# POST KEYNESIAN MACROECONOMIC THEORY

PAUL DAVIDSON

A Foundation for Successful Economic Policies for the Twenty-first Century

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## A Foundation for Successful Economic Policies for the Twenty-first Century

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Edward Elgar

Published by
Edward Elgar Publishing Limited
8 Lansdown Place
Cheltenham
Glos GL50 2HU
UK

Edward Elgar Publishing Company
Old Post Road
Brookfield
Vermont 05036
US

Reprinted 1996

**British Library Cataloguing in Publication Data**
Davidson, Paul
Post Keynesian Macroeconomic Theory:
Foundation for Successful Economic
Policies for the Twenty-first Century
I. Title
339

**Library of Congress Cataloguing in Publication Data**
Davidson, Paul.
Post Keynesian macroeconomic theory: a foundation for successful economic policies for the twenty-first century/by Paul Davidson.
p. cm.
Includes bibliographical references and index.
1. Keynesian economics. 2. Macroeconomics. 3. Economics--History—20th century. 4. Keynes, John Maynard, 1883–1946.
I. Title.
HB99.7.D393 1994
339.3—dc20 93–38374
CIP

ISBN 1 85278 835 6
1 85278 836 4 (paperback)

Printed in Great Britain at the University Press, Cambridge

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# Introduction

When the Old Keynesian analysis developed in the United States in the 1940s and 1950s failed to provide good policy guidelines for the stagflation period of the 1970s, it became fashionable among younger economists to declare that Keynesian economics was dead.[1] Hi-tech forms of classical economics were resurrected as the analytical framework used to justify the elimination of governmental responsibility for maintaining full employment.

This classical counter-revolution in economic theory provided the rationale for the decontrolling of financial, utility, and product markets that became the economic hallmark of the last years of the Carter presidency in the United States. It also conferred intellectual prestige on the siren song 'Get The Government Off The Backs Of The People' that became the triumphant march to power of the Reagan Administration in the United States and the Thatcher Government in the United Kingdom. The economic facts of the 1980s overwhelmed the Panglossian *laissez-faire* philosophy that produced the Reagan and Thatcher politico-economic revolutions. Monetarism and New Classical theories failed to explain the unfolding economic events.

A New Keynesian analytical framework was created as a counterpoint to the instantaneous solutions predicted by New Classical theory. Those who professed to be New Keynesians had never read Keynes. They still believed in the conclusions of the classical analysis, at least in the long run. They claimed that Keynes's

> *General Theory* is an obscure book . . . [it] is an outdated book. The rigor with which we develop economic theories and the data and statistical techniques with which we test our theories were unknown half a century ago. We are in a much better position than Keynes was to figure out how the economy works. . . . Few macroeconomists take such a dim view of classical economics [as Keynes did]. . . . Classical economics is right in the long run. Moreover, economists today are more interested in the long-run equilibrium. The long run is not so far away. . . . [There is] widespread acceptance of classical economics.[2]

It is paradoxical that, having adopted a Keynesian appellation for themselves, these economists describe Keynes's 1936 analysis as enigmatic and antiquated. Even more astonishing is their belief that the eighteenth and early nineteenth century classical theory is relevant to the modern world while Keynes's twentieth century analysis is not.

Despite the bravado claim that their 'rigour' and 'statistical techniques' permit New Keynesians to be in 'a better position than Keynes to figure out how the economy works', the record of recent years does not support the idea that today's mainstream economists have any idea of how a monetary, entrepreneurial economy operates. For example, in March 1990, as a recession was already under way, *The Wall Street Journal* reported that '60 per cent of macroeconomic forecasters don't expect a recession in the next three years'. In November 1990, four months after the recession began, *The New York Times* reported that the National Bureau of Economic Research's forecasting model, a preeminent mainstream model reflecting the best statistical techniques of modern macroeconometrics, was predicting real economic growth of 4 per cent and that there was less than a 5 per cent probability of a recession *beginning* by February 1991. Not until the summer of 1991, when the recession bottomed out, were mainstream economists willing to admit that the economy was in recession. Even then most predicted the recession would be short and followed by a brisk recovery. By the summer of 1993, as this is being written, the promised swift rejuvenation has still not appeared. An anaemic improvement is all that has occurred so far despite over twenty reductions in the interest rate engineered by the Federal Reserve System during the 36 months since the recession began. After three years we are still waiting to experience long run bliss.

The New Keynesian economists have not lived up to their claim of having bettered Keynes in figuring out how the economy works. The theoretical framework used by New Keynesians and other mainstream economists has not helped society to understand economic circumstances and trends. Despite the advances in economic data collection and statistical techniques of analysis used by central banks, governments, and many private sector enterprises, economic performance has been exceedingly poor compared to the magnificent record of the early post-war decades when Keynes's policies were still in vogue. Surely this evidence suggests that mainstream macroeconomics has gone off the track.

The purpose of this volume is to encourage students of economics to return to the path of Keynes's revolutionary analysis of a money-using entrepreneurial economy. Once economists become more familiar with this theory that is applicable to the enterprise economy in which we live, then they may be able to understand the causes of real world economic problems and to design policies to resolve them.

Knoxville, Tennessee

## NOTES

1. Robert E. Lucas, 'The Death of Keynesian Economics', *Issues and Ideas*, 1980.
2. N.G. Mankiw, 'The Reincarnation of Keynesian Economics', *European Economic Review*, **36**, 1992, pp. 560–61.

# 1. The background for Keynes's revolution

On New Year's Day in 1935 the English economist, John Maynard Keynes, wrote a letter to George Bernard Shaw. In this letter he stated:

> To understand my new state of mind, however, you have to know that 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. When my new theory has been duly assimilated and mixed with politics and feelings and passions, I cannot predict what the final upshot will be in its effect on actions and affairs, but there will be a great change and in particular the Ricardian Foundations of Marxism will be knocked away.
>
> I can't expect you or anyone else to believe this at the present stage, but for myself I don't merely hope what I say. In my own mind I am quite sure.[1]

A little over a year later, Keynes published a book that, for several decades, did revolutionize the way most economists and politicians thought about developing economic policies to deal with unemployment. That book was entitled *The General Theory of Employment, Interest, and Money*.

Keynes's book produced innovative thinking in policy discussions. Yet, orthodox economists failed to adopt the logically consistent innovative theoretical analysis laid down by Keynes. Instead, what developed in mainstream professional writings and popular economics textbooks was a modernized version of the pre-Keynesian classical system where Keynes's policy suggestions for solving the unemployment problem were grafted on to the axiomatic foundations of classical microeconomic theory. In the first three decades following World War II, the resulting Neoclassical Synthesis Keynesianism[2] (or what in the 1990s is sometimes referred to as Old Keynesianism) conquered mainstream academic discussions as completely as the Holy Inquisition conquered Spain (to paraphrase one of Keynes's more colourful expressions).

Keynes began work on his revolutionary book in 1932. Unlike the United States, Great Britain had been suffering from a great recession since the end of World War I. Between 1922 and 1936 the unemployment rate in Britain fell below 10 per cent in only one year. In 1927 it was 9.7 per cent.

In the United States, the roaring 20s had been a period of unbridled prosperity. In 1929, only 3.2 per cent of American workers were unemployed. The stock market climbed to unprecedented highs and everybody seemed to be getting rich. It is no wonder that English economists were more concerned about the problem of chronic and persistent unemployment when the Great Depression of the 1930s began than were American economists.

Just a few days before the stock market crash of October 24, 1929, one of the most eminent American economists of the time, Professor Irving Fisher of Yale University, told an audience that the stock market had reached a high plateau from which it could only go up. Then, suddenly, the bottom fell out. It is said that Professor Fisher lost between $8 million and $10 million in the stock market crash. The Great Depression had hit America.

From 1929 to 1933 the American economy went downhill. It seemed as if the system was enmeshed in a catastrophe from which it could not escape. Unemployment went from 3.2 per cent in 1929 to 24.9 per cent by 1933. One out of every four workers in the United States was unemployed by the time Roosevelt was elected president. A measure of the standard of living of Americans, the real gross national product per capita, fell by 52 per cent between 1929 and 1933. By 1933, the average American family was living on less than half of what it had earned in 1929. The American capitalist dream appeared to be shattered.

The economic experts of those times, including Professor Irving Fisher, argued that the high levels of unemployment being experienced in the United States in the early 1930s could not persist. The economy would soon right itself as long as the government did not interfere with the workings of the market-place. The prevailing orthodox classical theory provided the rationale for the '*laissez-faire*' or 'no government intervention' philosophy that dominated economic discussions before Keynes's *General Theory* was published.

It is claimed that, in 1751, the Marquis d'Argenson was the first writer to use the phrase '*laissez-faire*' in his argument for removing the visible hand of government from economic affairs. He said that 'To govern better one must govern less'. Although the phrase *laissez-faire* does not appear in the writings of the founding fathers of classical theory such as Adam Smith or David Ricardo, the idea is there. The pursuit of self-interest, unfettered by government interference is at the heart of the philosophy of classical economics.

In his 1776 classic, *The Wealth of Nations*, Adam Smith wrote:

> It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from regard to their own self-interest. We address ourselves, not to their humanity but to their self love, and never talk to them of our necessities, but of their advantage.... Every individual is continually

> exerting himself to find out the most advantageous employment for whatever capital he can command. It is his own advantage, indeed and not that of society which he has in view.... He intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention. By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it.[3]

Classical theory argued that if the government intervened in economic matters during any 'temporary' period of unemployment, then the economic situation would deteriorate and the economy would take a longer time to right itself. If the government did not interfere with the invisible hand of the market processes operating during this transient period of unemployment, then only the weak and inefficient would be weeded out, leaving a stronger, more powerful economy to carry on. In true Social Darwinian fashion, what was being asserted was that the Great Depression was merely a symptom of Nature's providing for the 'survival of the fittest'. When the economic system righted itself, it would regenerate full employment and prosperity for all.

In the very first paragraph of his book, *The General Theory*, Keynes challenged this orthodox dogma when he wrote:

> I have called this book the *General Theory of Employment, Interest and Money*.... The object of such a title is to contrast the character of my arguments and conclusions with those of the classical theory of the subject ... which dominates economic thought, both practical and theoretical of the governing and academic classes of this generation, as it has for a hundred years past.... The characteristics of the special case assumed by the classical theory happen not to be those of the economic society in which we actually live, with the result that its teaching is misleading and disastrous if we attempt to apply it to the facts of experience.[4]

Keynes explicitly tailored the exposition of his book to change the minds of his 'fellow economists' while hoping 'it will be intelligible to others'. Keynes's purpose was to persuade 'economists to reexamine critically certain of their basic assumptions'. Keynes believed that the fatal flaw of the classical system lay in the special axioms that were necessary to demonstrate the self-correcting tendency of an unfettered competitive economic system.

For several years before publication, Keynes circulated drafts of his work to world-famous professional colleagues in England. He took extraordinary time and effort to elicit comments from, and respond to, these economists as well as to his students in Cambridge. As a result of this ongoing dialogue, Keynes was fully aware of the arguments that his fellow economists would marshall to defend the classical orthodoxy. If he was to convince his professional colleagues of the errors of their ways, Keynes had to develop persuasive arguments to rebut the many comments he received.

The English experience of stagnating high levels of unemployment since World War I had convinced Keynes that the capitalist system was unlikely to survive unless proper policy actions were taken immediately. What was needed to galvanize professional support for his policy suggestions was something other than a tedious and contentious professional formalization of his model. Rightly or wrongly, in 1936, Keynes felt that

> It is a great fault of symbolic pseudo-mathematical methods of formalising a system of economic analysis . . . that they expressly assume strict independence between the factors involved and lose all their cogency and authority if this hypothesis is disallowed; whereas, in ordinary discourse, where we are not blindly manipulating but know all the time what we are doing and what the words mean, we can keep 'at the back of our heads' the necessary reserves and qualifications and the adjustments which we shall have to make later on, in a way in which we cannot keep complicated partial differentials 'at the back' of several pages of algebra which assume that they all vanish. Too large a proportion of recent 'mathematical' economics are mere concoctions, as imprecise as the initial assumptions they rest on, which allow the author to lose sight of the complexities and interdependencies of the real world in a maze of pretentious and unhelpful symbols.[5]

Keynes, a master expositor and essayist, developed his general theoretical analysis as an essay in persuasion just at the time that the economics profession was becoming more imbued with the belief in the necessity of presenting economic arguments in terms of formal mathematical models. Today's generation of economists, trained to think solely in terms of mathematical formulizations, have great difficulties in comprehending the analytical basis of Keynes's *General Theory* essay.

In an early draft of the Introduction to his *General Theory*, Keynes explained why he chose to de-emphasize formalisms when he wrote:

> In economics you cannot *convict* your opponent of error, you can only *convince* him of it. And, even if you are right, you cannot convince him . . . if his head is already so filled with contrary notions that he cannot catch the clues to your thought which you are trying to throw to him.[6]

Keynes believed that the classical formal analysis could never provide a meaningful explanation of unemployment or how it would be cured in the real world. He categorized the classical proposal for curing unemployment as an '*ignoratio elenchi*'.[7] Classical theorists, Keynes claimed, were engaged in offering a proof irrelevant to the proposition in question. Keynes compared classical economists to Euclidean geometers in a non-Euclidean world

> who, discovering that in experience straight lines apparently parallel often meet, rebuke the lines for not keeping straight – as the only remedy for the unfortunate collisions which are occurring. Yet in truth, there is no remedy except to throw over the axiom of parallels and to work out a non-Euclidean geometry. Something similar is today required in economics. We need to throw over . . . postulate[s] of the classical doctrine and to work out the behaviour of a system in which involuntary unemployment in the strict sense is possible.[8]

To explain the existence of involuntary unemployment in the real world, Keynes developed the economic theory analogue to non-Euclidean geometry where fundamental classical axioms were overthrown. If one accepts these classical axioms, then the only logical basis for unemployment involves some supply condition that causes wages and prices to be less than perfectly flexible.

During the depression, classical theorists argued that unemployment would end when the market would self-correct this supply imperfection. In the long run market forces would cause wages and prices to fall sufficiently to restore full employment. Keynes, on the other hand, argued 'We must not regard the conditions of supply . . . as the fundamental sources of our troubles. . . . [I]t is in the conditions of demand which our diagnosis must search and probe for an explanation'.[9]

In 1936, the rigorous axiomatic foundations of classical demand theory had not been specified.[10] It is not surprising, therefore, that Keynes did not identify all the specific classical axioms that his analysis had thrown out. At the time (and even today) many readers are not clear as to what were the specific classical axioms Keynes rejected in developing his 'non-Euclidean' general economic theory, and why he had rejected them.

Many of the cleverest young economists who were entering the economics profession in the United States and England during the Great Depression (e.g., Paul Samuelson, James Tobin, J.R. Hicks, James Meade) recognized that the unemployment problem of the economic system seemed too deep and long to be sloughed off as merely a temporary aberration or friction that a self-adjusting market could cure. Common sense told them that the invisible hand might not be able to resurrect a prosperous economy in their lifetime. They were too impatient to wait for the long-run revival that was promised by classical theory.

Yet these young economists of the 1930s had been trained in the classical economics tradition. They, therefore, did not find Keynes's essay in persuasion an easy one to comprehend. As classically trained economists, these 'young Turks' were unwilling to dispense with any of the implicit fundamental axioms required by the classical theory of demand. For those disciplined to believe in the beneficence of the invisible hand, all classical axioms are, by definition, universal truths. It is a herculean task to question what one has been trained to believe in as self-evident verities. This younger generation were unwilling, or unable, to free their formal models of these classical restrictive axioms underlying demand conditions. Their minds were so filled with 'Euclidean' notions that they could not catch the 'non-Euclidean' analytical insights that Keynes was throwing to them.

Instead, this younger generation of professional economists tried to translate Keynes's conclusions into formalizations of the evolving axiomatic [neo]classical theory that was coming into vogue during this period as a result of the work of Hicks, Meade, Samuelson, and others. Unable to decipher Keynes's 'non-Euclidean' message, they tried to develop his insights through the classical theory that they had been brought up on by introducing *ad hoc* supply constraints (e.g., the fixed money wages and fixprice models) on the workings of the 'invisible hand'.

Today, most economists are even more rigorously trained in the mathematical formalisms of classical axiomatic value theory than earlier generations. Most are, therefore, still wedded to the axioms of classical analysis and are unwilling to contemplate the throwing over of some of their cherished classical universal truths. Accordingly, mainstream macroeconomic models are still founded on the special classical axioms. The resulting policy implications are, as Keynes noted, 'misleading and dangerous' if applied to the real world in which we live.

Until mainstream classical economists are willing at least to contemplate more general economic theories that are free of the restrictive demand axioms of classical theory, it is unlikely that the applicable general theory of unemployment in a monetary economy will be the basis of widespread public discussions. Mainstream economists do not have the relevant theoretical tools to develop proper policies for resolving the major economic problems of the day.

Beginning in the 1980s a New Keynesian macroeconomic school of thought developed. Like the earlier generation of Old Keynesians, the New Keynesians still profess allegiance to the axioms of classical demand theory as the bedrock microfoundations of macroeconomics. The New Keynesians' advance over the Old Keynesian model is the development of sophisticated *ad hoc* constraints on the conditions of aggregate supply (in terms of fixed nominal values, coordination failures and/or asymmetric information upon which supply decisions are made). These constraints are justified by claiming that, at least in the short run, nominal fixities exist in the real world.[11] If prices were only perfectly flexible and existing information freely available to all, then the logic of the New Keynesians would force them to admit that full employment is the inevitable outcome of an unfettered market system. In the long run with sufficient price flexibility assured by a free market mechanism, though we may all be dead, New and Old Keynesians can agree with their classical brethren that full employment and economic prosperity are inevitable.

These Old and New Keynesian explanations of the existence of unemployment are the modern-day logical equivalent of rebuking the apparent parallel lines 'for not keeping straight'. In truth, these Old and New Keynesian models accept that the classical system is the general theory, while Keynesian unemployment is a special case that occurs in the short run because of some unfortunate market (supply) imperfection. More than a half-century after Keynes's *General Theory*, these mainstream Keynesians still fail to see that Keynes was attacking the beliefs in the 'universal truths' that formed the very foundation of classical demand analysis.

Keynes's squabble with the classical theory was not over whether temporary wage and price stickiness is the cause of unemployment. In attempting to differentiate his product from classical analysis, Keynes noted

> For Classical Theory has been so accustomed to rest the supposedly self adjusting character of the economic system on the assumed fluidity of money-wages; and, when there is rigidity, to lay on this rigidity the blame for maladjustment.... My difference from this theory is primarily a difference of analysis.[12]

Any supply failure that produces a wage and/or price inflexibility – whether ephemeral or not – is not the essence of Keynes's analysis of unemployment. Keynes always insisted that it is the conditions underlying demand, and not supply, that are the fundamental cause of unemployment in a monetary economy.

Keynes's theoretical analysis was immediately shunted onto a wrong track by the writings of Hicks, Samuelson, Meade and others who claimed to have the analytical key to explain Keynes's general system. The result was that Keynes's revolution was aborted almost as soon as it was conceived. More than a half-century later, Keynes's 'non-Euclidean' revolutionary approach remains undiscovered in the modern mainstream economics literature. There is, therefore, an analytical void that needs to be filled if Keynes's revolution in economic thought is to be understood and revived. Hopefully, this volume will fill the theoretical (and resultant policy) gap that mainstream economists have failed to close.

In the 1970s, Neoclassical Synthesis Keynesianism was declared dead by a younger generation of technically trained classical scholars who called