Keynes and Economics

Kevin D. Hoover

Keynes's stock as an economist rises in inverse proportion to the fall in economic indicators. The *Wall Street Journal* often reminds us that Keynes is dead. Yet, last November, writing in the *New York Times*, N. Gregory Mankiw, Harvard economics professor and former chairman of George W. Bush's Council of Economic Advisors, found a well-worn passage from Keynes's masterwork, *The General Theory of Employment Interest and Money*, that speaks to our time:

> At the present moment people are unusually expectant of a more fundamental diagnosis; more particularly ready to receive it; eager to try it out, if it should be even plausible. But apart from this contemporary mood, the ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else. Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist. Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler of a few years back. (Keynes [1936] 1973, 383)

Keynes himself is now that defunct economist. The *Wall Street Journal* knows that he is defunct, but fears that—zombie-like—he will not stay down. Mankiw too knows that he is defunct, but sees a friendly ghost.

Correspondence may be addressed to Kevin D. Hoover, Department of Economics, Duke University, Box 90097, Durham, NC 27708; email: kd.hoover@duke.edu.

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My job is to explain Keynes's economics and its influence. I leave it to you to decide whether Keynes is the living dead or Casper. There is not time, nor would it suit this audience, for me to give a technical account of Keynes's economics. What I can do is to note some of its central ideas.

The Fallacy of Composition

For Keynes, people are heterogeneous—each is situated differently, each has different tastes, different capacities, different beliefs. Yet, they form a society. And extending our reasoning from individual interactions to the whole economy is misleading. It commits a *fallacy of composition*. The quickest way for an individual to get from New Orleans to Baton Rouge is Interstate 10; but it is not the quickest way to get the whole population of New Orleans to Baton Rouge.

A key fallacy of composition in economics is a false analogy from elementary exchange to the economy as a whole. Robinson Crusoe faces a *microeconomic* problem: how to do the best he can with scarce resources. The appearance of Friday presents a new, but still microeconomic, problem. Crusoe's and Friday's different skills and different endowments give rise to mutually beneficial trade, and there is never any reason other than wanting to enjoy sleep or a meal or a swim that they should be unemployed. In contrast, *macroeconomics* concerns a whole economy—say, Friday's tribe or, for Keynes, Mandeville's grumbling hive of the "Fable of the Bees." A Lincoln Navigator or dinner at the Magnolia Grill is a dispensable luxury, but if enough of us dispense with such luxuries the autoworker and the busboy go without their dinner: "the gay of tomorrow are absolutely indispensable to provide a *raison d'être* for the grave of to-day" (Keynes [1936] 1973, 105–6). Unlike Robinson and Friday, workers in a complex economy can be unemployed; the economy can operate at less than full capacity.

Keynes was keenly aware that the complexity of the economy depends on the institution of money, which allows us to obtain goods from people we will never know, living lives that we can hardly imagine, in places we will never see. Robinson and Friday may be selfish, but in an obvious sense they work for each other. If they save, they save by laying up stores. We too work for each other, but only indirectly. Directly, we work for money. And when we save, we save money, and do not demand the work of others. The process of my abstaining from spending leading to another's loss of income and his abstaining from spending, leading to still another's loss of income . . . and so on is Keynes's famous *expenditure multiplier*. The mul-

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tiplier works the other way too—expenditure (yours or mine or the government's) gives some people income which, if they spend it, gives other people income . . . and so forth. The expenditure multiplier is the intellectual basis for President Obama's stimulus package.

Keynes did not believe that the private sector always failed us, but neither did he believe that it always and everywhere found and affected every valuable exchange. It fails us frequently enough and for long enough periods that the economy sometimes runs cold and unemployment sometimes runs high. Yet, Keynes possessed a self-confident optimism (or arrogance perhaps) and also thought that, with a little bit of shrewd macroeconomic management (guided by Cambridge men, of course), the economy could run warmer and unemployment could be kept low. Then, through the miracle of compound growth rates, we would soon solve the *material* economic problem. The real challenge that he saw for the grandchildren of his generation—provided that management of the economy was enlightened—was the problem of what to do with our leisure. This is Keynes of Bloomsbury.

Uncertainty

The multiplier explains the process of getting into and out of trouble, but what started it in the first place? Keynes's answer (surprisingly like that of the Austrian economists—often his most vocal opponents) is *time* and *ignorance*. The future matters to economic decisions, but we cannot know the future. Institutions have evolved to cope with time and ignorance—insurance, for example. As a chairman of two insurance companies and the author of a *Treatise on Probability*, Keynes understood *insurable risk*. The casino cannot predict each spin of the roulette wheel; the life insurance company cannot predict the day of each death; but the averages and their variability are known precisely. You take a chance on roulette; the casino calculates its return.

Keynes would no doubt see the onset of our latest financial collapse as the result of an intellectual error—confusing uninsurable *uncertainty* of the valuation of mortgage-backed financial derivatives with insurable risk. He illustrates uncertainty: "the prospect of a European war is uncertain, or the price of copper and the rate of interest twenty years hence, or the obsolescence of a new invention, or the position of private wealth owners in the social system of 1970. About these matters there is no scientific basis on which to form any calculable probabilities whatever. We simply do not know" (Keynes [1937] 1973, 113–14).

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For Keynes ([1937] 1973, 113–14) a conventional response to uncertainty is better than paralysis: "the necessity for action and for decision compels us as practical men to do our best to overlook [uncertainty] and to behave exactly as we should if we . . ." could calculate the prospects and the risk. Such a calculation requires a view of those prospects; yet they too are uncertain, and "sanguine temperament and constructive impulses" determine our positive evaluation of them: "If human nature felt no temptation to take a chance, no satisfaction (profit apart) in constructing a factory, a railway, a mine or a farm, there might not be much investment merely as the result of cold calculation" (Keynes [1936] 1973, 150).

Elsewhere, Keynes ([1936] 1973, 161–62) refers to "the spontaneous urge to action rather than inaction" as *animal spirits* and "if the animal spirits are dimmed and the spontaneous optimism falters, leaving us nothing but mathematical expectation, enterprise will fade and die;—though fears of loss may have a basis no more reasonable than hopes of profit had before." He does not put it this way, but there is an *expectations multiplier* as well as an expenditure multiplier that can turn a boom into a bubble or a slump into a rout.

The Role of Government

When the whirlpool of speculation destroys enterprise, when the financial bubble bursts, when animal spirits dim, and multipliers head south, investment collapses, businesses shut down, and unemployment rises. Then what? An inveterate optimist, Keynes's animal spirits were high. And possessed of a facile pen, an elegant prose style, and access to high places, he urged the government to action.

The *General Theory* is light on policy prescriptions—it is by no means the bible of deficit finance and big government that critics who know it without reading it suppose. Keynes would rather avoid slumps than fight them, which argued for sound passive policies (especially monetary policies) to prevent emergencies. He would certainly have welcomed the automatic fiscal stabilizers, such as unemployment insurance payments that rise as output falls. He did not call for the heavy regulation of financial markets, but for disincentives to too rapid turnover. Generally, small disincentives would probably be sufficient, but in a whimsical vein he suggested that perhaps "the purchase of an investment [should be] permanent and indissoluble, like marriage, except by reason of death or other grave cause" (Keynes [1936] 1973, 160).

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Nor was Keynes an enemy of the price system, arguing against wage and price rationing in the Second World War. The private sector and the businessman normally know their own interests and these typically coincide well enough with those of society. Nor was he a friend of inflation, warning in his prophetic *Economic Consequences of the Peace* against debauching the currency.

Yet, when the private sector misses its cue, when the price system fails adequately to coordinate, when the slump looms, Keynes advocates government intervention. He called it the "socialization of investment"; we call it "the stimulus." He preferred not to use the simple expenditure multiplier to buy us out of the recession; but to use it to jump start the expectations multiplier—to buoy the animal spirits of *private* business so that their own additions to investment would stimulate demand.

Do It Now

Keynes was not timid. President Obama's slogan, "the fierce urgency of now," would resonate for him. Conservative critics have generally hated this about him, seeing in it a kind of recklessness with respect to the future. His most famous quip, "In the long run we are all dead" (Keynes [1923] 1971, 65), is offered as exhibit one in his opponents' brief. But the quotation is taken out of context. Keynes does not hold up Aesop's gay grasshopper as our proper model; nor does he denigrate Aesop's grave ant. His point is rather that it is not much use to say that, on average, the temperature is mild, the sun shines, and the winds are fair, when summers burn, winters freeze, and hurricanes punctuate the autumn. Ant and grasshopper alike live or die in the short run and not in the average. Economists may be right about their analysis of the long run, but if they cannot say anything enlightening about the business cycle, they are not much use.

There can be little doubt that Keynes would support macroeconomic stimulus today. But Keynes was always a skeptic and a contrarian. Let me end with Keynes's assessment of the early days of the New Deal. If you do not hear its echo today, I have failed in my job. To Franklin Roosevelt, he wrote:

> You are engaged on a double task, recovery and reform—recovery from the slump, and the passage of those business and social reforms which are long overdue. For the first, speed and quick results are essential. . . On the other hand, even wise and necessary reform may . . .

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impede and complicate recovery. For it will upset the confidence of the business world and weaken its motives to action before you have had time [to] put other motives in place. . . In particular, . . . I cannot detect any material aid to recovery in the NRA [i.e., Roosevelt's National Recovery Act] . . . which is essentially reform and probably impedes recovery, [and] has been put across too hastily, in the false guise of being part of the technique of recovery. (Keynes 1982, 290–91)

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