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A Post-Keynesian Analysis of Financial Markets

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"Post Keynesian Economics"*

It is my presumption that the primary objective of these sessions is to discuss alternatives to the dominant macroeconomics paradigms. Although the latter are not specifically identified, I am assuming that three mainstream, competing paradigms dominate the textbooks. They are: the neoclassical synthesis version of Keynes, modern monetarism, and the new classical economics.

Economic theory--or a major paradigm--should do three things. First, it should explain how the economy works. Second, it should enable us to predict what changes in economic conditions are likely to ensue over a reasonable period of time. Third, it should be prescriptive, which is to say it should lead to policies which will correct any malfunction of the economic system. The reason for a session to consider alternative paradigms is that a growing number of economists, not to mention the public, no longer believes that the mainstream paradigms do any of these things well.

My role today is to look at where we are from a Post Keynesian perspective. To do this I shall attempt, first, to define the nature of a "Post Keynesian perspective," second, to examine the key attributes of this perspective, and, finally, to conclude with some comments concerning where I think the Post Keynesians stand with respect to developing a paradigm (or theory) suitable for making sense out of the real macroeconomic world in which we live.

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<u>A Point of Departure</u>

Today no less than in the 1930s, the fundamental task of macroeconomics is to explain how in the aggregate a market economy works, particularly one which a large public sector has become a norm. Any macroeconomic paradigm must address the question of how output, employment, the price level, and growth are determined. Although the public sector is far larger than it was when Keynes first wrote--government at all levels now uses 20 percent of real output--the vast majority of key decisions which determine how the economy works are private and market-based, linked to the expectation that profits are to be made by the production and sale of goods and services. This is one of two central ideas in Keynes's *The General Theory*, namely that total spending by consumers, businessmen, and governments is the key determinant of output and employment. This is a commonsense idea, for as Keynes clearly saw, no businessman will undertake production, and thereby offer employment, unless he expects to sell what is produced at a profit. Selling requires that someone buy, which means, of course, there must be spending. Thus, the bedrock first principle on which *all* macroeconomic paradigms are rooted, is that aggregate demand is the key to the economy's short-term behavior. A second central idea in *The General Theory* is that our system of market capitalism is characterized by basic, *systemic* instability--boom and bust are the order of the day. Although the growth in the sheer size of the public sector in the last half century imparts an element of stability to the system that was not present before the Great Depression, the business cycle has not been overcome. Four recessions since 1969 alone testify to this. In *The General Theory* Keynes saw investment spending as the key source of instability in market capitalism, a point of view which most Post Keynesians still share.

What Is Post Keynesian Economics?

What is Post Keynesian economics and who are the Post Keynesians? That is the question to which I know turn. As Paul Davidson, a leading Post Keynesian and Editor as well as founder of the Journal of Post Keynesian Economics, indicates, the Post Keynesians are a diverse and hetrogeneous group, bound together more by a common set of propositions about the economy than a completed paradigm, as is characteristic, say, of the monetarists.[1] Before turning to an examination of the key propositions they hold in common, a word is in order concerning the attitude of the Post Keynesians toward the three paradigms which now dominate macroeconomics. In one way or another each of these paradigms represents a return to classical economic principles and its belief in the inherent stability and self-correcting tendencies of market economies. This even includes the neoclassical synthesis interpretation of Keynes because by adding the essentially classical theory of the labor market to the Hicksian IS/LM model of Keynes, the system is shown to be self-equilibrating at full employment if wages and prices are flexible.[2] ~~Keynes~~, This is what Patinkin Did

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it is said, may have won the policy war, but did not win the theoretical war.

The Post Keynesians simply reject all three of these paradigms, being especially critical of the neoclassical synthesis interpretation. This interpretation, labeled by Joan Robinson as "bastard" Keynesianism, is viewed as an attempt to push the ideas of Keynes into the classical mold, thereby stripping the "Keynesian Revolution" of all its significance. Unlike the monetarists and the new classical economists, the Post Keynesians do not look to a pre-Keynesian past for their ideas and inspiration. Rather they look to what they regard as important but neglected elements in The General Theory as a springboard to a new and more realistic paradigm. But they go beyond this, seeking new theoretical insights into the structure and working of our system of contemporary market capitalism. It is a system in which power is as ubiquitous as is competition, a system far removed in time and structure from the simple competitive models which dominate monetarism and the new classical economics.

Key Post Keynesian Propositions

The common core of Post Keynesian thinking is found in four major propositions. By themselves these propositons do not constitute a complete theory, an alternative paradigm to any one of the major paradigms currently holding sway in macroeconomics. But they do represent fundamental ideas which must be incorporated into any paradigm which will give us a better explanation of how the economic world really works than those currently in fashion. As Paul Davidson has said, the "purpose of theory is to make the real world intelligible, not to substitute an ideal world in place of it."[3] Unfortunately, there is a strong tendency within the economics profession toward the latter, a tendency reflected in the statement by Cambridge University economist John Eatwell that "if the world is not like the model, so much the worse for the world."[4] It is the neglect by mainstream economics of these basic propositions stemming from The General Theory which perpetuates the continued preoccupation and mathematical tinkering by economists with increasingly complex and abstruse models--models which have little relevance to the real economic world and its tough problems. It is to these propositions that I now turn.

1. Rejection of Walrasian General Equilibrium Theory: A common element in all three of the major paradigms, including the neoclassical synthesis, is an acceptance of the Walrasian theory of general equilibrium. This provides the microeconomic foundations for all three theories. As is well known, the

Walrasian system of general equilibrium demonstrates how all markets--including the market for labor--clear at equilibrium prices. In this system, characterized by perfect information (which means no uncertainty), there is no "false" trading (J.R. Hick's phrase), which means all trade takes place at equilibrium prices. As far as macroeconomics is concerned, the existence of Walrasian general equilibrium means that the market automatically brings about the full utilization of all resources, including labor. There is no involuntary unemployment in Walras's system.

The definitive critique of the Walrasian general equilibrium model was made by Robert W. Clower. In what is now a classic article in the literature of macroeconomics, Clower demonstrated that there is a fundamental incompatibility between Keynesian economics and Walrasian general equilibrium theory.[5] Clower showed that in reality false trading does take place, that is, goods and services are exchanged at other than equilibrium prices. But when this happens effective demand--desire coupled with the money to buy--departs from planned or <u>ex ante</u> demand, what Clower calls "notional" demand. This means that an excess supply in one market is not necessarily matched by excess demand in another market, thus opening up the possibility of unsold goods, or unused labor. The reason this happens is that markets cannot convey adequate information from all suppliers about how much they would buy if trading actually took place at the equilibrium prices. Workers, for example, have no way of letting prospective employers know that if all persons seeking work are actually hired, they will spend the income received on the goods and services they produce, thereby justifying being hired in the first place. If employers don't know this, then they may hire fewer than the number actually seeking employment (the <u>ex ante</u> or notional demand for labor falls short of the <u>ex ante</u> or notional supply). But since the number actually hired determines the realized income of the workers, and thus their actual--or effective--demand, involuntary unemployment is possible. In a market system, there can be, in other words, effective demand failure, as a result of which goods are unsold or workers go unemployed.

Thus, Post Keynesians reject Walrasian general equilibrium theory. The real world simply does not work this way. On the theoretical level, the significance of Clower's analysis is that it shows that even with flexible wages and prices involuntary unemployment and unsold goods are possible. This undercuts the arguments of the monetarists and the new classical economists that Keynes did not offer anything new theoretically, that The General Theory, contrary to what Keynes argued in his opening chapter, is simply a special case within a more general framework of equilibrium economics.

2. The Economy and Historic Time: Because there is no uncertainty in Walrasian general equilibrium theory, as well as no distinct role for money, the Walrasian system applies to a world without time. But this is not the reality. The Post Keynesian view is that economic processes exist in real, historic time. We live in a world in which the past is known and irrevocable, but the future is unknown. The economy moves continuously from a known past through the present to an unknown future. The process is irreversible, which is fundamentally different from the view that exists in equilibrium economics. There a disturbed system always returns to its original state.

The fact that Post Keynesians see economic processes as being essentially one-directional has other implications. It means, for example, that economic change is frequently cumulative in character, especially during the ups and downs of the business cycle. It also means that because the economy has a historic past, we cannot understand it without a knowledge of its history. To understand the economy we have to realize that we are confronted with an evolutionary process, one in which change is the normal state of affairs, but it is not movement toward the state of rest depicted in equilibrium economics. As John Kenneth Galbraith has phrased it, "Post Keynesian economics.... holds that industrial society is in a process of continuous and organic change, that public policy must accommodate to such change, and that by public action performance can, in fact, be improved."[6]

3. Uncertainty and Expectations: Once we admit that the economy exists in a world of real, historic time, we encounter the third key proposition of Post Keynesian economics. This is the fact of uncertainty and its corollary, expectations. Uncertainty is probably the most important, single idea in *The General Theory*. As G.L.S. Shackle says, "Uncertainty is the very bedrock of Keynes's theory of unemployment."[7] Uncertainty pervades economic life because the economy exists in real time, because it cannot be separated from history. In his famous 1937 *Quarterly Journal of Economics* article, Keynes said that with respect to the kind of uncertain knowledge through which we form expectations, "there is no scientific basis on which to form any calculable probability whatever. We simply do not know."[8] This is a very fundamental point because it means that expectations about the future which necessarily influence current decisions rest upon uncertain and volatile foundations. This is especially true, Keynes emphasized, for one of the most important economic activities in which human being engaged, namely the accumulation of wealth--that is, investment.

There are two critical points at which uncertainty and the volatility of expectations based upon uncertainty enter into the economic process. They enter into the decisions that households, firms, and financial institutions make concerning their portfolio decisions, that is decisions on the kind of assets they wish to hold. This is what liquidity preference theory is all about in The General Theory. Second, they enter into the formation of views that business firms and lending institutions hold about the prospective yield on capital assets. This is what Keynes's investment theory is all about. Thus, of the three key functional relationships in The General Theory--the consumption function, the liquidity preference function, and the investment demand function--two are highly volatile, dominated by uncertainty. The inescapable and practical conclusion to be drawn from this is that instability is endemic to the economic system; it is not something imposed upon it by random events external to how the system functions.

The new classical economics, seeking to restore Walrasian general equilibrium theory as the centerpiece in its macroeconomics, attempts to cope with uncertainty by assuming that the future can be adequately represented by probability statements about an economic world that is statistically predictable.[9] What this means, according to Paul Davidson, is that the new classical economists are simply replacing the absolute certainty about the future which was built into traditional classical economics with the concept of a "known probability distribution." Actuarial knowledge replaces perfect foreknowledge, thus permitting people to act in the same manner as if they had perfect knowledge.[10] But this is a literary deception and does not change the fact that Keynes stressed so strongly in his 1937 QJE article: there is no basis whatsoever for any kind of probability calculation for determining the yield of an investment over its useful life. Risk can be dealt with in this manner, but not the uncertainty which arises out of the fact that the future is unknown.

4. Institutions and the Economy: This brings us to the final proposition characteristic of the Post Keynesians. This involves the powerful role that institutions play in determining how the economy works and how

economic events turn out. Basically, there are two reasons for the stress Post Keynesians place upon institutions. First, this follows logically from their rejection of Walrasian general equilibrium theory. In this theory there are no institutions, save that of the market itself. The reason is that in a Walrasian world of atomistic competition, price flexibility, and perfect knowledge no institutions other than the market itself can have any significance. But this is not the real world; institutions do count in the economic process and Post Keynesians pay attention to them.

The second reason why Post Keynesians are concerned with institutions stems from their belief that human behavior is shaped by and filtered through institutions. The atomistic, wholly rational, maximizing creature of classical economics is a caricature, far removed from the reality of how human beings actually behave in the real world. It is through institutions that patterns of human behavior are shaped and determined, and so to understand human behavior in the real economic world, we must understand the institutional arrangements of the society.

For the Post Keynesians two sets of institutions are especially important for understanding the economy. They are, first, those which center on money and finance, including the institution of money itself. Money and financial institutions are not only essential to the functioning of capitalistic, market economies, they are at the focal point of capitalism's basic force--the drive to accumulate. The second group of institutions which concern the Post Keynesians are those that reflect the importance that organized groups play in the life of the economy. Among these, the large, modern corporation and the trade union are the most crucial.

There are several reasons why the Post Keynesians place such a central emphasis upon money and the financial institutions which center around money in the modern day economy. One of Keynes' basic criticisms of classical economics was that it applied only to a "real exchange economy," one in which money, while facilitating the process of exchange, was essentially neutral. It played no role in its own right.[11] But this would not do. Keynes in The General Theory saw himself as developing a "monetary theory of production." By this he meant an economy in which money "plays a part of its own and affects motives and decisions and is, in short, one of the operative factors in the situation, so that the course of events cannot be predicted, either in the long period or the short, without a knowledge of the behavior for money between the first state and the last. And it is this which we ought to mean when we speak of a Monetary Economy."[12] In short, money is not neutral, a mere convenience to facilitate the process of exchange. It dominates the economic process; "making money" is the ultimàte rationale for a capitalistic system. Under capitalism production is a means to the end of "making money," not the other way around as in the classical analysis.

The other set of institutions--especially the big corporation and the trade union--are important because of their role in the distribution of income, another of the central concerns of the Post Keynesians. Earlier I indicated that the Post Keynesians believe power to be a force as equally pervasive in the economy as is the force of competition. Power in the Post Keynesian view is largely directed toward the struggle over who gets what in the way of income. Corporate and trade union behavior are the strategic institutions through which this struggle is waged. As Galbraith aptly states it, a dominant characteristic of our time is the ongoing struggle of people to get control over their lives, to escape from the "impersonal tyranny of the market."[13] Unless an individual has unique personal characteristics that offer a degree of monopoly power--as with many athletics and performing artists--the only way to bend the market forces in one's favor is through organization or resort to government. Both involve power and its exercise. For the Post Keynesians, power in this context is important not just because it plays a key role in determining how income gets distributed. It also affects both inflation and the economy's growth. The competitive struggle among organized groups to enlarge their share of the national income can be a major factor in inflation, while the ability of corporations to administer their prices affects investment and with it the economy's growth because of the dependence of corporate investment spending on internal cash flows.

Toward A New Paradigm?

In concluding my remarks I want to make a few comments on the third point I raised in the opening paragraphs of this paper. Where do the Post Keynesians stand with respect to developing a paradigm that makes more sense out of the real world economy than any of the three which now dominate macroeconomics?

To answer this, I wish first to ask another question. Do we need a wholly new paradigm? The answer, I think, is no. In Keynes' basic proposition that in the short-run (which is really want counts in the final analysis), the economy is driven by the forces which enter into aggregate demand we have an appropriate basic framework into which we can fit the propositions just discussed, as well as any others relevant to understanding the real world behavior of the economic system. I don't think even the supply-siders in their wildest flights of fancy--reinventing Say's Law, for example--can ignore the basic Keynesian proposition, namely that in a market economy nothing will be produced if there are not buyers or the expectation that buyers will appear ultimately.

Thus, we do not need to throw out the bedrock Keynesian principle of aggregate demand as the key strategic factor in macroeconomics. What we need to do better is to integrate into this framework the key propositions that characterize the Post Keynesian perspectives, propositions discussed in this paper. We must do this in such a way that we can also make sense out of such recent developments as the Reagan administration's emasculation of the federal tax base, a development which may make impossible any future use of fiscal policy for managing and stabilizing the economy. We must also be able to cope with the economic consequences of structural budget deficits in the $200 billion range which confront the economy far into the forseeable future.

There may not yet be in existence a fully formulated theoretical model which incorporates all of the Post Keynesian ideas, but an excellent and stimulative start in this direction is found in Professor Hyman Minsky's (Washington University) "financial instability" explanation for the systemic instability of contemporary market capitalism.[14] Time permits me to say only a word or two about Professor Minsky's perspective. Like Keynes, Minsky finds the basic source of the system's instability to be rooted in fluctuating investment, behavior that stems from the periodic and systemic inability of firms to meet the cash payment commitments that flow from obligations undertaken in the past. In a world dominated by what Minsky describes as a "Wall Street" perspective, it is money and financial institutions which call the tune. To get the financial resources needed to purchase real capital, business firms issue debts which entail contractual commitments for future repayment. As long as cash flows from current sales are adequate to finance their commitments no problems ensue. But if current cash flows falter because demand sags, then trouble erupts. What Minsky has done is update Keynes's perspective on the nature of a monetary theory of production by describing an economy with a highly developed and sophisticated financial system. In the "paper" world of Wall Street, the investment process flows from money (debt instruments) to real investment, and back to money, not from investment, to money, and to consumption, as in the classical world.

What has made the difference in the economy's post war performance as compared to prewar--why we have not yet had a major crash--is the willingness of the Federal Reserve to play the role of "lender of last resort" when a serious financial crisis erupts plus the sheer size of the federal government and its structure of transfer payments. When a financial crisis erupts, as happened several times during the 1970s, the Fed pours money into the system, thus preventing a full blown debt-deflation crash from taking place. But a downturn also leads to massive government deficits as incomes and production falls. This places a floor under the economy, thus preventing a deep and long-lasting depression from taking place. Unfortunately, the legacy of this process is enhanced liquidity which can fuel a new round of inflation once recovery gets under way. This is what happened in the 1970s, but whether it will continue to happen in the 1980s remains to be seen.

Let me conclude on a mildly optimistic note. Mainstream macroeconomic paradigms, especially monetarism and the new classical economics, are essentially bankrupt, even though they have provided the necessary intellectual rationale for the Reagan administration's attempted return to *laissez faire* economics. Keynes and the ideas of the Post Keynesians are not highly regarded at this time within the economics profession, but all the evidence from history argues against the notion that systems of market capitalism are inherently stable and will, if left to their own devices, automatically bring about full employment. In time, this will become apparent once again, even perhaps to a new generation of economists trained to a narrow technical perfection and largely unaware of even recent history, not to mention Keynes and his legacy. If economist are to justify their existence, they must have something meaningful to say about the real world and its problems. They did so once, and I believe they can do so again.

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Footnotes: "Post Keynesian Economics"

1. Paul Davidson, "Post Keynesian economics: solving the crisis in economic theory," in The Public Interest, Special Issue, 1980, p. 152.

2. Brian Morgan, Monetarists and Keynesians (London, the MacMillan Press, 1978), pp. 36-44.

3. Paul Davidson, op. cit., p. 158.

4. Robert Kuttner, "The Poverty of Economics," The Atlantic Monthly, Feb., 1985, p. 76.

5. Robert W. Clower, "The Keynesian Counterrevolution: A Theoretical Appraisal," in The Theory of Interest Rates, eds. F.H. Hahn and R.P.R. Brechling (London, Institute of Economic Affairs, 1956), p. 110.

6. John Kenneth Galbraith, "On Post Keynesian Economics," Journal of Post Keynesian Economics, Fall, 1978, p.8.

7. G.L.S. Shackle, The Year of High Theory (Cambridge, England, Cambridge University Press, 1967), p. 112.

8. John Maynard Keynes, "The General Theory of Employment," Quarterly Journal of Economics, February, 1937, p. 213.

9. Paul Davidson, op. cit., p. 162.

10. Ibid.

11. John Maynard Keynes, "On the Theory of a Monetary Economy," Nebraska Journal of Economics and Business, Autumn, 1963, p.7.

12. Ibid.

13. John Kenneth Galbraith, op. cit.

14. See esp. Hyman P. Minsky, John Maynard Keynes (New York, Columbia University Press, 1975) and Can "It" Happen Again? (Armonk, N.Y., ME..Sharper, Inc.,, 1982).