FINAL COMMENTS ON THE IMPACT OF THE GENERAL THEORY ON ECONOMIC POLICIES DURING THE LAST THIRTY YEARS. –BY PAUL DAIVDSON

We are celebrating the 80th anniversary of a book that is a classic in economics, namely Keynes' GENERAL THEORY OF EMPLOYMENT, INTEREST AND MONEY. A "classic in economics" can be defined as a book that everyone cites, very few people read, and even fewer people understand. Clearly what most economists believe is Keynes's general theory indicates that Keynes's book, The General Theory, lives up to my definition of a classic and therefore its impact on policy in the last thirty years has become less and less.

For the last three decades, a policy makers in government and central bankers and their economic advisors have insisted that (1) government regulations of markets and large government spending policies are the cause of all our economic problems and (2) ending big government and freeing markets, especially financial markets, from government regulatory controls is the solution to our economic problems, domestically and internationally. Since 1980, governments around the world have been freeing up financial markets and claiming to reduce the size of big government.. The papers in this session of our conference indicate why France, Germany and the UK have abandoned any semblance of policy that resembles what Keynes discussed in his classic economic work.

In 2007-8, global economy experienced a financial market meltdown that led to the Great Recession in which we are still enmeshed. In testimony before Congress on October 23, 2008 Alan Greenspan said that he had overestimated the ability of free financial markets to self-correct and he had missed the possibility that deregulation could unleash a destructive force on the economy[1] Greenspan then added "I still do not fully understand why it happened, and obviously to the extent that I figure it happened and why, I shall change my views". Had Greenspan any idea regarding what Keynes's

monetary theory of liquidity was about, he would have understood why financial markets cannot self-correct.

Greenspan, like so many other policy decision makers in OECD nations may cite Keynes, but they have either never read or understood Keynes's General Theory. Greenspan, Bernanke and most US economists explain the 2007-2008 collapse of Long Term Capital Management and Lehman Brothers investment bank and the shadow banking system to the "mispricing of [probabilistic] risk" despite the fact that many large financial institutions were utilizing some variant of "risk management" models developed by Nobel Prize winning economist (as Greenspan noted in his testimony). This was true even though the Novel Laureate Scholes' pricing model [Scholes a Ph.D. from Univ. of Chicago] did not avoid the collapse of Long Term Capital Management in the late 1990s although Scholes was a heavily involved in the management of LTCM.

Keynes's liquidity theory and the Post Keynesian analysis explain why laissez faire financial markets cannot be efficient. The reason is, as Keynes stressed, the economic future in real terms is uncertain and cannot be known or predicted via actuarial calculations based on past data.

Entrepreneurs, in our world of experience, always have recognized they face an uncertain future. Yet they must make decisions regarding actions whose actual rate of return will occur in this uncertain future. Consequently, to provide some certainty basis on which to base decisions whose pay off resides in the future, capitalist economies have developed an institution the use of which provides some certainty regarding the future. This institution is the use of spot and forward legal money contracts as the basis for ALL market transactions. These legal money denominated contracts, enforced by the State, provides decision makers with some degree of certainty regarding future cash inflows and outflows.

Keynes' theory principles can be understood, only if one comprehends what Keynes called "The Essential Properties of Interest and Money" in chapter 17 of his general theory. In her presentation,

Helene de Largentaye indicated that correspondence between Keynes and Helene's father, who translated the General Theory into French, emphasized the importance of understanding the technical aspects of the "essential properties" spelled out in chapter 17.

. Keynes's "essential properties" imply policies to alleviate the distress caused by real world experiences such as financial market instabilities and bubbles. They also explain why government deficits may be necessary in an economy where aggregate private sector savings out of income are large. Also it helps explain why a system of government unfunded debt liabilities need not lead to financial instability or government defaults. [To understand why, I recommend reading my book entitled Post Keynesian Theory and Policy which deals with these matters in greater detail then time will permit here.]

In their book entitled General Competitive Equilibrium, Arrow and Hahn (1971, pp 256-7) wrote "The terms in which contracts are made matter. In particular, if money is the goods in terms of which contracts are made, then the prices of goods in terms of money are of special significance. This is not the case if we consider an economy without a past or future. . . . if a serious monetary theory comes to be written, the fact that contracts are made in terms of money will be of considerable importance".

Keynes's liquidity theory provides a "serious monetary theory" for domestic and international transactions because it emphasizes the use of money contracts as a way of coping with an uncertain future .Keynes provided a new way of economic thinking which explains the operations of a monetary economy where entrepreneurs and households enter into money denominated contracts in order to organize all market oriented production and exchange activities.

In the world of experience, decision makers know that they do not, and cannot, know the future. Accordingly, the capitalist system has developed this institution of legal money contracts that are used in ALL market production and consumption decisions to provide cash inflow and outflow certainties to decision makers, operating in an uncertain world. These money contracts provide both parties to the contract with some legal certainty about future cash inflow and outflow outcomes of

today's decisions. Keynes's liquidity concept involves the ability of a decision maker to meet one's money contractual obligations as they come due. This liquidity concept is an essential aspect of decision making in a capitalist economy and a financial markets system.

<u>The sanctity of money contracts is the essence of the capitalist system</u> and is basic to Keynes's general theory analysis. That is why Keynes's theory is, in the Arrow-Hahn terminology, a serious monetary theory. In the Keynes-Post Keynesian theory, liquidity, i.e., the ability to meet one's money contractual commitments domestically and internationally becomes an essential foundation for understanding decision making in the operation of an entrepreneurial economy. Thus, as the biographer of Keynes, Lord Robert Skidelsky has noted, for Keynes "injustice is a matter of uncertainty, justice a matter of contractual predictability". In other words, by entering into nominal money contractual arrangements, people assure themselves a measure of predictability in terms of their contractual cash inflows and outflows, even in a world of uncertainty. For under the civil law of contracts, money is that thing that the State decides will settle all legal contractual obligations under the nation's laws.

Keynes's general theory rejected three restrictive classical axioms. These were (1) the ergodic axiom, (2) neutrality of money axiom, and (3) the gross substitution axiom   This first classical axiom is necessary to have knowledge of the future. As any statistician will tell you, in order to draw any statistical (probabilistic risk) inferences regarding the values of any population universe, one should draw and statistically analyze a sample from that universe. Drawing a sample from the future economic universe of financial markets, however, is impossible But classical economics assumes decision makers already know the future perfectly[the ordering axiom] or, at least, can calculate the objective probability distribution regarding future events [the ergodic axiom]. Simply stated, the ergodic axiom presumes that the future is already predetermined by an unchanging probability distribution and therefore a sample from the past is equivalent to drawing a sample from the future. [Stationarity is a necessary condition for ergodicity.] Assuming ergodicity permits one to believe one

can calculate an actuarial certainty about future events from past data and therefore have reliable knowledge about the future.

Efficient market theorists must implicitly presume decision makers can reliably calculate the future if they are to make efficient decisions.. The efficient market economy, therefore, must be governed by an ergodic stochastic process, so that calculating a probability distribution from past statistical data samples is the same as calculating the risks from a sample drawn from the future. It is this ergodic presumption that underlies Greenspan's belief that free financial markets can correct themselves. Accepting the ergodic axiom by mainstream economists makes a difference in determining whether there is an active role of government in the economy process or whether everything should be left to free competitive markets. Samuelson, Lucas and other mainstream, orthodox economists have adopted, either explicitly or implicitly, the ergodic axiom because they want economics to be in the same class as the "hard sciences".

Samuelson is quoted on pp. 159-160 in Colander and Landreth's book entitled The Coming of Keynesianism to America that when he [Samuelson] tried to read The General Theory, he found it "unpalatable" and not intelligible. So instead Samuelson simply assumed "there was enough rigidity in relative prices and wages" to make Keynes's theory a slowly adjusting Walrasian theory. Given Samuelson's world- wide influence on economists who cite Keynes but have not read the book, most economists believe Keynes's explanation of unemployment, recession, etc. is due to administered prices and sticky wages in a slowly adjusting Walrasian system.

Consequently, it should not be surprising that over the last thirty years policy makers have strived for ending rigidity in wages and prices and freeing financial markets in order to convert our economic system into a rapidly adjusting Walrasian system. Freeing up labor, product and financial markets was all that was necessary to guarantee a prosperous economic systems in any Walrasian system. That, I believe, is why any semblance of Keynesian stimulus policy, and, if necessary accumulation significant government debt to spend to create market demand for entrepreneurs to expand

production and employment has been abandoned in many OECD nations as the idea of austerity and small government was adopted by policy makers supported by elite economists' advice.

References

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