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Keynes: The Second Coming?

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Summary: This article outlines principles of a modernised macroeconomic framework, drawing on John Maynard Keynes. It explores the historical context in which Keynes' economic theory arose, and the history of its application and subsequent replacement by neoclassical economics. The article argues that any updated Keynesian programme must address three new problems: globalization, wealth inequality and climate change. It sketches out the ways in which these might be addressed.

Key words: Keynes, Neoclassical economics, Macroeconomic policy, Unemployment.

JEL: E12, E24, E5, E6.

The English poet Matthew Arnold talked about two worlds, “the old one dying, the new one powerless to be born”. The world that is dying is that of the neoclassical economics of the 1980s and 1990s. The world needing to be born, or, I would prefer, reborn, is the Keynesian social democratic world of the 1950 and 1960s, not of course in the exact form of its First Coming, but updated for the post-Covid world. So, it is to the spirit of Keynes rather than to the first historical appearance of Keynesianism that I wish to appeal.

Three things have changed in world since Keynes. First, we have globalization; second, huge inequalities of wealth and income; and, third, global warming. Keynesian social democracy repressed the first two; ecological concerns were then in their infancy. An updated Keynesianism will have to address the challenges posed by all three.

What has not changed is the basic premise which Keynes bequeathed, which is that the solution of the most urgent economic problems cannot be left to the market system. The State, he said, would need to intervene in markets much more than *laissez-faire* economics allowed, but in such a way as to leave a large area of economic freedom, and leave individual freedom intact. So it is to the political economy of a new Keynesian settlement that I chiefly wish to address myself to.

First, let me say a word about the world of neoclassical economics which came crashing down in 2008, mainly because of its failure to predict or understand the banking collapse and to understand the conditions of a proper recovery. Behind neoclassical economics are six specific propositions:

1. Market economies have an automatic tendency to full employment equilibrium, provided wages and prices are flexible.
2. Markets are more efficient in allocating capital than governments.
3. State spending and taxes should be kept as low as possible.
4. State budgets should be balanced.
5. The State's main macroeconomic duty is to control inflation.
6. This should be delegated to independent central banks.

You will see that this makes up a package of interrelated technical and political economy propositions.

Proposition 1 follows from Walrasian General Equilibrium. Proposition 2 assumes rational individual consumers and competitive markets. Proposition 3 follows from Proposition 2: given efficient market allocation, the State share in allocation should be limited to providing genuine public goods. Proposition 4 is intended to guard against the growth of the national debt, represented as a "burden on future generations". Proposition 5 reflects the view that economies are cyclically stable in the absence of inflation. Proposition 6 arises from mistrust of politicians: this mistrust is dignified with the name of "public choice theory".

"New Keynesians" added numerous qualifications, mainly to do with market imperfections, but they were constrained by the logic of the above.

Determined attempts were made to apply the policy prescriptions which flowed from the theoretical propositions:

1. Globalization represented a transnational "widening" of the market. While fuelled by the business drive to cut costs and avoid national regulation, it was actively promoted by deliberate State policies to deregulate labour, product, and financial markets.
2. Privatisation policies and elimination of subsidies progressively denuded the State of its investment function.
3. The share of State spending in GDP was cut back and a modified form of balanced budget rule was reinstated.
4. An inflation target replaced the full employment target.
5. Macropolicy was outsourced to independent central banks using mechanical rules to hit inflation targets.

The central ideological feature of the neo-liberal offensive was a denial of the State's ability to improve on market outcomes in the long-run, and scepticism concerning its ability to improve on market outcomes in the short-run. Indeed it was widely held that interventions to protect businesses and jobs in the short-run hindered long-term economic growth. We have here an example of how political ideology directs theoretical work. The corrupt, inefficient, and oppressive 18th century State spawned the twin movement for both political and economic liberty. But the connection between the two was always more circumstantial than logical. The twentieth century has shown that economic freedom serves political freedom to only a limited degree, and that excessive veneration for it can lead to the undermining of liberty and democracy. This was a point Keynes made repeatedly in the interwar years, and it has not lost its relevance today.

Now let me juxtapose the key Keynesian propositions. These as you know justify a much more robust economic role for the State.

1. The market economy has no spontaneous tendency to full employment equilibrium. This is because of the inherent instability of private investment governed uncertain expectations and the lack or weakness of price-adjustment mechanisms.
2. Keynes pointed first to the “fallacy of composition”. Wage cuts may enable one over-borrowed employer, one over-borrowed industry, or even one over-borrowed country engaged in international trade to offer more employment. But if all wages are cut together, all prices and money incomes fall, the real burden of debt rises, and demand is reduced as much as costs.
3. Keynes further emphasised the “paradox of thrift”. In the orthodox account, if people respond to a downturn by saving more, the rate of interest will fall, industry will borrow more, activity will start improve. Keynes pointed out that if the first effect of a fall in demand is to reduce incomes, this will simultaneously reduce saving, so there will be no tendency for the rate of interest to fall. Instead it was quite likely to rise as people “hoard” a higher proportion of their reduced saving. Under such circumstances, the interest rate becomes the price of money, not the price of saving.
4. Government should assume responsibility for maintaining full employment, because Say’s Law, that supply creates its own demand, does not hold.
5. With spare capacity, state investment does not “crowd out” more efficient private investment, it “crowds in” investment which may be less efficient but is more efficient than unemployment.
6. Fiscal policy is more powerful than monetary policy.
7. The macro aim of State spending and taxation should be to balance the economy not balance the budget.

A great deal of Keynesian theory was applied to policy in the period 1945 to 1975:

1. Globalization was repressed in order to give governments greater control over national economies. In particular, capital controls were universal.
2. Labour product, and credit systems were tightly regulated. Specifically, trade unions had a powerful influence on the wage bargain.
3. Government investment in developed countries amounted to between 25% and 50% of total investment.
4. States spent an average of 40%-50% of GDP.
5. All developed country governments were committed to full employment.
6. All States pursued counter-cyclical fiscal and monetary policies.

Value judgments underpinned Keynesian as much as they did neoclassical economics. Three in particular stand out. First, Keynes attached more importance to the short-run than the long-run: “in the long-run we are all dead”. The short-run costs are incurred today; future benefits are only promised, and we can never be certain that they will be realised. In short, his attitude was the opposite of that stated by Ricardo in his reply to Thomas Malthus: “I put (the immediate and temporary effects of particular

changes) quite aside and, fix my eyes on the permanent state of things which result from the” (cited in Robert Skidelsky 2008, p. 48).

Second, Keynes thought unemployment is worse than inflation: e.g. “it is worse in an impoverished world to provoke unemployment than to disappoint the *rentier*” (John Maynard Keynes 1923, p. 36).

Third, Keynes thought that democracy would not long survive failure to tackle twin problems of mass unemployment and the “arbitrary and inequitable distribution of wealth” (Keynes 1936, p 372).

In science, competing propositions are supposed to be put to the test of evidence. Economists like all social scientists try to do this. Both these opposing systems of political economy had fairly long trials. But, of course, these were not under controlled conditions, so it is impossible to prove that one worked better than another. In terms of the leading macro-indicators the thirty years years of Keynesian political economy (1945-1975) worked better than the thirty years of neoclassical economics (1985-2015). Both ended in crisis.

The neoclassical era had a better record on inflation (not much better). But in his book *Death of Inflation* the economist Roger Bootle argues that this was not because of central bank management, but because of structural changes in the world economy (Roger P. Bootle 1996).

The Keynesian era had a much better record on employment. But perhaps this was due not to Keynesian full employment policy but to a number of helpful features of the post-World War II environment. So perhaps both systems were lucky in their times, and failed to deliver when the times changed.

However, there is one clear opening for a revival of Keynes’s spirit, and that is the revelation of the weakness of monetary policy after 2008. The facts are scarcely in dispute now. In the immediate post-crash years (2008-2010), monetary and fiscal policy acted together to halt the downfall resulting from the 2008 financial crisis. “Deficits saved the world” declared Paul Krugman. In the United Kingdom, government deficit relative to GDP increased above the 9% level in the years 2009-2010, keeping the economy afloat. But subsequent monetary expansion failed to offset the effects of the ensuing fiscal contraction.

In the United Kingdom, three periods of “unconventional measures” (i.e. quantitative easing QE) in 2009-2010, 2011-2012, and 2016 injected into the British economy about £435 billions of “high-powered” money (M0) corresponding to 21.8% of GDP in 2016. These measures failed to achieve the promised recovery of prices.

Most importantly, they failed to achieve the promised recovery of output. The conventional expectation, based on the theory of the money multiplier, was that that an increase of M0 would lead to a multiplied expansion of M4 (mainly, deposits at banks and building societies), which would drive increased lending, spending, and growth. In fact, the relationship between the two variables M0 and M4 in the period 2009-2015 was inverse. This meant that QE failed unblock the two transition channels from money to output and prices: the demand for bank loans failed to respond to the lower structure of interest rates enabled by QE, and asset owners did not increase their spending. In the post-crisis years (2010-2019), real GDP growth was more than 1 percentage point lower than during the Great Moderation period (1997-2006). To this day

firms and households are sitting on huge piles of cash. It was not the scarcity of liquidity that stopped businesses from investing, but rather a lack of demand (for more details, see Skidelsky 2018, Chapter 9).

The theoretical reason for the failure of QE had been spotted by the economist Ralph Hawtrey as early as 1925: “When trade is slack, traders accumulate cash balances because the prospects for profit for any enterprise are slight, and the rate of interest from any investment is low. When trade is active, an idle balance is a more serious loss, and traders hasten to use all their resources in the business” (Ralph G. Hawtrey 1925, p. 40).

Keynes took hold of the idea of “liquidity preference” in the *General Theory* and ran with it. First, he thought of it arising not just in moments of anxiety but as a normal condition of capitalist economies, given the inherent uncertainty about the future. The rise in liquidity preference is an important explanation of long-run underemployment equilibrium. Second, he thought of the rate of interest as the “price” of dishoarding, not the reward for saving. Savings could not therefore be treated as “loanable funds”. Third, absent official intervention or “moments of excitement”, the liquidity premium attaching to money would prevent the establishment of a long-run rate of interest consistent with full employment. Fourth, Keynes distinguished clearly between the cost of capital and the demand for capital. Central Bank policy can influence the financing of credit, but not the decision to invest which depends on the expected returns from the investment. QE adds to the liquid reserves of banks and corporations, it does not automatically reduce “risky” lending rates or increase the marginal efficiency of capital. In short, it is not the production of money which stimulates the economy, it is the spending of money.

So what should a modernised Keynesian policy regime look like? It should in my view have behind it four principles:

1. It should be more automatic. It should have behind it the concept of built-in stabilisers rather than “discretionary” demand management. This would be to minimise the risk of politicians exploiting it for vote-catching reasons and capture by vested interests. So I would see a modern Keynesian fiscal system rest on two main non-discretionary pillars.
 - a) First, a much larger share of public investment in total investment than has recently been acceptable. The macroeconomic purpose of this enlarged investment function would be to offset the unsteadiness of private sector expectations. However, not all public investment needs to be done directly by the State. Much of it could be done by a National Investment Bank operating under a public mandate, but required to take investment decisions on commercial criteria.
 - b) The second pillar should be of a public sector job guarantee. The primary object of such a guarantee would be to offset cyclical variations in employment. Everyone able and willing to work would be offered a job at the minimum wage if there was no private sector job at that wage forthcoming. It would be automatic in that it would provide for a labour buffer

stock which would expand and contract counter-cyclically without further central government intervention.

2. It should redress the “arbitrary and inequitable distribution of income”. The macro rationale for a more equal distribution of wealth and income is that it would lessen the dependence of aggregate demand on continual credit/debt expansion: a link with Hobson’s underconsumption analysis of capitalist malfunction.
3. It should be given a strong “green” character.
4. It should be above all national. While governments should actively pursue the widest possible international (and in the case of EU members, regional) agreements on trade, money, and migration, they should retain sufficient national ammunition to fulfil their duties to their citizens. In particular, they cannot safely outsource this responsibility to the financial system.

Keynes was convinced that if democracies failed to tackle mass unemployment people would turn to dictatorships. He gave democracies a programme of action. We must build on it today. The economics profession has a special responsibility to show the way, which it has shamefully shirked. To paraphrase the poet W. B. Yeats: it is time for a Second Coming.

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