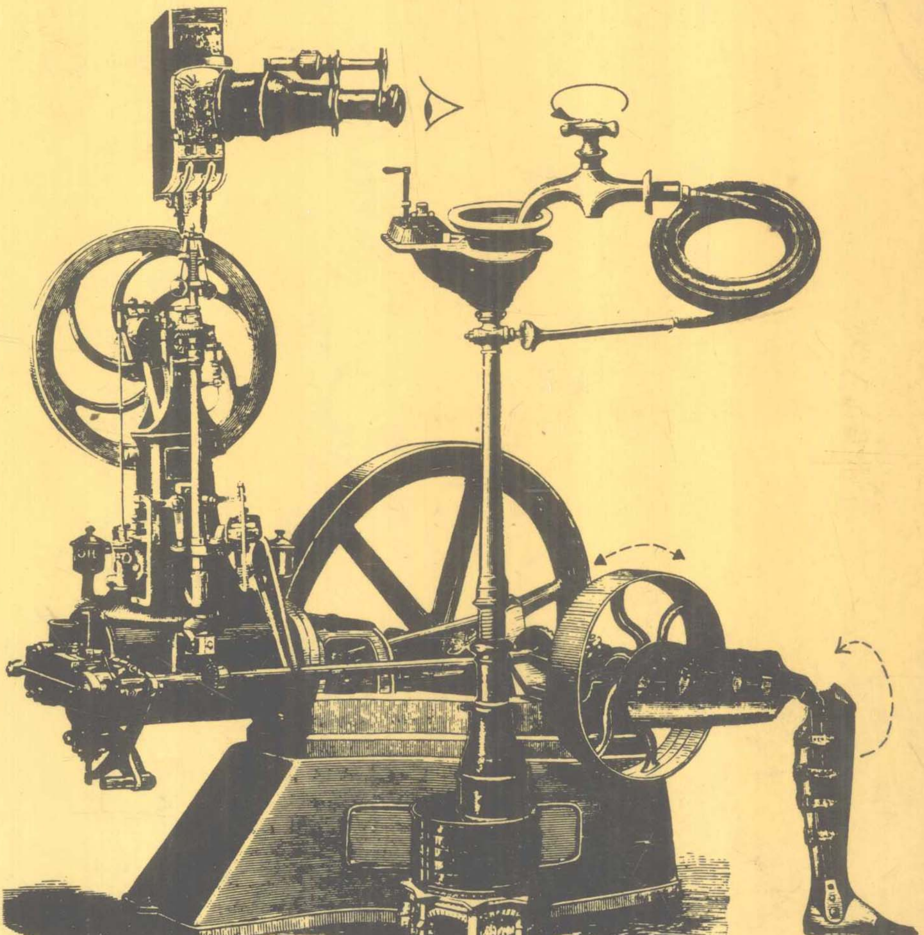
RADICAL ECONOMICS

THE RISE AND FALL OF KEYNESIAN ECONOMICS



MICHAEL BLEANEY

The Rise and Fall of Keynesian Economics

An investigation of its contribution to capitalist development

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Radical Economics

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Debates between economists are not just technical arguments amongst practitioners but often reflect philosophical and ideological positions which are not always made explicit.

Discontent grew with the prevailing economic orthodoxy as the long period of economic expansion in the advanced capitalist economies came to an end in the 1970s; disenchantment was expressed in open discussion about the 'crisis' in economics and in the rise of various kinds of radical economic theory, often using the general title of 'political economy'.

Many economists have looked for a more fruitful point of departure in the ideas of Marx and the classical economists and also in such contemporary economists as Kalecki and Sraffa. Although it is possible to identify a broad radical stream, it does not mean that there are no significant controversies within this radical approach and, indeed, it would be unhealthy if this were not the case.

Can radical economic theory interpret the world better than the current orthodoxy which it challenges? And can it show also how to change it? This is a challenge which this series proposes to take up, adding to work already being done.

Each book will be a useful contribution to its particular field and should become a text around which the study of economics takes place.

Radical Economics

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Preface

This book focuses on the practical achievements of Keynesian ideas. It is not a record of what government officials or academic economists thought at various times, but rather an attempt to assess what difference those thoughts and the policies which flowed from them have made to the economic history of the advanced capitalist world. This is a very big question – too big to be satisfactorily answered in one book – but also a very interesting one. It is one which is seldom addressed directly, although implicit answers to it underlie many deeply held opinions about macroeconomic problems. It raises major issues about the general pattern of capitalist development over the last half-century; the conclusions which I reach accordingly reflect much more than just a particular interpretation of Keynesian economics.

The book is structured as follows. Chapters 1 and 5 are theoretical. Chapter 1 reviews the whole debate about the Keynesian revolution, and Chapter 5 investigates how much is left of it after the Monetarist counter-attack. Those who feel they have had more than enough of such theoretical disputes may concentrate on the other chapters. Chapter 2 looks at the experience of four countries which employed fiscal measures to promote recovery in the 1930s, and draws some conclusions. Chapter 3 briefly describes the elevation of Keynesian thought into official orthodoxy in Britain and the USA during the war years. Chapter 4 investigates the contribution of Keynesian economics to the post-war boom, and Chapter 6 asks why it has slipped from official favour since that boom ended in the early 1970s.

Although the reader will find in this book much orthodox economic analysis, I would like to acknowledge my debt to writers in the Marxist tradition. The emphasis on class conflict, the insistence on the connections between economics and wider social developments, including politics, and the refusal to accept official formulations of economic problems at face value – all these have been consistent elements in the Marxist tradition and have powerfully influenced my own thinking. By contrast mainstream macroeconomics in the West, with the exception of a few individuals (amongst whom I would particularly like to single out Angus Maddison), has tended to remain trapped within the short-run perspectives of aggregate demand management or the abstractions of growth models, and has conspicuously failed to bring any sort of historical vision to current economic problems.

I would like to thank Sam Aaronovitch, Christine Ennew, Roger Middleton, Peter Morris and Jack Parkinson for their comments on chapters of this book in draft form. Any errors which remain are of course entirely my own responsibility.

M. F. B.

Abbreviations

EEC	European Economic Community
EFTA	European Free Trade Association
EO	OECD Economic Outlook
GDP	Gross Domestic Product
GNP	Gross National Product
OECD	Organisation for Economic Co-operation and Development
OEEC	Organisation for European Co-operation
TUC	Trades Union Congress
UN	United Nations

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The Keynesian Revolution

In one sense the Keynesian revolution was purely the product of one person's mind. Others made a significant contribution, but if the mind of John Maynard Keynes had worked differently, *The General Theory of Employment Interest and Money* would have been a different book, or might never have been written at all. But in another, deeper sense, it was the product of the Great Depression, or rather of the crisis in economic theory produced by that Depression. The policy recommendations of the *General Theory* were, by the time it was published in 1936, fairly familiar (Davis, 1971; Garvy, 1975; Shackle, 1967), not least because of the use that had been made of them in several countries over the previous few years (see Chapter 2). Keynes's achievement was to bridge the gulf between these practical ideas and pure neoclassical theory; to root these thoughts in (as he conceived it) a new, general theory of economics.

The issues raised by this project have racked economic theory ever since, and have certainly not been resolved. Monetarists tend to attach no great significance to Keynes's book, except as a source of a number of influential but erroneous intellectual fads. 'Left Keynesians' see it as the foundation stone of an anti-neoclassical economics which should be linked to an earlier, classical tradition. And finally the textbook 'neoclassical synthesis' simply juxtaposes Keynesian macroeconomics and neoclassical microeconomics in the hope that no one will bother to ask any awkward questions.

None of these attitudes seems to me to be particularly useful in deciding what was truly novel in Keynes's theory. In this chapter I summarise the main arguments of the *General Theory*, and survey the debates which have subsequently developed over its relationship to the pre-existing neoclassical orthodoxy. My conclusion is that the *General Theory was* revolutionary in its analysis of the laws of motion of capitalist production, i.e. in its macroeconomic theory; but since it concentrates on short-run dynamics and makes certain simplifying assumptions it takes as given a large slice of economic life almost without inquiry. The book does not investigate the structure of twentieth-century capitalist economies; it simply takes over orthodox nineteenth century assumptions of competitive markets and carries on from there. As a work of criticism of received theory this is one of its main sources of strength, but the limitations to the theoretical innovations which result must be recognised. Keynes's remarks about future perspectives for the capitalist economies are interesting, but anecdotal and no more than suggestive. Lacking any historical theory of capitalist development, he has much less to say on these matters than the 'underworld writers', like Marx and Hobson, whom he commends for keeping alive the concept of effective demand.

In sum, the *General Theory* does not present its own distinctive *Weltanschauung*; there is nothing new in its underlying vision of the economic and social order. The great weakness of the 'left Keynesians' is that they have never absorbed the true significance of this point, a further reflection of which is the fact that there could be a Keynesian revolution in Marxian economics (Kalecki) as much as in neoclassical economics. But the Keynesian revolution certainly did alter our understanding of the dynamics of capitalist economies, and its subversive element lay in the challenge to the exaggerated notions of their stability characteristic of the neoclassical tradition (of which more below). Politically, this was a powder keg, and has led directly to Keynesianism being associated with a high degree of state intervention in economic life. Amongst non-economists, 'Keynesianism' is a term often used to summarise the entire ideology of post-war Welfare State capitalism, and in modern Monetarist ideology attacks on Keynesian macroeconomic theory run alongside a vigorous defence of the market mechanism. Such a politicisation of the debate about Keynes in fact rests more on an association of ideas than strict logic, but is none the less powerful for that.[1]

The claim that the *General Theory* was a revolutionary book was first made by Keynes himself in a famous letter to George Bernard Shaw,[2] and also in the first chapters of the book itself. But a theory can only be revolutionary by reference to pre-existing doctrine, so to judge this claim we must first build up some picture of orthodox neoclassical theory as it stood on the eve of the Great Depression.

The question which Keynes himself asked – and many others have asked since – is why the neoclassical tradition did not believe in the possibility of deficient effective demand and involuntary unemployment. The difficulty is that, in all the volumes of economic analysis which were produced over the years by this tradition, there is no direct answer to this question. This might seem peculiar, but the explanation is really quite simple: no one thought in terms of concepts such as effective demand. The mental habits of neoclassical economics were such that it never occurred to anyone that a question such as Keynes's could be a sensible one.[3] But why not? To understand that, which concerns the instinctive responses of the trained neoclassical mind to a macroeconomic problem, is the essential first step to understanding what the Keynesian revolution was about.

The Neoclassical Mind

The rise of neoclassical economics is usually dated from around 1870, although its roots can be traced much earlier. But this was the date when Walras, Menger and Jevons quite independently but virtually simultaneously presented theories of the distribution of consumer demand based on the principle of utility maximisation, and derived the proposition that marginal utilities would be proportional to price. This picture of the rational self-interested individual in the marketplace busily working out the optimum response to changing price signals is the essence of neoclassical economics. As originally presented, it related exclusively to the demand side and tended to suggest that demand was the sole determinant of price, but this bias was firmly corrected by Alfred Marshall, who demonstrated that equal attention needed to be paid to the supply side of the market.

The central point of early neoclassical writing, that high prices of a particular commodity would discourage consumption of that commodity, had not escaped Smith, Ricardo or other classical economists, but they were content to assume that this fact, in combination with the restless search of capital for the maximum profit, would always be driving market prices back to 'natural prices', which would just earn capital the same rate of return in each industry. For them the real issue was to ignore the day-to-day fluctuations of the marketplace and to understand the economic system on the assumption that all commodities traded at their natural prices. Just how many eggs and how much bread people chose to consume at these prices they did not regard as a very interesting question, and one relating more to the psychology of human taste than to economics.

However, to the neoclassical thinkers such interactions of prices and quantities were the nub of economic life. To comprehend the market mechanism in all its facets was the crux of the matter. Production created an interesting category of persons called entrepreneurs and a whole new set of markets for 'factors of production', but was of no deeper significance. Economic theory moved into a search for general laws of supply and demand. The analysis of the utility-maximising consumer immediately suggested that the demand curve should be downward-sloping in terms of price, and the most general form of the supply curve, allowing for the fact that some suppliers might be in a more favourable position than others, seemed to be upward-sloping. The natural conclusion from this was that in the typical market there would be a unique and stable equilibrium, where the supply and demand curves intersected. This conclusion rested on the assumption that prices of other commodities, consumers' incomes and the rate of profit prevailing in the rest of the economy could be taken as given.

The neoclassicals then went on to postulate the existence of a general equilibrium, with demand equal to supply in *every* market. In essence this was perhaps little more than their predecessors had envisaged in concentrating on the case where goods exchanged at their natural prices; but it quickly became imbued with all sorts of assumptions about its stability and the self-correcting powers of the free market that were neither seriously investigated nor, as Keynes was to show, justified. The assumptions necessary to the proof of stability in the individual market were invalid for the economy as a whole, and yet the results were unceremoniously translated from the particular to the general case without recognition of this point. Those who went in for the formal investigation of general equilibrium, notably Léon Walras, avoided the stability issue by the use of intellectual devices such as the 'auctioneer' or 'recontracting' (Edgeworth), both of which effectively meant that what occurred when the system was not at its equilibrium could be ignored. Those, such as Alfred Marshall and his followers, who tended to regard Walras's exercises as somewhat arid and meaningless were no better, for in their approach to macroeconomic issues they took the existence and stability of a general equilibrium entirely as a matter of course (Marshall does not even bother to discuss it in his *Principles*). As Stigler (1946, p. 244) has remarked, it was sixty years before anyone bothered to follow up Walras's investigations into the existence and uniqueness of general equilibria, let alone their stability.[4]

The concept of general equilibrium was essentially a long-run concept. Since the long run never arrived, the real world could be forgiven for being continually disturbed by technical changes, random events, financial crises and the oscillations of business and consumer expectations. These formed the subject matter of trade cycle theory – an attempt to explain the observed patterns of boom and slump, aspects of reality with which 'pure' theory did not have to bother. But the relationship of trade cycle theory to the pure theory out of which the concept of general equilibrium was generated was essentially subordinate. The raw material – the basic elements of economic analysis – may have been the same, but trade cycle theory was merely a study of the ripples on the surface of economic life, not an investigation of its innermost secrets. Because price changes were always occurring, there was a strong temptation to regard observed economic fluctuations as a manifestation of a human propensity towards an over-exuberant response to changing price signals. In other words, trade cycle theory necessarily included strong psychological elements which could be ignored in the luxurious environment of pure theoretical inquiry. Firmly based in reality and having to deal with tricky issues like expectations of the future, trade cycle theory found itself almost overwhelmed by the