The Renaissance of Keynesian Economics[1]

A.P. THIRLWALL

Introduction

Not so long ago, Keynesian economists had the distinct feeling of being members of an endangered species, with the prospect of extinction in the face of the onslaught of Monetarism Mark 1 (the monetarism of Milton Friedman) and Monetarism Mark 2 (the new classical macroeconomics, led in America by Professor Robert Lucas). It looks now, however, that the tide is beginning to turn. The new classical macroeconomics seems to be dying a slow death; the empirical evidence from the behaviour of the British economy and the world economy seems to be on the side of the Keynesians, and papers are being written on the rise and fall and rise again of Keynesian economics.[2] There is also a revival of interest in Keynes the man with the publication of two new biographies by Professors Moggridge[3] and Skidelsky.[4]

Keynes' *General Theory of Employment, Interest and Money*, published in 1936, still provides the backbone of macroeconomic theory, in terms of the concepts it introduced – the consumption function, the multiplier, the marginal efficiency of investment, liquidity preference, etc. – but its theoretical and policy conclusions

□ University of Kent, Keynes College, Canterbury, Kent (Great Britain).

[1] This article is based on a talk given at Dalhousie University, Canada, October, 1992. The author is grateful for discussions with Robert Skidelsky and Hans Singer, and for the comments of two anonymous referees.

[2] An early prescient paper was Alan Blinder's "The fall and rise of Keynesian economics", *Economic Record*, December 1988.

[3] D. Moggridge, *Maynard Keynes: An Economist's Biography* (Routledge 1992).

[4] R. Skidelsky, *John Maynard Keynes: The Economist as Saviour 1920-1937* (Macmillan 1992).

BNL Quarterly Review, no. 186, September 1993.

have been continually attacked.[5] However, those of anti-Keynesian persuasion always seem to me to have misunderstood the basic message.

The classical-neo-classical response to Keynes was that the conclusion of the possibility of an unemployment equilibrium depended on the assumption that money wages and prices were rigid, and that if wages and prices were flexible there could be no such thing as long run involuntary unemployment.

Milton Friedman's response to Keynes, and the inspiration behind the doctrine of monetarism, was that "money doesn't matter in Keynes". For him, the *General Theory* provides an *apologia* for government intervention into the macro economy which leads to a misallocation of resources and disastrous inflationary consequences through the power of governments to 'print' money.

The response of the new classical macroeconomics of the 1970s was to say that Keynesian economics had outlived its usefulness because it could not explain the combination of high unemployment and rising prices (or stagflation), and that the rational expectations of economic agents makes all government attempts to stabilise the economy fruitless. In an article "On the death of Keynesian economics" written in 1980, Robert Lucas went so far as to say "one cannot find good under-fourty economists who identify themselves or their work as "keynesian". Indeeed, people even take offence if referred to as Keynesians. At research seminars, people don't take Keynesian theorising seriously any more; the audience starts to whisper and giggle at one another".[6]

There is a simple reply to each of these responses. Firstly, Keynesian conclusions concerning long run breakdowns of effective demand and involuntary unemployment do *not* depend on the assumption that money wages and prices are rigid. The ultimate source of involuntary unemployment is uncertainty associated with the existence of money. There is no immediate or automatic nexus which unites decisions to save with decisions to invest, as there would be in an economy in which goods exchanged for goods or in which the rate of interest was the price which equilibrated savings and investment. Reductions in money wages in conditions of high unemployment may reduce costs, but equally will depress the demand for output. Re-

[5] For an illuminating discussion of Keynes's vision of the functioning of the capitalist system, see F. Vicarelli, *Keynes: The Instability of Capitalism* (London: Macmillan, 1984).

[6] R. Lucas, "The death of Keynesian economics", *Issues and Ideas*, Winter, 1980.

ductions in prices increase the real value of money, and money balance holdings, but depress the profitability of investment. Long periods on involuntary unemployment are quite compatible with wage and price flexibility.

Secondly, money does matter in the *General Theory* in a number of ways. One of the fundamental purposes of the book was to integrate the theory of money with the theory of value; to show, in other words, that money matters for the functioning of the real economy and is not simply the determinant of the absolute price level. As mentioned above, the existence of money, and the desire to hold wealth in liquid form, is the fundamental source of involuntary unemployment. Keynes accepted the quantity theory of money that prices will rise in full proportion to increases in the quantity of money but only *if* there is full employment and *if* the demand to hold money is a stable proportion of income. What he questions is the validity of the quantity theory of money if there is not full employment, and if the demand for money changes with the supply. Furthermore, he also recognises explicitly that prices may rise before the full employment level is reached because costs may rise for a variety of reasons associated with trade union bargaining power and bottlenecks in particular sectors of the economy. We have anticipated in Keynes what we now call cost-push and structural inflation. There is also a hint in the *General Theory*, and in his earlier work on *A Treatise on Money* (1930), that money may be endogenous to an economic system which in a Keynesian model has profound implications for the interpretation of the causal relations between money, output and prices.[7]

Thirdly, it is perfectly possible to explain stagflation in a Keynesian model if the aggregate supply function is not forgotten. The aggregate level of employment is determined at the point of effective demand where the aggregate demand curve cuts the aggregate supply curve. The aggregate supply curve shows the necessary receipts that entrepreneurs must receive to employ a certain number of men. There will be a different aggregate supply curve for each level of the money wage. As wages rise, the aggregate supply curve shifts upwards producing rising prices and falling employment. If governments tackle the cost inflation as if it is a demand inflation, aggregate

[7] This idea has been developed, among others, by economists such as Richard Kahn, Nicholas Kaldor, Hyman Minsky, and Basil Moore.

demand will be reduced, leading to further falls in employment. There is no problem, therefore, in explaining stagflation in a Keynesian framework. The suggestion to the contrary of the new classical macroeconomists is a measure of their ignorance of Keynesian economics and the *General Theory*.

Indeed, if we want explanations of high unemployment and of rising prices in conditions of slump, we cannot return to pre-Keynesian economics, to the classical assumptions that monetarism and the new classical macroeconomics have revived in recent years. These assumptions I take to be: that inflation is always and everywhere a monetary phenomenon in a causal sense due to 'too much money chasing too few goods', as if money is totally exogenous to an economic system, and monopolies in the product and the labour market cannot cause prices to rise without prior increases in the money supply; that all unemployment is voluntary due to a refusal of workers to accept cuts in real wages; that the rate of interest clears the goods market so that there is never any deficiency of aggregate demand, and that ups and downs in the macroeconomy are to be explained by supply shocks alone. The world in which we actually live is very different.

The interesting question arises, however, of how is it that sections of the economics profession returned to pre-Keynesian modes of thinking by embracing Monetarism Mark 1 and Monetarism Mark 2, after a broad Keynesian consensus had united the profession for so long? There are undoubtedly many explanations, but I will mention two which are related. The first is that it is significant, and not accidental, that the anti-Keynesian movement started in the United States – a country historically and ideologically hostile to doctrines that suggest that the State might have a role to play in economic affairs. Keynes's use of the phrase "the socialisation of investment" (*General Theory*, p. 378) has always tainted him 'red' in the eyes of Americans, although misleadingly as it happens, because he goes on to say that beyond public investment in conditions of slump "no obvious case is made out for a system of state socialism which would embrace most of the economic life of the community". The second explanation is that the way economics is taught in the U.S., and increasingly so elsewhere, makes economists uncomfortable with the notions of disequilibrium and non-market clearing. A heavy premium is placed in the universities on the mathematisation of economics, to which the subtleties of Keynesian economics do not lend themselves.

The basic proposition that both monetarism and the new classical macroeconomics denies is that there can be such a thing as involuntary unemployment. Friedman's model of the natural rate of unemployment, and Lucas's model of the business cycle, *start* from the assumption of no involuntary unemployment, so that with either adaptive or rational expectations, any attempts by governments to reduce unemployment by spending more will meet with resistance by workers to cuts in their real wage, which then leads to accelerating inflation at the natural rate of unemployment. Why does monetarism and the new classical macroeconomics assert or assume what, in the first instance, must be proved: that markets do clear on the basis of voluntary exchange? One explanation might be that political ideology colours theoretical judgement. Monetarists simply do not like any economic theory which seems to imply market failure, and establishes a role for the State. The historian, E.H. Carr, once said about history that in order to understand history, one has to understand the historian that is writing it.[8] The same might be said for economics.

In the early 1980s, at the height of the recession in the U.S. and the U.K., when thousands queued at the factory gates when jobs were advertised, were these men and women voluntarily unemployed? When unemployment in the U.K. eventually fell from 3.4 million in 1986 to 1.6 million in 1990 as a result of financial liberalisation and tax cuts, were the nearly two million unemployed absorbed into the system voluntarily unemployed? It would be difficult to answer in the affirmative. Employment and unemployment responded to changes in the level of aggregate demand in exactly the way one would have predicted from a Keynesian model (without accelerating inflation). The notions of continuous market clearing and no involuntary unemployment were discredited by the events of the 1980s, and continue to be discredited today with unemployment in the U.K. at nearly 3 million (and in the EEC at over 17 million), with most willing to work at the going money wage (and a lower real wage if necessary) given the opportunity. It is significant that the British monetarist, Professor Minford of Liverpool University, who argued that the 'natural' level of unemployment in the UK in the early 1980s was over 3 million, now concedes that at least 2 million of the currently unemployed are involuntarily so. As Frank Hahn once said of Robert

[8] E.H. Carr, *What is History?* (Harmondsworth, Penguin 1964).

Lucas "I wish he would become involuntarily unemployed and then he would know what the concept was all about".[9]

Monetarism in the United Kingdom

The British economics profession was never seduced by monetarism and the new classical macroeconomics to the same extent as American economists, or to the same degree as the Conservative government when it came into office in 1979 under Mrs Thatcher. Mrs Thatcher's brand of monetarism was based on five basic beliefs. First was the Friedman doctrine that 'inflation is always and everywhere a monetary phenomenon' in a *causal* sense. This, in turn, has three corollaries: that the money supply is exogenously determined and controllable; that the demand for money is a stable function of income, and that changes in the money supply preceding changes in the price level and money national income are necessarily proof that money is the cause of price level changes and not *vice versa.* Within this framework of thinking, there is no such thing as cost push inflation accommodated by money responding to the needs of trade, or variations in the velocity of circulation of money. Friedman has always denied that trade unions can cause inflation.

A second belief was that there exists a direct link between the size of the public sector borrowing requirement (PSBR) and the growth of M_3 money, as if the PSBR is never funded and private sector demand for money is irrelevant for the growth of the money supply.

Thirdly was the article of faith that government spending crowds out private spending either directly if resources are fully employed (resource crowding out) or indirectly through rising interest rates to finance an ever-growing PSBR (financial crowding out).

Fourthly, there was an implicit (if not explicit) belief in the concept of a natural rate of unemployment, and if governments attempted to reduce unemployment below what was regarded as the natural rate, there would be ever-accelerating inflation.

---

[9] F. Hahn, *Money and Inflation* (Oxford, Blackwell 1982).

Finally, it was firmly believed that unemployment was high because real wages were too high; that is, that unemployment was essentially voluntary.

The theoretical and empirical validity of each of these beliefs and assumptions might be called into question, but I will focus here on the implementation of the monetarist experiment itself, and the results. The target money supply variable was M_3 money, consisting of notes and coins, current account bank deposits and deposit accounts with the commercial banks. The instrument was to progressively reduce the size of the PSBR from over £ 10 billion down to less than £ 5 billion, and to eventually eliminate the public sector deficit altogether. This was designed to give signals to markets and economic agents (*i.e.* workers and consumers) that the rate of inflation would gradually fall, so that workers should moderate wage inflation and price themselves back into work. As it turned out, it proved impossible to control the growth of M_3 money to within the target ranges, but the size of the PSBR and the rate of inflation did come down – the opposite of what monetarism predicted. The fiscal deficit contracted and the rate of interest soared – again, the opposite relationship postulated by monetarism – illustrating the fact that interest rates are determined by monetary policy not by fiscal policy (as we also see today, both in the U.K. and the U.S., with fiscal deficits at a historic high but with interest rates relatively low). The exchange rate appreciated which, together with tight monetary and fiscal policy, produced a deep slump, just as a Keynesian expenditure-income model would have predicted. Wage and price inflation moderated, but at the cost of heavy unemployment, just as a traditional Phillips curve would have predicted showing an inverse relation between the rate of unemployment and the rate of change of wages and prices. The announcement of targets for M_3 money had no noticeable effect on private sector behaviour. If monetarism had worked, it should have reduced the growth of the money supply, and reduced the rate of inflation, without affecting the level of employment and unemployment, by changing agents' expectations of inflation and shifting the Phillips curve inwards. There was no such movement. Friedman, in his evidence to the House of Commons Treasury and Civil Service Committee[10] on Monetary Policy, blamed the failure to meet M_3 targets on the incompetence of the Bank of

[10] *Memoranda on Monetary Policy,* 17th July 1980 (London: HMSO).

England. However, it was soon recognised that the only way to control the supply of money is to control its demand through raising its price, *i.e.* by high interest rates. Wage inflation was also recognised as a source of price inflation, and an attempt was made to impose a wages policy in the public sector. After only three years, the monetarist experiment was beginning to crumble, but the damage to the economy had already been done: negative growth, falling investment, the destruction of manufacturing industry, and with unemployment rising to over 3 million in 1983. Since those early years of the 1980s there has been a further boom and bust, with the economy behaving in a predictable Keynesian fashion, responding to the vicissitudes of monetary and fiscal policy. Financial liberalisation, and lax fiscal and monetary policy in the wake of the 1987 stock market crash, produced an unsustainable boom, and the tight monetary policy pursued from 1989 until the departure from the European exchange rate mechanism in September 1992 has produced the longest and deepest recession since the 1930s. The oscillations of the British economy over the last fourteen years have had nothing to do with supply side shocks or the business cycle theory of the new classical macroeconomics, but everything to do with good old-fashioned Keynesian demand *mismanagement.*

Those who did not lose their faith in Keynesian economics have been vindicated by events in the U.K., and also abroad, not least in the United States where President Reagan proved (without realising it) to be the greatest Keynesian ever to occupy the White House. This is not so say, however, that Keynesianism is enough to understand the serious conflicts between macroeconomic objectives and how to reconcile them. In most economies, both capitalist and former communist, there is growing structural unemployment to contend with which Keynesian economics does not address. It is almost certainly the case that demand management by itself cannot reduce unemployment in Britain below one million without the economy running into serious labour market bottlenecks, in contrast to earlier periods in economic history (in the 1950s and 1960s for example) when 200,000 unemployed was a reasonable, achievable target. Secondly, and a related point, in most economies the trade-off between inflation and unemployment is worsening, which may require institutional remedies. Keynes was aware of the problems that low unemployment may pose for wage push (as well as demand pull) inflation, but offered no solutions. Thirdly, many countries, including the U.K. and U.S., have structural balance of payments problems to contend with, which Keynesian economics *per se* is ill-equipped to deal with. Keynes recognised, however, the conflict that may exist between internal and external balance, and that the only secure foundation for low interest rates for internal balance is a healthy surplus on the current account of the balance of payments. Hence his defence of mercantilism.[11] The long run deterioration in the current account of the balance of payments in the U.K. would have worried him greatly, and would almost certainly have pushed him in an interventionist direction, even with the exchange rate allowed to float.[12]

The Central Messages of Keynesian Economics

To conclude this short essay, I outline below six central messages of Keynes's vision of the functioning of capitalist economies that I believe are still valid, and which provide a perfectly acceptable framework for analysing macroeconomic behaviour.

Firstly, the level of aggregate employment and unemployment is determined in the product market by effective demand, *not* in the labour market. In other words, at the macro-level (as opposed to the case of the individual firm) the level of employment is not a function of the real wage, but rather the real wage is a function of the level of employment, because associated with the level of employment there will be a particular level of labour productivity and, on profit maximising assumptions, employers will equate real wages and labour productivity. Cuts in money wages (in the attempt to reduce real wages) will not necessarily increase employment and reduce unemployment because wages are both a cost and a component of aggregate demand so there is no way of analysing the effect of wage cuts on employment except by analysing their effect on the components and determinants of aggregate demand, namely consumption, investment, interest rates and the foreign balance (exports minus imports).

---

[11] This issue is explored more fully in my article "The balance of payments and economic performance", *National Westminster Bank Quarterly Review,* May 1992.

[12] For a useful series of essays on the continued theoretical and practical relevance of Keynesianism, see Fausto Vicarelli (ed.), *Keynes's Relevance Today* (London: Macmillan 1985).

Secondly, unemployment is not all voluntary resulting from a refusal of workers to accept cuts in their real wages; that is, insisting on a higher real wage than their marginal product justifies. There can be involuntary unemployment defined as labour *willing* to work at or below the existing real wage, given the opportunity.

Thirdly, the act of saving (or abstaining from present consumption) does not lead to an equivalent amount of investment via changes in the rate of interest. Savings and investment are largely done by different groups in society and there is no automatic nexus that unites the two activities. The rate of interest is determined in the money market and may bear no relation to the rate of interest required to equate *ex ante* savings and investment which is necessary for an equilibrium in the product market.

Fourthly, the existence of money, and the ability to hold it liquid, creates great uncertainty for an economy because, as Keynes put it in the *General Theory*, "a decision not to have dinner today – does *not* necessitate a decision to have dinner or to buy a pair of boots a week hence or a year hence or to consume any specified thing at any specified date. Thus it depresses the business of preparing today's dinner without stimulating the business of making ready for some future act of consumption. It is not a substitution of future consumption-demand for present consumption-demand, – it is a net diminution of such demand" (p. 210). In addition, money has particular properties which makes an economy which uses money fundamentally different from either a barter economy or models of an economy in which money is treated simply as another good. Money is not like other goods because it is costless to produce, so that as people switch from goods to holding money less factors of production are employed.

Fifthly, the quantity theory of money, which lies at the heart of the doctrine of monetarism, holds only under the special assumptions that an economy is at full employment and the velocity of circulation of money is stable; otherwise, there will be no direct relation between the quantity of money and the price level. Moreover, cost push forces can cause prices to rise long before the full employment level is reached. In his chapter 21 on "The Theory of Prices", Keynes fully anticipated modern cost-push and structural theories of inflation.

Lastly, what drives a capitalist economy is the decision to invest. It is the sentiment and whims (or "animal spirits" as Keynes called them) of entrepreneurs that determine both the cyclical fluctuations of economies and their long run economic performance. Enterprise can only flourish in a stable macroeconomic environment, free, as far as possible, from uncertainty about the course of relative prices and the state of demand; but entrepreneurs must also be willing to take risks. Again, as Keynes put it in the *General Theory*, "if human nature felt no temptation to take a chance, no satisfaction (profit apart) in constructing a factory, a railway, a mine or a farm, there might not be much investment merely as a result of cold calculation" (p. 150) – "thus if animal spirits are dimmed and the spontaneous optimism falters, leaving us to depend on nothing but mathematical expectation, enterprise will fade and die" (p. 162).

In my view, monetarism and the new classical macroeconomics has diverted policy makers' attention from the real policy issues, and the evidence of retreat can only be welcomed.