keynesian reflections

Effective Demand, Money, Finance, and Policies in the Crisis

EDITED BY Toshiaki Hirai | Maria Cristina Marcuzzo | Perry Mehrling

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An Introduction

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The global financial crisis, which began in August 2007 and continues with no end in sight as we write these lines, has thrown macroeconomics into turmoil.

The New Classical idea that economies can be understood as if they were in full intertemporal general equilibrium at all times, shifting about in response to external shocks, was never taken very seriously by the majority of economists, neither as an empirically relevant description of reality nor as a normatively compelling guide to economic policy. Rather, the challenge of the New Classicals was always mainly to the theoretical structure and underpinnings of Old Keynesian orthodoxy circa 1970. The response to that challenge was the construction of a New Keynesian orthodoxy that achieved professional dominance with the publication of Michael Woodford's *Interest and Prices: Foundations of a Theory of Monetary Policy* (2003). Synthesizing decades of academic research, Woodford replaced the static monetary Walrasianism of the Hicks-Samuelson IS-LM

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(Investment-Saving/Liquidity preference-Money supply) model with the full Dynamic Stochastic General Equilibrium (DSGE) model preferred by the New Classicals, but with sufficient rigidities and imperfections added to create room for active policy intervention. This is the macroeconomic lens through which the majority of economists viewed the global financial crisis as it hit.

Unfortunately, that lens was ground with a particular set of economic problems in mind, the problems of the 1970s and 1980s, and so provided little insight into what was happening during the financial crisis, much less helpful policy advice concerning what to do about it. A model without banks is not going to help you very much when the problem you face is located in the banking system. Policymakers had to act, and they did act, but mainly by drawing on a hotchpotch of insights from outside modern mainstream economics, including some from the very practitioners who had built the financial house of cards that was collapsing around them, and also from older economics such as the rejected IS-LM. In response, economists had to act, and they did act, but mainly by adding financial frictions of various kinds to the pre-crisis DSGE orthodoxy.

The central purpose of the present volume is to suggest another possible road for the future of macroeconomics, a road that would confront economic reality without the comforting illusion of automatic (albeit imperfect) adjustment towards an intertemporal general equilibrium with rational expectations. If the world was really like that, we would know how to fix it, but the evidence of our senses tells us that it is not much like that. To paraphrase Keynes, the social object of economic policy should be to defeat the dark forces of time and ignorance which envelop our future, not to build models that take for granted the defeat of those forces. Keynes was, throughout his life, engaged with the concrete problems of his time, always starting from the economics that he knew, but never afraid to invent new economics as the situation might require. It is this Keynesian spirit, above all, that provides the linking theme for the chapters in this volume, chapters written originally for conferences held in Tokyo (2010, 2011) and in Florence (2012).

The present volume was initially conceived as a follow-on companion to *The Return to Keynes* (Bateman et al. 2010), a volume inspired by the aggressive worldwide policy response, both fiscal and monetary, to the global financial crisis that started in 2007. The more sober tone of the present volume reflects the mood of the present moment, when retrenchment and austerity are the themes of policy in most of the Western economies. Instead of celebrating the return to Keynesian policy, we find ourselves engaging with the more structural problems of our own time, starting from the economics that Keynes invented but then adapting and going beyond Keynes himself, as modern conditions require.

But what exactly is 'the economics of Keynes' and how, if at all, does it differ from the Keynesian economics presented in macroeconomic textbooks and described in the media? There is no easy answer to this question since many varieties of Keynesianism have made their way into the profession, competing for the 'best' interpretation of Keynes. Similarly, opposition to Keynesian policies has also been argued on multiple grounds, ranging from the purported superiority of market mechanisms to fear of government deficits and the ensuing size of the public debt. This book situates itself in the very middle of this maze of argument, and seeks to provide a modern key for those seeking to engage the modern debate over whether to support or to oppose Keynes and Keynesian theories and policy.

In all of its varieties, Keynesian economics is usually associated with an emphasis on changes in the level of income (rather than the interest rate) as the central mechanism that brings saving and investment into line with one another. A further idea is that it is mainly saving that adjusts to investment, rather than the other way around, since investment is determined by the independent fluctuation of the marginal efficiency of capital. A central question is *why* the adjustment mechanism does not guarantee that the level of income/output comes to rest in a position corresponding to full employment/capacity.

There are two views on the matter: one explanation is rigidity in prices, wages, and the interest rate (via a 'liquidity trap'); the other explanation is found in the role of money and expectations. The price rigidity view, which goes back to the formulation of the 'old' neoclassical synthesis developed between the 1950s and the 1970s (Arena 2010), has always been rejected by those who claim to be closer to the spirit of Keynes himself. Price flexibility, far from facilitating adjustment to full employment, may actually aggravate the downward trend in output and employment. Lower prices and nominal wages increase the interest payment burden of debtors, causing them to cut back on spending so that effective demand is likely to fall rather than to rise.

Rather than engaging in argument with fellow Keynesians, the New Keynesians in the 1980s preferred to focus their efforts on justifying the assumption of rigid prices or wages by the use of optimizing models—such as the efficiency-wage hypothesis, insider-outsider bargaining theory, and menu costs. Thus was the IS-LM model transformed into the DSGE model. In effect, the New Keynesians preferred to respond to the anti-Keynesian critics, who urged the superiority of optimizing models, and the necessity of building a bridge between microeconomics and macroeconomics, even if doing so took them farther away from the real world and its problems, where they had found their initial inspiration.

Another dividing line among the varieties of Keynesianism is whether Keynesian economics applies only to macroeconomic questions, such as deviation from full employment, or whether microeconomics is also at stake. For those who argue the latter, the emphasis is on deficiency of the standard model of the rational economic agent who makes choices under constraint in an environment in which radical uncertainty does not exist and risk is calculable. As against this caricature of human behaviour, Keynes himself presented a theory of individual decision-making which rejected the use of mathematical expectation as a criterion for making decisions, and instead built on his own theory of probability. Keynes's interpretation of probability, different from chance or frequency, treats it as a property of the way individuals think about the world. This way of thinking then leads to an explanation of human conduct whereby decision rules under uncertainty incorporate a measure of the degree of confidence in probability assessment. Since for Keynes the degree of confidence in the available evidence is as important as the amount of information, the weight of argument has a central role (Basili and Zappia 2010).

This way of thinking about human behaviour under uncertainty has far-reaching implications for how we think about markets and the economy as a whole. If risk cannot always be effectively tamed and priced, it follows that markets cannot always properly assess risk and shift it to those best able to bear it. Even more, the demand for liquidity as a kind of haven in a world of incalculable risk means that money and expectations are inextricably involved in determining macroeconomic outcomes. Until recently, this 'fundamental Keynesian' critique of standard finance and macroeconomics was a distinctly minority view. But the events which started in 2007 have made manifest that financial and macroeconomic instabilities cannot be explained with the standard macro models, and the profession is beginning to shift.

De Grauwe provides a compelling description of the status quo ante:

> A graduate student in a typical American or European university studying the subject of macroeconomics would be taught that the macroeconomy can be represented by representative consumers and firms who continuously optimize a multi-period plan, and in order to do so, use all available information including the one embedded in the model. These consumers and firms not only perfectly understand the complex intricacies of the workings of the economy, they also 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. Coordination failures do not occur because representative agents internalize all possible externalities. Bankruptcies of firms and consumers are impossible. Bubbles and crashes cannot occur because rational agents using all available information would never allow these to happen. Prolonged unemployment is impossible except when consumers choose to take more leisure.

Having mastered the intricacies of DSGE models, our brilliant new PhD graduate would then start a career teaching this model to the next cohort of PhD students (De Grauwe 2010: 157–8).

This book challenges the current mainstream macroeconomic tradition known as New Keynesian economics in so far as it shares common ground with the New Classical models. Specifically, this book rejects the view that some form of nominal rigidities in the goods market and/or in the labour market makes the indispensable core of an economics based on Keynes. And it further rejects the view that whatever shock hits the economy, the response is an automatic and rapid move towards market equilibrium that pulls the economy out of any kind of difficult situation.

In the world of Keynes himself, price rigidity is not at the source of economic fluctuations; economies could enter into depressions even with perfectly flexible prices and perfect competition. Further, policy intervention is needed not as short-run medicine, while waiting for the economy to return to the 'true' equilibrium values, but because shocks tend to amplify their consequences. Indeed, there is plenty of scientific evidence to the effect that there exists no *permanent* trend towards market automatic adjustment, in the sense of market clearing with full employment.

As such, this book explicitly aligns with one of the most strenuous contemporary defenders of the distinction between Keynesian economics and the economics of Keynes:

> The Old Neoclassical Synthesis, which reduced Keynesian theory to a general equilibrium model with 'rigid' wages, was an intellectual fraud the widespread acceptance of which inhibited research on systemic instabilities for decades. Insofar as the New Synthesis[a convergence of DSGE modelling technology with imperfections of capital markets and price inflexibility] represents a return to this way of thinking about macroproblems it risks the same verdict. The obvious objection to this line of theorizing is that the major problems which have had to be confronted in the last twenty or so years have originated in the financial markets—and prices in those markets are anything but 'inflexible'. But there is also a general theoretical problem that has been festering for decades with very little in the way of attempts to tackle it. Economists talk freely about 'inflexible' or 'rigid' prices all the time, despite the fact that we do not have a shred of theory that could provide criteria for judging whether a particular price is more or less flexible than appropriate to the proper functioning of the larger system. More than seventy years ago, Keynes already knew that a high degree of downward price flexibility in a recession could entirely wreck the financial system and make the situation infinitely worse. But the point of his argument has never come fully to inform the way economists think about price inflexibilities. (Leijonhufvud 2009: 12)

Old and New Keynesian models both built on the neoclassical model of individual behaviour to provide an underpinning for their aggregative models. The neoclassical canon is based on the rational optimizing assumption; economic agents are depicted as making optimizing choices under constraints. Keynes agreed that economic theory is about human choice, but always insisted that it is also about institutions (money, markets, and organization), which are not the outcome of individual choice but have evolved as social activities. He agreed that agents make constrained choices, but the constraints are mainly 'the dark forces of time and ignorance'. In such a world, optimizing behaviour is best approximated by groping and the trial and error method. Non-chosen results are precisely what macroeconomics is about: composition effects and unintended consequences are all examples of non-chosen results which are part and parcel of aggregate behaviour.

The essays in this volume represent explorations towards a new more satisfactory macroeconomics, on both analytical and empirical grounds, building on Keynes's legacy but also reaching out in new directions.

EFFECTIVE DEMAND IN THE CRISIS

In Part I, three chapters consider the present crisis and policy response from the perspective of Keynes's own teaching rather than textbook Keynesianism or stereotyped Keynes. All three share a common concern that Keynes's arguments have not been fully engaged in the 'Return to Keynes' euphoria. As a consequence, there is real danger that the return may be short-lived, and that many other promising future developments will be halted prematurely. Keynes's vision of economics as a realm of possibility to promote social values should inform our research agenda; behind the current crisis lies a 'failure of ideas' (De Grauwe 2010: 159) quite as much as a failure of markets.

The Keynesian resurgence has so far largely been a change in the political mood and the attention of the media, rather than a change in academia; no academic breakthroughs appear yet associated with the resurgence. The boost to aggregate demand through government expenditure and the injection of liquidity into the system to fight depressions and offset credit crunches are merely policy recipes, invoked often by people of non-Keynesian persuasion whose search for alternatives to mainstream economics looks in different directions. The fear expressed in the first chapter is that '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' (Marcuzzo).

Let it not be misunderstood. The lesson of today is all about the issue of aggregate demand, *not* the issue of debt and deficits that occupies so much of current policy debate. As Keynes taught in his 1936 *General Theory of Employment, Interest and Money*, the economy fluctuates mainly because of variations in the marginal efficiency of capital, which cause fluctuations in investment spending. Fluctuations can therefore be damped if the level of investment is sustained directly by public intervention, or indirectly by structural reforms that reduce uncertainty and improve profitability.

In a crisis, the primary concern must be to forestall the vicious circle whereby an initial decrease in income is followed by a fall in demand which then induces a further fall in income. The aim of policy should be to raise the level of effective demand closer to full employment. Ideally this is done not by stimulating consumption (private or public), but rather by targeting investment. Against the argument that we cannot afford to undertake stabilization policy because government deficits are creating a burden that will rest on future generations, Keynes's original insights still hold, as neatly summarized in the second chapter of the collection: 'investment creates assets that can compensate for, if not outweigh, the costs of any debt created in the process of building it up' (Backhouse and Bateman).

Granted the role of aggregate demand in generating income and employment, there are two issues still debated between the pro- and anti-Keynesian camps, namely the effects of changes in income distribution on the level of output and employment, and the ability of economic policies to exert a lasting influence on those variables. These issues are addressed by the third chapter of the section. In all the countries under his investigation (US, Japan, France, Germany, Spain, UK), López-Gallardo concludes that the evidence is on the Keynesian side:

> First, we find that a higher share of wages encourages demand and output in the short and in the long run.
>
> Second, higher government expenditure also stimulates demand and output. Let us note here that this positive effect takes place even when such expenditure is financed with higher taxes. ...
>
> Third, monetary conditions also influence demand and output, not only in the short but also in the long run. When credit conditions are relaxed and broad money grows, or when the interest rate declines, growth is stimulated (López-Gallardo).

In conclusion, the principle of effective demand remains the defining feature of a type of macroeconomics that does not rely on price and wage flexibility to bring about full employment. Since aggregate demand is likely to remain insufficient for significant periods, public intervention to sustain it is the only way to prevent serious recessions.

ECONOMIC THEORY AND THE WORLD RECESSION

Noguchi argues that Keynes went too far, as also do those who would start from Keynes today. But his real target is not Keynes, rather the Old Keynesian orthodoxy, IS-LM circa 1970, compared to which he asserts the superiority of New Keynesian orthodoxy. We include his essay in this collection partly as balance and contrast—all other chapters criticize the New Keynesian orthodoxy along one dimension or another—but more importantly as the strongest possible signal against a possible misinterpretation of the overall message of this book. Let it be clear that, like Noguchi, this book rejects Old Keynesian orthodoxy. Our call for a genuine return to Keynes is just as much a call for rejection of the Old as of the New; like Noguchi, we urge a new road for the macroeconomics of the future, not a return to the failed macroeconomics of the past.

In Noguchi's view, the macroeconomics which has evolved since the 1970s—that is, monetarism, rational expectations, and the real business cycle approaches—provides better policy guidance than the previous so-called Keynesian models. He writes:

> Most economists, if they are sincere, would agree with Krugman's contention that recent events have been forcing economists to shift the focus of their research, and that they should pay more attention to the actuality of an economic model than to its mathematical rigor. However, they would not agree with the statement that rather than subsequent macroeconomic theories including the new Keynesian economics, the old Keynesian economics, dominating the field until the 1970s, could better serve as a tool to analyse the recent crisis and to provide a policy prescription.

It should be noted that Noguchi's criticism is directed not so much against Keynes himself, but rather against the naive 'hydraulic Keynesianism' that Joan Robinson famously dismissed as an illegitimate American interpretation of Keynes. His criticism therefore opens the door to other potentially more productive ways of building on Keynes, which is the theme of the last section of the book.

The continued relevance of the classic Keynesian point of view is demonstrated in practice by two chapters that use it as a frame to understand Japan's bubble performance and the European crisis, respectively.

Rogers argues that Japan, which has suffered from a long period (18 years) of below par growth, finds itself in a predicament not unlike that of post–First World War Britain after its loss of export markets and return to gold at an overvalued parity which depressed the marginal efficiency of capital. There is, however, an important difference between the two, he argues:

> ...Japan finds itself 'trapped' on the US dollar standard in much the same way that Britain was trapped on the gold standard in the 1920s and 1930s—committed by the power of convention to stay on the US dollar standard even though that commitment puts it at a strategic disadvantage because it depresses the structural marginal efficiency of capital and the domestic point of effective demand. In Japan's case, not because it forces domestic interest rates up as was the case with Britain on the gold standard, but because the post–Bretton Woods non-system has allowed the US to induce an ever appreciating yen, and also allowed some countries to hold exchange rates for sustained periods of time at undervalued rates. (Rogers)

While the case of Japan represents a cautionary tale of the difficulties of emerging from a prolonged recession, the situation in Europe can be seen as a premonition of a similar scenario looming in the near future. The Euro crisis started with the fiscal crisis in Greece in the Fall of 2009—one year after the collapse in the US banking system following the subprime crisis and the Lehman shock. The policy response was a massive bailout implemented by the European Commission, the European Central Bank, and the International Monetary Fund, but accompanied by the condition that the countries concerned should pledge to carry out austerity measures. The point made in Hirai's essay, drawing on Keynes's analysis of similar circumstances occurring after the First and the Second World Wars, is that these austerity measures are sharply deflationary and far from offering a fundamental solution to the crisis.

In both cases, we are faced with a situation in which a recession has turned out to be broader and deeper than ordinary downturns, and in which standard policies that may have worked in ordinary downturns prove inadequate to the larger task. A combination of monetary and fiscal expansionary measures, combined with a new set of rules (structural reforms) for the international financial market and monetary system, are seen as the only adequate response to the present recession. Some in the economics profession have warned of 'need for considerable caution regarding the pace of fiscal consolidation in depressed economies where interest rates are constrained by a zero lower bound' (DeLong and Summers 2012: 1). We feel that more should be conceded to Keynes's argument that concern about long-term debt levels should never be a priority over the level of unemployment and income.

MONEY AND INTERNATIONAL LIQUIDITY

In Part III, four chapters focus attention on what is perhaps the most distinctive feature of Keynes's vision of the working of capitalist economy, that is, its monetary nature. For Keynes, the role of money, both in private hands (household and banks) and in the public sector (central banks and supranational monetary institutions) is not in any sense 'neutral' with respect to the 'real' variables in the economy and the working of the market mechanism. Kregel sets the scene by showing how present ideas and prescriptions are in fact recycling ideas already present in Keynes's 1930 *A Treatise on Money*, where recipes such as zero interest rate policy (ZIRP) and quantitative easing (QE) were spelt out with Keynes's typical clarity of language and thought, explaining why central banks might be forced to step 'into shoes which the feet of the entrepreneurs are too cold to occupy' (Keynes 1930: 335). Today, the same desperate measures are being adopted as central banks substitute for the cold feet of fiscal authorities and political leaders.

Keynes's attempt to understand how these monetary interventions worked, and why ultimately they did not work well enough, led him to invent new economics, in particular his conception of liquidity preference. Unfortunately, however, this key invention has survived in the economics literature only in a simplified and therefore distorted version. Cardim de Carvalho argues convincingly that liquidity preference is more than Keynes's preferred word for the demand for money; it is the central core of his distinctive theory of asset pricing. Asset markets have of course changed much since Keynes's day, but if we extend the application of Keynes's theory to banks, we find a clue to much of what we have observed in the financial markets during the current crisis, in which commercial banks borrowed from central banks but then refused to roll over brokers' debts or to extend them new loans.

This issue of liquidity preference is further elaborated in the next chapter (Fantacci) which argues that what has occurred, since the summer of 2007, is not so much a cancellation or restructuring of non-performing loans, but rather a substitution of one kind of non-payable debt for another kind of non-payable debt: from private debts, to public debts, to foreign debts. In current policy discussion, the emphasis is on what to do about the sovereign debts of potentially insolvent states, but Fantacci maintains that the problem is not solvency but sustainability, which requires the possibility of selling domestic debts on liquid international markets. From this point of view, the focus of policy discussion should be on the sources of international liquidity, including the state of the international reserve currency, the strength of issuing institutions, and the size of global imbalances. For developing this alternative frame, Keynes's intuitions and proposals, such as 'Bancor' and the Clearing Union, provide a fruitful place to start.

For modern conditions, however, Keynes's vision of a world central bank empowered to impose ceilings for account balances, and to distribute reserves according to political priorities, is arguably impossibly utopian (Spahn). What seems to be emerging instead is a system with two or even three key currencies, accompanied by regulations on the scope and structure of reserve holding. Our challenge today is to imagine how this emerging new system will work, and how it can be made to work better.

FINANCE AND INTERNATIONAL ECONOMIC DISORDER

In the final Part IV, four chapters engage with what is arguably the central issue of the present moment: speculation, finance, and global markets. The opening piece (Sen) offers an explanation of the recent pattern of rising commodity prices in the global economy, viewed through Keynes's writings on uncertainty and risk, and revolving around his notion of probability. This Keynesian perspective is contrasted with explanations based on conventional economic thinking, in which price volatility and trends are attributed mainly to fundamental supply and demand factors. Building on the foundations laid by Keynes, the author emphasizes the dominance of speculation which is made possible by the increased 'financialization' of commodity markets. Unlike the mainstream literature on derivative trading, speculation is viewed here as a de-stabilizing factor.