

SPRINGER BRIEFS IN ECONOMICS

Fikret Čaušević

The Global Crisis of 2008 and Keynes's General Theory

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Fikret Čaušević
School of Economics and Business
University of Sarajevo
Sarajevo
Bosnia-Herzegovina

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The outstanding faults of the economic society in which we live are its failure to provide for full employment and its arbitrary and inequitable distribution of wealth and incomes.

John Maynard Keynes, *The General Theory*,
Chapter 24

I conceive, therefore, that a somewhat comprehensive socialisation of investment will prove the only means of securing an approximation to full employment; though this need not exclude all manner of compromises and of devices by which public authority will co-operate with private initiative. But beyond this no obvious case is made out for a system of State Socialism which would embrace most of the economic life of the community. It is not the ownership of the instruments of production which it is important for the State to assume. If the State is able to determine the aggregate amount of resources devoted to augmenting the instruments and the basic rate of reward

to those who own them, it will have accomplished all that is necessary. Moreover, the necessary measures of socialisation can be introduced gradually and without a break in the general traditions of society.

John Maynard Keynes, *The General Theory*, Chapter 24

In telling people how to read The General Theory, I find it helpful to describe it as a meal that begins with a delectable appetizer and ends with a delightful dessert, but whose main course consists of rather tough meat. It's tempting for readers to dine only on the easily digestible parts of the book, and skip the argument that lies between. But the main course is where the true value of the book lies.

Paul Krugman, July 2006

Preface

When Richard Nixon, the US president of the day, took the US dollar off the gold standard on 15 August 1971, it produced major disturbances on national and global financial markets, and also marked the beginning of the end for what had up until then been the dominant intellectual influence on official economic policy-making in the largest world economy, Keynesian economic thought, or so it seemed. Definite confirmation that the system of fixed exchange rates had been abandoned in favour of a freely floating US dollar came in March 1973. As the most important global currency began to suffer major volatility, it meant not just the end of the international financial system based on fixed exchange rates, but also the start of a series of major disruptions on global and national markets for goods, services and financial assets.¹

The first markets for financial derivatives were established in the same year as the United States formalised its transition to a freely floating dollar. That year also saw the first oil crisis, when the price of oil practically quadrupled in just 2 months, a reaction on the part of the oil-producing countries that was both prompted by the fall in the dollar and represented a coordinated approach to limit the supply of this key fuel. The following year, 1974, the Basel Committee for Banking Supervision was created. At the time, 9 of the 10 largest banks in the world were American and the most important oil producers kept their deposits with them. In 1974, the developing countries mooted a proposal to establish new global economic relations, to be called the New Economic Order. Their intention was to respond to the urgent problems caused by rising oil prices, problems financing postcolonial recovery and attempts to re-establish the rules for international trade in goods and services on a new basis.

Chapter 1 of this book presents the international context and some of the reasons that led to this weakening influence of Keynesian economic thought at the

¹ This book has been translated by a native speaker, Desmond Maurer, MA.

beginning and, more especially, during the second half of the 1970s, and the subsequent strengthening of the intellectual influence of the New Classical macroeconomics. It also presents certain Keynesian economic responses offered by circles of economists who belonged (and still belong) to the neo-Keynesian and new Keynesian schools of economic thought.

Because of the intellectual influence previously enjoyed by Keynes' *General Theory of Employment, Interest, and Money*, an influence in large part recovered during the current global financial and economic crisis (to such a degree, indeed, that between 2008 and 2014, it has dominated economic policy-making in the most developed and largest economies of the world, particularly the United States and Japan), Chap. 2 of this book is dedicated to a commentary on the Master's great work. This decision to offer a concise interpretation of the *General Theory* stems from the fact that, although without doubt one of the most significant works of economic science, it nonetheless leaves unresolved a whole series of questions to which Keynes, whether because of his own lack of time or because of his primary focus on dealing with internal imbalances under given technological conditions (in the short-term), either provided no answer or provided answers which served in the 1930s his goal of securing an exit from the immediate trough of the business cycle, but fail to provide clarity now, in an environment of globalisation and very high international mobility of capital, as to the impact of the economic policy measures applied during the global crisis, even though they were almost entirely based on his immediate recommendations for a combination of expansionary monetary and expansionary fiscal policy in the *General Theory*.

Chapter 3 deals with the impact of financial liberalisation on the efficiency of economic policy of major economies in the world, from one side, and its impact on the cost structure in production of globally integrated manufacturing companies. The international capital mobility arising from the financial liberalisation measures implemented in developing countries, particularly the most populous ones like China and India, brought about a sharp reduction in the costs of production, compared to the same costs on the national markets of developed countries. Consequently, one of the fundamental assumptions of both the new classical model and the new Keynesian model of production in developed market environments, that is, the assumption of growing marginal costs and the consequent preoccupation with inflationary pressures, ceased to be a key problem in the period from 1990 to 2010 in the globally connected major economies.

On the other side, the measures of financial liberalisation adopted during the 1990s and in the first 5 years of this century created a situation in which the money supply was predominantly endogenously determined, that is, determined on the basis of the business policies and profit motives of banking groups which unified the operations of commercial and investment banking, as well as those of trading in financial derivatives on rapidly growing and, between 2000 and 2009, almost entirely deregulated over-the-counter markets. Given a US monetary policy that was, during the periods in which financial bubbles were being created, powerless (or uninterested) to step in, through determined measures to increase the interest rate, the enormous growth in lending activity from 2002 to 2008, particularly on the

interbank market, and given the multiple systems for ensuring through the issue and sale of financial derivatives that risk transferred *de facto* onto the public budget, a situation was created which is best described in theoretical terms in the works of the post-Keynesian economists who developed the monetary circuit theory.

Sarajevo, Summer 2014

Fikret Čaušević

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Chapter 1

Economic Theory and Economic Policy Since the Seventies: Keynesians Versus New Classical Economists

Abstract This chapter begins with the analysis of causes that led to the weakening of the intellectual influence of Keynesian economic thought at the beginning of the seventies of the last century and to the strengthening of the impact of the new classical economists led by Lucas, Sargent and Wallas. The theoretical response of the new Keynesians to the criticism, was based on the introduction of sticky prices in macroeconomic models in the works of Phelps, Fischer, Taylor and Dornbusch in the late seventies. The author also presents the role of modern financial theory based on the efficient market theory, portfolio theory and the capital market theory, and the criticism of these theories presented in the works of Mandelbrot, Schiller and Kahneman. In explaining the causes of the global crisis of 2008, the author pays special attention to the post-Keynesian monetary circuit theory and the Minsky's financial instability hypothesis and its relevance for the analysis of major factors that led to the global financial crisis. This chapter ends with the author's comparison of the effects of macroeconomic policies in the United States under the administrations led by the last three US presidents: Clinton, Bush and Obama. By presenting the data on the trends in unemployment, interest rates, inflation and changes in the market capitalization on the major capital markets, the author shows that the economic policy measures implemented during the global economic crisis in the U.S., Europe and Japan are based on the recommendations suggested by John Maynard Keynes in the General Theory regarding the simultaneous use of expansionary monetary and fiscal policy.

Keywords Keynes • Keynesianism • New classical economics • Modern financial theory • Monetary-circuit theory • Financial instability hypothesis • Economic policy • The global crisis

1.1 Keynes's Economic Thought on the Defensive

Oil shortages, a falling dollar and sharply rising oil prices during the second half of the 70s were accompanied by a marked growth in inflation in the United States, as in all the other developed and developing countries. This increase in the general

level of prices in the leading world economy was at least partly due to the negative supply-side shock of sharply rising oil prices, but also to the conducting of expansionary monetary and fiscal policies, as recommended by economic policy-makers in the United States, whose economic programs were based on Keynesian modelling. John Maynard Keynes had himself recommended an expansionary monetary policy and, if required, cutting the interest rate to zero (or close to zero) as a remedy for maintaining actual employment close to full employment, as we shall see in the second part of this essay.

Keynesian economic thought, as initiated with the publication of its best-known work, *The General Theory of Employment, Interest and Money*,¹ dominated the first two decades after the Second World War—both in academic circles and in economic policy-making. Economic policy measures themselves and forecasting of their possible impact were, however, based on the Hicks IS–LM model² or the Mundell–Fleming IS–LM–BP³ model of an open economy, in spite of the fact that the author of the IS–LM model later confessed that it was primarily useful for teaching purposes and did not provide an adequate basis for economic policy-making. Keynesian economic thought branched out, in the post-war period, in three directions: post-Keynesian, neo-Keynesian and new Keynesian. It is therefore worth noting that it was the neo-Keynesians and the neoclassical economic synthesis championed by Paul Samuelson that exerted the greatest influence on economic policy-making in the 50s and 60s.

Even though Richard Nixon had declared, on the day he took the dollar off the gold standard, “I am now a Keynesian”,⁴ the implementation of Keynesian recipes during the 70s, and particularly its second half, did not yield good economic results. Inflation was not under control, nominal interest rates were lower than inflation, and real interest rates were, as a result, negative.

This combination of expansionary monetary and expansionary fiscal policy between 1974 and 1976 (after Nixon’s resignation over Watergate, when Gerald Ford took his place as US president) was marked by increasing unemployment and sharply falling real interest rates (particularly 1974/75).

These trends on money and labour markets strikingly contradicted the results of studies by William Phillips,⁵ from which he had derived his recommendations for economic policy-making, represented on the Phillips curve. Investigating the relationship between the cost of labour and the unemployment rate in Great Britain, he had found that economic policy recommendations should rely on an expansionary monetary policy, which would facilitate, amongst other things, an increase in the price of labour and so in the inflation rate, leading directly to lower unemployment. The data from Tables 1.1 and 1.2 indicate that, in spite of negative real

¹ Reference [1]. <http://www.marxists.org/reference/subject/economics/keynes/general-theory/>.

² Reference [2].

³ References [3, 4].

⁴ See: http://www.ontheissues.org/celeb/Richard_Nixon_Budget+_Economy.htm.

⁵ Reference [5].

Table 1.1 Real interest rates in the United States 1974–1978

Year	Federal funds rate	Rate of Inflation	Real interest rate on inter-bank market
1974	10.51	11.03	−0.52
1975	5.82	9.20	−3.38
1976	5.05	5.75	−0.70
1977	5.54	6.50	−0.96
1978	7.94	7.62	+0.32

Source Federal Reserve System—<http://www.federalreserve.gov/releases/h15/data.htm>

Table 1.2 Real interest rates and the unemployment rate in the US: 1974/1978

Year	Real interest rate on interbank market in %	Unemployment rate in %
1974	−0.52	7.2
1975	−3.38	8.2
1976	−0.70	7.8
1977	−0.96	6.4
1978	+0.32	6.0

Source <http://www.davemanuel.com/historical-unemployment-rates-in-the-united-states.php>. <http://www.federalreserve.gov/releases/h15/data.htm>

interest rates and falling inflation, the unemployment rate rose between 1974 and 1975 and did not fall significantly during 1976, while inflation growth in 1977–1978 was accompanied by a growth in the federal funds rate, which switched from a real negative to a real positive rate, however small, accompanied by a reduction in unemployment from 7.8 % (1976) to 6 % (1978).

In a paper published in 1976, Robert Lucas⁶ explained why the Keynesian models could not provide answers to the evident problems of inflation and built-in inflationary expectations, which had given rise to a phenomenon directly opposite to neo-Keynesian predictions based on the Phillips curve. The Phillips curve describes a relatively simple trade-off between inflation and unemployment. As we have already seen from the data in Tables 1.1 and 1.2, however, after the transition of the US dollar to a free float and the first oil shock which followed, certain economic players (companies and trade unions primarily) closed ranks and built their inflationary expectations into the prices of their products and labour. The result was stagflation.

Lucas demonstrated that the Keynesians, relying on either the Hicks IS-LM or Mundell-Fleming IS-LM-BP model and so exclusively on macroeconomic relations, had left entirely out of their models how key economic players, i.e. firms and households, actually react. In other words, one of his fundamental criticisms was

⁶ Reference [6].

that the Keynesian models do not contain clearly specified goal functions describing how firms and households react when the government is changing its economic, and particularly its monetary and fiscal policy. Insofar as they are well informed and their expectations rational, economic policy measures will not, according to Lucas, have any impact on real variables. Econometric models based on past information do not provide a reliable basis for economic policy-making.

The rational expectations school thus appeared during a period of growing inflation, developing its conditions of "fitness of purpose" in economic policy-making by testing models for forecasting future prices. Based on a model for forecasting the inflation rate, adherents of the rational expectations school took the view that there was no need to use formula, except as an analytical condition for eliminating systematic forecasting error.⁷ The analytical condition sufficient to eliminate systematic errors in forecasting may be presented in rudimentary form by the following equation:

$$P_{t+j}^e = E(P_{t+j}/\Omega_t)$$

Accordingly, the analytical condition of the rational expectations school boils down to the claim that the expected rate of inflation is based on estimation of the future level of prices, $P(t+j)$, and a set of information available to all actors at time (t) during the decision-making process, or rather the time when expectations are being formed. For expectations to be rational, they must meet the condition that the deviation of real prices at a future time $P(t+j)$ from expected price $EP(t+j)$ is equal to zero, or that any eventual deviation is the result of the action of unforeseeable events (the random variable).⁸

Expectations are rational insofar as subjective expectations are consonant with objective expectations, which depends on the available set of information (Ω) . Objective expectations represents the average value of the distribution of conditional probabilities of the variable $P(t+j)$ for the given available information at time (t) . It is a condition of rational subjective behaviour that all mistakes from the past (systematic mistakes or errors in forecasting) be avoided, so that there is no discrepancy between real and expected values:

$$E(P(t+1) - P_e(t+1)) = 0$$

Application of the theory of rational expectations assumes a democratic organisation of the society and so a transparent economic programme for the conduct of economic policy. Consequently, so long as the government publishes an economic programme with all the important information on which implementation will be

⁷ Reference [7].

⁸ The condition of rational behaviour is for subjective expectations formed by market actors to be the same as the average value of the distribution of probabilities of the variable being predicted, for a given range of available information.

based, rational market actors can forecast all future actions taken in the name of economic policy, reducing significantly any room for economic policy to actively influence GDP growth over the short term and eliminating it entirely over the middle or longer term.

Given this conclusion, changes in monetary and fiscal policy, insofar as they are foreseeable and foreseen, serve no purpose in essence. It follows from this that Keynesian models do not provide any valid intellectual basis for tackling economic problems. A year before Lucas published his critique of Keynesianism and of the effectiveness of any economic policy based on it, Thomas Sargent and Neil Wallace had published a paper outlining the intellectual basis for strengthening the impact of the new classical economic teachings (new classical economics).⁹

The academic response to the challenge issued to the Keynesians by Lucas, Sargent, Robert Barro and Milton Friedman, was contained in a number of papers published in the mid-1970s by Rudiger Dornbusch, Stanley Fischer, Edmund Phelps and Robert Taylor. In a work from 1976, Dornbusch offered a theoretical model to explain major volatility in exchange rates over the short term.¹⁰ His "overshooting model" was a significant theoretical contribution to explaining the causes of major changes in exchange rates over the short term, at a time when the world of international finance had experienced a major transformation, with the transition to the system of floating exchange rates. The Dornbusch model combines elements from the monetary model and the Mundell Fleming model with his own original contribution, associated with analysis of how the exchange rate behaves over the short term. He started from the assumption that the prices of goods and services are rigid over the short term (the assumption of "sticky prices"), but they gradually adjust over the medium run, and are fully flexible in the long run as a result of changes in the supply of money and demand for it. On the other hand, financial assets prices (foreign exchange included) are flexible in the short run, and changes in the money markets are caused, primarily, by unanticipated changes in the money supply.

Unanticipated growth in the money supply over the short run causes a change in the nominal exchange rate. This change in the exchange rate is, however, greater in percentage terms than the change in the money supply. It is this more intensive exchange rate growth that forms the core of Dornbusch's model, whence its name, the "overshooting model." The exchange rate rises faster than the quantity of money in circulation because of (over)heated expectations of changes required in it over the coming period to establish a new exchange rate equilibrium. Since Dornbusch assumed that the prices for goods, labour and services are rigid over the short run (do not change), changes in the nominal exchange rate presuppose change in the real exchange rate of the same percentage (the prices of the goods of trading partners are also assumed not to change in the short run). Growth in the real exchange rate in the short run (real depreciation of the domestic currency) stimulate

⁹ Reference [8].

¹⁰ Reference [9].