The Relevance of Keynesian Ideas in the Current Economic Crisis’ Context

- PhD Thesis Summary -

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– summary –

Since late 2007, the world has been facing one of the worst economic downturns in history. Its effects are still being felt by millions of people across the entire globe, and its causes are multiple and controversial. Thus, given that John Maynard Keynes was the economist who pointed the road to overcome the deepest economic crisis in history, namely the Great Depression of 1929, we have tried throughout this scientific work to determine whether his revolutionary ideas are still actual and valuable, in the new global macroeconomic context.

Given the fact that "the central character" of this scientific paper is the famous British economist, its purpose was to analyze every “facet” of the economic doctrine he created. Consequently, this work is divided into four chapters, each of them aiming to emphasize the specific relevance of a substantial aspect that defines the Keynesian view on the economy.

The first chapter focuses on the impact that the Keynesian-inspired economic measures had on the development of the national economies, in the period of time that these kinds of measures were highly appreciated, both on the academic level and on the political level. The first part of the chapter is dedicated to some general considerations regarding the place that
economic history attributes to Keynes, and also to several environmental aspects that shaped the personality of the “founder of modern macroeconomics”, which represents basically a preamble to the problems treated in the last part of the paper.

The paper continues with a brief review that outlines the main ideas included in the Keynesian doctrine. Thus we explain the causes identified by Keynes concerning those "diseases" that the economy suffered from during the Great Depression, namely the impossibility of the private economic sector to provide a satisfactory employment level, and the persistence of a profoundly inequitable distribution of national income. It also highlights the crucial role that Keynes attributes to the investment component of aggregate demand for the increment of the employment level, as well as the multiplier mechanisms which are generated at a macroeconomic level by the increments of productive investments.

This section also presents the fundamental differences between the new Keynesian doctrine and the already existing doctrines, regardless of whether we refer to the liberal or the Marxist ones. We have also emphasized the points of convergence between Keynesian ideas and "sound principles" promoted by the Classical Economic School.

A very important section of the first chapter is aiming to bring into the spotlight the methodological
novelties which constitute the “pillars of strength” for the entire doctrine. The significance and consistency of concepts such as "expectations" or "irreducible uncertainty" are detailed in the second part of the first chapter. There are also presented some important methodological similarities between the Keynesian theories and those offered to economic world by the representatives of the Austrian School of Economics. We especially emphasize the strong opposition manifested by representatives of both doctrines concerning the attempts of “forced mathematization” of the economic science.

The last part of this chapter aims to highlight the impact of the Keynesian ideas, both on the economic theory and on the economic practices. In terms of economic theory, the new doctrine established by Keynes did inspire many economic currents of thought. Nevertheless, not all of them maintained the same degree of fidelity towards the master’s ideas. Thus, we can distinguish several different versions of neo-Keynesian theories which have developed mainly in the USA, but which deviate, sometimes significantly, from the true spirit of inspiring doctrine. One of the most striking examples of such theories, insufficiently connected with the essence of the original doctrine, is represented by the so-called “neoclassical synthesis”, which is most of the times, unjustifiably likened to the pure Keynesianism. At the same time, there also appeared currents of thought
which preserved untainted the Keynesian “theoretical core”, especially like the post-Keynesian doctrine, which developed mainly in the UK. The fundamental difference between the two newly created paradigms is related to the particular way in which each of them are connected to those methodological innovations included by Keynes in his theories. Thus, while both paradigms grant great importance to the social ends of economic policy measures, only the post-Keynesian paradigm preserves untainted the realism of the fundamental working hypotheses, envisaged by Keynes.

In the real economic life, the impact of the Keynesian doctrine was at least as important as the significance that the doctrine had on the economic theory. As we know, the "thirty glorious years" are the result of the application of Keynesian prescriptions. In that period of time the living standard of citizens of the countries that have followed the directions outlined by Keynes concerning the economic policy measures required to be adopted, grew steadily and visibly. Also, the level of employment registered in the “Keynesian years” was substantially higher than that recorded in the decades that followed, when the Keynesian theories had no longer represented the mainstream economic doctrine. Moreover, the statistics show that, in spite of the fact that Keynesian economic policy measures are often regarded as being compatible with high levels of inflation, the "Keynesian era" has been characterized by
a moderate inflation, only slightly higher than that which accompanied the process of economic development in the subsequent decades. More specifically, the average difference measured in the most economically developed countries over several decades, was less than 1 percent, fact that largely debunks the myth of the “Keynesian seed of inflation”.

The conclusions that end this first chapter illustrate how Keynesian ideas have met the criteria outlined by various famous researchers in economic epistemology, concerning the capacity of a new doctrine to produce a scientific revolution. Here, we also underline once again the most important trait of the Keynesian doctrine that gives it a significant potential for healing the economies affected during economic downturns, namely – the realism.

The second chapter begins with an attempt to capture the extent to which the main causes of economic crises identified by Keynes correspond to the current situation of the global economy. These causes, like human greed or the fragility of the financial sector of the economy seem to represent, once again, the “Achilles’ heel” of the global economic mechanism, as Keynes explained more than eighty years ago. Nevertheless, these are only general causes that determine the onset of economic crises, as each of them is determined by a set of specific causes as well. Therefore, the next section of this chapter is focused on the description of those
specific causes of the actual economic crises, which this time were represented mainly by the appearance of those financial innovations fabricated in the private financial sector of the U.S. economy. More specifically, we describe how various giant companies, representing the “key players” on different financial markets, adopted strategies that ensured them substantial, immediate and certain gains, resorting in this regard to securitization operations. In this manner, they were able to sell to certain investors, different kind of securities resulting from granting loans to different categories of very risky customers. We notice here certain substantial issues of "moral corruption" that were present within the private financial sector of the economy. But the aspects of "moral corruption" that led to the onset of this economic recession did not stop there. An equally important role was played by the assessment procedures of various categories of securities, performed by the U.S. rating agencies. Thus, favorable ratings were granted to certain financial products which later proved to be extremely toxic...

But the systemic risk presented by these giant financial corporations that started the "securitization madness" was a major one, mainly due to their enormous and disproportionate financial power, in comparison with their smaller competitors. However, this imbalance of power was possible only due to the gradual abolition of various legislative provisions, such as the famous
Glass-Steagall Act, which were established after the Great Depression and which had a key role in maintaining a reasonable equilibrium on the financial sectors of the economy. We also emphasize the warning launched by Keynes concerning the harmful potential had by the existence of such power imbalances in the private sector of the economy.

The following section of this chapter is focused on presenting the economic measures which have been adopted by the U.S. authorities so that the economy would overcome this financial crisis as quickly as possible. Both the benefits and the shortcomings of these decisions are also highlighted. Thus we underline the intense activity carried out by the Federal Reserve in order to insure the necessary financial support to those companies which were experiencing major liquidity problems, and whose collapses would have provoked intense reverberations throughout the entire economic system. The effects of this remarkable effort basically meant keeping the global economy afloat, but certainly nothing more than that.

Avoiding implementing fiscal policy measures in addition to the monetary policies that had been already implemented did nothing but postpone a vigorous economic recovery. The direct involvement of the state in ensuring an increasing level of the aggregate demand after implementing a program of substantial public investments, according to the Keynesian prescriptions,
was never really taken into consideration. Thus, the financial stimulus package approved by the U.S. government proved to be totally insufficient for "restarting the engines" of the American economy. Similar situations have also been recorded in the great majority of the European Union’s states. One of the main reasons for the inefficiency of the financial stimulus packages is the fact that a significant proportion of them took the form of tax incentives granted to the population, which meant directing most of the money towards hoarding. Of course this was not very helpful in order to revive a numb economy, and thus the veracity of the Keynesian “paradox of thrift” was yet again confirmed.

We also argue the ineffectiveness of austerity policies promoted in most EU countries, and which were motivated by the need of reducing the existing budget deficits. Numerous historical pieces of evidence also confirm the ineffectiveness of such policies, when they are adopted in times of economic paralysis.

Applied at such moments, they will inevitably lead to the occurrence of "deflationary spirals", with all the negative consequences deriving from it. Credible alternatives are also presented, which the Keynesian economists promote in order to gradually solving the “budget deficits problem”.

This chapter continues with the presentation of certain solutions, envisaged by Keynesian economists, concerning the achievement of a more stable
macroeconomic environment. It is primarily about the need for the implementation of an effective financial sector regulation, in the same manner as that which had been achieved in the period of economic growth following the Great Depression. This new regulatory system must be able to cancel the opportunities for adopting unethical strategies that can lead towards systemic imbalances, which certain financial institutions have had in the recent years. The components of this new regulatory system must aim to increase transparency on the financial markets, to forbid the trade of the assets which can not be objectively evaluated, to rethink the role of the rating agencies, so that their work would no longer be characterized by major conflicts of interest, and to reduce the power of the private financial institutions.

A special section of this chapter is dedicated to arguing the beneficial effects that a substantial international monetary system reform, like the one proposed by Keynes at Bretton Woods, would have on the global economic environment. The reason for that is represented by the equilibration of every state’s balance of trade which such a substantial monetary reform would produce.

The final part of this chapter emphasizes the advantages that the Keynesian doctrine has, related to some other major economic doctrines, when it comes to its “healing power”. Thus, in comparison to the
monetarist doctrine, the Keynesian doctrine can prove to be very effective in the “liquidity trap” situations. It is worth noting that such a phenomenon seems to occur in this very period, taking into consideration the sharp increases of the U.S. stock market indexes, together with the lack of improvement in the aggregate level of employment. On the other hand, in comparison with the Austrian doctrine, the Keynesian doctrine has an increased capacity to fight effectively against certain extremely harmful phenomena which can be found in the “economic landscape”, such as the one that Nouriel Roubini suggestively described using the term of “regulatory capture”.

In the conclusion section of this chapter we emphasize the increasing relevance of the Keynesian ideas in a world in which phenomena like the increasing speed of information may determine a higher degree of macroeconomic instability.

In the second part of this paper which consists of the last two chapters, the analysis focuses on emphasizing the relevance of certain basic directions of evolution for the economic science.

Thus, the third chapter of the thesis argues the need for the economic science to abandon using certain methods and instruments which are rather specific to the hard sciences, and which are extensively utilized be the mainstream economists nowadays. We believe that such an approach would be very useful as it is well known
that those forecasting instruments used by the majority of the economists nowadays have not proved to be of much help in anticipating the onset of an economic crisis of such magnitude as the current one.

The first part of this chapter is dedicated to the presentation of the origins of the present mainstream orientation, namely the neoclassical economic theories. The main purpose of this chapter is to highlight the extent to which certain instruments of analysis, such as the well-known homo economicus, can be beneficial to economics, as well as to underline the “landmark” from which the use of the same techniques becomes a threat to the harmonious development of the economic science. The firm delimitation is emphasized that Keynes and his followers made as against the “mathematical trend” which characterize the economic science nowadays. The British economist explains the crucial importance that the psychological factors have in the human economic decision making process, and therefore he argues about the necessity of abandoning those unrealistic assumptions which are the cornerstones of certain mainstream economic theories, such as the perfect rationality of individuals, or their unrestricted access to information. The main factor that determines the imperfect rational behaviors is related to the presence of “uncertainty” in every aspect of the human life.

The multitude of "deviations" from what means a perfect rational behavior is also emphasized by the
research made by the economists who work in one of the newest branches of the economic science, namely the “behavioral economics”. Their findings do nothing but indirectly provide support for the Keynesian working hypothesis. For this reason, a substantial section of this chapter is devoted to highlighting the results of these discoveries, and also to revealing the concordance between these results and the ideas promoted by Keynes and his followers. Thus, the paper presents how different concepts and aspects encountered in psychology such as the so-called “mental heuristics”, conventional behaviors, cognitive biases or affective influences are found in one form or another in various works written by the great British economist. The thesis also includes a series of experiments whose findings do nothing but solidify the Keynesian arguments.

On the following section of this chapter we emphasize the impact that each component of those Keynesian “animal spirits” has on the macroeconomic evolution. We also stress upon the role that each of them played in both the outburst and the development of the current economic recession. Phenomena are analyzed, such as overconfidence, the importance given by the individuals to the concept of equity, or even the macroeconomic effects generated by the manifestation of certain anti-social behaviors of large groups of people. Additional experiments are also presented, confirming each of these human tendencies.
A special subchapter is dedicated to a special component of the "animal spirits", namely the phenomenon of "money illusion". This is primarily motivated by the many existing forms of manifestation of this mental process. That growing reluctance of the workers to accept cuts in their nominal wages that was observed and emphasized by Keynes in the pages of his “General Theory” represents just one of the manifestation forms of this phenomenon. The significant delays that appear when the company owners have to adjust the prices of the marketed products, the “magic prices” technique, or what we know as “euro-illusion” represent other “facets” of the same phenomenon. Synthesizing, we conclude that it is almost impossible for the people not to be deceived, at times, by at least one of these manifestation forms of the "money illusion". This fact offers us an adequate picture of the potential that this phenomenon has regarding to its capacity to influence the macroeconomic dynamics.

The final part of this chapter is devoted to presenting a new set of evidences that another emerging branch of the economic science, namely the “neuroeconomics”, provide in order to support the realistic premises of the Keynesian doctrine. Various experiments conducted by researchers in this field show that, the economic decisions are often adopted following the activation of specific areas from the human brain that correspond to the "emotional thinking", but not to the
logical thinking. The manifestation of the various components of the "animal spirits" such as "fairness" or "money illusion" is proven also by the results of these neuroeconomic experiments. This section of the paper also brought to light the capacity that "visceral factors" have to model the macroeconomic evolution, as well as their potential to influence the social environment. The macroeconomic effects of these factors are also emphasized in the writings of Keynes, and we highlight that at the end to this subchapter.

The conclusions of this chapter are focused on the steps that should be taken in order to accomplish a complete and definitive separation, such as that envisaged by Keynes, of the economic theories from the improper analysis instruments that the economists use nowadays. It is also argued the necessity of a “rapprochement” between economics and the other social sciences such as psychology, which will determine at least an increment in the potential of the economic theories for anticipating the sound directions of macroeconomic evolution.

Considering that the current economic crisis was caused mainly by the widespread practice of certain unethical behaviors, the final chapter of this paper focuses on examining how John Maynard Keynes treats the ethical dimension of the human personality. The first part of the chapter is dedicated to the presentation of the environment, in which the famous British economist
completed his education, during his life as a student. We highlight the major relevance of the writings of the British philosopher George Edward Moore as well as the impact that they had on the elite of Cambridge University that undoubtedly included John Maynard Keynes. These writings constituted the cornerstone for the interest that Keynes had in the ethical sciences. The practical results of the cultivation of ideas such as those promoted by George Edward Moore practically meant the delimitation of Keynes from the essences of the utilitarian philosophical paradigm, as well as the “transposition” of this vision towards the “realm of economy”. His philosophy of life helps Keynes to attribute to the economy a well determined role in the human existence that is compatible with the fundamental moral principles, coming close in this respect to the vision of the ancient philosopher Aristotle. Thus Keynes easily identifies those assumptions that economists frequently use, which have the effect of cultivation the vices in the human minds. For example, Keynes states his deep disagreement towards the economists who promote, in any circumstances, the utility maximization theories.

In contrast to these views, Keynes firmly stands for the cultivation of spiritual values, being convinced that this is the only way for the people to obtain a genuine “good life”. The economic needs are not ignored, but they are regarded as the means that can
facilitate one’s way towards that much-desired “good life”. Not for one moment are they regarded as the ultimate ends of life. Moreover, the British economist repeatedly expresses his profound disagreement with the opinions according to which the economic goals coincide with the ultimate ends of life.

The second part of this chapter presents the Keynesian analysis regarding the virtues and the vices of capitalism. This section highlights, both the economic efficiency and the individual liberty that the capitalist system guarantees, but also the lack of social justice that characterizes the same economic system. Therefore, Keynes has no alternative but to conclude that an improvement of the capitalist system is necessary, in order to achieve a greater degree of social justice able to meet the requirements in terms of fairness of the citizens living in these countries. The solution that the British economist sees so that this improvement should be achieved is related to the manner in which the education system is designed, and how it performs.

The final part of this chapter highlights the increasing differences between the Keynesian preoccupations related to the ethical dimension of human life, and modern economic theories, which ignore these issues almost completely. Some techniques used by many current economists are highlighted, which distorts the true meaning of the concept of "happiness". Thus, while Keynes rightfully considers “happiness” as an
ultimate purpose of life, some modern economic theories reduce its significance to that of “material wealth”.

This chapter ends, like all the others, with a section reserved to conclusions. Here we try to argue the necessity of finding a way to include the ethical principles into the major economic theories. In our opinion this would only cause benefits, both to the exponents of the economic profession, and also to the members of the society. The economists would become much more appreciated, while the members of the society could find themselves one step closer to that “age of abundance” described by Keynes.