Keynes had no sure cure for slumps

By Edmund Phelps

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What theory can we use to get us out of the impending slump quickly and reliably? To use the "new classical" theory of fluctuations begun at Chicago in the 1970s – the theory in which the "risk management" models are embedded – is unthinkable, since it is precisely the theory falsified by the asset price collapse. The thoughts of some have turned to John Maynard Keynes. His insights into uncertainty and speculation were deep. Yet his employment theory was problematic and the "Keynesian" policy solutions are questionable at best.

Banks spoke of the downturn in house prices as an effect of some sort of shock. In their models, random shocks are forever knocking asset prices from forecast values. In fact, no quake or drought or other exogenous force caused prices to drop. The prime cause was forecasting with badly mistaken models. Speculators and home buyers, thinking that rentals or building costs would go up, bet on higher house prices in future, which also raised the price of existing houses. But over the years neither rentals nor costs (in real terms) budged. If they did not rise, (real) prices would sooner or later have to go back down.

This was Keynes's world. At Cambridge, he showed how an investor might allow for unknown contingencies in his *Treatise on Probability*. In London, he ran a hedge fund with O. T. "Foxy" Falk and grew rich, only to get caught in a collapse of commodity prices in early 1929. He concluded that investors' beliefs were "flimsy". As one investor, then others, desert, the asset price, previously rising, may merely falter at first but finally collapses sharply along with the conventional belief.

Keynes put asset prices at the centre of employment determination in his 1936 *General Theory*. If a change in sentiment causes steep declines in valuations of business assets (along with share prices and house prices), business investing is cut back and employment contracts – unemployment rises – mostly in capital goods industries.

Unfortunately nothing went well after that. Keynes made a huge mistake in not distinguishing between a drop in asset prices springing from monetary causes – an exogenous, or autonomous, increase in the demand for money – and one springing from causes having nothing to do with supply and demand for money – say, diminished expectations about future returns on business assets or houses. The former phenomenon could be solved by monetary means: the central bank could boost the money supply (by purchasing public debt, say), which would drive asset prices back up without driving up other prices and wages equally in a pointless spiral.

The recent collapse of speculation on houses, however, is a non-monetary phenomenon: there has to be a drop of the money price of (a basket of) houses relative to the money price of (a basket of) consumer goods. Keynes argued that a boost of the money supply would work here too: workers would be unaware that wages in competing jobs elsewhere had jumped as much as their own, so they would be afraid to require as high a real wage as before; thus hiring would be stimulated and employment would go back up. But sustaining that recovery would surely require endless wage inflation at a rate always a step ahead of expectations – an unappealing policy. Increasingly, Keynes focused on non-monetary measures to change the new non-monetary equilibrium following a loss of investor confidence.

Keynes always felt that consumer demand too drives employment. An increase in demand encourages companies to raise production and hire more workers – at first. But in an open economy with its own currency, the stimulus would mostly go abroad. In the global economy, increased consumer demand would ultimately do little more than raise interest rates, thus setting off declines in real asset prices, investment and real wages.

Keynes emphasised investment demand as a lever to increase employment. By that theory, one might stimulate private investment through an investment tax credit or subsidies for new companies or new hires. Keynes favoured investment by the state or state enterprises.

Americans – their airports nightmarish and their bridges falling down – would welcome "infrastructure". Yet it must be asked whether a massive shift from private to state investment would not damp the conception, development and adoption of new commercial ideas for innovation. Capitalism theory stresses diversity in sources of new commercial ideas, in the pool of entrepreneurs available for their development, in sources of finance – angel investors, venture capitalists and the rest – and in the array of end users. It also stresses how important it is that owners of financial and business enterprises be accountable to no one (except their own consciences) – thus free to use their intuition – in contrast to the strict accountability rightly required of state employees. Thus a greatly increased presence of the central government in a country's investment sector could constrict innovation and lower the quality of the innovations that are made. We would be left still in a slump.

At the end of his life Keynes wrote of "modernist stuff, gone wrong and turned sour and silly". He told his friend Friedrich Hayek he intended to re-examine his theory in his next book. He would have moved on. The admiration we all have for Keynes's fabulous contributions should not sway us from moving on.

The writer, director of the Center on Capitalism and Society, Columbia University, won the 2006 Nobel Prize for economics