THE RELEVANCE OF KEYNES IN THE CONTEXT OF ACTUAL FINANCIAL COLLAPSE

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Abstract:
This paper argues that the thinking of John Maynard Keynes remains highly relevant to an understanding of the financial collapse of 2007–8 and for policy measures to enable the world to escape from the 'great recession'. The essay explains the role of uncertainty in Keynes's theory, and the Keynesian case for fiscal and monetary 'stimulus'. It provides a Keynesian perspective on the reform of the world's monetary system, and concludes with reflections on the role of the state and the state of economics.

Key Words: *financial crisis, monetary policy, fiscal policy, uncertainty, keynesism*

JEL classification: A10 ; A11

1. INTRODUCTION:

We may say that the dominant tendency in the theory and policy was being set by the doctrines of Chicago School, despite a medley of New Keynesian, synthesizers, trimmers an occasional out breaks of common sense by policy-makers. Their "New classical economics" was simply a mathematical soup-up version of the old classical economics, which Keynes had overthrown in the 1930s. Markets were deemed to be optimally self-regulating so that government task in macro- economy was restricted to maintain "sound money' and in micro-economy was to free up markets in order to lower the natural rate of unemployment. The event that made possible the pre-1914 recipe for economic success, the restoration of a single world economy based on free trade, balanced budget, unrestricted capital movements was the fall of communism in 1990s. Globalization – was the name given to the world wide extension of the markets system.

With the financial collapse of 2007-2008 the "new classical" beliefs in self regulating markets has provide to be as illusory as the old classical belief. Recent events have brought Keynes to live. The so called "Great Moderation" which seemed to vindicate the new regime of deregulated markets, lasted less than ten years.

2. THE IMPORTANCE OF UNCERTAINTY IN ECONOMIC THINKING

The purpose of *General Theory* was to explain how an economy could get stuck in a low employment[1] trap. The explanation was provided by the theory of effective demand and that is why the uncertainty is not placed in the heart of Keynes's theory. Demand is effective at the point where the aggregate supply and demand schedules intersects; the theory of effective demand stares that any inequality between the two is removed by a change in output (or income) and not price. That is how an economy could get stuck in or alternatively oscillate around a state of underemployment equilibrium. The theory of the income or employment multiplier showed much extra demand needed to be pumped in a depressed economy to bring it back to full employment. The income /expenditure model is conventionally taken to be the core of Keynesian theory was thus the bit of Keynes most suitable for the policy maker.

[1] Stan Viorica, Sandu Gabriela, *Pricing and equilibrium condition for the market of production factor in the perfect competition* , Anale Univestatea Tibiscus,vol XVIII,2011

The instability of investment as a cause of crisis is a continuous theme in his writing with its cause – inescapable uncertainty about the future, clearly identified. As well as that Keynes identifies probabilistic knowledge of the future as the key "tacit assumption" behind the classical theory of self regulating market. If we know what tomorrow would bring there would never, assuming rational behaviour, be a financial or economic crisis.

It is remarkable the distinction that Keynes made between risk and uncertainty. Risk is when probabilities can be known (measured); uncertainty exists when they can not be known (measured). His original insight was that the classical theory of the self regulated markets rested on the epistemological claim that market participant have perfect information about the future events. On the other hand, Keynes economy is one in which our knowledge about the future is usually very slight and often negligible and expectation are frequently subject to disappointment. This makes investment a peculiar unsuitable subject for the methods of classical theory. Macro models that assume that we have calculable probabilities are irrelevant to the actual working of economies.

From the earliest time human being have relied on the magic of numbers to convert the unknown into known. Jevons, for example, attached a particular importance to the number seven. One of the earliest techniques and still the most prevalent is *induction*. Keynes has already exposed the flaw in induction in his *Treatise on probability*. It depends on an inductive principle, the assumption of a universe of finite probabilities, which cannot be established by induction itself. Induction appears in Keynes treatment as a *convention*, the convention being that the present is a much more serviceable guide to the future than a candied examination of past experience would show it to have been hitherto. A second convention that Keynes emphasizes is the testimony of the crowd. Knowing that our individual judgment is worthless we fall back on the judgment of majority or the average. We fallow the crowd which it relies on the opinion of experts, who are trying to guess what average expects average opinion to be.

Undoubtfully any view of the future based on conventions is liable to sudden and violent changes when the news changes, even transiently, since there is no basis of real knowledge to hold it steady. Suddenly everyone starts revising their bets.

This is a good theoretical explanation for the meltdown in the autumn of 2008and it also illustrates, with unerring precision, the contradictory character of financial innovation. By making investment more liquid, the stock market reduces the proportion of their resources that people would want to hold in cash. Other things being equal, it serves to increase the volume of real investment (accumulation of capital). Also this situation enlarges the scope for speculation and thus making economic life more volatile. This has been exactly the effect of "securitisation" in the last few years[2].

4. The debate about the stimulus and the similarity between great depression and actual collapse

When the financial system crashed in 2008, dragging down the real economy with it, governments stepped in everywhere with "stimulus packages" made up of a mixture of bailing out insolvent banks, printing money, providing tax rebates or subsidies for private spending and big increase in loan –financed public spending. We may say this was all according to Keynesian prescription[3]. Remember that even Robert Lucas, high priest of Chicago economics admitted that we are all Keynesian in the foxhole. But signs of economic recovery induced by the stimulus rapidly brought about

[2] See also Daniel Daianu, *Capitalismul incotro? Criza economica, mersul ideilor, instituții*, Polirom, 2009

[3] See also Ion Pohoata, *Doctrine economice contemporane, vol 2, ,* Editura Fundației Gh.Zane, Iasi, 1996

a resumption of normal intellectual service. Most economist and many policy makers are now calling for a swift withdrawal of the stimulus on the ground that it will bankrupt government or lead to inflation or both. What this rapid turnaround shows that the model of economy that Keynes has tries to blast out of the minds of economists in the early of 1930s is still firmly lodged there. In fact, the current debate about the stimulus is a reply of the debate between Keynes and his critics at the time of the Great Depression.

5. Keynes political economy

Keynes recipes for a less uncertain economy[4] consists in three main elements; measures to stimulate investments, measures to stimulate consumption and a reform of the international monetary system to prevent the transmission of unemployment from one country to another.

Keynes political economy will also use the taxation system to redistribute income since an increase in the habitual tendency to consume will be in general (except in condition of full employment) serves to increase the inducement to invest. The rational for this is that the poor spend a higher proportion of their incomes than do the rich.

A suction pump which had drawn into a few hands an increasing proportion of currently produced wealth was in operation in Britain and in the USA in the run up to the 2007 crisis, access to the credit compensating for the growing inequality of wealth and incomes.

Another important part of Keynes's political economy is a major reform of the international monetary system. The chief need is to reduce the amount of global reserves. Between 2003-2009 measurable reserves increased from $2.6 trillion to $8.6 trillion, an average annual rate of increase of about 17% at the time when global GDP grew at an annual rate of 4.6%. In 2003, global reserves amounted to 7% of total reserves; in 2009 the figure was 12%.

The flight into liquidity amounts to a large increase in deflationary pressure. Reserves are a way of insuring against uncertainty. What is required is to lower the cost of insurance by reducing uncertainty. A package of measures to achieve this would need to include internationalization of reserves, ”Tobin taxes” on hot money flows and agreement to exchange rates.

6. Towards a new economics

Keynes claimed his theory was more 'general' than classical economics because it encompassed a variety of economic situations exhibiting different states of knowledge.

The question is: how central is the Keynes case? If the capitalist growth engine is subject to irreducible uncertainty then its mediocre performance and frequent breakdowns are explained. If, on the other hand, uncertainty can be plausibly modelled as an information problem, to be overcome by learning and by more efficient data processing, then Keynes's case is marginalised, and the classical theory is reinstated as the central case. The comeback of classical economics consisted in marginalising the

Keynes case, and reinserting its own theory of the self-regulating market based on 'perfect information' as the 'general case'. The breakdown of the self-regulating market in 2007–8 suggests to me that Keynes's theory is the 'general' one. But what would an economics which takes uncertainty seriously look like?

[4] Robert Skidelsky *The relevance of Keynes* , Cambridge Journal of Economics , 2010

The fundamental issue involves the role of maths in economics. The older generation of economists used maths for a strictly limited purpose: to make more precise their intuitions about the real world, not to create an axiomatic system whose virtue lay in its unrealism.

There has to be a return to an economics that allows room for explanations of economic behaviour that cannot be expressed mathematically. Keynes himself was hostile to exaggerated precision: whether or not he was the author of the phrase ‘it is better to be vaguely right than precisely wrong’3 this summed up his own approach. It remains to work out the teaching of economics, the production of economic textbooks, and the reform of professional standards of economic journals to reflect this insight.

7 . Conclusion

One clear conclusion emerges from this discussion: the need for a greater role for government in the management of the economy. A greater role for government in turn requires the intellectual rehabilitation of the state as a potentially rational economic actor, rather than a mere vote-seeker. It is decades since anyone was able to write, as Keynes did in 1936, of the state being in a position to calculate the marginal efficiency of capital-goods on long views and on the basis of the general social advantage. We need to think about a structure of the state which allows its investment function to be separated from the political incentives facing politicians. We do not need a new Keynes; we do need the old Keynes, suitably updated. He will not be our sole guide to the economic future, but he remains an indispensable guide.

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