

An Investigation into a Reversal of the Keynesian-Neoclassical synthesis.

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The Keynesian/Neo-classical synthesis meant that Keynes's General Theory was demoted to a special case of the classical school. However, this special case was agreed to be more realistic and thus gave greater weight to Keynes's policy proposals. Sarah Rowell reviews the theoretical reappraisal of the Neo-classical synthesis as provided by Clower and Leijonhufvud and also examines the truth about his policy proposal and their implementation. She concludes that Keynes's true gift to future economic thinkers was the ability to consider the real economy in ways other than general equilibrium analysis.

"I consider that my suggestions for a cure, which, avowedly, are not worked out completely, are on a different plane from my diagnosis. They are not meant to be definitive; they are subject to all sorts of special assumptions and are necessarily related to the particular conditions of the time. But my main reasons for departing from the traditional theory go much deeper than this. They are of a highly general character and are meant to be definitive."

- John Maynard Keynes¹

Introduction

The Keynesian Revolution, which followed the publishing of Keynes's *General Theory of Employment, Interest and Money* in 1936 led to a championing of fiscal policy over monetary policy which was declared impotent. The central idea of this school was that the economy could be stuck at a position of persistent involuntary unemployment. The mainstream 'Keynesian' analysis gradually evolved into an IS-LM framework as designed by Hicks and developed by others. The classical rejoinder to the school comprising of the Pigou effect led to the Keynesian-neoclassical synthesis. The Pigou effect stripped the Keynesian school of the theoretical honours, however, the Keynesians were left in triumph over the policy debate due to the agreement that the Pigou effect was weak in practice. The 'Keynesian result' was reduced to a special case of the classical or traditional school.

The contention that this loss of 'honour' is due to a misinterpretation of the *General Theory* by the mainstream Keynesian school has been well documented. The reason for this misinterpretation must surely be due in part to Keynes's unwillingness to crystallise his own ideas, benevolently leaving that unglamorous

¹Keynes, J.M. (1937) p.224

job for his successors! However, it is probably mostly due to the immensely revolutionary concepts Keynes was grappling with, that in order to comprehend the *General Theory*, those interpreting it must first unlearn the orthodoxy ingrained in their minds. This proved too difficult, though, and thus Keynesianism was reduced to the above mentioned 'special case'. Although I believe Keynes's theory to have been misinterpreted by the neo-classical synthesis, I do not contend that Keynes's policy proposals contained the same kind of universal truths as his theory; an opinion that has the support of the esteemed gentleman himself, as can be seen from the opening quote. Thus reality may be a reversal of the neo-classical synthesis.

I propose, within this paper, to review this revised interpretation of the *General Theory* and then to look at what his policy proposals were, and whether those policies that were attributed to him were done so correctly. Finally, I shall discuss how, after thirty or more years of debate, economists may have found Keynes's true gift to us: the ability to revise permanently the way we perceive the macroeconomy.

Section 1: The Theoretical Reappraisal

To look more closely at this misinterpretation of Keynes I propose to use the framework of the re-appraisal of his *General Theory* by Clower and Leijonhufvud. Their works contain more ammunition to fight the traditional school than Keynes's as they have a clearer picture of the content of orthodox theory, namely its grounding in general equilibrium analysis and the Walrasian system. This is the extent of their advantage over Keynes, however, as we can see in the words of Clower "our basic problem is to discover and describe what has not but should have been said - and here we are on all fours with Keynes."²

The Walrasian System

Before deriving an alternative framework within which to analyse Keynes's system, we must first look at the principles underlying a general equilibrium framework in order to determine why they are not appropriate to our case. Say's principle that 'supply creates its own demand' underlies Walras' Law, which is in turn the cornerstone of the general equilibrium framework. Walras' Law determines that there exists a vector of market clearing prices at which the value of excess demands equals zero. Such a framework implies a unified decision hypothesis - that individuals simultaneously make a decision about the amount they wish to supply to and demand from the market. The amount they demand is naturally constrained by the amount they wish to supply.

²Clower, R. in Hahn and Brechling p.104

However, there remains the difficulty of showing how the market reaches its position of general equilibrium. To overcome this difficulty Walras invented the Walrasian auctioneer, who provided complete information about market clearing prices and future market clearing prices, at zero cost, in order for no trading to take place at 'false' prices. Walras uses the 'tatonnement' or groping mechanism in the market whereby in markets with excess demands the price is raised and vice versa. This mechanism is based on the Marshallian assumption of instantaneous market day price adjustments to fluctuations in demand. There is no room for analysing disequilibrium states in the traditional theory based on constantly clearing markets.

It can be seen that this system is really one of barter - money is artificially imposed on the framework. Keynes thus points out that to hold money as a store of wealth in such a system is only for fools. However in his system, as we shall see, the presence of uncertainty will lead people to hold money as a store of wealth, and this desire can be viewed as a barometer of the degree of our distrust about our calculations of the future. The orthodox model assumes away uncertainty. However, if this assumption breaks down (as it does) we shall see that the results of the model, in general, do not hold.

Clower's Dual Decision Hypothesis

Keynes's denial of the relevance of Walras' Law leads to rejection of the orthodox theory of household behaviour - the unified decision hypothesis. In order to reject this, an alternative theory of such behaviour must be derived. This alternative theory would have to include the orthodox theory as a special case (which is Keynes's contention) as the unique equilibrium solution of Walras' Law is not an independent postulate of orthodox theory; it can be proved through assumptions common to orthodox and Keynesian price theory. Clower provides us with such an alternative as he depicts in his declaration:

"I shall argue that the established theory of household behaviour is, indeed, incompatible with Keynesian economics, that Keynes himself made tacit use of a more general theory, that his more general theory leads to market excess demand functions which include quantities as well as prices as independent variables and, except in conditions of full employment, the excess demand functions so defined do not satisfy Walras' Law. In short, I shall argue that there has been a fundamental misunderstanding of the formal basis of the Keynesian Revolution."³

Clower's view of Keynes's work is that, unlike the traditional school, market excess demands are dependent on current market transactions. Income magnitudes do not appear as independent variables in the demand or supply

³ibid. p.111

functions in the general equilibrium model, because incomes are defined in terms of prices and quantities, and quantities do not appear in the market excess demand functions of the orthodox theory. This means that the Keynesian consumption function and other market relations cannot be derived through a general equilibrium framework.

It is here, therefore, that we must turn to Clower's dual decision hypothesis. Clower contends that people may be constrained in the amount they can work as demand is only submitted to the market indirectly. In a position of underemployment, the desire for workers to work more, in order to consume more, is seen in the market as the demand for money wages and not a placed order for more goods. Entrepreneurs do not react, therefore, to this demand. This is the distinction between notional and effective demand. Notional demand underlies the traditional school and when we use this concept of demand, Walras' Law always applies. In contrast, effective demand is the desire for more goods with the purchasing power to back it up. Thus if quantities in the market are determined by the 'short side' of the market, then using the concept of effective demand Walras' Law only applies in a situation of full employment i.e. when notional and effective demand coincide. In a state of less than full employment Walras' Law must be replaced with the more general condition that "the sum of all market excess demands, valued at market prices, is at most equal to zero."⁴ Thus we can see that orthodox price theory may be regarded as a special case of Keynesian economics, which is valid only at full employment. Keynes seems to have won the battle over the title of *The General Theory*.

Inversion of Marshallian Time Periods

It is important to look more closely at the mechanism that brings disequilibrium into the system. Keynesians within the orthodox school framework often had to resort to strong assumptions such as rigid wages and prices in order to obtain the Keynesian result. Within the above discussed framework this is unnecessary. It is sufficient to drop the strong orthodox assumption, that of instantaneous price adjustment, in order to show Keynesian multiplier responses to initial changes in the rate of money expenditures. This results in the removal of the unrealistic Walrasian auctioneer. "The removal of the auctioneer simply means that the generation of the information needed to co-ordinate economic activities in a large system where decision making is decentralised will take time and will involve economic costs."⁵ Thus if a transactor is subject to fluctuations in the demand for his good, he will wait before significantly changing his behaviour. This is an inversion of the traditional Marshallian market day and short run, where the instant market day reaction to a reduction in demand would be to reduce prices.

⁴ibid. p.122

⁵Leijonhufvud (1967) in Clower p.301

Keynes's theory points to a reduction in quantities at this initial period due to the transactor's reservation price. The seller will not drop the price until the fluctuation is proven to be permanent. This is due to the presence of uncertainty - the auctioneer is not available to provide the vector of market clearing prices. Thus the expectations of transactors plays a large role in the determination of the situation in which the economy finds itself.

Thus a fluctuation in demand will have an effect on output and hence on unemployment, unlike in the orthodox school where only an adjustment in the price level will be observed. This is the central theme of Keynes's work: "changing views about the future are capable of influencing the quantity of employment."⁶ These changes in output will also have a multiplier or deviation-amplifying effect throughout the economy. This is the appearance of the concept of involuntary unemployment of which the classical school denies the existence.

Relative prices

The classical analysis of the above situation is that prices are too high and when they fall the economy will re-equilibrate itself. However, this is not necessarily the case. Keynes believed that such contraction ensues because of the 'wrong' relative asset prices. Thus a general deflation would not change these relative values at all. Leijonhufvud points to the different levels of aggregation of goods between the orthodox model and Keynes's model⁷:

| Orthodox Model | Keynes's Model |
|-----------------|-----------------|
| commodities | consumer goods |
| bonds | nonmoney goods |
| money | money |
| labour services | labour services |

The price of nonmoney assets in terms of the wage unit determines the rate of investment. The price of nonmoney assets in terms of consumables determines the propensity to consume. It is when there is an inappropriately low price of nonmoney assets relative to wages and consumer goods there is an information failure; the 'wrong' level of investment is entered into and the system will respond to parametric disturbances in a 'deviation-amplifying manner'.

Section 2: Keynes's Policy Proposals

We have thus seen so far, that Keynes's theory gives support to the fact that persistent chronic unemployment may exist in an economy. He did not provide

⁶Keynes (1936) p.vii

⁷Table reproduced from Leijonhufvud (1967) p.302

much in the way of policy proposals in the *General Theory*, although, through Keynes's public activities at the time he was advocating a 'pump-priming' of the economy, through fiscal stimulus, in order to correct the deficient demand in the economy. Even though he did not provide these proposals in his major work (and additionally he even expressed explicit doubts as to their essential worth, as in the opening quote of this paper) it is his ideas on fiscal stimulus that gained the most attention. It may have even gained notoriety for the Keynesian school. However, I aim to show that:

- Keynes was writing at a time of great depression and thus even though he advocated 'pump-priming' of the economy, in general he was not a fiscalist.
- Those who implemented these policies were not facing such large scale depression and hence it is debatable as to whether fiscal stimulus is the appropriate policy to use. Thus, this was publicity for 'Keynesian' policies that were not, in fact, Keynesian - this served to add fuel to the anti-Keynesian fire.
- The implementation of such policies were open to abuse and misinterpretation, as we shall see in the Irish case of fiscal mismanagement, and hence government expenditure was expanded for non-Keynesian reasons in the name of Keynesian economics. Our bonfire has turned into a veritable funeral pyre.

Such views are succinctly expressed by Leijonhufvud: "Since abounding faith in fiscal measures and a withering away of interest in monetary policy was one of the most dramatic aspects of the 'Revolution', there is, I believe, a tendency to impute to Keynes himself the policy views characteristic of the New Economics in its early stages. The question is, to what extent is it warranted to do so."⁸

It is true that under conditions of self defeating expectations Keynes advocated government intervention in the form of an investment injection to stimulate demand. However, in a series of articles in 1937⁹, *How to avoid a Slump*, Keynes argued against a further general stimulus to aggregate demand. This was not because the economy had reached a position of full employment (in fact it was still around 10%) but, rather, that the economic structure was too rigid to benefit from further stimulus. He believed that the problem lay in regional unemployment and thus further fiscal measures would not have the desired effect. Therefore, public works were only useful in counteracting the deviation amplifying effects of an economy 'off' full employment. Fiscal measures should not be used as a counter cyclical stabilisation weapon around full employment as this would probably introduce further instability into the system. This point is dealt with in more detail below.

⁸Leijonhufvud (1968) p.402

⁹Morgan Ch.6

Keynes was also aware of the danger when full employment becomes an orthodox and primary policy objective. One certain way to achieve such an objective is to absorb ever-increasing numbers into the public sector. These points indicate that, contrary to popular belief, Keynes was not a fiscalist, he only advocated it in particular circumstances. Unfortunately for his successors, this misinterpretation was easy to make as Keynes was writing at a time when such circumstances did prevail.

Stocks vs. Flows

Leijonhufvud also provides further theoretical support for the mistrust of the use of fiscal measures as a counter cyclical stabilisation tool¹⁰. As we saw earlier Keynes's writings were mainly concerned with current flows and, thus, brought about an exaggerated view of the underlying disequilibrium tendencies of an economy. By just concentrating on current flows the economy does appear to be inherently unstable. However, this is an unrealistic premise from which to begin as stocks of wealth are present in an economy, which brings more stability to the system. A fluctuation of demand in the economy may cause, for example, a firm to build up or draw on its stocks of inventories if it does not believe the fluctuation to be permanent. Thus it can be seen that the level of stability depends on the future expectations of the transactors and the level of available stocks in an economy. Once the stocks are exhausted and the current flows are affected by fluctuations, the deviation-amplifying tendencies discussed by Keynes creep back into the system.

Leijonhufvud called the region where such equilibrating forces are strong as the 'corridor' and if the fluctuations remain within its bounds cumulative contractions will not be generated. Outside this 'corridor', though, the buffer stocks are no longer able to absorb the fluctuations and the system becomes unstable. It can be shown that within this region the fiscal multiplier is small and that monetary policy could be effective in stabilising the economy. However, outside the region the extreme Keynesian position of a large fiscal multiplier and ineffective monetary policy becomes more suitable. This seems to share similar results with Keynes's view on not continuing fiscal stimulus until full employment is reached. The question arises, though, as to whether Keynes himself had such an idea in mind. However, this should not deter us from seeing its applicability to the question in hand. As Keynes himself said:

"I am more attached to the comparatively simple ideas that underlie my theory than to the particular forms in which I have embodied them, and have no desire that the latter should be crystallised at the present stage of the debate. If the simple basic ideas can become familiar and acceptable, time and experience and the

¹⁰ibid.

collaboration of a number of minds will discover the best way of expressing them.”¹¹

Irish Fiscal Mismanagement

Hopefully, I have now provided sufficient evidence to show how, firstly, Keynes himself could not be conclusively described as a fiscalist and that, secondly, extreme caution must be employed when applying such fiscal measures. As I stated before, although I think it worth mentioning again, such fiscal measures should only be used for ‘pump-priming’ the economy and, if used as a stabilisation policy, it will only serve to increase instability. I will look now at the case of Ireland’s fiscal mismanagement, as an example of the confusion by policy makers over Keynes’s policy prescriptions and as an example of the aforementioned abuse of such policies.

These policies were begun in 1950 with aims of stabilising the economy - “there was explicit recognition that demand was an inherently unstable quantity and that positive action by governments was necessary to maintain and stabilise it.”¹² Such misguided policies, begun falsely in the name of Keynes, succeeded only in dismantling the disciplinary fiscal safeguard and left Ireland in a position of crisis and pessimism. This policy was far from being a once-off ‘pump-priming’ injection - the policy lasted through the 1950s into the 1960s, when the government to GNP ratio increased incrementally throughout the period into the 1970s. This was when the direct abuse seemed to really occur as the disciplinary fiscal safeguard was abandoned and current spending deficits emerged. Keynesian theory did not support such action - it only supported the capital budget as providing the expansionary stimulus. “Once a large current deficit had been allowed to appear, the government would find it extremely hard on political grounds ever to close the gap again, even when this course was dictated by sound economic principles.”¹³ Thus these badly adopted ‘Keynesian’ policies led Ireland struggling to escape from her fiscal situation : a situation from which we can still feel the repercussions today.

The above case, I believe, shows how not only were the policies misinterpreted, but also how what was interpreted was badly applied and abused by the politicians concerned. However, I do not believe this to be a special case: such policies are easily abused and if politicians believe they can promote such schemes as being backed by theory there is great incentive to do so. But why is it that such policies were so easily abused?

¹¹ Keynes (1937) p.215

¹² Whitaker p.82

¹³ *ibid.* p.99

The Imperfect Political Sphere

There may be a general belief that as society becomes older the scope of government will inevitably increase as explained by Skidelsky in 'Critique of the Ageing Hypothesis'. For example, he cites Adolf Wagner's Law of Increasing State Expenditure as having "helped to create a mood in which every increment of public relative to private activity tended to be accepted as inescapably in the nature of mature social life."¹⁴ Figures will show that public activities have expanded relative to private ones over the course of the twentieth century in developed democracies, however, the belief that it was inevitable is unfounded. This, though, is not important - the point is that it is enough for people to believe that such spending increments are inevitable to create the environment conducive to the abuse of fiscal policies.

The second step in such a fiscal policy abuse must come from the politicians wrongly implementing such policy measures. Politicians and civil servants have vested interests in increasing the amount of government spending. When such economic policies are placed in the imperfect political sphere there exists a temptation for politicians to abuse them, in the name of full employment, to increase their budgets and hence the scope of power that they yield. Economic cycles do not correspond to general election cycles and thus there is the likelihood that unpopular but necessary policies will be dropped when an election is imminent.

Therefore, such fiscal measures should be confined to periods of chronic disequilibrium not only because they are not an appropriate method of fine tuning the economy, but also because of their vulnerability to abuse.

Conclusion

I agree with Leijonhufvud when he expresses his opinion that the orthodox model is an inadequate vehicle for interpreting Keynes's works. I hope that I have shown in section one that a new framework is necessary to revert this injustice that was wrought upon Keynes's work. While maybe not deserving the notoriety they achieved, Keynes's policy proposals seem to be limited in their universal applicability. I therefore contend that a reversal of the conclusions arrived at by the Keynesian-neoclassical synthesis would be closer to the truth.

This reinterpretation of Keynes's theory led a new emphasis on the role of expectations and information in the economy. Such expectations can be seen to be fragile when we analyse the large degree of uncertainty that faces individuals every time they make a decision. If we divert briefly into the world of microeconomic theory the model of perfect competition has long been considered

¹⁴Skidelsky p.405

a benchmark from which we can measure our other models of imperfect competition. There is nothing new in acknowledging that perfect competition does not satisfactorily describe the real world. However, in the field of macroeconomic theory we find a considerably different story. Many still cling to their neo-classical models which are based on perfectly competitive micro substructures. It is only a relatively recent development that this parallel model is seen as the macroeconomic benchmark.

While still grounding his analysis implicitly in the perfectly competitive world, Keynes did bring us a step closer to realistic modelling. It is my belief, therefore, that Keynes's greatest gift to economic theory was to have the courage to look past the elegant simplicity of the general equilibrium model and attempt to model realistically. It is testimony to his revolutionary ideas that it took over thirty years of debate to realise this.

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