

A Keynes Redo

BY ROBERT J. BARBERA AND GERALD HOLTHAM

*An attempt at a
macroeconomics for
the twenty-first century.*

My intention in writing Raising Keynes is not antiquarian. My goal is to contribute to a macroeconomics for the twenty-first century, not one for the twentieth century. I firmly believe that Keynes's vision provides the best starting point for a twenty-first-century macro.

—Stephen A. Marglin (2018)

Did the United States overdo fiscal stimulus in response to the Covid-19 shock of 2020–2021? Alternatively, was the big policy mistake of the past two decades the limited rescue offered in the aftermath of financial crisis and the Great Recession of 2008–2009? Or perhaps the greatest blunder was the willful denial of self-evident financial market pathologies that allowed for the spectacular 2008–2009 collapse. Sadly, how one feels philosophically about economist John Maynard Keynes seems to color economists' answers to these questions at least as much as the facts on the ground associated with these economic events. Revisiting Keynes, it seems, is the logical starting point for any serious reflection on macroeconomic progress, both in theory and in practice.

Quite conveniently, economist Stephen A. Marglin's book *Raising Keynes: A Twenty-First-Century General Theory* (2021) provides a prodigious and relatively fresh restatement of Keynesian thinking. Marglin's text lays out a succession of models, one building on the other, that take us from pre-Keynes framing to simplistic Keynesian notions amid sticky wages,

Robert J. Barbera is Director of the Center for Financial Economics at the Johns Hopkins University. Gerald Holtham is visiting professor at Cardiff Metropolitan University, School of Management.



through Keynes without sticky wages, then centrally to Keynes insisting that portfolio choices, not funds flows, determine key interest rates. Marglin's final model, a dynamic framing with pervasive uncertainty, belies the notion that Keynes was only focused on the short run.

Marglin, in describing his effort, states

Keynes had the right intuition, but lacked the tools to carry through the methodological revolution his vision required. Mainstream economics, as it has evolved over the 80+ years since the publication of the General Theory, has long since come to possess the tools, but has never developed the intuition.

Marglin audaciously then suggests that his work is a stab at how Keynes might write his *General Theory* today, were Keynes up to speed on the new math and

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convinced that a text chock-full of math models was the right stuff for an economist circa 2020.

Why bother? Marglin lays out a description of economic thinking on the eve of Keynes' publishing of *The General Theory of Employment, Interest, and Money* in 1936. Full equilibrium, before Keynes, was an invisible-hand affair, with theory that we now label microeconomics. Markets cleared, and there was no involuntary unemployment, save for rigidities in labor markets. Supply exclusively determined equilibrium output and employment. Demand was missing, and so was finance. Marglin then gives us all we need for a rationale for his heretical text:

Whether or not the mainstream of Keynes's day held so clear a view of the determination of employment and output, there is no question that the view Keynes attributed to [economist Arthur] Pigou is the prevailing view in 2020.

Striking, but certainly true. Macroeconomics, born with Keynes' thoughts amid a global economic

collapse that defied the notion of a self-correcting system driving toward equilibrium, has managed to wind its way back to a frame that wagers amid much more math and much less thinking that markets are mostly self-correcting after all. Marglin's text at a minimum provides refuge from what mainstream macro has to offer.

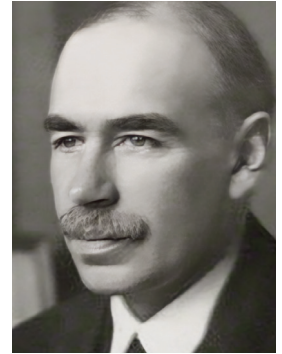
Marglin's text is therefore a painstaking assault on both the "market always knows best" nonsense of the Chicago School as well as a thorough rebuttal to the "when the market is not perfect, remove the sand from the gears" approach of mainstream Keynesians. Yes, major market failures are an undeniable fixture in the world. Moreover, sometimes—think health care—pushing a dysfunctional system toward a freer framing can clearly make a bad situation worse.

For the most part, however, it does not offer groundbreaking new insights. Economists Joan Robinson, Hyman Minsky, Axel Leijonhufvud, and others have emphatically made many of the same points throughout the second half of the twentieth century. For reasons we can only conjecture about, mainstream macroeconomic modeling has for nearly half a century insisted on embracing strictures that ensure these self-evident economic truths remain conspicuous by their omission.

What strictures? When macroeconomic forecasting models foundered amid the Great Inflation, a grand notion took hold. Since statistical relationships were recognized to be fleeting but motivations immutable, recast macro models centered on the quintessential rational, utility-optimizing agent. Indeed, they allow said agent to stand in as the sole representative agent for the overall economy. In this wonderfully safe virtual space, economies act as they should, and economic questions can be pursued without fear of the misuse of fleeting statistical linkages. Such micro-founded macroeconomic models have doggedly remained the workhorses of academic macroeconomics since the 1980s.

Economic practitioners, consumed with the need to make their best guesses about the world around them, rejected this framing entirely. In the forecasting game, on Wall Street, and when debates about policy arise in Washington, antiquated macroeconomic modeling frames carry the day.

Validating this judgement, a recent robust statistical analysis, compliments of economist Katarina Juselius in



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the journal *Econometrics* (2021), makes clear that both flavors of micro-founded models, RBC and DSGE, are completely at odds with relevant economic data. Their virtual worlds are a wonderfully safe places to play economic games, but the rules of these virtual roads simply don't square with traffic in the real world.

Allow oneself the dream of jettisoning virtual unrepresentative agent space. Then the self-evident truths that Keynes identified and that motivate Marglin's recent effort are a good place to start in a resuscitation of academic macroeconomics.

It is painful to list Keynesian heresies, as they are so obviously true, but here are four:

■ Clearly, a surge in panic savings can collapse demand, elicit a surge in firing, and lead to a large dissaving by the newly unemployed, paradoxically lowering the savings level. And yet in macroeconomic texts, the paradox of thrift is presented as controversial.

■ Recall that in 2005–2006, mainstream macroeconomists, gazing solely at stable goods and services prices and serene in the notion that financial markets policed themselves, insisted that excesses were absent. Yet denying the powerful role that finance plays in capitalist boom-bust cycles—the conceit that finance is a veil—persists, even after the Great Financial Crisis of 2008–2009.

■ Portfolio choices, not savings flows, largely determine key interest rates. Amid panic, households can dump risky assets and pile into government bonds, ensuring that despite an attempt to save more, panicked savers' portfolio choices deliver a surge in interest rates for companies and home buyers. The notion that an increased flow of savings ensures lower interest rates for risky borrowers is patently false.

■ Finally, the contention that demographics alone determine labor supply runs afoul of Keynes in the 1930s and the experience of the past several years. For more than two years now, the story has been that U.S. job gains above 100,000 per month exceed the sustainable pace, push joblessness lower, and reinforce inflationary trends. The facts of the matter? Over the past twenty-seven months, an average monthly gain of nearly 300,000 has peacefully coexisted with no change in unemployment. One can make a persuasive case that surprisingly strong labor force growth has been greatly influenced by the strength of the post-covid rebound.

Thus we commend Marglin and his attempt to reinstate a framing that can make sense of the real world.

Marglin, however, also ventures into dangerous territory—he offers up prescriptions. Once again, Marglin echoes Keynes, Joan Robinson, and Hyman Minsky as he champions, spectacularly uncritically, a much bigger role for public provision of investment.

And so we find ourselves wondering how an equal number of self-evident truths fails to appear in this text.

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Give elected officials and government bureaucrats the keys to the kingdom? Surely one must know that this invites a new set of daunting problems.

Marglin opens his chapter on functional finance with a John Kenneth Galbraith quote, penned in 1958, that reminds today's readers that private opulence amid public squalor has a storied history in the United States. (It came into view long before billionaires chose to burn up insane sums to spend five minutes lost in space.) He then dives into the question of the optimal size of government, imagining a social welfare optimization problem with welfare gains derived from public investment, private investment, and private consumption.

Marglin insists that we do not need to continually worry about deficits and debt—and we agree. Indeed, for both the long term and the short term, the deficit/debt angst is problematic. Clearly, amid recession, deficit-financed public investment need not crowd out private investment. Keynes, Minsky, Marglin, and many others point out that more often than not, increases in

government spending amid downturns raise the confidence of private sector decision makers, leading to more, not less, private sector investment. Marglin then provides the algebra that reminds us that the long-run implications of high debt-to-GDP levels look infinitely less daunting once one reflects on the historical fact that, for developed economies, long-run real GDP growth has greatly exceeded real sovereign borrowing costs. More generally, insisting on small government and balanced budgets on the grounds of crowding out and debt crises simply does not hold water. Marglin's dismissal of sound finance dictates rebut longstanding macroeconomic notions that have never had any serious theoretic or data driven justifications.

Marglin, like his forebears Keynes, Robinson, and Minsky, champions pervasive uncertainty in most of the book chapters. In fact, he argues persuasively that Keynes came to Knightian uncertainty notions well ahead of University of Chicago economist Frank Knight. But where is the lengthy discussion of the problematic nature of identifying, funding, and constructing public sector projects?

What about when calculations prove much too optimistic? A start-up, Minsky loved to point out, faces a cash-box constraint. Its cash inflows must meet or exceed its cash obligations, or it faces bankruptcy and oblivion. Not so a public endeavor. Cost-benefit analysis, championed by economist Otto Eckstein amid the proliferation of water resources projects and the construction of the interstate highway system in the United States, ran afoul of critiques by economists James M. Buchanan,

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Gordon Tullock, and countless others, many newly converted neo-conservatives. A central complaint was that benefits, unlike revenues, were in the eye of the beholder. As long as benefits could be rediscovered and redefined, the cleansing nature of bankruptcy, which wipes away ill-conceived ideas, is absent from public sector projects. When we remind ourselves that the motivations of public sector agents need have little to do with maximizing social welfare, where does that leave us? Again, the

economic literature abounds with papers that assume very different roles for public sector agents.

We venture that if there is a respectable reason for the abject state of current mainstream macroeconomics, it lies here. We have to ask why a theory persists that makes extravagantly counter-factual assumptions—not

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simply idealizations, but taking as axiomatic impossible states of affairs. Econometric studies have demonstrated that current micro-founded macro models are actually empirically inferior to the most old-fashioned Keynesian income-expenditure constructs. And in 2008, we had economy-shaking events that contemporary theory not only failed to predict, but excluded as impossible. When a framing fails conclusively for nearly half a century, something more than stubbornness must be at work. Few people are that obtuse.

Ideology informs what pathologies we worry about, and what we offer up as remedies. Economist and Nobel laureate Robert Lucas, for example, has said that nothing is as poisonous to sound economics as a focus on questions of income distribution. Fear of discussions of income distribution clearly reflects a fear of the untrammelled power of the state. A charitable explanation for clinging to the inanity of micro-founded real business cycle models is that if we must idealize the market and paint a surreal picture of perpetual equilibrium, it is in a good cause—avoiding the tyranny of the demagogue and the bureaucrat. Lucas has said that economists are storytellers. His stories, like those of Aesop, are fictitious but have a moral: don't trust the government.

Markets, in contrast, do clear away much idiocy in a way that public investment provision cannot. One can suppose that conventional economists deny self-evident

Keynesian insights, oversell free market magic, and warn of Armageddon risks in public debt markets in order to restrain the expansion of the public sector.

Friedman, himself a Nobel laureate economist, certainly grasped this. Asked to write an essay in 1996 about what economists would be grappling with one hundred years hence, he argued, “much of what we grapple with today,” and his opening epigraph is the following quote:

Economists generally desire increased intensity of State activities for social amelioration, that are not fully within the range of private effort: but they are opposed to the vast extension of State activities which is desired by Collectivists.

The quote was penned by Alfred Marshall in a 1907 paper entitled “The Social Possibilities of Economic Chivalry.” It offers a bromide: we should balk at collective action, except when market forces are ill-designed to deliver.

And therein lies the rub. Marshall’s advice, restrictive in theory, largely fails to sort things out in practice. Walrasian market efficiencies never are fully achieved in the real world, and so one is always compelled to take a stand on how far afield reality is from the general equilibrium model of Nobel economists Kenneth Arrow and Gérard Debreu, and whether intervention is likely to make things better or worse. Keynes, a product of the

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mandarin class of a relatively successful state, trusted implicitly that government would be run by chaps very like himself. By contrast, most Americans share a love for the self-sufficient frontiersman. Thus, collective action as the problem, not the solution, is a story that sells.

Marglin makes a robust case for a major revamping of macroeconomics. But at its essence, the book is about how mainstream macroeconomics ignores much of what

ails free markets. Marglin then leaps into the case for more public investment, to both ensure that more time is spent in and around full employment, and to make the world a better place amid substantially more public goods provision. But nowhere is there discussion of the deadly pathologies that attend many public sector endeavors.

Friedman invoked Marshall as he homed in on this issue: how to decide what is and is not the purview of collective action. The challenge amounts to an effort to judge, across a wide array of categories, whether commercial or political pathologies are the lesser of two evils. There is a vast literature analyzing both market failures and public actor malfeasances. Embedding this work into macroeconomic thinking, a multi-disciplinary effort, is long overdue.

Of course, Keynes too recognized that economists had the most to offer when they dirtied their hands and fashioned advice on the public-private mix:

[We cannot, therefore] settle on abstract grounds, but must handle on its merits in detail, what Burke termed ‘one of the finest problems in legislation, namely, to determine what the State ought to take upon itself to direct by the public wisdom, and what it ought to leave, with as little interference as possible, to individual exertion.’ We have to discriminate between what Bentham, in his forgotten but useful nomenclature, used to term Agenda and Non-Agenda, and to do this without Bentham’s prior presumption that interference is, at the same time, ‘generally needless’ and ‘generally pernicious.’ Perhaps the chief task of Economists at this hour is to distinguish afresh the Agenda of Government from the Non-Agenda; and the companion task of Politics is to devise forms of Government within a Democracy which shall be capable of accomplishing the Agenda.

—The End of Laissez-Faire, 1926

Thus macroeconomists, if we choose, can take the advice of both Friedman and Keynes, and seriously jump into this fray. Clearly, we owe the world more than the century’s old “too much” versus “too little” food fight, fought at all moments on ideological grounds. Imagine the reemergence of public finance notions, as macroeconomists replace cheerleading for team Red or team Blue with assessments of market failure costs, versus collective action risks.

Is that too grand to hope for? At a minimum, would it really be too much to ask for macroeconomists to summon the courage to discard a framing that, for more than a century, has been completely incompatible with what transpires in the real world? ◆