, will continue to ask for new enterprise rates of interest which the borrower cannot expect to earn ...

If this proves to be so, there will be no means of escape from prolonged and perhaps interminable depression except by direct state intervention to promote and subsidize new investment ...

J M Keynes ’The World's Economic Outlook’ (1932)
• **Austerity policies** (updated mathematical version of the fallacious ideas Keynes fought against in the 1930s)

Slow recovery -- ‘expansionary austerity’ (Alesina) thought to do wonders:

Fiscal bleeding on budget, debt and deficits => self-inflicted deflation => confidence fairy => recovery

Logic: you lay awake in the night worrying about debt – government says it will cut debt, so you pay less taxes in the future => you immediately start to consume more
Slashing oneself into insolvency is not the right solution to a crisis. Commiting the fallacy of composition in thinking household = nation.

The competitive struggle for liquidity has now extended ... to nations and governments, each of which endeavors to make its internal balance sheet more liquid ... the success of each one in this direction meaning the defeat of someone else ...

Competitive wage reductions, competitive tariffs, competitive economy campaigns ... are all of the beggar-my-neighbor description ... If the practice is universally followed every one will be worse off.

J M Keynes 'The World's Economic Outlook' (1932)
And in the June 2016 edition of *Finance and Development* we could read the following ...

Austerity policies not only generate substantial welfare costs due to supply-side channels, they also hurt demand — and thus worsen employment and unemployment. The notion that fiscal consolidations can be expansionary has been championed by, among others, Harvard economist Alberto Alesina ... However, in practice, episodes of fiscal consolidation have been followed, on average, by drops rather than by expansions in output. On average, a consolidation of 1 percent of GDP increases the long-term unemployment rate by 0.6 percentage point and raises by 1.5 percent within five years the Gini measure of income inequality.

IMF economists Ostry/Loungani/Furceri
Unemployment is a demand-led phenomenon and without D ↑ it remains high. Cutting public debts doesn’t make private sector expand, since they have too much debts, so G has to ↑, and when austerity => catastrophe.

Today you won’t even find ’unemployment’ in the index of some macroeconomic textbooks!

**Time to call a spade a spade** – telling us that markets get things right and governments don’t – is nothing but dressed up Chicago economics nonsense
If failing to understand some basic Keynesian relations is a part of the explanation of what happened, there was also another story behind the confounded economics of austerity ...

An analogy can help to make the point clearer: it is as if a person had asked for an antibiotic for his fever, and been given a mixed tablet with antibiotic and rat poison. Amartya Sen
• Public debt

Austerity -- ’ease the burden of the future generations’
- fallacious reasoning, those who pay in the future pay to others in the future

Low or even negative interest rates
⇒ governments should borrow a lot
(especially when no one else wants to invest)
The voices which ... tell us that the path of escape is to be found in strict economy and refraining, wherever possible from utilizing the world’s potential production are the voices of fools and madmen ...

The obstacles to recovery ... reside in the state of knowledge judgment, and opinion of those who sit in the seat of authority.

J M Keynes ’The World's Economic Outlook’ (1932)