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Raising Keynes: A *General Theory* for the 21st century

Stephen A. Marglin

Harvard University, United States

Abstract

Keynes's *General Theory* argues there is no self-regulating mechanism that guarantees full employment. Keynes's vision has been distorted by mainstream Keynesians to mean that it is the warts on the body of capitalism, not capitalism itself, that are the problem: frictions and imperfections and rigidities may interfere with the mechanism for self-regulation that inheres in the perfectly competitive model. This distortion has two supposed corollaries, first, that the more the economy resembles the textbook model of perfect competition, the less likely are lapses from full employment; second, that since imperfections are limited to the short run, so are lapses from full employment.

Keynes was unable to convince the economics profession that the problem is capitalism; that the warts, real though they are, obscure a more fundamental problem. The reason is that Keynes lacked the mathematical tools to substantiate his vision. This paper deploys tools that were unavailable to Keynes, in order to lay the foundations of a Keynesian macroeconomics for the 21st century.

Keywords: Keynes; Dynamic vs static models; Flexprice adjustment; Fixprice adjustment

JEL codes: B22; B41; E12

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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 (John Maynard Keynes to George Bernard Shaw, January 1, 1935, in [Keynes, 1973](#), p. 492).

Very likely Keynes chose the wrong battleground. Equilibrium analysis and comparative statics were the tools to which he naturally turned to express his ideas, but they were probably not the best tools for his purpose. . . Keynes's comparative statics were an awkward analytical language unequal to the shrewd observations and intuitions he was trying to embody (James [Tobin, 1975](#)).

Keynes wrote the *General Theory* (1936) with three goals in mind: to transform policy, theory, and economic method. My book, *Raising Keynes*, scheduled for publication in 2019, argues that he failed in his quest for a new method, and this failure undermined the theoretical novelty of the *General Theory*, so that it relatively quickly was assimilated to the economic canon as a more sophisticated argument about sand in the wheels. That is to say, the *General Theory* was transformed into an argument that there is nothing wrong with capitalism that a good dose of competition would not cure. This distortion of the theory in turn compromised the policy message, so that it took a financial crisis and recession, one that in its early stages rivaled the Great Depression, to bring Keynes back from oblivion.

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My intention in writing *Raising Keynes* is not antiquarian. My goal is to contribute to a macroeconomics for the 21st century, not one for the 20th century. I firmly believe that Keynes's vision provides the best starting point for a 21st century macro.

A necessary step is to correct the misunderstanding that mainstream economics has created and perpetuated: namely, that if only the economy were perfectly competitive—no monopoly power, no oligopolies, no trade unions, no frictions, no rigidities—then all would be well. Economic outcomes would be efficient; in layman's language we would have the biggest economic pie available from the available resources. In particular, there would be a job for every willing worker; we would always have full employment. Or at least would never stray far from full employment or be away very long. In this view a competitive economy is self-regulating.

Why should anyone care about how a perfectly competitive economy functions, whether or not it produces full employment? We all know that the world is full of monopoly and oligopoly; that trade unions make the labor market less than perfectly competitive; that the government intervenes in myriad ways, beginning with the safety net it provides, porous as that net is. The world is indeed full of rigidities—prices, and especially wages that do not adjust promptly to imbalances of demand and supply. The world is also replete with frictions. If an economy with frictions and imperfections does not lead to full employment, is not that enough to justify government intervention to accomplish this all important goal? Why do we bother with the competitive model at all?

In part, we study the perfectly competitive model to understand basic forces at work in the economy, just as physicists study a falling body in a vacuum to understand the basic force of gravity. But there is more to it than that: we have another objective. Physicists, so far as I know, have no ambition to remove the air we breathe in order to make the world more like the model. By contrast, economists not only study and diagnose, we prescribe. And, for the mainstream at least, the benchmark model of a well-functioning economy is perfect competition. Case in point: the push to deregulate the economy, especially the financial sector, in the last decades of the 20th century was founded on the idea that a competitive economy is self-regulating. Alan Greenspan was shocked! shocked! shocked! when he discovered that bankers did not put aside enough capital to cushion themselves against the risks they took on in the run-up to the financial crisis of 2008.

The heart of Keynes's vision is that there is no automatic mechanism whereby the mainstream view of a self-regulating economy is realized. He wrote the *General Theory of Employment, Interest and Money* to substantiate this vision. This vision had, as I have indicated, three components: method, theory, and policy. Practical man that he was, the first two components were in the service of the third, namely, the need to maintain aggregate demand either by aggressive monetary policy (to keep interest rates low in order to stimulate private investment), or—if and when monetary policy reached its limits—for aggressive fiscal policy to provide the requisite stimulus.

With an argument grounded in imperfections, frictions and rigidities, he feared that he would be dismissed like other brave souls who ventured policy recommendations that contradicted the competitive model. Take Jacob Viner, the great Chicago (and later Princeton) economist, who had written in 1933 (Viner, 1933, p. 130)

If the government were to employ men to dig ditches and fill them up again, there would be nothing to show afterwards. But, nevertheless, even these expenditures would be an indirect contribution to business recovery. Their major importance would not be in the public works or the unemployment relief which immediately resulted, but in the possibility of hope that a substantial expenditure would act as a priming of the business pump, would encourage business men by increased sales, make them more optimistic, lead them to increase the number of their employees, and so on.

Compare this with what Keynes wrote in the *General Theory*:

If the Treasury were to fill old bottles with banknotes, bury them at suitable depths in disused coal mines which are then filled up to the surface with town rubbish, and leave it private enterprise on well tried principles of *laissez-faire* to dig the notes up again (the right to do so being obtained, of course, by tendering for leases of the note-bearing territory), there need be no more unemployment and, with the help of the repercussions, the real income of the community, and its capital wealth also, would probably become a good deal greater than it actually is (*General Theory*, p. 129).

The difference is not in the policy itself, but in the fact that for Viner the policy relies on the imperfections and rigidities that characterized the American economy in 1933, whereas for Keynes, the policy is the logical extension of his theory of employment.

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