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Keynes's General Theory at 80

LONDON – In 1935, John Maynard Keynes wrote to George Bernard Shaw: “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 its economic problems.” And, indeed, Keynes's *magnum opus*, *The General Theory of Employment, Interest and Money*, published in February 1936, transformed economics and economic policymaking. Eighty years later, does Keynes's theory still hold up?

Two elements of Keynes's legacy seem secure. First, Keynes invented macroeconomics – the theory of output as a whole. He called his theory “general” to distinguish it from the pre-Keynesian theory, which assumed a unique level of output – full employment.

In showing how economics could remain stuck in an “underemployment” equilibrium, Keynes challenged the central idea of the orthodox economics of his

day: that markets for all commodities, including labor, are simultaneously cleared by prices. And his challenge implied a new dimension to policymaking: Governments may need to run deficits to maintain full employment.

The aggregate equations that underpin Keynes's "general theory" still populate economics textbooks and shape macroeconomic policy. Even those who insist that market economies gravitate toward full employment are forced to argue their case within the framework that Keynes created. Central bankers adjust interest rates to secure a balance between total demand and supply, because, thanks to Keynes, it is known that equilibrium might not occur automatically.

Keynes's second major legacy is the notion that governments can and should prevent depressions. Widespread acceptance of this view can be seen in the difference between the strong policy response to the collapse of 2008-2009 and the passive reaction to the Great Depression of 1929-1932. As the Nobel laureate Robert Lucas, an opponent of Keynes, admitted in 2008: "I guess everyone is a Keynesian in a foxhole."

Having said this, Keynes's theory of "underemployment" equilibrium is no longer accepted by most economists and policymakers. The global financial crisis of 2008 bears this out. The collapse discredited the more extreme version of the optimally self-adjusting economy; but it did not restore the prestige of the Keynesian approach.

To be sure, Keynesian measures halted the global economy's downward slide. But they also saddled governments with large deficits, which soon came to be viewed as an obstacle to recovery – the opposite of what Keynes taught. With unemployment still high, governments returned to pre-Keynesian orthodoxy, cutting spending to reduce their deficits – and undercutting economic recovery in the process.

There are three main reasons for this regression. First, the belief in the labor-market-clearing power of prices in a capitalist economy was never wholly overturned. So most economists came to view persistent unemployment as an extraordinary circumstance that arises only when things go terribly wrong, certainly not the normal state of market economies. The rejection of Keynes' notion of radical uncertainty lay at the heart of this reversion to pre-Keynesian

thinking.

Second, post-war Keynesian “demand-management” policies, credited with having produced the long post-1945 boom, ran into inflationary trouble at the end of the 1960s. Alert to a worsening tradeoff between inflation and unemployment, Keynesian policymakers tried to sustain the boom through incomes policy – controlling wage costs by concluding national agreements with trade unions.

Income policy was tried in many countries from the 1960s to the end of the 1970s. At best, there were temporary successes, but the policies always broke down. Milton Friedman provided a reason that jibed with growing disenchantment with wage and price controls, and that reasserted the pre-Keynesian view of how market economies work. Inflation, Friedman said, resulted from attempts by Keynesian governments to force down unemployment below its “natural” rate. The key to regaining stable prices was to abandon the full-employment commitment, emasculate the trade unions, and deregulate the financial system.

And so the old orthodoxy was reborn. The full-employment target was replaced by an inflation target, and unemployment was left to find its “natural” rate, whatever that was. It was with this defective navigational equipment that politicians sailed full steam ahead into the icebergs of 2008.

The final reason for Keynesianism’s fall from grace was the rightward ideological shift that began with British Prime Minister Margaret Thatcher and US President Ronald Reagan. The shift was due less to rejection of Keynesian policy than to hostility toward the enlarged state that emerged after World War II. Keynesian fiscal policy was caught in the crossfire, with many on the right condemning it as a manifestation of “excessive” government intervention in the economy.

Two final reflections suggest a renewed, if more modest, role for Keynesian economics. An even bigger shock to the pre-2008 orthodoxy than the collapse itself was the revelation of the corrupt power of the financial system and the extent to which post-crash governments had allowed their policies to be scripted by the bankers. To control financial markets in the interests of full employment and social justice lies squarely in the Keynesian tradition.

Second, for new generations of students, Keynes's relevance may lie less in his specific remedies for unemployment than in his criticism of his profession for modeling on the basis of unreal assumptions. Students of economics eager to escape from the skeletal world of optimizing agents into one of fully-rounded humans, set in their histories, cultures, and institutions will find Keynes's economics inherently sympathetic. That is why I expect Keynes to be a living presence 20 years from now, on the centenary of the General Theory, and well beyond.

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