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The Crisis in Mainstream Economics

G.C. Harcourt

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In preparing this chapter I have been greatly helped by hearing and then reading Bob Rowthorn's speech to the King's Economists on 17 April; Paul Omerod's dissection of modern macroeconomics in the February 2010 issue of *21st Society*, the Journal of the Academy of the Social Sciences; Heinz Kurz's paper, "On the dismal state of a dismal what?", on the deficiencies of mainly Lucasian theory in the light of the current prolonged crisis, together with his careful gathering together of Lucas's more outlandish and extraordinary claims for his approach and contributions and those of his tribe of admiring followers, especially when Keynes's contributions as they see them and which Keynes never claimed to have made, are used as his and their *numeràire*; Lance Taylor's "tome for our times", *Maynard's Revenge* (2010), published by Harvard University Press; Robert Skidelsky's, *The Return of the Master* (2009); Joe Stiglitz's many criticisms of the extreme versions of modern theory which served to justify the Washington Consensus and its implications for universal policy proposals, see, for example, *Freefall* (2010); Ben Friedman's review of recent books by John Cassidy and John Lancaster; Tony Judt's article, "Ill fares

[*] This chapter originated in a Valedictory Lecture I gave at SOAS, University of London, on 12 May 2010. I have revised it for the present volume in honour of Harald Hagemann, whose deep scholarship combined with independence of mind and a sunny temperament, should have kept mainstreamers on their toes, if only they had had the wit and open-mindedness to absorb his criticisms and positive contributions.

the land", in a recent issue of the *New York Review of Books*, April-May 2010; and John Quiggin's *Zombie Economics* (2010). I would also like to mention a most effective critique-from-within by Ricardo Caballero (2010).

My title is pinched from John Hicks, *The Crisis in Keynesian Economics* (1974), his Yrjö Jahnsson Lectures; but let us also remember the apocryphal story of "Sunny Jim" Callaghan returning, sun-tanned, to strife-torn UK at the end of the 1970s and responding "Crisis, what crisis?"

In his book Hicks saw Keynesian economics in crisis on three fronts – the multiplier (because of the role of stocks); liquidity preference theory (because of complex portfolios of financial assets rather than a simple choice between money and bonds, coupled with concentration on the long-term rate of interest[1]); and wages (Keynes's "failure" to provide an economic theory of the possible relationships between money wages, their levels and rates of change, and employment, its level and rate of change). So Hicks was tackling what he saw as deficiencies in a past theory when confronted with a (present day) reality. In my view Hicks rather overdid it because his view of Keynes was too much influenced by his own version of *The General Theory – IS/LM –* which by the 1970s dominated the profession rather than how Keynes himself had presented his theory in terms of his aggregate demand and supply functions. This provides yet another example of the tragedy that Lorie Tarshis's 1947 textbook did not

[1] Hicks must have forgotten the important article by Richard Kahn (1954) and book by Joan Robinson (1952), which tackled these issues.

dominate the post-war teaching of the economics of Keynes in the United Kingdom, the USA and elsewhere.[2]

There are similarities between this 1970s episode and what has happened in the last 30 years or more, now brought into sharp relief by the ongoing crisis in the capitalist world. Despite its great technical sophistication, in its conceptual essence, mainstream economics, now argued by its proponents to be increasingly converging on agreement and uniformity, is what Joan Robinson dubbed (as early as 1964) "pre-Keynesian theory after Keynes". Dominant figures in this transformation include Friedrich Hayek, Milton Friedman, Robert Lucas and Eugene Fama, with Lucas and Fama currently the patron saints of Chicago and modern macroeconomics (real and financial) and macroeconomists, including Michael Woodford and John Cochrane. Now that it is put to its first really challenging test in "the great recession", following the period of "the great moderation", let us examine whether its explanatory power and relevance have been found wanting.

Though there are several variants of modern macroeconomics, they all have their roots in (Irving) Fisherian Walrasian models of the process of accumulation in modern societies. In these, the consumer queen attempting to maximise her expected life time utility is the core actor and decision-maker,

[2] For the story of why this was so, see Harcourt (1995).

with all other actors and institutions subject to her whims and desires, especially within a competitive environment.[3]

Fisher's basic vision and construct in theoretical terms was spelt out most fully and rigorously in the Arrow-Debreu model of general equilibrium. Subsequently, in the hands of Lucas and others, it was simplified in order to analyse the macroeconomic economy and to be the basis of stochastic general equilibrium models which at a practical level came more and more to serve policy makers in both central banks and treasuries. (At the same time Fisher's perceptive analysis of the consequences of debt deflation has largely been ignored.)

Concomitant with these developments was the development of the rational expectations hypothesis and its implications for views on how the economy functions. Though the rational expectations hypothesis by itself is no more than a hypothesis about expectations formation, something to be adopted until found wanting, when it is integrated with views of how the economy works, it becomes in its simplest and most stark form the proposition that the world may be viewed *as if* perfect competition and perfect foresight ruled in all markets, what Willhem Buiter aptly dubbed many years ago, "The macroeconomics of Dr Pangloss" (1980). For example, Lucas's policy ineffectiveness result follows not from rational expectations as such but from its

[3] The major alternative view has ruthless, swash buckling capitalists – industrial, commercial and financial – as the core actors, with accumulation and profit-making a way of life, ends in themselves, and all other components of capitalism, including national governments, subservient to their decision-making.

use with a vertical aggregate supply curve. If a first-year student were to be asked what would be the impact on price and quantity of a rise in the demand curve in a market with a vertical supply curve, he/she would of course answer, price is higher, quantity is the same. As Joan Robinson once remarked (in another context), "After putting the rabbit into the hat in the full view of the audience, it does not seem necessary to make so much fuss about drawing it out again" (1966, 308).

Increasingly, in one strand of these developments, macroeconomic issues came to be analysed in terms of one representative agent models (Lorie Tarshis regarded this as the major heresy of (all) modern economics). This meant the rejection of any role for the fallacy of composition, a vital strand of the economics of Keynes. In turn this meant that the determination of the rate of interest could no longer be seen as the outcome of an uneasy truce at the margin between bulls and bears in financial markets; nor the role of sustained inflation as establishing disappointed but not worsening aspirations between the capitalist accumulating and employing class and the wage-earning class. It also rejects another core Keynesian insight that the whole is often greater than the sum of the parts, now re-established in modern economics by Wynne Godley and Marc Lavoie's remarkable new book, *Monetary Economics* (2007).[4]

[4] May I pay here a heartfelt tribute to my old and much admired and loved friend, Wynne Godley, who died on 13th May 2010?

Another development, which on the face of it (and when examined more deeply, even by reading the original article), is the inappropriate use of Frank Ramsey's benevolent dictator model to represent the essential workings of the economy. Ramsey's 1928 model of optimum saving was never so intended and it is salutary to reread or even read for the first time both it and its author's own evaluation of the article. When he submitted the article to the *Economic Journal*, he wrote to Keynes (28.6.1928): "Of course the whole thing is a waste of time … [It was distracting him from] a book on logic … [because] it [was] much easier to concentrate on than philosophy and the difficulties that arise rather [obsessed him]".

What of the New Keynesians? In his Marshall Lectures of some years ago (on a theorist looks at policy and a policy maker looks at theory), delivered when he was an advisor to President Clinton, Joe Stiglitz chose the New Keynesians as the modern development that most provided a rationale for Keynes-type results and policies. He also said that as a graduate student in Cambridge (UK) in the 1960s, he learnt most from the Cambridge Keynesians, especially Nicky Kaldor[5], and that it was their analysis and policies he drew on in his advice to Clinton. Nevertheless, he never once mentioned the Post-Keynesians, even though many of their ideas and insights were attributed by him to the other more fashionable "schools" he named.

[5] Stiglitz had been sent to Cambridge by Paul Samuelson and Bob Solow while still a graduate student at MIT. He went first to Joan Robinson, but they did not get on – principally Joan's fault – so he went to Frank Hahn who always defended Keynes's ideas even when he put them in inappropriate contexts.

The New Keynesians have made considerable contributions, not least when *internally* criticizing mainstream macroeconomics – think Hahn and Solow (1995). Yet, even though their theories do produce Keynes-like results, these are traced back to imperfections in the working of market processes. This has the implication that the removal of such imperfections in real world happenings would usher in the world of Dr Pangloss – which is exactly the claims that the other strands make for their analyses. In particular, there is the major claim made that if competitive pressures were allowed freely to operate in all major markets – goods, labour, financial (national and international, long-term and short-term), foreign exchanges – for most of the time we would get near optimum workings of economies. Moreover, if there were exogenous shocks such institutional set ups would be the best way of allowing systems to adjust and quickly remove their effects. The high priest of these views is/was Alan Greenspan (though his mentor is the appalling Ayn Rand).

As is now well known, in the laundry basket at Tilton, Keynes's drafts of the differences between the cooperative, neutral and entrepreneur economies were discovered after volumes XIII and XIV of the *Collected Writings* had been published, resulting in a supplementary volume XXIX. These contrasts figured prominently in Keynes's lectures at Cambridge prior to the publication of *The General Theory* and their omission was the event that most surprised and distressed Tarshis (who had been to the lectures) when he read *The Genearl*

Theory. Why? Because he thought them the best base on which to place Keynes's critique of the (non-) operation of Say's Law in an unregulated capitalist economy, see Harcourt (1995, 1246). Rather like an Evangelical Christian asking "Brother, are you saved?", Joan Robinson would ask what could or could not be determined directly by the actors most critically affected by the decision – the money wage or the real wage (the money wage, of course)? And Lorie Tarshis's litmus paper test for acceptance intellectually was which way does causation run – from the goods market to the labour market or the other way around? The entrepreneur economy was one of Keynes's ways of showing how and why monetary and financial matters must be integrated with real factors from the start of the analysis of a monetary production economy.[6]

It is this insight that is missing from virtually all strands of modern mainstream theory. They have not taken on board the fundamental criticism that Frank Hahn made many years ago (and Colin Rogers (2006) has revived recently in his criticism of Cochrane and Woodford), that there is no place for anything recognizable as money in general equilibrium models. Thus both the cycle and the trend (which, in Post-Keynesian analysis, are regarded as indissoluble), in mainstream theory are taken to be operating independently of monetary and financial matters. Real business cycle theory, which has some similarities with 1930s Hayekian conjectures (though Hayek certainly

[6] An excellent discussion of why this is so is Rogers (2010).

understood about the role of money) is exactly what it calls itself. And Lucas argues that the world operates for most of the time near enough to a steady-state rate of growth as to use the latter as a short cut in his explanations. “The balanced growth path will be a good approximation to any actual path “most of the time” … exactly the reason why the balanced path is interesting to us”, Lucas (1988, 11). Jean-Baptiste Kaldor of 1950s-1960s vintage could not have put it better.

Then there is the hoary old question of the essential difference between risk and uncertainty, so essential to the economics of Keynes, how they can be analysed and what their effects are on systemic behaviour. Bob Rowthorn (2010) makes the point that while microeconomic theories of risk have been systematically and usefully advanced, systemic spill over effects have been badly neglected in the analysis of a modern world characterised by wide-ranging networks of financial markets. Thus the possible malfunctionings of the latter and the feedbacks into real sectors, so prominent in the happenings of the last three years and more, have not been analysed in any fundamental ways in mainstream economics. Omerod (2010) adds to this insight by pointing out that the analysis of risk in financial markets rests on the assumption that underlying distributions usually approximate to the normal distribution and in particular “fat tails” are assumed away. He directs us to a long-established literature on the possible chaotic effects of the existence of fat tail distributions and relates this to recent happenings.

I have mentioned Lucas's arguments concerning the applicability of steady-state analysis usually associated with the theory of the long period (though Post-Keynesians would say, *correctly*, that it should not ever be thought to apply to the actual long run). But there is an element of wanting to have it both ways present when at the same time the short period and the long period are collapsed into one and all markets are taken to be clearing all the time.[7] The Lucasians also argue that if we do not start from an assumption of utility maximising individuals, we are inevitably guilty of *ad hockery*. In doing so they ignore Kaldor's critique, that this approach leads to begging the question about the world being observed, that the observed happenings must have been thrown up by such behaviour in an equilibrating setting in which the factors responsible for existence (unique or otherwise) may be separated from those responsible for stability (local and global). Though path-dependence and multiple equilibria have taken increasingly conspicuous roles in the most sophisticated versions of mainstream theory, they have had little systematic effect on its more down-to-earth and more used versions. Certainly the possibility of cumulative causation processes operating in many important markets and indeed in systems as a whole is rarely if ever discussed, let alone countenanced.

[7] Such a collapse is an unacceptable feature of the specification of neoclassical models in much econometric practice, see Harcourt (2007).

Moreover, the mainstream has increasingly argued as if saving led and investment followed, seemingly refuting, possibly in ignorance of, James Meade's take on the Keynesian revolution: "Keynes's intellectual revolution was to shift economists from thinking normally in terms of a model of reality in which a dog called *savings* wagged his tail labeled *investment* to thinking in terms of a model in which a dog called *investment* wagged his tail labeled *savings*", Meade (1975), 82, emphasis in original. Meade's insight should be coupled with the Keynes-Kalecki process, finance → investment → saving.

Nor is there ever much use made of the distinction between the investment goods sector and the consumption goods sector, or between the capitalist class (all three) and the wage-earning class when analyzing processes at work in modern capitalism. A person from Mars would be hard put to find much if any resemblance between the theory with which he/she was presented and the world with which he/she/it was confronted.

To sum up, there is a crisis in mainstream economics, in the teaching of it and in its application to theory and policy. For, by and large, it neither makes sense of what has happened or of what should and could be done about it. I would not go anywhere as near as far as Joan Robinson in "Spring cleaning" (1980, 1985) – scrap the lot and start again. Rather I am somewhere in between discerning a crisis and "Sunny Jim's" supposed response. We do need a thorough rethink and regrouping in order to back up the tentative measures being taken at the moment to tackle the present crisis (they are very much a curate's egg approach, often more bad than good in parts[8]), to better explain how our modern world functions and malfunctions and what may be done about it by people of goodwill who are humane, progressive and pragmatically practical. Immodestly, I hope I may be regarded a member of this band; I certainly regard Harald as a leading member of it.

[8] Decision makers in many European economies seem determined to create a double dip recession by their own efforts, not least in the UK.

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