

# REVIEW

## The Return of Keynes

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Peter Clarke. *Keynes: The Twentieth Century's Most Influential Economist*. London: Bloomsbury. 2009.

Hunter Lewis. *Where Keynes Went Wrong: And Why World Governments Keep Creating Inflation, Bubbles, and Busts*. Mount Jackson, VA: Axios Press. 2009.

Robert Skidelsky. *Keynes: The Return of the Master*. New York: Public Affairs. 2009.

A graduate student in a typical American or European university studying the subject of macroeconomics would be taught that the macroeconomy can be represented by representative consumers and firms who continuously optimize a multi-period plan, and in order to do so, use all available information including the one embedded in the model. These consumers and firms not only perfectly understand the complex intricacies of the workings of the economy, they also know the statistical distributions of all the shocks that can hit the economy. As a result, they can make scientifically founded probabilistic statements about all future shocks. In this world of God-like creatures, there is no uncertainty, there is only risk. Coordination failures do not occur because representative agents internalize all possible externalities. Bankruptcies of firms and consumers are impossible. Bubbles and crashes cannot occur because rational agents using all available

information would never allow these to happen. Prolonged unemployment is impossible except when consumers choose to take more leisure.

Having mastered the intricacies of Dynamic Stochastic General Equilibrium models (DSGE models), our brilliant new PhD graduate would then start a career teaching this model to the next cohort of PhD students.

In the process of acquiring supreme skills in solving DSGE models, our PhD graduate would not have learned what an investment multiplier is, nor would he have the slightest idea of what the paradox of thrift is. Instead, he would have learned that by the law of Ricardian equivalence, government budget deficits cannot affect output.

Then came the financial crisis. Will it surprise the outsiders that our bright PhD graduate was speechless and could only suggest that some unforeseen shock must have hit the economy?

The outsider will be equally unsurprised that policy-makers did not ask the advice of the fresh PhD graduate who knew how to solve complex DSGE models. Instead, policy-makers went straight back to the things that were taught in macroeconomic textbooks of 40 years ago before the Real Business Cycle (RBC) theory and the Rational Expectations (RE) revolution started captivating the macroeconomic profession. They applied the Keynesian principles found in these textbooks and massively increased budget deficits and flooded the money markets with hundreds of billions of dollars of liquidity. Forty years of intricate modelling using the RBC and RE paradigm had become useless, even those that had some sprinklings of New Keynesian wage and price rigidities. These models could not answer the question of what the authorities should do when the crisis hit. The fundamental reason why these models could not say anything useful is that they suggested that crises of the kind observed since 2007 could not occur. By default, policy-makers turned to Keynes to answer these questions.

The return of Keynes in policy-making has also led to a surge in new books on Keynes and why he is back at the centre stage in economic policy. Probably the best of these recent books is Robert Skidelsky's *Keynes: The Return of the Master*. It is a careful analysis of why, in his words, 'sixty years after his death, John Maynard Keynes is the most important economic thinker for America'.

If there is any contemporary historian and economist who knows Keynes and his writings it is Robert Skidelsky, author of a massive three-volume biography of John Maynard Keynes (1983, 1992, 2001). This expertise gives Skidelsky a special advantage in analysing the relevance of Keynes in the post-crisis period.

Skidelsky starts by warning that it is all too easy to become involved in a blame game. Many actors can be blamed: the bankers for their greed and lack of understanding of the risk they created; the central bankers for their

easy money and their *laissez-faire* attitude *vis-à-vis* bubbles in asset prices and credit; governments for deregulating the banking system and abandoning their responsibilities to supervise; and rating agencies for their conflicts of interest that allowed them to both advise on how to create risky financial products and to give favourable ratings. These are all failures that contributed to the financial crisis. However, according to Skidelsky, the real failure lies elsewhere. It is a failure of ideas. The author identifies this failure of ideas as originating in the new macroeconomic paradigm that developed during the 1970s and 1980s. This new paradigm is based on the assumptions of RE and efficient markets. Both assumptions have misled economists and policy-makers. They have created an intellectual framework that blinded economists and policy-makers, preventing them from seeing the bubbles and the dangers that these create for systemic stability.

Skidelsky stresses that when Keynes developed his ideas in the 1930s, he faced a classical economic doctrine that is very much the same as the one that has prevailed in modern macroeconomics since the 1980s. This economic doctrine has four elements. First, there is the idea of the perfectly informed *homo economicus*. Second, the economic system, if left sufficiently free, can converge to a full-employment equilibrium. There might be shocks that lead to temporary deviations from that full-employment equilibrium, but the economic system has enough self-equilibrating mechanisms to guide us to full employment. Third, money is neutral in the long run, so that monetary policy cannot affect real variables in the long run. Finally, according to Say's law, what is produced is always demanded. Thus, there cannot be a sustainable shortfall in demand. Jean-Baptiste Say may not be fashionable any more, but the RBC theory that has so much influenced modern macroeconomics can be said to be the modern reincarnation of Say's law. By stressing that productivity shocks are the only shocks that matter in explaining both long-term growth and cyclical movements, RBC theorists have resurrected Jean-Baptiste Say and denied the importance of fluctuations in aggregate demand. True, the RBC theorists have also stressed changes in consumer preferences, but because these changes are exogenous, it is difficult to see how this can provide for an interesting theory of the business cycle unless one accepts that a theory that says that output fluctuates because there are unpredictable shocks is an interesting theory.

Thus, we have come full circle. During the 1930s, Keynes fought the then-prevailing classical economic doctrine. Today, we face an economic doctrine that, in its main ingredients, is the same as the one Keynes fought. In the absence of a new Keynes, economists and policy-makers have turned to the old Keynes to make sense of the economic crisis and its aftermath.

Skidelsky spends considerable time criticizing how the New Keynesians have attempted to give some Keynesian flavours to modern macroeconomics.

This Keynesian flavour was obtained by introducing wage and price rigidities in an otherwise classical model in which agents are superbly informed and utility maximizing in an infinite horizon framework. Skidelsky is certainly not the first economist to stress that there is a huge difference between the Keynesians and Keynes. The best-known analysis making this distinction is still Leijonhufvud's superb book *On Keynesian Economics and the Economics of Keynes*, published in 1968.

Skidelsky correctly stresses that one of the key ingredients in the economics of Keynes is the distinction between risk and uncertainty. Keynes (1921) analysed the implication of this distinction in his first major publication, *A Treatise on Probability*, published in 1921. This was the same year in which Frank Knight (1921) published his dissertation *Risk, Uncertainty and Profit*, making the same distinction between risk and uncertainty. This distinction has been completely disregarded by modern macroeconomic model builders. In these models (DSGE models), agents are capable of making probabilistic statements about all future shocks based on quantifiable statistical distributions. Thus, in the DSGE models, there is risk but no uncertainty.

Keynes's view was that in a world of uncertainty, we have no reliable way of forecasting the future. There is no scientific basis for making predictions. In such a world of uncertainty we can only have optimistic or pessimistic beliefs. Neither of the two beliefs is well grounded. But these beliefs, 'animal spirits', have a self-fulfilling nature and are the main driving forces behind the fluctuations in the business cycle.

The idea that endogenous waves of optimism and pessimism are the main drivers of business cycle movements has no place in the world of New Keynesian DSGE modellers. In the latter, rational and superbly informed agents will never be carried away by beliefs that are dissociated from the objective economic reality that they understand in all its complexity. The fact that in these New Keynesian models prices and wages do not adjust instantaneously therefore has very little to do with the essence of the economics of Keynes.

Conventional wisdom has it that Keynesian policies during the post-war period ultimately failed because they led to an inflationary bias and an unsustainable upward trend in government budget deficits and debt levels. Skidelsky strongly disagrees. In order to prove his point, he splits the post-war period into two sub-periods: 1951–73 and 1980–2009. The first sub-period is labelled the Keynesian Bretton Woods system and the second period the Washington Consensus period. Skidelsky then goes on to compute average world output growth, inflation and unemployment during these two periods and finds that output growth was higher during the first period than during the second one. Inflation and unemployment are higher in the second period. The same is true with measures of volatility (of output growth and exchange rates). Skidelsky's conclusion is clear: all-important

macroeconomic indicators were more favourable during the Keynesian Bretton Woods system than during the Washington Consensus period that emerged after 1980, and Keynesian economic policies are responsible for this happy outcome.

I am not fully convinced. There is a methodological issue here. One has to control for many things that occurred during these two periods. For example, the first period was characterized by the reconstruction effort after the Second World War. Surely this must have increased the growth rates in many countries, an increase that has little to do with Keynesian policies. Similarly, the second period started with a major negative oil shock that plunged many countries into years of relatively low growth and high inflation. Should the Washington Consensus be made responsible for the oil shock and its aftermath?

After having criticized mainstream economics, Skidelsky offers some suggestions for reconstructing the discipline. The main one is to liberate economics from its mathematical shackles that have narrowed the scope of macroeconomic analysis, making it lose sight of broader social, historical and political trends and creating the illusion of excessive precision. Thus, for Skidelsky, students in economics should study, apart from mathematics, history, sociology and political science. Only then can macroeconomics become a science that is relevant for understanding the world.

I have sympathy with this view. I am afraid, however, that it will lead nowhere. Mathematics is now so much entrenched that a return to a classical education of the economist as it existed 100 years ago is out of the question. If an alternative to the mainstream macroeconomic model is to gain respectability, it will have to use mathematical methods.

A second very readable book about Keynes is Peter Clarke's *Keynes: The Twentieth Century's Most Influential Economist*. It treats very much the same material as Skidelsky's book, although the biographical part is slightly longer while the part on the economics of Keynes is correspondingly shorter. I found the description of how Keynes's ideas germinated during the 1930s and how he was influenced by the discussions within the Cambridge circle, the 'Circus', where Richard Kahn and James Meade helped him shape his ideas, fascinating. Equally fascinating is the story of how Keynes shaped the views of the Treasury people who were sitting in the Macmillan Committee, which had been set up in 1929 to investigate Britain's economic ills. By the sheer power of his intelligence and his persuasion, Keynes managed to steer most members of the committee away from classical economic thinking to his own thinking. The debates that went on in these different groups helped him to sharpen his views.

Although less detailed in his analysis of the economics of Keynes, Clarke's book provides a concise synthesis of the main differences between

Keynesian thinking and classical economic theory. He makes a point similar to Skidelsky's, that is, that the classical thinking Keynes faced in the 1930s is pretty much the same as the mainstream macroeconomics that evolved after the 1970s under the influence of the RE paradigm and the RBC theory. The only difference seems to have been the degree of formalism achieved in modern macroeconomics as compared with the classical thinking in Keynes's time.

I come to the third book: Hunter Lewis's *Where Keynes Went Wrong*. I hesitate to call it a book. It really is a collection of bullet point presentations with the same format throughout the book. First, Keynes's view on a particular subject is presented (often, this is no more than a caricature of Keynes's view); then it follows all the reasons why Keynes was utterly wrong and why he either did not understand basic economics or exhibited bad faith. After a while, the book tires and a sense of deep boredom prevails. Were it not that I had been asked to write a review, I would not have tortured myself reading it until the end.

I have rarely read so much dogmatism. For Hunter Lewis, governments are invariably bad and stupid, and markets are marvels of human achievements. Booms and busts only occur because of faulty policies of governments. If something goes wrong, it must be the result of bad policies of mischievous governments. And Keynes is the great devil because he has legitimized so much of post-war government policies, be they in the monetary or the budgetary fields.

According to Lewis, a modern acolyte of Keynes is Greenspan. The previous chairman of the Federal Reserve fuelled the American economy with too much money. This led to a boom and later the bust. Only Keynesians would do such mischief. Thus, the recent financial crisis is the fault of Keynes. If the man had not lived, Keynesian policies would not have been used and the beautiful equilibrating mechanism of efficient financial markets would have prevented the boom and bust from occurring.

According to Hunter Lewis, there are two types of recession. First, there are the good recessions. They cleanse the economic system of the unfit. As a result, after the recession, the system is rejuvenated and can continue to perform its wonders. Governments should not interfere and try to avoid these good recessions. Doing so only gives a second chance to the sick. In the long run this leads to less growth and less happiness for the survivors. This social Darwinism used to be a very popular doctrine in the 1930s. It has not lost its attraction for Hunter Lewis.

Then there are the bad recessions like the one we are experiencing today. They are deep recessions because they are the result of bad government policies, says Lewis. They should be avoided. This will be achieved when governments stop meddling in the free markets.

After reading this book I had a sense of desperation. Not so much because of the dogmatism (everybody has some form of dogmatism), but rather because of a feeling that if a book like that of Hunter Lewis can be published it must be that the essence of what we have learned in economics failed to filter through into large segments of the educated population.

What have we learned? First, of course, we have learned that markets are wonderful mechanisms to allocate resources efficiently and to foster creativity and innovation. But, second, we have also learned that markets have flaws. There is no secret about what these flaws are and economists have analysed these in detail for many years. They have to do with externalities, asymmetric information and moral hazard. These lead to departures from efficient outcomes. At the macroeconomic level, departures from optimality also occur when consumers and investors are gripped by excessive optimism, followed by pessimism. These waves lead to booms and busts that are not all due to government incompetence, and that are not all of the cleansing-of-the-unfit type because they also destroy innocent bystanders. It is therefore not very useful to lay the blame either on markets or on governments. Crises like the one we just experienced are the result of flaws in both the market system and the political system. Solutions, therefore, must also be sought in finding a new division of labour between markets and governments. Books that tell us that solutions can only be found by going back to pure market systems freed from government intervention are not useful and bring us back in time by at least 80 years – in much the same way as the books of the past that proposed to transform society into one where governments would steer all important economic decisions with little or no role for markets.

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