

## The failure of Keynesianism

There are two great merits of Keynes' contribution to understanding an economy. The first was a return to analysing an economy in its aggregate, not at the level of individual consumer's or firm's behaviour or preferences. This meant that the fluctuations in a capitalist economy could be considered in their whole and not just ignored or dismissed. In other words, macroeconomics replaced microeconomics.

The second contribution was to assert that capitalist 'free markets' do not 'clear' and so that supply equals demand, at least at a macro level. So the capitalist mode of production can be in equilibrium at less than full employment for some time. Keynes saw this discovery as a refutation of the old economic rule, called Say's Law, that supply always equals demand, namely that where there is seller there must be a buyer. This law is still held to in one form or another by neoclassical and Austrian economics schools. Keynes was attempting to break with the old adage of Thomas Carlyle, the reactionary Victorian anti-laissez faire writer that "*Teach any parrot the words supply and demand and you've got an economist*".

For Keynes, Say's Law was an example of the 'fallacy of composition', namely the false assumption that what is true for a part will also be true for the whole. In macroeconomics, the other-things-being equal assumption of demand matching supply does not hold. The 'paradox of thrift' is the traditional Keynesian example of the fallacy of composition. The paradox states that if everyone tries to save more money during times of slump, then aggregate demand will fall and will in turn lower *total* savings in the population because of the decrease in consumption. The paradox is that total savings may fall even when individual attempt to save more and that increase in savings may be harmful to an economy.

But these great insights have been whittled away over the last three decades. That's for two reasons. First, it became clear to mainstream economists that Keynesian economics did not work in explaining modern capitalism. Keynes' theory would suggest that if there is high unemployment, aggregate demand would be low and there would be over-supply, so inflation would be low or non-existent. Thus boosting demand by tax cuts and/or government spending could restore aggregate demand and reduce unemployment without generating inflation in prices of commodities. Once full employment was reached, however, further stimulus could start to drive up inflation. So there was a trade-off between inflation and employment. This led to the famous Phillips Curve that attempted to confirm this trade-off empirically. Unfortunately, the experience of the 1970s demolished this theory, when the major economies had high unemployment and high inflation, or 'stagflation'.

Neoclassical economics and monetarism regained the stage, with likes of Friedrich Hayek and Milton Friedman, who claimed that it was the interference of the state or central bankers that caused inflation and unemployment at the same time. The adoption of these theories was not an accident because the strategists of capital needed theoretical support for the counter-revolution they launched against the welfare state and labour in order to reverse the squeeze on profits and profitability of capital in the latter part of the 1970s.

Now Marxist economics could have told both sides that they were looking in the wrong place for an explanation of stagflation. If they had looked at the causes of falling profitability in the capitalist mode of production, that would have explained why fiscal stimulus and easy money was not restoring full employment but merely stoking up inflation. Stagflation was

the outcome of capitalist crisis plus Keynesian policy prescriptions, unlike the 1930s which was capitalist crisis without Keynesian stimulus.

The power of aggregate was now rejected.<sup>1</sup> As Keynesian aggregate econometrics explained nothing, mainstream economics returned to microeconomic theory. Although Keynes had brought mainstream economic theory to the macro and the aggregate, he had never broken with neoclassical marginal utility and general equilibrium theory at the level of the micro. He rejected any objective labour theory of value as a foundation for an explanation of economic processes. He held to the neoclassical ‘belief’ that starts with individual consumer preferences and moves onto markets clearing ‘anomalies’ before establishing an equilibrium of supply and demand. So any anomalies were external ‘shocks’ to the market system, not endogenous to the process of capitalist production and consumption.

So Keynes’ more radical insights were now reduced to the infamous IS-LM curve that argued an unemployment equilibrium would not occur under capitalism unless there was ‘stickiness’ in wages or other ‘shocks’ to the market system. In other words, market capitalism would not have slumps if labour did not resist wage cuts and government did not interfere. This reduced Keynes to a Friedman-style monetarism where central banks ‘enrich thy neighbour’<sup>2</sup> by controlling the money supply.

During the Great Moderation, when supposedly fluctuations in economic growth and prices fell away during the 1990s, mainstream Keynesian economics concentrated on explaining ‘business cycles’ or ‘fluctuations’ in an economy using ‘modern’ techniques of modelling from what it called ‘microfoundations’. Econometric analysis like the Phillips curve were ditched because such ‘correlations’ between employment and inflation had been proved wrong. The job now was not to look at macro or aggregate data but to work out some ‘model’ that started with some premises of agent (consumer) behaviour or preferences and then incorporated some possible ‘shocks’ to the general equilibrium of the market and then considered the number and probability of possible outcomes.

Thus were born the Dynamic Stochastic General Equilibrium (DSGE) models. They had equilibrium because they started from the premise that supply would equal demand ideally; they were dynamic because the models incorporated changing behaviour by individuals or firms (agents); and they were stochastic as ‘shocks’ to the system (trade union wage push, government spending action) were considered as random with a range of outcomes, unless confirmed otherwise).

This is now what most Keynesian economists spend their time doing. Forget empirical evidence, forget macro data, find a ‘micro’ foundation (model) that might help to at least offer a guide to what possibly might happen. Keynesians accepted the critique of

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<sup>1</sup> As arch Keynesian Simon Wray-Lewis put it in his blog recently: *“an empirically based aggregate model. You do not find macroeconomic papers like this in the better journals nowadays. Even if papers like this were submitted, I suspect they would be rejected. Why has this style of macro analysis died out? ... First, such models cannot claim to be internally consistent. Even if each aggregate relationship can be found in some theoretical paper in the literature, we have no reason to believe that these theoretical justifications are consistent with each other. The only way of ensuring consistency is to do the theory within the paper – as a microfounded model does. A second reason this style of modelling has disappeared is a loss of faith in time series econometrics.”*

<sup>2</sup> (to use Ben Bernanke’s recent term – see

<http://www.federalreserve.gov/newsevents/speech/bernanke20130325a.htm>)

neoclassical school, as presented by the Nobel prize winner Robert Lucas (“the problem of depressions has been solved”) that just looking at economic stats provided no theoretical base and thus was open to the distortion of spurious correlation. You needed to have firm micro theory.

As Lars Syll points out, those neoclassical micro foundations bear no relation to the real world:<sup>3</sup> But this is the hole that Keynesian economics has descended into. And it is a hole because DSGE models have been proved to be worthless in explaining anything. These models failed to predict before or explain after the Great Recession and are unable to explain the subsequent weak recovery, or Long Depression. And it is not hard to see why. There is a total absence of investment or profit as ‘shocks’ in these models. Everything starts with consumer preferences; the arch consumer is king as in the neoclassical world and Keynesian aggregate demand is reduced to just consumption<sup>4</sup>

The DSGE models’ capitulation to the concept of general equilibrium stands in contrast to Keynesian ‘lack of effective demand’ at a macro level. And as David Glasner puts it: *“There is no market mechanism that leads, even in principle, to a general equilibrium. ....Nor is there any basis for assuming that, if a general equilibrium does exist, it is unique, and that if it is unique, it is necessarily stable.”*<sup>5</sup>

After the experience of the Great Recession even some leading Keynesians started to disown DSGE modelling, just as Keynesians had disowned econometrics after the 1970s. The failure of DSGE models has led to some Keynesians to return to the macro and empirical analysis from the premise that markets do not ‘clear’ at the aggregate<sup>6</sup> Larry Summers is one.<sup>7</sup> Summers now preaches what he did not practise when an adviser to the Clinton

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<sup>3</sup> *“Microfoundations allegedly goes around the Lucas critique by focusing on “deep” structural, invariant parameters of optimizing individuals’ preferences and tastes. .... this is an empty hope without solid empirical or methodological foundation.”* As Lars adds: *“The almost quasi-religious insistence that macroeconomics has to have microfoundations – without ever presenting neither ontological nor epistemological justifications for this claim – has put a blind eye to the weakness of the whole enterprise of trying to depict a complex economy based on an all-embracing representative actor equipped with superhuman knowledge, forecasting abilities and forward-looking rational expectation”.*

<sup>4</sup> . As the grand old man of the neoclassical aggregate production function, Robert Solow, commented on DSGE models: *“a modern economy is populated by consumers, workers, pensioners, owners, managers, investors, entrepreneurs, bankers, and others, with different and sometimes conflicting desires, information, expectations, capacities, beliefs, and rules of behavior ... To ignore all this in principle does not seem to qualify as mere abstraction – that is setting aside inessential details. It seems more like the arbitrary suppression of clues merely because they are inconvenient for cherished preconceptions ... Friends have reminded me that much effort of ‘modern macro’ goes into the incorporation of important deviations from the Panglossian assumptions ... [But] a story loses legitimacy and credibility when it is spliced to a simple, extreme, and on the face of it, irrelevant special case. This is the core of my objection: adding some realistic frictions does not make it any more plausible than an observed economy is acting out the desires of a single, consistent, forward-looking intelligence ...”*

<sup>6</sup> Robert Gordon, [http://faculty-web.at.northwestern.edu/economics/gordon/GRU\\_Combined\\_090909.pdf](http://faculty-web.at.northwestern.edu/economics/gordon/GRU_Combined_090909.pdf).)

<sup>7</sup> Recently Larry Summers, former adviser to Clinton and Obama and a Harvard economist, complained: *“In four years of reflection and rather intense involvement with this financial crisis, not a single aspect of dynamic stochastic general equilibrium has seemed worth even a passing thought.”* He moaned: *“Is macro about—as it was thought before Keynes, and came to be thought of again—cyclical fluctuations about a trend determined somewhere else, or about tragic accidents with millions of people unemployed for years in ways avoidable by better policies? If we don’t think in the second way, we are missing our major opportunity to engage in human betterment. And inserting another friction in a DSGE model isn’t going to get us there. “*

Administration. He opposed regulatory and prudential controls for financial markets and joined Fed Chairman Alan Greenspan and his political sponsor, former Treasury Secretary Robert Rubin in smearing CFTC Chairman Brooksley Born, so as to make the world safe for OTC derivatives<sup>8</sup>.

The reality is that Keynesian economics fell into the neoclassical DSGE trap because it accepted the neoclassical theory of value, denied any role for profit even in its aggregate analysis and relied in essence on the implausible belief that capitalist markets will ‘clear’ and some form of equilibrium will be the norm, whether it is the Great Moderation of the neoliberal period or an inherent smoothness in the capitalist production process. Keynesian economics failed to explain stagflation in the 1970s and the Great Recession in 2008. That makes its prescriptions of monetary easing and fiscal stimulus in doubt as a way out of the Long Depression.

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<sup>8</sup>. Summers advised Obama *“not to take ownership of the banks as he has a healthy skepticism about schemes involving large government action and an awareness of the possibilities of unintended consequences.”*