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Papers Concerning Some Reinterpretations of Keynes

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Southern Economic Association

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Papers Concerning
Some Reinterpretations of Keynes

Program arranged by President-Elect Werner Hochwald

Some Reinterpretations of Keynes
November 12, 1966

"There is no Keynesian System - Only a Keynesian Language"
DAVID McCORD WRIGHT
University of Georgia

"Three Criticisms of Keynes Reconsidered"
MORRIS A. COPELAND
University of Missouri

Discussion:
HYMAN P. MINSKY
Washington University

JOSEPH P. McKENNA
Virginia Polytechnic Institute

Comments on Copeland and Wright:
An Alternative Interpretation of Keynesian Economics

Hyman Minsky

The question before us is: "What are the special characteristics of Keynesian Economics, if such an animal exists?". Our primary interest is not in the intellectual history of the participants in this session, of Keynes or even of the discipline. Our real interest is in the positive and policy aspects of Economics. Thus, if there is a Keynesian Economics, it consists of a set of propositions about system behavior which are true in the Keynesian and not true in the Classical, or whatever label you want to pin upon the non-Keynesian, system.

Upon occasion I have to give the first formal lecture in Economic Theory to an entering class of graduate students. In this introduction I tend to give the mystery of our discipline away. I inform these students that almost all of economic theory revolves around the conditions under which two propositions are or are not valid and how these propositions need to be qualified as different assumptions are introduced.

The first proposition is the current phrasing of Smith's invisible hand. It states that there is a one to one correspondence between competitive equilibrium and Pareto optimality. The second thematic proposition of economic theory is that there is one and only one equilibrium for the system as a whole, and this is at full employment.

The special Keynesian view relates to the second proposition; the Keynesian version is that less than full employment equilibrium is possible. To get such a radically different result it

is necessary to start from different assumptions. This the Keynesians do by introducing uncertainty as a fundamental aspect of the model. It is asserted that a world with uncertainty cannot be effectively analyzed by using a model that first assumes that uncertainty does not exist and then corrects the result to allow for the existence of uncertainty. It also is clear that the uncertainty of Keynes does not relate to those aspects of the economy for which a well defined stable frequency distribution exists. All decisions are made under conditions of uncertainty, but to Keynes the special impact of uncertainty is on decisions concerning wealth.

The Keynesian perspective with respect to uncertainty also throws light upon the validity of the Pareto optimality theorem. Thus when uncertainty is introduced into price theory---as is done by Galbraith and Arrow[1/]---it becomes clear that competitive markets do not in general lend to a Pareto optimum.

Keynes of the General Theory of Employment, Interest, and Money was also the author of A Treatise on Probability.[2/] Keynes' views of the nature and central role of uncertainty in his general theory are perhaps most clearly stated in his rebuttal to Professor

1/ J. K. Galbraith: The Affluent Society, Houghton, Mifflin Company, Boston 1958.

K. J. Arrow: "Uncertainty and the Economics of Medical Care" A.E.R., December 1963, pp. 941-973.

2/ J. M. Keynes: The General Theory of Employment, Horcourt, Brace & Co. New York December 1935.

J. M. Keynes: A Treatise in Probability, Macmillan & Co. 1921, Second Edition 1929.

Viner's review of The General Theory, which appeared in the February 1937 Q.J.E. The title of Keynes' rebuttal was The General Theory of Employment. I wish I had time to read a fair portion of this as my comments.[3/]

The significance of Keynes' piece is not that it throws light upon The General Theory, but that it leads to valid and important propositions about system behavior. Incidently both Professor Wright and Professor Copeland touched upon some aspects of Keynesian economics that follow from this Q.J.E. piece. Professor Copeland did this when he commented that the demand for long-lived capital is inherently speculative, Professor Wright when he turned into Cassendra and warned of the "--- impending financial crisis---".

I believe I might surprise Professor Wright and now say some things that he might find quite congenial. The Keynesian economics entombed in text books such as Ackley's[4/] does not do justice to either Keynes or the economy. Keynesian economics is very much the economics of capitalism. Unlike price theory, which is at least as relevant to a Socialist as to an enterprise economy, Keynesian economics is relevant only to a system in which private portfolio management is a major

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3/ I find that G.L.S. Shackle also considers this rebuttal by Keynes as an essential, major ingredient in the Keynesian "canon". For Shackle's view see "Recent Themes Concerning the Nature and Role of Interest" in Surveys of Economic Theory, American Economic Association and Royal Economic Society.

4/ G. Ackley: Macroeconomic Theory, The Macmillan Company, New York 1961.

determinant of the demand for investment output. Therefore the core of the system is the investment function, not the consumption function. And the investment function cannot be defined independently of the portfolio preferences of ultimate wealth holders and the existing system of financial intermediation. As is true of almost all of monetary economics, Keynesian economics is a form of "analytical institutionalism".

Portfolio preferences are the content of Liquidity Preference. Keynes' view of the demand for money as an asset was stated when he asked "Why should anyone outside a lunatic asylum wish to use money as a store of wealth" (Q.J.E. Feb. 1937, p. 216). Obviously sane men hold money as a store of wealth---and they do so because they are trying to behave rationally in the face of the fundamental irrationality of uncertainty. Men must hold the entire inventory of physical capital and money. The protection against contingencies, of the kind that cannot be summed up by "---a good Benthemite calculation of a series of prospective advantages and disadvantages, each multiplied by the appropriate probability, waiting to be summed." (Q.J.E. Feb. 1937, p. 214), takes the form-for quite insufficient reasons if looked at rationally---of holding money. Thus the Keynesian liquidity preference function is not as Professor Copeland wrote it but

$$\underline{4} / \quad r = L\,(P_y \cdot GNP,\ M,\ P_k \cdot K,\ \psi_L).$$

The "---desire to hold Money as a store of wealth is a barometer of the degree of distrust of our own calculations and conventions concerning the future" (Q.J.E. Feb. 1937, p. 216) and this degree of distrust, being based upon the most tenuous of feelings, is subject to sharp changes.

But the only way an individual portfolio owner can get more money quickly is by selling his other wealth. For the community this means that a rise in the demand for money [5/] lowers the market value of physical wealth; $P_k K$ must fall. If we assume that the stream of expected future earnings in the present value formula remains unchanged, a fall in $P_k K$ means a rise in r.

Investment (newly produced capital) and the existing stock of capital are perfect substitutes in portfolios. Thus P_k (or r) can be taken as the demand price for investment goods. But the cost of production of investment goods is given by P_y - which is some function of wages, w. That is, any increase in the demand for money first lowers the demand price for investment goods without lowering the costs of inputs for the production of capital goods.

The Keynesian price inflexibility is simply a statement that the price of stocks can fall-or-rise faster than the price of current output. A second Keynesian proposition is that the dynamic adjustment process set up when excess supply exists in the commodity and labor markets is inefficient in generating a rise in the demand price for investment relative to the supply price of current output. This proposition centers around the impact of falling current output prices upon the numerator in the present value formulas of our text books. There is no reason to believe that in such as dynamical content $\frac{dGNP}{dp} < 0$; that is the dynamics centering around the labor market and the price level of current output cannot rectify the underemployment situation.

5/ Of course a rise in the demand for money is a <u>shift</u> of the liquidity preference function.

Incidently, the remark by Keynes to the effect that a sudden large reduction of money wages (and the price of current output) would be most favorable, which was cited by Professor Wright in his text, is consistent with the above. A once-and-for-all large and unsustainable cut in money wages would abort the pessimistic expectations of future price movements. This could lower the supply price of the real investment needed to generate full employment to a level that is consistent with the demand price as generated by liquidity preference.

When the liquidity preference and investment relations are looked at as the carriers of the uncertainty inherent in decisions pertaining to wealth, Keynesian economics is the economics of tremors and booms. Professor Copeland is on the right track when he introduces indices of confidence into his investment and liquidity preference functions. In fact for the investing unit, real investment is a portfolio decision -- It is a simultaneous decision to emit financial liabilities in order to acquire real assets. A new era - such as was "introduced" into the United States by the announcement by members of the Council of Economic Advisers that "---the business cycle as we have known it is now obsolete"---will lead to a sharp increase in investment demand and an acceptance of liability structures that in prior circumstances would have been considered imprudent. A not unusual disturbance in the face of such euphoric expectations can lead to sharp revisions of desired asset and liability structures and a fall in asset prices which impinges upon real demand.

It is the fundamentally speculative nature of the demand for investment and the inherent instability of decisions based upon uncertainty that indicates that a speculative boom will necessarily follow a prolonged period in which the enterprise system functions well. As the world is not born de nova each morning; as yesterday's enthusiams are embodied in today's liabilities so the portfolios willingly accepted during such a boom period become back-breaking burdens during a period in which either calmer or pessimistic views of the future guide portfolio desires.

To summarize: Keynesian economics is different because it integrates the uncertainty inherent in a decentralized capitalist economy, where each household and firm makes portfolio as well as income decisions, into a model of system behavior. One result of this model is that the relative prices of capital goods (the stock) and current output (the flow) can change markedly and rapidly. This can lead to a large enough initial unemployment of labor so that the wage, price and interest rate movements set up by unemployment and excess supply are not efficient ways of returning the system to full employment.

This is something quite different from both classical economics and text book versions of the Keynesian system. But much more significantly, it is indeed a very good framework for analyzing the behavior of our intensely financial enterprise economy.