

## The Post Keynesian Difference

This evening I am going to try and set out the elements of Post Keynesian economics and its main differences from the mainstream. I am very conscious that a brief survey like this has inevitable limitations and I am relying on John McCombie to fill in the gaps. Nevertheless I think it is reasonable for people to expect a short and clear account of what is Post Keynesian economics, why we bother with it, and what difference it makes.

My approach will be to focus mainly on questions of policy rather than doctrine. Although theoretical clarification remains important, both to me and to a long roll-call of colleagues from Geoff Harcourt onwards, tonight I want to demonstrate two main things. First, that Post Keynesian thought is already a coherent alternative to the mainstream paradigm and second, that it is a powerful tool for the analysis of current economic policy. As we shall see, some of the policy implications are sufficiently different to raise understandable doubts as to their likelihood of inclusion in the next UK government's manifesto. Yet our job as economists must be to follow our reasoning to its practical conclusions. This is particularly important as the conventional opposition to those conclusions itself reflects a theory of the economy which, to quote Keynes, is "misleading and disastrous if we attempt to apply it to the facts of experience".

The distinctive and unifying feature of Post Keynesian economics is the principle of effective demand. Keynes set out his Marshallian version in Chapter 3 of his *General Theory of Employment, Interest and Money* while Kalecki independently developed another version on Marxist lines. The theoretical differences need not detain us. The key implication of the principle of effective demand is that, contrary to what students are now taught, demand matters in the long run as well as the short. In particular, the level of employment and economic activity, both in the short and in the long run, is determined by demand, by the monetary configuration of our economic system. This has nothing to do with sticky prices, wages or other rigidities. Indeed a virtue of Keynes's Marshallian approach to effective demand is that it scotches on its own terms the mainstream claim that competition will lead to full employment. By full employment they mean of course the so-called natural rate determined by the supply side.

The principle of effective demand leads to a quite different perspective on economic fluctuations. The economy is not like a life-boat, buffeted by the waves yet always righting itself. The very terms 'business cycle' and 'stabilisation' are loaded and imaginary trends are easily constructed. The Post Keynesian perspective is that the long run is simply a series of short runs, certainly the economy fluctuates but there is no automatic tendency towards equilibrium, in level or trend.

This brings us straight to the current policy of cutting the public sector in order to reduce its crowding-out of private activity. The policy follows directly from the concept of an equilibrium, natural rate of output and employment such that resources released from one occupation flow into others through price competition. It is allowed that market forces may need a little help to smooth the way and overcome imperfections in information, etc. Yet to a Post Keynesian the idea of cutting 700,000 public sector jobs in order to stimulate private employment, in a situation anywhere short of full and growing employment, appears sheer madness. Notwithstanding yesterday's letter to the Telegraph by captains of industry supporting cuts, entrepreneurs create jobs because they foresee a profitable demand, not because they

see a queue of unemployed workers at their door. The unemployed themselves make poor entrepreneurs. A debate about the balance between public and private sector employment is legitimate, but the argument for cuts has been couched in terms of a crisis in the public finances. The belief that putting public sector workers out of jobs will *per se* encourage growth of private employment can only be sustained by the self-righting myth, the idea that demand will look after itself. Say's Law will prevail.

Note however that effective demand is not the same as aggregate demand. Supply matters too and I was interested to read, in Stephen Dunn's recent interview of Tony Lawson in ROPE, that Richard Kahn once walked out on Bob Rowthorn for saying so. But I am not going to talk about our internal differences. The spending of money is a necessary but not a sufficient condition for full employment and this is important for several reasons, including the balance of payments. Yet it is a serious defect in mainstream economics to have reduced all long-term questions to matters of the supply side. Lack of demand destroys capacity and technology, and conversely demand is a key stimulus for innovation and investment in Post Keynesian theory.

Returning to the short term, another difference is over the theory of interest. This also ties up with the cuts: we are told that the deficit must be reduced because public borrowing crowds out private demand for loanable funds. Well, actually we have heard less about this since the election and more about the confidence of foreign investors (I'll come back to that). Yet mainstream economics does cling to the idea that the rate of interest, or at least the natural rate of interest, is the price which clears the market for saving and investment. The message is that thrift must be encouraged in order to reduce interest rates and increase private investment.

Keynes's most famous insight was (as James Meade put it) that the investment dog wags the saving tail, not the other way around. Investment can never be crowded out by a lack of saving, only by a lack of finance or money. The perennial confusion between savings and money owes something, I think, to the fact that most economists have no idea of accounting, despite the best efforts of Basil Moore, Wynne Godley and Marc Lavoie. The confusion is an elementary error: any book-keeper understands that saving and money are on opposite sides of the balance sheet.

Do we at present suffer from a lack of finance? Long term interest rates are at a record low and were so even before the election, *contra* the claim that it is only the present government's commitment to drastic spending cuts that has maintained confidence. What about foreign investors? There is an important difference between sovereign debt issued in the domestic and a foreign currency. We are not in the position of Greece or Ireland. And I will return to the role of international capital markets later.

Deficits on the government's current account are probably not sustainable for ever and Keynes was against them, although some Post Keynesians argue otherwise (I am thinking here of Randy Wray and the Kansas City school, in the land of the world's paper gold). Even if deficits must be closed over time to maintain bond-holder confidence, this can be done by increasing tax revenue, partly through a recovery in income, partly through increased rates of taxation, partly by new taxes on bads rather than goods, e.g. a carbon tax, and on capital. As Victoria Chick demonstrated last week, if the objective is to reduce the debt burden, i.e. the ratio to income, the lesson of history is that this is only achieved by keeping direct government expenditure growing. The budget cannot be balanced if there are powerful forces leading the private sector to run a surplus and to keep the trade balance in deficit. These forces need to be addressed directly by methods other than government cuts or tax rises. The

attempt to balance the budget by austerity will succeed only by impoverishing us in the process.

If spending on current account is deemed politically unsustainable because of the long-term tax burden, let the total spending be maintained on capital account until the economy recovers, allowing the government itself to create employment by private sector contractors as it reduces its direct employment. Would we burden the next generation by providing them with more or better housing, schools, hospitals, energy and transport systems? Are the cutters really claiming that investment in a healthier, better educated and housed population, and greener, more efficient infrastructure will not pay off in higher national income over say 50 years? And if such investments require financial underwriting against a possible failure to capture their benefits in tax revenue, is there not a strong case for a long-term capital levy or wealth tax to reduce the debt balance, since the blame for this recession lies squarely with the financial sector? I look forward to hearing Malcolm Sawyer's verdict on the spending review at this seminar on 30 November.

So far I have introduced the Post Keynesian principle of effective demand and the consequent repudiation of the loanable funds theory of interest against the idea that there are natural rates of output, employment and interest, an idea which underpins the claim that the public sector crowds out private employment in any short term sense.

A further implication of the principle of effective demand is that aggregate employment and real wages are determined in the product market and not the so-called labour market. Money-wages determine only the relative real wages of different employees, not the aggregate real wage of labour as a whole. The real wage is simply the resultant of money wages and product prices and not an independent causal force in the form of a price that clears a competitive market for labour.

The mainstream idea that labour and other factor markets are just like product markets leaves no room for long-term demand-deficient underemployment. As a matter of scientific integrity, as Keynes generously puts it, observed unemployment must be voluntary, due to wage stickiness or fecklessness, or the result of frictions related to information, retraining or geography. The doctrine of flexible labour markets follows: unemployment is due to a lack of competition and restrictive practices on the part of labour (or of course the infamous "tax on jobs"). There is much to be said for policies that make it easier for workers to retrain and move voluntarily from one job to another as the pattern of demand changes. Equally, it is important that employment and welfare policies do not create perverse incentives, preventing a rational reallocation of labour in the long-term interests of both workers and the economy as a whole. However the flexible labour market is often simply a euphemism for an attack on organised labour, employment protection rights and welfare benefits. We do not cure unemployment by bullying the workers.

Another implication of the principle of effective demand is that the money-wage determines not employment but the price level. There is no room in Post Keynesian theory for the quantity theory of money. Equally there is no room for the Marxist idea that class struggle can change the aggregate share of wages in national income. Of course an individual union can improve its relative position at the expense of other workers, but a rise in money-wages across the board simply produces inflation. The real wage and profit shares are determined by a combination of the degree of competition between employers and the rate of interest.

The Post Keynesian remedy for inflation has always been some form of incomes policy combined with commodity price stabilisation. The failure of incomes policy in the 1970s may partly have reflected the belief of some union leaders that labour as a whole could increase its real wage by industrial action, which I have said is a mistake from a Post Keynesian perspective. More generally union action reflected the need to defend relative money-wages (which certainly are real for the workers in question) and an overall failure to recognise that real wages had to fall, at least temporarily, because of the commodity price increases at the time.

From this perspective, inflation targeting is a clever exercise in political psychology (I hesitate to say a confidence trick). Philip Arestis and Malcolm Sawyer have shown that the variation of interest rates cannot explain that of inflation under this regime. Yet if enough people believe that the Bank of England can control inflation, or that inflation expectations are anchored by the monthly inspection of the entrails by the illuminati of the Monetary Policy Committee, or even if there is simply a tacit agreement among wage-setters to use the inflation target as the negotiating benchmark, it seems so far that we avoid the outbreak of fratricidal rivalry between workers. This seems to hold even when productivity dictates that real wages must stagnate or fall. Unions have also learned, the hard way, that the mayhem of the 1970s did not serve them well.

The Scandinavians seem to have managed all this far better than us and I look forward to hearing more about that from Jonathan Perraton and Jesper Jespersen at the seminar on 23 November. Perhaps the most significant thing the new Labour leader could achieve in opposition is the forging of a new consensus on income policy among the union movement in preparation for a return to a government commitment to full employment. Also it will be interesting to hear what Charles Goodhart, *illuminatus emeritus*, has to say about all this next week, on 26 October.

While the principle of effective demand is the key theoretical concept in Post Keynesian economics, its importance arises from the physical character of a monetary economy and in particular the nature of durable capital assets, including money, as a bridge between the present and the future. Post Keynesian economics takes time seriously. Production takes time, time to make as well as to use the tools of an advanced technology under a specialised division of labour. The flow of time is irreversible and the future is unknowable. The value of capital assets depends on future events which are subject to uncertainty, not merely to statistical random variation or risk. As Paul Davidson puts it, the world is non-ergodic, a term of which John Hicks said, “you need a word like that to ram the point home”. The value of money as a store of value is as an indefinite claim on future production which does not commit the holder to a decision: we call this liquidity.

It is therefore a mistake, as Tony Lawson and Jesper Jespersen rightly insist, to apply the well-trying statistical methods of the physical sciences to the subject matter of macroeconomics. We cannot close the system, undertake controlled experiments, or make reliable predictions of economic variables. That is not to say that we cannot offer insight and explanation, identify causal mechanisms and therefore predict, in a non-temporal sense, the likely consequences of specific policies. We have more in common with historians than physicists.

The financial crisis has brought this home once again. The efficient markets hypothesis holds that asset prices are reliable indicators of fundamental value, allowing for the statistical variation which can be overcome by portfolio spread. The

failure to recognise systemic risk, in the sense that both the stock market as a whole and the banking system can crash, can be traced at root to this comfortable but exceedingly dangerous hypothesis.

The Post Keynesian view is that there is no such thing as fundamental value, except with hindsight. Asset valuations are necessarily a matter of convention and are subject to discontinuous shifts in market sentiment. Liquidity has value only because the future is unknowable. The value of liquidity increases with our fear of our own ignorance. These considerations lead to a Post Keynesian perspective on the financial sector very different from the mainstream's.

First of all, Post Keynesians follow Kalecki, Galbraith and Eichner in recognising the well-established empirical evidence about the financing of investment. This is that the vast majority of physical capital formation or accumulation is financed from the internal cash flow of large corporations supplemented to some extent by bank credit lines. The social purpose of the stock market is not to finance new physical investment but to permit transfers of existing assets, including corporate control. Its speculative tendencies are not in fact offset by the benefits for enterprise which Keynes allowed. Industry could function quite well without the equity market, given alternative institutions focused on enterprise rather than speculation.

Secondly, following Minsky and the detailed analysis by Victoria Chick of the evolution of the banking system, there seems to be a pathological tendency in our society to misuse debt. This is driven partly by the speculative opportunities provided by the equity market but also by those of the housing market in certain countries such as the UK and US. The efficient markets hypothesis has combined with the idea of inter-temporal consumption smoothing to provoke a free for all in credit markets. Banks have reverted to their ancient role as irresponsible money-lenders rather than respectable financiers of enterprise and James Stewart style providers of personal finance. The foolish idea that governments could tame the wild beasts of Wall Street rather than keeping them in secure cages, together with the well-intentioned but misguided notion of deposit insurance, has led to the taxpayer picking up the bill for the party.

Post Keynesians would, in the words of Winston Churchill, see finance less proud and industry more content. Keynes thought casino banking should be kept expensive and inaccessible. A significant transactions tax going well beyond the current stamp duty should be imposed - a tax on speculation. Secondly, as Ajit Singh demonstrated long ago, there is no evidence that takeovers promote efficiency. Corporate governance should be reformed in the direction of greater accountability to stakeholders other than shareholders, notably but not exclusively workers. Then takeovers might be based on their true industrial merits, not the manipulations of corporate raiders. Thirdly, the license to take retail deposits (with its implicit state guarantee) and to manage the payments system should be restricted to publicly owned institutions or at least to utility banks restricted to investing in particular classes of asset. Private pension provision also carries a state guarantee in the sense that those who suffer investment losses are underwritten. We therefore need instead a decent state pension, backed by securities issued by government and by dedicated development banks funding long-term infrastructure with secure returns and again with effective, democratic corporate governance. Let people make risk investments in other institutions for higher returns, if they wish, but *caveat emptor*. Yet there is no sign that governments have learned very much from the 2008 crisis and the current

proposals for the reform of banking regulation are hopelessly timid. The City and Wall Street appear to be just too well organised and politically powerful. Sheila Dow will be giving her take on all this on 9 November.

Another play-thing of the markets in recent years has been the exchange rate. Post Keynesians dispute the claim that there is a natural tendency to equilibrium in the balance of payments, driven by fundamentals and brought about by a market-clearing exchange rate. You can listen to a talk by John Harvey about this on our website. Tony Thirlwall and John McCombie have done the work in developing the theory of balance of payments-constrained growth. The problem is that, just as domestic savers can hoard money rather than invest, so can whole currency areas. Critically, there is no penalty for accumulating reserves, only for running out of reserves. The result is a deflationary bias to the global economy offset only by the happy accident, in one sense, that the US can use its exorbitant privilege to print paper gold to finance its payments deficits. Meanwhile by its Faustian pact with international capital markets, the UK has for time being solved the financing of its chronic trade deficit by becoming a hub for capital flows orders of magnitude greater than the trade balance.

Post Keynesian economists argue that exchange rates should be consciously managed, like money wage rates, by a system of fixed but adjustable pegs intended to maintain relative purchasing power parity. This cannot be done in a world of unlimited capital mobility. Long-term capital flows by way of foreign direct investment, etc, are mainly desirable, but short-term portfolio flows have to be subordinated to the interests of exchange rate stability and the growth of trade and productivity. The Bretton Woods system, for all its flaws, saw the highest rates of growth of trade and output in history. Yet such a system cannot be sustained in a world where payments surplus countries refuse to accept revaluation as inflation rates diverge. Nor can the international reserve currency be the property of a single nation. These two flaws, the lack of an onus on surplus countries to adjust their exchange rates and invest their surpluses, and the ultimate lack of credibility of the US promise of gold convertibility, were at the heart of the failure of Bretton Woods.

The logical policy conclusion of Post Keynesian analysis was identified by Kaldor and Tinbergen in 1964 as an international commodity reserve currency, backed by stocks of the 30 or so key commodities in world trade. Unlike the gold standard or the Euro, domestic currencies would remain on a peg that could be adjusted if their domestic inflation diverged from the global. Such a system would do much to anchor commodity prices and reduce the risk of imported inflation as well as stabilise the incomes of commodity-dependent developing countries. It would incur storage costs, but these would hardly be greater than the costs of a financial sector grossly swollen by the activities of international portfolio investment and currency trading. Seen through Post Keynesian eyes, the churning of existing assets, however profitable, does not add to social welfare.

A reformed international monetary system with full employment as its objective would allow payments-constrained countries to achieve their potential and provide commodity-dependent countries with the resources to diversify. Kaldor coined the term 'Verdoorn's Law' for the relationship between the growth of output and productivity in manufacturing. In a nutshell, a growing industrial sector provides the incentives for innovation and for the transfer of productive resources from underemployment. Growth is demand-driven. Yes, of course growth also depends on good governance and institutions, but these are necessary and not sufficient.

There are several aspects of Post Keynesian economics I have not covered. This talk has been about macroeconomic policy and there are several areas of microeconomics in which Post Keynesians have contributed, including Marc Lavoie on consumption, Paul Downward and Fred Lee on industrial pricing, as well as Adrian Winnett and Eric Berr on the environment. I leave it to John to fill in my most glaring omissions.

In conclusion, I suggest that the over-arching policy thrust of Post Keynesian economics is to regard our economic troubles as a symptom of bad system design. The mainstream still attempts to apply to a monetary economy the prescriptions of a theory which might have made sense in an economy of yeomen and artisans. By contrast, Post Keynesians identify the dysfunction of our legal and monetary institutions as central. This is both radical and hopeful. Radical because we cannot expect progress without overcoming serious political and ideological obstacles to the reform of the ownership of corporate property and the relations between states. Hopeful because there is a rational way out of this mess, if we can but muster the will.

It will be clear that Post Keynesian economics has always been against financial liberalisation and yes, we did tell you so. We find ourselves as a society still in the grip of a laissez-faire ideology as firm as the Soviet Union's in its time, and this applies to the majority of academic economists also. It is not clear that any democratic political party can shift this consensus outside time of war or other catastrophe. The reform of the international monetary system and the taming of finance requires multilateral co-operation between states and the acceptance that a stable system of exchange rates is a public good. As in the case of climate change and nuclear disarmament, such a reform is against the short-term interests of the US and demands an almost unprecedented degree of international co-operation. It would be naïve to think that progress in science or politics can ever be completely independent of vested interests, yet Keynes was hopeful that in the long term sound ideas would win through. The stakes are higher now than ever. The recent G20 summit was a lost opportunity. If the time ever does come again, as in 1945, when governments seek to develop global institutions that govern the economy in the interests of free citizens rather than property, the analytical tools can be found here.